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Lothar Mentel

Lead Investment Adviser to Cambridge

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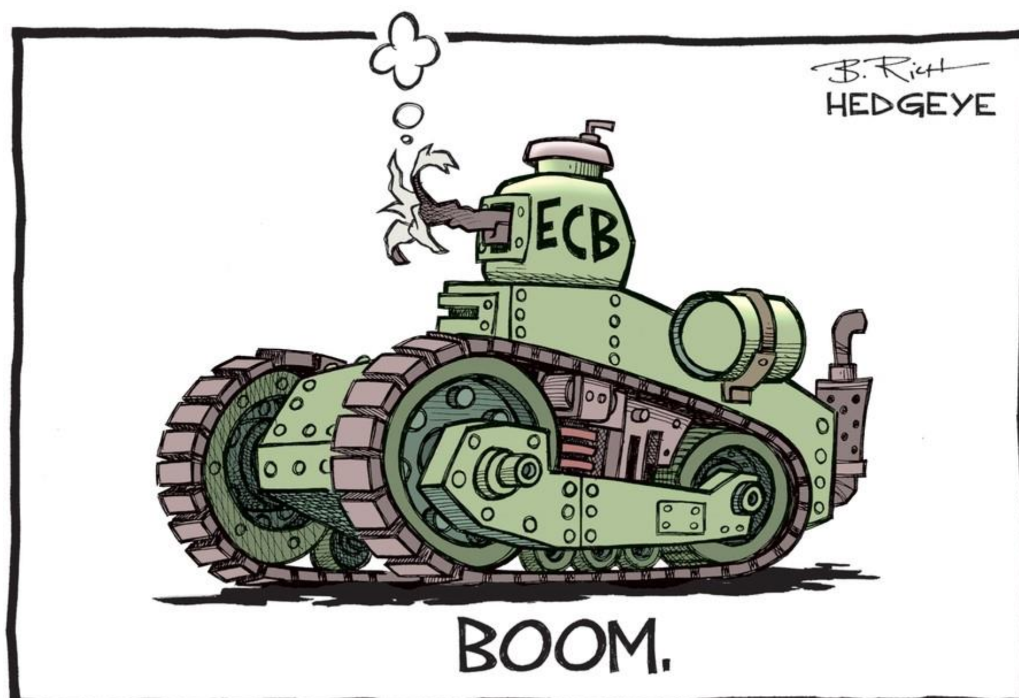


Stock markets react badly to ECB's monetary policy U-turn Source: Hedgeye.com

ECB stimulus U-turn leaves markets unimpressed

Last week, we wrote about the impressive 25% market recovery the Chinese stock market had witnessed since the beginning of the year. This week, the Chinese leadership demonstrated that it dislikes stock market exuberance at least as much as it does the credit excesses of the shadow banking sector. A 'sell-note' on one of China's stock market darlings by a government-owned stockbroker caused market speculators to rush for the exit and sent the stock market down 4% in a single day.

Profit-taking became the theme of the week, with most markets closing slightly lower for the week. The European Central Bank (ECB) caused a negative reaction by deciding to join their US colleagues in easing monetary policy. To ease the tightening of liquidity from the end of its QE purchases, the ECB will reintroduce a bank refinancing instrument known by its great acronym of TLTRO. This should help to ease pressure on banks amid slowing European growth – a result of the global decline of demand from China and other Emerging Market economies.

European investors were not just being ungrateful compared to their US peers – where the Fed's easing indications after Christmas initiated 2019's recovery rally. Rather, investors were spooked by the ECB's significant reduction in its growth outlook, which would suggest that much more easing may be necessary to really address the weakness. But the ECB is now very limited in their monetary policy, after their QE program has already purchased most of the government bonds they can buy without breaking their own rules. The fact that it's now in the hands of politicians – not central bankers – to take action caused discomfort in the markets.

The seemingly never-ending impasse in the Brexit negotiations did not help. Once again, the much-expected final decision-making week for Parliament may once again not really come to pass. This further increases the chances that our expectation will be realised that no matter what, the formal Brexit will not happen on 29 March. Brexit will likely go into 'overtime' through an Article 50 extension. But this is not the only outcome that would extend the UK's chronic uncertainty. Even if the government 'deal' somehow found a (pressed) majority in the end, it is dawning on the more forward-looking commentators that this may only mark the halfway point of trading uncertainty. With the final terms of any trade arrangement not part of 'the deal' we should expect a further two years of negotiation drama and uncertainty.

For UK-based investors, this would not constitute an overly adverse investment environment on the basis that, according to our assessment, worse has been priced in to UK asset prices already. However, they would have to endure another two years of political bickering here and elsewhere, while uncertainty keeps the country stuck in its rut – economically as well as politically.

Good then that progress appeared to happen elsewhere. The brewing geopolitical tensions between India and Pakistan that we suggested we needed to watch were just as swiftly and courageously defused by a grand gesture from Pakistan's president and ex-cricket celebrity Imran Khan. Fingers crossed that his military continues to back him.

France's president Macron provided another important step forward. In a European-wide newspaper article, he set out his vision for the EU's future. While much focus was on his call for more cohesion and the fight against populism, his proposals for a pan-European immigration framework appeared much less noted. To my mind, such a step was inevitable given the rise of populism, but more importantly it could become a crucial factor in overcoming much of the future Brexit hurdles. The highly contentious red lines of free movement may be very helpfully qualified in the direction that a certain David Cameron pleaded for only three years ago.

Returning to the international arena, China's annual People's Congress provided some insightful guidance how the ever-pro-active Chinese leadership plans to address current challenges. The various economic stimulus measures put forward strengthen our view that China is in the process of stimulating domestic demand in a similar vein to 2016, which should spill-over into global demand channels and kick-start a rebound in the recently declining rate of growth.

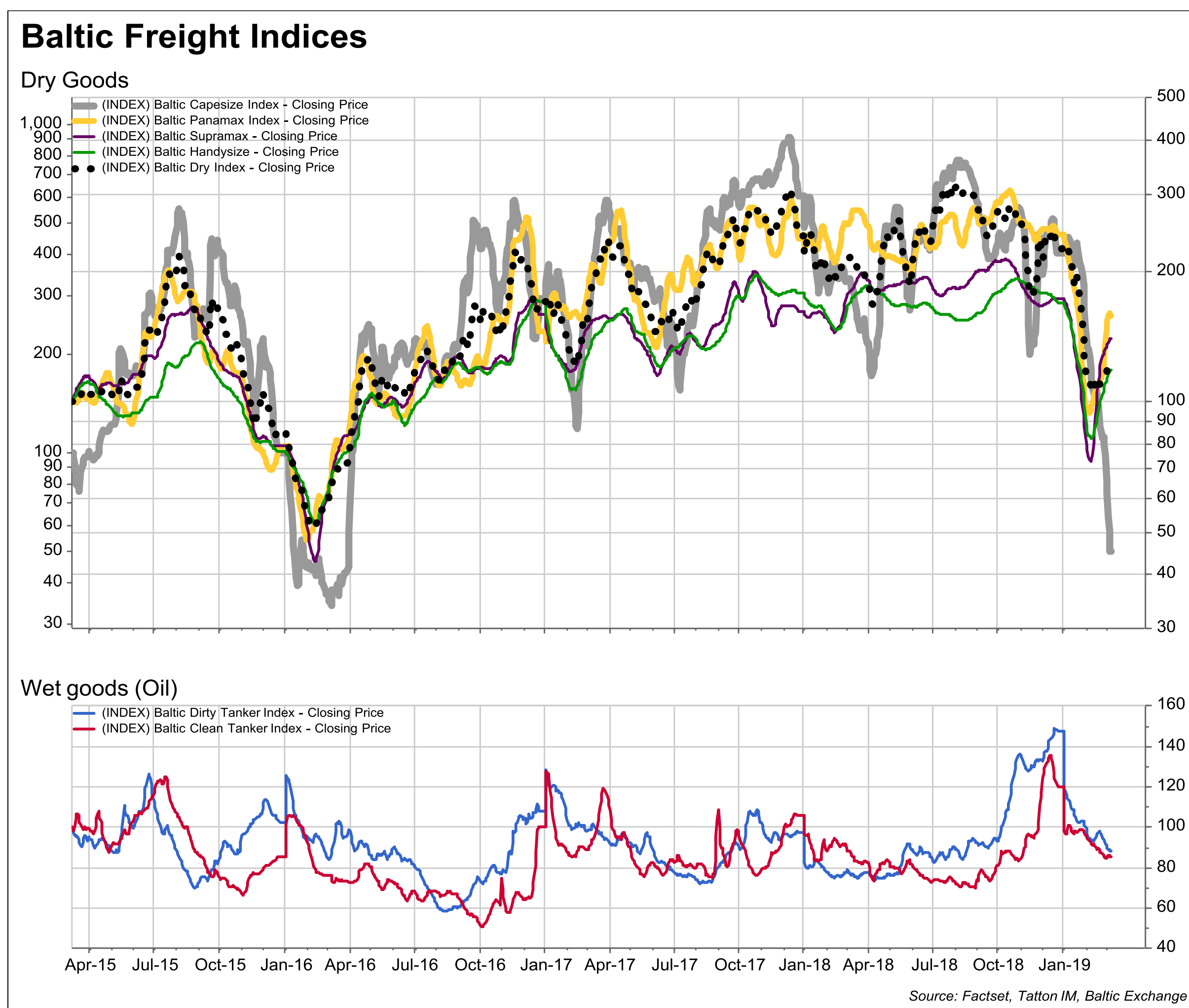
It may sound strange, but the combination of the Chinese resurgence with the moderation of further US growth impetus may well help to stimulate global growth further. This is because this constellation is likely to lead to a softer US$, which should further stimulate global trade, just as the stronger US$ in 2018 harmed Emerging Market trade and business investment.

The detailed articles this week cover those two latter aspects of Global trade dynamics and China's latest plans, while we have refrained from further Brexit commenting until next week. Instead, we give a little more insight on electrical vehicle producer Tesla and its maverick founder and CEO Elon Musk's motivations.

Dear Donald, this is how global trade actually works

Global economic activity has slowed. That is no longer a fear in the back of investors' minds: it is a reality. Into the end of last year, stock markets worked themselves into a panic over the prospect of a slowing global economy and sold off en masse, as if a looming worldwide recession had become all but certain. Now however, with global economic conditions actually slowing, asset markets around the world have recovered to much more reasonable levels. Regular readers will know that this is in line with what we had anticipated at the end of last year: "markets' fear narrative became almost apocalyptic", the reality turning out to be dreary but not dire.

But deciphering where we go from here requires looking at why things slowed in the first place. The chart below shows the various Baltic Exchange freight indices (BDI), which track shipping activity.



Wikipedia has the following helpful explanation of the indices:

"Most directly, the index measures the demand for shipping capacity versus the supply of dry bulk carriers. The demand for shipping varies with the amount of cargo that is being traded or moved in various markets (supply and demand).

The supply of cargo ships is generally both tight and inelastic - it takes two years to build a new ship, and the cost of laying up a ship is too high to take it out of trade for short intervals, the way you might park a car safely over the winter. So, marginal increases in demand can push the index higher quickly, and marginal demand decreases can cause the index to fall rapidly. e.g. "if you have 100 ships competing for 99 cargoes, rates go down, whereas if you've 99 ships competing for 100 cargoes, rates go up. In other words, small fleet changes and logistical matters can crash rates". The index indirectly measures global supply and demand for the commodities shipped aboard dry bulk carriers, such as building materials, coal, metallic ores, and grains.

Because dry bulk primarily consists of materials that function as raw material inputs to the production of intermediate or finished goods, such as concrete, electricity, steel, and food; the index is also seen as an efficient economic indicator of future economic growth and production. The BDI is considered by some people as a leading economic indicator because it predicts future economic activity.[6][7] and are generally thought to be a good indicator of global activity levels."

As you can see from the chart, there was a marked drop-off in the BDI into the beginning of this year. The most recent part shows continued weakness in the large vessels but a marked pick-up in the mid-size and smaller ships.

Turning back to the beginning of the fourth quarter of 2018, markets had started to become more worried about growth. Overall shipping rates had peaked in the summer, but it was not clear from the freight indices that global trade had slowed greatly into the year-end.

However, it seems that final end-demand had been slipping. What distorted the picture was that the prospect of increased tariffs from Donald Trump's trade war led to a stockpiling effect, where both US and Chinese businesses tried to get deliveries in before higher import duties were due to come into effect. After this artificial boost wore off, the drop-off in shipping was likely to be significant.

As the economic data showed this week, the same effect also led to a widening of the US's December trade deficit - as a consequence of falling exports. China fared similarly - February's exports were -20.7% year-on-year (although the Chinese New Year effect always makes data highly suspect). Despite President Trump's efforts to rein in America's trade deficit position, so far his policies have only made things worse. US importers stockpiled Chinese goods in anticipation of higher prices, while retaliatory tariffs from Beijing meant that exports to China fell. As we stated here before: trade wars have no winners.

Trump's government spending policies arguably widened the trade deficit even more. Last year the annual US budget deficit doubled just as the Federal Reserve accelerated its quantitative tightening (QT) program. The fact that the US was issuing (selling) much more debt to bond investors while the Fed was also selling the treasury bills (that it had bought in years past to create QE money) sent real interest rates skyward. That increase in real yields made treasuries more attractive for investors beyond the US, with the accompanying demand for the US currency leading to a strengthening of the already strong US$. Naturally, dollar strength caused imports to rise and exports to fall – just what Trump was trying to reverse.

This year, however, Trump may well get his wish. While the budget deficit shows no sign of coming down, the end of QT should lower real yields enough to send the dollar lower. And we expect the divergent development of relative strengths of the American and Chinese economies (and potentially some political engineering) to also contribute to dollar weakness. While the US has only just begun its

slowdown, there are signs that China may be on the way out of its malaise, thanks to Beijing's stimulus measures. What is more, the worsening US trade deficit was more about reduced exports than increased imports. If Chinese demand does indeed pick up – and particularly if a trade deal can be struck – we should expect the US's trade position to improve.

That brings us back to the global economy. The recent bounce in the small and mid-sized Baltic Freight indices is a good sign that global demand is still going at a reasonable level, despite the slowdown. Demand is not roaring ahead, but it is strong enough to keep activity ticking over at a fair pace, strong enough to soak up the tariff-fear-induced inventories. Meanwhile, strength in metal commodity prices in particular is probably indicating that government-led infrastructure spending is pulling raw materials into China.

In that respect, 2019 is starting to look quite a bit like 2016. As the Baltic chart suggests, mid-sized shipping rates picked up well ahead of the larger Capesize rates. Coming off the back of a fear-induced market wobble, government stimulus in China and a more dovish Federal Reserve are providing a boost to global demand. Of course, we should not take the parallels too far. We do not expect Chinese demand to power the global economy to the point that there are concerns of overheating as there were then. But Chinese demand should help paper over the drop-offs elsewhere and lead to a rebound of activity levels in the export-led economies of Europe and Japan. Overall, global demand is likely to stay robust. As we move further into this long economic cycle, that will be a big help.

China's expansion focus turns inward

The annual meeting of China's top legislative body is now in the middle of its session. The National People's Congress began on Tuesday (5th) for the opening of this year's session, which will last roughly two weeks and see delegates vote on key pieces of legislation. As well as the customary law-enforcement crackdown, so far this year we have seen some interesting talking points emerge.

Most of these have come from the government's work report, delivered by Premier Li Keqiang to the Great Hall of the People on opening day. The headline-grabber is the cut to economic growth targets: this year China is aiming for GDP growth in the 6-6.5% range, lower than in previous years. This does not come as too much of a surprise. 2018 was China's slowest year of growth since 1990, even going by official (read 'dubious') figures. And unfavourable conditions both at home and abroad have made lofty growth targets unfeasible.

Nonetheless, the target slashing is still significant. More than just a recognition of tough times, it is a reaffirmation from the leadership that there are problems that growth cannot cure. In his speech, Li emphasised that the government's reform plan would be pursued even if it came at the cost of lower short-term growth. According to China Daily the government will pursue "higher-quality development amid mounting uncertainties in the international economic landscape." The pollution issues are particularly at the forefront, given that the major steel producing areas were beset by smog issues this week.

The economic slowdown has meant that an expansion of the fiscal deficit was inevitable, and so it came to pass. Indeed, some saw the size of the announced fiscal boost as disappointing: the government will

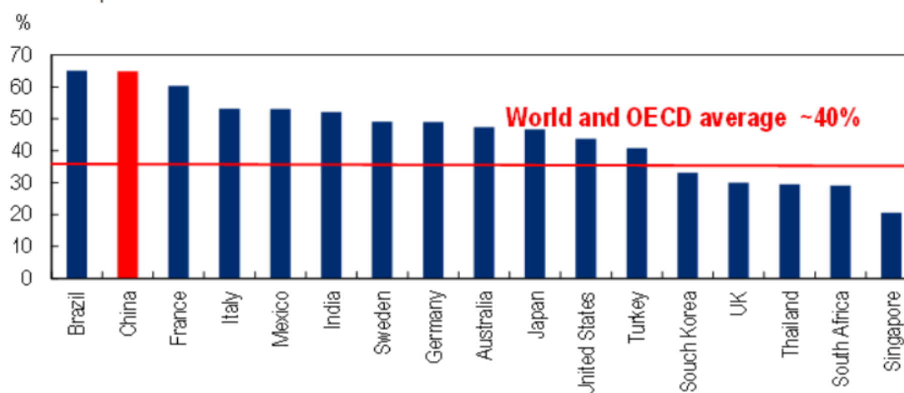
raise its fiscal deficit target to 2.8% of GDP, up from 2.6% last year. Li vowed to make proactive fiscal policy more forceful while keeping monetary policy neither too tight nor too loose.

The government fully intends to press ahead with major centrally-controlled infrastructure projects. However, a large proportion of this fiscal expansion will come in the form of tax cuts. The government is committing to a cut of nearly 2 trillion Yuan in taxes and corporate pension payments – especially for private and small enterprises. So, while the deficit target is lower than expected, "The tax cuts exceed general market expectations, and the raised deficit ratio will provide ample room for increasing investment in infrastructure this year," according to Cheng Shi, chief economist at ICBC International.

Premier LI Keqiang announced (on Mar 5th) a further cut of VAT rates in 2019. The 16% VAT rate (for general manufacturing industry) will be cut to 13% and the 10% VAT rate (for transportation, construction, agriculture industries, etc.) will be lowered to 9%. Citi Research said "the VAT cut should perform as a substantially effective measure to alleviate corporate tax burden and thus stimulate the real economy. From the experience in 2018, we expect the detailed VAT cut implementation circulars as well as the official effective timetable will be released soon". They also note that it will particularly benefit domestically-focused producers in China - rather than its exporters.

It will also help to underpin profits for the corporate sector. Chinese companies are amongst the most taxed in the world, a fact which has been significant in holding back foreign investment in China.

Corporate Tax Burden Comparison: Total Tax Rate % of Commercial Profits in 2018



Source: World bank and Citi Research

Note: Total tax rate measures the amount of taxes and mandatory contributions payable by businesses after accounting for allowable deductions and exemptions as a share of commercial profits. Taxes withheld (such as personal income tax) or collected and remitted to tax authorities (such as value added taxes, sales taxes or goods and service taxes) are excluded.

All of this is in line with what we have been saying on China for some time: Chinese stimulus is genuine, and will likely be effective, although it will not deliver the stellar growth spurt of previous episodes. Back in 2015/16, the government responded to economic weakness by encouraging a renewed private credit binge that substantially boosted short-term growth. But now – amid an ongoing reform and a crackdown on the shadow banking sector – Beijing cannot afford to inflate its credit bubble (one of the country's biggest sources of growth in recent years) any more.

This is apparent from the government's focus on "stabilisation" and "economic risks" rather than all-out growth. According to economist Zhang Ming of the Chinese Academy of Social Sciences, the lower-than-expected deficit target "points to the cautiousness of the central authorities," As we wrote last week, the apparent expansion of capital we have seen in China in recent months could be illusory when the rapidly

vanishing shadow banking sector is taken into account. On-the-books capital has expanded, but only just enough to compensate for the contraction of off-the-books capital, keeping overall money supply constant. With that in mind, it is telling that Li also vowed to keep broad money supply (M2) growth roughly in line with last year.

What does this all mean for the Chinese and world economies? In recent years, China's importance to the global economy has grown as fast as its own GDP. Back in 2016, when fears over slowing global growth and looming recession sent asset markets into tailspin (sound familiar?) it was China, not the US or Europe, that ignited global growth. Now, with the US cooling from its stellar 2018 (and Europe and Japan both still being 'demand takers' rather than 'demand givers') China is likely to be the deciding factor again.

As noted, hopes of a 2016-style binge are wishful thinking. Indeed, recent data from the world's second largest economy has been disappointing. But we still expect China to grow reasonably well, and thereby to have a positive effect for the rest of the world. This is especially true considering Beijing's focus on stimulating consumer demand and aiding smaller businesses. Tax cuts, infrastructure spending, and reforms of the financial sector should all support the private side of China's economy – to the benefit of everyone else.

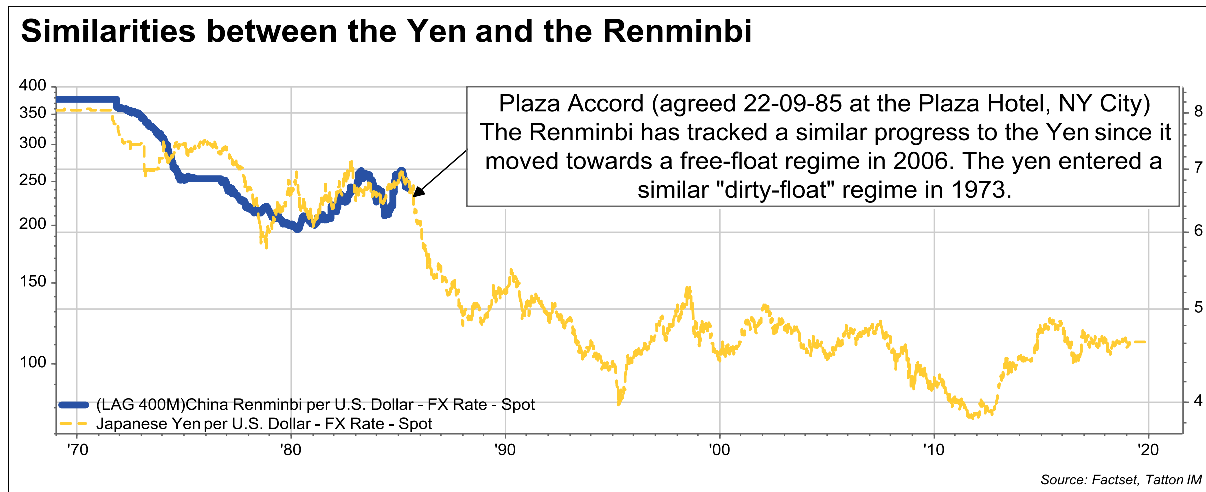
For the first part of this year, China's stock market has soared. China's CSI 300 index shot to a nine-month high on Monday, on the eve of the NPC session, and is around 25% up year-to-date (after an admittedly torrid 2018). The rally seems to be driven at least partly by optimism around China's economy – and Beijing's stimulus measures in particular.

The other part, of course, is trade. Chinese assets have undoubtedly been buoyed by a thawing of Sino-American trade relations – with President Trump's tariff delay last week sparking a near 6% jump in Chinese equities.

On that front, investors should take heart from this year's NPC session. Premier Li highlighted Beijing's commitment to settling US-China trade negotiations in his speech, as well as making the usual proclamations of further opening China's economy. But more importantly, this year the NPC is expected to pass the long-awaited foreign investment law, including provisions against forced technology transfers. This has long been one of the US's major gripes with China, so any move towards resolution here is a massive step.

As a final point, it is also likely that a stronger Chinese economy could itself help achieve a trade armistice. Chinese currency weakness and the US's trade deficit are among Trump's biggest talking points. But if Chinese consumer demand moves more strongly (which is likely) and investors flock to an improving Chinese economy (already underway) both could improve drastically.

This year, we could well see stronger Chinese consumer demand and a stronger RMB (China's currency). Indeed, it is a strong rumour in the foreign exchange markets that the trade deal could include some sort of currency pact, a commitment to engender currency stability, even RMB strength in both the medium and long-term. Although times are different, a similar deal between the US and Japan (and others) in 1985



ushered in the period of Yen strength which saw Japan's domestic demand soar. Without a doubt, the world would greatly benefit from a China-US equivalent now.

There is more to Tesla than EVs[1]

It seems not a week goes by when Elon Musk is not in the news. It is either his companies doing something great, getting something wrong, or him doing something unusual. Recently, we have had a dose of all three, even without mentioning the recent announcement of plans to close most of Tesla's hallmark shopping mall-based showrooms.

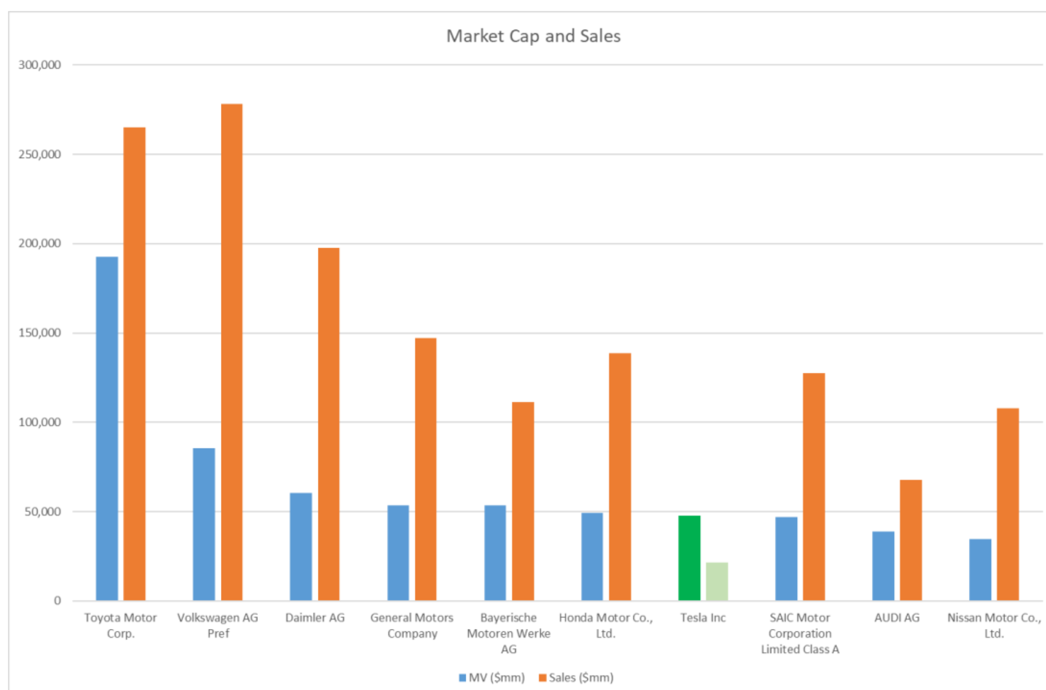
In the last week, Musk's aeronautical venture SpaceX successfully docked one of its Crew Dragon spacecrafts with the ISS and secured its position ahead of Boeing to ultimately be able to deliver people to the ISS without the Russian Soyuz-based system (the only way up since NASA's Space Shuttles were retired in 2011). An astonishing achievement as the company has made something which most nations cannot do look routine.

Unfortunately, Mr Musk's earth-based activities have seen a few more bumps in the road of late. His battle with the US's capital markets supervision authority, the SEC, continues, and whether he respects them or not (he does not, according to an interview late last year) they might well cause him some more headaches, thanks (unsurprisingly) to his Twitter output. He misstated the production numbers he expects for 2019, quoting instead the end-of-year expected run rate (500k/year) rather than delivered vehicles that year (400k). He has until next week to explain himself. But if the SEC find him in contempt of their agreement – which includes policing of his social media posting conduct – he could be in a lot of hot water.

[1] Electric Vehicles for the uninitiated

Tesla seemed to hit more of an operational hiccup last week as 1,600 Model 3s were impounded in China for import violations (thanks to a misprinted run of labels!). Luckily, this seems to have been dealt with and things appear to be running more smoothly now. And it is a good job too, given China will almost certainly be by far the largest market for electric vehicles, in the near future at least. China is also the place where Tesla is building a massive new factory, with production of cars there expected to start this year.

Despite all this volatility, Tesla remains in the top 10 automotive companies in stock market capitalisation terms, despite revenues only ranking around 40th in the industry (see comparative chart below – also showing Tesla to be the only one with a higher market capitalisation than annual sales). The usual explanation for this is their exposure to, and being a leader in, a rapidly growing market segment with structural tailwinds, which together should propel Tesla to the very top of the automotive tree. To that end, Tesla almost doubled their revenues from 2017 to 2018, and assuming revenues roughly scale with vehicle sale numbers, we should expect around a 60% increase in 2019 (101k sold in 2017, 250k in 2018, 400k in 2019 in very rough terms).



Whether this valuation remains justified is for stock pickers to decide. Perhaps the larger, more established companies will be able to head Tesla off at the pass. Or maybe Tesla will go the way of the dinosaur (ironic given that that is what powers their rivals' cars), or maybe Tesla will simply slot into the top table of automotive companies once electric cars become the norm.

Whatever is in store for Tesla, it is worth reminding ourselves what the goal for the company is and who is in control. Elon Musk owns around 20% of the company but is able to wield far greater control than this percentage would imply due to the company's voting structure. In 2006, Musk had this to say about the strategic goals of Tesla: "the overarching purpose of Tesla Motors (and the reason I am funding the company) is to help expedite the move from a mine-and-burn hydrocarbon economy towards a solar electric economy, which I believe to be the primary, but not exclusive, sustainable solution."

(https://www.tesla.com/en_GB/blog/secret-tesla-motors-master-plan-just-between-you-and-me?redirect=no). Note the lack of mention of profits, growth, or even survival of the company. I suspect that even if Tesla is ultimately run out of business, they will have achieved a large part of this lofty goal.

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11th March 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7104.3	0.0	-2.4	↘
FTSE 250	19047.7	-1.8	-352.0	↘
FTSE AS	3897.5	-0.3	-13.6	↘
FTSE Small	5419.1	-0.8	-44.9	↘
CAC	5231.2	-0.6	-34.0	↘
DAX	11457.8	-1.2	-143.8	↘
Dow	25337.0	-2.6	-689.3	↘
S&P 500	2734.4	-2.5	-69.3	↘
Nasdaq	6979.4	-2.4	-172.1	↘
Nikkei	21025.6	-2.7	-577.1	↘
MSCI World	2061.4	-1.7	-34.9	↘
MSCI EM	1043.6	-0.8	-8.0	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	5	16.8x	12.6x	13.2x
FTSE 250	3.4	24.0x	13.5x	14.1x
FTSE AS	4.7	17.8x	12.7x	13.4x
FTSE Small	4	-	11.0x	14.0x
CAC	3.3	17.6x	13.4x	13.4x
DAX	3.2	14.4x	12.6x	12.6x
Dow	2.3	16.1x	15.4x	15.0x
S&P 500	2	18.0x	16.4x	15.9x
Nasdaq	1.1	22.0x	19.4x	17.8x
Nikkei	2.1	15.5x	15.3x	19.0x
MSCI World	2.6	17.1x	15.3x	15.2x
MSCI EM	2.8	12.8x	12.3x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
British American Tobac	7.5	GVC Holdings	-11.6
Rightmove	5.4	International Consoli	-10.6
Reckitt Benckiser	5.0	Paddy Power Betfair	-9.8
Unilever	4.5	Schroders	-8.7
Imperial Brands	3.4	Persimmon	-7.6

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	-1.45	OIL	64.6	-0.7
USD/EUR	1.12	-1.05	GOLD	1298.6	0.4
JPY/USD	111.11	0.70	SILVER	15.3	0.9
GBP/EUR	0.86	-0.42	COPPER	289.5	-1.3
CNY/USD	6.72	-0.23	ALUMIN	1864.0	-2.5

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.189	-8.3	-0.11
US 10-Yr	2.634	-4.3	-0.12
French 10-Yr	0.407	-29.6	-0.17
German 10-Yr	0.069	-62.3	-0.11
Japanese 10-Yr	-0.033	-371.4	-0.03

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.53
2-yr Fixed Rate	1.73
3-yr Fixed Rate	1.93
5-yr Fixed Rate	2.05
Standard Variable	4.31
10-yr Fixed Rate	2.48

* 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.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD