



Weekly Market Comment

27 January 2017

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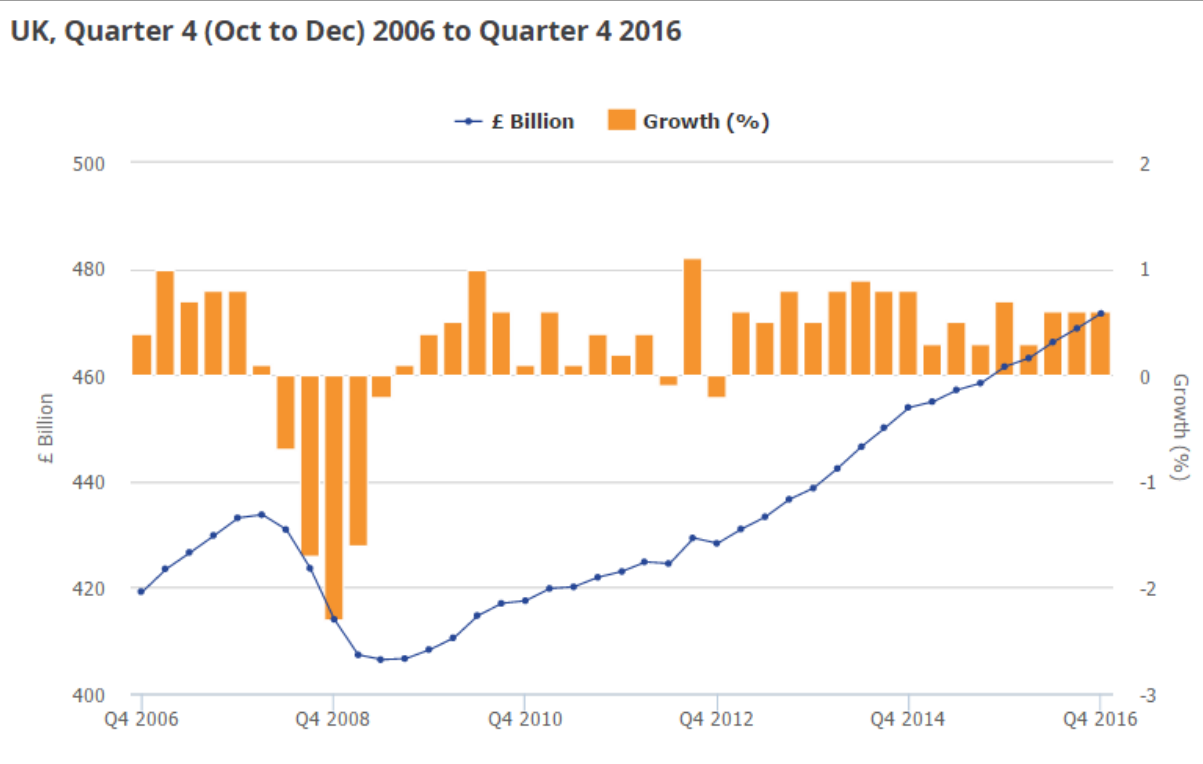
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*Seasonally adjusted GDP (£ billions) and quarter-on-quarter growths accelerating.
Source: UK Office of National Statistics (ONS)*

Consumers make UK the G7 growth champion

If you were expecting the latest interpretation of US president Trump’s outrageous policy announcements to dominate this week, I am afraid you may be disappointed. Given the very detailed coverage everywhere else in the media, there is not much that Tatton’s Weekly commentary would be able to add. Except perhaps for “Keep Calm and Carry On”.

Instead of second guessing which of the trumpeted policy intentions (pardon the pun) the still highly amateurish acting president will actually find executable and what that may mean, we will focus on those news items which still constitute reality.

Firstly, it was very pleasing to learn that according to first estimates from the UK’s Office for National Statistics (ONS), economic growth ended 2016 at a better than expected annual rate of 2.2%. While in the past we would have seen this as dangerously close to the perceived ‘stall speed’ growth rate of 2%, in this decade’s slow growth era it makes Britain the fastest growing economy amongst the G7 group of developed nations. What is more is that it was on an accelerating path, rather than a slowing one, as disappointing figures attested for the US from their end of year accounts.

Before getting overly optimistic about the UK’s far more than anticipated consistency in growth, it needs to be highlighted that it was neither increasing exports on the back of the much weaker £-Sterling, nor companies’ expansion investment that drove the improvement but entirely the resilience of the UK consumer. Spending accelerated as the UK public appears to have put

any potential concerns about the UK's longer term prospects outside the EU firmly to one side. Unfortunately, the spending increase was not funded by income, but by credit and is therefore unlikely to be sustainable. The government's newly announced industrial policy may therefore be more relevant than its fairly moderate measures would currently suggest. Many commentators see darkening clouds on the UK's 2017 economic horizon as increased import prices are expected to put a dampener on the UK consumers' spending spree.

Such concerns may be well-founded, but given the UK's trade relations with its direct neighbours and the rest of the world have not changed (yet), much will depend on economic progress elsewhere, because a global tide will lift all boats. The UK is currently suitably positioned to benefit disproportionately from a global upswing and such an upswing was well under way at the tail end of 2016. So 2017 could still turn out to be another strong year for the economy unless something unforeseen reverses the positive momentum.

Yes, you have guessed correctly – we are back at the damage potential of a new US president. While I worry much about the rapid deterioration of political etiquette and manners across the 'pond', I also observe Trump's astounding ability to reverse direction if it suits him. This is where I hope sanity returns, because first and foremost his aim is to increase the rate of growth in the US. The people in his administration are not stupid and they are likely to tell him that trade wars with his neighbours and biggest international trade partners are just as counterproductive to growing the US economy as is waterboarding torture for gaining reliable intelligence.

Markets, in my view, signalled an end to Trump's stock market honeymoon. We experienced a marked 4% fall of the previously strengthening US\$. The fact that parts of the US stock market hit new all-time highs – the Dow finally jumped over 20,000 – had much to do with the same reasons that pushed the UK's FTSE higher when the £-Sterling fell post-Brexit and some very strong corporate results announcements.

On this note, at Tatton we will not let ourselves be distracted by the loud shouting from Washington (and Twitter), but instead continue to observe and assess all the real economic parameters that have recently begun to move towards long-awaited normalisation.

Keep Calm and Carry On!

Why the average private investor underperforms

There is an adage that is often cited amongst the investing and advising community: "It's time in the market, not timing the market that result in the best long term returns". Investing to achieve the most reliable long-term returns possible is not a sport in which you try to gamble against the other players to get to the goal, but a journey through which you find the safest route to your destination. You can catch the winds of the market in your sails, but you can't beat the weather.

Of course, as with most chunks of wisdom that preach caution and restraint, it often falls on deaf ears. At least, this much is apparent from a Quantitative Investor Behaviour study last year by research firm DALBAR, which looks at the behaviour and returns of individual

investors over the past 30 years. The study, spanning from 1984 to 2013, compares the annualised returns of individual investors against the S&P 500 index, a benchmark standard for the US stock market. The results, shown below, reveal quite a profound discrepancy.

Over the past 30 years, private investors have lagged behind the index by a staggering 7.42% per year.

Fund investors' returns fall short of the market

TIME PERIOD	INVESTORS' EQUITY FUND RETURNS	STANDARD & POOR'S 500 INDEX	GAP BETWEEN S&P AND INVESTORS
30 Years	3.69%	11.11%	7.42%
20 years	5.02%	9.22%	4.20%
10 Years	5.88%	7.40%	1.52%
5 Years	15.21%	17.94%	2.73%
12 Months	25.54%	32.41%	6.87%

Note: Through December 31, 2013

Source: DALBAR

To put this into perspective, if you invested £100,000 into the S&P 500 in 1984, 30 years later you would be £2,061,719 better off than a private investor with the same starting point.

Clearly, investors are leaving much of the possible returns 'on the table'. But why?

Of the many reasons for individuals' underperformance of the market, Dalbar highlight 3 key factors. Lack of investible capital, the need to access invested capital in personal emergencies and, most importantly, human psychology all inexorably lead to the underperformance we see. The biggest reason by far is perhaps the simplest: Human behaviour. We are, by our very nature, emotional creatures. You could devise the most brilliant investment strategy imaginable but, when the fear sets in, be that fear of missing out on a rally or – worse – fear of greater losses, ignoring the urge to press the eject button becomes impossible for many. And, the more you mix emotion into your investments, the more likely you are to seriously mistime the market.



You may in the past have heard us at Tatton refer to this private investor behaviour as “Fear and Greed investing”. The greed, or ‘herding effect’ according to Dalbar, is when an investor starts chasing the performance they see others getting, leading them to go for assets which might already be starting to overheat – buying high. The fear, or ‘loss aversion’, is when an investor sees the downward path that their assets have taken and becomes fearful of further losses, leading them to sell their position at the worst possible time and crystallise their losses – selling low.

The ‘loss aversion’ mentality can be seen through the huge outflows experienced by Exchange Traded Funds (ETFs) in bear markets. In January last year, amid an almighty wobble in stock markets and regular updates of the impending doom from the news media, \$12.8bn was pulled out of equity ETFs in just 3 weeks. The problem here is that after these ‘crash’-type events, the recovery is often swift, meaning that investors who pull out during the downward spiral lack confidence to buy back in before the rebound has already taken place. As such, abandoning your investments through fear of greater losses actually ends up billing you with a greater loss than if you just stayed put.

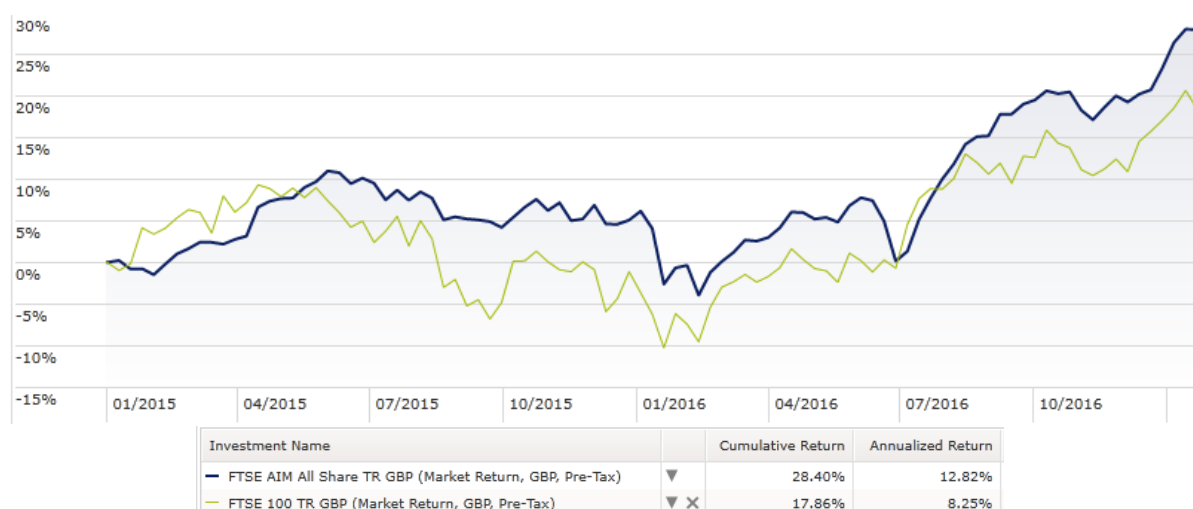
This point is captured perfectly by a study from Fidelity Investments on their famous Magellan fund. From 1977 to 1990, the Magellan fund made average annual returns of 29%, making it the best performing fund in the world and catapulting then fund manager Peter Lynch to legendary status. However, from the study, Fidelity found that on average investors in the fund actually *lost* money during this time. This is because the investors would become fearful and take their money out of the fund when its performance dropped and only buy back into it once things had already started improving – effectively getting all of the downside but missing out on the recovery.

So, the problem for investors in equity funds is not necessarily down to the underperformance from the fund managers, but rather the lack of perseverance from investors themselves. This much is shown by the retention rates of equity funds. According to Dalbar, equity fund investors hold funds for four years on average. This is far too short a time-span to properly take advantage of the long-term upward trends of equity markets, so it's no surprise that this can lead to missing out on returns. And, if investors keep switching between products to either chase returns or through fear of losses, this will inevitably mean they can't take full advantage of the actual returns that those funds offer over the long term.

It should also be pointed out that the above mistakes are not just from the inexperienced and uninformed. It can often be the case that the most well-informed and financially literate investors are just as, if not more susceptible, to these pitfalls than the layperson. Psychological studies have shown that investors who pay close attention to the financial news, trade more often than their counterparts who don't, and that this higher frequency of trading usually leads to lower returns than investors who tune out from the news. This is because the day-to-day happenings of the financial world should not affect your long-term strategy, but tuning in every day makes the noise difficult to ignore. And, anything you read about in the news has already not much to be gained from reacting to it after the fact.

What we believe this highlights is the benefits of a long-term investment strategy which is geared towards an individual's specific financial goals and capacity and/or appetite for capital volatility risk, rather than reactive to the short-term fluctuations of the market. That is, a strategy which doesn't bank on being able to second guess the market to gamble on the next boom and bust, but rather manages the structure of an investment portfolio so that it's better placed to take advantage of rallies and withstand crashes. This is what our investment philosophy at Tatton is about – time in the market, not timing the market, or how we like to express it: "Making sure investors achieve the investment returns they ought to achieve, given the risk profile and time horizon they have committed themselves to".

Review of 2016 AIM stock market returns



Total returns since 1/1/2015 of the UK's Alternative Investment Market (AIM), versus the main stock market as represented by the FTSE100 stock market; Source: Morningstar

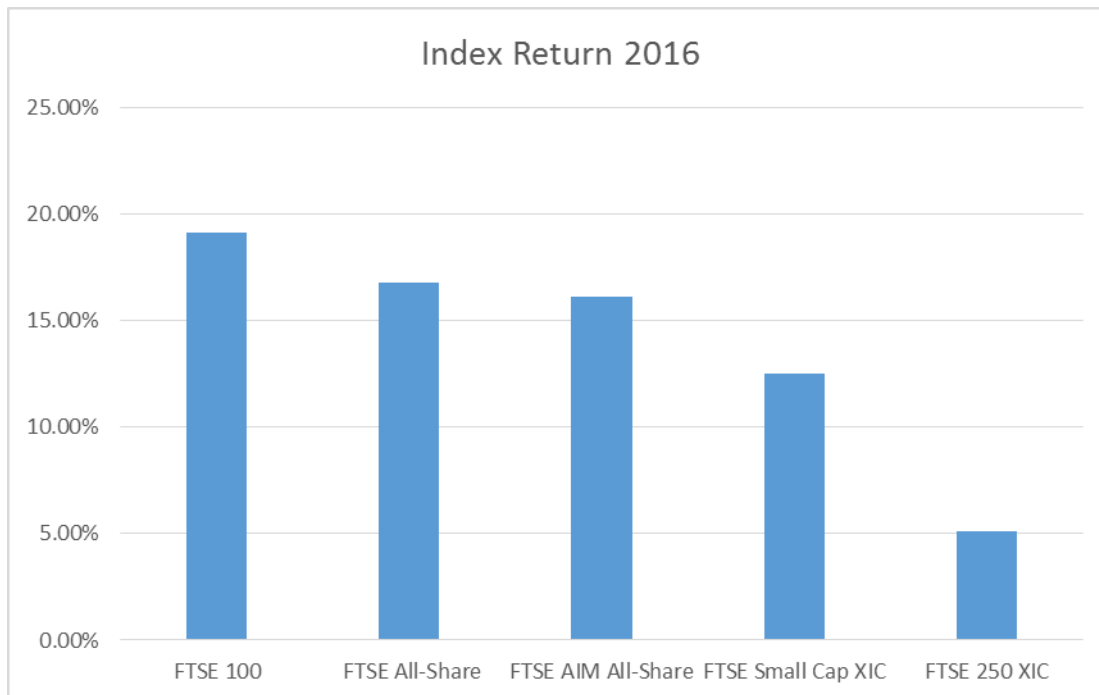
Across the UK stock market last year, the large cap FTSE 100 returned 19.1%, the All-Share 16.1%, the AIM All-Share (small and micro-cap) 16.1%, Small Cap 12.5% and the FTSE 250 5.1%. Thus the Alternative Investment Market (AIM) returns were just marginally below that of the FTSE 100 and the All-Share and significantly better than the FTSE 250 Mid-Cap and the Small-Cap index. So why did the AIM index, which many investors are wary of because of its relative illiquidity and mostly micro-cap nature, perform so much better than mid and small caps?

Was the reason behind this similar to large cap performance related to overseas sales and currency? Given 48% of AIM sales were not from the UK this might seem like a possible answer but 47% of mid cap sales were also from overseas so this answer looks less convincing. Was it to do with the amount of resource companies in AIM, as the resources sector experienced a strong rebound? When we strip out resources from AIM's returns they fall from c16% to c13% which is still ahead of the small and mid-cap indices.

OK so if not currency or resources was it down to tiny start-up companies in the AIM index which aren't in the others? Once again we find this explanation unsupported by the evidence as last year the top performers were its largest constituents including ASOS, Boohoo and GW Pharmaceuticals (although this company which is developing marijuana based treatments for epilepsy and multiple sclerosis has now moved to NASDAQ). In fact, ASOS now has a market cap of £4.49bn which comfortably puts it in the FTSE 100 if it were listed on the main market. So although the median market cap of the Alternative Investment Market's companies is only £20m, it is clear that just focusing on aggregates and averages can be misleading.

The AIM market universe of companies is not just small start-ups or resource stocks but a vast array of diverse companies regarding size, economic drivers and home market domiciliation. It is therefore hard to regress the returns of this market to one factor or industry but instead it

should be seen as a market which can reward investors who conduct rigorous research to identify compelling investment opportunities.



XIC = Excludes Investment Companies like investment trusts

Source: Paul Marsh, Scott Evans and Elroy Dimson (LBS, LSE).

Chinese New Year – an outlook to the year of the Rooster

As the Chinese year of the Fire Rooster is about to begin China's economy appears to be ending the year of the Monkey on a high note. In the week before Chinese New Year, data showed the domestic economy expanded at a better than expected annual rate of 6.8% in the fourth quarter, on the back of solid growth in retail sales, industrial production and FAI (Fixed Asset Investment).

The market's view on Chinese growth has remained remarkably stable over the past six months, having largely retreated from fears in early 2016 of a 'hard landing' scenario thanks to a rapid ramp in fiscal support. Investor confidence also continued to return, particularly in the latter half of last year, underpinned by solid economic activity levels, a resurgent housing market, rapid credit creation and increased infrastructure spending.

Overall, GDP increased 6.8% year-on-year (YoY) which was slightly above the 6.7% YoY forecast. However, there were some encouraging trends within the breakdown of China's Q4 GDP reading. Industrial production (IP) grew +6% in December, while retail sales rose an impressive 10.9% and FAI increased 8.1%.

The pick-up in retail sales growth was primarily driven by household goods, petrol and cars. We note that within FAI, both the property market and manufacturing investment rebounded. We believe this solid GDP reading and its beat relative to expectations, may help government officials feel more comfortable in the growth outlook.



Source: Bloomberg – China overnight lending rate (SHIBOR)

As a result, we anticipate that the official policy response may continue to have a mild monetary (credit) tightening bias. Evidence of this tightening has shown up in reduced financial market liquidity along with large increases in overnight lending costs (interbank funding markets – where banks lend to each other). Indeed, we have witnessed the People’s Bank of China (PBoC) drain a net ¥595 billion from the financial system during the first week of January – efforts we believe aimed at taking some of the very strong upward price momentum out of the property market.

However, with New Year approaching and demand for cash rising, the PBoC has adopted its typical seasonal pattern of shifting to net injections of liquidity (¥100 billion last week) so that individuals can use that cash to pay for gifts and entertainment. Additionally, the PBoC sought to further ease the pressure on banks to provide cash over the New Year by reducing the RRR (Reserve Requirement Ratio – the amount of money a bank is required to hold in cash) by 1% to 16%, which will be reversed shortly after the holiday has passed.

When we remove this seasonal factor, we still see clear evidence of overall tightening. One of the more interesting ways in which the PBoC is doing this is by offering more 28-day reverse repos (loans with an interest rate at which the PBoC borrows money from domestic banks and applies to control the money supply) rather than one-week loans, while also restricting the injection of cheaper short-term funds as it seeks to lower leverage in the financial system.

The other direct evidence for tightening comes in the use of its MLF (Medium-term Lending Facility). This week the PBoC increased the interest rate charged on MLF loans by 0.1% to 2.95% for 6-month and 3.1% 12-month loans. We note that while the magnitude of the rise was relatively small, this may well be another part of the government’s tightening bias.

In addition to its tighter policy stance, we see the key focus for the government likely to be both risk management and ensuring relative economic stability. We expect that stability will be the main policy theme this year, particularly as we head towards the highly important 19th National Congress of the Communist Party of China in September. The National Congress takes place once every five years and its role is to approve the Party's agenda for the subsequent five years.

Current President Xi Jinping was selected as China's leader at the 18th Congress in 2012, and is expected to at least want to serve his second term until 2022. Therefore, he will be keen to be confirmed on the back of stable and sufficient economic growth.

This makes it also somewhat unlikely that the government will speed up the pace of current economic reforms during 2017, as this would cause potential stability issues. It is, however, possible that there is an upside risk to Chinese growth during Q1 2017, given the strong performance of the economy in Q4 2016 and continued solid corporate profit growth. The risks to the government's 6.5% growth target for the full year therefore seems evenly balanced in both directions.

Unfortunately, the election of Trump as US president introduces a fair degree of uncertainty into many of the above expectations and forecasts. This is because there is a chance this target could be harmed if trade issues with the US emerge as President Trump embarks on his 'America First' trade policy, with possible tariffs placed on Chinese goods. This could have a dampening impact on growth – not just in China, but also the US and thus globally. We note that Xi Jinping, who spoke at last week's Davos forum, was keen to stress that "open markets and rules-based trade are the best engine" to "power global growth". Who would have thought only a years ago that the Chinese leader would become the leading advocate of 'free trade', whereas an American President is doing the exact opposite?

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7181.7	-0.2	-16.8	↗
FTSE 250	18186.7	0.2	35.8	↗
FTSE AS	3896.3	-0.2	-6.4	↗
FTSE Small	5233.0	-0.2	-10.3	↗
CAC	4839.1	-0.2	-11.5	↗
DAX	11808.0	1.5	177.9	↗
Dow	20082.4	1.3	255.1	↗
S&P 500	2293.8	1.0	22.5	↗
Nasdaq	5162.9	2.0	99.7	↗
Nikkei	19467.4	1.7	329.5	↗

Top 5 Gainers

COMPANY	%	COMPANY	%
ANGLO AMERICAN	6.2	BT GROUP	-21.7
ROYAL BANK OF SCOTL	5.1	DIXONS CARPHONE	-8.1
DIAGEO	4.2	EASYJET	-6.80
ASSTEAD GROUP	4.2	PADDY POWER BETF	-6.5
CARNIVAL	4.1	VODAFONE GROUP	-6.1

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	30.7	Brazil	253.1
US	26.9	Russia	183.8
France	40.4	China	107.7
Germany	19.7	South Korea	45.2
Japan	30.4	South Africa	208.3

Currencies

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.25	1.30	OIL	55.5	0.1
USD/EUR	1.07	-0.07	GOLD	1189.0	-1.8
JPY/USD	115.09	-0.41	SILVER	17.1	0.2
GBP/EUR	0.85	1.41	COPPER	269.0	2.5
JPY/GBP	6.88	-0.17	ALUMIN	1820.0	-0.3

Commodities

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.5	2.8	0.04
US 10-Yr	2.5	1.1	0.03
French 10-Yr	1.0	14.1	0.13
German 10-Yr	0.5	9.3	0.04
Japanese 10-Yr	0.1	27.3	0.02

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.3
Standard Variable	4.3
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

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For any questions, as always, please ask!

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