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INVESTMENT

Investment Commentary

AUGUST 2014

Summary of recent economic developments

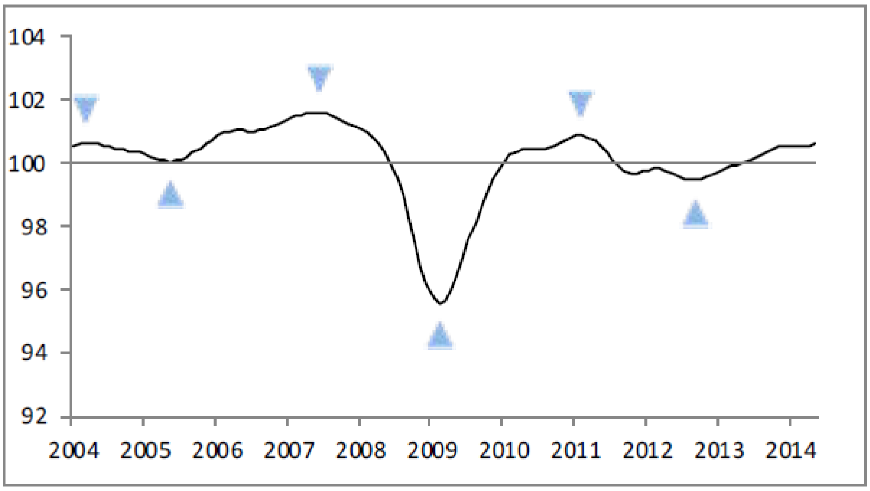
The global economy has made a strong start to the third quarter as output growth accelerated to multi-year highs.

Growth was led by the US but outside the US, global economic reports were also generally positive in July. In the UK, the 0.8% quarterly rise in GDP in the second quarter took output back to its pre-recession level. More recent data have also showed that the momentum of economic growth remains strong. In the major Emerging Markets, recent reports have pointed to improvements in the growth outlook and steps toward reforms in China and elsewhere have helped to boost investor sentiment. Data on the Euro-zone was more mixed but overall painted a picture of ongoing recovery.

In the United States, the "advance" estimate of GDP showed an increase of 4% (annual rate) in the second quarter of 2014. The positive news was further boosted by the report that the contraction in the first quarter was shallower than initially thought—a revision from -2.9% to -2.1%.

Data on the US labour market was also generally positive as the economy added more than 200,000 jobs for a sixth consecutive month in July. The sustained improvements in the labour market alongside the sharp rebound in growth in the second quarter have led to renewed investor concerns that the US central bank (Fed) may have to raise interest rates sooner than expected (current market consensus is for rates to start to rise in Q2 2015). However, following its meeting in July, the Fed's statement was largely in line with expectations. It persisted with tapering at the prevailing pace, acknowledged the recent uptick in inflation measures and expressed concerns about ongoing slack in the labour market. In all, we expect the Fed to err on the side of caution as it decides when to start raising interest rates.

Chart 1 – Leading indicators flag stable growth momentum in the OECD area



Source: OECD, July 2014

Financial market review

In last month's report, we noted that despite the longer term attraction of equities relative to other asset classes, we considered it prudent to be somewhat cautious on risk assets in the shorter term. Having been resilient so far this year, in late July, equities succumbed to a combination of risk factors. In addition to the ongoing geo-political concerns, in July, investors had to contend with a sovereign default by Argentina; the announcement of a plan by Portugal's central bank to bail out the troubled lender, Banco Espirito Santo (BES); some notable disappointments during the US and European earnings season; and concerns about impending rate hikes in the US and UK.

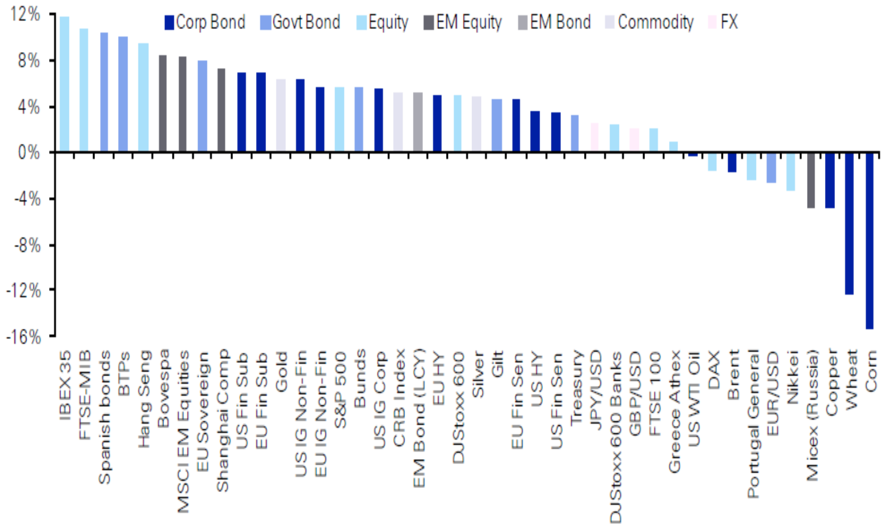
> **"Having been resilient so far this year, in late July, equities succumbed to a combination of risk factors."**

Overall, emerging market equities outperformed with price return of about 1.4% on the MSCI EM index in US Dollar terms. By comparison, the MSCI World index returned about –1.7% (USD price return). The US S&P 500 index, UK FTSE 100 index and Euro Stoxx index delivered –1.5%, –1.5% and –5.7% respectively during the month. EM equity returns were boosted by strong performance by Chinese equities as the Shanghai SE Composite returned about 8%. The weakness in the Euro-zone was broad-based, with French and German equities losing 4.0% and 4.3% respectively in Euro terms. Adverse currency movements amplified those losses to –6.2% and –6.5% respectively in USD terms.

Government bond markets were largely subdued in July. Again, emerging market debt led. Within corporate bonds, lower quality names underperformed during the month.

In the currency markets, the primary trend was that of US Dollar strength against the major currency pairs, as stronger-than-expected Q2 data led investors to bring forward projections of the timing of policy tightening in the US.

Chart 2 – Asset performance review: total returns so far in 2014 (Local currency terms)



Source: Deutsche Bank, Bloomberg

Monetary policy and investment strategy

In our view, the popular fixation on the precise timing of the first rate hike is not particularly useful. Barring any negative growth shock during the next 6-9 months, the Fed will start to raise interest rates at some point in 2015. From an asset allocation perspective, whether the first hike comes in March or May 2015 is largely inconsequential. Far more important is the probable path and peak in interest rates. In this regard, in light of the modest pace of economic activity, when the Fed eventually starts to raise rates, it will only do so at a very gradual pace. Importantly, given the current pattern of the economic recovery, it seems reasonable to expect a truncated tightening cycle in which the peak level of interest rates will be lower than the historical average "normal" level of interest rates.

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As we have contended for some time, from a longer term asset allocation perspective, fundamentals still favour equities over bonds. But neither asset class is 'cheap' in absolute terms. Moreover, despite the recent weakness in risk assets, shorter term concerns about stretched valuations and investor sentiment persist. On balance, the evidence suggests that conservative investors should not stray too far from benchmark allocations to the major asset classes at this time

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ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD

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

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

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