Weekly Market Comment

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Lothar Mentel

CHIEF INVESTMENT OFFICER

Samuel Leary

FUND MANAGER

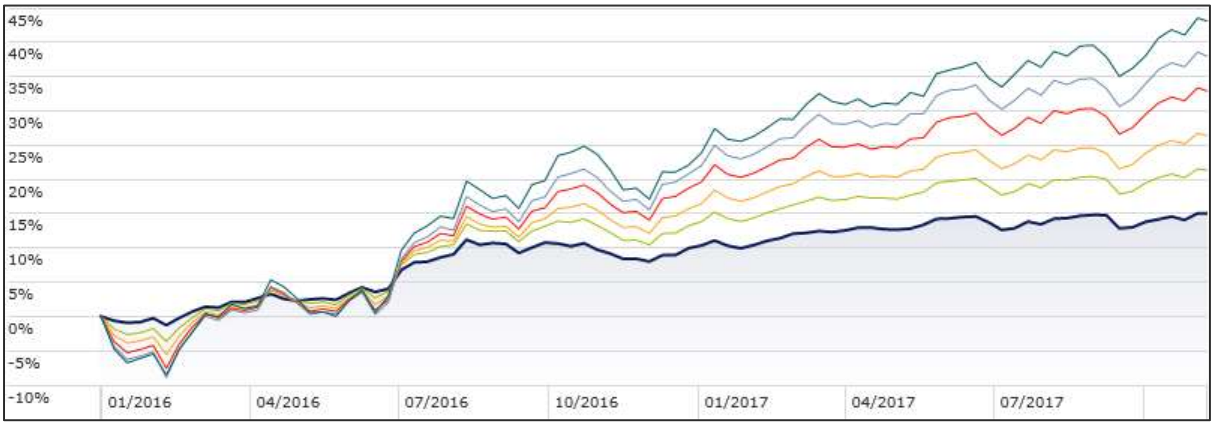
Isaac Kean

INVESTMENT WRITER

Duncan O'Neill

GUEST ECONOMIST

Buoyant 2016/2017 investment returns



Investment return potential of standard UK private investor multi asset portfolios with varying degrees of equity investment; Jan 2016 – Nov 2017;
Source: Morningstar;
Note: Past performance is no guide to future returns

Nervous investors herald more volatile markets

Private investors with globally diversified multi-asset investment portfolios tend to be quite happy these days. That is, unless they have more cash that needs investing. As the chart above shows, since the last large market correction at the beginning of 2016, investment returns have been plentiful, even for the less adventurous investors. We have written over the last weeks about how private investors are increasingly concerned that current market levels may be marking a high – simply based on their experience that, after a number of good years, not so good years tend to follow.

While we have explained that it is not as simple and that what counts is the direction of travel of the global economy – which remains on a synchronised expansion path – nervousness is spreading. Institutional and other professional investors and research entities are increasingly feeling compelled to debate whether capital markets have got ahead of themselves, and thus are likely to suffer a setback in the near future.

Such debate is good and bad. Good, because it tells us that we have certainly not reached the levels of exuberant overconfidence which regularly occur just before stock markets hit the buffers. On the other hand, it's bad, because it indicates that there remains a significant lack of confidence that the economic development is resilient and has the ability to generate further increases in growth. Such lack of confidence makes markets prone to overreacting to the slightest bit of less-than-good news from the economy.

After a good 18 months of ever improving economic updates around the world, with even the UK economy proving to be in better shape in the 2nd half of 2017 than many had forecast, it is inevitable that this continuous acceleration cannot carry on forever. In other words, the rate of growth should continue to be positive, but there comes a point when the rate of growth itself flattens out or even slightly declines. For the mathematically inclined, this is a period where we move from the growth rates' first and second derivative being positive, to only the first derivative remaining positive.

The most potent fuel for investment returns is an expectation of improving, not just steady, growth. If a steadying of the rate of growth is what we can reasonably expect for the coming 3-6 months, but at the same time we anticipate that investors have jacked up asset prices in the past months on the back of an expectation of an ever-improving outlook, then we should expect disappointment, leading to market setbacks.

Unfortunately, we cannot be sure about either of the two assumptions above. For example, the economic council of the German government warned this week that the economy was at a high risk of overheating, as German GDP growth reaches 2%. Only a few years ago, 2% growth was characterised as ‘stall-speed’, which meant that there was an increased risk of imminent recession. It is therefore not unreasonable to argue that there should be further upside potential in economic growth, if the experience of the past has any relevance for the future.

On the side of heightened valuations of risk assets after this year’s strong stock market returns, we cannot be sure that traditional valuation metrics remain valid. Are the various ratios, whose averages we deem a long-term guidance framework, but which were calibrated to ‘normal’ interest rate levels of 5-6%, still relevant, when ‘normal’ interest rates today are not expected to exceed 3-4%? Current valuation equilibrium levels may therefore - at least until yield levels of past periods return – be higher than historically observed.

Under our investment framework at Tatton, we aim to refrain from jumping to rash conclusions, but rather take a bigger picture into account. This bigger picture informs us that the global economy remains on track and is showing increasing signs of resilience to regional setbacks and disturbances. At the same time, however, we also observe growing levels of anxiety amongst the investment community, who, over the past decade had to experience that rules of thumb of the past are no longer applicable in this post-financial-crisis world of low yields and lower-than-average confidence.

As a consequence, we expect an increased risk of temporary market sell-offs if and when the rate of economic improvement slows, but are also cognisant of a scenario where risk asset valuations have the potential to (temporarily, at least) reach much higher levels without immediately becoming unstable. What supports this latter possibility is the fact that a significant amount of retail investor funds still remain in cash - futilely while waiting for better yields. Meanwhile, central banks are loath to bring these about through aggressive monetary tightening, for fear of undermining the finally returned upward dynamic of the global economy.

This all leads us to be prepared to once again face increasing levels of market volatility, while not losing sight of the state of the economy, which is now far more resilient to capital market upsets than it has been at any point over the past decade. Should capital markets prove to be equally resilient and continue their upward trend, then we will have to become more mindful of the possibility of the forming of potentially dangerous asset bubbles. While that is a somewhat unnerving prospect, at the current rate of change this is unlikely to become truly an issue before the second half of 2018.

Game of Thrones at the House of Saud: an oil price threat?

Since being named heir to the throne back in June, Saudi Prince Mohammed bin Salman's rise to power and prominence has been meteoric. Though his father is still the official head of state in the oil-rich kingdom, the palace coup established the young prince (only 32) as de facto ruler, with far-reaching consequences. Now, after initiating a dramatic corruption-crackdown which has claimed the heads of many high-profile princes and officials, Salman has tightened his grip on power substantially.

On Saturday night, at least 11 Saudi princes and dozens of senior officials and businessmen were arrested and had their assets seized by the anti-corruption commission. Just hours earlier, Salman had been named by his father as head of the commission. The next day, a helicopter carrying Prince Mansour bin Muqrin – a prominent opponent of Salman – and eight other officials crashed, killing all aboard, with various sources suggesting foul play. Among those detained is Prince Alwaleed bin Talal, one of the world's richest investors described by Time Magazine as the 'Warren Buffet of Arabia'.

On their part, the regime insists that the arrests are purely for the purpose of trying to "eradicate corruption", with one official Saudi source expressing "surprise" that media outlets are "falsely claiming these measures were conducted for other purposes". Indeed, no one would dispute that there is widespread corruption in Saudi Arabia. However, given the list of targets, it is easy to see why there are suggestions that accusations of corruption are being used as weapons against political rivals. Much like in China, where Xi Jinping's enormous anti-corruption drive has claimed many powerful scalps and left the ruler without any challenge to his authority, it's hard to avoid the conclusion that the current corruption crackdown is a thinly-disguised power grab, and an ambitious one at that.

Unlike China however, there is some suspicion that the crackdown might also have some financial motivation. Saudi Arabia's formidable asset reserves took a substantial hit from the suppressed oil prices seen over the past few years. Their previously generous social security system was subsequently trimmed by austerity policies, causing discontent among the public. The crown prince has been trying to raise the cash through outside investment and selling off the 'family silverware' (the upcoming Saudi Aramco IPO), but it's not enough to cover his big plans for the kingdom's post-oil future. The nearly $800bn in frozen bank accounts and seized assets from detained royals and officials would go a long way to closing the funding gap.

Just a couple of weeks ago, we wrote about how the Saudi crown prince gathered the world's biggest investors to a summit in Riyadh on the potential for the kingdom's post-oil future. There, he painted the not-too-distant Saudi Arabia as a modern, stable and liberal hub in the middle east, no longer as dependent on oil and a prime target for foreign investment. This week, the picture could hardly look more different. The same hotel that hosted the world's powerful and plentiful just a couple of weeks ago is now effectively a prison block for VIP detainees, with the gates clamped shut and police surrounding the compound.

On the weekend, the Saudi government announced that the corruption purge will lead to a more stable investment regime. But, at the moment, the market reaction seems to indicate the opposite sentiment. Brent crude prices rose to their highest in two years on Monday, surging up 3% during intraday trading to $64.44 per barrel, a sign that markets may fear how the Saudi political tensions will impact oil supply. According to Kathleen Brooks, research director at City Index, “Brent could be acting as a (money) safe haven in the midst of the confusion around the anti-corruption drive and Prince Mohammad bin Salman’s shifting economic agenda.”

Fears over Saudi Arabia are amplified by the fact that, just as this purge is getting underway, the cold war with Iran is burning at its hottest in decades. On Tuesday, the kingdom accused Iran of an “act of war” for supplying the missile recently fired (but intercepted) at Riyadh by Houthi Rebels in Yemen. According to Abdulkhapeq Abdulla, a Dubai-based political commentator, Saudi Arabia is “going from zero possibility of a direct confrontation with Iran to 20 to 30 per cent chance by the end of the year.”

On our part, we find it telling that these recent geopolitical tensions seem to have had such a pronounced effect on the price of oil. Over the past few years, tensions in the middle east and other oil producing nations have had little impact on oil prices. A prolonged civil war in Syria, the collapse of the Libyan state and the Yemeni humanitarian crisis caused by Saudi Arabia’s own heavy bombardment all proved insignificant for oil traders compared to the massive global oversupply which held prices so low. Instead, the fundamentals of demand and (particularly) supply have dominated market attention.

Now that those fundamentals have improved, with OPEC-Russia supply cuts seemingly having a big effect, as well as improving global demand, it looks like the traditional third element to the oil-price equation – geopolitics – is returning as a pronounced effect once more.

That having been said, we should not get ahead of ourselves here. Oil production is no longer as focused on the middle east (or even OPEC for that matter) as it once was, thanks to new technologies which allow shale producers to extract more than they ever could before and the prominence of Russia in the global oil market. Barring anything catastrophic, we don’t expect Brent to hinge too much on the politics of Saudi Arabia in the short term.

As for the kingdom itself, it’s ironic that the crown prince’s push to reinforce his position and enact his post-oil agenda was just the thing to push up his country’s oil revenues in the short term. Even more ironically, that increase in oil revenue could go a long way to funding his vision of a post-oil kingdom. The young prince has never been too far away from the headlines since the June palace coup, and this latest crackdown has proved what we’ve suspected: He is here to stay, and he means business.

Turning point for UK house prices?

The latest data from the Royal Institute of Chartered Surveyors (RICS) revealed that house price growth across the UK has stalled, as both interest from potential buyers and newly agreed sales continued to fall.

RICS said that buyer interest has been deteriorating, with 20% more surveyors reporting a fall in enquiries than an increase. The same percentage of surveyors reported a fall in the number of transactions in October across the UK.

The housing market appears to be suffering from several headwinds: uncertainties around Brexit, higher interest rates, currency-driven increases in inflation and, therefore, households seeing real incomes squeezed. As a result, estate agents expect further weakness. Optimism among surveyors of the residential housing market has declined to the lowest level since the Eurozone crisis.

The RICS data also suggests that two important divides remain: a north-south divide and a divide between house price brackets.

Surveyors observed a pick-up in sales in Scotland, north-east England and Wales, but negative or flat sales trends in London and the south. This chimes with the Bank of England's regional agents' report, which suggested that excess demand beyond the capital is supporting overall demand, but there are diverging regional conditions, with less demand than supply offered in London/South.

As a result of the oversupply, London continued to experience downward pressures on house values. Two-thirds of surveyors reported a drop in month-on-month prices, which is the weakest reading since the worst of the financial crisis in 2009. Disconcertingly, what happens in London tends to foreshadow wider UK trends. National sales as a whole are therefore predicted to flat-line in the next 3 months and decline nationally over the next 12 months.

There are different pressures for each market segment.

RICS data suggests that luxury housing continues to face a downturn, with three-quarters of surveyors reporting that homes worth £1 million+ tend to achieve less than the original asking price. Two-thirds of surveyors said that homes in the next tier (£500k-£1m) saw agreed prices about 5% below asking prices.

Only the lower end of the market saw any support, thanks to the government's Help to Buy (HtB) scheme. HtB appears to be channelling first time buyer demand towards unoccupied newer builds, rather than existing housing stock (2nd hand market).

RICS Chief Economist, Simon Rubinsohn, said that a "stagnant second-hand market is bad news for the wider economy, not just in terms of spending, but also because it restricts mobility".

Samuel Tombs, chief UK economist at Pantheon, went a step further, noting that "the period of leverage-driven growth in house prices is over". He predicts that prices will only rise in-line with nominal income, since weak demand is restraining upside – a result of higher mortgage rates.

But is there a danger of a larger correction? Not so fast…

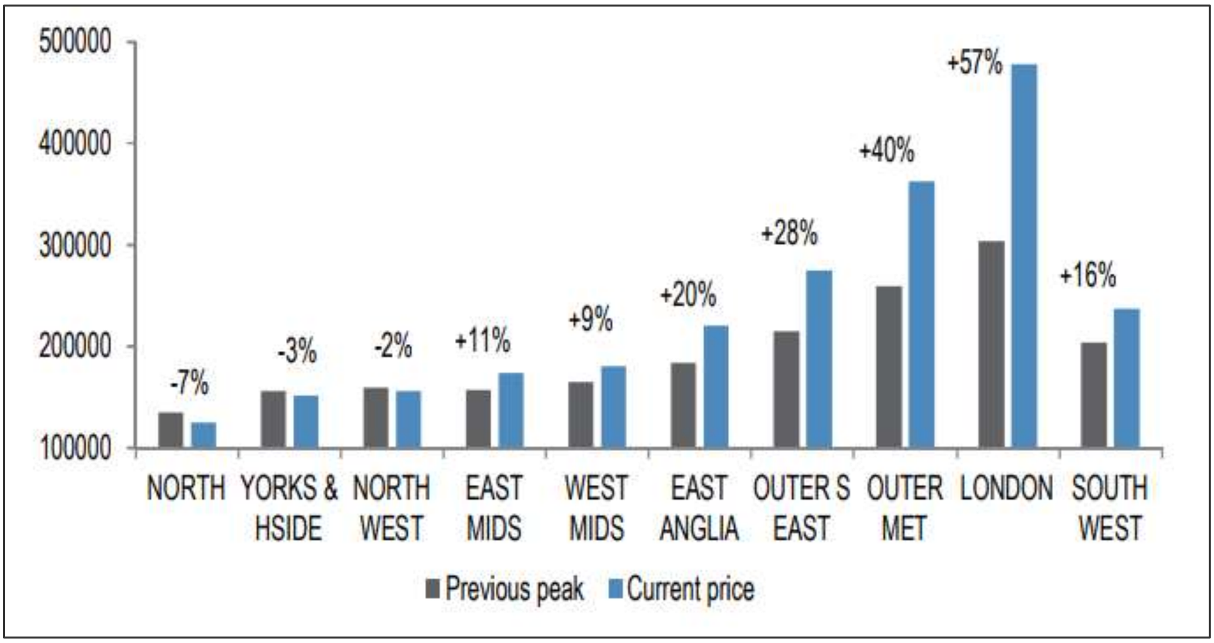
We believe that the continuation of low mortgage rates and more stringent mortgage regulation (macro prudential rules) should limit the risk of a material fall in house prices. This is because it means that neither affordability nor the mortgage burden on households is changing materially, while the tighter lending standards should have put more downside buffers into the system. In this context, it is of note that there have been just two instances of large house price falls in the last 45 years. Peak to trough, prices fell 10% nationally between 1989-91, driven by extreme interest rate increases and 15% in 2008/09, when credit availability and buyer confidence collapsed.

Affordability remains good

High prices in London/South tends to distort overall UK numbers, but continued low mortgage rates means that monthly affordability remains good. JP Morgan note that "while the affordability of mortgage payments for first-time buyers in London has returned to peak levels, outside the capital, the monthly cost of owning a home for first-time buyers is now cheaper than at any point since the early 2000s".

Interestingly, stripping out London, prices have not really changed in the 10-years since the last peak and, in areas in northern-England, prices still remain below that peak level. On this ex-London basis, price to earnings multiples are round 3-4x across much of the UK. Hardly concerning.

Current average house prices versus previous peak (and % change since prior peak) by region



Source: Nationwide

But rates are rising…

The Bank of England's recent hawkish shift towards tighter policy and 0.25% increase in rates left many wondering if there would be an impact on house prices.

First, we should note that, at least over the short term, the sensitivity of borrowers to changes in rates has become relatively low, as most will see almost no immediate change to their monthly payments. This is because, currently, less than 10% of UK households remain on variable rate mortgages, and over 80% of all new lending is also fixed.

JP Morgan calculate that the average mortgage burden on a first-time buyer is 26.9% of their income. A 1% rate rise would increase this to 30.3%, which remains affordable in a historic context. A HtB buyer on a 20% loan would see a bigger increase as a percentage of income, from 23.7% to 26.7%. But that is still below the scenario above for a non-HtB purchaser.

Zeroing in on London, the figure is 30.2% rising to 34%, assuming no wage growth. However, we would expect further rate rises only in the wake of wage increases.

What about Brexit?

This is the big 'known unknown' at present. With little apparent progress on an exit deal, nor clarity about future trading relationships, business investment remains supressed. This is damaging productivity growth and therefore the potential for wage rises. In turn, this should restrict the need for rate rises.

Discretionary expenditure continues to be under pressure from price rises, due to the weaker £-Sterling, and this has led to compressed consumer spending. Whether rate hikes will exacerbate this is not clear. In this respect, we observe that the shadow of Brexit makes it harder to predict whether we are about to experience a typical rate hiking cycle. The capital market is certainly supporting this view, with little difference between interest rates (at 0.5%) and yields of up to 5 years (at 0.75%) – a relatively flat yield curve, in market terms.

Interestingly, a flat yield curve makes it less profitable for banks to offer mortgages (the benefit of transforming short-term liability – deposits – into long-term assets – mortgages – known as maturity transformation). Therefore, it may be possible that banks retrench mortgage lending, potentially reducing property demand further.

Analysts estimate that the Brexit uncertainty could provide for a further 10-12% downside in £-Sterling's value, which could therefore further hamper the domestic property market via negative real wage growth effects.

What should we expect?

The housing market has shown a surprising level of resilience over the last 12 months. Activity levels should be broadly flat on the year, but up around 2% when excluding buy-to-let properties.

Price growth has shown signs of deterioration in London, particularly at the luxury end of the market. This is partly down to the rise in stamp duty and falling employment and wage prospects of the City of London's high earners in financial services. The wider housing market remains fairly affordable on a number of different metrics, even if there was a further 1% increase in rates.

We expect low (or negative) real wage growth may constrain further rate rises, and, thus, perversely support house prices. However, an inflationary/economic shock or a deteriorating Brexit outlook could raise the pressure on the housing market. Especially if the Bank of England was forced to raise rates without counterbalancing benefits from rising wages.

For now, the sales-to-stock ratio provides us with an alternative measure than the traditional RICS survey. On this basis, the ratio for London suggests further moderate price deflation, with modest price inflation beyond the capital.

'Keep calm and carry on' therefore seems an appropriate response in our opinion.

Can consolidation in UK electricity distribution increase competition?

Free market theory suggests that effective competition delivers innovation, improving (service and product) quality, and ever lower prices - a continuing cycle of consumer benefit(s) arising from suppliers vigorously competing for consumer demand. However, one might ask, how many suppliers does a market need to count as competitive? 2, 3, 4, 5, 6 or more?

Well, the proposed merger of SSE's and Npower's domestic electricity supply businesses (formerly Scottish and Southern Energy plc and Innogy plc respectively) will reduce the number of "big" suppliers in the electricity supply market from 6 to 5. As a consequence, the question of the 'right' number of suppliers in a market may now be an issue the UK competition authorities will have to consider, at least indirectly.

The proposed merger will likely fall under the jurisdiction of the Competition and Markets Authority (CMA), and there is certainly pressure from various quarters for the CMA to intervene. But will the merger necessarily reduce the nature and level of competition in that market?

Both companies are intending to merge their retail supply businesses to form a stand-alone entity that will supply >20% of the market. It is understood that SSE shareholders will own ~65% of the company, and Innogy – owners of Npower – the remaining ~35% cent. Innogy has committed to maintaining its stake for at least six months following completion of the deal, although, according to the FT, chief executive Peter Terium indicated it would seek to exit “in time”.

As one might expect, both parties argue that the merger will be good news for consumers. SSE retail's COO suggested that, “by merging SSE's retail business with Npower's retail business to form a new organisation, we think we can be more efficient, more agile and more innovative for customers”. Indeed, in terms of their own corporate strategy, both SSE and Npower need to act. Neither have been particularly successful in an evolving retail market.

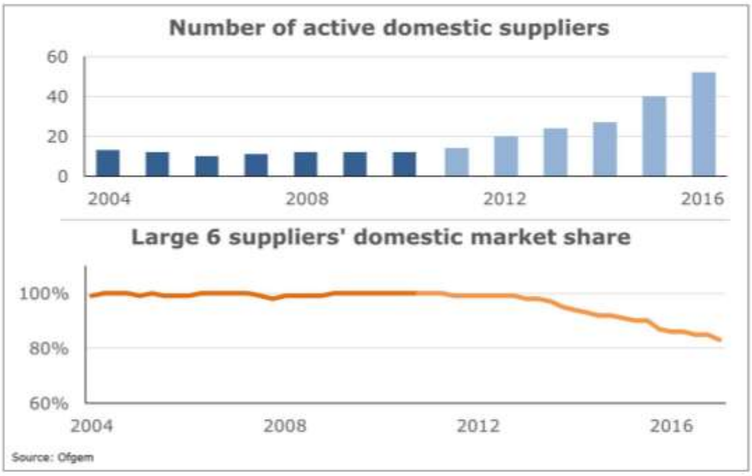
SSE has struggled in the retail supply market. Its retail operating margins are still in the low single digits (4% to 5%) and, in its last update in July, SSE reported that it had lost a further 230,000 customers in Q1. As for Npower, it has marginally less customers than SSE, but is also struggling to generate a reasonable profit in the retail market. It is forecasting an annual loss again this year, and has previously been fined £26m by Ofgem (Office of Gas and Electricity Markets, the industry regulator) for various billing and service issues.

The newly merged entity will be the second-largest supplier in the market with ~22% market share (relative to British Gas’ 24%). And, until very recently, it was only the so-called “big” 6 suppliers (the others being EDF, Scottish Power, E.ON and British Gas) that supplied the whole market. According to Ofgem, for a significant period of time, there were only the “big” 6 and around 5 small suppliers in the market; the “big” 6 had close to 100% market share.

Recently, however, this has been changing and, in fact, the number of suppliers entering the market has accelerated very quickly. There are now over 50 domestic suppliers, and a similar number for the non-domestic side of the electricity supply market. Although the “big” 6 still have a substantial share of the market, up to 18% of consumers have now switched to small or medium sized competitors. There would appear to be greater choice and more effective competition in the market now (see graph below).

Therefore, if one of the questions arising from the merger is: will there be enough competitors left in the market, the answer is, presumably, yes! However, even with the increase in competition “at the margin”, the merged entity will hold a 22% market share and be one of 5 companies that supply ~80% of the total market. While this may give the competition authorities reason to pause, given the recent and relative dynamic in the retail market and other factors, it is hard to see the CMA blocking the proposed merger.

Evolution of the retail electricity supply market



Source: Speech by David Gray (CEO, Ofgem), 11 October 2017

That is not to say that it is a "done deal" by any means. The competition authorities may still intervene and/or require assurances from the merging parties, should the deal be allowed to go ahead. For example, they may require guarantees of the assumed savings arising from the merger – presumably to be passed onto consumers in the form of lower prices. SSE have indicated that it expects to generate cost efficiencies of ~£100m from the deal.

Moreover, looking a little deeper into the underlying reasoning for the deal, it seems Government authorities have already exercised considerable influence, perhaps even inadvertently encouraging the merger. For example, SSE still has around 90% of its retail customers on so-called standard variable tariffs, and is arguably more exposed than any of the other suppliers with respect to retail price changes. This is the tariff rate that the Government has pledged to cap, and has recently brought forward draft legislation to give effect to its proposed price control.

Already buffeted by competition in the retail market, a further reduction in retail revenues – as result of the Government's cap – would have severely constrained SSE's scope for development in the retail supply market. Certainly, financial markets appeared buoyed by the merger announcement (and the decision by both to create a separate retail entity). Before news of the merger, shares in SSE were down ~12% over the year. Following the announced tie-up, SSE rose ~3.5%, while shares in German-listed Innogy – owner of Npower – were up ~1.3%.

Most commentators agree that SSE and Npower will be relieved to divest their respective retail supply businesses, as neither has done very well in this market. The industry has also become politicised over recent years and is subject to increasing regulatory scrutiny. Consolidation in this case will help generate efficiency and enable the new entity to compete against newer brands that have a lower cost base. It will also have the scale to compete more effectively with the market leader, British Gas.

In our view, the proposed merger is unlikely to have a material effect, either way, on competition in the retail electricity supply market. Furthermore, given that the merged entity will have a lower retail market share than British Gas, we would not expect the competition authorities to impose more stringent remedies.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7428.7	-1.7	-131.6	→
FTSE 250	20031.2	-2.2	-441.2	→
FTSE AS	4082.6	-1.8	-74.4	→
FTSE Small	5822.0	-1.2	-70.7	→
CAC	5379.8	-2.5	-138.2	→
DAX	13124.0	-2.6	-354.9	→
Dow	23413.7	-0.5	-125.5	→
S&P 500	2578.5	-0.4	-9.3	→
Nasdaq	6295.7	0.0	0.1	→
Nikkei	22681.4	0.6	142.3	→

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.32	0.99	OIL	64.1	3.3
USD/EUR	1.17	0.38	GOLD	1277.3	0.6
JPY/USD	113.44	0.56	SILVER	16.9	0.2
GBP/EUR	0.88	0.62	COPPER	307.8	-1.3
JPY/GBP	6.64	-0.03	ALUMIN	2093.0	-3.7

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.3	6.4	0.08
US 10-Yr	2.4	2.5	0.06
French 10-Yr	0.8	3.9	0.03
German 10-Yr	0.4	12.1	0.04
Japanese 10-Yr	0.0	-21.8	-0.01

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
IMPERIAL BRANDS	4.8	HIKMA PHARMACEU	-9.4
PADDY POWER BETFAI	3.4	BURBERRY GROUP	-8.7
INFORMA	3.2	AB FOODS	-8.0
SEVERN TRENT	2.0	BUNZL	-6.6
EXPERIAN	1.7	DIXONS CARPHONE	-6.2

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.6
3-yr Fixed Rate	1.7
5-yr Fixed Rate	2.0
Standard Variable	4.3
Nationwide Base Rate	4.5
Halifax Standard Variable	3.74

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	21.9	Brazil	177.3
US	24.8	Russia	140.8
France	18.8	China	59.1
Germany	10.4	South Korea	71.8
Japan	33.1	South Africa	205.5

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