THOMAS MILLER INVESTMENT

TMI Investment Commentary

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Macroeconomic Assessment

Regional variations in economic activity got more pronounced towards the end of 2012. For instance, while the US economy continued to show signs of ongoing growth, the UK economy slowed markedly during the final quarter of 2012 and the Euro-zone's economic woes intensified.

In the emerging markets, economic reports showed further evidence of renewed growth impetus in China and some of the other Asian economies. In Japan, the new government unveiled a new stimulus package in the hopes of boosting growth. While much of that stimulus package of more than 20 trillion yen will be aimed at public construction programmes and subsidies to strategically important sectors, the government's decision to raise military spending by 100bn yen raised concerns about further confrontations with China around islands in the East China Sea.

Once the fourth quarter numbers are published, year-on-year US GDP growth for 2012 is likely to be about 2.0%-2.3%. While far from stellar, that pace of growth would mark an improvement on the 1.8% recorded in 2011. Encouragingly, OECD composite leading indicators point to a pick up in the pace of growth in the quarters ahead. Combined with recent data suggesting sustained upturns in the US housing market, car sales, money growth, bank lending and the labour market, the outlook for the US economy in 2013 is decidedly rosier than it has been for several years.

However, expectations of a more robust US economy in 2013 carry the caveat of political uncertainty. Unfortunately political uncertainty seldom heralds upside surprises! Towards the end of 2012, a lot of media attention was focused on the issue of the US fiscal cliff. The concerns centred on the low but not insignificant probability that the US economy could be faced with a fiscal tightening amounting to about 3.5%–5% of GDP. For an economy that continues to operate with a substantial output gap and still growing at a below-trend pace three years into an 'economic expansion', it is clear that fiscal consolidation of such magnitude would result in a recession.

In the end, the Obama administration and Republicans in Congress reached a last gasp deal that averted most of the planned tax hikes, included no immediate spending cuts and postponed for two months, the "sequester" (automatic cuts in government spending that were previously scheduled to kick in from the start of 2013). As things stand (i.e. excluding the postponed sequester), fiscal tightening at the federal level will amount to about 1%–1.5% of GDP in 2013, with the bulk of the impact coming in the first half of the year. The two-month delay to government spending cuts means that they will have to be addressed at around the same time as the debt ceiling negotiations. Needless to say, the decisions that will be made in Washington over the next two months will play a crucial role in determining the outlook for the US economy over the next few years. If the sequester is removed in full and the debt ceiling is raised without excessive brinkmanship, then this could be a year in which the US economy delivers a pace of growth that is more akin to typical post-war recoveries. On the other hand, political gridlock and a government shut down in the face of political intransigence will undermine the economy.

Despite the fact that the UK economy was boosted by significant one-off effects in the third quarter of 2012, the 0.9% pace of growth recorded during that quarter engendered widespread optimism about the outlook for the economy. However, while market consensus estimates for UK GDP growth in 2013 are currently about 1%–1.2%, recent economic reports have been disappointing. For the year ahead, the outlook for the UK economy is particularly uncertain as several important indicators currently provide conflicting signals. While the OECD composite leading indicator continues to suggest that growth is picking up, a number of other important measures point to flagging economic activity.

Recent data reports showed that industrial production contracted on a year-on-year basis while the latest data on the UK's trade balance suggests that the external sector remains very weak. Moreover, evidence that the Euro-zone's recession is likely to intensify in 2013 means that a significant positive boost to UK GDP from the external sector remains a distant prospect. Perhaps the most disconcerting new evidence on the outlook for the UK economy came from the latest survey by the Chartered Institute of Purchasing and Supply (PMI services survey) which showed an unexpected contraction in the services sector—the first such contraction in two years. That evidence is particularly alarming because data from the Office for National Statistics (ONS) showed that the services sector was the primary driver of the growth recorded in the third quarter of 2012.

This assessment does not preclude a stronger outcome than what is currently built into consensus expectations for the UK economy in 2013. It simply highlights that emerging data increasingly point to downside risks to those expectations. While there is always scope for upside surprises (perhaps driven by a better than expected turn of events in the Euro-zone or a diminution of political risks in the US), that possibility should not form the central case of expectations. The reality is that on the basis of available evidence, it is currently difficult to see where more robust UK economic growth will come from in 2013.

Financial market outlook & Investment strategy

The compromise deal on the US fiscal cliff that was reached in Congress early in the New Year has boosted investors' confidence and fuelled further gains in equity markets. The FTSE 100 index marked its best start to any year since 1999 and now trades at levels last reached in mid-2008. Likewise, with gains of about 3.2% for the year so far, the S&P 500 index currently trades at a five-year high. Confirming the decline in risk aversion, the VIX has recently fallen to the lowest level seen in five and a half years. It is also noteworthy that inflows into equity mutual funds hit a five-year high during the first full week of January on the back of retail commitments. During the same period, actively managed funds also recorded their biggest inflows since 2000.

In contrast, government bonds experienced a weak start to the year. In particular, yields on US Treasuries rose sharply following the publication of the minutes of the Federal Reserve Bank's (Fed's) last meeting which showed a considerable amount of internal discussion over the timing of the Fed's end to its quantitative easing programme. However, despite investors' jitters, the reality is that the path of monetary policy is firmly linked to the performance of the US economy. And while the outlook for 2013 is much improved, the recovery in the labour market is likely to continue to be slow and drawn out. Besides, the prevalence of a sizeable output gap is likely to ensure that upward pressure on core inflation remains benign. These factors should ensure that Fed policy remains unchanged in 2013.

However, the expectation for monetary policy to remain exceptionally accommodative is not in itself a case for holding developed market government bonds. Indeed, for long term investors, any analysis of the risk-reward trade-off across different asset classes quickly shows that there is limited value to be derived from having a strategic allocation to such government bonds at current valuations. It is therefore arguable that for long term institutional investors such as pension funds and insurance companies, asset allocation to developed market government bonds should be limited to that imposed by regulations and requirements for liability matching. For this reason, our current investment strategy is to maintain allocation to government bonds in line with strategic benchmark levels. Within the fixed income asset class, we also remain neutral on index-linked bonds relative to portfolio benchmarks and we continue to favour corporate bonds over government bonds. We also prefer emerging market sovereign debt to their developed market counterparts.

Nevertheless, over shorter time horizons, government bonds may offer temporary shelter from bouts of equity market volatility and risk aversion. And while it is clear that, on the basis of current valuations, equities offer better value than government bonds, the prevailing elevated level of bullish sentiment is arguably inconsistent with the risks that lurk on the horizon. While it may have receded to the back of investors' minds, the Euro-zone crisis remains a source of downside risk to the improving global economic and financial market outlook. So does the potential for political miscalculation and policy errors in the US.

In the currency markets, we maintain a neutral stance across the major FX pairs relative to benchmark positions. Over the course of the year, we expect the USD to once again strengthen against both the Euro and Sterling. While there may be a temporary bounce in the Yen, in light of the level of commitment that the new Japanese government appears to demonstrate, the recent downward trend in the Japanese currency is likely to persist.

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