THOMAS MILLER INVESTMENT

Investment Commentary

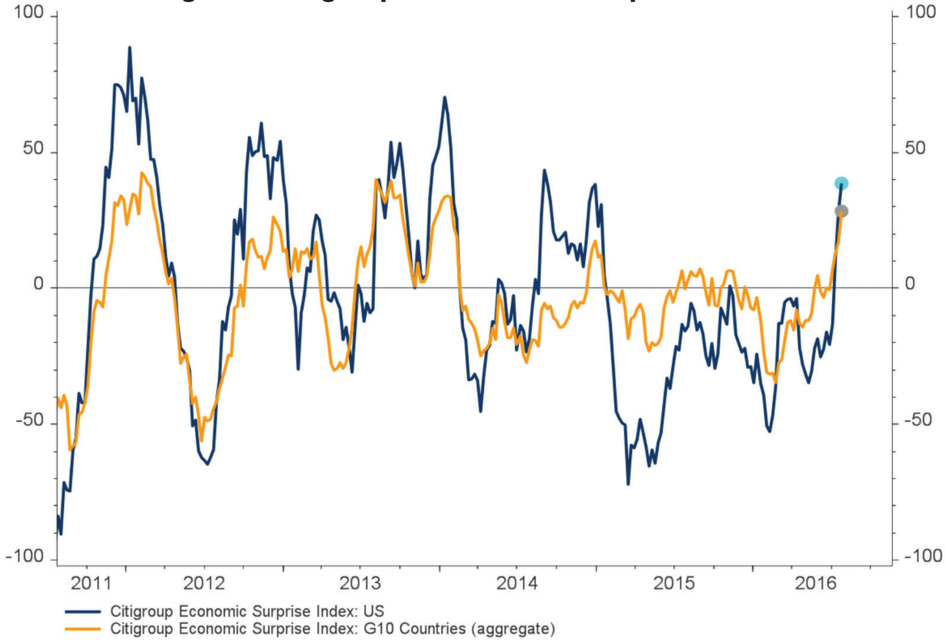
AUGUST 2016

An assessment of recent developments and outlook

As expected, recent reports on the pace of economic activity over the second quarter have shown improvements relative to the growth rates recorded in the first quarter of the year. Improved growth rates have been evident in the US, UK and major emerging market economies, including China and India.

Figure 1 illustrates the recent pick-up in economic growth relative to expectations. It shows the Citigroup Economic Surprise Index for the US and G10. The index 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. As shown, the indices have been on an upward trend since the middle of Q1.

Figure 1: Citigroup US Economic Surprise Indices



Source: Thomson Reuters Datastream

In the US, consumer spending has held up well, the labour market continues to show encouraging signs of resilience and corporate earnings have improved following the lows seen in the first quarter. However, the initial estimate of overall GDP growth suggested that the US economy expanded at a much slower than expected pace in Q2. The inconsistent nature of the evidence on US economic growth should ensure that the Federal Reserve maintains a cautious stance on monetary policy in the months ahead.

In the UK, the initial estimate of growth in Q2 showed that the economy expanded by 0.6% during the quarter. However, looking ahead (for the UK and Euro-zone), there remains a lot of uncertainty as to the magnitude of the economic impact of Brexit. In this regard, while there is as yet little hard data on the post-Brexit pace of economic activity, evidence from a range of surveys suggest a negative short term impact is materialising. Survey evidence from the UK services sectors in particular have shown signs of deterioration in activity levels in recent weeks.

Indeed, at its meeting in early August, the Bank of England's Monetary Policy Committee (MPC) affirmed the view that the outlook for the UK economy in the short to medium term has weakened markedly. Meanwhile, the sharp fall in sterling is expected to push up inflation in the near term. Overall, the BOE anticipates that the UK economy is likely to see little growth in GDP in the second half of 2016. In response, the MPC cut the base rate to 0.25% and introduced a package of additional monetary stimulus.

The evidence suggests that the uncertainty surrounding Brexit has resulted in a slowdown in the pace of business investment and consumer spending. In light of these developments, the Bank of England was right to announce further monetary stimulus. However, it remains to be seen how effective these steps would be in mitigating the anticipated fallout from the Brexit shock. At this point, it seems likely that further action and a broader policy mix (including fiscal policy measures) would be required in due course.

In Japan, the recent electoral victory for Prime Minister Shinzo Abe's ruling Liberal Democratic party and its allies has raised expectations of stronger policy support for the country's flagging economy. Investors now expect a combination of additional monetary policy support alongside fiscal stimulus programmes to be announced in the weeks ahead. It is worth noting here that investors' expectations have risen steadily in recent weeks and there is now a risk that the size of any programmes that are ultimately announced could disappoint investors.

Financial markets and investment strategy summary

As things turned out, Brexit caught most investors by surprise and triggered a sharp initial sell-off across global financial markets. In the UK equity markets, the largest initial declines were seen in those sectors with large exposure to the domestic economy and limited foreign currency revenues. In general, these tended to be mid-cap FTSE 250 stocks. Sectors that were particularly hit included house builders, retailers and banks. The sharp decline in the value of sterling boosted the FTSE 100 index relative to its mid-cap FTSE 250 counterpart.

However, while some individual stocks traded sharply lower, at the index level, the decline was both more short-lived and less severe than many had feared. Indeed, both the FTSE 100 and FTSE 250 indices had exceeded pre-Brexit levels within weeks of the referendum. Global stock markets have also showed remarkable resilience with strong performance across the board. It is particularly noteworthy that the US S&P 500 index now trades at new all-time highs. Figure 2 highlights the recent price or yield levels in selected financial markets.

For equity investors, much of the optimism has been driven by expectations that the Brexit vote will result in a more accommodative monetary policy environment. Indeed, recent decisions by the Bank of England to expand stimulus and the US Federal Reserve to delay further rate hikes have confirmed investors' expectations.

Like their equity counterparts, government bond markets have also rallied in recent weeks. Bond yields have dropped sharply (and prices have risen) as forecasts of modest economic growth have driven expectations of low inflation beyond the temporary effect of currency devaluation and more accommodative monetary policy. For instance, 10-year UK Gilt yields currently trade near all-time lows. Likewise, yields on 2-year UK Gilts are now barely positive and look set to join their Euro-zone and Japanese government bond counterparts in negative territory. Corporate bonds have also benefitted from an easing of the 'risk-off' sentiment and spreads have tightened across the credit spectrum.

Overall, the current backdrop throws up a number of conundrums for investors. No major asset class appears particularly attractive from a valuation perspective. Nevertheless, weak growth and benign inflation make long-dated government bonds appealing despite low yields, while ample monetary stimulus and liquidity continue to boost equity prices. In this environment, disciplined, objective-driven investors must avoid the temptation to chase returns and instead position their portfolios in line with carefully calibrated allocations to the major asset classes in order to meet long term objectives.

Abi Oladimeji
Chief Investment Officer

Figure 2: Recent market movements

	22/06/2016	28/06/2016	30/06/2016	28/07/2016
S&P 500	2,085	2,036	2,099	2,170
FTSE 100	6,261	6,140	6,504	6,721
FTSE 250	17,044	15,503	16,271	17,252
EUROSTOXX (50)	2,978	2,759	2,865	2,966
NIKKEI	16,066	15,323	15,576	16,477
MSCI WORLD	1,668	1,599	1,653	1,708
MSCI EM	829	805	834	876
US 10yr Govt. Bond Yield	1.69	1.47	1.47	1.50
UK 10yr Govt. Bond Yield	1.31	0.96	0.87	0.71
US 5yr Govt. Bond Yield	1.20	1.01	1.00	1.08
UK 5yr Govt. Bond Yield	0.84	0.45	0.35	0.30
US 2yr Govt. Bond Yield	0.74	0.61	0.58	0.71
UK 2yr Govt. Bond Yield	0.49	0.19	0.10	0.12

Source: Bloomberg

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 2nd August 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	0	0
Bonds (overall)	0					
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					

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

THOMAS MILLER INVESTMENT

London
90 Fenchurch Street
London
EC3M 4ST
+44 (0) 20 7204 2200

Birmingham
2nd Floor
Trigate Business Centre
210-222 Hagley Road
West Birmingham
B68 0NP
+44 (0) 121 222 5070

Southampton
Ocean Village Innovation
Centre Ocean Way
Southampton
S014 3JZ
+44 (0) 23 8038 1670

Isle of Man
Level 2 Samuel Harris House
5-11 St Georges Street
Douglas, Isle of Man,
IM1 1AJ
+44 (0) 1624 645200

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