ARTORIUS WEALTH

INVESTMENT OUTLOOK

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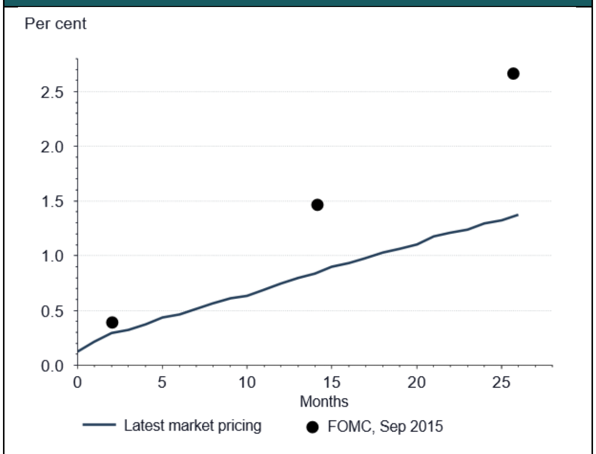
Central bank watch

Is ECB chief Mario Draghi dressed up as Santa, and Federal Reserve Chair Janet Yellen as Scrooge? Draghi is promising gifts of Christmas cheer, of the monetary kind Janet Yellen the Federal Reserve Chair, is coming over all sensible, as it looks likely that interest rates are about to be increased in the US in December.

Mind the gap

Attention in December is likely to be focussed on the Federal Reserve interest rate decision, to be announced on December 16th. The chart below highlights an interesting disconnect between the interest rate expectations from the Federal Reserve policymakers (indicated by the dots) and that discounted by the bond market (line). The Federal Reserve dots imply 100bp cumulative hikes during 2016 (Fed Funds would end the year at 1.4%) and a further 100bp tightening during 2017 (at the end of which Fed Funds would stand at 2.4%).

The bond market is pricing a slower pace of interest rate increases than expected by the Federal Reserve



Source: Artorius Wealth, Thomson Reuters

Investors currently expect a more moderate pace of interest rate increases than suggested by the Federal Reserve. The market discounts that the Fed Funds rate will be at around 85bp by December 2016. The forwards discount that in 2017 the pace of rate hikes will slow leaving policy rates just below 1.5% by December 2017.

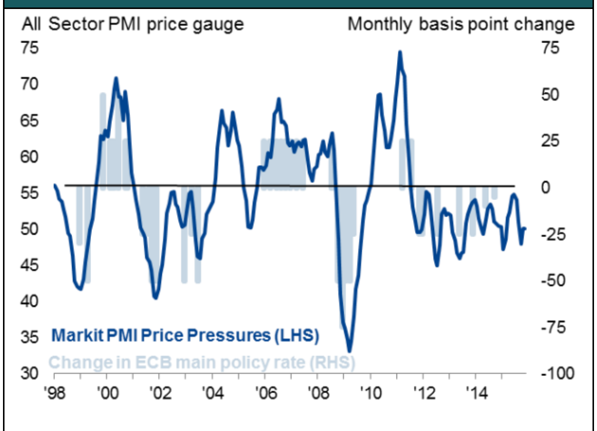
Watch their lips

Given that bond investors have discounted a rate increase in the US at the December meeting, if the Federal Reserve continue to see rates moving up faster than anticipated b y investors post the meeting update, this is likely to force a shift in investor expectations of interest rates. If investors have to price in a path of interest rates similar to that suggested by the Federal Reserve dots, this would raise the risk of higher bond yields and equity volatility. So in many ways the rate decision is probably less important than the commentary and forecasts produced at the meeting.

Meanwhile back at the ECB

Super Mario Draghi has also guided markets to expect policy moves in December in order to stave off deflation. Expectations are that the ECB will cut the deposit rate further from its current 0.2% at its December 3rd meeting and also expand its asset purchase programme beyond the current €60bn per month. Expectations around further stimulus is one of the reasons that the equity markets have risen in recent months.

Weak inflation backdrop invites the ECB to provide more stimulus



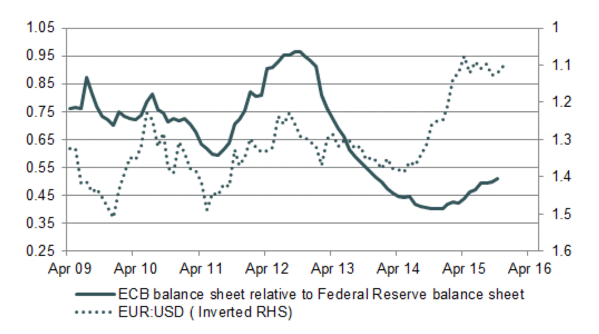
Source: Artorius Wealth, Markit

Over the past month markets have reflected the likelihood of a rise of interest rates in the US and further stimulus by the ECB as witnessed by a move higher by the US dollar.

Exchange rates driven by balance sheets

The relationship between the relative sizes of balance sheets has been associated with currency moves since 2009. In periods of ECB shrinking its balance sheet relative to the Federal Reserve, the Euro strengthened, and vice versa. Similar relationships can be found between the Yen and the major currencies.

ECB / Federal Reserve balance sheet changes and Euro US Dollar exchange rate



Source: Artorius Wealth, Thomson Reuters

The policy mix of the ECB easing monetary policy and the Federal Reserve seeking to raise rates in December 2015 favours further US dollar strength versus the Euro, over the near term. Sterling is left trapped between the two currencies, moving lower against the US dollar and higher vs the Euro.

Equity and bond markets

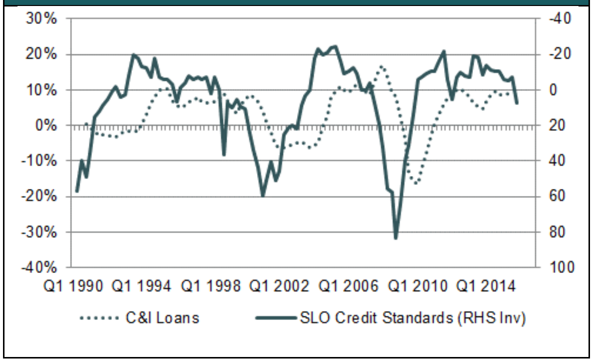
The US equity market appears fully valued, suffering downgrades to earnings, a slower economy and higher interest rates. In addition the progress in the US equity market has been driven be a relatively small number of large cap names. This narrow nature of the rally typically indicates that the investor community is losing confidence in further positive progress.

In addition, signals from the lending environment in the US suggest that the economic backdrop is likely to become more lacklustre. With greater uncertainty, we reduced our exposure to US equities, via selling of US small cap exposure as it is typically this sector of the US equity market underperforms when credit conditions worsen and when US interest rates increase.

The Federal Reserve Senior Loan Officer (SLO) Survey provides insight around the factors that influence credit lending, such as when lending standards are tightening (indicated by an SLO Survey score of greater than zero), it signals that credit conditions are worsening and the environment is becoming more restrictive. Typically, this slows investment and employment growth in the US which leads to periods of underperformance from risk assets such as equities and high yield bonds.

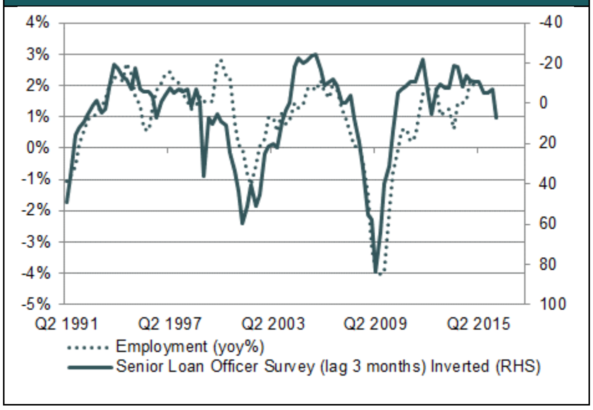
The charts below shows that there is an inverse relationship between lending and employment growth in the US and the SLO Survey score.

The SLO Survey points to a weaker credit backdrop in the US



Source: Artorius Wealth, Thomson Reuters

The SLO Survey points to slower US employment growth



Source: Artorius Wealth, Thomson Reuters

In the near term policy activity is likely to drive markets. For 2016, full valuations dampen enthusiasm for equities, and US interest rate increases puts upward pressure on bond yields.

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