THOMAS
MILLER
INVESTMENT

Investment Commentary

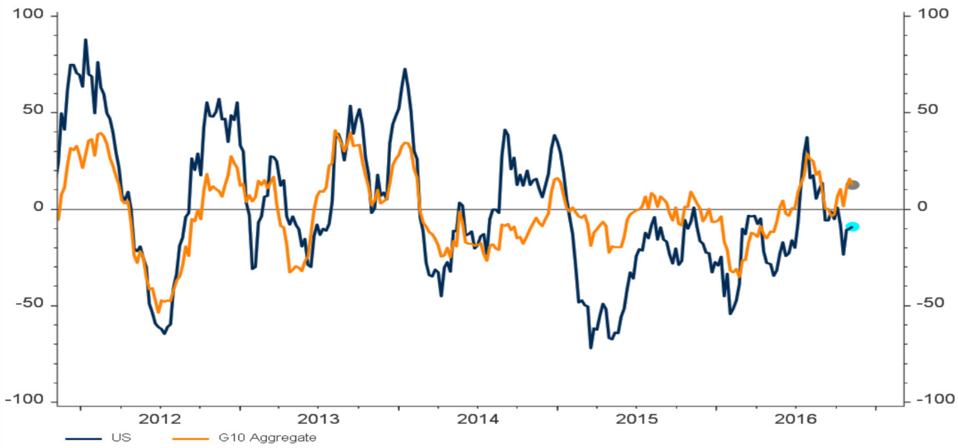
NOVEMBER 2016

The upswing in economic activity continues

Incoming data continue to signal a rebound in the pace of global economic growth from the depressed levels recorded in the first half of the year. The improvement has been broad based, with data across the G10 exceeding consensus forecasts in a sustained manner in recent weeks. This is illustrated in Figure 1.

The Figure shows the Citigroup Economic Surprise Index which tracks the deviation of economic data from market consensus forecasts. Positive [negative] readings of the index indicate that economic releases have on balance been stronger [weaker] than consensus forecasts.

Figure 1: Economic activity has been stronger than expected in recent weeks



Source: Thomson Reuters Datastream

In the US, the first estimate of third quarter real gross domestic product (GDP) showed an increase of 2.9%. Such a brisk pace of growth is encouraging coming on the back of a real GDP growth rate of 1.4% in the previous quarter. It should be noted that the first estimate is based on data that is incomplete and subject to revision, so the magnitude of the Q3 growth rate may well change. Nevertheless, the direction of travel in recent weeks is clear.

Similarly, recent reports on the UK economy have painted a picture of ongoing resilience. Following a strong Q3, recent business surveys suggest that the economy maintained its strength at the start of the fourth quarter and early indications are that the pace of growth in the final three months of 2016 could match that recorded in the third quarter.

From a global perspective, looking ahead to the next few months, the latest updates of key leading economic indicators suggest that the upswing in global growth momentum should persist for some time.

Our initial assessment of the implications of the US elections

It is currently difficult to assess the nature or magnitude of the likely impact of the recent US election results because of the uncertainty surrounding exactly what the President-elect's policies would be. Nevertheless, an initial assessment can be made on the basis of some of the policy ideas that Mr Trump has flagged in recent weeks. TMI's initial assessment is summarised below.

Broader political fallout: a potential ramification of the apparent electoral triumph for populism is that it could spread further across the globe. For instance there will be elections across key European countries in 2017, notably in France and Germany. Strong showing for populist parties there could trigger another episode of European political/economic crisis with significant consequences for financial markets.

US economy: the potential boost to aggregate demand from the anticipated fiscal policy stimulus (planned infrastructure spending) should lift nominal growth at least in the short term. This is however also likely to boost inflation which is already simmering.

On the negative side, the planned size and distribution of proposed tax cuts will likely result in a sharp decline in tax revenues. While this policy should support consumer spending, the dominant effect will be a marked deterioration in public finances. Combined with higher government spending, the upshot of this will be a wider deficit, higher debt to GDP ratio, higher borrowing costs, increasing concerns about credit worthiness and related pressure on credit ratings.

Global economy: A decisive turn towards populism, particularly with respect to trade policies and global trade agreements (e.g. imposing tariffs on imports) could not come at a less opportune time for the global economy. As the OECD recently highlighted, over the past few years, the rate of global trade growth has halved relative to the pre-crisis period. If recent political developments including Brexit and the US election result in a less trade-friendly world, we will all be poorer for it.

Monetary policy: when the Fed raised interest rates in December 2015, it anticipated four hikes in 2016. Those plans never materialised (although a hike in December 2016 has now been priced in by the markets). More recently, in September, the Fed cut its expectations for interest rate increases next year from three hikes to two. As things now stand, the risk is that if growth and inflation pick up materially in the year ahead, the Fed may be forced to tighten monetary policy more aggressively than it has guided the markets to expect.

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Equities: the longer term implications will depend on which policies end up being prioritised. Policies that undermine global trade will ultimately reduce global growth and curtail corporate earnings. In the shorter term however, the markets seem inclined to focus on the potentially more positive aspects of the policy proposals.

In our assessment, winners in the current environment will range from the banking sector, which should profit from rising rates and potentially lighter regulatory burden; to the defence sector and heavy construction industries which should benefit from government spending. The losers seem likely to include sectors such as utilities, which could suffer alongside bonds as yields rise. We also expect emerging market equities to remain under pressure due to a combination of US Dollar strength and the prospect of trade restrictions.

Bonds: in general, the combination of stronger growth, rising inflation (and inflation expectations), tighter financial conditions and more restrictive monetary policy should present notable headwinds to fixed income markets. Focusing on corporate credit, we expect bonds issued by companies with strong balance sheets to remain well supported. We continue to prefer short-medium term corporate bond maturities which we would be willing to hold to maturity.

Currencies: in our assessment, the key outcome of recent political developments is likely to be further strengthening in the US Dollar, particularly against EM currencies. For the UK, it is notable that sterling has recovered some ground against the US Dollar in recent weeks. However, GBP remains very sensitive to issues surrounding the nature and timing of the triggering of Article 50 by the UK government. Volatility in sterling is likely remain elevated for this reason.

Investment strategy summary

In summary, our assessment of the economic and financial market landscape leads us to a neutral stance on equities in aggregate. However, as noted above, there are important equity sector implications of recent developments. These present opportunities to add value to client portfolios. In terms of regional equity positioning, we are overweight US equities at the expense of EM equities within globally diversified equity portfolios.

We have reduced our allocation to bonds in general within balanced multi-asset portfolios. We retain an underweight duration position in UK bonds and have also extended this strategy across other key regions in anticipation of a widespread rise in bond yields (and fall in bond prices). 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 November 10, 2016

	United States	Euro-Zone ex UK	United Kingdom	Asia ex Japan	Japan	Emerging Markets
Equities (overall)	0					
Equity allocation by region	+	0	0	0	0	-
Bonds (overall)	-					
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
Alternatives	0					
Cash	+					

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

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