CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

29 July 2019

Lothar Mentel

Lead Investment Adviser to Cambridge

Source: Peter Brookes, The Times, 26th July

The quick and the not-so-quick

It's official: May is out and Boris is in. But despite the political changes this could bring, currency markets hardly reacted. £-sterling started the month at €1=£0.897, and remains at that level at the time of writing. It has weakened marginally since last weekend. Negotiators on both sides of the channel have signalled intransigence ahead of any new talks. Talk of an election before the Halloween deadline is growing. After Mr Johnson's question-time pummelling of Mr Corbyn (Quentin Letts in The Times), markets may not fear the prospect of a left-wing government so much. The opinion polls will be interesting over the next few weeks. Still, Mr Johnson will not forget Mrs May's electoral blunder and certainly won't be eager to hold the record for shortest tenure.

For investors, the risks remain large, and the outcomes binary and balanced. Our rough calculus is that "no deal" has about a 33% chance – causing sterling to fall 10-20% – while "deal" is more likely at about 66%, sending sterling up about 5-10%. While we think about Brexit outcomes often, we don't have any more information than others, so we don't think this is a good area to carry active risk for our clients. We talk more about the new government and what it means in a separate article below.

Last week, we wrote about the likelihood that there would be monetary policy action from the US's Federal Open Markets Committee (FOMC) and the Governing Council of the European Central Bank (ECB). This Thursday saw a statement from the ECB, followed by a post-meeting press conference from

President Mario Draghi. The decision was very clear. Unanimously, they have decided that is necessary to do something at some point, probably soon.

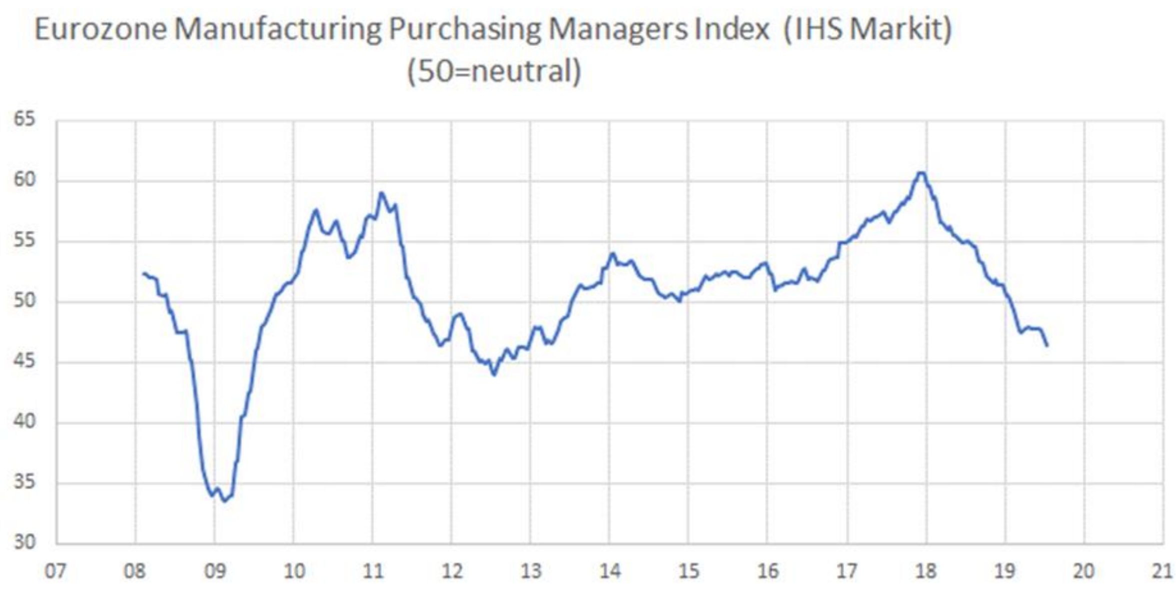
Draghi told reporters that all ECB members agreed further stimulus was needed, while the ECB changed the forward-looking component of the official statement, saying that it now expects its key interest rates to remain "at their present or lower levels" at least through the first half of 2020.

"A significant degree of monetary stimulus continues to be necessary to ensure that financial conditions remain very favourable and support the euro area expansion", though there were differences regarding the various elements of any program. "We had a broad discussion," he said, "Whenever we have a package so complex as this, you'd expect that people have different nuances about the different parts of the package."

The euro hit a two-year low of $1.1103 after the ECB's change in guidance, while the German 30-year bond yield traded at a record low, slightly below 0.17%.

That the currency and yields went down that much could be taken as a sign that traders were reacting to a rise in certainty that rates would be lowered. However, another explanation is that the chances are that euro-based asset returns will be lower for longer because the economy is not getting the support it needs quickly enough.

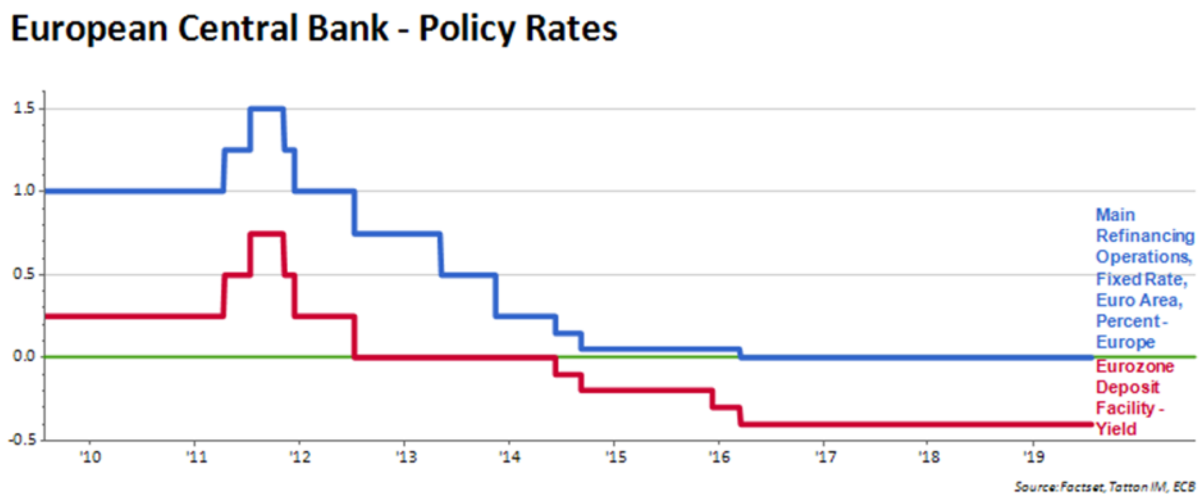
Data out on Wednesday highlighted the continued weakness of Europe's economy. It was hoped that the manufacturing PMIs (Purchasing Managers' Indices) would remain stable at least. But the IHS Markit Eurozone Manufacturing PMI dropped to 46.4 in July 2019 from the previous month's 47.6 and below market expectations of 47.6, while the German manufacturing PMI fell to43.1 in July from 45.0 in June. At the same time, new orders in the country dropped at their fastest pace since July 2012, on the back of weakness in Chinese demand and in the auto sector.



Source: TattonIM and IHS Markit

If it is so clear that the economy is weak and that action is needed, why the delay?

We had expected a move of 10bp downwards in the Euro Area Deposit Facility Rate, which would have taken it further into negative territory, to -0.5%.



But, as noted in previous weeklies and as is widely appreciated, bank profitability is damaged because depositors are reluctant to place money with the banks when rates are below zero. That reduces the funds that banks can lend and so the benefit of lower rates is not passed on to borrowers.

So, a rate cut would have to be accompanied by another program of targeted long-term funding from the ECB, and clearly the details have not been agreed.

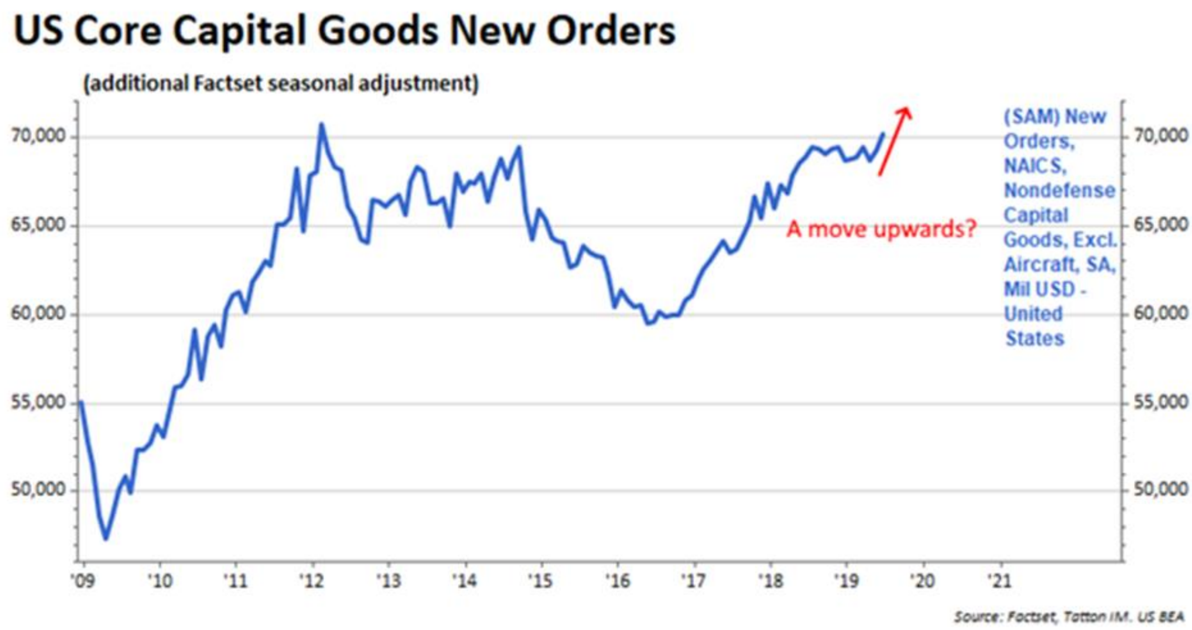
It is also possible that there is a political consideration – that the ECB did not want to poke the US Presidential bear. Trump could accuse Europe of trying to devalue the euro by cutting rates before the FOMC could, while raising the political pressure on the Fed. Perhaps the central bankers are sticking together.

The lower yields and euro currency are not substantial, and the market appears to be giving the ECB the benefit of the doubt. Draghi has been effective in the past, and his successor (Lagarde in November) will give the hawks the same treatment. Investors still seem to believe rate cuts will happen and quantitative easing will resume in September.

We think so too, but the delay is disappointing and does raise questions about the ability of Draghi to get his policies enacted. As such, the risks of a further decline in the euro and the European economy have grown.

Meanwhile, over on the other side of the pond, there are some encouraging signs for growth in corporate earnings. But crucially for investors, these green shoots are not enough to make the market question the outcome of next week's FOMC meeting: A cut of 0.25% in policy rates is expected on the 31st July, with another 0.25% cut being signalled for September.

Durable goods orders were perkier than expected and core capital goods new orders seem to have broken higher. Meanwhile, government and consumer spending were strong during the second quarter, according to preliminary GDP data.



Second quarter results are also better than expected, perhaps as a result of some fairly aggressive guiding down beforehand, but still are good enough to mean that an earnings fall (relative to 2Q last year) may not come to pass.

All this is adding up to a marginally stronger dollar, despite expectations of lower short-term interest rates. US real money supply is already rising ahead of rate cuts because borrowing has resumed, so the coming rate cuts should be insurance against a fire rather than fighting a fire. Markets have done well in this scenario for a year to 18 months.

Of course, the Fed prompted bond yields to fall by getting dovieish back in May. It will still need to be quick to deliver next week – especially now that the ECC is not so quick.

Trump in 2020

US election campaigns are notoriously long. Despite being 15 months away from the fateful day in 2020 when Americans will choose their president (Tuesday 3rd November), the electoral machine is already up and running.

The party "primaries and caucuses" are the first stage. The Republicans won't have a contest so the focus will be on the Democrats. They will be electing delegates from February to June. These "pledged" delegates will vote at the convention scheduled to be held from July 13–16. It was thought that the Republicans had a huge field of 17 candidates in 2016 so the 25 Democrats currently vying for the chance to face off against President Trump is remarkable. Part of the reason for the huge field is that the "unpledged" delegates, drawn from Democrat leaders, no longer have the first decisive vote so the race is thought to be much more open. The Democrat candidates have debated publicly with each other once already and another 11 debates are in store before the party primaries.

Meanwhile, over at the Republican Ranch (Mar-a-Lago), not having a contested candidacy does not mean there will be no Republican campaigning. The Trump team will be trying hard to get the Democrats to put up a candidate that Trump can beat easily. In the first weeks, however, he'll be firing his shotgun fairly indiscriminately.

Trump has already entertained crowds at seven of his signature rallies and has more on the way. Already we have seen policies floated and incendiary tweets sent out. There will undoubtedly be more where they came from.

Recently, the Democrat-controlled US House of Representatives passed a motion condemning comments made by the president as racist. Trump infamously took to Twitter a couple of weeks ago to tell four congresswomen – all of whom are US citizens and only one of whom was born outside the US – to "go home", later doubling down his criticism of them and claiming in a live press conference that "lots of people loved" what he said.

Unsurprisingly, these comments have proven controversial even by Trump's standards. Prominent Democrats were all quick to condemn his remarks and label them racist, but what was interesting was the response from Republican politicians. A few Republicans went as far as using the word "racist", a larger number expressed anger or disappointment at the president's words, while most of the rest tried to deflect attention from the subject. Virtually none were supportive of Trump.

On the face of it, this looks like another blunder from a president who often lacks restraint. But a number of political commentators have suggested that this divisiveness is intentional rather than accidental. In 2016 – so the argument goes – it was Trump's ability to divide and conquer that won him the world's most powerful job. By polarising voters and galvanising his enthusiastic base – mostly white, rural and without college degrees – he was able to overcome his unpopularity with large sections of the American populace. And by focusing the debate on polarising issues such as race and immigration, he seems to be opting for this tactic again.

Back in August 2017, Steve Bannon – Trump's infamous former strategist and architect of the alt-right movement – was upfront about his tactics: "The Democrats, the longer they talk about identity politics, I got 'em. I want them to talk about racism every day. If the left is focused on race and identity, and we go with economic nationalism, we can crush the Democrats."

The economic aspect of Trump's "America First" agenda is undoubtedly popular. Trump wants to be seen as putting American jobs and workers ahead of all else. If the Democrats' only response to that is to call him racist, Trump voters will become only more enthusiastic. Like most of the right-wing populist movements that have arisen over the past decade, polarisation is a feature, not a bug.

The main question is whether it will work. And on that, things are far less clear. While the president may revel in controversy, the American public are less amused. An Ipsos poll last week showed that 68% of those surveyed found Trump's comments to the four congresswomen to be "offensive". 65% said they were "racist" while 59% went as far as describing the remarks as "un-American".

In fact, even disregarding the latest incident, there is reason to doubt that controversy has always been a winning tactic for Trump. According to analysis website FiveThirtyEight, Trump's approach to race and identity politics almost certainly helped land him the Republican presidential nomination back in 2016. Of those Republicans who claimed immigration was their biggest concern, Trump gained 60% of the primary votes. Among voters most concerned about the economy, terrorism or government spending, his vote share was 41%, 41% and 35% respectively. Trump's inflammatory rhetoric talk of building a wall, and banning Muslims put clear distance between him and the other blander GOP hopefuls, and this was instrumental in clinching the nomination.

But that racial issues helped him win the presidency is more contentious. There is research supporting the notion that immigration clinched conservative support in key swing states – and the demography of Trump voters supports this. But others dispute this. As usual, voters mainly backed the same parties they did in 2012, but Hillary Clinton was seen as essentially a continuation of Barack Obama, who voters had become tired of after two terms. It is plausible that Trump's race rhetoric was electorally neutral, but partisanship and desire for change won him the election.

What's more, it could well be that Trump's controversy lost the GOP votes in last year's midterm elections. The data here is unclear, but we note that Republican candidates seemed to lose support from Trump's main voter demographics, while Democrat support among Clinton's main voter demographics increased significantly.

Overall, the results are mixed. Trump always divides but doesn't always conquer. Despite the voting public's clear distaste for his recent comments, his overall approval ratings remained unchanged – and even increased by 5% among Republicans. Only 45% of Republicans considered his tweets "racist" and only 25% of them called them "un-American".

Regardless, the tactic is now central to the Trump campaign. From our perspective, the most immediate impact from this will be how it affects the various targets the president has already identified. Being tough on China – and therefore upping the trade war rhetoric – is a proven popular measure, meaning we should not expect it to stop any time soon. It may even be the case that Trump starts going harder after other trade targets, such as Japan or the EU, to drive home the "America First" message.

Back at home meanwhile, the White House cross hairs have fallen on Silicon Valley. This week, the US Department of Justice announced an antitrust probe into leading online platforms – just the latest move against the perceived power of Big Tech. Over the longer term, the moves against Silicon Valley giants are likely to be some of Trump's most impactful – from an investment perspective.

At a time when the divide between America's two parties seems as great as it has ever been, the power of Big Tech prompts rare bipartisan agreement. It is likely that, whatever the colours of the next president, s/he will continue the pressure on the likes of Google, Facebook and Amazon. Given Trump has already come out all guns blazing in the identity politics fight, his opponent – whoever it turns out to be – will likely have to match at least some of his economic nationalist policies.

UK Equities – looking through the sectors

Last week, we looked at the US market's performance over the year, as well as the sectoral differences in performance and earnings outlook. This week, we turn our attention to the UK. Despite political upheaval, UK equities have returned around 14% year to date for GBP investors. That is a strong number, but not quite as strong as Global markets – up around 22% in Sterling for the same period. Global equity returns were boosted somewhat by GBP weakness, with sterling falling from $1.27 to $1.25 USD (though remaining pretty stable against the Euro). Even so, UK companies seem to have been less favoured than others of late – though with some variation across sectors. So, what are the standout performers and what type of earnings growth is expected?

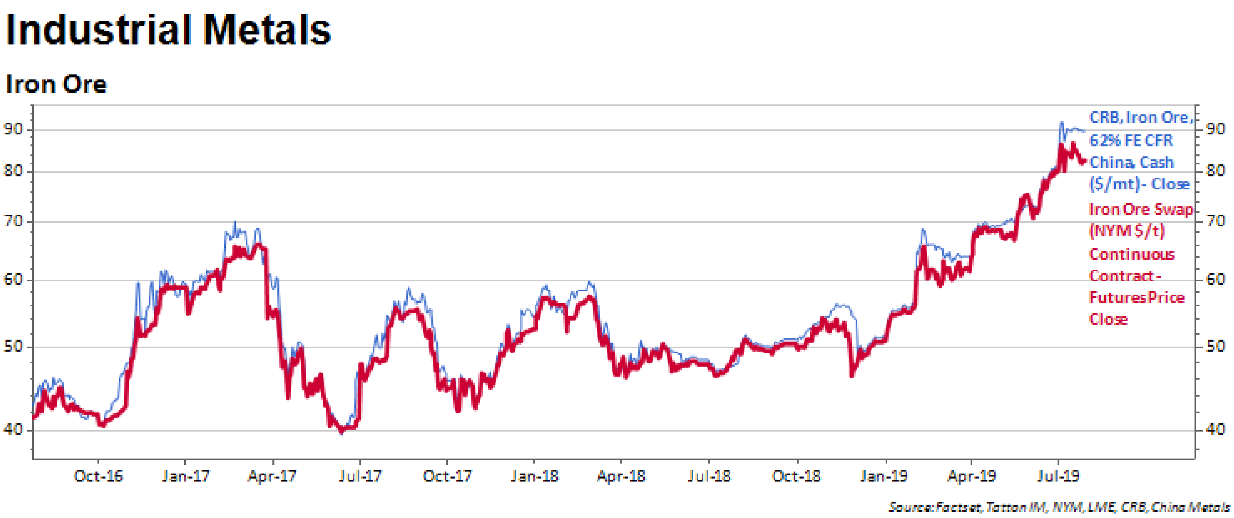
Last week, we wrote that "quality" companies had done the best in global markets. The same holds true in the UK, with the quality index outperforming by over 4% year to date. These companies have strong balance sheets, low earnings variability and high ROEs. As such, they have been rewarded in a market with high levels of uncertainty on other axes, such as geopolitics.

Interestingly, while in the US utilities have led the pack, in the UK they are in close to last place, with companies like Centrica and Drax weighing heavily on the sector. Centrica in particular is down significantly, with share price following expected EPS down since the start of the year as shown below.

Centrica's Share price (black) vs earnings expectations (blue)

Source: Bloomberg

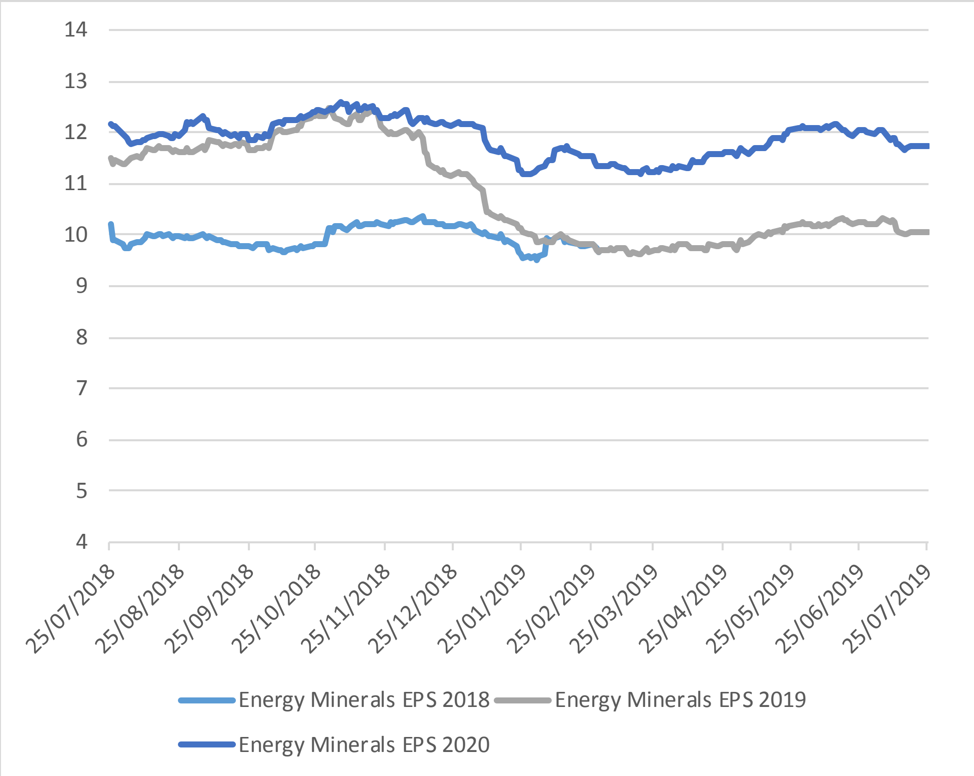
The UK's small tech sector (under 2% of the market) has led the way, with its largest company (Sage) up around 40% year to date. In contrast to global markets, the next best performer has been the far larger, and typically cyclical, materials sector. Rio Tinto and BHP are the two major companies with large returns (33% and 28% respectively), on the back of iron ore prices rising from $67 to over $135 over the year. Significant share price falls have been seen in far smaller companies, putting the sector ahead as a whole.



These sectors are followed by consumer stocks and industrials, while financials, healthcare and energy all lagged the market index. We can tell from this that "quality" can mean very different things in different countries, depending on the makeup of their markets. As we can see above, the UK's performance could have looked quite different if even a single commodity had taken a different path over the year, due to the UK index having fewer large companies than the US.

In terms of earnings outlook, US analysts were expecting a small fall in EPS for the coming earnings season, but early indications suggest companies might beat that low bar. So far, UK companies are repeating the pattern of beats, but it is too early in the UK reporting season to draw any conclusions.

Something we look at frequently is discrete year earnings expectations. This gives us an idea of what markets are pricing in and a flavour of whether current conditions are expected to persist. The chart below shows that 2019 earnings for the UK are now expected to be slightly below last year's, but if the early trend persists we may see some positive surprise.



Source: FactSet

These lines are smooth at an aggregate level, but individual industries paint a different picture. The biggest sectors in the UK market are currently financials, consumer goods, more cyclical resource industries and healthcare. Less cyclical areas such as consumer and healthcare have shown consistent numbers of year on year improvement (with estimates being revised down slightly as the year progresses). Cyclicals, on the other hand, have seen interesting moves.

The first is in the energy sector. 2019 earnings estimates were slashed in Q4, as the oil price fell from the high $70s to sub $45/barrel and fears of a recession began to surface. 2020 earnings estimates weren't brought down anywhere near that much and now sit only marginally below what was expected in 2019 before the drop in oil prices. Oil has recovered to $56 – still a long way from the levels last time earnings expectations were this high. We will watch with interest.

Non-Energy materials companies have seen a more consistent set of moves as we can see below.

Source: FactSet

Earnings for 2019 and 2020 have risen in line with iron ore prices. Maybe markets trust iron ore markets more than oil: they seem to be pricing in less of a reversion than for the energy sector.

This brief series of charts shows how much aggregate statistics can be distorted by smaller isolated factors. In a market without breadth and depth, in all industries we should trust but should also verify these headline numbers.

Deal or No-Deal – New host, same game

The Tory leadership race came to a close on Tuesday, with frontrunner Boris Johnson emerging victorious. The markets' reaction was pretty muted: with Boris being the big favourite for the job, the result was already priced in. Over the last month, sterling has moved lower against the US dollar, reflecting the markets' concerns that the new Prime Minister increases the chances of a disorderly Brexit.

Boris takes office at a challenging time. The Conservative Party is fracturing, the economy is slowing, tensions are mounting with Iran and in just under 100 days the UK is due to leave the European Union. As with his predecessor, the last factor is likely to define his time as Prime Minister.

Planning to leave the EU was far from straightforward for Theresa May and, despite a change in Prime Minister, the fundamental constraints on the withdrawal process remain the same. Boris has stated that the UK will leave the EU on 31st October with or without a deal but, in truth, there are number of scenarios that could play out.

Boris' first big decision as Prime Minister was to select his cabinet and here he opted for a dramatic reshuffle. 13 full cabinet ministers and four other MPs who attended cabinet have been replaced by predominantly hardline Brexiteers. Outside of the cabinet, the hire of Dominic Cummings (the mastermind behind the Vote Leave campaign) is a sign that Johnson wants to at least be seen as ready to play hard ball with the EU.

Researchers TS Lombard quite rightly highlighted in a recent note that, despite the new appointments, actively seeking a no-deal Brexit remains an unpopular option with the majority of the Conservative Party. Almost 90% of Conservatives voted in favour of the last deal that was tabled and so opting for a no-deal straight off the bat could risk provoking a vote of no confidence. It is more likely that the threat of a no-deal Brexit and the positioning of the cabinet will be used by Boris as leverage in negotiations with the EU.

Whether Boris can negotiate any major concessions remains to be seen, and a large-scale change to the backstop agreement is unlikely to be achieved. There might, though, be room for some smaller changes around the "interpretation" of the agreement – allowing Boris to rebrand it as his deal. Under this scenario, we could see a repeat of what we saw in March with the government trying to run down the clock to the October deadline to put pressure on the Commons to get behind "his" deal. In this environment, we would expect the value of sterling to be volatile and move around with positive and negative news on negotiations. If, like in March, the deadline is reached without a resolution, Johnson could ask for a further extension to the leave date. Although this may be viewed as further reluctance to leave without a deal and therefore have a positive impact on sterling, kicking the can further down the road doesn't solve the problem. The uncertainty of Brexit has weighed on the economy and business investment since the referendum result. Any long extension to the process would see this continue.

We feel the potential chaos caused by a no-deal Brexit makes it a less palatable option for most MPs than hashing out a deal. But it remains a possible outcome. The UK Office for Budget Responsibility has warned that a hard Brexit would cause a recession and knock 2% off UK GDP by the end of 2020. In the event of a hard Brexit, we would probably see the value of the pound fall further, importing inflation into the UK and hurting consumers who have been helping to prop up the UK economy. While it might help exporters, a collapsing currency could scare off foreign investors and make life difficult for British companies that have to make payments in dollars, impacting equities as well.

If Boris can't convince MPs to back his deal or to leave the EU without one, the other option he has left is to go back to the voters with either a referendum or, more likely, a general election. Arguably, his pivot to the right with his cabinet reshuffle is an attempt to outflank Nigel Farage's Brexit party and could indicate that a snap election is imminent. However, Farage has shown in the past that he is always prepared to move one step further to the right, so this would be a big gamble for the Conservatives. Nevertheless, the chances of an election before October have risen sharply, rising by c.25% over the month. A misstep from the Conservatives here could see the entrance of a Corbyn government, which would probably have a negative impact on UK assets. However, the Labour party is not currently in a strong position: by prevaricating over Brexit, Corbyn has lost his reputation for "straight-talking, honest politics" and the Lib Dems have ruled out working with him. If Boris were able to strike a deal on Brexit, it would take the wind out of several of his competitor parties' sails, so waiting until after Brexit to call a general election may be his preferred option. Early polling data will be a key metric to watch for when Boris decides to call an election.

The various outcomes of the Brexit process and its effects on the market make it a difficult issue to navigate for investors. An orderly Brexit or no Brexit at all would likely be positive for sterling and UK assets while a no-deal outcome would send the pound lower and make life tougher for domestic companies. Given this binary set of outcomes, we believe the sensible option is not to take a big bet either way and position portfolios more neutrally to UK equity, balancing this with non-sterling assets that should increase in value on a relative basis if the pound weakens.

CAMBRIDGE
INVESTMENTS LIMITED

29th July 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7549.1	0.5	40.4	↗
FTSE 250	19857.9	1.2	236.3	↗
FTSE AS	4124.1	0.6	25.8	↗
FTSE Small	5563.2	0.2	10.4	↗
CAC	5610.1	1.0	57.7	↗
DAX	12419.9	1.3	159.8	↗
Dow	27173.2	0.1	19.0	↗
S&P 500	3022.2	1.5	45.6	↗
Nasdaq	8014.5	2.3	179.6	↗
Nikkei	21658.2	0.9	191.2	↗
MSCI World	2206.9	0.6	12.3	↗
MSCI EM	1054.3	-0.3	-3.2	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	17.8x	13.0x	13.3x
FTSE 250	3.3	25.7x	14.1x	14.2x
FTSE AS	4.5	18.8x	13.1x	13.4x
FTSE Small	3.7	57.6x	-	14.1x
CAC	3.3	19.1x	14.8x	13.5x
DAX	3.2	18.9x	14.1x	12.6x
Dow	2.2	18.0x	17.4x	14.9x
S&P 500	1.9	19.8x	18.2x	15.9x
Nasdaq	1	25.1x	22.2x	17.9x
Nikkei	2.2	16.3x	15.5x	18.1x
MSCI World	2.4	18.6x	16.6x	15.2x
MSCI EM	2.8	13.9x	13.1x	12.0x

Top 5 Gainers / Top 5 Decliners

COMPANY	%	COMPANY	%
Vodafone Group	12.9	Sage Group	-7.6
AstraZeneca	8.1	Whitbread	-7.1
John Wood Group	8.0	easyJet	-6.3
NMC Health	7.4	Anglo American	-6.1
Melrose Industries	6.2	SSE	-5.7

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.24	-0.94	OIL	63.7	2.0
USD/EUR	1.11	-0.91	GOLD	1418.5	-0.5
JPY/USD	108.70	-0.91	SILVER	16.4	1.2
GBP/EUR	0.90	-0.05	COPPER	267.9	-2.4
CNY/USD	6.88	0.04	ALUMIN	1826.0	-1.5

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	0.69	-6.4	-0.05
UK 15-Yr	1.05	-2.0	-0.02
US 10-Yr	2.07	0.7	0.02
French 10-Yr	-0.12	-75.4	-0.05
German 10-Yr	-0.38	-16.0	-0.05
Japanese 10-Yr	-0.15	-12.1	-0.02

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.65
3-yr Fixed Rate	1.79
5-yr Fixed Rate	1.97
Standard Variable	4.30
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!

If anybody wants to be added or removed from the distribution list, please email
enquiries@cambridgeinvestments.co.uk

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