THE **CAMBRIDGE** WEEKLY

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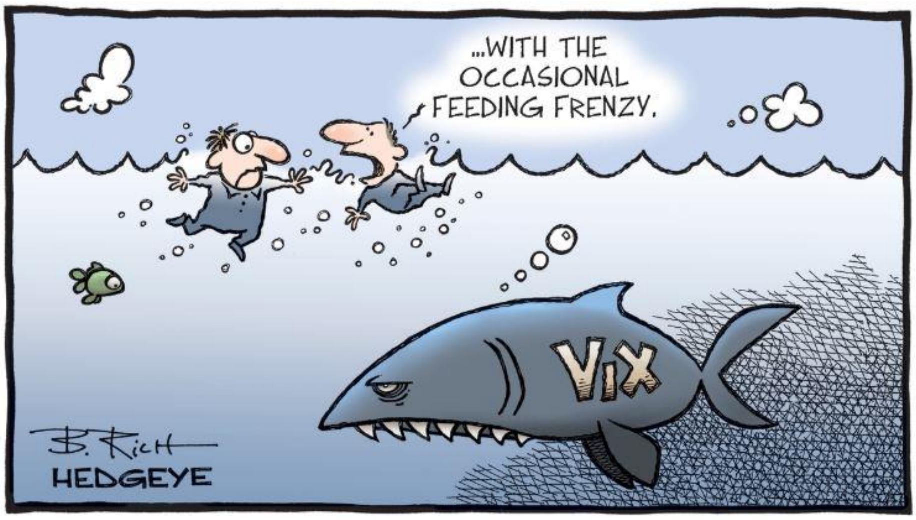


Source: Hedgeye – VIX (gauge for stock market volatility) shark, 17 May 2019

Mixed messages

After a good start, June has carried on in a positive way for investors. Over the past week stock markets consolidated their gains, while bond yields stopped falling. Following the rapid deterioration of US manufacturing data, a number of positive data releases confirmed the ongoing optimistic disposition of consumers and the upbeat sentiment of smaller businesses and the services sector. Notably these surveys took place before President Trump ended his Mexican tariff standoff over the weekend as suddenly as he had started it.

It is somewhat encouraging that despite better news, stock markets held on to the gains they made the week before, when bad economic news led to an overwhelming belief that this would force central banks to cut rates, or at least ease monetary conditions and thereby revive the 'central bank put' for stock markets (see last week's lead article).

This stabilisation of market sentiment can perhaps be seen as evidence that we are experiencing a period of fine balance. A balance between the fear that the global manufacturing slowdown will worsen through a proliferation of Trump's trade wars (to the point of causing a global recession), and the hope that the resilience of consumer sentiment and service sector momentum will carry the economy over this precarious period of potential instability.

China grabbed the headlines with the Hong Kong protests instead of the economic news bulletin, namely that their monetary and fiscal stimulus measures are now showing traction in the economy, and their export industries may already be finding routes around the tariff hurdles. However, as we have written before, this activity rebound will mostly stabilise China itself, but cannot be expected to bail out the global economy as well, as it at least partially did in 2015/2016.

In the UK on the other hand economic news was the opposite of encouraging. GDP growth came in negative for the month of April and growth in industrial production was not only negative for the month, but also year on year. UK stocks took it in their stride, because a setback after the 'March 2019 Brexit' stockpiling frenzy had been widely expected – although proved to have been underestimated.

That the UK's Bank of England nevertheless continued to try and persuade investors that it might well raise interest rates (against the economic and international trend) had much to do with its scenario planning for a 'Happy Brexit' which would likely lead to a rapid release of pent-up demand. There is a particular concern that in conjunction with ever lower mortgage rates from stiff lender competition, this could lead to a surge in UK house prices later in the year which could have unhealthy side effects. The rate-rise warnings therefore need to be taken with a pinch of salt – an amicable Brexit outcome would be a prerequisite for such a move.

On the Brexit front there was understandably much concerned debate about whether the election of a new Tory party leader – by a decidedly hard Brexit-leaning party membership – will lead to a higher probability of a No-Deal Brexit outcome – the opposite of a 'Happy Brexit'. Boris Johnson tried to defuse such concerns by stating that a No-Deal Brexit was not his favoured route, but as one political commentator put it, "the best thing about Boris is his ability to turn on a sixpence". Let us hope that this does not mean that the UK is following the US in adopting a new leadership style of utter unpredictability.

The coming weeks will be of crucial importance to the future course of financial markets in 2019. If the wider economy can remain resilient in the light of slowing trade and industrial production through continued consumer demand and service sector activity, then corporate earnings may not decline as much as some fear, and positive forward looking sentiment may carry us through this precarious stretch of global slowing. Unfortunately we are not starting from a particularly solid base and are therefore uncomfortably exposed to political derailments causing an abrupt souring of fragile sentiment.

Why does the BoE still want to raise rates?

The Bank of England (BoE) is beginning to look like the odd one out among the world's central banks. A slowdown in global growth looks set to force a loosening of global monetary policy, led by a more dovish (preferring lower rates) US Federal Reserve, according to market expectations at least. Meanwhile, the BoE continues to suggest that they are minded to tighten policy, rather than loosen it. At the BoE's last meeting in May, Governor Mark Carney suggested that UK interest rates may have to go up faster than expected in the event of an orderly Brexit.

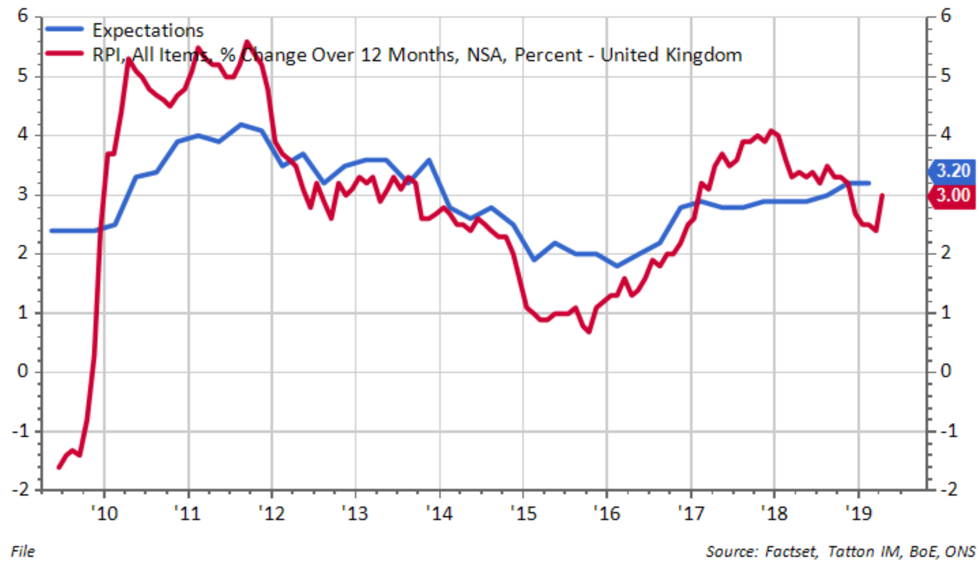
Several officials from the Bank have since then warned that their monetary policy committee is still on track to raise rates several times over the next couple of years. Just this week, Deputy Governor Ben Broadbent told MPs that "Were the economy to develop in line with our projection ... interest rates would probably have to rise by a little more than what was in the curve at the time of the forecast." (The 'curve' gives an indication of market expectations)

This stands in stark contrast to the US, where the Fed has sounded ever more cautious in recent months, and where investors now expect interest rates to fall three times before the end of the year. That might sound a little puzzling, given the underinvestment drag toll the Brexit drama is having on the UK economy. Despite both US and UK data showing a slowdown in growth, the central banks are not reacting the same way.

We wrote a few weeks ago that the Fed is in the process of changing its reaction function – choosing to look past a tight labour market and focus on the overall economy, which is currently slowing. Meanwhile, the BoE can see a similarly tight labour market here, and an economy under similar pressures, but with an extra dash of Brexit uncertainty on top. But recent comments from MPC members suggest they are staying optimistic about the political situation.

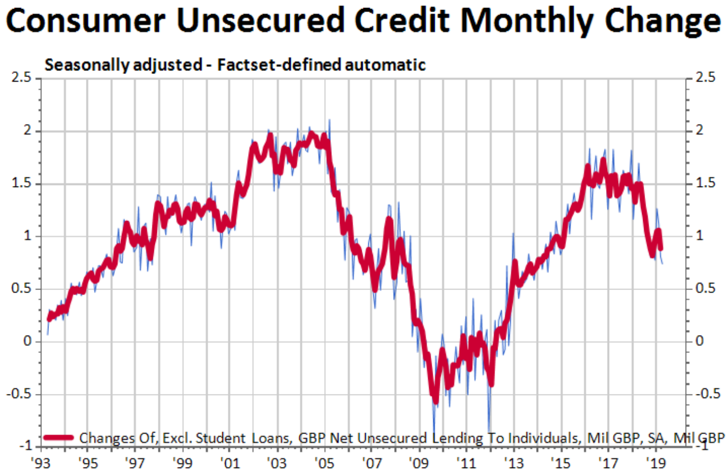
According to BoE forecasts, if the worst case scenario is avoided, the British economy will bounce back sharply. With unemployment low, that should lead to a rise in wages and, more importantly, a rise in inflation expectations. Indeed, as the chart below shows, inflation expectations have risen since 2016 and stayed higher.

UK Inflation and Public Expectations

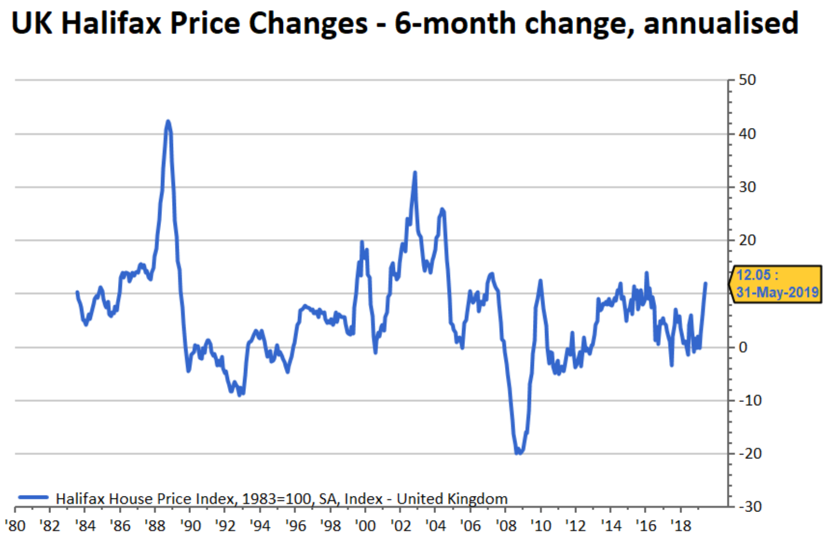


But the problem with this analysis is that, looking at our usual economic indicators, it is hard to argue that current interest rates are too low. Investment has taken a serious hit, the housing market looks lethargic, real (inflation-adjusted) wage growth is still lagging and business sentiment is low. Much of this has to do with Brexit uncertainty, but the fact is that UK companies (especially auto-manufacturers) are struggling.

Usually, the key sign that interest rates are too low (thereby causing instabilty) is large credit growth, particularly consumer credit, which pushes demand beyond the economy's capacity and thus leads to rising prices. But there is little sign this is happening. Unsecured borrowing, for example, shows little sign of any activity.



Then there is the housing market. The RICS residential property survey, released this week, had a mostly downbeat message for UK property. House prices in the South East, particularly London, are clearly still under pressure. But there were some bright spots: the commentary on sales was more supportive than in a number of months, and while letting agents are concerned about the ban on tenant fees (perhaps for the sake of their own profit margins) the overall rental market is showing some improvement. Outside of the South East, things are not as bad, with one estate agent commenting that the market is "still strong due to urban (mainly London/Essex) mass exodus."

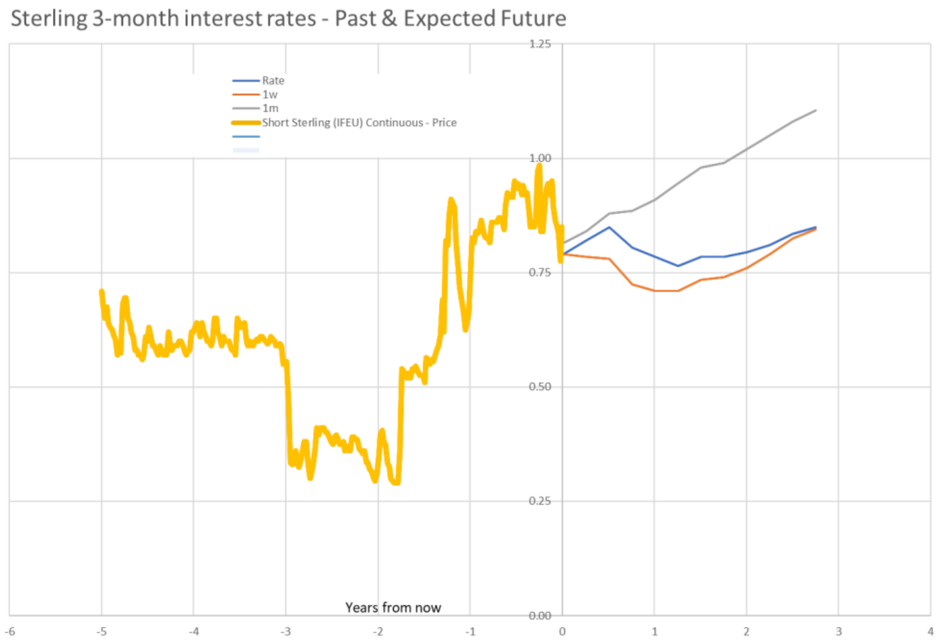


In fact, the Halifax house price index is actually showing a fairly strong reading for the UK overall, with an approximate annualised rate of 12%. We suspect that the BoE's view of the housing market is one of the main reasons for their hawkishness. They are probably concerned that a surge of optimism (i.e. if Brexit uncertainties suddenly disappear) could cause house prices to suddenly jump as they did in the 1980s and early 2000s. That may not seem likely, but when you bear in mind the current 'mortgage war' among the banks, it sounds less far-fetched.

But that scenario is wholly dependent on a strong labour market. If employment starts to flake and consumer confidence comes under pressure, house prices will have little support. And on that front, things are looking uneasy. It seems that every day we get more headlines about companies under stress. If that continues, we could see a bout of layoffs, pushing up unemployment. Fortunately, the current data has yet to show any signs of this. And with austerity policies becoming politically unpopular in all major parties, public spending is likely to increase – or at least stay the same – regardless of what happens in Westminster. That should at least keep public sector employment stable.

What should we make of all of this? As much as the BoE's inflation fears may seem odd to some, they are perhaps understandable. Inflation has been stable for a considerable period of time and public expectations of the long-term trend – which is the Bank's main concern – are usually fairly stable. But the housing market has long been a thorn in the side of policymakers, and if they suspect that it will turn quickly, they will want to act. As Mark Carney approaches the end of his term, you can understand why he would be concerned.

As always, the key question is whether that concern becomes a reality. At the moment, just as with so many other things, this seems to depend largely on Brexit. If Brexit has a happy ending before the year is out, expect higher deposit rates and yield. However, amidst all the fears all around, it is hard to see that happening. And the market (curve!) seems to agree.



China moving away from US dependence

While trade wars and Hong Kong's largest ever protests rage on in the background, the economic newsflow paints a better picture for China. Chinese exports are now showing signs of levelling off, after falls earlier in the year, while imports have also recovered from their lows. Meanwhile, the government continues to push forward supportive measures for the economy. On Monday, the State Council released a document allowing local government special bonds to be used as equity for infrastructure projects, and encouraging financial institutions to support those projects. Support for these infrastructure projects – i.e. in the form of bank loans – will not be considered as contributing to implicit local government debt.

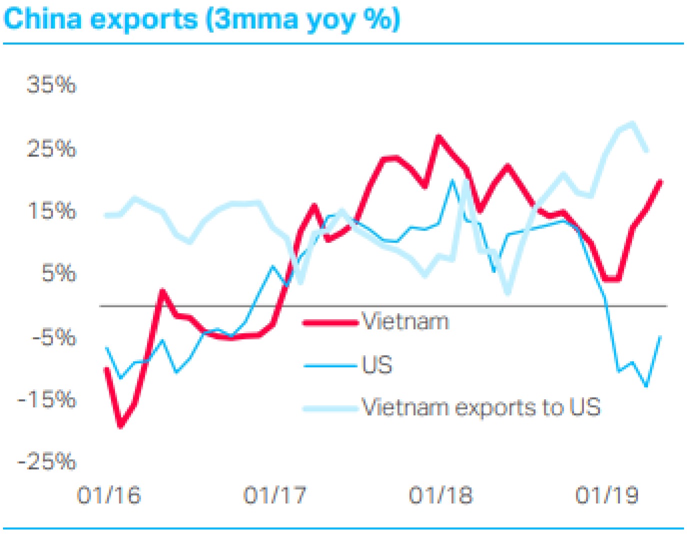
Not all of the data is gleaming in the world's second largest economy. Car sales fell 12.5% in May – making it a remarkable 12 consecutive months of sales declines for the country's automotive sector. This suggests the economic slowdown has not quite passed, and that consumer demand is still struggling. But overall, there are signs that Beijing's reflationary policies are starting to have an effect. And importantly, those policies show little sign of stopping yet.

According to Yi Gang, governor of the People's Bank of China (PBoC), China has "tremendous" room to adjust monetary policy, in particular if the US-China trade war worsens. "We have plenty of room in interest rates, we have plenty of room in required reserve ratio rates, and also for the fiscal, monetary policy toolkit. I think the room for adjustment is tremendous," Mr Yi told The Business Times.

This positivity stands in contrast to the rest of the global economy. A slowing US economy and dampening outlook for global trade have already made some financial and economic commentators sound the warning bells. The US-China trade war stands at the heart of that dour outlook, threatening to end the era of increasingly globalised trade. Negotiations have so far failed to show a light at the end of the tunnel, and more and more it seems as though business executives expect that tariffs are here to stay. What's more, as we wrote recently, anti-China policy is now a rare point of agreement between the US's two main political parties. So, it is plausible that Trump's trade wars could outlive their eponymous President.

That is what makes China's current domestic stability heartening. Tariffs have already been imposed, and even larger measures have been taken (such as Trump's move against Huawei). But Beijing's reflation continues to take hold – and not all the tariff impacts are necessarily bad for China.

Predictably, the hefty US levies on goods made in China are putting manufacturers off using the country as a base. Reportedly, Nintendo and Apple – both of whom have a huge production presence in China – are considering moving their production elsewhere in southeast Asia (most likely Vietnam) to avoid Trump's tariffs. But so far, the most obvious effect here has been re-routing, with Chinese companies sending their goods through SE Asia only to then be shipped to the US. While exports to the US have been hit hard by tariffs, exports to ASEAN (Association of Southeast Asian Nations) countries – and particularly Vietnam – have boomed. And as the chart below (from our external researchers TS Lombard; *3mma yoy = 3 months moving average year on year*) shows, that has coincided with a massive spike in Vietnamese goods going to America. The re-routing through Vietnam has become so obvious that the government in Hanoi is even taking steps to prevent Chinese exporters hijacking the "made in Vietnam" label.



Source: CEIC

Exploiting loopholes in the tariffs is not a long-term solution. What is more likely over the longer run is that manufacturers will shift production – as Apple and Nintendo have suggested. But this is not all bad for China. As growth boosts wages and Chinese companies move up the supply chain (as they are currently trying to do in the 5G race) outsourcing production to cheaper nations is likely to happen anyway – boosting capital inflow and investment within China.

This is a trend that was noticeable before Donald Trump, and is likely to continue regardless of US-China relations. But potentially permanent tariffs are likely to do two things: speed this process up, and hasten the creation of a large East Asian trading bloc, centred around China. This is not a straightforward process for the Chinese – who still do not have the means to generate all high-tech components themselves, but instead rely on countries like Taiwan to supply them to their assembly lines. The move away from globalisation in recent years means that moving up the value chain will now be a top priority.

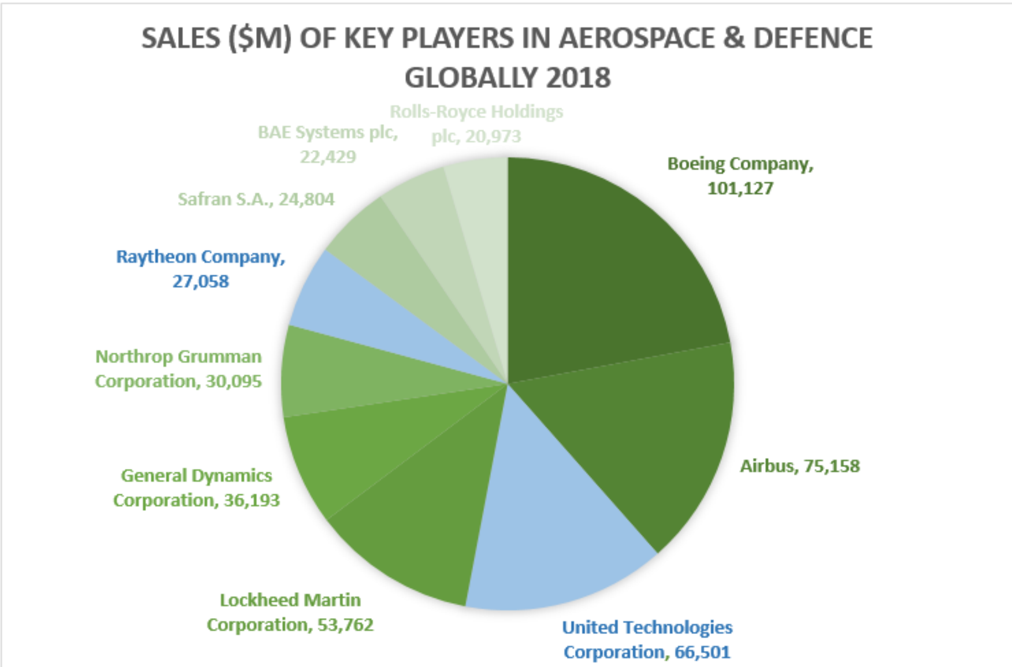
Indeed, the fact that Beijing is now pushing hard on the stimulus button suggests an acceptance that the trade war is not going to get resolved any time soon. Moves in the Chinese currency – which has been a major point of contention for Donald Trump – also support this. Throughout trade negotiations, Beijing has – despite economic pressure – kept the RMB from devaluing against the dollar as a gesture of goodwill to the White House (a lower exchange rate would undermine the price- increasing impact of the tariffs on Chinese exports). But in recent months, Beijing seems to have been happy to let it slide to multi-year lows. If negotiations worsen from here, they might forgo the niceties and let the currency weaken further – past the psychologically important $7 level.

It is worth pointing out however, that this move away from US dependence is not the same as China moving away from globalisation itself. Throughout the trade war, China has been at pains to reaffirm its trading ties with the rest of the world – including the UK, EU and throughout Asia. On this front, their insistence on pushing through the Hong Kong extradition law – despite publicised widespread opposition from their global trade partners – will not have done them any favours.

Unfortunately, one big downside to all this is that Chinese stimulus – no matter how big – is unlikely to provide much fuel for the global economy. Back in 2015/16, huge Chinese stimulus proved a boon for the world. But with the current outlook for global trade, and Beijing's domestically focused goals, we are not likely to see a repeat at the same level. For China, economic independence is the goal.

The 'Monster' in Defence

This week saw the announcement of what is likely to be one of the biggest corporate mergers of the year. United Technologies Corporation (UTC) and Raytheon are intending to combine in a 'merger of equals' to become the second largest company in the aerospace and defence industry by revenue. The deal has allegedly created a 'monster' supplier, with the two companies currently boasting a combined market cap of $166bn. This news comes off the back of a recent upturn in mergers and acquisitions (M&A) within the aerospace and defence industry, including UTC's own $23bn takeover of aircraft parts maker Rockwell Collins in 2018 (as well as Goodrich), and Raytheon's purchase of cybersecurity firm Websense (now known as Forcepoint) in 2015.



Source: Factset

One of the key drivers for action for the UTC-Raytheon deal (soon to be known as Raytheon Technologies Corporation) has been US defence spending. During Donald Trump's presidency, US defence spending has risen in line with his promises to "rebuild the military". However, this seems destined to wane over the longer term. In addition, the Pentagon are demanding better value from their defence contractors. This could lead to less lucrative contracts and significant pressure on profit margins in an industry dominated by just five key players: Lockheed Martin, Boeing, General Dynamics, Northrop Grumman and Raytheon.

Given the US Government accounted for 84% of Raytheon's $27.1bn revenue in 2018, the Pentagon's interest in the deal is understandable. But it is less clear what exactly their view of it is. On the one hand, the US is falling behind Russia and China in the hypersonic space (Mach 5+ vehicles/missiles), and a combination of these two corporations could promote developments in such technologies, especially given Raytheon's focus on missile systems. This could provide a single champion in charge of pursuing advancements, keeping it at the forefront of defence capabilities – something the Trump administration is no doubt keen to do.

On the other hand, the combination of these two corporations does further reduce the likelihood of competition and may provide less room for the US Government to negotiate the deals it is after. Trump himself has this week stated he is a "little concerned", adding "When I hear they are merging, does that take away more competition? It becomes one big, fat, beautiful company, but I have to negotiate - meaning the United States has to buy things - and does that make it less competitive? Because it's already non-competitive." Further to this, it puts more power into those at the top of the newly created pyramid, given the size of the contracts they are going to jointly be in control of.

The timing of this therefore is interesting. M&A is typically cyclical in nature. Volumes are driven by economic conditions, regulatory changes and changes in technology, meaning M&A transaction volumes have had peaks and troughs over the previous century. In recent years, where we have seen bullish growth and good expectations of future earnings, we have seen high M&A volumes, especially driven by industries such as software, furthering expansion through acquisitions.

From this perspective, the reasons for this merger are less clear. Is a gloomier outlook and potential pressure from government spending encouraging these companies to combine forces and push for efficiencies of scale? Or is it simply that any previous efforts to combine would have been revoked, and this has been the first opportunity for the deal to occur? Perhaps they believe they have room to monopolise certain technologies in aerospace and defence. What is very interesting is that both parties seem happy with the agreement, even without a premium included, something which is rare given that a 20% premium appears to be the consensus for most M&A activity.

It is invariably hard to tell the exact benefit to companies of their previous M&A activity. UTC's revenue and earnings over the past 10 years would suggest that the benefit from the $16.4bn purchase of Goodrich in 2012 had very little short-term impact on either revenue or growth, which remained flat for four years post-acquisition. It would not be prudent to include benefit from Rockwell Collins in the company's 2018 figures, given it was not finalised until later in the year. For Raytheon, Forcepoint's revenue has almost doubled since acquisition ($360m to $680m), contributing to Raytheon's $4bn revenue growth in the same period.

How this deal impacts further M&A within the sector could also be interesting. UTC and Raytheon's competitors will not be pleased to see the combination of two of the most important contractors to the US Government, especially with many of them having have had their eyes on acquisitions previously.

Closer to home, BAE and EADS, the Franco-German owner of Airbus, had previously, back in 2012, been negotiating a merger to create a European giant with over 220,000 employees. Competing on a global scale may entice both parties to revisit this agreement, although winning over Merkel and the German government could prove to be one obstacle.

It will be interesting to see in the short-term whether the ongoing M&A activity we see here is unique to the aerospace and defence industry, or whether it is a sign that some of these major multinational corporations are again beginning to hunt for a way to increase margins across borders. Perhaps globalisation has not entered eternal decline after all.

CAMBRIDGE
INVESTMENTS LIMITED

17th June 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7345.8	0.2	13.8	↘
FTSE 250	19118.3	-0.6	-114.1	↘
FTSE AS	4010.8	0.1	2.7	↘
FTSE Small	5583.3	0.1	7.6	↘
CAC	5367.6	0.1	3.6	↘
DAX	12096.4	1.2	143.3	↘
Dow	26066.4	0.3	82.4	↘
S&P 500	2884.7	0.4	11.3	↘
Nasdaq	7471.0	0.7	53.7	↘
Nikkei	21116.9	1.1	232.2	↘
MSCI World	2137.0	0.5	10.1	↘
MSCI EM	1022.1	1.5	14.7	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.9	17.4	12.8	13.3x
FTSE 250	3.4	24.2	13.3	14.2x
FTSE AS	4.6	18.4	12.9	13.4x
FTSE Small	3.6	-	17.1	14.1x
CAC	3.4	18	14	13.4x
DAX	3.3	16	13.1	12.6x
Dow	2.3	16.7	16.2	14.8x
S&P 500	1.9	18.9	17.3	15.9x
Nasdaq	1.1	23.6	20.8	17.9x
Nikkei	2.2	15.7	15.1	18.3x
MSCI World	2.5	17.9	16	15.2x
MSCI EM	2.8	13.3	12.7	12.1x

Top 5 Gainers / Top 5 Decliners

COMPANY	%	COMPANY	%
Evraz	10.0	Auto Trader Group	-5.9
Anglo American	6.9	Persimmon	-4.7
Antofagasta	6.7	Imperial Brands	-4.7
DS Smith	6.5	Centrica	-4.5
Rio Tinto	5.6	British American T.	-4.3

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.26	-1.08	OIL	62.2	-1.8
USD/EUR	1.12	-1.04	GOLD	1349.7	0.7
JPY/USD	108.45	-0.24	SILVER	14.9	-0.7
GBP/EUR	0.89	-0.04	COPPER	264.0	0.5
CNY/USD	6.93	-0.23	ALUMIN	1787.0	0.6

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	0.847	4.2	0.03
US 10-Yr	2.084	0.1	0.00
French 10-Yr	0.094	10.6	0.01
German 10-Yr	-0.255	0.8	0.00
Japanese 10-Yr	-0.129	-7.5	-0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.66
3-yr Fixed Rate	1.80
5-yr Fixed Rate	1.98
Standard Variable	4.29
10-yr Fixed Rate	2.61

* 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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