Weekly Market Comment

20 April 2018

Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENTS

Samuel Leary

FUND MANAGER

Isaac Kean

INVESTMENT WRITER

Chris Robinson

INVESTMENT ANALYST

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

A mixture of messages

As a youngster, our mum would occasionally treat us with a bag of "pick-n-mix" from the sweets counter at the old Woolworths. I say treat; we didn't get to choose. I loved jelly babies, but the liquorice all-sorts were horrible. I seem to remember the weather being glorious when we went.

This week has felt like that. Economic data has been a bit of a liquorice all-sort. Retail sales were probably affected by the weather but the fall of 1.2% month-on-month was worse than most economists had thought likely. Maybe they didn't see the snow. Below is a follow-up on last week's article on the UK.

As I write, the FTSE 100 is trading at 7,350, a full 7% higher than the low of a month ago, and 2% higher than last week. That's a definite jelly baby.

Last Friday night's strikes on Syrian chemical-weapon-related targets had little reported collateral damage and, so far, no immediate retaliation despite the further strikes, most likely from Israel. We look at the Israel-Iran issue in more detail below.

Unfortunately, this story is not over, and is deeply tied up with Russia. Russia's stock market actually did very well this week, up nearly 4% in sterling terms. However, that's a bounce-back from quite deep lows; stocks are still 8% below the level of a month ago.

Sanctions are biting especially hard on Rusal, the second largest aluminium producer in the world. And that's having swift and direct impacts on many global manufacturers. Their customers may want supplies but fear at best being bound up in US courts if they transact, and at worst faced with huge fines and loss of business. Rusal has refineries in Ireland and Sweden which are said to be at a standstill. Rio Tinto has been scrabbling for supplies of alumina for its Dutch facilities. German manufacturers have shortages of finished aluminium and say things are getting rapidly worse.

The sanctions imposed after the Ukraine invasion caused European milk farmers a lot of pain, from which they have only really recovered in the last year. It may be that these new sanctions will have some unfortunate impacts on us in home markets as well.

The price of aluminium and nickel for near-term delivery has risen sharply. So too has the price of oil. This seems to be largely due to seller discipline rather than middle-eastern conflict. OPEC and the Saudis have managed the crude price to levels that seemed unlikely at the start of the year.

This has coincided with a rise in yields in longer bonds across the developed world. After the softer patch of data in Europe and, to a lesser extent, the US, yields had fallen. The US 30-year yield dipped below 3% two weeks ago, from a high of nearly 3.25% in February. However, we're back to 3.15%, amid a rise in both inflation expectations and real yields.

US economic data has also been mixed through this week, with various regional "leading" indicators being softer than anticipated. What has been strong has been demand for credit from businesses, according to weekly loan data from the Federal Reserve. Having languished with almost no growth through 2017, it suggests that business confidence is solid and sustainable. More importantly, it has a direct impact on the way banks buy and sell government bonds and may be behind the rise in yields. Banks clear out government bond holdings when corporate credit demand steps up, and so yields rise.

The same might not be said about China. Here bond yields have fallen sharply this week after authority action. We've been mentioning in past weeks that confidence about Xi Jinping's government is not the same as confidence about economic growth. The signs are growing that the economic out-turn may be slower than many had anticipated. On that point, China's Shanghai Exchange index has fallen sharply and is flirting with a big psychological support level of 3,000.

Source: FactSet

Again, we look at China in a piece below.

News from Taiwan Semi that chip demand has been softer than expected knocked on to Apple and other techs, and reverberated across Asia. A large proportion of chip demand now emanates from Asia and China in particular.

Back finally to the UK. Here at Tatton, we have some interesting debates. One of the big ones has been about the Monetary Policy Committee and its dovishness or hawkishness. As a whole, is the committee predisposed towards rate rises or not? Underlying this is a question about the role of "forward guidance"; to what extent should the committee try to indicate their preference for future rates?. Undoubtedly the members have been signalling that they thought rates would be likely to go up in May. Thus, the Governor's interview with the BBC on Thursday was a surprise to the market, in that he seemed more dovish than expected. The sharp move in the Pound showed this. Yet, as some (including us) have been saying, the economy has not been strong enough through the start of this year to warrant a near-term rate rise.

We think it's likely that members will be a little more reticent in forward guidance in the next few weeks. They may still have a predisposition to raise rates but they'll be trusting that the glorious weather will cause enough of a bounce in consumption to help justify it.

Is the BoE backing away from a May rate rise?

It has been a rollercoaster week for the Pound, jumping to a post-Brexit high of $1.4376 versus the US dollar before dropping below $1.4050 on Friday Morning. Many investors (including ourselves) had thought a May interest rate rise was a "shoo-in", on the back of the unemployment rate falling to a 45-year low. But the Pound made an abrupt U-turn after the March inflation reading printed substantially below economists' forecasts, and then Mark Carney gave a decidedly ambivalent signal in an interview with the BBC ahead of the World Bank meeting in Washington.

In our article last week, we made the case that UK economic growth was stalling, given its increasing leverage to the slowdown occurring across the globe. This week's data releases appear to confirm this soggy trend, and it would have been difficult for the Governor to have ignored this.

Sterling has risen 6.2% year-to-date versus the US dollar (although it's still below pre-referendum levels, particularly against the Euro). Much of the Pound's strength is based on the view that the Bank of England (BoE) will be forced to increase interest rates to control inflation, despite the fact that overall levels of activity seem rather subdued.

Initially, the Pound climbed higher due to the employment and wage data. The numbers appeared to be mostly in line with expectations, with employment growth slowing but pay rises nudging above inflation.

Employment rose by 55,000 jobs in the 3-months to February. Although not bad, it represents a slowing from the previous 168,000 gain in the 3-months to January. The unemployment rate dropped 0.1% to 4.2%, a 45-year low, and the number of people in work reached the highest level (75.4%) since records began in 1971.

▲ Photograph: ONS

However, while good, Goldman Sachs said that both employment growth and total hours worked (-0.2pp to 0.4%) were weaker than they had been expecting, forcing them to reduce their median estimate of Q1 GDP growth to 0.27%.

Data for coming months will probably show that things have got tougher for the job market.

The physical stores retail sector is struggling, as evidenced by bankruptcies at Toys R Us and Maplin. Analysts predict up to 15,000 jobs are at risk and that around 6,000 retail store will close in 2018. Food retailers like Sainsbury's, Asda, Morrisons and Tesco have cut jobs as higher food costs hurt profitability. Other retailers like Card Factory, Moss Bros, Laura Ashley and Carpet right have all come under pressure, each issuing a profit warning.

Other sectors are also feeling the pinch. The fallout from the failure of construction and services firm Carillion are still being felt, with a total of nearly 1,500 job losses so far. Lloyds Bank is cutting about 305 jobs as it axes 49 branches, taking the total to 1,230 job losses. The European automotive sector is struggling, as the UK – the EU's 2nd largest auto market – saw car sales fall to a 5-year low, with Brexit uncertainties eroding demand. Additionally, consumers remain confused over the future of diesel engines. Sales of diesel cars fell a whopping 40% in March.

In response, Vauxhall, now owned by Peugeot, said it would terminate its network of 326 UK dealers, while Jaguar Land Rover said it would cut 1,000 staff as sales fell 26% in the UK and 32% in Germany. Perhaps the marquee British brand is feeling an anti-British backlash on the continent?

It might be easy to suggest that online retailers or changing user preferences are to blame, but the fact remains that consumers have reduced spending amid real (inflation-adjusted) wage declines over the past few years, and especially over the last year. Even though nominal wages have risen, workers are still around £800 worse off than before the financial crisis and real wage growth is likely to remain modest this year. Those at the lower-end of the income scale are still feeling the income squeeze.

The BoE may judge that the acceleration in headline pay growth from 2.6% year-on-year (YoY) to 2.8% YoY may be enough to offset recent softer activity readings. Pay growth is growing at its quickest rate since August 2015. The BoE's has suggested that it's harder to justify low interest rates given the economy has reached full employment, given the potential impacts on inflation.

What may give the BoE more pause for thought is the fall in UK inflation to its lowest level in over a year. The Office for National Statistics (ONS) said that the consumer price index (CPI) fell 0.2% to 2.5% on an annual basis. Economists had expected no change. Core inflation (which strips out more volatile items like food) fell 0.1% to 2.3%, driven by a drop in airfares and goods prices, suggesting that retailers have largely stopped passing on higher import prices.

JP Morgan estimated recently that about 75% of the pass-through from the inflationary impact of sterling's depreciation is now complete and has already started to fade. This suggests further downside to inflation forecasts. We would not be surprised to see the BoE lower its inflation forecasts, given the overall rise of the Pound, to its long-term target of 2%

The BoE recently downplayed the effect that rising interest rates would have on consumers, suggesting central bankers are retaining their more hawkish stance. The head of Financial Stability, Alex Brazier, expects that we would "not see large swaths of households getting into distress". A total of 1.4% of UK households have a debt-servicing ratio of over 40% of their income. Economists forecast this to rise to 1.9% if interest rates get to 2%.

On balance, we still think the BoE will hike in May. Mark Carney mentioned the effects of March's cold weather. So the current sunshine could produce an almighty bounce! Still, the chances of a rate rise in May is around 60/40, and is clearly more data-dependent than we had previously thought. But if they do hike in May, another rise could be some time in coming.

Israel-Iran tensions: conflict in Syria?

After last weekend's missile strike on Syria by US, British and French forces, President Trump took to twitter to announce, "Mission Accomplished!" Accordingly, he received some stick in US media for what might turn out to be a premature declaration, but the message was fairly clear: The strikes were a "one-time shot," with no further expected military action unless the Syrian government's suspected chemical weapons attacks continue. So, despite the recent spike in tensions – which we talked about extensively last week – this week seems to have brought a cooling off between the US, Syria and its backer Russia.

Unfortunately, it seems that, in Syria, when one problem dies down another one flares up. To somewhat less attention than the western missile strikes, last week also saw an Israeli missile directly striking an Iranian military facility in Syria, killing seven members of Iran's Quds force, including a top commander. It comes only two months after an Iranian drone – launched from the same facility that was later bombed – was shot down by Israeli for veering into Israeli airspace.

Iran and Israel have waged a cold war against one another for over 10 years, through proxy wars, cyber wars and espionage. But the attack on April 9th was the first direct strike by either side. Iran's government pledged to have its revenge on its nemesis, with a spokesman for the foreign ministry declaring that Israel will "receive the necessary response and will regret its misdeeds,"

Reports are now that the Israeli Defence Force (IDF) is preparing for a retaliatory strike, most likely a missile launched from Syria. They have strongly suggested that any direct retaliation by Iran will be met with a full counter-operation against Iran's entire military presence inside Syria. On Monday, Israel's defence minister Avigdor Lieberman told a crowd of Israeli soldiers that Iran and its proxies "are all becoming a single front against the state of Israel."

Iranian news, government officials and Iran's Lebanese proxy Hezbollah are all acting to suggest that a direct strike is imminent. But Iran has not made a move yet. Why?

Iran is all too aware how damaging the fallout from a war with their rivals could be. The Quds force – the elite extraterritorial arm of Iran's Islamic Revolutionary Guard Corps (IRGC) – has established a large military network in Syria where it could soon have forward air bases and missile factories, as well as a secure path through which to supply its Lebanese allies. But it currently stands very little chance against Israel's high-tech forces. Israeli defence officials have let it be known that they don't intend to let Syria become another Lebanon, where Iranian support has established a large missile threat, and would therefore likely grasp any chance to degrade Iran's Syrian presence before it become a significant threat.

But aside from military costs, political reasons could also be holding back an Iranian attack. The widespread protests which began in December in Iran will no doubt still be firmly in the minds of Tehran's political leaders. The protestor's two main gripes were the failure to improve the economy or living conditions after the lifting of sanctions, and what many in the country (especially the young) felt were unnecessary and damaging wars in Syria, Yemen and Lebanon. Both of these problems would be exacerbated by action against Israel.

Iran's foreign involvement is proving unpopular with its citizens, who feel that the money spent on the military abroad could be put to better use at home. And the Trump administration has long made clear its opposition to the lifting of sanctions in the denuclearisation deal with Iran. In January, the US President issued an ultimatum to his European counterparts to "fix the terrible flaws" in the agreement or see US sanctions on Iran resume – which they will next month unless Trump issues waivers. Britain, France and Germany have been lobbying the EU to impose fresh sanctions on Iran to appease Trump, but have so far had no success. Now, they have taken a different tactic: issuing sanctions not related to Iran's nuclear program but instead to its support of the Syrian regime – and its alleged use of chemical weapons. According to reports, on this point EU leaders have been far more receptive.

Given the recent unrest, and how badly Iran was hurt by sanctions before, Further military action against Israel will only worsen their situation. And all of this isn't even to mention their currency, whose recent tumble will hurt the economy even more.

So, considering what they have to lose politically, can we forget about an Iranian strike against Israel? Unfortunately, things are a little more complicated than that. It's likely that President Hassan Rouhani's government is largely in favour of winding down operations in Syria – and is certainly against war with Israel. But it's not up to the President. Qasem Soleimani, head of the Quds force, reports directly to Supreme Leader Khamenei and has virtually free reign from the executive. He has also demonstrated over the years both the desire and tactical acumen to project power across the middle east.

There is a tendency in the west to think of Iran as a centralised and coordinated mastermind. But this is far from the truth. Iran has two separate militaries, its conventional army and the IRGC, which was created with the intention of fighting unconventional warfare and defending the Islamic revolution both internally and externally. Soleimani's Quds is the elite external part of the IRGC, but he also has considerable power at home. Over the years, the IRGC has grown from a band of local militias into a huge military, political and economic force. There are IRGC affiliates at every level of Iranian government, and it reportedly owns assets which amount to roughly a third of the nation's economy.

Soleimani would no doubt be more inclined to strike against Israel than Rouhani, and the Quds force has never let economic constraints hamper it before. But even Soleimani has his limits. Considering the military disadvantage Iran are at, retaliation through its proxies looks the more likely. What's more, he still has to report to the Supreme Leader, whose word on the matter is final. Khamenei is the only one who can rule with both hands, at home and abroad. Whether he decides domestic concerns trump foreign policy ones remains to be seen.

China's micro-management continues

China released a raft of economic data on Monday evening. According to official figures, Q1 real GDP growth came in at 6.8% YoY, in line with market expectations. Chinese growth appears to have peaked – having sharply rebounded over 2017. However, considering all the tightening measures announced over the year, growth is holding up better than expected.

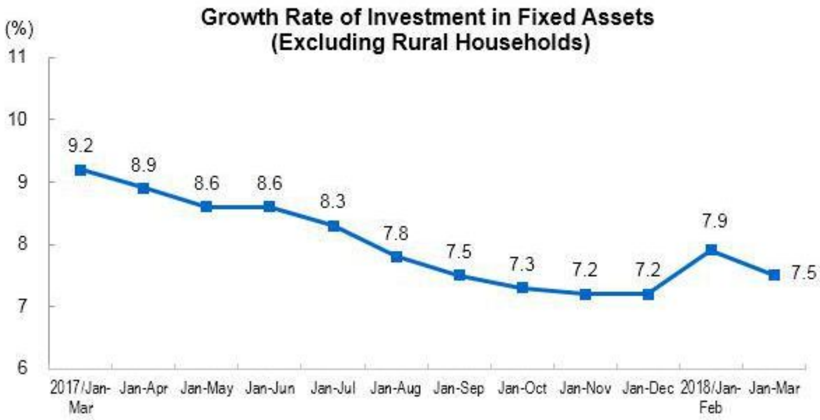
Source: Factset

This follows on from last week's -2.7% fall in exports, against market expectations of 11.8% growth. As exports decreased while imports continued to grow, China posted a surprise $5bn trade deficit, its first since February last year. This negative net trade position acted as a drag on Chinese growth, having provided strong support over the course of 2017. Despite this drag, growth has remained stable.

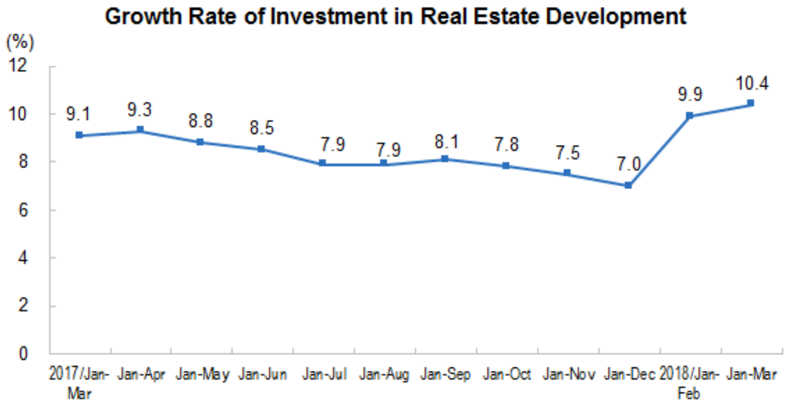
While the positive global growth backdrop should provide support for Chinese exports, recent trade tensions between the US and China may put further downward pressure on exports, leaving future economic growth to rely on domestic demand. Current indications are that any trade tariffs will likely be softened in extended negotiations, but this is something we're keeping a keen eye on.

One of the policy levers China has pulled over recent years has been to increase infrastructure spending in order to counter any slowdown in growth. However, much of this stimulus has gone through various backdoor routes such as policy banks, public-private partnerships (PPP) and through an increase in local government borrowing from the shadow banking sector. Many of these infrastructure projects have been described as white elephants, inefficient and costing more to produce than the economic benefit they eventually bring. The Chinese government have now put a priority on containing excessive leverage, restricting local government's ability to borrow and forcing them to postpone or cancel many infrastructure projects.

Despite this reduction in infrastructure spending, investment in fixed assets held up well over the first quarter, but appears to be declining more recently. Real estate development this year has so far compensated for any declines in infrastructure spending, especially through investment in residential buildings. However, this is also not sustainable in the long term.



Source: http://www.stats.gov.cn/english/PressRelease/201804/t20180418_1594701.html



Source: http://www.stats.gov.cn/english/PressRelease/201804/t20180419_1595012.html

Retail sales figures also gave a positive surprise. Sales growth came in at 10.1% YoY to beat expectations of 9.7%, which helped support internal growth. Other economic indicators also paint a positive picture of domestic conditions in China; inflation is relatively benign, consumer confidence is high and capacity utilisation has increased.

Following on from the economic data, the Chinese central bank (PBoC) unexpectedly reduced the reserve requirements by 1% for most banks. However, in a typically Chinese fashion, there were requirements attached to how the increased liquidity must be used. Most of it must be used to repay relatively expensive loans obtained from the PBoC's medium-term lending facility, but there will still be around $65bn in excess funds to lend to the real economy. Although the PBoC have been at pains to play down the move as not amounting to broad monetary stimulus, the bond markets took the news slightly differently. Chinese 10 Year yields tumbled 12bps on the announcement, the largest fall since 2016. Despite the relatively strong economic backdrop, policymakers are starting to consider longer-term economic conditions alongside their desire to curb mounting debt levels.

In summary, despite growing in-line with expectations, there's been a subtle shift in the source of growth for China. External demand and government spending have somewhat slowed and Beijing's ambitions to reduce leverage may further dampen growth. However, domestic strength through consumer spending, falling unemployment and rising incomes should provide support. Furthermore, slightly looser reserve requirements should provide a monetary boost to the domestic economy.

As we've discussed before, the Chinese model of playing whack-a-mole – continuously fine tuning economic policy as new issues pop-up – appears to still be à la mode. Traditional economic theory would suggest such levels of micro-intervention tends to skew markets, increase the probability of policy error and generally creates more problems than it solves. However, so far at least, it appears to be working for China.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7359.7	1.3	95.1	→
FTSE 250	20207.9	1.9	369.3	→
FTSE AS	4058.1	1.4	56.7	→
FTSE Small	5816.0	1.8	100.5	→
CAC	5410.9	1.8	95.9	→
DAX	12543.0	0.8	100.6	→
Dow	24485.1	0.5	125.0	→
S&P 500	2684.3	1.1	28.0	→
Nasdaq	6695.4	1.0	67.1	→
Nikkei	22162.2	1.8	383.5	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	13.0x	13.6x	17.1x
FTSE 250	2.7	15.1x	14.7x	17.0x
FTSE AS	3.7	13.2x	13.7x	16.6x
FTSE Small	3.2	10.7x	-	-
CAC	2.9	15.9x	14.4x	15.4x
DAX	2.5	12.5x	12.8x	16.9x
Dow	2.1	19.6x	16.0x	15.3x
S&P 500	1.8	20.5x	16.6x	17.5x
Nasdaq	1.0	25.6x	20.2x	20.2x
Nikkei	-	-	-	-

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
MEDICLINIC INTERNAT	16.5	BRITISH AMERICAN T	-10.4
HAMMERSON	14.0	RECKITT BENCKISER	-6.8
GLENCORE	10.0	LLOYDS BANKING	-3.7
NMC HEALTH	8.0	WPP	-3.6
SHIRE	7.2	IMPERIAL BRANDS	-2.5

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.40	-1.51	OIL	73.3	1.0
USD/EUR	1.23	-0.41	GOLD	1338.6	-0.6
JPY/USD	107.68	-0.31	SILVER	17.2	3.2
GBP/EUR	0.88	-1.09	COPPER	315.8	2.1
CNY/USD	6.30	-0.33	ALUMIN	2485.0	6.9

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.492	4.0	0.06
US 10-Yr	2.936	3.9	0.11
French 10-Yr	0.819	10.5	0.08
German 10-Yr	0.602	17.8	0.09
Japanese 10-Yr	0.060	57.9	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	4.23
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