Weekly Market Comment

1 September 2017

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Bad news, good news

This week began (belatedly for us Britons) with bad news and seems to be ending with some good news. I'll concentrate first on some overseas influences before looking at the UK.

North Korea has fired missiles across Japan before but Tuesday morning's test across North Japan marked another step up in potential danger; the floods in the US and in the eastern area of the Indian subcontinent are more immediately damaging.

The floods will cause pain for many and for a prolonged period. James covers more detail about the US hurricane below. Any disaster (such as the floods) has impacts on an economy which are difficult to gauge. Assets are destroyed and work is difficult for a period. Then there's a bounce back (which amounts to a drawdown in savings) as the rebuilding takes place, with the initial phase often pushing activity up sharply. It's the second phase of rebuilding that matters. If the people don't have enough personal savings or they don't get enough help, the affected area and the people therein suffer for a long period as their capital assets are much less productive.

In the US, this may be the event that galvanises support for Trump to spend on infrastructure as promised last year. Certainly, his administration is trying to tie it to the passing of the raising of the debt ceiling. The calculus is that members of congress will not want to be seen voting for more misery in Texas.

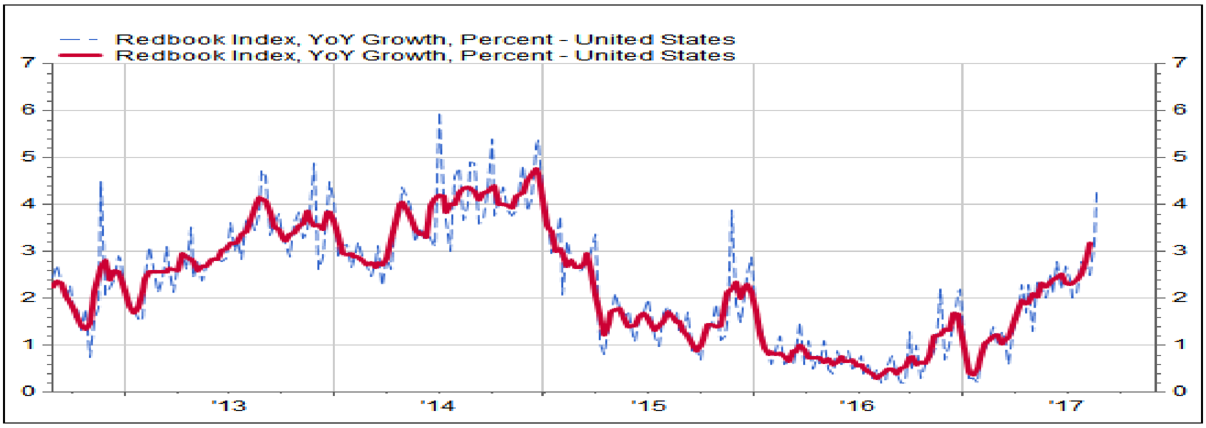
Trump's fortunes may be turning markedly in other areas.

The discipline instilled in his administration is may be progressing the tax proposals. There have been comments from his camp playing down the extent of reform, while Trump has been relatively quiet (in his own terms), and the floods will require funding, it seems that the administration is getting bipartisan backing for a program of tax cuts aimed at the "middle classes". Steve Mnuchin has pushed back the date of the packages release but we think this is a sign of a better working relationship with congress.

The biggest help comes from an improving economy. The US employment report was a little disappointing, with the unemployment rate rising 0.1% to 4.4%, but the Purchasing Manager Survey from the Institute of Supply Managers was resoundingly positive, with the headline manufacturing survey climbing back to 58.8.

(Source: FactSet)

It's not just businesses that are confident. Consumption is showing signs of climbing back to strong levels. The weekly Redbook data (a measure of retail sales) has hit 4% year-on-year growth after being in the doldrums.



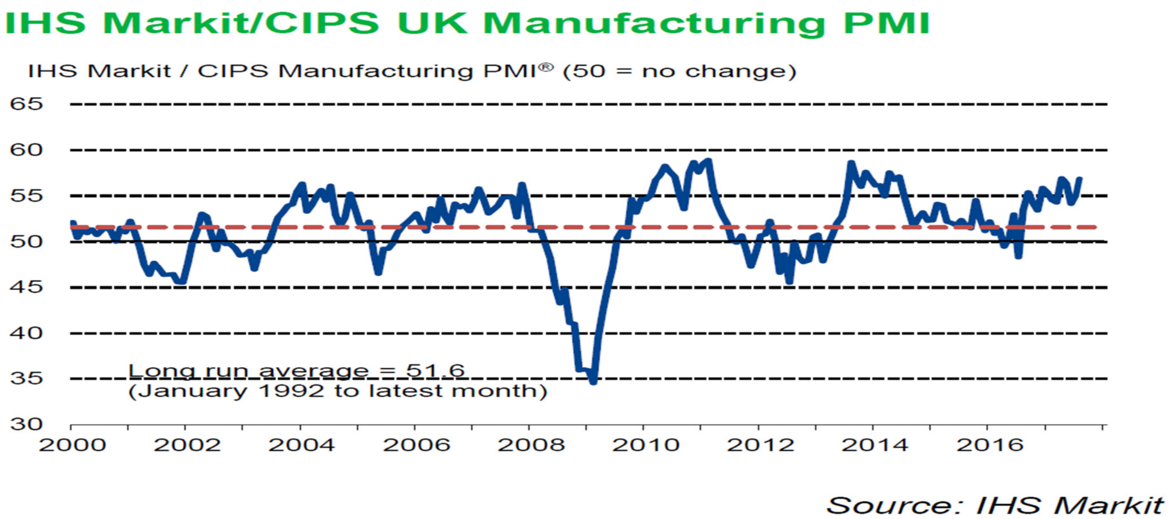
(Source: FactSet)

This underpins hopes for growth through the rest of the year, and puts a base under US equities. Revenues should be robust although we still think that valuations will cheapen as bond yields rise. Equities may end up trading flat from here.

One of the boosts for the US domestic economy has come from the weak US dollar. That weakness coincided with the perception that the Trump administration lacked ability to get its agenda through, especially in the area of business tax and regulation reform.

To us, it looks like better confidence in the US will stem the fall in the dollar. Having spiked above $1.20/€, the dollar has shown a bit of life and we may be in for a rally.

In terms of business confidence and the currency, there's a similar thing happening in the UK. The UK version of the manufacturing purchasing managers' survey was strong bouncing back unexpectedly to 56.9.



We don't have quite the same thing happening in UK politics. It may be that the Brexit negotiations are actually not important to the UK's near-term growth outcomes, that sterling is the key thing. Still that probably means, as we said last week that growth is now coming through because of sterling's weakness which should stabilise sterling without the need for better perceptions of the government.

One final note: Gold remains surprisingly strong (in US dollar terms). If the dollar starts to strengthen, on balance we expect the gold price to fall back from recent levels. Sometimes though, gold can be a signal of other problems so (although we do not include it in portfolios) we'll remain interested in its progress.

Source: CMC Markets

Investing in competition: competition or concentration?

The retail economic landscape is changing. Amazon, like Google, Facebook and Netflix are leveraging fundamental changes in the market, utilising electronic commerce platforms, tactical acquisitions and other strategies to move from simple online retailers (or search engine) to bookstore, media publisher, games producer, telecommunications provider and now even grocery deliverer. There are now few retail markets in which one or another of these large e-commerce companies does not operate.

On the face of it, competition from these rapidly expanding and growing e-commerce companies (to the more traditional retailers like Walmart in the US and M&S in the UK, and others), should be seen as a positive development for consumers, in the form of lower prices and more choice. However, that may not always be the case.

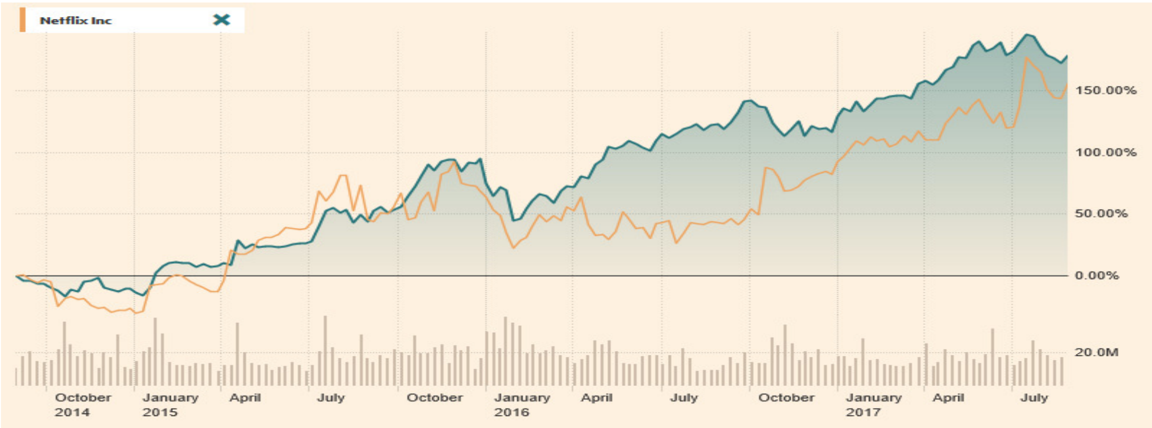
Many of our well established high street retailers are being forced to close their doors as they simply cannot compete with the size and efficiency of e-commerce; HMV, BHS, Jaeger, Jones the Bootmaker and even the 99p store being prime examples of this.

Increasing company size and market concentration - fewer firms supplying the same range of products and services – could actually lead to less competition, higher prices and lower levels of innovation and productivity over the long-term.

Moreover, market concentration appears to be on the increase across a number of markets and countries, where certain companies have grown considerably over the last decade, by means of acquisition and "organically". Notably, Facebook, Amazon, Netflix and Google (FANG).

The growth in the (equity) valuation of Amazon and Netflix is illustrated in the graph below. Over the last year alone Amazon's share price has surged by >40%, while Netflix is set to reach a valuation of ~$75bn; it now has more than 100m subscribers across almost 100 countries.

Netflix's pace of growth far out-reached that of similar companies offering products in the same economic market, e.g., Disney, Sky etc.; streaming and e-commerce providing the means for its considerable growth (and geographic expansion).



Amazon and Netflix: change in share price 2014 – 2017 *Source: Tatton analysis, FT Market Data*

Of course, Amazon is now also producing and distributing media content, while Google owns YouTube, and Facebook has acquired a number of technology companies capable of taking it into media production and distribution (and other markets). While the reach of FANG into media distribution and content production may deliver innovation and choice to consumers, (used to linear and Satellite TV), the long-term effect and influence in other markets could be less benign.

Amazon's recent acquisition of Whole Foods in the US is an example of potential short and long-term market effects. On news that Amazon would significantly cut its grocery prices (after the acquisition), even UK supermarket shares slipped on the back of news and were among the worst performers on the FTSE 100 index. Tesco dropped 1%, Marks & Spencer fell 0.85%, Sainsbury's declined 0.63% and Morrisons slipped 0.5%.

In the US, Amazon's expansive and "competitive" zeal has become something of warning signal to industries faced with the prospect of market entry or acquisition by Amazon. Even before Amazon's deal for Whole Foods had formally closed, US supermarket chains like Kroger and Walmart had lost between 5% and 9% off their share price. It seems that companies are increasingly "running scared" and that markets are ready to discount company valuations in anticipation of entry by Amazon (or another large e-commerce company).

However, this apparent spur to the competitive process across a number of different markets may not be all good news for the consumer, or the supplier(s) over the long-term. In the short-term, it may bring reduced prices and differentiation for the consumer. Depending on the circumstances, it may also result in significantly lower margins for suppliers and exit from the market by other companies who are no longer able to compete. Both of which could have a long-term impact on the structure of the market, the overall value-chain, employment and long-term prices for the consumer.

While increasing the scale and/or scope of a company is a recognised and legitimate strategy, strategies concerned with 'monopolising' or cornering the market are not (or even where a few companies effectively control the market – referred to as an oligopoly). A monopoly knows it can price independently of other market suppliers and consumers, and/or control output such that prices for its products and services are bid ever higher.

Some of the large e-commerce companies already have 'history' in this regard. For example, the EU's competition commissioner recently tackled Google for its monopolistic behaviour; it issued Google with a fine of €2.4bn for abusing its dominance of the so-called search engine "market".

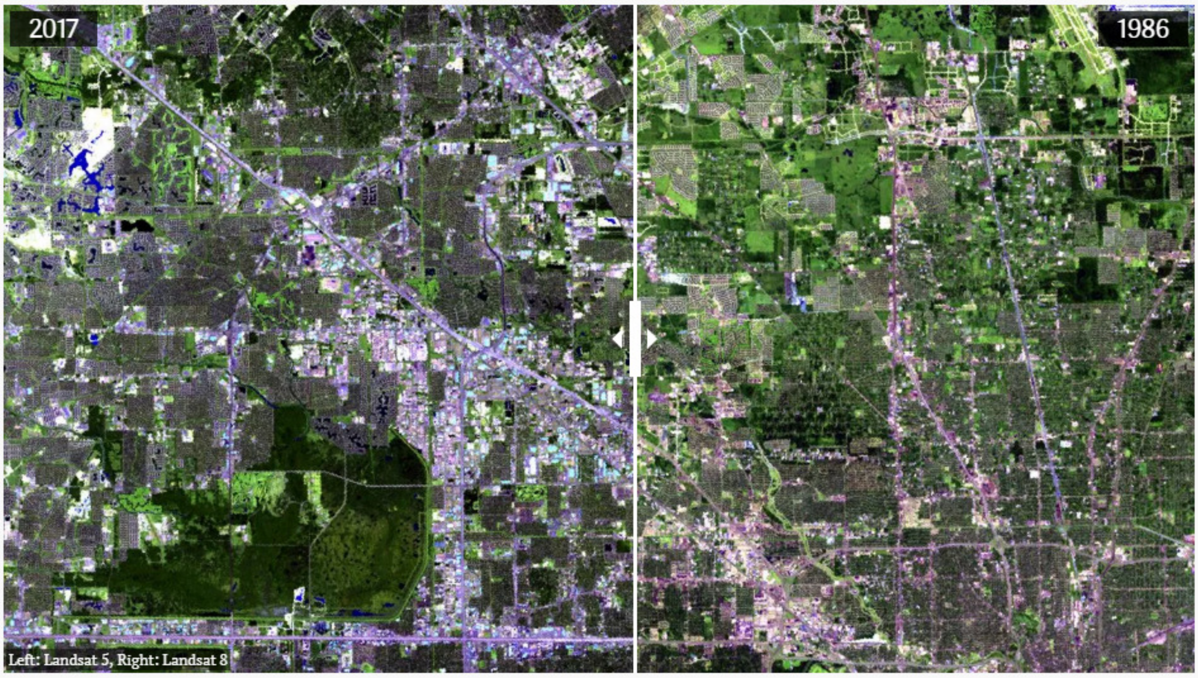
In our view, and from the perspective of the investor, overall consumer spend in many of these markets is either is set to increase (media, TV, internet connectivity), or at least continue to represent a reasonable proportion of household expenditure (groceries through to telecoms are of course staple household items). Competition in these (and all) markets should be protected; market concentration should be a function of the underlying economics, and not a result of corporate strategy.

The alternative is increased market concentration in both developing and existing markets, with fewer companies wielding greater control over products and services, and possibly, the overall supply chain(s) to the detriment of the wider economic infrastructure. Over the long-term, weaker competition implies fewer choices, higher prices, lower productivity and potentially a less efficient and vibrant investment market.

Hurricane Harvey

Harvey, the third hurricane of the 2017 season (after Franklin and Gert) made landfall in Aransas County, Texas on the evening of Friday 25th August, bringing with it a record amount of rain to the continental US (almost 52 inches in places).

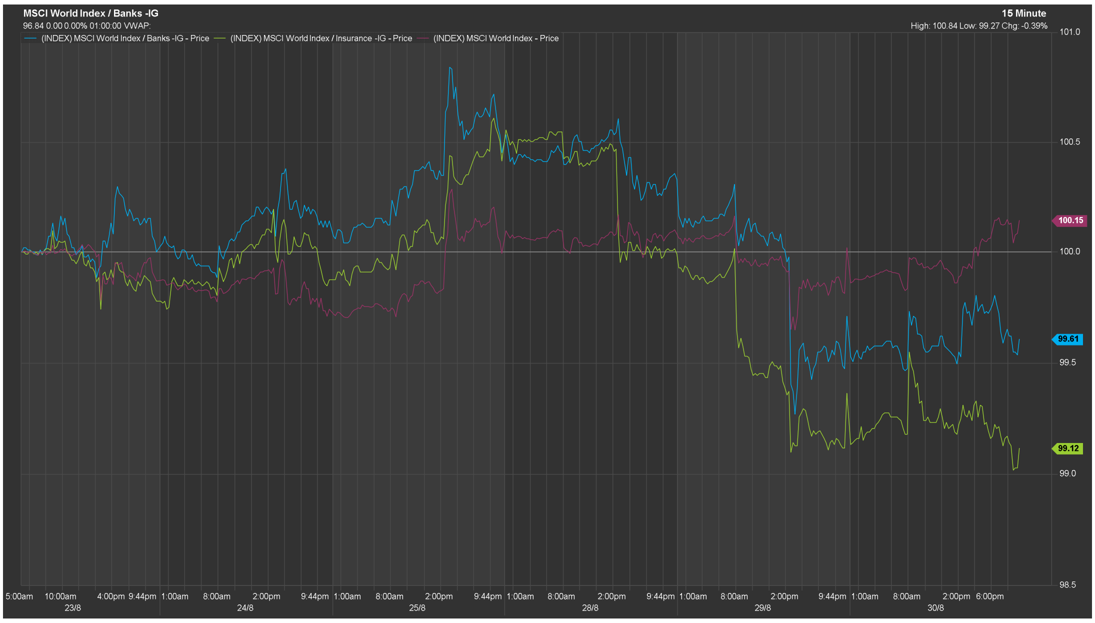
The most reported effects of this disaster have been the severe flooding in Houston, a city of over 2 million people. Tragically, 47 people so far have been reported killed as a result of the tropical cyclone. This situation has likely been exacerbated by Houston's lack of zoning laws leading to the widespread paving of wetlands which historically acted as at least a partial buffer by absorbing large amounts of flood water. This looks particularly stark in a graphic featured on Quartz, in the below image plants appear in green tones, developed areas in blues.



While the disaster recovery efforts will continue for weeks and months, financial markets are obliged to attempt to digest event far more quickly. This has manifested in several markets; insurance, as is expected in the wake of such destruction and, more specifically to Texas, the oil industry.

Looking first at insurance, estimates have started to come in for the total damage (as far as it can be estimated in monetary terms). The most visible early analytics have come from Enki who have been quoted in the Guardian and on CNBC, their most recent guidance being around $57B of total losses, unfortunately for those effected, significant amounts of this is likely to be uninsured with estimates as high as 70 or 80%. For context, this would represent damage levels similar to Hurricane Sandy ($70B), but some way off Katrina ($140B), or the Japanese earthquake and tsunami of 2011 ($229B), according to SwissRe estimates via the Guardian.

Insurers have sold off accordingly, the chart below (source: FactSet) shows the MSCI World index (red) as well as Insurers (yellow) and Banks (blue). While financials have suffered recently, it is specifically the insurers who have borne the brunt of this sell off, around 2% behind broad markets in the last 6 trading days.

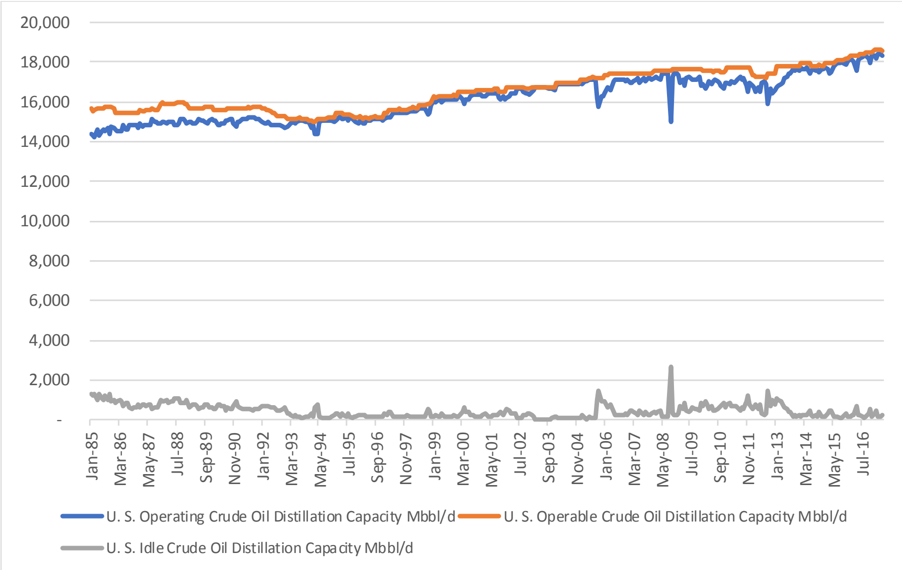


Source: FactSet

Only time will tell if these estimates are close to the mark, with new reports of damage coming through daily.

Meanwhile, oil prices seem to have moved in opposite directions depending which way you look. This is down to Texas' specific role within the oil industry. Gasoline, the final product of the industry has become more expensive, while US crude, the raw material (and major input cost) has fallen.

Texas is home to many of North America's refineries, where crude oil is converted to gasoline, amongst other products. According to CNBC, refineries with 4.2 million barrels per day worth of capacity were closed as a result of the hurricane, leading to the 5% surge in gasoline prices and a 1% fall in that of the raw crude. This in turn reduces demand for the raw material, and supply of the final product, hence the counter intuitive price action. For context, the chart below shows the EIA figures for US refinery capacity, in thousands of barrels per day, almost a quarter of this has been at least temporarily removed.



Source: FactSet

We will watch both of these markets with interest over the coming weeks as estimates for the damage are refined, and US oil capacity recovers. The key factors to watch will likely be any further damage caused by floodwaters before they subside, as we write this there are reports of explosions at a Texan chemical plant, and any reaction from non US refiners, who may well relish the chance to increase margins around the world in response to a drop in US capacity.

China remains solid, while Japan's economy continues to brighten

Initially, markets may have been rattled by news that a North Korean missile flew over the Japanese island of Hokkaido, but the stream of improving economic data from across the world, especially in Japan and China, appeared to help soothe investor jitters.

Building on the positive manufacturing and business sentiment data from Japan last week, investors saw rising domestic retail sales, higher inflation, improving wages and the strongest labour market since 1974.

Meanwhile, China and in particular, its 'old economy', has continued to grow above trend in the first half of 2017 on the back of higher investment spending and also rising exports. Chinese firms have experienced solid momentum in industrial profits growth and the recent fall in interest rates (i.e. financing costs) should help boost both private and manufacturing investment.

There has been a visible increase in corporate capex in China this year on the back of better earnings. When we couple strong Chinese growth, with the recent weakness in the US dollar, it becomes easier to see why industrial metals prices have jumped higher over the past few months.

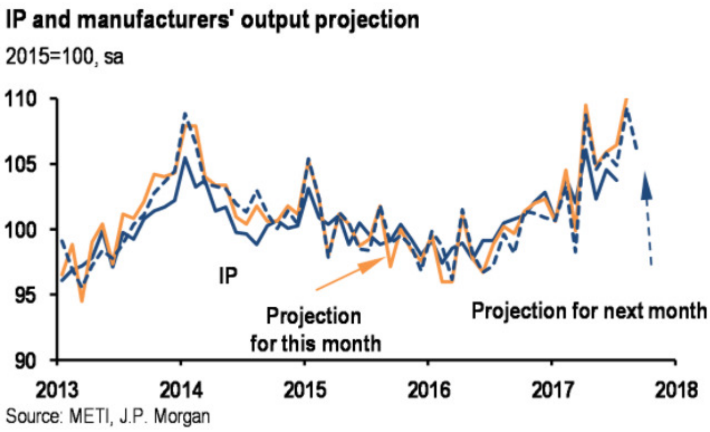
China's NBS (National Bureau of Statistics) said the manufacturing PMI for August was 51.7. The print was better than the consensus of 51.3 and higher than July's reading. We note that the subcomponents of new orders and production strengthened, while there was a large jump in inflation indicators (both input and output prices were up in August).

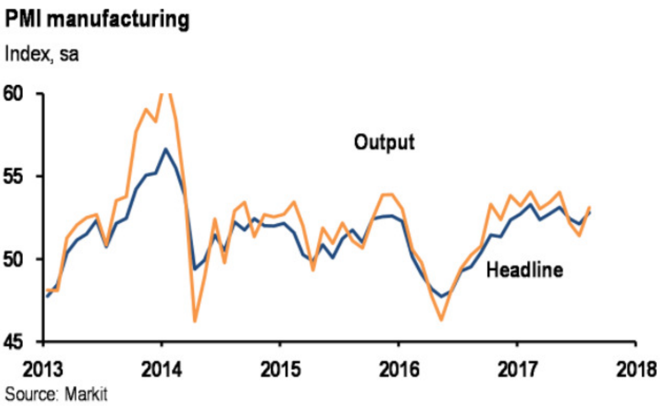
There are some concerns that the rebound in Chinese activity lacks some sustainability, post the important Communist Party Congress meeting in November. So far, China's government appears to be successfully managing the transition from investment-led economic growth to an increased share for domestic consumption.

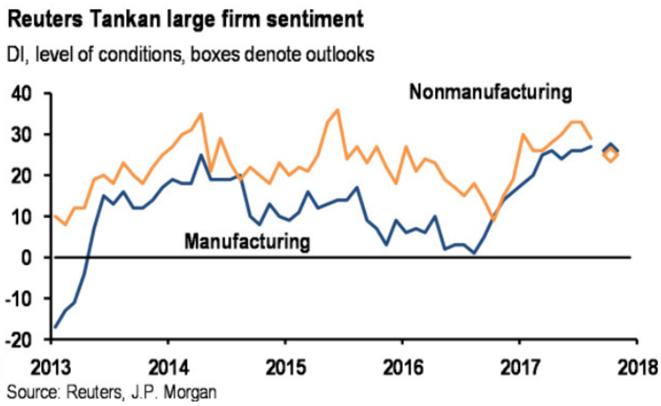
We note that China's and Premier Xi's focus on tackling the unregulated shadow banking system does not seem to have had an adverse impact on real activity. Domestic policy has focused on reducing excessive financial leverage but has allowed bank lending (credit) to continue expanding. Total Social Financing (TSF) hit a new record of RMB 3 trillion in July.

We think that the government will continue to focus on ensuring that financial leverage remains under control. We think Chinese interest rates could stay low, as the introduction of more effective capital controls seems to have stemmed money flowing out of the country, making the Renminbi more stable and potential rate rises less likely.

Over in Japan, we know economic data can be fairly volatile on a monthly basis due to movements in the Yen, but the trend is clear. Japan's economic prospects have continued to







brighten throughout 2017, along with our growing enthusiasm for Japanese stocks.

Wrapping up last week's data, while Industrial production (IP) decreased 0.8% month-on-month (MoM) in July, following a rise of 2.2% in June, the manufacturer's' output projection survey looks set for a 6.0% surge in August (revised up from the 3.6% reported last month). It suggests that IP, not only picks up in this month but that it continues to increase in 3Q, even after the 8.5% quarter-on-quarter jump in 2Q.

There was further good news from the manufacturing sector, with the forward looking Purchasing Manager's Index (PMI) printed at a better than expected 52.8 in August (+0.7 points from July), suggesting there is solid momentum in activity, after hitting a record high in July. All key components of output, new orders and employment picked up in August.

As a result of economic improvements, business sentiment also looks to be on the up. The Reuters Tankan business sentiment survey of large manufacturers reached 27 in August, the highest level since 2007. Companies cited solid external demand from both China and the US and momentum is expected to remain robust.

Small businesses sentiment is also improving, the Shoko Chukin (SC) Survey suggests the economy remains firm. We note that the capacity subcomponent of the SC turned positive for the first time since March 2008, which indicates that small firms are starting to sense a shortage of their equipment. This is an encouraging sign for the outlook for small business investment.

While the export side of the economy appears to be doing well, the surprise this year has been the rebound in domestic consumption, driven by higher real disposable income and a strong labour market.

Core consumption in Japan posted its second consecutive month of growth, rising +0.5% year-on-year in July. We think core consumption continues to be on a modest recovery trend since the end of 2016. We see further evidence of an improving consumer from the retail sales data. Retail sales in July rose 1.1%, leaving the annualised level of 2.9%, higher than the average from Q2, when sales rose 2.8%.

So what is supporting a rebound of the Japanese consumer?

The labour market is now at its strongest level in more than 40 years. The ratio of open jobs to applicants hit 1.52 open jobs/applicants, suggesting the country is facing labour shortages in some areas. So far, Japanese firms have been able to adapt to shortages and avoiding increasing wages but that ability now appears to be reaching its limit.

There are signs that price and wage pressures are building. As a result, inflation is starting to nudge higher, following 2 decades of deflation or price decreases. July CPI (ex-fresh food) printed at +0.5% year-on-year in July. We note that all of Japan's large logistics and delivery firms have announced price increases. Additionally, Torikizoku (a similar concept to Nando's) said it would be increasing the price of grilled chicken dishes by ¥18 (6.5%) to ¥298 from October.

For all the reasons above, we are increasingly optimistic for Japan's prospects, particularly given the robust global growth backdrop. We think markets should be encouraged by the developments in China, or at the very least, have less to worry about. Based on current official forecasts, China only needs to generate average annual growth of 6.3% between 2018 and 2020 in order to achieve its aim of doubling income between 2010 and 2020. This should give officials plenty of room in which to push ahead with necessary structural reforms with a lower growth target, without upsetting markets if there are fluctuations in the short-term data.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7449.3	0.6	42.2	↗
FTSE 250	19767.1	0.3	56.8	↗
FTSE AS	4079.8	0.5	21.3	↗
FTSE Small	5709.8	0.6	35.3	↗
CAC	5133.6	0.6	29.3	↗
DAX	12171.0	0.0	3.0	↗
Dow	22017.3	0.9	203.6	↗
S&P 500	2476.2	1.4	33.1	↗
Nasdaq	5992.9	2.9	170.4	↗
Nikkei	19691.5	1.2	238.9	↗

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
PROVIDENT FINANCIAL	16.6	POLYMETAL INTERN	-10.4
ASHTEAD GROUP	7.5	MICRO FOCUS INTER	-7.4
ANGLO AMERICAN	6.8	DIXONS CARPHONE	-5.8
SHIRE	6.2	ITV	-3.3
BHP BILLITON	5.0	WPP	-3.2

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	19.8	Brazil	195.8
US	25.9	Russia	140.7
France	20.9	China	56.5
Germany	13.6	South Korea	60.5
Japan	25.2	South Africa	169.7

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	0.69	OIL	52.9	0.9
USD/EUR	1.19	-0.38	GOLD	1322.3	2.4
JPY/USD	110.20	-0.76	SILVER	17.7	3.5
GBP/EUR	0.92	1.06	COPPER	311.5	1.9
JPY/GBP	6.56	1.39	ALUMIN	2117.0	1.0

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.1	1.3	0.01
US 10-Yr	2.2	-0.5	-0.01
French 10-Yr	0.7	-0.7	-0.01
German 10-Yr	0.4	1.8	0.01
Japanese 10-Yr	0.0	-105.3	-0.02

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.0
Standard Variable	4.5
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