THOMAS MILLER INVESTMENT

Quarterly Economic Review

April 2012

Investment Strategy Overview

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The Macroeconomic Assessment

The broad divergence in regional economic performance continued during the first quarter of 2012. Evidence of a rebound in the US economy contrasted with data showing varying degrees of weak growth and slowdown in the major emerging economies, UK and the Euro-zone. The best that can be said for the Euro-zone economy is that the region's actual economic performance over the past three months has not been as bad as previously feared. Overall, the balance of evidence remains consistent with expectations of outright recession in the Euro-zone during 2012. Similarly, the outlook for economic growth in the UK remains muted and recent data on the construction sector indicates that there remains a small threat of a technical recession.

From the perspective of TMI's investment process, the key economic developments during the first quarter were the positive changes in the momentum of the OECD composite leading indicators for the US and the wider OECD area. These are shown in Figure 1 to the right. The observed turnaround have important implications for both the economic outlook and our expectations of the relative performance of the major asset classes over the next 6-12 months.

Implications for the US economic outlook

The upturn in the composite leading indicator reflects a broad-based improvement in a range of variables that measure financial market performance, real economic activity and consumer sentiment. As the OECD notes, turning points of composite leading indicators tend to precede turning points in economic activity relative to long-term trend by approximately six months.

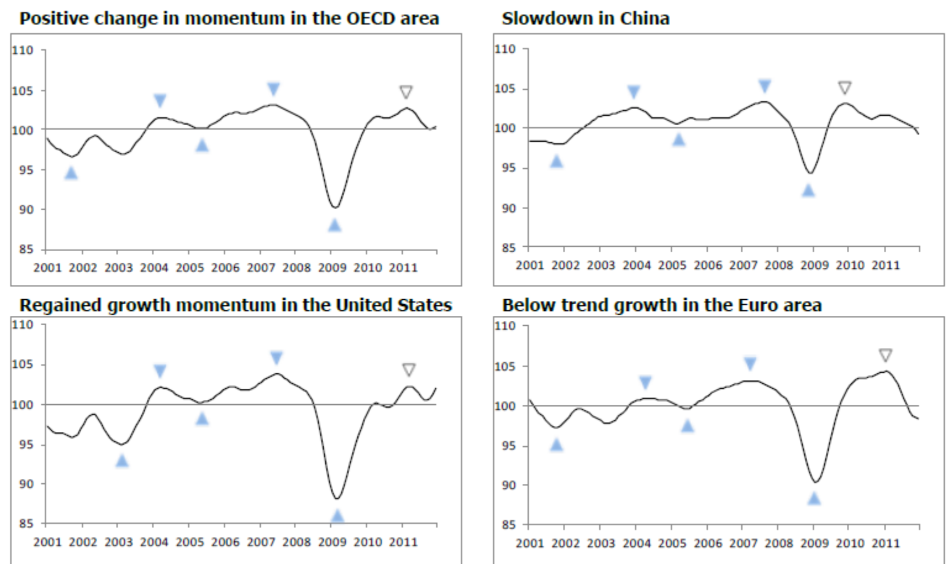
What could faster US economic growth look like?

The table below presents the projections for real gross domestic product published by the Federal Reserve Bank (Fed) following its meeting in January 2012.

The Fed's projections imply midpoint estimates of 2.6% in 2012, 3.1% in 2013 and 3.6% in 2014. The longer run range—that is, the range to which Fed participants expect the growth rate to converge under appropriate monetary policy and in the absence of further shocks to the economy—has a midpoint of 2.6%.

In light of the figures from the Fed in the table below, if sustained, the recent upturn in the OECD composite leading indicator for the US could herald a GDP growth rate that is somewhere in the upper end of the range for 2012 and beyond. That is, one could expect real GDP growth rate in the region of 2.6% to 3% in 2012 and potentially 3.1% to 3.8% in 2013. These figures are not TMI forecasts for US economic growth. They are merely logical deductions based on a combination of the available evidence.

Figure 1: OECD Compostie Leading Indicators



Source: OECD, February 2012.

Note that in each of the figures above, the horizontal line at 100 represents the long-term trend of economic activity. The shaded/solid triangles mark historical turning-points of the respective indicators while blank triangles mark provisional turning-points that may be reversed by the OECD.

Figure 2: Fed participants' range for real US GDP

Period	Real GDP
2012	2.1-3.0
2013	2.4-3.8
2014	2.8-4.3
Longer Run	2.2-3.0

Source: Federal Reserve Bank, "Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, January 2012".

Conclusions on the economic outlook

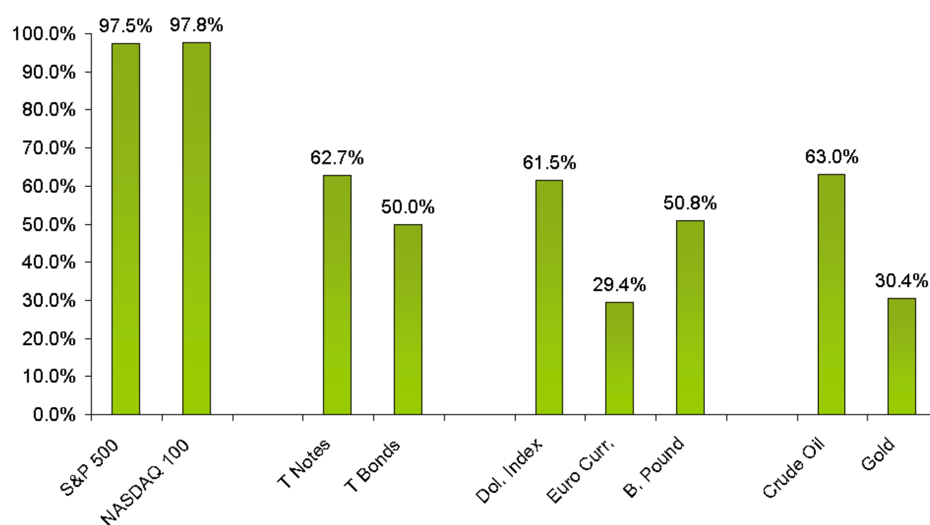
Given the analysis above, it is not hard to see why the recent batch of stronger than expected data has resulted in a ramping up of consensus forecasts for US economic growth. It is now taken for granted that the US has embarked on another upswing which should result in above trend pace of growth for 2012 and beyond. However, while such an outcome would be welcome, there remain clear risks to the economic outlook. Notable potential shocks to the economic outlook include the threat of a break-up of the Euro-zone, concerns about a crash in China's property market and the risks posed by the rising oil price. Furthermore, for various reasons, the economic outlook faces political risks from potential changes in government in Greece, France, the US and China. Overall, while the recent gains in US economic activity are encouraging, there remain numerous reasons to be cautious. Consequently, projections of 3%+ real GDP for 2012/2013—and the attendant expectations of monetary tightening by the Fed over the next year—that are now common place in the market are likely to turn out to be extrapolations too far.

Implications for asset allocation

Investors' appetite for risk has been boosted by monetary policy actions taken by the major central banks over the past six months. In our view, those actions provide a conducive liquidity backdrop for further gains in risk assets over the next 6–12 months. Given that valuations are not particularly stretched at this point, a sustained upturn in global leading economic indicators would only add to the supportive backdrop for equities.

> **"Overall, while the recent gains in US economic activity are encouraging, there remain numerous reasons to be cautious."**

Figure 3: Analysis of Bullish Consensus
(Data as at March 27, 2012)



Source: Market Vane data & TMI analysis

Short term concerns

Our positive medium term stance on equities is tempered by the observation that bullish sentiment is now once again approaching the higher end of short-term, tactical ranges that we monitor. The chart above depicts a measure of bullish consensus in various markets.

In the chart above, a reading of 100% (0%) indicates that bullish consensus is at the upper (lower) bound of its medium-term range. The key message here is that bullish consensus in equity markets is now approaching levels that are consistent with temporary market corrections. Alternatively, this 'overbought' condition may be unwound through an extended period of range-bound trading. Either way, it suggests caution in the short term as there is now a higher than typical probability of a temporary setback. However, in light of the supportive liquidity, valuation and (tentatively) growth backdrop, we would view such a setback as an opportunity to add to equity allocations at more attractive price levels.

In our view, while there is a potential for some correction in equities, government bonds of the major developed markets represent worse value at this point. Across the board, real yields remain near historical lows and government debt levels are unsustainable. Arguably, only a return to recession or a real threat of one in the US will justify an increase in allocation to government bonds of the major developed economies.

Conclusions on asset allocation

In summary, while short term concerns mean that we remain neutral on equities, so long as the upturn in the OECD composite leading indicator is sustained, our asset allocation bias will remain to overweight equities relative to bonds.

Economic and Market review

Stock Markets began the quarter with a bang but ended with a whimper.

All major stock markets have had a terrific start to the year, with the S&P Composite index enjoying the best first quarter to a year since 1998. Financial markets entered the New Year in much more optimistic mood about the outlook for the global economy. Equity markets rose by 12% in the USA, 12% for the Hang Seng, 19% for the Nikkei, and 17% in Germany. Commodity markets have also recovered with, for example, oil up 15% and industrial metals up 14%. The laggards have been the UK, up by only 3.5%, and peripheral European stock markets like Spain, which has fallen over 7% in the year to date. To some extent the equity market rally has been supported by hedge funds being forced to close out their short positions, after entering the New Year with an over-bearish outlook.

James Penn
Senior Portfolio Manager

However, markets ended on a slightly muted note, with falls in stock prices towards the quarter end, as sentiment grew that the rally had slightly outpaced growth prospects for the world economy. Meanwhile, government bond investors generally lost money over the quarter, with the FT All Stocks index down approximately 1.6%.

Undoubtedly, a major reason for the improving outlook has been the dramatic U-turn in ECB policy-making since the arrival of Mario Draghi last October, which has helped to avert economic catastrophe in the Euro-zone. The ECB has offered nearly €1 trillion in the form of three LTROs (long term repurchase offers), which has prevented a financial collapse.

Interest rates have fallen from 1.5% to 1.0% but more importantly the Central Bank has reverted to its 2009 policy of offering unlimited long-term liquidity to the banks, thereby relieving the bank funding crisis and reducing the risk of another damaging credit crunch. This has been far more effective in dealing with the Euro-zone debt crisis than all the summitry and bail-out funds. Commercial banks have used the proceeds from these ECB loans to purchase government bonds and bond yields have fallen sharply in Italy and Spain (see Chart 1). The impact of this policy should also be similar to the US and UK "QE" programmes and will give a welcome boost to Euro money growth. In other words, the ECB has shown that it is prepared to "print money" in order to avert another deep recession.

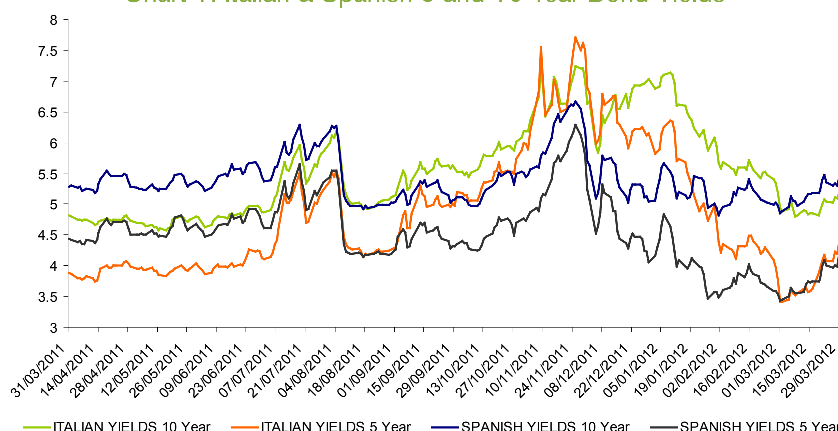
Confirmation that the limit on the European 'bail-out' fund had been lifted to €800bn has also helped sentiment. Originally the new bail out fund, called the European Stability Mechanism (ESM), was to have replaced the European Financial Stability fund (EFSF). Now, though, Chancellor Merkel has agreed that the two can run together. This is important, as a big pot of money in the background should help to maintain confidence in the Italian and Spanish government bond markets.

One concern for the longer term is the growing dependence of European banks on cheap central bank funding, leading to the emergence of 'zombie' banks. Banks and sovereigns are clearly now joined at the hip, and if one goes the other will surely follow. One result of this dependence is the increasing structural subordination of formerly 'senior' bank bond holders. Due to changes in legislation and preferred creditor status, over the past three years their senior status has become subordinate to both ordinary depositors and to supranational lenders such as the EIB, ECB and IMF. The chances of bank default are lower as a result of the ECB's actions, but the recovery rates if there is a default will be lower now than formerly.

More generally, markets have been encouraged that central banks worldwide have continued to relax their monetary stance in the last few months. Central bankers have been helped in taking this approach by their growing confidence that inflation will fall in 2012 as a result of more stable commodity prices. In the emerging world an easing of inflationary pressures has also provided some scope for central banks to reverse last year's tightening and provide more support to economic growth. Fears of a "hard landing" for the larger emerging economies have therefore subsided.

The other main reason for optimism has been the growing evidence that a new business upturn has begun in the USA. This has nothing to do with government spending; in fact, the public sector has already begun the painful process of retrenchment. Instead it is largely based on the improved health of the US banks which have re-built capital and are now expanding their balance sheets, despite continued regulatory pressures to shrink and to "de-risk". A new business cycle now appears to have started with an improving labour market, rising incomes and an increase in durable spending on autos and even houses. The unemployment rate has now fallen to 8.3% and initial jobless claims are running at close to 350,000 per week, the lowest level since early 2008. Notions that the improvement in the unemployment rate are only due to discouraged workers dropping out of the workforce are belied by the fact that the 'underemployment rate', or the rate that looks beyond benefit claimants, and which has been as high as 17% in the past three years, has itself come down to 15%. Sentiment gauges like the ISM, and Purchasing Managers Institute surveys in others parts of the world, have continued to come in relatively strongly, although a slight deterioration in the China PMI for March caused some concern at the end of the period.

Chart 1: Italian & Spanish 5 and 10 Year Bond Yields



Source: Bloomberg

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