Viewpoint

September 2017

Key Themes for the next 3-6 months

- US FED likely to announce its balance sheet reduction soon.
- Prospect of tighter monetary policy in Europe.

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Political and Macro Environment

The pickup in global growth anticipated by the IMF in its April 2017 World Economic Outlook remains on track, with global output projected to grow by 3.5% in 2017 and 3.6% in 2018 according to a July update of the same document. The unchanged global growth projections mask somewhat different contributions at the country level. Growth has been revised up in China and the euro area whereas US growth projections are lower than in April, primarily reflecting the assumption that fiscal policy will be less expansionary going forward than previously anticipated.

The economic recovery is gradually gaining momentum fuelled by improving global demand and strengthening labour markets, particularly in the developed world. In addition, except for the US, the world's leading economies are likely to maintain their accommodative monetary policies this year and governments are expected to support economic activity with fiscal stimulus.

Based on the solid growth data, the US job market will probably continue to tighten. Real GDP growth was revised up to 3.0% in Q2 and seems to be tracking at 2.7% in Q3. The threat of a renewed government shutdown and debt ceiling fight has diminished substantially following the devastation of Hurricane Harvey. Lawmakers are up against a 29 September deadline to raise the debt ceiling or risk a potentially catastrophic default on the nation's debt. This increases the likelihood that FED officials will announce balance sheet adjustment at the September FOMC meeting and start the process in early October.

Most market participants anticipate the FOMC to announce at its September meeting a date for implementation of a change in reinvestment policy. Minutes from the March Federal Reserve meeting showed that Fed officials backed a plan that would begin reducing the USD4.5 trillion balance sheet towards the end of 2017.

In the Eurozone, growth has quickened and unemployment has fallen against the backdrop of ultra-low interest rates and other measures by the European Central Bank (ECB) to boost activity. Seasonally adjusted GDP rose by 0.6% in both the euro area (EA19) and in the EU28 during Q2 2017, compared with the previous quarter, according to a preliminary flash estimate published by Eurostat. In Q1 2017, GDP had grown by 0.5% in both zones. Compared with the same quarter of the previous year, seasonally adjusted GDP rose by 2.1% in the euro area and by 2.2% in the EU28 in Q2 2017, after +1.9% and +2.1% in the previous quarter.

Jackson Hole meeting offered little clarity for investors

The meeting of central bankers in Jackson Hole was expected to provide more clarity about the way the world's central bankers intend to exit huge stimulus packages unfurled to dig the global economy out of a hole after the financial crisis. The world's two most powerful central bankers delivered warnings against dismantling tough post-crisis financial rules that the Trump administration blames for stifling US growth.

European Central Bank President Mario Draghi said it was a particularly dangerous time to loosen regulation given that central banks are still supporting their economies with accommodative monetary policies. That warning followed earlier remarks by Fed Chair Janet Yellen, who offered a broad defence of the steps taken since the 2008 financial-market meltdown and urged that any rollback of post-crisis rules be "modest."

In general the Jackson Hole meeting did not bring any major changes or surprises in policies of central bankers.

Hurricanes cause turmoil on the oil market

Crude prices received support following the aftermath of Hurricane Harvey as key refineries and pipelines resumed operation following hurricane-driven shutdowns, thus stoking demand. Harvey forced refineries, pipelines, ports and offshore platforms to shut as the storm intensified before making landfall on 25 August. While many of those facilities are back in service, others have yet to resume production.

Before being able to fully recover from the recent devastation, US is getting now ready for a new threat, Hurricane Irma, which can cause additional turmoil on the oil market.

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 (this was not the case during August).

Fixed Income

Since our last Viewpoint the geopolitical tensions in the Korean peninsula have intensified. This combined with rich valuations across different asset class has affected investors' sentiment, with safe havens assets gaining some traction. The US dollar was an exception. These factors together with the US political conditions brought the 10yrs US Treasury Note yield to the lowest levels this year. Along with the US, other developed bond markets also delivered a good performance in August.

We expect one more interest rate hike in the US this year and the 10-year US note yield to trend wider towards year-end. This is on the back of further gradual normalization by the FED, which could start unwinding the USD4.2 trillion balance sheet by the year-end. 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 underpinned a good demand for Emerging Market assets. Emerging markets equities, EM local debt and external debt indices performed strongly. Technicals remain strong with non-EM traditional investors continuing to allocate funds to the asset class.

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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 were a lot more subdued in August as the summer month ensured limited volume and limited volatility. Risk appetite remained largely positive during August however although returns were mixed between regions. The US equity market continued its run of positive returns every month this year to gain a further 0.3% and has now advanced almost 12% year to date. In Europe, the ever improving economic landscape is helping GDP growth grind higher although equity markets were mixed. The superpower of Germany saw declines for the 3rd month in a row, -0.5%, whilst the UK advanced 1.65% over the month. The Scandinavian countries also performed well, especially Denmark which gained 2.8%. In the emerging market space, returns were predominantly positive with Brazil especially strong in surging 7.5%. The MSCI World index marginally advanced in August when gaining 0.14%.

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 we have seen political risk recede slightly and thus we see no immediate reason for a significant pull back in equity markets, although we continue to monitor the recent situation in North Korea and US closely. 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.

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 see limited value for 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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