Tatton
Investment Management

Weekly Market Comment

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BoE guides for year-end rate hike - Bluff or real?

This week's cartoon depicts aptly how roughly half of the UK's economists and market commentators chose to interpret the Bank of England's (BoE) formal warning that there may well be a rate hike before the end of this year. Not at the end of 2018 as the markets had up to now priced in, on the back of the weakening economic environment due to the Brexit uncertainties.

To make sense of what is going on, we need to acknowledge the predicament the BoE's rate setting committee members face. On the one hand, weak business investment and inflation squeezed consumers are hampering the UK's economy to the point where in growth terms the rest of Europe is suddenly overtaking. This would call for more economic stimulus, i.e. low rates for longer.

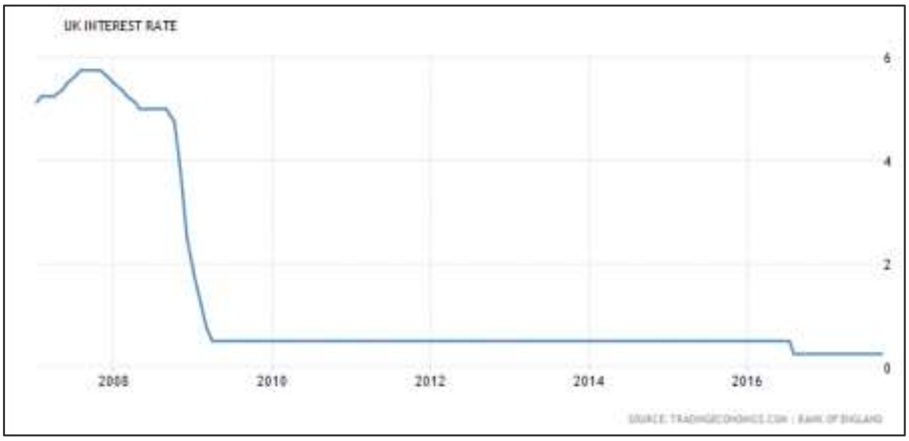
On the other hand, the UK's current inflation issue is almost entirely caused by the weakness of £-Sterling and the price rising effect this has on all imported goods and services. The BoE is explicitly tasked with guarding the UK's price stability. The prospect of higher interest rates usually strengthens a currency – this would call for raising interest rates.

With unemployment continuing to fall to lows last seen 40 years ago, and the combination of low rates and improved job security tempting consumers to take on more (credit card) debt than may be good for them once rates do rise, the BoE can also point at further good reasons to raise rates sooner rather than later.

The ideal scenario would be where the central bank could create the expectation of rate rises which strengthens the currency but doesn't actually have to raise rates which may still be harmful for the wider economy. On the face of it the BoE succeeded in achieving exactly that this week – despite all the talk that they are bluffing.

In our opinion this was mainly achieved by one of their most academically astute external committee members – Gertjan Vlieghe – in a speech presenting a cohesive argument why rate rises may be necessary now and at the same time not become an issue for the economy (more on the subject in the second article of this week's edition).

Nevertheless, the BoE's credibility is now at stake and if rates do not rise before the end of the year, then £-Sterling will plummet again. We therefore believe it highly likely now that we will get a 0.25% rate rise this year. However, this would simply return UK interest rates back to where they already were for nearly 8 years, prior to last year's referendum (see chart below).



Thereafter, further rate rises will once again be very dependent on the shape of the UK economy. To this end, we would not be surprised if the economists at the BoE are putting their hope into the same charts we have peered over during this week's investment committee. They are telling us that there is a good chance that the UK's economy will at long last come to enjoy a demand boost from export growth, as the weakness of £-Sterling is finally leading to a marked improvement in order books.

In other news this week, we were initially very relieved that the North Korean Kim Jong-un refrained from missile 'fireworks' to commemorate the country's founding day. We were perhaps even more relieved when markets almost ignored on Thursday the firing of a mid-range test missile that flew over Japan and then fell into the Pacific. It appears that 'missile fatigue' has set in and led to stress relief in markets, with bonds losing ground and equities gaining. Only in the UK both asset classes lost value over the week, but this was a straight reversal of what investors enjoyed last year when £-Sterling's depreciation led to rallying stock markets, as overseas revenue streams become more valuable and overseas investors snapped up shares that had become bargains from an external currency perspective.

The UK equity underweight across portfolios added value in this environment, but the £-Sterling underweight this brings needs to be continuously assessed. With the Global economic outlook consistently improving and even the US president finally beginning to achieve policy progress we are minded to raise portfolio equity allocations from underweight back to neutral. Higher than benchmark/risk-profile neutral still does not look like the right positioning as long as the North Korea conflict remains unresolved and thereby might or might not deteriorate investor sentiment rapidly. However, on the basis of its unpredictability it appears wrong to position portfolios in anticipation of an event that might never happen.

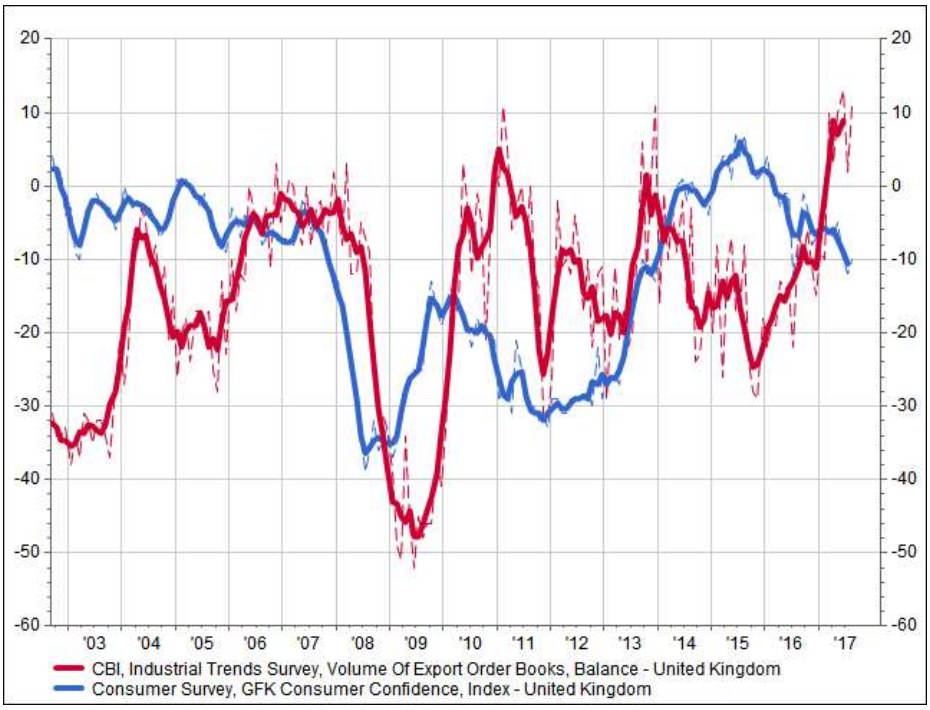
£-Sterling rises strongly – why now?

At the start of September, we suggested that £-Sterling might be oversold. At the time of writing on Friday, sterling has appreciated by over 6% against the US dollar from that point. Relative to the euro it's up over 5% and, against the yen, up over 7%. It would be nice if all our forecasts were as timely and accurate.

Rising UK bond yields (1st chart) and rising value of £-Sterling (2nd chart)

Source: Factset/Tatton IM; 15 September 2017

Our view was partly based on the idea that the current account deficit was showing signs of diminishing - confidence amongst (currency generating) UK exporters was rising while consumer confidence (a proxy for currency expending imports) was falling. The chart below shows the CBI's Industrial Trends export orders survey and the GFK consumer confidence measure:



Factset/Tatton IM, smoothed time series; 15 September 2017

Diminishing current account deficit stress relieves downward pressure on the currency.

We also felt that the recent new bout of sterling's depreciation meant that the pass-through of price rises from imported goods had not finished having an impact on inflation and that sterling's fall against the euro was likely to extend the period that inflation stayed uncomfortably high.

On Tuesday, the UK's inflation data report showed a higher rate than expected, the main consumer price index rising 2.9% year-on-year. The surveyed economists had predicted a rise of 2.8%, a small miss. Nevertheless, the weekend's press had suggested that the Bank of England and its governor, Mark Carney, was getting more concerned about inflation over the medium term. Gilts yields, on short and long maturities, started to rise, sterling started to strengthen.

Then came Thursday's Bank of England Monetary Policy Committee's interest rate decision. No rate change was expected and none was forthcoming. However, their statement more than confirmed the weekend press reports – the tone was decidedly more hawkish than in previous months – here is what they said:

"The MPC's remit specifies that, in such exceptional circumstances [the dilemma between Brexit uncertainty and rising inflation], the Committee must balance any trade-off between the speed at which it intends to return inflation sustainably to the target and the support that monetary policy provides to jobs and activity. **Recent developments suggest that remaining spare capacity in the economy is being absorbed a little more rapidly than expected at the time of the August Report, and that inflation remains likely to overshoot the 2% target over the next three years.**"

A rephrasing might be "we've kept rates low because jobs might have been lost after the Brexit referendum. It hasn't happened, and now it looks likely that wages are under pressure to rise". The effective ditching of the public-sector wage cap on Wednesday night must have been a factor in the discussion.

Friday morning saw the sharpest of the moves in the week. Yields are up another 0.11%, taking the rise across the maturity spectrum up over 0.25% since last Friday.

Interestingly, this includes yields on index-linkers, which means that the long-term inflation expectations **have not** moved up. The rationale; "if the BoE is worried about inflation, they'll raise rates so that inflation won't go up".

Friday's move seems to have been in response to a speech given by Gertjan Vlieghe, one of the external members of the Monetary Policy committee. Entitled "Real interest rates and risk", it sets out episodes that British real interest rates have been very low, looking back as far as the start of the 18th century.

He makes the case that different periods have different stable real yields (rather than there being a constant equilibrium real yield):

"the real interest rate depends on how people value the future relative to today..."

"Households especially value assets that pay off when they need the income the most: when the level of consumption is low. In a riskier world of higher volatility, there are more states of the world where consumption is very low. On average, households will therefore pay more for a safe asset, which pays the same return in all states. This mechanism depresses the risk-free rate when the volatility of consumption is higher."

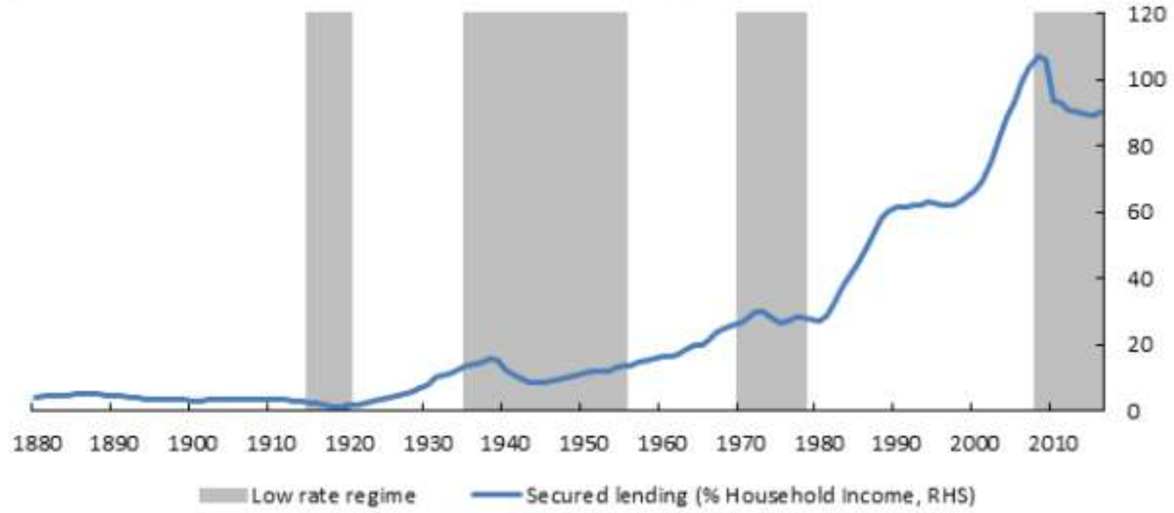
"… periods of low real rates coincided with high risk events: wars, breaks in the monetary regime, financial crises or some combination of these."

"… low real interest rate regimes have coincided with falls in the ratio of private credit to GDP, i.e. the private sector was deleveraging. ***I note that the deleveraging trend since 2010 seems to have come to an end, or at least a pause. That may be telling us that equilibrium real rates are now rising slightly****, although other drivers of low real rates do not show any signs of turning yet."*

The appendix of Vlieghe's speech manuscript has a chart showing that private sector leverage has decreased during periods of low interest rates, indeed implying that demand for credit is not always purely a function of price. Indeed, it is a function of perceived risk first and foremost.

This is important because private sector credit demand does seem to have started to rise, even though consumer confidence has been hurt by inflation. For example, UK unsecured lending (particularly credit card lending) has hit an all-time high. The chart shows what looks like the early stages of a rise.

Figure 4: Credit-to-household income ratio with real low rate regimes



Notes: The low real rate regime is defined by the Markov Switching Model in Section 5. Secured lending measure excludes impact of securitizations

Source: Bank of England's 'A millennium of macroeconomic data' database

Here's the link to the speech if you want to read and see more:
http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech995.pdf

So, what to take away from rising bond yields, a partially recovered £-Sterling and talk of increasing equilibrium real rates – are they or aren't they going to raise rates before year end?

According to market expectations - which we can read from the implicit signals of the forward looking swap rates market - this week's Bank of England 'forward guidance' has brought expectation for the UK first rate rise forward by a full year – from end of 2018 to end of 2017.

And why did the UK's central bank feel obliged to put us on rate rise notice, when the economy is suffering from inflation squeezed falling consumer demand and business underinvestment due to Brexit uncertainties. Does this not smell of a policy error of premature monetary tightening?

Well, if private credit growth is indeed picking up to levels which could come to haunt consumers once rates do rise, then the only way to prevent this is through rate rises. This would take account of the observation that the equilibrium rate consumers find acceptable is indeed moving upwards, as lower unemployment increases perceived job security and rising wages improve loan affordability.

For the near-term, the Bank of England has finished letting the currency take the strain. The Brexit negotiations may be softer or harder but they are not that relevant until they have a direct impact on jobs.

Short-term, interest rates may go up before Christmas back to where they were before the referendum (0.5%), but further rate rises will be highly data dependent, centred particularly on wage rises, but with house prices also taking a key part given that these are tightly linked to household credit creation.

The Bank of England will be watching the removal of the public-sector wage cap closely. If the policy committee thinks that actual pay awards are knocking on to private-sector wages, they will be left with no alternative but to raise rates. An inflation-targeting body cannot afford to allow a wage-price spiral to start.

They will be mindful of how this will play out politically – this is the sort of situation where governments are tempted to remove central bank independence.

Fears of inflation should start to diminish, as we pointed out earlier. Index-linkers are likely to be less attractive. All this should stabilise the £-Sterling exchange rate and prevent further price pressure from imports. Unfortunately, in such an environment of rising real yields, the attraction of equity dividends declines and in the specific case of UK multinational companies, overseas corporate earnings have a lower value in £-Sterling terms. Therefore, just as last year's Sterling devaluation led to rising UK stock markets, the opposite is on the cards now.

Since rates will only be hiked if the economy is in good shape, this should be good news for wage earners, while UK capital investments will face abovementioned headwinds. Another reversal to what we had over a number of years.

For our part, we will be monitoring further currency move potential very closely and may at some point consider to close our £-Sterling underweight position in portfolios, while likely maintaining the UK equity underweight.

Trump turns pragmatic and finally gets things passed

In recent weeks, we have seen President Trump make some unusual moves for a Republican. Particularly given his uniquely incendiary approach to partisan politics. Not only this but we have seen him (admittedly not for the first time), directly contradict senior Republicans such as Paul Ryan. We wonder if this is a sign of 'the Donald' rediscovering his independence or is it just borne of frustration with the lack of progress he has made through his first 8 months in office by relying on the Republican majority?

The first area of focus is the debt ceiling, an issue which feels like it comes around every few months and has previously led to highly damaging episodes of shut downs of the Federal Government, such as in 2013. Mr Trump has negotiated a three-month extension of the debt ceiling with the Democrats' leaders Nancy Pelosi and Chuck Schumer and they even explored what it would take to remove the national debt ceiling permanently.

President Trump has agreed to a plan decried as "ridiculous" and "unworkable" by House Speaker and Republican Paul Ryan. Who went on to say that it would lead to the Democrats gaining leverage over the Republicans. These negotiations were done on the back of funding required for ongoing recovery operations following hurricanes Harvey and Irma, but as Mr. Ryan points out, will lead to the issue re-emerging in December - although, some budget experts believe this could be drawn out as far as March 2018. Republicans fear that without the catalyst of disaster aid (hopefully) on the table, this will allow the Democrats to potentially extract more from the President than in the fraught atmosphere following hurricanes Harvey and Irma.

Further to this controversial (for much of his voter base) willingness to negotiate with the Democrats, we also find Trump willing to negotiate with the opposition regarding Deferred Action for Childhood Arrivals (DACA). The President has started to show signs of rowing back on his plan to abolish the plan introduced by President Obama, albeit in exchange for an upgrade to border security (but not including the infamous wall) link. These two cases of bipartisan negotiation could be signs of moderation, however one should wonder how long before the strategy of threatening to remove legislation to accomplish his goals will wear thin with fellow politicians and voters.

We have noticed marginally more stability within Mr. Trump's senior team, relative to his early months which had been characterized by exceptional team turnover. Michael Flynn, Sean Spicer and Reince Priebus, amongst others, have all left the White House team since Mr. Trump's election. However, it seems that (for now) the tides may have turned and there might be a bit of stability in the White House, regarding staffing at least. Is this the catalyst for the President to move more decisively to make deals with whoever looks most amenable?

Behind all this lurks the prospect of the mid-term elections next year. Following Trump's criticism of Republicans in some of the seats up for re-election, further alienating himself from some party members, we might well see if Trump's supporters are now Republicans, Trump supporters, or both. Whichever it is, we would suggest that all those who expected Trump to bail out in frustration by a least Christmas, will be disappointed – Trump's new team has just demonstrated that they know how to get things done in Washington – even if this means that the president who entered the White House on the Republican ticket now turns quasi-independent!

This latest Trump turn could become a positive for the US economy, if it means that he makes progress on his fiscally expansive policies around infrastructure programmes and (initially) unfunded tax cuts which the Republicans struggled to support. All the better if this likewise means that some of his more hair-raising projects like border walls and trade wars have to be sacrificed in return for the Democrats' support.

Investor insight - style based investing

Factor based investment has been around for decades, but has in recent years gained considerably more attention with new application terms such as 'smart beta' and 'alternative risk premia' appearing more regularly in the mainstream financial press.

One such example of factor investment is the concept of value investing. In its simplest form, the strategy seeks to identify companies whose share prices are so low relative to current earnings that investors perceive there to be very little downside, even if the company's profits worsen further from here.

Conversely, an alternative investment philosophy is to invest in companies with high predicted future earnings growth. Proponents of this strategy believe the markets have underestimated the level of growth a company is likely to experience in future. Buyers tend to pay a premium (in terms of price-to-trailing earnings) for the opportunity to participate in this extraordinary future growth.

Theoretically, investors are more willing to pay this premium for anticipated company growth when general economic growth is weak or uncertain and decent earnings growth is in short supply. The strategy may outperform as investors bid-up companies who have the potential to continue to grow despite the downturn in the economy.

At the other end of the spectrum, value should do better as economic growth returns and investors believe the worst of the storm is over. The bargain basement prices for companies who have managed to weather it are no longer justified.

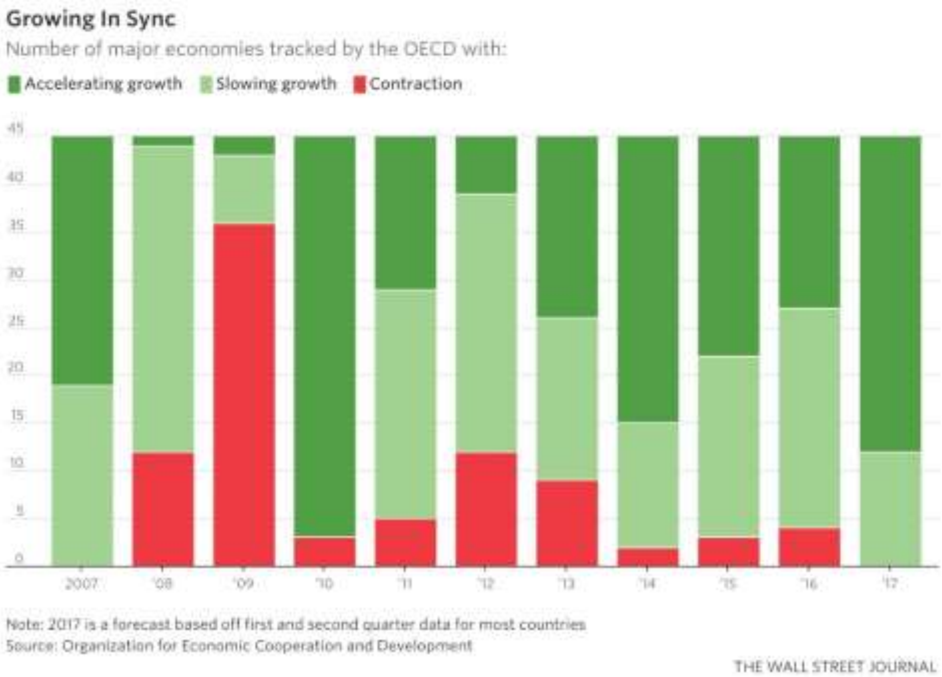


Fig. 1; Source: OECD and the Wall Street Journal 23rd Aug 2017

This year, according to OECD data, the 45 major economies that they track are displaying the most synchronised economic growth trend than at any other time since the financial crisis (fig. 1). However, contrary to the above investment insight, total return of the growth style of investment has outperformed that of value by over 14% (fig. 2).

Comparables Returns

	Price Change (%)		Total Return (%)	
	Cum	Ann (CGR)	Cum	Ann (CGR)
MSCI AC World Value	5.66	8.07	8.30	11.91
MSCI AC World Growth	16.34	22.79	17.86	26.08

Fig. 2; Source: Factset, 15th Sep 2017

An explanation for this counterintuitive outperformance during this stage of the cycle could be that many of the companies categorised as growth are true regime changers, introducing disruptive forces in the retail, media and transportation space amongst others. This can be contrasted against many of the value stocks, cheap for structural reasons to the point where they would be described as 'value traps' – i.e. looking like value, but in truth about to turn into failures. Such companies clearly sit outside the dynamics of the general global macroeconomic cycle. The oil & gas and high street retail sectors for example are facing competitive changes in their respective industries, not so much to do with global growth or the lack thereof.

Another potential reason could be due to the nomenclature of the indices. Dividing companies into two camps based upon how expensive they are and defining one as growth and the other as value has the potential to over-simplify which factors are currently more significant for a share price. Company qualities other than future growth may also be worth paying a premium for.

Management expertise, diversity of product range, low levels of debt, quality products or services and high barriers to entry could all be considered desirable company traits in a geopolitically fragile world which is undergoing rapid technological change and about to embark on the reversal phase of quantitative easing.

Companies with weak products, low productivity, bad management and high leverage could potentially be QE zombies, only being kept alive because of the cheap money provided by central banks over the past decade. Companies such as this may find themselves in for a tough time in the near future.

One of the risks of paying a premium for companies who are put on a pedestal for whatever reason is that they only really have one way to go if they fail to live up to overhyped expectations. Although the risks of absolute failure may be greater, value stocks on the other hand may be cheap due to temporary over-reactions, having only to improve slightly to see their share price rally sharply.

An interesting example of failing to live up to the hype happened at Apple's launch of the iPhone X this week. Over the past decade the company has progressed from being a highly innovative growth company to being one that is perceived as providing high quality, highly desirable products.

Unfortunately for Apple the trumpeted new face recognition feature failed to work during a live demonstration, almost instantly causing the share price to fall over 2%. (fig. 3)

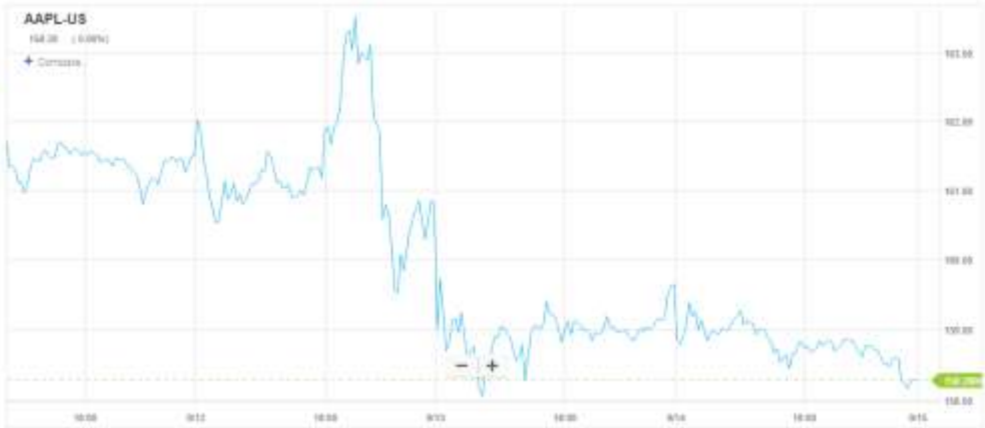


Fig. 3; Source: Factset, 15th Sep 2017

We look for more nuanced versions of investing in factors that may fall in and out of favour than the much heralded but somewhat simplistic approaches of ‘smart beta’. The old adage of buy low, sell high does still apply, but we must also carefully consider why low or why high.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7211.1	-2.3	-166.5	↘
FTSE 250	19355.0	-1.3	-255.4	↘
FTSE AS	3960.0	-2.1	-83.3	↘
FTSE Small	5650.7	-1.1	-65.6	↘
CAC	5207.7	1.8	94.2	↗
DAX	12518.8	1.7	214.9	↗
Dow	22243.2	2.0	445.4	↗
S&P 500	2497.2	1.5	35.8	↗
Nasdaq	5995.4	1.4	82.0	↗
Nikkei	19909.5	3.3	634.7	↗

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
NEXT	15.9	FRESNILLO	-11.1
EASYJET	4.9	RANDGOLD RESOURCES LTD	-7.1
RBS	3.0	POLYMETAL INTERNATIONAL	-7.1
GKN	3.0	WM MORRISON SUPERMARKETS	-6.9
M&S	2.9	ANGLO AMERICAN	-6.3

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	21.2	Brazil	181.7
US	25.9	Russia	134.0
France	20.3	China	56.2
Germany	12.4	South Korea	67.5
Japan	25.2	South Africa	164.8

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.36	2.92	OIL	55.8	3.7
USD/EUR	1.20	-0.67	GOLD	1322.2	-1.8
JPY/USD	111.04	-2.88	SILVER	17.6	-1.9
GBP/EUR	0.88	3.63	COPPER	293.8	-3.4
JPY/GBP	6.55	-0.89	ALUMIN	2098.0	-0.4

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.3	32.4	0.32
US 10-Yr	2.2	7.6	0.16
French 10-Yr	0.7	15.7	0.10
German 10-Yr	0.4	39.4	0.12
Japanese 10-Yr	0.0	625.0	0.03

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.4
5-yr Fixed Rate	1.6
Standard Variable	2.0
Nationwide Base Rate	4.5
Halifax Standard Variable	3.74

For any questions, as always, please ask!

If anybody wants to be added or removed from the distribution list, just send me an email.

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