Weekly Market Comment

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August 2017 asset class returns

Asset Class	Index	August	YTD	2016
Equities	FTSE 100 (UK)	1.6%	7.3%	19.1%
	FTSE4Good 50 (UK Ethical Index)	1.9%	4.0%	12.6%
	Dow Jones Euro-Stoxx 50 (Euro-Zone)	2.4%	14.9%	20.1%
	S&P 500 (USA)	2.6%	7.3%	33.6%
	Nikkei 225 (Japan)	1.3%	4.5%	23.6%
	MSCI All Countries World	2.5%	8.6%	26.7%
Bonds	FTSE Gilts All Stocks	1.9%	2.5%	10.1%
	IA Sterling Corporate Bond Index	1.0%	4.8%	9.7%
	Barclays Global Aggregate Bond Index	3.3%	2.8%	21.8%
Commodities	Goldman Sachs Commodity Index	1.5%	-10.7%	32.8%
	Brent Crude Oil Price	1.8%	-11.6%	81.8%
	LBMA Spot Gold Price	5.5%	8.0%	30.2%
Inflation	UK Consumer Price Index (annual rate)	0.6%	1.9%	1.08%
Cash rates	Libor 3 month GBP	0.03%	0.2%	0.6%
Property	UK Commercial Property (IPD Index)	0.8%	6.5%	1.4%

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

QT to reverse QE and 2-year transition period to soften Brexit

There had been substantial anxiety in capital markets community about the day the US central bank would announce the reversal of its monetary policy of quantitative easing (QE) towards quantitative tightening (QT). Well, the day came and went, and it has still been a good week for investors. Stock markets remained positive and bond markets remained calm.

Earlier in the week, the proliferation of threatening language between US president Donald and ‘Rocket Man’ Kim had been ignored by markets. Likewise, Theresa May’s Brexit speech to the EU in Florence on Friday was highly anticipated, but despite disappointing on the side of detail markets took it in their stride.

It almost seems as if all the big worry points of the past have suddenly lost their relevance and all capital market forces care about is consistency of central bank messaging and action, current macro-economic data and the next round of corporate earnings results.

True, economic data paints an encouraging picture, especially across the Eurozone and even the UK had some strong retail sales numbers to report for August, despite inflation climbing even further. But entering uncharted monetary policy territory as the US Fed for the first time in history unwinds QE by cancelling money it created (‘printed’) some years ago, or hearing how two nuclear armed nations threaten each other with total destruction may also point to the proverbial ‘quiet before the storm’.

As our regular readers know, we stick to the facts first and foremost, but will take market sensitivities into account, as they determine how quickly directional changes can occur.

At the moment both feel relatively reassuring. The major global economic areas continue to expand – some more dynamically, some less - but still in unison. Bond yields have recently recovered again as the demand for government bonds over war fears reduced.

Beyond the North Korea issue, political risk is reducing as well. We reported last week that there is now a 'risk' president Trump will actually make some policy progress around his tax reduction and infrastructure improvement plans. Germany will vote on Sunday, not whether Angela Merkel will be their head of government for the next 4 years, but merely in coalition with whom. The interesting insight will only be how many votes the populists on the right and left will gain. And finally Theresa May's indication that an extension of quasi EU membership for at least 2 more years after the formal Brexit in 2019 will be necessary as a necessary transition period, only confirmed what most market strategists had seen as an inevitability anyway.

All in all not a bad position for the usually less benign month of September. Whether the constructive environment can last, depends on a number of factors that are very hard to predict. Will the US, China and Russia find a way out of the North Korea conflict that minimises collateral damage? How will China's president Xi steer the second largest economy once the 19th party congress makes him as powerful as Mao? And most importantly from an investment point of view, how will bond investors react, once they realise that the US economy continues to thrive despite the Fed's QE reversal - which would leave them holding assets whose yield may not even compensate them for more normal rates of inflation for years to come.

In conclusion, it would be unwise to be complacent, but there is also no reason for particular precautionary measures as there may have been at the beginning of the year. On this basis, Tatton's investment committee has decided to close the US$ underweight position across our investment portfolios by increasing our US equity position back towards a benchmark neutral position. While we continue see more equity upside from our overweight position in European stocks, we believe the US$ weakness is highly likely to turn to at least temporary $-strength before the end of the year.

US Fed announces QE reversal: Trading inflation for employment?

The US Fed's announcement this week to begin reversing quantitative easing (QE), imaginatively referred to as quantitative tightening (QT), was of little surprise to us or the markets. Neither was the Fed's tentative approach to the start of its liquidity reduction programme – effectively reducing the level of QE stock on its balance sheet by ~ $10bn per month.

Currently, the Fed reinvests any cash it receives from coupons and maturing issues on the large volume of government bonds and mortgage-backed securities (MBS) it has purchased since 2008 (and throughout the financial crisis to date). As noted in our previous articles, the Fed now holds $4.46tn worth of assets on its balance sheet, which is a very large number, but still 'only' amounts to 24% of the US economy as represented by US GDP.

When the tapering programme begins in October, it will gradually sell these fixed interest bonds back to the market. In the opposite direction of the QE flow, under QT, the cash received back by the central back in return for the bonds will be ‘retired’ by computer keystroke, just as it had been created a few years ago for the QE bond purchases.

The reason why there had been considerable market apprehension about the onset of the QE unwind process is that it constitutes just as much a monetary experiment as QE was – uncharted territory. Therefore, if implemented without due care and consideration for market sensitivities this could result in a bond market shock on falling bond prices which could undo all the positive economic stimulus effects to date. It would therefore be wise to demonstrate to markets through a very incremental start to the process, that while without historic precedent, QT is nevertheless still only monetary tightening – just by different means than a rate rise. Such careful management and over a long period, with a tapered approach to any sell-back, consistent with managing money flows and interest rates toward target inflation is exactly how the Fed is planning to proceed, gradually.

Given the Fed had signposted its policy development over many months and the announcement confirmed the very gradual approach, markets largely took the news in its stride. Yield on the 10-year Treasury was up 3bps to 2.27% immediately after the Fed’s announcement, while the more policy-sensitive two-year yield increased by a little more, from 1.38% to 1.43%. Even the USD currency market did not stray beyond its usual daily volatility band of +/-0.5%.

Now that the Fed has got the initial news on QE turning QT out of the way, all eyes will again turn to the Fed’s interest rate setting policy - this is where it starts to get interesting. After four 0.25% rate rises so far, the Fed’s committee appears divided over the urgency of further rate increases. After given a string of surprisingly low inflation figures, which is of course one of the key metrics determining monetary policy and no meaningful pick-up in average wages this is understandable.

Even though inflation as measured by CPI increased in August (to 1.9%), this comes on the back of a number of months of lower inflation readings, and it is questionable whether this latest reading provides a barometer for the rest of 2017 and beyond. Moreover, price inflation (growth) remains relatively flat despite the summer uptick in inflation and the Fed is right to be a little concerned about the durability of underlying inflation.

The Fed has reduced its estimate for core inflation at the end of 2017 to 1.5% (from 1.7% in June), with core inflation - excluding food and energy - not forecast to return to the Fed’s target level of 2% until 2019. However, despite this apparent weakness in the data and uncertainty on inflation trends, markets still expect the Fed to raise interest rates again in December 2017. Why?

Goldman Sachs believe that the Fed is ‘on track’ for another rate hike in December because the Fed may be persuaded that diminishing slack (in the economy) will eventually lead to higher inflation and that easier financial conditions continue to support the growth outlook.

While we agree that the US economy continues to improve; revised GDP estimates indicate an annualised rate (after inflation) of 3% from April to June and the strongest quarter since the beginning of 2015, it may actually be the continuing improvement in the employment data that is really driving Fed thinking and market expectations for more near term rate hikes.

Unemployment is forecast by the Fed to drop to 4.1% next year (and in 2019), compared with 4.2% previously. Unemployment is now at very low levels, in relative and absolute terms (see graph below). Combined with diminishing slack in the system, the US employment must now be approaching a rate at which labour markets are set to tighten and wage pressures will begin to grow.

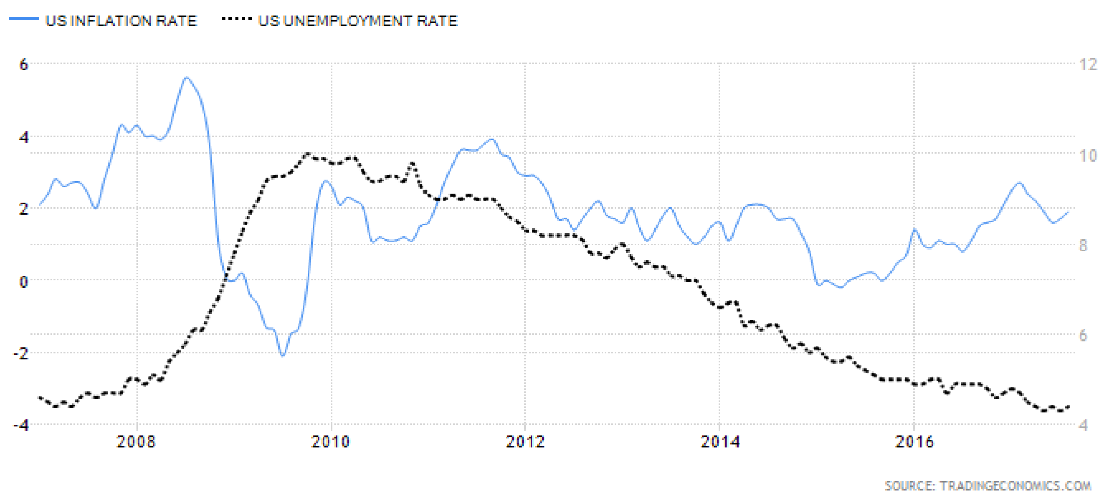
Indeed, this appears to the view of Ms Yellen (Chair of the US Fed), who is normally known as a dove – a person reluctant to raise rates unless absolutely necessary. She considers that a labour market-driven framework for inflation should determine Fed monetary policy which was further evidence by her recent statement that job gains averaging 175k per month in 2017 are well above the 100 -120k level that would be consistent with a stable unemployment rate. She stated that "while there are risks that inflation could continue below 2%, which we need to take account of in monetary policy, monetary policy also operates with a lag and experience suggests that tightness in the labour market gradually tends to push up wage and price inflation".

This reflects some conventional economic thinking on the potential trade-off between employment and inflation (first developed by the economist William Phillips, and generally illustrated using something called the *Phillips Curve*). The theory suggests that inflation increases when a growing economy results in a tight labour market, whereas unemployment increases during times of recession, i.e., lower unemployment tends to be associated with higher inflation. Is there some form of trade-off between the two variables?

It is reasonable to assume that immediately after the Global Financial Crisis (post-GFC) there will have been a significant surplus of labour, which could be (and has been) used to meet growing demand during recovery, without the need to raise wages (very much). However, as the economy turns from recovery to growth, labour should become increasingly scarce and so higher wages may have to be offered by companies (and the public sector) in order to obtain the required labour resource.

We assume the Fed's references to the ongoing *tightness in the labour market* is based, at least to some extent, on the *Phillips Curve*. As the graph shows, US unemployment (right hand scale) has fallen considerably since 2010, and although the graph is high-level and cannot be used to show a definite (negative) relationship between inflation (left hand scale) and unemployment, over the last 3-4 years there is the expected divergence in the two variables (inflation up/unemployment down) is still observable.

A high-level view of US inflation and unemployment



Source: TradingEconomics, Sept' 2017

One of the key questions for the Fed therefore is whether tightening labour markets will set off wage pressures, which in turn will drive underlying inflation. Data on wage pressures and settlements would be needed to understand whether the present low levels of unemployment are in fact generating labour scarcity and wage pressure, or whether productivity advancement and non-demand/structural factors are mitigating some of the potential wage pressures.

However, these are only one of the (many) potential considerations for the Fed. While the US economy is growing and markets are suggesting there a ~60% chance of rate hike in December 2017, we believe that the Fed's policy intentions are finely balanced and highly data dependent. It is still three months' worth of data until their December meeting and should employment data tail off, then we would not be surprised if the Fed pushed its intended rate increases into 2018. On the other hand, should unemployment remain at current lows, then the determined tone of this week's meeting informs us that the Fed will push ahead with further rate rises, regardless of an absence of imminent inflation pressure. Just as they (rightly) did in the late 1990s.

A Chinese party congress that matters

The Communist Party of China is preparing for its National Congress next month, an event that will define the direction of the nation's politics for the next five years. The congress will be the party's 19th, and will see top leadership positions change hands at all levels of government across the country. It is widely expected to be a consolidation of power for President Xi Jinping, who will likely be left without any major political rivals after the five-yearly congress opens on October 18.

As usual before important meetings, the ruling communist party has stepped up its security measures and tightened dissenting voices, with even the famously pro-Beijing Hong Kong broadcaster Phoenix TV being pulled off air with scant explanation. "Strong hands" are needed to deal with the "absolute principles" of stability and development in the run-up to next month's proceedings, Xi told security officials, as reported by official Xinhua news agency.

How significant is the congress for investors? There is no doubt that the past few years have seen politics take centre stage in markets. In the world's second-largest economy, this is particularly true, given the state's absolute control of both the economy and wider society. More recently, as discussed in these pages, Chinese officials have taken to what we termed a 'whack-a-mole' approach to economic issues, such as the bourgeoning private debt and the shadow-banking sector – in addition to the seemingly perennial desire of citizens to move money abroad.

In our view, Xi's consolidation will make the patchwork approach of recent times more, not less, likely. Chinese premier and Xi's main rival Li Keqiang is likely to see his influence greatly diminished come the turn of the next five-year-plan. Even if Li retains his position, his allies are being removed. This will embolden the President to continue the patchwork intervention strategy employed recently. What's more, Xi will now be in a position to crush dissent among large corporate leaders. Market-oriented voices will be even quieter.

Since assuming power five years ago, Xi has overseen a wide-scale crackdown on corruption that has claimed the heads of many high-profile party members. It has also resulted in a massive centralisation of power – even by Chinese standards. Many experts already believe President Xi to be the most powerful Chinese leader since Mao Zedong, and after the 19th party congress reappoints him this will be in no doubt.

However, with the revival of Mao's leadership style and personality-cult-politics also comes the revival of his communist beliefs. Contrary to leanings of his predecessors – which at times have verged on laissez-faire capitalism since Deng Xiaoping's reforms – Xi appears to be far more of a traditional communist leader, where party loyalty comes first and personal enrichment appears frowned upon, even if it is from legitimate business or investment interests rather than corruption.

Xi's strong-arm interventions have been economy and market's friend in recent times. Therefore, in terms of immediate market impact, we don't expect much. The authoritarian congress won't throw up the political shocks we've become accustomed to recently. As ever, China's impact on global markets will be more long-term and systemic, without necessarily immediately affecting valuations. The economy is strange in that its health is vitally important to global investors without its assets comprising a significant portion of international investment portfolios.

One of the most immediate concerns about China is its currency. International markets were stunned two years ago, when the government allowed the RMB to rapidly devalue against the USD. The issue was so great that then Presidential candidate Donald Trump made denouncing Chinese "currency manipulators" one of his central campaign pledges. More recently, and to much less furore, the RMB has been moving substantially in the other direction particularly against the USD.

There have been a number of good reasons to pursue a stable-to-stronger RMB. In the near-term, it quietens the noises coming from the US. China would like the RMB to be the Asian reserve currency of choice. From an economic perspective, while a strong RMB hurts China's price competitiveness, it provides an incentive for the ongoing rebalancing of their economy towards domestic demand (out of low-tech manufacturing and in to high-tech goods and services).

At the start of this year, it felt as if the RMB was incipiently weak. The government has been adept at using both market and regulatory pressures to reverse that perception. It tightened pressure on the insurers responsible for large overseas asset purchases; it succeeded in opening up Chinese assets (both equity and bonds) to foreign investors; it squeezed the large "short" positions among large Chinese corporates through reserve requirements and interest rate costs. For the first time in three years, August saw net inflows to China, with $9 billion coming into the country from abroad.

However, this use of the currency smacks more of "whack-a-mole" rather than an over-arching plan. With Xi at the helm, the relaxing of restrictions is likely to last only as long as it's useful. With property prices resuming a weaker trend and thus reduced domestic demand from further construction, the need for exporters to be stable becomes greater again.

Two weeks ago, the authorities announced that they were relaxing restrictions on selling the RMB. Speculators, badly hurt by the rally, may not rush to short the currency. However, individuals have yearly limits on foreign currency purchases and tend to want to make full use of them each year. The RMB has seen downward pressure build towards the end of each of the past 3 years and it would be reasonable to expect it again.

From a longer-term perspective, the issue for the RMB is simply that the Chinese seem desperate to move money abroad. With Xi consolidating power, that desire to sell RMB is only going to get stronger. Many fear the financial crackdowns associated with Xi's leadership, and many also want to get their money out of the country before any potential political persecution.

More generally, there is fear that the government's stabilising interventions will eventually cause more harm than good for business leaders. The party leadership's first priority will be ensuring a good social outcome from any economic slowdown. That means that, when the inevitable next slowdown comes around, someone will be asked to bear the pain so that Chinese society doesn't suffer. For Chinese business leaders and for foreign investors, the question is: Will it be me?

Toys "R" Us bankrupt – end of the 'lazy economy' era?

The news of Toys "R" Us' bankruptcy of at the start of the week took many by surprise, including it seems, its suppliers.

However, there may be a bigger story in play around the demise of easy money 'zombie' companies, than what some might simply view as the 3rd largest retail bankruptcy in history, a result of high post-LBO (Leveraged Buyout) debts and crushing competition from Amazon and online retailers.

Putting aside Amazon's growing impact on the traditional 'bricks and mortar' retail sector for a moment, we believe the larger and more interesting theme is actually that the low cost of finance that quantitative easing (QE) enable created what some economists term a lazy economy. N economy where unviable companies can survive as there isn't the usual scarcity of capital. Such 'zombie' companies may be seeing the writing on the wall as monetary policy normalises and yields gradually rise.

The question that arises as normalisation continues is: Will we witnessing the return of creative destruction as increased capital allocation scrutiny returns to the economy?

Before getting onto that argument, let us look at US retail and the reasons that led Toys "R" Us to seek Chapter 11 (C11 - bankruptcy protection).

The woes of the US retail sector are well-known. Toys "R" Us is the 27th retail casualty in 2017 alone, with assets of $6.9 billion, 3rd place behind K-Mart's $14.6 billion (2002) and Federated Department Store's $8 billion of assets (1990). Toys "R" Us takes 2017s total defaulted retail debt to $14 billion.

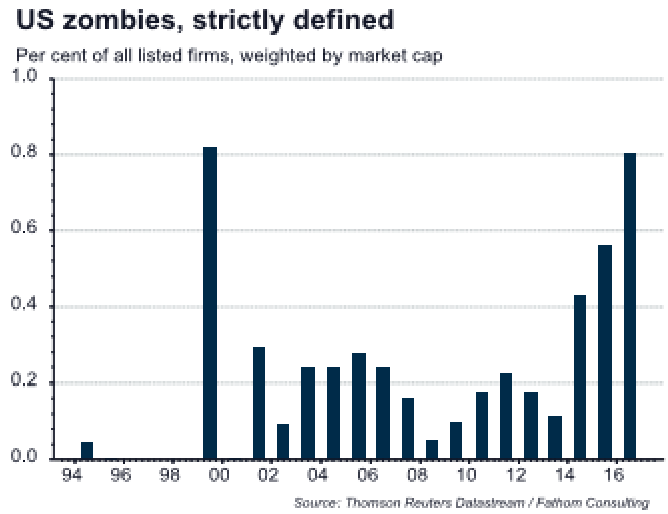
In its Chapter 11 regulatory filing, Toys "R" Us cited "expensive debt service", "unrelenting competition from ecommerce and big box retailers" and the news that it was considering C11 appears to have turned into a self-fulfilling prophecy.

40% of its suppliers had restricted delivery of products and demanded up-front cash payments, ahead of the crucial Christmas inventory build-up, worried they would not get paid. Toys "R" Us generates 40% of sales during Christmas alone, meaning it could not go into the season without an open supply chain.

Amazon has had a clear impact on the retail sector, particularly among more specialist firms like Toys "R" Us and as supermarkets continue to widen their offerings. For once, the 'blame' might actually lie with its private equity owners and the debts placed on the firm as part of the $5 billion LBO in 2005.

Servicing its $5 billion debt was costing the firm $400 million per year. This was hoovering up cash and restricting Toys "R" Us' ability to invest. Essentially, the company had become a 'zombie', merely surviving by paying interest costs, sucking up valuable capital but with no ability to grow or bring new innovations to market.

We suspect Toys "R" Us is not alone in this situation. Ultra-loose monetary policies have had unintended consequences, the biggest of which appears to be a breakdown in the efficient allocation of capital by providing unprofitable companies a lifeline (cheap debt costs), which, as Toys "R" Us found, restricts investment and restrains productivity growth.



Research by Fathom, one of the UK's better known independent investment research companies, conducted on 10,000 US firms suggests that the problem of zombie firms has grown quickly over the past few years. Fathom calculate that only once in the last 25 years, the share of US firms that could be classified as a zombie were higher than it is today during the dotcom bubble of the late 90's.

The Bank for International Settlements (BIS) define a zombie as a firm with an interest coverage (EBIT/Interest Expense) of below 1, on the condition the firm is at least 10-years old. Put simply, an established firm who's operating profit does not cover its interest payments. Low interest rates leading to growing numbers of zombie companies might at least partially explain the low productivity growth mystery of this cycle. Cheap capital tying up scarce (human) resources that could find more productive uses.

While some might think that a rise in zombie bankruptcies could persuade the US Federal Reserve (Fed) to pause further monetary tightening, we believe the opposite may now be true. When unemployment was sky-high it may have been desirable to keep as many job providing companies going as possible. But now the economic renewal process that bankruptcy enforces and the famous economist Friedrich Hayek termed creative destruction would hardly pose systemic risks.

By staying on current course and raising rates, the Fed could help free up resources for new innovative firms. Essentially, this process is, old unprofitable firms giving way to new profitable firms. Some economists consider creative destruction to be "the essential fact about capitalism".

As Fathom put it, "we think that low interest rates are stifling the forces of creative destruction. This is reflected by a fall in the corporate failure rate and the corporate birth rate". This means that western economies have become less dynamic than it was during previous business cycles.

It is not all doom and gloom. Although there is a higher number of zombies, the US corporate sector is in good health and corporate profits are near all-time highs ($1.7 trillion). The Fed's current tightening cycle appears to be benign and with possible US tax cuts on the horizon, the fact that the US economy is still creating enough jobs on a monthly basis, means that it could absorb zombie induced job losses without falling into a recession.

It is also interesting to note that Toys "R" Us went into administration even before their costs of debt finance had actually risen. Tightening payment terms by their suppliers became the catalyst for the insolvency filing. However, this only came after Chapter 11 plans had leaked, which leads us to believe that the toy retailer's management had more foresight than others and believed their corporate weakness was their LBO related debt burden rather than being a truly unviable zombie company without a trading future.

Future will tell and perhaps without the debt servicing costs the company can modernise and revive its business model as an independent global toys retailer. This may even find support from the big toy brands before they become entirely dependent on the 'behemoths Walmart, Amazon and Chinas even bigger Alibaba.

As to fears over contagion in capital markets as private equity funds are hit with the collapse of the businesses they saddled with so much debt. Well, once again, not systemic and more akin to the paper losses the bursting dotcom bubble inflicted on the highest risk investors. Those investors with well diversified portfolios only experienced a temporary downturn and soon experience a full recovery. At the moment, the affected private equity funds have already fully provisioned for the expected losses and are still showing healthy annual returns overall.

In such an environment rising numbers of corporate defaults may still be unpleasant for those affected, but for the broader economy they are yet another sign of economic and financial normalisation, but not renewed financial crisis.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7311.5	1.3	96.0	↗
FTSE 250	19499.2	0.6	121.0	↗
FTSE AS	4008.7	1.2	46.3	↗
FTSE Small	5648.2	0.1	6.0	↗
CAC	5283.1	1.3	69.2	→
DAX	12597.1	0.6	78.3	→
Dow	22352.1	0.4	83.8	→
S&P 500	2500.3	0.0	0.1	→
Nasdaq	5932.1	-0.9	-55.9	→
Nikkei	20296.5	2.5	489.0	→

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
JOHNSON MATTHEY	23.0	CAPITA	-9.4
ITV	6.2	HIKMA PHARMACE	-6.4
BABCOCK INTL GROUP	6.1	PROVIDENT FINANC	-5.6
BAE SYSTEMS	5.9	MEDICLINIC INTERN	-3.7
BP	4.4	SMITHS GROUP	-3.4

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	23.8	Brazil	203.7
US	25.9	Russia	150.0
France	20.6	China	58.5
Germany	12.5	South Korea	70.1
Japan	25.2	South Africa	190.5

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.36	-0.32	OIL	56.8	2.1
USD/EUR	1.20	0.27	GOLD	1296.2	-1.8
JPY/USD	111.94	-0.99	SILVER	17.0	-3.4
GBP/EUR	0.88	-0.57	COPPER	293.3	-0.5
JPY/GBP	6.59	-0.56	ALUMIN	2171.0	3.5

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.4	4.3	0.06
US 10-Yr	2.2	2.1	0.05
French 10-Yr	0.7	3.2	0.02
German 10-Yr	0.5	4.6	0.02
Japanese 10-Yr	0.0	17.2	0.01

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	2.0
Halifax Standard Variable	4.5

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