THOMAS MILLER INVESTMENT

Investment Commentary

NOVEMBER 2014

Economic Backdrop

Over the last month, we have seen a continuation of the divergence in the pace of economic growth across the globe.

Specifically, while the US and UK economies continue to post robust growth rates, the major emerging economies have slowed and the Euro Area has stagnated.

In the US, initial estimates from the Bureau of Economic Analysis showed that real GDP increased at an annual rate of 3.5% in the third quarter of 2014. That followed an increase of 4.6% in the second quarter, and marked the best back-to-back gains in US real GDP since 2003. The US labour market has also shown rapid improvement over the past year, with the unemployment rate now at its lowest level since 2008.

In the UK, the pace of growth remains robust even though it has moderated in recent weeks. The recent slowdown in growth momentum has been evident across a number of sectors. For instance, indicators such as ISM Non-Manufacturing have highlighted a slowdown in the services sector. Likewise, various housing market indicators have also pointed to a loss of momentum in that sector. Along with the weakness in the Euro Area (a key trading partner of the UK), these recent developments led the Bank of England to lower its forecast for UK growth in 2015 and 2016. However the revised forecasts, presented alongside the November Inflation Report, still show above-trend growth rate projections of 3.5%, 2.9% and 2.6% for 2014, 2015 and 2016 respectively.

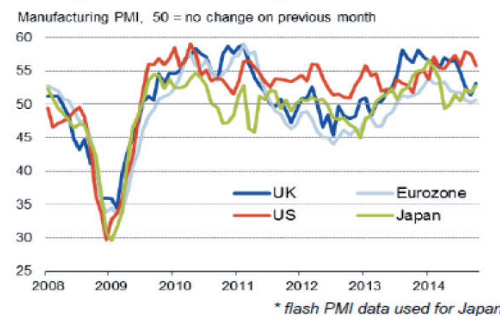
In the US as in the UK, the recovery in the labour market is tainted by the persistent weakness in the pace of wage growth. In terms of financial market implications, weak wage growth has put a lid on inflationary pressures and contributed to a more dovish monetary policy outlook on both sides of the Atlantic. This has boosted asset prices. In contrast to the benign financial market effect, weak wage growth has fuelled popular discontent on both sides of the Atlantic. Indeed, recent polls show that it was a significant contributor to the success of the Republicans in gaining control of US Congress for the first time since 2006.

"In the absence of a marked deviation from current policy, it is increasingly difficult to see how the Euro Area will snap out of its current stupor."

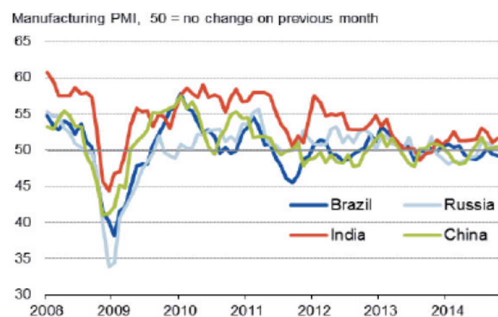
The Euro Area remains the stand-out laggard. Recent indicators continue to flag that the region is stuck in a rut with a moribund economy, weakening business surveys, contracting bank lending, severe levels of unemployment and ongoing risk of outright deflation. Unfortunately, the ECB lacks the political capital to take the big decisions required to mitigate the downside risks facing the region. During the press conference that followed the central bank's meeting in November, its president, Mario Draghi, again asserted that the ECB was prepared to take more policy action if necessary. For investors, the obvious question is 'how bad do things need to get before the Governing Council realises that such action is already necessary'? In the absence of a marked deviation from current policy, it is increasingly difficult to see how the Euro Area will snap out of its current stupor.

Chart 1 – PMI Surveys

Sources: Markit, JPMorgan, HSBC, Ecowin.



** flash PMI data used for Japan*



Source: Markit Reports

Financial market review & asset allocation summary

October has historically been a particularly volatile month for equity markets and this year was no different. In the US, the S&P 500 index had its widest intra-month trading range in three years. The index ended the month at an all-time new high of 2018 despite having traded almost 200 points lower at 1821 around mid-month. Likewise, in Europe, the Stoxx600 index had its widest intra-month trading range since August 2011. The spike in volatility was not limited to equities. In the fixed income markets, US Treasuries experienced what can only be described as a ‘flash rally’ in mid-October, with atypically sharp intra-day moves.

In September’s report, we noted that “seasonal tendencies would suggest that the elevated level of volatility should persist through the middle of the fourth quarter.” In this regard, markets continue to play out as expected. The market turbulence was largely driven by concerns about the outlook for global economic growth. These fears were exacerbated by geopolitical crisis in the Middle East, ongoing tensions in Ukraine and unease about the spread of Ebola to the US (Texas).

The extent to which markets remain dependent on central bank stimulus was laid bare during the second half of October. This is because the turnaround in equity markets was triggered by a combination of central bank responses. In the US, a number of Fed officials (most notably James Bullard, president of the St Louis Fed) talked about the scope for the US central bank to delay the end of quantitative easing in order to combat declining inflation expectations (in the end, the Federal Reserve stopped buying bonds in October). Also, at the end of October, the Bank of Japan surprised the markets by ramping up its asset purchase programme. In an open ended commitment, the Japanese central bank announced that it will increase its balance sheet by 15 percent of GDP per annum and will extend the average duration of its bond purchases from 7 years to 10 years.

From an asset allocation and investment strategy perspective, the market events of the past month have not altered our views. We continue to favour risk assets (in selected regions) in pursuit of superior risk-adjusted returns for our clients. Afterall, despite the recent bout of volatility, equity markets (on the whole, but with some notable exceptions) are currently trading at higher levels than before the spike in volatility began. Likewise, in line with our views on the fixed income markets, the benign backdrop for bonds persists and bond yields remain anchored at low levels. We expect this pattern of returns to continue for some time. So, while government bonds offer little value from a long term investment perspective, the combination of modest global economic growth and benign inflation mean that a sharp rise in bond yields (and decline in capital values) is unlikely in the shorter term. The issue is therefore not so much that bonds will lose capital values in the shorter term but rather that any upside is quite limited in the longer term. As for equities, monetary policy has become more supportive in recent weeks and the latest round of earnings reports again confirmed that corporate earnings remain robust.

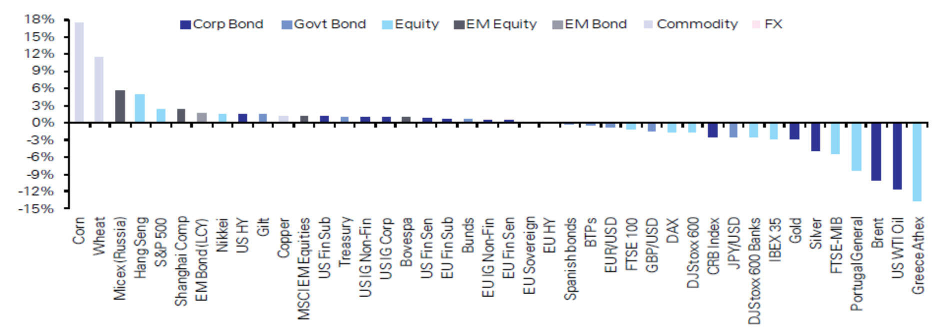
> **“We continue to favour risk assets (in selected regions) in pursuit of superior risk-adjusted returns for our clients.”**

On balance, therefore, a bias in favour of risk assets, including equities and a selected range of alternative investments, such as infrastructure and private equity, remains appropriate for all but the most conservative investors.

Abi Oladimeji
Director,
Head of Investment Strategy

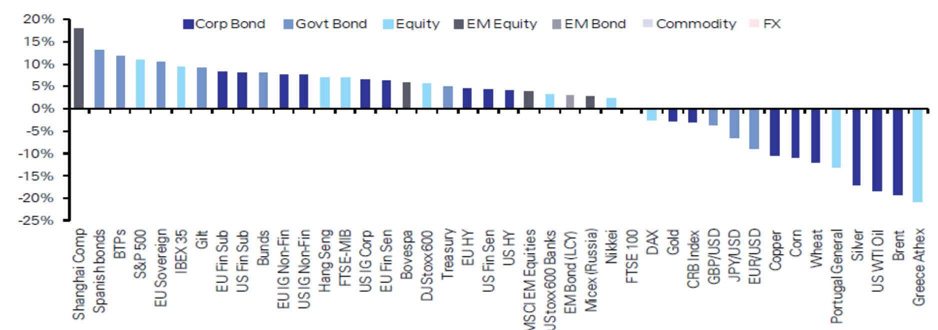
Chart 2 - Financial Market Performance

Figure 1: Total Return Performance of Major Global Financial Assets – October 2014 (local currency)



Source: Deutsche Bank, Markit, Bloomberg Finance LP

Figure 2: Total Return Performance of Major Global Financial Assets – YTD 2014 (local currency)



Source: Deutsche Bank, Bloomberg Finance LLP, Markit

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD

	United States	Euro-Zone ex Germany	Germany	United Kingdom	Japan	Emerging Markets
Equities (overall)	+					
Equity allocation by region	+	0	0	+	+	+
Bonds (overall)	-					
Corporate bonds	0	0	0	0	0	0
High Yield bonds	0	0	0	0	0	0
Govt guaranteed bonds	+	0	0	+	0	0
Index-linked bonds	0	0	0	0	0	0
Alternatives	0					

The scorecard above represents our current tactical asset allocation position relative to portfolio benchmark. 0 =neutral, + =overweight, - =underweight.

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