THOMAS
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INVESTMENT

Investment Commentary

February 2017

Political Risks Taint The Outlook

Recent economic developments

Economic reports over the past month have painted a picture of stable growth momentum. The benign data has been widespread, spanning both the developed economies and emerging markets.

In the US, the first estimate of real GDP for the fourth quarter of 2016 showed a growth rate of 1.9%. While that initial estimate marked a decline from the 3.5% pace recorded in the third quarter, it is broadly consistent with official estimates of potential growth rate for the US economy at this point. It should be noted that the first estimate of quarterly GDP is based on incomplete data and is therefore highly subject to revisions. A second official estimate will be published at the end of February.

Elsewhere in the US, reports provided evidence that there may be little scope for further labour market gains without spurring inflation. In January the headline US unemployment rate rose for the second consecutive month even as the pace of job creation remained robust. Meanwhile, inflationary pressures have risen steadily over the past year.

In the UK, recent reports have indicated a continuation of the purple patch that has been ongoing since the third quarter of last year. Importantly, although domestic demand (fuelled by strong consumer spending) has been particularly strong, the emerging evidence points to a more balanced pattern of growth across the key sectors of the economy.

In a further sign of improving sentiment, the Bank of England recently raised its forecast of GDP growth in 2017.

It now expects the economy to grow by 2% over the course of the year, up from a forecast of 1.4% in November 2016. It is notable that the Bank's projections are now ahead of consensus forecasts which remain at 1.4% for 2017. In line with consensus expectations, the Bank continues to anticipate a slowdown in economic growth in 2018. This is predicated on an expected slowdown in households' spending power owing to rising inflation. Also, the Bank expects the saving ratio to fall to its lowest level since the early 1960s as consumers compensate for the expected decline in real incomes.

> **"...Euro-zone governments are disinclined to provide further debt relief to Greece ahead of key elections... "**

Elsewhere in the developed economies, the Euro-zone recorded a GDP growth rate of 0.5% in Q4 on the back of a 0.4% growth rate in the previous quarter. Data from Eurostat also showed that in December 2016, the unemployment rate dropped to its lowest level since 2009. In a further sign of ongoing recovery, the headline inflation rate picked up to its highest level in almost 4 years, driven by a jump in energy prices. This is a welcome return to price growth for a region that has faced significant deflationary pressure for some time.

Political risks & financial markets

Over the next few months political risks will come to the fore and financial markets will have to contend with elections in key Euro-zone countries, beginning with the Dutch elections in mid-March. The outcome of the French elections in May in particular will have significant bearing on the viability of the 'European project' in its current form.

Concerns about the outlook for the Euro-zone have resurfaced in recent weeks due to the requirement for Greece to make debt repayments to creditors in July 2017. Greece can only make those payments if it receives the next instalment of its current bailout programme. However, there is currently a disagreement between the Euro-zone governments and the IMF

over the best approach to Greece's bailout arrangements. The key issue is that Greece has been unable to demonstrate sufficient progress on structural reforms and the Euro-zone governments are disinclined to provide further debt relief to Greece ahead of key elections in major Euro-zone countries.

While there has been significant volatility in Greek bond yields and some Euro-zone bond markets in recent weeks, broader financial markets have been relatively sanguine about the likely re-emergence of Euro-zone risks. We expect these concerns to become more prominent as we approach the summer months.

Investment strategy summary

The combination of better-than-expected pace of economic activity and expectations of predominantly pro-growth policies by the new US administration continue to drive strong gains in risk assets. In contrast, government bonds have remained weak.

While these expectations may turn out to be accurate, it is worth noting that the pace of US economic growth has accelerated in recent months, the labour market is notably tighter than it has been in years, inflationary pressures are building and valuations across key asset classes are stretched. These factors suggest that additional stimulus programmes (even if they get implemented) may not yield as much incremental upside as is currently widely assumed.

In light of our assessment of the market outlook, we maintain a moderately cautious asset allocation stance. Consequently, client portfolios remain close to their longer term strategic weightings across the major asset classes.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD Effective February 10, 2017

	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	0	0	0	0	0	0
Govt Guarenteed Bonds	+	+	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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