THOMAS
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INVESTMENT

IQ4

Global market intelligence, critical analysis and investor briefing

Investment Quarterly

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A NOTE FROM THE CHIEF EXECUTIVE

We start 2015 as a larger, stronger and more diverse business. The Broadstone acquisition, which is now Thomas Miller Wealth Management, adds 40 new staff, gives us greater depth in the investment team, adds £400 million in assets under management and expands our offering in the wealth management area.

Some clients will find benefit in our comprehensive wealth management offering, whereas other clients and their advisers might be attracted by our investment management services.

As always our goal is to focus on meeting your objectives, whilst providing exceptional service along the way. We look forward to 2015 being another year of success for Thomas Miller Investment and all of our clients.

Mike Balfour,
Chief Executive Officer

Investment Strategy Overview

Unusually for this time of the year, the financial pages are not filled with overly optimistic forecasts for economic growth and financial market performance in the year ahead.

Unlike in recent years, economists are not calling for global growth to finally return to pre-crisis norms in 2015. Nor are analysts anticipating double-digit returns for the major stock market indices. If anything, a certain sense of realism seems to have become widespread. For this reason, we find that our outlook for 2015 is currently quite close to market consensus. In summary, we expect global economic activity to show a similar pattern to 2014, with the US economy setting the pace and the Euro-zone lagging. Overall, relative to 2014, we expect that any improvement in global growth in 2015 will be marginal. As for the financial markets, investors should prepare themselves for a combination of low returns and high volatility.

The US and UK economies led global growth in 2014. On both sides of the Atlantic, the recovery in the labour markets and elsewhere has changed the tone of monetary policy debate and it is now widely accepted that the long running phase of monetary policy easing is drawing to a close.

TMI's view is that both the US Federal Reserve Bank (Fed) and the Bank of England (BoE) have sufficient room for manoeuvre. While the US and UK economies have improved over the past couple of years, the global backdrop remains one of modest economic activity with significant deflationary pressures. The recent sharp decline in the oil price has only amplified the deflationary trend.

It therefore makes a lot of sense for the Fed and BoE to err on the side of caution in deciding both the start of the policy tightening cycle and the speed of rate hikes. Markets now expect the Fed to start raising rates in June (and the BoE to follow in the third quarter), with some concern that the Fed might begin sooner—perhaps as early as March 2015. In light of recent developments, we see the risk of a delayed start as being greater than that of an earlier start to rate hikes by both the Fed and the BoE.

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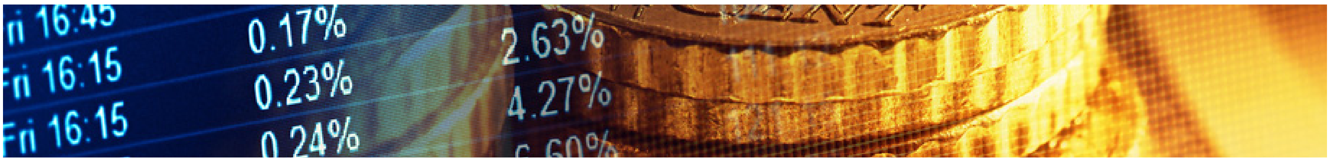

All Eyes on the ECB

For the Euro zone, it seems that the moment of reckoning is upon us. After several years of pretensions to the contrary by its troika of lenders—the International Monetary Fund, European Commission and European Central Bank—it now seems apparent that Greece is unlikely to ever grow out of its debt. Of course, a write-down of Greece's debt is not politically palatable to its creditors but at some point the penny has to drop. Greece can't pay. Perhaps it's time to come to terms with the reality that Greece won't pay! It remains to be seen how much longer this denial will carry on. Depending on the outcome of the forthcoming Greek elections (in late January), we may see the country get some 'breathing space' in the form of an extension of loan duration or perhaps a conversion of floating-rate loans to fixed rate ones. But arguably, these measures would simply postpone what has seemed inevitable since the original bailout package was agreed a few years ago.

In order to mitigate the potential fallout from the Greek elections, the ECB is widely expected to announce QE following its meeting in late January, just a few days before the elections.

Financial Market Outlook

For some time now, the consensus position has been that bonds are overvalued and should therefore be avoided. However, in the shorter term, the combination of modest growth, deflationary pressures and the potential for full blown quantitative easing by the ECB could result in further decline in bond yields (and increase in capital values) across the major developed markets.

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In light of investors' expectations for the ECB to begin outright QE early in 2015, failure by the central bank to deliver (either in terms of form of QE or magnitude of asset purchases) would undermine the outlook for risk assets. On the other hand, a larger than expected QE by the ECB could fuel strong gains in equity markets in general and in the Euro Area in particular. In the US, the strength of the domestic economy should boost earnings and support equity returns for those companies that are domestically-orientated. For the UK equity market, a slowdown in the pace of economic growth and the heavy weighting to energy related sectors is likely to act as a drag on performance. For emerging market (EM) assets, the key will be how various countries cope with the strength of the US dollar and weaker oil prices. Our current view is that EM oil importers should outperform their oil producer counterparts.

Overall, the prevailing backdrop calls for some caution in the short term. There will be better opportunities to add significant value to portfolios in the weeks and months ahead.

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)	0/-					
Equity allocation by region	+	0	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.

MARKET OVERVIEW

Depending on which side of the Atlantic Sea one is based, one could draw very different conclusions about 2014.

On the American side it has been a year of continued growth, increased optimism and better than expected equity returns. On the European side, it has been a year of disappointment, with another failure to reach 'escape velocity' from stagnation, and muted returns; government bond markets have generally beaten the returns from equity markets. Broadly speaking, defensive stocks did well and cyclical stocks underperformed.

Volatility was higher in the fourth quarter. Equity markets sold off significantly in October, with the first full blooded 'correction' (or 10% plus fall) since 2011. The beginning of a sell-off in the oil price had something to do with this; the end of Quantitative Easing in the US – in terms of its liquidity and sentiment impact – also probably contributed; finally, October has historically been a bad month for equities.

Markets then rallied sharply in the second half of October and first half of November, with the FTSE100 coming close to its highs and the S&P500 making new highs. Interestingly, the oil and commodity related stocks did not participate in this rebound, and the oil price itself did not recover and actually fell further, with WTI crude drifting down to $75/barrel in November having been at $105/barrel in mid-June.

In late November and early December there was then another savage sell-off, this time led by the failure of OPEC to agree a cut in their production. OPEC is a cartel of 12 major oil producing nations. Historically, they have managed to influence the oil price by over or underproducing in order to balance supply and demand. They have been producing collectively about 30m barrels/day, and to get the oil price back above $80 needed to cut 2m barrel of production. However, they failed to agree on any cuts, suggesting a diminished power to influence the oil market, given the growth in other sources, particular US shale oil.

The oil price slumped, taking the share prices of the oil companies and oil servicing companies with it. At the end of the year, WTI had fallen to $53/barrel and Brent crude to $56/barrel. The FTSE Oil & Gas index fell 13% over the quarter and was down 14% for the year. Other sectors were affected: The FTSE Oil Services index fell 27% over the quarter and 25% for the year, while the FTSE Industrial Engineers index was down 8% over the quarter and down 13% for the year.

Q4 2014 Highlights:

- **Broadly speaking, defensive stocks did well and cyclical stocks underperformed.**
- **At the end of the year, WTI had fallen to $53/barrel and Brent crude to $56/barrel.**
- **The FTSE100 finished down -3% in price terms, with the FTSE All Share faring a little better.**
- **The standout market was again the US, particularly for overseas investors, given the 12% rally in the Dollar since July.**
- **Against all expectations bonds had an outstanding year.**

Consumer and traditionally 'defensive' sectors performed better: Pharmaceutical stocks returned 8.5% for the year, led by takeover bids for Astrazeneca and Shire, but were down -3% for the quarter. The Gas, Water and Multiutilities index rose 1.3% for the quarter and 7.4% for the year. Meanwhile, the FTSE Electricity index was flat over the quarter and up 6.5% for the year. The FTSE Travel & Leisure index jumped 10% in Q4, benefiting from the lower oil price, and was up 9.25% for the year. The best performing sector was property, which returned 9% over the quarter and 19.5% for the year. Media rallied 3.8% in Q4 but was flat over the year.

The FTSE100 finished down -3% in price terms, with the FTSE All Share faring a little better. The standout market was again the US, particularly for overseas investors, given the 12% rally in the Dollar since July. The S&P 500 rose 12.5% in local terms but 19.5% for Sterling investors. European markets varied, with the Eurostoxx 50 up 1.1%. France was down, but the Dutch, Swiss and Swedish markets performed well. Italy lost all the gains in made in the first half of the year. The Nikkei gained 7% in local terms.

Emerging markets were even more of a mixed bag than usual. MSCI Asia Pacific was up 1.9% in USD terms for the year, but the MSCI Emerging Market index fell -4.8% in USD terms. Chinese A shares rose 50% and India rose 30%, but Mexico and the Hang Seng Composite were flat, Brazil fell 3%, Korea fell 5% and Russia was down 7% in local terms and 45% in USD terms.

Against all expectations bonds had an outstanding year. The Bank of America ML Global Broad Market index rose 8.2% for its best performance since 2008. UK gilts were the best government market, rising 13%, while UK index linked Gilts returned 18.7% at a time when commodity prices and inflation expectations were collapsing everywhere. How was that possible? Lower duration US Treasuries returned 5%, while the US High Yield market returned a relatively poor 2.5%. Bunds delivered 10%, with the 10 year Bund yield falling to 0.55%; while the trend is not quite as marked in the US, collectively government yields are back to where they were in early 2013.

James Penn
Senior Portfolio Manager

The Impact of Terrorism on Investment Markets

We start 2015 with a stark reminder of how terrorist activity can disrupt communities and shock nations. Paris was the unfortunate location for both incidents and our thoughts are with the victims and families following these terrible events.

How do the financial markets react to major terrorist attacks? A 2005 study by Ohio State university identified 75 terrorist-related attacks on specific companies and found that the average loss per firm (per attack) was $401m of its market capitalisation. Over recent years the focus of terrorism has shifted increasingly from small scale military to major civilian targets, and from individuals to business activities. Given the intertwined nature of today's global economy, the aftermath of terrorist attacks often spills over to a countries immediate trading partners and then beyond.

It is the indirect costs of terrorism which can be significant and hinder the economy in the medium term by undermining consumer and investor confidence; causing a tendency to save rather than spend. This also has the potential to trigger a generalised drop in asset prices, flight to quality that increases the cost of borrowing, slow demand for emerging market output and raise global commodity prices.

An interesting 2005 IMF Working Paper specifically looked at the reaction of the financial markets to the 11th September 2001 attacks in New York; and 11th March 2004 attacks in Madrid. Encouragingly, its conclusion was that well-functioning financial markets, bolstered by prompt and effective reaction from relevant authorities, were generally efficient in absorbing the shocks stemming from terrorist attacks.

Following their short term operational disruption the financial markets demonstrated some resilience together with a capacity to quickly return to normalcy. The effectiveness of the possible rapid and co-ordinated response by the authorities shouldn't be underestimated. Immediately after 9/11, the Federal Reserve made available its discount window to meet short term liquidity needs as well as deploying a wide range of instruments needed to ensure sufficient liquidity, ensure payments systems were operational and keep markets open. A $100bn unprecedented liquidity injection together with highly accommodative policy also helped calm and stabilise the broader economy through the US banking and financial sector.

Equity markets had the biggest impact from the 11th September attacks and experienced sharp and major declines on a global basis. Between 17th and 21st September, the S&P 500 index fell by 11.6% and the NASDAQ technology index declined by over 16%. Spill over was experienced globally with the European equity markets falling even further than the US, the DJ Euro Stoxx losing over 17% between the 11th and 21st September; possibly because it re-opened more quickly after the attack.

By way of contrast, whilst the human loss of life was equally tragic the terrorist attacks on Spain were felt much less by the capital markets. In the Euro area, the DJ Euro Stoxx index fell by around 3% on 11th March and continued to fall over the following days but had almost completely recovered by the end of the month as had the S&P 500.

Investor confidence deteriorated beyond national boundaries in the aftermath of both attacks due to contagion effects. However whilst the New York attack raised fears regarding the stability of the global financial system, the attack in Spain was perceived as having a mostly regional effect. 9/11 occurred in the midst of a global economic downturn but the terrorist attacks in Madrid happened when the world economy was growing strongly. Broad fiscal stimulus and other economic support measures were deemed unnecessary; and the European Central Bank felt comfortable leaving its refinancing and interest rates unchanged.

Our conclusion might be that the impact of terrorist attacks on the financial markets varies but the after effects of even a large scale attack can be dampened by a co-ordinated policy response, open liquidity provision and effective disaster recovery plans. Global economies are interlinked and asset prices highly correlated across different markets but markets generally fulfil their function of rapidly assimilating news and absorbing shocks. Those parts of our equity portfolio exposed to sensitive sectors including financials and oil-related industries, such as airlines and car manufacturers, could well experience sharp sell-offs but we rely on 'safety net' stocks including IT/physical security and defense to provide some support.

Tom Richards
Head of Private Investment Management (Offshore)

Oil - "Don't panic Captain Mainwaring"

Brent crude started 2014 at $105.4[1] and ended the year at $57.33 and continued its fall to $50.94 (as at 6th Jan 2015). It kept its head above $100 until half way through September when it began to fall hard. In November the press began to notice as the price fell below $80.

Oil held above $100 based on several factors. Instability in many oil producing regions led to concern over imminent supply shocks (Libya, Iraq, Nigeria, Venezuela, Russia) while successive rounds of quantitative easing led to a rise in the purely financial trading of oil (a rise in liquidity typically boosts asset prices). This added to geo-political fears and divorced the oil price from the fundamentals of supply and demand.

In fact, demand and supply were broadly in balance at about 93m barrels of oil per day. In Q3 2014 according to the International Energy Agency there was about 0.7% excess supply, though it is forecast to increase in 2015.

Were oil to continue to trade at this level, significant supply (some commentators say well into a double digit percentage) would be driven out of the market, and much planned production would become unviable. That would put the market in serious deficit, surpluses would disappear and fundamental buyers would bid the price up until enough supply became viable thus returning the market to balance. It is hard to assess the equilibrium price, but given implied costs of producing non conventional oil from shale and tar sands it is probably about $80-85.

OPEC's statement to the effect that it will no longer defend prices but rather its own market share, belies the fact that it lost control of pricing a long time ago. It produces less than a third of the world's oil and hence remains a strong, but waning, influence on the market.

Consumers, should enjoy this oil price fall while they can. It will not persist for a significant period, though it could easily fall further from here since supply does not shut off overnight. Expect it to rebound to the 80s over time.

In terms of stocks, the oil majors were never valued based on the oil price staying above $100 for long. When one reverse engineered the implied price of oil from their stock prices it normally came out at about $80-90. To the extent that the recent oil price fall affects the majors, there may be an opportunity, but as at year end (31/12/14) for example, Royal Dutch Shell delivered a total return of nearly 5% on a one year basis against a background of the nearly 50% fall in the oil price.

Andrew Herberts
Head of Private Investment Management (Onshore)

[1] The Brent Crude futures contracts of pipeline export quality Brent blend as supplied at Sullom Voe refinery on Shetland.

[2] International Energy Agency: Q3 14 world oil demand 93.08m barrels per day; supply 93.74m barrels per day

MARKET RATES

Historic Market Rates

As at 31st December 2014

	Close	1 month % change	6 months % change	1 year % change	3 years % change
FX					
GBP/USD	1.5581	-0.41%	-8.89%	-5.95%	0.24%
EUR/GBP	0.7766	-2.41%	-2.99%	-6.70%	-6.82%
EUR/USD	1.2100	-2.83%	-11.61%	-12.25%	-6.64%
USD/JPY	119.840	1.02%	18.31%	13.85%	55.82%
USD/CNY	6.2055	0.98%	0.04%	2.50%	-1.42%
BOND YIELDS					
US 10 yr	2.171	0.007	-0.359	-0.857	0.295
UK 10 yr	1.756	-0.170	-0.914	-1.266	-0.221
Germany 10 yr	0.541	-0.159	-0.704	-1.388	-1.288
Japan 10 yr	0.329	-0.092	-0.237	-0.412	-0.659
Swiss 10 yr	0.319	0.006	-0.339	-0.754	-0.344

Source: Bloomberg

	Close	1 month % change	6 months % change	1 year % change	3 years % change
EQUITIES					
S&P 500	2,059	-0.26%	6.11%	13.68%	74.55%
Dow Jones	17,823	0.12%	7.17%	10.04%	57.28%
NASDAQ	4,736	-1.08%	8.13%	14.83%	89.53%
FTSE 100	6,566	-2.26%	-1.00%	1.04%	32.82%
FTSE all-share	3,533	-1.59%	-0.26%	1.47%	38.63%
DAX	9,806	-1.76%	-0.28%	2.65%	66.24%
NIKKEI	17,451	0.05%	15.97%	8.91%	118.07%
Hang Seng	23,605	-1.58%	3.27%	5.31%	43.02%
COMMODITIES					
Gold	1,184.86	1.49%	-10.73%	-1.72%	-24.23%
Crude oil – WTI	53.27	-19.47%	-49.44%	-45.87%	-46.10%
S&P GS soft cmd	541.47	-0.55%	-12.19%	-10.73%	-22.08%
S&P GS ind metals	1,265.07	-4.41%	-8.59%	-7.44%	-18.25%

THOMAS
MILLER
INVESTMENT

London
90 Fenchurch Street
London
EC3M 4ST
Tel +44 (0) 20 7204 2200

Edinburgh
46 Charlotte Square
Edinburgh
EH2 4HQ
Tel +44 (0) 13 1220 9310

Isle of Man
Level 2 Samuel Harris House
5-11 St Georges Street
Douglas
Isle of Man
IM1 1AJ
Tel +44 (0) 1624 645200

Birmingham
125 Colmore Row
Birmingham
B3 3SD
Tel +44 (0) 12 1265 7226

Southampton
Maritime Walk
Ocean Village
Southampton
S014 3TL
Tel +44 (0) 23 8088 1836

THE WRITERS

Abi Oladimeji
Head of Investment Strategy

James Penn
Senior Portfolio Manager

Tom Richards
Head of Private Investment Management (Offshore)

Andrew Herberts
Head of Private Investment Management (Onshore)

CONTACT US

For more information on Thomas Miller Investment, our Funds and services please contact in the first instance:
Laura Dalton, Marketing Manager, on +44 (0) 1624 645200

tminvestment.com