Weekly Market Comment

13 April 2018

Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENT

Samuel Leary

FUND MANAGER

Isaac Kean

INVESTMENT WRITER

DISCLAIMER

This material has been written by Tatton Investment Management Limited and is for information purposes only and must not be considered as financial advice.

We always recommend that you seek financial advice before making any financial decisions.

www.tattoninvestments.com Twitter: @TattonIM

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

Source: Ingram Pinn on the US - China trade sabre rattling; 6 April 2018, Political Cartoon Gallery Putney

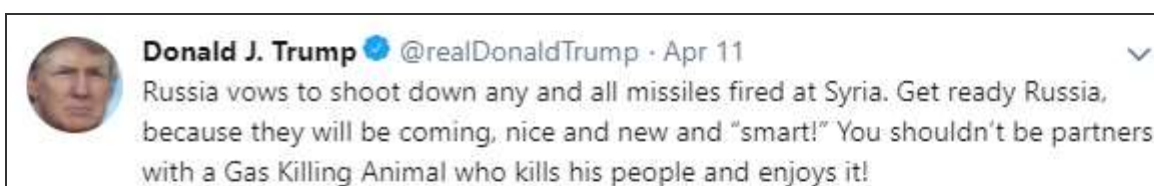
Peaking, plateauing or dimming – and how about that war?

Considering the sheer volume of geopolitical war talk, it might seem surprising that stock markets ended the week up, not down. The reason for this is most likely that the probabilities for an actual trade war between the US and China are seen as reducing, while the probabilities of retaliatory US military strikes against Syria's Assad regime (inadvertently) getting out of control are potentially underestimated.

A speech by China's president Xi on his country's plans for trade and economic rebalancing sounded so constructive and measured that investors became more inclined to believe that negotiations rather than tit for tat tariffs would be the further course of this trade dispute. Together with Trump's conciliatory tweet;

one could be forgiven to think it has all just been blustering and a storm in a teacup.

The prospect of renewed hostilities involving the US in Syria seemingly unnerved market only briefly.



When Trump's tweets were not followed by the intimated immediate rocket strikes, the assumption became that it had once again been more bluster and volatile tweeting, than an actual step up in retaliation measures compared to what has been experienced in the past. Indeed, the Trump administration's actions have proven to be far more measured than the president's language of tweets would have first suggested.

While we would like to agree with this interpretation, we know that capital markets are not particularly good at assessing political risks and therefore we will only breathe easier once the deed is done and the civilised world has delivered its message to the Assad regime that anybody resorting to chemical warfare will always pay a price that is higher than any possible tactical gain. In the meantime, we have to assume that things could inadvertently escalate, even if this is not our central case and expectation. More on this topic in our '*US and Russia conflict over Syria*' article this week.

Beyond this noise, investors are beginning to come to terms with the post equity market correction environment. Having rapidly switched from Goldilocks and stock market 'meltup' joys at the beginning of the year, to panicking over inflation and economic overheating in February, to expecting global trade wars and economic slowdown in March, 2018 has already provided quite a few contrary perspectives of where we may go from here.

In this regard, it is increasingly apparent from the economic data flow that the acceleration in growth last year is giving way to a more moderate pace of activity. Whether this is called rolling-over, peaking, plateauing or dimming of growth, it most probably sounds more worrisome than it actually is. With the growth dynamics of last year it is little wonder that business sentiment in Europe and the US got ahead of itself. This is now reverting back to more realistic levels, which makes it look like a significant drop, when in actual fact the previous expectation highs may have been just as overblown.

The two areas we will continue to pay closest attention to are changes to economic activity levels in China and the Q1/18 corporate earnings announcements. The latter kicked off in earnest over the week, with a number of US banks managing to beat the already elevated growth expectation (see earnings article last week) of company analysts and delivering 23% year-on-year earnings growth. If other sectors of the US economy can follow suit, then this would breathe new upside into what was deemed an overly optimistically priced stock market. If replicated in Europe and Japan – minus the tax cut windfall – then it would provide some evidence for the assertion that the economic data direction change is merely a consequence of previous overshooting, but not a first sign of lasting decline.

Data from China on the other hand is telling us that compared to 2016 and 2017 we should probably not expect incremental growth contributions from the still fastest growing -big- economy in the world. Just as elsewhere, the rate of growth has stabilised and the government does not seem inclined to change that in the near term.

Altogether this leaves us almost where we started the year. February and March have cancelled out January and after the roller-coaster of fast changing sets of expectation, somewhat more balanced expectations may return. However, let us not make the mistake and expect the 2017 low volatility goldilocks trading environment to return. Now that volatility has made a return it is here to stay and we can expect markets to remain jittery. At least until macro-economic data flow proves

stabilisation of growth, corporate earnings evidence continued business growth and the benign interpretations of the latest geopolitical frictions prove justified. Quite a few 'if's' and 'but's' which make us for the time being comfortable to remain underweight equity risk in portfolios, even if we can see that position not to become a permanent fixture over the remainder of 2018 – just like the negative absolute returns that the year has so far brought investors at large.

We need to talk about the UK

Since Easter, the UK's media coverage has been dominated by poisoning of spies, bad weather and (to a lesser extent) Brexit. But, quietly beneath those headlines, the UK economy appears to be stalling. The most visible evidence of this is in the stagnation of the housing market, the construction sector, and increasingly tough trading conditions in the retail sector.

Our previous thesis was that synchronous and robust global growth lifted the UK's boat, as the Brexit-induced fall in the Pound boosted overseas demand for British exports, particularly European demand. These factors helped spur continuous growth and investment in the manufacturing sector.

However, there are growing signs that the global rebound in manufacturing is losing steam, with the UK's near year-long manufacturing resurgence unexpectedly ending in February, prompting economists to lower their forecasts for Q1 GDP growth.

Manufacturing output declined 0.2% compared to January, which was the first drop since March 2017. Analysts had predicted a 0.2% gain in February. Against popular opinion, the Office for National Statistics (ONS) said that "despite snowfall in some areas of the UK during February 2018, there was no survey evidence to suggest that the snowfall had any negative impact".

This indicates the issues facing UK manufacturing cannot be easily shrugged off with the popular explanation of 'it's the weather'. The UK data corroborates equivalent experiences in France, Germany and Italy, who are facing a similar slowdown.

It is hoped that Brexit can increase the openness of the UK economy. But the downside to that is that it will become more correlated to global trade flows, which means that productivity growth will be increasingly levered to fixed investment both home and abroad.

Productivity growth can be defined as the annual growth rate of total factor productivity (TFP). TFP

Exhibit 1: Trend UK productivity growth has fallen over the past forty years

Source: Goldman Sachs Global Investment Research, Bank of England, ONS

measures how efficient the combination of economic inputs (labour and capital) are at producing economic output (GDP). One source of TFP growth is using existing labour and capital within one particular company or sector more efficiently. Another source of TFP growth is the efficient allocation of labour and capital between several companies or sectors.

Over the past 40 years, UK productivity trends have been negative, which partly explains the country's issue with wage growth. Higher productivity can lead to wage growth and visa versa. TFP growth has declined from about 2.5% p.a. in the mid-1960s to just 0.5% p.a. in recent years. The average rate of annual TFP growth from 2001-2016 was weaker than at any time since the early 1900s, according to research by Goldman Sachs.

In its February Inflation Report, the Monetary Policy Committee (MPC) expects global GDP growth between 2017-20 to rise more quickly than between 2012-16. However, the MPC predicts no meaningful acceleration in UK productivity over 2017-20 and the Office for Budget Responsibility's fiscal estimates paint a similarly uninspiring outlook for underlying productivity.

While UK productivity growth has declined over the past 4 decades, it need not exclude the potential for a cyclical rebound over the next decade. Indeed, an open economy typically fosters innovation; imports can create increased competition and exports induce more productive investments.

Brexit is likely to at least temporarily interrupt the virtuous cycle between external demand growth and domestic supply capacity. But if Brexit is not a threat to that cycle and ignites a positive trend in the UK's TFP, then supply capacity should expand. Under such a scenario, more labour market slack would need to be absorbed before inflationary pressures build. This would allow the BoE to tighten monetary policy through interest rate rises far more gradually.

We know that the prospect of Brexit provided an initial export boost for UK manufacturers via a weaker Pound, but that trend appears to be moderating. Sterling has gained 13% versus the dollar in the past year, but has remained relatively stable versus the Euro over the past 12 months (-2%). Additionally, economic data from across the world suggests that activity levels are slowing in response to tighter monetary policy in China, the UK, Europe and the US.

The movements in the Pound after the Brexit vote made it cheaper for overseas businesses to invest in the UK versus elsewhere in Europe. And added to this was the generally improving economic backdrop over the past few years. That had a positive knock on effect for business confidence, resulting in the robust UK labour market we see today, as firms took on new staff in response to rising demand.

Stronger exports and manufacturing activity for firms primarily located in Northern England helped underpin house price growth in those regions. But further upside looks limited, as economic indicators roll over and the effects of weakness in London eventually spreads wider.

The UK housing market is a key pillar of the UK economy, as it helps support consumer spending. The consumer had been buoyed by higher asset prices (homes) and cheap mortgages, but some believe borrowers have overleveraged. This means debt levels are high, and therefore vulnerable to higher domestic interest rates.

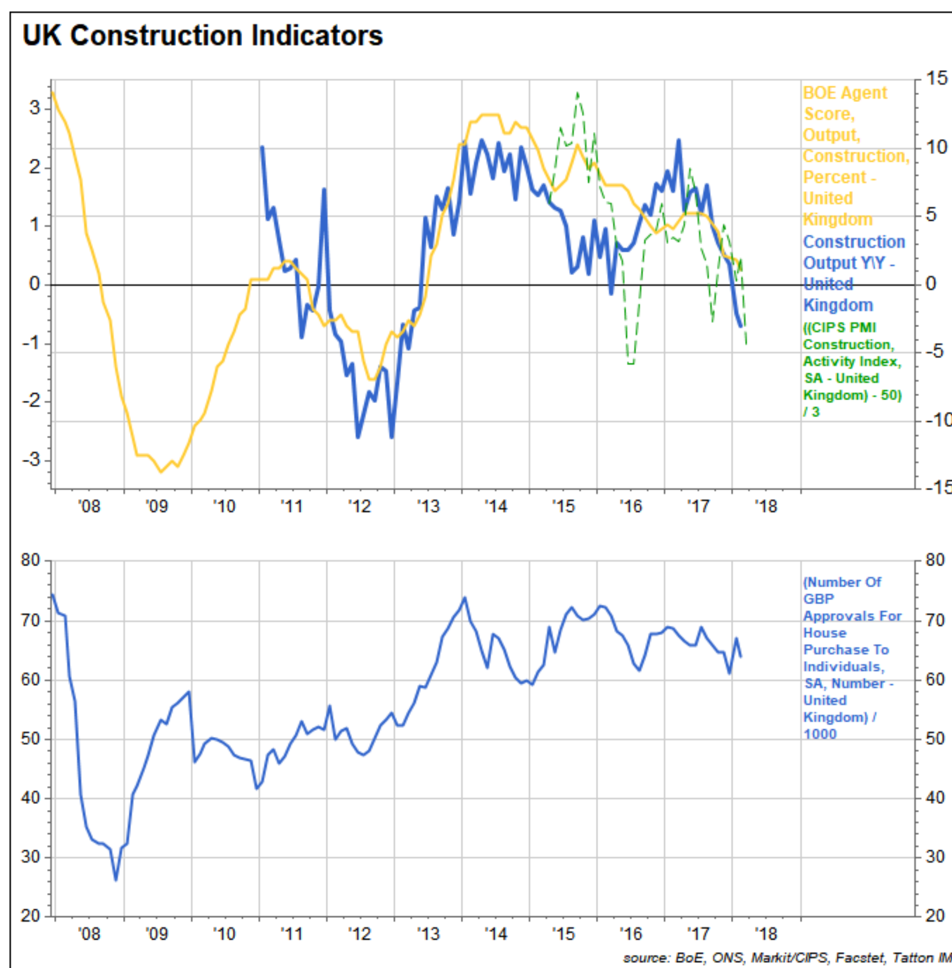
Prospective home buyers are becoming warier as the Bank of England increasingly appears intent on normalising interest rates, given already high mortgage debt levels. UK house prices did not

change in March, but more worryingly, buyer demand recorded its 12th consecutive fall in March. Interest from buyers appears to have weakened, with new instructions falling for a 7th consecutive month, while newly agreed sales also fell.

RICS said survey respondents expect house prices to remain flat over the next three months, but believe prices will likely rise over the next 12 months.

House prices were relatively stable nationally, but this hides the fact that gains in East Midlands and Northern Ireland were dragged lower by falls in London and the South East, according to RICS (Royal Institute of Chartered Surveyors). RICS also said that its latest survey provided "little encouragement" that the fall in housing market activity would likely be "reversed anytime soon". Additionally, RICS believe this has implications for the wider economy by "contributing to a softer trend in household spending".

The stagnation in the property market is having a negative impact on the domestic construction sector. Output in the sector shrank 1.6% in February, lower than the 0.7% increase expected by economists. Construction output is generally volatile, and cold weather in February may have exacerbated that.



It is becoming clearer that the support provided by higher housing prices for consumers is coming under threat. Consumers are likely to be structurally constrained by low savings, high debts and

mediocre wage growth (via soft productivity growth trends), along with the potential for higher interest rates to further compress spending.

Perhaps we are seeing some of the early signs of these factors in the struggles of the retail sector, along with the large drop recorded in new car sales in March (-16%).

We have seen a number of profit warnings in recent months from the UK retail sector, including Carpetright, menswear chain Moss Bros, and Debenhams, while Toys R Us and Maplin filed for administration in February. The UK consumer—along with the high street—are under pressure. Consumer spending has been falling, driven by rising living costs, weak wage growth and subdued consumer confidence. Payment processor Visa suggests that consumer spending during Q1 might be one of the worst on record, while growth in online spending has also been muted.

However, before we get overly depressed about what looks like a deteriorating short-term outlook for the UK, it is worth noting that this is largely in line with the expected deceleration in global growth – albeit a bit earlier. Even though UK economic growth has entered stall speed, there is no threat of outright recession. On the bright side, with £-Sterling strengthening recently and the subsequent receding inflationary pressures, there is now also less pressure on the Bank of England to raise rates further. This has lowered the probability of a second rate rise in May.

Brexit and the broader economy may have fallen to the background over Easter, as geopolitics took centre stage, but unfortunately this doesn't mean that the issues facing the UK's economic future have gone away. The less global growth there is to trickle down to the UK, the more the domestic challenges return to focus. The one consequence this has had is that the UK stock market has become one of the lowest valued ones in the developed world. This means that, with any meaningful progress emerging from the next round of Brexit talks, there could be considerable upside in UK stocks. Hence, we are watching the economic development in the UK very closely.

US and Russia conflict over Syria

Fears over military confrontation between the US and Russia were widespread this week. The suspected chemical attack by Syrian military forces started a series of threats between the two powers, with a Russian official stating on Tuesday that Russia would shoot down US missiles. In typical fashion, President Trump took to twitter to respond, warning Russia to "get ready" for American missiles.

Tensions cooled down slightly on Thursday. Backing off from his missile warning, Trump tweeted that he "Never said when an attack on Syria would take place." Russian officials also dialled down their threats, with a Kremlin spokesman conveying Russia's desire to avoid an "escalation in tensions in Syria." According to Russian analysts, Russia's focus is now ensuring no Russians are killed in any potential strikes by the US, meaning they wouldn't have to retaliate.

Still, some commentators blamed the flaring of tensions for holding back capital markets. The S&P 500, the Nasdaq and the Dow Jones indices were all down on Wednesday – and steepened their decline just when Trump sent his twitter threat. Safe haven assets like gold and bonds also rallied, suggesting markets were in a cautious mood. And while Thursday was positive for equities, early gains were trimmed later in the day after reports that the US has a handful of potential targets in Syria.

But despite this, we think markets may be underestimating the chances of a conflict and its potential effects. It goes without saying that direct military conflict between the world's two largest military powers would be disastrous. And while it's unlikely that either side has much of an appetite for it, tensions could well escalate to the point where conflict becomes inevitable. Any use of nuclear weapons is thankfully at the end of the spectrum in terms of likely scenarios, but there are plenty of undesirable outcomes in between.

Russia's economy is small relative to the world, with a lower GDP than South Korea. But it has an impact on the global economy that belies its trading size. Many global supply lines rely on Russian input, and its importance in the energy market is huge. Russia produces around 12% of the world's oil, and provides 39% of the EU's natural gas. In fact, it's a sweet irony for Russians that geopolitical risk around their country bolsters oil and natural gas prices – which greatly benefits Russian producers. And besides this, the nation has many allies in eastern Europe, the middle east and around the world. Despite the antagonism towards Russia from the west, they would not be hard pressed to find support if things escalated further.

We wrote a few weeks ago that Syria could turn into a flashpoint for the US and Russia, with forces from either side staring each other down in lots of places over the country. That now looks even more likely. But in general, there seems to be a perception in markets that calmer heads will prevail. Much like with North Korea, the hope is that all these threats will eventually just fizzle out without an actual confrontation. But this is potentially too complacent. North Korea is a small nation with small military capabilities relative to the US. The threat of conflict was always small there given that one side had all the cards. The situation now is different. Both countries possess huge nuclear arsenals and huge amounts of military power. And both countries have leaders who look prepared to escalate tensions for the sake of their own bravado.

This is not to say that either leader actively wants a confrontation. But both are uncompromising in their approach and likely wouldn't back down in the face of threats. President Putin has shown many times over the years that he is not one to shy away from a fight, and through multiple appointments Trump has shown he favours a much more hawkish foreign policy. His recent pick for national security adviser, John Bolton, is the clearest example of this – a consistent war hawk who has advocated pre-emptive strikes against Iran and North Korea. A more confrontational approach from the White House is therefore to be expected. Given these factors, the likelihood of a policy mistake of some kind – where confrontation happens without either side really wanting it – is potentially underestimated.

It looks very likely that there will be some kind of response against the Syrian government, especially given the involvement now of France and the UK. Once this happens, the potential for strikes against the Russian military – whether intentional or not – is high. If that happened, Russian leadership would probably feel obliged to offer their own response. It's not too much of a stretch of the imagination to see where that route could lead us. And as mentioned, markets don't seem to be pricing too high of a likelihood of this. On top of the obvious horrible human consequences, that could mean quite a market upset if things do turn sour.

This is especially true considering Trump's domestic troubles. The FBI investigation into Russian involvement in the 2016 election provides a strong incentive for the Trump administration to appear hard on Russia – so as to not seem too friendly towards them. The same is also true in Russia, where anti-American sentiment is often used by Putin to bolster his own support.

Markets are in general not particularly good at identifying the likelihood or consequences of foreign affairs such as this. None of this is to say that war is inevitable; our central scenario is one where tensions cool, in fact. Rather, it presents a difficulty in that it introduces a great deal of short term uncertainty into the mix. Given that markets have been on edge somewhat anyway recently, it might not take much to knock things into a downspin. A conflict between the world's two largest militaries could do just that.

Insight – Fundamentals of bond returns and yield curve reading

In most of the developed nations, investors view government bonds (that have a fixed coupon and pay back the capital at maturity in their own currency) as the least risky investment that can be made. The government will be able to pay back the capital at maturity because its revenue is enforceable by law and, if its central bank can print its own money, the government can force the central bank to print enough. And even if the government has problems paying capital back, it's highly unlikely that their bonds will be any worse off than other domestic fixed investments when and if the government gets into such a position. In terms of knowing what you're going to get as a nominal return, there is nothing better for an investor.

If the government doesn't alter things, tax revenue grows slightly quicker than the growth of the economy (including the inflation component – usually called nominal growth). That's because both direct and indirect taxes are broadly proportional on money spent or received which is, of course, the way we measure the economy. It grows slightly quicker because taxation is "progressive"; the rate increases with income growth.

The government's debt load will be stable as long it isn't paying out overall coupons of more than the overall tax revenue growth. To keep things stable, it can afford to pay a yield around the level as the growth of *[tax base / debt load]*. If the debt load doesn't change, that stable yield will be around *[nominal economy growth **x** tax base / debt load].*

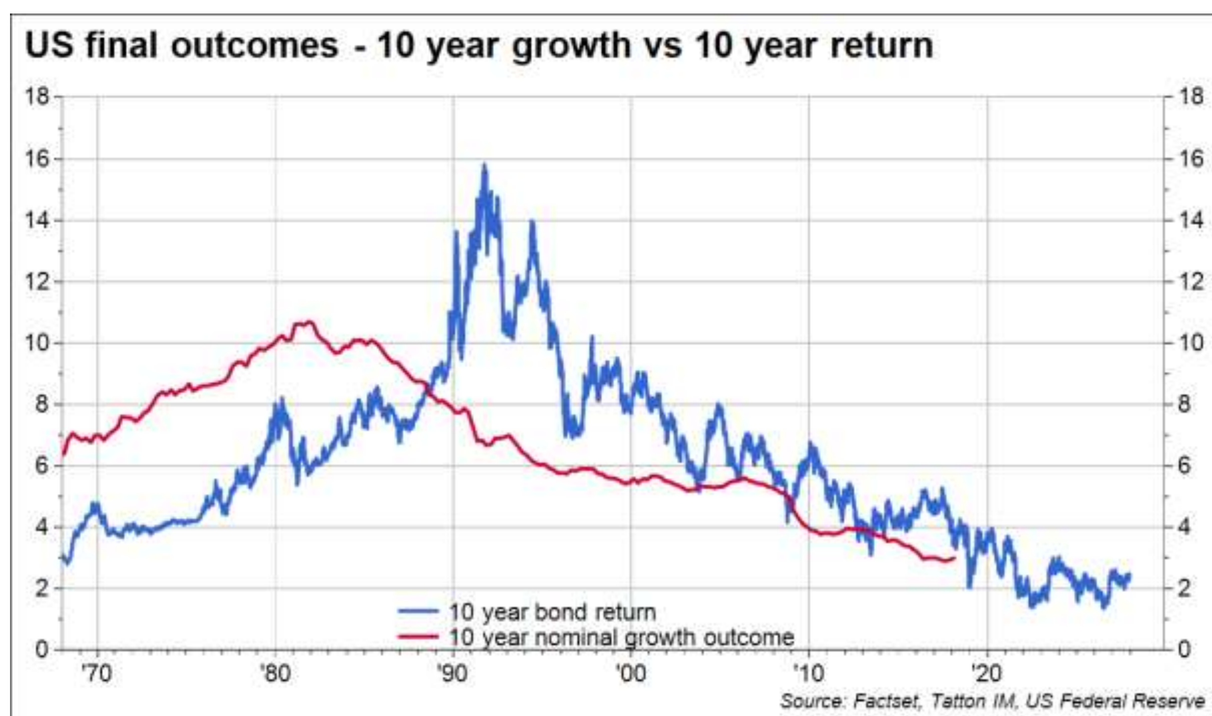
Of course, the government also has to compete for capital with the private sector, which itself has a similar dynamic. Private sector revenues also vary with nominal economy growth. If growth strengthens, opportunity arises, private sector demand for capital increases, so government bond yields have to rise to remain attractive. The yield on government bonds will probably settle around the level that maintains stability whether the debt load is high or low.

Thus, over the long term, the price of government bonds should largely reflect the market's expectation of economic growth, relative to the government's debt load. There are many other factors which affect government bond yields, of course. The debt load or tax base may change. However, central bank monetary policy and financial regulation in all its forms probably has the biggest impact.

Shorter term yields are set by the central bank, which enforces the interest rate by making the banking system keep a large amount of capital in "risk free" assets, either in central bank deposits or (generally) shorter-term government bills and bonds. Other regulation on asset managers, such as insurance companies and pension vehicles, forces them to match long-term liabilities with long-term "risk-free" assets – again generally government bonds. As we know, since the financial crisis 10 years ago, those regulations have increased dramatically.

The impact of the financial crisis on the government bond yield curve has been substantial. The central banks are often said to have “single” or “dual” mandates, in relation to the setting of monetary policy to generate growth and inflation. However, along with other regulatory bodies such as the UK’s Financial Conduct Authority, their primary mandate is to maintain financial stability. Before the advent of inflation and growth mandates, the central banks were the “lender of last resort” to banks. The financial stability responsibility is their primary objective, even before the monetary stability and economic mandate – single or dual - comes into play.

The shape of government bond yield curves has long been a good predictor of economic growth because of the connection between yields and growth. Movements in the yield curve were seen as the most sensitive (or, at least, the most direct) indicator. However, given that the financial crisis has clearly changed monetary and regulatory policy, what impact should we expect on the yield curves? Have the signals changed?



The chart above attempts to show a rather simple idea. It looks at the US 10-year bond returns relative to the annualised nominal growth of the US economy. The idea here relates to the concept of government finance stability. The red line shows the annualised return if an investor had been able to buy the whole US economy. The last 10 years would have returned an annual 3%. In April 2008, an investor could have bought the US 10 year at around 3.8-4%, so the blue line shows the 10-year yield moved along 10 years to match the end of the red line.

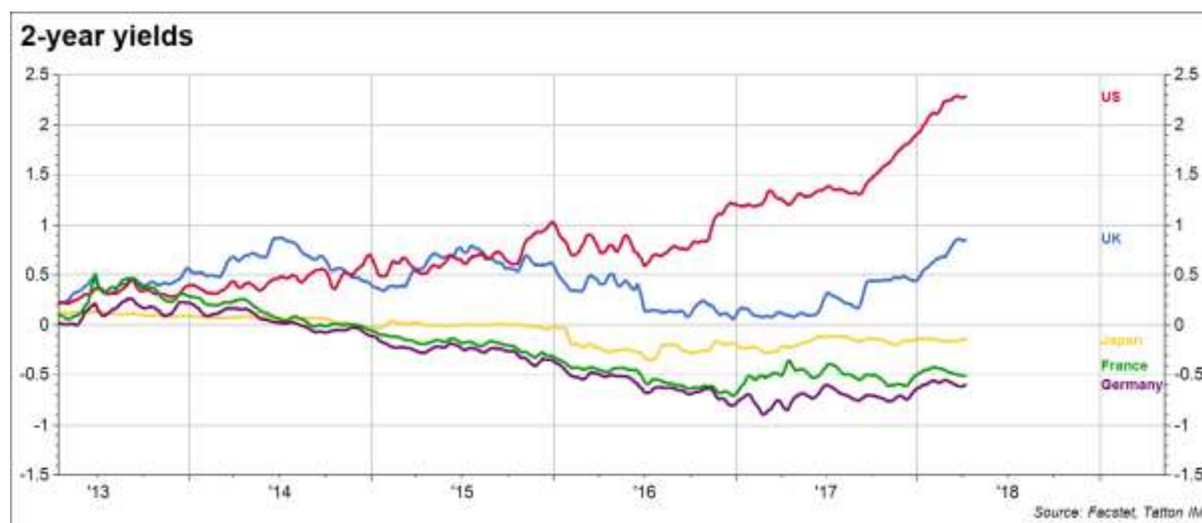
The point is: since the Volcker era began in the 1980s, the fixed return achieved on the risk-free 10-year has virtually always exceeded the economy’s growth.

The way to keep the system stable in the near-term is to increase near-term growth through debt expansion. But of course, that comes at the expense of long-term stability, since it increases the long-term debt load and thereby economic sensitivity to the variability of interest burdens or the continued willingness of investors to hold ever higher volumes of savings in the form of bonds.

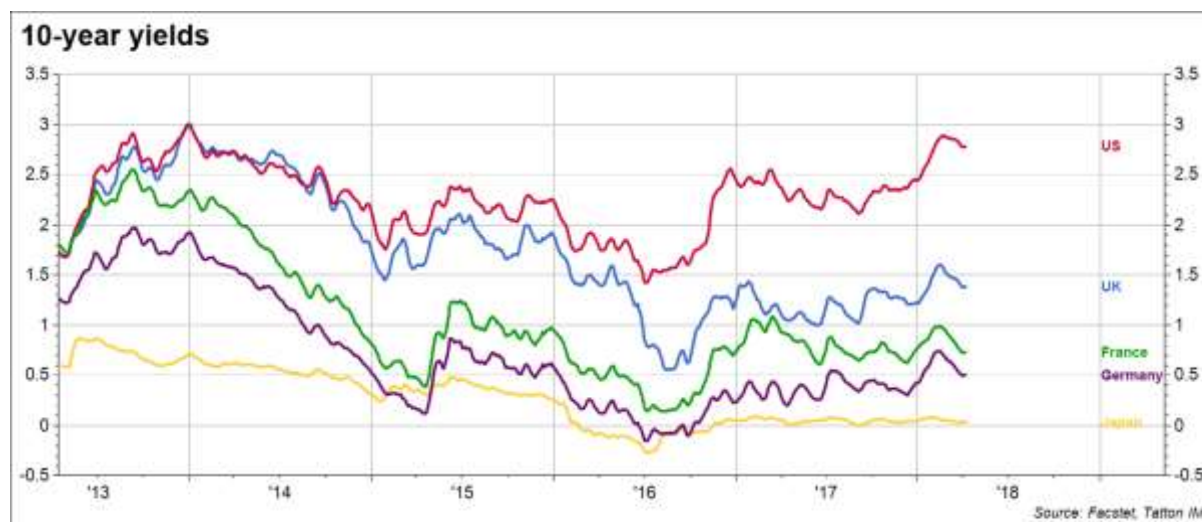
This, we think, is evidence that central bank policy was set in an unstable way; too high short-term rates with too little containment on debt expansion. It would suggest that the financial crisis was a direct consequence of a policy that may have been needed in 1980 but wasn't needed 10 years later.

That would suggest that the current policy of greater regulation and relatively lower policy rates is more the likely norm than previously. In the US, we should expect that, if both inflation and normalised real growth stay at 2%, rates will probably be no higher than that. And with regulation remaining tight, they may be a little bit less than that. 3% in the long term seems about right.

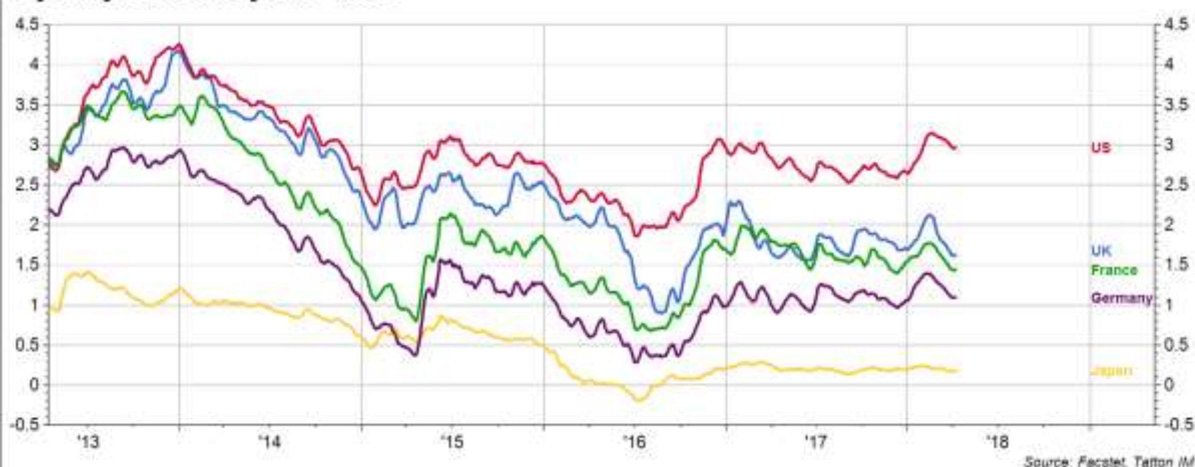
Let's look at how the past 5 years have moved for yields and their curves, globally.



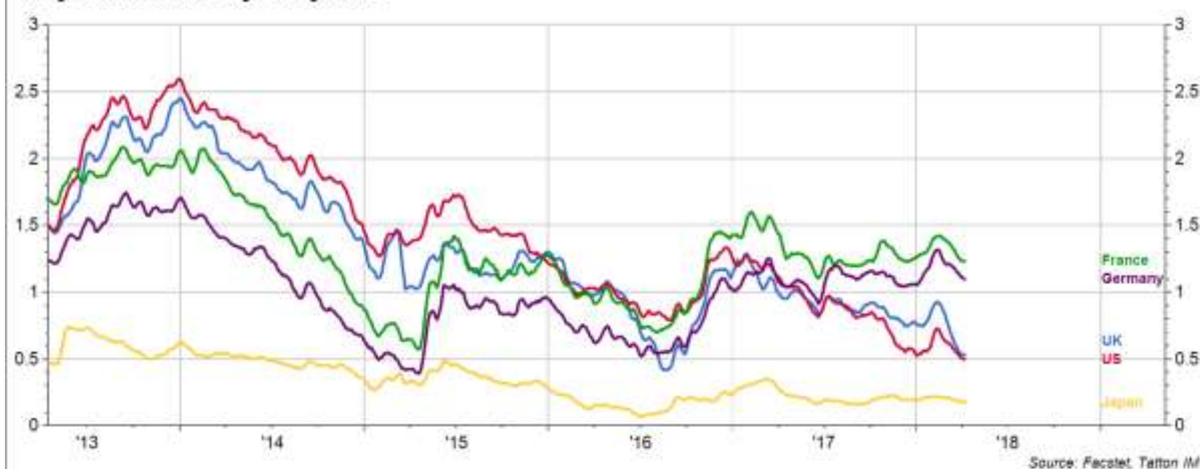
Five years ago, everybody's short rates were in the same place. The divergence since then has been clear. The US has led the way, with the UK following recently. What is notable is that much of the policy reaction seems not due to better growth (Europe has been as good as the US and much better than the UK), but because of rising private sector debt.



Above illustrates 10-year rates, showing how yields recently rose only to come back somewhat again.



The next chart shows what the market expects a 5-year bond's yield to be in 5 years' time. We tend to look at this point because it shows what the market expects beyond shorter-term influences. In the US, at 3%, it's at a level that we see as stable. Having risen quite sharply in January, it's moved back a bit to 3%. It's not moved worryingly lower in recent weeks, despite some weaker economic data. However, France, Germany and especially the UK have weakened more. Recent macroeconomic data has shown a deceleration of growth but, of course, the point of this measure is that it looks at long-term not short-term.



The more classic yield curve measure is the simple spread (difference) between the 10-year and the 2-year. Here, one would get the opposite impression to the previous chart. The US and UK would, in normal times, be sending worrying signals, because a shrinking spread points to diminishing growth expectations for further out time periods. However, for us, the US is less worrying because we think this is a function of the Fed being well into a normalisation of policy, which I pushing up shorter term yields as they are closest to the interest rate levels the central bank sets. What is clear though is that the current weaker global economic data is probably likely to lead to a less hawkish Fed in the second half of this year (hawkish = inclined to raise rates, dovish = inclined to keep rate low).

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7265.3	1.1	81.6	➔
FTSE 250	19841.3	1.6	311.1	➔
FTSE AS	4002.1	1.2	48.6	➔
FTSE Small	5729.0	1.6	91.8	➔
CAC	5315.3	1.1	57.1	➔
DAX	12443.4	1.7	202.1	➔
Dow	24407.0	2.0	474.2	➔
S&P 500	2661.3	2.2	56.9	➔
Nasdaq	6638.4	3.2	205.2	➔
Nikkei	21778.7	1.0	211.2	➔

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	12.9x	13.5x	17.1x
FTSE 250	2.8	14.8x	14.4x	17.0x
FTSE AS	3.8	13.0x	13.7x	16.6x
FTSE Small	3.3	10.3x	-	-
CAC	2.9	15.6x	14.2x	15.4x
DAX	2.5	12.3x	12.6x	16.9x
Dow	2.1	19.5x	16.1x	15.3x
S&P 500	1.8	20.2x	16.5x	17.5x
Nasdaq	1.0	25.5x	19.9x	20.2x
Nikkei	-	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
MICRO FOCUS INTERN	15.1	HAMMERSON	-12.0
TESCO	14.1	COCA-COLA HBC AG	-7.9
JUST EAT	6.9	SAGE GROUP /THE	-5.9
GKN	6.9	BRITISH AMERICAN T	-4.5
WHITBREAD	6.7	IMPERIAL BRANDS	-3.6

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.43	1.13	OIL	72.6	8.1
USD/EUR	1.23	0.33	GOLD	1346.2	1.0
JPY/USD	107.52	-0.55	SILVER	16.7	1.7
GBP/EUR	0.86	0.78	COPPER	307.0	0.4
CNY/USD	6.28	0.45	ALUMIN	2325.0	15.7

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.435	2.8	0.04
US 10-Yr	2.821	1.7	0.05
French 10-Yr	0.740	0.5	0.00
German 10-Yr	0.511	2.8	0.01
Japanese 10-Yr	0.038	-17.4	-0.01

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	1.5
Weighted Average Interest Rate (BoE)	-
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