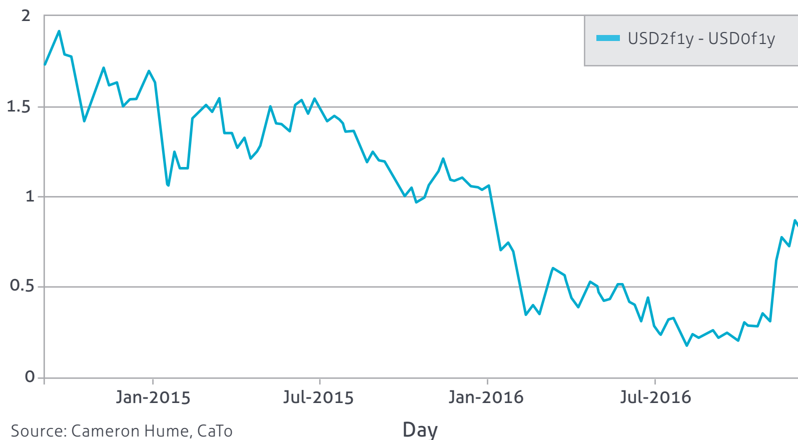
Market Update December 2016

Since our last market update, sentiment within global financial markets has changed considerably. We would like to update you with our current views and positioning.

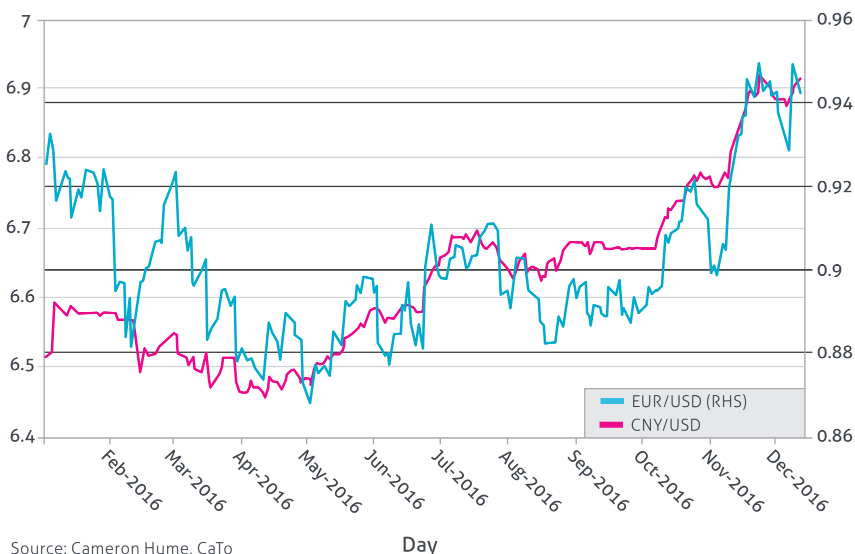
The US Presidential election has led to a significant shift in US interest rate expectations through to the end of 2018. Assuming the US Fed increase the Federal Funds Rate (FFR) by 0.25% points this week, market participants now expect further increases of around 0.75% points over the next 2 years (Figure 1). This is a far less accommodative stance than was expected by market participants only 2 months ago and has led to an acceleration of cyclical US dollar appreciation (Figure 2[1]). The euro and Chinese renminbi make up 40% of US trade and these currencies have depreciated 3.5% points on a trade weighted basis post the Presidential election. FOMC Governors caution that their current modelling estimates that a 5% appreciation in the US dollar is equivalent to a 0.5% point increase in the FFR[2]. Given the 20% appreciation of the US dollar since 2014 then this alone equates to a 2.0% points increase in the FFR. Continuing US dollar strength from here implies that the US monetary policy tightening cycle may be more than half-way complete.

Figure 1: US interest rate expectations



Source: Cameron Hume, CaTo

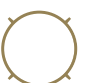
Figure 2: History local currency



Source: Cameron Hume, CaTo

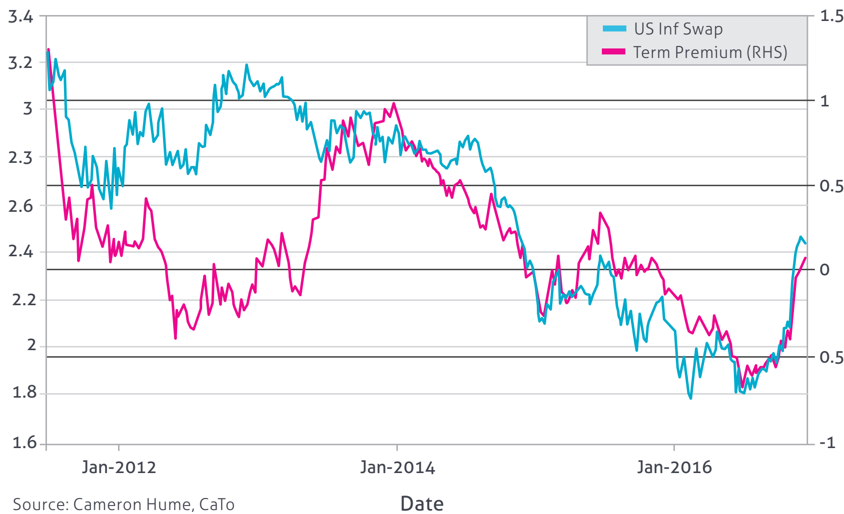
[1] Euro vs US dollar FX is inverted in Figure 2

[2] See Lael Brainard for current FRB model estimates: https://www.federalreserve.gov/newsevents/speech/brainard20160912a.htm



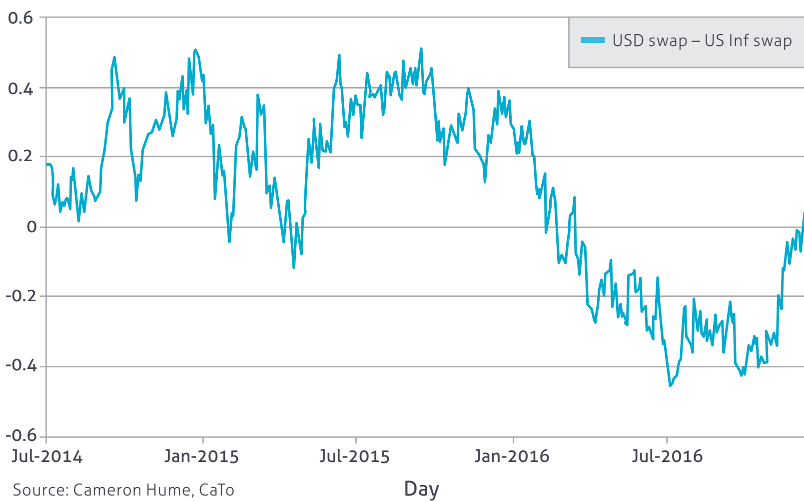
The US yield curve was under steepening pressure before the election due to rising inflation expectations, pushing term premium higher in long-dated US yields also (Figure 3). Post-election, this trend has accelerated in reaction to anticipated increases in domestic incomes and government investment promised in the economic manifesto of President-elect Trump. The rise in inflation expectations has tightened real yields considerably in a short space of time (Figure 4). However, real yields remain near zero which is exceptionally accommodative given the maturity of the US economic cycle. Should the new US administration deliver on promised fiscal initiatives then the current monetary policy backdrop and higher nominal GDP growth should push the US term premium much higher[3].

Figure 3: US term premium & expectations for long-term inflation



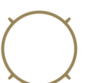
Source: Cameron Hume, CaTo

Figure 4: Current long term real yields



Source: Cameron Hume, CaTo

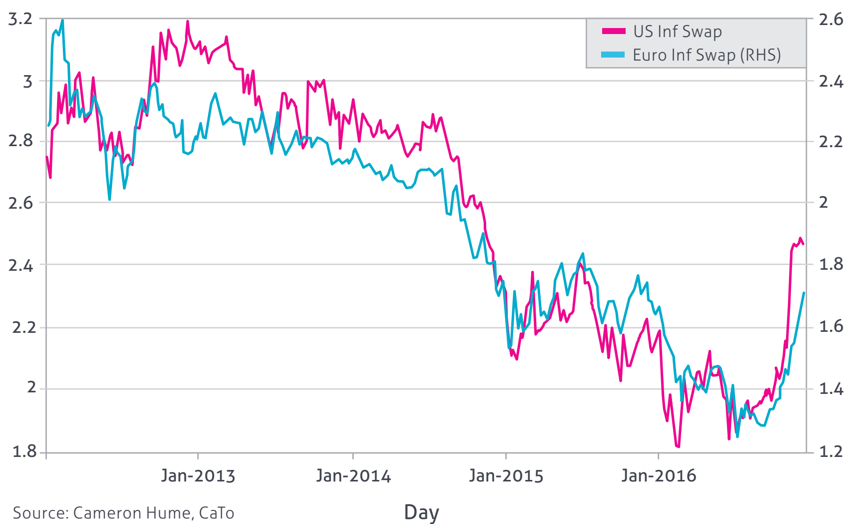
[3] See Cameron Hume, US term premium, disinflation and the death of the rates cycle: http://www.cameronhume.com/wp-content/uploads/2016/09/US-Term-Premium.pdf



We believe that the recent rise in long-term Eurozone global inflation expectations are unjustified. US long-term inflation expectations have risen (Figure 5) and now imply that market participants believe the FOMC is close to its longer run inflation objective of 2%. For context, US core CPI is already above 2% and the FOMC's preferred inflation measure, Personal Consumption Expenditure (PCE), is now 1.7%. This suggests that US long-term inflation expectations have been catching up to realised inflation. However, Eurozone long-term inflation expectations have risen by a similar amount and imply the ECB is also close to their 2% target. This is despite core Eurozone inflation remaining below 1%, continuing restrictive fiscal policies and ongoing downward revisions to official inflation projections.

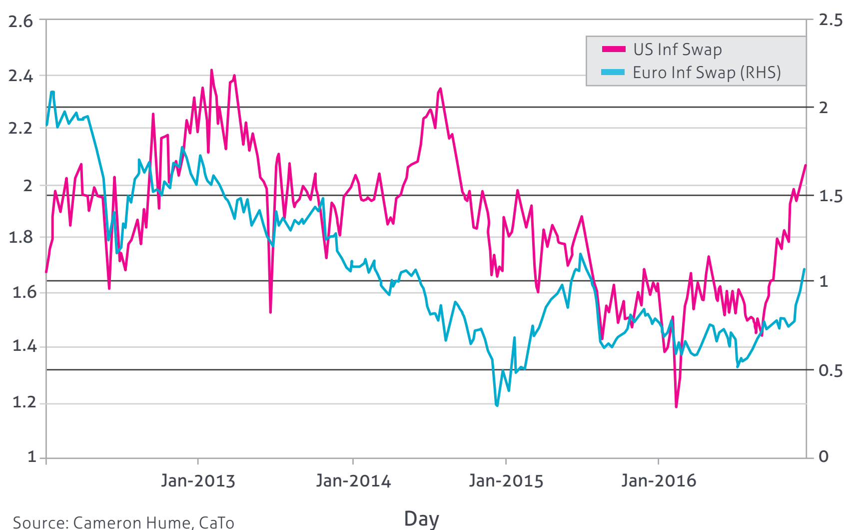
Short-term inflation expectations are perhaps a more robust reflection of the near-term path for Eurozone inflation (Figure 6). These expectations indicate Eurozone inflation peaking at 1% over the next 2 years (largely as a result of oil related base effects which will be realised in the first half of 2017). This continues to suggests to us that the ECB remains far from reaching its mandated inflation objective and that exceptional monetary policy stimulus needs to continue for some years to come in order to support this.

Figure 5: Long term inflation expectations

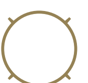


Source: Cameron Hume, CaTo

Figure 6: Short term inflation expectations



Source: Cameron Hume, CaTo



Portfolio commentary

We have made some changes to our core investment views for the year ahead.

With respect to the ongoing political surprises within western democracies we have added a new theme to the portfolio, **Populist Politics**. The evident shifts within UK and US politics, and the 2017 Eurozone national electoral cycle will have future ramifications for global trade and the EU project in particular. One strategy we have added is **Short France vs German Treasuries**. Whilst we are cautious on the actual outcome of the 2017 French Presidential election we do believe that a wider sovereign credit spread is justified given the uncertainty that the campaign will create. Further, the recent adjustment of the ECB QE programme will push peripheral and semi-core sovereign yields higher. The ongoing global curve steepening induced by rising inflation expectations has led market participants from expecting a cut in Bank of England (BOE) base rate over the next year to now expecting an increase of almost 0.5% points over the next 2 years. Given the economic impediments facing the UK economy into and beyond an eventual exit from the EU, we believe it more likely that the BOE will eventually cut base rate towards 0.1%, and we have added the strategy **UK term spread tightener**.

Within our **Reflation and Normalisation** theme we expect the spread between forward-dated US interest rates to continue widening over time. We express this in our **US forward spread widener** strategy. It remains likely that the FOMC will keep the Federal Funds Rate below 1% for at least another year, hoping that inflation will overshoot the 2% target modestly in that time. This boosts the recent steepening bias in the US yield curve and so we recently complemented our view on short-dated forward spreads by adding an explicit **US 'steepener'** strategy. Further, our long held **Eurozone long-dated rates RV** strategy will benefit from the recent adjustment by the ECB to its QE programme: buying less bonds every month and allowing purchases to be more focused on very short-dated bonds will push very long-dated Eurozone yields higher. Our strategy will benefit from this yield curve dynamic.

We continue to hold a **Long Eurozone vs Japan forward rates** strategy within our long-term theme **Eurozone: Japanification**. The strategy has underperformed recently after market participants anticipated the ECB adjustments to its QE programme. This has removed some support for long-dated yields in the Eurozone and widened the strategy spread considerably. However, this is a long term strategic view and the Bank of Japan is currently making similar adjustments to its own QE programme. Given the shared difficulties that both the Eurozone and Japan have with low core inflation and limited structural reform, we continue to expect the spread between these market-based long-term interest rates to narrow significantly over time. Our complementary **Japan curve 'steepener'** strategy has benefited from rising global yields in this environment.

Into the US election we added a **Short Chinese renminbi vs trade basket**[4] strategy within our **EM weakness** theme. We expect Chinese monetary policymakers to continue to engineer slow trade-weighted currency depreciation and gradual opening of the capital account. However, the election of Donald Trump may place further depreciation pressure on the renminbi if his administration follows up on campaign pledges to undermine the Chinese export platform by imposing US tariffs. We also re-instated the **Long Indian rupee vs Korean won** strategy shortly after the US election: South Korea faces longer term export competitiveness pressures from Japan and China. Further, the South Korean export economy would not be immune from import tariffs imposed by the new US presidential administration. India on the other hand is relatively insulated from any US-Asia export trade frictions as its economy is largely driven by internal consumption and agriculture.

[4] Our proxy for the renminbi trade basket is a weighted combination of long positions in US dollar, euro and Japanese yen

Contact

Keith Logan
keith.logan@cameronhume.com
T +44 (0) 131 603 6988
M +44 (0) 7860 925 131

Author

Dr Kevin Kidney, CFA is an Investment Manager at Edinburgh-based fixed-income specialist Cameron Hume Limited

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