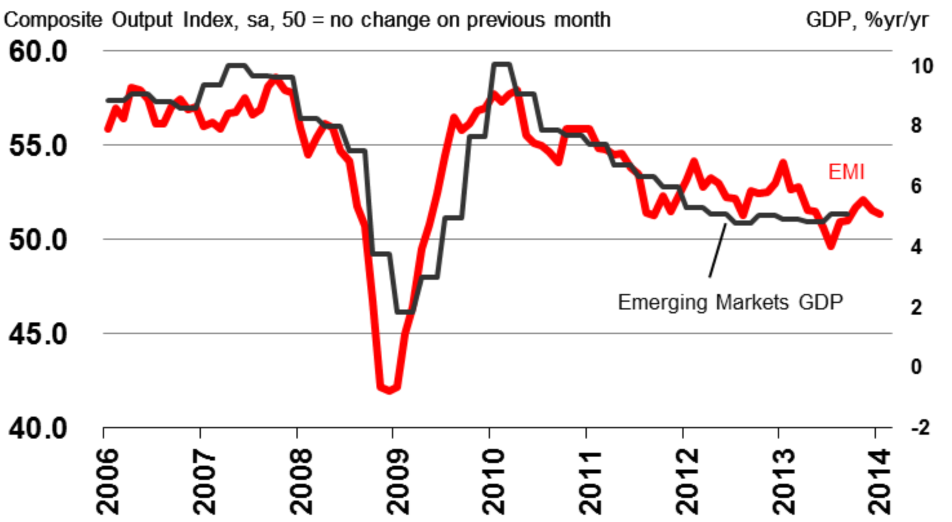
THOMAS MILLER INVESTMENT

Investment Commentary

FEBRUARY 2014

Recent Economic Developments

Chart 1: Chart 1: HSBC Emerging Markets Index (and EM GDP)



Source: HSBC, Mark-it

Looking at the incoming data on economic growth recorded during the last quarter, the distribution of global economic activity mirrors the pattern that has been in place for some time now.

While the major developed economies continue to grow at brisk rates, the major emerging market economies are experiencing ongoing economic slowdown.

Confirming the weakness in the emerging markets, in January, HSBC's composite Emerging Markets Index declined for the second consecutive month. The index fell to 51.4 from 51.6 in December. By comparison, the index stood at 54.1 in January 2013.

Conversely, in the developed markets, economic reports have been largely positive, with the US and UK in particular, experiencing strong rates of growth. In the US, GDP grew at a pace of 3.2% annualised in the fourth quarter of 2013, following a gain of 4.1% in the third quarter. The recorded pace of economic activity in Q4 is particularly impressive given the shutdown of the federal government for almost three weeks at the start of the quarter—an event that was largely responsible for a reported 12.6% drop in federal government spending during the quarter.

In the UK, growth continued apace, with GDP expanding at a quarterly rate of 0.7% in Q4. That meant an annual growth of about 1.9% in 2013—the strongest pace since 2007. The evidence suggests that the UK should be able to sustain a brisk pace of growth over the course of 2014. Recent positive developments have included signs of increasing confidence among households and firms, rapid improvement in the labour market and a sharp downturn in inflation. The decline in inflation should mean that the Bank of England is able to continue with the current accommodative monetary policy regime.

Global economic outlook: the error of optimism

Investors ushered in 2013 with a lot of enthusiasm and high expectations for both economic growth and financial market performance. Indeed, most forecasters currently expect global growth in 2014 to show a significant improvement on the pace recorded in 2013. For the developed markets in particular, investors have built in expectations that the growth spurt seen in the second half of 2013 will continue during 2014. Indeed, in the case of the US and the UK (and to a lesser extent the Euro zone), official projections are even more optimistic than private forecasts.

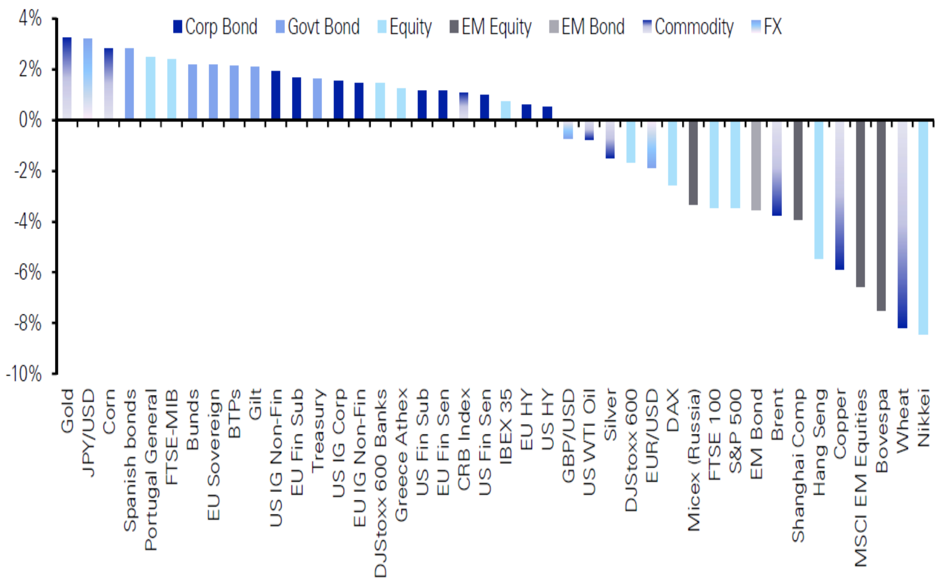
> **"...most forecasters currently expect global growth in 2014 to show a significant improvement on the pace recorded in 2013."**

Focusing on the US, there are good reasons for some optimism on the economic outlook. Relative to last year, one notable upside is that the US economy should face much lower fiscal drag in 2014. However, at this point, there is a case to be made that current consensus forecasts are likely at the upper end of the range of probable outcomes. For instance, it remains to be seen to what extent severe weather conditions in the US can be blamed for a cluster of weak data ranging from the sharp decline in January's ISM manufacturing index to the downturn in motor vehicle sales during the same month, the unexpected weakness in recent payroll reports and the recent softness in housing market data. From a global standpoint, perhaps more worrying is the recent tightening in global liquidity conditions. Bank credit growth has weakened in the US, Chinese authorities (PBOC) may have raised interest rates too aggressively, expectations for rate hikes in the UK have been brought forward and the ECB remains reluctant to do more in the face of clear deflation threat.

In December, the Fed's announcement of its plans to begin tapering triggered a rally in risk assets as investors interpreted the decision as a confirmation that the US economy was on a firmer footing. A review of the Fed's forecasting record in recent years should give investors pause for thought. But while the true extent of the impact of weaning the US economy off its dependence on monetary policy support remains to be seen, the ramifications of the Fed's actions are currently being felt further afield.

In the emerging markets, the fallout has been most pronounced in countries with sizeable current account deficits. This has led central banks in the vulnerable economies to raise interest rates in a bid to stabilize their currencies. The problem is that such rate hikes could ultimately have negative implications for economic growth in those countries. Weaker growth (and higher interest rates) would likely undermine asset prices in those countries, and potentially act as catalysts for further capital flight which might in turn force the beleaguered central banks to raise rates again! Avoiding this vicious circle scenario may yet require a coordinated global central bank response. Both the IMF and the OECD currently forecast a global economic growth rate of 3.6% for 2014. In light of the recent

Chart 1: Chart 1: HSBC Emerging Markets Index (and EM GDP)



Source: Deutsche Bank, Bloomberg Finance LLP, Mark-it

developments highlighted here, the risks are clearly to the downside.

From a developed market risk assessment standpoint, the risk of 'contagion' from the EM crisis currently appears low but investors cannot take this for granted. Overall, despite rampant optimism on the economic outlook, investors must neither lose sight of the downside risks nor take official growth projections as sacrosanct (BOE and Fed forecast 2014 growth rates of 3.4% and 3% for the UK and US respectively).

"Overall, despite rampant optimism on the economic outlook, investors must neither lose sight of the downside risks nor take official growth projections as sacrosanct."

Financial markets and asset allocation

In recent weeks the combination of Fed tapering and concerns about the outlook for growth in China have resulted in declines in global equity markets, with the worst of the decline seen in Japan and the emerging markets. In the developed markets, periphery European equities held up relatively well, supported by expectations that the ECB may be forced to go down the route of BOE/Fed style quantitative easing to combat the threat of deflation in the Euro-zone. Government bonds were boosted by safe haven demand and bond yields declined across the board.

For now, the evidence suggests that the cyclical upswing in developed economies remains intact and the correction in equity markets should therefore be short-lived. Moreover, the recent decline in government bond yields has once again eroded the attraction of the asset class from the perspective of the long term investor. While short term risks persist, equities remain the asset class of choice for longer term investors.

Overall, we retain a moderately positive bias on equities in general but remain cautious on emerging market stocks. We continue to favour corporate bonds over government bonds in the fixed income markets.

Abi Oladimeji
Director,
Head of Investment Strategy

London
90 Fenchurch Street
London
EC3M 4ST
Tel +44 (0) 20 7204 2200
Fax +44 (0) 20 7204 2737

Edinburgh
46 Charlotte Square
Edinburgh
EH2 4HQ
Tel +44 (0) 13 1220 9310

Isle of Man
Level 2 Samuel Harris House
5-11 St Georges Street
Douglas
Isle of Man
IM1 1AJ
Tel +44 (0) 1624 645200
Fax +44 (0) 1624 645220