Weekly Market Comment

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Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENTS

Samuel Leary

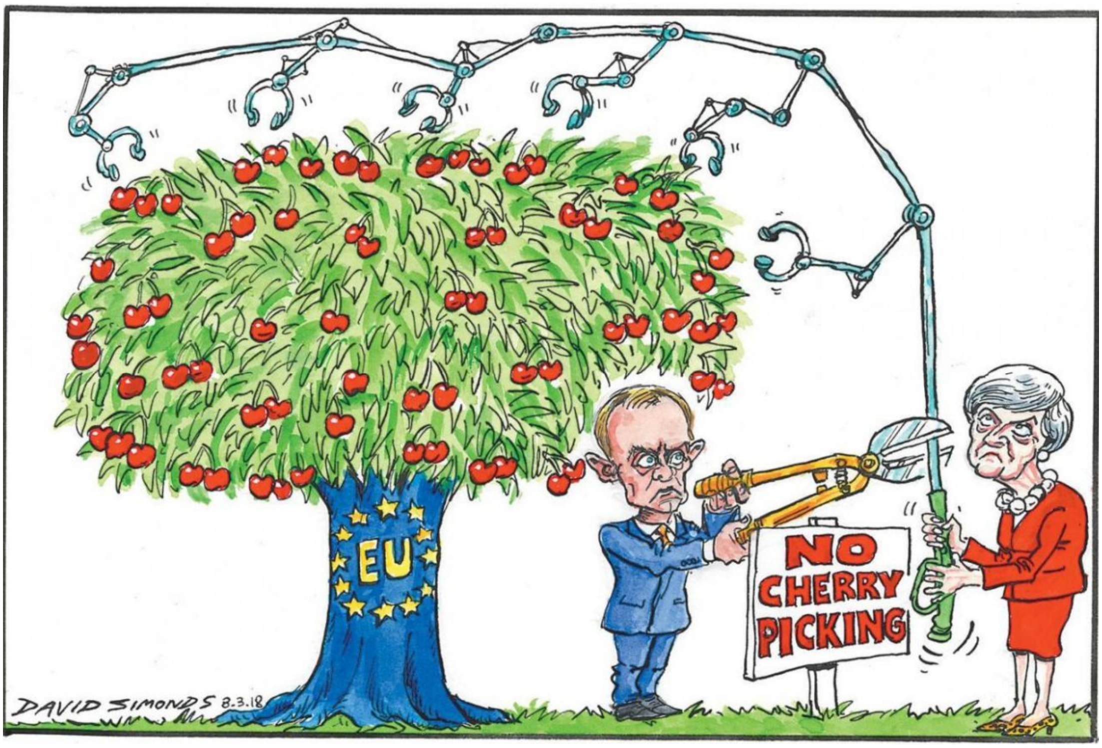
FUND MANAGER

Isaac Kean

INVESTMENT WRITER

www.tattoninvestments.com Twitter: @TattonIM

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



Source: Evening Standard, 8 March 2018

Tariffs to growth

It has been one of those weeks where it is hard to decide where to start, where to end and what to leave out. Most welcome for investors were the ECB's monthly announcement and the thawing of the relations between North Korea and the US. Least inspiring was Donald Trump's introduction of import tariffs on steel and aluminium, Italy voting in majority for EU critical parties and the EU's sobering post-Brexit free trade agreement draft.

The sudden and rapid improvement in diplomatic relations between North Korea and the US feels most relevant because it significantly lowers the main geopolitical risk of recent times. The probability of a regional nuclear showdown between North Korea and the US has, for the time being, been reduced from 'not very likely' to 'highly unlikely'. Not that the simmering conflict had weighed down market valuations in the regions or globally. Nevertheless, a sudden flaring up of hostilities would have created formidable external shock potential for the global economy.

The ECB statement and Mario Draghi's press conference comments were taken positively, as he reassured markets that the European central bank expects a continuation of the recently strong growth momentum across the Eurozone. Such reassurance was welcome, because the very latest economic data releases are pointing to a marked slowing of the recent upward momentum.

Turning to the negative news-flow, the EU's Brexit opening gambit post Brexit stance was sobering for anybody who had hoped for leniency from the EU leadership. To me, Donald Tusk's quote in the FT sums up the reality of the current negotiating positions: *Mr Tusk said at a press conference that he respected Mrs May's political objective to demonstrate at any price that Brexit could be a success, but added: "sorry, it is not our objective".*

Unsurprisingly, there was plenty of wailing across the UK's media channels and a call to adopt a more realistic and perhaps less rosy outlook for the UK's economic conditions post Brexit.

It seems to me that the Commission in Brussels is not necessarily a true reflection of the various national government's positions on the matter. It's not surprising that politicians who have dedicated their lives to promoting the European ideal would find it near impossible to accept that a UK outside the EU that is not demonstrably worse than if it remained an EU member. On the other hand, there are economic interests and political pressures which should improve the UK's position over the medium term. The election outcome of Italy's election is one of those political pressure points. With the 5 Star movement and the Lega Nord winning a majority, the electorate showed that it is willing to support quite anti-European politicians as long as they promise they address the public discomfort about immigration pressures and government spending. The surprisingly high share of the German general election vote last year for the xenophobic AfD party points to the same conclusion.

National governments across the EU are therefore facing not dissimilar pressures to those that led to the Brexit majority in Britain. If and when the EU Commission and parliament have to recognise the growing anti-immigration sentiment through the – in my view – inevitable introduction of a European immigration management framework, the biggest 'red lines' of the UK over freedom of movement may no longer differ quite so much from the EU's position.

The developments around Trump's steel tariffs already appeared to move in a more pragmatic/deal-making direction when, on the actual announcement, Canada and Mexico were exempted and it was suggested that other strategic allies may be exempted.

Markets took the political news in their stride, as they have now done for a while and instead focused more on the economic data flow. Here, the surprisingly strong US job market numbers, combined once again with quite subdued wage growth figures, seemingly brought back the goldilocks conditions of last year's stock market boom. Stock markets continued their recovery after the short sharp setback triggered by Trump's surprise tariff announcement a week earlier.

As our article on the global macro-economic picture further down shows, however, we are currently experiencing a slight loss of economic upward momentum, which markets will ultimately recognise. Given the growth momentum slowdown appears least pronounced in the US, we would not be surprised to see the past 12 months of US-$ weakness rebound into dollar strength.

European politics frightens again

Politics is back on the agenda in Europe. On Sunday, Italy's general election delivered a shock result that saw its populist parties emerge by far the strongest political force. The vehemently anti-establishment Five Star Movement (M5S) took 32% of the popular vote – the largest of any single party – while the Eurosceptic Northern League gained 18%, emerging as the largest party in the right-wing electoral coalition.

It was expected by many that the election would see the parties of former Prime Ministers Matteo Renzi (The Democratic Party) and Silvio Berlusconi (Forza Italia) join forces in a grand coalition, keeping the populist fringe parties out. However, after the respective centre-left and centre-right parties gained a measly 33% of the vote between them, that option is now gone.

Whether a governing coalition can be formed from this election result, and what it would look like, remains to be seen. But it's almost certain that whatever outcome is reached will put at least one of the populist parties in power. M5S may have gained the highest single-party vote share, but the right-wing coalition headed by the Northern League's Matteo Salvini gained a plurality of votes at 37%, making it the largest political force in Italy's parliament.

For many European politicians, this is a far worse result than was ever imagined. Under Salvini's leadership, the Northern League has transformed into an anti-immigrant Eurosceptic party often accused of outright xenophobia. M5S' position on Europe is more inconsistent, with leader Luigi Di Maoi calling for a referendum on Eurozone membership in December, retracting those comments in January and then claiming the "European Union is Five Star Movement's home" in February. But both parties agree on a few things: EU shackles on budgetary constraints should be removed, allowing for larger fiscal deficits; immigration, particularly illegal immigration, needs to be curtailed; Italy has done poorly out of the euro and significant changes need to be imposed on the single currency.

It had looked like the rise of populism across Europe, particularly of the far-right variety, was stemming after it was on the up in the wake of the Brexit vote. French Nationalist Marine Le Pen was comprehensively defeated by centrist Emmanuel Macron last year, while results in the Netherlands and elsewhere showed a similar theme. Just on Sunday, the centre-left SPD reached an agreement with Angela Merkel's CDU party to form another grand coalition government – giving hope to those wishing for continuation of the status quo in Europe. The latest results show that hope to be a little misguided.

It's important to note that receding market fears over the political future of Europe coincided with a strong and notably synchronised bout of growth in the Eurozone. It wasn't just the traditional European heavyweights that saw strong economic growth; the periphery countries like Portugal, Spain and indeed Italy also joined in on the party. On Wednesday, Eurozone growth in 2017 was revised down from initial estimates to 2.3%, but that's still the fastest rate of growth the bloc has seen since 2007.

As we have noted in these pages before, recently the economic indicators on Europe have begun turning over. Growth and business sentiment is still going strong – especially relative to the post-crisis stagnation – but the acceleration seen last year appears to be dropping away. A lot of this deceleration is to do with the euro, which naturally rose in value on the back of the strong economic backdrop in Europe. This made the continent a victim of its own success somewhat, as European exports became more expensive to foreign buyers, slowing export growth.

We believe that this previous bout of strength did a lot to paper over the cracks in the Eurozone, but now that things are moderating tensions are rising once more. In Italy for example, the mass of non-performing loans (NPLs) weighed down heavily on the country's banking sector since the financial crisis, hampering banks' ability to lend and thereby constraining credit available to consumers. When growth took an upturn, suddenly pressure on the country's banks eased as more and more NPLs began performing.

Accordingly, Italian bank stocks were some of the hardest hit by the election news. Banco BPM's share price fell 6.7% on Monday, while BPER Banca and UBI Banca fell 5%, despite the wider FTSE Mib falling just 1% on the day (and since recovering that fall).

And the political risk for markets extends far beyond Italy. Despite the apparent receding of the far-right last year, Viktor Orban still leads a self-described "illiberal democracy" in Hungary and the far-right Law and Justice party still holds power in Poland. Both governments are vehemently anti-immigrant and have been repeatedly accused of undermining the rule of law.

Even in Germany, one could easily read the coalition agreement as a worried attempt at defending the status quo against the far-right AfD's surge rather than a reaffirmation of liberal centrism. After the SPD suffered their worst post-war election performance in September, former leader Martin Schulz vowed his party would not serve in a coalition with Merkel again. But on Sunday, amid recent polling figures which put their popularity as low as 15%, party members saw no choice but to take the chance at governing once more.

Until now, the reaction of core EU leaders to the rising anti-establishment sentiment has usually been one of 'keep calm and carry on'. While the economic backdrop kept on with its own momentum, that approach looked like it might be working. But without that impetus things will likely get worse, unless leaders in Berlin, Paris and Brussels commit to significant policy changes. Some of these might involve relaxing budgetary constraints on member states to allow for greater fiscal stimulus. But the main issue remains the growing anti-immigration sentiment, both in terms of people from outside the EU in and within the union itself.

For many, instituting any kind of migration barriers within the EU is anathema to the spirit of the European project – contradicting one of the 'four freedoms'. But increasingly it looks as though there's little other option.

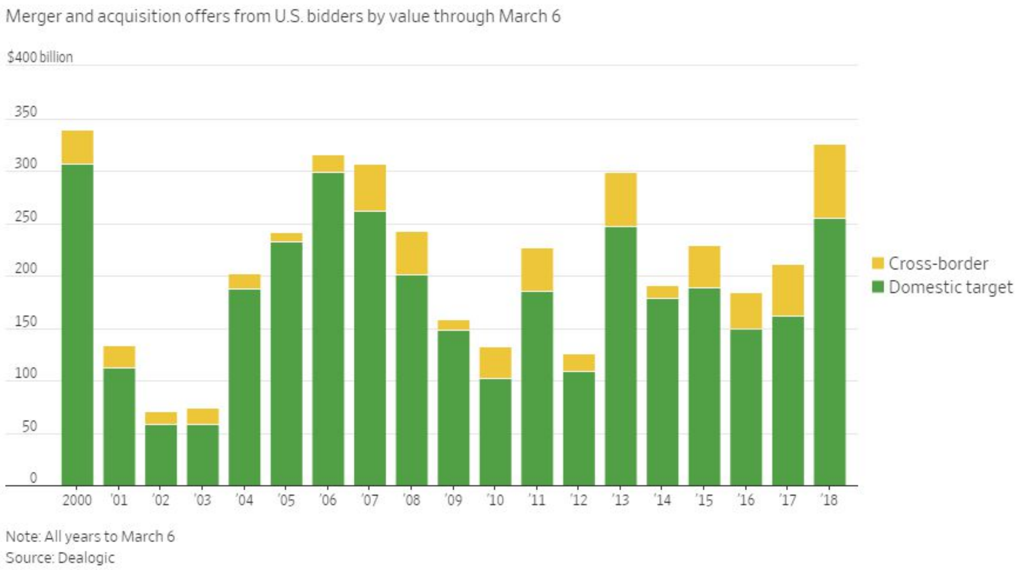
If measures are taken to appease the anti-immigrant movement, it will be interesting to see what effect this has on the Brexit negotiations. Undoubtedly the largest component of Brexit vote was worries over immigration. If such worries are then addressed within the EU itself because of internal pressures, that takes away the main reason for exiting the EU in the first place. Furthermore, until now the pressure on EU negotiators to give the UK a good deal out of Brexit has been entirely lacking. But with more and more Eurosceptic voices at the head of member states, the UK might find negotiators more sympathetic.

Stock market implications of bond financed M&A

US corporate merger and acquisition (M&A) activity reached a whopping $3.54 trillion in 2017. It capped a strong deal-making year, reaching the third highest annual total since the Global Financial Crisis (GFC) in 2008.

It appears that company bosses' confidence in future business prospects has been further increased by an accelerating economic backdrop and robust financial markets. This has bolstered corporate growth appetite enough to engage in increasing numbers of "hostile" or unsolicited approaches, as well as friendly mega-deals to fuel further profits and sales growth.

Recent stock and bond market jitters and the potential for higher interest rates do not yet seem to have harmed M&A appetite; 2018 looks set for another bumper year, with $325 billion worth of deals already announced in the first two months of the year in the US alone. The start of the year



looks very strong by comparison to recent history, as the chart above shows.

This week's gargantuan $44 billion bond sale from US pharmacy chain CVS Health to fund its $46 billion purchase of health insurance firm Aetna seems to underscore that increasingly confident backdrop. It seems that not only are corporates willing to engage in large takeovers, but also finance them through fixed cost-debt capital raising, rather than more flexible equity issuance.

We believe there are some interesting implications emerging from the CVS deal that investors might not yet fully appreciate.

Firstly, there is the sheer size of the deal – the biggest corporate bond sale in over two years and the third largest in history. Only Verizon's $49 billion issuance in 2013 to fund Vodafone's purchase of its stake in Verizon Wireless and Anheuser-Busch's $46 billion offering to pay for SABMiller in 2016 were larger.

CVS' move also demonstrates the health and depth of the Investment Grade (IG) bond market at present. All indications suggest the market is both willing and able to absorb deals of such size. Investors appeared only too willing to participate. With $121 billion in orders from investors for its $44bn the CVS debt issuance was nearly three times oversubscribed. This suggests that appetite and demand remains strong and liquidity is plentiful.

Secondly, the defensive nature of the deal is testament to the changing industry dynamics (higher drugs prices, Obamacare) and threats from online competitors (Amazon). Amazon's imminent entry into the pharmacy sector is cited as a key catalyst behind companies' recent drive towards vertical integration. Firms are altering their business models and cost structures to offset competition from the profit-hoovering online juggernaut.

Thirdly, recent US corporate tax cuts may trigger further M&A, both friendly and unsolicited. Tax cuts provide firms with an incentive to repatriate foreign cash holdings and invest them back in the US. Some of that money will go into boosting wages, so that companies can retain their labour forces amidst a tightening job market. But the numbers will pale in comparison to the hundreds of billions becoming available for investment into growth and productivity enhancing projects.

It is interesting to observe that according to M&A experts Dealogic corporate acquisitions are paid for through all-cash offers versus all-share deals at a rate of 3:1. This cash is obtained via corporate debt issuance, suggesting that despite the recently rising cost of debt finance, this form of acquisition finance remains more attractive than raising equity in the stock markets. However, this also means that the corporate shopping splurge adds to the total amount of cash flowing back to investors via buybacks and dividends, which exceeded $200 billion in the 3-months to Feb, according to the Wall St Journal. In other words, the gearing of corporate US through debt capital is further stoked through recent M&A activity.

This tells us that contrary to what may be a reasonable expectation, recent US central bank rate rises and rising longer maturity bond yields are not yet leading to a tightening of financial conditions for US businesses. However, it could be that this recent increase in debt issuance is driven by a corporate desire to secure the last low-cost debt deals before the era of cheap money comes to an end. If so, this will only bring that end point forward. The demand for debt finance paired with the US central bank's (Fed) selling of QE debt back to the markets as they start their quantitative tightening process (QT) will lead to a big increase in the supply of debt securities. Eventually, this supply will be so great that the levels of oversubscription we've seen with CVS' debt raising will fall, and yields that corporates have to offer to get their issuance placed should rise.

Rising cost of debt finance through higher yields should on the one hand calm the M&A activity levels. But on the other hand, it could also put pressure on equity valuations, as the relative attractiveness of dividend streams and return prospects of equities slowly reduces relative to the very low return prospects fixed interest bonds currently offer.

Altogether therefore, we are likely to experience the self-rebalancing forces of capital markets, where counterbalancing forces of availability and cost of finance can prevent the overheating and overextension of one segment over the other. This is yet another step towards a gradual normalisation, after the ultra-low costs of debt finance of the post GFC years distorted equity valuation metrics and led to much confusion and angst over what valuation level of equities relative to underlying corporate earnings may be reasonable compared to historical averages (under much higher average yield levels).

Unfortunately for equity investors, this is very likely to mean that the boost to equity valuation from cheap debt will also gradually end and likely lead to a less vibrant equity market then would have been historically experienced when the underlying economy is doing so well.

Cryptos update: growing pains

Increased regulatory scrutiny of cryptographic currencies (cryptos) in recent weeks has led to heavy selling and double-digit percentage falls for popular coins like Bitcoin (BTC), which breached below $10,000 per coin and, at the time of writing, stood to have lost 25% over the course of the week.

The key driver was two landmark events: firstly, a US Federal Judge that ruled cryptos should be regulated like commodities and then the SEC (Securities Exchange Commission) that said that popular trading platforms might be unlawfully allowing trade in digital assets, via ICOs (Initial Coin Offerings).

Further pricing pressure came from Japan, where it was reported that the Financial Services Agency was considering suspending some exchanges. Additionally, one of the country's largest exchanges, Bitflyer, experienced technical difficulties that impacted clients, while Mt. Gox trustees announced they had sold a sizable sum of ¥43 billion worth of Bitcoin and Bitcoin Cash.

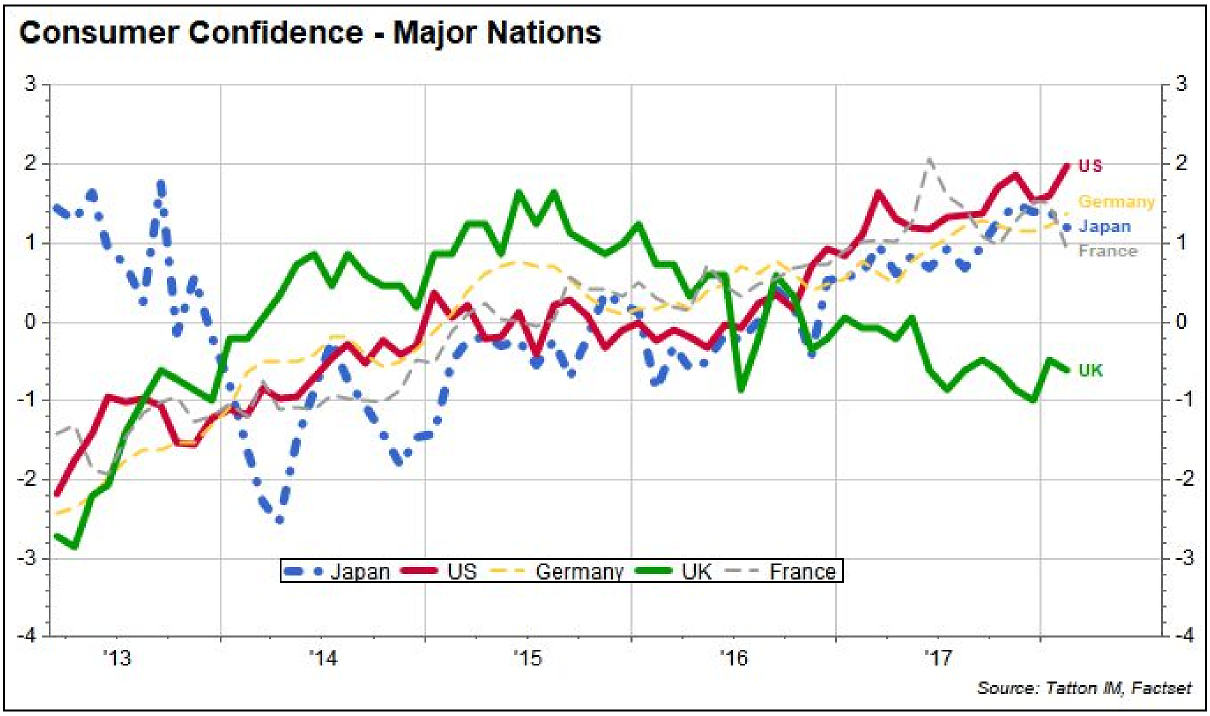
Back in December, we warned investors of the dangers of buying into a "gold rush" ICO without adequate due diligence. Unfortunately, a number of investors hoping to find the next Bitcoin have encountered a prevalence of near-fraudulent activities, hence why the SEC was forced into action.

As a reminder, ICOs are simply a fund-raising mechanism, one that issues "tokens" (pre-paid credit) which can be used within a defined ecosystem in a secondary market. But with little information available, an investor would find it difficult to assess the validity of any secondary market to spend those pre-paid credits. An ICO is a little like buying a gift card. Such a card is worthless if you can't use it with relative ease.

A detailed analysis by Bitcoin.com found that of the 902 ICOs from 2017, 147 failed at the funding stage and a further 276 folded after taking money and running away or collapsing as a business. That means ICOs had a 46% failure rate in a single year. Adding in an extra 113 ICOs that have "semi-failed" – due to no further public communication or a small user base meaning little chance of succeeding – the failure rate jumps to 59%. It is highly likely that percentage will rise for one simple reason: most of them have zero utility, meaning we expect some kind of consolidation down to a handful of coins.

ICO participation should be analogous to investing in a business; it must provide value or utility to justify its existence. Cryptos are entering a difficult phase, as they and their underlying blockchain technology seek mainstream acceptance. Digital currencies still require a certain amount of 'growing up' and the recent shake out may be part of this process.

The 2018 global economy - still strong?



Financial markets are influenced by vast amounts of information, flowing on a near-constant basis from all corners of the world. Taking a step back to review that information and see what's important and how it may be viewed by others is often very useful. So, we'll look at economies of the UK and beyond.

As we entered the new year, the UK was perhaps in a different place to much of the rest of the world. Consumers weren't feeling especially happy, with inflation running at the highest level since the start of 2012, wage growth still subdued, and the Bank of England raising rates. House prices in the north were slowly rising, but in the south east slowly declining. However, companies clearly felt better. A weaker pound through much of 2017 boosted trade with the rest of the world, with earnings rebounding sharply for globally-focussed companies.

The rest of the world was clearly in a good place. Outside of the UK, global consumers were busy spending.

The US consumer was probably the stand-out. As the tax-cuts became certain, so the value of their equity holdings and houses rose, jobs openings increased and wage rises beat low inflation. General confidence (and the prospect of tax money being returned) encouraged people to spend a very large proportion of their income. The US savings rate fell to the lowest level ever. Companies were very bullish about prospects. Interest rates had started to rise a bit but the increasing cost was more than offset by rising revenues.

In Germany, France and Benelux, consumers were as confident as they'd been in a long time. Inflation remained low, and the banks were keen to lend at continued low rates. Companies were doing well despite the strengthening euro. There was surprisingly good demand for the sorts of high-end equipment that Europe specialises in, and borrowing costs remained low. This environment was helping peripheral nations as well, with unemployment falling quickly, albeit from still high levels. Japan, which structurally resembles “core” Europe in many ways, followed the same path.

China’s consumers were perhaps surprisingly buoyant given that house/apartment prices had started to fall. Jobs remained plentiful, and the consolidation of Xi’s power lead to visible improvement in pollution issues. Indeed, the forced removal of old, excess manufacturing capacity was a significant factor for the world as a whole. The overhang of excess capacity had been reduced considerably during 2017, a factor in companies across the world feeling more confident about their longer-term pricing power.

Stable and strong output, removal of excess capacity, and the weaker US dollar, helped commodity-producing emerging nations to share in the upswing, with metal and energy prices rising throughout the year.

With the exception of the UK, confidence was at historically strong levels for both consumers and companies. Often it can take a catalyst – a surprising event – to shake confidence, but sometimes it can be just a matter of time for the more slow-burning factors to come through. That seems to be the case for the start of this year.

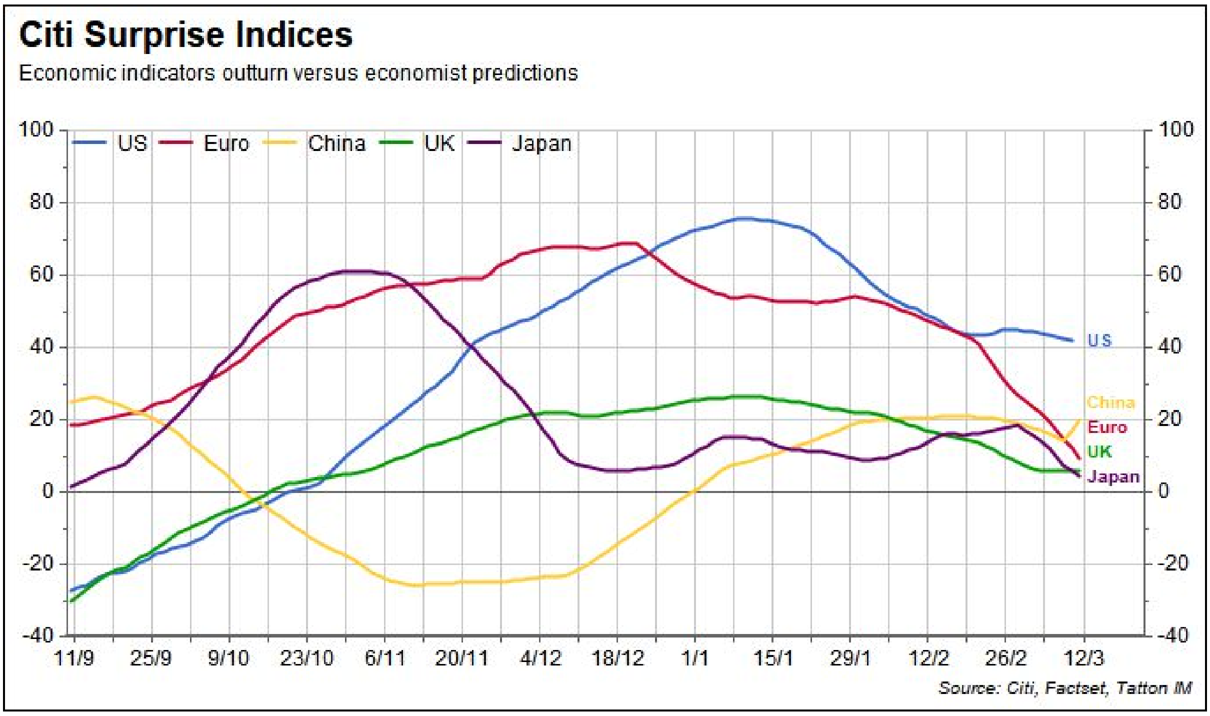
The sharp rise of the Euro, Yen and Chinese Renminbi has probably led to a slowing of external demand for Europe, Japan and China. Corporate confidence has edged lower from high levels. That in turn has caused consumer confidence to edge back, at least in Japan and Europe.

Confidence is generally a good indicator of the path for actual data. Still, actual data can influence confidence, especially when it shows a reverse of previous surprises. Recent data on Germany and France have been lower than economist expectations, both for consumers and companies.

January’s German industrial production rose 3.6%yy, less than the 6% expected; French industrial production was unchanged year-on-year, not the expected 3.8%yy. German retail sales were up 2.3%yy but not the 3.5%yy expected; French consumers bought fewer goods by nearly 2%yy, not the 2% increase economists had predicted.

Japan’s data has also disappointed. Industrial production surprisingly dropped 6.6% month-on-month (mm) (consensus was for a 4.0% drop) in January after a 2.9%mm gain in December (see Figure 1), while retail sales decreased 1.8%mm (consensus was for a 0.6% decrease) in January after a 0.9%mm advance in December (although caution is required because these figures can be more volatile around year-ends).

Concentrating on items in the mass of data can sometimes mislead. A better indication of whether overall data is relatively good or bad can be found at “surprise” indices – a measure of the difference between economist forecasts and actual data. We look at Citibank’s investment research group versions; weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median) over a rolling 3-month period. Here is a graph of the indices’ evolution in the past quarter:



All of the indices are above zero, suggesting economists continue to be surprised by the various economies' strength. However, the indices' move lower suggests a slowing of growth momentum, especially in Europe.

The US index is "surprising" less now, but recent data still suggests continued US economic strength.

The corporate confidence measures (manufacturing and non-manufacturing Institute of Supply Management Diffusion Indices) beat expectations for survey data collected in February, the manufacturing measure hitting a cycle high of 60.8. February employment data was strong, especially in terms of new entrants to the workforce by people who previously said they didn't want to work.

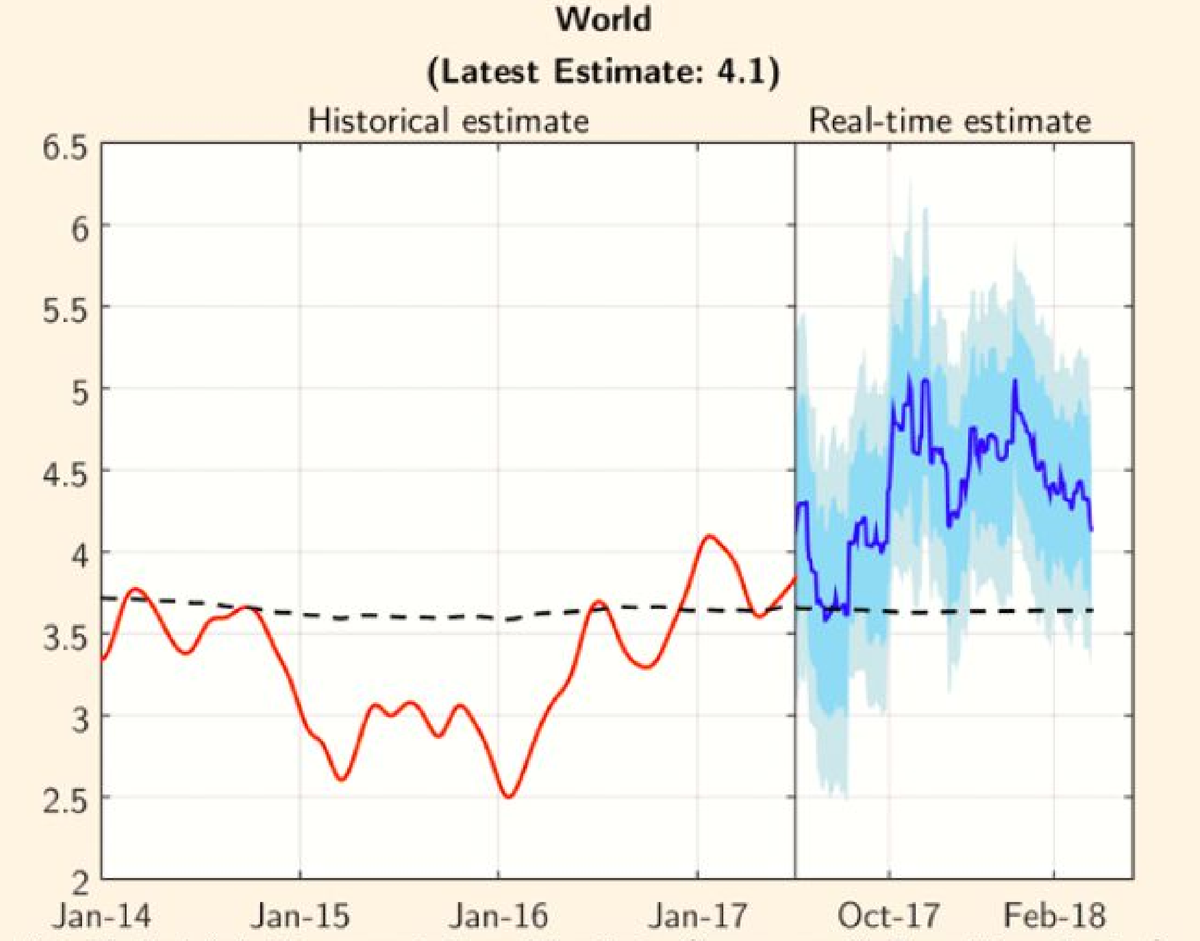
For the UK, Europe's signs of a nearer-term flattening in growth has more implications than any continuation of US strength. The Bank of England's determination to constrain personal credit growth may be understandable, given that its net increase remains at around £1.5bn per month, while employment growth is also strong. In this respect, the UK looks a bit like the US, with both countries' savings rate down sharply since 2015.

UK data showed some upside surprise at the end of 2017 courtesy of manufacturing, the major source of demand coming from Europe. However, January industrial production data suggested that 2017's pickup may be transitory, with a return to the anaemic 1.5%yy growth of 2014-2015. Meanwhile, the RICS survey of the housing market suggested more sogginess through the rest of the year.

Soggy UK domestic demand amid relative BoE hawkishness does have a mildly positive consequence. The British Retail Consortium reported renewed shop price deflation for February of 0.8%yy. The stabilisation of sterling has reduced cost-push inflation pressures as expected.

Still, the picture for the UK remains markedly less supportive than for other countries. The underlying drivers of personal consumption remain weak, while corporate strength has tended to rely on a weak sterling.

Fulcrum Asset Management produce a “nowcast” of global growth (an estimate of current global real activity rather than the hugely lagged official data) which appears in Gavyn Davies’ FT blog (always worth a read). Here’s the chart from a few days ago:



Note: The black dashed line represents the model's estimate of long-run growth. The real-time estimate of underlying activity (blue line) considers only the data available at each point in time. The historical estimate (red line) uses all available data as of today, including revisions.
Source: Fulcrum Asset Management.

As the surprise indices suggest, activity does look to be moderating, with Europe moderating more quickly than elsewhere. The breadth of growth is still ok, but is becoming more reliant on the US. Given the lower savings rate in the US, the continued tightening by the Federal Reserve, and the step-up in trade frictions, this may be a less stable position than last year.

However, a big surprise last year came from China. We’ll take another look at the Chinese economy in next week’s missive.

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7198.6	1.8	128.7	↗
FTSE 250	20043.1	3.4	656.5	↗
FTSE AS	3980.6	2.1	80.9	↗
FTSE Small	5772.7	1.7	97.2	↗
CAC	5262.5	2.5	125.9	↗
DAX	12320.5	3.4	406.8	↗
Dow	25145.9	2.5	607.8	↗
S&P 500	2761.6	2.6	70.3	↗
Nasdaq	7050.3	3.5	239.3	↗
Nikkei	21469.2	1.4	287.6	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	21.9x	14.3x	17.1x
FTSE 250	2.7	18.4x	14.7x	17.0x
FTSE AS	3.6	20.8x	14.4x	16.7x
FTSE Small	3.0	13.4x	-	-
CAC	2.9	17.3x	14.8x	15.6x
DAX	2.5	16.9x	13.5x	15.7x
Dow	1.9	22.4x	18.2x	15.3x
S&P 500	1.8	21.9x	18.4x	17.6x
Nasdaq	1.0	24.8x	20.8x	20.3x
Nikkei	-	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
SMURFIT KAPPA	31.7	JUST EAT	-7.8
ROLLS-ROYCE	12.9	WPP	-5.1
DS SMITH	10.7	PADDY POWER BETF	-4.8
MEDICLINIC INTERNAT	7.1	SAINSBURY (J)	-4.0
JOHNSON MATTHEY	6.9	MARKS & SPENCER	-3.5

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.39	0.53	OIL	64.7	0.4
USD/EUR	1.23	0.03	GOLD	1321.6	-0.1
JPY/USD	106.96	-1.13	SILVER	16.6	0.4
GBP/EUR	0.89	0.52	COPPER	313.5	0.3
CNY/USD	6.33	0.17	ALUMIN	2106.0	-1.9

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.503	2.0	0.03
US 10-Yr	2.907	1.5	0.04
French 10-Yr	0.894	-2.8	-0.03
German 10-Yr	0.652	0.2	0.00
Japanese 10-Yr	0.053	-22.1	-0.02

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.5
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.0
Standard Variable	4.24
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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Lothar Mentel