THOMAS
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INVESTMENT

Investment Commentary

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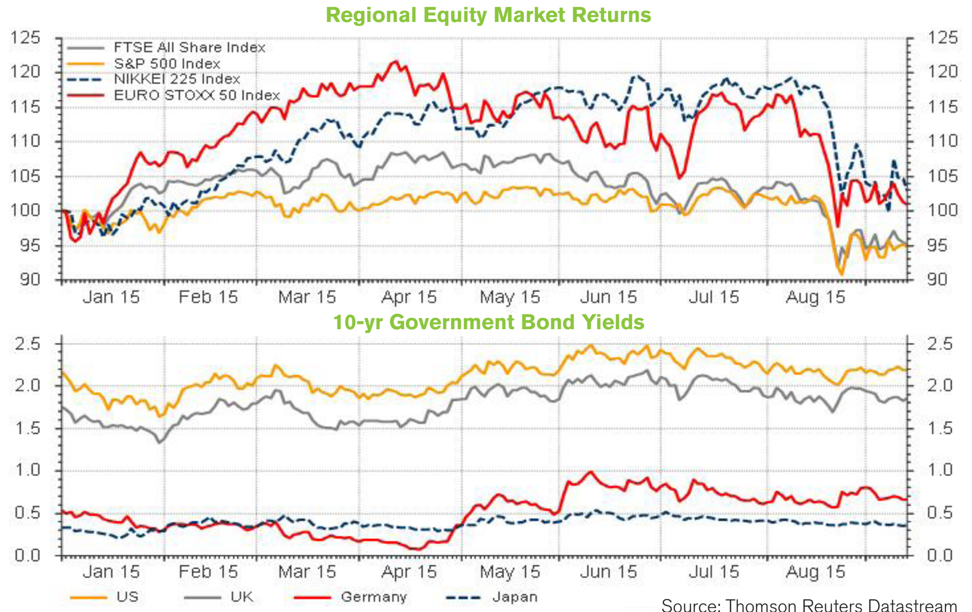
As things stand, the evidence is pretty clear that the global economy is currently going through another soft patch. However, significant regional variations persist, with the developed markets faring much better than their emerging market counterparts.



Source: Thomson Reuters Datastream

The US has been one of the bright spots in recent weeks. Perhaps the key data on the US economy over the past month has been the upward revision to GDP growth for the second quarter (from 2.3% to 3.7%). Labour market data has also remained strong, with the headline unemployment rate recently hitting a seven-year low while the pace of job openings has reached multi-year highs. It remains to be seen whether these will drive wage inflation higher in the months ahead but the evidence on that remains weak.

Turning to the UK, the economic recovery appears to have faltered in recent weeks. Manufacturing and construction activity remain very weak while the labour market seems to have lost some of its momentum. Furthermore, the renewed weakness in commodity prices means that inflationary pressures remain extremely muted and a return to deflation now looks likely over the next few months. Nevertheless, the UK's economy remains one of the best performers of the major developed countries.

Unfortunately, reports over the past few weeks have pointed to an acceleration in the pace of the ongoing slowdown in economic growth rates across the emerging markets, with China being the key focus of investors' concerns. The deterioration in China's trade statistics has been a particular source of worry for investors due to the potentially negative implications for world trade. Indeed, while such a scenario is not currently our base case, investors should not underestimate the capacity for a protracted slowdown in China to derail the global economic recovery.

In the Euro-zone, the pace of growth has moderated in the past month while inflation expectations have declined. In response, the ECB has reaffirmed its commitment to extensive monetary policy support. Likewise, as we suspected last month, Japan's anaemic recovery has raised the prospect of further fiscal and monetary stimulus.

The backdrop of weaker than expected global growth, particularly in the major emerging market economies has triggered sharp declines in global financial markets in recent weeks. The increase in volatility has been evident across equity, bond and currency markets; and has been amplified by uncertainties surrounding the outlook for monetary policy in the US.

> **"On balance, the evidence suggests that a moderately pro-risk bias remains appropriate for all but the most risk-averse investors"**

The case for the US Federal Reserve Bank (Fed) to begin raising interest rates in September is based largely on the assumption that the domestic US economy is strong enough for the tightening process to begin. In contrast, the case for a delay in tightening focuses primarily on the implications of Fed tightening for global financial stability. Both sides of the argument have been put forward by various members of the Federal Open Market Committee in recent weeks. At this point, it remains unclear which of these strands will prevail when the Fed meets in mid-September.

However, as we have noted in the past, the popular fixation on the precise timing of the first rate hike is not particularly useful. Clearly, the Fed is now committed to starting the process of tightening monetary policy. We may not get 'lift off' in September but it seems likely to come at some point over the next few months.

Of greater importance than the precise timing of the first hike, is the probable path and peak in interest rates. In this regard, in light of the modest pace of economic activity and persistent deflationary pressures, when the Fed eventually starts to raise rates, it should only do so at a very gradual pace. Furthermore, it seems reasonable to expect a truncated tightening cycle in which the peak level of interest rates will be notably lower than the historical average "normal" level of interest rates.

As we have contended for some time, from a longer term asset allocation perspective, fundamentals still favour equities over bonds. But neither asset class is 'cheap' in absolute terms. On balance, the evidence suggests that a moderately pro-risk bias remains appropriate for all but the most risk-averse investors.

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ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 2nd September 2015)

	United States	Euro-Zone ex Germany	Germany	United Kingdom	Japan	Emerging Markets
Equities (overall)	+					
Equity allocation by region	0	0	0	0	0	0
Bonds (overall)	-					
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	+					

The scorecard above represents our current tactical asset allocation position relative to portfolio benchmark. 0 =neutral, + =overweight, - =underweight.

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