THE **CAMBRIDGE** WEEKLY

24 December 2018

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Fed tightens, market falls and economy keeps on going

We wrote about our outlook for 2019 last week. After that slightly lengthy read, we thought a shorter note discussing what has caused market behaviour would be helpful.

So, this week all eyes were on the US Federal Reserve's Open Markets Committee (FOMC) meeting. As widely expected, the FOMC raised interest rates for the fourth time this year. However, given the current state of capital markets – the sell-offs in equities and the increase in credit spreads – investors hoped that they would acknowledge the likelihood of an economic slowdown is ahead and would adjust accordingly. They obliged; in his press conference afterwards, Fed chairman Jerome Powell lowered the central bank's expectations for rate rises next year from three to two.

And yet, despite guiding rate expectations lower for next year, markets sold off heavily. So, what's going on?

Perhaps it might be that the FOMC's expectation of two rate rises next year is still one-and-a-half more than markets are currently pricing in. Markets are pricing an impending economic slowdown, one which would force the Fed to hold off completely next year.

More likely, some investors seem to have been hoping that for an adjustment in the pace of the Fed's balance sheet reduction. No such luck – Powell indicated quantitative tightening (QT) would go ahead just as planned.

A liquidity "shortage" caused in part by QT is, we think, behind 2018's market falls. Many investors hoped that a change of heart from the Fed would be the catalyst for a stabilisation of both the economy and financial markets. Some commentators are calling their "inaction" a policy error.

We've written (quite a lot) about liquidity this year. Although they're linked, there are two different kinds of liquidity: First, there's the cash created by a central bank which provides fuel for financial markets, keeps yields down and valuations high. This is the kind of liquidity that QT directly affects. Given that the removal of QE now seems set in stone – not just in the US but globally – this is the kind that will keep falling throughout next year.

Secondly, there's liquidity provided by the market, enabling transactions to happen. In the past, large investment banks "made the market", enabling liquidity by providing risk capital. Changes since the financial crisis (both regulatory and technological) have meant that, today, investment banks have significantly reduced their role in providing transaction liquidity. Institutional investors have had a larger role, but see transaction as a cost, so would rather reduce the involvement than increase it.

Indeed, institutional "active" investors have been under pressure as retail investors have switched towards "passives", especially Exchange-Traded Funds (ETFs) which track mechanically-priced indices. Historically, institutional investors have tended to increase cash when valuations get expensive, and reducing cash to buy when valuations cheapen, effectively acting as a dampener on market fluctuations to a degree.

The rise of ETFs has reduced this available cash, while increasing the market's sensitivity to direct end-investor risk-appetite.

When markets are trending up, things don't feel risky. But when prices start falling, the risks seem a lot clearer. A run for the hills causes liquidity to fall further and volatility to spike even more.

That's exactly what happened this year.

Initial confidence, especially in the US, has petered out. Slowing economic growth amid tightening central bank liquidity caused market sell-offs, starting in emerging markets and culminating in the US market's turnover in October. US investors, (especially the active retail investors) started selling ETFs, pushing up volatility and driving down risk appetite.

In addition, hedge funds were hit with massive redemptions. There wasn't enough secondary liquidity even to mop up assets which had become "cheap" in valuation terms.

Crucially, this scenario has nothing to do with the underlying economic fundamentals, and everything to do with the workings of financial markets. If you were to use current prices as an indication of market expectations, you'd think markets are expecting a monumental economic downturn next year. It could happen, but we really don't think that's the case.

Risk assets always come with a risk premium attached – the amount you get paid for tolerating a certain level of risk. Due to the torrid 2018 we've had, risk premia have gone up, which in large part explains why equities have fallen so much. It's this that has changed, rather than a significant change in the global economy's outlook. This makes the current pullback look like the start of an opportunity rather than the beginning of a crash. A year ago, stocks globally looked overvalued. Now, there's virtually nowhere where that's true and, especially outside the US, equities look quite undervalued.

Of course, financial markets aren't in a vacuum. Falling stocks and (particularly) widening credit spreads aren't just an expression of an economy. Asset price movements have an impact on the real economy, and if things get really bad, it could cause more of a slowdown than expected.

How will we know if this might be happening? Bankruptcies will be important to watch early next year. The weak spots are especially among the retailers both in the UK and the US. However, outside of this, corporate cashflows are doing okay. Without default contagion, we would not expect dour markets to have too large an impact. The global economy should remain on a reasonable growth path, markets should stabilise, and risk appetite rebuild. That's why, after having underweighted equities this year, we expect to move to a neutral position early next year.

There's a difference between having good reason to think markets should stabilise and knowing when it's going to happen. For market liquidity, the key question will be a return of risk appetite for end investors. As we end the year, we expect there'll be a natural end to some of the selling pressures, as redemption deadlines pass and investors finish their capitulation. Everything else being equal, the more markets fall, the more of a buying opportunity it seems.

That brings us back to the Fed. In our outlook we said that the upside risk involves central banks easing policy more than expected next year. And the Fed has indeed shown a response to a weaker economy, even if it wasn't the response markets wanted. Given there were also hints from the ECB that they may have to ease their outlook too, there are some reasons for positivity. As we wrote in our outlook, we also expect some fiscal easing in the EU, which could make the union a source of growth next year.

But while there's potential for a relative policy easing in the world's developed economies, the same isn't true in China. In a recent speech, President Xi Jinping gave no hint of any fiscal moves from the government, and there's even been whispers from the politburo about shifting the economic targets so as not to reverse the deleveraging process. The stimulus measures they've already enacted have been and will be effective, but those hoping Chinese demand can bail out the global economy again will be disappointed.

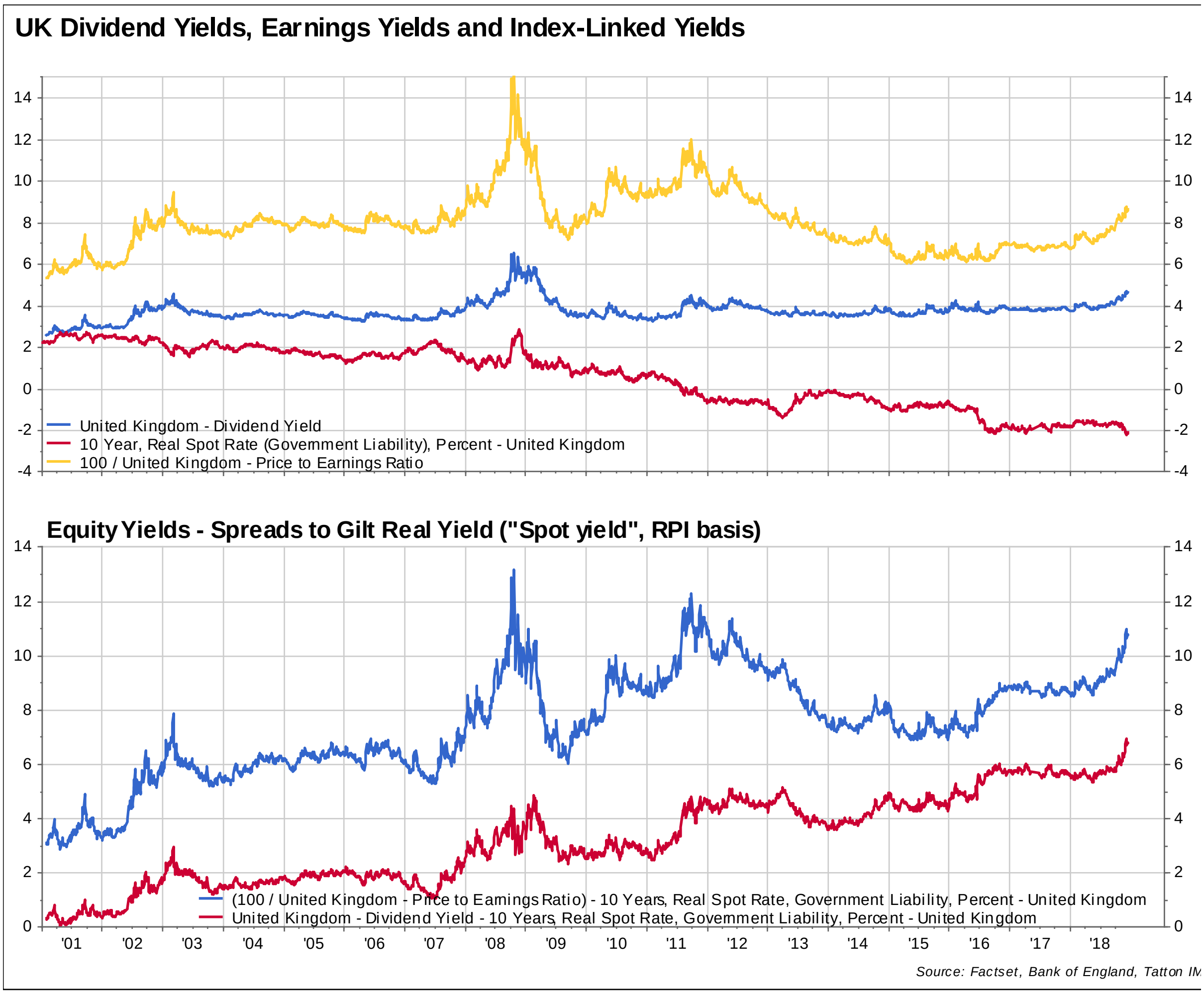
Another factor that could help is the apparent end of dollar strength. The strength of the US dollar, and its effect on emerging markets in particular, has been one of the main concerns over this year. Recently it's looked like this trend will change – particularly with the Fed's change of tone. If the dollar does indeed weaken next year, that could well help sentiment and bring back some risk appetite – at least among investment managers.

We've been cautious this year. Given how low valuations have fallen, we're becoming neutral. If it gets cheaper, it will be a buying opportunity. As the saying goes: "the time to buy is when there's blood in the streets."

The last word is about the UK and Brexit. As we approach the "deadline" without a clear move towards a decision, each day that passes heightens a sense of crisis. We're trying not to get caught up in that emotion. Globally, equity market valuations have improved, but they're clearly cheap in the UK.

The charts below show the UK equity market's measures of "pay-out" – the earnings and dividend yields (as expected for next year by analysts) and the 10-year government bond real yield. Given that earnings will tend to rise (somewhat, over the long-term) in line with inflation, the comparison is a good indication of the relative pay-out to risk.

Relative to the risk-free alternative, on an earnings basis it was slightly better when the world teetered at the precipice. On a dividend yield basis, it's not been better in modern times. Investors are not getting paid to be risk-averse. Investors are getting paid a lot to take on risk.



To all our readers, may we wish you a most joyous season and a less stressful and more prosperous new year!

CAMBRIDGE
INVESTMENTS LIMITED

24th December 2018

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	6690.1	-2.3	-155.1	→
FTSE 250	17370.3	-1.7	-296.7	→
FTSE AS	3652.6	-2.2	-80.3	→
FTSE Small	5127.0	-1.6	-81.8	→
CAC	4661.2	-4.0	-192.6	→
DAX	10578.5	-2.6	-287.3	→
Dow	23206.3	-3.7	-894.2	→
S&P 500	2469.9	-5.0	-130.0	→
Nasdaq	6287.2	-4.7	-307.8	→
Nikkei	20166.2	-5.7	-1208.6	→
MSCI World	1862.8	-4.1	-79.7	→
MSCI EM	959.8	-1.2	-12.1	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	15.2x	11.8x	13.2x
FTSE 250	3.9	21.5x	12.4x	14.0x
FTSE AS	4.7	16.1x	11.9x	13.3x
FTSE Small	4.1	-	12.3x	13.9x
CAC	3.7	14.4x	12.5x	13.3x
DAX	3.5	11.6x	11.8x	12.5x
Dow	2.4	15.5x	14.6x	15.0x
S&P 500	2.2	16.8x	15.1x	15.8x
Nasdaq	1.2	20.5x	17.5x	17.7x
Nikkei	2.2	14.0x	14.6x	20.0x
MSCI World	2.7	15.4x	14.1x	15.1x
MSCI EM	3.1	11.5x	11.3x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Evraz	4.0	NMC Health	-13.3
Smurfit Kappa Group	3.7	Carnival	-12.9
Standard Life Aberde	3.4	John Wood Group	-12.3
Intertek Group	3.3	Ashtead Group	-7.3
Barratt Developments	2.9	Scottish Mortgage In	-7.1

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.26	0.44	OIL	53.8	-10.7
USD/EUR	1.14	0.73	GOLD	1258.5	1.6
JPY/USD	111.28	1.90	SILVER	14.7	0.8
GBP/EUR	0.90	-0.31	COPPER	269.6	-2.3
CNY/USD	6.91	0.03	ALUMIN	1912.0	-1.0

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.324	6.8	0.08
US 10-Yr	2.799	-3.1	-0.09
French 10-Yr	0.690	-3.1	-0.02
German 10-Yr	0.247	-2.0	-0.01
Japanese 10-Yr	0.047	34.3	0.01

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.73
3-yr Fixed Rate	1.85
5-yr Fixed Rate	2.02
Standard Variable	4.45
10-yr Fixed Rate	2.72

* 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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