Market viewpoint

by the Asset Management team

GIB
بنك الخليج الدولي

Key Points:

- **The US economy will continue in a positive vein with the lagged effect of lower energy prices on consumption yet to take effect**
- **Inflation is going to rise along with real wage growth**
- **Chinese growth to be softer than government projections, albeit GDP is not collapsing**
- **The European and Japanese equity markets are a better investment than the US market, although positive returns are expected in all three**
- **The Euro is likely to depreciate further against the dollar**
- **Global growth to be subdued with limited upside, opportunities in EM debt favoured via our Emerging Markets Opportunities Fund (EMOF)**

Macro Environment

Sharp price action in global equity markets dominated the newswires this month as volatility soared in most indices around the world. With the wider market already on tenterhooks awaiting the first FED hike in almost a decade later this month, the timing of a an effective devaluation of the Chinese RMB –yielding to pressure from a dwindling capital account - could have been better timed. The ripples of the move were felt by many, and not least by Janet Yellen and co at the FED, with a large segment of the market now pushing their expectations out to October, December and even Q1 2016 – the corollary to which raises an interesting question in itself: ***Is it appropriate to raise rates if the market is not priced for it?***

Evolution of US Macro

Nevertheless, one must countenance this with the evolution seen in key US indicators lately which certainly seem to be pointing towards the FED going sooner rather than later. Accounting for revisions, employment numbers, and wages, were solid indeed. The unemployment rate fell to 5.1%, which is effectively full employment by historical measures and brings the NAIRU discussion to the forefront. Wage growth of 0.3% m/m will make the up and coming FOMC discussion interesting to say the least. In terms of U6 unemployment rate, we expect the US to approach 9.5% in the first half of 2016, which was the level where the FED started hiking during the last cycle (June 2004).

The Fed: where is this going?

Perhaps then, with the vital signs of the US economy looking the best they have for a while; it's high time to move the patient out of the intensive care (zero rates) and into the recovery room (policy normalisation), so to speak.

As far as we are concerned, September would have been ripe for at least a symbolic move but, as many will be undoubtedly aware, the Yellen Fed has gone through great pains to reassure markets that the transition from zero rates will be as seamless and pain-free a process as possible. As such, to move in September– when market conditions look ill-equipped to deal with such a shock – would appear at odds with the FED's

very intention to keep things in the market amicable. To this end, we should also bear in mind that considerations for the removal of emergency policy rates are likely to be very different to those of a bona fide monetary tightening.

We therefore see a growing probability that the FED will delay the first rate hike until early 2016 with rate rises more gradual in order to allow the economy to continue its recovery.

A few words on China

In relation to China, while we certainly do not profess to be experts in Chinese Economic policy (if such a thing can be said to exist outside of the government apparatus) we expect Chinese growth to be softer than the government projections, albeit we do not believe GDP growth is collapsing. IMF's recent Chinese GDP growth forecast was +6.8% (as of July 2015). We don't expect the Chinese stock market correction/currency devaluation to have a major impact on the real economy with the latest uptick in Retail Sales showing that household demand is at least unaffected for now (see chart below). The Chinese equity market is small relative to the size of the real economy, with a tradeable value equal to 1/3 of GDP; for developed economies this ratio is around 100%.

What does this mean for the US dollar?

In concert with the above, we believe that all the components are here to support the case for a stronger US dollar over the medium term. Growth prospects continue to be brighter in the US, the quantitative easing in Europe and Japan should continue to increase or at least maintain the interest rate differential between the US and the rest of the world. This interest rate differential coupled with inflation expectations, on a relative basis; continue to favour the US Dollar. In relation to the YEN, as expected in the case of risk aversion, it is a currency that tends to appreciate.

Bonds

At August month end the US Treasury Note yield did not reflect the volatility which took place during the month; it returned -0.42%, the yield ended 5bps wider at 2.23%. In the case of 10yr Bunds, the return for the month was -1.39% and the yield ended 15bps wider at 0.79%. It is important to point out that the US Treasury price action has been more muted than in previous episodes of extreme volatility and considerable corrections in equity markets. It seems that investors are more cautious in G7 bond market given these bonds valuations.

In relation to Emerging Markets, the asset class was not isolated from the sharp equity market volatility and concerns about economic growth. The EMBIGD was down -0.91% with the index spread widening by +21bps to end the month at +389bps. The CEMBI BD returned -1.55%, while spread widened + 36bps. Year-to-date (August), the EMBIGD and the CEMBI BD returned +1.24% and 2.05% respectively.

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Equities

We are optimistic on equity markets and expect to see positive returns over 2015 even after the recent volatility. 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.

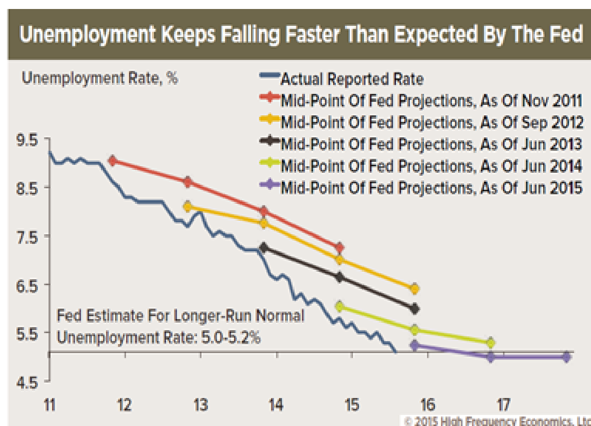
We expect higher local returns in both Europe and Japan as lower energy costs, an improving money supply and weaker currencies positively impact corporate earnings. As a result, we consider that exposure to these local equities coupled with an FX hedge against further currency weakness should outperform in the months to come.

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 Emerging Markets Opportunities Fund (EMOF). 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.

Charts and tables

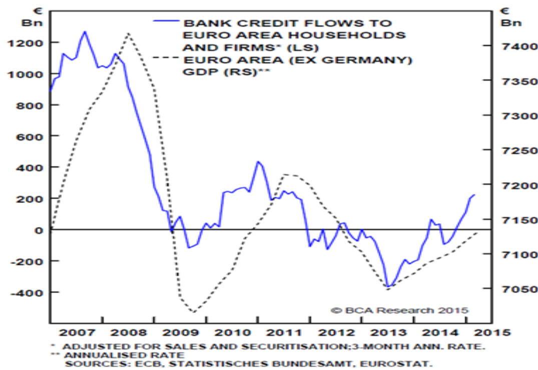
Unemployment falling faster than FED predictions



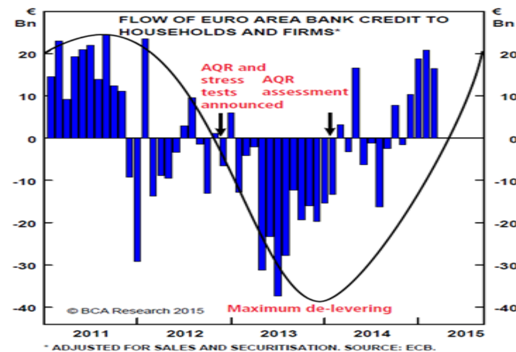
Evolution of key US macro inputs from Dec - July Fed meets

	Dec-14	Jun-15	Now
ATL FED Q2 GDPNOW	2.70%	1.90%	1.50%
UNEMP RATE	5.70%	5.50%	5.40%
AVG HRLY EARN %Y/Y	1.80%	2.25%	2.2%
CORE PCE	1.44%	1.40%	1.29%
S&P 500	2013	2096	1980
DXY USD Index	89.13	94.91	95.30
OIL (Crude)	58.89	60.84	47.85
10 Year US Treasury yield	2.13%	2.32%	2.28%

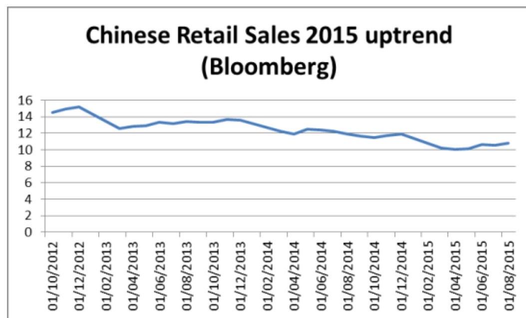
Credit-flows emboldening Euro Area GDP



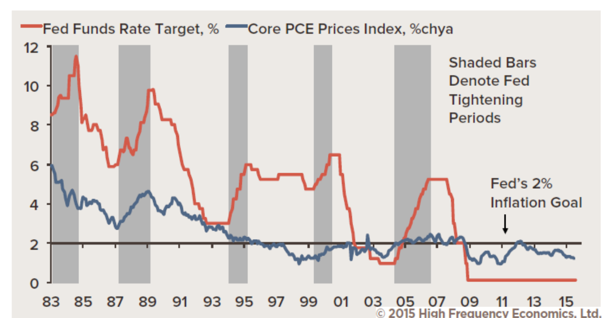
Euro area households re-levering



Chinese Household demand looks to have based…



Start of tightening does not require a pick-up in inflation



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