THOMAS MILLER INVESTMENT

IQ2

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **JULY 2014**

A NOTE FROM THE CHIEF EXECUTIVE

A company's culture is shaped by the people who work for it. I consider myself lucky to be CEO of a business with such a fantastic culture where the principles of respect, focus, excellence and responsiveness to clients are key.

Respect of colleagues and clients is a founding principle of the business. Maintaining an absolute focus on achieving our clients' investment objectives is, we believe, why our relationships with clients are so strong. Everyone in the business endeavours to achieve excellence, and this is evident in the quality and consistency of our investment returns. Our culture is visible, and is reflected by our continued success.

The Commonwealth Games start in Glasgow at the end of July. We wish all the athletes luck, and in particular Grace Reid who is representing Scotland in diving. TMI has sponsored Grace since 2010 and we have truly admired her focus and endeavour to succeed. We look forward to hearing her results.

Mike Balfour,
Chief Executive Officer

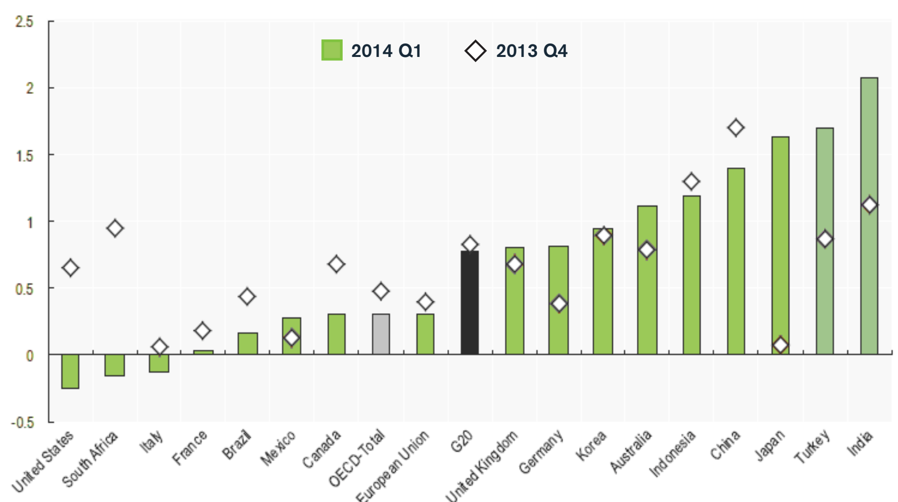
Investment Strategy Overview

In contrast to heightened optimism about the economic outlook at the start of the year, for most economies, the pace of economic activity in the first half of the year has been subdued.

Looking at the G20 economies, rather than accelerate into the new year (as was widely forecast), many economies have slowed since the turn of the year. The chart to the right shows the pace of growth in the first quarter of 2014 alongside the growth rate recorded in the final quarter of 2013. Taking the G20 as a whole, growth was flat over the period.

Looking ahead, it is encouraging that a broad range of activity surveys have posted strong readings in recent weeks. Likewise, leading economic indicators continue to flag improving growth momentum. All these point to stronger growth for the global economy in the months ahead.

Chart 1 – Quarterly GDP in volume terms for the G20
Percentage change on the previous quarter, seasonally adjusted data



Source: OECD

Low-interest rate policy, financial markets & investment strategy

Following its meeting in June, the ECB announced a range of monetary policy stimulus measures including the decision to cut both the main refinancing and deposit rates. The ECB's decisions had been widely anticipated in the markets. Indeed, in recent weeks, government bond yields in the Eurozone had fallen to multi-year lows, driven by a combination of falling inflation and rising expectations of such monetary stimulus measures by the ECB. Overall, these measures should support the downward trend in bond yields while also boosting European equities. In the currency markets, we expect the euro to remain under selling pressure.

More broadly, monetary policy divergence will remain a dominant theme for markets for some time. 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 economic backdrop in the Euro-zone should mean that the ECB maintains a loose monetary policy stance for the foreseeable future. Likewise, the Bank of Japan is expected to remain in loosening mode for some time.

While markets now widely expect rate hikes in the UK and US over the next year, our long held view that we are likely to get a truncated tightening cycle—with lower peak level of interest rates than in previous cycles—is now consensus view. This expectation of a low-interest-rate-policy environment has helped to drive down volatility across the financial markets.

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Looking ahead to the rest of the year, while there are pockets of relative strength (such as the UK and, more recently, Japan), we expect economic growth to remain modest and core inflation to remain benign across the developed economies. Consequently, any push up in government bond yields from current levels will likely be minimal—at least until the pace of economic growth picks up notably. For equities, we continue to believe that the backdrop of steady, albeit slow, global economic growth; moderate inflation; decent corporate earnings; and accommodative monetary policy can support mid to high single-digit rates of return. However, future equity returns are likely to come with higher market volatility. This is because we consider the current situation of extremely low equity market volatility (as proxied by the VIX) to be unsustainable.

Asset allocation summary

Despite the challenges of the current investment landscape, nothing has happened in recent months to change our view that equities remain the asset class of choice for long term investors. While no asset class is cheap at this point, relative to bonds, equity valuations look more reasonable, particularly beyond the US. Consequently, our general bias is to favour equities over bonds. In the shorter term though, we still consider it prudent to be somewhat cautious on risk assets. As noted above, the Euro-zone and Japan stand out as areas where central bank policy will remain particularly loose in the months ahead. It therefore follows that within equities, we favour overweight positions in the Euro-zone and Japan. We also retain a positive view on UK equities.

In the fixed income markets, we are taking advantage of the rally in bonds to cut back on duration in the UK and US, in anticipation of a gradual grind higher in bond yields over time. With corporate credit spreads at historical lows, we have also reduced exposure to that segment of the bond market. In the currency markets, we have moved to underweight position in the Euro (against both the US Dollar and sterling). While there are technical signs of overextension in the sterling, any pull back is likely to be temporary as the GBP continues to benefit from the relative strength of the UK's economic fundamentals.

Abi Oladimeji
Director & Head of Investment Strategy

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD

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

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

Economic recovery continues

Bond and equity markets both performed well in the second quarter, but most noteworthy was the drop in volatility to extraordinary levels.

Volatility has fallen to near all-time lows in equity, bond, commodity, forex and money markets. Equity market volatility, as measured by the VIX index, has fallen to half its long term average, and the lowest since February 2007. The MOVE index of bond volatility tells a similar story.

This is that the world economic recovery is continuing, led by developed countries, and central bankers do not want to do anything to jeopardise it. Accordingly, while in previous cycles interest rates would have risen at this point to more 'normal' levels, this time the central banks are leaving the process as late as possible.

In such an environment there is a danger of stock market bubbles, but there is little evidence of this currently. The FTSE 100 is still below the highs it reached in May 2013, albeit the US market has been making new highs. European markets have been recovering well, but are still well below their 2007 levels.

Over the quarter the US was the best performing major market with a rise of 4.7%. The Eurostoxx 50 index rose just over 2%, with Spain staging a catch-up in relation to the other peripheral markets and gaining 5.5%, while Japan rose 2.25% to claw back some of its losses from the first quarter. The hike in the Consumption Tax from 5% to 8% in Japan seems to have gone according to plan, with weak retail sales figures in April itself but a rebound the following month. The rise has been flagged for several years now, and there is little danger that it will have the devastating impact that the last one had in 1997.

Q2 2014 Highlights:

- **Volatility has fallen to near all-time lows**
- **There is little evidence of stock market bubbles - with the FTSE 100 still below the highs reached in May 2013**
- **M&A activity overall in the first half of 2014 amounted to $1.7 trillion**
- **Sterling rose above $1.70 to its highest level in five years**
- **Mark Carney: UK long term interest rate is likely to be half its pre-crisis rate, or about 2.5%**

The FTSE100 rose 2.3%, beating the FTSE All Share by a full percentage point. This has been the first outperformance by large cap stocks for some while, and it will be interesting to see if it persists. The FTSE 250 index fell 3.4% in a period marked by a preference for high dividend payers and dividend strength. The FTSE Smallcap index also fell, with the AIM index down 8%. Earnings disappointments resulted in sharp falls for 'high growth' stocks, with ASOS, the online retailer, dropping 42% over the quarter.

A return of M&A activity on this occasion favoured large caps, with the pharmaceutical industry in focus, and tentative bids made for Astrazeneca and Shire Pharmaceuticals in the UK, and Allergan in the US. M&A activity overall in the first half of 2014 amounted to $1.7 trillion. Oil stocks were also strong around the world as the oil price increased. Earnings have generally been supportive, with first quarter US profits up 6% on the previous year and 68% of S&P companies beating estimates. Share buybacks have also been a factor, with $160bn spent in the US in Q1.

The US stock market was untroubled by a 2.9% fall in Q1 GDP, double the drop in the 2001 recession. This was regarded as being largely weather related, with pent-up demand likely to lift GDP in the later quarters. Consumer confidence continues to be high, with the Conference Board's measure rising to 85.2 for June, the highest since early 2008.

The UK economy is motoring on all cylinders, with growth at last more balanced. Investment grew 10% year on year in the first quarter. Business confidence is at its highest in 22 years, according to Lloyds Bank. The strength saw Sterling rise above $1.70 to its highest level in five years.

Banks were again in the spotlight, with a $8.9bn fine applied to BNP Paribas for averting sanctions on Iran, Sudan and Cuba – the company will also be banned from making Dollar payments for a year. This followed a $2.5bn fine for Credit Suisse for assisting US citizens in tax evasion. Barclays is likely to face fines for misrepresenting liquidity in its 'dark pool', used in equity trading.

Emerging stock markets also rebounded, with the Hang Seng rallying 4.6% and China finishing up in both June and the quarter. The rest of Asia was up 5-6%, while India's BSE Sensex rose 13.5% in response to the pro-business election result.

Bonds had another strong run, led by the long end of the market leading as central bankers rein in expectations for the peak in short term rates. At the latest meeting of the Federal Open Markets Committee in the US members reduced their expectation for the Target Rate from 4% to 3.75%. In the UK Bank of England governor Mark Carney has said that the long term interest rate is likely to be half its pre-crisis rate, or about 2.5%.

There is still disagreement about the path of interest rates globally. In the past month the Bank of International Settlements and the International Monetary Fund have given contradictory messages, the former recommending a rapid normalisation while the latter advised further monetary loosening in Europe, even after a cut in the ECB's Repo rate to 0.15% and negative interest rates on commercial bank deposits at the ECB.

James Penn
Senior Portfolio Manager

Musings of a Private Client Investment Manager

I remember the raised eyebrows when Roger Bootle, one of the City of London's best known economists, told a roomful of the Isle of Man's investment professionals to expect five years of rock bottom interest rates.

That was in 2009, yet here we are five years later and the market has found itself consistently wrong-footed with its rolling forecast that base rates will start rising nine months hence.

The effects of this loose monetary policy are all around us. Major developed economies had a deep but relatively short recession and have since established positive, albeit sub-normal, levels of economic growth. Those predicting rampant price rises as a consequence of fiscal spending and ultra loose monetary stimulus have thus far been disappointed with sub-trend, low inflation. UK headline unemployment peaked at a whisker under 8.5% in late 2011, but has since steadily trended downwards to its present rate of 6.6%. UK corporate balance sheets and earnings are generally fairly healthy; and Britain's consumers relatively confident.

Of course, spending on today needs to be paid for tomorrow and the other side of the picture is that we should be rightly concerned by total (published) UK public debt to GDP levels of over 90%; and which hasn't yet peaked despite the impact of well-publicised austerity measures. However, whilst this level of UK government debt will prove a drag on future growth, at least we can derive some comfort from its relatively long duration compared to the US and Europe which reduces the likelihood of UK sovereign bankruptcy, in the near term at least.

The authorities will be hoping that economic growth becomes self-sustaining to the point that stimulus can be unwound and interest rates rise to more normal levels. The market on the other hand is a fickle and short-sighted creature and, whilst fixated on the timing of the first interest rate rise; is blithely ignoring the fact that what's really relevant is the speed and trajectory of those rises. Perhaps the implication of all this is that, given likely slower economic growth and sub-par inflation, we will see interest rates peak much lower in this than in previous cycles. Steadily declining economic growth and interest rate cycles… Japan, anyone?

With sustained historically low base rates and a relatively shallow yield curve, cash savers have unfortunately been the big losers over recent times; with the winners being borrowers and investors. Cash held with good quality institutions is generally yielding under 1% per annum. Including capital and income, UK Government Gilts have gained +27.4% in the five years ending 30th June 2014; and the FTSE All Share Index has produced an eye-watering +99.9%.

Just as interesting is the incredibly low volatility across major equity markets. The S&P 500 hasn't seen a 1% daily move for a number of weeks which is the longest such streak in over two decades; and it has been nearly three full years since that stock market experienced a 10%+ correction. "Elvis, and volatility, has left the building", read a ConvergEx Group analyst's note early last week. With Wall Street's "fear gauge", the Vix volatility index, lingering around 12, well below its long run average of about 20; some commentators are even willing to proclaim the "death of volatility". Markets seem convinced that central banks will keep easy monetary policy in place and support risk assets indefinitely. To the investment cynics amongst us, it's a reminder of the old adage that the best time to buy an umbrella is always before it starts raining…

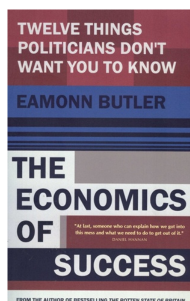
However, we are amidst a multi-year stock market bull run. This year's out-performance of traditionally defensive sectors including utilities and energy suggests investors may be considering parts of the market somewhat frothy; and are seeking protection in traditional equity safe havens with strong dividend streams and non-cyclical business revenues. This isn't in itself a danger sign, it is fundamentally healthy when stocks and sectors are able to self-correct their valuations without disturbing the broader bull market.

One nascent issue for equities is that in the main it has been the numerator of the P/E ratio (price) which has been driving their strong returns; and not the denominator (earnings). Growth investors are typically less interested in valuations but are attracted to upwards momentum and most mainstream assets have been rising in the last five years. For our investment portfolios this starts to cause problems as rising correlations between bonds and equities conspire to make well-diversified, "safe" portfolios riskier than they first appear.

Diversification is like insurance; we don't need it until we need it. Ongoing bull markets herd investment managers towards engaging in a performance race that then speeds us too quickly into the next corner in the road. Ersatz diversification enables better headline returns in the good times but allows a gradual underlying creep up the risk spectrum. Perhaps it is not a bad current strategy to be actively trimming profits to reinvest into lagging areas of the market; and even retaining a little dry powder for use if markets correct, as they surely will.

Tom Richards
Director & Head of Private Investment Management (Offshore)

The Economics of Success



By Eamonn Butler

In today's climate, as free market capitalism struggles to shake off its association with the ills of the last few years, and calls for more and deeper regulation of markets abound, it is refreshing to read an unashamed defence of the open market and an assault on the assumption that government intervention is always the optimal solution. This ought not to come as a surprise since the author is Director of the Adam Smith Institute and one imagines his interview would have been short had he propounded radically different views.

The Economics of Success is robust in its refusal to meet on ground chosen by critics of the free market. As Butler points out, anti-capitalists are very eager to argue about the actual experience of capitalism versus the imagined reality of the anti-capitalist society, but less keen to frame a discussion in terms of pitting either the reality of capitalism against the reality of the tried alternatives or indeed the theory of capitalism versus the theory of an anti-capitalist alternative.

Dr Butler follows closely in the footsteps of FA Hayek, though he has seventy more years of history from which to gather examples to illustrate his arguments. Butler's book does not have the urgency of Hayek's "The Road to Serfdom" – given the circumstances in which Hayek was writing – but it is a timely reminder of the drivers of the free market economy. The key principle – that markets are better arbiters of supply and demand than bureaucrats or politicians – is continually challenged by politicians and pundits, as they respond with calls for regulation and legislation to deal with an enormous variety of perceived problems. Butler's argument is that these interventions distort efficient pricing which in turn undermines market efficiency and leads to much criticised outcomes, wrongly laid at capitalism's door.

Dr Butler furnishes a number of contemporary and historic examples of such distortions and the effect of the reversal of some of those distortions. His description of the lifting of price and wage controls in post war Germany is interesting, though I am still not in a position to judge whether they were solely responsible for that country's subsequent recovery to European pre-eminence.

Many commentators refer to the greed or caprice of the market causing unfair outcomes. The strength of this book is to vigorously assert the position that markets are not in themselves greedy. Further, capriciousness in the economy largely emanates from governments, regulators and bureaucrats making large and flawed decisions purportedly on our behalf, rather than millions of us making small decisions based on our own circumstances and knowledge.

For me, if one wants the most cogent explanation of the principles underlying an open market liberal democracy one should read two classics: the aforementioned "The Road to Serfdom" and Tom Bingham's more recent "The Rule of Law". Dr Butler's book may not establish itself as a classic (it feels too polemical), but it is nevertheless a valuable contemporary commentary.

Andrew Herberts
Head of Private Investment Management (UK)

MARKET RATES

Historic Market Rates

As at 30th June 2014

	Close	1 month % change	6 months % change	1 year % change	3 years % change
FX					
GBP/USD	1.7102	2.07	3.24	12.42	6.44
EUR/GBP	0.8005	-1.62	-3.83	-6.40	-11.37
EUR/USD	1.3690	0.40	-0.72	5.23	-5.67
USD/JPY	101.290	-0.47	-3.77	2.17	25.73
USD/CNY	6.203	-0.70	2.46	1.07	-4.03
BOND YIELDS					
US 10 yr	2.530	0.055	-0.498	0.045	-0.630
UK 10 yr	2.670	0.100	-0.352	0.227	-0.710
Germany 10 yr	1.245	-0.113	-0.684	-0.483	-1.780
Japan 10 yr	0.566	-0.012	-0.175	-0.287	-0.574
Swiss 10 yr	0.658	-0.067	-0.415	-0.369	-1.074

Source: Bloomberg

	Close	1 month % change	6 months % change	1 year % change	3 years % change
EQUITIES					
S&P 500	1,960	2.07	7.13	24.60	58.42
Dow Jones	16,827	0.75	2.68	15.56	46.48
NASDAQ	4,408	4.00	6.20	31.24	65.59
FTSE 100	6,744	-1.22	2.06	12.69	28.00
FTSE all-share	3,600	-1.25	1.74	13.44	30.55
DAX	9,833	-1.11	2.94	23.54	33.31
NIKKEI	15,162	3.69	-6.11	12.67	63.60
Hang Seng	23,191	1.32	1.98	15.38	15.38
COMMODITIES					
Gold	1,327.32	6.21	10.09	7.51	-11.53
Crude oil – WTI	105.37	2.59	7.06	9.12	10.43
S&P GS soft cmd	616.62	-7.07	1.66	-8.37	-18.35
S&P GS ind metals	1,383.87	2.51	1.25	5.36	-29.45

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