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Global market intelligence, critical analysis and investor briefing

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A Note From The CEO

Mike Balfour
Chief Executive Officer

Jeremy Corbyn's rise to become leader of the Labour party is unlikely to have an impact on financial markets in the shorter term and many commentators believe he will not be in that position for long. At TMI we like to look far into the future and muse about how the consensus might be wrong.

Corbyn's unexpected ascent to the top of the UK's second largest political party is expected to be short lived and is often compared to Michael Foot's ill fated leadership of the party in opposition in 1980 to 1983. Corbyn's reign is unlikely to be the same. Foot came to power when the country was fed up of left wing politics, the power of the unions, and the UK's decline in global significance. Now people are discontent with seemingly endless wars in the Middle East, bankers, rich bosses and the distance between the richest and poorest in society. Corbyn's left wing politics will attract voters back to Labour, most noticeably in Scotland. If Labour had not been almost completely wiped out North of the border, David Cameron would probably not be in No. 10. Corbyn and/or his policies will be here for a lot longer than presently expected.

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Investment Strategy Overview

As investors recover from the weakest quarter for risk assets for several years, it is easy to forget that Q3 2015 actually got off to a good start for financial markets in July as equities recovered from the sell-off that had been induced by the re-emergence of the Greek debt crisis.

However, a chain of events including concerns about a slowdown in China's economy, the widely anticipated start of an interest rate tightening cycle in the US and an unexpected devaluation of the Chinese currency triggered downward revisions to the outlook for global economic growth and resulted in steep declines across financial markets.

Global economic activity & monetary policy outlook

For some time now the evidence has been clear that the global economy is going through another soft patch. From a global perspective, the bulk of the slower growth has been driven by weakness in emerging economies while the pace of growth has been steady, albeit modest, in the major developed economies. The outlook for China in particular is worth deliberating on as that is likely to be a key macro factor in the months ahead.

China: a long slowdown

For several years now China's economy has been unbalanced and overly reliant on exports and capex. To redress this imbalance, Chinese authorities have begun the process of transitioning the economy to a more stable growth model, with greater emphasis on consumption and services. That this transition process would entail a slower and perhaps more sustainable pace of growth is not in itself surprising. The problem is that it is very difficult for investors to accurately ascertain how far down this road China has gone. This is because any assessment of China's economic performance is undermined by reservations about the integrity of the country's official economic statistics. At this point, a large gap has emerged between official records of economic activity and private sector estimates of key economic variables. For instance, while reported GDP growth rate has held steady around the official target of 7% for the year, key indicators of underlying activity, such as railway freight volume and electricity production, point to an ongoing broad-based decline in demand.

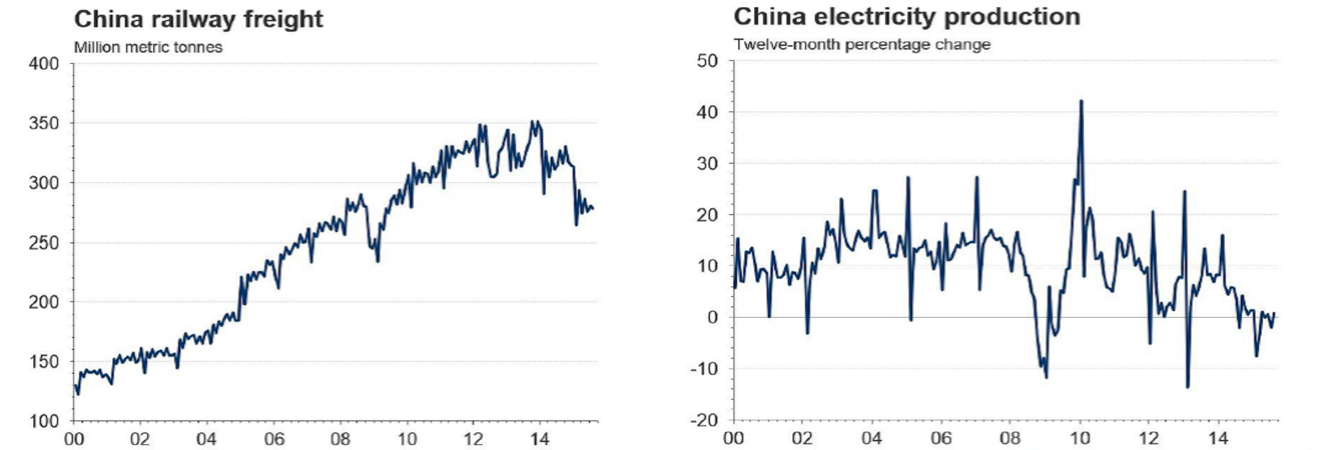
Overall, we expect the long-term pace of China's economic growth to eventually settle somewhere in the 3% to 5% range, but the path there could be quite bumpy.

Fed pulls its punches again

For several months, the US central bank (Fed) has led the markets to believe that interest rates would start to rise in September 2015. However, in a largely unexpected move, at its September meeting the Fed pointed to recent events in China (and to a lesser extent, the financial markets) as reasons for leaving rates unchanged.

To be fair to the Fed, they have also said all along that monetary policy would be data-dependent. And for those who have been watching the US data, never mind the global picture, the case for raising rates as early as Q3 2015 was weak at best. It is worth highlighting that economic reports have been notably softer in the weeks since the Fed's decision. Moreover, with leading indicators still pointing to waning growth momentum in the US, the Fed may struggle to raise rates at any point over the next six months.

The weakening growth pattern is also evident in the UK where the pace of economic activity has faltered in recent weeks. Manufacturing and construction activity have been very weak while the labour market seems to have lost some of its momentum.



Source : Thomson Reuters Datastream / Fathom Consulting

Furthermore, the renewed weakness in commodity prices means that inflationary pressures remain extremely muted and another bout of deflation now looks likely over the next few months. Consequently, we expect the MPC to remain on hold well into 2016 and possibly longer.

In time, the current global Zero interest rate policy (ZIRP) will morph into a Low interest rate policy (LIRP). But if any reminders were needed, the Fed's recent decisions and the persistent pattern of weak global economic growth have again highlighted that we remain in a low growth and interest rate environment.

Asset allocation summary

Sustained equity bull markets typically feature two things: earnings growth and multiple expansion. Examining both, one could conclude that conditions are no longer as conducive to a sustained rally as they have been over the past few years. Looking ahead, earnings growth could well be anaemic since while the economy should continue to grow at a modest pace, reported corporate operating margins are approaching historical highs (excluding commodities). Also, while valuation multiples are not over-stretched in a historic context, they are not cheap and have limited scope to re-rate meaningfully upwards. Even if we are not at the end of the bull run, it is hard to see how the developed equity markets can continue to deliver at the same rate as we have enjoyed since 2009.

Overall, while the major economies continue to record positive growth rates and the monetary policy backdrop remains accommodative, equities should offer a better risk-return profile than bonds. But at this point, no 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. Consequently, while we still prefer equities over fixed interest on a relative basis, we are tempering our return expectations for all asset classes in absolute terms.

"Moreover, with leading indicators still pointing to waning growth momentum in the US, the Fed may struggle to raise rates at any point over the next six months."

Abi Oladimeji
Head of Investment Strategy

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.

Governments Outperform Over The Quarter

The third quarter of the year was an excellent one for fixed income, but on this occasion only for holders of the highest quality bonds.

Government bond markets around the world enjoyed strong returns, with the FT All Gilts index returning 3.1%, recovering more than what they lost in the second quarter.

This was driven by the belly of the curve, and the 5-15 year index returned 3.02%. Short dated Gilts also had a decent quarter, but not to the same extent, the 0-5 year index returning 0.87%.

The blended effect of the above was that the 0-15 year index returned a more moderate 1.81%.

The second quarter's confidence in an improving developed world growth picture, and a growing certainty that the United States would finally raise interest rates, were replaced by concerns over the growth picture elsewhere – particularly in China and other parts of the developing world.

In addition, the decision of the Fed not to raise rates at its September 16/17 meeting was a big fillip to bond markets, with the Fed adducing the slowdown in China in its decision.

For bonds lower down the credit scale the picture was not quite so rosy. Corporate bonds as a whole made 0.98% over the three months, underperforming Gilts by more than 2%. For the year to date, corporates have returned just 0.21%.

So while the income was higher, there was a marked price deterioration, with corporate investment grade spreads widening to nearly 1.6% by the end of September.

This is still some way short of the spread levels reached in 2011, the last major crisis point for corporate debt, but the deterioration is concerning, and shows no sign of ceasing yet.

"There is certainly some value in high yield bonds, and in Emerging Market debt (both local and hard currency), but these asset classes are not for the faint hearted."

The drivers were forced selling into an illiquid market, and the sudden downturn in the Chinese growth trajectory. The accompanying devaluation of the Yuan, in early August, has created new worries over corporate profitability and a rise in risk aversion.

This was compounded by some huge individual disappointments – Volkswagen and Glencore, both big debt issuers, were obvious examples. VW's bonds are now trading at BBB levels (they are still A rated, but the scandal over 'defeat devices' will likely lead to downgrades), while Glencore bonds are trading as 'junk' – a worry given the company's need to raise large levels of finance in its trading division.

There were plenty of other examples of deteriorating credit in oil and commodity sectors, while anything in any way linked to Brazil got an automatic downgrade when S&P cut the sovereign Brazilian rating to 'junk' status, or BB+, in early August.

Brazil still carries an investment grade rating from Moody's and Fitch, but this is vulnerable, given the government's inability to agree to a primary surplus in 2016 and the apparent lack of consensus on how to tackle the country's recession and collapsing currency.

Ten year Brazilian bond yields have blown out to 6.5%. While we think that the country has the ability to weather its current pressures and get onto a growth profile again in late 2016, there is a danger at this stage of matters getting out of control without concerted action.

The fact that Brazilian corporates are large issuers of US Dollar debt, which some of them are now struggling to repay with the Real at USD4, creates additional problems. The last major crisis in the country was in 1982, when the US had to step in and help refinance Brazil's debt through the issue of 'Brady bonds' – let's hope we don't get a rerun of this now, as this would be another big blow to Emerging Market, and world, growth.

US Treasuries also had a good quarter, benefiting from the rise in risk aversion and returning 2.16% over Q3, while yields in core Eurozone countries also fell.

The worst performing asset class was high yield, which fell 5% for its worst quarter since the Eurozone crisis in 2011. 'Junk' yields have reached 8%, with the spread over Treasuries standing at 6.3%.

There is certainly some value in high yield bonds, and in Emerging Market debt (both local and hard currency), but these asset classes are not for the faint hearted, and it won't be as easy to make money in these areas as in the previous five years.

James Penn
Senior Portfolio Manager

More Sellers Than Buyers

In late April this year, I wrote an article for the Glasgow Herald up here in Scotland. At the time, the Chinese Shanghai Composite equity index had doubled over a year and I thought it looked expensive.

When I wrote the article, I cautioned about speculative bubbles and compared the market with that of 1999 and our own technology bubble. The Shanghai Index was at 4293 when I wrote the article on 22nd April. Two months later it was at 5166 (up another 20%). In the meantime, the UK FTSE All Share index had fallen nearly 3% in capital terms. Glaswegians stopped me in the street to mock (OK, not really).

June 2015 however, proved to be the high and in the period from the high to the end of the quarter, the Shanghai Index has fallen over 40%. I'm no Alan Greenspan, but the markets rallied for four years after he warned of "irrational exuberance", and the Shanghai Composite only had two months left of its bull run after I cautioned the good burghers of Glasgow against betting the house on Chinese equity. I'm not sure how many listened to be honest, but if there is one child in Glasgow getting an extra can of Irn Bru or extra chips with his donner meat, then it was worth it.

As you have no doubt picked up, it has not simply been Chinese equities that have sold off. The UK FTSE All Share is down 8.35% this quarter, the US S&P500 index is off 8.8%, the German DAX index is down over 13% and the Japanese Nikkei is off over 16%. All of this against a background of generally positive economic news in the developed world.

So, has anything fundamentally changed, and if so, what are we doing about it? First, the event or series of events that commentators have chosen to highlight as a cause of the recent weakness has been the signals emanating from China regarding its growth prospects. It is no surprise that Chinese growth is slowing. It is currently trying to shift the focus of its economy from that of producing/exporting domination to a more balanced one in which consumption plays a larger role. This was always going to be difficult, but that has been well flagged and investors should not have been surprised. So what else? The Eurozone is actually still in relatively good health (growing from a low starting point, but still growing) and the migrant crisis, while a humanitarian disaster, is not of a scale to knock growth out. UK and US consumers are confident and real wages are pushing up, under-pinning those economies.

As Abi notes earlier in this document, fundamentally, the world economy remains in expansion territory, with the US and UK further along the cycle than Europe and Japan. In that environment, equities should outperform other assets. We will continue to monitor signs that this context is changing, but as long as this regime continues, we see value in equity markets.

Two areas of the market are at crisis points in terms of valuation. Emerging markets are beginning to look very cheap on a long term basis and when I was at a conference last week, no-one had a good word to say about them. Asian equities (ex Japan) are now trading at price to book valuations that we last saw in 2009 at the height of the financial crisis. If China falls into recession, there may be further to go, but in the last twenty years buying at these valuations has typically delivered a positive return in twelve months.

Second, the commodities and energy related sectors have been hit hard. As Scott mentions elsewhere, low commodity prices are testing the resilience of dividends in these sectors which has investors concerned. Nevertheless, these are cyclical businesses and buying a cyclical business for its dividend does not make too much investment sense. The time to buy cyclical businesses is at the bottom of the cycle when they are hated, and, like some of the emerging markets, this sector is beginning to be reviled. We are looking at the overall commodity cycle to assess at what point we should act.

Broadly speaking, we continue to monitor global economic conditions. At the moment they remain favourable to equities and when that changes, we will change our view. We are also looking at those areas of the market which have been disproportionately hit in the recent sell off, both at a regional/sector and an individual stock level to see where the opportunities are.

Andrew Herberts
Head of Private Investment Management (UK)

Renewable Energy - The winds of change

Energy production from renewable sources is hardly a new concept. There have been renewable energy projects in operation for many years, and these have been touted as the solution to the satisfaction of global energy demand as we steadily deplete the earth's finite natural resources.

However it is only in more recent times that the desire for a broad switch to more sustainable energy production has become embedded within the public consciousness. Significant momentum is currently behind transitioning away from fossil fuels to greener sources of energy production. There are binding greenhouse gas emission reductions required by the Kyoto Protocol and this places a requirement on the EU to produce 20% of energy from renewable sources by 2020. Sector growth is strong; the current UK renewable share of electricity generation is 25% (Q2 2015), up from less than 10% three years ago. Nonetheless this still leaves significant required capacity to meet these targets and should be supportive of further expansion.

Political uncertainty is often cited as being the biggest risk when considering the investment case for the renewable energy sector. Even in developed countries with well-established regulatory regimes there is always the possibility of change. This was evidenced earlier this year in the UK with a revision to the renewable energy subsidies announced by the Department of Energy and Climate Change (DECC). Broad energy prices can have an impact on project revenues, although the pass-through is dampened significantly as a consequence of the dominance of green incentives within a project's revenue structure. Indeed the volatility seen recently in energy markets has not had an adverse impact on returns in the sector. Nonetheless an ongoing backdrop of depressed energy prices would likely have negative implications for long term project revenues.

"One of the key attractions to the sector for us is quasi-government backed revenue with the potential for inflation linkage."

Despite these risks we remain favourably disposed to renewables and include an allocation within our alternative asset investing strategy. One of the key attractions to the sector for us is quasi- government backed revenue with the potential for inflation linkage. Further support is provided by the improving energy conversion efficiencies (notably within the solar sector) from technological advancement. From a geography perspective we prefer the UK and Northern European assets due to the favourable regulatory regime.

The potential for regulatory change may well be a lurking shadow for the renewable energy sector with the potential to bare its teeth, but we are reasonably sanguine about the extent to which this will be a material threat. We believe that renewable energy story is here to stay and offers an an attractive opportunity for investment.

Mark McKenzie
Portfolio Manager

Too Good To Be True?

On the back of the carnage wrought across the resources sector over the past twelve months the dividends on some of the UK-listed oil & gas majors and diversified miners are approaching 8%; that's almost 4.5x that available on a 10-year UK government bond. Royal Dutch Shell and BHP Billiton (based on last year's dividends and current exchange rates) will return 7.8p this coming year for every 100p invested.

Bargain I hear you say……well, not quite so fast. As with everything in life, those things that appear too good to be true usually are! The catch, as most will appreciate, is the sustainability of this income. Will the operations of the business and the fortitude of management result in them continuing to pay out this level of income?

This is not an easy question to answer and rest assured it will be taxing the equity team here at Thomas Miller Investment over the coming months. The key determinant is likely to be the future direction of commodity prices and critically, whether they go lower for longer. The chart below is that of the S&P Goldman Sachs Commodity Index and illustrates the general weakness in prices across the commodity complex since the peak in April 2011. It is not a pretty picture.

At the moment supply exceeds demand in many commodity markets. One of the largest and most visible being oil where, since February, OPEC has increased production by around 1.5 million barrels per day. At the same time, US production which has increased significantly in recent years due to fracking has remained surprisingly resilient in the face of falling prices. We are seeing a rather unsubtle production war going on between OPEC and the US – the Saudis have their taps fully open trying to squeeze out supply from the US frackers – the Americans, through technology and efficiency gains are fighting back. The winners of course will be the consumer (you and I). It looks like low oil prices will be around for the coming year, although these levels are not sustainable indefinitely. Within industrial metals the supply dynamics are similar with production levels very high in the face of waning demand from China; the inevitable laws of economics are exerting their influence with prices the relief valve for this supply/demand imbalance.

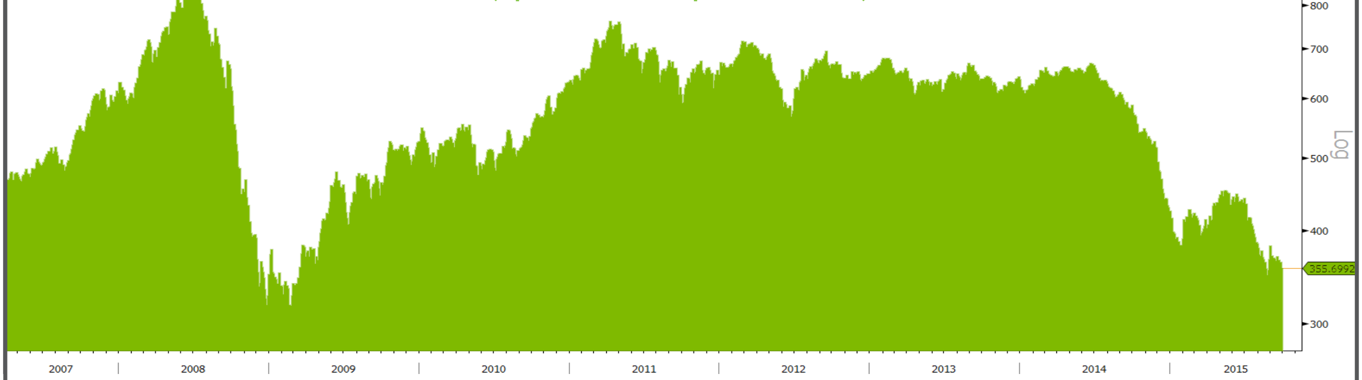
There are however a number of levers company management can pull to at least shore-up the cash available for dividends. The first of these has been capital expenditure (cap-ex) which has dropped dramatically in recent years – as one CFO of a European oil & gas company was quoted as saying – "capex is whatever is left after the dividend". Expect further cuts to come from both oil & gas and mining companies. It should not be lost that over the medium-term such under-investment will help rebalance the over-supply dynamic highlighted above.

Another, less salubrious mechanism is for these resource companies to borrow to cover their dividends. Gearing across the European oil & gas majors sits at around 15-20% allowing them some scope to cheer their friendly banker. This is clearly not a long-term option but could be used to bridge current low prices.

Given the 'parrying' options available to company management it looks unlikely that we will see any cuts to the 8% yields on offer for the time being. However, it is difficult to foresee an immediate reversal in current market dynamics and if prices continue on their current trend, the rather large question mark overhanging the sector's dividends is likely to remain in place well into 2016.

Scott Baikie
Senior Portfolio Manager

S&P Goldman Sachs Commodity Index
(April 2007 to September 2015)



Source : Bloomberg

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