The Tatton Weekly

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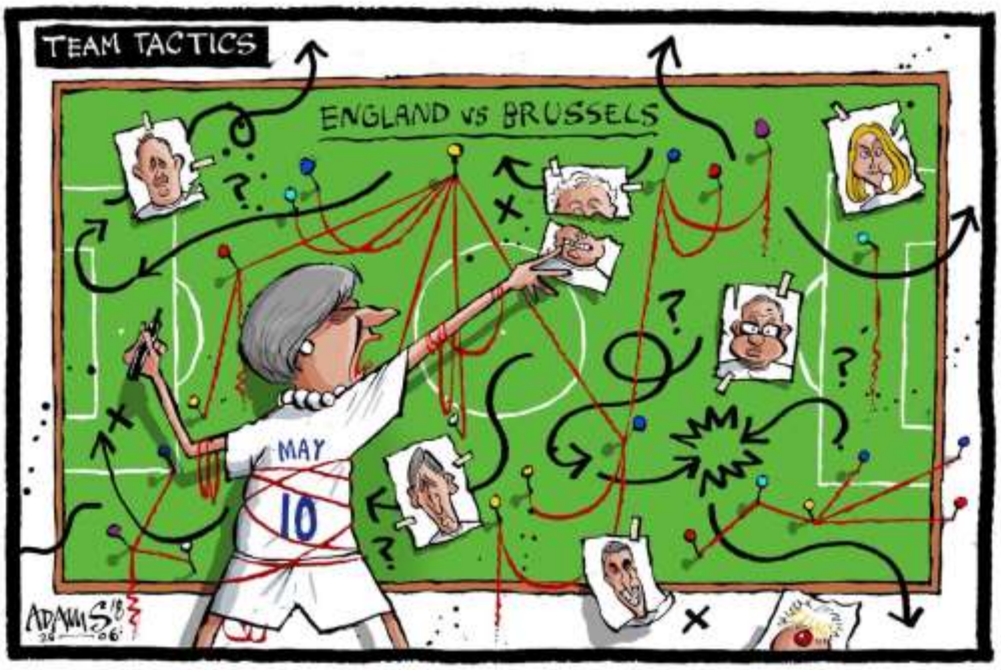


Source: Adams, Political Cartoon Gallery - Team Tactics 28 June 18 - T May and England vs Belgium

Digesting or consolidating?

A lot of digesting of changed realities seemed to be going on over the course of the week, and that is even before we start to talk football – which for obvious reasons I will refrain from!

Despite a lack of market-moving economic or political news, markets recovered some ground towards the end of the week, as concerns over an imminent trade war appeared to abate. It is emerging market equities and in particular China which have borne the brunt of the latest market sell off. It would be reasonable to blame all of this on the Trump administration's playing with 'trade war' fire. However, that has only exacerbated the downward pressure that started with the mass repatriation of US$ following last year's tax reform.

While the severe liquidity shortage in US$ started the headwind for emerging markets, it is China's reluctance to counter through another massive stimulus which is sending investors reeling. We have a separate article this week that explains and discusses these dynamics. We suggest that this trend may have further to run and, despite having fallen substantially already, we are not yet tempted to buy back into emerging markets from the distinct underweight position we've had in portfolios since early March.

In terms of 'Digesting', we observe that businesses have started to plan or take evasive action in reaction to the uncertainty created by politics. They no longer seem to trust that politicians are generally pro-business and understand that their chances for re-election will suffer if the economy suffers. With only 9 months remaining until the UK officially leaves the EU, we are witnessing rare political interference from businesses. This appears to be driven by the realisation that the remaining time is no longer sufficient to execute significant change in management projects, as would be required should the UK's economic links with the rest of Europe change fundamentally, causing significant logistical and process redesign. We believe that much of the political noise coming out of Westminster is caused by the realisation that only either a comprehensive 'good deal' with the EU or a procrastination of the status quo will keep significant harm from the UK's economy. Not a great negotiating position – granted – but not businesses' fault.

US multi-national firms are facing similar uncertainties and they too are beginning to act, as they (just like their UK counterparts) have no choice, due to their need to protect shareholders, other than to take evasive action against adverse political decision or non-decision. Mr Trump's Twitter propaganda attacks will be just as ineffective against such corporate defence mechanisms as Boris Johnson's use of swear words.

In the meantime, the economic data has remained steady. And the corporate earnings forecasts for the industrialised world would suggest that market declines are not yet fundamentally justified. What's more, if Trump's trade war threats were to lead to improved, not worsened trading conditions, then this consolidation could turn out to have created the springboard for the next leg up in markets.

As much as we would like to concur, we would need to see more evidence to support such a stance. For the time being, we think it more likely that the recalibration of market risks and valuations that started in February has not quite run its course, and may quite possibly lead to more volatility over the summer.

Emerging Markets: US$ and China dragging the pack down

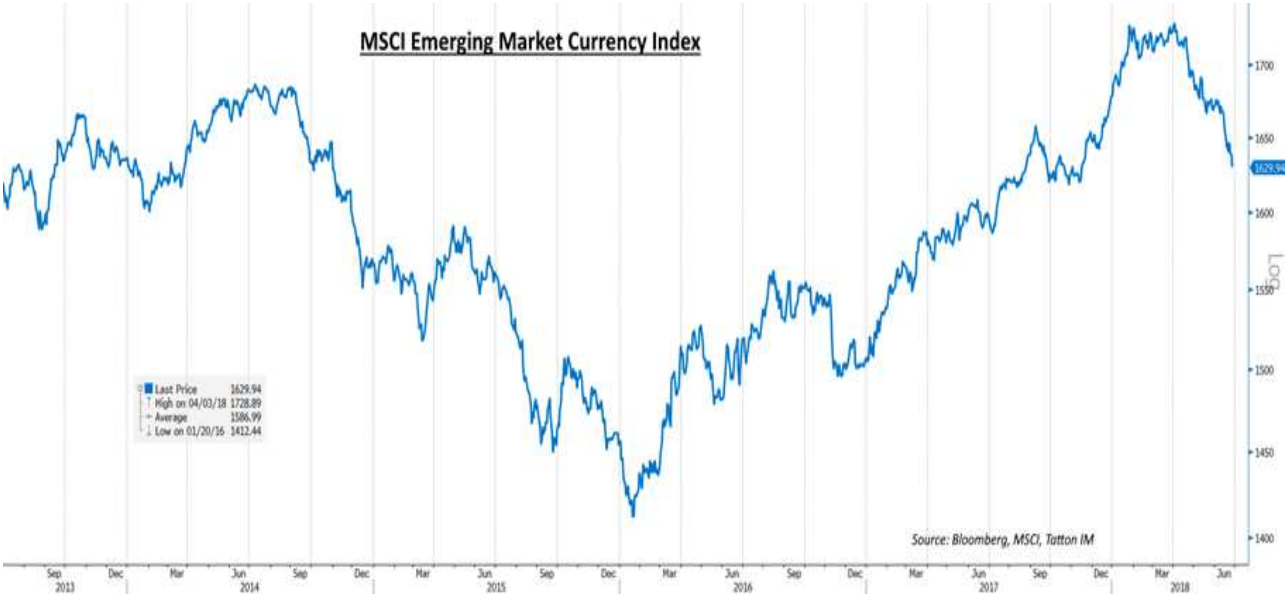
Emerging market (EM) investments have been under strain recently. Wednesday delivered a fresh blow, as both EM currencies and equities took a dive, seemingly prompted by fears over trade tensions with the US. Every EM currency tracked on Bloomberg screens was down, while shares extended a three-day drop to 3.6%.

As we have written here before, the difficulty for EMs is that the global macroeconomic picture is stacked against them. Good US growth may mean demand for their export goods but rising US interest rates, combined with a strong dollar, mean that capital is being drawn away from developing economies and towards the US. Meanwhile, China, the world's second largest single economy and the one to pick up the slack during previous hard times for EMs, is now choosing to deal with long-term problems, and is not so inclined to pull the rest of the pack up.

To stem the flowing capital tide, many developing nations have had to tighten their own monetary policy to prevent further currencies depreciation by keeping up with the US Fed's. Turkey and Argentina have both had to raise interest rates sharply to defend the plummeting values of their currencies. Turkish benchmark rates have increased 5% since April alone and now stand at 17.75%, after the Turkish Lira lost a fifth of its value against the dollar, while Argentina's short-term rates are now at a staggering 40%.

For many EMs, such moves are necessary to defend their international trading positions. But it will undoubtedly put a dampener on growth in the months to come, particularly as rate hikes are outstripping inflation. Despite these factors, we've had investors ask us whether the recent EM sell-off marks a potential buying point. After all, the internal dynamics for many EMs look good. So, are they now cheap?

They're cheaper, but we think probably not yet cheap enough.



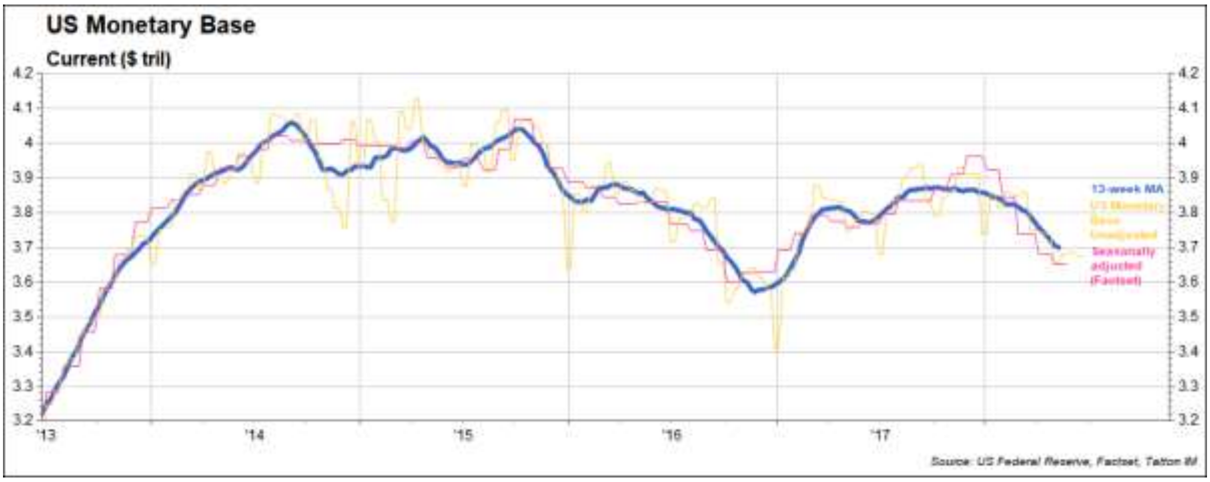
Strong US domestic demand would usually increase the appetite for EM-produced goods and offset the headwinds from higher domestic interest rates. Unfortunately, this time around, the threat of increased trade protectionism from the Trump administration weakens investor sentiment on EMs. And as we've covered in recent weeks, we expect actual trade barriers to only get worse in the coming months.

Trump's plan to impose tariffs of 25% and 10% on steel and aluminium respectively will likely hurt some EMs, such as Brazil (who account for 13% of the US' steel imports) and Mexico (who account for 9%). These particular tariffs likely won't affect China greatly, the main target of Trump's ire, as their metal exports to the US represent less than 1% of total Chinese exports. Other measures that the administration have announced however – such as a 25% tariff on $50bn worth of Chinese exports to the US – very well might.

On this point, our main worry for the future of the US-China trade relationship (the largest between any two nations) is that Trump's goals are less about getting a deal with China and more about halting their development altogether. The more that Trump listens to his trade adviser Peter Navarro – author of "Death by China" – the more likely that becomes. Although, Trump's less aggressive stance towards Chinese foreign direct investment this week might suggest a change of plan.

Are there any shining lights for EMs?

US monetary policy may have stopped tightening in the near-term. The Fed’s weekly data for the monetary base shows a stabilization following a sharp contraction during the first half of the year. Also, while still at relatively elevated levels, the fall back in longer-dated US treasury yields also eases the pressure (US 30-yr has gone from 3.25% to 2.97%). This might cause some speculative “shorting” of EM equities to be reversed.



An interesting point to note recently is that, while all other EM central banks tightened monetary policy to keep pace with the Fed, China effectively loosened monetary conditions by cutting banks’ reserve requirement ratios (RRR). That cut translates to around an extra 500bn yuan for the country’s largest banks, and an extra 200bn yuan for small and mid-sized banks, which could be used to lend to small businesses.

Unfortunately for wider EMs, that freeing up of Chinese liquidity probably won’t be enough to have any significant pull-through effects for them. Simply, the move isn’t big enough. The current weakness in China’s economy – prompted in large part by the government’s reforms cracking down on the shadow banking sector – has clearly prompted officials in Beijing to ease off in their approach slightly, but it seems far more like a stabilizing move than anything else.

The RRR cut pales in comparison to the easing from the government through 2015/16 – which saw a huge expansion of credit and propelled both EM and global growth through the latter stages of 2016. Now, the authorities clearly have no appetite for that level of response, mostly as that was what helped cause the credit excess problems they’re tackling now. Although, further fudged measures along the same lines as the RRR cut wouldn’t be too much of a surprise – particularly considering this week’s warning from a Chinese thinktank of “financial panic” in the world’s second-largest economy (which was quickly removed after its initial website posting).

One thing that Beijing may do is quietly increase regulations that act as capital controls – something they have a history of when they feel their currency is under threat. As we wrote recently, they may also be tempted to sell down their huge stockpile of US bonds if trade tensions worsen. While that would cause an increase in US treasury yields, it might ease credit spreads by providing a supply of US dollars. On balance, such an action would probably not be good news for anyone involved, but Beijing may see it as their only weapon if the Trump administration remains relentless in their anti-China stance.

Whatever the case, China is now acting as somewhat of a dampener on EMs rather than a driver of growth – primarily through its effect on overall investor sentiment. Some EMs might well feel a little hard done by at this; their own economies have looked good recently. But the overall macroeconomic picture is against them. We think it's probably not time to buy just yet.

Businesses finding their voice

Source: Brian Adcock, Political Cartoon Gallery, 23 June 2018
On Liam Fox saying May not bluffing in threat to leave EU without deal

In rare concerted action, businesses and trade unions have started pressuring the government for Brexit assurances this week. The CBI and the TUC – combining with their European counterparts BusinessEurope and ETUC – released a joint statement on Wednesday calling for "pace and urgency in the negotiations" and "measurable progress". In the unprecedented statement, the four organisations – who together represent 45 million workers and 20 million employers across Europe – urged British and European politicians to "put economic interests and people's jobs, rights and livelihoods first."

In these politically charged times, such a public and direct message about Brexit is undoubtedly a bold move – for the CBI in particular, who run the risk of falling into the hard line Brexiteers' crosshairs. But it's in-keeping with a trend we've observed lately: more and more businesses beginning to speak up about their Brexit concerns.

Take Airbus, for example, who recently warned that they may have to move their production outside of the UK unless a satisfactory Brexit deal can be achieved. The fact that the company is making plans for a crash-Brexit scenario isn't surprising, but the fact they've said so publicly is. The Aerospace firm is a major employer in many British regions, and will be wary of the potential for political backlash.

Similarly, the Society of Motor Manufacturers and Traders (SMMT) told Theresa May's government earlier this week that Britain's car industry requires membership of the customs union "as a minimum". "There is no Brexit dividend for our industry," said chief executive Mike Hawes.

This is a significant change in tack. In the build-up to the referendum – and largely since – business leaders appeared hesitant to talk directly about Brexit, wary of the PR maelstrom that such talk can bring (just think about supreme court judges that the tabloids openly called “enemies of the people” for ruling that Parliament needed to vote on Brexit). Apart from a few brief chirps from certain executives – often quickly shouted down by politicians – most have kept their heads down. But now, with the divorce date drawing ever closer and Theresa May’s cabinet still negotiating more within than with Brussels, the potential Brexit losses seem to be forcing businesses to action.

Much as before, however, the responses are similarly dismissive. Health Secretary Jeremy Hunt called Airbus’ warning “completely inappropriate”, as it could undermine the government’s negotiating position with Brussels. Meanwhile, (now former) leader of the Welsh Conservatives Andrew RT Davies – an avid Brexiteer – was highly critical of the company’s decision, calling their claim “hyperbole”. And finally, to put the icing on top, Foreign Secretary Boris Johnson reportedly said “f*** business” to a diplomatic gathering last week.

Unlike before, business leaders don’t seem like backing down any more – as the CBI’s comprehensive statement this week showed. Responding to Mr Hunt’s comments, director of policy at the Institute of Directors Edwin Morgan said “Business leaders have every right to speak up about their needs and concerns”.

What’s more, while indignant responses came from some of the political establishment, the government was quick to show its backing businesses. Mr Davies seems to have lost his job over his Airbus comments, with his unexplained resignation following shortly, along with condemnation from another Tory minister over his “inflammatory” remarks. Similarly, Business Secretary Greg Clark sent a rebuke to his cabinet colleagues by saying that businesses “are entitled to be listened to with respect”, while Johnson has backtracked on his reported comments somewhat.

The reason for businesses finding their Brexit voice and urgently demanding clarity has a lot to do with the ever-closer exit date, which leaves less and less time to plan for what may be substantial process changes to inter-company logistics. While May and co. have managed to secure a few extensions to Britain’s eventual exit from the EU, in terms of concrete policy post-Brexit little seems to have changed; things are as uncertain as ever. Given that, it’s not unreasonable that businesses should start drawing up plans for the worst-case scenario: a “no deal” Brexit. As Mr Morgan puts it, “Firms think very carefully before sticking their heads above the parapet, so they should be listened to by politicians, not dismissed.”

It’s unlikely that companies like Airbus or BMW would float the idea of moving their production abroad as a threat unless they were seriously considering following through with it. Simply from their own corporate governance perspective, firms will need to draw up contingency plans for the various possible Brexit scenarios. Or putting it another way – shareholders these days command better protection of their economic interests than voters. And whereas before business leaders were often told to stop interfering in the political sphere, many now seem to feel that we’re past the point where such matters are ‘just’ political.

It’s also no longer just the UK where companies are losing the support of politicians. US president Trump’s ongoing trade wars with just about everyone are making American companies with global customer bases think twice about where they base themselves. Even Harley-Davidson – the quintessential American manufacturer – is reportedly planning to move production abroad as a response to the administration's tariffs. That provoked a characteristic twitter tirade from the President. “The aura will be gone and they'll be taxed like never before!” proclaimed Trump.

But despite Trump, Hunt and Boris' complaints, the response of companies will inevitably be action to follow these announcements. Interestingly, we shouldn't be surprised if many of the US and UK's disgruntled corporates actually find their way into Europe. Business conditions there remain decidedly pro-business and more stable (Italian elections and Eastern European crypto-dictators notwithstanding), and the underlying growth factors look relatively good. Of course, a mass corporate exodus is still unlikely. But if Brexit uncertainty and Trumpian trade aggression persist, it could well prove to be a boon for the EU.

Whatever the case, we would do well to remember that businesses announce these plans usually because they are genuine plans. While politicians talk about the various Brexit eventualities, businesses are the ones that will have to act on them.

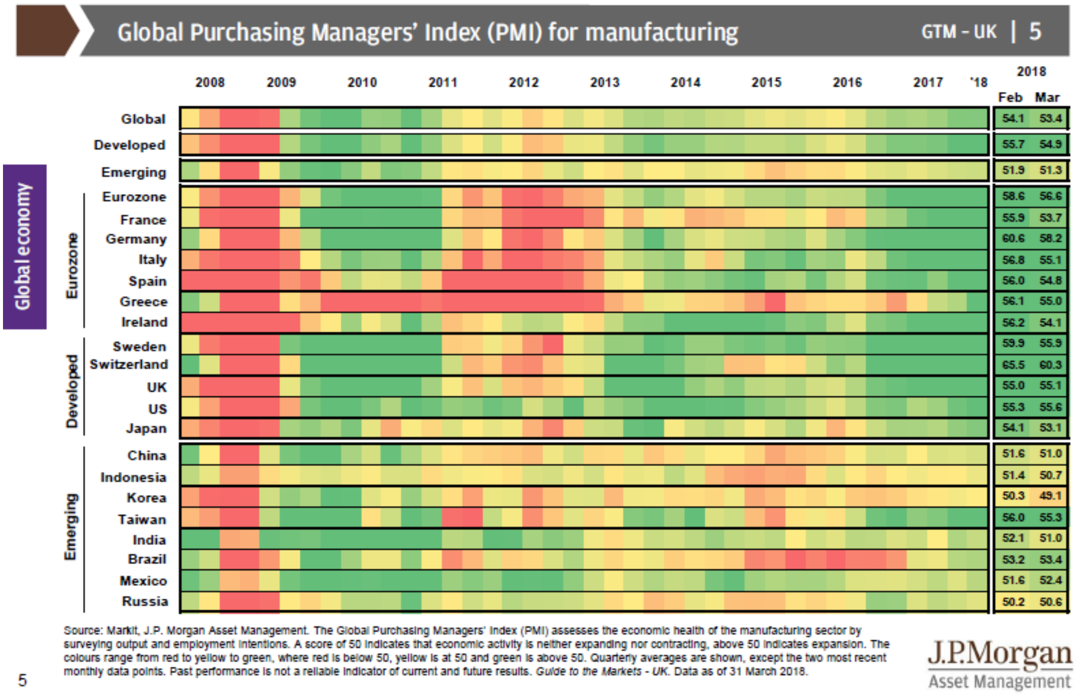
Corporate earnings growth vs trade concerns

With plenty of macro-economic clouds on the horizon, from uncertainties over future trade frameworks to slowing economic growth in China and emerging markets, it is worth having a look at the other end of the spectrum – the micro-economic perspective of corporate earnings.

Here, equity analysts still expect Earnings Per Share (EPS) to rise low double-digits in the US and mid double-digits in both Europe and Japan. If expectations prove correct, then such earnings growth should provide a measure of stability for investors by underpinning stock market valuations.

In terms of the global economy, the US economy has taken growth leadership and fundamentals remain strong, which is supportive for earnings. We note that measures of consumer confidence are at their highest level in over 15 years, exceeding previous highs in the late 1960s and late 1990s (tech bubble). Optimism among small business sits at the highest level in 45 years (only beaten by a single reading in September 1983).

This is also reflected in solid employment. The US unemployment rate stands at 3.8%, the lowest level since the late 1960s, and economists predict further falls to just over 3% in 2019 (lowest since 1953). Europe and Japan are seeing similar improvements in unemployment (Europe 8.5%, Japan 2.5%), which is feeding through into rising domestic demand. Measures of forward looking activity (Purchasing Manager's Indices) suggest the economies of Europe and Japan should remain robust.



As a result of the continued solid corporate and global economic backdrop, analysts have upgraded their forecasts. Below are the current bottom-up EPS estimates. We believe these numbers are a consequence of stronger-than-forecast earnings during both 2017 and 1Q 2018, faster US and global growth, higher oil prices, and a slightly larger boost from US tax reform.

Region	2018	Growth	2019	Growth	2020	Growth
US	$161	21%	$176	9.3%	$192	9.1%
Europe	€ 26.70	12%	€ 28.62	7.2%	€ 30.87	7.9%
Japan	¥128.30	4.6%	¥138.91	8.3%	¥146.67	5.6%

Source: Bloomberg

Such strong earnings growth numbers normally suggest considerable upside to current stock market levels. But with the previously discussed headwinds, earnings growth might not translate into stock market growth. Below, we consider the various ways in which stock markets take rising levels of uncertainty further down the line into account.

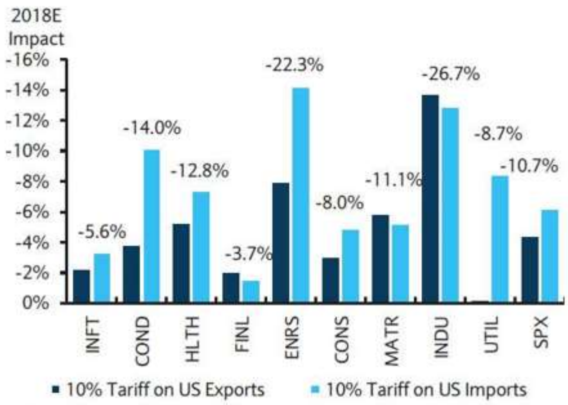
Firstly, valuation multiples – which are positively correlated with investor sentiment – may remain largely unchanged at the end of 2018 versus today's level, or indeed fall further than the 10% they already gave back after January's peak. This is called valuation compression and occurs when earnings growth exceeds share price gains. In this scenario, equity prices may still rise, but their advancement may just not match corresponding earnings growth, leading to potentially lower relative valuations overall – or consolidation of stock market levels without a fall.

Secondly, profit margins may come under pressure. Average US profit margins are currently at record high levels (11%), boosted by lower taxes. The tightness of the US labour market, however, has the potential to increase input costs by accelerating the cost of labour through wage inflation. Tariffs could add further upward pressure on already rising input costs. Margin compression is therefore a real risk. Goldman Sachs calculate that a 50 basis point reduction in 2019 margins could cut around $6 from EPS estimate, resulting in growth of just 3% (instead of 9.3% as in the table above).

An interesting side note on US profitability in particular came from research by Bank of America this week. They suggested that globalisation (offshoring of jobs as global labour markets replaced fairly domestic ones) accounted for 40% of margin expansion over the last 20 years. This is the very catalyst behind the ongoing nationalist/populist tide against the status quo being experienced across the US, UK (Brexit vote) and the Eurozone.

With Trump seemingly intent on igniting a trade war, which would put globalisation in reverse, the most globally-oriented sectors – Tech, Energy, Industrials, Materials – could see both margins and multiples hurt in such a shift. The introduction of tariffs could raise operating costs (i.e. materials prices) for firms and hurt investment (capex intentions). So far, there are no signs of this; capex guidance remains above average and S&P companies have cited capex as their key use of tax reform proceeds in order to overcome the cost pressures from the tight labour market.

Impact of Tariffs vary significantly across sectors…



Source: Barclays Research

Last week, Barclays estimated that the threat to S&P earnings was roughly an 11% drop if 10% tariffs were enacted across the board. Bank of America, using input cost data from the BEA, estimated that a 10% increase in import costs would equate to a 3-4% hit to S&P 500 EPS (assuming foreign sales fall by ≤2%), and a ~50 basis point hit to operating margins.

What about the potential impact of higher interest rates on wider valuations?

The Fed has increased rates seven times since it began the current tightening cycle in December 2015. On current consensus, there are a further two-to-three additional hikes during the second half of 2018, followed by as many as four hikes next year.

Past tightening cycles have led to lower equity valuations but also higher stock prices. During the last three prior hiking regimes (1994, 1999, 2004), S&P 500 PE multiples reduced as rates increased, but this was more than offset by strong earnings growth. Basically, this is the same scenario as above where we discussed the impact of rising uncertainty while corporate earnings are still rising.

Today's hiking cycle appears to be an irregularity because PE multiples have actually expanded from the first hike in December 2015 through January 2018, rising from 17x to 19x. Conventional wisdom suggests that higher interest rates result in lower PE multiples.

The types of sectors that generally do well in above-trend economic growth and rising rates tend to be more cyclical in nature, outperforming defensive sectors. You can think of cyclicals as having a higher beta or correlation to an economy than a wider stock index. Cyclical sectors are primarily: Financials, Industrials, Energy and Materials.

Financials have the strongest positive correlation with rising Treasury yields of any sector or factor because they benefit from both the higher economic activity levels and improving interest margins. In contrast, lower risk “bond proxy” Defensives, such as Utilities, Telecom Services, and Consumer Staples, typically underperform under rising interest rates.

Despite the uncertainty of the past decade, technology shares have shown remarkable resilience to the discussed valuation metrics. This is because investors often have the hope that, with their innovations, technology companies can create demand dynamics which are somewhat immune from the general economic demand determinants, and are therefore willing to pay a premium for them. This may well explain why tech stocks have made such a remarkable recovery from their severe 1st quarter correction.

To conclude, as long as we do not face an actual worldwide economic downturn, which still seems unlikely, it is entirely possible that stock markets will grind higher while at the same time becoming relatively less expensive. This is mainly because current earnings growth would not be expected to continue at quite the same rate into the future and therefore does not lead to proportional reflection in share prices. Such a consolidation phase can make stock markets more resilient, should the negative expectations indeed prove to come true, but they can equally set the basis to the final up-leg of a cycle that is reaching final maturity should the concerns eventually turn out to have been unfounded.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7669.0	-0.2	-13.3	↗
FTSE 250	20840.2	-0.8	-169.7	↗
FTSE AS	4217.6	-0.3	-12.9	↗
FTSE Small	5910.6	-0.9	-55.2	↗
CAC	5348.8	-0.7	-38.6	↗
DAX	12338.9	-1.9	-240.8	↗
Dow	24499.4	-0.3	-81.5	↗
S&P 500	2742.1	-0.5	-12.8	↗
Nasdaq	7094.7	-1.4	-102.9	↗
Nikkei	22304.5	-0.9	-212.3	↗
MSCI World	2079.6	-1.7	-35.3	↗
MSCI EM	1046.7	-3.8	-41.3	↗

Currencies

PRICE	LAST	%1W
USD/GBP	1.32	-0.48
USD/EUR	1.17	0.15
JPY/USD	110.80	-0.75
GBP/EUR	0.88	-0.61
CNY/USD	6.62	-1.70

Commodities

CMDTY	LAST	%1W
OIL	79.5	5.2
GOLD	1251.2	-1.5
SILVER	16.1	-2.0
COPPER	297.0	-2.6
ALUMIN	2143.0	-1.5

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.278	-3.1	-0.04
US 10-Yr	2.849	-1.6	-0.05
French 10-Yr	0.666	-6.1	-0.04
German 10-Yr	0.304	-9.8	-0.03
Japanese 10-Yr	0.036	2.9	0.00

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	13.7x	13.0x	18.9x
FTSE 250	3.1	16.5x	13.1x	23.5x
FTSE AS	3.9	14.3x	13.0x	19.3x
FTSE Small	3.6	67.3x	11.4x	-
CAC	3.2	16.8x	13.3x	21.9x
DAX	3.1	13.7x	11.6x	20.5x
Dow	2.2	18.3x	14.6x	24.2x
S&P 500	1.9	20.9x	15.6x	28.6x
Nasdaq	1	26.0x	18.6x	47.1x

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	2.1
Standard Variable	4.16
Weighted Average Interest Rate (BoE)	1.7
Nationwide Base Rate	2.50
Halifax Standard Variable	3.99

Top 5 Gainers

COMPANY	%
ROLLS-ROYCE HOLDI	5.6
SHIRE	5.1
BAE SYSTEMS	3.8
BHP BILLITON	3.3
SKY	3.3

Top 5 Losers

COMPANY	%
CARNIVAL	-8.1
INTL CONSOLIDATED	-8.0
EASYJET	-6.2
GLENCORE	-5.9
JUST EAT	-5.2

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

For any questions, as always, please ask!

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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