



## Weekly Market Comment

24 March 2017

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### Returning themes

The senseless terror suffered by innocent tourists and Londoners last week was a stark reminder that 2017 still carries many of the same issues as the world of 2016.

Stock markets were served a reminder as well and it almost felt as if my weary comments from last week were read by broader markets. Stock markets stopped rising and even settled down for the week. Obviously, it was not because they shared my concern that a continuation of the recent market gains might lead to an overheating in the near term, but because a number of the assumptions that had driven up markets seemed a bit less certain. Especially president Trump getting stuck with his reform agenda as he is trying to force through Congress a repeal of president Obama's Affordable Care Act (Right to health care insurance for the all) was single out as a major setback.

When he threatened to simply leave the ACA in force as it is and move on, if he couldn't get his own party to toe his line, there appeared to be differing market interpretations. Some voices saw it as a positive development, because the ACA repeal and redesign negotiations would no longer be a road block in the way to get on with tax and regulation reforms. Others believed that failing with the repeal would leave the Trump administration much weakened to pursue any further reforms that require ratification by Congress.

Fact most probably is that the US economy does not desperately require fiscal stimulus or structural reform in order to continue on its recent upward trajectory. However, there are concerns that the high market valuations already reflect corporate tax cuts and fiscal stimulus that may never actually be delivered by the Trump administration. US industry contrary to the stock market appears to not yet believe in Trump's 'America First' agenda. Soft forward indicators like purchasing manager surveys may all be at very high levels, but hard indicators like durable goods orders (machine investment) or commercial loan growth have remained at the lower levels of last year.

Combined with the notable slowdown in China's growth indicators and their reflection in softer energy and commodity prices this leads us to expect that the first phase of the 'reflation' cycle that started in the early summer of 2016 may be drawing to an end. By no means does this have to lead to a reversal back to where the state of the economy was at the beginning of 2016, but the so nicely synchronised growth picture around the world is crumbling somewhat.

This time around the Eurozone seems to be in much better shape and progressing with more sustainable momentum, which is encouraging given some of the political uncertainties still ahead. The first round of televised candidate debates brought the French 3 ½ hours of aggressive political discourse and the insight that populist Marine Le Pen's nationalistic message should really only attract 25% of the electorate. This should mean that newcomer Emmanuel Macron's progressive but more liberal manifesto should eventually gain the support of those who currently side with one of the other 3 moderate candidates.

Altogether, we see early indications for the onset of yet another mini-cycle in this otherwise extremely extended recovery cycle since the end of the financial crisis. Stock markets are no longer trading towards new highs, but neither have they fallen much below them. The global economy is still running at a good pace, but we shall be observing market reaction very closely when more investors begin to notice that in the near-term there is an increasing likelihood that 2017 is only turning out to be a little better than 2016, but that a return to the 'old normal' may still take a little longer than many thought only a month ago.

### Trump's dislike of German cars - or: Trade deficit misconceptions

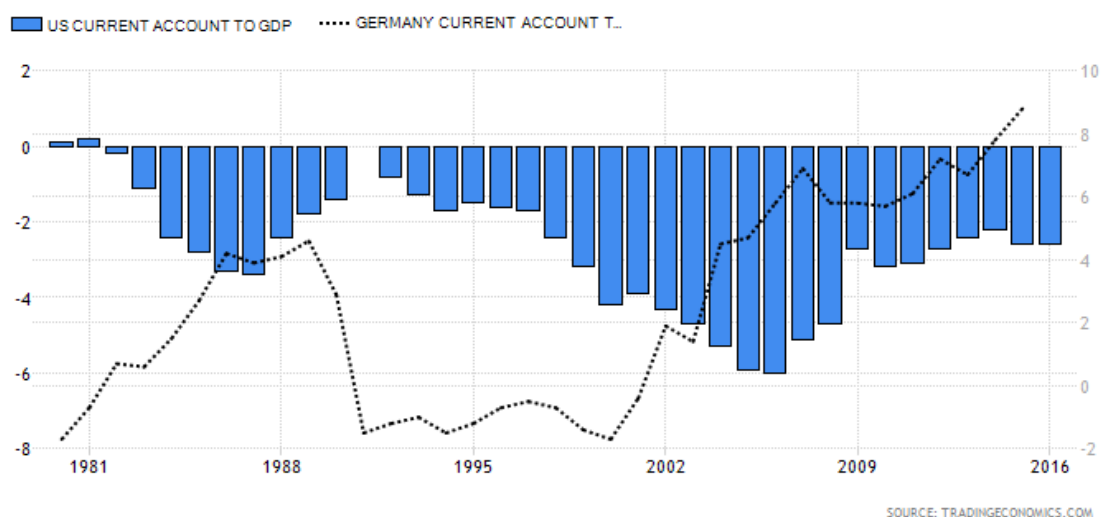
The recent meeting of the G20, previously a relative highlight in the economic calendar, seemed to pass with little financial commentary. Indeed, if it weren't for the minor trade skirmishes between the new US administration and the German Government (and several other countries), it might have gone completely under the radar.

While the G20 communique re-emphasised the organisation's commitment to refrain from competitive (currency) devaluations and not to target exchange rates for competitive purposes, this latest communique removed a key reference to resisting "all forms of (economic) protectionism". It seems the US envoy to the G20 – US Treasury Secretary Mnuchin – opposed the inclusion of a reference to (avoiding) protectionism, citing it as irrelevant (!) from a US perspective.

While the US has undoubtedly benefitted from global trade, and continues to do so, the new US administration appears to be extremely concerned about the country's persistent trade deficit and a current account balance that refuses to move out of the red.

As is shown in the graph below, which illustrates the *current account* as a percentage of GDP, the US has, on average, operated a trade deficit for the last 4 or 5 decades (left hand scale). Clearly trade deficits are not a new economic development for the US.

## Trade and current accounts as a proportion (%) of GDP



Source: *TradingEconomics*, March 2017

The US's continuing trade deficit has, however, been identified by President Trump and his advisers as the primary cause of the loss of US manufacturing jobs and even a threat to national security. Trump's administration is therefore calling for protectionist / "America first" economic policies, including the proposed border adjustment tax. As we have noted in previous weeklies, the long-term effects of these types of policies are uncertain, while almost certainly very disruptive in the short term against a still fragile economic environment.

There have also been various statements from the new president and his officials to the effect that Germany (and other countries) should do more to redress the trade imbalance with the US. In the case of Germany, President Trump even suggested that Germany was manipulating the Euro in order to extend its trade surplus with the US (through more competitive pricing). Indeed, as the graph above shows, Germany is running a significant trade surplus relative to its GDP, and with the US (right hand scale).

However, it is clearly incorrect to assume that Germany can unilaterally influence EZ trade policy, or, for that matter, determine the scale of US demand for German products. Germany can neither directly control, nor determine, the EZ interest rate or the €-Euro exchange rate. Anybody following economic news will also be well aware that the German central bank has for years actually pursued the opposite – pressing the ECB for tighter monetary policy which would lead to a stronger, not weaker €-Euro versus the US\$.

Of course, the new US administration's underlying concern relates not only to US employment and a desire to 'repatriate' manufacturing and production, but the extent to which the US appears to be indebted to other countries (as a result of its continuing trade deficit).

As with all countries, the US's current account is broadly determined by its balance of payments: - the total value of its exports (of goods and services) minus the total value of its imports. In national income accounting, the *current account* must equal the *capital account* (see our previous article on trade and national accounting), and imports are paid for (by the US and indeed all countries) by exchanging its own currency for foreign currency. Thus, more and more US\$ end up in the currency reserves of Germany (and China).

Therefore, in simple terms, if a country's *current account* is positive (in surplus), the country is effectively a net lender to the rest of the world. However, in the case of the US, which has been running a significant negative *current account* (in deficit) for decades, it effectively became a net borrower a long time ago (from Germany and other countries around the World).

The *current account* can also be a barometer for a country's savings and investment. In the same way that the *current account* shows either the relative export competitiveness of an economy or its strong demand generation and international creditworthiness, it is also a proxy for the level of investment in the US that is effectively financed by foreign savings. This is because Germany and China are unlikely to simply hoard US\$ cash, but instead buy US financial securities which pay a yield or generate an investment return. Therefore, perhaps to appeal to public anxieties connected to debt and thereby generate support for specific policies, President Trump's new administration has been keen to suggest that the US is "borrowing" from other countries such as Germany, China and others.

Given that forecasts for US growth currently surpass those of many other economies, paying for imports that are in turn helping to fuel that US economic growth further does not imply that it is unsustainable. If nothing else, continuing growth provides the means for the US to address any further expansion of imbalances in trade by keeping the deficit level the same or even outgrowing it relative to GDP through faster GDP than account deficit growth. Absent imports, US businesses and consumers would simply not be able to satisfy the demand for goods that the strengthening US economy is currently experiencing.

At first glance, the US trade balance does appear somewhat skewed, although it seems to have improved relative to the long-term average (the deficit is reducing). Moreover, some of the apparent imbalance might be addressed by a further strengthening of the \$-Dollar (or a depreciation in other currencies, notably the €-Euro).

Trade is widely recognised – even within the US - as an enabler of economic growth that benefits all sides as long as it is organised through free markets and goods are produced following comparable standards. Indeed, according to the US's own Department of Commerce, global trade now accounts for more than 60% of gross domestic product (GDP) and trade volume growth has in the past outpaced real GDP growth. As we have said previously, policies designed to prevent certain types of trade or otherwise "protect" domestic production can generate counterintuitive outcomes that damage domestic economies rather than support them.

We believe the new US administration would be better focussing on sustaining the current (consumer led) growth in its economy by means of tax reforms, infrastructure improvements and by addressing structural deficits in its productive sector that lead to global demand preferring non-US to US products. Promoting educational standards and productivity enhancing investments should be far more effective than seeking to undermine and/or re-draw all its trading arrangements with the rest of the World or cutting education spending (!) to pay for more arms.

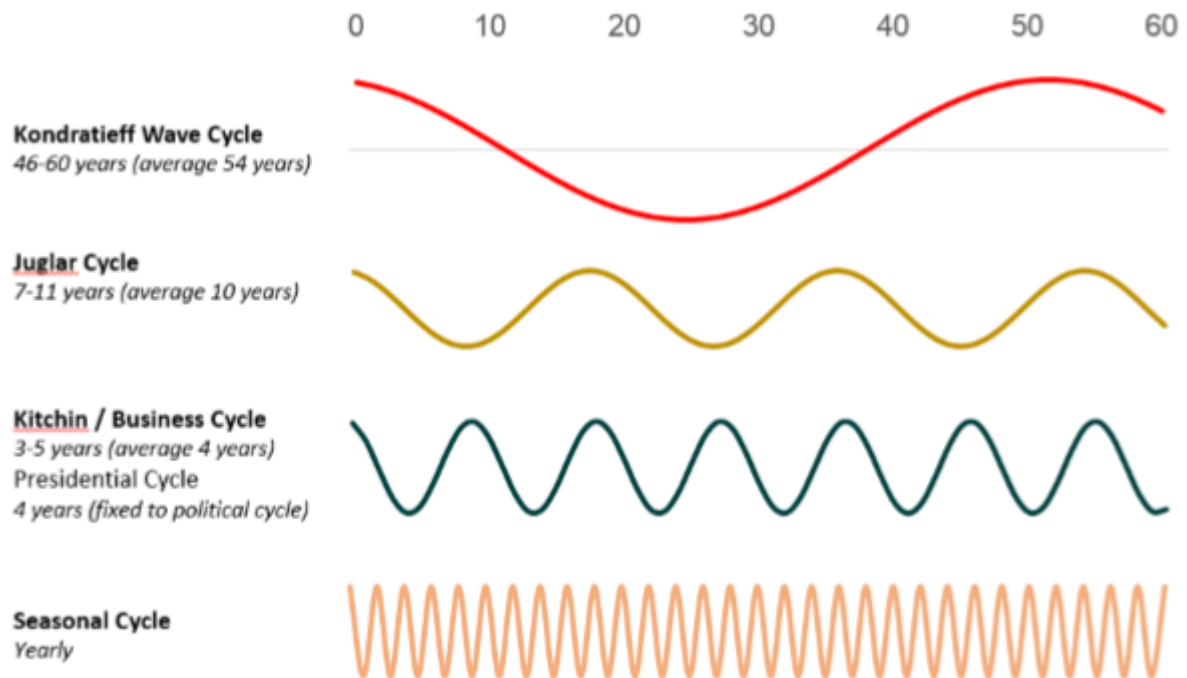
What makes the least sense is to mark Germany's trade surplus with the US as a national security threat and in the next sentence demand from them a doubling of their military budget. At this point informed observers struggle to detect any cohesion in Trump's policy initiatives and is left musing whether it is plan or just simply incompetence.

## Long wave economic analysis: A new 'K-spring' (up cycle) dawning?

*"There is a tide in the affairs of man..."* William Shakespeare

*"History doesn't repeat itself, but it rhymes."* Mark Twain

It is well known that human activity progress does not necessarily occur in a rigid straight line. Not surprisingly, there is a branch of economics that believes that progress can even be measured by examining shorter-term confidence cycles that operate as an integral part of ever longer wave economic and business cycle.



Source: The ECU Group

This long-wave cycle is known as the Kondratieff Cycle (K-Wave) lasting an average of 54 years (46-60 years) from peak to peak, with the frequency of those peaks and troughs increasing as the timeframes decrease.

The next longest cycle is the Juglar Cycle, which takes roughly 7-11 years (average of 10). Following this is the Business Cycle, lasting between 3-5 years (average of 4) and usually correlates with changes in parliaments or presidents. This leaves the annual Seasonal Cycle (more confidence or trend based). We think, however, that the pace at which events are happening is accelerating predominantly as a result of the ever-faster rate of technological change.

Intersecting these cycles or waves are two primary trends; secular and cyclical.

- Secular trends in both the economy and stock market typically last around 10-15 years (Juglar) and are driven by variables like demographics, valuations and creative/destructive events. An example might be the rise of Asian economies versus the relative 'decline' in the west.

- Cyclical trends are highly significant for long-term investors as they can drive movements in economic activity over shorter periods to produce trends in assets, stock prices and even sectors that we can identify and benefit from.

How these cycles interact, converge and diverge can have implications for both short-term and long-term asset prices. We have repeatedly made investors aware that the strong investment returns (double digit) they have experienced over the past few years, even in lower-risk portfolios with a higher proportion of fixed income investments, are very likely to moderate back towards long-term averages (mean reversion).

Despite this possible 'mean reversion' of shorter-term investment returns, we observe that the global economy has improved markedly since the Global Financial Crisis (GFC) in 2007, and now operates on a more stable base. It is from these steadier foundations that we consider it possible that the world has entered a long-term upswing K-Wave (Kondratieff) cycle. Nevertheless, in the shorter-term, it is likely that we will see contraction or correction periods, all viewed within that longer-term perspective.

*What is a K-Wave?*

A K-Wave is a long-wave cycle of economic activity, focusing on price levels (inflation) and debt. Named after the Russian Nikolai Kondratieff, who was appointed by Lenin to analyse capitalist economies to determine when the system would fall.

Lenin did not get what he wanted.

Kondratieff concluded, in his 1922 paper, that the capitalist system was inherently self-regenerating, merely going through cycles of expansion and contraction rather than outright collapse. This conclusion earned him solitary confinement in a Siberian Gulag, where he fell ill and died in 1938.

Researchers have traced K-cycles going all the way back to the Sung Dynasty in China during 930-1250 AD. In the past 150 years, they identify four cycles. Some suggest underlying themes driving each one, generally associated with major technology advances. (This "causal" approach is not followed by all K-wave aficionados)

It is possible that a new fifth cycle is beginning, after the Great Financial Crisis:

Cycle number	Date range	Cycle length (years)	Tech driver?
1	1789-1844	55	Industrial revolution
2	1845-1896	51	Railway construction
3	1897-1948	51	Electricity/Cars/Chemistry
4	1948-2007	59	Electronics/Internet/Communication
5	2007-2061?	?	Robotics/Alt Energy/ Genetics

There are two primary phases inherent in a cycle, an upswing and a downswing.

The upswing consists of:

- **Spring** – rebirth of the economy
- **Summer** – economy reaches its potential with robust inflation

The downswing consists of:

- **Autumn** – financial bull markets achieving highs on increased optimism
- **Winter** – the payback or decline as excesses are purged from the system

An upswing begins with low levels of interest rates, inflation and consumer confidence. At this point, individuals and companies have rebuilt savings and capital is plentiful at cheap rates of interest during the spring. New innovations emerge and help boost growth, which eventually leads to an inflationary summer.

The downswing essentially begins with a plateauing of activity, with stock markets reaching their highs. This can be followed by the appearance of asset bubbles and later a 'winter', in which all the excesses that have accumulated (debt and asset prices) are purged from the system (creative destruction). During the winter, deflation sets in and assets find a new supply and demand balance.

*So where are we now?*

The battle between bulls (positive) and bears (negative) is an ongoing saga, with one side typically gaining advantage over the other based on the incoming economic data. Right now, that battle appears finely balanced at the tail end of 'Trump Trade 1.0', which appears to have temporarily run out of steam. This coincides with the S&P 500 Index in the past week ending the unbroken run of 110 days without a fall larger than 1%.

The apparent cause of the bears' rising volume stems from the divergence between soft data (confidence) and hard data (loan data, production levels, etc.), as well as the start of a new tightening cycle of monetary policy across the globe. The US Federal Reserve raised rates last week, the Peoples Bank of China is trying to take the heat out of its economy by withdrawing liquidity, while the central banks in Japan and Europe are reducing their quantitative easing programmes.

Clearly, we have entered a new medium-term tightening phase, which should be seen positively, as it means the global economy is expanding. Markets have been particularly resilient throughout this period, where 'animal spirits' have remained largely in control, but the bears are getting louder, pointing to possible bubbles in property markets in places like the UK, China, Canada and the US as evidence.

*Conclusion – rebirth of global growth longer-term*

As mentioned above, we consider that we may actually be at the beginning of a new K-spring or rebirth of growth in the global economy.

An argument against the start of a new cycle is the remnant or hangover of debt. Worldwide, debt levels are even higher than they were before the GFC, which could delay the potential start of the 'fifth wave' due to the fact the debt liquidation typically associated with the end of a cycle was sidestepped by the vast QE programmes of central banks to reduce the effects of the financial crisis.

Above, we suggested investors should prepare for a period of lower realised returns. Though, as the K-Wave cycle suggests, these short-term movements should be viewed, however



disconcerting, as small parts of ever larger cycles of activity that point to an overall upswing in the global economy.

### Chinese central bank playing Whack-A-Mole with their economy?

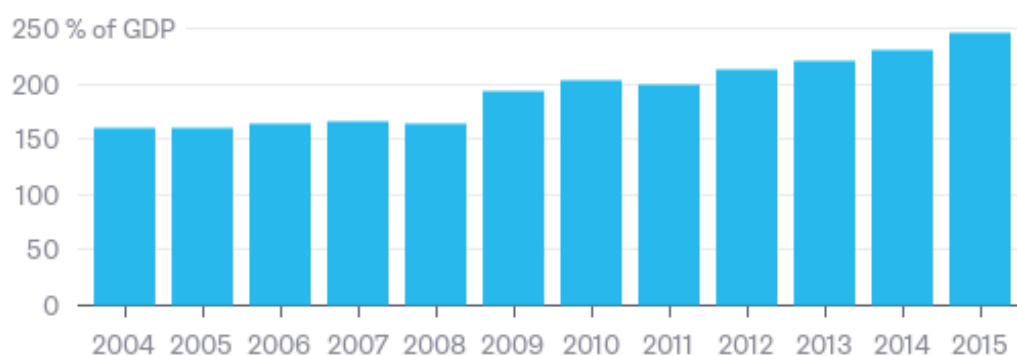
For the better part of 6 months now, Chinese authorities have been trying to curb an ever-growing expansion of credit in their economy. What started last year with restrictions on property lending intended to contain runaway house prices has since developed into an all-out attempt to stem the risks of overheated growth in the debt market.

Earlier this month, Chinese Premier Li Keqiang announced before the National People's Congress that the government's focus is now on curtailing risks and "high leverage in non-financial Chinese firms". Then, just last week, the People's Bank of China (PBoC) raised short term interest rates for the third time in as many months, only hours after the US Federal Reserve (Fed) raised its benchmark interest rate.

The country's credit binge has been remarkable in the years since the financial crisis. The total outstanding debt pile now stands at around 264% of the nation's GDP, up from 164% in 2008. Given that China's GDP has more than doubled in that time, it makes for an impressive stat, and it's a growth in credit that outdoes even that seen in the US and the UK in the run-up to the crisis. This extreme borrowing was what sustained high levels of growth in the world's second largest economy despite the global economic hardship, which in turn was one of the driving factors behind the global recovery. In fact, growth in Chinese debt accounts for roughly half of all new credit created around the world since 2005.

### China's Debt Splurge

Total borrowing increasingly dwarfs annual economic output



\* Includes corporate, household, government and bank debt

Source: Bloomberg

Inevitably, that initial growth impetus slowed and, as early as the autumn of 2015, the government was rolling out new infrastructure spending measures to combat slowing economic growth. These measures worked, of course, and made 2016 a year where China started on a cliff edge and ended on a mountain top. But, it was only by further enabling of the borrowing addiction, propelling outstanding debt to new highs.

It is perhaps ironic that the Chinese Government is now so intent on deflating the bubble, given their encouragement of the debt build-up since 2008. Still, there's no doubting that intent. Late last year, one communist party mouthpiece went as far as to say that high leverage was the country's "original sin".

A lot of the demand for the new long maturity bond issuance has come from financial institutions and the general investing public taking advantage of the difference between bond yields and short-term borrowing rates. They bought these assets, then borrowed against their own assets and bought them again (and again..., the process of borrowing being done through "repurchase agreements"). This has led to the high leverage (debt over equity) decried by the authorities.

Now, the government is attempting to deleverage the economy through a tightening of financial conditions. But, if this process is done in an unorderly way, the risks could be substantial, with head of markets strategy and research for Asia at National Australia Bank Ltd. Christy Tan commenting that "We expect the risk of stepped-up leveraging to be quite real," Effectively, with investors so heavily leveraged on their assets, a relatively small rise in borrowing costs could see them unable to service their debt – leading to default and subsequent fire sales of assets.

Indeed, this is already beginning to happen in some areas. On Tuesday, China's seven-day repurchase rate – one of the country's most widely used interbank borrowing rates – shot up to 5.5% from just 3.8% the day before, its highest since late 2014. This led to some of the smaller banks being caught out in the cold, unable to make debt repayments and being faced with default, which caused the PBoC to inject some emergency cash into the economy.

The central bank and the authorities would clearly want to curtail the credit excesses without causing too much disruption, but the extent to which this is possible is dubious. In truth, the PBoC's hike in short term rates isn't solely an effort to contain the debt situation. As mentioned, the bank's rate increase last week came in quick succession to the Fed's own hike. To preserve its foreign currency reserves China relies to a large extent on the fact that its comparatively high deposit interest rates incentivise investors to keep money in the country and, when US rates go up, this incentive drops. China has been having troubles with capital outflows for a while now, as rich individuals and companies have become worried at the perceived risks in the Chinese economy and have sought to diversify their wealth through international investments. So, when the Fed raises its rates, the PBoC has little choice but to follow suit to stem the money flowing out of the mainland, even if the underlying economy doesn't warrant such a rise.

So, what does this mean for the global economy? Well, the implications are two-fold. Firstly, a tightening in monetary conditions means that growth – particularly in the intensively debt-fuelled sectors such as infrastructure and energy – is likely to moderate. And, with the global economy in its current 'turning over' phase (see article above), this will lessen one of the key driving forces behind global growth. After all, it was the rampant growth spurt in the world's second largest economy that pushed economic activity levels out of the mire of January 2016 and into the decent returns seen last year. Effectively, even if the government's tightening plans go off without a hitch, it will likely result in a tempered – but still respectable – growth force coming out of China.

Secondly, and perhaps more importantly, the increased intervention by the government means that the risk of a policy error is greatly increased. As the title suggests, the level of micromanaging that the authorities in China are engaging in (increasing short term interest rates, enforcing capital

restrictions, etc.) renders their approach to regulating the economy like a game of Whack-A-Mole – hitting the “smaller” problems back down when they come up because dealing with the big problems is too painful.

When the authorities are engaged in economic intervention on a case by case basis rather than trying to holistically treat the situation, the potential for slip-ups – which could be catastrophic with the debt levels as high as they are – increases by several orders of magnitude. As Richard Jerram, chief economist at Bank of Singapore Ltd., mentioned in an interview with Bloomberg, despite the government’s attempt to create as little trouble as possible, “The process is still relatively immature and you are going to have these periods of disruption.”

Needless to say, were any significant downturn to arise in China from the authorities’ interventions, it would be felt around the world. We don’t, however, see this becoming a reality in the near term. It seems that markets have bought into the idea that the authorities can control things, meaning that the one thing that would be truly disastrous – a run on the Chinese economy – is unlikely to come about. Furthermore China is holding its five yearly National Congress in the autumn where president Xi is widely expected to further consolidate his leadership by retiring a number of his adversaries and appointing a more closely aligned executive. We can be relatively certain that until then the Chinese economy is unlikely to suffer a hard landing.

Over the medium term, however, we acknowledge that the risks associated with China and, therefore, the rest of the world are increasing.

# PERSONAL FINANCE COMPASS

## Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7335.6	-1.2	-89.3	↗
FTSE 250	18973.1	-0.6	-121.8	↗
FTSE AS	3994.1	-1.1	-44.2	↗
FTSE Small	5374.9	-0.7	-39.7	↗
CAC	5020.9	-0.2	-8.4	↗
DAX	12066.3	-0.2	-28.9	↗
Dow	20676.5	-1.1	-238.1	↗
S&P 500	2350.6	-1.2	-27.7	↗
Nasdaq	5387.4	-0.4	-21.4	↗
Nikkei	19262.5	-1.7	-327.6	↗

## Top 5 Gainers

COMPANY	%	COMPANY	%
NEXT	6.5	HIKMA PHARMACE	-7.7
POLYMETAL INTERNAT	4.0	BHP BILLITON	-6.6
DIXONS CARPHONE	3.8	GLENCORE	-6.6
TRAVIS PERKINS	2.9	KINGFISHER	-6.3
NATIONAL GRID	2.9	RIO TINTO	-5.7

## Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	31.4	Brazil	241.4
US	26.9	Russia	176.1
France	47.2	China	84.0
Germany	18.4	South Korea	49.8
Japan	30.4	South Africa	191.0

## Currencies

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.25	0.78	OIL	50.7	-2.1
USD/EUR	1.08	0.60	GOLD	1247.5	1.5
JPY/USD	111.05	1.49	SILVER	17.7	1.8
GBP/EUR	0.86	0.19	COPPER	262.7	-2.4
JPY/GBP	6.88	0.29	ALUMIN	1933.5	1.8

## Commodities

## Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.2	-3.5	-0.04
US 10-Yr	2.4	-3.8	-0.10
French 10-Yr	1.0	-11.0	-0.12
German 10-Yr	0.4	-6.0	-0.03
Japanese 10-Yr	0.1	-13.3	-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	4.5
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

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Lothar Mentel

