THE **CAMBRIDGE** WEEKLY

9 September 2019

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Matt, 4 September 2019

Choppy water but no storm, yet

The week has, yet again, felt tumultuous. The government's Brexit strategy has been halted in its tracks by a miscalculation of the official opposition and internal Conservative Party opposition. Many commentators were also confounded, and we would count ourselves among them. One can see evidence of the upset when looking at the probability of an October election - Betfair has reduced the chance of an election to 35% from over 80% when Boris Johnson became leader. Choppy political waters indeed.

From the first Brexit delay, we had thought that the most probable path was that the Conservative party would put in a pro-Brexit leader. If the party regained the approval of the voters that had defected to the Brexit party, then the Conservative leadership would reinforce the pro-Brexit line-up of MPs, firstly though strong-arm internal tactics, and ultimately though an election where the softer elements were suborned or removed.

The miscalculation has been that the improvement in Conservative popularity has undermined Labour's reasons for wanting an election, and that the election timetable is not now in the control of the government.

Perhaps it appears odd, but UK financial markets have been decidedly less tumultuous and far less choppy.

Although there were lots of headlines about the Pound's "massive" fall, it actually has not been as volatile one might believe. Although Sterling is more volatile than the Euro, it is not as volatile as previous episodes over the past three years.

Source: Factset 2019

Meanwhile UK stocks have underperformed Europe in the past two days by about 1%. Not so good, but well within the bounds of normality. The chart above shows the moves the UK, US and European markets since the August bank holiday, in Sterling terms.

UK equities are yielding enough to keep domestic and international investors engaged. The risks of a no-deal Brexit may have reduced a little (though perhaps not greatly).

Meanwhile, while many domestic investors fret that a Corbyn government may affect their holdings, the factionalisation and resultant fracturing of both the Labour and Conservative parties has increased the odds of an explicit coalition. Certainly, there is little sign of capital flight from Sterling assets, and market research, suggests that their international clients do not see a strong likelihood of a government emerging with a socialist mandate.

Further, UK equities are also being helped by a possible rebound in confidence about the global economy. The start of the month is when the results of the monthly Purchasing Manager surveys are released with manufacturing PMI bouncing back to 50.1. This was heartening for markets which had become extremely pessimistic over the outlook for the rest of the year. The fact that the improvement, centred on the previously weakening Europe and emerging Asian economies, was especially welcome.

That is not to say that the news was resoundingly good. JP Morgan produced analysis that was decidedly more downbeat than might have been suggested by the positive regional market reactions contained in their own data. The decline in the global services PMI and a decline in the sub-data relating to new orders caused their economists to worry about further weakness through the rest of the year.

And the US Institute of Supply Management manufacturing data showed a worrying decline into contraction territory, an event which in the past has been linked with recessions a few months later.

For a few moments after this US data was released, it looked like there may be quite a sharp negative reaction, but it didn't come, perhaps because both long-term and short-term investors appear to have lightened up considerably on risk assets in recent months (as evidenced by last week's Bank of America Merrill Lynch investor survey).

We write about the news from Asia below. It may be that the withdrawal of the Hong Kong extradition bill, renewed support measures for the economy, and reports that trade talks with the US will resume shortly, are signs of weak Chinese growth. However, Beijing's triple-pronged policy response has rekindled the view that its government's approach is pragmatic, realistic and likely to be effective.

This has sparked quite a bit of a "bear-squeeze" in cyclical assets; resource stocks, energy, and industrial metals have rallied. Banks and other financials are being helped by a fall in long-bond prices.

Certainly, the bull case for global equities needs the economic outlook to improve, and the US consumer is unlikely to be the leader. The jobs market is not deteriorating but, at the margin, the wage gains are being saved rather than spent. Perhaps we might see a pickup in business capital expenditure, if the cash raised in this week's record-breaking corporate bond issuance is spent rather than used to fund dividends and buybacks.

However, there have been many comments and news articles emanating from the Federal Reserve's conference at Jackson Hole, all pointing to a growing consensus among leading central bankers that monetary firepower is waning and that governments must invest in their economies. Expanding fiscal deficits from the current extended levels clearly requires a change of mindset among wary politicians. With that in mind we also discuss the rise of Modern Monetary Theory.

So, while one might be forgiven for feeling close to despair, the choppy waters of Westminster have not spilled over into financial markets, where waters appear calm and they are holding course.

Modern Monetary Theory

Over the last few months, expectations of central bank policy have been a driving force for markets. Policy announcements and central bankers' comments have pushed risk-assets in both directions, and no bank has bore the brunt of market reaction as much as the US Federal Reserve. Even when they opted to cut interest rates last month, the accompanying press release was deemed hawkish (favouring higher rates) enough to sour investors.

In the middle of a global economic slowdown, investors are hoping that the 'great accommodation' – the extraordinarily easy monetary policy of the last decade – will be enough to see them through. In the absence of improving data, they are taking their cues from central banks. Two weeks ago, the world's central bankers met to discuss the outlook for global monetary policy – at the annual Economic Symposium in Jackson Hole. Appropriately, this year's event was titled "Challenges for Monetary Policy".

The theme is fitting because, after more than 10 years of historic monetary easing, the global economy is as lethargic as ever. In Europe and Japan, not even negative interest rates or huge asset purchase programs were enough to spur inflation. And across the developed world, the negative side effects of these policies – increased wealth inequality and reduced bank lending – are being felt. In a panel discussion at the conference, RBA governor Phillip Lowe talked about "the elevated expectations that monetary policy can deliver economic prosperity" versus the reality that central banks do not have "the best lever" for economic management.

There is an increasingly common opinion among policymakers – both central bankers and politicians – that conventional monetary policy is now either insufficient for stimulating the economy or actively harmful. Recently, Fed officials and the Bank of England's own Mark Carney have suggested in no uncertain terms that the onus is now on governments to increase their spending to boost the economy, even if it means running up budget deficits in the process.

This idea is central to what has become a popular challenger to conventional monetary policy – dubbed Modern Monetary Theory (MMT). MMT diverges dramatically from orthodox economics with its very first assumption: governments create and spend money, then collect it back as tax – not the other way around.

Traditional macroeconomics says that the value of a currency comes from the taxes the state collects. But MMT turns this relationship around: as the issuer, governments can set the value of a currency as they see fit, and taxes only have value because they are in government-issued currency. As a result of this 'monetary sovereignty', governments borrowing in their own currency can never go bust: they can just print more money. For MMT, taxes do not fund spending. Spending funds taxes.

There is much confusion about exactly what follows from this. US economist Paul Krugman has accused MMT of advocating policies that would lead to hyperinflation and extreme currency devaluation. But while MMT theorists do indeed believe that currency-issuing governments are not restrained by financing costs, they do not advocate unrestrained spending. Instead, as proponents, the journalist and commentator Thomas Fazi and Australian economist Bill Mitchell put it, "the real limit to government spending is the capacity of the economy to absorb it without generating runaway inflation."

Importantly, MMT differs from conventional theory in its proposed role of the government. Interest rates are not the most effective way to ensure growth and contain inflation. This is because, in a slow growth environment, businesses expecting weak profits and few customers have little incentive to invest, even at low financing costs. Instead, fiscal policy – through productive spending (to generate growth) and taxation (to contain inflation) – is the most effective way of managing an economy.

Without question, MMT represents a radical breakaway from conventional theory. But it has gained traction with monetary policymakers and politicians (prominent Democrats Bernie Sanders and Alexandria Ocasio-Cortez have both voiced their support). This is no doubt helped by the fact that many of its critiques ring true, and its suggested remedies seem right.

Despite incredibly low financing costs for over a decade, private sector investment has been seriously lagging. For the most part, the largest businesses have used their abundant capital either to buy back their own shares – driving up their own stock prices and exacerbating wealth inequality – or to buy out smaller businesses and consolidate their positions. Meanwhile, public services and investment (on infrastructure projects, for example) have fallen by the wayside through years of austerity. For businesses, there is little incentive to invest when growth is low and profit margins can be maintained – or expanded – through consolidation. Without significant fiscal spending, there is no one to pick up the slack.

Of course, you do not have to go as far as MMT to say that this should change. But the fact that many central bankers are now (implicitly or explicitly) advocating directly funding deficits to enable more government spending shows a significant shift in attitudes. Given the political obstacles in the way, a radical change in how policymakers think about the relationship between governments and capital may be what is needed.

In any case, the theory is gaining more and more recognition, and MMT theorists are far from the only ones calling for more fiscal spending to see us through the current growth slump. With growth currently stalling – and political polarisation increasing across the developed world – these voices are likely to only get louder.

China's Hong Kong concession: a sign of weakness?

In September 1982, Prime Minister Margaret Thatcher met with paramount leader of China Deng Xiaoping, to discuss the future of British Hong Kong. Thatcher went in to the talks listing Britain's desires for Hong Kong after its lease expiry in 1997, justifying them by reference to previous historic treaties signed between the UK and China. According to her memoirs, Deng's response was unequivocal: "I could walk in and take the whole lot this afternoon"

The British government was under no illusions that he was wrong. The fact that the handover agreement happened as it did is only because the Chinese were convinced that the "one nation, two systems" principle was in their interest. A functioning Hong Kong, as a financial and economic hub, is worth more to Beijing than a city in ruins.

That is most likely why Carrie Lam, Hong Kong's chief executive, announced this week that the extradition bill which sparked massive protests and led to huge unrest in the city will be withdrawn. The bill – which would allow for Hong Kong residents to be taken to and tried on the mainland – was seen by many citizens as a nail in the coffin of Hong Kong's independence. Its withdrawal is a victory for protestors, but it may also reveal a deeper weakness for China.

The islands' importance to the mainland should not be understated. Hong Kong is the world's gateway to China, and the investment they have received through it has been crucial for growing China's businesses. In the 1970s, Shenzhen (just north of Hong Kong) was a fishing village with a population of just 30,000. Today, that figure is over 12 million, and it has become home to China's rapidly growing technology giants like Huawei and Tencent. The greater Guandong bay area – including Guangzhou and Macao – is the site of the biggest infrastructure expansion in the world.

At the moment, it is a bright spot they cannot afford to dim. It is no secret that the Chinese economy is flagging. Caught between an attempt to deleverage their debt-laden economy and a damaging trade war with the US, China's economy has slowed substantially. At the beginning of the year, the government went as far as downgrading their lofty GDP growth targets – acknowledging that keeping up their usual rampant pace would be difficult.

Over the last year, Beijing has announced numerous measures to try and jump start the economy – from tax cuts to increased lending. But, despite these being well-received by investors, the underlying data has shown little improvement.

Recent months have seen a number of smaller regional banks go bust or come under direct government control – pointing to stress in the financial system and a problem with bad debts. Just this week, the central government announced a further cut to banks' reserve requirement ratios and called for lower borrowing costs for businesses. The statement released by the State Council suggested that an interest rate cut could be on the way as well. These are supportive measures, but Beijing would not be considering them if all was well.

We have also noticed a peculiar trend recently. Over the last couple of months or so, daily trading volumes have plummeted for a number of Chinese stocks. This is despite the fact that the underlying economy is continuing to show weakness and the stocks in question are usually very volatile. We can only speculate on this, but if officials were cracking down on stock traders to stop excessive market falls, this is exactly what it would look like.

Still, claiming that this explains Beijing's Hong Kong concession might be jumping the gun. Party officials have always been very careful to keep economic issues separate from matters of sovereignty – such as Hong Kong and Taiwan. But the protests have undoubtedly caused disruption to the economy, and business leaders have indeed been pressuring their government to find a resolution. For all the talk of "two systems", Carrie Lam would not have been able to withdraw the extradition bill without at least tacit approval from Beijing. Perhaps they gave that approval with one eye on the domestic economy.

If so, that could have wider implications for the US-China trade war. We wrote recently that both sides seem to have accepted that the spat could go on for some time, given how talks have repeatedly fallen apart. As such, China's acknowledgement of their own internal weakness and their policy reaction could be read in two ways: either they are battening down the hatches and preparing to go it alone or they are eager to make a deal and take the pressure off. But the fact that vice-premier Liu He called US negotiators to arrange face-to-face meetings next month suggests that it is the latter. And with President Trump's approval ratings taking yet another hit recently, he could well be telling his side to make a deal before tariffs begin to bite American consumers.

We should not get our hopes up too much, however. Even though Beijing seems willing to compromise, they undoubtedly will have prepared for the worst. And Trump's unpredictability in negotiations needs no discussion. As for Hong Kong itself: if it is indeed economic timing that made Beijing back off, they only need better timing to try it again. Perhaps Carrie Lam's concession will be enough to quell protests (now in their fifth month), perhaps not. But it certainly will not be enough to stop Beijing's appetite for encroachment. They could take the whole lot this afternoon, but it would be a costly afternoon.

CAMBRIDGE INVESTMENTS LIMITED

9th September 2019

Global Equity Markets — Technical

Market	FRI 13:19	% 1 Week*	1 W	Short	Medium
FTSE 100	7263.9	0.8	56.7	↘	→
FTSE 250	19652	1.3	258.8	→	↗
FTSE AS	3987.6	0.9	34.5	↘	→
FTSE Small	5419.5	0.8	43.2	↘	→
CAC	5599.4	2.2	118.9	→	⬈
DAX	12201.4	2.2	262.2	→	↗
Dow	26728	2.7	692.1	→	↗
S&P 500	2976.0	3.0	88.1	→	↗
Nasdaq	7862.5	3.6	274.6	→	⬈
Nikkei	21199.6	2.4	495.2	→	↘
MSCI World	2174.3	1.7	35.7	→	↗
MSCI EM	1003.0	1.9	18.7	⬊	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Melrose	13.9	Fresnillo	-4.5
NMC Health	10.8	United Utilities	-3.8
GVC	9.2	Admiral	-3.6
Johnson Matthey	6.3	Centrica	-3.5
Legal & General	5.6	Barratt Devts	-3.1

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.231	1.3	Oil	59.97	-0.8
GBP/EUR	0.896	0.9	Gold	1504.5	-1.0
USD/EUR	1.10	0.4	Silver	18.18	-1.1
JPY/USD	107.01	-0.7	Copper	260.2	1.7
CNY/USD	7.113	0.6	Aluminium	1784.0	1.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.54	0.06
UK 15-Yr	0.77	0.06
US 10-Yr	1.60	0.10
French 10-Yr	-0.30	0.11
German 10-Yr	-0.60	0.10
Japanese 10-Yr	-0.24	0.03

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.1	17.7	12.8	13.2
FTSE 250	3.4	26.2	14.0	14.2
FTSE AS	4.8	18.7	12.8	13.4
FTSE Small	3.9	43.9	-	14.0
CAC	3.3	19.3	14.9	13.4
DAX	3.3	20.3	14.3	12.5
Dow	2.3	17.8	17.6	14.9
S&P 500	1.9	19.5	18.0	15.9
Nasdaq	1.0	24.5	21.8	17.9
Nikkei	2.2	15.0	15.3	17.8
MSCI World	2.5	18.5	16.6	15.2
MSCI EM	2.9	13.5	13.1	12.0

UK Mortgage Rates

Mortgage Rates	Estimate	Aug	Jul
Base Rate Tracker	2.56	2.56	2.56
2-yr Fixed Rate	1.66	1.64	1.66
3-yr Fixed Rate	1.77	1.75	1.77
5-yr Fixed Rate	1.95	1.92	1.96
10-yr Fixed Rate	2.64	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.

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