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INVESTMENT

Investment Commentary

DECEMBER 2015

Global Economic Assessment

Relative to the lofty consensus expectations for global economic growth in 2015, the year has turned out to be rather disappointing. Over the course of the year, growth forecasts were progressively revised lower as it gradually became apparent that 2015 was not going to be the year that the global economy finally broke the pattern of sluggish trend growth that has characterised the period since the end of the Great Recession.

In a continuation of the trend from the previous year, global growth exhibited significant regional variations in 2015, with the developed markets faring better than their emerging market counterparts. In the developed markets, the US and UK led in absolute terms but growth momentum now favours the Euro-zone. Japan has been a laggard. Of the major emerging economies, India has been the main bright spot while others including China, Brazil and Russia continue to face significant challenges.

2016 economic outlook: evidence from leading indicators

Leading economic indicators provide an important gauge of the likely future path of economic activity. Consequently, it is noteworthy that the latest updates of OECD composite leading indicators (shown in the chart below), point to a deteriorating economic outlook in the US and UK—two economies that have led the global economic performance over the past couple of years.

Overall from a global perspective, leading indicators suggest that the pace of economic growth in 2016 is unlikely to be much better than that experienced in 2015; and the risks to the outlook are skewed to the downside.

Some notable risks to global growth

For the developed economies over the next few years, a key challenge will be how central banks manage the exit from unconventional monetary policy programmes without undermining the recovery which, as the data shows, remains weak by historical standards.

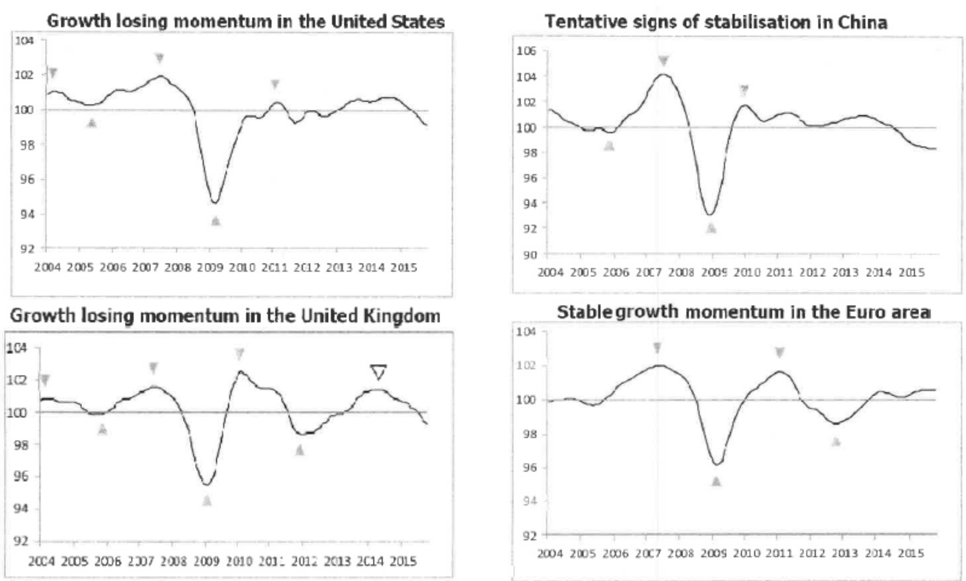
This is particularly pertinent for the US where the central bank (Fed) raised interest rates, on December 16th 2015, for the first time in almost a decade. In doing so, the Fed also published its forecast for interest rates of 1.4%, 2.4% and 3.3% at the end of 2016, 2017 and 2018 respectively. In light of the troubling evidence from leading indicators, it remains to be seen how the US economy copes with a tighter monetary policy environment. It is also worth noting that 2016 is a US Presidential Election year. Consequently, political uncertainty will become an important concern for investors as the year progresses.

In contrast to the Fed, most central banks are likely to remain on hold throughout 2016. Indeed, the European central bank, the Bank of Japan and the People's Bank of China will remain in monetary easing mode and could take further steps to ease monetary policy in the year ahead.

In the UK, the Bank of England should maintain the current level of interest rates for at least the next six months. Beyond monetary policy, a key source of concern for UK investors is the uncertainty surrounding the forthcoming EU referendum. This is likely to be reflected in greater volatility in Sterling as the voting date draws nearer.

Notable vulnerabilities remain across the emerging markets. In particular, the incidence of cyclical slowdown and sustained fund outflows driven by monetary policy changes in the US poses ongoing risks to the near term economic outlook. However, leading indicators are starting to offer tentative evidence of stabilisation across the emerging markets. Given that a lot of bad news has been factored into emerging market asset valuations, a turnaround in leading indicators would suggest diminishing downside risks as the year progresses.

Figure 1: Leading indicators flag muted growth



The above graphs show country specific composite leading indicators (CLIs). Turning points of CLIs tend to precede turning points in economic activity relative to trend by approximately six months. The horizontal line at 100 represents the trend of economic activity. Shaded triangles mark confirmed turning-points of the CLI. Blank triangles mark provisional turning-points that may be reversed.

Source: OECD, December 2015

Financial market assessment

Now that the Fed has actually raised interest rates, what is likely to happen to the financial markets? Below we summarise some important considerations for the major asset classes.

Bond markets:

The key for the fixed income asset class will be whether or not the Fed hikes at a faster rate than markets expect. While stating that policy will remain data dependent, the Fed's interest rate forecasts indicate that rates will rise by about 100 basis points in 2016. Clearly a faster rate of hikes will pose significant challenges for the fixed income markets. However, a faster pace of tightening would only happen if inflation and economic growth pick up more aggressively than currently expected.

On the other hand, demand for government bonds remains very strong and issuance is expected to be lower in 2016. Moreover, growth and inflation may turn out to be weaker than the Fed anticipates. These factors could mean that yields remain anchored around current levels. The evidence is finely balanced but we currently do not expect a significant rise in bond yields in the year ahead. Investment grade corporate bonds should have a good year but we are cautious on the outlook for high yield and EM debt (particularly local currency EM debt).

Currency markets:

The US dollar should continue to benefit from rising yield support for a while longer. However, in a pattern consistent with historical precedent, we expect the dollar's strength to fade over the next few months as the Fed gets into the swing of actually raising interest rates. Consequently, we are paying close attention to shorter term indicators of momentum and investor sentiment for early warning signs of weakness in the US dollar.

Equity markets:

History suggests that equity markets typically perform well during rising interest rate episodes. For instance, averaging across recent Fed tightening cycles, the S&P 500 has returned about 6% over the year following the start of interest rate rises. However, the devil is in the detail! Taking a closer look at the numbers, rising interest rates tend to cause investors to revise valuations downward. But since interest rates tend to rise in the context of strong economic growth, the impact of the growth in corporate earnings typically outweighs the compression in valuation multiples. Clearly a combination of rising rates and falling earnings will be bad for equities. Therefore, for the year ahead the key is whether earnings can grow at the circa 8%–10% annual rate that is currently projected by analysts. If not, then, like 2015, the year ahead could be another tough year of equity markets in general, and the US market in particular.

> **"Consequently, investors should temper their return expectations for all asset classes."**

We expect Europe and Japan to outperform global equities on the back of a more favourable monetary policy environment.

For emerging market equities, in the shorter term, weaker currencies and flagging growth should mean a continuation of the recent weakness. Longer term however, the potential combination of stabilisation in the growth outlook, diminution of US dollar strength and better valuations should ultimately result in attractive entry points for long term equity investors in the year ahead.

Asset allocation and investment strategy

Overall, while the major economies continue to record positive growth rates and the monetary policy backdrop remains broadly accommodative, equities should offer a better risk-return profile than bonds. But investors must not take it for granted that this backdrop will persist indefinitely. Moreover, as we have noted repeatedly, no asset class is 'cheap' by historical standards. Consequently, investors should temper their return expectations for all asset classes.

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ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 7th December 2015)

	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					
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.

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