THE **CAMBRIDGE** WEEKLY

19 August 2019

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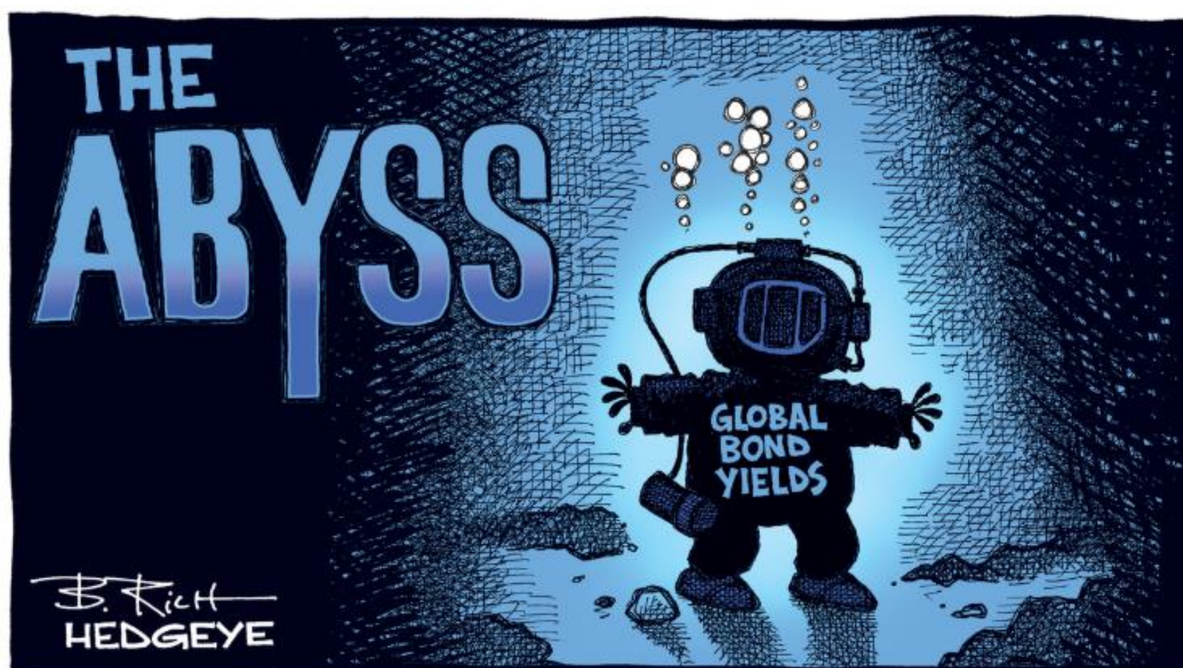


Source: Hedgeye, 12 August 2019

Market spat between bond and equity markets

Last week, we suggested that the recent market pullback (down, then up to almost recovered) is unlikely to be the end of this bout of market volatility. Sure enough, markets became even more volatile over this week, despite the Trump administration's delay to the next round of tariff hikes against China – a move some saw as a desperate attempt to stop the rapid souring of US investor and economic sentiment.

Trump's proverbial blinking first in his own stand-off only provided a short 24h reprieve to stock markets before they succumbed to the next scare (although that scare was neither new nor unexpected). This week it was the inversion – at least temporarily – of a crucial part of the US and UK government yield curves that spooked markets. Essentially, demand is increasing for safe-haven long maturity bonds by institutional investors that are unnerved by the vagaries that trade politics add to the already weak economic outlook. Because of the inverse relationship between bond prices and their yield, the higher demand has led to yields on 10 year bonds being quoted lower than the yield for bonds with just 2 years to maturity (more on this in the second article this week).

Given this yield level inversion has in the past almost always eventually been followed by an economic and stock market downturn, investors swiftly 'forgot' that Trump had just signalled a higher probability of a trade settlement and rushed for the exit even more vehemently than the week before. At the time of writing on Friday, markets had stabilised once again as 'buying the dip' mentality supported stock markets, albeit only to lower levels.

The ensuing market and academic debate has been insightful. Even previously bearish commentators noted that bond markets appeared to predict a recession which, to come to fruition, would require a lot

of the prevalent political risks ending in the worst case scenarios all at once – which is somewhat implausible given historic precedent.

It is always dangerous to suggest that 'this time is different', but we have to note that 10 years of extraordinary monetary stimulus have likely distorted bond market dynamics to a point that have also undermined the predictive powers of yield curve inversions. As encouraging as the market stabilisation is, the current nervousness of stock markets and previous episodes of similar pullbacks of May 2019 and October 2018 suggest that we may still not have seen the end of this bout of late summer volatility.

In other news, last week's political EU hot spot of the Italian government crisis calmed, as immediate general elections and a sure win for the Lega Nord's populists appeared to drift into greater distance, thereby reminding more of what tends to be associated with political 'normality' in Italy than heightened risk.

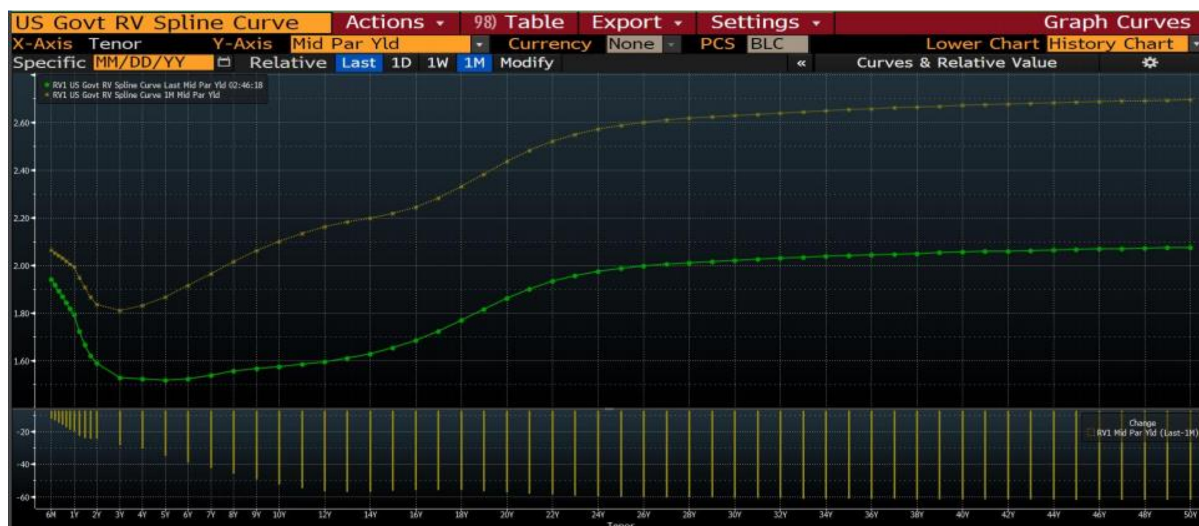
In the UK, there was a feeble recovery of £-Sterling versus the €-Euro and the US$, after a lowering of no-deal, Hard Brexit expectations and encouragingly strong annual real wage increase figures of 1.8% (I.e. after subtracting inflation). All of this suggests the UK economy is not doing too badly. The fly in the ointment is that the strong employment data corresponds with exceptionally weak business investment figures, which could lead to higher inflation. This would make it more difficult for the Bank of England to follow the US Federal Reserve's example of lowering interest rates to stimulate the economy should it become necessary.

The remainder of the newsflow tells us that the global economy is not yet re-accelerating, but also not sliding towards outright recession. In such an environment, a mild market correction – like the one we have just witnessed – can offer better entry prices for those who have been waiting to invest. The political risk scenario and nervous markets, however, also mean that now is not the time to be taking on more market risk than one would normally be comfortable with. For this to happen, we would need to see a few more substantially positive surprises from the political side; Donald Trump's tariff retreat last week is not quite enough.

Investors' aversion to inversion

One of the most closely watched economic indicators finally took a turn for the worse this week. The yield curve – the slope of the graph of government bond yields across increasing maturities – inverted in both the US and UK. In particular, the much watched yield difference between 2-year debt and 10-year debt has turned negative – meaning you now get a higher yield when only tying your capital for two years than you get for a ten year coupon tie. This development is significant and potentially dangerous, but had been entirely expected for a while.

The actual 2-10 spread has only just turned negative this week and for now also did so only temporarily. But the overall shape of the US curve has been skew-whiff for some time now. In particular, given capital markets anticipate the Federal Reserve will cut interest rates significantly over the next two years or so, short dated bond yields have shown a dip down for a while now, as shown in the chart below.



Source: Bloomberg/Tatton IM; Yellow line: US yield curve 1 month ago, Green line: Current yield curve

What's more, we are in the midst of another global economic slowdown, with the added risk that politics could turn us towards outright recession. As a countermeasure, central banks around the world – led by the Fed – have signalled that they are once again set to loosen monetary policy and introduce more liquidity into the financial system. Faced with hard-to-predict political risks and the absence of strong growth prospects, the natural tendency for institutional investors to mitigate against rising uncertainty is to increase their allocations towards 'risk free' assets such as longer-term government bonds despite these yielding very little, if anything at all. Or to put it more colloquially, the return of capital becomes more urgent than the return *on* capital. This buying pressure drives up prices for long-dated bonds (10-years and beyond), driving down yields. In this scenario, inversion should not be a surprise, particularly when we consider that much of the normally available government bonds volume is locked up in central banks' QE coffers.

But what exactly does it mean? The relationship between economies and yield curves is one of strangely tangled cause and effect. It is often read as a reflection of market expectations of the economy. In a healthy, expanding economy, we expect future returns to be higher than current returns – so investors usually demand a higher yield on longer bonds. If the yield on long bonds is below that for short bonds, that suggests the market expects slow or negative growth over that time.

But it shows more than just markets' growth expectations. At the same time, a yield inversion can itself hamper the real economy by constricting bank lending. One important source of bank profit is taking in deposits – whose interest is set by short end yields – and lending out at the long end of the curve. A higher spread therefore increases profitability, and banks' ability to lend with it. Conversely, a negative spread hurts banks' profits, making them less likely to lend. With a lack of available finance for companies and consumers, default rates go up and recession sets in.

To make matters even messier, over the years the shape of the yield curve has itself become a hugely important downturn indicator for both banks and investors – to the extent that banks will factor it into their risk-pricing models when lending, and businesses will become more risk-averse when inversion occurs. All of this makes yield curve inversion a surprisingly reliable recession indicator: since the 1960s, every US recession has been preceded by a yield curve inversion, and every yield curve inversion was followed by a recession some 18-24 months later.

So, does that mean we are heading for a recession? Not necessarily. The era of extraordinary monetary policy (QE) has had a number of distortional effects on the financial system, making it difficult to tell whether the signals of old still mean what they used to. With the recent expansion of the monetary base – and the potential for more expansion through a rumoured extra round of quantitative easing – it could be that inversion reflects liquidity flows and the quirks of the bond market more than actual expectations for the economy.

That same distortion means bank lending may not take such a big hit either. When term spreads have inverted before, banks have been forced to slow down lending due to a lack of available capital. But for a number of reasons – historically easy monetary policy, tighter regulation and improved internal procedures – banks are now more capable of lending even through the hard times and making their profits through credit spreads rather than term (maturity) spreads. Low bond yields have certainly hurt banks' bottom line results and their stock prices (see next article). But as we have seen in Europe – where banks have struggled with lower yields for years – this has not yet hampered lending.

Unless this changes, there is a good chance the longest business cycle ever will carry on – albeit at a sluggish pace. Unfortunately, political risks make the path ahead anything but clear. Wherever you look, there are significant looming uncertainties. At home, a hard Brexit threatens to knock both Britain and the EU – already teetering on the edge of contraction – into a deep recession. Across the Atlantic, Donald Trump's 'art of the deal' has yielded nothing but increased trade disruption with China, presenting a serious threat to the world's two largest economies. Other political risks loom in Hong Kong, Italy, Argentina, Brazil and Turkey – to name just a few.

Any one of these straws could break the camel's back. And the fact that a yield curve inversion is happening against this backdrop is sure to worry investors. If risk sentiment does take a hit, that would make asset markets extremely vulnerable. Until now, central bank liquidity has done a good job at stopping that from happening, but whether that can go on is questionable. If not, there is a risk that markets could end up talking the broader global economy into a recession.

Financials: A sector that might be pricing in too much bad news

Another casualty of the US-China trade war has been the financial sector – which is one of the factors driving down global interest rates. Even with stock markets all over the world taking a hit in the past two weeks, shares of financials have been the biggest losers, with a combination of factors impacting sentiment, particularly in the banking sector. Since November, the KBW index of US bank shares has fallen 5%, whilst the S&P 500 has risen 6%. This pattern is the same globally (see Chart 1) with the UK MSCI financial sector significantly underperforming the MSCI UK equity market.

Chart 1:

Source: Bloomberg/Tatton IM; White line: UK Financial sector stocks, Green line: MSCI UK stock market index:

Sentiment on financials has soured because of investors' nerves about the sector's ability to generate earnings in a low and falling interest rate environment which produces low or negative bond yields. And judging by the current discount at which financial stocks are trading, markets do not expect this to change for some time.

Given this expectation, it is worth noting which countries' financial sectors are most likely to be affected, and how big a drag this could have on their equity markets, based on market capitalisation. As (Chart 2) demonstrates, the countries most impacted are Australia, Canada, Hong Kong, Italy and Spain.

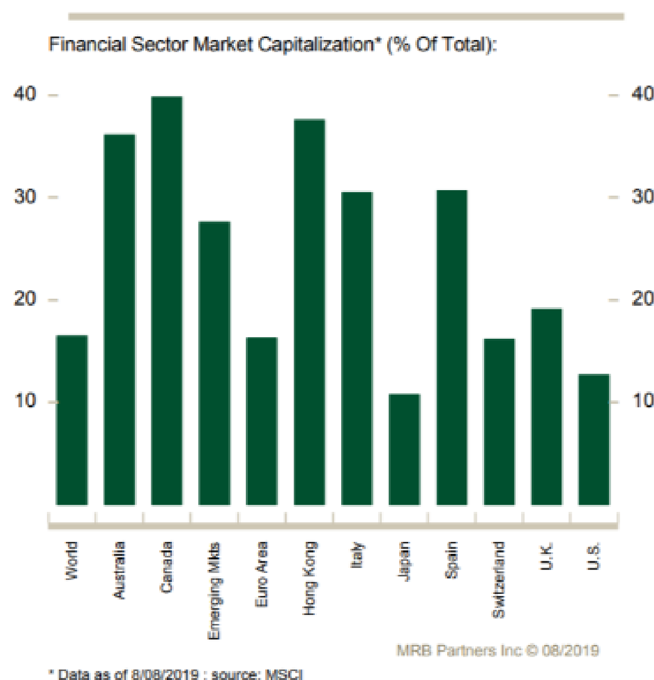


Chart 2:

So how bad can this get? Negative bond yields are now in place in Japan, Sweden, Switzerland, Denmark and the Eurozone. Overall, bonds worth $15trillion – around a quarter of the debt issued in both the public and private sectors around the world – are trading at negative yields. Outside of Japan, this is a relatively new phenomenon for investors. Most are unfamiliar with this puzzling scenario, where a Danish lender Jyske Bank issued a 10-year mortgage bond at an interest rate of -0.5%, in effect meaning homeowners could soon be paid to borrow (at the moment the bank takes it as a profit instead). For all its oddities, this situation has its downsides, and could prove counterproductive at some point. This will occur when savers move to store their cash "under the mattress" rather than paying someone to hold their deposits, forcing a radical change in the environment.

But for now, this is just one of the many difficulties the financial sector faces: low interest rates, new Basel IV capital adequacy rules which will increase their capital requirements and make trading less profitable, the growth of automation, and start-up digital disruptors. So far, these changes have led to over 30,000 job losses reported in the industry since April, with nearly half of these coming from Deutsche Bank.

But it is these structural changes, particularly in automation and digitalisation, that are likely to provide key opportunities going forward. One area that has been a focus for some time has been digital and online banking. Positive steps, admittedly largely through new entrants/challengers (potentially becoming ripe for takeover in the future), have been seen in Australia, Britain, Hong Kong and Singapore, where there is a relatively clear path to regulatory approval. The US has a more difficult and complex regulatory system, but even here both new and traditional names have been able to make an impact. The most prominent of these is Goldman Sachs, with its offshoot consumer bank *Marcus* gaining $35 billion in deposits. Meanwhile, *BankMobile* (providing banking services under the telecoms networks brand T-Mobile) announced they are gaining 5,000 accounts a week. These figures were further supported in another recent survey by CB Insights, which noted that customers had opened more than 30 million accounts with start-up banks (excluding Indian and Chinese groups). The survey also highlighted that challenger banks have raised more than $2.5bn in 55 deals this year to the end of July.

One region that is benefiting from this need for structural changes is India, with several international banks having increased their presence in the region. For example, Goldman Sachs employees in the area have risen from just under 300 in 2004 to over 5,000 today. UBS has opened three new centres, taking their staffing numbers to 4,000. And unlike in the past, when India benefited from just outsourced jobs such as call centres, international banks are now utilising India's high-skilled workforce. Their universities are churning out engineers and computing experts in line with the trend towards a more global network of applications and of analysis in cloud computing, statistics, machine learning and automation.

In short, the financial sector is not doomed. So, has too much bad news already been priced in? There is little doubt that the forecasts are pessimistic: according to one of our independent research providers MRB, the financial sector is currently trading at the same relative price / book ratio discount as it did at its lows in early 2009, when the highly leveraged financial sector was imploding across the globe.

It is difficult to see how the sector can bounce back significantly when bond yields remain low and negative, but this might be offset to some degree by the moves already under way. The financial sector is one that is known to be able to adjust to new environments and trends and this could soften the impact of negative bond yields.

CAMBRIDGE
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19th August 2019

Global Equity Markets

Market	FRI 15:37	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7101.8	-2.1	-152.1	↘	→
FTSE 250	18733	-1.9	-359.0	↘	→
FTSE AS	3884.2	-2.1	-81.4	↘	→
FTSE Small	5341.5	-1.8	-96.7	↘	→
CAC	5290.0	-0.7	-37.9	↘	→
DAX	11536.7	-1.3	-157.1	↘	→
Dow	25798	-1.9	-489.2	↘	→
S&P 500	2874.7	-1.5	-43.9	↘	→
Nasdaq	7583.2	-0.8	-63.1	→	↗
Nikkei	20418.8	-0.8	-174.5	↘	↘
MSCI World	2082.8	-2.5	-52.5	↘	→
MSCI EM	963.5	-1.8	-17.7	↘	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Admiral	4.6	Evraz	-12.2
United Utilities	3.4	RBS	-11.2
Hikma Pharma	2.8	easyJet	-10.1
Unilever	2.6	TUI	-9.9
Reckitt Benck	2.1	Hargreaves Lansdown	-8.5

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.214	0.9	Oil	58.52	0.0
GBP/EUR	0.913	2.0	Gold	1512.3	1.0
USD/EUR	1.11	-1.0	Silver	17.20	1.3
JPY/USD	106.33	-0.6	Copper	259.2	0.1
CNY/USD	7.040	0.3	Aluminium	1782.0	0.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.48	0.00
UK 15-Yr	0.73	-0.09
US 10-Yr	1.57	-0.18
French 10-Yr	-0.40	-0.13
German 10-Yr	-0.68	-0.10
Japanese 10-Yr	-0.23	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.2	17.4	12.3	13.3
FTSE 250	3.5	24.4	13.2	14.2
FTSE AS	4.9	18.3	12.2	13.4
FTSE Small	3.9	49.6	-	14.1
CAC	3.5	18.4	14.1	13.5
DAX	3.4	19.1	13.5	12.6
Dow	2.3	17.1	16.9	14.9
S&P 500	2	18.8	17.4	15.9
Nasdaq	1.1	23.6	21	17.9
Nikkei	2.3	14.5	14.8	17.9
MSCI World	2.6	17.7	15.8	15.2
MSCI EM	3	13	12.3	12

UK Mortgage Rates

Mortgage Rates	Estimate	Jul	Jun
Base Rate Tracker	2.56	2.56	2.56
2-yr Fixed Rate	1.66	1.66	1.68
3-yr Fixed Rate	1.77	1.77	1.78
5-yr Fixed Rate	1.96	1.96	1.99
10-yr Fixed Rate	2.57	2.61	2.60
Standard Variable	4.30	4.30	4.30

* 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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