Tatton
Investment Management

The Tatton Weekly

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Source: David Pope - Dog's Brexit - Political Cartoon Gallery, 11 July 2018

Trump's trade wars - Hard Brexit demonstration potential?

What a week of drama and upset! For all the drama in the football, the political and global economic side were even more dramatic – at least from an investment managers' point of view.

We had suggested last week that the UK government may experience some staffing changes, even when it looked like Theresa May had finally managed to rally her cabinet behind a more economically pragmatic Brexit course. In the overseas press, the resignations of Davis and Johnson over the weekend and Monday were therefore seen as a major setback to May's leadership. But in the UK, it appeared to be interpreted more as a chance for stabilisation and at long last the possibility of beginning negotiations with the EU rather than having them primarily in the cabinet.

Together with the publication of the government's white paper / plan for the UK's Brexit, it now seems almost inevitable that there will not be a substantial break away from the EU when Brexit formally occurs in March 2019. Instead, and as we have now predicted for a while on these pages, it will be a rather soft affair initially, with everything else being developed, negotiated and executed over many years thereafter. This should effectively allow the UK to exit without a sudden shock to businesses and travel while initially at least continuing to enjoy the benefits of being a member of the world's largest free trade zone for a while longer.

Speaking of free trade benefits, Donald Trump's decision to engage the rest of the world in a full-on trade war may actually provide us with a live demonstration of the economic impact of having to trade under significant tariff burdens. The real drama was not Trump's ability to absolutely upset every one of the US' hitherto allies, but his insistence on escalating the trade war with China. Knowing how sensitive the Chinese public is to any perception of being pushed around by imperial powers of old, it would seem to us that he may have to go rather further down the road of confrontation than he believes. The November US Midterm Elections also provide us with a time frame of how long it might last until he can reign back in trade hostilities without losing face with his electorate.

It is common knowledge that there are only losers in trade wars. This may also explain why stock markets still refuse to price in any collateral damage that would occur to the US economy; they don't really think Trump will go through wit it . China's current stock market correction is unlikely to be a one-sided reflection of who investors see as the likely losing side, but much more the manifestation of slowing growth in China and a realisation that this time the Chinese government is less likely to prop up markets through excessive demand stimulus as they have in the past.

All in all then a mixed picture. A somewhat improving near term outlook for the UK, but a distinct risk if global economic shock on the global trade horizon. At Tatton we have used the week to take stock of everything that is known, reported or projected and have weighed it against our own insights, experience of 30 or more years in economic and capital market dynamics and investment portfolio management knowledge. This will lead to some allocation changes over the coming weeks, although perhaps less drastic than some readers may expect given the drama described above. After all – our main experience is that in the end, outcomes tend to be much less dramatic than what we may come to expect when we play through everything that could possibly happen. For more please see the main document this week for our investment strategy update.

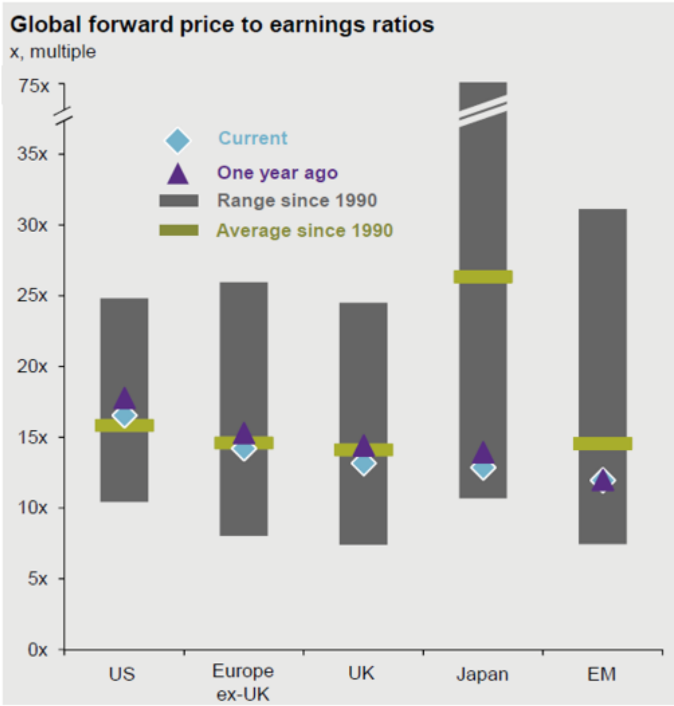
As good as it gets? Investment strategy update

The past week was incredibly busy at Tatton's headquarters in the heart of the City of London. It was investment committee week during which we look at many, many macroeconomic and capital market charts and discuss for many hours to determine whether we should adjust our investment strategy to the changed environment.

We kick-off with a review of how our expectations and portfolio positioning panned out versus our forecasts from the last investment committee around two months ago. This time, it was quite pleasing because most of our expected changes in capital markets came to the fore, and relatively quickly as well. In particular, we had expected the US$ to strengthen further, which we predicted would hurt Emerging Markets, while South East Asia would be additionally set back by demand weakness from China. Meanwhile, US stock markets would do better than the rest.

These expectations were fulfilled and, as a result, underweighting not only Emerging markets, but also South East Asian equities in favour of US equities improved portfolio returns over the period. We had expected better returns across the board from Europe and Japan than materialised, but our fund selection towards more domestically orientated investment exposures paid off nevertheless. In absolute terms, 2018 returns year to date have recovered from their Q1 lows but remain 'pedestrian' – low single digit – compared to 2017.

The big question therefore was where things go from here and whether we should change our portfolio positioning versus the first half of 2018. Our assessment of the status quo is that, thus far, the global economic environment has coped quite well with tightening monetary conditions, the threat of a US led trade war and a higher oil price. Corporate earnings growth rates have therefore remained high. And because profits have risen faster than equity prices, equities are not valued above their historical averages, despite the strong returns they have generated for investors over the past years. The US is the exception to this, but then the US economy is currently also the one with the strongest growth momentum.



Source: IBES, MSCI, Standard & Poor's, Thomson Reuters Datastream, J.P. Morgan Asset Management.

Looking forward, we think stock markets will come to price in a slower rate of growth. The US economy has recently shown signs of a topping out, as it is becoming increasingly harder for companies to fill job vacancies and the cost of capital is rising as a result of the central bank's steady, quarterly raising of interest rates, which have now reached 2%. The deceleration could also be a first sign of business uncertainty in light of Trump's trade war with the rest of the world. Markets may still be largely discounting it to actually happen, given it is accepted wisdom that it is non-sensical to pursue trade wars, but businesses have started to say that they are refraining from certain business investments until the uncertainty around future trading positions clears.

Against this backdrop, we have become more cautious than the current data flow would suggest. We see a higher probability that global trade conditions will worsen, as Trump may have to actually curtail global trade flows for a while or risk losing face ahead of the crucial midterm election in November. At the same time, we note the economic improvement we expected for the Eurozone is materializing in the data. Given the significant domestic demand power of the European consumers, we are optimistic that economic growth momentum here will hold up better – trade war or not. The UK is already experiencing a positive spill-over effect from the European rebound and after the 0% GDP growth between February and April, some positivity has returned to the UK economy.

The dark cloud of a 2019 hard Brexit is also beginning to brighten, after the most recent cabinet changes have provided more evidence in support of our view that the government has run out of time to execute any form of substantial Brexit by March next year. Together with the finally released government white paper for Brexit, it now looks almost certain that next year's article 50 deadline will only result in a very mild departure from the European Union, with everything else having to be worked out over many years to follow (See also the dedicated UK article this week).

This overall assessment has led us to anticipate more downside risk than further upside potential for the highly valued US stock market, while Europe is set for a valuation catch-up to the upside. Given we are already overweight Europe, we have decided that we will reinvest our profit taking from the US to neutralise our current UK equity underweight position. This is on the basis that the unloved UK equity market may actually be best positioned to benefit from the improvements in Europe.

We will, however, retain our overall underweight to equities in portfolios, because we do not yet want to rebuild our emerging market and South East Asia positions, and see a possibility for markets to suffer another correction on adverse trade war news, which may offer selective buying opportunities.

UK a buying opportunity?

Regular readers may be surprised to learn that, within our investment team, we're starting to become more optimistic on UK equities. The fact that we're saying this after a week in which the British government has been engulfed in Brexit turmoil will be even more of a surprise.

First, let's recap. UK stocks have been unloved for some time now – eschewed by both retail and institutional investors. The standard reason given for this unpopularity is Brexit and the various woes it brings; uncertainty over future trading conditions increases the risk premium on UK assets and puts a dampener on the economy. But this isn't the whole story. Even before the referendum result two years ago, UK equities were unpopular among investors. The Investment Association's UK all companies sector has been the worst selling sector every year since 2014.

That unpopularity hasn't been matched by a marked underperformance, however. Until about a year ago, the FTSE 100 index kept pace fairly well with global equity markets. So, what's the issue?

The underlying economy has a long term structural problem. As a services rather than industry dominated economy, the UK used to enjoy considerable overseas export demand for its financial and business services. But since the Financial Crisis, the Global financial services sector has shrunk considerably, and with it the overseas revenues of the UK's vast financial sector. Incremental demand is now focused largely on domestic consumption, which has left the UK with a current account deficit (exports minus imports) of 4.1% of GDP. That's the largest of any developed economy, and well above the US' 2.4% figure that's caused so much uproar from the Trump administration. This, combined with extremely weak productivity growth since the financial crisis and the consequent sluggish wage growth, has meant that consumers have had to run down their savings and rely on artificial creators of wealth (such as the housing market) to keep the economy chugging along.

The Brexit vote was the spark that ignited these issues, with sterling-induced inflation eating away at real wage growth, putting downward pressure on housing-derived wealth and dampening sentiment. And of course, the soap opera we've seen from Whitehall since the referendum has greatly increased the sense of political risk (the resignation of Boris Johnson and talk of a leadership challenge being the latest example).

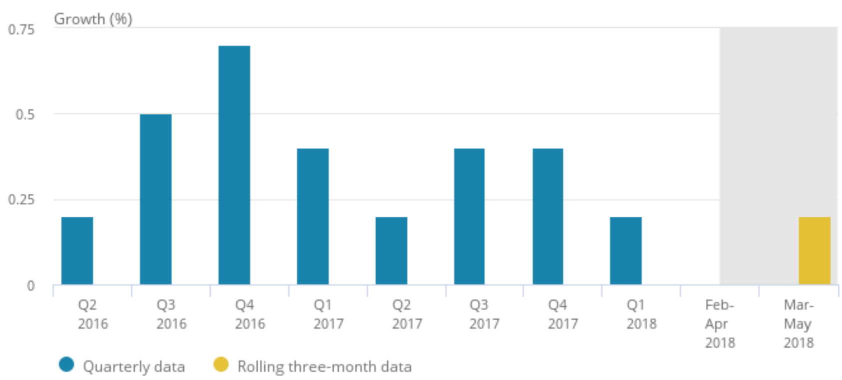
Why are we becoming more positive then? As we have written here before, while falling real wages and the constant drip of stories about companies moving their production abroad is keeping a lid on the British consumer – now the key driver of the economy – broader economic conditions remain supportive. It's no secret that the weak value of sterling since the referendum has been a boon for British exporters, who now have a clear price advantage over their European competitors. That's been one of the main factors propelling the UK over the past two years, which can be seen in how the performance of the manufacturing sector has neatly followed the value of the pound – and the economic fortunes of the rest of Europe which drives demand from there.

This does mean that the UK's growth becomes heavily reliant on demand from Europe, however. Thankfully, as we wrote last week, we seem to be entering into a virtuous cycle for Britain: the strength of the US dollar has weakened the €-Euro which boosts European exporters, which then feeds through to their consumers, leading to demand increases – for British goods. What's more, the weak sterling dynamic is going some way to addressing the aforementioned structural problem for the UK; we are now rebalancing towards more of an export-oriented economy (which itself is rebalancing growth towards the long-ignored regions). And, as long as the political drama looks set to continue, we don't see a strengthening of sterling any time soon, particularly against the euro.

And the rebound in economic activity levels across Europe appears to already be spilling over to the UK. The latest GDP growth data from the ONS (below) shows a return of economic expansion in the newly adopted rolling 3 months figure.

Figure 1: Three-month growth to May increased at the same rate as in Quarter 1 (Jan to Mar) 2018

GDP growth, quarter on quarter and three-months on previous three-months



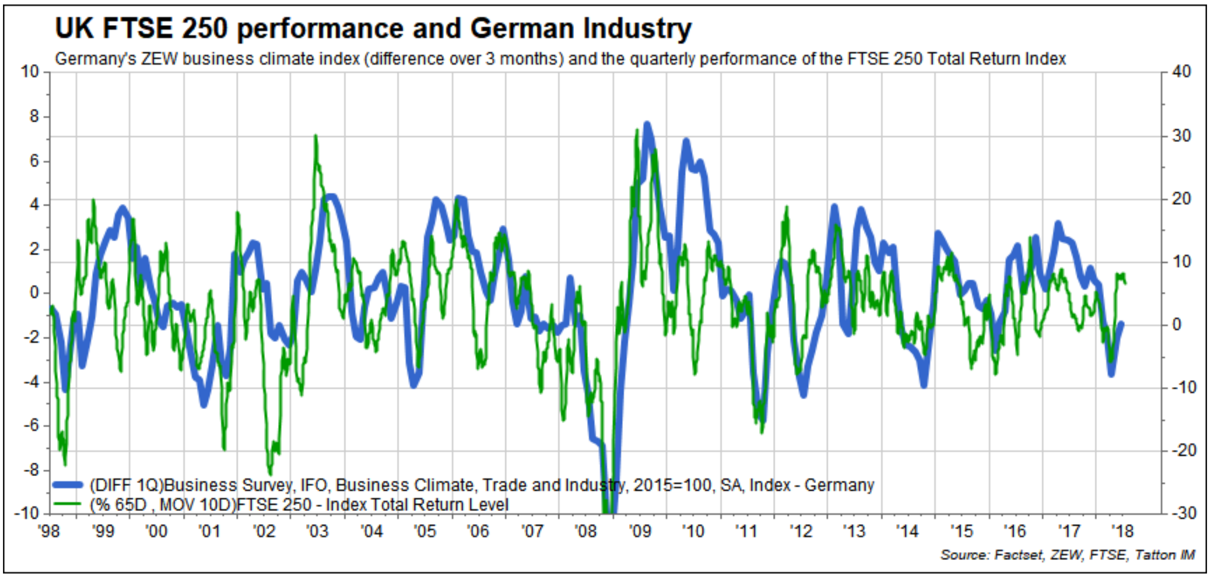
Source: Office for National Statistics

That covers the general macro backdrop, but what of equities specifically? Essentially, we see UK stocks as undervalued, to the point where they are now looking cheap. On a forward price-to-earnings basis, the FTSE 100 has one of the lowest valuations of any major index. Only Germany's DAX and MSCI's Emerging Market index are cheaper. The same is also true on a 10-year average price-to-earnings basis, which has the FTSE 100 as the best valued of developed market indices.

We don't think that the form of Brexit which is now in the pipeline for next year justifies this level of discount. The latest developments provide more evidence that 2019's initial Brexit will be very soft and followed by extended transition period, an outcome we have expected and written about for a while now.

What's more, much as the low value of sterling boosted British exporters, it also initially boosted equities back in H2 2016. When sterling falls it makes stocks cheaper for overseas buyers, which pushes up the price in sterling-terms (as we saw with the FTSE in the weeks following the referendum). More importantly however, it boosts the value of overseas earnings for companies that operate abroad. Domestic investors sometimes forget that more than 75% of earnings for the companies in the FTSE 100 and 50% for the FTSE 250 indices come from overseas.

Positivity about Europe doesn't mean that one should just focus on the overseas earners. While we expect that domestic demand and consumption will be slower than in Europe, UK domestic demand will be underpinned and steady. Employment is tight, wage growth should be constrained but generally showing increases above steady inflation. Thus, we could well see good out-turns for domestic companies that have been suffering from weak consumption. As the graph below shows, the changing fortunes of Germany (and, extension, Europe) have a decided similarity to the changing fortunes of the domestically-focussed FTSE 250.



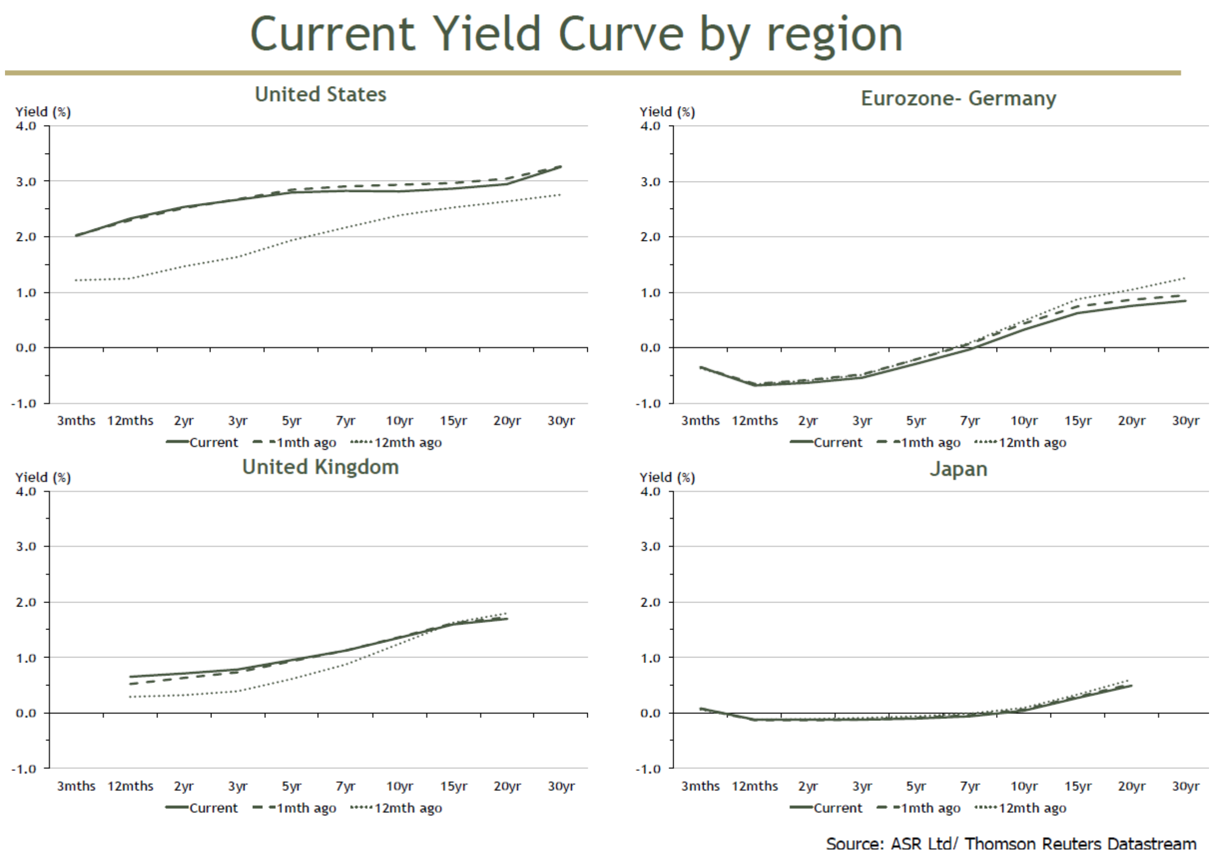
Overall, we believe that, combined with the macro picture and the valuation metrics, this removes our rationale for underweighting the UK in our investment portfolios and presents a buying opportunity. While the UK economy must be expected to continue to lag behind its EU neighbours, due to the lack of business investment confidence, the stock market valuation gap no longer appears justified. The combination of the strengthening of European demand and the prospect of continued – even if only de-facto – membership in the world largest free trade zone mean that UK stocks now offer better potential than many other regions.

Always keep your eye on the curve

We have written about the 'yield curve' a number of times on these pages and its use as an economic indicator. We have also written about the new economic environment we and the world are entering: the very real likelihood of a US vs the rest of the world trade war, the certainty of new UK and the rest of the world trading environment. We like to keep an eye on the yield curve and sometimes both, because it matters.

Why does the yield curve matter? It matters a great deal because it's a measure of the spread (the gap) in yields between longer dated and shorter dated government bonds. The price being paid for investors to retreat to the safety of short term or longer-term government debt indicates their confidence in the growth of the economy. The traditional measure is the difference in yield between Government bonds with two year remaining maturity and ten years. In a growing economy yield curves rise and ten year bonds yield more than two year bonds.

When the yield curves start to flatten and the spread narrows we should normally become very nervous as it is an indicator that growth expectations for the future are souring. For example banks create income by exploiting the spread between long-dated loans and cash deposits that are priced on shorter-term rates – a bigger spread means greater income, a smaller spread damages profits



and makes banks worry about their loan book, retreat from lending, stifling growth and fuel to fire of fear.

If the yield curve inverts - where two year bonds yield more than 10 year bonds – we are normally entering a recession. An inverted yield curve has led all bar one US recession since 1955.

Currently, much is being made in the financial press of the flattening of the yield curves (particularly in the US) and whether this signals a recession ahead. Indeed, this week we saw the minutes from the Federal Reserve in the US and hidden away in the depths was a discussion of this phenomenon as the spread between the two and ten year bonds has narrowed to a current 0.27% having been as high as 0.78% in February.

The Fed actually noted that recent research shows that while an inversion may signal an increased probability of recession, at the critical threshold of zero the probability of recession in the 12 months ahead is still only 24% and with a spread around 0.5% the estimated probability is only 11%, in their eyes “comfortably below the critical threshold”.

For comparison purposes, the same spread in the UK is 0.55%, having flattened from close to 1% in February.

So, are we about to roll out those famous words “it’s different this time”? Perhaps, and perhaps not. We think it’s important to remember than none of these prior curve inversions has occurred in the context of Quantitative Easting (QE - the bond purchase programs) which has undoubtedly driven down yields across the developed markets. This has the knock-on effect of causing many institutions needing to cover income such as insurers or annuity providers, seeking to buy longer dated bonds in a search for stable yield – adding flattening pressure to the yield curve.

With that in mind and the ECB still applying a QE programme until September 2018, yes, it does look like a different environment this time.

Evidence for this was backed up this week by comments from the Governor of the Bank of Canada, Stephen Poloz, who, after raising interest rates, was asked about the impending inversion of the Canadian curve (the two year to ten year spread in Canada is just 0.2%) and if he felt that constituted a warning sign of impending recession? In short his answer was no, he did not. Why? His response was that the flat yield curve has occurred because of an “absolutely huge” demand for long-dated bonds from insurance companies and pension funds and the like.

So, if the Fed and the Bank of Canada are calm about a potential yield inversion, are we as well? Our view is that given all the circumstances and the fact that the curves are yet to invert (and still may not) there seems little to worry about for the next 12 months. We always keep an eye on the yield curve but we don’t think the time has come yet for both.

Banks falling behind: a warning sign?

Banks all over the globe have been struggling this year. Collectively, the global Systemically Important Financial Institutions (SIFIs) monitored by the Financial Stability Board (FSB) lost $800bn in market capitalisation between January and May – almost 18%. Sixteen of the SIFIs are down by more than 20% from their 12-month highs, officially in bear market territory.

On the face of it, this is worrying. Bank share performance is often thought of as a key indicator of the health of the global economy, due to the importance of their lending. The fact that this is occurring at the same time as the US yield curve (the difference between long term and short-term bond yields) is flattening (historically a good predictor of approaching recessions) makes it even more concerning.

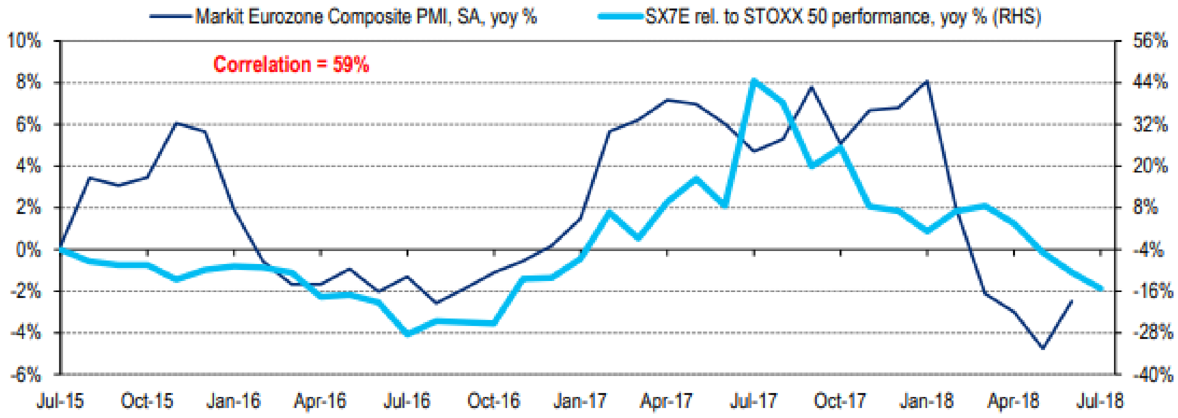
Much like with the yield curve, however, bank prices are not sure-fire signs of economic health. An explanation of why they are behaving as they are is more important. So, why have banks suffered such a miserable time of late?

One of the peculiar things we've noted is that many of the researchers we subscribe to don't seem to have a solid answer to this. Many have noted the weakness and it's potential to spell danger, but a rationale behind these moves has been elusive.

From our point of view, it seems more a case of several disparate problems for different regions rather than one over-arching factor. Firstly, financial stocks had a great 2017, when the expectation of the speed of improvement in their profit making was perhaps slightly overoptimistic. A good part of this year's decline may therefore just be a correction for last year's overshooting. Even without such exuberance in expectations, banks tend to be quite cyclical – performing well when the underlying economy is accelerating and not so well in other times. In particular, they're fairly correlated to changes in the purchasing managers index (PMI) – a forward-looking sentiment indicator.

In the first half of the year, European PMIs slowed from the strong readings they showed last year. They were still firmly in the expansionary territory, but the relative slowdown suggested a wider slowing of growth. As the chart below shows, the price performance of European banks showed similar trends.

Figure 7. Eurozone Composite PMI vs. Banks Performance



Source: DataStream, Citi Research

We think that the relative weakness in Europe for the first half of the year goes some way to explaining why European banks were the hardest hit among the SIFIs. Another likely cause is the scares over the Italian elections and the related issue of non-performing loans. Of those sixteen bear market SIFIs, eight of them are European. Comparatively, there's only one US bank in that list.

That brings us to the next point: regulation. While both the US and EU banking sectors are down from their January peaks, the difference is stark. While European banks have fallen 22% in that time, American banks have lost only 11% of their value. In that period, President Trump has been trying to repeal or alter much of the Dodd-Frank act (imposed in the wake of the financial crisis) to make regulation lighter for banks. In particular, the administration has raised the bar on how big a bank has to be to count as a SIFI. Falling under that bar makes for lighter capital requirements, among other things.

US banks who no longer count as SIFIs have generally outperformed those who haven't. There have been no such regulatory changes in Europe or Asia (another area where banks have been especially struggling), so it looks as though regulatory difficulties may be playing a part here.

For Asian banks, it's likely that a great deal of the stress is coming from the ongoing slowdown in China (three of the sixteen worst off SIFIs are Chinese). In particular, the crackdown on shadow banking and excessive credit is likely having a big impact.

While there is likely to be more pain from Asian lenders, we expect that the outlook for European banks will improve. We see European growth starting to rise as Asia continues to struggle. While not perhaps as dramatically as in the US, private sector credit growth in Europe has picked up and is now matching that of the US (where the growth rate has eased back), while the NPL problem is starting to dissipate somewhat as there are fewer struggling companies, and this should be a positive for banks. In fact, in line with our global outlook, we should probably expect to see Europe's banks take over growth leadership from the US in the second half of the year.

Overall, we don't think that the weakness for banks is in itself a reason to worry. Unlike in 2007, the troubles don't seem to be caused by credit problems; there doesn't seem to be any indication that defaults on loans are rising. Much like the recent moves in the yield curve, it seems to be more noise than signal.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7667.2	0.6	49.5	➔
FTSE 250	20829.6	1.0	211.3	➔
FTSE AS	4216.0	0.7	28.8	➔
FTSE Small	5895.1	0.1	7.1	➔
CAC	5427.8	1.0	52.0	➔
DAX	12547.0	0.4	50.8	➔
Dow	25007.4	2.3	550.9	➔
S&P 500	2802.9	1.6	43.1	➔
Nasdaq	7385.3	2.5	177.9	➔
Nikkei	22597.4	3.7	809.2	➔
MSCI World	2130.9	0.8	17.1	➔
MSCI EM	1070.2	1.0	10.3	➔

Currencies

PRICE	LAST	%1W
USD/GBP	1.32	-0.49
USD/EUR	1.17	-0.63
JPY/USD	112.47	-1.78
GBP/EUR	0.88	0.15
CNY/USD	6.69	-0.73

Commodities

CMDTY	LAST	%1W
OIL	75.4	-2.2
GOLD	1242.6	-1.0
SILVER	15.8	-1.3
COPPER	278.1	-1.5
ALUMIN	2036.0	-2.1

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.3	0.6	0.01
US 10-Yr	2.8	0.5	0.01
French 10-Yr	0.6	-3.3	-0.02
German 10-Yr	0.3	16.8	0.05
Japanese 10-Yr	0.0	21.2	0.01

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	13.7x	12.9x	19.5x
FTSE 250	3.1	17.1x	13.8x	23.5x
FTSE AS	3.9	14.3x	13.0x	19.8x
FTSE Small	3.7	78.8x	11.1x	-
CAC	3.2	17.1x	13.4x	22.7x
DAX	3.1	14.0x	11.8x	21.1x
Dow	2.2	18.6x	14.9x	24.8x
S&P 500	1.8	21.4x	15.9x	29.4x
Nasdaq	0.9	27.0x	19.1x	48.8x
Nikkei	1.8	17.2x	14.3x	31.6x
MSCI World	2.4	18.9x	14.8x	25.5x
MSCI EM	2.6	13.4x	10.7x	18.6x

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.7
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.0
Standard Variable	4.2
1o-yr Fixed Rate	2.8

Top 5 Gainers

COMPANY	%
BARRATT DEVELO	7.2
COCA-COLA HBC AG-DI	6.9
NMC HEALTH	6.6
ASTRAZENECA	6.1
KINGFISHER	6.0

Top 5 Losers

COMPANY	%
SEVERN TRENT	-6.1
UNITED UTILITIES	-5.9
GLENCORE	-4.8
VODAFONE GROUP	-4.8
RANDGOLD RESOUR	-4.1

* LTM = last 12 months' (trailing) earnings; **NTM = Next 12 months' estimated (forward) earnings

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/FactSet 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