THE **CAMBRIDGE** WEEKLY

19 November 2018

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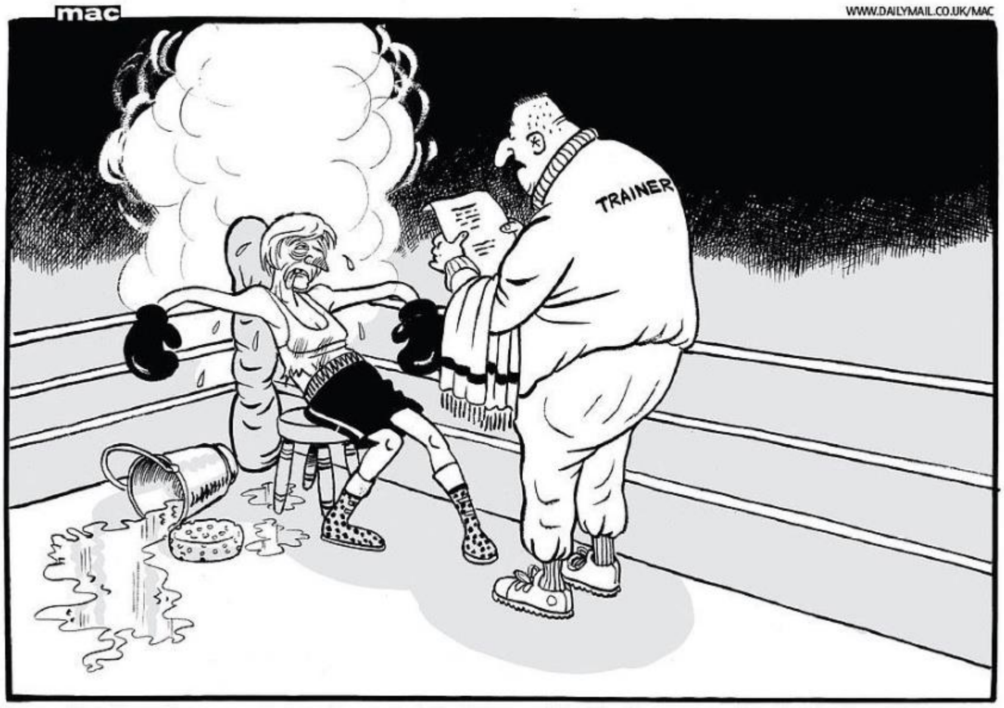


'Don't get too comfy, luv. Your next fights are with: the Commons, the Lords, the DUP and 27 other countries.'

Mac on Theresa May's EU Withdrawal Deal; 15 Nov 2018; Source: Political Cartoon Gallery in London

Keep calm and carry on

It has undeniably been the most unnerving week in UK politics since the week following the Brexit referendum, when the British electorate unexpectedly rejected the EU status quo. Representatives of both sides have finally agreed on a withdrawal agreement that lays out how to achieve a least disruptive Brexit as possible, that doesn't throw both sides into economic turmoil. And it's sent both ends of the UK's Brexit spectrum screaming in disgust.

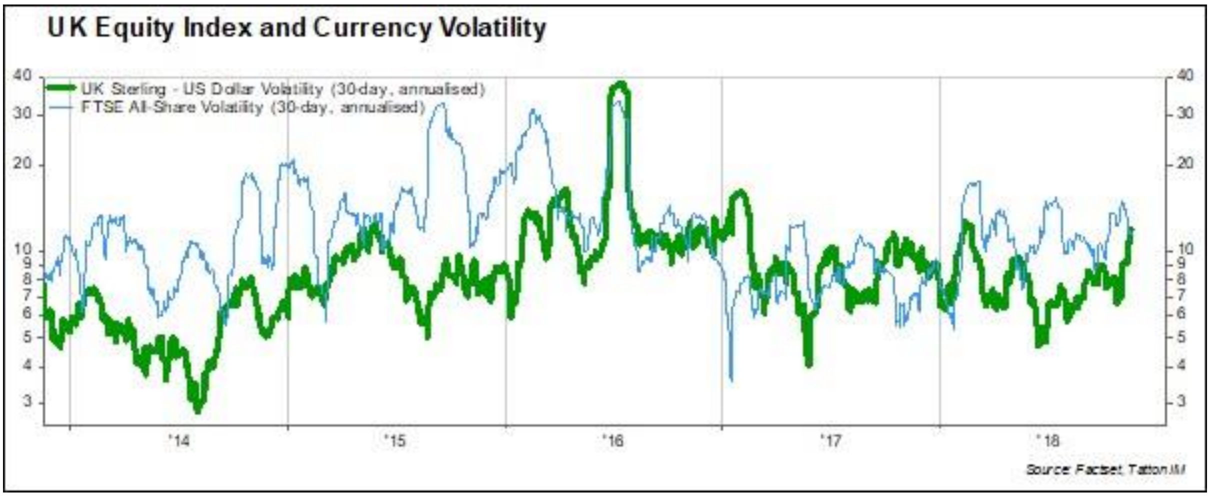
So, is this a true compromise, which makes neither side happy? Or, it is dawning on the Brexiteers that the whole 'cake and eating it' idea really has no chance of becoming reality and instead of owning up to the blunder they have returned to their cloud-cuckoo-land in which this is simply the wrong Brexit plan? The Remainers on the other hand see the turmoil of the "Brexit means Brexit" government as their chance to reverse the referendum outcome and return to the safety of the old status quo.

It was therefore interesting to note that in all of this noise only the business community appeared to support Theresa May's moderate route. Her gradual EU divorce would neither return the UK entirely to its pre-EU membership nation status, nor immediately expose it to having to re-establish new trade terms with the whole world. Or perhaps once again only the noisy fringes made themselves heard, and the majority in the middle kept stumm, because they realise that what is on offer may not be so bad - but is nevertheless only the best of a bad bunch and therefore a hard sell.

While there was much citing of adverse market reaction as if to prove the severity of the situation not just in terms of government continuity, our volatility chart below for the UK's currency and stock market shows that capital markets were far more alarmed during the summer of 2016 and even the Q1 2018 stock market correction.

Pessimists will argue that stock markets have simply not correctly priced in the rising probability of a disorderly no-deal Brexit crash out. We would instead side with the markets and suggest that the balance of probabilities stands against such an outcome. There's a higher likelihood that MPs will in the end support the lower risk option of 'Brexit means Brexit' on Theresa May's terms. If they shy away from the historic responsibility and ask the electorate for a second opinion, it could cost them their seats - whereas the no-deal option remains too unpalatable for anybody seeking re-election.

We have suggested since the summer that the end process would get very unnerving, unpleasant and



outright frightening, but in the end, we would get some form of a Brexit fudge rather than a disaster. The possibility of a second referendum may have risen over the week, but we still regard this as a low probability outcome, unless the EU suddenly offered some concessions around a pan-European migration framework which we attach a low probability to.

For the UK assets we hold in our investment portfolios, we believe that their comparatively low valuations reflect the most likely outcome of a lengthy muddling through towards a sort-of-Brexit but as a result offer a decent yield and plenty of upside potential. The downside risks inherent in this position is therefore well balanced by the possibility of a better than expected outcome.

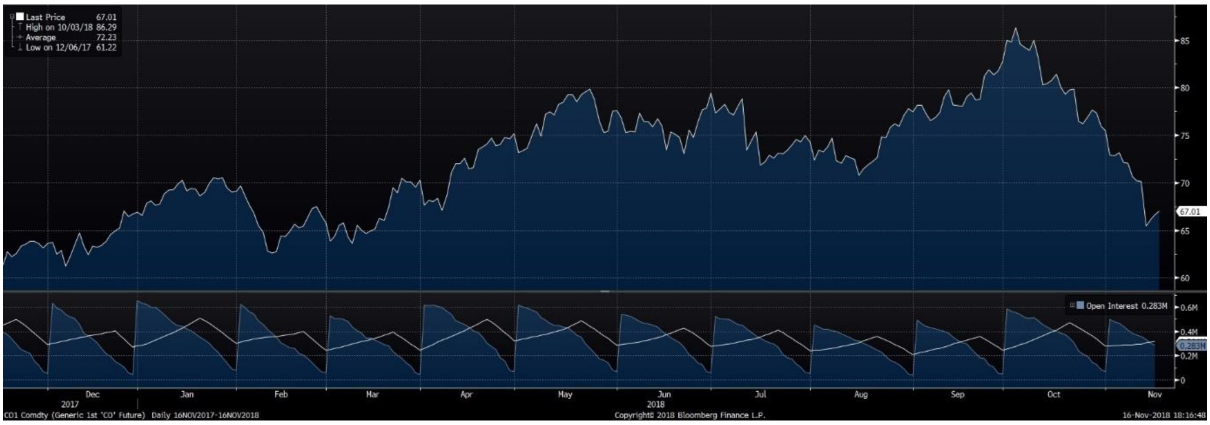
I suspect our readers and clients are just as tired with having to read about the Brexit process as anybody else across Britain and so I am more than happy to leave all further political comment to the journalist experts and their weekend papers.

While the Brexit drama for once caught international attention, it was still not the centre of attention for capital markets. Instead, there was a certain air of 2015 déjà vu, as the oil price accelerated its fall to reach -25% since its early October peak and the price of credit for the highest risk borrowers rose, while the demand for safe haven government bonds drove their yields down – for the first time during this correction. As during any previous risk-off period, there are suggestions that the stock market is just pre-empting a looming downturn – one that's not yet visible in the data. Cleary, the longer the current economic cycle lasts the higher the probability that such predictions eventually prove correct, particularly now that there is a real threat to the global trade framework through Trump's trade war threats towards China and a lesser degree Brexit.

It is also undeniable that, beyond the US, economic growth has slowed compared to 2017, with emerging market economies bearing the brunt of China's demand slowdown and Trump's fiscally driven US$ strength. However, if the biggest risk to the global economic cycle is the risk of a disorderly unwind of the bond market from historically low yield levels, then lower oil prices, lower US government yields and a reduced rate of global growth are all factors which lower the probability of such a bond market 'riot' actually occurring in the near future.

So, while the various signs of slowing are eerily reminiscent of late 2015, neither the oil price decline nor the economic slowdown are anywhere near the levels of back then. The global economy is also in a more stable environment. But, just as the lower oil price and lower yields of 2015/2016 turned into a formidable stimulus for late 2016 and 2017, the current price changes could serve as stimulus for 2019. Unfortunately, the pain of price adjustments to the changed outlook comes first and the benefit follows only with a time lag. Therefore, unless politicians either in the US and China or the UK and the EU provide us with somewhat unexpected positive surprises and reduce trade tensions, then the prospect for positive investment portfolio returns for 2018 are dwindling.

Sorry for being the bearer of negative news, but it does appear that what started as a very strong economic environment may once again be turning into a mini downturn, which introduces unwelcome market volatility but ultimately extends this economic cycle for yet another year or more.



Oil price development over the past year; Brent future in US$; Source: Bloomberg, 16 Nov 2018

Oil rollercoaster (again) or price 'reset'

Since the Q1 2016 lows of the oil price in the $30/bbl range the price oil seemed to know only one direction and that was up. However, when the oil price for Brent hit $85/bbl in early October, we wrote here (19 October) that we were sceptical that the oil price might – as suggested by some – climb further towards $100/bbl. Sure enough, since then we have seen a full reversal of the previous uptrend, with oil plunging continuously. On Tuesday, WTI sank a further 7% to $55.7 per barrel (bbl) – it's biggest single day drop in over three years – while Brent was down 6.6% to $65.5/bbl. This means that in little over a month, both oil price benchmarks have fallen by 25%, putting us officially into a bear market.

The financial media blamed this week's price action on an itchy Twitter finger in the White House. Despite oil already moving significantly lower, President Trump tweeted on Monday: "Hopefully, Saudi Arabia and OPEC will not be cutting oil production. Oil prices should be much lower based on supply!" Oil traders seem to suspect that US political pressure on Saudi Arabia will keep the oversupply flowing, driving down prices of crude.

Of course, Trump's tweets don't tell the whole story. But while the oil bear market is the result of a number of factors, most of them are to do with the US. In the weeks and months prior to the fall (amid steadily rising prices), the Trump administration put pressure on OPEC and Russia to add more oil to the market to counterbalance Trumps promise to flush out Iranian supply with crushingly harsh sanctions.

But while Trump tweeted to the world the "toughest sanctions in history", actual measures failed to live up to the hype. The oil sanctions imposed were relatively light compared to what was promised, and a sizeable amount of Iranian supply is still finding its way onto the market – around 500,000 more barrels a day than expected.

On the other hand, the White House was far more successful in convincing other oil producers of the probability of an oil shortage. Reports this month show that the Saudis upped their daily production by 700,000 barrels this year, while Russia added another 400,000 in daily production and Kuwait and UAE chipped in with a combined 270,000 increase. Iranian sanctions barely offset any of this; lost Iranian exports in October were only 525,000 a day.

And then there's the US supply itself. US oil production has soared in recent months, making the US now the world's largest oil producer, according to data for August. The world's largest economy is currently pumping 11.6mn barrels of crude out of the ground every day which, together with other fuel sources and gains in refinery efficiency, leaves them relatively energy independent. Everything else therefore merely adds to the oversupply.

All of that is only one side of the story. While supply factors continue to more than support markets, the demand side of the equation is struggling. Chinese oil demand – which in the past has often powered prices to new highs – is slowing as their economy does the same. In fact, a drive to switch energy generation to natural gas means that demand in the world's second largest economy is slowing even more markedly than their economic downshift would suggest. Meanwhile, emerging markets – the growth laggards of 2018 – don't have enough internal strength to fuel global oil demand.

Once again, however, US factors are arguably more important. Donald Trump's trade war threats against the world is expected to slow global trade and global growth with it. Already, we're seeing a rapid deceleration in air freight trade and shipping, and if more protectionist measures were to materialise it would mean less oil demand from US and worldwide economic activity.

But many are expecting US demand to slow not just because of Trump. The US economy is widely expected to come off the boil next year, and markets are increasingly betting on a downturn. While current data is far from awful, we are beginning to see signs of a slowdown, particularly in capital expenditure. The Federal Reserve's (Fed) Senior Loan Officer Opinion Survey – which collects responses from 70 domestic US banks – shows that demand for credit is decreasing, which suggests weakness in business demand up ahead. This might explain the slight fall-back we've seen in long-term US Treasury bond yields, with investors reducing their recently gushing optimism about the American economy. All the while the Fed continues to raise interest rates – possibly even faster in the face of Trump's inflation driving trade and industrial policies.

This all points to over- rather than undersupply in the short term, robbing the oil price of its previous upside potential. But then there could be some stabilising factors up ahead as well. Underinvestment in oil exploration equipment over the oil price downturn might well mean that current production levels prove unsustainable. And just as bullish oil made US shale producers rapidly turn their taps back on, falling prices could well do the opposite. Already we're seeing credit spreads widen on shale companies' corporate bonds, and more pressure could see some of them begin to default.

Outside of the US, falling oil prices will be a boon for many EMs, who – as we have written recently – could see a turnaround of fortunes as we move into next year. If so, this could generate increased demand to stop falling prices.

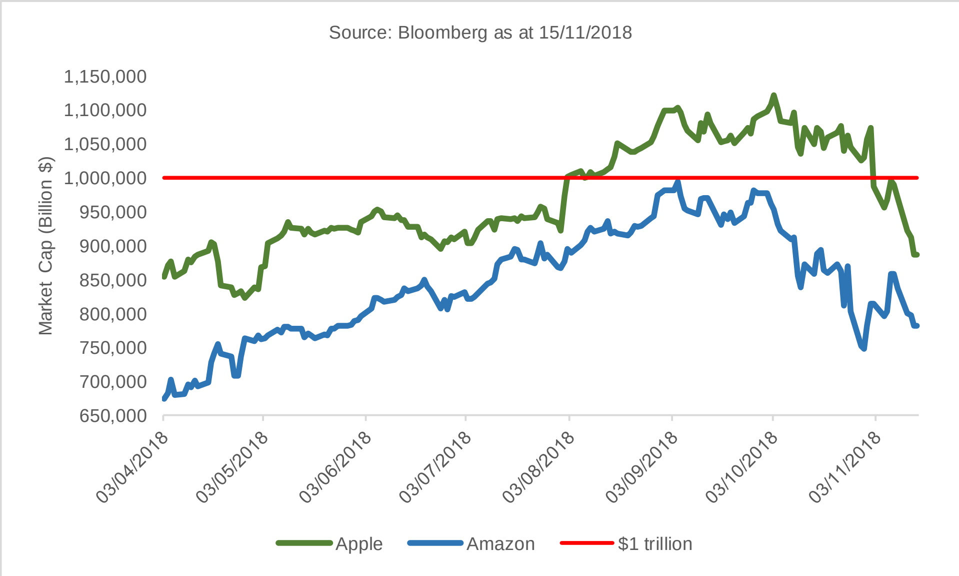
One final factor that could be at play here is investor positioning. As oil prices fall, we are seeing a number of more leveraged investors like hedge funds being forced to close their positions – either through losses or investor redemptions. This is potentially exacerbated by the fact the final date for redeeming hedge fund investments this year is approaching soon, and investors may want to cash out before the deadline. Given that many of these positions were long of oil, this could explain the increased selling pressure among traders. It will be interesting to see whether things will calm down once we pass this deadline.

Either way, the seemingly unstoppable rise in the price of oil has come to an end for now and whether this just leads to a more stable oil price level that balances supply and demand or leads to the return of the oil price rollercoaster of 3 years ago waits to be seen. We would suggest that just as there was little ground for oil prices rising above $100/bbl, there is now equally not much reason for prices to fall much further, as both the speculative interest overhang as well as the global oversupply are so much less pronounced than they were back in the run-up to the 2014 oil price bubble.

Cambridge Investments Limited

19th November 2018

Apple's waning allure and the pressures in the global tech sector



66 days. That's how long Apple's market value of remained over $1 trillion, with a high of $1.12 trillion on 3 September.

Since then, Apple's shares have gone only one way – down. Apple has lost over $230 billion in market value, abdicating its position as the only US listed firm to top the $1 trillion level. Amazon, who approached the trillion barrier back in September (but fell $5.2bn short), have seen similar falls.

At the beginning of the recent correction Apple's shares held up much better than the rest of the US tech FAANGs. But this week moved into a bear market, recording a fall of 20% from the recent peak. The world's largest company also slumped below a key technical level: the 200-day moving average (DMA). This came on the concern that demand for the iPhone – particularly in China – has peaked. But before anyone gets too dour, it's worth remembering that Apple's shares have still gained 12% year-to-date (YTD) on a total return (TR) basis, outpacing the 2.7% gain in the broader S&P 500 Index.

Apple's recent experience is not unique. Globally, the share prices of technology stocks have come under severe pressure, as the growth story over the past few years that powered indices higher seems to have come unglued – at least in the short-term.

Investors are left wondering just what is going on. We believe there are a number of factors that help explain recent movements in the wider tech sector.

High profile firms like Google and Amazon warned growth would slow. Semiconductor chip makers said end corporate demand had waned, leaving analysts little choice but to reign in overly optimistic earnings forecasts, denting enthusiasm for growth stocks (i.e. predominantly tech). Buying the dip (BTD) looks to have been replaced by 'sell any rally' (SAR?)– more so in tech stocks.

The higher potential growth offered by tech firms seemingly proved attractive to many investors chasing returns. As a result, growth stocks became a crowded trade. As with any fashionable trade, this made growth stocks vulnerable to rapid mean reversion. That's exactly what happened when sentiment turned last month.

Lately, tech firms seem unable to hold above 200-DMAs, amid rising selling pressures. It's interesting that this coincides with Thursday's (15th Nov) year-end redemption deadline for Hedge Fund investors, who have largely seen poor performance during 2018.

Perhaps they are grossing down leveraged positions in anticipation of investors wanting some of their money back? -Maybe it's just a spurious correlation, but Hedge funds were reported to have been increasingly using Bitcoin (crypto-currencies) as a hedging tool, so to see Bitcoin plunge 12% the day before redemption day is certainly curious. Especially considering Bitcoin's daily volatility had declined below that of the moves for the S&P 500.

The attractions of growth stocks for international investors and the sheer size of the US' tech sector (~20% of S&P 500) help explain the extreme divergence in performance against everyone else earlier in 2018. Maybe everyone wanted a piece of the [Apple] pie.

But why single out Apple?

To some, Apple may represent the biggest growth story of all. Going from near bankruptcy in 1997 to the US' largest company by market capitalisation is impressive. The return of Steve Jobs in '97 marked the start of the company's turn around and focus on product and User Interface (UI) innovation. The launch of the iPod/iTunes in 2001 brought the cool factor to consumer tech, which was previously dominated by functional, but visually unappealing slabs of black or grey plastic. By contrast, an Apple product was a statement more than an electronic device.

2007 marked the next upward shift in Apple's profits with the launch of the iPhone and its finger friendly UI (no dodgy plastic stylus required). Ever a fan of the 'rule of threes', Steve Jobs proudly promoted the first iPhone as an integrated web browser, iPod and phone. Ever since, the company has reported iPhone sales each quarter, helping to keep the narrative going that it was a market leader, with new models continuing to sell well to a growing user-base.

Investors used those quarterly iPhone sales numbers in their valuation models to estimate future profits. To this day, Apple remains one of the most covered stocks by analysts, with a total of 57 brokerage firms tracking the stock (27 are 'Buy' ratings, 20 'Hold' and just 2 rated 'Sell').

The market was shocked to learn that Apple would no longer provide quarterly unit sales numbers, with management saying they were "less relevant" as the company should be seen as a services business rather than a seller of iThings.

Investors were not happy. Shares fell 7% on the news. Sure, the quarterly revenues of its services unit are worthy of a place on the Fortune 500 list of firms, but we think that the management's shift in reporting focus may have permanently punctured Apple's growth and market leading narrative.

The obvious question arises: does Apple have something to hide?

Apple's new focus will be on providing sales/revenue numbers only. This 'trick' nicely clouds a possible fall in unit sales, which can be offset by increasing ASP (Average Selling Price) – such as the $200 price jump for the newest iPad.

For analysts, so long as Apple can maintain price increases in the face of falling units – as are being reported in China this week – then sales may look ok. But consumers can only stomach so many price rises before turning to something cheaper.

This has led some to ask if Apple is approaching the ergosurface or boundary of an event horizon, where the Apple magic and growth story fades and the company's products are just seen expensive yet pretty things.

Today, even a £300 phone can do most of what a £1,000+ iPhone can do. That's the danger the company faces – the shift to a profitable niche but one with decreasing unit sales. Apple may be the world's most profitable company, but it would only take a small sentiment shift to make it just another tech firm. Blackberry, Motorola, Nokia and not to forget Sony have taught us that the path towards commoditisation looms in the future.

Supplying unit sales allowed us a window into Apple's future trajectory. Just giving us sales numbers obscures that. Don't forget Ford was once the market leader. Now it's just a decent car company, but certainly not the most valuable (ironically the most valuable tends to be fashionable, but small in overall unit sales).

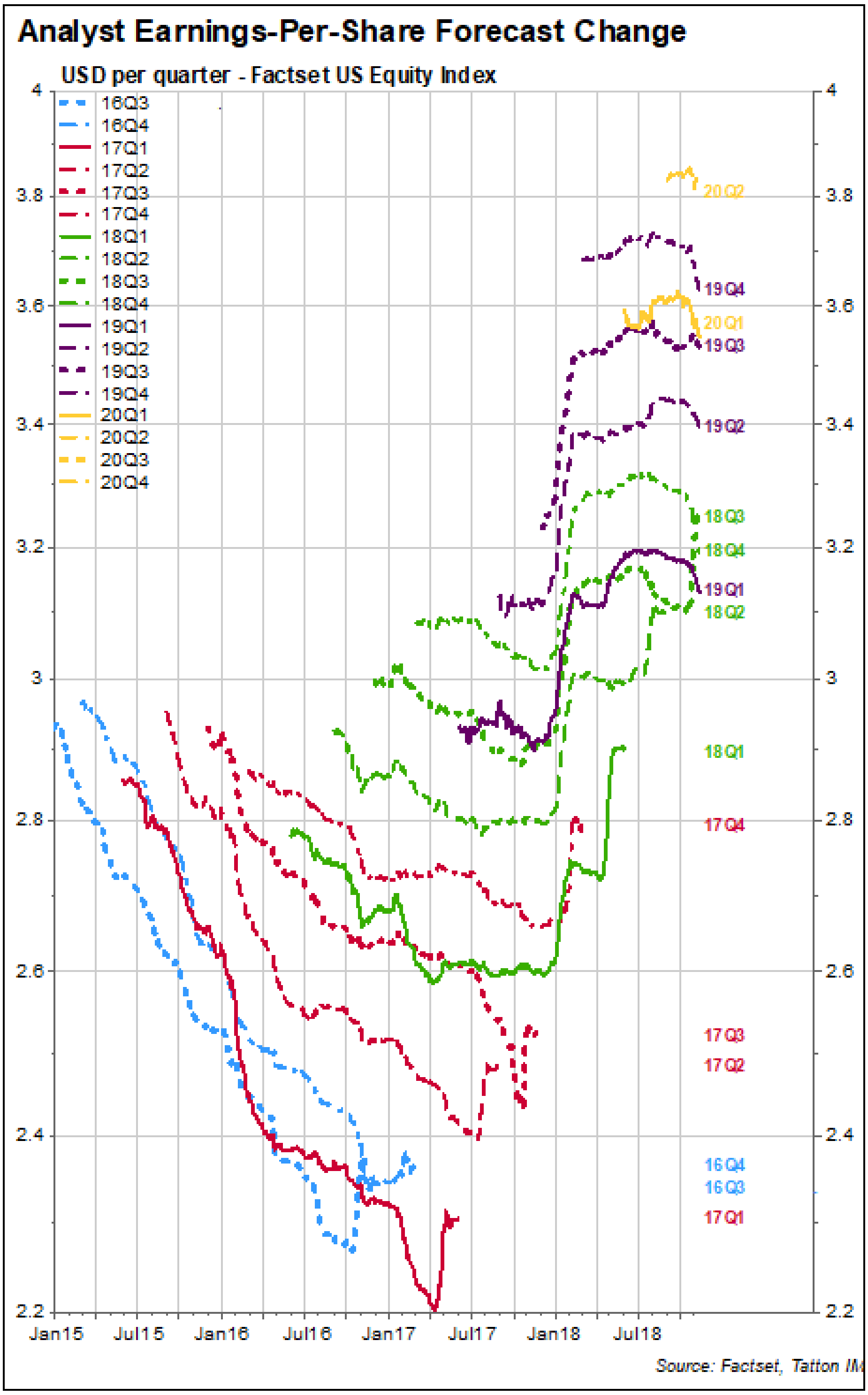
Anything else in Apple's results that gives that impression?

Investors have become laser focused on the outlooks for 2019 and Apple is no different. The company's 2019 revenue forecasts were disappointing – mainly on softening emerging market demand (read China and India).

Then came negative news from Apple's supply chain this week. The magnitude of the profit warnings from suppliers for parts used in iPhones suggest that Apple might be closer to the event horizon than many believed possible. Perhaps it suggests Apple's struggles have far wider implications for other mobile phone manufacturers.

Lumentum (3D sensing cameras used for FaceID) lowered guidance by 17%, the UK's IQE announced one of its largest customers (Apple?) was cutting shipments and Japan Display's quarterly results were 30% below market expectations, forcing it to lower its outlook.

These announcements forced Goldman Sachs to lower iPhone unit sale forecasts by 6%, FY19 revenues by 3.5% and the share price target by 6% to $209. As a result, tech stocks took another sentiment knock. But analyst forecasts do matter for investors, as they provide a guide to forward expectations.



The tech sector has seen some of the most aggressive downgrades in recent weeks. Sometimes it's not the numbers that count but sentiment. The green lines – 2018 – have largely seen large upgrades as the announcement drew nearer – a result of the tax cut boost in the US. Growth in 2019 (purple lines) remains positive (I.e. drawn at a higher level, but the rate of change is much slower than in previous years, leading to fears that the growth story is nearing its end.

Perhaps as a response to slowing future growth, tech firms have ramped up share buyback and investment plans (+42% to $42.6 billion). The five tech firms with the largest cash reserves spent $115 billion on their own shares between Q1 and Q3 of this year. Apple alone has $73 billion on authorisation – more than 463 of the S&P 500 constituents made in revenues over the last year.

As a reminder, share buybacks reduce the overall number of shares in circulation, which means per share profits get an artificial boost (as the divisor is smaller), creating 'value' for shareholders.

Lowered profit forecasts by analysts have a potential negative side effect on company valuations.

A quick analyst forecast model building lesson: Analysts use Discounted Cash Flows (DCF) as the basis for determining an estimate of a company's worth. If a stock is simply the sum of a stream of future cash flows measured in today's terms using the interest rate from a 10-year bond (Net Present Value) then higher interest rates and lowered future sales lowers valuations.

These pressures are not unique to Apple; we see them in the tech sector as a whole – markets' growth engine in recent years. Other parts of the tech sector have been flagging the prospect of still positive but slowing growth. Apple was thought to be a special case in the growth story, somewhat immune from factors impacting others, but management's decision to reduce disclosure (iPhone unit numbers) may have perforated the Apple magic.

Sir Isaac Newton's thoughts on gravity were inspired by the falling of an apple. Perhaps Apple's recent fall will stir something within investors. Either way, the share price growth narrative looks to be subject to gravity (or at least some downward revisions). Thus far the jury is still out whether this tech share bear market is heralding a reduction in revenue and profit growth rates or simply constitutes a correction of previous overvaluation and assumptions of exponential growth.

It is worth remembering that the attraction of tech growth stocks was their innovation driven expansion dynamic that during the past decade of low rates of general economic growth offered much higher returns on investment than almost any other part of the economy. Should the return to the 'old normal' we experienced over recent times pause – as it has done before in this very extended economic cycle – then the attraction of tech growth may well return quite quickly.

Hopefully, for now, the price correction from exuberant levels and more realistic growth assumptions will simply mean that tech stocks return to a less exposed market trajectory and investors' share capital allocations once again reach wider parts of the productive economy.

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Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7013.9	-1.3	-91.5	→
FTSE 250	18589.1	-2.7	-517.5	→
FTSE AS	3843.1	-1.5	-58.6	→
FTSE Small	5437.1	-1.1	-60.3	→
CAC	5025.2	-1.6	-81.6	→
DAX	11341.0	-1.6	-188.2	→
Dow	25299.7	-2.7	-689.6	↗
S&P 500	2723.5	-2.1	-57.5	↗
Nasdaq	6825.3	-3.0	-213.8	↗
Nikkei	21680.3	-2.6	-569.9	→
MSCI World	2026.3	-1.8	-36.9	→
MSCI EM	980.9	0.5	4.7	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.6	15.9x	12.4x	13.1x
FTSE 250	3.6	8.4x	13.4x	14.0x
FTSE AS	4.4	14.5x	12.6x	13.3x
FTSE Small	4	-	13.0x	13.8x
CAC	3.4	15.5x	13.4x	13.3x
DAX	3.3	12.9x	12.4x	12.5x
Dow	2.2	16.9x	15.8x	15.0x
S&P 500	2	18.7x	16.6x	15.7x
Nasdaq	1.1	22.4x	18.9x	17.7x
Nikkei	2	15.0x	15.5x	20.0x
MSCI World	2.5	16.8x	15.3x	15.1x
MSCI EM	3	11.8x	11.5x	12.0x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Micro Focus Int.	13.9	BAT	-18.3
Paddy Power Betfair	10.0	RBS	-13.9
Vodafone Group	6.6	Taylor Wimpey	-11.7
Smiths Group	4.5	Persimmon	-10.8
Reckitt Benckiser	4.4	Ocado Group	-9.9

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.28	-1.03	OIL	67.2	-4.3
USD/EUR	1.14	0.61	GOLD	1221.1	0.9
JPY/USD	112.78	0.93	SILVER	14.4	1.4
GBP/EUR	0.89	-1.64	COPPER	275.9	2.8
CNY/USD	6.94	0.27	ALUMIN	1929.0	-3.1

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.412	-5.3	-0.08
US 10-Yr	3.076	-3.3	-0.11
French 10-Yr	0.764	-2.9	-0.02
German 10-Yr	0.367	-9.8	-0.04
Japanese 10-Yr	0.104	-15.4	-0.02

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

For any questions, as always, please ask!

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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