THOMAS
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INVESTMENT

Investment Commentary

November 2018

Recent economic developments

■ In the US, real gross domestic product (GDP) increased 3.5% in Q3 2018, according to the "advance" estimate. While that initial estimate is subject to revisions, it gives a broad picture of the trajectory of growth. Overall, the message is one of ongoing strength in the US economy. It is also notable that the strong initial reading comes on the back of a particularly brisk GDP growth rate of 4.2% in the second quarter of 2018.

■ The strength of the US economy has been particularly evident in the labour market, where the headline unemployment rate has fallen to a multi-decade low. Importantly, wage growth has also picked up materially in recent months, hitting a 9-year high in October. Although headline inflation has risen in recent months, the sharp decline in oil prices in recent weeks is likely to dampen inflation pressures in the months ahead.

■ The performance of the economy has enabled the US central bank (Fed) to maintain its policy of gradual increases in the level of interest rates. Following three hikes so far in 2018, the Fed has guided the markets to expect a further 25 basis point increase at its next meeting in December. Beyond that, however, there is some divergence between Fed guidance and market expectations, with prices indicating that markets expect the Fed to end up raising rates fewer times in 2019 than the central bank's projections currently suggest.

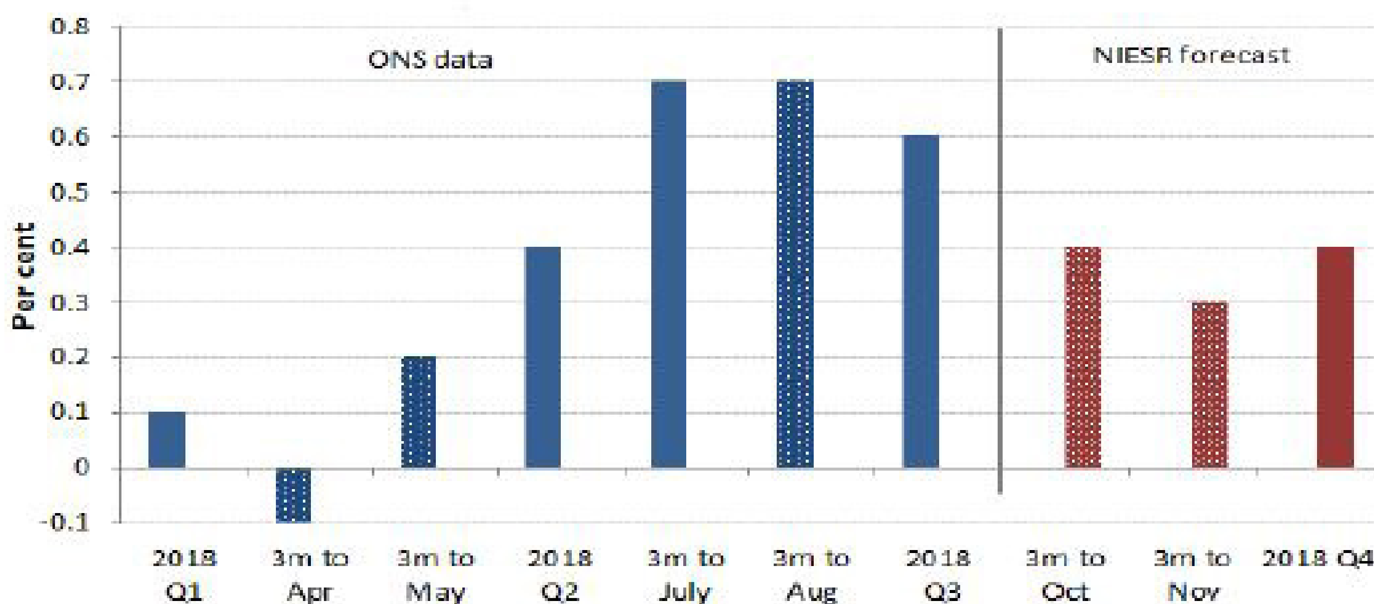
■ In the UK, GDP expanded by 0.6% in the third calendar quarter of 2018, marking a significant uplift from the 0.4% rate reported in the previous quarter. The Q3 growth rate was the best quarterly growth in almost two years. Importantly, the UK's Q3 numbers were driven by particularly strong performance in July. Since then however, growth has been flat. Moreover, initial data on the start of the fourth quarter have been weak. For instance, Markit/CIPS UK Services PMI, an indicator of activity in the services sector, recently fell more than expected, indicating that the services sector experienced its weakest pace of expansion in seven months during October. A similar report for the manufacturing sector also showed a marked slowdown.

■ The slowdown in growth in recent weeks has led to downward revisions to UK GDP for the final quarter of 2018. For instance, a recent report by the National Institute of Economic and Social Research (NIESR) notes that "the apparent strength in third quarter growth masks a loss in momentum in industrial production as well as services output in the latter part of the third quarter. There are a number of factors at play, including Brexit-related uncertainty." The NIESR projects a growth rate of 0.4% for Q4. Figure 1 shows actual GDP data from the Office for National Statistics (ONS) and projections from the NIESR.

■ Elsewhere in the developed economies, recent reports also showed waning growth momentum. In Europe, the extent to which the outlook for growth has deteriorated is

Chart 1: UK GDP Growth

3 months on previous 3 months



Source: NIESR, ONS

illustrated by the fact that consensus expectations are that German GDP contracted in Q3 by -0.2% from a growth rate of 0.5% in the preceding quarter. With regards to the issue of Italy's budget, the most likely outcome is a compromise agreement of some sort. However, what form that takes, or what path the parties take to arrive at the point remains to be seen. In the meantime, European financial markets are likely to remain vulnerable to further decline.

Financial markets & asset allocation summary

■ The combination of concerns about the outlook for global economic growth (including fears about the risk of trade wars) and elevated political risk in the US (mid-term elections) and Europe (Brexit and budget crisis in Italy) triggered a sell-off in financial markets in October. The ensuing correction was broad-based as equities, bonds, commodities and a broad range of alternative investments all suffered declines. Despite a relief rally in the days following the US mid-term elections, global financial markets remain jittery.

■ The US elections delivered a split Congress, with the Democrats winning control of the House of Representatives while the Republicans strengthened their majority in the Senate. Historically a split Congress has resulted in policy gridlock, with the government unable to deliver its legislative agenda. In this instance, it is likely to mean that the Republicans struggle to deliver on plans for further tax cuts. More broadly, it could curtail the scope of other planned fiscal expansion. This could help to dampen upside pressure on inflation and reduce the risk of a more aggressive Fed in 2019.

■ Looking to the rest of the year, the shorter term market outlook is likely to be driven by ongoing concerns about the sustainability of corporate profits and broader uncertainty about the economic outlook. Given ongoing strength of the US economy and expectations of a further Fed hike in December and several hikes in 2019, US Treasury yields should continue to drift higher in the near term.

■ However, key leading economic indicators point to further deterioration in global growth momentum and suggest that growth rates should slow further in the coming months—including in the US. While a marked slowdown may seem unlikely at present given the recent strength of the US economy, it is a clear risk to the outlook for the year ahead. An important asset allocation implication of this scenario is that following a poor showing in 2018, government bonds may play an important role in multi-asset portfolios in 2019. Meanwhile, with corporate credit spreads remaining tight, corporate bonds offer little value in risk-adjusted terms. In broad terms, equity markets remain reasonably attractive, but we expect elevated volatility levels to persist for some time. In the currency markets, uncertainty around Brexit and Italy weigh on sterling and the euro respectively and any positive news on either will boost the related currency.

■ Overall, client portfolios are currently positioned in line with the longer term strategic weights to each of the major asset classes.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 9 November 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	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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