5th October 2016

Key Points for the next 3-6 months:

- Expectation of a hard Brexit is raising fears of future economic growth
- With the US presidential election getting close, political risk is increasing
- Going forward, central banks' monetary policy is less clear with the potential for slightly less accommodative measures
- Question marks over the liquidity/solvency of Europe's major banks resurface

Macro Environment

In the UK, Prime Minister Theresa May has announced that Article 50 is to be triggered by March 2017, which will kick off the process of exiting the EU over two years. Hard or soft Brexit is up for debate, but May has been an advocate of no special treatment to the city of London and its financial sector. The impact of the Brexit vote has been limited so far with recent data coming out of the UK showing services PMI at 52.6 (vs. expectations of 52.1), construction PMI at 52.3 (vs. expectations of 49.1) and manufacturing PMI at 55.4 (vs. expectations of 52.1).

Central banks are more hesitant with regards to further monetary easing, given that current policies have been benefiting financial markets (fuelling stretched valuation across risky assets), rather than the real economy. The FED's interest rate hike rhetoric has become more pronounced over the past couple of weeks as data coming out of the US continues to be resilient. US growth was soft in the first half of the year; however, the economy seems to be picking up momentum with consumer confidence at the highest level in 9 years and Q2 GDP growth coming at 1.4% qoq (above expectations of 1.3%). Recent ISM data out of the US is also positive with manufacturing PMI coming out at 51.5 (vs. expectations of 50.4) and non-manufacturing PMI coming out at 57.1 (vs. expectations of 53.1). A likely increase in capital investment and inventories build-up should help support the economy given growing 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 (4.9%) and underlying inflation rate at around 2%. The most recent ADP Non-farm employment number for September (154k) appeared to be resilient given that the unemployment rate is below 5%, the rate that the Fed officials believe to be consistent with full employment.

The current nominal FED funds rate is very low and implies a negative rate in real terms. Such level may be justifiable in an emergency situation but not necessarily now, 8 years after the beginning of the crisis. The primary aim of this tightening cycle is not to prevent the overheating of the economy or to target inflation, but to normalize emergency interest rate levels. As such, we expect the FED to implement one interest rate hike of 25bp before the end of this year. However, we do not expect the FED to hike more than once this year because of the dynamics of the economic recovery, the

headwinds stemming from Brexit and the concerns over Europe's large banks, and the potential impact of rapid hikes in interest rates on the financial markets.

The current global political landscape is complex with populist parties gaining ground worldwide as evidenced by the swings in political power in Austria, Germany and the UK. In the United States, the same dynamics are playing out with the upcoming presidential elections expected to be very tight. Investors are still trying to make sense of what a potential Trump victory would mean for markets.

What does this mean for the US dollar?

Given our base case of a Clinton victory and the improving growth prospect for the US, interest rate differentials and divergence in monetary policy should support the US dollar relative to other major currencies in the medium term. That said, in the run up to the elections in November, we are likely to see increased volatility.

The value of the USD is a fragile equilibrium of interest rate differentials going forward. In the political landscape, a stronger USD does not benefit either China or the US. We also, acknowledge that a stronger USD could influence the Fed's policy actions as well as the PBOC policy (as seen with previous efforts to devalue their currency).

Bonds

Given the decent data out of the US (as mentioned above) and a slightly more hawkish tone from the FED officials, US rates pulled back (US Treasury 10yr Note YTM widened +12bps to 1.72% between September 6th and October 6th).

As mentioned before, FED fund's rates remain at emergency levels several years after the global financial crisis, whilst in G7 countries nominal yields are very low or negative. We do not consider the monetary policy targeting negative nominal rates to be a solution for growth; there is a limit to central bank policy. We have seen its effects in Denmark, the first country to adopt negative rates, where the private sector is saving more than when the rates were positive and companies are not investing more despite low rates. Consumers and companies probably view the extreme interest rate policy as an indication of a crisis with an unpredictable outcome and this has driven their behaviour. The G7 bond yields are in a historically low range with limited room for central banks to pursue further monetary policy.

With nominal G7 yields at the lowest levels in decades, and while central banks are still continuing with accommodative monetary policies, the global search for yield and risky assets continues although with limited upside given already stretched valuations and tighter spreads since the beginning of the year.

For investors seeking yield in fixed income assets, EM credit (cash USD-denominated bonds) offers more attractive yields (or spread over US treasuries) on a relative basis, though a close focus on fundamentals remains essential, especially as spreads have tightened quite significantly.

Equities

September was another subdued month in equity markets with limited volatility over the month. Equity markets remain resilient with the UK and US near all-time highs, but we have begun to feel that we are entering a wait-and-watch-the-US mode. Financial markets remain cautious of the upcoming US elections and future interest rate hikes and these two themes are directing risk appetite. Global markets did see minor gains, however with the MSCI World advancing 0.5% over the month and has now gained 5.6% over 2016.

We remain of the view that the US recovery continues with improving economic data and accommodative monetary policy helping equity markets to steadily grind higher, although we acknowledge that the US elections could increase 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, especially in the UK where nervousness around Brexit is yet to take effect. Indeed, the UK 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 2016 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. However, further rate increases in the short term could weigh on risk appetite.

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.

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. Going forward, we believe there is limited value to investors in G7 bonds, whereas the positioning of our EMOF product should provide income with a chance of capital gains based on a relatively short duration assets.

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**

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