Market viewpoint

by the Asset Management team

GIB بنك الخليج الدولي

Key Points:

- **US Federal Reserve kept policy rates unchanged**
- **Strong fight back by the financial markets**
- **PBoC cut lending rates in October and expectations increased that the ECB will also ease further**
- **Conditions continue to support case for stronger US dollar over medium term, Central Banks' policies will be key**

Macro Environment

October saw financial markets fight back strongly after a very poor September with equities, emerging markets and spread products posting strong returns. Equities were particularly strong, with MSCI World jumping by an impressive 7.92%, its best monthly performance since October 2011. MSCI Emerging Markets was up a strong 7.13%. Most commodities posted positive returns although natural gas continued to plunge and was down another 14% for the month with mild weather impacting demand.

Markets were buoyed by a number of positive moves by authorities with the PBoC cutting lending rates by 0.25% continuing a general theme of increasing measures to help support growth. The ECB also spurred risk appetite providing strong indications that current monetary stimulus will be increased over the coming months.

The Fed: what next?

During the month the US Federal Reserve met and kept policy rates unchanged as expected.

Whilst some parts of the US economy are showing solid numbers (consumption and housing) it is clear that growth overall is abating. Without a clear pickup in growth and inflation we reaffirm our view that there is a good possibility that the Fed will delay the first rate hike until early 2016.

We believe that unlike the previous interest rate hiking cycle, rate rises this time will be more gradual in order to allow the economy to continue to recover with monetary policy remaining accommodative for the foreseeable future. The statement was more hawkish than expected and very much put the possibility of December action back on the table. This was confirmed by financial markets which saw the implied probability of a December rate rise move from 33% to 50%.

A few words on China

Chinese growth continues to be a strong barometer for risk appetite and its trajectory will continue to impact global markets. Our continuing expectations surrounding Chinese growth is that we will not see a collapse and that authorities will continue to increase their support in a measured and targeted manner delicately balancing continued support and rebalancing measures. This should provide a strong platform for financial markets to continue to improve over the medium term.

Chinese GDP was confirmed at 6.9% y/y in Q3 (survey: 6.8%) and although slower than Q2 was better than consensus estimates providing some assurance that growth is not collapsing.

What does this mean for the US dollar?

Our expectations of central bank policy divergence were confirmed during the month with the ECB becoming more dovish and the Fed more hawkish. We continue to believe that this theme will continue into 2016 as expectations increase that the BoJ will increase their monetary stimulus over the coming months. We believe that this provides the platform for a stronger US dollar over the medium term. Interest rate differentials should increase between the US and Europe/Japan which will continue to favour the US Dollar. We do acknowledge that a stronger USD will impact the US economy which could impact policy action by the Fed.

Bonds

As the outcome of the Fed meeting in December will be more ‘data driven’ and less focused on global economic and financial developments, the market will closely watch the next two labor market reports. US nonfarm payroll employment is expected to increase by 182k over the month of October, while the unemployment rate is expected to decrease from 5.1% to 5.0%. This is below the level where unemployment was at the start of all historic rate hikes since the 70s. The U6 underemployment rate is on track to approach 9.5% around the end of 1Q 2016, which is around the level where the Fed started hiking in the last cycle (June 2004). We reiterate our belief that the Labour market is and will continue to be the key variable influencing the Fed’s behaviour in the coming months. Labour income is resilient, household saving rates are healthier, US corporates have strong balance sheets, the banking system is recovering and local financial conditions remain accommodative. Though there has been some headwinds caused by the stronger USD it has been partially offset by the fall in energy prices.

US treasuries responded to the news by the Fed that the first hike may be coming up in December with the 10yr US Treasury Note yield expanding to 2.23% as at 4th November, up 19 basis points from September month-end. In the case of the 10yr Bund, the yield was unchanged at 0.60% despite some intra-month volatility. The ECB has been vocal about potentially increasing its QE program and this will limit any selloff in European government bonds. At the same time, with peripheral European debt at current levels, we fail to see significant upside in the European space. Low European nominal yields will put a cap on US treasury nominal yields.

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Equities

We continue to remain optimistic on equity markets and expect to see marginally positive returns over 2015 even after the recent volatility. We continue to believe that current market expectations of positive growth in the US over the coming quarters and an improving European GDP outlook should be positive for future equity returns. In the US, we expect to see marginally positive gains for the year as earnings growth although positive, will remain muted as a stronger dollar continues to impact earnings. We expect higher local returns in both Europe and Japan as lower energy costs, an improving money supply and weaker currencies positively impact corporate earnings. As a result, we consider that exposure to these local equities coupled with an FX hedge against further currency weakness should outperform over the medium term.

After recent volatility, equity markets have recovered strongly from being negative on the year and are now generally positive over the year. We expect equities to continue their recovery and forecast that equities should return between 0-4% in 2015. We do however acknowledge that any surprise moves by either China to further devalue their currency or an unanticipated Fed move (not our base case) 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 global 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 relatively short duration assets. We expect EMOF to deliver 4-6% in 2015, outperforming global bonds and credit.

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**