Weekly Market Comment

15 December 2017

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2017 asset class returns up to 30 November

Asset Class	Index	November	YTD
Equities	FTSE 100 (UK)	-1.8%	6.6%
	FTSE4Good 50 (UK Ethical Index	-1.6%	2.0%
	MSCI Europe ex UK (Euro-Zone)	-1.7%	13.1%
	S&P 500 (USA)	1.1%	10.0%
	Nikkei 225 (Japan)	2.9%	15.1%
	MSCI All Countries World	-0.1%	9.4%
Bonds	FTSE Gilts All Stocks	0.3%	0.4%
	£ Corporate Bond Index	-0.1%	3.4%
	Barclays Global Aggregate Bond Index	-0.8%	-2.3%
Commodities	Goldman Sachs Commodity Index	-0.5%	-7.5%
	Brent Crude Oil Price	3.1%	2.1%
	LBMA Spot Gold Price	-1.3%	1.0%
Inflation	UK Consumer Price Index (annual rate)	N/A	N/A
Cash rates	Libor 3 month GBP	0.02%	0.28%

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

2017 drawing to a close

As we look forward to the Christmas holidays and the new year ahead, we also tend to look back at what the year past brought us. In particular, in our profession, we look back at how the year actually unfolded relative to the expectations and forecasts we published a year ago. Surprisingly positive is likely to be the reaction of holders of globally diversified capital market investments, like the various portfolio types we manage for UK savers and investors at Tatton. As our generic asset class returns table above shows, up to the end of November, stock market investors enjoyed another year of very reasonable returns. Only low risk fixed interest bond investments and commodity investors not a not-quite-as-stellar year; yields simply couldn't fall any lower to provide yet another boost to bond values. December has not changed the picture materially for the year, with markets trading more sideways than decisively up or down.

Looking back at what we wrote a year ago, I am pleased that our outlook and anticipated central scenario was very close to how 2017 developed. I am particularly relieved that the risks to our central scenario which we had also listed did not materialise. I'm especially pleased that our hope that the already strong and globally synchronised upward economic momentum would carry on and perhaps prevent president Trump from feeling obliged to push through some of his more obscure and potentially damaging election promises has played out.

The prospect of less regulation and lower taxes helped to lift sentiment and thereby activity levels of the smaller business sector in the US, while the checks and balances of the US political system prevented the Trump administration from passing into law any really damaging ‘America First’ policy initiatives.

The rise of populism also seemed to have passed its peak, as electorates across Europe observed Trump’s political ruckus and appeared to have realised the potentially severe consequences protest voting can have.

2017 turned out to be a far less turbulent year, and it proved that 2016 had indeed marked a turning point in the aftermath of the global financial crisis and recession of 2008/2009. Fiscal austerity did fall out of fashion in most countries and business confidence slowly returned. With it, business investment also came back, which allowed the global economy gradually turning towards a development path more in line with historical observations and averages.

That was good news for corporate earnings, which expanded rapidly as a result and supported higher than expected valuation levels for stock market quoted companies. This led to much better than the just ‘decent’ returns we had expected, with global equity investors enjoying yet another year of double digit returns.

This then leads to the dominating investor concern of 2017: have stock markets risen too far and therefore become susceptible to a painful correction? Since the spring, this fear has dominated investor meetings and discussions. All the while stock markets kept grinding higher, supported by continued corporate earnings growth and an ever brighter macroeconomic picture developing around the world.

Sadly, the UK marked the exception to the strong economic trend, with the persistent uncertainty over the nation’s trading position post Brexit holding back business investment. Increases in the cost of living as a consequence of the £-sterling weakness additionally put additional pressure on consumers, who slowed their demand as nominal wage rises failed to compensate the price rises. Towards the end of the year, however, we observed that global and particularly Eurozone growth is finally trickling down to the UK economy. And, together with the Brexit negotiation breakthrough, light at the end of the tunnel seems to be in sight.

We will close the year of Tatton’s Weekly next week with our more comprehensive investor outlook for 2018, but as an ‘outlook to the outlook’ let me say this much: the theme for 2018 will likely become readjustment pains to an ‘old normal’ environment. What I mean by this is that all those capital market aspects that over the past years have moved away from their long-term averages – as a consequence of the extraordinary monetary policy measures that had to be deployed to get the economy back on track – will begin to drift back.

This means rising yields will result in even lower returns of low risk fixed interest bonds than 2017, and all assets whose valuations were particularly boosted by low interest rates and bond yields are likely to come under pressure. This makes us concerned about commercial and residential property values, especially in those regions where they have significantly surpassed the pre-2008 levels. Canada and Australia, but also the UK, are unfortunately such regions.

For now, we are pleased that capital markets have enabled us to generate another set of decent-to-very-decent annual investment returns. We turn to tackling the challenges of 2018 in the knowledge that the global economic backdrop is resting on much more solid foundations than 12 months ago. However, after another very strong year for both the global economy and capital markets, we also acknowledge that further improvement in the rate of improvement may from here be more limited. This, together with the potential headwinds discussed above, makes it prudent to assume that, while the global economy is most likely to continue to expand and normalise during 2018, capital markets are likely to become turbulent once more and produce more pedestrian results, while the 'hangover' from the heady days of QE-induced easy money requires time to wear off.

Busy week for Central Bankers

With central banks only recently switching their messaging from monetary expansion to gradual monetary tightening focus was on the world's central banks this week, as they were all scheduled to make announcements. First up, US Federal Reserve chair Janet Yellen announced another 0.25% - widely expected - interest rate rise on Wednesday. Only hours later, the People's Bank of China (PBoC) followed by upping interest rates in both its short term open market operations and its medium-term lending. Next up was the European Central Bank (ECB), who on Thursday broke the trend by keeping interest rates and QE operations on hold, despite revising upwards their growth and inflation forecasts. Finally, the Bank of England likewise kept interest rates on hold in a unanimous decision from its rate-setting committee, and confirmed that it anticipates only "further modest increases" over the next few years.

As for the Fed, their decision came after a two-day meeting of the federal open markets committee (FOMC), where members mulled over the "strong" labour market and growth in both household and business spending. The (modest) rate hike was widely anticipated and so provoked limited market impact – barring US equity indices coming down slightly from their recent all-time highs. Likewise, the FOMC's expectations for 2018 – the quarterly 'dot plot' – pointed to another three modest rises, unchanged from their September meeting.

Overall, the committee displayed a mildly hawkish sentiment, in that their desire for further rate hikes was less due to actual inflation expectations than it was a general fear of letting the economy 'run too hot'. The bank upgraded its forecasts for growth and employment while its inflation forecast was left unchanged. It was this discrepancy which caused two surprising dissenters on the FOMC, who voted against the majority to keep rates on hold, highlighting as-yet benign inflation. Last month, core CPI inflation (excluding food and energy) in the US came down from 1.8% year-on-year to 1.7%, and the figure hasn't printed above the target 2% since February.

With the labour market getting tighter, one would traditionally expect upward wage pressures leading to inflation quickly following suit. But, in recent times this just hasn't happened. The fact that the Fed appears ready to move ahead with its monetary tightening agenda, therefore, suggests to us that they have faith in the traditional macroeconomic models based on the Phillips curve – the supposed inverse relationship between unemployment and inflation – despite inflation expectations remaining subdued.

But perhaps there are other factors at play too. For the first time, Yellen explicitly mentioned President Trump's proposed tax cuts and the growth they're touted to bring. The Fed expects

Trump's tax plans to only "provide some lift to economic activity in the coming years," and did not price in anything like the growth boost Republicans have claimed will come through. On top of this, the Fed has pointed out in previous communications that elevated asset price levels are becoming a concern, suggesting that asset-price inflation and not just retail inflation is something to consider in their policy actions. Before we get ahead of ourselves however, Yellen insisted in the conference that there were no warning lights over financial stability. But, it's worth bearing in mind the other factors that might influence monetary policy going forward, particularly as new Fed chair Jerome Powell takes over next year.

In truth, his appointment makes Yellen's interest rate road map a little less informative. That FOMC members are now factoring in some effects of Trump's tax cut while still maintaining the current rate path implies that they are inclined to use any incremental growth stimulus arising from the fiscal easing effect of the tax reform towards their own growth stabilisation target, rather than raising rates as a counter measure. That is, at least as long as inflation continues to skew to the downside. Indeed, it does seem that they are leaving themselves a bit of room to ease up on further rate rises (tightening) if inflation remains subdued, and this could well translate into a decidedly less hawkish policy outlook when the new chair comes in.

As for China, the PBoC's slight monetary tightening was much more of a surprise for markets. Given the slightness however (just 0.05% for 7-day and 28-day reverse repurchase agreements), it looks more symbolic than substantive. PBoC officials called the decision a "normal market reaction" to the Fed's policy move. It seems that the bank wants to keep pace with the Fed in order to stem capital outflows, which have become quite problematic for the government in Beijing. For some time now, the Chinese government has been working hard to stem the country's bourgeoning credit and (particularly) rein in the shadow banking sector. Looking forward, we expect that China will continue its current policies on compressing the old industries and shifting the country towards a consumption-led economy. And, in the near-term, this will likely lead to their monetary policy being relatively tight.

Now for the rest. There was little really of note in the ECB's announcements. Governor Mario Draghi praised the "strong pace of economic expansion and a significant improvement in the growth outlook", but tame price pressures mean the Eurozone is still expected to miss its price target this decade. The ECB did become the first central bank to produce inflation forecasts into 2020, with the central bank now expecting price growth to not exceed 1.7% until 2020. Draghi's comments were in line with what we have been saying on the matter: "An ample degree of monetary stimulus . . . remains necessary for underlying inflation pressures to continue to build up," according to the governor.

The minutes of the BoE's December meeting revealed the committee was relaxed about November's 3.1% inflation reading – which they had forecast themselves earlier in the year. They seem happy to let markets expect two rate rises from them next year, bringing official interest rates up to 1%, despite acknowledging that the economic news since their November rate hike had been "mixed and limited". They did acknowledge the progress made on the Brexit negotiation front, but the bank still expects uncertainty over UK-EU trading conditions to be one of the main headwinds for the economy.

Overall, actual global central bank policy continues to diverge across different regions, while the forward guidance is far more coordinated in the upwards direction. In the US, it's possible that, if employment data surprises to the downside – and inflation continues to be lacklustre – the speed of monetary tightening might lessen. Meanwhile, in Europe, economic upward momentum could generate more pronounced surprises for central bankers, which could persuade them to reign in monetary conditions sooner than they currently anticipate. For investors, this means that they will – once again – need to keep a watchful eye on these developments, because deviations from current expectations can swiftly lead to currency movements that can easily wipe out market return leadership in local currency.

Japan: the turnaround story

Last week we discussed our rising optimism for Japan's economic prospects, but we didn't touch on our outlook for Japanese asset prices specifically. Well, we essentially believe that Japanese stocks are not only under-owned by global investors but they also look 'cheap' relative to other developed equity markets.

It can be far too easy to be a Japan bear. Stories about aging demographics, 'lost decades' of economic growth, historically dubious corporate governance and relatively weaker focus on shareholder returns abound. But whether founded or not, collectively, this evidence portrays the world's third largest economy as some kind zombie death trap which seems to scare investors away.

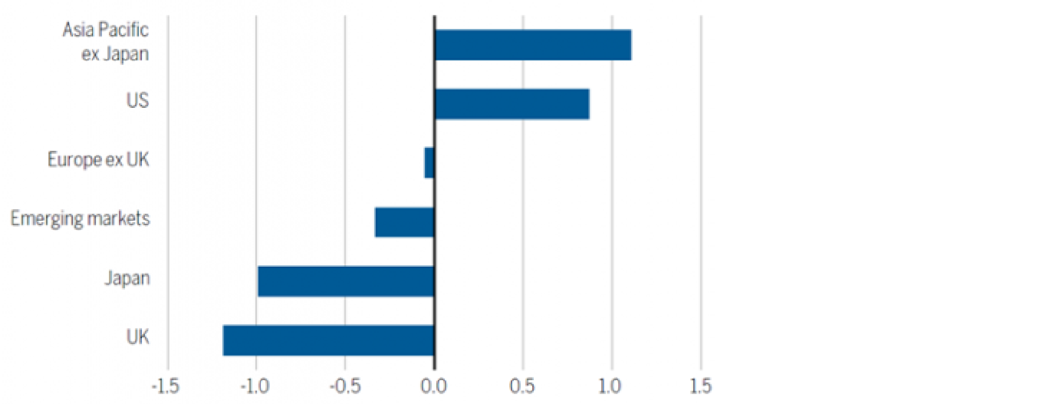
But we believe that Japanese stocks are now at a turning point. Using the well-known tools of value and momentum investing, we can better forecast equity returns. The vast body of academic literature suggests that investors should buy stocks that are cheap and improving just before everyone else also realises that there is a longer-term arbitrage opportunity.

In our view, this is exactly the point that Japanese assets are at now, given that the country's domestic economic engine appears to have ignited and looks to be accelerating. On valuation grounds, Japan is one of the cheapest developed equity markets (Europe also looks interesting in this regard) and investor sentiment looks to be shifting more favourably, as others start to appreciate Japan's improving prospects.

We note that Japan has now registered seven continuous quarters of positive GDP growth, the longest such run in over 16 years. From 2016, its economy has shown remarkably consistent growth, expanding between a minimum annualised rate of +0.9% and a maximum of +2.6% every quarter.

It seems fairly apparent that the country has now broken the near 30-year secular downtrend, particularly from recent economic data. Perhaps Japan has finally produced enough evidence that it is an under-owned turnaround story; it is finally benefitting from Abenomics and now offers potentially attractive markets.

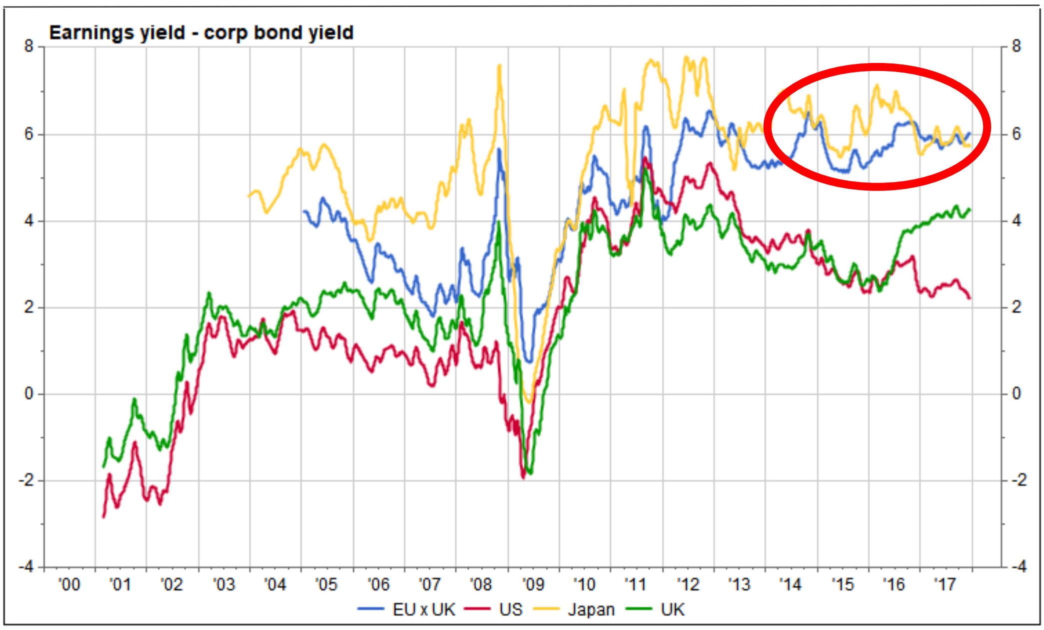
Figure 1: Global Asset Allocators Significantly Underweight Japan (Z-Score in Standard Deviations from Mean)



Source: *Wellington Management*, November 2017.

Global ownership of Japanese stocks is low, relative to other developed equity markets. In its November report, Wellington Management detailed the regional asset allocation positions of international investors (see above chart). This report revealed a significant and – we think – undeserved underweight to Japanese stocks of over 1 standard deviation versus their respective benchmarks.

On a forward looking (NTM or Next Twelve Months) Price to Earnings (PE) basis, Japanese stocks are one of the cheapest developed markets, trading at around 15x versus 17x for Asia Pacific, 19x for North America and 16x for global equities as a whole.



Source: Factset, Bloomberg-Barclays

We believe the chart above demonstrates our point. By taking average company earnings yields (corporate earnings/profits, relative to share price, or reciprocal of the forward PE multiple) and subtracting the average corporate bond yield, we see that, in Japan (and Europe), the surplus that companies generate in earnings over what they have to pay if they wanted to raise more loan capital is the largest. In simple terms, this means they look cheap relative to the US. It's interesting that the UK is also beginning to get cheaper as it diverges from the US trend.

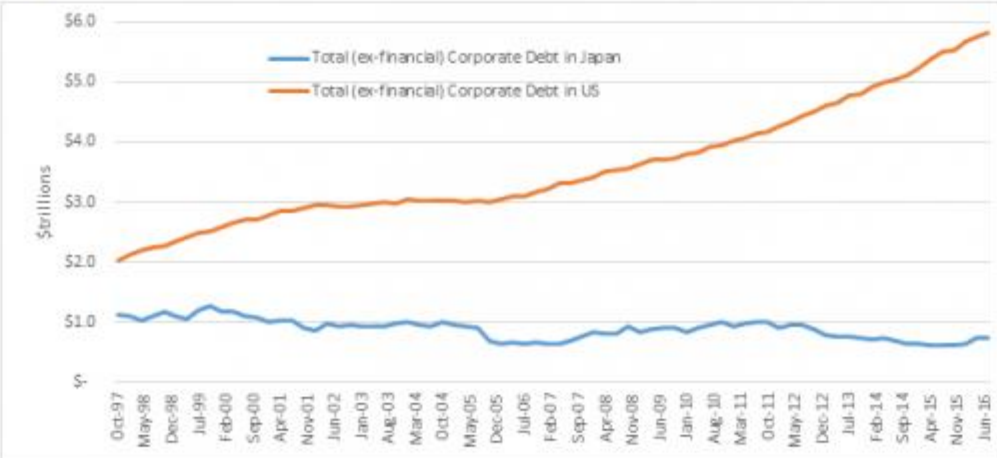
Japanese stocks, valued on an Enterprise Value to Earnings Before Interest Tax & Depreciation (EV/EBITDA), raise further questions for Japan bears. What could possibly justify Japan trading on just 7x EBITDA while the US is on 13x? Put another way, why is Japan some 40% cheaper per dollar of earnings or dollar of book value than US equities?

We believe that Japan equity market bears essentially have three main arguments:

1. **Aging population will hurt GDP growth** – while this may be accurate, there does not appear to be an empirical link between GDP growth and stock market returns. Vanguard found almost no correlation between the two factors when it analysed 42 years' worth of data.

2. **Japan has a corporate debt problem** – if one is worried about high corporate debt levels, consider this: one country has nearly tripled borrowing in the past 20 years, while another has almost cut theirs by 50%.

Figure 4. Corporate Ex-Financial Debt (Japan vs US)



Source: Federal Reserve Bank of St. Louis

3. **Japanese stocks are zombies and a value trap** – Some bears often cite the fact that both the Topix and the Nikkei are flat over the past few decades and that there is a kind of magical "iron coffin lid" preventing markets from going beyond an arbitrary point.

We cannot predict the future, nor determine if Japan will grow at a certain rate or not over the next decade, but it was interesting to see a study from AQR founder Cliff Asness showing that an investor using a deep value approach to Japanese stocks would have significantly outperformed on a risk-adjusted basis. This was even true during the so-called 'lost decades', when Japanese stocks suffered from the most focused bearish consensus opinion about a developed market in recent memory.

We believe that global investors undeservedly overlook Japanese equities, even on the fundamentals alone, never mind valuation grounds. It is interesting that much of what has been said above could also apply to European stocks, where we hold an equally positive view. So much for the zombie death trap.

M&A: Mickey and Amazon

We recently wrote about impending changes to the retail landscape, and how e-commerce has fundamentally changed retail economics and how companies like Amazon, Netflix and Google are beginning to become a dominant force in the supply metrics for end-user demand. This changing economic landscape, and the threat posed by Amazon and others to more established brands and companies, is now evident in recent M&A activity. Maybe the "traditionalists" are starting to fight back?

This week, we saw Unibail-Rodamco and the Westfield Corporation announce an agreement to create what was described as "the world's premier operator of flagship shopping destinations". The merger means that Westfield shareholders will receive cash and shares in Unibail, valuing Westfield shares at US$7.55 (a premium of ~18% on Westfield's closing price on December 11, 2017) and an assumed value for Westfield of US$24.7bn.

Later in the week, Rupert Murdoch's 21st Century Fox agreed to sell its entertainment businesses to Walt Disney in a deal worth just over $66bn. As part of the deal, Disney will also acquire Fox's stake in Sky, the pan-European broadcaster. Estimates suggest the deal values Fox shares at ~US$40. Again, this is something of a premium on the closing share price the day before the acquisition was announced (US$32.75).

Already a major player in media content and distribution, if the proposed deal is cleared by US (and other) competition authorities, Disney will become world's largest media company. It will need to be, if it is going to compete with Netflix and Amazon prime (see brief discussion below).

Bearer is entitled to a share of 21st Century Fox

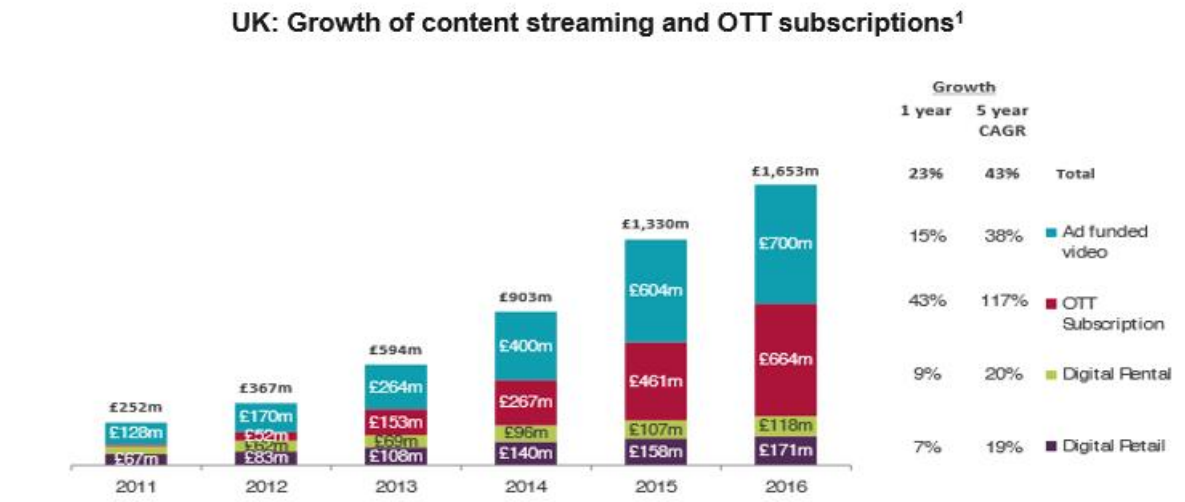
As well as the more eye-catching announcements, there has been a gradual but noticeable uptick in M&A activity and market consolidation in the US and elsewhere. For example, in the pharmaceutical sector in the US, Walgreens finally received approval from the US authorities to proceed with its acquisition of half of Rite Aid's business – a move which will see Walgreens acquire more than 2,000 Rite Aid stores for $5.2bn.

Although this deal has been months in the making, it has been prompted by changes in retail markets and speculation that Amazon was intending to enter the prescription drugs market. Indeed, just as we saw with Amazon's recent acquisition of Whole Foods and its immediate effect on the grocery market, it is now the retail healthcare industry's turn to worry about the possibility that Amazon will budge in on their market share.

It seems that companies are increasingly “running scared”. Markets already seem prepared to discount company valuations in anticipation of entry by Amazon (or another large e-commerce company). In the context of media content and distribution, however, there hasn’t been the same level of concern, or significant discounting of established company stock. Yes, markets recognise that Disney and Fox are potentially lagging behind Amazon Prime and Netflix in terms of the distribution model and volume of subscribers, but markets also know that scale can effectively be bought.

Similarly, markets are aware that developing and leveraging existing content can be considerably more cost-effective than having to lease, commission or invest in new content (which is something the newer e-commerce players are required to do). In this regard, both Disney and Fox may now be ahead of the game; each has significant experience of media production, established content libraries, entertainment studios and extensive rights to other content.

Moreover, Fox’s 30% stake in Hulu, the digital streaming service, will be included in the sale. And, given that Disney/Fox supply a large portion of the content streamed over Netflix and Amazon Prime, this newly merged entity will be well placed to compete in streaming and all other on-demand markets. Disney have already indicated that it will not extend its current content supply contract with Netflix, preferring to market exclusive and other content over its own distribution channels. The gloves are off.



Source: Ofcom, Communications Market Report, 2017

However, as we’ve seen with the road-block placed in front of AT&T’s proposed acquisition of Time Warner (and closer to home, the UK’s on-going consideration of the Fox/Sky deal), regulatory and competition authorities could have a bearing on the outcome of these mergers and acquisitions.

While increasing the scale and/or scope of a company is a recognised and legitimate strategy, strategies concerned with ‘monopolising’ the market are not. In that respect, the competition rules applying media content ownership and distribution are no different to any other market.

However, despite the obvious regulatory risks, the Boards of more established and ‘traditional’ companies are having to develop new and aggressive strategies just to keep pace. This includes ever more consolidation in order to generate the scale to compete with rapidly growing e-commerce platforms, and developing (or mimicking) the new delivery and supply methods.

Clearly, this is not without financial and commercial risk, and it might also mean paying a premium for certain assets and companies. Perhaps the premiums on the Disney and Unibail deals are more about ensuring commercial survival than they are about the assumed future value of the acquisition (Fox and Westfield)?

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7474.2	1.1	80.2	→
FTSE 250	20023.6	0.2	31.0	→
FTSE AS	4100.8	0.9	37.1	→
FTSE Small	5766.0	0.6	32.1	→
CAC	5337.9	-1.1	-61.1	→
DAX	13069.8	-0.6	-83.9	→
Dow	24649.8	1.3	320.6	↗
S&P 500	2669.7	0.7	18.2	↗
Nasdaq	6435.4	1.4	90.9	↗
Nikkei	22553.2	-1.1	-257.9	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE
FTSE 100	3.9	21.8x	14.3x
FTSE 250	2.7	18.3x	14.6x
FTSE AS	3.7	20.6x	14.3x
FTSE Small	3.0	13.1x	-
CAC	2.9	17.1x	14.7x
DAX	2.5	16.9x	13.4x
Dow	2.0	22.3x	18.2x
S&P 500	1.8	21.7x	18.3x
Nasdaq	1.0	24.7x	20.8x
Nikkei	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
DIXONS CARPHONE	12.9	CAPITA	-16.9
MONDI	7.1	ASHTEAD GROUP	-6.1
HARGREAVES LANSD	6.6	NEXT	-5.4
BHP BILLITON	5.7	TRAVIS PERKINS	-5.3
GLENCORE	5.4	MARKS & SPENCER	-4.5

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.33	-0.49	OIL	63.4	0.0
USD/EUR	1.18	-0.04	GOLD	1254.1	0.4
JPY/USD	112.68	0.71	SILVER	16.0	1.0
GBP/EUR	0.88	-0.46	COPPER	312.9	5.0
CNY/USD	6.61	0.18	ALUMIN	2049.5	2.0

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.2	-9.5	-0.12
US 10-Yr	2.4	-0.1	0.00
French 10-Yr	0.6	-0.2	0.00
German 10-Yr	0.3	-2.0	-0.01
Japanese 10-Yr	0.0	-13.2	-0.01

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	4.4
Weighted Average Interest Rate (BoE)	4.37
Nationwide Base Rate	2.50
Halifax Standard Variable	3.99

* LTM = last 12 months' (trailing) earnings; **NTM = Next 12 months' estimated (forward) earnings

For any questions, as always, please ask!

If anybody wants to be added or removed from the distribution list, just send me an email.

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