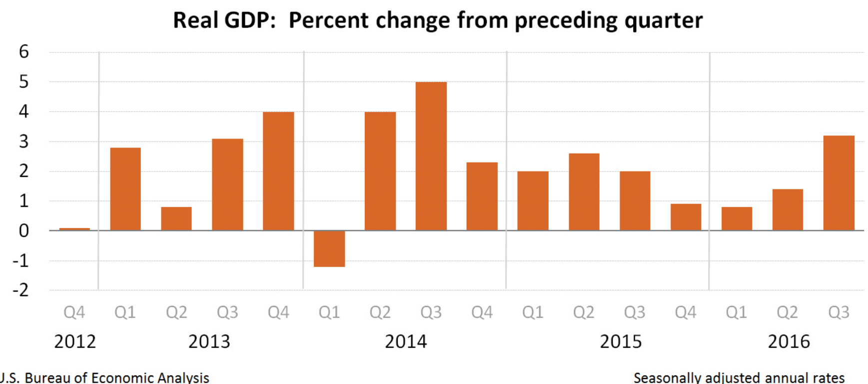
The global economy continues to strengthen

The upturn in the global economy since the start of the third quarter persists. The improvement in economic activity has been broad-based, with a raft of data showing stronger than expected performance across the developed economies and the major emerging markets.

In the US, the second estimate of economic growth in Q3 showed that real gross domestic product (GDP) increased at an annual rate of 3.2%. That performance was better than initially estimated (2.9%) and notably stronger than the 1.4% annualised pace of growth recorded in the previous quarter. The healthier pace of economic activity has driven further strength in the labour market and the headline unemployment rate fell to 4.6% in November 2016, its lowest level since August 2007.

Similarly, the UK economy continues to grow at a brisk pace with a low unemployment rate and robust average earnings boosting retail sales and consumer confidence. While uncertainty around the timing of the triggering of Article 50 persists, it has not had a negative impact on economic activity so far. However, the weakness in sterling since the referendum vote means that inflationary pressure is building rapidly. Indeed, in November, UK inflation (as measured by the consumer prices index) rose to 1.2%, a two-year high, from 0.9% a month earlier. Looking to the year ahead, inflation looks set to exceed the Bank of England's target by some margin. That is likely to constrain consumer spending as real incomes decline.

Looking across the developed markets, the data continues to point to ongoing positive growth momentum. For instance, composite leading economic indicators remain constructive across the OECD area



and Purchasing Managers' Indices remain in expansionary territory across the board. These suggest that growth should remain at or perhaps somewhat above trend across the key developed economies. Equivalent indicators for the major emerging markets also suggest a broadening recovery in the momentum of economic growth.

Financial markets & investment strategy

In the US, the combination of the afore-mentioned upturn in economic data and the optimism generated by expectations around likely fiscal stimulus measures by the president-elect have resulted in a rally in equities and a sell-off in bonds.

In last month's commentary we highlighted the financial sector (and banks in particular) as a notable winner in the current environment as it should profit from rising rates and potentially lighter regulatory burden. Indeed, the gains in the US stock market since the Presidential elections have been driven primarily by the financial sector which has risen by over 17% [over the period between the 8th of November when the US elections took place and Friday 16th December]. The strength of financials has seen the S&P 500 index rally by about 5.8%. In contrast, the S&P 500 index excluding financials has returned about 3.9% over the same period.

Monetary policy

Over the past year the markets have come to terms with the divergence in monetary policy across the major central banks. The year ahead looks set to see a sharp extension of that policy divergence.

Early in December the European Central Bank (ECB) announced that it will extend its asset-purchase programme until at least December 2017. However, it surprised the market by indicating that it would reduce the size of monthly purchases by €20bn a month (from the current €80bn a month) from April 2017. In line with market expectations, the ECB also kept its key interest rate unchanged at zero.

In contrast to the ECB the US Federal Reserve bank (Fed) raised interest rates by 25 basis points in mid-December as expected. Importantly, as we anticipated last month, the Fed also changed its guidance

on the likely number of rate hikes that it expects to implement next year, from two hikes to three. The financial markets have taken these developments in their stride and the general pattern of rising equity markets and falling government bond markets has continued since the Fed's decision. This pattern seems likely to persist until we get greater clarity on the policy priorities of the new US administration. It remains unclear how Trump's campaign rhetoric will translate into government policy. While the markets have chosen to look on the bright side for now, investors would do well to realise that there is substantial scope for disappointment. The first quarter of 2017 therefore looks set to be a volatile one for the financial markets.

Investment strategy summary

We retain a neutral allocation to equities and continue to place emphasis on sector-level assessment of the implications of the prevailing financial market landscape. The post-US election trends seem likely to persist in the short term and seasonal tendencies favour a continuation of strong equity market performance for the time being. It is also worth noting that the third quarter earnings season has been largely positive, with 71% of S&P 500 companies having reported earnings above analysts' estimates. This suggests an improving outlook for corporate profits.

Within fixed income, following the recent sell-off, we have covered our underweight position. We have now moved to a neutral allocation relative to our long term benchmarks. Likewise, we retain a neutral allocation to alternative investments and the major currency pairs.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD Effective December 6, 2016

	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	-
Bonds (overall)	0/-					
Agency / Supra	0	0	0	0	0	0
Corporate Bonds	0	0	0	0	0	0
High Yield Bonds	0	0	0	0	0	0
Govt Guarenteed Bonds	+	+	0	0	0	0
Index-Linked Bonds	+	+	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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