Weekly Market Comment

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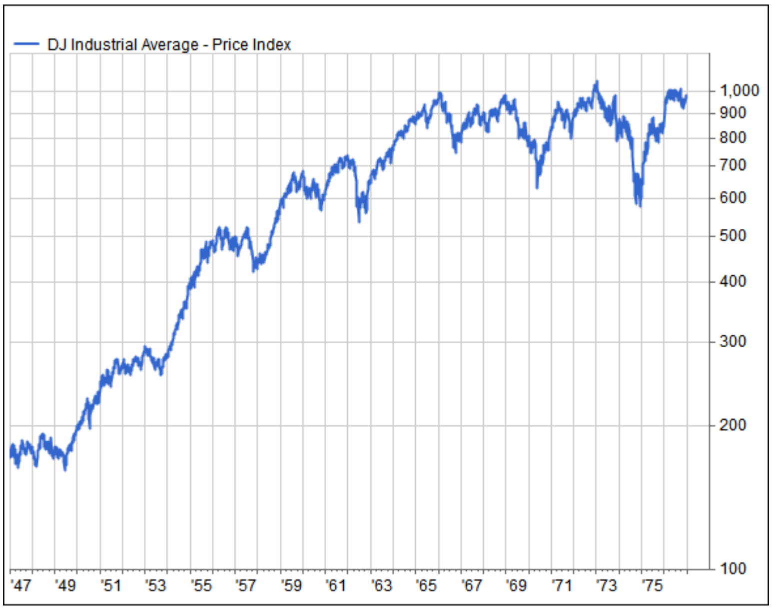
More sellers than buyers

Last week had news that felt like it should affect markets. Risks were obvious and it was unsurprising that risk assets came under pressure. As we wrote, it was perhaps more surprising that there was such little reaction.

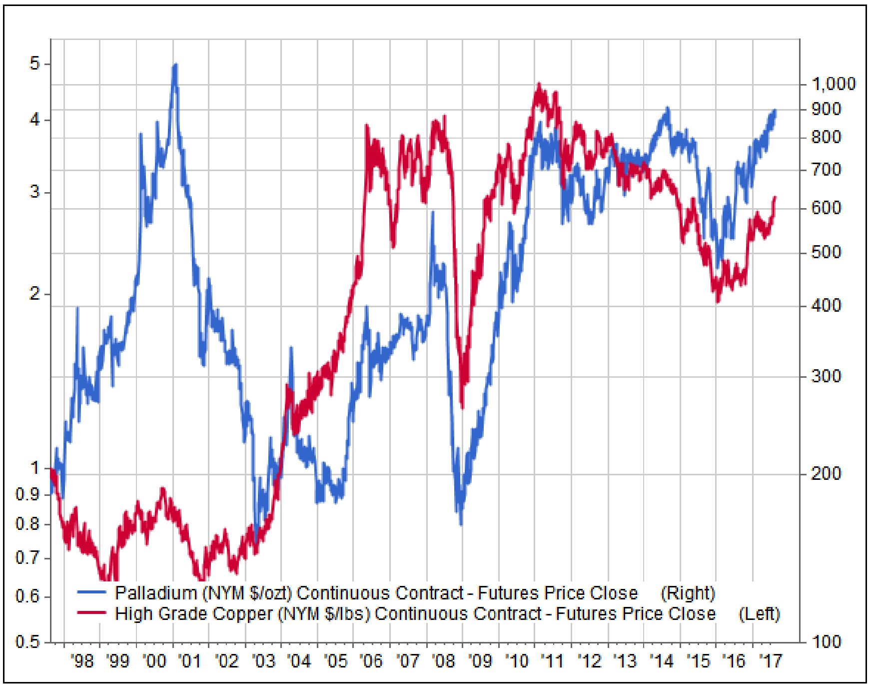
Still, historically, the prospect of war tends not to have too much impact. That's probably because potential conflicts often do not become actual. It's only the long-term consequences of actual war that create destruction of wealth. The Korean War was 1950-53, the Cuban Missile crisis ended in 1963, and the Vietnam War main phase 1968-75 - see below for the Dow Jones Industrial Average history:



(Source: Factset)

Therefore, this week's moves have been interesting. As I write, equity markets are trading some 2.5% down from the recent highs. In itself the sell-off is just revisiting last Friday's lows. However there is no obvious rationalisation – war is not more imminent, the end of the Q2 earnings season has continued to be relatively upbeat, economic data continues to signal steady growth.

Indeed, copper has hit a new 3-year high and palladium has hit its best level since the bursting of the tech bubble



(Source: Factset)

As an indicator of global growth, metals prices may be imperfect and more typically seen as a reflection of China's demand for resources. China's data did show signs of slowing. As Dow Jones Newswire said, "the deceleration in growth, from a rise of 0.9% on the month in June to just 0.6% in July, is relatively minor. "

"But consumer-loan growth and tightening mortgage restrictions have already put the lid on rallies in top-tier coastal markets like Beijing and Shanghai. If prices in the interior begin falling outright, or if housing investment weakens again in August, it may be time to start hedging bets on China growth plays. Some vulnerable stocks include mining firms and U.S. construction-equipment maker Caterpillar, which has been testing new highs this year as global growth rebounded."

"Some slowdown in the interior is to be expected. Credit has been gradually tightening in China for months. Steel prices are up, buoyed by mill-capacity cuts. That is fantastic for steel producers but bad for downstream industries like construction, which buy steel. Steel sector growth accelerated in July, while most other sectors decelerated."

"The biggest bullish factor for Chinese construction remains intact: Massive housing inventories, which depressed construction growth for years, are still falling. Vacant, unsold housing floor space in China fell 10 million square meters in July to the lowest level since February 2014. Vacant floor space is down 20% on the year."

"Nonetheless, China's housing market looks close to an inflection point. If August data shows sales and investment weakening again, or the fall in inventories levelling off, sentiment on China may deteriorate".

Blaming China's economic data for a turn in global equities may be missing the point. Perhaps more likely is just a near-term case of more sellers than buyers. The pressure from China's regulator on the likes of Anbang Insurance to cease their buying spree is intense. Lipper fund flow data for last week showed marked selling by US investors, in certain cases the biggest outflow in

33 weeks. Meanwhile the strength of the Yen (and its coincidence with the timing of falls in the S&P500) suggest that Japanese holders have continued their selling from last week.

As we've mentioned before (and discuss in more detail below), Central Bank commentary is raising the probability that quantitative easing support for long-term assets will start to be removed soon. The Fed's minutes for its last meeting told us as much. Next week, the Fed holds its annual powwow at Jackson Hole (Wyoming), courtesy of the Kansas City branch. Yellen will give a speech regarding financial stability, a topic in which QE plays an important part. Draghi will also attend and speak.

We feel reasonably sure that they've already reached a conclusion that the start must be made, knowing that markets will wobble as the reality of support removal will sink in.

Political incompetence hasn't helped. The US market has certainly not been helped by Trump's diminishing support, evidence by the collapse of the Economic Advisory Council. The President still has Gary Cohn's passive backing, with Cohn still being seen as a likely replacement for Yellen at the Fed. If Trump loses the Goldman Sachs ex-chief, that would be significantly worse.

We take a closer look below at the UK's issues regarding Brexit negotiations.

The confident phase that took equity markets to highs a month ago feel as though it's passed for the moment. Holidays have inevitability compressed liquidity which surely has led to the pickup in volatility, and next week is still holidays for many so we should expect it all to feel a bit risky in the next few days.

Global monetary policy: not if, but when …

The key economic issues this week were arguably the release of the minutes to the US Fed's interest rate-setting meeting in July (released on Wednesday), and the minutes relating to the ECB's recent policy decision on Thursday, which also took effect in July.

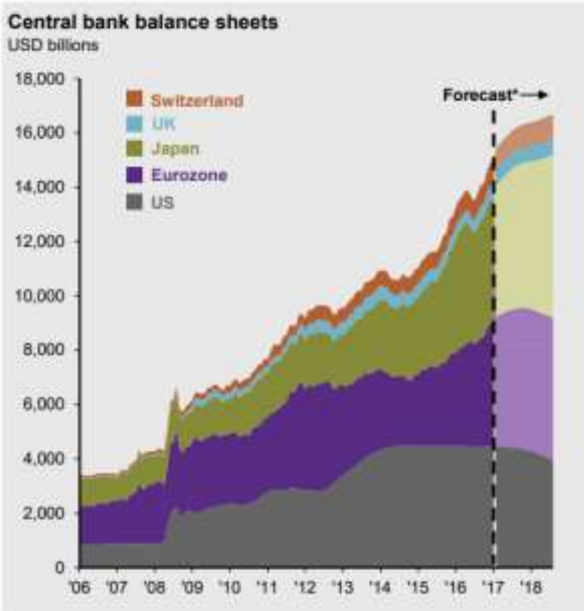
Even though neither set of minutes is definitive, there appears to be emerging clarity on one of the key issues set to affect global economics in the medium to long-term – quantitative easing (QE). Whereas the Fed has broadly signalled in terms of unwinding QE, the ECB has yet to give any firm indication of its future policy on QE.

However, in the case of the US and the EZ (and very possibly other central banks) it now appears to be a matter of when, not if, central banks begin to unwind their position on QE. Answers to the related questions of how the central banks undertake any programme, and the potential economic and financial effects, are less clear.

Recall that, post-GFC, QE provided an injection of liquidity into the markets and financial system ('oil the wheels', as it were), while its asset purchases also helped to underpin asset values. According to some analysts, QE has had a profound effect on markets, effectively pushing investors into a search for yield that has resulted in an era of low volatility, ever lower yields on bonds, cash flows into emerging markets, and equity indices hitting record highs.

As we know, the economic downturn lasted longer than initially expected and, as a consequence, the central banks of the US, UK, Bank of Japan and the ECB now hold ~$14tn of assets on their balance sheets. Clearly, removing this kind of economic stimulus must have some effect on markets over the medium to long-term. It is, in effect, a scale repatriation of assets off the bank's balance sheets back into the market.

Climbing Mount QE …



Source: JP Morgan, 30 June 2017

As things stand, the US Fed is divided but clearly minded to start unwinding its balance sheet later this year. The minutes of the Fed's July meeting revealed differences of opinion on when to begin shrinking the Fed's balance sheet, together with concern among some over low inflation, which militates against a tightening (in money policy). It seems that a firm decision on when – and more information on how – has been postponed to the Fed's September meeting.

Faced with a fast appreciating €-Euro and a rapidly improving economy, the ECB faces an equally difficult policy decision. An appreciating €-Euro may hinder the ECB's attempts to meet its inflation target of ~2% - a result of imports being relatively cheaper and a strong currency weighing on the EZ's export volumes. The minutes of the ECB's meeting also indicate that there is a risk that the currency could continue to appreciate.

In any event, and assuming no material appreciation in the €-Euro, there is clearly a case for the ECB to consider reducing the level of economic stimulus. While the ECB would be right to wait until growth in the EZ is sustainable before acting on QE, we assume the ECB's meeting in October will result in significant policy changes. This may not be a full balance sheet adjustment, but a reduction in the monthly volume of (net) asset purchases.

In order to avoid market shocks the unwinding of QE will require careful management over a long period, with a gradual approach to any sell-back consistent with managing money flows and interest rates toward target inflation. And this would appear to be how central banks are approaching this issue, gradually. For example, the Fed's proposal to increase the amount released quarterly over 12 month periods up to the end of 2020, appears measured and pragmatic.

Moreover, the Fed has also indicated that any sell-back will only proceed "as long as the economy evolves as expected". Again, we believe this is measured and unlikely to cause any severe market adjustments, assuming of course the US economy does evolve in accordance with the Fed's own projections.

The more involved observer might also note that the US Fed (and to an extent other central banks) have become more focussed on financial conditions and FCIs (Financial Condition Indices, which measure liquidity much more broadly than interest rates) in their rate-setting policy. As economies recover and policy needs to tighten to prevent inflation and overheating, interest rate rises will be one of the signals for an unwinding of QE (as in the US). However, interest rate rises are most effective in tightening credit supply with maturities of 0-2 years in, whereas an unwinding of QE is likely to have long-term effects.

Therefore, if central banks come to believe that markets are "exuberant" or asset values are inconsistent high relative to developing economic fundamentals, e.g., financial conditions are too "easy", then a return of central bank held QE assets into the market will tighten overall liquidity much more effectively over a broader maturity spectrum than interest rates.

Brexit papers and Sterling: What does it tell us?

The Conservative government laid out its vision for post-Brexit arrangements in two key areas this week; the customs union and the Northern Ireland border. A Whitehall paper published on Tuesday detailed the UK's wish to remain part of the customs union for around three years after the official divorce date, while a further 'position paper' ruled out a hard physical border between Northern Ireland and the Republic of Ireland.

Both papers point to a considerably softer stance than has been previously taken by the government. The call for an extended interim period is one that many business leaders have been making recently, arguing that a cliff-edge scenario could be disastrous for the UK economy. And the government has now heeded those calls, with one Whitehall official saying that "It should look and feel the same for business," until the three-year interim is up. The change in tack on the customs union especially represents a victory for the soft-Brexit proponents within the Tory party, such as Chancellor Philip Hammond.

Yet, despite this softening on Brexit, Wednesday saw £-Sterling fall to its lowest price compared to the €-Euro in seven years. The breaking of that particular record likely has (almost) as much to do with the strength of the Euro as it does the weakness of the pound. But, even compared to the US$, sterling continues to be pinned at lower levels. Given that movements in sterling's value have been overwhelmingly driven by Brexit-related news snippets since ex-Prime Minister Cameron announced the referendum over two years ago, shouldn't the government's new stance have seen a reversal in the downward trend?

Of course, there are other factors at play here. The trigger for the recent fall came from Tuesday's unexpectedly low inflation reading (2.6%), which implies a flatter trajectory for the Bank of England's (BoE) rate-rising path. In terms of current considerations, the government's softer Brexit stance failed to pump up expectations for the economy mainly because of how badly they were received by critics on the continent and elsewhere. Brexit Secretary David Davis paints the proposed interim period as a best of both worlds scenario, where the UK maintains the current trading set-up while also negotiating future trade deals. However, the European Commission and various trade experts have pointed out that such an arrangement would still mean big changes for businesses. “Frictionless trade not possible outside Single Market & Customs Union,” said the Commission on Wednesday.

There is widespread feeling that the government’s recent communications are more wishful thinking than genuine detailed policy proposal. For example, the government maintains that Northern Ireland’s food producers will be exempt from sanitary checks at the border, yet doesn’t make clear how this is possible in the context of EU health and welfare standards for imports from outside the customs union.

It has now been 14 months since the Brexit referendum result, but the government is no closer to substantial policy proposals for leaving the EU. In a candid interview this week, Mr Davis admitted that EU chief Brexit negotiator Michel Barnier is “getting quite cross with us”. Mr Barnier himself said on Twitter that negotiations on Northern Ireland and the future of the customs union couldn’t begin in earnest until the size of the ‘divorce bill’ is agreed – a line that EU officials have been consistent on since the referendum but one that the government has continued to be coy about.

All of this might explain currency market’s lack of enthusiasm about the government’s new Brexit vision. But what does it mean for £-Sterling going forward? In our view, there isn’t much more room for sterling to fall in the current environment. It’s worth bearing in mind that, from a national accounting perspective, the primary impact of sterling’s fall has been to reduce the UK’s current account deficit (exports minus imports).

It has done this through effectively making the country’s labour force cheaper relative to other countries, and thereby more attractive to foreign buyers. The boost to exporters that this brings has been mainly felt by manufacturers, though the all-important services industry has also seen some benefit. Generally, with an improving current account, we would expect the currency’s value to improve.

Of course, national accounting is only a small detail in the larger puzzle, and the fast-approaching Brexit-shaped iceberg explains why markets are so downbeat on sterling (and, by extension, the UK economy). However, at such depressed levels, we believe that markets are effectively pricing in the failure of the UK economy in the medium-to-long term.

And, this is where the government’s softer stance comes into the picture. While the government has yet to come up with detailed policy proposal, the recent softening does suggest that they will be more amenable to Brussel’s wishes than the previous “Brexit means Brexit” rhetoric suggested.

As Mr Barnier reminded us recently, the clock is ticking, and it seems that we are approaching the point where the economic/business interest will supersede the electoral interest. With Europe showing signs of strong growth, as well as strong global growth generally, the trajectory for the UK economy is unlikely to be as steep a fall as currency markets are pricing in.

However, we shouldn’t take these developments to mean that sterling is in for a boost any time soon. Just because currency markets might be overly pessimistic, that doesn’t mean we should be overly optimistic. As mentioned, the UK’s current account deficit has generally been falling since the referendum, but the improvement hasn’t been as dramatic as hoped.

In fact, last quarter saw the current account deficit rise to £16.9 billion, though that is still a big improvement on the £25.7 billion in Q1 2016.

Furthermore, the low sterling valuation itself has compressed demand somewhat, through stagnating wages. This limits the effects of medium and long term inflation, meaning the BoE might not be as keen to tighten monetary policy as quickly as expected.

All in all, we believe that, barring any major shocks, we have found a new equilibrium in £-sterling, where further substantial falls look unlikely, though substantial rises look equally unlikely.

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.

Lothar Mentel