Investment Solutions

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Market Commentary August 2017

The Federal Reserve is no longer the only G10 central bank tightening monetary policy. The Bank of Canada has raised rates for the first time in seven years, helping to fuel speculation as to who will be next. Global growth data was solid in July with a notable bounce back in US business confidence. Inflation indicators remain soft. This is a good environment for risk assets and with central banks looking through the inflation weakness it should keep upward pressure on bond yields. Euro strength is weighing on European equities but data remains robust and market views are positive in this region. US oil inventories have fallen substantially in recent weeks and this should continue through the rest of the summer. Meanwhile, evidence is building that political uncertainty in the UK is starting to result in slower activity data.

Economic picture: Recovery Phase

Trend measures of growth remain healthy with unemployment rates generally falling. The Investment Clock has moved into the 'Recovery' phase of the economic cycle. This stage of the cycle is typically favourable for equities relative to other asset classes. The Fed delivered its fourth-rate hike of the cycle at their June meeting and was joined by the Bank of Canada in July. Other central banks have yet to act but expectations are rising that further tightening is forthcoming.

Market Positioning: overweight Energy and Europe

The economic backdrop supports being overweight in risk assets over bonds and the market is positive on equities and commodities. European data continues to outstrip global measures and the market is still positive on European equities and the euro and negative on German government bonds. US oil inventories have fallen sharply over the last month and this should continue through the summer, supporting prices. Political uncertainty in the UK appears to be weighing on UK data. There is a negative stance on sterling relative to European currencies and also to be underweight within UK domestic equities.

The Bank of Canada has become the first G10 central bank to follow the Fed in tightening monetary policy. As the economy most interlinked to the US this is not a total surprise. But given the economy is still recovering from the collapse in oil prices and inflation is relatively soft; this shows the Bank of Canada's high degree of confidence in the outlook.

Attention is now turning to which central bank will be next to tightening policy.

As the most important central bank apart from the Fed, much of the focus is on the ECB. Eurozone unemployment has been falling steadily for four years, growth is running well above potential and inflation is no longer at risk of slipping into deflation. With political risks greatly diminished, at some point the ECB will begin to remove the extraordinary policies they have in place.

The euro has rallied aggressively this year despite little change in rate expectations. In part, this is explained by Mario Draghi's perceived willingness to allow euro strength as long as rates, particularly

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peripheral rates, remain contained. If the euro continues to rally this stance will be tested but for now the outlook is positive on the euro and negative on German government bonds.

The strength of the euro also reflects broad based dollar weakness as scepticism grows that President Trump's unconventional approach will deliver anything positive for the economy.

The appreciation of the euro has been a significant headwind for European equities in recent months. The strength of the currency will depress foreign earnings in euro terms but this should be more than offset by the health of the domestic economy. Europe is at an earlier stage of the cycle than other markets and profit margins should expand in the coming quarters as growth comes through. The outlook is positive on the region.

In addition to weighing on the dollar, Trump's unpredictable way of doing things increases the chances that raising the debt ceiling will be problematic. The challenges in passing healthcare reform give an indication of the difficulties ahead.

The US has been operating under "extraordinary measures" since March of this year but the Congressional Budget Office expect that if the debt limit remains unchanged those measures will be exhausted in early October.

While an actual default by the US would be expected to result in significantly higher bond yields the price action in the run up to the deadline is likely to be volatile. In the last debt ceiling crisis in 2011 yields rallied very sharply as part of a broad risk-off move in the run up to the deadline and we may well see something similar this time around.

Oil performed strongly over the month but remains the weakest performer so far this year. The dollar continued to weaken, benefitting the euro and sterling. Equities were mixed this month. Emerging markets benefitted from the weaker dollar and is now the strongest performer year to date while developed market equities and government bonds were generally softer over the month.

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