



Weekly Market Comment

31 March 2017

Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENT

Samuel Leary

HEAD OF INVESTMENT COMMUNICATIONS

Isaac Kean

INVESTMENT WRITER

Chris Swanepoel

HEAD OF AIM INVESTMENT

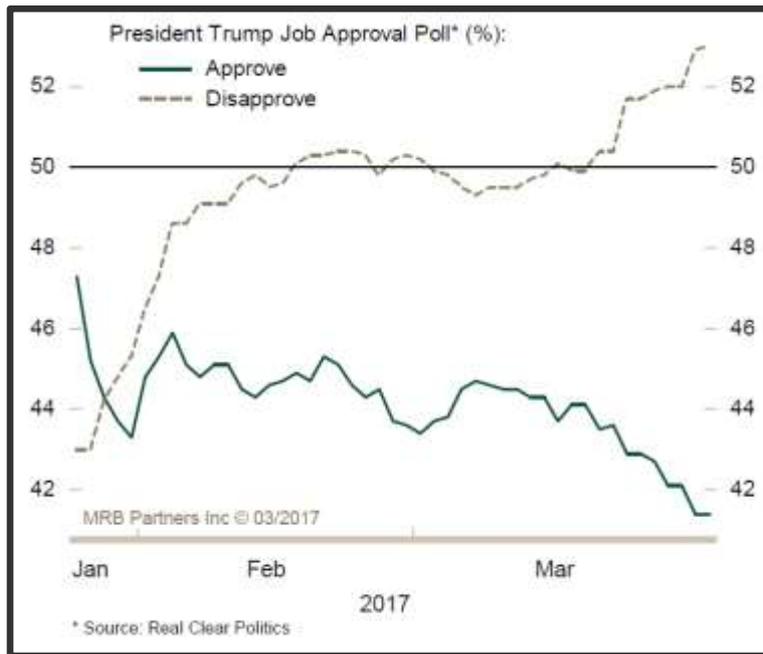
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www.tattoninvestments.com Twitter: [@TattonIM](https://twitter.com/TattonIM)

125 Old Broad Street, London EC2N 1AR. Tel: 0207 190 2959



Remarkable market resilience

Considering the political developments during the month of March, stock and bond markets ended the first quarter of 2017 on a surprisingly strong note. For the month of March both capital market segments posted modest positive returns, although the stock markets of the Eurozone and Emerging markets clearly outpaced the rest.

This must be of particular surprise to anybody who follows market developments and knows that equity markets are trading at elevated valuation levels that already anticipate a considerable amount of positive economic news in the near future. Market commentators' mainstream explanation was so far the 'Trump' and the 'reflation trade' inspiring investor sentiment. If that was indeed the case then there was every reason for markets to suffer a formidable correction during March, because president Trump's change agenda was served a severe blow by his own party in the US Congress and declines in oil and commodity prices made return of inflation expectations at least somewhat doubtful. On top of this the US central bank raised rates for the second time in 3 months which should have hurt bond valuations and finally the UK's government made the Brexit process fairly irrevocable by serving Article 50 notice to the EU.

Capital markets closing in the positive for the month informs us that compared to recent years investors have seemingly become a lot less easily scared. Or rather they may have come to conclude that what really matters is economic momentum and not political posturing. For the near term the US economy is expanding at fast enough a pace to not depend on additional deregulation and fiscal stimulus from the Trump administration. Over on this side of the Atlantic, economic growth has reappeared across the Eurozone economies with such a vengeance that even increased investment uncertainty across the UK cannot seriously change the current direction of travel of the economy on either side of the Channel.

On top of this, fear of policy errors by Trump may be reducing on the back of his failure to get his (apparently) poorly devised repeal of Obamacare past the checks and balances the US' founding

fathers put in place. The accelerating fall in his approval ratings may also rob him of further momentum to push through other similarly contentious initiatives.

It is encouraging to witness the new-found confidence markets are displaying in light of recent economic 'sunshine' - if only there weren't also all those clouds that we can also make out on the horizon – as there are:

During the week ahead president Trump is going to meet president Xi of China and his administration is already making protectionist noises ahead of the meeting.

Furthermore, as I pointed out last week, there is currently a disconcerting gap between hard and soft economic indicators, particularly in the US, which point to a renewed slowing of Global economic progress – China's slowing demand for commodities being another sign.

As far as the medium to longer term perspective is concerned, the UK's exit from the EU remains another considerable concern – at least for the UK. It is all very well that both sides used reassuring language around the formal serving of the Article 50 Brexit notice. However, little progress can realistically be expected during 2017 – at least until the general elections in Germany have taken place in the autumn. And, as we point out in our second article this week, rational scenario assessment currently leads to a higher probability of a 'crash-Brexit' than a mutually beneficial free trade deal.

In other words, plenty more potentially adverse news for the Global economy ahead.

For the time being, however, economic and market momentum appears strong enough to not be derailed easily. Instead of constant 'Armageddon Paranoia' the new market paradigm seems to be that real events turn out to be far less radical than they are initially portrayed. This is very encouraging, given one of the biggest deficiencies of the post Financial Crisis recovery has been the general lack of confidence amongst businesses.

While I would dearly want to interpret the recent resilience of market and business sentiment as the beginning of a more resilient growth phase, this is probably still premature. Yes, true, nothing is changing in the shorter term, but the potential and apparent willingness of Trump, China and the UK/EU to fundamentally change the terms of Global trade and with it the framework that has brought us growth and prosperity must be truly concerning.

As I have written here before, it is not in the interest of most politicians to undermine economic progress now, when they have waited for it for such a long time. Perhaps we should therefore align our medium to longer term views with the markets' new found optimistic approach and propagate 'where there is a will there is a way'?

Well, I would love to, but until we arrive there, at Tatton, we will continue to watch the economy and politicians' attempts at changing the framework vigilantly. With so much reason for markets to 'throw a tantrum' ahead, I continue to expect markets to experience a return of bouts of volatility in the near term. Our current neutral portfolio positioning should therefore continue to be the most suitable approach to navigate clients' investments through whatever may lie ahead over the coming months. For the first quarter of the year I am happy to report that this positioning has generated quite pleasing results after the already very strong results for 2016.

Article 50 triggered – Quo Vadis UK?



No easy route; Source: Financial Times, 9 March 2017

It's happened - nine months after a small but nevertheless decisive majority of the British electorate voted to leave the European Union, the formal divorce proceedings have started. On Wednesday, as expected, Prime Minister Theresa May sent a letter to European Council head Donald Tusk invoking the fabled Article 50, and officially setting off on the two-year road to Brexit. The news was heralded with dread and fanfare in equal measure by the British and pan-European press. And, with expectations of the UK's economic and financial demise abounding in the run up and aftermath to last year's referendum, it's easy to see why Mrs May's letter garnered so much attention.

In truth, however, market-wise the announcement was more of a mole-hill than a mountain. Both £-sterling and the UK's stock market seemed to shrug off the news completely, both gaining slightly on the day, up 0.21% (against the Euro) and 0.41% (FTSE100) respectively. Given the inevitability of Wednesday's events since the EU Withdrawal Bill was passed by Parliament a few weeks ago (and indeed, to a large extent before even then), the news has long been priced in by markets. So, May's act of putting a rubber stamp on what we've long since known to be the case – that the UK will leave the EU in the coming two years – was effectively old news.

What was good to hear, if at all predictable, was the conciliatory tone struck by the Prime Minister, repeatedly emphasising her government's desire for a "deep and special partnership" – a tone that was well-received across the continent's capitals. Admittedly, her words weren't all courteous, with the (not-so) new PM unable to resist a seemingly veiled threat that an unamicable split could harm the EU's security – a notion reinforced by Home Secretary Amber Rudd's comment that "if we left, we'd take our information with us,"

That slight aside, Mrs May's letter – and accompanying speech to Parliament – was far less antagonistic towards the bloc than the previous "Brexit means Brexit" rhetoric had alluded to. From a business perspective, this is indeed good news, as a crash exit – as some of her cabinet

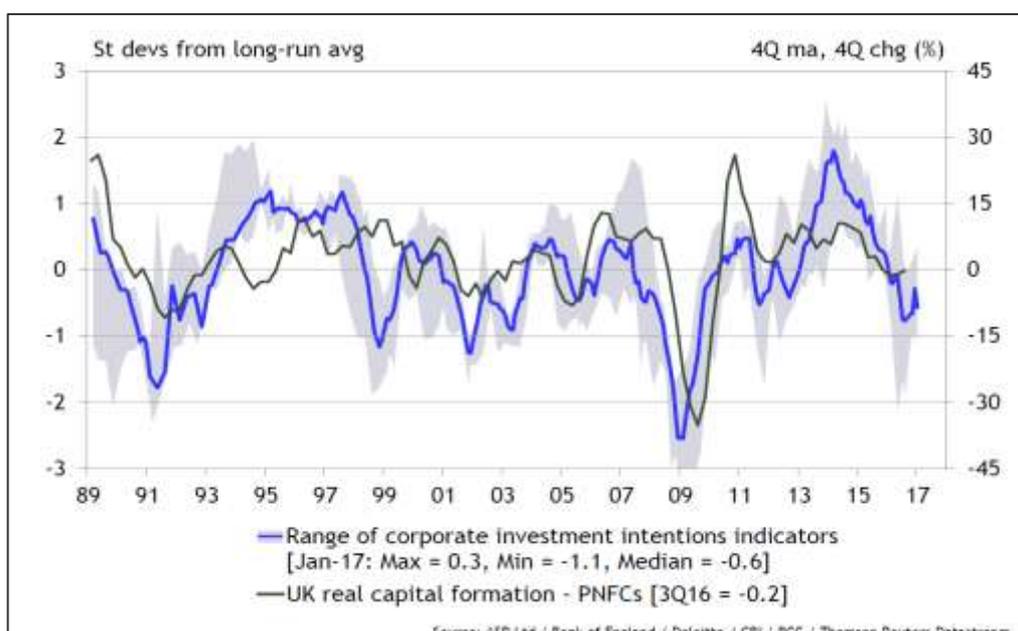
members had recently suggested not to be a big issue (!)- would no doubt leave many businesses in an extremely uncertain position with regards to their trading arrangements with the world's largest single market.

So, what now? Well, as we have said since before the referendum, not much actually changes in the short term. In the long term, Brexit will undoubtedly have wide-ranging investment impact – particularly if the fundamentals of the UK's economic framework change drastically. This is what economists refer to as 'change of institutions'. But, what exactly these changes will be are no more knowable from Wednesday's events than they were from the vote nine months ago. What exactly the UK-EU relationship will look like beyond 2019 will become ever more apparent over the coming two years but, until then, we suspect that news-flow from businesses about their own arrangements will be almost as important as news from the political side.

Already, we have seen some investment banks trying to reassure EU-national staff of their positions, in an effort to retain employees from the continent that are worried over their future UK job prospects. This is a positive sign, and watching the reactions of companies to the unfolding separation will be crucial in the coming years.

One point to watch in particular will be the ability of exporters to arrange and maintain contracts with buyers in the EU. As we have stated in these pages before, we currently observe strong upward momentum in the EU's economic growth, reflected in increased demand for UK goods and services from the continent. And, with the pound as low as it is, this should benefit UK exporters, as their goods are now more attractive to the growing demand from Eurozone businesses than was the case before the referendum. Effectively, we predict that the strong growth environment across the channel will have a spill-over effect on UK growth. This is important because, to this point, recent UK growth has been largely sustained by rampant consumer demand backed by consumer credit growth – something we believe unsustainable once sterling-based inflation filters through and undermines wage growth in real terms.

Hopefully, this increased demand from EU buyers will be enough to offset the lack of long-term investment into the UK – an effect of the uncertainty that we are already seeing (see chart below).



As much as we do expect positive European growth to benefit the UK, however, we do also note that, as much of the UK's exports to the EU are intermediate goods (i.e. components rather than end products), it's possible that the cheaper sterling valuation won't be enough to compensate for the uneasiness of EU businesses to 'deal in the dark' with UK exporters.

Supply chain contracts in many of the relevant industries are negotiated on a long-term basis, meaning that EU companies may be unwilling to sign up to trade with UK businesses despite their price advantage – if in just 24 months' time terms may turn sour. For existing contracts, we don't expect this effect to be disastrous for UK exporters, however, contract renewal rates are likely to drop and this may become an even bigger drag for the economy than the lack of long term business investment.

In the short-term, the effects of Brexit are mostly currency dependent, and therefore hard to predict. Political news to the effect that the UK may 'get its cake and eat it' will be greeted by capital markets with a recovery of the value of £-Sterling (GBP), whereas the opposite will put additional downward pressure on the currency. Since the referendum, the suppressed value of sterling has pushed the FTSE 100 to record highs, as UK equities have become comparatively cheaper for foreign investors and UK-based multinationals have been buoyed by the fact that much of their revenue stream is in foreign currencies. This has led many to wonder whether a move back upwards in £-Sterling could see a reversal of their UK stock gains. Indeed, many big market players have substantial short positions on the currency, lending credence to the argument that a correction on the trend of the last nine months is on the cards.

However, while we acknowledge the potential for short-term spikes in the value of sterling from sellers being forced to close their positions – a 'short-squeeze' – we don't expect that GBP will increase in a sustained enough manner to cancel out the stock gains. The dark cloud of Brexit looms large over the currency, meaning that a prolonged upswing is highly unlikely, and any increase that is seen would likely be capitalised on by short-sellers who would see it as a sell opportunity.

As for our general outlook on Brexit, we aren't so bold as to venture a specific prediction of the outcome in two years' time. But, we do note that from the perspective of rational assessment, a 'hard Brexit' – one in which the two parties part ways without a trade deal and the UK is forced to trade with the EU under WTO rules – seems the most likely outcome if neither side shows willingness to concede movement away from their 'red lines'. For the UK, this is regaining full sovereignty over its borders and legislative power, and, for the EU, it is the Four Freedoms (Free movement of goods, people, capital and services). Economically, this would be one of the most undesirable outcomes for many businesses, second only to a full breakdown in negotiations – something that one may see as the second most likely outcome, once all the additional complications are taken into account, particularly the time timeline of just 2 years to design and negotiate and comprehensive free trade arrangement (It has just taken Canada and the EU 7 years to achieve a less comprehensive deal).

At Tatton, we are unconvinced that 'hard Brexit' is inevitable, but acknowledge that treating it as a base case is perhaps the most sensible way forward. We are unconvinced because 'where there is a will, there is a way'. This aspect may become particularly pertinent if US president Trump

launches a full-frontal attack on free trade globally, and the cohesion of the remaining EU in particular. Nothing welds wavering partners back together more than a real external threat.

European banks – unloved perhaps, but welcome harbingers of economic growth

Regular readers will know – and we made the point again above - that we're positive on growth prospects for Europe, both in absolute terms, and in terms relative to the growth in the US and the UK. For this view to be borne out, one crucial condition is a fully functional financial system. This would be most clearly evidenced by a return to health and profit of European banks, underpinned by the strengthening equity positions on European banks' balance sheets.

So, are we worried that these banks reported an aggregate loss of €18bn in the 4th quarter of 2016?

In a word, no.

We believe that the financial sector's journey to health is increasingly pacey; banks are both set to provide finance to the broad economy and profit from doing so.

Goldman Sachs, in a report published on 29th March (see below footnote), noted that revenues grew by 1%, and that it was litigation, restructuring and clean-up charges that pushed the sector into an aggregate loss.

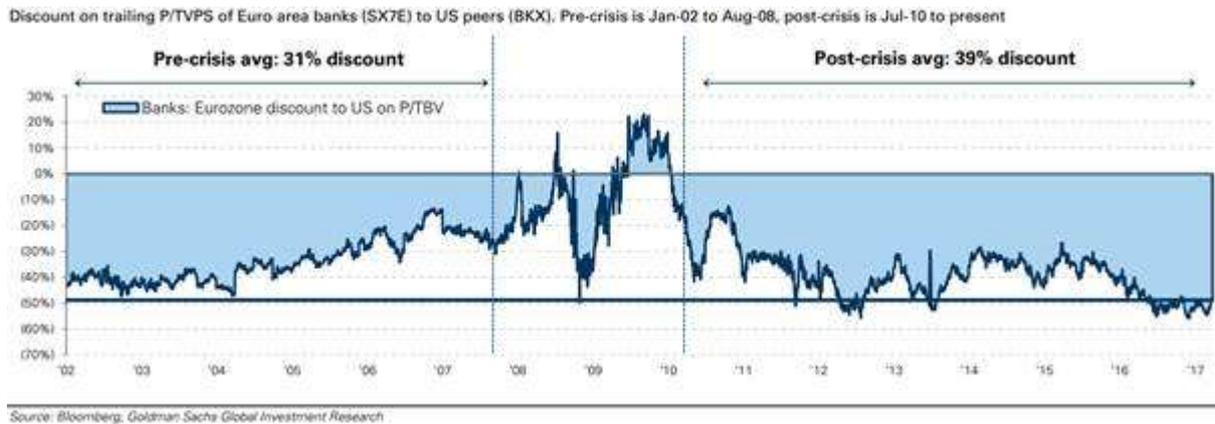
They note that the absence of these factors leads them to forecast a 2017 profit of €97 billion (an 8% return on "tangible" equity, the most relevant measure for banks) – follow this link for some background reading: https://en.wikipedia.org/wiki/Return_on_tangible_equity).

They identify three particular themes conducive to their positive outlook: 1. rising nominal growth and "interest rate bias"; 2. the US vs. Europe valuation gap; and 3. receding political risk.

The prospect of higher rates is the most powerful factor. Goldmans calculate that every increment of 0.1% on short rates could add 2%-3% to large banks' 2018 profitability (those banks with a market capitalisation over €10 bn). Each 0.10% interest rate increase could add as much as 4% to EPS (Earnings per share) for some banks.

In terms of our starting observation, we would note that banks' profitability has a strong multiplier on growth, leading to a virtuous circle. Profit goes up, lending goes up, growth goes up, rates goes up, profit goes up... and so on.

In terms of investment return prospects, Eurozone banks are relatively cheap. When looking at the "trailing-price-to-tangible-book-value" measure, they have been trading at a 49% discount to US banks, compared to the 15-year average of 32%, a pre-crisis average of 31% and post-crisis average of 39%. In Goldman's opinion, "future rate developments have the greatest scope to reduce this valuation gap".



Meanwhile, we and Goldmans note that the Dutch election, the first of six core Euro area votes this year, produced a supportive outcome for banks with the loss of the populists, by signalling receding political risk.

Admittedly, the ECB is not yet about to raise rates, and we think that the Euro is likely to strengthen in the face of stronger growth. This would contain inflationary pressures, potentially delaying the prospect of rate rises. However, a currency move would not stop markets anticipating rate rises – it would just be seen in rising longer bond yields first, rather than in short rates. Such a steepening in the yield curve would still be positive for bank profits and equity. Indeed, we also think a strengthening of the euro might well lead to a “Goldilocks” scenario of capital inflow, compression of savings rates and a prolonged bout of real growth – a very positive scenario for financials and non-financials alike, and for the prospects of their equity prices.

* “Europe: Banks -The Aggregate Picture: Rate gearing, the great valuation gap & receding political risk” (Omahen, Neuez, Dziedzic, Leitgeb 29th March 2017)

Bankruptcy of Westinghouse and why companies should be allowed to fail

The news that Westinghouse Electric – the only remaining division of 131-year-old energy specialist that still traded under the historical name – filed for Chapter 11 bankruptcy protection this week will not have surprised those who follow the sector closely. It follows spiralling costs at four new nuclear plant developments in the southern US, as well as ongoing financial and accounting troubles at its current Japanese parent Toshiba.

Chapter 11 proceedings do not necessarily mark the end of Westinghouse altogether, because the bankruptcy filing for the US firm allows Toshiba to continue operating, but raises questions about the future of nuclear energy in the US, the potential impact on Japanese banks (which provided Toshiba with loans) and the wider investment implications of how a historic company like Westinghouse could fail.

First some background.

Founded by 19-year-old George Westinghouse after the end of the US civil war, the company remained an innovation powerhouse for over a century, keeping at the forefront of commercial radio broadcasting, energy generation and electricity transmission technology.

Westinghouse can be thought of as the parent of the civil nuclear energy age, by building the world's first commercial nuclear reactor, a pressurised water reactor (PWR), in 1957. The company's PWR technology is found in half (430 installations) of all nuclear plants operating today, which accounts for 10% of global electricity production.

What went wrong?



The problem can be summed up in two simple words: spiralling costs. The underlying cause of Westinghouse's default is the runaway cost overruns on four new nuclear reactors it was building in south-eastern US. The costs from the currently half-finished reactors grew so large that it threatened its Japanese parent, Toshiba, who have themselves been struggling with declining profitability, accounting and fraud issues over the past few years. These problems even attracted the attention of the Japanese government.

Is that why Westinghouse had to file for Chapter 11 (bankruptcy protection)?

In February, Toshiba guided the market to expect an operating net loss of up to ¥1 trillion for the full year. This is the largest loss ever recorded by a Japanese manufacturer, but analysts expect those losses could mount as the company incurs further impairments/write-downs and possible additional liabilities relating to other US nuclear construction projects.

With Toshiba's survival at stake, the Japanese company placed the iconic Westinghouse in Chapter 11 or bankruptcy protection this week to stem further losses.

With Westinghouse now under court protection, Toshiba has lost control over its former subsidiary, which means it can be deconsolidated (taken out) from Toshiba's group accounts. Toshiba's CEO, Satoshi Tsunakawa, declared that "the risk from our overseas nuclear business is eliminated". However, that view may not be shared by all, and more needs to be done to shore up its damaged balance sheet.

As part of this repair process, the company won shareholder approval to spin off its flash memory chip unit in a full or partial sale. The CEO believes the NAND flash chip unit is worth "at least ¥2 trillion", which some believe could be bought by a rival like Western Digital. The remains of Westinghouse could be acquired by South Korean utility company Kepco.

Are there any spill-over impacts elsewhere?

We believe there are wider implications for the US nuclear industry, which relies on Westinghouse reactor designs and construction knowhow. Even the chair of the Atlanta Fed thought that the company “declaring bankruptcy has national security implications”. The failure raised the question of the viability of nuclear energy, given rising costs of construction, maintenance, decommissioning of plants and storing spent fuel.

For now, the immediate concerns relate to subcontractors involved in construction of the four projects. SCANA Corp and Southern Company could both face the risk that costs continue to rise. Interestingly, the firm Fluor could be a beneficiary of higher project costs as the primary subcontractor for two projects, as it could take a greater share of the construction work.

What about back in Japan?

As Toshiba’s financial woes increased, the company grew increasingly reliant on bank loan funding for its operations. The three main banks that JP Morgan identified as most exposed are SMFG, Mizuho FG and MUFG, who collectively had a lending balance of over ¥1 trillion with Toshiba.

While the three banks will seek to manage their exposures as best they can through provisions for bad debts (expected at around 20-40%), there is the potential for a negative impact on earnings of the aggregate banking sector.

How do companies fail?

They fail because they do not have the cash to pay their bills. The old adage that “profits are theory, but cash is a fact” rings true. A company will not fail because of profits, but because they lack cash, and then it’s game over.

Analysts estimate that a total of 96% of all businesses fail within 10 years of being founded, leaving just 4 out of 100 firms that survive beyond 10 years. The good news is that business failure rates are falling, and the rate at which US firms go bankrupt is down 30% since 1977.

One possible reason for this decline could be the rise of technology and the spread of information. It is now much easier to identify reasons for failure and learn from past mistakes. The addition of new business management technologies make it easier to retain a greater grip on cash flow management, helping increase survival rates.

Other equally valid explanations are that new company formation rates are lower, competition has decreased or existing firms are simply better at using their scale to offset downturns in business cycles through product, market or service diversification. Additionally, the sectors in which new businesses form increasingly concentrate on services, where business survival rates have risen.

The reason we hear about company failures more in the west, particularly in the US, is that more companies are publicly quoted and markets are more ‘free’. The latter means that rather than prolonging the existence of inefficiently operating companies through government interference, the failing corporate structure disappears, while the market quickly redeploys the tied resources of the company (Patents, labour, monetary and much of the productive capital) towards more effective uses.

But not in all cases?

Clearly, in Westinghouse's case, the reasons for failure are not so much market, but rather company specific due to the problem of mismanagement of costs.

What are the investment implications?

In our piece on Kondratieff Cycles last week, we discussed how short-term business and confidence cycles interact with longer-term cycles of economic activity. The consequences of these interactions can lead to periods of expansion and contraction, during which businesses do better in up cycles and the stronger firms survive down cycles, while weaker ones go bankrupt.

Typically, this expansion and contraction action can account for a majority of business creation and failure, in what is termed 'Creative Destruction', popularised by Austrian economist Joseph Schumpeter in 1942. Essentially, old inefficient companies die and new ones take their place in a process of "industrial mutation", or natural evolution of "spontaneous order", as termed by the famous economist F.A. Hayek.

As Kondratieff noted, the capitalist or free market economic system is naturally self-regenerating. The implications for investors are that the optimal outcome over the long-term is to have a wider selection of investments, spread across multiple asset types, companies, sectors and regions, to help offset or even benefit from changes in business cycles and the natural process of Creative Destruction.

It's not Size that matters

Many have asked us how the AIM Portfolio investments fit into the Life Cycle theory of businesses. There are many theories describing the various life cycles that businesses may go through, and here we present one of those to contextualise our portfolio and where the investments fit in.

1. Development / Seed Stage

The development or seed stage is the beginning of the business lifecycle. In this stage, ideas are tested and research conducted regarding business idea profitability and market acceptance.

2. Startup Stage

In this stage, it has been decided that the business idea is worth pursuing, meaning the product is developed and marketing and selling will begin.

3. Growth / Survival Stage

The business is consistently generating revenue and adding new customers. There will be many challenges in this phase, including dealing with increasing revenue, increasing customers and market competition.

4. Expansion / Rapid Growth Stage

The business has established a presence in the industry and is now looking to expand and spread into new markets and distribution channels. If the business can achieve this, and take advantage of the proven sales, marketing and operating models used in the growth phase, it will experience rapid increase in revenue and cash flow.

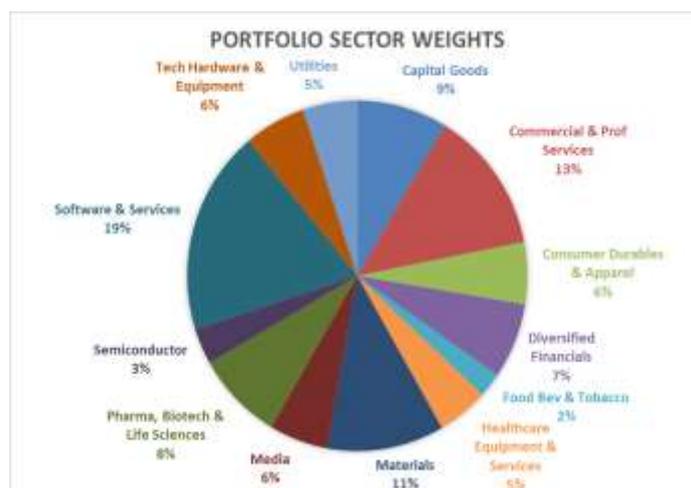
5. Maturity Stage

After a successful expansion, the business is on top of its industry and has matured. At the final stage of the business lifecycle, it has a large presence in its market. The business could still be growing, but not at the substantial rate previously experienced, and profit margins may be at risk from competitors entering the market.

We would remind readers, however, that, once a business reaches the stage where it is able to raise capital from investors through the stock exchange, the business has already moved relatively far along the life cycle curve. In this regard, we can assume we have moved beyond the Seed and also the Start-up Stage.

Most professional AIM investors (Tatton's AIM team included) only really start considering investing when businesses reach the Growth / Survival Stage, and, even then, only to a limited extent. One example of a business in our portfolio that is only moderately profitable currently, but with demonstrable and sizeable prospects, is RedT, involved in energy storage technology.

The investment objective is to produce most value in the portfolio at the Expansion / Rapid Growth Stage. It is at this stage of development that we find most of our current investments. Although it may seem that there is a concentration within this stage, diversification can nevertheless be achieved by investing in businesses with various uncorrelated earnings streams within a very diversified set of sectors.



Further diversification can be achieved through investment in companies of differing sizes. For example, the smallest company by market capitalisation in Tatton's portfolios at £28 million, Vianet, which measures beer volumes in pubs, can be perceived as being in the Mature Stage. ABCAM, on the other hand, valued at £1.8 billion and a global leader in the supply of life science research tools, can be perceived as a Rapid Growth company.

We would therefore point out that the size of a company does not matter as much as its future profitable growth prospects. Professional AIM investors will strive to quantify future earnings streams of each company through thorough research, ensuring diversified investments to control risk and produce favourable long term return on capital.

Personal Finance Compass

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7335.6	-1.2	-89.3	↗
FTSE 250	18973.1	-0.6	-121.8	↗
FTSE AS	3994.1	-1.1	-44.2	↗
FTSE Small	5374.9	-0.7	-39.7	↗
CAC	5020.9	-0.2	-8.4	↗
DAX	12066.3	-0.2	-28.9	↗
Dow	20676.5	-1.1	-238.1	↗
S&P 500	2350.6	-1.2	-27.7	↗
Nasdaq	5387.4	-0.4	-21.4	↗
Nikkei	19262.5	-1.7	-327.6	↗

Top 5 Gainers

COMPANY	%	COMPANY	%
NEXT	6.5	HIKMA PHARMACE	-7.7
POLYMETAL INTERNAT	4.0	BHP BILLITON	-6.6
DIXONS CARPHONE	3.8	GLENCORE	-6.6
TRAVIS PERKINS	2.9	KINGFISHER	-6.3
NATIONAL GRID	2.9	RIO TINTO	-5.7

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	31.4	Brazil	241.4
US	26.9	Russia	176.1
France	47.2	China	84.0
Germany	18.4	South Korea	49.8
Japan	30.4	South Africa	191.0

Currencies

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.25	0.78	OIL	50.7	-2.1
USD/EUR	1.08	0.60	GOLD	1247.5	1.5
JPY/USD	111.05	1.49	SILVER	17.7	1.8
GBP/EUR	0.86	0.19	COPPER	262.7	-2.4
JPY/GBP	6.88	0.29	ALUMIN	1933.5	1.8

Commodities

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.2	-3.5	-0.04
US 10-Yr	2.4	-3.8	-0.10
French 10-Yr	1.0	-11.0	-0.12
German 10-Yr	0.4	-6.0	-0.03
Japanese 10-Yr	0.1	-13.3	-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

GLOBAL RESEARCH TEAM

Lothar Mentel – Chief Investment Officer

Lothar.Mentel@tattonim.com

Jim Kean – Head of Investment

Jim.kean@tattonim.com

Mark Murray – Fund Analyst

mark.murray@tattonim.com

Sam Leary – Strategist

Sam.leary@tattonim.com

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 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

