Weekly Market Comment

4 May 2018

Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENTS

Samuel Leary

FUND MANAGER

Isaac Kean

INVESTMENT WRITER

Past the peak?

We wrote last week how we observe that – after the recent correction - stock markets now appear to have entered a consolidation phase, expressed by an unwillingness to rally despite daily announcements of exceptionally strong corporate profit growth. This reached an average annual rate of over 23% in the US this week. We concluded that this may well be because investors are finally coming to notice that global growth is no longer accelerating further and therefore the highest earnings growth levels may also be behind us. Whether this means that we are past the peak of this very long economic cycle and have entered a terminal downward slope or just experiencing yet another mini cycle within the much larger cycle cannot be determined at the moment. What is mostly consensus, however, is that there are no particular recession indicators on the horizon as there were at the end of 2015, which would point towards a mini cycle.

During this week's Tatton investment committee meetings we took a very extensive look at all the indicators that we and our research providers observe and debated at length what implications the emerging picture should have for the most appropriate positioning of our investors' portfolios.

In this article Tatton's head of research, Jim Kean, will therefore present the larger picture we observe and do his best to translate it into a narrative that is accessible to our wider readership.

2017 will be remembered as the year when regional growth became the most synchronised in history. Given that global growth at an aggregate level had been improving for over ten years, this is perhaps surprising. One might have expected that economies would reach limits of capital and productivity at different times which would lead to growing dispersion.

However, it looks like such dispersion may well have prevailed 18 months ago as we headed into 2016, when emerging markets, and China particularly, hit a decidedly icy stretch of road. The deflation of the commodity bubble, a strong US-$ and a slowing economy in China had led to a substantial slowing of global trade.

China's early response to weakness in 2015-16 had been to encourage a weaker Renminbi (devaluation). This had bad impacts, with residents trying to get their money out of the country, while Chinese companies that had borrowed in dollars faced increasing financial burden. The end of 2016 saw the Chinese leadership change their focus, easing monetary and fiscal policy, but wanting to stabilise the Renminbi. This shift markedly improved demand for commodities, while easing dollar liquidity.

Trump's arrival was the other major event of 2016. His policy mix – fiscal looseness, deregulation, and pressure on trade partners – may not have been obviously beneficial for 2017. However, the delays in fiscal measures meant that while the Fed tightened, it did not do so in a way which caused overall financial conditions to tighten. Personal (i.e. retail investor / consumer) sentiment was strong, leading to an oddity – retail investors increased their risk allocations, and equities saw large inflows. Equity prices rose and, helped by affordable but rising house prices, personal balance sheets improved, which meant that improving wages were channelled into spending. Indeed, the savings rate declined to historic lows.

Meanwhile Trump's trade policy shift did not result in tariffs immediately. Rather, it was in the interests of both China and the US to see trade improvement through a weaker dollar. Having expected speedy US company repatriation of overseas earnings, it became apparent that this would be more closely tied to tax changes later. Perhaps more importantly the dollar had reached very expensive levels when measured by “purchasing power parity”. In other words, you could buy more with Euros, Yen and Renminbi than with dollars. The dollar proceeded to weaken throughout 2017.

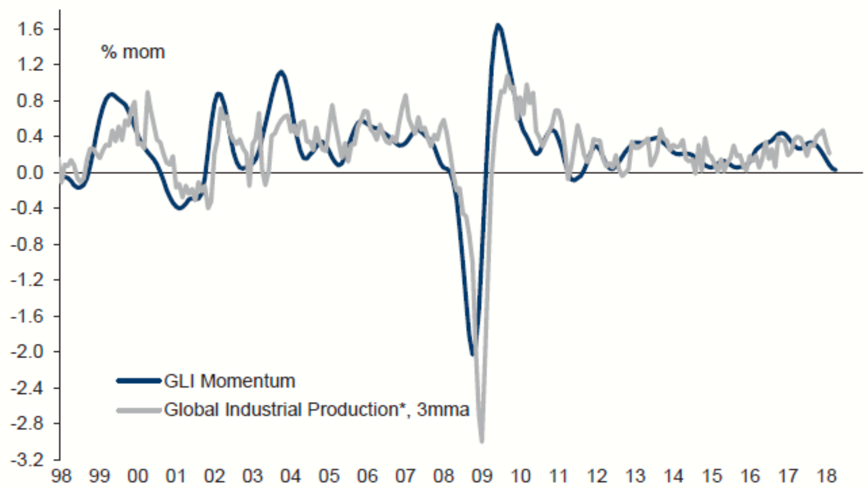
January this year probably marked the high point for this recovery cycle that started in Q1 of 2016. The benefits of the policy mix ebbed as the policies moved from expectation to reality in the US. The dollar bottomed against most major currencies and then stabilised, as tariffs became a likelihood and US interest rates had been increased enough to increase capital inflows. The substantial US tax cuts started to be reflected in corporate accounts, leading to sharp rises in expected post-tax earnings growth but with expected pre-tax earnings growth levelling and even starting to decline. Retail investors slowed and then reversed their purchases of equities while the tax cuts raised savings rates off the lows rather than boosting consumption further.

In China, economic policy had begun to shift early in 2017 towards monetary tightening but its impacts were complicated. The rise of Xi Jinping to supremacy had a similar impact to that of Donald Trump, with his policies seeking to redress many of the ills which had been created during the unrestrained commerce years. Overall popular sentiment was very positive leading to strong consumer spending. The policy of guiding lending towards the real economy and away from funding the purchase of financial and property assets met with widespread approval. However, the constraint in overall lending meant that infrastructural spending growth started to decline. The general tightness of money raised interest costs and indebted companies started to feel the effects.

All of which leads us to the present day. As the first chart shows, the rate of actual global growth (as measured by industrial production) has plateaued and a leading indicator (as measured by the Goldman Sachs Global Leading Indicator’s momentum) has started to decline.

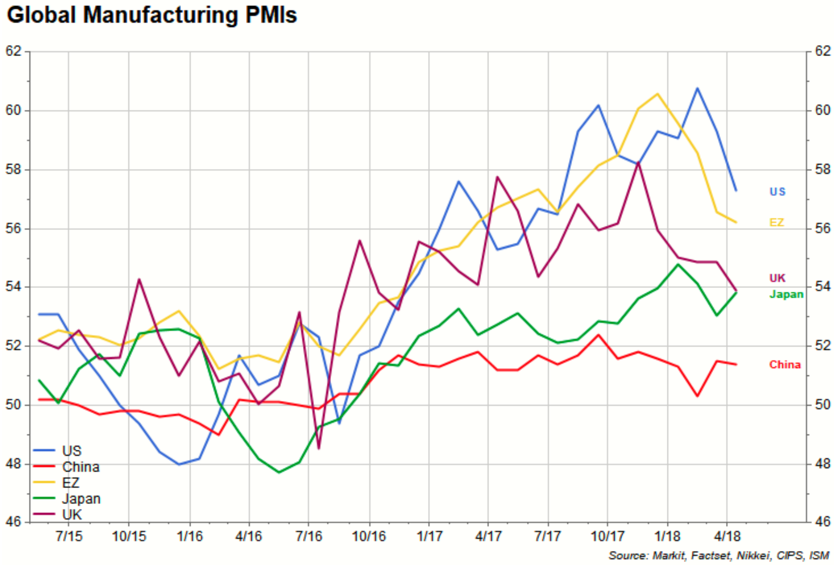
GLI Momentum vs. Global Industrial Production*

* Includes OECD countries plus BRICs, Indonesia and South Africa



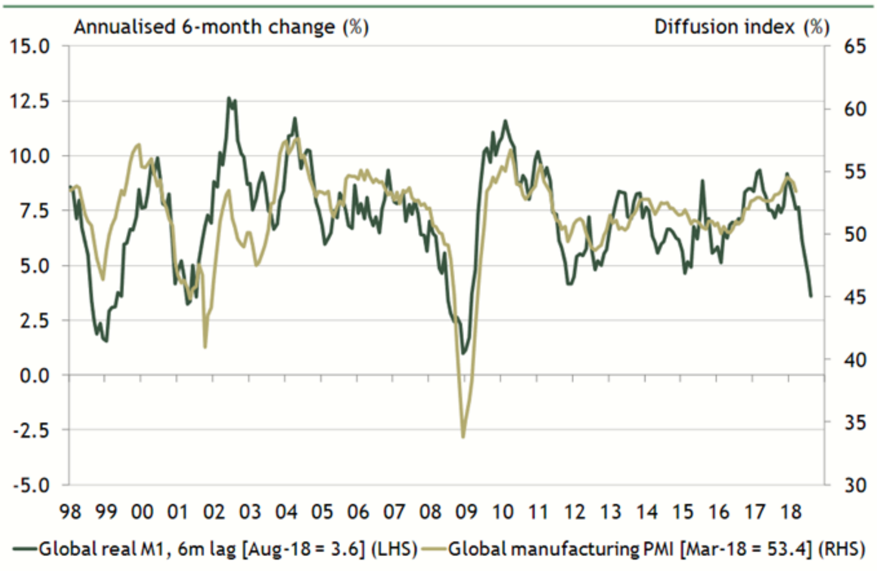
Source: OECD, Goldman Sachs Global Investment Research

At a more regional level (as indicated by corporate purchasing manager surveys) we can see that major developed regions peaked either in late 2017 or early 2018, with the difference in timing probably influenced heavily by the bottoming US-$ in early 2018. Some of the surveys are components of the Goldman Sachs Growth Leading Indicator, and are considered to be among the best indicators of the path for near-term real growth:



The long period of aggregate global growth has reduced excess productive capacity – during the last year especially so. Unemployment has declined across the developed and emerging world, with the US rate going below the Federal Reserve's "non-inflationary" estimate of around 4.2. The measures of industrial utilisation have also stepped up smartly during 2017 to reach levels which have led to increased capital expenditure in recent months. Inflation, which started to increase noticeably in late 2017, typically tends to lag behind growth.

Underlying all of this is another aspect. Money supply growth across the world has been slowing for some time at a nominal level. When inflation is taken into account, it has historically provided another reasonable leading indicator for growth. Below is Absolute Strategy Research's measure (the "real M1 proxy") shown against the JP Morgan Global Manufacturing PMI):



Source: ASR Ltd. / Thomson Reuters Datastream

The confirmation of this current slowdown which we had anticipated since the end of last year and the negative impact potential this is likely to have on near term corporate profits, causes us to remain cautious over risk assets, as their valuations do not yet sufficiently reflect a slowdown. We suspect that China continues to slow more than the market anticipates, and that Xi Jinping is not as likely to institute the sorts of policy easing that we've seen in previous years. We think he will be less inclined to protect private companies from the consequences of overborrowing; the recent downswings in the Shanghai Composite Index may show some credit-related stress and investors suspecting there will be less support than previously hoped.

As a note, Reuters reported Xi's speech today, "Writing Marxism onto the flag of the Chinese Communist Party was totally correct... Unceasingly promoting the sinification and modernisation of Marxism is totally correct."

We also think that the factors behind the strengthening of the US-$ are likely to continue, and that the dollar has further to run. As we mentioned at the start, a strong dollar tends to compress global trade. The combinations of factors leaves us slightly more cautious on the South East Asian export powerhouse and their stock markets in the medium-term.

As we stated at the beginning, we are confident that global growth and the world's economic systems are resilient, and that there is little reason to believe that the global economy is heading for outright recession. A noticeable economic slowdown now has a significant potential to lead to further equity market consolidation, as we head towards the second half of the year. Against the backdrop of sustained global economic growth, this development is likely to provide buying opportunities for the benefit of longer term investment portfolio growth.

UK, EU and the "Customs partnership"

Eurosceptic Tory MPs have told Theresa May to ditch her government's plan for a "new customs partnership" with the EU, suggesting it could cause the government to "collapse". The Brexiteers in question, members of the pro-Leave European Research Group (ERG), are "not in the business of making threats", according to their leader Jacob Rees-Mogg, but warned that the proposed model is "deeply flawed and would not take us out of the EU."

The proposal in question is a "new customs partnership", which would see the UK enact a dual customs regime at its borders. Goods from outside the EU arriving at British ports will have different tariffs imposed on them depending on their final destination. Those bound for Britain would be charged Britain's tariff rate – which the government is free to determine. But those headed for the EU would be charged the EU tariff rate, and the proceeds collected will be paid back to the EU.

It's the Prime Minister's preferred option, and the rationale behind it is that it supposedly gets the best of both worlds. With this agreement, the UK could have frictionless trade with the EU while at the same time being allowed to sign its own trade agreements with other countries. The Brexit camp should (in theory) be happy as Britain gets to "take back control" of its own trade destiny, while pro-remainers should be happy that we won't have barriers with our largest trading partner.

Needless to say, things haven't quite worked out that way. Beyond the dissatisfaction among the hard-Brexit wing of the Tory party, officials in Brussels have reportedly already said that this won't work. The practicalities of one nation collecting tariffs for another (a first in global trade) would no doubt cause a serious headache. But as many have pointed out, May's proposal missed out whether or not the EU would have to reciprocate by collecting tariffs for Britain at its own borders. This would be crucial to the deal working, but would no doubt be met with a cold reception by EU negotiators. Reportedly, even prominent cabinet members have "grave concerns" about the proposal.

But the prospects for the government's other main proposal don't look too bright either. If the customs partnership can't be reached, the government want a "highly streamlined" customs arrangement, where the UK is outside of the customs union but tries to limit the disruption that would cause as much as possible. The border between Northern Ireland and the Republic of Ireland would have minimum controls, with a trusted trader scheme and remote monitoring. New technologies are hoped to be introduced which would speed up border checks and allow importers to pay tariffs in lump instalments rather than every time they cross the border. Critics have argued that this would still impose a hard border between the two Irelands, a violation of the Good Friday Agreement.

Why is this important? Ever since the EU referendum was announced, no assessment of the UK's financial or economic future has been complete without mention of the Brexit-shaped elephant in the room. From our viewpoint, this has a number of effects. In the short term, the will-they-won't-they Brexit drama has a huge impact on the value of sterling. Barring other influences, the harder Brexit looks, the more it weighs down on the currency. And the softer it looks, the stronger sterling becomes.

After the nosedive in sterling's value immediately following the referendum, British exporters gained a price advantage over European competitors, giving them a welcome boost. This effect was compounded by the strong growth momentum on the continent, and we wrote some months ago that Britain was doing well "riding on Europe's coat tails" by having a weak currency while still under EU regulations.

More recently, sterling has regained some of the value it lost, as a soft Brexit – and even Britain potentially remaining in the customs union – started to look more and more likely. Just as weak sterling was a boon for British exporters, stronger sterling proved a hindrance, dampening demand.

Given the noise coming from the Brexiteer Tory wing, it looks like we're moving back towards a harder Brexit environment, in terms of market sentiment. Accordingly, the value of Sterling took a big hit this week, going from over $1.43 in mid-April to under $1.36 at the time of writing (-4.6%). So, should we expect another boost for exporters?

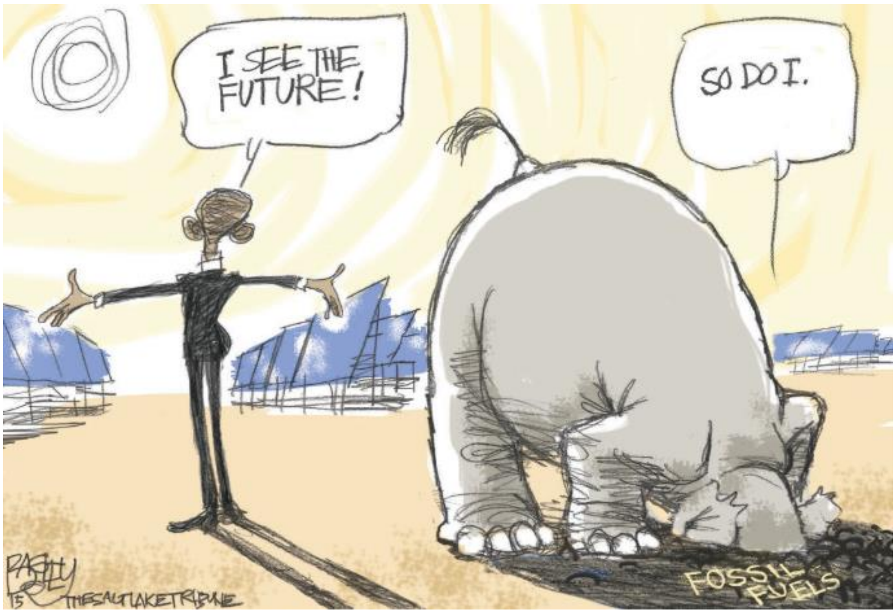
Unfortunately not. Part of that boost was predicated on the strong economic growth in Europe which, as we've noted in these pages, has started to peter out recently. Beyond that, as we approach the Brexit deadline, it becomes less and less likely that European companies will want to establish new trade relationships with British ones, even though they may be cheaper than domestic alternatives. This is because the uncertainty of trading conditions will hang over any attempt to draw up even short-term contracts. So, we should accordingly expect the export effect of weak sterling to be much smaller. However, the inflationary impact of weaker sterling (as import prices go up) on consumers and businesses will likely remain.

Over the longer-term, the ongoing situation will determine capital market sentiment on the UK and its assets. Theresa May is currently in a very precarious position with regards to Brexit negotiations. Each move she makes has to be made with one eye on EU negotiators and the other on her own Brexiteer MPs. The latest proposal is clearly an attempt to reconcile the differences between pro-leave and pro-remain Tories. But the reaction to it suggests that these differences are irreconcilable. Of all the options on the table, each one is unacceptable to either: EU negotiators, Tory Brexiteers, Tory Remainers or all of the above. The problem is that, without a majority in Parliament, each of those factions effectively has a veto.

All of this translates into a very unhealthy deal of uncertainty over the UK's future. We have heard some say recently that the dark cloud of Brexit has made UK assets look relatively cheap compared to others, and present a potential buying opportunity. However, the fact that we do have so much Brexit uncertainty hanging over our heads increases the risk premium on UK assets – investors demand more of a return for tolerating risk in UK assets. When taking this into account, we believe Britain's risk assets look cheap for a reason.

However, that is not to say that we are necessarily bearish on the UK for the longer term. Indeed, the fact that the government appear determined to try find an agreement which could work is at least a good sign. We also note how Paris and Berlin are increasing their pressure on Brussels to find a better way forward. But all in all, current market expectations for the UK are probably justified.

Solar energy turns game changer



From an economic and investment perspective once thought of as little more than a pipe dream of liberal environmentalists – solar is gradually becoming a serious competitor to traditional fossil and nuclear based energy. As solar electricity generation costs are quietly falling to comparable levels of those of fossil and nuclear fuel based production it seems only a matter of time until we witness a game changing moment in the global energy sector. Thanks to vastly improved economics, solar power is at least in Europe on the verge of permanently disrupting the energy mix in Europe, which may at the very least disrupt the energy sector, could possibly bring lower energy bills and would quite definitely reduce Europe's energy dependency for supply from beyond its own shores.

Refresher – how does solar work?

In simple terms, PV panels (or modules) turn sunlight into electricity. A more accurate description is that photons hit a silicon (Si) semiconductor (silicon is the 2nd most abundant element on earth and obtained from sand) which ultimately generates electricity.

The process is as follows: Each semiconductor is a stack of two separate layers of Si: one layer is negatively charged, where each atom of Si has an extra electron and the other is positively charged meaning each Si atom is missing one electron. Sunlight stimulates these additional electrons which then start moving in search of a parking space (atomic orbit) to settle into. A metal plate connects these two Si layers, which collects all the free electrons from the negative layer allowing to flow across the positively charged layer – an electric current is generated.

What about power at night?

No amount of money can change the fact solar power is limited by changes during the day: power is variable during daytime but there is zero at night. Both of these factors create challenges, but these can be reduced by investing in the electricity network or grid to send surpluses where needed and storage may be available in the form of traditional hydro-electric pump and generator based reservoirs and more recently storage with batteries and hydrogen generation. Battery storage has come a long way with lithium batteries, but the true leap is expected to arrive in the next few years with solid state batteries – called super capacitors that can store and discharge energy easily and cheaply with minimal degradation unlike today's lithium-ion batteries.

We suspect that the combination of PV-solar, storage and wind will likely become the medium-to-longer-run solution to smooth out electricity output.

But isn't solar expensive?

PV-solar costs on a LCOE (Levelised Cost of Energy) basis have dropped by a stunning 80% since 2010. The cost of building a large-scale PV plant has now fallen below that of an equivalent fossil-fuel plant.

This should be a game-changer in electricity/power markets as it nearly eliminates the main barrier that historically prevented renewables from gaining series market share without the help of subsidies. Technological and production advances, in terms of lower equipment costs, lower opex (operational expenses) and enhanced PV-solar efficiency, may further widen that cost gap, with solar LCOE forecast to fall by an additional 30-50% by 2030.

LCOE, as developed by Goldman Sachs, can be used to determine the break-even point and profitability via the Internal Rate of Return (IRR). An accountant would add up all costs, including investment (depreciation), opex and cost of capital (the target return on investment) and divide these by the expected lifetime of the plant (generally 30 years) by the output generated over that timeframe. Since sunshine is a fixed factor in these calculations, it can be argued that the uncertainty of future fossil fuel prices already makes PV-solar the better quality investment.

How much has solar grown then?

The PV sector has experienced a strong, nearly exponential boom over the past 20 years, growing at an annual growth rate of 50%. The amount of capital invested in PV has transformed the sector into a near $1 trillion industry.

Despite it becoming much harder to achieve high growth rates as the existing base has grown (base effect), analysts believe PV-solar could continue to expand at around 14% per year through to 2030. Interestingly, Europe has led the PV shift, accounting for about 30% of the install base worldwide.

European political support

Continued strong political support from the EU could accelerate the PV transition, taking renewable's share in Europe from below 30% today to an estimated 60% (based on current European Parliament proposals for 2030). The economics for PV look especially compelling in Spain with its abundance of non-arable land under scorching sunshine. This could lead to a significant structural change in Spain by attracting energy intensive industries and potentially become a large exporter to electricity to the rest of Europe.

How will the shift impact traditional electricity producers?

Analysts estimate that the most exposed legacy power producers could by 2030 see about 15-40% of their earnings at risk from rising PV/renewables adoption and their improving economics. Lower electricity prices and an increasing role for PV in baseload output could also lead to a much earlier phasing out of coal and a possible reduction of nuclear plants than assumed in past business plans which would lead to painful exceptional write downs.

Rising PV-solar output could place severe pressure on wholesale power prices by 2030, with the biggest reductions in Spain (-42%) and the UK (-26%). We do not expect legacy producers to stand still in the face of such competition. Indeed, we may see sector consolidation (i.e. to gain PV exposure), changes to generation mix (reduce legacy output) and an increase in renewables investment (capex) to offset lower earnings.

Any additional impacts?

Any acceleration in the PV shift is likely to be necessitate a ramp up in digital grid investment to better manage output volatility. This digital grid would need to be connected Europe wide to enhance electricity distribution from PV (in hotter regions), offshore wind (North Sea) and hydro storage (Alps and Scandinavia), which would optimise supply-management and lower opex.

We may also see a move towards the electrification of heating and transport. Buildings account for 40% of energy consumption and PV electricity may help meet environmental targets, while the wider penetration of electric vehicles (EVs) could provide a two-fold benefit. Cars could be recharged cheaply during periods of excess PV supply and the EVs themselves could act as portable energy storage devices.

Summary

Renewables have endured a long road of subsidy dependency, but the technologies have finally matured to a state where they can succeed without artificial support and therefore now have the potential to significantly alter Europe's energy mix. When environmental concerns and the prospect of cheaper electricity prices for consumers are added into the mix, the proposition looks even more compelling.

Profits for the traditional energy sector are likely to come under increasing pressure and that could lead to significant changes in the investment landscape. Having achieved profitability in their own right one thing looks certain, renewables/PV is no longer the pipe dream it once appeared to be.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7559.9	0.8	57.7	↗
FTSE 250	20440.4	0.8	168.8	↗
FTSE AS	4156.2	0.8	32.3	↗
FTSE Small	5907.4	0.9	52.2	↗
CAC	5507.0	1.0	53.4	↗
DAX	12791.8	2.3	291.4	↗
Dow	24138.1	-0.7	-173.1	↗
S&P 500	2648.9	-0.8	-21.0	↗
Nasdaq	6730.0	1.1	73.6	↗
Nikkei	22472.8	0.9	194.7	↗
MSCI World	2071.4	-1.2	-24.7	↗
MSCI EM	1137.8	-1.6	-18.4	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	13.5x	13.6x	17.1x
FTSE 250	2.7	15.1x	14.5x	17.0x
FTSE AS	3.7	13.6x	13.7x	16.6x
FTSE Small	3.1	11.2x	-	-
CAC	2.8	16.3x	14.5x	15.4x
DAX	2.5	12.6x	12.8x	16.9x
Dow	2.2	19.0x	15.3x	15.3x
S&P 500	1.9	19.9x	16.0x	17.5x
Nasdaq	1.1	25.1x	19.4x	20.2x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
SAINSBURY (J)	11.7	SMITH & NEPHEW	-6.9
WPP	11.6	KINGFISHER	-6.8
PEARSON	8.6	BT GROUP	-5.4
INTL CONSOLIDATED A	7.7	MONDI	-5.0
TUI AG-DI	5.5	PADDY POWER BET	-3.5

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.35	-1.91	OIL	74.2	-0.6
USD/EUR	1.19	-1.67	GOLD	1310.9	-1.0
JPY/USD	109.19	-0.13	SILVER	16.4	-0.5
GBP/EUR	0.88	-0.29	COPPER	307.0	0.0
CNY/USD	6.36	-0.47	ALUMIN	2269.0	-0.3

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.395	-3.5	-0.05
US 10-Yr	2.950	-0.2	-0.01
French 10-Yr	0.779	-2.1	-0.02
German 10-Yr	0.542	-5.1	-0.03
Japanese 10-Yr	0.045	-18.2	-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	4.14
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