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Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENTS

Samuel Leary

FUND MANAGER

Isaac Kean

INVESTMENT WRITER

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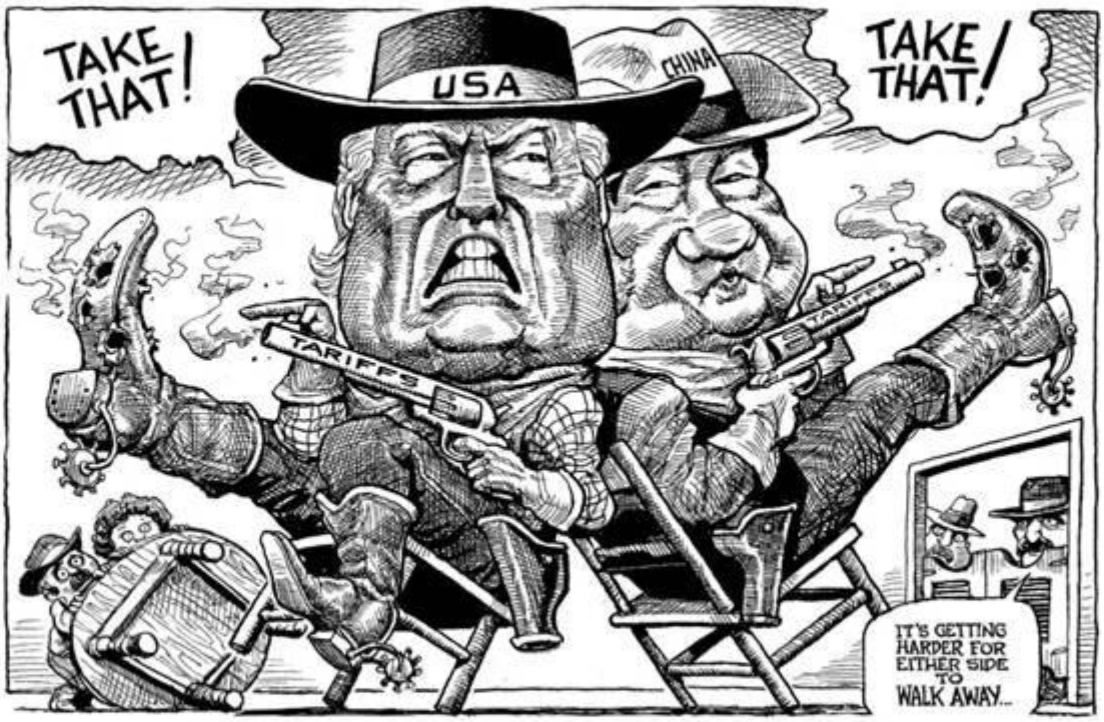


KAL's take of how the worsening trade war between the US and China is inflicting self-harm on the combatants
Source: Political Cartoon Gallery

Political strongman tactics come home to roost

This week continued in decidedly risk-off mood in global stock markets, as concerns spread that Turkey's currency tail spin could spread to all emerging markets and cause considerable damage to the Eurozone's banking sector as well.

As so often when contagion is in the air, investors sell first and ask questions later. The exposure of European banks to the Turkish economy may be unpleasant but, on the basis of all the research we have been able to sift through, it is hardly going to constitute a systemic threat or extend to the scale of the Greek crisis. Furthermore, different to how it may be portrayed in the wider media, Turkey's issues have been well known for quite some time and Trump's sanction-slapping action was just another case of exerting maximum pressure on an opponent when they are on the ground already.

Turkey's problems will therefore not be solvable on the political level but will require strongman Erdogan to concede that his dictatorial powers do not extend to capital markets. Unless Turkey stabilises its currency through a more restrictive monetary policy and weans off foreign capital for its economic growth ambitions, it is heading down the familiar Argentina route.

Trump used the same tactic with China, where the economy is slowing because its forward-looking leadership is reining in a profligate financial sector and restructuring its economy towards domestic demand to become less export dependent. However, China is not Turkey and, given its economic might and intellect of leadership, it matters a lot more for the global economy whether this trade war truly takes hold or gets resolved before much collateral damage is caused. Interestingly, China has a few more defence mechanisms in its arsenal than Erdogan's threat to stop buying iPhones. And that is its currency. With the US$ already going up and the Chinese Yuan going down due to the relative weakness of the economy, all the Chinese central bank had to do was not to intervene as usual in FX markets and the Chinese currency had fallen almost as much as Trump had slapped in tariffs onto their exports. That may explain why Trump increased his tariffs so quickly from 10 to 25%. But the US$ strength is beginning to hurt US exporters and slowing the emerging market economies to a point where it is beginning to pose a risk to Trump's economic ambitions.

No wonder then that markets sighed in collective relief when it became known that both sides will restart trade negotiations in the coming weeks. The US side stating its intention to discuss the Chinese currency weakness tells us that Trump may be beginning to realise that China has a better negotiating position than he anticipated (or at least his advisers did).

This brings us back to the UK, which is in a not too dissimilar position. The £-sterling weakness versus the €-Euro and the US$ is clearly supporting the economy and the latest retail sales figures are showing that there is still life in the UK shopper. Brexit scaremongering headlines will accompany us for the foreseeable future, as it is in the interest of both sides to rally their respective audiences to score points at the negotiating table. However, since time is running out to introduce anything overly complex (like trading under WTO rules and tariffs) in the remaining 7 months to March 2019 and the UK public is not favouring a hard Brexit, politicians and parliament are unlikely to go for anything overly radical. Brexit-in-name-only (BINO) remains the most likely starting point for the UK's post-Brexit relationship with the EU27 next year.

In terms of capital markets, all the above tells us that the relative safety of government bonds is unlikely to lose its attraction anytime soon, which removes one of the concerns earlier in the year. This leaves the risk of a serious deterioration of trade relations as another potential reason for a premature end to the current cycle. Here, the latest developments between China and the US give us hope that both sides are aware what is at stake and that Donald Trump is keen to add another 'big win' before the November Midterm Elections.

For emerging markets at large, a stabilisation of the Turkey crisis is likely to be a necessary condition before investors are willing to rediscover the value of this asset class. Until this happens, we will be happy to retain the substantial underweight in emerging markets that we have had since March.

Turkey: Will Europe's sick man infect others?

Turkey's ailing economy has been one of the main emerging market stories this year. While 2018 has been hard for all emerging markets (EMs), few countries have received as little love from investors as Turkey. This can clearly be seen in currency markets, where the Turkish lira has had a torrid time. As recently as April, $1 could buy you TL4.00. Now it fetches more than TL6.00. Year to date, it's the world's worst performing currency.

That's even after a week of some respite, which saw the lira rebound from a record high of 6.90. Few believe that rebound is sustainable. Structural issues, overleveraging on foreign loans in hard currency, political risk and an international dispute with the US are weighing down on the country and don't look like they'll let up any time soon.

The diplomatic feud between Turkey and the US is only the latest thing to turn investor sentiment sour. This week, Authoritarian President Recep Erdogan slapped large tariffs on US goods in retaliation to Donald Trump's announcement of additional tariffs on Turkish steel and aluminium. The heart of the issue is Turkey's imprisonment of American pastor Andrew Brunson, whom they accuse of having a hand in 2016's failed military coup, as well as their demand that the US extradite Fethullah Gülen, a Turkish preacher and religious leader who lives in the US and is accused of the same. Trump has called Brunson a "great Christian" and demanded his release as a precondition for the lifting of sanctions and tariffs. But in typical fashion, Erdogan chose to remain firm. So, sanction pressure looks unlikely to go away.

Turkey's problems started long before Donald Trump, however. While the country has seen stellar growth over the past decade and a half, the economy has been allowed to run too hot, leading to chronically high inflation. In addition, that growth has been largely fuelled by foreign capital, which has left Turkish firms with huge Euro and dollar-denominated debts on their balance sheets. And now that the lira is locked in an almighty nosedive, the cost of financing that debt is spiralling.

Typically, the remedy to this kind of situation would be a substantial tightening of monetary policy, curbing runaway inflation and defending the currency's value. But here enters Erdogan. While Turkey's central bank is nominally independent, the President has exerted massive political pressure on monetary policymakers.

Turkey's strong-man leader has an unusual obsession with interest rates. He called high interest rates "the mother and father of all evil", and even accused former chief Erdem Basci of treason for not lowering them fast enough. His highly unorthodox theory is that higher interest rates promote rather than contain inflation.

He's not entirely alone in believing this; some economists have argued that tighter monetary policy is harmful for developing economies as it increases companies' expenses through borrowing costs, which feeds through to higher prices. But theoretical considerations are beside the point. Turkey runs a $40bn current account deficit (exports minus imports), which means the economy is beholden to global capital flows. Stemming outflows and defending the lira's value are therefore imperative. If markets lose faith in Turkey's currency, it could send the economy reeling even further. And encroaching on central bank independence will hardly help that cause.

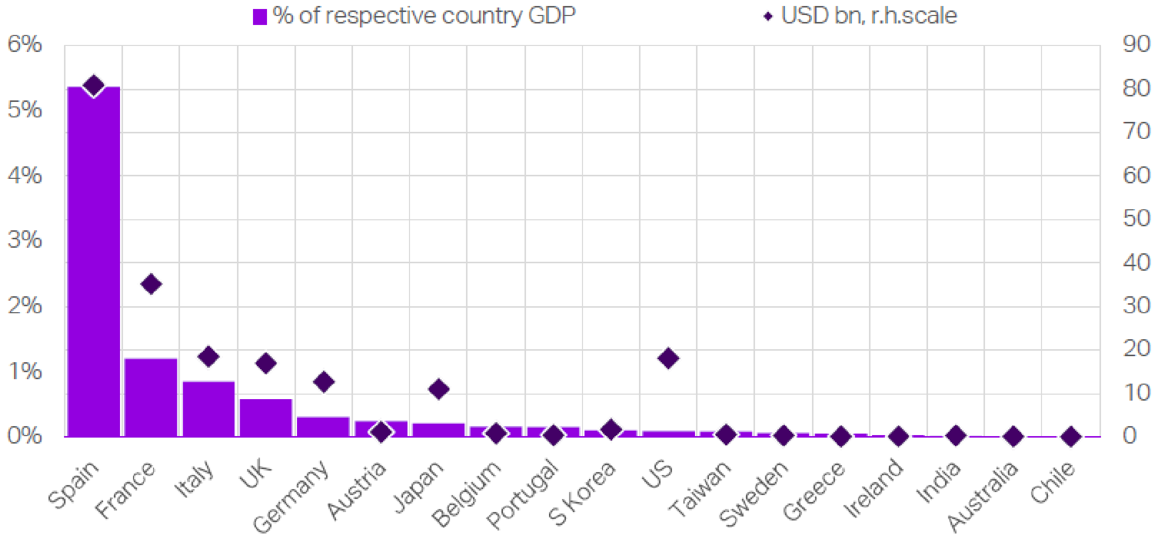
That brings us to the other side of the equation. If Turkish firms are unable to service their foreign currency debts, that also spells trouble for their creditors. European banks are some of the biggest lenders to Turkey, leading to worries that financial contagion could spread to the Eurozone. Direct lending is high and indirect is even higher, increasing the risk that the original 'sick man of Europe' could infect the rest of the continent.

Spanish lenders have far and away the highest exposure to Turkey. Their $80bn Turkish debt pile amounts to 5.4% of Spain's GDP, while French and Italian banks (Turkey's next largest funders) have only 1.2% and 0.8% of their respective countries' GDP outstanding. Spain's exposure is highly concentrated with BBVA, who generate a staggering third of their pre-tax profits from Turkey.

Given this is largely through their Turkish subsidiary Garanti Bank, it is noteworthy that these are predominantly domestic Turkish loan relationships and not foreign currency debts.

Chart 4: Exposure to Turkey - the banks channel

Consolidated statistics, domestic banks' claims on Turkey, ultimate risk basis, Q1 2018



Source: Datastream, BIS, TS Lombard

However, most analysts agree that even in the worst-case scenario Turkey itself doesn't present a systemic threat to Europe's financial system. The real threat is that contagion risk could spread and weaken banks, particularly in already struggling areas such as Italy – which could ultimately require the European Central Bank to step in.

Investors are similarly worried about contagion to other EMs. A strong US dollar, trade tensions and weakness in China have already created a harsh environment for developing nations. The fear is that crises in countries like Turkey could spark the bonfire. But this is unlikely, at least in terms of the real economy. Most of Turkey's trade is with Europe, and the knock-on effects for EMs in terms of reduced Turkish trade should be relatively small.

However, where it could impact EM assets is through investor sentiment. Markets are already wary of EMs at the moment, and further pain in Turkey could be one crisis too many. What's more, many investors tend to buy EM assets en masse through broad EM fund investments rather than individually, meaning that outflows are often correlated even without any obvious trade or banking links. When the sense of dread sets in, even those EMs who have kept their noses clean get punished.

For Turkey, things don't look like they will get better any time soon. For Europe and (especially) EMs, that's another problem to add to the list, but it shouldn't be catastrophic. It's far from an ideal situation – and could well be a dampener. But unless the US trade war with China proliferates into a Global trade war, it's unlikely to cause yet another short term ruction for Global stock markets.

UK stock markets' post Brexit prospects

The summer's heat wave revealed the evidence of our history in the parched fields of Old England. The activities of the ancient Britons, Romans and Anglo-Saxon invaders have all left their mark on the land. It took a lot of hot air to reveal the foundations of Britain, and in a political summer dominated by Brexit bluffs, it's worthwhile to ask what kind of mark this type of hot air is leaving on the economy and investments.

Brexit and its potential impact on investment portfolios is the number one question we receive at the moment (Admittedly though, as always during August, it is still a very quiet period in terms of inquiries). Some of our investors are questioning if catastrophe is really at hand and, if so, how may we keep harm away from their lifetime savings. Here it is crucial to point out that the state of the UK economy is not as closely connected to the condition of London's stock markets as one might think.

Let's look at the economy first. The economic data releases this week suggest the UK economy remains relatively healthy with retail demand and economic activity actually improving. The caveat is that the country still hasn't left the EU, and weaker Sterling means the UK economy benefits from the current upswing in Eurozone activity and demand.

At a high level, GDP growth rebounded in Q2-18, following a weather-related dip in Q1. According to the Office for National Statistics (ONS), the preliminary Q2 GDP reading showed growth of +0.4% over the 3 months, as warmer weather during the quarter helped support food & drink sales in the retail sector and boosted construction output.

The outlook for Q3 GDP seems a bit more mixed. The construction sector is being held back by shortages of skilled workers. On the other hand, surveys from the Confederation of British Industry (CBI) suggest a further summer weather pick-up in growth. According to the CBI, consumer facing firms are reporting the first expansion of volumes in five months, while retailers saw sales growth for the first time since September 2017.

The glorious but dry summer seems to have had an impact on inflation rates. Consumer Prices (CPI) nudged higher by 0.1 percentage point to an annual rate of +2.5% in July (as widely expected) while core CPI was largely flat at +1.9%. The BoE had anticipated a slightly higher +2.6% reading in July, leaving a few questioning the recent 0.25% rate increase.

The ONS attributed video game sales and transport costs as the driver (no pun intended) of the increase. The World Cup sales effect was in full swing over the summer. Prior to the first kick-off, retail sales were muted, but it would seem consumers hit the shops once France lifted the trophy. Sales volumes increased by a bigger-than-expected 0.7% during July, following a 0.5% decline in June.

The economic data appears to be evolving in-line with the Bank of England's (BoE) forecasts. However, if we factor in Brexit, we add a risk that currently cannot be fully planned for, leaving the economy vulnerable to changes, particularly in the event of a cliff-edge or 'no deal' Brexit. What does that mean for equities?

UK equities look relatively attractive, trading at only around 12x forward earnings for the FTSE100 and 13x for the FTSE250, yielding 4.2% and 3.1% respectively. For our Brexit concerned investors attractive valuations are probably little consolation, but where FTSE Index listed companies generate their income is of great importance.

For many FTSE100 and FTSE250 businesses, the UK is merely the country where their respective companies are listed and not their main source of income. Companies on the FTSE100 are generally large global businesses, deriving 71% of revenues from overseas. The FTSE250 on the other hand is more evenly balanced, generating a lower 51% of sales from abroad, meaning it has greater leverage to the domestic economy. The other half of FTSE250 earnings are predominantly from Europe.

FTSE 100 firms generating income from the global economy does mean that companies experience the impact of fluctuations in international currency markets, where a weaker pound can be beneficial. If the pound was trading at \$2, then each \$1000 of sales is worth £500. If the pound fell to \$1.50, each \$1000 of sales would be worth £667, or a 33% jump in revenues without an actual increase in \$-based sales volumes.

If anything, GBP depreciation has a beneficial impact on stock returns. The Pound better reflects the Brexit uncertainty than the FTSE100 and FTSE250 do.

Source: Bloomberg, Tatton 16 August 2018; Green – UK corporate revenues, White – UK stock market, Pink – FX value of £-GBP

So, if the hot air of the summer turns into a blast of cold wind from a looming hard Brexit, what will happen to the UK's leading companies? (Still extremely unlikely in our view, because it will be decided by politicians and parliament not referendum – see last week's edition)

After the inevitable short-term market shock, the longer-term stability of international earnings of their underlying companies should protect them from the domestic damage of a hard Brexit, and the benefits of a weaker Pound. Even with a weak currency the UK stock market dwarfs its EU mainland counterparts. The total market cap of the FTSE 100 is around €3 trillion, compared with a combined total market cap of the CAC40 and DAX30 of €2.8 trillion. That's attractive, considering the strength of the companies that make up the Index.

And this comes down to the most important point in all of our investor questions. Do we think the UK and the EU will allow a hard Brexit? The most recent cabinet changes have provided more evidence to support 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 much more likely that next year's article 50 deadline will only result in a very mild initial departure from the European Union. The positive for investors is that the impact on the longer-term valuation of leading UK equities is not directly affected by their UK earnings. Unlike the foundations of ancient buildings etched into the green fields of England, perhaps the impact of Brexit will not etch such a lasting legacy on our portfolios.

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7558.5	-1.7	-131.9	→
FTSE 250	20403.1	-1.3	-264.3	→
FTSE AS	4141.9	-1.6	-68.8	→
FTSE Small	5818.1	-1.3	-74.5	→
CAC	5334.0	-1.5	-80.7	→
DAX	12194.4	-1.9	-230.0	→
Dow	25581.7	1.1	268.6	→
S&P 500	2837.9	0.2	4.6	→
Nasdaq	7334.6	-1.0	-73.7	→
Nikkei	22270.4	-0.1	-27.7	→
MSCI World	2131.1	-0.4	-8.8	→
MSCI EM	1021.6	-3.8	-40.8	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.2	16.8	12.4	18.8
FTSE 250	3.1	18.1	13.3	22.8
FTSE AS	4	17.2	12.5	19.2
FTSE Small	3.8	-	-	-
CAC	3.2	16.4	12.9	22.3
DAX	3.2	14.2	11.6	20.7
Dow	2.1	18.2	15.1	25.3
S&P 500	1.8	20.6	15.9	29.6
Nasdaq	1	25.7	18.6	48
Nikkei	1.8	16.1	14.1	31.4
MSCI World	2.3	18.4	14.8	25.5
MSCI EM	2.8	12.5	10.5	18.5

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
HARGREAVES LANSD	3.4	ANTOFAGASTA	-14.3
WPP	3.2	ANGLO AMERICAN	-8.6
GLAXOSMITHKLINE	3.0	EVRAZ	-8.6
DIRECT LINE	2.9	KINGFISHER	-7.7
ADMIRAL GROUP	2.3	RANDGOLD RESOURC	-6.6

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.27	-0.17	OIL	71.7	-1.5
USD/EUR	1.14	-0.02	GOLD	1179.1	-2.6
JPY/USD	110.48	0.32	SILVER	14.7	-4.1
GBP/EUR	0.90	-0.27	COPPER	263.6	-3.9
CNY/USD	6.88	-0.45	ALUMIN	2048.0	-1.4

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.231	-0.9	-0.01
US 10-Yr	2.857	-0.6	-0.02
French 10-Yr	0.661	-1.3	-0.01
German 10-Yr	0.303	-4.4	-0.01
Japanese 10-Yr	0.098	-3.0	0.00

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!

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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.

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