THOMAS MILLER INVESTMENT

IQ Q4

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **January 2019**

A Note From The CEO

2018 ended on a disappointing note, with all major equity markets suffering steep declines in the final quarter. Fears over a marked slowdown in global growth alarmed investors and pushed global equities into their worst year of performance since the global financial crisis in 2008.

Notwithstanding companies have materially grown earnings over the course of 2018 while strong employment rates support consumer income and broad demand for goods and services. Today, we believe valuations across the major equity markets are attractive as they are for the corporate bond markets and across segments of the alternatives asset market.

While such market conditions present attractive investment opportunities, we are cognisant that the longer-term risks to global growth remain with central banks tightening monetary policies, increasing levels of household & corporate debt and the continued spread of populism. As we have stated previously, at this stage of the economic and business cycle it is important to be prudent.

Valuations can remain depressed for some time and are not guaranteed to improve as quickly as they may have done in the past. Our research capabilities are focussed on identifying opportunities within such conditions. We do not attempt to time the market, rather we seek to understand how your underlying investments behave at different times in the cycle and tilt the portfolio appropriately. This disciplined and robust approach is the bedrock of our investment process.

Our expectations and forecasts are of course data dependent, and our job as long-term guardians of your capital is to comprehend, monitor and act decisively as market conditions develop and evolve. This will help to determine our longer term expectations for global economic growth and subsequent portfolio positioning over the year ahead.

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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Anticipating further deceleration in the year ahead.

Global Economic Outlook:

- The pace of global economic growth slowed in the second half of 2018. Importantly the incoming data suggests that the momentum of growth decelerated notably around the turn of the year with weakness recorded across some key developed economies (including the UK, Japan and the Euro-zone) and major developing economies, particularly China. Furthermore, important leading economic indicators continue to flag diminishing growth momentum across the OECD over the next few quarters.

- We titled the January 2018 edition of the Investment Strategy Overview, “Rising Growth Breeds Excessive Optimism” because investors, as we noted then, had ushered in 2018 in the same high spirits with which they saw out 2017. In contrast to the start of last year when investors erroneously expected a continuation of the synchronised growth upswing from the previous year, investors’ expectations currently appear more realistic and better aligned with the prevailing evidence on the economic outlook. The table below presents consensus forecasts for several macroeconomic variables across selected regions:

- As the table shows, from a global standpoint, growth is expected to soften from about 3.7% in 2018 to 3.5% in 2019. The pace of economic activity is expected to slow across the major developed economies, with forecasts for the UK and Japan bucking the downward trend slightly.

- At this point, our assessment of the evidence from various leading economic indicators supports consensus expectations of a modest outlook for global economic growth. The caveat is that the risks to the outlook for 2019–2020 are tilted to the downside due to the prevalence of notable events that could introduce negative shocks to various key economies. For instance, the outlook for both the UK and the Euro-zone is very dependent on how the ongoing Brexit negotiations are concluded. For the US, depending on its eventual duration and severity, the ongoing government shutdown represents a potential source of negative shock while the trade disputes between the US and China could yet take a larger than expected toll on the global economy.

Figure 1: Consensus Forecasts for Key Macro Variables

	2018			2019		
	GDP Growth[1]	Unemployment	Inflation[2]	GDP Growth[1]	Unemployment	Inflation[2]
US	2.9	3.9	2.5	2.5	3.6	2.0
UK	1.3	4.1	2.5	1.5	4.1	2.1
Euro zone	1.9	8.2	1.7	1.5	7.9	1.5
China	6.6	4.0	2.1	6.2	4.0	2.3
Japan	0.8	2.4	1.0	0.9	2.3	1.0
World	3.7		3.8	3.5		3.2

Note: [1]Real GDP is presented as year-on-year % change; [2]Inflation is year-on-year CPI.
Source: Bloomberg (as at January 18, 2019).

Financial Markets & Investment Strategy Summary:

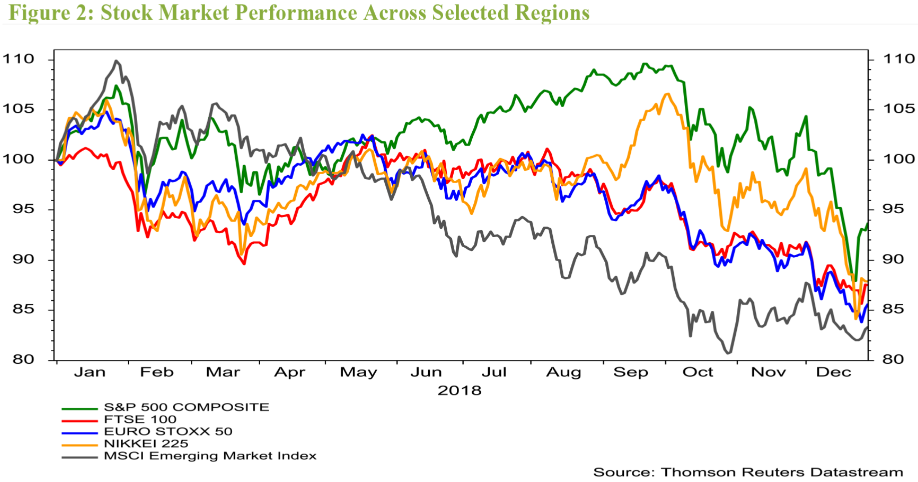
- 2018 turned out to be a turbulent year for financial markets, with the majority of asset classes recording negative returns for the year. The bulk of the losses were recorded in the final quarter of the year as markets sold off on the back of a combination of risk factors including fears about the outlook for monetary policy in the US, the uncertainty surrounding Brexit and concerns about the impact of the ongoing ‘trade war’ between the US and China.

- In the end, in local currency terms, all major equity markets suffered losses over the year (the Brazilian Bovespa and Russian Micex were notable exceptions with gains of 15% and 18.5% respectively). In the US, the S&P 500 index declined by about -4.4% while the technology index (Nasdaq) fell by -2.8%. The UK’s FTSE 100 index lost -8.8% while Germany’s DAX index finished the year -18.3% lower. Financial stocks were the laggards on both sides of the Atlantic as the European banking index (DJ Stoxx 600 Banks) lost -25.2%, while in the US, S&P 500 Financials lost -13% over the year. Fixed income markets were mixed, with negative returns across the board for corporate credit balanced by generally positive (albeit, modest) returns for government bonds. Commodity markets also experienced sharp losses, with the broad commodity index (CRB index) recording a decline of -12.4% for the year.

- Looking to the year ahead, financial market volatility is likely to remain elevated as investors weigh the changing balance of risks. From a fundamental standpoint, the primary concern for investors will be whether the ongoing global economic slowdown morphs into something more sinister, with important implications

INVESTMENT STRATEGY OVERVIEW

Figure 2: Stock Market Performance Across Selected Regions



for corporate earnings and monetary policy. As noted above, key leading indicators point to further deceleration in growth momentum but some of this is already reflected in forecasts. However, given this backdrop, any negative shock could result in an adverse swing in growth rates beyond the modest softening outlined in the forecasts presented in Figure 1. The problem is that there is currently no shortage of potential sources of negative shocks to the main developed economies.

- At the time of writing in January, equity markets are enjoying a recovery from the severe pull back experienced in the fourth quarter of 2018. However, the high level of political and policy uncertainty gives cause for caution. For this reason, we have turned somewhat more defensive on equities for now and await better opportunities to add to holdings. Fixed income and alternative investment portfolios are currently positioned in line with longer term strategic weights. We also retain a neutral stance across the major currency pairs.

Abi Oladimeji
Chief Investment Officer

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 14 January 2019)

	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	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.

A look at the Sterling Bond Market

The sterling corporate bond sector has always been highly interesting given the large universe of UK domestic investors (both retail and institutional) who include the asset class within their long-term asset allocations.

This backdrop is important to identify from the outset because the sterling investment grade corporate bond market is a slight outlier in the context of the global credit universe. From a size perspective it is certainly much smaller. At over £300bn, the sterling investment grade corporate bond market is only a quarter of the size of the euro denominated investment grade market, which in turn is only a quarter of the size of the dollar-denominated market. The sterling market might be the fourth largest in the world after the Japanese yen market but it remains far smaller than the US dollar market.

From an issuance perspective, the length of maturity in the sterling market is typically longer than in the euro or dollar market. This is because of the demand for longer dated bonds by pension funds and life insurance companies who look to hedge the duration of their liabilities. It is estimated that half of the sterling bond market is owned by life insurers while pension funds own about a quarter, demonstrating how institutional investors drive pricing and flows. As a result of their presence the sterling market is considered to be a 'longer duration' market, compared to the rest of the world, irrespective of the new issuance side-effects from QE.

"It is estimated that half of the sterling bond market is owned by life insurers while pension funds own about a quarter"

Despite the foibles of the sterling investment grade market it is important to recognise the issuer base are not solely comprised of UK companies, in fact more than half of the issuers are domiciled outside of the UK. The presence of global corporations in the index provides a more international feel to the UK credit market, implying that Brexit need not always be the chief driver of current risk. Indeed the broad strength of the global economy since the EU referendum in 2016 has been a positive for the underlying issuers in the sterling investment grade market with companies exhibiting stable leverage and improving profitability ratios.

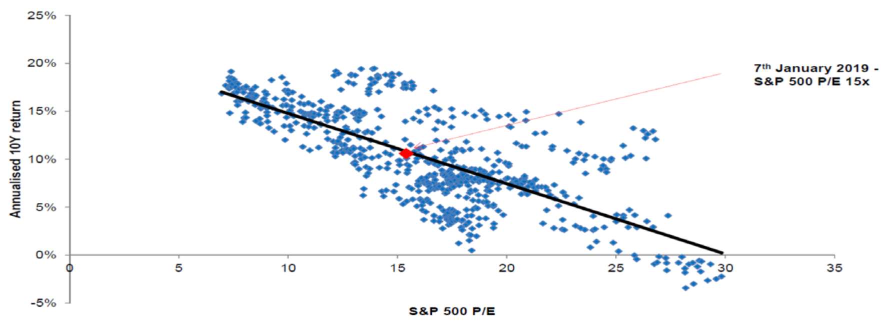
The macro view for the sterling investment grade market is a little more mixed. The clear and present danger for the asset class lies with where we currently sit in the credit cycle. Since QE began in the US in 2009 the structure of the credit market has changed significantly and nine years later corporates have expanded their balance sheets to levels where we were before the credit crisis. While interest rates were low this wasn't a problem as interest coverage ratios remained relatively low. However, the tightening of monetary policy by the US Federal Reserve since 2015 has pushed up global borrowing costs.

In a world of increasing global financial inter-linkages the Fed's actions do impact the sterling corporate bond market, after all more than half the issuers are global companies. If we throw in the current trend of weakening corporate profitability, albeit from a high base, then it would be prudent to manage the increasing risk exposure in credit portfolios. Therein lies the potential value for the long-term investor. As spreads widen to reflect a weaker global economic environment, herding behaviour among investors can unfairly punish those companies with strong balance sheets and robust cash flows. Over a one year time horizon bond prices are trading at their lows, although the valuation case is not as compelling when looking over three and five years. Patience and conviction will reward those active corporate bond managers as we approach the end of this credit cycle.

Jordan Sriharan CFA
Head of Collectives Research

Equity investing is a risky, yet ultimately, rewarding process.

Chart 2: Historically, buying at these levels results in strong subsequent returns



Source: TMI and Bloomberg

Being an investment manager can be brutal and markets have a habit of punishing anything that looks like complacent comment or hubris. This is what I said in the last quarterly:

"It is hard to be hugely bullish at this present moment in time, but with earnings growth set to continue and central banks acting slowly, the conditions do not seem in place for a violent pull back in equity markets."

Well, we know how that ended. The US market promptly fell 19.6% before rallying slightly, ending the quarter down 14% and the year down 7% in capital terms (in US$). The UK All Share fell 11% in the quarter and 15% from its May high, ending the year down 12.5%. European equities dropped 12% in the quarter, 17% from their January high and 13% for the year (The MSCI Europe ex UK Index in Euros) with the German DAX index falling 13.6%, 18% and 22% respectively (in GBP).

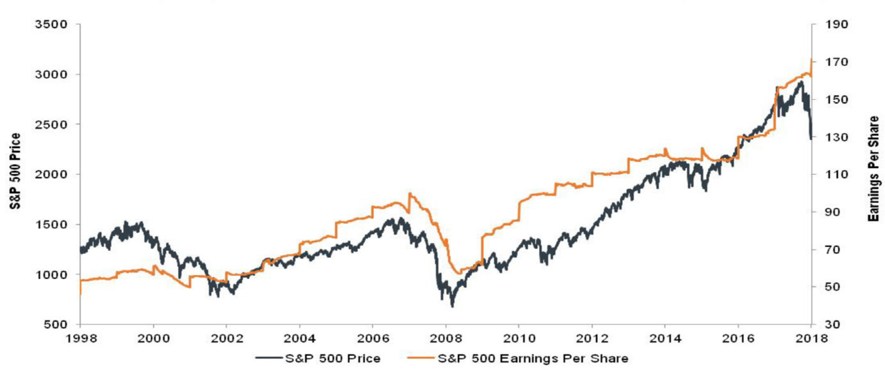
These are close to the moves that one expects when markets predict a recession, and indeed 75% of bear markets (when a market drops more than 20% from its peak) are indeed followed shortly by a recession. However, economic data is still robust. Forward looking indicators still predict growth, investment spending is healthy, consumer balance sheets are healthy and earnings are coming in strongly. We do not expect a recession in 2019. So why did the markets fall so dramatically in Q4, seemingly disconnecting from fundamentals?

The rate of economic growth slowed in the second half of 2018 globally due to a variety of factors. The economy was not flirting with recession, but it was slowing. In this environment, one needs to have confidence that central bankers will not make a policy mistake. The one mistake we all fear at this point in the cycle is that monetary policy is tightened too fast and too hard causing demand to falter and a recession to follow. Right at the start of October, the new Fed Chairman delivered a statement that indicated that even in the environment of slowing growth, against a background of global trade tensions he was considering further rate rises. It looked like a policy mistake was on the cards and investors reacted accordingly. The change in sentiment was marked and the evidence that a recession was not around the corner was largely ignored in favour of any negative news.

Nothing we see at the moment indicates to us that a recession is imminent. The Fed has moderated its tone so the risk of a policy mistake has receded. The levels extant in markets at the end of the year price in a markedly higher recession risk than we believe is realistic and as a result we believe the sell off went too far.

Finally, putting the current market valuation in long term context, one can see that we are at market levels where buying here has historically delivered a subsequent ten year return of 10% compounded annually. Valuation is less useful for short term horizons, but a strong indicator of long term returns which reinforces the view that equity investing remains a risky but ultimately rewarding undertaking.

Chart 1: The sharp drop in the US index does not reflect current or expected earnings



Source: TMI and Bloomberg

Andrew Herberts ASIP
Head of Private Investment Management (UK)

Shop-ocalypse Now!

Retail woes unlikely to abate in 2019.

The fourth quarter proved to be challenging for return generation across risk assets and alternative sectors were not immune from the elevation in risk aversion. Fears of escalating trade wars between the US and China, tightening of monetary policy and the uncertainty surrounding Brexit all served as a catalyst for increased volatility across financial markets.

One area of the market that needed no nudge to take a lurch downwards was the retail property sector. The justly maligned sector has seen tenants continue to vacate property as CVA utilisation grabbed headlines throughout the course of the year. The structural move away from physical stores, as the online retailing shift accelerates and continues to disrupt the market, suggests little scope for any imminent stabilisation. We are beginning to see appraisers aggressively cut valuations as the stark reality of the severity of the market decline bites and this will only exacerbate the already depressed transactions market. It is likely that 2019 will see at least similar levels of retail failure as were experienced in 2018. Further consolidation into high quality centres is required before we could consider the downside to be fully priced in.

Picking up the slack from retails woes has been the warehousing and logistics sector and last year saw significant take-up in logistics space by retail focused businesses. With online sales growth as a percentage of total sales continuing to grow, the demand for logistics space will only increase. If this growth endures at current levels this could see ten million square feet of new logistics tenant demand over the next two years. With supply constrained this will put significant upward pressure on rents. Taking a contrarian view on UK property sectors is unlikely to bear fruit at this point.

Looking ahead it seems reasonable to anticipate that volatility will persist across all financial markets. With this in mind we continue to believe that allocating to areas of the markets that exhibit reduced economic sensitivity can prove to be a successful strategy.

Within property markets this approach encompasses the industrial and logistics sector. Another area that has appeal is the UK listed infrastructure market. Corporate activity in 2018, notably the acquisition of John Laing Infrastructure by a private consortium in the summer, validated our view that long-lived inflation linked assets with government backed revenue streams are attractive. The pricing achieved for this transaction implies considerable support for valuations in the sector. Although scope for growth is somewhat limited, a high quality fully covered dividend yield of over 5% has appeal to a broad investor base. We of course cannot discount the Corbyn risk to the sector, with Labour's nationalisation plans looming large given the current state of our incumbent Government. However the extent to which this risk can manifest itself is, in our view, somewhat limited. Looking beyond the UK, digital infrastructure, notably tower and datacentre infrastructure, continue to be growth areas. Both should enjoy insulation from any end of business cycle risk that materialises as the global appetite for data production and consumption exponentially accelerates.

A sensible strategy within alternative markets for 2019 would be to avoid recent losers and back the winners. Although alternative investing does not imply a direct hedge, adding diversification to traditional portfolios at this point in the cycle can add stability in volatile markets.

Mark McKenzie
Head of Alternatives Research

The search for ‘good’ companies and the potential for outperformance.

Despite their preferences for investing, investors have often stated that they only like to invest in ‘good’ companies.

Investing in equity markets for many can be an emotive process, some investors may avoid certain companies or sectors where perhaps they have suffered previous losses while others may invest in companies or names they are familiar with.

Naturally, this leads to the question of what constitutes a ‘good’ company? Is it an investment perceived as having low risk or perhaps a company that is expected to outperform its respective index? Is it possible to construct a portfolio with more favourable risk/return characteristics than a traditional benchmark?

Traditional finance states that financial markets are completely efficient as the market participant knows every piece of information and makes completely rational decisions. Behavioural finance states that this is not the case and there are plenty of examples to show that managers can not only outperform a benchmark but significantly underperform as well.

So how do we construct a portfolio of these so-called ‘good’ companies? Conventional stock analysis techniques are sometimes referred to a ‘top-down, bottom-up’ approach or both together. For example, in ‘top-down’ analysis we may focus on selecting a group of industries and invest in the best companies within that sector while ‘bottom-up’ analysis would focus on looking at the company on a stand alone basis focusing on its financial performance. One way we can employ a ‘top-down’ method would be to take a chosen stock universe, for example the S&P 500, and using various criteria, eliminate unfavourable companies while investing those we hope will perform well.

Looking at a company’s financial performance provides a good starting point for this process and when we look over a period of 5 to 10 years, we can start to see differences in financial performance measures. For example we can identify the free cash flow growth of a company to see if this has consistently grown, the importance being that free cash flows are related to the value of a company. We can consider the company’s return on capital - how efficient has the company been in using its capital, equity and any debt, in generating profits? We can look at both gross and operating margins, has management been effective in maintaining or growing margins? Does the business have margins that are in excess of the opportunity set average? Is the company in a sector where there are higher barriers or can it benefit from economies of scale? Of the profits generated, what percentage is converted into operating cash flows and are those levels consistent? All of the above serve as useful determinants to focus on which companies may look more attractive than others. Using this technique we can start to form a list of companies with what we would hope have both strong and consistent financial performance.

While this provides us with a starting point it still doesn’t tell us whether a company is cheap or expensive relative to its current market price. For that we would employ a method where we discount future cash flows, for example, cash flows the investor would receive as dividends or free cash flows generated by the company itself. As with any type of forecasting model the output is only as good as the input data and using sensible assumptions we can arrive at a value or more usually a range of values of what we think the company is worth.

Of course companies will often be cheap or expensive for a reason, nonetheless this analysis can pin point some wildly high valuations. For example, the lofty valuations we saw last year, especially in some of the US technology names and smaller UK companies had priced in very high levels of earnings growth, that high that some investors might have said those levels weren’t sustainable in the long run.

So putting these methods together we hope over the long term that as these companies continue to post strong financial performance similarly their share price will be strong as well. Such a strategy based on out-performance, often referred to as an active strategy, is not one that every investor will want, many investors will simply want to mirror a benchmark index.

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