THOMAS MILLER INVESTMENT

TMI Investment Quarterly

Q4 2012

Investment Strategy Overview

From a global economic standpoint, the last quarter brought some respite as the tone of economic data improved across several regions. Importantly OECD composite leading indicators, designed to anticipate turning-points in economic activity relative to trend, now point to stabilisation in the pace of economic growth in the OECD area. Nevertheless, the indicators continue to show diverging patterns of growth across major economies, with the Euro-zone remaining a drag on global growth.

For the US economy, 2012 ended in quite the same way it started with data showing broad improvements across the economy. Looking to the year ahead, leading economic indicators suggest a brighter outlook for the US economy. However, better expectations for 2013 carry the caveat of political uncertainty and heightened risk of policy errors. For instance, while one would expect that political self preservation would ensure that a deal to raise the US debt ceiling is reached in February or March, it seems reasonable to expect the negotiations to once again go to the wire. Indeed, the political *danse macabre* in Washington in August 2011 (last debt ceiling negotiations) should serve as a warning from history.

Unlike the US, emerging data suggest that the UK economy lost momentum in the last quarter of 2012. Nevertheless, as with the US, recent updates of the OECD composite leading indicators suggest that the UK should see an upturn in economic growth in 2013. Furthermore, the economy should continue to benefit from very accommodative monetary policy. Balancing that more positive outlook is the UK's susceptibility to further fallout from the Euro-zone crisis or the potential impact of policy errors in the US.

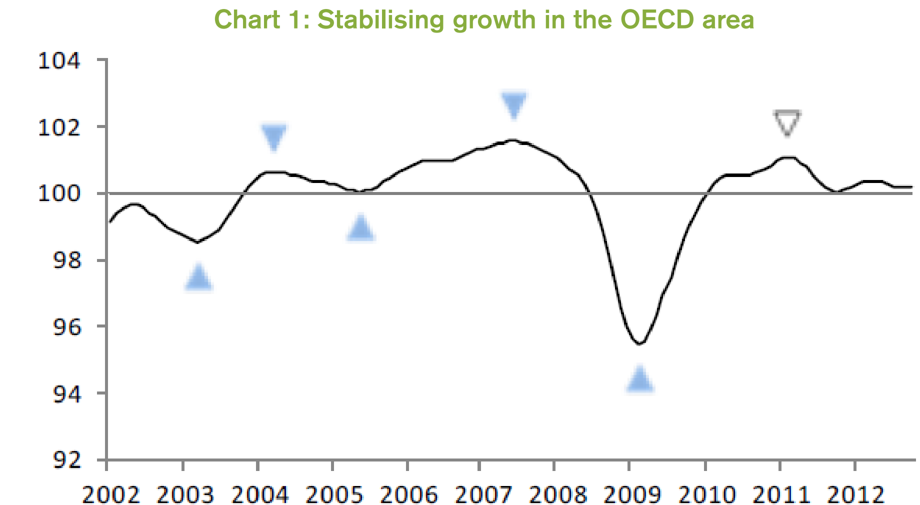
As we have noted in the past, from a valuations perspective, equities continue to offer better long term value relative to government bonds. US earnings are currently forecast to grow by about 6% in 2013 and about 11% in 2014. That puts the S&P 500 index on a price-earnings (PE) multiple of 12x and 11x for 2013 and 2014 respectively. For the UK market (FTSE All Share), earnings are expected to grow by about 5.6% and 10.4% in 2013 and 2014 respectively, implying a PE of 11x and 10x for 2013 and 2014. In light of current strong levels of dividend yields, these forecasts suggest a reasonable outlook for equities over the next year. Barring the potential for economic growth to disappoint, the main source of concern for equity investors is likely to be policy-induced volatility.

While concerns about the economic outlook, political uncertainty and unconventional monetary policy actions by the major central banks mean that bond yields are unlikely to rise substantially in the short term, the reality is that the potential for further capital gains in developed market government bonds is greatly diminished. Indeed, looking beyond the short term, it is reasonable to expect that the bulk of the return from developed market government bonds over the next few years will be coupon income. Chances are that such income will struggle to match inflation, resulting in an erosion of invested capital over time.

Within the fixed income asset class, we remain neutral on index-linked bonds relative to portfolio benchmarks. On the whole, while spreads have tightened in recent months, corporate bonds continue to offer better value than government bonds.

Abi Oladimeji
Head of Investment Strategy

Chart 1: Stabilising growth in the OECD area



Note: The horizontal line at 100 represents the long-term trend of economic activity. The shaded/solid triangles mark historical turning points of the indicator while the blank triangle marks a provisional turning point that may be reversed by the OECD.

Source: OECD, December 2012

TMI Asset Allocation Scorecard

	United States	Euro-Zone ex Germany	Germany	United Kingdom	Japan	Emerging Markets
Equities (overall)			0/+			
Equity allocation by region	+	0	0	0	-	+
Bonds (overall)			0			
Corporate bonds	+	+	+	+	0	0
High Yield bonds	0	0	0	0	0	0
Govt guaranteed bonds	0	0	0	+	0	0
Index-linked bonds	0	0	0	0	0	0
Alternatives (including ARFs)			0			

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

Market Overview

Stock markets ended the year on a positive note, with many major markets registering strong returns for what is still, admittedly, a lacklustre economic background.

Government bond returns were positive, but dull. In the fixed interest space the best place to be was investment grade and high yield bonds, with the latter capping the former for moderately higher volatility. Overall, it represented a complete turnaround from 2011, when government bond markets were the best performers and equities and corporate bonds trailed.

UK Gilts and US Treasuries returned only 2.7% and 1.97% for 2012, while German Bunds outperformed with a return of 4.5%. Intriguingly, this is the first time in a while that the performances of these three markets have diverged to any extent, and reflects expectation that the UK and US will grow at a better pace in 2013. The Bundesbank recently downgraded German 2013 growth to 0.4%, a major slowdown given the economy was growing at an annual 2% pace as recently as Q1 2012.

Peripheral European sovereign bonds were a surprise area of outperformance, given the scares about deficits and funding that have recurred over the past 18 months; they returned 15%. The biggest shock has been the recovery in the Greek government bonds, with S&P recently upgrading them to B- from Selective Default, following savage public spending cuts and a buyback of some of its debt. Yields on 10 year Greek government bonds have fallen to 13% from 35% in June.

Investment grade bonds were generally considered a 'good bet' 12 months ago and did not disappoint, with the Citigroup Dollar investment grade bond index returning 8%. The average yield to maturity has fallen to 2.2%. High yield total returns were better still, with European high yield up 25% and US high yield up 15% for the year. Emerging market local currency debt rose 10% and EM Dollar denominated debt rose 15%.

The FT All Share index rose 12% in total return terms, but performance was skewed towards smaller companies with the mid-250 index rising 24% and the Small Cap index up 25%. In contrast, large caps were muted, although the FTSE100 index still posted a very welcome 10% total return. UK investors were rewarded for remaining invested despite continued economic sluggishness and a "double dip" recession. Perhaps surprisingly, the strongest gains in 2012 were seen from such cyclical sectors as banks (bouncing back from extreme lows), chemicals, general retail, leisure, and property. In contrast, oil & gas and mobile telecoms delivered negative returns, while it was only thanks to a year end rally that miners were able to post a small gain. Previously, mining stocks had been affected by weakness in the Chinese economy.

Having led earlier in the year on better prospects for economic recovery, the S&P500 held onto its gains into the year end, returning nearly 17% on a total return basis, and at 1445 is a little shy of its high reached in September when the Federal Reserve committed itself to more quantitative easing. US stock markets endured a bout of volatility in late October and early November in the wake of hurricane Sandy, which caused severe but temporary disruption to New York, and the re-election of Barack Obama as US President. While Mr Obama was returned on a landslide in the US electoral college, the margin of victory in the popular vote was considerably smaller and raised questions about whether the two major parties in the United States would be able to agree the budget reductions needed to avert the 'fiscal cliff'. In the event, a temporary agreement on tax rises (though not on spending cuts) was agreed in early January, which has helped markets to recover their poise.

The worst two performing US sectors, with negative returns in capital terms, were Utilities, and Gold and Silver miners; given this was a 'risk on' year this is perhaps no surprise, but both sectors have suffered their individual problems: falling power prices as a result of cheap shale gas, and the inability of the precious metal miners to restrain their cost base even in the face of high prices for gold.

The second half of the year saw leadership shift away from the US to European markets. These actually managed to finish the year with slightly better returns in Dollar adjusted terms. Spain was the worst Euro market, mildly negative in total return terms (having been down 20% at one point), but other peripheral markets fared well: Italy rose 10%, Ireland 20% and Greece 30%. The German Dax was up an impressive 30%.

Emerging market performance was varied, with the Hang Seng and broad Asia Pacific indices up 25%. But while India participated in this with a 26% rally, other BRIC nations were lacklustre: Russia and Brazil rose 6% but China finished in negative territory.

It is worth pointing out that most overseas local currency performances were reduced by Sterling's strength over the year. For Sterling investors, this clipped 5% off US and Emerging Market returns, 3% off European returns, and a remarkable 15% off Japanese returns in what was otherwise a good year for the Nikkei index.

James Penn
Senior Portfolio Manager

Historic Market Rates

As at 31st December 2012

	Close	1 month % Change	6 month % Change	1 year % Change	3 years % Change
FX					
GBP/USD	1.6242	1.43%	3.41%	4.50%	0.59%
EUR/GBP	0.8125	0.18%	0.76%	-2.50%	-8.46%
EUR/USD	1.3197	1.62%	4.18%	1.82%	-7.91%
USD/JPY	86.6200	5.02%	8.56%	12.63%	-7.00%
USD/CNY	6.2306	0.06%	-1.94%	-1.02%	-8.74%
BOND YIELDS					
US 10 YR	1.757	0.142	0.113	-0.119	-2.079
UK 10 YR	1.828	0.053	0.094	-0.149	-2.187
GERMANY 10 YR	1.316	-0.070	-0.267	-0.513	-2.071
JAPAN 10 YR	0.791	0.075	-0.046	-0.197	-0.504
SWISS 10 YR	0.526	0.072	-0.139	-0.137	-1.375

	Close	1 month % Change	6 month % Change	1 year % Change	3 years % Change
EQUITIES					
S&P 500	1,426	0.71%	4.70%	13.41%	27.90%
Dow Jones	13,104	0.60%	1.74%	7.26%	25.66%
NASDAQ	3,020	0.31%	2.88%	15.91%	33.07%
FTSE 100	5,898	0.53%	5.86%	5.84%	8.96%
FTSE ALL-SHARE	3,093	0.92%	6.98%	8.24%	12.05%
DAX	7,612	2.79%	18.64%	29.06%	27.78%
NIKKEI	10,395	10.05%	15.42%	22.94%	-1.43%
Hang Seng	22,657	2.84%	16.54%	22.91%	3.59%
COMMODITIES					
GOLD	1675.35	-2.30%	4.88%	7.14%	52.73%
CRUDE OIL - WTI	91.82	3.27%	8.07%	-7.09%	15.70%
S&P GS Soft Cmd	739.75	-5.71%	0.96%	6.46%	20.18%
S&P GS Ind Metals	1568.66	-0.99%	5.06%	1.37%	-8.10%

Source: Bloomberg

Autumn Statement: Continued Tough Times Ahead as the UK Economy Slows

Britain will face economic austerity until 2018. Here, we look at the Chancellor's Autumn Statement, the third since he took office. The Autumn Statement serves as an update on the economy, fiscal progress and the unveiling of new policy initiatives.

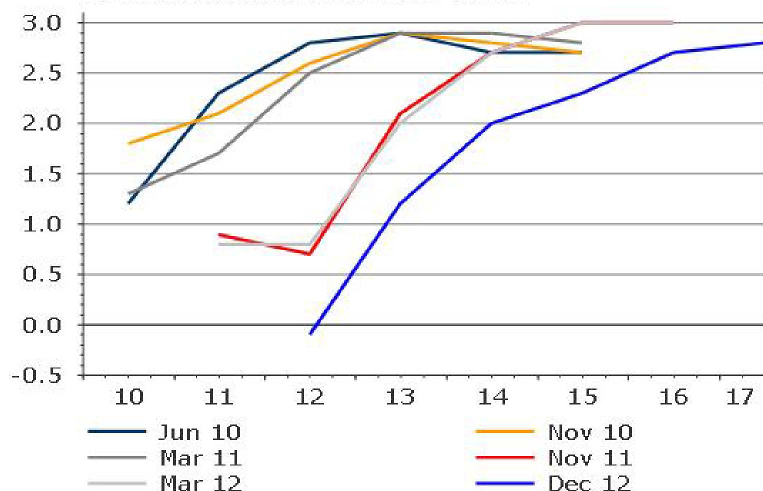
The UK Coalition Government took over a dire situation from the previous Labour government, with borrowing and spending spiralling out of control. Throughout the developed world, both the private sector and governments are struggling to restore financial health. The problem is that balance sheet repair takes time, and debt repayment slows economic growth. Although the repair of household and financial balance sheets is well underway, the UK faces three major hurdles. The UK entered the crisis with banks that were far larger relative to GDP than those of the US or Euro-zone. The slowdown of their international cross border trade has constrained banks at home. Second, the credit bubble saw British households become more highly leveraged than households in any other economy. Finally, the Government had been running deficits for six years before the crisis, which severely constrained the scale and scope of any stimulus. The work-out process is more likely to imply two parliaments of pain rather than one as the Coalition had hoped when it took office in May 2010.

George Osborne faced an enormous challenge when he took over as Chancellor. Economic growth began to slow in 2010 and it has been disappointing ever since. Public borrowing will shrink even more slowly as a consequence of slower growth. Austerity is beginning to seem less like a project but more like a permanent state of affairs. First impressions of the Autumn Statement were relatively favourable, although some have said his actions were not bold enough. The key message is that the Chancellor is sticking to his fiscal consolidation plans, with the period of austerity being extended by a further year.

The Office of Budget Responsibility (OBR) has cut its economic growth forecasts repeatedly It now expects that GDP will be a modest 0.8% for 2012. It has marked down forecasts for each of the next three years by around 0.75%. Meanwhile, the Euro-zone's troubles will persist.

A weaker economy means lower tax receipts which in turn suggest extra borrowing will be needed to fill the gap. A combination of accounting changes and a few windfalls have made it more difficult to determine precisely what the gap really is. One estimate is that the budget deficit will fall from 7.7% of GDP to 3.1% by 2016/17, leaving it 2% points of GDP higher than forecast in March.

Chart 1: OBR UK GDP Forecasts
(Percentage change from year earlier)



Source: Office for Budget Responsibility (OBR), December 2012

Mr Osborne got some relief from the OBR, which put poor growth down to the feeble business cycle rather than a permanent loss of economic potential. He has used this not to raise taxes nor cut expenditure immediately.

The Chancellor did not avoid more austerity. He took money from the better off and those on benefits, whilst trying to preserve the incomes of those in the middle. Welfare payments for working households will be increased by 1% for three years commencing April 2013. That will save £4.4bn a year by 2017/2018. The threshold at which the top rate of tax is paid will also rise by just 1%. This will draw more income into the top tax bracket and raise an extra £1.1bn by 2017/18. A similar sum will be saved by restricting tax relief on pensions. The annual cap on pension contributions will fall from £50,000 to £40,000, and the lifetime limit will be cut from £1,500,000 to £1,250,000, both changes being effective in 2014/15.

There were few sweeteners in the statement. The long delayed rise in petrol duty due to come into force in January was cancelled. The personal tax free allowance will rise £235 to £9,440 next year. On the business side the main rate of corporation tax will be cut by 1% to 21% in 2014. Capital allowances for business investment will be allowable against mainstream liabilities which is hoped will spur business investment near term.

The extra borrowing has hurt the Chancellor's chances of complying with both his fiscal rules. He will hit his primary target, which is that the government must clear the structural deficit in five years. This is defined as the deficit on the Government's current, or day to day budget. To do this he will have to find £5bn extra money by 2017/2018. The OBR reckons the budget will be in surplus by 0.9% of GDP in that year, once the influence of the economic cycle is taken into consideration. Mr Osborne though will not reach his second target to bring down net public debt relative to GDP by the end of this parliament in 2015.

The increase in the public borrowing forecast is making the Fitch credit rating agency nervous. They have suggested that Mr Osborne's decision not to chase the "debt" target weakens the credibility of the fiscal regime, It will conduct a formal review after the Spring Budget.

Speaking at the end of the special Cabinet meeting, Prime Minister Cameron said "Britain is on the right track. We are dealing with the deficit and debts in a fair way. Everyone must make a contribution. We are equipping Britain to succeed in the global race."

Andrew Buchanan
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A Closer Look at Emerging Markets

With emerging market equities and debt having gained 18.5% and 23% respectively in 2012, investor opinion now seems to be evenly split between increased exposure to this growth area or adoption of a more cautious approach to a hot asset class. Whilst favourable demographics, low debt/GDP ratios and relatively cheap currencies provide structural support to continued emerging market growth, as valuations rise the scope for broad market performance reduces and sub-asset class and stock selection become more important.

Let's put things in perspective. Of a world population approaching 7bn, the US and western Europe together account for a mere 770m. Their GDP per head, a very approximate guide to living standards, is three times the world average. Such discrepancies can hardly be expected to last in an increasingly globalised planet and emerging and developing countries now account, for the first time in the modern era, for about half of total world output.

The IMF's World Economic Outlook projects emerging market growth of 5.6% in 2013, down slightly from 2011 but far ahead of the 1.5% growth projected in the 'advanced' economies. Investors are aware that there is a very real shift underway from the old to the new world; not just in manufacturing but now also in the services industries including finance, the sector in which the developed regions have historically boasted a competitive advantage.

Much attention has focussed on China but in a multi-polar world there are many other growing centres of economic power. In addition to the well-known BRICS (Brazil, Russia, India and China) we now also have the MINTS (Mexico, Indonesia, Nigeria and Turkey). More surprising is not the economic catch-up we are seeing but the changed direction of capital flows and hardly anyone foresaw a situation in which the emerging and developing countries would have savings surpluses on which the old industrial world now relies to finance its current account and budget deficits.

Emerging market equity valuations are not particularly stretched following the recent strong run and their forward price-earnings ratio currently stands at around 10, compared to an historic multiple of above 12. Emerging market capitalisations to GDP are also trading a fair way below their historical average, again historically a very good indicator of long-term over or under valuation. Both provide fundamental equity price support in the absence of geo-political shocks to corporate earnings.

Emerging market debt has also had a stellar recent run with each of the sub-components (sovereigns, corporates and local currency) posting double-digit returns in 2012. Following such a strong run, investor sentiment remains positive but is understandably more cautious on what has become an increasingly mainstream asset class. Emerging markets are almost certain to out-grow their anaemic developed counterparts during 2013, but we should not be under any illusions that these countries will completely de-couple from the rest of the world. However, history has shown time and time again that global liquidity is even more important than growth in driving emerging market debt returns and governments and central bank policy remain highly accommodative.

So what does this mean for global emerging market equities and bonds in 2013?

In all likelihood we will get a continuation of anaemic developed but much stronger emerging market economic growth, ample liquidity, continued low interest rates and positive markets. Tail risks including the negotiations on the US debt ceiling and the Eurozone debt-crisis remain. However, we remain positive on emerging market equities over the medium term and superior returns should continue to be generated by those companies with strong business models and which can generate quality growth at attractive valuations. Emerging market government bonds are a mixture of pricey and very cheap but corporate spreads are still wide compared to developed market credit and scope remains for broad market performance. However, those who are selective and nimble should out-perform as yields compress and credit/duration selections are likely to be the main drivers of performance. Stock-pickers will find opportunities in both markets.

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