THOMAS MILLER INVESTMENT

IQ Q2

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **July 2018**

A Note From The CEO

Following a challenging first quarter of 2018, the second quarter proved far less menacing, despite the plethora of economic and political risks in evidence. Geopolitical tensions continued, fuelled to a large extent by the US administration's unconventional foreign policy and the possibility of market threatening trade wars in prospect. At home, in the UK, the Brexit negotiations continue to dominate the political landscape and in Euroland we witnessed a seemingly unlikely Italian coalition formed between the anti-establishment Five Star Movement and the far-right League parties.

Without doubt, one of the largest risks to global growth remains a full-blown trade war. Having said that, economic data has shown some recovery in the last quarter following the weak, weather-impacted first quarter we witnessed. At present, we see enough signs that suggest the global economy remains on a steady footing.

Monetary policy will also remain a key driver of financial markets. For the moment, the broad direction and anticipation is an upward movement in interest rates. This clearly has an impact on both equity & fixed income investing - as such we believe the best course of action remains to stay active and pragmatic when managing portfolios, looking through a long-term lens with a close eye on shorter-term risks and opportunities.

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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Interest rate hikes and ongoing trade uncertainties look set to drive market volatility in the coming months

A brief review of the economic and financial market backdrop

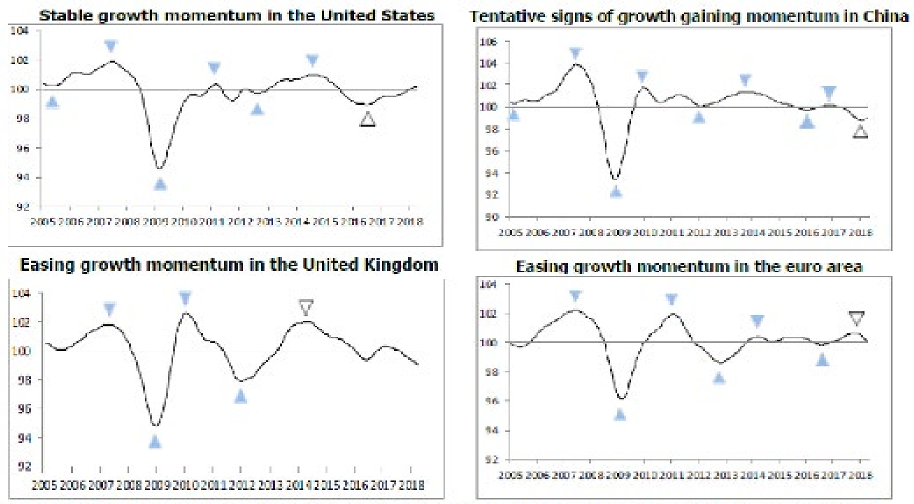
- Over the first half of 2018, the pattern of global economic activity deviated markedly from that recorded in the second half of 2017. This is because in contrast to the period of synchronised growth seen last year, this year has brought wide divergence in fortunes across major economies.

- Data from the OECD shows that while all major economies and key regions have seen a decline in the rate of growth in recent quarters, the range of outcomes has been wide. The US economy has shown the most resilience but nevertheless exhibited a notable slowdown in Q1 2018 relative to Q4 2017. Sharper slowdowns were recorded across the UK and Euro-zone while Japan suffered an outright contraction in GDP. In the emerging markets, slower pace of economic activity has been recorded in key economies, particularly China.

- Encouragingly, incoming data indicates a broad-based improvement in growth in Q2 relative to the first quarter of 2018. In the UK, recent surveys conducted by Markit/CIPS have provided evidence that the economy has rebounded in recent months as data on manufacturing, construction and services all strengthened in June. The rebound has eased concerns about the UK economic backdrop and raised expectations that the Bank of England may finally be able to increase interest rates for the first time this year when it next meets in August.

- In the US, both the manufacturing and non-manufacturing ISM indices strengthened in June, indicating strong pick-up in the pace of economic activity following a downward revision to GDP growth rate in the first quarter. The resilience of economic activity, demonstrated by a strong labour market and an uptick in inflation has boosted expectations of two further hikes in interest rates by the Fed this year.

CHART 1: LEADING INDICATORS FLAG MUTED GROWTH



The above graphs show country specific composite leading indicators (CLIs). Turning points of CLIs tend to precede turning points in economic activity relative to trend by approximately six months. The horizontal line at 100 represents the trend of economic activity. Shaded triangles mark confirmed turning-points of the CLI. Blank triangles mark provisional turning-points that may be reversed.

Source: OECD, July 2018

- Leading economic indicators provide an important gauge of the likely future path of economic activity relative to trend. Consequently, it is noteworthy that the latest updates of OECD composite leading indicators (shown in Chart 1), point to modest economic growth in some key economies.

- Beyond shorter term dynamics, the medium term global economic outlook has become clouded by the risk of a trade war between the US and its major trading partners. At this point, it remains unclear how the trade disputes will pan out but the risk to the global economy and financial markets from an outright trade war could be significant. This introduces a notable negative skew to the range of possible outcomes for the global economy in the months and years ahead.

Asset allocation summary

- Our assessment of the balance of macro risks and opportunities leads us to a neutral stance on the major asset classes relative to longer term strategic allocation. Overall, policy uncertainty is higher than typical and monetary policy appears to have crossed an inflexion point with quantitative tightening and interest rate hikes in the US looking likely to be followed elsewhere. This, in addition to ongoing trade uncertainties, looks set to drive market volatility during the low-volume summer months.

INVESTMENT STRATEGY OVERVIEW

Equities:

- Our overall equity position is neutral and we have now also moved to neutral weights across the main regional markets. Equity market outlook is clouded by weakening growth momentum, risk of trade war and less accommodative financial conditions. However, equities continue to be supported by strong earnings which have helped to reduce multiples to normal levels.

Bonds:

- Fed tightening and rising inflation are negative factors for bonds. However, government bonds (US Treasuries and German Bunds in particular) continue to benefit from some safe haven flows as investors weigh growth and trade uncertainties. Further flattening in the US government bond yield curve is likely as the Fed continues to tighten.
- While credit spreads have widened in recent weeks, they are still some way off providing compelling value. Furthermore, we maintain a cautious view on high yield debt in light of the maturity of the credit cycle.

Alternatives:

- Alternatives have staged a strong rally in recent months and fundamentals remain strong for key sectors such as digital infrastructure and selected PE.

Currencies:

- The key trend has been of US Dollar strength on the back of rising US interest rates and geo-political tension. The USD should continue to benefit from Fed support in the months ahead. Sterling has come under heavy selling pressure as investors assess the news flow on Brexit negotiations. We anticipate that GBP will remain broadly range-bound (within a wide $1.28 to $1.38 range) until investors get greater clarity on the likely nature of the eventual Brexit deal. However, the closer we get to the end of Q1 2019 without this clarity, the greater the risk that sterling could breach the lower end of that range.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 5 July 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	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	0					
Cash	0					

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

Bond returns muted in lacklustre quarter

Bonds had a dull quarter, with returns in most markets on the low side.

The one distinguishing feature was that government bonds outperformed corporate bonds – for the second quarter this year.

The FTSE All Gilts index returned 0.16% over the period, somewhat better than the -1.1% performance recorded by investment grade corporate bonds.

In the United States the picture was similar. US Treasuries returned 0.11%, a marginally positive return, and considerably better than the -2.4% return from investment grade corporate bonds.

There is a slight sense of over-consumption in investment grade bond markets at present. What has been a favoured asset class for many years has suffered from a sense that issuers are over-exploiting it, many in order to facilitate share buybacks and acquisitions. Spreads have pushed out along the curve, particularly at the longer end on concerns over long term balance sheet strength. Last year was the sixth consecutive year of record U.S. corporate bond issuances, and in the past month we have seen bumper new issues from Wal-Mart and Bayer.

> *“Gilts have had a strong run after a savage sell-off in the first six weeks of the year. ”*

Meanwhile, the short end of the yield curve has suffered as some natural buyers (US multinationals parking their overseas cash offshore) have retreated from this market because of the tax cuts implemented in late 2017.

Curiously, the superior performance of governments did not persist down to high yield grades, and sub-investment grade bonds managed a return of just over 1% over the period.

Gilts have had a strong run after a savage sell-off in the first six weeks of the year. The 10 year yield peaked at 1.65% in February and has been declining since, reaching 1.28% at the end of the quarter.

We began the year with a strong sense that the Bank of England’s MPC would follow up its November 2017 rise with another hike in May, to take the base rate above 0.5% for the first time since 2009.

However, a weak first quarter of 2018, caused by weather related factors including ‘the Beast from the East’, but continued weak consumption and investment trends, and uncertainty in relation to the Brexit saga, was enough to dissuade the Bank, and to encourage them to think that doing nothing was once again the best policy.

The jury is still out over an August hike, with the BOE’s Chief Economist, Andy Haldane, surprisingly joining the other two hawks and voting for a rise at the most recent June meeting.

Yields in the US peaked in mid-May, with the 10 year US Treasury yield briefly hitting 3.12%, before finishing the quarter at just over 2.8% as trade fears clouded the global growth picture.

As expected, the Fed raised the upper bound of the target rate by 0.25% to 2% in June. US CPI inflation rose to 2.8% year on year in May, while core PCE crept up to 2% year on year, in line with the Federal Reserve’s 2% target level.

Confidence in the ongoing strength of the US economy continues, with GDP picking up in the second quarter, led by consumer confidence, investment and the effect of last year’s tax cuts. Consumer confidence dipped slightly in June but is not likely to flag much. The employment situation remains strong with the unemployment rate at 4%, and the June ISM Manufacturing index rebounded to over 60.

The 10 year Bund yield has hit preternaturally low levels of 0.25%, despite noises from the ECB that it will end quantitative easing later in 2018.

James Penn
Senior Portfolio Manager

Despite all the noise, it's been a steady quarter for equities

We entered the second quarter of the year with markets somewhat downbeat. Largely this was a result of fears of an early monetary tightening cycle based on a resurgence in inflation.

These fears proved premature as further economic indicators were released and April and May saw most markets more than recover the ground lost in the first quarter.

However, as fears grew of an escalating global trade war, June proved to be a weak month for equities which means that after lots of volatility, noise and fury, equity markets year to date have done little.

Underlying earnings growth has, however, remained strong. This means that we have seen a downwards re-rating of market valuations which alleviates one of the potential pressures on markets. As the year progresses, earnings should continue to grow, probably at a high to mid teens rate but as time passes the figures against which growth is compared rise. Hence we expect the growth rate will slow into 2019.

Fundamentals of the economy and corporate earnings drive our expectations of modest rises in equity markets to the end of the year which keeps us invested. However we will be increasingly looking for signs that the economic cycle is turning.

A word about stewardship

There is a profound difference between an asset owner and an asset trader. An owner tends to think long term, to understand that sustainable earnings are more valuable than short term maximised profits. Owners are also very careful about costs and about to whom they entrust the operation of their assets. They worry about the impact their activities have on others and on the reputation of the business. Traders value the short term above all, thinking less about the underlying business represented by their equity ownership and more simply about how short term gains can be realised. The long term is largely unimportant, since the trader knows he or she will have sold out. Traders provide liquidity and price discovery in markets, but often at the cost of engaged shareholders interested in holding managements to account on difficult issues.

Thomas Miller's heritage inclines us to think of ourselves as asset owners rather than traders. We are a signatory of the Stewardship Code and take our responsibilities seriously. We vote on all the direct holdings that we can and on contentious subjects engage directly with company managements.

Typically we engage on governance issues but as our involvement in the ESG framework deepens, we are likely to broaden out those issues on which we become more active shareholders. ESG is a development of ethical principles and stands for Environmental, Social and Governance. This guides engagement on a number of issues and is being widely adopted by pension funds and other long term asset owners (often embodied through signing up to the UN Principles for Responsible Investment).

These developments are positive and in fact take us along a route that could address some of the key current criticisms of free market capitalism – that the dis-engagement of large shareholders has led to a lack of control on corporate behaviour.

Make no mistake, capitalism has been the single biggest force lifting people out of absolute poverty across the world, however for it to fulfil its potential as a positive force in the future and maximise its ability to be a part of the solution to major global issues, shareholders have to think and act as owners, not passengers along for the ride. We are proud to be in the vanguard of this change.

Andrew Herberts ASIP
Head of Private Investment Management (UK)

Opportunities in Digital Infrastructure

The amount of digital data created globally has been proliferating at an exponential pace. Analysing this data is becoming a key basis for competition across many industries with few being immune from this rampant growth.

All sectors will soon need to tackle this challenge as the volume and detail of data permeates all aspects of the economy. Market participants who fail to react may be left trailing in the competitions dust as the size of the digital universe at least doubles every two years.

From some quarters there is a perception that we are overburdened with big data, and that our ability to store, process and analyse this data such that is can be utilised in decision making is consequently limited. This challenge is potentially greater at the larger scale, with multi-national organisations operating in highly complex environments. It is therefore an issue of capturing the data generated and using the information to take action.

The benefits of doing so are wide-reaching. Organisations that are able to capture greater transactional data in digital form can develop a more accurate analysis of operational information, ultimately enabling them to boost performance. Market leaders are utilising this analysis to deliver better management decisions. Big data is enabling ever-narrower segmentation of the customer base, consequently products and services can be targeted in a much more precise manner. Furthermore it can also be used to improve the development of the next generation of products and services.

The effective use of big data can make information transparent and usable at much higher frequency, conferring a significant competitive advantage on those who can do so effectively. No-one wants to be late to the big data party.

Given this seemingly insatiable appetite for data the question as an investor becomes how best to capture part of this growth. One way to do so is through investing in property facilities that enable data to be stored and used.

Data centres are buildings housing servers and network equipment. They are designed to provide a reliable and secure environment containing redundant mechanical, cooling, electrical power systems and network communication connections. In terms of building one of these facilities the first stage is to construct the shell of the building to house the equipment. This building contains the electrical systems and cooling systems to maintain an optimal operating environment for the equipment. Crucial aspects of an operationally successful data centre are scale and connectivity. Scale enabling customisation of the environment to meeting specific deployment needs of clients and connectivity, having access both to power networks and sufficient infrastructure for clients' needs.

Data Centre REITs are providers of this infrastructure architecture to companies around the globe and these structures offer a means for an investor to access the space. The REIT rents space within their data centres to clients and earn a rent in much the same was as a traditional property investment. Companies who use these facilities include some of the largest technology companies in the world. Demand for this space is high and this is helping drive up rental value. We anticipate a continuation of the double digit earnings growth across the sector.

Capturing trends in digital infrastructure is becoming an increasingly meaningful component of the TMI Diversified Assets Fund's allocation. We believe that an allocation to high quality data centre REITs within a portfolio adds a welcome combination of added diversification and growth prospects for investors.

Mark McKenzie
Head of Alternatives Research

A revival in value investing fortunes in Japan?

Value investing, the contrarian strategy which focuses on buying unloved and cheap stocks in the expectation that valuations will revert back to their long-term averages, has been a winning strategy in Japan over the long-term. However, returns from value investing have lagged that of its rival growth since the Global Financial Crisis (GFC).

Most of the underperformance of value investing can be attributed to two factors: (1) a weak economic recovery since the crisis, and (2) a negative interest rate environment.

Since the GFC value indices have been dominated by cyclical stocks. As a result, the favourable environment for value's outperformance are periods of accelerating, broad-based economic growth – conditions that have not been present on a consistent basis in Japan (or indeed the global economy) since the crisis.

Another characteristic of value indices is a large exposure to financial stocks, with the MSCI Japan Value index having a 23.25% allocation to the sector as of the 30th June 2018. In general, financial stocks tend to perform strongest during periods of rising interest rates (assuming growth remains stable over this time frame), hence why the negative interest rate environment in Japan since 2016 has been so painful for financials performance.

Taking the above into account, it's hard to build a case for value investing as the same factors that have hindered value's performance are likely to remain in place. Global growth has lost some momentum, and there are many late cycle characteristics within the global economy to be overly bullish on growth accelerating. Added to that, the Bank of Japan, unlike the US Federal Reserve, is in no rush to alter its ultra-loose monetary policy, at least in the short-term.

Despite this seemingly unfavourable backdrop, there are signs of a revival in value's fortunes, with the most important being valuations. A valuation gap has widened substantially to a point where value stocks currently trade on a price-to-book ratio that is just 40% to that of their growth counterparts – the cheapest since the technology bubble of the early 2000's.

Value investing as a strategy takes advantage of mean-reversion – seeing as the potential for mean-reversion is greatest when the dispersion is largest, current valuations make a strong case for favouring value at this point.

Furthermore, there are also early signs that suggest fundamentals are beginning to turn in value's favour. One of the key reasons that growth stocks have outperformed value stocks on a consistent basis is due to their superior ability to deliver higher returns for shareholders. However, when assessing their return-on-equity (ROE) ratios, this gap is narrowing.

By its very nature, value investing is a risky investment strategy and as a consequence we believe value exposure is best captured through an active manager. Whilst there are a small number of passive value options in Japan, we believe that value-tilted indices potentially leave investors overly exposed to value traps due to the lack of qualitative analysis run on companies. Instead, we prefer to get our exposure to value via active managers who have carried out research into a company's management, governance and the strength of the balance sheet. As a result, they should be more likely to avoid said value traps.

The active manager we currently prefer in Japan is the Man GLG Japan CoreAlpha equity fund. As recent performance shows, to be a value investor requires patience and the team are open about how stubborn they are when they invest, taking care to avoid a common error of exiting positions too early. Add an excellent long-term track record of outperformance as well as a stable, experienced and recently expanded investment team, the prospects of this fund for value exposure look strong.

Dan Smith
Investment Analyst

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