THOMAS MILLER INVESTMENT

IQQ2

Global market intelligence, critical analysis and investor briefing

Investment Quarterly

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A Note From The CEO

Mike Balfour
Chief Executive Officer

Over the last 12 months there have been a number of political decisions outsourced by politicians to the public they serve. The Scottish referendum was one of the first (to be repeated?), the Greek government backed away from making awkward austerity decisions and referred it to the fiscally bruised electorate, and the UK government is already lining up an in/out vote on Britain's inclusion in Europe.

These votes are campaigned predominantly on emotion and marginally on fact, which is dangerous, and probably more dangerously they leave the politicians free from any blame should the vote lead to disaster.

It's clear that investors and markets don't like uncertainty, we should prepare ourselves for continued volatility, however we don't believe in passing on difficult decisions to our clients, we make them ourselves. Similarly we don't make decisions on emotion, instead our opinions are formulated through the collection of facts and our investment process.

Our IQ contains our current opinions on geo-political events and their impact on markets, but for any further information please do not hesitate to contact us.

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Investment Strategy Overview

Q2 2015 would have left a lot of investors with mixed feelings. This is because while the quarter saw improvements in the pace of global economic activity, it brought broad weakness across most financial markets.

In the US, the rebound in growth confirmed that the contraction in GDP during Q1 was partly due to transitory factors. There was also positive economic news from the UK, Euro-zone and Japan. In China, the weakness in economic activity has prompted the central bank to implement further efforts to stimulate economic growth.

Focusing on the US, in light of the decline in Q1 2015, many commentators had anticipated a rebound akin to that seen in the second quarter of 2014 when US GDP grew by 4.60% (followed by 5.0% in Q3 2014) following a weather-induced contraction in Q1 2014. In contrast, the evidence so far suggests a Q2 2015 growth rate that is likely to be in the 2.0% to 2.5% range. That would obviously represent a welcome improvement on the Q1 performance but it would not suggest that the US economy is currently firing on all cylinders as one might expect given the increasingly hawkish bent of the consensus expectations for US interest rates. As at the time of writing, consensus forecasts for US central bank rate show a hike in Q3 and another in Q4 2015.

The US Federal Reserve may want to begin the process of raising interest rates for reasons beyond underlying economic fundamentals (e.g. to prevent speculative excesses). However, the ongoing modest pace of economic growth would seem at odds with a tightening monetary policy environment. This raises the risks of a policy error and suggests that, unlike current consensus forecasts, a rate hike by the US central bank in 2015 is not inevitable.

Greek Crisis Again

Although there were a number of concerns playing on investors' minds (including the outlook for China's slowing economy and ongoing geo-political tensions in the Middle East and Ukraine), the primary driver of risk aversion over the last quarter was the latest episode of the crisis in Greece.

"As at the time of writing, consensus forecasts for US central bank rate show a hike in Q3 and another in Q4 2015."

Towards the end of the quarter, market sentiment swung from optimism to pessimism on a daily (and often intra-day) basis as multiple iterations of a new bailout agreement were proposed and rejected by Greece and its creditors. Markets became increasingly volatile as we approached the June 30 deadline for Greece to make a repayment to the IMF.

In the end, the parties failed to produce their trademark eleventh-hour deal. Greece failed to make the payment to the IMF. The government shut banks and imposed capital controls. It also called a referendum on the latest bailout package put forward by its creditors.

Greece remains in a precarious situation and the risks relating to a disorderly "Grexit" should not be underestimated, not least because it would unleash a period of economic, social and political uncertainty. But as things stand, the balance of probability leads us to the view that a Grexit is not the most likely outcome in the short term. Therefore we view the current market volatility as an opportunity to gradually increase exposure to risk assets in general.

Asset allocation summary

We have a favourable outlook on risk assets such as equities and alternative investments (including private equity, infrastructure and property). The higher allocation to those asset classes comes at the expense of bonds and cash.

In reaching this asset allocation decision, we note that, from a global standpoint, the main impact of the crisis in Greece thus far has been to undermine investor sentiment rather than fundamentals. The global economic backdrop remains positive; leading economic indicators are constructive across the OECD area; for all the concerns about the outlook for interest rates in the US, monetary policy remains highly accommodative globally; and corporate earnings remain robust overall. Furthermore, shorter term indicators of market momentum and investor sentiment are also now more supportive of risk assets, having declined from the elevated levels reached at the end of Q1. All these suggest that risk assets are likely to out-perform in the months ahead.

Abi Oladimeji
Head of Investment Strategy

"We have a favourable outlook on risk assets such as equities and alternative investments (including private equity, infrastructure and property)."

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD

	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.

Is Some Degree of 'Normalisation' Finally Taking Place?

In Q2 bonds reversed the gains they made in the first quarter of the year. UK government Gilts lost 3.41% over the second quarter in total return, with the yield on the 10 year bond rising sharply from 1.6% to over 2% by the end of June.

For the year to date, gilts are now down 1.29%.

The same process was evident in the US, where Treasuries lost -2% over Q2 and the 10 year Treasury yield rose from 1.92% to 2.35%. For the year to date, Treasuries are now down 0.2%.

The catalyst seems to have been a new confidence that commodity markets have bottomed, a troughing in inflation expectations, and a sense that finally, (finally!) some sort of interest rate normalisation is appropriate. A better run of data out of the United States also contributed.

The most spectacular action took place in the German bond market, where the yield on the 10 year Bund rose from 5 basis points (yes 5bps – that is 0.05%) on April 20th to 1% on June 10th (these figures are intra-day and the closing low on the Bund was actually 7.5bp). Losses in longer dated bonds were horrendous, albeit these have to be seen in the context of some exceptional returns in recent years.

The German bond market was ripe for a correction, and yields had fallen to ridiculous low levels given there are signs of an economic turn.

A huge momentum trade had developed over the course of the previous 15 months, with the drop in yields continually defying belief ('the Bund at 0.8%, this is absurd! It can't conceivably fall from here'). With such little value on offer, as soon as the momentum turned it was inevitable that the spike upwards would be savage.

For those who have studied the maths of bonds, the volatility will have come as no surprise. Duration, or interest rate risk, increases in relation to three factors: low coupons, long maturities, and low yield. It is the last factor particularly that has impacted markets recently.

Interestingly, the Japanese bond market has not been so volatile, despite trading at comparable levels to German yields. The Japanese 10 year yield rose from 30basis points to 45 basis points, a rise of 50% - well below the 20 fold increase in the German yield.

The Japanese are used to lower yields, which have been a feature for well over 20 years. Also, deflation has been far more marked than the Eurozone's brief flirtation with it in the Spring.

Corporate bond markets in both the UK and US suffered more than government markets, with returns roughly 1% lower than that of governments. There were shades of 2013's 'Temper Tantrum' in this, when corporates also underperformed during a bond sell-off. However, the reverse was the case in Europe, where Euro denominated corporates actually outperformed government markets due to their shorter duration.

"Overall, while we have seen some back up in yields over the last quarter, we would expect to see some further 'normalisation' over the course of the rest of the year "

A renewed panic over Greece (will she/won't she leave the Euro?) in the final week of June brought more interest back to 'risk free' assets, and government bonds clawed back some of their losses.

The best performing fixed income market to date has been high yield, after the concatenation of horrors and potential defaults that appeared imminent in January failed to materialise.

Overall, while we have seen some back up in yields over the last quarter, we would expect to see some further 'normalisation' over the course of the rest of the year.

James Penn
Senior Portfolio Manager

Broadly Positive

At the end of last quarter, I noted that given current valuations and recent performance it might be a stretch to expect the pace of advance to continue. The market complacency over geo-political risks left it potentially vulnerable to a shock or shocks.

Nevertheless, the quarter started reasonably well. In the UK the surprise general election result gave a fillip to the market, but the rally failed to take hold and the FTSE 100 index could not break through the new high set at the end of April. Meanwhile in Asia, markets were more lively and Japanese and Chinese markets were up low double digits. The Japanese market reflected confidence in the ongoing reform of the Japanese economy and corporate governance while the Hang Seng was boosted by a combination of relative economic growth and a growing bubble in mainland China stock markets.

Corporate activity helped. Royal Dutch's bid for BG in the first quarter was joined by other high profile and high value deals announced in Europe and the US. The activity around Time Warner and Charter is the one that grabbed the headlines, but overall in the US we are seeing levels of activity last seen in the late 90s.

In the background, economic growth has been slowing. In the developed world, leading indicators in the UK and US point to slowing growth and Chinese growth looks set to continue to be lacklustre by recent standards. The outlook in Europe looks relatively better and Japan's leading indicators show signs of turning up, so the picture is not uniform, but it does look as though expectations for US and UK interest rate hikes can be pushed to the right, again.

Q2 however, is likely to be remembered as the point at which Greece's position was acknowledged to be untenable. As I write, Greek banks have shut their doors and Greeks are being restricted to withdrawing €60 a day from cash machines as the ECB capped its emergency lending to Greek banks. The precipitate end to the talks between the Greek government and her creditors was a surprise, and the referendum adds another layer of uncertainty. Markets exist to price uncertainty among other things but odds on a disorderly exit shortened and risk assets bore the brunt.

"In the developed world, leading indicators in the UK and US point to slowing growth and Chinese growth looks set to continue to be lacklustre by recent standards."

Thus, as we exit the quarter, only three major markets show a three month gain on a capital return basis. The Hang Seng fell 7% from its peak, but still advanced 5% for the quarter and the Japanese Nikkei index continued its run, ending up over 5% in local currency. The US Nasdaq index, reflecting the strength of the biotech sector and information technology scraped into positive territory.

It seems likely however, that the Greek story will prove to be a bit of a sideshow. Exposure to its debt is markedly lower in the private sector than it was in 2012 and so the second order effects even of default should be dampened. Not to say that we cannot envisage a spanner in the works, but my suspicion is that the important events from a global equity standpoint will be focussed around the state of the global economy and whether current growth is sustainable. If we get back on track, equity markets can advance although I find myself counselling once more that valuations, while not at historic extremes imply returns over the next few years will be more muted than those we have enjoyed latterly.

Andrew Herberts
Head of Private Investment Management (UK)

UK Property - A Regional Resurgence?

The resurgence in the UK commercial property market has been continuing at quite a pace over recent years. With the UK economy appearing increasingly buoyant and with a recent election result that should continue to deliver pro-business policies the prospects of a sustained recovery have increased.

Property company results over the first quarter of 2015 have re-enforced this continued appreciation with the IPD UK All Property Monthly Index registering a 1.6% increase in capital values over the first three months of the year.

The persistent strength of the property market over recent years is encapsulated by the fact that IPD All Property capital growth has been positive for 23 consecutive months since May 2013. Despite this on average values are approximately 25% below the 2007 peak. However these aggregated figures mask the two tiered nature of the UK property market. Prices in London and the South-East have accelerated notably higher benefitting from a wall of money that has continued to flow into the UK from overseas investors. Whilst this is a trend unlikely to abate in the near term, and indeed we could see yields on prime London property fall below levels seen in 2007, there would now appear to be an opportunity to boost returns by allocating to more regional assets.

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It could be argued that the combination of strong occupational and investment demand seen within Central London infers an increased risk of a reversal in capital values should we see a shift in investor sentiment. Although we do not see this as an imminent threat the relative lack of investment demand for regional property enables such property to offer higher net initial yields to the investor. Indeed the higher yield may even confer a greater degree of downside protection if a reversal were to occur given the lack of yield compression we have seen to date across the regions.

Vacancy rates have also been falling, although the extent to which this trend can continue may diminish. There should be a natural level of vacancy which is driven by underlying obsolescence of buildings which are not fit for purpose and await redevelopment. As such supply shortages should continue to drive upward rental pressure.

In light of these changing dynamics we believe that shifting the focus of a property allocation from prime London to more regional assets can add value for our investors.

Mark McKenzie
Portfolio Manager

Technology - The Dominance of the American Dream

The proliferation of technology affects all corners of our lives and after the bold predictions at the start of this millennium, as evidenced by the stock market's technology bubble in 2000, those high expectations are now beginning to look downright conservative.

The Americans are leading the way in this technological revolution through widely recognised and dominant companies such as Apple, Google, Amazon and Facebook. Such businesses are pushing the boundaries as to what is possible. What was once deemed fanciful is now just a handful of years away from becoming reality. The driverless car is being tested by Google in certain US cities – just think how this will transform peoples' lives; the biggest constraint is likely to be how quickly legislation keeps pace! Jeff Bezos, founder and CEO of Amazon, floated the possibility a few years ago of delivering packages via drones (a type of miniature helicopter), which I recall was widely derided by the media at the time. In March of this year the US Federal Aviation Administration authorised the first testing of such vehicles over US soil.

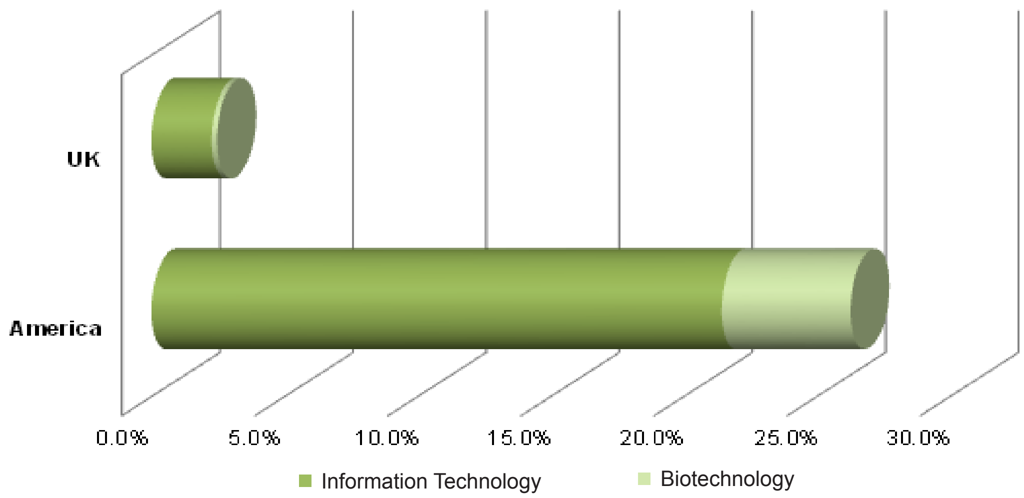
The destructive change that accompanies technological advances can be devastating for incumbent businesses and as direct equity investors this is something that is at the forefront of our analysis. Have you seen the size of the Yellow Pages these days – testament to Google's disruptive advance. No more heading out to your local Blockbuster as Netflix allows unlimited access to content from the comfort of your own home. Tesla is not widely known to most (as yet) but watch out Ford/Volkswagen/BMW as this 12-year old start-up transforms the possibilities for the electric car, delivering a truly viable challenger to the existing petrol/diesel driven automobile. Not to mention the advances in medical science and future possibilities from the mapping of the genome.

"The technology and biotechnology sectors represent more than 25% of the American equity market; our own stock market has a paltry 2.4% representation."

The pace of change is quickening and as investors we need to be acutely aware of the implications. The technology and biotechnology sectors represent more than 25% of the American equity market; our own stock market has a paltry 2.4% representation. Investors should rightly put a valuation premium on US leadership in these fields albeit at an individual stock level valuations should be treated with caution. Despite a relatively poor start to the year for US equity markets, here at Thomas Miller Investment we are maintaining a full weighting to this innovative and entrepreneurial region.

Scott Baikie
Senior Portfolio Manager

Stock Market Sector Weightings



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