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IQ Q3

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **October 2017**

A Note From The CEO

With the final quarter of 2017 now in course, financial markets continue to be resilient in the face of significant ongoing political uncertainties both here within the UK and in many other parts of the world. So dramatic has been the change in political mood that one may be forgiven for thinking the global economy would be under significant pressure. Far from it, economic growth is now so firmly entrenched in the global economy that the OECD has reported that every country in the 35-nation club is experiencing positive GDP growth. This is a statistic not seen in almost a decade.

As long term guardians of capital, our investment approach has always focused on the fundamentals first and foremost, despite all the political noise around us. The result has been a positive one for our clients and our investment performance has been strong. When compared to our Private Client peer group (as measured by the Asset Risk Consultants or ARC indices), our portfolios have materially outperformed the average across their respective risk profiles – over both short and longer time periods.

Of course our job continues as we head towards the year end and we remain active in the ongoing management of our clients' portfolios by identifying attractive investment opportunities whilst continuing to apply a robust risk management approach.

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

Contents

Investment Strategy Overview 2
Fixed Interest 4
Equities 5
Alternatives 6
Area of Focus 7

Synchronised upswing in global economy

Following a weak start to the year the pace of economic activity picked up over the last few months as the global economy experienced a synchronised upswing in growth. Across the OECD area, quarterly growth of real GDP accelerated from a pace of 0.5% in the first quarter of 2017 to 0.7% in Q2. Growth has also been stronger than expected across the major emerging economies.

In the US, the growth rate of real GDP has picked up from the tepid Q1 pace of 1.2% (quarter-on-quarter) to 3.1% in the second quarter. The key beneficiary has been the US labour market where the headline unemployment rate has now dropped to 4.2%, the lowest recorded since February 2001. The combination of weaker US Dollar and strong global demand recently led to a jump in the ISM manufacturing index to a 13-year high, indicating that US factories continue to enjoy a purple patch.

In the Euro-zone, a recovery in consumer and business confidence has boosted domestic demand and investment. While the strength of the Euro has weighed on export growth, the robust pace of business investment, consumer spending and government expenditure has driven strong performance across the region.

> ***"...the BOE now appears to have talked itself into a choice between doing nothing in November and risking a loss of credibility; and hiking rates at the risk of a damaging policy error..."***

The UK's economic performance has been less positive and the country has slipped from the top to the bottom of the G7 growth ranking over the past year. The combination of weak wage growth and elevated inflation has dampened consumer spending and ongoing Brexit uncertainties cloud the economic outlook. Some of the pressure should ease as the rate of inflation is expected to decline in the months ahead. However, the decline in service sector output in July alongside the drop in consumer spending in September suggests that the pace of growth remained muted during the third quarter and the slowdown in growth is likely to persist for a while longer.

Looking ahead to the next few quarters, the latest updates of the OECD composite leading indicators suggest that the cyclical outlook remains strong from a global perspective. However, there are some notable regional variations in the outlook. Specifically, while composite leading indicators (CLIs) continue to point to stable growth momentum in the OECD area as a whole, they flag easing growth momentum in the UK. CLIs also point to a pick-up in growth momentum in the major Asian economies including China, India, Indonesia, Japan and South Korea.

SUMMARY OF LONGER TERM ASSET CLASS VIEWS

Equities

- Asset class no longer cheap in absolute sense but still offers good value relative to bonds and cash
- While valuations have been supported by improvements in global growth and corporate earnings in recent quarters, they look stretched in historical context
- Potential downside from uncertainties surrounding the US fiscal policy, geo-political risk, risk of monetary policy mistakes and immenent changes at the Fed

Bonds

- Asset class remains relatively unattractive from a longer term standpoint
- Bond prices have been underpinned by modest growth declining inflation and geo-political uncertainty
- Corporate bonds no longer offer compelling value - focus on names with strong balance sheets

Alternatives

- Asset class offers good value relative to bonds and cash and fundamentals remain supportive for key alternative investment sectors
- Enduring benefits from low correlation with traditional asset classes
- Emerging political risk to key sectors (specifically infrustructure) could undermine future upside

Cash

- Asset class offers relatively poor long term return at current rates
- Rising rates have improved returns relative to short term bonds in recent months
- Cash continues to provide buffer against occasional bouts of risk aversion

INVESTMENT STRATEGY OVERVIEW

Investors anticipate a shift in the direction of monetary policy

The combination of stronger growth, ongoing monetary policy support, enduring expectations of substantial fiscal policy support in the US (infrastructure spending and tax cuts) and improved corporate earnings have boosted stock market performance. Likewise, despite the correction seen in recent weeks, bonds have also performed reasonably well so far in 2017, supported by lower than anticipated inflation in the US and elevated geo-political risk.

Looking ahead, the performance of the major asset classes looks set to depend heavily on the path of monetary and, to a lesser extent, fiscal policy in key regions. In the US, the Federal Reserve Bank (Fed) has led investors to expect one more interest rate hike of 25 basis points this year and possibly three such hikes next year. In the Euro-zone, investors are increasingly pricing in a cut back in quantitative easing by the European Central Bank (ECB). Perhaps most surprisingly, in the space of a few summer weeks, market consensus has shifted from expecting no interest rate increase by the Bank of England (BOE) for the next two years to expecting one at the Bank's meeting next month. This shift has been driven by the surprisingly (and repeatedly) hawkish rhetoric of several members of the BOE's Monetary Policy Committee, including both the Governor and Chief Economist, in recent weeks.

The problem for the BOE is that the balance of evidence on the economic outlook does not justify a hawkish tilt at this point. As noted above, the risks to the outlook for the UK economy appear to be tilted to the downside. In light of this assessment, the BOE now appears to have talked itself into a choice between doing nothing in November and risking a loss of credibility; and hiking rates at the risk of a damaging policy error.

Having benefited from accommodative monetary policy for an extended period, investors now have to contend with the prospects of a somewhat tighter monetary policy backdrop. This is not in itself a problem if tightening occurs within the context of strengthening economic growth. For now, from a global standpoint this remains the case. With the immediate outlook in mind we have rebalanced allocation across major assets classes back to longer term strategic weights. The figures below outline our current asset allocation and summarise our longer term views on the major asset classes.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 5th October 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	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.

Strong inflation figures spark a move in yields

Bonds had a slightly dull quarter in the third quarter of 2017, with yield movements largely determined by the 'will they', 'won't they' vacillations of central bank policy makers and their pronouncements on the future of interest rates.

While gains were made in both July and August (in terms at least of the UK markets), all of this was wiped out in the space of a couple of weeks in September.

The FTSE All Gilt index returned -0.72% for the quarter, while the shorter dated 0-5 year index returned -0.37%. Meanwhile, spreads narrowed to levels we have not seen in several years, allowing corporate debt to outperform.

"...the majority agreed that the bank rate needed to rise soon..."

In some ways, it was a repeat of the second quarter, when small gains in April and May were wiped out by a savage sell-off in the space of a couple of weeks at the end of June. The sell-off in September was, if anything, more brutal than that in June, with the 10 year Gilt yield climbing to 1.42% on September 28th, a rise of 40bps from its intra-month lows, before closing the month at 1.36%.

As in June, the move in yields was sparked by some stronger inflation figures and talk from the UK central bankers. This included the minutes from the Bank of England meeting in early September. While members of the Monetary Policy Committee voted 7-2 to keep rates unchanged, the minutes of the meeting showed that the decision was more finely balanced, and the majority agreed that the bank rate needed to rise soon.

UK inflation figures for August later showed CPI rising to 2.9% year on year, higher than expectation and higher than the 2.6% rate in July.

Since then, we have had further comments from a number of members suggesting that a rate rise is needed – if only to take out the 0.25% cut introduced in August 2016. Both Mark Carney, the governor, and Andy Haldane, the BOE's Chief Economist, have suggested a rise is needed, while in mid-September, we saw Gertjan Vlieghe, long regarded as the Bank's 'uber dove', change his position and put the case for a rise.

Other than lifting bond yields, the other effect of all this talk was to push the pound up to $1.36, the highest level it has been since the Brexit vote in June 2016, while the pound also rose to EUR1.14 from 1.08 in late August.

Manufacturing and sentiment gauges, meanwhile, have generally stayed strong – both in the UK and the rest of the world.

At their annual Jackson Hole conference in late August, the world's central bankers did not say anything in particular that unsettled markets, but did give a broader steer that there will be moves to reduce unconventional policy measures in the year ahead. The Fed is still planning to reverse its Quantitative Easing programme later in the year, and it will be interesting to see how this progresses. This will not involve outright sales into the market, but will mean that redemptions and coupons are not reinvested as they have been previously. The rate at which this is done will start at $10bn per month in October, and then move progressively to $50bn per month, which represents a significant withdrawal of stimulus from the system.

"...The Fed is still planning to reverse its Quantitative Easing programme later in the year..."

US All Treasuries returned 0.43% over the quarter, while the 1-3 year index returned 0.28%. Investment grade corporate bonds outperformed, while High Yield also had a good quarter.

The fact that the labour market in the US was softer than expected in August helped bond markets, with downward revisions for Non Farm Payrolls in June and July. Average hourly earnings growth was slightly weaker at 2.5% year on year, but rose to 2.9% in September.

As a result, expectations for another rate rise in December dropped below 50% during August, but have since risen to 70%.

James Penn
Senior Portfolio Manager

Equities remain attractive versus other asset classes

Global equity markets have continued to focus on economic and corporate fundamentals rather than react to political events.

This is good because if investors priced shares based on their reading of the newspapers, the picture might not be quite so healthy.

The spat between Trump and Kim Jong-un would be comic if they were not both armed with nuclear weapons. It feels like a nightmare reality TV show but the stakes are somewhat higher than those in the Apprentice. One hopes that behind the scenes grown-ups are talking, but there is no strong impression that this is the case. Nevertheless, the South Korean stock market (whose capital Seoul is within range of North Korean conventional artillery) was flat for the quarter. Maybe the prospect of nuclear war is just too dreadful to contemplate.

> ***"...The key to this market resilience is the expectation of double digit corporate earnings growth around the world which keeps investors interested and reinforces its relative attraction versus other asset classes...."***

British negotiations with European bureaucrats seem to be going nowhere (EU officials trying to take advantage of the wafer thin UK government majority). Again, one hopes that there are grown-ups talking in the background, but in the meantime markets have risen.

The key to this market resilience is the expectation of double digit corporate earnings growth around the world which keeps investors interested and reinforces its relative attraction versus other asset classes. Economic indicators show a continuation of this benign environment into 2018, which will support equities. This keeps us in the market for now, but we remain aware of the downside.

If markets have been relatively constructive at index level, movements in underlying stocks have been extreme. In the UK, Provident Financial (weekly collected credit) and Carillion (construction) reported poor numbers and were severely punished, down 65% and 73% in the quarter. We do not hold either stock directly. Meanwhile, Next came out with interim numbers that drove 2.5% earnings upgrades. However, the tone of the accompanying presentation caused a marked shift in sentiment and the shares rallied nearly 40% during the quarter. Better news on commodities also drove strong performance from that sector.

So, calm at a market level belies "normal" activity at a stock level. As we look forward, there does not appear to be anything that will knock the markets off their stride. However, valuation provides no protection in the event of a shock and we are arguably entering the last phase of the current market cycle as central banks look to normalise interest rates. This keeps us from exuberance, but means we will retain exposure.

Andrew Herberts ASIP
Head of Private Investment Management (UK)

Listed infrastructure and political risk

2017 is shaping up to be another positive year in terms of performance for infrastructure assets. The third quarter has also been reasonably active for the listed infrastructure sector.

HICL Infrastructure completed the acquisition of HS1, BBGI announced an agreement to invest in five PPP projects in Canada, and International Public Partnerships have committed to a £45m investment into digital infrastructure.

However what has grabbed headlines in recent weeks was John McDonnell's announcement at the Labour party conference that a future Labour Government intends to bring existing PFI (Private Finance Initiative) contracts 'back in house.' The shadow chancellor in effect announced plans to scrap any new, and re-nationalise existing, PFI projects if Labour were to win the next election.

"... A politicised attack on PFI has always been a recognised background risk for the listed infrastructure sector..."

It is certainly true that many of these PFI contracts are expensive for the government and refinancing the debt within these infrastructure projects at current Gilt yields would be financially beneficial. In this context the most vulnerable projects to this would likely be hospital or school projects given political sensitivities. To achieve a wholesale bringing 'in house' of the PFI market however would be a substantial undertaking. In the near term at least this would seem an unrealistic option as to achieve this would require an outlay in the region of £200bn. The contractual protections embedded within the projects should be highly robust which should mitigate the potential downside risk to investors.

One other point of note for the sector has been the style drift that has been seen in the listed infrastructure sector over recent years. There has been an evolution within underlying portfolios of infrastructure companies away from pure availability based PFI assets into regulated utilities and in certain cases taking on more corporate risk. One can make the argument that this change is a consequence of the strong pricing seen in the secondary market for PFI projects and therefore companies are maintaining pricing discipline on acquisitions. This has also created diversification away from PFI assets and this movement has enabled companies to maintain existing return targets.

Despite the recent market noise we remain constructive both on PFI infrastructure and the listed infrastructure sector in general. In our view the political risk, whilst not being immaterial, has been overplayed by the market and we think that investors need to remain cognisant that recent price movement has been driven by conference rhetoric from a party out of power. A politicised attack on PFI has always been a recognised background risk for the listed infrastructure sector and in our view the recent price weakness represents an opportunity to add to the sector. An exposure to a diversified portfolio of infrastructure assets which generate inflation-linked and government backed revenue streams remains an attractive proposition. Indeed within the TMI Diversified Assets Fund and across client portfolios we have been adding to positions over recent weeks. We continue to subscribe to the belief that an allocation to infrastructure assets has an important role to play in improving portfolio diversification.

Mark McKenzie
Head of Alternatives Research

Thematic investing offers superior long-term returns

Thematic investing has long been a popular way to invest. It uses a top down approach to identify long-term secular trends that are likely to shape the world and be key driving forces behind financial markets in the future.

Thematic strategies are designed to invest in assets where returns are influenced more by long term structural trends than the economic cycle. Such themes typically centre on social, political, demographic or technological change.

Pure thematic strategies will typically enjoy returns that are much less correlated to index returns.

Investments that provide unique or alternative source of return are attractive. Hence buying a thematic fund not only offers the opportunity of an additional source of alpha but also has diversification benefits, which can enhance a portfolio's risk-adjusted return.

In identifying themes, the investor has to decide whether the idea under consideration will have the expected impact on society. Second, if this impact occurs, what is the likely time frame. Third, can winners and losers be identified such that a well managed investment can identify the associated profitable opportunities. Thematic funds are designed to take advantage of long-term trends, which means even if they work they can take a long-time to come to fruition.

> ***"...Thematic funds offer the potential for investors to capitalise on long-term secular investment trends, and in the process offer, over a longer-time horizon, the opportunity of superior investment returns...."***

For a company such as Thomas Miller Investment, we need to establish that themes we identify are significant but also that there are viable ways in which to invest our clients' money. Historically, it has been the second of the two issues that has been more problematic, particularly for clients who cannot invest directly into stocks. However, there is an increasing number of both active and passive vehicles focused on specific themes. An example of the way passive investments are developing is the iShares Ageing Population ETF which is focused on the growing needs of the worlds ageing population. The passive fund is diversified across sectors and countries and focuses on biopharmaceuticals, life and health insurance, biotechnology, hospital facilities and travel. There are also a plethora of active managers offering thematic funds. Our job is to decide whether a theme merits interest and if it does, how best to access it.

The key consideration for an investment in a thematic fund is how it fits within client portfolios. These funds offer the opportunity of superior long-term investment returns, but also possess a higher level of risk, as the drivers of their returns are often more concentrated than in a more typical active equity fund.

Thematic funds offer the potential for investors to capitalise on long-term secular investment trends, and in the process offer, over a longer-time horizon, the opportunity of superior investment returns. While thematic funds present the possibility of an alternative and diversified source of return, they also bring additional risk as returns in early stages are often dependent on a smaller number of factors and the investment opportunities can be less developed. They are best suited as a complement to an already diversified portfolio and as this area of the investment market continues to develop, we expect to introduce an element of this exposure to more client portfolios.

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