2018 Outlook

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Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENT

Isaac Kean

INVESTMENT WRITER

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www.tattoninvestments.com Twitter: @TattonIM

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

Tatton's 2018 Outlook

Overview

As we move into 2018, the 'end of the cycle' has become the dominant topic for the investment community. After 10 years of both markets and the real economy trending upwards (though only recently has the economy been strong), some fear that things will head the other way soon. However, our central case for next year is that the global economy will continue to move forward, even though capital markets may be entering some choppy waters.

Let's start with a recap. Investment returns were overwhelmingly positive over 2017, as markets shook off worries at the beginning of the year to end near or on record highs. Despite global central bank policy starting to become less easy, the spare liquidity available to investors (termed "financial conditions") increased sharply and sloshed towards assets – equities in particular – producing very healthy returns with historically low volatility.

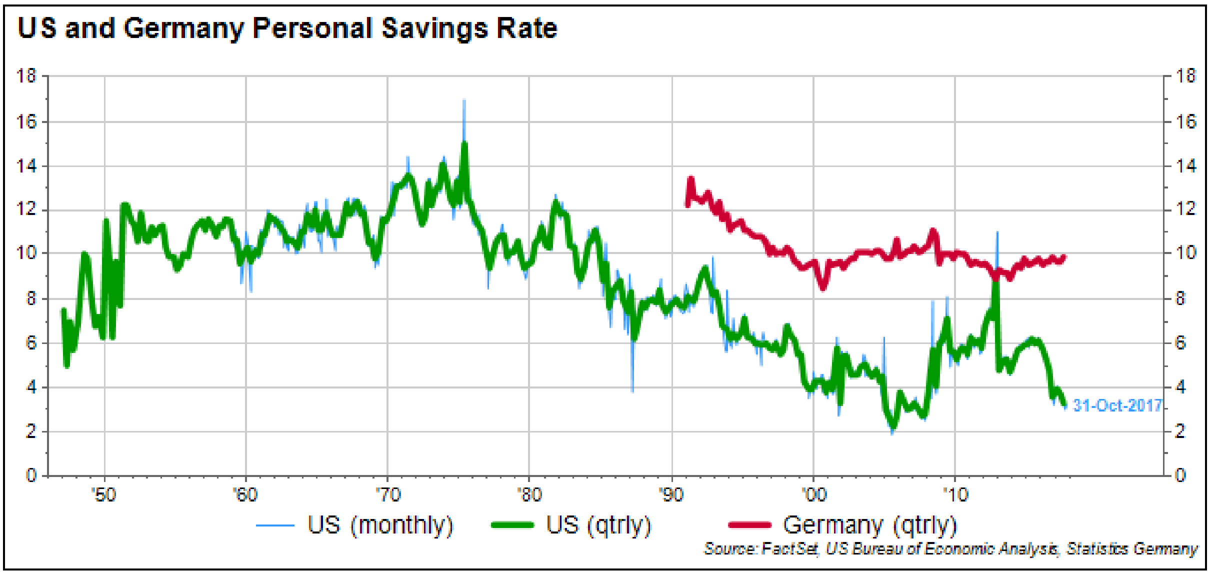
This boom in the financial economy has been backed up by solid real economic growth., and we end 2017 at a very strong level. Goldman Sach's December estimate for current global growth is 3.7%, the strongest since 2006. Employment rose and confidence generally went up. In this strong picture, the surprise was that inflation stayed low, apart from the UK. That's one reason why the UK performance lagged the rest.

Everything going so smoothly has led many to suspect it's the calm before the storm. This is understandable; post-war economic cycle lengths have averaged about six years while investment returns have tended to see flat-to-bad years follow a couple of good and vice versa. But cycles don't die of old age. Without some dynamic causing a downward shift, it's reasonable to expect that the global economy will continue to move forward even as the current cycle enters its tenth year. So, what could bring the party to an end?

In our view, the two factors that could cause a slowdown in 2018 are a fall in consumer confidence and the continued effects of quantitative tightening (QT). If the former happens, it is likely to be in those regions where wage growth is low, consumers have already expanded their debt and – such as in the US and the UK – traditional businesses face yet more pressure from tech-based competition.

The rise in employment this year has brought a large number of people's spending power up. But as we hit "full" employment, the rate of employee growth slows. At this stage, one would expect wages to rise more quickly. But so far, in most regions, it hasn't happened to any extent. In our discussions with many analysts, we would characterise the consensus view on wage growth acceleration as "it hasn't yet happened but it will". We disagree with this view, and think that, if it was going to happen, it should have happened already. Structural issues in certain economies (Brexit in the UK and labour market issues in the US, which we'll cover more later) are the main constraint.

If employee growth slows and wage growth remains slow, continued consumption growth relies on debt growth. In the US and the UK, savings rates have already been coming down considerably and its unlikely that savings can decline much more. However, we should say here that we don't expect this effect to be homogenous across the world. Savings rates have fallen in Europe or Japan but remain at levels which leave room for further falls.



Consumer confidence in the US could be bolstered by the effects of President Trump's tax cut, and UK consumers could well beat the markets' low expectations, perhaps if Brexit uncertainties continue to clear up. Whatever the case, we'll likely see a divergence of growth rates across the globe, compared to the very synchronised rates in 2017.

As for QT, we believe this will be one of the dominant macro factors to consider for capital markets next year. The huge amounts of liquidity provided by QE since the financial crisis buoyed assets across all classes and underpinned global activity by keeping the financial system healthy. It's natural, therefore, that its unwinding might have the reverse effect, particularly in those areas most 'propped up' by the incredibly loose financial conditions. Residential property will likely be the prime example of this next year, which we cover in more detail later on. The US Fed has already begun unwinding their asset purchases, and all else being equal they plan to speed this up next year. But, in our view, the more significant factor will be when the ECB and BoJ begin their own QT. The latter two central banks have collectively injected far more money into the global economy than the Fed over the past five years and, even if it's marginal, their tightening will likely have a bigger impact.

ECB members have already begun "forward guidance" on tightening toward the end of next year. This halting of asset purchases will be priced by markets well in advance. This may mean a tightening of general financial conditions. However, because ECB liquidity has flowed substantially into US assets, it would be as likely to affect the US, where financial conditions have been loosening despite the Fed's policy moves. We would therefore expect increased bouts of volatility, a distinct change from 2017.

The underlying economy could well keep going strong despite the removal of QE. One of our central predictions for 2018 is that there will be a rotation from capital market growth to real economic growth. The tightness of employment, particularly around skilled labour, and the need to enhance technological assets will drive company capital expenditure. In effect, this would be a reversal of the trend seen since the financial crisis, where booming financial markets raced ahead of lacklustre economic growth.

So, at a general level, we agree with the consensus, that global growth will be positive (although slowing) in 2018 and far from a 'doom and gloom' scenario involving a recession. Our "desynchronization" view is probably more pronounced than others, however, and is focussed mainly on potential consumption.

How will the year play out? For the economy, a slowdown is likely to become apparent in the second half of the year – particularly in the US. The consensus view is that the first half of the year will see a continuation of recent momentum, and we're in line with this. Even so, Christmas consumer spending statistics will be very important for the start of 2018 – again, particularly in the US. If the consensus view of the first six months is correct, we would expect consumer spending to be high, even by seasonal standards. If it's not, it could well cause market panic that the positive forecasts are wrong.

One last word on cycles. While business cycles don't die of old age, they tend to be heavily correlated with confidence levels – particularly in investment terms. Towards the end of the cycle, markets become exuberant and tend to approach the 'overheating' stage. That is, one can often tell when a crash is about to occur by the fact that everyone becomes massively overconfident. One of the striking things to note this time around, however, is that, despite equities trading at all-time highs with a year of strong synchronised growth behind us, markets appear to lack almost all confidence, with investors extremely worried about valuation levels rather than celebrating them. In our view, this tentativeness makes any sudden crash unlikely. It's possible that, with growth having moved sluggishly upwards since the financial crisis, when the unwinding of this particular cycle comes it will be similarly sluggish.

Regions

UK

2017 had more surprises for the UK than most other places. The election miscalculation and the rise of Jeremy Corbyn's star might have been the most newsworthy; the Bank of England's monetary policy committee's decision to become more hawkish and raise rates was arguably more important. Both have consequences that will be felt through 2018.

The UK underperformed on most measures, with early consumer confidence quickly wiped out by rising inflation and consequently falling real wages. Political signs did improve toward the end of the year after a breakthrough on the Northern Irish border and the size of the 'divorce bill'.

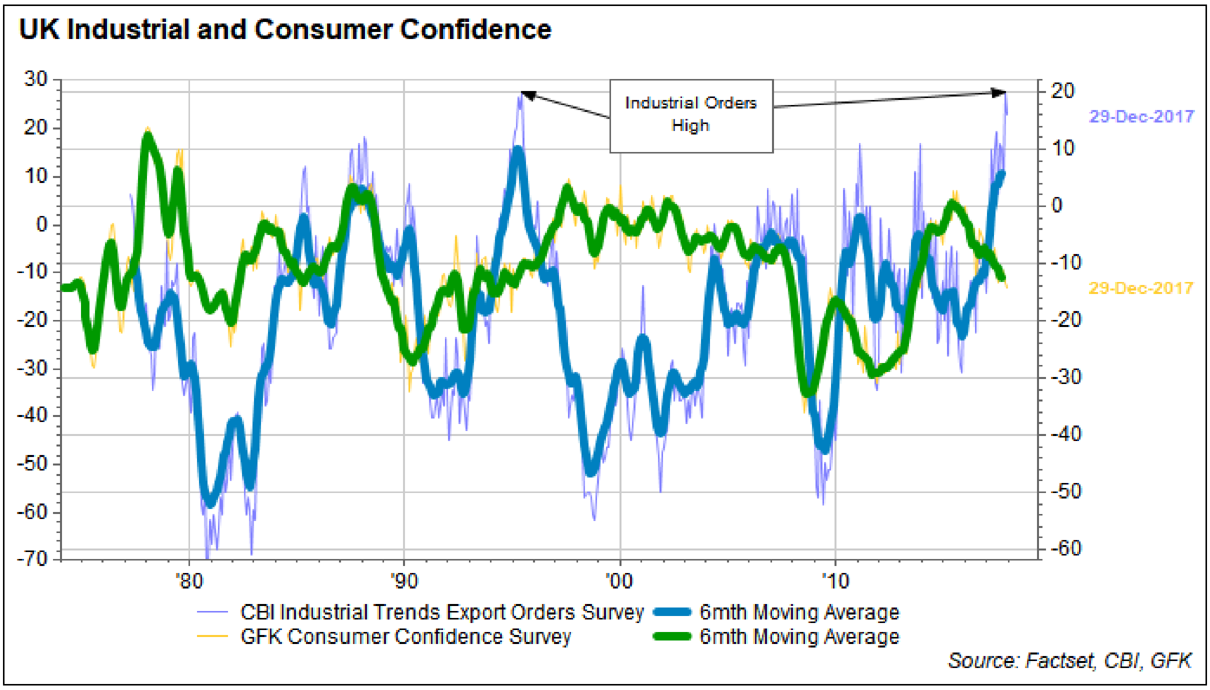
Brexit negotiations remain key - in particular, the faster an agreement can be reached on the fate of the services sector the better. That will have major consequences for the UK property market and not just in the South-East. As we've progressed through 2017, the price weakness seen in London has spread out, impacting consumers by quickly limiting any ability to raise borrowing.

Corbyn's popularity is likely to keep the hard-line Brexiteers from being too vocal. Most of them would view a Corbyn-led government with as much dislike as a soft Brexit.

There's potential for some positive surprises if the gloomy forecasts from the Office for Budget Responsibility prove to be too pessimistic on productivity – something many economists now believe. the economic conditions will depend largely on external factors, particularly the spill-over demand from EU growth. If the EU fails to do as well as we expect (see below), things will be difficult.

Business sentiment could be helped by progress towards a softer Brexit, although the lengthening of processes makes final outcomes more uncertain; things can easily change despite supposed agreement. Still, currently, Britain is in a reasonably good position in terms of export competitiveness – we've not yet left the EU yet, after all.

Further weakness in £-sterling would help manufacturing as demand from the EU spills over, which could buoy the regions outside of London and the southeast – as it did towards the end of 2017. The chart shows the continued divergence between consumer and industrial business fortunes.



The Bank of England's monetary policy committee will have a fine line to tread initially. 2017's RPI rise to 4% year-on-year left them with little choice but to raise rates but inflation pressures have fast been dissipating despite apparent full employment. As the impact of previous sterling weakness drops away, the MPC will have room to allow sterling to take the strain of domestic demand softness. While we expect no major shocks to the value of £-sterling, with success or failure in negotiations causing only marginal moves upwards or downwards respectively, we think it likely sterling will end the year lower on a trade-weighted basis, especially against the euro.

EU

We expect Europe to outperform other developed markets in 2018, particularly the US. European equities have actually beaten their US counterparts so far this year (not in local currency terms but, in GBP total return terms, the STOXX Europe 600 is up 12.4%, S&P 500 11% according to Factset).

The underlying economy was one of the success stories for markets in 2017. We predicted some outperformance at the end of last year and overweighted EU assets in our portfolios accordingly.

The growth was more broad-based than expected, with the Eurozone being powered by the periphery as well as 'core' France and Germany. This addressed some of the structural imbalances which have previously hampered the EZ, which is good news.

Ahead, the pickup in German demand should decrease the country's current account surplus, reducing the current account deficits of other EU nations and the rest of the world.

Banking weaknesses in Italy and Spain cleared up significantly in 2017, lifting a weight off the continent. France looks to be in good position if President Macron can push his employment reform agenda through, which could see the country take centre-stage within the union.

The ECB's continued loose monetary policy should help underpin growth, particularly in the early part of the year. However, as the central bank begins to signal an unwinding of its asset purchase program in the latter half of the year (as is widely expected), some teething problems are likely as we return to the 'old normal'. External pressures from a slowing US and China could also act as a significant drag.

Our risk case for Europe is that its good performance becomes its undoing by causing a sudden spike in the value of the euro. European exporters are sensitive to currency moves, so this could cause a retreat in business sentiment which would hamper growth. Still, our central case is that there is a slow rebalancing towards the currency as the year wears on. This will likely mean that growth won't be as spectacular as in 2017 – particularly towards the end of the year – but will still remain positive.

US

We expect that the US will slow more significantly than other countries next year, on the back of falling consumer demand. The US labour market has some structural issues which seem to be stopping it from generating sustained wage growth, even though unemployment fell to its lowest in 16 years in October (4.1%). The lack of tech-skilled employees, unequal wealth distribution and growing presence of oligopolies in sectors across the board – the 'Amazon effect – severely limits the effectiveness of the traditional Phillips curve (the supposed inverse relationship between inflation and unemployment). This means that, in order to grow their spending, consumers will need to take on more debt or run down their savings. But the chart of personal savings rates showed that they are close to the lows seen just before the financial crisis of the last decade, constraining citizens' ability to expand their debt.

For this reason, we don't see much potential for higher growth into the tail end of 2018. President Trump's tax reform might provide some lift, but it's likely to quite small in terms of boosting individuals' spending. What's more, given the administration's difficulty in passing this tax legislation, passing any (potentially more effective) infrastructure plan will likely be even more difficult. On the political side, we suspect that the above-mentioned 'Amazon effect' will garner even more attention next year, possibly leading to calls for new anti-trust legislation.

We don't believe that US inflation will pick up next year, and see employment growth slowing, which could well lead to a slower rate-rise path than the Fed has previously indicated. All of this will likely translate into the US dollar weakening over the year – certainly if the Fed deviates from the expected rate rise path at least.

Our risk case here is that the dollar falls sharply, which could be harmful to global growth by choking US demand for overseas goods. The base case is that the dollar falls gradually as the year goes on.

In terms of US equities, they may well be boosted by higher profits from tax reform, but as the year goes on we expect optimism to fade, as EPS growth runs out of room. We expect this to lead to underperformance relative to European and Japanese assets in particular.

China

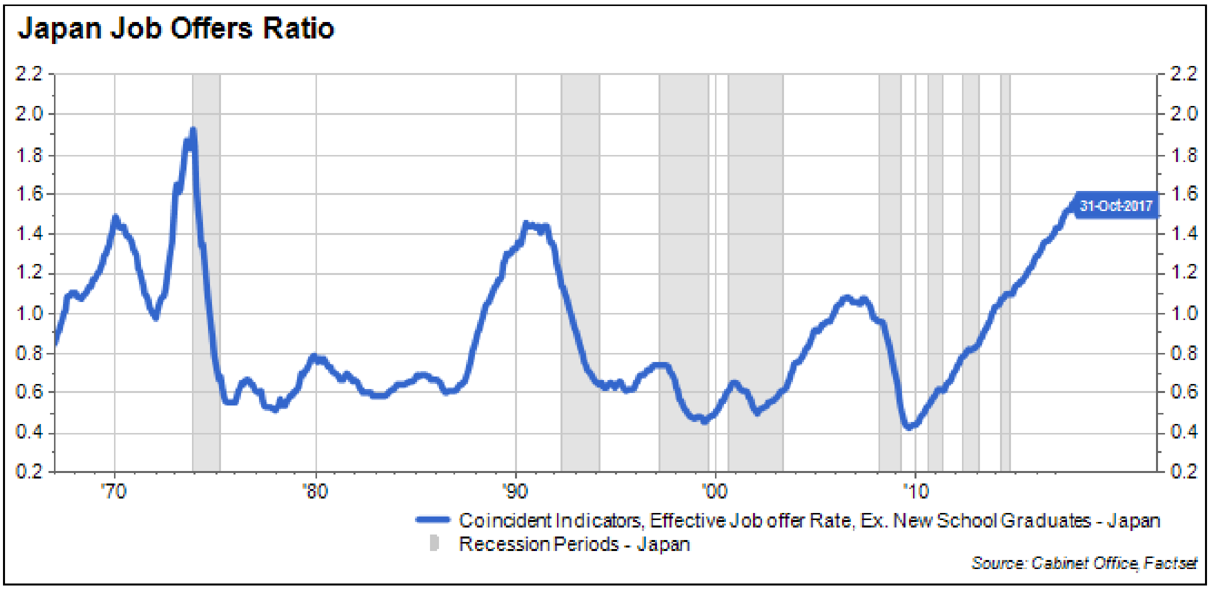
We believe that the Chinese government will continue their reform agenda throughout next year. The transition away from a focus on indiscriminate investment-led growth to consumption and environmental reform will likely slow growth somewhat. 2017 saw President Xi Jinping's entrance into the history books as one of modern China's most powerful leaders, and his government's as-and-when interventions into the economy made some investors a little nervous at first. However, officials in Beijing have proven themselves quite competent at the whack-a-mole approach towards curtailing the country's problematic shadow banking sector.

Through the first half of 2018, we expect the government to continue the monetary tightening they began towards the end of 2017. As we close the year they show signs of responding to slower growth indicators and we expect an end to tightening before the second half of the year, and a possible resumption of their lower renminbi policy. This focus on domestic reform will likely compress activity, which would dampen Chinese demand for foreign goods, particularly commodities. Given that rampant Chinese demand has been one of the largest contributing factors to global growth over the past couple of years, any drop off here is bad news for global activity. Having said that, the potential slowing of activity from China is unlikely to be major.

The wildcard here is the growing tensions between China and the US on trade and other issues (such as North Korea). Although President Trump's fiery criticism of China waned in the year since his election, it has heated up again in recent weeks, leading to potential escalation next year. This could become particularly prominent if both nations slow economically toward the second half of the year, as we expect them to. It's very hard to predict what outcome a 'trade war' between the world's two largest economies would have, but it's unlikely to be good. We're not convinced that it will come to that, but it remains a risk going into next year.

Japan

We are positive on Japan's economic prospects for 2018. 2017 saw something of a demographic "miracle" for Japan, as women and older people who had previously not participated in the labour market got more and more jobs. This compensated greatly for the 'demographic problem' of Japan's aging population, and left the country in a far better position economically than they have been in decades. The chart below shows how job offers have continued to outpace the seekers of work:



We expect these positive developments to continue, boosting Japan's growth prospects. Much like Europe, we expect Japan and its assets to outperform the US next year. Also like Europe, however, we expect Japan's growth to lead to a gradual strengthening of the Yen, which will balance out the effects of growth and leave it slowing slightly (but with still positive growth) towards the end of 2018. Overall, this means that we expect Japanese growth to be positive in 2018, but below the 2017 figure.

Emerging Markets

We expect a general slight slowing in global activity to dampen investor sentiment on EMs in 2018. The environment for EMs was extremely positive in 2017, with strong global growth and low inflation from developed nations pushing up demand for EM goods, while the political instability usually associated with developing countries settled significantly. The falling value of the USD also provided a boon by lowering servicing costs, while recovering commodity prices boosted revenues.

We don't expect things to be quite as rosy next year, however. This is mainly due to our outlook on slowing (but still positive) global growth, as well as our expectation that commodity prices will fall slightly. EM investors tend to get nervous as things start to slow, so some falling sentiment and rising volatility is likely. We're not overly bearish, however, since we expect the USD to fall further, which should help stabilise things for EMs.

Asset Classes

Equities

As 2018 wears on, we expect a more risk averse environment than we saw in 2017. This will be especially prominent in the second half of the year, where we expect economic growth to slow and fears over the 'end of the cycle' to become even more pronounced. Early in the year, US equities should see a boost from President Trump's tax reform, which is expected to boost earnings per share (EPS). However, this boost isn't likely to be enough to sustain valuations which look extended.

Given our positive outlook on Europe and Japan, we expect EPS growth to outperform there. We expect a more volatile environment than in 2017, with rising default rates in retail and commercial property creating some disruption. Equities should find some support from stable government bond yields however, which should prevent any major bear market.

Bonds

Bond yields will likely see more divergence in 2018, with US and UK yields potentially falling later in the year while European and Japanese bonds remain stable. This largely reflects the differing economic prospects for these regions.

Monetary policy will play a dominant role, with the bond market likely to suffer a hangover from QE. The flattening of the US yield curve is likely to continue early on as the Fed raises short-term interest rates, and an inversion may cause fears of recession to rise. Surprisingly the ECB's quantitative tightening could help here though, as the spare liquidity provided by the ECB has hitherto anchored the long end of both EU and US yield curves, and so removing that anchor should allow for some steepening.

Corporate bond markets should be stable but are unlikely to better performance than governments if defaults start to rise.

Commodities

We expect a slight fall in commodity prices in 2018, largely on the back of reduced demand from China. In metals, this trend already began in 2017 as prices peaked, while oil fared slightly better due to supply cuts and demand from other areas. We don't expect these falls to be too large however, with a weaker dollar providing some support. Overall we expect Brent to settle around the $50 per barrel mark, but only towards the latter part of the year when our central scenario of slowing growth plays out.

Property

Our outlook for residential property prices is stable-to-negative for 2018, with a continuation of the sogginess seen in 2017 in the UK and other areas. The areas most at risk are those where property prices have risen above their pre-2007 peak, such as Canada, Australia and the UK. Long-term loose monetary policy has inflated prices in these areas leaving them inherently more susceptible to shocks. European nations, especially Germany, are in better shape.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W
FTSE 100	7,604.0	1.5	113
FTSE 250	20,422.7	1.9	374
FTSE AS	4,173.0	1.6	64
FTSE Small	5,839.7	1.2	68
CAC	5,386.0	0.7	37
DAX	13,109.7	0.0	6
Dow	24,782.3	0.5	131
S&P 500	2,684.6	0.3	9
Nasdaq	6,472.7	0.1	6
Nikkei	22,866.1	1.4	313

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE
FTSE 100	3.8	22.2x	14.4x
FTSE 250	2.7	18.2x	14.6x
FTSE AS	3.6	21.0x	14.4x
FTSE Small	3.1	13.4x	-
CAC	2.9	17.1x	14.7x
DAX	2.5	16.9x	13.4x
Dow	1.9	22.5x	18.3x
S&P 500	1.8	21.9x	18.4x
Nasdaq	1.0	25.4x	21.1x
Nikkei	-	-	-

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.34	0.3	OIL	58.4	1.8
USD/EUR	1.19	0.8	GOLD	1,267.3	1.0
JPY/USD	113.50	0.7	SILVER	16.1	1.0
GBP/EUR	1.13	-0.5	COPPER	2.9	0.0
CNY/USD	6.59	-0.3	ALUMIN	2,108.5	3.6

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.26	-1.0	0.11
US 10-Yr	2.48	-1.0	0.13
French 10-Yr	0.74	-1.0	0.11
German 10-Yr	0.42	-1.1	0.11
Japanese 10-Yr	0.05	-0.1	0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.4
5-yr Fixed Rate	1.6
Standard Variable	2.0
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!

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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