THOMAS MILLER INVESTMENT

IQ Q2

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **July 2017**

A Note From The CEO

Hugh H Titcomb
Chief Executive Officer

The second quarter of 2017 saw significant changes in the UK political landscape. Whilst Theresa May launched the Conservative Party's election campaign with both a majority in the House of Commons and a commanding lead in the opinion polls, the outcome of the election was not as anticipated and Mrs May now finds herself leading the Country as the Head of a minority Government largely dependent on the support of the Northern Ireland DUP Members of Parliament. Time will tell whether this arrangement is sustainable to provide the stable backdrop to progress the Brexit negotiations which are now in course with the EU.

It is too early to judge the outcome of these Brexit negotiations but the indications suggest a move away from the so called 'hard Brexit' to something more accommodating. The diplomatic and political complexities in play are further compounded by changes in the political landscape across mainland Europe with the recent election of Emmanuel Macron as the French President and the German election scheduled to take place in September.

We have seen some fluctuations in both equity and currency markets over recent weeks and anticipate this pattern will continue over the coming months. Notwithstanding, we believe there continue to be attractive investment opportunities supported by the macro and micro research approach we use.

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

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

Contents

Key Leading Indicators Point To Stable Global Growth momentum

From a global perspective, the last quarter has seen some improvement in the momentum of economic growth following lacklustre performance across several key economic regions in the first three months of 2017. Importantly the available evidence suggests that the next six months should see a modest acceleration in the pace of economic activity relative to the first half of the year.

Key leading indicators point to stable growth momentum across the developed market economies including the US, UK and Euro Area. Likewise, in the major emerging economies, leading indicators flag stable growth momentum in India and China while growth is seen gaining momentum in Brazil and Russia.

UK Focus: Is the Bank of England really facing a policy conundrum?

Anyone who has been paying attention to UK central bankers in recent weeks might be led to conclude that the prevailing evidence on the strength of the economy was mixed and the risks to growth were balanced. Far from it, the direction of travel in recent data is quite clear; the UK economy is slowing, albeit slowly.

Yet Bloomberg reports that investors currently see about a 50% chance that UK rates will rise by the end of the year. In their defence, investors have merely reacted to confusion at the Bank of England (BoE). BoE's governor and chief economist seem to be in different camps, while the rest of the Monetary Policy Committee (MPC) appear almost evenly split on the outlook for interest rates.

"...we retain a positive long term outlook on equities. In the short term though, we believe that a period of consolidation or outright correction is increasingly likely."

Taken at face value, the backdrop of rising inflation and robust labour market might seem to justify the surprisingly hawkish tone of the BoE's Monetary Policy Committee following its meeting last month. However, it is important to note that the primary driver of inflation in recent months has been the Brexit-related decline in sterling. Importantly, there is little evidence of wage pressure or other signs of overheating that might suggest a sustained build-up of inflationary pressure across the economy. Indeed, far from showing signs of overheating, at this point the risks to the UK economic outlook are skewed to the downside. For instance, in recent weeks, data covering broad sections of the economy including manufacturing, construction, services and consumer spending have been weaker than expected.

The BoE has been under significant political pressure since the run up to the UK/EU referendum. That pressure intensified following the BoE's decision to respond to the referendum outcome by cutting interest rates last August. In light of the seemingly hostile political climate, the MPC may well be tempted to reverse the August 2016 decision at some point over the next few months. While a solitary 0.25% hike will not in itself significantly undermine the economic outlook, the risk is that it could be misinterpreted by investors and markets could drive much further tightening in financial conditions. With this in mind, UK policy makers would do well to heed the lesson from the European Central Bank's narrow focus on inflation when it hiked interest rates twice in 2011 only to beat a hasty retreat shortly thereafter.

Financial markets & investment strategy

Despite occasional and short-lived sell-offs driven primarily by political uncertainty at various points during the quarter, risk assets delivered strong returns in Q2, led by double-digit gains across stock markets in the Euro-zone periphery. By contrast, fixed income returns have been more muted with government bond yields rising (and capital values falling) across the yield curve in the UK and Germany. In the US, increases in yields were confined to the short end of the yield curve which is more responsive to changes in central bank rates. Yields on 5 and 10 year US Treasuries actually declined slightly over Q2. Corporate bonds outperformed government debt over the quarter.

INVESTMENT STRATEGY OVERVIEW

The gains in risk assets have been driven by a combination of improving economic sentiment and an upturn in corporate earnings, with positive earnings momentum being recorded across key regions. Furthermore, in Europe the emergence of a more benign political backdrop has enabled investors to focus on the positive fundamental dataflow.

We head into the third quarter of 2017 with a cautious asset allocation stance. Specifically, where client constraints allow, we trade off small underweight positions in equities for overweight positions in a selected range of alternative investments which exhibit lower volatility and modest correlation with mainstream asset classes.

Our short term caution is driven primarily by lingering concerns about stretched equity valuations and the ongoing divergence between investors' expectations and fundamentals. In our assessment the current combination of risk factors leaves equities vulnerable to 'air pockets' or unexpected bouts of volatility during the low-volume summer months. To be clear we retain a positive long term outlook on equities. In the short term though, we believe that a period of consolidation or outright correction is increasingly likely.

We are neutrally positioned on fixed income investments across key developed markets. In the US, while the Fed remains in gradual tightening mode, we expect to see further flattening of the Treasury yield curve. In contrast, relatively stronger growth in the Euro Area should mean further steepening in the major Euro Area government bond yield curves. Despite the recent sell off in UK gilts, the muted growth outlook and low probability of an imminent tightening cycle point to a range-bound market, possibly with a downward yield bias. These factors, alongside lingering Brexit uncertainties should continue to amplify volatility in sterling.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 6th July 2017)

	United States	United Kingdom	Euro-Zone ex UK	Asia ex Japan	Japan	Emerging Markets
Equities (overall)	0/-					
Equity allocation by Region	0	-	+	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	0	0	0	0	0	0
Govt guaranteed bonds	+	+	0	0	0	0
Index-linked bonds	0	0	0	0	0	0
Alternatives	+					
Cash	0/-					

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

Bond Yields Rise In Europe, UK And US

A six month bull run in bonds, which has lasted since January, came to an abrupt halt in the final week of June.

After what has seemed easy gains, the going got tougher at the end of the quarter, with sudden rises in government bond yields for most markets around the world.

The impetus for this was a renewal of the 'reflation trade', after central bankers around the world suggested that higher interest rates might be appropriate henceforth.

The catalyst was a remark by the ECB President, Mario Draghi, on June 27th, who suggested that "deflationary forces have been replaced by reflationary ones". This immediately raised the prospect of a taper in the ECB's bond buying programme, which is still running at a massive €60bn per month.

ECB officials subsequently tried to correct the impression that an end to QE was imminent, but that did not stop bond yields rising in Europe, with follow through to other markets including the UK and US. German and French yields rose the most in eight months, with the 10 year Bund yield finishing June at 0.46%, having touched 0.15% at one point in the quarter.

This was followed by comments a day or so later from Mark Carney, Governor of the Bank of England, and Andy Haldane, its chief economist, who both talked of the possibility of higher interest rates later in the year, particularly if the current run of inflation in the UK persists.

Again, Mr Carney subsequently tried to correct the impression that he had made, but the damage had been done. The 10 year Gilt yield rose near 30bps in the space of a week to 1.26%. This illustrates how tricky it will be for central bankers to exit the longest period of low interest rates in history without a few wobbles along the way.

The paradigm here is the 'temper tantrum' in the US in 2013, when the Fed tried to signal an end to Quantitative Easing, only to be faced by a rout in both bond and equity markets. The ECB and the BOE will both be anxious to avoid a repeat of this.

A difficult final week saw the FTSE All Gilts index lose 2% for June, although better months in April and May meant that returns for the quarter were better at -1.29%. UK investment grade corporates did better, with a return of 0.46% over three months.

Over the month of June the 0-5 year Gilt index returned -0.53%, while the 0-15 year index was down -1.06%

UK data was generally disappointing, with June retail sales dropping to a 0.9% annual rate, and other indicators of consumer spending also weak. However, in mid month attention refocused on CPI inflation, which hit a four year high of 2.9%. A couple of days later it was revealed that three members of the Monetary Policy committee had voted for a rate rise.

While a rise is still not a certainty, it looks more likely than for some time, with a distinct possibility that the MPC at least reverses the 0.25% cut it made in August 2016. However, the prospect thereafter is for any further increases to be slow and gradual.

In the US, Q1 GDP was revised up slightly to 1.4% from a previous reading of 1.2%. Meanwhile, manufacturing survey indices continue to be reasonably strong, although inflation indices have been mostly weak. Core CPI inflation came for May at 1.7%, while core PCE inflation, the Federal Reserve's preferred measure, came in even lower at 1.4% for the first quarter.

The May US jobs figures was on the low side, while capital investment and durable goods data was weak. The US 10 year yield fell back to 2.12% in mid-June, its lowest close of the year,, but by the end of the month was near 2.3%.

The oil price has remained weak, with WTI falling to $43 per barrel in June, but rallied a little towards the end of the month. Higher US production, and high global inventories, continue to put pressure on the price.

US 1-3 year Treasuries fell -0.82% over June, while longer dated Treasuries lost more. Over the quarter, US Treasuries gained 1.16%. US Corporates outperformed during the month, with US investment grades bonds showing a small gain of 0.4%, and 2.5% over the quarter. Investment grade bond spreads tightened slightly over the month, while high yield spreads widened a little from 3.63% to 3.68%. The sell off in bonds means that the High Yield index now yields 5.63%, still a low level for the riskiest part of the bond market.

James Penn
Senior Portfolio Manager

UK And International Equity Markets Remain Confident

June 24th saw the one year anniversary of the UK's vote to leave the European Union.

Since the end of that trading day (a Friday), the UK equity market has delivered a 24% total return (somewhat surprisingly both large and mid-cap have delivered about the same). The US S&P500 index grew 21% in dollar terms. Simultaneously sterling fell 12% against the US dollar. Quite a year for investors. June 19th, only a few days short of the anniversary, saw the start of the exit negotiations proper.

Mrs May's retrospectively ill-judged snap UK General Election meant that the UK Government went in with what looked to be a weakened hand on June 19th. Negotiating with the bureaucracy of the EU while having to defend a tenuous majority in the Commons does not suggest a focused effort or an optimal outcome, but one remains optimistic. As our political class is fond of telling us, the people have spoken. No-one is quite sure what they have said, but that will not stop politicians interpreting in their own special ways.

In the most recent quarter, despite the drama of the UK general election, UK and international equity markets remained fairly sanguine. While the UK's election has more limited impact on the rest of the World, protracted disputes in the Middle and Far East, Eastern Europe, Africa grind on, so geo-political risk is not receding. Even Trump's novelty (like a new computer game or gym membership) is wearing off, if not thin, but markets keep pushing higher. Total returns of 1.4% in the UK, 3% in the US, 1% in Europe and more than 6% in the Emerging Markets and Japan are welcome. Against the current political backdrop, this seems a good result and while sentiment is not, to my mind, pricing political risk adequately, investors are not entirely just shutting their eyes, crossing their fingers and buying indiscriminately. As I mentioned last quarter, the global economy appears to be in decent shape and this growth is feeding healthy corporate profits. As earnings growth overtakes stock market growth, valuations are being tempered. This is healthy as equity valuations are stretched in historic terms and at current levels provide limited downside protection. Clearly as a market participant, I would rather see valuations fall through earnings rises rather than price falls!

Finally, a note on oil. While OPEC continue to try to shore up the price, other producers are working on a cash cost basis and OPEC cannot stem the flow. Long term, given the cost of exploration and field development, oil prices will rise, but for now the phenomenal effort of US shale gas producers to drive efficiency has kept them in the game far longer than anyone (me included) would have forecast. So far in 2017, Brent crude has fallen 17% from its opening level and trades below $50 again. At these levels, you may see speculation about a dividend cut from the majors (in the UK that being Shell and BP). Historically, these companies have only cut dividends when their balance sheets start coming under pressure and given recent corporate action, that point is still several years away even at $45 oil. At $60 these questions go away.

Andrew Herberts ASIP
Head of Private Investment Management (UK)

Unlocking Opportunities In UK Property Markets

Just over a year has passed since the Brexit vote instigated a significant amount of uncertainty in property markets.

The initial volatility quickly abated as concerns were seemingly offset by the sharp currency devaluation that followed. Taking a high level view UK property has actually performed remarkably well over the past twelve months. There has however been a notable shift of foreign investment from the UK and into European property funds as investors anticipate an increased demand for office space if financial services companies shift operations out of the UK. Now that the clock is ticking following the triggering of article 50, and with the UK Governments stability in question after the recent general election, headwinds to future returns would seem to have increased. These concerns may be most acute in the London markets and notably the office sector. With potential for a significant change in the landscape of the financial sector the longer the uncertainty persists, and with valuations at elevated levels, it would seem reasonable to conclude that future growth is going to be more challenging in these areas.

Whilst we are not overly bullish on UK property markets in aggregate we do believe that by being more targeted in our approach and accessing specific niches within markets we can drive positive performance. As we have highlighted for some time now areas that we favour tend to have strong fundamental support and exhibit positive trends which are likely to persist with little economic sensitivity. Areas such as social housing and healthcare property have these qualities and are also supported by ageing demographics. 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. We find the logistics sector attractive as it is supported by the disruption of the ongoing move to online retail. The sector will not be immune to uncertainty around the trade impacts of Brexit but supply remains weak enough to suggest rental yields will remain well supported. Further ahead, technological change in the logistics sector will continue to influence real estate preferences.

"...despite the overhang of potentially challenging and protracted Brexit negotiations certain areas of the UK property market remain attractive..."

Whilst we favour these more specialist areas a word of caution is necessary. Over the course of 2017 a significant amount of new capital has been raised in the investment trust sector, notably within infrastructure assets, but more recently we have seen a number of new entrants to the REIT sector. This in and of itself is not a bad thing, and there are indeed opportunities which allow for and therefore can justify this new capital. Nonetheless it remains imperative to ensure that the managers have the requisite skills in their specialised area and are able to deploy sufficient capital in a timely manner to both provide investors with liquidity and diversification. Through our investment research process we seek to identify both these opportunities but also importantly the risks. We believe that despite the overhang of potentially challenging and protracted Brexit negotiations certain areas of the UK property market remain attractive and we will continue to allocate accordingly.

Mark McKenzie
Head of Alternatives Research

Active Versus Passive Strategies For Portfolios

The active versus passive debate continues to generate headlines with campaigners on both sides making credible arguments. We at Thomas Miller Investment believe that a well-constructed portfolio will contain elements of both.

To maintain a steadfast loyalty to one over the other would be to the detriment of client portfolios. In this article we explore why simply comparing fund performance to a benchmark can lead to incorrect conclusions and how portfolios can allocate to both and produce a more efficient outcome, particularly in global equity markets.

Much has been made of the underperformance of active US equity managers in recent times and some of these warnings do warrant investor attention. However it is equally important to understand the underlying drivers of performance for an equity market. The most popularly tracked US equity market is the S&P 500 with a market cap of over $21 trillion. By far the largest sector, accounting for nearly a quarter of the index, is the Technology sector. An area that has enjoyed huge growth in the last 10 years but not one without its risks as veterans of the infamous "dotcom bubble" of 2000 will testify to. The Technology sector is broadly recognised as a 'growth' industry where companies typically reinvest profits to grow, rather than pay them out as dividends to shareholders.

Herein lies the issue when making simple inferences of performance relative to a benchmark. Many investors are focused on generating an income from their portfolio to sustain their retirement or lifestyle. As a result of their requirements, portfolios are positioned towards income generating (or dividend paying) stocks. Performance data reveals that returns for active US equity managers with a focus on generating income have been materially lower than the benchmark (S&P 500), principally because their investment style bias has been out of favour. Take the example of Facebook or Google (now called Alphabet), two companies that do not pay a dividend and thereby would not qualify for inclusion in an income portfolio. Yet despite not paying a dividend over the past 5 years (and accounting for over 4% of the benchmark) the capital growth of the two stocks amounts to a lofty 396% and 233%, respectively. Given the benchmark has achieved slightly over 100% over the same period one can see how an income-orientated investor, specifically, would have underperformed an S&P 500 benchmark.

For the UK equity market, a strong understanding of the underlying sector biases (and, again, thereby performance drivers) within an index is just as important. In the middle of 2014, prior to the oil price crash, Energy companies accounted for almost 18% of the FTSE 100 – dominated by the likes of Shell and BP. Unsurprisingly, as commodity prices fell that summer, so too did the benchmark (FTSE 100). Both continued to do so for the next 18 months. During this period active managers in the UK were able to significantly outperform the benchmark, avoiding commodity-related companies and being broadly quite nimble. As the oil price bottomed out at the start of 2016, Thomas Miller Investment rotated away from active managers and into the passive tracker. Knowing our active managers were structurally underweight the Energy sector, portfolios were able to benefit from a cyclical upswing in the global economy as the oil price rallied back.

Then again at the start of 2017, for reasons not limited to commodity prices, portfolios moved back towards active UK equity managers and away from the passive tracker. A considerable level of outperformance of the FTSE 100 benchmark has been achieved through our investment process. In seeking to understand where our active managers hold genuine skill and where the benchmark contains structural biases we have been able to add alpha. Indeed the UK equity allocation has been an important driver of returns for client portfolios.

We believe that divergences in sector returns is only the start of the journey back to a more normalised economic environment. With a more transparent read on the underlying economy, one possibly less manipulated by central bank intervention, active managers now have the platform to outperform their respective benchmarks. Furthermore we make the argument that to invest in passive-only portfolios ignores the inherent risks that exist within every equity market. Whilst the passive approach may have worked well in the US equity market, the same cannot be said for the UK equity market. For the UK investor with a dominant home bias to their equity allocation the difference in return profile is material. Whilst opportunities to outperform their equity market benchmarks will improve for active managers, it remains fundamental to performance in a multi-asset portfolio that investors understand the underlying risks to a passive tracker are just as important.

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