For Real or Just Noise?

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- **Markets see room for US inflation to rise providing a challenge for bonds**
- **Equities to take some heart that corporate profit forecasts could rise**
- **Scope for equities to outperform bonds in the short term**
- **Sterling's sharp drop is maybe unwarranted but reflects genuine concern about a hard Brexit**
- **Gold close to an excellent buying opportunity**

While markets were generally on a weaker footing last week, there was a great deal going on. The difficulty is to work out what is a really a new trend and what is just noise around still a difficult path for the global economy.

As we wrote last week, the bond market is starting to anticipate more inflation. The 5-year break even in the US is pricing an inflation rate of 1.54% compared to 1.27% at the start of September. In the UK the fall in the value of Sterling has boosted break-evens to 3.0% from 2.55% a few weeks ago. The Citigroup Economic Surprise Index is showing that while inflation data is still coming in below expectations, the degree to which it is missing estimates is the lowest since 2012. To be sure Japan and the eurozone still seem marooned in very low inflation. However, the more robust oil price will at the very least have taken away some the downside risk to inflation.

The better flow of global economic news has reinforced the perception that the downside risk of global inflation has abated. Indeed it was quite telling that the IMF made only modest cuts to their global GDP report last week. The reason that the IMF only made a minor cut to their current year growth forecasts this week is that global economic data has been far from disastrous in recent months.

But can we believe the news flow? Is this just another false dawn of better times? To us, it certainly feels that some of the downside risks have abated. However, we get no sense that the direction of travel has changed. The global economy still faces significant challenges of ageing populations, poor productivity and investment spending leading to perennially weak growth in the western economies and a build-up of enormous amounts of debt. The history of the Japanese asset markets is that even in the midst of a structural slide in their economy, asset markets can still give significant short-term returns. Buy and hold investors must remain cautious in their investment mix, traders may have a little more to play with.

We do not change our medium-term view that the global economy still has its problems. Indeed the IMF global outlook report released this week while only reducing global growth modestly, still highlighted that there are significant challenges ahead. In fact, the best news from the report is that there was no significant downgrade to their projection for global growth. For the IMF one of the key challenges for the global economy is the unprecedented amount of global debt, some $152 trillion equating to 225% of global GDP. As the IMF reflects this mountain of debt has been accumulated at a time when the ability of individuals and companies to repay their debts is impaired by low inflation and little or no income growth.

A little more inflation will help equities to maintain if not extend some of the gains they have made in recent weeks. However for it to really have a stronger impact would need the healthier levels of inflation to manifest themselves in upgrades to corporate profit forecasts. If there was a sharp rise in government bond yields equities could be challenged. The US 10-year has moved to the top end of its three-month trading range, but for the moment there doesn't appear to be sufficient momentum for yields to press on to 2%.

Bonds will also be somewhat fearful that central banks appear to be taking more a back seat regarding supporting global growth. The Fed looks minded to raising rates before the end of the year. The Bank of Japan has in the last month backed off doing anything remarkably positive. And in the past week, some commentators raised the prospect of ECB tapering their quantitative easing.

The Fed still looks determined to raise rates by year-end. The market is now discounting a higher probability of a December rate rise. The market pricing climbed to 67% compared to 59% a week earlier. We wouldn't completely write-off a November rate rise.

Our argument would run that the Fed may prefer to raise rates ahead of the election for fear that the election result could generate some volatility in the market that might then compromise a decision to raise rates in December.

The big news of the past week was the drop in Sterling by 6.1% in Asian trading on Friday morning for reasons that still are unclear. At one stage it traded as low as $1.1819, the lowest level since 1985. In most recent trading it has recovered to around $1.24. The suspicion was that there was a 'fat finger' trade, but the scale of the volumes around the move and the continuity of the market suggest that there may have been other factors at work.

Sterling has traded with more downside risk in the past week due to more talk that there could be a 'hard' leaving the EU by the UK. Hence the UK might cut more ties with the EU than was previously thought. In a sense, the markets were probably being complacent about the likely level of engagement between the UK and the EU in the future. There was even talk that the UK would not go through with leaving the EU. However, at the Conservative party conference which ended last week, the Prime Minister made it very clear that the UK would leave the EU and that it would reverse many of the laws that the EU had imposed on the UK, thus making the UK's exit more emphatic than was previously thought.

Assessing where fair value is for sterling in the current environment remains hazardous. Before Brexit, the assumed fair value for sterling was around $1.55. Clearly, an exit from the EU puts downside risks on that number to say $1.40-45 but any way you look at it the UK pound does look fundamentally cheap at current levels.

However, currencies spend the little time at fair value and history is littered with examples of currencies that traded significantly well away from fair value for extended periods of time. Traders will also be mindful of the $1.0520 level that Sterling reached in 1985.

Bear positions were already well established in the market with very sizeable net positions in sterling-dollar. One assumes there will be some covering/profit taking of those positions in the coming days which will provide some support for sterling.

The medium term trading of sterling will be dominated by industries' perception of whether the UK will retain sufficient access to the EU markets to warrant companies growing or indeed maintaining their investment in the UK. The UK is vulnerable to a reversal of foreign capital flows which helps to offset the very sizeable UK trade deficit. In the second quarter, the current account deficit hit £28.7 billion 5.9% of GDP.

Sterling has settled into new the trading range of $1.20 - $1.25. It is likely to continue to trade weakly as the market absorbs the shock of last week's trading.

As deflation worries abated and the dollar strengthened, gold came under pressure breaking technical supports. We see the sharp fall as noise rather than presaging a fundamental change of direction. The world still has its problems, and there remain considerable challenges in the future. **We see gold weakness as a buying opportunity.** The technicals suggest we could see a fall back to $1,215 before the sell-off is complete, representing a 50% retracement from the previous high. Anywhere below $1,230 provides a long-term buying opportunity.

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