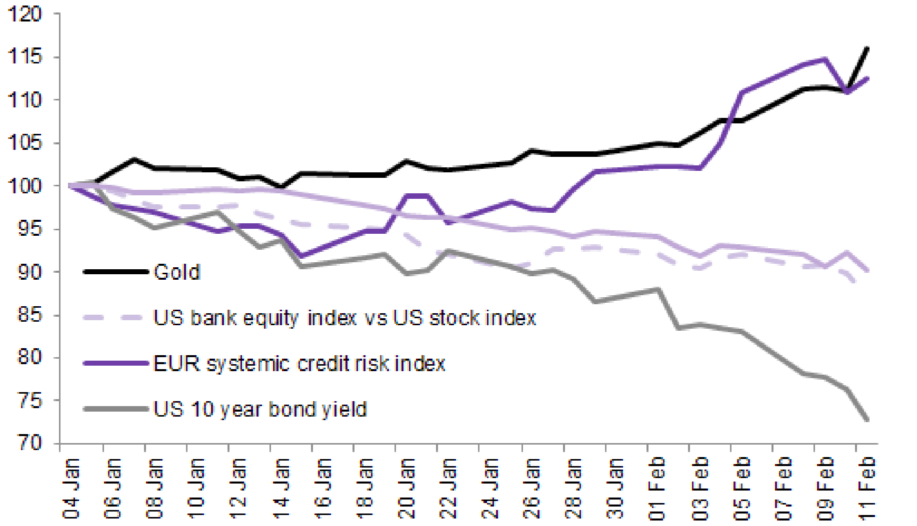
THOMAS
MILLER
INVESTMENT

Investment Commentary

FEBRUARY 2016

Triumph of the pessimists?

Figure 1: Gauges of Fear



Source: Goldman Sachs Global Investment Research, Bloomberg, COMEX

For some time now, we have been more cautious than the market consensus on the outlook for the global economy in general and the US economy in particular. For instance, back in August 2015, following a strong US GDP print in the second quarter, we argued that the substantial build-up in inventories, which had boosted the quarterly growth numbers, would ultimately mean that inventory investment would "make a significantly negative contribution to real GDP growth at some point in the second half of 2015." We went on to conclude that:

"…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..."

The point of highlighting the above is not to note that we have been right but rather to place the current backdrop of heightened risk aversion in some context. The market consensus has a penchant for oscillating between extremes of optimism and pessimism. As things stand in early 2016, the dominant narrative is that the sky is falling. In our opinion, the consensus view has now extrapolated the economic weakness that has ensued over the past couple of quarters beyond what is justifiable by the incoming data and a dispassionate assessment of the evidence.

For this reason, since the turn of the year, financial markets have been in the grip of a significant rise in risk aversion. In government bond markets, it is difficult to find a historical parallel to the current time. Bloomberg recently estimated that nearly 30% of the global government bond market is trading on a negative yield. Equity markets have sold off sharply and credit spreads have widened to levels that are rarely seen outside economic recessions or financial crises.

The drivers of the elevated risk aversion have varied over time as investor concerns have moved from the weakness in oil prices to fears of widespread default in the energy sector; and from concerns about the Chinese and US economies to worries about banks' balance sheets.

> **"Since the turn of the year, financial markets have been in the grip of a significant rise in risk aversion."**

Is the global economy on the verge of a new recession?

The tendency of financial markets to rush to bearish conclusions on the economic outlook is best summed up in the words of economist Paul Samuelson who once said that "the stock market has predicted nine out of the last five recessions". However, it is also the case that markets can often appreciate the constantly changing balance of risks better and quicker than policy makers and forecasters.

Global growth is moribund and key leading economic indicators suggest that the outlook remains precarious. Furthermore, the recent widening in credit spreads and the circa 20% rally in the broad dollar effective exchange rate since mid-2014 has resulted in much tighter financial conditions than a 0.25% interest rate hike by the US central bank (Fed) would suggest. Consequently, it would be complacent to dismiss the possibility of a new recession.

But there are several reasons why one could be more optimistic on the global economic outlook. Outside of some emerging market economies there is little evidence of excess capacity (think Chinese steel production and property sector) or strains (think global energy sector) in key sectors and there remains little monetary constraint on growth.

Still, classical business cycles tend to slow down before contracting; and it is clear that the global economy is currently going through a slowdown. Whether this morphs into a recession could depend on the timing of any negative shock. Essentially, the vulnerability of the economy to negative shocks varies across the business cycle and we are currently passing through one of those windows of vulnerability. In the absence of any negative shocks in the immediate future, the developed economies should avoid outright recessions.

In conclusion, the risk of recession in developed economies remains low but it is rising. Policy makers and investors must not get complacent.

Investment strategy summary

At the turn of the year we noted that the combination of lower liquidity, stretched valuations and weaker earnings could present a challenge to the long term uptrend in equities. However, although we were cautious on the outlook for equities in the year post the Fed's first rate hike in nearly a decade, the speed and severity of the decline in equity markets in the first few weeks of 2016 was not on the cards. Experience suggests that in such market environments, the best course of action is to refrain from panic-induced decisions and maintain investment positioning that does not stray too far from long term strategic asset allocation weightings to the major asset classes.

The concluding paragraph of last month's report stated that "On balance, the evidence suggests that a defensive bias is the most appropriate stance for investors to adopt at this point…" That remains true. What has changed in the ensuing weeks is that important indicators of shorter term market momentum and investor sentiment are now more supportive of risk assets, having declined from the elevated levels reached towards the end of 2015. This suggests that we are likely to see a more conducive environment for risk assets in the near term and equities should recover some of the ground lost so far this year. Consequently, we are cautiously optimistic on the shorter term outlook for equities in particular but risk assets in general.

In the currency markets, a notable development in recent weeks has been the strength of the Japanese yen and, to a lesser extent, the resilience of the euro and sterling against the US Dollar. Sure it makes sense for the USD to weaken in the face of concerns about near term US economic growth and expectations that the Fed will likely find itself unable to raise interest rates as much as it flagged in December.

But, like the sell-off in equities, these moves now look overdone in the shorter term. Over the next few weeks, we would expect to see a recovery in risk appetite as incoming data confirms ongoing global growth, albeit at a modest pace. Consequently, we would expect to see the Yen and the Euro strength fade relative to the USD.

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ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 15th February 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 / -					
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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