Market viewpoint

by the Asset Management team

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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**
- **Slower Chinese growth coupled with revisions in FX policy**
- **Volatility in commodities**
- **Persisting geopolitical tensions**
- **New regulations negatively impact liquidity**
- **Brexit**

Macro Environment

Spread products (EM, US & EU HY) and equities performed well in May. The recovery in asset valuations since mid-February and the prospects over the next 3 to 6 months are important for investors. Price action in commodities has been more mixed with crude oil performing well (WTI +6.9% m-o-m) whilst copper was down (-8.1%).

The real US Q1 GDP growth rate of 0.8% q-o-q 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 month of May saw lacklustre employment gains (38k) and the U6 underemployment rate of 9.7% remains slightly elevated (last rate hike in US started in June 2004 when U6 underemployment was at 9.5%). However other labour market indicators have not shown any signs of weakness to date (2.5% growth in the average hourly earnings for nonfarm private workers was faster than in previous years).

The European GDP grew by +0.6% q-on-q or by +2.4% annualized in Q1 2016. The ECB has entered a new phase of efforts to stimulate euro region growth with the purchase of corporate bonds for the first time. Such action has driven German bund yields close to all-time lows.

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. The "Leave" campaign has gathered some momentum recently but our base case continues to be that the UK remains in the EU.

In the FOMC meeting, Yellen presented a generally upbeat view on the US economy despite indicating that a gradual increase in rates will probably be appropriate. However she did not provide an explicit timeline for additional rates and investor opinion about the timing of the next rate hike is split. For some it has opened the door for speculation about a potential rate hike soon whereas others interpret the 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 beyond June. 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).

After all, the Fed is now basically meeting both of its mandates – the unemployment rate fell to 4.7% in May (lowest since late 2007) and underlying inflation rates averaged around 2%. 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?

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 US dollar could be further supported in the event of a leave vote on Brexit.

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.

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 May, the yield in the 10yr US treasury tightened from 1.83% to 1.70% mid-month before closing flat at 1.84%. The most notable change took place in the Europe where the 10 year German bund yield tightened from 0.27% to 0.14%, close to all-time lows. At current yields European bonds, like Japanese bonds, offer no value to any type of investors.

The US is likely to 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 have been positive for equity, emerging markets and spread products. Commodity prices have only partially recovered 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 noted the volatility seen in equity markets at the beginning of the year but since the mid-February low, we have benefitted from the strong recovery seen in equity markets with the MSCI World index climbing 15% from the -11.5% trough to end May 1.8% positive for the year. We remain of the opinion that equity markets will remain resilient and will manage to navigate the inevitable volatility that will come with diverging central banks and will post positive returns over the second half of 2016.

We continue to believe that current market expectations of improving growth in the US, as backed up by recent economic data (despite the recent weak employment numbers), will support US equity markets and ultimately drive them higher. Within Europe we maintain our view that the improving GDP outlook, supported by accommodative monetary policy should be positive for future equity returns. Low energy costs and an improving money supply positively impacting corporate earnings should help European equities move higher from current levels although we do 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. The uncertainty surrounding Brexit and Federal Reserve talk on interest rate increases has seen markets fairly muted over the last few weeks with investors seemingly in wait-and-see mode. Once Brexit is resolved and with an easing of global growth concerns we expect equities to continue to grind higher over the course of the year as the global recovery gains traction. 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.

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**

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