THOMAS MILLER INVESTMENT

Investment Commentary

December 2018

Recent economic developments

- In line with the trend elsewhere in the major developed economies, recent data on the US economy has shown a moderation in the pace of economic activity. However, for the US, unlike other major developed economies, the slowdown has occurred from a high base. For instance, the second estimate of Gross Domestic Product showed a slowdown from an annualised growth rate of 4.2% in Q2 to an annualised growth rate of 3.5% in the third quarter. That left the estimate unchanged from the "advance" estimate published October.

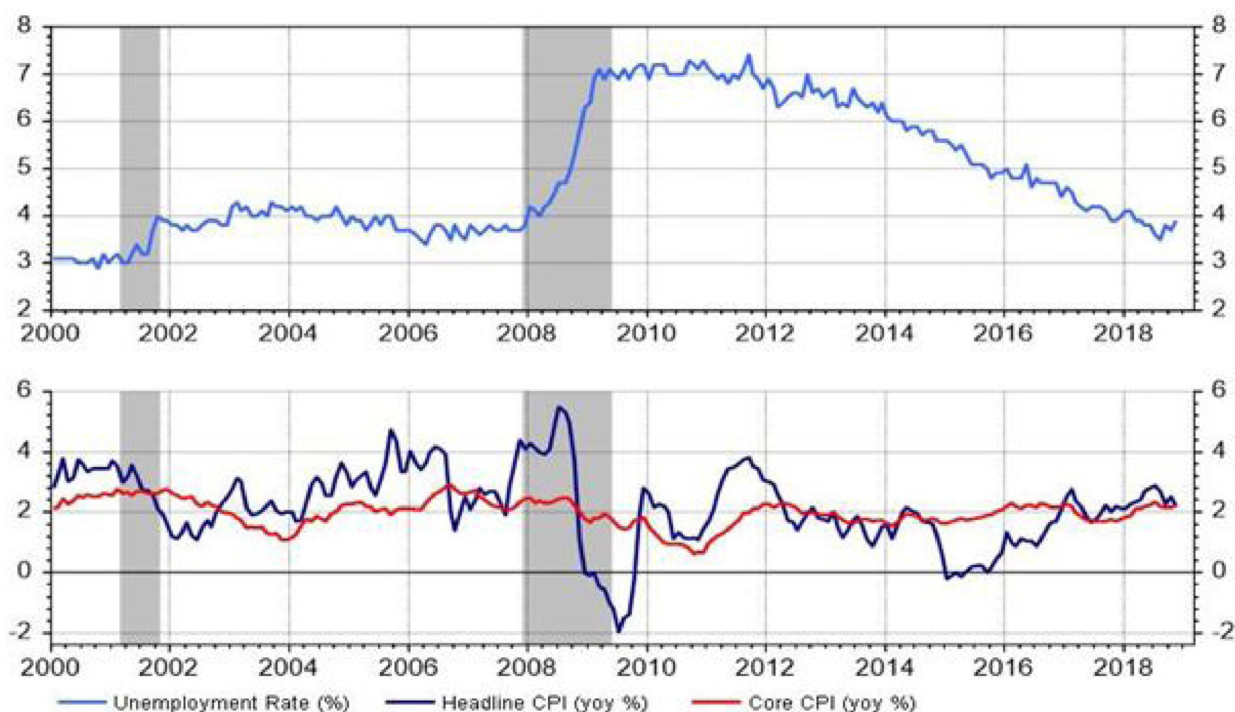
- In a largely unexpected turnaround that has raised questions about the likely path of US monetary policy, inflationary pressures have dissipated in recent weeks, with the core inflation rate (i.e. headline inflation excluding food and energy prices) falling to 2.1% in October from 2.2% in September. However, wage inflation pushed higher, with year-on-year average hourly earnings rising to 3.2% in October from 2.8% in September. Nonfarm payrolls rose 250,000 while the headline unemployment rate remained at a 48-year low of 3.7%.

- In the UK, the Office for National Statistics (ONS) reported that the economy grew by 0.4% in the three months to October. That represented a slowdown from the 0.6% growth rate recorded in the three months to September. The services sector recorded its lowest growth rate since April 2018 (on the three-month rolling measure) due to a fall in car sales. Furthermore, weakness in the pharmaceutical industry resulted in soft performance in manufacturing which saw no growth at all over the three-month period. On a positive note, recent data confirmed that the UK labour market remains strong, with the unemployment rate at a multi-decade low of 4.1% while wages continue to rise at their fastest rate (3.1%) for nearly a decade.

- Data on the Euro-zone economy has been lacklustre. The region's growth rate for Q3 2018 was weaker than expected and economic sentiment has weakened progressively over the past year. The deteriorating economic environment has increased investors' unease about plans for further withdrawal of monetary stimulus by the European Central Bank and political uncertainty in Italy has only served to increase concerns about the outlook for the region. As we have noted in the past, for the UK and Euro-zone the importance of the ongoing Brexit negotiations for future economic growth can hardly be overstated. Brexit uncertainty has been partly responsible for weak business investment and waning business and consumer confidence across both the UK and Euro-zone. This will persist until there is a clear resolution.

- In China, the uncertainty engendered by the ongoing trade dispute with the US has contributed to a slowdown in the pace of economic activity in recent months. However, more recently there have been encouraging signs that the Chinese and US governments are keen to tone down aggressive rhetoric and avoid escalating the dispute. Any truce that results in a reversal of the tariffs that have been imposed in the past few months will be a positive development for the global economy and financial markets.

Chart 1: US Unemployment Rate and Inflation



Source: Thomson Reuters Datastream

Financial markets & asset allocation summary

■ In the US, the combination of weakening inflation pressures, signs of slower growth and increasing tendency of Federal Reserve officials to downplay the likelihood of a more aggressive series of rate hikes in 2019 has led markets to recalibrate monetary policy expectations. As a result, yields on government bonds have fallen sharply (and capital values risen) in the US (and to a lesser extent elsewhere in the developed markets).

■ As bond yields have fallen, the US government bond yield curve has flattened to the extent that yields on 5-year Treasuries fell below those on 2-year and 3-year equivalents early in December. Likewise, the widely watched spread between the 10-year and 2-year Treasuries fell below 15 basis points around the same time. These moves have fuelled investors' concerns about the outlook for the US economy (and by extension, the global economy, given that the US economy has led other developed markets this year). It is worth noting that in the post-war period, US recessions have typically been preceded by the incidence of the 2-year Treasury yield rising above the 10-year Treasury yield (i.e. inversion of the yield curve). This is likely to challenge the Fed's previous plans for how much to raise interest rates over the next year.

■ Investors' concerns about the outlook for global economic growth and monetary policy alongside unease about trade tensions (US/China) and geo-political uncertainty (UK/EU, Italy) have triggered another bout of risk aversion in recent weeks. For instance, at the time of writing in December, the S&P 500 index is currently trading about 4% lower than its close in November. The renewed downturn since September/October has wiped out most of the gains on the S&P 500 index for the year to date. Nevertheless, the US stock market remains the clear leader for the year so far.

■ Looking to the year ahead, the primary risks to the outlook for equity markets in particular and financial markets in general relate to the extent to which growth slows and the monetary policy response to that slowdown; and political developments.

■ Firstly, market expectations for the path of rate hikes in the US have changed materially over the past few weeks and market pricing currently indicates that investors now expect no more than a single hike by the Fed in 2019. This is clearly far more dovish than the Fed has indicated at any point in the past year. Uncertainty about monetary policy will result in elevated levels of volatility over the course of the year. Secondly, it is relatively easy to foresee important political flashpoints on both sides of the Atlantic over the next few months. Notably, during Q1 2019, markets are likely to have to contend with the combination of elevated risks from Brexit and potential ramifications of gridlock in Congress (e.g. US government shutdown or another debt ceiling crisis).

■ Overall, client portfolios are currently positioned in line with the longer term strategic weights to each of the major asset classes.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 5 December 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.

THOMAS MILLER INVESTMENT

London
90 Fenchurch Street
London
EC3M 4ST
T: +44 (0) 207 204 2200

Birmingham
2nd Floor
Trigate Business Centre
210 - 222 Hagley Road West
Birmingham
B68 0NP
T: +44 (0) 121 222 5070

Isle of Man
Level 2 Samuel Harris House
5 - 11 St Georges Street
Douglas
Isle of Man
IM1 1AJ
T: +44 (0) 1624 645 200

Southampton
Ocean Village Innovation Centre
Ocean Way
Southampton
SO14 3JZ
+ 44 (0) 23 8038 1667

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