THOMAS MILLER INVESTMENT

IQ Q4

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **January 2018**

A Note From The CEO

In the words of Charles Dickens, 'It was the best of times, it was the worst of times'([1]). After the political melee that followed the EU referendum in 2016, many assumed that financial markets would operate at the whim of political upheaval. The reality however has been global economic growth providing clear direction and a strong fuelling for financial markets.

Whilst there were some worries in the Eurozone over the French and German elections last year, both passed without much upheaval. Similarly, Donald Trump's first year as US President has passed without the markets blinking and his overarching US tax reform bill, finalised in December, helped send equity markets higher.

With economic confidence relatively strong and many of the major asset classes trading at multi-year highs, we are acutely aware of the need to be cautious in the medium term. We expect central banks across the Globe to increase their focus on increasing interest rates rather than lowering them and further, 2018 is anticipated to see a reduction in the balance sheets of the some of these central banks as they continue to reduce their quantitative easing programmes led, primarily, by the US Federal Reserve. How the financial markets interpret these developments is difficult to forecast and this further reinforces the need for vigilance.

Notwithstanding this outlook, we continue to see attractive investment opportunities supported by our focused risk based investment 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.

Hugh H Titcomb
Chief Executive Officer

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

[1] *'A tale of Two Cities' 1859 - Charles Dickens*

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Rising Growth Breeds Excessive Optimism

A Brief Review of the Economic and Financial Market Backdrop

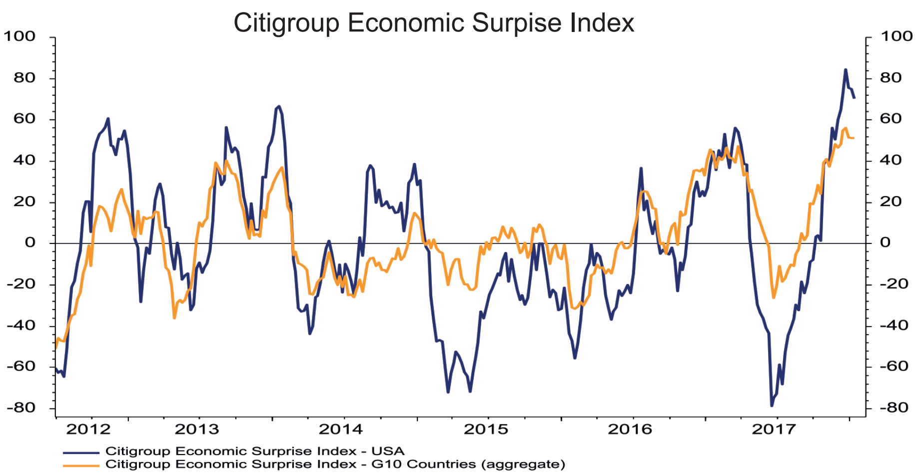
- During 2017 investors enjoyed several positive surprises. Economic growth was stronger than consensus forecast at the start of the year, inflation was notably lower than expected in most major economies (with notable exceptions like the UK) and corporate profitability recovered from the weakness seen the previous year.

- The strength in economic performance relative to consensus expectations (for the US and G10) is illustrated by Chart 1. The chart shows the Citigroup Economic Surprise Index which tracks the deviation of economic data from market consensus forecasts. Positive [negative] readings of the index indicate that economic releases have on balance been stronger [weaker] than consensus forecasts.

- As the chart shows, while the incidence of stronger-than-expected pace of activity has been particularly pronounced in the US, the trend holds across the G10 economies.

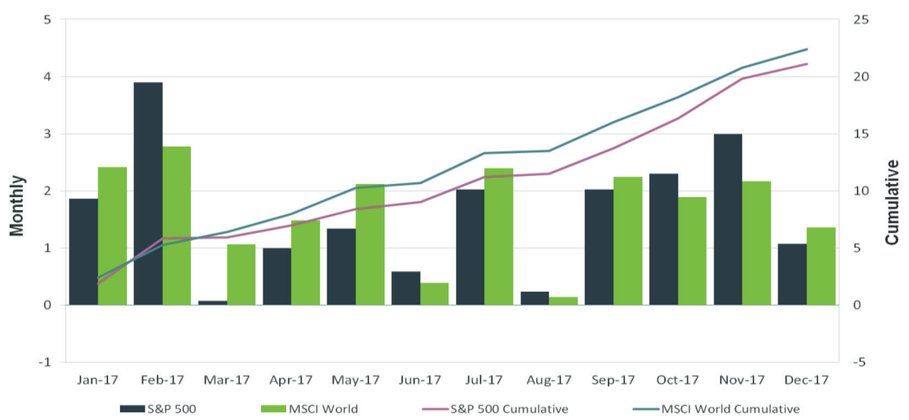
- The benign backdrop fuelled a remarkable rally in risk assets and investors enjoyed strong gains across the board in global equities during 2017. Corporate bonds and major commodities also delivered strong returns over the year. As illustrated in Chart 2, over the course of the year, both the S&P 500 index and the MSCI World index set new records by delivering positive returns in each of the twelve months.

CHART 1: ECONOMIC DATA CONSISTENTLY BEAT EXPECTATIONS OVER THE PAST YEAR



Source: Thomson Reuters Datastream

CHART 2: MONTHLY NET TOTAL RETURN OF S&P 500 INDEX & MSCI WORLD INDEX IN 2017 (USD)



Source: Bloomberg data, TMI

INVESTMENT STRATEGY OVERVIEW

What to expect in 2018?

- Investors have ushered in 2018 in the same high spirits with which they saw out 2017, with strong gains across a broad range of financial assets. For instance, at the close of trading on Friday 19th January, the US S&P 500 index was up over 5%, while the UK's FTSE 100 index had gained a more modest 0.6%. In the fixed income markets, government bond prices have fallen in recent weeks as yields have risen sharply on the back of a combination of ongoing optimism about the economic outlook, expectations for less accommodative monetary policy and, specifically in the US, concerns about the durability of international demand for US Government debt securities.

- Looking across the developed markets, the data continues to point to ongoing positive growth momentum. For instance, composite leading economic indicators remain constructive across the OECD area and Purchasing Managers' Indices remain in expansionary territory across the board. These suggest that growth should remain at or perhaps somewhat above trend across the key developed economies. Equivalent indicators for the major emerging markets also suggest a positive outlook for economic growth.

- Nevertheless, there is some cause for caution. In the US, while activity levels should remain strong overall, it seems prudent to expect a somewhat lower pace of economic growth in the year ahead than was recorded in 2017. For instance, while indicators such as the key ISM and PMI measures will most likely remain in expansionary territory, their levels should moderate from the elevated readings seen at the end of 2017. Consequently, we would expect to see the aforementioned economic surprise indices turn lower from the levels reached at the end of 2017.

- For markets, a softening of the data may well come as a negative surprise given elevated levels of investor optimism. However, the diminution of upside surprises to growth and corporate earnings in the year ahead does not preclude the possibility of another strong year for asset prices in 2018. Rather it is likely to trigger a rise in volatility and thus interrupt the calm that descended on markets in 2017.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 19th January 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/-	+	+
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
Index-linked bonds	0	0	0	0	0	0
Alternatives	+					
Cash	-					

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

Economic Indicators Continue To Come In Strongly

Fixed income markets remained benign in the final quarter of 2017, and indeed in the year as a whole, despite a few tentative moves over the past twelve months towards a more 'normal' interest rate policy.

Global economies are enjoying the first period of coordinated economic growth since 2007, and the need for Quantitative Easing and unconventional monetary policy seems less appropriate by the day. Yet a growing requirement for normalisation has not seen any panic in bond markets, or even a concerted sell-off.

In any previous economic cycle, we would now be in the later stages of the expansion, and interest rates would have been expected to have moved back towards previous cycle highs. But there has been nothing normal about this low inflation, low growth background, often referred to as the 'New Normal'.

> ***"...UK corporate bonds had an even better year, with spreads reaching new lows, corporate profitability strong, and trading liquidity generally very good..."***

In the UK, inflation is a bit more of a problem, with Mark Carney, governor of the BOE, having to write to the Chancellor in December to explain why CPI inflation in November was again above 3%. However, Sterling has strengthened to nearly USD1.4, and it could be that inflation has now peaked, and could soften to 2.5% later in the year.

In the UK, Gilts made a strong fightback in Q4, despite the Bank of England increasing interest rates for the first time since 2005. The increase, from a mere 0.25% to a still paltry 0.5%, was pitched by the BOE as a reversal of the emergency cut in August 2016, and was accompanied by language that it was not the start of a hiking cycle.

Gilts returned 1.5% in December, and 2.95% for the fourth quarter as a whole – a pretty strong return given that the return for the year was just 1.8%.

UK corporate bonds had an even better year, with spreads reaching new lows, corporate profitability strong, and trading liquidity generally very good.

The US saw similar trends to the UK, with corporate bonds outperforming government bonds, albeit we saw more of a 'flattening' effect there than was apparent in either the UK or Europe.

Bond yields in the medium to long end space traded sideways over the year, with the 10 year US Treasury yield closing at 2.41%, almost the same level it started the year. US 30 year Treasury yields closed about 20 basis points lower over the year, at 2.8%. Meanwhile, the 2 year yield hit a new post-crisis high of just under 1.9%, almost 60% higher than the year before, reflecting a rising interest rate environment.

At the most recent FOMC meeting in mid December, US rates were raised to 1.5%, the third increase of the year, and the fifth since 2008, although the members gave a fairly dovish stance on their position, reiterating their expectation of three rate rises this year (2018) and three rises next year (2019). As a result the bond market took the move benignly, and there has been little change in longer term interest rate expectations. The 2 to 10 year spread is now about 55 basis points, the lowest it has been since 2007.

Most of the economic indicators continue to come in strongly in the UK, Japan, Asia and the US, and particularly in Europe, with surveys suggesting the manufacturing sector is still experiencing buoyant conditions. Strength in Europe has caused a strong bounce in the Euro, while the US Dollar ended the year on a weak note.

The other major development of the quarter was the passing of tax reform by both the upper and lower Houses in the US. This will reduce the corporate tax rate in the US from 35%, which is above international norms, to 21%. There are also reductions for personal tax rates, although these are due to expire in a few years time, while the corporate tax changes are permanent.

While this looks like a big fiscal stimulus, the bond market seems to have taken the view that the impact will be fairly muted, with more impact on corporate profitability than on aggregate demand.

James Penn
Senior Portfolio Manager

2017: Record Breaking Year For Many Markets

2017 saw another bumper year for equity markets as much political noise was essentially ignored by investors who focussed on the positive news coming out of the economy. This fed through to corporate earnings strength, supporting markets.

Currency played an important part in returns to UK investors as Sterling strengthened meaningfully against the US$ and Yen but weakened against the Euro. As at 3rd Jan 2018, Sterling sits about 13% below its pre-Brexit level against the Euro and over 9% down on the US$.

2017 was a record breaking year for many markets, and unprecedented in the US as it achieved twelve straight "up" months. This has not happened in the history of the US index and speaks volumes about investor sentiment.

2017 was also a very strong year for the technology sector. Excitement about advances in AI drove some small companies onward, while the huge increase in memory and processing requirements saw chip manufacturers soar (and M&A ramp). The US IT sector rallied nearly 37% while the UK sector was up an impressive 32%. However, with the IT sector representing over 20% of the US market but only 1.2% of the UK, the effects on index returns were markedly different.

"...2017 was a record breaking year for many markets, and unprecedented in the US as it achieved twelve straight "up" months. This has not happened in the history of the US index and speaks volumes about investor sentiment..."

One of the most positive indications for equities that we are seeing is the return of capital spending. The lack of such spending has been a severe headwind to productivity and it has been the lack of productivity growth that is behind much of the sluggish growth in consumer earnings. To the extent that it stimulates real wage growth and also frees capacity for growth (particularly in labour markets) this could extend the cycle further. This would reinforce earnings momentum, however let's not forget that lack of wage driven inflation is one of the key reasons that central banks have kept monetary conditions as loose as they have. If it looks as though inflation is beginning to bounce, expect central banks to try to pre-empt it and clamp down on money supply.

If 2017 has taught us anything it is that politics does not matter in a bull market and, at a market level, neither does valuation. However, history should also have taught us that valuations very much matter in the long term, and investors who wish to deliver long term performance must have cognisance of them. 2017 corporate earnings growth took some of the pressure off valuations, but in a historic context equities are not cheap. At this point in the cycle one is paying reasonably high but not outrageous multiples for later cycle earnings. The party can continue but it is time to be selective. Investors are faced with the quandary of taking risk off and missing the last jump in markets, or holding on and trying not to lose out too much when the fall comes. At the moment, there is enough tailwind to remain at least neutral, but it is prudent to build resilience in portfolios through a slightly more defensive stance.

Andrew Herberts ASIP
Head of Private Investment Management (UK)

PFI Infrastructure; Is Increased Volatility Creating A Buying Opportunity?

2017 was a year of enduring strength across traditional asset classes and this buoyancy has extended into the world of alternatives.

It was a good year for the listed private equity sector as strong realisations supported valuations. The sector has been further boosted in recent weeks through the sale of the Aberdeen Private Equity portfolio at a modest premium to the net asset value. Given current discounts for the sector are in excess of 10% there remains scope for further gains in 2018. In commercial property markets more specialised sectors such as logistics, healthcare and social housing fared well, whereas offices and retail sectors were laggards. The renewable infrastructure sector was supported by technological efficiencies lowering costs and a recovery in the forward power price curve.

It was an interesting year for the listed social infrastructure sector. Last October we reviewed the space following comments from John McDonnell (the Shadow Chancellor) regarding PFI infrastructure projects and the prospect of a future Labour Government taking these back 'in-house'. The last weeks of 2017 saw a rally following a period of weakness and closed a broadly positive 2017 with solid gains enjoyed across the sector. However as we enter 2018 the impact from the Carillion liquidation and publication of a National Audit Office (NAO) report on the use and impact of PFI threatens to dampen further gains.

The Carillion liquidation initially created a few market jitters as a number of companies engaged Carillion for the provision of facilities management services on various infrastructure projects. However the use of Carillion is not extensive and companies have enacted contingency plans which have been in place for this eventuality. Whilst we anticipate little operational disruption as a consequence, this will likely draw some of the bubbling disquiet on the sector from certain political circles back to the surface and grab column inches over the coming weeks. The NAO report itself does not highlight anything particularly revelatory, although coming on the back of the Carillion news will deliver a further negative shock to investor sentiment.

Our view from three months ago - that price weakness should be considered a buying opportunity - is largely unchanged; indeed we now find prices back at levels last seen in October. However persistent negative press will create headwinds for near term growth. Investors should be allocating to these assets for the attractive dividends on offer (4.5% - 6%) and should not expect significant growth beyond this. A persistence of the double digit returns enjoyed over recent years is unlikely. It should be highlighted that the sector is not a pure play on PFI infrastructure and that companies have significantly diversified themselves away from this exposure in recent years into regulated utilities and economic infrastructure projects. We therefore still feel the sector offers value and it retains a prominent position within our alternative allocations.

As we look ahead to 2018 it feels increasingly likely that we can expect a long awaited wobble in equity markets. High valuations and seemingly unquenchable bullish thirst make equity markets particularly vulnerable to an external shock. Our central thesis would not be that bond yields will rise aggressively, particularly in the UK, but this cannot be ruled out entirely. Set against this market backdrop an allocation to alternative assets remains a sensible way to diversify portfolios.

Mark McKenzie
Head of Alternatives Research

Capitalising On Digital And Demographic Trends In The Property Market

The rise of e-commerce can arguably be traced back to 1995, when Jeff Bezos boxed up and shipped the first book sold on Amazon.com from his Seattle garage. Since then, almost all major retailers have embraced online sales strategies and started selling items from their own websites.

While much of the market's recent focus has been on how e-commerce is challenging the "high street" brick-and-mortar stores, one should consider that a sizeable part of the property market stands to benefit from this trend. As a result of the incredibly fast shift to online retailing, demand for large warehouses (or big-box logistics) is continuing to outstrip supply. This has resulted in higher rents and strong logistics space leasing in core strategic locations. In addition to big-box warehouses that represent the "first mile" of distribution, the "last mile" distribution properties stand to benefit from the rising demand for space that facilitates next-day or even same-day delivery. These properties are urban warehouses strategically located near population centers with easy motorway access, delivering the products to the end-customer. We consider both Tritax Big Box REIT and Pacific Industrial & Logistics REIT are well-positioned to take advantage of this accelerating trend.

Another property sector providing critical infrastructure for the e-commerce value chain is Data Centres. Data centres are industrial buildings where businesses can rent space for data storage, interconnection and communications hardware. Growth drivers include the surging adoption of cloud computing, e-commerce and digital media, rising demand for computing power and data streaming and the cost advantage of outsourcing IT infrastructure. As more people consume digital content and make purchases online, landlords of data centres are looking to expand faster to meet this increasing demand. One attractive player in this sector is Digital Realty Trust, a globally diversified data centre REIT with a strong track record.

"...The importance of stock and sector selection within property markets cannot be understated..."

Another significant factor shaping the property market is demographics. Rising numbers of seniors and growing longevity are increasing demand for medical services and health care real estate. The latest projections from the Office for National Statistics suggest that the UK's proportion of people aged 65 and over will rise from 18.0% in 2016 to 23.9% by 2036. This powerful demographic trend should act as a tailwind for health care real estate. A continuation of the trend towards modern outpatient facilities, along with a rapidly aging population that requires more health care services, should make the sector an attractive investment option. Two trusts that offer a decent proposition are Primary Health Properties and MedicX Fund, both backed by strong management teams with long-term track record in this market.

Further, it has been widely reported that the UK faces a severe housing shortage across all tenures, including social housing. Jones Lang LaSalle reports that there are today approximately 4.3 million people on local authority waiting lists for social housing - a figure that is expected to rise by a further one million over the next five years as the UK population growth rate exceeds that of housing completions. New social homes built in 2016/17 continued to fall well short of demand, reflecting modest levels of government grants available for development. This supply-demand mismatch should both create opportunities for investors and enable local councils and housing associations to mitigate some of the chronic shortage of UK social housing. We favour recently listed Civitas Social Housing to access this market.

Within the TMI Diversified Assets Fund, we identify certain trends that are fundamentally shaping property markets and access these sectors via a range of real estate investment trusts. The importance of stock and sector selection within property markets cannot be understated. As such we remain constructive on certain niche sectors such as industrials/logistics, data centres, health care, social housing, student accommodation and government properties whilst avoiding sectors which we regard as more vulnerable to economic shocks such as high street retail and city offices.

Georgios Nikolaou
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