CAMBRIDGE
INVESTMENTS LIMITED

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Nicola Jennings on Theresa May's drowning under Brexit at the Salzburg summit
Source: Political Cartoon Gallery; 20 Sep 2018

Brexit clamour vs. real market news

The UK's establishment had pinned high hopes on a Brexit breakthrough at the EU's Salzburg (non-Brexit specific) summit. But the rest of the EU had a different agenda, so disappointment was inevitable. Judging by the vastly different media interpretation between Continental and UK media outlets, the Salzburg snub is a matter of vantage point. French and German comment centred around the detail of the proposed Northern Ireland border solution, not the Chequers plan altogether. Otherwise it was seen as presumptuous that the UK side felt duped that their plan to ask for broadly the same trade benefits without being a member was not warmly welcomed. There were no suggestions of intentional humiliation of the UK's prime minister.

Here, many interpreted events to mean a no deal Brexit is now more likely. But this seems a vast exaggeration to me. Much more likely is that it is all politics yet again – or rather playing to domestic electorates and party conference expectations. The Irish border issue is solvable, given the Canary Islands are part of Spain and the EU customs union, but not the VAT regime. This already requires inner-European customs processing without anybody seeming particularly bothered by it.

For Theresa May's position at the October Tory party conference on the other side, being in a state of frontal conflict with the EU may prove to be a much stronger platform than being at the compromise stage of negotiations.

Far more interesting for global investments was once again the non-Brexit related news-flow. This led to a positive week in global stock markets, but interestingly to a lagging of the US market, which had thus far been the year's undisputed leader. Global trade concerns eased as the Trump administration refrained from imposing 25% tariffs on China as signposted by Trump.

The 10% tariffs put in place instead are valid until the end of the year and can then be raised to 25%, should no deal be done. China's retaliation was also softer than expected. This suggests a deal will be done by year end. For such a short time period, the 10% is seen as not constituting a significant threat to either the US' or China's economy.

That US stock markets did not rise as much as other markets may have had less to do with lowering trade tensions than a sudden step up in long term bond yields in the US, which had been static since the last step up in February. Different to then – and contrary to perceived wisdom that higher yields increase the attraction of US$ holdings – this time the US$ weakened and stock markets did not panic (like they did in February).

Interpretations have been plentiful as to the deeper reasons for the change in US market dynamics since August. But regular readers of The Tatton Weekly will know that we had been expecting this to happen in due course, as inflation expectations have begun to lower future expectations of (real) returns after inflation.

The weakening of the US$, in combination with an improved outlook for global trade, is good news for emerging markets (EM), where this year's rising dollar and falling trade volumes have battered stocks. Expectations that the Trump trade wars will end sooner rather than later also suggests that the Chinese leadership can effectively counter the self-inflicted slowdown with decisive short term fiscal and monetary stimulus measures. In 2015/2016, similar action resulted in a massive boost to global demand. Even if the stimulus is less prominent this time, there is a growing perception that the EM liquidity crisis and trade slowdown may be nearing its end.

The fact that rising US yields aren't causing the US$ to rise could be a sign that risk capital is beginning to turn its back on the US in search for better (real) valuation opportunities. If so, we may indeed be witnessing a rotation of capital market leadership away from the US, where growth in real terms may well have peaked.

UK economy defying Brexit gloom

The UK economy is looking brighter after recent data. Following last week's news that the quarterly growth rate was at its fastest pace in over a year (+0.6%), data this week showed that retail sales played a significant part. The Office for National Statistics (ONS) reported that sales in June-August were 2% higher than the previous three months, and 3.4% higher than a year ago.

Most commentators put the retailers' joy down to the warm weather and the recent return of positive income growth after inflation (real income growth) – plus a one-off boost from the World Cup. What was significant however was that there was strong sales growth in most areas (except food and clothing, due to large discounts), which points to more genuine and sustainable growth. It suggests that consumers may indeed be feeling more optimistic after wage growth rises than the subdued Brexit mood amongst the nation's leaders and media would otherwise suggest.

It also serves as more vindication for the Bank of England (BoE), who in August, for the first time since the financial crisis 10 years ago, raised interest rates above 0.5% to 0.75%. Recent inflation data – showing a higher than expected reading – already made the decision look apt.

And, with retail sales suggesting strong demand, it looks as though activity levels are continuing to recover from the slump seen earlier in the year. According to Deloitte chief economist Ian Stewart, “The Bank of England’s decision to raise rates in August looks eerily prescient given the surge in inflation and growth over the summer.”

Regular readers will know that we’re more optimistic about the UK stock market than others. In our view, a positive macroeconomic backdrop and an undervalued equity market means that British stocks are a buying opportunity. Strong demand from Europe and the weak value of sterling means British exporters are in a good position, while imminent Brexit risks currently look overstated by markets.

We take this week’s positive news to support this view. Thursday’s news that EU leaders denied Theresa May a Brexit negotiation breakthrough over her Chequers Brexit plan and instead gave her a four-week deadline for saving exit talks may look worrying. However, reality is that recent deadline misses for substantial progress mean that the ship had long sailed on a fully defined Brexit 2019. There is no longer enough time to execute a meaningful departure next year, without causing (preventable) economic havoc. The highest probability is therefore for the ‘can’ to get kicked further down the road into the transition period and embark on another of many previous European muddling-through projects.

Markets now also seem ready to accept that a gradual Brexit is very much a possibility. Before the perceived Salzburg setback, Sterling jumped to a 10-week high against the dollar on Thursday, before falling back but still settling above the rate it hovered around for most of August. This could have been to do with the surprise strength of the economy, Brexit positivity, heightened expectation of further rate hikes or all of the above. But we interpret these bouts of sterling strength as indication that markets are becoming more positive on the UK’s near term economic prospects one way or another.

However, our optimism relative to markets doesn’t mean we think things are going swimmingly for the UK. A number of potentially damaging issues remain. While the rising inflation can be seen as a positive as it comes from increased activity, the fact it was so relatively strong (2.7%) compared to recent readings suggests that even modest growth is likely to generate inflationary pressures – potentially forcing the BoE to be more aggressive in its rate rises. The UK is also extremely dependent on two factors: strength in Europe and weakness in sterling. If Eurozone demand disappoints, it could harm British exporters, or likewise if Sterling strengthens too much and erodes exporters’ currency discount.

For the latter, fortunately that doesn’t look too likely. While this week’s price action boosted the pound, it still remains low historically – especially against the all-important euro. And the continuing Brexit soap opera suggests that’s unlikely to change too drastically any time soon.

Beyond that, Brexit uncertainties could start to effect consumer or business confidence as we approach the official deadline next year, and the housing market – often the engine of British spending – continues to struggle and could do so even more if the BoE quickens its rate rise path.

Most of that weakness is localised to London however, with prices in the capital falling 0.7% in the year to July. This dragged nationwide house price growth down to 3.1%, despite booming prices in the North West.

The BoE believes that London's lacklustre housing woes are unlikely to be replicated nationwide, and we agree. As we have written before, one of the consequences of the pound's weakness is that it is helping to rebalance the economy away from consumption and towards exports, particularly manufacturing. The latter tends to be a major strength in the regions and particularly the North, so we expect house price growth outside of London to continue as long as sterling weakness does.

This point, together with the inflationary pressures discussed, means the BoE could have to seriously consider a more hawkish (high rates) stance. But if they raise more aggressively than currently expected, that could dampen British growth prospects significantly.

And of course, Brexit uncertainties – whether justified or overly pessimistic – continue to loom large over the UK's prospects. While we don't expect a 'no deal' scenario to actually materialise, increased market expectations that it might could be enough to undo the positive effects of sterling weakness. Either way, the Britain remains in a delicate balance. Fortunately, for now, that balance is proving beneficial. But the risk remains that things could quickly turn if any of the above factors change. That means that, despite attractive valuations, our UK specific portfolio holdings remain at no more than neutral compared to the long term asset allocation parameters.

Rising inflation – return to normal or bad omen?

Following a considerable pause since February, the past six weeks has seen an upswing of global bond yields. Given that yields often react to inflation expectations, it might be tempting to think that the surprisingly high UK inflation data for August was the cause. But the UK's price increases haven't been symptomatic of a change worldwide; global data has signalled little change in the current pace of inflation in the various major regions.

And yet a number of economists and strategists have recently fretted that longer-term signs of inflation are picking up. Why is this?

Deutsche Bank economists released a report this week that put forward a long-term view point about inflation and its political nature: "Future inflation outcomes could also be a battle between the temptation to inflate away the excessive debts (that) we've been left with, post the 40-50 year credit binge, and the fact that we currently have independent central banks with specific low inflation mandates..."

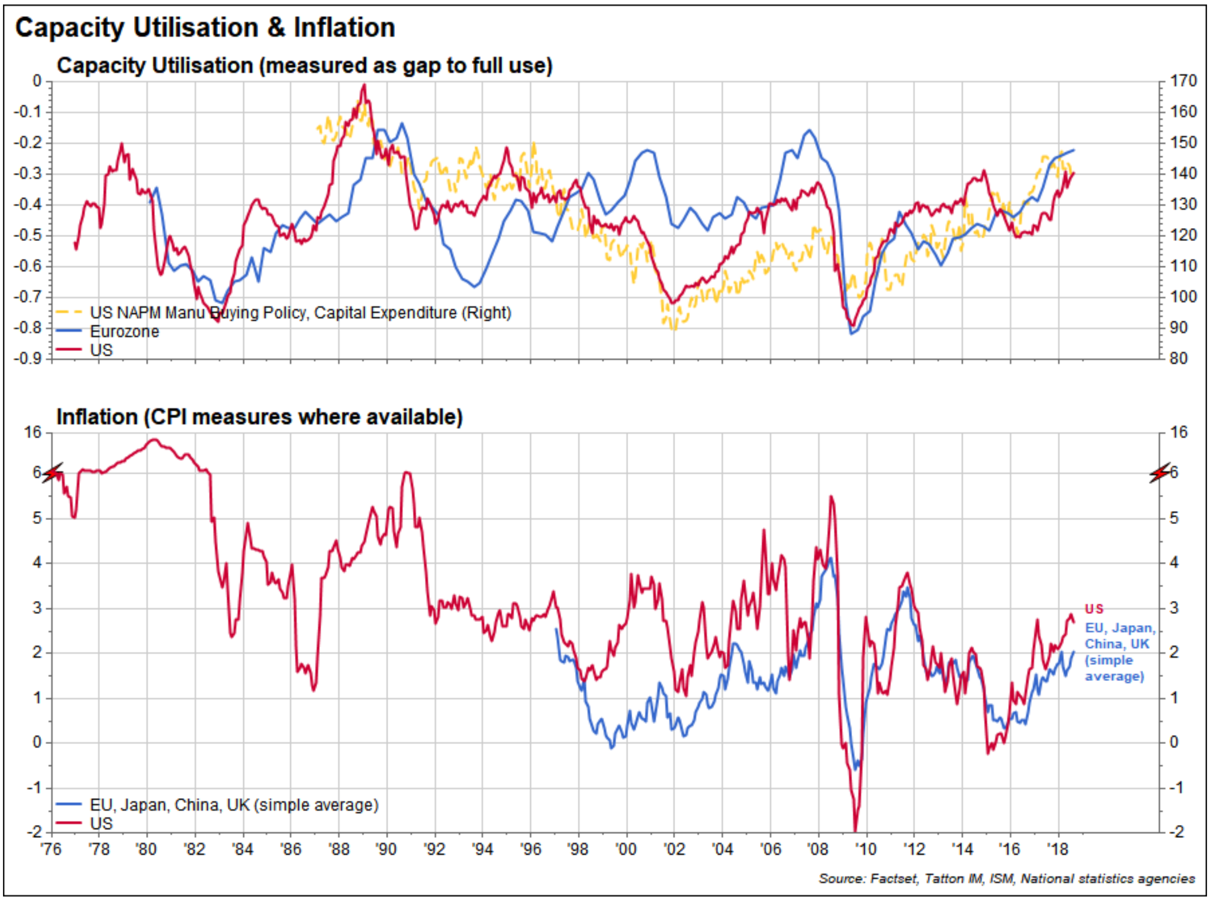
The FT summarised DB's further thoughts thus: "it is easy to assume that... independent central banks, with their restrictive approach towards inflation, are a permanent part of the financial architecture, rather than simply another short-term political institution.

Any such assumption would be unjustified in an environment in which both the political left and right are rounding on a perceived technocratic centre. This attack is likely to play out in explicitly political arenas, such as elections and referendums, before it moves to institutions where political incentives are somewhat disguised, like central banks. As Deutsche Bank researchers point out, “inflation in a fiat currency world is a political choice and very easy to create if there is the appetite and the appropriate policy response”.”

While DB pointed out how politics could impact inflation, Citi (Bank) researchers made the more mundane point that economic forces continue to grind the global rate of inflation higher. Here’s a snippet from their recent report “Inflation – Tipping Point or Nothing to Discuss”:

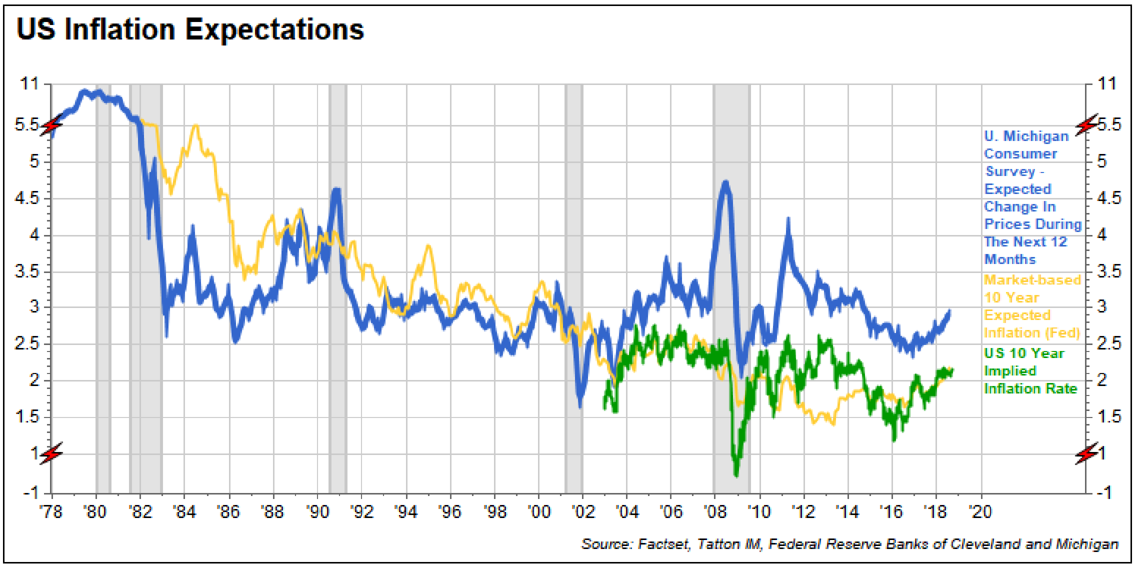
“Citi European & Global economists see the case for positive Advanced Economies core inflation surprises replacing negative surprises… ; equity investors are not positioned for this.”

They think that we’re moving into a new stage for global inflation. We would agree – at least in so far that we expect a return of pre-Financial Crisis levels of inflation rather than the ‘low-flation’ of the past 10 years. Interestingly, while the rise in global bond yields hasn’t obviously been caused



by rising inflation expectations, there is good reason to think they have been. Below is a chart of capacity utilisations (using our proprietary calculations for the US and Eurozone, and inflation rates in the US and an average of other major developed economies, including the UK):

For the US, the move up in inflation (lower chart) may be enough to worry the Federal Reserve Open Market Committee (FOMC) which sets rates. In his speech made at the August central banks’ convocation at Jackson Hole, Jerome Powell pointed out how expectations of inflation are a deciding factor in actual inflation. In this respect, the continued rise of consumer inflation expectation, accompanied by the tightening of both the labour market and spare production capacity, leaves the economy vulnerable to inflationary surprises/shocks.



Meanwhile, the rest of the world has experienced a mild slowdown during 2018, with its centre being China. That has helped against a rising inflation outlook outside the US, with falling inflationary pressures coming from slightly weaker commodity prices and a stronger dollar. However, the past couple of weeks have seen those forces reverse direction.

The FOMC meets next Wednesday and Thursday and is all but certain to raise rates once more. Despite Jerome Powell attempting to de-emphasise the "dots" plot (the graph showing each voting member's estimations of the fed funds rate over two years), the outlook will be closely scrutinised, especially for next year. A move higher would indicate a willingness to move rates into "restrictive" territory.

And yet, for global bonds, it may be that we've reached a point where the FOMC is a side-issue. This week's sharp move up in yields seems to have been a result of better sentiment towards emerging markets (especially China), and (probably consequential) rises in commodity prices and a fall in the dollar. All of those factors are reasons to think that the US inflation outlook could worsen, at the same time as both the ECB and the BoJ could tighten monetary policy by accelerating their moves towards reducing their balance sheets. Indeed, on Thursday, the BoJ signalled a reduction of bond-buying, causing a small rise in Japanese long yields but, reportedly, a larger rise in US yields.

For equities, all of this could well signal a change in investment styles. For starters, the rise in US bond yields seems to be at the heart of the very recent relative underperformance of US equities (versus other developed markets). Beyond that, it is also likely that increased inflation expectations could signal a market change from growth to value. Here's what Citi say on the matter:

"Financials would fare much better than Defensives… At a style level, there is only one style with positive correlation to inflation; that's Value. So, any firming of inflation is likely to drive a sharp squeeze in Value in Europe." [implying that value stocks would rise, as those who had run a short position on European Value stocks would be ‘squeezed’ into covering their positions and limiting further losses by buying the stocks]

Statistically, higher inflation tends to benefit value stocks. This is likely to do with a lack of the real growth driving force which propels growth stocks during high growth phases; inflation instead supports the older businesses with more consistent cashflows. So, we should expect shifting capital from growth to value – finally.

As the ECB and BoJ end the era of central bank net bond-buying (the move towards “quantitative tightening”) by the end of this year, it is possible that the market that has done the best may not do so well in the next phase.

What’s driving the car makers around the world

Even those without an interest in James Bond or high-end performance car marques will have found it difficult to miss the business pages coverage of the upcoming listing of Aston Martin on the London Stock exchange, planned for this October. The speculation around the valuation of Aston Martin has been rife, but that’s not the only car maker news this week. All this car talk prompted us to take a wider look at the dynamics of global car manufacturing and sales since, like no other sector, cars are embedded in daily lives across every developed country and at virtually all levels of society across the world. We take an ‘MI6’ look at what’s driving the car makers around the world.

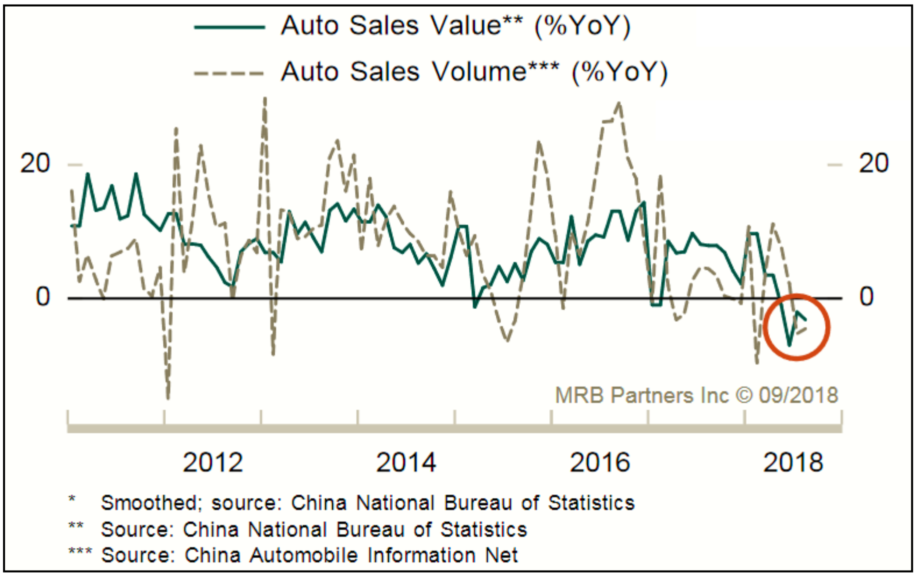
Whether Aston Martin is worth £5 billion or less than £1bn, as hotly debated in the City’s pubs, is not up to us, but as car manufacturer supplying a global market, its fortunes are affected by the same forces affecting its competitors and manufacturers of family saloons. Aston Martin makes all of its cars in the UK. Currently, it keeps three days’ worth of components in its warehouse and this week has already indicated that it will push this out to five, because of the supply worries concerning transport of goods following Brexit. Mini announced this week that it will close its factory for a month immediately after Brexit. Land Rover then moved some of its workforce in Solihull to a three-day week and the European boss of Honda said it would become less competitive in the event of a hard Brexit.

It’s very difficult to know what the truth is behind any Brexit-related manufacturing news as the March 2019 deadline approaches. Car manufacturing won’t end in the UK; neither Honda nor Mini are shutting down production in the UK after Brexit – indeed the Mini factory closure will allow a refit to enable manufacture of its electric model. And as for Land Rover, 90% of its sales last year were in (now shunned) diesels, so perhaps it is more general market dynamics affecting its production lines rather than simply Brexit.

However, car makers have immensely complicated products and global supply chains and are therefore highly exposed to any frictions and additional costs arising from international trade tensions and tariffs. And investment is negatively affected by uncertainty. In the UK, the Society of Motor Manufacturers & Traders has said that Brexit uncertainty was "thwarting" decisions by major car companies to put more money into UK car makes. In the first six months of 2017, investment in new models and factory improvements stood at £647 million, but fell to £347m for the same period in 2018.

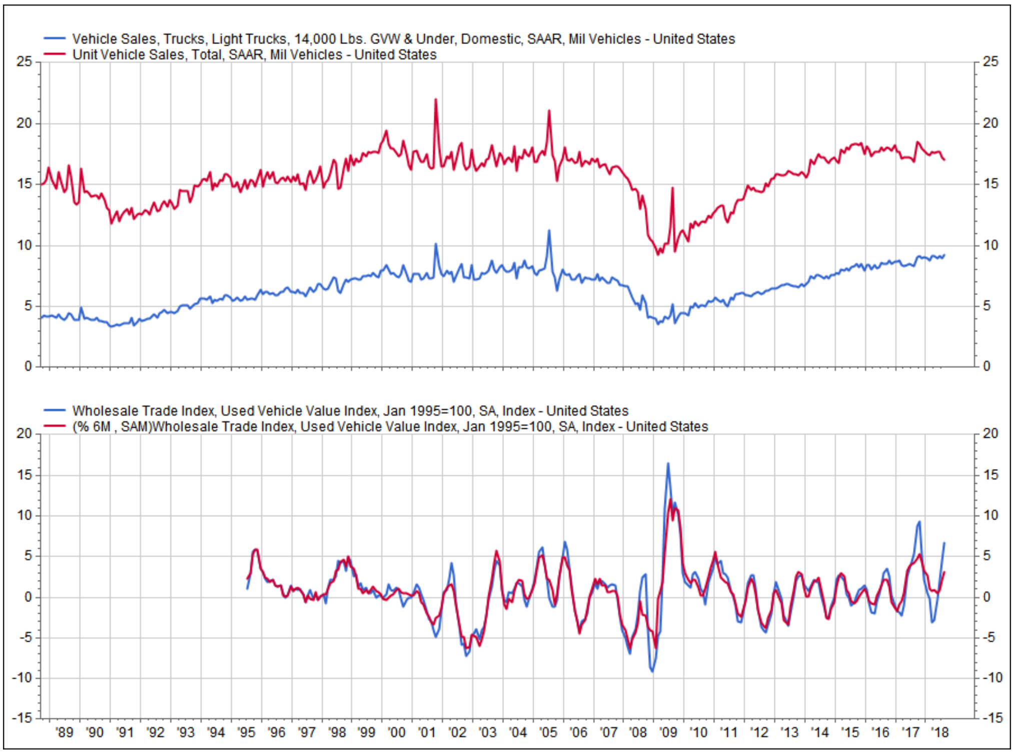
It is not just UK-based car manufacturing and Brexit. Donald Trump's trade war with China has negatively affected the US car makers and the workers it was designed to help. Indeed, there is a degree of irony that vehicle shipments of Mercedes and BMWs to China have been impacted by sanctions, since they are built in the US. This demonstrates that the automotive manufacturing industry is under pressure not only from (in its terms) rapid and unforeseen change (Brexit wasn't supposed to happen and Trump was supposed to lose) but also from dynamic changes to the global car market.

As the chart from one of our research providers below shows, in China, year on year sales have shrunk this year. This has also been reflected in India and across Asia. China's automotive sector could face a period of overcapacity simply because, after such a prolonged period of infrastructure expansion, urban car ownership is slowing as the market reaches capacity. In 2016, car penetration in Beijing was about 16% – compared with 50% in the US – and that has already created significantly more congestion and pollution than the US experiences. China and similarly India have huge populations and increasingly large economies, but in terms of car

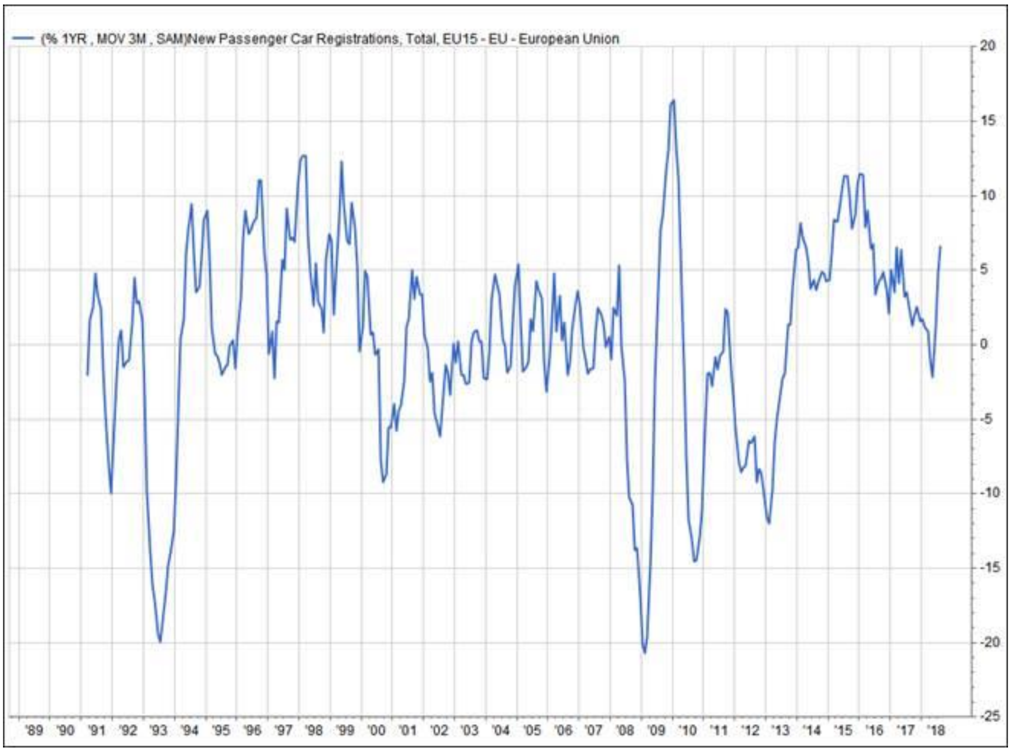


ownership, their urban infrastructure and public health requirements might not allow the levels seen in Europe and the US.

In the US, car sales are also slowing, as the chart below shows, for the first time since the financial crash. This is due to a number of negative factors: tighter tariff pressured margins are removing manufacturers sales incentives, interest rates are rising, and vehicle prices are reaching record highs. In the chart below, the red line showing car sales and the blue line pick-up trucks, which are more stable. Nevertheless, as the US population remains highly dependent on car mobility, the demand for vehicles remains high as the lower chart of used car values shows. Perhaps, as cars have become more durable over the past decade and the gap between high and low income households has widened, more US consumers are resorting to buying nearly new cars than high income owners are replacing for the latest model.



In Europe, however, the picture is different. Passenger car registration across Europe rose by 10.5% in July, compared to the same month last year, and grew "significantly" in August by 31.2% across the continent, according to the European Automotive Manufactures Association. This particular spike comes ahead of dealers shedding stock ahead of new "World Harmonised Light Vehicle Test Procedure", making them incentivised to offer heavy discounts on "pre-WLTP" vehicles. Nevertheless, this comes after quite a marked 12-month slowdown.



What does this mean? It demonstrates that the international trading environment for car makers is clearly a more volatile one. Going forward, ongoing uncertainty in tariffs and trade restrictions will remain a feature and we also need to bear in mind the move to electric vehicles, the incompatibility of cars and urban planning and possibility of market saturation in emerging markets for new cars.

We don't know if Aston Martin will raise £5 billion when it lists in October. We also don't know what sort of Aston Martin James Bond will be driving in the US, the EU or China in 10 years' time, or how long the parts will take to be delivered. What we do know is that cars continue to fascinate and serve as status symbols around the world. As such, there may be changes and volatility in the car sector ahead. But the rumours of the automotive industry's demise have been greatly exaggerated.

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CAMBRIDGE
INVESTMENTS LIMITED

21st September 2018

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7476.9	2.4	172.8	↗
FTSE 250	20561.4	0.9	185.6	↗
FTSE AS	4121.8	2.1	83.7	↗
FTSE Small	5838.4	0.8	44.6	↗
CAC	5484.3	2.5	131.8	↗
DAX	12389.4	2.2	265.0	↗
Dow	26726.8	2.2	572.1	↗
S&P 500	2933.3	1.0	28.4	↗
Nasdaq	7564.4	0.3	18.9	↗
Nikkei	23869.9	4.6	1048.6	↗
MSCI World	2195.7	1.3	29.1	↗
MSCI EM	1036.9	0.8	8.4	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.3	16.6x	13.5x	13.0x
FTSE 250	3.2	18.4x	15.0x	13.9x
FTSE AS	4.1	17.2x	13.7x	13.2x
FTSE Small	3.8	-	-	13.7x
CAC	3.1	17.4x	14.6x	13.2x
DAX	3.1	14.3x	13.2x	12.5x
Dow	2.1	19.0x	17.1x	14.9x
S&P 500	1.8	21.2x	18.2x	15.7x
Nasdaq	1	26.2x	21.6x	17.6x
Nikkei	1.7	17.2x	16.8x	20.0x
MSCI World	2.3	18.9x	16.6x	15.0x
MSCI EM	2.7	12.6x	12.0x	12.0x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
ANTOFAGASTA	13.6	NMC HEALTH	-8.2
ANGLO AMERICAN	12.9	BURBERRY GROUP	-7.2
EVRAZ	11.9	ITV	-5.0
GLENCORE	10.5	SMITHS GROUP	-4.1
BHP BILLITON	8.9	JUST EAT	-3.8

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	0.14	OIL	78.7	0.7
USD/EUR	1.18	1.12	GOLD	1199.0	0.3
JPY/USD	112.58	-0.46	SILVER	14.4	2.1
GBP/EUR	0.90	-0.98	COPPER	285.2	7.8
CNY/USD	6.86	0.16	ALUMIN	2043.0	-1.0

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.552	1.4	0.02
US 10-Yr	3.068	2.4	0.07
French 10-Yr	0.778	1.4	0.01
German 10-Yr	0.459	2.0	0.01
Japanese 10-Yr	0.133	12.7	0.02

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.75
3-yr Fixed Rate	1.83
5-yr Fixed Rate	2.04
Standard Variable	4.33
10-yr Fixed Rate	2.76

* 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