THOMAS MILLER INVESTMENT

Investment Commentary

April 2019

Recent economic developments

■ Continuing the trend of weakening economic growth, the latest estimate of US real gross domestic product (GDP) for the last quarter of 2018 was revised lower than expected. The updated estimate showed that real GDP increased at an annual rate of 2.2% (from an initial estimate of 2.6%). This was also notably below the growth rate of 3.4% recorded for the previous quarter. Figure 1 illustrates the progressive decline in growth rates since the peak in the second quarter of 2018.

■ On a positive note, despite the weakness in the fourth quarter, the US economy still performed strongly over the course of 2018. Over the full year, the US economy expanded by 2.9%, the most since 2015. Nevertheless, the underlying data raises some concerns. For instance, in December US consumer spending dropped by the most since 2009. Then personal income fell for the first time in more than three years in January 2019. More recent economic releases have provided further evidence of waning growth momentum. In February, factory orders dropped to the lowest point in over two years while retail sales came in well below forecasts. Overall, the data suggests that the economy has lost speed as the stimulus from the $1.5 trillion tax cut package and increased government spending has faded.

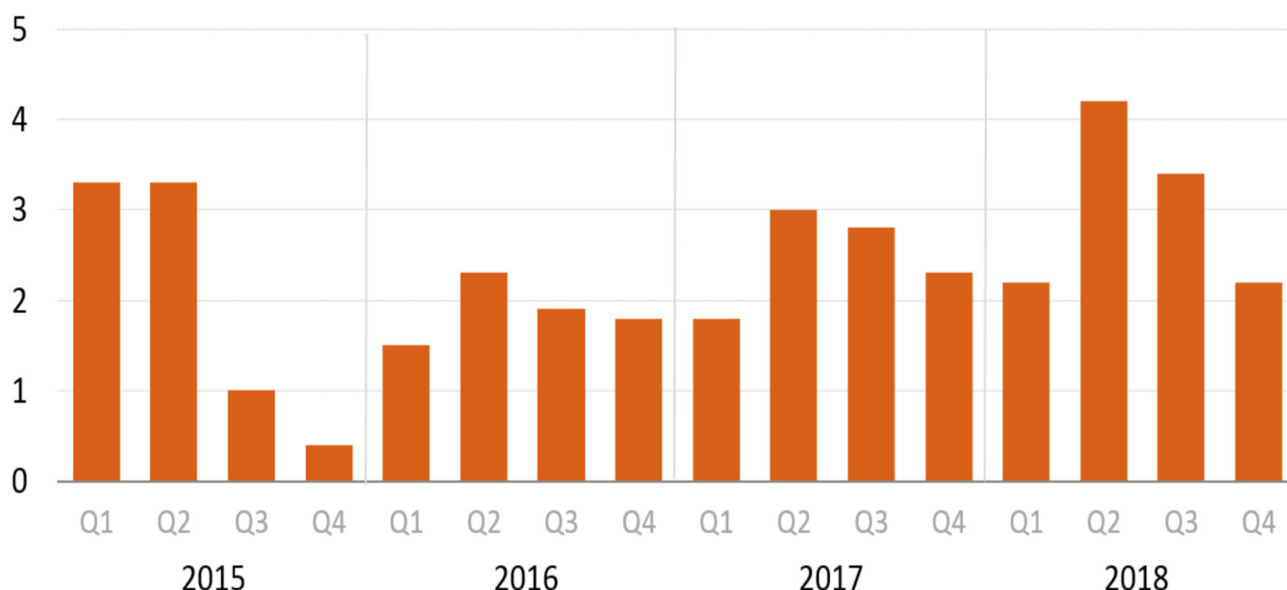
■ In the UK, economic reports over the past few weeks have painted a mixed picture. On the positive side, the Office for National Statistics (ONS) reported that the economy expanded by 0.3% in the three months to February, beating forecasts. Reporting on the drivers of growth, the ONS noted that "the services sector was the largest contributor to rolling three-month growth, expanding by 0.4% in the three months to February 2019. The production sector had a small positive contribution, growing by 0.2%. However, the construction sector contracted by 0.6%, resulting in a small negative contribution to GDP growth."

■ Taken at face value, the GDP report shows that the UK economy has been very resilient. However, a potential problem lies in the details of recent economic reports including the one by the ONS. Essentially, emerging evidence suggests that the recent growth spurt has been driven by strength in the manufacturing sector which has benefited from stockpiling as companies guarded against the risk of supply disruptions in the run up to the original planned date for the UK's departure (29th March) from the European Union.

■ The risk here is that the inventory build-up resulting from stockpiling may in time act as a drag on future demand and production. Furthermore, insight from recent purchasing managers surveys indicate that the dominant services sector contracted in March. This may well mean that UK services sector, which has long been a primary driver of growth, could soon start to act as a drag on GDP. Indeed, the sector's contribution to quarterly GDP growth has more than halved over the period between July 2018 and February 2019.

Figure 1: Real GDP - percentage change from preceding quarter

Seasonally adjusted at annual rates



Source: US Bureau of Economic Analysis

Financial markets & investment strategy summary

■ Equity markets have had a stellar start to the year with the S&P 500 index and the UK's FTSE 100 index gaining about 13.6% and 9.5% respectively in local currency terms over the first quarter. The rally has been broad based as corporate bonds also gained between 4% and 7% depending on credit quality. Government bonds also delivered positive performance albeit of lower magnitude, with returns around 1.5% to 3.0% across the developed markets. In the currency markets, over the quarter, sterling gained about 2.2% and 4.5% against the US Dollar and Euro respectively while the Euro lost about 2.2% against the US Dollar. Over the quarter, the best performance came from oil as both Brent crude and US WTI Oil returned 27% and 32% respectively.

■ Risk assets have continued to benefit from dovish comments by officials of major central banks including the US Federal Reserve (Fed) and the European Central Bank (ECB). In the US, the moderation in the pace of economic activity has altered market expectations about the outlook for interest rates and the Fed is now widely expected to remain on hold throughout 2019. In the Eurozone, expectations are now that the ECB could deploy new stimulus measures to kick-start the region's stalling economy. In the emerging markets, incoming data suggest that efforts by authorities in China to loosen lending criteria, cut taxes and boost government spending are starting to stimulate growth. Investors have also been buoyed by news that point to an amicable resolution of the US-China trade war. All these have boosted investor sentiment and supported the rally in risk assets.

■ Looking ahead, key economic leading indicators still point to weakening growth outlook and corporate earnings look set to fall again in Q2 2019, marking the second consecutive quarterly decline. This combination is not supportive for risk assets and calls for caution in portfolio positioning. In contrast, this environment should continue to support government bond prices even though yields have fallen (and prices risen) quite a bit in recent weeks.

■ On balance, monetary policy should remain supportive of the rally in risk assets as the major central banks now appear to have curbed their enthusiasm for policy tightening. However, there may be trouble lurking beneath the surface in the US because while the Fed's move to a 'wait-and-see' policy following a period of gradual tightening is supported by the data, there are ongoing political attempts to undermine the independence of the central bank. In the past such attempts have mainly entailed vocal criticism of the Fed by the US President. For Fed watchers, perhaps more worrying is the ongoing push to fill vacant Fed seats with Trump loyalists. Clearly, this carries significant risks as any move that successfully turns back the clock on central bank independence will undermine investor confidence in the US.

■ In the currency markets, sterling's recent gains have been driven by investors' relief that a "no deal" outcome seems likely to be averted. Whether this is justified or merely another case of wishful thinking on the part of investors remains to be seen. In our view, the optimal course of action is to maintain exposure to sterling only to the extent dictated by long term asset allocation requirements based on clear investment objectives.

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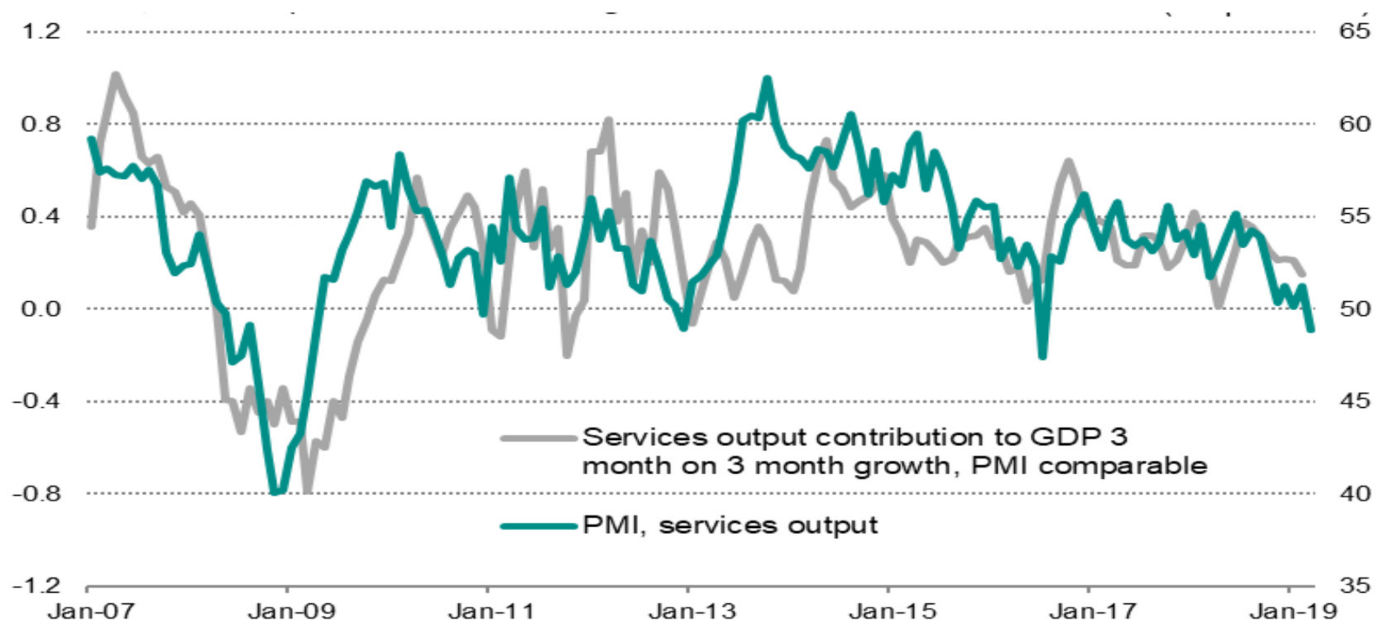
Figure 2: UK Services PMI & GDP

UK GDP, constant prices 3m/3m % change

Services PMI (Output Index)



Sources: IHS Markit, CIPS, ONS.

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