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Bob Moran on Jeremy Corbyn being prepared to support Theresa May on the right Brexit deal
Source: Political Cartoon Gallery; 28 Sep 2018

Poor politics containing bond market risks?

As September and Q3/2018 drew to a close, investors enjoyed a second consecutive week of positive returns, ending the period not only with positive returns overall, but also in an uptrend. This must have been all the more confusing for those who follow politics more than the economy and capital markets. In the UK, the volume of the domestic Brexit debate is gradually rising to a crescendo, in Italy the populist government agreed on a near doubling of the budget deficit which was met with disapproval from the EU and finally the tone between the US and China over the trade conflict deteriorated to the 'not-talking' level.

Cynics argued that stocks only rose because in light of rising inflation, investors shunned bonds and cash which only left equities as the least worst option. While there is some truth in this, it is nothing new. Not even that the US central bank, the Federal Reserve, raised rates again and for the third time this year to now just over 2%. The real news was that the US rate setters dropped the word 'accommodative' from their accompanying notes that describe their monetary policy.

Before the Global Financial Crisis (GFC) ten years ago this would have been a relatively regular change in central bank policy communication, but today it marks the end of one of the longest ever periods of extraordinary monetary accommodation. As such it was greeted as another sign that the global economy is further progressing on the gradual path of normalisation back to the 'old normal'.

Indeed, the global economy and capital markets appear remarkably robust in terms of consistent but not exuberant growth. The same cannot be said about the political environment, where the upheaval of the economic damage and financial aftermath of the GFC has led to an unexpected level of instability - with an immense time lag.

Political representatives of the traditional parties these days appear incapable to provide the stability of framework economies require to thrive. Their fearfulness that their electorates will succumb to the siren calls of populist politicians if they dare to support slightly more complex and cooperative routes to collective benefit rather than the simplistic self-interest of 'we win – you lose' is leading to increasingly bizarre results. Case in point is the UK, where neither of the two dominating political parties dares to admit to the public that any form of substantial exit from the trading framework of the past 40 years will at least initially worsen economic standards.

In the absence of constructive political debate, it is left to journalists, business and trade representatives to take hold of the debate. It seems very unorthodox that it is the non-political leaders of society who feel obliged to create a sense of urgency by pointing out uncomfortable truths and inevitable consequences of politicians' current course of action but also identify the more constructive paths towards solving the looming 'impasse'.

No wonder the British public is becoming increasingly alarmed as the press no longer merely reports and comments, but seemingly exaggerates deliberately in order to force politicians to take constructive action. It is sadly fact that in the first 2 years of Brexit negotiations very little progress has been made towards establishing mutually acceptable and constructive terms of an exit. While this is mostly blamed at individuals I suspect it is more likely the consequence of the vast majority of the political and administrative leadership of the UK being unconvinced of the benefits of a Brexit.

In such an environment of political indecisiveness it strikes me as very unlikely that far reaching economic decisions can be executed by weak political leaders. Much more probable that either a muddle through around some compromise relatively close to the status quo is pursued or the proverbial can is kicked further down the road - towards a further extension of the transition period, as now frequently suggested. Neither would be ideal, but certainly far less dramatic than the different opinion influencers are trying to portray April 2019 to be. I take comfort that capital markets appear to see it similar, with the value of £-Sterling recovering towards its pre-Salzburg levels rather than taking much note of the rising crescendo of the no-deal Brexit scaremongering that took hold of the public debate over the week.

In the US where a populist is in power the situation is slightly different. Trump's fiscal stimulus fireworks are beginning to shine less brightly, while the potential for collateral damage from his trade disputes with China are beginning to hold back business investment. The free trade agreements his administration reached this week with both South Korea and Japan make it seem less likely that the US will descend into a global trade war, but there are various rational arguments that suggest that Trump's America First dispute with China is not ending any time soon.

The difficulty is that rational arguments require rational politicians or at least decision making that follows historical precedent. Neither can be assumed for Trump and so it is preferable to go by those metrics that are more predictable. From this angle, the decoupling of US growth and stock market valuations from the rest of the world ended or at least paused over the course of September. Europe has not quite taken back the lead, but Japan's and the previously beaten up UK stock markets did.

In Europe much focus was once again on Italy, with fears for its bond market dragging down equities as the populist government hiked the budget deficit to 2.4%, much to the disapproval of the EU's leadership. We would note that 2.4% remains substantially below the EU's imposed 3% of GDP deficit limit while also still constituting a primary budget surplus – before interest payments. We are not the only ones who believe that Italy should be permitted some fiscal slack given its economic reform burdens and the fact it shoulders much of Europe's immigration pressures from Africa. Germany's politicians would do well to remember that they exceeded the EU's budget guidelines far more substantially in the early 2000's when they had become 'the sick man of Europe'.

From this perspective the pressure on Italian bonds appears somewhat an overreaction, although admittedly it should serve as a warning shot to the populists in government that if they take their fiscal initiative any further, then every additional Euro of stimulus may lead to an equal or higher debt servicing burden for Italian businesses, households and the government itself.

From this perspective it is not too far off the mark to conclude that the strong economic upward momentum which at the beginning of the year had led to fears of a disorderly bond investor exodus, has now been largely contained by political malfunctioning. The robustness of the global economic growth picture should mean that upward momentum can be maintained despite the political headwinds, while an overshooting that would destabilise fragile bond markets should be contained for the foreseeable future. From this angle it may be more understandable why stock markets have had a good September, even though political progress seems to have gone into reverse.

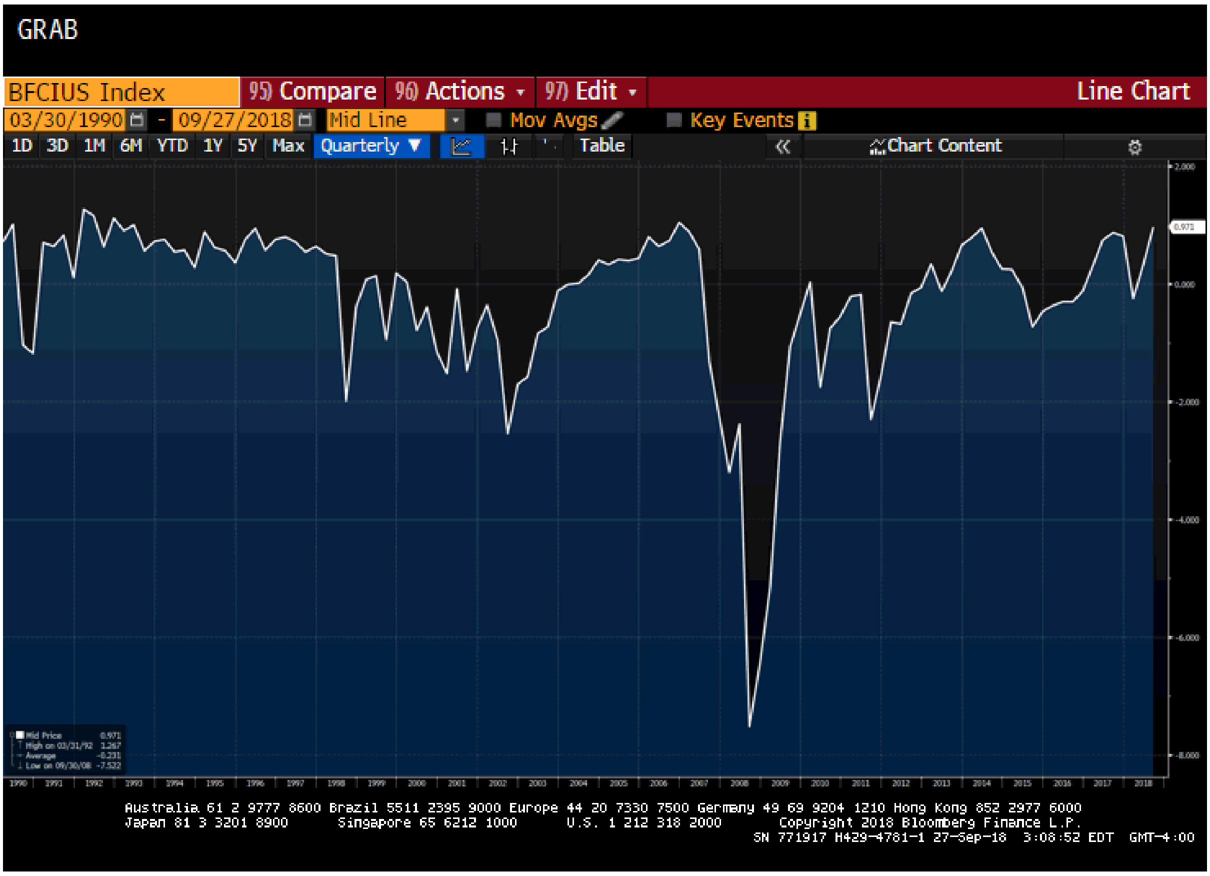
End of an era for the Fed

The era of unprecedented monetary easing has ended not with a bang but with a whimper. That is, in the US at least. The Bank of Japan (BoJ) and European Central Bank (ECB) continue to hold down interest rates and pump out money elsewhere around the globe. Nevertheless, the Federal Reserve's (Fed) rate hike this week was significant – despite not causing much of a reaction in capital markets.

While the 0.25% increase in the Fed funds rate was widely expected (in fact not doing so would have likely caused market gyrations), it leaves US interest rates above 2% for the first time in nearly 10 years. Historically speaking, that's hardly unusual. But the last decade hasn't exactly been usual for central banks all over the world. Now, the Fed's eighth rate rise since the end of 2015 looks like confirmation that we're now leaving it behind us.

In the aftermath of the financial crisis, the total fear that gripped the financial system forced it into a state of paralysis – tightening credit availability and by extension wider liquidity. In the throes of the worst global downturn since the great depression, this was liquidity the underlying real economy desperately needed, as it had not nearly shrunk as much as the collapsing credit markets. In came central banks, whose extraordinary measures sought to provide that liquidity through an expansion of the monetary base that credit markets were at that time unable to provide. Monetary policy had to loosen massively to offset the tightening going on in the financial system itself.

Nearly a decade down the line, we're finally seeing the reverse of this. The financial system is itself once again creating ample liquidity through an acceleration of the turnover of the monetary base (as recent scares over bourgeoning corporate debt show), to the point where the Fed's interest rate rises are mostly just keeping overall financial conditions stable. We've spoken about it plenty over the past couple



of years or so, but we're now firmly on the path back to the 'old normal'.

US financial conditions (indicator) since 1990; Source: Bloomberg; 27 Sep 2018

Like any big change, this brings challenges. Those highly leveraged businesses kept alive by cheap financing – the zombie firms – will naturally come under stress. Over the long term, this is often a force for good, weeding out failing business models and leaving a more productive economy. But the danger is that too many bankruptcies could cause enough of a short-term liquidity squeeze to starve the real economy of the money supply it needs, causing a downturn. You only need to look at the current troubles in China – where the deleveraging process is threatening to cause a downturn – to see that.

This would be particularly true if the Fed raised rates quicker than expected. That's why markets this week reacted negatively to what they perceived as hawkishness from the Fed – with chair Jerome Powell's comments and changes to the 'dot plot' (committee members' expectations of future interest rates) causing a slight fall in long-term US treasuries (US Government bonds). The central bank now seems to agree somewhat with the White House's high growth expectations, raising concerns that an overheating economy could force the Fed's hand.

That brings us to the 'orange elephant' in the room. At the beginning of the year, we feared that Donald Trump's loose fiscal policy would cause inflationary pressure, forcing the Fed to take action and risk a boom and bust style end to this business cycle. But now, we no longer expect this to happen. Why?

While Trump's tax break cranked up the heat under the American economy, it's likely that his trade policy will cool it off. The President's tariffs (and the retaliations from China) are expected to dampen global trade and activity – as tariffs are wont to do. Ironically, the dampening effect on US growth this could have would provide exactly the breather the Fed needs to be able to raise rates in a more gradual way.

Of course, there are understandable worries that his trade wars could have the opposite effect. Tariffs would undoubtedly boost prices for consumers, which cause inflationary pressures and could force the Fed to tighten monetary policy more aggressively.

But we don't expect this to happen. The Fed is unlikely to see a one-off tariff-induced price rise as anything more than transitory and will probably allow it to pass through without too much of a reaction. Their concern is an overheating economy, not one-off inflationary spikes.

This is a luxury the US enjoys alone. To defend pound-sterling after its Brexit-induced suppressed value caused a spike in UK inflation, the Bank of England (BoE) felt obliged to raise rates, and would have to do so again in similar circumstances. This is because the BoE had to defend the value of sterling, or ultimately risk having to run to the IMF for a bailout.

As the world reserve currency, there is next to no risk of that happening to the US dollar. That puts the Fed in a fortunate position, allowing them to focus on the underlying economy rather than currency markets.

That likewise puts investors in a fortunate position. With the dampening effects of Trump's tariffs and the continued steady rate path of the Fed, a boom and bust in the US looks less likely. Of course, this doesn't mean everything will go swimmingly. Once the BoJ and ECB join in the tightening, it's entirely possible that global liquidity could dry faster than anticipated. US treasuries, previously pinned down by yield-chasing investors unhappy with non-yielding Japanese and German bonds, could be under particular threat should inflation eat away at the yield – especially considering Trump's appetite to issue more of them to finance the fiscal expansion of the Federal budget. Over the medium term, longer term US bond yields returning to historically common levels of 4-5%, from their current levels of around 3%, is therefore not a completely outlandish expectation.

But this is part and parcel of the ongoing normalisation process. And over a decade after the crisis turned the financial system upside down, maybe that's not a bad thing. It's unlikely to hurt the real economy too much as long as the adjustment process remains gradual and businesses have headed the advice of their financial advisers. In many cases, they will have secured the low rates of the past years for some years into the future through more longer term borrowing than they might have done in the past.

Tariffs mitigation – the world's reaction to America First

As you would expect in our weekly investment meeting, we have spent quite a lot of time discussing the changes to the global trading environment since Donald Trump became President. Whether Donald Trump has achieved "more than almost any other administration in … history" (which caused the tittering from the United Nations General Assembly of government heads from around the planet) is debatable. One thing he has done, however, is to create some turmoil with his America First trade war.

Trump's reasoning to protect America's interest has been steadfast since his election campaign and he started as soon as he took office, abandoning the Trans Pacific Partnership early in 2017. Since then, the US has announced tariffs on imported solar panels and washing machines (January 2018), steel and aluminium (March 2018), and threatened tariffs on car imports. Trump ended the North American Free Trade Agreement (NAFTA), reinstated economic sanctions against Iran and of course started a tit-for-tat trade war with China.

Even though the GDP impact of trade with China in the US is less than 1% (even as the largest trading partner in goods), the ripple effect on non-US global trade will likely be more significant. Last week, we touched on how car manufacturers are very sensitive to changes to cross border sanctions, but that applies equally to smartphones, tablets and other tech.

The need for non-US business to maintain trade and work around (not necessarily against) the US became more evident this week with a number of news items that caught our attention.

On Monday, the EU announced that it is creating a new cross border payment mechanism Special Purpose Vehicle (SPV) to allow countries both within the EU and elsewhere to transact with Iran and avoid US sanctions and "assist and reassure economic operators pursuing business with Iran." Federica Mogherini, the EU's high representative for foreign affairs, told the UN General Assembly on Tuesday that "no sovereign country or organization can accept that somebody else decides with whom you are allowed to do trade with."

That the EU SPV is highly unlikely to work (since the US is the dominant economy in the global financial system and the US can simply adjust its sanctions to include the SPV itself or any business that uses it) is in some ways irrelevant. It is a blatant and public demonstration of international frustration that Trump directs his sanctions and tariffs indiscriminately towards allies and adversaries. A further example came on Tuesday from China's vice minister of commerce stating that Beijing and Moscow could combine their efforts to counter the impact of Washington's protectionist trade policies.

Which leads onto the real target lined up in Trump's trade tariff cross hairs: China.

The challenge for China is that the trade war is escalating at a time when its growth is already in slowdown, in part as it seeks to reform its financial sector to manage debt and create more sustainable expansion. Increasing tariffs on US goods in direct retaliation to Trump's administration is underway. However, some analysts are concerned over other actions China can take to make life more difficult for US companies operating there.

In previous trade disputes with the US, as an analyst at fund manager Neuberger Berman points out, consumers in Japan and South Korea boycotted US goods through a sense of national pride. Something similar could well happen in China, where national pride is strong. For China, their emergence as a new superpower in its terms is simply re-establishing its position in the world, before the destructive impact of Western powers in the 19th century: Britain, France and the US. Taking on the US in trade war taps into that deep sense of national pride. As such, President Xi Jinping cannot lose face in the trade war with the US for more reasons than the economy.

So, on Wednesday, China unveiled plans to cut tariffs for non-US imported machinery, electrical equipment and textile goods. This effectively cuts the prices on over 1,500 industrial products by an estimated 60 billion yuan (US$8 billion) this year alone. Is this reduction in general (non-US product related) tariffs from 9.8% to 7.5% – making non-US products cheaper in China – a tactic to create a longer-term drop off in demand of US products?

Perhaps, but the behaviour of China has principally been retaliatory to the actions of Trump. So what is his next move?

As we have said in the past, Trump delights in the art of the deal. His tactics come in three phases: threaten and make a lot of noise, act unpredictably and then come back to the negotiating table. This appeared to work with the European Union, as Trump's smiling handshake with Jean-Claude Junker on the lawn of the White House staved off that trade war. It also worked with Japan and South Korea, with both of which the Trump administration reached bilateral free trade agreements. The difference between the EU, Japan, South Korea on one side and negotiating with China on the other is that the former are allies of US, even if the US dominates the alliances. China and the US are adversaries, which explains why the Chinese cancelled trade talks this week.

Where we go from here is unclear and much depends on the results of the US midterm elections in November. The Republicans are predicted to do badly and lose their majority in the House of Representatives (the 'lower house' of the two chamber US Congress). Therefore, for the time being, Trump is unconcerned with the actions of other economic regions and the domestic contagion of some of his sanctions. Instead, he needs to promote his America First agenda and keep saying he's winning to gain Republican votes. There will be no change in rhetoric in actions in the short term.

Either way, win or lose in the mid-terms, these are the tactics he has adopted to create an administration better than 'almost any other.' He has indicated he wants to run for a second term in office and its likely he will want to create a political legacy defined around his deal making. With just one tactic and China in no mood to cut a deal, the trade war is not likely to end any time soon.

Are Emerging Markets reaching an inflection point?

To say Emerging Markets (EM) have had a disappointing 2018 is an understatement. Year-to-date, EM equities (MSCI EM Index in £-Sterling) are down –4.2%, while US equities have enjoyed double digit gains.

Trump's trade war and a higher US dollar (that impacts $2.3 trillion dollar denominated debt) appeared to ignite the negativity, particularly around China's exports, sending local shares on the Shanghai Composite -15.6% lower. Additional pressures in Turkey (Turkish Lira is -60% lower) and political issues in Brazil (the Real is down ~24%) added to the gloom.

Investor sentiment has been markedly negative during 2018. But is there potential for developing equities to bounce back, and are there now some bargains in EMs?

Four pivotal events occurred this week that may perhaps mark a turning point for EMs.

1. On Monday in New York, President Trump signed a revised free trade deal with South Korean President Moon Jae-In.
2. China's State Council lowered import tariffs for MFN (Most Favoured Nations – that theoretically includes the US) from an average of 9.8% to 7.5% - perhaps a tactic by China to defuse trade tensions.
3. The IMF announced it would provide a $57 billion bailout agreement with Argentina to halt the economic, currency and financial crisis hitting the country.
4. The US Pastor at the centre of the dispute between the US and Turkey, which triggered the US sanctions and expedited the currency crisis, might be released in the near future. This should thaw relations, while a more conventional monetary policy stance from the Turkish central bank, spurred a rally in the Lira.

The clear theme emerging over the past few months is that, while the US remains a key figure in international affairs, countries are responding to Trump's more isolationist 'America First' policy by building new bridges with other nations and lessening their collective reliance on the US. For example, this week, the EU announced an SPV (Special Purpose Vehicle) to help transfer payments to Iran as an alternative to the US controlled SWIFT system.

This growing interconnectedness between EMs – particularly in Asia, is becoming more evident as China's "Belt & Road" initiative seeks to transform trade in South East Asia, Europe and Latin America. Essentially, China is emerging as the dominant force around which other SE Asian nations cluster, benefitting economic growth.

From a market perspective, investor positioning in the US has become a crowded trade. On a Price-to-Book basis, the S&P500 trades at historic 2x premium versus the rest of the world (RoW) and a similar picture appears on a Price to earnings (PE) basis.

We do not believe this situation can continue; US growth looks like it's peaking. So the days of rampant outperformance of US equities might be over. Any trade de-escalation, or a sudden pivot by Trump on China, could weaken the US dollar and put EMs on a more positive footing.

Trump's pick of tariffs and exclusions were chosen to limit damage to the US. But applying tariffs to all China trade could lead to higher prices for US consumers and weaker corporate profits (as Nike and Ford warned this week). To counteract this, Trump tried to prepare the US for a trade war by cutting taxes and enacting other stimulus measures to make the economy more resilient. Trump's trade escalation clearly caught China off-guard, coming as the country was deleveraging its financial sector through a clampdown on shadow banking. Its economy was therefore hit.

Recent price action has helped buoy depressed investor sentiment for EMs assets (of which China is the largest component of and MSCI may double China's weighting in the EM index – which would automatically attract an estimated additional $66 billion in flows from index trackers). The four events listed above may collectively get investors to begin discussing the opportunities rather than the downside risks for EM assets in the remainder of 2018.

This is in contrast to July, when EM assets were largely flat, but valuations were not as depressed and investor interest less concrete. Of course, there are still downside risks looming (further Fed hikes, geopolitics, and few tangible signs of a real turn in EM growth), but the shifts in Turkey's central bank, a soft US inflation reading, and tentative signs of China easing suggest that EMs may have the potential for a bounce.

But such a move would likely require an improvement in the growth differential between different regions (which has fallen precipitously this year). Fortunately, we think EM growth has good prospects between now and mid-2019. This is backed up by the reassuring increase of financial stimulus figures (Total-Social-Financing) in China and recovering demand for commodities. However, for the moment we interpret this as a signal of EM growth stability (supportive of equity) rather than outperformance.

Given 2018's bearish sentiment, early signs of growth stability, and low valuations, the tide could soon be turning for EMs. The global growth cycle is far from over and stresses in EM are considerably less today than in previous episodes, such as the 2015 crisis.

For this one only has to view the scale of two key EM stress drivers: USD and commodities. In 2014-16, the USD jumped 25%, versus 2018's 5% move. Given that the dollar is trading close to the top of a 5-year range, it's unlikely the greenback would rally a further 10-20%. Quite simply, neither the Fed nor Trump would stand for it. Back in 2014-16, commodity prices slid 45%, but are down a more modest 7% this year. On this basis, EM stress today is 5x smaller than those experienced during 2014-16. The big differentiator this time is that interest rates are structurally higher. Back then, EM equities fell -35% in US dollar terms.

Investors generally treat EM as a single bucket, lumping together Asia (mostly finished goods exports) and LatAm (mostly commodities). So when EM sentiment turns more negative, all EMs generally get caught up whether deserved or not. A more selective approach to the EM investment universe, separating out the different regions could be beneficial, given the differing prospects for each.

Overall, there are some positive signs for EMs. The improvement of situations in Turkey and Argentina and China's countermeasures to stimulate demand are chief among them. In the past, Chinese stimulus has tended to spill over to EMs, first through SE Asia and then more widely. That's why, having been heavily underweight EMs for most of 2018, we are now becoming more positive on EM assets, which look cheap and with considerable recovery potential in places. But as ever with EMs, risks and uncertainties remain – Trump's trade war chief among them. We will be watching, assessing and debating the situation closely over the coming weeks.

CAMBRIDGE
INVESTMENTS LIMITED

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Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7530.6	0.5	40.3	↘
FTSE 250	20343.4	-1.2	-247.0	↘
FTSE AS	4138.3	0.2	9.7	↘
FTSE Small	5829.6	-0.1	-6.3	↘
CAC	5501.2	0.1	7.0	↘
DAX	12266.0	-1.3	-164.9	↘
Dow	26476.8	-1.0	-266.7	→
S&P 500	2918.8	-0.4	-10.8	→
Nasdaq	7637.8	1.4	106.8	→
Nikkei	24120.0	1.9	445.1	↘
MSCI World	2188.7	-0.5	-11.3	↘
MSCI EM	1051.3	0.0	-0.1	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.2	16.7x	13.5x	13.0x
FTSE 250	3.3	17.9x	14.7x	13.9x
FTSE AS	4.1	17.2x	13.6x	13.2x
FTSE Small	3.8	-	10.8x	13.7x
CAC	3.1	17.6x	14.7x	13.2x
DAX	3.1	14.4x	13.4x	12.5x
Dow	2.1	18.8x	16.9x	14.9x
S&P 500	1.8	21.1x	18.1x	15.7x
Nasdaq	1	26.6x	21.9x	17.6x
Nikkei	1.7	17.4x	16.9x	20.0x
MSCI World	2.3	18.8x	16.5x	15.0x
MSCI EM	2.7	12.7x	12.1x	12.0x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
RANDGOLD RESOURCE	10.9	MELROSE INDUSTR	-9.3
SKY	9.0	RSA INSURANCE	-8.4
NEXT	5.8	EASYJET	-5.9
ASTRAZENECA	5.2	DCC	-5.6
COMPASS GROUP	5.0	INTL CONSOLIDATED	-5.3

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	-0.22	OIL	82.7	4.9
USD/EUR	1.16	-1.10	GOLD	1190.9	-0.8
JPY/USD	113.56	-0.85	SILVER	14.7	2.6
GBP/EUR	0.89	0.82	COPPER	281.1	-1.6
CNY/USD	6.87	-0.17	ALUMIN	2030.0	-0.6

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.575	1.4	0.02
US 10-Yr	3.048	-0.5	-0.01
French 10-Yr	0.807	3.6	0.03
German 10-Yr	0.474	2.6	0.01
Japanese 10-Yr	0.130	-2.3	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.75
3-yr Fixed Rate	1.83
5-yr Fixed Rate	2.04
Standard Variable	4.33
10-yr Fixed Rate	2.76

* LTM = last 12 months' (trailing) earnings; **NTM = Next 12 months' estimated (forward) earnings

For any questions, as always, please ask!

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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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