THE **CAMBRIDGE** WEEKLY

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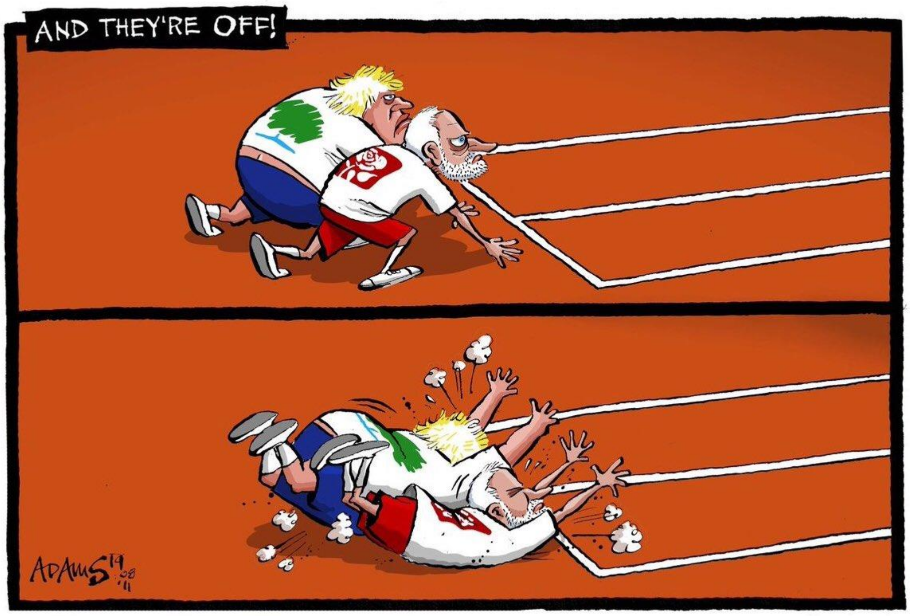


UK election campaigns - off to a bad start?, Source: Christian Adams, 8 Nov 2019

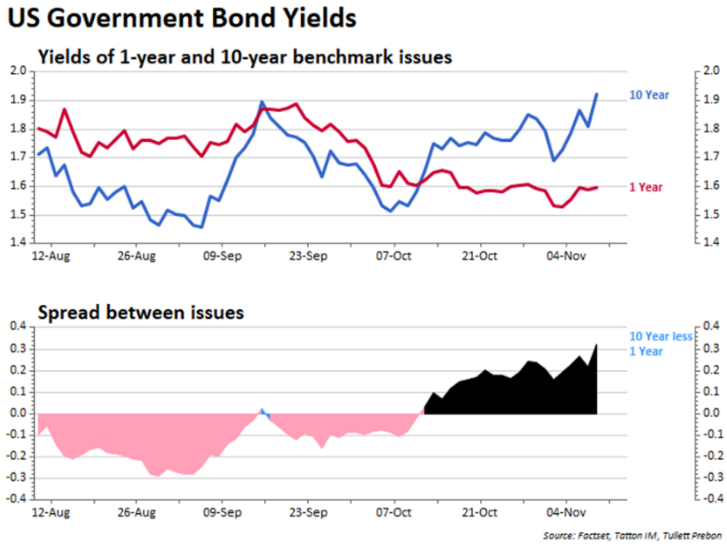
Recession concerns retreat, but growth remains a hope

Equity markets were in a good mood this week. That is in no small part due to progress in US-China trade negotiations, in which both sides agreed to the removal of already imposed tariffs in a number of phases. Donald Trump's trade war against China is among the biggest concerns for global investors (even more so than the all-encompassing Brexit drama here). It seems that recent weakness in the Chinese economy (and possible electoral weakness for the Trump administration) has made a compromise necessary. And as we have written before, with a sluggish global economic backdrop, a positive outcome on trade between the world's two largest economies will be vital for the health of markets and the economy going forward. Investors are well within their rights to have a little optimism then, albeit with a dash of caution. We discuss this in more depth in a separate article this week.

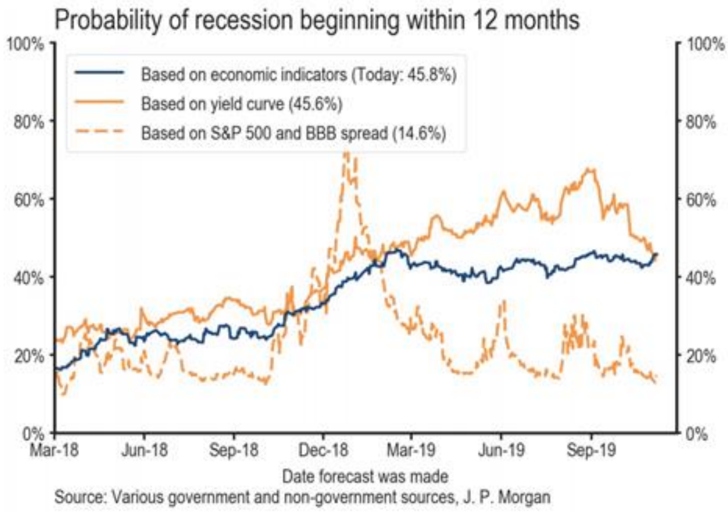
Sentiment is also being buoyed by a potential turnaround in manufacturing, with new orders showing a recovery from the lows they sank to this year. Not all manufacturers are positive though, with the autos sector still getting to grips with overcapacity in inventories. Peugeot and Fiat have pledged not to close factories in their upcoming merger, but the combined group is expected to have spare production capacity of almost six million vehicles amid slowing demand. We devote another article this week to manufacturers and business sentiment.

Where there certainly seems to be an improvement is in financials. Banks have done well recently, buoyed by optimism over the economic outlook for 2020. That optimism is partly due to resurgent demand for capital in corporate bond markets. This week, the funds raised for European corporate bonds hit €1.28 trillion – the highest ever yearly record. And we still have five weeks of activity left this year. The Bloomberg Barclays Global Corporate Aggregate has been rapidly increasing throughout the year, but the cash has mostly been sitting on the side-lines. With sentiment improving, the likelihood of that cash being put to work in actual investment – to the benefit of the global economy – is high.

What's more, the demand for capital is strong. That suggests businesses believe there are enough opportunities for profit out there. It may also mean the era of extraordinarily low cost of debt capital is coming to an end. While short maturity yields have remained relatively stable (on the basis that central bank policies will remain accommodative – leaving rates low - even if growth picks up), long maturity yields have risen sharply this week in all developed markets. In the US, the 10-year yield has gone back to almost 2%, a rise of 0.5% since the beginning of September. Yield curves – the difference (spread) between government bond yields at different lengths of maturity – are steepening into unambiguously positive slopes. This is a good sign, as the inverted yield curves we saw during the summer suggested a



recession could be on the cards. Analysts often use the shape of the yield curve as an indicator of recession probability, and according to JP Morgan Research, on that basis the probability of a US recession in the next 12 months has dropped below 50%. As the chart above shows, it now matches the probability of recession based on actual economic indicators. Unfortunately, both are still a little too high



for comfort.

However, if we take stock markets as our guide, things look a lot calmer. This reflects the improving sentiment we have witnessed in equity markets. Of course, stock markets are not always a good guide to the actual economy. As you can see, market-derived recession probability spiked to over 70% at the beginning of the year; no recession was forthcoming. Markets now are betting that things will improve next year. We happen to agree with them. But current equity levels already have a lot of improvement priced in. At lower levels a month ago, risk markets were resilient to a run of bad news. Now, they need the data to improve just to hold to their current levels.

The current availability of cheap debt (and the fact it may not be around for long) and improving business sentiment should motivate firms to invest more to improve their profitability. As we have written before, profitability is becoming a difficult issue for many businesses, with margins coming under pressure from rising wage costs as low unemployment restrict the availability of labour. This is not particularly concerning for nominal growth, however, and should incentivise investment if sales are forecasted to rise again.

Lastly, let's turn to the UK. The major parties may not have managed to get their election campaigns off to a particularly smooth start, but with both promising large fiscal expansion in their election manifestos, it is no longer a question of if, but how or where extra public spending will go. For 2020, this should be positive for the economy either way, but the biggest long-term benefit to growth would most likely come from investment in productive public infrastructure, such as physical infrastructure, education and vocational training.

The uncomfortable truth is that public health spending and policing are not likely to add directly to productivity in the short-term and so would inevitably have to be paid for through higher taxes in the long-term. Of course these things may be a necessary public good, but their immediate effect on GDP growth is hard to quantify.

Given the almost inevitable increase in government spending and borrowing, it is perhaps surprising that the Bank of England struck a dovish (favouring low rates) tone in their latest monetary policy report. Their forecasts for growth and inflation were downgraded, and two members of the Monetary Policy Committee even voted for lower rates. The Bank's current forecast for inflation two years in the future is below 2%, which suggests an easing bias on their part. No doubt, the new-found strength of £-Sterling is a factor in their dovish move – as are the global developments they acknowledged in their report. The latter suggest they may even be behind the curve, with JP Morgan predicting that the BoE will cut interest rates in January.

Of course, their forecasts lean heavily on their own Brexit expectations. And on this there has been some suggestion that the Bank are concerned that a 2020 Brexit along the lines of Boris Johnson's deal would not end the uncertainty currently facing businesses and consumers – as trade negotiations with the EU could still take many different directions. It is worth noting that the BoE's forecasts have already included a number of assumptions that may prove to be a little optimistic: a smooth Brexit transition, a pickup in growth next year, fiscal easing and an orderly transition to a Free Trade Agreement in 2021. All of those are, on balance, reasonable expectations. But none of them is a certainty. Like capital markets, we will have to see significant improvement just to match the current predictions. Returning confidence is a positive; let's hope it ends up justified.

Asset Class	Index	October	YTD	12 months
Equities	FTSE 100 (UK)	-2.1	12.1	6.5
	FTSE4Good 50 (UK Ethical Index)	-2.2	10.0	6.8
	MSCI Europe ex-UK	-1.7	17.1	10.9
	S&P 500 (USA)	-2.3	21.2	12.9
	Nikkei 225 (Japan)	-1.2	14.7	7.8
	MSCI All Countries World	-2.1	17.5	11.2
	MSCI Emerging Markets	-0.9	8.6	10.5
Bonds	FTSE Gilts All Stocks	-1.8	9.2	10.3
	£-Sterling Corporate Bond Index	-0.2	11.1	10.3
	Barclays Global Aggregate Bond Index	-4.3	5.3	8.2
Commodities	Goldman Sachs Commodity Index	-5.1	8.2	-11.1
	Brent Crude Oil Price	-7.1	9.1	-21.5
	LBMA Spot Gold Price	-4.2	15.7	22.2
Inflation	UK Consumer Price Index (annual rate)*	0.1	1.3	1.5
Cash rates	Libor 3 month GBP	0.1	0.7	0.8
Property	UK Commercial Property (IA Sector)*	0.1	0.1	-0.7

Data sourced from Morningstar Direct as at 31/10/19. * to end of previous month (30/09/19). All returns in GBP

Asset Class returns up to October 2019

Trade truce on the horizon?

Progress at long last. US and China are close to ending some of the tariffs they have imposed on each other's exports. Spokesperson for China's Commerce Ministry Gao Feng told reporters on Thursday that both sides had agreed "to remove some of the additional tariffs in phases" which will "help to stabilise market expectations,"

Questions remain over the much-discussed 'phase one', not least where presidents Trump and Xi will meet to put pen to paper (officials are still squabbling over whether the signing party should be in Iowa, Brazil, Hawaii or Alaska). More importantly, which tariffs are first to go is still undecided; "that will depend on the content of the phase one agreement," according to Gao.

Nevertheless, capital markets took the comments as decidedly good news. Both Chinese and US stock markets climbed higher in response, with the Hang Seng index up 0.6% and the S&P 500 futures up 0.4%.

The US-China trade war has been one of the biggest market concerns ever since Donald Trump was elected – even more so since evidence of its negative effects on businesses and consumers has started to come through. We recently wrote that negotiations between the world's two largest economies were now more important than ever, as markets needed reasons to be positive in the face of slowing global growth. And sure enough, the apparent thawing of trade tensions (along with some other titbits of good news) seems to have precipitated a big improvement in market sentiment.

We should not get ahead of ourselves however. Erratic policy decisions and sudden turnarounds are the hallmarks of Trump's presidency, often swinging from confrontation to reconciliation in the space of 140 Twitter characters. Only three months ago he seemed to support the idea of decoupling the two economies entirely. Chinese policymakers have also proved surprisingly stubborn or opportunistic at key moments of decision. Experience of this trade war makes us wary of false dawns. The two sides have found a way to talk to each other but their ultimate aims may still be incompatible.

Still, there are reasons to think genuine agreement could be around the corner. As we have written before, both sides have an incentive to get a deal done. China is in the throes of a damaging economic slowdown, while the Trump administration is no doubt worried about how tariffs are affecting the President's voter base.

The latest signals point to compromise from both sides. Beijing seems to have loosened its requirement that the US drop all tariffs as a precondition to any trade deal – with officials now accepting the more gradual approach to negotiations. The US is also reportedly considering removing the round of tariffs it imposed in September on around $112bn worth of Chinese exports. "It's the first time the US compromises on tariffs," according to Tu Xinquan, professor at the University of International Business and Economics in Beijing.

Crucially, China also appears willing to make the value of their currency part of a deal. Currency is a key talking point for Trump, labelling China a currency manipulator the moment he stepped into the White House and continuing to allege (somewhat incorrectly) that they have been forcing their currency lower to gain a competitive edge (rather, they did not prevent market forces driving the Yuan's value down). Earlier in the year, Beijing held the value of RMB relatively strong against the dollar as a show of good faith. When discussions stalled during the summer, they seemed to let the value of the currency fall. Ahead of the announcement this week, however, they seem to have re-strengthened the RMB to 7 against the dollar (the chart of the Yuan's exchange rate below needs to be inverted to be interpreted – less Yuan per US$ means a stronger Yuan). And there are suggestions that fixing the currency exchange rate at a different level could be a part of any comprehensive deal moving forward.

Source: Factset, Tatton IM 8 November 2019

Questions remain. Chinese leaders will no doubt be aware of the historical parallels of their situation. An East Asian country with an aging population and burgeoning credit bubble, involved in a trade dispute with the US – with the latter demanding a currency fix. Japan found themselves in this exact scenario in the 1980s, after which they agreed the famous Plaza Accord with President Reagan which stipulated that they would allow their currency to strengthen. That accord is now often cited as one of the main reasons behind the Japanese asset bubble of the late 1980s, and years of economic stagnation that followed. Japan's high level of savings were not channelled outwards, at least not directly. Investor conservatism and the perception that the Yen would strengthen instead led to plunging interest rates. Banks, corporations and their regulators were ill-equipped for the situation, so the liquidity channelled straight into unproductive real estate investment and the property bubble ensued. The similarities for China are obvious and, for a government dominated by growth targets at all levels, a similar outcome is unthinkable.

That may explain their willingness to have an agreement in phases. Last week, Chinese officials were said to think that a comprehensive trade deal with "this president" would be impossible – hinting that they would prefer to work with Trump's potential successor.

China may prefer to drag it out beyond the end of next year (or sooner, depending on the impeachment proceedings) – in the hope they will have a more amenable negotiating partner.

That may be the case, but the outcome of the US election is impossible to call at the moment and is beyond Chinese control. It would not be wise to make the trade outcome a hostage to fortune. Beijing may prefer to have someone else on the other side of the table – if only for the sake of having a more consistent negotiating partner, but there is no guarantee that Trump's replacement would be more willing to compromise. Elizabeth Warren, the current favourite for the Democratic candidacy, is known for taking a tough line on many issues, and could well outflank Trump's hard-line approach on China.

Indeed, Trump is more likely to ignore any political action that China's administration may take in its "hemisphere of interest" (to use the phrase that the US coined in the Cold War). Noises from Vietnam, Taiwan and Hong Kong rumble on, and there is a clear risk that China becomes unable to bear the dissent.41

The end is far from nigh for the US-China trade war. But the Trump administration will want to get to sign off on an effective victory for phase one, and start work on phase two of the agreement as soon as possible, Whatever way you look at it, this week's developments are decidedly positive compared to what we heard, thought and wrote about last week. Given how important an issue this is for equities, we think it makes the recent swing up in valuations justified. The only negative is that – barring a capitulation of one side, and removal of all tariffs – further upside for sentiment may now be limited.

Global PMIs: Not out of the woods yet

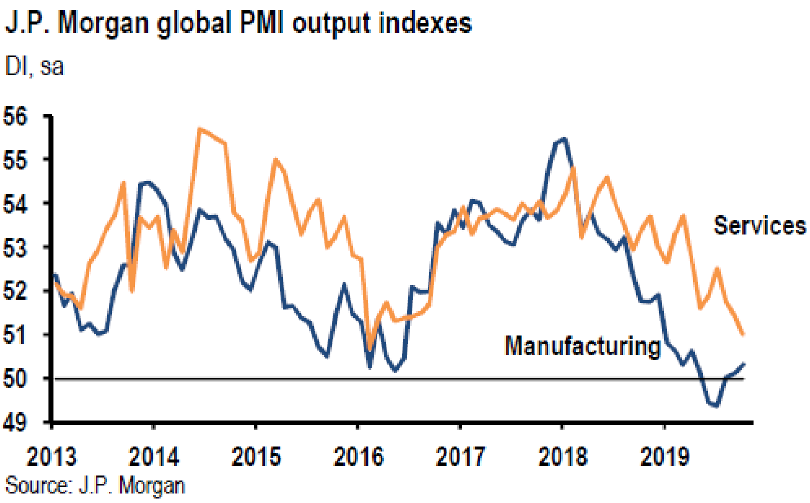
As regular readers will know – 2019 has seen a marked slowdown in global growth. Anticipation of this caused panic at the end of 2018 as equity markets convinced themselves that a global recession loomed ahead but central banks would continue to tighten monetary conditions regardless. There has been a recovery in market sentiment since the start of 2019 as central banks reversed monetary policy back to an easing stance. But we wrote some weeks ago that, for this to continue, we would need to see a definitive turnaround in the underlying economic data. So, it is worth having a look at what the latest data say on the matter.

A key forward looking indicator for growth is the purchasing manager's index (PMI), which measures business sentiment on a score out of 100. Any reading above 50 is supposed to indicate expansion, while any reading below indicates contraction. In reality, the so called 'neutral' level (consistent with a steady expansion) is a little higher than 50. What's more, it is often the direction of travel (change on the previous month's figure) that tells more about growth prospects than the absolute figure.

The latest global PMI, published by JP Morgan, shows a reading of 50.8 for October, down from September's 51.1. It also marks the third consecutive month of decline. This is not such a great sign, with global business sentiment now flickering close to contraction levels and still falling. Taking a deeper look can tell us a bit more, however.

As we have written before, the slowdown in global growth has been led by the manufacturing sector. Over the summer, the manufacturing PMI fell firmly into contraction (with particular 'horror shows' in Germany and a few other export-driven European economies). But in October, manufacturers posted a figure of 50.3, a nudge up from September and the third consecutive month of improvement. In general, a turnaround for manufacturers tends to foreshadow a recovery in global growth. Of course, the actual figure is still nothing to get too excited about, but the fact that the sector seems to have stopped the bleeding is a good sign at least.

Unfortunately, things are not so positive on the other side of the economy. While the fall in manufacturing seems to have bottomed out, the same cannot be said for the services sector. The services sector had been a bright spot for the global economy for most of the year, making up for the falls in manufacturing, but the latest figures show that this counterbalance is declining. The October services PMI came in at 51, indicating stagnation and again marking the third consecutive month of decline. Services



sentiment is still at an 'okay' level, but it is decelerating abruptly.

We wrote before that the potential for manufacturing weakness to spill over into services was a key risk for the global growth outlook. This is particularly true for developed economies, where services usually form a larger part of the economy. The latest figures show exactly that: manufacturing is weak but no longer falling, and the services sector is okay but falling. The overall picture we are left with is uninspiring at best. A turnaround in manufacturing tends to lead global growth but the struggles of the services sector are a reminder that such turnarounds can take some time. According to JP Morgan, these results are consistent with a lacklustre 2.3% global GDP growth for this year.

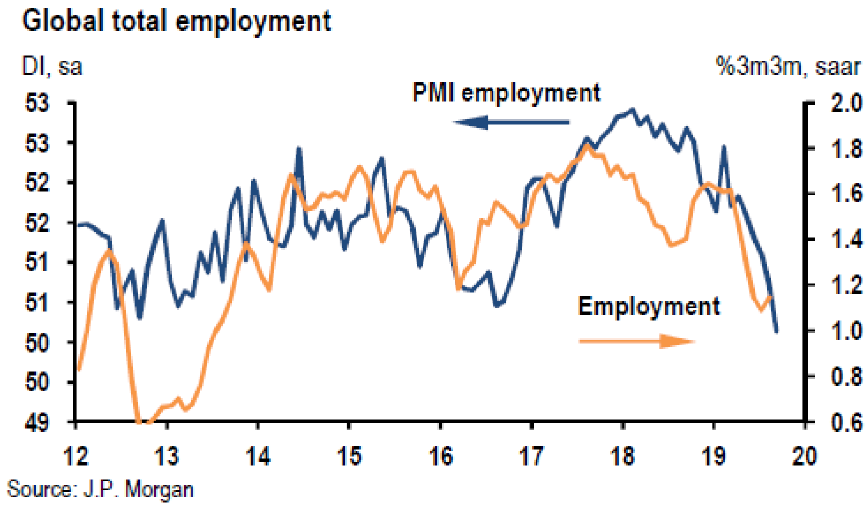
Nonetheless, capital markets have become significantly more confident that we are in for a turnaround. What is interesting is that this is the mirror image of what we experienced around this time last year. Into the end of 2018, growth was still running at a fair pace, but markets sold off as though the apocalypse was nigh. Now, the global economy shows little sign of a sustained turnaround, but markets are brimming with risk appetite. So, are they seeing something businesses are not?

Well, there are reasons for (cautious) optimism. The trials and tribulations of manufacturers this year show all the classic signs of an inventory cycle. Globally, manufacturers had built up their inventories from the previous period of growth such that waning demand left them with an over-supply, and hence falling prices. And the trade friction made the planning process even more difficult.

Now, however, that over-supply seems to have run down, indicating a rebound in demand and prices for manufacturers.

That process will take time. Fortunately, it should be aided by a more positive political backdrop. The US-China trade war (which we cover in a separate article this week) is edging closer to a resolution – which would remove one of the biggest worries and uncertainties facing businesses and investors. Meanwhile, governments across the developed world, egged on by exasperated central bankers, are finally moving from fiscal austerity towards fiscal expansion – which would be supportive of growth. All these things would help manufacturers.

Those are the positives. The negative (aside from potential political disappointment) may be that the services sector is not subject to an inventory cycle: rather it is linked more closely to employment. This means we cannot be sure whether the expected rebound in manufacturing will translate into growth for services. It may well do, but it is still too early to tell, and the employment components of the PMIs were weak.



It is also worth noting that the Service PMIs are a bit more variable than the manufacturing counterparts. A two-monthly average is a more dependable indicator but, of course, that reduces its timeliness.

Meanwhile, equities moved ever higher on the back of improving sentiment – but not yet improving results. Optimism abounds in capital markets. The same is not yet true for businesses.

CAMBRIDGE INVESTMENTS LIMITED

11th November 2019

Global Equity Markets

Market	FRI 14:50	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7368.2	0.9	65.8	→	⬀
FTSE 250	20375	1.1	216.6	→	↗
FTSE AS	4059.7	0.9	37.0	→	⬀
FTSE Small	5524.5	0.6	33.2	→	→
CAC	5877.8	2.0	115.9	⬀	↗
DAX	13234.6	2.1	273.5	↗	↗
Dow	27681	1.2	333.4	⬀	↗
S&P 500	3081.1	0.5	14.2	⬀	↗
Nasdaq	8224.0	0.8	62.9	↗	↗
Nikkei	23391.9	2.0	464.8	↗	↗
MSCI World	2266.7	0.6	14.6	⬀	↗
MSCI EM	1073.6	2.3	24.4	↗	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
John Wood	10.4	Hiscox	-13.1
Assoc. Brit. Foods	8.4	GVC	-10.4
Rolls-Royce	6.5	Ocado	-9.9
Glencore	5.9	BT	-7.6
Micro Focus Int'l	5.6	Fresnillo	-7.6

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.281	-1.0	Oil	61.12	-0.9
GBP/EUR	0.861	0.3	Gold	1459.0	-3.7
USD/EUR	1.103	-1.2	Silver	16.83	-7.2
JPY/USD	109.35	-1.1	Copper	269.5	1.6
CNY/USD	6.992	0.6	Aluminium	1813.0	3.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.8	0.1
UK 15-Yr	0.9	0.2
US 10-Yr	1.9	0.2
French 10-Yr	0.1	0.1
German 10-Yr	-0.2	0.1
Japanese 10-Yr	-0.1	0.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.9	18.1	13.4	13.2
FTSE 250	3.7	24.0	14.6	14.2
FTSE AS	4.7	19.1	13.5	13.4
FTSE Small	3.7	170.9	-	13.9
CAC	3.1	21.0	16.0	13.4
DAX	3.0	23.8	15.9	12.5
Dow	2.2	19.1	18.7	14.9
S&P 500	1.9	20.4	18.7	16.0
Nasdaq	1.0	25.5	22.4	17.9
Nikkei	1.9	18.7	17.5	17.5
MSCI World	2.4	19.7	17.4	15.2
MSCI EM	2.8	14.8	13.8	11.9

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	2.62	2.59
2-yr Fixed Rate	1.55	1.56
3-yr Fixed Rate	1.63	1.65
5-yr Fixed Rate	1.74	1.77
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.29	4.29

* 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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