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Lothar Mentel

Lead Investment Adviser to Cambridge

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www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk

Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD

Christian Adams on the latest Brexit scare; 19 Oct 2018; Source: Political Cartoon Gallery in London

Complicated picture suggests taking a step back

The global equity market sell-off calmed this week, even though the predicted bounce back petered out sooner than most had expected with selling pressures already returning mid-week. This left stock markets roughly where they had been the previous Friday, i.e. in a sad state from a 2018 year to date perspective. Average earnings growth of above 20% reported by the first cohort of US and European companies of this earnings season failed to impress equity investors and were regularly greeted with selling rather than buying orders.

The initial sell-off, triggered by concerns that a bond market riot may be brewing because of normalising yield levels has turned stock market pundits away from the positive US and global growth narrative to look for other reasons with which to rationalise their sudden risk-off stance. And once they are looking they can find far more than just Donald Trump's trade war poker games: Saudi Arabia threatening with an oil shock; Brexit routes becoming so confusing and ever changing that all sides seem to be screaming 'No!' in unison; Italy provoking the bond markets by submitting budget proposals they know are unacceptable for the EU and Eurozone and perhaps most importantly Chinese stock markets suffering a bigger than -20% and accelerating equity bear market.

The last point may indeed have been the most relevant factor in this week's lacklustre market recovery. In today's interconnected capital markets it is entirely feasible that the liquidity squeeze in the Chinese stock markets spread through selling pressures of Chinese institutions and private investors to other markets and exacerbated the newly adopted risk-off mood.

With the exception of the liquidity squeeze – which China's central bank sought to alleviate through effective monetary counter measures – I struggle to share markets' sudden and overly negative sentiment. The Saudis had thoroughly miscalculated the collateral damage of first dealing with a critical Saudi journalist medieval style, then denying it and once cornered, threatening to wage 'oil-war' on the world. Their attempts at damage limitation since Monday from the very top, indicates that it must have dawned on them that their initial strategy would hurt them more then help.

Oil markets appeared to agree, leading to a fall in the oil price back to $80/bbl which makes more sense given supply is very likely to once again exceed demand at such elevated prices and against the not insignificant emerging market deceleration of the past months.

The Italian budget proposal may have been made by radical populists, but its substance has been reported to be solid, professional and not as outlandish as some commentators first suggested. This makes a negotiated compromise solution before year end the most likely outcome, rather than the big stand-off confrontation the bond markets fear and have begun to price in and penalise through higher bond yields for Italian bond issuers.

On the Brexit side finally, most of the points we discussed on these pages over the past weeks have now entered the mainstream of the negotiations. Be they the likely extension of transition periods, a temporary continuation of the customs union to prevent trade disruptions or a bespoke association model for the UK. The seeming unwillingness of the opposing political sides within the UK's political leadership and parliament to seriously consider any of them makes me suspect that we are witnessing deliberate rather than situational brinkmanship on the side of the government. The more to the wire negotiations appear and the later Theresa May's team presents any form of Brexit deal, the less the time, opportunity and public support for those who prefer chaos to pragmatic compromise – to agitate against it.

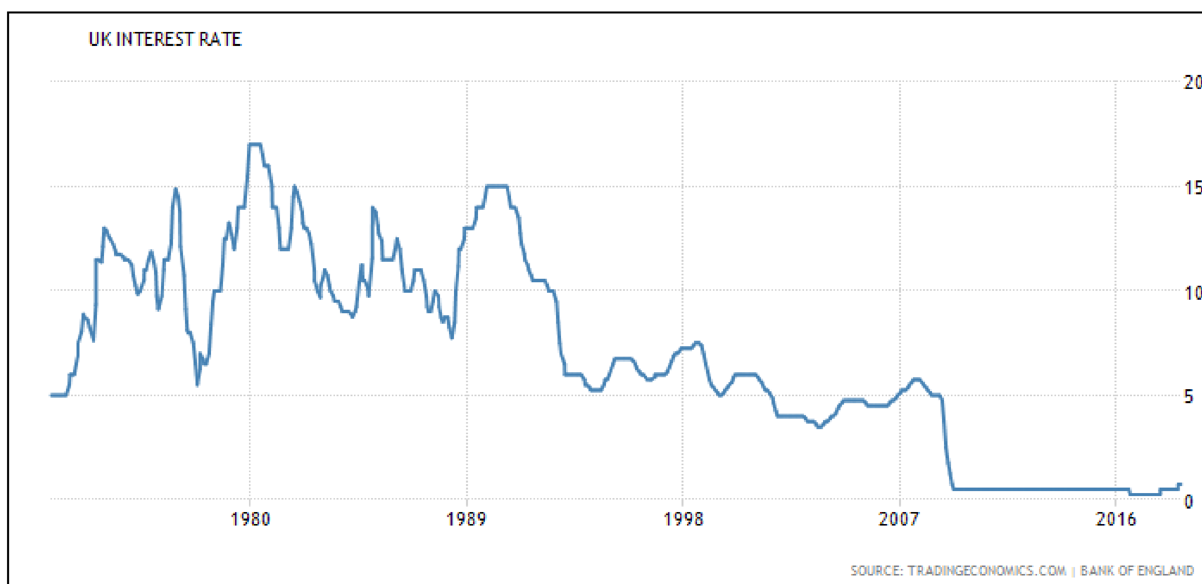
The weeks until year end can therefore be expected to remain as unnerving as the weeks since the summer, which may well put renewed but temporary pressure on £-Sterling, until at the last minute the looming crisis is resolved in a nail biting finale which both sides will hope to make the result 'sellable' to their respective electorates.

For capital markets the ongoing liquidity shortage may become the biggest headwind, but one that the continued economic expansion is capable to overcome and reverse. This is unless a strengthening USD counteracts the reduction of liquidity tensions by withdrawing more liquidity from the global economy than the credit expansion of the normalising bank and financial sector can generate through increased monetary turnover. Thus far this has not happened which makes me optimistic that this global risk-off episode will wash over, just like the previous ones and investors will once again focus on real economic progress and corporate earnings rather than on a vast array of 'what-if' scare scenarios.

Is Brexit keeping a lid on UK interest rates?

Those observing the UK's steadily improving macroeconomic data points may well come to the impression that, if it wasn't for Brexit, UK interest rates would otherwise be following their US peers higher. And even considering it, the country is very unlikely to fall off the economic cliff edge next year – given that some form of compromise is still by far the most probable Brexit outcome. Surely then, rates should be higher than they currently are.

Leaving Brexit to one side, the UK economy is healthier and more robust than some may care to admit. It is therefore unsurprising that the Bank of England (BoE) seem as though they will be happier when interest rates are higher – or more accurately closer to the long-run neutral rate (economists call this R*). Such a neutral rate has historically kept the balance between promoting credit conditions needed for a steady growth environment and too low a cost of capital level that leads to economic overheating, causing a disruptive state of boom and bust.



Even though the BoE seems ready to pounce on any piece of data to justify such a move upwards, however gradual it might be, there isn't currently enough in the data to justify further rate rises. The bond market appears to agree, with the 2 years out market implied interest rate of 0.788% only being marginally higher than the current rate.

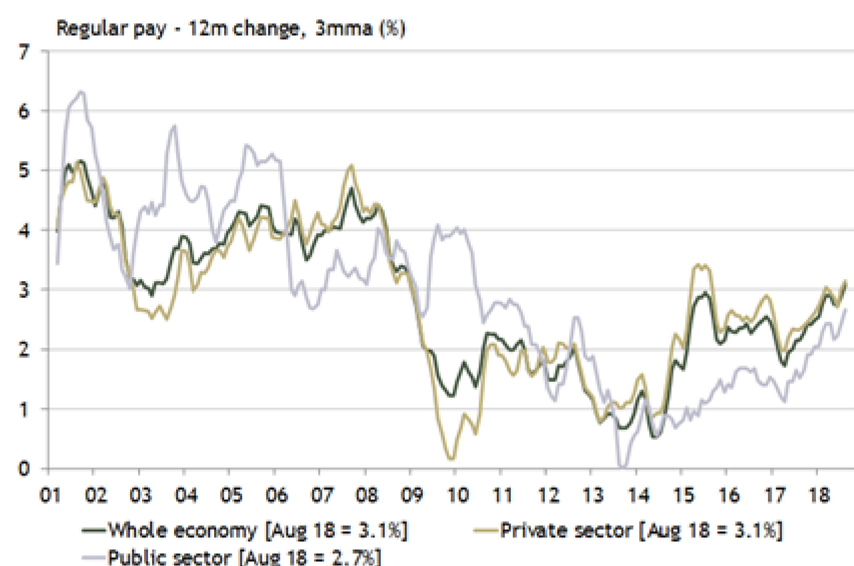
Rates of inflation and wage growth are two key pieces of price stability data the BoE monitors to inform its decisions. The BoE increased rates by 0.25% to 0.75% in August, for only the second time since 2009, on the expectation that both wages and inflation were likely to increase further. This week's data provide some mixed messages that would suggest the BoE should perhaps 'watch and wait' rather than be tempted into more rate rise action.

Despite still being above the BoE's 2% target, CPI inflation showed a downside surprise on Wednesday, falling from +2.65% YoY in August to +2.4% YoY in September – below estimates of +2.6%. A decomposition of CPI reveals that falling imported food prices drove the overall level lower, offsetting energy price increases.

Core inflation, which excludes volatile items like energy and food, was also reported below expectations. It fell from +2.1% YoY in August to +1.9% YoY, suggesting underlying inflationary pressures remain largely contained, which reduces the pressure for counter balancing monetary policy response. Economists predict both headline and Core CPI to continue falling throughout 2019, ending the year just shy of 2%. Again, this is hardly a case for faster rate hikes.

In addition, on Tuesday, the Office for National Statistics (ONS) grabbed the headlines by releasing the latest readings of wage growth. Wages in the three-months to August expanded at their fastest rate since the financial crisis, while unemployment remains at a 40-year low. Average weekly earnings (ex bonuses) rose 3.1% YoY – better than the 2.9% economists predicted. Wages may not yet be growing significantly above the prevailing rate of inflation, but real wage growth is finally positive, even if it is currently a relatively meagre 0.4%. Any wage increases above price inflation is seen as a driver of future inflation, unless it resulted from a productivity improvement that also expanded the volume of goods available.

Here it was notable that Jon Cunliffe, Deputy Governor of the BoE, cautioned that we have seen a number of "false dawns" on pay growth and that more evidence that wage increases were "firmly established" in the 3% region was required before a move towards earlier interest rate hikes may be justified. Mr Cunliffe suggested an improving economy could still tempt more people into the workforce,



which could contain further wage growth pressures from a tight labour market.

UK whole economy pay growth reaches 3%; Source: ASR (Tatton research partners)

This fact that wage growth is a lagging data point – reflecting changes that have occurred in the past but has little indication of the near-term future – may help explain the 0.8% fall in the volume of September's retail sales. This was driven mostly by the largest month-on-month drop in food sales since 2015, while a sunnier summer helped drive overall sales higher by 1.2%, particularly for jewellery and online shops.

Beyond food, the retail sector can breathe a temporary sigh of relief. But there is a cloud on the horizon: an uncertain property market – another lynchpin of consumer spending. The average UK house price rose at an annual rate of 3.2% in August – the slowest pace in five years, driven by 0.2% fall in London – the fourth month of declines.

A slowdown in London, particularly prime properties, overshadowed gains in the rest of the country. While prices in the east Midlands gained 6.5%, transaction volumes for homes worth £2+ million has fallen by 16% between Q1-Q3 as both buyers and sellers at the luxury end of the market appear to lack appetite amid higher stamp duty rates and Brexit fears. According to estate agents, only needs based on the three D's (death, debt or divorce) are current drivers of activity at that end of the market.

Property experts predict that, while housing activity has moved off its 2018 lows, further upside will be limited. Howard Archer, chief economic adviser at EY Item Club sees house price growth of just 2.5% each year for both 2018 and 2019.

Overall, there is little doubt that the UK economy is in surprisingly good shape, but without any signs of overheating. From a purely economics-based point of view, only sustained evidence of rising inflation and persistent growth in real wages and house prices should warrant further rate hikes.

Simply jumping on a string of strong data points to justify getting to R* sooner rather than later may not hold water, because the health of the economy is increasingly tied to the fortunes of the Pound. The pattern seems to be better economic data following a weakness in the Pound and the reverse when Sterling strengthens. If this pattern holds, the Pound's recent rise should produce weaker economic numbers in the near future.

Of course, the BoE also has a large idiosyncratic shock risk – Brexit – to contend with. Should the Pound come under further downward pressure because of fears over future trading conditions, then the BoE may want to have retained the capacity to raise rates to defend the exchange rate – without putting undue stress on the domestic economy from higher interest rates.

Saudi, Oil and the Middle East

The suspected murder of journalist Jamal Khashoggi by Saudi Arabia is gripping international media. Fresh reports confirming the Kingdom's guilt seem to emerge each day, and pressure is mounting on the young Saudi ruler Crown Prince Mohammed bin Salman. As well as condemnations and threats of reprimands from international politicians, many of the Saudis' commercial partners are trying to distance themselves from the kingdom.

The Future Investment Initiative conference in Riyadh – dubbed 'Davos in the desert' – has seen cancellations from the US treasury secretary Steven Mnuchin, the UK's secretary of state for

international trade Liam Fox in addition to the chief executives of JP Morgan, BlackRock, Uber, Ford and more, as well as from the event's major media partners. The conference – and the ambitious Saudi Vision 2030 project this is part of – is either Salman's whole-hearted attempt to bring Saudi Arabia into the 21st Century or his lavish vanity project, depending on who you talk to.

But either way, it's now a diplomatic nightmare for the young prince. He had hoped that massive investment would generate wealth, prestige and influence for himself and his country for decades to come. Instead, the 'young reformer' image he's tried to project now stands in stark contrast to the medieval warlord tactics he's accused of.

Where he goes from here is unclear. While there are reports that Riyadh is willing to accept some limited liability for the Washington Post writer's death – the prepared story being that his death was the result of an interrogation gone wrong – they have also threatened to restrict oil supply if faced with sanctions. One Saudi state media outlet opined that, if sanctions were imposed on the kingdom, "no one should rule out the (oil) price jumping to $100, or $200, or even double that figure."

It's these threats that have been playing havoc with oil prices. Last week, Brent crude rose to $86 per barrel – it's highest level in four years – before falling back down below $80 this week. Traders are concerned that the Saudis could use supply restrictions on a scale not seen since the 1970s oil embargo that established the current order of the oil market. This, combined with sanctions on Iran coming into force, could deliver a very nasty shock to markets and the global economy.

But we think these apocalyptic predictions are a little far off the mark. In reality, the Saudis' leverage over global energy market isn't anyway near as great as it was back in the 1970s. Despite being the world's largest oil exporter, the young prince's political agenda and reliance on foreign support – both militarily and financially – mean that holding oil supply hostage would likely do far more damage to them than it's worth.

Already, senior US politicians across both parties have suggested removing military aid for the regime. Given that British and American arms sales and logistical support is a vital crutch for Riyadh's 'stop Iran' war in Yemen (a region the Saudis consider tactically invaluable), Salman is likely to seek a compromise

wherever possible. And Donald Trump's insistence on supporting the regime despite the mounting evidence against them means he's likely to find that compromise.

What's more, the clamour around Khashoggi's death hides an important factor: tensions in the middle east actually look lower now than they were some months ago. We wrote a while back that the probability of globally significant confrontation breaking out in the region was high. Worrying flash points in Syria, a strongman Turkish dictator with a knack for causing trouble and a sudden ignition of the cold war between Israel and Iran all seemed to be coming to a head at the same time.

Now, things look very different. Bashar al-Assad has all but won the civil war and effectively crushed Syrian rebel groups. War between Iran and Israel never transpired, and the Iranian Revolutionary Guard Corps seem to have accepted that their Syrian adventure is a lost cause. And in the likely murder of a journalist on Turkish soil by a foreign government, President Erdogan seems to have found a common cause with western governments previously against him. All in all, the potential for conflict that could constrain global oil supply has decreased.

The supply soap opera which so often dominates short-term moves in oil prices is inherently hard to predict. But in our view, it's at least as likely that the Saudis will aim to appease President Trump and comply with his request to increase oil supply and bring prices down. And in any case, we would point to the research reports that suggest that the world's remaining oil suppliers have enough spare capacity to capitalise on any drop-off from the Saudis.

This brings us to the demand side of the equation. While geopolitical drama often drives short term oil moves, longer term trends tend to have more to do with demand. And on that front, it's unlikely global demand is strong enough to support even current prices, let alone the $100+ figures threatened by Saudi officials. China – the world's biggest oil importer – and other emerging markets are currently going through an economic slowdown that doesn't look like stopping any time soon. Their roaring demand for black gold was one of the main factors that pulled prices out of the sub-$40 mire two years ago, and their lacklustre demand could be similarly significant now.

The complete miscalculation of the repercussions of Khashoggi's violent death will undoubtedly be significant for Saudi Arabia. The diplomatic storm it's brought will do them no favours commercially or politically, and it could well bring big changes – perhaps even a ceasefire in Yemen. But a shoot up in oil prices a la a second oil crisis is unlikely to be one of them.

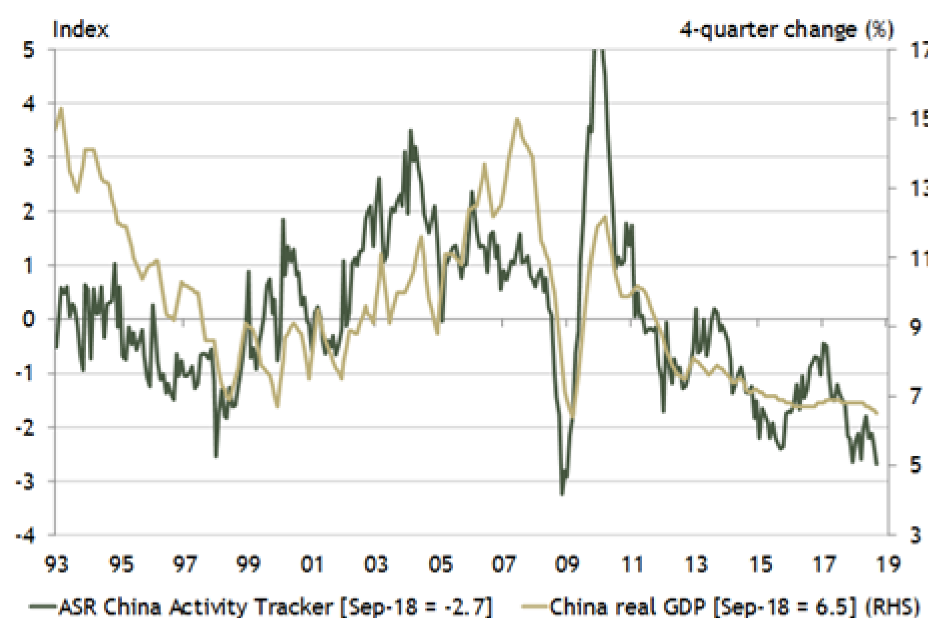
China: Command economy vs. a free but regulated economy

Economic growth in China has dropped to its lowest level since 2009. Official GDP figures released this week show that activity in the third quarter of this year was 6.5% higher than a year before – the lowest growth number since the depth of the financial crisis nearly 10 years ago.

Of course, 6.5% growth (after more than three years of consistent 6.5-7% figures) is hardly a lacklustre posting, even considering Beijing policymakers' obsession with keeping the economy booming. But then,

neither is it particularly believable. It's well known among economists and China watchers that official economic figures are to be taken with more than just a pinch of salt.

When it comes to Chinese data, what's often the most significant for getting the real picture isn't the headline figures but the trend. That's why the lowest reading in nearly 10 years is significant: without any doubt, China's economy is slowing. Some analysts suspect that actual GDP growth has in the last few



years dropped from 8% or above to now around 4%.

Official and research based growth indicators for China; Source: ASR (Tatton research partners)

This is hardly surprising. The government's clampdown on the shadow banking sector and attempts to rein in the credit expansion that fuelled their ascension to the second largest economy in the world has taken its toll. The fact that the deleveraging process is happening at the same time as a trade war with their largest trading partner is getting under way only adds to Beijing's headache. Now, what was supposed to be a managed slowdown is looking like more and more like it could be a bit of a meltdown.

It was this fear that pushed policymakers to roll out stimulus measures and increase financing for companies. Central bank monetary policy has been loosened and – more significantly – there has been a large expansion of local government bond issuance. Beijing's commitment to propping up the economy has been enough to turn some investors positive on China. But as we have written here before, there are a couple of problems with this view.

First of all, investors expecting a stimulus package the size of the one enacted in 2015/16 will be disappointed. It was exactly those measures that pushed China's credit problem past the tipping point, and for officials to do so again would be an enormous risk. Secondly, while the slowdown started as a deliberate attempt by the government to unwind the credit build-up, that unwind has now become self-sustaining. After the easy credit taps were shut off, the zombie companies who survived on ample cheap liquidity came under serious stress. Many of them have gone bust. But this has increased the levels of risk

in the economy to the point where banks are now terrified of their own loan books, and unwilling to extend credit. The lack of available financing then hampers even healthy businesses.

The government is encouraging (and 'encouragement' carries a lot more force in China) banks to increase their lending once more, but much of this is aimed at the large state-owned enterprises (SOEs). On the other side of the economy, small and medium sized companies are still very much struggling. This is why, on Thursday, all major Chinese stock indices posted losses. The tech-dominated Shenzhen composite index fell -1.84% on the day, after similar falls in the days before.

Due to Chinese banks' inability to risk price their loans (offer different interest rates based on how risky a company is), many of the smaller tech companies on the Shenzhen exchange couldn't borrow from traditional banks. This led them into other avenues of financing, including the shadow banking sector and through arrangements with investors. Typically, these arrangements involve an investor securing a loan through a stock brokerage house using the stocks themselves as collateral. Often, this came with an agreement that, if the value of the stock fell below a certain level, the investor would have to pay the extra money to cover the losses.

If they are unable, the stock broker takes the stock and sells it to cover their own losses. But many of these stocks are highly illiquid, with extremely low trading volumes. As such, it only takes a few forced sellers – the stock brokers in this case – to send equities tumbling. Once that happens, the classic spiral ensues: forced selling compresses value which leads to more forced selling.

The local government is now intervening to encourage more buyers. If Friday's action is anything to go by, this could be very effective; the Shenzhen composite bounced 2.6% in afternoon trading. But even at effectively discount prices, investors have good reason to be wary of these companies. Often, the owners of the businesses serve as both the chairmen and the CEOs – and are afforded an almost godlike respect by their employees. This leads to conflicts of interest and inevitable corruption; the chairmen often have the ability to get a hold of cashflow that should be headed for shareholders or bondholders.

But this is just China's (and emerging markets' in general, for that matter) old problem rearing its head once more: corporate governance structures just aren't yet strong enough for a healthy and thus stable equity financed economy. Rules are thin on the ground, and regulatory structures often fail to enforce them. That may sound like a strange thing to say about a command economy, but a vital thing to remember is that Beijing's interventionist approach to controlling corporate China is very different to the comprehensive and strictly enforced regulatory framework we're used to in the west. While one focuses on creating a stable environment, the other has allow for corrupt enforcement officials a plug leaks as and when they appear – only to lead to more holes elsewhere. President Xi's other reform project to crack down on corrupt government structures has so far delivered fear and uncertainty but seemingly not yet established a more reliable framework for the economy. Until China can change that, the underlying weakness and vast swings in economic activity will remain. And no amount of growth can change that.

CAMBRIDGE INVESTMENTS LIMITED

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Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7049.8	0.8	53.9	→
FTSE 250	18795.8	-0.9	-177.7	→
FTSE AS	3868.5	0.5	18.3	→
FTSE Small	5549.7	0.1	7.5	→
CAC	5084.7	-0.2	-11.3	→
DAX	11553.8	0.3	30.0	→
Dow	25463.8	0.5	123.8	↗
S&P 500	2780.2	0.5	13.1	↗
Nasdaq	7149.3	-0.1	-8.0	↗
Nikkei	22532.1	-0.7	-162.6	→
MSCI World	2064.5	0.1	1.0	→
MSCI EM	970.9	-0.9	-9.2	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.5	15.7x	12.6x	13.1x
FTSE 250	3.5	8.6x	13.5x	13.9x
FTSE AS	4.4	14.4x	12.7x	13.2x
FTSE Small	4	-x	15.1x	13.8x
CAC	3.4	16.2x	13.5x	13.2x
DAX	3.3	13.6x	12.5x	12.5x
Dow	2.2	17.7x	16.0x	15.0x
S&P 500	1.9	19.9x	17.1x	15.7x
Nasdaq	1	24.9x	20.0x	17.7x
Nikkei	1.8	16.2x	15.8x	20.0x
MSCI World	2.5	17.6x	15.5x	15.0x
MSCI EM	3	11.7x	11.2x	12.0x

Top 5 Gainers / Top 5 Decliners

COMPANY	%	COMPANY	%
PEARSON	12.1	EASYJET	-10.8
PADDY POWER BETFA	12.0	BAE SYSTEMS	-7.6
GLAXOSMITHKLINE	9.0	CRH	-6.8
RANDGOLD RESOURC	8.5	STANDARD LIFE ABER	-6.2
ASTRAZENECA	7.2	TAYLOR WIMPEY	-6.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	-0.83	OIL	80.1	-0.4
USD/EUR	1.15	-0.52	GOLD	1227.4	0.9
JPY/USD	112.46	-0.22	SILVER	14.6	0.3
GBP/EUR	0.88	-0.29	COPPER	277.3	-1.0
CNY/USD	6.93	-0.10	ALUMIN	2013.0	-0.3

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.560	-4.5	-0.07
US 10-Yr	3.188	0.9	0.03
French 10-Yr	0.836	-3.6	-0.03
German 10-Yr	0.443	-11.0	-0.06
Japanese 10-Yr	0.149	-0.7	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.71
3-yr Fixed Rate	1.81
5-yr Fixed Rate	2.01
Standard Variable	4.38
10-yr Fixed Rate	2.7

* LTM = last 12 months' (trailing) earnings;
**NTM = Next 12 months estimated (forward) earnings

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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