Weekly Market Comment

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Lothar Mentel

CHIEF INVESTMENT OFFICER

Samuel Leary

HEAD OF INVESTMENT COMMUNICATIONS

Isaac Kean

INVESTMENT WRITER

Chris Robinson

INVESTMENT ANALYST

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www.tattoninvestments.com Twitter: @TattonIM

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

Summer lull - delayed

As the summer holiday season is getting into full swing, one would expect capital markets to be calm. The opposite was the case, as particularly European stock markets continued to grapple with the perspective of their central bank threatening to take away the (easy money) punch bowl, just when their regional economy is shyly starting to 'party' a little.

We wrote about the dynamics of market tantrums last week and it appears we are not far off with our expectation that the prospect of monetary policy change will keep markets in motion for a while. This week, the late stock market sell off on Friday came as a bit of a surprise, because European Central Bank's (ECB) president Mario Draghi had sought to reassure markets that the Eurozone's central bank would not tolerate significantly tighter financial conditions as could result from market (over-) reactions to the prospect of future monetary tightening.

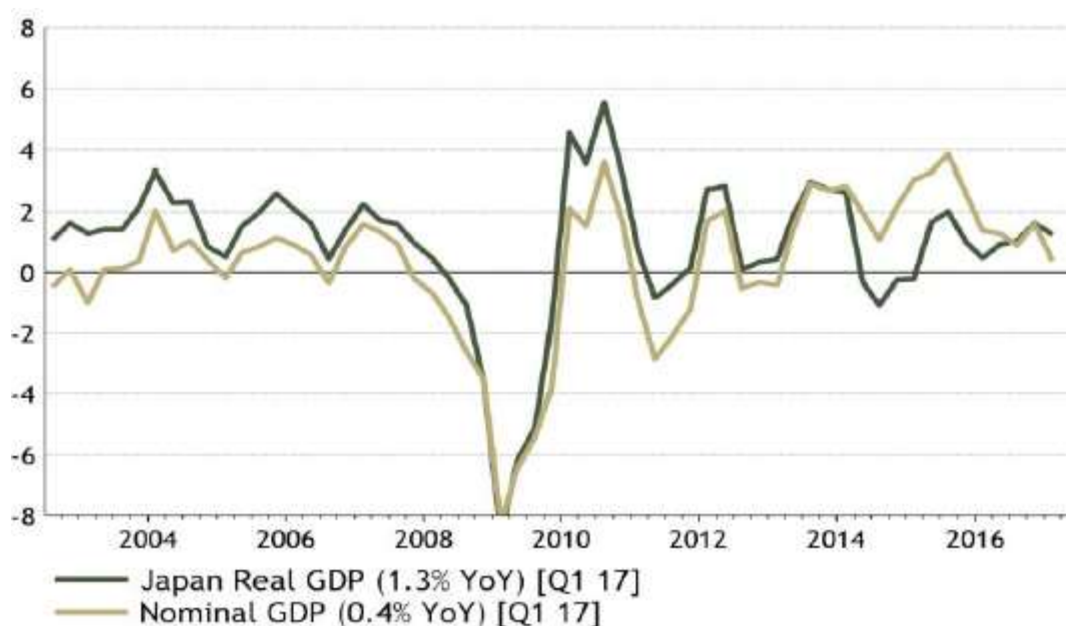
Instead, markets took it as confirmation that the ECB's direction of travel had changed. This, together with increasingly disappointing political prospects in the US for any Trump driven fiscal stimulus or deregulation relief, led to a rally in the €-Euro while the US$ sold off. Such €-Euro strength in itself should lower the need for the ECB to reduce monetary liquidity in a hurry, because it lowers prices for imported goods and undermines export competitiveness, which combined reduce any feeble inflationary pressures further and prevent overheating of economic activity. This is precisely what we observed when the US$ rallied 3 years ago, on the back of the US Fed's own QE taper program.

An overly strong €-Euro would also reduce the value of European companies' overseas revenue streams, which would explain the sudden fall in share prices, when actually normalisation in central bank policy should be seen as a positive sign of a strengthening economic outlook.

Just as was the case with the US$ strength, we do not foresee the €-Euro strength to become a significant headwind for Europe's recent economic revival. Instead we observe earnings announcements which show continued faster growth of corporate earnings than in the US, where earnings are still expected to be running at a very respectable growth rate of 10% year on year.

So, in summary, we have found our expectations of vulnerable equity markets confirmed, even if we continue to see this more of an issue for the much higher trading US equity market than Europe's far lower valued stocks.

Japan taking the foot off the accelerator?



Source: ASR Ltd. / Thomson Reuters Datastream

We have had a particular focus on Japan since the beginning of the year, because it looked as though the far eastern G7 country was finally escaping the clutches of nearly 3 decades of deflationary malaise and slow growth. In particular, the tightening labour market – and rising real wages in its wake – gave rise to expectations that domestic consumer demand would reawaken in this nation of savers. Such increased domestic consumption, funded by savings rather than debt, could have made Japan in 2017 one of the strongest growing economies amongst the G7. We have therefore been watching Japan's economic data releases and central bank announcements with keen interest.

One of those was the Bank of Japan (BoJ) latest interest rate setting decision on Thursday to keep its monetary policy unchanged. More significantly, the BoJ cut its inflation forecasts for the next three fiscal years, with the 2% inflation target being pushed back once again. The bank now

expects fiscal year (FY) 2017 to see only a 1.1% rise in the CPI inflation measure, compared with a 1.4% forecast back in April. Likewise, FY2018 and FY2019 inflation forecasts have been cut, from 1.7% to 1.5% and from 1.9% to 1.8% respectively.

Despite pushing back their inflation target, slashing price growth forecasts and holding still on their accommodative stance, the BoJ didn't actually sound disappointed at all. Overall, the message on the economy was decidedly upbeat, with the bank's monetary policy statement emphasizing "a virtuous cycle from income to spending". While inflation expectations fell, real (inflation adjusted) GDP expectations rose. The BoJ now forecasts that Japan will grow at a real rate of 1.8% this fiscal year (compared with 1.6% expected in April) and 1.4% next year (compared to April's 1.3% projection). It seems that the BoJ has faith that, despite the as-yet failure of their measures to propel price growth forward, a tightening labour market will filter through into wage increases and subsequent price growth sooner or later.

Is this optimism justified? In many respects, things are going rather well in Japan's economy. Exports rose for a seventh consecutive month in June, with last month's 9.7% year-on-year (yoy) rise beating expectations of 9.5%. Growth in import values also beat expectations, at 15.5% yoy compared to the predicted 14.4%. The growth from exporters was enough to leave Japan with a ¥440 billion trade surplus, undershooting the ¥488 billion expectation but up from the ¥204 billion deficit in May.

But a breakdown of the figures reveals a slightly less optimistic picture. Export volumes (as opposed to values) did grow 4% last month, but this slowed from 7.5% in May. Even the 9.7% yoy export value increase mentioned was well below May's impressive 14.9% figure. Import volumes likewise grew 4.1% yoy, but this again was a slowing from May's 5.4%. On a quarterly basis things look even less rosy, with Q2 seeing a -1.2% fall after Q1's 6.4% gain.

Overall, conditions are still generally expansionary, as the BoJ rightly notes. But prospects don't look quite what they did two months ago, when it seemed as though the famously stagnant economy would finally get properly moving again. Political fears have also returned. Prime Minister Shinzo Abe's ruling Liberal Democratic Party (LDP) lost an important Tokyo assembly election this month, scoring a record-low 23 seats. The Prime Minister has been hit by a pair of scandals that have seen his approval ratings fall to 34%, meaning the likelihood of his premiership being challenged at next year's LDP leadership election has increased.

Japanese politics has been a non-issue for markets over the past five years, as the LDP have had a stranglehold on parliamentary power and its premier is seen as unabashedly market friendly. And with the man came 'Abenomics', an ambitious economic agenda encompassing monetary and fiscal stimulus and structural reform. An exit from the Prime Minister would likely leave investors worried that his accommodative policies will walk out the door with him. However, all this still remains a minority case.

The more pressing issue facing Japan is the continued lack of consumer demand revival, reflected in slowing import growth and, more importantly, chronically low inflation. The Japanese have long had a tendency to save rather than spend, which takes productive capital out of the economy and presents a real barrier to growth. Unless this aspect is addressed, it's unlikely that we'll see the economy firing on all cylinders. And, we don't share the BoJ's optimism that monetary policy's expected tightening effect on the labour market will cure this all by itself. The other 'arrows' of

Abenomics – fiscal expansion and especially structural reform – will need to be fired too to stimulate demand further. This, however, requires a solid political base, which is now crumbling.

What does this mean for the wider world? The BoJ's lack of movement on monetary policy already sees them bucking a trend in recent G7 central bank policy. Most of the other major central banks – the US Fed, the ECB and the BoE – have all indicated that extremely loose monetary policy is coming to an end, and the tightening cycle for interest rates (and the tapering down of QE) has begun. Japan, for reasons covered above, still needs its loose monetary policy going forward, as the country doesn't seem to be subject to the same inflationary pressures as others. After years of highly coordinated moves in global central bank policy, then, we think that the BoJ will continue to stay still on rates and their bond-purchasing program regardless of what happens in the rest of the world.

For the other central banks, this is good news. It means that loose monetary policy in Japan can act as a buffer while tightening begins elsewhere. The ECB in particular will welcome any 'wiggle room' that the BoJ's policy gives them by upholding global liquidity supply. Hopefully, it will also mean that another 'taper tantrum' becomes less likely. On this we watch and wait.

Whatever the case, we are slightly less optimistic on Japan than some months ago. Falling optimism isn't the same thing as pessimism, however, and we note that, as detailed above, the economy is still growing at a much better rate than over most of the past 25 years. As ever, the issue remains deflation. While the BoJ's monetary policy alone is unlikely to stimulate demand enough to address this, we hope at least one of Abenomics' three arrows will hit the bullseye.

UK fiscal policy – a dilemma on the horizon

The UK election outcome in June seemed to give a clear indication of the public's view on fiscal austerity, with disgruntled voters wishing for Government spending, not the cuts we have become accustomed too. Labour gained a significant number of seats with promises to spend and support the poorest in society, and even Conservative members of parliament suggested things must change. In the weeks following the election, Conservative ministers Boris Johnson and Jeremy Hunt joined in to support the austerity-weary workers of the public sector, restricted to a 1% ceiling on pay rises.

We have long argued that monetary policy cannot be expected to do all the economic heavy lifting on its own, and that fiscal stimulus is generally seen as a required complementary policy element

to re-establish growth momentum after an economic crisis. The relatively stronger and quicker economic recovery of the US has shown that a 'money tree' is not needed but decisive structural reform is, flanked by unwavering monetary and fiscal support. Despite the US government's higher initial deficit spending, the nation's crucial debt-to-GDP ratio is now lower than elsewhere, because tax revenues recovered more quickly as well.

Unfortunately in the UK, fiscal stimulus appears to continue to be a taboo, given that, since those early calls in June, we've heard very little about structural investments, tax rate cuts or further benefits that were discussed prior to the election.

In fact, the government appears to continue to tread the pre-election path, as the most recent change to pensions has us believe. This week, it announced an earlier phasing in of the increase to state pension age from 68 to 65. Instead of 2044, it will now come in force between 2037 and 2039, impacting anyone between the ages of 39 and 47.

So how indebted is the government and is expansionary fiscal policy possible?

Public debt totalled £1,400bn at the end of the first quarter, up from £622bn in 2008. Government debt-to-GDP sits around 90%, growing marginally year-on-year since 2012 (85%) but slightly lower than our neighbouring Europeans', with French debt-to-GDP at 96% and Spain at 99%. German debt-GDP sits at 68%, significantly less – not because of spending cuts, but due to its better tax revenue position from a faster, export-led recovery.

As Japan's above 200% debt to GDP levels show, government debt levels are not an issue per se, as long as they are covered by domestic savers' money, rather than volatile funding from beyond the borders. Where fiscal deficit spending is used to cover ongoing expenses rather than investments into infrastructure and education that increase an economy's future tax revenue potential, overseas bond investors can begin to doubt a nation's ability to repay or even service its national debt going forward. In the UK, with debt levels having more than doubled quickly following the financial crisis, but little to show for in terms of sustained economic momentum, it is little surprise that the UK Government is treading carefully before expanding fiscal policy.

This dilemma for British politicians could get worse as a new economic headache appears on the horizon.

Accommodative monetary policy has supported the economy over the last ten years in the form of lower interest rates and liquidity injections through QE gilt purchases. This combination has stimulated the housing market and enabled businesses to refinance at lower rates, in turn preventing an enduring recession and establishing a feeble recovery. But prolonged monetary easing has negative side effects like any medication taken for too long, and ever rising house prices and increased household debt have come to a point where the Bank of England (BoE) is signalling potential interest rate rises with their three-to-five vote for a rate rise at the most recent monetary policy meeting. We do not believe that this will actually happen for at least another year, because inflation has helpfully fallen back. However, when the BoE rate setters do have to raise rates, despite a weak economic setting, then economic theory suggests that fiscal expansion is the only way to prevent the economy from falling into recession.

Yet a study by the OBR (Office for Budget Responsibility) out this week suggested the Government doesn't have the ability to provide the fiscal offset due to the economic storm already on the horizon.

The OBR study focused on weaker average growth rates in the near future, a near inevitable recession in the years ahead and the impact of higher interest rates and higher inflation posing significant risks to public finances. The report emphasised that the combination of Brexit and rising interest rates would leave lower revenue generation for the government, which in turn would leave less available funds in the public purse to provide fiscal stimulus.

The balanced scales between monetary and fiscal policy may be shifting, and there is no doubt the government is very cautious before it begins to spend. With the additional strong redistribution signals from the electorate, and with the challenges of the Brexit process ahead, the government finds itself in a very difficult position. Please the electorate with more debt financed spending for the most needy in society and risk the withdrawal of funding support from global bond investors, or redistribute through tax changes and risk an even larger potential exodus of globally mobile professionals than the business sector is expecting already as a result of Brexit.

In such a catch 22 situation, in our view, the government would be best advised to prioritise all measures that improve the UK's competitive position in the world and soften the blow of leaving the EU. Investments into education, professional development and infrastructure tend to be good uses for fiscal stimulus, while wise diplomatic compromising usually leads to better outcomes than hard-line approaches. Once economic growth has regained a better footing, redistribution becomes much less consequential for the economy, as Scandinavia and more recently Germany has demonstrated.

Tech sector valuations – where to next?

US technology stocks made headlines this week – of a dubious type. Share prices of the biggest tech stocks as represented by the S&P500 Information Tech Index moved above the previous "dotcom" peak.

Tech stocks back at 2000 internet bubble levels – without mania but with earnings

Following an unbroken winning streak of 9 consecutive up days, the S&P500 IT Index touched 992.29, above the previous peak of 988.49 on 27 March 2000. On a simple "Buy & Hold" strategy, an investor purchasing shares on 27 March 2000 would finally have turned a profit this week, some 17-years later.

The S&P500 IT Index is considered by some to be the purest measure of the health of large-capitalisation US tech stocks. But we should note that the technology heavy NASDAQ Index rose above the pre-dotcom peak back in 2015, and it also continues to hit new highs.

Technology has had a stellar 2017, outpacing all other S&P500 sectors with almost 23%, versus 10% for the broader index. Investors appear to have favoured tech stocks this year, allocating over $9 billion of money to the sector, according to analysts at EPFR. Some may even view the sector as overly crowded.

The reason for the added attention could be explained by the old adage: In a low growth environment, you buy growth. In other words, investing early in the next decade's 'Microsoft' or 'Apple' should turbocharge an investor's portfolio when average returns are weak. Technology stocks are considered growth companies on the belief they can expand profits and revenues faster than other sectors like telecoms or utilities.

However, compared to the 1998- 2000 Tech Bubble, when internet start-ups with no revenues or even the prospect of profits rose to stellar heights, nowadays even tech companies need to prove their worth through at least revenue growth momentum (Tesla) but better still, profits (Earnings; Facebook, Amazon, Google). As a result, even tech stock prices follow earnings. And, growth in the sector is rising, meaning investors appear to have gravitated towards firms that have a record of expanding both sales and profits. Before getting overly comfortable though, it needs to be noted that the downside to the strong share price increases in the tech sector are excessively high valuations, which only makes sense if these companies can grow exponentially – which over the longer term is impossible.

It is because of these sky-high valuation levels that the Tech sector has become vulnerable to sharp share price swings, and there are more and more clouds on the horizon.

The prospect of rising interest rate and yield levels changing the discount factors (used in valuing future cash flows in today's terms) is one, and now an impending change to accounting rules has become another concern.

Without getting too technical, the Financial Accounting Standards Board (FASB) who coordinate GAAP (Generally Accepted Accounting Principles) rules issued an ASU (Accounting Standards Update) under the wonderfully titled ASU 2016-08.

In a nutshell, it concerns whether a company records, as its own revenue, payments for goods and services it has merely arranged to be exchanged between buyers and sellers as an agent, or only records revenues it has had full responsibility for as a principle.

For example, this determines in the new world of Tech whether a company like Uber or AirBnB account their revenue like a traditional transport or hotel company, or as an estate agent.

On the old standard, Uber counted both commissions from rides, plus the entire fare of the rides as revenue. However, under ASU 2016-08, the company can only report the commissions as

revenue, but not the customer payment it passes straight through to the drivers for the rides they have arranged.

Microsoft has said that the new rules could have a material impact on revenues, as it currently recognises upfront from the sales of Windows 10 licenses, which are treated as a license fee spread over a number of years.

Internet retail giant Amazon said that ASU 2016-08 will mean revenue is recognised earlier when it sells items such as Kindles from non-Amazon sources, and it will also recognise revenue sooner from unused portions of gift cards.

There could be a similar impact on costs at software firms, as they can defer more of their costs until points in the future, which could increase profits today.

Until the application of the new rules has settled down, it could make it harder for investors and analysts to assess the relevance of changes in reported revenues for any actual change in the underlying business.

So – bubble trouble ahead?

Comparisons of the tech sector today to that of firms in the dotcom bubble 17 years ago abound. We think the crash that followed the bursting of that bubble ushered in significant positive changes for investors.

Share price (Green) against Profits (EPS – blue); Source: Factset

The market today is not the same as it was 17 years ago. Companies are much more robust and generally have more visible business models, allowing easier identification of revenues and profits for analysts. Companies like Google, Facebook, Amazon and Netflix are typically asset light (they do not need vast/expensive production sites), they have an ability to grow quickly from network effects and appear able to rapidly scale up, potentially allowing faster profit growth.

Market data provider Factset reports that the IT sector is expected to post earnings expansion of 10.9% for Q2 over the same time last year, which would be better than any other sector except energy.

Price (green) versus PE (blue) Source: Factset

As the chart above shows, valuation levels may be excessive for some companies, but, across the whole sector (blue line), we are nowhere near the lofty heights of the dotcom bubble.

Currently, valuations are much closer to those of the wider market, which stands in stark contrasts to the extreme gap in the 2000s. Tech stocks trade at 19.4x 2017 full-year earnings, and the wider S&P 500 is on 19x. For comparison, tech PE's in Q1 2000 were at a nosebleed level of 73x earnings, according to Bloomberg, often with little or no profits.

At the same time, the tech sector has matured well beyond levels in 2000 and regularly pays dividends. Tech companies also hold more cash than any other sector, which Moody's estimates to be $870 billion or 47% of all the cash on non-financial balance sheets.

Summary

Outside of a few lofty valuations like Netflix (PE 101x) and Amazon (152x – i.e. it would take 152 years to get your money back), the tech sector remains in-step with the wider market. While there are some challenges for the sector, business models are more robust, they are actually generating profits and have high levels of cash.

For now, we do not see a reason to be overly concerned about technology firms, relative to any other sector. However, we are not complacent, and will adjust our fund selections should the underlying backdrop change.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7446.1	0.9	67.7	→
FTSE 250	19713.7	1.6	305.3	→
FTSE AS	4075.1	1.0	41.5	→
FTSE Small	5656.5	1.0	57.8	→
CAC	5111.4	-2.4	-123.9	→
DAX	12215.3	-3.3	-416.4	→
Dow	21540.9	-0.4	-96.8	→
S&P 500	2467.9	0.3	8.6	→
Nasdaq	5904.2	1.1	66.1	→
Nikkei	20099.8	0.0	-0.1	→

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
ASHTEAD GROUP	6.7	EASYJET	-6.9
HARGREAVES LANSD	5.7	INTL CONSOLIDATED	-5.5
MICRO FOCUS INTERN	5.5	EXPERIAN	-4.3
NEXT	4.9	PADDY POWER BETF	-3.7
PROVIDENT FINANCIAL	4.7	SMITHS GROUP	-3.4

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	18.0	Brazil	211.2
US	19.3	Russia	164.1
France	18.4	China	66.0
Germany	13.7	South Korea	56.9
Japan	49.0	South Africa	192.3

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	-1.02	OIL	48.6	-0.6
USD/EUR	1.17	1.57	GOLD	1251.2	1.8
JPY/USD	111.21	1.19	SILVER	16.5	3.0
GBP/EUR	0.90	-2.58	COPPER	272.6	1.3
JPY/GBP	6.77	0.13	ALUMIN	1917.0	-0.3

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.2	-10.3	-0.14
US 10-Yr	2.2	-4.0	-0.09
French 10-Yr	0.8	-12.8	-0.11
German 10-Yr	0.5	-15.4	-0.09
Japanese 10-Yr	0.1	-19.3	-0.02

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!

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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