THOMAS
MILLER
INVESTMENT

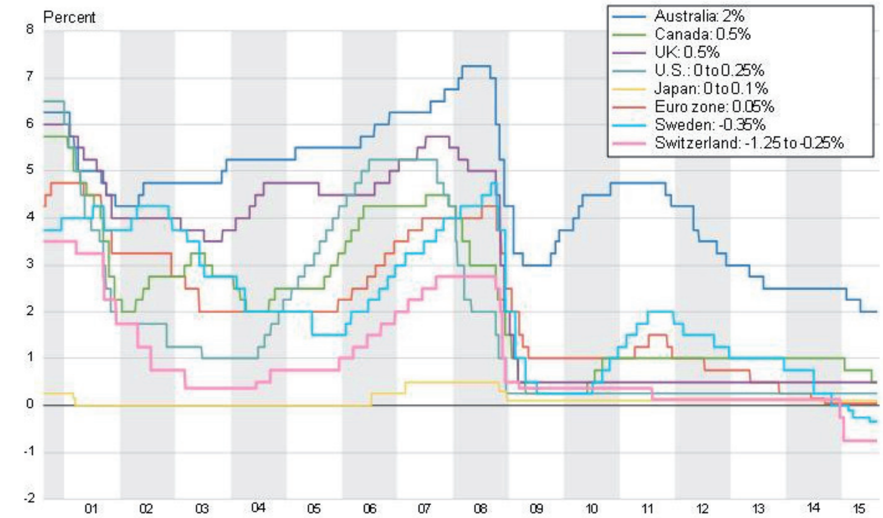
Investment Commentary

AUGUST 2015

Headwinds to global economic activity abound

Recent data on the global economy have been mixed. There has been positive news from the Euro-zone and the UK. However, reports on the US economy have been steady but not buoyant, while data on the Japanese economy as well as the major emerging market economies have been weaker than expected.

Chart 1: Central Bank Interest Rates



Vincent Flasseur @ReutersGraphics

Source: Thomson Reuters Datastream, data to 18/08/2015

Recent data on the Chinese economy have painted a picture of a country that is struggling in its attempt to transition from export-led growth to a more stable growth model, with greater emphasis on consumption and services. For the second consecutive quarter, the official estimate showed that the economy expanded by 7% (real terms, year-on-year). This was met with widespread scepticism by investors. The remarkable thing is that the apparently brisk official pace of expansion occurred despite the backdrop of notable weakness in several important indicators of economic activity during the period, including multi-year lows in industrial production growth; steep falls in exports; and sustained softness in the property sector. This weakness arguably explains why the government has recently implemented measures to stimulate the economy, including more accommodative monetary policy, increased fiscal policy support, and–perhaps more controversially–currency devaluation.

In the Euro area, growth has picked up notably in recent months, supported by a weaker currency. The recent 'resolution' of the Greece crisis has also boosted sentiment in the region. However, the boost to exports from the weaker euro may diminish in the weeks ahead as China's devaluation of the yuan could reduce the Euro-area's export advantage. Furthermore, it remains to be seen whether other countries will resort to competitive devaluations in the months ahead. For instance, given the contraction in the Japanese economy in the second quarter, policy makers may seek to increase the size of quantitative easing that the Bank of Japan is currently implementing, thereby reducing the value of the yen further.

> **"It is notable that the UK economy has grown for 10 consecutive quarters and GDP is now well above pre-crisis levels."**

Rising risk of policy errors by key central banks

In the UK, the first estimate of Q2 GDP showed that the economy expanded by 0.7% over the second quarter of 2015, a significant improvement from the 0.4% growth recorded in the first quarter. It is notable that the UK economy has grown for 10 consecutive quarters and GDP is now well above pre-crisis levels. However, the data showed that growth in the UK remains uneven. The service sector continues to be the dominant driver of growth, construction output was flat and manufacturing production declined over the quarter. Nevertheless, the recovery in the aggregate level of growth, with particular strengths in the housing and labour markets, has led to calls for the Bank of England to begin the process of interest rate hikes.

Similar clamour for rate hikes can also be heard in the US, where the first estimate of Q2 GDP growth showed a welcome increase on the first quarter. Taking the recent data revisions into consideration, the US economy continues to grow at a modest pace, averaging about 1.5% over the first two quarters of 2015.

US monetary policy officials looking to start raising interest rates from September have been arguing that the recent lull in the pace of growth is down to transitory factors—specifically bad weather and port disputes during Q1, 2015. Consequently, they expect the pace to accelerate notably in the second half of 2015. But looking at the broader trend in growth, at 3.3% the year-on-year growth rate in nominal GDP has decelerated from the 4.8% pace recorded in Q3 2014 and is currently at its lowest level since the first quarter of 2014. Importantly, the bounce in GDP reported in the second quarter was boosted by a large build-up in inventories.

Indeed, over the past two quarters, the US economy registered its largest two-quarter accumulation of inventories in 15 years. The problem with this is that periods of inventory accumulation tend to be followed by periods of inventory drawdown (and correspondingly, weak factory activity). This suggests that we should expect inventory investment to make a significantly negative contribution to real GDP growth at some point in the second half of 2015.

Furthermore, important leading economic indicators cast doubt on the likelihood of a notable acceleration in the economic growth rate in the second half of this year. For instance, OECD composite leading indicators designed to anticipate turning points in economic activity relative to trend, continue to point to easing growth momentum in both the United States and the United Kingdom. At the same time, events such as the recent collapse in commodity prices and China's recent devaluation of the yuan will ensure that global deflationary pressures persist for a while longer.

In summary, in the absence of rate hikes, there is a high probability that the recorded pace of economic growth over the next two quarters will undershoot expectations. Given this outlook, rate hikes at this juncture would risk amplifying the headwinds facing the US and UK economies. Proponents of near term rate hikes are right to argue that a September 'lift-off' in the US would reduce the need for much steeper hikes in the near future—but not for the reasons they imagine!

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Asset allocation summary

From the perspective of long term investors, while the economic recovery continues–albeit at a modest pace–and monetary policy setting remains accommodative, equities remain the preferred asset class. This is because, for all the shorter term risk that they exhibit, equities offer superior longer term risk-adjusted returns than bonds. Likewise, our selected range of alternative investments should continue to outperform cash and bonds.

The recent deterioration in global leading economic indicators is concerning. However, it should also mean that monetary policy remains very accommodative. The net effect of these forces on risk assets (i.e. soft fundamentals and supportive monetary policy) should be positive in the longer term.

For this reason, we retain a cautiously optimistic outlook on risk assets including equities and selected alternative investments. Conversely, relative to portfolio benchmarks, we maintain lower allocations to bonds and cash where client mandates permit. However, while bonds are not particularly attractive from a longer term investment perspective, concerns about the economic outlook over the rest of this year should mitigate any downside in government bond prices (and corresponding upside in bond yields). Renewed global deflationary pressures will also support the prices of developed market government bonds. The asset allocation implication of this is that the duration of our bond portfolios are close to those of their respective benchmarks. In other words, we are not expecting bond yields to rise sharply in the shorter term.

In the currency markets, we retain our underweight positions in the euro and yen against the US dollar. We are neutral on other major FX pairs.

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ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 5th August 2015)

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

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

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