Weekly Market Comment

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Lothar Mentel

CHIEF INVESTMENT OFFICER

Samuel Leary

HEAD OF INVESTMENT COMMUNICATIONS

Isaac Kean

INVESTMENT WRITER

Duncan O'Neill

www.tattoninvestments.com Twitter: @TattonIM

125 Old Broad Street, London EC2N 1AR. Tel: 0207 190 2959

All-time highs and Q3 results outlook: Reasons to be fearful or optimistic?

While the general public struggled with lack of political progress around the world, most western stock markets reached new highs. Fitting that this happened as we passed the 10th anniversary of the pre-GFC (global financial crisis) stock market highs.

On the political side, it was frustrating to observe that the two sides of the Brexit negotiations still appear to be focusing on their differences, rather than trying to establish coming ground in order to move forward. Similarly, in Spain, the Catalonian regional government and the Spanish government in Madrid exchanged tit-for-tat threats, rather than following the explicit wish of their population to engage in talks to find a better solution. For the time being, the Catalans seem to want to avoid having their very own ‘Brexit moment’, and so the optimists will be hoping for de-escalation over the coming weeks. Over in the US, president Trump’s keenness to reverse as much of Obama’s reconciliation deal with Iran – as well as his Affordable Care Act (ACA/Obamacare) – is equally frustrating.

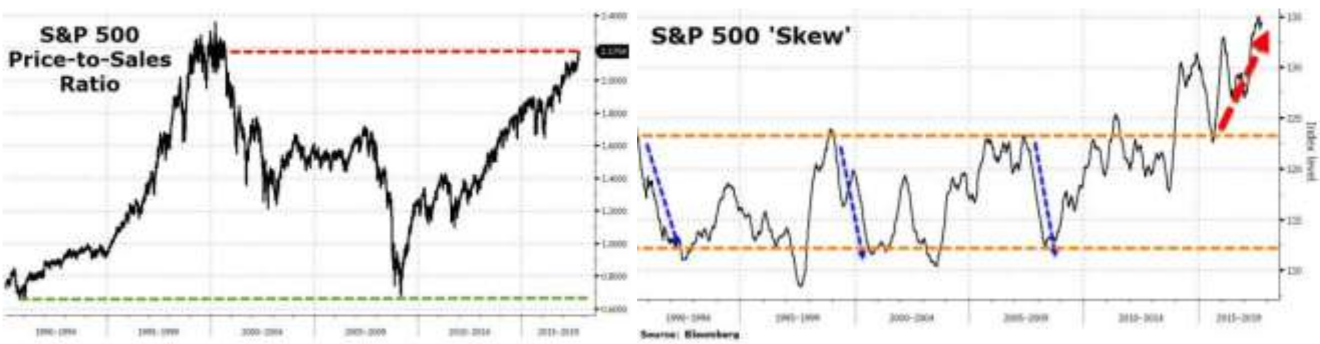
For investors, it is therefore more uplifting to focus on the world of the actual economy, and the companies whose shares we invest in. Against the aforementioned historical and present stock highs, it is worth reflecting on both, and exploring what they tell us about the likely future course.

More cautious investors were keen to focus on the 10th anniversary of the previous market peaks for both the S&P500 and DOW Industrials. Back then, the Dow hit a record high of 14,000 and President George Bush Jr was on TV stating the US had a “vibrant economy”. As we now know, that peak was followed by a fall of more than 50%, as the financial crisis later gripped the world.

Source: Bloomberg

As can be seen in the chart above, those who invested into a multi-asset portfolio at this historic stock market peak would have found bonds and gold to be the best immediate counterweights to their stock market losses, while, over the years since then, stocks themselves made such a vigorous comeback that they have beaten bond returns, and will soon leave gold behind as well.

Some commentators to last week’s high point and anniversary cited statements from central bankers, like the US Fed’s Williams, cautioning that they “don’t want there to be any excesses in financial markets” as reasons to worry, given the strong market performances over the past few years. Others point to financial ratios like high Price-to-earnings (PE) and Price-to-sales (currently 2.2x) coming within 4% of the March 2000 peak (see chart below).



Source: Bloomberg

This may have led to the apparent rise in the S&P500 SKEW Index (a measure of tail risk or potential risk in financial markets), amid expectations of some kind of market pullback.

But are these fears justified?

We believe there are good reasons to be more optimistic, and expect further gains in asset prices. Admittedly, these might be more muted relative to previous stronger years, when central banks' QE programs provided additional support.

Those reasons are twofold:

- Synchronised and fairly resilient global economic fundamentals
- Further growth in corporate earnings

We note that economic activity levels during Q3 have remained robust, with strong forward-looking Purchasing Manager's Index (PMI) prints and the US ISM (manufacturing) index reaching its highest level since 2004.

Additionally, we had upgrades to global growth expectations from the OECD in September and the International Monetary Fund (IMF) this week. The OECD projects that world GDP will grow 3.5% in 2017 and a quicker 3.7% in 2018. It would seem that the current upturn in momentum has "become more synchronised across countries" as "investment, employment and trade expanded".

The IMF said that the world economy is enjoying the broadest and fastest rate of growth since 2010, on the back of rising business investment (!), which is improving longer-term economic prospects. The IMF broadly agrees with the OECD's projections and expects global GDP to expand a stronger 3.76% in 2017 (+0.4pp) and another 3.7% in 2018.

These expected rates of growth are much stronger than those seen earlier this decade, allowing the world to move back to the 30-year longer-term average. Better global growth prospects are supported by continued low inflation across the world and low interest rates. The winding down of fiscal austerity should additionally help boost household incomes.

These are powerful tailwinds for the prospect of improving corporate earnings, which form the ultimate foundation for share valuations and thus sustainable stock market levels. 2017 has so far been a good year for company profits. Q1 in the US delivered double-digit annual earnings growth of 14% and another 11% in Q2, but earnings growth was even stronger in Europe with an annual rise of 25% in Q1 and 14% in Q2.

Compared to these past results, consensus projections for Q3 in the US have more than halved over the past six months, from 9% at the beginning of the quarter to just 2.8% for the S&P500, and 12% to 6% for Europe. Ironically, these reductions actually lower the hurdle rate for companies, and make it easier to deliver positive earnings surprises.

For Europe, in 2018, consensus expectations predict just 8-12% EPS growth. This is the lowest hurdle rate for companies since 1990. It would seem that beating the current consensus might not prove to be that difficult.

At a sector level, financials (banks) should continue to see earnings improvements on the back of rising credit growth and higher bond yields, which helps expand Net Interest Margins (the measure of profits at banks). Additionally, the earnings base itself for the financial sector still looks low relative to history.

The recent rebound in commodity prices during Q3 could likely provide support to the earnings of the Energy and Mining sectors. Some analysts believe that the Energy sector in particular could move higher, given fairly depressed relative share price performances, and with oil moving near the top of the current higher range. Like the US, financials and commodities in Europe appear to be driving a large bulk of EPS growth in 2017. But, growth looks more balanced next year across multiple sectors. Industrials, Staples, IT and Telecoms are all predicted to post double-digit EPS expansion in 2018.

In a historical context, the EPS base of the Eurozone is still some 24% below the peak reached during the last cycle, according to JP Morgan, meaning Europe offers greater upside potential relative to the US. On the downside, a stronger Euro could act as a headwind, especially for exporters.

If the 2018 Eurozone GDP growth forecast of around 2% materialises, then investors could see double-digit full year EPS growth. JP Morgan estimate that across Europe the leverage between real GDP growth and nominal EPS growth rate is 7:1. We think this helps support our positive stance on European equities.

That is not to say we are negative on US equities, particularly given the fact that, on current estimates, analysts appear to be only pricing in around a 60% chance of tax reform, where each 5% cut in taxes equates to an EPS boost of $5 per share. There is the chance that the recent US hurricanes have a negative impact on profits, but, given the scale of earnings downgrades, it seems that this effect has already been priced in to estimates (or more!).

The combination of a stronger, more synchronised global economy (UK notwithstanding) and more stable commodity prices should allow for improved corporate pricing power. Inflation readings appear to have hit an inflection point and are possibly now on an upwards trend. Correspondingly, Eurozone selling price expectations on consumer goods have recently reached new highs. JP Morgan estimate that the spread between output prices and wage costs is trending higher, which has positive implications for both sales and profits growth.

We also note that sales growth in the US is tracking near its 5-year high, and firms are increasingly able to pass those revenues to the bottom line. This is possible through increased productivity from business investment measures, given the continued low cost of capital and scarcity of qualified labour.

Those worried that current elevated levels of economic growth are unsustainable (which would make markets vulnerable to sell offs) should be aware that, historically, from the point at which the ISM index hits a reading of 60, stocks rise 70% of the time in the following three and six months.

Amidst the political frustrations, much investor focus will, over the coming three weeks, be on the Q3 corporate results announcements. While we expect certain sectors and companies to report a hurricane related slump in profits, with the so-much-lower hurdle rate, the inevitable positive earnings surprises could act as a positive catalyst that drives further upward momentum in equities as we head into 2018.

Central banks' monetary policy: Have they got it all wrong?

We observed numerous press articles over the past few weeks questioning central banks' current policy stance and asking whether central bankers are facing a crisis of confidence. In short, the theme appears to be: Central bankers' continuing adherence to economic models that may have worked in the past may be misplaced in the current environment. Specifically, central bankers are being challenged over whether they have failed to properly understand today's dynamic of inflation. Or, whether they may be focussing too narrowly on general price inflation, when asset price inflation, in the current environment, may pose the same or perhaps an even higher risk to ongoing economic stability and prosperity.

While there may be some merit to some of these lines of argument, many of the points made in support of the overall suggestion that central banks have run out of policy options appear inaccurate. Moreover, if these reports were entirely accurate, then markets, bankers and the public would presumably have greater concerns than a – now familiar – story that (conventional) economic theory is wrong.

As we have previously said, economic models can be powerful tools for understanding and explaining market developments and macroeconomic relationships. To the extent that markets and economies continually change and adapt, then so will the economic models. This is perhaps best illustrated by the policy actions of central bankers immediately after the global financial crisis (GFC) in 2008.

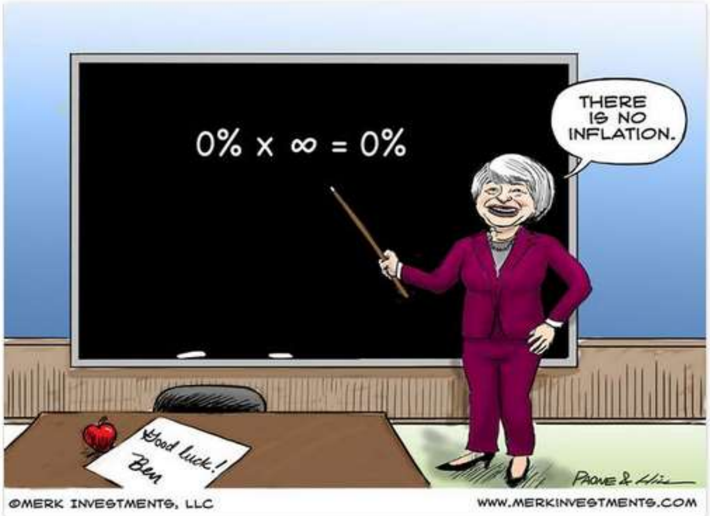
From an economic perspective, we are still in unique territory, as demonstrated by negative real interest rates and voluminous programmes of quantitative monetary easing (QE). Therefore, it is perhaps unsurprising that certain conventional theories appear to be less applicable. However, it is important to observe that, back in 2008/2009, there was little in the way of economic theory (and even less previous experience) underpinning the actions of central banks, particularly in respect of QE.

QE, as a relatively extreme form of accommodative monetary policy, was therefore largely experimental, and the evidence from the countries that have undergone this so-called "portfolio rebalance" is limited, and could not be described as conclusive. That said, comparison with the economic fallout after the previous global financial crisis of 1929 indicates that QE – and a central bank monetary policy of low (and negative) interest rates – prevented the global recession of 2009 turning into a far longer-lasting depression of economic activity. It also suggests that monetary policy has since provided a stability of financial markets, allowing a gradual recovery of both the financial system and the global economy.

Nevertheless, the economic context in which central banks are now operating is atypical. While every business cycle will of course be different, the current economic cycle and the preceding events are unique. Central banks have clearly recognised this, and, far from adhering solely to conventional economic theory and models, central banks have taken account of a multitude of factors, data and different models in developing monetary policy over the last decade.

We previously wrote how the US Fed, the Eurozone's ECB and other central banks are looking to a wider-than-usual array of metrics and models to gauge the effects of monetary policy and/or the need for further policy action, like FCIs (Financial Conditions Indices). More generally, the US Fed and other central banks also routinely assess non-domestic economic conditions, financial and currency markets, and political developments etc.

Economic models exist in relation to all of these areas. However, understanding the combined effect of all these factors is an extremely complex exercise, particularly in the current policy climate. Notwithstanding, one area that should be easily measurable, readily understood, and in which critics of central banks may be right is the dynamic of inflation.



Put simply, after years of the threat of deflation undermining financial and economic normalisation, central banks have effectively been keeping their fingers crossed for a general and sustained return of normal inflation, on the back of the gradual return of a more balanced economic environment. However, one of most conventional sources of inflation – the labour market – has recently not contributed any meaningful inflationary pressures, despite record levels of low unemployment in the US, UK and elsewhere.

More generally, inflation in many developed economies remains surprisingly low despite positive economic growth, labour shortages and very low cost of capital. Even Janet Yellen (Chair of the US Fed), who is known as proponent of the more traditional monetary teachings, admits that they may have got it wrong on inflation. She recently stated that "*our framework for understanding inflation dynamics could be mis-specified in some fundamental way*". This is a very recent observation by Yellen, following earlier suggestions by the US Fed that the recent drop-off in US inflation was transitory. It is not just the US Fed that is struggling with the inflation puzzle, the Bank of England, the ECB and the Bank of Japan all face the same conundrum.

The current central bank (monetary) policy framework is, of course, centred on inflation. The US Fed's mandate is to manage monetary policy with a view to keeping inflation at 2% over the longer run and seek full employment (to help maintain a productive and well-functioning economy). Core inflation in the US in August 2017 remained at a low of 1.7% (and has been the same for the last 3 months). Furthermore, despite marginal increases in producer prices and certain input costs, there appears to be little, or no, general upward pressure on inflation.

Therefore, if the Fed's inflation target of 2% is unlikely to be reached, and there is no obvious or foreseeable build up in inflationary pressure, markets may be a little puzzled as to why the US Fed is still minded to raise interest rates in December. And, this is the area where critics of the US Fed (and other central banks) are focussing their arguments; the historically observed link between low unemployment, wage pressures and inflation does not appear to be valid in the current environment.

Conventional economics still holds though. There is likely to be a point – possibly in the very near term – at which labour-related inflationary pressures begin to emerge. Perhaps the rate at which unemployment begins to have a noticeable influence on inflation is now lower than previously assumed, e.g., at ~3% - 4% (as opposed to 6% - 7%). This could be a consequence of the fundamental demographic changes to societies, weighting of differing activities across economies over the last decade, and other contributing factors like ingrained job loss fears. However, can the central banks wait any longer?

As noted, central banks will be aware of the side effects of (monetary) policy in many areas, not least in driving up asset prices and thereby distorting long term overserved financial markets equilibria. Given the duration of QE and loose monetary policy, this may have encouraged increasing – and potentially uneconomic – levels of leverage (and household credit etc.) and created potential for future instability coming from – for example – the property markets. This may in turn affect financial stability, which arguably brings greater risk to an economy than low inflation. Inflation may no longer be the only barometer for central bank interest rate policy and, as long as there is sufficient economic growth and low levels of unemployment, central banks may indeed be well advised to widen their inflation focus from mere price inflation to include asset price inflation. That is, at least as long as there is not any outright price deflation.

Emerging Markets on the up?

On Monday, the US decided to suspend the issuing of non-immigrant visas to Turkish citizens. It followed the Turkish government's arrest of Metin Topuz, a Turkish employee at the US consulate in Istanbul, last week. Pro-government newspapers allege that Topuz had ties to Fetullah Gulen, the Turkish cleric who President Erdogan blames for last year's failed coup attempt. The incidents mark a new low in US-Turkey relations, which have been turning bitter for some time now.

Amid the rising tensions, the Turkish lira saw a big bout of volatility, falling to a record low against a basket of currencies. The lira fell as much as 7% against the US$, before regaining some initial losses to trade down around 3% down. In addition to the currency moves, both Turkish bonds and equities saw significant falls, with Turkish Airlines leading the way in a 3.6% decline in the Istanbul stock market.

There were worries that Turkey's problems might lead to a wider financial contagion for emerging market investors. Indeed, the MSCI Emerging Market index fell 0.2% on Monday, breaking a five-day winning streak. This added to the news that, a couple of weeks ago, Emerging Markets saw their largest outflows since last November, as foreign investors withdrew $1.8bn in EM equities and $1bn in EM bonds, after a seemingly hawkish meeting of the US Federal Reserve (Fed).

The worries were short-lived, however. On Wednesday, EM equities enjoyed their second successive day of gains, climbing 0.4% on the day towards a new six-year high. Strong gains in Asia meant that markets shook off worries over another rate rise in the US – and the capital inflows to the US that this would bring – to keep going strong. Even EM currencies broadly strengthened, led by a strong yuan and a falling dollar. MSCI’s index of emerging market exchange rates has now risen 14% since January 2016 – its best 18 months since 2011.

According to Nomura economist Inan Demir, the fact that Turkey’s woes don’t seem to be affecting investor sentiment on wider EMs is hardly surprising, given that the nation was already more vulnerable than other EMs, due to its large current account deficit. “Turkey already stood apart from its peers … If coupled with political risks, its isolation could be further amplified,”

For the past few years, EM investors have had to weather stormy seas. In 2013, markets’ “taper tantrum” after the Fed hinted at a slowing down of asset purchases saw EM assets sustain significant losses. The following year began a prolonged dip in commodity prices which many EMs are still recovering from. A couple of years ago, China’s sudden devaluation of their currency seemed to top off the various crises and send EM sentiment tumbling. Then, last year, just as Donald Trump’s surprise election victory was buoying US equity markets, it turned EM assets the other way, through fears over the new President’s seemingly protectionist policies.

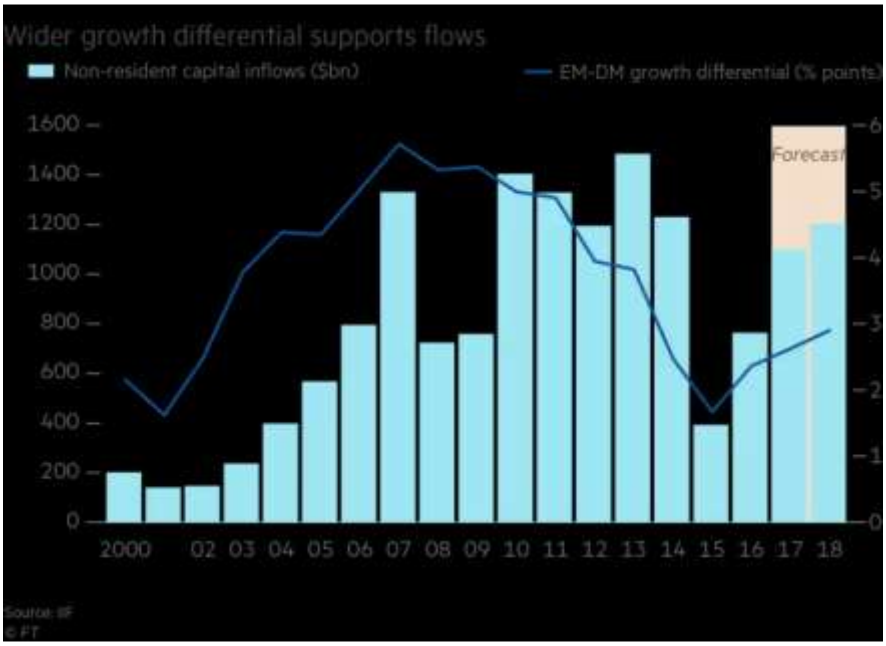
Now, it seems like there’s a renewed optimism among EM investors. Political turmoil in places like Turkey and the potential effects of US monetary policy – as well as continued fears over the way China is handling its bourgeoning private debt – might have previously been enough to spook investors. Instead, EM assets are breaking fresh ground. Why is this?

A lot of it has to do with EMs’ reduced vulnerability to movements in US$. As the Economist weekly pointed out last week, “emerging-market crises often begin in Washington, DC, when the Fed raises interest rates or tightens monetary policy in other ways.” For many EMs, monetary tightening in the US used to see them faced with an unenviable choice: Tighten their own monetary policy in order to keep their currency up with the dollar, potentially choking growth; or see their currency lose value, which meant increased defaults from companies with dollar-denominated debt – again choking growth.

Now, the choice isn’t so bleak. First of all, the current tightening cycle in the US isn’t putting as much upward pressure on the US$ as usual, with the currency actually falling this year. This has meant that EM central banks don’t have to worry about their currencies depreciating in the short term. Perhaps more importantly, high inflation, once the hallmark of EMs and the reason that keeping pace with the dollar was so vital, doesn’t plague developing economies as much now. The latest average inflation figure among countries in the MSCI EM index, weighted by size of the economy, came in at 2.6% according to UBS. This leaves central banks with more room to manoeuvre when faced with woes, rather than just following US monetary policy to maintain (in some cases) dollar-pegs.

Furthermore, more generally, the recovery in commodity prices and increased demand from China over the past year or so has turned many of the ailing economies into good performers. In the first half of 2017, the BRICs (Brazil, Russia, India, China – the largest developing economies) all grew simultaneously for the first time in three years, and all of the countries in the MSCI EM index that have reported Q2 GDP figures so far showed growth.

There is an economic momentum in EMs not seen for a number of years; these economies are now being discussed as real positives over the next 12 months. Even Turkey is gaining of that momentum, rebounding from the lows seen earlier in the week, largely off the back of inflows to emerging market funds.



Of course, we should be careful here. As mentioned, a great deal of the momentum seen recently has come from demand – in particular commodity demand – from China. The upswing in Chinese building last year was the real driver that pushed EM growth (and global growth for that matter) into positive territory in 2016. As we have discussed before, it doesn't look likely that that level of demand growth is sustainable. If the dreaded drop-off in Chinese demand did occur, EMs would likely be among the hardest hit. For now, things are looking good in developing economies. But, as is usually the case with emerging markets, much will depend on what happens in the world's second largest economy.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7550.1	0.4	27.2	↗
FTSE 250	20269.1	0.5	102.5	↗
FTSE AS	4144.0	0.4	15.9	↗
FTSE Small	5831.9	0.4	20.6	↗
CAC	5362.4	0.0	2.5	↗
DAX	13008.6	0.4	52.6	↗
Dow	22879.7	0.5	106.0	↗
S&P 500	2556.5	0.3	7.2	↗
Nasdaq	6094.5	0.5	29.9	↗
Nikkei	21155.2	2.6	526.6	↗

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
PROVIDENT FINANCIAL	5.8	GKN	-10.9
BURBERRY GROUP	5.3	MONDI	-9.5
RECKITT BENCKISER	5.3	DIXONS CARPHONE	-5.0
POLYMETAL INTERNA	5.2	NEXT	-4.8
WHITBREAD	4.4	HIKMA PHARMACE	-3.5

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	23.3	Brazil	183.0
US	24.8	Russia	128.8
France	20.5	China	57.0
Germany	11.8	South Korea	69.8
Japan	25.8	South Africa	170.9

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.33	1.78	OIL	57.0	2.4
USD/EUR	1.18	0.95	GOLD	1300.1	1.8
JPY/USD	111.92	0.65	SILVER	17.3	2.9
GBP/EUR	0.89	0.87	COPPER	312.2	3.1
JPY/GBP	6.58	1.11	ALUMIN	2146.5	-1.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.4	0.3	0.00
US 10-Yr	2.3	-3.2	-0.08
French 10-Yr	0.8	10.9	0.08
German 10-Yr	0.4	-12.2	-0.06
Japanese 10-Yr	0.1	14.3	0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.4
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.6
5-yr Fixed Rate	1.9
Standard Variable	4.3
Nationwide Base Rate	4.5
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