Weekly Market Comment

10 February 2017

Lothar Mentel

CHIEF INVESTMENT OFFICER

Samuel Leary

HEAD OF INVESTMENT COMMUNICATIONS

Isaac Kean

INVESTMENT WRITER

Duncan O'Neill

GUEST ECONOMIST

www.tattoninvestments.com Twitter: @TattonIM

125 Old Broad Street, London EC2N 1AR. Tel: 0207 190 2959

Greece's economic outlook weighed down by debt; Source: ARmedia.am

Market focus returns to Europe

Market focus returned to Europe as US president Trump made his first sobering experience with the nation's well-established system of checks and balances, when the judiciary arm threw out his travel ban as potentially unconstitutional. While he made clear he would hold judges responsible for any future misdemeanours of 'aliens' on US territory, he tried to instead progress his business agenda through an executive order to roll back most of Obama's tightened post crisis bank regulation and hinting at a "phenomenal" tax reform announcement in the coming days.

Stock markets rallied on the prospects and in delight over strong corporate results as companies publish their earnings figures for the last quarter of 2016. However, as we point out in the next article, the growth dynamic baton is seemingly being passed on from US (and UK) companies to those domiciled in Continental Europe and Japan. Not only this, but most political commentators have cast significant doubts over the timelines of Trump's tax and trade reform. Given tax cuts would have to be counterbalanced by new revenues from import taxes, the former depends on the latter and the latter can't be introduced overnight without risking much worse implementation chaos and legal challenges than the travel ban created. This gives the big fiscal stimulus and tax reform more of a 2018 perspective, which leaves us concerned that either the rallying markets will be left disappointed by the forthcoming "phenomenal" announcement or Trump risks making another highly unrealistic promise only then to blame non-delivery on his adversaries.

Sadly, the cause for Europe returning into the Global market limelight was not the lack of further US policy upsets, but a combination of Brexit progress, French election noise and the return of the Greek debt crisis evergreen. The UK parliament's House of Commons bowing to the outcome of the Brexit referendum and empowering the government to give formal notice to the EU of the country's desire to leave the European Union has put the UK one step closer to getting on the path of inevitable exit from the trade benefits of the largest economic bloc in the world and the uncertainty of the trading environment we enter into thereafter. Currency markets appeared unimpressed by the prospect with £-Sterling depreciating against the US$ and other currencies.

Over on the Continent, April's French presidential election suddenly looks more winnable for the populists, as the hitherto leading conservative candidate Fillon became embroiled in a scandal of misuse of public funds to employ his wife and children in pseudo jobs. Markets reacted nervously, increasing the French government's cost of borrowing, although political insiders didn't change their view that Front Nationale's Mariene Le Pen would only likely win the first round of the election, but not succeed in winning the second, final round.

Even more attention was given to news that there is renewed quarrel over the ongoing terms of the Greek debt bailout. It seems that politicians' attempts to making sure the Greek debt issue will not raise its divisive head during the forthcoming elections in France, the Netherlands and Germany have backfired. The International Monetary Fund (IMF) took the opportunity to warn that in its view the ongoing burden of the historic debt remained too high to ever allow Greece to prosper again. While German government representatives vehemently disagree to any further debt forgiveness, they have also said that they would not continue to support even the existing bailout arrangements, should the IMF withdraw its involvement.

As we have written here over the past 4 years, the Greek public debt issue is truly tragic and every renewed bailout failed to recognise that the country has been allowed to become over-indebted, which is to no small extent also to be blamed on reckless lending by their Northern European creditors. As long as the creditors feel unable or unwilling to formally write off their demands, Greece will be condemned into eternity to regularly approach national default, until their creditors once again extend payment terms. The IMF rightly points out that this is not fair and violates their fundamental belief and objective to reforming over-indebted countries within finite time scales. Their European counterparts argue that no harm will come to Greece as long as the big European countries extend them their low rates and very long repayment terms and Greece in return continues to repay its historic debt through a continuous annual budget surplus of 3.5%(!!!).

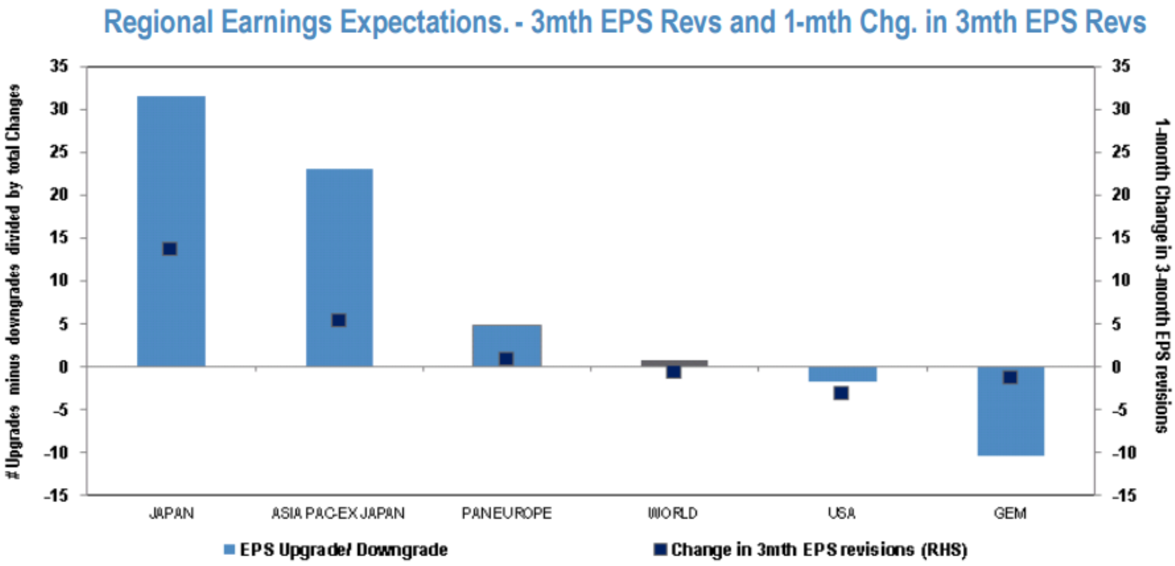
I personally do not believe that the EU will, during 2017, allow the Greek situation to deteriorate to crisis level again while German politicians are seeking re-election. However, the German government may be forced to either accept the IMF's demands for a lower Greek budget surplus target or see the IMF exit the bailout triumvirate to leave World Bank and EU to deal with future crises on their own. Wolfgang Schaeuble's (German finance minister) unveiled threat that Greece would have to leave the EU if it asked for further debt reductions does not strike me as a particularly wise opening gambit, when the biggest threat to the EU this year is its continued cohesion as a solidary union.

Regional shift in corporate earnings growth

Now that we are halfway through the Q4 earnings season, the picture emerging is one of further solid progress. Most of the world is still seeing Earnings Per Share (EPS) upgrades and the trend in consensus expectations suggests that upgrades continue to outpace EPS downgrades.

As a result, investor positioning remains firmly bullish, despite markets largely stuck in a range close to record highs. Analyst firm *Investors Intelligence* said that bullish sentiment rose to 62.7% at the end of January, marking the highest level since December 2004. We note that this marks a vast improvement over the 41.6% reading from before Trump's election victory.

On the back of positive investor sentiment, last week saw the largest inflows into equities in over seven weeks. The 'reflation' trade still seems to be in play, with financial stocks seeing inflows for the seventh straight week. Again, some investors have cautioned that this trade appears to be losing steam, as the big expected EPS drivers from the Trump administration (corporate tax cuts, infrastructure spending) look as if they will be more a 2018 story than a 2017 one. This means that the Trump rally may be temporarily losing some support.



Source: J.P. Morgan Quantitative and Derivatives Strategies, MSCI, I/B/E/S

In the US, an encouraging 76% of companies have beaten EPS forecasts, translating to year-on-year growth of 4.6%, up from the 3.1% at the end of the quarter. We note that, on average, company earnings are some 2.5% above estimates, just shy of the 4.4% one-year average surprise rate. At the current growth rate, Q4 will be the first time that we have seen consecutive year-on-year earnings expansion since Q4 2014 and Q1 2015.

Nine out of the 11 S&P 500 sectors are reporting higher growth rates than estimates from the end of 2016, on the back of both better earnings surprises and upward revisions to earnings estimates – led by financials. Typically, financial companies have high operational gearing to an improving economy as both businesses and consumers take out more loans.

While US companies' past performance has been strong, they now face the complication of a relatively uncertain political backdrop and unsure future relationship with President Trump, who has shown a clear willingness to single out individual companies (via Twitter) and seek to persuade their management to see his viewpoint. We note that a total of 120 S&P 500 companies mentioned Trump either directly or indirectly, trying to predict what the new President will be able to get through policy wise this year.

In Japan, a total of 73% of the companies listed on the Topix index have beaten EPS estimates, with growth up 10%, and 49% of them have exceeded sales forecasts. Over in Europe, 53% of the companies listed on the Stoxx600 have printed above EPS expectations, with growth hitting 7% year-on-year, while 64% of firms are posting better sales numbers, rising 5% year-on-year.

Japanese firms are also increasing their attractiveness to shareholders by sharpening their focus on enhancing RoE (Return on Equity – giving money back to shareholders) through higher dividends and stock buybacks. This is an additional favourable longer-term trend.

Clearly, both Europe and Japan are the better performing regions across the globe from a corporate perspective, even more so than the US. Analyst forecasts for Japan are particularly impressive, given the strong performance of the domestic economy, which is benefitting from a tightening labour market and improved growth.

For Europe, the recent weakness of the Euro has boosted exports, and a solid reduction in unemployment is underpinning gains in consumer spending. Germany in particular is seeing increases in spending, which is not only lifting the prospects of the domestic economy but also the rest of the Eurozone, as it drags in imports from the periphery.

Overall, European firms are showing continually improving EPS expectations, with consistently more earnings upgrades than downgrades. At a country level, both France and Germany are seeing EPS upgrades as well as improving EPS revisions. We also note that now France has positively contributed to the rise of European EPS upgrades during January, while Spain and Holland are still seeing solid upgrades.

Both Europe and Japan also have strong support from their central banks (Bank of Japan and European Central Bank), who are providing additional liquidity through their asset purchase programmes (QE), which is helping to keep borrowing costs low and, as a side effect, helping to weaken the Euro and Yen.

At an aggregate, global level, corporate earnings forecasts continue to see upgrades, but the pace of those revisions has slowed, due to the slowdown in the US and Emerging Markets. Looking back in history, we know that share prices tend to move up and down in response to changes in EPS revisions. From that perspective we believe that regionally, the growth prospects for both Japan and Europe look more attractive than the US and UK. When combined with the EPS improvements expected for both Japan and Europe, this supports our recent change in regional allocations.

Trump to unburden US banks?

On Friday 3 Feb, in an act we have become familiar with, Donald Trump signed another executive order. The new incumbent to the most powerful public office in the world has made cutting back federal legislation a regular feature of his still young presidency. On the chopping block last week was the Wall Street Reform and Consumer Protection act – better known as Dodd-Frank act. Named after its congressional sponsors, it is a reform act that was introduced in response to the banking sector excesses that led to the Global Financial Crisis (GFC) of 2008 and the great global recession it caused in 2009.

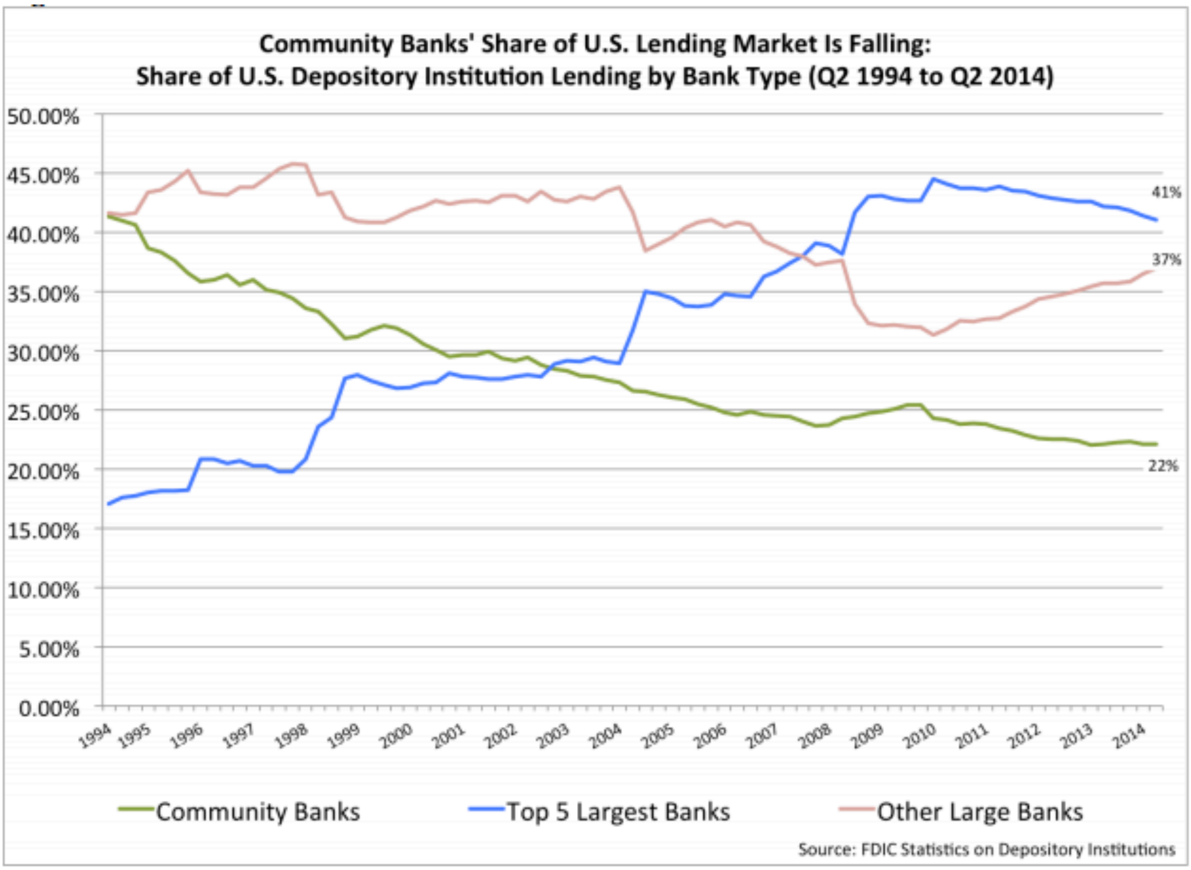
The President made repealing Dodd-Frank a big talking point during his campaign, complaining that “Dodd-Frank made it impossible for bankers to function,” and “it has to stop”. And, when pressed prior to the election on the extent of his intended reforms, Trump said “it will be close to dismantling of Dodd-Frank.” As with many of his pre-election pledges, it seems that Trump has every intention of keeping this promise. The executive order, initiated on Trump’s ninth of his first 14 days as Commander-in-chief, defines the “core principles” of financial regulation under the new administration and tasks the US Treasury with reviewing the Financial Stability Oversight Council (FSOC) and other regulations brought in through Dodd-Frank.

Dodd-Frank is a series of laws that enacted substantial reform of US financial regulation. On signing the act back in 2010, then President Obama declared that it meant “American people will never again be asked to foot the bill for Wall Street's mistakes”. The act was designed to add greater oversight and stability to the financial system, instituting greater capital requirements and the Volcker Rule, a kind of ring-fencing law that prevents depository banks from making proprietary (speculative) trades on their own accounts, as well as requiring banks to draw up a ‘living will’ to ensure a quick resolution in the event of financial distress.

Dodd-Frank has always been a sticking point for Republicans, with many in the party criticising it for being overly complex and too burdensome for the financial community. The President echoed these sentiments on signing the order last week, claiming that he knows of "so many people" that "just can't get any money because the banks just won't let them borrow because of the rules and regulations in Dodd-Frank." However, when it was pointed out by reporters that, contrary to the President's claims, Federal Reserve data shows commercial lending reaching record highs since the GFC, White House officials clarified that Mr Trump was talking about community banks – defined in the US as being banks with less than $10bn in assets. Indeed, an official added that "community banks have suffered needlessly" as a result of the act.

The notion that the Dodd-Frank act has hampered the little guys while letting the big ones off free is far from a novel one, but it doesn't stack up too well against reality. According to Stephen Klein, a former bank regulator now at law firm Miller Nash Graham & Dunne, "realistically much of Dodd-Frank doesn't apply to community banks", with many provisions such as the Durbin amendment (which limits credit card fees paid by banks to merchants) only applying to larger banks.

However, smaller banks in the US have indeed suffered somewhat since the GFC, with their share of the lending market falling steadily since Dodd-Frank came into force in 2010 (though admittedly this is part of a longer term trend stretching back to 1994). However, we don't believe Dodd-Frank to be the sole or even the main culprit for this. One of the biggest factors affecting community bank profits have been the ultra-low interest rates seen since 2008, with many unable to counteract the squeezing effect on profit margins through large scale trades that the biggest banks can.



There are, however, certain parts of Dodd-Frank which have adversely affected small banks. The Collins amendment, which disallows regulators for adjusting capital requirements for different size banks, isn't in itself a problem for community banks. But, when taken together with the capital requirements of the Basel III international accords, it means that higher capital standards intended for large multinational banks are then applied to community banks.

So, is the apparent repeal all good news for US banks and the borrowing US public? Well, not quite. Firstly, it entirely depends on how much Trump can actually achieve with this executive order. Financial regulation tends to die one step at a time rather than by one hammer blow. So it's likely that we'll see Trump first trying to degrade and slow the act before completely repealing it. Due to a lack of clarity in the original legislation, much of the detailed rulemaking was left to executive agencies rather than the US congress. As a consequence, many of the act's rules are unfinished even now – with a report in July showing that over a quarter of the rules has yet to be finalised. The easiest way for Trump to carve a large chunk out of Dodd-Frank, then, would simply be to direct agencies to never finish these parts. Additionally, personnel changes to financial oversight bodies so as to make them more sympathetic to the President's aims would also blunt much of the regulation. An official large scale revision to the act however, could prove far more difficult to actually impose.

Furthermore, even if Trump completely got his way in repealing Dodd-Frank, the multinational banks would still have to contend with the international rules of Basel III – a global regulatory framework for banks agreed in the aftermath of the GFC. In fact, having one set of rules for their US contingent and another for Europe, Japan and elsewhere could prove an administrative nightmare for the larger banks. Many banks have put a lot of time and money into making sure they comply with current rules meaning that a sudden reversal to regulation would be unwelcome. This is particularly true given that the regulatory framework in Europe is unlikely to change in the short to medium term – especially with elections in France and Germany on the horizon. This is why, all in all, we see these changes as a potential headwind for international banks, despite the slight rally in stock prices of US financials on the back of the news.

As a closing point, we note that, after an extended period of tightening financial regulation since the GFC, Trump's initiative to review the reached state of financial control may not be quite as rebellious as most of his other initiatives. Regulation is usually cyclical, and after 8 years of the regulatory pendulum swinging towards ever tighter rules and oversight, one would expect the direction of travel to eventually reverse as the slowing impact of rules becomes increasingly apparent, while the memory of the horrors of the financial meltdown slowly fade.

It's too early to tell whether or not Trump's attempted repeal of Dodd-Frank is a significant turning point or just another one of Trump's publicity stunts but, once the upcoming elections in Europe are settled, it will be interesting to see what becomes of the international regulatory environment. At least in the UK many have already noted a somewhat less hostile approach from the regulatory institutions and their representatives, after some personnel changes in their top tiers.

Trump's 'border adjustment' tax and its inadvertent consequences

In the previous Tatton commentary, we outlined President Trump's proposed changes to corporation tax and the introduction of a so-called border adjustment rate. Last week, the financial press also picked up on the story, approaching it from a number of different angles, effectively (and collectively) giving President Trump's proposed policy the thumbs down.

As we have stated before, changes to tax systems and their economic effects are rarely accurately predictable. In this case, however, the President's objective is clear, as are the potential economic effects.

The proposed changes are set out in the President's (and the Republican Party's) blue-print of economic policy, and the context is important, given the populist nature of the proposed reform.

According to the blue-print, the change in tax policies are said to prevent "overtaxing products that are made in America" and to "restore American competitiveness by lowering the corporate tax rate to 20% and shifting to a 'territorial' system with more competitive rates". Other commentators are suggesting that the President's proposal is little more than 'protectionism' cloaked in terms of competition and fair trade.

The policy proposes to move toward a cash-flow tax approach for US businesses (as opposed to corporate income tax on foreign sales), which is more like a consumption-based tax (similar to VAT in the UK and Europe), with tax being applied on a destination basis. Therefore, it is a cash/consumption oriented tax rather an income/production based tax.

This means that products and services (and intangibles) that are exported outside the US will not be subject to US tax regardless of where the majority of their component parts were produced. It also means that products, services and intangibles that are imported into the US will be subject to US tax regardless of the origin of production. In simple terms, the border adjustment rate means that companies would no longer deduct the cost of imported goods from their taxable profits, while exports would not be taxable at all.

We should remind ourselves, of course, that a blue-print of policy is exactly that, and it is difficult to criticise the blue-print statement for being short on detail. Nevertheless, there is sufficient detail to understand that this could be a fundamental change in policy, and to recognise the outcomes the President and his advisors are hoping to achieve.

For example, taxing spending on imports instead of taxing sales of exports may result in a positive outcome for a country with a large trade deficit (a country that imports and consumes more than it exports). As shown in the graph below, the US has been running a significant trade deficit for a number of decades.

US Current account (trade) in $US

However, it isn't necessarily that straightforward and there are a number of potential adverse effects; the President's advisors might themselves be advised to 'be careful what they wish for'. As suggested by some of the commentary this week, if nothing else changed and the policy was introduced, US imports would likely fall, exports would increase and the trade deficit would effectively narrow.

However, according to national income accounting, the *current account* must equal the *capital account* (see our article in a previous edition on comparative trade and national accounting). To clarify, imports are paid for in foreign currency (reserves). And, since the new tax regime would reduce US demand for imports and lead to a lower volume of/demand for dollars in foreign markets, the $-Dollar must appreciate if the current and capital accounts are to balance.

An alternative way of understanding this effect is to consider it from the perspective of the US consumer. A 20% corporate tax increase on imports would make imports relatively more expensive for US consumers (but some or all of the additional expense could be offset by a stronger $-Dollar). That is, the consumer could purchase the same volume of imports after the tax was imposed only if the value of the value of $-Dollar rises against these other currencies.

Some economists would argue that all of these (and other) effects will eventually balance out; appreciation of the US$ would eventually make US exporters less competitive, thereby offsetting any initial benefit from "export subsidies" (or the imposition of taxes on imports). While this may be correct, in the short-term, there are likely to be significant distortions and market uncertainties from the sudden change in prices across the economy, which could actually harm the US economy.

As the graph above shows, the US is a net-importer and the US economy is effectively driven by consumer spending. So, a tax on imports will almost certainly put a dent in that consumer spending. This could put the US economy back into reverse and, in the worst case scenario, generate import led inflation combined with low or limited growth.

Moreover, the US is a key trading partner for much of the World and, aside from the likely negative effects on trade relations, the resulting appreciation of the US$ would have more immediate economic effects. Firstly, rather than a "repatriation" of US companies and income to the US (one of the President's objectives), it would actually reduce the value of foreign investments held by US investors and, conversely, increase the wealth of foreign-owned US assets.

Secondly, given that the $-Dollar is effectively the global reserve currency, any appreciation of the US$ would likely tighten global market liquidity and increase the risk of default on huge sums of foreign-held dollar-denominated debt (as it will be more expensive to finance that debt).

The more sceptical commentator has even questioned whether the change in tax would actually result in a large appreciation of the US$ (and the consequent negative outcomes) at all, due to the foreseeable negative economic impact on the US. In our view, a reduced level of US corporate tax, combined with border adjustments and a change to a destination-based consumption tax would almost certainly have an appreciative effect on the $-Dollar (irrespective of any need to balance the national accounts).

President Trump's policy has already set US businesses against one another (net importers *vs* exporters); not an ideal start for a change of policy. Furthermore, any proposed change in tax and trade policy would have to navigate the US administrative system and the WTO, neither of which are easy or quick processes. In this instance, it is to be hoped that these processes are slow, as this will provide the opportunity for markets to better understand the proposals and adjust investments accordingly.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7258.8	1.0	70.5	↗
FTSE 250	18715.4	1.6	303.7	↗
FTSE AS	3950.4	1.1	42.7	↗
FTSE Small	5321.3	1.1	58.1	↗
CAC	4828.3	0.1	2.9	↗
DAX	11667.0	0.1	15.5	↗
Dow	20242.8	0.9	171.4	↗
S&P 500	2312.7	0.7	15.3	↗
Nasdaq	5225.3	1.2	63.7	↗
Nikkei	19378.9	2.4	460.7	↗

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
ROLLS-ROYCE	9.2	LSEGROUP	-4.0
RANDGOLD RESOURC	8.6	BP	-4.0
CAPITA	8.2	WORLDPAY GROUP	-3.8
ASTRAZENECA	6.2	CRH	-3.1
MEDICLINIC INTERNATI	6.0	KINGFISHER	-3.0

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	30.7	Brazil	234.2
US	19.3	Russia	176.4
France	51.6	China	105.4
Germany	22.2	South Korea	46.5
Japan	49.0	South Africa	203.6

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.25	0.11	OIL	56.8	-0.1
USD/EUR	1.06	-1.32	GOLD	1233.8	1.1
JPY/USD	113.24	-0.56	SILVER	17.9	2.5
GBP/EUR	0.85	1.48	COPPER	276.5	5.7
JPY/GBP	6.88	-0.16	ALUMIN	1850.0	1.1

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.3	-7.1	-0.10
US 10-Yr	2.4	-2.4	-0.06
French 10-Yr	1.0	-2.9	-0.03
German 10-Yr	0.3	-22.1	-0.09
Japanese 10-Yr	0.1	-8.0	-0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.7
5-yr Fixed Rate	2.2
Standard Variable	4.2
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

GLOBAL RESEARCH TEAM
Lothar Mentel – Chief Investment Officer Lothar.Mentel@tattonim.com
Jim Kean – Head of Investment Jim.kean@tattonim.com
Mark Murray – Fund Analyst mark.murrary@tattonim.com
Sam Leary – Strategist Sam.leary@tattonim.com

For any questions, as always, please ask!

If anybody wants to be added or removed from the distribution list, just send me an email.

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg and is only valid for the publication date of this document.

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

Lothar Mentel