GLOBAL VIEWS

The US economy grew faster than previously estimated in the first quarter of the year, according to official figures. The Commerce Department said gross domestic product (GDP) grew at an annual pace of 1.1% in the quarter, up from an earlier estimate of 0.8%. The upwards revision was helped by stronger export sales. However, growth in consumer spending was revised down to 1.5%, the slowest pace since the first quarter of 2014.

That weaker number was a reflection of slowing spending in service sectors such as health care and weak consumer spending during a harsh winter in many regions of the US. This is the third estimate of first-quarter US GDP by the Commerce Department, which said "the general picture of economic growth remains the same". The Commerce Department also revised upwards its estimate for the growth in the fourth quarter of 2015 to an annualised pace of 1.4%

The upward revision is a positive sign for growth in the current quarter, but there are concerns that the impact of the UK's decision to leave the European Union could send shockwaves through the US economy, slowing growth in the autumn. Economists currently expect second quarter growth in 2016 to be close to 2.4% Nariman Behravesh chief economist at IHS, said: "Consumers will resume their role as the powerhouse of the US economy, with personal consumption expenditures in the second quarter estimated to grow by 3.7%."

SECURE ASSET MANAGEMENT LIMITED

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Editorial

Outlook for the global economic scenario has brightened over the last three months, as the downward adjustment in world growth and the slump of financial markets have halted. The 6.7% growth YoY registered in China's economy in 1Q16 has calmed jitters about the potential shock waves of China's economic reshaping process, which is in fact being smoothed out by authorities' greater monetary and fiscal support. The risk of a dramatic adjustment in the exchange rate, once capital outflows have been curbed, has also been mitigated. As regards the Fed, the perspective of very slight interest rate hikes relies on the lack of immediate pressure from prices or wages and the effects of the complex global scenario on employment in the US.

The evolution of commodity prices, particularly oil, has also been positive in the last quarter. Prices have increased from levels so low that large dollar-indebted corporations from emerging markets were having troubling servicing their debt. This in turn triggered deterioration in markets and a negative wealth effect on spending in oil importing economies. The brighter global scenario is limited in scope and is fragile, however. It does not involve fundamental changes in the factors which cause a background of low growth with exposure to many different sources of uncertainty.

The improvement in recent months is limited because the pace of global growth in the first part of 2016 will be between 2.6% and 3.0% YoY. This is more positive than the 2.5% YoY in 4Q15, but falls short of the average 3.2% for the 2011-15 period or the 4% of the decade up to 2008. Another reason for caution is the deceleration in global trade, where the growth in goods and services is at its lowest levels since the collapse at the end of 2008.

Economic outlook is fragile. For example, the Fed has warned of downside risks, confirming the weakness of the present recovery. Furthermore, the fact that the ECB, the Bank of Japan and the Bank of China are applying or are going to apply expansionary measures underlines how precarious growth is and the difficulty in achieving price stability. Economic outlook is also fragile because now there are a greater number of events of uncertainty which are significant enough to affect growth, in this "new normal" period following the 2008-09 global crisis and the 2010-11 European sovereign debt crisis.

In short, the strength of the economic global economy will continue to be shaped by financial markets which have to cope with a great variety of potential risks against the background of different economic forces consistent with anaemic growth.

Quarterly Market Update:

Q2 2016 key takeaways

Market summary: Tepid global growth gets markets off to a volatile start

Continued concerns about China's outlook and the trajectory of the global economy weighed on sentiment at the start of 2016, causing a steep drop in global risk assets during the first few weeks. Government bonds and gold benefited from the risk-off environment.

However, the tone reversed sharply mid-quarter amid the steady U.S. economy and easier global monetary policy, including the Federal Reserve (Fed) softening its rate-hiking stance. The worst performers in 2015—emerging-market equities, commodities, and non-U.S. currencies—suffered further losses in the first several weeks of 2016, before rebounding to finish with Q1 gains. We expect global economic stabilization will provide favorable support for equities, but elevated volatility is likely to continue. Inflation-resistant assets may offer protection against an upside surprise. Economy/macro: Late-cycle indicators rise in U.S., but the global economy likely to stabilize as 2016 progresses.

Global economic growth remains tepid, but we expect the global environment to be stable in 2016. China and several other emerging markets, such as Brazil, face recessionary pressures, while most of the developed world remains in a slow expansion. China's economy faces massive industrial overcapacity and an overleveraged corporate sector, but the policy emphasis on stability and fiscal stimulus makes a near-term stabilization the most likely scenario. Leading indicators of global manufacturing activity show incipient signs that global trade and industrial activity may have bottomed.

Countries that are highly dependent on commodity exports and trade with China have suffered in recent years, but they may benefit the most if China and the global economy can find their footing.

The U.S. economy faces low odds of a recession in 2016, due in large part to a healthy household sector. With labor markets continuing to tighten and inflation remaining low, U.S. consumers have enjoyed solid real (inflation-adjusted) income gains and have experienced a steady rise in future real wage expectations. The current U.S. expansion is a mix of mid- and late-cycle dynamics. Rising late-cycle indicators include tighter bank credit for businesses and emerging signs of profit margin pressures.

Global policy easing continued during Q1. The Bank of Japan and European Central Bank eased monetary conditions, although their negative policy rates did not weaken their currencies and may be an example of the limits of monetary policy. The Fed lowered its forward rate-hike guidance to be more gradual and closer to market expectations, which reduced financial pressure on China. Due to the more mature U.S. business cycle, risks in China, and uncertainty around unconventional monetary policies, we maintain an expectation of elevated market volatility. However, any stabilization in the global economy may support risk assets, and the potential for upside inflation surprises was not reflected in prices at quarter end.

4 Four Themes

1 Time to pay attention to inflation?

The economy's transition from a mid-cycle to a late-cycle phase typically involves a pickup in inflation indicators, with commodity prices and wages tending to accelerate. These rising input-cost pressures adversely affect profit margins and credit conditions. Today, wage inflation is gaining traction, but commodity inflation remains generally absent. However, oil futures are at levels that could lead to an outright decline in non-OPEC (primarily U.S.) production in 2016, since drilling new wells may not be cost effective for oil producers if prices stay low. Reduced investment in future production could, therefore, bring greater supply-demand balance, and higher prices, as the year progresses. With core inflation already firm, any stabilization in oil prices could push headline inflation higher over the course of 2016.

Late cycles have the most mixed performance of any business cycle phase, with more limited overall upside than mid-cycle phases. There is less confidence in stock performance, though stocks have typically outperformed bonds. Inflation-resistant assets, such as commodities, energy stocks, short-duration bonds, and Treasury Inflation-Protected Securities (TIPS) typically have performed well relative to other assets.

2 U.S. stocks: After initial wobble, most categories turn positive.

Stock markets got off to a rocky start in Q1, but most categories ended the quarter in positive territory. Non-cyclical sectors outperformed, with telecom, utilities, and consumer staples leading the way. Earnings expectations dropped amid concerns about growth, dollar strength, and low oil prices, but the market's muted outlook may pave an easier path to upside surprises. Companies have used more of their cash for share buybacks, a strategy often employed as investment opportunities become more limited in a maturing cycle.

A disciplined business cycle approach to sector allocation can produce active returns by favoring industries that benefit from cyclical trends. For example, the late-cycle phase has historically rewarded inflation-sensitive sectors such as energy and materials. U.S. equity valuations are somewhat above their longer-term historical averages, but are likely to sustain a level closer to the average of the past 20 years. Valuations and inflation historically have a negative relationship, but inflation has room to rise from today's low levels and still be generally supportive of higher price-earnings multiples.

4 Four Themes

3 International stocks and global assets: Emerging markets gold outperform

In a volatile quarter for risk assets, emerging-market stocks outperformed developed-market stocks. Unlike much of 2015, currency was a positive contributor, as dollar weakness provided a boost for U.S.-based investors. Gold prices benefited from the risk-off environment, and commodities recovered from weakness at the beginning of the quarter to finish roughly flat. Forward-looking corporate earnings estimates for non-U.S. stocks have fallen to more realistic levels.

This may provide potential for companies to beat expectations, particularly if currency values remain relatively stable. Non-U.S. equity valuations are attractive relative to the U.S. and to history, particularly in the peripheral eurozone countries and in emerging markets. Despite facing numerous cyclical challenges, emerging markets have favorable long-term prospects, as we expect economic growth in these countries to notably outpace that of developed countries over the next 20 years. Non-U.S. equities also provide ample opportunities for active management.

4 Bonds: Widespread gains in Q1

Interest rates dropped sharply during the first quarter, resulting in the outperformance of long-duration bonds and positive gains across every major bond sector. Most credit spreads narrowed, but they remained somewhat above their historical averages for both corporate and emerging-market debt at quarter end. High-yield investors continue to price in a default rate that implies a significant deterioration in the fundamental outlook.

While the fundamentals for high-yield companies have weakened amid energy-sector challenges and rising U.S. late-cycle indicators, they remain considerably more favorable than the overheated episodes during the 2000s. Inflation expectations remain near multi-year lows, making TIPS an attractively priced hedge against potentially higher inflation. Fixed-income strategies with designated allocations to both high-quality bonds and higher-yielding sectors: (e.g., high-yield bonds, leveraged loans, and emerging-market debt) have exhibited consistent downside protection that may make them attractive components of a diversified portfolio.