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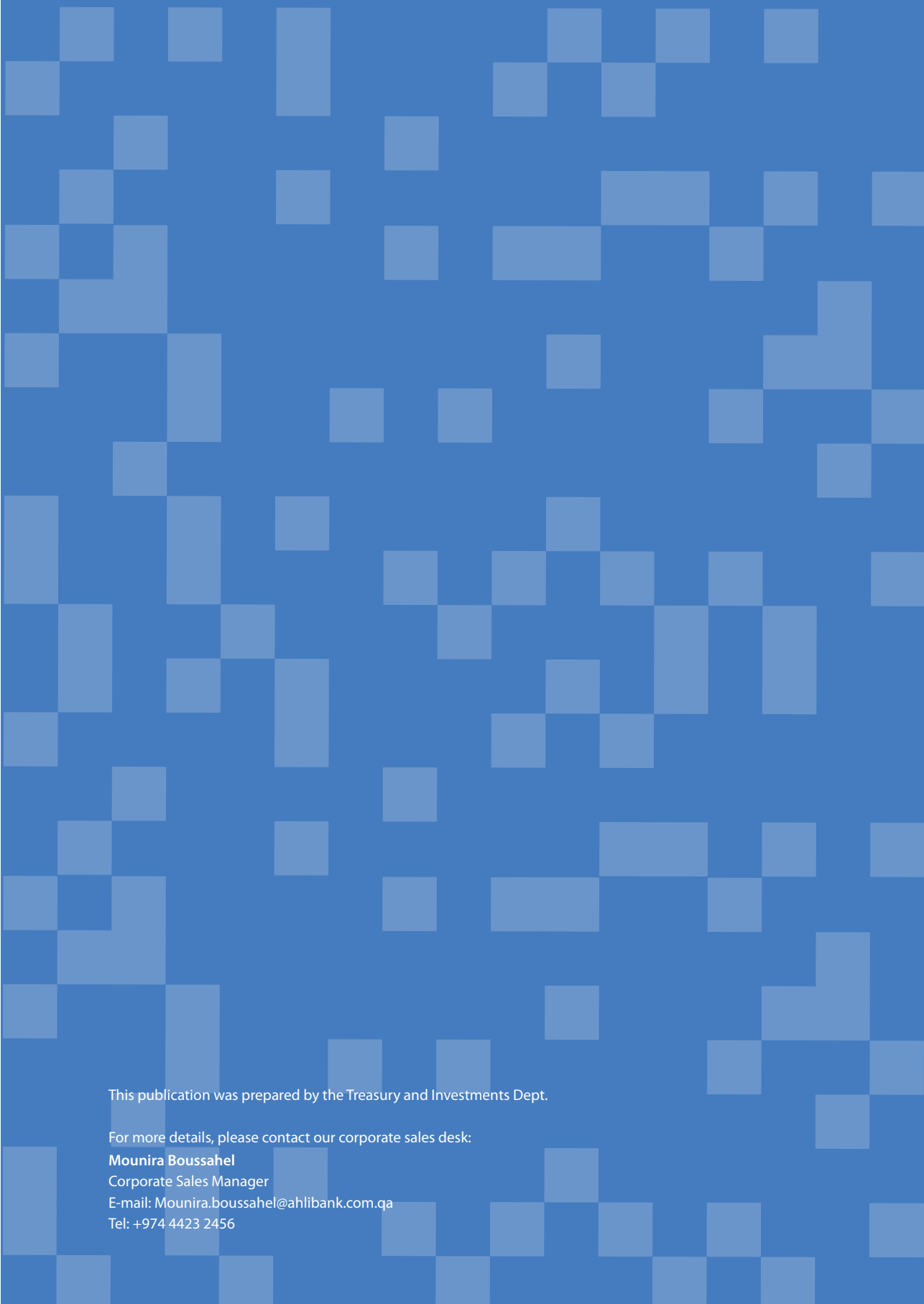
Global Economic and Currency Outlook 2016 First-Half Review



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Global Economic Outlook 2016 First Half Review

At the beginning of this year our economic review of 2015 noted that the previous twelve months had seen a return to economic fundamentals rather than financial market speculation. Unfortunately, the first half of 2016 began with significant volatility in global markets and investors started the New Year ignoring economic fundamentals.

The biggest political and economic event of this year so far has been the referendum held in the United Kingdom in June over future membership of the European Union, where voters decided by 52pct to 48pct that the country should leave the EU. We will discuss this further in this report.

Economically we have seen very little new information on the health of other major trading nations. The US economy continues to lead global growth amongst the G7 nations, and the Federal Reserve remains indecisive on the timing of further interest rate rises.

Equity markets have remained resilient despite significant volatility resulting in sharp declines of over 10pct in the first few weeks of the year. Stock markets will remain risky areas of activity for investors, but if global GDP continues its slow recovery the long-term outlook should remain positive.

The surprising performer in 2016 has been the commodity markets, with precious metals experiencing the most significant gains. Boosted by global investors moving into the safe haven of Gold during volatile markets, the precious metal has rallied over 20pct in the first six months of this year. Oil prices have also recovered, aided by the reduction in shale gas producers in the US, with Brent Crude rising from a low of $27 in January to close to $49 at the end of June, a near doubling in the value of a barrel.

US Economic Outlook First Half Review

Figures released in Q1 showed the US economy grew by 1.10pct, slightly below economists' expectations. Weighed down by the reduction in domestic oil production and revenue, and the ongoing sluggish economic performance of other major trading nations, growth was lower than expected. US unemployment has continued to fall, with the latest data showing a rate of just 4.85pct, against a rate of 5.5pct in 2015 and as high as 7.5pct in 2013.

US equity markets have held up well over the first half of the year, with the Dow Jones closing at 17,929 on the 30th June, a rise of 2.8pct compared with December 2015. The Dow did see a low of 15,660 in February during the volatile early weeks of 2016, making the 2.8pct gain an impressive result.

With the US economy continuing its path of slow but steady growth, investors have been focusing on two key issues: the upcoming Presidential election later this year, and the interest rate decisions of the Federal Reserve Open Market Committee (FOMC).

Since the FOMC decided to raise US interest rates by 25bp in December 2015, investor attention has turned to the timing of the committee's next move. Speculation mounted over the first half of the year, with some market commentators calling for a rise of 25bp in interest rates in June this year, and others expecting September.

With the UK referendum vote being held the day after the June meeting, the FOMC chose to adopt a 'wait and see' policy on future interest rate movements. The UK referendum decision has had, and will have, significant global implications, and a cautious approach from any central bank in this uncertain economic climate would appear to be prudent.

The 'wait and see' policy of the FOMC has now raised doubts over the possibility of a rise in official US interest rates in September, and the general market consensus is that December is the most likely date for the next move. The timing would be beneficial to the Federal Reserve as it would occur after the Presidential elections, and therefore allow the Federal Reserve to avoid any political accusations of an inappropriately-timed decision.

Both political parties have now chosen their candidates for the Presidential election to be held in November, with the Democrats electing Senator Hillary Clinton and the Republican Party choosing the businessman Donald Trump.

With both candidates running such diverse election campaigns the impact on financial markets could be significant. It should be noted that if either party fails to obtain control of both the House of Representatives and Congress, then the ability to pass through legislation might be severely hampered due to political disagreements in both legislative houses.

Senator Hillary Clinton has been a key figure in President Obama's two terms in office, and is likely to represent a 'business as usual' candidate from the financial markets' viewpoint. Donald Trump, though a well-known figure in the US, has never before run for political office and therefore represents an 'untried and unknown' figure in the world of politics. For this reason, any success by Mr Trump will be treated with 'uncertainty' by the markets and could trigger volatility into the year-end, in what has already been a turbulent year for global markets.

As in previous years, we continue to maintain a positive outlook for the US economy for the rest of the year, and though the performance of equity markets disappointed last year, they may prove to be the surprise area for a strong performance in 2016. The key focus for investors will be the US presidential election, with President Obama's time in the White House coming to an end.

United Kingdom – EU referendum result and its future impact

In June the United Kingdom became the latest country to hold a referendum regarding their ongoing membership of the European Union. Unlike other smaller countries, the United Kingdom voted by 52% to 48% in favour of leaving the European Union.

As the fifth largest trading nation globally the result caused shockwaves around the political world. Ahead of the referendum we saw comments from major central banks, most notably the Federal Reserve and the Bank of Japan, referring to the upcoming vote as a contributing factor on them both maintaining an 'unchanged' decision on their respective monetary policies.

Financial markets took the result negatively and sterling weakened significantly against other major currencies, most noticeably against the US dollar where it hit a 31-year low. The rating agencies also reacted quickly to the result, with all three major agencies downgrading the UK Sovereign rating, and the United Kingdom has become the latest country to lose its prestigious 'AAA' rating.

Before any future action can be taken to separate the United Kingdom from the European Union the UK must invoke Article 50 of the Lisbon Treaty, which is effectively a two-year notice period.

As we look ahead to the potential impact of the referendum on future economic performance of the UK we should look objectively and ignore current speculation in the media. It is true that the result has created and will continue to create uncertainty in the financial markets, however this is true of any forecasting of the future? Do we not already have 'uncertainty' when we look at possible future decisions from the FED on US interest rate movements, for example?

From a day-to-day perspective, UK residents will see very little change to their lives. Many thousands of small, relatively minor, EU-UK agreements will be 'repatriated' back to the management of the UK Government directly during the two-year notice period.

We will see the UK Government and other nations begin to discuss, and establish, their own bi-lateral trade agreements. We do not expect the US, China or Japan to stop trading with the United Kingdom as a result of the referendum outcome. All major trading nations are members of the 'World Trade Organisation' (WTO) and this will surely form the basis for many future agreements. The same principles will also apply for European nations, both France and Germany have extremely close economic ties with the UK and this will continue long after the UK has left the European Union. Additionally, the recent fall in the value of sterling will also make UK exports more competitive.

To conclude, in the long term we do not see any significant impact on the UK from its recent referendum result. We do see changes to the economic relationships held by the UK, and the way trade is conducted in the future, but it is only change and not the breaking of an economic trading nation.

In the short term, we will continue to see volatility in the financial markets as the impact of the decision develops over time, but we have already seen the UK equity market return to normal trading patterns with little negative impact on valuations. A new government led by Prime Minister Theresa May will begin the Brexit negotiations in earnest.

European Economic Outlook

We began the new year with a neutral outlook for the European economy, and for the first five months of 2016 we saw muted economic growth and a further cut in European interest rates by the European Central Bank (ECB) in March. The ECB Refinancing Rate is now at zero pct, and the deposit rate is at -0.30pct.

The UK referendum has now created political uncertainty within Europe, as member nations await the EU negotiating as a block with the United Kingdom. The short-term concerns will have a negative impact on consumer sentiment, as seen by the immediate fall in European equities following the referendum, until the political situation becomes clearer, and we would expect to see economic growth remain subdued for the remainder of 2016.

We also believe that the UK referendum result will create further political instability on the continent, with more anti-EU political parties becoming emboldened by the UK result within their own country, perhaps resulting in further withdrawal referendums in member nations.

Therefore, we are downgrading our economic outlook for Europe to mildly negative as the political uncertainty created by the UK referendum hinders economic growth within Europe in the short term.

GCC Region Economic Outlook

Despite GCC nations having historically used an ultra-low level for the price of a barrel of crude oil in their budgetary forecasts, the decline in the price of the commodity last year was far greater than expected.

2016 has seen regional governments seek to bolster their liquidity by sourcing funds from the international loan market, despite the recovery in oil prices seen in the last six months. Every GCC member nation except for Kuwait has raised funds this way, with Saudi Arabia and Qatar borrowing billions of US Dollars from the international markets. With global interest rates so low it is prudent to borrow cheap money rather than seek to unwind international investments. We continue to see regional governments source alternative revenue streams as they begin the slow process of diversifying their economies away from the reliance on oil.

Earlier this year Saudi Arabia announced their first ever long-term development plan with the aim of generating up to 20pct of their annual revenue from non-oil derived sources by 2030. A significant target to aim for, but one that is necessary in the long term for the health of the nation. Our negative outlook for the country in 2016 remains unchanged, but as oil prices continue to show signs of recovery we feel 2017-18 could see balanced budgets return to the country if oil returns to the $65-70brl range.

In the UAE we have seen Abu Dhabi source long-term funding from the financial markets this year as the economic reality of lower oil prices drives regional governments towards more balanced budgets. The remaining six smaller emirates continue to rely on financial assistance from the capital as has historically been the case. With a decline in sales and valuations in the residential property market this year in Dubai, it is speculated that the emirate might be driven to seek additional external funding from the financial markets. We remain neutral in our outlook for the UAE for the remainder of 2016, as we await to see how the fall in the property market impacts other sectors in the country.

As in previous years, Bahrain and Oman continue to struggle for economic growth without the assistance of their wealthier neighbours. This struggle was only intensified in 2015 as revenues across the region fell sharply. We remain negative in our investment outlook for Bahrain and Oman in 2016. We also add Kuwait to our negative outlook, as the planned growth in government projects failed to materialise as they become mired in political stalemate. The effect on Kuwait of the fall in oil revenues leads us to believe that there are better areas for investment within the region.

Overall though, we are maintaining our neutral outlook for the GCC region as a whole, despite the recovery in oil prices in recent months, as budgetary imbalances need to be addressed.

Qatar Economic Outlook First Half Review

This year we have begun to see Qatar seek to raise additional domestic revenues by reducing subsidies on various services. The most notable change has been in the price of petrol, and electricity and water. From an economic viewpoint the decisions were one of the many steps a government can undertake to assist in the diversification of its revenue streams.

The non-hydrocarbon sector is responsible for 20pct of government revenues which affords Qatar a long-term buffer against dips in commodity prices, but this is external revenue and the government is wisely acting to increase domestic revenue by reducing overly-generous subsidies.

The reduction in the population, as reported by the Ministry of Planning and Statistics, is an inevitable consequence of an economy adjusting to lower government revenues. This should be viewed within the bigger picture of companies having to become more efficient in their operations, which again is beneficial for the long-term health of both public and private sector companies.

The government continues to implement the Qatar National Vision 2030 created under the guidance and leadership of HH The Father Emir, Sheikh Hamad Bin Khalifa Al-Thani and continued by HH The Emir, Sheikh Tamim Bin Hamad Al-Thani, but with no new infrastructure projects expected in the next 6-12 months, investment opportunities in Qatar will likely have to be focused on the private sector.

Local banks remain committed to supporting the development of the country, and with the stable interest rate environment we continue to see healthy demand for funding from the private sector.

Qatar remains our preferred investment destination within the GCC region.

Currency Outlook for 2016 First Half Review

2015 was a year dominated by dollar strength, and the pro-active weakening of currencies by many governments around the world who sought to stem their own economic declines and use currency manipulation to limit their budgetary shortfalls.

It was a second consecutive year of strength for the US dollar and our thoughts and expectations for the remainder of 2016 are outlined below:

USD/JPY
(2016 range: 100.54 – 121.14; currently 104.60)

The new year began with forecasters expecting a continued weakening of the yen towards 135.00 against the US dollar. How wrong they were, and us, with the Japanese currency having strengthened almost continuously since early February.

The yen has benefitted from a market overly expectant of a weaker currency, and any time there is a market imbalance of such size any correction will be sharper, and more painful, than the original currency move. In recent weeks the yen has also become a safe haven currency ahead of the EU referendum vote in the UK, and by the end of June the currency finished the half year at 103.00 against the dollar, an appreciation of 14pct.

Looking ahead, we have to reassess our goals for the remainder of 2016. The appreciation of the yen will have a significant negative impact for Japanese exporters, though talk of further domestic economic stimulus will do little to boost the fortunes of the country.

For the remainder of 2016 we are forecasting a range of 98.00 – 110.00 for the yen against the dollar. Any move below the psychological 100 level should be short-lived, and any move towards 110, or above, is unlikely to change investor attitudes of playing it safe for the next six months.

USD/CHF
(2016 range: 0.9536 - 1.0231; currently 0.9850)

Our initial forecast of 0.90-1.10 for the Swiss franc against the dollar has held well, and, as expected, volatility in this currency pair has reduced from previous years.

The primary focus for investors will be the rate for the currency against the euro, for which we forecast a 2016 range of 1.02-1.12 (2016 range 1.0788 – 1.1154). With the single currency seeing little impact after the EU referendum in the UK we see few economic hurdles to weaken the euro significantly for the remainder of the year, and consequently we are narrowing our euro/Swiss franc range for H2 to 1.07-1.12.

USD/CAD
(2016 range: 1.2530 - 1.4579; currently 1.3040)

AUD/USD
(2016 range: 0.6864 - 0.7813; currently 0.7625)

The volatility seen in the currency markets at the beginning of the year helped weaken the Canadian dollar to a multi-year low of 1.4579 against the US dollar, and slightly above our forecast cap of 1.4200.

The resulting correction, again the function of an over-extended market, saw the Canadian dollar reverse the early weakening and rally to 1.2500, a swing of 12pct, a major correction in modern markets and particularly for this currency pair.

For the remainder of 2016 we are unlikely to retest the 1.4000 level as speculators have achieved their short-term goals. We now target a range of 1.2500 – 1.3500 for H2, 2016.

The Australian dollar was particularly hurt by the fall in commodity prices during H2 2015 and in the first quarter of this year. Though oil and gas prices have recovered from their recent lows both commodities' prices are a long way from generating a budget surplus for the country.

For 2016 we forecasted a range for the Australian dollar of 0.6600-0.7700, with sub-70 bringing the currency back towards fair-value in the eyes of investors. A slight extension to 0.7813 was seen, but the sharp reversals in other currency markets impacted on the currency which soon slipped back against the dollar.

With commodity prices slowly recovering we feel the currency will rebound too, and therefore are raising our forecast for the remainder of 2016 to 0.6950 – 0.7850 but any approach towards the psychological 0.8000 barrier will be tough to maintain.

GBP/USD
(2016 range: 1.2800 - 1.5776; currently 1.3260)

The UK took centre stage during the first half of the year with investors focusing on the EU referendum held in June. The surprise result to leave the European Union, as discussed earlier, triggered the largest one-day fall for the currency in history and a 35-year low against the US dollar.

At the beginning of the year we forecast a range of 1.4300 -1.5600, which has proven to be optimistic, as the currency failed to break back above the psychological 1.5000 level. Many market commentators have now turned pessimistic for sterling, forecasting a lower target level around 1.2500 later this year.

As mentioned earlier we do not see the EU referendum result as negatively as many others do, and we are beginning to see early signs of the currency recovering. For the remainder of 2016 we are amending our forecast to 1.2700 – 1.4100, as we believe any dip below 1.3000 will be short-lived and a time when we will see longer-term investors look to buy the perceived 'cheap' currency.

And finally, the Euro

(2016 range: 1.0748 - 1.1534; currently 1.1075)

The lack of positive economic data continues to weigh on the single currency despite the relatively calm political environment, and with the US economy expected to see GDP growth of 2.5% in 2016 and the Federal Reserve raising interest rates, the dollar is in the ascendancy.

However, the reluctance of the FOMC to raise US interest rates too quickly has helped to stabilise the single currency, however the cut in EU interest rates earlier this year to stimulate domestic growth was hardly currency positive.

We started 2016 forecasting a range of 1.01-1.14 for the single currency against the US dollar, though it now appears that our negativity was misplaced as other countries took investor focus elsewhere. For the remainder of the year we again feel investor focus will be drawn elsewhere and the single currency should see a relatively calm H2, and we are now forecasting a range of 1.0800-1.1600 for the next six months.

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