Tatton

Investment Management

Weekly Market Comment

16 December 2016

Lothar Mentel

CHIEF INVESTMENT OFFICER

Jim Kean

HEAD OF INVESTMENT

Samuel Leary

HEAD OF INVESTMENT COMMUNICATIONS

Isaac Kean

INVESTMENT WRITER

www.tattoninvestments.com Twitter: @TattonIM

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

Good-bye 2016 – Hello 2017!

	Annualized Return
FTSE 100 TR GBP (Market Return, GBP, Pre-Tax)	8.65%
FTSE Gilts All Stocks TR GBP (Market Return, GBP, Pre-Tax)	7.88%
Halifax UK All House Prices NSA PR GBP (Market Return, GBP, Pre-Tax)	5.66%
UK RPI (Market Return, GBP, Pre-Tax)	3.33%
UK Savings 2500+ Invt NR (Market Return, GBP, Pre-Tax)	2.64%
MSCI World NR LCL (Market Return, BASE, Pre-Tax)	6.96%

Value development of UK and international asset classes since 1987, up until 8 Dec 2016; Source: Morningstar

As Christmas draws closer we all have the peculiar habit of looking back at the last 12 months and then attempting to forecast developments of the 12 months ahead, simply because we are nearing the start of new calendar year. Our medium term views at Tatton are not particularly governed by this annual recurrence, but I am happy to bow to popular demand and join in with the tradition.

Looking back at what I wrote a year ago, I can congratulate the Tatton team for getting the 2016 economic forecast right – growth to persist and perhaps surprise on the upside – but have to admit that we didn't foresee the upheaval in the political landscape. And had we known, we would never have projected double digit investment returns across most major asset classes (as were achieved), or even dared to suggest middle to low single digit returns (as we did forecast).

2016 appeared to become a very difficult year, when it began with a major stock market sell-off that many interpreted as heralding a global recession. We disagreed, held portfolios steady and found our view confirmed as markets recovered rapidly by early March.

The market action that followed from there onwards was treacherous for any 'high conviction' active investment manager, with even those who managed to anticipate political outcomes correctly being caught wrong footed with their reasonable positioning towards less risk. Market sentiment seemingly swung 180 degrees from being hyper-sensitive to anything mildly unexpected to adopting a very relaxed 'benefit of the doubt' attitude.

What I believe actually happened was that the decisive Chinese economic stimulus intervention to their 2015 growth and stock market slump boosted the global economy sufficiently so that the perspective of a UK Brexit a couple years down the line was not able to derail resurgent economic optimism. On top of this, the combination of stabilising oil/commodity prices and an expectation that the political establishment would be scared enough by the populist uprising to finally fight it with fiscal stimulus programs, further improved market sentiment.

This led to an upward normalisation of long term inflation expectations, which made long term bond yields at or below 0% illogical.

While the US election success of Donald Trump in November shocked the intellectual and political leading classes of the Western world, financial markets and business interpreted it as the final death knell of fiscal austerity and quite possibly the return of more business friendly economic policies. This perspective propelled stock markets further upwards, while longer maturity bond yields rapidly retraced back to levels they had in some cases last been at more than a year ago.

We are ending the year with stronger positive economic growth momentum that has allowed the US central bank to raise interest rates for a second time in 12 months, while projecting another 3 rate rises over the course of 2017. Oil price volatility may have been tamed for a while if OPEC and Russia stick to their newly agreed supply reducing production targets. All in all, evidence that the economic and financial markets environment continues to return to the long term averages and thus a more normal environment.

What is not quite normal is the new political landscape that 2016 created. This has not only brought division to western societies not seen for a generation but also created uncertainties about the future global economic framework of trade, commerce and freedom of movement. It has been a great surprise that capital markets have thus far chosen to cherry pick only the potentially positive aspects of what a future under Trump and Brexit may hold, while discounting the potentially very negative aspects as unlikely because of their obvious destructiveness to the wealth of nations.

This leads nicely to the outlook for 2017.
Just like at the end of last year, the economic outlook is positive and the growth momentum sufficient to generate economic and financial progress. But not strong enough to have to be concerned about possible overheating, with the prospect of a return of boom and bust scenarios. Capital markets appear to anticipate as much and more for 2017, which has driven stock markets higher and fixed interest bonds lower as one would expect in the classic growth scenario. The question now is whether they have overshot and are due a correction or at least flat-lining for a while as we find out whether the high hopes for growth and better corporate profits are justified.

Some doubts are certainly in order. Will Donald Trump really get his promises of significant corporate and income tax cuts through Congress, when it is not clear whether this will increase economic activity and thereby the tax base enough to equalise the lower tax rates. 2 years ago, when the more than halving of US energy bills created a similar windfall, the money was saved, not spent or invested. Likewise, major infrastructure improvement programs will face funding difficulties and are unlikely to get on their way during 2017. Furthermore, the rapid rise in the cost of finance through the risen bond yields and the stronger currency value of US$, have in the past constituted significant headwinds for corporate US as well as US-Dollar dependent Emerging World economies.

Compared to last year there are also more known political risks on the horizon for 2017. What if a president Trump feels obliged to start a trade war with China, or generally restrict free trade? Or the EU's political establishment gets steam-rolled by a further swing towards nationalistic populism that also seeks to roll back globalisation? These are just some examples, which make forecasts for 2017 very dependent on political developments, which, as we have just found out, are ever more difficult to foresee.

On the other hand, should political influence turn out to be more benign or even supportive by way of measured fiscal stimulus particularly in Europe, then the discussed monetary and currency headwinds could be more than compensated through additional money that is currently still sitting idle.

One may also wonder whether the recent improvement in economic sentiment is sustainable, when the political outlook is so depressing for many. However, improvement in confidence can become a virtuous circle and lack of confidence has been one of the major factors that has held back the economy since the Global Financial Crisis.

I am afraid therefore my 2017 outlook is somewhat conditional. If politics don't interfere negatively and fiscal austerity does not return, then the economy and investments should have a good year with decent positive returns. However, if the populist politics of simplistic but economically detrimental de-globalisation succeed, then we could be in for a nasty market backlash.

I judge the probabilities for a benign political scenario higher, simply for the fact that the resurging economic momentum is already leading to the largest real wage growth amongst those lower income receivers who have been particularly discontent with the performance of the political establishment. This should reduce the pressure on Donald Trump to attempt anything particularly radical, while allowing to sell the improvements as his own rapid delivery of relief to his voters.

As for the UK, much depends on developing and ever changing Brexit expectation and their impact on the further development of the currency value of £-Sterling. Should the UK's currency remain weak, then the inflationary impact of higher import prices may erode much of the nominal gains we have seen over the second half of 2016. A stabilisation to slight improvement in the currency value would be the best outcome for the UK. A rapid recovery on the other hand – however unlikely at the moment – would not only be tough on business but also unwind a substantial part of recent investment returns that arose as a result of the higher value of overseas investments from the weaker £-Sterling perspective.

Bond and currency outlook

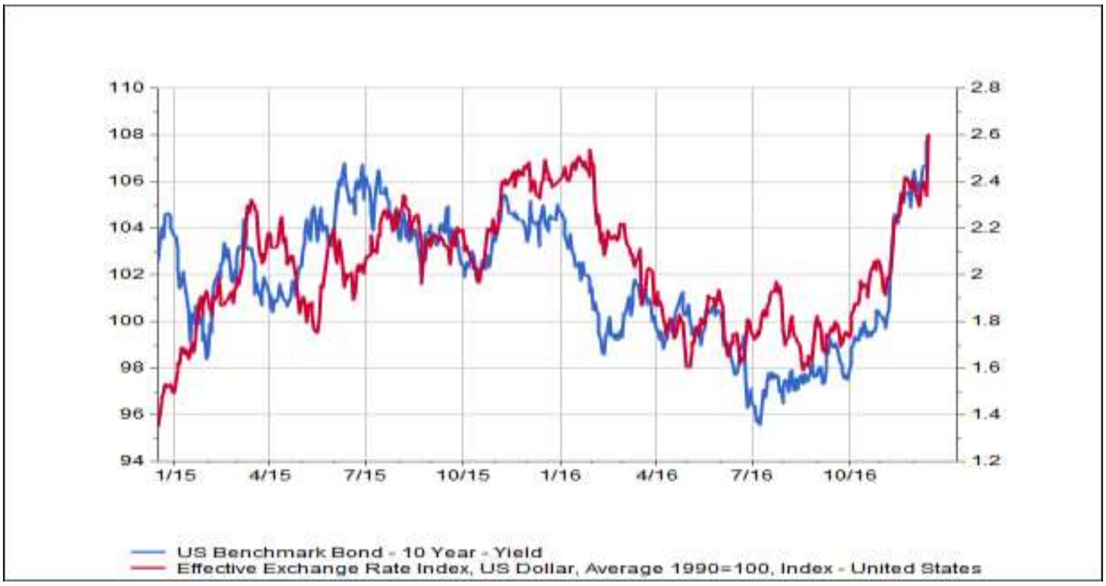
Given the importance of currency and fixed interest bond dynamics as outlined in the 2017 outlook above, Jim Kean, Tatton's head of investment provides a specific bond and currency outlook for 2017:

At the beginning of 2016, the 10-year gilt (2% 7-Sep-25) yielded 2% and had a price of 100. As I write, it has a yield of 1.3% and a price of 105.75. It suffices to say, bonds have had a good year.

Of course, it doesn't feel that way. Bond prices rose in the winter months and again through the summer to peak over 113. September and October, however, saw sharp declines, with the final smaller fall happening just after the US election. Since then, prices have actually been pretty stable.

Lower yields make long maturity assets more volatile – the "duration" effect. With a large impact on both equities and bonds, it was a big reason why the falling yield environment of the first half of 2016 felt so risky.

US 10-yr yields have moved much more, as the chart shows. The summer of 2015 saw an intermediate peak. Only the US has breached the levels reached then – now at 2.6% against the 2015 high of 2.5%.



A lot has been made of the increase in growth prospects for the US following the surprise election result. The move made by US domestic investors from bonds into equity is clear. What has not been so obvious is the move made by overseas central banks out of US treasuries. According to Reuters and the Institute of International Finance, a Washington-based group of financial institutions world-wide, the People's Bank of China sold $41.3bn of US government bonds in October. Since then, the Yuan has weakened much further and there has been a lot of talk about necessary intervention to buy the Yuan and sell dollars. And yet, the single biggest correlation with the strong dollar has been the rise in US long yields. The Chinese may have been officially buying dollars, but their action in selling Treasuries has had far more impact.

As mentioned in previous weekly comments, there are a number of factors affecting Chinese flows as we head into the year-end which have little to do with expectations about the economy. They revolve more around current Chinese restrictions and feared US barriers to those flows through next year. While Donald Trump's assumption of the presidency may make fears an actuality, the Chinese may well have finished moving to offset the risks by then.

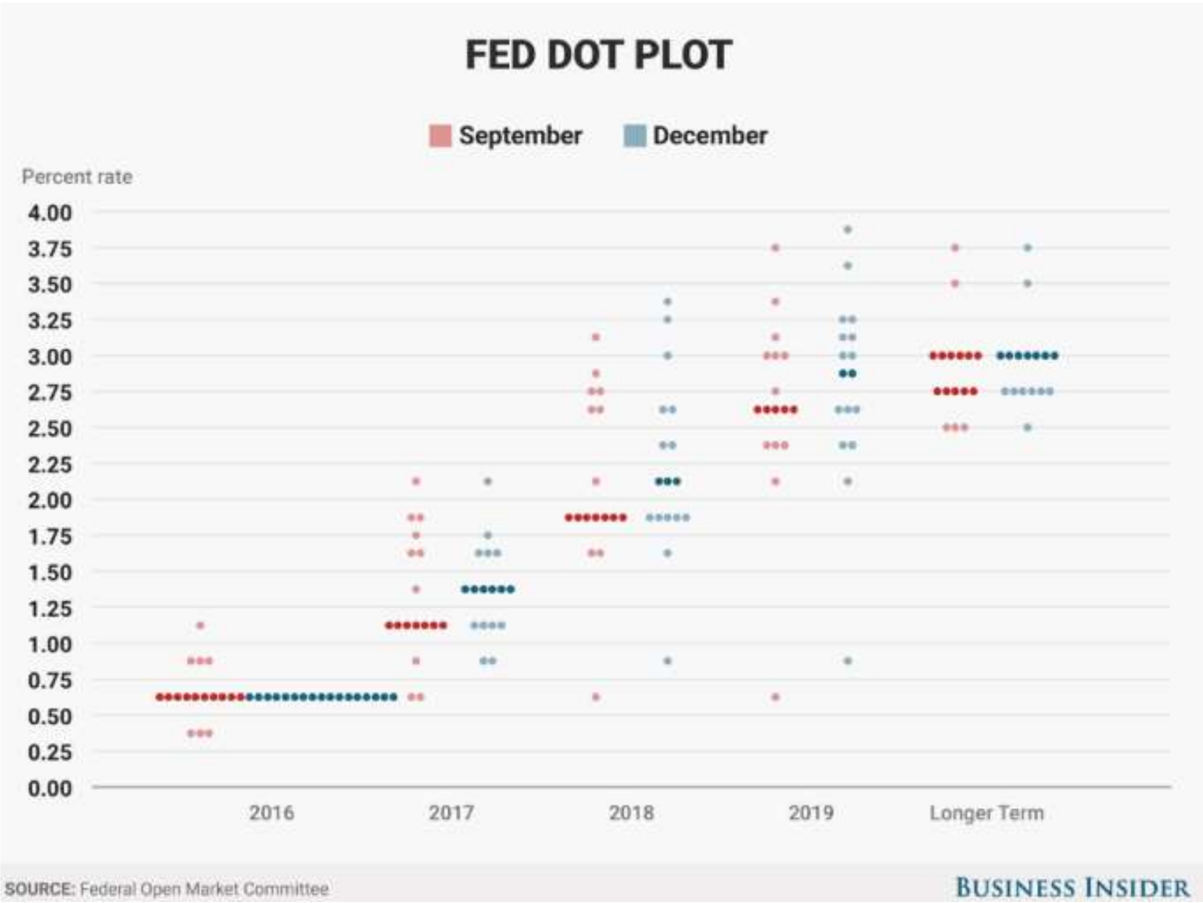
So here's a prediction for the first quarter of next year: The dollar will stop rising and probably fall back against most currencies. The 10-year treasury will have an intermediate yield peak near current levels and fall back towards 2.25% before rising somewhat in the second half of 2017.

Hawkish Fed in Trump turn

It came as no surprise on Wednesday when the US Federal Reserve (Fed) raised interest rates for only the second time in just over a year – and the past decade. The Fed opted for the expected 0.25% increase, leaving the target for its federal funds rate at 0.5%-0.75%. The hike itself was all but certain for some time, with markets effectively pricing in the move ever since the election of Donald Trump failed to upset markets. In truth, previous communications from the Fed's FOMC (Federal Open Markets Committee) had given capital markets such confidence in the prospect of a rate rise that not moving on rates would have likely caused considerable disruption.

While the Fed's actions were largely predictable, the accompanying words were slightly less so. Along with the rise, the FOMC announced that they expect to raise rates no less than three times over the course of 2017, while markets had anticipated only two. The Fed's December 'dot plot' – the individual committee members' projections for where the federal funds rate will be at the end of each year – shows a 0.25% rise in the median 2017 prediction to an overall 0.75% increase next year, meaning they expect interest rates to end the year in the 1.25-1.5% range. This picking up of the pace in terms of rate hikes came as somewhat of a surprise to analysts, with most expecting a steadier pace of tightening from the Fed. As University of Oregon Professor Tim Duy explained, "The Fed is shifting gears, a shift I did not expect until more data piled up in the first quarter of 2017."

Indeed, one could well make the argument that neither the changes in the underlying economy since the Fed's last meeting in November, nor even their own projections for the path of the US economy, really warrant the more hawkish turn the Fed is now taking. Their expectations for growth, unemployment and inflation over the next few years have remained virtually the same as in their September report, while their prediction of the 'appropriate policy path' (the natural interest rate required to promote sustainable growth) has gone notably higher. The Fed's median projections for growth and unemployment next year currently stand at 2.1% and 4.5% respectively, just 0.1% out from the September report.



To muddy the waters even further, the bond yield recovery over the past couple of months have seen a substantial tightening of credit conditions, with bonds taking somewhat of a battering both prior to and since the election of Donald Trump. In effect, as the Financial Times' Martin Sandbu pointed out on Thursday, the very expectation of tightening from the Fed (among other factors) has meant that "markets have in the meantime performed the Fed's job for it." As Sandbu goes on to argue, a perhaps prudent move from the Fed in response to this tightening might have actually been to prepare for minor monetary loosening rather than reinforcing it with a more aggressive policy path – at least if their expectations for the economy really are as stationary as they proclaim.

So, why the increased hawkishness then? Well, the elephant in the room, evidently, is a certain short-tempered President-elect. Though FOMC chair Janet Yellen noted that the rise in expectations was not related to last month's presidential election, nor Mr Trump's proclamations of both tax cuts and fiscal stimulus in the time since, it is only really in light of the 'Trump factor' that the discrepancy between economic and rates forecasts begins to make sense. Markets have been buoyed over the past month by Trump's plans for a loosening of fiscal conditions, with promises during the campaign for both a major cut to corporate tax rates and a significant program of government infrastructure spending. And, with the boost this is expected to bring to both growth and inflation, a pre-emptive policy reaction from the Fed might explain why the committee's dot plot moved up.

Certainly, despite her claims to the contrary, this was the feeling one got from Mrs Yellen's press conference on Wednesday. The Fed chair noted that fiscal spending was not actually necessary to help the economy achieve full employment, and that the US economy already had enough momentum behind it to push it to that particular threshold. We believe that the slightly subtle point being conveyed here is that any fiscal boosts to the demand side of the economy might well have to be met with corresponding further rate increases to ensure price stability and stop expectations of deflation in 2016 becoming an inflation overheating in 2017. Effectively, should the government attempt to boost growth through bolstering demand, the Fed could offset this effect through a tightening of monetary conditions.

This last point is significant. Were that scenario to become a reality, it might well lay the groundwork for conflict between the Trump administration and the Fed. Trump has already proven that he is not afraid to venture criticism of the central bank, proclaiming during the pre-election televised debates that Yellen was doing "political things" through her monetary policy. Admittedly, back then the president-elect was lambasting the Fed's low interest environment, rather than the current interest rate raising cycle they're embarking on, but the important point is that such conflict was there at all. If these tensions were to resurface in the coming year or later, the consequences for future monetary policy are difficult to predict.

Ultimately, however, much rests on what the US under Trump will actually look like, and how much of his stated policy intentions are realised. Such a consideration is also quite unpredictable. He has already shown that he is willing to renege on certain campaign promises, and it's possible that the Republican-controlled congress, traditionally more tight-fisted than their Democrat counterparts, might block some of the excesses of Trump's spending promises. We believe the corporate tax cuts, however, look more likely. Such a policy action would sit more comfortably with the Republican party, fitting with their pro-business, anti-taxation focus. Although, their fiscally conservative leanings may be challenged if the tax cuts don't boost economic output enough to keep tax revenues roughly the same. This is where additional Fed rate rises could create conflict. And, with Fed chair Janet Yellen's office term ending in Q1 2018 such conflict may or may not be short lived.

Less upside potential for UK residential property in 2017

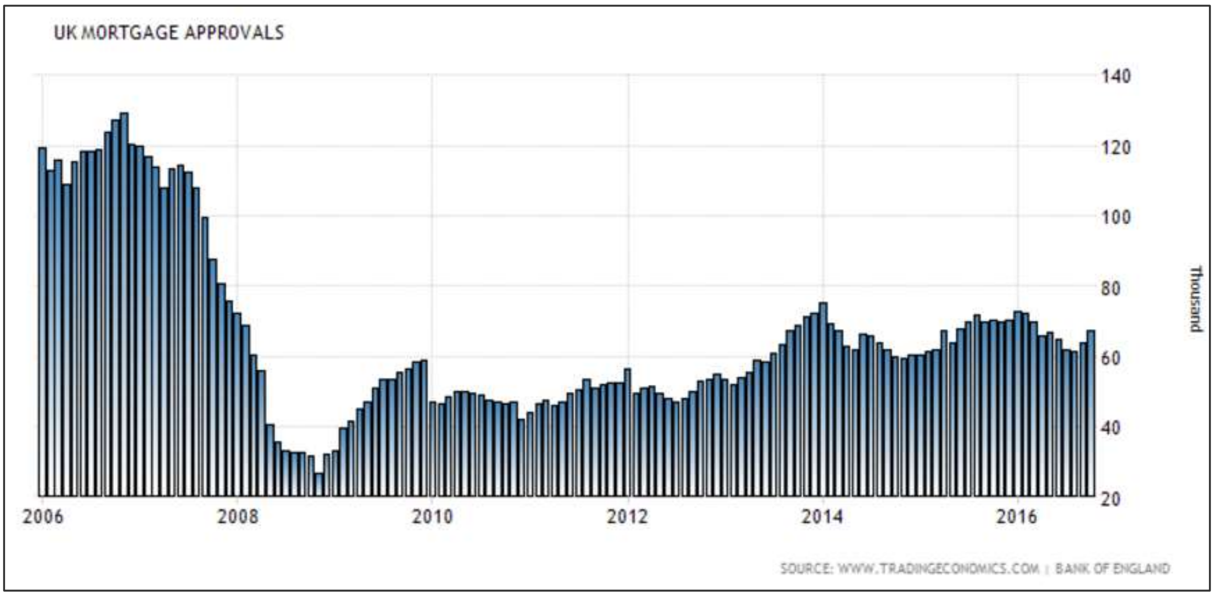
The UK residential property market has shown remarkable resilience in the wake of this summer's Brexit vote. Country-wide, sales trends have remained robust, but there has been a deterioration at the top end of house prices, particularly in London. The outlook for 2017, however, has become less clear, with the era of ultra-low interest rates coming to an end and heightened uncertainty over what Brexit actually means for buyers in terms of continued employment when Article 50 is triggered next year.

We believe, as a result of a number of different uncertainties, that the UK property market is likely to be subdued in 2017. House price inflation is likely to moderate after the strong gains in 2016, but that is not to say that we expect to see a material pull back next year.

It has been harder to track the housing market activity trend with true accuracy since the EU referendum, as there have been a number of distorting factors. This was predominantly due to the change in stamp duty on second/buy-to-let homes in April, which led to a rush of transactions prior to its introduction. Activity levels were brought forward during March, with transactions jumping 87% year-on-year – roughly 70,000 properties above trend levels. This meant that we saw a fairly significant undershoot of transactions in April, May and June – around 20,000 transactions a month.

We would expect that these distortions had largely washed out by September, when activity was still down around -5% on the month.

Despite this, the data for mortgage approvals has shown modest improvements over the last three months and approvals are generally considered to be a leading indicator for transactions. October saw 67,500 approvals granted, a healthy bounce back from September's low.



We have seen a clear moderation in house price inflation, but that is merely from high mid-digit, down to mid-single digit growth. The average UK home is close to £220,000 and prices have continually risen since 2013, so it seems reasonable that the market would experience a natural – and healthy – pause. The chart below suggests that we may have seen a temporary peaking of UK house prices over the summer.

Figure 9: Average UK house price (2004-2016)

Source: Bloomberg, Halfax / Nationwide average.

Data from the Royal Institute of Chartered Surveyors (RICS) that looks at sales as a ratio of housing stock (i.e. measuring market availability against demand) has been a decent lead indicator for future price increases (or falls). The past few months has seen a relatively modest decline in the ratio, after it reached a level not seen since 2007, but it remains well above the value of the period from 2009-12 when there was practically zero increase in house prices.

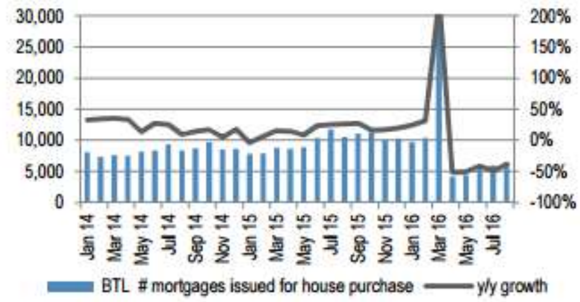
So what can explain the overall slowdown in the housing market?

We think the key driver looks to be the rapid drop in demand from the buy-to-let market. In 2015, mortgages for buy-to-let properties accounted for 15% of all purchases, while this year buy-to-let properties amounted to 14% of all transactions. As we noted above, there was a significant 'brought forward' effect through the introduction of the 3% additional charge on stamp duty for second/investment properties.

Figure 15: Buy-to-let mortgages as a % of the UK total

Source: HM Land registry

Figure 16: New buy-to-let mortgages for house purchase and y/y change (%)



Source: CML

Following a dramatic 232% year-on-year surge in March for buy-to-let mortgage grants, Q2 saw a sudden 50% drop, but it only now appears that the market is showing signs of stabilisation.

2016 has been an interesting year for the buy-to-let market. On the rentals side, the market appears to be booming, but at the expense of the sales market, meaning that house buying transactions could be outnumbered by new rental agreements for the first time in nearly 80-years. This is to some extent because the tightening affordability criteria from mortgage lenders affects standard buyers via threshold household income multiples more than buy-to-let buyers with the latter only having to demonstrate mortgage yield cover through rental income.

It would appear that Brexit-related uncertainty has provided a further boost to the rental market, as both buyers and sellers defered transaction activity. September was a record month for the rental market and, as already alluded, 2017 may well become the year in which there will be more lets than purchases for the first time since the 1930s.

Looking forward, there is the possibility that, as a result of Brexit, immigration flow into the UK will decline. This should ease the top-end pressure on housing and rental demand. However, as RICS regularly state, only a significant increase in new housing stock will be sufficient to reduce the price driving shortage of homes.

Given its significance to overall house price dynamics, the further development of the buy-to-let investment market is crucial. However, forecasting future buy-to-let demand trends is relatively difficult, because there are a number of factors that come into play;

- In March 2015, the government announced that mortgage interest on buy-to-let properties would only be tax deductible at the basic rate of income tax, rather than the higher rate. However, these changes will be phased in slowly over 2017/18 through to 2020/21.
- Additionally, the UK's bank regulator, the Prudential Regulatory Authority (PRA) provided new guidance on interest coverage ratios for buy-to-let properties. The PRA said that interest payments should be covered 1.4x by rental income versus the previous ratio of 1.25x.
- Any rise in interest rates will have significant impact on geared rental investments, because landlords might struggle to pass on mortgage cost increases 1-1 to their tenants.
- The post-Financial Crisis flight to safety from retail investors, which previously pushed up bond markets, has also been a driver in residential property markets, which the investing public has perceived as a safer investment – despite its high financial gearing – than the stock markets. Should rising mortgage rates alter this perception, then buy-to-let housing demand pressure could quickly abate.

The combination of the above factors, as well as a potential drop in demand due to lower net migration, informs us that buy-to-let investor demand is unlikely to continue to be a significant price driver over the course of 2017. This leaves the traditional live-in demand side as the remaining determinant of 2017 price dynamics. Here the relative housing stock shortage will continue to drive demand, although, as already discussed, lenders' stricter lending criteria locks first time and step-up buyers (who lack the equity to back up transactions) out of the markets, even if they could afford purchase prices at current mortgage rates. For the remaining higher equity buyers, rising mortgage rates will undermine affordability and could do so quite substantially, should the weakening bond markets continue to push up mortgage costs.

On this basis, the price drivers of the past years are closely tied to the further development of rates and yields. Should their upward trend continue (or just not reverse), then little price pressure is to be expected from them.

Accelerating economic growth is then the remaining incremental price driver. If strengthening economic growth results in rising real wages, then households would be able to overcome the discussed limitations to some degree. However, the £-Sterling weakness is re-introducing inflationary pressures, which may well eat into nominal wage rises, leaving little growth in real wages.

In summary then: There is not much evidence to suggest that house prices should continue to increase at their past rates, but equally not much to suggest falling prices either. Our guidance would be to expect modest price falls where net migration turns negative, stable prices in most other areas and slight increases where prevailing housing stock shortages are largest, while Brexit uncertainties drives rental demand (London and the South East).

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7011.6	0.8	57.4	↗
FTSE 250	17784.8	0.3	51.7	↗
FTSE AS	3803.7	0.7	27.9	↗
FTSE Small	5059.0	0.8	39.9	↗
CAC	4833.3	1.5	69.2	↗
DAX	11404.0	1.8	200.4	↗
Dow	19882.6	0.6	125.8	↗
S&P 500	2261.8	0.1	2.3	↗
Nasdaq	4921.5	0.5	25.6	↗
Nikkei	19401.2	2.1	404.8	↗

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.25	-0.71	OIL	55.1	1.4
USD/EUR	1.05	-0.99	GOLD	1137.7	-1.9
JPY/USD	117.74	-2.06	SILVER	16.2	-4.1
GBP/EUR	0.84	0.14	COPPER	255.9	-3.3
JPY/GBP	6.96	-0.77	ALUMIN	1735.5	0.7

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.4	-1.0	-0.02
US 10-Yr	2.6	4.2	0.10
French 10-Yr	0.8	-5.7	-0.05
German 10-Yr	0.3	-14.0	-0.05
Japanese 10-Yr	0.1	32.8	0.02

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
CENTRICA	6.0	GLENCORE	-10.5
MARKS & SPENCER	4.9	TESCO	-8.1
ROYAL DUTCH SHELL	4.8	FRESNILLO	-7.0
RBS GROUP	4.7	ANGLO AMERICAN	-6.7
EASYJET	4.6	RANDGOLD RESOUR	-4.9

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.3
2-yr Fixed Rate	1.4
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

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	29.9	Brazil	295.0
US	19.3	Russia	231.3
France	36.7	China	113.7
Germany	21.9	South Korea	43.2
Japan	49.0	South Africa	255.7

GLOBAL RESEARCH TEAM
Lothar Mentel – Chief Investment Officer Lothar.Mentel@tattonim.com
Jim Kean – Head of Investment Jim.kean@tattonim.com
Sophie Huang – Head of Research Sophie.Huang@tattonim.com
Mark Murray – Fund Analyst mark.murrary@tattonim.com
Sam Leary – Strategist Sam.leary@tattonim.com

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