



Weekly Market Comment

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Source: FT, 24 Nov 2016

UK Autumn Statement: Phasing out of austerity, but no fiscal stimulus kick-off

UK Chancellor of the Exchequer Philip Hammond delivered his Autumn statement to Parliament, announcing some large revisions to government finances alongside some key policy changes. The headline figure is a £122bn dent in the five year forecast for government finances up to 2021, when compared to March's projections. As expected, Hammond also announced the abandonment of the previous Chancellor's commitment to a budget surplus by 2019-20, opting instead to balance public expenditure "as soon as practicable".

Overall, the statement was somewhat a tale of two Britains. On the one hand, the increase in public spending announced this week is perhaps the final nail in the coffin of the previous Conservative leadership's austerity stance – with the government now gradually moving towards a policy of (albeit slight) fiscal expansion. On the other, the outcome of June's EU referendum has undoubtedly cast a long shadow of uncertainty over the future of Britain's economy, translating into a substantial effect on projections for government finances.

In truth, the statement itself was somewhat underwhelming. Notwithstanding a ban on letting agency fees "as soon as possible" and a number of new infrastructure spending initiatives, the statement lacked the kind of large scale fiscal stimulus turnaround many had been hoping for. As such, on the whole, the Chancellor's inaugural statement was more evolution than revolution – moving away from his predecessor's predilection for fiscal austerity, but without completely abandoning the tight public purse spirit of 'Osbornomics'.

In terms of new spending, the largest fiscal outlays were reserved for a few key targeted areas. Infrastructure, housing and research and development all received modest budget boosts from Mr Hammond, in the hope of injecting productive capital into Britain's economy and providing a solid base for stable growth.

For housing, the new budget has established a £2.3bn housing infrastructure investment fund, with a view to helping build 100,000 extra homes (£23,000/home) in areas of high demand. In addition, a further £1.4bn has been earmarked by the government for the construction of 40,000 affordable homes (£35,000/home). In

Hammond's own words, "this package means that over the course of this Parliament, the government expects to more than double, in real terms, annual capital spending on housing."

Housing investment could prove to be of real benefit to the wider economy, providing an injection of money which in the past has filtered through with a multiplier effect of increased demand as well as going some way to addressing the chronic undersupply in the nation's housing market. However, the question remains whether the figures Hammond gave – both in terms of amount to be spent and number of houses to be built – will be enough to have a meaningful impact.

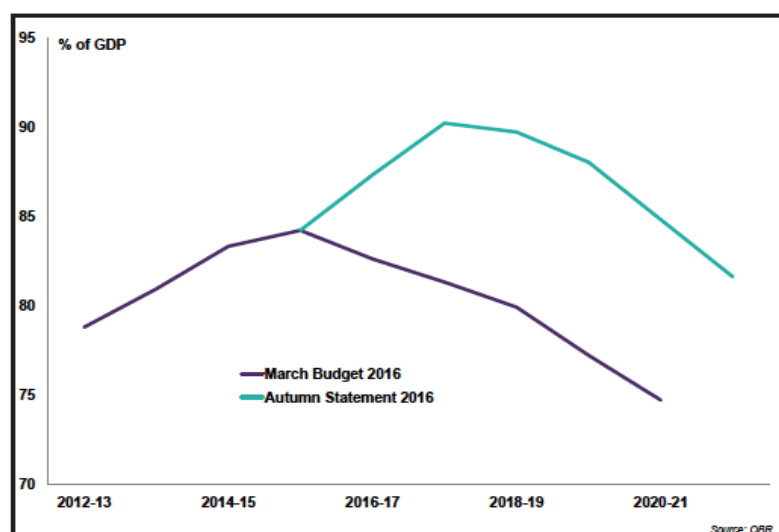
On the infrastructure side, the Chancellor announced a number of smallish programmes, all quite sensible, but none of a dimension to make a difference for the economy as a whole. For example, the extra £1.1bn investment into English transport networks, more than £1bn for digital infrastructure and £1.8bn in the Local Growth Fund to English regions appear quite small beer, when considering the London Bridge Station redevelopment is costing £6.5 billion and London Crossrail link tunnel £14.8 billion.

If increased investment made up the bright spot in the Chancellor's Autumn statement, the Brexit clouds undoubtedly brought the gloom. And, just as the Brexit chatter has permeated virtually all discussion surrounding the UK (both politically and economically) of late, the Office for Budget Responsibility (OBR) made sure that Wednesday was no different.

While the OBR actually revised upwards their growth predictions for 2016 – from a 2% expectation to the 2.1% now predicted – their projections for the next 2 years took a substantial fall. The OBR now expects GDP growth to be only 1.4% next year, down significantly from March's forecast of 2.2%, while their 2018 prediction of 1.7% also falls below the previously expected 2%. This means that, overall, the OBR now expects the UK economy to grow 7.4% from 2016 to 2020, 1.4% down from their March forecast of 8.8%.

It's the smaller tax revenues that these lower growth expectations imply which have led to the increase in projected government borrowing over the life of this Parliament. The debt to GDP ratio is now expected to peak in 2017 to 2018 at 90%, falling to 85% in 2021.

OBR Public debt forecasts (as a % of GDP)



Interestingly, and perhaps by some cosmic irony, a small portion of the expected worsening of public finances stems from an increase in payments to the European Union over the next few years. This is due to the fact that much of the UK's payment into the EU budget is euro-denominated, meaning that the large depreciation

in our home currency has caused the payments to increase in £-sterling terms – roughly by £0.8bn a year from 2018 onwards.

Thus, with such factors in mind, the minimal fiscal expansion of Hammond's budget looks slightly less effective. As we have already mentioned, the measures announced in this statement are far from the heralding in of the new era of fiscal stimulus which some had been calling for. Indeed, while the speech did have a less fiscally conservative air to it than previous ones, we believe the increase in borrowing is made to look far starker due to the fall in expected government income. Effectively, the marginal increase in infrastructure spending is translated into quite large amounts of borrowing as a result of the dampening effects of Brexit on public finances.

As we pointed out in our 4th November Weekly, Hammond is after a fiscal policy that avoids the potential pitfalls presented by Brexit while continuing to keep the nation's long-term debt levels from spiralling out of control. Not surprisingly then, the main message for us is, that this budget announcement only messaged an end to ever tighter fiscal austerity, even if it didn't switch straight to large-scale fiscal expansion stimulus. Against the backdrop of a presently relatively strong UK economy and the absence of an immediate Brexit inflicted demand shock, such measures would have also looked neither necessary nor prudent. The prime minister may have wanted to hand out more to those discontent parts of the UK electorate who no longer support the political mainstream, but chancellor Hammond proved his relative independence, by keeping desperate measures in the bag in case the Brexit uncertainty first and potential trade decline of later years ahead indeed brings desperate times to the UK economy (as many economists still deem possible).

Looking forward to what lies ahead, political focus will turn from the US to Europe, as Austria is rerunning its election for the republic's president and Italy decides for or against constitutional reforms of its political system. Both offer the respective electorates a choice between progress offered by the political establishment and the prospect of a return to more inward orientation and stronger focus on the individual nation state. While not of the dimension of the Brexit vote or the US presidential election it will be interesting to observe whether the trend towards the populists continues or the Trump election has had a sobering effect.

Improving investor confidence because of or despite Donald Trump?

Remembering all the angst and resultant equity market volatility ahead of the first US rate rise at this time last year, one may be forgiven for wondering why, this year, equity markets are hitting fresh highs. On top of the looming rate rise, there is once again a stronger US\$ and, of course, all the uncertainty around a President Donald Trump. Yet, the Dow Jones Industrial Average moved over 19,000 for the first time ever, while the S&P 500 broke over 2,200.



US equity markets as represented by the S&P500 stock market index for the past 5 years
Source: FT.com 25 Nov 2016

Might it really be that the prospect of Trump's populist policy agenda is soothing markets to the point that they chose to ignore all the risks to global trade that come with his presidency? One point is most certainly true - we have seen a regime change in investor perceptions. At the start of 2016, investors were worried about the potential of deflation, slowing growth (especially in China) and an observed recession in company earnings. At the end of 2016, resurgent global growth, a turnaround in company profit growth and the prospect of an end of fiscal austerity have caused a return of financial market confidence, which is confounding political analysts.

The financial market's debate of the moment is whether the markets are on the move because of or despite the surprise election of Donald Trump.

In this respect, the release of the November minutes of the US central bank's rate setting committee (FOMC) provided a bit of insight into the pre-election outlook – i.e. what was already in the pipeline. From that perspective, the minutes are entirely consistent with previous comments from the Fed, where officials expected rates to rise “relatively soon” on the back of strong and improving economic data. Indeed, market odds of a rate hike are now at 100% according to Bloomberg, which means everyone now thinks a move in December is a certainty.

The Fed tried to be as accommodative as they could in the face of more solid data, noting that “underlying economic growth had been relatively modest” and while the US was “reasonably close to maximum employment”, there was still some “appreciable slack” in labour markets.

However, on inflation, the Fed commented that “readings on headline and core PCE price inflation had come in somewhat higher than expected in recent months”. Officials even made reference to the rise in the long term inflation expectations as expressed by the bond market’s breakeven inflation rate (see chart below).



The key theme over the week has been the significant (Bank of America even called it “violent”) rotation out of bonds and into equities (real assets). BofA noted that there had been record inflows to equity-based ETF products (\$28 billion), particularly financial sector ETFs (\$7.2 billion), and the largest redemptions from bond ETFs in over 3.5 years (-\$18 billion). This is the widest weekly disparity between stock and bond flows “ever”, according to the US bank.

If Brexit marked a historic low in global interest rates, Trump’s victory “marked the moment that investors started to position for a bond bear market”, the BofA said. At these turning points, price action can be large and yields can rise quickly, such as the 20 basis point change in yield we have seen over the past two weeks. Our macro-economic research provider ASR said that the move in bond yields since Trump’s election had been one of the biggest on record.

At the moment, the jury is out on whether the movement from bonds into equities is an inflation rotation, or a growth-driven rotation back to a more normal growth and financial market expectation environment. Either way, financials and materials stocks, which had biggest inflows in three years, are key beneficiaries, while government bond outflows are the largest in a year.

Post-election data has been supportive of the higher-yield environment. We note that industrial production and durable goods orders suggest a rebound in manufacturing, while retail sales indicate continued strength in consumption. In addition, and perhaps surprisingly, strong housing starts could be the ignition of a long awaited pick-up in residential investment.

Back to the question whether the prospect of Trump has been a catalyst for the change towards a more optimistic economic outlook. On this point, we observe that all current economic readings relate to a time when consensus was for a Clinton presidency. Furthermore, the bond market sell-off really started at the beginning of October, when it became clear that fiscal austerity had lost the support of electorate. The post Global Financial Crisis era of monetary easing is likely to have similarly run out of favour with those in charge of the economy. That the biggest moves in the bond markets have occurred since the Trump election may be more rationally explained by the fact that the feared market upset didn’t happen. Similar to the aftermath of the Brexit vote, without the markets triggering a negative chain of events, the opposite happens. This is to

say that, with a major fear obstacle removed, remaining doubters feel proven wrong and scramble to jump onto the moving bandwagon.

The distinction between whether the confidence improvement is happening because or despite Trump is important, because Trump policy changes will, in all likelihood a) fall short of campaign pledges and b) only become effective far further in the future.

We currently believe that markets have moved because of the economic momentum already under way and have simply not been derailed by the political upset. This would bode well for early 2017, because a growth rather than inflation driven yield increase is far less likely to slow down the US and world economy than recent yield increases, which were driven by fears of central bank policy errors more than rising growth expectations.

How international trade increases the wealth of nations

Political developments this week again generated an uptick in political-type risk, whether as a result of comments by the US president elect, the outcome of the French preliminaries, or the – relatively positive – news that Angela Merkel, the German Chancellor, is intending to stand for a further term.

As things stand, Mrs Merkel may be one of the few ‘centrist liberal’ politicians left with a mandate to govern. And, we say relatively positive not out of any political bias, but simply because it would offer continuity and financial stability to the German economy and the EU.

The rise of ‘populist’ policies and associated parties, and the tangible gains being made by ‘non-centrist’ political parties in many other countries, is diverting the attention of investors, financial commentators and others. ‘Political economy’ appears to be a key determinant of current business sentiment and behaviour.

As we have previously said, ‘populist’ governance in the US, EU, UK (and elsewhere) could be potentially damaging to the World economy, whether because of a protectionist and regressive policy stance, or simply because short-term populist type interventions could materially distort trade and economic growth. In our view, now is not the time for the US, UK, or any other country, to retrench from trade. Indeed, in light of Brexit, the UK can ill afford such a policy and it will have to be considered (but vigorous) in the pursuit of new trading agreements.

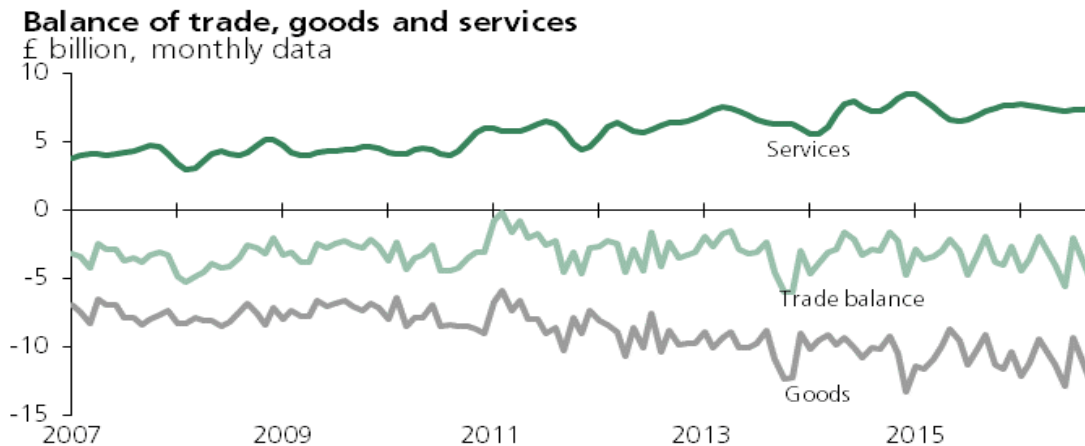
In that regard, the UK’s policy makers may still have much to learn from a British economist who wrote about trade at the turn of the 19th century. [David] Ricardo’s theory showed that specialisation in combination with free trade will support GDP growth and further a nation’s economic health.

Here is why:

As we know, Gross Domestic Product (GDP) is a function of consumption (described as demand by consumers and businesses), investment, government expenditure and net exports. Net exports equal the sum of exports less imports. Imports represent purchases of foreign-produced goods and services.

Therefore, imports are deducted from the calculation of GDP. In the UK, net exports continue to be a drag on GDP, because the UK regularly imports more than it exports; net exports are in deficit. Nowhere is this more evident than in the UK’s trade relationship with the EU (see the graph below).

UK Trade with the EU



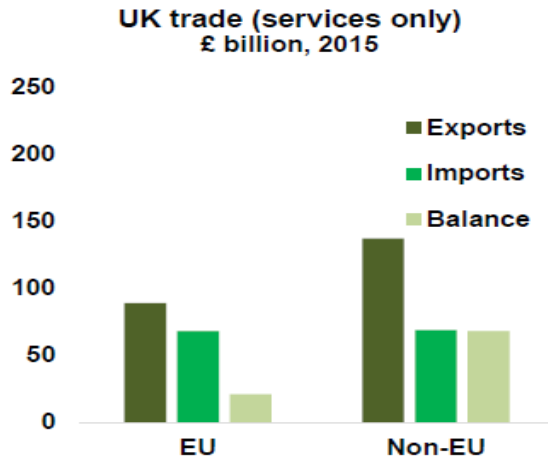
In 2015, the UK's exports of goods and services totalled £509 billion and imports totalled £547 billion. The EU accounted for 44% of exports of goods and services in 2015 and 53% of imports. A surplus on trade in services (£88 billion in 2015) is, however, more than offset by a deficit on trade in goods (£126 billion in 2015). The overall trade deficit was £38.6 billion (2.1% of GDP) in 2015.

The UK's surplus in trade of services provides a good illustration of Ricardo's concept (and guidance for today's policy makers?). It makes little economic sense for a country to be wholly self-sufficient, or to produce every good and service themselves. Indeed, there has to be a degree of *specialisation*, not least, when countries are not endowed with the resources needed to produce a particular good or service.

Countries will also vary in their ability to produce certain goods and in how efficient each is at supplying these goods. While some countries may have an *absolute advantage*, meaning it can manufacture a product using less input and resource than any other country, there is also the key question of whether a country has a *comparative advantage*.

For example, if a country allocates resource to a certain production activity, that resource cannot then be used for the production of other goods. Even if that country has an *absolute advantage*, the *opportunity cost* to that country may be greater than it is in other countries. Therefore, countries will gain from trade if they produce (and export) those goods that have a relatively low *opportunity cost* compared to other countries.

At the moment, this seems to be the case with the UK and the trade in services (particularly financial services). Although, even in respect of services, the UK only has a narrow *comparative advantage* relative to the EU (see below).



Moreover, this trading advantage could be eroded depending on the UK's future terms of trade. Ricardo advocated free trade (a conclusion of his research) – as one of the options likely to be considered by the UK Government. However, a free trade agreement between the UK and the EU is an intermediate option between EEA membership (like Norway) and trading under general World Trade Organisation rules.

In this case, a free trade agreement will offer less access to the single market but impose fewer obligations. For example, the agreement between Canada and the EU gives Canada less access to the single market (than the UK), but Canada will not make contributions to EU spending, or be required to accept free movement of people.

The key issue for the UK will be properly understanding and maintaining its *comparative advantage*, while ensuring that tariffs, quotas or otherwise do not eradicate the UK's competitiveness in services.

Oil price update – OPEC's Vienna summit: What to expect?

It would seem that, with Organization of the Petroleum Exporting Countries's meeting in Vienna just around the corner, the pieces are beginning to fall into place. A preliminary agreement in September set out the plan to limit the cartel's production to between 32.5m and 33m barrels a day (b/d). Consensus amongst traders and analysts is now that the final cut would be around 800,000 b/d. Once again, the fundamental details of individual country allocations remain unknown. In fact, the levels of unknowns prompted Citigroup to conclude that "the outlook for oil prices is really a binary one", a yes or no, as to whether OPEC can make a deal.

However, what is known is that Iraq, previously resistant to any cut, has now agreed to participate. In a statement this week, Iraq's Prime Minister said the country was willing to 'shoulder responsibility' by cutting some of its own production – 'some' being the operative word. Moreover, Russia has been more forthcoming in what it is prepared to offer. President Putin earlier this week reaffirmed that the country is willing to freeze production. Although not the 'cut' that Saudi Arabia had pursued, the freeze amounts to a 200,000 to 300,000 b/d cut compared to next year's plans.

These promising announcements have been compounded by recent data that showed the first decline in U.S. crude supplies this month. The 1.3m barrel fall surprised analysts who had expected an increase of 671,000. Yet, for all these overtures pointing to success in Vienna, traders and analysts alike remain cautious of an inherently unpredictable cartel. Although the odds of OPEC securing a deal continue to rise, the risks remain palpable.

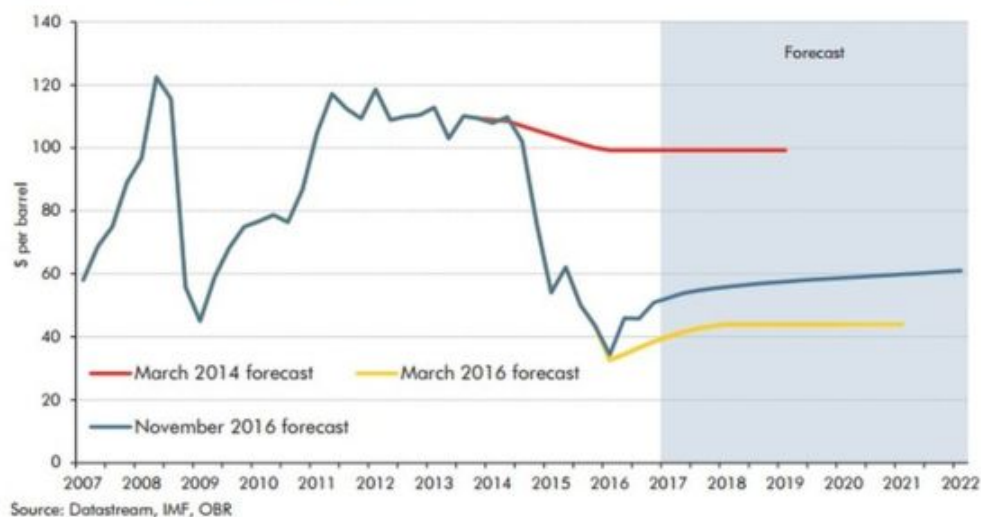
However, look a little further ahead and the landscape appears to change entirely. Recent data from the International Energy Agency has revealed that, for a historic third year, investment in new oil production is set to fall as energy giants continue to feel the pinch of sub \$50 oil prices. Resultantly, analysts have estimated that 2019 will see a global oil supply crunch, as a gap between supply and demand establishes itself at approximately 3m b/d. The International Energy Agency forecasts rapid price increases by the early 2020s, but whether this will mean a return to \$100-barrel market remains to be seen. So, as OPEC strives to reign in the current global oversupply, Barclays analysts are predicting that “an increase in production by the cartel may actually be needed within the next couple of years”.

Yet, all these predictions become almost superficial when one considers the possible impact of Trump’s presidency, specifically with regards to the Iranian nuclear agreement. Trump was extremely vocal on his intention to tear up the nuclear deal during the election campaign, but has been markedly silent on the matter since his victory. Prior to the nuclear agreement coming into place, Iran had faced heavy international oil sanctions, the extent of which saw their output fall to 1m b/d in 2013, compared with their current output of close to 4m b/d. A return to those sanction levels would undoubtedly prompt a price rise, potentially to \$60.

Columbia University reported that U.S. shale would see an increase in output of between 300,000 and 900,000 b/d if prices rose to that figure. Such a boost to not only oil output, but taxation and employment means that a reneging on the historic agreement with Iran could be argued to be in the interest of the US, if well paid oil exploration jobs are given a higher priority than higher energy costs for all.

Moreover, this is not simply Trump rhetoric. The nuclear agreement faced stark opposition from Republicans when it was first introduced. Moreover, Trump’s cabinet selection has included individuals, such as Congressman Mike Pompeo, who are and have been extreme critics of the nuclear deal. Certainly, the possibility of a return to sanctions for Iran is a constant subtext in the run up to OPEC’s meeting.

Chart 3.11: Oil price assumptions



With so much up in the air, the success or failure in Vienna is but a number of major determinants of the oil price. Over the near term, it would seem to us at Tatton that the current oil oversupply is set to continue. Saudi Arabia’s late announcement that it would not attend the non-Opec Vienna pre-meeting is already casting fresh doubts whether far reaching supply side coordination for 2017 will be at all possible. Beyond 2017 however, much will depend on whether the new, less capital intensive and faster realisable fracking technologies will be able to substitute the volumes of older less efficient production capacities, which at

current oil price levels will be run off over time. In combination with the prospect of further persistent global economic growth and the resultant increase in oil demand, the medium perspective for the oil price level has suddenly significantly improved – for oil exporters.

India cash demonetisation update

The surprise demonetisation of 500 and 1,000 Rupee notes in India by the Modi government (covered in the Tatton commentary two weeks ago) appears to have been met with relative calm by the general public, despite scenes of people in long queues patiently waiting for new 500 and 2,000 Rupee notes. While there seems to be a common consensus that the move to stamp out corruption could have long-term positives, the country may face a number of short-term challenges from the sudden drain of a large amount of liquidity.

Modi's decision to crack down on the shadow or non-tax paying 'black' economy by withdrawing higher-value notes in the middle of crop sowing and wedding season appears to have brought large parts of the economy to a virtual halt. India was up to now still overwhelmingly a cash economy, with an estimated 90% of all transactions taking place in cash in both the 'black' and 'white' economies. Most of these transactions are perfectly legal and, for relatively small amounts, done by people who fall below income tax thresholds.

The problem is that money flows in and out of both the black and white economies fairly easily and untangling these transactions could prove more difficult. For example, an individual may conduct a 'white' transaction by buying an item at a store, but that same person may then use some surplus cash for undocumented transactions which are untaxed.

The sectors that attract both black and white money are retail, fashion, hospitality, medical services, construction, real estate and jewellery. Even land is traditionally sold with a large proportion of the price being paid in cash.

Reports have quickly surfaced of farmers and crop traders being unable to pay for produce. A majority of India's 260 million farmers currently have no bank accounts and are dependent on local money lenders to fund future sowing, meaning they could come under increased financial pressure should they be unable to generate a decent winter crop harvest.

As a result, the government has sought to ease the pressure on farmers by allowing them to withdraw up to 25,000 Rupees (about \$368) a week against loans in order to ensure future sowing "takes place properly". Officials have also extended the deadline by which individuals must convert old notes into new ones by an additional 10 days.

The statistics are interesting. Nearly 85% of all currency in circulation in India has suddenly become mere pieces of paper, which can only be exchanged at banks and post offices. The old notes are allowed to be converted into new currency if an individual has proof of ID – which hundreds of millions do not have – and there is the additional pain of standing in a long queue for up to 10 hours to get new notes. This means people are pulled away from productive work and time is wasted, possibly with a loss of income.

Around 50% of India's 1.34 billion people do not have access to a bank account and around 300 million do not have a form of ID, meaning they cannot access the banking system. Some 130 million Indians do have access to a mobile phone wallet, while there are about 25 million credit cards and an estimated 600 million debit cards. Clearly, cash and access to cash is an important necessity for many citizens.

As a result, we expect that a significant amount of liquidity is likely to be drained out of the economy for many weeks, due to the restrictions on daily cash withdrawals from ATMs and bank accounts. Then there is the additional issue of getting new notes into circulation quickly enough (apparently, the new notes do not fit in existing ATMs without modification) along with the costs of printing and distributing new money, while taking old notes out of circulation.

The size of the black economy is estimated to be anywhere between 20% and 40% of GDP, which, in 2016 nominal terms, is worth \$2.25 trillion. Households hold assets in the form of property, gold, or overseas bank accounts. Growth in the black economy is likely to be highly impacted by the sudden liquidity drain, but we suspect that this may not be fully captured in official statistics. Consumption is also likely to decline, at least in the short-term, as people simply do not have enough cash to pay for anything else than bare necessities.

We also think that the liquidity drain could squeeze small cash-dependent firms out of business, thereby increasing default rates and raising non-performing loan rates at banks. It is entirely possible that we see a concentration of business activity, as highly liquid firms are able to capitalise on the failure of competing firms. Essentially, they can just buy the assets or production of other businesses.

For now, the anti-corruption move seems to be fairly popular among the general populace. We find it interesting that the demonetisation of existing notes is likely to be less popular with Modi's traditional support base, who are larger cash holders. We may see a transfer of support from lower income earners, particularly if the rumoured wealth transfer (from higher tax revenues on new declared assets) takes place in the form of a direct cash payment into bank accounts.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	6840.8	1.0	65.0	→
FTSE 250	17603.4	-0.3	-55.8	→
FTSE AS	3719.3	0.7	27.1	→
FTSE Small	4923.8	0.4	21.5	→
CAC	4550.3	1.0	45.9	→
DAX	10699.3	0.3	34.7	→
Dow	19133.6	1.2	229.8	→
S&P 500	2210.0	1.0	22.8	→
Nasdaq	4866.7	0.8	40.1	→
Nikkei	18381.2	2.9	518.6	→

Top 5 Gainers

COMPANY	%	COMPANY	%
ANGLO AMERICAN	13.4	FRESNILLO	-4.4
GLENCORE	8.2	BARRATT DEVELOPM	-4.3
BHP BILLITON	7.3	BABCOCK INTL	-4.0
ASSTEAD GROUP	6.6	PERSIMMON	-3.9
RIO TINTO	6.1	TAYLOR WIMPEY	-3.7

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	35.8	Brazil	307.0
US	19.3	Russia	231.3
France	39.7	China	121.3
Germany	22.8	South Korea	51.0
Japan	49.0	South Africa	255.7

Currencies

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.25	0.91	OIL	47.5	1.4
USD/EUR	1.06	0.10	GOLD	1181.0	-2.2
JPY/USD	113.08	-1.92	SILVER	16.5	-0.4
GBP/EUR	0.85	0.80	COPPER	267.6	7.0
JPY/GBP	6.92	-0.47	ALUMIN	1770.0	4.9

Commodities

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.4	-3.0	-0.04
US 10-Yr	2.4	0.9	0.02
French 10-Yr	0.8	3.4	0.03
German 10-Yr	0.2	-13.2	-0.04
Japanese 10-Yr	0.0	5.0	0.00

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!

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

Lothar Mentel

