THOMAS MILLER INVESTMENT

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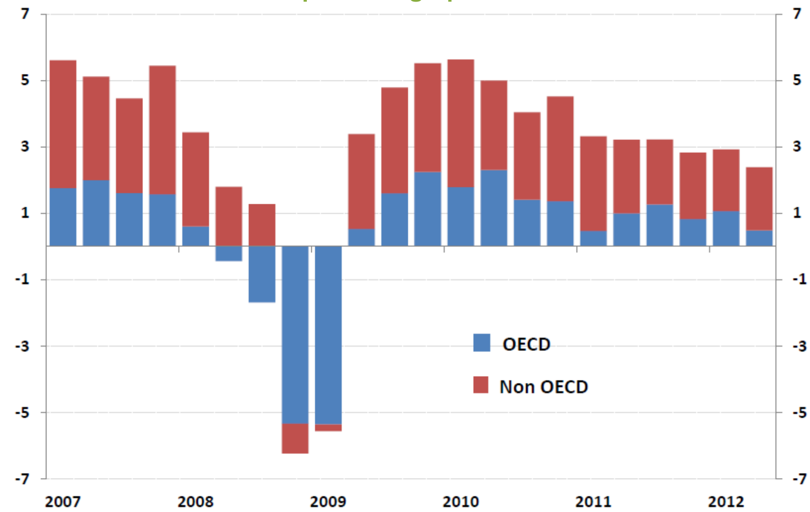
Investment Strategy Overview

Perhaps the most topical theme for debate in the last few weeks has been central bank activism. Many investors and commentators have argued that there is a weaker case for unconventional monetary policy stimulus now compared to previous episodes of quantitative easing in 2008 and 2010. After all, during those two episodes, break even inflation rates were at much lower levels than they are now, indicating that investors are not currently worried about deflation. Others have also noted that the direction of economic data has turned up recently. These arguments miss the broader picture.

While day-to-day economic data can be volatile and inconclusive, the underlying trend in global economic growth has been clear for some time. The data shows that the current pace of global growth is the softest recorded since the recovery began in 2009. The decline in the pace of growth has been pervasive. In the Euro-zone, the periphery remains in recession and the core is experiencing a sharp slowdown which may well turn into outright recession in the months ahead. The UK is in recession—albeit a relatively mild one; and Chinese slowdown is proving deeper and more protracted than previously anticipated. And the US economy has slowed to stall speed.

It is in this broader context that the recent spate of central bank actions must be assessed. Central bankers recognise that the global economy is particularly vulnerable at this point and therefore will do well to avoid a major negative shock over the next few months. Unfortunately, there is no shortage of potential sources of negative shocks in the months ahead. Besides the risks of another flare up in the Euro-zone crisis, a prominent source of concern is the unresolved political risk in the US that may culminate in the 'fiscal cliff'—a combination of tax hikes and deep government spending cuts in 2013.

Chart 1: Contribution to annualised quarterly world real GDP growth, percentage points



Source: OECD, September 2012

While the jury is still out on the impact that central banks' stimulus programmes will ultimately have on real economic activity, their impact on financial markets have been more apparent. In particular, monetary policy actions by the ECB and the Fed have boosted investor sentiment and resulted in sharp rallies in risk assets despite the rather dismal economic data.

Government bonds of the major developed economies continue to offer relative safety and liquidity which makes them attractive to many investors in these uncertain times. However, from a valuations perspective, equities trade at attractive yields both relative to inflation and relative to yields on government bonds. In our view, this makes equities the preferred asset class for long term investors. However, concerns about the short term outlook for equities (given very low levels of volatility and elevated bullish sentiment) tempers the bullish message from relative valuations.

Consequently, we maintain a small overweight position in equities and a slight underweight in bonds relative to portfolio benchmark allocations. Within bonds, we prefer investment grade corporate bonds (selected companies with strong balance sheets) to government bonds. We have a neutral allocation to alternative assets including commodities and hedge funds. We also maintain a neutral stance relative to portfolio benchmarks on the major currencies.

Abi Oladimeji
Head of Investment Strategy

TMI Asset Allocation Scorecard

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

In the second quarter the central bankers, once again, came to the rescue. Both the European Central Bank and the Federal Reserve committed to further monetary loosening. The result was more money printing and a rally in risk assets.

Signs that Spain was disappearing into a deflationary vortex grew during the summer with requests for bail-outs from various regional governments. The yield on 10 year Spanish government bonds rose to new highs of 7.5% during July, until Mario Draghi, President of the ECB, said that the ECB would do 'whatever it takes' to keep the Euro (both political bloc and currency) together. This sparked a strong rally and equity markets are up 10-15% since their lows in early June.

In early September Mr Draghi confirmed formally that the ECB was prepared to buy the bonds of peripheral European countries, although on several conditions: the country concerned must request assistance, and sign a Memorandum of Understanding; while purchases will be concentrated at the short end, and be 'sterilised' by the ECB increasing reserve requirements so that there is no net increase in the money supply (thus appeasing the Germans' fears of inflation). As a result of the announcement, the rally in Spanish government bonds has continued, and the two year yield has fallen from 6.5% to 3%. This is without the ECB yet purchasing a single Spanish bond.

The US soon followed suit with further monetary support. Perhaps sensing that the Eurozone crisis was in danger of spiralling out of control, and that the US economy itself was running out of momentum, Governor Bernanke of the Federal Reserve announced QEIII in early September, or the third bout of quantitative easing in the United States since the crisis began, committing to $40bn of purchases of mortgage backed securities per month indefinitely into the future in order to keep mortgage costs and interest rates low. This was a surprise, given the imminence of the US Presidential elections and the dangers of prejudicing the outcome in favour of the incumbent. One can only conclude that Bernanke felt leaving it until early next year, after the elections, would be too late, and that immediate action was warranted.

The combination of inexhaustible monetary support, and strong corporate results, has meant that the S&P 500 is at its highest level since the end of 2007, and has returned 16% in the year to date. Who would have thought that last September? Over the quarter, the S&P 500 rose 5.8% in local currency terms.

One side effect of the Fed's latest easing has been a strong rally in the Euro against the Dollar, rising from 1.22 in mid-July to 1.3 in the space of two months. The price of gold has also risen further. Gold is up 5% over the past month and 11% over the quarter and is close to the US$1800 level once again.

Government bond returns were low but positive, with the FT All Gilts index up 1.4%. Corporate bonds outperformed, with investment grade corporates up over 5% over the quarter. Indeed, July was the best month for UK corporate bonds for 15 years with gains of over 3%.

While the US equity markets recovered strongly over the quarter, Sterling appreciation against the Dollar has clouded the issue in terms of currency adjusted returns, and the S&P was up just 2.6% for GBP investors. UK equities gained 5% in total return terms, with high commodity exposure working against it given economic and manufacturing weakness in China. European equities have rebounded strongly and were the stand out performer, after suffering worst in the Spring sell-off. European markets outperformed, rising 5-11% in Sterling terms.

Commodities generally responded positively to further monetary easing. Gold has already been commented on, but copper was up 7% and oil up 9%. Other alternative asset classes were lacklustre, though, with UK commercial property prices weakening slightly over the quarter. Hedge funds were up 1.4% over the quarter, and are up 2.7% in the year to date, given by the HFR index.

James Penn
Senior Portfolio Manager

Historic Market Rates

As at 28th September 2012

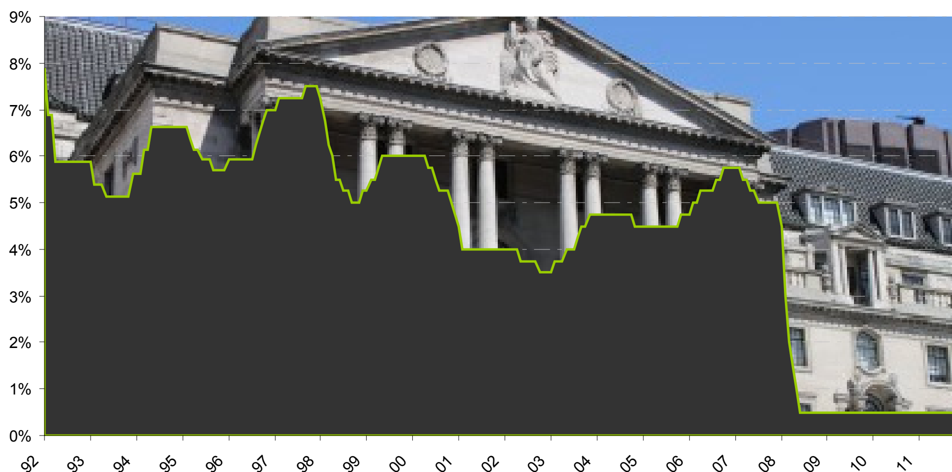
	Close	1 month % Change	6 month % Change	1 year % Change	3 years % Change
FX					
GBP/USD	1.6167	1.89%	0.99%	3.74%	0.94%
EUR/GBP	0.7955	0.30%	-4.47%	-7.39%	-12.99%
EUR/USD	1.2860	2.23%	-3.62%	-3.94%	-12.18%
USD/JPY	77.9600	-0.55%	-5.92%	1.17%	-13.08%
USD/CNY	6.2847	-1.01%	-0.22%	-1.51%	-7.94%
BOND YIELDS					
US 10 YR	1.634	0.085%	-0.575%	-0.282%	-1.672%
UK 10 YR	1.727	0.263%	-0.477%	-0.703%	-1.865%
GERMANY 10 YR	1.442	0.108%	-0.352%	-0.445%	-1.778%
JAPAN 10 YR	0.778	-0.019%	-0.211%	-0.254%	-0.523%
SWISS 10 YR	0.541	0.020%	-0.325%	-0.401%	-1.449%

	Close	1 month % Change	6 month % Change	1 year % Change	3 years % Change
EQUITIES					
S&P 500	1,441	2.42%	2.29%	27.33%	36.29%
Dow Jones	13,437	2.65%	1.70%	23.13%	38.35%
NASDAQ	3,116	1.61%	0.80%	29.01%	46.82%
FTSE 100	5,742	0.54%	-0.46%	11.96%	11.85%
FTSE ALL-SHARE	2,999	0.88%	-0.13%	12.98%	13.82%
DAX	7,216	3.52%	3.88%	31.15%	27.15%
NIKKEI	8,870	0.34%	-12.03%	1.95%	-12.46%
Hang Seng	20,840	6.97%	1.39%	18.46%	-0.55%
COMMODITIES					
GOLD	1772.10	4.73%	6.22%	9.12%	75.86%
CRUDE OIL - WTI	92.19	-4.44%	-10.51%	16.40%	30.56%
S&P GS Soft Cmd	822.99	-3.34%	16.21%	18.98%	48.87%
S&P GS Ind Metals	1623.11	10.19%	-1.34%	6.71%	10.60%

Source: Bloomberg

Can you live off interest? Many cannot. Here we consider the alternatives

Chart 1: Twenty Years of Base Rate Changes



Source: Datastream & TMI

The world as we all know has become a tougher place in recent years. The excesses of the 1980's and then of the 2000's, have given way to a double dip recession, austerity measures and official interest rates close to zero. Think then the effect this has on the elderly, pensioners and those who have to live on pensions and savings. With interest rates at record lows, official government intervention through "quantitative easing" is putting cheap money back into the economy and is largely funding the clearing banks. Whilst bank balance sheets have improved over the last few years, household balance sheets have only seen modest improvement. With base rate set at 0.5% where it has been since March 2009, interest rates on mortgages are in the region of 3 – 5% per annum, whilst the interest rate charged on credit cards in many cases is a staggering 25% per annum.

Think then about the impact of low or no interest rates on savings. The Bank of England and the UK government recognise that consumption plays a pivotal role in economic recovery and that they need to encourage more consumption. One of the many ways to do this is to make savings unattractive and encourage savers to spend thus accelerating the recovery. With an ageing population and a swathe of that population 10 – 15 years away from retirement, pension pots have already been hit by the UK government abolishing tax relief on dividends within pension funds (back in 1997).

In the last 10 years savers' attitudes have changed; they have had to. The clearing banks have paid very little on deposit accounts and the ability to live off the interest on one's life savings has all but disappeared. The elderly and pensioners have increasingly had to spend capital to maintain living standards – this can only endure for so long. Back in 2008/2009 we started reorganising investment portfolios to enhance the income profile, initially through UK Treasury issues (Gilts) and then in recent years utilising sterling corporate bonds. There is a point which we are reaching where existing attractive issues are in short supply, being drawn for redemption; or are just so expensive that a conversion of capital to income is a meaningful number and inefficient for tax purposes.

On the daily bond sheets new issues by acceptable names rated 'A' or better are coming to market at a yield of only a few basis points over the equivalent gilt yield. Maturity and running yields are between 1 – 1.5%. Banks on longer term deposits are now paying up to 3% if you are prepared to tie your money up longer term – typically 24 – 36 months.

What other alternatives are there available? The Gilt and corporate bond markets have long been considered a "safe haven" for investors, you get a known coupon payment each year, and depending on the credit worthiness of the issuer expect to get your money back on the maturity date of the bond. Like all investments it pays to diversify the risk of default amongst a number of issues, or you can invest via a collective fund.

As the business cycle and the investment cycle progress, then investors need to consider alternatives to corporate bonds and as interest rates will potentially move up from here the question then needs asking again: Where can I get an attractive income with safety of capital? In a rising interest rate environment, which is normally accompanied by an economic expansion and an uplift in inflation, the answer has to be dividend flows from companies. The UK FTSE All Share index has many companies across a wide range of industries paying dividend yields in the range of 4 – 7%. Equity investors are only too aware of the compounding effect of dividend income on investment returns. Dividends are excess income after operating costs that the company considers it can pay to shareholders to reward them for buying and retaining the company's shares. Companies who need to retain cash for operating purposes normally do not pay out dividends, or may cut the dividend payout if they need cash for the business. The next critical measure is the dividend cover ratio – this measures the number of years the same dividend could be paid from retained earnings. The higher the number the better the company's ability to maintain the dividend year over year.

Investment in equities, that is the shares of companies, carries more risk than government or corporate bonds, but historically companies with above average yields and in stable and growing sectors tend to provide better investment returns than many other companies. Companies that are generating excess cash through their operations tend to be better managed and provide better and more stable returns. Many equities are currently looking attractive, while there are a number of collective funds that focus on equity income.

Andrew Buchanan
Senior Associate,
Private Investment Management (CI)

Implications of the Fed's QEIII for TMI's investment strategy

Following the conclusion of its meeting on 13th September, the US Federal Reserve Bank (Fed) announced a third round of asset purchases (commonly referred to as quantitative easing and, in this case, QEIII).

Brief outline of QE3

There are two key elements to the Fed's announcement:

In addition to continuing its ongoing maturity extension program to the end of this year and maintaining its current policy of reinvesting principal payments (from its holdings of agency debt and agency mortgage-backed securities) in agency mortgage-backed securities, the Fed will purchase additional agency mortgage-backed securities at a pace of $40 billion per month. This is an open-ended commitment from the Fed.

The second key outcome of the Fed's meeting was an extension of the guidance on interest rates. In particular, the Fed stated that "exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015". This stretched the guidance period from the previous wording of "...at least through late 2014".

Importance of the US labour market

The Fed linked the future path of monetary policy closely with the fortunes of the labour market. It stated that "if the outlook for the labour market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability."

Implications for aspects of TMI's Investment Strategy

Equities:
If anything, the Fed's announcement reinforces our current slight overweight position in equities. Short term risks remain however. These currently centre around investor sentiment: bullish consensus is now rapidly approaching levels that have historically been associated with short term market corrections. Also, the volatility index (VIX), which is widely viewed as a measure of investors' complacency, is currently at multi-year lows, which is rarely a positive sign!

Government bonds:
While the Fed expects its latest round of asset purchases "to put downward pressure on longer-term interest rates", bond yields have tended to rise following previous rounds of asset purchases as investors anticipate a positive growth effect from quantitative easing. Nevertheless, we note that the prevailing weak economic backdrop is likely to limit the upside in bond yields for some time.

Foreign exchange:
Arguably, the Fed's decision should weaken the USD but potential risks elsewhere (especially Euro-zone) may mean this is not quite clear cut. In the short term, we maintain a neutral stance across the main currencies.

Gold:
We recognise that there is a potential for an extended rally in gold prices as a result of the latest round of asset purchases. However, in light of risk exposures elsewhere, we maintain a neutral stance relative to benchmark allocation.

TMI's interest rate outlook:

In light of the moderate pace of economic growth, low inflation pressure (especially true of core inflation) and the Fed's explicit forward guidance on interest rates, in our view, the Fed is unlikely to raise the federal funds rate over the next 12–18 months. While the Fed's current guidance period is longer, we focus on this shorter horizon because the degree of uncertainty increases substantially beyond this sort of horizon.

TMI's view on the interest rate outlook is the same for other developed economies in that we believe that the major developed market central banks are unlikely to raise interest rates over the next 12–18 months.

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