Tatton
Investment Management

The Tatton Weekly

25 May 2018

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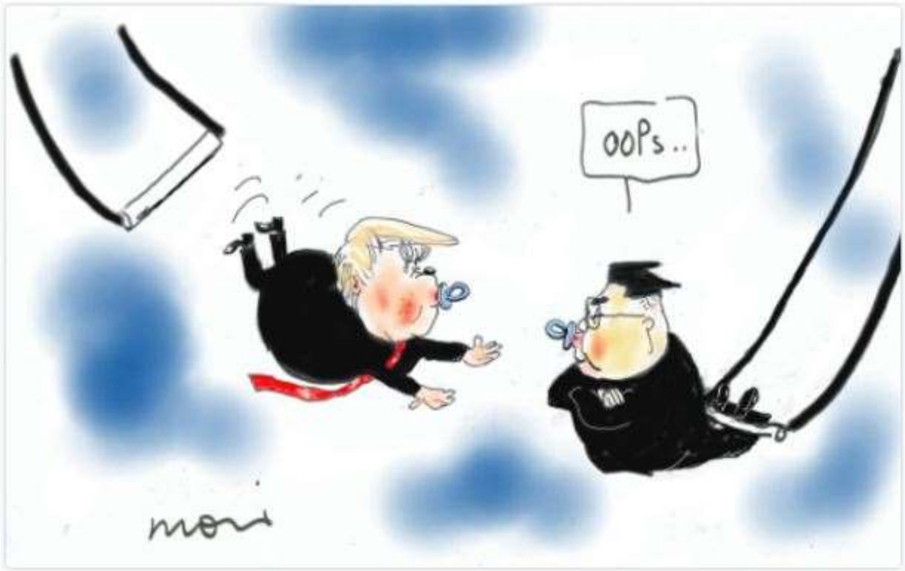


Source: Alan Moir; Missed; 22 May 2018; Political Cartoon Gallery Putney

Far more interesting than GDPR!

I suspect most will remember this 4th week in May of 2018 as GDPR email madness week. Hopefully you will have noticed that The Tatton Weekly did not join the crowd and unless you feel the urge to click the 'unsubscribe' button at the bottom of the email you will be allowed to continue receiving this weekly fixture without further action required. Research skills applied differently.

For us and investors the week had far more interesting aspects than businesses turning data protection into a Y2K déjà vu.
Politicians who believe their success lies in ripping up political convention and employing disruptive strategies - suffered setbacks. Turkey's strongman Erdogan threw his country into a currency crisis when after trying to apply the same bullying tactics he normally uses on his political opponents to international capital markets. I must admit to taking pleasure from him being humbled and forced to 'apologise'.

Italy's populists were next, when markets in Italian bonds staged somewhat of a tantrum upon their agreement to actually forming a government. Like Erdogan, they similarly quickly distanced themselves from some of their more extreme plans from the campaign days like cancelling government bonds or leaving the Euro. They may have taken comfort from their bond yields still not exceeding those paid on US government bonds – except that in Italy they jolted upwards as a result of fear of decline, whereas in the US yields have gradually risen in expectation of future growth.

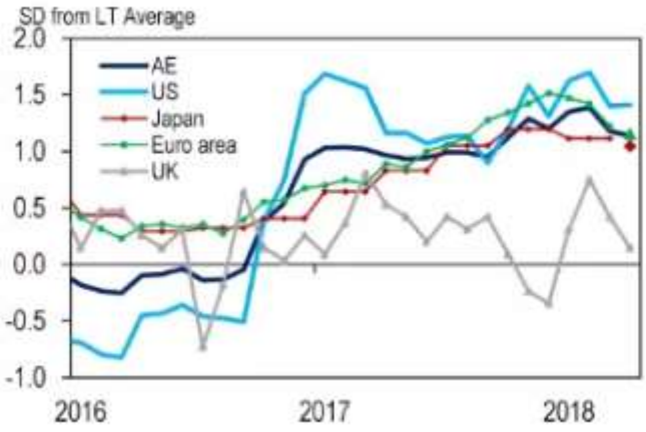
Trump suffered a personal defeat when he was forced to cancel the planned summit with 'little rocket man' Kim Jong-un after North Korea's leadership reacted very robustly to suggestions of senior members of the Trump administration that the denuclearisation of North Korea might be achieved in the same way as it was with Libya (!). As we had suggested a few weeks ago: it is one thing to force your opponents to the negotiating table, but if you don't have a good plan what sort of deal to exactly negotiate for then little more than embarrassment has been achieved.

The administration's trade negotiations with China suffered a similar fate. With Trump's negotiation team deeply divided in what they aim to achieve they managed to generate so much confusion over the likely path and outcome during the course of the week that one feels inclined to draw similarities to the UK's uncertainties over post Brexit trade relations. At least it has given the Chinese side a temporary advantage by preserving the status quo for the time being.

On the capital markets side the US and UK central banks strived to assure those who follow their communications closely that their actions will remain predictable by being determined by economic and monetary conditions rather than a sudden surge of dogmatism. The Bank of England's governor Mark Carney made his remarks as part of a speech at an economist's dinner that I had the pleasure to attend. The content was widely reported in the financial press afterwards, but only those present appear to have noticed how he seemed to revive the spirit of Mario Draghi's 'whatever it takes' speech at the height of the Eurozone Crisis, when he said: "We are ready for Brexit whatever form it takes".

Such words will have been welcomed by all who felt despair over yet another week of 'non-progress' in the Brexit negotiations, although the head of the BoE was also frank in his assessment that the negative economic impact of the Brexit decision on the UK so far had been quite close to their original projections – which had been ridiculed by Brexiteer critiques when they only materialised with some delay (see chart below)

Figure 22. Selected Economies – Business Sentiment (Std Dev), 2016-Apr-2018



Note: Long-term average is 1990-2016. Source: National Statistical Offices, National Central Banks, CIB, NFIB, The Conference Board, and Citi Research

Meanwhile economic data flow continues to confirm that global growth has come off the boil and the growth leadership baton has passed from Europe back to the US, which is enjoying a substantial fiscal stimulus through Trump's debt financed tax breaks, whereas demand for European capital goods has fallen back as a consequence of the strengthened Euro-€. At the same time though, the recently observed headwinds from currency, cost of capital (credit yields) and money supply deteriorations appear to be easing. This may or may not be the beginning of improving economic news flow, but if it is then this would be good news particularly for emerging markets, but also European exporters.

2018 economic and currency developments have followed quite closely the path we had anticipated at the beginning of the year, except that the economic slowdown had only been expected for the second half of the year. With overheating conditions clearly having been avoided there is a fair chance that H2/2018 will turn into a far better second half of the year than had been anticipated at the beginning of the year. Notwithstanding such improvements, corporate earnings will have to slow over the coming quarter as a result of the economic slowing. In the US this may be exacerbated by the slowing effect that uncertainty over future trading condition can create – as we in Britain only know too well now.

US growth leadership may therefore end sooner and be passed on than the Trump administration likes to believe. That is unless Trump's administration can pull a few more 'rabbits out of the hat' like the fiscal stimulus of last year's tax reform. The hints on Friday evening by the US president and people around him that the summit with North Korea may against all odds still happen in June, makes me think that his unpredictability is still going strong and that the array of possible outcomes may be far wider than we currently anticipate on the basis of our past experience.

Markets are not keen on unpredictability plus falling earnings growth rates, which puts continued market volatility on the cards. However, over the past week we have seen the first – if faint – indicators that this mini-cycle slowdown that started at the beginning of the year may have run its course. Watch this space.

Economist.com Kal

Trade Trumplomacy: Advantage China

Trade relations had a rollercoaster ride over the past week. On Monday US Treasury Secretary Mnuchin said the US and China were putting the trade war "on hold" while the framework was being discussed which buoyed stock markets Monday and Tuesday. But then on Wednesday, Donald Trump cast doubt on the possibility of the US and China striking a trade deal any time soon, calling the current set up in negotiations "too hard". He tweeted that, while talks were "moving along nicely", the countries will "probably have to use a different structure" in order to "verify results after completion." Predictably markets gave back their gains on Wednesday.

It comes after a weekend of talks between the world's two largest economies. Chinese negotiators, spear-headed by vice-premier Liu He, met with their US counterparts to talk about the energy and agriculture sectors, as well as seek assurances on issues such as security related US sanctions on Chinese telecommunications company ZTE.

Those talks seem to have yielded mixed results so far. Mnuchin's announcement appeared to give China some vital breathing room. On the other hand, Trump's tweet and the announcement that the administration might initiate a national security investigation into automobile imports paints a more worrying picture. And that's without mentioning Trump's flip flop tweeting on the rescue of ZTE, which threatens to derail a core tenet of the negotiations.

Still, we think that markets may be overestimating the odds of a deal being worked out in the short term.
Here's why:

As we've mentioned before, one of the major issues is the lack of unity in the US negotiating team. It's unclear exactly what it is they want, and that makes it extremely difficult for Chinese officials to make any progress. Mnuchin and Commerce Secretary Wilbur Ross seem to favour more short-term trade based goals, such as improving US access to Chinese markets and addressing trade imbalances. But Trade Representative Robert Lighthizer and (especially) presidential adviser Peter Navarro have far more wide-reaching goals: use tariffs and other measures to halt China's modernisation and growing economic clout. Goals of the first kind are negotiable, and at least give a basis for talks. Goals of the second kind are inherently non-negotiable, and are a barrier to talks.

For the President's part, giving Mnuchin the leading role suggests he's more swayed towards the first kind – making a deal. And as well he might, given that there's no chance China will budge on their longer-term goals such as the "Made in China 2025" project. So, we should expect any influence from Lighthizer and Navarro to be disruptive to negotiations. But even without their influence, there are significant roadblocks in the way.

One of them is the Trump administration's insistence on numbers rather than principles. Trump has threatened more tariffs unless China cuts its trade surplus with the US by $200bn within the next two years. To call that a tall order would be an understatement, given this could only be achieved if the US was able to export goods in such an amount to China, which they do not have

the capacity to produce in the first place. The other alternative would to deprive US consumers of Chinese goods of the same amount – which seems even less likely.

But it's not just the size of the figure that offends Beijing. Even a far more realistic target would likely be met with serious pushback from China, who have consistently said that trade deals should be based on principles that each side follows, and not strict targets that they must reach. Besides, setting these targets goes against the entire point of the trade war with China: getting them to 'play by the rules'. While the rest of the world insists that China frees up its markets, Trump is now asking them to intervene to engineer a specific market outcome.

Liu He and co probably thought they had scored a big win when they emerged from talks after the weekend agreeing only to broad assurances and not many specific promises. But now that Trump is pushing for specific targets, the inherent issues are becoming clearer.

Arguably, however, the biggest roadblock is a political one. Trump's initial willingness to lift sanctions on Chinese firm ZTE – one of President Xi Jinping's conditions for a broader trade deal – is proving very unpopular in Washington. Members of Congress from both the Democratic party and Trump's own republican party are reportedly planning to stop any deal that lets ZTE off the hook. This point alone should be worrying for Trump, but the broader issue it highlights is no doubt even more concerning. The political mood in the US is turning towards a more uncompromising stance on China. "In a polarised time, concern about China and national security seems to be a rare bipartisan unifying force," says Philip Levy, former adviser to George W Bush.

This autumn will see the midterm elections for the US Congress, where politics might well get in the way of deal making. Given the displayed anti-sino bi-partisan sentiment, it will be seen as crucially important how the tough the government looks on China. Despite his reputation and preference for deal-making, the pressure will be on Trump to take a principled approach, and not cut corners to get an outcome quickly. This is why we suggest not to overestimate the chances of the trade war coming to a close any time soon, no matter what concessions China offers.

For now, the stalemate in the US plays into China's hands; a continuation of the status quo is their most preferred outcome. For the US on the other hand the uncertainty appears to be hurting the economy, as the US central bank (the Fed) reported in its May meeting minutes: "… some participants observed that while these policies were being debated and negotiations continued, the uncertainty surrounding trade issues could damp business sentiment and spending."

Global growth leadership shifts to the US but also H2/2018

At Tatton we started the year 2018 with the view that the pace of global growth would slow from quite a high level to a more moderate level by the half-way point. Meanwhile, global inflation would peak at a relatively moderate level during the first half before slipping back somewhat.

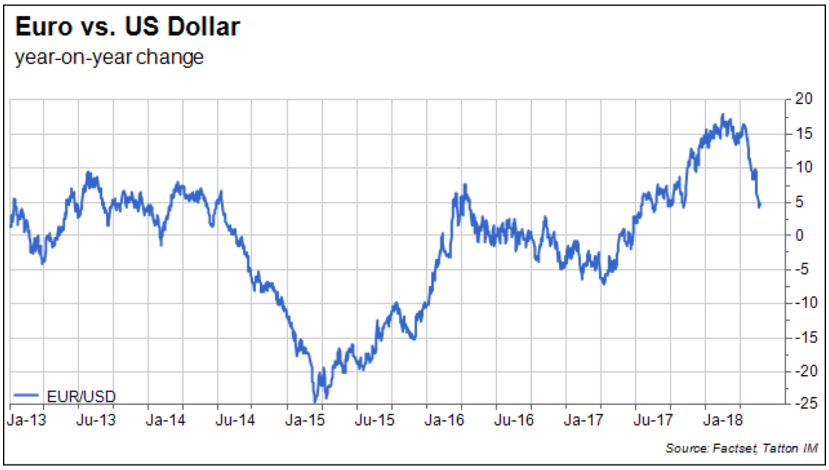
Underneath we expected that business capital expenditure would be strong but also start ebbing lower at the halfway point. Consumer spending, we anticipated, would be the somewhat weaker part of the picture because wage growth still lagged business growth and there is not much remaining credit headroom for households (in the US and UK particularly, less so in the Eurozone and Japan).

In general, our views seem to have been borne out (which is quite nice, of course) but there were some underlying developments which either happened quicker or differed from our original thoughts. As we are moving closer to that halfway point of the year it is therefore appropriate for us to update our audience on the thoughts for the rest of the year.

At the beginning of the year we said that changes in currency exchange rates could constitute important return dynamics and that despite the 2016 declines, the US$ could get more expensive again than it still is. In general, you can buy more things with £1 in the UK than with US$1.34 in the US (the current exchange rate). That is true for the Euro vs the US$ as well; €1 buys more in Europe than $1.17 buys in the US.

Last year, when growth in the EU was effectively stronger than in the US, there was little to stop the cheaper currencies doing better and so they did. However, because Europe's economy has a greater proportion of external trade than the US, the degree of change in currencies carries a greater impact on the European economy than the impact on the US.

The euro hit $1.25 in January, having been at $1.04 a year earlier. The proportional change versus the rate a year ago (rolling) is shown below:



The Euro still buys you more than $1.25 buys in the US. However, the sharp change inevitably squeezed out some marginal buyers of the goods that the world buys from Europe. Germany and core Europe produces the capital equipment for businesses worldwide. Therefore, strengthening business demand from the US and Asia started to be offset by the rise in prices caused by a stronger Euro.

Purchasing Manager Indices (PMIs) of business activity expectations have been a consistent and timely indicator of growth. There are now different providers of these types of survey such as Markit. They compete with the likes of the US Institute for Supply Management (ISM) whose version has had a very long history. This week saw the release of what are known as "flash" data from Markit and their partners in each region. While their data does not necessarily match other providers, these "shorter" surveys are seen as good approximations of the others' data.

These data were mixed. Germany's manufacturing indicator remained well above the "neutral" 50, at 56.8 but below the 57.8 predicted. France was at 55.1, above predicted 53.8 (by Factset).

While good, EU growth indicators have backed off, with business confidence falling from extended levels; Germany hit 63.3 in December. The consumer seems less affected, however, with access to credit improving while jobs continue to be created. Loan demand to households continues to rise, underpinned by mortgage borrowing in Germany particularly.

Italy had been a bright spot as well, with the politics not affecting much until perhaps the past couple of weeks.

Similar dynamics are at play in Japan as well, although here the consumer has been perhaps less resilient. Business confidence slipped somewhat to 52.5. Like Germany, this was less than predicted. Despite jobs remaining plentiful, consumption has been weaker than expected, perhaps also affected by a prime minister under pressure.

Europe and Japan have ceased being major suppliers of demand for the global engine – earlier than we had expected. So too has China. Their consumers are in a good position; confidence is high and stable and the move to a more environmentally and socially beneficial policy structure is popular. However, it is not designed to generate near-term growth. Government lending is more targeted, while companies are facing persistent rises in costs. Reuters reported today (Friday 25th) that debt growth for Chinese companies has slowed to the lowest rate in more than a decade.

Growth leadership has transferred to the US. The US economy had some impact from the currency moves but the follow-through from domestic fiscal (tax) policy changes seems to have been more important. Some of the consumer tax cuts went to savings but businesses continued to employ and increase spending on new equipment (although decreasingly from abroad). Government policy of borrowing aggressively to fund tax cuts and defence spending, alongside positive consumer and business confidence, has raised expectations.

We had expected that there would be a demand for capital from most areas of the US economy. The rise in yields, credit spreads and the US dollar itself is good evidence that this is so. Money supply growth has picked up (a little) from slow levels during the past few weeks as well.

However, there are small signs that the rise in costs (including the price of capital) may be slowing some parts of the US economy. Durable goods spending showed the 6-monthly rate slowing to 6% annualized growth – still good but down from 10% at the start of the year. The housing market has been very strong but now the pace of mortgage approvals has slipped back after long rates moved up sharply.

For consumers, costs are moving up – energy and fuel prices are rising, oil having risen above $75 per barrel. The consumer price inflation (CPI) data show no real sign of slowing.

However, the tightness of the labour market suggests that wages are moving ahead again (although that may be slowing the pace of job creation). Goldman Sachs' wage tracker indicates rises still above the CPI rate, which should enable them to keep spending.

Source: Goldman Sachs Global Investment Research

This implies that businesses are facing pressure from rising wage costs, which in turn spurs more capital spending in order to counter that pressure through higher productivity.

With labour tight and inflation rising, the Fed is likely to continue on its gradual but persistent pace of rate hikes, despite this providing additional fuel for a further rise of the dollar. While their May meeting minutes this week indicated that they are not dogmatic about hitting the inflation target at all times and thus a willingness to let inflation run up somewhat, the room for manoeuvre is it not great.

US 30-year rates hit 3.25% a week ago and have since moved lower, to trade at 3.10%, quite a sharp move. We may have hit a point where the cost of capital has started to brake the economy's acceleration. It may be that the strengthening of the dollar has run its course in this phase as well.

That would be welcome for emerging markets particularly. Trade friction is offsetting prospective good demand for their goods from the US, leaving them only with rising interest rate costs. A period of a calm dollar and bond markets would at least stem capital outflow.

For Europe and Japan, the dollar's rise that has happened already is welcome. Business sentiment will probably remain buoyant rather than slipping, while the consumer will continue spending in a reasonably merry way. Compared to our expectations for economic progress at the beginning of the year, the pace slowed more quickly in Europe, Japan and China than we anticipated and the growth dynamic has proven more resilient in the US. This has made the first half of 2018 somewhat less strong and the growth picture less synchronised than anticipated, which lies at the heart of the reasons for less upward momentum in the stock markets.

However, given the slowdown occurred earlier than anticipated but without leading to a distinct deterioration of the general outlook, the prospect for the second half of 2018 is now set fair.

Demise of investment banking – good? bad? or indifferent?

Rumours about a possible tie up between Barclays and Standard Chartered – to strengthen their retail and corporate lending franchises – triggered a debate in our team about the traditional role banks played in the economy, and what a possible retrenchment from investment banking means for liquidity in markets.

These changes are occurring against a backdrop of increased regulation. This has led to the capital market trading part of investment banking being no longer as profitable as it once was. It has, for many, become a high cost, low margin business with large capital requirements.

The profit warning and job cut announcement from Deutsche Bank this week is further evidence of the tougher conditions across the sector generally, and the decline of investment banking in particular.

The reason bank CEOs are refocusing on traditional banking is not just driven by the fewer opportunities for profit in investment banking. It is also a function of the gradually normalising interest rate environment. The traditional core banking model of borrowing at the short end of the yield curve (paying interest to depositors) and lending long (i.e. making loans/mortgages with long term yield payment obligations) is coming back in fashion. Banks are once again able to increase their profits (technically net interest margin) as a result of steeper bond yield curves – i.e. the difference between longer maturity yields and short-term interest rates is far greater than it has been over the past decade.

Perhaps this also explains the resurgent appetite for banking sector consolidation. Increased regulation has made it difficult for banks to use capital from one region to underpin business in another region, which reduces the scale advantages of the old global players. Instead, regulation may be leading to the formation of dominant regional players in retail, rather than ever larger global banks.

Amongst other factors, this may explain why, over the past decade, the large US banks have significantly outgrown their European competitors, who often remained focussed just on one of two countries in their traditional banking operations. Ten years ago, the market capitalisations of JP Morgan and HSBC were the same, today JPM is 2.5x bigger. Over that same time frame, Spanish lender Santander was just 30% smaller than Wells Fargo in market cap terms, now Wells Fargo is 3x larger.

A deal between Barclays and Standard Chartered might go some way to redressing the size imbalance growing market share of US investment banks. Analysts suggest a tie up could create the next HSBC, given Standard Chartered's large Asian deposit base ($127 billion), which lowers funding costs for a combined entity. There is limited geographic revenue overlap (Barclay's profits are 80% US/UK driven whereas Standard Chartered is 90% emerging markets). Barclays could also sell Barclaycards and investment banking products into Asia.

However, we believe these mergers are no longer about creating global scale. Rather, banks are aiming to consolidate and own a larger presence across the entirety of a region. Such refocussing on traditional lending operations, which are streamlined across specific regions, has the potential to significantly improve the effectiveness of the credit / money supply side of the financial sector. If banks resume their old money-transmission function, it would be another welcome sign that we are returning to the 'old normal', where central banks didn't have to constantly intervene.

But the decline of investment banking is still worrying, because they perform a vital function in capital markets. Here is why:

Before the GFC, the US had about US$2,800 billion in outstanding corporate bond debt, against which investment bank bond dealers held US$260 of inventory in the same bonds – almost 10%. This allowed an acceptable level of market liquidity for the then mostly institutional investors. 10 years on, the same corporate bond market has grown to US$5,300 billion on the back of low credit yields (costs). However, as investment banks have reduced their capital markets operations, bond traders now hold a paltry 0.8% or $40bn in outstanding stock. What's more, the rise of ETFs has moved US$300bn of direct ownership of these corporate bonds to retail investors, who have historically had a tendency to all head for the exit at the same time when the outlook deteriorates.

On top of this, the liquidity that used to be provided by the 'fast money' brigade (traditionally prop traders and hedge fund managers) has increasingly been replaced by algorithmically driven computer trading. Altogether, this makes recent episodes of 'flash crashes' more understandable. In fact, they might well continue to occur at an increasing rate.

In terms of the stability of the financial system (as far as it is rooted in the ongoing ability to rely on current values of financial assets), the decline of the liquidity provided by investment banks has changed the landscape. Whether it is as material as the rise of structured credit (shadow banking) was in the run-up to the GFC, we will only know in years to come.

Where financial leverage was the power of the banks that contributed to the GFC when it was abused for personal gain, liquidity could become the temptation for asset managers, given those who control incremental liquidity also gain control of price movements of individual market segments.

However, we expect that, this time, the structural shift has not been ignored by the central banks – the guardians of financial stability. Instead of focusing on the trading operations of investment banks, we expect them to be having many more meetings with the institutional investors of large fund management firms like Vanguard, BlackRock and Pimco, who have become the new providers of liquidity of last resort – potentially with similar emergency support measures that central banks used to only extend to banks.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7709.1	-0.9	-69.7	↘
FTSE 250	21087.0	0.5	97.2	↘
FTSE AS	4245.0	-0.7	-28.8	↘
FTSE Small	5972.7	-0.9	-52.7	↘
CAC	5531.6	-1.5	-82.9	↗
DAX	12889.9	-1.7	-224.7	↗
Dow	24782.8	0.3	67.7	↗
S&P 500	2724.8	0.4	11.8	↗
Nasdaq	6973.9	1.6	107.6	↗
Nikkei	22450.8	-2.1	-479.6	↗
MSCI World	2117.7	-0.1	-3.1	↗
MSCI EM	1135.1	-0.2	-2.7	↗

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.33	-1.14	OIL	76.7	-2.3
USD/EUR	1.17	-0.99	GOLD	1303.3	0.8
JPY/USD	109.27	1.38	SILVER	16.5	0.5
GBP/EUR	0.88	-0.17	COPPER	307.4	0.3
CNY/USD	6.39	-0.18	ALUMIN	2281.0	-0.5

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.325	-11.7	-0.18
US 10-Yr	2.937	-3.9	-0.12
French 10-Yr	0.714	-14.2	-0.12
German 10-Yr	0.404	-30.2	-0.18
Japanese 10-Yr	0.041	-32.8	-0.02

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	13.4x	13.7x	17.1x
FTSE 250	2.7	15.4x	14.6x	17.1x
FTSE AS	3.6	13.6x	13.8x	16.7x
FTSE Small	3.1	11.8x	-	-
CAC	2.8	16.4x	14.5x	15.4x
DAX	2.5	12.9x	12.8x	16.9x
Dow	2.1	19.7x	15.7x	15.4x
S&P 500	1.8	19.9x	16.4x	17.5x
Nasdaq	1.0	25.3x	20.1x	20.2x

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.7
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.0
Standard Variable	4.14
Weighted Average Interest Rate (BoE)	1.7
Nationwide Base Rate	2.50
Halifax Standard Variable	3.99

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
MARKS & SPENCER	6.4	ROYAL DUTCH SHELL	-6.1
INTERTEK GROUP	5.4	BP	-5.4
PADDY POWER BETF	5.3	MEDICLINIC INTERNA	-5.0
G4S	4.7	ANGLO AMERICAN	-4.2
HALMA	4.4	AVIVA	-4.2

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

For any questions, as always, please ask!

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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