CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

27 January 2020

Lothar Mentel

Lead Investment Adviser to Cambridge

Source: Christian Adams, Spoiled Chinese Lunar New Year celebrations, 24 January 2020

Consolidation ahead?

The quiet period of Christmas and New Year has definitely ended. Davos World Economic Forum, Chinese Coronavirus, Q4 earnings season, central bank deliberations, first batch of 2020 business sentiment figures and – you guessed it – the next steps in the Brexit process have all provided plenty to think and write about, and to discuss. We suggested last week that, following the strong 2020 start in stock markets, it was quite possible that a period of consolidation might lie ahead. Sure enough, this week markets lost their vibrance and moved sideways to slightly down.

We can muse whether this was driven by the Chinese coronavirus scare or the growing insight that central banks have successfully plugged the shortage of transactional cash and will therefore discontinue any further liquidity injections (which they started last September). Many suspect that these injections have been the main driver of up-trending equity markets.

We run a full article this week on the coronavirus threat for the Chinese and global economy, however, it is worth remembering that 'keep-calm-and-carry-on' has been the best advice for investors during historical episodes of similar epidemic scares. The public's collective mind seems more influenced by doomsday movies, featuring apocalyptic virus plotlines, than by past reality. In any case, we should know within 10 days or so whether this outbreak is comparable to what we know from recent history or is of an altogether different dimension. The Chinese authorities have acted so much more quickly and decisively than during the 2002/2003 outbreak of SARS, and the WHO has decided to refrain from declaring a global health emergency. This leads us to believe that this one will follow similar, if not less severe patterns than observed in the past.

On the side of the economy, data flow underlines what we discussed over the last week: activity levels are improving after a downtrend and the first set of business sentiment survey readings from Europe and Japan came in better than expectations.

The gloomy Q4 2019 data indicators for the UK economy are also drifting into the background as the turn in sentiment following the general election begins to show up in forward-looking business surveys. The latest data set no longer suggests that the UK is drifting towards a downturn, but instead that the country is participating in the same upswing of sentiment as the rest of the world. On this basis, we reiterate that we deem it highly likely that the Bank of England will cut rates at the end of the month by 0.25%, but only once. This should ensure that £-Sterling is at a level where the UK can take advantage of the global upswing, even if the trading terms of Brexit once again sour the recently improved levels of certainty – temporarily.

Given the strong start to the year, we are not holding our breath for the coming two weeks, during which markets will have to digest the impact of the Wuhan virus and the end of the central bank liquidity spree. Beyond, however, we see more and more of the positive aspects replacing liquidity, and pure hope, as the drivers of market action. In particular, the fact that there wasn't anything to note or write about in the US-China trade war fills us with optimism that US and Chinese businesses will also no longer see this topic as a hindrance to business investment.

Wuhan virus makes global markets sneeze

Nothing captures the mind and our apocalyptic imagination quite like a viral outbreak. We could hazard a guess that viruses feature in more doomsday movie plotlines than meteors, nuclear war or any of the sort. The coronavirus outbreak in the Chinese city of Wuhan ticks many of the scare boxes: an (as yet) untreatable disease with uncertain effects originating in a densely populated and globally connected city.

At the time of writing, there have been 26 deaths and 870 cases reported, both 50% higher than yesterday. This is enough to evoke the memory of the SARS crisis in 2003. Back then, China struggled to deal with a rapidly spreading respiratory disease of unknown origin just as the country headed into its new year festivities.

We should not get carried away with comparisons, however. Reports suggest the virus is not as deadly as SARS, and the China of 2003 is not the China of today. The country's rapid development since then increases the risk of the virus spreading, with better transport links both within China and with the rest of the world. But on the other hand, Chinese health authorities learnt much from the devastating SARS episode.

Liu Heng, an adviser to the government, points out that it took authorities four months to announce SARS to the public and report it to the World Health Organisation. This time, it took less than one month. On Thursday morning, the government quarantined the whole of Wuhan – a city larger than London or New York. Two other major cities were also quarantined and Chinese New Year celebrations in Beijing, Zhejiang and Macau have been cancelled – the equivalent of cancelling Christmas here. These are faster and far more decisive measures than those taken 17 years ago.

This should create some peace of mind as far as public health goes. Unfortunately, as investment professionals, there are still reasons for concern. The Chinese New Year holiday, which officially begins on Friday, is usually a boon for the travel, tourism and retail industries. Now, Chinese consumers are – willingly or not – avoiding public places and cancelling their travel plans. This led to Chinese travel company Trip.com falling 7.9% in New York stock market trading earlier in the week. Stocks of other travel and aerospace firms also suffered. The most notable of these was Boeing, which had already been hit by its own bad news, leading to a further 3.4% fall.

On Thursday morning, after Wuhan was quarantined, US stock market indices fell overall, but to a much lesser extent. In terms of equity moves, the biggest response was actually on the upside, with vaccine maker Novavax shooting up 71%(!) in Monday trading – though it is hard to see this as anything other than speculation.

In previous high-profile global virus scares (Ebola, Swine flu, SARS, etc.) the reaction in capital markets was minor, short-lived, and stock markets closed the quarter (and/or year) higher. The same appears to run true for the underlying economy: as a case in point, trade, fixed-asset investment and industrial production were all proving exceptionally resilient during the SARS outbreak.

However, it is the timing of this episode that makes it concerning. The Chinese economy slowed significantly last year – hit by a double whammy of a credit crunch and Donald Trump's trade war. Going into the turn of the year, there was an expectation that Beijing's substantial support measures were beginning to pay off and confidence was returning in the world's second largest economy – aided by the news of a 'phase one' trade deal with the US. Sure enough, more recent economic data points to a turnaround, but conditions are still fragile.

While international investors are increasingly keen to take advantage of China's opening markets, the ongoing paralysis of Hong Kong – China's financial gateway to the world – has made it difficult. A nation-wide disruption at this juncture might stall the nascent economic recovery.

That is worrying for the global economy. At the moment, there are signs of a turnaround from 2019's manufacturing and trade slowdown, but broader conditions remain in a delicate position. Investors have taken the recovery signs and run with them, pushing stock markets up to new highs, but market confidence can only go so far before it has to come back to economic reality. Equities around the world are now as expensive in valuation terms as they were at the end of 2018 (just before an almighty correction sent stocks tumbling).

The promise of returning strength in emerging markets – led by a rejuvenated China – is one of the key factors underwriting confidence in capital markets. This makes the current crisis, and its effect on China's economy, a key risk to watch in the coming weeks.

Only time can tell how damaging the outbreak will really be. The speed and scale of the government's response is a cause for optimism. The scale of the measures already taken is without historic precedent. They suggest Beijing is determined not to allow this to become another SARS. This will no doubt give the western press a lot of headline material – but the World Health Organisation has not declared an international health emergency, yet. Given the current lack of epidemiological detail on the new virus, that does not mean it will not. This will stay front-of-mind for some time to come. However, we expect it only to be a week or so before it becomes clearer whether this virus can be contained in a similar manner to SARS and Ebola or has to be assessed at a different level. Until then, we can only wait.

UK housebuilders – from dogs to darlings

Changes in the housing market grab headlines in the UK. This makes sense: those who own homes (or want to) have a vested interest in the value of property. In economic terms, there is another reason: more so than most economies around the world, the UK economy is underwritten by its housing market.

Britain has a high current account deficit – meaning we import much more than we export. As a percentage of GDP, it is nearly double the US deficit. Our economy is also hugely reliant on domestic consumer demand. These things can only be sustained through a high level of private borrowing, but consumers' willingness to take on debt (and their ability to pay it back) is only possible if they have a strong asset-backed balance sheet. For most people, assets on their balance sheet means property. That is why economic policymakers keep such a close eye on the housing market – and why it generates so much news in the financial press.

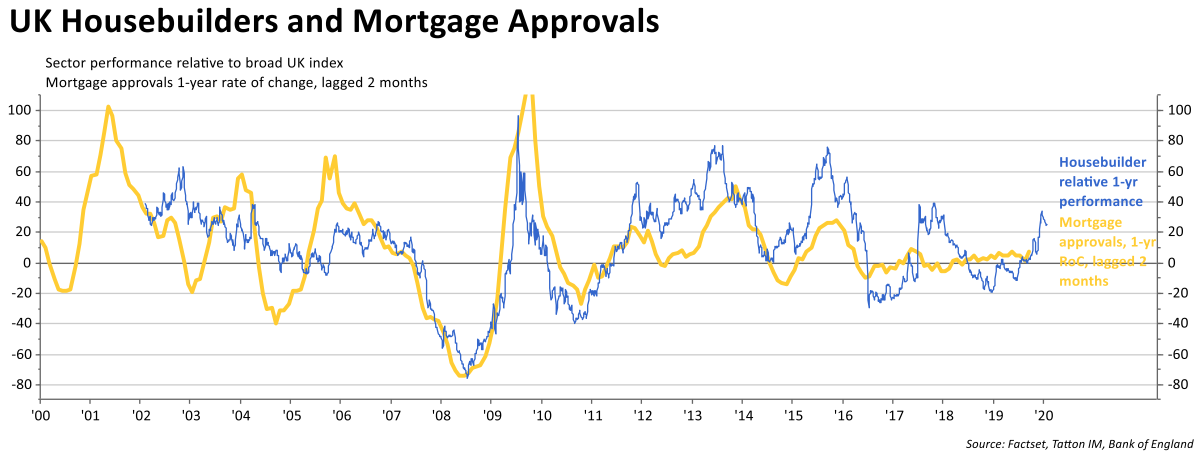
Or, rather, why it *usually* does. There is one notable housing market story which seems to have gone under the radar recently: over the past six months, share prices for the big housebuilding firms have stormed ahead. Stock in Persimmon group, the UK's largest housebuilding firm by market capitalisation, has risen 48% since the summer, while Taylor Wimpey shares have risen over 30%. Overall, the Household Goods & Home Construction Sector has risen 14%. Compare this with the 3.7% increase in the wider UK stock market (FTSE100) over the same period and the dimension of the surge becomes evident.

UK house prices have been floundering since the Brexit referendum in 2016, due to a combination of weak demand from overseas buyers (put off by Brexit uncertainties), stagnant wage growth undermining the public's purchasing power, and underlying structural issues. Last year was hardly a let-off in this regard: the political backdrop looked as turbulent as ever and economic data was weak. Despite this, the new build market exceeded analyst expectations. Barratt Homes topped the list in terms of completed constructions – building 17,579 homes – with Persimmon and Taylor Wimpey following behind on 16,449 and 14,933 respectively.

Prior to this impressive run, investors were anxious about the viability of housebuilding companies. As well as the general ills of the housing market, some of the high-profile names were put under considerable public scrutiny for their business practices. Persimmon was lambasted in the national press last year for the greed of its senior management team – revelations that saw CEO Jeff Fairburn resign, but only after pocketing a £75mn bonus. Even this year its public image was further tarnished by an independent review highlighting the poor quality of its houses. Further down the list of big names, Galliford Try faced bankruptcy after huge financial difficulties – only to be bought out by rival firm Bovis Homes. So, what has made housebuilders such a hot ticket again?

One of the main reasons is the clearing of the economic and political uncertainties in the UK. The housing market was mostly quiet for the second half of last year, prices were stable and did not come under much pressure. And as the outlook for the UK became more and more stable, private home buyers could only put off moves for so long. Boris Johnson made clear his intention to hold an election soon after his arrival into Downing Street, and since then there has been a growing sense that his Brexit deal and Tory government – promising to ease regulation and support home building – would win out. Every development since then only increased this likelihood and sure enough, share prices for housebuilders climbed steadily the whole time.

More recently, expectations for monetary policy have become increasingly favourable for housebuilders. In the past, housebuilder fortunes have been supported by more and more mortgage lending piling into the



housing market. This is somewhat less true recently, as effective growth in mortgage debt has been curtailed in recent years. Nevertheless, if one expects mortgage lending to ease, one should also expect housebuilders to benefit. Recent comments from the Bank of England indicate that mortgage lending is indeed about to get easier.

The Bank has signalled in quite clear terms its desire to cut interest rates and we expect it to do just that at its next meeting. The BoE has not been housebuilders' biggest supporter in recent years, but a rate cut now would certainly shore up mortgage demand, aiding house prices.

In this environment, market positivity on housebuilding firms makes sense. All the leading indicators point to a pickup in demand, supported by a tight labour market, and while the likes of Persimmon and Taylor Wimpey will not get a free ride from the government, the fact the government are committed to building more houses is positive for them.

There are strong parallels here to the US market. There, the problems from the financial crisis (too much housing being built on too much debt) are beginning to recede and the current housing stock looks tight. Housebuilders both here and across the Atlantic could well be the first big beneficiaries of this changing tide, but they would not be the only ones: furniture and general home furnishing suppliers have historically also benefited, further explaining the multiplier effect housing activity has on consumer demand.

A 'wall' of central bank money propelling up stock markets?

In mid-September 2019, the US central bank (the Fed) began injecting considerable amounts of short-term liquidity into the Wall Street money markets to counter a global shortage in the availability of transactional cash. This cash shortage had manifested itself by a steep rise in overnight interbank lending rates in the

New York market at a time when there was no good reason for banks to not want to lend to each other – i.e. other indicators of interbank credit risks were actually declining.

Since then, US stock markets have risen 13%, with global risk asset markets trailing not far behind.

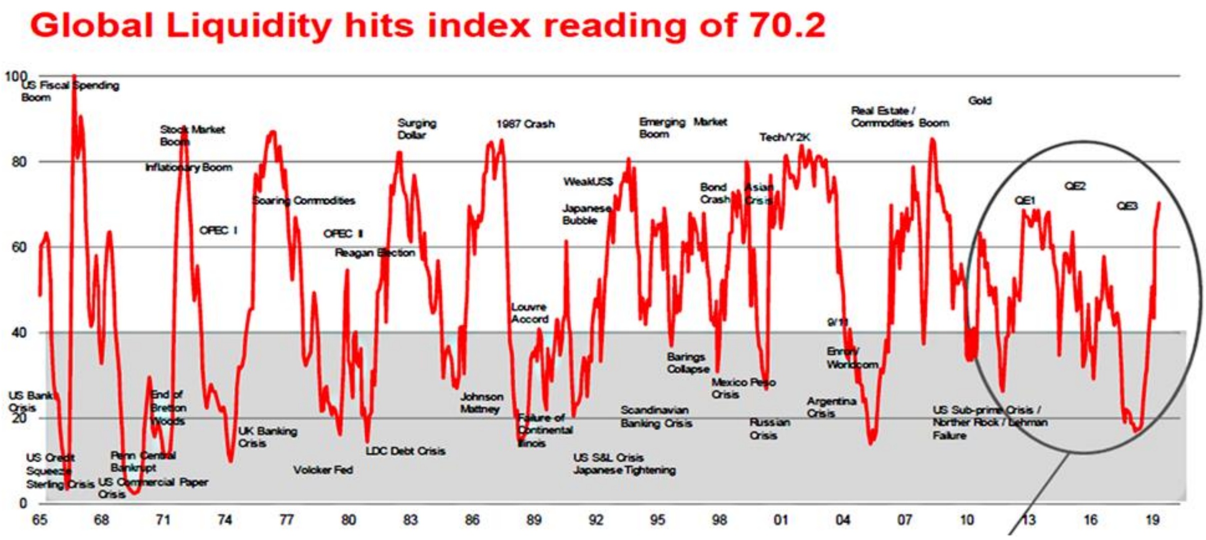
The Fed went beyond conventional measures of flooding banks with additional cash funding: they also injected liquidity into the wider markets by purchasing short maturity US government bonds. This made their cash market intervention similar to earlier rounds of quantitative easing (QE). Add to this the vibrancy of risk asset markets since – while corporate earnings went sideways or down – and it is not surprising that many commentators dubbed the latest central bank action 'QE4'.

Except that it was not. The difference is in the intention. The objective of quantitative easing (QE 1-3) was to force down long maturity bond yields. This encouraged yield-seeking investors into higher risk assets, thereby stabilising risk asset valuations at a time when depressed levels of investor confidence had them trading at much lower relative valuation levels than had historically been the case at similar stages in the economic cycle. This lifted investor and business sentiment enough to stimulate economic activity to levels that saw a gradual recovery of the global economy.[1]

The aim of the current intervention is to ease a distinct tightness of transactional cash in the interbank overnight lending markets, and to ensure that the (short term) interest rate which the central bank has set for the wider economy actually feeds through to consumers and businesses. This is clearly a different aim and is one of the core responsibilities of a central bank, not an 'extraordinary' measure.

Except that for most market participants these are only subtle differences and once the 'fear of missing out' makes the round, cash sitting idle on the side lines is quickly reallocated into the stock markets. Furthermore, the liquidity injections by the Fed have not exactly been small fry. Together with supporting measures from other central banks, the expansion of the global monetary base as measured by the narrowest of measures (M1) has been right up there with the biggest we have experienced historically (See chart on the next page by CrossBorder Capital Research).

[1] It is thought that this prevented the global economy from descending into a long lasting recession or even depression as had been the case after the previous financial crisis of 1929, when central banks refrained from such actions in the belief that the purgatory and self-healing forces of open capital markets would return economies to an improved growth environment.



So, there are good reasons to be somewhat suspicious of the recent stock market surge, especially in those sectors where valuation levels have become extended beyond reasonable expectations of 2020 earnings growth. However, it has also coincided with the recent economic slowdown bottoming out and political uncertainties somewhat reducing, which provides a justified base for an improvement in expectations.

And now? The European central bank (ECB) and the Bank of Japan have stopped their generosity and some Fed members look uncomfortable with the risk-taking they have created. Next Wednesday 29th, the Fed's rate and policy-setting Open Market Committee meets and members have already made known that they consider the liquidity shortage dealt with and will therefore reduce further liquidity injections. Usually, such early warning means that markets anticipate what will happen and so when it actually occurs, not much more market action takes place. Sure enough, markets have gone sideways or down over the past week. But in combination with the uncertainties over the Chinese coronavirus, we suspect that the equity market may be a little less rocket-fuelled in the coming weeks.

CAMBRIDGE
INVESTMENTS LIMITED

27th January 2020

Global Equity Markets

Market	FRI 14:15	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	7622.7	-0.7	-51.9	➚	→
FTSE 250	21760	-0.6	-125.7	⬀	⬀
FTSE AS	4229.3	-0.7	-28.6	➚	→
FTSE Small	6001.9	-1.1	-64.2	➚	⬀
CAC	6036.2	-1.1	-64.6	⬀	⬀
DAX	13591.8	0.5	65.7	⬀	➚
Dow	29160	0.4	129.9	➚	➚
S&P 500	3325.5	1.1	36.2	➚	➚
Nasdaq	9217.0	2.0	181.3	➚	➚
Nikkei	23827.2	-0.9	-214.1	⬀	⬀
MSCI World	2406.1	-0.4	-9.4	➚	➚
MSCI EM	1122.2	-2.1	-24.6	➚	→

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.6	18.4	13.7	13.3
FTSE 250	3.7	25.4	15.2	14.2
FTSE AS	4.4	19.4	13.7	13.4
FTSE Small	3.3	181.4	-	13.9
CAC	3.0	21.6	14.9	13.5
DAX	2.9	25.2	14.6	12.5
Dow	2.2	19.8	17.8	15.0
S&P 500	1.8	22.1	19.1	16.0
Nasdaq	0.9	29.1	24.0	18.0
Nikkei	1.9	19.1	17.0	17.2
MSCI World	2.3	20.9	17.6	15.2
MSCI EM	2.6	15.5	13.2	11.9

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Berkeley	7.7	NMC Health	-12.3
Persimmon	6.0	Antofagasta	-10.4
Legal & General	5.3	Burberry	-8.8
Taylor Wimpey	5.2	Evraz	-8.6
Next	5.2	BT	-6.9

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.310	0.7	Oil	61.41	-5.3
GBP/EUR	0.842	1.1	Gold	1561.3	0.3
USD/EUR	1.10	-0.5	Silver	17.90	-0.8
JPY/USD	109.52	0.6	Copper	270.8	-4.9
CNY/USD	6.94	-0.9	Aluminium	1795.0	-0.9

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.6	-0.1
UK 15-Yr	0.8	-0.1
US 10-Yr	1.7	-0.1
French 10-Yr	-0.1	-0.1
German 10-Yr	-0.3	-0.1
Japanese 10-Yr	-0.0	-0.0

UK Mortgage Rates

Mortgage Rates	Dec	Nov
Base Rate Tracker	2.53	2.50
2-yr Fixed Rate	1.45	1.44
3-yr Fixed Rate	1.56	1.58
5-yr Fixed Rate	1.69	1.69
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.28	4.28

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

For any questions, as always, please ask!

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

CAMBRIDGE
INVESTMENTS LIMITED

27th January 2020

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