THE **CAMBRIDGE** WEEKLY

28 October 2019

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Christian Adams, BoJo trying to 'do' Brexit, 22 Oct 2019

Slowly turning

Another week, another Brexit delay. EU leaders have decided to wait until after the election vote next week before saying how long may be acceptable for another delay. Despite some tough words from France, it seems unlikely they will be so unreasonable as to force the UK to emergency measures to avoid being 'thrown out'. Meanwhile Jeremy Corbyn and the Labour PLP are caught in "the Cummings Trap", the party that says "no".

We wrote before that the Boris Johnson story would mark the closing chapters of Brexit – but that an exit by the end of October was unlikely, his preference for being dead in a ditch aside.

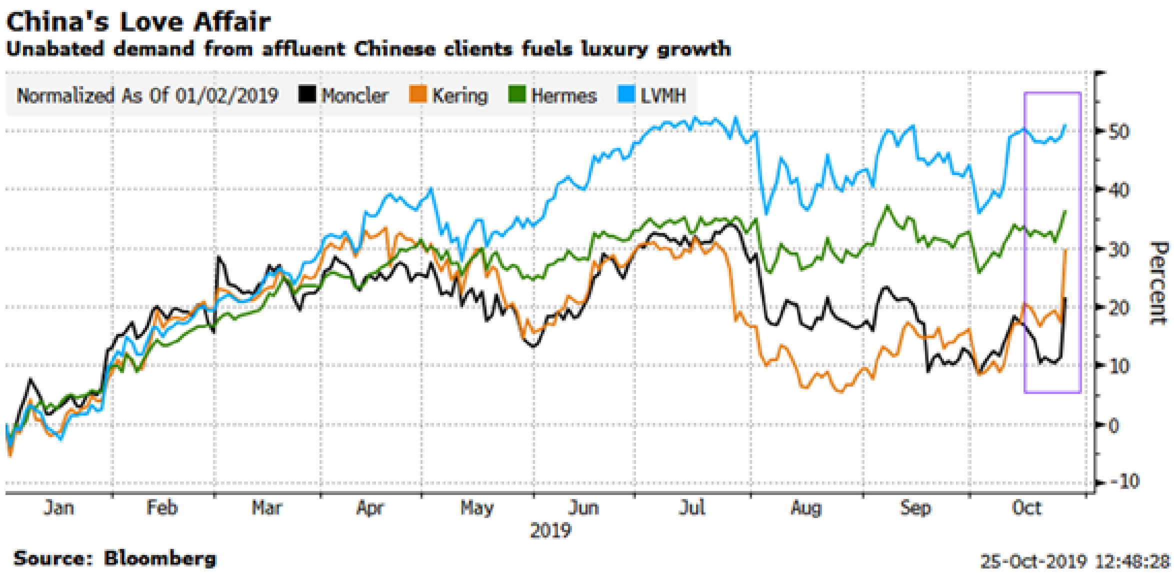
If the Prime Minister gets his election on December 12 after having delivered on his Brexit promises, it would most likely give us significantly reduced levels of near-term uncertainty, which would be a considerable positive for both the UK economy and its stock market. But the trade-off for this is increased medium-term uncertainty: the real negotiations – which will determine the UK's future – will only start at that point. There is a real chance that Johnson's envisaged form of a relatively hard Brexit would lead to a break-up of the UK itself, and substantive trade negotiations can only really happen at that point. For all the negativity however, there is still a strong case for the UK as an investment proposition. We write more about this in a separate article.

Now on to other developments. We note that the movers and shakers in the economic policy realm are becoming increasingly in favour of fiscal easing – with a chorus of economists and global central bankers now urging governments to invest. Outgoing ECB President Mario Draghi found it difficult to convince

European politicians of any real change during his tenure. But the incoming Christine Lagarde is a politician herself and may prove more persuasive. Many European governments are on board with fiscal action, but her task will be to convince German politicians that, if they want to save their banks from negative interest rates and yields, they need to flank monetary policy with fiscal support. Either that or accept that the ECB needs to buy Italian government bonds. We will see which route it takes. See our article below for more on the growing consensus for fiscal expansion (more in the separate article).

In other news, we advised last week that we would keep an even closer eye on the corporate results announcement season this quarter, because investor sentiment now hinges on it more than usual. The earnings season has made an encouraging start in the US, but slightly less so in Europe and Japan. 82% of the American companies that have reported so far have beaten earnings-per-share estimates for the last quarter, with that figure at 59% and 54% in Europe and Japan respectively. As we wrote last week however, these figures can be a little misleading. Since the surprise metrics (how earnings fared relative to estimates) are important for sentiment, companies have learnt that they are better off guiding forecasts down in the run up to the earnings season only to beat them later on – precisely what happened this time.

More important therefore is companies' expectations for the coming quarters. And on that front, things have been mixed. There were some positive statements from European luxury goods makers – which most likely is due to positive demand from China.



But elsewhere in Europe things were not as rosy. Future guidance was particularly dreary for cyclical companies.

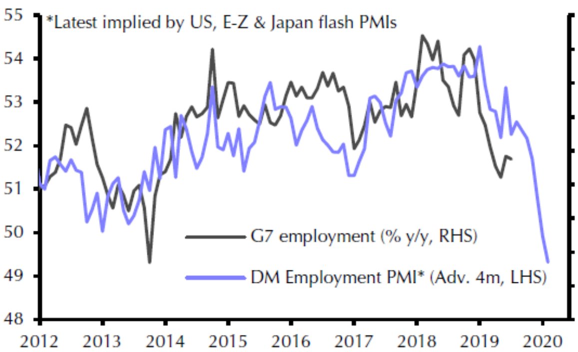
Nevertheless, market sentiment seems to be picking up. The fact that bond yields have moved higher while equity markets have traded sideways suggests that short sellers are getting squeezed out of the market, and risk sentiment is improving. The economic data does not yet support a significant move up in markets, but it does seem to be stabilising – which will likewise have a positive impact on sentiment.

The big one to watch for markets this earnings season is the fate of large US technology companies which had been driving stocks upwards for most of this market cycle. When office space provider WeWork had to shelve their prospective IPO a few weeks ago (and in the week had to seek a bailout by its biggest private equity investor) many commentators suggested it could mean the end of big tech's stock market supremacy. Spectacular growth has been the main aim of these companies for some time. But we note that many of the outlook statements from tech companies this time around seem to be focusing on the prospects for profitability, rather than just growth. This could well be a sign of the changing times, with the economic and regulatory environment now seeming to swing against them and tech growth gradually morphing into less exciting utility companies.

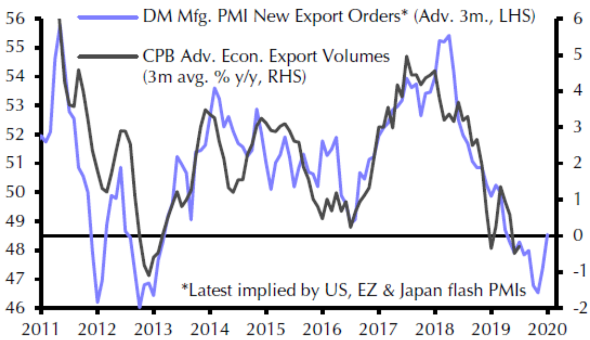
But as we noted some weeks ago, companies all over the world are seeing their profit margins squeezed as a global slowdown, trade frictions and growing wage pressures begin to bite. Amazon's results on Thursday showed that even the tech superstars are facing the same problems. That may be a cause for concern.

The preliminary-release Purchasing Manager Indices signalled a currently weak global economy (according to Capital Economics) but it does not seem to be spoiling the mood in capital markets. They seem to be betting that a turnaround is in store for the economy. The turn-up in new orders is now into a second month, most likely led by that swing in demand from Asia (chart below, right panel). The sharp fall in the employment forward indicators (chart below, left panel) would have been a worry a month ago, but the bad news might actually be good if it presages a slowdown in wage pressures rather than a rise in unemployment.

DM Employment PMI & G7 Employment



DM New Export Orders & Export Volumes



Sources: Refinitiv, Markit, Capital Economics

Looking to the coming week, the US rate-setters (the Federal Reserve Open Market Committee or FOMC) meet and are expected to cut rates on Wednesday. Analysts have expected another 0.25% cut for some time and continue to do so.

However, the past week has seen a fall in longer bond prices (and consequent rise in yields) following the IMF meeting. The market is taking the central banks' concerns about the efficacy of monetary policy seriously. Shorter-term rate expectations have not moved much, but the market is now moving away from believing monetary policy is the likely response to a crisis. The market's implied probability of even lower rates has diminished, and expectations of more QE are also on the wane.

So, investors will care most about the FOMC's future disposition. If other central banks are an indicator, we should expect to hear more about being "responsive to the upside" and "signs of labour cost pressures". That is not such good news for longer bonds. The price falls this week may be the start of a bout of medium-term downward pressure.

Given that the very strong returns of 2019 have been largely attributed to improving sentiment, and given the return of the central bank's monetary easing (introduced after the fears for the opposite caused the Q4 2018 market correction), the big question is how much central banks will be able to step back from further easing without causing another market tantrum. Much will hinge on whether the 'green shoots' of returning demand growth can sprout further, and whether governments are willing to help them with constructive fiscal easing.

The fragile balance between fear and greed continues.

(…or between JOMO and FOMO if you are trying to explain to your teenager or grandchild; Joy of missing out vs. Fear of missing out in case there is no access to younger generation translation support)

End of monetary policy era forces fiscal stimulus rethink

The IMF and World Bank hold their joint meeting in Washington each autumn, where the bigwigs of the global financial system gather together for a series of closed-door meetings, briefings and news conferences.

This year's meeting happened last week, with the key-note speech – the prestigious Per Jacobsson lecture – being presented by former Bank of England governor Mervyn King. His pronouncements were as damning as they were interesting. Economists and policymakers are "sleepwalking" towards the next financial crisis, warns King.

He evoked the memory of the great depression, the rise and fall of the Bretton Woods system and the intellectual revolutions brought about by Keynes, Lucas and Friedman. Modern history shows that these times of great upheaval require radical changes in economic thinking. We are in such a time of turmoil now. But this time around no one is willing to challenge the old ideas. Those in power have been resistant to sweeping changes like Roosevelt's New Deal, preferring instead minor tweaks to the system. The continued focus on monetary policy – despite a decade of extraordinary measures with little tangible effect – is symptomatic of this, according to King.

Central bankers seem to agree. Later in the week, outgoing ECB President Mario Draghi used his last annual meeting at the helm to deliver a gloomy warning: "The risks surrounding the Euro area growth outlook remain on the downside." Once again, he warned that monetary policy alone is not enough to solve Europe's economic and political crises. The ECB announced that it would keep interest rates unchanged after September's cut and resume its bond-buying program with another round of targeted long-term refinancing operations – but the president urged European politicians to match the central bank's ambitious policies with new fiscal spending.

This sentiment is becoming increasingly common among central bankers. Policymakers at the US Federal Reserve and even the Bank of England's own Mark Carney have recently urged governments to step up public investment in the face of global economic stagnation, caused by below average demand. In fact, central banks are becoming increasingly concerned that monetary stimulus on its own is causing more long-term harm to the economy than the short-term benefit it brings. In September, the ECB's decision caused a substantial rift, with a third of board members dissenting against the decision. Since then, a number of Draghi's allies have expressed concerns about the effect of negative interest rates, including the governor of Italy's central bank.

Sweden's Riksbank has recently announced that it is set to begin raising rates (admittedly only to zero), while Swiss private banks are pressuring their central bank to remove negative rates as well. The Bank of Japan also hinted that it is unlikely to ease monetary policy at its meeting next week, after it allowed a rise in long term government bonds.

In the absence of government spending and investment, the fear is that historically and persistently low interest rates are now only generating diminishing benefits while hurting banks, and thereby limiting a key source of capital for the real economy. Besides this, there is also a growing sense that the inflated asset prices that have come about from monetary easing are adding to wealth inequality and worsening political divisions.

Governments, for their part, are starting to listen. Both the US and the UK look likely to loosen the public purse strings. And in Europe, both France's and Belgium's latest budgets make room for increased spending. Unfortunately, in doing so, both countries have now joined Italy in falling foul of the EU's strict budgetary guidelines.

What this suggests to us is that – as many commentators have lamented since the dawn of the Eurozone – those budgetary guidelines need to be relaxed. Political obstinacy has got in the way of any fiscal changes until now. But with the EU's second-largest economy now joining in the protest, it looks increasingly likely that some kind of fiscal change will be the next item on Europe's to-do list.

As mentioned, central bankers seem to agree – with some even hinting that they would be prepared to buy government bonds if the proceeds were put towards public investment. Their message is nothing new, but what is new is the messenger. Even the old neoliberal thinkers (like Mervyn King) are urging governments to take more risks in funding vital public projects – before another crisis forces them to.

A recent research report from Citi exemplifies this. In it, they suggest that consensus longer-term economic forecasts are too optimistic. This is because they assume a large change in "total factor productivity" (TFP), the growth that comes from the interaction of labour and investment capital. The changes in infrastructure, management or general well-being is a big contributor to TFP. In most Western economies, investment in that component has been lacking for some time. And according to Citi's research, only vast improvements in public infrastructure will be able to deliver the required productivity increase. So, only a generous bout of public investment will be able to drag us out of the post-crisis rut.

In the US, the Democratic party are moving towards a policy of investment and higher progressive tax rates. Elizabeth Warren is leading the policy debate and has just moved into pole position. Her radicalism will likely wane somewhat before the November 2020 Presidential election, but government infrastructure investment will be a key commitment, particularly since the current Californian power cuts are a direct consequence of little spending since the 1930s New Deal!

Europe may lack a voter-led catalyst to action. The old guard of German politicians continue to stick to fiscal (over-) prudence as gospel, and they are trying to block changes that allow higher budget deficits in the Eurozone. As we have written over the past few months however, even in Europe's powerhouse there is now a lot of internal debate on this issue, which, interestingly is not coming from the political left but the same economists that are official advisers to the government. Newer and fresher-faced politicians, encouraged by central bankers and economists, are pushing for some fiscal relief.

As yet there is no actual change, but things seem to be moving that way. As Mervyn King warns, we can only hope change comes before the next crisis. But when capital markets offer governments funding for free even over longer term maturities and conservative economists urge a fiscal rethink, how long will politicians be able to withstand the temptation to create a 'New Deal' type legacy – or at least improve re-election chances against populists?

Why hold UK equities?

There is no escaping the B word. Anyone could be forgiven for a certain amount of Brexit fatigue, given how all-encompassing the issue has become over the past three and a half years. Parliament's vote this week to back Boris Johnson's Brexit deal in principle raised hopes that an end to the drama and uncertainty may be in sight. But the later vote against Johnson's timetable for the bill gave those hopes a battering. Huge uncertainty still looms for the UK. And few things hamper economic and market sentiment quite like uncertainty.

Understandably then, these days we receive a fair share of calls from financial advisers relaying the fears of their clients, wondering how Brexit will affect their investment portfolios. The first thing to bear in mind here is that our portfolios are made up of assets from across the world, with UK assets making up only a proportion. As such, even in the worst-case outcome for Brexit, the value of our investments will have a fair amount of protection.

Still, the worried investor might wonder: given the substantial Brexit uncertainties and their negative impact on the economy, why hold UK assets at all?

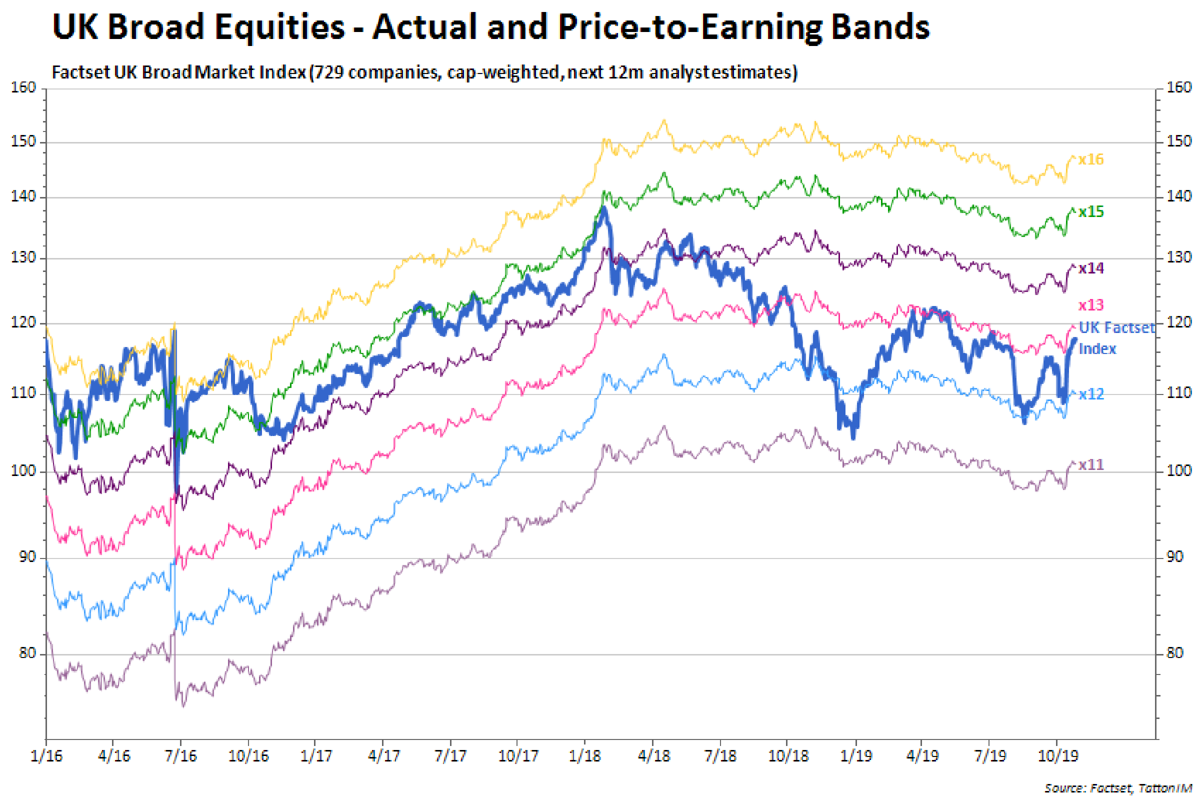
In our outlook piece at the beginning of the year, we made the case that both UK assets and the underlying economy had some potential upside. Equity valuations had fallen so low that only an apocalyptic scenario could have justified them – which we argued would not (and indeed did not) happen. Meanwhile, we argued a tight labour market and healthy manufacturing sector would give the economy enough juice to keep ticking over at a fair pace.

For the first half of the year this was essentially what happened. Some of that had to do with the low value of £-Sterling. The low currency value made British equities more attractive to foreign buyers, as well as amplifying the overseas revenues of larger companies. For exporters, a lower currency value increased demand for their products, which was a boon for manufacturers.

As we wrote a few weeks ago however, the more recent data is not so positive. Consumer confidence – which was the UK's economic driving force in the face of Brexit gloom – has clearly dropped off, and business sentiment in both the services and manufacturing sectors indicates decline. Brexit fears are now clearly taking their toll on the British economy.

But there is still a strong case for holding UK assets. The sectoral makeup of the UK equity market is more pro-cyclical than other regions – with more companies doing better in expansionary times and vice versa. Of course, while the current global economic slowdown has been worrying, any swing upwards in cyclical sentiment from markets will be a big positive. And recent news makes that look fairly likely. Citi's economic surprise indices have shown a tick up for the UK, which is now only marginally behind the US and well ahead of the struggling Eurozone. This is based on some better-than-expected forward guidance from British companies in their latest earnings reports.

That brings us nicely to the next point. Despite the fact that UK equity valuations have recovered from their lows somewhat this year, they are still firmly in the 'cheap' territory, and well below equity valuations in other regions. As the chart below shows, the price-to-earnings ratio for British stocks is still below 13x. Compare that to the US, where stocks stand at a price-to-earnings ratio of just under 18x, and you can see that market sentiment for the UK is clearly depressed. What that means is that a move up in company earnings is not needed for equities to move higher: all that is needed is some recovery in market sentiment.



What, then, could bring that about? Well, given the pro-cyclicality of UK stocks, any acceleration in the lethargic global economy would be sure to do some good. Signs of a sustained recovery in global growth have proved elusive so far, but there are some reasons to be hopeful.

Other than that, the answer comes back to the B word. Brexit fears are the main reason why sentiment for the UK is so low. So, movement towards a resolution will undoubtedly be a big boost. Despite all the commotion over timetables, Boris Johnson's initial victory for his withdrawal agreement suggests that the Brexit merry-go-round may really be coming to an end. And what's more, recent events point to two things: a diminished possibility of a no-deal scenario and increased certainty over short-term trading conditions (as any deal will at least include a transition period). For business as a whole, that is emphatically a positive.

That definitely seems to be markets' interpretation at least. The value of £-Sterling – the main proxy for Brexit sentiment since before the referendum – spiked higher on the recent news. What now seems certain is that, even if the long-term arrangements are still up in the air, the short-term outlook has materially improved. And with equities trading at such low valuations, that means there is plenty of upside to be found in UK assets.

Of course, the longer-term Brexit risks have not disappeared and remain substantial. The situation really could harm the economy and markets further down the line. These risks, in our view, may well limit the potential further upside, once the initial valuation level recovery rally has occurred. And that is why our neutral positioning on the UK still seems right for now.

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28th October 2019

Global Equity Markets

Market	FRI 15:06	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7294.5	2.0	144.0	→	⬀
FTSE 250	19986	-1.2	-242.0	→	⬀
FTSE AS	4012.7	1.4	55.8	→	⬀
FTSE Small	5456.9	0.2	11.6	→	⬀
CAC	5697.9	1.1	61.6	→	↗
DAX	12856.9	1.8	223.3	↗	↗
Dow	26855	0.3	85.1	→	↗
S&P 500	3009.7	0.8	23.5	→	↗
Nasdaq	7961.4	1.2	92.9	→	↗
Nikkei	22799.8	1.5	348.0	↗	↗
MSCI World	2215.6	0.9	20.4	→	↗
MSCI EM	1037.4	1.3	13.4	⬀	→

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.0	17.0	13.3	13.2
FTSE 250	3.8	23.7	14.4	14.2
FTSE AS	4.7	17.8	13.3	13.4
FTSE Small	3.7	131.8	-	14.0
CAC	3.2	19.6	15.4	13.4
DAX	3.1	22.4	15.2	12.5
Dow	2.3	18.3	18.1	14.9
S&P 500	1.9	19.8	18.3	16.0
Nasdaq	1.0	24.8	21.8	17.9
Nikkei	1.9	16.3	16.9	17.6
MSCI World	2.5	18.9	17.0	15.2
MSCI EM	2.9	14.0	13.4	12.0

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Fresnillo	10.5	M&S	-9.3
AstraZeneca	8.5	RBS	-6.1
Prudential	7.3	NMC Health	-5.6
Burberry	7.1	Barratt Devts	-5.0
WPP	6.5	Land Securities	-4.3

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.282	-1.3	Oil	61.46	3.4
GBP/EUR	0.865	-0.5	Gold	1513.8	1.6
USD/EUR	1.11	-0.7	Silver	18.27	4.1
JPY/USD	108.59	-0.1	Copper	267.3	1.4
CNY/USD	7.067	0.2	Aluminium	1724.0	-0.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.7	-0.0
UK 15-Yr	0.9	-0.0
US 10-Yr	1.8	0.0
French 10-Yr	-0.1	-0.0
German 10-Yr	-0.4	-0.0
Japanese 10-Yr	-0.1	0.0

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	2.62	2.59
2-yr Fixed Rate	1.56	1.59
3-yr Fixed Rate	1.66	1.71
5-yr Fixed Rate	1.80	1.85
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.29	4.29

* 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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CAMBRIDGE
INVESTMENTS LIMITED

28th October 2019

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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