The Tatton Weekly

10 August 2018

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Asset class returns to 31 July 2018

Asset Class	Index	July	YTD	12 months
Equities	FTSE 100 (UK) Total Return	1.5	3.2	9.4
	FTSE4Good 50 (UK Ethical Index)	1.8	0.8	3.7
	MSCI Europe ex-UK	4.9	1.1	2.8
	S&P 500 (USA)	4.4	9.8	16.8
	Nikkei 225 (Japan)	0.7	3.9	14.5
	MSCI All Countries World	3.3	4.5	9.6
Bonds	FTSE Gilts All Stocks	-0.4	0.1	1.3
	£-Sterling Corporate Bond Index	0.3	-1.5	-0.1
	Barclays Global Aggregate Bond Index	0.5	1.5	0
Commodities	Goldman Sachs Commodity Index	-2.9	9.8	20.6
	Brent Crude Oil Price	-5.7	14.4	41.5
	LBMA Spot Gold Price	-1.9	-3	-3.2
Inflation	UK Consumer Price Index (annual rate)* End of May	-	0.8	2.5
Cash rates	Libor 3 month GBP	0	0.3	0.4
Property	UK Commercial Property (IPD Index)*	-	3.7	9.1

***Data to end of previous month (30/06/18) All returns in % and GBP: Source Bloomberg**

Summer heat wave makes way for return of political heat

Having returned from my annual summer holiday that took me across the heat-parched landscapes of western Europe, it feels like I have been cheated for the summer lull. As last month's asset class returns table above shows, July turned out to be a decent month for most investors despite all the dark clouds on the economic horizon, be they trade wars, looming Brexit headwinds or Emerging Market stress from US$ strength.

As the summer heat wave made way across much of northern Europe, all the above appear to suddenly have returned to the attention of market participants. It is also bolstered by some additional ones, like the resumption of US sanctions on Iran and a fast deteriorating outlook for the Turkish economy as the Turkish Lira entered a tail-spin as the result of US sanctions. The only bit of adverse news that cannot be blamed on Donald Trump's unorthodox political style was the return of hard Brexit fears.

Interestingly, it was the Brexit aspect more than anything else that seemed to capture the imagination of the UK investors – or at least that was my impression from the enquiries I received (or rather requests for reassurances that even if the UK was to go down the economic drain as a result of a disorderly Brexit we would have means of protecting retirement nest eggs from any resulting market downdrafts).

This did remind me of the time ahead of the Brexit referendum in May 2016 when similar requests reached us as the Remainer campaign beat the drum that a Brexit vote would lead to immediate economic disaster for the UK. This time it is the Brexiteers' turn for scaremongering, having turned from assuring the public that the EU 27 would have no other choice than offer the UK preferential trading terms to predicting a crash Brexit that would bring inevitable pain to both sides.

Just as then, the headline-grabbing scare statements have political purpose but little predictive relevance. First and foremost, politicians seek to get re-elected. Leading a nation or economic area knowingly and unnecessarily into economic hardship has historically not proven a vote winner. This applies to both sides of the negotiations and makes a 'Fake-Brexit' the most likely outcome, both for 2019 and also likely thereafter.

But then again there is politics. If Dr Fox's message was intended to threaten the European public that harm may come upon them unless they put pressure on their politicians to sway un-elected Eurocrats to become more Brexit pragmatic, then would it not also be possible that politicians risk a crash Brexit, exactly to prove how deeply committed they are to their respective electorates? After all, letting Greece go over the national default precipice also did not make any economic sense for the wider Eurozone, but appeared politically necessary to gain public support for the terms of eventual bailout - on both sides.

This is the only theoretical risk I can see in terms of the looming March 2019 Brexit. Should politicians on either side fear that they might suffer negative electoral consequences should they agree to a compromise, then there is a small possibility that they may feel the need to demonstrate the repercussions of a crash Brexit by inflicting chaos for a few weeks. Such brinkmanship is still much less likely to happen as was the case with Greece, because arguably more level-headed politicians are conducting the negotiations. Also, irresponsible action as described above would be more than sufficient to end political careers.

We feature a separate article on the subject and so we will leave it here and return to matters which are more likely to actually influence medium term investment returns.

From our perspective, the increased use of economic pressures by the Trump administration in the US is proving far more unnerving. Strong US economic momentum that has been further boosted by the one-off effect of tax cuts has led `US stock markets to seemingly ignore the potential for a trade related downturn. As the returns table at the top shows, the rest of the world has been far less blasé. Whether this US investor attitude will continue is discussed in another article this week, which looks beyond the headline profit growth numbers in the US and suggests that, while the US economy may be doing better than the rest at the moment, corporate earnings momentum may already have slowed considerably.

The US sanctions on Iran, Turkey and Russia may have stolen the headlines over the week, but frankly the economic consequences of those are miniscule compared to the ratcheting up of the trade war with China. It is hard to see how either side can step back from the current tit for tat, at least until the US midterm election in November. On the other hand, given Trump's political style is so much more akin to US (Show) Wrestling than Olympic wrestling, anything seems possible. That appears to be exactly what US investors still expect; it's all just a big show.

If they are right in their assessment, then markets beyond the US would have considerable catching-up potential. But if not – even just in terms of timings until the conflict is resolved – then the US markets are more exposed than the rest and another down-leg of the February/March correction is possible. Bearing this in mind, we are comfortable with the slightly cautious stance we currently have in the Tatton portfolios and the underweight to US equities. July has shown that timing is fiendishly difficult, but August so far has demonstrated that fundamentals eventually come through in market action.

P.S.: Our investment mandate would in theory allow us to underweight UK investments down to a 0% portfolio allocation.

No-deal Brexit?

Christian Adams on Liam Fox blaming Michel Barnier for lack of progress on Brexit deal
Source: Political Cartoon Gallery

British media and currency markets were shaken this week by comments from UK trade minister Liam Fox over the potential for a 'no-deal' Brexit. The "intransigence" of the Eurocrats in Brussels has left the chance of the UK exiting the EU without any agreed deal at "60-40", according to Dr Fox.

Such a prominent government figure speaking so pessimistically about the Britain's future relationship with the EU understandably ruffled currency traders. After the comments, sterling fell to its lowest value against the dollar in nearly a year, and its lowest euro value in 11 months. At the time of writing, sterling is sitting at $1.28, some 13% below where it was on the eve of the referendum. With the overseas holiday season in full swing, this unwelcome increase in the cost of travel money hit a raw nerve for the travelling UK public.

Equally understandably, we've had several enquiries asking how these developments are going to affect investment portfolios and medium to longer term return prospects. What's going on? And what does this mean in terms of our investment strategy?

A first thing to point out is that our portfolio are globally invested and far from entirely UK focused. Even in a worst-case scenario where a no-deal or 'crash' Brexit causes a major economic downturn for Britain and an underperformance for UK assets, the overall effect on global investment returns should be small – provided that Brexit doesn't prove a significant dampener on global growth (which seems unlikely at the moment).

However, we recently made the decision to remove our previous underweight position for UK equities – increasing our allocation to neutral. This was based primarily on two observations: broader economic conditions are supportive due to weak sterling and strong demand from Europe, and UK stocks have much cheaper valuations than we believe is justified by Brexit worries. And despite the raucous week we've had politically, we see no reason to change this general view.

As we wrote some weeks ago, we have entered into somewhat of a virtuous cycle for the UK economy: the strength of the US dollar increases demand for European exports, which boosts their economy and in turn creates demand for British goods. And due to the low sterling valuation and (as yet) unchanged trading conditions, British exporters can take full advantage of this. What's more, this cycle seems to be going some way to addressing the UK's long-term structural problem of overreliance on domestic demand and the London services sector. Instead, it is rebalancing the economy towards a more export-oriented model, which benefits the regions.

Meanwhile UK stocks trade at a fairly hefty 'Brexit discount' in valuation terms. But this overlooks the fact that many companies at the larger end of Britain's stock market make most of their earnings overseas, and so are less affected by the struggles of the British consumer.

However, all of this is dependent on the government walking a fine line on Brexit negotiations. If markets become overly optimistic about the UK's post-Brexit prospects, the value of sterling will rise, which could counteract the positive effects mentioned. If things go the other way however, the negative impact on business and consumer sentiment could mean that those positive effects are all for nought. Already we've seen large companies like Airbus threaten to move their production out of the UK if a no-deal scenario comes about, and sudden or significant drops in sterling could threaten to derail things.

But we don't think Dr Fox's comments are at that level. After his claims that the "theological obsession of the unelected" would likely get in the way of an agreement, Downing Street was quick to distance itself from the remarks. "We continue to believe a deal is the most likely outcome," said the Prime Minister's spokesman, adding that "Not only is it in the best interests of the UK, but also of the EU and its 27 member states."

And in any case, it's quite possible that these remarks were more about tactics than about bare admissions. As the deadline rapidly approaches and the EU negotiators seem to be ceding virtually no ground to May and co., threatening to inflict economic self-harm, should it come to that, might be one of the few negotiating positions the government has left. The government is right that a no-deal Brexit is mutually assured economic destruction (though the scale of damage for each party is debatable). But as EU leaders have proven before, they're prepared to take a worse economic outcome to protect the union's political ideals (as seen with Greece and Italy). Dr Fox may have felt that a threat to drive over the precipice could wake up the broader EU 27 public, letting them know that Brussel's dogmatic stance could actually harm their near-term economic prospects. Hopefully, this will create some pressure towards an agreement.

What's more, after the resignations of David Davis and Boris Johnson, and the press accusations that May's Chequers plan gave away too much, appearing tough on the EU is politically valuable for the government. 'We won't be bullied by Brussels' has long been a popular rallying cry, and May is no doubt in need of one of those.

We believe that this is brinkmanship, designed to improve the negotiating position with the Eurocrats and bolster morale back home. Our central scenario is still that the initial deal to be made for 2019 will be one that initially extends the status quo, resulting initially in a BINO (Brexit in name only) rather than a Crash-Brexit, followed by years of gradual steps towards a more substantial change in the relationship. This week is just another episode in the negotiation soap opera. All the while, the UK economy chugs along much more nicely than the public is led to believe by attention-grabbing media headlines.

'Tax cut tail wags the US profits dog' - Q2 earnings update

At some point, most of us have come across the phrase 'and that's the bottom line'. As investors, the origin of this phrase directly impacts us via stock market levels.

In stock markets, the bottom line, company earnings and net profit all refer to the same thing: how well a company is doing at generating a positive return for its investors. For an accountant, gross profit is simply revenue minus expenses (cost of goods sold). Subtracting taxes (minus one-off charges or adding one-off gains) to get net profit.

On the surface, the continued profit growth reported in the current quarterly earnings season for Q2 2018 across the world looks remarkably comforting. One would therefore expect global equity markets to be within touching distance of all-time highs. However, this is currently only true for the US.

On the face of it, the fact that earnings in the US are growing at around twice as much as elsewhere may appear justified. On the other hand, the US economy has reached a later growth stage, displayed through peak of cycle characteristics like tight labour markets, rising inflation and rising interest rates, which normally raises concerns among investors about the sustainability of the prevailing rates of profit growth. Areas like Europe and Japan, who appear more early stage, should therefore offer more stock market upside potential. It is therefore worth having a look at the Q2 numbers across regions in more detail.

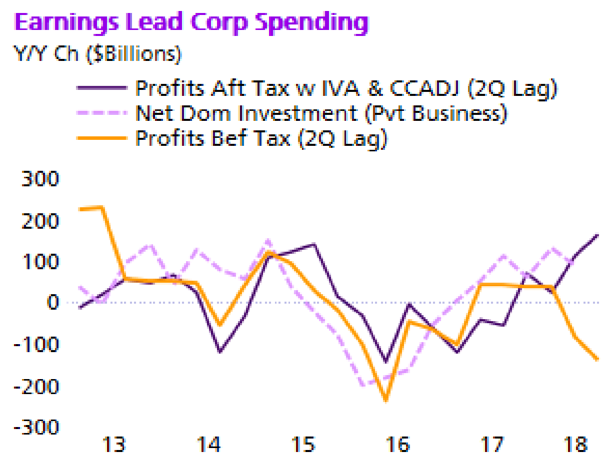
At a high level, both earnings and sales are growing. A total of 84% of firms listed on the S&P 500 Index have reported. 83% of those have beaten estimates. This is the strongest level in the US since Q3 '09, leaving the blended EPS growth rate at +25% year-on-year and beating forecasts, up from 20% expected at the start of the quarter. Most sectors reported double-digit earnings growth, with cyclicals expanding at nearly 2x the rate of defensive sectors.

Sales growth looks healthy too. 70% of US firms topped forecasts, with blended growth of +9% year-on-year. However, as indicated, a number of late cycle headwinds are beginning to materialise that could pressure both sales and profits. Rising interest rates may increase debt servicing costs. Labour is starting to attract a higher share of income (meaning a decline for capital and possibly lower profits). While Trump's recent trade tariffs may push input costs higher and profit margins lower.

This has led to an increasing number of US firms lowering earnings forward guidance. Facebook's outlook downgrade is the most visible example, while solid earnings and earnings guidance from Apple, Amazon and Alphabet (Google) did at least sooth some fears around the buoyant tech sector.

The big three carmakers point to trouble ahead for the broader US economy. Ford missed badly. It cut guidance and announced a long and expensive restructuring plan. General Motors guided lower, warning of margin pressure from higher commodity prices. And Fiat Chrysler said rising trade tensions could hurt Chinese sales, resulting in a 15.5% daily fall in its share price.

The US earnings picture looks even less impressive when we strip out the one-off effect of Trump's corporate tax cuts. As the left-hand chart below shows, after tax (solid blue line), the numbers look



Source: Thomson Reuters Datastream, TS Lombard

Source: Datastream, TS Lombard

impressive, but they have actually been falling pre-tax (yellow line) which paints an entirely different picture. As the chart also shows, business investment growth has historically followed pre-tax and not after-tax earnings, which bodes ill for the recently so supportive return of Capex investment demand. Current US earnings growth might therefore not be as good an indicator of ongoing business profitability as normal. The typical late cycle profit erosion looks like it's already begun. This may be why so many companies have been guiding lower in their outlook statements.

Companies in Europe and Japan guided lower too, but less so than their US peers. At least firms in the UK appear to have gotten the bad news out in the market already.

Europe posted sequential improvements in EPS from Q1 to Q2 and that was without the tax cut boost. 56% of companies have beaten forecasts, surprising positively on earnings growth by 3%. The blended rate of growth is still an impressive 11% year-on-year (+7% ex energy). 62% of firms topped sales forecasts, growing +6%.

In Japan, 60% of Topix firms beat EPS estimates. Year-on-year, EPS grew +9%, with all sectors posting positive growth. 52% of companies beat sales forecasts, up +6% year-on-year. 10 of 11 sectors delivered positive growth.

On the back of these numbers, we expect investors to become a bit more cautious in extrapolating future US EPS growth from current numbers, particularly now that the tax boost has largely run its initial course and economic growth is increasingly benefitting labour and not profits/capital. The January melt-up in stocks was a result of a jump in earnings upgrades, followed by a second round in May. But things are now broadly flattening out. It was a similar picture in Japan and the UK, while in the euro area the revisions had been sharply negative for a while but have now started to turn around (see right hand chart above)

So, once the extraordinary boost effect of the tax cuts is accounted for in the US, the lower earnings guidance and equity returns of the European and Japanese stock markets may have been a better reflection of global profit growth dynamics than the relentless upward trend of US shares. This leaves US stocks far more vulnerable once the tax effects fade and the more 'normal' profit growth picture begins to reappear.

The bottom line for investors is that earnings are the fuel for stock markets and there is an increasing nervousness over US corporates' ability to continue to grow profits despite late cycle (as well trade war) pressures. The excessive derating of stocks that dare to guide lower like Facebook are evidence for this. With the positive global economic growth picture remaining broadly intact – subject to the US-Chinese trade wars not escalating significantly beyond the 'bluffing stage' – there remains upside to equity markets. However, there is a distinct possibility that the US stock market will adjust to the realities of the pre-tax earnings picture through another market correction. This is why our portfolio positioning is currently cautious towards equities and underweight to the US, even though our medium-term outlook remains positive.

Iran under fire

As signposted by the Trump administration for a while, harsh US sanctions against Iran came into force on Tuesday. The White House confirmed on Monday that sanctions which had been suspended as part of the landmark 2015 nuclear deal would be reinstated, as part of President Trump's effort to "stand up to the Iranian regime's aggression." It marks the latest development in

Trump's campaign against the "horrible, one-sided" Obama-era deal, from which the US withdrew in May.

The sanctions imposed this week include: Iranian government purchases of US dollars, Iran's precious metals and other commodities, Iran's car industry, and financial restrictions on Rial transactions and Iranian sovereign debt. Further sanctions are also planned to take effect in November, on the country's oil exports, shipping sector, and any foreign financial institutions trading with the Central Bank of Iran. In typical Trumpian style, the US President accompanied the sanctions' re-imposition with a twitter warning: "Anyone doing business with Iran will NOT be doing business with the United States."

Trump cannot unilaterally "tear up" the Iran deal as he promised during his election campaign; the deal remains in place with the six other signatories (China, Russia, UK, France Germany, EU) even without US participation. But his threat that sanctions will apply to even those foreign businesses who trade with Iran could well be its death knell. If the administration follows through with penalising European and other companies who trade with Iran, it will hugely discourage firms from doing so. No one is realistically going to choose Iran over the US.

Good news for Iran then, that the EU announced on Monday its own measures to counter the "unlawful" reach of US sanctions. A new EU law to shield European companies forbids them from complying with US sanctions and makes it possible for firms to sue parties who withdraw from contracts on their basis. The hope is that, as well as encouraging businesses to keep trading with Iran, it will also deter US authorities from actually enforcing penalties.

But few expect the 'blocking' measure to work. Large companies in energy, aerospace and technology have already begun winding down their Iranian interests. This has only ramped up the pressure on Iran's beleaguered economy. Months of panic over Trump's sanctions have already caused capital flight from the country, sending the Rial tumbling and prices soaring. Since last summer, the Iranian currency has lost more than 60% of its dollar value in foreign exchange terms, and there has been a 50% rise in the price of some food items in the past few weeks alone. With sanctions now in place – and even harsher ones coming in a few months – Iran's economy could soon begin to unravel entirely.

That's an extremely worrying prospect for President Hassan Rouhani, who has already experienced numerous protests in recent months. Rouhani – a reformist and relative moderate – was lauded in Iran for his part in engineering the nuclear deal which promised to bring prosperity to Iranians. But even before Trump pulled out of the deal, many had become disillusioned with the apparent lack of improvement. The subsequent fall in living standards has led to widespread anger among the population.

Now, Rouhani finds himself besieged on all sides. Iran's Supreme Leader Ali Kahmenei has recently urged him to stamp out corruption in the Islamic Republic. Only two weeks ago, the head of the powerful and pervasive Islamic Revolutionary Guard Corps (IRGC) Mohammed Ali Jafari publicly told the President to focus on the country's sliding currency. And a section of Iran's parliament summoned him to criticise his handling of the failing economy.

Their concern, like Rouhani's, is that continued economic hardship will see the simmering protests across the country boil over into a full-blown revolt. At the beginning of the year, similar protests broke out across the country, motivated initially by economic concerns but later by wider dissatisfaction with the government. Falls in living standards acted as a catalyst for a more general disenchantment; citizens – particularly the young – began raging at issues from corruption and involvement in foreign affairs to the very theocracy itself. "Death to the dictator!" rang the cries from those on the streets. This must be truly worrying for the clerical leadership that itself came to power through a popular revolution that brought down the previous (feudal) regime of Shah Reza Pahlavi 39 years ago.

While the Trump administration is eager to point out that regime change is not its goal for Iran, the sight of unrest will likely cause lip-licking in the White House. Much like many Iranian citizens, the US government has become frustrated that Iran has chosen to focus the benefits of its freer rein in global trade since the 2015 deal on increasing its military operations in the region, rather than its domestic economy.

It's a worry that European leaders share, though are often less public about. Iran's military presence within Syria and suspected support for Houthi rebels in Yemen has crystallised the coalition against them in the US, Israel and Saudi Arabia. Trump no doubt hopes that the increased economic pressure on Iran will put the brakes on their operations abroad.

He may well be disappointed however. Iran's foreign operations aren't run by the government but by the IRGC – in particular the clandestine Quds force headed by Qasem Soleimani. Started as an ideologically driven militia tasked with defending the Islamic Republic system, the IRGC has since become an incredibly powerful organisation that pervades every level of Iranian society.

Crucially, the IRGC and Soleimani's Quds force do not have to answer to Rouhani or the civil government, only the Supreme Leader. In fact, it's thought that Rouhani himself would rather rein in Iran's military excursions. But Soleimani and the IRGC more generally are not as sensitive to the changing tide of public opinion. They see great tactical benefit in Iran's current military operations; an established base in Syria would give them a clear path to supply allies in Lebanon, while a presence in Yemen would allow them to control the key Bab al-Mandab strait.

But the IRGC still has to listen to the Supreme Leader. And "Death to the dictator!" chants could worry him enough to rein in his commanders. In the meantime, the situation for Iran is unclear. US sanctions will bite, but the fact that other deal signatories wish to remain could alleviate some of the worst effects. In any case, Rouhani's government will need to find a way to calm the unrest that's been building – for their own sake.

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7667	0.0	2.2	↘
FTSE 250	20645.8	0.1	10.4	↘
FTSE AS	4207.3	0.0	1.6	↘
FTSE Small	5888.0	0.2	12.4	↘
CAC	5395.9	-1.5	-83.1	↘
DAX	12395.3	-1.7	-220.4	↘
Dow	25320.7	-0.6	-141.9	↘
S&P 500	2834.0	-0.2	-6.3	↘
Nasdaq	7421.0	0.3	25.5	↘
Nikkei	22298.1	-1.0	-227.1	↘
MSCI World	2163.7	0.4	8.3	↘
MSCI EM	1078.7	0.5	5.3	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	17	12.7	19.2
FTSE 250	3.1	18.3	13.5	23
FTSE AS	4	17.5	12.8	19.6
FTSE Small	3.8	-	-	-
CAC	3.2	16.6	13.1	22.9
DAX	3.1	14.1	11.7	21.2
Dow	2.2	18.1	14.9	25.8
S&P 500	1.8	20.6	15.9	30.1
Nasdaq	1	26.1	18.8	48.9
Nikkei	1.8	16.1	14.1	32
MSCI World	2.3	18.7	15	26.1
MSCI EM	2.7	13.4	10.6	19.1

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
STANDARD LIFE ABERD	5.8	PADDY POWER BE	-10.3
BURBERRY GROUP	4.4	INTERTEK GROUP	-8.7
ASTRAZENECA	4.3	EVRAZ	-7.8
WPP	4.2	RIO TINTO	-4.6
ASHTEAD GROUP	3.8	BT GROUP	-4.6

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.28	-1.75	OIL	73.1	-0.2
USD/EUR	1.14	-1.17	GOLD	1216.4	0.1
JPY/USD	110.72	0.48	SILVER	15.4	0.0
GBP/EUR	0.90	-0.59	COPPER	276.1	-0.1
CNY/USD	6.84	-0.21	ALUMIN	2078.0	2.1

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.247	-6.2	-0.08
US 10-Yr	2.880	-2.3	-0.07
French 10-Yr	0.670	-9.5	-0.07
German 10-Yr	0.321	-21.3	-0.09
Japanese 10-Yr	0.101	-8.2	-0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.76
3-yr Fixed Rate	1.83
5-yr Fixed Rate	2.04
Standard Variable	4.06
10-yr Fixed Rate	2.74

* 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 market data tables above 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