THOMAS MILLER INVESTMENT

# IQ2

*Global market intelligence, critical analysis and investor briefing*

*Investment Quarterly* **JULY 2016**

# A Note From The CEO

The result of the Referendum held on 23rd June which saw the UK electorate vote in favour of the UK exiting the European Union has proved to be a catalyst for significant political change within the UK. Indeed, we now have a new Prime Minister and anticipate further changes within the government ranks.

The economic impact of the vote is somewhat less certain – not least because the terms and timing of the Brexit arrangements have yet to be determined. Early indications however suggest lower levels of economic growth here in the UK, in the short term at least.

The foreign exchange markets reacted negatively with significant downward pressure on the value of Sterling, resulting in a 31 year low against the US dollar. Whilst this move will have a negative impact on the cost of imports to the UK, it will benefit exporters to a significant degree. Indeed, following initial falls in the early days after the Referendum result was announced, we have seen a strong re-bound in the FTSE 100 index to overtake pre-Referendum levels as investors recognised the positive impact of the lower value of Sterling on corporations with strong overseas earnings. Financial services, house-building and construction companies are however amongst those which have seen falls in value.

We have seen a strong demand for Government securities, putting pressure on yields such that the 10 year Government bond yield has fallen to an unprecedented sub 1% level – a precursor to a possible interest rate cut in the short term.

Notwithstanding this back-drop of change and uncertainty, we believe there will continue to be attractive investment opportunities and our team of investment and wealth management professionals remain focused on delivering investment outcomes in line with your financial objectives.

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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# Investment Strategy Overview

## Post-referendum assessment of the economic & policy outlook

Relative to upbeat expectations at the turn of the year, global economic growth in the first half of 2016 was disappointing. Growth has been muted across the board, with both the developed economies and emerging markets showing signs of slowdown. Earlier in the year, we highlighted the UK Referendum as one of the key sources of political risks facing markets. That risk has now crystallised. Below we outline a summary of our assessment of the post-Brexit outlook for the global economy and financial markets.

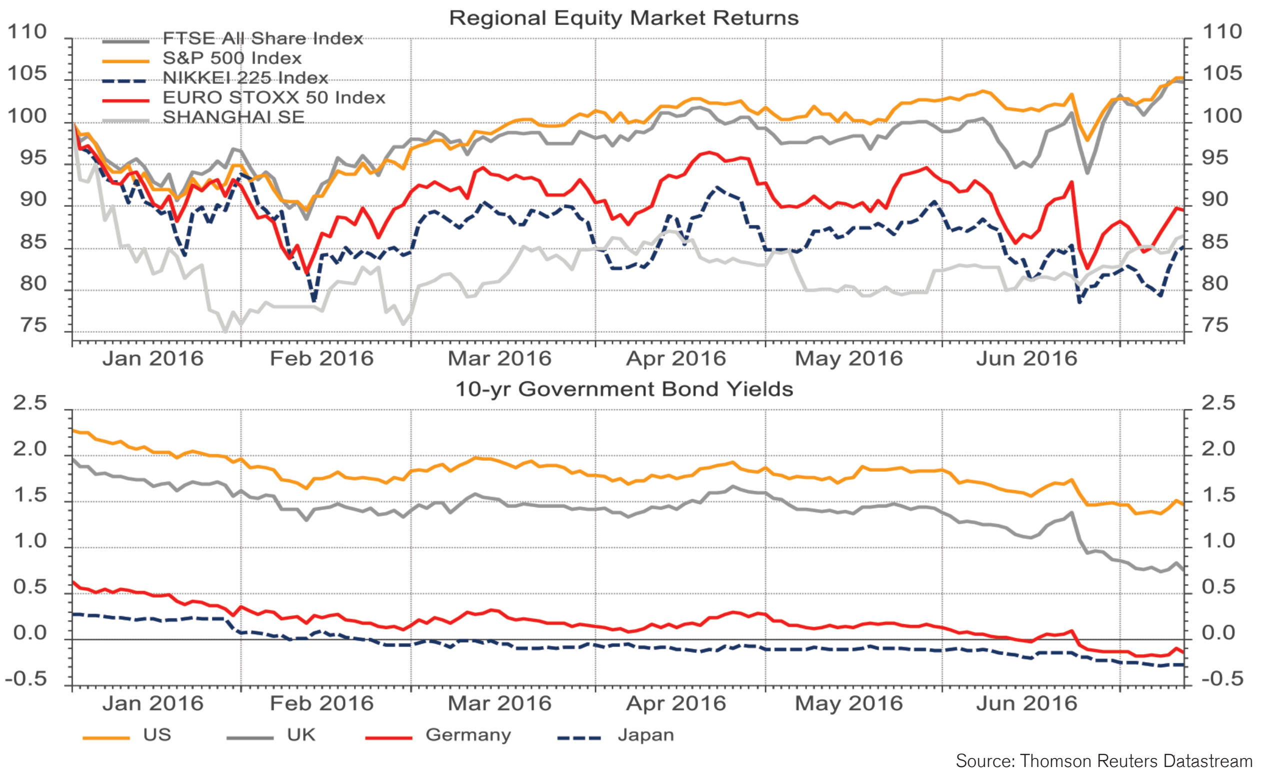
**Global economy**: direct effects of Brexit should be minimal at the global level. However, the likely deterioration in economic sentiment and financial conditions could undermine global economic activity at a time when the pace of economic growth is already modest. Overall, while the impact is hard to quantify, 'Brexit' clearly amplifies the downside risks to global growth.

**Political fallout**: perhaps the most obvious ramification of Brexit has been the political fallout. The UK has a new Prime Minister and the leader of the main opposition party seems likely to face a leadership challenge. Meanwhile, the strength of the 'Remain' vote in Scotland has increased the likelihood of a second Scottish Independence referendum. Likewise, the clamour for referendum elsewhere in Europe seems likely to grow. More broadly, a widespread rise in populist sentiment could increase protectionism and undermine global trade at a time when trade volumes are already weak.

**UK & Euro-zone economies**: from an economic perspective, the UK faces a lengthy period of uncertainty. In the short term, greater uncertainty is likely to lead to lower investment and consumption. The severity of the short term impact will depend on the extent of the policy response. As things stand, the risks of a UK recession at some point over the next year are finely balanced. While the longer term economic implications remain uncertain, the bias is largely to the downside. Likewise, the outlook for the Euro-zone economy is tied to the outcome of the forthcoming negotiations with the UK. While the likely impact is virtually impossible to quantify at this point, clearly, any restrictions on free trade will dampen future growth prospects.

**Policy support**: we expect a loosening of monetary policy across key developed economies. In particular, we expect that the US Federal Reserve will refrain from implementing two rate hikes as planned in 2016. In the UK, the Bank of England is expected to implement further stimulus via rate cuts, relaxation of rules governing bank capital requirements and possibly further quantitative easing. Unfortunately,

**Asset price movements since January 2016**




Source: Thomson Reuters Datastream

contrary to what seems to be a widespread misconception, monetary policy is no panacea and central banks can only do so much. At some point, expansionary fiscal policy measures will have to be implemented across the UK and Euro-zone if economic growth is to recover meaningfully in the months and years ahead.

## Financial markets & investment strategy

**Equity markets**: elevated levels of volatility will persist over the next quarter as equity markets are buffeted by powerful forces in opposite directions. On the positive side, investor sentiment will be boosted by expectations of significant central bank stimulus. On the other hand, we are now on the cusp of the 2Q earnings season. A prominent risk at this juncture is that the prevailing backdrop of slower economic growth could trigger weaker-than-expected corporate earnings while Brexit-induced uncertainty could result in widespread negative guidance by companies, particularly the financial sector. Whatever the outcome, it seems clear that sector-specific vulnerabilities will linger as investors periodically re-evaluate the impact on various segments of the market. UK market sectors such as banks, retailers and property are likely to remain particularly volatile.

**Bond markets**: government bond yields have fallen dramatically (and bond prices have risen) since the UK referendum. The severity of the declines has pushed short term momentum indicators into extreme readings. Consequently, we expect government bonds to give back some of the gains made in recent weeks. However, the bounce in yields is likely to be temporary as the prevailing backdrop of modest inflation pressures, slow growth and less restrictive monetary policy should support government bond prices for some time. Corporate bonds should also benefit from an easing of the 'risk-off' sentiment but performance is likely to be mixed and dependent on factors such as strength of corporate balance sheet, sector exposure, credit quality etc.

**Currency markets**: greater clarity on the political front will provide some support for sterling in the shorter term. However, GBP is likely to remain under pressure as investors await/anticipate central bank response. Longer term, the value of sterling will depend on the results of the UK/EU negotiations as the outcome of those negotiations will have material implications for the medium term outlook for the UK economy.

Overall, in terms of investment strategy, having been defensively positioned ahead of the UK Referendum (by being slightly underweight equities and overweight bond duration), our client portfolios are now positioned in line with longer term target weightings to the major asset classes.

**Abi Oladimeji**
*Chief Investment Officer*

## ASSET ALLOCATION

**TMI ASSET ALLOCATION SCORECARD (as at 7th July 2016) [previous position where there has been a change]**

| | United States | Euro-Zone ex UK | United Kingdom | Asia ex Japan | Japan | Emerging Markets |
|---|---|---|---|---|---|---|
| **Equities (overall)** | 0 | | | | | |
| Equity allocation by region | 0 | 0 | 0 (underweight FTSE 250) | 0 | 0 | 0 |
| **Bonds (overall)** | 0 [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 guaranteed bonds | + | 0 | + | 0 | 0 | 0 |
| Index-linked bonds | + | 0 | + | 0 | 0 | 0 |
| **Alternatives** | 0 | | | | | |
| **Cash** | 0 [0/-] | | | | | |

The scorecard above represents our current tactical asset allocation position relative to portfolio benchmark.
0 = neutral (i.e. in line with benchmark), + = overweight (i.e. bullish v benchmark allocation), – = underweight (i.e. bearish).
0/– Indicates that PMs have discretion within 0 and – ; and 0/+ Indicates that PMs have discretion within 0 and +

# Another strong quarter for Bonds

Bonds in most parts of the world enjoyed another strong quarter, after yields fell almost everywhere to levels that – in any previous era – would not have been thought possible.

Year to date gains have been relatively high in most markets, but have been most marked in the UK, where the FTSE All Gilts index returned 11% in the first half of the year, and 6.1% in the second quarter.

The gains were driven by the 10 to 30 year maturity space, with the 30 year bond yield dropping a whopping 1% over six months – from 2.67% on January 1st to 1.69% on June 30th.

Yields in the UK have been trending down in line with those of other government bonds markets for several years now since the global financial crisis first struck, but the falls accelerated after Brexit.

The 10 year government bond yield stands, at the time of writing, at 0.86%, having begun the year at 1.96%. So it has more than halved over a period of six months.

It has been said that yields are now the lowest they have ever been 'since the Bronze Age'. Given that the peoples of the Neolithic Age, who preceded them, are unlikely to have engaged in much money-lending or mortgage financing, this can be understood to mean that they are at the lowest levels ever.

And to think that the famous bond investor, Bill Gross, said in 2010 – just before the May general election, when the 10 year Gilt yield was above 4% – that UK Gilts were 'sitting on a bed of nitro-glycerine'.

Political risks, government deficits, high debt levels, and the dangers of inflation, have all been overestimated.

Meanwhile, the impact of central bank Quantitative Easing, risk aversion, and low nominal GDP growth rates, have all been underestimated.

It seems that no-one will now dare forecast the bottom in bond yields, after bearish siren voices have been so wrong, on so many occasions.

The entire Swiss government bond market – from short dated bills to 30 year bonds – trades at negative yields, while the German 10 year yield moved decisively into negative territory in Q2. The 10 year Japanese government bond yield is a negative 25bps.

The big story over the month was the UK Referendum on EU membership. With a narrow majority the British voted to leave the EU, a result that was totally unexpected by pollsters, analysts and market commentators.

The immediate impact of the result was a 'risk off' moment, with government bond yields sinking in most parts of the world (including the UK) to all time lows. Stock markets have since recovered, with confidence also since returning to investment grade corporate bond and high yield bond markets.

Bond yields have also sunk in the US, which – with the 10 year yield above 1.4% – remains the world's 'high yield' market.

It remains to be seen whether the assumption markets are making of no change – anywhere – in interest rates (other than further moves downwards) is correct.

While the Federal Reserve did not raise rates at its June meeting, and will likely not raise them at its July meeting, it is not beyond the realms of possibility that a rate rise comes at the September meeting. Any decision, however, remains data dependent.

The US economy is likely to grow at a 1.5-2% rate for the year as a whole, and some of the data continues to surprise positively. The US ISM Manufacturing index for June, for instance, came in considerably better at 53.2, a marked improvement on the 51.3 figure for May.

The US High Yield market (by which we mean the real High Yield market, not the 'high yield' US government market) has staged an impressive recovery from the lows in January, with a double digit return that makes up for the underperformance last year.

Spreads as a percentage of overall yield are at extreme levels (6% of yield spread versus an all-in yield of 7.5%) and look attractive.

But there may be a case for taking profits after the rebound, and future performance will to an extent depend on what happens in commodity markets, which were the cause of the distressed trading conditions in January.

Defaults peaked at 6% in the early part of the year, and have been trending downwards since.

Investment grade bonds also performed well, though spreads widened – particularly in the financial space – following the Brexit decision.

**James Penn**
*Senior Portfolio Manager*

# Brexit opens the gap between the FTSE100 and the FTSE250

After making steady progress since January's sell off, investors entered the second quarter in confident if not ebullient mood. As we headed off to the polls on the morning of June 23rd, the market had risen 3% since the end of March, and had shaken off a wobble in early June, rallying nearly 7% as bookmakers and pollsters agreed that the Remain campaign had done enough to win, albeit by a small margin.

During this period, the mid cap index (the FTSE 250) had given back some previous gains versus its big brother, the FTSE 100, but nothing remarkable.

June 24th, however changed this picture and opened an interesting gap between the large and mid cap indices. After an initial sell off, the FTSE100 rose 2.5% above its pre-referendum level and closed the quarter up nearly 13% from its Friday low. The FTSE250 followed a similar path, but fell further and rallied less such that it underperformed the 100 by 8.5% in the days following the referendum. Why was this, and does that mean there are opportunities?

**"the precipitous fall in Sterling effectively turbo charged performance in overseas markets for Sterling investors."**

The FTSE 100 comprises large UK headquartered companies who tend to have a global footprint and be less reliant on domestic UK economic conditions. With the devaluation in sterling, their overseas sales and earnings received an unexpected boost. Meanwhile, mid cap companies tend to be much more tied into the health or otherwise of the UK economy and sterling weakness might have the effect of raising their input costs to more than offset any improvement in international competitiveness.

As always, there is a tendency for over-correction when the market is ruled by emotion, and we believe this is the case in certain areas. Some mid cap stock prices are now discounting a steep recession in the UK and to the extent that the UK either avoids recession or suffers mildly, they are cheap. On the other side of the coin, some equities perceived as defensive have benefited from lots of investor interest (Unilever, which sells everything from Magnum Ice Creams to Domestos globally, rose over 14% from Friday 24th to the end of the quarter). As a result we have been making selective purchases for those clients who hold direct equities, and are examining the most appropriate collective vehicles through which we might benefit.

As Warren Buffett is quoted as saying: "Be fearful when others are greedy and greedy when others are fearful". In the UK, we are honestly not feeling greedy yet, but we are trying not to join the fearful.

Meanwhile, the precipitous fall in Sterling effectively turbo charged performance in overseas markets for Sterling investors. For example the US S&P500 equity index fell between the 23rd and 30th of June when measured

in US dollars, but rose nearly 11% during this period in Sterling terms. This was repeated in most of the major overseas indices, with Sterling extending its weak run and boosting overseas returns. Year to date, Yen strength over the pound has translated a 17% fall in the Nikkei 225 index into over a 7% gain in Sterling terms. One question we are currently dealing with as equity investors is the question of whether to hedge currency at these levels. This will be a focus of strategy conversations over the coming weeks and months.

**Andrew Herberts ASIP**
*Head of Private Investment Management (UK)*

# Steady growth in the second quarter for our alternative allocations

Over the course of the second quarter our alternative allocations had been making steady if slow progress.

With hindsight it is easy to say that markets had become complacent as to the outcome of the EU referendum as we saw both Sterling and equities rally in the lead up to the vote. Certainly the result took many investors by surprise and saw a sharp drop across risk assets in the immediate aftermath.

Whilst we have seen broad equities stage a recovery (albeit the FTSE 250 has remained depressed) one area which suffered in the initial sell-off and that is starting to see increasing downward pressure has been the UK property market.

In the days that followed the referendum there were multiple reports from estate agents of deals being cancelled as buyers either postponed, cancelled or even sought better pricing on current deals. This uncertainty was not limited to the residential marketplace and investor sentiment towards commercial real estate has also taken a negative turn. Indeed in recent days a number of open-ended property funds have had to gate due to redemptions exceeding the available liquidity within their strategies. The extent to which this situation persists or indeed escalates is something we will closely observe over the coming days, although it is likely that volatility will remain elevated as the political uncertainty endures.

In terms of our positioning for clients, we have for some time favoured more regional property exposure alongside some more specialised allocations to student and healthcare properties. More recently we have also been slightly more cautious on property in general and this has provided some protection from the more dramatic recent declines we have seen. However what history teaches us is that markets frequently overshoot to the downside during times of elevated risk aversion and this may create attractive entry points to increase allocations the UK property in the weeks and months ahead.

Whilst UK property continues to look vulnerable there have also been brighter notes and the recent increase in volatility has seen certain alternative assets perform very well. Infrastructure as one of our core alternative holdings has justified this rating as we have seen good resilience here with positive returns being delivered during the second quarter. We believe the sector looks increasingly attractive as a source of sustainable income against a backdrop of steadily declining bond yields and should remain well supported.

Away from our core alternative holdings we have also seen a bounce from precious metals as investors have looked to hedge their risk exposure. We are not advocates of holding precious metals (or gold in isolation) on a strategic basis due to a range of factors including the lack of yield and consequent valuation conundrum. However it can certainly serve a purpose on a shorter term tactical basis as recent moves have shown and with the prevailing uncertainty there may well be further upside in this space.

**“overall the second quarter has been a positive one for the alternative assets in which we invest.”**

Overall the second quarter has been a positive one for the alternative assets in which we invest, albeit with notable sector variations. We believe this environment is likely to persist and highlights both the benefits of having sufficient diversification within an alternative asset portfolio, and the ability to be nimble when volatility intensifies.

**Mark McKenzie**
*Portfolio Manager*

# "Events, dear boy, events."

[Harold Macmillan's response when asked what a prime minister feared most]

Mr Cameron will have renewed respect for this well-known quote.

The results of last month's referendum are what economists technically refer to as an exogenous shock – an unexpected, external jolt to the economy and financial markets. As the dust settles, it is fascinating to look back at the stock market's gyrations during these past few weeks. To assist, it is useful to view the stock market as an individual entity, to borrow from Benjamin Graham's allegory, let's call him 'Mr Market'.

On Friday morning, the first trading opportunity following the vote, the UK equity market sold off heavily with a 9% drop after just eight minutes of opening. The UK had decided to leave the European Union which surely was bad for the economy and companies. Well, Mr Market's amygdala went into overdrive. This is the part of the brain that triggers emotional reactions such as the instincts to fight or flee. Such animal instincts are primitive and spontaneous; driven by fear. As most will no doubt recognise, decisions based on such factors inevitably turn out poorly.


**"As active investors we attempt to consider the first, second and if necessary third-order consequences of events before positioning our clients' portfolios."**

After the initial wave of fear, Mr Market's thinking became more considered in the days following the vote. His pre-frontal cortex fired up and the logical part of his brain started thinking in a more reasoned fashion. Sterling had dropped violently depreciating by more than 10% against most major currencies – great for UK-based companies with international earnings. The Bank of England indicated it may have to drop interest rates reversing expectations which were for the next rate move to be upwards – more stimulus on its way. After no more than five trading days the UK equity market was back above its pre-referendum levels reversing the entire 9% loss.

There were of course casualties. Downside was felt most acutely by domestically focussed cyclical businesses. Property companies and house builders, airlines and banks – all were marked down significantly by a more reflective Mr Market. His concerns centring on an anticipated drop-off in domestic demand and the potential for falling property prices. The risk of a UK recession had risen as far as he was concerned.

We are at an early stage in proceedings as far as 'Brexit' is concerned and Mr Market's accuracy is less than assured. What this period does demonstrate is the initial reactionary and then reasoned thinking of investors and their synthesis of information. As active investors we attempt to consider the first, second and if necessary third-order consequences of events before positioning our clients' portfolios. Not an easy task in light of the unknowns that lie ahead.

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