



Weekly Market Comment

17 March 2017

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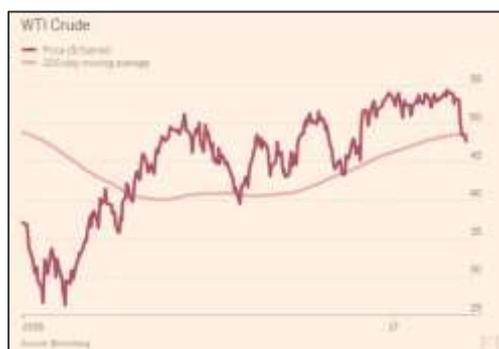
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Return of the 'old normal' or calm before the storm?

Scanning the events that made the financial news of the past week it would appear difficult to choose what to comment on. US employment highest in 2 decades? Pan-European stock markets hitting new all-time highs? 2nd rate rise in the US in 3 months, but with very dovish accompanying commentary? No rise in sight for the UK? European populism on the retreat? Chancellor Hammond forced into humiliating U-turn over NIC increase? Chinese authorities increasing their efforts to counteract credit excesses? US President Trump presenting his budget proposal and getting nowhere with his policy initiatives? India's president Modi winning landslide regional elections despite/because of his audacious but poorly executed monetary reform? Or the oil price falling 10%, back to the \$50/bbl level?



From an investor's perspective, the stock market highs are perhaps the most pleasing, while the sudden oil price decline is perhaps the most relevant concern for the near term.

The oil price fall was caused by doubts over OPEC's ability to stick to its price stabilising production cuts and led to investor concerns that the reflation theme of the past 2 quarters, that arguably drove up stock markets, may not be as sustainable as thought (falling energy prices could see a

return of deflationary pressures). The muted market reaction tells us that there is widespread belief that Saudi's threat to crank up production volumes will be sufficient to 'encourage' the rest of OPEC (and Russia) to stop playing games.

How about the rest of the news? Well, it shows in my opinion that economic and capital market circumstances are much calmer than one would think or would have expected at the end of last year and that there is indeed a possibility that we are more likely to witness a gradual return to what we would call the 'old normal' rather than having to accept a continuation of the growth ice age as seen during most of the post Financial Crisis decade.

That is perhaps with the exception of the UK, where the humiliating U-turn of the chancellor's attempt to raise additional revenue tells the story of a government that appears utterly challenged by 'the hand of cards it has been served to play'. Compared to everywhere else, UK consumer and business confidence is beginning to wane and only the prospect of strong global economic growth momentum and a weak UK currency offer a positive tilt to the near-term UK outlook.

Such global momentum is increasingly apparent and Trump's Twitter storms appear to have lost their scare potential. They seem to be increasingly interpreted as what they have been so far – reassuring sound bites to those amongst his electorate who he would expect to struggle to assess the viability of his initiatives(?).

The first quarter of 2017 therefore feels like another one of those rare 'Goldilocks' periods, when the stock market climate is neither too warm nor too cold. Compared to last summer, however, returns for bond investors have not been equally pleasing. And how could they, after last year's bond rally drove interest income potential for the coming 10 years very close to 0%. For the moment, we are happy that, much as we expected, the feared bond sell-off has not materialised, allowing bond allocations in portfolios to continue to play their role as volatility 'shock-absorbers', while equity allocations are contributing positive returns.

As ever there are also clouds on the investment horizon. Trump is, perhaps surprisingly, the lesser concern for the coming months as his plans and policies will be substantially slowed and neutered by Washington's political apparatus. Of larger concern is the sustainability of Chinese growth, now that the government has turned its attention from economic stimulus to containing excesses. So far this has not led to a marked slowdown, but considering how crucially dependent last year's growth was on the thrust from China, this is one to be watched very closely.

Once the China concern has passed – and we anticipate chances are higher than evens that it will for coming 6-12 months - now that broader global growth has returned – then the inevitable monetary tightening cycle through rising rates will constitute the next challenge. The US central bank has already embarked on a gradual tightening course, but so far this has not had a significant impact, as all other western central banks have continued to keep their rates extremely loose and below the rate of inflation or even still pursue QE bond purchase programmes. When inflationary pressures from the strengthening economy force central banks into a policy reversal we could experience another 'market tantrum'. Should markets and businesses feel that confidence levels are still too low or uncertainty too high, then overreaction by the economic subjects has the potential to lead to a premature end of the cycle.

Such concerns are probably 12-18 months down the line and while we monitor developments closely they are not of immediate concern. For the near term, we are more concerned that stock

markets get ahead of themselves and thus become vulnerable to short, sharp corrections. This is the reason why we are content to continue to hold government bond allocations at risk profile target levels in our portfolios. Even though their long-term return potential may at best be at current cash return levels, they tend to be the only asset class that offers a true value counterbalance when equities suffer a correction.

That is except for the case of 'market tantrums' but as I said above that is more of a concern for 2018.

Central bank monetary policy: Divergence

It has been a busy couple of weeks for the Western world's central bankers. While there were no material surprises in the announcements made by the ECB (European Central Bank), the US Fed or the BoE (Bank of England), economists and commentators have been scouring the detail to better understand each (central) bank's decision, and the likely future direction of monetary policy from a global perspective.

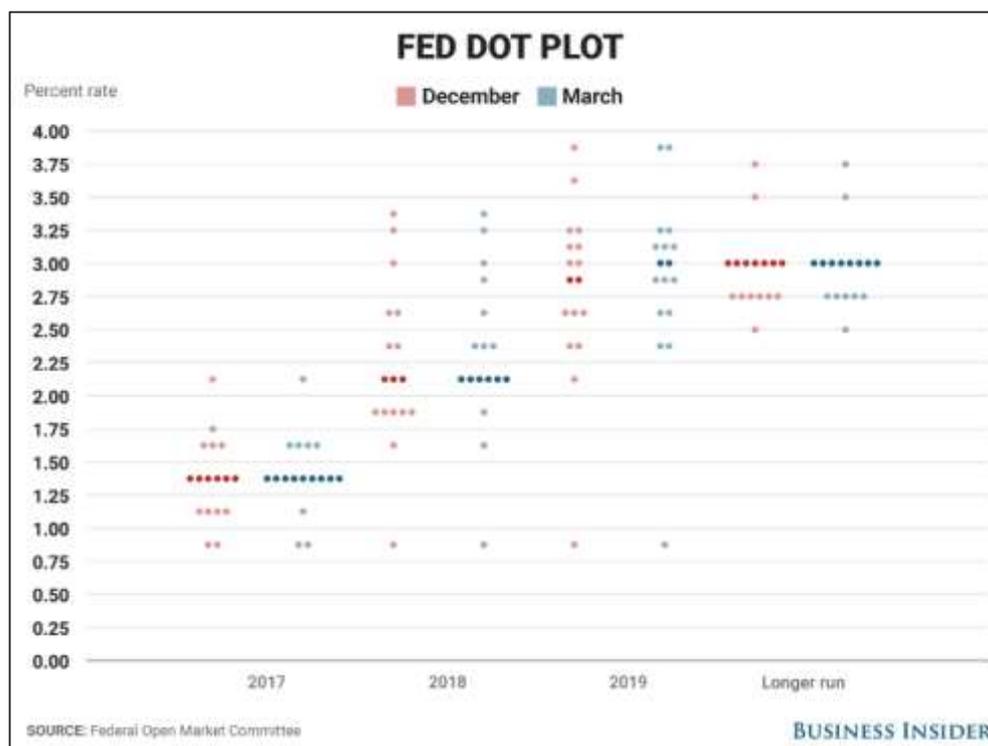
The decision by the Fed to increase the Fed funds rate by 0.25% (raising the Fed funds target range to between 0.75% and 1%) was widely expected and effectively priced-in by the markets. Less expected was the "dovish" language the US Fed's chose to present its rate rise decision. The Fed indicated that, subject to the data, they were minded to adhere to their previous forecast of just three rate increases this year. Many analysts had predicted that the strong recent economic data reports would lead to a more assertive approach to rate-setting (4 or more rate increases in 2017).

Given the relative and continuing strength of the US economy, some analysts argue that the Fed is now falling "behind the curve". This might explain markets' initial reaction to the Fed's statement. Yields on the 10-year Treasury note fell by 10.7 basis points back to 2.5%, its biggest intra day drop since November, as did the 2-year yield which was down 7.9 basis points to 1.29%. Markets subsequently rebalanced and both yields and the \$-dollar were trading a little higher by the end of the week.

The Fed's cautious approach is consistent with its own policy forecasts and the underlying economic data. The Fed's analysis illustrates that there have been no substantive changes in the economic variables and data (or forecasts) since December 2016, and the gradual tightening of monetary policy is consistent with a gradual and sustained improvement in the economy (and steady increase in inflation). Moreover, tightening policy in advance of understanding the potential extent (and timing) of President Trump's proposed fiscal reforms could be counter-productive.

Going forward, and assuming the US economy continues to deliver to forecast, we can expect the Fed to raise interest rates twice between now and the end of the year. As to the possible level of the Fed funds rate at the end of 2017 (and beyond), the outlook also remained broadly unchanged. This is regularly expressed through the rate setting committee members (FOMC) own individual forward looking rate forecasts ("dot plot"), which indicate a median outturn interest rate of 1.375% for 2017 — unchanged from December's forecast. The median projection for the longer-run interest rate also remains at 3%.

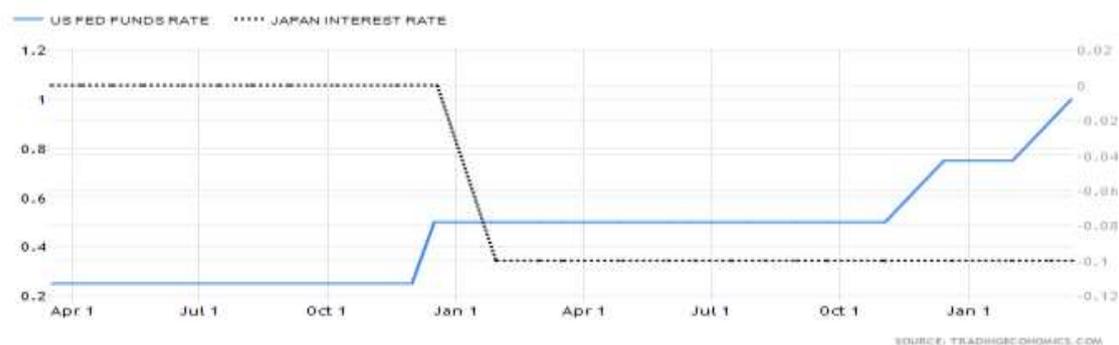
The US Fed' "dot plot": Midpoint of target range or target level for the federal funds rate



The option to raise interest rates in 2017, as a result of improving economic activity and emerging inflation, is surely an option that many country's central bankers would like to have (as opposed to struggling with accommodative monetary policy that appears to be having little effect). For example, the economy of Japan and the stark contrast in monetary policy between the Fed and Bank of Japan (BoJ) is illustrated in the graph below.

Short-term interest rates in Japan are at -0.1%, 10-year bond yields are capped near zero and asset purchases (QE) are at about ¥80tn a year. Despite the BoJ's very aggressive (loose monetary) policy stance, the Japanese economy has yet to gain any traction and deflation remains a risk, meaning that there is very little prospect of any interest rate increases in the near term.

Contrasting fortunes: US Fed funds rate relative to Japan's interest rate



Source: *TradingEconomics*, March 2017

In the UK, the BoE's statement on interest rates this week largely met with expectations – the UK central bank's rate setters elected to keep interest rates on hold at 0.25%. As we have previously said, economic consensus suggests that consumer spending in the UK is likely to slow later this

year (and into 2018), and this view was echoed in the BoE's announcement. The BoE's MPC (monetary policy committee) forecast a slowdown in aggregate demand in line with declining household demand growth - itself a reaction to lower real income growth - as rising inflation begins to take effect.

Moreover, as we have also previously written, current inflationary pressures in the UK are effectively transitory. The BoE's analysis indicates that CPI inflation increased to 1.8% in January and is expected to rise above the Bank's 2% target over the next few months. However, while it is forecast to peak at around 2.75% in early 2018, it is set to drift gradually back down towards the target thereafter.

Whereas the direction of US, Japanese and, to an extent, European monetary policy is reasonably clear, the direction of monetary policy in the UK is less straightforward. The economy appears well placed for moderate growth but, according to the BoE, there is a disconnect emerging between the views of financial markets and those of households as to the UK's economic prospects.

Given the level of uncertainty around the prospects for the UK economy, the BoE is keen to indicate that monetary policy is presently finely balanced (it is, however, considerably more accommodative than the historical long-term average). Assuming the Bank's economic forecasts are broadly met, they would expect to reduce the level of monetary stimulus (introduce higher interest rates), although they also state that there are risks in both directions. For example, a more marked slowdown in activity than anticipated by the Bank could imply more monetary support (lower interest rates).

Clearly, the short-term direction of monetary in the UK policy currently appears less clear than elsewhere. Ongoing uncertainty, coupled with an economy that has yet to show concrete signs of sustained activity and growth, suggests that the BoE is right to keep rates on hold (pending the outcome of certain critical events and more sustained economic momentum).

The increased levels of uncertainty around not only the economic direction of the UK, but also the monetary policy, makes our domestic market as a whole a somewhat less attractive target for our investment strategy than other global regions. As always, regardless of such a relative disadvantage position vs other regions, there are still plenty of good investment opportunities available in the UK's stock markets – it may just become a little harder to identify them!

Emerging Markets Outperform

Contrary to expectations at the end of last year things seem to be looking up in Emerging Markets. After an almighty wobble in January 2016 – one that rocked the global economy with it and saw the MSCI Emerging Markets (EM) Index lose 13% in just the first 21 days of the year – EM equities went on to have a strong year last year. In US\$ terms, the MSCI EM Index ended up +11.6% for 2016, once commodity prices curtailed their nosedive and investors began to realise the end wasn't as nigh as it looked. Given the often cyclical nature of EM equities then, as well as the feared strengthening of the US\$ and the protectionist policies of US President Donald Trump, many commentators had thought that 2017 would see a reversal of last year's trend, resulting in an unfavourable environment for EMs.

As of this week, however, the MSCI EM Index has already gained another 12% year-to-date, and is 25% up from the same time last year (when the recovery had already begun). It seems that investors are unperturbed by Mr Trump's protectionist threats of imposing tariffs on imports – something that would no doubt deal a serious blow to US-focused exporters in the developing world. Instead, investors appear to be more concerned with missing out on the return of EM equity return dynamics of old, fearing that staying away would see them fail to take advantage of the rally. As Kamakshya Trivedi, strategist at Goldman Sachs, points out, “Investors are concerned about being underweight emerging markets if materially protectionist policies aren't introduced and the rally continues,”

Indeed, as we have written in these pages before, the ability of the Trump administration to implement the protectionist policies he promised on the campaign trail, or engage in the kind of ‘trade wars’ his team have alluded to since, is at best doubtful. And, it seems as though this realisation is coming about in the minds of many investors, driving the EM rally even higher.

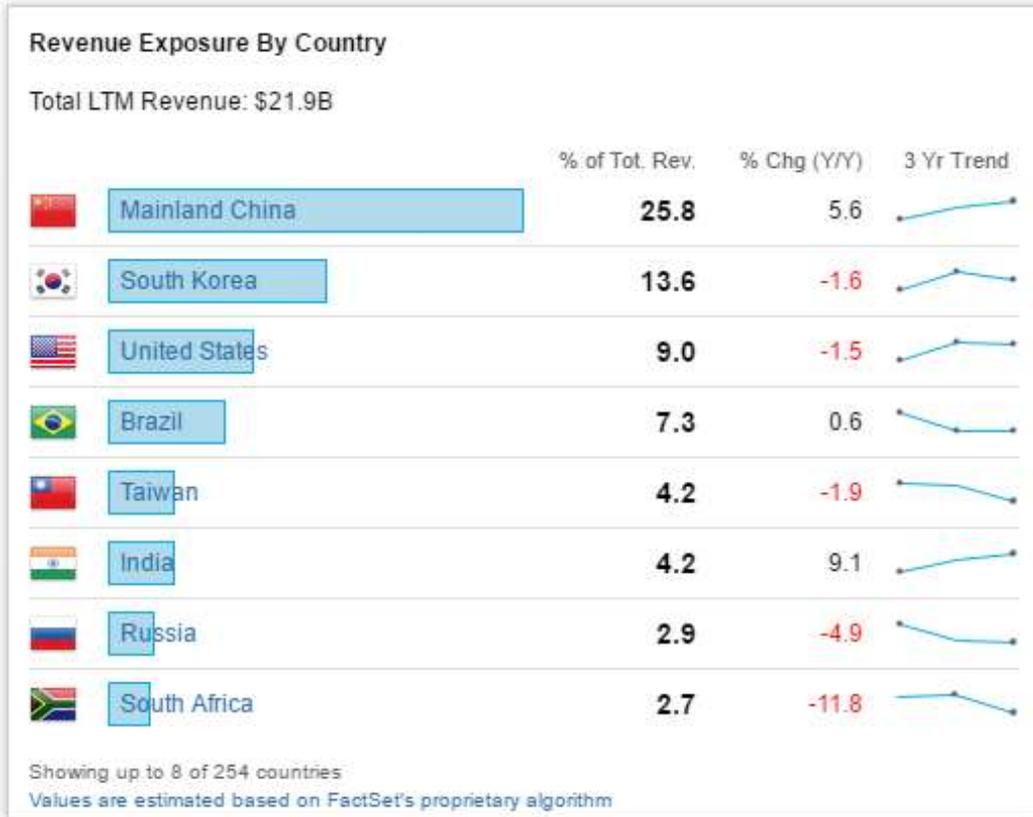
However, while Trump's inability to get the worst of EMs' fears through into law is certainly a boon for EM equities, we don't believe that this is the whole story. After all, regardless of what the Commander-in-chief does or doesn't do, the US Federal Reserve (Fed) has already embarked on a tightening process in interest rates – a process that traditionally can hamper EM growth significantly. Generally, when the Fed tightens, the US\$ increases in value, meaning that dollar-denominated debt held by EM companies (which is substantial, after the extreme borrowing brought on by the low-interest rate era) becomes harder to service. Additionally, tighter monetary policy in the US attracts more capital into the nation, diverting it away from EMs.

Indeed, back in May 2013, when then Fed chair Ben Bernanke announced a tapering down in monetary stimulus through QE, EM equities fell 14% in the month alone – earning this period the name ‘Taper Tantrum’. So, even considering Trump's failure, this doesn't explain why EM investors appear so nonchalant about a tightening environment which (theoretically) should be bad news for them. What's keeping the boat afloat then?

Well, there seems to be a general perception that, during this tightening cycle, EMs are far better placed to handle increases in US interest rates than in previous cycles. Brazil and Russia are just on the way out of deep recessions, while, in general, synchronized global growth is extremely positive for EMs. And, average current account balance (exports minus imports) across EMs as a percentage of GDP is at its highest since 2010, meaning money flows into the developing world are positive.

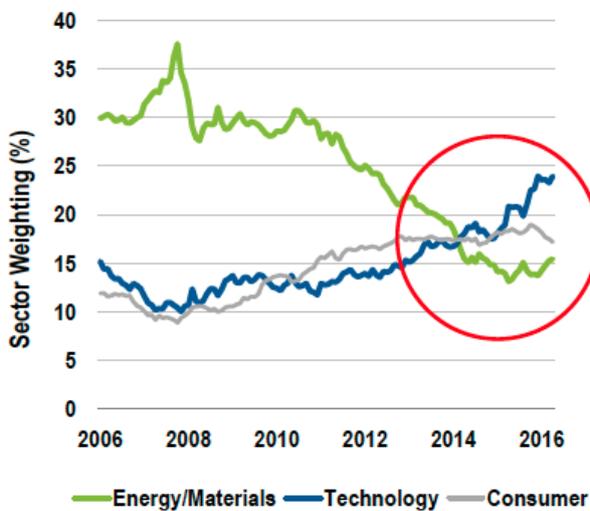
Furthermore, we note that the strong performance from EM equities despite apparent headwinds from the US is indicative of a broader point – that EMs - on the whole - are becoming less reliant on the US as their best customer. As the chart below shows, the revenue streams for companies in the MSCI EM Index are increasingly coming from inside EMs themselves – particularly China. 60% of revenue for EM companies now comes from the developing world, while only 35% comes from the developed world. EMs now have a broader regional base to drive their growth, meaning harmful US trade policies might just not have the same bite they used to any longer.

iShares MSCI Emerging Markets ETF (EEM) \$39.32

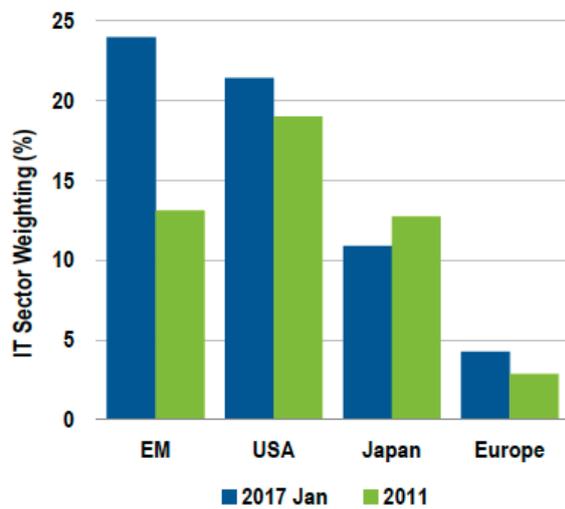


The spread of revenue sources is not just regional either. Where once EM investment was thought of as essentially a commodity play – from their heavy reliance on mining and oil – now technology companies are playing a much larger role, meaning that dips in commodity prices don't provide as much of a headwind as they once did. Effectively, EMs have diversified their sources of GDP, both

MSCI EM Sector Evolution
October 1996 – January 2017



IT Sector Weighting: MSCI Indices
December 2011, January 2017



region and sector-wise, meaning that growth is likely to be far more stable and broad-based than it used to, and most probably not as sensitive to cyclical factors.

For these reasons, we remain positive about EMs on the whole, and see potential for EM equities to outperform developed world equities in the near term. As ever when talking about EMs though, it's important to not treat the emerging world as one homogenous bloc, and instead view EMs as containing some ripe fruit, but some rotten too. For example, despite the fact that Brazil looks as though it's beginning to recover from recession, the country remains mired in corruption at the top level, and the extreme currency volatility means that the risk factor remains uncomfortably high.

Others, however, appear far more stable. In China, officials appear to have a strong grip on the economic situation, with their focus now moving to curtailing what looks like a unhealthy reliance on credit leverage, mitigating risks and giving the nation a far more stable growth outlook. India, meanwhile, portrays a political stability which has surprised many western investors – us included. Prime Minister Modi's party has just won a landslide victory in key assembly elections, solidifying its status as the dominant political force in the country and apparently vindicating Modi's controversial demonetisation 4 months ago (we reported).

In general, then, we note that Ems are undergoing gradual change that should make them somewhat less volatile in investment terms than used to be the case. But make no mistake they will continue to be more volatile than more developed western markets. Despite increased intra-EM trade volumes and more domestic consumer demand from a growing middle-class they remain a geared play on wider global economic growth. If Trump manages to placate his disgruntled voter base with policy measures that furthers US growth then EMs should do also benefit, as US growth inevitably spills over to global growth and long before Trump would be able to repatriate much productive capacity back to the US. China, however, may have become an even more important linchpin recently than the US. There are increasing indications that last year's economic upswing was to a considerable amount driven by economic stimulus originating in China – not the US.

Over the coming months, our view of the EMs in investment terms will therefore continue to largely be determined by economic signals coming from both China and the wider western world. Declining growth stimulus in China would mean an immediate drag on resource exporting EMs, while more consumer oriented economies may continue to thrive. This is why our positivity on EMs is slightly more nuanced, and we don't think EM portfolio allocations should not simply be a case of buying the MSCI EM Index, but rather being more selective.

Intel bets big on driverless cars



Source: Mobileye

The headline reads: “Intel buys Mobileye in \$15.3 billion deal”. But what did the US computing chip giant actually buy, and why were they willing to pay so much for it?

The answer to that question relates not only to Intel’s own future, but also that of driverless or automated vehicles (AV), a market that is cautiously estimated to be worth over \$70 billion by 2030 and perhaps more importantly create more demand for computer micro-chips than traditional computers and smartphones.

The recent emergence of AVs as a viable profitable enterprise has been made possible by the convergence of artificial intelligence (AI) software and better hardware, which includes processing power, sensing and camera technology.

So, who or what is Mobileye?

Mobileye is a leading provider of vision-based safety systems for vehicles. The firm blends (radar) sensors and cameras with its own machine learning algorithms, so that cars can detect people, other vehicles and road signs, and is a key technology in enabling autonomous driving.

At the start of the week, Intel announced the second largest acquisition in its history by agreeing to buy Israeli firm Mobileye for \$15.3 billion, with the deal expected to close by the end of 2017, barring any regulatory issues.

Intel said it would pay \$63.54 a share for Mobileye by using offshore cash currently held on its balance sheet. Intel also believes that the deal will immediately contribute to earnings (EPS - Earnings Per Share) and cash flow, along with potential synergies (business term for cost savings) of around \$175 million.

To gain true benefits of scale, Intel will merge its Automated Driving Group (ADG) into Mobileye under current leadership. Equity analysts thought that the valuation metrics of the deal appeared fairly rich, which values the Israeli firm at around 20x next year’s sales.

So why would Intel pay that much money?

Ever since the founding by technology pioneers Robert Noyce and Gordon Moore in 1968, Intel has been a key driving force in the development of the PC and server chip market.

However, the landscape has changed and Intel has seen the market for desktop and laptop chips gradually decline, as smartphone chips continue to make rapid progress, gaining even performance parity in some areas. Once, a user was confined to a desk or a laptop, but technology has moved on and users now take mobility for granted. One can replicate many of the tasks previously reserved for bigger machines on a phone or tablet device.

The chips that sit in your desktop or laptop will likely contain an Intel one, powered by its flexible x86 architecture. The problem for Intel is that these chips were originally designed around a constant supply of electricity, which is incompatible with mobile working. While Intel has made large leaps in energy efficiency, the company was outflanked by the low power mobility-focused chips designed by the UK's chip design specialist, ARM Holdings.

Intel is an integrated business, meaning that it designs and makes the chips that it sells, whereas ARM is merely a chip designer, leaving it to manufacturers like Samsung, TSMC and new fast developing entrants from China to make the end chips. Intel's traditionally advanced manufacturing processes have faced increased difficulties in staying ahead of the competition, as costs have risen and the constraints around the physics of ever smaller designs has allowed others to catch up.

This vast and growing ecosystem of producers around ARM's standard designs (and custom in some cases) has drastically lowered chip costs, as their efficiency scales up to performance levels that match and even beat some of Intel's products at a lower price. An ARM chip can cost a smartphone maker as little a dollar, whereas an equivalent Intel Atom was estimated to have been as high as \$70 per chip.

This cost and ecosystem disadvantage led to Intel abandoning its Atom chips in May of last year. Faced with the shrinking of its traditional market and no access to growing markets, Intel needed a new market to target

So, is this where AVs come in?

At last month's investor day, Intel's chief executive, Brian Krzanich, said that the "traditional market view" of the company as a chip maker was wrong, announcing that the firm was a "data company".

It would appear that the Mobileye acquisition is a key part of the CEO's view of the company. Intel believes it will be "the global leader in autonomous driving" in a TAM (Total Addressable Market) worth \$70 billion by 2030.

The world's biggest companies have spent billions on the bet that smarter and more connected cars are the future.

Last year, Qualcomm paid \$47 billion for NXP, Samsung spent \$8 billion on Harman and Japan's Softbank paid \$32 billion on ARM Holdings. Intel believes it benefits from some key advantages and Mobileye already has its road safety systems in 15 million vehicles and partnerships with 25 car makers worldwide, giving it around 80% market share.

Graphics chip maker Nvidia has taken an early lead in the market, with Tesla cars using its technology, but Intel will combine its advanced mapping, data centres, 5G wireless modems and AI systems with Mobileye's chips and software, meaning the company will be attractive as a one-stop shop approach for car makers.

It would seem that big IT companies view AV as a priority, and US technology firms remain cash rich, having \$650 billion on their balance sheets. It is possible that Intel's acquisition could be the start of a 'gold rush' into the market by other big players. AV and connected cars look to be a high growth market. One can easily imagine fleets of automated trucks and taxis (and aerial drones?) providing a new high tech and low cost 24/7 transportation network. As the supporting 5G (telecom) infrastructure rolls out over the coming years, numerous tech gurus are foreseeing the next transportation revolution – with similar far reaching consequences for society as the move from horse draws cart to cars at the beginning of the 20th century.

Having been stuck in traffic during a visit to the US last week, I can easily see why this would be a highly attractive transport alternative for time poor, cash rich commuters anywhere in the world (Lothar).

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7415.9	1.0	72.8	↗
FTSE 250	19032.5	0.4	71.0	↗
FTSE AS	4031.9	0.9	35.3	↗
FTSE Small	5401.7	0.8	42.1	↗
CAC	5012.3	0.4	19.0	↗
DAX	12078.0	1.0	114.8	↗
Dow	20920.3	0.1	17.4	↗
S&P 500	2378.5	0.2	5.9	↗
Nasdaq	5411.7	0.5	25.8	↗
Nikkei	19521.6	-0.4	-83.0	↗

Top 5 Gainers

COMPANY	%	COMPANY	%
ANGLO AMERICAN	13.9	STANDARD LIFE	-6.2
GLENCORE	11.0	PEARSON	-3.5
FRESNILLO	11.0	DIRECT LINE INSUR	-3.0
RIO TINTO	9.0	MERLIN ENTERTAI	-3.0
POLYMETAL INTERNAT	8.5	BT GROUP	-2.9

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	31.4	Brazil	216.8
US	26.9	Russia	166.2
France	55.6	China	81.0
Germany	20.1	South Korea	43.0
Japan	30.4	South Africa	191.0

Currencies

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.24	1.60	OIL	51.7	0.6
USD/EUR	1.07	0.58	GOLD	1229.8	2.1
JPY/USD	112.62	1.93	SILVER	17.3	1.8
GBP/EUR	0.87	1.06	COPPER	269.2	3.7
JPY/GBP	6.90	0.09	ALUMIN	1900.0	1.7

Commodities

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.2	0.1	0.00
US 10-Yr	2.5	-3.3	-0.08
French 10-Yr	1.1	-1.5	-0.02
German 10-Yr	0.4	-11.3	-0.06
Japanese 10-Yr	0.1	-15.7	-0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
3-yr Fixed Rate	1.7
5-yr Fixed Rate	2.2
Standard Variable	4.5
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

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For any questions, as always, please ask!

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The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel

