The Tatton Weekly

31 August 2018

Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENTS

Samuel Leary

FUND MANAGER

Isaac Kean

INVESTMENT WRITER

KAL on UK's Brexit landing prospects
Source: Political Cartoon Gallery; 31 Aug 2018

"Not the end of the world"

But not a walk in the park either. (Theresa May, Tue 28 August 2018) That's how the Prime Minister described the prospect of a 'no-deal' Brexit.

After a summer of dithering, does this mean the UK's government is back to "Brexit means Brexit" and that's how it will be next March – seven months from now?

No, that is not how the prime minister's comment on what a No-Deal Brexit may mean for the country should be seen. To the contrary, after a week of far more conciliatory language than we have heard since the very start (on both sides of the negotiating table), odds for a softer Brexit should have significantly increased. That's at least what currency markets signalled, where the external value of £-sterling rose notably on the news.

However, let's make no mistake – should the Brexit negotiations in November end with no deal and the resumption of WTO tariffs coming immediately into force by March 2019, then all involved parties would at the very least face a likely recession, caused by the shock of having to adjust without any transition period. Theresa May's statement is only plausible if businesses are given a couple years notice to adjust to a significant change in their trading framework. Indeed, I have not come across a statement from a government representative with responsibility in the matter suggesting 'no-deal' means an immediate return to WTO rules. Please see this as the context for my choice of the cartoon this week.

We therefore read the Brexit newsflow of the past week as further evidence that March 2019 will only mark the starting point of the journey towards whatever type of Brexit divorce we end up with in November. We have a more in dedicated article on the subject: *UK: Good news is bad news is good news.*

Going beyond UK, capital markets had a bit of a mixed week, with equity markets rising at first when US president announced an end to trade wars with Mexico and appeared to suggest that trade frictions with China would be resolved in due course – Excerpt from a series of tweets from his account:

As for the U.S.–China trade disputes, and other differences, they will be resolved in time by President Trump and China's great President Xi Jinping. Their relationship and bond remain very strong.

However, Trump's insistence later in the week to implement the next round of tariffs against China regardless sent stock markets into reverse and erased the earlier gains. Nevertheless, before this retreat, US stock markets hit new all-time highs, which is triggering concerns about overshooting US equities not dissimilar to what we saw in January, when they experienced their last 'melt-up'. More in the article: Is economic strength behind the US equity market 'melt-up'?, where we discuss that there is undeniable economic momentum behind the US economy, but we may also have reached the point of 'as good as it gets'.

Meanwhile in Europe, focus has once again returned to Italy and its potential to cause another sovereign 'debt wobble' should certain things go wrong. With all the scare mongering going around we would like to inject a bit of levelheadedness and point to some facts, figures and political dynamics which make us expect that the clamour is merely another sequel in the never ending series of Eurozone scare stories.

UK: Good news is bad news is good news

For once, there was a double dose of Brexit positivity this week. Brexit Secretary Dominic Raab told Parliament that he was confident a deal with the EU is "within our sights" as he heads back to Brussels for talks on Friday. Meanwhile, the EU's chief negotiator Michel Barnier said that the trading bloc wants to keep ties with the UK as close as possible, and that the UK could be offered an unprecedented partnership.

Currency markets – our most reliable Brexit barometer since the referendum – seemed to take this as good news. Sterling gained more than 1% against the dollar to near a four-week high and held around that level until the end of the week, despite Mr Barnier tingeing that accommodative sentiment with a reminder that a no-deal Brexit is still possible. Most analysts put the sharp reaction down to market positioning on the currency. In the run up to the 2019 Brexit deadline, more traders have been taking out short positions against sterling, which got squeezed during Wednesday's boost.

Even more dramatic than the currency moves however was the jump up in bond yields. 10-year UK gilts rose 18 basis points on Tuesday, the biggest single day rise in three years. The UK yield curve (spread between 2-year and 10-year bonds) is on track to steepen 16 basis points this week, the biggest weekly increase since 2016. This is while yield curves around the world have been either flattening or staying the same. In general, a steeper yield curve means investors are more positive about a country's long-term growth prospects and expect a pickup in inflation as a result.

Unfortunately, what was deemed good news for the UK economy was bad news for UK large cap stocks as represented in the FTSE 100. Britain's main stock index hit its lowest level in two weeks on Thursday, as currency moves weighed down equities. As a reminder: Sterling's depressed value since the referendum has boosted British stocks by making them cheaper for foreign buyers and by increasing the value of overseas revenues – which many FTSE 100 companies rely on. Naturally, a reversal of this trend should have the opposite effect.

What does this mean for our investment position? Readers may recall that we have recently become more optimistic on UK equities, and removed our underweight position. This was primarily based on two observations: Broader economic conditions are supportive due to weak sterling and strong demand from Europe, and British stocks have cheaper valuations than justified by Brexit risks.

As we said then, much of the UK's economic prospects rely on sterling staying at a relatively low value. As well as boosting equities, low sterling has given British exporters a price advantage, which has gone some way to addressing the UK's structural dependence on domestic demand. But the fact that sterling rose this week doesn't give us cause for concern.

Ultimately, sterling is still extremely 'cheap' in terms of purchasing power parity, and it has a long way to go before that changes. As long as European demand stays strong (which we expect it to) and medium-term Brexit realities remain benign (as this week's news suggests), Britain should continue to ride on the coattails of the union it voted to leave.

Of course, we shouldn't get ahead of ourselves. Brexit uncertainty still weighs down on the economy in other ways (lack of foreign direct investment being one). And while the aforementioned yield curve tends to signal dour market expectations when it flattens, the reverse doesn't always hold. Often a steepening of the curve simply means markets expect higher inflation and not necessarily higher growth – which is arguably the case now.

Nevertheless, this week's developments play into our positive scenario for the UK. Even when Brexit rhetoric turned sour in recent months, we believed that the likelihood of a hard Brexit – in the short term at least – was not high enough to justify how cheap the UK had become. That sterling sellers got squeezed on the mere suggestion that the EU is considering playing nice(r) proves this point well.

Even Mr Raab's bad news is positive. In the same speech to Parliament, he admitted that the October deadline for a deal with Brussels would not likely be met (It is November now). This admission all but confirms that 2019 will effectively see a Brexit in Name Only (BINO) – with the can kicked further down the road into the transition period. In the meantime, Britain gets the economic benefits of EU membership and a discount on its currency. And with that we've come full circle: good news is bad news is good news.

Italy scares again

The Italian question has been a recurring one in the Eurozone for years now. A stagnant economy, ailing banking system and (recently) populist government have made Italy the perennial crisis up ahead. In particular, political movements in the Eurozone's third largest economy have a great power to cause investor panic for European assets.

That's why the rumblings of a 'showdown' between Italy's coalition government and EU officials shook markets once more this week. Deputy Prime Minister and leader of the anti-establishment Five Star Movement (M5S) Luigi Di Maio stated in an interview that he "can't rule out" breaching the EU's 3% budget deficit limit in order to enact his government's spending plans. One Italian newspaper also reported that Italy may ask the European Central Bank (ECB) to continue buying Italian government bonds even after their QE program ends in December.

The yield on 10-year Italian government bonds went to its highest level in over four years after the news, while the euro broke its week-long rally against the US dollar. Markets are worried that, with a public debt equivalent to 132% of GDP and a banking system weighed down by non-performing loans, fiscal loosening in Italy could lead to another Greek style debt crisis, only much bigger.

Finance Minister Giovanni Tria tried to calm tensions and assuage bond markets. He has before confirmed that Italy will keep within the EU's budgetary constraints (a yearly deficit of no more than 3% of GDP), and reportedly told Deputy Prime Ministers Di Maio and Matteo Salvini (head of right-wing nationalists Lega Nord) to tone down their rhetoric. According to an Italian newspaper, Tria warned the pair that inconsistent messages on the upcoming budget would ignite bond speculation and damage the country.

But his conciliatory tone is unlikely to do much good. He cuts a lonely figure in Italy's government; he was a compromise figure after the coalition's Eurosceptic first choice was vetoed by the President. Markets real worry is that an impasse between Italy and the eurocrats will lead to a bloodbath for Italian debt once the ECB's taps run dry, sending shockwaves across the continent.

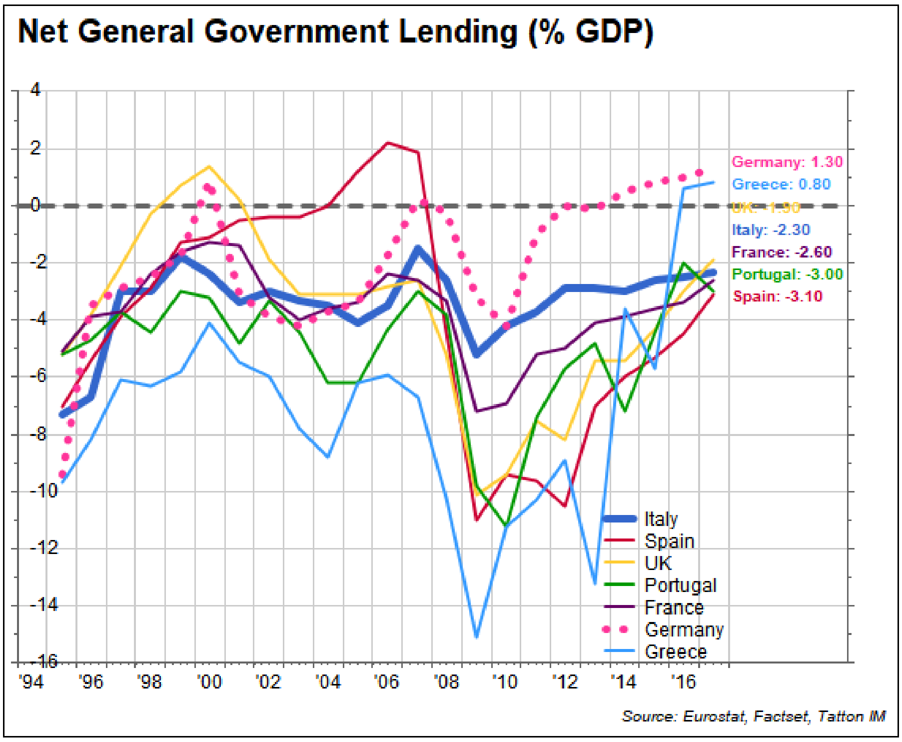
Earlier in the month, the head of Italy's budget committee was brutally honest about the prospect. "The bond spreads will widen dramatically. The whole situation is unsustainable without an ECB guarantee, and the eurozone will collapse," according to Claudio Borghi.

It would leave us with three options, each unpalatable to someone: some form of continued easing from the ECB, with a hurricane of political blowback from Germany; an EU bail-out with Greek-style Italian austerity, which the coalition will never accept; or Italy's exit from the euro, an option no one (barring a few extremer voices in Italy's ruling parties) wants.

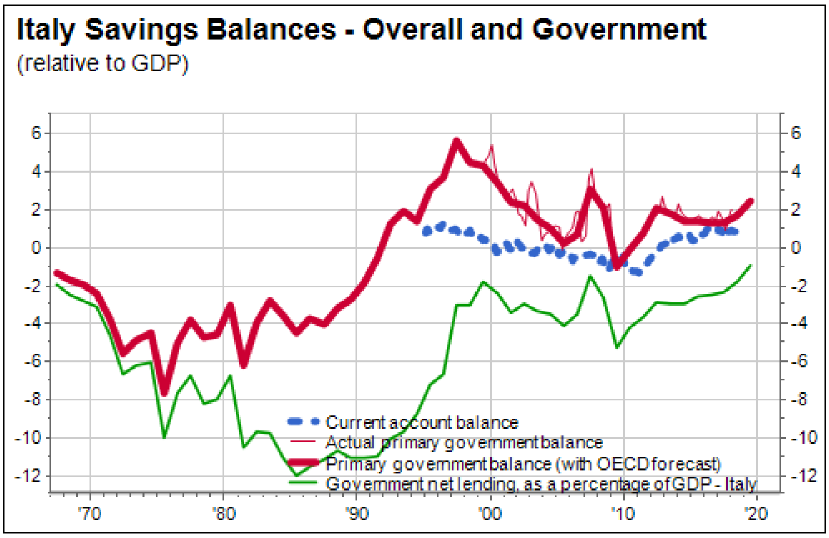
By far the biggest risk is that the negotiating parties' ideological opposition to the first two options will lead to each accepting the third – that political inertia will lead to mutually assured destruction. Given the EU's track record on Greece and Italy again back in 2011, that worry is understandable. But there are good reasons to think that this time is different.

As we have written before on the country, Italy is not a financial failure. While general government debt-to-GDP is high, overall levels of debt are not. The International Bank of Settlements put Italy's 2017 non-financial sector core debt-to-GDP ratio at 263%, compared to 303% and 321% in France and Portugal respectively. And accusations of continued fiscal irresponsibility are widely off the mark: Italy's relative budget deficit has been smaller than France's since before the financial crisis.

The government ran a primary (before interest payments) budget surplus in 2017.



What's more, economic growth improved last year, which even improved the dreaded non-performing loan (NPL) situation for Italy's banks. While EU budgetary rules are more stringent on Italy than others (as their 132% central debt-to-GDP ratio means they must prove they're working towards debt reduction), the fact remains that they have fiscal headroom to enact at least some fiscal measures – e.g. to repair crumbling infrastructure. Simply, there's more room for compromise between the populists and the eurocrats than there was before.



Italy is also in a much better bargaining position than Greece ever was. Aside from accounting for roughly 15% of Eurozone GDP, Italy has had to bear the brunt of the immigration wave from North Africa to Europe (Lega Nord's anti-immigration stance was in fact one of their main vote-winners). Due to the lack of a unified European response to the migrant crisis, this led to Italy developing its own tactics for tightening its borders. As unsavoury as some of those tactics are (the accusations are that they involve effectively paying Libyan warlords and human traffickers to become gatekeepers), they have been extremely effective.

Given how much of an issue the immigration crisis has become for Europe and especially Germany, this gives the Italians a crucial bargaining chip. Ms Merkel may well tolerate Italian budget deficits of 4% or even 5% if it means that Italy continues to keep a lid on immigration. And in any case, it's not just Italy that will need a contingency bond-buying plan when QE winds down. Spanish, Portuguese and even French bonds will come under pressure and it will be in the interest of the whole continent to stop another Europe-wide debt crisis.

For us, this looks more like just another Italian scare that will come to little. Italy's government has a problem financing legacy debts from the 1990s – they don't know where their money will come from after December – but not a structural problem. Their money will most probably once again be provided by Italian savers. The underlying economy and even the populist government isn't bad enough to start a crisis all on its own.

Is economic strength behind the US equity market 'melt-up'?

US stocks have hit new, or remain close to, all-time highs – and US indices are on-track for their best August since the dotcom peak.

The question asked by investors is: what's driving it, will stocks keep going up and can the US continue to outpace everyone else?

In our article on 20 July ("*A technical view: are markets about to go risk on*?") we pointed out that US markets looked ripe for a rally, according to a number of technical indicators. Price action indicated a possible release of energy – and, although the direction was unknown, the balance of probability was that it would move higher at least in the short-term. After writing the article, prices initially looked slightly weak but then rallied back – and from the start of August, moved back into positive territory.

US technology stocks continue to hold leadership (despite regulation fears), rising 17.2% year-to-date, accounting for 54% of the S&P's 8.4% gain in 2018. Amazon alone accounts for 20% of the S&P gain thanks to a rise of 65%, despite an index weight of just 2.6%.

S&P500 growth stocks are up 14.5% year-to-date, courtesy of Amazon, Apple and Alphabet. But even value stocks have moved up, erasing losses to be 2.1% higher on the year.

Meanwhile, the US has outperformed Europe in local terms and in currency terms as the US$ strengthened, although the greenback has started to look less positive recently.

Maybe the technical traders have avoided debating the why, how far, or if is it right. For some, it's hard to weigh up all the conflicting fundamentals (good earnings, solid macro data, trade wars, valuations). Perhaps it boils down to simple supply and demand. Price momentum in the best names still looks strong, as share buybacks have favoured US equities. The run rate for this year is at a record $650bn, or 2.75% of market cap. In contrast, Eurozone buybacks languish at 0.85% of market cap.

But is that all there is to it?

The combination of a strong US economy and healthy Q2 corporate earnings has supported sentiment, but trade war fears have loomed. Trump's announcement of a trade deal with Mexico eased fears the President would wreak havoc on global trade. Perhaps Trump just wants a more equitable outcome for the US after all.

The US economy had an exceptionally strong first half of 2018. The Bureau of Economic Analysis (BEA) reported that its second estimate of Q2 GDP growth was 4.23% – even stronger than its previous estimate of 4%.

The upward GDP revision mainly reflected stronger capital expenditure (+8.5% in Q2 after rising +11.5% in Q1), helped by tax cuts that made it more appealing for companies to invest in new equipment and staff. Durable goods orders in July also showed momentum, rising +0.2% month-on-month (ex-transport goods).

Still, there are signs that a rise in domestic inflation is starting to impact real spending, even if nominal spending is on the increase.

US firms are raising prices at the fastest rate in the current 9-year expansion. Non-manufacturing firms reported to the Philadelphia Fed that they expect to increase prices 3% this year, up from the 2% they reported in May.

While companies may be initially happy with higher prices, customers probably won't be, and customers are also employees. Until recently, consumers had seen their wages stagnate despite multi-decade low unemployment. Higher prices and bigger pay increases mean more inflation, made worse with price-increasing trade tariffs.

Economists expect inflation (Personal Consumption Price Index) to rise above the Federal Reserve's target of 2% in the near-term. The recent minutes from the Fed revealed "increased confidence" in the outlook and that a further rate hike would "likely soon be appropriate". Economists believe the Fed will continue with gradual rate hikes to control inflation, with one likely in September and another in December.

Higher rates are already having a knock-on effect on the US housing market. Pending home sales fell -0.7% MoM in July – missing expectations – as mortgage costs rise. The Case-Shiller house price index of 20 cities rose just 0.11% MoM in July, slowing to an annual growth rate of just 6.3% year-on-year

So, does this suggest that the US economy might have peaked – reaching 'as good as it gets'?

One of the oddities after the Federal Reserve's Jackson Hole meeting was an emerging view that chairman Powell might pause the Fed's monetary tightening in 2019 after the next two rate hikes this year. His speech was interpreted as saying that two further hikes would take rates to "neutral", as was a San Francisco Fed research paper saying that a US treasury yield curve "inversion" portended slow growth (thereby seemingly suggesting the US Fed may not want to bring the inversion about by raising interest rates further before longer maturity yields rise as well).

This angle provides us with a greater context in which to understand the powerful relief rally seen in US stocks during August. An analysis by Nomura suggests that US equities are increasingly showing negative sensitivity to "tighter financial conditions", with the S&P500 now negatively sensitive to inflation expectations, real interest rates and also the US dollar.

As Nomura note, "any market-view that the Fed is approaching "pause" to avoid "over-tightening" is positive for U.S. Equities". Fed governor Powell's speech at the annual Jackson Hole conference added further support to the idea of an equity-friendly Fed.

From our point of view, we think this is where US equities may come unstuck. Stronger nominal growth could easily destabilise the "Fed on hold" view, especially if inflation eats away an increasing proportion of that nominal growth. And given the rise of "pricing power" for both companies and labour, that's quite likely.

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7444.6	-1.6	-118.6	→
FTSE 250	20705.5	0.2	40.0	→
FTSE AS	4112.7	-1.2	-50.6	→
FTSE Small	5864.2	0.4	21.8	→
CAC	5410.3	-0.4	-22.2	→
DAX	12376.4	-0.1	-18.1	→
Dow	25969.8	0.7	179.4	→
S&P 500	2904.1	1.0	29.4	→
Nasdaq	7662.1	2.4	176.7	→
Nikkei	22865.2	1.2	263.4	→
MSCI World	2181.6	0.9	20.0	→
MSCI EM	1057.8	0.7	7.7	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.3	16.5x	13.3x	13.0x
FTSE 250	3.2	18.0x	14.9x	13.9x
FTSE AS	4.1	17.0x	13.5x	13.1x
FTSE Small	3.8	-	13.1x	13.7x
CAC	3.2	16.7x	14.5x	13.2x
DAX	3.1	14.4x	13.1x	12.4x
Dow	2.1	18.4x	16.7x	14.9x
S&P 500	1.8	21.0x	18.0x	15.6x
Nasdaq	0.9	26.8x	21.9x	17.6x
Nikkei	1.8	16.5x	16.2x	19.9x
MSCI World	2.3	18.8x	16.5x	15.0x
MSCI EM	2.7	12.9x	12.2x	12.0x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
WHITBREAD	15.3	BRITISH AMERICAN T	-7.9
NMC HEALTH	3.3	SAGE GROUP	-7.6
LSE Group	3.3	VODAFONE GROUP	-6.5
BUNZL	3.2	SAINSBURY (J)	-4.6
MICRO FOCUS INTERN	2.8	BARCLAYS	-4.1

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	1.04	OIL	77.5	2.2
USD/EUR	1.16	-0.07	GOLD	1201.7	-0.3
JPY/USD	110.86	0.34	SILVER	14.5	-2.0
GBP/EUR	0.89	1.08	COPPER	268.5	-1.4
CNY/USD	6.83	-0.28	ALUMIN	2132.0	3.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.432	12.1	0.15
US 10-Yr	2.837	1.0	0.03
French 10-Yr	0.683	-0.6	0.00
German 10-Yr	0.329	-4.6	-0.02
Japanese 10-Yr	0.107	5.9	0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.73
3-yr Fixed Rate	1.82
5-yr Fixed Rate	2.05
Standard Variable	4.10
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