THOMAS MILLER INVESTMENT

IQ4

Global market intelligence, critical analysis and investor briefing

Investment Quarterly **JANUARY 2016**

A Note From The CEO

Mike Balfour
Chief Executive Officer

Firstly I would like to take this opportunity to wish you a very Happy New Year and thank you, our clients and business friends, for your support during the past year.

It has been another exciting and busy year for Thomas Miller Investment as we continue to grow our core business offerings of investment and wealth management for private and institutional clients across the UK, Isle of Man and internationally. It has also been a great year for our Collective Investment Funds business, where we continue to develop our fund range and offering. In the UK, we have successfully completed the integration of the Broadstone business and now have wealth management teams based in London, Southampton and Birmingham. We are delighted with the progress the team have made and how well they have complemented and enhanced the already established TMI business.

Our latest Investment Quarterly provides you with a number of interesting articles reviewing the major asset classes and providing you with our outlook for 2016.

We are looking forward to2016 with great enthusiasm and as always our primary goal is on meeting your specific objectives, whilst providing you with exceptional service.

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Investment Strategy Overview

Global economic reports over the past quarter have confirmed the trend of weakening growth momentum that has been in place since the end of the second quarter of 2015.

In the US, incoming data suggest that fourth-quarter GDP growth slowed to around 0.5% to 1.5% annualised and the manufacturing sector is now in recession. On a brighter note, headline labour market data remains impressive, with the main unemployment rate now standing at a multi-year low of 5%. Still, the absence of any notable upward pressure on wages suggests that the labour market is not quite as robust as the headline data might suggest.

In the UK, a raft of disappointing official data towards the end of 2015 meant that growth for the year was below consensus forecast. Notably, survey evidence so far in 2016 have been equally downbeat. This suggests that the UK economy should experience a muted pace of growth over the next few quarters. Elsewhere in the major developed markets, the Japanese economy continues to struggle and investors anticipate further efforts to stimulate growth by both the Bank of Japan and the Abe government. As we have noted in recent months, the Euro-zone remains the only major developed area that is currently experiencing strengthening growth momentum. Nevertheless, in light of the exposure of the German economy to China, the durability of the ongoing recovery in the Euro-zone economy cannot be taken for granted.

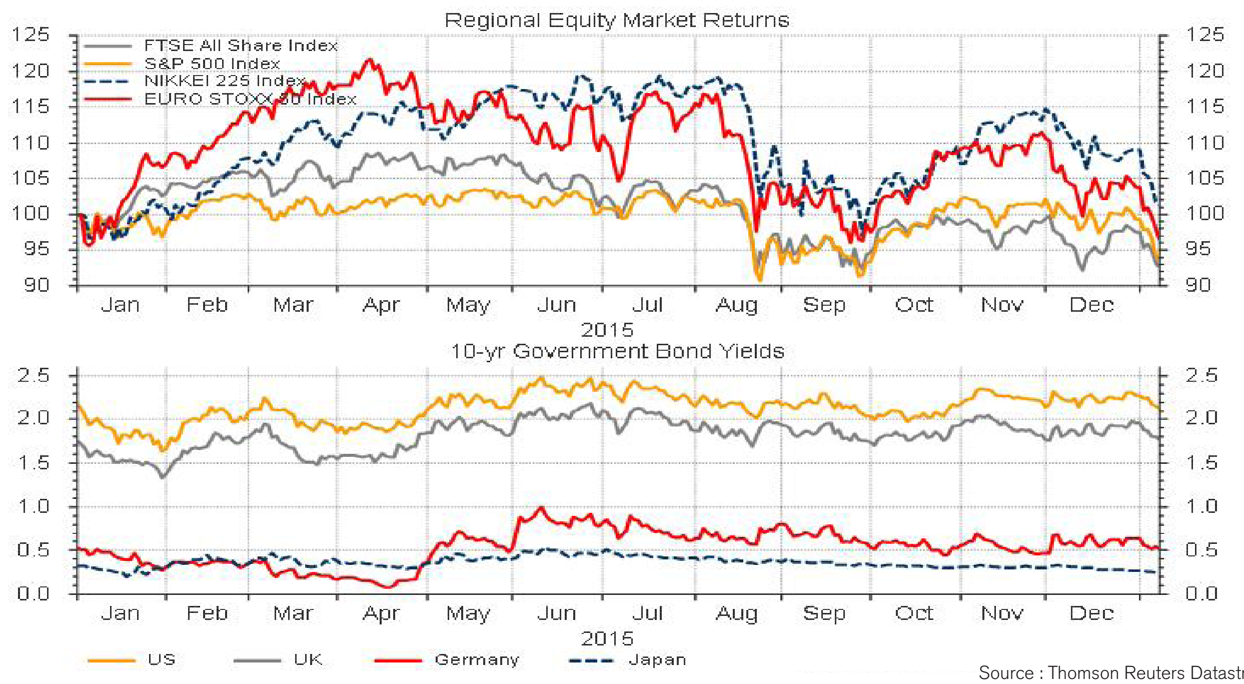
Beyond the developed markets, India remains the flag bearer of the major emerging economies while Russia and Brazil continue to lag. In China, there are tentative signs of stabilization in the shorter term cyclical outlook although significant longer term structural challenges persist.

Overall, the evidence point to ongoing softness in the pace of global economic activity. An important cause for concern is the fact that key leading economic indicators point to a deteriorating outlook in the US and UK—two economies that have led the global economic performance over the past couple of years. This suggests that the risks to the already modest outlook for global growth in 2016 are skewed to the downside.

Market Outlook & Investment Strategy

For bond investors, the key consideration will be whether or not the ongoing economic slowdown morphs into something more sinister. That will in turn determine whether or not the Fed hikes at a faster or slower pace than markets currently expect. On balance of evidence, we currently do not expect a significant rise in bond yields in the year ahead. Indeed, bond yields should face downward pressure from the combination of weaker than expected economic growth, lower than expected inflation and lower debt

Figure 1: Performance of key financial markets in 2015



Source : Thomson Reuters Datastream

issuance.

In the currency markets, the main trend remains one of US Dollar strength. That is likely to persist for a while. However, in a pattern consistent with historical precedent, we expect the dollar's strength to fade over the next few months as the Fed gets into the swing of raising interest rates. The uncertainty surrounding the forthcoming referendum on Britain's continued role in the EU has meant that sterling has come under heavy pressure in recent weeks. A clear resolution of that uncertainty is required for sterling to stage a sustained recovery from current levels.

The strong rally in equities since 2009 has been fuelled by three key factors: monetary policy stimulus, expansion in valuation multiples and rising corporate earnings. Each of these factors now appears to be at an inflexion point which could turn them from tailwinds into headwinds for risk assets.

First, the tone of monetary policy in the US (a key determinant of global market trends) is now less accommodative. This could mean lower liquidity across the financial markets. Second, the start of a Fed tightening cycle typically causes investors to reassess valuations. Over the next year or so, a contraction in multiples to the tune of about 10% will be consistent with historical precedent. This will present a significant challenge to the longer term uptrend in equity markets. Third, in previous cycles, interest rates have risen in the context of a strengthening economy which has in turn led to rising corporate earnings and stronger margins. Unfortunately, earnings have been weakening in recent months while reported corporate operating margins are near historical highs. This suggests that, unlike in previous tightening cycles, earnings are unlikely to grow at a sufficient pace to outweigh the impact of multiple contraction and lower liquidity in markets.

On balance, the evidence suggests that a defensive bias is the most appropriate stance for investors to adopt at this point. For all but the most risk tolerant investors, that should mean not straying far off long term strategic asset allocation weightings to the major asset classes. We expect financial markets to be very volatile in the year ahead and that will throw up attractive opportunities to raise allocation to risk assets over the course of the year. But for now, investors need to be cautious and patient.

Abi Oladimeji
Head of Investment Strategy

Monetary policy in the US

Ahead of the decision by the US central bank (Fed) to begin raising interest rates in December 2015, we argued that the prevailing economic backdrop did not warrant a tighter monetary policy environment. We retain that view. Fundamentally, central banks should tighten monetary policy to curb the excesses of an overheating economy facing the risk of a significant rise in inflation. At this point, the US faces neither the challenge of an overheating economy nor the risk of escalating inflationary pressures.

Importantly, in raising interest rates in December, the Fed also flagged its intention to do so on several occasions this year, for a combined total of about 100 basis point hike in 2016. The issue is not whether or not the US economy can cope with a few basis points hike in interest rates. Indeed, US monetary conditions have tightened in recent months via higher real rates, stronger US dollar and wider credit spreads.

What should give the Fed pause is the asymmetry of the risks that the US economy faces: the threat posed by unanticipated inflation pales in comparison to the danger of stunting growth. The risk of a major policy error has not been greater since the end of the Great Recession.

ASSET ALLOCATION

TMI ASSET ALLOCATION SCORECARD

	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.

2015 Fixed Interest Wrap-Up

Looking back at 2015, bond investors will feel a little more satisfied than equity investors, but perhaps not a great deal more so. In years when equity markets disappoint, bond returns can often be strongly positive.

While bonds did offer positive returns (for both Gilts and corporate bonds, although high yield posted negative returns), it has to be said they were fairly negligible.

Gilts returned 0.56% over the year, while Sterling investment grade bonds managed 0.72%, an excess return of 0.16%. In the final quarter, Gilts lost 1.2% as bond yields globally moved higher. Much of this came in December with a 1% loss.

On reflection, most of the action in the Gilt market occurred back in January, when the oil crash caught the market by surprise and there were fears that the Russian economy might implode. Gilts made big gains in the month, but most of these were lost over the course of the rest of the year.

Interestingly, the shorter dated 0-5 year Gilt index outperformed longer dated indices, rising just under 1% over the year.

The slightly superior return on investment grade bonds was driven by the higher yield offered by corporate debt, as spreads actually widened a little over the year by 20 bps. However, this doesn't give a full picture of what was a volatile year.

Spreads initially tightened from 120 basis points over Gilts in January to 100bps in March, then widened to 157bps by the end of September as previously benign liquidity conditions were severely tested by waves of selling, and as the Chinese devaluation in August raised concerns of a global slowdown or recession.

In the final quarter of the year, spreads tightened and finished the year at 140bps. This is in contrast to the High Yield market where spreads continued widening in the final quarter.

US Treasuries also managed a positive return of 0.88%, though this too was nothing to write home about. The 10 year yield finished the year at 2.27%, having started the year at 2.17%

The final quarter was marked by the first rise in US interest rates since 2006, with the US Federal Reserve hiking the Fed Funds Target Rate by 0.25% to a range of 0.25-0.5% range. Holders of US Floating Rate Notes will be grateful and will see a rise in coupons paid.

Core European yields were little changed over the year, with the short end still deeply negative while the 10 year bund yield rose from 0.54% to 0.63%. Again, this masks a lot of volatility, as the benchmark Bund yield dropped to 7bps in mid-April before staging a savage two month sell off to just under 1%.

"While bonds did offer positive returns, it has to be said they were fairly negligible."

In December the ECB extended its QE programme by six months to early 2017, but otherwise disappointed by not increasing the amount of bonds bought per month.

The US High Yield market lost 4.5%, underperforming US equities, as spreads surged to levels not seen since 2011. Spreads hit 7% in mid-December, and yields briefly touched 9%, driven by distress in the materials and oil & gas sectors where yields reached levels of 14-15%.

Many of the shale oil producers that have emerged in recent years (and which financed themselves largely with debt) have now defaulted.

The extent to which these will be followed by higher profile names remains unclear at present, just as it is unclear how long the oil price and various metal and other commodity prices will remain at current depressed levels.

James Penn
Senior Portfolio Manager

Equity Review 2015

UK Equity markets ended 2015 with a whimper rather than a bang as the final quarter came to a close, though there was a rally in the final fortnight that took capital returns positive for the three months.

The global picture was mixed, with poor performance from emerging markets and many Asia Pacific indices, offset by strength in Europe and Japan. The S&P 500 in the US was up slightly if one includes dividend income while the UK's FTSE 100 was down slightly on the same basis.

What was interesting from a UK point of view was the divergence of performance between the largest 100 stocks and the next 250 stocks by size (as represented by the FTSE 100 and FTSE 250 respectively). While the FTSE 100 dropped nearly 5% in capital terms (1% including dividends) the FTSE 250 rose 8.4% (with dividends adding a further 3%).

There are several reasons for this divergence, but one of the most telling is the sizes of the energy and mining sectors in the indices. The FTSE 100 entered 2015 with almost a quarter of its market cap in these two sectors while the FTSE 250 had only 8%. As a result, as the rout in commodity prices played out in 2015, the larger capitalisation index was hit proportionately harder.

On the flip side of this, consumers were given an unexpected income boost as refinery products fell in price. As the UK market is a much larger proportion of FTSE 250 companies' revenues, this consumer boost was felt more in that index than in the FTSE 100.

Typically, smaller sized companies attract less external investment research and tend to have simpler business models than their larger counterparts. This makes the area attractive to stock pickers for whom analysis is paradoxically slightly simpler but also likely to add more value. This was reflected in underlying performance of both our own UK equity direct holdings, but also in the performance of our selected UK funds. 2016 promises to offer similar opportunity.

As regards 2016, it is difficult to predict where overall markets are going from here. Valuations imply continuing global growth, but leading economic indicators show a weakening of that improvement. The geo-political landscape is still fraught and few of the issues that spooked us in 2015 have truly gone away. Tension remains high in the Middle East, the Russians still threaten Ukraine, and even Greece is not in the clear yet. Add to that the fiscal pressure oil producing countries are under and you have a volatile outlook. Parochially we can add uncertainty about the UK's European referendum into the mix. Despite all of this, as long as we do not see an out and out economic recession equities should hold their own, but we remain vigilant.

Andrew Herberts
Head of Private Investment Management (UK)

"As regards 2016, it is difficult to predict where overall markets are going from here. Valuations imply continuing global growth, but leading economic indicators show a weakening of that improvement"

Opportunities for Alternatives in 2016

2015 proved to be a tough year for return generation across asset classes. Equities barely scraped into positive territory and whilst there was not the dramatic rise in bond yields anticipated by many commentators, bonds did not offer much in the way of positive returns.

Within the alternatives space there were some notable declines but also some brighter notes.

Commodities were broadly routed throughout the year with oil prices dominating headlines. Ultimately significant supply side pressure led to prices falling to levels not seen for over ten years. There was also little relief from the supposed safe haven assets either and gold posted a third straight annual decline in 2015, the longest retreat in fifteen years.

Infrastructure continued to be a well-supported area, with many of the social infrastructure focussed companies in which we invest successfully raising further capital. Within the renewable energy infrastructure space we took comfort from the resilience shown by companies in the face of strongly declining energy prices. The solid performance delivered against a weakening backdrop provided a validation of the operational models to which these companies run.

The upward trend in the UK property market was persistent and the broad market saw gains of 13.5%, with the combination of yield compression and rental growth serving to bolster returns. However the scope for capital appreciation of the magnitude that has been enjoyed over recent years is greatly diminished. This is exemplified in the London office market where city prime yields are currently at 4.0%, some 25 basis points below the 2007 low. Similarly west-end prime yields are at 3.5% matching the 2007 low. These indicate that rental growth will need to be the key driver of future returns.

"We believe that the addition of selected alternatives to a balanced portfolio can improve risk-adjusted returns in the year ahead."

In terms of the outlook for 2016 we anticipate another volatile year where return generation is an ongoing challenge. Within this context we retain our positive bias towards infrastructure which we believe will garner continued support as interest rate rises are somewhat muted and an attractive yield gap will persist. Also for the more risk tolerant we continue to believe that listed private equity is one of the few areas which offers some real value and we anticipate further NAV growth as more realisations feed through from mature underlying portfolios.

Within the UK property market we see potential for the logistics market to outperform. The trend of structural changes in the retail industry, notably the expansion of online delivery services, will continue to drive demand for logistical space in prime locations. The supply constraints in the sector offer strong support to current pricing.

Overall within the alternatives space we continue to see opportunities to add value to a portfolio on both a return generative and risk diversification basis. With bond yields perhaps at risk of a steady, if shallow upward march as we enter a rate hiking cycle and the likely commensurate increase in equity volatility, we believe that the addition of selected alternatives to a balanced portfolio can improve risk-adjusted returns in the year ahead.

Mark McKenzie
Portfolio Manager

Debating Active versus Passive Investment Funds

It has become something of an investment cliché to debate the respective merits of active and passive investing. Suffice to say that both approaches have their advantages and disadvantages and both play important roles in portfolio management and asset allocation.

Investment performance also varies through the cycle as different market conditions favour one approach or the other. Active managers will often outperform in modestly rising markets or when there are clear and sustained trends.

With this in mind, I thought it would be useful to look back and see how the two strategies complemented each other in 2015. Interestingly enough, in an unpredictable environment it was the passive market tracking funds that generally outperformed active managers in the fixed interest space; whereas in the equity universe active managers typically found ways to add value above their benchmark indices.

If we recall the start of 2015, consensus expectations were for a steadily improving macroeconomic backdrop with steady tightening from the United States Federal Reserve and rising government bond yields. As a consequence, the typical active fixed interest manager had a short duration and consequently reduced interest rate risk; but a long credit risk position. The search for value and high income led more than a few active managers to seek increased returns on offer within the sub investment grade, or junk, bond universe.

In the event this active positioning generally detracted value. Global economic data proved mixed, with a China growth scare being partly responsible for the Fed delaying its rate rises until December and the European Central Bank having to turn on its liquidity taps. Whilst government and top quality corporate bonds held their value there was a notable widening of credit spreads (the difference between government and corporate bond yields) and underperformance across the lower rated end of the bond spectrum.

Perhaps cognisant of this relative underperformance, during the second half of the year many active bond fund managers acted to improve the credit quality of their portfolios and moderately increased their interest rate sensitivity. To some extent the horse had already bolted. Most bond funds remain shorter duration than their benchmarks and will continue to underperform passive market trackers should interest rates remain lower for longer.

By way of contrast, active equity fund managers tended to outperform passive market tracking funds with a reduced exposure to the worst hit sectors such as energy and commodity; and a bias toward developed rather than emerging market equity exposure. Despite some heady valuations, growth stocks continued to generally outperform their value counterparts as investors paid a premium to own those businesses still able to deliver in a low growth environment.

Active equity managers were also generally able to exploit last year's best performing growth sectors including technology, healthcare, consumer staples and consumer discretionary. Value stocks were left behind and are now even cheaper on a valuation basis. We remain vigilant to of a future turning point as cheaper valuations combine with an improvement in fundamentals to see a reversal of this relative performance.

Notable features of 2015's equity market performance were the ongoing weakness of the manufacturing sector due to sluggish world trade particularly in the emerging markets; and the resilience of service and consumer driven sectors. The three best performing stocks of the S&P 500 Index were all consumer-oriented stocks: Netflix (online movie rental service), Amazon.com (online retailer) and Activision Blizzard (gaming company). Smaller company equity indices also outperformed their larger counterparts in the United Kingdom, Continental Europe and Japan. Passively managed funds, which generally focus on large capitalisation indices, typically lagged behind the more flexible active managers across these regions.

Finally, gone for the time being are highly correlated 'risk on' and 'risk off' movements whereby similarly themed stocks, sectors and markets move together in tandem. Over recent years, the gap between the best and worst performing bond and equity sectors has widened dramatically. Will the winning themes of 2015 continue to shine in 2016? Will we see a reversal whereby junk starts to outperform high quality bonds; and value starts to outperform growth equity?

What we can say with some certainty is that, in an environment of higher valuations and gradually rising rates, fundamental analysis coupled with market timing should reward most active management styles. Additionally, whatever the outcome, passive funds should remain an intrinsic core of a balanced portfolio providing low cost, diversified exposure and the ability to quickly shift our tactical asset allocation.

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

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