



Weekly Market Comment

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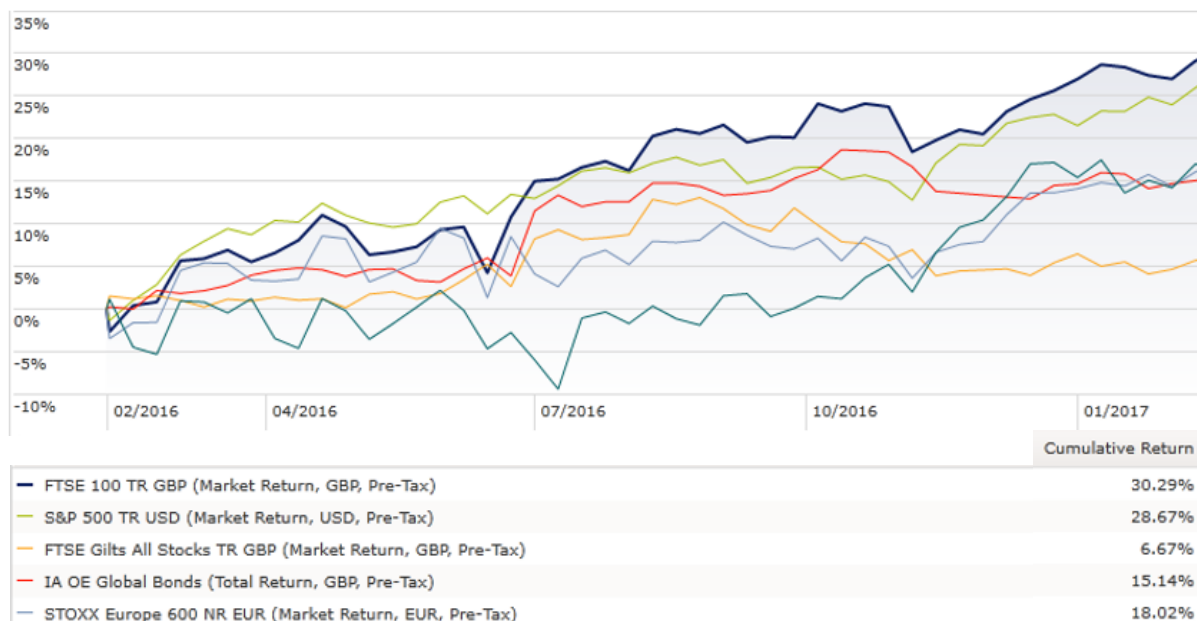
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Local returns of major UK and global asset classes since 8 Feb 2016 to 23 Feb 2017; Source Morningstar

One year on from the last stock market correction

It is now roughly one year since many market experts were adamant that the stock market correction of January and February 2016 was heralding the beginning of the end of the economic and capital market cycle that started in 2009. China's and the US' economies had slowed in their pace of expansion, the oil price hit a low of \$25/bbl and corporate earnings had fallen successively for the past 4 quarters. Political risks from the UK's EU referendum and the US presidential election were only going to make matters worse and provide markets with even more reasons to trade lower.

As the chart above shows, it turned out to have been the turning point in markets and those who did not lose their nerve but instead relied on their observations of the real economy have since made handsome returns. This is even without the effect of the post Brexit vote £-Sterling weakness, which I have deliberately neutralised in the chart, by showing the non-UK returns in local currency terms, rather than from the even more positive £-Sterling perspective.

One year on and the perspective could not be more different. The global economic expansion is back on track and for the first time is running synchronised across global regions and sectors. From a market perspective, UK and US electorates have opted for what was previously perceived as the worst possible outcomes, but markets quickly changed their minds and now seem to interpret them as the most positive possible option. Commodity prices have stabilised and resource companies and the manufacturing industries most closely connected to them are once again talking about investment and expansion, instead of battenning down the hatches.

The same market strategists who told us a year ago that we were heading for the abyss are now telling us that the 'Trump trade' is pushing stock markets to ever higher all-time highs, as investors are supposedly under the spell of what the new US president may be able to conjure up in terms of corporate tax breaks and fiscal stimulus through vast infrastructure investments.

At Tatton - in 2017 as in 2016 - we filter out as much of the ongoing market noise as we can and focus on what is really going on in the global economy. From that perspective we have regularly written on these pages that the global economy seems to have overcome a number of the headwinds which had hitherto hampered economic expansion back to the pre Global Financial Crisis levels. Particularly, the return of business confidence in the 2nd half of last year on the back of the persistency of global growth has led to the return of some level of 'animal spirits' behaviours in the economy. This has the potential to mobilise the vast corporate cash reserves for growth and productivity investment and we therefore gave it considerable attention.

While this may lead to a very positive impression of economic progress potential and thus further corporate earnings growth - which should reflect positively in stock market valuations - there are also more potential headwinds on the horizon than the currently bullish market sentiment may be willing to see. The risks of ill-guided decisions by the Trump administration to global trade and of acrimonious divorce proceedings between the UK and its EU trading partners have not yet led to a noticeably negative economic decision making impact. This is encouraging, but means by no means that it never will.

The rapid intra-day stock market sell-off at the end of the past week, in absolute absence of adverse news, was therefore perhaps a timely reminder that market volatility can return with a vengeance at any point. As it happens this episode was most likely a long overdue profit taking move by short term investors. However, numerous parallels have been drawn between 2017 and 1987, when economic expansion was similarly picking up and fuelled by previous commodity price falls – but market suffered a one day 20% correction in the autumn.

History does not repeat itself, but it rhymes - as we say in our profession. We would therefore like to remind investors that unnerving market corrections as we experienced just one year ago, are quite probable and can be extensive during the latter part of an economic cycle. Cycles in the aftermath of financial crises have historically lasted far longer than the more frequent boom-bust cycles, but in the 9th year of the current cycle we should expect to be at least in the second half of it. The other useful old adage is that 'cycles do not die of old age'. It is therefore entirely possible that just as in 2016, political risks do not materialise and economic progress simply carries on.

This is why we currently prefer to neither overweight nor underweight growth assets vs defensive asset relative to their respective risk profile allocations. Instead we use our investment discretion to differentiate more strongly between regions and within asset classes on the basis of price and relative valuations. This allows us to continue to fulfil our mandate to position clients' investment portfolios such that – based on current insight - they can participate in the best return opportunities that are available for their chosen investment and risk objective in the current environment.

The UK economy: mind the gap

Mark Carney, the Governor of the Bank of England (BoE) was heavily criticised after the EU referendum, as were most economists. The charges were twofold: Firstly, for painting an adverse picture of events immediately post-Brexit and, secondly, for incorrectly forecasting UK economic activity post-Brexit.

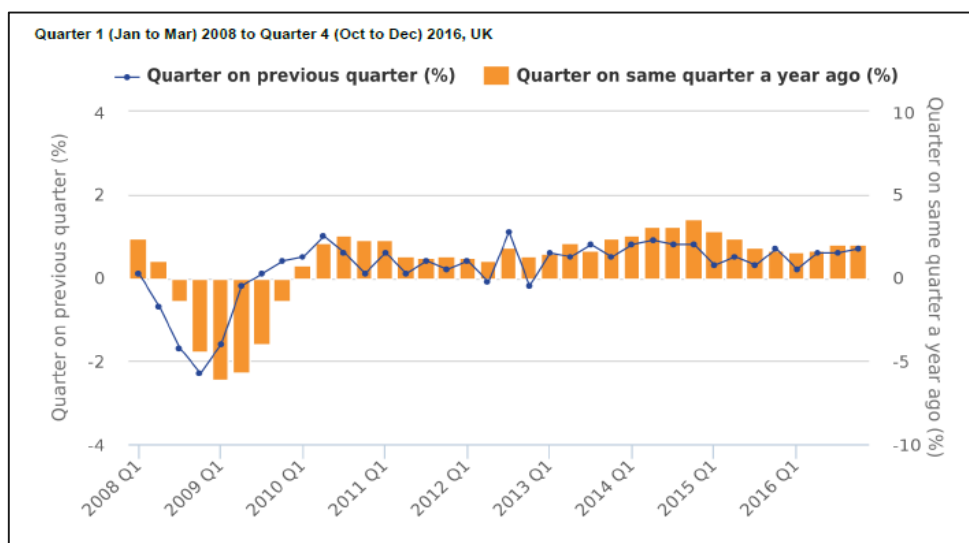
Perhaps unsurprisingly then, in comments to the Treasury Select Committee this week, the Governor was more measured, and chose to describe “different scenarios around alternative economic forecasts”, albeit in the context of future monetary policy.

He appeared to be implying that, while immediate headwinds to the UK economy may have dissipated (or not materialised), it is by no means certain that the UK economy is set for a smooth path to future growth. Irrespective of the Brexit process and the UK’s future terms of trade, one of the potential scenarios might be less optimistic, requiring looser monetary policy than is currently being forecast by the BoE.

Indeed, the latest macroeconomic data does not appear to contain a definitive positive or negative trend. There are a number of puts and takes in the data, but not necessarily a discernible and sustainable medium-term trend for any of the key variables. This would suggest an even more cautious approach to any medium-term economic forecasting, and markets are right to be wary of commentators predicting a binary outcome for the UK economy.

According to the Office for National Statistics (ONS), UK GDP grew by 1.8% in 2016 – some way below the average rate of GDP growth in the decade prior to the downturn (2.9%) and lower than the average of independent forecasts made at the start of 2016, which was 2.2%. It also represents a downward revision on the previous estimate, resulting from slightly lower than expected growth in the first quarter of 2016.

UK GDP growth rates



Source: Office for National Statistics, Feb 2017

As we wrote a few weeks ago, consumer spending has been solid over the last two quarters (as has manufacturing over the last quarter). However, what is less clear is whether consumer spending – the powerhouse behind the current level of growth – is set to continue at current levels. We don’t believe it will, not least because inflation will gradually eat into income and slow consumer spending. This is borne out by the ONS data.

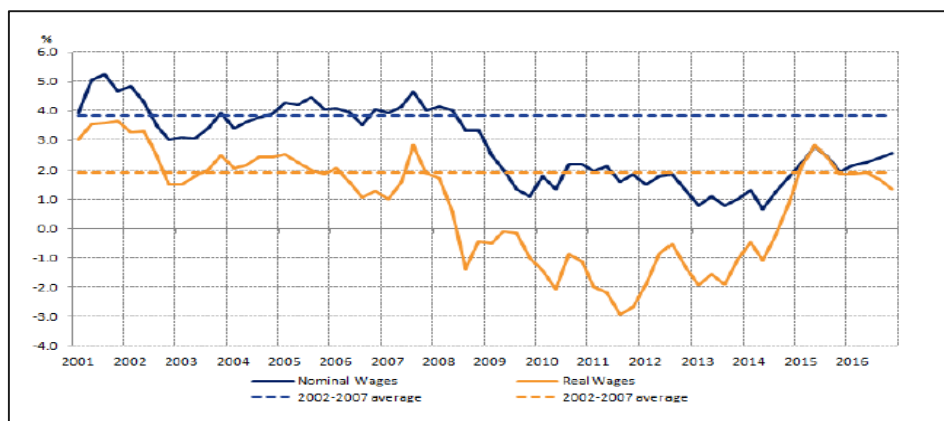
Moreover, consumer spending can only continue to drive growth if it is effectively supported by further employment and wage growth. While the employment rate has now reached a record high of 74.6% (welcome news), the pace of employment growth is actually slowing and, in the second

half of 2016, moderated from the average rate experienced 2012-2015. Perhaps more importantly, wage growth remains subdued.

The ONS state that average weekly earnings for employees increased by 2.6% in the year to December 2016 – both including and excluding bonuses. The rate is the highest since the 3 months to June 2015, but below the pre-crisis average of 3.8% (between 2002 and 2007).

Taking into account the recent pick-up in the rate of inflation, real average weekly earnings have only increased by 1.4% over the year, the weakest pace of growth in almost 2 years (see graph below).

Annual growth in average weekly earnings, real and nominal terms



Source: ONS, Feb 2017

As we have previously shown, consumer spending contributes ~60+% to GDP (and growth), and consumption increased by 3.0% in 2016, the highest since 2004. The contribution from private consumption was significantly above the average since the economic downturn (1.0%), but was similar to the average for the 7 years leading up to the downturn (2.1%).

If nothing else, there appears to be an unsustainable “gap” emerging between the current level of consumer spending and the future level of spending as suggested by the recent employment and wage data. Neither wage growth nor inflation would support the current level of consumer spending.

The other issue is an apparent conundrum presented by the (record) high levels of employment combined with relatively subdued wage growth. This would appear to suggest that the labour market is not actually tightening, to the extent that there is still considerable slack in the economy (and/or the economy is somewhat short of its supply potential). This would seem to be reflected in the latest business investment figures: fourth quarter investment was down 0.9% on a year earlier, only marginally better than expected before the EU referendum.

The various puts and takes (manufacturing up, net trade down; consumer spending up, business investment down) are helping to stabilise the UK economy. However, we remain of the view that, even if economic buoyancy in the US and (emerging) in the EZ helps certain large cap UK

businesses, the absence of post-Brexit certainty for the wider UK economy might imply a more cautious stance as far as mid cap and other investments are concerned.

US Fed demonstrates reassuring business as usual attitude

The US Federal Reserve (Fed) may have to raise interest rates “fairly soon”, according to minutes from their January meeting released on Wednesday. In the meeting, the first for the Federal Open Markets Committee (FOMC) since Donald Trump’s inauguration last month, the committee talked at great length about the potential effects of the President’s much discussed fiscal policies. According to the minutes, the FOMC could raise rates as early as their next meeting in March, despite market expectations that the next hike wouldn’t come until June.

Many of the committee’s members felt that raising rates sooner rather than later would be appropriate if labour market and inflation figures match or exceed expectations. Overshooting the Fed’s 2% inflation target appeared to be a concern among the FOMC, with one member going as far as to claim that a near-term rate rise would give the central bank greater flexibility. However, many members “continued to see only a modest risk of a scenario in which the unemployment rate would substantially undershoot its longer-run normal level and inflation pressures would increase significantly.” Prior to the release of the minutes, markets had put the chance of a March rate rise at 20%, according to CME Group analysis.

Whether the hike will come next month or later, it’s clear that Fed chair Janet Yellen and her fellow rate setters of the committee are preparing to up the pace of rises. After raising rates only once a year in 2015 and 2016, the FOMC has pencilled three more rises for 2017. The main sticking point for the committee was the great uncertainty surrounding the policies that were likely to come out of the White House, with the minutes showing a belief among the FOMC that it would be “some time” before it became clear what effect Mr Trump’s potential policies would have.

Effectively, the Fed seem to be acknowledging that currently there is not yet real direction from the Trump administration – with details rather than promises of tax cuts, deregulation and infrastructure spending failing to materialise as yet – so they will have to just keep focused on their primary role of taking their hints from the actual economic development. Indeed, while tax reform and fiscal stimulus were big talking points for Trump on his campaign trail, he has yet to clarify many crucial details since assuming office. And, Ms Yellen has stressed over the past few weeks that this has made the outlook for the US economy difficult to gauge.

Regarding the current state of the US economy, things are indeed looking strong. According to Reuters, the four-week average for unemployment claims fell to its lowest in 43 years last week, with total claims remaining below 300,000 for the 103rd consecutive week. And, while the unemployment rate edged up 0.1% to 4.8% last month, it has remained at or below 5% for over a year now, edging closer to the ‘full employment’ level. Meanwhile, inflation has gradually recovered, hitting a 4-year high of 2.5% last month.



In our view, the Fed is right to note that the increasing strength of the US economy means it may no longer need the ultra-low interest rate environment (once deemed an extreme measure) to sustain further progress. It is, however, important to point out that the rate at which the US is pushing ahead is starting to let up. Despite the four-week average for unemployment claims falling last week, the actual claims themselves increased on the previous week, while the unemployment has risen 0.1% for the last two months. If this plateau continues, and the effects of Trump's promised fiscal policies continue to lag, raising rates too quickly could result in unwelcome disruption.

On a separate point, we find it interesting to note the effects (or lack thereof) that both Trump and the more hawkish turn from the Fed are having on the value of the US\$. Despite expectations of high growth and the acceleration of the rate rise cycle, the US\$ has remained remarkably subdued in 2017, with the Dollar Index returning -1.1% year to date. The expectation from most at the beginning of the year was that the aforementioned factors would lift US treasury yields further, attracting more capital flows into the US, thereby pushing up the dollar. That this hasn't happened is, we believe, an interesting reflection on both the inflationary pressures inside the country and markets' perceptions of Trump's preferred dollar policy.

As stated above, rising interest rates should put upward pressure on the US\$, but if inflation expectations are also rising at the same or higher pace then this can provide a counteracting downward pressure. In other words, if general price levels increase, then yields after inflation (real yields) come under pressure, meaning that the value effects of Fed rate rises are neutralised by the expected pick-up in inflation. And, with many expecting more of an inflationary than growth effect from Trump's policies, it's unlikely that Fed rises alone could cause a substantial increase in the attractiveness of the US\$.

Furthermore, Mr Trump has now stated himself that he would prefer a policy of a weaker dollar, aiding US exporters and thereby helping to bring about the manufacturing jobs he promised during his campaign. Trump was extremely vocal about China's "currency manipulation" in the run up to November, and since assuming office his National Trade Council has signalled out Germany and Japan for taking advantage of low respective currencies. And, a strong dollar is inconsistent with

reducing the US trade deficit, something the former businessman made a lot of noise about before the election.

For his part, Treasury Secretary Steve Mnuchin effectively denied that a weak dollar was a part of the government's plans, by insisting last Wednesday that "appreciation of the dollar is a good thing". The fact remains, however, that a strong dollar doesn't jar well with the President's stated goals. And, if inflationary pressures coming from Mr Trump's policies continue to collide with interest rate pressures coming from the Fed, we would expect the stationary position of the dollar to continue.

This would be a change to the consensus expectations of a further strengthening of the US\$ from the beginning of the year and thereby improve global economic prospects in general, and those of developing economies more specifically. This is because dollar denominated commodity input factors would not increase in price purely for currency reasons, meaning dollar denominated debt shouldn't become costlier to service and capital outflow pressures should subside.

Whether this situation is sustainable politically however – and whether it will generate increased friction between the government and the central bank – is another matter entirely, and one we will watch with great interest.

For the time being, we are satisfied that our neutral to negative US\$ view from the beginning of the year is becoming more consensus and confirms our investment positioning of maintaining our portfolio allocations to US\$-exposed emerging markets.

The 'UniKraft pantomime' – madness or system?

Insight by Chris Swanepoel, Tatton's resident company analyst and head of AIM investment

We were intrigued as to events between Friday and Sunday of the week past, when Kraft Heinz pulled its bid to acquire Unilever. To be honest, not being specialists in the global consumables sector, we present a cynical view of some wider corporate trends in global mergers and acquisitions.

The consensus is the weekend's deal/no-deal farce was a long overdue outbreak of common sense in Kraft Heinz as the US food giant realised a hostile takeover would be "resource inefficient". The hostile Unilever response killed the deal. Warren Buffet's experience tells him anything but a friendly merger would have been value destructive. We suspect he'll be less than happy at the way it's all panned out. Embarrassing to say the least...

The deal begs many questions... How could any global firm contemplate a deal that's bigger than itself without already having the in-depth intelligence to know how the target is likely to respond? Being surprised when the prospective bride shuns the proposal is pretty embarrassing.

Investors will want to understand why Kraft spooked the markets so early during a potential bid process... Some of the news flow suggests the deal was leaked early, thus making the US company look distinctly amateur. That's Kraft's problem – and will no doubt be reflected in expectations.

But step back and understand the drivers facing all global corporate behemoths like Kraft: corporate debt at its cheapest levels ever, stock markets on a stratospheric trajectory and able to supply unlimited capital, the feel good of likely US and global recovery, and a US government that is going to be extremely pro US firms in the global market place.

Moreover, the likely changes to the US tax code – especially in terms of the potential to repatriate and use foreign cash reserves - are further drivers of corporate action. And, if Trump succeeds in cutting US tax rates, then US corporates are going to find themselves cash rich...

These are not reasons to make acquisitions – but they sure make them easier.

These environmental factors lie outside any fundamental logic for a deal. The risk is analogous to the argument “the only thing more dangerous than a bank with too little capital is a bank with too much” – it encourages them to do silly things... like buy overpriced Dutch banks and trigger the summer of 07... If you make corporate capital too cheap, then it loses its value and ability to use discipline in decision making.

There’s a danger in the next phase of this peculiar 10-year global slow growth ice age following the dead hand of monetary experimentation, and now the first snowdrops of renewed growth, could be a plague of corporate stupidity.

M&A provides great banking and advisory fees, makes executives feel very important, but seldom adds as much to the sum of corporate value as their proposers expect.

For the last 8 years or so, we’ve seen corporates adding value by using ultra-cheap rates to ramp up their debt to buy-back their own stock. While there are sometimes sound financial (and accounting) reasons for buying their own stock, generally the rash of corporate debt to fuel stock buybacks has added nothing to the global stock of factories, jobs created or corporate value. It’s pushed up corporate valuations – financial asset inflation being very beneficial for CEOs and senior execs’ bonuses.

In order to justify their now stratospheric salaries, they now need to be seen to be doing the next clever thing to “add value”. Which will include looking to make mega-acquisitions.

So, in the wake of the “UniKraft” pantomime it’s probably worth checking which US corporates are sitting on huge cash piles, look a bit stagnant, and could do with the push a major acquisition might raise. Everyone is now talking about what Kraft might go for instead of Unilever... This is the time to be looking across the whole corporate market and flagging the likely targets.

UK dividend investors benefitted from weak Pound: 2017 could see another boost

On a global level, investors looking for dividend growth may have been fairly disappointed last year, as corporate earnings growth was subdued and a stronger dollar reduced the value of shareholder payouts when translated back into their home currencies.

However, from a UK perspective, investors benefitted from the fall in the value of the pound, which boosted payouts by a record £5.2 billion in Q4 2016. We believe it likely that Sterling will remain low and potentially continue to fall in 2017, a result of the UK’s uncertain economic framework

setting as Brexit negotiations begin. Further Sterling weakness could therefore provide another dividend boost to UK investors this year.

At a larger (non-Sterling) global view, overall dividend growth rose just 0.1% in 2016, according to a dividend study by fund manager Henderson. This followed 2015's declining trend and substantially trailed the healthy 10.7% growth seen during 2014. Despite solid economic growth last year, US corporates, who account for 40% of all payouts worldwide, sharply slowed their dividend payments on the back of softer profit growth. Energy firms in particular were under pressure from lower commodity prices.

In dollar terms, payouts from UK businesses fell 3.5% last year to \$92.9 billion – the lowest level since 2012. One of the main drivers of anaemic dollar-based dividend growth last year was a drop in the use of special dividends. Resource firms, especially oil and miners, were focused more on strengthening their balance sheets in the face of lower commodity prices, rather than shareholder returns.

Typically, commodity-related firms are large special dividend payers during 'good' years, but it has become harder for such companies to grow dividends in a weaker price environment. Resource firms generally pay dividends in dollars, given their commodities are priced in dollars.



While international investors would have seen the value of any dividends from the UK fall as a result of a weaker pound, it led to a large positive benefit for sterling-based investors. Analysts estimate that a whopping 90% of the £5.2 billion Q4 payout increase was a result of the fall in the pound.

The record payout in Q4 helped boost total full-year dividends to nearly £85 billion, which represents a 6.6% increase over 2015 and the second largest amount in history. The currency uplift for UK investors turned what was a poor start to 2016 (on dividend cuts) into a rather pleasing one, thanks to a disproportionate impact from some of the UK's largest companies.

Oil firm Royal Dutch Shell was 2016's single largest payer both in the UK and worldwide, with a total dividend worth £11.1 billion (increasing by £3.2 billion from 2015). BP and Shell alone provided UK investors with a Christmas present of £500 million worth of dividends, boosted by sterling depreciation. Both companies saw their Q4 payouts jump by 20%, as they pay dividends in dollars rather than pounds.

There was a similar currency impact from other companies that provide dividends in dollars. HSBC was the second largest dividend payer (£7.5 billion), followed by pharmaceuticals giant GlaxoSmithKline. The top five paying firms accounted for 38% of all UK dividends last year, and these five received 30% uplift over 2015 levels thanks to the pound's fall.

Analysts expect that some large UK companies might be susceptible to cutting dividends this year, particularly firms like insurer Admiral (estimated cover 0.9x) and BHP Billiton (0.7x) who have low dividend cover (how many times earnings can cover dividends). Educational publishing giant Pearson suggested it would cut its dividend, after the firm issued its 5th profit warning in just four years.

Pearson was ranked among the 10 highest forecasted dividend-yielding stocks in the FTSE 100 Index before the profit warning, but some investors may seek to reassess their strategies to ensure that the yields they thought would be due are relatively 'safe'. The average dividend cover for the FTSE 100 is 1.6x, while dividends are forecast to grow an annual average of around 5% from 2015 through 2018.

Dividend coverage ratios of anything less than 1.5x could suggest a company may struggle to sustain current dividends, should it encounter profitability issues in the future.

The UK economy has remained robust since the Brexit vote last year, underpinned by growth in consumer spending, while growth at a global level continues to gradually accelerate, driven by the US, Europe and China. This has allowed commodity prices to rise strongly in 2016, and we expect that further economic growth should help support additional price gains.

An improved commodity price backdrop, along with an improving economy, should help provide resource stocks some wiggle room to increase dividends, which are – as shown above – quite currency sensitive.

So far in 2017, trading conditions continue to be solid and firms like Halfords and Lloyds Bank have revived the use of special dividends as their respective companies have posted better performances. We think that the UK economy could come under Brexit-related pressures over the next few years, which could potentially reduce dividends of more domestically focused companies. On the flip side, those which are more internationally exposed may feel more confident about increasing dividends.

Further £-Sterling weakness for dollar-based dividend payers could provide a welcome boost to UK income investors in 2017. Furthermore, the current and finally synchronised economic expansion across all major economies around the globe should lift all (corporate) boats – particularly those who with a global footprint.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7253.5	-0.6	-46.5	→
FTSE 250	18594.4	-0.6	-113.1	→
FTSE AS	3943.7	-0.6	-25.1	→
FTSE Small	5311.5	-0.7	-35.5	→
CAC	4851.0	-0.3	-16.6	→
DAX	11815.2	0.5	58.2	→
Dow	20751.1	0.6	131.4	→
S&P 500	2359.8	0.5	12.5	→
Nasdaq	5317.0	0.3	16.4	→
Nikkei	19283.5	0.3	48.9	→

Top 5 Gainers

COMPANY	%	COMPANY	%
ROLLS-ROYCE	14.6	MEDICLINIC INTERNA	-10.9
INTU PROPERTIES	7.2	HSBC HOLDINGS	-8.1
CAPITA	6.7	RIO TINTO	-7.9
BT GROUP	5.3	ANGLO AMERICAN	-6.9
PROVIDENT FINANCIAL	4.7	BHP BILLITON	-6.2

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	31.4	Brazil	220.2
US	26.9	Russia	168.3
France	70.4	China	91.6
Germany	22.6	South Korea	44.2
Japan	30.4	South Africa	188.9

Currencies

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.25	0.67	OIL	56.1	0.5
USD/EUR	1.06	-0.30	GOLD	1257.4	1.8
JPY/USD	112.26	0.52	SILVER	18.4	2.2
GBP/EUR	0.85	1.07	COPPER	269.6	-1.4
JPY/GBP	6.87	-0.04	ALUMIN	1867.0	-1.6

Commodities

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.25	0.67	0.01
US 10-Yr	1.06	-0.30	0.00
French 10-Yr	112.26	0.52	-0.58
German 10-Yr	0.85	1.07	-0.01
Japanese 10-Yr	6.87	-0.04	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

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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

