THOMAS MILLER INVESTMENT

Investment Commentary

November 2017

Recent economic developments

■ Economic reports over the past month have confirmed ongoing strong global growth momentum. Rising GDP growth rates have been recorded across both the developed economies and emerging markets as the global economy continues to experience a synchronised upswing.

■ In the US, initial estimates showed that GDP grew at a pace of 3% in Q3, exceeding consensus forecasts of 2.5% and only slightly below the 3.1% GDP growth rate recorded in the second quarter. Assuming no downward revisions to the growth numbers, the last two quarters mark the US economy's best 6-month stretch of growth since mid-2014.

■ It is notable that while the underlying strength of US economic activity has led to further gains in the labour market, those gains have not resulted in a worrying rise in inflation. This combination of strong growth and muted price pressure has enabled the Federal Reserve (Fed) to maintain a slow and steady path of interest rate hikes.

■ As in the US, the initial estimate of Q3 GDP growth in the UK pointed to better-than-expected growth. The estimate showed a growth rate of 0.4% over the previous quarter (versus 0.3% consensus forecast). On a year-on-year basis, UK GDP growth rate was stable at 1.5%. The labour market remains strong, with the headline unemployment rate at a multi-year low of 4.3%. However, as in the US, the strength of the labour market has not generated much upward pressure on wages.

■ Elsewhere in the developed markets, recent data showed a slower than expected GDP growth rate in Japan in Q3. Nevertheless, the country recorded its seventh consecutive quarter of growth–its longest stretch since 2001. Data on the Euro-zone showed that the region's economy is currently enjoying its strongest growth in a decade and a broad range of leading indicators point to further gains in the months ahead. Reflecting expectations for strengthening growth momentum, in November the European Commission raised its 2017 growth forecast to 2.2% from an estimate of 1.7% in May. The IMF also recently upgraded its growth forecast for the region.

■ In the major emerging economies, China's economy continues to display remarkable resilience as the government embarks on a drive to transition the country's economy to a more balanced growth model with less reliance on export and capex.

Monetary policy and financial markets

■ The prevailing backdrop of strong growth and modest inflation has boosted corporate earnings and supported equity markets. For instance, the US S&P 500 index has gained about 15% so far this year. Returns in the Eurozone and UK have been more modest, with the Euro Stoxx 50 and FTSE 100 indices up about 8% and 4% respectively in local currency terms over the same period. Looking ahead, while key leading indicators point to a continuation of the cyclical upswing in growth and monetary policy remains broadly accommodative, equity markets should remain well supported.

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■ In the fixed income markets, while absolute returns have been lower than for equities, in aggregate, bonds have also performed well over the year to date. In the government bond markets, a dominant theme in recent months has been a dramatic flattening in yield curves across the major developed markets—but particularly in the US. This reflects a combination of rising yields at the short end of the yield curve (as investors anticipate monetary policy tightening) and falling yields at the longer end of the yield curve (as investors respond to weaker than expected inflation and concerns about the growth outlook further out).

■ Historically, an inverted yield curve (where the yield on longer-dated government bonds falls below those on shorter-dated equivalents) has been a reasonably good (albeit imperfect) indicator of an impending recession. For this reason, the recent acceleration in the pace of yield curve flattening in the US has caused some concern among investors. Clearly, there is still some way to go before we see an inverted yield curve in the US.

■ Nevertheless, concerns about valuations persist across both equity and bond markets and investors now have to contend with a changing monetary policy environment. So far this year, the US Fed has raised interest rates on two occasions and is widely expected to do so again in December. The US central bank has also guided markets to expect three rate hikes in 2018.

■ For its part, the Bank of England (BoE) recently raised rates for the first time in a decade. Unlike the Fed, which was able to hike in the context of strengthening economic growth, the BoE's hike was driven by a concern about inflation, despite a backdrop of waning economic activity. In the Euro-zone, while the ECB maintains its accommodative stance, investors increasingly expect the European central bank to soon begin taking steps to drain some liquidity from the markets.

■ Another important recent development relates to personnel changes at the Fed where President Trump has nominated Jerome Powell to take over from Janet Yellen as Fed Chair in February 2018 (subject to Senate confirmation). While Powell is widely considered to be of broadly similar views to Yellen on monetary policy, it remains to be seen how he would respond to challenges that the US economy will inevitably face over the next few years. Moreover, the incidence of several vacancies on the Fed's Board means that the President will have a lot of leeway to shape the central bank in the months ahead.

■ The risk here is that the Fed becomes relatively light on experienced personnel (in terms of both tenure and advanced training in economics) at a time when it faces the challenges of unwinding extensive monetary policy stimulus against the backdrop of an extended business cycle and richly valued financial markets. Needless to say, there is plenty of scope for significant policy errors in the months and years ahead.

■ In the meantime, looking to the rest of 2017, the standout risk event appears to be the requirement for Congress to vote to raise the US debt ceiling by mid-December. Consensus expectation is that a deal will be done in time despite likely political posturing. This has been the typical expectation around such events, perhaps because the alternative, a technical default by the US government, is almost unthinkable.

■ Clearly, some caution is warranted. Within client portfolios, we maintain allocation broadly in line with longer term strategic weightings across the major asset classes.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 5th November 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/+
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
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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