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INVESTMENTS LIMITED

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KAL; Uncle Sam and Libertas to put extra lock on real war weapons cabinet, 17 Apr 2018

Market support for Trump or unwarranted equanimity?

A little over one week into the escalation of the US-China trade wars, stock markets have calmed and even made a partial recovery from last week's sell-off. Globally, stock markets are now trading around 3.5% below their highs, but that is still only about a third of a correction (a 'correction' is defined as a 10% decline). Given how extended stock markets appeared following the extended recovery since the beginning of the year, they could have been described as being in a state where investors start to search for reasons to take profits.

So why is it that stock markets have stabilised even though the rapid turnaround in the trade negotiations, that was initially talked up by the Trump administration, no longer seems plausible? Well, more research has been conducted into the likely short, medium and long term damage potential to the US and global economy, and the conclusion has broadly been that the long term damage potential is frightening, but over the shorter period of the next few months the deterioration of the economic outlook is fairly small. Not dissimilar to the aftermath of the 2016 Brexit referendum, in a way. And just as then, as long as economic sentiment does not sour to create second order effects, the markets may actually not be too far off.

From that angle capital markets are not just a barometer of change in the economic climate, but their reaction can influence the climate itself – make the weather change, if you will. Paradoxically therefore one can interpret the relative market calm as implicit encouragement for the Trump administration to play hard ball against the Chinese side – at least over the coming months. Whether this stance will pay off will only become clear in time.

Back in the UK, looming currency market turmoil next week was averted by Theresa May's announcement that she would agree in June to a time plan for her stepping down regardless of whether she wins or loses a fourth attempt to get Parliament to pass her Brexit deal. Turmoil averted, because on the basis of the current polls for the European elections, the Conservatives will suffer such catastrophic declines that the pressure for her to resign there and then could have created a power vacuum that would have sent £-Sterling into another downward spiral.

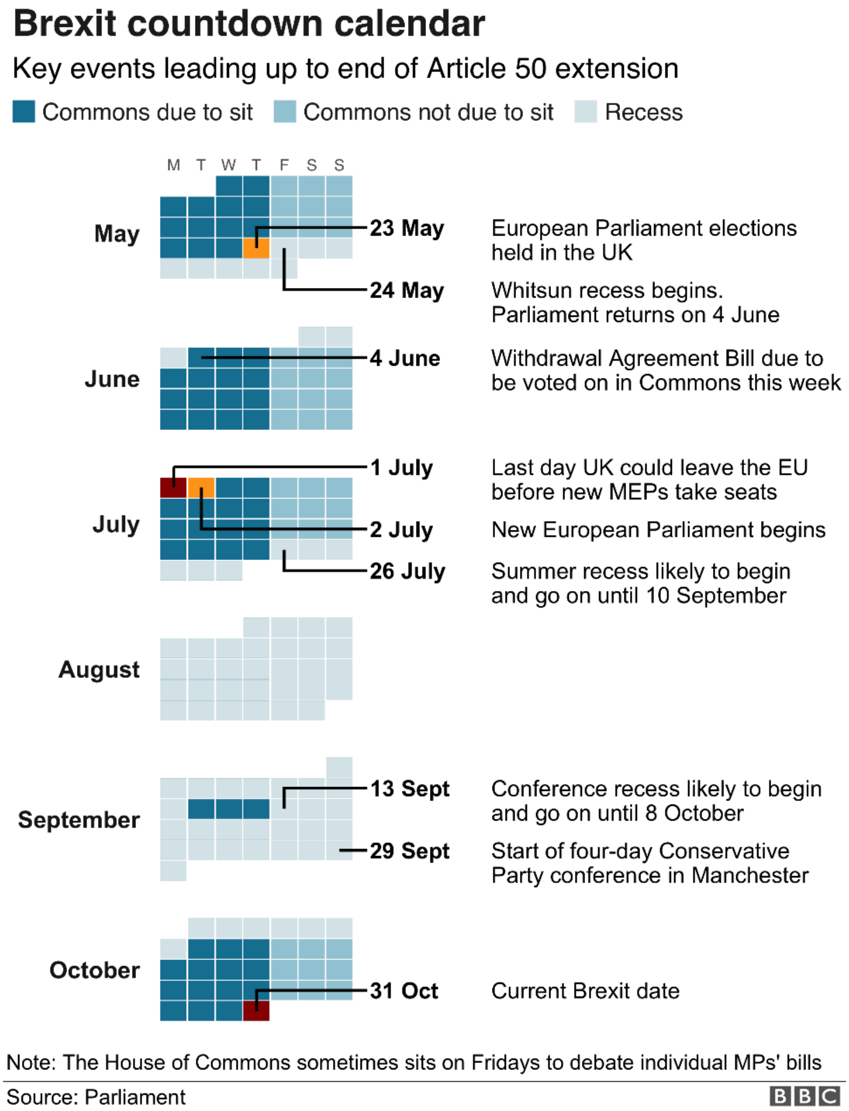
However, £-Sterling still declined against the US$ to levels last seen at the end of last year, as international investors realised that her stepping down will usher in a more determined Brexiteer to lead the country, given it is the Tory party membership that will elect the next leader not Parliament or the Conservative MPs. Depending on the severity of the outcome of the elections next week it may also become plausible for the Conservatives to swing behind a hard Brexit agenda and agree with Corbyn to call a general election in the hope of regaining a parliamentary majority.

Sadly this means the Brexit respite has ended already and we will have to return to monitoring every new turn carefully for its potential economic impact. A bit of a shame really, because the UK's economic trend has improved further over the Easter break as has Continental Europe's.

In summary then, the economy and markets are doing their best to 'keep calm and carry on' but we will have to watch the political world very closely for any indications that this calmness may turn irrational.

Irony: UK's European elections matter more than ever before

Assuming the official schedule, there are 49 official working parliamentary days before the Brexit deadline is upon us again. The disintegration of the previous centres of power in Westminster (Conservatives and Labour) means that MPs may be working more in their constituencies to ensure their re-election. For them, the European Parliament (EP) vote next week will be key.



In European legislative terms, how the UK votes on a body it has already asked to be removed from will not have a big impact. The EP does not wield much power at the best of times, and there is a very good chance that the MEPs Britain elects next week will only be there for a few more months. But next week's results may nonetheless play a decisive role in the country's near term future.

MPs will want to be active in their constituencies. Brexit is the only campaign issue, and most will try to put themselves on one side of it or the other.

On current polling, the newly formed Brexit party – led by former UKIP personality Nigel Farage – is set to take the largest share of votes. Around 30% of the electorate intend to cast their votes for the Brexit party according to an aggregation of the latest surveys (with two pollsters putting the number as high as 34%). But by other measures, they are set to score even higher. Below is the current vote share calculated (in house) from the political betting exchange on Betfair:

Party	Vote share
Brexit	35%
Labour	22%
Liberal Democrat	16%
Conservative	15%
Green	6%
UKIP	3%
Change UK	3%

It is difficult to tell how much we should read into this, especially given the shifts that might occur now that Theresa May has promised to set a timetable for the election of her successor in June, regardless what the outcome of a fourth vote on her Brexit deal may be. EP elections often see more votes and seats go to the fringe parties than in national votes as it is a proportional rather than 'first-past-the-post' ballot (other populists across the continent are also expected to make gains). The 24 seats the Brexit party is expected to win is equal to the number of seats won by UKIP in 2014. And the Brexit fatigue amongst those with little emotional involvement will probably give outsized representation to hard Brexiteers.

But if the polling turns out to be correct, it would still be significant. It would be the largest vote share for any single UK party in EP elections for 25 years. And it would solidify just how seismic the drop in support for the main two parties is.

The Labour party is still set to take the second biggest vote share, but every poll puts them substantially behind the Brexiteers. In constituency terms, Labour's ambiguous stance towards Brexit is not doing it many favours, and their exit this week from the cross-party discussions won't help, no matter how rational it might be.

This is clear from looking at its voter base. Undoubtedly the party is alienating some of its Brexit voters, but at the moment the bigger problem seems to be Labour Remainers. The most recent YouGov poll found that nearly half of the people who voted Labour in the 2017 election intend to vote for anti-Brexit parties next week.

Its problems are not as bad as the Conservatives' however. The opinion polling earlier this week put the Tories at around 12% (though the betting exchange numbers above are more recent, reflecting May's effective resignation). One YouGov poll even put them behind the Greens. The government's handling of Brexit has seen their support drop by a staggering amount, with Remain voters put off by what they see as a Brexit government, and Brexiteers angry at what they see as a betrayal of Brexit in order to reach a soft Brexit compromise with Brussels.

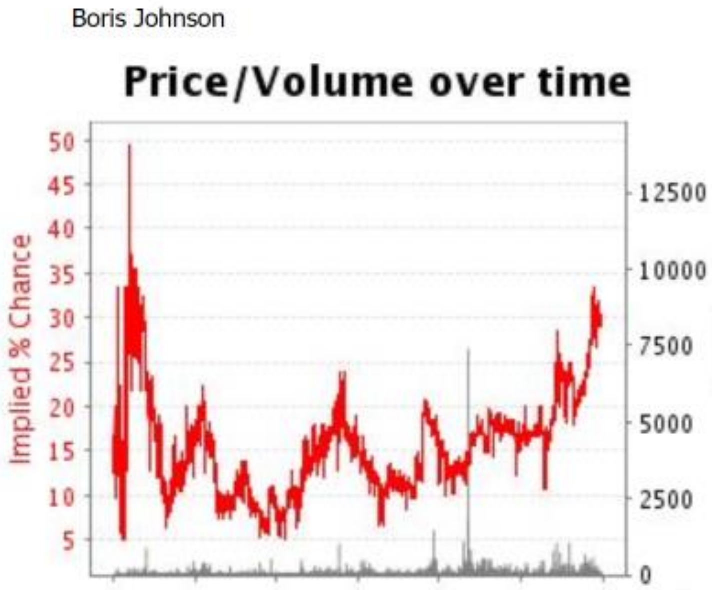
Theresa May has spent the majority of her time in Downing Street with people calling for her to leave. The inevitable fall has been accelerated by her inability to avoid next week's election. Now the question is: will the leadership race make the European election less relevant?

It is not likely that the party can coalesce behind a probable winner before Thursday. But it does seem that no potential candidate can come from the Remain/softer-Brexit group. The Tory backbenches are awash with hard Brexit supporters, making it likely that one of them will be the next leader.

And then there is May's fourth iteration of her Brexit bill, scheduled for June 4th. Labour's exit from talks makes it most probable that this will again be shelved, rather than just going through another pointless defeat. Even before May's effective resignation, her most ardent supporters admitted that it would be the end of her premiership.

And yet the odd thing is, a majority of MPs are in the centrist soft Brexit/Remain camp. If the European election suggests that a hard Brexit coalition could win a general election, it could spell out to them that to avoid a no-deal scenario, they must support the PM's deal.

The Tory leadership election is imminent and clearly the chances of a hard Brexiteer winning have shot up. Again, from the political "exchange", here are the probabilities of the two most likely candidates



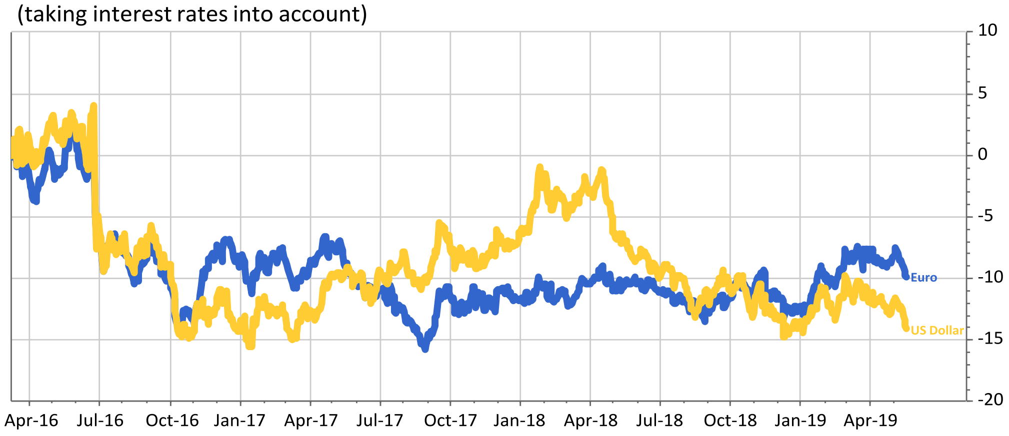
winning:

Michael Gove is the softest Brexiter deemed to have any chance (!! At 10%) and no Remainer is deemed to be better than 50-1 odds.

As ever with Brexit, the situation has weighed – and will continue to weigh – on our currency. The news this week has caused yet another bout of Sterling weakness.

Sterling's trajectory since the referendum

(taking interest rates into account)



Source: Factset, TattonIM

So it has been interesting to note over the past few weeks that UK economic data has actually been fairly good. The labour market continues to be tight. Indeed, the unemployment rate fell again to 3.8% while average wage growth is running at 3.3%. Growth for the first quarter came in at 2% annualised, while the expected flat March industrial production turned out to be a small rise of 0.7% month-on-month. Compared to the rest of the world, this is not too bad. In purely fundamental economic terms, £-Sterling has reasonable support, particularly because assets look cheap. But as has been the case since before the Referendum, Sterling's value is almost entirely related to Brexit sentiment.

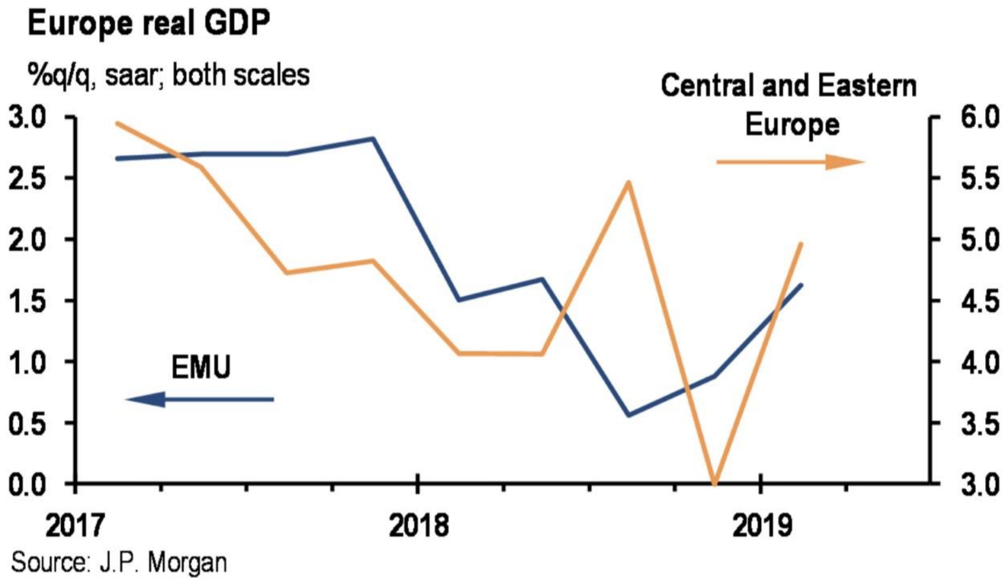
We cannot expect any positive data to turn into Sterling positivity while Brexit's clouds linger overhead. And especially when they are turning darker. We hope that the next few weeks will reduce that uncertainty. But we won't hold our breath.

Eurozone looking brighter

In the midst of the Brexit drama, the European Parliament elections and the ever-present 'Italian problem', the latest European economic data are providing some much-needed respite. Eurozone GDP grew 0.4% in the first quarter of 2019 (1.6% annualised) showing signs of a recovery from the lacklustre 0.2% quarter-on-quarter (q/q) growth at the end of last year.

Looking at a more detailed breakdown shows some positive trends. Germany – Europe's largest economy and so often the driving force of growth on the continent – grew at an annualised rate of 1.7%, after flat or negative growth throughout the end of last year. The European giant only narrowly avoided recession last year, sparking fears of a prolonged downturn. But the rebound at the beginning of this year should help to soothe those worries.

Results from elsewhere on the continent were even more positive. Figures from central and eastern Europe look very strong, with near 6% annualised growth in Poland and Hungary. Meanwhile, the title of "European growth engine" has gone to Spain – of all places. Spain's 2.5% expansion last year made them the largest contributors to EZ growth. And their 0.7% q/q growth in the first three months of this year is the highest of Europe's major economies. That's not bad for a country that has had two recessions in a



decade and claims the largest number of unemployed citizens.

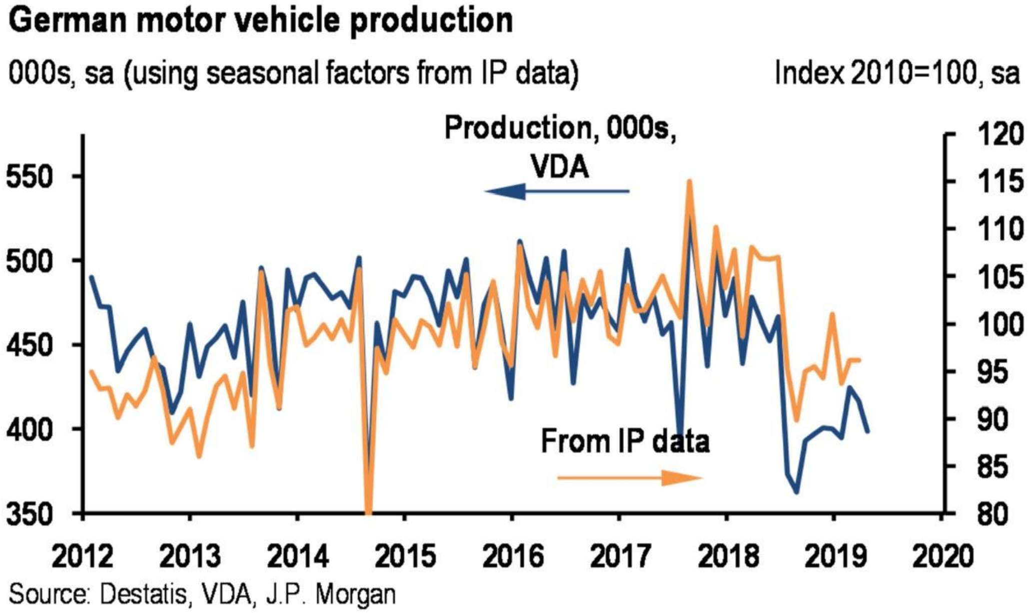
Beneath the headline growth, other measures point to a fairly healthy Eurozone economy. Employment expanded at an annualised 1.4% in Q1, and unemployment – which had remained stubbornly long at above 10% over the past decade – came in at 7.7% in March, the lowest level since 2008. It seems that Europe's economic slowdown last year did not lead to businesses shedding jobs, with most of the adjustment occurring via productivity.

That might sound bad – as falling productivity is usually always a negative for the economy. But job hoarding is a good sign of economic resilience. Stable employment is crucial to maintaining consumption levels: underpinning domestic demand, rather than having to rely on exports. Indeed, EZ consumption figures have looked more positive recently. A healthy labour market means that uptick has the potential to continue, which should spur overall EZ growth.

Meanwhile, Eurozone industrial production also looks positive. While March showed a 0.2% month-on-month decline, overall Q1 posted a strong 3.3% annualised expansion. We saw a marked waning of activity in the second half of 2018, but the strong industry numbers suggest that a rebound is already underway. A number of one-offs and special circumstances hurt European industry in 2018, but these seem to be fading away.

We expect industrial production to grow at a solid pace again this quarter. This should be underpinned by a recovery in the German autos sector, which endured a number of damaging factors last year. The new emissions testing regulation slowed production just as global (and particularly Chinese) demand tailed off, leaving Germany's all-important car companies hamstrung. Both of those things should improve this year. And there are early signs that improvement has already begun.

As the chart shows, German car production has already come off its lows. But at the moment it is still



nothing to get too excited about. Output has rebounded from the dire levels at the end of last year, but it declined again last month. At the moment, these figures are still consistent with a contraction in German industrial production.

And unfortunately, there are signs that the German rebound could be short-lived. The ZEW sentiment indicator – a closely-watched economist poll of expectations for the German economy – came in at negative 2.1 this month, well below expectations. The poll from a Mannheim-based research house measures economists' sentiment. The negative reading shows that "financial market experts continue to expect restrained economic growth in Germany for the next six months," according to ZEW president Achim Wambach.

Some of the researchers we subscribe to agree. They point to increasing inventories and falling orders as a worrying sign for Germany. Many commentators believe that, with a backdrop of heightened trade tensions and a slowing global economy, there is not much upside for the German economy. Germany "is likely to lose momentum again in the further course of 2019" according to Allianz economist Katharina Utermöhl.

Indeed, some suggest this is true of the Eurozone more generally. With trade wars waging in the background and a return to the post-crisis trend of lethargic global growth, it is not a good time to be an export-led economy.

Europe is certainly that. And for that reason, we should treat the rebound in growth figures with caution. But that does not mean we should write it off. A few months ago, European data painted a dire picture.

Regardless of the global backdrop, things have certainly improved on that front. And from our perspective, one of the crucial aspects of the European recovery has been domestic consumption – predicated on a stable labour market.

Even in Germany – the export world champions – the growth rebound was boosted by domestic factors such as investment and private consumption. These are factors which have been stubbornly low in the Eurozone for some time. And so improvement here could be hugely beneficial. There are not clear skies for Europe yet, but things are looking brighter.

Cars again

Automobiles have been a significant part of the global economic slowdown both this year and last, with the sector having many issues, not least of which is its exposure to the ongoing trade wars. The nature of the product also means that demand for vehicles impacts various input sectors further up the line.

The slowdown in demand throughout 2018 has continued to feed through the intermediate product suppliers. This is most apparent among steelmakers.

For steelmakers, auto products are one of the most profitable products, so global auto weakness has significant impact on the bottom line. Carmakers usually buy higher quality steels, which attract higher margins. Autos account for 20% of global steel demand, but car sales in EZ have seen seven straight months of declines.

German steelmakers like Klöckner issued profit warnings, saying that weak orders and lower prices were to blame.

Further afield, India's steel conglomerate ArcelorMittal warned last Thursday that it sees European demand being weaker than previously expected (contraction of 1% this year) versus forecast of 1% growth. It posted its lowest quarterly profit since 2016 on lower demand and cheap imports. It said that "...market conditions in the first quarter of 2019 have been challenging. Demand has generally been lacklustre, reflecting softness in manufacturing activity and continued weakness in automotive."

The company said it would have to reduce production in both Poland and Spain. The cuts will lower output of flat steel, used primarily in cars and machinery, by about three million tons a year. This equates to about 3.2% of Europe's total flat steel output.

Steel makers have also been facing a squeeze from higher iron ore prices (up - at least partly - because of the Vale-related mine closures in Brazil). European makers also faced more local pressure with cheap imports from Turkey.

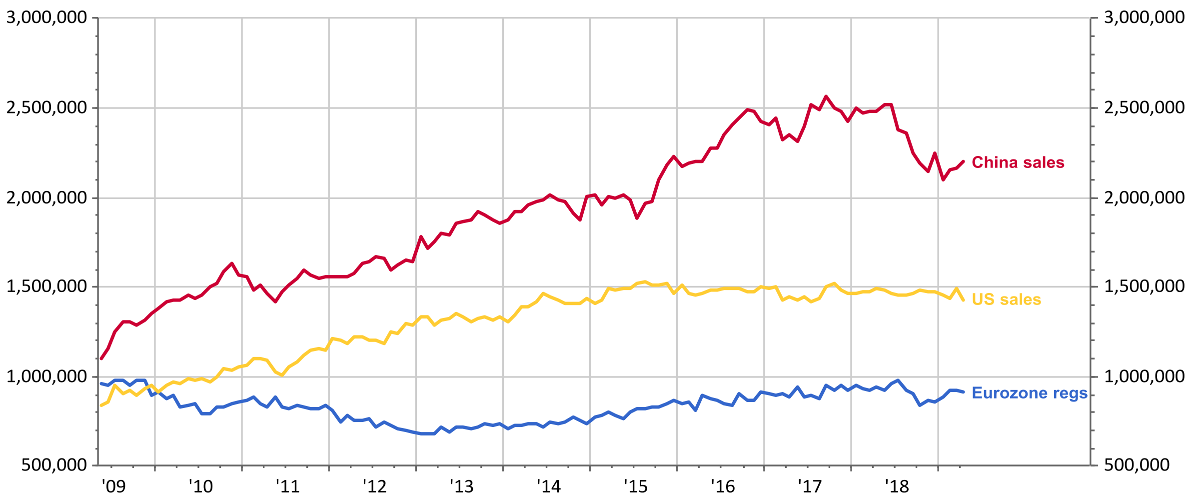
On Monday we were told that there was further bad news on autos from China. The world's largest car market (supposedly) saw further deterioration. Passenger vehicles fell 16.6% YoY in April to 1.54 million units, following declines of 12% in March and 18.5% in Feb. April's SUV sales were down 14.7% to 642,220 units. Cars were the only consumer product category in China that shrank in the first two months of 2019.

Cui Dongshu, Secretary General of the industry group, said "There's little hope of us seeing positive signs for the auto market in the first half of the year". Chen Hong, the chairman of China's largest car company, SAIC, said that "2019 will bring severe challenges". He called on all workers to "accelerate innovation" (a nod towards China's push for the country to lead in EVs) and "strive towards higher quality". SAICs sales were 17% lower in the first two months of 2019.

However, the early part of the year is always beset by seasonal adjustment issues. We take a rather primary approach by doing a mechanical adjustment, rather than trying to delve too deeply. While we may miss some information, it does mean we don't get overly focused on the latest "exceptional" thing.

Below is the chart of the three largest demand regions, the Eurozone, US and China, seasonally adjusted:

Main Region AutoSales / Registrations



Source: Factset, TattonIM, National Auto Agencies

Recent data from both the EU and China show some signs of reversing the slide of last year. The US seems to be weaker, having not faced last year's dynamic. Still, the sum of all of them is on a mildly more positive track.

And further help may be forthcoming. Noises from the Chinese Government suggest that they may well ease some of the regulations which have increased costs and lowered demand. Following intense lobbying from the Chinese auto sector, the government may also introduce demand incentives and tax cuts.

With most of the world's attention on the US-China skirmish, there was an unexpected positive change of fortune for Euro car makes, with news that Trump plans to delay tariffs on auto imports by up to six months. Trump reportedly did not want to further anger allies as he ramps pressure on China. Without this largesse, implementation would have been on Saturday May 18th.

While global stock markets rebounded, the real action was in Europe with the Stoxx 600 climbing, led by BMW, Daimler and Volkswagen, helping the euro move higher at least temporarily.

Still there is no doubting that the medium-term outlook is cloudy. Ultimately there are probably too many global producers amid a constrained market. Consumers are not buying more conventional cars.

The 2018 US market was able to offset this with sales of much higher value pick-up trucks, but this has not been repeated elsewhere, and there are signs that the US consumer is now being constrained by rises in gasoline and other prices.

Jaguar-Land Rover's owner, Tata Motors, is rumoured to be seeking a buyer for the unit (initially said to be Peugeot Citroen [PSA] and then denied). PSA has itself also been rumoured to be merging with Fiat-Chrysler.

A round of consolidation seems highly likely in the near future. Without a big reduction in capacity, the current trajectory for individual players remains tough.

Auto Manufacturers - Total Market Cap (USD)

Source: Factset, Tatton IM

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7348.6	2.0	145.3	→
FTSE 250	19498.6	0.7	131.8	→
FTSE AS	4025.3	1.8	69.5	→
FTSE Small	5620.6	0.6	34.9	→
CAC	5438.2	2.1	110.8	→
DAX	12238.9	1.5	179.1	→
Dow	25896.9	-0.2	-45.4	→
S&P 500	2875.7	-0.2	-5.7	→
Nasdaq	7560.6	-0.3	-25.9	→
Nikkei	21250.1	-0.4	-94.8	→
MSCI World	2126.1	0.0	-0.3	→
MSCI EM	1011.1	-2.2	-22.3	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	5.1	16.3	12.6	13.3x
FTSE 250	3.3	25	13.4	14.1x
FTSE AS	4.7	17.4	12.7	13.4x
FTSE Small	3.7	104.5	11.6	14.0x
CAC	3.4	17.8	13.8	13.4x
DAX	3.1	16.1	13.2	12.6x
Dow	2.3	16.3	15.9	14.8x
S&P 500	2.0	18.5	17	15.9x
Nasdaq	1.1	23.5	20.8	17.9x
Nikkei	2.2	15.9	14.9	18.6x
MSCI World	2.5	17.5	15.7	15.2x
MSCI EM	2.8	12.9	12.3	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Micro Focus Int.	6.9	Vodafone Group	-10.6
Spirax-Sarco Engineer	6.8	Ocado Group	-7.2
BP	6.1	SSE	-6.4
DCC	6.0	Kingfisher	-6.1
Hiscox Ltd	6.0	NMC Health	-5.5

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.27	-2.10	OIL	72.3	2.3
USD/EUR	1.12	-0.61	GOLD	1277.1	-0.7
JPY/USD	109.90	0.05	SILVER	14.4	-2.4
GBP/EUR	0.88	-1.53	COPPER	275.0	-1.3
CNY/USD	6.92	-1.38	ALUMIN	1860.0	3.4

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.034	-8.9	-0.10
US 10-Yr	2.394	-3.0	-0.07
French 10-Yr	0.286	-17.8	-0.06
German 10-Yr	-0.104	-131.1	-0.06
Japanese 10-Yr	-0.052	-6.1	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.67
3-yr Fixed Rate	1.98
5-yr Fixed Rate	2.03
Standard Variable	4.29
10-yr Fixed Rate	2.59

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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