Investment Commentary

August 2018

Recent economic developments

■ Economic releases over the past month have demonstrated the extent of the ongoing divergence in growth momentum across major economies. Recent data for the second quarter showed that the Euro-zone's economy expanded by 0.3% over the previous quarter, the weakest pace in two years. In contrast, the US reported a growth rate of 4.1% (and the Q1 growth rate was revised higher from 2.0% to 2.2%) for the second quarter of 2018, the fastest pace of growth since the third quarter of 2014.

■ The US Q2 GDP growth rate showed upside surprises in virtually all demand components. Particularly noteworthy elements included consumer spending which grew by 4% (boosted by recent tax cuts) and non-residential business investment which increased by 7.3%. The US economy also enjoyed an unexpected upside from the ongoing concerns about trade wars as net exports contributed 1.06 percentage points to GDP growth rate as a result of a surge in soybean shipments by exporters keen to get ahead of retaliatory tariffs.

■ In the UK, a report by the Office for National Statistics showed that the economy expanded by 0.4% in the second quarter of 2018. The rebound in the pace of economic activity in recent months enabled the Bank of England (BOE) to raise interest rates by 0.25 percentage points to 0.75% on the 2nd August.

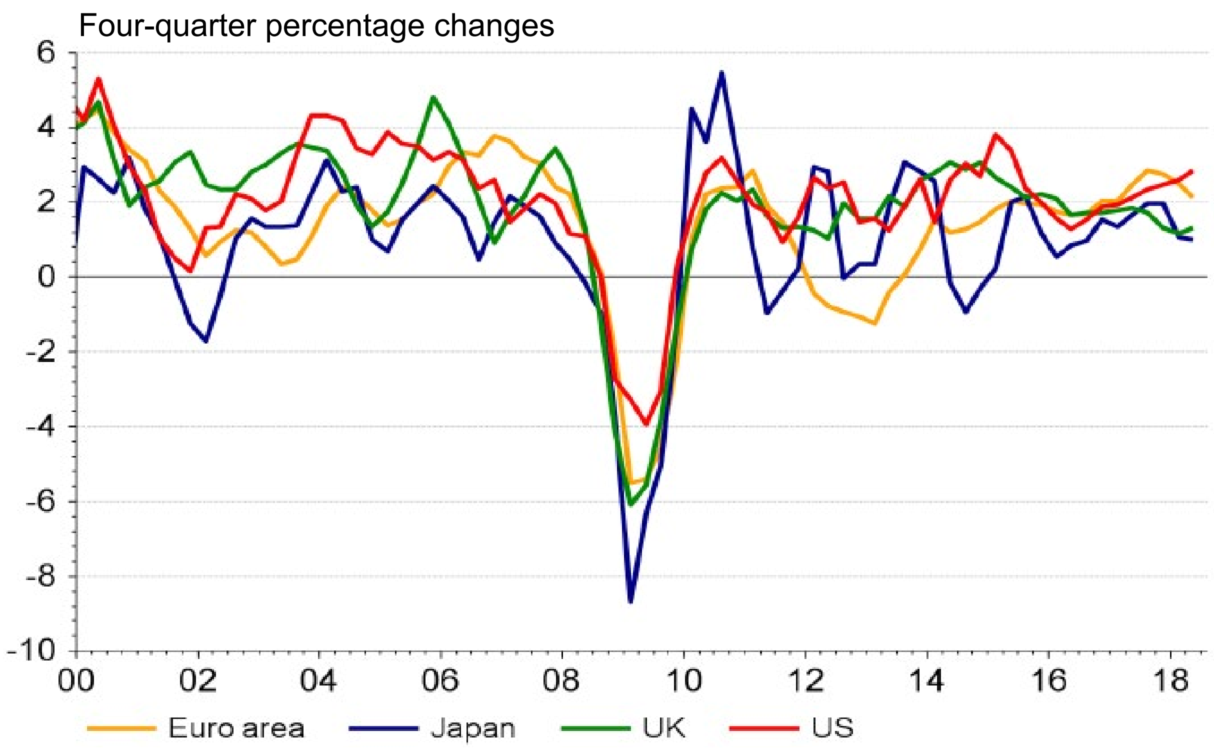
■ The BOE forecasts modest economic growth of 1.4% for 2018 and an increase to a growth rate of 1.8% in 2019. It expects further gains in the labour market as well as a pickup in wage growth over the next year. Finally, the BOE expects inflation to decline to around 2% by 2020. Longer term, the BOE estimates that interest rates will settle somewhere between 2% and 3%, its range for the so-called neutral rate (the level of interest rates consistent with stable inflation and growth when the economy is at full capacity).

■ For the UK and the EU, the outcome of the ongoing Brexit negotiations will have significant bearing on the outlook for economic growth and monetary policy over the next few years. On this point, it is noteworthy that Mark Carney, the governor of the Bank of England, noted that all bets on future rate hikes would be off in the event of a no-deal Brexit.

Financial markets & asset allocation summary

■ In line with our conclusions last month, we continue to believe that the balance of macro risks and opportunities warrants a neutral stance on the major asset classes relative to longer term strategic allocation. Therefore, we maintain broadly neutral asset allocation positions.

Chart 1: GDP growth across selected economies



Source: Thomson Reuters Datastream / Fathom Consulting

■ **Equities:** we remain neutral across the main regional markets. Equity markets are caught between the positive effects of robust growth and strong earnings and the negative influence of uncertainties about interest rate outlook and trade policy. Moreover, despite providing short term support, the strength in recent earnings growth is not sustainable and the likely decline in earnings growth rates should begin to weigh on expectations for 2019.

■ **Bonds:** Strong growth, low unemployment rate and rising inflation mean that the US Federal Reserve is likely to maintain its course of interest rate hikes. Further increases in US interest rates will drive further flattening in the yield curve. The direction of monetary policy has also changed outside the US, with the Bank of England recently raising interest rates while the European Central Bank has announced plans to end quantitative easing. This combination is negative for bonds in general. However, safe haven demand, driven by concerns about the economic impact of a potential trade war and fears about spill over effects from the ongoing crisis in Turkey should provide some support. We remain cautious on corporate bonds across the credit spectrum on the basis that credit spreads remain tight.

■ **Alternatives:** following the risk-off period in the first quarter, the alternative assets that we invest in have staged a strong recovery. The performance of the listed PPP/PFI Infrastructure sector has been particularly notable as a series of secondary market transactions have supported the notion that underlying portfolios are conservatively valued. Fundamentals also remain strong for other sectors such as digital infrastructure and private equity.

■ **Currencies:** the key trend in currency markets looks set to remain that of US Dollar strength against other major currencies as the USD continues to enjoy yield support. Focusing on sterling, the recent slide in the GBP/USD rate has been driven by ongoing Brexit-related uncertainties as investors assess the risk of a no-deal exit from the EU.

■ In the short term, the weight of bearish investor positioning could push GBP much lower than what could be justified on fundamental grounds. Nevertheless, an actual no-deal outcome would most likely result in a far more protracted sterling sell-off, likely pushing sterling below $1.20. On the other hand, sterling's sensitivity to Brexit news flow is such that any news of a UK/EU agreement could trigger a sharp relief rally which would be further fuelled by short covering as bearish positions are unwound. It looks set to be a long summer for sterling!

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 2 August 2018)

	United States	United Kingdom	Euro-Zone ex UK	Asia ex Japan	Japan	Emerging Markets
Equities (overall)	0					
Equity allocation by Region	0	0	0	0	0	0
Bonds (overall)	0					
Agency/ Supra	0	0	0	0	0	0
Corporate bonds	0/-	0/-	0/-	0/-	0/-	0/-
High Yield bonds	-	-	-	-	-	-
Govt guaranteed bonds	0	0	0	0	0	0
Index-linked bonds	0	0	0	0	0	0
Alternatives	0					
Cash	0					

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

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