THE **CAMBRIDGE** WEEKLY

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Q1 earnings season coming to an end by Hedgeye, 24 April 2019

Central banks disappoint expectations

Last week we wrote that stock markets faced being challenged by the decline of a number of stimulating aspects that had been regularly named as the drivers of the 2019 recovery. The most crucial one being central banks' assurances that they would refrain from further monetary tightening and might even consider renewed rate cuts.

No wonder then that the past week began with weaker trending stock markets as everyone was waiting with bated breath for the latest policy announcements by the central banks of the US and UK. Better-than-expected European and US economic growth (GDP) rates had already raised the prospect that further monetary support might not be forthcoming. This was precisely what happened. Rate-setters at both the US Federal Reserve (Fed) as well as the Bank of England (BoE) 'disappointed' any remaining expectations of forthcoming rate cuts. Indeed, BoE's Mark Carney went as far as suggesting capital markets were mistaken in only pricing in a single 0.25% rate hike for the next two years.

The fact that stock markets took the news in their stride and actually regained ground towards the end of the week will have disappointed all those who had suggested the 2019 recovery was merely a function of a return of central bank support. The remarkable aspect of the week's dynamics from our perspective was that the economic data was not in any way positive enough to compensate for the loss of further central bank easing prospects.

It would seem that investor sentiment has improved so decisively since the turn of the year that confirmatory evidence that the global economy is not slowing further is sufficient to keep investors interested. Yes, corporate earnings growth has inched back above the 0% line, but at an annual growth rate of 3% it is a far cry from last year's double digit pace. Forward indicators of economic activity in the form of PMIs are at best stabilising at low levels, and GDP growth has only recovered to very pedestrian rates of around 2%, which we used to dismiss as stall speed.

The crucial point is that this is enough to underpin the expectation of continued economic expansion – albeit at a once again slow speed – rather than to suggest a looming recession. Such an environment is sufficient to allow companies to continue to grow their profitability and thereby make money for their shareholders. This re-establishes the benign environment for risk asset investors where the big question is not to worry about the return of capital but focus on where the best *returns* on their capital will be achievable in 2019.

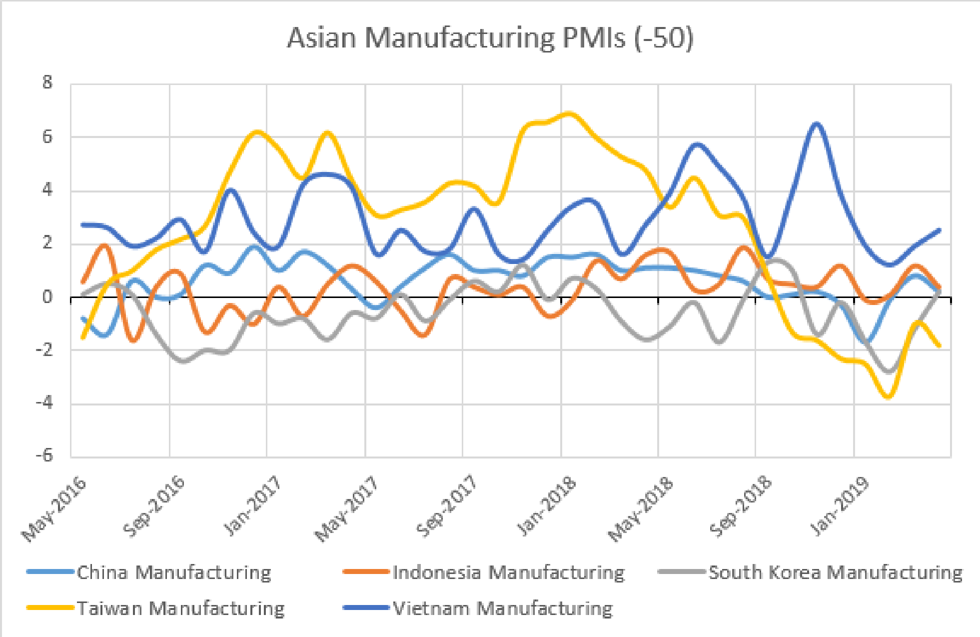
Here the debate continues to rage at to whether the US stock market will be able to continue to reward its investors with significantly higher company valuations relative to their ongoing earnings than elsewhere. In this respect it is interesting to observe that year on year earnings growth in Europe is currently running at exactly the same rate as in the US: 3%. Perhaps the fact that over the past weeks the US market has no longer led the rest of the western world is an indication that market leadership is slowly changing.

To close this week's summary with a more domestic observation, we found it very notable that our most reliable 'Brexit-Barometer', the £-Sterling currency market, reacted remarkably strongly to the poor performance of the Conservative and Labour parties in the UK's local elections. £-Sterling has reached its highest level against the €-Euro for a year, so it may be tempting to purchase one's holiday currency before currency markets change their minds about political weakness making an imminent agreement on a Brexit deal more likely.

An early view on April PMIs

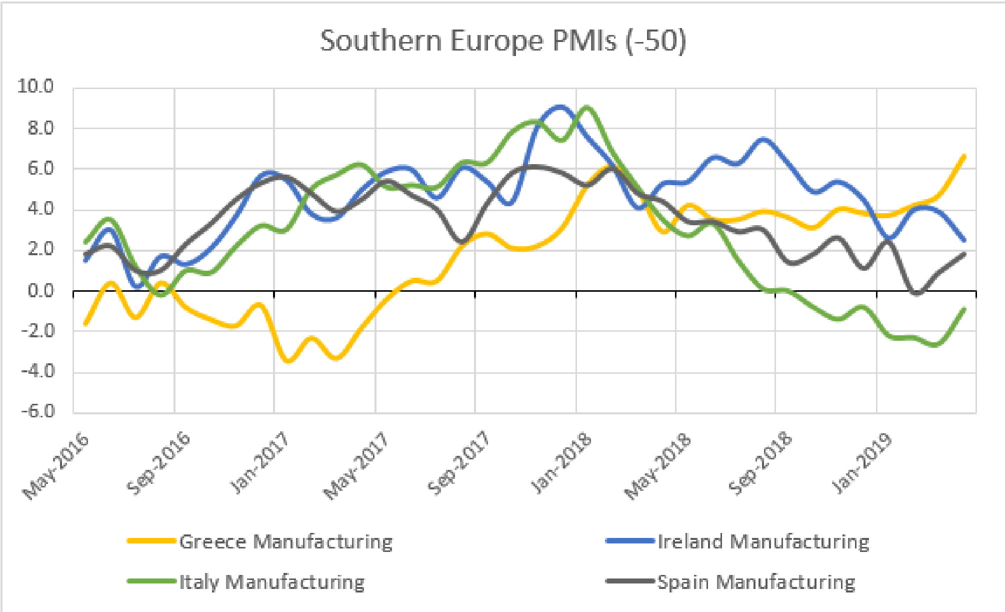
We keep an eye on data releases on a weekly basis at Cambridge, one of the more important ones being the PMIs which gauge if things are improving or deteriorating in terms of new orders, employment, output and various other factors. This is distilled into a single number which oscillates around 50 (over 50 = getting better, below 50 = getting worse). As we've discussed in these pages before, we are positioned for a moderate improvement in economic data relative to the gloomy expectations which gripped the markets through the turn of the year. Chinese stimulus (via the rest of Asia) leading to increased international demand, a pool of savings, and a fiscal tightness in countries like Germany which could be reversed, alongside reasonable valuations -- this was part of the argument for our overweight position in European equity. PMIs give us a timely indication of how well part of this story is playing out.

Starting with Asia: we have had reports for April for five countries' manufacturing sectors within Asia. Since the start of the year we have seen a notable tick-up after an initial drop (this chart shows the PMI minus 50, e.g. 2 corresponds to a PMI of 52).



Source: Bloomberg; 2 May 2019

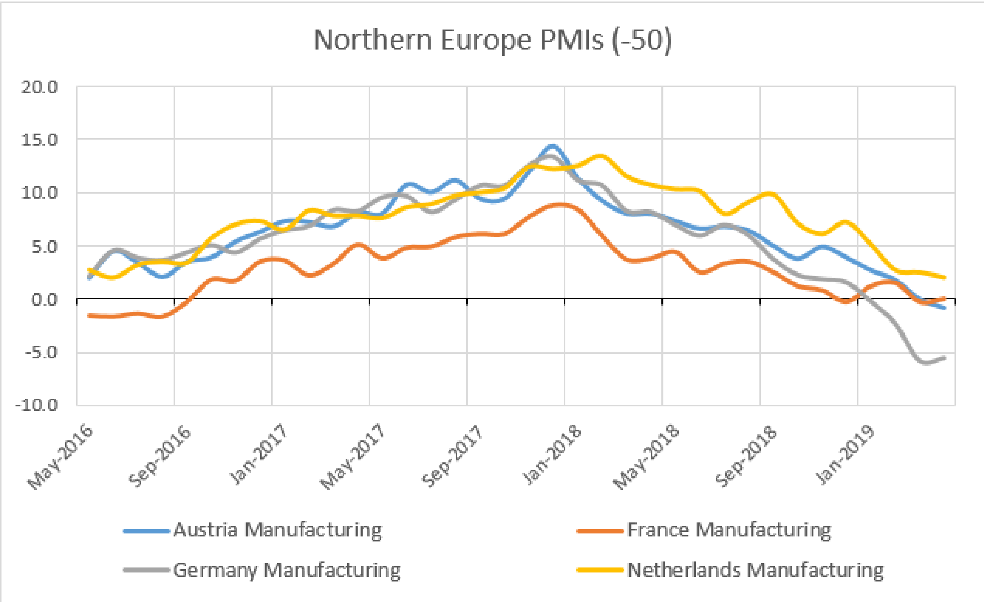
The most recent observation indicates an improved picture in Korea and Vietnam, however we have seen small drops in China, Indonesia, and Taiwan figures after a rebound. A lack of continued improvement may test our thesis of gradual improvement in growth through 2019, should the next set of readings not resume the upward trend.



Source: Bloomberg; 2 May 2019

The question from here is whether this modest improvement in manufacturing outlook in Asia has made it across to Europe. Below we have the European manufacturing numbers to April (which have been in far worse shape than their services counterparts).

As is often the case with Europe, we see a bifurcation along geographic lines. At the moment southern Europe seems to have bounced in concert with Asia, however northern Europe seems to be stuck in the doldrums, flatlining at best.



Source: Bloomberg; 2 May 2019

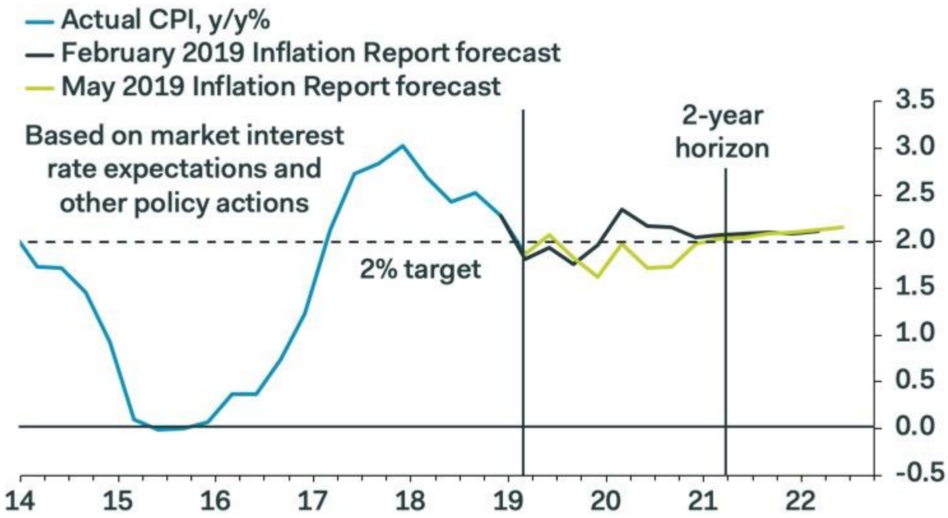
This flat result for Europe in aggregate is actually marginally ahead of the early estimates from "Flash" indicators but there's no getting away from the fact that it still looks a sad picture. Clearly European markets are somewhat discounted compared to some other regions, but should the rebound from Asia fail to materialise on the continent at least one potential catalyst for a rerating of the markets relative to others is in doubt.

One of the other reasons for Europe's discount to the rest of the world is its relatively cyclical composition: high fixed costs in many industries such as autos give them a higher operational gearing than other regions. So we would expect a relatively small tick-up in these figures to be a boon for asset prices in mainland Europe. We will continue to watch with interest.

The UK's inflation conundrum

The Bank of England is one of a few global central banks that has steadfastly maintained its message that interest rates are set to rise, slowly. This is against a backdrop of other central banks ending their tightening bias as global growth weakened in 2018. An example of this is the US Federal Reserve who noted in this week's FOMC statement that core inflation is now "*below 2%*", and therefore the Fed "*will be patient*" regarding any further interest rate moves.

For the UK, the last increase in rates was in August 2018. Since this point the central bank has been walking a tight rope: balancing evidence of increasing inflationary pressures against the economic threat of a no-deal Brexit. It was only in February that the Bank of England (BoE) cut its forecasts for output growth this year in a dovish report that left the market anticipating interest rates would remain at 0.75% until at least the end of the year. Now, the reduced threat of a no-deal Brexit, alongside resilient



economic data, continued strength in employment, and wage growth that is underpinning consumer spending, have seen market expectations move to a 0.25% hike in rates.

Source: Pantheon, Bank of England

On Thursday, the BoE, Monetary Policy Committee (MPC) continued its stance and signalled its commitment "*to ongoing tightening of monetary policy*" but any rate rises would take place "*at a gradual pace and to a limited extent*". It also revised up its forecast for growth to 1.6% in 2020, and 2.1% in 2021, from 1.5% and 1.9% respectively.

That said, the MPC also judged that Brexit uncertainties still had the potential to hit business investment and that the recent rise in sterling would keep import prices under control. Alongside a predicted fall in energy prices and following an expected fall in oil prices they anticipate that Ofgem will reduce the cap on electricity and natural gas prices later this year.

But the MPC has also noted that wage growth has "*remained strong*" and that unit labour costs have "*risen to rates that were above historical averages*". In the UK, year-on-year growth in unit wage costs have picked up to a 9 year high of 3.1% in 2018 from 1.5% in 2017.

Thursday's report also showed that the MPC model implies that they need to raise rates by 0.90% over the next three years taking into account the expected downward pressure from energy prices. If this view regarding energy prices is incorrect then the tightening could be more aggressive. But even at face value there is a disconnect between market expectations of one 0.25% hike and the MPC model.

The conundrum for the BoE regarding inflation has been ongoing for some time as they balance forward guidance of the risk of increasing inflationary pressures against market expectations that these pressures remain more benign and economic momentum weak. Quantitative easing (QE) was aimed in part to raise inflation to its target level. Despite the enormous amount of stimulus applied, inflation has remained contained without the need for significant interest rate rises. Historically, before QE central banks considered the trade-off between unemployment and inflation. The view being that high unemployment would diminish employees' expectations of wage growth. Unemployment in the UK has now reached historically low levels, but despite this, wage demand from workers has also remained contained. Why is still unclear, but arguments range across globalisation, technology, demographics and weaker unions. All are likely to have played their part.

As such, the disconnect in labour between wage growth expectations and unemployment remains; and the disconnect between market expectations and the MPC forecasts remain. The latter is more likely to be addressed by the risk that more aggressive interest rate hikes get priced into the market expectations. Currently, the MPC forecasts that CPI will rise to 2.1% in two years and 2.2% in three years – judging by the muted market reaction this week, investors remain more concerned about Brexit than inflation risk for the UK.

The demise of LIBOR signals further loss of bank influence

In the US and the UK, the interbank lending system is declining. The associated reference rates, in particular the London Interbank Offered Rate, are set to disappear.

Born in 1969, LIBOR came on the scene when Greek banker Minos Zombanakis, a managing director at Manufacturers Hanover Trust in London, brokered a syndicated loan of $80 million. Ten months after the first deal – on June 5, 1970 – "Manny-Hanny" announced a second 5-year loan of $100 million bearing a fluctuating interest rate "based on the six-month interbank rate in London." These are the first records of the London interbank offered rate - LIBOR.

In 1986, the British Bankers' Association formalised a system for the various rates' calculations, just a few months ahead of the "Big Bang". LIBOR and the rise of the City went hand-in-hand.

LIBOR was a big improvement in interest-rate transparency. The publication of a set of rates formed from the reports of competing banks allowed the markets to see how those rates varied on a daily basis. Previously there were only the policy (unvarying) rates set by the Bank of England. It led to much more confidence from participants that both lenders and borrowers were getting a fair rate. This in turn enabled a new set of instruments to develop – swaps. These allowed participants to make long-term transactions which would exchange an ongoing fixed rate for the market-based short-term rates. Loans and floating-rate notes also became based on these rates.

According to the Financial Stability Board (2014), LIBOR rates were the basis for in excess of £200 trillion of financial instruments. So the LIBOR scandal was a big deal given that the market had expanded because LIBOR had been deemed trustworthy.

75% of the LIBOR-based market is in US dollars (FSB 2014 again). A year ago, the US central bank, the Federal Reserve started publishing the Secured Overnight Financing Rate (SOFR), to replace LIBOR. The new SOFR rate represents interest rates for overnight secured borrowings, commonly referred to as repurchase agreements (or "repos"), secured because the borrower posts U.S. Treasury securities as collateral.

According to JP Morgan, average daily trade volumes of the SOFR index components are now regularly in excess of $900bn, 1,800 times the average daily unsecured bank trades in underlying USD LIBOR. Activity in SOFR futures and floating rate notes (FRNs) continues to build, facilitating the growth of OTC swap markets.

Smaller in size, a similar process is happening in £-Sterling. SONIA (Sterling Overnight Interbank Average) was established in April 2017 as the risk-free rate for the UK. However, it differs from SOFR in that it is a pure interbank rate as well as unsecured.

Risk seminars and conferences throughout the financial centres constantly focus on this changing environment.

The first area of attention is: How will outstanding contracts and financial instruments be successfully translated without creating huge amounts of risk? Most people believe that a fair translation of valuation between SOFR and USD-LIBOR is possible, but until it is, there is a commonly agreed basis for transferring contracts. There is a large potential for problems if the LIBOR system is destabilised before that point. This heightens liquidity appetite – or rather reduces risk appetite. If the holder of a previously highly liquid LIBOR-based note thinks it may get locked up in a legal rut, that holder has a big incentive to get rid of it quickly.

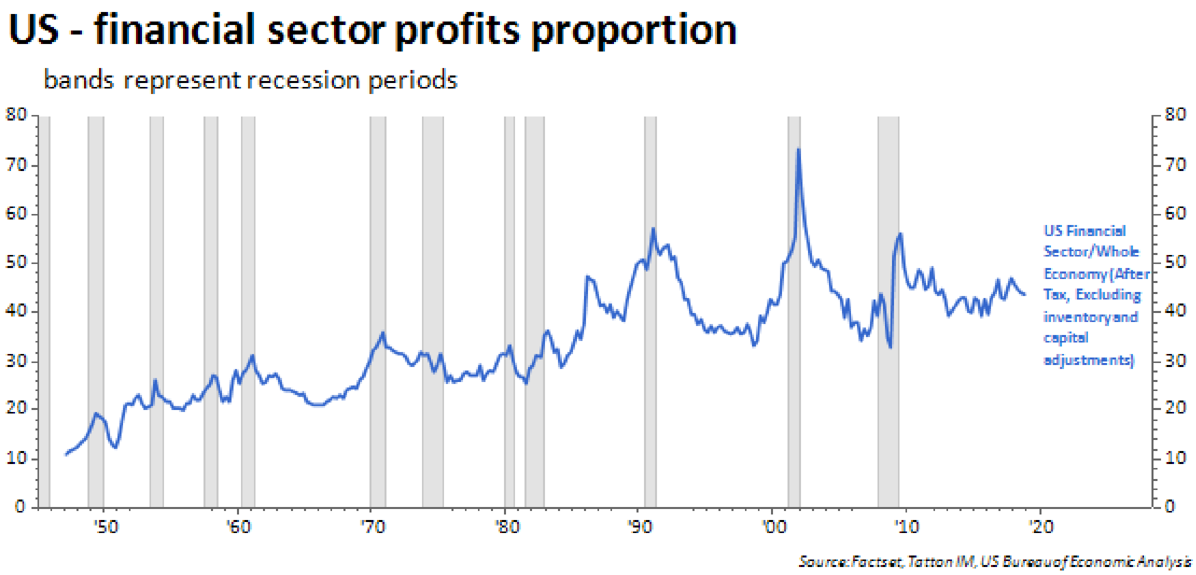
So the second focus is about access to cash on an ongoing basis, amid signs that depositors and investors have increasingly fickle risk appetites.

The vast pre-eminence of the US-dollar market makes the secured nature of SOFR more notable. We think there is a clear sign that the business of finance is moving away from banks. Unsecured lending requires that the lending counterparties are extremely creditworthy, of a size and stability that means liquidity is constantly available. Balance sheet is everything. The need to have collateral at the heart of liquidity suggests that participants no longer believe that banks are creditworthy enough.

The holders of collateral are the asset managers. Most assets are not government bonds, but asset managers are still in a more favourable position than the banks. Essentially they have a competitive advantage over the banks. They have the capital to lend and now the access to liquidity. Banks must continue to be intermediaries rather than the primary risk-takers.

Meanwhile, recent bouts of illiquidity in markets have been blamed on "shortage of off-shore US-dollars", with Asian borrowers unable to find lending counterparties.

The chart on the next page shows how an increasing proportion of US profit has gone towards the financial sector, of which the banks have been the main beneficiaries. Even after the financial crisis, their share of profit has remained high. Perhaps the change, the narrowing of the interbank markets and the demise of LIBOR is signalling the end of a 50-year era of bank dominance in credit markets and beyond.


US - financial sector profits proportion
bands represent recession periods
80
70
60
50
40
30
20
10
0
'50
'60
'70
'80
'90
'00
'10
'20
US Financial Sector/Whole Economy (After Tax, Excluding inventory and capital adjustments)
Source: Factset, Tatton IM, US Bureau of Economic Analysis

CAMBRIDGE
INVESTMENTS LIMITED

7th May 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7380.6	-0.6	-47.5	↗
FTSE 250	19705.2	-0.8	-151.7	↗
FTSE AS	4044.0	-0.7	-28.7	↗
FTSE Small	5646.1	0.0	-2.2	↗
CAC	5548.8	-0.2	-8.8	↗
DAX	12412.8	1.1	130.2	↗
Dow	26467.4	-0.3	-75.9	↗
S&P 500	2937.8	-0.1	-2.1	↗
Nasdaq	7818.6	-0.1	-8.1	↗
Nikkei	22258.7	0.3	58.2	↗
MSCI World	2161.1	-0.6	-12.7	↗
MSCI EM	1079.0	0.1	0.9	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	5.0	16.7	12.7	13.3
FTSE 250	3.3	25.6	13.7	14.1
FTSE AS	4.7	18	12.8	13.4
FTSE Small	3.8	108.7	11.6	14
CAC	3.2	18.4	14.4	13.4
DAX	3.0	16.2	13.7	12.6
Dow	2.2	16.8	16.4	14.8
S&P 500	1.9	19.2	17.7	15.9
Nasdaq	1.0	24.7	21.7	17.9
Nikkei	2.1	16.4	15.3	18.6
MSCI World	2.5	17.8	16	15.2
MSCI EM	2.7	13.5	12.8	12

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Standard Chartered	7.2	Micro Focus Internati	-22.2
Smith & Nephew	4.6	Whitbread	-6.1
Hikma Pharmaceutica	3.7	John Wood Group	-5.9
CRH	3.2	Antofagasta	-5.7
Halma	2.7	Pearson	-5.6

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	1.75	OIL	71.3	-1.2
USD/EUR	1.12	0.34	GOLD	1280.3	-0.5
JPY/USD	111.27	-0.28	SILVER	15.0	-0.9
GBP/EUR	0.85	-1.33	COPPER	283.1	-1.9
CNY/USD	6.73	0.13	ALUMIN	1816.0	-2.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.220	6.8	0.08
US 10-Yr	2.531	1.3	0.03
French 10-Yr	0.372	5.7	0.02
German 10-Yr	0.025	213.6	0.05
Japanese 10-Yr	-0.040	0.0	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.68
3-yr Fixed Rate	2.00
5-yr Fixed Rate	2.04
Standard Variable	4.27
10-yr Fixed Rate	2.58

* 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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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet 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.

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