Weekly Market Comment

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End of globally synchronised growth upswing

At the end of weeks like this, I tend to struggle with the prospect of writing about the economy and global investment opportunities. However, it is not the purpose of these pages to pass comment on what may have made our world as divisive and lacking in moral restraint as the past week's event so painfully demonstrated again. My heart and thoughts go out to all affected, and I sincerely hope that the community cohesion Manchester so powerfully demonstrated this past week will become a more effective antidote to the divisive aims of the terrorists than all other counterterrorist measures.

Back to the economy and markets.

Data flow around the globe continues to present a mixed picture. There are clear signs that Chinese economic growth is slowing in response to tightening credit availability, as the authorities clamp down on China's (still) sprawling shadow banking sector. While China in Q1 was still growing at one of its fastest rates in some years, growth in the UK and the US had already meaningfully slowed.

The Eurozone, on the other hand, has finally entered a period of better growth rates, after having been stuck for so long in the slow growth rut. Japan has shown similar signs of accelerating growth, and, given the savings surpluses of the Japanese population and their considerable domestic demand potential, the country finds itself in a similar position to Europe.

The fly in the ointment is that, compared to the US, both regions are more deeply integrated in global trade. Should China slow as expected and the US not re-accelerate, then their falling demand for Japan's and Europe's exports would constitute a considerable headwind to the current positive growth momentum.

Unfortunately, this means that the highly encouraging synchronised global growth scenario we observed during the first quarter of the year has, most probably, already ended. This is not to say that this slowdown in growth will lead to a contraction of growth and recession. What it does mean, however, is that the overall growth prospects for 2017 have been reduced to just a slight improvement over 2016.

This matters, because capital markets value investable assets on a forward looking perspective, rather than looking back. As I commented last week, on this basis, equity market valuations – particularly in the US and the UK – look frothy and thus vulnerable to any indications worse than simply moderating of previously overly optimistic expectations.

This week, Tatton's investment committee therefore decided to take some profits and lower the overall exposure to global stock markets across all portfolio strategies by approximately 5%. On the basis that markets remain relatively calm and are trading at close or at their all-time highs, we are rebalancing portfolios gradually, which will allow us to implement various fund selection upgrades at the same time.

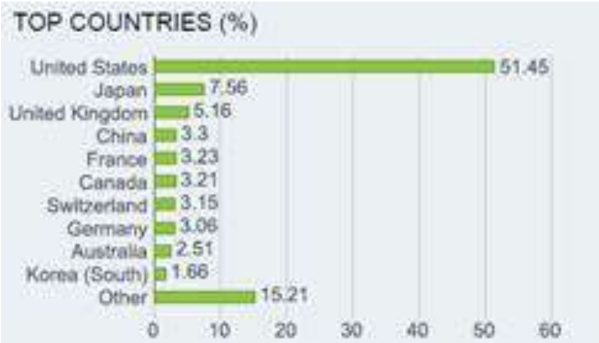
Even though this is the first time since 2013 that we have explicitly reduced our stock market allocations below the standard allocations, our relatively measured move (of only half of the maximum amount our management mandate permits) indicates that, while we would expect temporary market setback, we are not expecting the imminent end of this investment cycle.

Our central case for the coming 12 months remains one of resilient global growth and gradual monetary policy normalisation. Over the coming 3-6 months, however, we expect stock markets to struggle to reach much higher valuation levels than they have already achieved, but with a considerable chance of a short sharp selloff, not dissimilar to January last year. This risk reduction move should therefore lower portfolios' potential for short term value fluctuations (volatility reduction) without costing much - if any - loss of upside. Or, it could provide us with the opportunity to buy back the equity positions we are now selling, at lower prices.

In order for our view over the coming months, we would need to see a stronger resurgence of growth in the US in Q2 than already anticipated (and therefore priced in) and/ or a much lower reduction in China's rate of growth than current credit tightening effects and falling commodity demand would suggest. We will therefore be monitoring all critical parameters of economic activity across the major economies even more closely, to detect early whether our short term view is too optimistic or too pessimistic, relative to our portfolio positioning.

Why does China matter?
By Tatton's head of investment, Jim Kean

In the MSCI All Country World Index, which is as good or bad a representative for global equity markets as the FTSE100 is for the UK, China, as of the end of March 2017, accounts for just 3.3% of total global stock markets.



(Source iShares 31/03/17)

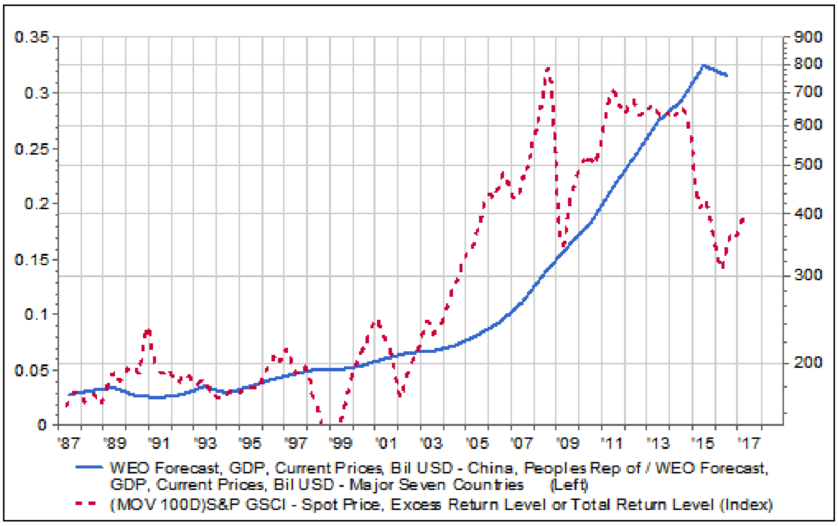
China accounts for a similarly small proportion of bonds traded in the world. So, in terms of investment performance, China has only a small impact on most global investors' portfolios. Yet, at times, China can dominate the discussion among the same global investors.

In the early 1980s, it began to open its economy and signed many regional trade agreements. From 1986, China began working towards joining GATT, the then eminent global trade framework.

China had aimed to be included at the start of the World Trade Organization (WTO) on 1 January 1995, validating it as a world economic power. Its attempt was thwarted by the then major industrialised nations, which required changes in tariffs, open markets and industrial policies. However, China finally became a member of the WTO on 11 December 2001.

The blue line in the chart below shows the relative size of China's economy (gross domestic product, estimated by the IMF's World Economic Outlook unit, source Factset) in comparison to the G7.

Note that the left hand scale is relative to 1, i.e 100%, which means that China has grown from a size of under 5% (0.05) relative to the sum of the G7 countries to now over 30% (0.3).



Source: Factset

That growth has been the juice of globalisation, and has led to the transformation of China in so many ways.

The impacts across the world have been immense and have varied. The access to cheap production has vastly improved the profit margins of global companies and (at least until 2012) rocket-fuelled demand for commodities needed to build the Chinese urban and manufacturing infrastructure. (The red-dotted line shows the Goldman Sachs Commodity Index level averaged over 100 trading days).

The phenomenal rise was engendered by a huge bout of almost unfettered capitalism; easy access to markets, easy access to credit, and a removal of regulation. Government involvement came through public spending and the subsidy of the old state-owned enterprises.

The inevitable downside which followed was: A significant amount of poor investment, a weak banking system, environmental problems, corruption and more recently, ballooning public and private debt.

Xi Jinping became President and General Secretary of the Communist Party at the end of 2012. Wikipedia says the following: “Xi has significantly centralized institutional power, chairing the newly formed National Security Commission, and new steering committees on economic and social reforms, military reform, and the Internet.”

“Xi has called for further market economic reforms, for governing according to the law and for strengthening legal institutions, with an emphasis on individual and national aspirations under the neologism "Chinese Dream".

“Xi has also championed … its role as a leading advocate of free trade and globalization. He has sought to expand China's regional influence through the One Belt, One Road initiative, played a leading role in the fight against climate change, and invested heavily in energy and natural resources.”

He is the most powerful Chinese leader since Mao, and clearly sees himself as strong and highly principled – a man of the people rather than of business.

So, the graph also tells another simple story; Xi’s reestablishment of central control caused the economy to hit its first significant barrier by 2015-2016. And, that control had already fed through to commodities and their producers throughout the world.

By the end of 2015, the Chinese government realised that the brakes had been applied too quickly. Chinese growth had become too important to the rest of the world and the second-round effects of their tightening had been underestimated. Outside China, financial markets were going through a worrisome time, with many experts worried that the world’s growth had disappeared, that globalisation was over and that goods prices were about to go into near-freefall.

Xi ordered the taps to be turned on again, both monetarily and fiscally. Fulcrum Asset Management (Gavyn Davies) showed estimates of the effect from the trough of early 2016 to just over a year later:

Decomposition of the World's underlying activity growth (% MoM Ann.)

	24-Mar-16	03-May-17	Change
World	2.15	4.06	1.91
US	0.47	0.73	0.26
Euro Area	0.15	0.36	0.21
Other Advanced Economies	0.11	0.24	0.12
China	1.24	1.66	0.42
Brazil	-0.46	-0.02	0.44
Russia	-0.01	0.09	0.10
Other Emerging Economies	0.65	0.99	0.34

Of the world's 1.91% growth in that period, 1.3% (over 2/3) was attributable to China and emerging market economies. China's reflation was a huge proportion of last year's reflation story, while Trump's US was just over 1/8.

Towards the end of last year, Xi decided that the need for full-blown reflation was past. Policy returned to dealing with the problems.

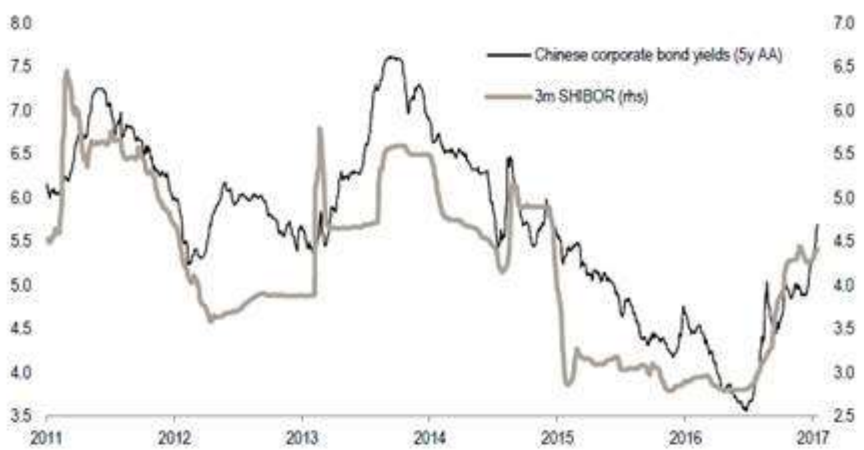
Compared to the last squeeze, Xi and his government now have more information, some advantages, and some disadvantages.

The information is that they need to be more careful than they previously thought. Policy needs to be more finely tuned.

The main advantage appears to be that the rest of the world is in a better position. Europe is strong and no longer in a stability crisis, while the US has shown lots of confidence – if not particularly strong actual growth. Meanwhile, emerging markets had a year's breather and may have become more resilient.

The main disadvantage is that the problems were probably exacerbated by the stop-start bout. The financial system was left as weak as before by a huge spurt in "Shadow Banking". Debt default is at greater risk now than before, especially if interest rates must be raised beyond current (already

Figure 34: The corporate bond yield has risen, Shibor is at a two year high



Source: Thomson Reuters, Credit Suisse

high) levels. Moody's ratings downgrade this past week for China's external sovereign debt is a small part of the story.

Industrial overcapacity, which created a collapse in goods prices world-wide, has not disappeared. The government recently said that steel production overcapacity had been reduced by some 70%. Better, but not gone, and this is an area that has had intense focus and a large demand benefit from the reflation burst. There's been virtually no removal of (nor incentive to remove) capacity elsewhere.

This suggests that the recent burst of producer price inflation could dissipate quickly. Given that this inflation has been the major component of nominal growth in China and globally, it does not bode well.

The Government now fine-tunes market policy daily. New initiatives such as the revised foreign exchange basket appear frequently. However, the sledgehammer is greater non-market restrictions. It has been noticeable that local equity market weakness has not been accompanied by weakness in the currency, the Yuan-Renminbi. Capital outflows have been stemmed somehow, and not just by higher rates.

Policy has clearly been tightened again. The problem for market participants is that negative effects may be more difficult to perceive in this episode, given the reliance on non-market measures. We should expect that Xi is as committed as before to eradicating the problems, but he has shown repeatedly that he does not care much for openness. If (when) problems reappear, they will be in a worse position than before.

Risks emanating from China remain high. The world may be better able to supplement demand if China's demand backs away, but there is little evidence to suggest that last year's global growth was much better balanced than before 2012.

China's impact on growth and on markets was substantial before, and its potential to do so again remains large. We therefore take the signs of rising risk of a slowdown in China seriously. At the same time, we are hopeful that the global economy is now more resilient than it was in 2015. Unfortunately, much will hinge on the US' growth path, and that is currently slightly clouded by political uncertainty, as discussed in this week's update article on the US

US update: Rate rises while economic growth is slowing?

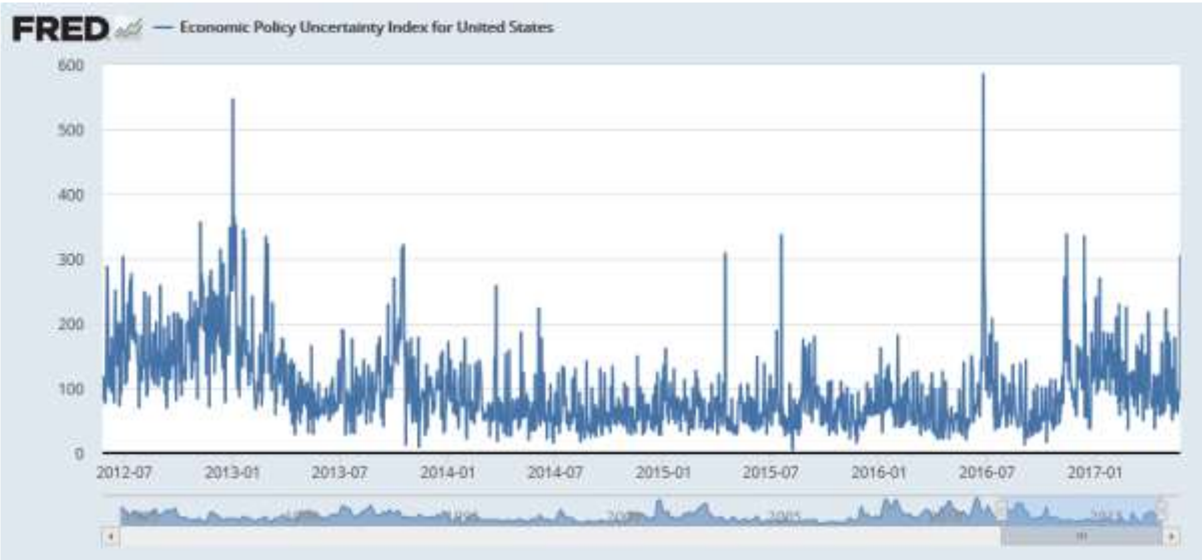
Most of the time, the financial press is measured in its commentary on the political economy. Not this week. President Trump's budget proposals sparked a series of extremely critical reviews in the FT (and elsewhere), with one commentator describing the proposals as an "epic betrayal of the American middle class", and another calling them implausible and wishful thinking.

Trump's budget announcement followed on the heels of the US Fed's latest published deliberations on monetary policy. Some of the comments in the Fed's minutes have made economists question whether an interest rate-hike is still on the agenda for June (as previously indicated), and relatedly, whether the US economy is as healthy as was thought.

The combination of the Fed's apparent hesitancy and the government's budget proposals that appear (at best) ill-considered and optimistic, has left markets and investors uncertain about the near and medium-term prospects for the US economy.

Of course, not so long ago, the underlying economic data – the buoyancy of the so-called "Trump trade" and the Fed's intended policy direction – provided markets with much needed confidence, and indicated the US economy was on-track (albeit not on a fast-track). Markets are now less sure, as shown in the graph below, which illustrates the growing level of economic policy uncertainty in the US.

Economic policy uncertainty index for the USA



Source: Federal Reserve Bank of St. Louis, May 2017

We are also a little sceptical of the new President's budget proposals, largely because of one of the key assumptions underpinning the entire proposals. This assumption is that GDP (gross domestic product; the size of the US economy) will grow by 3% per year until 2021 and stay at 3% per annum indefinitely. History and initial research suggests that the assumption is very optimistic.

Moreover, as we have previously said, Mr Trump's proposed changes to the tax regime, whether with respect to income, excise, corporate or even import tax, may produce unexpected outcomes. They are no guarantee of economic growth – particularly when unemployment is already at a low point.

However, we believe the Fed's deliberations are more relevant for the US economy, and overall market sentiment over the coming months, because they aren't subject to the inner politics of US Congress. The Fed's public announcement in early May was forthright in tone, maintaining that, while risks to the economy were balanced, the Fed's committee expected economic conditions to evolve in a manner that warrants gradual interest rate increases (this is consistent with market expectation of a further rate rise in June).

However, the recent slowdown in economic activity growth in the US - viewed by the Fed as transitory – was coupled with some less-hawkish comments in the minutes to the Fed's May session. For example, some members judged that the Committee could withdraw monetary accommodation even more gradually than reflected in the medians of forecasts in the “March Summary of Economic Projections”.

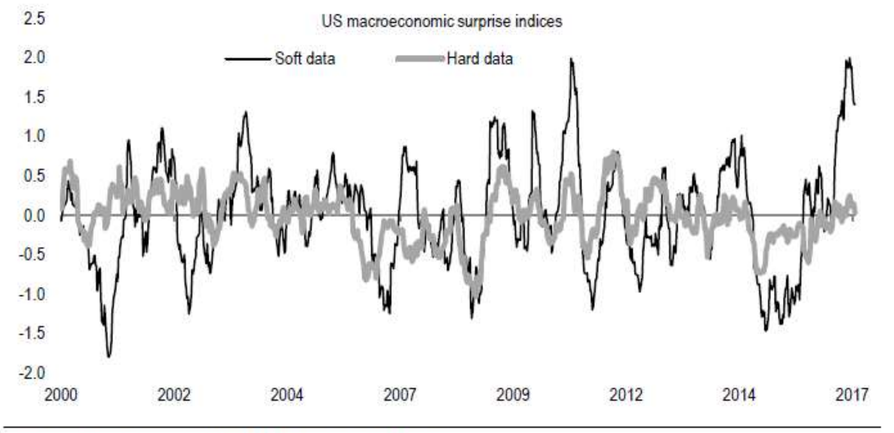
Analysts are now wondering whether the deceleration is indeed just transitory, or whether the US economic growth is actually going to stall. Clearly, if that were to be the case, and the Fed chose not to increase interest rates in June, this would send a more worrying signal to markets than President’s Trumps budget proposals.

As it is, we also judge the slowdown in Q1 as transitory, and believe the US economy will continue on its growth path, albeit with much less risk of overheating than was anticipated earlier in the year. This is because, even though economic activity slowed a little during Q1, the labour market has continued to tighten, business investment is accelerating and household spending remains at a reasonable level. Moreover, inflation, measured as the 12-month change in the headline PCE price index, is running near the 2% level, broadly consistent with the Fed’s target.

Perhaps more importantly, even though recent months have seen a divergence between 'soft' (survey-based) data and 'hard' data (quantifiable data pertaining to output, employment etc.), we observe some convergence in the two data sets (see chart below). Also, given the different nature of the data, there is inevitably a lag (time difference) between the two sets of data.

We expect the soft data to come down (partly reflecting the recent slowdown and reversal of the reflationary “Trump” trade etc.), while the hard data will gradually increase and converge with the soft readings (reflecting the relatively strong fundamentals described above).

US Economic data surprise index



Source: The BLOOMBERG PROFESSIONAL™ service, Credit Suisse

In our view, one of the key questions for the US in the short-term is how the Fed’s intended policy will interact with slowing US economic momentum on the one hand and the Trump administration’s various policy initiatives on the other. The budget proposal does not bear the hallmarks of fiscal stimulus, with its significant cuts to social welfare to fund the defence budget and the Mexican border wall. The tax reform initiative, on the other side, would clearly be fiscally stimulating, given its proposed cuts to corporate tax levels.

If the Fed’s analysis is correct, then the US economy doesn’t actually require further stimulus at the moment and, therefore, if administered, might simply dissipate through rising inflation. For its

June rate decision, as discussed, the Fed faces three significant areas of uncertainty. Is the slowdown transitory? Which budget proposal will find a majority? And, can tax reforms be factored in and, if so, when?

Against this backdrop, we expect the Fed to persevere with the long 'telegraphed' 2nd rate rise for 2017, but tone down the language in their announcement towards an increased emphasis of a 'wait and see' approach regarding any further monetary tightening.

Brazil back in Crisis: Pitfalls of EM Investing

Brazil is back in the news, as a political crisis surrounding President Michel Temer threatens to destabilise the government once more. For the second time in less than a year, a corruption scandal has engulfed Brazil's head office, leading to an increased probability that Temer will follow his predecessor Dilma Rousseff out the door.

This latest chapter in Brazil's ongoing corruption story centres on incriminating recordings between Temer and billionaire owner of JBS (the largest meat processing company in the world) Joesley Batista, implicating Temer in bribery. The news sparked public protests in the capital Brasilia, in turn leading the embattled President to deploy federal troops to bring order back to the capital. The political fervour is now at levels not since the impeachment of President Rousseff last August, with not just the public but now several key politicians out for Temer's head.

The man himself took to national television on Thursday to announce that he wouldn't resign his post, calming some of the more hysterical investors in the process. However, Temer's job is still in a precarious position, as are the region's economic prospects and its investable assets.

It was hoped that the removal of former the former President last August would help stabilise the political situation. Temer's installation by congress promised to make the relationship between the executive and the legislative far less antagonistic than had been the case in the past, and the unpopular circumstances through which he came to power meant the administration had nothing to lose in passing extremely unpopular reform policies (on tax, labour, pensions etc.).

Indeed, until these recent allegations surfaced, Latin America's largest economy was experiencing something of a turnaround, after years of recession. At the beginning of the year, there were predictions that the country's rate of GDP growth would turn positive for the first time since 2014.

Such hopes were always optimistic, however. Congress were never likely to align themselves with unpopular policies in the run up to 2018's election. Even more so because Temer was alleged to already have been deeply embroiled in the corruption scandal when Rousseff's impeachment was first discussed (in fact, even more so than Rousseff herself).

So, why does it matter for UK portfolio investors? As the largest economy in South America, and the third largest emerging market (EM) economy in the world, Brazil has a high impact on EM equities in general – and they are usually a small part of the equity allocation of risk profiled investment portfolios. After a relentless -35% stock market sell-off between 2012 and Q1/2016, the country has been at the forefront of the recent surge in EMs, with Brazilian equities up 10% from the beginning of the year until earlier this week. The currency made an additional 6% gain

against the US$ over the same time period. It took just 5 minutes to wipe out this 5 month trend, however, after the corruption evidence against Mr Temer emerged. According to Citi's EM credit strategist Luis Costa "Brazil is the biggest trade of the past two years … so big it led investors to emulate the thinking in other markets".

Just as Brazil's upward trend had been pushing up other EM assets earlier this year, so too could Brazil's downswing hold them back. This is particularly true when one considers the timing of Brazil's political crisis, coming just as a slowdown in Chinese growth is starting to materialise across in South East Asia.

Overall, we now see risks for EMs returning. Into the end of last year, it was beginning to look as though political risk had shifted somewhat to the western world, after populism's surge across the US and Europe had investors worrying about the strength of western political institutions. By contrast, the stability of the Chinese government (and not to mention the country's growth spurt) and the improving prospects for the Brazilian economy made it look as though EM investments may do much better than previously anticipated, when the strengthening of the US$ was feared to shift capital back to the developed markets. Fast forward to now, and the picture looks much different. Populist candidates have been defeated all across Europe, and China's 'whackamole' economic intervention approach to tackling its credit market issues is making investors nervous.

Now, with Brazil being once again engulfed in a corruption crisis, we see yet more evidence that it is indeed in EMs where political risk is the most prominent.

Of course, EMs are not one homogenous block, and it would be remiss to continue to treat EM investments that way. One of the biggest divides is along commodity lines, with developing nations whose industries are heavily correlated to the commodities sector often fairing very differently to those who aren't. Filing Brazil into one of the above categories is complicated, however. While natural resources make up around 40% of their total exports, they also have a very large domestic consumer base, and so are far more of a demand-led economy than the traditional commodity exporters.

To be clear, we are not quite joining in with the usual EM doomsayers. Indeed, if Brazil can shrug off the corruption scandal and resolve the new issues more expediently than the Rousseff impeachment, then this would inspire further investor confidence in Brazil's economic reform potential, which will likely bode well for the economy. In fact, Morgan Stanley analysts predict that the shares of oil giant Petrobras – a company at the very heart of Brazil's ongoing scandal – has an upside potential of 80%.

Rather, we believe that, after a very strong run since January 2016, for now the risks have grown too large, and, as such, further upside potential for EM assets is decreasing. This is why we are lowering our EM exposure in favour of areas such as Europe which continue to experience strong upward growth momentum, paired with pent-up demand from a vast, savings-rich consumer base. This, we believe, should give the Eurozone the ability to outperform other regions over the remainder of 2017.

Back to the emerging markets regions, one of the main dangers of EM investing is that EMs have the ability to drag in external capital in large amounts – as investors want to jump on the bandwagon of the promised higher returns. Very often, due to the underdeveloped political structure of these economies, this capital is then misused and put into weak private institutions – ridding the capital of its productive capacity. This is often why EMs engender corruption – money flows in faster than can be put to good use and the promise of inward investment overrides the need to properly develop key areas of the economy. This kind of corruption is antithetical to sustained growth. In this sense, Brazil provides the prime example of what can go wrong; heralded for so many years as a future powerhouse of the global economy – and now mired in a corruption scandal so deep that economic growth prospects have been severely handicapped.

Whatever the case, Brazil has merely woken up investors around the world that EM investing has its pitfalls. While the risks in South America have increased quite suddenly, we have observed for a few week's now that the risk balance has begun to shift against the wider EMs. Given EMs are a less cohesive classification than they used to be, we have not just simply reduced our exposure, but also refocused it on the less resource dependent towards more consumer demand driven countries. From that end, a swift political resolution of the Brazilian crisis could bring their stock market quickly back to being an opportunity rather than a threat. Alas, our hopes are not overly high for now!

Oil: Can OPEC contain US shale but keep prices stable?

One of the biggest questions facing oil market watchers at the moment is: Can OPEC contain the rapid growth of US shale oil production, at the same time as keeping prices high enough to avoid budgetary and social issues in Saudi Arabia (the bloc's biggest member by oil output).

While it appears that OPEC is slowly losing pricing power for the longer-term, because non-OPEC counties like Russia and the US gain market share, the oil cartel still has an ability to impact short-term prices.

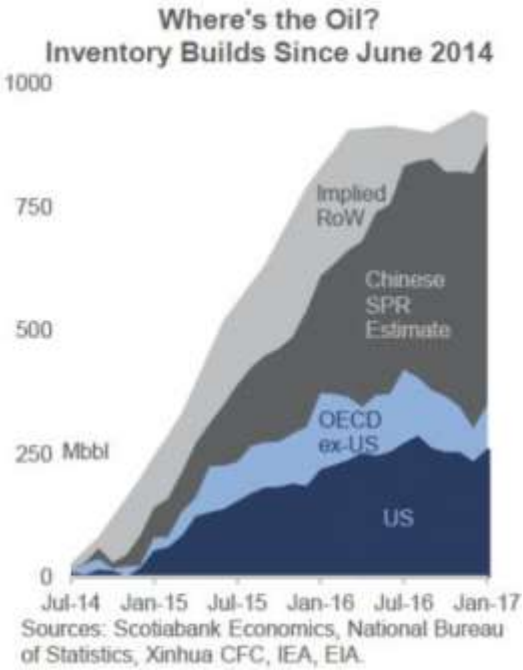
This week's agreement at the OPEC meeting in Vienna of a 9-month production cut extension is set against a somewhat changed demand environment to the original supply reduction decision last December. Growth in oil demand is now expected to be much smaller from China, the world's largest energy consumer.

The possible drop in further Chinese demand is not even primarily driven by the well-known factor of slowing economic growth, but more by the belief that China's vast Strategic Petroleum Reserve (SPR) is finally reaching capacity and the country will therefore simply import less oil.

Oil experts have only recently begun to realise just how large China's SPR has become, with some estimates of over 700 million barrels of oil. According to the International Energy Agency, this is equivalent to about 2% of the 35 billion barrels of oil consumed world-wide during 2016. Oil consulting firm Orbital Insights believes the total capacity of China's SPR could be around 900 million barrels of oil.

Why does the SPR matter?

Private estimates of the size China's SPR dwarf official statistics. Officially, China's National Energy Administration state that the country has 'just' 234 million barrels of oil, as of September last year.



We think that China's SPR could be more important to the global supply and demand balance than initially believed. The situation OPEC faces today is a market that is oversupplied. The supply glut that began in the middle of 2014, saw an estimated one billion extra barrels of oil find its way into global inventories.

Only around 35-45% of global inventory is held by the US and OECD nations. The chart above shows just how much oil China has stored in the past year, as it bought when prices were lower. Late last year, JP Morgan estimated that China's SPR grew rapidly from an average daily increase of 491k barrels to initially 1 million barrels per day and then 1.6 million at its peak in Q1.

The official data has now finally shown a levelling off in April, to around 1.36 million barrels per day, which is the sharpest decline in reserve accumulation in a number of years. It is also in-line with the slowdown in overall oil imports in China. Perhaps speculation about the country's SPR reaching capacity are starting to reflect reality?

Should it be confirmed that China's SPR is essentially 'full', then this would explain why the OPEC meeting's agreement to merely extend the production limits of last December where met with a steep decline in the price of oil. A 1.6 million barrel/day demand reduction by China amounts to 1.7% of daily global oil production. This significant decline is on top of the already lower restated demand growth expectations since last December (which were themselves due to slower-than-expected global growth predictions for 2017).

OPEC production cut extension priced in?

We believe that the market had not only already priced in OPEC's decision to extend production cuts, but were expecting further reductions, in light of the changed demand projections. Oil prices had rebounded, hovering above $50 (Brent), on recent inventory drawdowns (in OCED countries) and greater clarity around OPEC countries generally meeting production cut targets.

Without additional production cuts which would allow global inventories to normalise, the risks for a renewed surplus rise next year has increased. With neither Russian nor US oil and gas output levels under OPEC's control and faltering Chinese demand, the re-balancing of supply and demand has once again slipped beyond the immediate time horizon

Issues for Saudi Arabia?

This leaves OPEC between a rock and a hard place. There are growing questions over the financial and social prospects of the cartel's largest member Saudi Arabia. With oil prices below $60, the country has faced budget deficits for the first time in recent history, given its economic reliance on 'black gold'.

Saudi's growth outlook was cut by the IMF back in January, and the country is also looking to cut government spending, as a result of lower oil prices. The state remains both the largest employer and spender in the Saudi economy.

The government aims to cut about $20 billion from spending, in order to reduce the country's 12.6% budget deficit and, if prices remain around $50, then that deficit should further reduce. Should oil prices fall from current levels, then the Saudi government might need to sell more bonds (following last year's $17.5 billion bond sale) around $15 billion expected this year, which would increase debt to GDP to 30%.

Where does US shale fit in, given its increased share of global production volume?

Following oil prices briefly reaching a 13-year low of $26 in early 2016, prices have stabilised around $50, which appears to have once again encouraged shale producers to increase output. During the downturn, firms rapidly cut spending, idled production and staff. However, since then, shale firms have become much more efficient, utilising new technology to obtain more oil at lower expense levels from each well. As a result, production costs have fallen to just $45 a barrel. Prices above this level attract profits, helping to service debt burdens.

OPEC pricing dilemma – not too hot, not too cold, but just right

If OPEC manages to spur too ‘hot’ an increase, then shale production could go exponential, which could add to the global inventory glut we see today, unless demand can soak up supplies. Too ‘cold’ an increase, then Saudi might face financial issues.

What can OPEC do about the US shale swing factor?

The strength of the US shale sector is in its relative low capital outlay per well and ease of attracting financing, and higher oil prices could make it easier for shale firms to obtain loans. So, for OPEC to suppress US production volumes, they would need to force expected future oil prices lower, below that of today’s spot levels. A situation where spot prices are higher than futures is known as backwardation.

We see it working in the following way. A sustained oil market in backwardation could make it harder for shale firms to access large amounts of money from private equity and junk bond (high-yield, HY) credit markets.

Backwardation could lead to three negative impacts

1. Increased use of hedging – an opportunity cost for higher future profits
2. Lower profit forecasts might restrict higher valuations on the equity side
3. Lower profits might make it harder to service debts, thereby raising leverage

Interestingly, shale firms are already making greater use of hedging. In 2016, leading shale firms hedged just 17% of revenues, but this year that figure has risen to 27%. The increase in hedging activity has already been heavy enough to negatively impact futures prices.

While this might be attractive from a debt investors’ side (given the increased cash flow certainty), it takes away upside for equity investors, as it caps profit growth. Essentially, shale firms are limiting their own future prospects for the sake of increased cash flow certainty. Should debt leverage increase as equity capital goes elsewhere, then equity investors may begin to demand even higher yields for putting their capital at higher risk, therefore further raises funding costs and limiting access to capital for future expansion.

How would OPEC achieve backwardation?

The first step would be to continue cutting production until excess inventories have normalised. At the same time, they need to grow future production capacity so that, once supply and demand have rebalance, they can gradually increase daily production again and regain lost market share.

Pulling off such a strategy is difficult, but not unheard of. During the 1990s, OPEC used this strategy. But the risk is that debt markets don't dry up for shale producers, even in the face of lower futures prices. This is especially true as there appears to be little HY debt that is maturing in the next few years, and investors are still in the "search for yield" mode.

What are the longer term implications for oil price levels?

Market's disappointment over the past week have reinforced the view that OPEC's price supporting measures of last year will be insufficient to support price rises and will, against the lower expected demand growth, keep prices at best around $50. Should the Chinese oil reserve dynamics prove to be true, then this could push oil prices back down to the $45 level. On the other hand, general demand growth may currently be underestimated, if economic growth in China and the US slows less than feared.

On balance, we therefore see little upside in the price of oil, and expect prices to continue to fluctuate between $45 and $55/bbl. This would make it neither an obstacle nor a further stimulus for global growth, and give us one less economic variable to worry about.

PERSONAL FINANCE COMPASS

My apologies, but due to technical issues the data below has not been updated from last week

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7469.7	0.5	34.3	↗
FTSE 250	19818.9	0.3	55.9	↗
FTSE AS	4087.2	0.4	16.1	↗
FTSE Small	5592.0	-0.6	-31.1	↗
CAC	5326.1	-1.5	-79.3	↗
DAX	12653.5	-0.9	-116.9	↗
Dow	20781.1	-0.6	-115.5	↗
S&P 500	2383.3	-0.3	-7.6	↗
Nasdaq	5662.7	-0.4	-24.2	↗
Nikkei	19590.8	-1.5	-293.1	↗

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
RIO TINTO	6.7	BRITISH LAND CO	-6.6
CAPITA	5.4	HARGREAVES LANSD	-6.0
FRESNILLO	5.4	LAND SECURITIES	-5.7
KINGFISHER	5.1	TUI AG-DI	-5.3
ANGLO AMERICAN	4.9	INTU PROPERTIES	-4.7

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	31.4	Brazil	265.8
US	26.9	Russia	160.9
France	29.9	China	81.9
Germany	16.5	South Korea	60.1
Japan	30.4	South Africa	203.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	1.12	OIL	53.7	5.5
USD/EUR	1.12	2.42	GOLD	1254.1	2.1
JPY/USD	111.37	1.80	SILVER	16.8	2.3
GBP/EUR	0.86	-1.31	COPPER	258.2	2.3
JPY/GBP	6.89	0.21	ALUMIN	1923.0	2.6

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.1	-0.2	0.00
US 10-Yr	2.2	-3.5	-0.08
French 10-Yr	0.8	-4.2	-0.04
German 10-Yr	0.4	-6.1	-0.02
Japanese 10-Yr	0.0	-14.9	-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	2.1
Standard Variable	4.3
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

For any questions, as always, please ask!

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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