



Weekly Market Comment

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Lothar Mentel

CHIEF INVESTMENT OFFICER

Samuel Leary

HEAD OF INVESTMENT COMMUNICATIONS

Isaac Kean

INVESTMENT WRITER

Duncan O'Neill

GUEST ECONOMIST

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www.tattoninvestments.com Twitter: [@TattonIM](https://twitter.com/TattonIM)

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



Recent hedge fund industry publication cartoon with the subtitle:
Stock market 'Perma-bears' have been getting shellacked. What they haven't figured out yet is that U.S. economic growth is accelerating.

Living with new realities

Stock markets have hit new all-time highs already this year, while government bond markets have markedly calmed down after their violent correction in the last quarter of 2016. So, all is well and almost back to the Goldilocks feeling of the summer of 2016, when everything just went up?

All very confusing to discerning followers of global current affairs, who read every day about the monumental risks to world trade that the highly emotional personality of the new populist US president will bring to us all from 20 January.

Well, the flow of economic data from the tail end of last year, indicates that businesses and the majority of consumers do not appear to share the concerns of their intellectual elites about political style, having lost all manners and are more and more upbeat.

I wrote last week how perceived political risks currently appear to be almost entirely discounted by capital markets as well, when they are usually much more sensitive to any potential obstacles somewhere in the future. The UK's currency may be a slight exception, because it weakens every time when there is any suggestion that the UK may indeed no longer be a member of the European Unions in a few years' time.

But even that doesn't deter the UK economy, as so far non-Sterling based supplies have mostly absorbed the fall in revenue which the pound's devaluation has bestowed on them. Retailers and especially online retailers delivering abroad have enjoyed a much better Christmas season than expected, with most firms reporting improvements on the previous year.

I have decided to decrease the political focus of my market observations for the time being, even if that feels somewhat odd. The fact that the global economy and the US economy in particular is experiencing a strong uptrend. This makes markets - for a while - less prone to be upset by political surprises. Although, should Mr Trump be outrageous and impose lots of import tariffs straight after his inauguration then that may be a different matter.

However, I believe the risk of that is relatively low. The very measured or even contrary statements of some of his future cabinet members to his strong (and sometime outrageous) words during his first press conference in six months suggests that we still must not take him literally.

As an easily hurt individual and inexperienced politician, his style is entirely different to most of what we have seen in the western world. Objective of his answers to pesky journalists' questions are by no means to provide policy statements, but first and foremost to establish and/or defend his public persona.

Over the course of the year, I believe we will have to learn to differentiate between political news that have the capacity to really matter to the economy and those that merely insult the intellect.

For the time being, I am glad to be positively surprised about the various upbeat economic data reports around the world and the fact that government bond values have stabilised. This tells me that capital markets have not gone 'bonkers' but recognise that a few promising green shoots do not yet make a full bloom. As a consequence, I believe that our central scenario assumption, of another politically unnerving, but economically stable and improving year is more realistic than to continue to expect the next economic and financial Armageddon, as so many in the hedge fund industry have done for the past years.

In the main body of this edition we debate whether the economics profession is indeed in crisis or merely apologising for not delivering on forecasting accuracy it never was designed for in the first place.

Following very upbeat results guidance from major UK housebuilders, we also once again turn to UK property, as it is such a key element of what makes the UK's economy go around.

We then discuss the market concentration dynamics most of us will have observed over Christmas with the ever increasing volume of deliveries from online retailers. Will our competition authorities be able to contain the potential market abuse that is inherent to every monopolistic dynamic?

Last but not least, we look at currency developments, which carry so much weight in economic terms. Except this time, we discuss the latest swing in the value of the cyber currency Bitcoin and what it tells us about Chinese monetary policy.

Crisis in Economics?

When geologists predict displacement of ice sheets, they can be fairly confident that the ice sheets won't notice. Unfortunately for economists, they don't get that luxury. Their objects of interest are far more elusive, constantly in motion and don't even always stick with the same pattern. So when it comes to predictions, it's hard to hit a target when you don't know where you're shooting.

Because of this, economic forecasts can be – and often are – wide of the mark. This we're told is the fate that has befallen the Bank of England (BoE), whose errors in predicting a recession following the UK's vote to leave the EU have seen not just them but the entire economics profession come into the firing line (again). Andy Haldane, chief economist at the BoE, took the stage at an Institute for Government event last Thursday to decry the “crisis” in economics, after a number of high-profile misses in recent memory has left the public without faith in the prediction profession.

The failure of many, central banks included, to predict the 2008 global financial crisis (GFC) was a “Michael Fish” moment for the industry, said Haldane, in reference to the now infamous dismissal of an oncoming hurricane by the BBC weatherman. In addition, BoE governor Mark Carney's warning of a “technical recession” following the ‘leave’ vote, as well as the Bank's announcement in August that it expected the UK economy to stagnate for the second half of 2016, turned out to be false, and the UK went on to experience some of the strongest growth among the developed nations. For many, this crystallised what they had long suspected – the central bank was just another pawn of ‘project fear’, playing along to the tune of the ‘remain’ vote with their politicised forecasts.

The media has taken Haldane's words as an effective confession – damning himself and his colleagues for the repeated inaccuracies of their forecasting. Such talk has inevitably evoked the ire of many in the economics profession, with former Monetary Policy Committee (MPC) member David Miles writing in the Financial Times that “Mr Haldane should worry less about a crisis in economics and instead enjoy reading the best of it that has been written.” Meanwhile, Tony Yates, professor at Birmingham University, admitted that “economics is hard” and “from time to time there are going to be big errors”, but dismissed the idea that such errors bring the field into disrepute.

So, is Haldane right that economics is in a crisis because of the repeated failure of its forecasts? Well, not quite. Firstly, it's worth clearing up what Mr Haldane actually said on the matter. Despite reports to the contrary, Haldane never claimed that the inaccurately gloomy picture painted by the BoE (as well as many others) in the run up to the Brexit vote was what had brought about the “crisis” in economics. The “Michael Fish” moment was in 2008, not 2016, when the models relied upon for the machinery of the global economy failed to see the approaching iceberg. In fact, Mr Haldane reaffirmed that the bank's basic outlook on the Brexit situation had changed very little, and the eventual economic downsides to Brexit were “more a question, I think, of timing than of a fundamental reassessment of the fortunes of the economy.”

Secondly, Michael Fish's immortal error 30 years ago was not a reason to disregard meteorology. Indeed, back then, Fish had in fact been told by other forecasters about the oncoming storm, but he denied it. The fact that the BoE was wrong in their forecasts doesn't

damn all of economics any more than a doctor's misdiagnosis damns all of medicine. Besides which, the BoE's forecasts weren't even all that wrong. Many of the assumptions their models were based on were correct: the huge slide in £-sterling, the drop-off in foreign investment and the overall effect on business confidence of the uncertain Brexit environment were all real. What they didn't predict, and what is arguably often the most unpredictable component of the equation, was the undeterred appetite of consumers, who shrugged off Brexit fears to keep spending as strong as before.

The predictions of a slide in the UK economy following Brexit were predicated largely on the thought that markets would be in turmoil post-result, which in turn would undermine consumer confidence. But, barring the initial wobble on the 3 days after June 24th, the market reaction was surprisingly sanguine. And, once this expectation turned out to be wrong, and consumer demand turned out to be practically unaffected, it should be of little surprise the results that followed then also did not match economists' further prognostications.

We do, however, believe this to be revealing of a more fundamental point. Economics is a policy science and, as with any predictions with whose use is policy-based, if you do a good job, your downside predictions should always be wrong. As Carney himself stated on Wednesday, the BoE didn't just passively predict a storm, they "helped make the weather". The very fact that a forecast has been made, especially from as big a market player as the central bank, affects whether or not it will turn out to be true.

Also, despite the allure of the analogy, the economy isn't like the weather. It isn't a disinterested natural phenomenon, but a highly reactive beast. If policy-makers' predictions are effective in helping achieve their policy aims, they will most likely be inaccurate. Or to look at it in a less theoretical way, markets knew that the BoE feared market turmoil and would counteract with all its might. When the value of £-Sterling started plunging immediately after the referendum surprise one didn't have to be Sherlock to deduce that this would soften the economic blow to the UK and may therefore well be the central bank's doing – who has the deepest pockets of all market participants!

Economics makes no claim at being able to see the future. Its efficacy lies in being able to explain events, and inform us of ways to get desired results, not in determining when those events will happen. As Mr Miles quipped in the aforementioned FT article "Any criticism of "economics" that rests on its failure to predict the crisis is no more plausible than the idea that statistical theory needs to be rewritten because mathematicians have a poor record at predicting winning lottery ticket numbers."

To our minds, what this highlights is the often ineffective nature of short-term market forecasts. Long-term economic trends are largely the result of underlying supply-demand dynamics, making them more explainable through our economic toolkit. Short-term movements, on the other hand, can often be heavily influenced by the smallest of events – making them far more unpredictable. This is, we believe, vindication of our investment ethos: keeping our clients' investments in line with their long term goals without trying to 'outsmart' the market over the shorter term.

Whatever the case, we certainly don't believe that the inaccuracies of some short-term economic forecasts put the discipline of economics in crisis. We think there is certainly an

interesting debate to be had about the flaws of economic theory, which, to his credit, Mr Haldane alluded to with his reference to the “rather narrow and fragile” models which are predominantly used.

To claim that this “crisis” is one of inaccurate forecasting from a failure to see the dark clouds, however, is to miss the point entirely. Economics is not the ‘weather forecaster’ of the economy, but a behavioural science which endeavours to find explanations for economic patterns and phenomena. If they repeat, their insights can be useful for predictions of the future. Alas, human behaviour changes constantly and so every comprehensive economic theory ever developed comes not only with a proof of its validity, but also its formal falsification as well. Very frustrating for every novice to economic science and an important fact many journalists and politicians seem to be unaware of!

UK Property market update: no sign of a Brexit effect (yet)

Ever since the UK voted to leave the European Union in the summer of last year, analysts had expected that Brexit would have a negative impact on the domestic property market. However, the reality has so far proved somewhat different, and house prices appear to have shrugged off some of the gloomier predictions. The past is not always a reliable guide to the future, however, and we expect price rises in 2017 to be more muted, especially if interest rates rise and further income growth is pressured by higher inflation – the result of a weaker pound increasing import prices (see our article in Tatton’s Weekly of 16 December 2016).

While we have seen some effects, particularly for prime (luxury) property in London, this looks to be largely due to reduced overseas demand from Chinese buyers, who themselves face limitations in getting money out of the country, as well as a recent change in preference for purchasing financial rather than hard assets.

House prices for the most expensive properties in London began falling during 2016, following a period of rapid price increases. Average prices of prime properties in London have fallen 12.5% since their peak in 2014, after a drop in demand from international buyers and the impact of the change in stamp duty on second and buy-to-let homes introduced in April last year.

Away from London’s luxury end, the capital appears to be suffering from a growing oversupply problem of new-builds, according to research firm Moliar London. Their research reveals that the number of construction starts in London have been higher than those being sold since 2012, which has led to an estimated over 10,000 units unsold at the end of 2016. Anecdotally, we have learned that property developers appear to be taking action by slowing the pace of construction in the capital to help offset the high number of unsold units.

As a result, companies focused on London are beginning to look to diversify towards opportunities across the country as the London slowdown begins to bite. Luxury property developer Berkeley Group has altered its strategy by opening a new unit in Birmingham – its first move outside the capital for nearly 10-years.

Berkeley plans to use its “expertise in large-scale regeneration” in Birmingham, a city that is undergoing rapid regeneration as a result of new transport links. HSBC plans to move the

headquarters of its retail banking arm to Birmingham and we would not be surprised to see others follow suit.

Away from the capital, prospects remain healthy and UK-wide house prices posted a much better than expected rise of 1.7% between November and December, breezing past estimates of 0.2% - the best monthly performance since March last year.

In Q4 2016, house prices were up 6.5% over the same period a year earlier, leaving the average price at £222,484, easing fears that prices would dramatically decline following the Brexit vote. Luton experienced the single largest price rise in the country, jumping 19.4% to £256,636. The chronic shortage of properties across the country, along with low interest rates and subdued building activity, have helped to support prices.

Looking at the performances of the house builders themselves, trading updates at the end of the year from both Persimmon and Taylor Wimpey were particularly solid. Taylor Wimpey said full-year profits should be at the “upper end” of market forecasts following “strong” trading in 2016 “despite wider macroeconomic uncertainty”. The company said that its profit margin widened to 20.8% (+0.5%) thanks to support initiatives from the government (Help to Buy HtB).

Likewise, for Persimmon, the company said that completions rose 4% to 15,171 homes as HtB continues to be a key driver of demand, particularly at the more affordable end – at least as long as the labour market remains healthy.

Both companies highlighted Brexit as a key challenge for 2017. As a result, Halifax and Nationwide expect house price growth to moderate to low-to-mid-single digits this year. We believe that price growth will become more highly correlated to the growth in household incomes, which will come under increased pressure in 2017 as inflation rises from the Brexit-related movements in the pound, providing a headwind to further price increases.

Despite the high level of uncertainty surrounding Brexit, the residential property market should remain relatively robust across the country, notwithstanding the issues in luxury London homes. At the low-to-middle end of the market, prices should receive support from continued low interest rates, easy mortgage availability and HtB as a powerful driver of additional demand.

E-commerce - emergence of new monopolies?

During the pre-Christmas season we observed from our office building’s post room that the majority of packages of fellow online shoppers are now labelled ‘Amazon’. This led to discussions whether we are witnessing a resurgence of monopolies and what this may mean for wider competitive dynamics and the economy as a whole. We therefore ask our economist Duncan O’Neill – who happens to be a renowned expert and adviser on the subject matter – to share his thoughts with us and our Tatton Weekly audience:

In an article on digital cartels this week, the FT suggested that competition authorities may struggle to keep pace with developments in the digital and online markets. For example, online pricing algorithms that calculate prices based on instantaneous market information, and which

are designed to meet a specific profit or price target, could also be used by companies to collude in order to keep market prices and profit margins high¹.

While digital pricing algorithms may be a relatively new phenomenon, corporate strategies concerned with 'monopolising' the market are not. A monopoly knows it can price independently of other market suppliers (and consumers), and/or reduce output such that prices for its products and services are bid ever higher. Market dominance is not bad *per se*, but the abuse of market power (monopoly) harms the competitive process and the wider economy.

Increasing the scale and/or scope of a company is a recognised and legitimate strategy, whether to sustain market share, or as a means of operating more efficiently (regulation, fixed costs and other factors may in fact require the company to operate at a minimum scale). Conversely, these types of costs and other constraints might also make it difficult for other firms to enter the market (entry-barriers).

Nonetheless, increasing company size and market concentration - fewer firms supplying the same range of products and services – can result in less competition, higher prices, reduced choice, and lower levels of innovation and productivity, etc. Moreover, market concentration appears to be on the increase across a number of markets and countries, where certain companies have grown considerably over the last decade, by means of both acquisition and organic growth.

A good example is Amazon. From simple online start-up book retailer to e-commerce "behemoth", Amazon has grown its total assets from ~\$4bn in 2006 to its current worth of ~\$65bn. Few companies have experienced similar growth over such a short period. Amazon, like Google, has effectively leveraged fundamental changes in the market landscape, utilising electronic commerce platforms, tactical acquisitions and other techniques to move from simple online retailer (or search engine) to bookstore, media publisher, games producer, telecommunications provider and even grocery deliverer.

Amazon: from online bookstore to industry 'heavyweight'



Share price development of the past 10 years of Amazon (AMZN - white line) vs. Walmart (WMT - orange line) and the top end of the US stock market (SPX - S&P500 - yellow line)
Source: Bloomberg. 13/1/2017

¹ The US Department for Justice has recently brought a prosecution for price rigging (for classic cinema posters and wall art sold through Amazon's online marketplace). It concerned manipulation of the market by programming customised algorithms to keep prices artificially high. Once rival sellers had agreed to the plan, the algorithm automatically maintained what prosecutors called "collusive, non-competitive prices" on printed wall art.

Horizontal type concentration (within markets as opposed to across different markets) is also increasing. According to the Council of Economic Advisors in the US, growing market share concentration in industries such as transportation, retail and insurance is slowing economic growth and reducing living standards. Companies in the US and elsewhere are said to be growing older (as a result of fewer new entrants), competition is less fierce and market power is consolidating in the hands of a few large companies in many industries.

In the UK, the Competition and Markets Authority (CMA) continues to be very busy with investigations and merger reviews – most recently, the proposed merger of VocaLink and Mastercard. According to the CMA's statistics, it reviewed 62 potential mergers in 2015/16, of which 20 were found to result in a substantial lessening of competition.

As a consequence of this dynamic (as well as companies being taken off stock exchanges due to private equity driven delisting), the number of public listed companies in the US (and elsewhere) has reduced from more than 8,000 in 1996 to about 4,300 today. Continuing technology acquisitions, like those described above, or Microsoft's recent takeover of LinkedIn together with increasing market concentration is also shrinking the public equity pool. The rise of the big firm and increasing market concentration could have implications beyond just competition - it may extend to wider considerations of economic and public policy.

For example, if mini cab portal Uber can raise investment capital of more than \$3bn via private equity in one round of funding (and ~\$15bn in overall debt and equity), it is questionable whether its management would also want to expose itself to the competitive rigours of the equity and financial markets (in addition to competition in the taxi product market). This may be the case for a number of companies that have gone into "private hands". Incidentally, Uber also employ price algorithms to implement "surge-pricing" (source FT, 8 January, The Big Read).

Uber is another company that has rapidly expanded, at least territorially. Much of the reasoning for companies like Uber and Amazon seeking to grow in size relates initially to cost and scale - spreading fixed costs over a larger market and/or geography (thereby reducing the unit cost). However, so-called economies of scale (or scope) must eventually be exhausted; companies may continue to expand, but for very different reasons. Companies will continue to boost profits not by reducing cost, but by raising prices. Acquiring a rival firm reduces competition and enables the acquirer to set higher prices.

While competition authorities cannot – and should not – impede market developments, we consider that arguments made by companies in defence of certain mergers or acquisitions need to be treated with caution, e.g., scale efficiencies. Moreover, companies across all sectors need to be exposed to vigorous competition, whether in product markets or in the financial markets.

This holds for e-commerce and digital companies as much as it does for traditional markets. Indeed, given the continuing changes in the market and prevalence of online transactions and commerce, it may be even more important to ensure there is competition in these areas. The unimpeded growth of companies and increasing consolidation could mean fewer choices for all of us, higher prices, lower productivity and potentially a less efficient and vibrant investment market. Good to know then that today's market concentration tendencies are not very different

than those of 50 or 100 years ago. This should mean that our competition supervision mechanisms that have been developed over an even longer time span are equipped and able to deal with this innovation driven market concentration trend just as they did with those in the past.

Bitcoin and currencies remain volatile

While both equities and fixed income investments have experienced some sharp movements since Trump's election victory, it is currencies that have seen some of the largest swings over the past few months.

The trade-weighted US dollar hit a 14-year high on expectations of domestic reflation; the Japanese Yen has continued to fall, as the Bank of Japan remains committed to holding 10-year rates at zero; the Chinese Yuan has lost 5% over the past month, as money flows out of the country; and the Pound has lost over 14% against the dollar in a year, following Brexit.

However, beating them all is the virtual or cyber currency known as Bitcoin, which jumped over 190% over the past year, breaching the psychologically important \$1,000 level for the first time since 2013. The Bitcoin price quickly retreated back to around \$760 after news



Source: Paul Mylchreest at ASMSI

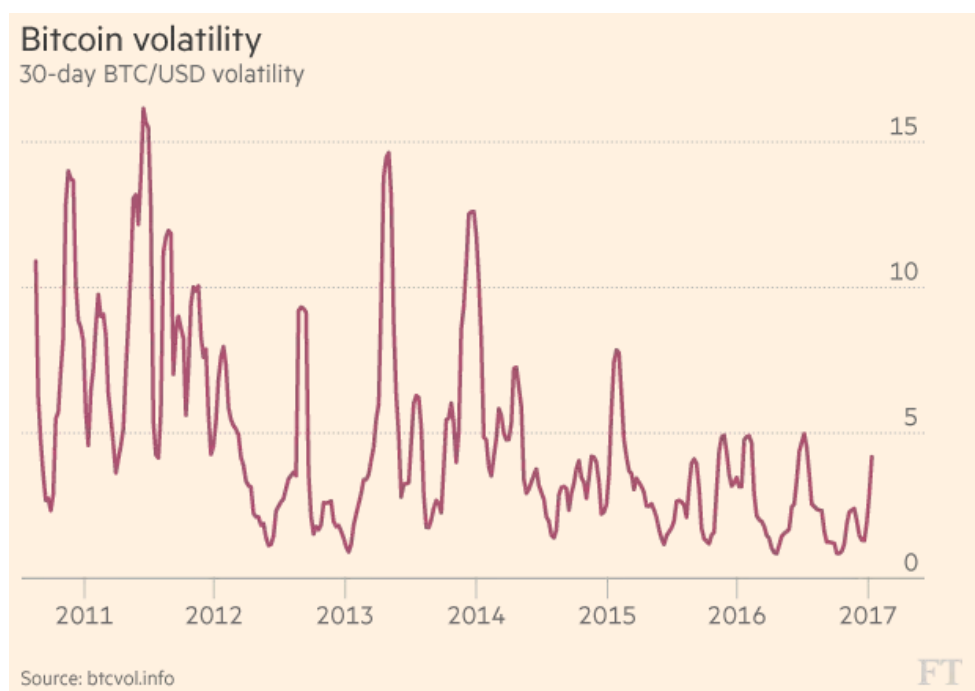
emerged that Chinese authorities were probing the Bitcoin exchanges for potential money laundering.

The strong rally of Bitcoins at the end of 2016 must have caught the eye of Chinese regulators, who appear to have become concerned that the virtual currency had become a convenient and way for Chinese citizens to send money overseas and exacerbate capital outflows from China, therefore causing further weakness of the Yuan.

The reason it caught the attention of the People's Bank of China (PBoC) is the apparent correlation between the price of Bitcoin and the offshore Renminbi (see above chart). Bitcoin had its best year in 2016, while the Chinese Renminbi experienced its worst year on record, falling 6.5%. Chinese activity dominates Bitcoin movements and Renminbi transactions accounted for 98% of all trading volume over the past six months.

As a result of that apparent correlation, the PBoC sought to 'crack down' on the virtual currency by "reminding" the three largest Bitcoin exchanges they need to "strictly" follow money laundering regulations and "clean up" any irregular practices. The PBoC also "reminded" the same exchanges that they should avoid mentioning Renminbi depreciation in all marketing materials.

As a result of the PBoC move, the Bitcoin price fell by more than 25% over the next few days, back to around \$760. Despite the recent price movements, the evidence is that Bitcoin is becoming less volatile and acting more in line with 'real' currencies like the Japanese Yen, Pound, and even the Euro. The virtual currency has managed to be more stable than the Brazilian Real, the South African Rand and also the oldest currency – gold. Interestingly, the



increasing stability of Bitcoin has occurred all without the need for a central bank. Perhaps this

free market solution to currency has the capacity to mature towards a truly stable and thereby reliable store of value over time.

PERSONAL FINANCE COMPASS

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7317.8	1.5	107.7	→
FTSE 250	18354.0	0.1	12.8	→
FTSE AS	3962.4	1.2	48.9	→
FTSE Small	5268.9	1.0	51.7	→
CAC	4913.6	0.1	3.8	→
DAX	11608.6	0.1	9.6	→
Dow	19913.3	-0.3	-50.5	→
S&P 500	2276.2	0.0	-0.8	→
Nasdaq	5063.9	1.1	56.8	→
Nikkei	19287.3	-1.2	-233.4	→

Top 5 Gainers

COMPANY	%	COMPANY	%
ANGLO AMERICAN	17.1	ROYAL BANK OF SCO	-4.9
BHP BILLITON	10.3	DIRECT LINE INSUR	-4.6
RIO TINTO	10.3	SHIRE	-4.1
GLENORE	10.1	LAND SECURITIES	-3.4
BURBERRY GROUP	9.2	ADMIRAL GROUP	-3.1

Sovereign Default Risk

DEVELOPED	CDS	DEVELOPING	CDS
UK	30.7	Brazil	255.5
US	19.3	Russia	231.3
France	41.8	China	113.9
Germany	22.0	South Korea	49.5
Japan	49.0	South Africa	255.7

Currencies

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.22	-0.82	OIL	55.5	-2.8
USD/EUR	1.06	0.82	GOLD	1193.5	1.8
JPY/USD	115.17	1.61	SILVER	16.7	1.5
GBP/EUR	0.87	-1.60	COPPER	268.2	5.3
JPY/GBP	6.90	0.37	ALUMIN	1790.0	5.1

Commodities

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W
UK 10-Yr	1.4	-1.2	-0.02
US 10-Yr	2.4	0.0	0.00
French 10-Yr	0.8	-2.6	-0.02
German 10-Yr	0.3	13.4	0.04
Japanese 10-Yr	0.1	-15.3	-0.01

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	4.3
Nationwide Base Rate	2.25
Halifax Standard Variable	3.74

GLOBAL RESEARCH TEAM

Lothar Mentel – Chief Investment Officer

Lothar.Mentel@tattonim.com

Jim Kean – Head of Investment

Jim.kean@tattonim.com

Mark Murray – Fund Analyst

mark.murray@tattonim.com

Sam Leary – Strategist

Sam.leary@tattonim.com

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

