The Tatton Weekly

7 September 2018

Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENTS

Isaac Kean

INVESTMENT WRITER

Asset class returns to 31 August 2018

Asset Class	Index	August	YTD	12 months
Equities	FTSE 100 (UK)	-3.3	-0.2	4.1
	FTSE4Good 50 (UK Ethical Index)	-3.9	-3.1	-0.6
	MSCI Europe ex-UK	-1.4	-0.3	-1.3
	S&P 500 (USA)	4.2	14.4	18.6
	Nikkei 225 (Japan)	3.4	7.4	16.7
	MSCI All Countries World	1.7	6.3	8.8
Bonds	FTSE Gilts All Stocks	0.2	0.2	-0.4
	£-Sterling Corporate Bond Index	0.5	-1.1	-0.9
	Barclays Global Aggregate Bond Index	1.0	2.5	-2.2
Commodities	Goldman Sachs Commodity Index	2.0	12.0	21.1
	Brent Crude Oil Price	5.6	20.8	45.6
	LBMA Spot Gold Price	-0.1	-3.1	-8.4
Inflation	UK Consumer Price Index (annual rate)* End of May	-	0.8	2.0
Cash rates	Libor 3 month GBP	0.1	0.4	0.5
Property	UK Commercial Property (IPD Index)*	-	4.5	9.2

* Data to end of previous month
Source: Bloomberg; 7 Sep 2018

Interesting times ahead

It has been one of those weeks, where so much news comes across our desks that I do not quite know where to start and where to finish, but we can be sure not to get bored in the near term.

After all the Brexit drama of the past weeks, there is some evidence emerging that our rationally argued view that contrary to all the recent talk, next year's formal Brexit, will be just that.

As leaked discussions between UK and German trade representatives this week showed, it is entirely feasible that the two parties will decide to merely aim for an agreement in principle and then kick the details into the long grass of the transition period (which could be extended). This would stabilise economic conditions, as well as preventing an entirely unpalatable and time pressured vote of parliament between two bad choices. Political instability for the UK should thereby be prevented and the Tory party may refrain from entering self-destruct mode, both of which would otherwise steer the country towards new elections which is the last thing the negotiation parties seek.

Compared to the latest Brexit news, the turmoil surrounding the Trump administration was of far higher potential impact to global near term prospects. With the stream of scandals and revelations of incompetence beginning to seriously threaten Trump's chances to retain the majority in both chambers of Congress in November's midterm election, a timely resolution of his trade wars appears unlikely. It lies in his nature to assume that he will win more votes while seen fighting for his electorate with foreign powers than compromising towards a deal and seeing the results picked apart by the opposition.

This does not bode well for the US as the recent locomotive of global growth. Tariffs result in higher prices for US industry and consumers and reduce rather than stimulate economic activity. The US central bank – the Fed - would be forced to raise rates faster than economically digestible to fulfil its mandate of achieving price stability, which could -just as so often before- turn the boom to bust.

The rest of the world looks somewhat less exposed in comparison. China can unleash another centrally orchestrated fiscal stimulus package toward infrastructure improvements which it could even finance by selling some of its vast USD currency reserves to pay for imported input factors. Europe and Japan are experiencing improving consumer sentiment on the back of strong jobs markets which should lead to more domestic consumption demand through lower savings rates between those two world champions of savers.

Europe may have looked unstable again because of Italy's debt refinancing woes and Turkey's currency crash. Here, however, Italy's populist government assurance that it will not seek to breach EU budget deficit rules has already brought about much calmer bond markets. In Turkey the central bank has vowed to return to orthodox monetary policy measures and anyway Europe's relative exposure to Turkey's economy and financial assets is no longer deemed a systemic threat.

This leaves the wider emerging markets, where there has been much talk about contagion spreading from Turkey and Argentina, which could lead to a much larger stock market fall than the 20% they have already suffered since the beginning of the year. True, they have suffered from a triple onslaught of falling Chinese demand, higher costs of finance from a rising US$ and the prospect of significant curtailment of global trade, curtesy of Donald Trump.

As discussed, China's demand may well experience fiscal stimulation while rising inflation and slowing economic activity in the US has in the past driven the US$ down. This leaves global trade and as this conflict is unlikely to be resolved quickly it is likely to continue to weigh down emerging market prospects for a while longer.

All in all a complex picture, which contains some cause for concern, although by no means at the levels we have read in some of the more sensationalist comments of the past week.

Perhaps unsurprisingly stock markets did not have the best of times, but it was notable that for the first time in a while the US tech sector suffered larger declines than the rest of the market. This, combined with the upwards jolt in £-Sterling on the prospect of a more prolonged rather than cliff edge Brexit, inform us that our portfolio positioning away from the emerging and US stock markets and towards Europe, Japan and at least a neutral allocation towards the UK is proving an adequate response to the changing, but not necessarily overall negative outlook for the remainder of the year.

Brexit Fudge

Sterling went for a ride on Wednesday. After concerns over the lack of Brexit progress turned investors sour on the currency in the morning, a report containing much needed good news precipitated an almost-immediate 1.2% jump against the dollar. That bounce left sterling up 0.96% overall on the day.

Early price action made it clear that political and Brexit risks are the key drivers of the currency. A positive surprise on UK services data – a 54.3 PMI versus the expected 53.9 – was ignored by markets. Then came the news that both Germany and the UK are willing to drop key Brexit requests in order to avoid a “no deal” scenario next year, causing the jump.

The British press were characteristically triumphant on the story. “Germany is ready to cave to Britain’s Brexit demands”, according to the Daily Express, “and a deal looks ever closer.” The reality is somewhat less impressive, though important nonetheless. According to an unnamed official speaking to Bloomberg, the German government will accept a less detailed Brexit plan for next year, in order to get an agreement ready on 2019’s initial separation. In return, Theresa May’s government is prepared to give a vaguer statement of intent on Britain’s future relationship with the EU.

Both sides have effectively agreed to disagree on the long term plan in exchange for a clearer short term plan. It comes after last week’s admission from Brexit secretary Dominic Raab that a deal with the EU would not be reached before the October deadline, pushing it back to November. We wrote then that this effectively confirmed that the ship had sailed for a meaningful Brexit 2019: there isn’t enough time to design and implement all necessary process changes for a substantial departure from the bloc for next year.

This week’s news is further confirmation. Both sides have little choice but to accept an extended transitional period after Britain’s nominal exit from the EU in March, and delay a genuine Brexit until further notice. No matter what kind of agreement can be reached before then, the shock effect that a sudden enforcement of material changes for 1 April would have on British and European businesses would be harmful to everyone. Companies and trading partners will need time to prepare for substantial changes. May’s government has missed the boat on that front. This is where much of the current clamour has its roots.

What does this mean for our investment position? Regular readers will know that we have a relatively positive assessment of the UK, on the back of the notion that Brexit upheaval fears have darkened the economic and investment outlook more than is justified. For the time being, a supportive economic environment on the continent is spilling over the channel through strong demand for British goods. And the weakness of sterling means British exporters can take full advantage of this. Meanwhile, Brexit upset risks are, in all likelihood, going to prove far more benign than many make them appear – in the short term at least. The result is that the UK gets the full economic benefit of EU membership with an added trading bonus of a weak currency.

The leaked compromise between British and German negotiators adds weight to this assessment. It’s unlikely that fundamental changes will be enacted to the existing trade framework next year; both sides will have to agree to kick the can further down the road – to the benefit of British exporters. We have also written before that the UK's economic fate is tied to the value of sterling, rising when it falls and vice versa. If the news-flow is positive enough to make currency markets realise that the short-term Brexit outlook isn't too worrying, would that be enough to spoil the weak sterling effects?

Fortunately not (or unfortunately, depending on how you look at it). While this week's news confirms somewhat the Brexit prospects for next year, beyond that is anyone's guess. Mrs May is still pushing her Chequers plan, and getting little back from Barnier and co. Most of the major 'breakthroughs' in negotiations have been about postponing the decision rather than making it. All this uncertainty is weighing down on sterling and making sure that any rallies are short-lived. For now, Britain can look forward to supportive trading conditions without having to worry that Brexit positivity might be its undoing.

Not only is the positive backdrop boosting UK growth, it's also addressing some underlying structural problems. The UK has one of the largest current account deficits (exports minus imports) of any developed nation; it's higher as a percentage of GDP than the figure that has Donald Trump so angry in the US. This was made possible by our reliance on domestic demand and credit (which is why the housing market is so important to the economy, as consumers borrow against their homes).

This has had a number of negative effects, such as low savings rates and wealth and growth concentration in London. But since the referendum two years ago, export growth has been one of the main drivers of the economy. Not only is this alleviating our current account deficit, but it's also rebalancing growth towards the regions.

All this looks set to continue. Both sides have agreed to fudge a Brexit plan for next year, and the macroeconomic backdrop remains supportive. Against these more realistic expectations, UK stocks look much cheaper than justified by the longer term uncertainties around the final shape of Brexit. Once it dawns on more investors that March 2019 will only be the starting process of the Brexit divorce, but is unlikely to be a collapse of pan-European level headedness, there is a high potential for UK asset prices to catch up with their global benchmarks. This week's sudden surge in Sterling's value gave us notice from capital markets to expect as much.

Global round-up

After a very synchronised global upswing in 2017, 2018 has seen significant changes in the regional dynamics of the global economy. Most of the world's economies continued to expand at steady pace while the US has soared ahead, with the consequently strong US dollar and tightening monetary conditions (even more than the Fed's reversal of QE) causing serious troubles for Emerging Markets (EMs). As we move into the last third of the year, each major region is facing risks of its own making. Given this, we wanted to give you a breakdown of the rationale behind our current investment position, and what we see as the major themes for each region.

To start with, a recap. In the US, the most powerful man in the world is, depending on your point of view, a stable genius or an erratic narcissist. He doesn't respect institutions, is sceptical about globalisation, in favour of bilateral rather than multilateral trade deals and doesn't believe in climate change. Meanwhile, the US central bank, the Federal Reserve (Fed) has begun its monetary tightening in earnest and is expected to raise interest rates again soon.

Globally however, monetary tightening has yet to take effect. Both the European Central Bank (ECB) and Bank of Japan (BoJ) continue to provide liquidity to the global financial system through their quantitative easing (QE) operations. This is currently enough to offset the Fed's balance sheet reductions but their money creation is slowing. The ECB will cease QE in December.

The move from net-easing to net-tightening (Quantitative Tightening, QT) is likely to begin in the last quarter of this year and accelerate through 2019. At the same time, demand for "productive" capital is fuelling a rotation from the financial economy to the real economy. All of this translates into a drying up of liquidity around the globe.

For EMs, this isn't good news. They still rely heavily on overseas investment and are sensitive to capital outflows; with US companies being encouraged to bring home their overseas cash, they have already suffered this year. Emerging economies are also extremely sensitive to global trade flows. One of their defining characteristics is their cheap labour costs, which usually means local employment, and – by extension – domestic demand, tracks global trade (with a bit of a lag).

That's exactly what's happened. But currently, EMs have the added problem of excessive leverage; their credit build-up on the back of low global interest rates following the financial crisis has left many companies with large amounts of debt. The last slowdown in 2016 has made many EMs more resilient, but there's no escaping that a number of them are in an extremely difficult period. And, while some argue that EM assets have been oversold and are now a buying opportunity, until the global macroeconomic and trade backdrop improves for them it's hard to see much of an upside.

Nowhere is the debt problem as prominent as in China, where the government has been trying to unwind the credit build-up and rein in the shadow banking sector. The slowdown this has caused was threatening to turn into a meltdown, which is why the government has begun easing credit conditions and pressuring financial institutions into more lending. But, as we wrote recently, this will be difficult with a banking system that's terrified of its own loan book; banks will likely just offset increased lending with decreased lending elsewhere.

The Chinese government's fiscal expansion will hopefully be more effective in countering the slowdown, but the issue remains that opportunities for productive investment in China are slim due to the credit build-up, and so lenders will remain reluctant. What's more, the money from local government bonds will take time to come through as infrastructure spending. At a time when unemployment is rising (possibly due to the closure of polluting plants) and consumption growth is slowing, it's needed sooner rather than later. As ever with China however, the power, centralisation and past sure-footedness of the government inspires some confidence that the country's economic managers will steer away from disaster.

The same can't be said of the US. This week's revelations and Trump's lashing response epitomised his volatile Presidency. As we come up towards the midterm elections – which are turning into an effective referendum on Trump – it's highly probable that he will become even more combative. It's in his interest not to make trade deals at this stage but to be seen fighting for America, meaning more tariff tough talk is likely, particularly with China. He may even want to be seen throwing the US' military might around – triggering confrontation over the South China Sea (an area he's been unusually quiet about) for example.

The one boast he can still make is the US economy, which has undeniably been the world's real growth engine this year. But there are signs that this is now feeding through into inflation pressure, with tight labour markets and tariffs pushing prices up. Trump may claim (truthfully) that his tax cut has helped propel American growth, but the danger is that his fiscal policy has become pro-cyclical – spending during the boom and then being forced to cut back during the bust. This makes the highs higher but it will inevitably make the lows much lower.

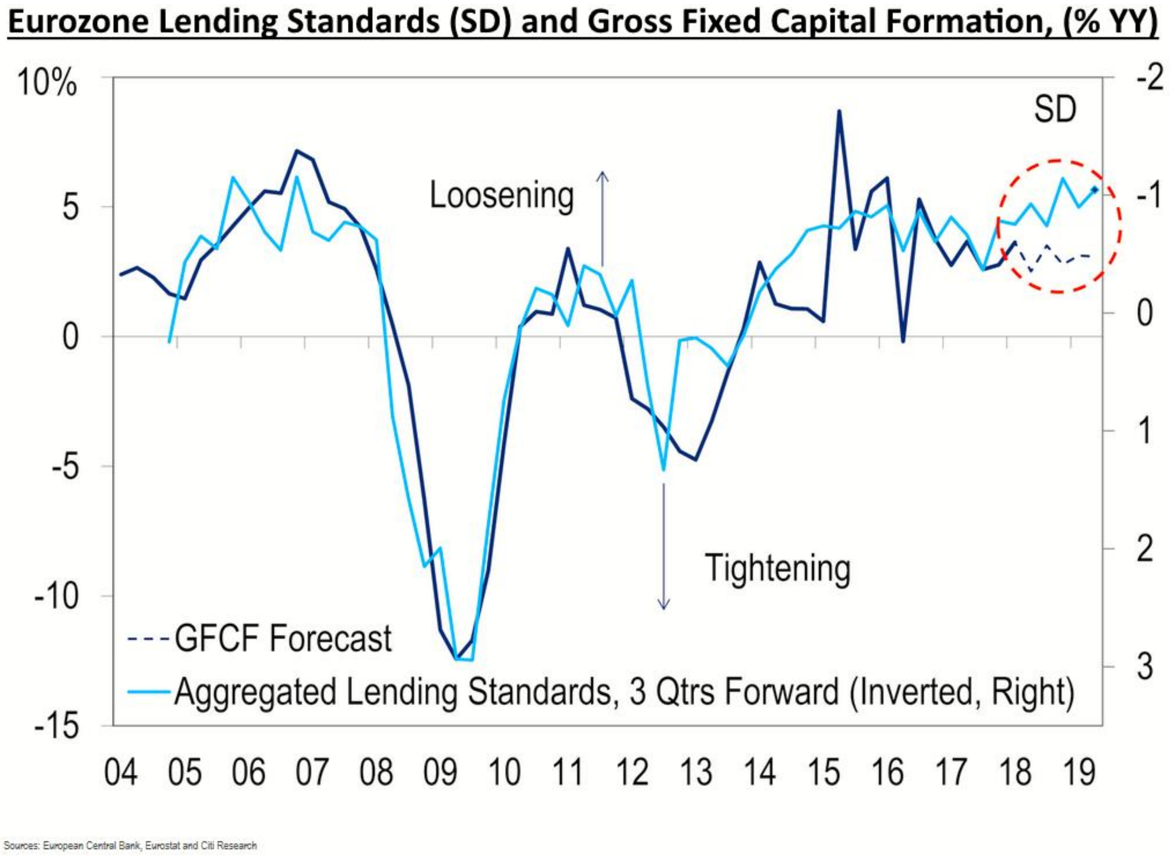
This is especially true considering his isolationist trade policy – as globalisation has been one of the main factors behind the low inflation we've seen since the mid-1990s. Not only will his tariffs have a one-off inflationary impact, but they could also act as a catalyst for wage inflation pressures, by changing the general public's inflation expectations.

These inflationary pressures make the dollar vulnerable. Dollar strength has been one of the defining features of this year, but capital flows have stabilised recently. If US inflation does push the dollar lower, we could enter a vicious circle where rising import prices cause more inflation, which causes more dollar weakness and so on. In such a case, the Fed would have little choice but to quicken the pace of their monetary tightening. Knowing Trump, he's unlikely to take that well. And a spat between the White House and the Fed doesn't help anyone.

Finally, to Europe. Italy stands out as the biggest cause for concern on the continent; their large debt pile is in need of refinancing which will be harder after the ECB stops its QE purchases. But Italy is far from a basket case, and if the eurocrats allow it to become an existential threat to the bloc they would be shooting themselves in the foot.

Otherwise, things look positive in Europe. Growth is stable and strengthening in the core, while private sector credit is on the rise. With exports under pressure from Trump's tariffs, domestic demand is having to pick up the slack – which is helping rebalance the economy away from being export-dominated. The Union is still sensitive to export slowdowns, but high savings rates of the past and present mean there is room for demand to pick up even more on the back of improving consumer sentiment.

Concerns continue over European banking sector profitability, generated by the continued low interest rate policy of the ECB. But it's worth noting that a lack of profitability isn't hindering the banks from wanting to lend (they may be reluctant to lend profligately but that's no bad thing). Bank lending standards are easing, and credit is available. Historically, that's led to corporate capital investment, which bolsters both growth near-term and profitability in the long-term. The chart below (from Citi) shows how the bank loan officer survey responses (measured in standard deviations) have led to capital formation (investment):



Meanwhile the rise in European wages is likely to feed through to spending, since savings rates are already at high levels. Indeed, we expect a combination of stable household asset values, falling unemployment, and improving access to personal credit, to allow consumption to lead European growth.

While Europe rebalances towards consumption, the UK rebalances away from it. This is being driven primarily by the weakness of sterling, as well as the troubles of the housing market. Consumption is being supported by the low levels of unemployment and so will remain stable if a bit anaemic. In the past, rising house prices have helped household balance sheets and allowed spending to rise through credit expansion. Now house prices seem to be at an equilibrium and are likely to remain static unless unemployment reverses its recent falls.

As has been the case since the referendum, weak sterling has been a major boon for exporters, who enjoyed added price competitiveness over their Continental rivals. While Brexit concerns have been positive in this regard, they've been damaging in others: investment and capex is constrained by fears over the future trading relationship. The political risks are clear, but we believe that UK equities are trading at lower valuations than justified by Brexit concerns. As such, they present a buying opportunity.

The rest of the year and 2019 will present challenges for the global economy as liquidity becomes scarcer. Europe and the UK look fairly well placed to deal with those challenges, while things could be more difficult for EMs and – to an extent – the US.

The Trump Risk

Ingram Pinn's take on Donald Trump's latest journalistic headwinds
Source: Political Cartoon Gallery; 7 Sep 2018

Another week, another controversy for Donald Trump (or a few, to be precise). First, veteran Watergate journalist Bob Woodward – whose reporting helped bring down President Nixon – released a book about Trump's presidency that's just about as damning as such a book could be. Then, an anonymous White House official wrote an op-ed for the New York Times claiming that members of the administration are working to "frustrate parts of his agenda and his worst inclinations."

It shows how desensitised we've become to Trump's behaviour that his partisan criticism of Attorney General Jeff Sessions for publicly charging two Republican congressmen shortly before the midterm elections barely registered as news. Both the book and the anonymous op-ed paint a picture of a presidency even more erratic and dysfunctional than it seems from the outside. According to the unnamed official, cabinet members even considered trying to prematurely remove Trump from office, before deciding to subvert his decisions at every turn.

Trump's replies to both were as predictable as they were frightening. The President accused Woodward of being an operative for the democratic party trying to swing the midterm elections in their favour. Immediately after the release of the op-ed, Trump simply tweeted the word "TREASON?", before demanding that the New York Times turn over the "gutless" writer to the White House "for National Security purposes".

A week like this would be enough to bring down most Presidents. But Trump has proven strangely impervious to the controversies he leaves in his wake, defying many predictions of his downfall.

America under Trump is characterised by two contrasting stories. On the political side, division and chaos dominates – as this week has epitomised. But on the economic side, things are entirely different. For all of his erratic behaviour, Trump has overseen a booming US economy. While most of the world has been chugging along at a decent pace, the US has raced ahead. The annualised growth rate came in at 4.2% for Q2, while the Institute for Supply Management's sentiment survey for the services sector came in at 58.5 in August – well above the expected 56.6. Anything above 50 indicates expansion.

How much of the US growth story is because of Trump is debatable, but most economists agree that his tax reform last year delivered a boost to the economy. At the very least, it seems unlikely that his policies or behaviour so far has done US growth any damage. And yet, most people – ourselves included – list Trump and his policies as one of the main risks to the US economy. How can that be when he's presided over such a roaring expansion?

Investors' number one fear about Trump is tariffs. He has shown that he is willing to threaten and follow through with tariffs on just about anyone. The US' trade flow with China (the largest between any two nations) has already taken hits, and American companies have warned that they will not be able to absorb Trump's proposed 25% tariff on $200bn worth of Chinese imports. Negotiations between the US and EU looked promising, but Trump has reportedly rejected plans to lower tariffs to zero as "not good enough" – begging the question of what would be.

Trade policy is where the damage of Trump's erraticism is most keenly felt. There has been recent progress on a 'new NAFTA' with Canada and Mexico, but markets know full well that Trump might turn around at any point and kill the deal. On China, the flip-flop tactics have given negotiators headaches. At various times over the past year or so, bright spots have appeared on the horizon for the US-China relationship, only to be promptly extinguished by the most powerful man in the world.

The heart of the issue is that the administration has no clear goal or ideas of how to achieve it. As we have written before, some in the White House are pragmatic on China and want to address trade wrongs, while others are ideologically opposed to China's economic and technological development altogether. The result is an inconsistent trade policy, seemingly without clear leadership from Trump himself.

As well as the economic impact of actual tariffs, the uncertainty surrounding trade is likely to dampen growth itself. Without knowing what future trade relationships will look like, we would expect firms to rein in their capital spending plans – taking liquidity away. This is especially true for the short-term.

What's more, we expect that the upcoming midterm elections will simply make all this worse. Despite being one of the most unpopular presidents in modern history, the congressional elections in November are far from a done deal. For all his faults, many voters have done quite well over Trump's time in office. But a win for the Republican party would still be extremely difficult. Forecasting website FiveThirtyEight put the chances of the Democrats winning control of the House of Representatives at 77%. However, the Senate seems a much harder win for the Democrats.

A Democrat-controlled congress would be a real issue for Trump (and could eventually even lead to criminal charges), so he has incentive to up his popularity before then. Appearing tough on trade – being seen as fighting for America – is one way to do that. That's why, as we head into the next couple of months, we see trade agreements being reached with anyone – and especially China – as unlikely.

For all the good Trump can claim to have done the US economy, his presence at the helm is one of the biggest risks facing it.

Due to technical issues no finance data update can be provided this week - apologies

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100				
FTSE 250				
FTSE AS				
FTSE Small				
CAC				
DAX				
Dow				
S&P 500				
Nasdaq				
Nikkei				
MSCI World				
MSCI EM				

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100				
FTSE 250				
FTSE AS				
FTSE Small				
CAC				
DAX				
Dow				
S&P 500				
Nasdaq				
Nikkei				
MSCI World				
MSCI EM				

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %

* 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