Weekly Market Comment

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2016 Asset Class Returns

Asset Class	Index	December	Q4	2016
Equities	FTSE 100 (UK)	5.4%	4.3%	19.1%
	FTSE4Good 50 (UK Ethical Index)	5.3%	3.8%	12.6%
	Dow Jones Euro-Stoxx 50 (Euro-Zone)	8.5%	8.5%	20.1%
	Standard & Poors 500 (USA)	3.1%	9.2%	33.6%
	Nikkei 225 (Japan)	3.1%	6.1%	23.6%
	MSCI All Countries World	3.2%	6.1%	26.7%
Bonds	FTSE Gilts All Stocks	1.8%	-3.4%	10.1%
	IA Sterling Corporate Bond Index	1.7%	-2.5%	9.7%
	Barclays Global Aggregate Bond Index	0.7%	-2.3%	21.8%
Commodities	Goldman Sachs Commodity Index	5.9%	11.2%	32.8%
	Brent Crude Oil Price	13.8%	21.8%	81.8%
	LBMA Spot Gold Price	-1.3%	-8.2%	30.2%
Inflation	UK Consumer Price Index (annual rate)		0.3%	1.1%
Cash rates	Libor 3 month GBP	0.04%	0.1%	0.6%
Property	UK Commercial Property (IPD Index)		1.3%	1.4%

* **Source: Morningstar, all returns in Pounds - Sterling (£ - GBP)**

As 2016 drew to a close, December's Santa Rally provided a final return boost to annual asset class returns which had already turned out much better than most prognosticators (including myself) had expected. It does not happen often that both low risk investments (such as government bonds) and high risk investments (equities) both generate double digit returns over the same 12-month period.

In this regard however, it is important to note – as I have done here before, that investors need to be somewhat careful in their interpretation of 2016 investment returns, due to the overwhelming influence of currency movements during this year. As the UK's electorate voted to leave the EU and brace the vagaries of global trade relationships on its own, £-Sterling bore the brunt of the resulting uncertainties for the British economy and depreciated by around 15% against other currencies.

This boosted all overseas investments' value in Sterling terms by exactly this rate, without any need for the investments themselves having to appreciate. Indeed, investors looking at the same portfolio of investments from a €-EUR or US-$ perspective will have experienced far more pedestrian, low single digit returns. In other words, UK investor concerns that markets have overheated on a broad basis are premature. Should - contrary to current consensus expectations - £-Sterling recover significantly over 2017, then much of UK investors' 2016 currency induced investment gains could evaporate.

Beyond these more general interpretative comments, what was notable about December's positive picture was that the bond sell-off due to rising yields stopped and partially reversed. This was good news for lower risk investors and helped our lowest risk Tatton portfolios to just about finish the year in double digit territory.

For a more comprehensive review of market action during 2016, please refer back to the Tatton's Weekly edition of 16 December 2016.

Growth boosting 'Animal Spirits' finally returning?

From a market perspective, 2017 has started on the same tune as 2016 ended: Stronger than expected economic data reports push risk asset markets higher and in some cases to new all-time highs.

Particularly the considerable improvement in business and consumer confidence in the US has in the new year sparked a discussion whether the low growth 'ice-age' of the current economic cycle is finally coming to an end. Four positive developments are noted by the more optimistic commentators: The manufacturing and commodity price revival, a restart of corporate earnings growth, synchronized global economic stimulus as fiscal austerity is abandoned to appease discontented voters and a return of (mild) inflation expectations. On top of this there is the view that a President Trump will be - beyond all (social media) noise - pro-business, through lower taxes and less regulation.

This has led some to suggest that the recent confidence improvement may finally lead to a re-awakening of the economic 'animal spirits' which have historically led to significant boosts in business investment and private consumption, which are necessary for a return of healthier growth rates of 3-6%. The strong growth, so the further assumptions go, will soften the negative impact of the rising cost of capital as more confident investors unwind the historic yield lows as they rotate out of bonds back into equities.

I am an optimist at heart and I can follow much of the argument, including the fact that this cycle has not witnessed any of the excesses that have historically heralded the nearing end of a cycle. However, in my opinion this view chooses to extrapolate economic parameters and ignore the potentially adverse political dimension. I have always argued that the main reason for the lacklustre economic development of this cycle is indeed the lack of general confidence, particularly of businesses who have become cash hoarders. 2016's pick-up in economic momentum with the four driving factors discussed above has undeniably led to a significant improvement in business confidence. But this recovery in sentiment remains brittle and can easily turn as the past years have shown.

For the moment business and capital markets appear to have given the benefit of the doubt to the new nationalist and simplistic tone in global politics, because if the promised rewind of globalisation was indeed executed, then the economic outlook would have to be far less optimistic, given the inevitable reduction in global trade and commerce. In principle I would agree that such a policy shift would be so detrimental to nations' economic prospects, that more levelheadedness will prevail in the longer term. However, in the shorter term Donald

Trump's aggressive megaphone diplomacy and politics and the UK's seemingly plan-less or even illusionary approach to an economically viable Brexit route, tell me that there is plenty of potential to undermine resurgent business confidence during 2017.

Therefore, and as already stated in the 2017 outlook published in December, this new year can take a number of directions, but given the experience of the last seven years it is probably unwise to expect either miracles in terms of a substantial economic breakout, or total disasters in terms of politics wilfully derailing recent economic progress. More realistic is a continuation of the slow normalisation process we have experienced since the end of the Global Financial Crisis (GFC). Sadly, this would also mean a continuation of what Wells Fargo's chief economist Jim Paulsen has so aptly named "Bunny Markets", where lingering "Armageddon Paranoia" leads to a regular recurrence of overshooting markets – in either direction.

On the back of the currently positive economic and market momentum, at Tatton we are expecting the earlier part of 2017 to continue to generate positive overall investment returns, but can foresee trading to become choppier as time progresses and old demons return. In such an environment we will confidently continue to apply our measured investment management approach to investors' portfolios, with which we managed to outmanoeuvre the various wrong turns 2016 offered and were once again able to allow our clients to get the investment returns that were achievable for their chosen level of investment risk.

'Trumponomics'

The New Year brings new challenges (and opportunities) and in time-honoured fashion, the financial press has published series of articles debating the challenges to the global economy in 2017 while also providing their "tips" on potential investment strategies.

In a number of cases the commentary appears contradictory, while in one particular area there appears to be consensus - the lack of clarity surrounding the US President elect's economic policy (and the likely consequences for the US economy and elsewhere).

Even the US Fed has suggested it is operating within a "cloud of uncertainty" regarding Mr Trump's intentions. If the US Fed is struggling to understand the possible impact of Mr Trump's tentative economic policies, then markets can be forgiven for temporarily mispricing certain types of risk, or simply adopting a tactical (wait and see) approach.

As expected, in its December meeting the US Fed elected to raise short-term rates; only the second time in a decade. The Fed also predicted a quicker speed of (monetary) tightening this year compared with the policy approach taken in 2015 and 2016, which was one increase in interest rates per year.

Part of the reasoning for a possible increase in the speed in monetary tightening is due to the risks of economic growth surpassing the Fed's forecasts, because of the possibility of more expansionary fiscal policy under the (Republican) President elect and a Republican-controlled Congress (which should in theory ease the passage of any proposed legislative changes to fiscal policy).

Given the uncertainty surrounding the course of economic policy under a Trump administration, only half of the Fed incorporated looser fiscal policy into their macroeconomic and interest rate forecasts. However, almost all of the Fed officials are predicting "upside risks to their forecasts for economic growth". This is despite the fact that the Fed's collective growth forecasts have already marginally improved, even since the Fed's September meeting (see below).

Economic projections of Federal Reserve Board members

Percent

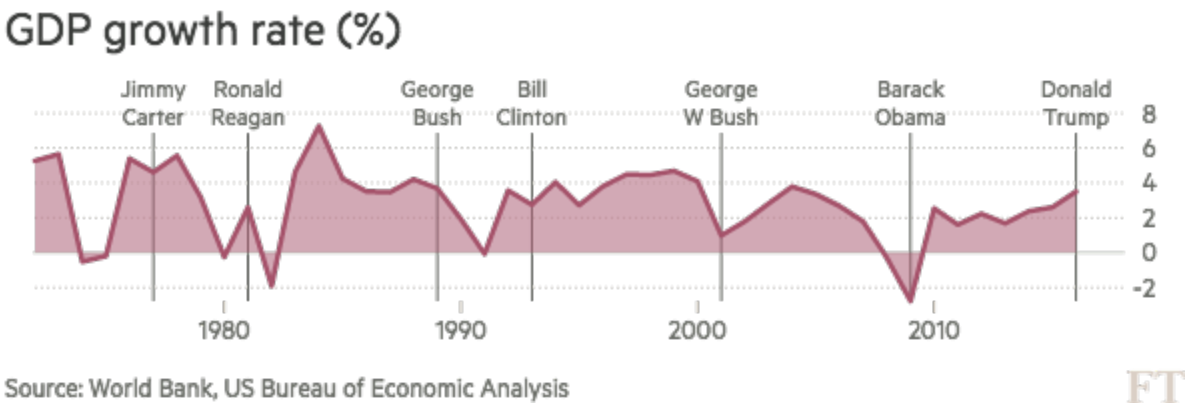
Variable	Median[1]					Central tendency[2]					Range[3]				
	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run
Change in real GDP	1.9	2.1	2.0	1.9	1.8	1.8 – 1.9	1.9 – 2.3	1.8 – 2.2	1.8 – 2.0	1.8 – 2.0	1.8 – 2.0	1.7 – 2.4	1.7 – 2.3	1.5 – 2.2	1.6 – 2.2
September projection	1.8	2.0	2.0	1.8	1.8	1.7 – 1.9	1.9 – 2.2	1.8 – 2.1	1.7 – 2.0	1.7 – 2.0	1.7 – 2.0	1.6 – 2.5	1.5 – 2.3	1.6 – 2.2	1.6 – 2.2
Unemployment rate	4.7	4.5	4.5	4.5	4.8	4.7 – 4.8	4.5 – 4.6	4.3 – 4.7	4.3 – 4.8	4.7 – 5.0	4.7 – 4.8	4.4 – 4.7	4.2 – 4.7	4.1 – 4.8	4.5 – 5.0
September projection	4.8	4.6	4.5	4.6	4.8	4.7 – 4.9	4.5 – 4.7	4.4 – 4.7	4.4 – 4.8	4.7 – 5.0	4.7 – 4.9	4.4 – 4.8	4.3 – 4.9	4.2 – 5.0	4.5 – 5.0
PCE inflation	1.5	1.9	2.0	2.0	2.0	1.5	1.7 – 2.0	1.9 – 2.0	2.0 – 2.1	2.0	1.5 – 1.6	1.7 – 2.0	1.8 – 2.2	1.8 – 2.2	2.0
September projection	1.3	1.9	2.0	2.0	2.0	1.2 – 1.4	1.7 – 1.9	1.8 – 2.0	1.9 – 2.0	2.0	1.1 – 1.7	1.5 – 2.0	1.8 – 2.0	1.8 – 2.1	2.0
Core PCE inflation[4]	1.7	1.8	2.0	2.0		1.7 – 1.8	1.8 – 1.9	1.9 – 2.0	2.0		1.6 – 1.8	1.7 – 2.0	1.8 – 2.2	1.8 – 2.2	
September projection	1.7	1.8	2.0	2.0		1.6 – 1.8	1.7 – 1.9	1.9 – 2.0	2.0		1.5 – 2.0	1.6 – 2.0	1.8 – 2.0	1.8 – 2.1	
Memo: Projected appropriate policy path															
Federal funds rate	0.6	1.4	2.1	2.9	3.0	0.6	1.1 – 1.6	1.9 – 2.6	2.4 – 3.3	2.8 – 3.0	0.6	0.9 – 2.1	0.9 – 3.4	0.9 – 3.9	2.5 – 3.8
September projection	0.6	1.1	1.9	2.6	2.9	0.6 – 0.9	1.1 – 1.8	1.9 – 2.8	2.4 – 3.0	2.8 – 3.0	0.4 – 1.1	0.6 – 2.1	0.6 – 3.1	0.6 – 3.8	2.5 – 3.8

Source: US Federal Reserve, 14 December 2016

According to the Fed's analysis, there should be a gradual adjustment in the stance of monetary policy, economic activity is set to expand at a moderate pace and labour market conditions will strengthen. Inflation is expected to rise to 2% over the medium term as the transitory effects of past declines in energy and import prices dissipate (and the labour market strengthens). While near-term risks to the economic outlook in the US are described as roughly balanced, this does not take account of any new (Trump) economic policies.

In light of the continuing improvement in the US economy, and after so many false starts, it is perhaps ironic that the Fed may now be required to consider a hasty reversal of its accommodative policy stance, not least because of the unanticipated effects of an, as yet, undefined set of economic policies.

Moreover, it is also questionable whether the US economy actually needs further (fiscal) stimulus; a further boost to the economy now could require tighter control of monetary policy and thereby effectively neutralise the fiscal stimulus effect. As is illustrated below, the President elect will be inheriting a relatively benign economy. Arguably, an economy that requires only careful nurturing and management as opposed to detailed Government intervention and/or (fiscal) stimulus.



Mr Trump's proposed economic policies are said to focus on various fiscal (and trade) initiatives. However, proposed changes to the tax regime, whether in respect of income, excise, corporate (or even import) tax, can sometimes produce unexpected outcomes, and reductions in tax are no guarantee of economic growth.

For example, the significant oil price reductions from 2014 acted as a proxy for tax cuts for the US consumer. Estimates suggested that cheaper petrol alone would add an extra $1,500 to annual household budgets and that extra funds would lead to higher consumer spending. US consumers did quite the opposite and saved – more than - the “windfall” from lower energy costs. Therefore, while an income tax cut may increase a household’s disposable income, it does not follow that the additional income will be spent.

There would be similarly complex issues in the context of corporation or so-called ‘wealth taxes’. Analysts predict that Mr Trump’s proposed tax breaks will disproportionately benefit the richest proportion of the population. This would worsen inequality in the US, where the average income for the bottom half of US workers has not increased since the 1970s (source: FT.com) - this remains a significant political and economic issue for any US administration.

The effects of simple changes to corporation tax (on profits or capital gains) are also not easy to predict. Given the excessive existing cash piles of US corporates it is reasonable to assume that some or even most of any corporate tax “windfall” would be used by companies for further share buy-backs – effectively returning the money to shareholders, as opposed to leading to business investment. Alternatively, targeted corporate tax incentives on capital and infrastructure investment could provide a much needed boost to US infrastructure (road, rail etc.).

A looser fiscal policy will generally increase economic activity, at least to the extent that it would lift consumer and business confidence. However, in our view, non-material and/or simple tax cuts alone have as little chance of delivering a sustained impetus to economic growth as the reduction to households’ energy bills did two years ago. Even if we are wrong, and “Trumponomics” in the form of loose fiscal policy does significantly boost the already accelerating US economy, the Fed would have to tighten monetary policy. You can’t have your cake and eat it.

Should spiking Chinese interbank rates ring alarm bells?

Gradually rising global equity markets seem to be telling us that all is alright with the world. Furthermore, stock market volatility as measured by the Chicago Board of Trade’s VIX index is back below 12%, the lowest levels seen since 2008. It’s human nature to look for potential risks during the periods of calm, and one should be careful not to think that potential is the same as actual.

Still, we should be mindful of how things might develop - and the turbulence in currency markets bears some examination.

12 months ago, investors were worried by the tightening of global monetary policy that had ensued during 2014-2015, which had not been driven or intended by central banks, but was a consequence of currency markets. The strong dollar finally caught the attention of Chinese investors which led to China experiencing significant capital outflows as 2015 ended. The People’s Bank of China stemmed the outflow through a variety of measures, finally signalling its concern by allowing overnight (interbank) rates to spike above 60% annualised. What

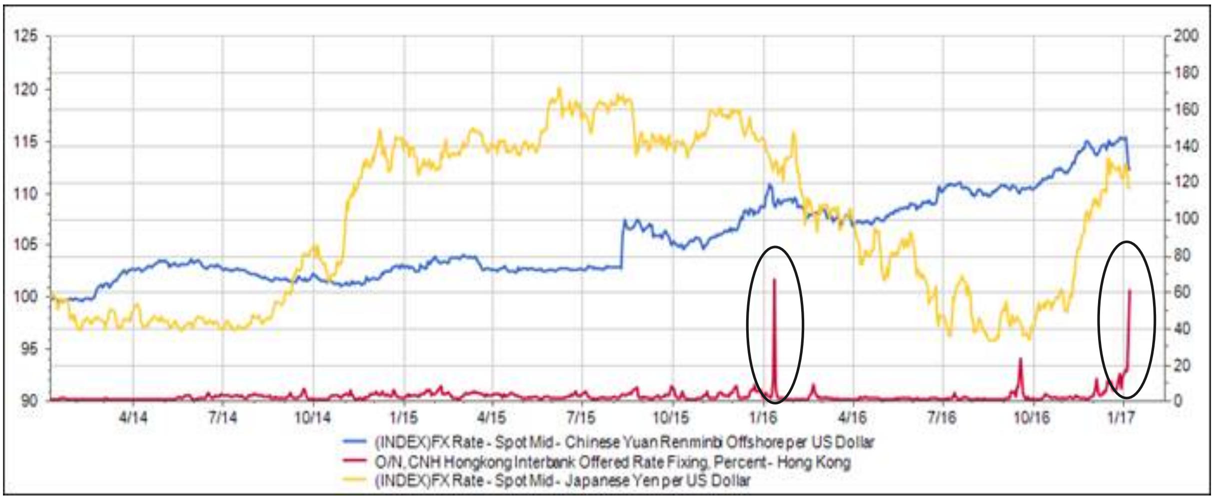
followed was the Chinese growth scare which together with the slowing of the US economy led to the Jan/Feb 2016 stock market tantrum.

Compared to 2015, 2016 was different inasmuch as the year was marked by explicit global monetary policy easing from central banks as a response to the deflationary impetus of the unintended monetary tightening of 2015. We ended 2016 in a very different place with global inflation on a clear and strong upswing, with real growth on a positive note, and oil at twice the price seen last January.

However, the resultant rise of US rates and yields (and the stronger dollar) is now once again feeding through to higher rates elsewhere, particularly in Asia outside of Japan. China's monetary policy is definitely having to respond, with a repeat of last year's overnight rate spike. The offshore overnight Yuan rate hit an intraday high of over 100% this past week and ended at above 60%.

There is no doubt that we are now in a very different growth environment and 2017 global monetary policy is easier now than at the start of 2016. Stronger nominal economic growth means that the demand for money is inherently stronger than 12 months ago. Thus the rise of rates isn't the same as "tight" policy.

At the same time, financial markets have benefited from the abundance of liquidity during the year. The real economy could start to draw that liquidity away from financial markets if central banks don't continue their easiness. Even if the economic circumstances are entirely different, liquidity squeezes have the unpleasant habit of triggering sudden market sell-offs, which means that we will be watching this development at the other end of the planet closely for any signs of contagion to the broader global capital markets.



Source: Factset

UK retail clothing sector update

The UK clothing retail sector is facing many challenges. The year ahead is likely to be extremely difficult with the cyclical slowdown in spending on clothing and footwear set to continue.

In addition to this, there will be two further headwinds likely to depress top line sales numbers. The first is a further squeeze in general spending as inflation begins to erode real earnings growth. The next is due to currency, following the devaluation of the Pound the price of garments and other textiles imported will rise and this will likely lead to depressed revenues and/or margins.

On top of these pressures to the top line we are also seeing an increase in costs which is squeezing the bottom line as well. These are mostly inflationary pressures on the cost base including the National Living Wage which became law on 1st of April 2016 and is set to increase further in April 2017. This and other general inflation in wages will put significant pressure on staff costs going forward.

Some of this can already be seen in the recent trading update by high street clothing retailer Next. The revenue it generated over the Christmas period was lower than its 2015 figures (which were themselves disappointing) and its end of season sale revenue was also down 7%. Next are expecting FY2016 profit before tax to be £792m which is 3.6% lower than last year. The poor results are not expected to turn around anytime soon as the company warns of a challenging year ahead.

These issues are clearly not isolated to Next and other retailers such as Debenhams, H&M, M&S and Esprit have reported poor numbers during 2016. With rising costs and weak demand in this sector we are cautious about entering.

In selecting investments for Tatton’s AIM portfolio investments, we have been cautious about companies in the retail sector exposed to these headwinds in trading and profitability described above and have in the whole avoided the sector. We do, however, see value in some niche opportunities that have compelling scope for further growth despite these headwinds in the broader sector.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7202.9	1.2	82.7	↗
FTSE 250	18331.3	1.7	301.8	↗
FTSE AS	3910.0	1.3	48.9	↗
FTSE Small	5211.9	1.8	94.1	↗
CAC	4908.5	0.9	46.2	↗
DAX	11596.6	1.0	115.5	↗
Dow	19953.6	0.7	133.8	↗
S&P 500	2274.5	1.1	25.2	↗
Nasdaq	4999.7	1.7	81.4	↗
Nikkei	19454.3	0.3	52.6	↗

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.23	-0.22	OIL	57.1	1.6
USD/EUR	1.06	0.39	GOLD	1172.0	2.1
JPY/USD	116.85	0.09	SILVER	16.4	3.1
GBP/EUR	0.86	-0.46	COPPER	253.4	1.8
JPY/GBP	6.93	0.27	ALUMIN	1702.5	-0.1

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.4	11.9	0.15
US 10-Yr	2.4	-1.2	-0.03
French 10-Yr	0.8	22.7	0.16
German 10-Yr	0.3	45.7	0.10
Japanese 10-Yr	0.1	28.3	0.01

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
PERSIMMON	10.8	NEXT	-17.1
FRESNILLO	10.2	MARKS & SPENCER	-5.0
TAYLOR WIMPEY	10.0	ROLLS-ROYCE	-4.1
STANDARD CHARTER	6.7	TESCO	-3.3
BARRATT DEVELOPM	6.5	DIXONS CARPHONE	-3.2

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	4.2
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	31.4	Brazil	258.2
US	26.9	Russia	231.3
France	37.9	China	113.7
Germany	22.8	South Korea	43.8
Japan	30.4	South Africa	255.7

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For any questions, as always, please ask!

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The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel