CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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Matt - Turkey's plan B - Delay Christmas, 7 Dec 2018 - Political Cartoon Gallery in London

Roller-coaster Advent

The news of a 90-day trade truce between presidents Trump and Xi's was widely welcomed this week. It was probably the most that could be expected of their much-anticipated dinner conversation at the fringes of the G20 summit last weekend in Argentina. Despite offering the prospect of a road-map to new trade terms and thereby the potential for defusing the biggest concern for any 2019 outlook, its good news fuel for stock markets only lasted for a one-day stock market rally, before equities were once more caught in selling downdraft.

UK investors could be forgiven for thinking Brexit blues is what's holding down the British stock market. After all, it's widely expected that parliament will reject the withdrawal deal on offer. But no: it had all to do with continued trade concerns and a partially inverted yield curve. Trade war concerns quickly returned with a vengeance after the finance director of China's largest IT company Huawei was arrested at the behest of the US in Vancouver. And with 5-year yields this week falling to lower levels than shorter term US bond yields, the predictive power of yield curve inversions is creating additional fear, given every US recession since WWII was preceded by a yield curve inversion.

We have written about this phenomenon here before and it is worth repeating that (a) the reverse is not also true, i.e. not every yield curve inversion has been followed by recession, (b) when inversions were

followed by recessions, marked economic slowdown had preceded the inversion, (c) this is currently only a partial inversion in the middle of the yield curve and (d) the US central bank has already signalled that it will consider pausing further interest rises should the economy slow, which is likely to steepen the yield back to normal.

On the trade war side, it transpired over the week that the Huawei arrest was very likely unrelated to the restart of the trade negotiations and in any case the Chinese appear to have decided to not let this sideshow get in the way of their efforts to resolve the trade issues.

Against the backdrop of otherwise stable if uninspiring macro-economic news flow and data releases, it seems to me that short-sellers are looking for bad news. The short-term, speculative investor fraternity was merely putting forward reasons to liquidate positions on which they made gains last week.

What we are witnessing at the moment is an outsized market reaction to a mild economic slowdown. It's exacerbated by a global liquidity squeeze and fears that central banks will raise interest rates regardless of economic conditions, despite having repeatedly stated that they will not. Longer term investors are usually well advised to endure and look through such periods of heightened market volatility until underlying economic fundamentals once again persuade all market participants that there is upside potential.

The one issue we will be watching closely during this period is whether there is a risk that the above relationship is turned on its head which is the one effect where capital market overreaction can create a negative feedback loop. This is where risk aversion leads to such a rise in corporate borrowing costs through tightened bond markets that it causes a rise in corporate defaults, which eventually undermines the economy as a whole.

The last time this threat was looming was during the market downturn of Q1 2016, when credit spreads widened so substantially that default levels indeed rose significantly. Back then, the Fed's pausing of monetary tightening led to a fall in general yield levels and the US$ which, together with economic stimulus measures by China's government and lower oil and resource prices, converged to a global stimulus wave which culminated in the 2016/2017 growth spurt and stock market rally.

This time around, all of the aforementioned stimulus elements are once again present, although less pronounced. At the same time, however, there is nowhere near the same level of economic slowing we witnessed over 2014/2015. And, equity valuations have fallen to levels where dividend yields are now above their historical averages. This should entice long term investors back into the markets, even if the stimulus effect is less pronounced this time around.

One last word - on Brexit: Not much to add over what we wrote last week, except to say that it may be premature to write off Theresa May's Brexit deal or her government, even if it does get rejected by parliament in the first reading next week. I sense that the UK's electorate is by now so tired of everything Brexit that MPs may then well only be left with the choice between Theresa's Brexit or no Brexit at all. Either outcome would be welcomed by UK business and stock markets.

We will know more at the time of next week's Cambridge Weekly.

Europe beyond Brexit

As we approach Parliament's historic vote on Theresa May's exit deal with the EU, Brexit media chatter is building to a fever pitch. In all this noise, other EU news tends to get drowned out in the UK. But just as Britain is mulling over its own future, politicians and policymakers on the continent have many of their own problems to worry about. Given their relative obscurity for our UK audience compared to the all-encompassing Brexit display, it's worth looking at Europe's political, economic and market stories, and how they affect our outlook on the bloc.

Where do we begin? The big scare story for European markets in recent times hasn't been us divided Brits but those pesky Italians. Back in June, two populist parties – Lega Nord and the Five Star Movement (M5S) – formed a ruling coalition in Italy, promising radical policies on everything from immigration (they don't want it) to welfare handouts (they do want it). The latter in particular is what has worried investors. Given Italy's large legacy government debt pile (132% of GDP), the coalition's promises of debt-financed fiscal expansion have angered Brussels, who have even gone as far as initiating the "excessive deficit procedure" – a measure never before used in EU history and one that would hit Rome with punishing fines.

As we reported in past issues, if Italy's showdown with Brussels gets nastier, it could lead to a bloodbath in Italian government bonds. Yields have already soared since the populists took power, and many suspect that things will get much worse when the ECB stop their QE bond purchases at the end of the year. The consequences of yields more than 3% higher than what the German government has to pay shouldn't be understated. Italian banks – already struggling under a mountain of non-performing loans – would take a huge beating, and could spread contagion across the continent. If things really got out of hand, fears loom that this could trigger yet another EURO Zone crisis – and much bigger than with Greece.

2018 development of the yield 'mark-up' (spread) investors demand from the Italian government for its borrowing versus Germany, Source: Bloomberg

Good news then that – as we suggested in previous issues – Rome is sounding much more conciliatory. Last week, the government signalled it was willing to revise its proposed budget in the face of eurocrat criticism, and on Wednesday the Italian Prime Minister signalled the government would "recover some funds" and "tweak the final figure" if it meant avoiding Brusselite scorn, as long as their planned welfare policies stay in place. Markets took the news well: Italian bonds and equities both rallied, with the yield on 10-year Italian debt coming down 0.5% (see chart above) in the last few weeks. Obstacles certainly remain, both in terms of the fractured internal politics of Italy's coalition parties and sheer eurocrat obstinance. But it's a step in the right direction of a negotiated settlement – perhaps even before the year end.

Over in France, not so much. Pent-up populist anger appears to have found a focal point in a proposed fuel tax increase and has now morphed into a widespread and entirely leaderless protest movement against President Macron and his perceived economic failures (as well as affluent city folk in general). In a widely anticipated response to the *gilets jaunes* movement and the riots it spawned, the government this week announced increases in fuel taxes are "cancelled for the year 2019".

Putting aside environmental concerns, this isn't a big deal in itself. But the protests, their widespread support (84% of the French public are sympathetic to protestors according to a poll) and the speed of Macron's capitulation, point to a President in a weak position. The young President was full of reformist vigour when he took office 18 months ago, with many believing his agenda could breathe new life into both France and the wider Eurozone. But that lustre has faded and his popularity dropped. The fuel tax U-turn could well be followed by another on wealth tax – one of the President's most significant reforms to date.

Without domestic support, the man of Europe's union-wide reform is fading too. Investors approved of his Eurozone reform plan proposed in August 2017 – which included a long-discussed Eurozone budget – but recent talks with German officials removed some of the key measures. The Franco-German blueprint that emerged was then watered down even further this week in a meeting of European finance ministers. The all-important Eurozone budget proposal saw fierce opposition from the Netherlands and other northern countries, and the final statement produced confirms there is no "common view on the need and design" for a fiscal stabilisation mechanism. The decision has effectively been handed off to EU leaders, and hopes of a significant change are slim.

Speaking of weakened leaders, this Friday saw Angela Merkel step down from her role as leader of the CDU party, and likely from the Chancellorship before her term is up. The three candidates to replace 'Mutti' have been on tour across Germany over the past weeks. It was seen as a race that would decide the future direction of the CDU and – potentially – Germany itself.

Annegret Kramp-Karrenbauer (AKK for short) – widely seen as Merkel's favourite successor – represents continuity and a claim to the historically important centre ground. Friedrich Merz – an old rival of Merkel's and head of BlackRock Germany – would have represented a shift to the right, and had gained the endorsement of ex-finance minister Wolfgang Schäuble. In the end, the race was won by AKK by a small but decisive enough margin to install her firmly as the leader of Germany's largest political party.

This can be interpreted as positive news for the rest of Europe; she is not known to be anywhere nearly a fiscally restrictive as Herr Merz. We have written before that the Eurozone's inability to stimulate more internal demand – in large part due to the fiscal and consumer spending tightness of countries like Germany – creates a drag on the European economy and makes it more dependant on global demand than the US. And considering the Eurozone budget proposal looks like it won't come to much, that situation is unlikely to improve.

Of course, the other big part of all this is Europe's central bank and its monetary policy. The ECB is set to end additional QE purchases at the end of this month, and has expressed a desire to begin gradual monetary tightening within a year. But given sluggish European growth and the existing structural problems, many are calling for an extension of the ECB's extraordinary monetary stimulus measures. On this front, markets were pleased last week to hear suggestions that the ECB's new rollout of targeted longer-term refinancing operations – a sort of refinancing subsidy for banks, funded through monetary policy (not taxes) – could be on the way soon.

What does this all mean for our investment position? As we have laid out for some time, the economic fundamentals in Europe point to a strong basis for growth, of which we got a brief glimpse towards the end of 2017. High savings rates, an overall current account surplus and still loose monetary policy mean that there is plenty of room for demand to grow. But the structural issues mentioned and the myriad of political crises has hampered this demand growth in the past. On this front, a pick-up in the Italy story is welcome, while other developments like France and Brexit still require resolution.

For now, the Eurozone remains very sensitive to global demand growth, considering its export dependency. If globally things improve – and especially if European consumers start to spend rather than save – then Europe has a good chance of surprising investors as it did last year.

US still leading the lacklustre pack

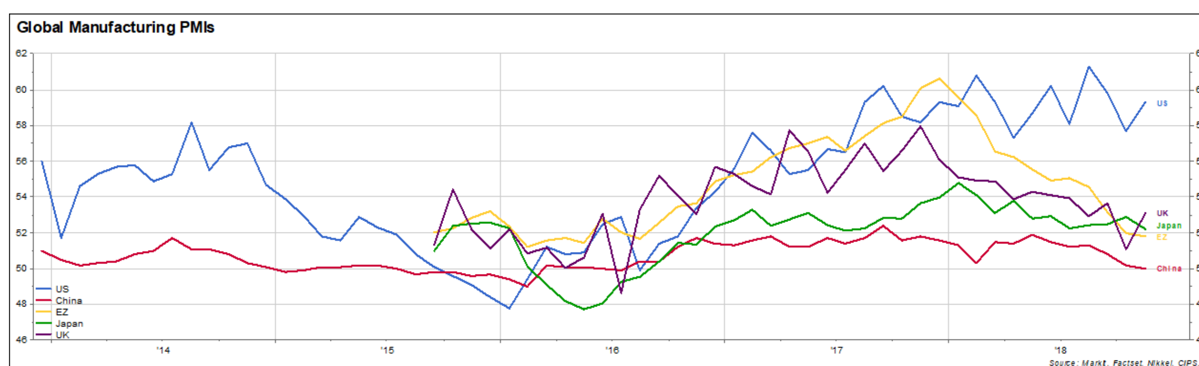
The latest surveys of purchasing managers across the globe are a mixed and slightly disappointing bag for the global economy. Overall, the November indices pointed to an unchanged figure (52) globally, though certain more forward-looking key components are either stalling or falling.

The surveys collect businesses' expectations (for the near future). The resulting data are used to create the Purchasing Manager Indices (PMI), constructed so that a reading of above 50 is supposed to signal expansion. In fact, a few points above 50 tends to be the point that indicates a "normal" moderate and sustainable expansion.

These surveys, which began in the 1940s in the US, have proved so useful, consistent and robust as leading indicators of economic growth trends that most nations have created versions of their own. JP Morgan combines the national indices to create Global PMIs.

Their global output PMI edged up 0.1 points to 51.9 last month and is consistent with 2% annualised growth in global manufacturing production. But expectations for future output, export orders, employment and output prices all declined.

Breaking it down by region however, we see a large amount of divergence. The US is staying ahead of the pack, according to the survey data. ISM's non-manufacturing PMI for November came in at 60.7, up from October's 60.3 and well above the expected 59.2 reading. New orders in particular look strong, registering 62.5. US strength has been one of the defining features of 2018. As the chart below shows, the American economy has pulled away from the otherwise lacklustre bunch. Recent economist expectations (and some signals from the data) suggest the US economy could be coming off the boil as we end the year. But the ISM numbers tell a different story.

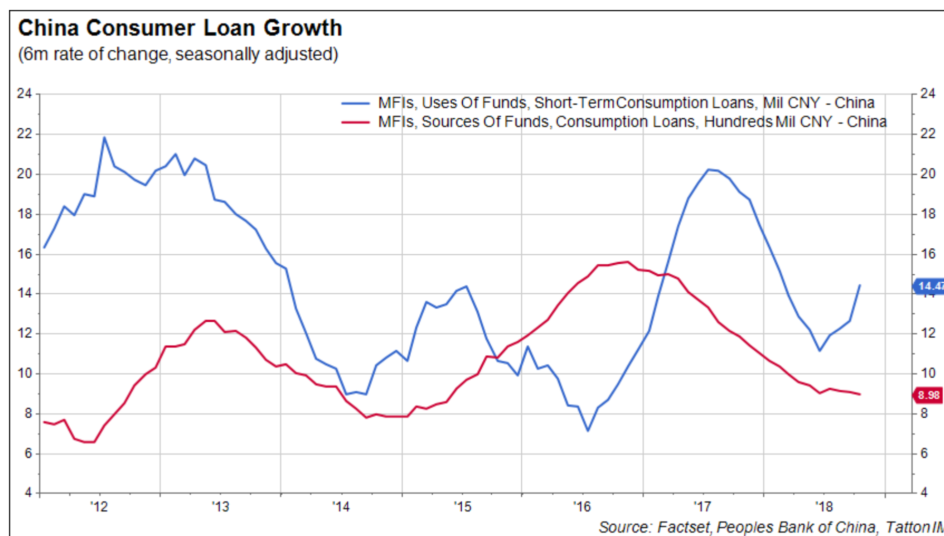


UK data was somewhat less inspiring. While November's manufacturing PMI beat expectations and shot up from October's reading, the 53.1 figure is still one of the lowest for the past couple of years. And in the services sector, things look far worse. IHS Markit's services PMI fell to 50.4 last month, well below expectations and the lowest reading since just after the Brexit referendum. Manufacturing seems to be stuck in the same pattern it's been since the referendum: improving when sterling falls (due to the price advantage for exporters) and falling when sterling falls. As we have written before, this is helping to rebalance wealth away from London and the services sector towards manufacturing in the regions – a result many Brexit voters would likely be happy with.

Of course, even with a currency advantage, British exports will only benefit if the main destination of those exports – Europe – is also doing well and generating growing demand. On that front, things are sluggish at best. As you can see in the chart above, 2018 has been one long deceleration for Eurozone manufacturing. Recent struggles for European carmakers forced to cut production while implementing new emissions testing standards and a general global slump in car demand have made things worse for exporters. Meanwhile, stubbornly high savings ratios and perennial crises (Italy) have hampered demand. But there are signs things could improve from here. The trouble for autos was a one-off and is now behind us, and rebound in global car demand should be on the way next quarter after the dearth we've seen into the year end. We covered more on Europe and our investment view in the previous article.

The real worry for global growth is China. The economic slowdown with Chinese characteristics has been well-documented, as have the recent attempts by the government to rev the stimulus engines. We've written numerous times before that, while Beijing's stimulus response might well get things moving in the right direction, it's unlikely to have the booming effect their 2015/16 measures had on the global economy. With the credit bubble that episode inflated still at dangerous levels, officials simply can't afford to repeat pumping money in with the same gusto. And looking at the recent Chinese PMI, there appears to be no real sign of resurgence. It's possible we could see a pickup in consumer demand however, as short-term loan growth has risen substantially – as the chart below shows. It is unlikely this

will lead to runaway economic growth in the short term, but it could well stabilise an otherwise shaky economy.



Overall, the survey data doesn't look particularly great for the global economy, but likewise doesn't look awful enough to suggest looming global recession. That the US is still the standout performer even after a year of gangbusters growth is significant. Despite predictions to the contrary (and a now much more dovish-sounding Fed chair) there is still little sign of a US slowdown in these main numbers. Overall manufacturing rose sharply, despite export numbers remaining stable (possibly a consequence of trade war fears).

Of course, the likelihood of a US slowdown next year cannot be written off. The reasons for suspecting it do not stem from the immediate data; they come largely from cyclical, political and policy considerations. But the risks these pose are not insignificant. If such a slowdown was to occur in the world's largest economy, it would not bode well for global growth. Unless Europe or China can offer enough offsetting strength that is (which doesn't look likely at the moment, but has happened before). For now, we'll have to content ourselves with the knowledge that this hypothetical slowdown hasn't yet appeared on the horizon, even if globally the data is not as encouraging as it was at this time last year. We will be watching carefully.

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10th December 2018

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	6778.1	-2.9	-202.1	↗
FTSE 250	17844.1	-3.4	-636.7	↗
FTSE AS	3710.7	-2.9	-112.7	↗
FTSE Small	5277.0	-2.0	-106.6	↗
CAC	4813.1	-3.8	-190.8	↗
DAX	10788.1	-4.2	-469.2	↗
Dow	24543.7	-3.1	-795.2	↘
S&P 500	2655.3	-3.0	-82.5	↘
Nasdaq	6689.8	-2.9	-202.6	↘
Nikkei	21678.7	-3.0	-672.4	↘
MSCI World	1990.8	-2.5	-50.5	↘
MSCI EM	978.9	-1.6	-15.8	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	15.4x	12.0x	13.2x
FTSE 250	3.7	15.3x	12.8x	14.0x
FTSE AS	4.6	15.6x	12.1x	13.3x
FTSE Small	4.1	-	12.8x	13.9x
CAC	3.6	14.9x	12.9x	13.3x
DAX	3.4	11.8x	11.9x	12.5x
Dow	2.3	16.4x	15.4x	15.0x
S&P 500	2.0	18.1x	16.2x	15.8x
Nasdaq	1.1	21.9x	18.5x	17.7x
Nikkei	2.0	15.0x	15.6x	20.0x
MSCI World	2.6	16.5x	15.1x	15.1x
MSCI EM	3.0	11.8x	11.5x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Randgold R. Ltd	6.1	GlaxoSmithKline	-11.4
Evraz	6.1	Standard L Aberdeen	-11.1
Berkeley G. Holdings	4.0	ITV	-9.5
Smith & Nephew	3.5	GVC Holdings	-9.5
Anglo American	2.7	Kingfisher	-8.6

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.27	-0.08	OIL	62.8	7.0
USD/EUR	1.14	0.61	GOLD	1244.6	2.0
JPY/USD	112.68	0.79	SILVER	14.6	2.5
GBP/EUR	0.89	-0.71	COPPER	275.3	-0.9
CNY/USD	6.87	1.25	ALUMIN	1936.0	-0.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.265	-7.3	-0.10
US 10-Yr	2.883	-3.5	-0.11
French 10-Yr	0.688	0.6	0.00
German 10-Yr	0.249	-20.4	-0.06
Japanese 10-Yr	0.059	-35.9	-0.03

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.79
3-yr Fixed Rate	1.85
5-yr Fixed Rate	2.07
Standard Variable	4.45
10-yr Fixed Rate	2.72

* 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.

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