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Weekly Digest

Week ending **6 December 2015**

These days attention is never too far away from the activity of central banks. Mario Draghi, President of the European Central Bank, disappointed the markets last week not because he did nothing, but because he was deemed a little scrooge-like when it came down to adding liquidity to markets. All eyes are now on the US Federal Reserve (Fed) where markets are currently pricing a 76% chance of a rate hike in the US. This is still a reasonable amount of uncertainty given the decision is barely more than a week away. We have remarked before that a lack of inflationary pressure has been something of a gift for central bankers because it has enabled them to continue to prime the pumps to spur economic activity.

Despite the lack of immediate inflationary pressure, the Fed appears keen to put interest rates up. Indeed, were it not for the bout of market weakness in the third quarter spooking the rate decision committee, it arguably would have happened already. So, if anything, the Federal Open Market Committee (FOMC) would be keen for a tick up in inflation to help them force markets to come to terms with their view that a rate hike is necessary. There are a number of reasons postulated as to why the Fed feels the need to increase rates now. Whether it is intended as a signal to the market or whether the committee feels that failing to increase interest rates in the near future removes from them a key policy tool when the economy weakens in future. Perhaps the Fed sees a pipeline of inflationary forces that are not widely perceived today. Managing stable asset prices remains one of their two key objectives, and others in the market are starting to express a similar view. There is an increasing sense that the market is too sanguine on its inflation forecasts. The tightness of the labour market and diminishing benefits from a strong US dollar are often cited as reasons for this.

Activity is reasonable in the US now and data, such as growth in hourly earnings, has been positive since 2010 and is now increasing at its fastest rate since the crisis. Furthermore, the Federal Reserve of Atlanta's measure of 'sticky' CPI (a basket of goods that change price relatively slowly) is increasing. One key deflationary force of the past twelve months is commodity prices, especially oil, which has now been at a relatively low level for most of this year. Crude is nearly 40% down on a twelve month basis and this has a significant impact on inflation for economies that consume a large amount of oil. Looking at the US, year-on-year producer price inflation is -1.4% when including food and energy, but excluding the negative influence of these items the level increases to a still modest 0.2%. There are clearly other forces at work aside from oil. The strong dollar has placed downward pressure on imports: over the past twelve months import prices for the US have fallen by approximately 10% which corresponds with the strength of the greenback on a trade weighted basis. Consumption is key in the US, and the lowly unemployment rate (5%) combined with solid consumer and business confidence should point to increases in consumption. It is worth bearing in mind that the Fed had identified an unemployment rate of 6.5% as the threshold where they would seriously consider starting to tighten policy. Employment and consumption should create a positive impetus for inflation and should lead to consumers making purchases that they would otherwise defer in a deflationary environment. While we do not expect inflation to run away in the US there does seem to be sufficient activity and demand to create inflationary pressures that will be apparent once commodities cease falling or if the dollar's recent inexorable rise pauses.

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

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The **Marketplace**

- ECB disappoints markets
- US Fed hike increasingly likely
- US sees continued job growth
- PMI data falling in US and China
- OPEC maintains current output levels

Market **Focus**

Global

- Developed market equities fell by 0.3% last week, with emerging markets dropping by 1.7%.
- US Treasuries fell 0.2% with UK gilts declining by 0.9% in sterling terms. Emerging market bonds fell by 1.0% last week.

United States

- In the US, the Chicago Purchasing Managers' Index (PMI) fell an unexpected 7.5 points, to take the measure below 50 indicating contraction in activity. The print read 48.7 versus expectations of 54.0.
- The US Institute of Supply Management (ISM) indicator also showed contraction in the manufacturing industry, dipping below 50 for the first time since November 2012 (printing 48.6 versus expectations of 50.5)
- The US economy added 211,000 non-farming jobs in November, above consensus forecasts of a 200,000 new jobs.
- The Chair of the US Federal Reserve, Janet Yellen, testified before Congress last week. Ms Yellen cited positive growth prospects and a strengthening labour market and hinted strongly at a December interest rate rise.

Europe

- In Europe, President of the European Central Bank (ECB) Mario Draghi disappointed markets by merely announcing an extension the Bank's Quantitative Easing (QE) programme and by lowering the deposit rate by a modest 0.10 percentage points.
- Markets had expected Mr. Draghi to commit to more aggressive easing, and European equities fell by 3.2% in euro terms last week.

China

- China's November PMI number fell by 0.2 points to 49.6 (versus forecasts of 49.8), while the unofficial Caixin PMI print rose by 0.3 points to 48.6 (versus forecasts of 48.3). Both numbers continue to sit below the 50.0 level, highlighting the difficulties presently faced by Chinese manufacturing industry.

Commodities

- Commodities had another volatile week, with oil ending the period down by 4.1%. Friday's OPEC meeting resulted in no change to current output levels, despite rumours earlier in the week of a potential cut.

James Klempster, CFA & Scott Gordon

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

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Asset Class/Region	Currency	Currency returns			
		Week ending 4 Dec. 2015	Month to date	YTD 2015	12 months
Developed Market Equities					
United States	USD	0.1%	0.6%	3.0%	2.4%
United Kingdom	GBP	-2.2%	-1.9%	-2.3%	-3.8%
Continental Europe	EUR	-3.2%	-3.7%	11.8%	10.5%
Japan	JPY	-1.3%	-0.4%	13.8%	11.3%
Asia Pacific (ex Japan)	USD	-0.1%	0.6%	-9.1%	-10.3%
Australia	AUD	-1.0%	-0.3%	-0.4%	0.5%
Global	USD	-0.3%	0.0%	0.9%	-0.5%
Emerging Market Equities					
Emerging Europe	USD	-3.6%	-2.5%	-11.0%	-22.9%
Emerging Asia	USD	-1.0%	0.1%	-9.0%	-10.2%
Emerging Latin America	USD	-1.9%	1.8%	-26.7%	-29.8%
BRICs	USD	-0.7%	0.5%	-11.4%	-14.5%
MENA countries	USD	0.1%	1.0%	-12.4%	-17.3%
South Africa	USD	-6.4%	-5.5%	-21.3%	-22.3%
India	USD	-1.8%	-2.2%	-10.0%	-14.9%
Global emerging markets	USD	-1.7%	-0.2%	-13.2%	-15.7%
Bonds					
US Treasuries	USD	-0.2%	-0.2%	0.8%	1.4%
US Treasuries (inflation protected)	USD	-0.4%	-0.3%	-1.2%	-1.6%
US Corporate (investment grade)	USD	-0.1%	-0.2%	-0.1%	0.5%
US High Yield	USD	-0.1%	-0.2%	-2.2%	-2.8%
UK Gilts	GBP	-0.9%	-0.8%	1.5%	3.4%
UK Corporate (investment grade)	GBP	-0.6%	-0.6%	0.9%	2.5%
Euro Government Bonds	EUR	-1.4%	-1.3%	1.4%	2.7%
Euro Corporate (investment grade)	EUR	-0.9%	-0.8%	-0.6%	0.1%
Euro High Yield	EUR	-0.2%	-0.2%	2.7%	2.3%
Japanese Government	JPY	-0.1%	-0.1%	0.4%	1.7%
Australian Government	AUD	-0.5%	-0.5%	1.5%	3.2%
Global Government Bonds	USD	0.2%	0.4%	-3.0%	-2.9%
Global Bonds	USD	0.3%	0.5%	-3.3%	-3.6%
Global Convertible Bonds	USD	0.3%	0.4%	0.6%	-0.8%
Emerging Market Bonds	USD	-1.0%	-0.7%	2.5%	0.5%

* Estimate

Source: Bloomberg

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Asset Class/Region	Currency	Currency returns			
		Week ending 4 Dec. 2015	Month to date	YTD 2015	12 months
Property					
US Property Securities	USD	-1.1%	-0.3%	-0.7%	0.5%
Australian Property Securities	AUD	-0.6%	0.1%	6.4%	6.2%
Asia Property Securities	USD	0.3%	1.4%	1.6%	0.7%
Global Property Securities	USD	-0.5%	0.2%	-0.9%	-1.1%
Currencies					
Euro	USD	2.7%	3.0%	-10.1%	-12.1%
UK Pound Sterling	USD	0.5%	0.4%	-3.0%	-3.6%
Japanese Yen	USD	-0.3%	0.0%	-2.8%	-2.1%
Australian Dollar	USD	2.1%	1.6%	-10.2%	-12.4%
South African Rand	USD	0.2%	0.5%	-19.5%	-22.0%
Swiss Franc	USD	3.4%	3.3%	-0.2%	-2.5%
Chinese Yuan	USD	-0.1%	-0.1%	-3.0%	-3.9%
Commodities & Alternatives					
Commodities	USD	0.0%	0.1%	-22.4%	-29.1%
Agricultural Commodities	USD	2.2%	2.5%	-12.2%	-12.6%
Oil	USD	-4.1%	-3.6%	-25.0%	-38.3%
Gold	USD	2.8%	2.1%	-8.3%	-9.8%
Hedge funds	USD	-0.5%	-0.4%	-2.8%	-3.0%

* Estimate

Source: Bloomberg

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