THE **CAMBRIDGE** WEEKLY

26 November 2018

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KAL's view of the meeting between Trump and Xi at the G20 – ready to embrace for a brotherly hug; Source: Political Cartoon Gallery in London, 23 Nov 2018

Muted replay of 2015 or end of cycle approaching 2019?

It certainly helped nerves this week that the US was distracted by their Thanksgiving celebrations and politics in the UK calmed down, after the Eurosceptic Tory rebels' spectacular failure to deliver on last week's promise to bring about a vote of no confidence against Theresa May's leadership. Still, stock markets took little notice and continued their decline, fanning widespread discussion over whether a 2019 global economic downturn has become all but certain, now that risk asset markets seem to be anticipating one.

As discussed last week, this feels reminiscent of late 2015 and early 2016, to the point of a déjà vu. Back in Q1 2016, 'Mr. Stock Market' was proven wrong by reaccelerating economic growth on the back of Chinese fiscal stimulus and a windfall from lower oil prices, as well as falling credit yields. This time around there is again stimulus from China, though it is admittedly less decisive. But added to this we also see considerable (yet waning fiscal) stimulus from the US. The oil price and bond yields have once again fallen, but nowhere nearly as much as back in 2016.

On the other hand, economic activity has not decelerated as much either and corporate profitability has continued to increase rather than contract. Unfortunately, just as back then, global liquidity supply – read cheap credit – has been reduced just as much if not more by the combination of US central bank monetary tightening, inadvertent Chinese monetary tightening (through their crack down on their shadow lending markets) and the usual retreat of short term risk capital we see once a market correction gets into full swing.

Unfortunately, the advanced stage of this economic cycle increases everyone's suspicion that it's about to end, which in itself can create a self-fulfilling prophecy. But there are reasons for thinking that might not be the case. If 2018's slowdown cools the economy enough to stop major asset bubbles expanding to bursting stage or central banks raising rates too fast, it could merely prolong the cycle even more. Effectively, this correction may have created a far more solid base for 2019 than what we had at the end of 2018. Equity markets are no longer valued as uncomfortably high relative to their aggregate forecast earnings and dividend yields are back in sync with risen bond yields.

This leaves the risk that an external shock or central bank error on monetary policy could render current forecasts unachievable. This explains the even higher than usual attention on central banks' policy statements and the focus on any potential shocks from politics. We will not hear much from central banks until the end of December, but I would suggest that they are unlikely to become unsupportive of the economy, should markets by then have been proven correct in their implied anticipation of a substantial slow down.

So, back to politics. Over the course of the coming week, US president Trump's trade war meeting with China's leader Xi is likely to dominate headlines worldwide. There has obviously been plentiful analysis and speculation as to what may happen, but given Donald Trump's unpredictability I would suggest there is at least a 50/50 chance for either some form of breakthrough or another couple of months of utter confrontation. A breakthrough because the US president desperately needs a thriving rather than declining economy to stand any chance to get re-elected, or confrontation because Trump likes himself most when in 'deal making combat'. We will know more next week and discuss the outcome here.

Regarding Brexit, we will know more by Monday already, if the EU summit goes ahead as planned. Even after the relative calm in UK politics compared to last week, debate in the media would suggest that we are no nearer to knowing whether the next weeks see May's proposed EU Withdrawal Treaty terms for Brexit passed or another referendum or even another round of elections.

What we have observed this week is that politicians seem more uncertain about voting for a future relationship with the EU which (at least in the early years) will be less advantageous for the UK economy than the membership status quo, without returning envisaged levels of independence. On the other hand, do they ask the electorate for a second opinion, which will return the country to the level of division across society that proved so painful and divisive 2 years ago and is unlikely to resolve the dispute anyway?

Business leaders on the other hand appeared far more willing to accept the proposed withdrawal terms and leave EU membership and the prospect of regaining full sovereignty behind, given the terms seem much better than they feared.

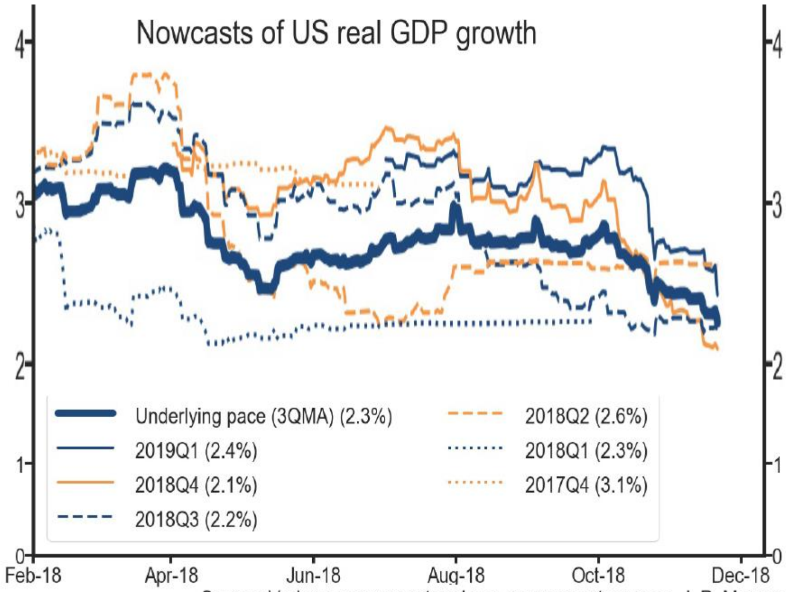
Either way, the prospect of a no-deal crash Brexit scenario appears to be fading, which was supported by a slight strengthening of the value of £-Sterling against the €-Euro and US$. In the past, this has proven a fairly reliable barometer for the state of Brexit.

Please return for our interpretation of the turns of the coming week for UK investors in The Cambridge Weekly next Monday morning.

US economy – weaning off cheap credit

During 2018 the US economy has once again been the global growth engine, after demand from China and business activity in Europe slowed. But with stock markets in the US now caught in the downdraft as much as elsewhere, even though consumer demand and corporate profitability remain as high as ever, it is worth taking a deeper look at what could slow the US economy down to a level that may justify recent stock market falls.

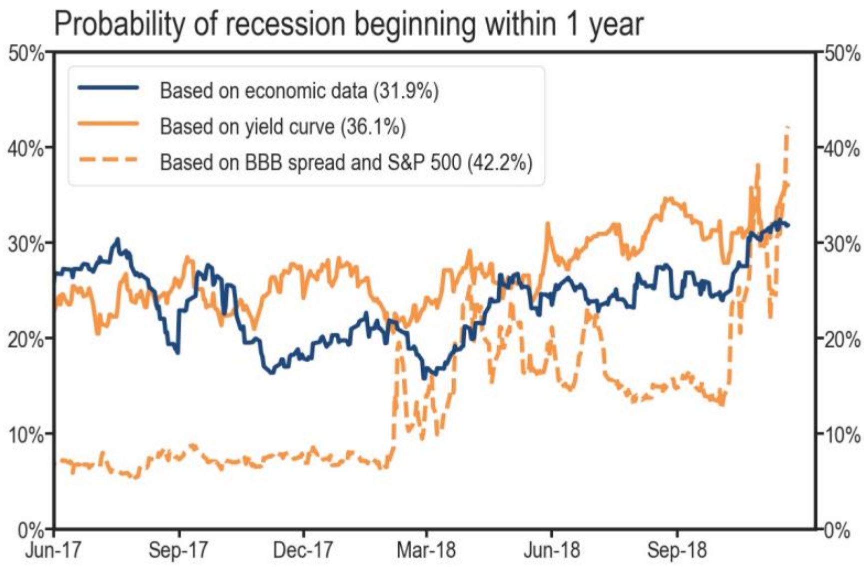
Despite the 25% corporate earnings reported for Q3, growth in forward looking US economic data has been slipping over the past few weeks. This follows quite a long period where the data had been strong, but not quite as strong as most economists were expecting. The chart below shows JP Morgan's estimate of the current pace of growth and how it's been declining since October, now running at an equivalent of 2.3% per year.



Source: Various government and non-government sources, J. P. Morgan

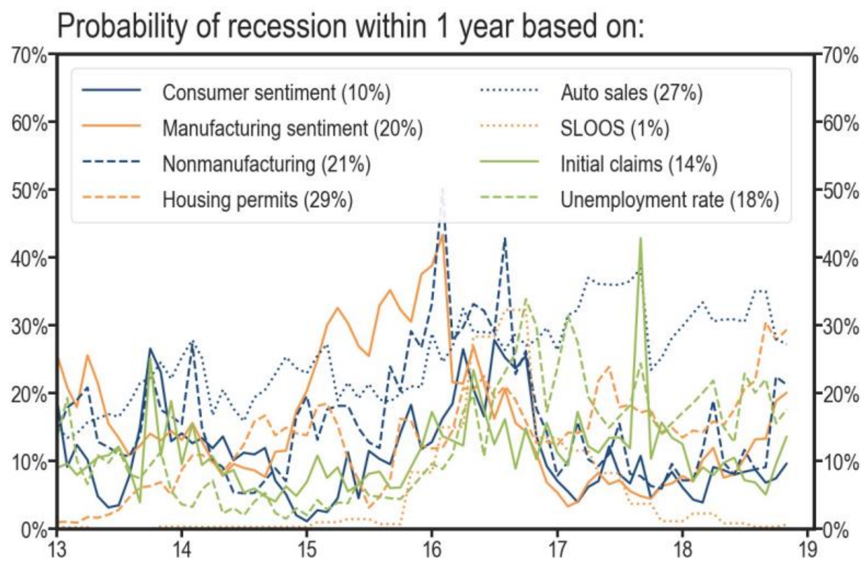
Clearly US economic growth has pulled back, at quite a fast clip.

Perhaps more importantly, financial market expectations for medium-term US prospects appear to have weakened over this month. The chart below, again using JP Morgan's work, shows the probabilities of a recession occurring within a year from now, as priced by the economic data, the treasury market, and the credit and equity markets:



Source: Various government and non-government sources, J. P. Morgan

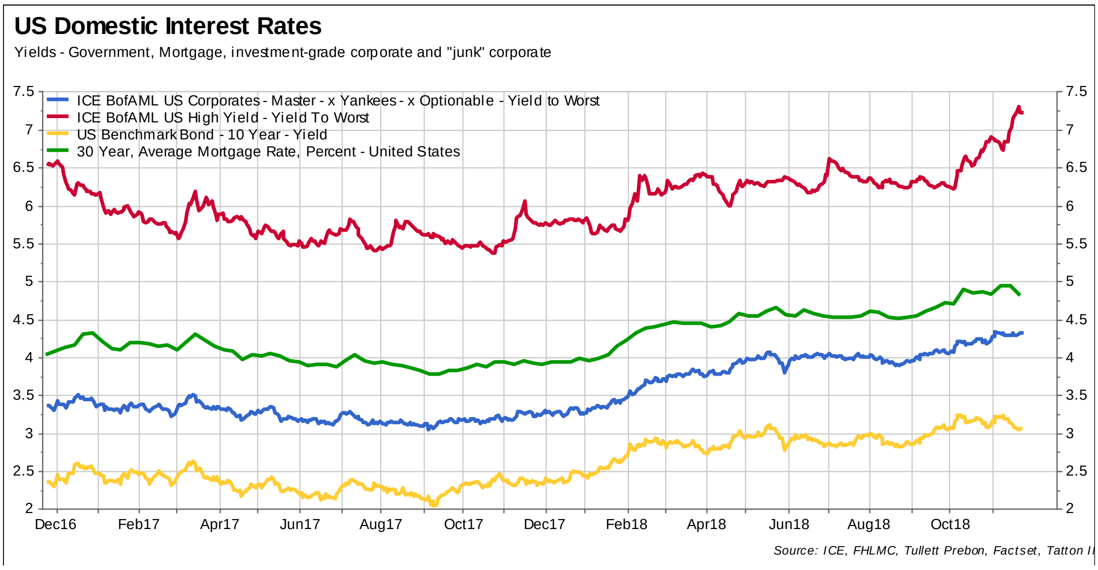
As we see here, all these indicators show the likelihood of recession increasing – not to levels that make such an event inevitable in the near term, but certainly higher than it has been. Of course, not all areas of the economy are under equal strain. The next chart shows which components of the economy are stressed and which aren't:



Source: Various government and non-government sources, J. P. Morgan

The good news is that employment indicators are robust, as is general consumption. The bad news is that housing has joined autos (problematic for some time) in being weaker after the mortgage rate rises. Also joining the problem areas is non-manufacturing, which is probably the major factor in this recent general shift.

The rise in long-term interest rates has clearly had an impact. The chart below shows the cost of capital being felt by the different sectors. In the last two weeks, mortgage rates edged back from 5%, in line with the fall in US treasury yields. However, this hasn't benefitted companies, especially those with lower credit ratings.



In the chart before, the line entitled "SLOOS" showed no recessionary indication. "SLOOS" is the Senior Loan Officer Survey (run by the Fed, surveying the US bank loan officers), released at the start of this month. It showed banks easing their terms of lending, generally a good sign for the economy. But it also showed a remarkable lack of demand for borrowing, especially from companies. That's a significant point. While banks are indeed more eager to lend, the data suggests that the demand for credit just isn't there.

This is part of a wider story we've seen since the financial crisis: since then, bank lending as a channel for finance has been almost irrelevant. Consumers have been choosing to pay down unsecured debt rather than borrow more. Meanwhile, the banks have not been involved in direct mortgage lending for some time.

As for corporate lending, the easing of bank regulation (that had been put in place in the aftermath of the financial crisis) occurred at the same time as companies had had their fill. The rise in borrowing from small and medium-sized companies has been sharp but hasn't come from banks. Rather it seems to have come from asset managers and private equity groups. Indeed, the rise in corporate lending has been entirely accounted for by the institutional bond and loan markets rather than banks.

Long-term investors appear to be the main providers of finance. For the Fed, this might present a problem. They inadvertently encouraged this through quantitative easing (QE) which drove down yield levels from traditional sources of securitised lending and made low risk investors more desperate in their search for yield. Now that the Fed is reducing their balance sheet through quantitative tightening (QT), which drives up yields and thus begins to trigger higher corporate default rates, long-term but low risk investors are reassessing the risks inherent in their fixed interest loan portfolio investments. Fears about market liquidity could cause individual investors to tighten financial conditions much more quickly than in previous years, just by trying to redeem their holdings in ETFs and other funds.

Banks may once again become a greater channel for the real economy next year and are willing to do so. However, it's not clear that the effective cost is yet cheap enough to do so. Meanwhile, the tightening of financial conditions driven by the long-term investment markets is likely to impact the US economy from now through to the end of the spring.

Putting it another way: investors may be thinking that recession risks have risen. It's the perversity of feedback loops that their risk aversion makes it more likely!

Investors may currently believe that the biggest risk with US economy stems from Donald Trump's trade war with China. However, as the analysis above shows, even if that potential economic obstacle was removed, the weaning off from cheap and abundant credit will slow US growth dynamics anyway. That is, unless the US central bank – the Fed – moderates its pace of interest rate rises enough during 2019 to allow credit markets to adjust so gradually back to the 'old normal' that demand doesn't slow, as we have seen in the housing and car sectors.

Recent reductions in inflationary pressures from falling oil and import prices may just be what the Fed needs to soften their general comments accompanying their next rate rise decision, which is all but certain as the outcome of their December meeting. Markets will be on tenterhooks to find support for their current expectations that the Fed will, at a maximum, only raise rates once during 2019, when until recently all Fed indications have been for at least three.

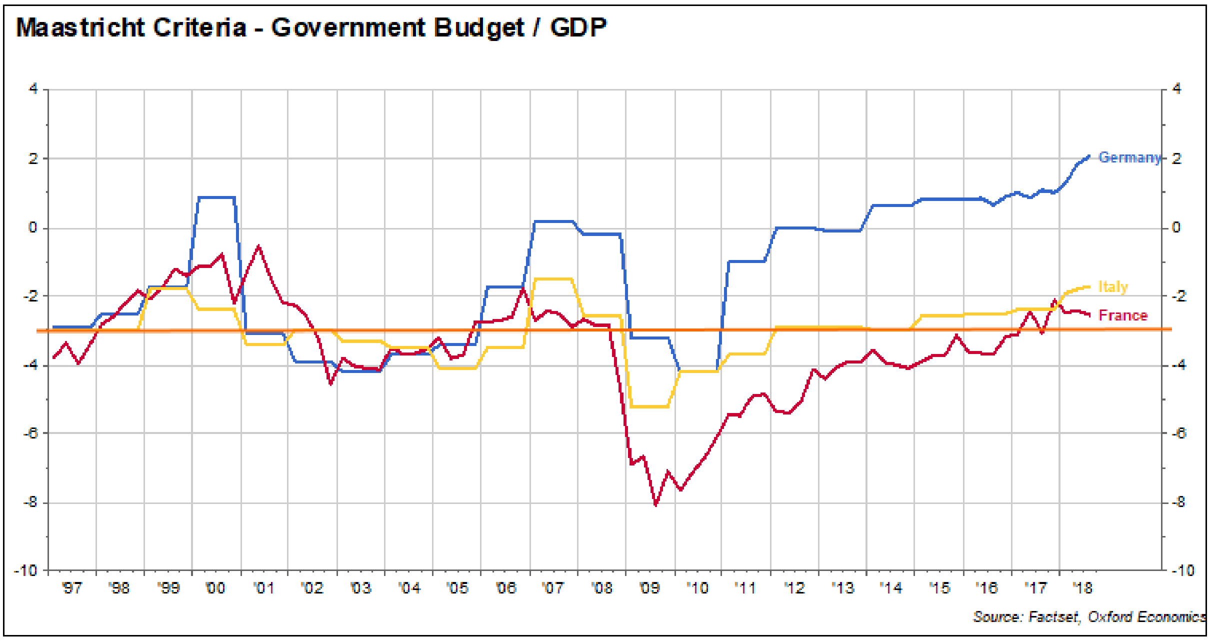
Italy suffers from lack of European Unity

As Brexit dominates headlines up and down the UK, you could be forgiven for thinking that it's doing the same on the continent. But on the list of issues preoccupying Brusselite politics, Italy's firebrand government is arguably higher up. Since the populist coalition came to power back in June, markets and European leaders have tossed and turned over their proposed expansion of the budget, and what it could mean for the EU.

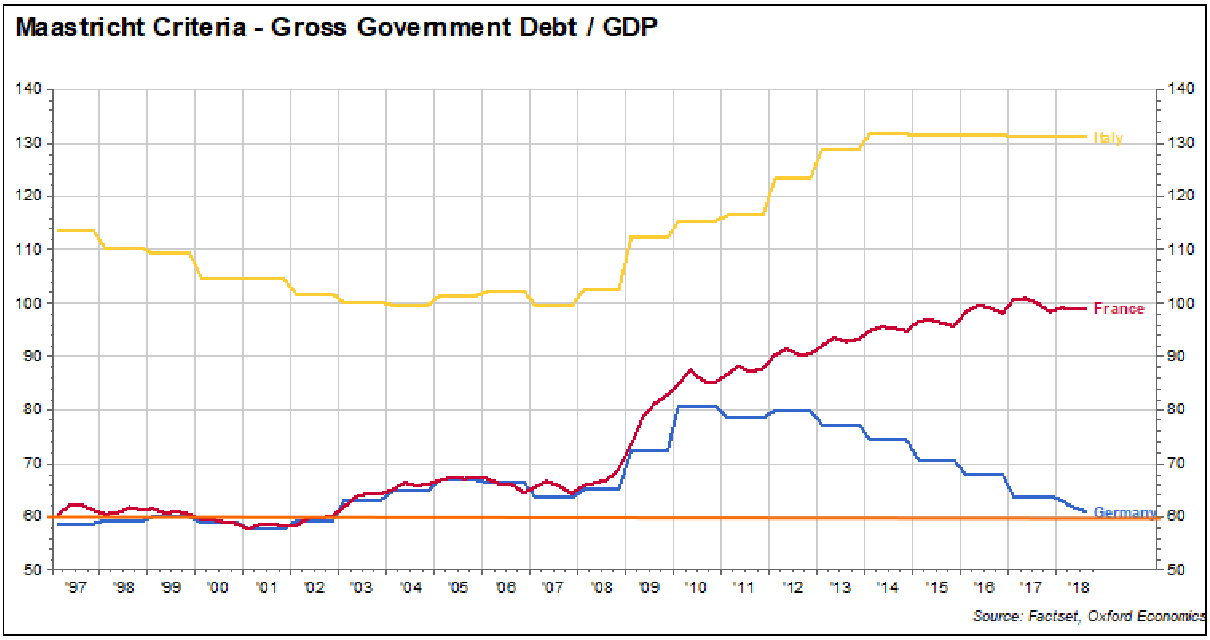
The Five Star Movement (M5S) and Lega Nord – Italy's governing populists and the two largest parties in parliament – both made election promises to increase state spending, and have shown since that they fully intend to make good on that promise. Predictably, this has attracted the ire of Europe's budget hawks, and sparked fears that Italy's debt situation could spiral out of control, potentially destabilising the entire Eurozone.

Lately, the Italian story has taken another scary turn. On Wednesday, the European Commission moved to enforce the "excessive deficit procedure" against Italy – a disciplinary mechanism that imposes fines for failing to meet Brussels' stringent budget rules. It has never before been used in the Eurozone's 20-year history, despite the transgressions of both the French and Germans.

Maastricht Euro Criteria 1: "Annual government deficit: The ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding fiscal year. If not, it is at least required to reach a level close to 3%. Only exceptional and temporary excesses would be granted for exceptional cases." (Economicshelp.org)

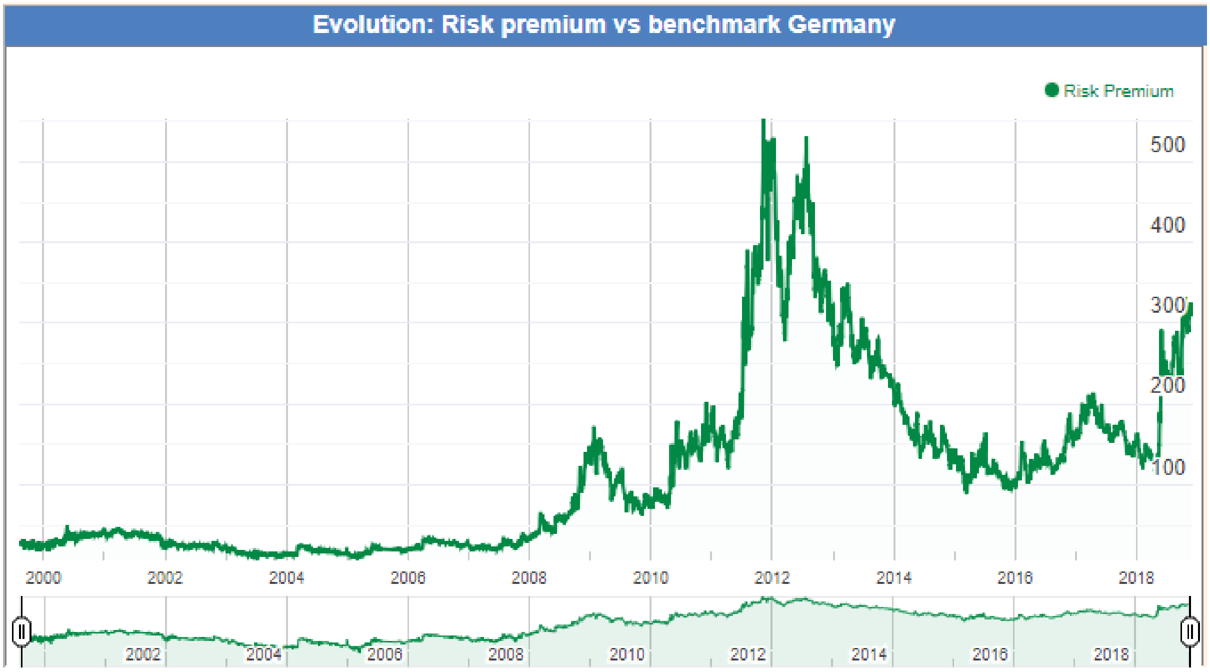


Maastricht Euro Criteria 2: "Government debt: The ratio of gross government debt to GDP must not exceed 60% at the end of the preceding fiscal year. Even if the target cannot be achieved due to the specific conditions, the ratio must have sufficiently diminished and must be approaching the reference value at a satisfactory pace." (Economicshelp.org)



In all likelihood, actual measures won't be used this time either. But using it isn't the point. By holding the threat of fines over the coalition, the eurocrats hope to widen credit spreads for Italian bonds, forcing the government to back down. The commission plan to punish Rome's recalcitrance by hitting them where it hurts: their financing costs.

But while the coalition's spending plans did initially cause a spike in Italian yields, bond markets failed to deliver the killer blow Brussels may have hoped for. Italian credit spreads are still at uncomfortable levels for the government, but they are acceptable. What's more, Lega Nord leader Matteo Salvini – Italy's de facto leader – is in a strong political position versus Brussels. With European Parliament elections coming up next year, the more that the eurocrats push back against Rome the more it vindicates the anti-euro



sentiment.

***Spread BTP-Bund**: Italy risk premium is the spread between 10-year Italian bond (ITAGER10), and the benchmark, 10-year German bond (bund) or 10-year U.S Treasury bond (T-bond). In other words, Italy´s risk premium is the increment in interest rates that investors have to be paid for loans and investment projects in Italy compared to some standard country (Germany or US). Source: Countryeconomy.com*

Italy hopes that, by that time, its fiscal stimulus will have fed through into the economy and delivered their target of 1.5% growth for next year. But on that front, things are less promising. Most forecasts for 2019 Italian growth are below that figure, and the IMF expects only 1% expansion in the Eurozone's largest economy. Despite improvements in recent times, Italy still suffers from a chronically sluggish economy, and a banking system struggling under the weight of non-performing loans. Recent spikes in bond yields have done little to help ailing banks either.

And all of this is without mentioning the elephant in the room: the ECB. Bond vigilantes may not have sunken the Italian ship just yet, but many suspect that a withdrawal of additional ECB bond purchases at the end of this year could see some holes appear. Come the beginning of next year, the ECB is set to stop its QE bond purchases, removing a vital source of liquidity that's been holding European yields down. Many investors worry that when that happens, it could lead to a bloodbath in Italian bonds – with potential repercussions throughout the Eurozone.

The major concern is what happens after that. Bond markets have been the demise of Italian leaders before. While the current leaders are not as Eurosceptic as is made out in some media, in a crisis it is possible that they could see a euro exit as preferable to the Troika's crushing bailout conditions.

Investors, a generally pragmatic group, see such a course as irrational; surely no one involved would let such a situation happen. But as we've seen in the past, eurocrats are there to enforce rather than decide. They have "form" in the use of brinkmanship, of teaching pesky governments a lesson. As we've written before, Italy is not a basket-case. While government debt is high relative to GDP, overall debt levels are low compared to the Eurozone. And the government even ran a primary budget (before interest payments) surplus last year. What markets fear is not that fiscal irresponsibility will itself plunge Italy into crisis, but that stubbornness on both sides will lead to mutually assured destruction by virtue of escalating cost of capital for the Italian economy.

Italy's major problem is that the single currency's structure has effectively left them with an overvalued internal exchange rate. This saps external demand from the economy, as Italian goods become more expensive than their European counterparts. Meanwhile, the union's budgetary rules prevent them from borrowing to stimulate internal demand. Without either of these sources of demand (and especially with an ailing banking sector) a sluggish economy is hardly surprising.

This shines a light on one of the Eurozone's greatest weaknesses: it has little means of stimulating internal demand. There is no fiscal union to act as a stabiliser during downturns, while budget rules prevent national governments from playing that role. French President Macron's push for a Eurozone budget to do exactly that – widely backed by economists – looked promising when it appeared to get the support of Angela Merkel. But the version that's made it past German scrutiny is disappointing. The Franco-German blueprint includes no mention of how big the budget will be, and talk of its "stabilisation" role has been omitted.

While disappointing, it's hardly surprising. Any move closer to the fiscal union has always been politically unrealistic. Even with the head of the Eurozone's second largest economy on side, the German government – and their electorate – remain the largest hurdle.

But as we have written here before, the way to solve these issues could be economic as well as political. Germany's own relative fiscal tightness and focus on export-led growth has historically left the Eurozone with a shortfall in consumption. But if that imbalance could be redressed and German demand stimulated, it would likely address many of the bloc's imbalances. Rather than pursuing political pipe dreams like a fiscal union, simply encouraging German and French consumers to buy Italian goods could do the trick. What's more, given Germany's reliance on the now struggling car industry, rebalancing the economy towards internal demand might not be such a bad thing anyway.

Of course, for Italy these ideas won't be much comfort in the short term. Salvini and co are right about one thing: if the Italian economy can grow well, suddenly its problems won't seem so bad. Where that growth will come from is another question. In the meantime, more 'showdowns' are inevitable, but given experience with previous 'Italian Jobs' and the EU's propensity for last minute compromises, it is not entirely unreasonable to expect the Italian budget issue to be long resolved before the UK has formally left the EU.

Is volatility paving the way for a 'Santa Rally'?

Investors have endured a bumpy ride during 2018. Initially, equity returns were driven up by a robust acceleration of economic and corporate profit growth, continuing the nearly uninterrupted upwards trend that began in 2016.

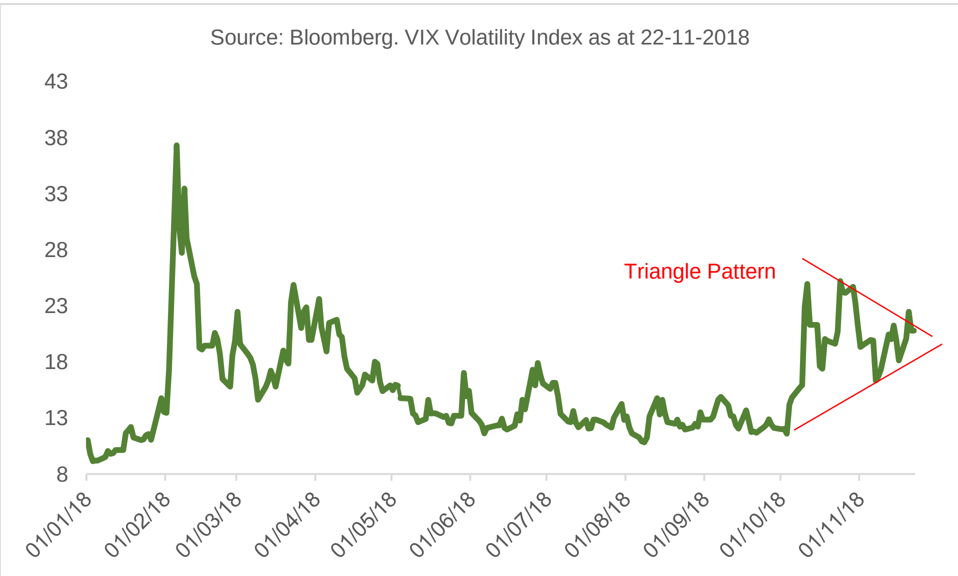
The steady upwards trajectory, accompanied by record low levels of volatility, had many investors lulled into a false sense of security. That serene environment was then punctured by two distinct market corrections, first in February ("Volmageddon") and again in October ("Shocktober"), leaving many global stock markets in the red on a year-to-date basis.

Each large market fall registered a big spike in volatility. This makes sense, as volatility rises in times of market stress and vice versa. February's move may have felt like a heavyweight punch for investors, but it was primarily technical in nature. It was triggered by a rapid decline in market liquidity and reduced trading volumes, during which relatively minor selling pressures had the power to send stocks reeling. This led to the single largest one-day jump in volatility ever recorded.

October's downward move didn't occur all at once like in February. It felt more like a prolonged series of bantamweight jabs, gradually wearing investors down. Markets fell for a total of 13 days during October on concerns that an aggressively hiking US Federal Reserve would add further downward pressure on lofty technology (growth stock) valuations – particularly for the FANG firms like Facebook, Amazon, Netflix and Google.

It remains to be seen if Apple has truly met 'peak-smartphone', which has seen its shares fall into a bear market, perhaps permanently perforating the crowded long growth (tech) story. While the events surrounding each downward shift are slightly different, the end result was the same – a volatility jump followed by a return to calm and maybe even complacency.

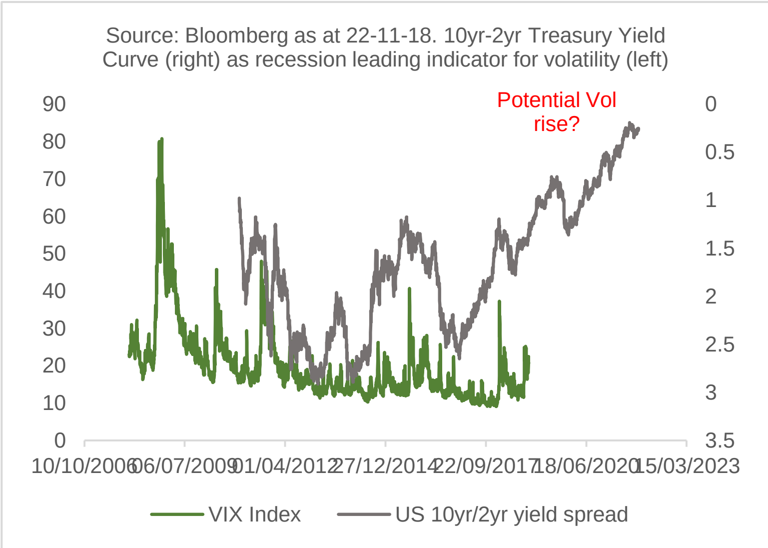
So what can the latest market action in volatility itself tell us about market prospects as we head towards



the end of the year?

From a "technical" perspective using classical chart analysis, the VIX (implied equity volatility index) looks to have formed a triangle pattern, suggesting – by historical precedence - a sharp move soon. A repeat of the February episode, when volatility spiked higher, would accompany a bearish equity market. However, a downward VIX break could be a sign that an extended market bounce (aka a 'Santa Rally') is on the cards.

It's too early to tell in which direction any break will occur, but a possible relationship between bond yield spreads (grey line) and volatility (green line) indicates caution ahead. The next chart shows the yield difference between the US 10-year and US 2-year bonds (subtract 2yr yield from the 10yr yield, inverted in the chart – i.e. the higher the less steep the yield curve) and how it tends to lead the VIX by three years.



As a possible explanation, a flattening in the yield curve has tended to precede recessions, which also lead to rising equity market risks. We may be in for an even bumpier ride in the next few years amid the start of a higher volatility cycle.

It's unfortunate that events in 2018 have proved challenging for investors and their portfolios, but the regime shift away from quantitative easing and ultra-low interest rates, towards higher rates and quantitative tightening was always likely to ruffle some feathers in capital markets.

This shift is occurring against a backdrop of slowing economic momentum and increasing divergence between countries. The result of these effects has been rising market volatility, which is unnerving for investors, leaving investment portfolios vulnerable to technical disruptions (February) and other behavioural biases.

Investors may have, over the past 25 years, mistakenly become reliant on central banks riding to the rescue to help dampen volatility in times of stress. But many are now waking up to the new (old?) reality of reduced liquidity; central banks have remained relatively tight lipped during 2018's corrections, leaving markets to themselves.

What complicates matters is that the era of the ultra-loose monetary policy was meant to be replaced by structural reforms and fiscal policy to boost growth (through business investment, household consumption and government spending). But excluding the US, most developed nations are still yet to adopt any significant growth policies.

That's not to say emerging economies aren't without their issues. Slowing consumption and bank lending in China are clouding the outlook, forcing the government to resort – once again – to policies that are facing waning potency as the economy matures. Movements in the US dollar and oil price further complicate matters.

While it can be easy to dismiss periods of volatility as transitory, it would be hard to argue against the fact that prolonged ample liquidity in the wake of the Global Financial Crisis (GFC) has left some investors overly exposed to sectors they might avoid in normal circumstances. In other words, the easy access to capital, together with the lack of decent low risk yields, led investors to take riskier positions. Now, markets are feeling the pain of unwinding those popular positions, especially in the tech sector.

Investor biases can also complicate the picture. Sudden market drops can lead investors to panic, selling what they can, not what they should, often leaving prices below what is justified fundamentally. The loss aversion bias is one example of an asymmetrical response. Losses feel more painful than any equivalent gains.

On top of this, the rise of passive investing has the potential to magnify moves, especially during tighter liquidity episodes (such as in February). "Cheap" passive funds deliberately forego the skill of an investment manager. At a fundamental level, a more volatile world will mean greater variation in corporate performance, perhaps warranting once again the use of more active management, sorting the winners from the losers.

Investors may also need to employ more resilience. The good news is that returns should actually improve but they may also take longer to materialise, and the wait is likely to be occasionally stressful. For the short period of time between now and the end of the year, determining whether volatility is indicating a rally or a lump of coal from Santa will be much harder from a fundamental assessment basis. Suffice to say that we will be closely monitoring market action for any near term technical breaks. Changes in volatility levels will be one of them.

CAMBRIDGE
INVESTMENTS LIMITED

26th November 2018

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	6952.9	-0.9	-61.0	↗
FTSE 250	18533.0	-0.3	-56.1	↗
FTSE AS	3812.3	-0.8	-30.8	↗
FTSE Small	5362.1	-1.4	-75.0	↗
CAC	4947.0	-1.6	-78.3	↗
DAX	11192.7	-1.3	-148.3	↗
Dow	24330.2	-3.8	-959.0	↗
S&P 500	2644.3	-3.1	-85.9	↗
Nasdaq	6540.5	-5.1	-350.0	↗
Nikkei	21646.6	-0.7	-157.1	↗
MSCI World	1984.0	-2.3	-47.7	↗
MSCI EM	976.0	-1.0	-10.3	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.7	15.8x	12.4x	13.1x
FTSE 250	3.6	15.7x	13.4x	14.0x
FTSE AS	4.5	16.1x	12.5x	13.3x
FTSE Small	4	-	12.9x	13.8x
CAC	3.5	15.3x	13.2x	13.3x
DAX	3.3	12.3x	12.4x	12.5x
Dow	2.3	16.2x	15.2x	15.0x
S&P 500	2	18.1x	16.2x	15.7x
Nasdaq	1.1	21.4x	18.1x	17.7x
Nikkei	2	15.0x	15.5x	20.0x
MSCI World	2.6	16.4x	15.0x	15.1x
MSCI EM	3	11.7x	11.4x	12.0x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Just Eat	8.5	Evraz	-14.4
Royal Mail	7.6	Centrica	-11.3
Compass Group	6.8	John Wood Group	-9.5
Severn Trent	6.3	Anglo American	-7.9
United Utilities Group	6.2	Rio Tinto	-6.9

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.28	-0.21	OIL	58.6	-12.2
USD/EUR	1.13	-0.71	GOLD	1222.7	-0.1
JPY/USD	112.84	-0.01	SILVER	14.3	-0.9
GBP/EUR	0.89	0.52	COPPER	276.9	0.8
CNY/USD	6.95	-0.15	ALUMIN	1946.5	0.9

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.381	-2.2	-0.03
US 10-Yr	3.048	-0.5	-0.01
French 10-Yr	0.721	-5.6	-0.04
German 10-Yr	0.340	-7.4	-0.03
Japanese 10-Yr	0.100	-3.8	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.71
3-yr Fixed Rate	1.81
5-yr Fixed Rate	2.01
Standard Variable	4.39
10-yr Fixed Rate	2.68

* 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

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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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