THE **CAMBRIDGE** WEEKLY

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Source: Bob Moran on B Johnson's fiscal expansion announcements 3 Aug 2019 in PCGL

Bond markets unnerve equity markets - again

We have repeatedly commented on these pages that the good mood in asset markets this year is more to do with central bank policy than a positive backdrop of the real economy. With poor economic fundamentals, central banks will pump liquidity into the financial system, supporting both bonds and equities. As the asset class returns table for July illustrates (see further down), this trend continued into the summer and all those who followed the old UK investment adage of 'sell in May and go away, don't come back till St. Legers day' would have missed out considerably.

However, the first full week of August provided a timely reminder that current stock market levels are not well supported by economic growth prospects, making them even more vulnerable to shifting investor sentiment. This time, the souring of sentiment was once again caused by the Trump administration, when they announced another round of tariff increases after the ongoing trade negotiations hit a renewed impasse. China's apparent retaliation then exacerbated the trade scare story, as they allowed their currency to drift lower – offsetting the cost burden introduced by tariffs. This signalled that the trade war will likely continue longer than markets thought, which dampened growth expectations. The notion that, after a flat first half of 2019, the global economy and corporate profits would return to growth looks increasingly less likely.

This setback was most visible in the government bond markets, where yields, particularly on long term bonds, fell back to either new historical lows or lows last seen a few years ago when the economic environment was far worse. This market- (rather than central bank) driven downward shift in government yields upset risk asset markets. This is because lower growth expectations (which are implied by bond yields) expresses a worse outlook for corporate profits – increasing yields for more risky corporate borrowers (junk bonds of single B and lower), further reducing corporate profit upside potential.

Stock markets around the world suffered their biggest one-day losses since late last year and fell between 3 and 7% between last Thursday and early this week. However, the 'buy the dip' mentality quickly came to the rescue – with investors believing that this equity market slump is a buying opportunity rather than the end of the 2019 bull market. On the back of this, equities swiftly switched into recovery mode, with the US markets bouncing back up to the previous week's highs.

Asset Class	Index	July	YTD	2018
Equities	FTSE 100 (UK)	2.2	15.7	-8.7
	FTSE4Good 50 (UK Ethical Index)	2.4	14.1	-9.2
	MSCI Europe ex-UK	1.9	19.2	-9.9
	S&P 500 (USA)	5.4	25.1	1.6
	Nikkei 225 (Japan)	4.1	12.2	-7.50
	MSCI All Countries World	4.2	21.2	-3.8
	MSCI Emerging Markets	2.7	13.6	-9.3
Bonds	FTSE Gilts All Stocks	2.1	6.9	0.6
	£-Sterling Corporate Bond Index	2.3	9.7	-2.2
	Barclays Global Aggregate Bond Index	3.7	9.5	4.9
Commodities	Goldman Sachs Commodity Index	3.7	17.6	-8.5
	Brent Crude Oil Price	4.4	25.8	-14.5
	LBMA Spot Gold Price	5.2	16.1	5.0
Inflation	UK Consumer Price Index (annual rate)*	0.3	0.7	2.1
Cash rates	Libor 3 month GBP	0.1	0.5	0.6
Property	UK Commercial Property (IA Sector)*	-0.3	0.3	2.9

Data sourced from Morningstar Direct as at 31/07/19. * to end of previous month (30/06/19). All returns in GBP

Asset Class Returns at the end of July 2019

So, all but a storm in a teacup then for investors? Well the increase of political risks to growth in the second half of 2019 is real and, as UK readers know all too well, that is even more true for the UK's near-term trade prospects with its immediate neighbours. Therefore, unless the seemingly concerted 'Game-of-Chicken' on either side of the Atlantic is either called off – or it works out better than 'car-crash' scenarios that are currently looming – markets will remain vulnerable. Indeed, as our one of our research providers – Longview Economics – pointed out in their daily market action assessment today, recent rapid market recoveries have initially proven unstable, before a more sustained market recovery has taken hold.

As regular readers will know, we have been anticipating heightened market volatility over the summer, which is why we decided against a risk asset overweight earlier in the year. We remain cautiously optimistic that we will see a further stabilisation of global economic growth over the second half of the year, but we recognise that this expectation is uncomfortably dependent on political developments that are difficult to forecast for the short term. For the medium term, we observe that political tensions and fears before the fact are precisely what leads to these being resolved before they truly become an issue. To this end, we remain optimistic that the Johnson government will not be able to cause a major UK constitutional crisis just to keep a small 'no-deal Brexit' interest group in power.

Trump's trade war deteriorating into a currency war?

The US-China trade war has a new battleground: currencies. On Monday, the value of the Renminbi was allowed to fall to its lowest since the financial crisis. One US dollar will now buy you a smidgen over 7RMB. And while that is not much of a fall from the 6.99 level at which China's currency traded last week, it is a psychologically important barrier that was enough to evoke the ire of Donald Trump.

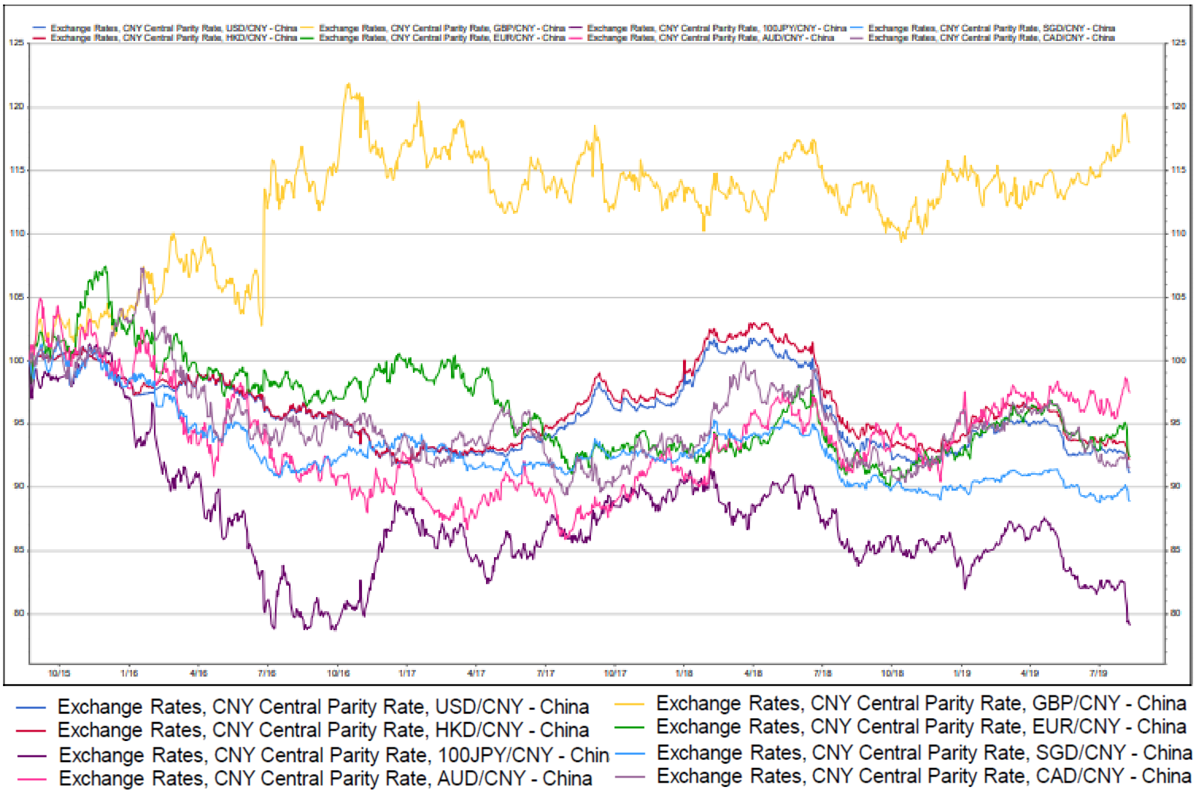
The US President wasted no time in calling out China for its perceived unfair behaviour. What was even more significant was that – as if Trump was writing policy from his Twitter account – the US Treasury moved to officially label China a "currency manipulator". It is the first time that the Treasury has levelled a foreign government with the charge in over 25 years.

This is hardly the first time currencies have caught Trump's eye. Anti-China sentiment formed a huge part of his 2016 election campaign – much of which centred on the role that RMB devaluation played in giving Chinese exporters an 'unfair' advantage. More recently, the President has even accused the European and Japanese central banks of doing the same thing – "making it unfairly easier for" their businesses to compete with the US by artificially suppressing the value of their currencies (in their case through loose monetary policy). But the real crime – "manipulation" – has always been China's.

In one sense, Mr Trump is obviously correct. The RMB is not a free-floating currency: the People's Bank of China sets a range the currency can trade within and explicitly pursues policies designed to keep it in that range. And the reason the RMB has fallen to its current level is precisely because the PBoC *decided* to move the mid-point of that range to just over 7RMB to the dollar.

The accusation is nonetheless misleading. The PBoC maintains the currency peg to the dollar by counteracting – through its huge store of foreign exchange reserves – the buying and selling pressures that usually determine a currency's value. But if they did allow currency markets free rein, the RMB would almost certainly be lower than where it is now, maybe even substantially so. The divergent paths of the world's two largest economies over the past couple of years has caused capital to flow toward the US and out of China. There is a strong case that the main reason for the currency's fall is the internal weakness of the country, as well as the external pressures on it.

The PBoC acknowledged this themselves. They pointed to increased tariffs and the effect they are having on the economy as a reason a lower RMB was needed. As the chart below shows, despite the falls against the dollar, since 2015 China has kept its currency broadly level with other major world currencies. Against the pound in fact (the yellow line at the top), it has significantly strengthened. Donald Trump may bemoan China's 'devaluation', but for some time now most of the PBoC's forays into currency markets have been to support rather than to lower the RMB. Many economists and investors have argued that the latest 'devaluation' is a sign they are actually becoming less interventionist.



Source: Factset, Tatton IM, 8 Aug 2019

But there is still some more to the story. While the case for allowing a devaluation has been there for some time, the timing is a little suspicious. Throughout the many ups and downs of US-China trade talks, Beijing's apparent commitment to maintaining the exchange rate has been an important gesture of goodwill, because a RMB devaluation counters the cost increase in exported goods to the USA through tariffs. But last week saw trade talks break down yet again and Trump declare a fresh round of tariffs to hurt Chinese exporters.

As we said at the time, China's most powerful retaliation would be its currency. And, like clockwork, the PBoC moved their currency past the 7RMB level only a few days later. The only question is whether this was an aggressive move – showing the Trump administration that they are prepared to play hardball – or whether it was an acceptance of reality.

At the moment, the latter seems more likely. Both sides in the trade war have been preparing for a lengthy spat – the US by continually imposing new sanctions and China by adjusting their internal policies. Judging from the PBoC's accompanying statement, the move was more out of necessity than anything else. Trump's response was, of course, to be expected. But judging by capital markets – which reacted only slightly – this is not the end of the world.

Even so, the move down in RMB does make it harder to see a resolution to the trade war any time soon. The Trump administration is showing no inclination of budging, and have even suggested that they might try their hand at currency devaluation themselves. What's more, the PBoC acknowledged that the currency may need to weaken even further to adjust for new trade realities – possibly to 7.5 or 8. If that happens, things could get worse before they get better – to the detriment of the global economy.

Modi's Kashmir land grab follows disconcerting new trend in global politics

Indian Prime Minister, Narendra Modi, was sworn in for a second term at the end of May. In doing so, he and his Hindu nationalist Bharatiya Janata Party became the first to secure a single party majority in back-to-back elections since 1971.

Although widely heralded for bringing much needed economic and bureaucratic reform to India, Modi's populist and nationalist backed leadership is not without controversy. He has gained a reputation for Trump-style decision making: he often chooses to ignore the insights of close advisors and experts, instead relying on his own 'raw wisdom' to make snap decisions. His detractors also accuse him of being a Hindu supremacist.

Over the years his government has drawn many criticisms: a botched attempt to remove black money from the economy, increasing unemployment, failing to prevent anti-Muslim lynching, and increased polarisation through the BJP's Hindu Nationalist rhetoric – leaving minorities nervous.

Modi came off the election with a wider lead and a stronger mandate, so political commentators were watching in anticipation of what he might do in his second term. On Monday, the world found out: Modi stripped the disputed Kashmir region of its constitutional protections that guarantee special status of the state.

Control over Kashmir has been contested for over seventy years since the partition of India and creation of Pakistan. Both claim Kashmir in full but control only part of it. The Indian-administered Kashmir has held a privileged position in the country historically, due to a clause in the Indian constitution that gave the region significant autonomy (including its own flag), constitution and independence over most domestic matters bar communication. As the only predominantly Muslim area in India, these laws helped protect the state's distinct demographic character.

In the lead-up to Monday's announcement, telephone lines and access to the internet were cut, public gatherings were banned, and thousands of Indian troops were sent into Kashmir to enforce curfews. Revocation of the freedoms of autonomy, along with legislation that only allows permanent residents to buy property, does not sit well with Kashmiris. They fear this is the first stage of Hindu nationalist groups encouraging migration into the state, displacing Kashmiri Muslims and eventually annexing Kashmir into the wider, increasingly sectarian, India.

Such blunt enforced changes to historic constitutions, in a region which has already seen armed revolt waged against Indian rule for the past three decades, has the potential to spur more violence and civil unrest within the region. Furthermore, it is likely to increase tensions between the nuclear capable nations of India and Pakistan. Pakistan have already branded the actions as illegal and promised to exercise all possible options – bar outright war - against it.

The news caused a fall in Indian assets, with the Rupee sinking 2.5% and Indian stock exchange by around 2%. But the action has wider global implications.

Modi's modus operandi is the same as many populist demagogues thriving in today's society: push the buttons of fearful populations, who are angry at wealth inequality and frustrated by an apparent lack of change in their standards of living. People want somebody to blame and minorities, immigrants, liberal thinkers and foreigners often become the scapegoats.

Now that the walls have been built, politically and culturally if not physically, the next phase in geopolitical development appears to be a land grab and a revoking of long-standing laws or agreements in order to exert political control as far as possible in the name of national pride and patriotism. We see the same land grab theme appear beyond India in Hong Kong/Taiwan (China), and Crimea (Russia), while it can be argued that the populists' theme has created divided societies and sectarianism in the US and the UK.

The theme is something we continue to monitor avidly. Aside from the moral implications, heightened tensions, conflict and societal uncertainty, there is a huge negative for growth, causing businesses to delay investment, consumers to delay spending, and a slowing of global trade.

CAMBRIDGE
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12th August 2019

Global Equity Markets

Market	FRI 12:25	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7280.5	-1.7	-126.5	→	→
FTSE 250	19152	-0.5	-101.1	→	→
FTSE AS	3979.4	-1.5	-60.2	→	→
FTSE Small	5441.4	-0.7	-37.3	↘	→
CAC	5342.8	-0.3	-16.2	↘	↗
DAX	11721.3	-1.3	-151.2	⬊	→
Dow	26378	-0.8	-205.2	→	→
S&P 500	2938.1	-0.5	-15.5	→	↗
Nasdaq	7724.8	-1.0	-76.3	→	⬈
Nikkei	20684.8	-1.9	-402.3	↘	↘
MSCI World	2146.9	-0.1	-3.1	→	↗
MSCI EM	984.3	-1.9	-19.5	⬊	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company		%
Fresnillo	13.1	NMC Health		-14.2
Hikma Pharma	7.8	StanLife-Aberde		-13.7
WPP	4.5	Centrica		-8.9
easyJet	4.4	Spirax-Sarco		-8.3
Experian	4.3	BT		-7.3

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.207	-0.7	Oil	58.20	-6.0
GBP/EUR	0.928	-1.5	Gold	1503.5	4.3
USD/EUR	1.12	0.9	Silver	17.02	5.0
JPY/USD	105.75	0.8	Copper	260.0	1.1
CNY/USD	7.060	-1.7	Aluminium	1778.0	-0.1

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.48	-0.07
UK 15-Yr	0.81	-0.11
US 10-Yr	1.70	-0.15
French 10-Yr	-0.28	-0.04
German 10-Yr	-0.59	-0.09
Japanese 10-Yr	-0.22	-0.05

Global Equity Market - Valuations

Market	Div YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	5	17.6	12.6	13.3
FTSE 250	3.5	26.1	13.5	14.2
FTSE AS	4.7	18.6	12.6	13.4
FTSE Small	3.8	48.3	-	14
CAC	3.4	18.6	14.3	13.5
DAX	3.4	19.5	13.7	12.5
Dow	2.3	17.5	17.2	14.9
S&P 500	1.9	19.2	17.8	15.9
Nasdaq	1	23.9	21.4	17.9
Nikkei	2.3	14.7	15	17.9
MSCI World	2.5	18.2	16.2	15.2
MSCI EM	3	13.3	12.5	12

UK Mortgage Rates

Mortgage Rates	Estimate	Jul	Jun
Base Rate Tracker	2.56	2.56	2.56
2-yr Fixed Rate	1.66	1.66	1.68
3-yr Fixed Rate	1.77	1.77	1.78
5-yr Fixed Rate	1.96	1.96	1.99
10-yr Fixed Rate	2.57	2.61	2.60
Standard Variable	4.30	4.30	4.30

* 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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12th August 2019

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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.

Lothar Mentel