THOMAS MILLER INVESTMENT

Investment Commentary

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Economic assessment: a two-track world

Data released over the past few weeks have reinforced the ongoing trend of a two-track world economy, with the major developed markets (DM) experiencing upturns in growth momentum while the major emerging markets (EM) suffer slowdown in growth rates.

Chart 1: PMI Output/Business Activity Index—Developed v Emerging World

Source: Markit, JPMorgan, HSBC

Stagnation in major emerging economies

In discussing the EM, one runs the risk of over generalising. Disaggregated data show some marked divergence in fortunes across the EM and, despite the headline weakness, some emerging economies are thriving. On one hand, some countries (such as Mexico and Poland) have benefited from exposure to improving growth in the developed economies. Conversely in recent months, others have suffered disproportionately from deteriorating external balances which have either limited the extent of monetary policy response or led to forced tightening by domestic central banks in response to weakness in local currencies. Notable examples of the latter group include the likes of Turkey, Brazil and Russia.

Recent data showed that across the EM, PMIs (Purchasing Managers Index, a forward-looking gauge of business conditions) averaged 50.3 (below 50 indicates contraction; above 50 indicates expansion). That was the second worst performance since the depth of the financial crisis.

Momentum strengthening in developed economies

The developed economies are faring better and, for the OECD area as a whole, growth remains around trend. However, leading indicators flag markedly different speeds of growth across the UK, US, Japan and Euro-zone. Of that group, the outlook for the UK is most positive, with growth expected to remain above trend. Growth remains around trend in the US while leading indicators for the Euro-zone show a positive change in momentum. Indicators for Japan show a tentative loss of momentum.

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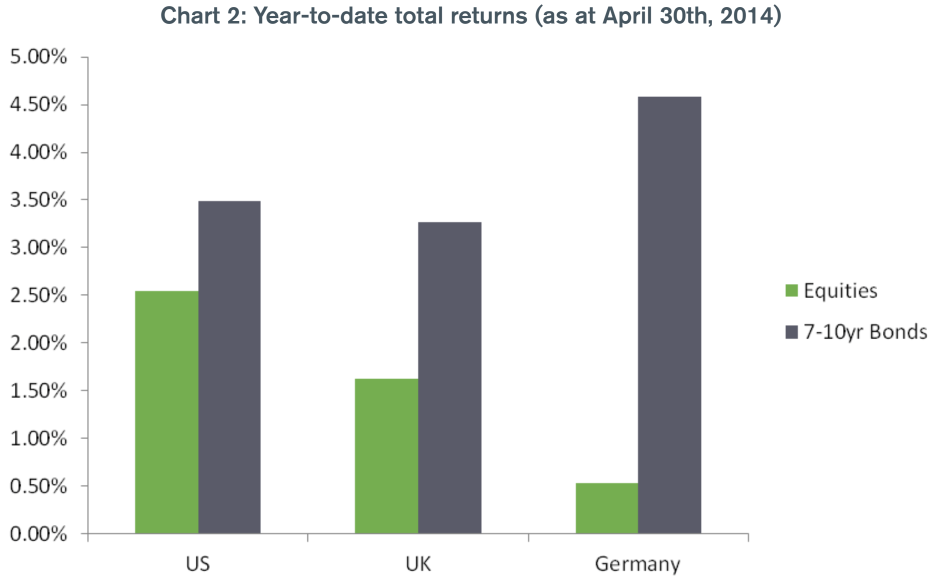
Risks to the outlook

While concerns about the global economic outlook currently focus on the EM, there are some clear risks to the outlook for the DM too. The key risk in this regard is that economic activity in the US undershoots expectations for the year. For now, the significant weakness recorded in Q1, when US GDP grew by a paltry 0.1% (quarter on quarter), is being attributed to severe winter weather. More recent data on international trade suggest that the initial estimate of 0.1% GDP growth rate was overstated and the US economy likely contracted in the first quarter.

At the start of the year, we contended that US economic fundamentals had not improved as much as consensus forecasts for growth in 2014 would have us believe. Nevertheless, we did not anticipate the severity of the weakness in economic activity relative to consensus projections. While it is clear that harsh weather had a negative effect on activity in some sectors (such as construction), the increasingly popular 'blame it on the poor weather' argument seems excessively complacent.

Financial markets and investment strategy

The combination of weaker than expected economic data, diminishing monetary policy stimulus and geo-political tensions in Ukraine has undermined investors' risk appetite so far in 2014. For the year-to-date as at the end of April, government bonds had delivered better returns than equities



Source: Bloomberg, Thomas Miller Investment

Note: S&P 500 index is used as proxy for US equities, FTSE All Share index is used as proxy for UK equities and DAX index is used as proxy for German equities. The country-specific Citigroup 7-10 year government bond index is used as proxy for bonds in the three countries.

across the US, UK and Germany. During April, returns on developed market equities were generally positive. UK equities led the way, with gains of 3.12% for the FTSE 100 index. However, the UK mid-cap index (FTSE 250) fell by 2.31% during the month. The S&P 500 index returned 0.74% while the Euro STOXX index gained 1.66% [all total returns in local currency terms]. Emerging market equities were flat for the month (although Russian equities again suffered heavy losses). Sentiment towards Japanese equities remained weak. While European equities have outperformed their US counterparts so far this year, it is noteworthy that first quarter earnings reports from European companies have largely disappointed. In contrast, the majority of companies that have reported in the US have beaten earnings expectations. This raises the risk of significant setback for European equities in the event that the ECB does not deliver (either on scope or scale) on anticipated monetary stimulus.

> **"While European equities have outperformed their US counterparts so far this year, it is noteworthy that first quarter earnings reports from European companies have largely disappointed."**

Bond markets again enjoyed another good month, with Euro-zone periphery government debt enjoying a remarkable run. Government bond yields in the periphery have now declined to multi-year lows, driven by a combination of falling inflation, improving economic outlook and rising expectations for further monetary stimulus by the ECB. At this point, periphery government bonds appear priced for perfection and the risks of disappointment are high.

Impact of the Russia-Ukraine crisis on financial markets

So far, the impact of the crisis has largely been confined to the Russian markets where equities have sold off and the currency has been very volatile. Beyond Russia, the financial market response has been relatively muted. However, investors must not get complacent. Clearly, there remains lots of scope for the crisis to escalate and undermine investor sentiment.

With global growth slowing in recent months, the last thing financial markets need is a significant negative shock coming from a trade war or military stand-off between the West and Russia. While such an outcome will have far reaching consequences, in the developed economies, the bulk of the damage will be felt in Europe, which receives some 40% of its natural gas supply from Russia. The region's nascent recovery could be undermined by a significant energy price shock. Elsewhere, a severe escalation of the crisis, with negative knock-on effects on global trade, could be the trigger that turns weak growth in the major emerging markets into outright contractions. It also has the potential to turn modest growth in the major developed economies into stagnation. Financial markets could be particularly vulnerable to any negative shocks during the summer months as volumes will typically be lower and volatility may therefore be amplified.

At this point, the most likely outcome seems to be an extended period of diplomatic gridlock between Russia and the West. A military solution seems inconceivable while sanctions alone will likely have slow incremental impact. A broad-based diplomatic solution appears the only viable option.

Investment strategy summary

We retain the view that equities remain the asset class of choice for long term investors although we are cautious on the shorter term outlook for risk assets in general. In the fixed income markets, we continue to favour corporate bonds over government bonds. However, we have cut back on exposure to corporate debt in the US where valuations are somewhat less attractive. In the currency markets, we have moved to neutral positioning (relative to client portfolio benchmarks) across the major pairs. In the shorter term, we see scope for further gains in sterling. The preferred way to exploit sterling's strength is against the Euro. This is because, unlike the Bank of England and the US Federal Reserve Bank which are widely expected to begin raising interest rates next year, the European Central Bank is likely to take further steps to loosen monetary policy in the near future (perhaps as early as next month).

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