Market viewpoint

Asset Management – 2nd November 2016

Key Points for the next 3-6 months:

- Brexit continues to provide uncertainty on the economic outlook, especially in the UK.
- As the US presidential election is nearing, with Trump closing the gap, volatility in markets is rising.
- Central banks' monetary policy is less clear with the potential for slightly less accommodative measures, especially in the US.
- Ongoing question marks over the liquidity/solvency of Europe's major banks.
- Oil fate is dependent on whether or not OPEC is successful in reaching an agreement in its meeting end of November over a proposed production cut.
- Global trade is expected to grow at the slowest pace since the financial crisis in 2016, according to the World Trade Organization.

Macro Environment

In the UK, inflation picked up to 1% as a result of the depreciation of the GBP, making the case for a rate cut less likely. Consequently, the yield of the 10 year Gilts rose 50bps to 1.24% between 30th of September and 31st of October. Brexit talks continue, fuelling further uncertainty with Prime Minister Theresa May targeting March 2017 to trigger Article 50, which will kick off the process of exiting the EU over two years. With corporations contemplating to move their offices to other capitals in Europe (especially big banks if they lose their passporting rights), Mrs May is considering to cut corporate tax to offset the potential impact. Whilst negotiations continue, the actual impact of the Brexit vote has been limited so far with third quarter GDP growing by 0.5% q/q, ahead of expectations of 0.3% and October UK PMI data suggesting growth in both construction (52.6) and manufacturing (54.3). In Europe, composite PMI for October came out at 53.7, the highest in 10 months.

In the US, data continues to be resilient. US advanced GDP growth was 2.9% in the third quarter, the highest in two years and ISM Manufacturing PMI was at 51.9, higher than expected (51.8) and suggesting growth. Going forward, a likely increase in investment and inventories build-up should help support the economy given healthy consumer spending and a well-capitalised banking system. The US economy seems to be on the right track with the Fed basically meeting both of its mandates – low unemployment (5%) and underlying inflation rate at around 2%. The most recent ADP Non-farm employment number for September (147k) indicates a solid job market given that the unemployment rate is at 5%, a rate that the Fed officials believe to be close to full employment.

The political landscape is at the forefront of investors' minds with the presidential elections in the United States taking centre stage. Until recently Hilary Clinton was ahead by a wide margin, but the latest FBI case has caused the race to the White House to get tighter with some polls suggesting

Trump may even have a slender lead. The swings in polls have provided a certain amount of volatility as investors try to make sense of what a Trump presidency would mean for markets.

World trade is set to grow at 1.7% in 2016; the slowest pace since the financial crisis and below April's forecast of 2.8%, according to the World Trade Organization. The forecast for 2017 has also been revised lower to a range between 1.8% and 3.1%, down from 3.8%. The slower growth is driven not only by the slowing growth in developing nations, such as China and Brazil, but also by North America, according to the organization. If Trump potentially becomes president, we should expect further revisions to the forecast for world trade, as he is against The North American Free Trade Agreement (NAFTA) and has on several occasions proposed imposing tariffs on Chinese and Mexican imports.

Regarding monetary policy, central banks are expected to be less accommodative going forward as the Fed is preparing to potentially hike once this year and once or twice next year. As implied by the market, the probability for a hike of 25 bps this year stands at 74%. That said, we expect central banks to be cautious about rate normalization with only gradual rate hikes. The ECB has mentioned that it will not end its bond purchasing program without first tapering it, suggesting that it could run beyond the scheduled end-date of March 2017.

The oil price rally reversed, declining 10% from its recent peak, as OPEC members appeared to be in disagreement on which member should sacrifice output in order to restore the market balance. As we approach the scheduled OPEC meeting in late November, a few members (Libya and Nigeria) are ramping up production (that was cut due to domestic unrest), Russia has sharply raised its production and others are asking to be exempt from any cut for varying reasons. This has made investors suspicious about the prospect of any deal to be reached.

What does this mean for the US dollar?

Given our unchanged base case of a Clinton victory and the continuation of the interest rate hike cycle (albeit at a cautious and gradual basis), we believe that this should support the US dollar relative to other major currencies in the medium term. That said, we believe that volatility will continue and possibly increase in the run up to the elections in November.

Bonds

Given the solid footing of the US economy and the rising expectations of a FED hike, US rates pulled back with US Treasury 10yr Note YTM widening +10bps to 1.8% between October 5th and November 2nd).

With nominal G7 yields at low levels and negative in some cases, and while central banks are still accommodative, the global search for yield and risky assets should continue although with limited upside given already stretched valuations and tighter spreads since the beginning of the year. That said, in the last four weeks, we have seen yields widening slightly on the back of US treasuries and the presidential debate in the US.

We continue to believe that for investors seeking yield in fixed income assets, EM credit (cash USD-denominated bonds) offers more attractive spreads on a relative basis, though a close focus on fundamentals remains essential, especially as yields are close to its historical lows.

Equities

October was a volatile month in equity markets as investors turned their attentions to the US as the election gets nearer and the result gets more uncertain. Risk sentiment was fragile as polls across the United States began to show that Donald Trump had narrowed the gap to Hilary Clinton after further issues surrounding Mrs Clinton's term as Secretary of State came to light. This uncertainty has weighed on risk appetite. Indeed the majority of local markets declined over the month whilst the MSCI World global index declined 1.9%.

We remain of the view that the US recovery continues as the economy nears the Federal Reserve's dual mandate targets regarding inflation and employment and a second rate hike is largely priced in for December. However, we remain of the view that policy will remain accommodative with a cautious approach towards the pace of policy normalisation. Indeed, economic data continues to stabilise helping equity markets to steadily grind higher although we acknowledge that the US elections has increased volatility as the vote approaches. In Europe the picture is unclear as the full ramifications for the UK leaving the EU are unknown but economic data remains resilient. Despite the vote, the UK economy continues to perform strongly but we remain cautious and will closely monitor the UK as Brexit negotiations progress slowly although politicians are becoming increasingly vocal on the topic. We still believe that central banks remain a key driver of risk in equity markets although we feel that central banks could move to a slightly less accommodative stance as the year, and 2017 progresses. In the US however, the Federal Reserve is seemingly nearing the second hike in their normalisation cycle although rates will remain accommodative and we feel financial markets will absorb the probable imminent rate hike effortlessly. Further rate increases in the short term could weigh on risk appetite however.

We remain of the view that equities could be positive over the rest of the year assuming a soft UK exit from the EU with limited further shocks to the financial system. We continue to believe that investors will keep on searching for yield within a low growth/return environment. This would result in more money flowing into equities as they offer better value relative to government bonds.

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