Weekly Market Comment

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October 2017 market returns

Asset Class	Index	October	YTD
Equities	FTSE 100 (UK)	1.70%	8.50%
	FTSE4Good 50 (UK Ethical Index	0.80%	3.70%
	MSCI Europe ex UK (Euro-Zone)	1.40%	15.00%
	S&P 500 (USA)	3.40%	8.80%
	Nikkei 225 (Japan)	8.30%	11.90%
	MSCI All Countries World	3.00%	9.60%
Bonds	FTSE Gilts All Stocks	0.30%	0.10%
	£ Corporate Bond Index	0.50%	3.40%
	Barclays Global Aggregate Bond Index	0.60%	-1.50%
Commodities	Goldman Sachs Commodity Index	4.90%	-7.00%
	Brent Crude Oil Price	7.80%	0.50%
	LBMA Spot Gold Price	0.00%	2.30%
Inflation	UK Consumer Price Index (annual rate)*	N/A	2.20%
Cash rates	Libor 3 month GBP	0.01%	0.26%
Property	UK Commercial Property (IPD Index)*	N/A	7.60%

Source: Morningstar, all returns in Pounds - Sterling (£ - GBP)
* Inflation and property index values only available to previous month

UK rate rise: ‘one and done’ or beginning of rate hiking cycle?

It has been an eventful start to November, following a full-on October that generated pleasing returns for investors in global capital markets (see table above). The financially interested UK public will have focused on the first interest rate rise in the UK for more than a decade – by 0.25%. Two weeks ago, we had covered the UK’s developing inflation and interest rate dynamics in our second article and strongly suggested that this 0.25% rate rise would happen this week. Our readers will therefore have been as unsurprised as markets were and so the little market reaction there was to the announcement by the Bank of England (BoE) on Thursday was actually a small but still counter intuitive decline in short term yields and £-Sterling.

This would have been a reaction to what one City commentator called the ‘least committed rate hike we could have expected’ – on the basis that the BoE’s accompanying comments focused more on the weaknesses of the UK’s economic situation – hardly a backdrop for further rate rises next year. Nevertheless, the rate setting committee’s indication that another two 0.25% rate rises over the next 24 months (!) were likely, may still be sufficient to prevent a deterioration of £-Sterling’s value beyond the recent lows. This in turn could indeed be the best medicine of the UK’s central bank against further inflationary pressures which thus far have not been caused by rising wages, but increasing prices of imported goods.

So, is there now the risk of increasing pressure on the mortgage laden UK public, which would further undermine the UK consumers' propensity to spend? Well, at this pace probably little. The BoE itself estimates that the average mortgage burden will increase by £15 per months. But even from that angle, the Financial Times reported that due to lower home ownership, only 24% of UK households now even have a mortgage (compared to 34% in 2000) and only 9.6% remain on variable rate mortgages, while the over 14%, who are on fixed terms, will initially be unaffected.

As a consequence, we see our view confirmed that despite all the rate rise rhetoric, the BoE remains on a very glacial path of rate rises, which for the time being has minimal impact of the discretionary spending power of the UK consumer. But make no mistake – unless the UK falls into a Brexit induced recession – the direction of travel of interest rates and bond yields has been reversed and points upwards from here.

Other notable developments were president Trump's announcement (finally) that he would replace Fed chair Janet Yellen by appointing Jay Powell. Again, this had been widely expected as of late and since – as we recently wrote here - his policy views have been very similar to Yellen's, markets took it as another non-event. On the more market and economy relevant subject of the tax reform, far less progress was forthcoming and with the Trump administration coming under increasing investigative pressure over the Russian influence affair, many expect that very little real will happen this side of Christmas.

The more unnerving developments occurred in Spain, where, as widely reported, the Catalan conflict seemed to come to a head. However, the situation remained as relatively calm as the Spanish bond markets. This may have had to do with the fact that the Spanish government also announced that it would call for early regional elections in Catalonia. This would return the conflict resolution onto a democratically legitimised political path. This remains a watch and wait situation, but for the time being it feels that the risk of immediate escalation has been defused.

Finally, the more speculatively inclined investors where enthralled by the renewed meteoric rise of the trade value of the crypto-currency Bitcoin. Reaching $7,000 per coin over the week, its perceived value has now increased 7-fold since the beginning of the year and all virtual coins in circulation are equivalent to more than 100 billion US$. There are plenty of voices around warning that this pseudo currency is backed by not much more than speculative interest and the hope of internet finance enthusiasts that global crypto currencies may one day replace traditional national currencies. At the very least however, I would note that the recent value development has all the hallmarks of a market mania which inevitably will end in a value collapse at some point in the not so distant future.

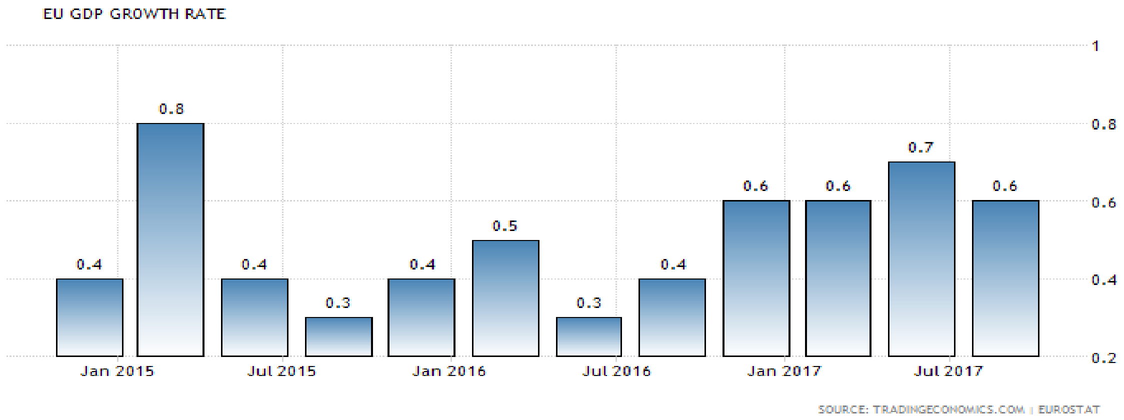
Eurozone: on the periphery or in the game?

With the Catalan drama currently dominating the headlines, one could be forgiven for thinking that things are once again going pear-shaped on the continent. Indeed, when reading the press here, it often seems like crisis is always just around the corner in the EU. Fortunately for investors, markets apparently didn't get the memo about doom in the Eurozone (EZ). Instead, European assets continued full steam ahead with their recent momentum this week.

The latest flash estimates of economic growth for the EZ revised up expectations for 2017, and provided a positive signal for continuing momentum in 2018. According to Eurostat – the statistical office of the European Union – the latest seasonally adjusted figures show GDP increasing by 0.6% in both the Euro area (EA19) and in the EU28 during the third quarter of 2017.

In the second quarter of 2017, GDP had grown by 0.7% in both of these zones. Compared with the same quarter of the previous year (2016), seasonally adjusted GDP rose by 2.5% in both the euro area and in the EU28 in the third quarter of 2017, after 2.3% and 2.4% respectively. In simple terms, year-on-year the EZ economy grew 2.5%, beating the market consensus of 2.1%. It was the strongest pace of expansion since the first quarter of 2011.

Overview of EZ (EU) GDP growth rate



Source: Trading Economics, November 2017

We wrote recently about the favourable economic conditions taking hold across the EZ, but what is now also noteworthy is how broad-based that economic strength is. The activity and strength of we are seeing now isn't just down to a few countries but the wider EZ and, in particular, the so-called periphery countries. There is no precise definition of periphery in the context of the EZ, but countries beyond a so-called 'core' of the UK, Germany and FR, are conventionally seen as periphery, e.g., Italy, Portugal, Spain etc.[1]

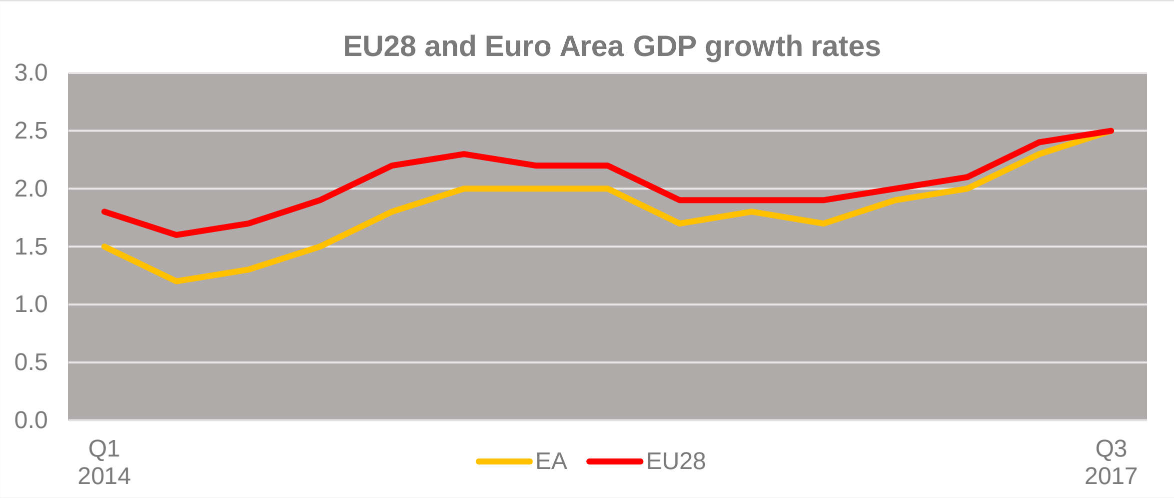
While the EZ is clearly on the right trajectory, the ECB's accommodative (monetary) policy is obviously playing a key role, and is likely to be required for some time yet. As we wrote last week, the ECB's strategy of "lower for longer" will continue to underpin the current economic growth, and provide a fillip to all regions across the EZ.

Also, at this stage, there does not appear to be a divergence between the activity levels and (proportionate) contributions to EZ growth between the so-called core and periphery countries. Instead, it looks like all countries in the EZ – whether core, periphery or outer-periphery – are all pulling their economic weight.

For example, according to Eurostat's figures, there isn't a discernable difference in the latest growth estimate even when all of the EZ countries are included in the analysis (see graph below; the euro area includes the so-called periphery countries referred to above).

[1] Other countries are also sometimes referred to as being on the "outer-periphery".

EU28 and euro area GDP growth rates (% change on the previous quarter)



Tatton analysis (Eurostat source data), November 2017

The open-ended nature of the ECB's recent policy announcement appeared to send a particularly bullish signal for the EZ periphery. BTP and Bonos spreads over German Bunds tightened considerably (Italian and Spanish vs German Government bonds respectively), which was in turn a positive for the Italian and Spanish equity markets. The FTSE MIB and the IBEX have also rallied somewhat on the back of the ECB's announcement and continuing positive economic developments.

Moreover, the activity and growth in the periphery does not look like a transitory boost. More recent data on Italy, Spain and Portugal suggest that all are firmly on track for sustained growth. Spain's manufacturing sector gathered real pace in October, according to a closely-watched gauge of factories' health. IHS Markit said its purchasing managers' index (PMI) rose to 55.8, the highest reading since May 2015, and well above September's reading of 54.3.

Italy is also experiencing robust growth, a particular highlight being businesses reporting much better than expected conditions in October. Unemployment has fallen to ~11%, in line with market predictions, and significantly down from an all-time high of nearly 13% in November 2014. In addition to jobs growth, a new reading for Italy reports the strongest growth in both output and new orders for more than six years. The Italian index rose from 56.3 to 57.8, better than even the most optimistic forecasts.

The EZ's economic growth, combined with subdued price pressures, is also buoying periphery-country debt. Yields have reduced to multi-year lows in Portugal – the lowest since April 2015 (and Italian bonds are now back to levels last seen at the start of this year). The premium paid by investors for Portuguese debt over that of Germany has decreased significantly, to its narrowest in two and a half years.

All in all, it would seem that the periphery is effectively managing its respective (macro and structural) risks, and is developing strongly, albeit largely on the back of the ECB's accommodative monetary policies. Indeed, there is potential for the periphery to not only fill the gaps in EZ growth in the medium term, but to be the primary driver of sustained EZ future growth. These countries will all have relatively more economic slack, greater scope for employment growth and more appetite for business investment.

Therefore, we disagree with some of the financial commentary that the EZ recovery has been the surprise economic success story of the past year. What may be a little surprising, however, is the strength of economic activity and scope for growth now emerging in the periphery countries. It would seem that the EZ periphery may no longer be a disproportionate risk to potential investors.

Abenomics revitalised

Shinzo Abe was re-elected Japan's Prime Minister by its parliament on Wednesday, after his coalition's big victory in last month's election. The ruling bloc, led by Abe's Liberal Democratic Party, retained its "super majority" of two thirds of seats in the country's legislature, meaning Mr Abe has the ability to change the country's pacifist post-war constitution.

The Prime Minister wasted no time in detailing his plans. In a press conference following his re-election, he announced a ¥2 trillion (~£13.5 billion) government spending package to be compiled next month, reflecting one of his central campaign pledges. The Prime Minister said he will use every tool to beat the deflation endemic to Japan's economy, including budgetary and tax measures. "We will remain committed to reviving the economy," Abe told the press, unveiling such measures as financial help to young people in higher education and a free day care service – at a cost of ¥700bn. Those initiatives, he claims, are aimed at making Japan's social security system work for the whole of society, in order to address productivity problems stemming from the country's rapidly aging population.

Only days after his party's big win on October 22nd, the reinvigorated Prime Minister declared a war on low wages, urging the private sector to implement a 3% pay rise from next year. Along with the aforementioned changes to the social security system, interventions like that could put some force behind the third arrow of 'Abenomics' – structural reform.

Since their promise propelled Abe to his second term as PM in 2012, the three arrows of Abenomics – monetary easing, fiscal stimulus and structural reform – haven't quite been flying at the same speed. The Bank of Japan's (BoJ) extremely accommodative monetary policy (negative interest rates combined with quantitative easing) has been going full steam ahead for some years now, and has kept even long-term government bond yields at historic lows; Abe's fiscal stimulus has often flattered to deceive, with big promises and not-as-big payoffs; and the structural reform push has yet to show much in the way of tangible results.

But now, with the strength of a massive new mandate behind him, Abe might well be able to push for greater productivity and escape the deflationary mire Japan has been stuck in for over two decades. Naming a specific number for the private sector pay rise – 3% – shows more commitment here than in the past, when the Prime Minister would simply make general pleas for a wage rise. Last year, the IMF similarly suggested that the government in Tokyo make designated annual pay rises the fourth arrow of Abenomics, arguing for an incentive-based 3% annual rise. On this front, Abe's pronouncements will also help the country's trade unions, who until now have been hampered in wage negotiations by trying to counteract the effects of 2014's consumption tax hike.

Consistent wage growth looks like the final missing piece of the puzzle for the Japanese economy. The unemployment rate held steady for a fourth straight month in September, with only 2.8% of the population searching for jobs, the joint lowest for over 20 years. As we've covered in these pages before, Japan's incredibly low unemployment and low inflation are somewhat perplexing from the point of view of traditional macroeconomic teaching, as theory suggests an inverse relationship between the two. But, if the government's push can drive up wages, stable inflation should follow.

The good news here is that the most recent data looks promising. Average earnings grew 0.9% year on year in August, the highest since July last year and a big improvement on the -0.6% fall the month before. What's more, the country's GDP grew 0.6% in Q2, below the expected 1% but still the highest since early 2015. That means that Japan has now seen expansion for six consecutive quarters, its biggest winning streak in over a decade. This, coupled with improving consumer confidence (the highest since May 2013) and inflation expectations, provide a very solid base for Abe's expansionary policies.

The improving picture in Japan also seems to have caught the eye of international investors. According to the Tokyo stock exchange, foreign investors bought ¥4.4tn in Japanese stocks and futures over the past six weeks. And, while some of those inflows might be a rebound from the ¥2.4tn outflows from July to September, the appetite for Japanese assets now seems strong.

As a result, the Nikkei 225 rose to its highest level since 1996. The index has now returned 17% in local currency terms this year, and 20% in USD terms. All of this comes despite the fact that the yen has gained nearly 3% in 2017. Yen appreciation usually hurts Japanese companies, who largely rely on exports, but Japanese assets seem to have shaken off those worries. According to Russ Koesterich, a global fund manager at BlackRock, "It's probably the cheapest developed market out there - maybe the only cheap developed market out there,"

The inflows are effectively a vote of confidence in Japan's near future, which looks decidedly brighter than its recent past. The general economic conditions are improving, and the government's recent big win should give them the confidence to push forward with a renewed agenda of Abenomics. If successful, the world's third largest economy could be on the cusp of escape from its deflationary quagmire. There are, of course, structural issues which still hamper Japan's economy greatly, the aging population, gender inequality and barriers to immigration chief among them. But these are not entirely unfixable, and some of Abe's promises – particularly the fee childcare and financial help with education – show a genuine willingness to address them.

After years of deflation and dampened outlooks, perhaps it's time for a little optimism in Japan.

Butter shortages and metals prices linked by cobwebs?

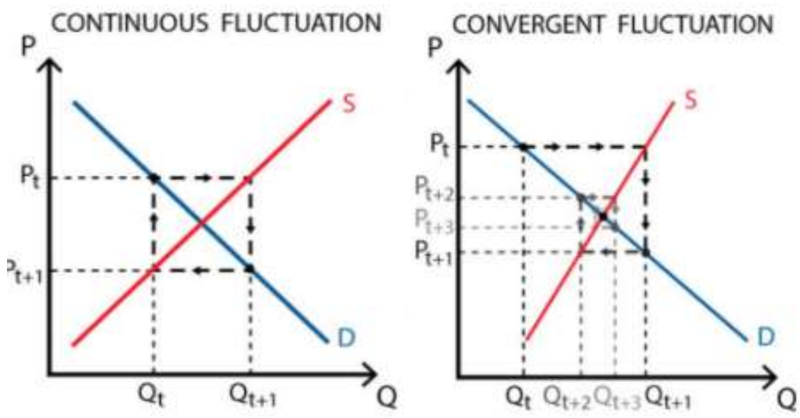
How do butter shortages in France, surging prices for metals, a changing diet in China, Russian sanctions, synchronous improvements in global growth and rising optimism among commodity firms all link together?

One could be forgiven for answering 'nothing'. However, a theory from 1938 by economist Mordecai Ezekiel called the "Cobweb Theorem" gives us that missing link. He aimed to explain how supply and demand forces bring about equilibrium in markets over time, via price changes. Applying the theory to commodities, where supply volumes are often slow to react to price changes, is enlightening here. It gives us a good framework to understand how certain supply and demand dynamics can lead to spikes or falls in the supply and prices of commodities which, at first sight, seem to contradict the supposed efficiency of markets.

Given the wider effects these dynamics have on the economy, politics and society, we thought it useful to explain theory and its relation to commodity markets.

What is the Cobweb Theorem?

In simple terms, the cobweb model helps explain irregular fluctuations in both prices and supply surpluses and deficits, such as those often seen in commodity markets. The key variable for the cobweb model is time. This is because the way price expectations adapt determines the magnitude of price and supply changes over different time periods.



Source: www.policonomics.com

If one assumes that the elasticity (the extent to which one variable reacts to the other) in both prices and quantities are equal (known as continuous fluctuation: left chart) then we would expect a supply glut (at point Q_{t+1} P_{t+1} in the graph) to cause a proportional fall in prices. And, conversely, we would expect excessive demand to lead to prices spiking (at point Q_t P_t in the graph).

The more traditional cobweb model of convergent fluctuations (demand elasticity is higher than supply elasticity: right chart) causes the familiar cobweb spiral between prices and quantities to find an equilibrium level. For example, if milk prices fall, then a reduction in supply will take far longer than a demand adjustment to higher prices.

French butter 'shortage'

Cobweb models can explain the 'mountains' of butter in Europe in the 1980s, due to Common Agricultural Policy (CAP) subsidies, which effectively guaranteed a minimum price regardless of whether there was supply for the quantities produced, and encouraged over-production.

More recently, the current shortage has a lot to do with the end of milk-production quotas in April 2015 and sanctions placed on exporting dairy and other products to Russia by the EU in the wake of the Ukraine crisis. Today's European butter shortage (UK shoppers may find it harder or more expensive to acquire butter at Christmas) probably traces back to these interventions, which disrupted fragile longer-term natural equilibriums

The end of milk quotas first and the subsequent inability of Russian consumers to purchase western dairy products disturbed the supply-demand equilibrium greatly. When quotas fell away, a supply glut in milk developed, as the previously protected prices first caused a significant increase in supply, which outstripped demand. This lead to a significant drop in prices below their previous guaranteed levels, only to fall even further when Russia fell away as an export market. As a result, the world saw one of the longest periods of sustained low dairy prices, with pricing halving between 2014-15 and, for many producers, falling below the cost of production. Dairy farmers around the world suffered income losses, leading to widespread bankruptcies and thereby massively discouraging milk production. The EU tried to soften the blow of a new, lower supply-demand equilibrium by introducing voluntary output cuts that compensated farmers for cutting their milk production.

As one might expect, producers around the world naturally curbed output in response. Unfortunately, at that point, demand had started to rise above previous levels for a number of different reasons. Chief among them: global dairy-producing countries reduced their export volumes. US producers halted exports to help satisfy rising domestic demand, while the world's largest dairy exporter, New Zealand, experienced droughts and lower output.

Global milk production declined 3% in 2016, quickly turning the milk glut into a 'milk (shortage) crisis'. Unbeknown to many producers, who still cut production in response to the previous price signals, there was a positive push on the demand side, as analysts identified a structural shift in butter consumption and demand patterns: Manufactured food (ready meals) are increasingly including larger quantities of butter. At the same time, there were studies suggesting that vegetable-spreads may be less healthy than previously assumed. This prompted a shift back to butter, given it could be seen as a more organic or natural alternative. A home baking boom, led by TV shows (Think Great British Bake Off), also promoted additional butter usage not just in the UK. Meanwhile, China continues to shift towards a more 'western' diet that includes more dairy.

Since then, global butter prices tripled to a new record of €7,000 a ton from €2,500 in 2016, according to consultants Agritel. Cobweb models would suggest that farmers will now expand their production once again to meet the stronger demand, and they most probably will. But, once productive capacity has been removed, it takes time (remember our key variable of time) to truly increase output.

This may explain the frequent overshooting we observe in markets for food staples, but there are plenty of other examples of cobweb theory from the mining industry. There, lead times for changing supply volumes are even longer, due to the substantial investment (of both capital and time) needed to open up more production streams.

Cobweb in metals markets

This week is LME (London Metals Exchange) week, where the global mining industry descends on London. Like in the dairy sector, the mood among attendees appears remarkably upbeat on the back of strengthening demand for base (industrial) metals, particularly those used for electricity and battery technologies like copper, lithium and nickel.

This comes after an episode of supply-demand disequilibrium in the hard commodities markets of much larger dimensions than in dairy. We reported how capital-market-driven price speculation pushed up prices far higher than demand growth would justify, which then led to the sudden end of the so-called commodity super cycle and a rapid deflation of the commodities price bubble. Just as with milk, miners reacted as quickly as they could and mothballed as much of existing and planned capacity as they could. More and more, there are suggestions that this may have led to an overreaction on the supply side, while measured demand growth has continued and, of late, the synchronous economic strength across much of the globe has led to faster increases in metals demand. As this increases general business confidence, we're also finally seeing a recovery in business investment into productive machinery and goods, which further stimulates demand for hard commodities.

With that backdrop in mind, it becomes easier to see why commodities, after ending the first half of 2017 as the world's worst-performing asset class (-6.8% from January to June), have recently turned around. So much so, in fact, that a broad commodity price index is now outperforming all markets bar a handful of equity indices (most of which also contain a high percentage of commodity activity in their weights).

We believe that lagging supply reductions in response to the 2014-2016 commodities slump remain the major factor behind the surge in metals prices this year. Energy and agriculture beyond dairy remain flat to down, as they did not experience output reductions to the same extent. It is well known that energy experiences continued excess upstream capacity. And now, with shale technology, suppliers can quickly vary production volumes even more, which keeps cost inflation in check. In contrast, metals have far less spare capacity (added to Chinese capacity reductions), are facing cost inflation pressures, and have no shale equivalent. This suggests more upside in metals prices over energy.

HEVs and EVs could provide long-term demand catalysts

Longer-term, the global trend towards HEV (Hybrid) and EVs (Electric Vehicles) for environmental reasons will likely provide promising demand growth dynamics for certain metals prices. HEVs are predicted to go from a 2% market share today, to 26% globally by 2025.

The key beneficiaries of this change in the automotive industry are likely to be aluminium (lightweight structures), nickel (nickel sulphate is key for Lithium Ion batteries) and copper (electrical infrastructure).

Summary

We believe that supply dynamics, as opposed to demand, is the key difference between the energy and metals price dynamics of the second half of 2017. We note that metals face no shale equivalent, and expect a limit to energy price upside (for environmental reasons), while metals have more positive cost inflation dynamics, due to the more significant capacity reductions of the last years.

As the Cobweb model suggests, finding a natural equilibrium between supply and demand becomes more difficult when lead times to ramp up production get wider. Balancing the two may be more art than science. But, in a free market system with minimal outside interference, these forces should produce a more optimal outcome.

Too much interference in a natural system can produce butter mountains on one end, and, in the tragic case of Venezuela (use of price controls limits profitable production), severe shortages that can take years to correct.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7561.8	0.8	56.8	↗
FTSE 250	20464.3	1.6	318.2	↗
FTSE AS	4157.4	0.9	37.1	↗
FTSE Small	5894.7	1.0	59.9	↗
CAC	5508.7	0.3	14.6	↗
DAX	13476.7	2.6	343.4	↗
Dow	23546.8	0.5	112.6	↗
S&P 500	2583.6	0.1	2.5	↗
Nasdaq	6273.8	1.0	60.3	↗
Nikkei	22539.1	3.7	799.3	↗

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	-0.41	OIL	61.0	0.9
USD/EUR	1.16	0.04	GOLD	1267.8	-0.4
JPY/USD	114.29	-0.54	SILVER	16.8	-0.2
GBP/EUR	0.89	-0.46	COPPER	311.6	0.4
JPY/GBP	6.64	0.17	ALUMIN	2173.5	-0.8

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.3	-5.9	-0.08
US 10-Yr	2.3	-2.5	-0.06
French 10-Yr	0.8	-4.6	-0.04
German 10-Yr	0.4	-4.4	-0.02
Japanese 10-Yr	0.1	-24.7	-0.02

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
PADDY POWER BETFA	9.8	NEXT	-8.4
CRODA INTERNATIO	5.7	DIXONS CARPHONE	-7.9
ROYAL DUTCH SHELL	4.7	RANDGOLD RESOUR	-6.6
RIO TINTO	4.7	MARKS & SPENCER	-5.2
BHP BILLITON	4.6	BT GROUP	-4.9

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

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	22.7	Brazil	170.2
US	24.8	Russia	129.9
France	19.1	China	52.7
Germany	10.0	South Korea	70.5
Japan	33.0	South Africa	183.7

For any questions, as always, please ask!

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The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel