Weekly Market Comment

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1 -6 / 2017 asset returns

Asset Class	Index	June	Q2	YTD	2016
Equities	FTSE 100 (UK)	-2.4%	1.0%	4.7%	19.1%
	FTSE4Good 50 (UK Ethical Index)	-2.1%	0.3%	2.1%	12.6%
	Dow Jones Euro-Stoxx 50 (Euro-Zone)	-2.2%	2.6%	9.8%	20.1%
	S&P 500 (USA)	0.0%	-0.8%	4.0%	33.6%
	Nikkei 225 (Japan)	-0.3%	1.2%	3.5%	23.6%
	MSCI All Countries World	-0.1%	-0.2%	4.9%	26.7%
Bonds	FTSE Gilts All Stocks	-2.0%	-1.3%	0.3%	10.1%
	IA Sterling Corporate Bond Index	-0.9%	0.9%	3.0%	9.7%
	Barclays Global Aggregate Bond Index	-0.7%	-1.2%	-0.7%	21.8%
Commodities	Goldman Sachs Commodity Index	-2.5%	-9.0%	-14.6%	32.8%
	Brent Crude Oil Price	-5.3%	-12.7%	-19.8%	81.8%
	LBMA Spot Gold Price	-2.2%	-3.6%	2.0%	30.2%
Inflation	UK Consumer Price Index (annual rate)	0.0%	0.8%	1.4%	1.08%
Cash rates	Libor 3 month GBP	0.02%	0.09%	0.2%	0.6%
Property	UK Commercial Property (IPD Index)	0.0%	1.5%	3.8%	1.4%

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

Global growth ploughs on while markets take a breather

Rather unsurprisingly, investment returns' upward momentum slowed in Q2, and in some cases reversed, following the very strong results of the first quarter. In particular, June developed very much along the lines we had anticipated, which was that, with economic growth perspectives returning from 'gushing' back to 'new normal', capital market investors reassessed valuations and concluded that there was not much headroom left.

Nevertheless, investors in globally diversified multi asset portfolios, such as we run at Tatton, should still be looking at half year returns around mid-single digit levels, with only the very lowest risk portfolio strategies generating a lower 2-3% return.

What made the second quarter of 2017 – and June in particular – a little disconcerting for investors is that both equities and bonds experienced disappointing returns. We wrote last week that this is unusual, as these two asset classes are usually negatively correlated. This means, when equities suffer a setback, money tends to flow into the safer government bonds, which therefore appreciate and vice versa.

When both equities and bonds fall at the same time it tends to be the result of a slowing economic outlook, combined with indications from central banks that they will raise rates regardless. Investors have come to call this a 'market tantrum' on the basis that capital markets appear to indicate that they are concerned about the seeming disconnect between perceived economic reality and monetary policy from the central bank(s). The last time this happened was in the early summer of 2013, after the US central bank announced a gradual reduction of further monetary easing from the autumn onwards, while capital markets remained uncertain whether the economic recovery was already firmly enough on track to justify such a move. We suspect that, just as was the case back in 2013, markets will calm down once it becomes clearer that the central banks are not committing a policy error and global economic growth remains on track – albeit stubbornly slow.

This time around, capital markets are more prone to valuation level vertigo, which makes the next quarterly series of corporate earnings announcements – we call it 'earnings season' – all the more important. Early indications point to potentially better-than-recently-expected earnings growth. In numbers, this means that company analysts are expecting annual profit growth in the all-important US market to be around 6.6% for the 2nd quarter. Quite a decline from the lofty 14% recorded over the first quarter of 2017, but by no means a disaster. If forward looking macro data continues to re-accelerate – as both the Fed's comments and last week's ISM and employment data suggest – then stock markets may be inclined to view this more than halving of corporate results growth as a temporary blip, rather than a worrisome overvaluation.

We are encouraged by the recent recovery in forward looking economic sentiment indicators, especially in the recently slightly flagging economies of the US and China. Earnings data across the Eurozone is expected to look more like the very strong results in the first quarter in the US and may well lead to a change in market leadership from the US to the EZ. The UK remains a special case in the Global framework due to the looming uncertainty over Brexit. We have dedicated a separate article to the latest UK productivity figures, which increasingly tell a story of a country put on hold until more clarity about its future trade position is achieved.

The EU in the meantime is showing how to make the best of global free trade opportunities and just agreed high level deal details with Japan, just months after concluding a free trade agreement with Canada. We cover the implications for the UK's own upcoming trade negotiations and what we can learn from the EU's experience.

Over the coming weeks, we expect a somewhat reduced risk of a capital market selloffs, as was pertinent over the past weeks and indeed occurred to a small extent over the past two weeks. However, the disturbing development of North Korea successfully firing - on the US' sacred 4th July Independence Day – a rocket that could be developed into a transcontinental missile warhead, significantly raises geopolitical risk levels. It was good to observe the Chinese government harshly criticising its ally's actions, but unless China follows up those words with action, the US may feel pressured to take action themselves. It should also not be forgotten that the conflict between Qatar and its neighbours continues to have the potential to disrupt oil supply for large parts of the leading Asian and much of the European economies.

Under this general scenario of a fragile 'truce' between capital markets at the top end of acceptable valuation levels, stabilising corporate earnings declines, macroeconomic sentiment improvements and a somewhat unpredictable geopolitical theatre of potential conflicts flaring up, we remain content with our current equity underweight position which has served our investors well since we introduced it at the beginning of June.

Lost decade for UK productivity

This week, data from the Office for National Statistics (ONS) gave many economists food for thought on the UK economy. Productivity, as measured by output per hour, fell 0.5% in the first quarter to a level last seen during the financial crisis. However, there was a divide. Services output continued to shrink while manufacturing output rose, perhaps due to the weaker sterling we have experienced since the Brexit vote.

Source: ONS, graphic by FT – 5 July 2017

The UK average weekly hours sit at 32.20 hours per week for March, under the record level seen in November 1994 of 33.5 hours but well above the lows of 31.30 hours in April 2011. This, combined with a significantly increased workforce and unemployment sitting at just 4.7%, shows just how much the economy has recovered and grown since 2009/10. This would suggest increasing output per worker in the UK, and not a flat-lining, as the graph above shows.

Interestingly, labour costs continue to grow in excess of the Bank of England's inflation target, at 2.1%, but this appears not to be a sufficiently high wage pressure to incentivise businesses to invest into productivity increases. There are also no imminent slowdown expectations to hold back investment, with the forward-looking indicators – the Manufacturing and Services Purchasing Managers Indices – suggesting more economic expansion, albeit at a slightly slower pace. So, what are the causes?

GDP for the first quarter suggested a slowdown attributed to reduced consumer spending, a key driver of economic growth over the past five years. Automotive sales fell 4.8% for June, the third consecutive fall in car sales, and house price growth, arguably the kick-starter of the return to economic growth in 2011, may have run out of steam.

Mortgage applications, which remain at an average of 40,000 per month, have slowed from the highs of near 50,000 seen between 2014 and 2016. If we see further restrictive monetary policy through interest rate rises, this is likely to slow mortgage applications further.

To us, none of this sufficiently explains the disappointing productivity numbers. We believe it is a combination of factors, which are all coming together and affect the UK more than other nations. Firstly, fiscal austerity is pushing larger numbers of employees from the public sector – where productivity is measured by salaries paid – into the private sector, where actual factor productivity is measured. Secondly, the UK's financial sector is no longer generating the same revenue per employee as it did during the pre-crisis credit bubble. And, finally, the uncertainty over the post-Brexit trade relations environment is discouraging long term business investment into productive capital, for fear of not achieving the necessary payback. Taken together, they encourage taking on more staff to satisfy growing demand, but not machines, who are far harder to 'make redundant' should demand deteriorate in future.

Our expectation for the coming 12 months is that the low productivity issue is likely to persist, unless staff shortages become more persistent, forcing businesses to upgrade production processes. This will mean slower growth in the UK, compared to the rest of Europe, where uncertainty is reducing rapidly and business confidence is hitting ever higher levels recently. Some of this Eurozone growth momentum is likely to also stimulate demand for the UK's products and services, but, with stagnant productivity and labour force numbers, at best it will only dampen the effects of falling UK consumer demand.

EU reaches trade deal with Japan

The EU and Japan have come to a "political agreement" on opening trade barriers. The 'in principle' trade deal was given blessing on Thursday by Japanese Prime Minister Shinzo Abe, along with EU council and commission presidents Jean-Claude Juncker and Donald Tusk respectively, when they met for a summit in Brussels. The agreement isn't yet a full signoff from the powers that be, but it covers more than 90% of the issues up for discussion, and officials are optimistic that a full trade treaty will be wrapped up by the end of the year.

The agreement's focus is on the removal of tariffs and other such material barriers to trade. At the moment, EU exporters to Japan pay €1bn a year in tariff payments, according to a factsheet released by the European commission. As part of the agreement EU markets will now be opened up to Japanese cars, while agricultural goods going the other way will see the high levies – with tariffs on Beef and Cheese as high as 40% – coming down. The 'cars for cheese' agreement - as the press quickly called it - will eradicate tariffs on 99% of goods. "We ironed out the few remaining differences in the EU-Japan trade negotiations," tweeted European trade commissioner Cecilia Malström.

Source: Jim Brunsden, FT.com, 4 July 2017

The timing is no accident. As the heads of government involved set off for the G20 summit in Hamburg this weekend, the deal sends a message that the two economies aren't "closing themselves off from the world" says Juncker. According the commission's own website, part of the self-proclaimed mission of the EU's talks with Japan was to "send a powerful signal that two of the world's biggest economies reject protectionism." After a year in which protectionist rhetoric saw numerous election victories in the western world, including to the most powerful office in the world, European and Japanese leaders are resurrecting the spirit of globalisation. "There is no protection from protectionism", according to Mr Juncker.

The deal is also opportunistic on the EU's part. The four-year history of talks between the union and Japan were stalled at various points by the government in Tokyo's preference for finalising the trans-pacific partnership (TPP) with the US. TPP was dealt a crippling blow by Trump's election, with the President pulling out and leaving Japan's hopes of a deal dead in the water. That's opened up a spot for Europe at Japan's trading table, and given both sides the impetus to drive negotiations forward. While Trump delivered a rapturous nationalistic speech on the need to "defend our civilisation" to a rare friendly audience in Poland, Abe and EU officials celebrated both the trade deal and the "strategic partnership" that comes with it, committing to fighting together on climate change and other international issues.

It's the second such deal the EU has made in the last year. The Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada was signed by leaders last October. Similar to the Japan deal, 98% of tariffs on EU-Canadian trade will evaporate when the treaty comes into force. Unlike the current deal, however, that one took a gruelling 12 years of negotiations before the documents were signed. CETA went through different names and forms through its long birthing period, until it returned after a 2006 hiatus with increased scope and ambition to see it through. That ambition then took 10 more years to produce results. It's testament to the complicated and arduous process of trade negotiations that the EU-Japan deal, at 4 years of talks, can be considered 'quick'.

Why do these agreements take so long to formalise? On the face of it, things should be simple. In the age of globalisation, politicians almost unanimously agree (until recently, perhaps) with the Adam Smith ideal that free trade is good and mercantilism bad, so reduction of tariffs and other barriers to trade should be an easy decision to make.

If only it were that simple. The EU, as in all its trade commitments, attaches a number of other conditions to the simple swap of goods and services. The EU's plethora of regulations on product safety and standards must continually be met by all imported products, and the union as ever reserves the rights to update these as and when they choose. Likewise, any trade agreements have to meet with the commission's 'precautionary principle', as well as the rights of nation states to decide on their own public services. And, of course, both parties insisted on concessions for a few of their (electorates') pet sectors.

As, such, the EU-Japan deal picked up a few battle scars from the negotiations. "Sensitive economic sectors" will be protected with "adequate transition periods before markets open." Many cheese tariffs will be phased out under the deal, but Japanese-produced mozzarella and camembert face the compromise of a duty-free quota. Rice production, a sacrosanct part of Japanese culture, will also see concessions.

Besides which, as mentioned above, the deal isn't even really finished yet. Investment protection, the most controversial part of the modern trade treaty phenomenon, is still to be agreed upon. Japan doesn't want to sign up to the EU's proposed investment courts, which will replace the current system of investor-to-state disputes (ISDS). Investment protection was one of sticking points of CETA, and public backlash against the idea caused them to replace ISDS with the new court system. For context, public uproar against the very idea of investment protection – whereby multinational companies can sue democratically elected governments for potential loss of revenue resulting from policy – was what derailed the highly secretive TTIP. Accordingly, EU officials got wise to ISDS' unpopularity, if their release is anything to go by: "For the EU ISDS is dead."

The Brussels leadership still faces a challenge on these issues. Officials have said it's not yet clear how the EU-Japan deal will be ratified in Europe. Do they present the treaty (when it's written by year-end) to the EU institutions alone or ask individual member states for ratification? In the former case, the chants of 'democratic deficit' will get louder. In the latter, the four-year negotiation might very well get made redundant by a national (or even regional) veto. The full national ratification was used in passing CETA, which led to a stand-off with the Wallonian regional government in Belgium – who were concerned about labour and environmental standards – nearly stopping the whole thing.

What does this mean for the UK? As is apparent, the lengths CETA and the (comparatively quick) Japan negotiations hardly bode well for talks held under the ticking two-year Brexit clock. A UK-EU trade deal needs to be reached, lest Britain's businesses find themselves selling to their biggest customers under stingy WTO rules. The hope of getting that done from scratch in the next (slightly less than) two years are, to put it politely, optimistic. The good news is that they won't be starting from scratch. The EU's two trade deals in under a year provide a solid blueprint for talks, and

Britain already trades under EU law at the moment, meaning UK businesses won't need to adjust to European regulation.

But we shouldn't underestimate the size of the task. The EU-Japan deal didn't say much about financial services – it focused mainly on the (relatively) simple area of material goods. Financial services are one of the biggest components of the UK economy, and the menagerie of regulations there will be tough to navigate for negotiators.

The wider angle that must not be forgotten is that the various trade agreements the EU is now establishing will not apply to the UK, once it leaves. This will create additional competitive disadvantages for UK based businesses over EU based ones, unless the UK can achieve such a comprehensive agreement with the EU that it can 'piggyback' off the EU's existing trade agreements.

What this tells us is that (A) comprehensive trade deals are hard to achieve and take considerable time. And (B), leaving the EU 'free trade club' behind does not only affect the way we trade with the EU, but also with much of the rest of the world – we're leaving not just the union but its umbrella of free trade agreements.

With any luck, EU officials' re-emphasised desire to rebuke protectionism – and the June UK election's similar (seeming) rebuke against isolationism – will see them make reaching a deal a top priority. Trade deals are hard work, but tariffs are harder.

US rate setting committee minutes point to further rate rises

The core message from the June FOMC (Fed) minutes released this week appears to be 'steady as she goes'. This suggests that the US central bank remains on-track for its third interest rate rise in 2017, absent any nasty economic shocks or surprises.

The Fed downplayed recent softness in inflation readings as transitory, mirroring Fed chair Yellen's comments in the June press conference. There was a surprising degree of confidence in a stabilising inflation outlook, a view that appears to be shared by her colleagues.

The Fed referenced recent declines in the core consumer inflation readings. These were viewed as mostly "transitory" effects, reflecting "idiosyncratic factors" that would have "little bearing" on longer term inflation readings.

In fact, the minutes suggest Fed inflation forecasts have been upgraded since May and that inflation should return to its 2% target in 2019. Participants "judged that inflation would stabilize" around the target over the medium-term, suggesting a fairly high degree of confidence, given recent disappointments. The weakness in oil prices may restrain inflation from here, given that the cost of a barrel of oil looks range-bound between $45-50, at least until the oil market finds a new equilibrium.

On the US economy, the Fed noted that measures of activity were seen as "rising moderately on average", while international risks appeared to "recede further". They highlighted that corporate profits are still growing, household spending seems to have "bounced back" and investment continues to expand.

FOMC members were more sanguine about the labour market; only "a couple" were concerned "that a tighter relationship between inflation and resource utilization could re-emerge…which could result in inflation running persistently above the Committee's 2% objective."

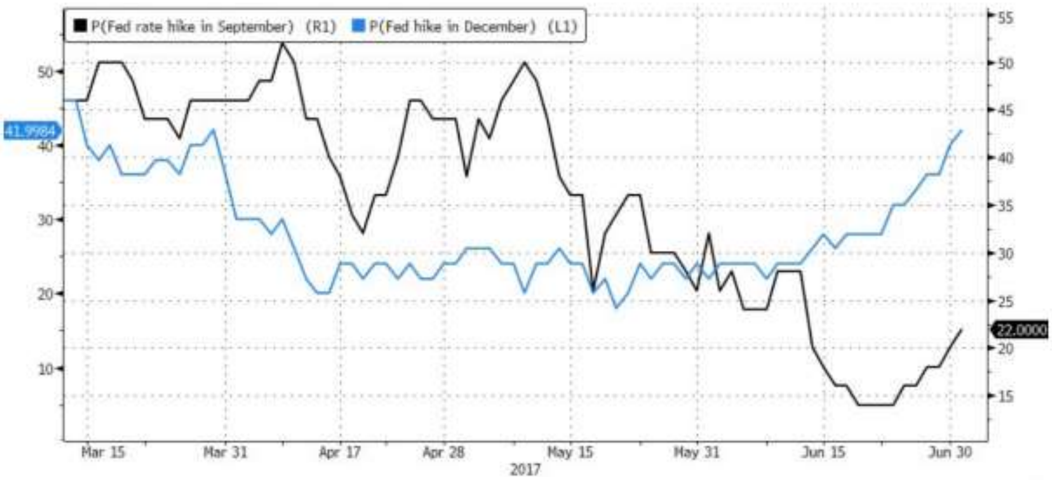
While tighter labour markets are a core component of future rate rises, the statement above does not seem to be creating any urgency in hiking rates faster at this time.

The Fed appeared more "divided" over when they should begin the process of reducing its $4.5 trillion balance sheet. These assets on its balance sheet were accumulated as a result of its QE policies in the wake of the global financial crisis.

This could indicate that the FOMC is open to tactically selecting the best timing to announce a change in its reinvestment policy. Some economists believe this could be as early as this month, or possibly in September but "some others" preferred to "defer the decision until later in the year".

"Some" officials also highlighted risks to financial stability from "high" asset prices, when "judged against standard valuation measures", but members thought this could be due to increased risk tolerance among investors (due lack of investment alternatives and cheap credit). We note that volatility is hovering at record lows, which may be artificially encouraging excessive risk taking by otherwise rational investors.

Additionally, there does not appear to be any external pressure on the Fed to hike rates faster from the recent easing in financial conditions. The Fed said that "financial conditions had eased even as the Committee reduced policy accommodation", which could actually strengthen the case for rate hikes.



Source: Bloomberg, 6 July 2017

We agree with the market sentiment that the combination of the odds for a balance sheet normalisation announcement in the autumn with the hawkish discussion around asset prices means we are likely to see a third 0.25% rate hike in 2017. As the graph above shows, the market appears to have settled more on December, rather than September. Odds for September have risen more modestly (now 20%) but the odds for December now stand close to 50%.

The relatively calm market reaction to the release of the FOMC minutes, stands in stark contrast to last week's mini 'taper tantrum' over the ECB indications that the end of their monetary expansion programme is drawing nearer. Perhaps, finally, investors are heeding the Fed's message that it is largely sticking to its view of long-run policy normalisation, despite underwhelming economic growth rates. We believe this consistent message should be broadly welcomed by investors.

Indeed, with gold prices retreating towards seven week lows, it would seem that investor fear continues to moderate and government bonds are once again seen as a true safe haven asset – just as one might expect in gradually improving economic backdrop.

In summary, the FOMC minutes reinforce the view of a further rate hike this year, particularly given the robust economic data. Our base case is for the Fed to announce the start of its balance sheet reduction in September, followed by a December rate hike of 0.25%. However, we believe this remains highly dependent on continued economic normalisation and core inflation trends over the next three months.

The issue facing the Fed, perhaps a year from now, is what to do if the current inflation momentum falters. The Fed now has a very difficult balancing act, between its inflation and financial stability goals, especially if inflation were to remain below its 2% target, alongside continued lofty asset prices and also higher (credit) leverage. How the Fed deals with these factors could leave markets nervous for the foreseeable future.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7338.4	0.4	25.7	↗
FTSE 250	19361.1	0.1	21.0	↗
FTSE AS	4014.2	0.3	12.0	↗
FTSE Small	5588.1	0.1	3.2	↗
CAC	5135.0	0.3	14.3	↗
DAX	12372.1	0.4	47.0	↗
Dow	21409.5	0.6	122.4	↗
S&P 500	2419.2	0.0	-0.5	↗
Nasdaq	5655.1	0.0	2.1	↗
Nikkei	19929.1	-0.5	-104.3	↗

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
WORLDPAY GROUP	17.0	FRESNILLO	-4.4
BHP BILLITON	5.7	CAPITA	-4.1
PERSIMMON	5.5	WHITBREAD	-3.1
ROLLS-ROYCE	5.1	BURBERRY GROUP	-3.1
RBS GROUP	4.7	JOHNSON MATTHEY	-3.0

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	20.2	Brazil	242.2
US	19.3	Russia	170.5
France	21.8	China	68.9
Germany	14.8	South Korea	52.0
Japan	49.0	South Africa	197.3

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.29	-1.13	OIL	46.8	-2.4
USD/EUR	1.14	-0.31	GOLD	1209.9	-2.6
JPY/USD	114.14	-1.53	SILVER	15.5	-7.0
GBP/EUR	0.88	-0.84	COPPER	265.0	-1.7
JPY/GBP	6.81	-0.36	ALUMIN	1944.0	1.5

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.3	3.5	0.04
US 10-Yr	2.4	3.8	0.09
French 10-Yr	0.9	15.1	0.12
German 10-Yr	0.6	22.3	0.10
Japanese 10-Yr	0.1	1.2	0.00

UK Mortgage Rates

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

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