Viewpoint

May 2017

Key Themes for the next 3-6 months

- US FED may start interest normalization process sooner rather then later
- UK has officially started its separation from the European Union
- Political balance of power shaping in post-election France

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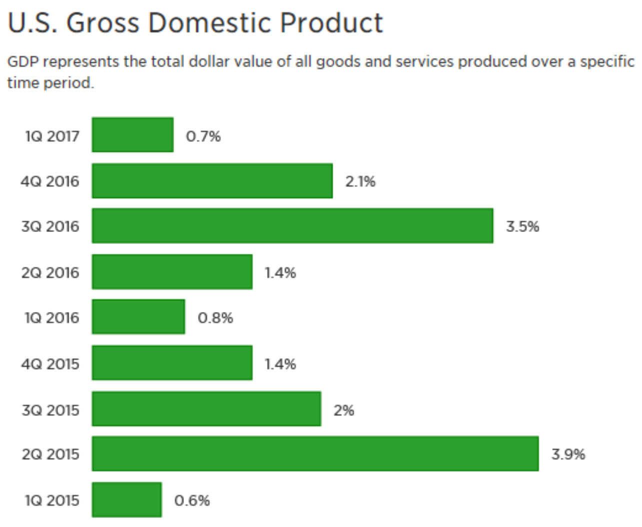
Political and Macro Environment

The U.S. economy delivered a weaker than expected growth in Q1 2017 as consumer spending increased only marginally and businesses invested less on inventories. This may suggest that the growth promised by President Donald Trump may not be easily achievable. Gross domestic product advanced by 0.7% q/q annualised constrained among other things also by the Government cut back on defence spending.



Source: Bloomberg

The slow first-quarter growth figure is, however, a distorted picture of the health of the US economy. The labour market is near full employment and consumer confidence is near multi-year highs, suggesting that the mostly weather-induced sharp slowdown in consumer spending is probably temporary.

A measure of private domestic demand increased at a 2.2% rate in Q1 2017. First quarter GDP tends to underperform because of difficulties with the calculation of data that the government has acknowledged and is working to rectify. Even without the seasonal effect and temporary restraints, economists predict that it would be difficult for Trump to fulfil his pledge to raise annual GDP growth to 4%, without increases in labour productivity or the size of the labour force.

Since Q3 2016 the world economy has experienced growth in all regions. G3 economies have been performing relatively well with the US being the laggard. Major EM economies are also displaying positive dynamics with China exceeding the expectations. The IMF forecasts the 2017 global growth to amount to 3.5%, an increase from 3.1% achieved in 2016. The 2017 global growth expectations are placed in the upper range of the last 5 years.

Commodities again under pressure

Many commodities prices came again under significant downward pressure. The oil prices fell sharply, with Brent spot approaching USD47/bbl, the lowest level since before the OPEC cuts were announced last November. The Brent price came under pressure most likely due to sharp declines in other commodities (copper and iron ore) on investors' concerns over growth in China, and the influence of technicals and positioning. The US inventory data declined pretty much in line with expectations offering little support to the price.

FED stays the course undisturbed by weaker Q1 2017 data

The FOMC at its early May meeting kept the funds rate target range at 0.75-1.0%. The statement published after the meeting suggested that the weak GDP growth reported in Q1 2017 was of transitory nature and the fundamentals remained solid. The FOMC also noted that the labour market conditions are good, characterised by solid job gains and decline in unemployment. The labour market conditions are expected to strengthen somewhat further while near-term risks to the economic outlook appear roughly balanced.

What does this mean for the US Dollar?

We have to recognise the US Dollar has appreciated significantly during the last two years, we believe this currency will remain well supported but volatility could pick up going forward. Trump's economic policies, if implemented, have the potential to support the US Dollar and this is in an environment where the US has the best prospect of economic growth of the G3 economies. The US Federal reserve monetary policy cycle and the geopolitical uncertainties in other countries could also provide support for the US Dollar.

Fixed Income

During April, developed bond markets did well. The 10yr US Treasury note led this performance, with its yield to maturity sliding to 2.17% the lowest level since Trump's Election Day. This was on the back of disappointing data from the US in the March job data and Q1 GDP growth combined with risk aversion going into the first round of the French presidential elections. Toward month end, the US Government bond market pulled back slightly driven by the relatively positive political balance of power shaping in France and solid Employment Cost Index number in the first quarter.

The FED committee stated that inflation measured on a 12-month basis recently has been running close to the Committee's 2% longer-run objective. Excluding energy and food, consumer prices declined in March and inflation continued to run somewhat below 2%. In the short term this backdrop paints a positive picture for risky assets in general including global spreads products (in particular high yield) despite expensive valuations.

We expect 2 more hikes this year and the 10-year US note to continue trading within the current 2.30%-2.60% range with possibility of breaking the upper range of the band towards year end. This is on the back of further gradual normalization by the FED, which could start unwinding the $4.5 trillion balance sheet by year-end. In Europe the ECB could commence the tapering process sooner rather than later. Our view remains that G7 Government bonds offer no significant value at current yields levels given the gradual changes in monetary policy.

Emerging markets remained well supported despite weakness in commodities (WTI -2.51% and the CRB Commodity Index -2.24%). The technicals remain strong with non-EM traditional investors continuing to allocate funds to the asset class.

Equities

Risk appetite continued in April with improving economic data and a strong earnings season across the majority of the developed world. The majority of companies reporting in the US and Europe saw earnings surprise to the upside whilst the first round of elections in France also boosted risk appetite as the populist candidate Marine Le Pen performed weaker than expected, thus financial markets reduced the likelihood of her being appointed the next President of France. This ensured positive returns across the majority of equity markets. Indeed, the S&P500 nudged up another 1% whilst in Europe, gains were seen in most major countries after a strong relief rally post-1st round election.

The super power of Germany advanced just over 1% whilst France and Spain gained 3.1% and 2.9% respectively. Greece reached a deal on economic reforms, paving a way for the country to keep getting money from its bailout programme and this spurred local markets which gained over 7% in April. In Asia, Japan saw the Nikkei advance 1.5% whilst the Australian equity market also saw gains over 1%. The positive regional returns ensured the MSCI World Index gained 1.5% over the month

We acknowledge we have seen an extremely strong rally in equity markets and valuations are currently rich as investors remain optimistic around the Trump-led US economic recovery. Whilst interest rate policy remains accommodative, we see no immediate reason for a significant pull back in equity markets. We expect equity markets to stabilise around current levels but remain cognizant of the potential impact of the next attempt by Trump to implement a policy change, elections in Europe or any complications around the UK’s Brexit divorce including and/or the June Prime Minister elections.

We continue to believe that investors will keep on searching for yield within a low growth/return environment and this should result in more money flowing into equities as they offer better value relative to government bonds.

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. Going forward we see limited value for investors in G7 bonds whereas the positioning of our EMOF product should provide income with a chance of capital gains based on a relatively short duration 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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