Tatton
Investment Management

The Tatton Weekly

20 July 2018

Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENTS

Samuel Leary

FUND MANAGER

Isaac Kean

INVESTMENT WRITER

www.tattoninvestments.com Twitter: @TattonIM

125 Old Broad Street, London EC2N 1AR. Tel: 0207 190 2959

Earnings are growing, why of worry?

Chris Swanepoel, our estimable head of AIM investments, says that he doesn't know anybody who has stopped doing their weekly shopping because of Brexit or Donald Trump.

His job is to invest in companies and a lot of them are doing better than OK.

Companies across the developed world are reporting their earnings for the second quarter, and forecasts for the rest of the year and, so far, many are backing up Chris's observations.

As of yesterday, JP Morgan reported:

Consensus estimates for 2018 and 2019 earnings per share growth

Source: IBES, JP Morgan, 19-Jul-2018		2018e EPS Growth, %		2019e EPS Growth, %	
Area	Index	Current	Jan '18	Current	Jan '18
Developed World	MSCI World	15.6%	10.0%	9.2%	9.6%
US	S&P500	22.3%	12.3%	10.1%	10.3%
Europe (inc. UK)	Stoxx600	8.1%	9.2%	8.8%	8.8%
Eurozone	EuroStoxx	6.9%	9.4%	9.8%	9.6%
UK	FTSE100	11.3%	7.0%	6.4%	7.0%
Japan (year to end of March 19 + 20)	Topix	4.2%	8.7%	8.9%	8.6%
Emerging Markets (MSCI)	EM	15.6%	13.1%	11.4%	11.1%

"So far" means we've only had 10% of the US companies that are due to report, 15% in Europe and 8% in Japan. There's a lot to come but the tone is definitely set fair.

Developed-world equity markets have been rising, with the US continuing to dominate the leaderboard. The strength of growth means that price-to-earnings ratios have remained within recent ranges, with Factset's US index (similar to the S&P500) P/E ratio at 17.19 on a next-12-month basis. That's the same as it was on 19th April but the rise in actual and forecasted earnings means that the index has returned 5%.

Sam points out, in his article on what the equity index price charts might portend, that cooling sentiment towards equities and other risk assets may mean investors have been building up spare cash rather than investing. That could mean there are few sellers even if news appears relatively bad. If the newsflow were to suggest global risks are reducing or even just not worsening, equity markets could push on further during the summer.

The news about current corporate earnings is good but investors worldwide are being given quite a bit to worry about. The three current themes show no sign of taking a holiday.

Today's Trump-CNBC interview saw the Chinese being threatened with tariffs on all US-bound exports. At the start of the week, the US identified $200bn in goods which may be targeted for tariffs, giving a total of $250bn. Anything further, Mr. Trump has said, depends on the extent to which China retaliates.

When asked during Friday's interview, "Will you ever get to 500, though?" Trump responded that he is "ready to go to 500," referring to the approximate total dollar value of Chinese goods exported to the US last year.

During the week, financial commentators have noted the weakness of Chinese equities and currency, usually inferring that it's down to trade issues.

The weekly has covered China regularly in the past few months and regular readers will be familiar with our view that the trade spat is getting more heated perhaps because of China's weakness rather than the other way around. The time to pressure an opponent is as they weaken.

There's been a really large number of actions by the Chinese authorities in the past 48 hours, with suspected currency intervention happening overnight. Perceptions of authority ineffectiveness appear to be growing much as they did in late 2015. Isaac notes in his article below, weak systems are not fixed by strong control from the top.

And then there's the UK. There was a BBC Radio 4 program last night ("The Briefing Room – What does the UK want from the EU?" - https://www.bbc.co.uk/programmes/b0b9zbpn) which made the case that the Conservative Party is moving from pragmatism to ideology quickly, and that a no-deal scenario is becoming more likely.

Readers will have differing views about the impacts that this might have. We have come to the view that UK companies are currently faring quite well, and earnings growth is robust. The uncertainty that politics has introduced has caused domestic UK stocks to embed a reasonable risk premium over the long-term. There is a lot of risk, but the pay-out compensates enough for us to warrant a neutral holding.

Meanwhile, Trump's comments today about rising US interest rates suggest that the Federal Reserve Open Market Committee may face interference. Below is an article about "the next crisis", written before his comments. Suffice it to say, in comparison to the UK, we think the markets have been unduly sanguine about the medium-term risks that President Trump poses to US domestic markets.

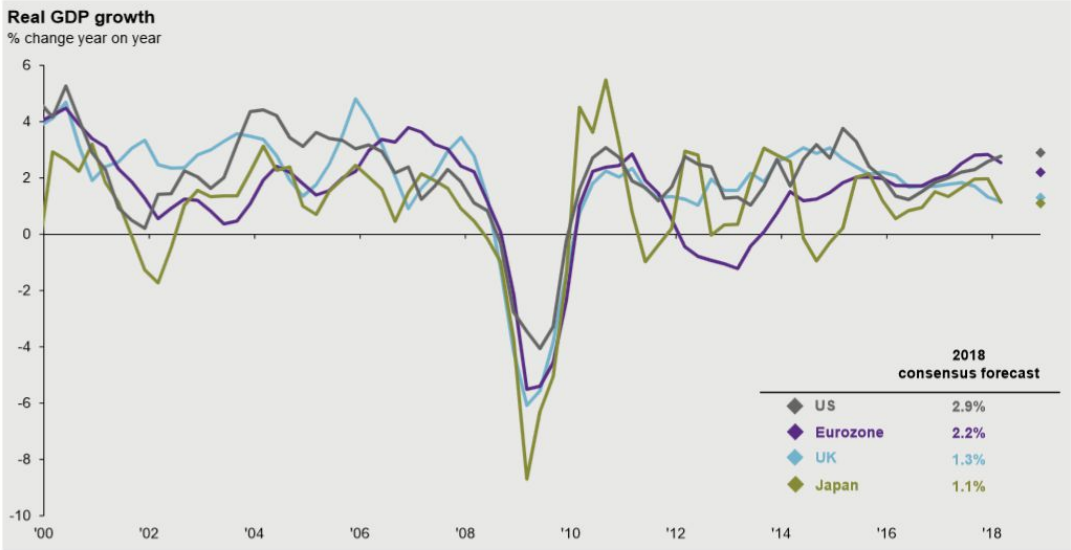
A technical view: are markets about to go risk on?

It's been a funny year so far, swinging from extreme optimism at the start of 2018 to the other end of the spectrum, making markets jittery and increasingly sensitive to shocks.

But one-by-one, the dominoes-of-fear keeping markets relatively range bound appear to be falling – or at the very least becoming less worrisome. This suggests a bout of 'risk on' for equity markets is on the cards in the near future, especially given the marked drops in the price of gold over the past few weeks, a typical indicator for returning risk appetite among investors.

Monitoring technical indicators provides us with a position of markets and what they *might* do, given previous market behaviours and current trends. We review our normal basket of indicators and also comment on Bitcoin and its pricing is now correlating to other technical signals.

Some of the traditional 'risk off' indicators we watch include: measures of market volatility, corporate earnings revisions, economic and technical price signals. And collectively they indicate further positivity ahead. Even newer measures, such as the growing correlation between Bitcoin prices and wider equity market movements, provide further support for a potential rally.



Source: BEA, Bloomberg, Eurostat, Japan Cabinet Office, ONS, Thomson Reuters Datastream, J.P. Morgan Asset Management. Forecasts are from Bloomberg contributor composite. Past performance is not a reliable indicator of current and future results. *Guide to the Markets - UK.* Data as of 30 June 2018.

The global economy still makes positive progress, with measures of forward looking activity indicating further expansion. Rates of GDP growth across the US, Europe, the UK and Japan during 2018 are expected to average around 2%. Purchasing Manager's Indices on a global basis remain robust, at 53 (a reading above 50 is expansionary). Activity is stronger in the developed world at 54.4 and 51.2 for emerging markets – perhaps an artefact the recent strength of the US dollar, which hurts developing economies more.

Unemployment rates continue to nudge lower, hitting multi-decade lows in the US, Japan and the UK, alongside improvements in Europe. There is growing evidence of labour shortages – extreme in some sectors in the US – helping support wage growth and push rates of inflation to – shock horror – 'normal' levels of around 2% seen before the financial crisis.

This robust economic backdrop is feeding through into a beneficial environment for both consumers and businesses. Measures of consumer spending are solid globally. The latest quarterly earnings season is looking reassuringly positive, with decent performances across the table. While still early, with just 63 out of the 497 companies on the US S&P500 Index reporting so far, the numbers are far from bearish.

Both sales and profits (EPS) have beaten estimates, growing +9.2% and 21.8%, respectively – exceeding expectations by 1% and 5%. Higher commodity prices have boosted the Energy and Materials sectors, but the stand outs have been the Financials, Consumer Staples, Consumer Discretionary and Information Technology sectors.

These sectors have strong leverage to a reduced corporate tax rate but also increased consumer activity. Sales growth at Consumer Staples firms was up 18.5%, boosting profits by a whopping

40%. Financials are benefitting from rising interest rates and rising demand for loans, which allows for higher net interest margins (essentially banks' profits).

Investors appear to be increasingly rewarding companies that not only have solid cash flow generation, but those that also have better ROEs (Return on Equity – a measure of the efficiency of how they deploy cash for higher returns).

On the technicals side, most indicators remain broadly supportive and US equities retain strong upward momentum (S&P500 reached a new multi month closing high in Wednesday's session). Most equity markets globally are within around 2% of all-time-highs and remain above Moving Average (MAVs) support levels at 50, 100 and 200 days. Breadth (i.e. the number of stocks taking part in market movements) continues to improve, suggesting wider investor interest is strengthening.

Additionally, levels of market volatility remain low; the VIX Index has returned to more normal levels of around 12, falling from a recent high of 37.3 back in February.

We think it's interesting that a rising number of analysts now believe that Bitcoin prices are becoming a good lead indicator for equity markets in general.

In the early days, Bitcoin moved wildly but lacked correlation to wider asset prices – perhaps part of its initial attraction. However, as the links between Bitcoin (and crypto-currencies in general) and the broader economy increase, the movements (correlation) in one asset class are likely to begin impacting others. This might be an important factor going forward, now that Bitcoin futures entered wider financial markets at the end of 2017.

The events of market February's correction do suggest a correlation between equities and Bitcoin. A chart of Bitcoin's price versus the S&P 500 E-Mini future shows how both prices moved in remarkably similar ways, especially when prices bottomed and a mini-rebound began. A regression analysis over the past two years reveals a correlation of 0.7 between Bitcoin's price and the S&P 500 Index, where 0 is the weakest correlation and 1 the strongest. Over a year, the correlation is 0.8.

It might follow then that Bitcoin's price spike this week (+20%) and down-channel break could foreshadow similar moves in equity markets.

In summary, the technicals support a view that equity markets have more or less factored in the risks from the ongoing trade war, possibly allowing stocks a relatively smooth spell, buoyed by improving economic conditions. However, we all know that investing is not that simple. While the indicators show a benign path, we should fit this into our broader picture. As active investors, we watch the technical and they help shape our thinking, but they don't tell us what to do.

The Next Crisis?

Three of the "Great Financial Crisis" rescue crew held a press conference this week to discuss what the world had learnt and has yet to learn since then. Former Federal Reserve chair Ben Bernanke, former New York Fed chair Timothy Geithner and former Treasury Secretary Henry Paulson (during George W. Bush's presidency) gathered in Washington DC to voice their concerns about the US' ability to deal with another financial meltdown.

They spoke about regulatory successes and failures and the lack of emergency powers afforded to key financial institutions like the Fed. But one threat they highlighted caught our eye. The three policymakers all joined in to bemoan the ballooning US budget deficit, warning that if left unchecked it could prevent the government being able to effectively deal with another downturn or, worse, cause a debt crisis. Geithner, who also served as Treasury Secretary under Obama, said that "the deficit fever of '09 through '13 was mistimed," and prevented larger stimulus spending that could have turned the economy round faster. But "the new complacency about the larger deficits is mistimed, too."

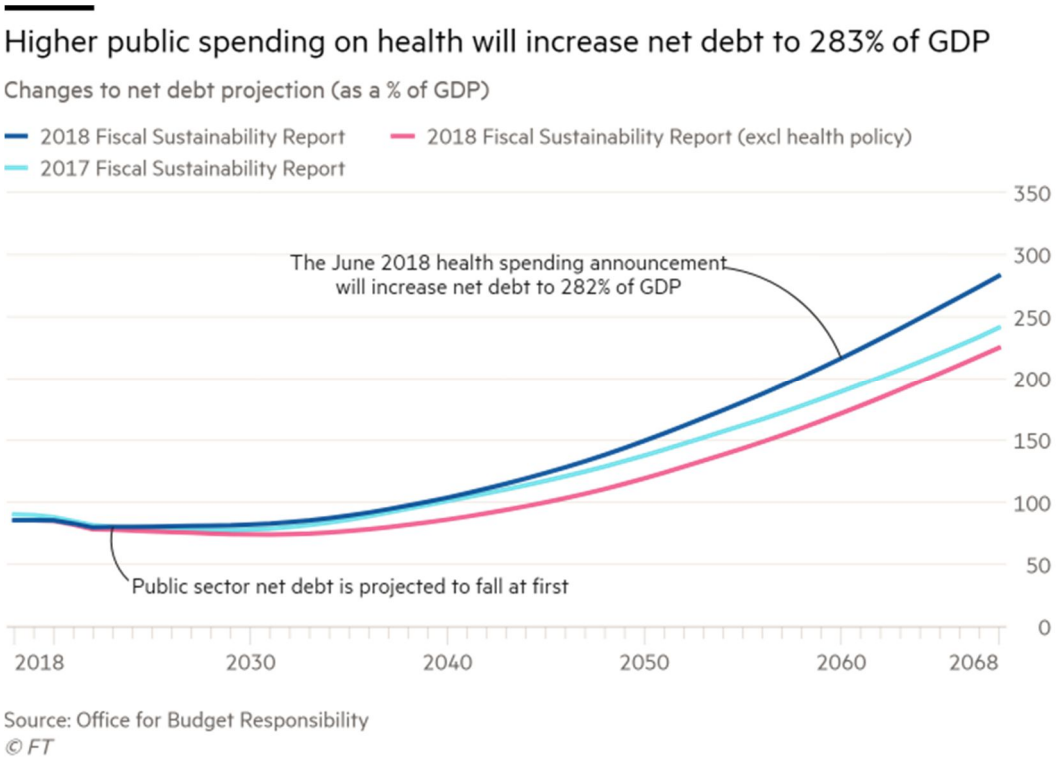
Their fear is not an unwarranted one. Many have warned that loosening fiscal policy and allowing for a bigger pile up of public debt at the same time as the US economy is already expanding rapidly and consumers have already run down their savings could cause an aggressive 'boom and bust' scenario.

Government debt and large fiscal deficits are not a bad thing per se. When output falls and the private sector is a net saver, stimulating demand by running up large budget deficits in the short term can often be very effective, especially if the money is spent on true public investment. Arguably, it was this approach from many western governments that prevented the great recession

from turning into a full-blown depression. But the worry is that President Trump's expansionary fiscal policy is exacerbating the extremes of the business cycle rather than counteracting them, and is not focussed on public investment (e.g. much of the cut in taxes ends up as consumption). With a pro-cyclical policy such as this, it would leave little fiscal headroom when the economy takes a turn.

There are similar worries here, though for slightly different reasons. This week, the Office for Budget Responsibility (OBR) warned that, on current projections, the UK's public finances are unsustainable in the long-term. In their fiscal sustainability report, the OBR made the unusual move of illustrating the effects of Theresa May's recent health spending pledge both in the short and long term. According to chairman Robert Chote, the effects were "so large that we have made an exception this year". Due to the UK's aging population, the OBR's current forecast sees the primary budget deficit at 8.6% of GDP in 50 years' time.

This, along with better accounting for student loans, means that the government's target of keeping the deficit below 2% in 2020/21 will now likely not be met.



In both the US and the UK, ballooning public debt makes it much harder for the government to support the economy in the event of a downturn or crisis. In the worst-case scenario, it could even be the cause of a potential crisis. While this is a long-term story and is unlikely to have large effects any time soon, it's worth thinking through what such a crisis would look like.

Let's start by looking at the last such event, the global financial crisis (GFC). The GFC was a credit crisis, but not a monetary crisis. The issue was widespread worry over the credit-worthiness of key financial institutions, but not about the value of the money itself.

The private sector banking system created a vast amount of credit, secured on collateral which was effectively valued too highly. When the overvaluation became apparent, the huge amount of collateral became illiquid quickly and its overvaluation became undervaluation. Banks and

Investment institutions' dependence on trading both the collateral and the credit was exposed. They wouldn't trade with or lend to each other. Credit which had supported house prices and other economic activity was no longer available, as confidence in the financial system had sunk.

But confidence in the monetary system remained. It was governments and central banks that stepped in to provide the liquidity that the private sector no longer could. Despite creating vast amounts of money to do so, the value of that money remained the same – and inflation in the developed economies remained at the weakest level in a hundred years.

In a government debt-inspired crisis, we think those institutions wouldn't be able to do that. At its heart is the fundamental issue of "willingness to pay". Lenders need to know from the start that the borrower is serious about paying back the value they've borrowed. Circumstances such as the GFC may force a nation to print money to keep the financial system liquid, but its actions thereafter will show if its serious about maintaining value. Thus, the UK government's austerity following the GFC was understandable from the point of view of not destabilising the Bank of England's money-printing.

But if a government borrows hard when not driven by circumstance and then is willing to entertain the idea of printing money to pay its past debts, lenders become very reluctant when considering that the borrower might pay them back in toilet paper; just look at Venezuela. In such cases, in order to regain trust, countries have typically had rely on the independent reputations of institutions such as the IMF or World Bank, and would have to suffer the crushing conditions that usually come with bailouts (e.g. Greece).

Of course, increasing budget deficits and government debt loads – even over the longer term – doesn't necessarily lead to a crisis. Japan's government debt stands at 253% of GDP and has been running a deficit larger than 4% of GDP for most of the last 20 years. Japan has run a current account surplus since the 1970s and therefore the Japanese people are the lenders themselves, allowing the government to use the savings rather than the private sector.

Countries like the US and UK run current account deficits, and ultimately rely on foreign lenders. Expansion of government debt now means that, when a crisis comes along (as it always does) "quantitative easing" is much less viable. The crucial issue is whether markets and bond vigilantes lose faith in a nation's money. Whether that will happen is extremely difficult to say, but over the long it is a risk that we suspect will become more and more apparent.

Big Trouble in (not so) Little China

It's been a tough year for China's economy. Years of credit-intensive growth have left the government in Beijing with a huge debt pile – much of it off the books from shadow banking. The deleveraging process is currently in full swing, as the government cracks down on the shadow banking sector. As we have written before, this process is proving painful, as recent underwhelming data have shown.

Chinese equities were all down this week, while the onshore Renminbi (RMB) exchange rate (which is permitted to trade within a 2% band) fell to $6.74, its lowest since July last year. Many parts of the media are attributing these moves to President Trump's trade crusade against China; some even suggest that it may be a deliberate tactic on Beijing's part to show Trump what a trade

war would actually look like. But we think that this misses the point: internal weakness in China is already enough to justify dampened investor sentiment there.

Back in 2015, there were similar concerns over China's slowing growth rate, under pressure currency and credit-worthiness of many companies. Then, the government's response was to inject large amounts of liquidity into the system and pump up the economy. It worked, and demand from China's growth spurt was one of the main reasons 2016 was so positive for the global economy, and emerging markets (EM) in particular.

Now, however, the government appear reluctant to do the same. While they have effectively eased financial conditions somewhat recently (and are the only EM to do so), they show no sign of embarking on the same stimulus program as a few years ago. That's understandable; the credit-fuelled binge of 2015/16 is one of the reasons the problem now is so big. Overleveraging – particularly among the old and monolithic state-owned enterprises (SOEs) – led to a huge build-up of debt in weak institutions. Just as historically low rates and QE perpetuated many 'zombie' companies in the west, many Chinese companies have come to rely on easy credit for their cashflow.

The fact that much of this borrowing came from the shadow banking sector and was kept off the books is also important. From the government's perspective, a large part of the problem is that they don't even know how badly companies are indebted – even the SOEs who are directly run by the state. While the SOEs are officially under government control, misreporting is widespread.

This is symptomatic of a wider problem in corporate China: governance structures are extremely weak. This may sound an odd thing to say of a country whose ruling party is about as iron-fist as they come, but recent news backs it up. This week, China's statistics bureau acknowledged that it had revised past data on corporate profits. They also revealed that an internal investigation had uncovered 72 cases of illegal statistical manipulation at the national level and over 7000 cases at the municipal level between 2017 and April this year. At one corporation, 19 of the 25 subsidiaries submitted earnings figures that included those of the parent company.

This makes a huge difference to the economic data, and casts yet more doubt on the reliability of official Chinese figures. For example, the bureau reported that industrial profits had grown 16.5% on the year during January-May once last year's figure was revised down. But without that revision, the 2.72tn yuan figure for this year would actually be a 6% drop from the year before. Even the retail sector – which is thought to be highly accurate in its reporting – showed a huge downward revision; the bureau reported 7.5% year-on-year sales growth in January-May, but based on last year's figures it would have been a 9.1% decrease.

The careers of Chinese officials – particularly at the local level – are often tied to GDP and tax data, and so they have incentive to pressure companies into padding their earnings reports. This is important, because it erodes the one thing that often reassures investors on China: the sense that the state is ultimately in full control. No matter what measures the government roll out to counter this economic weakness, if they're going on false information then they likely won't be effective. So, the extent to which the party-state apparatus is actually in control of the running of corporates and the SOEs is exaggerated.

This is why we think markets may be underestimating the potential for economic turmoil in China. The combination of excessive debt leverage and widespread financial misinformation is

reminiscent of the situation in the US prior to the financial crisis. And when you add in a general economic weakness and the external shock that could be provided by Trump's trade wars, there is a danger that things could quickly turn for the worse in the world's second largest economy.

To be clear, we don't think that a crash is the likeliest outcome in China. While the sense of control may be exaggerated, the centralised nature of power in China means that the government can be quick to react to dangers in the economy, and are likely to do so. What's more, the state's healthy balance sheet means they have the capability to take a huge chunk of the debt burden off of SOEs and even the private sector if necessary.

But we do think that markets underestimate the potential for a crash. In our central scenario, weakness will persist in China for some time while the government tries to restructure and deleverage its economy in an orderly but painful way. In our worst-case scenario, things could spiral out of control and cause a sudden downturn – not just in China but all over EMs and to some extent the global economy. That's enough to stop us from becoming positive on China or EMs any time soon.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7674.4	0.2	12.5	→
FTSE 250	20943.3	0.6	130.1	→
FTSE AS	4223.2	0.2	10.0	→
FTSE Small	5906.4	0.2	9.4	→
CAC	5370.5	-1.1	-58.7	→
DAX	12537.0	0.0	-3.7	→
Dow	25087.5	0.3	68.1	→
S&P 500	2805.8	0.2	4.5	→
Nasdaq	7381.5	0.1	5.7	→
Nikkei	22697.9	2.3	509.9	→
MSCI World	2134.8	0.0	0.2	→
MSCI EM	1060.6	-1.4	-15.0	→

Global Equity Market - Valuations

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

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
OCADO GROUP	4.9	WPP	-8.4
UNILEVER	4.0	SMITHS GROUP	-7.4
PRUDENTIAL	3.7	CENTRICA	-5.0
INTERTEK GROUP	3.6	ROYAL MAIL	-4.7
HARGREAVES LANSD	3.4	ANGLO AMERICAN	-3.8

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	7674.4	0.2	OIL	73.0	-3.1
USD/EUR	20943.3	0.6	GOLD	1230.0	-1.1
JPY/USD	4223.2	0.2	SILVER	15.5	-2.0
GBP/EUR	5906.4	0.2	COPPER	275.0	-0.9
CNY/USD	5370.5	-1.1	ALUMIN	2022.5	-0.4

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.227	-3.6	-0.05
US 10-Yr	2.867	1.4	0.04
French 10-Yr	0.659	6.6	0.04
German 10-Yr	0.353	3.8	0.01
Japanese 10-Yr	0.035	-12.5	-0.01

UK Mortgage Rates

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

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

For any questions, as always, please ask!

If anybody wants to be added or removed from the distribution list, just send me an email.

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel