THOMAS MILLER INVESTMENT

IQ Q1

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **April 2017**

A Note From The CEO

Hugh H Titcomb
Chief Executive Officer

The first quarter of 2017 witnessed some much anticipated but truly significant political events. The inauguration of Donald Trump as the 45th President of the United States on 20th January gave rise to the prospect of his much heralded plans for stimulating growth within the US economy becoming a reality. Time will tell however whether he is able to follow through with some of his stated intentions – the lack of support from the US political system for Mr Trump's attempts to repeal the 'Obamacare' health care programme provides one example of the challenges he faces. Domestically, our Prime Minister, Theresa May, signed a letter triggering Article 50 of the Lisbon Treaty on 29th March, thereby beginning the two year process of exiting the European Union. Negotiations on the terms of the exit – including any trade agreements which will be established with the EU members states on expiry of the two year period – are in course and clearly the outcome is very much an unknown at this stage.

A number of elections are due to take place in mainland Europe this year, notably in France and Germany, and these offer the possibility of additional change.

Whilst this political uncertainty prevails, the economic fundamentals and strengthening corporate earnings have served to support the equity markets, with the major indices in the UK, US and Euroland delivering gains in the first quarter. The value of Sterling against other major currencies was effectively re-based at lower levels following the Brexit vote last year and this relative weakness has continued to date. Looking ahead, we remain cautiously optimistic about the investment markets although, given the uncertainties, some volatility should be anticipated over the coming period.

I would like to take this opportunity to thank you for your continued support and we very much look forward to continuing to work with you to achieve your financial goals in 2017.

Please do speak to your investment manager or wealth management consultant should you wish to discuss your financial affairs.

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Expectations soar but data lags…

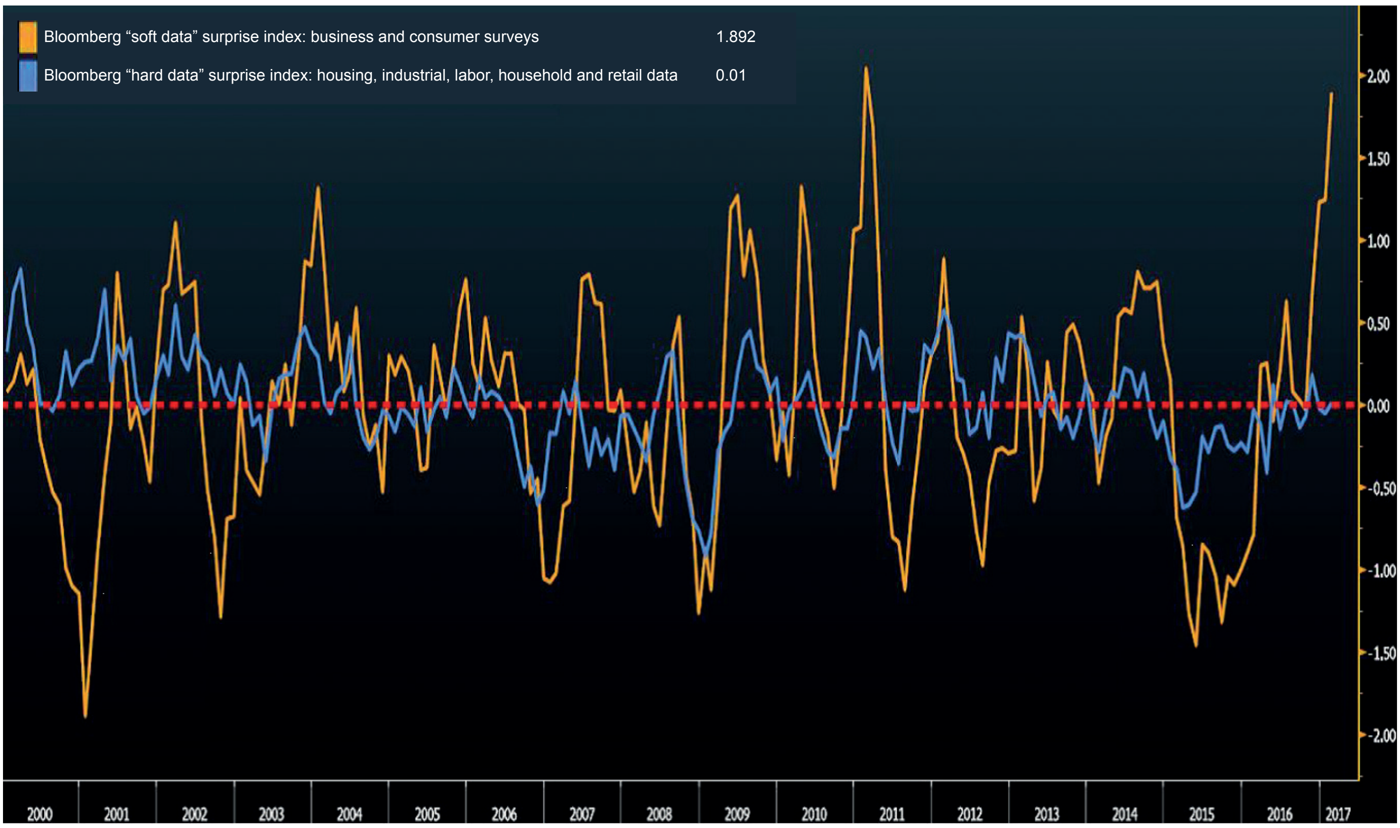
Around the middle of 2016, we noted an upturn in key leading economic indicators which heralded a cyclical upswing in the momentum of economic growth across the OECD area in general but in the US in particular. The US presidential elections in early November 2016 took place within this context of improving growth. Nevertheless, it is arguable that the most prominent feature of the period since the US elections has been the surprising spike in investors' expectations about the future path of economic growth. This has driven strong performance in risk assets such as equities while fixed income securities, particularly US government bonds, have lagged over the period.

Given the afore-mentioned pick-up in key leading indicators, the spike in investors' expectations was not surprising from the stand-point of improving growth momentum. Rather, the surprise derived from the fact that market consensus had painted a gloomy view of an unlikely Trump victory in the run up to polling day. The volte-face was striking but the question remains as to whether it was completely justified.

Since mid-November 2016, the Bloomberg Economic Surprise Index has been indicating that the US economy was accelerating much faster than analysts' expectations. Delving a little deeper, the chart below splits the Bloomberg Economic Surprise Index into two subcomponent parts; a survey data subcomponent which focuses on expectations about future economic activity (depicted in yellow in the chart) and a 'hard economic data' subcomponent which measures the deviation of actual economic data from consensus forecasts (depicted in blue).

Viewed this way, it is clear that the recent run up in optimism has not been matched by the hard data. The reality is that while sentiment, or so called 'animal spirits' can be lifted at a moment's notice, it takes considerable time for optimism to feed through into hard data. And it often never does. In this regard, it is worth noting that there is as yet no guarantee that the new US administration will manage to deliver on its pro-growth agenda while simultaneously refraining from its less desirable policy proposals.

Chart 1: A widening chasm between economic expectations and hard data



Source: Bloomberg

INVESTMENT STRATEGY OVERVIEW

Importantly, in light of the recent outbreak of optimism, investors must distinguish between the cyclical and the structural. The recent period of modestly stronger pace of economic activity reflects the cyclical upswing in growth momentum which began around mid-2016. This is welcome. However, there is as yet no evidence of a change in the downward trajectory of structural growth that has been evident over the past few years in the US and other developed economies. In the absence of concrete policies designed to address the longer term drivers of growth, such as productivity and demographics, that underlying structural decline will ultimately reassert itself.

This has important implications for investment strategy. First, it suggests that current equity valuations leave little margin for error and risk assets are vulnerable to disappointment on the economic or policy front. Consequently, a cautious stance on asset allocation seems prudent. Second, it flags the possibility that despite the fact that government bonds have been in a long running bull market for well over three decades, widespread expectations of the asset class's imminent demise might be premature.

Meanwhile, there are notable developments elsewhere in the advanced economies. In the UK, the recent triggering of Article 50 may well herald an extended period of uncertainty, particularly for business investment. It remains too early to determine the ultimate impact that Brexit will have on long term growth in the UK and a lot will depend on the nature of the agreement that is ultimately reached between the two parties. In the meantime the French go to the polls in early May in a vote that will go much further in defining the Euro-zone's long term viability than Brexit ever could. Markets are quite sanguine about the political risks surrounding the French elections as a victory for Marine Le Pen is seen as a low probability outcome. While we share the market's view on probabilities, we are humbled by recent high profile low probability events that have nevertheless materialised.

As is our long standing pragmatic approach at times like these, we prefer to err on the side of caution in the belief that the avoidance of disasters is a necessary condition for ensuring strong long term investment returns.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD Effective April 3, 2017

	United States	United Kingdom	Euro-zone ex UK	Asia ex Japan	Japan	Emerging Markets
Equities (overall)	0/-					
Equity allocation by region	0	-	+	0	+	-
Bonds (overall)	0/+					
Agency / Supra	0	0	0	0	0	0
Corporate Bonds	0	0	0	0	0	0
High Yield Bonds	0	0	0	0	0	0
Govt Guarenteed Bonds	+	+	0	0	0	0
Index-Linked Bonds	0	0	0	0	0	0
Alternatives	+					
Cash	-					

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

Bond Markets Experience A Positive Start To 2017

Fixed interest markets performed (surprisingly) well in the first quarter of the year.

Data continued to be positive, and yet bond yields remained low. Also, equity markets globally had another strong quarter, and bonds might have been expected to sell off in response to this, yet didn't.

Perhaps this phenomenon – low bond yields, and strong equity markets – has become such a persistent feature in recent years, that investors have finally come to accept it as 'normal'.

The FTSE All Gilt index returned 1.62% over the quarter, with Gilts one of the best performing major markets. There was an element of catch-up, as Gilts had lost 3.3% in the previous quarter.

The UK 10 year Gilt yield hit 1.5% in January, a post-Brexit high, as European yields more broadly sold off. However, UK yields rallied in both February and March, as the Bank of England indicated that it remains firmly in 'easing' mode.

Returns came largely from the longer end, unsurprising given how low yields are at the short end. Returns from the 0-5 year index were just 0.23%, and 0.85% from the 0-15 year index, over the quarter.

At the March meeting of the Monetary Policy Committee, one member dissented and voted for an increase in interest rates. But Kristin Forbes is an external member of the MPC, and is due to leave the committee by the end of June, so this may not have longer term ramifications.

Remaining members left rates at 0.25%, taking the view that sluggish pay increases and rising inflation would keep a lid on real pay growth and demand. Retail sales in the UK have been on the weak side in the first three months of the year, and interest rate futures in the UK now point to a rate rise in 2019 at the earliest.

US Treasuries returned 80bps over the quarter, while 1-5 year Treasuries returned 28bps. In contrast, US Investment Grade Corporates returned 1.25%, with US high yield returning 2.94%. however, both investment grade bond spreads and high yield spreads widened slightly in March, as the oil price weakened.

In contrast, UK Corporates made a positive return in March, and 1.78% for the quarter.

The 10 year US Treasury yield rose as high as 2.62% in mid-March, just before the Federal Reserve increased its Target Rate for the second time in three months, but declined to 2.38% by the end of the month, down 5 basis points on the quarter.

The new range for the Federal Reserve's Target Rate is 0.75-1%, but the members did not increase the 'dot plot' forecast from the December meeting, despite decent employment and survey data, and a strong stock market. While survey indicators like the ISM have been strong, some of the actual data like industrial production has lagged a little, while inflation remains around the 2% targeted level.

The third interest rate rise since the financial crisis had been 'priced in' by markets, with the probability of a rise reaching 98% in the days before the announcement. The gap between the last rise in December and this one – a mere three months – suggested an accelerating pace of rate rises, but bonds actually rallied – testimony to perceptions that this was a 'dovish hike'.

The accompanying statement, and the comments in the press conference, were benign, and the Fed governors gave no indication that they are steering away from the likelihood of three rate rises in total this year, and three next.

There was some talk that policy setters want to see the less well-educated, who tend to get employed in the latter stages of the cycle, benefiting before moving more aggressively. Meanwhile, the Atlanta Fed's 'GDP Now' indicator, which has had a high level of accuracy in tracking actual GDP changes in the US, has shown a bit of a bit of a drop off since the start of the year.

On present trends the next rise is more likely in September, though it is still too early to be sure at this stage. US GDP growth in Q1 is likely to be on the weak side, around 1% annualised.

Central banks in Norway and Switzerland also left rates on hold in March. Meanwhile, the ECB's colossal Quantitative Easing programme steps down from €80bn to €60bn per month from April onwards.

Nevertheless, we are currently confident enough to be underweight duration – but modestly so, with a negative stance on the low yielding markets of the UK and Europe, and a preference for US yields.

James Penn
Senior Portfolio Manager

Markets Continue To Enjoy Positive Returns

During the first quarter of 2017 the world finally got to see the first signs of how the 45th President of the United States would form his executive and searched for clues as to how this presidency might develop.

Thus far, the impression has been of a team struggling to deal with the checks and balances of the US Constitution and the realities of working with legislators. The first real test of President Trump's ability to push through substantive legislative change (the repeal of the Affordable Care Act) failed. Some observers worry that this might call into question the implementation of the market friendly policies that Trump has alluded to, but thus far investors have remained positive.

Around the world, most markets continue to enjoy positive returns. In Q1, the MSCI All Country World equity index rose 6.4%. Emerging markets returned over 11% in the same period against the US's 5.5% and the UK's 3% (within that, the UK FTSE 250 index of mid cap stocks was up 5%). Japan was the only major market to fall, losing just over 1% of its value. Investors have cash and seem anxious to invest, which meant any market pull backs were short lived.

It is as difficult as ever to predict what will happen as we advance through 2017. Geo-political uncertainty has not abated, albeit the UK is further along the road to leaving the European Union and Mr Trump is choosing the wallpaper in the White House. If 2016 illustrated anything, it was the difficulty of trying to predict outcomes as well as the folly of trying to second guess market reaction to those outcomes. Thus we invest with the risks in mind (and contributing to our overall level of perceived risk) but not positioned for any specific outcomes.

"...Leading indicators of economic activity suggest growth will gain momentum this year..."

Putting politics to one side, the global economy actually looks quite healthy. Leading indicators of economic activity suggest growth will gain momentum this year. The US and UK look buoyant, signs from the emerging markets are positive and even mainland Europe ex Germany looks to be creating jobs and growing.

The return of inflation should encourage corporate capital investment – something that has been disappointing thus far. If companies do indeed begin to invest strongly, we should see multiple benefits. The direct impact is the increase in earnings of those companies involved in producing the capital equipment. The indirect impact is more profound and should result in an improvement of the productivity of the workforce justifying higher real terms wages and feeding through to consumer confidence. Thus we should see investment returns broadening across sectors (you will remember from IQ Q4 the narrow nature of UK equity returns last year).

Against this positive backdrop, equity valuations are at elevated but not extreme levels, and in light of continuing low interest rates, look less vulnerable than at first sight. The US looks expensive relative to its earnings prospects, while Europe, Japan parts of Asia and certain emerging markets look relatively better value. [Note, in the near term, valuation as an investment factor needs to be tempered by such measures as momentum and sentiment but in the long term is a key indicator of future returns.]

Overall then, we are cognisant of elevated geo-political uncertainty, but in the short to medium term macro-economic conditions remain supportive.

Andrew Herberts ASIP
Head of Private Investment Management (UK)

*All performance statistics from Bloomberg

Property Markets Optimistic Despite Brexit

Despite the turmoil following the Brexit vote in June 2016, it has proved to be a fairly buoyant period for property markets.

The post Brexit uncertainty initially made occupiers more cautious leading to a slowdown in both volumes and rental growth. However, this reversed somewhat over Q4, preventing vacancy rates from rising markedly.

The income return component looks to remain the driving factor for total property returns in 2017. Market projections indicate modest improvement in rental growth across the majority of property sectors and overall, property fundamentals remain supportive. It is a two-tiered market with central London trading significantly ahead of the pre-financial crisis peak in contrast to regional markets. While the influx of foreign capital bolstering London prices has been supported by Sterling's depreciation, we feel there is better value in regional and more specialised property markets.

In traditional markets we feel Brexit related uncertainty will likely lead to a weakening in demand for office space in London. In contrast, many of the regional city office markets are likely to break new records for annual take-up. The industrial and logistics property market was an outperformer in 2016 and we expect this to continue. While the sector will not be immune from uncertainty surrounding the trade impact of Brexit, lack of supply creates strong price support. Retail property may face a more challenging environment as labour costs and Brexit worries weigh on sentiment. The impact of online retailing will also continue to drive structural change in the market.

From an alternative market perspective we favour student property, healthcare and social housing. The student property market is supported by significant supply/ demand imbalances and the UK's position as one of the leading centres of higher education. The healthcare sector continues to attract significant interest and our aging population should make this an enduring trend, and is well placed to weather any economic downturn. There is an equally strong story in the social housing market where lack of supply is well documented and all major political parties have indicated that provision of additional housing is a priority. This fundamental imbalance should mean demand remains high.

In terms of property exposure, we have a preference for allocating via closed ended funds. We feel the closed ended structure has a number of benefits over the open-ended structure due to the permanent capital nature of the investment vehicle. In particular, not having to carry a liquidity buffer to satisfy investor flows and therefore gaining purer exposure to the asset class is of significant benefit. The cash drag this can impose on performance can materially detract from long term returns.

For the sector as a whole we feel that whilst there may be some headwinds for certain sectors of the UK property market due to potentially protracted Brexit negotiations, certain sectors will continue to be well supported. Sectors with less economic sensitivity remain in focus for us such as the healthcare, social housing and student property, and a bias towards more regional markets is warranted at this point in the cycle.

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