Tatton

Investment Management

Weekly Market Comment

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Surprises

Stocks around the globe rose for yet another week while the US$ continued its downward trend. What made the week interesting, however was the change in direction of some variables that many had not expected. In the UK, economic growth for the last quarter of 2017 positively surprised forecasters with a rate of 0.5%, which was up from 0.4% for Q3 (and not down) and took annual growth to 1.8%, only marginally below the 1.9% of 2016 (still the worst since 2012).

This may still be too close for comfort and stall speed, but it is encouraging to note the expansion in the services and manufacturing sectors, despite the flagging consumer demand and disappointing Christmas retail results. 2.5% average wage increases were seen by some as pressure for the Bank of England to further raise rates, when actually, after inflation, the increase amounted to a 0.5% loss in purchasing power for UK consumers.

In the US it was the other way around, Q4/17 GDP growth was lower than expected, bringing the figure for the first year of Donald Trump in office to a meagre 2.3% - considerably below the 3% the president had envisaged. Despite better upward momentum than in the UK on the back of strengthening consumer demand and sentiment, £-Sterling gained the most of all global currencies against the US$. Given there were only much smaller gains versus the Euro, it would seem that it was more the (trade) proximity to the accelerating Eurozone and the lower starting point of the UK's currency, that allowed £-Sterling to regain its pre-Brexit referendum value against the US$.

Whatever the true reasons, the partial currency recovery will help to stem the inflation pressures on UK consumers and should the 2.5% wage growth momentum persist while inflation subsides, then there may indeed be better times ahead for the UK consumer and domestic demand.

The other surprise came once again from US politics - and it was not the fact that Washington's politicians where once again prepared to shut down the entire US government controlled public sector in return for very little gain in political capital on all sides. The real surprise came from the conciliatory tone Trump and his representatives adopted at this year's World Economic Forum in Davos. On the basis that out of all the nationalists in his start of presidency line-up, only his quite extreme anti-global trade representatives have survived (Ross, Navarro and Lighthizer), there had been an expectation of confrontation at this unashamedly cosmopolitan gathering of the global leading class. Instead, Trump and his entourage turned away from confrontation to sales. 'America first does not mean America alone' was their forum mantra and they portrayed the US as the best place in the world to do business and invest.

There was the occasional whistling, booing and laughter but in general it appeared that the global business community has come to appreciate the business-friendly reforms delivered, rather than worry about the relentless barrage of un-presidential but inconsequential Trump tweets.

As such it may not be such a surprise after all, that out of relief over a more globally pragmatic Trump administration, US stock markets staged their best day since last March, despite the disappointing GDP numbers and slumping bond values. Or is it that there is also an increasing expectation that the world economy is finally exiting the era of slow growth and entering an era where politicians' efforts to 'invest in the forgotten' as Trump put it in Davos, leads to a resurgence of domestic consumer demand. This may indeed have the potential of returning the 'old normal' of decent economic growth that benefits not only those at the top of society's pyramid but distributes progress a little more equally.

Trump meets Davos

Leaders of all varieties met in Switzerland this past week, for the widely publicised World Economic Forum's annual meeting. Davos, the alpine mountain resort whose name has now become synonymous with the forum itself, hosts a who's who of the world's movers and shakers. Representatives from the world's largest businesses, world leaders, academics and even media personalities met to discuss the state of the global economy and its future direction.

As widely reported in the media, and much to the surprise of the congregated cosmopolitan community, this year's Davos meeting is joined by Donald Trump – the first time a sitting US President has attended the conference in almost two decades. This has caused quite a stir, since the meeting's unapologetic pro-globalisation stance is thought to be antithetical to Trump's own politics. Given the media prominence, we thought it might be worth providing some historic perspective on the gathering, and considering its influence today.

The "World Economic Forum" (WEF) began its life in 1971 as the "European Management Forum", when business professor Klaus Schwab invited European executives to the Swiss resort with the intention of teaching them about American management practices. The conference's scope expanded to economic and political issues a few years later, after which political figures started receiving invitations too.

The meeting soon changed its name to reflect its more global focus, and world leaders started using it as a neutral arena. Greece and Turkey famously avoided war in 1988 after their respective leaders met at the Davos WEF, while a draft agreement on Gaza was reached between Israeli and

Palestinian representatives at the 1994 event. World leaders have since become regulars at the forum, whose self-described “mission” is “to shape global, regional and industry agendas.”

The conference’s mantra started around the ‘stakeholder’ theory of management, which says that businesses should take account of all interests – including employees and communities – rather than just shareholders or consumers. Today, the organisation lacks an official political ideology beyond a vague commitment to bringing leaders together and improving society, but it’s generally considered to promote globalisation and global free trade.

That’s what makes Mr Trump’s appearance this year such a standout. His “America first” policies and threat of tariffs on countries his administration deems to have been acting ‘unfairly’ go against the grain in Davos. It’s hard to read the description of this year’s forum topic without sensing some anti-Trump sentiment. “Politically, new and divisive narratives are transforming governance”, while policies that limit “shared obligations” are being pursued, according to the forum. Even this year’s title for the conference, “Creating a Shared Future in a Fractured World”, could be interpreted as a jab at President Trump’s nationalist leanings.

Europe’s two highest-profile leaders, Angela Merkel and Emmanuel Macron, both took to the stage on Wednesday to rebuke the anti-globalisation populism. Ms Merkel decried the “poison” of populism in her speech, also remarking that national isolation “will not lead to a good solution.” French President Macron took an even firmer stance, declaring that globalisation was undergoing a “major crisis” and issuing a “call to all and every one of us” to fight back against nationalism and protectionism.

Of course, the Trump camp was quick to try and dispel the narrative of a newly protectionist US. In a panel discussion, US Commerce Secretary Wilbur Ross challenged the panel find a “less protectionist country” than the US. “We don’t intend to abrogate leadership, but leading is different from being a sucker.” Sticking to his previous line, Ross denied that ‘trade wars’ were anything new for the US, and blamed the administration’s move towards tariff imposition on “various parties violating the rules and trying to take unfair advantage.”

Despite not being a hammer-blow response to Macron’s impassioned defence of global liberalism, Mr Ross’ comments raise a fair point. The Trump administration has never claimed that globalisation is bad per se, only that other countries have not been abiding by the same ‘rules’ of market liberalisation that the US has.

A particular irony of this year’s Davos meeting is that one of the main parties championing the cause of globalisation is China. The world’s second-largest economy has been the primary target of President Trump’s tirades against unfair trade practices, both in his Presidential campaign and since. This week, after new tariffs on washing machine and solar panel imports were announced, the US International Trade Commission accused China of selling “artificially low-priced” solar components in the US, subsidised by the state. And, while progress has been made in terms of China abiding by international trading rules, Trump’s complaints against the nation aren’t completely unfounded (even if they are exaggerated).

Last year was the first time a Chinese head of state had attended the Davos summit. Back then, President Xi Jinping defended the global economic order and presented China as a leader on global issues, particularly the environment. This year, an economic adviser to Mr Xi said that China was “moving economic globalisation forward with concrete actions”, and pledged to “open up the financial sector”.

There is no doubt that an actual ‘trade war’ between the world’s largest economies would have dire consequences for the world economy. But not many expect it to really come to that. On the escalation of US-China trade, Chief Executive of Standard Chartered Bill Winters remarked “The US appears to be taking a measured approach and I would expect the Chinese to take a measured approach in response.”

We agree with this assessment, and don’t expect any retaliatory tariffs from the Chinese at least for now, even if there are some uncomfortable moments between the two economic giants in the year to come.

It was interesting to hear Trump’s speech on Friday afternoon and the conciliatory tone he chose. While he predominantly advertised the US as the best place in the world for businesses to invest, he conceded that “America first does not mean America alone”. He also tried to address some of the themes of the forum by stating that, to overcome the issue of increasing disparities, there needed to be investment into those that had been forgotten (left behind). Regarding trade, his focus was not de-Globalisation, but rather fairer terms of trade to establish mutual benefits of trade to all.

The discussion with host Schwab that followed the written speech contained all the cringeworthy elements we have become used to from Donald Trump, but it was noteworthy that the WEF audience was fairly supportive and certainly not hostile, even though there was occasional booing and laughter in response to the President’s usual self-adulations.

In summary, Donald Trump proved that he has the ability to modulate his tone between different audiences and, compared to other heads of state, portrayed himself much more as the business rather than political leader of the US. Anybody who had expected major changes or announcements will have been disappointed. However, his (at times awkward) appearance at Davos is evidence that, despite the populist rhetoric, Trump remains a business man with the US’ economic interests at heart.

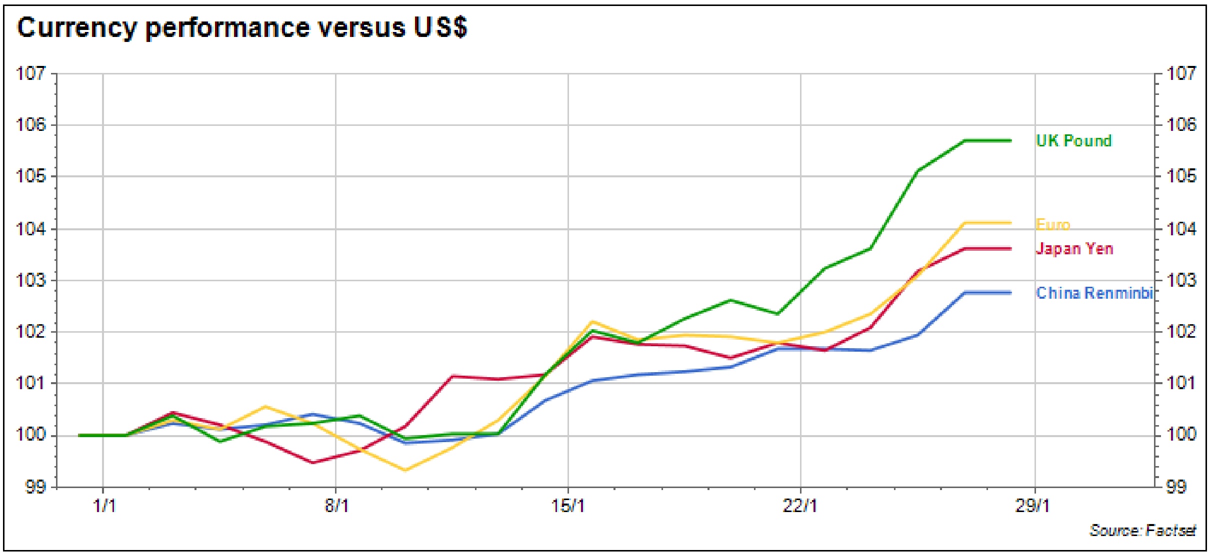
While global growth is still strong and synchronised, his aim of putting America first is best served by keeping a constructive relationship with the rest of the world. Perhaps his conciliatory tone towards the global business community is a recognition of this fact. If that’s the case, it would after all mark a major change of direction from the anti-globalisation rhetoric that was a hallmark of his election campaign and early presidency.

US$ in a 1985 déjà vu?

We mentioned last week that the US dollar has been weakening amid what appears to be quite large investor flows away from US assets. Here, we take a short look at the current dynamics for the Greenback.

The Davos Forum (as commented in the previous article) created quite considerable volatility on the foreign exchange markets on Thursday, when US Treasury Secretary Mnuchin appeared to first welcome the dollar's fall as part of the wider "America First" policy, only to subsequently talk about "a strong dollar", with President Trump reiterating that sentiment.

The US dollar weakened against £-Sterling to $1.43, a level not seen since before the Brexit referendum. Sterling has been the strongest currency recently, but then it had also fallen the most previously and all major currencies have shown significant gains against the dollar. The chart below shows their relative gains over January.

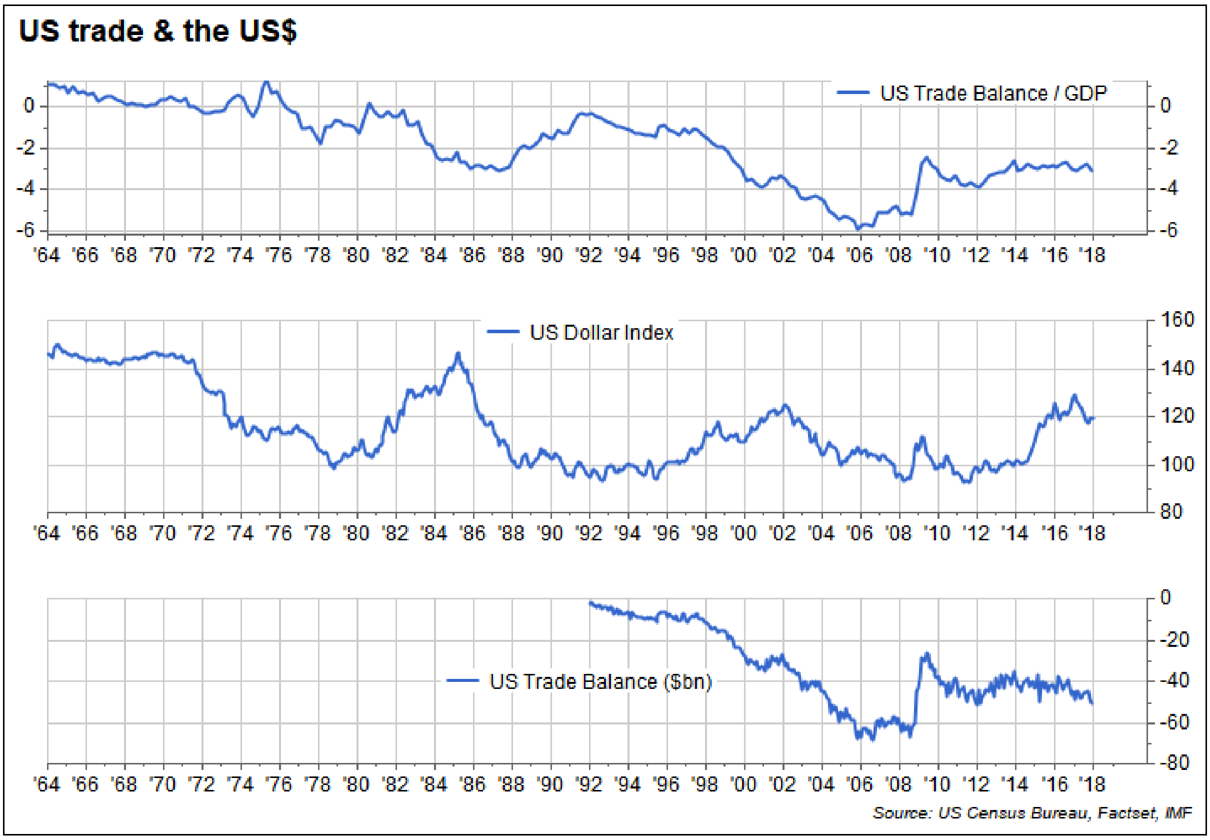


Looking back a year ago, it's interesting to note how the dollar hit a 30-year high just as President Trump was inaugurated. The rationale for that post-election dollar rally was that, as a consequence of the President's tax policy, the repatriation of US corporate cash held abroad would drive the US currency even stronger.

As the chart below shows, Trump's other policy goal of reducing the US trade deficit was at odds with further strength in what was already a strong dollar. From early 2014, the dollar had appreciated some 20% on a trade-weighted basis. While the US economy didn't feel especially robust at that point, it was in a better position than others, largely because it had dealt with problems in its financial system more robustly and effectively than others. Europe was still dealing with Greece, and China was experiencing a marked slowdown as a counter-reaction to its huge spending in 2008/2009.

The trade-weighted dollar index is shown in the middle panel, with the trade and current account balances. The dollar was at a strong and stable level in the 1960s, weak in 1979, strengthened through to 1985, and so on.

The trade (and current account) balances tend to worsen as the dollar gets more expensive, and improve as the dollar cheapens. However, the currency moves take time to impact trade. The early 1980s strength led to the Plaza Accord of 1985, the agreement among the major nations and central banks to push the dollar lower. It still took two years for the trade balance to show an improvement.



The third panel shows the absolute level of the trade balance on a monthly basis. Despite the dollar's fall back during 2017, the US trade balance has continued to worsen. If the past is anything to go by, the trade deficit could well continue to worsen for another two years. And the dollar's fall is relatively small compared to other moves which precipitated an improvement in the trade balance.

As we in Britain know, a falling currency is likely to lead to inflationary pressures. The US bond market has seen yields rise, mostly because of rising inflation expectations. Also, Trump's tax policy pushes additional money into an economy that already has strong levels of domestic demand. The US central bank, the Federal Reserve Board has already expressed concern that the tax policy could lead to more growth at a point when inflation is pointing upwards, and that was before the latest currency move.

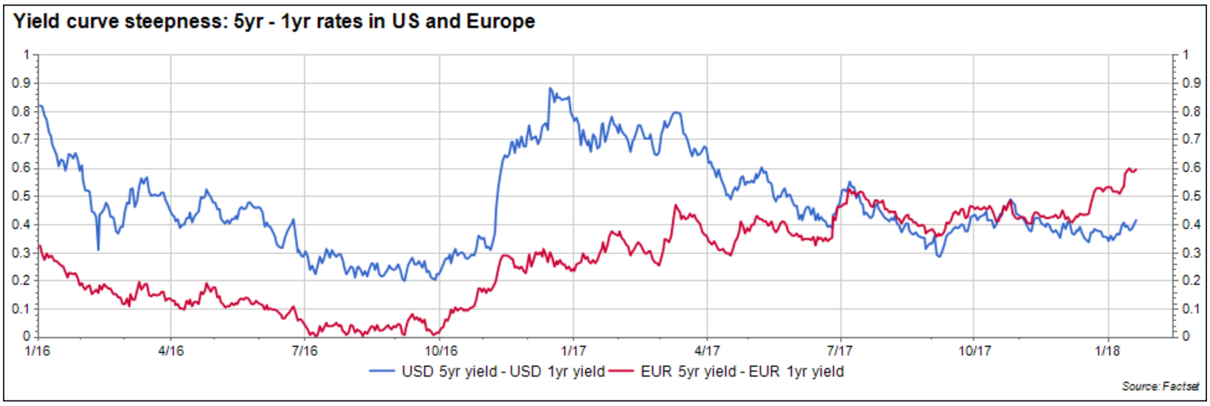
So surely the rise in yields, and the prospect of higher interest rates, ought to make US bonds more attractive?

Not necessarily, at least in the shorter term. There's a conundrum in the way that bonds are often held by foreign investors. Many investors prefer to hold bonds on a currency-hedged basis. Certainly, the dollar's fall won't have hurt them in this phase. However, overseas bonds have actually become more attractive in recent days. This is especially true for the other major bond market, Europe.

One can think of a currency-hedged dollar bond investment like this: the investor holds their home currency in a bank deposit, and uses it as collateral to borrow dollars, for a period which is typically between 3 months and a year. Those borrowed dollars are used to buy a longer bond, yielding higher than the borrowing costs. The difference between the longer maturity bond yield and the short-term borrowing rate is what makes this position attractive.

The difference between the one year and the five-year yield in US treasuries has recently narrowed considerably, while expectations of growth have caused the Eurozone bond difference to widen. Thus, it's more attractive to shift money from the US to the Eurozone, even though US bond yields look more attractive at first sight.

We showed the following chart last week in a different context. However, it illustrates the point. US bonds have become relatively less attractive, and Euro bonds have become more attractive (the two graphs show the yield difference between 5 year and 1 year maturity rates in the two regions over time).



Of course, this could reverse. But it would mean that US 5-year bonds would probably have to rise, given that the Fed is highly unlikely to push short rates down. Rising US yields means falling US bond prices. Foreign investors are therefore not likely to return to US assets in the near-term.

In the current move down in the dollar, US bond sales may well be as big a factor as statements from politicians. Indeed, while we expect volatility, we think the dollar has further to go in the medium term, especially against the Euro.

Whether that is good or bad depends on one's perspective. Historically a weaker US$ has been beneficial for the Global economy as well as the US economy. However, for all those who fear a disorderly unwind of the overvalued US bond market, the inflationary pressures of a weaker US$ leading to rapidly rising rates and short maturity yields can be seen as a potential catalyst for such an event.

At the other end of the spectrum, a continuation and expansion of the 2017 goldilocks economic environment could lead to a further strengthening of the normalisation trend back to the 'old normal' which would not at all be destabilising. As we can see, currency moves in the current environment can have a multitude of primary and secondary effects and further currency dynamics are therefore very worthwhile monitoring. For the time being we are glad to observe that our Eurozone equity overweight has benefitted through the currency boost, while we will in due course re-evaluate whether we continue our UK equity underweight position.

US tax cuts and the 'marginal propensity to consume'

Do Trump's tax cuts justify the highs in US equity markets and what impact will it have though secondary economic stimulus effects, for example an individual's Marginal Propensity Consume (MPC)?

That is an increasingly pressing question for investors. Judging from current equity prices, it looks like markets have now priced in primary effects of the tax cuts – the immediate boost that lower tax rates on corporate earnings might have on corporate profits (EPS – earnings per share).

However, we think there has been less attention paid to the potential secondary effects, such as increased corporate investment driving productivity and wages higher, which can have a beneficial effect on consumption.

It would appear that a whole host of US corporate giants have begun rewarding Trump's administration for passing the tax reform bill by creating the new jobs and higher wages that the President has sought since his election. We have seen companies announce tens of billions of dollars in tax-cut fuelled spending plans, which are encouragingly centred on Capex (Capital expenditure = investment), boosting incomes - or paying one-off bonuses to their staff.

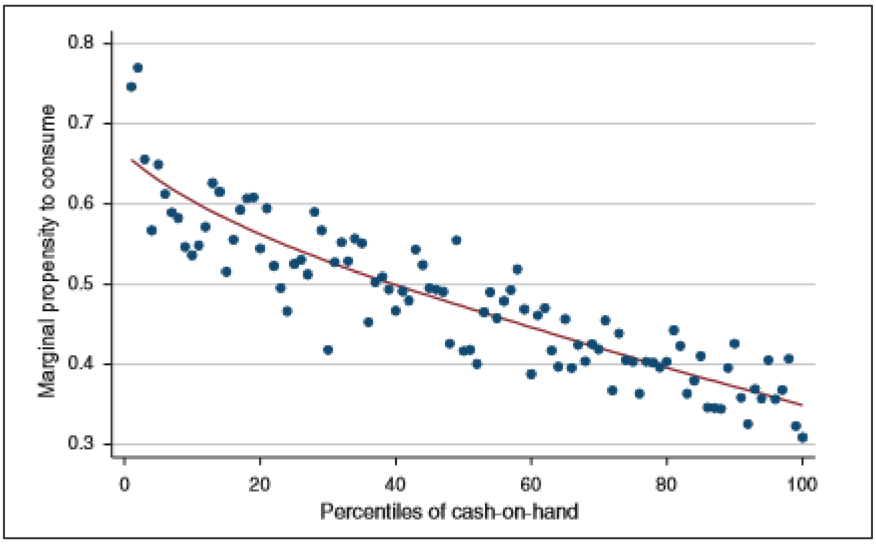
In just the past few weeks, JP Morgan said it would invest $20 billion on hiring new staff, raise wages for 22,000 employees by an average of 10% (paying between $15-18/hr) and open 400 new bank branches. Apple said it would invest $350 billion in the US over the next five years, hire 20,000 new workers and pay bonuses of $2,500 in Apple stock to every one of its 125,000 staff.

The growing list of companies issuing tax-cut fuelled staff rewards reads like a list of who's who. AT&T (+$1 billion in capex + $1,000 bonuses to 200,000 workers), Comcast, Boeing, Starbucks ($250 million in raising wages for 150,000 US staff), Disney ($1,000 bonus to 125,000 staff, + $125 million on providing higher education to 88,000 workers) and Wal-Mart (owner of Asda in the UK) have all announced new spending plans.

Going back to the initial question, an individual's marginal propensity to consume is the proportion of additional disposable income that gets spent rather than saved.

An MPC framework can help us estimate the impact of any spending. For example, if you were given $10 now, would you spend it all, save it all, or decide on a combination of both options? Your answer to the question would tell us your MPC (and propensity to save, calculated by taking 1 minus your MPC). This provides an indication of what happens to spending levels when income or wealth rises. It can also help us to understand how MPC/S can impact the levels of demand in the economy.

The average MPC for all households in the US is between 0.2 and 0.4, according to Christopher Carroll of Johns Hopkins University. Using our £10 example, that equates to spending of $2 or $4. Of course, different people spend differently but, generally, less wealthy households (i.e. those that will most benefit from tax-cut fuelled pay rises) have higher MPC's than more wealthy ones. This makes sense, as the percentage of income spent on things falls as your income rises, and visa versa (see empirical chart below).



Source: https://web.stanford.edu/~pista/MPC.pdf

Studies suggest that any fiscal stimulus targeted toward individuals in the bottom half of the wealth distribution curve are 2 to 3 times more effective than just a blanket stimulus across all wealth groups.

While it could be easy to question how a $1,000 one off bonus could have any meaningful impact on the wider economy, one should remember the powerful effect the PPI compensation payments had on UK consumer spending, which were roughly similar in amount. Those £50 billion in PPI payments were estimated to have added 1% to annual household disposable incomes, helping to simulate spending and drive economic growth.

The net effect of increased consumption could be higher corporate profits, which could in turn provide more wage rises, leading to a positive feedback loop. Perhaps company EPS estimates we see today have yet to take account of these second-round effects of an individual's MPC, which could make equities look more attractive while reducing valuation multiples.

While longer-term spending patterns are generally guided by MPC rates, perhaps the US is about to see a similar "PPI effect" on consumer spending. This will first come from any one-off bonuses, while the impact will potentially increase as consumers increase spending from structurally higher rates of pay.

Chinese property and demographic dynamics that matter

Over the last 30 years, Chinese cities have expanded massively, fuelled by a mass rural-to-urban migration and a generation that was hungry to increase their earnings and buy their own homes. The knock-on effect of wealthier Chinese consumers has been significant domestic growth, as well as growing reciprocal trade with Europe and the US.

For all the growth, recent analysis has pointed to a slowdown in the rate of further economic growth driven by President Xi Jinping's corruption and regulatory controls. No more closely is this regulation being felt than in the property market. Similar to the UK, many Chinese households have become ‘paper’ rich (in other words consumers’ wealth is based on the value of their property on paper) which was due to house prices quadrupling in major cities. Access to credit and rapidly rising prices has encouraged many to buy multiple properties for investment or as a sheer speculative asset, reducing supply and further pushing up prices. At the recent party congress, president Xi Jingping described residential property as “a place to live”, a clear rhetoric from that top the China must control its housing market and not use it as an investment.

Such efforts to cool private property markets, as well as recent efforts to curb further property backed credit growth to prevent a Chinese version of the US property bubble may well lead to a substantial slowdown in construction. Given that from a trade perspective, incremental demand from China was more influential than that of the US in 2016 and 2017 across the globe, any significant slowdown in the property market could have an impact on global demand and growth.

Past beneficiaries of growth in Chinese consumption of the past will need to monitor the extent of a potential slowdown in the property sector. Xi’s policy tightening is already influencing property sales growth, which turned negative last year. This has lead to much lower annual house price growth of now around 5% per annum and in some regions even to price falls. A gradual balancing of consumer debt, greater control and management of the property sector and the sustainable consumption that should bring, are all important to maintaining domestic and global demand. If an equilibrium isn’t reached, the likely consequences may be felt outside of China as well as domestically.

If the cooling property market is an important short-term driver of global demand we need to reckon with, then changes in Chinese demographics may well have a longer-term impact on future price inflation metrics around the world. The 45-65-year-old workforce, arguably the great beneficiary of the house price rises discussed above, are also coming to the end of their working careers. Due to China’s one-child doctrine of the past they usually only replaced by one younger worker. Latest metrics suggest workforce utilisation is high and labour costs continue to rise, as you would expect in a developing economy. However, as the workforce diminishes as it approaches retirement age, so does the price to hire from the limited remaining pool.

The consequences of these labour cost increases could be global consumer price inflation, as the cost of goods and services from China increases and the nation no longer serves as a massive sink for global inflation over the past 25 years. Unless global production investment can replace the - no longer - cheap Chinese labour my moving elsewhere where wages are still low, or compensate labour costs through productivity increases, goods prices globally will begin to rise.

It is worth stating at this point that this is a possible, but not necessary scenario. Firstly, productivity improvements through industrial robots have already allowed Chinese manufacturers to moderate wage price pressures. Secondly, India, as another billion-people nation has been very keen to create comparable (infra-) structural foundations to China though its recent radical reforms. It is not entirely inconceivable that India may take China’s place as the low-cost manufacturer of the world over the coming decades. Change in macro-economic fundamentals we have grown used to, may be disconcerting, but they often lead to new developments with new opportunities.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7659.6	-0.9	-71.2	↗
FTSE 250	20623.0	-0.1	-30.3	↗
FTSE AS	4207.3	-0.8	-33.2	↗
FTSE Small	5959.2	-0.6	-36.8	↗
CAC	5527.4	0.0	0.9	↗
DAX	13319.7	-0.9	-114.8	↗
Dow	26476.6	1.6	404.9	↗
S&P 500	2853.4	1.5	43.1	↗
Nasdaq	6974.5	2.1	140.2	↗
Nikkei	23631.9	-0.7	-176.2	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE
FTSE 100	3.9	22.1x	14.5x
FTSE 250	2.7	18.2x	14.7x
FTSE AS	3.6	20.6x	14.6x
FTSE Small	2.9	11.4x	-
CAC	2.8	17.5x	15.0x
DAX	2.4	17.3x	13.7x
Dow	1.8	24.0x	18.3x
S&P 500	1.7	23.1x	18.5x
Nasdaq	0.9	26.8x	21.9x
Nikkei	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
LSE GROUP	7.4	SAGE GROUP /THE	-7.3
EASYJET	6.6	WPP	-6.7
NEXT	6.4	RENTOKIL INITIAL	-6.1
KINGFISHER	5.4	ANTOFAGASTA	-5.3
BARCLAYS	4.7	RELX	-5.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.42	2.27	OIL	70.4	2.6
USD/EUR	1.24	1.65	GOLD	1353.7	1.6
JPY/USD	108.40	2.19	SILVER	17.4	2.4
GBP/EUR	0.88	0.59	COPPER	319.3	0.2
CNY/USD	6.33	1.20	ALUMIN	2241.0	0.0

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.433	7.2	0.10
US 10-Yr	2.658	0.0	0.00
French 10-Yr	0.908	7.8	0.07
German 10-Yr	0.624	9.9	0.06
Japanese 10-Yr	0.078	-8.2	-0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.7
3-yr Fixed Rate	1.6
5-yr Fixed Rate	1.7
Standard Variable	2.1
Weighted Average Interest Rate (BoE)	4.55
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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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet 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