THOMAS MILLER INVESTMENT

IQ Q1

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **April 2018**

A Note From The CEO

The first quarter of 2018 was a challenging period for most asset classes, reflecting the re-emergence of significant market volatility after a long period of absence. In our last Investment Quarterly we forewarned against complacency, citing a need to be cautious in the medium term against a backdrop of strong economic confidence. Whilst a tightening in monetary policy has been a key driver in weakening investor sentiment, it is also clear that unconventional foreign policy by the current US administration has played a part, with the prospect of a potentially damaging international trade war being a key development.

A deep-seated international trade war would, undoubtedly, be negative for Global growth prospects and whilst markets have in recent past largely ignored much of the political posturing by Global leaders, they now appear to be taking notice, with increased volatility being the result.

The tighter monetary policies being adopted by major economies signal an end to an era of relatively easy gains for investment asset prices and further volatility can be expected. Whilst this is understandably uncomfortable for investors, we believe it is precisely at this point that our long term investment thinking and ability to actively manage portfolios will prove important contributors to delivering strong long term returns for our clients.

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

Please do speak with your Investment Manager or Wealth Management Consultant should you wish to discuss your financial affairs.

Hugh H Titcomb
Chief Executive Officer

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The World Economy is Vulnerable to Negative Shocks

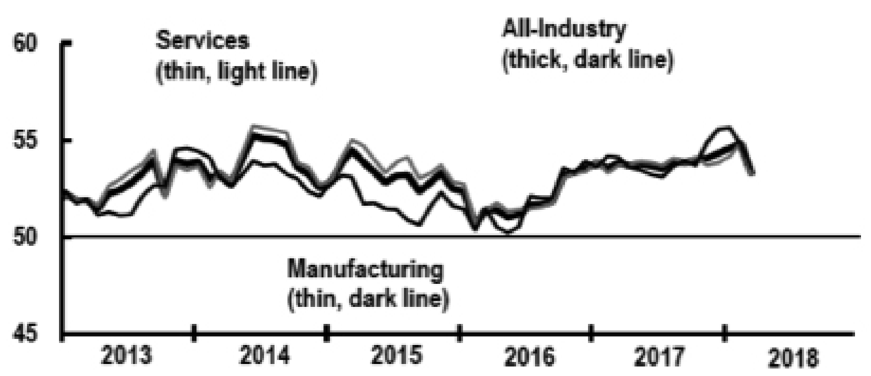
Economic growth momentum eases

- In line with our expectations at the turn of the year, the momentum of economic growth has slowed across the major developed economies in recent months. Perhaps the clearest illustration of the global nature of the slowdown in growth momentum came from the J.P.Morgan Global Manufacturing & Services PMI which indicated that the pace of global economic expansion eased to a 16-month low in March. The report by IHS Markit highlighted that on a sector basis, “growth of manufacturing production eased to an eight-month low and service sector business activity rose to the weakest extent in almost a year-and-a-half”.

- Disaggregating the global data, IHS Markit noted that National PMI data signalled a widespread growth deceleration. The report stated that “rates of expansion eased in the US (two-month low), the euro area (14-month low), China (four-month low) and Japan (17-month low). Growth in the UK was the weakest during the current 20-month sequence of increase and also moderated in Brazil (two-month low) and Russia (five-month low)”.

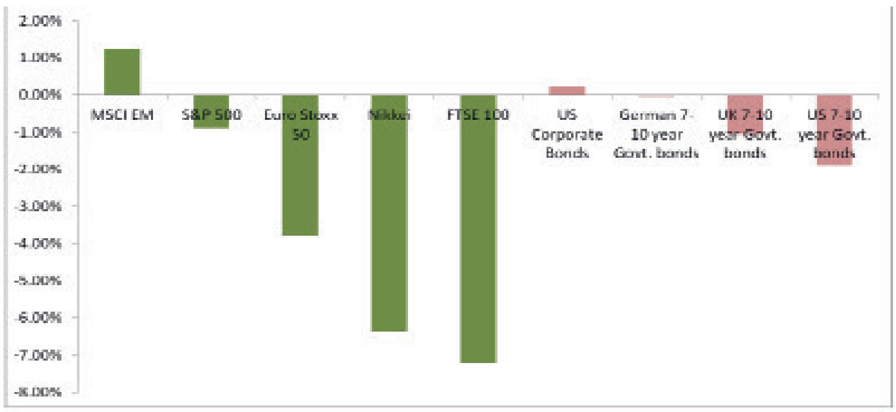
CHART 1: JPMORGAN GLOBAL PMI OUTPUT

Diffusion Index, sa



Source: IHS Market, April 2018

CHART 2: Q1 2018 TOTAL RETURN (LOCAL CURRENCY, %)



Source: Bloomberg data, Thomas Miller Investment.

Political risks, financial markets & investment strategy

- The Strategy Overview section of last quarter’s report was titled “Rising growth breeds excessive optimism”. If investor exuberance was fostered by an extended period of low volatility across financial markets, the period since the end of January 2018 has served to reset expectations and recalibrate risk appetite.

- As Chart 2 illustrates, markets struggled in the first quarter and, with some notable exceptions, most financial assets recorded sharp losses. Across asset classes, the losses were not limited to equities as corporate bonds, government bonds and a broad range of alternative investments, also recorded losses over the quarter. This meant that even well diversified portfolios suffered over the quarter.

- In late January, investor concerns were initially triggered by stronger than expected inflation data in the US, which led to fears that the US central bank (Fed) may be forced to raise interest rates more sharply

INVESTMENT STRATEGY OVERVIEW

than expected. However, while softer data in subsequent weeks helped to ease those fears, other negative factors gained prominence. These have included uncertainty about the regulatory outlook facing technology firms following allegations of privacy infringements at Facebook and, more importantly, concerns about the outlook for global trade and therefore the world economy.

- Early in 2017, we observed that the period following the US elections in November 2016 had seen a market consensus form around the view that the Trump era will be bullish for equities. We noted that the consensus view was predicated on the assumption that while the new administration would follow through on proposed pro-business policies, its latitude to execute some of the less desirable policy proposals would be constrained by a combination of political realities and the vaunted US constitutional checks and balances. We worried that those expectations could turn out to be wishful thinking on the part of investors. As things stand, a year on from that observation, it looks like investors have started to lose confidence in that rosy narrative.

- Beyond the ongoing cyclical slowdown in growth momentum, the medium term outlook has become clouded by the risk of a trade war between the US and its major trading partners. At this point, the focus of attention has been on the tit-for-tat announcements of tariffs by the US and China but the core issue is the insular trade policies of the Trump administration. At this point, it remains unclear how the trade disputes will be resolved but the risks to the global economy and financial markets at this stage in the economic cycle are significant.

- From an asset allocation perspective, we retain a modest overweight position in risk assets, including equities and selected alternatives while mindful of the downside risks noted above. Our positioning reflects our current expectation that while growth is likely to turn out lower than consensus forecast, it should still be strong enough to support corporate earnings over the quarters ahead. The real challenge to the long running equity bull market will ultimately come from a downturn in the business cycle. While the risks are rising, the balance of evidence from multiple leading economic indicators suggests that we are not at that juncture yet.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 5th April 2018)						
	United States	United Kingdom	Euro-Zone ex UK	Asia ex Japan	Japan	Emerging Markets
Equities (overall)	0/+					
Equity allocation by Region	0/-	0	+	0/-	+	+
Bonds (overall)	0/-					
Agency/ Supra	0	0	0	0	0	0
Corporate bonds	0/-	0/-	0/-	0/-	0/-	0/-
High Yield bonds	-	-	-	-	-	-
Govt guaranteed bonds	0	0	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 Settle After Interest Rate Hike in March

It has been a challenging start to the year for bond investors.

Bond yields around the world underwent one of their biggest sell-offs in recent years over the first seven weeks of the year, led by the United States as growth and inflation expectations picked up in the New Year. Ten year yields in the US rose about 50 basis points by mid-February from their January the first levels.

The move came as a bit of a shock after the benign way bond yields behaved last year, against a background of economic expansion and soaring stock markets. Throughout January bond yields tracked stock market indices higher – with the US stock market enjoying its best month for several years, up 7%.

In early February bond yields received a further shock as evidence emerged that some inflationary pressures could be emerging.

"Bond yields around the world underwent one of their biggest sell-offs in recent years over the first seven weeks of the year, led by the United States as growth and inflation expectations picked up in the New Year."

One of the surprising features of recent years has been the way in which wage gains have remained at low levels despite the tight labour market. So a surprise reading in the January Non Farm Payroll data, which showed wages rising at 2.9% - their highest level since the financial crisis - sparked a further big sell-off, this time in equity markets as well.

This was the first real evidence we have seen of wage inflation since the crisis, though it will need to be sustained to have inflationary implications.

The 10 year yield peaked at 2.95% on February 21st, with expectations that it would retouch 3% for the first time since 2013. While the sell-off was broad based, the curve did steepen a little – the 2-10 year spread rising from 55 bps to 75bps.

During February Jay Powell took over as the new Fed chairman from Janet Yellen, and in his Humphrey Hawkins testimony indicated that the economy was doing much better than in December, and that interest rates could rise more than three times this year.

This rhetoric was followed up in March, when Powell raised interest rates by 0.25% in his first FOMC meeting to a new higher range of 1.5-1.75%. Expectations remain that rates could rise a further two times this year.

The March hike was fully expected, and bond markets have calmed down a little since then, seeing such pre-emptive hikes as helpful in curbing any overheating in the US economy. Bond markets have also been partly helped by weakness and volatility in the equity market in both February and March, and by relatively benign wage growth and inflation data. Wage growth in February declined to 2.6% from the surprisingly high January figure of 2.9%, while core PCE for February remained flat at 1.6%.

Over the period as a whole, US Treasuries returned -1.37%. UK gilts fared better, with a total return of 0.15%. Gilts also recovered much of their losses from the first seven weeks of the year, and the 10 year yield returned to 1.35% by the end of March after touching 1.65% in February.

"Throughout January bond yields tracked stock market indices higher – with the US stock market enjoying its best month for several years, up 7%. "

The Bank of England at its March meeting continued to guide markets to a second rate hike in May, which would take the bank rate to 0.75%.

Economists are evenly divided at present as to whether this will happen. Policy makers wish to wean the UK off low interest rates, are worried about rising wage claims, and are also concerned that doing nothing in the face of rate hikes in the US represents a form of passive 'loosening'. On the other hand, the UK economy does appear to have slowed in the first quarter, with the high street and retail sales in particular showing a weaker trend. Lower housing transactions, caused by high house prices, lack of mortgage availability, and the increased taxes and regulation that comes with home ownership these days, are also having an effect.

Meanwhile, manufacturing indexes around the world remain strong, suggesting that current buoyant – but at the time of writing non-inflationary – conditions can continue.

James Penn
Senior Portfolio Manager

Equity Investors Nervous

As 2018 began, investors were confident. Economists predicted strong global growth, corporate earnings were expected to come in strongly and 2017 had seen double digit returns. January started strongly, but then sentiment turned.

Wage growth figures in the US surprised on the upside and investors sold risk as they began to question whether inflation presaging the end of the cycle was imminent. Just as equity markets were shrugging off this worry another blow was delivered with the beginnings of what could turn into a nasty little trade war. At the end of the quarter, of the major equity markets only the Italian and Brazilian showed positive returns in local currency. The UK's FTSE All Share was down nearly 8%, with the US S&P500 down over 1% and the German DAX fell over 6% in the same period. We watch developments closely.

Tech bubble 2018?

Technology stocks were a significant driver of 2017 performance with the American quartet of Facebook, Amazon, Netflix and Google (now called Alphabet) providing market leadership. Emerging market tech stocks joined in the fun and one reason that the UK equity markets lagged was the bare fact that tech represents only 1.4% of the FTSE100 index (against nearly 25% of the S&P 500). Recent weakness in the tech sector has had some commentators worrying about whether we are about to see a millennium type market crash led down by over-valued tech stocks. While nothing in markets should surprise, this does not quite ring true.

There are some very expensive tech stocks out there certainly. Tesla is a $48bn market cap company which is not due to make a profit until next year. When it finally does, at current prices, $1 of Tesla earnings will cost $139 to buy through the stock market. In 2019, $1 of Ford's predicted earnings will cost $7.50 (and buying today, by then you would have already got 80c in your pocket from Ford dividends). Amazon has been making profits, but in 2017 this $683bn company made only 17% of the net profit that Walmart did and was worth 2.5 times more. These valuations tell us that great things are expected but such companies need to deliver and are vulnerable to disappointment. We do not have to go over the arguments about new versus old economy and where the future is – I need no persuading as my bored colleagues will attest – but as investors we have to understand what an asset price implies about expected growth and assess the reasonableness or otherwise of that expectation.

Not all tech is valued on extremes. Facebook currently trades on the same multiple of next year's earnings as Unilever which makes (among other things) Brut (those of an age will remember the advert with Barry Sheene and Henry Cooper?). Alphabet (Google as was) trades on the same multiple as Diageo which supplies Smirnoff Vodka to a grateful world. This is a long way of saying that like the rest of the market, some tech stocks embed achievable, if not conservative growth in their stock price while others need to stretch credulity to justify their current valuation. Investors need to be discerning. I do not sense the general, undifferentiating euphoria of the late 90s tech bubble and so am less concerned about a catastrophic unwind, although I do believe that some individual stocks are stretched.

Andrew Herberts ASIP
Head of Private Investment Management (UK)

Uncertainty in the UK Commercial Property Market

The UK commercial property market appears to be thinning of late, foreign capital inflows have been trailing off and broad property markets may be due a more pronounced wobble than we experienced in the aftermath of the Brexit referendum in 2016.

The Bank of England recently warned of overly extended property valuations, and the quarterly 'Adjusted Market Value' (AMV) metric shows that UK commercial property values are 12.2%* above trend. AMV is a mean-reversion index which compares current property values with the inflation adjusted long-term trend. Whilst not necessarily a pre-cursor of impending doom this should certainly create significant headwinds to further capital appreciation in the short-term.

Although fears of a disorderly Brexit are dissipating for now, the overhang continues to cast a shadow on the market. Occupier demand for London office space remains depressed despite company estimates of jobs moving to Europe declining and we cannot fully discount a re-escalation of chaotic exit fears.

Furthermore, markets are now widely expecting an interest rate hike in the UK in May with a further rise anticipated in November and then a further two hikes in 2019. This creates a potential challenge for investors in those sectors where rental growth isn't sufficient to offset increasing yields.

Pain is already being felt in the retail sector. If your store is not a flagship shop on Bond Street then it is becoming increasingly hard to justify retaining it. Although prime shopping centre yields are half those that community shopping are currently achieving, this will not necessarily protect you from a de-rating. We are already seeing failures with Toys R Us and Carluccios being two of the more recent high profile demises.

The argument being trotted out of late that the retailer requires stores in order for online shoppers to collect and return purchases simply doesn't wash anymore. This point-of-view wholly underestimates changing retail habits and the increasingly sophisticated logistics infrastructure supporting this change. The case has been made that retail assets are now looking attractive given recent declines but it seems a little early to make that call. The old adage of not trying to catch a falling knife springs to mind. Where retail assets used to counteract the cyclical nature of office returns, this is no longer being evidenced.

Despite the preceding negativity, there are pockets of optimism. Within the Thomas Miller Investment Diversified Assets Fund we allocate to sectors where we see a strong fundamental support and trends that are likely to persist. Areas such as social housing and healthcare property have less sensitivity to the broader economy and are supported by ageing demographics of the UK. Demand on the occupier side for health care is ultimately driven by the domestic population which will continue to need the services offered by the operators regardless of economic growth. Despite declining yields, the logistics sector is supported by the disruption of the ongoing move to online retail. The UK is 'under-warehoused' when compared to other developed countries and despite logistics occupier demand, development remains limited. This inelasticity of supply can continue to support prices and drive rental growth.

Overall, it is difficult to feel terribly bullish on the UK property market right now but there remains opportunities to improve risk-adjusted returns. Irrespective of the notoriously difficult to predict point in the cycle at which we currently find ourselves, a diversified investment approach will always be a sensible strategy.

Mark McKenzie
Head of Alternatives Research

* Jefferies

UK Banks Showing Signs of Progress

Recently all four big UK banks – HSBC, Lloyds, Barclays, and RBS – reported Full Year 2017 results. (Note the order – could there be an indication of quality there?)

Britain's banks seem to be back from the brink. Overall, recent 2017 results gave an encouraging picture. Full year underlying profits rose 11% at HSBC, 24% at Lloyds, 10% at Barclays, while RBS produced its first annual profit in… wait for it, ten years. Even RBS's 'statutory profits', as opposed to 'underlying profits', were positive at £750m ('underlying profits' allow companies to ignore nasty 'one off' or exceptional items – things like misconduct charges and restructuring costs).

As one would expect, there were improved rewards for shareholders. Lloyds upped its dividend by 20%, and promised £1bn of share buybacks. Barclays reinstated its 2015 dividend at 6.5p per share, reversing the 50% cut it made in 2016, and suggested it too would look at buying back its own shares.

HSBC held its dividend, but there have been substantial increases in recent years and the shares already yield over 5%. The issuance of additional Tier 1 debt currently prevents it buying its own shares, but later this year it will likely do more of this.

RBS is still not paying a dividend (a mere ten years after cancelling the last one), but once it settles with the US Department of Justice over the alleged misselling of US mortgage backed securities it is likely to reinstate one.

The better picture fits with a UK economy that trundles along with some momentum – albeit at a 1.5% annual pace rather than the 2.5-3% pace of a few years ago. While things haven't been brilliant, they have at least been OK.

Interest rates are still low, meaning mortgage affordability remains good. Overall loan growth may be low, but consumer credit is still growing, assisted by select bolt-ons, like Lloyds' purchase of the MBNA credit card book. Net interest margins are flat, or up slightly. Impaired loans and provisions remain low.

HSBC, with its exposure to loan growth in Hong Kong and Asia, and higher US interest rates, is in a better place in this respect, underlined by its superior share price performance over the past two years.

While HSBC's and Lloyds' results were much as expected, positive surprises came from the other two, which in stock market parlance have been 'dogs' for some time.

The fact that RBS finally made a profit last year was a relief, though a big fine by the DOJ – some reports have suggested $10bn – could wipe out 2018 profits.

The biggest positive surprise was from Barclays. Its investment bank did much better than peers (even US peers) in Q4. All its main divisions are now profitable. It still has to weather issues (and possible fines) related to its 2008 refinancing, and retain its CEO (Jes Staley is under FCA investigation for past HR issues). But it could be past the worst (note that the conditional tense has become a prerequisite when discussing bank performance).

One of the common themes in the various CEOs' statements was a commitment to technological investment. Lloyds is investing £3bn in systems over the next few years. RBS incurred a £2.5bn restructuring charge over the next two years, partly for digital investment.

The flipside of lower UK branch transactions, and a reduction in branch networks, is more 'video bankers', as RBS puts it.

RBS is now offering 'digital mortgages', with the agreement period cut from 23 days to 11 days. It has also invested in an 'AI chatbot' with the charming name of Cora. This 'visual avatar' is apparently available 24/7 with no 'wait time', and can field unlimited queries simultaneously. Over the past ten months, it has held '400,000 conversations responding to over 200 different questions.' How about that for the old concept of 'talking to your bank manager'?

More seriously, it illustrates how technological change is helping banks to reduce costs, and become less labour intensive – helping to offset the effects of low interest rates and sluggish loan growth… and fines.

Who knows, the machines may even give out better advice in future.

There were a few slip ups (Lloyds recording another £600m of PPI charges). But overall, the banks look to have got through a tough patch… perhaps their worst period in a hundred years (or maybe since the nineteenth century)?

In terms of value, HSBC and Lloyds trade above book value, while Barclays (conduct fines, governance issues, questions over investment bank) and RBS (conduct fines, government ownership, and ten years of restructuring) trade below.

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