CAMBRIDGE
INVESTMENTS LIMITED

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Global share index MSCI World since 2016; 26 Oct 2018; Source: Bloomberg

Stock markets suffer liquidity squeeze

During the recovery from February's stock market correction, we wrote on these pages that the upsurge in equities – particularly in the US – felt a little uncomfortable. This was because the correction had not followed the usual pattern such corrections are known to follow, and therefore did not seem to provide a particularly solid base for a durable upturn. Sadly, our suspicion turned out to be justified.

After last week's calming, the downdraft in equity markets returned with a vengeance this week. So much so that we even had to apply the latest regulatory reporting requirement, and write to investors in our highest risk portfolio style (Global Equity) to inform them that, over the course of Thursday, the value of their investments had at one point dipped to -10% below the value recorded at the beginning of the quarter.

While this sounds painful, it actually happens at a higher frequency in the case of global equity portfolios than one might think. Last time it happened was in February 2016 and before that in August 2015.

Nervous and less experienced investors might suspect that this second bout of stock market correction turbulence during 2018 may be the sign that good times for investors are finally coming to an end, after having enjoyed a choppy but very profitable uptrend for more than 9 years. We would disagree. But we also reiterate our message we first published in our 2018 outlook article: it is reasonable to expect that, in this late phase of the economic cycle, investors need to brace for slightly lower overall investment returns and higher levels of volatility.

Lower overall returns because fixed interest bond holdings – while still reducing risk - struggle to contribute positive returns when interest rates and yields rise back to more normal levels and profit margins of stock market quoted companies come under pressure (as rising wages from tightening labour markets and higher cost of capital increase the cost of business activity). It appears this insight has finally hit home with global equity investors, who – despite news of continued economic growth – have suddenly felt the urge to part company with their previously so cherished and profitable stock market

investments. This has led to (as Jim Kean likes to remind the wider investment team) “a classic scenario of more sellers than buyers in the markets”.

This may sound overly simplistic, but is nothing more than a more colloquial description of a liquidity squeeze, where the sudden removal of previously plentiful liquidity leads to a string of self-enforcing rounds of equity market falls. This carries on until most opportunistic holders of shares have thrown in the towel and the more fundamentally judging investor community can see considerable profit upside in a return to the market.

As we wrote when the sell-off began, the trigger point was a step-up in longer term US bond yields, when bond investors began to price in US interest rates rising to the 3% level - as the US central bank had communicated for a while but had not been believed by markets. Just as in February, the prospect of removal of the very cheap credit equity markets had thrived on for the past decade was enough to stop and reverse their September rush to ever higher valuation heights. The chart at the top illustrates this. The February correction only returned stocks globally back to their previous trajectory, after they had clearly overshot over December and January. However, they continued more or less within the boundaries of their trend channel that started in 2016 and was predicated on the assumption of continued cheap credit.

The forced deleveraging of the Chinese financial sector at the behest of the government (see last week’s edition) has added to this liquidity squeeze. Not only have more nervous domestic investors cashed in their holdings, but there was additional forced selling by overseas Chinese equity investors, who need to raise cash to pay back loans they can no longer afford. To top this, the ‘stock-market-fuel’ of company share buybacks that pushed liquidity into markets over the summer is also currently absent, as companies are not permitted to buy their own shares during the so-called blackout period before their quarterly results announcements.

The interaction of these three factors makes it harder than usual to predict turning points in this stock market rout. We are therefore for the time being content to continue with the reduced risk positions we have held in portfolios throughout the year. But we will rebalance portfolios over the coming weeks to position them for the changed market environment

This episode is painful for investors who have only recently invested from cash. For all other long term investors, it is just another period of volatility which is part and parcel of healthy capital markets and the risk discomfort factor that rewards equity investors with higher long term returns than lower risk bond investors. In the meantime, the fundamentals of the economy and corporate earnings have not changed direction or deteriorated in outlook since the beginning of October. It is therefore reasonable to expect that stock markets will eventually return to follow their lead – even if that is at a more realistic trajectory of expected future profit growth than had been the case in the US over much of the last 2 quarters.

In terms of other news, upon re-reading what I wrote last week, things have progressed – or not for that matter – as we suggested last week. So anybody keen to learn our views on Italy, Brexit, China or the Saudi oil price threats may want to revisit last week’s edition.

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29th October 2018

Turning point in Asia?

The global stock market sell-off that's been running for all of October struck Asian markets hard this week. Despite a cooling off in European markets and a higher opening for Wall Street futures, Thursday saw selling pressure turn eastwards, as both Japanese and Korean indices took big hits. Japan's Topix slumped 3.1% to its lowest since September 2017, while South Korea's Kospi fell 1.6%, putting it down more than 20% since January.

While Hong Kong's Hang Seng index fell 1.6% in afternoon trading, mainland Chinese stocks didn't fare as badly on Thursday. The Shenzhen composite index fell only 0.3%, while the Shanghai composite recovered from early losses to end the day slightly up. But this will come as little comfort. While October has been a rout for stocks across the globe, for Chinese equities the hard times have been going all year. As the chart below shows, Shanghai A-shares have declined 21.3% since the beginning of this year. The Hang Seng – which is more available to international investors – is down 15.6% over the same time period.

China's Shanghai A-shares index for 2018 ; 26 Oct 2018; Source: Bloomberg

And analysts don't see the winds changing for Asian stocks any time soon. According to Kathy Lien, managing director of FX strategy at BK Asset Management, Asian markets could come out of the current bout of selling even worse off than those in the US. Unlike in the US, "It's not in an environment of positive growth trend so the pressure will be exacerbated".

Selling pressure in the US and Europe is being driven by fears that the economy is running out of steam just as central banks – particularly the Federal Reserve – are tightening monetary policy and available liquidity is drying up. But as yet, the underlying economy is still supportive (if somewhat uninspiring) with no clear sign that that will soon change.

In emerging markets (EMs), and particularly in Asia, those fears have already been realised. EM weakness has been one of this year's distinguishing features, as a strong US dollar, slowing demand from China and a variety of political risks have combined to hurt developing nations. Whereas the Fed's interest rate hikes have been motivated by strength in the economy, EM rate rises have been motivated by a need to defend currency values, depriving the underlying economies of liquidity and choking off growth potential.

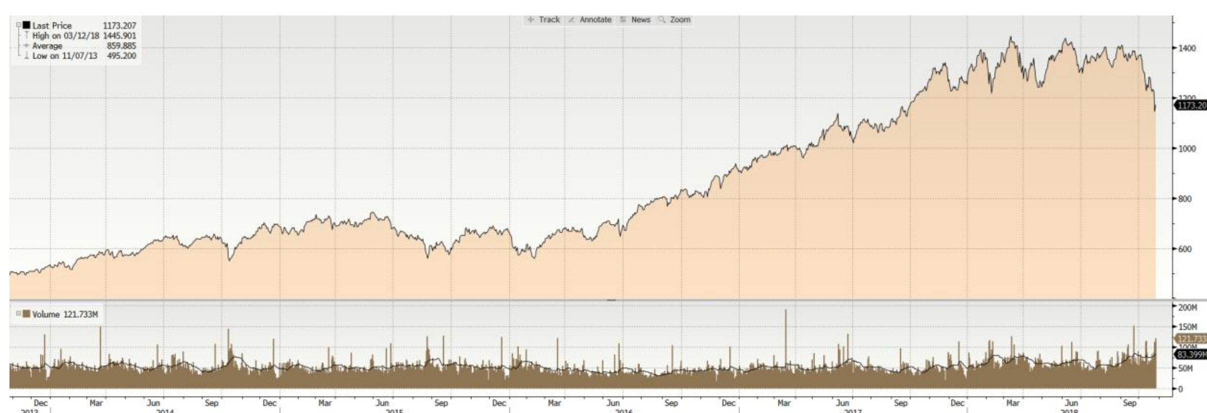
The only EM nation not to tighten monetary policy has been China, whose internal weakness has been another major feature of 2018. There, what started as a controlled deleveraging process from the government has since morphed into a full-blown economic slowdown, with liquidity drying up and small and medium sized businesses coming under serious pressure. And this weakness is spreading throughout Asia.

Given that all of these problems remain, it might surprise readers to know that we are beginning to consider getting back into Asian markets. Why? First, let's start with the long view. Few would doubt that EMs have higher potential over the long term. A lower base to grow from, extra capacity and untapped resources (both physical and human) mean that EMs have more room to expand than developed economies, where capacity is already stretched.

In Asia specifically, rapid technological and urban development (led by China) also means that corporate structures are likely to become more efficient as time goes by. We wrote last week that a lack of strong corporate governance was one of the underlying factors holding back Chinese businesses. But there are incentives for this to change, and over the long term we expect it to.

Then we come to the short and medium term. Emerging Asia has structural qualities that distinguish it from both developed markets and other EMs. Due to its stage of development, it's at a different place in the economic cycle to the western world. This is obvious enough to see at the moment, where the US is showing signs of being at or near its peak growth potential while Asia has already begun its decline. But due to its high dependence on the technology industry (at different points along the value chain for different countries), EM-Asia is also extremely sensitive to the technology cycle – tending to do well when tech-sector investment is strong and vice versa.

This means two things: While it was the first to slow down it could well be the first to speed up again. And when this does happen, it will likely be precipitated by a pickup in the tech sector. Below is a chart of the SOX index – a Philadelphia-listed index featuring companies involved in building or designing semi-conductors.



SOX Semi-conductor share index over the past 5 year since Nov 2013 ; 26 Oct 2018; Source: Factset

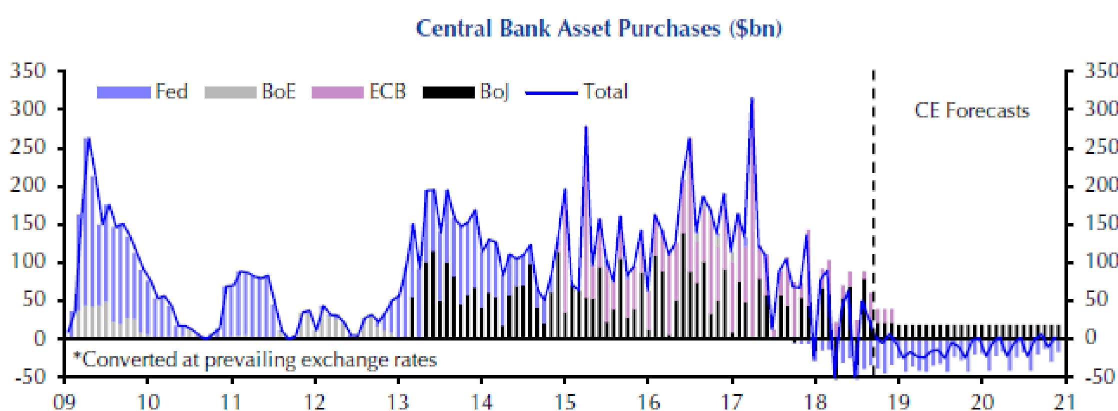
After a flatlining year and torrid October, the SOX is down year-to-date, and the immediate prospects for the tech sector don't look too good. But we believe that when it does improve, and other indicators show a healthy tech sector, it could be a sign that EM-Asia is about to turn.

At the moment, the problems in Asia – and particularly in China – are still too great for it to be time to buy. Things could well get even worse in the next few weeks as the US dollar has strengthened again and turn into a bloodbath for Asian stocks in particular. But as Baron Rothschild is credited with saying, "buy when there's blood in the streets".

Many analysts and commentators are beginning to become wary of the US' and other developed markets' capital return prospects over the next couple of years or so. Rising wages and interest rates, fears over peak growth and a pro-cyclical fiscal policy raise the risk of lower capital returns for investors. At the same time, China's deleveraging process, outsourcing of labour to surrounding countries and shift towards domestic consumption driven demand sets up the prospect of a strong economic bloc in east Asia, with the world's second largest economy at its core. We're not at the turning point yet. But it might not be far off.

European Central Bank: What to do when QE ends

The European Central Bank (ECB) this week reaffirmed its commitment to begin winding down quantitative easing (QE) operations by the end of this year. This is despite what looks like choppy waters between now and the planned December end date. At a conference in Frankfurt on Thursday, ECB President Mario Draghi signalled that the bank wouldn't be deterred by Italy's looming confrontation with Brussels, Brexit risks or the current rout in capital markets. The ECB's governing council still "anticipates" an end to their asset purchases of €15bn a month, mostly in the form of Eurozone government bonds. This is despite acknowledging the "weaker momentum" in the Eurozone economy, and the threats posed to the global economy from Donald Trump's trade policies, emerging market struggles and Brexit.



Sources: Thomson Reuters, Capital Economics

Unlike in the US, where the Federal Reserve's monetary tightening came in response to the strength of the underlying economy, the ECB's desire to turn off the QE liquidity tap isn't motivated by booming growth. After a strong showing in 2017, data this year have been steady but uninspiring on the continent – not the usual background to a tightening of monetary policy.

But there's not much that's usual about QE. It formed a key part of the coordinated post-crisis monetary stimulus across the globe, keeping bond yields low and liquidity ample to spur growth in a financial system and economy that was devoid of confidence. In recent years, the ECB's QE program in particular has been very successful, keeping interest rates well below growth rates – ensuring that Eurozone growth is fed back into the economy rather than 'absorbed' by savers – and easing the debt burden of Eurozone nations.

So why are they so eager to bring it to an end? Like all the world's central banks, the ECB has a strong desire to "normalise" monetary policy. Despite the need for it, they are extremely aware that the last decade's ultra-loose policy is a 'desperate times' measure more than a long-term solution. Even aside from QE's effects on wealth distribution and tendency to generate bubbles in certain asset classes, it's an uncomfortable policy for central bankers.

One of an independent central bank's foremost goals is to defend the value of its currency. But if markets suspect that the bank will continue printing money over the long term and use it to fund government debt, confidence in currency will eventually plummet, particularly if fiscal policy expands.

The tension this can cause between governments and central banks (as monetary policy usually has to tighten when fiscal policy loosens) is one of the main reasons why central banks across the western world are nowadays independent – so that political agendas don't interfere with their attempts to keep the ship stable. This is exactly the tension we're seeing in the US, where Donald Trump's massive expansion of fiscal policy through tax cuts and defence spending is prompting the Fed to raise interest rates faster – to the dismay of Trump himself.

It also helps explain why Eurozone (EZ) interest rates are still the lowest they've ever been, and why the ECB's asset purchases have continued for so long. While European monetary policy is at historically loose levels, fiscal policy across the EU remains tight. A focus on 'responsible' (a eurocrat euphemism for 'stingy') government spending is endemic to the bloc; the uncoordinated nature of EZ fiscal policy means that Germany's political obsession with budgetary prudence rules the roost.

This compresses growth potential across the bloc, which in turn forces the ECB to reluctantly keep monetary policy loose. Even the bank's QE program comes with a clause to address German fears that ECB asset purchases would leave their taxpayers on the hook for other nations' profligate spending. The capital key – the ECB's answer to these worries – divvies up ECB bond purchases on the basis of the size of each nation's underlying government fiscal stance, rather than the size of their bond market. This capital key (recalculated every five years) depends on keeping the budget to GDP ratio low. The larger export nations (especially Germany) can operate relative fiscal austerity and still grow reasonably. In turn, the ECB's policy rewards them further. This means that more money is funnelled into faster growing economies (read Germany) instead of the struggling periphery nations.

Of course, that stinginess removes a source of demand for the smaller nations. And, if a nation becomes so squeezed that they turn to fiscal expansion as a last resort, they may find they're kicked out of the ECB's bond-buying party. We've seen this with Greece, we've seen it with Italy before and we're seeing it with Italy again. And with a recalculation of the capital key coming up just as €117bn worth of European sovereign bonds are set to mature and be reinvested, markets fear that we could be approaching another serious headache in the Italy saga.

Thankfully, Draghi's latest suggestions are that the reinvestment of matured bonds will be done according to the previous weightings, rather than the updated capital key calculations. This should be a welcome development for the Italian government, providing some help in avoiding a refinancing nightmare.

It probably won't go down as well in Germany. But until they themselves start loosening fiscal policy, changes to the capital key rule are the least they can expect. Many would agree that an end to the over-stinginess, probably through a European fiscal expansion, is a key part of getting the Eurozone growing again. But this expansion can't come from the already troubled pockets in Greece, Italy or Portugal. Just as the bloc needs a normalisation of monetary policy away from ultra-loose, it needs an equal normalisation of fiscal policy in the core countries away from "tight". Angela Merkel is probably as weak as she's ever been during her time in power and, though it won't win the approval of all Germans, perhaps more government largesse could be popular, when seen as a consequence of a strong domestic economy and record budget surpluses. For Draghi and co, that would no doubt be appreciated.

+20% US earnings growth dismissed as 'peak earnings'?

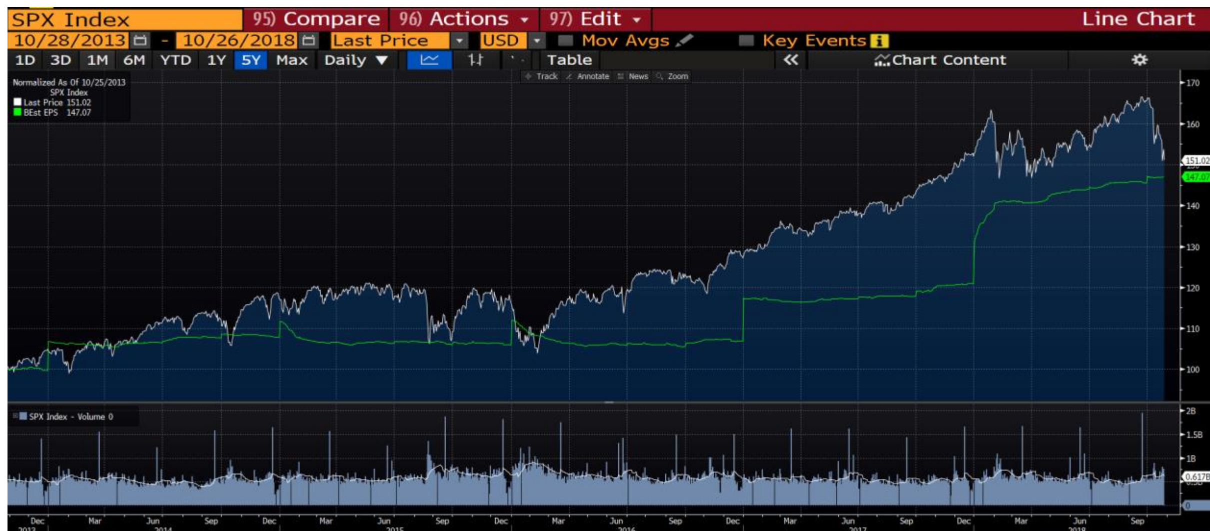
It's quarterly reporting season again and pleasing double digit growth reports are coming in thick and fast. But judging from this month's equity market rout, one would think the opposite. We're still relatively early in terms of the number of firms that have reported, but the trend is showing the third strongest quarterly results since 2011, with US companies for the third consecutive quarter posting double-digit profits growth. All this would normally have a reassuring effect on markets.

However, liquidity-deprived market dynamics appear to be overshadowing constructive earnings news, leaving the share prices of a large number of US firms in correction territory. 353 firms on the US S&P500 Index are off 10% or more from their 52-week highs. 179 firms are down over 20% from their highs, leaving them in a bear market. If it were not for the sheer size of Apple (the world's largest stock, which is only down -4.5% from the October high) US markets would have fallen through the -10% correction threshold much earlier.

It's not just the US though. Share prices are depressed globally and markets now look oversold, at least on a chartist's or technical viewpoint. So, a bounce may be on the cards in the near-term.

Perhaps investors have set a higher bar. Now that the US tax boost is largely factored in and cannot be repeated, it's harder for companies to positively surprise. The blended EPS (Earnings per share = profits) growth rate is showing little in the way of any further meaningful acceleration.

This is illustrated by the chart below, which shows US corporate earnings (green line) growing at one of their fastest rates in 5 years, but the step up from Trump's tax cut at the beginning of the year far outweighs this organic growth. Against this share prices (white line) had been moving up faster than perhaps justified by underlying EPS fundamentals.



5 years of US S&P500 stock market index vs underlying earnings growth; 26 Oct 2018; Source: Bloomberg

While the fundamental global economic growth backdrop remains positive, fears around trade wars, US Midterm elections, valuation pressures from rising interest rates, Italian budgets and the potential for 'peak earnings' (i.e. – after the peak the only way is down) all seem to be dragging sentiment lower. It is worth noting that the current quarter looks as if S&P 500 company earnings will still deliver and astonishing EPS growth rate of at least +20%. Next year, even though the tax boost will fall away, analysts forecast +10% growth. Earnings growth may be slowing, but organic double-digit growth should provide some comfort to investors.

In terms of the numbers so far, in the US, 240 out of the 500 firms on the S&P 500 index have reported. The current blended EPS growth rate is running at almost as high a level as last quarter, with +23.4% Year on Year (YoY) and sales up +8.6%.

The highest EPS growth rates can be found in the more cyclical sectors like Oil & Gas, Basic Materials (+72%), Industrials (+25%) and Telecommunications (+36%). Higher commodity prices have boosted the earnings of related stocks and a lower tax rate has provided a tailwind for those with a formerly higher effective tax rate. Only 38.5% of reporters have seen a positive price impact, fitting with concerns about peak growth.

Individual companies within diverse sectors like aerospace, autos and financials have provided solid earnings delivery. Industrial bellwether Boeing handily beat expectations across the board and its management raised future earnings and sales guidance above analysts' forecasts. The company's cash flow expanded, leaving full-year (FY) cash flow at between $15-15.5 billion, allowing ample room for further shareholder-friendly activities like share buybacks/dividends.

The big US banks also posted a decent set of results, as rising US interest rates improved their lending margins. JP Morgan, Bank of America and Morgan Stanley all surpassed expectations of already strong profit growth. This is important for the wider economy, because a healthy financial system is more likely to provide loans to both consumers and businesses. On the other end of the scale, the highly valued technology stocks have had a wobble. The semiconductor sector has reported slowing growth, with chipmaker AMD falling 22% after it missed estimates and cut guidance.

Lastly, even (recently) unloved Tesla, the electric car innovator, managed to report a profit. The company far exceeded analysts' expectations on sales, margins, profits, free cash flow (FCF) and net cash. Revenues hit $6.8 billion (exp. $6.3 billion), EPS hit $2.90 a share versus the expected -$0.15 cent loss. Margins climbed to 25.8% up from 18.3% year-on-year, while FCF was a positive $881 million (est. $280 million) and net cash ended the quarter at $3 billion (up $731 million). This allayed fears that the company was facing a cash crunch and was facing troubles over future financial liquidity. Markets were euphoric, sending the shares +12% higher.

In Europe, earnings were still decent despite the lack of tax boost. EPS grew +5.8% YoY and sales were up +1.9%. Companies across Europe have posted more mixed performances. Like their US peers, European technology shares have been hit hard. Financials are still struggling with a zero interest rate environment which is restricting profitability – despite the ramp up in loan volumes and positive economic backdrop.

In summary, markets are disregarding the positive earnings reports and are still driven by the correction dynamics of the early-October scare over the rising cost of capital (which began in bonds and ended in equities). As rates move higher, particularly in the US, valuation pressures around the Net Present Value of future earnings are likely to increase and geared stock market investments on the back of cheap loans will decrease, together adding further pressure on US stocks.

Market corrections can have a purgatory effect and bring about shifts in stock market leadership. It is therefore possible that we will see a shift from the US back to Europe and Japan, as these regions offer brighter growth prospects. Both are at an earlier economic stage, while the US is getting closer to its peak.

A solid earnings season on its own may not be enough to convince investors that good times are not ending, but we believe more than peak EPS growth will be needed to justify a rotation out of equities. Another factor to keep in mind is the lack of support from share buybacks over October. Companies are not allowed to make any further purchases during their so-called blackout periods ahead of their results reports. Given some estimates suggest up to $1 trillion worth of aggregate cash available for buybacks for 2018/19, we would not be surprised if markets begin rallying when blackouts end and corporates begin hoovering up 'undervalued' stock. This could be particularly effective given the likely trading conditions, which will be liquidity deprived with thin volumes – thin from investors lacking similar levels of liquidity that was burnt in the recent equity market downturn.

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	6906.1	-2.0	-143.7	↘
FTSE 250	18352.9	-2.4	-442.9	↘
FTSE AS	3784.7	-2.2	-83.8	↘
FTSE Small	5380.3	-3.1	-169.3	↘
CAC	4967.4	-2.3	-117.3	↘
DAX	11200.6	-3.1	-353.2	↘
Dow	24650.0	-3.1	-794.3	↘
S&P 500	2653.1	-4.1	-114.7	↘
Nasdaq	6858.5	-3.5	-248.7	↘
Nikkei	21184.6	-6.0	-1347.5	↘
MSCI World	2006.3	-2.7	-56.1	↘
MSCI EM	949.0	-2.3	-22.5	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.7	15.3x	12.2x	13.1x
FTSE 250	3.6	8.4x	13.2x	13.9x
FTSE AS	4.5	14.1x	12.3x	13.2x
FTSE Small	4.2	-	13.5x	13.8x
CAC	3.5	15.8x	13.2x	13.2x
DAX	3.4	13.4x	12.2x	12.5x
Dow	2.3	16.8x	15.5x	15.0x
S&P 500	2	18.6x	16.3x	15.7x
Nasdaq	1.1	23.0x	19.1x	17.7x
Nikkei	1.9	15.3x	14.9x	20.0x
MSCI World	2.5	16.9x	15.1x	15.1x
MSCI EM	3.1	11.4x	11.0x	12.0x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
BRITISH AMERICAN TO	9.7	WPP	-15.4
EASYJET	9.4	STANDARD LIFE ABER	-13.0
NMC HEALTH	6.5	MICRO FOCUS INTER	-10.7
RIGHTMOVE	5.7	GVC HOLDINGS	-9.8
INTL CONSOLIDATED A	5.1	OCADO GROUP	-7.6

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.28	-1.92	OIL	77.5	-2.9
USD/EUR	1.14	-1.09	GOLD	1240.1	1.1
JPY/USD	111.65	0.81	SILVER	14.7	0.8
GBP/EUR	0.89	-0.76	COPPER	273.5	-1.5
CNY/USD	6.94	-0.21	ALUMIN	1994.0	-0.9

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.383	-12.2	-0.19
US 10-Yr	3.076	-3.7	-0.12
French 10-Yr	0.738	-12.1	-0.10
German 10-Yr	0.352	-23.5	-0.11
Japanese 10-Yr	0.113	-24.2	-0.04

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	2.68

* 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

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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