Weekly Market Comment

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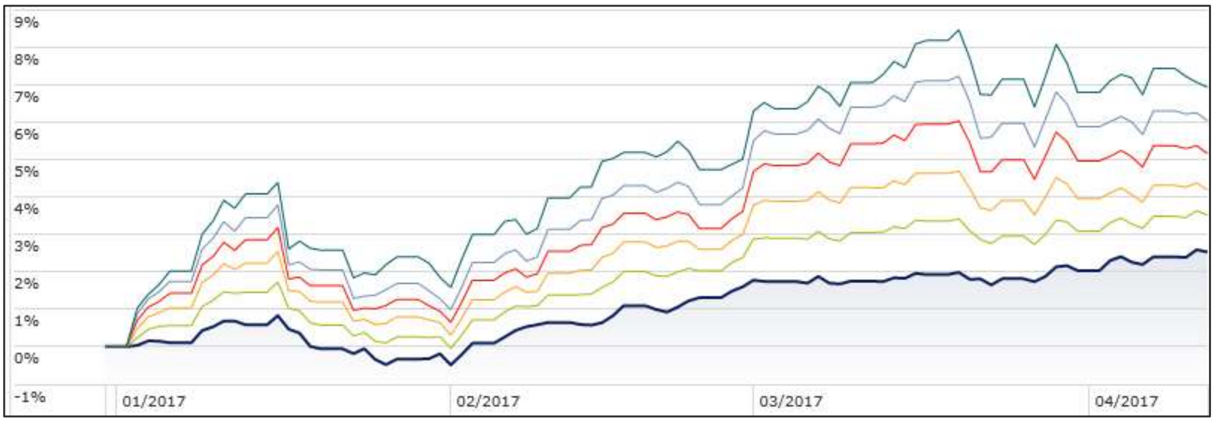
Typical 2017 UK risk profiled portfolio returns



Source: Morningstar; Note: Past performance does not provide guidance for future returns!

Rollercoaster of expectation changes

For most, the Easter holidays mark the drawing to a close of the year's first quarter. Although I have already, over the past 2 weeks, reflected on what 2017 brought us thus far, it was only over the last few days that things really sprung out. We started the year expecting the biggest political upheaval in decades, but also, economically and in investment terms, a continuation of the strong recovery momentum that had started in Q2 of 2016.

Three months on, it looks more the other way around!

As we move from winter to spring, we see more and more evidence that Donald Trump's tweets and interview statements should indeed not be taken at face value, as he is more than willing to change his views quicker than other people change their shirts. Over the past days, we have learned that Mr Putin is actually not to be trusted, that the US will continue its role as global police man after all, that he regards the Chinese no longer as currency manipulators (as long as they help him contain the North Korea threat), that he actually prefers low interest rates over higher rates (for savers?) and that US Central Bank chair Janet Yellen is – quote: "not toast". No wonder Mr Putin complained that he no longer knew where the US administration stands.

It appears to me that since the year began, we have moved from expecting destructive incompetence to experiencing randomly constructive incompetence in the field of foreign policy and a 'going nowhere' with his domestic change agenda when faced with the realities of a checks-and-balances-based legislative. Make no mistake, the impression of lack of plan, strategy, capable resource and consistency is still very worrisome. But, there is also the distinct impression that the comprehensive, fact-based briefings the new president is now subjected to are beginning to have an effect and are returning US policy somewhat back to the past norm.

For the US economy, capital markets and the US$, the direction of travel has also gone the other way. While, in January, there were expectations that the US$ would continue to rise on the back of US economic growth rates returning to the 4-5% pre-Financial Crisis levels and stock markets rallied in anticipation, since then markets and the US economy have lost much of their momentum, and have entered more of a holding pattern, awaiting new direction.

As I mentioned last week, the quarterly round of corporate results announcements (Q1 earnings season) that has just commenced may prove crucial in this respect. With the macro economic data side being somewhat ambiguous at the moment, hard corporate earnings numbers and outlook statements will help to create a clearer picture about the state of the economy. As we discuss in a dedicated article this week, we are fairly optimistic that earnings growth will have been strong. But whether it is strong enough to not disappoint the high expectations from the beginning of the year, and the stock market valuations this generated, is a different matter.

We are hopeful that the substantial improvement in business sentiment over the past 12 months will counterbalance the slight flagging of consumer demand, resulting in still healthy earnings growth. This may be sufficient to underpin current stock market valuation levels in the US and provide further upside dynamic for the lower valued European and Asian markets. This has also the potential to change recent exchange rate parities, as we are discussing in a further article this week. If Europe and Asia overtake the US in growth terms, then there is in our view a high probability that the US$ will continue to decline from the high it reached at the end of last year.

Unfortunately, there is also a pessimistic scenario for the shorter term, where markets are disappointed by the US results and enter a correction which then spreads around the globe – as we experienced before. However, since this would most likely be merely a correction from elevated US valuation levels, rather than a prolonged bear market because of declining economic prospects, we would expect a fairly swift recovery. Such a recovery would then be likely to provide the catalyst for a change in market leadership. The US markets would be unlikely to recover quickly back to their previous highs, while the European and Asian markets would have the potential to go further.

So, either through currency movements or market gyrations, we expect the capital market leadership to pass on from the currently very optimistically priced US stock market.

Where does that leave our home market, the UK? Well, as so often, most likely somewhere in the middle. UK consumer demand has, similarly to the US, slowed, but business sentiment is improving. The latter is most likely to do with the economic acceleration in the Eurozone, with UK businesses currently enjoying the paradoxical, yet enviable position of still being part of this biggest free trade zone in the world, while operating with pricing advantage of a currency that has already substantially devalued in anticipation of leaving the EU in 2 years.

The chart at the top shows roughly the returns corridor UK investors in risk profiled portfolios similar to the ones Tatton manages would have experienced over the first quarter. The fact that the lines don't cross informs us that it has been a benign investment period with decent returns. Easter 2017 we find us at a crossroads – if previous expectations have to be scaled back, then these lines could get a whole lot more volatile. But equally, if companies can positively surprise, then there is potential for gradual upwards movement to continue, even if the regional market leadership is still likely to change.

Why currency moves matter in 2017

Over the past 5 days, the US dollar fell to its lowest against the Yen in 5 months, while the DXY dollar index, which measures the greenback's strength against a wider basket of currencies, fell 1% to 100.3. This came after the US$ had experienced a short 'flight to safety' spike last week, following the surprise US missile strike on a Syrian government airbase, but moves since then have seen a steady reversal of those gains.

DXY index - value of the US$ against basket of global currencies (5 years)

Source: CNBC.com

The 5-month low versus the Yen marks the culmination of a recent trend in dollar movements, where the (supposedly) Trump-induced climb into the tail end of last year has been slowly unwinding through the first few months of 2017. Contrary to widely held expectations of further appreciation, the US currency has actually declined 3% since the high last year.

On paper, this makes little sense. The US Federal Reserve (Fed) is firmly in the midst of a monetary tightening cycle, with consensus expectations indicating 2 further interest rate rises this year to follow March's hike. Just this week, in fact, Fed chair Janet Yellen abandoned her usual dovish (low rates) demeanour at a University of Michigan event to note that the appropriate Fed policy stance is now closer to neutral. In theory, rising US interest rates should make the US$ more attractive and thus divert capital to the world's largest economy, which should push the currency up, not down. What's more, the expected loosening of the public purse strings by President Trump had markets salivating over the 'great reflation trade' in the months following his election, on the assumption that fiscal stimulus would boost both growth and inflation. Again, the growth element should provide upward pressure on the global reserve currency.

Like anything in Economics, however, currencies don't just exist on paper. The 'Trump trade' euphoria seen in November has since fizzled into a mild discomfort, as investors are beginning to realise that the predicted fiscal boosts won't materialise any time soon, while the disruptive effects of the President's anti-globalisation tilt just might and inflation eats at any rate rise attraction.

The financial commentariat have been at pains to attribute the dollar's weakness to political factors. Geopolitical instability, they argue, is the tide that sinks all boats – and the administration's crash intervention in the Syrian conflict, as well as Trump's determination to "solve the problem" of North Korea, place the US right at the heart of that instability.

In our view, the geopolitical explanation of dollar weakness misses the mark considerably. The US is an omnipresent player on the global stage, putting them in the midst of most conflicts (directly or indirectly). There's little evidence that such involvement materially harms the US economy or currency (except perhaps in the case of long-term involvements such as Vietnam or Iraq in the past). What's more, with its status of global reserve currency, dollar assets such as US treasuries are considered 'safe-haven' investments, meaning geopolitical instability should *increase* not decrease capital flows into the country.

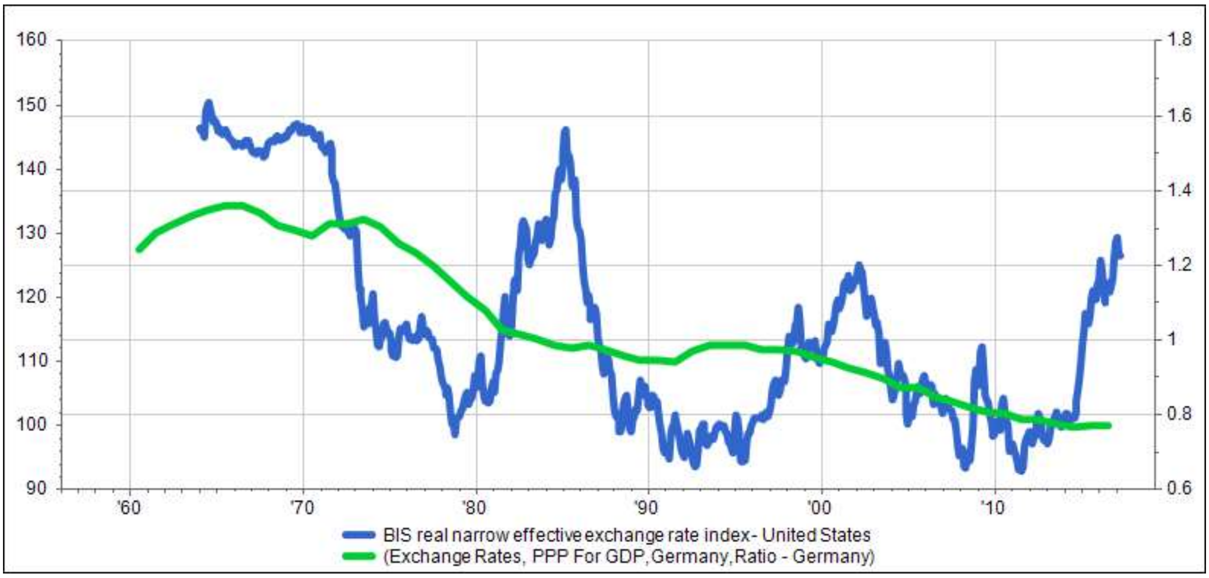
By all standard accounts, there should be considerable upward pressure on the US$. So why isn't there? Answering this involves delving into the realm of what drives currency movements in the first place.

It's an established mantra that, all else being equal, central bank policy determines currency movements. The reasoning behind this is sound; investors are incentivised to move their money wherever yields are highest, meaning a country's rising interest rates lead investors to buy that currency in order to generate higher return over yields elsewhere. Higher rates should thereby encourage capital inflows while, conversely, low rates should encourage capital outflows.

The problem with this view, however, is that you can't tell which factors are already priced into a currency's value. As we mentioned some weeks ago about the US$, if inflation goes up then real (inflation adjusted) yields are held back, as the higher prices of goods cancels out the higher yields. And, inflation in the US is the highest it has been for 5 years, with year-on-year inflation for February (the latest figure) coming in at 2.7%.

Related to this is the theory of purchasing power parity (PPP). Roughly, PPP states that the equilibrium exchange rate between countries is determined by the purchasing power of their citizens. That is, the equilibrium exchange rate is the rate at which it costs the same amount to buy goods in either country. This is why inflation puts downwards pressure on currencies – the more expensive it is to buy goods in a country the less other countries buy those goods.

This goes some way to explaining the dollar's weakness despite tight monetary and loose fiscal policy. The chart below provides the evidence for what we have stated above. It shows the US$'s historical value (blue line) against the PPP exchange rate with Germany (green line, an example



of a strong, yet similar economy to the US). It demonstrates that, while the exchange rate fluctuates greatly over time, PPP is the driver of the long-term trend.

What we also see is that, relative to PPP, the US$ is the most expensive it has been in decades. The last time the dollar's value was so much higher than purchasing power was in the 1980s, which led to an agreement by then President Reagan with the governments of Japan, Germany, France and the UK to intervene in currency markets to devalue the US$ - known as the Plaza Accord.

Whether such an agreement could be in store in the near future is debatable. Certainly, President Trump's determination to address the nation's current account deficit (exports minus imports) would suggest he is keen to see the dollar fall. But, the more hawkish tone from the Fed would imply that a devaluation of the size seen in 1985 would be majorly disruptive for the economy. Furthermore, while the 1980s record high was brought on by capital flows from Japan, the strength of the dollar over the past few years has largely been the result of capital flows from China. And, as a global rival vying for superpower status, the world's second largest economy might be more reluctant to limit its purchase of US assets as much as US ally Japan was back then.

Of course, this doesn't give the whole story either. Another major driving factor behind currency movement over shorter time periods is expected levels of growth relative to growth in the rest of the world. In general, an economy growing relatively faster attracts capital, thereby pushing up the currency's value. And, while US growth was predicted to be stronger at the beginning of the year, the 'hard data' has failed to live up to these considerable expectations.

As we have noted in these pages before, we currently expect the US economy to lag behind that of Europe, Japan and Emerging Markets (particularly China) in the short to medium term. The 3% currency depreciation may indicate that we are not alone with our expectations. The lagging effect could very well continue to pass on to the dollar, as capital is diverted away from the US.

Given these factors, our conviction that the US$ will likely weaken not strengthen significantly in the near term has further increased - despite the apparent upward pressure from the Fed and Trump's expected policies.

Unfortunately, if the above considerations show anything it's that currency movements are particularly unpredictable in the medium to long term – and only in the very long term follow PPP changes. It was not always the case that central bank policy was thought to be a main determiner of a currency's value, and, given the weakness of US$ despite the Fed's tightening cycle, it's possible that more market participants will come around to our current way of thinking. What 'determines' a currency's value at any one time is notoriously ephemeral; for a while it may be interest rates, inflation, growth or political stability, but that doesn't mean it will always be so.

For 2017, we expect currency moves to matter more than usual, as they may generate bigger value differentials than the regional stock and bond markets. Just as £-Sterling based investors learned in 2016, such shift can be substantial. For this year, we expect the value of £-Sterling to remain under pressure, but, more importantly, the US$ to come under more downward pressure than the 3% decline from the highs of last year. So, while equity markets have increasingly moved very much in tandem over recent years, currencies have diverged substantially. Our current underweight of US and UK investments in favour for those in the Eurozone and Japan is very much driven by this insight and expectation.

Q1 2017 corporate earnings look stronger but what's priced in?

The quarterly corporate earnings announcement season kicked off over the past week. In the US, Q1 is shaping up to provide investors with some key 'hard' data on the wider economy, post Trump's election victory, and help support (or not) the positive expectations built into current equity valuations. On current analyst consensus expectation numbers, Q1/2017 is tracking even stronger than Q4/2016, driven by improvements in financials and energy/commodity sectors. We see a possibility that earnings will come in stronger than consensus currently anticipates, given the generally cautious nature of company guidance and the supportive impact of a steady upward-trending economy.

We believe that there is potential for companies to positively surprise relative to expectations, on the back of high operational gearing (to an improving economy), the base effect of higher commodity prices, better corporate pricing power and still supportive credit conditions during Q1.

While the US Q1 season is expected to be solid, we anticipate that earnings in Europe and Emerging Markets (EM) could offer even more upside, on the back of accelerating growth across the Eurozone, higher commodity prices and a lower US$ benefitting EMs.

When does it start?

S&P500 companies will report Q1 earnings from 13 April, with 89% of firms finishing reporting by 5 May. However, this season is looking somewhat different. Aluminium giant Alcoa has traditionally been the first to report, but, this time, analysts are shifting their focus to financials and commodity related sectors, because Alcoa has delayed its report release to the 24th. Citigroup, JP Morgan, Wells Fargo and PNC Financial all reported on the 13th. With the exception of Wells Fargo, they didn't disappoint and beat expectations by a healthy margin. Wells Fargo, which is more high street orientated and less investment banking heavy, was unable to post an improvement. This tells us that it is increasing business confidence that is currently driving the US economy forward, and somewhat less the consumer.

What are analysts expecting?

The consensus expectation is that, compared to a year ago, Earnings Per Share (EPS) of the companies listed on the US S&P 500 Index will expand 9% in Q1, marking the fastest rate of profits growth since the third quarter of 2011. A large proportion of this growth can be attributed to just two sectors; financials and energy.

On the energy side, oil prices have continued to rebound during the quarter, and we note that the average price of WTI over Q1 was $52 per barrel, which is some 50% higher than the $32 average price seen in Q1 of 2016.

How about earnings excluding energy?

Ex-energy S&P 500 EPS is projected to grow 5%, marginally softer than the year-on-year growth experienced over the past two quarters. At a sector level, financials (+16%), Materials (+14%) and Information Technology (+13%) are expected to show the strongest growth. EPS in the Consumer Discretionary sector may see a 5% fall, driven predominantly by Ford and a 3% decline in Industrials EPS from Airlines.

What about sales or top line growth?

We anticipate that sales growth should continue to see further improvements in Q1, with analysts projecting +7% year-on-year growth over the quarter, versus the +4% for Q4 of 2016. Excluding financials and energy, sales should remain relatively flat at +4% year-on-year. This follows two consecutive quarters of sales growth. We suspect that recent recovery in sales may be more sustainable than before, given that analysts have made more upward than downward revisions to estimates in March for the first time since 2014.

What about other global regions?

JP Morgan estimates that Q1 EPS is projected to grow +15% in Europe and +16% in Japan, which is substantially stronger than the 9% expected for the US. EPS in EM may even expand at a faster rate than developed markets, which would mark the first time this has happened since 2010.

For Europe, EPS momentum looks to be accelerating, which contrasts the disappointing numbers over the past few years. We see corroboration from the economic data, with Eurozone PMI over 56, suggesting an annualised GDP growth rate of almost 3% and potentially double-digit EPS growth. The biggest beneficiaries of this growth and EPS upside may be domestically leveraged stocks, along with banks, which do better as loan growth rises.

For EMs, GDP growth versus developed markets appears to have bottomed, and the impact of a lower dollar and recovery in commodity prices could lead to a strong earnings recovery.

What are companies saying?

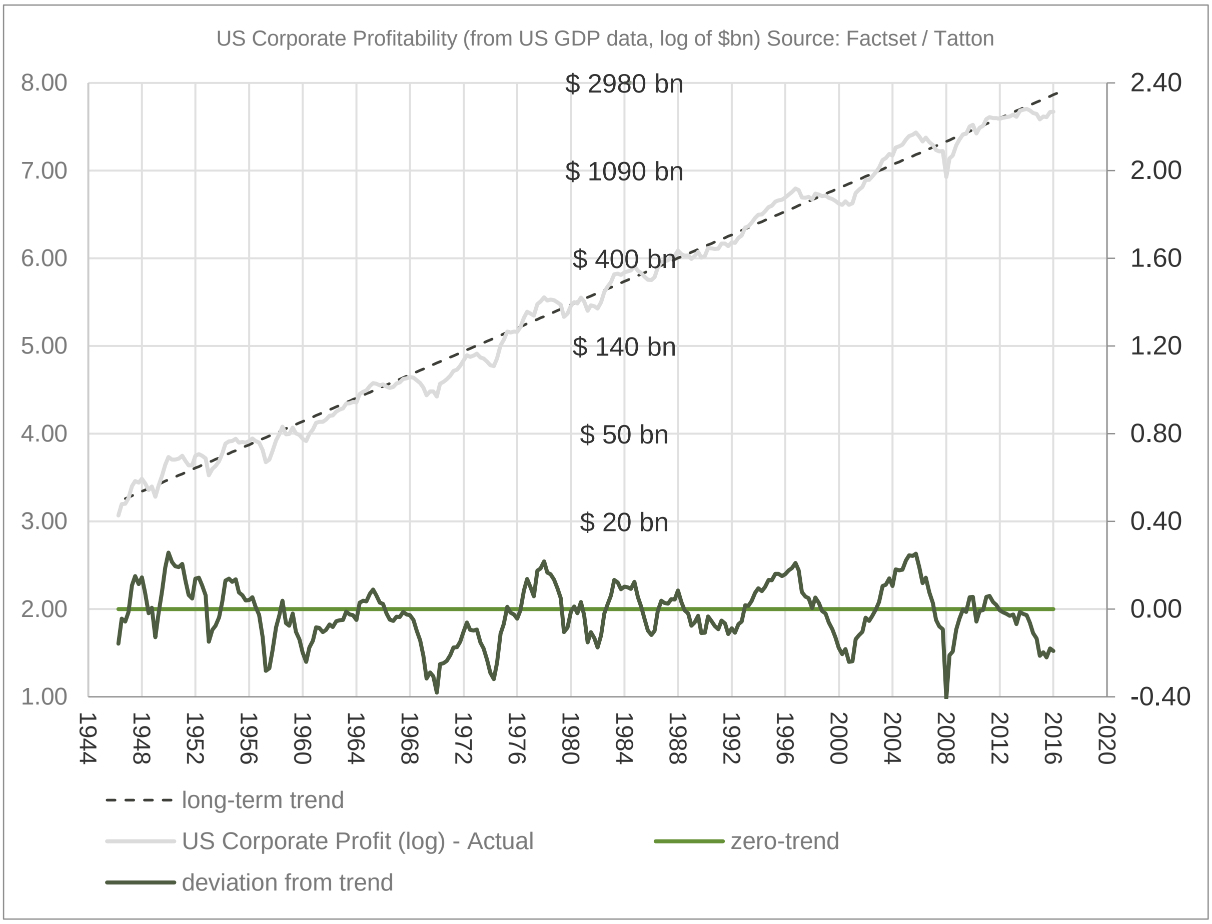
The ratio that tracks above vs below earnings guidance by management currently remains below long-term averages. However, we should note that company guidance will typically be highly cautious at the start of any year. A cautious management can bring benefit, particularly if earnings beat expectations and the share price ‘pops’, moving higher on better than expected earnings. Another reason for the guidance ratio being below average may be related to the lack of progress from the Trump presidency on tax reform and reduction of regulatory burdens. It is possible that company bosses are simply playing a game of wait and see, before revising their outlooks as and when more clarity emerges, or if the global economy improves more than expected.

Supportive economic environment

Despite the recently widely discussed divergence between the hard and soft economic data, the hard numbers are still showing growth (albeit marginally slower), while the soft (forward looking surveys) are at decade highs – economic surprise indices are at the highest level since 2012 and expectations for new orders continues to rise.

For these reasons, we believe the combination of an improving underlying economy and solid corporate health (including cautious management guidance) has the potential for EPS, on a global basis, to beat even the upwardly revised estimates we see today.

The long-term picture



Since the end of WW2, the long-term trend in profits growth has been about +6.8% per annum, but, since 2010, growth hit a 'new normal' of just +2.8%. We note that the distance from trend growth (dark green line in lower chart) appears to be close to extreme low levels, meaning a return to the previous trend (stronger earnings) could be on the cards.

If our theory about the global economy potentially entering a new longer-term growth phase (in Kondratieff Cycle terms) has merit, then we may even see a recovery of EPS growth back to the previous trend growth, which would be equivalent to a 21% upswing or about $450 billion in additional corporate profits.

Either way, following the recently receding stock market momentum, the Q1 earnings results will provide crucial evidence for investors as to whether their regained confidence in the stock market is justified, and whether extended valuations in the US are underpinned by continued earnings growth momentum. So, while we are relatively optimistic that earnings growth will be solid, the 'million-dollar' questions is whether it will be enough to appease investors. We expect that, at the very least, the increasingly marked difference between the global regions will lead to a change in market leadership, from the US to Europe and Asia.

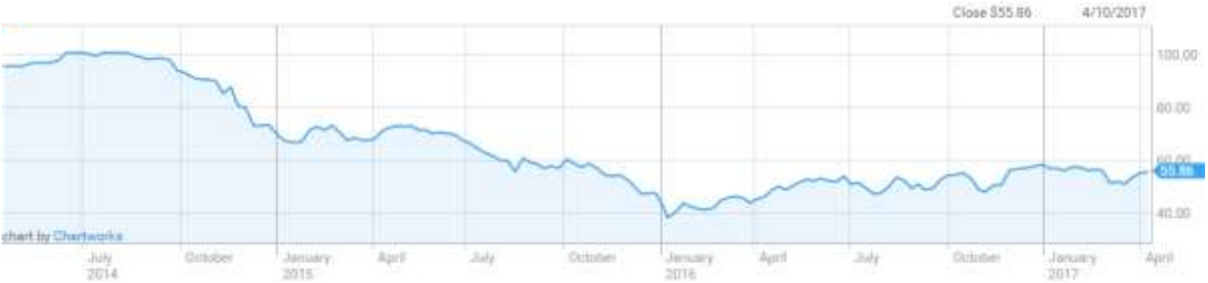
(and Q2 as well) earnings season could provide us with growing evidence that we may be on the cusp of another step higher in corporate profits in the longer-term, not driven by financials (as it was during the deflationary period over the past few years) but by non-financial corporations driven by the new inflationary period we appear to have entered.

Oil prices – back to stable?

The volatility in oil prices over the past two weeks stands in stark contrast to the relative stability in the first two months of 2017. Despite the noise created by US strikes on targets in Syria, unplanned production outages in Libya, the North Sea and Canada, the underlying recovery in oil prices appears to be building momentum.

While news of outages helped support prices this week, the bigger drivers appear to be this year's largest drawdown in US gasoline inventories and reports that Saudi Arabia is set to push for additional production cuts.

Oil price (Brent) over the past 3 years



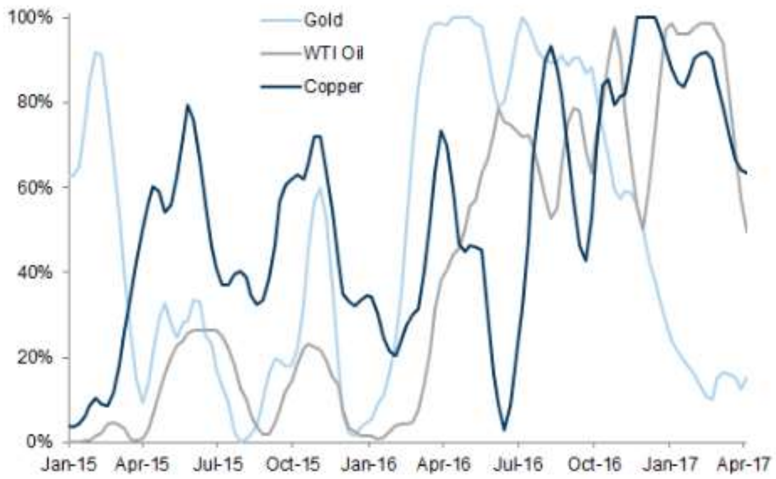
Source: Bloomberg.com

Over the past 6 days, oil prices had been trending quite gradually higher, but that took a step up when the API (American Petroleum Institute) said that petrol inventories fell a larger-than-expected -3.7 million barrels (vs -1 million estimate). This was the largest drawdown since December 2016. On top of this, reports that the Saudi's want to extend the 6-month 1.2 million barrel per day production cut by an unspecified number of additional months generated further upward pressure.

The upcoming summer 'driving season' in the US and continued strong demand from China provides support to the view that the rebalancing of supply and demand in the oil market is now

Exhibit 37 : Commodity net long positioning

Scaled from 0 (short) to 100 (long) relative to 1y window, 4-week moving average



Source: Bloomberg, CFTC, Goldman Sachs Global Investment Research really progressing. When we add in the fact that speculative net long positions (fast money) have materially reduced (chart above silver line), this could mean a reduction in near-term price volatility, or stabilisation in the mid-50 $/bbl, as at the beginning of the year.

More stable and not excessively high or low oil prices will constitute another positive factor for the economy, because it improves planning certainty and thereby increases business' willingness to invest.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7328.6	0.3	25.4	→
FTSE 250	19512.6	2.0	386.6	→
FTSE AS	4012.3	0.7	26.1	→
FTSE Small	5484.5	1.3	69.9	→
CAC	5070.9	-1.0	-50.5	→
DAX	12114.2	-1.0	-116.7	→
Dow	20589.8	-0.4	-73.1	→
S&P 500	2347.4	-0.4	-10.1	→
Nasdaq	5393.7	-0.5	-27.2	→
Nikkei	18426.8	-0.9	-170.2	→

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
MEDICLINIC INTERNAT	11.1	ANGLO AMERICAN	-6.2
AB FOODS	8.0	STANDARD CHARTER	-4.9
SAGE GROUP /THE	6.2	RIO TINTO	-4.5
RANDGOLD RESOURC	6.0	RBS GROUP	-4.1
POLYMETAL INTERNAT	5.9	GLENCORE	-3.5

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	31.4	Brazil	226.0
US	26.9	Russia	171.5
France	56.9	China	85.6
Germany	17.7	South Korea	57.8
Japan	30.4	South Africa	191.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.25	0.44	OIL	55.8	1.6
USD/EUR	1.06	-0.13	GOLD	1285.3	2.7
JPY/USD	109.20	1.47	SILVER	18.5	1.3
GBP/EUR	0.85	0.58	COPPER	256.8	-3.4
JPY/GBP	6.89	0.12	ALUMIN	1898.0	-3.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.0	-5.5	-0.06
US 10-Yr	2.2	-3.9	-0.09
French 10-Yr	0.9	0.7	0.01
German 10-Yr	0.2	-30.0	-0.08
Japanese 10-Yr	0.0	-48.3	-0.03

UK Mortgage Rates

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