THE **CAMBRIDGE** WEEKLY

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Source: Hedgeye 15/7/2019. Earnings are under the microscope as Q2 reporting season begins

…'twere well it were done quickly

It has been another reasonable week for risk assets, especially equities. At the time of writing, markets around the world are within a percentage point of last week's highs. In the US, large cap stocks are floating just off the all-time highs. Meanwhile, the global economy continues to look lethargic, and political headwinds aren't making things any easier. In the US, the quarterly earnings season is expected to reveal the first corporate earnings recession since 2016, and Europe's company statements indicate a similar picture. Around the world, trade wars, Brexit and other issues threaten growth.

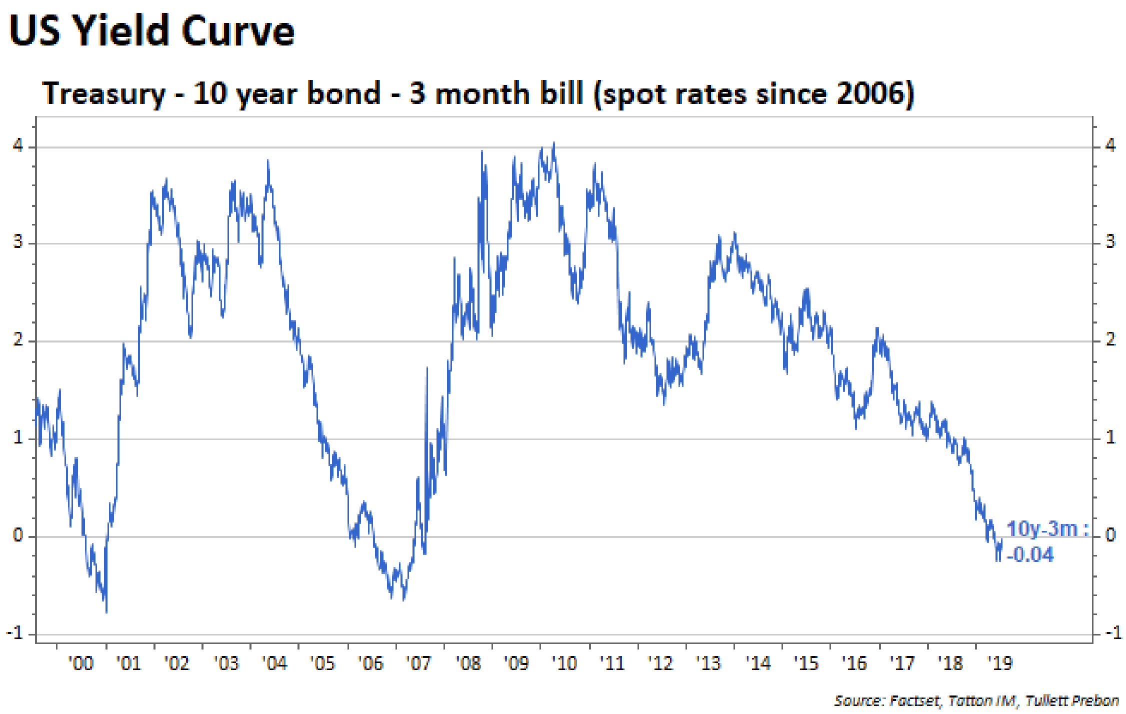
Investors are choosing to look past this and focus on the positives. Monetary policy looks set to get more accommodative and many expect the soft patch for global growth to be ending. Despite the current troubles, a rebound in corporate earnings is expected before the end of the year.

Donald Trump's trade wars have been close to the top of investor concerns for over two years now. Anticipation of a trade armistice between the US and China has pushed market sentiment up and down in that time. But the markets' current good feeling has little to do with trade talks. Negotiations between the world's two largest economies are stuck in the slow lane. While US Trade Secretary Steve Mnuchin made some positive comments about establishing face-to-face meetings, other noises from the US administration show an underlying mistrust between the two sides. Donald Trump has even gone as far as declaring that American tech giants Facebook and Google are China's stooges for their attempts to grow businesses there. Underlying the rhetoric is the constant implication that China is an enemy.

Currently, any kind of agreement that ends the tariffs already imposed looks far off. And given the US presidential election cycle is already in full swing – with Trump looking for ways to show strength – things could well get worse before they get better. The trade war is proving to be one of attrition. The damage to this is already doing to global activity is clear enough, but the added pressure it puts on an already weak Chinese economy doesn't bode well. Moreover, Trump's strategy of using tariffs to reframe trade seems to be setting a global precedent that could well outlive his tenure. As we can see in the recent spat between Korea and Japan, there are signs that the weaponization of trade is becoming a fixture of global politics.

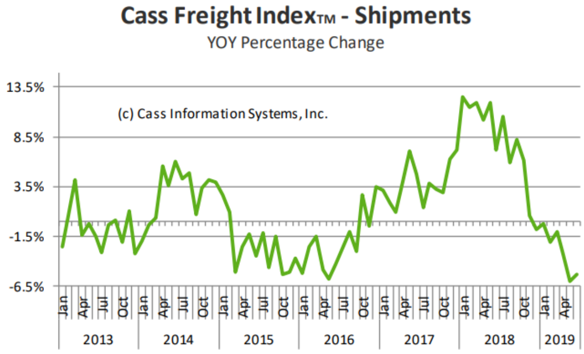
Fortunately for markets, while trade conditions may be getting harder, financial conditions have eased and look set to get easier. The US Federal Reserve has shown a clear bias towards dovishness, with Chairman Jerome Powell and those close to him on the policy team pushing for interest rate cuts. On Thursday evening John Williams (President of the New York Fed and noted expert on monetary policy in a crisis) was thought to suggest that the central bank could be even more aggressive than anticipated in slashing rates. His comments were later clarified by the New York Fed, but they led many to believe that the Fed's imminent rate decision (on July 31st) could be 0.5% rather than 0.25%. Implied market expectations are now split 50/50 on how large the cut will be. Not only that, but markets now also expect the ECB and possibly even the BoJ to follow suit in loosening monetary policy within days of the Fed decision – and allowing more cuts from other central banks, especially in emerging markets.

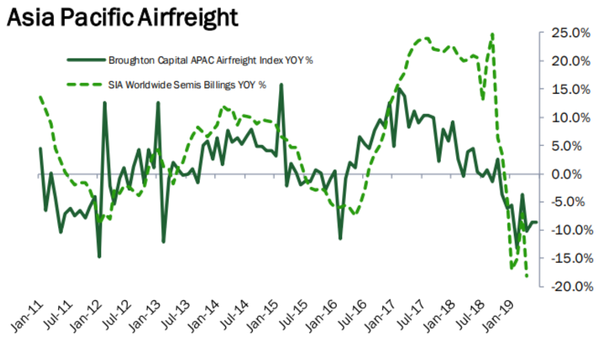
The market's favourite recession indicator, the US yield curve (as measured by the 10-yr - 3-mth differential), bounced briefly back above zero in late trading:



This helped prop up market confidence especially with business sentiment data showing some tentative improvement: the Fed's Beige Book (their long-standing qualitative survey) showed stability, the US Philadelphia Fed July Index unexpectedly bounced higher.

There was other less good news in a sombre US-based Cass Freight Index Report. Freight is viewed as a good tracker of overall trade and the report caused some consternation:





"With the -5.3% drop in June following the -6.0% drop in May, we repeat our message from last month: the US shipments index has gone from "warning of a potential slowdown" to "signalling an economic contraction." (We acknowledge that…the Index has gone negative before without being followed by a negative GDP).

We are concerned about the severe declines in international airfreight volumes (especially in Asia) and the ongoing swoon in railroad volumes, especially in auto and building materials;

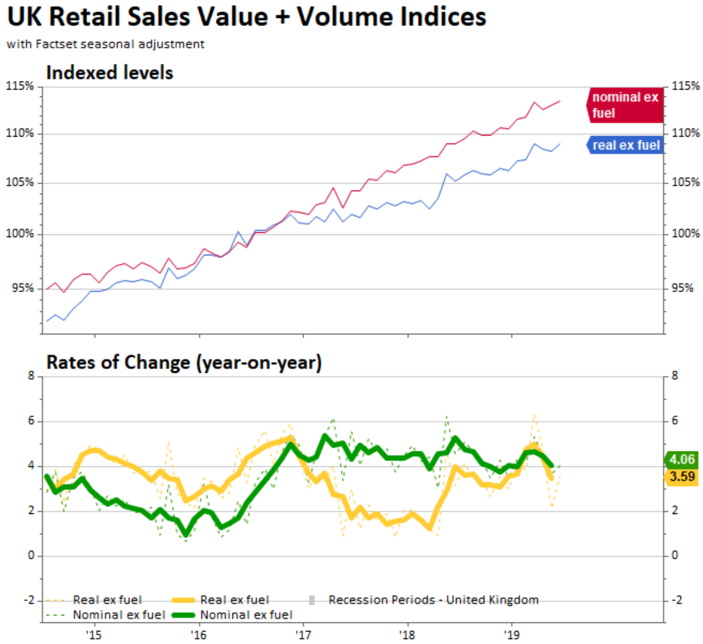
…As volumes of chemical shipments have lost momentum, our concerns of the global slowdown spreading to the U.S., and the trade dispute reaching a 'point of no return' from an economic perspective, grow."

It may be, though, that the US is suffering from a hangover due to a booming 2018, when capacity grew strongly. According to Zach Strickland of analysis company FreightWaves: "With so much freight moving last year, and carriers getting an added incentive to invest in fleet growth with the accelerated depreciation tax cut, trailer and class 8 truck orders hit new highs."

He noted that "many other industries increased investment in capital goods, with orders over pre-recession levels throughout 2018. The side effect of this was front-loading, with companies across most sectors incentivised to invest before tariffs kicked in and while tax cuts still made it beneficial. That created a bubble, whose deflation led to an inevitable drop off in investment and activity."

Despite this gloominess, we think a rebound towards the end of the year or into 2020 seems likely – especially with a Fed as easy as this one has become. The only problem is whether external factors (such as a certain President with an itchy Twitter finger) can rock business or consumer confidence enough to stop that from happening.

Of course, in the UK we have become accustomed to an economy endangered by politics. Business, investor and consumer confidence have all suffered substantially from political headwinds over the last three years. So, it has been good to see the latest data show a reversal of this. Retail – for so long the sick man of the British economy – revealed some surprisingly positive data this week. This is down to consumer confidence, which despite a tight labour market was expected to have a poor showing. Instead, consumer spending appears to be going up largely in line with a rise in incomes. The only downside is that – as you can see in the chart below – inflation is rising to match it, cancelling out real (inflation adjusted) growth in spending.



That would be fine if inflation was being spurred by economic activity. But at the moment, the main culprit in inflation moves seems to be currency, with a falling pound leading to rising costs. And as usual, sterling moves are largely political: Boris Johnson's suggestion that he would suspend parliament to push through Brexit sent sterling down to $1.24.

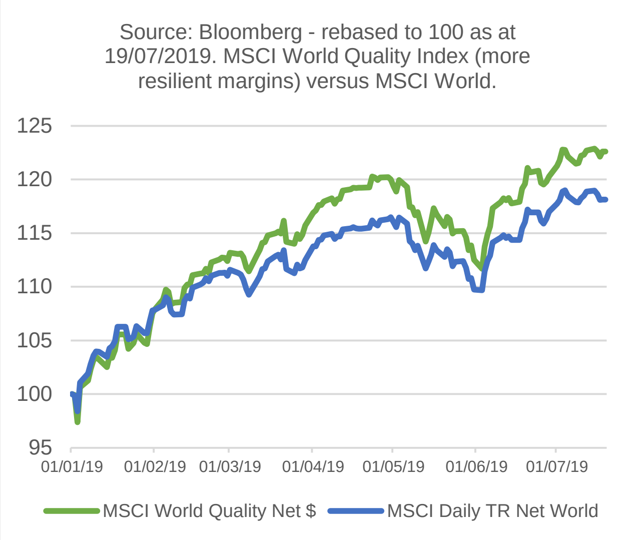
But we take heart in the fact that consumer data shows resilience. While political games play in the background, British consumers are focusing on the conditions in front of them. If the rest of the world could do the same, we may be in for a more positive end to the year.

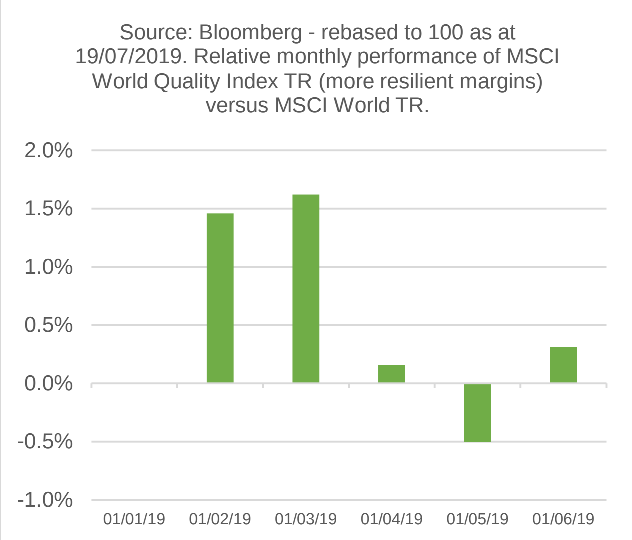
Q2 Earnings could beat low expectations

The US earnings season has kicked off this week, with companies starting to reveal their profits over the second quarter of 2019. But they do so without much fanfare, given the generally dour expectations among analysts. The consensus is that we are in for a poor showing – a 2.8% fall in earnings per share (EPS). That follows a 0.3% EPS fall in Q1 and means that the US is facing its first earnings recession – defined as two consecutive quarters of decline – since 2016. The culprit seems to be profit margins, which after a generation of expansion are coming under pressure from rising costs – particularly wages.

Strangely, this gloomy view on profits doesn't match the sunny skies in equity markets however. Stock markets around the world – and especially US indices – are at, or close, to all-time highs. On Friday, just before US companies were set to report lower earnings, the S&P 500 closed trading above 3000 for the first time in its history. EPS falls increase stocks' price-to-earnings ratios, making them less attractive to investors.

When you combine this with a lethargic outlook for the American economy, the ongoing rally looks strange. But underneath the headline figures, we see some interesting trends that could explain the mismatch. Despite equities going nowhere but up, investors are looking increasingly cautious. Long/Short equity investment funds currently have below average exposure to equity markets, while Systemic and Risk Parity funds have above average exposure.





The one thing that seems to be common across the board is the impressive rise in defensive stocks (those that perform better when economic growth is low or negative). On a year-to-date (YTD) basis, the utilities sector – favoured for its immunity to the economic tide – has beaten all other US sectors with an impressive 16.7% rise. In fact, even globally, utilities are the second-best performing sector, climbing 7.8% over the same time period.

A defensive move from investors is understandable. Both EPS and corporate profit margins peaked in late 2018, and since then have declined largely in step with PMIs (forward-looking measures of business sentiment). Pre-announcements by companies have been the worst since 2016, with a balance (measuring the number of positive announcements against the negative ones) of -51%. It seems that investors have taken note of this negativity and are positioning themselves accordingly. With a move away from growth stocks and into defensive ones, it looks as though they are preparing for a recession.

The good news is that, so far, reality isn't matching the gloomy expectations. Earnings reporting has only just begun – with just 49 S&P 500 companies reporting – but both sales and EPS are showing positive at an index level, at 2.2% and 0.9% growth respectively. Healthcare is the standout performer, with EPS growth of 20% across the sector so far. On the other end of the scale, technology firms have struggled. The tech sector – for so long the shining jewel of the US equity market – is currently showing a 23% fall in earnings. Like many other US corporates, tech companies are facing rising cost pressures from wage increases, suppressing their profit margins.

The interesting one to watch as more companies report will be the banking sector. So far, earnings reports have been positive enough, and largely in line with expectations (of the big banks, only Wells Fargo reported a slight miss, while Goldman Sachs beat expectations). But share prices fell, as investors paid more attention to the outlook and general economic environment for banks more than their

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bottom-line results. With the Federal Reserve set to lower interest rates, net interest income and net interest margins – a proxy for bank profits – will come under pressure. Given banks' importance to the economy, this could make things difficult for an already slowing US economy. How the rest of the earnings season goes for them, and how they react, will be crucial.

In fact, this earnings season will likely be crucial for markets more generally. The year-long slowdown in the global economy depressed earnings expectations for Q2 and appears to have already pushed investors into a defensive positioning. But it is not a forgone conclusion. If weaker earnings and falling profit margins cause companies to cut costs, jobs and wages, the slowdown could become a stall. Indeed, every previous US recession has been preceded by falling profitability. For now, job growth and capex growth are both cooling off, but neither are contracting. That could well change depending on how this earnings season goes, shaping analysts' expectations for the future.

There are reasons to be positive, however. Low expectations are much easier to beat – exemplified by the reporting so far. Aggregate earnings have surprised on the upside, which will help both market and business sentiment.

Elsewhere, both capital markets and the real economy have sources of support. Corporate share buybacks continue to boost equity demand substantially. US businesses set a record last year, buying $806bn of their own shares. This was largely due to President Trump's tax cuts, which prompted a large repatriation of overseas capital. But even without those inflows, share buybacks reached $205bn in the first quarter of 2019. If that rate continued throughout the year, it would beat 2018's record – an impressive feat.

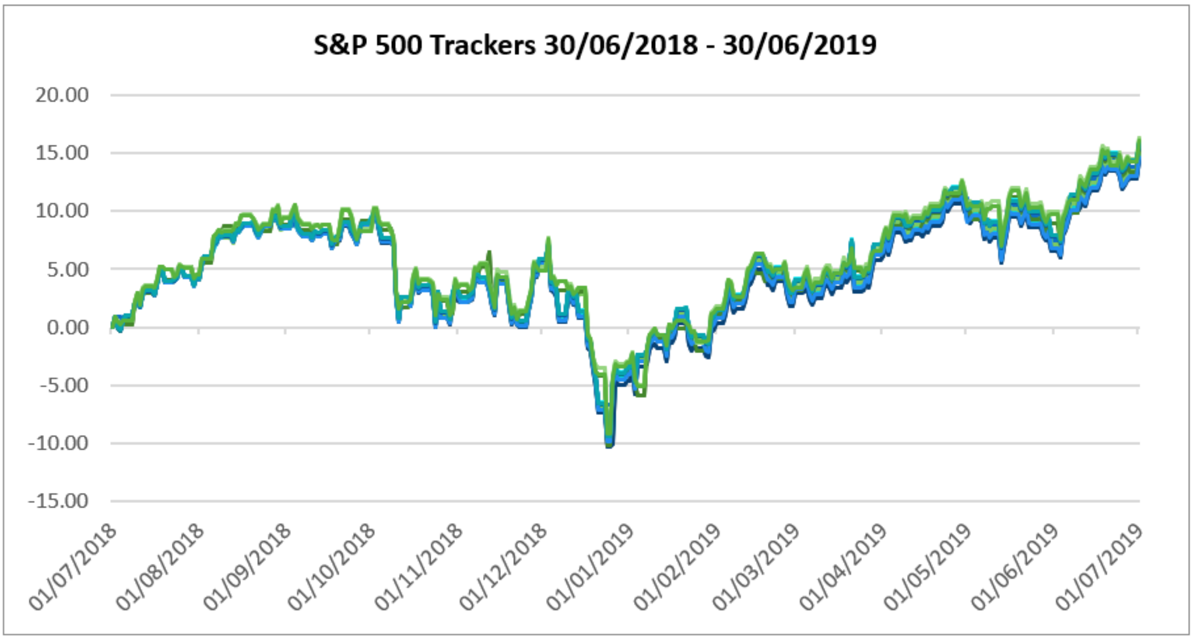
In terms of the economy, the US-China trade war has undoubtedly been a drag, but we take heart in the fact that global trade has stabilised. And the Fed's clear bias towards looser monetary policy should help underline market sentiment. Of particular importance are the latest figures in the Fed's beige book (employment, etc.) which look stable. That could indicate an earnings recovery in future quarters.

Whatever the case, this earnings season will have a big impact on equity markets. If things are indeed better than they seem, the positivity in markets will be underpinned. But if earnings match or disappoint the low expectations, stretched valuations will make investors nervous. Watch this space.

Choosing a passive is not a passive decision

Often at Cambridge we're faced with a choice: investing in an asset class through active management or via passive means. Many variables are considered when making this decision, including cost, probability of adding alpha, availability of options, efficiency of the underlying market and whether there are any concentrated or excess risks embedded within the passive fund.

Even after choosing passive, there are further decisions to make. A simple search on Morningstar for S&P 500 trackers, for example, returns over 200 options. Looking at a small sample of 12 of these shows that the worst returned 14.42% over the past year, the best returning 16.4%: a difference of almost 2% in just



a year!

Source: Morningstar

How can this be? Surely, all these funds buy the same 500 stocks within the index and leave it to run?

Well, one clear source of performance difference is cost – the manager's AMC. Within the sample above, management fees range between 5 and 30bps. That's enough to make a difference, but not a 2% difference. In fact, the fund with the highest headline cost is far from the worst performer: both the most expensive and the cheapest funds sit mid table.

A second differentiating factor is the methodology a manager uses to track the index. Some funds aim to fully replicate the index, others use sampling techniques to gain exposure to similar factors such as sectors, market capitalisation and revenue sources without actually buying all of the underlying stocks. Sampling an index means a fund's transaction costs and potential impact on the market are lower. But there's a trade-off: the less accurate the replication is, the more likely a fund is to out- or under-perform the index. The directionality of which, however, is simply down to luck.

Aside from replication technique, part of the passive portfolio manager's role is making decisions on the day-to-day running of the fund. Indices change composition from time to time and companies pay dividends or engage in a variety of other corporate actions such as takeovers, stock splits and rights issues. Furthermore, investors contribute or remove their money on a daily basis and the portfolio manager has to choose where to invest or what to sell. How the manager handles such cash-flows and constituent changes all impact how closely the fund performance matches the index. The more able the manager, and the more tools at their disposal, the further they reduce their tracking error.

In a similar vein, how actively a fund is traded by investors impacts the relative performance versus the index. The more a manager has to deal with cash inflows or outflows, the more transaction costs a fund will suffer and the worse its performance is likely to be. The pricing methodology used by the fund can have a dramatic influence here, especially if the underlying market is illiquid or particularly expensive to trade. Some funds are dual priced, with investors paying transaction fees when buying and selling their holdings. This helps to avoid investor flows negatively impacting the fund, but it has its drawbacks. For example, when a fund receives an equal volume of subscriptions and redemptions, all buyers and sellers will pay transaction fees despite no real transactions taking place.

Other funds get around this problem by using a single price which fully swings up or down depending on net flows that day. All transaction costs are covered by investors trading the fund, but such price movements make the fund's performance appear different to the underlying index. Other firms compromise and only move the price up or down when hit with large inflows or outflows. Such partial swinging methodologies enable tracking error to be kept low but transaction costs from small flows are a drag on performance. The fairness of pricing policy, including how prices are adjusted for overnight news, has to be considered for each fund independently.

Another source of performance difference is fund size. The larger a fund is, the lesser impact new monies into the fund have in terms of cash drag and transaction costs. However, once a fund gets too large, it may face other problems. Trying to source liquidity when indices change constituents may be more difficult for a $200bn fund than for smaller counterparts. Conversely, larger funds may be able to source better prices for large deals.

Simply where a fund is domiciled can also have an impact on performance. Funds domiciled in the UK may benefit from favourable tax treaties negotiated by HMRC. Dividends paid by a US firm to a UK fund, for example, only suffer 15% withholding tax. Those paid to Luxembourg however are taxed at 30%. The impact of domicile can be beneficial, but the magnitude of the benefit varies depending on the country in question, composition of the underlying index, and the extent to which those companies pay dividends.

Finally, many funds also engage in stock lending. Rather than sitting on the assets, they lend out their positions to short sellers, making interest in the process. This goes some way to help offset management fees. The extent to which securities are lent, what proportion of the revenue generated the fund receives' and the security of the collateral against the loan must all be considered here. It introduces an extra source of return, but another source of risk in the process.

In summary, there's a lot more to passive investing than price. Pricing methodology, portfolio construction techniques, historic tracking error, domicile, fund size, current investor composition and transaction costs are all taken into consideration before adding a fund to a customer's portfolio. The cheapest isn't always the best. Unfortunately, there isn't a correct answer to most of these questions and therefore there is no fund provider that is best for all indices. Like so many things in life, the best option tends to come with trade-offs. The correct methodology and therefore fund provider varies depending on the underlying market, index and size of transaction.

CAMBRIDGE
INVESTMENTS LIMITED

22nd July 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7508.7	0.0	2.7	→
FTSE 250	19621.7	0.4	69.8	→
FTSE AS	4098.3	0.1	3.4	→
FTSE Small	5552.8	-0.1	-3.4	→
CAC	5552.3	-0.4	-20.5	→
DAX	12260.1	-0.5	-63.3	→
Dow	27278.5	-0.2	-53.6	→
S&P 500	2991.9	-0.7	-21.9	→
Nasdaq	7901.9	-0.5	-41.3	→
Nikkei	21467.0	-0.8	-176.5	→
MSCI World	2198.4	-0.6	-14.2	→
MSCI EM	1051.7	0.1	0.8	→

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	24.4	13.9	14.2x
FTSE AS	4.5	18.7	13.1	13.4x
FTSE Small	3.7	55.6	-	14.1x
CAC	3.3	18.7	14.7	13.5x
DAX	3.2	16.2	13.9	12.6x
Dow	2.2	17.4	17.1	14.9x
S&P 500	1.9	19.5	18	15.9x
Nasdaq	1.0	25	21.9	17.9x
Nikkei	2.2	16	15.3	18.1x
MSCI World	2.5	18.4	16.5	15.2x
MSCI EM	2.8	13.7	13	12.0x

Top 5 Gainers

COMPANY	%
Burberry Group	16.1
easyJet	11.0
Antofagasta	8.2
British American Toba	6.5
Imperial Brands	5.5

Top 5 Decliners

COMPANY	%
Micro Focus Internati	-6.0
BP	-5.2
Johnson Matthey	-5.0
WPP	-4.6
Rightmove	-2.9

Currencies

PRICE	LAST	%1W
USD/GBP	1.25	-0.59
USD/EUR	1.12	-0.45
JPY/USD	107.78	0.12
GBP/EUR	0.90	-0.14
CNY/USD	6.88	-0.02

Commodities

CMDTY	LAST	%1W
OIL	61.9	-7.2
GOLD	1425.0	0.7
SILVER	16.1	6.0
COPPER	276.3	2.6
ALUMIN	1854.0	1.4

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	0.734	-12.1	-0.10
UK 15-Yr	1.071	-8.2	-0.10
US 10-Yr	2.040	-3.9	-0.08
French 10-Yr	-0.069	-213.1	-0.13
German 10-Yr	-0.324	-54.3	-0.11
Japanese 10-Yr	-0.132	-15.789	-0.018

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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