Weekly Market Comment

17 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

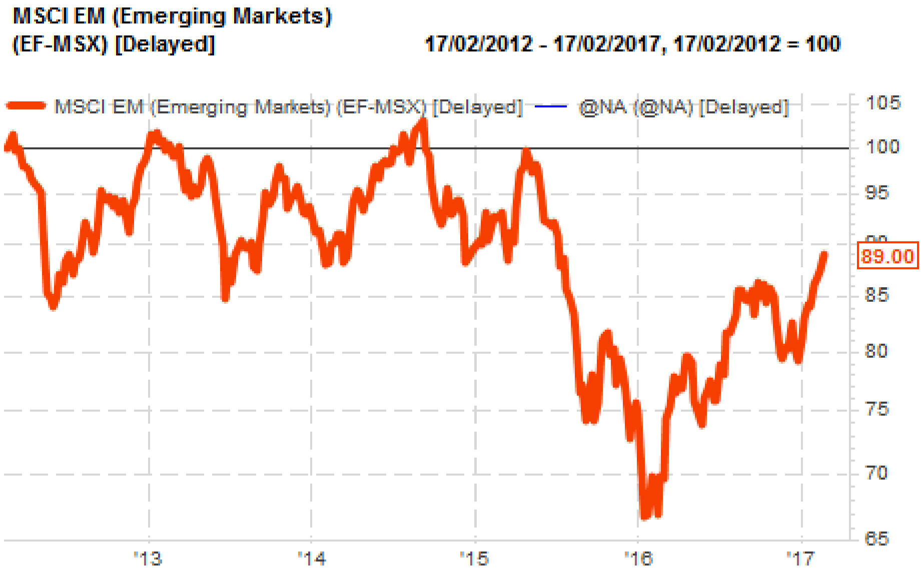
US rate rises! UK rate rises?

It emerged last week the Federal Reserve Bank is extremely likely to raise rates on March 15th. The Bank of England's MPC will look on with envy.

The continued strength in US employment and inflation data evident in the past two weeks set the scene. Then in congressional committee testimony, both Janet Yellen and William Dudley (the FOMC or "Federal Open Market Committee" chairman and vice chairman) indicated that the current economic conditions warranted a rise.

What set the seal on the deal is the market response. Most stocks brushed off the move. Bank stocks soared, Goldman Sachs hitting all-time highs. Perhaps most importantly, emerging markets continued their market-leading march upwards.

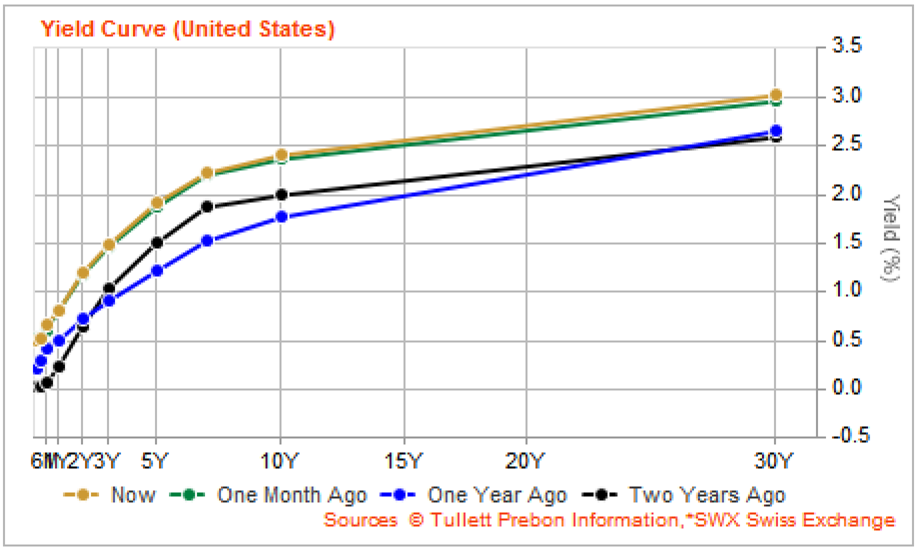
This is materially different to the situation of just over a year ago, when discussions of a US rate rise led to visceral fears about emerging market collapse amid commodity price falls.



Source: Factset

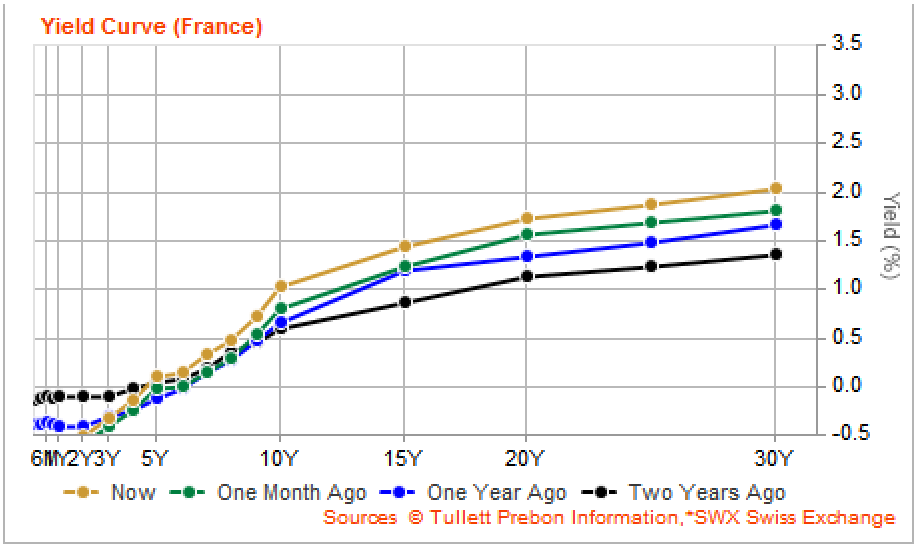
And as we know the Fed changed tack in that March meeting, allowing an easing which has subsequently led to the current position.

So, this time around, markets are prepared. Bond yields are higher than two years ago, though not enough to create any destabilisation.



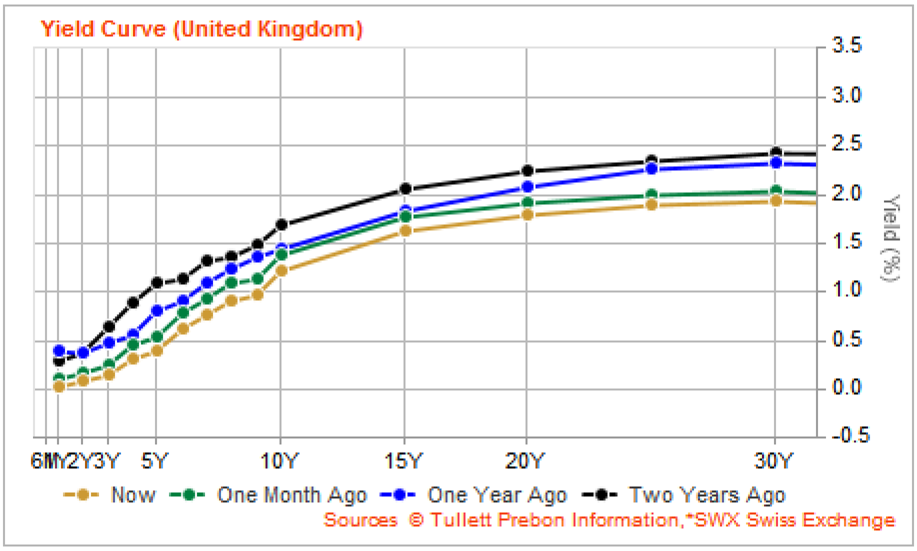
Source: Factset

That's true also for Europe (in general, although the move up in yields in Italy, Portugal and Greece is not borne directly out of current economic strength).



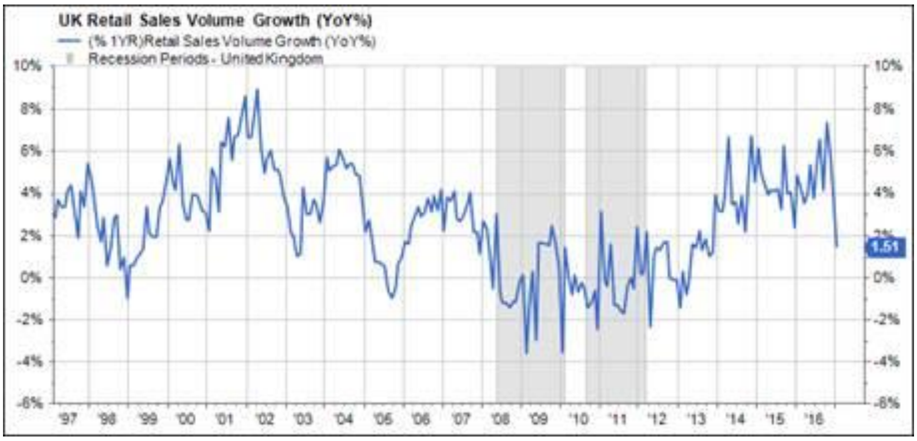
Source: Factset

However, the UK is different. Yields remain at or around two-year lows despite the pick-up in inflation.



Source: Factset

And here's the reason:



Source: Factset

UK domestic activity shows every sign of slowing in the face of inflation. That really shouldn't be a surprise since real wages have been compressed by the rise in consumer prices, both actual and expected.

However, the housing market, a significant influence on personal spending, is weakening in the South-East, which may be socially desirable, but not a help for growth.

So will the Bank of England follow the Fed or not?

Our expectation is that the Monetary Policy Committee will see the rise in inflation as a one-off spike. The retail sales volumes tell the story that wage growth is not spiralling up with inflation rise.

The sterling move and its consequent inflation will lead to lower real growth, not higher; the process of slowing has begun a new cycle and the questions are probably "how weak can growth get and when does it trough?".

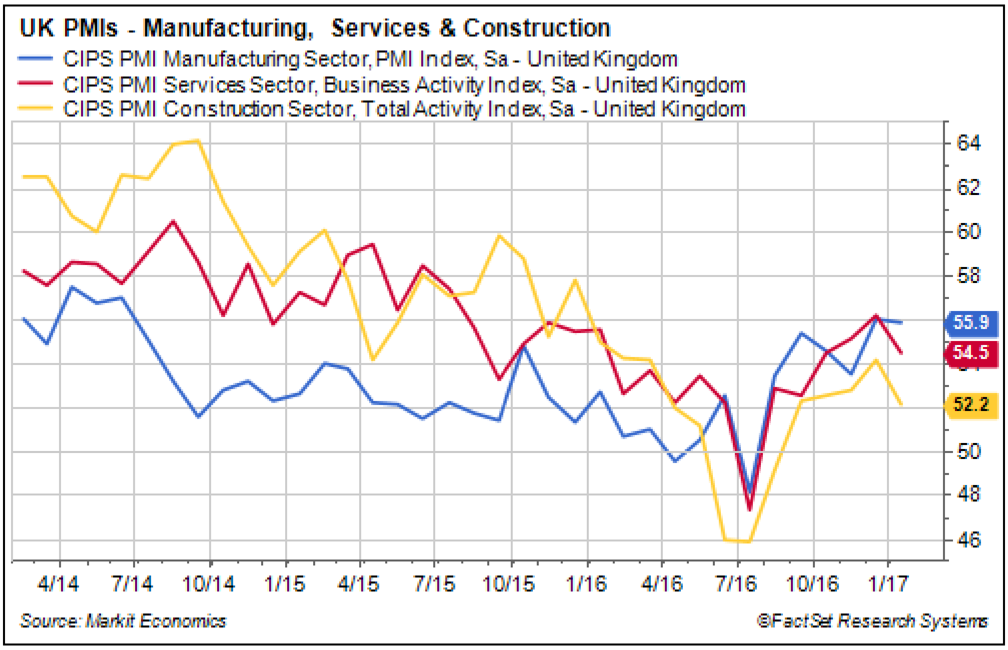
The UK has a problem.

In normal circumstances, a currency fall cheapens the costs of production (especially in skilled labour) and that promotes inward foreign investment, helping stabilise growth.

The BREXIT process (and other countries' potential imposition of trade barriers) puts big hurdles in the way of that inward investment. Direct production costs will not be the most important component of the net selling price in the future.

There's evidence that the UK regions have increased production where global manufacturers have flexibility. That only goes so far and, by definition, isn't necessarily sticky.

In services, so much more important to growth, the evidence is that a slowdown is underway.



Source: Factset

The MPC's post-referendum policy has been characterised as letting sterling take the strain. We think, if economic growth weakens as seems likely, the MPC will be happy to do so again.

Don't expect the MPC to follow the Fed.

Growth of the EZ: beware of bumps in the road

The latest survey of economic forecasts by the European Central Bank (ECB) revised up expectations of Eurozone (EZ) growth for 2017 by 0.1%, but there was no change to expectations for 2018 or for the longer term (to 2021). Real GDP growth expectations remain at 1.5% per annum for each calendar year from 2017 to 2019.

While the EZ is on a positive trajectory, the ECB's accommodative monetary policy will be required for some time yet, and there may be other potential risks on the immediate horizon. For example, Greece's continuing travails and the recent IMF/EU rescue package, as well as the challenges posed by Italy's banking system (and general economic malaise), could both present problems further down the road.

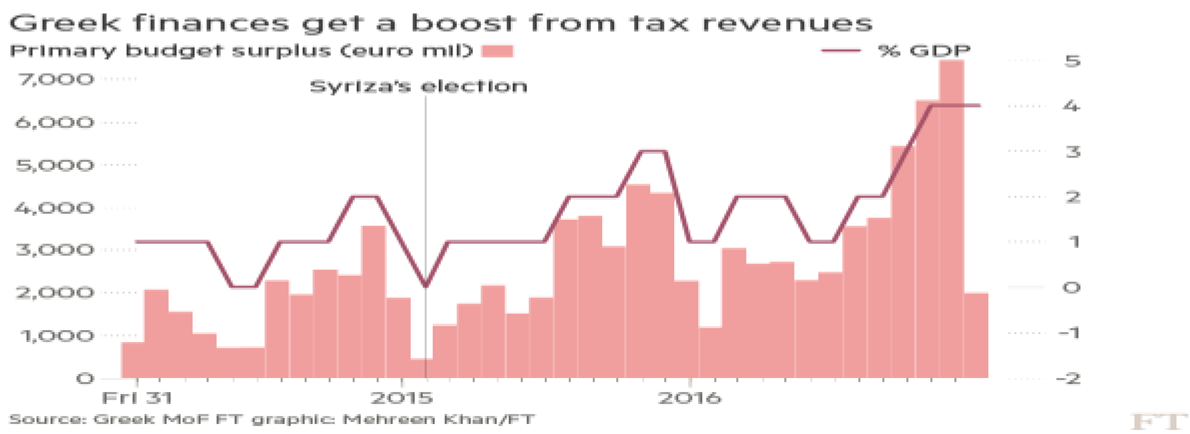
On the face of it, the scale of the credit extended to Greece appears insignificant relative to overall EZ GDP; the loan package of €86bn agreed with the IMF and the rest of EU is a fraction of total EZ GDP (at ~€12trn). However, any risk of default (or actual default) by Greece would clearly still be felt by the rest of Europe's economies (and on the €-euro).

As Greece approaches another round of negotiation (and disbursement), the headlines this week have been about a renewed spat between the IMF and the EU's finance ministers. There is again disagreement on the conditions of the loan to Greece. The EU is arguing to retain a clause requiring that Greece operate to a primary budget surplus of 3.5%, while the IMF believe the target cannot be maintained over the long-term and that it should be lowered (to 1.5%).

In fact, the IMF's concerns go beyond the conditions of the existing loan. It is suggesting that, without some form of debt relief, Greece could be facing an unsustainable level of public debt. In short, absent relief and further structural reforms (to pensions, employment and tax), the IMF estimate that Greece's debt load will reach 170% of GDP by 2020 and 164% by 2022, but could become "explosive" thereafter, growing to 275% of GDP by 2060.

So far, Greece has surprised to the upside. As reported in the FT some weeks ago, the structural changes already made by the Syriza Government are – perhaps unexpectedly - delivering the desired outcomes. The primary budget surplus, excluding debt repayments, nearly doubled last year as the Government's collection of taxes exceeded even the targets sets by the terms of the EU loan (see graph below).

Greece's receipts and expenditure



Source: FT, 25 January, Article by Mehreen Kahn

As noted, however, the IMF's real issue is the burgeoning overall level of Greek debt. If the IMF do consider the level of debt unsustainable, it cannot then extend further credit without breaching its own credit rules. In addition, the EU would presumably be unwilling to extend its own terms to Greece without also having the IMF on-board.

We believe, however, that there will be a compromise between the EU and the IMF. For example, the scope for further reform and the target level of budget surplus are both likely to be negotiated. Moreover, given the Greek Government's achievements to date, the prospect of 2.7% growth in Greece's GDP in 2017/18, and the need for other EU partners to focus on their own political issues, we expect Greece to successfully navigate this latest round of "negotiation". Of course, issues arising from the process will have to be carefully monitored to ensure they do not have a material (negative) bearing on the positive trajectory for the EZ.

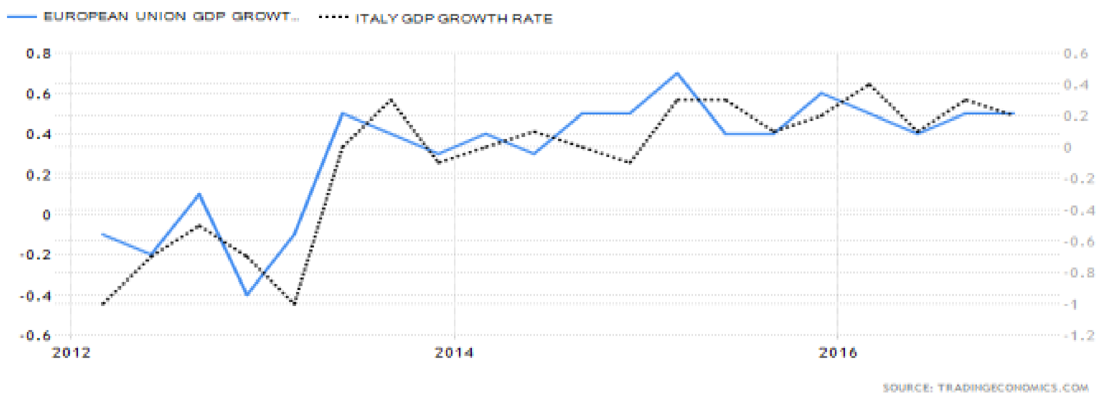
So what about Italy? According to recent research, the challenges posed by the Italian banking system are now finally being addressed. Recall that Italian banks hold ~30% of the EZ's non-performing loans (NPLs), and could pose a serious risk not only to the Italian economy, but to the entire EZ.

Absolute Strategy Research (ASR) state that recent reforms in Italy should encourage mergers of smaller regional banks, foster greater independence and improve sector profitability. Furthermore, changes to the insolvency and enforcement frameworks should simplify debt restructuring and procedures, supporting the market value of NPLs.

Also, ASR suggest that public guarantees for senior tranches of securitized NPLs and a privately-owned backstop fund should facilitate the removal of NPLs from the books of commercial banks and develop a market for impaired assets. Taken together, all of these reforms should free up banks' capital, increase their profitability and boost lending.

While reform to the banking system should provide the Italian economy with a welcome impetus, we are sceptical as to whether this will be sufficient to offset the other structural challenges facing the Italian economy. However, as the graph below shows (and as might be expected), as the wider EZ economy improves, we expect the Italian economy to "adjust and follow" (albeit lagging this a little).

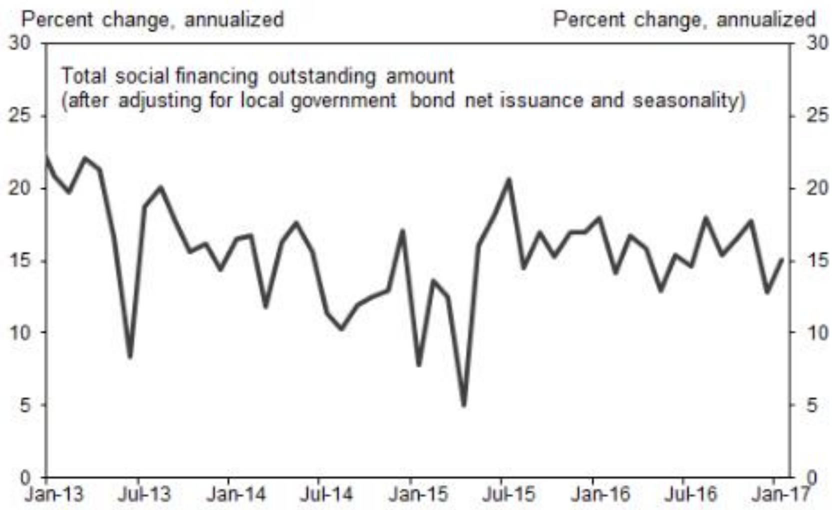
Italy might, therefore, await further positive momentum in the EZ and undertake the necessary structural reforms as and when the economy is buoyant and growing. Although the Italian economy is in need of reform, we believe it is more likely to (eventually) follow the example of Spain (which has restructured and is now growing) than the example set by Greece (which required loans and forced restructuring).



EU GDP growth rates. *Source: TradingEconomics, Feb 2017*

Solid Chinese loan demand could underpin further global economic growth

As stock markets around the world continue to either set new records or hover at historic highs on the back of stronger than expected inflation readings and media grabbing Tweets about US tax reform, two pieces of Chinese data appear to have gone somewhat under the radar. We think that the solid loan and credit numbers from China this week suggest positive implications for further domestic investment, manufacturing sentiment, and upward pressure on commodity prices, equities and currencies.

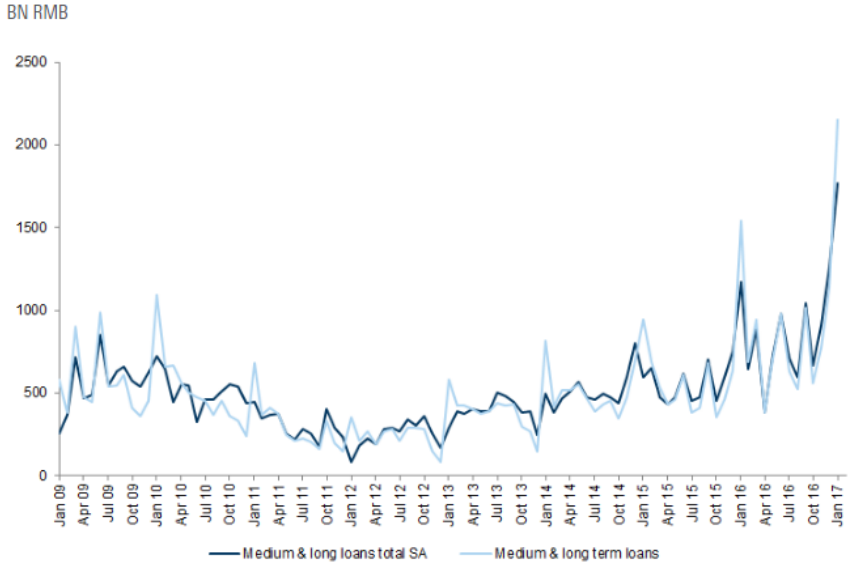


Source: PBOC, WIND, Goldman Sachs Global Investment Research

Firstly, Total Social Financing (TSF - loans provided by banks into the real economy) was a much better than expected ¥3.74 trillion in January, up 15% on a month-on-month annualised basis from December. The driver of this increase looks to be due to an encouraging combination of both lower real interest rates (i.e. loans are cheaper) and continual improvements in domestic corporate profitability during 2016, which has helped underpin loan demand.

We also note that there was an acceleration in broad money growth from December, possibly indicating that the pace of currency outflows from China have slowed, leaving more money in domestic circulation. Generally, when broad money growth expands, there is a net upward impact on activity growth in the shorter-term. We therefore think that Chinese growth might even surprise positively.

Exhibit 1: Metals intensive 'old economy' credit - medium and long term loans - were up sharply in December and January, +50% yoy, reaching record high levels



Source: CEIC, Goldman Sachs Global Investment Research

When we dig further into the drivers of loan demand we find some encouraging dynamics. Loan demand from the commodity intensive ‘old economy’ (manufacturing, infrastructure, property) has been particularly strong, reaching record levels after rising 50% between December and January.

By comparing the December-January loan data from 2016 to the same two-month period in 2017, we find some interesting parallels. Over the December-January period last year, the large government-directed credit stimulus programme was ramped up in response to slower economic growth. As a result, the ‘old economy’ received ¥2.2 trillion of medium and long-term loans, which was the fastest pace since the Global Financial Crisis in 2009. These loans found their way into metals-intensive property projects, thereby increasing manufacturing capacity, infrastructure projects and property purchases. This drove a stunning 9% jump in Chinese FAI (Fixed Asset Investment) in the subsequent two months, which appears to have formed the basis for the positive turn around in commodity prices in 2016.

Looking at the same two months from this year, the ‘old economy’ has received 50% more loans (or ¥3.3 trillion) than it did last year. To put these numbers into some context, that extra ¥1.1 trillion (~US$160 billion) works out to be more than 1.5 years of Trump’s proposed $100 billion a year infrastructure initiative.

So far, the rapid rise in credit (money) does not appear to have materialised into the ‘old economy’, due to some seasonal factors such as the wee- long Luna New Year celebrations. We expect that, like last year, FAI could very well expand rapidly and have a positive impact on manufacturing sentiment over the next few months.

We do not find it particularly surprising that China has had a very slight bias towards higher interest rates on the back of very strong private sector demand for credit. In the past, these credit signals have been a sign of strength.

As the ‘old economy’ ramps up, it is entirely possible that the resulting increase in demand for metals, such as copper and nickel, could push those markets into a deficit situation, and we expect that commodity prices could find further support in 2017 from these raw materials sensitive industries. As such, we believe that

China will be a source of inflation (rather than deflation or lower prices) for the global economy in 2017 (as discussed in the article lower down), which can help support growth.

Finding the value in AIM

In our last piece, we noted the strength of large cap stocks over 2016, with the FTSE 100 returning 19.1%, while the small cap index returned 12.5%. This trend has started to see a reversal, with investors shifting more capital from large cap markets into small cap ones. This can be seen by looking at the returns from the FTSE AIM market of 15.9% and the small cap index of 9.6% over the last 6 months, compared to the FTSE 100's return of 5.4% and the All-shares return of 5.5%.

If we drill down deeper into these returns, we find that the energy sector has performed well, with returns of 47% over the period – presumably on positive sentiment from a rising oil price environment. Particularly strong stocks in this sector include Sound Energy (+71%), an African and European focused upstream gas company; Hurricane Energy (+130%), a North Sea deep exploration company; and Ithaca Energy (+75%), also a North Sea oil and gas operator. Another noticeably strong sector was the pharma sector, which was up 20% with foreign earners such as GW Pharma returning 33% and Hutchison Meditech returning 20%.

However, we need to be careful when just looking at top down aggregate returns of sectors, as they can paint a misleading picture. For example, although the energy sector has seen strong returns, not all resource companies performed as well. The precious metal explorer Pan African Resources fell by 23% over the period and Pantheon Resources, the US focused oil and gas exploration company, fell by 36%. This demonstrates that companies in similar sectors are not just driven by the same factors but are subject to individual company specific factors. Another example of this is the IT services company, Redcentric, whose share price has halved over the period due to an accounting irregularity. Clearly, this is independent of the sector it sits in.

We can see clearly from the above the importance of carefully researching individual stocks and understanding the economic drivers of each company, rather than simply attempting to buy stocks based on top down sector or economic views.

The Reflation Trade

Last month, inflation in the US hit its fastest pace in four years, as reported by the Labour department on Wednesday. The consumer price index (CPI) rose 0.6% in January, making it the third consecutive increase and the largest one since February 2013. In year-on-year (yoy) terms, the jump was even more pronounced, with the CPI posting a 2.5% increase on the January 2016 numbers – the largest yoy hike in 5 years. The biggest driver of the increase was fuel prices, with the energy index seeing it's largest yoy gain since 2011 with a rise of 11%. Even excluding the volatile areas such as food and energy however, US inflation took a significant step up, with core inflation coming in at 0.3% for the month and 2.3% yoy.

On the same day as the news, global stock indices hit record highs, with the FTSE All World index (which has a 50% weighting to the US) climbing 22% over the last year, and 8.1% just since Donald Trump's surprise election win. Bank and tech stocks joined in the rally – with Goldman Sachs and Apple pushing at their own record highs – while the US 10-year treasury yield climbed up to 2.5%. All of this came despite Federal Reserve (Fed) chair Janet Yellen delivering a hawkish speech to the US congress, making another rate rise in March ever more likely, and the fledgling Trump administration continuing to trip over itself.

It seems that, despite the realisation of what were for a while investors' greatest fears – Brexit, Trump and rate rises – the good times have kept on rolling. The global reflation trade is on, as markets appear to be banking on a pickup in global inflation and activity to push growth forward.

Much has been said about the role of Donald Trump in all of this. After his election win back in November, markets appeared buoyed by promises of tax cuts, deregulation and fiscal stimulus and the effects they would have on growth. And yet, despite a flurry of executive orders in his young presidency, little of what got the corporate sector so excited looks as though it will be coming in the near term from President Trump (the exception being the proposed repeal of Dodd-Frank which, as we discussed last week, may even become a headwind for financials). Indeed, much of what has come through from the Trump administration appears to be bad news for big businesses, such as the proposed border adjustment tax.

So if not Trump, then what? Well, for one, the Q4 earnings season has come up with plenty of good news for markets. S&P 500 earnings are on course for a 7.2% yoy gain according to Thomson Reuters, with sales growth of 4.3%. Financials in particular have rallied substantially, with profits up 11.6%. Secondly, data releases have been surprising to the upside all around, with Citi's surprise indices show how positive surprises have risen to their highest level since 2010.

However, in our view, one of the most significant factors behind 'the great reflation' that some have taken to calling the past few months has been the bright picture coming out of China. As discussed above, the data on loan demands in China is looking positive, and it is this dynamic which could underpin solid growth throughout the world. Crucially, an important point to note is that China is now becoming a source for global inflation, rather than deflation.

Since the last sustained bout of global inflation in the 1970s, the increasing globalisation and interconnectedness among the world's economies has brought with it a somewhat disinflationary environment. This is to be expected, given that globalisation could (perhaps crudely) be understood as the ability to import goods and outsource costs (labour, for the most part) to wherever is cheapest. And, with their status as the de facto 'factory floor of the world', China has spent the better part of the last 30 years serving that purpose. This has meant that the country acted as an effective dampener on inflation – absorbing rising costs through excess capacity.

Now, however, that looks as though it might be changing. Both increased demand (as shown in the loan data) and rising costs from producers in the country are having a knock-on effect on prices across the world. Wages in China have, for a long time, been increasing in line with the country's rampant growth spurt and manufacturers have been subsequently forced to raise their prices, meaning the country is no longer the cheapest place to source goods.

The question is, of course, whether the pick-up in near-term inflation coming out of China is just that, or whether this is a structural change that will see global inflation become a prominent feature of the world economy once more. This is hard to say, as it would be all too easy to overstate the situation. The government's response to the last big pickup in inflation at the end of 2015 was to embark on a program of increased infrastructure spending. And, while this has partly led to the increased demand we see now, over the long term this will translate into extra capacity in the world's second largest economy – capacity which will yet again act as a dampener on global inflation.

On the other hand, taking a larger view, one could argue that other factors around the world are also signalling an end to the disinflationary epoch. For one, the huge money supply created through Quantitative Easing looks as though it's finally having a real effect on activity – as seen in the Eurozone and Japan. Furthermore, globalisation appears to have reached slight crest in two interesting ways: Firstly, as explained in the case of China, the traditional sources of cheap labour and goods are no longer as cheap, with the balance of money flows seeing a levelling occur. And secondly, there is an increased political pushback against globalisation and its associated features – particularly immigration – as witnessed in the Brexit vote, the election of Trump and the surge of far-right extremism across Europe.

The rampant inflationary environment of the 1970s came about largely through changes to the global political and monetary system and in particular, the abandonment of the Bretton Woods system. While we are, of course, not at that level of upheaval, it is undoubtable that the global political and financial structure is going through some great changes. Britain's exit from the EU, together with the Trump administration's antagonistic nature towards any political or economic power centre outside of his control (with his rumoured pick for EU ambassador once comparing the bloc to the Soviet Union), paint a picture of a much less integrated global economic order. Combined with the other factors mentioned, it's not hard to imagine global inflation taking hold again.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7292.0	0.5	33.3	→
FTSE 250	18678.5	-0.2	-36.8	→
FTSE AS	3964.7	0.4	14.3	→
FTSE Small	5362.2	0.8	40.9	→
CAC	4858.1	0.6	29.7	→
DAX	11739.2	0.6	72.3	→
Dow	20555.6	1.4	286.2	→
S&P 500	2340.6	1.1	24.5	→
Nasdaq	5304.0	1.5	77.3	→
Nikkei	19234.6	-0.7	-144.3	→

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
UNILEVER	14.7	ROLLS-ROYCE	-9.1
COCA-COLA HBC AG-DI	8.9	MARKS & SPENCER	-4.8
RBS GROUP	5.9	DIRECT LINE INSURA	-3.8
INTL CONSOLIDATED A	5.3	ROYAL DUTCH SHELL	-3.6
SHIRE	5.2	JOHNSON MATTHEY	-3.4

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	30.7	Brazil	228.1
US	20.0	Russia	177.3
France	56.0	China	98.2
Germany	22.5	South Korea	46.2
Japan	49.0	South Africa	186.3

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.24	-0.58	OIL	55.5	-2.2
USD/EUR	1.06	-0.19	GOLD	1238.5	0.4
JPY/USD	112.83	0.35	SILVER	18.0	0.5
GBP/EUR	0.86	-0.49	COPPER	271.4	-2.4
JPY/GBP	6.87	0.17	ALUMIN	1897.0	2.5

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.2	-3.6	-0.05
US 10-Yr	2.4	0.4	0.01
French 10-Yr	1.0	-1.9	-0.02
German 10-Yr	0.3	-5.6	-0.02
Japanese 10-Yr	0.1	2.2	0.00

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.murray@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