Weekly Market Comment

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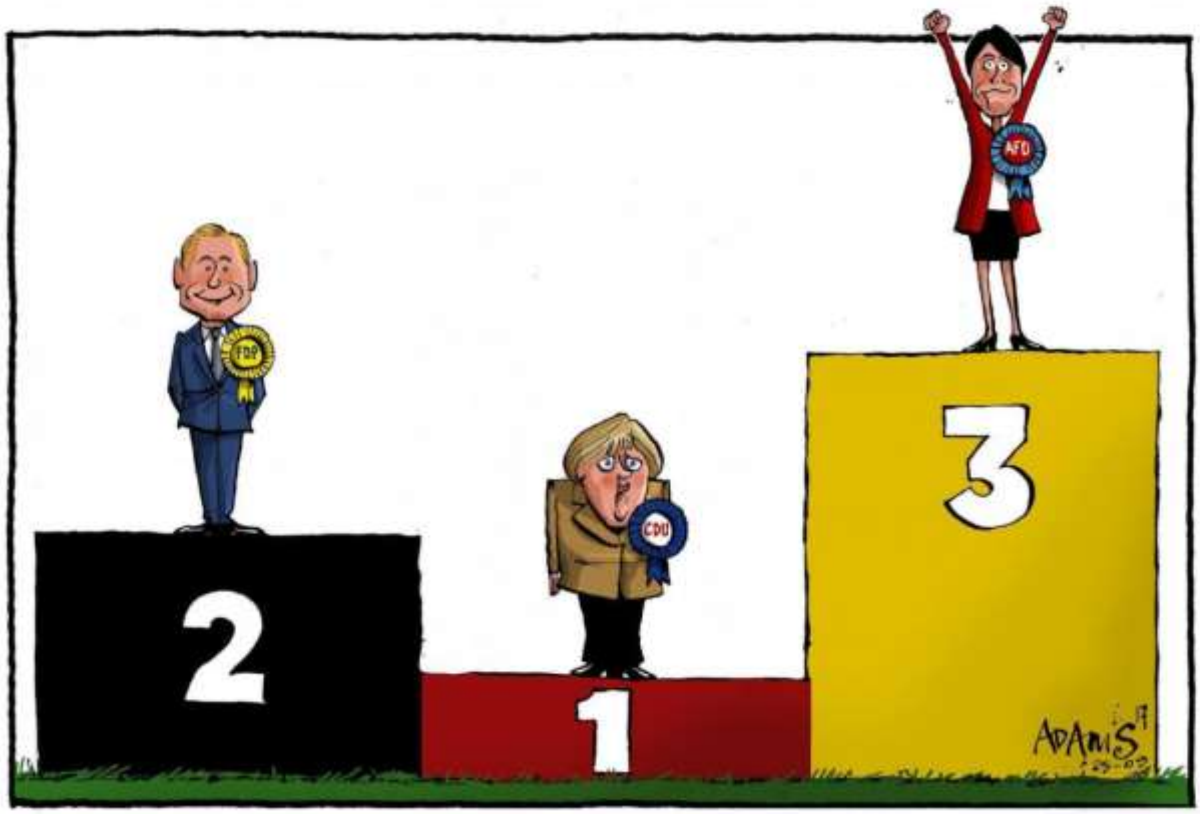


A humourist's perspective of the German election result; Source: Adams/Evening Standard; 25 Sep 2017

Movement

It has been a week full of political movements and stock markets managed to regain ground lost over the previous week.

In Germany chancellor Merkel's governing coalition lost 14% of the vote to the populists of the AfD, but Angela Merkel will continue as head of the government as had been expected. She will be forced to govern with a differing coalition after her previous partners, the centre left SPD refused to carry on and instead will attempt to regain voters trust in the opposition. However, do not expect too much change in German politics as a result – it may, however, busy Merkel's top team a little more than before to hold such a coalition with two new coalition partners (Greens and Liberals) together. My hope that focus would finally turn to navigating towards are more constructive Brexit framework could therefore be disappointed.

Luckily, France has with Emmanuel Macron a new president with a strengthened mandate, who took the opportunity over the week to inject life back into the European idea. In a landmark speech, he set out a strong vision for the European Union, which envisages a higher level of political cohesion, defence and very important for our perspective first steps to underpin the mal-designed monetary union with a joint taxation approach. This would finally allow the issuance of true EU government bonds and thus at long last provide its central bank, the ECB, with the instruments of a properly empowered central bank. Merkel's positive comments give hope that we may witness the resurrection of the powerful Franco-German axis, which under Kohl and Mitterrand led to the last peak of EU progress. Let us hope they do not forget Britain's Brexit needs in the process!

In the US, Trump for once made headlines with a truly constructive tax reform outline, which did not mention the destructive border adjustment tax but proposes that the US corporate tax system finally follows the territorial tax base approach rather than continuing to insist on its global approach which results in double taxation unless US corporates engage in all sorts of damaging tax mitigation tactics. His proposal was ridiculed by many, but it would seem to us that this has almost become a Pavlovian reflex. His bundle of tax reform proposals has the potential to add significant additional growth momentum to the US economy and if designed properly should be able to pay for itself over the medium term – just as the last successful US tax reform under Ronald Reagan did.

Trump's chances of getting at least some form of tax reform through Congress are far, far higher than his Obama Care repeal bill and as such we suspect that the markets underestimate the chances for success – given their muted welcome to his announcement.

Moving further East, 'Rocket Man' Kim Jong-Un kept relatively quiet over the week, but I suspect this will not last. China and Japan on the other hand are seeking political mandates from their respective power bases. We wrote about the 19th Party Congress in China last week. This week the Japanese prime minister Shinzo Abe surprised his country by calling snap elections for October. Given that he has actually managed to drive the Japanese economy forward further than any of his predecessors of the past 25 years, we wish him more luck than his British colleague experienced in June.

I suspect many people look anxiously East these days and wonder whether we will witness the first thermos nuclear conflict in a lifetime and the shock potential this may have for capital markets. We would side with the muted response from capital markets, where the South Korean stock market index has even risen over 30% this year. Clearly, the threat has to be taken serious but the North Korean dictator will be aware that he would most likely pay with his life for a nuclear attack and thus, for the time being this remains a rather unnerving 'game of chicken' rather than a 'hot conflict'.

With the moving parts in politics over the coming weeks, the central banks' determination to bring the era of extraordinary monetary easing to a gradual end and the upcoming quarterly corporate earnings announcements, there is plenty ahead to keep capital markets in suspense. October is a month that has historically seen some extreme market movements and so market participants will be nervously eyeing latest developments. But then, the same is true for September and similar concerns were raised at the end of August and we now look back to positive stock market returns for the past month. We will therefore continue to be on our guard about the short-term impact potential of the various unfolding scenarios, while we do not lose track of the positive longer term picture of a gradually and consistently improving global economic growth environment.

I would like to end this week with a rare mention of a Tatton business matter which the whole team is rightfully proud of. Tatton Investment Management was voted Best Discretionary Fund Manager by the 2017 Money Facts Awards. Having won this coveted accolade against our venerable competition of much longer established and in many instances far larger competitors is a wonderful recognition of what we have been able to achieve for our investors over the past 5 years.

Deutschland 1 – Rest of the World 1 (German win on penalties?)

Both brexiteers and remainers agree that the UK's exit from the EU will have a big economic impact. So, mitigating the potential negative effects will depend as much on the direct engagement of our EU partners (and their own trade preferences etc.) as it will on the UK's policy and the negotiation process.

Unfortunately, one of the UK's potential allies in this process, Germany, is set to be very busy with its own domestic issues, following the general election outcome of last weekend. The two leading German parties CDU (Merkels's centre right) and SPD (Schulz's centre left), who had governed for the past 4 years under a coalition government, suffered heavy losses – as 12.6% of votes went to the ultra-right populists of the AfD. This persuaded the SPD to change into the opposition, which leaves Angela Merkel having to form a more complicated coalition with the Greens and the FDP (known for their business orientation).

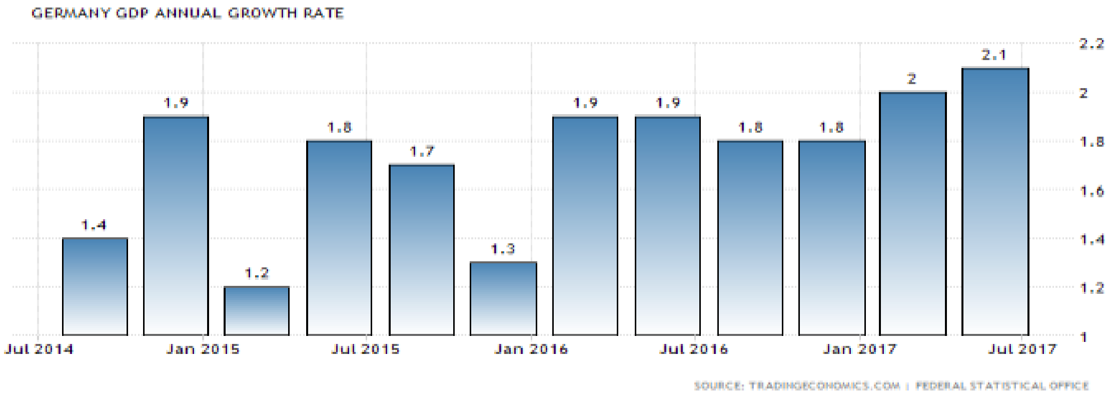
Similarly, France (Macron's agenda for structural reform) and Spain (the Basque region) are also likely to be focused more on internal politics and economics over the next 12 months. Contrary to our previous expectation that the passing of the German election would refocus Europeans on the negotiations with the UK, there is now a risk that Brexit will now be relegated to second or even third priority among European politicians.

The election result in Germany illustrated that even the bloc's largest economy is not immune to the populist vote, following the example set in in the UK (UKIP), US (Trump) and other countries. However, while the success of the AfD party is said to be a response to Germany's relaxed immigration policy, the regions in which AfD gained most traction are actually those with very low levels of immigration.

We believe AfD's relative success is a reflection of the relative economic and industrial decline in certain regions, and therefore, more akin to the populist outcome in the US rather than the specific policy oriented outcome of the EU referendum (and election) in the UK. Given that Germany's economy is robust with good prospects for medium-to-long term growth (see graph below), it may be difficult to reconcile this overarching macroeconomic view with the muted levels of economic activity in certain (large) regions in the former East Germany, e.g., Saxony (Dresden).

We hope that Germany does not become too distracted by domestic politics for too long. It remains the engine of the EZ, accounting for 28% of the EZ economy, and has a material impact on pan-European economic activity, aggregate growth and overall inflation. Whereas other countries are just at the start of their economic upswing, Germany has been steadily growing for some time and this has helped to underpin enhanced EZ economic activity, business investment and growth (and much needed wage driven inflation).

German annual GDP growth



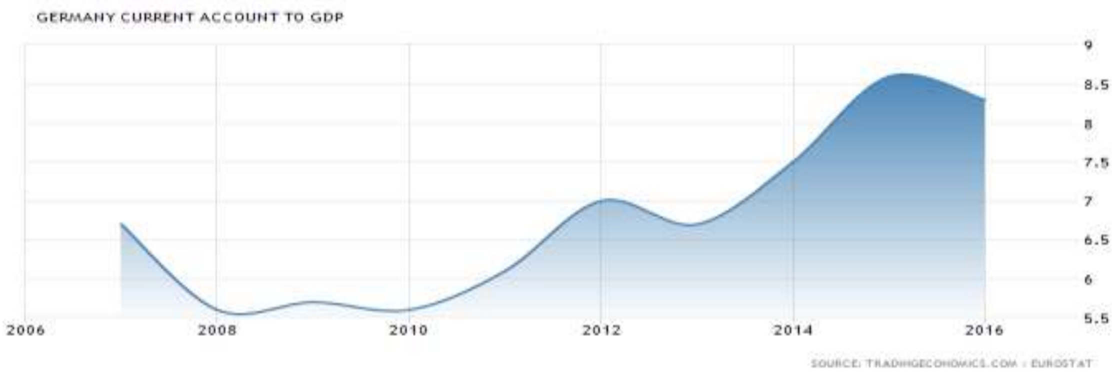
Source: TradingEconomics, Sept' 2017

Even though Germany's economy has been performing well, assisted by prudent economic management and previous structural reforms, wage growth and core inflation remain low, and business investment has yet to gain real momentum. Meanwhile, adverse demographics could weigh on long-term growth prospects. Indeed, according to the IMF, GDP is expected to grow by just 1.8% in 2017 and 1.6% in 2018, but "over the medium term, population aging and slow progress on structural reforms is expected to weigh on growth".

This may in fact be one of the key issues facing Germany's economy. It is at least indirectly related to one of the issues raised by Germany's trading partners – Germany's large trade surplus. For an economy with a rapidly aging population such as Germany's, some economists would argue that it is prudent run a current account surplus. It is questionable whether Germany's surplus of the past several year's needs to be as large as it is – i.e. larger (even in absolute terms) than China's (!).

While the current account surplus declined slightly, from 8.6% of GDP in 2015 to 8.3% in 2016 (due a deterioration in the services balance), this large and persistent current account surplus is presumably a result of a relatively high domestic saving rates and better investment opportunities abroad, though external factors might also be a factor.

Germany's burgeoning trade surplus



Source: TradingEconomics, Sept' 2017

Despite the large current account surplus, it is not clear that Germany is saving too much relative to investment and consumption (economic theory states that, in equilibrium, savings must equal domestic investment). We note that Germany's consumers have steadily increased their level of consumption in absolute terms since 2008 (for example, from €375bn in Q2 2014, to €395bn Q1 2017).

German consumption as a proportion of GDP is, however, relatively low, at ~55% (when measured against the UK, US and elsewhere). But, the household savings rate in Germany is considerably higher than in other developed economies (at nearly 10% of household income). All else being equal, there is an imbalance in the German consumption and savings rates. And, not all of it can be attributed to the need to save more because of an aging population (and diminishing workforce).

In our view, Germany is well placed to further develop its own economy and increase consumption (through lower taxes, higher wages, public investment and otherwise), and this need not be at the cost of its competitive trade position. Indeed, the more that Germany effectively deposits abroad – as a result of its surplus and capital accounts – the less it will have to invest in its own economy. The current account surplus can be evidence that a country is investing abroad instead of at home. This might be because the country is not very attractive to investors.

Encouraging more domestic consumption will reduce the reliance on exports and decrease the trade surplus; an appreciating €-Euro might help in this regard. If the German trade surplus has bolstered the savings, we believe it prudent to release more of that saving to (domestic) investment. This should underpin economic growth and, critically, promote investment and growth in the declining regions. This would be in Germany's economic and political interests, as well as the economic interest of its trading partners.

Trump's first sensible policy initiative?

This week President Trump resurrected his policy initiative for the tax reform that formed one of his key campaign pledges. While the 8-page framework document is by no means formulated legislation, it did grab the headlines with its corporate tax reform outline. Under the President's plan, American companies will pay a tax rate of 20%, down greatly from the current 35% but still some way off the 15% that Trump had promised last year, although still much closer to the international average of 22.5%.

There is a need to change "America's outdated, complex and burdensome tax code," Trump told a crowd in Indiana on Wednesday, where he unveiled his "framework" for tax reform – and for once we wholeheartedly agree with him.

For individuals, the current tax reform proposal is far more vague, but would see a simplification of the current system. It would shrink the currently seven different tax bands which US citizens can come under to just three: 12%, 25% and 35%. But, White House officials said that they hadn't yet decided the income bands that these rates would correspond to and thus this change may not actually result in lower income taxes overall.

Beyond these headline numbers, there were two further points which we find very noteworthy. Firstly, there was no mention of the dreaded 'border adjustment tax' with which Trump had previously wanted to protect US jobs from imports but would have risked triggering global trade wars. Secondly, the proposed reform envisages the US moving its general taxation approach from global to territorial – like most of the rest of the world. This would mean that companies operating in the US would only pay tax on profits generated there – the standard throughout most of the world. The current system sees US companies paying tax on their total profits generated worldwide.

According to Tom Donohue, head of the US Chamber of Commerce, “Today’s announcement is good news for American families and employers. Tax reform will help families who are struggling to make ends meet and employers who want to grow their business and create new jobs.”

Certainly, this reform would greatly boost profits of US corporations, not least by avoiding a situation of ‘double paying’ – where profits from abroad get taxed both in the country they came from and back in the US. Yet, the S&P 500 gained only marginally on Wednesday, as well as on Thursday. With the promise of greater future profits from the most powerful office in the world, why hasn’t this given more of a boost?

Well, for many investors, the Trump-tax story is the same hollow story again and again. In the wake of Mr Trump’s shock victory last October, US equities gained a major boost on the promise of “the biggest tax reform ever” and other fiscal stimulus packages. Since then, the ‘Trump trade’ has well and truly fizzled out, as investors have become increasingly aware that, eight months into his presidency, Trump’s genuine policy achievements are virtually non-existent.

Back in April, a one-page proposal with largely the same contents as the current one was widely ridiculed in the media for its unrealistic aims. And, Trump’s fractious relationship with the congressional Republican party has handicapped his ability to implement policy. As John Authers noted in the FT this week, the 50 S&P 500 companies with the highest effective tax rate (those who would benefit the most from Trump’s reforms) underperformed the 50 companies with the lowest effective tax rate by more than 11% since December, meaning that markets effectively ruled out any chance of tax reform in that time. Even now, according to prediction markets, the implied odds of tax reform stand at 30%, unmoved in recent times.

However, it does seem that the winds are changing somewhat. As Authers also notes, the past week has seen those same 50 top paying companies outperform their low-tax counterparts by 2.3%. More generally, there is a feeling that, while Republicans may have had a far spectrum of positions towards repealing Obamacare, they are firmly united in their desire for tax cuts. Furthermore, with the fine tuning of taxation bands still to be defined, the proposal has enough room for negotiation to even bring in the Democrats.

Needless to say, the effects of reform success would be huge. Research from Goldman Sachs indicates that the reform, if passed this year, would see an additional boost to S&P earnings of 11.5%. As ever, the only question is whether or not it will actually happen.

Whatever the case, we believe that – much as markets overestimated the probability of tax reform late last year – they seem to be underestimating it now. That means that, if tax reform does actually come, it will provide a boost to earnings of US corporates which would suddenly make US equity valuations appear a lot less extended than they are today.

Macron adds vision to EU’s economic resurgence

French President Emmanuel Macron took to the stage in Paris this week to lay out his ambitious vision for the future of the European Union. It was widely expected that Macron, perhaps the staunchest Europhile among this generation’s leaders, would outline his plan for Eurozone reform. He did much more than that. The address spanned almost two hours, and covered every area of EU policy from agriculture to defence, mixing detailed policy suggestions with more abstract goals, all aimed at reinvigorating the push for European integration.

While the president may have come out all guns blazing on the integration front, it was interesting to note that his speech laid out several areas where France could compromise on some of its historic sticking points. One of these proposed compromises was on the common agricultural policy (CAP), an almost sacred prize among previous French leaders.

Perhaps more significantly, Macron offered to give up France’s member on the EU commission, and called for the other big nations to do the same. This would ‘streamline’ the commission, reducing its 28 members down to 15, making the bureaucratic process faster. This was part of the young president’s desire to reimagine European democracy. “The essence of the European project is democracy” proclaimed Macron, adding that the UK’s EU Parliament seats should be replaced by transnational ones – an idea previously suggested by EU Federalists as a way of creating a truly European electorate.

Macron’s vision for Europe even stretched to the area of defence, where he outlined his (admittedly vague) ideas for a “common intervention force, a common defence budget and a common doctrine of action”.

He also reiterated France’s desire for a common eurozone budget. It was interesting to note that on this point, much unlike the others and despite the vigour with which it was said, detail was a bit lacking. The size and scope of this common budget were left unspoken, as were the specifics on what Macron sees as the future of economic and monetary union.

This is undoubtedly a nod to his German counterpart. Germany has historically been opposed to any economic or fiscal integration which would see poorer nations piggy-backing off their financial prudence. And, with the recent election seeing a surge in support for the alt-right Eurosceptic AfD, there’s not much political appetite in Germany for more integration. Ms Merkel, bruised by a reduced vote share (despite her win), will likely see a renewed integration push as an open goal for AfD, who capitalised upon Merkel’s perceived mishandling of the refugee crisis to win 12.6% of the national vote – making them the third-largest party in the Bundestag.

Given the likely unwillingness of its largest member, it might seem like a bad time for a renewed EU integration push. However, on the other hand, Macron might see the push as both a tactical and ideological boon right now. The president could have waited for the dust to settle in Berlin before looking for a helping hand. Instead, he has announced himself as the leader of what might become the new political landscape in Europe. By insisting on a multispeed Europe – where further integration is done on the basis of ‘coalitions of the willing’ – he has ensured that only those nations that wish to will join in his vision. This could bring the reluctant nations (read Germany) to the table for fear of missing out.

Furthermore, while the past few years have seen far-right extremism spread quite markedly across Europe, election results within the past year have seen somewhat of a reversal of that trend. After results in Austria, the Netherlands and France have given some respite to the pro-EU camp, now seems like an opportune time to push forward the project of political integration. As argued in a recent FT editorial, “The EU has spent the best part of a decade fighting for survival. ... This is a real opportunity for the bloc to rediscover its sense of purpose.”

What’s more, the economic timing looks even better than the political timing. At the beginning of this year, the continent was still plagued by economic stagnation, the potential fallout from a messy Brexit divorce was a niggling worry and the Italian banking crisis looked like a problem that was just never going to go away. Now, things are looking markedly better. The Eurozone grew 2.1% year-on-year in Q2 – its highest level in five years – and there is now an economic optimism to match Macron’s political one. Even Italy has seen improvements, and the economic momentum there has lifted some of the weight of the country’s non-performing loans – as the upturn has suddenly given those in debt the ability to meet their interest payments.

Ultimately, further European integration will hinge on what agreements can be reached between its two largest countries. Macron’s focus on areas in which both nations agree will help here. Germany will always be afraid of mechanisms for direct fiscal transfers, so Macron’s insistence that a Eurozone budget could be funded through harmonising the corporate tax system towards a common source of tax revenue is a good starting point. From a common tax base, it is only a small step to common Eurozone government bond issuance. This, as we have written here many times before, would be an immense step forward in turning an initially ill-founded monetary union into a proper common currency area.

Macron’s vision is full of optimism and ambition, traits which have been notably lacking in Europe’s political discourse since the great financial crisis. Even if that spirit gets brought back to Earth by the continent’s pragmatists, the fact that new solutions to the bloc’s old problems are being discussed can only make us hopeful.

Oil - is ‘Lower for Longer’ over?

Investors should not have been surprised by oil’s resurgence this week. As the saying goes: ‘It’s the economy stupid’, and the underlying global economy appears to be increasingly in good shape, which is leading to strengthening demand for oil.

Could it be that the mantra of ‘Lower [oil prices] for Longer’ is coming to an end, as tighter supplies and growing demand encourage a more supportive pricing environment?

It looks as if the oil market is emerging from its recent period of rebalancing. While the US benchmark price of oil (West Texas Intermediate – WTI) has advanced this week to $52 per barrel (the highest since April), the more internationally used Brent benchmark experienced a large jump to almost $60 per barrel – the highest level since July 2015.

Another factor seeing Brent gain faster than WTI has been 2017’s decline in the US dollar, which makes it cheaper for overseas buyers to purchase oil. The US$ fell nearly 10% against the Euro (a 2-year low) during the summer, and the dollar index remains near an 11-month low.

In the short-term, we believe prices and US demand for WTI are likely to be restrained from the effects of hurricanes Harvey and Irma. As one might expect, the decline in demand is commensurate to the intensity of the storm.

Source: US$ Index CNBC

Interestingly, the negative impact on both US production and processing should not be as large as that of demand, given the protective measures producers and refiners took prior to the hurricanes making landfall. Certainly, the lessons from Harvey suggest only modest production disruption.

Both hurricanes are estimated to have removed around 900k barrels of US oil demand per day during September, moving to a projected 300k barrel shortfall in October. History would indicate that there will be a positive demand shock for oil demand in the following months, to a level higher than would have been the case had there been no hurricane, as rebuilding activity begins.

Indeed, for oil watchers, recent data from the American Petroleum Institute (API) suggests that the market has already begun normalising, as refinery outages continue to fall. API data from this week revealed crude inventories saw a surprise draw, against expectations of a large build.

It could be that the oil market has hit a turning point, following a three-year slump, as cheaper petrol prices have lifted demand and as OPECs production cuts look to be finally clearing excess global inventories.

OPEC nations have reduced production by an estimated 500k barrels per day to combat excess inventories. Added to this are possible supply disruptions of over 500k barrels per day from Kurdish-controlled northern Iraq. When combined with the stronger demand picture noted above, this led some analysts to speculate we may be quickly facing a significant shortage of oil capacity in the near future.

Trafigura, one of the world’s largest commodity traders, calculated that the world might need an extra 2-4 million barrels of oil per day by the end of 2019, as the largest energy companies had reduced investment spending on new capacity by nearly $1 trillion over the past few years.

The price of Brent has jumped by a third since June, on the back of a synchronous expansion of oil demand in both developed and emerging markets. The first time that demand has increased in this way since the financial crisis.

The strength of oil demand has been surprising, both from a geographical and composition of demand standpoint. As noted above, regionally, oil demand growth has been strongest relative to recent years in DM economies, and seems to be running slightly ahead of macro activity. The acceleration in growth has, however, been most pronounced in EM economies, where growth had previously been restricted by weak industrial activity and exports.

As a result, we think further inventory draws are possible. China has continued to use cheaper prices to help build its strategic petroleum reserve, in order to cushion the country from future energy supply problems. Analysts expect that oil exports to Asia will rise by 7.5 million barrels per day to 22 million barrels per day between 2016 and 2040.

We note that global oil demand growth has remained very strong throughout the second quarter, at around 2.25 million barrels per day. That is the second highest quarterly growth since 2010, and forecasts for Q3 implies continued robust growth.

We expect that global oil prices may continue to find support as we enter 2018. Oil demand growth is likely remain strong, crude supplies are likely to stay tight, and, as a result, global oil inventories are likely to continue to fall at a fast pace.

US shale and other non-conventional oil production growth may help correct the global deficit that has emerged in oil markets, but there are huge question marks over OPEC output in 2018. This could see market tightness persist in 2018 for longer than many expect.

Lastly, we find further support for the idea that prices could be in a new higher range from the oil futures market. This week, investors saw the Brent futures curve move into sustained backwardation (spot or today's price is higher than that in the future).

Exhibit 1 : The Brent forward curve is now in sustained backwardation

Brent prices $/bbl

Source: ICE

While there are risks to the sustainability of this current period of supply-demand rebalancing, the mixture of very strong demand, potentially more cohesion among OPEC members (higher prices may ease tensions) and a reduced likelihood of further rapid gains in shale production means that backwardation and the current range could be here to stay in the medium-term, absent any large negative economic shocks. A $50-60/bbl range should be seen as good news, as it provides us with further evidence of steady economic growth, without being a real headwind. It will be interesting to observe how quickly additional shale volumes will come onstream this time around.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7375.9	0.9	65.2	↗
FTSE 250	19832.3	1.6	314.9	↗
FTSE AS	4049.7	1.0	40.8	↗
FTSE Small	5706.2	1.1	62.3	↗
CAC	5309.3	0.5	28.0	↗
DAX	12790.6	1.6	198.2	↗
Dow	22361.2	0.1	11.6	↗
S&P 500	2514.0	0.5	11.7	↗
Nasdaq	5951.8	0.3	19.5	↗
Nikkei	20356.3	0.3	59.8	↗

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
PROVIDENT FINANCIAL	9.3	LAND SECURITIES	-5.5
DIXONS CARPHONE	8.5	MEDICLINIC INTERNA	-4.5
HIKMA PHARMACEUT	6.6	BABCOCK INTL GRO	-2.5
PEARSON	6.2	WPP	-2.3
ITV	5.1	NATIONAL GRID	-2.2

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	23.6	Brazil	199.7
US	25.9	Russia	145.2
France	20.5	China	62.8
Germany	12.3	South Korea	75.4
Japan	25.2	South Africa	190.5

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.34	-0.64	OIL	57.6	1.2
USD/EUR	1.18	-1.11	GOLD	1285.2	-0.9
JPY/USD	112.56	-0.51	SILVER	16.8	-1.0
GBP/EUR	0.88	0.48	COPPER	296.6	0.7
JPY/GBP	6.65	-0.92	ALUMIN	2131.0	-1.8

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.4	0.1	0.00
US 10-Yr	2.3	2.9	0.07
French 10-Yr	0.7	1.9	0.01
German 10-Yr	0.5	4.0	0.02
Japanese 10-Yr	0.1	100.0	0.03

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	2.0
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