THOMAS MILLER INVESTMENT

IQ Q4

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **DECEMBER 2016**

A Note From The CEO

2016 was undoubtedly a year of truly significant political change with a number of key developments which were largely unforeseen at the start of the year. Within the UK we witnessed the referendum result in June which catapulted the Nation towards an exit from the EU, swiftly followed by a changing of the Government guard with Theresa May taking over the role of Prime Minister from David Cameron and making wholesale changes to the Cabinet team. Further afield, but undeniably significant, we saw Donald Trump's victory in a highly eventful US Presidential election.

Notwithstanding such events and the inevitable uncertainty created, the UK economy continued its growth trend in the second half of the year and at a rate far stronger than many commentators anticipated. Against this background, we have seen a strong performance from the equity markets with the FTSE 100 index in particular making strong progress towards its post year end record highs driven, to a large extent, by the influence of corporates with significant overseas earnings which have benefited from the weakness in the relative value of sterling against other currencies.

Looking ahead, a number of key developments are anticipated. Donald Trump will have commenced his term of office as US President by the end of January and the triggering of 'Article 50' to kick-start the formal exit process of the UK from the EU is expected towards the end of the first quarter of this year. The impact of both is, as yet, unclear and we must recognise there may be some degree of volatility in the financial markets as a consequence.

I would like to take this opportunity to thank you for your support throughout 2016 and we very much look forward to continuing to work with you towards the achievement of your financial goals in 2017.

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

Global economic growth: anticipating a modest acceleration in the first half

The pace of global economic growth picked up strongly in the second half of 2016. Importantly the incoming data suggests that the momentum of growth accelerated around the turn of the year led by strong gains in the US. Furthermore, key leading economic indicators continue to flag that, barring any negative shocks, the pace of economic growth should remain above trend during the first half of 2017.

The table below presents consensus forecasts for several macroeconomic variables across selected regions:

As the table shows, from a global standpoint, the year-on-year increase in the pace of economic growth is expected to be modest. That reflects a marked regional divergence in economic performance, with the US economy expected to accelerate while other key developed economies, including the UK and the Euro-zone, are expected to experience declines in GDP growth rates. Overall, the quarterly details of consensus forecasts indicate expectations of a strong start to the year followed by a modest deceleration in the pace of growth in the second half.

As noted above, at this point, our assessment of the evidence from various leading economic indicators supports consensus expectations of a relatively strong first half of the year. However, beyond the next two quarters, the risks to consensus forecasts are fairly balanced.

Political uncertainty breeds economic risks

At the risk of hyperbole, while the future is always uncertain, the outlook at this point in time is particularly so, primarily due to the political challenges that the year will bring. In the US, the uncertainty surrounding the likely policy mix from the new administration must not be underestimated. The upside potential is clear: for some time now we, along with many commentators and policy makers, have argued that monetary policy is no panacea and that the task of lifting the global economy out of its sluggish growth required a broader policy mix. From this standpoint, the promise of expansionary fiscal policy (if appropriately designed and implemented) and tax reform (again, the devil lies in the detail) is encouraging. But investors' optimism must be tempered by the clear danger that these desirable policies could be paired with potentially destructive policies on trade as well as foreign policy positions that could herald a period of elevated geo-political instability. At this point, the Trump effect has been to amplify the range of possible outcomes for global economic growth and financial market performance in the year ahead. Put another way, while it remains unclear what impact Trump's policies will have on trend growth rate over time, what seems clear is that the volatility around that trend looks set to increase, perhaps substantially.

Beyond the US, further political risk emanates from Europe where there will be elections in several key countries

	2016			2017		
	GDP Growth[1]	Unemployment	Inflation[2]	GDP Growth[1]	Unemployment	Inflation[2]
US	1.6	4.8	1.3	2.3	4.6	2.4
UK	2.0	4.9	0.6	1.2	5.2	2.4
Euro zone	1.6	10.1	0.2	1.4	9.7	1.3
China	6.7	4.1	2.0	6.4	4.1	2.2
Japan	1.0	3.1	-0.2	1.0	3.0	0.6
World	3.1		2.9	3.2		3.3

Note: [1]Real GDP is presented as year-on-year % change; [2]Inflation is year-on-year CPI.
Source: Bloomberg (as at January 12, 2017)

over the course of the year. Populism appears to be contagious! As with Brexit and the US election results, the risk is high that populist parties could cause major upsets across Europe in 2017. Such an outcome could raise concerns about another Euro-zone crisis.

Investment strategy summary

In the period since the US elections a market consensus has formed around the view that the Trump era will be bullish for equities and bearish for bonds. This is predicated on the expectation that pro-business policies will boost growth and corporate earnings (good for equity returns) while spurring inflation (bad for fixed income returns).

Taken at face value, this appears to make sense. The issue is that it makes the somewhat arbitrary assumption that while the new administration will follow through on proposed pro-business policies, its latitude to execute some of the less desirable policy proposals will be constrained by a combination of political realities and the vaunted US constitutional checks and balances. This could turn out to be wishful thinking on the part of investors. Moreover, we have been here before. The 'great rotation' out of bonds into equities was supposed to have begun a few years ago.

Over the course of the year, outside of specific equity market sector effects, the broad financial market implications will depend on which policies are implemented. A lurch towards protectionism will weaken global trade, undermine global economic growth, dampen investor confidence and curtail corporate earnings. Likewise, any attempt to undermine the independence of the US Federal Reserve Bank will likely result in adverse market reactions.

This assessment does not preclude a strong, sustained improvement in the performance of the US economy and global financial markets. It simply highlights important downside risks to increasingly optimistic consensus expectations. As things stand, there is little basis for high conviction asset allocation decisions. Consequently, we have recently adopted a cautious stance by positioning client portfolios closer to their longer term strategic weightings across the major asset classes. We expect to see an elevated level of financial market volatility during 2017. That volatility will present opportunities to add value to client portfolios as the year progresses.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 5th January 2016)

	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
Alternatives	0					
Cash	0/+					

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

Brexit Result Led to a Prolonged Rally in Yields

The final quarter of 2016 was a trickier one for bond investors, eradicating some of the gains made earlier in the year.

The FT All Gilts index lost 3.3% in the final quarter, taking the shine of what was otherwise an excellent year in which the index gained over 10%.

A strong rally in the final two weeks of December put a better gloss on what otherwise could have been a very poor quarter. Gilts were down by over 6% by December 12th, but gained 2.9% from then until the end of the year.

Looking back, it turned out to be a bizarre year for UK Government bonds. Yields were already low at the start of the year, then fell lower in sympathy with other markets. The surprise Brexit result led to a prolonged rally in yields, culminating in the 10 year yield dropping to 0.52% on August 4th, the day that the Bank of England cut interest rates to 0.25% and introduced a further £70bn of Quantitative Easing. It will be intriguing to see if yields return to those levels again.

The sell off in bonds began in earnest in October. Bonds had rallied in the second half of September, but this proved to be a bit of a 'head fake'. They stabilised ahead of the US Presidential election, but yields rose rapidly after the unexpected election of Donald Trump. In his acceptance speech, Trump committed to high levels of infrastructure spending, which could reduce dependence on monetary policy which has been such a feature of recent years.

Details are still sparse, and we won't know the extent of any spending commitments until January or later, but together with tax cuts (Trump has also committed to reducing the corporate tax rate from 35% to 15%) this could result in the budget deficit rising by $600bn per annum for the next decade.

Additional issuance, combined with a higher nominal GDP growth rate, is not a great recipe for the bond market, and 5-30 yields rose by 60-80 basis points. Yields also rose at the short end, reflecting the probability of more interest rate rises, though overall the curve steepened.

"Quite what the post Brexit future will be for the UK remains opaque."

This meant for an ugly November, and most bond markets around the world, including investment grade corporates, lost 2-3% over the month.

The December FOMC meeting raised the Target Rate to 0.625%, a year after the first US rate hike. The committee also raised its 'dot plot' forecast for next year, suggesting three hikes rather than the two expected back in September.

Also in early December, Italian voters recorded a decisive 'No' in the Referendum on the constitution, with Prime Minister Renzi resigning. Italian 10 year yields touched 2%, a near doubling from their lows.

The outlier was the high yield market, where spreads actually contracted a little after an initial sell-off.

The other outlier over the quarter was the Greek bond market, where yields fell from 8% to 6.9%, partly in sympathy with the outperformance of the high yield market, but also due to the release of further bailout payments from the Troika.

Emerging market bond yields rose too, while Emerging currencies weakened decisively after a big rally in the US Dollar. The US Dollar spot index has now managed its fourth successive annual rise.

While the outlook looks good in the US, three further interest rate rises next year may be stretching it. In the UK, the outlook remains clouded at best. Real earnings are likely to slip again, productivity growth remains low, and investment intentions have been scaled back post the Brexit vote.

Quite what the post Brexit future will be for the UK remains opaque. The housing market is likely to be soft, while employment may also weaken after several strong years. Inflation will rise as a result of the weak Sterling, but the odds are that the Bank of England's MPC will look through the rise, even if it exceeds 3% as it did in 2011, and leave rates unchanged.

James Penn
Senior Portfolio Manager

Weak British Pound Benefits Large Cap Companies

2015 was a lacklustre year for equities, the UK's All Share equity index just squeezing a positive total return as dividends paid just outweighed capital falls. 2016, despite the risks and headlines, was a far more constructive year and the index delivered 15% total return.

That, however, does not tell the whole story. Had you not been invested in Oil & Gas or Basic Materials (essentially miners) you would have returned 9% less. These two sectors were less than 1/6 of the overall market capitalisation of the index at the start of 2016 but delivered 2/3 of the index returns. As Buffett says, be greedy when others are fearful and fearful when others are greedy. Brave investors could have made nearly 50% in the oil and gas sector and over 100% in miners. To put this in context though, even after a 72% rally last year, the largest UK miner, BHP Billiton remains 46% off its 2011 high.

The effect of the weak pound disproportionately benefited large cap companies as a significant percentage of their revenues is derived outside the UK (or denominated in other currency). We saw the FTSE 100 index of large companies deliver over 14% capital return while the FTSE 250 mid cap index was over 10% behind at 3.7%. This is only the second year since the financial crisis that the mid cap has underperformed its larger peer.

Two things strike me from 2016. The underperformance of the mid cap versus the large cap indices pushed the limits of what is normal. Typically, relative underperformance of this scale is reversed in succeeding periods as the drivers behind mid and small cap performance reassert themselves. These drivers are the combination of simpler business models and higher growth potential. Simpler business models are easier for management to understand, to control and to focus effort and resource onto new opportunities or threats. This should manifest in stronger growth. Such growth can be more meaningful for a smaller company in terms of transformation. A £20m opportunity for a company with revenues of £100m will have a far greater impact on that company than the same £20m on a company with £10bn revenues.

So, have either of the normal drivers disappeared? For me, the answer is a resounding no and so ceteris paribus, I am more constructive on mid cap stocks in 2017. Market nervousness overall could dampen recovery, but if sterling remains weak and fiscal purse strings are loosened in the UK, both factors should benefit mid caps. Proportionately more of their operations are UK based and they are slightly more sensitive to domestic than international economic conditions. We could see a meaningful resurgence in relative performance of the mid cap index in 2017.

"Brave investors could have made nearly 50% in the oil and gas sector and over 100% in miners."

Second, since 2010 we have seen a long period of underperformance of what the market perceives as "Value" stocks versus "Growth" stocks. In a period of underwhelming earnings growth and low interests rates this is understandable – when growth is scarce, investors pay more for it. However, if fiscal stimulus allies with still loose but tightening monetary policy, we could see the conditions ripe for a reversal. If both these factors align, mid cap value is going to be the place to be in UK equities for 2017.

After a year such as 2016, and with equity valuations where there are, there are opportunities to add value, but it would not be rational to expect a repeat performance in 2017.

Andrew Herberts ASIP
Head of Private Investment Management (UK)

*All performance statistics from Bloomberg

Bond Yields Still at Low Levels & Equities at All-Time Highs

2016 was certainly a year of surprises, and perhaps the biggest of which was how these surprises translated into returns in financial markets.

If I was to have posited at the start of the year that the UK would vote to leave the EU, that Donald Trump would become President Elect in the United States, and that on the back of that equity markets would deliver double digit returns I suspect I would have had few supporters. We also had the first interest rate hike in the US since 2006 and yet bond markets also delivered good returns despite a slight sell off into the end of the year.

So although undoubtedly a year of significant change it was a positive year for returns in traditional markets. This also extended into the alternative investment arena where various sectors delivered positive returns.

Despite being the largest year for catastrophe losses since 2012 (estimates at c. $50bn*) our exposure to insurance-linked strategies was able to deliver a positive return. An encouraging validation of this strategy, and perhaps the sector with the purist uncorrelated return stream to which we allocate.

Private equity markets enjoyed a strong second half of the year, buoyed by a combination of strong realisations and corporate activity within the sector which led to the pleasing combination of increasing valuations and narrowing discounts. This is a trend we can see continuing into 2017.

June and July proved to be challenging months for property funds, many of the open-ended variety having to close to redemptions following the Brexit vote.

Certain areas of the market were more resilient with the larger, London focused REITs bearing the brunt, and overall our bias towards smaller lot sizes and more regional property enabled our clients to navigate this period successfully.

Looking ahead to 2017 and without wishing to sound like a broken record (following predictions at the start of previous years!) we should expect an increasingly volatile year in traditional markets. Within the UK the spectre of Brexit looms over the economy and the navigation of the ‘leave’ process is likely to be bumpy. In this environment it is difficult to envisage UK interest rates rising significantly. These conditions mean social infrastructure assets should be well positioned to deliver another year of good returns, with ostensibly government backed revenues streams with a high degree of inflation linkage remaining attractive to investors. We can also see the positive trend that private equity markets enjoyed over the latter part of 2016 persisting into 2017. Within property markets we favour more specialised areas such as healthcare and student property where there is less vulnerability to economic shocks and also the industrials, warehousing and logistics markets which are more defensive in nature.

Overall with bond yields still at low levels and equities at all-time highs the alternative investment arena can offer a compelling refuge from an environment less favourable to a traditional balanced portfolio model. As always one must select wisely from the broad range of options on offer, and with a comprehensive understanding of the profile of any particular investment. One must guard against falling into the trap of simply adding alternative assets into a portfolio for alternatives sake.

Mark McKenzie
Senior Portfolio Manager

*Trading-Risk.com [estimate from Munich Re]

How Smart is Your Beta?

An area of the equity universe that has witnessed significant growth in recent years is that of Smart beta. Interest has been driven, in part, by investors' greater demand for transparency and lower costs, as well as their desire to move away from the concentration bias of traditional market capitalisation-weighted indexes.

Market capitalisation-weighted indexes weight stocks according to their total market value (stock price x total outstanding shares) and are often criticised for being overexposed to the largest companies in an index or concentrated in a few sectors.

Smart beta products attempt to address the inefficiencies created by market capitalisation-weighted indexes by breaking the inherent link between a company's equity market capitalisation and its weight in an index. In its most basic definition, a smart beta strategy is one which systematically selects, weights and rebalances a portfolio on the basis of anything other than the traditional market capitalisation. Therefore, smart beta is often described as sitting somewhere in between passive and active management. Strategies are passive in that they track an index but active in their construction, in that the index they track has been customised.

The most popular smart beta equity strategies tend to fall within three broader categories: factor, fundamental and low-volatility investing. The aim of factor investing is to tilt portfolios towards factors that are typically long term drivers of returns such as value, size or momentum (at least those proven to in academic research). Fundamental weighting uses accounting-based metrics such as sales, profitability ratios etc to weight stocks in an index. Low-volatility strategies aim to improve the return per unit of risk of a portfolio, in general, by investing in stocks as a proportion of their volatility (inverse proportions) or running minimum variance optimisation across an index to suggest portfolio weights (a little black box, but essentially statistically modelling historic stock behaviour to maximise exposure to preferred characteristics).

Smart beta products are competitively priced and allow investors to access different themes, which may be present in actively managed funds, but at a lower cost. Smart beta products are transparent and the consistent investment approach helps investors to better identify the risks and drivers of returns within portfolios. The wide variety of smart beta products provides greater investment choice and the flexibility to better tailor portfolios to an investment view. They can add an additional layer of diversification as portfolios can be constructed to reflect different underlying factors with lower correlations, dependent on the stage of the economic cycle.

With that said, smart beta does not come without risks. Moving away from a market capitalisation-weighted index will decrease your exposure to specific biases, but in the process create new ones. For instance moving to a FTSE 100 equally weighted index will lower your sector allocation to energy and consumer staples, but increase your exposure to consumer discretionary and industrials, in the process significantly altering the drivers of index performance. Similarly, whilst some smart beta factors have been proven to outperform over long time horizons, in the short term those same factors can significantly underperform a market capitalisation index, creating a large tracking error for benchmark aware investors.

Overall, we believe that the inclusion of smart beta in a portfolio has the potential to improve its risk-adjusted return profile. We are currently analysing some of the major strategies and how they might achieve our clients' desired return objectives.

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