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Bob Moran on the chancellor's Brexit verdict - what are the options? 29 Nov 2018 - Political Cartoon Gallery in London

Predicaments

As November draws to a close, global stock markets have provided a positive last week to an otherwise bleak month for investors. And as it stands, it is not just October and November but the whole of 2018 that has turned into a disappointment for investors across almost all asset classes. According to a study by US investment bank JP Morgan none of the 17 major asset classes (equities, fixed interest bonds, etc.) has outperformed the rate of inflation – something that has not happened since they started tracking these figures in 1992.

While this is a somewhat depressing insight for an investment manager, the returns at portfolio level are only slightly negative. Arguably, 2018 was simply the return to a more realistic growth outlook after 2016 and 2017 generated overshooting return levels which were unsustainable. Without a doubt, if we look at portfolio returns across risk profiles from a 2016 starting point perspective, then total returns achieved on an annualised basis look more than acceptable. Even when choosing 2017 as the starting base, returns should not cause too much concern.

The correction to lower valuation levels means that stocks no longer look expensive relative to earnings and the historic context. It can be argued that they are now pricing in a considerable amount of economic slowdown for 2019, which is by no means a given. However, compared to the end of 2017, the outlook to next year is fraught with more uncertainties.

Economic growth momentum has slowed everywhere, even in the US where Trump's fiscal stimulus continues to boost the economy at the expense of creating public debt burdens for future generations. The trade uncertainties from Trump's 'America First' trade wars and a still unclear shape of Brexit can no longer be expected to be neutralised by elevated business activity levels. To top it all off, central banks have begun to end the extended period of extraordinarily cheap credit, which creates the risk of a credit crunch as higher financing costs lead to increasing default rates amongst weak businesses.

On the last point, the US central bank's chairman Jay Powell provided some relief by stating in a prepared speech that the Fed no longer sees current interest rates a "long way" below the required neutral position but only "just below". This suggests that the pace of US interest rate rises might slow or even stop and was welcomed by equity investors with an upward surge in share prices. Interestingly, bond markets had already anticipated this change for a while and therefore simply consolidated at already lowered levels of long term bond yields.

This stabilisation of the cost of credit, together with significantly lower oil and commodity prices could prove a welcome stimulus for 2019 or at least stem the recent slowing trend. If it additionally stops a further appreciation of the US$, which already stalled over recent weeks, then this would be good 2019 news for emerging market economies. Those who muse about the possibility of a 'Santa Rally' on the basis that oversold markets should bounce in anticipation of an improved 2019 outlook may nevertheless be disappointed. US$ funding rates have the unhelpful habit of increasing towards the end of the year as lending activity winds down in preparation of year end.

Which once again leads us to politics, where a number of issues could cause headwinds. Here, only the Italian budget issue saw some notable progress, with the EU Commission as well as the Italian government signalling willingness to compromise – along the lines we expected, as outlined here a few weeks ago.

On the trade war issue, we are writing this Cambridge Weekly edition before the dinner between Trump and China's leader Xi Jinping on Saturday night on the fringes of the G20 summit in Argentina. Consensus is that even if they wanted they would not be able to agree 'a deal' because the required preparations for such a step have not yet happened. The best that can be hoped for is some form of positive statement of intent to find a mutually agreeable solution. Even the probability of this is very hard to gauge. Trump has a volatile nature as we well know, but beyond this neither side can afford to be seen at home as having caved in to the other side.

On the Brexit front, the 11 days until parliament votes on 11 December are strewn with similar predicaments for the UK's MPs. Approve the bill for May's Withdrawal Treaty which would respect the referendum outcome for a Brexit as they promised in return for being given a meaningful vote in the matter – or reject it as it is neither economically beneficial nor sovereignty-restoring. If MPs opted for the latter, they would thereby risk even more political instability and either an even worse economic/dependency outcome or an end to Brexit altogether.

It is understandable that non-political observers will be increasingly concerned that this is leading straight towards a disorderly non-deal crash Brexit which for the economy would likely be the worst of all possible outcomes. At Cambridge we stick to what we have said all along: It will get very frightening when it comes to decision time (and it has!) but in the end politicians will chose the least risky outcome

for themselves and the country. This might not happen in the first vote on 11 December as MPs may feel obliged to demonstrate their principles towards their constituencies, but there is a high likelihood that the vote will go differently if the bill is returned for a second reading. It should also be comforting for investors that the one notion that has an overwhelming majority in parliament is the prevention of a no-deal exit.

The new fear that poor political management may lead to an even worse outcome for the country in the form of a Labour government under Jeremy Corbyn that repeats the mistakes of the 1970s also needs to be put into perspective. Just as Donald Trump's administration has not been able to follow through on his wackier ideas and plans like the border wall with Mexico, we should also expect a Corbyn government to be far tamer than his campaign promises. It is also hard to imagine that Labour would gain an absolute majority in a 2019 general election, given their current standing among the electorate.

In summary then, hopes for a 2018 Santa Rally belong to the realms of wishful thinking, but would at the very least require a significant breakthrough in the trade negotiations between Trump and Xi and probably also a smoother sailing in parliament for Theresa May than currently seems possible. So, after two quite pleasing years for investors, 2018 may turn out to be an even more damp squib than we had anticipated. However, if so, then this will at least lay the foundations for a better outlook for 2019.

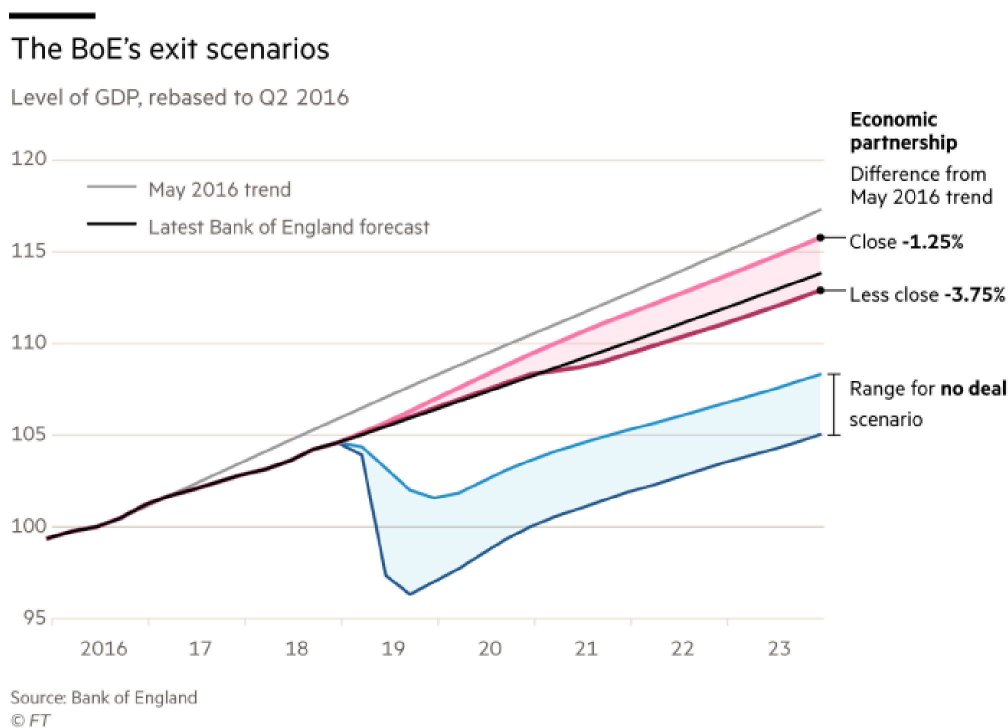
Markets unmoved by Carney carnage

This next couple of weeks will be ones for UK history books. Theresa May's Brexit deal faces an uphill battle when Parliament begins debate on Monday. Several MPs and one former Prime Minister have already declared it dead before it's even hit the floor of the commons. As things stand, neither Parliament's Brexiteers nor Remainers see the deal as a happy compromise, and both camps seem to think that they can use its potential defeat to push forward their own preferred outcome. But a week is a long time in politics, and we've got two of them before we'll know the fate of the Prime Minister's deal (and indeed, the Prime Minister).

Before the details get picked apart by MPs however, the Bank of England (BoE) has released its own assessment of the different Brexit outcomes and what they could mean for the economy. And they certainly make for an eyeful. The headline-grabbing figures point to an 8% drop in British GDP in the worst-case scenario following a crash Brexit, and a 30% fall in house prices. If no deal is agreed and no transition period put in place, the BoE predicts the worst fall in national income since the second world war.

This isn't the BoE's first Brexit warning, but it's probably their most bleak. Gloomy Brexit forecasts are a sure way to be branded 'political' by the right-wing press, as the bank is all too aware. But predictions of this apocalyptic scale bring worse. Governor Mark Carney is "a second-tier Canadian politician who failed to get a job in Canadian politics" and has damaged "the Bank of England's reputation", according to arch-Brexiteer Jacob Rees-Mogg. Of course, Rees-Mogg's damning assessment is to be expected of a man he once dubbed "High priest of project fear".

But criticism of the bank's forecasts spread further than the Brexit brigade. Former BoE member Andrew Sentance and even left leaning Nobel laureate economist Paul Krugman expressed doubts about the models the central bank used to arrive at these conclusions. The timing of the bank's announcements didn't go unnoticed either. MPs are lining up to hammer their nails into the PM's plan. Although the Bank was tasked with producing these forecasts, their release just days before the debate begins might seem a little suspicious to some. According to Bloomberg, "The central bank has taken a calculated gamble with its credibility."



If those comments indeed were aimed at soliciting a severe market reaction to pressure politicians into supporting May's plan, then the gamble doesn't seem to have paid off. Against the dollar, £-sterling actually ended the day slightly up after the BoE's report was released. If the bank really was betting their credibility, investors' reply seems to have been 'what credibility?' Many investors and financial commentators point to Carney and co's previous Brexit warnings, and how they got it 'so wrong'.

In fairness to Mr Carney, the headlines that emerged from the forecasts were (predictably) not quite the whole story. The governor was asked by the Treasury select committee to imagine the worst-case scenario for no-deal Brexit Britain, and that he did. He remained clear throughout that the BoE don't actually expect any of this to happen, and that they aren't making "the f-word" (forecasts). Absent too from most media coverage was the central bank's assertion that, even in that worst-case scenario, Britain's banking sector is stable and resilient enough to keep serving the economy. Overall, the tenor of the report and Mr Carney's speech to the select committee was that, even in the event of an unlikely crash exit and the worst-case scenario economically, both the financial system and monetary policy is ready.

This touches on a broader point: Central bankers are monetary policymakers, not just forecasters. It seems to have been widely accepted that the BoE got it badly wrong on Brexit before, by predicting a

post-referendum slump that didn't materialise. But this misses the point. They use those projections to inform monetary policy and avoid such situations. They aren't weathermen; they help make the weather. Being good at your job means your gloomy predictions don't come true. But it would be silly to conclude from this that you should always forecast sunny skies.

Of course, it's still entirely possible that Mr Carney did indeed have an ulterior motive. The 'rock-star' central banker of today is media-savvy. He will have been aware of how the BoE's forecasts would be interpreted by the media, and that the headlines would immediately point to their crash-Brexit apocalypse. Perhaps the governor would even see an intervention as justified. No one seriously doubts that a sudden and unexpected hard exit in March – with the UK reverting to WTO rules – would harm the economy. If headline-grabbing projections can persuade politicians to avoid that option, perhaps the BoE would consider it a job well done.

But now we're getting into the realm of conjecture. What's certainly true is that central bankers these days have to know how to play the political game too, so perhaps Mr Carney's comments are understandable. Just look at the US, where Federal Reserve chair Jerome Powell made some decidedly dovish sounding comments this week, without really nailing down any specifics. It's highly likely his words were more of a White House appeasement than an actual forward guidance, after President Trump has cranked up the political pressure on the Fed.

Of course, central bankers don't always win at this game. The muted market reaction to the BoE's assessment suggests Carney has spent a large amount of political capital already, and has lost quite a lot of credibility, at least in markets. Meanwhile, Powell's market reaction suggests he's got a fair amount of it left. Whether the BoE's projections will be more successful in swaying MPs is another story. We'll have to await the next chapter for that one.

Powell deflects or genuflects?

The Independence of the US Federal Reserve (Fed) is under attack. That's the line that many a financial commentator has been pushing throughout Donald Trump's tumultuous presidency. Even in the run-up to the election two years ago, Trump never shied away from making his thoughts known. And during his stay in the White House, he has – with a tweet here and public speech there – exerted pressure on the central bank. And in the latest speech from Fed Chair Jerome Powell, it looks to many as though that pressure is working.

Let's take a step back. What is this independence the Fed is losing and why does Trump want to take it? The 1913 act of congress that gave birth to the Fed explicitly delegated responsibilities of monetary policy to the central bank. But it has been argued that the 'independence' the act supposedly enshrines is not quite what it was supposed to be. The Fed answers directly to Congress, it's top officials are selected by the President and it has to work very closely with the Treasury – particularly in times of crisis.

What's more, historically political meddling in monetary policy affairs has been fairly common. In the 1960s, President Lyndon B. Johnson put enormous pressure on the Fed to not raise rates, and accused Fed chair William McChesney Martin of putting himself above the presidency for not doing so. One President and one Fed chair later things got even more muddled. In the run-up to the 1972 election,

Richard Nixon practically forced Arthur Burns to keep rates low to ensure high growth. Nixon got his wish, and the disastrous stagflation of the 1970s ensued.

It's largely because of that episode – and similar ones in the other industrialised economies – that the modern conception of central bank independence was formed. Since then, politicians have generally steered clear of commenting on monetary policy. Enter Trump the disruptor. The President has called the Fed's rate-hiking decisions "crazy", and has accused Powell of being "happy raising interest rates." And last month, Treasury Secretary Steve Mnuchin reportedly surveyed prominent bond dealers and investors on what their preferred method of monetary tightening would be.

It's widely thought that this is one of the reasons Powell's speech before the New York Economic Club on Wednesday sounded so dovish. It certainly seemed like a U-turn from his October narrative of interest rates still a 'long way off the neutral rate'. The chairman instead told the forum that interest rates are now "just below" the so-called neutral level, at which steady economic growth, inflation and employment can continue. This suggested a slower pace of rate hikes than markets – or indeed (according to the closely-watched dot plots) the Fed's own members – expected. Powell even suggested that it would make sense for the central bank to pause their monetary tightening next year to see what effects it has had.

So, is Trump getting his way? And will it lead to a Nixon-style disaster? Things aren't so straightforward. While no one could deny that Powell is sounding far more in tune with the White House than before, the changes to actual Fed policy are far less drastic and far less sudden. The minutes from the Fed's November meeting, released on Thursday, showed that members still strongly suggest another interest rate hike next month. And while some members echoed Powell's line that rates were close to neutral, the dots plot – a survey of where members expect rates to be over the next few years – remains unchanged. It's entirely possible that Powell's words were just that: a token to appease the noisy President, while actual policy goes on as normal.

But even if the Fed really was caving to Trump's pressure, there is a very valid argument that a slowing of rate rises is entirely justified. After the tremendous growth spurt the US displayed, there are now signs that the economy is coming off the boil and that the looming trade war with China is beginning to bite. Figures on bank lending and other indicators point to a slowdown in activity up ahead, and signs of overheating are no longer overwhelming.

And yet the Fed's last projections (released September) point to an acceleration of quantitative tightening and more interest rate hikes next year. A White House figure might well feel justified in questioning the logic of this. After all, the Fed's famous 'dual mandate' dictates that they are to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." The latest data don't suggest inflationary pressures are too strong, while overall employment still has room to expand – so what's the rush?

This argument is fairly convincing, but it misses something. A large factor behind the American growth story is Trump's large fiscal expansion, in the form of tax cuts. It looks like this has boosted growth in the short term, but at the expense of loosening the government's fiscal policy substantially, at a late stage in the business cycle where the opposite would normally be expected. What this means is that, if boom turns to bust – as it so often has – the government will have no fiscal headroom to stabilise the economy,

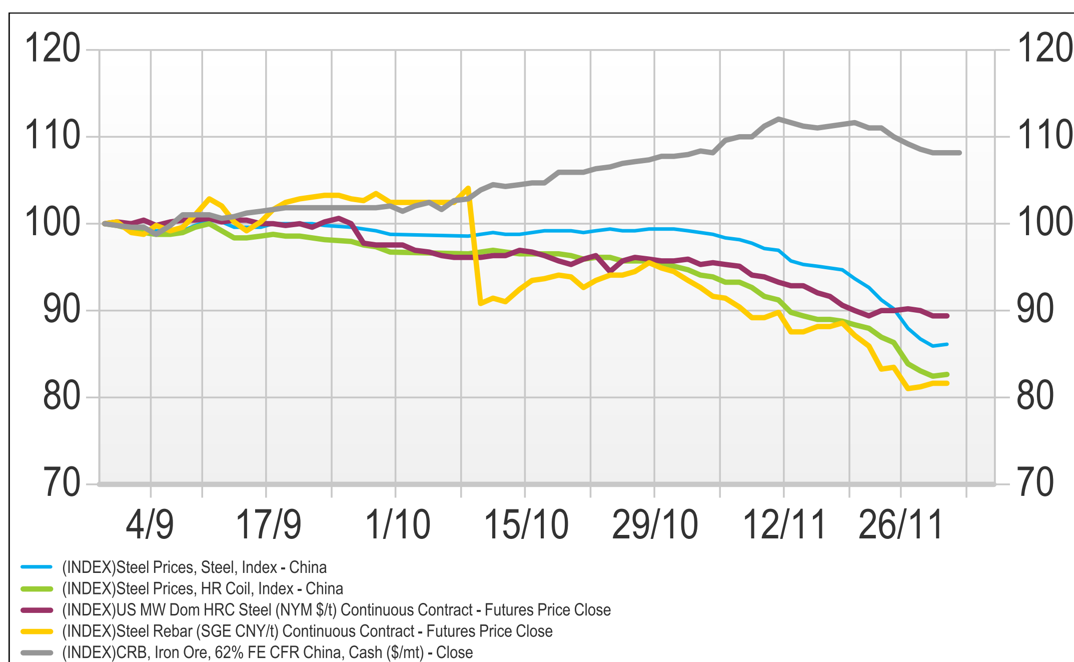
deepening any potential recession to the point where economic stabilisation once again becomes reliant on monetary policy. The fact that fiscal profligacy has now become mainstream in both US political parties only adds to this point.

The Fed has no control over government spending, but they can counteract its overheating effects and build up monetary policy 'ammunition'. We suspect that the Fed's tightening agenda is based in large part on two goals: cooling the economy to avoid sudden and sharp downturns, and giving themselves more room to ease monetary policy if such a downturn does occur. The Fed has made no secret of its desire to gradually "renormalize" monetary policy away from the extreme measures that followed the financial crisis. The fact that fiscal policy has become incredibly loose can only strengthen that desire.

Underneath everything else, this is why the supposed attack on the Fed's independence is worrying. If Powell is appeasing rather than adjusting expectations to a changed outlook, that would mean that both fiscal and monetary policy are too loose as we move into the late stages of the cycle. We know from history that that's a bad mix.

What the price of steel tells us

At Cambridge, we keep our eyes out for early market signs of changes up ahead. One which came up on our radar this week was the large moves we have seen in Chinese steel prices, down almost 20% below where they were three months ago and a recent turning over in the Iron Ore market (top line in the chart below). The pertinent question is whether this is driven by a global decline in demand from slowing



economic activity levels.

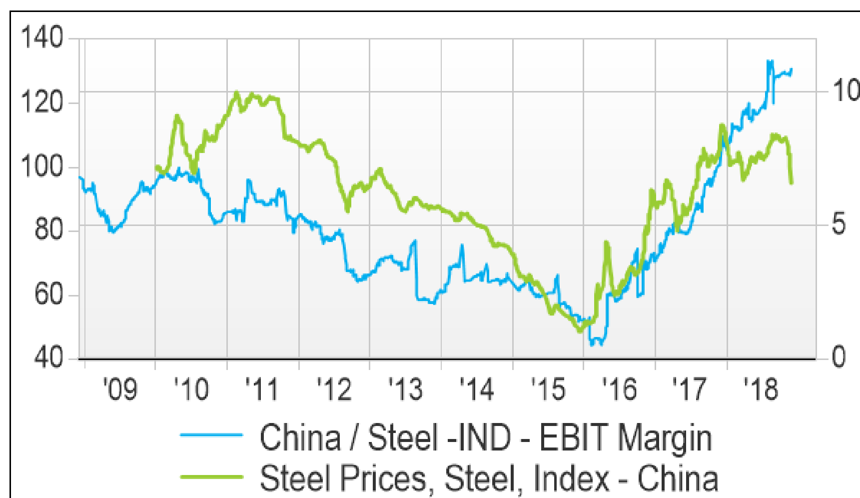
Price development of steel and iron ore around China since Sep 2018; Source: FactSet

Broadly speaking, Chinese steel price weakness may not have come as a surprise to close observers, having seen Caixin purchasing managers indices (forward indicators of manufacturing activity) in China falling recently. And let's not forget the backdrop of a trade war with the US, the possibility of growth having peaked (for the time being at least) and the tough times in the auto sector, as we've discussed in these notes previously. But in this case, it could be supply rather than demand which is causing trouble.

Chinese production has increased at a rate of almost 10% over the past twelve months, while other steel manufacturers have held volumes flat to slightly down, with the exception of the USA, which is also posting double digit increases over the period.

The increasingly insular policies of the Trump administration perhaps explain why US manufacturing has increased at the expense of others; it's protectionism in action. The Chinese increases are more perplexing. China runs a large surplus in the trade of steel (unlike the US), i.e. it exports far more steel than it imports. Why then would it ramp up production in the face of a potential slowdown?

We think clues may be found elsewhere. The Government enacted supply side reforms in 2016 to try and handle excess capacity, closing some of the less efficient mills, and improving profitability of these remaining companies. Capacity has fallen while profitability has increased enormously, even as prices of steel have fallen over the last year. EBIT margins are almost 5% higher than they were last time steel was this price. Even before the slowdown, those efficient plants were working flat out to increase production.



Source: FactSet

The last few quarters of sluggish data may have taken us through a tipping point. It seems that the Chinese leadership's announcements of further infrastructure investment plans were accompanied by an easing back of pollution restrictions on the older producers. As fans of Chinese industrial production numbers will know, they tend to be 6%. Occasionally there will be peaks and minor troughs, but since 2015 this number has been between 5.6 and 7.6% per year. A command to produce more would seemingly help economic activity. It may explain why prices have fallen back, adjusting to an increase in production by the world's largest steelmaker. Unfortunately, the customers may turn out to be less willing or able to buy than first thought.

Of course, whether this downturn in steel prices drives a quicker shuttering of excess capacity is another question. With trade war looming, central Government might well look favourably on an industry that can increase production, especially if they can remain profitable despite dropping prices for producers all around the world and thus overcome some of the new US tariff hurdle.

In that case, those set to suffer most would be other steel producing nations without tariffs to protect them from this Chinese excess capacity entering the market at very low cost, whether through competitive advantage or "dumping" (state sponsored sales below the cost of production). Those highest in this list are Japan, India, and Russian steel industries. Of course, the largest producer in the world getting more efficient over the medium term is likely to mean these markets face a headwind beyond this year's increase in production.

As we saw with the oil price when Saudi Arabia embarked on a similar strategy to undermine the US shale producers, this is not good news for anybody in the wider trade. Sadly, this constitutes yet another headwind for Emerging Market economies, one they could really have done without, having just had to deal with the resurgent strength of the US$.

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Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	6980.2	0.4	27.4	→
FTSE 250	18480.8	-0.3	-52.2	→
FTSE AS	3823.3	0.3	11.0	→
FTSE Small	5383.5	0.4	21.4	→
CAC	5003.9	1.2	57.0	→
DAX	11257.2	0.6	64.5	→
Dow	25321.0	4.3	1035.0	→
S&P 500	2742.9	4.2	110.4	→
Nasdaq	6898.1	5.7	370.8	→
Nikkei	22351.1	3.3	704.5	→
MSCI World	2034.9	3.0	59.8	→
MSCI EM	998.1	3.0	28.9	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.6	15.8x	12.3x	13.1x
FTSE 250	3.6	15.8x	12.0x	14.0x
FTSE AS	4.5	16.1x	12.3x	13.3x
FTSE Small	4	-	13.1x	13.8x
CAC	3.5	15.4x	13.3x	13.3x
DAX	3.3	12.4x	12.5x	12.5x
Dow	2.2	16.9x	15.8x	15.0x
S&P 500	1.9	18.8x	16.8x	15.7x
Nasdaq	1.1	22.6x	19.1x	17.7x
Nikkei	2	15.5x	16.2x	20.0x
MSCI World	2.5	16.8x	15.4x	15.1x
MSCI EM	3	12.0x	11.7x	12.0x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Vodafone Group	8.9	Persimmon	-12.6
John Wood Group	8.1	Taylor Wimpey	-12.2
Centrica	6.9	TUI AG	-10.7
Scottish Mortgage Inv	5.2	Barratt	-9.2
Ocado Group	4.6	Berkeley Group	-8.8

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.28	-0.32	OIL	58.8	0.0
USD/EUR	1.13	-0.11	GOLD	1222.1	-0.1
JPY/USD	113.53	-0.50	SILVER	14.2	-0.7
GBP/EUR	0.89	-0.20	COPPER	278.0	0.5
CNY/USD	6.96	-0.17	ALUMIN	1940.0	-0.3

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.364	-1.2	-0.02
US 10-Yr	3.015	-0.8	-0.02
French 10-Yr	0.684	-5.1	-0.04
German 10-Yr	0.313	-7.9	-0.03
Japanese 10-Yr	0.092	-8.0	-0.01

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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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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