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Investment Solutions – Market Commentary – April 2017

Global Overview

Amid the recent steps taken by the Fed to normalise policy and lean against improving economic and asset price momentum, a debate among investors continues to rage about how much global monetary policy is tightening and whether market pricing is appropriately calibrated to policymakers' reaction functions. Certainly, there is now a smaller gap between central banks' guidance about the likely future path of policy than was the case for most of 2016.

The two rate hikes in the US this year is in line with the projections, though investors still appear sceptical of the Fed's 3% terminal rate projections. The Bank of England did not lift rates in March, but the meeting statement and minutes did appear to be an attempt to reduce market complacency about how long the bank rate would remain at 25 basis points if the MPC's economic and inflation forecasts were realised. Meanwhile, ECB policy may be more or less on a set course through 2017 - but that is not stopping market speculation about when and how they will seek to exit from their unconventional measures through 2018. Among the large central banks, only the Bank of Japan's policy outlook seems stable, both because its own credibility is now so bound up with the yield targeting regime, but also because of the wide recognition that real rates must be kept low for many years if underlying inflation is ever to reach 2%.

The Fed is adjusting policy because it continues to make progress towards its objectives. The BoE is sounding a bit more hawkish because the domestic economy continues to surprise in its resilience. The ECB is debating its exit strategy because the economy is growing above trend and it expects that to feed through to inflation over time. Indeed, this trend toward normality should be welcomed.

US

As expected, the Fed voted to lift the target range for the federal funds rate by 25 basis points in March meeting to 0.75-1%. The market interpretation of the meeting was that the Fed delivered a dovish hike. There were also only fractional changes to members' forecast for GDP growth, unemployment and inflation.

The domestic and external economic environment is currently very favourable, risk assets have been buoyant despite the recommencement of normalisation, and fiscal policy is more likely to loosen than tighten over the coming year.

Markets expect two more rate hikes this year, with the first of those delivered in June if the economic, market and political environment remains supportive. Three more hikes are possible, but only if indicators of inflation pressures surprise to the upside or fiscal stimulus is delivered well before the end of the year.

UK

Cracks are starting to appear within the MPC. The March meeting saw no change to the BoE's current policy settings, as widely expected. However, this decision was not unanimous. Moreover, there were other hints within the meeting minutes that the Bank is becoming more divided. Some members noted that it would take relatively little further upside news on the prospects for activity or inflation for them to consider a more immediate reduction in policy support. Nine months after the EU referendum, the Bank is becoming even more divided on how the fallout will affect the economy, if at all.

The performance of the economy in coming months will be critical for determining the next move from the Bank. There are three key assumptions to monitor: that rising inflation does not feed through to long-term expectations, pay growth remains modest and growth slows as household spending softens.

Europe

With the Eurozone economy riding high on the global cyclical upswing and headline inflation reaching 2% year-on-year in February, debate about the outlook for monetary policy is increasingly focused on when and how unconventional support is next withdrawn. While the ECB had committed to a continuation of the asset purchase programme through to December 2017, market participants are impatiently awaiting signals from the Governing Council about its plans for 2018 and beyond. As anticipated, the March meeting saw interest rates unchanged, while stating its intention to keep policy rates at current levels or lower. Draghi also reiterated the Council's previous commitment to continue the asset purchase programme throughout 2017, or beyond if necessary.

Japan

Given the rebound in prices remains promising**,** it is of little surprise that measures of inflation expectations remain muted. Households' inflation expectations for one-year ahead fell in February, compared to January. The corporate sector price outlook has also been in freefall. Overall, a price outlook consistent with 2% remains a distant prospect. Inflation is expected to reach just 1% by the end of 2018. This progress remains too slow to justify an increase in the BoJ's yield curve target over this period, without damaging its inflation targeting credibility. The one wildcard is the global interest rate environment. A material rise here, and subsequent depreciation in the Yen, could put pressure on the BoJ to lift its yield curve target, even though this would not necessarily raise the prospects for long term inflation.

Emerging Markets

Chinese data covering the first few months of the year has showed unexpectedly strong momentum. This has defied some of the predictions that the economy would begin to weaken early in the year amidst a monetary tightening-induced housing slowdown. In addition to the widespread forecast upgrades from global investment banks, it has also given the PBOC (Chinese Central Bank) enough confidence to further increase interest rates. While much of the attention has been paid to the PBOC "following the Fed", Fed rate hikes are just one reason why the PBOC is raising the repo and lending facility rates. Keeping a stable rate differential is an important central government policy priority, especially given how much importance policymakers have placed on attracting foreign investors into the domestic bond market. They see a stable yuan as being necessary to attract inflows and most indications are that this will continue to be a high priority throughout the year.