THOMAS MILLER INVESTMENT

# Investment Commentary

**MARCH 2016**

## Rebound in economic activity steadies investors' nerves but growth outlook remains muted

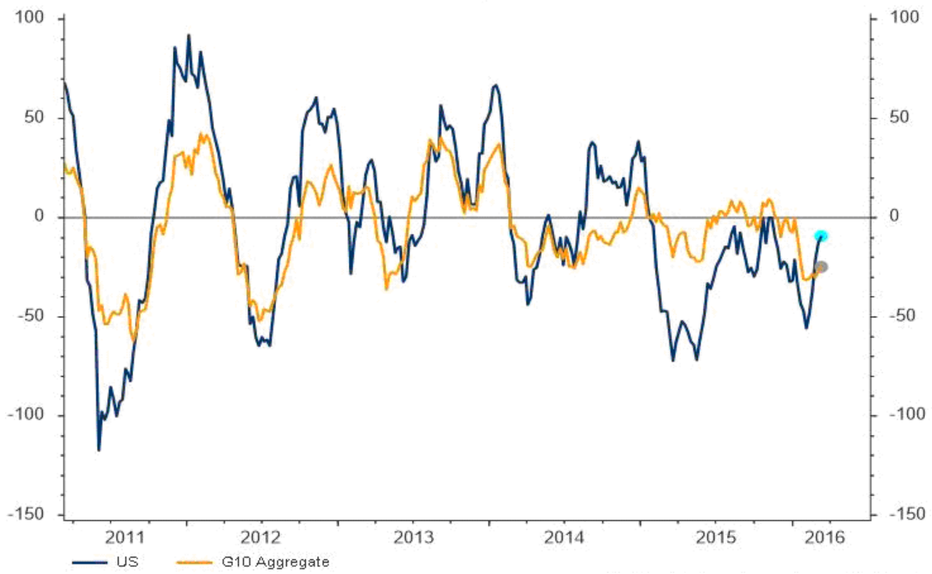
A combination of more upbeat economic reports and new stimulus measures by major central banks have helped to stem the tide of pessimism that swept through the financial markets in the first six weeks of 2016. More positive news in the second half of February and in early March have included upward revision to US GDP growth for the last quarter, evidence of ongoing robust growth in the Euro-zone and UK; and further monetary policy stimulus measures by the European central bank. Investors also expect further easing by the Bank of Japan by mid-year.

The rebound in economic data relative to consensus expectations (for the US and G10) is illustrated by Figure 1 opposite. The Figure shows the Citigroup Economic Surprise Index which 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.

US Q4 2015 GDP data was revised from 0.7% to 1.0%. The revision to 1% was more notable for the fact that consensus expectation was for a downward revision to 0.4%. Of course, GDP data remains subject to revision (the late February update was the second of three; and the final update is due in late March 2016) but the upward revision was consistent with more recent reports elsewhere which have, on balance, been stronger than consensus forecasts. Nevertheless, while the emerging data has allayed fears of an imminent US recession, the evidence still points to a muted outlook and monetary policy makers still need to be careful not to stifle the recovery.

In the Eurozone, industrial production increased by 2.1% in January. That marked the strongest monthly gain in six years and boosted optimism about the region's economic prospects. Investors' confidence in the region was also boosted by the ECB's announcement of a more aggressive monetary stimulus package than investors had anticipated.

**Figure 1: Economic expectations recover from pessimistic extremes**




Source: Thomson Reuters Datastream

In the UK, the latest estimate confirmed that the economy expanded by a better-than-expected 0.5% in the fourth quarter of 2015. Recent data showing ongoing weakness in construction and industrial output had meant that consensus forecasts had been revised slightly lower to 0.4%. However, as has been the case for a few quarters now, the strength of the services sector offset the relative weakness of the rest of the UK economy. Looking to the year ahead the outlook for the UK is particularly uncertain.

The UK recovery has been very reliant on consumers in recent quarters. That situation was sustainable while households benefited from the combination of growing real incomes and strengthening labour market. However, the year ahead is likely to be less conducive for consumer spending. A gradual pick-up in inflation will slow the growth in households' real incomes while a widely expected intensification of the fiscal squeeze and slower employment growth could undermine consumer confidence and constrain spending. Furthermore, the ongoing uncertainty surrounding the impending 'Brexit' referendum will continue to weigh on business confidence and restrain investment. At this point, consensus forecast is for the UK economy to grow by 2.1% in 2016. On balance of evidence, the risks to those expectations are firmly to the downside.

### The strong rally across risk assets has corrected the excesses of the January sell-off

In the concluding paragraph of last month's report, we stated that:

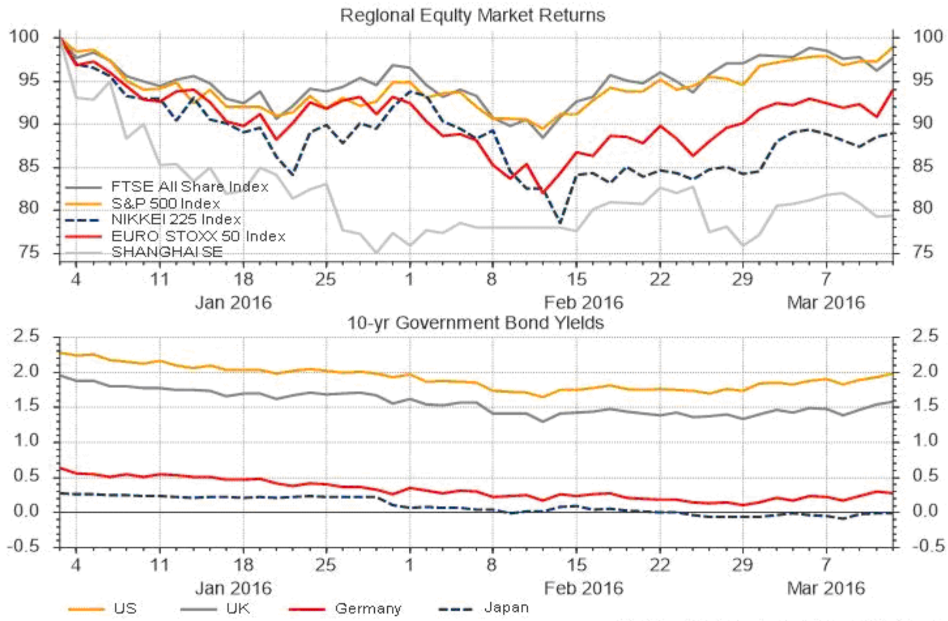
***"…important indicators of shorter term market momentum and investor sentiment are now more supportive of risk assets, having declined from the elevated levels reached towards the end of 2015. This suggests that we are likely to see a more conducive environment for risk assets in the near term. Consequently, we are cautiously optimistic on the shorter term outlook for equities in particular but risk assets in general."***

In line with our expectations, financial markets have staged a strong recovery since mid-February and have now largely corrected the excesses of pessimism that gripped markets earlier in the year. Figure 2 shows the performance of selected financial markets in 2016. Global equity markets have delivered double-digit gains over the period, led by commodity producers and banks. However, the rally has not been limited to equities. The recovery in investor sentiment has boosted risk assets across the board with strong gains in investment-grade corporate bonds, high yield bonds and a range of commodities, particularly oil.

In the government bond market, while yields have risen (and capital values fallen) more recently, they remain at low levels across the yield curve. We expect this pattern of low but volatile bond yields to persist while the economic backdrop remains weak and inflation remains benign. While inflation should grind higher in the months ahead, the pace of economic growth looks set to remain muted for quite some time. On balance therefore only a stronger-than-expected pick-up in inflation will cause government bond yields to push notably higher from current levels.

In the currency markets, the strength of the US Dollar has eased in recent weeks benefiting emerging market currencies (and EM assets and commodities in general) and also the Yen, Euro and Sterling. We expect the major currency markets to remain volatile in line with investors' changing assessment of the likelihood of Federal Reserve Bank (Fed) rate hikes in the near future. In this regard, it is worth noting that having originally guided investors to expect four rate hikes this year, the Fed has now indicated that US interest rates are only likely to be raised on two occasions in 2016.

**Figure 2: Steady recovery in equities since mid-February 2016**




Source: Thomson Reuters Datastream

As we have noted in the past, the current environment calls for the tactical flexibility to vary risk exposure in line with the available market opportunities. In light of the prevailing economic and financial market conditions, investors should continue to err on the side of caution and focus on maintaining asset allocation that is consistent with their longer term investment objectives. Consequently, our client portfolios are now positioned in line with longer term target weightings to the major asset classes.

**Abi Oladimeji**
*Head of Investment Strategy*

## ASSET ALLOCATION

**TMI ASSET ALLOCATION SCORECARD (as at 16th March 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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