Weekly Market Comment

14 July 2017

Lothar Mentel

CHIEF INVESTMENT OFFICER

Samuel Leary

HEAD OF INVESTMENT COMMUNICATIONS

Isaac Kean

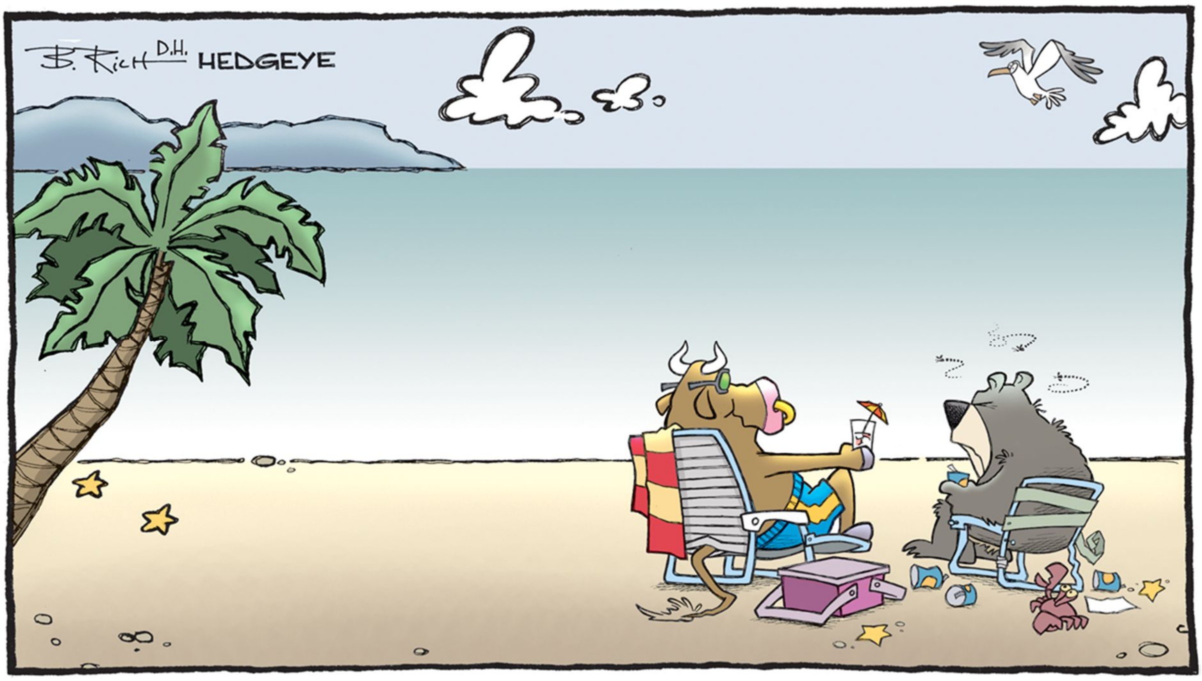
INVESTMENT WRITER

Chris Robinson

INVESTMENT ANALYST

Duncan O'Neill

GUEST ECONOMIST



Pre summer-holiday investment check

As we head towards the summer holidays, it's worth checking on some of the expectations we had at the start of the year.

Last December, we wrote that much would depend on politics; would "populism" spread from the Anglo-Saxon nations across the Western World (we thought growth and culture would see off the threat); would an unorthodox US president Trump undermine global trade (a negative which we thought unlikely); would he unleash fiscal stimulus and deregulation benefits on the US economy? (a positive but we thought even less likely given intractable US domestic politics).

So far, in these respects at least, our central case has largely played out.

Populism across Europe appears to have been set back by the reality of a populist in the White House. Furthermore, Trump's administration may have already turned into a 'lame duck' presidency, resulting in little policy progress regardless what the president may tweet to the contrary.

The global economy's momentum has continued, buoying economic regions with the higher catching up potential – especially in the Eurozone and Japan.

But, as is always the case, unexpected headwinds emerged.

Concerns arose over slowing growth in China. Their formidable stimulus of early 2016 got the global growth momentum rolling in 2016 in the first place. However, this encouraged "off-balance sheet" lending. Having achieved some stability, China needed to regain some control over these "shadow" banking markets.

The resulting monetary tightening had the potential to lead to significant economic activity curtailment. To our surprise, thus far this has not been the case, as the Chinese authorities appear to have been able to deploy other policy levers successfully enough to prevent the feared fall in Chinese demand in global markets.

The second reappearing market 'demon' was a weakening in "hard" commodities, especially oil.

The collapse of the commodity price bubble back in 2014 had led to painful capacity adjustments in the resource industries. The consequent decline in industrial and machinery production around the world led to another bout of deflation fears.

This does not appear to be happening this time. Price declines are smaller (oil has fallen from \$50/bbl to around 45; in 2014 it fell from \$110 to \$45). Consumer price inflation has reduced somewhat, but not enough to seriously bring back deflation scares (yet). Additionally, it is mostly oil that has come under pressure, affected by volatile supply conditions rather than worries over a fall in demand.

The third concern had been for a further strengthening of the US\$, upsetting trade flows and weighing down developing economies through their \$-denominated debts. This has also not happened and indeed the US\$ has weakened as we expected, rather than strengthened as had been consensus.

So, at the beginning of June it could have almost been a return of a 'Goldilocks' market environment; stable low growth, low but positive earnings growth, low inflation; and, therefore, really low interest rates.

At this point, a familiar market demon re-enters the scene: fear of rate rises. At the beginning of the year this was only a US topic and even there, the tightening through the slow rise in rates by the US Fed was largely neutralised by continued easing by the European Central Bank.

Now central banks of across the Western hemisphere have started to get more vocal: 'economic normalisation has to be accompanied by normalising monetary policy'. The central banks of North America and Europe announced (equivocally) that extraordinary monetary stimulus is likely to be coming to end sooner rather than later.

Such marked shifts in policy frameworks tend to be associated with changes in financial market "regime", especially when conducted in concert – a definite increase in risks for the second half of 2017.

There is some potential for a disorderly reaction in bond markets. Low current yields mean there is no "carry" benefit in holding on during price falls; bond holders can't recover as quickly from losses as in the past. This could mean large numbers of bond investors suddenly heading into cash, pushing yields up far more quickly than they came down.

Equity yields valuations would come under pressure, given that the major justification for high P/Es is low bond yields. In addition, one would expect some impact on growth in the economy which, in turn, would reduce expected company earnings growth.

No wonder then that the central bankers equivocated; any reduction in monetary support would be small and very gradual, hoping to reassure bond investors that the risk of capital losses through rising yields should be small.

For us, this slight change in outlook scenario has diminished our attraction to bonds. We had previously extended duration to offset the possibility of an equity market correction in face of high valuation levels against slowing economic growth rates in Q2. Now we may increase cash levels in portfolios.

If this is not really the sort of pre-summer-holiday reading one might want before departing, then it's comforting that, over the past 18 months, markets have become far more measured in their reactions. And, while the above scenario's probability may have increased, for us it remains an outlier.

Our central case is for a continuation of a steady, if somewhat below average, growth normalisation. Over the mid and long-term, equity investments should continue to outperform lower risk asset classes. The return outlook for fixed interest bonds has taken a turn for the worse – and that's welcome if this tells us that almost 10 years after the Financial Crisis began we are slowly returning to more normal economic conditions.

The Road to Brexit

Just over a year on from the referendum result, the UK's future relationship with the EU is about as unclear as it was then. On Wednesday, the EU's chief negotiator Michel Barnier responded to Boris Johnsons suggestion to "go whistle" by telling him that "I'm not hearing any whistling, just a clock ticking," Let's take stock; how did we get here?

Before the referendum, virtually all forecasts saw a Brexit outcome resulting in generally slowing growth and falling living standards. The six months following the result saw the opposite happen – in the case of growth at least. Were these predictions foolish (or worse, the machinations of 'project fear')?

It was widely foreseen that £-sterling would fall, causing a spike in inflation (correct); that this would in turn discourage consumer spending in the short-run (incorrect). Many forecasts coupled these with a fall in inward investment (largely correct), thus expecting both short-term and medium-term downturns. Some thought that a £-sterling would be large enough to boost exporters – particularly manufacturers – but few expected it to be large enough to offset the falls in other areas.

As it transpired, the pass-through of inflation did not happen immediately (the textbooks say that inventory should be worked through before price rises are felt). This meant that the economy could take full advantage of export benefits of low sterling.

Manufacturers saw a considerable boost in their competitiveness. Britain's exports became more attractive, particularly for EU buyers buoyed by Europe's strong economy. Growth in the UK's regions (where manufacturers are mainly based) was very positive, contrary to the usual dynamic of services-led growth focused largely around London.

The combination of delayed inflation pass-through and strong regional employment propelled the UK to the second fastest 2016 growth rate out of the G7 with 1.8%, behind Germany's 1.9%.

It hasn't been all positive of course. In the housing market, the referendum preceded a sharp drop-off in prices and (more importantly) sales volumes that continues to this day, especially in London. The Halifax housing price index, which fell markedly last summer, did recover into the tail end of last year and beginning of this year. However, as the year has progressed we've seen a levelling out and, more recently, renewed falls.

That brings us to now. June's residential housing market survey from RICS doesn't paint a particularly pretty picture. Price growth was down over the last three months, with London and the South East seeing some of the worst of it. The capital in particular had a net balance of around -45%. More concerning than prices is the marked drop off in sales volumes and enquiries, with both down considerably over the past three months. As a risk asset, falls in trading volumes often indicate that property is very vulnerable to further price falls.

As for consumer demand, the rampant appetite shown by the British public in the aftermath of the referendum slowed at the beginning of this year. Inflation came in at 2.9% year-on-year in May, compared with 0.6% last June. As reported some months ago, inflation is now well outpacing wage growth, meaning that real earnings are falling – going some way to explaining the fall in demand growth seen after Christmas. However, after that slow start to the year, retail sales were back up year on year (and by 4-month average) over the following few months.

So, what does this mean for the future of Brexit Britain?

After the majority of short term Brexit expectations (including our own) failed to materialise immediately following the referendum, we hesitate to offer any kind of exact diagnosis on what we expect – particularly one that could be classed as 'doom and gloom'. But it would likewise be silly to expect that the positive consumer demand that propelled the economy forward into the end of last year can keep on going full-steam ahead. This is particularly true considering how long real wage growth is expected to remain negative; the latest forecasts predict that British workers will earn less in 2021 than they did in 2008.

On the other hand, with £-sterling seemingly firmly settled around its current valuation, the inflation pressures that that brings will eventually subside. This too, however, is a bit of a double edged sword. Until now, the manufacturing sector has been greatly helped by low sterling valuation, but the price competitiveness this offers will likely be outweighed by EU businesses' unwillingness to establish relationships with UK businesses – due to the uncertainty over the future trading situation.

EU businesses will be wary about the prospect of drawing up long contracts with trading partners when the terms of those contracts will need to be renegotiated within (less than) two years.

In the run-up to the referendum, business leaders were generally circumspect in making any comment. Now, uncertainty appears to be having direct impact and they are less backward in coming forward. Last week, CBI director Carolyn Fairbairn urged the government to agree to an indefinite delay in a formal exit, until the details can be properly worked out.

We don't believe that a cliff-edge scenario (where the exit date is around the corner and we're still none the wiser) is likely. We have nearly two years – probably more as an extension is likely – to find a path away from the precipice.

Politicians can be effective but, like everybody else, they need to be able to work away from constant emotional oversight. Perhaps what they need most is for us to not require certainty too early, but to allow them a less heated and more agreeable environment to be reasonable.

Q2 corporate earnings outlook

The quarterly earnings season unofficially kicks off in the US this week and, together with companies in Europe and Japan, stock market quoted companies report their results over the next four weeks. Q2 is looking fairly pivotal for equity investors, who are awaiting validation that their positive stance on equities and the subsequent rally – which has taken markets to new record highs – is justified even if economic growth rates have moderated.

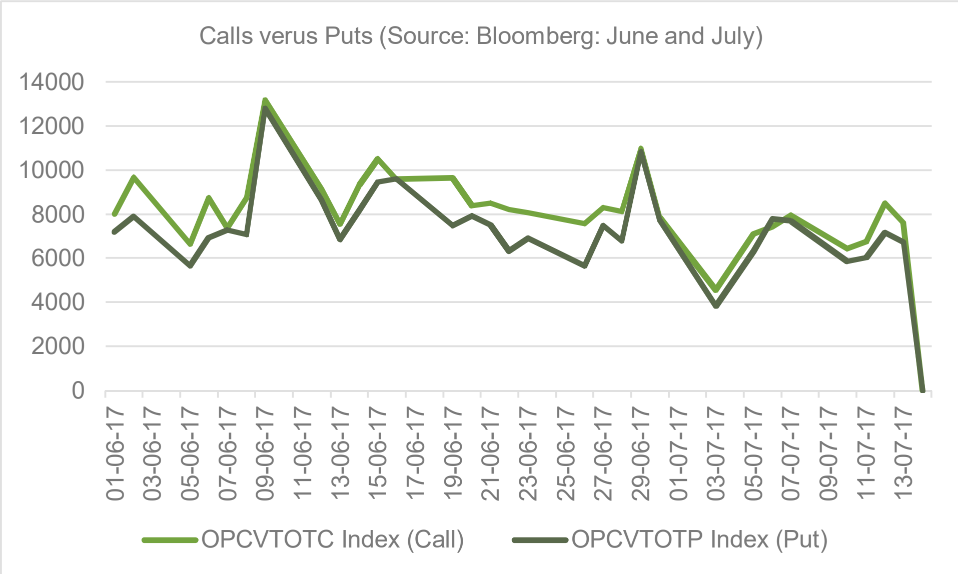
Q1 earnings set the bar for Q2 high, given the strong double-digit gains in both revenues and profits across the world, especially for the current leading regions of Europe and Japan. Stocks reacted highly positive to Q1 numbers and as a result, analysts upgraded full-year forecasts.

Consensus expectations predict that the positive momentum seen in Q1 is likely to continue to act as a tailwind for investors, as the synchronised global upturn in earnings has only really just begun. However, there is also a rising chance that outright earnings could disappoint in the second half of the year, leaving markets vulnerable to a pullback.

We find further evidence of increased investor nervousness going into the Q2 season from the options market. Option buying can provide us with a 'big picture' view of any sizeable skews (volatility levels), either bullish or bearish, and therefore an indication of investor positioning ahead of Q2.

As an example, if an investor is bullish (positive) about a company before they announce their earnings, then they might buy upside calls. This would increase the potential for a bigger gain in the share price (or implied move) when they announce and also depress skew, which could further attract 'low vol' buyers and enhance upside movements.

On the flipside, if an investor was bearish or worried about earnings, then we might observe an increase in the purchase of puts. In this situation, the implied move is negative as skew rises, meaning the likelihood of a stock price gapping lower goes up.



We think it is notable that, when investors reduce the aggregate amount of option buying/selling ahead of results reason, overall this might suggest that investors have become less certain about company earnings. The chart above shows the decline in total volumes of both calls and puts as we moved closer to results season.

That being said, we still expect Q2 earnings progress to Q1 likely to be relatively stable. This is because, on a comparative 1 year (comps) basis, the base effects from the first half of 2016 versus those from 2017 were relatively ‘easy’, given the fairly depressed state of EPS levels in Q1 2016.

We note that activity levels in Q2 have remained robust, hovering at their best levels in seven years. IP (Industrial Production) and PMIs (Purchasing Manager’s Indices) are up on an annual basis. This could have positive implications for cyclical stocks like capital goods, chemicals and autos.

Despite the easy comps, we are not expecting analysts to materially upgrade their outlooks post the Q2 season. Indeed, EPS (earnings per share) revisions seem to have recently begun rolling over in most regions, which is why we think H2 (second half of 2017) could be more difficult for markets.

We believe there are three main issues facing investors this quarter.

1. EPS expectations for H2 high
2. Less pricing power in H2
3. Slowing momentum in China

The latest analysis from FactSet and JP Morgan would indicate that year-on-year earnings per share (EPS) growth in both Europe and the US for Q2 could rise between 2-6% (excluding commodities). These more modest growth rates accelerate to around 7-8% for Q3 and up again to around 12-15% in Q4. So, while the low base of H1 2016 provided support for H1, it will be more challenging for companies to deliver in H2, as we move though tougher comps.

Q2 results still to be good, but weakening global PPIs argue EPS momentum will decelerate in 2H…

Source: Bloomberg, IBES * assuming spot oil in 2H

This takes us to weaker pricing power in H2, relative to previous quarters and the chart above. JP Morgan suggest that inflation, as measured by Producer Price Inflation (PPI), has a strong correlation to actual company earnings. The chart above might indicate that EPS growth could slow in H2 from the current year-on-year pace of 15% towards 5% in Q4, simply as a result of once again declining rates of inflation.

This slowing could be a reflection of slowing momentum in China and also a reversal of the monetary stimulus of the past year, as Chinese authorities are trying to reign in excessive lending through the clamp down on the shadow banking sector. Furthermore, China ramped up its budget deficit levels from just 1.1% of GDP in 2011 to 2.3% of GDP in 2015 and spent the money boosting infrastructure to revive growth. As this second stimulus element is also reduced, we expect global PMIs to retreat from today’s high levels as Chinese demand contracts.

Currency movements are another factor investors should consider. We think that a stronger Euro could hurt Eurozone exporters, but help domestic Eurozone plays and US exporters. Perhaps President Trump would be happy to see a higher Euro and increased US exports to Europe.

We believe that Europe continues to offer better growth prospects. Consensus estimates indicate year-on-year Q2 EPS growth of +6% in the US and +11% in Europe, down from +13% and +25% respective levels in Q1. The sectors driving this growth are likely to be materials, information technology and consumer staples.

In terms of the ‘big picture’, JP Morgan expect markets to continue consolidating, as the Rates/Earnings trade-off deteriorates. We know that valuation multiples (Price to Earnings) are sensitive to actual EPS delivery.

At the same time, rising rates could pressure today's elevated valuations, as higher discount rates reduce the value of future cash flows, putting downward pressure on EPS estimates. We note that the forward 12-month PE for the S&P500 is 17.3x, which is above the 5-year average (15.3x) and 10-year averages (14x).

It is for these reasons that we recently reduced our overall equity exposure. But, regionally, we continue to favour Europe and Japan over the US and UK. We would review our stance should we see sales and profits materially improve in Q2, which could trigger further upgrades and carry on the positive momentum markets have experienced over the past year.

Germany: Don't mention the …er…trade surplus

Germany's annual trade surplus stands at ~ $300bn (~8% of GDP) and is greater even than China's ongoing surplus (of $200bn) – and with that continues to be the world export *Weltmeister*. This clearly illustrates that, while Germany is doing something right from a trade perspective, it may be saving too much of its income relative to investment and consumption. Aside from the obvious economic points, the trade imbalance is causing considerable political angst within the G20.

While President Trump's idea that Germany is manipulating the €-Euro to influence trade is a red herring, Germany's sizeable and growing surplus, both with the US and rest of the World, may indeed have economic consequences for other countries. However, it is not the result of an explicit and targeted industrial policy, nor in our view, is it necessarily economically wrong.

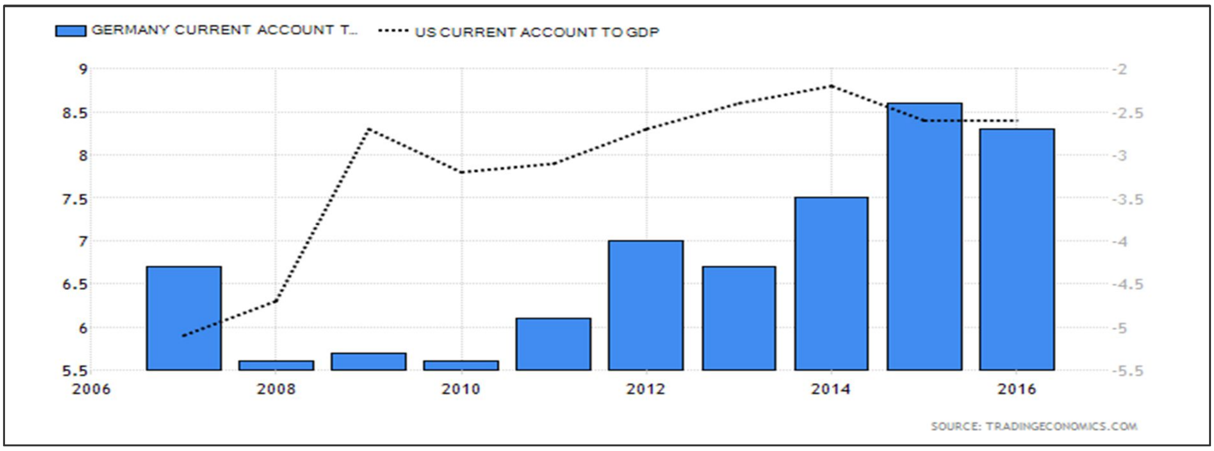
This week, a number of economists and institutions, including the IMF, picked up the baton from the US and commented on the potential imbalance in global trade, and relatedly, the German surplus. All appear to be arguing that it could be destabilising – or at least distorting – financial markets and global economic growth. Why?

It is intuitive that, in the context of global trade, if some countries export more than they import and thereby run large surpluses, this means that other countries are running equivalent deficits. Countries in deficit risk incurring debt towards the surplus countries and therefore need to adjust (as with Greece, Spain and Portugal, but not the UK, US and China). Where GDP = Private sector output + public sector output + exports – imports, then, in short, the general argument appears to be that Germany is effectively benefitting at the expense of other countries.

To give a sense of the scale of the potential issue, the graph below provides an illustration of the differences in trade flows between Germany and the US, and the different trends. It is interesting to note that Germany (left hand scale) only moved into surplus again around ~2001, in the decade prior to that it was frequently referred to as the "sick man" of Europe.

In respect of the US, it has operated a trade deficit for the last 4 to 5 decades, so this is not a new phenomenon for the US economy (or indeed for many of the other countries with which Germany currently trades).

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



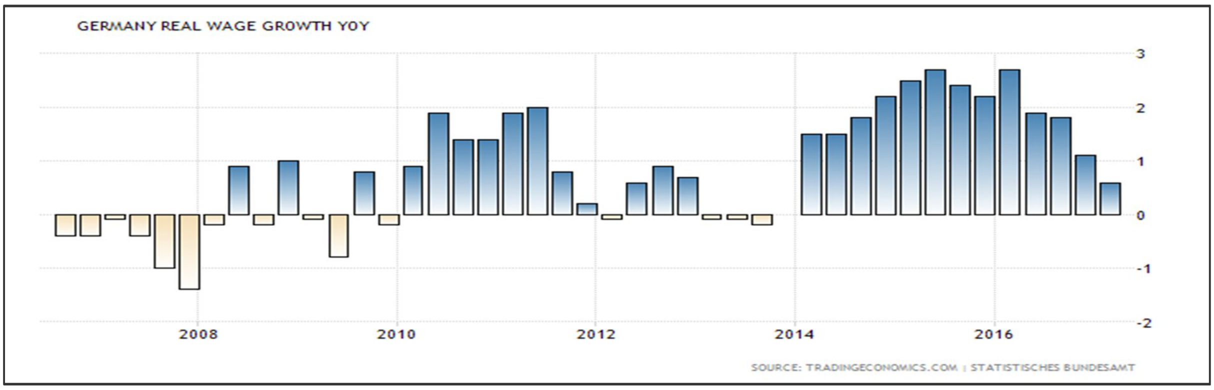
Source: TradingEconomics, July 2017

It is it is clearly incorrect to assume that Germany can unilaterally influence global trade policy or, for that matter, determine the scale of external demand for German products and services; this is as much a matter of domestic economics as the relative competitiveness of German products. Moreover, Germany does not also have such a significant trade surplus within the Eurozone (+€50bn). The latest set of data for the EZ shows that, in terms of intra-EU trade in goods, it was in fact the Netherlands that had the healthiest intra-EU trade balance (+€176bn).

According to many analysts, Germany's trade surplus is a result of its (cost) competitiveness – a direct function of their relatively low levels of wage growth coupled with high levels of productivity. Some also suggest that labour reforms in the early 2000's were a key factor which were, in effect, brought forward in anticipation of the threat from low wage emerging markets (e.g., China).

While we agree wage costs are clearly a determinant, we are less persuaded by the argument that Germany's surplus is solely attributable to (collective) wage restraint. In fact, data on real wage growth appears to show that wage growth in Germany has indeed been conservative. The pattern is not too dissimilar to that of other countries (real terms increases in a number of years since the GFC).

Quarterly change (%) in real wage growth



Source: TradingEconomics, July 2017

Also, it is not wholly clear that Germany is saving too much relative to investment and consumption (economic theory states that, in equilibrium, savings must equal investment). We note that

Germany’s consumers have actually steadily increased their level of consumption in absolute terms since 2008 (for example, from €375bn in Q2 2014, to €395bn Q1 2017).

Notwithstanding, German consumption as a proportion of GDP remains relatively low at ~55% (when measured against the UK, US and elsewhere). Whereas the household savings rate in Germany is significantly higher than in other developed economies (at nearly 10% of household income). All else being equal, there is an imbalance in the domestic German consumption and savings rates, not all of which can be down to the need to save more because of an aging population (and diminishing workforce).

In our view, Germany is well placed to further develop its own economy and increase consumption (through higher wages and otherwise), and this need not be at the cost of its competitive trade position. Indeed, the more that Germany effectively deposits abroad – as a result of its surplus and capital accounts – the less it will have to invest in its own economy.

Inflation is now slowly picking up across the EZ, and this is something German authorities should and indeed have accommodated by means of encouraging higher real wage growth settlements, increasing the spending proportion of income. Similarly, the German Government should also consider fiscal policy – relaxing the tax burden on households (among the highest in the EZ).

Encouraging more domestic consumption will reduce the reliance on exports and decrease the trade surplus, and an appreciating €-Euro will also help. If the German trade surplus has bolstered the savings, we believe it prudent to release more of that saving to (domestic) investment to further underpin future economic growth across the EZ. This would be in Germany’s economic interests as well as its trading partners.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7378.3	0.4	27.4	→
FTSE 250	19382.5	-0.1	-12.6	→
FTSE AS	4032.6	0.3	11.8	→
FTSE Small	5599.1	0.2	10.3	→
CAC	5226.2	1.6	81.0	→
DAX	12610.1	1.8	221.4	→
Dow	21557.4	0.7	143.1	→
S&P 500	2451.4	1.1	26.2	→
Nasdaq	5813.2	2.8	156.8	→
Nikkei	20118.9	1.0	189.8	→

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
ANGLO AMERICAN	6.7	DIXONS CARPHONE	-8.7
GLENCORE	6.4	PEARSON	-7.7
BHP BILLITON	5.1	MARKS & SPENCER	-5.5
BT GROUP	4.5	MICRO FOCUS INTER	-5.4
FRESNILLO	4.4	PROVIDENT FINANC	-4.9

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	20.3	Brazil	227.8
US	26.9	Russia	165.2
France	21.5	China	66.8
Germany	15.0	South Korea	58.2
Japan	30.4	South Africa	200.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	1.50	OIL	48.7	4.2
USD/EUR	1.15	0.44	GOLD	1228.0	1.3
JPY/USD	112.61	1.16	SILVER	16.0	2.2
GBP/EUR	0.88	1.07	COPPER	269.3	1.7
JPY/GBP	6.78	0.45	ALUMIN	1923.0	-1.1

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.3	0.5	0.01
US 10-Yr	2.3	-2.9	-0.07
French 10-Yr	0.9	-8.0	-0.08
German 10-Yr	0.6	4.0	0.02
Japanese 10-Yr	0.1	-4.6	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.5
3-yr Fixed Rate	1.7
5-yr Fixed Rate	2.0
Standard Variable	4.2
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

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