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2016 Mid-Year Outlook – Monetary Policy On Normalization Path

Living in a world of uncertainty

We firmly believe that the world will continue to be driven by macro rather than micro factors. Consequently, geopolitics, security, and macroeconomic issues will require close attention.

We will also have to differentiate very carefully between uncertainties, risks, and opportunities. For instance, Brexit is a major ongoing uncertainty and complication for everybody – for some a risk, for some an opportunity, and for some less relevant.

Fed to hike rates soon

In a nutshell

"Our conclusion is that policy normalization should be welcomed. That normalization might generate some volatility in the short term, but would help contain risks in the longer term." (Jaime Caruana, General Manager, BIS, Basel, June 28, 2015).

This policy normalization has been postponed due to anemic global growth, sub-par inflation, disruptions in developing economies, and a negative geopolitical backdrop. Due mainly to US domestic considerations, and in the absence of further significant troubles in the world, we think the Fed will hike rates sooner rather than later in H2 2016.

This would have an almost immediate global effect via traditionally high correlations, but would also ease the unsustainably painful situation of negative interest rates. Complacent investors would be caught by surprise, leading to significantly heightened volatility in the short term, and a negative adjustment for large parts of the capital markets.

Equities remain the asset class of choice

In 2015, the Bank of England's Andy Haldani said global interest rates were "lower than at any time in the past 5000 years". Fixed-income markets are in many ways being massively distorted by unconventional monetary policies and yield-hungry institutional investors.

In the event of any interest rate hikes, cash will beat equities in the short run. Over the medium to long term, however, equities will continue to offer by far the best risk/return characteristics of any asset class. High-quality companies in the industrialized markets look the most attractive, as do value plays in the slowly but steadily recovering emerging markets.

Populists on the march

We expect to see a continuation of the nationalist and populist wave, with their anti-trade and anti-immigration politics. That said, rather than populists winning elections and gaining parliamentary majorities, we think it is more likely that mainstream parties will adopt the corresponding policies.

Just think of the Green parties 20 years ago. None of them has ever run a country, but they have nevertheless made lasting impacts in many ways. In 2016 and 2017, we will have elections and

referendums in the US, Italy, France, and Germany, and therefore plenty of scope for news, noise, surprises, and uncertainty.

Volatility creates unique opportunities

Trust, confidence, and sentiment remain driven by news and noise to a remarkable extent. Investors would be well advised to focus more on the underlying political realities and monetary, economic, and corporate fundamentals and dynamics.

Capital markets are mean reverting from fear to greed, and vice versa, and in that there is nothing new. The huge performance and valuation disparities offer a rich field for active investors, be it in the real economy or in capital markets.

The European financial sector stands out in this respect. It is still only half way through a lost decade, but nonetheless offers selected opportunities of generational proportions driven by revaluation, the normalization of financial conditions, and unprecedented technological and regulatory developments

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If you would like more information or would like to discuss this in more detail, please don't hesitate to contact us.

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