THOMAS
MILLER
INVESTMENT

IQ1

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **APRIL 2016**

A Note From The CEO

Hugh Titcomb
Chief Executive Officer

As the recently appointed CEO of Thomas Miller Investment, I am delighted to introduce the latest edition of our Investment Quarterly publication. There is no doubt the past quarter has presented its challenges with stock-market weaknesses being a feature, particularly in February. Notwithstanding, the markets have recovered significantly with both the UK FTSE All Share index and the US S&P index showing positive positions year to date (at the time of going to print).

This publication includes commentary on our investment strategy and our views on the investment outlook, along with commentary on a number of related topics. I do hope you find the content of interest and please do not hesitate to contact us for any further information.

On a personal level, I joined the business in January this year having pursued a leadership career within the investment, wealth management and banking sectors. I have spent the past few months reviewing and digesting the service we offer to our clients and am truly excited by the prospects ahead as we continue to develop this service going forward.

Contents

Investment Strategy Overview	2
Fixed Interest	4
Equities	5
Alternatives	6
Area of Focus	7
EU Referendum	8

Investment Strategy Overview

In the first few weeks of 2016, the combination of uncertainty about the health of the global economy, fears about the solvency of European banks and concerns about the outlook for corporate profits triggered a sharp sell-off in risk assets.

Facing double-digit declines by mid-February, investors could have been forgiven for fearing the worst, cutting back on risk assets (such as equities, alternatives investments and corporate bonds) and shifting into risk-off mode.

However, a closer examination of the data available in early 2016 indicated that the sell-off had more to do with a temporary deterioration in investor sentiment than any material new negative information about the outlook for the global economy or financial markets. In the end, a combination of more upbeat economic reports and new stimulus measures by major central banks helped to stem the tide of pessimism and spark a broad-based recovery in risk assets from mid-February through the end of the quarter (see Figure 1 below).

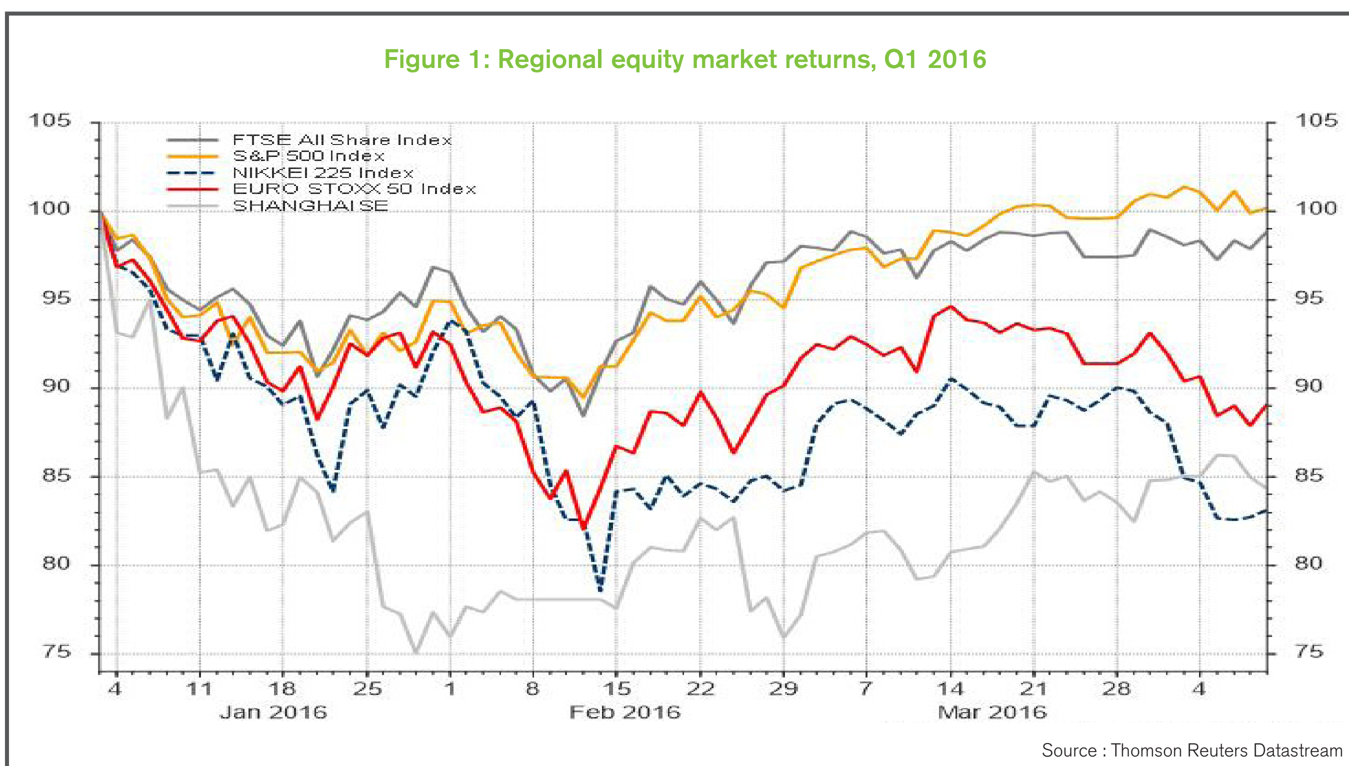
By the end of the quarter, the US S&P 500 index had moved into positive territory for the year and the UK's FTSE All Share index was not far behind. Supported by weakness in the US Dollar and favourable valuations, emerging market assets (both equities and bonds) led the rally. In a move that made a mockery of widespread investor expectations, Eurozone and Japanese equities lagged over the quarter despite further monetary stimulus measures by the respective central banks.

Perhaps key among the more upbeat economic reports in the latter part of the quarter was the upward revision to US GDP growth for the previous quarter. The data was revised to 1.4% having originally been reported as 0.7% in the first estimate. The revision was consistent with more recent reports elsewhere (e.g. labour market and manufacturing sector) which have, on balance, been stronger than consensus forecasts. Recent economic reports from the UK and Euro-zone have also been more upbeat, with stronger than expected GDP and industrial production numbers respectively.

It is noteworthy that while a rebound in economic activity has helped to steady investors' nerves, there has been little evidence in the past few weeks to indicate a meaningful change in the fundamental picture. Examining the trend in growth rates by comparing the last two quarters, the available data shows that growth of real GDP has eased across the G20 area. The recent changes in GDP growth rates are illustrated in Figure 2 overleaf.

As Figure2 illustrates, the majority of G20 countries experienced a slowdown in the pace of GDP growth over recent months.

Figure 1: Regional equity market returns, Q1 2016



Source : Thomson Reuters Datastream

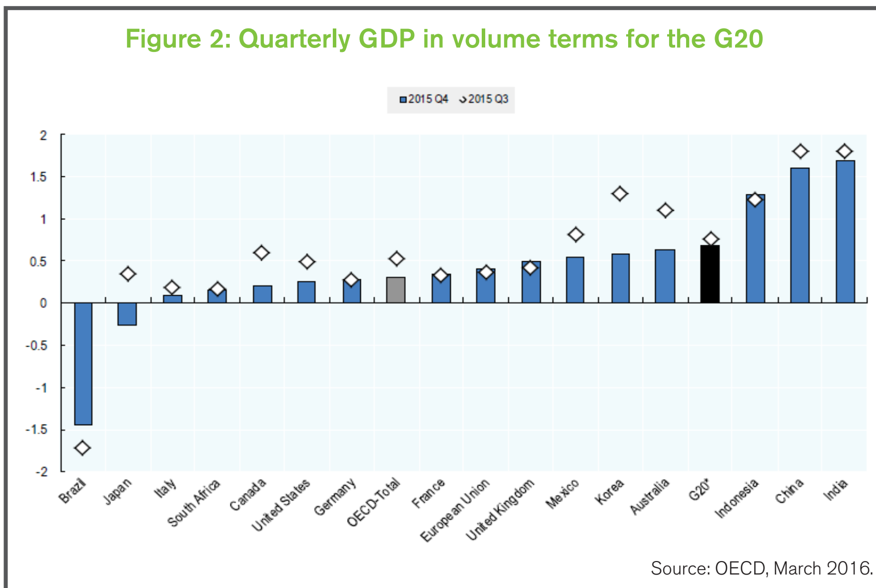


Figure 2: Quarterly GDP in volume terms for the G20

Source: OECD, March 2016.

Investment Strategy Summary

Looking ahead, as has been the case for the past few months, key leading economic indicators continue to project modest pace of global economic growth, with easing growth momentum in some key regions. Additionally, corporate profits look set to remain under pressure and, in the absence of considerable improvements in fundamentals, current valuations will present challenges to further notable upside in risk assets from current levels.

Furthermore, as we approach the low-volume summer months, political risks will come to the fore, beginning with the UK Referendum and, later in the year, the US Presidential Elections. These events are likely to introduce volatility and downside risks to financial market returns in the months ahead.

One implication of this lacklustre growth environment is that monetary policy is set to remain largely accommodative for some time. As afore-mentioned, several key central banks (such as the European Central Bank, the Bank of Japan and the People's Bank of China) remain in easing mode and the US Federal Reserve Bank has also dialled back on its forward guidance on the likely pace of rate hikes in 2016. This should boost financial markets.

In light of the prevailing economic and financial market conditions, investors should continue to err on the side of caution and focus on maintaining asset allocation that is consistent with their longer term investment objectives. Consequently, having taken short term tactical opportunities to add to risk exposure in mid-February, our client portfolios are now back in line with longer term target weightings to the major asset classes. The expected increase in market volatility in the weeks and months ahead will provide further opportunities to vary risk exposure as we seek to enhance investment returns.

Abi Oladimeji
Head of Investment Strategy

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD (as at 7th April 2016)

	United States	Euro-Zone ex UK	United Kingdom	Asia ex Japan	Japan	Emerging Markets
Equities (overall)	0					
Equity allocation by region	0	0	0	0	0	0
Bonds (overall)	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					

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

Fixed Income Finishes the Quarter Strong

Fixed income securities enjoyed another strong start to the year, with yields globally revisiting levels that would never have been thought possible a few years ago.

Whatsmore, all sectors of the fixed income market enjoyed the rally, whether governments, investment grade, high yield and even – in March – Emerging Market bonds.

Indeed, March saw a huge turnaround in some of the riskier areas of the bond market, with corporate bonds and Emerging Market bonds staging a significant catch up rally, with Emerging Market currencies enjoying one of their best months ever, the JP Morgan Emerging Market currency index rallying 5.5%.

However, the quarter started rather differently (as with the equity markets), and it was only the highest quality bonds in favour in January and the early part of February. Risk aversion rose and a 'flight to quality' ensued, as market chatter turned to the possibility of a recession in the US.

The FTSE All Gilts index rose 4.6% over the quarter, with the 5-15 year index up 4.2% and the 0-5 year index up 1.4%.

Gilts peaked on February 11th – on the same day that equity markets bottomed (no coincidence there). They did well to hang on to most of their gains during March when risk assets began rallying again.

Investment grade corporate bonds also had a good period, though they lagged government returns.

Sterling investment grade corporates returned 2.8% over the quarter, with much of this coming in March. The spread over governments, which had been as wide as 180 basis points at one point in February, narrowed to 140 by the end.

In terms of sectors, financials in particular suffered in January, with a near panic out of so-called Cocos, or Additional Tier 1 bonds, which can be converted into equity in certain circumstances. However, even these had recovered most of their losses by late March. Deutsche Bank's affirmation in February that it had enough money to pay interest on its Cocos, and its offer to tender back some of its senior bonds, helped sentiment in this respect.

"All sectors of the fixed income market enjoyed the rally, whether governments, investment grade, high yield and even – in March – Emerging Market bonds.."

In the US, Treasuries did not quite match the gain in Gilts given the lower duration of the index, returning 3.1% over the quarter.

Coincidentally, and rather unusually, the Barclays High Yield index returned exactly the same over the period (also 3.1%). This represented a good recovery given the index was down 5% at one point in early February as the oil price plummeted to $26 and the prospect arose of a big spike in the default rate.

The bottoming in commodity markets largely fuelled the rally, with oil, copper and iron ore prices all making strong gains over the period from lows reached in either December, January or February.

Other than commodity markets, the other catalyst for gains in high yield and Emerging Market bonds was the Federal Reserve meeting of March 16th, when the central bank not only kept rates on hold, but slashed their 'dot plot' of projected rate rises for the remainder of the year. The Fed now expects just two rate rises in 2016, rather than the four that had been expected as late as December. The meeting was deemed to be one of the most dovish in recent years, and helped to ease strength in the US Dollar, which has been a big headwind to Emerging Markets and to the US manufacturing cycle over the past 18 months.

Elsewhere in the world, yields ground down to new, unconscionably low levels, the Japanese 10 year yield falling to a negative -10bps, the Swiss 10 year yield to a negative -38bps, and the 10 year Bund yield dropping to a mere 16 bps: still positive, but not far off the levels it reached in March last year.

The introduction of negative deposit rates in Japan, and further easing by the ECB on March 9th were the catalysts for this. The ECB reduced the repo rate, the deposit rate and the marginal lending facility, discussed further TLTROs and stepped up its asset purchase scheme by a further €10bn per month to €80bn from €70bn.

Following this, the quantity of negative yielding, high quality bonds in the Eurozone grows ever larger.

James Penn
Senior Portfolio Manager

A Flat Start to the Year for Equities

On the 31st December 2015 the FTSE100 closed at 6242.32: three months later it was 6,174.90. Allowing for dividends, this equated to a gain of +0.15% over the first quarter. With risks finely balanced, it is perhaps to be expected that equities were effectively unchanged over this time frame. Indeed, compared to other asset classes in 2016, equity returns look quite dull.

Except, of course, this isn't the whole story – on the 11th of February the index closed at 5,536.97. So the quarter actually saw a decline of over 11% in a little over five weeks before this was reversed in the second half of the period. Day-to-day and even intra-day movements of many individual stocks were abnormally high and this pattern was broadly repeated across most major markets. Oscar Wilde described a cynic as someone who knew the price of everything and the value of nothing. I wonder what he would have made of markets which found assessing fair value to be such a challenge.

In simple terms, the price of an equity should theoretically approximate the current value of its future cash flows appropriately discounted to reflect the required rate of return of that equity. The sell-off indicated either the market's expectation that future cash flows would fall (i.e. corporate earnings would be lower as growth disappointed) or that perceptions of risk had sharpened (a higher rate of return was required and those cash flows thus subject to greater discounting), or a combination of the two.

What I think is still quite surprising, though, is the magnitude of the moves in both directions and the speed with which markets then turned and recovered. This perhaps suggests a third factor to consider – that markets just aren't as good a discounting mechanism as some models suggest and are, at times, quite inefficient.

Initially, markets were preoccupied with a deteriorating economic outlook in the US and China; with diverging central bank policies, the strong US Dollar and the impact on emerging economies; and with the continuing decline of commodity prices. Oil in particular came under scrutiny given the rising risk of loan defaults in the energy sector. As the quarter moved on, the price of oil began to recover, monetary policy remained supportive and economic data began, if anything, to surprise on the upside.

So on a fundamental level there was clearly some reassessment of risk and return but this looks to have been magnified by momentum and sentiment (or greed and fear). I am sure technical factors played a part too; program trades perhaps exaggerated the down draft and short covering may well have led to a sharper recovery. Responding to every nuance in central bank communiques remains a popular, if unproven, investment strategy.

The simple answer may just be that markets over-reacted to a few weeks of poor news-flow. There certainly seemed to be a disconnect in early February between what they seemed to be pricing in (a US recession) and what fundamentals were indicating (lacklustre but positive growth, that was likely to pick up as the year progressed). Perhaps an air of cynicism will pervade markets for as long as they remain overshadowed by an experimental monetary framework.

Andrew Taggart
Senior Portfolio Manager

Convertibles: Not Just for a Sunny Day

Bond yields are at exceptionally low levels, equity markets are certainly not cheap and volatility is increasing.

The looming spectres of Chinese growth concerns, declining energy prices and the prospect (albeit diminishing) of interest rate increases are causing financial markets to be a precarious place to inhabit. Against an increasingly uncertain backdrop any asset which offers a degree of asymmetry in its return profile is an intriguing proposition.

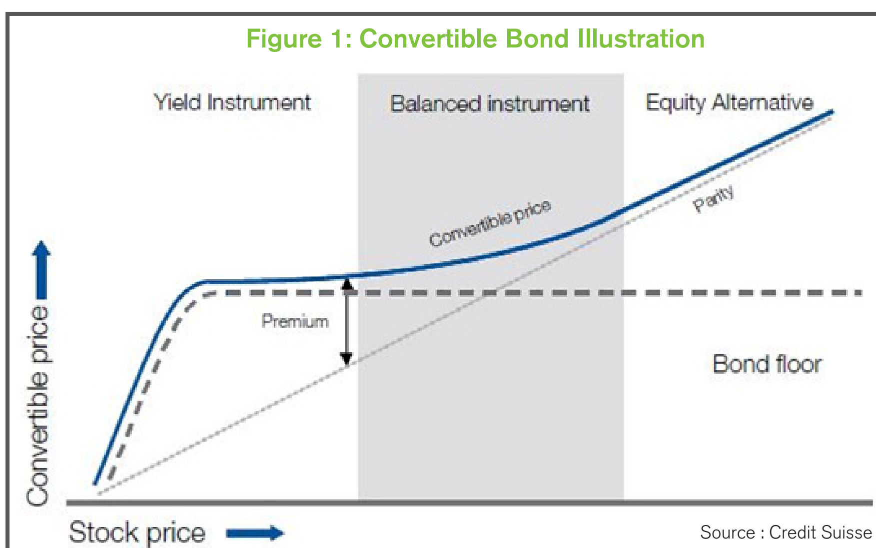
Convertible bonds arguably provide this asymmetry. They offer investors an exposure that combines features of both debt and equity. Similar to a traditional corporate bond, convertible bonds pay a fixed coupon and have a fixed maturity. Unlike a traditional corporate bond they contain an embedded option which gives the holder the ability (but not the obligation) to convert their bond into a pre-determined number of shares of the underlying company at a given price. When the value of the equity is far from its conversion price the convertible trades much like a traditional bond. As the underlying equity begins to increase so too does the value of the embedded option and the convertible takes on more equity like characteristics. Figure 1 depicts this graphically.

This is an attractive combination of features. Asymmetry is often considered the holy grail of investing. The rising value of the convertible in rising equity markets provides investors with upside participation. In declining markets the bond aspect acts as a floor below which the value of the asset cannot typically fall. Asymmetry is a key driver in generating stable long term returns.

"Overall we feel that convertible bonds can bring some benefits to a balanced portfolio."

What is crucial in capturing this asymmetry is the discipline in rotating from convertible bonds that, having risen in value, are trading as an equity alternative and into those which are trading either as a yield instrument or a balanced instrument.

Figure 1: Convertible Bond Illustration



Source : Credit Suisse

There are also reasons why convertibles, given current market conditions, are attractive beyond their intrinsic qualities.

Firstly valuations of convertibles are currently below fair value on average and cheap by historical standards providing an appealing entry point for investors considering an allocation. Moreover the attractiveness of individual convertible valuations is disguised by averages. This dispersion creates opportunities to buy cheap assets whilst avoiding the more expensive issues. All of the above support the case for accessing the asset class via an active manager rather than a passive route.

Overall we feel that convertible bonds can bring some benefits to a balanced portfolio. It then becomes a question of where they fit from an asset allocation perspective. Many would argue that they offer an attractive alternative to equities, others who use them as a means to generate yield see them sitting within a fixed income allocation. For us it makes sense to see them as separate to both and would allocate within an alternative allocation within a balanced portfolio. Whilst it is important to recognise that convertible bonds have a higher degree of correlation to equity markets than some other alternative asset classes, their underlying asymmetry means they can provide investors with a return profile that can be of benefit in all weathers.

Mark McKenzie
Portfolio Manager

Don't Discount Ouija Boards

Ouija boards and Investment Trusts make strange bedfellows. Besides the tenuous fact that they both use 'boards' the similarities are not immediately obvious.

Firstly a caveat to those readers with a penchant for the occult, you may prefer not to read on. Ouija boards work on the fairly simple principal of 'ideomotor movement'. Simply put, by focussing on the idea of movement sufficiently, you end up making an actual movement without consciously realising. This is an interesting psychological phenomenon and one which has, not unexpectedly, parallels with investor behaviour.

Investment trust discount widening (viewed by some as the work of the devil!) was discussed in this quarterly update early last year and this trend has gathered further momentum in 2016. As a brief reminder, this is where the share price of an investment trust moves below the market value of the assets it holds due to a supply/demand imbalance. Last year we offered a variety of reasons why this was happening and the passage of time has allowed further deliberation and clarity.

For many months now there has been a subtle shift in investor psychology. Where buying the dips had become second nature, the average professional investor has now become wary of such reflexive practices. Risk seeking behaviour has receded and risk aversion carries the day. The collective focus on risk aversion by market participants is, I would contend, showing up in the significant widening of discounts across the investment trust sector. These unusually large discounts are the apparition of wide-spread risk aversion if you like. In a similar vein to the ideomotor effect described above, this is not a conscious drive by investors but a side-effect of their current thinking.

On the assumption that this thesis is correct, it begs the question – can such behaviour be used in a predictive way? At extremes I would contend, yes. Take for example Temple Bar, a large and broadly conventional UK equity income trust, managed by Investec's contrarian talent, Alastair Mundy. His value-style has been out of favour in recent years leading to under-performance. I have no doubt Alastair's style will return to favour; what is more interesting is the discount and indeed the magnitude in relation to its history (see the chart below of Temple Bar's discount (red) and premium (green) to net asset value since late 1999). During this period, each and every time the discount has punctured the 10% level a bear market has ensued – early 2000, late 2007 and now Spring 2016. Also noteworthy is the proclivity of the discount to move to a premium near bear market bottoms.

Now, I'm not suggesting that we at Thomas Miller Investment hang our tactical calls on such market factors. However, our understanding of the true dynamics of unusual phenomenon, whether that be Investment Trust discounts or indeed Ouija boards, leads to stronger, more informed, decision making.

Scott Baikie
Senior Portfolio Manager

Figure 1: Temple Bar share price discount/premium to NAV October 1999 to April 2016

Source: Bloomberg

A Brief Overview of the EU Referendum and Implications for Asset Allocation

Introduction & summary of our position

- In a referendum to be held on June 23rd 2016, British voters will be asked: "Should the United Kingdom remain a member of the European Union or leave the European Union?" The G20, IMF and various US officials have highlighted "Brexit" as a key risk facing the global economy. This note explores the implications of either outcome for financial markets and asset allocation decisions.

- In line with the market consensus position, our base case scenario is that Britain will vote to remain in the EU. This is simply an assessment of probabilities and does not rule out the possibility of a "Leave" vote.

What happens after a "Leave" vote?

- David Cameron has said he would trigger Article 50 of the Lisbon Treaty, the formal mechanism for leaving the EU. That would begin a process of complicated negotiations for ending membership which could go on for up to two years. All EU members will need to agree to an extension of this 2-year deadline if that were required.

- It's worth noting that during these two years both the French Presidential Election and German Federal Election will take place. Political posturing may thus be expected to complicate the negotiation process.

- Proponents of Brexit have suggested an alternative in which Parliament could repeal the 1972 European Communities Act to achieve a de-facto exit.

- A leave vote will herald a period of political upheaval in the UK. For instance, it could trigger a Conservative leadership challenge. It is also likely to lead to calls for a new Scottish Referendum.

What are the financial market implications of a "Remain" vote?

- Investor positioning data currently shows historically high levels of GBP short positions. A vote for the status quo will restore investor confidence and likely trigger short covering which could result in a sharp rally in sterling. The combination of ongoing expectations for low interest rates and record current account deficit will keep a lid on sterling's upside in this scenario.

What are the financial market implications of a "Leave" vote?

- While the longer term implications of a Leave vote for the British economy are highly uncertain, there is little doubt that the shorter term implications are largely negative.

- The UK currently runs it largest peace-time current account deficit on record. It is worth noting that much of this deficit derives from trade with EU partners.

Below, we note some plausible financial market implications of a leave vote:

Currency markets:

- The negative current account balance leaves the UK heavily dependent on foreign capital to finance its deficit. This leaves the country vulnerable to changes in investor sentiment.

- In the worst-case scenario, Brexit could trigger a sharp sell-off in the trade-weighted value of sterling and lead to a full-blown sterling crisis.

Bond markets:

- Sterling corporate bonds may suffer as UK companies (and possibly the country) could face ratings downgrades.

- Gilts could remain well supported through a combination of likely central bank buying and safe haven demand [other safe havens such as gold are also likely to rally].

- All else equal, other developed market government bonds (particularly US Treasuries) will rally in this scenario.

- A sharp decline in sterling will trigger inflation concerns further down the line [and potentially increase the attractiveness of index-linked gilts].

Equity markets:

- The impact will vary by sector and market cap.

- Due to higher diversification of sources of revenues, large cap stocks should outperform their small/mid cap counterparts.

- Sectors with heavy UK exposure such as house-building and retail are likely to underperform the broader market. Defensive sectors such as utilities should hold up better.

- Euro-zone equity markets will also suffer.

- Overall, both UK and Euro-zone equities will lag the US markets but we're likely to see broad-based risk aversion across financial markets.

Monetary policy:

- The Bank of England may well have to intervene in the currency or government bond markets or in both markets.

- The Bank of England may be inclined to leave interest rates on hold for longer in an attempt to contain the economic fallout but pressure from weak sterling could force market rates higher. The BOE will face a difficult choice.

- In the worst case scenario, the Bank of England may be forced to raise interest rates in an attempt to stem the flight of foreign capital.

- Other major central banks may be more inclined to maintain accommodative monetary policy settings in the immediate aftermath of a leave vote. The US Federal Reserve Bank in particular may point to this "international development" as an excuse to delay further policy tightening in June.

Investment strategy & portfolio positioning:

- While it is tempting to try to pre-empt the outcome of the referendum and position portfolios for a particular expected outcome, the prudent course of action in the run up to the vote is to maintain positioning in line with long term asset allocation consistent with our clients' investment objectives (i.e. "neutral").

- For UK investors, a key part of this long term strategy is to maintain broadly diversified portfolios with global exposures that mitigate the EU/UK—specific downside risks of the Referendum.

- Non-sterling base currency clients with exposure to sterling assets (such as specialist insurers with sterling liabilities and assets) should maintain sterling hedges to mitigate the downside risks to sterling.

- The situation remains very fluid and highly uncertain. Post referendum, we will tilt our strategy to reflect the financial market expectations outlined above, while responding to any new developments. Indeed, the initial market reaction may throw up unanticipated opportunities as markets could overshoot.

THOMAS MILLER INVESTMENT

London
90 Fenchurch Street
London
EC3M 4ST
Tel +44 (0) 20 7204 2200

Birmingham
2nd Floor
Trigate Business Centre
210-222 Hagley Road West
Birmingham
B68 0NP
Tel +44 (0) 121 222 5070

Edinburgh
46 Charlotte Square
Edinburgh
EH2 4HQ
Tel +44 (0) 131 220 9310

Southampton
Maritime Walk
Ocean Village
Southampton
S014 3TL
Tel +44 (0) 23 8088 1836

Isle of Man
Level 2 Samuel Harris House
5-11 St Georges Street
Douglas
Isle of Man
IM1 1AJ
Tel +44 (0) 1624 645200

Thomas Miller Investment Ltd's Bespoke DFM service has been rated 5 Star by Defaqto.

CONTACT US

For more information on Thomas Miller Investment, our Funds and services please contact in the first instance:
Laura Dalton, Marketing Manager, on +44 (0) 1624 645200
tminvestment.com

Clients are advised that the value of all investments can go up as well as down. Any past performance or yields quoted should not be considered reliable indicators of future returns. Opinions, interpretations and conclusions expressed in this document represent our judgement as of this date and are subject to change. Furthermore, the content is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or a solicitation to buy or sell any securities or to adopt any investment strategy.

Thomas Miller Investment is the trading name of the businesses in the Thomas Miller Investment Group. Thomas Miller Wealth Management Limited is authorised and regulated by the Financial Conduct Authority (Financial Services Register Number 594155). It is a company registered in England, number 08284862. Thomas Miller Investment Ltd is authorised and regulated by the Financial Conduct Authority (Financial Services Register number 189829). It is a company registered in England, number 2187502. The registered office for both companies is 90 Fenchurch Street, London EC3M 4ST. Thomas Miller Investment (Isle of Man) Limited is licensed by the Isle of Man Financial Services Authority. It is a company registered in the Isle of Man, number 48181C. The registered office is Level 2, Samuel Harris House 5-11 St Georges Street, Douglas, Isle of Man, IM1 1AJ. Thomas Miller Investment is a registered business name of Thomas Miller Investment (Isle of Man) Limited. Telephone calls may be recorded.