THE **CAMBRIDGE** WEEKLY

15 July 2019

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Lead Investment Adviser to Cambridge

Source: Hedgeye – The Fed signals rate cut at next meeting, July 2019

Positioning for a summer of wait and see

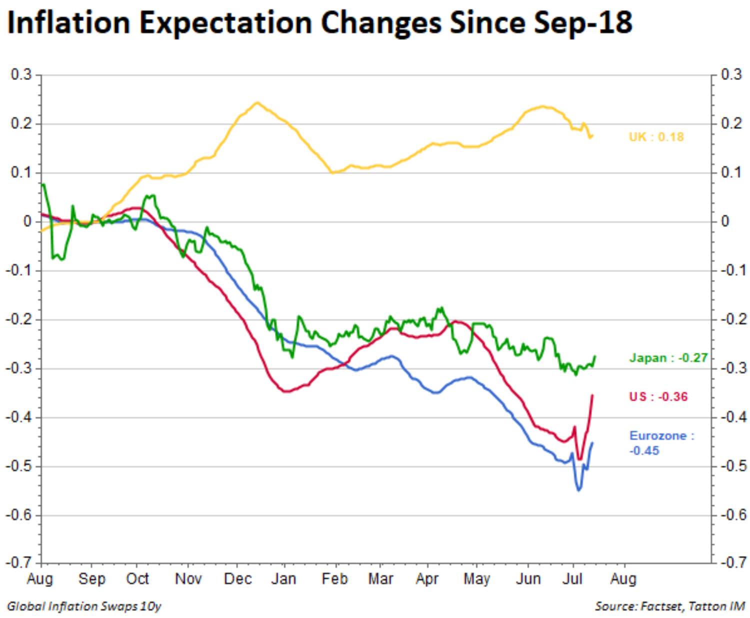
Cambridge's investment team held its in-depth investment committee meeting last week, where we reflect on how the economy and capital markets have developed relative to our expectations from previous meetings and what may have changed that would justify a change of direction. As laid out last week we are currently holding a neutral position across portfolios. This is because the central banks' indications to ease monetary policy once again have driven bond yields down and equity valuations up, but their stimulating effect has yet to filter through to actual activity level improvements across the global economy, and as a result corporate earnings growth has fallen behind the upward surge dynamic of stock markets.

While this may, over the shorter term, defy the economic rationale that governs the longer term direction of capital markets, there is also the US mob's adage 'Don't fight the Feds' which investors have adapted to 'Don't fight the Fed' – the US central bank, not the FBI. Periods of this type of market dynamic are uncomfortable because it is hard to project how long investors will accept bad news as good news in return for central bank liquidity, however these periods tend to be very profitable while they last, as the very positive returns for 2019 thus far prove.

The myriad of macro, micro and monetary charts and tables we went through informed us that this period of little economic justification for stock market advances is very likely going to continue until at least the early autumn. By then it will become clearer whether the recent stabilisation in industrial production and in sentiment will be sufficient to allow the much better-faring services sector and consumer sentiment to lead the global economy back to the resilient (if sluggish) growth that has characterised much of the past decade.

Central bankers certainly did everything in their power to deliver their side of the bargain. The US Fed Chair Jay Powell's testimony at Congress left no room for the rate setting committee to do anything other than to cut US interest rates by at least 0.25% when they meet at the end of the month. The same cannot be said about politicians. Trump's unprecedented personal insults on the leading public servants and politicians of his closest allies can be seen as an indication that he will not shy away from training his trade war guns on his partners in the West once he is done or gets bored with his adversaries in the East. Similarly, the disconcertingly hard and uncompromising Brexit message from the most likely future leader of the Tory party (and of the country) was taken badly by capital markets, driving down £-Sterling. However, these Brexit tones need to be seen in the context of a political campaign aimed towards a subset of just 0.25% of the UK's electorate. Given the UK remains a parliamentary democracy, regardless of who selects the prime minister, the available set of EU exit options will not materially change between the incumbent and future prime ministers, regardless of what may have been alluded to in order to win the leadership contest.

In terms of economic news flow and market action, this week may well have marked the end of declining bond yields. There were much stronger than expected employment numbers in the US, and positive industrial production data from Europe, signalling that the economy is perhaps in better health than suggested by the negative long-term bond yields in many parts of the western world. The UK followed this trend with its own set of Brexit-distorted data, with a remarkable deviation from the trend, namely much more constructive inflation expectations than anywhere else. As the chart below shows, compared to all other central banks the Bank of England's rate-setters may indeed have very little reason to lower rates on grounds of deteriorating inflation expectations. Whether that's a positive or negative indicator is another mystery which we will hopefully be able to understand better by the end of the summer. By then we should know whether we are nearing another Brexit cliff-edge or - as seems more likely – another procrastination of the process.



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Will US rate cuts lead to a weaker US dollar?

On Wednesday, the chair of the US central bank, Jerome Powell, appeared before Congress to give his testimony on the state of the US economy. In his speech the Federal Reserve Chairman cited a weakening global outlook, trade tensions and muted US inflation as risks to the US economy and gave a strong hint that the FOMC would soon cut US interest rates. Alas, the market had already priced in a 0.25% reduction in US interest rates for July, yet Mr Powell's dovish speech still managed to push the S&P 500 higher and briefly above the 3000 mark for the first time, while also moving the US$ lower.

President Trump has been very vocal in demands for a weaker US$ to help make the US export industry more competitive. Will a rate cut grant his wish for a sustained devaluation of the US$? And from an investor's perspective what are the implications of lower US interest rates for the rest of the world?

Currencies do not work in isolation and the global reserve currency least of all. For a weaker US$ other countries' currencies would necessarily have to appreciate. If we take Europe as an example, a relatively stronger Euro would have a tightening effect on the Eurozone's export industries and a dampening effect on European inflation through falling import prices. This comes at a time when the rhetoric from the European Central Bank (ECB) is rather dovish itself toward interest rate levels as inflation expectations have fallen sharply.

In June, ECB policy makers stated that they stand ready to provide further stimulus to the euro-area economy with cuts to interest rates included as a possible tool to use. Since that meeting, data releases such as forward-looking manufacturing PMI surveys have merely indicated a stabilisation in economic sentiment at subdued levels. With this in mind it seems likely that a rate cut in the US would be met with similar action from Europe. Indeed, this was the view the market took, as evidenced by Eurozone government bond yields edging lower on Thursday following Mr Powell's remarks.

The number of rate cuts that the US enact would play a role in the relative valuation of the US dollar. Having previously begun normalising rates through a number of hikes, the Fed arguably has more ammunition available in terms of rate reductions than other developed markets such as Europe or Japan, which are still sitting at their lows. But with interest rate differentials in excess of 2% between the currency blocs, one 0.25% rate cut from the US is unlikely to have a profound impact even if the ECB and BOJ were not to follow suit. An interest rate of 2% (US) is still much more attractive than a negative yield (EU, Japan), so selling pressures out of US$ may remain muted unless we see further cuts from the Fed with which other central banks cannot keep pace.

Donald Trump could instruct the US Treasury to intervene directly in the foreign exchange markets to force the dollar lower. However, given the US$'s status as the global reserve currency, in past interventions multiple central banks have acted together. If the US was acting alone this time, it would limit the potential scale, given that the daily forex market volume at c.US$5 trillion is of extraordinary size. Therefore the impact is likely to be minimal. If this policy resulted in further trade tensions the ramifications could also be counterproductive and drive down capital markets. The US$'s status also as a safe haven currency (due to its liquidity and the credibility of the US legal system and government) means that money flowing out of risk assets could end up back in the dollar, propping up its value.

Beyond the developed world, a reduction in US interest rates could be more of a positive for emerging markets given they can reduce from relatively higher domestic interest rate levels. This would come as a welcome respite to emerging market economies after the negative impact of the uncertainty surrounding global trade, slowing growth and weaker inflation, which have hurt investment and manufacturing.

For those countries that rely on refinancing through the issuance of US dollar denominated debt, a cheaper US currency would reduce the strain on the issuer's finances. Lower US rates would also be supportive of emerging markets' higher-yielding currencies, giving these economies some leeway to ease monetary policy themselves without risking a flight of capital. One such economy is Indonesia. During the emerging market rout last year the bank had to raise rates six times adding a further 1.75% to its policy rate. The expectation of a Fed move to lower rates may give the Indonesian central bank the window it needs when it meets next week to reduce its rate from 6% without undermining its currency. While lower rates are beneficial for emerging markets it is also an area highly exposed to global trade and so a clearing of trade tensions would be a bigger positive for the region.

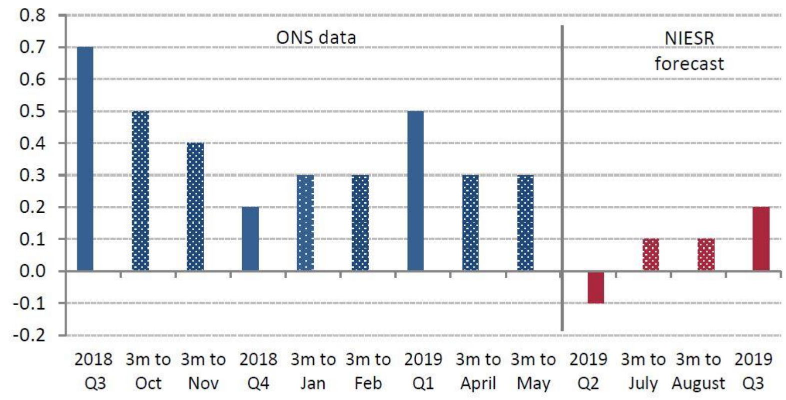
Following last week's much better than expected US employment numbers, interest rate traders have been pulling back their expectations for US interest rate cuts. A week ago, consensus was for four quarter-point rate cuts, a full 1% reduction over the next twelve months. Still, as of now, they expect three –more than any other developed market.

Meanwhile the currency markets have been stable, perhaps remarkably so. The belief is that a policy mistake is being avoided and that the US Fed's pre-emptive dovishness ("insurance rate cuts") has underpinned future growth expectations globally, and not just for the US. In this environment, capital flight becomes less likely and so volatility is declining. As such, a period of continued calm is the most likely outcome. The US dollar is likely to stay pretty much where it is now. It would take a lot more US economic weakness to drive expectations of an aggressively easy Federal Reserve or of capital, en masse, looking for better economic opportunities elsewhere.

Following the Q1 front loading in anticipation of a 31 March Brexit, it is still possible that the UK economy may have managed to post some growth in the second quarter of this year. Higher electricity production has helped, as has a resumption of car output (in anticipation of a 31 March Brexit some manufacturers had shut down their factories in the first quarter). The data for the three months to May indicated real growth moving along at a sluggish but not awful 0.3%. Nevertheless, when the quarter's data is finally published, the National Institute of Economic and Social Research (NIESR) estimates that we are on course for a contraction of 0.1%.

They estimate that we will avoid a technical recession (two successive negative quarters) but that the economy has lost significant momentum since the first quarter. The initial outlook for the third quarter of

Figure 1: UK GDP growth (3 months on previous 3 months, per cent)

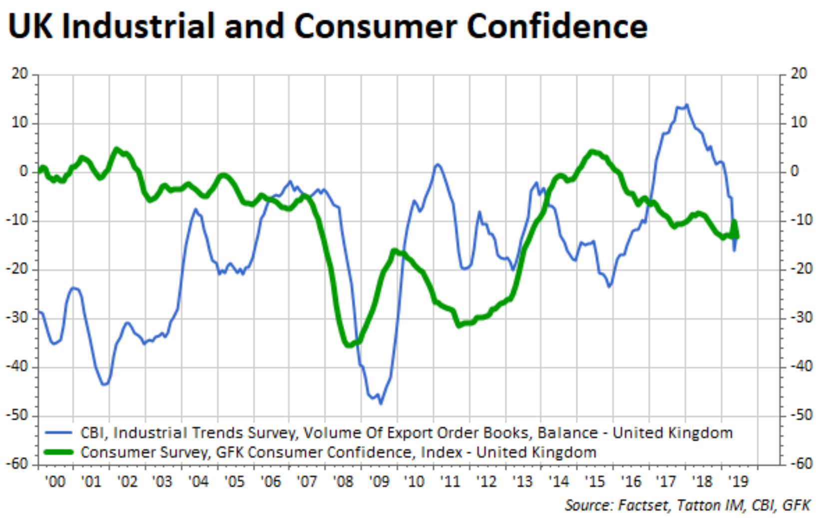


Source: NIESR, ONS
Note: the solid bars show the 3m/3m growth rate for complete calendar quarters and the shaded areas show rolling 3m/3m growth rate for the intervening months. There may be inconsistencies in the growth rate arising from rounding.

2019 is for growth of 0.2% (as shown in their chart).

They comment "this reflects the impact of Brexit-related uncertainty and slower growth in the global economy outside of the United States. The near-term outlook for the UK economy continues to depend on the outcome of the Brexit negotiations."

While almost certainly true, the statement does not tell the full story. As we can see from the chart, the CBI Industrial Trends Survey indicates that industry, and car manufacturing in particular, has suffered since the start of this year. Weak global trade has compounded the Brexit-related influences for manufacturers.

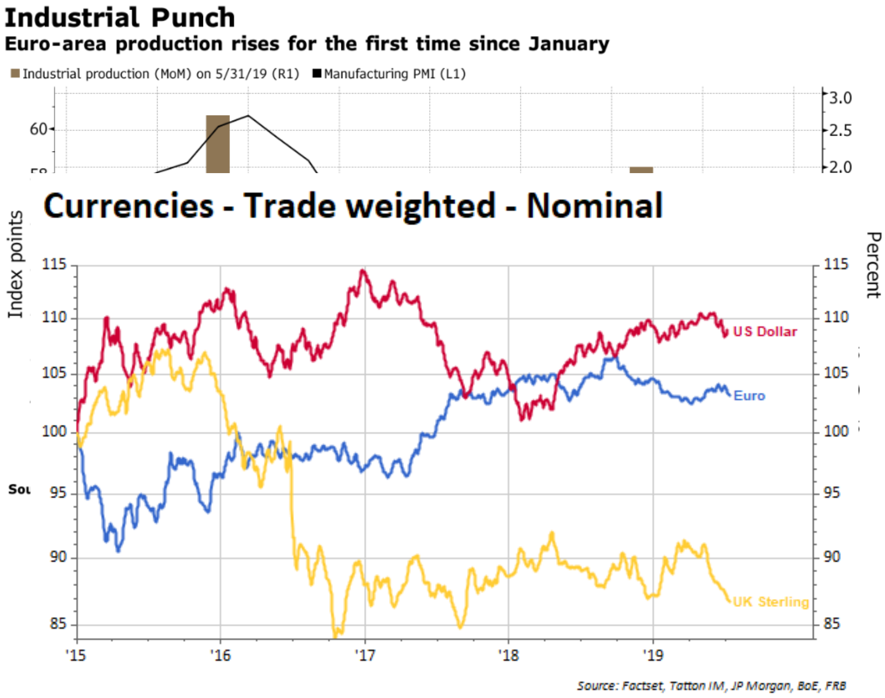


The first quarter also saw £-Sterling strengthen mostly against the Euro. Pessimism about Europe's growth was greater than for other regions at that point. Since Theresa May's resignation and the rise in fears of a harder Brexit, £-Sterling has weakened.

Trade between the UK and the nearby continent remains the most important factor in the health of manufacturing and so the nature of Brexit will undoubtedly have a large impact on the future of UK industry. But it isn't just about the ease of trading. The overall health of Europe is probably more important. When Europe is doing well, UK manufacturing does well – and vice-versa.

The recent relative pick-up in Europe's growth indicators is positive (as evidenced by the manufacturing Purchasing Manager Index and the Eurozone industrial production below), especially when combined with improvement in competitiveness as a result of the fall in sterling.

Admittedly, this pick-up in Europe is an improvement from a very low level so we are at an early stage.



The expectation of monetary easing in Europe needs to be fulfilled soon. A rate cut of 0.2% and a return to active quantitative easing in September is a near-consensus view across markets.

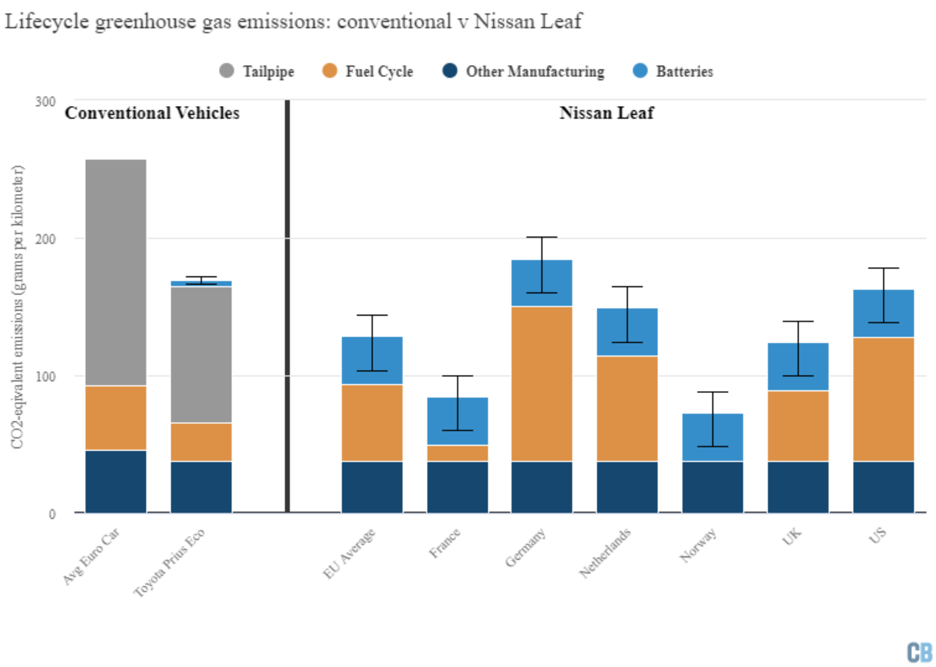
We think the consensus is right, and consumption-based European growth is emerging. Of course, Brexit could still be a huge disruption in the near-term, but the combination of weak £-Sterling and a bouncing Europe should mean the underlying UK manufacturing situation is improving.

Lastly, as the second chart indicates, consumers are not particularly pessimistic. They may be going to town less often so physical shops are struggling, but online retail continues to grow while jobs remain plentiful. The housing market seems to be turning up as well which will be a big underpinning for domestic demand stability. As we head through the second half of this year, the UK economy should have a bit of a tailwind.

UK wind energy turns from niche to serious

We have spent some time in these newsletters discussing the autos sector as well as some of the challenges that incumbent firms face from the likes of Tesla, and the challenges faced by the challengers themselves. A common theme has been an increasing tilt towards at least partial electrification of the automobile market. The most recent news on this front has been the partnership between Ford and VW which will give both access to VW's MEB electric car platform (to which VW have already committed €9bn), and Ford's autonomous driving research.

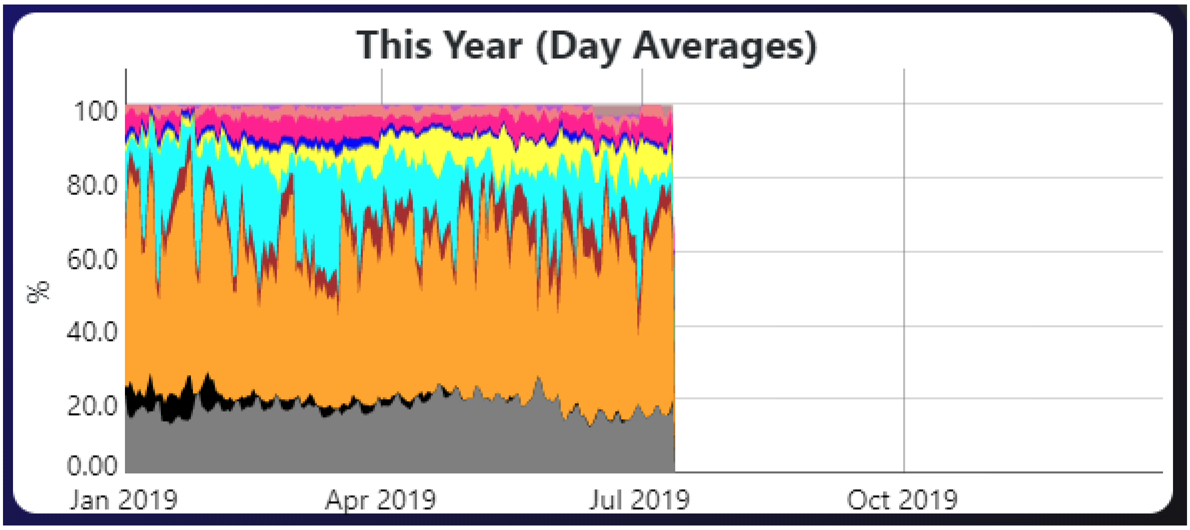
One aspect we have not covered quite as frequently however is the source of fuel for these cars – electricity. While mains-generated power is far more efficient in local emissions terms than the internal combustion engine alternative, there is clearly room to improve until we get to the point of total carbon neutral generation. As a result, electric cars generate differing levels of benefits depending on which grid



they are plugged into – Norway being amongst the best and Germany among the worst in Europe.

Source: Carbonbrief (https://www.carbonbrief.org/factcheck-how-electric-vehicles-help-to-tackle-climate-change)

What we can see from the above chart is that as the grid improves, the green credentials of these cars also increase. To that effect the progress in the UK in the last few decades has been staggering. Britain has seen a sharp decrease in the use of coal in its energy mix over the last 15 years and has just gone a week without any electricity from coal whatsoever, for the first time. The chart below from the excellent Grid Watch shows how small a fraction comes from coal even in winter (black shaded area). Unfortunately, gas remains the largest contributor to our energy mix, cleaner than coal but still a significant source of CO_2 emissions.



From bottom to top: Nuclear, Coal, Gas, Biomass, Wind, Solar, other

Source: Gridwatch (http://gridwatch.co.uk/demand/percent)

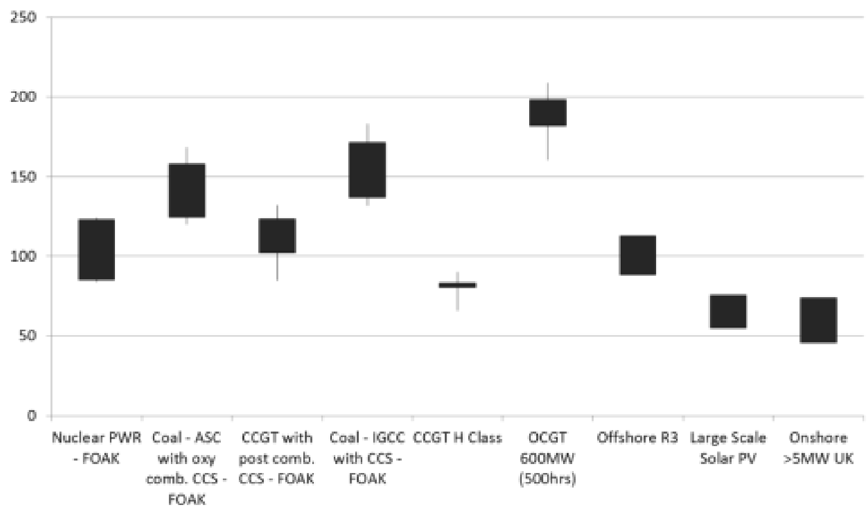
This was shortly after an announcement from the Electricity System Operator (now a separate entity to the National Grid) that the grid will achieve the same reliability from 100% carbon free sources by 2025 that it provides today with fossil fuels' ability to turn production on and off at will. (https://www.nationalgrideso.com/news/zero-carbon-operation-great-britains-electricity-system-2025).

That is great news for the planet when taken in isolation but not much use if renewables are not competitive enough to justify having that much capacity installed economically. The most common way to compare methods of generation is levelized cost of energy (LCOE), which divides the output over the lifetime of a generator by the cost to build it, in other words the breakeven price. One area of great development has been the offshore wind market, of particular interest to the UK given its geography.

As the European wind industry has matured over the last few decades, turbines have grown from 35m diameter (Vindeby, Denmark, 1991), to 2017's Burbo Bank Extension off the coast of Liverpool with diameters of 164m (the London Eye is 120m for reference). As power generation scales with the square of this value, even assuming no efficiency improvements, the newest windmills' blades cover a circular area almost 21x larger than those installed in the early wind farms, and bigger turbines are being planned.

As we would hope, this has led to a precipitous drop in the cost of wind energy. The government's Department for Business, Energy & Industrial Strategy (BEIS) expect that for projects set to begin

Chart 7: Levelised Cost Estimates for Projects Commissioning in 2025, Technology-specific Hurdle Rates, Sensitivities, £/MWh



generation in 2025 in the UK, onshore wind will be cheapest followed by solar, combined cycle gas (fossil fuel) turbine, and then offshore wind and nuclear. The most recent offshore wind auctions point to this perhaps even being too cautious with a project being won by EDF to build an offshore farm by Dunkirk at €44/MWh (becoming operational between 2023-2028), lower than any of the options in this BEIS study. These costs compare favourably with some new nuclear developments, and while the wind ebbs and flows it is significantly less volatile than solar power.

Source:BEIS (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/566567/BEIS_Electricity_Generation_Cost_Report.pdf)

There are obviously questions left to answer about vastly increased use of wind power at a national scale, however answers seem to be turning more positive as technology improves. The most obvious is – what do we do when the wind does not blow? A recent Goldman Sachs report has pointed to German data which has shown a very helpful negative correlation between wind and solar power. Their typically offsetting patterns may well reduce the need for baseload power below current requirements.

And is there enough wind? Vestas and GE have both talked up prospects of 200m turbine blades, a 25% increase in capacity over today's largest, which will help. Equally the UK is ideally placed to benefit greatly from these developments in offshore wind, given its island nature and typically windy climate. This paired with increases in solar energy (the cheapest source of power according to the BEIS) could well help us on the path to not only greener transport but cheaper energy, and a far more environmentally sound economy with fewer looming power plants and land-based turbines.

CAMBRIDGE INVESTMENTS LIMITED

15th July 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7506.0	-0.6	-47.2	→
FTSE 250	19551.8	-0.5	-103.4	→
FTSE AS	4094.9	-0.6	-25.6	→
FTSE Small	5556.2	-0.9	-52.7	→
CAC	5572.9	-0.4	-20.9	→
DAX	12323.3	-2.0	-245.2	→
Dow	27232.4	1.2	310.3	↗
S&P 500	3005.6	0.5	15.2	↗
Nasdaq	7928.6	1.1	87.3	↗
Nikkei	21685.9	-0.3	-60.5	→
MSCI World	2205.3	0.0	-0.2	→
MSCI EM	1055.2	-0.5	-4.8	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	17.8	13	13.3x
FTSE 250	3.4	24.5	13.8	14.2x
FTSE AS	4.5	18.7	13	13.4x
FTSE Small	3.8	55.6	-	14.1x
CAC	3.3	18.7	14.7	13.5x
DAX	3.2	16.3	13.8	12.6x
Dow	2.2	17.4	17	14.9x
S&P 500	1.9	19.7	18.1	15.9x
Nasdaq	1.0	25.4	22	17.9x
Nikkei	2.1	16.1	15.4	18.1x
MSCI World	2.4	18.5	16.5	15.2x
MSCI EM	2.7	13.8	13	12.0x

Top 5 Gainers / Top 5 Decliners

COMPANY	%	COMPANY	%
Barratt Developments	9.2	Micro Focus Intern.	-16.0
John Wood Group	6.7	GVC Holdings	-11.4
Smurfit Kappa Group	5.2	NMC Health	-10.1
Imperial Brands	3.7	Ocado Group	-6.7
Persimmon	3.5	Coca-Cola HBC AG	-4.7

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.26	0.26	OIL	66.8	4.0
USD/EUR	1.13	0.26	GOLD	1408.6	0.7
JPY/USD	108.01	0.43	SILVER	15.2	1.1
GBP/EUR	0.90	-0.03	COPPER	268.1	0.8
CNY/USD	6.88	0.19	ALUMIN	1828.0	1.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	0.835	13.1	0.10
UK 15-Yr	1.167	8.1	0.09
US 10-Yr	2.124	4.4	0.09
French 10-Yr	0.061	172.6	0.15
German 10-Yr	-0.210	42.1	0.15
Japanese 10-Yr	-0.114	26.452	0.041

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.65
3-yr Fixed Rate	1.79
5-yr Fixed Rate	1.97
Standard Variable	4.30
10-yr Fixed Rate	2.61

* 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!

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

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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