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Lothar Mentel

Lead Investment Adviser to Cambridge

KAL on US and UK model democracy shambles - 17 Jan 2019 Political Cartoon Gallery

Markets looking ahead

The New Year's stock market recovery rally we wrote about last week has continued, to the surprise of many who are observing unprecedented political shambles on either side of the Atlantic. The UK appeared to be descending into political chaos, with a disorderly Brexit seemingly only 10 weeks away. Meanwhile, the US economy suffers from the longest government shutdown on record. So how can it possibly be that investors are willing to return to risk asset markets?

The answer is probably that liquidity easing and an actual reduction in perceived political uncertainty has made risk assets look cheaper than justified.

Just before Christmas, stock market valuation levels priced in a material decline in corporate earnings which only normally happen during a recession. The stock market reaction to the slowing economic growth outlook will have been exacerbated by the liquidity squeeze we wrote so much about in December.

That shortness of liquidity initially eased at the beginning of January, as hedge funds had finished liquidating their portfolios to satisfy year-end redemption requests and the Fed signalled that it may well pause its recent series of interest rate rises in response to falling economic growth. This week, the third culprit for the global liquidity drain of Q4 2018, China, also sprang to action: The PBoC, their central bank, injected a surprisingly large volume of additional liquidity into their financial system. The step up in fiscal easing initiatives, in the form of rail infrastructure investment that the government announced in parallel, helped to rekindle market expectations that China would not allow its economy to take as big a hit from the structural reform pains as it had done in 2018.

President Trump's continued government shut-down show-down against the new Democratic House of Representatives over the funding for his Mexican border wall, on the other hand, is beginning to have a negative impact on the near term economic outlook for the US. Here, interestingly, capital markets appeared to be minded looking through this impasse as short-term noise rather than interpreting it as a potential cause for longer term economic derailment. Beyond this, a number of factors have significantly lowered the anticipated risk of US recession in 2019: continued strong domestic consumer demand, various rumours that the US-China trade negotiations are taking a constructive turn and a positive start to the corporate earnings season.

Markets also took the House of Commons' emphatic rejection of the government's Brexit plans surprisingly well. Any expectation that £-Sterling would suffer was quickly disappointed, as the currency actually rose not insubstantially against the US$ and the €-Euro in the aftermath. This positive market reaction to what seemed like a historical disaster for the UK's political class is aligned with our view that the rejection is leading towards either another procrastination in Brexit proceedings or at least a softer version of what has been voted down. 'Dr Currency Market', and in its wake the stock market, certainly signalled that the probability of a disorderly EU departure is now perceived as much smaller, despite some noises from politicians to the contrary.

So far so good then. But is the new-found market positivity going to last?
We see recession expectations waning, which justifies the market recovery thus far. But we do not expect a significant further easing of liquidity conditions. This is because the US central bank, the Federal Reserve, will continue with its liquidity reduction program under QT, while the European Central Bank (ECB) has stopped providing further liquidity under QE and the Chinese have the capital control means to prevent most of their central bank's liquidity provision from leaking out of China. This means that we must reasonably expect that any swing of the ongoing news flow to the negative or the positive compared to where we are now to cause larger than perhaps expected swings in the stock markets as well. The significant one day moves up or down as we have seen so far over the course of January are therefore likely to be the norm for a while, at least until financial sector liquidity sources replace the receding central bank liquidity.

This Friday's near 2% upsurge in stock markets on news that China may have offered the US to reduce its trade surplus towards 0 by boosting imports from the US over the coming 6 years was a good example for this two-way volatility.

To summarise then, we are pleased to see some rationality returning to stock market valuations as China is stepping up efforts to support its wider economy that is under the strain of the painful but necessary structural reforms and US trade repression. The slowing of the US economy is now finally recognised by capital markets, which has not only brought US stock markets 'down to earth' again, but also significantly reduced the risk of a disorderly bond market unwind. This should in turn prevent any further strengthening of the US$. In the past, a stable or falling US$ has been beneficial to the global economy which should get a further boost from China's domestic stimulus measures. Encouragingly, the relative US weakness also seems to spur the Trump administration into action to progress their trade negotiations with China.

All this taken together makes us optimistic that markets in 2019 will be a better reflection of economic progress and decent corporate earnings growth than 2018, when fears and liquidity issues prevented a positive year end result. However, as central banks continue on their path of monetary policy normalisation through QT, liquidity will not return to previous surplus levels. It will now once again depend more strongly on the private financial sector's willingness and ability to turn over the existing monetary aggregates effectively. This limits the absolute upside of risk assets and increases market volatility but should still be supportive of sustainable economic and corporate earnings growth to underpin higher stock market valuations.

One last word on the UK after the tumultuous week in parliament. The currency and stock markets may have reacted positively, but that does not mean that indecision and continued uncertainty about the UK's future among its EU trading partners has suddenly turned into a positive for the economy. All that has happened is that – as we had laid out here in the past – capital markets had priced in a harder and more imminent Brexit than now looks likely. If the political stalemate results in a 'kicking the can down the road' Brexit approach of continued uncertainty of trading conditions, then this will also continue the performance drag of underinvestment the past two years' uncertainty has had on the UK economy.

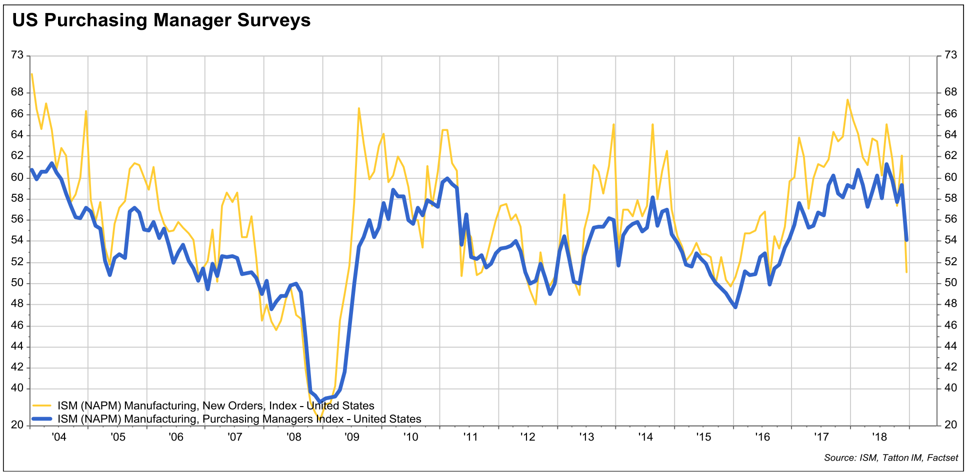
Not an immediate disaster but leading to economic performance of the UK that is increasingly below its potential. It will be interesting to see which political class on either side of the Atlantic realises first that their political incompetence is not just an embarrassment but has real economic consequences. As odd as this may sound, but I would not be surprised if Donald Trump solved the US conflict with China before the UK finally finds a viable way forward for its relationship with the EU.

US turning over but not going under

The US economy was last year's star of the show. The stimulatory effects of Donald Trump's tax cuts added to already strong consumer demand, which meant the world's largest economy led the pack in the developed world, while emerging markets suffered under the weight of a Chinese slowdown, fears over trade tariffs and a rising US$. But despite its roaring 2018, analysts have become wary of the US' prospects for this year, generally predicting a slowdown (and in some cases even recession).

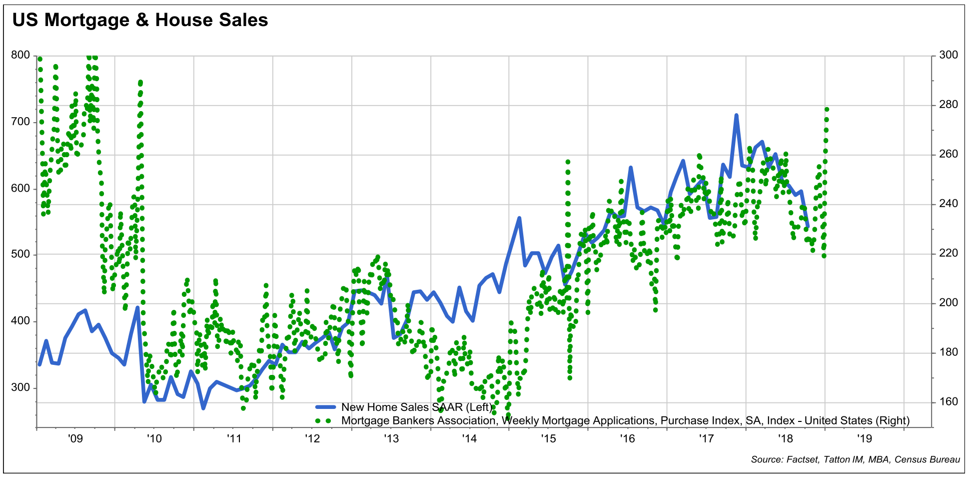
So far, the early signs corroborate this story. As we wrote last week, sentiment surveys have shown a waning of business confidence, particularly among manufacturers. Last week's ISM manufacturing index came in at 54.1, well below both the previous month's figure (59.3) and economists' expected figure (57.9). Theoretically, a reading above 50 indicates expansion but, because an economy generally has expanding resources, the neutral reading is a little higher. For the US, 51-52 signals growth running at "potential". What's more, for gauging the economy's prospects, the absolute figure is often less important than where the momentum is heading. And for US manufacturers, that momentum is almost certainly heading down.

The new orders component of the survey was undoubtedly the major factor in the fall. November saw a lofty 62.1 for new orders, whereas last month's figure came in at just 51.1. This could well reflect slowing



Chinese and European demand, as well as the well-documented troubles in the autos sector or even simply earlier stockpiling in anticipation of tariffs that were originally meant to start in January. In other data releases, business capex also disappointed, as analysts' high expectations were only met with weakness.

There is one bright spot, however. US consumers appear to be hard at work, in some cases quite literally. Manufacturing hours worked increased 0.5% in December, which suggests a welcome increase in output. Perhaps more importantly, consumer demand has also shot up – which will be a huge boost to America's slowing economy. The exception to this healthy consumer demand is once again the autos



sector, which for various reasons is having trouble all over the world.

The key question, of course, is whether this can continue. Fortunately, there are some good reasons to think so. Wage growth has been disappointing recently, but JP Morgan points out that consumers should still feel as though they've got the money to spend as inflation is falling back quite significantly, aided by lower oil prices. This means that wages are still outpacing inflation, which should support demand.

A good outcome needs the US job market to remain relatively tight. There was a slight wobble in the weekly unemployment claims data, showing a recent rise, which throws some doubt on whether this labour market tightness can continue. However, some of this is attributable to the government shutdown and this week's data was less worrisome. Unemployment data has been at or below 4% for nearly a year now, while December's non-farm payroll figure came in extremely positive. The US added 312,000 jobs in December, well above economist expectations of 177,000 and rebounding from November's lower figure. Wages should continue to be on an upward trend and add to the positive consumer spirit.

Meanwhile, the weaker growth outlook has led to lower bond yields. That links straight back into mortgage rates, which in the US are still generally done on a long-term fixed basis. As mortgage rates have declined, applications for new purchases have reached a cycle high, which should mean the weakness in construction seen in H2 2018 is coming to an end:

The sugar rush of Trump's tax cuts has undoubtedly worn off, and further fiscal expansion from here could well make things more dangerous. For business, the fairly decent sentiment in the services sector is outweighed by the disappointing data from the manufacturing side. But consumer demand is key, and while demand is unlikely to surge we see no reason to think it will go too far the other way either.

A repeat of last year's stellar growth is highly unlikely. But nothing about the current data suggests that a recession is looming. What's more, the fall-back in inflation means that a more aggressive rate-hiking path from the Federal Reserve is also unlikely – removing one of the key risks for US capital markets, both fixed interest bonds and equity. The US is indeed turning over, but there's very little sign that it's going under.

As a more sanguine view of the US economy's 2019 path has emerged, equities have regained a foothold. Regular readers will know that we believe markets sold off too heavily last year, briefly pricing a recession that we don't see coming. If the data confirms an only mildly slower economy, equities should be underpinned.

There is a caveat for the US markets. Over the fourth quarter, US equity valuations fell no more than elsewhere and still remain relatively less attractive. So, US equities might not see the same bounce back as other regions. Whatever the case, the upcoming earnings season for US companies will tell us a lot about where equities are relative to expectations.

China hands its consumers a big red packet

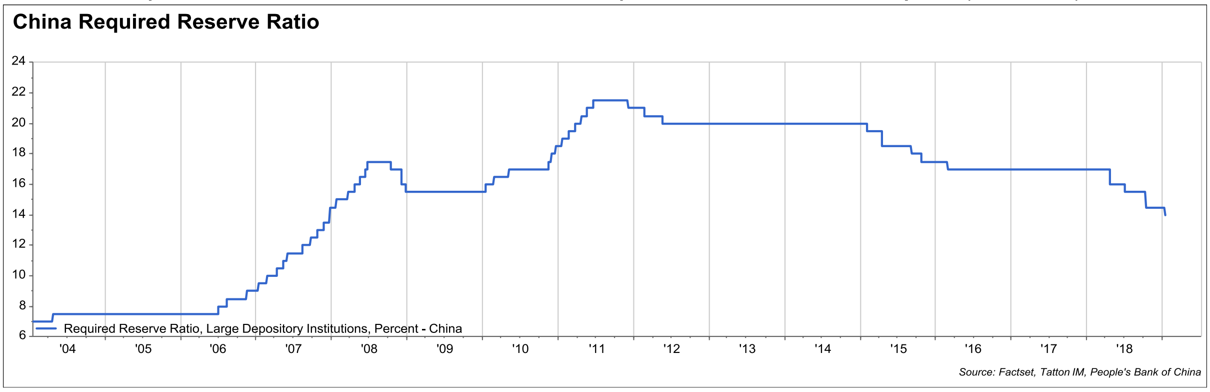
The People's Bank of China (PBoC) injected a staggering RMB570bn ($84bn) into its banking system on Wednesday, the largest single day liquidity boost on record. This was followed by Thursday's sale of RMB250bn in 7-day repos, and RMB150bn in 28-day repos, resulting in a further net liquidity injection of RMB380bn ($56.2bn) via its open market operations. That brings this week's net liquidity boost to RMB1.14tn at the time of writing. If the bank sticks to trend on Friday, we're in for a record-breaking week too.

The official story is that the money is needed to keep up cashflow in the run-up to Chinese New Year. The economy is "in a peak period for tax payments, and the overall volume of banking system liquidity has declined rather quickly," according to the PBoC. With the week-long national holiday around the corner, the banking system will see a huge surge in liquidity demand. Not only will companies need money to pay taxes and employee bonuses, but households will need cash for the traditional 'red packet' gifts exchanged at this time of year.

Of course, that's the same every year. So why the record liquidity surge this year? For starters, the underlying liquidity in the banking system is a little drier than usual. The government's crackdown last year on the shadow banking sector and the country's burgeoning credit pile has left the economy with a liquidity shortage. If the central bank needed to put so much money into the financial system just to meet regular seasonal demand, then it shows just how dangerously tight China's financial sector reforms have left general liquidity.

But in all likelihood, that wasn't the only reason. It is no secret that growth in the world's second largest economy is slowing. The government's deleveraging efforts last year likely slowed growth to its lowest level since 2009, according to a Bloomberg survey of economists. And Beijing's recent efforts to avert some of that deceleration have included both fiscal and monetary easing measures. Due to fears that the slowdown could worsen, "Chinese banks are also under pressure to ramp up lending to support Beijing's call to support growth" according to Nomura Hong Kong chief economist Ting Lu.

This is on top of the PBoC's cut to banks' reserve requirement ratios late last year (see chart), as well as



tax cuts from the government. Earlier this week, senior economic policy officials announced tax cuts "on a larger scale" to aid the slowing economy.

Back in 2008/09 and again in 2015/16, Beijing's stimulus measures encouraged a credit-binge that pulled China out of a slump and the global economy with it. But we wrote before that those expecting a similarly full-fat response this time will be disappointed; the government simply can't afford to inflate that credit bubble any more. Given this week's record measures, have officials changed their minds and decided to go all out once more?

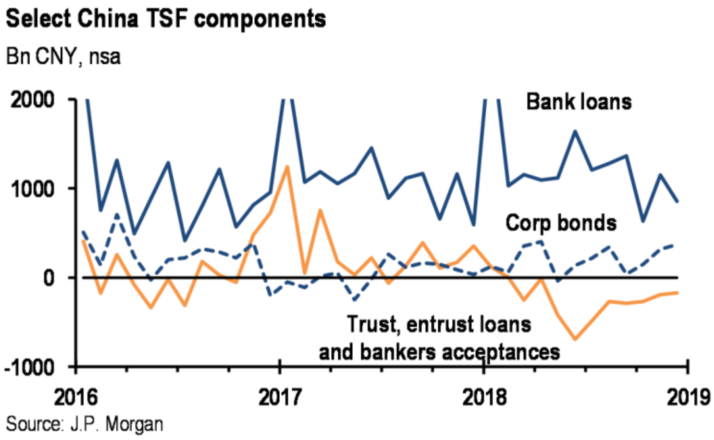
Not exactly. Officials have maintained throughout that policy easing won't become a free-for-all, but will remain a tweaking tool for softening the landing. "The central bank will avoid damaging the real economy with too fast credit shrinkage while refraining from indiscriminate easy credit," according to PBoC governor Yi Gang. In his address to state media, he repeatedly used the word "precise".

More importantly, it's worth pointing out where this round of easing is going. Last time around, China's economic managers were indiscriminate in their stimulus measures. Officials pumped vast sums of money into the financial system and encouraged banks to lend to businesses. Naturally, most of this credit ended up going to the large state-owned enterprises (SOEs), the traditional transmitters of Chinese economic policy.

That's largely what caused the credit problems the country faces now. While the SOEs were free to gorge themselves on easy credit, smaller businesses and individuals were forced to find alternative sources of funding like the shadow-banking sector – as Chinese banks' inability to risk-price loans barred them from the official channels. The shadow banks were effective in lending but problematic in their practices.

Thus 2018 saw the shadow banking channel being strongly compressed while banks were required to change their practices. The amount of credit for private enterprises (Total Social Financing -TSF) underwent a severe slowdown.

As we enter 2019, the compression of shadow banks is lessening while banks and the bond markets are being encouraged to take up the slack. Although banks continue to struggle to lend more, financing is being starting to find its way into the system as the chart below from JP Morgan indicates:



Now, most policy is targeted to smaller businesses and consumers, rather than to overleveraged SOEs. One PBoC official announced that the bank would work to improve policy transmission and guide funding costs lower, according to Bloomberg. Infrastructure projects are still being thrown into the mix, the largest of these being $125bn in new railway construction approved in the past few months. But this project is designed to benefit consumers rather than industry. The focus on tax cuts and other fiscal stimulus measures shows that the government is focused on boosting consumer demand.

All of this fits well into Beijing's long-term reform plans. Getting the banking system functioning properly and giving businesses and consumers access to credit is a key component of achieving the stable, self-reliant economy the government wants. Transitioning away from reliance on exports and towards an internal demand-led economy is a top priority for the government – particularly as trade tensions show how fragile reliance on external demand can be.

All of this takes time. The banking system cannot change overnight and consumer demand will only improve in a stable environment. What that means is that, while these stimulus measures are indeed significant, they're not necessarily good for companies in the short term. That's why growth is still stalling despite the government's efforts, why high-profile bankruptcies are still occurring and why China's stock market hasn't reacted to the good news. As we wrote before, the focus now is on reform rather than boosting short term prospects, and the liquidity shortage will continue to be an issue for businesses.

That being said, these measures are undeniably a good sign. As consumer demand improves, it will inevitably bring business fortunes up with it. It will take some time, but the signs for China's future are bright.

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21st January 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	6968.3	0.7	50.1	↗
FTSE 250	18764.5	1.2	222.2	↗
FTSE AS	3826.1	0.8	29.0	↗
FTSE Small	5337.9	-0.2	-12.3	↗
CAC	4875.9	2.0	94.6	↗
DAX	11205.5	2.9	318.1	↗
Dow	24667.8	2.8	671.8	↗
S&P 500	2668.2	2.8	72.0	↗
Nasdaq	6800.4	3.0	199.0	↗
Nikkei	20666.1	2.5	502.3	↗
MSCI World	1975.6	0.9	18.4	↗
MSCI EM	1009.0	0.8	7.9	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.9	16.0x	12.1x	13.2x
FTSE 250	3.6	20.9x	13.0x	14.1x
FTSE AS	4.6	16.9x	12.2x	13.3x
FTSE Small	4.1	-	10.7x	13.9x
CAC	3.6	15.1x	12.2x	13.4x
DAX	3.2	12.4x	11.9x	12.5x
Dow	2.3	16.3x	14.9x	15.0x
S&P 500	2	18.1x	15.8x	15.8x
Nasdaq	1.1	22.3x	18.5x	17.8x
Nikkei	2.1	14.3x	15.0x	20.0x
MSCI World	2.6	16.3x	14.3x	15.1x
MSCI EM	2.8	12.1x	11.4x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Royal Bank of Scotland	8.8	Pearson	-9.9
Persimmon	8.7	John Wood Group	-6.8
United Utilities Group	8.6	ITV	-4.5
Taylor Wimpey	7.1	Paddy Power Betfair	-4.4
Barratt Developments	6.3	Evraz	-3.7

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.29	0.40	OIL	62.7	3.6
USD/EUR	1.14	-0.95	GOLD	1282.4	-0.6
JPY/USD	109.78	-1.18	SILVER	15.4	-1.2
GBP/EUR	0.88	1.39	COPPER	271.5	2.0
CNY/USD	6.78	-0.22	ALUMIN	1858.0	-0.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.4	4.9	0.06
US 10-Yr	2.8	3.2	0.09
French 10-Yr	0.7	-0.5	0.00
German 10-Yr	0.3	9.6	0.02
Japanese 10-Yr	0.0	-5.9	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.74
3-yr Fixed Rate	1.82
5-yr Fixed Rate	2.02
Standard Variable	4.41
10-yr Fixed Rate	2.67

* 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!

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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

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD