CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

8 October 2018

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Lead Investment Adviser to Cambridge

2018 asset class returns to 30 September

Asset Class	Index	September	YTD
Equities	FTSE 100 (UK)	1.2	1
	FTSE4Good 50 (UK Ethical Index)	1.2	-1.9
	MSCI Europe ex-UK	-0.6	-0.9
	S&P 500 (USA)	0.2	14.7
	Nikkei 225 (Japan)	3.3	10.9
	MSCI All Countries World	-0.4	5.9
	MSCI Emerging Markets	-0.5	-3.5
Bonds	FTSE Gilts All Stocks	-1.5	-1.3
	£-Sterling Corporate Bond Index	-1	-2
	Barclays Global Aggregate Bond Index	-1.2	1.3
Commodities	Goldman Sachs Commodity Index	3.6	16
	Brent Crude Oil Price	6.2	28.3
	LBMA Spot Gold Price	-2.3	-5.3
Inflation	UK Consumer Price Index (annual rate)* End of May	-	0.8
Cash rates	Libor 3 month GBP	0.1	0.4
Property	UK Commercial Property (IPD Index)*	-	5.1

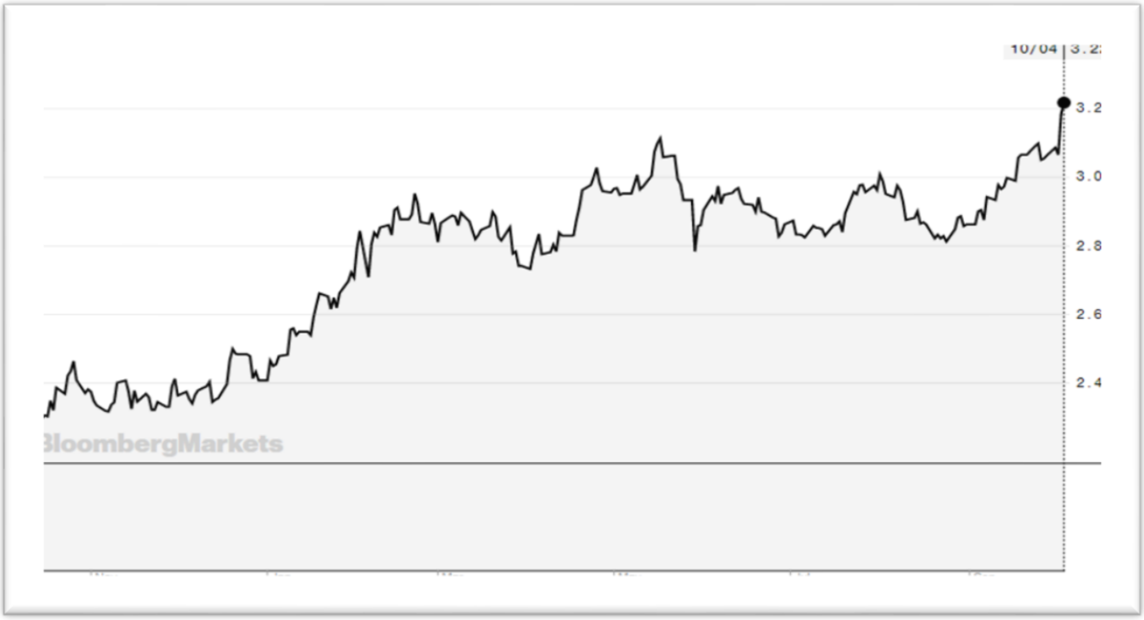
***Data to end of previous month (31/08/18). All returns in percent % and GBP**

Source: Tatton IM, Bloomberg

Bond market sell-off surprise

Having written only last week that Trump's trade wars may prove a bizarrely supportive factor towards safely unwinding overvalued bond markets, I feel as if I provoked bond markets to prove me wrong. Amongst the other news stories, bond markets will have been hardly noticed by most and, so far, the bond sell-off and resultant rise in yields has not been so dramatic that it would divert mainstream media attention from party conferences or potentially untruthful US supreme court candidates.

But, capital markets do notice these things; the very sudden 0.15% jump in the yields of US government bonds with 10 years to maturity (10yr Treasuries) did send shivers through them, because the last time we experienced a similar magnitude yield move equity markets corrected very sharply. However, thus far, the reaction of stock markets has been far more muted, with equity markets more flat than significantly down. The reason for this may be that this time the yield hike was triggered by unexpectedly strong US economic data (service sector performance and jobs growth) rather than a jump in inflation readings.



Yield on 10yr US government bonds over past 12 months; Source: Bloomberg

While there is little difference for bond markets between the two (i.e. expectations of future inflation increase, requiring higher yields to prevent bond holders from selling), equity investors may be less worried that central banks commit a policy error by hiking rates to prevent inflation from taking hold.

To recap the developments of the past months: After a considerable upward surge in US economic growth that was largely fuelled by Trump's fiscal stimulus from last year's tax cuts, data over the summer had suggested that the upward momentum was waning. The looming trade conflict escalation with China put some additional slow down concerns on the horizon. And consequentially, bond and stock markets had recently begun to trade sideways. But the latest economic figures might suggest that slowing concerns are unwarranted.

US central bank head Jerome Powell appeared to support such views with statements during the week that the outlook for the economy is "remarkably positive" and mused that the ongoing expansion can continue "effectively indefinitely". He did not voice concerns over the looming trade conflict with China and suggested that interest rates would need to continue to rise.

At the beginning of the year, such marked words would have sent the equity markets reeling, because the growth spurt had only just started in the US and the fear would have been that the central bank smothers the upturn with premature rate rises before it has really started to take hold.

Now that growth momentum appears more solidly entrenched than previously thought, such central bank policy error concerns may be less prevalent. This may be good news for the economy and company profits, but it is bad news for holders of bonds with still historically low yield levels. As demanded yields rise, the value of their lower yielding bonds falls.

Towards the end of the week, market commentators started to fret that rapidly rising yields could have negative side effects. This dampened sentiment, sent yields in the other direction and cause some losses for equities. Up to a point, equity declines make sense, given rising bond yields decrease the relative attractiveness of current dividend and corporate earnings levels. However, it will be interesting to observe whether this still marginal stock market reversal will actually trigger a larger scale US stock market correction, given valuations there are at odds with those elsewhere. If this occurred, sentiment would likely turn on US stocks, especially if investors underestimate future interest rates and yields. In that case, even continued growth wouldn't indicate further upside in US stocks, and investors may turn to less highly valued (but also economically expanding) regions like Europe or Japan.

At this point, we are comfortable with our underweight to both long maturity bonds and US equities across portfolios and will be assessing further developments with particular interest.

In other news, currency markets signalled – with a strengthening of £-Sterling versus the US$ as well as the Euro€ – that Theresa May's Tory party conference speech might have, after last year's disaster, strengthened her mandate for a constructive Brexit deal with the EU,

Following popular demand from our readers, we have dedicated a full article to our Brexit expectations. We lay out why we firmly believe that the current scare mongering is squarely political tactics and that the initial Brexit outcome next March will be far less disruptive.

With Italy being the other most often cited worry spot, we also summarise our views on why we see it as unlikely that the country should cause another Eurozone crisis but rather will manage itself out of its current troubles in typical Italian style.

Given we see China as far more influential to the global economic and investment prospects of 2019 than Brexit and Italy, we also run an in-depth article by our head of investment, Jim Kean, who has just returned from a week-long research trip all across China. He lays out that we should not expect significant growth impulses from the 'Middle Kingdom' as it grapples with the double challenge of improving governance across its economy while at the same time mitigating the negative effects of Trump's trade war campaign.

Italy lives up to its reputation - again

As Mark Twain (probably) didn't say, "History doesn't repeat itself, but it often rhymes". Maybe so, but with certain news stories you can't help but feel like you've heard this song before. Italy, with its struggles, scares and 'showdowns' against EU leaders, is a case in point.

For years, Italy's sluggish economy, ailing banking sector and huge public debt pile have popped up on investors' radars and sent Brusselite Eurocrats into crisis mode. The formation of a populist coalition government in June added to the mix an element of political recalcitrance not seen since the days of Silvio Berlusconi – Italy's own proto-Trump.

Unsurprisingly, the EU considers the budgetary spending plans presented last week Lega Nord and the Five Star Movement (M5S) – the two insurgent parties making up Italy's government – to be overly lavish and fiscally reckless. And on Monday, finance ministers from across the bloc urged Italy to stay within the union's budgetary rules.

The coalition's current plans will see an expansion of the budget deficit to 2.4% of GDP next year, with slight reductions in that over the next two years. The EU's stability and growth pact sets a 3% deficit on member states. But Italy's government debt – at 132% of GDP and well over the 60% EU limit – means that budgetary rules are more stringent on them. Brussels' target for Italy is a deficit of no more than 0.8% of GDP.

While there was little doubt Italy's new budget proposals would breach that barrier, the extent to which it did seems to have surprised EU officials. Italian Finance Minister Giovanni Tria – a far less radical figure than his coalition colleagues – had previously promised a limit of 1.6%, but lost out in government talks. Now he finds himself between a rock and hard place, with characteristically stubborn eurocrats on one side and brazen ideologues on the other.

Predictably, Italian government bonds saw a substantial sell-off after the news. Yields on 10-year Italian debt shot up to 3.4% on Tuesday, a level not since in over four years. Italian yields have been on a roller coaster since Lega and M5S took power; 10-year bonds were at less than 2% as recently as May.

Some of this price action is to be expected. Through upping spending plans, the government is increasing the bond supply and so rising yields are unsurprising. But the extent to which Italian debt has been battered points to deeper market worries. And while it's often framed in media as though these worries are over fiscal profligacy and instability, the 2.4% budget deficit figure is hardly catastrophic.

As we have said before, Italy is no basket case. It currently runs a primary budget surplus and has had a smaller deficit than France since before the financial crisis. While the public debt pile is high (more a legacy of economic stagnation and pre-2000 rather than recent fiscal irresponsibility), overall debt levels are low relative to the eurozone. What investors fear is not that Italy will spend its way into oblivion, but that the eurocrats will force a devastating showdown for the sake of ideological purity. As we wrote just over a month ago:

"It would leave us with three options, each unpalatable to someone: some form of continued easing from the ECB, with a hurricane of political blowback from Germany; an EU bail-out with Greek-style Italian austerity, which the coalition will never accept; or Italy's exit from the euro, an option no one (barring a few extremer voices in Italy's ruling parties) wants. By far the biggest risk is that the negotiating parties' ideological opposition to the first two options will lead to each accepting the third – that political inertia will lead to mutually assured destruction."

In truth, the suggested 2.4% deficit figure already represents a compromise from the populists. M5S leader Luigi Di Maio had said that they may have to exceed the EU's 3% deficit limit to enact their spending pledges for a citizens' income and flat tax. Reportedly, Mr Tria then gave both Di Maio and Lega leader Matteo Salvini a stern talking to over their rhetoric and its effect on bond markets. Whatever the case, that the coalition's spending plans can be achieved within a 2.4% budget deficit is a positive sign indeed.

Unfortunately, that EU leaders don't look as though they'll budge one bit is not. For Italy, the biggest issue is what happens when the European Central Bank stops supporting the Italian government bond markets through their QE purchases in December. This event is already expected to send their bonds into a nosedive. But as coalition members have (rightfully) pointed out, that's not just a problem for Italy. Bonds in Portugal, Spain and even France could come under intense pressure as well. If the EU decides to hold the refinancing issue over Italian heads, it could be devastating for all involved.

Fortunately, as we've also written before, Italy has its own bargaining chips. Beyond the sheer size of its economy (the third largest in the Eurozone), it's also the EU's unofficial gatekeeper for migration from North Africa. Given how sensitive an issue that has become on the continent, the Italians might be able to force more of a compromise.

Whatever the case, the one thing we can be fairly certain of is that we haven't heard the last of the ongoing Italy story. It's not new, it's not special and it will happen again. For the time being the one positive for the Eurozone is that it keeps a lid on the currency, which benefits their all-important export industries. We'll just have to hope the EU doesn't allow it to go so far that it morphs into another Euro crisis. That's one rhyme we'll be glad not to hear again.

China: Not terrible, not great

It's not been an easy year for China. The worsening trade war with the US has come at the same time as the government's deleveraging process has been slowing the economy. The result has been more stress in the economy than the country's central planners anticipated. Opinion on China now ranges from those who expect a crash landing to those who see a smooth exit from this tough period. We're somewhere in the middle.

First, a recap. China's credit build-up over the last decade or so has been one of the most intensive in recent history – in some ways echoing the build-up seen in western economies before the financial crisis. It was successful and well-timed, producing stellar economic growth while most of the world reeled during the great recession and, and propagating growth (and influence) through to the rest of the world.

But it blew credit in the economy to bubble-like proportions. Aware of the threat this poses to the country's stability, the government cracked down on lending – in particular to the State-Owned Enterprises (SOEs) and the shadow banking sector. The slowdown this caused has since become self-sustaining: forced deleveraging restricts available capital, which increases default rates and the worsens creditworthiness, which then forces banks to tighten up their own lending, restricting even more capital.

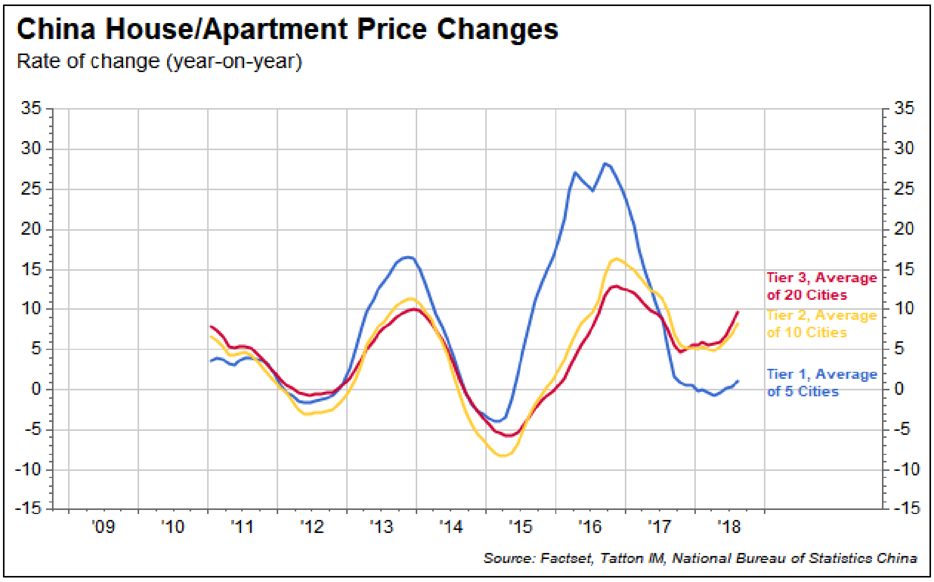
The effect became significant enough for the government to loosen financial conditions once more – through a cut to banks' reserve requirement ratios – and even roll out a hefty fiscal stimulus package. Most of this has come from an expansion of local government bond (LGB) issuance. Newly issued LGBs totalled ¥1.6trn in July and August, compared with ¥1.4trn in the entire first half of the year.

Beijing's commitment to pumping life back into the economy looks sincere enough that markets seem to be expecting a stimulus response on the scale of 2015/16 – when a similar slowdown was averted (and then some) by a huge easing from the government. But this is misguided. The government is acutely aware that those stimulus measures are in large part the reason for the current credit issues. This puts them between a rock and a hard place: they spent their way out of this once and can't do so again. Measures which would put more debt on individuals' and businesses' balance sheets will only make matters worse.

To avoid a recession, this has forced them to ease the economy in the only ways they can control: local government spending and the expansion of large state-owned enterprises (SOEs). Where big SOEs were before focused on paying down their debt, officials are now encouraging them on expanding their balance sheets, often with the financial backing of local governments.

But while the state-corporate side of the economy is being supported, smaller businesses and individuals are still struggling. Due to Chinese lenders' historical inability to price loans according to risk, shadow-lending is often the only form of credit available to small and medium-sized businesses. This means that the crackdown on shadow-banking hurts those businesses the most. And no matter what other stimulus measures the government pursues, there is no way they will ease up on the shadow banking sector.

This means the mid and lower end of the economy are being squeezed. Meanwhile, consumption – an increasingly important part of the Chinese economy – isn't providing the boost needed to counteract the lag. The reasons for this aren't entirely clear, but it likely has a lot to do with the struggles of the property market.



Property prices in China's tier 1 cities (Beijing, Shanghai, Guangzhou Shenzen, Tianjin) have been largely flat for a while now – in part due to government measures. Considering that property prices are still extremely expensive relative to incomes, this is understandable, and there's unlikely to be any increases in the near-term.

The key point is that stalling house prices aren't really a mortgage issue. Despite the credit drive, one of the main reasons that property prices are so high is because individuals often don't have anywhere else to put their savings, and so homes are used as a store of value. This makes consumption extremely sensitive to property fluctuations, as hits to property prices are effectively hits to consumer savings.

However, it's important to note that, while Chinese consumption isn't exactly roaring ahead, it's not falling off either. In fact, while large tier 1 cities are seeing property stagnation, tier 2 and 3 cities are seeing rising prices. Overall, consumption is stable, but not strong.

This adds some much-needed calm to our China outlook. The world's second largest economy tends to generate quite extreme reactions among market commentators. The China bears continually warn of imminent collapse, while at the other end there are those who put a great deal of faith in the government to steer its economy through even the choppiest of waters.

For our part, we don't quite buy either of these arguments. The slowdown is real and China's underlying issues are plentiful, but the economy still has a stable basis and even a drop off to 5% GDP growth (extremely slow by China's standards) would hardly be the end of the world. But by the same token, too much faith is put in the government's abilities to manage and orchestrate the economy. Despite the all-seeing big brother picture we are presented with in the west (a picture often promoted by the government itself) Beijing often lacks the information or bureaucracy to regulate industry effectively. Instead, they often take a micromanaging approach that lacks an overall strategy (what we've termed the whack-a-mole approach). In reality, the government is just as likely to cause an economic problem as it is to solve one.

Our outlook is more moderate. The Chinese economy will continue to struggle for the time being, but will keep on muddling through without causing too much damage. Over the long term, the deleveraging and creative destruction this brings will likely be a positive. But in the short-term, it's not time to turn positive just yet.

Brexit 2019 – muddle fuddle rather than crash exit most likely

For UK investors – and the general population for that matter – the prospects for post-Brexit Britain top the list of concerns (even if more and more are fed up hearing about little else being debated). This is, of course, understandable. Despite truly domestic British assets forming a relatively small section of our overall investment portfolios compared to global assets, the UK's future relationship with the EU has nevertheless a potentially significant impact on our lives.

Given that the merry-go-round of Brexit media coverage is often more like a roller-coaster, this can be very disconcerting. Over the summer, negotiations sometimes looked as though they were improving, and that we were moving away from a hard Brexit. Then came the EU's summit two weeks ago, where EU27 leaders reportedly ambushed Theresa May over her Chequers Brexit plan. To follow that up, the French government raised the rhetorical stakes this week again by claiming that a 'no deal' Brexit would be better than May's proposal.

With the March's official Brexit date fast approaching and hardly any concrete progress since the referendum result over two years ago, the nation seems to be staring down the barrel of the gun. It may come as a surprise then that, at Cambridge, we're relatively sanguine about the whole thing – for the time being at least.

Regular readers of our weekly will know that our Brexit outlook is somewhat more optimistic. Admittedly, there is a cloud of uncertainty over the UK's future. How long will this government last? Will we soon have another election or even referendum? What options would such a referendum even pose? And that's just the short term; the shape of Britain's long-term arrangement with the EU is even more uncertain.

But there are certain things we can be fairly confident about. The most important of these is that, while March 2019's official exit will undoubtedly be a significant milestone, it's unlikely to see too many changes to the actual business environment. A transitional period and a BINO (Brexit in name only) for the near future, without a solid long-term agreement, are the most likely outcomes for next year.

That the October deadline for an agreement was missed all but confirms this in our eyes. Put simply, there is no way to have a substantial breakaway from European laws in five months' time without significant damage to both British and (to a somewhat lesser extent) European economies. While many businesses have contingencies for the various strengths of Brexit, such a sudden shift would force them into a difficult position. This is something that politicians and electorates on both sides couldn't abide. And unlike the longer-term arrangements, this could be easily avoided without too much complication or loss of face.

As strange is it may sound, we think this is especially true considering the weakness of politicians on all sides. Rarely do you get aggressive or far-reaching decisions with weak leadership. At home, Theresa May's minority government faces both internal and external opposition. While some of this is pushing her towards a harder Brexit, a larger proportion is pushing her the other way. In Germany, the Merkel era looks as shaky as it ever has, and general Eurosceptic sentiment across the continent is pushing national governments and even Brusselite technocrats away from causing a pan-European economic upset for the sake of proving the supremacy and integrity of the remaining EU27 .

All this points to a continuation of the Brexit muddle-through in the short term. And during that time, the UK should be able to take full advantage of EU member status with the added bonus of a low-valued currency. As we've written before, the price advantage this gives exporters has boosted the British economy and gone some way to redressing its underlying structural issues. So long as this continues and demand from Europe doesn't fall off too dramatically, we see a relatively good picture for the UK in 2019.

But we tinge this rosy picture with a fair dose of caution. Economically, Britain is in a fragile balance. Recent inflation data suggests that even modest growth is likely to generate inflation pressures. Combined with continued weakness in the housing market, this could give the Bank of England a serious headache on whether to raise rates more aggressively in case £-Sterling came under undue pressure – and risk choking off economic activity – or hold back – and risk inflation getting out of hand.

Politically, things are equally fragile. British politics has three main Brexit camps who all have a fair chance of being in power in a few months' time: The Labour Party, who are pushing for a Brexit lite; The Johnson-Rees-Mogg axis of the Tory party, under whom a hard Brexit looks fairly certain; and Theresa May's unassuming band of Tory MPs, who are not overly keen on Brexit but will have to seek re-nomination from a Tory membership which appears firmly pro-Brexit. Given that market expectations for the UK are almost directly correlated to the expected strength of Brexit, the one comforting part of this balance is that two out of three of those options avoid a damaging hard Brexit.

On the continent, things are much the same. European electorates would prefer the UK to remain but, if an exit is inevitable, businesses (in particular) just want the outcome that leads to least disruption. The Eurocrats in Brussels are ideologically opposed to Brexit and have shown in the past (Greece, Italy) they're willing to forgo easy solutions for the sake of purity. And, on the whole, the national governments are somewhere in the middle.

The difference here however is that, while Europhobic Tory backbenchers are noisy, they aren't in control. The Eurocrats – who combine their technocratic management style with a dogmatism usually reserved for more extreme ideologues – are. As ever in European politics, this makes easy solutions more difficult.

But even the self-styled protectors of the European project are ultimately subordinate to national leaders. If the economic threat to electorates is big enough, national leaders will put enough pressure on Brussels to make a deal. Over the long-term, this could well lead to an arrangement somewhere between a Switzerland/Norway model deal or (in a worst-case scenario) a Canada-plus. None of these trade models with the EU are likely to be as good or better than full membership, but then this may be the price to pay for increased levels of sovereignty and being able to negotiate free trade deals with other global regions on our own.

To use Theresa May's words, "not a walk in the park", but "not the end of the world" either is what we would expect as a worst case for March 2019. This, in our assessment, means that the shunned £-Sterling and UK stocks are currently lower valued than the medium-term outlook justifies, which is why we removed the previous UK underweight from portfolios in August.

CAMBRIDGE
INVESTMENTS LIMITED

8th October 2018

Global Equity Markets

MARKET	CLOSE	% 1 WEEK	1 W	TECHNICAL
FTSE 100	7343.0	-2.2	-167.3	↘
FTSE 250	19955.4	-1.7	-351.6	↘
FTSE AS	4040.3	-2.1	-87.6	↘
FTSE Small	5733.8	-1.5	-88.2	↘
CAC	5371.7	-2.2	-121.8	↘
DAX	12140.4	-2.4	-295.2	↘
Dow	26510.7	0.2	52.3	→
S&P 500	2900.5	-0.5	-13.5	→
Nasdaq	7440.9	-2.4	-186.7	→
Nikkei	23783.7	-1.4	-336.3	↘
MSCI World	2165.4	-0.9	-18.6	↘
MSCI EM	1010.4	-3.6	-37.5	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.3	16.4x	13.1x	13.1x
FTSE 250	3.3	16.9x	14.3x	13.9x
FTSE AS	4.1	16.8x	13.3x	13.2x
FTSE Small	3.9	-	15.6x	13.8x
CAC	3.2	17.2x	14.3x	13.2x
DAX	3.2	14.3x	13.1x	12.5x
Dow	2.1	18.8x	16.7x	15.0x
S&P 500	1.8	21.0x	17.8x	15.7x
Nasdaq	1	25.9x	20.8x	17.6x
Nikkei	1.7	17.2x	16.7x	20.0x
MSCI World	2.3	18.6x	16.3x	15.0x
MSCI EM	2.8	12.2x	11.6x	12.0x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
RENTOKIL INITIAL	5.5	ROYAL MAIL	-28.1
ITV	2.3	TESCO	-10.4
BT GROUP	2.2	OCADO GROUP	-9.9
PADDY POWER BETFA	1.9	EASYJET	-8.9
BARCLAYS	1.2	FERGUSON	-7.7

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	0.39	OIL	84.5	2.1
USD/EUR	1.15	-0.81	GOLD	1202.0	0.9
JPY/USD	113.72	-0.02	SILVER	14.6	-0.2
GBP/EUR	0.88	1.19	COPPER	276.5	-1.4
CNY/USD	6.87	-0.17	ALUMIN	2169.5	6.9

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.7	8.6	0.14
US 10-Yr	3.2	5.1	0.16
French 10-Yr	0.9	11.7	0.09
German 10-Yr	0.6	20.0	0.09
Japanese 10-Yr	0.2	19.2	0.03

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.71
3-yr Fixed Rate	1.81
5-yr Fixed Rate	2.01
Standard Variable	4.38
10-yr Fixed Rate	2.70

* 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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