THE **CAMBRIDGE** WEEKLY

27 August 2019

Lothar Mentel

Lead Investment Adviser to Cambridge

DISCLAIMER

Source: Peter Brookes, The Times, 26th July

Source: Matt, 21 August 2019

Populism politics reversing austerity?

Following last week's excitement over the yield curve inversions in the US and UK – which have been powerful recession predictors in the past – this week saw the return of calmer capital markets. World stock markets have stabilised and, while still reacting quickly to political news flow, the outlook appears to have stabilised too. All eyes were firmly pinned on the US mountain resort of Jackson Hole, where the world's central bankers have gathered for their annual convention. Given that the ebb and flow of central bank-induced liquidity has driven markets over the past 12 months, this focus is not surprising. Indeed, on Friday, when China's announcement of retaliatory tariffs soured market sentiment, US central bank chair Jay Powell's confirmation of continued monetary support was enough to swing stock markets from negative back to positive.

For UK investors barraged by disconcerting Brexit news reports (about how daily life could be seriously derailed – at least temporarily – in the event of a no-deal-Brexit) this positivity in capital markets may be hard to fathom.

However, even the UK's outlook appears brighter, if the continued recovery of £-Sterling against the €-Euro is anything to go by. Perhaps Boris Johnson's tour of European capitals, showing that there is still more goodwill than bad there, is supporting all those who expect Brexit to be far less rapturous than the leaked predictions suggest.

UK investors may be experiencing a sense of déjà vu with the run up to the Brexit referendum back in May/June of 2016. Indeed, there are parallels. We are told about all the things that could happen in a worst-case scenario, but experience has shown that even in such a worst case, real outcomes versus those previously expected tend to be far less extreme. To be sure, we continue to see the no-deal Brexit scenario mainly as a political tool to find a more palatable solution to the Irish border problem. As such, we ascribe a much higher probability to a further postponement followed by a general election.

However, even if the incumbent Prime Minister felt that the temporary chaos of a no-deal trading environment might further his chances of gaining a parliamentary majority despite economic turmoil, then over the short-term, UK investors' globally diversified investment portfolios would probably fare better than the living circumstances of their owners. As the aftermath of the Brexit referendum showed, it is £-Sterling which bears the brunt of any near-term economic outlook adjustment through rapid devaluation. This tends to increase the value of capital market holdings of internationally diversified investment portfolios like ours - whose fortunes are far more determined by the global rather than the UK economy.

If we experience the more likely outcome of somewhat smoother divorce proceedings, then there is considerable upside in £-Sterling's external value and in UK stock markets. To this end, we have dedicated a separate article to UK investments this week, which should assure investors that, regarding Brexit, their investment portfolios are probably going to be a lesser cause for concern than they may think – just as back in June 2016.

Beyond the UK's specific concerns and capital markets' infatuation with central bank policies, we were pleased to see a stabilisation and reversal of trends in the industrial activity readings. Europe's exporters may not be out of the trouble zone, but things now finally appear to be getting better, not worse.

The other positive news came, for once, from the political side. After the loosening of the fiscal purse strings in the UK and China, it seems that both the US and Germany are considering fiscal stimulus investment measures to prevent the economic slowdown getting any worse. Given their deep pockets and/or considerable reserves, this is good news for the global economy and central bankers. Together with economists around the world, they have lamented for years that monetary stimulus can only be truly effective if accompanied by productive public sector investments, such as human resource qualifications and reliable infrastructure. Even if we do not yet quite get governments to commit to fiscal stimulus, this new trend could mean the end of the era of fiscal austerity. This would be quite good news in its own right.

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UK investments in times of uncertainty

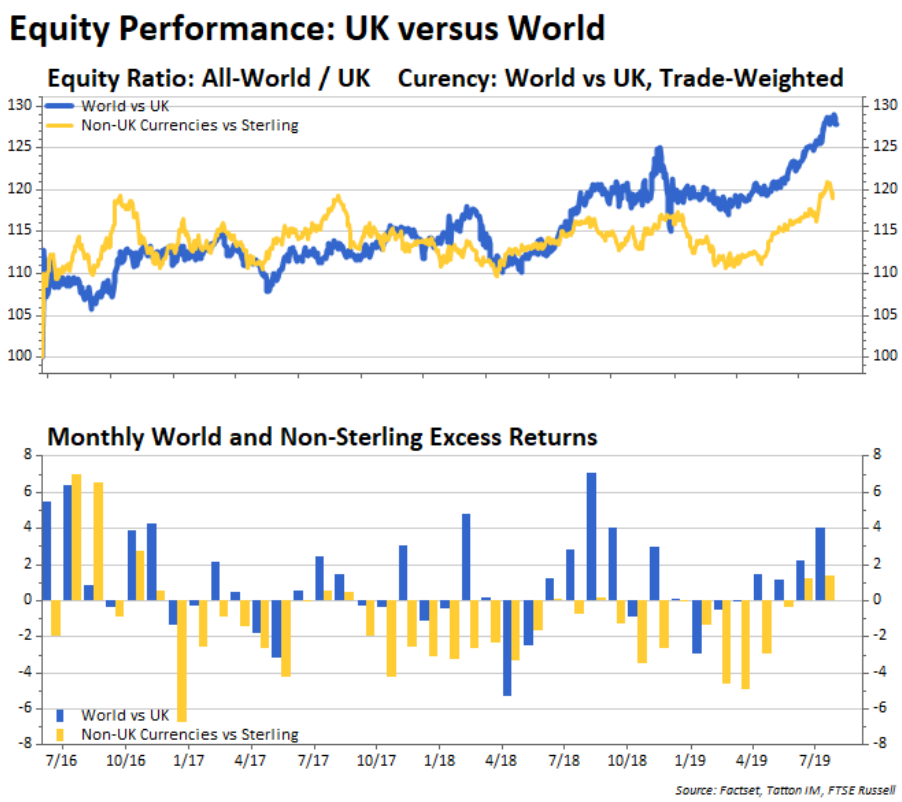
In general, the job of an investment manager is to buy assets where the expected return for the investment is at least in line with its risk taken. Managers never buy an asset today if they know that the asset's price will fall because of a riskier environment tomorrow. If they knew it would be riskier tomorrow than the majority of other investors expect, they would sell the asset today and buy it back tomorrow. But how can you know that it will be riskier, what risks are discounted in today's price, and that tomorrow (rather than the day after tomorrow) is the best time to buy?

Specific risks do become reality and have very bad consequences. However, Daniel Kahneman, Amos Tversky and other behavioural psychologist-economists have shown that we, as human beings, tend to think about the future in terms of discovering risks. We then over-estimate the likelihood of risks becoming reality and over-estimate the bad consequences in that event.

There are many strands and theories about why this might be the case. One theory is that, having identified a risk, we tend to avoid paths which increase the likelihood of it becoming reality, taking insurance and planning actions to mitigate the consequences if it happens. This is often termed the (policy) reaction function.

Which brings us to Brexit.

It has been a difficult time for investment managers, especially those of us based in the UK. The chart below shows the total-return performance of the UK relative to the world (using the FTSE indices):



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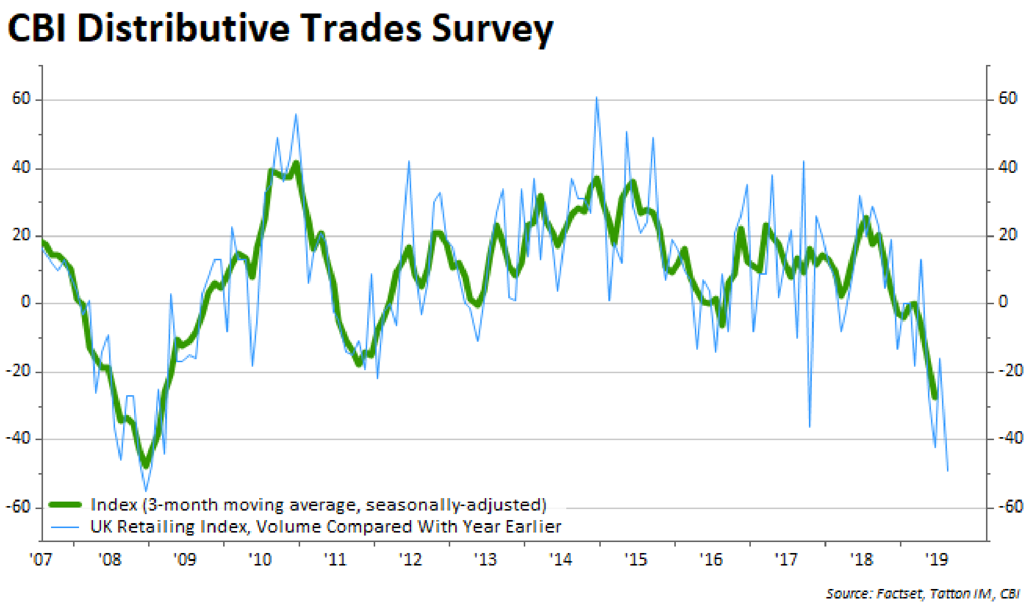
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD

Holding a decent proportion in global equities has added significantly to a UK-based portfolio. For UK equities, the global nature of large UK companies (with overseas revenues usually outstripping domestic) does not seem to have offset the fall in £-Sterling in the way that was hoped. If that effect had happened, UK equity performance would have been better than the performance of the currency index. As you can see, global equities have done better just because of £-Sterling's weakness.

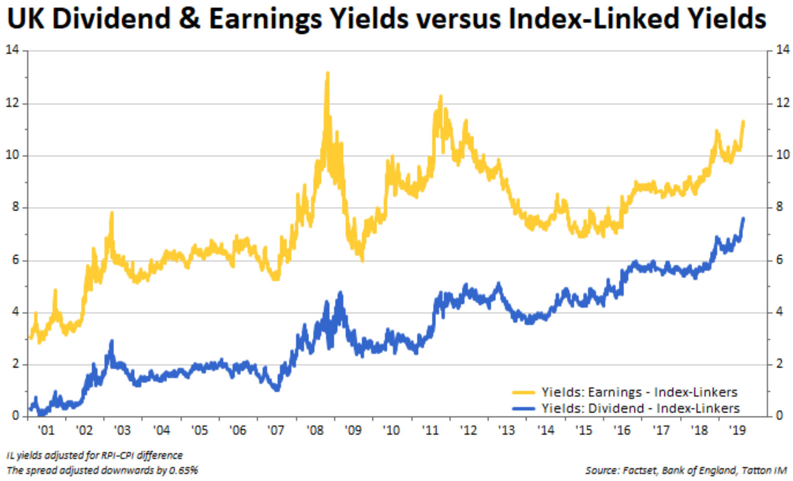
The sectoral weightings of the UK equity market are more cyclical than the rest of the world (especially compared to the US) and so the overall slowdown in the world economy is having a bigger impact here.

But it is the relatively recent sharp economic slowdown in the UK that is the most likely cause of the latest bout of relative underperformance. Perhaps Brexit effects are finally feeding through to the UK worker/consumer, rather than just affecting business expectations? Earlier this week, the CBI told us that their Distributive Trades Survey Index had fallen to near the lows of 2008. And retail sentiment has declined sharply during the spring and summer:



Having held an underweight position to UK equities since the Brexit referendum in 2016, we reduced the underweight in 2018 as we headed into the winter. (We should note that our portfolios' neutral weight for UK equities is still below that of the average UK Private Client portfolio, as indicated by the private investor portfolio indices published by the Personal Investment Management & Financial Advice Association's survey). By 2018, the dividend yield on UK equities was higher than the rest of the world and that extra expected return balanced the risks.

The UK slowdown has not been kind to expected dividend and earnings growth rates, especially for domestically-oriented stocks. Still, even taking into account lower earnings estimates, the UK market looks historically cheap on most measures (P/E, dividend yield, price to book, return on equity). This is especially true when adjusted for domestic real yields (using the 10-year index-linked yield):



So, what should the investment manager do now?

Expected returns have risen, especially in relation to domestic lower-risk assets and global risk assets. But so have the risks: a no-deal exit is clearly more of a possibility since the Johnson government has deliberately chosen a clearer but more confrontational approach.

What is interesting is that the policy reaction function also appears to have changed. The Johnson strategy is much more dynamic in a number of ways, particularly in looking beyond the October 31st deadline. That might mean that the consequences will be less disruptive than would have been the case previously.

We cannot see the case for selling UK assets. For example, Merkel's mildly positive noises on Wednesday suggest that the situational risks are more evenly balanced now while the expected returns are attractive. For us, the probability-weighted payouts are not screaming a buy, but they are not far off.

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Fiscal easing at last - to balance political risks

Source: Andy Davy, 9 August 2019

Last week, all eyes were on the inversion of the US yield curve (the difference in yield between 2-year bonds and 10-year bonds turning negative). Given that in the past this has been a reliable precursor of recession, investors and the financial commentariat were naturally alarmed. But our assessment is that years of extraordinary monetary easing have undermined the predictive quality of the yield curve. In the absence of external shocks, the sluggish growth the global economy has slowed to this year is likely to continue without deteriorating further towards economic contraction. At the moment, there is not enough doom and gloom in the data to justify recession predictions, and the return of loosening global monetary policy should be enough to see us through.

The problem, as we wrote, is that the probability of external shocks is much higher than usual. This is in the form of hefty political risks all over the world, from a disorderly Brexit to escalating Trump trade wars, to Populist infighting in Italy, not to mention the various pressure points around China. These risks have the potential to push the fragile global economy from slow growth into outright recession. This means that capital markets are far more focused on politics than usual, given they could well determine the continuation or end of the current, already very 'long-in-the-tooth', economic expansion cycle that began 10 years ago.

This week, the political side provided us for once with some refreshingly supportive news. Both the US and German governments are considering expansionary fiscal policy, according to reports on Monday. Donald Trump is reportedly thinking about a fresh round of tax cuts, aimed at reducing both capital gains tax and payroll taxes. Meanwhile, German government sources have claimed that the government is drawing up plans to bolster consumer demand and prevent a rise in unemployment – with a stimulus package similar to the one they unveiled 10 years ago, in the wake of the great recession.

This could be very good news. For all the focus on political risks to the economy, proposals like this show that political action can provide opportunity potential too. President Obama's refusal to follow his global peers into fiscal austerity after the Global Financial Crisis is cited as one of the reasons why the US economy recovered much faster and more strongly than other G7 nations. Likewise (although perhaps ill-timed) President Trump's corporation tax cut in 2017 is credited with helping the US economy reach the stellar growth that very nearly led to overheating conditions in 2018. A further cut could well have a similar but better-timed effect now – particularly a cut to payroll taxes, which would help consumers and the middle class.

German finance minister Olaf Scholz recently suggested that his government could increase spending by up to €50bn in the event of an economic crisis. That would equal the huge stimulus package the German people received back in 2009, when the global economy was in disarray. Back then, the government went as far as temporarily paying workers' wages so companies could hold on to them, and giving consumers incentives to buy new cars – supporting the all-important automotive industry. This intervention from the government is one of the reasons that Germany recovered from the financial crisis in less than half the time that the overall Eurozone did.

For the last decade, we have seen historically loose monetary policy all over the developed world, but without much accompanying response at all from fiscal policy. Low interest rates and abundant liquidity certainly helped sentiment to recover after the financial crisis by putting a floor under asset prices. However, with widespread austerity in Europe moving fiscal policy the other way, the positive potential for monetary policy has been limited, while the negative side-effects have become more pronounced. Central bankers are becoming increasingly worried that their quantitative easing measures have worsened wealth inequality – leading to the rise of political populism.

Meanwhile, the low rates era has undoubtedly taken its toll on banks – as we can see in the EU and Japan – which limits the effectiveness of the banking system. Last week's yield curve inversion itself probably has something to do with the Federal Reserve's recent interest rate cut – as an expanding monetary base found its way into 'risk free' assets like US government bonds.

Those bond market moves actually make it good timing for fiscal easing. Lower yields on long term bonds lowers the governments' borrowing costs. And with flagging private sector demand, it could be a good opportunity to expand the public sector through debt-financed investment. Some have even suggested that negative yields on many governments' long-term borrowing is equivalent to bond markets 'shouting' for the public sector to use the 'free' money to invest it into the economy productively. For a country like Germany, which is suffering under a fall of export driven demand, that is exactly the sort of thing that could help it out of its current slump. And as we have written here many times before, it could even address some of the deep structural demand issues plaguing the Eurozone economy.

The fact that two of the world's largest economies are now considering fiscal stimuli shows a changing of global political attitudes – which for the past 10 years have been dominated by the balanced budget doctrine. In China, Italy and even here in the UK (with Boris Johnson's newly unveiled spending plans) we see the same trend.

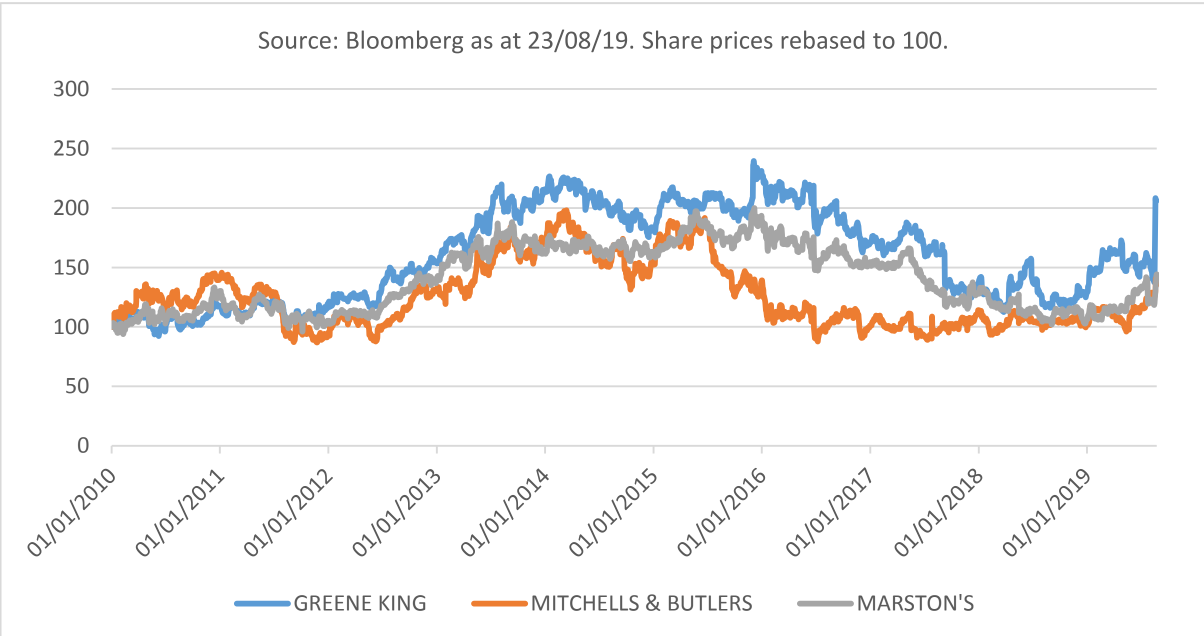
If it happens, this will be a positive for the global economy. But whether it will actually happen – and how effective it would actually be – remains to be seen. The only reason these policies are being entertained is because of politicians' fear of what will happen if they are not. Trump repeatedly insists that the US is in "such a strong economic position" and "very far" from a recession, but his recent actions and comments suggest he is trying to convince himself as much as everyone else.

Export 'Weltmeister' Germany has already experienced the full force of declining global trade, which in less than two years has dethroned it as Europe's growth engine and has driven the country to the brink of recession. As such, it is surprising that it took this long to get the fiscal conversation going. As for the UK, we should hardly be surprised that the government wants to increase spending at a time when Brexit risks have so severely reduced business investment and demand.

In any case, any fiscal expansion will face difficulties. Another tax cut in the US will face huge obstacles in the Democrat-controlled House of Representatives – unless it demonstrably benefits the masses, rather than the wealthy few – which will make it costly. And German politicians will have to work around tight constitutional budget rules – not to mention an entrenched political aversion to spending – to enact any changes. These are not insurmountable, particularly if they are directed at popular causes like the reduction of inequality of opportunities through investments in education, healthcare and addressing global warming.

Unfortunately, the benefit of fiscal programs will probably be offset by the economic downsides it would take to get them. Politicians are unlikely to get over the aforementioned hurdles unless the economy takes a turn for the worse. That means that, while fiscal expansion would help, the scenario in which it may become meaningful enough to overcome flagging global demand is a negative one. However, the positive takeaway from this is that the rise of populism, with all its negative effects, may at least put an end to the damaging era of fiscal austerity.

Greene King is dead, long live Greene King



International investors are looking through the Brexit gloom to see the hot property available in UK stocks: British beer. At least, that's one way to spin the news this week that pub chain Greene King has been snapped up by a Hong Kong holding company. CK Asset Holdings – founded by Hong Kong's richest man Li Ka-shing – offered £8.50 per share for the pub chain and brewer, a hefty 51% premium on Greene King's closing share price last Friday. The deal values the company at £2.7bn – £1mn for each of its 2,700 pubs across the country – although the actual figure CKA will pay will rise to £4.6bn when the debt that the Hong Kong business will be taking on is included.

The deal has not been finalised yet, but the jump in Greene King's share price following the news suggests markets believe it will go ahead. A competing bid could scupper the purchase, but that looks unlikely. The few potential buyers around are more focused on their own businesses – given the high levels of debt leverage in the sector. And CKA's 51% mark-up makes it unlikely that a competitor could stump up the cash fast enough.

Commenting on the deal, CKA said that it followed a "strategy [of looking] for businesses with stable and resilient characteristics and strong cash flow-generating capabilities […] the UK pub and brewing sector shares these characteristics and we believe that this sector will continue to be an important part of British culture and of the eating-and-drinking-out market in the long run,"

So, CKA get stable business with a large property footprint, Greene King get an eager foreign backer willing to take on their considerable debt and British businesses get a signal that Brexit does not mean the end of foreign investment. Good news for all involved then?

Yes and no. There is a solid business rationale behind the deal: CKA want a business that can reliably generate cash over the long term and that has real estate backing. Greene King fits that bill, owning (through freehold or leasehold) around 81% of its real estate, and in a sector that tends to make money regardless of the economic conditions. But the cynical view is that this could be a way for CKA to get money out of Hong Kong at a difficult time politically.

What's more – despite CKA's overtures to the UK pub industry – analysts have suggested that Greene King's sizeable property portfolio may be the real reason for CKA's interest. A recent property valuation put Greene King's combined properties at a market value of £4.6bn, against a book value of £3.6bn. For the holding company, many of Greene King's pubs may be worth far more if made residential. If that is their intention, it could mean a significant fall in Britain's already shrinking number of pubs.

However, we should perhaps take CKA at their word – given their history with Greene King. Their relationship first started in 2016, when CKA leased a portfolio of pubs to Greene King and promised to provide "resources to invest capital in new initiatives". This suggests they do want to develop the brand and refresh the pub chain after all.

That would have a positive impact on the wider sector – as their current offer already has done. CKA's acquisition comes only a month after Stonegate Pub – the owner of chain Slug and Lettuce – announced it was buying rival Ei Group (previously Enterprise Inns) for £1.3bn. And back in January, brewing company Fuller's was bought by Japanese drinks giant Asahi in a £250mn deal. Given the sorts of valuations we have seen in these deals, investors might start looking at similar companies like Marston's and Mitchells and Butlers for a similar deal. All of these have significant real estate holdings which make them an attractive proposition.

They may look even more attractive to foreign buyers – given the cut-price value of £-sterling. Sterling's depressed value seems to be drawing out international buyers, indicating that they are not yet put off by the Brexit negativity we have seen elsewhere around British assets. Given how tumultuous the last few weeks have been politically – and the perceived increased likelihood of a no-deal Brexit under Boris Johnson – these deals show that investors see value in the UK even in a no-deal scenario. With October 31st rapidly approaching as the next potential exit date, we are hearing reports that the fall in £-Sterling is causing overseas investors to take a serious look at cheap British assets.

Of course, this is not to say that overseas investors are positive about the prospect of a no-deal Brexit. Capital markets, analysts and economists mostly agree that it would be a serious dampener on the UK economy. But the dour mood around Brexit has reduced both currency and assets to levels that may be too cheap to resist. Everything has some value, and even if Brexit hampers business, it will not destroy it.

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Global Equity Markets

Market	FRI 15:19	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7154.9	0.5	37.7	↘	→
FTSE 250	19323	2.7	500.8	→	→
FTSE AS	3928.2	0.9	34.5	↘	→
FTSE Small	5397.0	1.2	63.4	⇘	→
CAC	5390.1	1.7	89.3	⇘	⇗
DAX	11754.7	1.7	192.0	↘	→
Dow	26238	1.4	351.8	⇘	→
S&P 500	2914.7	0.9	26.0	⇘	⇗
Nasdaq	7681.2	1.0	77.1	⇘	↗
Nikkei	20710.9	1.4	292.1	↘	⇘
MSCI World	2131.7	1.1	23.2	⇘	⇗
MSCI EM	975.7	0.6	5.4	↘	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company		%
NMC Health	18.4	John Wood		-9.2
ITV	10.4	BHP		-3.5
TUI	8.9	Evraz		-2.7
J Sainsbury	8.8	Direct Line		-2.6
GVC	8.4	Prudential		-2.5

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.224	0.7	Oil	59.17	0.9
GBP/EUR	0.905	0.9	Gold	1505.0	-0.6
USD/EUR	1.11	-0.2	Silver	17.15	0.2
JPY/USD	106.44	-0.1	Copper	255.2	-1.7
CNY/USD	7.085	-0.6	Aluminium	1766.0	-0.9

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.53	0.06
UK 15-Yr	0.84	0.10
US 10-Yr	1.59	0.04
French 10-Yr	-0.35	0.06
German 10-Yr	-0.65	0.03
Japanese 10-Yr	-0.23	0.00

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.1	17.5	12.5	13.3
FTSE 250	3.5	25.7	13.7	14.2
FTSE AS	4.8	18.5	12.5	13.4
FTSE Small	3.9	50.5	-	14
CAC	3.4	18.8	14.4	13.5
DAX	3.3	19.6	13.8	12.6
Dow	2.3	17.5	17.2	14.9
S&P 500	2	19.1	17.6	15.9
Nasdaq	1	23.9	21.1	17.9
Nikkei	2.3	14.7	15.1	17.9
MSCI World	2.5	18.1	16.2	15.2
MSCI EM	3	13.1	12.5	12

UK Mortgage Rates

Mortgage Rates	Estimate	Jul	Jun
Base Rate Tracker	2.56	2.56	2.56
2-yr Fixed Rate	1.67	1.66	1.68
3-yr Fixed Rate	1.79	1.77	1.78
5-yr Fixed Rate	1.97	1.96	1.99
10-yr Fixed Rate	2.59	2.61	0.00
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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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

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD