CAMBRIDGE
INVESTMENTS LIMITED

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Lothar Mentel

Lead Investment Adviser to Cambridge

Hedgeye, 19 Nov 2019, Bulls getting ahead of themselves

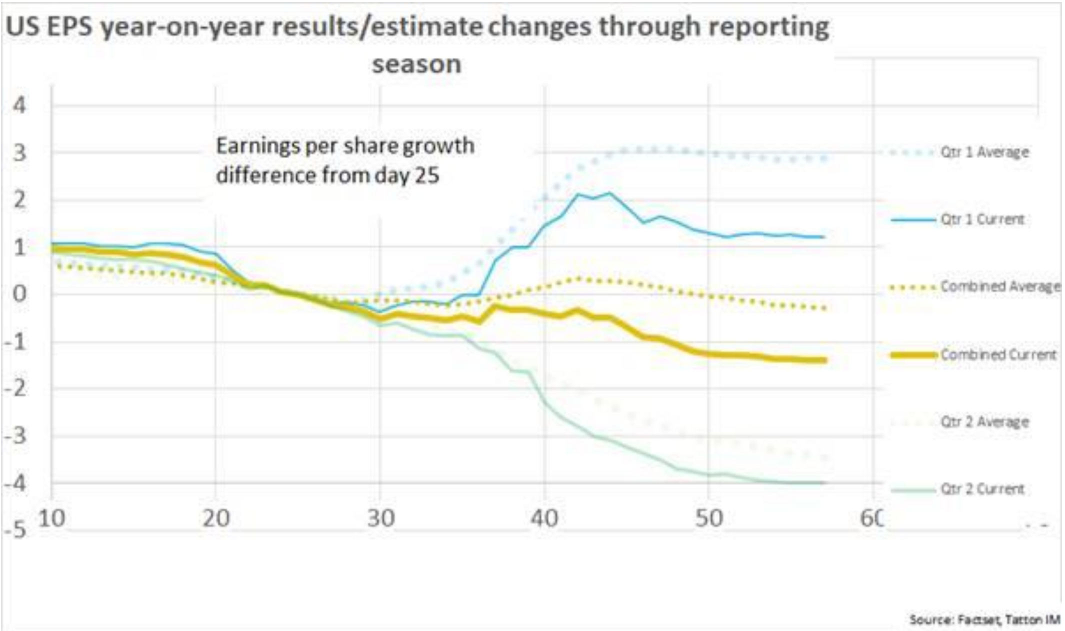
Markets pause for reality check

Conventional market wisdom holds that the cold and damp of autumn usually heightens the probability of downside volatility in markets – particularly when the economic outlook is unclear. The last quarter of 2018 was a prime example of this. Fortunately, no one seems to have told the markets. The waning of summer only saw the markets' upward momentum briefly disrupted during October, with stock indices around the world now sitting at highs, not lows, for the year - this is despite an economic and political outlook still plagued with uncertainties.

Perhaps we should not be surprised. The recovery in market sentiment we have seen this year has certainly propelled equities to new heights in nominal terms, but in terms of valuations (share price levels as a multiple of annual earnings per share) we are merely back to where we were before the almighty sell-off at the end of last year.

Back then, we said that markets were overreacting. When central banks moved from tightening monetary conditions back to a loosening stance, fears over higher corporate financing costs – and the recession-inducing default cycle they could trigger – dissipated. This prompted a turnaround in investor risk appetite (we cover the relationship between central bank policy and markets in a separate article below).

However, the latest earnings season has failed to bring any more growth in company profits, so it is difficult to see where further upside for stock markets could come from. Overall earnings per share in the last quarter were slightly down from the same period last year. This is not too surprising: Q3 2018 delivered double digit growth in earnings (boosted by Donald Trump's tax cuts) that was never going to be surpassed. More concerning are the outlook statements from businesses and analysts, which point to no significant growth rebound in the current quarter. The outlook statements are worse than historical standards, as the chart below shows. Certainly, they provide little justification for the market optimism



we are seeing.

For markets to move up from here, we need to see improvement in the global economic growth outlook – or at least some hope that it is coming. The most obvious catalyst for that is an end to the US-China trade war and a removal of its damaging tariffs. A couple of weeks ago we seemed to have a breakthrough, but as has been the custom with Donald Trump, things have turned around yet again. The ongoing protests in Hong Kong (supported by Republican politicians all the way up to Vice President Pence) and the escalation of impeachment proceedings will make a trade deal difficult in the short term. Trump's administration will not be focused on China at the moment and may well want to stir up fervour against China as the enemy in order to rally domestic and Republican party support.

Just last week, we heard through the financial grapevine that many institutional investors who had previously held large cash positions jealous of the lofty returns on risk assets were deciding to join in the party. Fear of a slowing macroeconomic environment was outweighed by fear of missing out. This created positive market momentum, suggesting that the rally of the last few months might lead naturally into the traditional Santa Rally, to the benefit of those investment groups only now joining in the festivities.

But this week, that kind of talk has receded, with many now worried about the sustainability of the rally. This is despite this week's European and US business sentiment numbers (Purchasing Manager Indices - PMIs) providing some hope that global economic conditions have found their low point and are set to improve from here. The return of positive (albeit sluggish) growth from here seems reasonable. In a way, the fact that markets are not reacting with jubilation to these uninspiring but somewhat reassuring figures is a good sign. If risk markets took this as a signal to steam ahead into a Santa Rally, we would start to feel quite nervous about the sustainability of asset prices. If that happened, valuations would be back at the unsustainably high levels from the turn of the year 2017/2018.

The real base for sustained stock market growth would be a meaningful rebound in global economic growth, but the catalysts for that growth are still lacking. Fundamentals have yet to recover and the global political backdrop still presents many risks which could undermine any nascent return of growth. Additionally, central banks have been at pains to make clear that they can no longer salvage the economy with monetary policy. Central bankers are concerned that ultra-low interest rates and yields are damaging the banking sector, which remains vital for the overall health of economies due to its credit transmission function.

In summary, we at Cambridge are neither surprised nor entirely unhappy that stock markets have paused their upward surge, perhaps for an overdue reality check. Readers who may have feared that this week's slightly negative stock markets are a sign that investors have been frightened by the openly socialist Labour Party manifesto, can be reassured that those movements followed global not domestic developments. The value of £-Sterling, which has typically been the best indicator for the waxing and waning of investor sentiment around political developments in the UK, has hardly moved, and has held the considerable gains since the lows of the summer.

We would agree with markets and not regard this as ignorance of the potential damage Labour's stated policies could have on UK investments. Instead, the calmness comes from the realistic assessment that even under the currently unlikely scenario of a Labour-led government – likely a minority or coalition that would force the Labour leadership to a more 'middle of the road' agenda. Those who would abandon UK stocks from fear of the Labour Party could be compared to those who sold their US holdings worried about President Trump – leading to very considerable loss of upside opportunity against a marginal reduction in overall downside risk.

Central bank liquidity support – a double-edged sword

In recent weeks, we have talked a lot about the puzzle of the current market rally. All around the developed world, stock markets have risen – with many now at or close to their all-time highs. At the same time, economic indicators are, on a charitable interpretation, uninspiring – and on an uncharitable one, perhaps worrying.

This puzzle is clearest when looking at comparisons of recession indicators. If we take the shape of the US yield curve (the difference in yields between government bonds at different maturities – usually thought to be a pretty good recession signal) as our guide, the probability of a recession in the next 12 months has come down substantially. But if we take economic recession indicators as our guide, the probability has risen steadily. Indeed, economic indicators now suggest a higher probability of recession than financial or market-based ones.

In short, global growth is struggling, but markets *seem* happy. We say "seem" because few investors actually appear convinced that the current rally in risk assets is sustainable, with some thinking that equities are becoming materially overvalued relative to the underlying economy. So why is the rally happening?

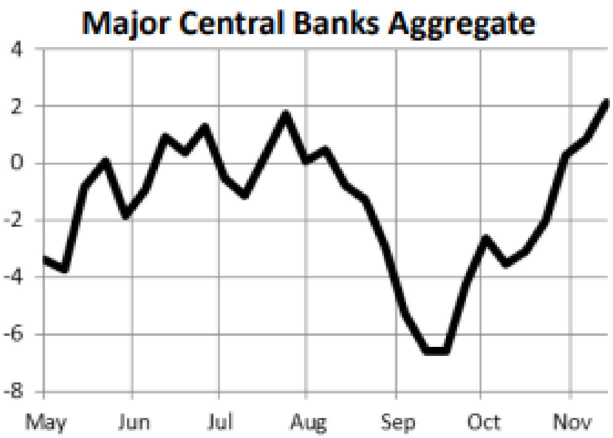
There are a few standard solutions to the puzzle proffered: markets are encouraged by signs that the global economy is turning around, political headwinds like Brexit and (more importantly) Trump's trade war are fading, governments are moving towards increased fiscal spending and central banks are committed to keeping interest rates lower for longer. These explanations have their merits, but are not sufficient.

This week's PMI data does indeed suggest that slowing growth has found a floor both in Europe and the US, but there is still no sign of a sustained turnaround and, in Europe' services sectors, the pace of slowdown remains fairly steep. There has been some progress in trade talks between the US and China, but hardly enough to suggest that an end to tariffs is imminent, and the outcome of Brexit is hardly any more certain than it was two years ago. Rumours of looser fiscal policy are indeed a positive, but it would be quite a stretch to imagine governments' fiscal spending being successful enough in the short term, and on its own, to justify current equity valuations.

Perhaps it is a little from hopes for a recovery in global trade, a little from governments helping on the side of flagging demand. According to some recent research however, the explanation is simpler: central banks are flooding the market with liquidity, and markets are just going up with the rising tide. Earlier this year, the return of major asset purchase programs from the Federal Reserve, the European Central Bank and the Bank of Japan excited investors. But the heads of the central banks were insistent that the limited asset purchases to which they committed did not constitute another round of quantitative easing (QE).

After a decade of extraordinary monetary policy, worries about the negative effects of QE on banks and wealth inequality are pervasive among policymakers. In the minutes from the Fed's latest meeting – released this week – committee members were at pains to make clear that they were not performing more QE. The bank will not be buying swathes of long-term government bonds (as in previous episodes of asset purchasing) but is instead focused on injecting just enough cash to cover the short-term needs of banks and other financial institutions. QE holds down government bond yields and inflates asset markets, which central banks want to avoid. Meanwhile, the latest liquidity support merely ensures less erratic conditions in the short term lending markets.

Unfortunately for the Fed, it looks as though its current policy is doing the very same thing as before. An informative research note from Citi suggests that, when it comes to global financial markets, the aggregate liquidity input from global central banks matters more than any individual bank's policies. And on that front, the liquidity taps are definitely on again. CrossBorder Capital produce a Global "liquidity"

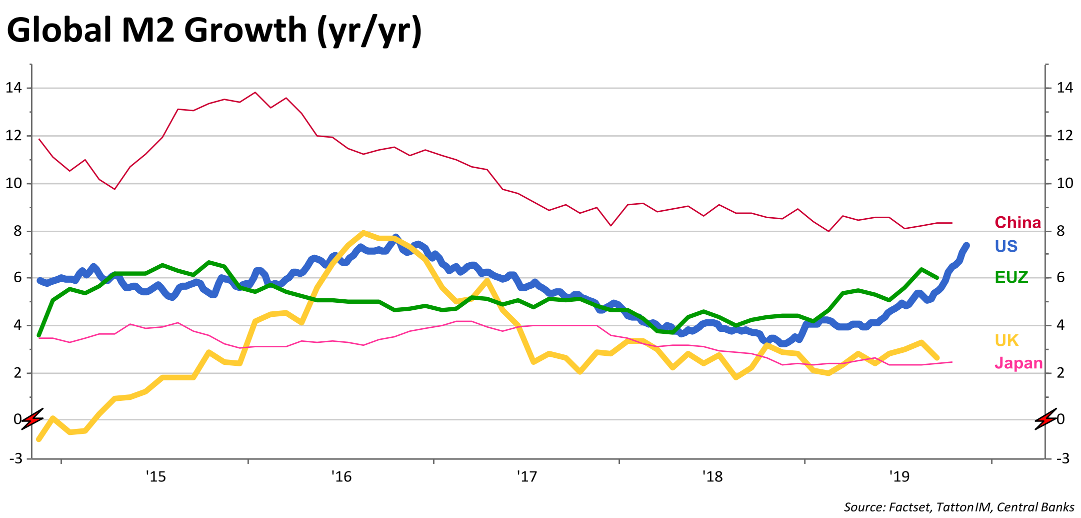


indicator, which shows the current pickup.

This is backed up by the rise in broader money (at the M2 level). The chart shows that the major source is coming from both the US and Eurozone:

The Fed may not want to call it QE, but in the end the effect is the same. Once liquidity is injected into the system, it has to find its way into something. What this means is that, if there is even a hint of economic improvement (or potential improvement from political developments), the risk of being stuck holding cash while risk assets rally becomes too great. The cash that was already building up in companies, private equity funds and with different fund managers has now been matched by an influx of cash from central banks. So, a rise in equity valuation metrics – as we have seen recently – is unsurprising. Even though the Fed is apparently unconcerned with buying long-term assets, because of its policies, long-term assets are sure to be bought.

There is one important difference between the Fed's current policy and QE, however. Under QE, asset prices were supported directly by central bank purchases. Now, the support is indirect – by decreasing the relative attractiveness of holding cash. That means that optimism on the economy – even if just a



whiff of it – is all that is needed to keep asset prices where they are. But that makes the current rally more fragile. The longer that we go without witnessing a true growth turnaround, the more nervous investors will get, and the more likely they will be to run away – even if there is ample liquidity around.

That is, of course, not to say that a meltdown is imminent. We do think that the current market bet – that global growth will turn around – is broadly right, if a little optimistic. But it is certainly overoptimistic if investors are assuming a return of higher single digit global growth rates, given the unresolved political backdrop.

US consumers refusing to revert to trend

The Q3 earnings season is now coming to a close, with most companies having reported their results for the period. As we have written before, firms guiding forecasts lower, only to subsequently beat them and get a boost to their stock price, is a well-known pattern – so it is unsurprising that it happened again. Coupled with a return of risk sentiment in capital markets, who seem to be expecting a turnaround in the global economy, this has left the US stock market around its all-time high - despite corporate profits actually having slightly declined over the year.

But not everyone has been a beneficiary of this investor optimism. US retailers, hit with a string of bad results among headline names, saw their stock prices come under pressure this week. Kohl's, Home Depot and Urban Outfitters all posted disappointing figures, raising fears that the sector is in trouble. Kohl's and Home Depot caused particular concern, downgrading their financial forecasts for the second time this year, while Urban Outfitters missed their sales forecasts for the quarter.

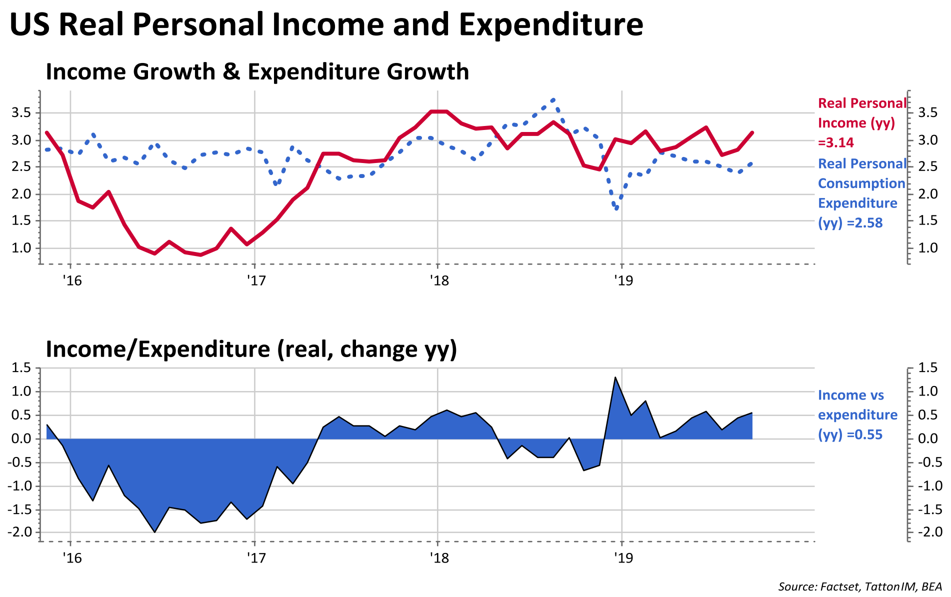
Struggles in the retail sector are increasingly common – as anyone who has walked down a British high street in the last few years can tell you. But there is something perplexing about this episode. Retailers are beholden to the health of the consumer. But the US consumer is – or at least should be – in rude health. The unemployment rate came in at 3.6% for October, and has been below 4% for the whole of 2019. It has not been consistently this low since the early 1970s. What's more, the strength of the labour market has been reflected in increased wages – which are still on a reasonably strong upward path. Measures of consumer confidence have swung upwards in the last two months. There is a solid base for consumers to spend more – to the benefit of the retail sector. But we are not seeing this in the data.

There are caveats to this. The 'Amazon effect' continues to hurt traditional retailers with a big physical footprint. It is worth noting that those firms who have done well – such as Target, whose results showed signs of hope – are those who have a big e-commerce component themselves. And consumption as a whole is running at a decent pace. But even looking at the e-commerce results reveals an interesting trend: Target and similar companies only managed to perform well by beating competitors, not because of an increase in overall demand.

A good indication of this is what is going on in US freight. According to the Association of American Railroads, freight shipping (rail) activity is incredibly weak, with other types of freight shipping showing similar signs. Shipping activity is more driven by business demand rather than consumers, but it does indicate that demand for goods from the end consumer is dropping off.

This is not what you would expect to see. When employment is strong and wages are rising, US consumers typically seize the opportunity to extend their credit and increase their spending. This effect has been one of the main driving forces of American growth for the last few decades. On certain measures, we are seeing something similar now – with overall borrowing levels holding strong. But what is interesting about this current bout of borrowing is that it is mostly coming from an increase in mortgage applications.

This is supportive of the housing market, but mortgage lending has recently not led to increased consumer spending in the same way as other types of credit. In fact, mortgage borrowing has to a large extent been a re-mortgaging to lower rates or a trading up to larger houses, and is thus effectively a kind of saving: consumers lower their overall debt burdens or increase their property assets and thereby effectively increase their savings rate by way of property assets. Bearing this in mind, what we are seeing overall seems to be a change of mentality from consumers. Instead of using their job security to consume more, they are building their savings. The next chart shows how household income has been outstripping expenditure again this year.



Perhaps recessionary fears are creeping into people's minds, or previous bouts of credit-fuelled spending have left them searching for greater financial security rather than having more "stuff". Whatever the reason, it does not spell good news for the US economy. As mentioned, a confident consumer has been the cornerstone of American growth for years now. If that willingness to spend is dropping away, growth could well follow it.

Of course, it is not yet time to sound the alarm bells. The Christmas period usually brings a bump up in both discretionary spending and seasonal employment. Fortunately for retailers, there is no reason to think that this time will be any different. However, if the outlook statements for the big names mentioned earlier are any guide, for many in the sector it may not be enough to make 2019 a good year. US retailers are already seeing their cost of financing shoot up with widening credit spreads, with some famous brands even close to default. The fact that American consumers are feeling frugal will not help in this regard. That is why company results for the current quarter will be crucial. If businesses show a decent year end, it could be the start of better things. If results go the other way, it would be time to start getting worried.

Global Equity Markets

Market	FRI 14:38	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7334.6	0.4	31.7	⬀	→
FTSE 250	20488	0.4	83.9	↗	⬀
FTSE AS	4049.2	0.4	17.2	⬀	→
FTSE Small	5552.2	0.3	19.2	⬀	→
CAC	5905.5	-0.6	-33.7	↗	↗
DAX	13180.2	-0.5	-61.5	↗	↗
Dow	27831	-0.6	-174.3	↗	↗
S&P 500	3103.5	-0.5	-16.9	↗	↗
Nasdaq	8287.5	-0.3	-28.0	↗	↗
Nikkei	23112.9	-0.8	-190.4	↗	⬀
MSCI World	2270.4	-0.5	-12.4	↗	↗
MSCI EM	1044.6	-0.4	-4.2	↗	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Centrica	12.2	Johnson Matthey	-10.9
Halma	9.6	Aviva	-8.0
M&S	6.8	Fresnillo	-7.7
Direct Line	6.6	Kingfisher	-6.2
Rightmove	6.4	Burberry	-4.7

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.286	-0.3	Oil	64.00	1.1
GBP/EUR	0.860	-0.4	Gold	1468.5	0.0
USD/EUR	1.11	0.1	Silver	17.11	0.9
JPY/USD	108.60	0.2	Copper	263.5	-0.1
CNY/USD	7.037	-0.4	Aluminium	1734.0	-0.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.7	-0.0
UK 15-Yr	1.0	-0.0
US 10-Yr	1.8	-0.1
French 10-Yr	-0.0	-0.0
German 10-Yr	-0.4	-0.0
Japanese 10-Yr	-0.1	-0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.9	17.7	13.4	13.2
FTSE 250	3.7	24.4	14.8	14.2
FTSE AS	4.7	18.7	13.5	13.4
FTSE Small	3.6	181.2	-	13.9
CAC	3.1	21.2	16.1	13.4
DAX	3.0	24.4	15.7	12.5
Dow	2.2	19.2	18.8	15.0
S&P 500	1.9	20.6	18.9	16.0
Nasdaq	1.0	25.8	22.8	18.0
Nikkei	2.0	18.4	17.6	17.5
MSCI World	2.4	19.7	17.5	15.2
MSCI EM	2.9	14.6	13.6	11.9

UK Mortgage Rates

Mortgage Rates	Oct	Sep
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

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25th November 2019

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Lothar Mentel