Viewpoint

GiB

October 2017

Key Themes for the next 3-6 months

- US FED likely to start its balance sheet reduction
- Prospect of improving global growth
- Inflation pressures may pick up

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Political and Macro Environment

According to the World Bank, global growth picked up in Q2 2017, reaching 3.6% (q/q), the strongest reading since Q4 2010. The uptick mainly reflects an acceleration of activity in the United States, the Euro Area, and Japan, continued robust growth in East Asia and Pacific, and strengthening growth in Eastern Europe and Central Asia. Global manufacturing PMIs remained firmly in expansionary territory in July and August, suggesting continued momentum in Q3 2017. The ongoing recovery in advanced economies and diminishing obstacles to activity among commodity-exporting emerging market and developing economies continue to be key drivers of the pickup in global activity in 2017. Global median inflation edged up in July and August, reaching 2.4%, its highest level since March 2017.

The FED announced at its September meeting that it would embark in October on its biggest post-recession policy shift since it first raised interest rates at the end of 2015. The central bank confirmed that it would start trimming its USD4.5 trillion balance sheet. No member of the FOMC, which decides policy, disagreed with this move. As it responded to the US economic slowdown and housing crisis a decade ago, the FED acquired Treasury and mortgage-backed securities to push down borrowing costs. But with the economy recovering, this emergency measure is no longer needed. The FED began tapering its purchases in 2013 and now wants to actively get rid of the bonds it owns. The reduction of the balance sheet is very gentle, only USD10bn a month (USD6bn in US Treasuries and USD4bn in mortgage back securities).

FED's Chairwoman Yellen is approaching the end of her four-year term, which ends in February, and President Trump has both criticized and complimented her. Experts are not convinced President Trump will nominate Yellen. But they are more confident that Yellen, who has spent much of her career at the FED, would accept a second term.

The Eurozone's energetic recovery sped up in Q2, with GDP growing a seasonally-adjusted 0.6% q/q—above Q1's 0.5% increase (similar to the US). Detailed data confirmed a broadening of the bloc's growth drivers as a pick-up in external demand combined with a healthy domestic economy drove activity. The Eurozone has emerged as a solid spot in global growth this year—with GDP expanding much faster than expected. Available data for Q3 also supports a bright picture of the economy. In September, the Economic Sentiment Indicator (ESI) continued the upward trend prevailing since autumn last year, increasing by 1.1 points in both the euro area and the EU to levels last seen in the summer of 2007 (113.0 points in both regions).

Strengthening national independence movements around the globe have the potential of destabilising the economy in their respective regions

Spain. Catalonia's separatist leadership said nothing will stop it setting up an independent republic, dismissing the condemnation of Spanish King Felipe VI. Regional government spokesman said the monarch's criticism of October's illegal referendum, with no reference to the police violence that saw more than 800 people injured, had given a "free bar" to state forces as they try to shut down the secessionists. Catalan President Carles Puigdemont has said that he expects to declare independence within days. The clash between Madrid and the rebel administration in Barcelona is escalating again after the King, whose word traditionally carries weight in Spain, sought to impose his authority in a televised statement and condemned the "unacceptable disloyalty" of the Catalan leaders and vowed to keep Spain together.

Kurdistan. Almost 93% cent of those who took part in the referendum on support for Kurdish independence from Iraq on 25th September voted to split from Baghdad, officials have said. The results of the vote were announced in Irbil, the semi-autonomous Kurdish Regional Government (KRG)'s capital. A total of 92.73% said 'yes' in response to the question, "Do you want the Kurdistan Region and the Kurdistani areas outside the administration of the Region to become an independent state?", head of the electoral commission Hendrin Mohammed told the press. Turn out had been high, with approximately 72% of the 8.4 million strong population taking part. The decision to declare Kurdish independence has angered the Iraqi government and neighbouring states.

What does this mean for the US Dollar?

During H1 2017, the US Dollar (as represented by the US Dollar Index) has weakened driven by the lack of implementation on President Trump's economic policies. However looking forward, the FED monetary policy cycle and the geopolitical uncertainties in other countries could provide support for the US Dollar. During September between a slightly more hawkish FED and investors' expectations of a potential tax reform/cuts the US Dollar appreciated versus the majority of the DM and EM currencies.

Fixed Income

Despite the worsening US - North Korea geopolitical situation, safe heaven assets like gold, US treasuries and other developed bond markets pulled back. This was on the back of a somewhat more hawkish FED announcing a moderate balance sheet reduction and indicating that subdued inflation is due to temporary factors, thus opening the door for a rate hike in December. In addition, President Trump called for major tax reforms/cuts as part of a longstanding Republican effort to overhaul the US tax system.

The markets began to price in this information with US Dollar appreciating versus the majority of DM and EM currencies and the 10-year US treasury yield widened 22bps to end the month at 2.33%. EM fixed income hard currency had a relatively flat performance, absorbing the majority of the selloff in US rates as spreads compressed. Commodities provided support to EM with the CRY commodity index up +1.23% and oil up + 9.40% on the month.

We expect one more interest rate hike in the US this year and the 10-year US treasury yield to trend wider towards year-end. This is on the back of further gradual normalization by the FED, which will start unwinding the USD4.5 trillion balance sheet in October 2017. In Europe the ECB could commence a timid tapering process sooner rather than later. Our view remains that G7 Government bonds offer no significant value at current yield levels given the gradual changes in monetary policy.

This low rate environment combined with a stronger global output and weaker US Dollar (not during September) has underpinned a solid demand for Emerging Market assets. Emerging markets equities and EM local debt indices had a slightly negative performance on the back of a stronger US Dollar. Technicals remain strong with non-EM traditional investors continuing to allocate funds to the asset class.

While long term fundamentals remain attractive in emerging markets, asset valuation levels across all asset classes have reached expensive territory. The expected exit from a low rate environment in the US and Europe as well as the reduction in the central banks' balance sheets, coupled with poor liquidity in various markets, are likely to bring about a significant amount of volatility.

Equities

Equity markets bounced back strongly in September as risk appetite returned to financial markets and gains were seen across virtually all major developed equity indices. In the US, equity markets were propelled by proposals to cut taxes with the S&P500 advancing 2.06% in September for its best return since February. In Asia, a snap election in Japan helped drive risk appetite with the Nikkei surging 4.2% for its best return this year whilst in Europe, returns were supported by improving economic data and the election result in Germany that saw Chancellor Angela Merkel tasked with forming a new government for the fourth time, following her victory. The German equity market surged 6.4% for its strongest return in 2017. Italy and France advanced 5% and 4.9% respectively whilst returns in the Scandinavian countries were also strong. In the UK, equity markets fell 0.7% as the GB Pound strengthened 3.6%. Returns in the emerging market space were more mixed with the region underperforming the developed indices for the first time this year with US Dollar strength weighing on the region. Indeed, China declined 0.3% and weakness was seen across Eastern Europe however gains were seen in Brazil which advanced 4.9% and Thailand which gained 3.7%. The MSCI World Index surged 2.24% in September and has now advanced 16% in 2017.

We continue to acknowledge that we have seen an extremely strong rally in equity markets and valuations are currently rich as investors remain optimistic around global growth. Recent data has backed up this optimism with solid growth seen across the US, Europe and in China and this has kept equity markets well supported. Economic data remains positive across the globe and thus 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 removal of the accommodative monetary policy, despite economies being healthier than at any time over the last few years, and any complications around the UK's Brexit divorce.

We continue to believe that investors will keep on searching for yield and this should result in more money flowing into equities as they offer better value relative to government bonds of developed countries.

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