THOMAS MILLER INVESTMENT

Investment Commentary

JUNE 2016

An assessment of the economic backdrop and outlook

Global growth remains modest and inflation, on the whole, remains muted (apart from the US which is seeing a mild cyclical upswing in inflation). Within the major developed economies, the US, UK and Japan continue to experience slowing growth. In contrast, the Euro-zone continues to show stable growth momentum while there are tentative signs of stabilisation in growth rates in the major emerging markets following a period of weakness.

In the US, in May, consumer and investor sentiment was boosted by an upward revision to GDP growth for the first quarter. In its second estimate of GDP (second of three), the US Bureau of Economic Analysis reported that real gross domestic product increased 0.8% in Q1 2016–0.3 percentage points higher than initially reported. The upward revision to real GDP growth was primarily down to upward revisions to private inventory investment and net trade.

However, data on the recent performance of the US economy has raised concerns about the outlook for growth. Notable in this regard were reports on the non-manufacturing sector, which showed a slowdown in the pace of expansion; and data on the labour market, where the pace of job creation slowed sharply in May.

In light of the unexpected signs of weakness in the US labour market, investors rolled back expectations of a rate hike in the summer by the US Federal Reserve Bank (Fed). In recent weeks, various Fed officials, including the Chair, Janet Yellen, have reiterated the central bank's plans to raise interest rates at least twice over the course of 2016. However, as things stand, in the absence of an unexpectedly robust recovery in the pace of US economic activity in the second half of the year, the Fed will find itself sailing against the wind.

In the UK, the initial estimate of quarterly GDP growth rate of 0.4% for the first quarter was left unrevised although the annual pace of growth in Q1 was revised down from 2.1% to 2.0%. Brexit uncertainty contributed to the slowdown as business investment fell on the quarter. Overall, UK economic growth remains unbalanced. Indeed, growth in Q1 was driven by consumer spending while net trade made a negative contribution.

YIELDS ACROSS G7 GOVERNMENT BOND MARKETS

Country	2 year	3 year	5 year	7 year	10 year
Japan	-0.269	-0.246	-0.240	-0.248	-0.128
Germany	-0.541	-0.557	-0.411	-0.287	0.066
France	-0.453	-0.401	-0.192	0.005	0.425
Italy	-0.075	-0.017	0.432	0.836	1.438
United Kingdom	0.341	0.499	0.746	1.046	1.269
Canada	0.534	0.518	0.637	0.898	1.224
United States	0.781	0.921	1.231	1.509	1.718

Source: Bloomberg, 7th June 2016

The key short term challenge facing the UK (and Euro Area) economy is the spectre of Brexit. Thankfully, the referendum is only a couple of weeks away so the heightened level of uncertainty deriving from it should be short-lived. As we have noted in the past, while the longer term implications of Brexit for the British economy are somewhat uncertain, there is little doubt that the shorter term implications are decidedly negative. For this reason, any assessment of the outlook for the UK economy (and resultant monetary policy setting) over the next 12–24 months has to be predicated on the outcome of the forthcoming referendum.

Financial market developments and investment strategy

The dominant theme for the financial markets in May was the rapid change in investors' expectations for Fed tightening during the summer. Guided by comments from various Fed officials including the Chair, investors initially revised higher the probability of another rate hike possibly as early as June.

The concerns led to a notable spike in bond yields particularly at the short-medium end of the yield curve. Emerging market assets sold off sharply (both bonds and equities) while developed market equities were more resilient. However, the publication of much weaker than expected data on the US labour market at the end of May led to further revision of interest rate expectations. Investors essentially ruled out a rate hike in June and marked down the probability of a hike in July. On the back of this, equities recovered some ground and government bond yields [prices] resumed their long running decline [rally].

Along with US Treasury yields, yields on UK Gilts fell sharply (e.g. yields on 10-year UK Gilts are now at an all-time low), and yields on key European government debt descended further into negative territory.

Due to the modest pace of economic growth, we continue to expect ongoing monetary policy support in Europe, Japan and China. In the UK, in the absence of Brexit, there is little scope for a change in monetary policy setting over the next year.

INVESTMENT COMMENTARY

Brexit is likely to result in a more dovish policy stance by the Bank of England. In the US, while the Fed may hope to raise interest rates twice this year, the ongoing sluggishness of the US and global economy may yet curtail those plans.

As we noted at the start of this year, for US and global bond investors, the key consideration will be whether or not the ongoing economic slowdown morphs into something more sinister. That will determine whether or not the Fed hikes at a faster or slower pace than markets currently expect. On balance of evidence, we currently do not expect a significant rise in bond yields in the months ahead. Indeed, yields should face downward pressure from the combination of weaker than expected economic growth, modest global inflationary pressures, ongoing monetary easing in vast areas of the developed world and generally lower government debt issuance.

For equities, we reiterate the view that the combination of high valuation, weak earnings and heightened political uncertainty suggests caution in the shorter term. Moreover, during the summer months, the combination of low transaction volumes and elevated event risk (UK Referendum and Fed meetings in June/July being closely watched events in this regard) could result in heightened volatility in equity markets. Our current investment positioning is one of short term de-risking.

In the currency markets, the primary focus is on the forthcoming UK Referendum. Over the course of this year, Sterling has been largely range bound against both the US dollar and the Euro although it lost value against both over the past month. A Brexit vote is likely to result in substantial Sterling weakness across the board. Should the referendum result in a "Remain" vote, we could see a brief period of relief rally in Sterling as hedges and short positions are unwound. However, any upside would be curtailed by the relatively weak fundamental position of the UK (negative current account balance).

Overall, in terms of investment strategy, we maintain our defensive positioning by being slightly underweight equities and overweight bond duration.

Abi Oladimeji
Head of Investment Strategy

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 2nd June 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)	+					
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

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

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

Professional Adviser 2015 awards
WINNER
Best DFM

defaqto
2016
DFM Bespoke

Thomas Miller Investment Ltd's Bespoke DFM service has been rated 5 Star by Defaqto.

Clients are advised that the value of all investments can go up as well as down. Any past performance or yields quoted should not be considered reliable indicators of future returns. Opinions, interpretations and conclusions expressed in this document represent our judgement as of this date and are subject to change. Furthermore, the content is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or a solicitation to buy or sell any securities or to adopt any investment strategy.

tminvestment.com