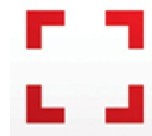
momentum

Viewpoint

Monthly market update

May 2016



global investment management

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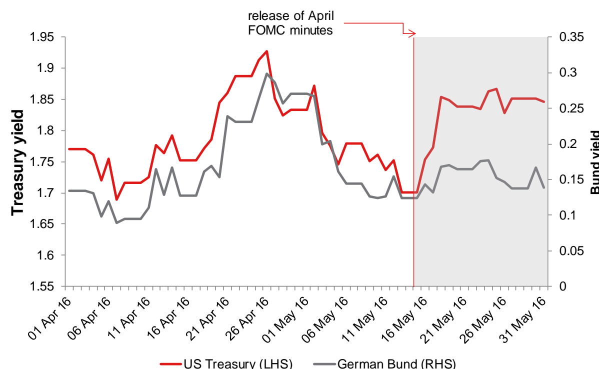
1. Market commentary

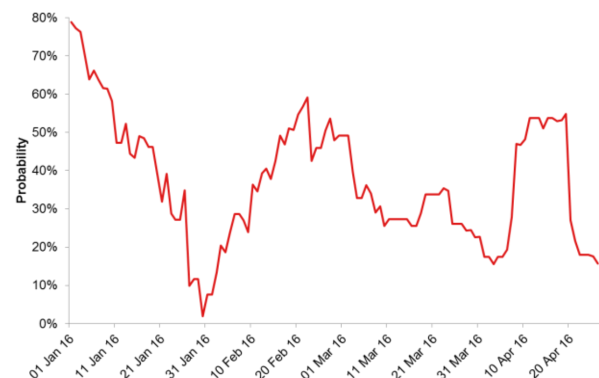
By far the most significant development in the month was the change in expectations for a US Federal Reserve (Fed) interest rate hike in 2016. During May the probability of a rate rise for the June and July meetings increased from 12.0% and 26.1% at the start of the month to 24.0% and 52.9% at month end. Markets reacted fairly predictably to this development. The US dollar rallied sharply, reversing some of its weakness earlier in the year: the greenback was up by 2.9% against the euro and 4.0% versus the yen, as well as rallying against many emerging market currencies. The gold price fell 6.0% over the month in US dollar terms, giving back some of the sharp gains from early in the year. Industrial metal prices also reversed direction, notably iron ore which fell by 28.3%. Emerging market equities fell by 3.7% and EM debt declined by 0.2%, although both these falls came after sharp rallies in previous months. High yield bonds (flat over the month) continued to outperform government bonds, which were down 1.2% in US dollar terms. Yields on shorter-dated US Treasuries fell in the first half of the month but reversed direction following the release of the Fed's April meeting minutes, which struck a hawkish tone. Longer dated Treasuries were little changed. In contrast to Treasuries, European bond yields fell, with the European Central Bank being a major buyer. Perhaps surprisingly, developed market equities predominantly reacted with equanimity to a less dovish Fed and the increased likelihood of an early interest rate rise, with the US returning 1.7% for the month, Europe adding 2.4% and Japan rising by 2.6% in local currency terms; the UK was a notable exception, returning 0.2% in sterling terms. Returns from markets outside the US were trimmed by currency weakness versus the greenback however, such that the MSCI World index returned 0.6% for the month in US dollar terms.

Figure 1. US and German government bond yields, in April and May.



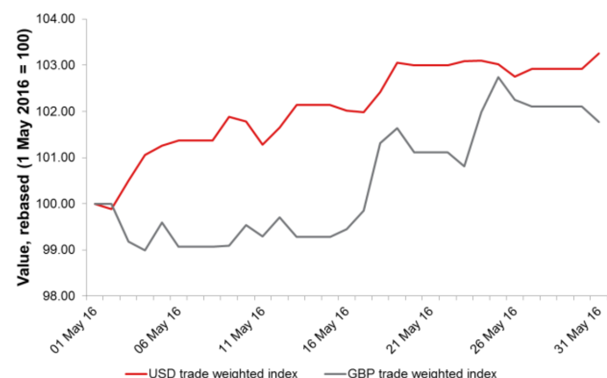
Although the Fed had indicated in December last year that they were targeting four incremental rate rises this year, weak global conditions in the early weeks of the year caused plans to be put on hold. However, continued improvement in the labour market and some evidence of a pick-up in wages, together with increased stability in financial markets, produced a marked change in the Fed's rhetoric. The mid-month release of the April Open Market Committee (FOMC) meeting minutes showed that the Fed were still contemplating a summer hike, and with the inflation rate hovering at 1.6% using the Fed's preferred measure, Fed governors indicated that a rate rise in either June or July was likely.

Figure 2. Expected probability of a Fed hike in July, over the year to date.



Notably, at the time of writing, the expectations for hikes at the June and July meetings have lowered significantly to 0.0% and 15.7% respectively, due to the May non-farm payrolls report on 3 June of 38,000 jobs dramatically disappointing relative to expectations.

Figure 3. USD and GBP over may.



Arguably the biggest political risk of the first half of 2016, the UK EU membership referendum, is drawing nearer and until recently the remain camp had consistently polled ahead of those looking to leave the EU. Those advocating to remain have pursued a relentless campaign predicting significant economic damage should the UK leave, and had appeared to shift the polls towards staying in. Sterling reacted accordingly by strengthening against most currencies, other than the resurgent USD. However various polls thus far in June have showed the leave vote ahead, producing a wobble in sterling. The bookies, which are usually a better guide to election results than opinion polls, still show remain as the stronger side. The likelihood is the UK will remain in the EU, but the outcome is of course binary and position taking ahead of the result is particularly risky. While nothing would change for some time after the vote whatever the outcome, a vote to stay in would probably see a short relief rally in markets. Conversely a vote to leave would see markets stumble and sterling take a meaningful dip, before stabilising at somewhat lower levels. In the longer term the UK will undoubtedly perform well whether in or out of the EU, and any sharp falls in markets over the next few weeks are likely to prove to be a good long term opportunity to accumulate holdings.

Markets recovered strongly after the sharp falls in January and early February, and have now consolidated in the past few weeks. On top of continuing uncertainty in the global economy, there is increased risk of another interest rate rise in the US this summer. On balance a June rate rise is, now, very unlikely in our view, as the economy continues to show a mixed picture. Longer term inflation expectations remain anchored around 1.5% and the Fed will want to see this move higher. All eyes will be on the data and the Fed as the year progresses. On a positive note, economies continue to grow, albeit modestly; emerging markets are five years through the down cycle and offer recovery prospects from these levels; and a damaging surge in inflation seems a distant prospect. With competing forces influencing markets it is likely that the volatility we have witnessed in the first quarter of this year will be a feature in the months if not years ahead. Against this background, in the shorter term a period of consolidation and drift in markets is likely, but further upward progress is expected over the next 12-18 months.

Source: Bloomberg. Returns in US dollars unless otherwise stated. May 2016.

2. Market performance

		To 31 May 2016		
Asset class/region	**Index**	**Currency**	**1 month**	**Year-to-date**
Developed markets equities				
United States	S&P 500 NR	USD	1.7%	3.3%
United Kingdom	MSCI UK NR	GBP	0.2%	1.8%
Continental Europe	MSCI Europe ex UK NR	EUR	2.2%	-3.6%
Japan	Topix TR	JPY	2.9% e	-9.9% e
Asia Pacific (ex Japan)	MSCI AC Asia Pacific ex Japan NR	USD	-1.6%	0.2%
Global	MSCI World NR	USD	0.6%	1.8%
Emerging markets equities				
Emerging Europe	MSCI EM Europe NR	USD	-6.7%	10.6%
Emerging Asia	MSCI EM Asia NR	USD	-1.2%	-0.6%
Emerging Latin America	MSCI EM Latin America NR	USD	-10.8%	12.6%
BRICs	MSCI BRIC NR	USD	-2.9%	0.7%
Global emerging markets	MSCI EM (Emerging Markets) NR	USD	-3.7%	2.3%
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.0%	3.3%
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	-0.8%	4.3%
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	-0.1%	5.3%
US High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	0.6%	8.1%
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	1.8%	5.8%
UK Corporate (investment grade)	BofA Merrill Lynch Sterling Non Gilts TR	GBP	1.2%	4.4%
Euro Government Bonds	Citigroup EMU GBI TR	EUR	1.0%	3.3%
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	0.3%	3.1%
Euro High Yield	BofA Merrill Lynch Euro High Yield Constrained TR	EUR	0.3%	4.3%
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.4%	6.2%
Australian Government	JP Morgan Australia GBI TR	AUD	1.5%	4.1%
Global Government Bonds	JP Morgan Global GBI	USD	-1.2%	6.7%
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	-1.1%	5.6%
Global Convertible Bonds	UBS Global Focus Convertible Bond	USD	-0.8%	0.2%
Emerging Market Bonds	JP Morgan EMBI+ (Hard currency)	USD	-0.5%	7.4%

Source: Bloomberg. e denotes estimate

		To 31 May 2016		
Asset class/region	Index	Currency	1 month	Year-to-date
Property				
US Property Securities	MSCI US REIT NR	USD	2.3%	5.7%
Australian Property Securities	S&P/ASX 200 A-REIT Index TR	AUD	2.6%	11.3%
Asia Property Securities	S&P Asia Property 40 Index NR	USD	-3.5%	0.5%
Global Property Securities	S&P Global Property USD TR	USD	-0.4%	5.0%
Currencies				
Euro		USD	-2.8%	2.4%
UK Pound Sterling		USD	-0.8%	-1.7%
Japanese Yen		USD	-4.0%	8.6%
Australian Dollar		USD	-4.9%	-0.7%
South African Rand		USD	-9.5%	-1.5%
Commodities & Alternatives				
Commodities	RICI TR	USD	-0.1%	8.4%
Agricultural Commodities	RICI Agriculture TR	USD	0.5%	5.4%
Oil	Brent Crude Oil	USD	3.2%	33.3%
Gold	Gold Spot	USD	-6.0%	14.5%
Hedge funds	HFRX Global Hedge Fund	USD	0.4% e	-1.0% e
Interest rates		**Current rate**		
United States		0.50%		
United Kingdom		0.50%		
Eurozone		0.00%		
Japan		-0.10%		
Australia		1.75%		
South Africa		7.00%		

Source: Bloomberg. e denotes estimate

3. Asset allocation dashboard

Positive (green)	Neutral (yellow)	Negative (red)

Asset class	View
Equities	
Developed equities	Neutral
UK equities (relative to developed)	Neutral
European equities (relative to developed)	Positive
US equities (relative to developed)	Negative
Japan equities (relative to developed)	Positive
Emerging market equities	Neutral
Fixed Income	
Government	Neutral
Index-linked (relative to government)	Positive
Investment grade (relative to government)	Positive
High yield	Neutral
Loans	Neutral
Emerging market debt	Neutral
Convertible bonds	Positive
Alternatives	
Commodities	Neutral
Property (UK)	Negative
Currencies	
GBP	Neutral
Euro	Neutral
Yen	Neutral

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