Weekly Market Comment

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July 2017 and year to date asset class returns

Asset Class	Index	July	YTD
Equities	FTSE 100 (UK)	0.9%	5.6%
	FTSE4Good 50 (UK Ethical Index)	1.6%	3.7%
	Dow Jones Euro-Stoxx 50 (Euro-Zone)	2.2%	12.1%
	S&P 500 (USA)	0.6%	4.6%
	Nikkei 225 (Japan)	-0.4%	3.1%
	MSCI All Countries World	1.1%	6.0%
Bonds	FTSE Gilts All Stocks	0.3%	0.6%
	IA Sterling Corporate Bond Index	0.7%	3.7%
	Barclays Global Aggregate Bond Index	0.2%	-0.5%
Commodities	Goldman Sachs Commodity Index	3.1%	-12.0%
	Brent Crude Oil Price	8.3%	-13.2%
	LBMA Spot Gold Price	0.4%	2.4%
Inflation	UK Consumer Price Index (annual rate)		1.4%
Cash rates	Libor 3 month GBP	0.03%	0.2%
Property	UK Commercial Property (IPD Index)		4.8%

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

Stocks take note of North Korea crisis - or do they?

Over the week, the main global stock markets fell by between 2 and 3.5% and thereby finally appeared to acknowledge the heightened geopolitical risk levels emanating from the nuclear showdown of words between North Korea's dynastic leader Kim Yung Un and US president Donald Trump. That at least is how the market media was very quick to conclude.

We would agree that the North Korea crisis was the catalyst for the mini sell-off in a market environment that has been fraught with talk of an imminent stock market correction for reasons of overvaluation, looming bond market collapse or economic downturn around the corner. In situations like this, any half-rational justification 'will do' to persuade the 'fast money' that there should be more sellers than buyers in the market.

To us, what was more important to observe is how relatively calm they remained. The positive, rather than negative sentiment that has reigned ever since the Brexit vote, once again persevered. Major 'flight to safety' moves in the currency markets did not happen and by Friday evening, US stock markets had turned around already.

If we assume the markets are right and there is no imminent threat of an outbreak of (nuclear) hostilities between the US and North Korea, then this could be because of a number of reasons.

Firstly, the current shouting match may be seen as no different to those we have witnessed over the years and just as they didn't come to anything, neither will this one – another storm in a tea cup. We would somewhat disagree: The western world will want to prevent North Korea from acquiring transcontinental nuclear arms capability and ratchet up pressure, just as they did with Iran. This pressure point is therefore not going to just turn into another frozen conflict, but likely to become worse over time.

Secondly, markets may assume that this is not as serious as it sounds, because North Korea is no longer enjoying the irrevocable support of China. It is therefore a rather irrelevant skirmish between an underdeveloped, rogue state with an economy of a GDP size that their opponent and eminent leading world power annually spends on pet care. This may be closer to what is actually going on. It is important to note that the whole shouting match only started at the beginning of the week, after the UN Security Council passed further sanctions against North Korea – with the support of China(!).

Thirdly, the probability that this conflict will cause some damage in Asia may be rising, but the fact that it appears to be binding the US and China closer together should be more positive, than any collateral damage would be negative. While cynical, this is probably also a contributing factor to the relative calm, even though it overlooks that China's interests are far more complex relative to North Korea than those of the US. They neither want to face a refugee crisis, nor would they want to suddenly have a common border with united Korea that aligns itself closer to the US, than China.

Our own view is that there is a possibility for this conflict to escalate over the coming weeks, however, we ascribe a higher probability to this happening much further in the future. In the meantime, we are pleased to see that the US has once again taken a back-step to triggering an unhelpful trade conflict with China.

In summary, we are reassured by the measured market reaction to what could escalate into quite a nasty military conflict. At the same time we note the nervousness of the markets which, as we have anticipated for a while, are increasingly uncomfortable about the valuation levels they have reached on the back of quite reasonable economic growth in combination with too loose a monetary environment.

Only once central banks in a more concerted effort begin to scale back their monetary support from the autumn onwards, will we know whether general market confidence has become strong enough to substitute the monetary ‘crutches’ with genuine positive sentiment. As central banks appear determined to head down this road we will find out sooner rather than later whether the monetary accelerators of re-awakened economic animal spirits will be sufficient to carry this cycle further.

Our central case is that yes, after an initial period of doubt and volatility the global economy will plough on – albeit with the possibility of heightened levels of price inflation further down the line.

Regarding the asset returns table for July at the top, it is probably looking better than it actually was. This is because June had ended on a low after the mini market tantrum over the central banks’ coordinated announcements that they will begin to reduce monetary support across the board. As a result, the year to date return figures are merely back to where they stood already at the end of May. Nevertheless, just like the North Korea episode this week the bounce back of asset markets during July is reassuring for investors as it indicated that there is considerable resilience in the positive turn of sentiment that we have now experienced for more than 12 months.

UK house price growth “grinds to a halt”: £1m+ homes struggle the most

The latest residential market survey from The Royal Institute of Chartered Surveyors UK (RICS) reveals that, at a national level, property price growth has “ground to a halt”. This comes on the back of fallen transaction volumes, which in some parts of the country have now fallen back to levels last seen in 2011.

London saw the largest declines, but the RICS data now suggests that falling prices have started spreading beyond the capital – particularly the wider South East region. There are multiple drivers for this development, but, at its core, we believe it’s a combination of fallen demand from overseas (due to Brexit uncertainties), Chinese capital controls and lower demand due to tax changes from buy-to-let investors and for £1m plus homes. This would suggest that, unless either the tax framework is reversed or a favourable Brexit outcome suddenly materialises, this subdued backdrop is unlikely to change in the medium-term.

Back in April, we reported that both the Nationwide and Halifax pricing indices were already slowing. Back then, our view was that price growth beyond the South-East would be slowed by rising pressures on household incomes. This appears to have taken hold.

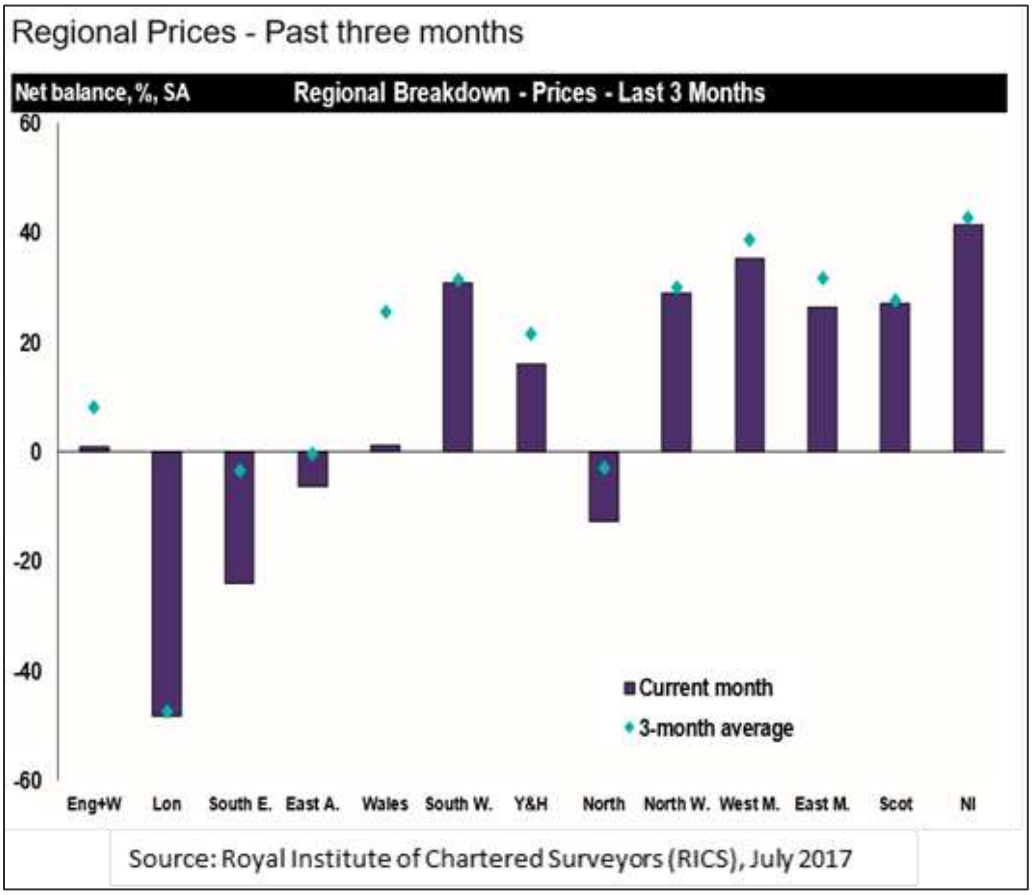
The latest update from RICS confirms our recent suspicions that sales activity levels lack any meaningful momentum, as evidenced by the negative reading for the net balance of new buyer enquiries versus agreed sales. We see further corroboration of property market pressures from the ONS (Office for National Statistics), who reported that construction activity for commercial building declined again in June.

At a headline level, annual house price growth fell from +7% to just +1% over the three months to July, which is the softest reading since the start of 2013. However, breaking down the data by region and price bracket reveals some interesting regional divergences.

Firstly, we see the pricing pressures facing London, particularly at the luxury end of the market, widening beyond the capital to surrounding areas, such as the South-East. It is possible that these negative effects could spread further across the map in the medium-term.

Downward dynamics in house prices are spreading beyond London

Net balance of survey respondents (% reporting rising prices over last three months, less % reporting fall



The market for homes worth £1m+ looks particularly affected, with stagnating sales. The net balance of agents reporting price increases in London was strongly negative at -48%. RICS said that 68% of estate agents surveyed saw the greatest variation between final sale and asking prices, of between 5-10%

It would seem that the increase in stamp duty and additional 3% charge for buy-to-let properties by former chancellor George Osborne has had a negative impact on more expensive homes, typically located in London and the south east. Stamp duty on a £1m+ home now costs a buyer £43,750, making moving homes more expensive.

The combination of stamp duty changes and the removal of interest relief for landlords, has increased selling pressures and subdued buying interest, according to estate agents located in more affluent areas. This has coincided with falling rents in the capital, which have now fallen for seven consecutive quarters.

Buy-to-let property investors often act as a large driver of incremental demand, but this seems to have largely dissipated in the £1m+ price bracket, as rental yields and prices remain under pressure.

Some such property investors may have simply turned their attention to other parts of the UK, where prices and therefore taxes are 'cheaper'. In combination with a far lesser impact of falling overseas demand, this may help explain why, in contrast to the troubles in the capital, the property market further North is generally still buoyant.

But, as ever with the property market, short-term variations should be viewed within a longer-term perspective. The recent slowing in annual house price growth – to around 2% in July – stands in contrast to the rapid and unsustainable rates of near 10% back in March last year. Double-digit increases in property prices were becoming a potentially unhealthy mix in the view of the Bank of England (BoE), given the prospect of eventually higher interest rates and squeezed incomes.

It might be too easy to say that the Brexit vote was the decisive turning point, but it is an additional factor in London's slowing price growth. The single largest factor is the sheer expense of housing relative to earnings. Average house prices are roughly 6x average earnings, a level reached just before the financial crisis in 2007.

We believe that affordability concerns and current uncertainties for both home owners and potential purchasers are likely to continue to restrain further upside. The one overriding factor for countering upward pressures could be the continued shortage of homes on the market, which are at all-time lows, according to Halifax.

Overall, economists are predicting house price growth of 2% in 2017, but this may prove to be optimistic given the growing pressures on UK households. While interest rates are likely to remain low for the foreseeable future, the BoE will be cognisant of its need to gradually withdraw the extraordinary monetary policies (QE) put in place at the end of the financial crisis.

The BoE may cautiously welcome a softer property market, as it would mean less stress for the general mortgage-rate-exposed public once rates do eventually rise.

To add to this, the government has begun to review its Help to Buy scheme, with a view of either replacing or ending earlier than the current expiry date in April 2021. It is worth noting that the UK's housebuilding sector is heavily reliant on HtB to provide up to 40% of new completions, which are a key driver of new housing demand and supply.

In summary, as indicated at the beginning, there is little to suggest the imminent return of the house price inflation we saw in past years. Indeed, we expect house price growth to fall towards the 0% mark across the country over the coming months. There is a possibility on the other had that some overseas demand will return over the same period, as the weakness of £-Sterling has lowered prices for overseas buyers to attractive levels. So, price falls at the upper end of the London market may just be about to stop.

Trump's Fire and Fury

In an off-the-cuff statement, Donald Trump promised to bring "fire and fury like the world has never seen" down upon North Korea this week, if the government in Pyongyang doesn't let up in its provocation. The President's comments came after a report this week from the Washington Post that said North Korea had developed a nuclear warhead capable of fitting inside one its missiles that could reach US territory, according to US intelligence officials.

Sure enough, the North Korean regime responded in kind, with a military spokesperson telling a state-run news agency that the government was "carefully examining" a plan to strike the US island territory of Guam. The proposed missile strike, set to land in the sea just 17 miles from the Pacific island, is pending approval from leader Kim Jong Un, the state news said.

Global equity markets appeared to feel some of the burn from Mr Trump's "fire and fury" comments. European equities dropped off somewhat on Wednesday, while Thursday marked the third consecutive fall for the S&P 500 index. None of the sell-offs have been overly dramatic, but traditional safe-haven assets such as gold and the Japanese Yen have also strengthened, as tends to be the case during times of perceived geopolitical risk. Strangely enough, the dollar, another traditional safe haven, hasn't strengthened as much. We discuss the currency-related issues around the current North Korea crisis in a separate feature this week.

Despite these moves, Goldman Sachs have suggested that investors are actually more worried about the North Korean problem and its potential effect on the global economy than is implied by current asset prices. In a research note published on Wednesday, Capital Economics detailed the potential economic impact of military engagement on the Korean peninsula. "The most important impact of a full-scale conflict on the Korean peninsula would be a massive loss of life. But there would also be significant economic consequences." Last time war broke out in Korea, nearly 70 years ago now, 1.2 million Koreans lost their lives, and South Korean GDP fell over 80%. Now, South Korea contributes around 2% to global GDP, but the larger economic fallout from potential conflict would stem from disruption to global supply lines, with technology and manufacturing industries relying on South Korean exports.

Of course, that is the worst-case scenario and, despite the ratcheting up of rhetoric on both sides, not many expect things to come to that. In terms of global markets, the New York Times reported back in May research from InvesTech that found that only two of their examined major geopolitical events – the German invasion of France and the Japanese bombing of Pearl Harbour – caused sustained market losses over one-week, three-month and one-year periods. Even after the 9/11 terrorist attacks, US stocks bounced back quite quickly.

What's more, in spite of the rhetoric, military engagement still looks unlikely – if anything less likely after other events this week. Trump has lambasted his Chinese counterparts recently for their apparent lack of cooperation over North Korea. But, this week, the government in Beijing backed the UN security council's increased sanctions on the hermit nation, which suggests they are not in Mr Kim's corner as much as is sometimes thought. In fact, this week China has been trying to play the role of mediator between the at-odds leaders. The Chinese government's official news agency Xinhua argued in English-language commentary that "tit-for-tat confrontations" between Washington and Pyongyang would lead nowhere and only constructive dialogue could defuse the situation.

On their part, Chinese government officials have always insisted that their supposed 'client state' was far from that, and they had little control over the actions of Mr Kim's government. The UN vote this week seems to back up some of these claims. As discussed in an article last week however, the situation is difficult for China, in that China constitutes North Korea's only real lifeline in terms of resources. They therefore (not unreasonably) fear a collapse of the regime and the economy in North Korea would flood them with a refugee crisis. Strategically, it would also be a blow to China, because it would remove a key strategic buffer state between them and the US' sphere of influence.

We understand that the current rhetoric breeds considerable fear, as does the idea from some that both the US and North Korea have rash and unpredictable leaders at the helm. But, with regards to Mr Kim, incendiary rhetoric in the past (of which there has been much) has rarely lead to action. His main concern is ensuring the continuation of the Kim dynasty, and a military mis-match against the world's only superpower is hardly a way to achieve that. We believe there is a considerable amount of playing politics on his part. He seems to believe that the US can't do anything while he has the big beast of China at his back. But, as stated, it's becoming more and more clear that the Chinese aren't happy with that situation.

As far as Mr Trump goes, we again think that the fears are perhaps overstated. According to a report in the Pacific Standard a couple of months ago, Trump has been increasingly ceding oversight of military operations to Secretary of Defence James Mattis. Back in June, Mattis gave the order on his own to increase the American troop count in Afghanistan, something previously left in the hands of the President. And further back in April, Trump boasted that he had given the military "total authorization" to act without interference from politicians.

What's more, his recent appointment of former US Marines general John Kelly to the chief of staff role in the White House suggests a willingness to take more of a backseat. It's likely that Kelly, known for his no-nonsense and disciplined approach, wouldn't have accepted the role without some level of control over issues like North Korea. And the military heads in general appear a lot cooler than their commander-in-chief. As one Pentagon analyst told the New European magazine, "You've got to realise that, no matter how worrying this development is, we're still some way from Kim Yong-un being able to deliver any form of nuclear Armageddon."

However, we should note that, even if the actual risks of military engagement aren't as high as is made out, that doesn't mean the tensions will improve in the short-term. Given the volatile nature of the leadership in each country, it's unlikely that the rhetoric is going to dissipate. Trump has proved that he's perfectly willing to engage in the war of words. And, with his Chinese allies apparently leaving him out in the cold, Mr Kim will likely feel increasingly isolated and fearful of his own position. In such a case, the war of words will only get worse.

Beyond heated rhetoric and perhaps more North Korean missile tests in the shorter term, what should we expect over the medium term? Well, it is clear that the western world (Including China and potentially Russia) feels very uneasy about a rogue and unaccountable regime like North Korea establishing nuclear intercontinental missile strike capability. We saw in the case of Iran, just how determined the international community can become on the issue and how severely global sanctions pressures can affect the targeted country.

So, while we do not believe that the immediate tensions of the last days will lead to extensive hostilities over the short term, the issue is not about to go away. Markets are most probably correct not to descend into outright panic right now. But, just as with Iran, the North Korea conflict will flare up continuously until either the nuclear arms capability is removed or a far-reaching regime change in North Korea occurs. It will therefore be necessary to keep a watchful eye on the further development.

A fistful of Dollars

Few things affect currency markets and financial markets generally, quite as much as geo-political events (and tensions). Yes, intervention by central banks on interest rates and other economic fundamentals will all influence the course of a currency over the medium to longer term. But over the short term and along with so-called safe-haven assets, currencies like the Swiss franc (SFr), the Japanese Yen (¥) and even the $-Dollar tend to fluctuate significantly during periods of political instability and uncertainty.

As news this week concerning the tensions over North Korea developed and increased, investors gravitated toward safe-haven assets like gold, which reached a fresh two-month high of $1,293 after already climbing 1.3% on Wednesday (and earlier in the week).

This coincided with reductions in the main equity market indices which all lost between -2 and -3.5% over the week. It seems even the prospect of nuclear confrontation isn't yet quite enough to seriously derail markets from their current (relative) highs.

Nonetheless, it is arguably the course of currency markets, and particularly the Swiss franc (SFr), the Japanese Yen (¥) (and the $-Dollar), that may provide a barometer for the likely extent and duration of these current geopolitical type risk(s).

Political and other crises are often associated with significant movements in exchange rates, which reflect both increasing risk aversion (risk off), and changes in the perceived risk of investing in certain currencies (relative to the so-called safe haven assets and currencies). And, it seems this latest political skirmish is no exception.

Firstly, more traditional safe-haven currency, the Swiss franc (SFr), appreciated on the back of increased demand as did the Japanese yen (¥). However, initial and relatively significant gains for the Swiss franc (SFr) appeared to reflect reactive, short-term positioning. These gains eased by the end of the week; the Swiss franc (SFr) lost a little of its 1.1% lift on Wednesday and began to slip back from a 10-week high. The Yen (¥), however, remained broadly stable even gaining a little on the $-Dollar over the week.

The US$ is (rightly) perceived as the global reserve currency, akin to a safe-haven asset. And, during the course of the week the $-Dollar decidedly stopped its recent steady decline and slightly increased in value relative to other currencies – see chart below for the US$ index, a measure of the US$ against a basket of its peers.

Source: Bloomberg.com,10 Aug 2017, US$ DXY currency Index

This is by no means a significant shift in the value of the US$. But it may represent something of a turning point for the US$. As we reported and had anticipated contrary to consensus, the US currency took something of a battering over the year so far; now that sentiment has become dollar-bearish – and thus in the near-term, the US$ may be oversold.

Perhaps this small initial appreciation in the $-Dollar could therefore be viewed more as the start of a corrective rebound as opposed to demand for a safe-haven currency. Indeed, this would seem to be the case given the slowing in demand – over the week - for other safe-haven type assets. The easing in demand for safe-haven assets might also suggest that markets consider the North Korean tensions as a form of "regional and containable" risk event. This may of course be premature.

The US$ has been overvalued relative to other currencies, when looked at on a "purchasing-power parity" basis. That parity, relative to the euro is probably around $1.30/€ (Current fix is at $1.18/€). The US' prevailing conditions of trade (e.g., current account deficits – as the US has run for many years) will tend to put further downward pressure on the exchange rate over the long-term.

However, in our view, as the economic data for the US has been improving the currency weakness may be overdone.

Moreover, even though the US Fed now appears to be retracing its steps on rate rises as US inflation remains subdued, we do expect the Fed to begin unwinding its QE bloated balance sheet – in earnest – later this year. This will likely impact markets, liquidity and the value of the US$. Equally, continuing growth in the US labour market and marked improvements in net exports (perhaps also a reflection of the depreciated $-Dollar), provide further positive indicators for growth. In short, just as the consensus has swung behind the US$ weakness, we could be due another change in fortune.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7305.7	-2.7	-206.0	↘
FTSE 250	19544.1	-2.1	-425.7	↘
FTSE AS	4008.1	-2.6	-106.1	↘
FTSE Small	5660.2	-1.1	-60.3	↘
CAC	5054.0	-2.9	-149.4	↘
DAX	12006.3	-2.4	-291.4	↘
Dow	21884.1	-0.9	-208.7	↘
S&P 500	2441.7	-1.4	-35.1	↘
Nasdaq	5820.3	-1.3	-79.6	↘
Nikkei	19729.7	-1.5	-299.5	↘

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
COCA-COLA HBC AG-DI	10.4	HIKMA PHARMACEU	-9.5
WORLDPAY GROUP	9.8	INTERCONTINENTAL	-8.5
FRESNILLO	6.5	DIXONS CARPHONE	-8.5
RANDGOLD RESOURC	5.3	PADDY POWER BETF	-8.4
POLYMETAL INTERNAT	4.9	STANDARD LIFE	-8.1

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	16.8	Brazil	206.9
US	26.9	Russia	157.3
France	18.6	China	65.2
Germany	14.1	South Korea	63.1
Japan	30.4	South Africa	185.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	-0.49	OIL	51.8	-1.2
USD/EUR	1.18	0.20	GOLD	1287.6	2.3
JPY/USD	109.08	1.48	SILVER	17.1	4.9
GBP/EUR	0.91	-0.71	COPPER	291.3	1.0
JPY/GBP	6.66	0.98	ALUMIN	2037.0	6.3

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.1	-9.5	-0.11
US 10-Yr	2.2	-3.1	-0.07
French 10-Yr	0.7	-9.2	-0.07
German 10-Yr	0.4	-17.9	-0.08
Japanese 10-Yr	0.1	-3.1	0.00

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	2.0
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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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.

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