Weekly Market Comment

21 April 2017

Lothar Mentel

CHIEF INVESTMENT OFFICER

Samuel Leary

HEAD OF INVESTMENT COMMUNICATIONS

Isaac Kean

INVESTMENT WRITER

Chris Swanepoel

HEAD OF AIM INVESTMENT

www.tattoninvestments.com Twitter: @TattonIM

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

Source: Financial Times

Snap - political risks return – or do they?

It appeared very opportunistic of Theresa May to call a snap election on June 8, after the latest polls showed the Tory party with the biggest lead ahead of Labour for probably 3 decades. Predictably, most of the media have focused on the short-term potential for the Conservatives to significantly increase their parliamentary majority. Much has also been commented on how a strengthened and specific mandate for May's government will vastly improve her negotiating position with the EU, as well as her own Eurosceptic firebrands, in the Brexit negotiations.

In our view, the more important consideration is how a parliamentary reset this year removes some time pressure points beyond 2019, which previously looked to make the Brexit negotiations very difficult indeed. Until the June 2017 elections were called, the next general elections were scheduled for 2020. This perspective of re-election pressures, just 1 year after the formal Brexit and most probably while many transition negotiations will still be ongoing, made it very difficult to see how both side could possibly reach mutually beneficial 'divorce' terms. A 2022 election date introduces considerable stress relief.

Currency markets, which have, in my view, provided the least biased assessment whether certain Brexit related events may be good or bad for the UK's future, appeared to agree with our view. £-Sterling strengthened – even if it was not quite as dramatic a gain as some of the media interpreted it: Roughly 1% against the €-EUR and 3% against the currently weakening US$. UK stocks, which have been trading inversely to the movement of the UK currency since the referendum, reacted more than the currency movement would have suggested, but that was more likely caused by the general downtrend in equity markets of the past 3 weeks. We would disagree with those who now suggest that Sterling will strengthen considerably further in the near term. Under the current election outcome scenario, Brexit still means Brexit – even if the path to get there should now be a bit longer and potentially less bumpy.

In conclusion, at Tatton we are of the opinion that calling an election now was the right decision for Theresa May. From a democratic legitimisation standpoint, it strengthens her electoral mandate and, from a UK strategic angle, it dampens some of the time pressures the Brexit negotiations would have inevitably experienced. That is obviously only if the election outcome reflects the current polls – and how unreliable they are in predicting electoral outcomes we have just painfully experienced twice over the past 2 years (For more comment on the election please see the dedicated article further down).

For Britain, the snap election call dominated the week, but, globally, the first round of the French presidential election over the weekend and the Turkish referendum outcome from the previous weekend dominated. Turkey's president Erdogan achieved a slim majority for his constitutional reform that will shift power from parliament to him. Importantly, he won no majority in Istanbul and Ankara, which spells continued friction and trouble for a country that, under his divisive leadership, has already fallen from one of the fastest growing developing countries into enduring recession.

France's economic growth prospects, on the other hand, are currently surpassing even Germany's. At the time of writing, the election outcome is unknown, but there is a strong expectation that populist and 'Frexit' supporter Marine Le Pen will not finish as the leading candidate for the second round, despite a high probability of her finishing second. As long as the other top 2 finisher is not left populist Melenchon (which seems unlikely), then we can reasonably expect Le Pen to lose the 2nd round, as the moderate majority would unite behind the remaining moderate candidate.

From this vantage point, politics may dominate the headlines, but the political risk scenario appears less uncertain than it was at the beginning of the year. If it pans out as I outlined then, it will be a relief for capital markets, which have recently lost momentum on the back of increasing indications that 2017 economic growth will just be a little (but not substantially) better than 2016.

That the slow but steady stock market downtrend of the past 3 weeks halted this week (UK being the exception), was not because of the above, but because of the first batch of Q1 corporate earnings announcements. As we discussed last week, in light of the lack of decisive direction from economic indicators, there is a larger than usual focus on corporate results and outlook statements. The first nearly 100 results managed to beat the already optimistic expectation we mentioned last week, and have thereby (for now) provided support for markets, which are nervous about valuation levels they attained when 2017 growth prospects were still higher – particularly in the US.

For the near-term, strong Q1 corporate results would help to stabilise the market, but the recently softer data from the US, the UK and some parts of the Chinese economy tells us to continue to be cautious and prepared for a potential market setback, should another growth scare emerge. Once again, falling yields in global bond markets tell a similar story, although they might be as well a bounce back from oversold bond markets at the end of last year, on the insight that the global economic expansion continues to progress only at a moderate speed.

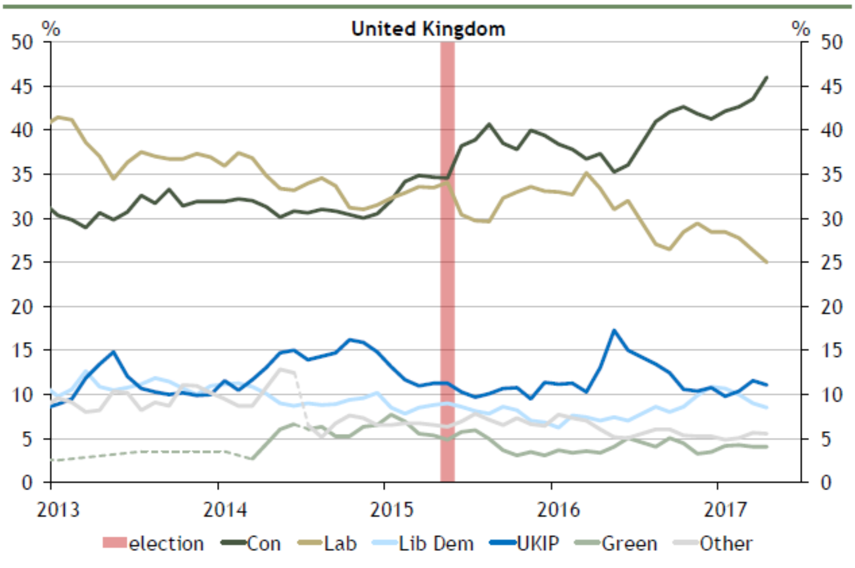
To close on another positive note, this moderation in outlook has, to my mind, actually reduced overall investment risks for 2017. This is because the much discussed scenarios from the beginning of the year – economic overheating ending the cycle, financial stresses from surging interest rates and credit costs causing similar damage – have all but disappeared beyond the economic horizon.

May calls snap election

In seven weeks' time, Britain will head to the polling stations again. Prime Minister May has called a snap election on June 8, just two weeks before the anniversary of the nation's vote to leave the European Union. Less than a year after the EU membership referendum which left the country close to evenly split (and unleashed a hell-storm of upheaval across the party-political landscape in the process), the UK's political future will once more be in the hands of its public.

The press are predicting a big win for the Prime Minister's Conservatives. The Poll of polls that our research partners ASR compile on the back of all respected polls around has the Tories' popularity at currently over 20% ahead of their nearest rival – at over 45% to Labour's 25%. If these numbers held out on June 8, the Tories would be looking at a three digit 140-seat majority, according to pollster Michael Thrasher.

UK Poll of polls



Source: ASR Ltd. / ICM / ComRes / Ipsos MORI / Ashcroft / Populus

The 'forgone conclusion' status of the snap election is why currency markets seemed to have taken the news rather well. As we have noted before, £-Sterling is currently perhaps the biggest indicator of market confidence in the UK's political and economic outlook, nosediving last year after the Brexit result and fluctuating around its lower valuation since, on each bit of news coming from the UK-EU divorce proceedings. So, the currency's spike to a 6-month high of $1.29 against the US-dollar can be taken as a general expectation that the election will help shore up Mrs May's position in negotiations with the EU, ensuing a 'softer' Brexit than had previously been predicted.

How can this be so? The Prime Minister's triggering of Article 50 and accompanying slogan of "no turning back" last month hardly put hope into those wanting to escape a hard Brexit – not to mention the repeated rhetoric of 'Brexit means Brexit', or her statement at the Tory party conference last year that those who thought themselves citizens of the world were "citizens of nowhere".

While the tune may be the same, however, the timing has changed. Under the stipulations of the EU's formal leaving procedures, the negotiating period will come to a close in March 2019. If no fully worked-out agreement on the transition is reached by then (which is highly unlikely), a hard Brexit would be the only option. Such a situation would leave May coming into the close with the

2020 election looming just a year away, meaning a politically unpopular transitional period post-2019 would be unlikely.

With her mandate extended by 2 years to 2022, she gains more leeway to reach the compromises that leaders in Brussels will surely be demanding – such as continuation of the UK's financial obligations and the rights of EU citizens in Britain. An increased majority, particular of the triple-figure size being touted by some commentators, could also drown out the noisy contingent of hard-line Brexiteers within the Prime Minister's party – whose appeasement by previous PM David Cameron was what brought about the referendum in the first place.

In terms of actual content, June's surprise election will likely be a dull affair, with many predicting a very low turnout and the government unlikely to detail much real policy (May has even refused the customary TV debate). Brexit will dominate the issues, and on this both main parties are largely in agreement. The Liberal Democrats, the only big party in England to unabashedly court the remain vote (with the SNP doing the same in Scotland), could stand to gain in some of the seats they lost to Labour and the Conservatives 2 years ago. But, rumblings that they'll overtake Labour as the country's main opposition are far-fetched.

Interestingly, if the Lib Dems are successful in current Tory constituencies that voted Remain last year (as they were in the Richmond by-election earlier this year), it could have the effect of whittling down the pro-EU Conservative MPs. This, combined with the expected Tory gains in majority-Leave north of England, could leave Mrs May with an even more Eurosceptic parliament – albeit with Eurospectics who feel more indebted and therefore loyal to the prime minister who brought them into parliament, the the older die-hard Brexiters. Of course, if she achieves a majority as big as predicted, a Eurosceptic party won't be much of a worry anyway.

Furthermore, despite markets' apparent belief that the election makes a soft Brexit more likely, in the interim period it could very well have the opposite effect. Mrs May has been (in our view deliberately) aloof about what kind of Brexit she will be aiming for, talking up the mandate she wants from this election without really specifying what that mandate will be for. When pressed for details in the coming weeks, she will likely be forced into more hard Brexit rhetoric – the kind of talk she hasn't shied away from in the past. This political gesturing would no doubt scare markets, but we believe that it would be just that.

So, what does this all mean from an investment perspective? Ultimately, as UK investors, the main effects of Brexit proceedings (in the near term) will be felt through currency valuations, as the value of overseas holdings will fluctuate in accordance with the value of the pound. Sterling's gain was UK equities' loss this week, with the FTSE 100 falling in tandem with the currency's rise, as the UK companies became less attractive to overseas investors. As noted, the Brexit cloud has been hanging over £-Sterling for 10 months now and, though the expected victory for May has alleviated some of these factors, we don't expect sunny skies ahead for the currency.

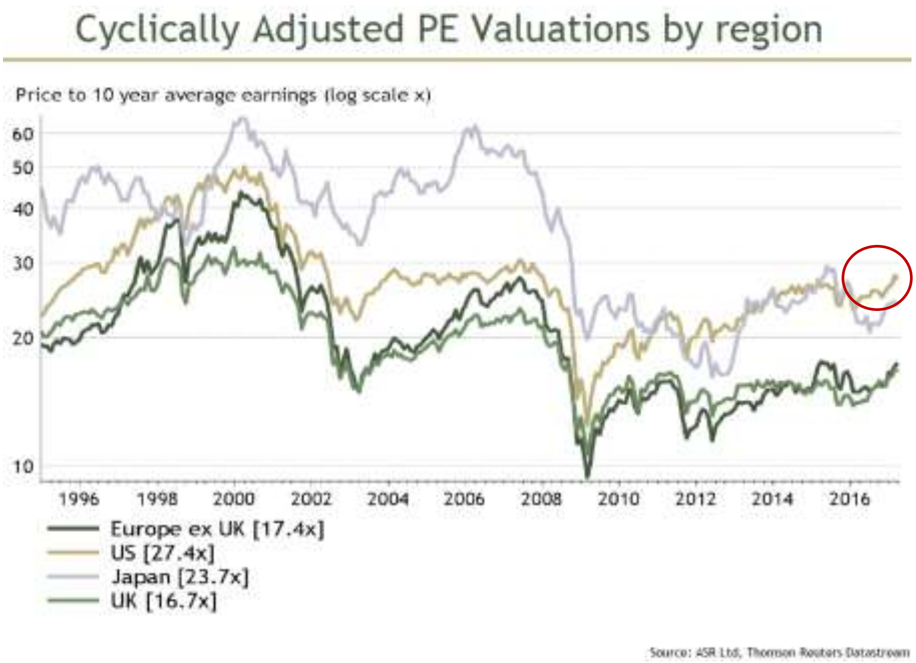
Even if the government's next evaluation is pushed back to 2022, there are still a number of obstacles in the way of a soft Brexit. The European Parliament is set to hold their own election in 2019, and the 2-year timeframe will still be wanted by many European politicians – particularly those whose electorate have their own Eurosceptic leanings. While the chance of a hard Brexit – where the UK ends up just trading with the EU under WTO rules – might decrease with a win for Mrs May's party, it's still highly unlikely that the government will emerge with their desired outcome from negotiations of getting the best of both worlds. Brexit still means Brexit, and, as Mrs May says, there is “no turning back”.

As a final word, it’s perhaps worth pointing out that an increased majority for the Conservatives might be the most likely outcome, but it’s not the *only* outcome. A week is a long time in politics, and there’s 7 of them between now voting day. UK polls have traditionally overestimated the Labour share of the vote, a fact many pollsters have tried to rectify since the polling miss that was the 2015 election. It’s possible that this could have led to an overcorrection, and unpopular leaders such as Labour’s Jeremy Corbyn tend to skew the polling results somewhat. If, though unlikely, the Tory majority was reduced, it could leave more voting power in the hands of the firmly pro-EU Lib Dems. Alternatively, of course, a reduced majority could also embolden the Eurosceptic wing of the Tory party. We don’t expect these situations to materialise, but it’s worth noting even the unlikely eventualities, because over the coming weeks foreign investors may come to similar views and this is likely to increase downward pressure on the UK’s currency once again.

Q1 Corporate earnings – more crucial this time?

Carrying on from our piece last week, we are picking up the topic of the corporate earnings announcement season again. We do so because there is a far greater focus on the numbers now than we have observed for several years.

One obvious reason is that relative valuation levels of equities are quite high compared to long term historical averages – particularly in the US (see graph below). When this happens, investors



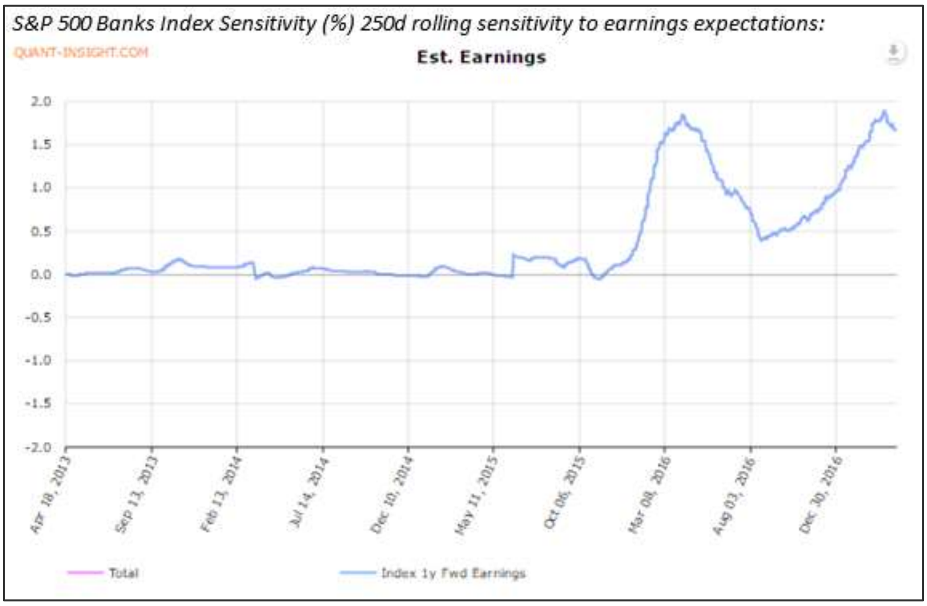
like to receive reassurances from companies that their earnings (profits) are continuing to grow at a pace which justifies current market valuations over the medium-term.

This quarter could provide investors with the key piece of information to drive, or at least underpin, markets in the near-term. Over the past few years, macro factors have sometimes been the primary drivers of higher market levels, even when corporate earnings declined. Since February 2016, stock markets globally have risen sharply, in anticipation that the Global economy has once again reached a firm growth footing, after growth scares over US' and China's growth prospect receded.

Such expectations were further fuelled by Trump's election, on the belief that the new US president would boost US growth prospects further through corporate tax cuts, deregulation and infrastructure investment programs.

Fast forward to today, and reliance on macro factors to justify valuation prospects has deteriorated, as it has become clear that Trump's campaign promises may have been somewhat overoptimistic, given his inexperience of the congressional system.

Furthermore, there are some signs of slowing growth both in the US and China, which have also



seemingly found reflection in commodity markets, where key raw material prices have once again fallen after last year's staggering recovery.

With such increased focus on corporate earnings, when the macro outlook is no longer offering valuation inspiration, it is perhaps not surprising that there is also a bigger focus on what actually are the biggest drivers of earnings themselves.

According to Quant Insight (QI), the most important medium-term driver of forward earnings estimates for US stock markets is the financial sector. They also believe that financials are the most sensitive to changes in real interest rates and the dollar.

When compared against all other sectors, as well as its own 5-year history, earnings sensitivity for the financial sector could be key for markets.

QI commented that "most of the investment banks are trading 0.3 - 0.4 sigma [I.e. only marginally] below fair value on our well-explained medium term models – the valuation cushion is not large enough to offset the importance of earnings this season. Corporate CEOs need to express confidence for loan growth to re-accelerate but if they stick to a cautious tone, the sector likely remains on the back-foot for now".

The health of banks in general is important, especially as they provide a conduit for further economic growth via lending. However, it is specifically the investment banks that have taken on the role of being the catalyst during this quarter. We note that some of the investment banks, like Citigroup, JP Morgan, Bank or America and Wells Fargo, have large retail arms that engage in lending to both businesses and consumers.

The earnings from five of the top six US banks have reassuringly come in above expectations, bar Goldman Sachs, which missed forecasts for the first time in two years. The issue at Goldman's appears to be related to the fact they merely got the 'Trump trade' wrong, rather than poor fundamentals.

It was Morgan Stanley that was the star of the big banks this quarter, thanks to a jump in trading revenue from its FICC (Fixed Income, Commodities and Currencies) unit. Q1 profits within FICC at Morgan Stanley nearly doubled to $1.7 billion and we note that, while FICC provides lumpy revenues, this is now the fourth quarter that the bank has topped its $1 billion quarterly profit target for the unit. The company appears to be reaping the rewards of Chief Executive James Gorman's new strategy of rebuilding its trading unit, following years of cost cutting and reduction of allocated risk capital.

Alongside the rebuild of trading, Morgan Stanley has also focused on generating more stable (and recurring) profits from wealth and asset management.

Analysts believe that companies beyond banks, listed on the S&P 500 Index could deliver their strongest earnings growth in nearly 22 quarters, on the back of an accelerating US and global economic growth, higher commodity prices and rising US rates which are particularly beneficial for financials. JP Morgan expects the EPS of the S&P500 could end the quarter near $30 a share, which would represent a healthy 11% jump y/y.

With roughly 15% of companies' results published, early indication are that markets may be getting what they desire – average EPS growth currently stands at 16.8%. Note, however, that this is somewhat positively tilted by the very strong results from the banks!

Chinese authorities relax capital controls – positive sign of confidence?

At the start of the week, China reported a raft of better than expected economic data points for both March and Q1. The data revealed the first consecutive acceleration in GDP growth in nearly seven years, but also a solid pick-up in investment, retail sales and factory output on the back of strong credit growth and a rebound in the domestic property market.

Despite, the better data, China bears (those expecting economic weakness) pointed to the rise in debt levels over the past few years, the weakness in commodity prices and also slowdown in both money and credit growth.

We recently wrote how it seems the Chinese authorities are playing a game of 'whack-a-mole' with the policy levers they have under their control, appearing to believe a free market economy can be fine-tuned even more than their old command economy.

One moment tightening monetary policy, then loosening it, then attempting to reign in property prices. The mix and match of policies appear aimed at steadying economic growth. So far, that approach appears to be working, but there are inherent risks in attempting to control the growing 'free market' in China that could cause unanticipated issues in other areas that leads to growth undershooting expectations.

In light of the above it is therefore reassuring that seemingly in response to the improvements in the underlying economy and reduced investor concerns over growth, Chinese economic have become more relaxed and lifted some of the more draconian capital outflow controls they only imposed earlier in the year.

Back to the macro reports, the highlights for Q1 include

- GDP expanding 6.9% (0.1pp above expectations) and faster than the 6.8% in Q4
- FAI (Fixed Asset Investment) was up 9.2% year-on-year, up from 8.1% and beating the 8.8% estimate
- Industrial Production gained a bigger than expected 7.6% y/y in March (est 6.3%)
- Retail sales jumped 10.9%y/y in March above the 9.7% forecast

In nominal-price terms, China expanded 11.8% y/y which may help ease fears around excess levels of leverage in the economy as expressed in the debt/GDP ratio. We note that household debt as a percentage of GDP in China is now 43.2%, well above the ten-year average of 27.2%, but still comparatively low against the US' 79.4% and a ten year average of 56.3% there.

Growth in Q1 remained robust on the back of continued strength in the housing market, infrastructure investment and growing overseas demand. The NBS (National Bureau of Statistics) said that the 70-city house price index gained 0.5% in March m/m and 11.4% y/y. We note that average price growth seems to be resilient even in the face of more than 40 cities last year introducing tightening measures on mortgage availability. We anticipate the impact of those policies to continue to help cool the property market in the near-term.

Looking at the internals of the GDP data, we see some progress on the official stance of rebalancing the economy away from old industrial growth drivers. Consumption now contributes 77.2% of growth in Q1, versus the 64.6% of growth from last year.

On the negative side of economic data, the drop in commodity prices (of which Chinese demand is a big driver of) since February and the contraction in broad money supply and credit growth, reflect the recent tightening bias from the PBoC.

We find it interesting that one of the biggest drivers of the slowdown in M2 money supply (cash plus time deposits and 24hr money market funds) as highlighted by the bears, likely came from "alternative inter-financial credit channels" according to Goldman Sachs. These credit channels largely represent Wealth Management Products (WMPs) that are part of the shadow banking system that sits outside the control of the PBoC, but has recently come under pressure from the regulator.

WMPs remain an area of concern for China watchers, given their huge size. These investment products are worth almost $4 trillion or close to 40% of China's GDP. The government's crackdown on such unregulated products was necessary and overdue in order to improve governance and transparency across the financial system. The slowdown in M2 may therefore be more a result of this crackdown rather than lack of underlying demand. This is at least what the continuing growth of retail sales at double-digit rates, as we highlight above, tells us.

While we acknowledge, that yes, economic data is inherently backward looking, the current trajectory of the Chinese economy appears to continue to be positive. It can also be argued that this is unlikely to see any dramatic changes, as the government would want to ensure stability in the run up to the 19th National Congress of China's Communist Party – due to be held late October/November.

Regarding the lowering of capital control measures we do not expect that China will totally drop capital controls, as they provide the government with an instrument to influence the direction of capital flows. Policy setters could for example limit Chinese investment in overseas sectors that they may deem undesirable. It is not inconceivable that the recent softness at the prime end of London's property market, might be a reflection of the ability to direct capital flows.

We have been concerned about signs of slowing economic activity in China and we are therefore observing the latest signs of stabilisation with considerable relief. At the same time, regular readers will also know that Chinese official data has not been quite as reliable as observers of western economies are used to. We are therefore continuing to watch developments in China closely.

AIM stock insight: Budgets cuts and healthcare companies

After a year of political upheaval, the outlook for the healthcare industry remains volatile, with pricing and US politics the key concerns. Here we focus on the alarming National Institute of Health (NIH) spending cut proposals in the US and summarise the stock-specific impacts below.

Recently, the White House published President Trump's proposed first budget, which outlined a request for its 2018 budget to cut $5.8bn in funding from the 2017 NIH budget of $31.7bn. This equates to an 18% cut in NIH spending which is the biggest source of basic life science research funding in the US. This is an enormous cut which would be by far the biggest cut in US biomedical R&D funding in history. The NIH news took a further turn last week when the White House proposed a $1.2 billion cut to the current year 2017 fiscal year budget. In the current (2017) funding year, which runs to end September, the White House budget rise request was originally 3%, though this has not been implemented and funding has been continuingly frozen at the 2016 level. 2016 saw a 6% increase, a rare real rise in inflation-adjusted terms with real NIH funding having been in constant decline since its peak in 2003.

At the time this was announced we were initially very sceptical whether this funding proposal would be able to be implemented as it would likely meet with significant political opposition, even within the Republican party which has generally been supportive of increased basic US science spending. Following the news there have been a flurry of statements across the US political spectrum echoing this sentiment, with prominent republicans unwilling to support it and describing it as likely to be “dead on arrival” in Congress. This scenario unfolded in a House Oversight hearing last Wednesday with both Republicans and Democrats condemning the proposal, and instead calling for increased biomedical funding, especially for cancer.

The White House’s recent failure to implement a repeal of the Affordable Care Act (‘Obama Care’) shows that politics does not get done in the US without the support of Congress and also without some form of bipartisan co-operation between Republicans and Democrats. Ironically, one of the key areas both parties agree on is support for basic NIH spending, so we cannot see how this is ever going to make it through.

What happens next then? In 2011, the Budget Control Act was passed to mandate spending cuts over 2013-2021, and when no agreement could be reached on negotiations in 2013 this lead to government shutdown and sequestration – indiscriminate cuts to both defence and non-defence spending, with a 5% cut in NIH funding in 2013.

How would this affect the AIM universe?

The White House NIH spending request signals a change in the direction of travel on US biomedical research spending and has reduced our expectations for the rise in NIH spending from the 3% requested in 2017.

Abcam, which is a global supplier of antibodies for research purposes, is the most exposed company in our universe due to its direct exposure to research funding. After strong H1 results the share price performed well, but it has since weakened on these budget developments, falling c.10%, though its revenues have remained resilient in previous spending downturns and the share price move appears to have overreacted compared to life science tools peers with more exposure to capital spending, which tends to be more sensitive to budgets.

Here at the AIM desk we are monitoring these developments. However, we look at the very long term potential of this business combined with evidence provided by the actual results. As such, we try and avoid getting caught up in short term market news that has no long-term impact on the fundamentals of the business going forward.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7122.3	-3.1	-226.7	→
FTSE 250	19366.5	-0.3	-57.5	→
FTSE AS	3916.2	-2.5	-101.9	→
FTSE Small	5448.1	-0.6	-33.0	→
CAC	5063.0	-0.7	-38.1	→
DAX	12059.9	-0.8	-94.8	→
Dow	20586.0	0.6	132.7	→
S&P 500	2352.5	1.0	23.5	→
Nasdaq	5448.9	1.8	95.3	→
Nikkei	18620.8	1.6	285.1	→

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
AB FOODS	7.6	BURBERRY GROUP	-10.3
EASYJET	7.1	SHELL -B SHS	-7.5
MARKS & SPENCER	4.8	FRESNILLO	-7.3
RBS GROUP	3.6	BP	-6.6
PERSIMMON	3.2	BHP BILLITON	-6.0

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	19.0	Brazil	226.9
US	19.3	Russia	164.3
France	56.5	China	87.0
Germany	17.7	South Korea	57.6
Japan	49.0	South Africa	191.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.28	1.94	OIL	52.0	-7.0
USD/EUR	1.07	0.69	GOLD	1283.0	-0.2
JPY/USD	109.14	-0.46	SILVER	17.9	-3.7
GBP/EUR	0.84	1.24	COPPER	255.1	-1.4
JPY/GBP	6.89	-0.01	ALUMIN	1943.0	1.1

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.0	-0.6	-0.01
US 10-Yr	2.2	-0.7	-0.02
French 10-Yr	0.9	2.6	0.02
German 10-Yr	0.3	35.3	0.07
Japanese 10-Yr	0.0	60.0	0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.7
5-yr Fixed Rate	2.2
Standard Variable	4.4
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

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

For any questions, as always, please ask!

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

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

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

Lothar Mentel