Weaker data tempers growth expectations

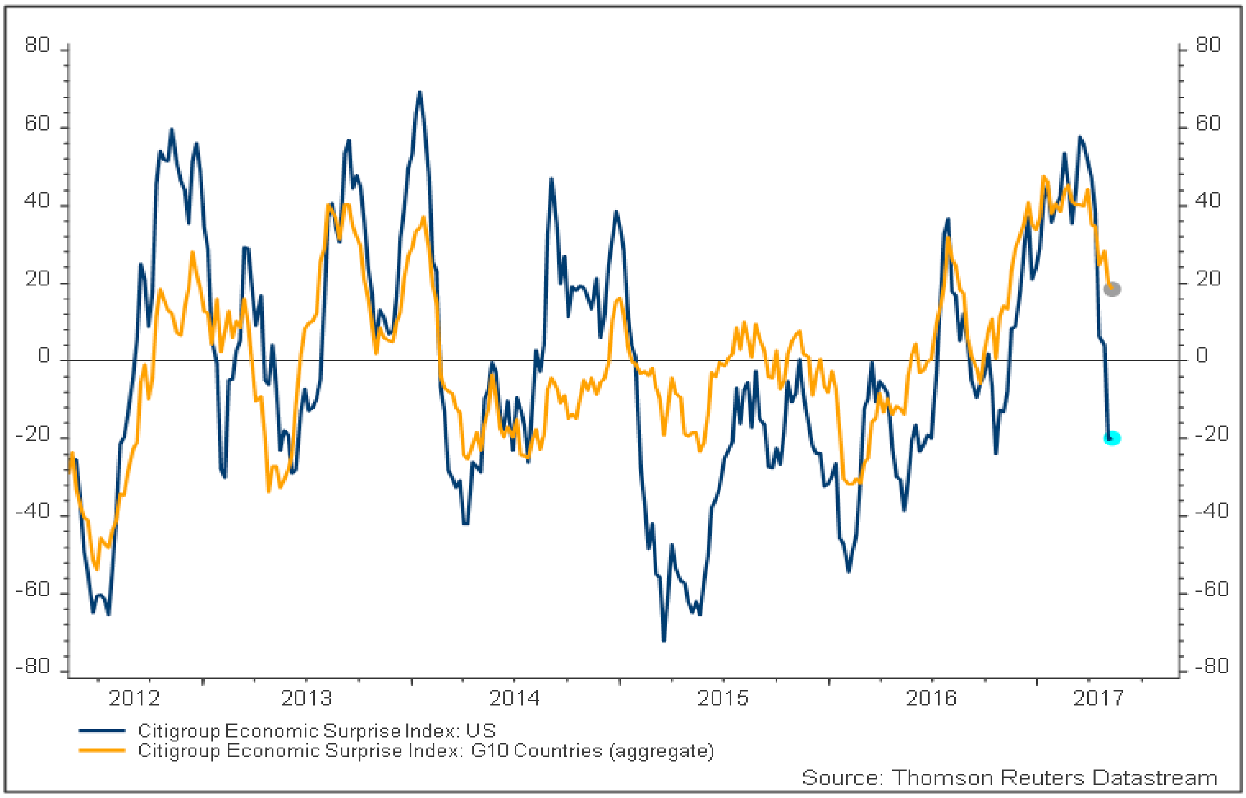
In last month's commentary, we flagged that the incoming data pointed to a widening gap between exuberant expectations and modest economic data. Nowhere has that divergence been more striking than in the headline data on US real gross domestic product (GDP) for the first quarter of 2017. At the start of the quarter, consensus forecast for Q1 GDP was for a figure close to 3.0%. That estimate declined steadily over the quarter as various reports indicated a slower than expected pace of growth. In the end according to the advance estimate, US real GDP increased at an annual rate of 0.7% in the first quarter of 2017. That marked a sharp slowdown from the 2.1% annualised pace recorded in the previous quarter.

The weakness in economic data relative to consensus expectations (for the US and G10) is illustrated by Figure 1 below. The Figure shows the Citigroup Economic Surprise Index which tracks the deviation of economic data from market consensus forecasts. Negative [positive] readings of the index indicate that economic releases have on balance been weaker [stronger] than consensus forecasts.

As the chart illustrates, while the incidence of weaker-than-expected pace of activity is particularly pronounced in the US, the trend holds across the G10 economies. However the Euro-zone has been a notable exception to this pervasive trend. The pace of economic recovery in the Euro-Area has exceeded expectations in recent months as the region has benefited from a combination of sustained monetary policy stimulus, firmer global growth and diminishing political uncertainty. Looking ahead to the next few years, the uncertainty surrounding the impending Brexit negotiations represents a key source of downside risk for the Euro-zone and UK economies.

In the UK, the pace of economic growth slowed sharply in the first quarter, driven largely by a substantial slowdown in the service sector. Looking to the rest of the year, 2017 could prove very tricky for the UK economy in general and the UK consumer in particular as the full effect of the decline in sterling following last year's referendum kicks in.

Figure 1: Economic data undershoots expectations



Are investors throwing caution to the wind?

While economists have been recalibrating growth expectations in light of disappointing data, equity investors untroubled by doubt, have driven stockmarkets to new highs. In recent weeks, indices ranging from the S&P 500 and Nasdaq Composite in the US to the FTSE 100 and FTSE 250 in the UK have raced to new highs. At the same time measures of risk aversion such as the volatility index (VIX; known as Wall Street's fear gauge) have declined to multi-year lows.

In light of the prevailing backdrop, strong stockmarket returns are not in themselves a cause for concern. Afterall, the economic outlook remains positive, monetary policy remains broadly accommodative, corporate earnings have picked up in recent months and political risk has faded. Indeed, following the recent election results in France, an eerie sense of calm has descended on financial markets. In recent weeks, the afore-mentioned VIX index has posted its lowest closing values since 1993, implied volatility across G10 major currencies has declined to its lowest in three years and bond market volatility is currently close to record lows.

> ***"...the economic outlook remains positive, monetary policy remains broadly accommodative, corporate earnings have picked up in recent months and political risk has faded. ... "***

While there is clearly cause for optimism, conservative investors may want to consider whether the noted positive factors justify the prevailing incidence of multi-year lows in measures of expected future volatility across a broad range of asset classes.

Overall, the combination of stretched valuations in equity markets, uncertainty surrounding policy outcomes in the US and signs of a consumer-led slowdown in China suggest that risk assets remain vulnerable in the short term. Conservative investors should maintain portfolio exposures in line with long term strategic asset allocation designed to achieve predefined investment objectives.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 12th May 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	-
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 guaranteed bonds	+	+	0	0	0	0
Index-linked bonds	0	0	0	0	0	0
Alternatives	+					
Cash	0/-					

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

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