Weekly Market Comment

16 March 2018

Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENTS

Samuel Leary

FUND MANAGER

Isaac Kean

INVESTMENT WRITER

James Saunders

QUANTITATIVE RESEARCH ANALYST

www.tattoninvestments.com Twitter: @TattonIM

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

Back to Normal?

Over the course of last week it felt very much as though things were returning to normal after the short sharp shock in equity markets in early February. Stock markets in the US have returned to their previous long term trading ranges, while markets elsewhere are slowly heading into the same direction. Even the diplomatic tit-for-tat action between the UK and Russia feel strangely familiar – although that stems from a time much longer ago.

It is notable that none of the pessimistic predictions that were released during the market correction are en-route to becoming reality. This is particularly true for the bond markets, where the rise in yields has plateaued and especially the yield for US 10 year government bonds has not advanced to 3% and beyond but even briefly fell back below 2.8%. Stabilising yield and inflation expectations bode well for a continuation of further corporate earnings growth around the world. This would help to underpin elevated stock market levels despite less favourable valuation metrics due to the slowly returning return competition of rising bond yields.

As long as stock markets do not get ahead of themselves again and bond markets remain as level headed as they have been, then investment returns are on track to return to positivity once more. Respected economists and central bankers frequently state that economic cycles do not 'die of old age' but because of either economic overheating, central bank policy errors or external shocks.

Unfortunately, all three are more on the radar this year than they were in 2017. A potential external shock could develop from the resurgence of trade barriers morphing into an outright global trade war. With the traditional leader of the free trade movement – the US – at its forefront this has the biggest upset potential at the moment - even if it currently carries a low probability. Donald Trump's carry through from his periodic harsh rhetoric has been quite limited, whereas his medium term success rate regarding the stimulation of US business sentiment is increasingly undeniable.

It was remarkable to observe how the German press picked up on the fact that German cars suffer a maximum import duty of 1% in the US, whereas US car imports to the EU are charged at 10% - thereby not building public support for the EU's notion of unfair US tariff threats. Could it be that Trump's tariff shocker might actually lead to a general lowering of tariffs rather than a global trade war? This is currently quite an optimistic perspective and much will hinge on Trump's approach and negotiations with China and whether his administration plays its cards well rather than aims to score populist points back home.

The other hurdle to watch are the looming interest rate hike by the US central bank (US Fed) and the UK's Bank of England (BoE). Both are going to announce their March rate decisions in the coming week and so the fear and debate about the potential for central bank policy errors will resurface. Another 0.25% US rate rise is currently widely expected and therefore highly unlikely to cause turbulences. However, the Fed's quarterly publication of their committee member's combined forecast for their future decisions – called the dot plot – should be more interesting and inform us whether there may be reason to be concerned. The UK's Bank of England is now less likely to raise rates this month, but we expect some decisive language that another rate rise is on the cards – we suggest this will take place in May, but then pause potentially until 2019.

Neither central bank's potential rate hike falls into the policy error territory, but given the UK's recent lacklustre economic progress, a UK rate rise would require more justification and would be aimed at stemming inflation pressures driven by currency weakness rather than an overheating economy. On the subject of the UK economy we received a comprehensive update this week through the chancellor's spring (non-) budget statement (the actual budget moved to the autumn in 2017). While he was trying to paint a positive picture, the detail revealed that the public finances remain tight, despite recently improved tax revenues. No risk from economic overheating then and instead a chancellor who keeps the purse strings tight, just in case Brexit turns against the odds into a nasty shock and requires a fiscal bailout.

The heated diplomatic exchange with Russia over the reckless release of Soviet era nerve gas in the middle of Salisbury is also unlikely to morph into an economic threat scenario, given how little trade there is between the UK and Russia since the sanction of the Ukraine conflict.

This then leaves the general economic picture, which contained mixed news for market strategists. Lagging indicators tell us that the global economy was running towards the risk of overaccelerating at the end of last year, whereas leading indicators inform that is unlikely to be the case now.

All back to a far less fast moving picture then and much more reminiscent of the 'old normal' from 10 years ago. However, until we actually reach that old economic and monetary normal again, there are still a number of 'new normal' abnormalities which need to be unwound gradually or bear the risk of causing upset – just as the sudden jolt in stock market volatility back to normal levels did at the beginning of February.

UK Budget: It's a spring statement

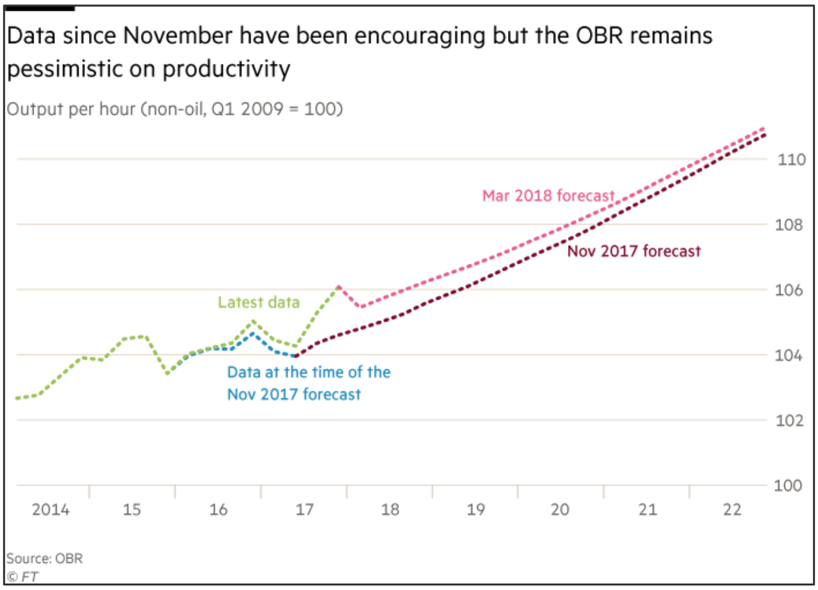
Philip Hammond's announcement of the Spring budget on Tuesday was a rather dull affair – just as the Chancellor had briefed beforehand. Hammond's 2016 promise that the treasury would switch its biannual budget back to an annual one (like in virtually all other developed economies) and present this in the autumn rather than spring had been greeted with approval from business leaders. And as promised, this spring budget-turned-statement presented no changes to spending or taxes and only a slightly updated economic forecast from the government's independent financial watchdog – the Office for Budget Responsibility (OBR).

Despite the lack of policy update, Hammond made sure to come off upbeat in his speech. He noted that the OBR had upgraded their forecast for UK growth in 2018, and that Britain's manufacturers had seen their longest continued growth spurt in 50 years. The fiscal watchdog also upgraded their outlook on government borrowing following the positive surprise on tax revenues last month, and the chancellor used that fact to celebrate the improved health in public finances. In a jibe at the Labour party and a rebuke of his pessimistic reputation, the Chancellor told MPs that he was feeling "positively Tigger-like" while the opposition remained the "Eeyores".

Unfortunately for the Chancellor, his optimism in the forecasts wasn't shared by those who produced them. Countering Hammond's news of an improved forecast, the OBR claimed their revision for 2018 was just a "modest cyclical upgrade" and reiterated that the medium-term outlook remained the same. Indeed, while their expectations for this year have seen a slight increase, forecast growth for the next two years is unchanged, and expectations for 2021 and 2022 have actually come down.

Most of the OBR's gloom comes from their predictions on productivity. Back in November, the OBR made substantial downgrades to their forecasts for productivity growth. Prior to this, the fiscal watchdog had assumed that the long-term average in productivity growth (roughly 2% a year) would prevail – an assumption that had been routinely disappointed since the financial crisis. Since adjusting their assumptions to reflect the post-crisis trend, treasury officials spoke of a "bloodbath" in public finances. The expected 'balanced budget' date was accordingly pushed back by the Chancellor, despite little changes to spending plans.

Many wondered if the OBR had become too gloomy on productivity, a thought which was given credence last month when it was reported that the last half of 2017 saw the UK's strongest productivity growth since before the crisis. Indeed, the decrease in government borrowing was another big positive last month. But despite acknowledging the improved trend on borrowing in their latest projections, the OBR seems to think the productivity boost was nothing more than a temporary spike, as the graph below shows.



Others also joined the OBR to pour cold water on the Chancellor's good mood. Two independent think-tanks, the Institute for Fiscal Studies (IFS) and the Resolution Foundation, warned that even with a decreased deficit the UK has little scope to ease austerity policies in the coming months. The IFS claimed that the treasury would need to raise at least £30bn extra in taxes in order to balance the budget by 2025, while the Resolution Foundation pointed out that the OBR's forecasts rely on a great deal more spending cuts being made.

This last point is particularly significant. The recent improvements on public debt seemed to suggest that the government had some room for increased spending. Mr Hammond used this and his cheery reading of the growth data as a way to dangle the carrot of fiscal expansion in front of parliament. If the positive trends in the OBR's borrowing data continue, Hammond said he will have "the capacity to enable further increases in public spending and investment in the years ahead," But as the above think-tanks pointed out, that spare borrowing capacity already assumes that more spending cuts will be made. The government may actually have less fiscal wiggle-room than the recent deficit-reduction improvements imply.

This makes it hard to get excited about the prospects for fiscal stimulus. It's also interesting that Hammond predicated any more public spending on the OBR's forecasts. As Chris Giles pointed out in the FT, that's quite problematic. The role of fiscal watchdogs like the OBR is to temper politicians' proven bias towards optimism on the economy – to add a sense of realism to policy considerations by looking at the hard data. It isn't to give a guide to economic policy-making.

Like all economic forecasts, the OBR's predictions are highly fluid and likely to change with unexpected developments. As Mr Giles says, they "are best described as informed guesses." If the treasury rests public spending plans on the shoulders of these forecasts, they give them undue political weight. As mentioned before, many other forecasters – including the Bank of England and the IMF – are more optimistic than the OBR about Britain's growth. This is not to say that the fiscal watchdog is wrong in its forecasts, just that they rely on debatable assumptions – such as the future trend on productivity. So predicating future policy on them seems unwise.

In defending the OBR's downbeat outlook, its chairman Robert Chote said himself that even just evaluating how the UK economy had performed since 2016 was extremely difficult, with GDP figures varying greatly depending on whether one uses income data, output or other factors to measure them.

What does this all mean for fiscal policy? When the treasury received good news on both debt-reduction and productivity growth last month, we wrote that we may see increased public spending as a result. While the Chancellor did allude to that on Tuesday, it was telling that he tempered it with dependency on continued improvements in the OBR's forecasts. Given that those forecasts already assume more cuts to public spending, it's more likely that the spare borrowing capacity would be taken up by enacting fewer cuts than fiscal expansion. We believe the Chancellor most likely wants to save what fiscal firepower the government can spare for any potential slip-up in growth.

However, how much is saved will also depend on how much pressure he gets from his neighbour on Downing Street. With regards to Hammond's optimistic outlook on Tuesday, one of Theresa May's allies said "The PM wanted him to make it clear that after all the hard work, there were better times ahead," Indeed, from the outside it looks as though there's some conflict between the PM's office and the treasury over spending plans. While Hammond has shown his focus on the balanced-budget approach (though somewhat less than his predecessor), May clearly feels her opposition number breathing down her neck.

Jeremy Corbyn's anti-austerity platform has proven extremely popular recently, with recent polls putting his party either neck-and-neck with the Conservatives or slightly ahead. Combined with the recent fiascos with public-service firms like Carillion and Capita, as well as the ongoing crisis in the NHS, the PM likely feels significant pressure to increase public spending. Whether she'll be able to convince the treasury is another matter, particularly considering her precarious position within the party since June's snap election.

Potential fallout from Russian recklessness

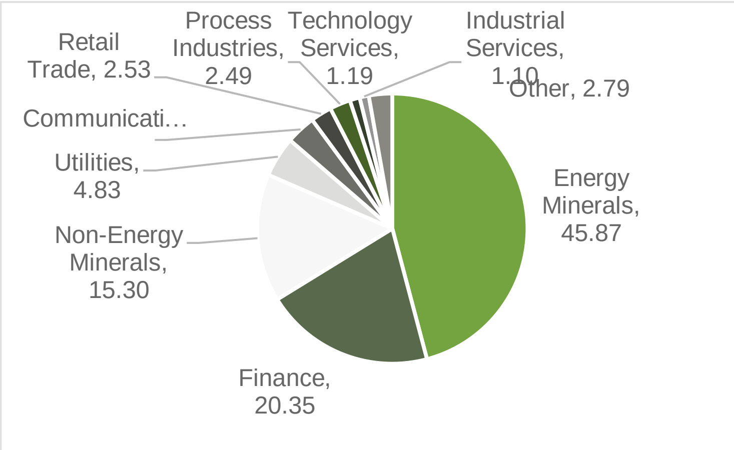
In what is probably the first time that Salisbury has made global news headlines, coverage of Sergei Skripal and his daughter's apparent poisoning in a supermarket has dominated recent headlines in the UK and across the world.

While the Le Carré-like threads involving double agents, expulsions of diplomats and the reckless use of nerve toxins have unsurprisingly captured the imagination of the public, in this article we look at potential economic repercussions from escalating tensions between Russia, the UK and the broader world. Needless to say, we hope that any further measures taken will remain on the diplomatic and economic stage.

Russia is the largest nation by land mass according to the World Bank's 2017 statistics but is relatively sparsely populated. It has under half the population of the USA and a 2016 GDP of just less than $1.3tn, which puts it between South Korea ($1.4tn) and Spain ($1.2tn) (source: World Bank).

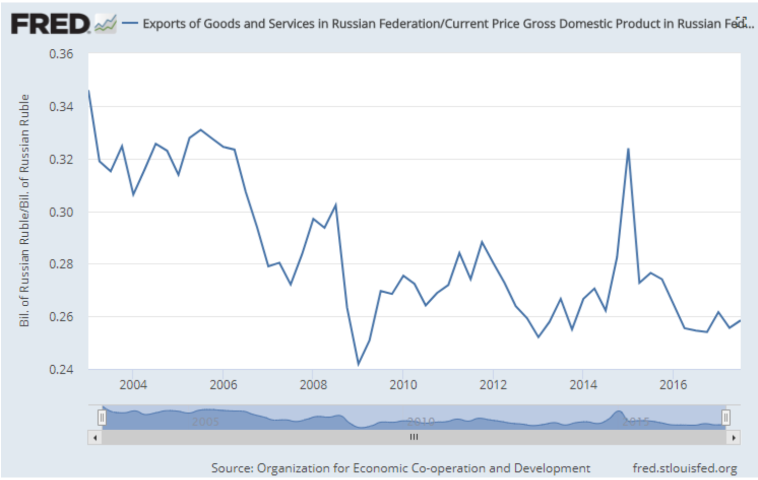
Its output is dominated by mineral and energy companies, thanks to its relative abundance in natural resources. For us, the main questions are: To what external markets does this output go? How crucial is it to these markets? Can it be replaced?

Using FactSet's Russian equity index, we can see the breakdown by market value of the largest Russian listed companies. As alluded to above, Energy and non-Energy Minerals make up over 60% of the Russian stock market.



Source: FactSet

Russian exports as a percentage of GDP have been falling for the last ten years, going from 34% to 26% at the most recent observation. This is a similar level to the UK (albeit in the UK that percentage is increasing).



Sources: *Organization for Economic Co-operation and Development, Exports of Goods and Services in Russian Federation [RUSEXPORTQDSMEI], and Organization for Economic Co-operation and Development, Current Price Gross Domestic Product in Russian Federation [RUSGDPNQDSMEI], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/RUSEXPORTQDSMEI, March 15, 2018.*

As a result of previous sanctions over the Ukraine crisis, Russia currently exports around £2.8bn worth of goods and services to the UK per year, while importing £3.9bn from it (source: FactSet), meaning Britain run a small trade surplus with Russia. Russian imports represented only 1.1% of the total into the UK in 2015 (and 0.9% of our exports went to Russia, according to HMRC). Vice versa, in revenue terms the UK makes up just 3% for Russian companies as estimated by Factset. In most economic measures, Russian trade is a small part of UK business.

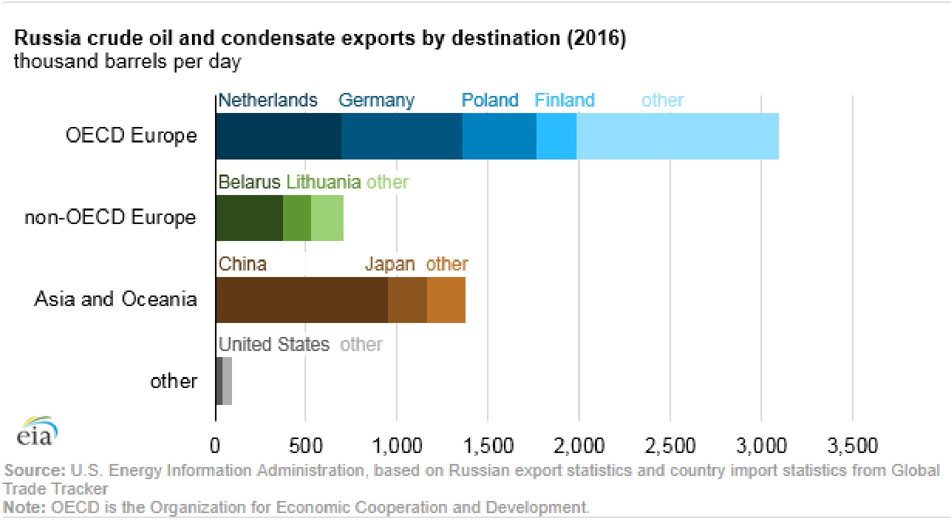
The story is similar for most non-CIS countries (CIS countries are those of the former USSR). The following table shows imports from Russia as a % of GDP for various countries. As we can see, the list is dominated by former USSR countries and those with some financial idiosyncrasies, such as Luxembourg and Panama.

Country	Imports from Russia as %GDP
Cyprus	12.5%
Luxembourg	2.9%
Belarus	2.8%
Estonia	1.8%
Kazakhstan	1.4%
Ukraine	1.4%
Latvia	1.1%
Azerbaijan	0.9%
Lithuania	0.8%
Panama	0.8%

Source: Factset, Bank of Russia

So, if Russia can't cause widespread economic damage to most Western countries because of the size of its trade with them, we should look at where it can affect global trade. Namely, this is through the global energy supply.

An informative chart from the US Energy Information Administration (EIA) is shown below:



Source: EIA, retrived from https://www.eia.gov/todayinenergy/detail.php?id=33732, March 15th, 2018

As we can see, some European countries, most significantly the Netherlands and Germany as well as Poland and Finland, have large imports of oil from Russia. It's also worth noting that all of these bar Finland are members of NATO.

The Netherlands is a large hub for liquid fuel processing, storage and transportation through its large ports. As well as this, it is a significant producer of natural gas through its North Sea gas fields which powers much of the electricity production (alongside coal this makes up almost 80% of electricity production https://www.eia.gov/beta/international/analysis.cfm?iso=NLD). It is currently a net exporter of gas and so not hugely vulnerable to external pressures in this regard.

While Germany has made huge strides recently to increase its renewables energy output and has some indigenous coal reserves, it currently relies on imports of oil and gas to meet its energy demand. Russia supplies 40% of the imported gas used by Germany (EIA: https://www.eia.gov/beta/international/analysis.cfm?iso=DEU) and also is the origin of the Druzhba pipeline, one of the two largest oil pipelines supplying Germany.

We would conclude that, provided the repercussions from the incident in Salisbury are contained to economic measures, business in general terms probably wouldn't miss a beat around most of the Western world. However, Russia holds significantly more leverage in the energy market, being able to exert pressure on NATO members Germany and Lithuania (who buy 63% of their electricity from Russia: https://www.eia.gov/beta/international/analysis.cfm?iso=LTU).

While Russia is no longer a global force economically in some respects, Russia hold a key card with respect to a few key nations. This can provide them with significant leverage when used strategically. Short of threatening (or starting) full scale military conflict, based on fundamentals, few Russian measures could trigger significant fallout in economic and capital market-terms. But they could make it very tough to keep the lights on in Berlin. Given this did not even happen during the height of the Ukraine conflict, we are fairly convinced that the aftermath of the current tensions will be mostly diplomatic, for the time being at least.

UK property market: resilient so far but pressures remain

The UK property market has shown remarkable resilience in the face of both political and economic uncertainties over the past two years. But with rents and property values close to all-time-highs, there are growing pressures suggesting that prices and rents have the potential to retreat from today's peak-cycle levels.

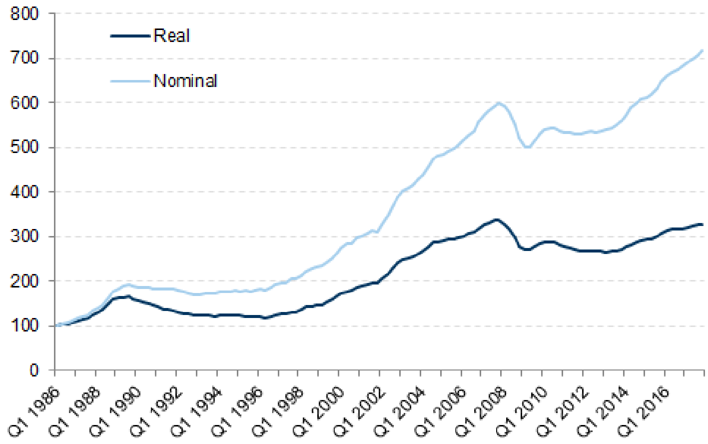
The UK property market is made up of four main sub-sectors: residential, Office Space, Retail and Industrial. Of those four, only industrial property values currently look set for further increases – supported by a manufacturing resurgence on the back of a weaker Pound. On the other side, Residential, Office and Retail property all face different but interrelated headwinds.

From a broader economic point of view, the residential market is one of the most important drivers of economic activity given its impact on domestic consumption. The past twenty years has seen significant structural change in the UK's residential market, where a real (inflation adjusted) 250%

increase in prices have stretched affordability for first time buyers. This has lead to a shift in tenancy mix towards rental properties, especially in higher cost areas like London.

In pure nominal terms, house prices have risen 20% above their previous pre-crisis peak in 2007, but are actually still 3% below that level on a real (inflation adjusted) basis.

Exhibit 50 : A 250% increase in nominal prices in the last 20 years ...
Quarterly UK residential price index, 1Q1986 (indexed: 100)-4Q2017



Source: OECD

Higher property prices have occurred against a backdrop of improving mortgage affordability and a rapid rise of buy-to-let properties, for which mortgages were far easier to obtain. This increased rental supply and generated additional investment demand, which became a larger driver of house prices. It is no secret that for many a house is no longer just a home but has become an investment. The UK rental sector went from just 12% of all dwellings in 2004 to 20% in 2015. This coincided with a near five-fold jump in buy-to-let mortgages since 2009 and the reasonable assumption that the growth in buy-to-lets was behind the rise in rental properties and not a result of higher demand from tenants.

This notion is supported by the observation that compared to property values, additional supply has helped keep a lid on rental price growth, with real rents up just 11% over the past 20 years. This makes residential rents in real terms today lower than they were in 2015. However, it is possible that this dynamic between rents and property values is about to reverse as two formidable determinants for housing markets – inflation and interest rates are beginning to return towards their historically norms.

Residential rent growth exhibits a strong correlation (81%) with retail price indices (RPI) and UK population levels (86%). Historically, negative population growth – a future risk from Brexit – coincides with negative real rent growth, while the recent pick-up in inflation could be mirrored in rents, thereby adding pressure to household budgets.

That household budget pressure is already being keenly felt by the retail sector which moves that pressure onto falling property demand. The traditional 'bricks and mortar' retailers are facing disruption from online sellers along with changing consumer shopping preferences. This is leading to changes in the way both consumers and retailers use property and the data suggests there is a growing dispersion in performance among retailers depending on store location.

Rents for the best quality properties have continued to rise, up 15% from the 2008 peak. In stark contrast, the lowest quality properties have seen rents fall 28% below that peak. To us, this indicates that retailers are willing to pay higher rents where customer traffic justifies such a premium. It may also suggest that retailers are becoming aware that they either have too much or not enough of the right floorspace.

Retailers may be subject to a negative spiral leading to further performance polarisation. Better footfall drives higher rents, resulting 'better' experiences in 'good' areas and visa versa. The competition from online retailers appears to be leading to higher vacancy rates and a reduction of floorspace and lower rents in the best case and bankruptcy in the worst – as Maplin, Toys R Us, etc demonstrate.

Like retailers, office properties are also starting to feel rising pressure on headline rents. London office rents and values have continued to be robust against various uncertainties, remaining close to their 25yr peak. This trend is helped by a 1.4% increase in London office-based employment since Brexit.

However, a deeper analysis of the underlying trends appears less supportive, with net rents falling by as much as 20%, rising vacancy rates and a high volume of un-let space currently under construction in the capital. The data would indicate there is plenty of occupier demand to let space, but little information about take-up and new development volumes could put downward pressure on rents if employment growth weakens.

One bright spot for the property market comes from industrial use, where trends appear positive and uncertainties seem to have few impacts. Following a near continuous decline in industrial rents over the past 20 years, rents hit an inflection point at the start of 2014 and are up 19% since then. For contrast, real industrial rents were down 48% between 1990 and 2013. Interestingly, despite the pick-up in activity, there does not seem to be a rise in new development, resulting in an overall reduction of available space.

Growth in employment in industrial sectors (manufacturing, construction & transport) has been positive since 2013 and the rate of growth has been consistently above overall growth in UK employment, having lagged for nearly 25 years.

It is worth noting that the importance of the transport and storage sectors have grown in that time, rising from 18% of employment to 25% of the wider industrial sector today. We believe that this growth could reflect the force of globalisation, resulting in goods moving worldwide. A similar trend in the storage sector is the rise of online shopping and the need for well-located urban warehouses as part of the 'last-mile' local loop for internet deliveries.

Summary

We think that industrial properties are likely to fare better than Office, Retail and Residential markets, where we expect slow declines. This is driven by normalising rates of inflation driving up interest rates. This could be exacerbated by a negative Brexit outcome. Offices might be impacted by any slowing office-based employment as businesses consider the impacts of Brexit, while Retail could continue to face a growing dispersion of high versus low footfall driven rent premiums or discounts.

Lastly, on Residential, we expect the flight of equity from London to the North to continue, especially as this is where more manufacturing occurs. This will likely pressure both rents and values more in London than elsewhere.

Goldman Sachs estimate that since 1997, house prices exhibit a negative correlation of around 90% to mortgage rates. With UK rates set to rise (possibly five x 0.25% by 2021), there are some estimates that suggest on the back of diminished affordability house prices could up to 15% by the end of 2021, which would equal the 14% drop in residential values between 2008-09.

Under this scenario, London might face a deeper decline of 19%, over the next four years. This could place negative pressure on the buy-to-let market, forcing sales and reducing rents for tenants.

A 15% decline in UK residential property prices suggests that the house price-to-income ratio for the UK property market retreats back towards its 30+ year historic average. This would make some sense if normalising interest rates reduced mortgage affordability back to historic averages. This is a big if and we should probably expect the Bank of England only to raise rates at this pace if real wage growth forces their hand. Real wage growth acts as a counterbalance as it helps offset helps mortgage payment burdens for consumers.

Against the backdrop of rising interest rates and structural demand change in the commercial property markets, we have identified above causes for declining or at the very least stalling UK property values. Only a better than expected outcome of Brexit and a more vibrant UK economy would make us change our outlook. In such a case, increased demand for the UK's traditionally scarce property supply would counter the higher burden of the cost of finance.

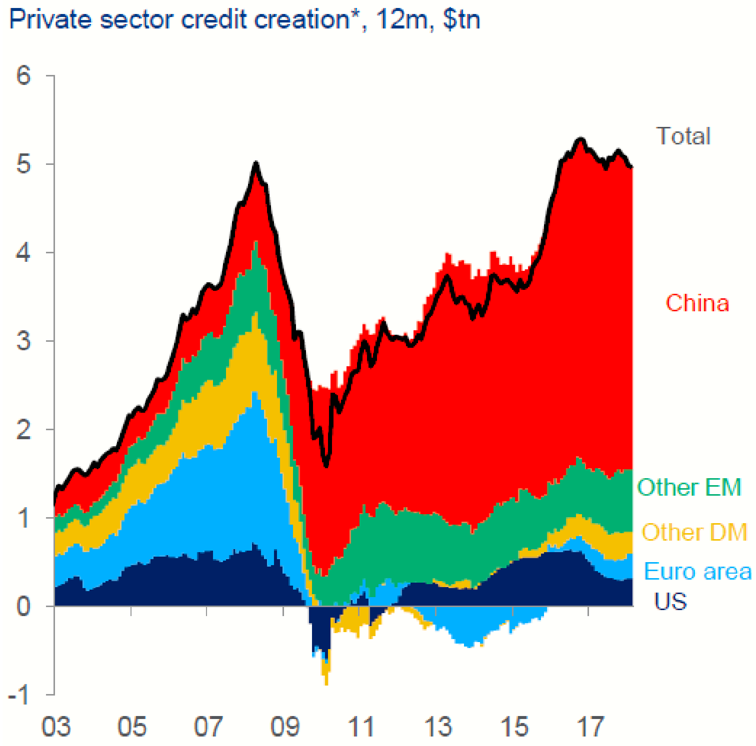
Don't bet on China

Insight by Jim Kean – Tatton's Head of Investment

At the start of the millenium, it was clear that China's wish to take a full part in the global economy would have profound impacts. Its population of 1.4bn (as of now) as a new and cheap resource ensured that producers would rush to employ them. At the time, China's government not only eased that access but actively encouraged a form of free market which released massive potential internally at the same time as they provided significant expenditure to build the infrastructure to gain global market share.

One can make the argument that the disinflationary impetus that this created after China's accession to the World Trade Organisation (WTO) in December 2001 was a big part of why central banks did not see the 2007-9 financial crisis coming. But that discussion is for another time.

However, as the chart below indicates (from Citi Research this week), the financial crisis in the west was the point where China's biggest impact on the global economy switched from supply-side to demand-side.



Source: National central banks, Citi Research. *US series contains bank credit only.

The chart above shows how its "private-sector" credit creation China has dominated world credit flows since 2008. The downward slope rather disguises the increase into 2010 but there's no mistaking that over $3.5 trilllion of credit was being created in China during 2016-17 versus the $1.5T for the rest of the world.

One might observe that the data obviously does not show Western non-private (government) issuance. In fact, western fiscal policy has been of little importance to world growth. While not neutral, the transfer of private sector debt into public sector hands because of the collapse of the financial system meant that fiscal policy had no headroom to expand meaningfully. While Europe and the US were not as stingy as the UK, all regions were forced into some form of relative austerity.

In the west, economic policy was put into the hands of the central banks. Of course, with fiscal policy bound up, it fell to the private sector to channel cheaper money into credit creation. As the chart shows, non-Chinese credit creation has recovered somewhat, but at nowhere near the pace of China.

The chart also tells us something which should give pause for thought. The significant improvement in the global economy's growth seen through 2017 was presaged by the sharp chinese credit creation growth which started in 2015.

In the preceding phase of 2013-15, global private sector credit creation had plateau'd, with Chinese credit creation actually declining. Global trade growth became negative, with the downturn centring on a fall in commodity prices and trade. That fall came about almost certainly because of the pullback in Chinese infrastructural spending growth.

If the 2013-15 phase led to a global growth slowdown, should one expect something similar now?

The uneasy answer is a definite maybe.

China has been going through a passage of change which has made prediction very difficult. Xi Jinping's rise to near-absolute power has been achieved (partly) because the policies he espouses have been beneficial for China's huge working population.

The near-capitalism of the Hu Jintao era (begun shortly after the WTO entry of 2001) created an economy which quadrupled in GDP terms during his 10 years' power (15% growth p.a.!). However, relative inequality remained unchanged. Communist Party roles were captured by people with little regard for its ideology or aims. The focus on growth brought huge financing and investment for state-owned enterprises, leading to wealth and power for its leaders, but little in the way of efficient production. While offering the jobs which were needed to support the workers migrating from agriculture, pollution destroyed the environment in which they now lived.

The flow of credit was stemmed the moment Xi Jinping took over at the beginning of 2013. He also started to deal with the poor management and corruption in the State-owned enterprises (SOEs). Xi's removal of Bo Xilai from the Party leadership of Chongqing (ironically seen as a favourite of the left and a fighter against corruption) left nobody under any illusions.

Unfortunately for Xi, the combination of policies swiftly brought the SOEs' and banking system's weakness to light. Economic growth initially slowed only little in 2014 but by 2015 the slowing became pronounced, with all forms of infrastructure spending being curtailed. Fears of both capital controls and bank weakness caused sharp bouts of Renminbi weakness amid capital flight.

With little choice, Xi reversed the tightening of credit, with growth returning to levels last seen in 2009. The SoEs and banks stabilised, but capital flight worsened as credit leaked out through various unplugged channels (pushing up property prices from Vancover to London).

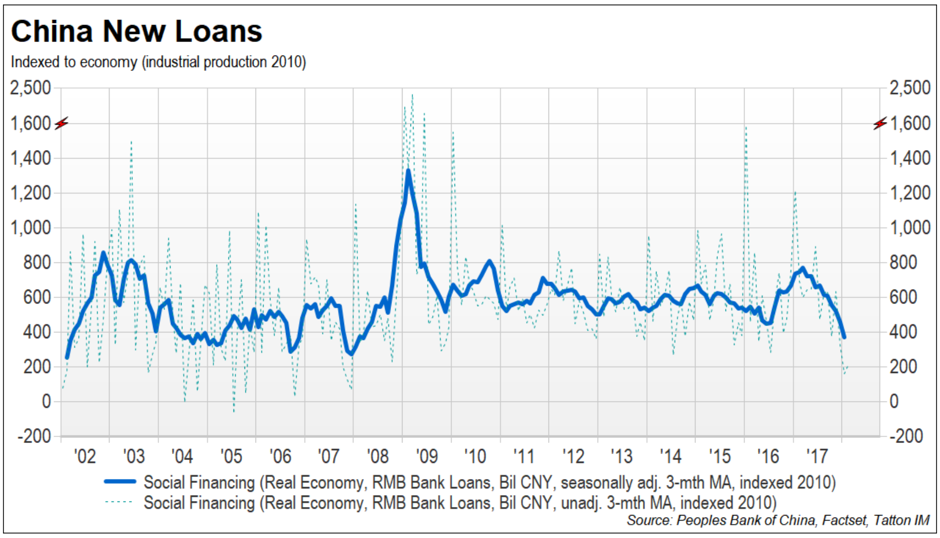
The above goes some way in explaining how 2017 unfolded. Xi had become convinced that unrestrained self-interest was anathema to the country and Party. The way to remove it - deal with those who had been opportunistic and ensure that they had no control over state apparatus by entrenching his own power.

The next phase was to plug the leaks. He clamped down on the insurers buying overseas assets against domestic funding. He gained direct control over domestic companies selling the Renminbi. He effectively shut down the shadow banking system which was channelling the credit away from the domestic economy. Most importantly, from the view point of the poorer Chinese workers, he forcibly shut down polluting manufacturers (mostly SOEs), transferring their business to the better producers.

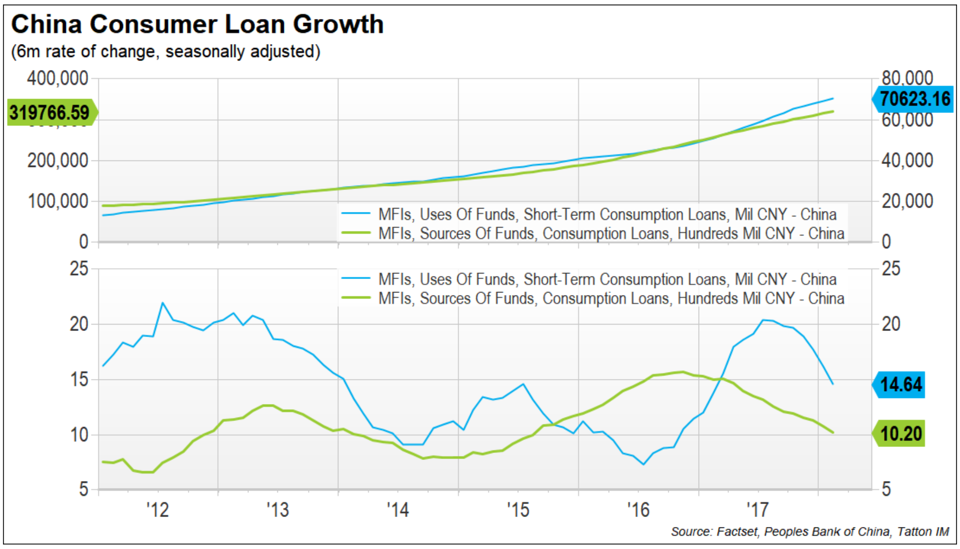
The channelling of existing credit to better domestic entities was especially effective in the early part of the year. Although overall credit was slowing, it had a better multiplier – it produced more activity. It also meant that credit was more available to individuals; consumer sentiment soared to unprecedented levels, amid the growing belief in their beneficent ruler.

Further gains in optimism due to the benefits of Xi's ascent are much less likely following the congress of last week now that there is no lever left to grab. Consumption indicators remain strong, business indicators slightly less so.

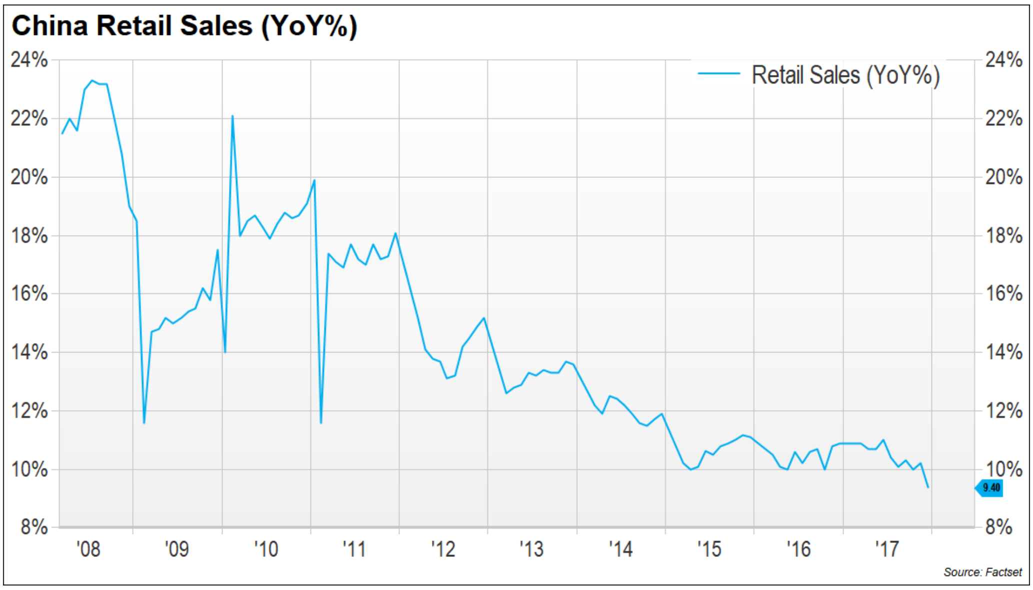
What has been apparent for some months is that credit growth is relatively soggy and is likely to remain so despite some reduction in short-term rates.



In the chart above, I try to show how new economy-wide loans have slowed sharply. The graph is indexed against the economy as measured by industrial production. This week's data, although higher than economists had been predicting, continued the weakness seen in the previous month. What's important about the chart above is that the social financing relates to funds for the domestic economy. The first chart showed a slight rise in credit at the start of 2017 but not to the same degree as the second. However, the latter chart now indicates a distinct slowdown in recent months.



Consumer loan growth remains stronger than overall loan growth but both are slowing as the chart above shows. And that's leading towards a slowing growth in retail sales:



Other Chinese data this week has surprised on the upside and, relatively, recent data has been better than economists' predictions. However, the Chinese economy's long period of strong growth, fuelled by extraordinary private sector credit, is drawing to a close. (we should also note that the last year was a "long" year of 384 days which plays havoc with the data for this January and February when comparing to the last).

Judging from his policy actions, we believe Xi has no commitment to capitalism like his predecessor, and that he observed from his first years in power that it only benefits the few. While he allowed a huge increase in credit in 2016, it is more likely that he sees direct non-market interventions as the defining marks of his regime, and that they would appear to be successful in a way that market mechanisms were not.

While he is still likely to let credit policy loosen in the face of a slowing economy, we think he unlikely to repeat the enormous expansions of credit from previous years.

This is likely to have global impacts. The flow of Chinese funds abroad has already slowed – the likes of HNA buying US and other assets (especially property) are well behind us. The support for valuations will diminish. Secondly infrastructure spending will be of better quality but will not grow at previous levels and that is likely to ease demand for commodities. We've seen stronger than expected real estate development data for February, with growth up nearly 10% on the month, but as we said before, the year-end makes these data untrustworthy. Apartment prices have stopped rising in the major cities and have been falling in the five tier-1 cities.

The Renminbi rose through last year especially against the US dollar. That has ceased now and while we wouldn't expect sharp falls, we would expect the authorities to let it slide a bit.

There is another factor which may impinge as well, but needs a different discussion; that of the possible imposition of trade barriers. For the moment, what we can say is that China was a surprising engine of global demand in 2017. But to expect a repeat this year would underestimate Xi's determination to reign in the forces of the Chinese economy back under the control of the communist party of which he is now the near omnipotent leader.

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7174.7	-0.7	-49.8	↗
FTSE 250	19819.8	-1.3	-265.3	↗
FTSE AS	3962.3	-0.8	-31.2	↗
FTSE Small	5756.1	-0.3	-19.6	↗
CAC	5286.5	0.2	12.1	↗
DAX	12417.5	0.6	70.8	↗
Dow	24956.7	-1.5	-379.0	↗
S&P 500	2758.7	-1.0	-27.9	↗
Nasdaq	7019.4	-1.2	-81.7	↗
Nikkei	21676.5	1.0	207.3	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	13.2x	13.3x	17.0x
FTSE 250	2.8	15.4x	14.3x	17.0x
FTSE AS	3.9	13.4x	13.4x	16.6x
FTSE Small	3.1	10.2x	-	-
CAC	3.0	15.6x	14.2x	15.8x
DAX	2.6	14.3x	12.7x	16.8x
Dow	2.1	19.8x	16.5x	15.3x
S&P 500	1.8	20.9x	17.1x	17.5x
Nasdaq	0.9	27.5x	21.2x	20.3x
Nikkei	-	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
ANTOFAGASTA	8.4	WM MORRISON SUP	-7.4
EASYJET	6.0	MICRO FOCUS INTER	-6.5
GLENCORE	3.9	JUST EAT	-4.8
PRUDENTIAL	3.6	HAMMERSON	-4.8
PEARSON	2.9	IMPERIAL BRANDS	-4.8

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.39	0.48	OIL	66.0	0.8
USD/EUR	1.23	-0.21	GOLD	1313.5	-0.8
JPY/USD	106.10	0.68	SILVER	16.3	-1.9
GBP/EUR	0.88	0.69	COPPER	310.2	-1.1
CNY/USD	6.33	-0.01	ALUMIN	2085.0	-1.0

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.431	-4.1	-0.06
US 10-Yr	2.846	-1.6	-0.05
French 10-Yr	0.817	-8.3	-0.07
German 10-Yr	0.571	-11.9	-0.08
Japanese 10-Yr	0.038	-28.3	-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	2.0
Weighted Average Interest Rate (BoE)	4.24
Nationwide Base Rate	2.50
Halifax Standard Variable	3.99

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

For any questions, as always, please ask!

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

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/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