The Tatton Weekly

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Asset class returns to 30 June 2018

Asset Class	Index	June	YTD	12 months
Equities	FTSE 100 (UK)	-0.2	1.7	8.7
	FTSE4Good 50 (UK Ethical Index)	-1	-1	3.5
	MSCI Europe ex-UK	0.1	-3.7	-0.5
	S&P 500 (USA)	1.4	5.2	12.5
	Nikkei 225 (Japan)	-0.5	3.1	13.3
	MSCI All Countries World	0	1.2	7.4
Bonds	FTSE Gilts All Stocks	-0.6	0.4	1.9
	£-Sterling Corporate Bond Index	-0.5	-1.8	0.4
	Barclays Global Aggregate Bond Index	0.3	1	-0.3
Commodities	Goldman Sachs Commodity Index	2.2	13.1	27.9
	Brent Crude Oil Price	3	21.4	59.8
	LBMA Spot Gold Price	-3.3	-1.2	-1
Inflation	UK Consumer Price Index (annual rate)*	-	0.4	2
Cash rates	Libor 3 month GBP	0	0.3	0.4
Property	UK Commercial Property (IPD Index)*	-	2.9	9.2

Data to end of previous month (31/05/18)
Source: Morningstar, 4 Jul 2018

It is getting hot

It was a week with two faces – strong economic data across the developed world on the one side and disruptive political rhetoric on the other. Donald Trump's administration imposed tariffs of 25% on $34 billion worth of Chinese imports and China retaliated in kind. At these volumes, the tariffs are currently not expected to have materially negative consequences to the wider economy. But there is a widespread fear that they are only the opening salvo to a tit-for-tat trade war that would have no winners. It is perhaps this generally accepted insight which has had markets remain surprisingly calm, even when it is entirely unclear how the Trump administration will progress towards negotiations which are neither scheduled yet nor their objectives agreed by a deeply divided team under Trump.

This will sound uncomfortably familiar to our UK audience, who face similar uncertainties over the direction of Brexit. However, at least the UK's Prime Minister appears keen to avert harm from the UK's economy and unite her cabinet behind a comprehensive negotiating strategy – even if that means that she might have to lose some of her most dogmatic cabinet members.

As deeply unpleasant as all this divisiveness around the world may be, there are feeble signs of movement here or there. The European car industry signalled that they are not particularly wedded to the EU import tariffs on US cars, which found German chancellor Angela Merkel's support. She also noted during a visit by Theresa May that Brussels' negotiating approach was perhaps not pragmatic enough to secure a mutually beneficial end result.

Stock markets took the political noise in their stride and posted a mildly positive week. Given Trump's trade war politics and Brexit negotiations are highly unpredictable, and have little influence over the shorter term corporate earnings and the Global economy at large, there was more focus on future interest rate movements, changes in the cost of capital around the world and the likely rate of corporate earnings growth for the past quarter.

The asset class returns table at the top shows that, despite the pronounced return of market volatility during the first 6 months of the year, returns overall are broadly positive. That US stock market returns are leading others has much to do with the strengthening of the US$, driven by the repatriation of large volumes of US multinationals' overseas earnings in the wake of the tax reform. This appears to have also provided a boost to US stocks, as many of the tech companies elected to use some of the cash to buy back shares.

While such effects cannot last, the positive momentum of the US economy is far more likely to carry on into the second half of the year. Similarly, the latest updates from across Europe suggest that the distinct economic slowdown in the first quarter of the year was only temporary and either a counter-reaction to overheating in Q4 2017 or weather and sickness related – but most likely a combination of both. This paints a more positive picture for the economic environment during the second half of the year (H2 2018) than we had dared to predict at the end of last year, when it had seemed that economic conditions would possibly overheat in H1 and then decline in H2.

Unfortunately, that doesn't mean we should expect investment returns to pick up their pace from the fairly pedestrian levels we've seen so far. While improving corporate profits would normally be expected to see markets trend upwards, this could be disrupted by a number of things: higher costs of capital through rate rises, the reversal of QE and the prospect of Trump's deliberate disruption to global trade flows. In such a scenario, investors are less willing to project current earnings conditions into the future, which results at least in a temporary ceiling to market levels and at worst increased levels of volatility, as every piece of news is scrutinised for the medium term impact it might have on the future direction of the economy.

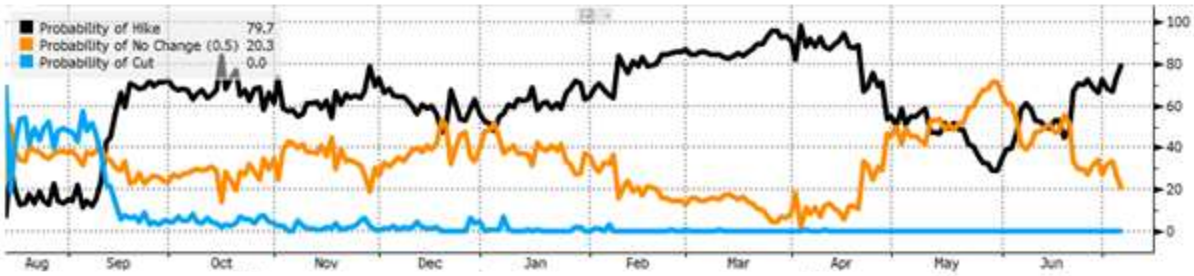
Over the coming months, we will therefore have to watch and observe political change just as much if not more than the economic data flow, even though political action tends to impact the economy only over the much longer term – if at all.

Why we should expect the Bank of England to raise rates

Bank of England governor Mark Carney was upbeat about the UK economy this week. At a speech in Newcastle on Thursday, the BoE chief said that "the incoming data have given me greater confidence that the softness of U.K. activity in the first quarter was largely due to the weather, not the economic climate,"

He went on to say that the economy had developed in line with what the bank expected back in May, with "demand growing at rates slightly above those of supply and domestic cost pressures building." While he wasn't specific about when the central bank's next hike in interest rates would come, he did say that more of the same from the economy would warrant "an ongoing tightening of monetary policy over the next few years would be appropriate to return inflation sustainably to its target,"

Given these comments and the past voting behaviour of the BoE's Monetary Policy Committee (MPC), markets are now pricing in an 80% chance of an interest rate rise at the August meeting, as the chart below shows.



Source: Bloomberg, Tatton 5 July 2018

While we agree that a rate hike is on its way soon from the MPC, we don't quite share the apparent optimism on the UK economy. Mr Carney pointed out that "Indicators of household spending and sentiment have bounced back strongly" from recent weakness. But last week the GfK consumer confidence index fell unexpectedly to a reading of -9, two points down from the previous month. Furthermore, we would argue that the previous drop in household spending seems to have been more down to inflation – from rising petrol prices and a falling pound – rather than the weather.

We don't expect sentiment to improve much in the near term either. The constant drip of stories about firms moving jobs away from the UK because of Brexit uncertainty is likely to stop consumer confidence getting any better than tepid. Given this, we see the UK consumer as more 'stable' than 'strong', and not quite enough to warrant Carney's outlook.

But the economy should still be able to withstand the BoE's next hike. House prices – a key pillar of consumer demand through – are no longer coming under extreme pressure in the southeast, and are in fact increasing in many of the regions. And as long as falls remain small and not destabilising, the MPC will be able to focus on the factor that does seem strong: business confidence.

On that front, things are looking better. A rebound in business sentiment – especially among manufacturers – is visible in the latest data. As we have mentioned before, we believe this is largely to do with the weakness of sterling, which gives British exporters a price advantage over their European competitors. Since the referendum two years ago, the health of manufacturers seems to have neatly followed the value of the pound – strengthening when it falls and weakening when it rises.

Now is no different; the current bout of sterling weakness is helping British businesses. But that's also dependant on the strength of the European consumer. Thankfully, we seem to have entered into a virtuous (albeit uneasy) cycle at the moment: European exporters are being boosted by the €-Euro's recent weakening against the dollar, which in turn boosts their consumers. This then increases demand for British goods, which helps the UK economy.

As long as all these dynamics remain in place, a rate rise from the BoE seems justified. The vote at the MPC's last meeting was unexpectedly close, with BoE Chief Economist Andy Haldane voting for a rise. That suggests a change of view from within the bank's own research, and so we should expect a more upbeat message in August.

One thing to note, however, is that MPC members are characteristically reluctant to opt for a change in monetary policy during August meetings – due to the 'summer holiday' effect. So, while we do expect the MPC to raise rates soon, it might not be until September that we see lift-off.

Whatever the case, the BoE look set to begin their monetary tightening procedure in earnest, and slowly return to the 'old normal' regime in interest rates. That may cause some unexpected teething problems up ahead, but should ultimately be a good thing for the economy, not least because it will gradually remove the risks that arise from the side effects of ultra-cheap credit, like asset bubbles and low incentives to save.

2018 - half way point reflections

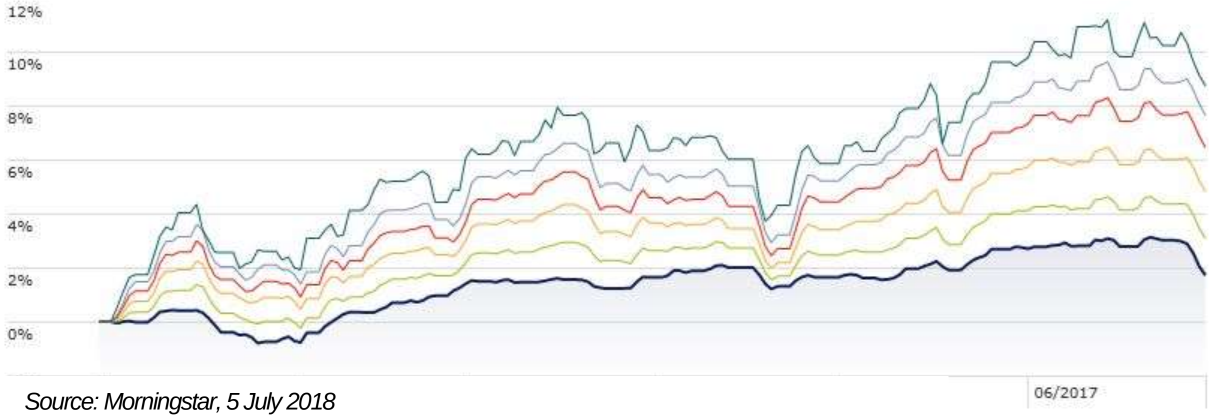
As we have passed the halfway point of 2018, it is worth reviewing how capital markets have fared thus far, how our predictions from last December held up against reality and what the second half of the year may have in store for us.

Firstly, our expectation that markets would get more volatile has certainly come true. This becomes particularly obvious when comparing the H1 2018 performance of typical multi asset portfolios with that of H1 2017, as illustrated in the 2 graphs below.

H1 2018 return path of typical UK risk profiled multi asset portfolios (for illustration only)

Source: Morningstar, 5 July 2018

versus
H1 2017 return path of typical UK risk profiled multi asset portfolios
(for illustration only)



Source: Morningstar, 5 July 2018

While we had not anticipated in December such a sudden correction in the first quarter, we had certainly come to expect it halfway through January, after equity markets had turned exuberant. Q1 was marked by two sell-off phases, the first of which was triggered by concerns of rising inflation from overheating economic conditions. The second, just before Easter, came from the opposite concern. Investors feared that global economic growth was actually consolidating rather than overheating and that central banks would continue to tighten monetary conditions regardless, and thus commit a policy error which could threaten economic progress more fundamentally.

The second quarter saw a stellar recovery over April and May, as very strong corporate earnings (profit) growth rates reassured equity investors that, for the time being at least, stock markets aren't overpriced. It made stocks look more in line with long term valuation multiples than it may have seemed at the beginning of the year.

Risk assets reached new highs in June, despite the fact that, for anybody who looked more closely, it had become apparent that emerging market economies had begun to suffer under higher prices resulting from a resurgent US$, as well as reduced demand from China. On top of this, two more concerns began to sour market sentiment: Donald Trump's trade war rhetoric and ongoing liquidity tightening as a result of a persistent global US$ shortage, itself caused by the repatriation of overseas earnings by US multinationals in the aftermath of Trump's tax reform.

While macro-economic data reports continued to show a burgeoning US economy and the European economy stabilising at a healthy rate of growth, stock markets came off their highs and began to trade sideways. It no longer seemed quite as certain that corporate earnings would continue to grow at their H1 rate.

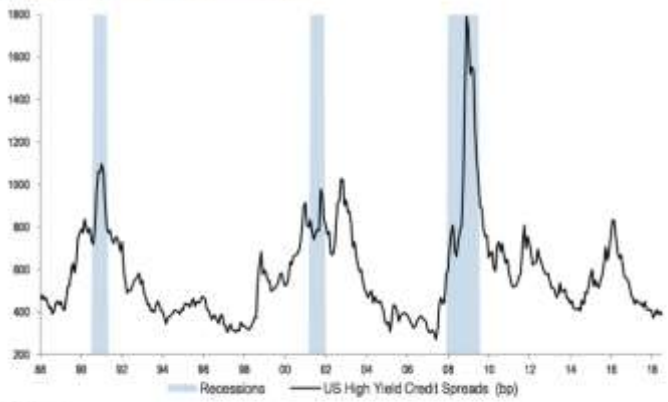
On the investment return side, in Q2, global markets reflected the uncertainty caused by the appreciating dollar and continued trade tensions. In local currency, 16 indices finished in positive territory and 23 in negative.

On a YTD basis, there are 15 indices in positive territory in local currency terms. Oil (West Texas) was the best performer up 22.7%, with China's Shanghai Composite at the other end of the leader board, losing -12.9% - followed closely by Copper (-10.6%), European banks (-9.8%) and EM equities (-6.6%). The US S&P 500 index, with its 2.6% total return, is ahead of most other core equity markets, while the European Stoxx 600 Index (+0.1%) is roughly flat. German Bunds

(+1.6%) have outperformed US Treasuries (-1.1%) so far, while in credit US High Yield (+0.3%) is the only positive returner in the corporate bond world.

Looking ahead to the second half of 2018 (H2 2018), the ingredients are in place for further economic improvements, putting political and trade uncertainties to one side at least. We note that companies globally, but particularly in Europe, continue to see strengthening cash flow generation and historically low funding costs. Furthermore, while monetary policy has tightened, overall financial conditions – driven by commercial banks' credit activity – have loosened, which is the more relevant factor for business funding.

Figure 4: US HY credit spreads and recessions



Source: J.P. Morgan

Corporates, therefore, have robust fundamentals and look to be well placed to drive further expansion. JP Morgan highlight that corporate bond yield spreads, typically an "early warning" signal for deteriorating economic conditions, do not currently suggest a slowdown, as high yield spreads remain contained (see chart above).

Interestingly, JP Morgan also note that 2018 is now the second year in a row where analysts have upgraded their earnings expectations as the year progresses. As the chart below illustrates, these are typically downgraded gradually the course of a year.

Figure 8: MSCI World 2018e EPS trend vs previous years

Source: IBES

When we look at business investment or capex intentions, it would seem that we are nearer the start of an investment cycle, rather than closer to the end. Levels of capex, as a percentage of depreciation expenses, are at lows, currently nearer 2003 levels than 2007 (the end of the last cycle). Tightening labour markets, easy credit conditions and the improved cash flows have in the past indicated that corporate investment should expand.

Against that solid corporate environment, an increasingly upbeat consumer bodes well for the consumer demand side. This is supported by some of the lowest ever unemployment rates in the US labour market and continued wage and employment rate improvements in Europe. Wage growth across much of the world is trending higher, increasing the prospect that consumer demand will continue to improve, while business demand for capital goods is finally returning to previous cycles' levels

Relative to our expectations back in December of last year, the second half of 2018 is looking stronger not weaker. With growth having remained strong in the US and having stabilised across Europe, there is every reason to look more optimistically ahead to H2 2018.

Unfortunately, the combination of the stress that the stronger US$ has put on emerging market economies and the real possibility that Donald Trump's trade war negotiating gamble gets out of hand have also increased uncertainty levels for the remainder of the year. Until growth stabilises across emerging markets and trade wars are defused, stock market valuations are unlikely to go up in line with improving corporate profits, because of fears that they may prove unsustainable.

This means that, for the second half of 2018, there is every reason to expect that economic conditions around the world will continue to be strong, but that investment returns may well lag the rate of progress in actual economic conditions, as investors gauge what likely impact the changed monetary and trade environment may have on future corporate earnings.

India: No longer the darling of emerging markets?

It's been a tough year so far for India. As with many other emerging markets (EMs), the great capital rotation into the US – brought about by strong US growth, tightening monetary policy and a strong dollar – has hurt them. It's put downward pressure on India's Rupee and left the economy short of vital financing, a reflection of India's own problems, not just of EMs as a whole

Last month in fact, Reserve Bank of India (RBI) governor Urjit Patel wrote in the Financial Times (FT) that EMs were going through "upheaval" due to the "double whammy" of the US Fed both raising interest rates and shrinking its bond balance sheet – resulting in a shortage of dollar funding. Like many other EMs, these factors have forced India to tighten its own monetary policy, with the RBI lifting interest rates for the first time in over four years last month.

Mr Patel is right that the global macroeconomic picture is currently stacked against EMs. Unfortunately for India, however, that doesn't explain the whole story. As the chart below shows, Indian government bond yields (in dark blue) have increased even relative to most other EMs.

Since the liberalisation of its economy in the early 1990s, India has often been the darling of EMs, particularly for UK investors. This is understandable, given that India is the world's fastest growing large economy, and is already the third largest single economy in terms of purchasing power parity. It is, however, wracked with its own problems. And the growing recognition of these problems among investors is leading to a dampening of sentiment.

First up is its ailing banking sector. India's banks are struggling under the weight of around $150bn in non-performing loans. That's 11.6% of the nation's total debt load – the second worse ratio in the world behind Italy. Most of this bad debt is in the hands of 21 state-run banks, who control around 70% of the country's banking assets.

India's private banks are doing far better on the NPL front. In fact, over the long term it's likely that the current strains on the banking sector will have a positive effect – as the old inefficient state banks get replaced by private ones. "If you take a 10-year view, currently the private sector banks' market share is 30 percent. Probably it will become 60 percent," says Sukumar Rajah at Franklin Templeton Emerging Market Equity.

But regardless of the long-term benefits, the NPL problem will hamper state banks' ability to lend to the real economy, which will no doubt be a drain in the short term. This goes some way to explaining why Indian government debt has struggled recently, even compared to other EMs. The yield on India's 5-year government bond has risen nearly 2 percentage points since December 2016, the biggest increase in the Asia-Pacific region.

However, as ever with India, another huge factor in all of this is the political side. Corruption and bureaucratic inefficiencies are widespread in the country, and often present serious barriers to growth. Prime Minister Modi's reforms – particularly the tax reform which aimed to simplify and coordinate tax laws across India's many states – were an attempt to address this. Only time will tell whether they'll be successful in the long run, but over the short term they've caused considerable disruption. And in particular, both the infamous 2016 demonetisation and the aforementioned tax reform have made tax collections extremely difficult, which has led to shaky government revenues.

That brings us to another of Modi's policies. The government has recently opted to increase the minimum standard price (MSP) for certain crops to ensure that farmers make at least 50% more than their production costs. It's a popular policy, but it will undoubtedly put even more upward pressure on inflation. And at a time when the government is struggling for revenue, investors are becoming wary about India, and its government bonds in particular.

India's 10-year government bond yields had actually been falling this week, after selling pressures from the country's banks had subsided. But the announcement of the MSP hike broke that rally, and we expect it to remain that way over the near term.

All this leaves the RBI in a difficult position. They'll want to stem rising bond yields (particularly if they climb above 8%), but all the ways of doing this have their own difficulties. Back in May, the central bank tried to tackle the shortage of liquidity in the market by enacting their own program of bond purchases – buying around $1.5bn worth of government bonds.

But using that same tactic now to cap bond yields could have dire effects. It would put even more downward pressure on their currency – which is already the worst performing in Asia this year. With the rupee currently at all-time lows as it is, that would be an unpalatable option for the government, given the upcoming election next year. Since the RBI isn't independent, we can safely say that's unlikely to happen.

The other option would be to go the other way, and tighten monetary policy even further. We've already seen this from other EMs trying to curb spiralling inflation (the most hawkish examples being Turkey and Argentina). But that would have its own undesired effects. It would mean choking off a big chunk of growth, which will only worsen the NPL problem.

Whatever the case, India has lost its shine to many investors. Getting it back will need more than stop-gap RBI policies. A decade ago, addressing the underlying problems would have seemed an impossible task. Now, however, having delivered both the largest demonetarisation and tax reform ever attempted in an economy the size of India, the next government should feel confident to dare.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7617.7	-0.5	-37.4	→
FTSE 250	20618.0	-1.2	-244.0	→
FTSE AS	4178.1	-0.6	-24.1	→
FTSE Small	5887.3	0.2	10.5	→
CAC	5346.8	0.4	23.3	→
DAX	12458.5	1.2	152.5	→
Dow	24405.0	0.8	188.9	→
S&P 500	2748.6	1.2	32.3	→
Nasdaq	7152.7	1.7	121.1	→
Nikkei	21788.1	-2.3	-516.4	→
MSCI World	2096.2	0.3	6.9	→
MSCI EM	1054.3	-1.4	-15.2	→

Currencies

PRICE	LAST	%1W
USD/GBP	1.33	0.42
USD/EUR	1.18	0.59
JPY/USD	110.42	0.31
GBP/EUR	0.89	-0.17
CNY/USD	6.64	-0.32

Commodities

CMDTY	LAST	%1W
OIL	77.0	-3.1
GOLD	1255.5	0.2
SILVER	16.0	-0.8
COPPER	281.1	-5.4
ALUMIN	2092.0	-1.9

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.253	-2.0	-0.03
US 10-Yr	2.820	-1.4	-0.04
French 10-Yr	0.635	-4.5	-0.03
German 10-Yr	0.288	-4.6	-0.01
Japanese 10-Yr	0.033	-8.3	0.00

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	13.6	12.8	19.1
FTSE 250	3.1	17	13.7	23.3
FTSE AS	3.9	14.1	12.9	19.5
FTSE Small	3.7	68.3	11.2	-
CAC	3.2	16.8	13.2	22
DAX	3.1	13.9	11.7	20.4
Dow	2.2	18.2	14.5	24.2
S&P 500	1.9	21	15.6	28.7
Nasdaq	1	26.2	18.6	47.3
Nikkei	1.8	16.7	13.8	30.6
MSCI World	2.4	18.6	14.6	25.1
MSCI EM	2.7	13.2	10.5	18.4

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2 yr Discounted rate 95% LTV	1.6
2-yr Fixed Rate	1.7
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.0
Standard Variable	4.16
10 yr Fixed Rate	2.76

Top 5 Gainers

COMPANY	%
BT GROUP	6.2
JUST EAT	5.2
SEVERN TRENT	4.4
NATIONAL GRID	4.0
MARKS & SPENCER	3.9

Top 5 Losers

COMPANY	%
GLENCORE	-9.5
AB FOODS	-8.7
BARRATT DEVELOPM	-6.3
BERKELEY GROUP	-6.2
SMITH & NEPHEW	-5.9

* 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