THOMAS
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INVESTMENT

Investment Commentary

June 2018

Recent economic developments

■ The chart opposite compares GDP growth data over the past two quarters (Q1, 2018 v Q4, 2017) for selected countries and regions. As the chart illustrates, in virtually all cases shown, there has been a notable slowdown in the pace of economic activity. The slowdown has been most dramatic in Japan where the economy contracted during the first quarter of 2018.

■ More recently, economic reports across the major markets have been mixed, with data on the US economy being more positive than elsewhere. In the US, a recent update showed that economic growth slowed slightly more than initially thought in the first quarter due to downward revisions to inventory investment and consumer spending. The revised estimate of GDP growth was 2.2% rather than the 2.3% previously reported.

■ Looking ahead, the stronger than expected rebound in the ISM manufacturing index to 58.7 in May from a previous level of 57.3 provided further evidence that the pace of US economic activity has picked up notably in the second quarter. Also, the recent increase in the inflation rate to a 6-year high in May, alongside further gains in payrolls and a decline in the unemployment rate to an 18-year low of 3.8%, suggest that the US Federal Reserve (Fed) is likely to maintain the planned pace of rate hikes when it next meets in mid-June.

■ In the UK, the Office for National Statistics (ONS) recently confirmed its previous estimate that GDP growth slowed to 0.1% in the first quarter of 2018, making it the worst quarter in five years. The underlying data showed household spending at its weakest for three years while the level of business investment

Chart 1: Gross Domestic Product (percentage change on the previous quarter, seasonally adjusted data)

Source: OECD (May 2018)

continues to fall. The message from more recent data on the UK economy has been mixed. For instance, while the latest reading on retail sales, inflation and the labour market have been encouraging, the ONS reported that UK factories recorded the largest monthly decline in output in over five years in April.

Financial markets & investment strategy

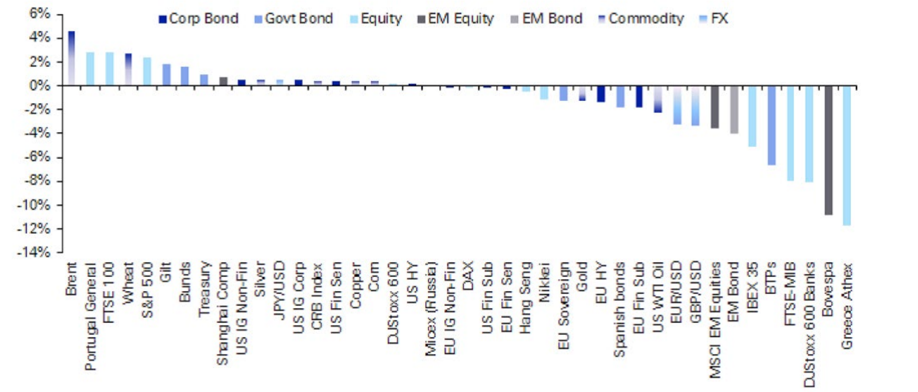
■ Over the past few weeks, financial markets have been caught between two powerful forces. On the positive side, investor sentiment has been buoyed by strong corporate earnings, particularly in the US, where some 78% of S&P 500 companies have reported earnings in excess of analysts' forecasts. On the negative side, markets have had to contend with the combination of a rise in political risk emanating from Italy and ongoing uncertainty about the potential fallout from US trade policy.

■ In the end, performance across global markets was quite mixed in May (see Chart 2). Italian political developments towards the end of the month led to sharp losses in the country's equity and government bond markets (-8.0% and -6.7% for the FTSE MIB index and BTPs respectively). Sharp losses were also recorded in the European banking sector and across European high yield. The spike in risk aversion benefited safe havens, such as US Treasuries, UK Gilts and German Bunds, which gained 0.9%, 1.8% and 1.7% respectively in local currency terms.

■ Among the major equity markets, the UK stock market was the best performer for the month (in local currency terms), while Portugal stood out as the only one to deliver a positive return among the European periphery markets. Currency markets were again dominated by ongoing strength in the US Dollar, which continues to be supported by expectations of further rate increases by the Fed.

■ The Fed's shift in policy has been partly responsible for significant fund flows out of the Emerging markets, resulting in sharp losses across financial markets in the region. Indeed, in recent weeks, EM economies including Argentina, Turkey and Indonesia have had to take steps to

Chart 2: Total return performance of major global financial assets - May 2018 (local currency)



Source: Bloomberg Finance LP, Deutsche Bank

support their currencies in the face of sharp declines.

■ Looking ahead, uncertainty over US trade policy seems unlikely to ease in the short term, while a supportive economic backdrop should ensure that that Fed continues its gradual tightening of monetary policy. Across the UK and Euro zone, the ongoing weakness in incoming data introduces some doubt about the extent to which the sharp slowdown in the first quarter was weather-related and therefore, transitory. Economic uncertainty and political upheaval could encourage the European Central Bank to keep its options open and refrain from a premature end to monetary stimulus. Likewise, the Bank of England may find it has much less scope to implement its stated plan of earlier and more frequent increases in interest rates.

■ In our assessment, the balance of risks could prevent equity markets from making much headway during the historically low volume summer months. Consequently, we have taken profits on overweight equity positions and aligned portfolios with longer term strategic weights across the major asset classes.

Abi Oladimeji

Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 7 June 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
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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