Weekly Market Comment

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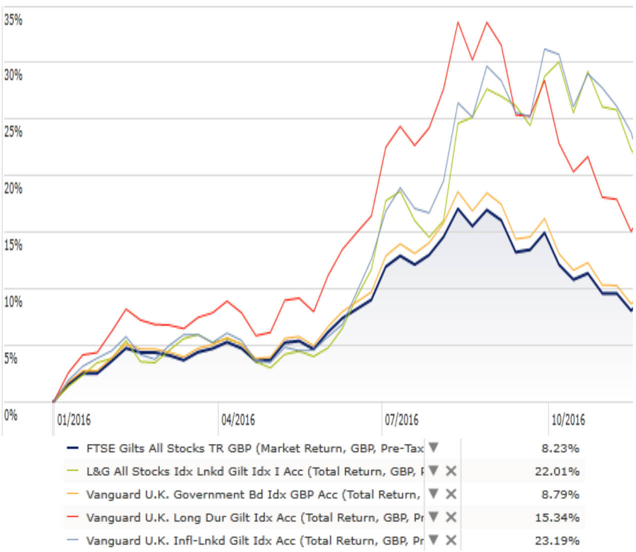
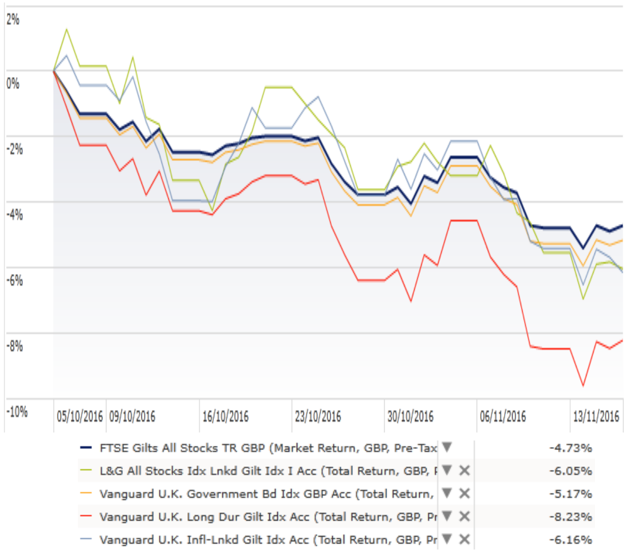
Long maturity UK government bond returns

2016 to 17 November



6 October - 17 November 2016



Various long maturity bond proxies' value development over the course of 2016 and over the past 6 weeks;
Source: Morningstar, 17 Nov 2016

Bond market volatility takes centre stage

In the previous Tatton commentary, I explained the similarities between the post-Trump and post-Brexit reaction of financial markets, and now based on last week's movements, I need to slightly qualify this observation. We have now seen some exactly opposite market movements to the immediate post-Brexit period. The US$ has appreciated rather than depreciated and bond markets have sold off, rather than rallied. In bond markets, the sell-off has spread across to other Western markets and in the FX markets at least the £-Sterling has also experienced a recovery. Only equity markets have continued to be relatively unfazed, with only the UK stock market experiencing slight declines, as a reaction to the strengthening of the Pound – reversing some of the upward dynamic when the currency fell.

There are widespread discussions around what is behind the surprising moves, but I can see two main strands of interpretation. The first one is that Trump's election marks the end of fiscal austerity around the world, while Brexit only suggested that it should be on the cards. The expectation here is that not only will Trump embark on immediate aggressive fiscal stimulus through broad tax cuts akin to Ronald Reagan's first 100 days, but also the rest of the western world will try to prevent a wider spreading of the populists' movement with aggressive economic stimulus as well. While the longer term economic success and sustainability of such policies is not certain, there is a high likelihood that the rate of inflation would rise as governments would have to tap markets for funding. This inflation expectation is what drives up yields as investors swap bonds for more inflation safe assets. If the fiscal stimulus measures succeed in stimulating a persistent improvement in economic growth rates, then this would move inflation expectation even more back to the higher long term averages.

The second strand is that bond markets are simply unwinding some of their excessive, very long term expectations of very low rates of deflation that drove up long maturity bond values so much over the course of 2016 (See the left-hand chart at the top). With the likely end of fiscal austerity on the cards such expectations simply no longer appear plausible. However, just as bond markets overshot on the upside in the summer, they are now at the risk of overshooting on the downside. After 35 years of gradual decline in government bond yields and thereby rise in bond valuations there have been many points over the past 6 years when market experts called the final inflection point or announced the onset of the ‘Great Rotation’. It didn’t happen then and I am not convinced it is happening now. There are too many structural reasons for the heightened demand for low risk government bond type assets and continued QE-driven bond purchases by central banks for yields to move back up to the long term averages over the shorter term. Please note that we have dedicated the third article in this commentary to a more detailed discussion of the different long term forces in the bond markets.

It is undeniable that the bond markets are where the financial market action currently resides and the resultant volatility of what has been dubbed the ‘Trump Tantrum’ is not really in the interest of investors who hold government bonds for their normally more stable values when compared to equities. To conclude, however, that the bond market move is a precursor of the imminent return of either persistently higher rates of inflation or the end of the post financial crisis era of low growth is probably just as far-fetched as was the conclusion at the beginning of the year that a global recession was imminent when stock markets sold off significantly.

For the time being, I observe that Donald Trump appears to be lacking as much a concrete plan of action as the UK’s political class did after the Brexit referendum (and was suggested to lack this still recently in a leaked report). This brings us back to the similarities and differences between the Brexit and Trump and I expect the actual course of post-Trump events to be quite a lot less dramatic than bond markets may currently suggest.

The Trump Factor: An ‘Orange Swan’ for Emerging Markets?

Since candidate Donald Trump turned into US President-Elect, holders of Emerging Market based assets have taken quite a beating. Since that fateful day, the MSCI EM equity index has fallen over 7%, on the back of fears that an increase in US interest rates – coupled with a supposed new-found protectionism in the world’s largest economy – would be the end of the party for emerging markets.

The falls were far from being restricted to equities however, with currencies and government bonds experiencing similar sell-offs. The yield on 10-year dollar-denominated Indonesian government bonds, for example, have shot up to 4.1% over the past week, up from 3.3% on the eve of Trump’s ascendency. More generally, the JP Morgan GBI-EM bond index, which tracks local currency emerging market government bonds has fallen over 8%, the steepest fall since the ‘Taper Tantrum’ of 2013. Over in currency markets, the Chinese Renminbi (RMB) traded at around an 8-year low on Thursday, leaving the RMB 5.5% down in 2016. Across the board, investors appear to be trembling at the thought of what President Trump might mean for emerging market assets if he fulfils the serious intentions stated during his election campaign of turning back the clock in terms of global trade.

Unlike the result of the Brexit referendum, after which £-Sterling dropped to lows not seen in decades and interest rates were cut amid fears of lower growth, Trump’s election has precipitated the US$ hitting a 14-year high, long maturity bond yields have risen, not fallen, and interest rates look almost certain to rise next month at the Federal Reserve’s meeting in December. As such, while Brexit has in financial market terms proved to be – as yet – quite a contained event, the impact of Trump’s victory has had far more reach.

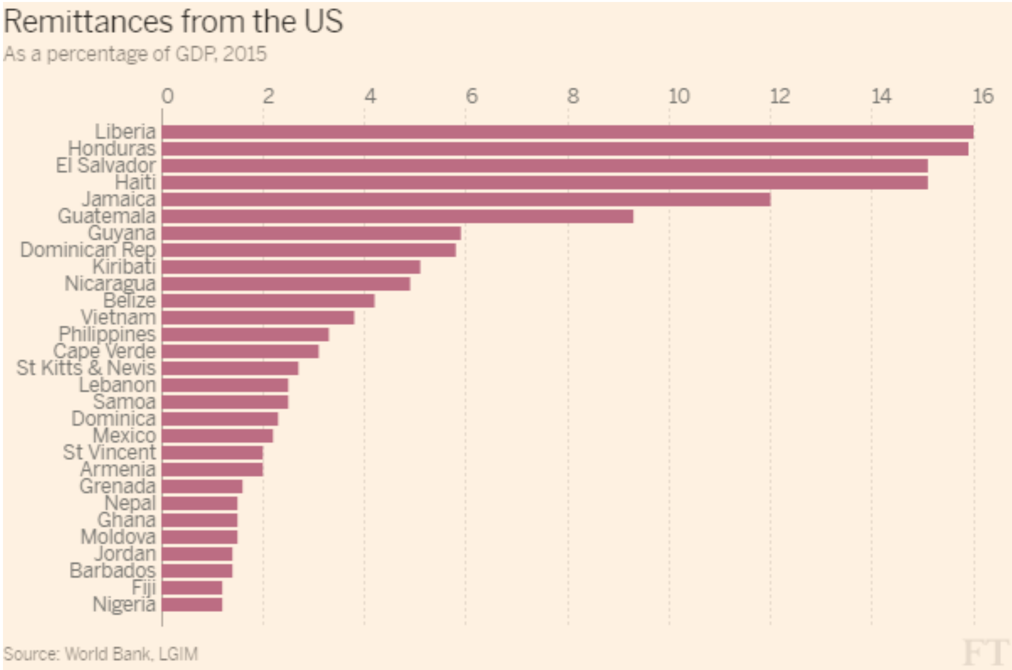
There are a number of reasons for this. Commodity prices are one of them, as they are priced in US$ but do not originate from the US. Therefore, the strength of the dollar is most of the time inversely related to commodity prices, which means that surges in the US$ tend to correspond to falls in commodity prices. Given that the relative health of many emerging economies is closely tied to the commodities industry, one would expect the current dollar strength to spook investors holding emerging market assets. More importantly perhaps, the rising US treasury yields vastly decreases the relative risk-premium of (generally riskier) emerging market securities. Effectively, while yields in the US and the developed world remain low, the incentive for 'carry trades' – where investors borrow money at low rates to invest in higher-yielding assets – is significant. However, with current US 10-year yield up to 2.3% from just 1.9% last week, the emerging market yield advantage is falling, dragging many investors out with it.

Arguably, however, the biggest factor behind the emerging market rout is the fear that President Trump will follow through on the more outlandish promises of his campaign. The President-Elect made a lot of noise about, amongst other things: Repealing the North American Free Trade Agreement (NAFTA), imposing tariffs on companies who outsource production to foreign countries, repatriating capital held in foreign countries and – last, but not least – building a wall on the US' border with Mexico.

All of this has translated into significant capital outflows from emerging economies, after a year where up to this point the reverse trend has largely been seen. In fact, The Institute of International Finance reported that, as part of the 'Trump tantrum', more than $7bn of foreign investment has been pulled out of emerging markets. This kind of capital flight could have real damaging effects for many developing economies, particularly if the current trends are sustained. Also, with Trump emphasising deregulation, increased fiscal spending and corporate tax reform in his post-election remarks, markets are expecting increases in US growth and inflation – meaning the EM outflows are unlikely to subside too soon.

Indeed, Trump's election has already lead economists to assume that a tightening of emerging market monetary policy is on the way, in order to re-establish the previous levels of return risk premium. Mexico's central bank is now expected to raise interest rates by more than 1% above previous expectations, while both Turkey and South Africa are also expected to tighten. While arguably necessary to curtail the negative effects of currency depreciation, the raising of interest rates could very well put the brakes on the positive growth in emerging markets seen over the year. As senior EM strategist at NN Investment Partners Maarten-Jan Bakkum points out, "This will probably stop the recovery in EM growth momentum. This is not an environment where flows to emerging markets can quickly recover."

While the general picture for emerging markets may now appear less sunny than before, not all the dark clouds are equal. In our assessment, the domestic demand emanating from China (and Japan, to a lesser extent, but now growing dynamically) will likely mean that the worst effects of the Trump tantrum will be negated in much of Asia. To a lesser extent, the same argument could be made for Eastern Europe, for whom the EU might act as somewhat of a buffer. The real loser in this scenario then, is Latin America, with the region already experiencing its lowest rates of growth since the 1980s. Over 80% of Mexican exports go the US, while, for Colombia, the figure is still approaching 30%. And, as the chart below shows, remittances from the US account for a substantial percentage of GDP for several Latin American countries. With talk of tariffs and reducing immigration, it's possible that a Trump Presidency will hit the region the hardest.



So, is this the end of a short lived emerging markets rally? Well, that depends entirely on what comes next. The move down in emerging markets is predicated partly on the assumption that the Trump administration will embark on a protectionist route, curtailing global trade. However, we have already seen from Trump's comments since the election that he is perfectly happy to renege on his pre-election promises – such as repealing Obamacare and marriage equality. In our view, then, it seems unlikely that Trump will see the US overcome by a wave of protectionism, as has been feared, even if he is unlikely to become a protagonist of breaking down further trade barriers. As such, we believe the downtrend in emerging markets to be somewhat overdone.

Unlike the Taper Tantrum of 2013, the economic fundamentals of many EMs are looking quite healthy, evidenced by the strong 2016 they've had. Even Latin America, for whom the strong US$ and rising US treasury yields will be the biggest blow, have other avenues to explore. China has already surpassed the US as the region's largest trading partner, and President Xi Jinping has pledged recently that, by 2025, trade and foreign investment will increase to $500bn and $250bn respectively. Even now, China's two development banks give more financing to Latin America than the World Bank and the Inter-American Development Bank combined.

Sustained capital outflows will undoubtedly hurt some developing economies, and it's true that a Trump victory makes certain emerging markets less attractive than previously – at least in the short term. However, while Trump has certainly rocked the boat for emerging economies, we don't see many capsizing in the near future.

Great bond market rotation finally upon us?

Over the last few weeks, the financial press began to report on what it is being described as a possible 'inflection point' or the 'Great Rotation' in the bond markets. In short, as economic growth rates are increasing and stock markets are turning upward, commentators are beginning to wonder whether this is reflecting moves toward a reflationary cycle as opposed to having to manage (and hedge) the risks in what has been a (long) period of falling rates of inflation.

The Economist, for example, suggests that markets are overdue a correction, and there are clear signals of a turnaround. While we agree with some of the recent analysis, we don't necessarily agree with the methodology and remain cautious of some of the conclusions.

The debate relates partly to the decline over the (very) long-term in Government (and other) bond yields. To illustrate, the graph below shows the yield on a UK 10-yr Government bond, from 1981 to 2016. While there have been cyclical upticks in yields during that period, reflecting business and economic cycles and other major economic events, the overall trend has clearly been downward.

The 10-yr UK Government Bond reached an all-time high of 16.09%(!) in November 1981 and a record low of 0.52% in August of 2016. The yield on UK and other Government stock has effectively been in decline since 1982.

Yield on UK 10-yr Bond

As noted, financial commentators have seized upon recent market developments and identified several potential turning points in the data. For example, the US 10-yr Treasury bond yield *bottomed* at 1.37% on July 7th and has since risen to 2.3%. The 10-yr German bond yield reached a low of -0.18% on around the same date and has since edged back into positive territory at 0.27%.

UK bond yields of the same maturity have shown an even sharper shift, rising from 0.52% to 1.45%, perhaps largely because of concerns about the inflationary pressures arising from the Brexit-driven £-Sterling depreciation. When combined with the potential need of the government to increase borrowing (to continue to meet their obligations to the public when tax revenues fall due to a slowing economy), then it certainly appears as if talk of a revival in yield-demands by bond investors is not entirely premature.

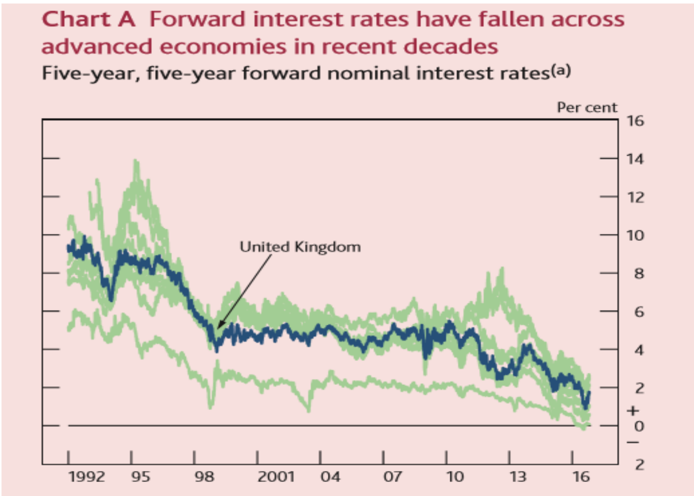
Of course, one explanation for the apparent bounce is that yields effectively had fallen further and bonds rallied more than was justified relative to the post-Brexit economic outlook – which had recovered quite swiftly. In simple terms, if loose monetary policy has some positively stimulating impact on markets and asset values, eventually resulting in reaccelerating growth of economic activity, then interest rates (and yield) must at some point start to increase again. As bond investors demand at least some form of proportionality in compensation relative to equity investors' rise in dividend receipts.

Moreover, if inflation is making a durable comeback, central banks will eventually begin to tighten monetary policy by raising rates to moderate economic growth, and thereby counter inflation pressures. Also, recognising the "term structure" of interest rates, yield on Government stock of differing maturities will again provide a good barometer for market expectations of growth, general interest rate risk and inflation going forward. As we have seen in the US, markets are now starting to price in higher levels of inflation, and there is a high probability of a December interest rate rise in the US – albeit only the 2nd in 12 months.

However, if this present uptick in yields is just a reflection of a shorter term cyclical expectation change, might this simply be just another transitory bounce as opposed to a fundamental trend reversal? Clearly, this is a difficult question, and there is no right answer. Indeed, it seems that even the Bank of England (BoE) - and a number of other economists - are struggling to understand the issue.

For example, the BoE are scratching their heads trying to understand the decline in long term expectations of forward interest rates over recent decades (see graph below). As you would expect, the downward trend shown in the graph on expectations for the level of (nominal) five year forward interest rates 5 years down the line looks very similar to the graph (above) on (Government) yield.

Bank of England Forward Interest Rates



Source: Bank of England, Inflation Report November 2016

The BoE suggests that some of the recent declines in short-term interest rates reflect cyclical factors, with many economies having experienced similar shocks and policy responses during and after the 2008/2009 financial crisis. Longer-term interest rates have, however, been declining globally for several decades, suggesting that structural factors — such as demographics and increased risk aversion — are likely to have been the primary driver.

As we have previously written, the so-called 'savings glut' tends to reduce interest rates, as a result of lower levels of spend and, therefore, lower economic activity and inflation. The issue is that global demographic change means that an ageing population is simply saving more (as opposed to spending), while the higher proportion of the population living in retirement has further increased the demand for low risk, low volatility fixed interest assets, rather than riskier stock market investments.

In terms of investment, the Bank of England suggests that the compensation that investors require for holding risky assets like equities has increased, perhaps reflecting increased risk aversion or heightened perceptions of risk. Also, that lower levels of public sector investment, to the extent these would, or could not, be carried out by the private sector, is also weighing down on general incentives to invest.

So, while we think markets are right to be optimistic about the potential for a revival in the medium to longer term, we are less persuaded by the commentary suggesting that recent data is already the start of a structural change and long-term turnaround. With central banks in the UK, the Eurozone and Japan continuing to pursue their quantitative easing bond buying programs, purchasing in excess of £100 billion of fixed interest bonds every month, we are cautious to embrace the Great Rotation narrative – that selling pressures from privates will tilt the balance of the bond markets sustainably. Even when central banks give notice that they will taper back their buying, we would expect that, after an initial jump back to around 3% (for the 10-year bond yields), further bond sales pressures will continue to be stifled by the structural factors already discussed, namely demographic factors and broader investor appetite for risk.

We observe that yields for longer maturity bonds have risen more than we originally expected, equalising some of the considerable gains in bonds over the summer months. Much of the current rise in inflation expectations has been fuelled by expectations that the President-Elect Trump will succeed in implementing an aggressive fiscal stimulus program through broad corporate and income tax cuts. On this basis, we suspect that financial markets have overreacted as much on the yield upside this time as they did on the yield downside in the summer. The Republican Congress remains concerned about rising public debt levels, as much as it might welcome tax cuts.

Thus, there has been recently almost as much discussion in the financial press about yields now overshooting in the other direction as there is and has been about this finally being the inflection point after 35 years of downward-trending yields. While we can never be certain with these judgements, we tend to believe that bond markets are overshooting at the moment. This is particularly true because equity markets are still holding up relatively well, which would not be the case if expectations that yields remain at these elevated levels were more widely spread. The resultant tightening of monetary conditions would damage prospects for economic growth, and equity valuations would additionally be reduced by rising discount factors for future earning streams.

We are therefore monitoring both ends of the financial markets very closely for indications and will act as required, should the overall perspective change from how it currently presents itself. Watch this space.

Japan’s prospects continue to improve while Chinese growth moderates

Tatton has become more positive on the longer-term prospects for the Japanese economy, and recent data releases have only strengthened our conviction. At the same time, China continues to provide reassurance that the government remains fully in control of the stimulus levers of economic growth. Recent actions by Chinese officials to remove some frothiness from the property market and policies to increase transparency in the banking system do not seem to be harming the strong long-term growth momentum the country has seen throughout much of 2016.

It appears as though the baton of growth has been passed from China (following its solid reacceleration of activity this year) to Japan, after the country far exceeded expectations for growth in Q3. Japan’s economy grew a much better than expected 2.2% (quarter-on-quarter) in the 3 months to September, against forecasts of a rise of 'just' 0.8%. This marks the first three consecutive quarters of positive growth since the beginning of 'Abenomics' back in 2013.

Japan benefitted from both a sharp rise in net exports and positive consumer spending(!). There was a significant increase in net exports, with decomposition of the data revealing a +8.1% jump in exports, while imports fell -2.4% during the quarter. Trade contributed +1.8 percentage points (pp) to GDP, consumer spending added a further +0.2 pp and there was a strong +0.2 pp contribution from housing investment, which grew +9.6% in Q3.

While Japan's prospects seem to have swung back and forth over the past few years, the overall trend has been positive and we continue to see further signs of upward momentum. Japan has been a key beneficiary of the solid recovery in the US economy, and the pleasing stabilisation of Chinese growth. We note that a particularly encouraging feature of Japan's current momentum has been the continued upswing in domestic consumption, aided by fiscal expansion.

Backing up consumer spending has been the year-on-year growth, in both nominal and real terms (I.e. after inflation), of income levels and employment income (wages per person x number of workers) on the back of a tighter labour market. We believe additional growth in employment income will further underpin consumption in 2017. Historically, Japan has one of the world's highest savings ratios and the OECD stated that, in 2014, the amount of financial assets as a percentage of total household assets amounted to 52.1%. Should individuals draw down their savings (as the continued economic improvement leads to higher perceived job security), then we could see even stronger support for domestic demand.

A more upbeat consumer is also likely to have a positive impact on measures of domestic inflation. Goldman Sachs forecasted the Consumer Price Index (CPI) accelerating to +0.2% year-on-year in 2017, up from -0.3% this year. This is still someway shy of the Bank of Japan's (BoJ) 2% inflation target, but finally pointing in the right direction. In light of this directional change, we do not expect the BoJ to introduce yet more policy easing unless we see any further sharp appreciation in the Yen.

We could even see the yield on 10-year Japanese Government Bonds (JGBs) gradually rising into positive territory, as a result of continued positive economic momentum. In practical terms, as an economy grows, inflation rises, leading to low yielding assets like bonds becoming far less attractive compared to real assets like equities, which offer better protection from inflation. This means that investors are more likely to sell bonds and buy stocks or other inflation-protected assets like property.

This could make it somewhat more difficult for the BoJ to maintain its current monetary stimulus policy position of not just keeping interest rates below 0%, but also preventing government bond yields (up to 10-year maturity) to exceed 0%. We note that the BoJ found itself tested by markets on this very issue this week. For the first time since February, yields on 5-year maturity government bonds spiked above the official policy rate. This led some to question if BoJ governor Kuroda was losing control, at least of the short-end of the yield curve. Additionally, the 10-yr JGB yield saw 5-straight days of rises, increasing around 17 basis points to a positive (!) 0.01%. Interestingly, as yields rose, share prices for Japanese financials also gained, as investors concluded it could help ease the pressure on bank profitability.

Much of the recent moves in bond yields can be explained as a reaction to the bond rout in Western government bonds. This started back in October as a consequence of rising UK inflation expectations emerging from £-Sterling's fall, but is now dubbed the "Trump Tantrum". Over this period, investors in long duration/maturity bonds experienced significant losses, with the longest inflation linked bonds chalking up as much as double digit losses (We wrote about this possibility, despite rising inflation expectations, in the weekly commentary of 16 September). The correction in US bond markets was staggering, 10-yr yields climbed over 40 basis points in just three trading days, taking us back to levels last seen at the beginning of 2016.

Back in Japan, overseas investors appeared to essentially move out of Japanese bonds in particular and back into the now 'cheaper' (and thereby higher yielding) US Treasuries. This seems to have had a direct knock-on impact on the currency, the Yen. As foreign JGB buyers sold, they needed to sell Yen and buy US dollars to purchase 'cheap' US bonds. As a result of these movements in fixed income markets, the single largest move of any asset in the wake of the Trump Presidency is that of the Yen. Since last Wednesday morning's panic move, where the Yen strengthened (as a safe haven) to ¥101.21 against the dollar, it rapidly reversed course and has since fallen a stunning 8% in less than a week.

We find it noteworthy that the $/¥ exchange rate didn't even move this much so quickly after the decision to expand quantitative easing (QE) in Japan in November 2014. This suggests that Trump has had a larger impact on the Japanese economy than the BoJ's printing of trillions of new Yen. Perhaps Japan owes Trump an early thank you?

With JGB yields moving higher, we were not surprised to see the BoJ rise to the market challenge and intervene to bring rates back in line with its 0% target. In essence, this was the BoJ "sending a warning to markets" that it is determined to defend its target. It was impressive to see market yields plunging immediately after the the BoJ announced two operations to buy 2-yr and 5-yr notes, below the actual market price (!) but in unlimited (!!) volumes. In actual fact, it achieved its goal without having to purchase a single bond – marked evidence for the market adage 'Don't fight the Fed' (Fed being the synonym for central banks).

Perhaps it is interesting that Prime Minister Shinzo Abe will have been the first foreign leader to meet with Trump. Japan remains a key ally for the US, with the President-elect warning in the build-up to the election of Chinese currency manipulation and the possibility of imposing trade tariffs on Chinese goods. Maybe this is why China has decided that it would allow the value of the Yuan (its currency) to yield to downward market pressures and adjust lower before Trump takes office in January.

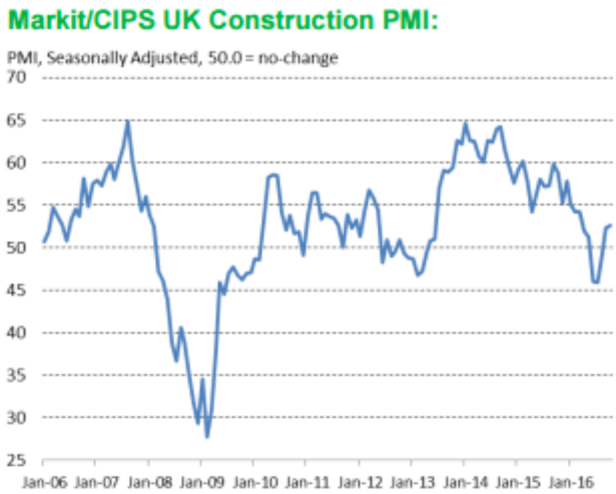
The Chinese currency fell to an 8-yr low this week, declining in 7 out of the last 8 trading days. Despite the talk of China being a currency manipulator, the People's Bank of China appears to have done the exact opposite over the last two years. The country has sold dollars from its FX reserves to help prevent excessive depreciation, as the government has tried to ensure a measure of stability in its currency as the Yuan joined the IMF's Special Drawing Rights (SDR) basket of global currencies.

Back to Japan. We believe that Japanese equities will become increasingly attractive to investors, given the improving economic climate there and the fact that domestic companies are adopting an increasingly shareholder-friendly focus. Japanese firms are looking to reward investors with higher dividends and possibly share buybacks.

UK housing market update: Housebuilders remain stable

Now that we are a full quarter away from June's Brexit vote and the big housebuilders have reported their latest results, we have a better idea on the current state of the UK's property market. Against a backdrop of robust house prices and still-solid residential construction activity, we can identify two clear themes. Outside of London, trends look positive, but within zones 1 & 2 in London (luxury end), things look predictably less rosy.

First some background. Markit's construction PMI, the forward looking industry sentiment indicator for the sector, revealed that the industry remained firmly in growth territory for October. The index has quickly overcome the initial Brexit-led uncertainty, rising to 52.6 in October, up from the 52.3 in September – when it rose over the crucial 50 level for the first time since May. A reading over 50 indicates growth, and below 50 suggests contraction.



Source: IHS Markit/CIPS

Markit commented that growth in the sector was "dependent on a solid recovery in residential work, as civil engineering and commercial building struggled for momentum". They also noted that "uncertainty and concerns" about the economic outlook in the UK had "held back investment spending" and "subdued new order intakes contributed to a fall in construction sector business confidence for the first time since July".

The PMI reading may add to the view that domestic economic growth will remain robust for the remainder of the year. Indeed, if we look at how optimistic UK consumers are, as a barometer for economic health, then things do not look so bad. Retail sales growth jumped 1.9% in October – above estimates – to a 14 year high, as the sudden drop in temperatures after the unseasonably warm September and early October boosted sales of warmer clothing.

As a result of an unperturbed consumer confidence, house prices unexpectedly rose 1.4% in October, according to the Halifax house price index. The gain erases the post-referendum blip and prices are now up 5.2% over the past year, ahead of the 4.9% forecast. This means that the average UK property value is now £217,411. While the rate of house price growth has halved from the 10% peak in March, continued low mortgage rates and the chronic shortage of housing stock may continue to support prices at current levels.

As we noted above, there is a fairly clear divide in direction between commercial and residential property. The results from both Land Securities (LandSec the UK's largest listed property company) and British Land (BL - number two listed firm) confirmed this, with both posting losses in the first half of the year on the back of a reduction in the estimated values of their properties. Both companies may likely take a more cautious approach to further investment in an uncertain environment.

LandSec recorded a H1 loss of £95 million, on the back of a 1.8% drop in asset values to £14.4 billion, while BL posted a H1 loss of £205 million on a 2.8% reduction in asset values to £13.9 billion. While both firms warned of an uncertain environment, Rob Noel, the chief executive of LadSec, said the company remains "chipper" and the business "could not be in a better position". Chris Grigg, BL's chief executive said that they were "confident" that their income streams were "secure" and its "strong finances" should help ensure the company remains "resilient". Despite the losses, the results from both firms were better than first feared.

On the residential side, the likes of Barratt Developments, Taylor Wimpey, Persimmon and Berkley Group all struck a more upbeat tone. Barratt said that the demand for new homes remained "strong" thanks to supply shortages and low mortgage rates. The company said conditions in the sector were still "healthy", despite the "potential for economic uncertainty".

Housebuilders have been reporting that confidence among home buyers had "largely returned to the market", according to Crest Nicholson. However, like the split between commercial and residential, there is a distinct difference between the prospects for luxury central London properties and the remainder of the country.

The market within central London (mainly in zones 1 & 2) is one area where both prices and demand have fallen. It is largely contained to high value or luxury properties and can be explained by the fact that price inflation at the high end was more prevalent in recent years, particularly with the large rise in stamp duty on properties worth over £1.5 million in late 2014 and a big increase in supply through new developments around Battersea and Canary Wharf.

Trends for the rest of the UK appear to be more positive. Demand for new builds outside of London has continued to positively surprise and Persimmon, which has no London exposure, reported a 19% year-on-year rise in sales during Q3. Barratt said that sales in both the Midlands and the North had risen strongly. Data from other sources appears to back up the view that the market outside London is generally robust. The numbers from the Royal Institute for Chartered Surveyors (RICS) indicated the rest of the UK is holding up, and McCarthy & Stone reported it saw an improvement in sales trends in the autumn. It is possible that the Help to Buy scheme will continue to provide new builds with a competitive advantage over existing homes, should there be any market slowdown.

Given the relatively healthy state of the residential property market, we do not think that the government is likely to introduce further stimulative measures. We note that, during George Osborne's tenure as chancellor, nearly every budget announcement contained new housing policies.

Interestingly, the share prices of housebuilders may suggest that there is bad news to come for the sector, as it is trading on a forward price to earnings multiple of just 8.8x and 1.5x price to tangible Net Asset Value, according to JP Morgan. Analysts at JP Morgan believe that house prices would need to decline mid-single digits to justify current valuation multiples.

Housebuilding firms appeared to have taken precautionary steps ahead of the Brexit vote and companies remain in a net cash position, while generating a Return on Capital Employed (ROCE) of 25%, according to JP Morgan. The sector is a large dividend payer (average of 5.2%) and dividend cover looks relatively robust at 2.1x (a reading over 2 is seen as healthy). Persimmon alone, at its recent analyst day, revealed detailed cash flow models to reassure investors demonstrating that its £340 million dividend could be comfortably paid, even if the sector encounters a downturn. We think that these factors should hold true for the other players in the sector.

However, should both UK economic momentum and consumer sentiment remain positive, then it is possible that the sector could continue the trend of its traditional outperformance in the first quarter of the year, especially given the upside of the valuation multiples as quoted above.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	6782.3	0.8	51.9	↘
FTSE 250	17659.3	1.2	214.3	↘
FTSE AS	3694.9	0.8	30.8	↘
FTSE Small	4896.9	0.7	34.2	↘
CAC	4508.5	0.4	19.2	↘
DAX	10676.9	0.1	9.0	↘
Dow	18870.2	0.1	22.6	↘
S&P 500	2181.7	0.8	17.3	↘
Nasdaq	4811.8	1.3	59.8	↘
Nikkei	17967.4	3.4	592.6	↘

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
TESCO	7.1	ROLLS-ROYCE	-11.2
3I GROUP	6.4	FRESNILLO	-10.2
INTERCONTINENTAL H	6.4	POLYMETAL INTERNA	-8.8
PROVIDENT FINANCIAL	6.1	GLENCORE	-6.2
SAGE GROUP /THE	5.2	STANDARD LIFE	-5.7

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	19.0	Brazil	493.9
US	19.3	Russia	304.2
France	26.0	China	26.0
Germany	12.5	South Korea	12.5
Japan	49.0	South Africa	49.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.23	-2.13	OIL	46.4	3.6
USD/EUR	1.06	-2.44	GOLD	1207.9	-1.6
JPY/USD	110.64	-3.61	SILVER	16.5	-4.7
GBP/EUR	0.86	0.39	COPPER	247.1	-1.9
JPY/GBP	6.89	-1.08	ALUMIN	1688.0	-4.6

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.5	7.7	0.11
US 10-Yr	2.3	8.4	0.18
French 10-Yr	0.8	3.6	0.03
German 10-Yr	0.3	-7.5	-0.02
Japanese 10-Yr	0.0	281.8	0.06

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.2
2-yr Fixed Rate	1.5
3-yr Fixed Rate	1.8
5-yr Fixed Rate	2.3
Standard Variable	4.2
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

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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 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