Weekly Market Comment

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US-Dollar exchange rate index DXY over the past 12 months

Source: www.tradingview.com, 19 Jan 2018

US$ weakness versus Bitcoin and Carillion

Across the mainstream media, the past week's finance news was dominated by the collapse of construction conglomerate Carillion and the rapid fall of Bitcoin. However, the investment world was more transfixed by the continued fall of the US-Dollar (US$), which is occurring despite the US economy being the home to strong economic growth and as a consequence the highest interest rates and bond yields of the western world – usually the pre-requisite for a stronger, not weaker currency (see chart at the top which shows the declining value of the US$ against a basket of global currencies over the past 12 months).

Being the currency of global trade, large and unexpected moves in the Dollar can be disruptive to the world economy, because the sudden price changes derail long term planning and thereby slow growth. The explanation for the unorthodox fall may actually be less mysterious than many commentators suggest. The consensus view that US stock markets are trading at exceedingly high valuations compared to Europe and Japan (See last week's CAPE article), without good economic rationale, is increasingly persuading global investors around the world to shift capital from the US to Europe and Japan. This leads to a selling of US$ for Euros and Yen. One is almost tempted to say the US is suffering the consequences of too much of a good thing – vibrant and dynamic capital markets.

For the time being, the fall in the dollar relative to the Euro, £-Sterling and other global currencies has not reached dimensions that are overly disruptive, but it is a dynamic that merits monitoring. The same applies to the rise in US long term bond yields over the week, where the yield on 10-year Treasuries jumped above the critical mark of 2.6%, which many fear could trigger an even stronger bond market sell-off that rapidly sends the 10-year to 3%. Just as with too rapid movements in the currency markets, this could put an end to the Goldie-locks environment of strong economic growth, rising corporate earnings and vibrant stock markets in the US.

In this context, the volatility experienced by Bitcoin investors and the noise around the Carillion collapse seem distractions. We will refrain from discussing Bitcoin again in this edition, but the Carillion liquidation raises some important questions about the effectiveness and sustainability of the public-private partnership (PPP) and private-finance-initiative (PFI) model. Unless handled with utmost care, Carillion was big enough to have the potential to drag down other, perfectly healthy and well managed construction and servicing firms. At the very least, however, the public sector will have to accept a rise in costs – not in the form of a bailout, but most probably in higher prices for buildings and services to prevent the effects of ruinous competition in future. Higher taxes may

well be the longer-term result. P.S.: Tatton's investment portfolios had no exposure to Carillion except for some relatively insignificant tracker fund positions.

To end the summary on a more positive note, RICS' monthly house price survey reported healthy annual house price increases of around 5%. Interestingly, the report shows that UK's house price dynamics continues to be somewhat on its head: The southeast is experiencing slight downward price pressures, whereas the revival of export demand for manufactured goods is leading to up-trending prices in the middle and north.

Carillion's collapse: an earthquake or a tremor?

The collapse of construction and services company Carillion has been all over the news this week, with media eulogies mostly highlighting its mismanagement and the issues it presents to taxpayers. It's a story that has all the ingredients for a good public furore: corporate mismanagement of public contracts, boardroom 'fat-cattery', layoffs, and a headline-grabbing 'bill' to the taxpayer.

From a market perspective, Carillion's collapse was hardly a surprise. Three profit warnings since July, tumbling share prices and a visibly flimsy balance sheet all painted a classic picture of a company that had become overleveraged in the face of increasing costs and a shortfall in profits. According to the FT, Carillion held just £29mn in cash when it collapsed on Monday. The company had such a gap in its funding that consultants PwC and EY both turned down administration roles over concerns that they wouldn't be paid. At that point liquidation became inevitable.

The failure of the construction giant – and especially how spectacular and apparently predictable it was – has sparked widespread debate about public-private partnerships (PPPs) and the

relationship between the public and private sectors. In particular, private finance initiatives (PFIs), which in recent times have provoked much political ire, have come under the spotlight again.

PFI first came about under John Major's conservative government in the early 1990s, but their real proliferation came during Tony Blair's premiership. In short, PFI contracts are public projects (usually construction) where the upfront capital is provided by private firms, who then lease the service back to the government. Rather than raising taxes or dipping into the bond market, PFIs allow the government to build roads, hospitals and other vital infrastructure projects without putting a blot on their balance sheet. Payments back to the PFI contractors (the 'rent' the government pays for its public services) usually take place over 20+ years, while both the upfront bill and the day-to-day management falls to the private sector.

For PFI companies, the incentive is obvious enough. By providing the capital upfront they can demand long-term payments in excess of what the public sector would usually pay for ongoing management. But what about governments? Part of the reason is ideological; since the 1980s, the dominant idea throughout Westminster and elsewhere is that private management is more efficient than public management (though evidently that mood is now changing).

The more cynical – though perhaps more likely – reason is that PFIs look far better on the government's balance sheet than publicly owned assets. As mentioned, the first PFIs came early in John Major's premiership, when the early 90s recession increased the budget deficit and the government needed a way of maintaining public services without adding more debt (or raising taxes). When the economy improved – and the government's tax revenue with it – the need for PFIs dropped away. When New Labour came into power in 1997, their commitment to maintaining the Tories' fiscal discipline while also bolstering public services led to a PFI bonanza, of which companies like Carillion and Serco were great beneficiaries.

So how did it all go so wrong? One main issue for PFI contractors is structural and common to all PPPs. In writing up contracts, governments need to set future 'rent' prices long in advance – often extending up to 30 years. This means companies have to make extremely long-term predictions about their profits. In sectors like construction (which is wrought with PFIs), input costs can vary dramatically (just look at the commodity bubble, unwind and rebound over the past few years), meaning profits are by their nature unpredictable. When revenue is fixed but your costs vary, blows to the balance sheet are inevitable.

For the first few years, business can be – and indeed was – very good for firms like Carillion. But, for all the talk of private-sector efficiency, the incentives that executives face (generating short-term profits and bolstering share prices) has a tendency to make them overvalue future profits. This leads to mismanagement situations like at Carillion, where bosses 'overpay' themselves on the assumption that cashflow will remain stable, but can't be held accountable when things turn sour. The 'pocket-and-run' critique of private sector management may be a cliché, but it has some truth here.

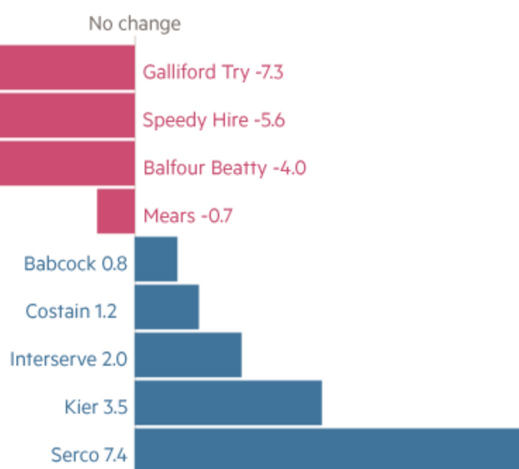
We suspect the Carillion case will intensify the political debate around PPPs, as well as government oversight and corporate law more generally. The government's role in Carillion's demise could be particularly harmful to them, especially if it turns out they knew the full extent of the construction giant's budget problems but kept supplying them with contracts regardless. In 2016, Carillion revoked a clause in the contract which stated that executive bonuses could be

clawed back in the event of "corporate failure", while the government didn't say anything. Their handling of the liquidation so far suggests they're happy to let shareholders and debtholders take the hit, which could potentially result in lawsuits if government collusion turns out to be true.

But the bigger effects could be the systemic ones. The knock-on effect for PFI firms could see costs begin to rise for local government trusts. This could very well raise costs for NHS trusts, worsening the issues for the health service. Without trying to paint a 'doomsday' scenario, the political fallout from a deepening of the NHS crisis shouldn't be understated. With the minority Conservative government already looking weak, another election would definitely be a possibility. If that did happen, all bets are off on the outcome. The Labour party has always been seen as stronger on public service issues. Were they to come into power and enact the policies in their last election manifesto, UK equity markets would likely have an almighty tantrum.

Fallout from Carillion's collapse: Sector split as investors bet on some companies to pick up business

One-day share price change, 15 Jan (%)



Source: Thomson Reuters Datastream

© FT

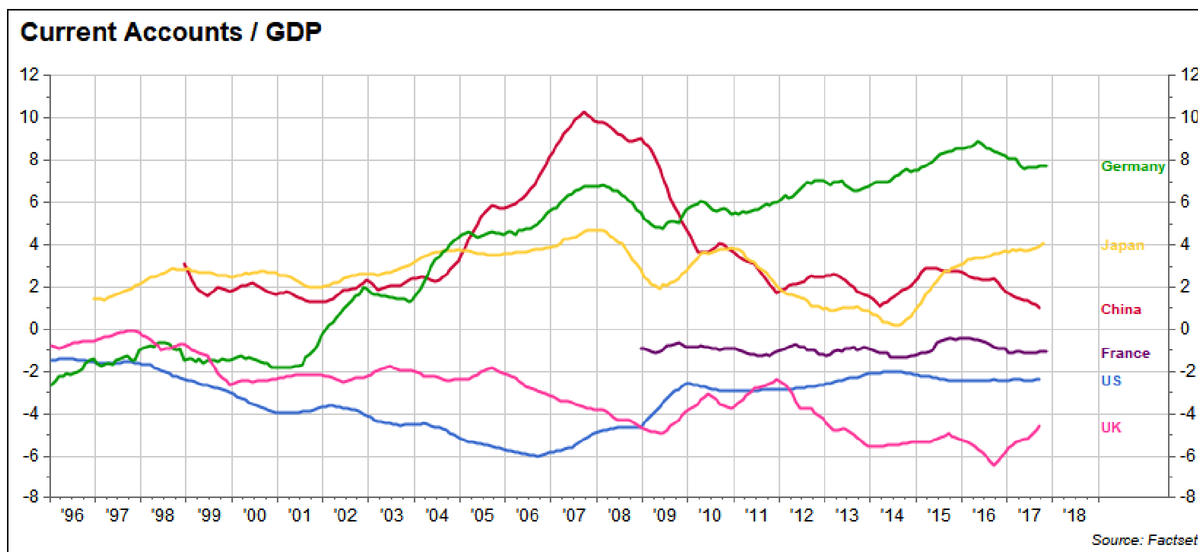
Of course, it goes without saying that all of the case just painted comes with a huge 'if' in front of it. It's far from being our central scenario, but it's worth thinking about the potential systemic issues arising here. When bankruptcies begin – particularly in sectors involved in public services – the snowball effect can be quick and unpredictable. With any luck, the contagion will be minimal and contained. If it isn't, things could start to get quite difficult, and not just for the construction services sector.

Germany, Europe and the Euro

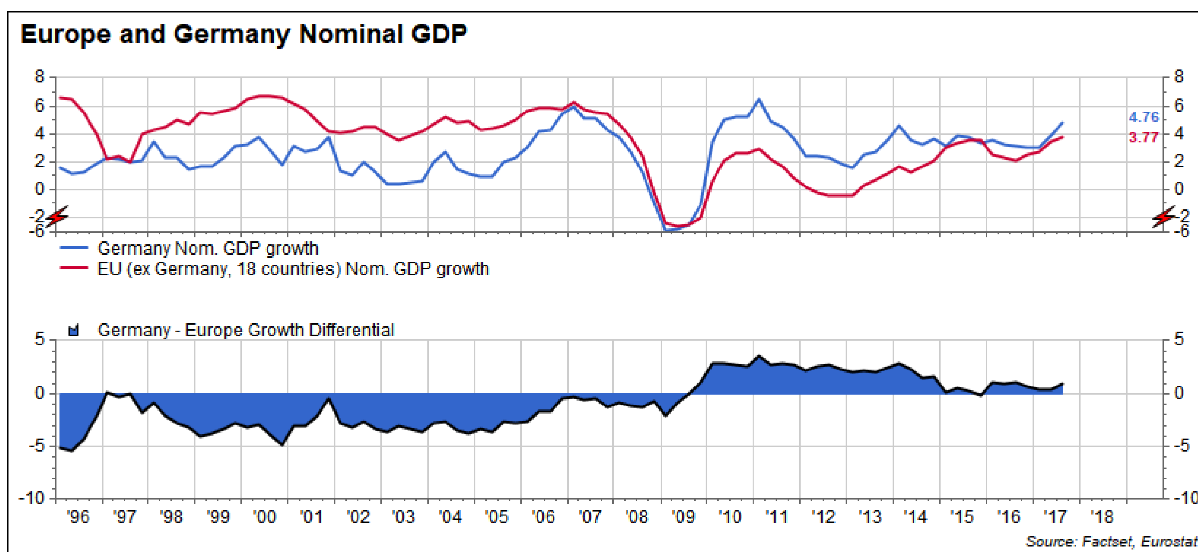
In his memoirs, Denis Healey recounted a conversation from 1978. A senior German negotiator, state secretary and later finance minister Manfred Lahnstein, told Healey that the Exchange Rate Mechanism (the precursor to the Euro) was designed to prevent an overvaluation of the Deutsche mark "thus keeping Germany more competitive and other countries less so". Herr Lahnstein – a social democrat and previous union representative – was likely just making an observation rather than revealing a conspiracy. But, in the last few years, Germany has indeed been ultra-competitive at the same time as the Euro has been cheap. Now, the Euro strengthening and undoing some of that cheapness. Let's look at why.

Last July, the Economist ran a lead article; "The German Problem - The country saves too much and spends too little". The nation's seasonally adjusted trade balance for November was €22.3bn, about €2.5bn above expectations. Despite strong domestic demand increasing imports, German exporters are maintaining their edge.

The graph below shows the German current account (in percentage points of GDP) in comparison to other major nations:



The aftermath of reunification did have a notable impact on German growth. Right up until the breaking of the "Great Financial Crisis" (GFC), growth in Germany lagged the rest of Europe as the Germans rebuilt East Germany and their labour productivity, choosing restraint over consumption and debt creation (see the chart below). Meanwhile, the rest of Europe went on a debt binge – the Irish, Dutch, Spanish, and British through the housing markets, the Greeks and Italians more through the public sector. The Germans channelled their savings out to these nations through their banks.



After the "GFC", Germany has fared the better than any in Europe. Nominal growth has been 2% higher than the rest of Europe on average, and has stayed 1% above the rest during the recent acceleration.

And yet, during the same period, the current account surplus increased by another 2% of GDP. That means that, if Germany had spent the profit from their trade rather than saved it, economic growth would have been even higher, by about 1% per year.

Despite Germany's international competitiveness, the weakness of the rest of Europe depressed the Euro's value relative to the rest of the world's currencies. The US dollar strengthened, taking Sterling with it (although China's internal fragility seems to have stopped the Renminbi following, mostly because the Chinese were keen to get money out of the country). Europe's period of stabilisation led to Herr Lahnstein's predicted outcome.

The Economist weekly pointed to companies and the government as the "excess" savers. This is true, but both had good reason.

The post "GFC" world felt very volatile, especially for German exporters of machinery. In 2009, China began a quick binge of capacity expansion. This proved misjudged, as overall global final demand did not rise to meet the new capacity. Excess capacity was holding back global buisiness investment (CAPEX) and, by 2014, global trade was actually declining. Inevitably, German producers felt as nervous as everyone else.

Meanwhile, the German government faced pressure from its voters to remain wary of financial system issues as the Euro crisis spread from Greece to Spain, Portugal and Italy. Credit-wise, Germany's lenders found themselves on just as short a lead as everywhere else in Europe.

It looks like 2017 saw a change in perceptions of the global economy for the better. This should be particularly beneficial to Germany and, consequently, Europe.

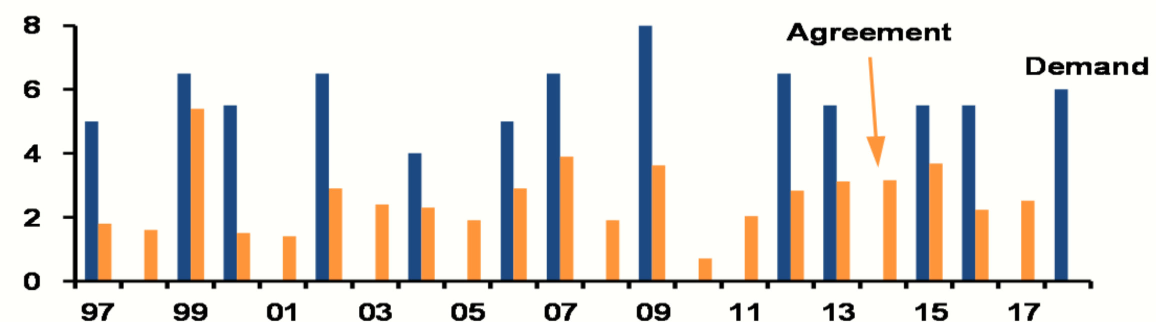
Employment in most developed and emerging nations has sharply rebounded. Although wage growth has remained low, the talk of employee shortages is everywhere. Consequently, global CAPEX intentions have risen sharply and German export orders have benefitted.

While employees are in short supply globally, they're particularly hard to come by in Germany. The Economist pointed to German pay restraint as ensuring corporate stability in the difficult times. Now the unions no longer think that restraint is necessary when profits are stable and growing. Importantly, politicians on all sides agree.

The annual pay round has begun with a higher starting point than in recent years. As of last week, four of the "single-sector" unions had asked for a 6% yearly increase, and more flexible hours. The counter has been an initial 2% and a one-off payment leading to an equivalent approximate 2.5%.

Figure 3: Wage negotiations in the German metal/engineering sector

%oya, in years without blue bars, the previous year's deal applies



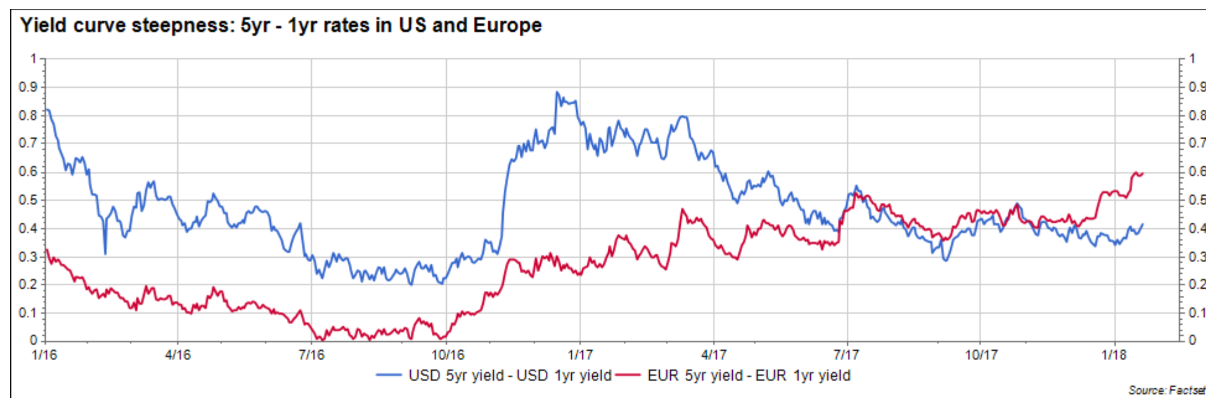
Source: IG Metall, J.P. Morgan

The current demand isn't much higher than 2016's starting point (for a 2-year deal) but the outcome is likely to be very different. In strong growth years, the wage negotiations have been more successful for the unions and this year they have a lot on their side. The demand for shorter hours in the face of labour shortages is likely to lead to better monetary compensation. Also, wages in the factories on the other side of the Eastern border have been rising sharply already.

JP Morgan estimates that the ECB and Bundesbank expect German wage growth to be around 3%. The ECB may prefer to see 3.5% as it would make the inflation target achievable. History suggests that the starting point of 6% is likely to end with deals averaging around the 3% level. However, it is unusual to find political forces lining up to pressure companies to pay rather than unions to show restraint. We may well find deals average above 3% (a simple model based on German capacity utilization suggests an outcome closer to 4%), and this will become clear in the next few weeks.

Against the potential for this inflationary pressure, it is worth recalling that, only in the autumn of 2017, Draghi gave "forward guidance" on loose ECB monetary policy stretching out to September 2018. There would be no short-rate rises, and QE would remain at a reduced but still significant level of €30bn per month. He also said that QE would probably continue after September 2018.

The ECB minutes of December's meeting, published last week, shows that there is clear internal disagreement with Draghi's "forward guidance", at least regarding the extension of further bond purchases. The market is reflecting a growing likelihood of an earlier end to ECB QE through yield expectation in the steepness of the Euro yield curve. This doesn't reconcile with the forward guidance (see red line in chart below).



However, there's an even better indicator of belief in rising German and European growth. As mentioned earlier, the Euro has been undervalued (as measured by "relative purchasing power parities") for several years. Europe's economic strength is translating into perceptions of higher returns for EU assets and so investors see good reason to own them. Indeed, the start of this year has seen very good signs that investors worldwide have been rebalancing towards European equities, given that earnings growth is solid, underpinned by well-based economic growth, and finally valuations are cheap relative to the US. This demand for European capital assets is likely to have been the main driver behind the Euro's strengthening versus the US$.

We have thought since last spring that Germany, Europe and the Euro are in "a good place"; the returns available are relatively cheap, and they hold up under both positive and negative scenarios. Most importantly, German domestic demand is not driven by raising debt, but by an ability to draw down high levels of savings, especially as things get better. This provides the virtuous circle of

growth which can keep things going for an extended period. In such an environment, even a stronger Euro should not prove too much a headwind, given much of the demand increase is likely to come from inside the Euro area.

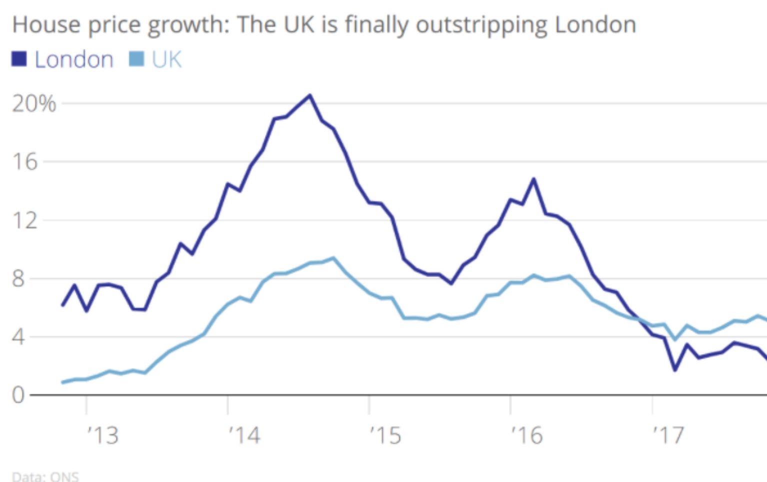
UK housing update

In its housing market report for December 2017, the RICS (Royal Institute of Chartered Surveyors) said that that activity levels in the housing market remain relatively subdued. House prices nationally have risen, reflecting better growth in cheaper areas, but the number of properties changing hands (Agreed Sales) fell.

The RICS figures chime with data from other sources, such as the Offices for National Statistics (ONS) and property website Rightmove, which covers about 90% of the UK residential market.

The ONS and Land Registry said that, UK wide, the average house price rose to £226,000 (a rise of +5.1% year-on-year) in November, led by increases in the West Midlands (+7.2% to an average of £192k) and East Midlands (+6.4% to an average of £185,047).

The data indicates that home buyers are increasingly opting for less expensive areas. Research house UK Finance reported a 15.2% rise in new first-time buyer mortgages in areas like the Midlands and Northern England.



While the prospects for the UK as a whole look more buoyant, London continues to buck the trend. RICS said its headline price balance[1] remains firmly in negative territory, with a reading of -32% and -15% for London and the South East respectively in December.

In terms of supply, new selling instructions fell at the headline level, continuing a run of 23 consecutive months of decline. RICS believes that the lack of new supply is having an “adverse impact” on the market, along with the government’s Help to Buy scheme, a plan that was aimed at helping the property market.

The government said the aim of Help to Buy was to “restore the dream of homeownership for a new generation”. However, the response from professionals was pretty damning for the chancellor.

[1] The house price balance figure is calculated as the proportion of surveyors reporting a rise in housing prices minus the proportion reporting a fall in prices.

86% of surveyors reported no increase in first-time buyer (FTB) enquires following the change. 66% of those thought the cut would have little impact, with just 12% believing it would result in higher activity levels.

If activity stagnates in the key FTB market, then a critical link in the property chain could be vulnerable. The next few steps on the property ladder could see knock on effects to those wanting to trade up, but unable to do so without those critical FTBs getting on the first step of the ladder.

This appears to be most notable in London, where average house prices are simply too high for those not on high incomes. London appears to have been a victim of its own success. Years of double-digit price gains, along with high stamp duty rates which now apply to homes in the capital, have left prices beyond the reach of most people.

Absent a significant pick up in incomes or growth in the economy, the uncertainties around Brexit are likely to weigh on prices in the capital. So, despite stock shortages, London is now seeing a correction, as sellers reduce prices to attract buyers.

The problem is that many of those potential buyers may have given up on London and have begun looking for better value outside the M25. This might explain the flight of equity from the south east towards other regions.

House prices in the capital remain the highest in the country, but further appreciation across the UK continues to be restricted on measures of affordability, as incomes become stretched amid higher inflation. As a result, Nationwide’s analysts predict prices to be relatively flat in 2018, but Halifax thought price growth would be in the region of 0-3% this year.

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7724.0	-0.7	-54.6	➔
FTSE 250	20652.4	-1.0	-207.0	➔
FTSE AS	4237.6	-0.7	-31.3	➔
FTSE Small	5999.7	-0.3	-15.7	➔
CAC	5519.8	0.1	2.8	➔
DAX	13420.2	1.3	175.1	➔
Dow	25972.1	1.6	397.3	➔
S&P 500	2800.8	1.2	33.3	➔
Nasdaq	6811.4	1.5	102.9	➔
Nikkei	23808.1	0.7	154.2	➔

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE
FTSE 100	3.8	22.5x	14.6x
FTSE 250	2.6	18.4x	14.8x
FTSE AS	3.6	21.0x	14.6x
FTSE Small	2.9	11.5x	-
CAC	2.8	17.5x	15.0x
DAX	2.4	17.3x	13.7x
Dow	1.8	23.7x	18.3x
S&P 500	1.7	22.8x	18.4x
Nasdaq	1.0	26.4x	21.9x
Nikkei	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
HARGREAVES LANSD	6.2	PROVIDENT FINANCI	-22.4
GKN	4.6	CAPITA	-13.5
ROLLS-ROYCE	3.5	BURBERRY GROUP	-10.8
OLD MUTUAL	3.5	DIXONS CARPHONE	-6.0
EASYJET	3.4	MICRO FOCUS INTER	-5.6

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.39	0.92	OIL	68.6	-1.9
USD/EUR	1.22	0.23	GOLD	1333.8	0.1
JPY/USD	110.66	0.36	SILVER	17.0	-1.1
GBP/EUR	0.88	0.69	COPPER	319.1	-1.3
CNY/USD	6.40	1.02	ALUMIN	2241.0	3.0

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.342	0.2	0.00
US 10-Yr	2.641	3.7	0.09
French 10-Yr	0.844	-0.9	-0.01
German 10-Yr	0.568	-2.2	-0.01
Japanese 10-Yr	0.085	9.0	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	2.1
Standard Variable	4.55
Weighted Average Interest Rate (BoE)	1.6
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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Lothar Mentel