



Weekly Market Comment

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March and 1st Quarter asset class returns

Asset Class	Index	March	Q1	2016
Equities	FTSE 100 (UK)	1.1%	3.7%	19.1%
	FTSE4Good 50 (UK Ethical Index)	0.5%	1.8%	12.6%
	Dow Jones Euro-Stoxx 50 (Euro-Zone)	5.8%	7.0%	20.1%
	S&P 500 (USA)	-0.4%	4.8%	33.6%
	Nikkei 225 (Japan)	-1.2%	2.3%	23.6%
	MSCI All Countries World	0.5%	5.1%	26.7%
Bonds	FTSE Gilts All Stocks	0.3%	1.6%	10.1%
	IA Sterling Corporate Bond Index	0.5%	2.0%	9.7%
	Barclays Global Aggregate Bond Index	-0.3%	0.6%	21.8%
Commodities	Goldman Sachs Commodity Index	-4.4%	-6.2%	32.8%
	Brent Crude Oil Price	-5.4%	-8.1%	81.8%
	LBMA Spot Gold Price	-1.3%	5.9%	30.2%
Inflation	UK Consumer Price Index (annual rate)		0.2%	1.08%
Cash rates	Libor 3 month GBP	0.03%	0.1%	0.6%
Property	UK Commercial Property (IPD index)		1.3%	1.4%

* Source: Morningstar, all returns in Pounds - Sterling (£ - GBP)

Constructive tones amongst much noise

Compared to the decent Q1 asset class returns, as shown above, the month of April started on a more muted note. However, after 12 months of strongly up-trending capital markets a certain amount of consolidation and sideways trading is to be welcomed, to prevent overheating.

Since I already commented on the March and Q1 returns last week, let me turn to the notable events and news since. The media's focus was rightly on the Stockholm terror attack and the heinous sarin gas bombardment by the Syrian Assad regime on its own people. The abhorrent Stockholm incident echoes those in London, Berlin and Nice. They are all sadly aligned to the concern we expressed last year, namely that defeating IS extremists in Syria and Iraq will return those of European immigrant origin – now brutalised - to spread their terror here. An unpleasant challenge for our western societies and politicians certainly, but likely of very limited impact on the economy and capital markets - as we have learned.

Trump's retaliatory attack on Syria on the other hand carries a different message. For one, that the international community's failure to retaliate after the gas attacks 2 years ago has finally been reversed. All other rogue states in possession of weapons of mass destruction must know that their actual application will always have severest consequences for those responsible. Secondly, the US are not retreating from their traditional role as the ultimate global police force regardless of what the president may have suggested about a US withdrawal from the global theatre. This is important because it provides us with yet another indication that the Trump administration is perhaps not as radical and non-conform as the president's tweets suggest.

The removal of Steve Bannon, the former senior executive of the nationalist website Breitbart News, as a permanent member of the US' National Security Council is another such sign of 'de-escalation'.

The summit with China's leader Xi Jinping at Trump's Florida golf resort had concerned political observers for a while as there were fears that the politicians of the 2 most powerful nations might clash, which could start a trade conflict. At the time of writing such concerns seemed unfounded, as the two appeared to get on well. Common security and economic interests may well play a strong role in this. More about the summit's wider implications and the current state of the US economy in the next article.

Turning from the Global to the domestic UK perspective, there seemed to be a widespread and collective sigh of relief when Theresa May suggested that her government would accept that an orderly Brexit may require transitional arrangements that would take the exit process well beyond 2 years. During such a transition period, the UK would no longer be EU member in name, but remain de-facto member by trading continued membership obligations for continuation of the existing preferential treatment until a final deal is achieved (or not). The acceptance of this approach by even the staunchest Brexiters will have sent a conciliatory signal to the EU-27 nations, that perhaps there is room for compromises amongst all those 'red lines'.

This slight change of tone obviously doesn't automatically lead to a mutually beneficial divorce arrangement, but it wins more time to avert a 'Crash-Brexit' simply because the negotiators run out of time. The muted reaction by currency markets tells us that there had been an assumption all along that negotiating lines would inevitably soften. In the meantime economic data releases for the UK were mixed, with the services sector displaying strength while industrial production suffered a sudden month on month decline.

Other less noticed de-escalations came from the Greece-EU-IMF negotiations, where some surprise breakthroughs in principle were agreed.

Another renewed threat in the form of falling oil prices has also morphed back to a non-issue, with the price per barrel of oil having gradually recovered back to the previous low to mid \$50/bbl level.

With markets in calmer waters, a number of previous concerns receding and the Global economy still making steady progress, it is possible that some of the potential market volatility that we foresaw will not come to the fore. However, there are undeniably also still obstacles and threats that have not been removed, like the slowing of growth rates in China and the US or political instability in South Africa and the threat of Turkey formally turning into an autocracy. The poor US employment numbers for March may have been caused by temporary effects like the snow storms in the East, but they serve as a reminder that markets are right to pause in their further upward movement until more evidence emerges about the true state of the economy.

The coming weeks will provide good opportunity for such evidence through the quarterly company earnings announcements season, which starts next week. I am hopeful that we will see more signs of steady progress, but at the currently still quite elevated stock market valuation levels there is equally opportunity for disappointment and subsequent market correction. Markets have prices in considerable growth expectations and disappointment could be badly received – watch this space!

US - China summit amid hawkish signals from the Fed



The US economy returned to the forefront of the financial news this week, with 2 big events. On Wednesday, the US Federal Reserve's publication of the minutes from their March meeting contained a surprise for markets. The notes recorded a more upbeat assessment of the American economy than the immediate post-meeting press conference statement had us believe. The Federal Open Markets Committee's (FOMC) discussion notes showed a more hawkish outlook on their monetary policy, emphasising the upside risks of the fiscal and underlying financial conditions, culminating in some FOMC members expressing their expectations to reduce the Fed's balance sheet this year if the economy continues to expand as predicted.

Then, on Thursday, Chinese President Xi Jinping made his much anticipated first official visit to the US since Donald Trump took office. The President has said prior to the meeting that "nobody really knows" what the outcome of the two-day summit at the Mar-a-lago resort in Florida (owned by no other than Mr Trump himself) will be, but the much discussed US trade deficit with China and – perhaps more importantly – the growing boldness of the North Korean regime will have been top of the list.

The relationship between the world's two most powerful nations has been a point of nervousness for global markets (and indeed the general public) since Trump won the election last year. In his campaign (and since), the now US president regularly blamed China for the worse sides of globalisation, promising to label the country a currency manipulator on his first day in office. Then, after the election, Trump upset the Chinese rulers by questioning the necessity of the US' long standing acceptance of the 'One China' policy, through which China has forced partial isolation of renegade Taiwan.

That kind of rhetoric has been toned down in the months since Trump assumed office; he has yet to formally pursue the currency manipulation charge against China, and the 'One China' policy has since been reaffirmed after a quick phone call with Mr Xi. The first night of the summit appeared all smiles, with Trump saying that the two leaders had "developed a friendship". But, the administration has largely kept on message about the US' trade deficit, with secretary of commerce Wilbur Ross writing in the FT on Tuesday that the government "must establish which bilateral

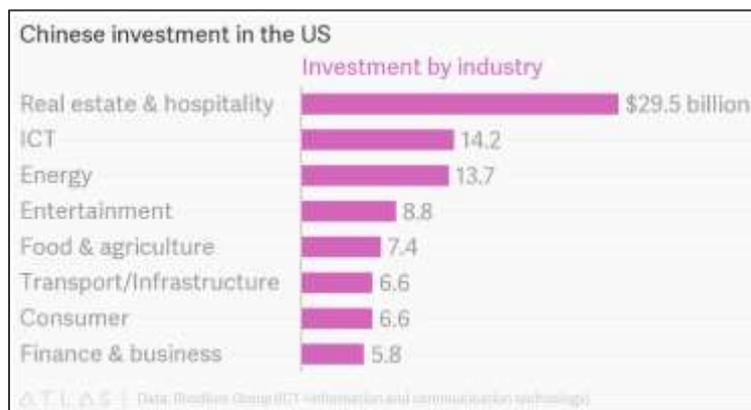
deficits are caused by dumping or other cheating”, a thinly veiled reference to China’s trade practices.

While Markets’ nervousness is understandable – with the S&P 500 selling off 0.9% on Wednesday – there is promise that the summit could be beneficial for both parties. Despite the rhetoric over unfair Chinese practices, addressing the North Korean security threat is far higher up the agenda. And on this front, actions speak louder than words. Trump may talk up his willingness to pursue North Korean disarmament all by himself, but his demotion of far-right adviser and ideologue Steve Bannon from the National Security Council suggests that the administration knows they will need the Chinese on this one.

Of course, we note that the Thursday evening airstrike by the US against Syria’s Assad could be interpreted as sending the opposite message to China – a willingness to unilaterally follow through on military threats. The Syrian and North Korean situations are vastly different however, the former being a warzone in which the US has long had a military presence, while the latter is a stable autocracy on the border of global power China.

China has a unique ability to pressure the hermit nation, for whom they are the only port of contact with the wider world, both economically and diplomatically. This does give officials in Beijing leverage in the North Korean affair, meaning that Xi is unlikely to give Trump everything he wants – reducing tariffs on US exports, enforcing copyright laws etc.

Actions like supporting Trump’s \$1 trillion infrastructure plan with Chinese investment, however, could kill 2 birds with one stone – addressing the bemoaned trade deficit while also providing the



Chinese with useful investment opportunity. Just last week, CRRC, China’s biggest railway equipment producer, signed a \$650 million deal to supply railway carriages to Los Angeles – referred to in Washington as a “tweetable result”. In fact, China’s outbound investment into the US was higher than foreign direct investment going the other way in both 2015 and 2016, a fact Mr Xi could do well to remind the Trump administration.

So, despite the moans of foul play from the President’s camp, we don’t expect US-China relations to turn sour enough to materially damage either country’s economy, especially with the North Korean crisis requiring cooperation on both sides. Given the threat posed to market sentiment from this summit, and with Trump’s hands currently tied on many of his other economic policies he promised on the campaign trail, we expect a further fizzling out of the so-called ‘Trump Trade’.

Instead, US investors will largely be driven by both the signs coming out of the US central bank (Fed) and the underlying economic momentum.

Markets' reaction to the Fed's surprise that they might begin reducing their balance sheet already this year, thereby reversing quantitative easing (QE), was tepid. The S&P regained some of the Wednesday losses, but this really meant that it continued to trade sideways, as it has since the end of February. In truth, 'reducing the balance sheet' is perhaps a misnomer. The Fed is unlikely to sell any of the assets purchased under their QE program, but allowing some of its purchased bonds to expire without replenishing them is possible. The fact that markets haven't thrown a fit over the Fed's desire to calm down the flow of easy money – as they did in the 'Taper Tantrum' of 2013 – is good news. The Fed's balanced message, expressing a desire to normalise monetary policy only when it is in sync with a strengthening US economy, is apparently what markets currently want to hear.

This would make sense, as it seems to be becoming consensus opinion that, despite all the pomp over the 'reflation trade' of the past few months, the upward momentum of the US economy perhaps isn't as strong as was thought at the beginning of the year. As we noted in these pages some weeks ago, this view is reinforced by a growing discrepancy between 'soft data' (sentiment surveys) and 'hard data' (actual performance). While hard economic data has been improving, it hasn't kept pace with the strength of business and consumer sentiment surveys, the two painting different pictures of the economy and making investors wonder which is correct.

The Fed themselves have acknowledged this discrepancy, perhaps explaining why their forecasts have remained largely the same despite the recent surge in the survey based so-called 'nowcasts'. So, which is right? We believe the truth lies somewhere in the middle – not quite at the rampant level made out by the sentiment surveys but some way above the sluggish level shown by the performance data.

The results for the first quarter in the US are notorious for coming in below expectations, so it's possible that it is only a matter of time before the reality begins to reflect the growing confidence from businesses and consumers. The release of weaker than expected US employment growth figures on Friday was another 'hard' data point that disappointed but is nevertheless a lagging indicator, that has little predictive quality for what lies ahead. For now, we maintain that we are not worried about the US economy, but note that the US\$ and the US stock markets have probably priced in a higher level of positive news ahead than there actually will be. The much lower valued Eurozone and Emerging Markets – and associated currencies – should therefore outperform in the near term. That said, the nature of market dynamics is such that, in case it came to a market correction, then such outperformance may only crystalize over the course of the subsequent recovery.

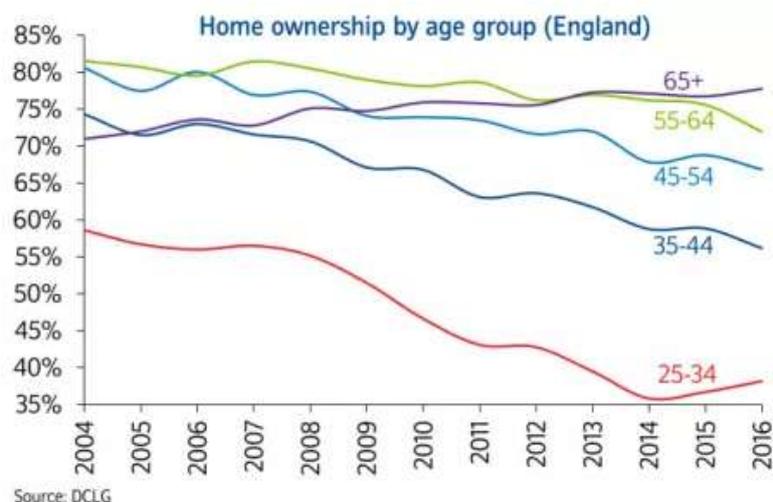
Slowing UK house price growth

The latest reading from Halifax' and Nationwide's house price index showed that house price growth is slowing. More interestingly, Nationwide reported that home ownership rates touched the lowest levels in more than three decades.

Nationwide said that the annual rate of price growth slowed more quickly than expected to 3.5% in March, down from the 4.5% rate in February. Economists were anticipating a rise of 4% over March.

This slowdown looks to be due to the surprise 0.3% decline in month-on-month house prices, which were predicted to rise by 0.3%, according to the consensus estimate on Bloomberg. The data revealed that prices in southern England remained slightly stronger than those in the North.

The strong rise in house prices over the past few years has made it harder for First Time Buyers (FTB) to access the property market. This has had a corresponding impact on the rental market and homeownership rates.



Over the past decade, homeownership rates have fallen, particularly among the key 25 to 34-year-old group – which accounts for most FTBs – reaching its lowest level since 1985. As ownership rates have declined, there has been a corresponding 111% rise in demand from that same age group for rental properties. A record high of 20% of all English dwellings are privately rented, up from the 12% just 10 years ago. The number of rental properties has jumped 75% over the past decade to a record 4.5 million.

Interestingly, the data for FTBs reveals that a total of 34% of purchasers between 2013-2014 required help from the 'bank of mum & dad'. This represents a 20% increase from a decade ago, according to the Social Mobility Commission. This figure is predicted to rise to almost 40% for FTBs by 2019. Savills said that the 'bank of mum & dad' provided £2.8 billion of assistance in the year to September 2016.

March's fall in house prices follows a 0.6% month-on-month increase seen during February, perhaps alleviating some of the concern that prices are on a falling trend. Despite this, the Nationwide data indicates that house price growth has slowed to the lowest year-on-year rate since August 2015. This is also corroborated by other data points from Halifax, Rightmove and house builders themselves.

Retirement house building specialist McCarthy & Stone said that its profits for the first half of the year were down 25% because of the slowing house price growth, while estate agents Foxtons and Countrywide noted that a softer property market had cut their profits by 54% and 59% respectively.

We anticipate that house price growth will likely continue to moderate over the course of 2017, as the pressure on household incomes builds – itself a result of higher inflation (mostly from a weaker Pound) and subdued wage and employment growth.

The UK housing market is thought to be one of the key pillars that supports domestic consumer spending, which in turn helps drive economic growth. Consumer spending accounts for over 60% of GDP. When the UK has a solid jobs market and house prices are rising, consumers feel more optimistic about spending and the reverse can be true when conditions deteriorate.

Over the past four years, the housing sector has been a strong growth engine, but evidence is mounting that this is now faltering, amid rising uncertainties related to the Brexit negotiations and where the UK economy might stand at the end of this process.

We think this leaves the BoE in a more difficult position when it comes to monetary policy. With household incomes becoming more stretched by higher debt levels, rising inflation and the possibility of increased Brexit related uncertainties, consumers may now have a greater sensitivity to changes in interest rates and, by extension, aggregate consumer demand. We feel that stagnating house prices may provide the BoE with a good argument for keeping rates low for longer. However, the constant supply constraints in the UK housing market should inevitably act as a stabilising factor against any more drastic price declines.

Return of stock-picker's markets?

The decision by Apple, the world's largest company by market capitalisation, to cease using UK firm Imagination Technologies' graphics chip technology in future products sparked an interesting debate in the Tatton office this week.



The company saw its shares experience their biggest ever intra-day plunge – close to 70% at one point – on the realisation that they could lose up to 50% of their revenues. Not only did the decision provoke a discussion about the immediate impact on Imagination, but also about the tendency towards reduced competition (monopoly or oligopoly) in sectors, revenue diversification and finally the possible return of the 'stock picker's market'.

All of 'that' from a news story about a change in one of Apple's suppliers?

Stay with us a moment, as we build up to why we think there could be some reversal of the recent rising popularity of cheap index tracking investments, back into active or stock picking funds.

This is not an active versus passive argument, but more a realisation that different investment styles can experience varying degrees of benefit over different parts of an economic or business cycle, according to how returns might be generated during cyclical swings.

Firstly, what happened?

It all started on Wednesday, with a statement from Imagination Technologies that its largest customer, Apple, would phase out Imagination's GPU (Graphics Processing Units) designs currently found in tens of millions iPhones and iPads over the next 15 months to 2 years, in favour of a new in-house design that is in development.

As a result, Imagination lost around half its market value in a single day, on the prospect of the company having to rapidly adjust its cost base in response to a customer that accounts for about 50% of revenues effectively walking away.

What a difference a year makes. In March 2016, when investors valued Imagination at £500 million, Apple confirmed that the UK GPU designer had rejected its interest in a potential purchase of the company. Apple already owns nearly 10% of the company anyway, but this week's share price slide may tempt the US firm into another offer at a far cheaper price, with its market capitalisation now 'just' £291 million and the Pound also weaker versus a year ago.

Revenue diversification – what revenue diversification?

It can be a benefit to have a large stable customer, as that customer's growth takes you with them. However, should that client suddenly decide to switch suppliers then, as in Imagination's case, you are left horribly exposed, with a cost base that no longer matches the revenue profile. Drastic cost cutting could be in short order for Imagination to re-orient the business to the new reality. Just as with picking investments, never have all your eggs in one basket. Always seek to diversify, having a greater spread of investments, so that any issues in any single asset is minimised.

Imagination believes that it might have some recourse legally. The company believes that it could still be entitled to royalty payments on Intellectual Property (IP) that it thinks Apple may infringe on in any of its own in house GPUs in future.

How does that relate to monopoly, oligopoly and competition?

All firms have a tendency to want to improve their market positions, hope to beat any competition and maximise profitability. There are various ways in which this can be achieved. From patents, to buying competitors, technology or suppliers, to enhancing routes to new or existing customers' wallets.

For example, Amazon are busy developing new delivery methods (sea and air-based drones), Google bought Android (the now dominant smartphone software) and UK firm Deepmind (AI specialist) and Apple acquired PA Semi (custom chip designer behind the iPhone) and Beats (the headphone specialist).

We have seen various moves over the past few years, by some of the big technology players, towards 'owning' more of the value chain to better control costs and profits.

Why would Apple want the direct burden of costs associated with developing graphics chips?

It is no secret that Apple likes to own as many of the underlying technologies in its products as possible, so it can cut costs and improve profit margins, which have become some of the highest of any in the industry. The company has a long track record using custom in-house components that give it a perceived edge against the competition.

The company uses custom-silicon chips in iPhones (A-series chips) and Beats Headphones (W1-series advanced audio chips). However, the step to produce its own graphics chip appears to be a long-term strategic bet on the emerging field of Augmented Reality (AR) and, in our view, a greater push on voice, spatial and 3D recognition rather than it being about smartphone video games.

On top of the chip, Apple already own the programming and tool-kits to enable developers to build software that only future iPhones and iPads may be initially capable of, ahead of any competition.

OK, but how does any of this relate to my pension or ISA investment portfolio?

Investors have enjoyed one of the longest bullish markets since the 1940s, now in its 8th year. Stock indices around the world are at all-time highs and it would appear that, in light of the general upward market momentum, a rising number of investors are opting for cheaper tracker funds or passive ETFs (Exchange Traded Funds).

Investors have taken ETF assets from just \$230 billion 10-years ago to over \$4 trillion today.

In contrast, active managers have found it increasingly difficult to beat their benchmarks when viewed against their running costs. Index tracking fund provider Vanguard calculated that a total of 82% of actively managed funds have either underperformed their benchmark or shut down. Increased regulation is on the way in the form of MiFiD 2, which aims to enhance investor protection and lower fees and charges.

Despite these challenges and flows into passives, the situation could be set for some form of reversal.

The driver of this could very well be the return of increased stock market volatility, arising from the political uncertainty of European elections, Brexit negotiations and how Trump's presidency plays out over the next four years.

When we add in the fact that we now appear to be well within an interest rate tightening cycle, we think it is possible that we could enter an environment where general market momentum is less pronounced, and thus stock pickers have better potential to select market-beating companies.

Perhaps we are leaving a paradigm where large macro trends dominate, supporting the mass buying and selling of baskets of assets, with investors simply seeking the cheapest way to market exposure to benefit from market movements.

Going forward, investors may benefit from being more discerning in the securities they own. As Morgan Stanley points out, since the global financial crisis, correlations (the extent to which securities move in relation to one another) are at record highs, while dispersion (the average difference between an index return and the return of each index component) is at record lows.

The unintended consequences of Trump's policies might be lower correlations and higher dispersions, which means that skilled active fund managers should have a greater ability to generate excess returns (alpha). A computer running an index tracking fund will not 'know' that Apple likes to centralise its technologies and that its suppliers can be squeezed. Nor will they 'know' which companies can benefit from tax reform or regulatory changes, or which firms may win or lose from more protectionist trade policies.

We may well be at an inflection point, where active managers have a better chance of alpha generation. Studies have shown that index tracking funds can underperform actively managed funds, especially in a bear (down) market. After the last two market crashes of the 21st century (Dot.com and GFC), both the US-based S&P 500 and Russell 2000 Indices trailed the corresponding universe of actively-managed funds for a quarter of a century, in spite of the fact that this time period included the two longest bull market runs in U.S. history.

Having a diversified portfolio that includes both active and passive investments may be the best strategy. Knowing when to rotate in and out of each style could make an even bigger difference to client portfolios.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7335.5	0.2	12.6	→
FTSE 250	19197.2	1.2	225.4	→
FTSE AS	4003.1	0.3	13.1	→
FTSE Small	5428.0	0.0	-2.4	→
CAC	5124.0	0.0	1.5	→
DAX	12200.6	-0.9	-112.3	→
Dow	20658.5	0.0	-4.7	→
S&P 500	2357.5	-0.2	-5.2	→
Nasdaq	5416.8	-0.4	-19.4	→
Nikkei	18664.6	-1.3	-244.6	→

Top 5 Gainers

COMPANY	%	COMPANY	%
POLYMETAL INTERNA	7.2	NEXT	-7.2
MICRO FOCUS INTERN	6.7	PEARSON	-6.7
BRITISH LAND CO	6.2	LLOYDS BANKING	-5.1
RANDGOLD RESOURC	5.9	HIKMA PHARMACE	-4.6
ROLLS-ROYCE	5.8	OLD MUTUAL	-4.5

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	31.4	Brazil	224.8
US	26.9	Russia	161.6
France	52.5	China	81.8
Germany	18.3	South Korea	51.1
Japan	30.4	South Africa	191.0

Currencies

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.24	-1.26	OIL	55.4	4.8
USD/EUR	1.06	-0.35	GOLD	1265.8	1.3
JPY/USD	110.73	0.60	SILVER	18.4	0.5
GBP/EUR	0.86	-0.95	COPPER	264.3	-0.4
JPY/GBP	6.90	-0.19	ALUMIN	1953.0	-1.0

Commodities

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.1	-6.1	-0.07
US 10-Yr	2.3	-2.8	-0.07
French 10-Yr	0.9	-9.1	-0.09
German 10-Yr	0.2	-30.5	-0.10
Japanese 10-Yr	0.1	-12.9	-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	4.4
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

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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

