



Weekly Market Comment

3 March 2017

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February 2017 asset class returns

Asset Class	Index	February	2017
Equities	FTSE 100 (UK)	3.1%	2.5%
	FTSE4Good 50 (UK Ethical Index)	2.7%	1.3%
	Dow Jones Euro-Stoxx 50 (Euro-Zone)	2.3%	1.1%
	Standard & Poors 500 (USA)	5.1%	5.2%
	Nikkei 225 (Japan)	2.1%	3.5%
	MSCI All Countries World	3.7%	4.6%
Bonds	FTSE Gilts All Stocks	3.1%	1.3%
	IA Sterling Corporate Bond Index		
	Barclays Global Aggregate Bond Index	1.6%	0.9%
Commodities	Goldman Sachs Commodity Index	1.3%	-1.9%
	Brent Crude Oil Price	0.9%	-2.9%
	LBMA Spot Gold Price	5.6%	7.3%
Inflation	UK Consumer Price Index (annual rate)		-0.5%
Cash rates	Libor 3 month GBP	0.03%	0.1%
Property	UK Commercial Property (IPD Index)		0.7%

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

2017 has started well for investors with stock markets climbing to new highs, while bonds have also been posting gains. The bond gains probably need to be seen as a bounce back from oversold levels, following the sharp sell-off in the last quarter of 2016. Equities around the world have been buoyed by a combination of further improvements in corporate earnings and a surprise continuation of rising business and consumer sentiment.

Added to these positive factors, the world is for the first time since the immediate recovery from the Global Financial Crisis (GFC), displaying synchronised economic growth without major structural headwinds like the unwind of the commodities bubble of 2015/2016.

This encouraging outlook is overshadowed by political risks. The unorthodoxy of the US populist president Trump has sent shudders around the world and the prospect of further populist shifts in major European election during 2017 also sits uneasy with the more positive outlook.

For the moment the jury is out, whether the economic momentum that has built up since April/May last year will overcome political headwinds as it did in 2016, or whether we will witness a major paradigm shift against trade and globalisation. At the end of February, it seemed as if the 2016 mood would be set to continue for a while into 2017. This mood seems to be carried by the belief

that political pressures will lead to reduced fiscal austerity headwinds, but radical political shifts will not necessarily lead to radical policy changes to the detriment of the global economy.

At Tatton, we see the odds as fairly balanced which leads us to maintain our neutral asset allocation positioning between riskier growth assets and lower risk fixed interest bond assets. However, at the regional and currency level we see significant differences in relative valuations, with considerable catch-up potential in some areas.

Sadly, as is often the case when things are running just fine in the world of investment returns, sudden setbacks have to be factored in. In past years that displayed similarities in setting with 2017, stock markets have sometimes suffered sudden and painful corrections. A policy error or failure of judgment on the political side could well interrupt the current strong market dynamics. For this reason and mainly this reason, we are hanging on to long duration bond positions which we do not expect to provide much upside over the medium term, but could once again prove to be very useful counterbalancing other portfolio areas, when growth assets hit a stretch of unpleasant bumps.

However, this also means that those seeking to gradually withdraw funds from their invested savings over the shorter term may be well advised to plan ahead a little more than used to be necessary. A temporary cash position to cover a year or two years of future cash requirements (or longer, depending on one's attitude to risk), so as not to be forced to having to liquidate parts of the portfolio when markets hit the next bout of volatility, may well be a prudent move of forward looking financial planning.

Sentiment shift or still 'Trump rally'?

Two notable things happened last week. Firstly, all three main US stock indices hit record highs at the same time, in a dizzying surge which saw the S&P 500 index gain 1.4% on Wednesday alone. Secondly, and perhaps more surprisingly, Donald Trump showed his presidential side, which we had not seen since his acceptance speech on Election night.

In his first address before the US congress, the newest incumbent to the most powerful office in the world gave a performance that reflected a calmer and more composed tone. The Commander-in-chief even managed to refrain from any of the incendiary remarks that have become a hallmark of his early days in office. In the opinion of some commentators, Trump did not only act presidential, but had perhaps even managed to 'hit the reset button' on his early presidency.

With US stock markets already closed, Asian and European markets were first to express relief the next morning with a strong uptick, followed in quick succession by Wall Street indices setting records across the board. While markets did pull back slightly the following day, it certainly seems that the 'Trump rally' – as it has been dubbed by many - seen from the back end of last year isn't losing any steam. As we have seen for a while now, markets are buoyed by the growing reflationary environment sweeping across the global economy, and in particular the US, with many analysts attributing this partly to Trump's promised fiscal stimulus policies and the extra growth this is expected to bring.

There is a caveat to add to Wednesday's stock market boom of course. The President's speech happened to coincide with comments from New York Federal Reserve president William Dudley

who suggested that a rate rise at the Fed's March meeting in 2 weeks was likely – pushing the probability of a hike up to 70%-80% from 50%, and less than 40% only last week. This more hawkish turn seen from the Fed of late has undoubtedly had a positive effect on market sentiment, with investors emboldened by the Fed's vision of an expansionary economy and what this might mean for stocks. Banks in particular are aided by a rising rate environment and the increased profitability this brings to their lending margins.

Whatever the case, the mood is good among the investing public. The same day as the S&P broke records, the SPDR S&P 500 ETF tracker fund saw inflows of \$8.2bn, its biggest daily intake since December 2014. A year on from the recession panic that saw markets locked into a nosedive in the beginning of 2016, it seems the 'risk-on' mentality has returned for investors. Given the timing of this extended rally, starting around the time of Trump's surprise election win in November, and the expansionary nature of some of his stated policies, one could be forgiven for calling this – as in the title – the 'Trump rally'.

However, the causes for this sustained rally are not quite as clear cut as many would like to have it. Some even suggest the markets are rallying despite him, rather than because of him. The events of the week certainly provided some support for the latter view. There were high expectations and considerable nervousness in the markets, that Trump needed to deliver some policy details or risk disappointing markets. What they got was no detail, no policy announcements but a more measured sounding president – on the back of which they rallied.

Many of the President's promised policies have been evaluated as counterproductive to a sustained growth environment, with his emphasis on strict border control, repatriation of illegal immigrants and the threat of tariffs on imported goods all presenting potential headwinds for business. Late on Wednesday, a separate report to Congress on his trade policy agenda even revealed the administration's desire for a more "aggressive" approach to international trade, whereby they might bypass the WTO, and we have detailed in previous commentaries how such policies as the suggested border adjustment rate and even the repeal of the Dodd-Frank act might present problems for businesses.

Why is it then that markets are not pricing in the risk of these policy initiatives to the economy, which should see them fall not rise?

Well, it would appear that the investing public has begun to make up its own mind which of his policy targets appear achievable and which do not. The time since his election has been sufficient for political analysts to assess what he might get through Congress and what may come through in a neutered or perhaps even constructive transformation.

Interestingly, policies which got markets so excited when Trump emerged victorious on 8 November – tax reform, fiscal stimulus and deregulation – all look as though they will be postponed until next year at the earliest, and the actual details are very thin on the ground.

The way we see all this making sense is that a dynamic is emerging, where the current rally is first and foremost driven by economic upward momentum which began well before Trump was elected. The uncomfortably elevated valuation levels the stock markets have now reached are carried by further improvements in consumer and business sentiment, which indicate more expansion potential over the course of 2017. It would appear that there is a belief that the US democracy's system of checks and balances between their executive, legislative and judiciary duties will reign

in any Trump excesses. However, his relentless enthusiasm for reform will find an escape valve in reversing overburdening red tape in regulation and administration, particularly in those areas where tightening was not necessarily based on legislation, but attitude changes of the supervisory side following the financial crisis.

This is perhaps indeed a somewhat better perspective than had presented itself a few weeks ago, when the Trump policy mistake risk became quite overwhelming.

The US (and global, for that matter) economy now largely has enough of its own momentum and has become more sanguine about the political situation. Against this momentum is Trump and the detrimental potential effects of some of his more outlandish policies. But, should the checks and balances of the US political system continue to frustrate his agenda enough so that it doesn't become a problem for businesses – we expect that the economy will keep going along as it has.

Of course, however, if Trump has taught us anything so far it's that his potential to rock the boat shouldn't be underestimated. So, for now then, perhaps a bit of cautious optimism is appropriate. Whatever the case, the 'Trump rally' is a misnomer – the rally has its own fuel and Trump is currently still more along for the ride.

Regarding market allocations across our portfolios, we believe it prudent to continue to underweight the US market as it is the highest valued in the Western world and represents the most progressed economy in this economic cycle. Other regions like Europe and Japan now have the great opportunity to catch up, both in economic growth terms and also higher valuations. Observing strong investment flows from the US markets to Europe and Japan over recent weeks confirms to us that we are not alone with our assessment of this relative value opportunity shift.

Europe: Welcome return to broad based growth

The European Central Bank's (ECB) economic bulletin informed us last week that the Eurozone (EZ) has now achieved 14 consecutive quarters of economic growth. The unemployment rate – measured across the region as whole - has finally returned into single digits (~9.5%), and economic sentiment continues to improve towards ever healthier levels.

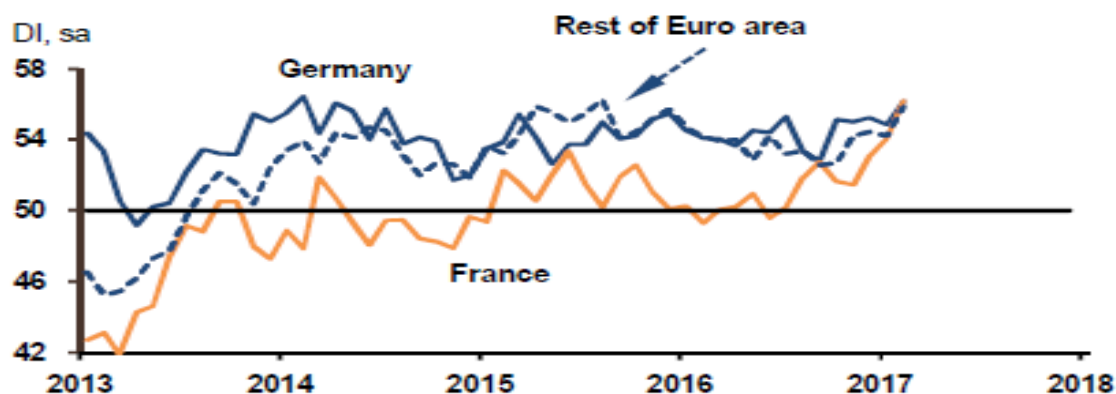
It seems the EZ is not, as many commentators predicted, a potential drag on the global economy, but among the areas showing the strongest potential signs of growth. Moreover, the ongoing momentum appears resilient and sustainable.

This momentum is reflected in the latest economic and business surveys. The forward looking indicator in the form of the Euro area composite Purchasing Manager Index (PMI) climbed another 1.6 pts in February to a six-year high of 56.0. Analysis by J P Morgan of the underlying data also indicates that sentiment and growth is well distributed across the EU, and not just a reflection of the health of the "northern economies" of Germany, France etc.

While there were expected gains in Germany (+1.3 to 56.1), and France (+2.1 to 56.2), the rest of the region also signalled a further increase in sentiment and confidence (+1.7 to 55.9). The French composite PMI has now increased almost 5 pts in just three months and no longer lags the Euro area overall. And, the increase in the rest of the region, which mostly covers the periphery, is also

very positive, despite the political risks in Italy and France (and to a lesser extent elsewhere in the EZ).

Europe's growing confidence: the EZ composite PMI



Source: J P Morgan, Global Data Watch, February 2017

The market view of the prospects for EZ is now also broadly consistent with the European Central Bank's (ECB) own thinking and analysis. The ECB's view remains cautious but positive – describing conditions as expansive and strengthening, currently driven mainly by domestic demand. However, the ECB expects the economic expansion to firm-up as the pass-through of the ECB's monetary policy measures continues to support domestic demand (while also facilitating the ongoing deleveraging process).

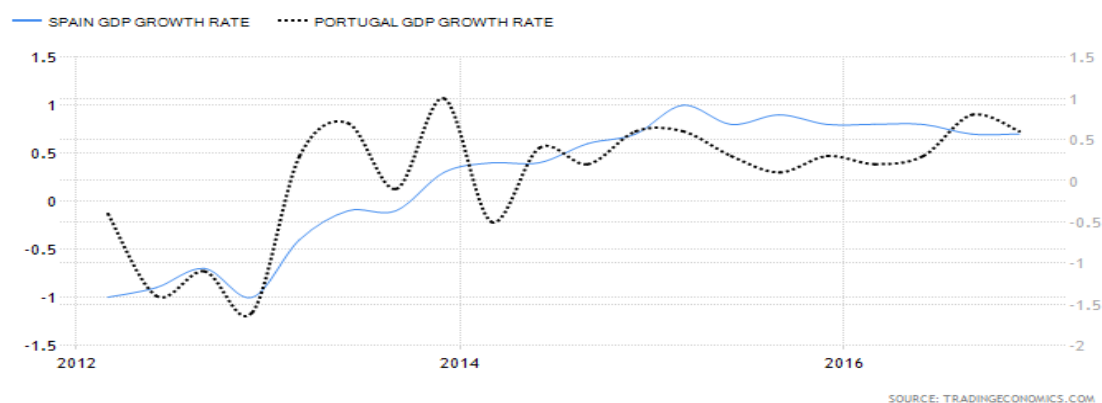
In addition, the favourable financing conditions are said to be driving improvements in corporate profitability and, therefore, a recovery in business investment. This is borne out by the data. In Q4 2016, the ECB's information suggests that business investment picked up while construction investment also rose, albeit at a slightly slower pace than in the third quarter (although construction may have been higher in Q3 to avoid higher input cost inflation in Q4 and beyond).

Moreover, sustained employment gains, which are also benefitting from past structural reforms, provide support for private consumption via increases in households' real disposable income. Meanwhile, all of this is happening against the backdrop of a somewhat stronger global recovery.

As we said last week, even though the EZ is on a positive trajectory, the ECB's accommodative (monetary) policies will be required for some time yet and there may be other potential risks on the horizon - Greece's ongoing IMF/EU "rescue" package, the challenges posed by Italy's banking system and the overall increase in political risk. These issues notwithstanding, we are encouraged by the overall performance of the EZ "periphery", not least, Spain and Portugal (and to a lesser extent Italy).

The Spanish economy expanded 0.7% in the last quarter of 2016 (that is close to a 3% annual rate!), the same as in the previous period and generally in line with market expectations. Portugal's economy also advanced 0.6% in Q4/2016. Domestic demand rebounded as household spending accelerated and investment recovered, while net trade dragged a little on GDP growth. Both economies are, however, displaying signs of steady but sustainable growth.

EZ growth rates: Spain and Portugal



Source: *TradingEconomics, February 2017*

There is general consensus on the reasons for the renewed performance of the EZ, not least, it is starting from a relatively low point (as did the US and other nations post - Global Financial Crisis), with some countries still undergoing reform and re-balancing. Also, the UK's vote to exit the EU has not had the negative material impact some were expecting and, noting arguments to the contrary, all countries in the EU appear to have benefitted from the accommodative monetary policies of the ECB.

Furthermore, if France can avoid political upheaval (with Marine Le Pen, the populist candidate for the French Presidency advocating "Frexit" and leaving the €-Euro), it would be well placed to support a sustained recovery in the EZ. "Frexit" risk would, of course, generate significant uncertainty, including depreciation of the new Franc, higher inflation and an increase in Government borrowing (not dissimilar to the situation in the UK). Alas, few seem to appreciate that without a parliamentary majority (which is very unlikely) Le Pen would not even be able to initiate a Frexit referendum.

So, if these political risks are avoided, the resulting economic stability and ongoing reforms - to the banking system and employment legislation - could mean France surprises to the upside. For example, France's output fell by 3.1% during 2008/9 – a shallower slowdown than the UK and US – but annual growth has averaged only 1% since 2010. There is considerable scope for upside in France's economy.

As ever, there may be a fly in the ointment. EZ growth could be hindered by sluggish structural reform and remaining balance sheet adjustments in a number of countries and sectors. Also, inflation and financing costs are low and unemployment is declining, which is driving consumer spending, but this could change in the face of returning inflation and other risks. The main other risks facing the EZ are the same as those in many regions around the World, protectionist policies and/or monetary tightening in the US, and the ongoing political cycles and risks.

UK economy: too reliant on the consumer?

Over the years, economists have learned to never underestimate the powerful effect UK consumers have on the fortunes of the domestic economy. When consumers feel optimistic about the future, the labour market is solid, wages are growing and there is access to cheap financing,

this can have a positive impact on economic growth. Conversely, the opposite can of course also hold when conditions deteriorate.

An estimated 60% of the UK economy is dependent on consumer or household spending. This has led some to ask if the country is too reliant on consumption and, if so, if the consumption boom seen through 2016 is about to hit a few bumps in the road.

While consumers appear to have been in a post-Brexit 'sweet spot', as loan and mortgage costs remained at record low levels despite rising wealth, alongside credit growth and wage increases (partly boosted by low inflation), there are a number of darker clouds gathering that could erode the continued ability of consumers to prop up growth.

Economists estimate that household spending accounted for nearly all of the UK's GDP growth last year, which provided a large stabilising factor in the wake of the country's vote to leave the European Union in the summer. Without this resilience, the UK may not have been the fastest growing economy in the G7 group of industrialised nations.

However, the fact that Sterling has taken the brunt of the impact, needed to help the economy adjust to the new environment, means that the cost of imports is forecast to continue to rise, and we are concerned that this is likely to slow retail sales. Indeed, the latest data from the Office for National Statistics (ONS) indicate that retail sales are beginning to feel the effect of higher prices. Retail sales have dipped to the weakest quarter since Q4 2010, which suggests GDP could also begin to slow as a result.



The ONS said in January that rising food and petrol prices led to a second consecutive month of falling retail sales. Economists have been expecting that the impact of a lower Pound in the wake of the vote would squeeze incomes. The January reading showed that seasonally adjusted sales volumes were 0.2% lower than in December, which was significantly weaker than forecasted. It also defied expectations that the fall seen in December was a one-off event.

The Bank of England (BoE) believes that the potential for consumer spending to be boosted by further declines in the savings rate remains low. In fact, rises in food and energy costs tends to negatively impact consumer confidence, which in turn drives up household savings rates. At 5.6%

of disposable income in Q3 2016, the household savings rate is already low in a historical context (back to levels from the 1960s), so it would appear there is little room for further declines.

The precarious and possibly unbalanced nature of future economic growth in the UK is highlighted by additional data from the ONS. The ONS state that sectors that are leveraged to consumer spending have accounted for 25% of growth since the referendum, more than double its normal importance. We believe this indicates the economic vulnerability to any slowdown in consumer spending.

The increase in prices appears to have had a knock-on effect on consumer lending growth. Data from the BoE shows that lending growth slowed in the three-months to January, despite robust mortgage approvals data. The fall in consumer lending was primarily driven by a reduction in borrowing on credit cards. The three-month annualised rate of growth fell from 8.3% to 6.9%.

The real interesting point from the BoE lending data was about the property market. On an annual basis, mortgage approvals are down 5.7%, a possible reflection of softer activity of buy-to-let lending since the summer. We note that mortgage approvals typically lead house prices by around 6-months and, given the slowing of approvals, we think it is likely that house price growth could also moderate.

As we highlight above, both growth in jobs and consumer credit showed some signs of levelling off in late 2016 as the cycle matured. We expect interest rates to stay low as the BoE will be wary of any tightening in financial conditions in this environment, which should prevent a sharper slowdown in credit growth.

Higher rates of inflation and acrimonious Brexit negotiation 'noise' could push consumer confidence lower, relative to other G7 nations. The housing market has already slowed, but financial wealth will have been buoyed up by solid equity markets across the world.

We expect the trend for household spending is likely to point downwards, given softer retail sales data in January, following the last likely post-Brexit high point. Higher prices for everyday items like food should apply downward pressure on day-to-day spending. Retail analysts suggest that trading in 2017 has had a "tough start", especially for items like clothing, and this trend is even beginning to appear in essential items.

Given the UK economy's high leverage to consumer spending, any fall in household expenditure is more challenging than for other countries. Additionally, we highlight that the UK's retail sector has had one of the strongest rises in productivity growth (thanks to new technologies such as tap to pay and self-checkouts) of any sectors in the UK economy since 2013. If other sectors are unable to pick up the slack, then UK productivity growth could further slow and pressurise wage growth, thereby increasing inflationary pressures. This could provide the BoE with another argument to keep rates low in the medium-term.

It is for these and other previously discussed reasons, such as the possibility of house price falls and the negative impact on spending (via the wealth effect) that our view on UK equities has become less positive. However, our less rosy picture for the UK could become brighter if the global economy as a whole takes an even better turn upwards. After all, a rising tide lifts all boats; it's just that the boat the UK is in a slightly impaired position relative to other countries given the uncertainties around its future trade position. Only a pick-up in the rate of long term business

investment in the UK to levels in the EZ and US would be a signal that Brexit 'clouds' may not have as material an impact on growth as currently projected.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7371.5	1.8	127.8	↗
FTSE 250	18875.8	1.5	287.2	↗
FTSE AS	4006.0	1.7	66.8	↗
FTSE Small	5356.7	0.9	46.5	↗
CAC	4996.3	3.1	151.0	↗
DAX	12021.3	1.8	217.3	↗
Dow	20972.9	0.7	151.1	↗
S&P 500	2377.2	0.4	9.8	↗
Nasdaq	5355.0	0.2	11.7	↗
Nikkei	19469.2	1.0	185.6	↗

Top 5 Gainers

COMPANY	%
GKN	8.6
CRH	8.2
CRODA INTERNATIO	7.5
BUNZL	6.3
BURBERRY GROUP	5.5

Top 5 Losers

COMPANY	%
CAPITA	-8.1
POLYMETAL INTERNA	-7.5
FRESNILLO	-7.3
WPP	-6.0
DIRECT LINE INSURA	-5.1

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	31.4	Brazil	223.6
US	26.9	Russia	165.8
France	60.4	China	88.3
Germany	21.7	South Korea	44.0
Japan	30.4	South Africa	191.0

Currencies

PRICE	LAST	%1W
USD/GBP	1.22	-1.72
USD/EUR	1.06	-0.09
JPY/USD	114.57	-2.14
GBP/EUR	0.86	-1.62
JPY/GBP	6.90	-0.41

Commodities

CMDTY	LAST	%1W
OIL	55.6	-0.7
GOLD	1224.7	-2.6
SILVER	17.7	-3.7
COPPER	268.5	-0.4
ALUMIN	1911.0	2.4

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.2	9.9	0.11
US 10-Yr	2.5	8.4	0.20
French 10-Yr	0.9	1.4	0.01
German 10-Yr	0.4	91.4	0.17
Japanese 10-Yr	0.1	14.7	0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.2
Standard Variable	4.5
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

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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

