



Weekly Market Comment

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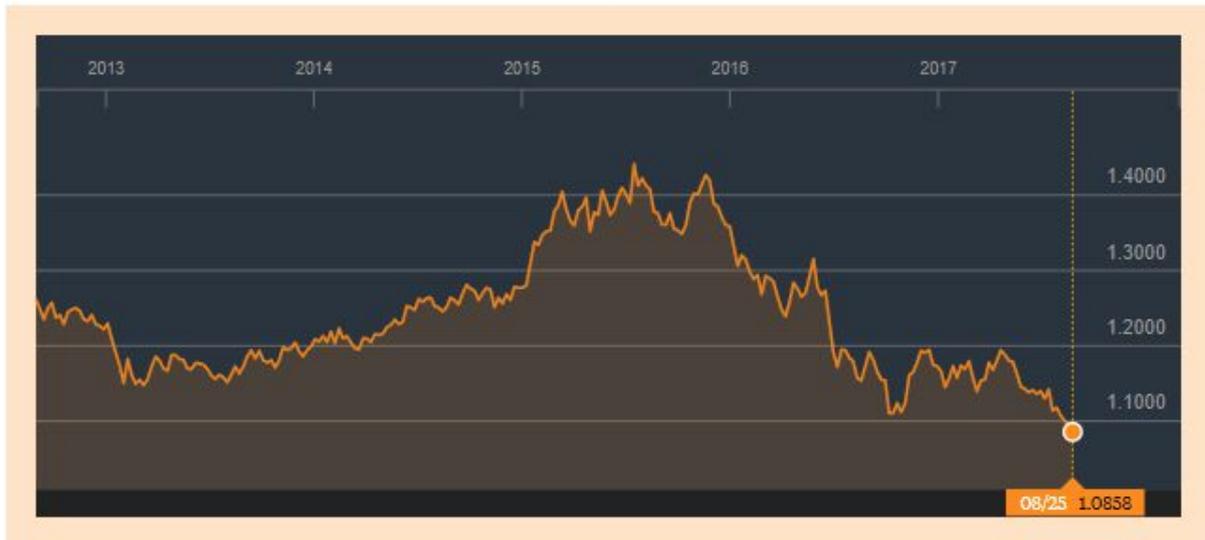
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£-Sterling exchange rate to the €-Euro; Source: Bloomberg.com 25 August 2017

Summer low or summer lull?

The past week brought a stabilisation of stock markets, as buyers returned to buy the latest dip. It would seem that despite the looming announcement of the reversal of QE by the US Fed (probably September) investors worldwide continue to have confidence that markets will not collapse as a result.

Macro-economic data releases provided support for such a view with the latest readings confirming that global economic growth remains firmly on track. Forward looking activity indicators in the form of the purchasing manager indices (PMIs) reported healthy levels of activity growth, with further acceleration still observable in the Eurozone, which is clearly taking over the growth baton from the US where waning business exuberance for Trump policy potential is leading to a first slight deceleration in the manufacturing sector.

On the back of this, Bloomberg, the global financial data, research and news provider expects 2017 global growth to accelerate to 3.4%, following the 3.1% reading for 2016.

The proverbial fly in the ointment for domestic UK assets was that £-Sterling hit a new low in its external value to other leading currencies (see chart above against the €-Euro), which can be interpreted as a no confidence vote of markets for the near-term future of the UK's economic progress relative to the rest of the world. We look at this in more detail in a separate article and note that this latest decline may be no more and no less than a wider realisation that the UK's economic progress has begun to diverge from the rest of Europe because of uncertainty over our future trade relationship with the rest of the block.

While we are currently likewise not the greatest fans of the UK stock market relative to the Eurozone and other global regions, we wonder whether this sudden renewed focus on the UK's currency actually marks the end of this currency depreciation round, rather than the beginning of another.

While thoroughly unwelcome by all holiday makers from the UK, the lower value of £-Sterling also has its benefits for the economy, particularly in respect to export competitiveness and foreign investment.

This latest decline that started in April/May now amounts to roughly 10% and brings the total fall of the UK's currency since the Brexit vote to around 25%. At this level UK business and other fixed assets are looking far more attractive to foreign buyers than those in the Eurozone and elsewhere, even with the looming Brexit uncertainty. Export growth on the back of the improved pricing position has so far disappointed, but the recent pick up in industrial production and manufacturing PMI readings suggest that there may have been a longer lag in this coming through than initially expected.

We therefore anticipate that we may well have reached the trough of the 2017 UK activity decline and that it is more likely to get better from here to the end of the year, than worse.

The bigger concern for investment portfolio returns between now and year end is how capital markets will react to the aforementioned reduction of QE asset volumes by the US central bank, the Fed. It would be reasonable to expect that if QE had a positive impact on the development of asset values when it was in full swing, that its reduction will constitute a headwind to further upside in asset values.

This is broadly our expectation, although as we have commented on these pages in the past at length, this is likely to affect fixed interest bonds far more than equities. While rising yields rob bonds almost entirely of medium term upside potential to their capital value, growing company earnings can continue to provide valuation support for equities.

However, for the near-term the more imminent question is whether markets will experience a repeat of the 2013 taper tantrum, when both bond and equity values fell, when the Fed first announced that the time had come to gradually reduce any additional QE asset purchases. We got a timely reminder of this scenario back in June, however, it was quite brief and not very severe. It is therefore quite possible that history will not repeat and instead equity markets simply trade sideways until the economic impact becomes clear.

The economic impact is what will really count and here, from my vantage point three schools of thought are being most discussed. The first suggests that as long as central banks proceed with caution and plenty of pre-warning, broader financial condition should not tighten unduly because the improving economic environment, which necessitates the QE reduction in the first place, accelerates the turnover of money enough to compensate for the overall volume reduction of liquidity through the QE unwind. Thus, economic conditions should not deteriorate, but further asset price inflation beyond reasonable valuation levels should find less (liquidity) fuel.

The second view is even more straight forward and suggests, that since QE never really improved economic conditions in the first place and only inflated asset price, its gradual withdrawal will have equally nil impact on the economy and only reign in runaway valuations. While we beg to differ somewhat, the outcome would be the same than if we followed the first argument.

The third is the view of the doom and gloom mongers, who predict a collapse of bond markets, which triggers the second global financial crisis in just 10 years. We see this as highly unlikely, given the recent, very cautious track record of central bankers and would be concerned that on the

opposite, interest rate and yield curve normalisation progress might prove too slow, opening up more substantial pressures to general price inflation further down the line.

As usual our view at Tatton is somewhere in the middle. We don't expect major negative impacts on the global economy, but anticipate increased short term market volatility. This could be heightened to more disruptive levels through the unfortunate coinciding of any major geo-political crisis, be that from the side of the North Korea tensions or any rash global trade suppression from an increasingly ineffective US president Trump.

Undoubtedly equity investors are on edge (despite low general volatility readings) as three UK FTSE100 companies found out quite painfully this week. Profit warnings by international advertising agency WPP Plc led to their share price plummeting 12.5%, while Dixon Carphone warehouse Plc lost a staggering 32% on theirs, citing less consumer appetite for the latest mobile phone. Truly exceptional was the up to 75% share price collapse of subprime lender Provident Financial Plc, who were hapless enough to be able to combine every bit of current investor concern in one single company update.

That the FTSE nevertheless closed up for the week underpins our medium term central case of a resilient overall economy and stock market.

Clearly, however, investors have also begun to apply far more scrutiny to individual company fortunes, now that with higher cost of capital on the horizon, plastering over poor performance or even the survival of 'zombie' companies will be so much harder than during the era of 'easy money'.

This may provide a much needed boost to lagging productivity levels through better allocation of capital but could potentially lead to disappointment for purely passive equity market investors.

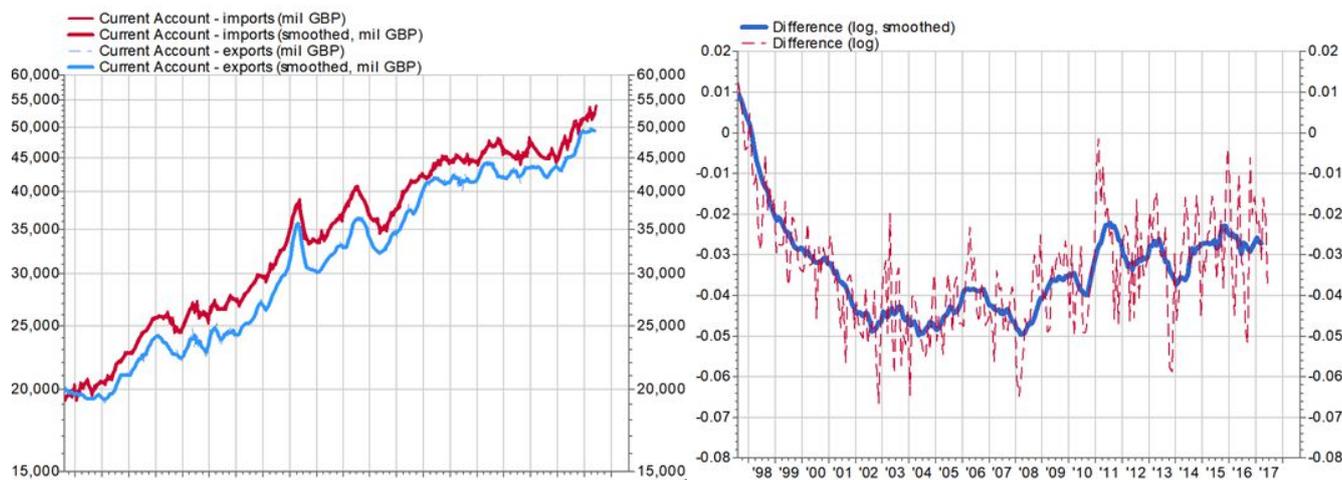
Latest £-Sterling weakness a bad economic omen?

Rather poetically, just as the symbolic chime of Big Ben fell silent on the capital this week, £-Sterling came under renewed pressure, hitting lows not seen since October 2016.

On a trade-weighted basis against a basket of the main global currencies, sterling touched 74.70, only a short hop from the 30-year support level of 73.65. Against the US dollar, the pound is at a two-month low, while against the Euro things are even more dramatic, with sterling at an eight-year low against the common currency.

The falling external value of the pound can be seen as a further 'thumbs down' from capital markets for the short-term prospects of the UK economy. Indeed, a gloomy UK economic outlook by global investment bank UBS, which was widely cited in the press, even suggested that the UK's economy may be doing worse than currently observed.

The low sterling valuation has undeniably made UK exports more price competitive abroad. But, without certainty over Brexit, business confidence remains depressed, which prevents much needed business investment. This, together with slowing UK consumer demand (a result of currency-induced inflation), has led to the mixed-to-disappointing economic news. The improved export competitiveness, meanwhile, is either lagging or simply hasn't led to increased activity levels as expected.



Source: FactSet

However, prospects might not be as gloomy as they appear. We see encouraging improvements in the UK's current account deficit trend (see chart above). The left chart is looking at the UK's external accounts, but because both exports and imports have grown quicker than GDP, the size of the current account deficit has naturally increased relative to GDP. While the right chart shows the difference of the external account normalised against UK GDP, which shows that actually the trend of current account deficit trend is relatively getting better, not worse.

In the short-term, the deficit may deteriorate, as the toll of higher import costs bite. But, in the medium-term, a lower sterling and a softer Brexit approach may well make UK Plc more attractive to FDI (Foreign Direct Investment).

Immigration – often cited as a key driver of Brexit – should naturally fall, as economic migrants may well be more attracted by the improving European economies and their stronger €-Euro. This would mean that the UK's Balance of Payments would also improve, as fewer foreign workers would be sending wages home.

In previous editions, we have observed for a while that the UK economy is slowing to stall speed. Now, it seems that international capital markets have finally caught up with economic reality as well. While a short-term pick up in exports will help improve the UK's current account deficit, we are still lacking the 'shot in the arm' that comes from sustained longer-term investment.

Perhaps it is pure coincidence, but it would appear that politicians have finally understood the messages that both the markets and business leaders have been delivering. Business has become more vocal, calling for more certainty around Brexit, along with possible transition stages as part of the exit process.

The weak pound may have provided the necessary wake-up call, but a lack of long-term investment – and data suggesting that businesses are indeed right – may have helped to soften the government’s ‘hard’ Brexit stance.

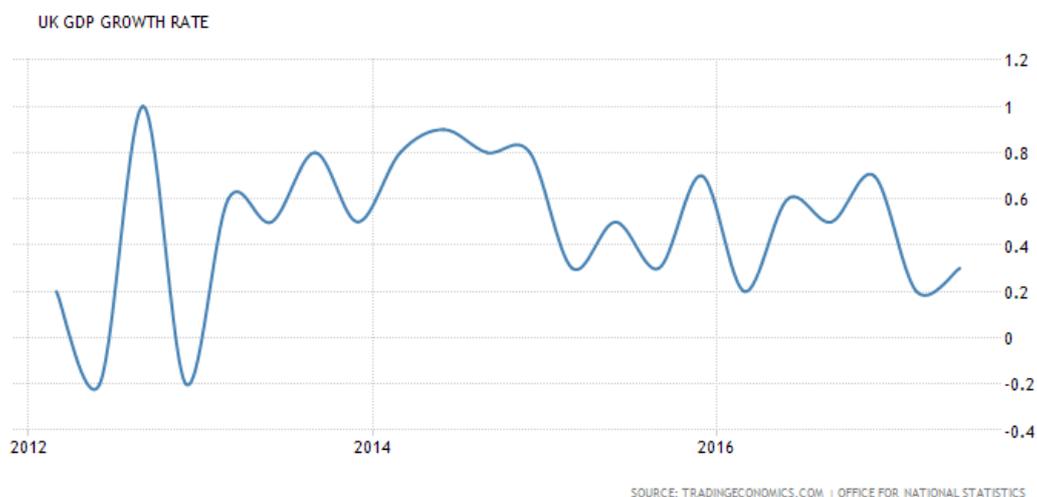
Besides these factors, there are further tangible positives and negatives of a lower pound for the UK economy.

The most notable beneficiaries of a weak pound are the industries of tourism, exports, film production (money comes in as production is cheaper) and even financial and business services – where the country has a comparative advantage. The negatives of a lower external pound value have already been felt by consumers, holiday makers and businesses relying on overseas inputs.

However, despite all the Brexit uncertainty, international business leaders and investors may begin to see value in the UK business assets which, from their currencies’ perspectives, are now trading at much lower valuations. Anecdotally, estate agents have told us that Chinese interest in UK property is rising once more.

As a result, the Pound may have found its short-term base. It might even be deemed cheap and oversold, particularly in light of the apparent softening of the government’s stance on Brexit, as well as the positive (albeit slow) economic growth and the gradual improvements in the UK’s current account position.

While it is certainly true that growth in the first two quarters of the year has been trending lower, employment, overall spending and house prices have all held up well in the face of Brexit uncertainties.



This week, the UK’s Office for National Statistics (ONS) confirmed that GDP grew just 0.3% in Q2. Higher than expected government spending and capital investment helped offset some negative impacts on household budgets from currency-related inflation. Indeed, the news this week that German discounter Lidl’s market share overtook that of Waitrose would lend support to that idea.

Even with the modest Q2 reading, the UK is still expected to expand 1.5% in 2017, which is 0.3 percentage points lower than the 1.8% rate of growth in 2016.

Consumer spending has been one of the key pillars behind the UK’s economic resilience in the wake of last year’s vote to leave the European Union. Households have drawn upon savings to

support spending and perhaps the new pension flexibility rules have helped release some cash into the economy.

The weak pound could also help to address some of the UK's problem of poor productivity, simply by making labour cheaper in the international arena. That does not let the country off the hook, however. The root cause of low productivity still needs to be solved, possibly through increased education and professional training spending, as well as further thoughtful and targeted infrastructure spending (not wasteful 'tent pole' projects).

Our enthusiasm for UK assets is restrained in the short-term, but we are beginning to see the currency as potentially undervalued. When business, economists and politicians all start talking the same language, real progress can be made in the long-run.

The fall in the pound does not tell the whole story. Things are not as bad as they may seem and perhaps, in four years' time, when Big Ben's silence breaks, the UK's economic foundations will be on a more solid footing.

The world's central bankers meet at Jackson Hole, Wyoming

Those with one eye on central bank news will have noticed a great deal of press attention around a small town in the Western US. This weekend will see the annual Economic Policy Symposium in Jackson Hole, which since 1982 has hosted a plethora of international central bankers, government officials and economists. The central bankers are invariably the key players at the yearly policy forum, to the point where the Jackson Hole symposium has effectively come to be known as a 'central banker meetup'. The event is even sponsored by the Federal Reserve of Kansas City.

This is why the meeting garners so much attention. In the past, Jackson Hole has been used as a Launchpad for new ideas in monetary policy governance. Former Federal Reserve (Fed) chair Ben Bernanke used his 2010 speech at the mountain resort to introduce the second round of extraordinary monetary easing in the form of quantitative easing (QE). His speech the following year prefigured the Fed's so-called 'operation twist' – whereby the proceeds of short-term treasury bill sales were 'recycled' to buy long-term treasury notes, thereby putting downward pressure onto longer maturity cost of capital.

Often the noises coming out of the Wyoming resort signal the future direction of both US and global central bank policy, particularly the major changes on the horizon. As such, markets go on high alert when the summer meetup rolls around, looking for any hints as to the future intentions of the world's leading economic policy-makers.

Besides the fact that the get-together sees the heads of global central banks come together, Jackson Hole's reputation as a market mover is also greatly enhanced by its timing – coming in the slow summer months when markets are 'taking their holidays' and so news is often thin on the ground. Yet, the current meeting has undoubtedly garnered more attention than any for quite some time. Why?

Well, the hot topic on everyone's lips this time around is QE, more importantly its looming end and the consequences for global finance. Officially, 2017's symposium is entitled "Fostering a Dynamic

Global Economy”, and the focus of the big-hitters’ speeches will be on financial stability, and how monetary policy can help promote it going forward. But, judging by recent market comment, investment professionals can’t help but feel that the discussion of financial stability might be a pretext for a more-aggressive-than-expected reduction of central banks’ balance sheets. It has been clear for a while now that central bank heads want the era of extraordinarily accommodative financial conditions to come to an end. The monetary-tightening cycle that the Fed began (and that the ECB will soon follow) back in 2015 is part of that, but arguably more important (from an investment perspective) is the unwinding of central bank asset holdings by the US Fed and reduction to 0 of further QE asset purchases by the European Central Bank (ECB).

The record highs seen recently in equity markets has led to concerns that the era of loose monetary policy has inflated asset prices beyond sensible valuation levels, making them vulnerable to shocks and thus, leading to renewed financial instabilities. In particular, Fed vice-chair Stanley Fischer told the Financial Times earlier this month that he didn’t understand why equity valuations were still rising in the face of the Fed’s tightening cycle and deterioration of factors which had previously buoyed markets (read the exuberance of the ‘Trump trade’ and the subsequent lacklustre Republican attempts at tax reform). Indeed, general financial conditions are looser now than when the Fed began tightening in 2015 (we reported). But, with inflation persistently undershooting the Fed’s target, there are worries that the blunt tool of interest-rate-setting might be too clumsy to address the issue, potentially killing off economic momentum. Hence why the focus is on using the unwinding of QE to reverse some of the original effect of successfully underpinning asset price growth and ensuring financial conditions recovery from the mire seen after the 2008/2009 Global Financial Crisis (GFC).

Despite all this, however, not many expect any outright signals of major policy change. The big discussions at Jackson Hole happen behind closed doors, so markets are more looking for signals than outright speeches. Besides, the general direction of monetary policy is pretty much fixed (barring any major unforeseen disturbances) for the foreseeable future. The only question is the rate of tightening, and this has some observers nervous. According to UBS chief investment strategist Mike Ryan, “the concern has always been that they’d do it in a manner that’s going to be disruptive to the markets”. One topic that will surely be up for debate in Wyoming is what the ‘natural’ interest rate now is – the interest rate at which the economy won’t accelerate or won’t decelerate.

Despite its international status, the Jackson Hole forum is first and foremost a Fed event, concerned with the future of Fed policy. The fact that central bankers from around the world come to talk and speak is effectively recognition from the Fed of their importance to the global economy. However, this time around a great deal of attention has been paid to European Central Bank (ECB) head Mario Draghi. The Eurozone economy has been going strong for a while now and recent data has helped to underpin that assessment. Like in the US, there is now a recognition that the ‘good times’ of low rates and QE can only last so long, and so guidance from Draghi is important due to the potential ripple effect of ECB policy worldwide. On his part, Draghi has been coy in the build-up to this weekend’s events, giving nothing away about ECB policy in a speech in Germany earlier this week.

On the whole, we don’t expect that any major changes will be announced in Jackson Hole. The unwinding of QE is already on the horizon, and central bankers will be wary of giving markets a scare when trading is thin for the summer. But, the big conversations will undoubtedly be had, and

could potentially have a large impact further down the line. The key thing to watch this coming week and in the coming months will be changes in tone from central bank communications.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7407.1	1.1	83.1	↗
FTSE 250	19686.3	0.3	59.8	↗
FTSE AS	4057.6	1.0	38.9	↗
FTSE Small	5671.9	0.3	19.2	↗
CAC	5107.0	-0.1	-7.1	↗
DAX	12169.1	0.0	3.9	↗
Dow	21833.3	0.7	158.8	↗
S&P 500	2442.9	0.7	17.4	↗
Nasdaq	5827.3	0.6	36.4	↗
Nikkei	19452.6	-0.1	-17.8	↗

Top 5 Gainers

COMPANY	%	COMPANY	%
HIKMA PHARMACEUT	15.0	PROVIDENT FINANC	-50.8
RIO TINTO	7.1	DIXONS CARPHONE	-25.3
MICRO FOCUS INTERN	6.7	WPP	-7.9
BHP BILLITON	6.6	EASYJET	-5.7
ANGLO AMERICAN	4.9	PADDY POWER BETF	-5.4

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	18.8	Brazil	206.9
US	29.5	Russia	157.3
France	18.6	China	65.2
Germany	14.1	South Korea	63.1
Japan	25.2	South Africa	185.0

Currencies

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.29	0.07	OIL	52.2	-0.9
USD/EUR	1.19	0.95	GOLD	1292.1	0.6
JPY/USD	109.21	-0.03	SILVER	17.1	0.7
GBP/EUR	0.92	-0.91	COPPER	306.1	3.3
JPY/GBP	6.65	0.36	ALUMIN	2106.0	1.4

Commodities

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.1	-3.6	-0.04
US 10-Yr	2.2	-1.0	-0.02
French 10-Yr	0.7	-1.8	-0.01
German 10-Yr	0.4	-7.7	-0.03
Japanese 10-Yr	0.0	-42.4	-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	2.0
Standard Variable	4.3
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

For any questions, as always, please ask!

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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.

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