CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

2 March 2020

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Instead of cartoon: The Economist's title image of this week's edition, 28 Feb 2020

Coronavirus – hitting too close to home

What a difference a week makes. For most of February, we had been discussing on these pages why equity markets had remained sanguine about the virus scare and even reached new all-time highs. At the end of this week, there is very clearly no need for such discussions any longer – equity markets around the world have turned and rapidly entered correction territory.

The rapid spreading of confirmed infection cases throughout the western world has ended the (now clearly misguided) belief that the implications of COVID-19 would be confined to faraway China. Even Donald Trump's TV broadcast proclamation on Wednesday night that *"Because of all we've done, the risk to the American people remains very low"* was unable to persuade the wider public that the virus outbreak would not touch them personally one way or the other.

To paraphrase the famous economist Paul Samuelson: when events change you change your mind. When the virus initially took hold in China, rational investment considerations from the professional investment community dominated were based on past experience that similar pandemics do not leave lasting damage and have not historically caused lasting recessionary periods. On the contrary, history tells us that monetary and fiscal stimulus countermeasures have usually led to a v-shaped recovery, once the warmer and dryer weather of spring brings the annual flu season to its natural end. However, once there was an increasing count of confirmed cases in South Korea, Iran and Italy, investor sentiment flipped, as less rationally inclined investors headed for the exit, creating a downdraft momentum that at the time of writing is still in full swing.

The severity and suddenness of the sell-off has been widely covered (and embellished) by the media and as readers will have noticed also resulted in Cambridge issuing two ad hoc updates on Wednesday and Friday. Those who read last week's edition will also remember that we noted then that stock markets were vulnerable to sudden, crash-like corrections because we had entered this difficult period with already quite extended stock market valuations following a very prolonged bull market and economic cycle.

That said, it is also worth noting that not much has changed factually since last week. China, the epicentre of the virus outbreak is reporting a steady decline in new infections and the country is returning to work. Both improvements reflected in positivity in the Chinese stock markets – in stark contrast to everywhere else.

As the virus has turned from an abstract economic hindrance to a personal and daily life changing threat, its impact on collective investor behaviour (and therefore market activity) has become far harder to gauge and forecast. During violent market movements as we're experiencing at the moment, the least potential damage comes from as little action as possible, given the propensity of wild swings between under-reaction to over-reaction.

The offsetting elements we discussed over the last weeks remain in place, as the positives include a global economy on a fairly durable footing, central banks that remain supportive to counter credit market deterioration and governments at the ready to provide fiscal support should it be required. However, as we also discussed, the feared negative economic ramifications are mostly related to the containment countermeasures of restrictions of movement, rather than the actual illnesses and fatalities. Under these circumstances we will need to adopt a 'watch and wait' stance for the near future to ascertain whether our previous fundamental assessments need to change.

If the spread of the pandemic is indeed already on the decline – as the figures from China indicate – and/or the Western world can deal with infections more effectively because of the one month warning our health systems received, then there is the possibility that this pandemic will follow the same relatively benign path for the economy as previous ones. On the other hand, much will depend on how much reduction in public and social activity will be necessary to contain the further spreading enough to defuse and restrain the public health impact of the virus. Should it become necessary to escalate such measures to levels China imposed over weeks then this could constitute a significant enough inactivity shock to the global economy to become the catalyst that ends this longest cycle in recent history – even despite all of the potential countermeasures aforementioned.

At the moment, we cannot know exactly what shape and direction the virus containment and market actions will take. But team Cambridge has plenty of experience of dealing with bouts of market volatility, and history has taught us that the best course of action usually is to 'keep calm and carry on'.

We will therefore continue to do exactly what we have done over the past 30-40 years of our capital market involvement. That is, to assess the developing dynamics in markets, evaluating the economic issues as well as political and societal concerns, all with the aim of steering investors' investment portfolios through the stormy waters towards the longer term enhanced returns over bank savings they expect from investing in capital markets.

For the immediate future, we will continue to look for good reasons to buy back into the much-cheapened stock markets, while remaining mindful that the more prudent approach could be to sit things out, or to

even reduce risk levels if evidence emerges that COVID-19 will leave a bigger dent in the global economy than previous pandemics. As always, we will be observing developments very closely and act when necessary or opportune. But even if no action is deemed the best course of action, we will continue to report back to you on a weekly basis or even intra weekly to keep you abreast of the latest insights.

Brexit may be 'Harder' than you think

Thank goodness Brexit is over. Years of uncertainty, multiple elections and round-the-clock media coverage are now behind us after the UK officially left the EU at the end of last month. Except, of course, it isn't. The decisive Conservative victory in December settled who would represent Britain in negotiations with our largest trading partner, but the long road to an agreement is still very much ahead. Aside from a few Brexit-themed parties, not much really happened at the end of January (one civil servant working on the issue told us his department had nothing to do in the weeks leading up to the supposedly all-important deadline).

On Monday, talks begin on issues ranging from fishing to financial services. But ahead of those discussions, the public posturing game has already started. The government announced on Thursday that it wants a Canada-style arrangement with the EU, but that it will consider walking away from talks in June and prepare for an "orderly" transition period. And last week, the UK's chief Brexit negotiator David Frost told a university audience in Brussels that Britain will not accept EU supervision as part of any future trade deal. The so-called 'level playing field' rules the bloc wants to impose are "undemocratic", in the eyes of the government. The message is clear: it's sovereignty or bust.

Brexit-and-brimstone has been the Conservative party's public stance since Boris Johnson became leader in the summer. But there has long been a suspicion that Johnson's hard-line approach was something of an act, both to win over the British public and to strengthen his government's bargaining position with a credible threat. When all is said and done, the thought goes, Johnson's ideal Brexit is much softer – and much closer to Theresa May's deal – than the public image he presents.

It was a thought that soothed capital markets in the wake of the Tories' election victory, sending the value of sterling higher. But the government's announcement, and Frost's comments, suggest that Johnson's preferred Brexit may be harder than we thought. The government does not want a tailored trade agreement that keeps the UK aligned with EU rules and standards, but would rather have something like the EU-Canada deal, which abolished tariffs but kept significant trade barriers in place.

In his speech, Frost raised eyebrows by drawing a connection between trade rules and democratic consent – which he claimed would "finally and dramatically" snap if the UK were forced to abide by the union's rules. He was also clear that these statements are not "a simple negotiating position which might move under pressure – it is the point of the whole project".

The content of the message is not particularly new. Government officials have long lamented that Britain cannot be a "rule taker" in its relationship with Europe. But for a trade negotiator to wax lyrical about the philosophical underpinnings of Britain's independence – and for the Prime Minister to so publicly announce his demands on the eve of talks – is significant. This is almost certainly why sterling has fallen against the

dollar and the euro (though, with the financial turmoil around coronavirus fears, such trends are hard to pick out with confidence).

Of course, it could be that this is posturing after all. Johnson has always placed a high value on establishing a credible threat in Brexit negotiations, but as the negotiators know themselves, every form of overseas trade requires a compromise of one's own specific standards in order to generate products and services that can be distributed in regions under differing jurisdictions. Nevertheless, judging from markets, foreign investors now seem to be convinced that a harder Brexit is the endgame. And importantly, even if it is not, the government is increasingly backing themselves into the corner on the issue. Having so publicly declared that Britain would not accept any role for the European Court of Justice, it would now be extremely difficult for Johnson to backtrack on the issue. As such, there is every reason to take the government's proclaimed stance seriously.

That hardly spells good news for the UK economy. Since December's election cleared away some uncertainty, there has been a bounce in both consumer and business sentiment. But the fact remains that Britain is in a weak position economically. And, however much the government strives to not be a "rule taker", we are still a growth taker in relation to the EU. The prospect of severing ties with our largest trading partner in the summer – just as coronavirus fears are paralysing the global economy – is an uncomfortable one.

For the government, the added complication is how this will affect their budget. It is easier to go into negotiations all-guns blazing when the government still has fiscal firepower in case things go wrong. But the Institute for Fiscal Studies has already noted the government is unlikely to meet its manifesto pledge of a balanced budget in three years with spending plans as they currently are. Fiscal spending is expected to increase significantly at the delivery of the next budget – with some estimates suggesting as much as an additional 4% of GDP over the next five years. If that is not matched by an increase in tax revenue – which will only come with a strong enough economy – the budget deficit will balloon.

All of this leaves the UK in a difficult position in terms of its economy and assets. If the hard-line stance continues from Johnson and co, we may end up approaching another perilous 'no deal' deadline as early as June. And even if that works as a negotiating tactic, it will still do significant economic harm – as the last few years have shown.

US 2020 election update

Electioneering never stops in the US. Despite election day still some nine months away, the Republican and Democratic campaigns are in full swing for the Presidential, Senatorial and Congressional contests.

Barring a calamity, Donald Trump will not face any Republican challenge – since his party almost unanimously voting to acquit the President in the senate (a tearfully repentant Mitt Romney excepted).

The Democrats have no such certainty.

Their current most likely challenger is Senator Bernie Sanders. The underdog for the Democrat ticket four years ago, each day it becomes harder to see his opponents winning the nomination. Sanders is already

leading in delegates from states that have voted, and is predicted to win the biggest share on 'Super Tuesday', when 14 states will head to vote for their Democratic nominee.

The 78-year-old self-described socialist plans to shake up America's economy, financial system and political establishment. Many investors and business leaders have expressed concerns – especially those in the healthcare and financial sectors. Both Trump and Wall Street bond trader Jeff Gundblach have claimed that the almighty market sell-off this week is due to the Vermont Senator's success (we disagree as made clear in our opening article above).

In fact, Team Bernie has been the perceived frontrunner since the start of candidate voting on 3rd February. Markets paid little attention despite Bernie's policy proposals becoming more radical (by US standards) and his voter base more energised. The S&P 500 peaked last Thursday 20th February.

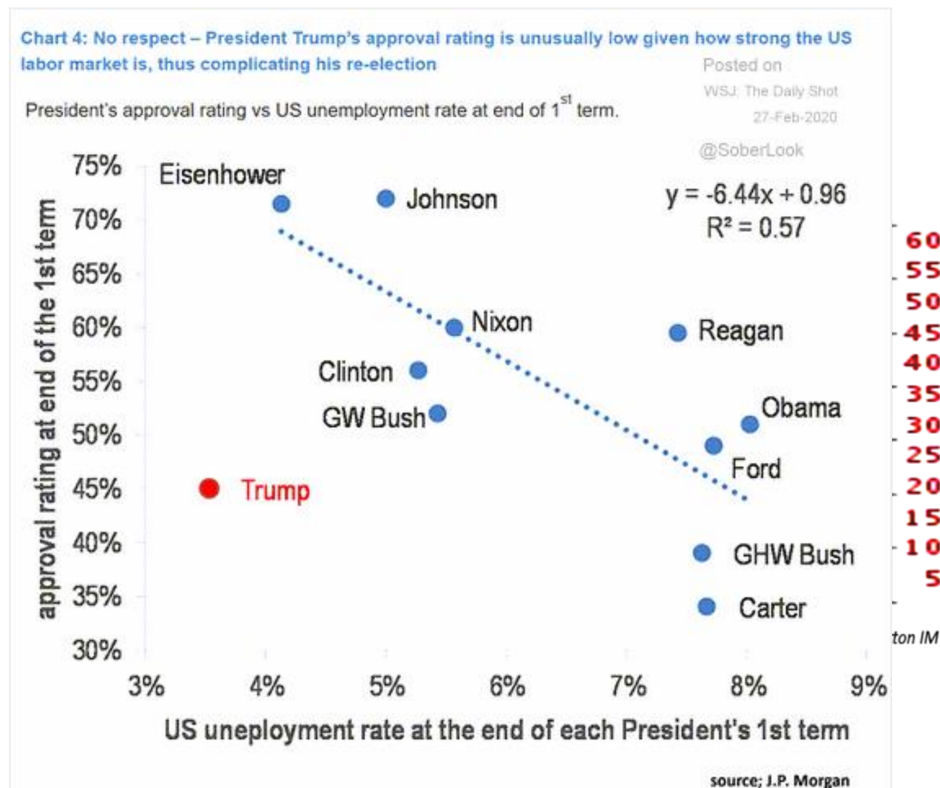
The explanation most seem to have for investors' sanguine attitude up to that point is the belief that Bernie is 'unelectable', his name on the Democrat ticket meaning four more years of Trump.

Indeed, some see an anti-Bernie wave robbing the Democrats of their hold over the House of Representatives in Congress. Florida, now the most important swing state, is a case in point. The Latin-American emigres and descendants split their allegiances between the parties. The Democratic Party supporters have tended to favour Sanders among the current candidates. However, few are fans of the dictators that their families left behind, so when Sanders' appeared to endorse Cuba's Castro regime, it was met with cries of anguish from the Florida Democratic congressmen and women.

Recapturing the House would leave Trump's Republican party in control of the presidency and both legislative chambers. We could then expect more of the same from the Trump administration, including possible further corporate tax cuts and deregulation. It would also mean a US Supreme Court dominated by conservative judges for many years, thus allowing Trump to gain control over the federal government's "independent" agencies.

It is not so clear that a Republican-controlled Congress and four more years of Trump would be unequivocally good for markets. There was the 'Trump trade' rally back in late 2016 when the President was first elected – on the expectations of tax cuts and regulatory rollbacks. But since then, the relationship between the commander-in-chief and markets has not been all plain sailing. His trade wars against China (and the rest of the world) have created a significant degree of uncertainty over the last three years. That destabilisation has been a big factor in reducing business investment, a crucial economic demand component which would have otherwise propelled economic growth.

What's more, the notion of 'electability' is pretty thin as far as political forecasting goes. Trump was previously the most unelectable candidate America had seen in a generation – right up until he was elected. According to some polls, Sanders tops Trump in a hypothetical head-to-head (as this Vox opinion piece outlines). In fact, all the Democrat candidates do, although Sanders has the biggest lead.



One of the key predictors of electoral results is the approval ratings of the sitting president. Trump's "approvers" (those who are positive as a ratio of all electors) is around 45%. This is surprisingly low given the strong state of the economy:

Meanwhile, the ratio of net approval (percentage who approve minus percentage who disapprove) is currently -9%. This has improved somewhat in recent weeks, but no incumbent has ever won re-election with approval ratings that low before.

Does this mean the Democrat nominee – even Bernie Sanders – is the favourite to win? Detailed forecasting based on individual states and incumbent popularity makes Trump's chances look a little better. According to forecasting site 270ToWin, Trump is roughly neck-and-neck against a generic Democrat candidate. His chances increase again when factoring in Sanders as the presumed opponent.

An unfortunate fact for political scientists is that, more than a few months out from an election, opinion polls have proven to have limited value. Such is the fickle nature of public opinion that what voters think today doesn't tell you much about what they will think in nine months.

And, as with everything else right now, coronavirus fears threaten to derail that. If the economy takes a turn for the worse, political scientist Allan Lichtman has gone as far as saying that it "would obviously doom Donald Trump." As would a perceived bad handling of a virus crisis. As you may recall, George W Bush's

approval rating never recovered after his mishandling of storm Catrina's devastation on New Orleans. Trump's press conference statement of Wednesday night, where he said: "Because of all we've done, the risk to the American people remains very low" may well return to haunt him fairly soon.

On the other hand, a Chinese style 'national emergency' approach could bolster Trump's support, making him appear a strong leader to voters. Since the start of the Democratic primaries, the betting market has raised the chances of a Trump victory but, at 60%, his re-election is not "a done deal". We think the odds are a fair reflection of the uncertainty; investors should not write off the possibility of Sanders winning the White House.

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2nd March 2020

Global Equity Markets

Market	FRI 15:47	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6466.4	-12.7	-937.5	↘	↘
FTSE 250	19075	-12.4	-2705.4	↘	→
FTSE AS	3613.7	-12.6	-519.0	↘	↘
FTSE Small	5347.8	-10.8	-648.0	↘	→
CAC	5237.3	-13.1	-792.4	↘	↗
DAX	11754.6	-13.4	-1824.7	↘	→
Dow	24777	-14.5	-4215.8	↘	→
S&P 500	2866.2	-14.1	-471.6	↘	↗
Nasdaq	8200.6	-13.2	-1246.1	↘	↗
Nikkei	21143.0	-10.0	-2336.2	↘	→
MSCI World	2177.3	-9.4	-225.6	↘	↗
MSCI EM	1030.7	-4.9	-53.5	↘	↗

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
NMC Health	9.7	TUI	-30.2
Pearson	-2.6	easyJet	-27.2
Rolls-Royce	-3.2	Int'l Consol Air	-24.8
Bunzl	-4.3	WPP	-24.0
Rentokil Initial	-4.9	Carnival	-21.5

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.281	-1.2	Oil	50.34	-13.9
GBP/EUR	0.857	-2.3	Gold	1580.5	-3.8
USD/EUR	1.10	1.2	Silver	16.61	-10.2
JPY/USD	108.03	3.3	Copper	252.1	-3.3
CNY/USD	6.99	0.5	Aluminium	1690.0	-1.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.44	-0.14
UK 15-Yr	0.65	-0.13
US 10-Yr	1.16	-0.31
French 10-Yr	-0.29	-0.09
German 10-Yr	-0.61	-0.18
Japanese 10-Yr	-0.15	-0.10

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.5	18.7	11.8	13.3
FTSE 250	4.2	22.4	13.4	14.3
FTSE AS	5.2	19.7	12.0	13.4
FTSE Small	3.8	-	-	13.9
CAC	3.5	18.9	13.1	13.5
DAX	3.4	20.2	12.8	12.5
Dow	2.6	17.6	15.7	15.1
S&P 500	2.1	18.9	16.5	16.1
Nasdaq	1.1	25.1	20.9	18.1
Nikkei	2.2	18.6	16.7	17.1
MSCI World	2.5	19.0	16.2	15.3
MSCI EM	2.8	14.4	12.6	11.8

UK Mortgage Rates

Mortgage Rates	Jan	Dec
Base Rate Tracker	2.51	2.48
2-yr Fixed Rate	1.45	1.45
3-yr Fixed Rate	1.59	1.57
5-yr Fixed Rate	1.69	1.69
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.27	4.27

* 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.

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