THOMAS MILLER INVESTMENT

TMI Investment Quarterly

July 2012

It was a half of two quarters

After the positive early showing of markets in the first quarter, sentiment deteriorated in the second quarter of the year. Some of the early optimism was shown to have been misplaced, as problems in the Eurozone surfaced once again. The strong rally in equity and credit markets towards the end of 2011 and in the first three months of 2012 petered out, and started to go into reverse towards the end of March.

James Penn
Senior Portfolio Manager

By April markets were clearly on the slide, with the French election result and the collapse of the Dutch government in the latter half of the month demonstrating just how big an impact political developments are having at present. In France, the socialist Francois Hollande beat Nicholas Sarcozy into second place in the primary election, before winning in the run-off. The headline in The Times newspaper was 'Après Sarco, le deluge.' Hollande has a radical agenda, involving a reversal in rises to the pension retirement date, the separation of retail and investment banking functions, and increases in taxes on both companies and the wealthy. He has already reduced the retirement age to 60, reversing the increase to 62 years that Sarcozy had made. While he may temper the aggressiveness of some of his other policies, the risks remain.

On the positive side, he has begun flagging a 'growth agenda', intended to contrast with the current German-mandated policies of 'austerity', or the cutting of government expenditure and reduction of budget deficits. This may have a positive effect on the economic trajectory of the Eurozone, although it is not clear where the money will come from to finance this.

In the Netherlands, the ruling coalition splintered over the imposition of budget cuts, which displays the difficulty in gaining unanimity of decision about the difficult decisions that need to be made in order to restore government finances. There will be a new election in the country in September.

Elections are a theme of 2012. We still have arguably the two biggest to come: the election of the US President in November, which Barack Obama is expected to win, and the replacement of Wen Jiabao in China. But the election that exercised most investors' minds in the last quarter was that in Greece. It is not quite clear in retrospect why this was necessary. The interim technocrat Prime Minister, Lucas Papademos, had been in place for several months and was making progress with the agreed cuts. For better or worse, New Democracy, the Conservative opposition party, insisted on fresh elections. These were held in May and resulted in New Democracy gaining a slight outright win with 18% of the votes. However, Syriza, a completely new, and radically left wing party, completely opposed to the terms of the bail-out agreed at the end of last year, came in a close second. The election also threw up a host of other extremist right and left wing parties. Due to its inconclusive nature, a second election was agreed a month later on June 17th, and thankfully a government was formed with New Democracy gaining 28% of the vote and forming a coalition with Pasok. Some stability has emerged in the near term, but it is still unclear what will happen to Greece in the longer term in terms of whether it remains inside or outside the Euro.

It has been extraordinary what effect this tiny nation, comprising just over 2% of European GDP, has had on the rest of the continent, and on the world economy. But the secondary effects of contagion and capital flight mean that this leveraged impact on the Eurozone is likely to continue. The impact has shown up in the increase in yields on peripheral government bonds, as the initial benefit of the ECB's LTROs wore off. The corrosive effect of the Eurozone crisis has also shown up in a gradual deterioration in data coming out of the United States, with the ISM Manufacturing survey for June coming out below 50 for the first time since 2009. Meanwhile, in China the Manufacturing PMI has fallen for eight successive months as the economy slows.

A recovery in stock markets in June meant that the losses over the quarter were not as bad as initially expected. European markets were down -8.8% and the Nikkei index down -10.7%, but losses in the UK and US were confined to -3.4% and -3.8% respectively.

TMI Asset Allocation Scorecard

	United States	Euro-Zone ex Germany	Germany	United Kingdom	Japan	Asia ex: Japan	Emerging Markets
Equities				+			
Equity allocation by region	+	-	+	0	0	+	+
Bonds				-			
Corporate bonds	++	++	++	++	0	0	+
High Yield bonds	+	0	0	+	0	0	0
Govt guaranteed bonds	+	0	+	+	0	0	0
Index-linked bonds	-	-	-	-	0	0	-
ARFs				0			

The scorecard above presents our current tactical asset allocation position relative to portfolio benchmark. As it shows, we are currently underweight government bonds and overweight equities. We are neutral relative to benchmark in other asset classes including commodities and absolute return funds.

Investment Strategy Overview

Abi Oladimeji
Investment Strategist

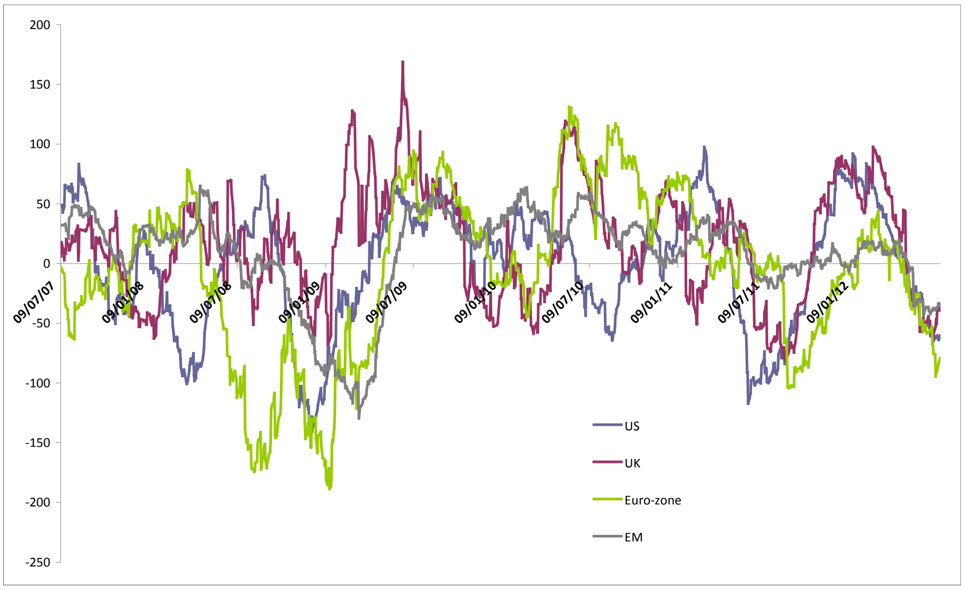
The Economic Backdrop

The second quarter of 2012 was an eventful one. During the quarter, a number of factors dampened investors' appetite for risk. The three most prominent factors were events in the Euro-zone, weakening growth momentum in the US and concerns about an economic slowdown in China. These are discussed in turn below.

Firstly, elections in France and Greece jolted the financial markets and challenged the prevailing Franco-German consensus on the right approach to resolve the ongoing crisis in the region. The political fallout in Greece in particular was a source of anxiety for investors. Investor sentiment was undermined further by renewed signs of stress in the Spanish banking sector and the rise in Spanish bond yields towards 7%. In a widely expected move, the Spanish government sought support for its banking system in June. In Greece, New Democracy's narrow victory in the elections on the 17th of June eased the threat of an imminent and disorderly Greek exit from the Euro-zone. That prompted a relief rally in Greek government bonds, the Euro and risk assets across the board. The rally in equities has been extended on the back of the outcome of the EU Summit at the end of June which managed to exceed low market expectations.

Secondly, US economic releases during Q2 lagged consensus estimates. The series of economic releases that have disappointed have included the report on US Q1 GDP, data on the US labour market and data on the housing market. In the last edition of this report (TMI Quarterly, Q1 2012), we concluded the economic outlook by stating that "…projections of 3%+ real GDP for 2012/2013—and the attendant expectations of monetary tightening by the Fed over the next year—that are now common place in the market are likely to turn out to be extrapolations too far." In recent months, those expectations of a brisk pace of economic growth in the US have been toned down. It is now widely expected that the US Federal Reserve Bank is likely to embark

Figure 1: Citigroup Economic Surprise Indices (US, UK, Euro-zone, EM)



Source: Bloomberg[1]

[1] "The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news, covering all G10 economies. They are defined as weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beaten consensus. The indices are calculated daily in a rolling three-month window. The weights of economic indicators are derived from relative high-frequency spot FX impacts of 1 standard deviation data surprises. The indices also employ a time decay function to replicate the limited memory of markets." Source: Bloomberg

on another round of quantitative easing in a renewed effort to boost economic activity. In June, the Fed announced an extension of 'Operation Twist', its program to extend the average maturity of its holdings of securities.

Citigroup Economic Surprise Indices illustrate the deviation of reported economic data from market consensus estimates. The indices for the US, UK, Eurozone and Emerging Markets (EM) are presented in Figure 1 above. As the chart illustrates, economic releases have consistently lagged consensus estimates across the various economic regions since the early part of 2012.

In addition to a moribund Euro-zone economy and a moderating pace of growth in the US, investors have had to contend with the confirmation of technical recession in the UK.

Finally, recent weak data from China have led to renewed fears of a hard landing in Asia's biggest economy. Data released over the past few months have shown evidence of sluggish loan growth, weakening industrial output and deteriorating trade balance. Furthermore, a vulnerable property sector and softer European demand for Chinese exports pose significant downside risks. However, in our view, China retains the capacity for further substantial stimulus programmes. The government recently unveiled plans to bring forward planned infrastructure investment projects and make available new funds to build affordable housing. A new round of subsidies for consumer goods is also expected.

Given the recent developments outlined above, it is easy for one to get carried away with the gloomy reports. However, just as we were unconvinced by the case for a renewed upswing in economic fortunes at the start of this year, we are also hesitant to draw any firm conclusions from the recent batch of softer economic data. At this point, key leading economic indicators continue to suggest ongoing economic growth in the US, a 'soft landing' in China and a relatively mild technical recession in the UK. Nevertheless, the risks are clearly to the downside and we remain vigilant to any changes in the incoming evidence.

Investment Strategy & Asset Allocation

Three months ago, in the last edition of this report (TMI Quarterly, Q1 2012), we highlighted some short term concerns about the outlook for the equity markets. In particular, we stated that: "our positive medium term stance on equities is tempered by the observation that bullish sentiment is now once again approaching the higher end of short-term, tactical ranges that we monitor." We presented one of our preferred gauges of investor sentiment and contended that:

"the key message here is that bullish consensus in equity markets is now approaching levels that are consistent with temporary market corrections… it suggests caution in the short term as there is now a higher than typical probability of a temporary setback..."

The factors discussed above resulted in a flight to the relative safety of government bonds in the major developed markets. For instance in May, 7-10 year US Treasuries outperformed the S&P 500 index by over 880 basis points. Figure 2 to the right illustrates the difference in performance between equities and bonds in the US, UK and Germany during the second quarter.

It is notable that 7-10 year German government bonds actually underperformed their US and UK counterparts in local currency terms. Overall, the bulk of equity losses were concentrated in Europe. Equity markets have since moved off their May lows with total returns of about 4.1% and 4.9% for the S&P 500 index and the FTSE All Share index respectively (in local currency terms) in June.

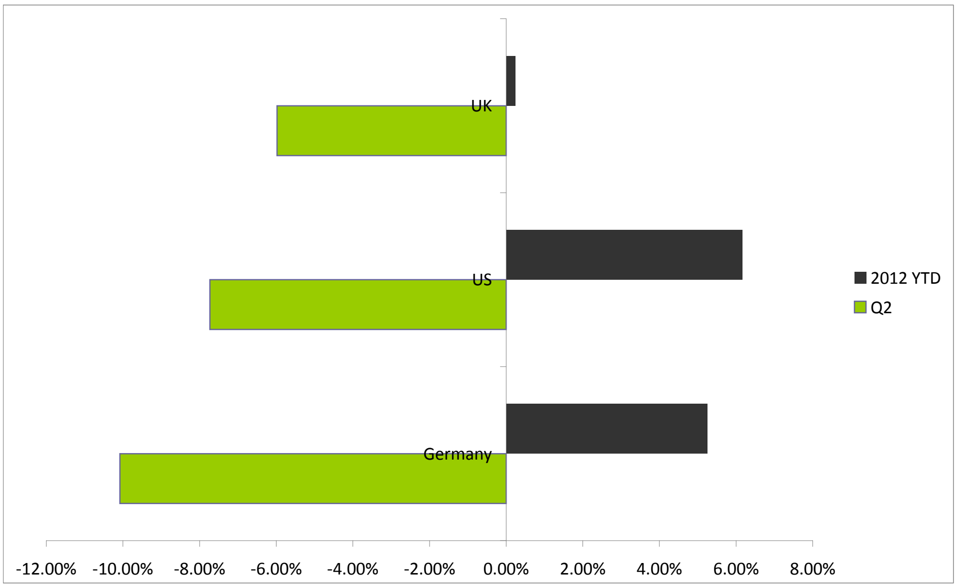
Figure 3 to the right reproduces our analysis of investor sentiment/bullish consensus. The comparison of the recent data (as at late June) with the levels shown in the Q1 (TMI Quarterly, Q1 2012), report indicates that bullish consensus in equities has now been reined in.

In Figure 3, a reading of 100% (0%) indicates that bullish consensus is at the upper (lower) bound of its medium-term range. From the perspective of our tactical investment process, the observed moderation of investor sentiment in equities is a constructive development. In contrast, the increase in bullish consensus in government bonds reinforces our view that government bonds of the major developed markets offer poor long term value at this point. Across the board, real yields remain near historical lows and government debt levels are unsustainable. A brief summary of the drivers of our current asset allocation position is outlined below:

Leading Economic Indicators: the most recent updates of OECD Composite Leading Indicators (designed to anticipate turning points in economic activity relative to trend), suggest a deceleration in growth momentum but nevertheless continue to signal improvements in economic activity in the OECD area.

Valuations: the longer term outlook for government bonds is not particularly favourable. Real yields remain extremely low and sovereign debt levels are unsustainable. In contrast, US, UK and German equities currently trade at attractive yield levels both

Figure 2: Q2 Equity returns minus bond returns, US, UK & Germany, Local Currency terms (%)



Source: Bloomberg

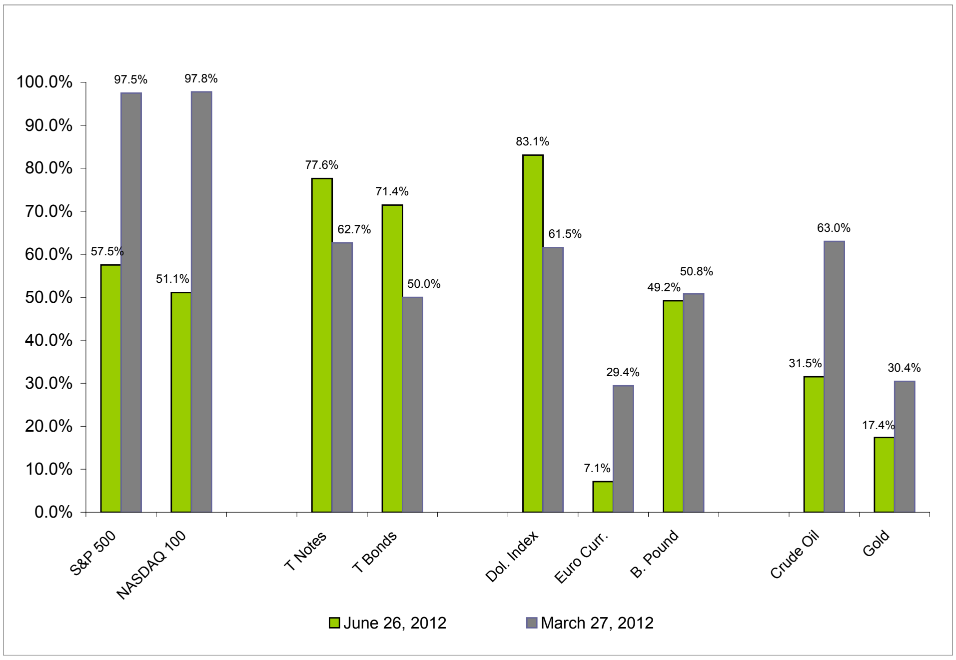
Note: The S&P 500 index is used as proxy for US equities, FTSE All Share index is used as proxy for UK equities and DAX index is used as proxy for German equities. The country-specific Citigroup 7-10 year government bond index is used as proxy for bonds in the three countries.
Source: Bloomberg, TMI.

relative to inflation and relative to yields on long-dated government bonds.

Investor sentiment: At the end of Q1, we highlighted that bullish consensus in equities had risen to levels consistent with short term corrections. More recent readings on Bullish Consensus show that the technically 'over-bought' situation in equities has eased.

In terms of investment strategy, on the basis of the above, we are currently underweight government bonds and slightly overweight equities. We are neutral relative to benchmark in other asset classes including commodities and absolute return funds. In the currency markets, we have moved back to neutral positioning in the Euro, US Dollar, Sterling and Yen. Our current asset allocation is outlined in the scorecard presented on page 1.

Figure 3: Analysis of Bullish Consensus (Late March v Late June 2012)



Source: Market Vane data & TMI analysis

Note: Chart based on data for March 27, 2012 and June 26, 2012.

Historic Market Data

As at 30th June 2012

	Close	1 MONTH	% CHANGE	3 MONTH	% CHANGE	6 MONTH	% CHANGE	1 YEAR	% CHANGE	3 YEAR	% CHANGE	5 YEAR	% CHANGE
FX													
GBP/USD	1.5707	1.5417	1.88%	1.6008	-1.88%	1.554	1.06%	1.6004	-1.86%	1.6004	-1.86%	2.0088	-21.81%
EUR/USD	1.2667	1.2363	2.46%	1.3343	-5.07%	1.296	-2.27%	1.4355	-11.76%	1.4355	-11.76%	1.3541	-6.45%
USD/JPY	79.8000	78.3900	1.80%	82.87	-3.70%	76.910	3.76%	80.96	-1.43%	80.96	-1.43%	123.17	-35.21%
USD/CNY	6.3540	6.3685	-0.23%	6.2985	0.88%	6.295	0.94%	6.4702	-1.80%	6.4702	-1.80%	7.6132	-16.54%
EUR/GBP	0.8064	0.8020	0.56%	0.83269	-3.15%	0.833	-3.24%	0.89691	-10.09%	0.89691	-10.09%	0.6745	19.56%
BOND YIELDS													
US 10 YR	1.645	1.558	0.087	2.209	-0.564	1.876	-0.231	3.031	-1.386	3.533	-1.888	5.024	-3.380
UK 10YR	1.734	1.571	0.163	2.204	-0.470	1.977	-0.243	3.262	-1.528	3.690	-1.956	5.463	-3.729
GERMANY 10YR	1.583	1.200	0.383	1.794	-0.211	1.829	-0.246	2.933	-1.350	3.386	-1.803	4.574	-2.991
JAPAN 10YR	0.837	0.824	0.013	0.989	-0.152	0.988	-0.151	1.090	-0.253	1.359	-0.522	1.879	-1.042
SWISS 10YR	0.665	0.546	0.119	0.866	-0.201	0.663	0.002	1.655	-0.990	2.319	-1.654	3.226	-2.561
US 5 YR	0.718	0.655	0.063	1.039	-0.321	0.832	-0.114	1.579	-0.861	2.555	-1.837	4.921	-4.203
UK 5YR	0.747	0.633	0.114	1.030	-0.283	1.051	-0.304	1.968	-1.221	2.883	-2.136	5.704	-4.957
GERMANY 5YR	0.611	0.337	0.274	0.796	-0.185	0.758	-0.147	2.129	-1.518	2.493	-1.882	4.527	-3.916
JAPAN 5YR	0.220	0.207	0.013	0.318	-0.098	0.349	-0.129	0.390	-0.170	0.725	-0.505	1.478	-1.258
SWISS 5YR	0.078	0.017	0.061	0.258	-0.180	0.158	-0.080	0.888	-0.810	1.416	-1.338	3.053	-2.975
US 2 YR	0.301	0.262	0.039	0.329	-0.028	0.239	0.062	0.473	-0.172	1.109	-0.808	4.858	-4.557
UK 2YR	0.282	0.235	0.047	0.419	-0.137	0.327	-0.045	0.793	-0.511	1.333	-1.051	5.771	-5.489
GERMANY 2YR	0.124	0.002	0.122	0.206	-0.082	0.144	-0.020	1.471	-1.347	1.365	-1.241	4.462	-4.338
JAPAN 2YR	0.114	0.105	0.009	0.118	-0.004	0.136	-0.022	0.165	-0.051	0.320	-0.206	1.025	-0.911
SWISS 2YR	-0.238	-0.217	-0.021	0.046	-0.284	-0.032	-0.206	0.242	-0.480	0.477	-0.715	2.888	-3.126
EQUITIES													
Dow Jones	12,880	12,393	3.93%	13,212	-2.51%	12,218	5.42%	12,189	5.67%	8,447	52.48%	13,409	-3.94%
S&P500	1,362	1,310	3.96%	1,408	-3.29%	1,258	8.31%	1,297	5.05%	919	48.17%	1,503	-9.39%
NASDAQ	2,935	2,827	3.81%	3,092	-5.06%	2,605	12.66%	2,729	7.54%	1,835	59.94%	2,603	12.75%
FTSE ALL-SHARE	2,891	2,767	4.49%	3,003	-3.71%	2,858	1.17%	3,006	-3.81%	2,172	33.12%	3,404	-15.06%
FTSE 100	5,571	5,321	4.70%	5,768	-3.42%	5,572	-0.02%	5,767	-3.39%	4,249	31.11%	6,608	-15.69%
DAX	6,416	6,264	2.42%	6,947	-7.64%	5,898	8.78%	7,170	-10.52%	4,809	33.43%	8,007	-19.87%
NIKKEI	9,007	8,543	5.43%	10,084	-10.68%	8,455	6.52%	9,649	-6.66%	9,958	-9.56%	18,138	-50.34%
Hang Seng	19,441	18,630	4.36%	20,556	-5.42%	18,434	5.46%	22,062	-11.88%	18,379	5.78%	21,773	-10.71%
COMMODITIES													
GOLD	1597.40	1560.43	2.37%	1,668	-4.25%	1,564	2.16%	1,501	6.39%	927	72.39%	650	145.89%
OIL	84.96	86.53	-1.81%	103	-17.53%	99	-14.03%	93	-8.54%	70	21.56%	71	20.20%
S&P GS Soft Cmd	732.74	633.80	15.61%	708	3.47%	695	5.45%	783	-6.42%	564	30.00%	641	14.26%
S&P GS Ind Metals	1493.06	1489.03	0.27%	1,645	-9.24%	1,547	-3.51%	1,909	-21.78%	1,216	22.82%	2,153	-30.65%

Source: Bloomberg

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