THE **CAMBRIDGE** WEEKLY

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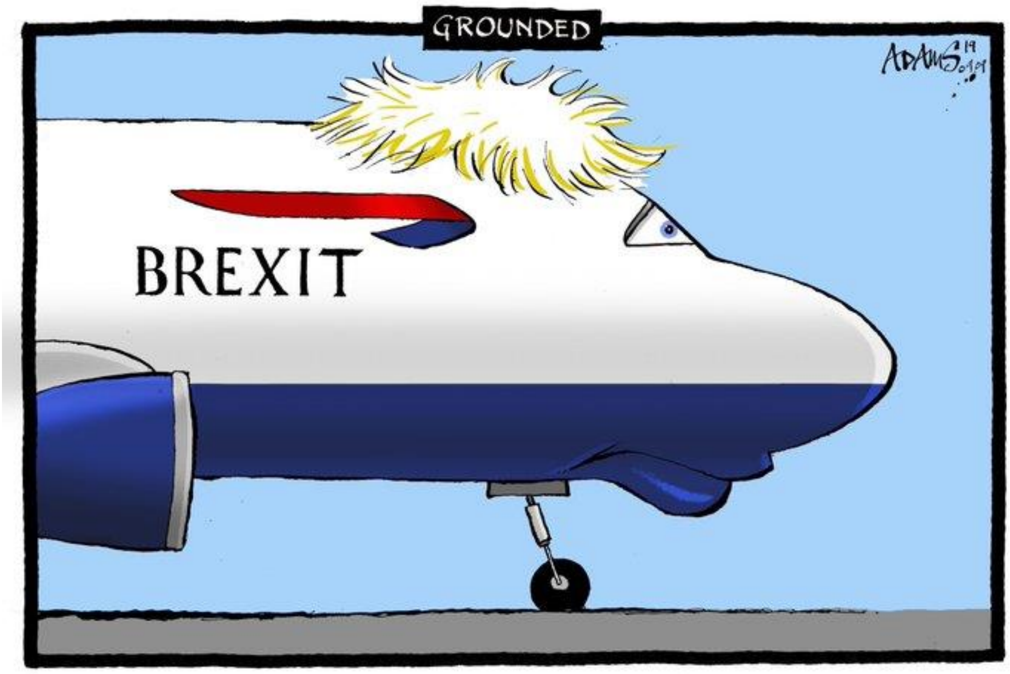


Source: Christian Adams, Brexit grounded, 9 Sep 2019

Market sentiment rebound

Last week, we wrote that equity markets would need to see an improvement in global economic growth if they were to move higher. So, it was typical commentator's curse that this week saw a rise in equities all over the world, despite no clear improvement in the underlying economic data. Even though we have not seen improvement yet, however, the rally suggests that capital markets see light at the end of the tunnel.

Certainly, the uptick in equities cannot have been due to company earnings. We saw an ever-so-slight pickup in earnings expectations for this year and the next – mainly for US businesses – but you would have to squint hard to see this as a trend. Rather, investors seem to have decided that equity markets have been right and bond markets wrong over the summer and now is the time to put their money to work – before the actual economic data improves and they miss the boat.

The current mismatch between market sentiment and company performance can be seen in equity valuations, which, despite mostly unchanged near-term earnings expectations, have moved back up towards recent highs. The economy has not changed, but confidence in it has. Or putting it in market terms, the majority of investors seem to have concluded that the gloominess emanating from rock bottom bond market yields over the summer was perhaps exaggerating the depth and tenure of the ongoing economic slowdown.

The question is, of course: is that confidence justified?

When looking just at indicators like business survey data, one would probably say no. But as we have pointed out recently, markets are increasingly having to take cues from politicians as well. The US-China trade war – one of the biggest concerns for investors for nearly three years – looks as though it may be cooling down. Equities reacted positively to the improved tone of discussions between the world's two largest economies. In particular, Trump's removal of former US National Security Advisor John Bolton – an unapologetic war hawk and China hardliner – was taken well. And sure enough, shortly after his departure from the White House, the Trump administration announced delays to scheduled tariffs on China.

Politically, the timing is looking better for a trade deal. Trump is desperate for good news to bring to the American people (his approval ratings are as low as they have ever been). And the continued weakness of the Chinese economy means Beijing will be eager to join the negotiating table.

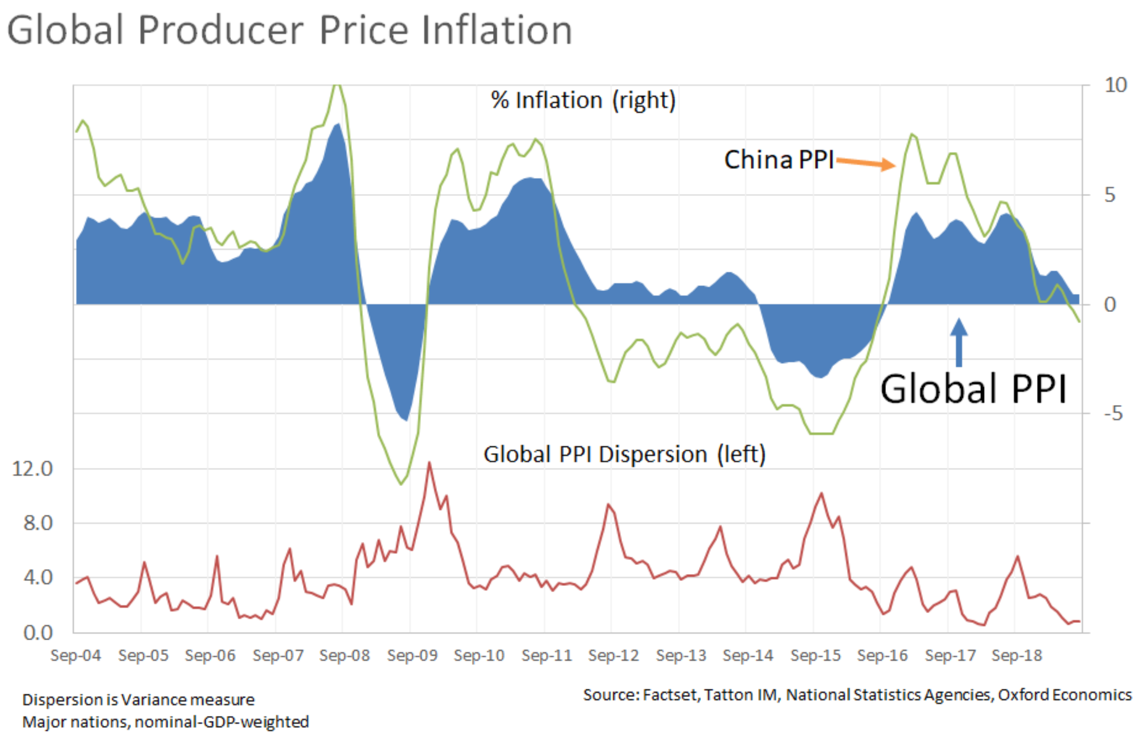
Elsewhere, the political situation looks rosier too. The prospect of an imminent no-deal Brexit looks less likely, after Parliament closed down the 'easy' routes to a 31 October divorce. European political risks (Italy) have also subsided and there are continued rumblings of fiscal expansion on the continent – especially from the ultra-hawks - Germany. A call for looser European fiscal policy has come from Mario Draghi himself – who in his final weeks as ECB President has mustered just about every tool the central bankers have to boost growth through monetary stimulus, but noted their increasingly diminishing effectiveness in the absence of accompanying fiscal support.

Increased growth expectations certainly seem to have impacted the bond market, where yield curves (the plot of a governments' bond yields at different length maturities) have been steepening rather than flattening for the first time in months across the world. Perhaps equity markets are taking signals from the bond market – rather than politics or underlying company or economic data. The rise of bond yields this week probably also had a lot to do with the record-breaking issuance (capital raising) in investment grade bonds, and a much quieter (but still significant) issuance in high yield debt. All of this could be good news for equities, as the proceeds will go some way to funding dividends (and share-buybacks!).

It would be better for the underlying economy, however, if that abundant capital was used to fund productive business investment. Until that happens (or until governments take the responsibility on themselves) it is hard to see a way toward a re-acceleration of global growth. Economic data has stabilised somewhat, but there are signs that businesses are struggling to re-invigorate profit growth. Producer price inflation (PPI) is usually a good proxy for company profitability, and it has been lagging recently.

Nowhere is this more apparent than in China. Chinese PPI – a key signal of company pricing power – came out negative year-on-year for the second month in a row, with a reading of -1%. This is a worrying sign, and it is hard to see how it would improve in the short term. The importance of China here should not be understated. When Chinese companies have an overcapacity, they push that excess stock out to the rest of the world – creating a global oversupply and subsequent drop in prices. This creates a deflationary environment which severely dampens growth prospects. Particularly vulnerable are European producers, which creates a knock-on effect.

The chart below shows our measure of average producer price inflation for the world's top 10 nations by nominal GDP. China is the most influential component and the second largest. It dominates the average not only because of its size but because it is the major competitor, essentially driving the pricing power of the other. What the dispersion measure shows is that more nations than ever are now being affected by the Chinese lack of pricing power. National PPI measures have declined in unison since the start of the year.



Fortunately, Chinese government officials are acutely aware of this. And given the ongoing difficulty in the domestic economy, they are determined not to let the downturn get worse. Officials in Beijing have already loosened fiscal and monetary policy and taken measures to support consumer demand and small businesses.

What's more, next month marks the 70th anniversary of the People's Republic founding and will see a hugely important central party plenum take place. For investors, this is good news. The government usually lends heavy support to the economy around important dates and events, and has already showered traders with 'gifts' such as lifting barriers on foreign investment, cutting banks' reserve requirement ratios and fixing the RMB's daily trading band at a higher-than-expected level for 17 days. Ever since 2004, the month leading up to big anniversaries has seen the Shanghai Composite Index increase by an average of more than 4%. All of this has made Chinese shares the world's top performers recently. According to chief strategist at Bocom International Holdings Co. Hao Hong, *"Authorities will definitely try to maintain order, and the bottom line is we're unlikely to see any big declines,"*

Whether that will translate into a sustained pickup in the economy, however, is another matter. We are in a delicate balance, with supportive policies and high political hopes on the one side, and the reality of struggling businesses on the other. But for now at least, the fact that markets think that high hopes will win out is a positive sign.

For the time being we are pleased that 2019 investment returns continue to build up well for our investors. (See August asset class table below and positive start for September, bar bonds). However, as the market sentiment roller-coaster over the summer months has shown, the returns picture will remain volatile until it becomes more evident that improvements in risk asset valuations are founded on actual earnings improvements through economic growth, rather than on hopes and dreams that politics will finally end its sabotaging of the economy, and that the ongoing slowdown is just that, another mid-cycle slowdown and not the beginning of the end of this long-in-the-tooth cycle.

Asset Class	Index	August	2019 to Aug	2018
Equities	FTSE 100 (UK)	-4.8	11.0	-8.7
	FTSE4Good 50 (UK Ethical Index)	-5.2	9.1	-9.2
	MSCI Europe ex-UK	-1.8	17.7	-9.9
	S&P 500 (USA)	-2.9	23.8	1.6
	Nikkei 225 (Japan)	-1.8	11.7	-7.50
	MSCI All Countries World	-3.3	19.0	-3.8
	MSCI Emerging Markets	-5.6	8.7	-9.3
Bonds	FTSE Gilts All Stocks	3.9	10.7	0.6
	£-Sterling Corporate Bond Index	1.6	11.2	-2.2
	Barclays Global Aggregate Bond Index	2.0	12.3	4.9
Commodities	Goldman Sachs Commodity Index	-5.6	11.6	-8.5
	Brent Crude Oil Price	-8.5	15.2	-14.5
	LBMA Spot Gold Price	6.6	24.6	5.0
Inflation	UK Consumer Price Index (annual rate)*	0.0	0.8	2.1
Cash rates	Libor 3 month GBP	0.1	0.6	0.6
Property	UK Commercial Property (IA Sector)*	0.1	0.4	2.9

Data sourced from Morningstar Direct as at 31/08/19.
*** to end of previous month (31/07/19). All returns in GBP**

Capital market activity rebound

As usual, political turmoil and central bank action grabbed the financial news headlines this week. But underneath these big macro themes however, there were some eye-catching business stories. It has been a busy week for company news, so we thought we should take a look at the standout stories from the business world.

First up, serviced office property group WeWork was told to shelve its upcoming IPO by SoftBank, the company's biggest outside shareholder. We Company, WeWork's parent, wants to raise $3bn to $4bn by floating the business on the stock market. But Japanese firm SoftBank urged the group to hold back after a cold reception from investors.

WeWork is a heavily lossmaking business, but its ballooning debt and growing losses are matched by its rapid growth. By their own admission, the team at WeWork has “disrupted the largest asset class in the world — real estate”. They now want to follow the likes of Uber, Lyft and Pinterest by becoming the next ‘unicorn’ to float on the stock market. But the $15bn to $20bn valuation WeWork is looking for is just 1/3 of what SoftBank thought the office-space provider should be worth. When the Japanese group invested $2bn into WeWork during last year’s private funding round, it was valued at $47bn.

SoftBank has its own reasons to be reluctant; the company is trying to raise cash for other acquisitions. But the hesitance is significant. WeWork’s hotly anticipated IPO was expected to be a big test of investor appetite. Even compared to its rapidly growing peers, WeWork’s penchant for rapidly burning cash worries investors, as does its reliance on chief executive Adam Neumann. With global growth still struggling and central banks opening the liquidity taps again, equity demand for a company like WeWork is a good measure of market sentiment.

In other news, Apple announced the iPhone 11 this week. There were some significant upgrades announced, but you get the sense that the tech giant’s sparkle is fading. The new model has no 5G capabilities – despite mobile carriers pumping $160bn into 5G infrastructure over the next few years. Apple has been the top dog in smartphones for years, but the lack of 5G and only modest camera upgrades point to a company playing catchup behind competitors like Samsung and Huawei. They offered a surprise $50 cut in the price of the low-end model, suggesting they had overestimated how much consumers would be willing to pay for the latest Apple gizmo.

The biggest surprise, however, came from the price of its new streaming service Apple TV+. Viewers will be able to stream for just $4.99 a month (and get one year free when streaming on an Apple device), undercutting Netflix. It follows a similar move by Disney, and suggests that the two giants are more interested in gaining market share than turning a short term profit. It looks like 2020 will be the year the steaming wars begin, with no less than eight providers on the market – backed by some of the biggest companies in the world.

As a wider point, this also seems to be another step towards a rented-service economy and away from an economy based on actual ownership. This will no doubt have big implications for the global economy – but we will save that discussion for another time.

Lastly, Hong Kong Exchanges and Clearing (HKEX) stunned investors with a surprise bid for the London Stock Exchange (LSE). The Hong Kong operator offered £32bn for LSE, claiming that the takeover would combine “the largest and most significant financial centres in Asia and Europe”. Markets were not too impressed, however. The deal faces hurdles that could well be insurmountable – most of them political. British politicians are wary of the effect of foreign ownership of the LSE, and reportedly consider the takeover a national security risk. No doubt the recent turmoil in Hong Kong – where the government is the stock exchange’s largest shareholder – is also a factor. As we have seen in the US with moves against Huawei and other large Chinese tech companies, western politicians are becoming increasingly wary of China’s influence. Through Beijing’s steady encroachment on Hong Kong’s autonomy, that concern seems to extend to Hong Kong as well.

That political pressure seems to be making investors wary too. After HKEX made its bid on Wednesday (which represented a 23% premium on LSE's market value) the Hong Kong bourse's share price fell 3.4%. Clearly, markets do not think this is a deal that will be allowed to happen.

Private Equity – the next asset bubble?

Private equity (PE) has been a particularly popular asset class for investors over the last few years. Over the past year alone, almost $500bn has flowed into private equity funds – who invest in companies not directly listed on a public exchange (or buy out those that are). That equals the gross inflows into public equity over the same period. And it is despite the assets under management (AUM) in private equity being only 6% of the total market capitalisation for public equity.

These impressive inflows are becoming increasingly common. In 2018, private equity funds raised $462bn. By the end of last year, private equity funds that specialise in leveraged buyouts – using debt to take publicly listed companies off the exchange – had a total of $3.6tn in AUM, representing a six-fold size increase from the end of the year 2000, when the sector looked after $600bn of investor funds.

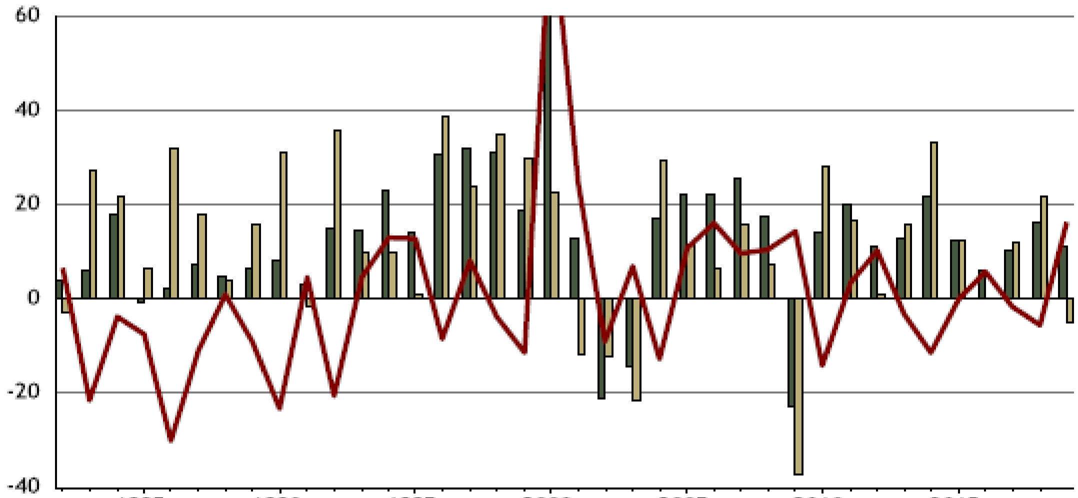
In fact, it would appear that it is becoming an issue for the sector, namely that investors are handing more money to private equity managers than they know what to do with. When investors put capital into a private equity fund, it can sit with the investor or limited partner for extended periods of time until it is called upon to be utilised – lately this has been as long as four years. Usually, the money will sit in highly liquid securities, such as US Treasury bonds with short maturity dates. In that time, the capital is 'dry powder' – capital in reserve waiting to be put into action. At the moment, private equity managers have around $1.5tn in dry powder. That represents almost 10% of the $16tn outstanding in the Treasury market.

It is also around 35% of private equity's total AUM. This is problematic for the private equity market. It means that the large inflows cannot be sustained without significantly inflating acquisition prices within a limited pool of available deals. And this threatens the asset class's ability to generate returns.

One of the main arguments for private equity as an asset class is that managers can get access to a company in its early years before it floats on the stock market. That early period is usually when the most rapid growth occurs; public companies are usually larger and more mature, limiting their upside potential. The number of publicly listed companies in the US, for example, has almost halved since 1996.

However, the returns on publicly listed small cap equities are almost as high as those for private equity over time. In recent years especially, private equity has not fared better than public equity. Public equity returns were higher than private in 2009, 2012, 2013, 2014, 2016 and 2017. And the rolling five-year figures paint a similar picture.

Of course, the overall returns are not the whole story. There is a wide dispersion in the performance of private equity funds, and so the top performers can often have consistently higher yields. But there are other factors to consider. There is usually a much higher manager risk in private equity funds. According to data from Morningstar and Burgiss, between 2013 and 2018 the interquartile range on annual returns for US mutual funds was less than 5%. For private equity funds, the range was over 20%.



When we combine that with the build up of dry powder mentioned before, the case for private equity looks weaker. With piles of cash waiting to be deployed, there will likely be upward pressure on valuation multiples and, consequently, downward pressure on future returns. In cases like this, the market gets into a 'lack of ideas' problem. With so much dry powder in the barrels, fund managers simply cannot allot the capital in a prudent way. And this kind of stagnation makes positive returns harder to come by and substantially increases the risk of bad deals creeping into portfolios as managers come under pressure to fulfil investor expectations.

Due to the sheer size of the PE sector it is now also slowly creeping up on the risk radar screen of central bankers whose job it is to protect the financial system from systemic risks emanating from the wider financial sector. Historically the private equity part of the capital market introduced a level of stability during volatile times in the public markets, because private equity investors are locked in for extended time periods and cannot suddenly withdraw capital when general investor sentiment sours.

However, private equity has never been immune to actual economic downturns, when they have to adjust valuations downwards if the companies they hold struggle to remain profitable. This exposure to economic downturns is now exacerbated by the credit leverage that is being used to a large extent (per the increase in leveraged buyout funds mentioned earlier). This means managers could be caught out fast if things take a turn for the worse. Increased default level potential amongst private equity owned firms could therefore now become a source of market instability since default contagion across an economy is known as one of the main factors that drive recessions.

We observe that the private equity sector appears to have recently attracted similar volumes of investor capital that we previously observed flowing towards commodity funds 10 years ago, and before that to hedge funds, and before that to the technology or TMT sector. It would seem that whenever a particular investment segment has shown the ability to generate super-normal investment returns over the previous decade, then this past performance leads to such vast levels of inflows that the limited return opportunity is quickly diluted down to either just average returns (Hedge Funds) or even the deflation of an asset bubble (Commodities, TMT)

The headline historic growth figures of private equity funds clearly make them very attractive to investors – as the huge inflows we have seen show. But there are reasons to be cautious, as history may repeat. So on the basis of what we discussed above we will be monitoring further developments surrounding the private equity sector very carefully. This is particularly so, because at the heart of our core investment beliefs is the fact that fashion-driven returns have historically been unsustainable over time. They merely expose investors to a roller coaster of super-normal positive returns, followed by the inevitable steep losses. The only winners each time have been the managers and promoters of the respective investment hype. In this respect we note an ever increasing number of manager names that we knew from the hedge fund world reappearing as private equity fund managers or promoters.

Corporates getting in while the window is open

It has been a busy week in the corporate world. While global growth remains lethargic, central banks have once again loosened the taps and provided the financial system with ample liquidity. Now, companies seem to be rushing to take advantage of this easy access to credit – due to fears that it may not last for long. This has prompted some big moves – from record-breaking corporate bond issuance to a rush of IPOs, to headline-grabbing acquisitions. Last week, $72bn worth of investment grade debt was issued, nearly equal to the entire issuance in August. Below, we take a look at some of the stories that stood out.

According to estimates, around 70 private US companies have registered with the US Securities and Exchange commission to go public. One of these was the rapidly growing property group and office-space provider WeWork. But this week, WeWork's much-anticipated IPO came up against a big hurdle. The company was told to shelve the listing by SoftBank, the company's biggest outside shareholder. We Company, WeWork's parent, wants to raise $3bn to $4bn by floating the business on the stock market. But Japanese firm SoftBank urged the group to hold back after a cold reception from investors.

WeWork is a heavily lossmaking business, but its ballooning debt and growing losses are matched by its rapid growth. By their own admission, the team at WeWork has "disrupted the largest asset class in the world — real estate". They now want to follow the likes of Uber, Lyft and Pinterest by becoming the next 'unicorn' to float on the stock market. But the $15bn to $20bn valuation WeWork is looking for is just 1/3 of what SoftBank thought the office-space provider should be worth. When the Japanese group invested $2bn into WeWork during last year's private funding round, it was valued at $47bn.

SoftBank has its own reasons to be reluctant: the company is trying to raise cash for other acquisitions. But the hesitation is significant. WeWork's hotly anticipated IPO was expected to be a big test of investor appetite. Even compared to its rapidly growing peers, WeWork's penchant for rapidly burning cash is a worry to investors, as is its reliance on chief executive Adam Neumann. With global growth still struggling and central banks opening the liquidity taps again, equity demand for a company like WeWork is a good measure of market sentiment. Clearly, SoftBank are concerned that even with abundant liquidity around, they might not be able to get a decent enough return on last year's investment.

In other news, the ease of credit availability seems to be proving too good to resist even for the world's largest and most solvent companies. Both Apple and Disney – who both have billions of dollars sitting on their balance sheets – have issued large amounts of new debt. "Corporations are getting in while the credit window remains wide open as you just never know when it slams shut," according to Greg Peters, head of multisector and strategy at PGIM Fixed Income.

Interestingly, both seem to be using their cash piles to gain future market share, instead of generating profit. Apple had a number of product announcements this week – including the new iPhone 11 and more details on streaming service Apple TV+ – but their sparkle seems to be fading, and they are losing ground to competitors like Samsung and Huawei. They offered a surprise $50 cut in the price of the low-end model, suggesting they had overestimated how much consumers would be willing to pay for the latest Apple gizmo. The biggest surprise, however, came from the price of its new streaming service Apple TV+. Viewers will be able to stream for just $4.99 a month (and get one year free when streaming on an Apple device), undercutting Netflix.

Disney made a similar price move on their upcoming streaming service, suggesting that the two giants are more interested in gaining market share than turning a short-term profit. The move by both to issue even more bonds suggests they are more than capable of weathering the storm to do it.

Lastly, Hong Kong Exchanges and Clearing (HKEX) stunned investors with a surprise bid for the London Stock Exchange (LSE). The Hong Kong operator offered £32bn for LSE, claiming that the takeover would combine "the largest and most significant financial centres in Asia and Europe". Markets were not too impressed, however. The deal faces hurdles that could well be insurmountable – most of them political. British politicians are wary of the effect of foreign ownership of the LSE, and reportedly consider the takeover a national security risk. No doubt the recent turmoil in Hong Kong – where the government is the stock exchange's largest shareholder – is also a factor. As we have seen in the US, with moves against Huawei and other large Chinese tech companies, western politicians are becoming increasingly wary of China's influence. Through Beijing's steady encroachment on Hong Kong's autonomy, that concern seems to extend to Hong Kong as well.

That political pressure seems to be making investors wary too. After HKEX made its bid on Wednesday (which represented a 23% premium on LSE's market value) the Hong Kong bourse's share price fell 3.4%. Clearly, markets do not think this is a deal that will be allowed to happen.

All of these moves show just how eager corporates are to use up the credit being offered. The key question for us is whether this is just opportunism on their part ('get the money while you can') or a sign that they fear things may soon change for the worse. Perhaps companies fear an oncoming recession – or upcoming volatility around next year's US Presidential election.

All of these moves show just how eager corporates are to use up the credit being offered. The key question for us is whether this is just opportunism on their part ('get the money while you can and use it to buy back your shares'), or a sign that they see better times ahead and are raising new capital to fund their businesses' expansion. If it is the latter, then it is a positive sign that corporates are more optimistic and no longer fear the onset of a recession. If it is the former, it may just end up to be the proverbial 'flash in the pan'.

CAMBRIDGE INVESTMENTS LIMITED

16th September 2019

Global Equity Markets

Market	FRI 15:19	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7354.2	1.0	71.9	⬂	↗
FTSE 250	20143	2.2	437.4	→	↗
FTSE AS	4045.5	1.2	47.3	→	↗
FTSE Small	5501.0	1.0	53.0	→	⬀
CAC	5657.4	1.0	53.4	→	↗
DAX	12475.5	2.3	283.8	→	↗
Dow	27221	1.6	423.2	→	⬀
S&P 500	3010.9	1.1	32.2	→	↗
Nasdaq	7893.6	0.5	41.0	→	↗
Nikkei	21988.3	3.7	788.7	→	→
MSCI World	2201.8	1.1	22.9	→	↗
MSCI EM	1022.3	1.4	14.4	⬂	⬀

Top 5 Gainers

Company	%
Centrica	11.5
RBS	11.4
Barclays	11.4
Schroders	11.3
Wm Morrison	10.9

Top 5 Decliners

Company	%
Coca-Cola HBC	-7.0
Rentokil Initial	-6.6
Sage	-6.6
Compass	-6.5
RELX	-6.2

Currencies

Pair	last	%1W
USD/GBP	1.243	1.2
GBP/EUR	0.890	0.9
USD/EUR	1.11	0.3
JPY/USD	108.08	-1.1
CNY/USD	7.079	1.0

Commodities

Cmdty	last	%1W
Oil	60.30	-2.0
Gold	1502.3	-0.3
Silver	18.02	-0.9
Copper	267.0	2.1
Aluminium	1803.0	1.1

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.73	0.22
UK 15-Yr	0.92	0.18
US 10-Yr	1.83	0.27
French 10-Yr	-0.20	0.14
German 10-Yr	-0.48	0.16
Japanese 10-Yr	-0.15	0.08

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.1	17.9	13.0	13.2
FTSE 250	3.3	26.1	14.5	14.2
FTSE AS	4.7	18.9	13.0	13.4
FTSE Small	3.8	48.9	-	14.0
CAC	3.3	19.5	15.1	13.4
DAX	3.2	20.8	14.6	12.5
Dow	2.2	18.2	18.0	14.9
S&P 500	1.9	19.7	18.3	15.9
Nasdaq	1.0	24.6	21.9	17.9
Nikkei	2.1	15.6	15.9	17.8
MSCI World	2.5	2.5	18.8	16.8
MSCI EM	2.9	13.6	13.1	12.0

UK Mortgage Rates

Mortgage Rates	Estimate	Jul	Jun
Base Rate Tracker	2.56	2.56	2.56
2-yr Fixed Rate	1.68	1.64	1.66
3-yr Fixed Rate	1.80	1.75	1.77
5-yr Fixed Rate	1.98	1.92	1.96
10-yr Fixed Rate	2.59	2.67	2.61
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

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