Market viewpoint

by the Asset Management team

Key Points:

- **Pace of the US interest rate hike cycle, the Fed brings its stance closer to investors' expectations**
- **Accommodative policies of many central banks keep impacting risk sentiment**
- **Slower Chinese growth coupled with revisions in FX policy**
- **Continued weakness in commodities**
- **Persisting geopolitical tensions**
- **New regulations negatively impact liquidity**
- **Brexit**

Macro Environment

Spread products (EM, US & EU HY) and commodities delivered a good performance in April, whereas equities were more muted than in previous months. The recovery in asset valuations since mid-February and the prospects over the next 3 to 6 months are important for investors.

The real US Q1 GDP growth rate of 0.5% was weaker than expected (+0.7%). As we have mentioned before the US recovery is irregular and we have seen this cyclicality of softer Q1 GDP in previous years.

The European GDP grew by +0.6% q-on-q or by +2.4% annualized in Q1 2016. Investors and policy makers should be concerned about Brexit, given the recovery in asset valuations and the poor secondary market liquidity. The result of the UK vote to stay or leave the EU is likely to be tight and the substantial uncertainty could put pressure on markets. The UK leaving the European Union and the potential political knock-on effects could disrupt markets and consequently result in a risk off scenario in the short term.

After the FOMC meetings, investor opinion about the timing of the next rate hike is split. For some the change in rhetoric from the "global economic and financial developments continue to pose risks" to "closely monitor inflation indicators and global economic and financial development" has opened the door for speculation about a potential rate hike in June. Others interpret the FOMC statements as putting a rate hike on hold and the Fed in wait-and-see mode.

Given the timing of the Brexit vote (23 June 2016), which is to take place a few days after the June FOMC meeting (14-15 June 2016), we believe the Fed will delay any decision on a rate hike. Whilst the Fed prefers to be cautious in order to protect the recovery of the US economy, the trend in economic data has improved (albeit unevenly) and we continue to expect the Fed to hike rates later in the year - conditional upon a no vote on Brexit (this is in contrast to the market that is pricing in zero to one hike). A further argument to support a rate hike is that the Fed values the role which savers have in the economy and therefore a gradual normalization of rates sooner rather than later is important.

Whilst our base case is for a hike in H2, we believe Fed monetary policy will remain accommodative and gradual for the foreseeable future. This is a benign environment for risky assets. However, if for any reason US growth is much stronger or much weaker than expected; risky assets will have a more challenging time ahead.

What does this mean for the US dollar and Yen?

The USD strength paused, reflecting a softer Q1 GDP growth and the prospect of a cautious Fed. At present investors may be pricing in (i) the Fed delaying interest rate hikes or not hiking at all this year and (ii) a limited capacity of central banks to go deeper into negative interest rate territory.

We expect the policy divergence theme (Fed to normalize rates while the ECB and BOJ remain in accommodative stance with negative rates) to continue during H2 2016, and that should provide the platform for a stronger US dollar over the medium term.

The value of the USD is a fragile equilibrium of interests going forward. In the political landscape of power, a stronger USD does not benefit two of the main central banks and we acknowledge that a stronger USD could influence Fed's policy actions.

In Japan, since the BOJ adopted negative interest rates in at the end of January, demand for government bonds has rallied and the Yen has appreciated against the dollar, contrary to what such policy was intended to do.

Another example is in Denmark, the first country to adopt negative rates, where the private sector is saving more than when the rates were positive and companies are not investing more despite low rates. Consumers and companies probably view the extreme interest rate policy as an indication of a crisis with an unpredictable outcome and this has driven their behaviour.

Bonds

We expect the Fed actions to be data driven in particular after the Brexit vote. We consider the labour market to represent the key variable influencing the Fed's behaviour going forward. Labour income appears resilient, household saving rates are healthier, US corporates have strong balance sheets, banking system is recovering and local financial conditions have improved and remain accommodative.

During April the yield in the 10yr US treasury increased from 1.76% to 1.83%, a negative performance of 0.57%. The most notable change took place in Europe with the 10 year German bunds yield widening to 0.27% from 0.15%, a negative return of 1.12%. This happened after the ECB stepped up the monthly purchase of securities to EUR80bn from EUR60bn (including corporate bonds); clearly the markets priced this fully in. This widening illustrates that the valuations of European bonds, like Japanese bonds, offer no value to any type of investors at current yields.

The US will hike on the backdrop of a narrowing budget deficit, meaning the supply of treasuries will be reduced which should provide a good technical platform for these securities, whilst inflation expectations are well anchored. The potential scenario for other central banks could be to maintain the level of negative interest rates, and this will also help to constrain the upward movement in US treasury yields.

The low G3 rates environment and higher commodity prices are positive for equity, emerging markets and spread products. Commodity prices are most likely bottoming out and consequently their impact on inflation will be limited. The US wage inflation trend is highly important with a strong USD potentially serving as a mitigating factor for inflationary pressures going forward.

Equities

We have previously acknowledged the volatility seen in equity markets over the first 6 weeks of the year and the rapid reversal of that weak performance. After the MSCI World touched -11.5% during February the global equity index has recovered strongly and as at end April was essentially flat for the year. We are of the opinion that equity markets will remain resilient and will manage to navigate the inevitable volatility that will come and will post positive returns over 2016.

We continue to believe that current market expectations of improving growth in the US will support US equity markets whilst within Europe the ever improving GDP outlook, supported by accommodative monetary policy should be positive for future equity returns. We expect the US to post positive returns over the year whilst we feel European indices will continue to move higher from current levels. European equities should fare better over the remainder of the year as lower energy costs and an improving money supply positively impact corporate earnings. We acknowledge the potential for some volatility depending on the outcome of the Brexit vote in the UK but feel ultimately that European equities will be positive from here.

We maintain our view that the overall economic landscape hasn't changed significantly and the rally in equities is evidence of financial markets believing the same. Despite global growth concerns we expect equities to continue to grind higher over the course of the year on the back of marginally positive earnings growth that will become more evident further as the year rolls on. We do acknowledge however that any surprise moves by central banks (most likely the US) would affect risk appetite and thus equity returns. We believe any impacts will be more short term in nature and that the continuing search for yield within a low growth/return environment will result in more money flowing into equities as they continue to offer better value relative to government bonds which should be positive for equity returns over the medium term.

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Asset Allocation

We are close to neutral weight versus the benchmark between equities and bonds, and within bonds we remain allocated to EM debt via our EMOF product. We expect the G7 bonds to continue to offer low returns and exhibit limited upside, whereas the positioning of our EMOF product should provide income with a chance of capital gains based on a relatively short duration of assets.

If you have any questions or wish to speak to someone about our investment products, please contact your relationship manager or email us at: **investment.enquiries@gibuk.com**