Market viewpoint

by the Asset Management team

Key Points:

- **All signs point to "yes" for December Fed action, implications for USD and growth ahead**
- **Policy divergence: ECB, BOJ and Fed to go their separate ways**
- **Chinese Yuan admission into IMF basket a starting point for financial reforms**
- **Positive returns expected in US, European and Japanese equities for 2016, G3 bonds offer little value at current levels**

Macro Environment

Equity market volatility, USD strength and commodity weakness were dominant themes in much of November's newswires as the wider market continued to brace itself for the first US interest rate hike in almost a decade ahead of December's up and coming Fed sit-down. The prospect of the hike was made increasingly likely owing, in no small part, to October's non-farm payrolls print of +271k (including upward revisions to the previous two months) with payroll gains broad based across sectors. More hawkish language observed in the latest FOMC minutes further bolstered sentiment, with most FOMC members being of the opinion that interest rate normalization "could well be met by the time of the next meeting".

Evolution of US Macro

The balance of macro data from the past month continues to paint a positive picture, specifically in the US, with the main positives seen in employment, consumption growth and housing. As expected, the October unemployment rate decreased to 5.0% while 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). 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. There have, however, been headwinds caused by a stronger USD; although this effect has been partially offset by the fall in energy prices. Furthermore, as some parts of the US economy are showing solidly, it is clear that growth overall is abating. As we have said on previous occasions, the Fed should show confidence in the US economy by starting the interest normalization process sooner rather than later and we are of the opinion that the Fed will not disappoint investors in December.

The Fed: where is this going?

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. We believe that this scenario is the most probable; it's the one being priced in by the markets and more benign for risky assets. If by any reason US growth is much stronger or much weaker than expected, risky assets will have a more challenging time ahead.

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. We believe that Chinese growth is far from fragile and that authorities will continue to increase domestic support in a targeted manner, delicately balancing an increase in local consumption and reducing its reliance on exports. As expected, the IMF has approved the inclusion of the Chinese Renminbi to the IMF's Special Drawing Rights (SDR) currency basket. This is recognition that China is an engine of trade and capital flows.

What does this mean for the US dollar?

We believe that the stage has been set 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. In relation to EUR/USD we believe there is a decent probability that EUR will break below parity in 2016. We do acknowledge that a stronger USD is a headwind to the US economy which could influence policy action by the Fed.

Bonds

We believe the market is well prepared for the first interest rate hike in December 2015 and for gradual and modest hikes thereafter. We also believe that treasury yields are going to be constrained in terms upside risk. This is because, from an ECB standpoint, marginal lower nominal yields in Europe will cap the upside in nominal yields in the US. The US will be hiking with a backdrop of a narrowing budget deficit, meaning the supply of treasuries will be reduced which should provide a good technical platform for these securities. Inflation expectations meanwhile are also well anchored. We further believe that European and Japanese bonds do not offer any value at current yield levels. If we take the JPM GBI bond index USD hedge, the most probable scenario is that yields widen in the US, Europe and Japan by +25bps, the index will return 0% to -0.40%. Under a more bullish scenario where rates in the US pull back +35bps and in Europe/Japan tighten -25bps the expected return for next year is in the range of +1.5% to +2%.

Equities

We continue to remain optimistic on equity markets and expect to see positive returns over the remainder of 2015 and into 2016. We also 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 2016 as earnings growth, although positive, will remain muted as a stronger dollar continues to impact earnings. European and Japanese equities should fare better in 2016 as lower energy costs, an improving money supply and weaker currencies positively impact corporate earnings.

After volatility this year, equity markets have recovered strongly from being negative 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 and 4-6% in 2016. We do however acknowledge that any surprise moves by central banks (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 2015/16, 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**