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Ingram Pinn's End of the year show to greet 2019, 28 Dec 2018 - Political Cartoon Gallery in London

Year-end turbulences heralding difficult 2019?

Happy New Year from team Cambridge and here's to a more joyful 2019 for investors!

As our 2018 table of asset class returns below shows, 2018 brought even less joy for investors worldwide than we had expected. The only consolation is that it came after two very pleasing years of investment return and did not reflect a similar downward development across the global economy. Indeed, the state of capital market sentiment could not be more contrary to one year ago, while the rate of economic growth has merely fallen back to the previous state of 'slow but steady growth' which gave us one of the longest economic cycles in history.

Admittedly, looking ahead into 2019 appears more precarious from the UK perspective, given most expected to know by now what shape Brexit would take. With the only consensus seemingly being decisive opposition to a no-deal crash Brexit it is not surprising that the economists' outlook for the UK is very hesitant, with the majority forecasting a procrastination of the exit proceedings leading to more or less a repeat of the 2018 environment of subdued, below-potential growth in the UK. We have this week dedicated an article to the consensus 2019 outlook of UK economists, as they were spot on with their 2018 forecasts, and capital markets have written down prospects of UK investment assets much more than we believe is justified.

Asset Class	Index	Dec 2018	Q4 2018	2018	2017
Equities	FTSE 100 (UK)	-3.5	-9.6	-8.7	11.9
	FTSE4Good 50 (UK Ethical Index)	-3.4	-7.4	-9.2	6.7
	MSCI Europe ex-UK	-4.8	-11.2	-11.9	13.3
	S&P 500 (USA)	-8.9	-11.5	1.6	11.3
	Nikkei 225 (Japan)	-7.0	-11.8	-2.2	14.7
	MSCI All Countries World	-7.2	-11.6	-6.4	11.2
	MSCI Emerging Markets	-3.8	-8.3	-11.5	34.0
Bonds	FTSE Gilts All Stocks	2.2	1.9	0.6	1.8
	£-Sterling Corporate Bond Index	1.1	-0.3	-2.2	5.0
	Barclays Global Aggregate Bond Index	2.2	3.6	4.9	-1.9
Commodities	Goldman Sachs Commodity Index	-7.6	-21.1	-8.5	-3.4
	Brent Crude Oil Price	-9.4	-33.4	-14.5	7.5
	LBMA Spot Gold Price	5.2	10.9	5.0	2.2
Inflation	UK Consumer Price Index (annual rate)	-	0.1	1.7	3.0
Cash rates	Libor 3 month GBP	0.1	0.2	0.6	0.3
Property	UK Commercial Property (IA Sector)*	-0.9	0.3	3.6	7.6

All returns in GBP; Source Morningstar Direct, 4 Jan 2019

***Data to end of previous month (30/11/18)**

Outside the UK, where the 2019 outlook was not overshadowed by such fundamental paradigm shift potential, unusual year-end market volatility provided unnerving signalling potential for investors. Instead of a pleasing year-end Santa rally, stock markets – particularly in the US - experienced a rollercoaster of flash crashes and flash recoveries as we have not seen in living memory. However, regular readers will know that we anticipated as much on the back of the tight market liquidity in the run-up to Christmas, which had persuaded us to refrain from increasing our equity allocations (after almost a year of being underweight) and in light of the now very attractive valuation levels compared to a year ago. In another dedicated article we therefore discuss the likely drivers of the market action between Christmas and New Year and what it does and does not tell us about 2019.

Turning to more soothing developments, we were pleased to observe that our prediction of a resolution before year-end of the Italian budget dispute with the EU came true and thus removed one of the major European scare stories.

Further East, China's leadership reemphasised in its New Year messages its determination to follow its long term course of structural reforms towards more "self-reliance" and less dependence on credit growth and export surpluses. Meanwhile, policy action by the Chinese central bank and the bank regulator(to ease credit funding access for hitherto locked-out smaller private enterprises) informs us that the leadership appears to be prepared to do what it takes to counter the inevitable economic reform pain, but without a repeat of the 2015 credit binge of large and state owned enterprises. Early signs of a re-acceleration of the services sector bode well in this respect.

Over in the US the year started with a reminder for the Trump administration that US wealth may be more dependent on trade with China than it would like to admit. Declining Apple iPhone sales in China led to a 10% fall in Apple's share price, costing investors more than $70 billion in notional valuation losses. It may therefore not be surprising that President Trump is making increasingly optimistic (Twitter) statements about the prospects of a US -Sino trade settlement.

US central bank chair Jerome Powell calmed the other major pre-Christmas stock market concern (of a monetary policy error through overtightening) by stating that the US central bank would take a "patient" approach to raising interest rates and to unwinding its post GFC stimulus. This was very welcomed by markets as it coincided with a surprisingly strong US jobs and wage growth data release for December which would otherwise have further fuelled market concerns over further interest rate hikes. In tune with the previous week's market volatility, stock markets rallied by up to 4% on the day, leading to a strong start to 2019 for equity investors.

A strong first week does not make a strong year, but the series of recent upward surge days informs us that we are not alone in judging market valuations as having undershot economic reality as much on the downside towards the end of 2018 as they overshot it at the turn of 2017 to 2018. As we laid out in the last two Cambridge Weekly editions there are many changes and adjustments in train which will continue to cause heightened market volatility, not least because numerous of them depend on political decision-making which has become less predictable in the short term.

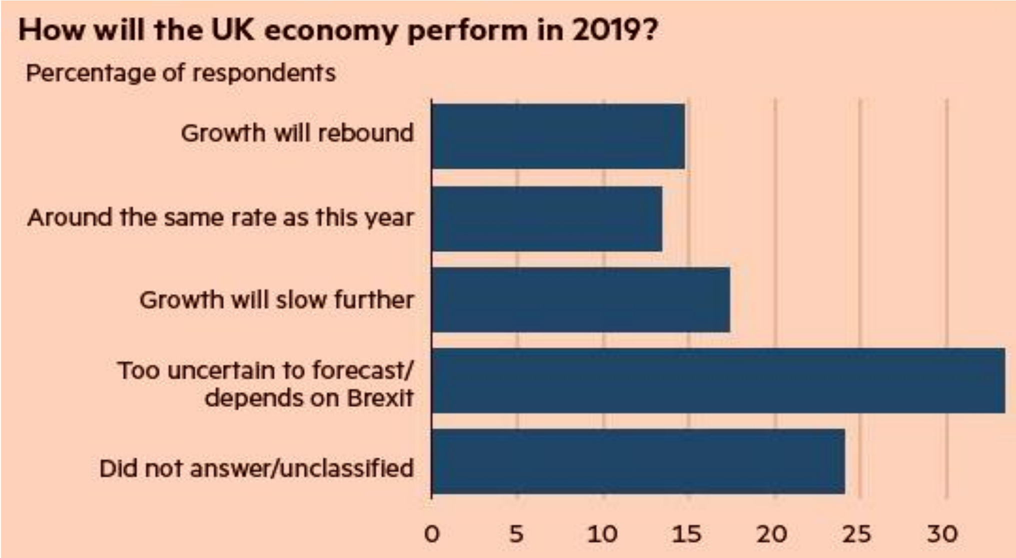
Overall though, the developments since Christmas have provided us with more reassurance that Q4 market action has once again been excessively emotional in light of the likely future path of global economic growth: not back to the 'old normal' as quickly as perhaps anticipated by many a year ago, but nevertheless steady and expansionary – rather than falling off a cliff towards global recession.

Britain in 2019: What the economists say

Economists' expectations for Britain in 2019 are in, and they don't look good. This week, a survey conducted by the Financial Times of leading economists showed they expect Brexit uncertainties to cripple business investment and consumer sentiment over the next year. Wage growth, productivity and all the usual growth engines are therefore likely to be subdued.

It's fairly common these days to say that economists 'got it wrong' before on Brexit, predicting a Brexit-induced downturn after the referendum that failed to materialise. While the extent to which that's true is debatable, what seems to have flown under the radar is the fact that forecasters got it very right last year. Experts polled a year ago predicted GDP growth of 1.5% in the UK, along with a drop-off in inflation and a rise in wages. All those things indeed came to pass.

However, when asked this year, most respondents declined to offer any actual numbers, given the "chronic" uncertainty surrounding Brexit negotiations. What they did say is that Britain's 2019 prospects come in fifty shades of……not good. According to one Cambridge professor, "the outlook is anything from lacklustre to catastrophic, but who knows?" Those that did venture some numbers mostly predict a repeat of last year's 1.5% growth – or thereabouts.



Sources: Financial Times Research, ONS; 2 Jan 2019

Where does that leave us? Those who read our outlook piece at the end of last year will know that we expect some upside in UK assets, which have been so badly beaten by investors that anything better than the apocalypse will be a positive surprise. So, are we expecting a much better 2019 for Britain's economy than others?

Not exactly. Most of the survey opinions seem true enough. The government looks unable to even set a date for a parliamentary Brexit vote let alone win one, and what defeat or further postponement could mean as we draw towards the March divorce date is anyone's guess. This prevents business investment and encourages consumers to save any wage increases that may come their way, removing a vital stimulus from the economy. Many businesses are already drawing up plans for moving abroad. Even in the event of the least disruptive outcome (no Brexit) the government's brinkmanship could have a lasting impact on growth prospects.

The reason we're relatively positive on UK assets despite this negativity is that they are currently trading at values below what even the dourer Brexit outcomes would justify. Mild, barely positive growth this year wouldn't be good, but it would be much better than what is currently priced in by capital markets. Current valuations seem to be pricing in an unrealistic drop-off in activity. Just like with global markets, we think this is more to do with the increase in risk premium (the amount investors expect to be paid for tolerating a certain level of risk) than actual recession expectations.

This means that, once investors realise that Britain hasn't fallen off a cliff, there's a good chance that asset values will rebound, adjusting to lower – but not catastrophic – economic levels. Even if Brexit ends up being harder than we at Cambridge expect, there could still be enough of a rebound to bring confidence back into markets.

Besides, there are silver linings to the Brexit cloud too. Uncertainty has been the biggest thing holding back business investment for the past two years, but sooner or later this uncertainty will have to fade. So, anything other than a crash Brexit (disorderly no-deal without giving businesses time to make preparations) is likely to see business investment increase – if for no other reason than it can't get much lower. And, even though it would bring more short-term uncertainty (from a possible second referendum) a soft Brexit or even no Brexit seems entirely possible at this point.

Even in the event of a positive surprise, however, not all assets are likely to see the same rebound. Companies with large overseas revenues are likely to be stable or better (particularly if sterling weakness continues) even if domestic demand drops off. The same is true for exporters, and particularly manufacturers, who have benefited greatly from sterling's weak value since the referendum.

Domestic-focused companies could come under more pressure, at least until consumer spending rebounds (which could take a while even if we get some Brexit positivity). That brings us to retailers, who have been having a difficult time in recent years and are unlikely to see a change of fortunes. Retailers' issues go far beyond Brexit; they are cyclical and even structural. Even improvements in the Brexit outlook are unlikely to help them too much.

We suspect the same is true for the property market. We have written in the past that there are structural issues holding down property prices that aren't Brexit- related but to do with stretched affordability and wealth inequality. Brexit outcomes will make little difference to these underlying issues, though they could well worsen the effects.

But while there are pockets where low asset prices are justified, in general, prices have fallen below what could be reasonably expected given the range of Brexit outcomes. Of course, downside risks do remain, and as we see it are largely centred around employment. Unemployment has so far remained low in spite of Brexit uncertainties, but if that changes significantly it could be particularly bad. If not, we expect a lacklustre performance from the UK economy this year, but perhaps a better one from UK asset markets.

End of year stock market rollercoaster & other 2018 trading anomalies

Investors expecting 'Silent Night' in markets over Christmas will have got quite a shock. On Christmas Eve, the S&P 500 fell -2.7%, the largest Christmas Eve fall in US stock market history. Perhaps even more surprising, when trading resumed on Boxing Day the index rose 5%, the largest rebound since March 2009. It seems that while everyone else curled up by the fire, US traders frantically rushed to get in last minute trade before the year end.

The size of the moves is undoubtedly unique, smashing the usual festive lull. No doubt for many investors it must also feel pretty worrying. If markets can't even relax over Christmas, what will happen when traders come back to their desks?

Before we get ahead of ourselves, we should remember the roller coaster year we had. A liquidity shortage was one of the main themes of 2018. And illiquid markets can turn on a dime, no matter what the time of year. The Christmas up and down was just the last episode of 2018's market imbalances.

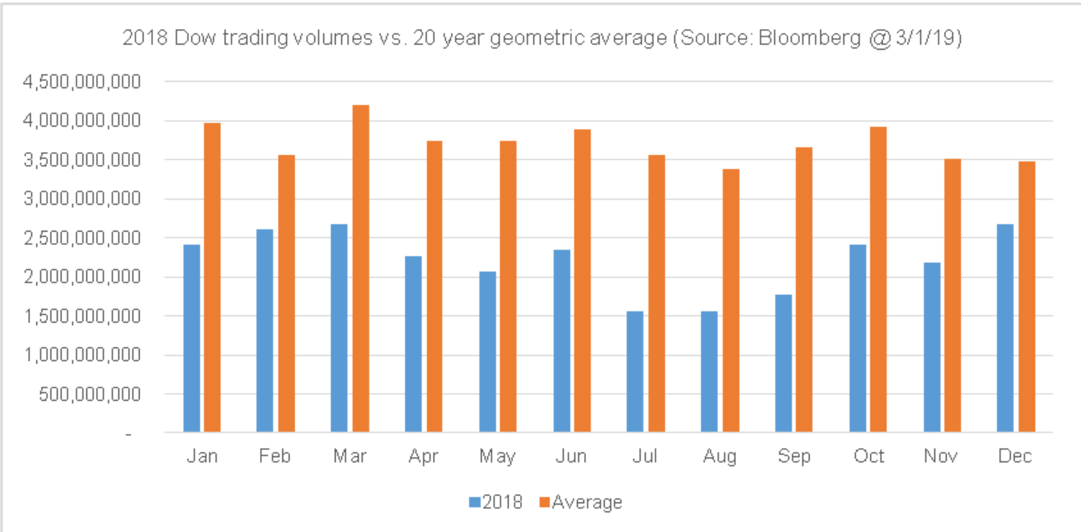
One such imbalance in February 2018 was that the sheer weight of volatility (vol) short sellers (i.e. expecting vol to remain low) seemingly broke the equity vol market. This resulted in a 'flash jump' in the VIX Volatility Index, as those short sellers were caught flat footed and needed to rapidly short cover (buy) vol options and sell equity – the typical inverse relationship. This caused a general rise in vol and greater variation in daily equity price movements than had been seen over the past decade.

Later in the year, we started to see a reversal of the secular growth story for US tech companies. The combination of slowing profit growth for the big tech firms and rising interest rates pressured valuation level as both lead to a shrinking of the value of future cash flows.

It seems the crowd got wise in October/November and reduced US tech exposure, resulting in equity performances more in line with those from around the world.

Underneath these movements has been the gradual withdrawal of central bank liquidity. Quantitative Easing (QE) has morphed into Quantitative Tightening (QT), and this could well cause the next set of trading imbalances.

But central banks aren't the only sources of liquidity. There's also the kind provided by investors themselves. As we have written before, this second kind of liquidity is extremely sensitive to changes in risk sentiment, as investors often pull their money when the market outlook turns negative or just more uncertain. Courtesy of QT, Donald Trump and a reform slowed China that's exactly how uncertainty over future trading conditions increased (Brexit falls into the same category but has little global impact). As the chart below shows, despite all the market movements during 2018, trading volumes are down



overall in comparison to the past 20 years.

The chart above shows the typical trading seasonality over the past 20 years (orange bar), but also how far away 2018's volumes are from the average (blue bar). What's particularly interesting for us is what occurred in the last week of December – typically a quiet time for traders resulting in 'thin' liquidity. US S&P500 trading volumes suddenly spiked on Christmas Eve to over 2.5 billion contracts, well above the average of the past 7 years, leading to the -2.7% drop.

The cause of the fall could be down to year-end investor redemption requests hitting Hedge Funds, who struggled throughout the year (HFRX Index was down 7.3% in 2018). Also, both CTAs (trend-following strategies) and HFs increased shorts over the last few weeks leading to the lowest net equity exposure in three years. According to Nomura, not only are CTAs now net short the S&P500 for the first time in three years, they are also net short developed world equities.

The Boxing Day jump that followed was unprecedented. For the first time on record, 99.8% of S&P500 stocks gained (there are currently 505 stocks on the S&P500), beating the previous 99.6% of stocks gaining (or 498/500) back in 2011. Just a single stock closed red on the day – poor Newmont Mining. All 30 Dow stocks were red on Christmas Eve.

As we have said, low general trading volumes make moves like this possible, as price jumps or falls force investors to cover their positions. It is perhaps not surprising that this kind of move would happen in the US, where traders tend to have less time off over Christmas than elsewhere. But what were the specific reasons?

The spike could be to do with President Trump calling a potential market bottom. This was reminiscent of Obama's comments on 3 March 2009 when the S&P 500 hit the 'Devil's Level' of 666. The resulting rebound led to the world's longest bull run. Echoing his predecessor (in deed but not in style), Trump tweeted "We have companies, the greatest in the world, and they're doing really well. They have record kinds of numbers. So, I think it's a tremendous opportunity to buy. Really a great opportunity to buy."

US officials also removed the looming threat of firing current Fed chair Jerome Powell, noting he was "100%" safe in his position. This eases the government's pressure on the Fed, which could be seen as a positive by markets. Investors may have also taken heart in US oil prices (WTI) having their best day since November 2016, helping push inflation break-evens higher and temporarily reversing disinflationary pressures.

Lastly, there was a great deal of year-end pension fund rebalancing, with funds rotating out of bonds into equity. According to US bank Wells Fargo, there was a cumulative net buy order of $64 bn in the last few trading days of 2018. Wells Fargo said "Some pensions rebalance every month and some only at quarter-end. Since bonds trounced equities both on a quarterly and monthly basis, the flows from the two groups of rebalancers will go the same way. This should amplify the market impact." Adding, "**For now, however, buckle up for what may be the single largest quarter-end pension rebalancing in history.**"

Source: Bloomberg, Tatton IM; 3 Jan 2019

The intraday trading chart above from Bloomberg shows these movements in action. We saw it two days in a row: someone (pension fund rebalancing, as per Wells Fargo's comments) initiates a huge buy programme from around 14:00-14:30 US time. The orders simply overwhelm everything, pushing markets higher.

So, while the Christmas moves may look a little bizarre and frightening, they are still consistent with our overall investment view. Which is: markets oversold in 2018 and valuations are now below what is justified by the global economic outlook. We do see signs of slower economic growth and an increase in recessionary risks should the US/China trade wars remain unresolved. But there is little evidence of a looming crisis – which current market levels seem to suggest.

This recent downside imbalance will likely cause investors to begin reassessing valuations and some to eye selected opportunities. Companies will start releasing quarterly earnings for Q4 2018 in a few weeks, so that data will provide a good indication of future market direction, and we believe there will be more pressure from businesses to push politicians to resolve trade wars, which could ignite further upward pressure.

Bulls kept calling ever higher market targets in September and now Bears are looking for ever lower targets. It might be best to take a step back and conduct a sober analysis of current and future market conditions relative to the reality of the actual economic environment and resultant corporate earnings. Remember, imbalances never last.

China's short-term pain for long-term gain

2019 will bring "opportunities and challenges" for China, according to President Xi Jinping. In a new year's address broadcast on all major state media, the President reaffirmed China's commitment to reform – as the country marks its 40th year since reform began. Without mentioning the trade war with the US or China's ongoing economic slowdown explicitly, he promised that "the door to opening up will widen further."

While the speech was light on details, the message was relatively clear: short-term economic concerns don't outweigh the government's long-term goals. The most eye-catching of these goals for western media is China's relationship with Taiwan, on which Xi spoke of the inevitability of reunification and reserved the right to use military force to deal with foreign interference. But perhaps more significant are Beijing's structural economic changes.

Throughout 2018, their crackdown on the shadow banking sector and attempts to unwind China's burgeoning credit bubble took their toll on the economy. Regulated financial institutions were not equipped nor, despite a lot of pressure from government, did they want to take up the shortfall in lending. The cost of credit rose and lack of available finance led many companies to struggle and some to default. As we described at the time, soon enough the economic slowdown became self-sustaining, and posed a serious threat to Beijing's growth targets.

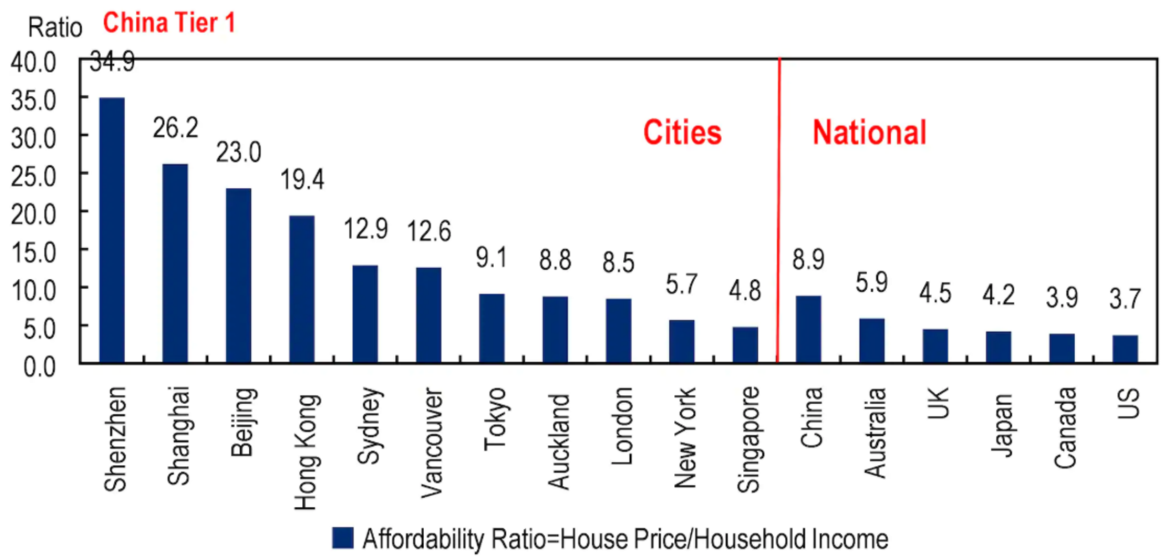
In recent months, the state has eased policy somewhat in response. The People's Bank of China (PBoC) cut banks' reserve requirement ratios while central and local government (fiscal) stimulus measures have also been announced. Authorities seem to be trying especially hard to encourage lending to small and medium size private businesses – many of whom previously relied on the shadow banking sector. Just this week the PBoC announced changes to their lending rules that loosened the definition of small businesses, while one of China's leading economic policy councils is reportedly planning measures to boost private consumption.

But we have warned before about overestimating the scale and effects of these short term stimulus policies. While Beijing's measures are genuine, they fall short of the full-fat package we saw in 2015/16 – when a similar slowdown prompted the government to pump vast amounts of money into the economy and boost growth (in China and globally) substantially. It was that episode which pushed China's credit pile to bubble proportions. Authorities simply can't afford to do it again.

The new year's comments from Xi back up this assessment, as do similar pronouncements from the PBoC and the NDRC. While placating the populace with economic growth is greatly important to the government, making the economy more stable and self-reliant seems to be the priority. The latter is particularly true in the face of Trump's trade wars and a potentially shifting global economic order. The message from Beijing seems to be that China should take its medicine now and just bear the pain. In return, the long-term benefits could be substantial.

In particular, central government wants property prices to stagnate. Official state media The People's Daily wrote this week that China's regional economies need to end their reliance on the property market for growth and focus on sustainable development. This is significant, given that property prices in China have a big effect on consumer spending (mostly, we think, through the balance sheet effect – i.e. feeling wealthy or poor based on the paper value of one's assets). Affordability has become extremely stretched over the years, particularly in the big tier 1 cities (see chart below). The government has put in place measures to address this over the past two years which have had some impacts. However, the total sales of China's top 100 real estate developers soared 35% last year, according to private research firm CIRC.

Affordability Ratio Comparison 2017



Source: Ehouse for China(2017H1), demographia (2017) and Citi Research

Beijing is concerned that local governments and cities are continuing to look for rapid expansion and have grown their property markets too quickly, at the expense of new industry development. A number of cities have been hoping for a relaxation of constraints but, if anything, central government is likely to impose greater restrictions. That structural change could well be beneficial further down the road, but it's undeniably a negative for short-term prospects.

Reform of the banking sector and further unwinding of the credit bubble is arguably the larger priority. While the PBoC is trying to encourage more lending for small enterprises, it's unclear how successful this will be. This is partly due to the fact that rising default rates have made banks terrified of their own loan books, but it's also due to Chinese banks' structural inability to risk-price loans as is standard practice in the rest of the industrialised world. Neither the regulation nor internal bank infrastructure are there for lenders to price loans according to risk, meaning that many just deny credit to smaller businesses. Changing this will likely be a top priority, but it will take time. In the meantime, Beijing's eagerness to encourage this smaller lending isn't the same thing as actually being able to do it.

Financial assets are unlikely to benefit from all this, in the short term at least. Some measures, such as the tax cuts, could boost consumption enough to ameliorate the worst outcomes. But overall, it's hard to see this as a big positive for China's capital markets. There will be some stimulatory effects for sure, but those hoping that China will bail out the global economy again will be disappointed.

We wrote a year or so ago that the Communist Party's whack-a-mole approach to economic problems was not likely to be effective in the face of large structural issues. And through the course of 2018, the government's approach has become less short-term reactive and more focused on addressing the big issues. Structural reform is now the name of the game.

For the rest of the world, China's move away from ever-increasing infrastructure spending and export-led economy towards a consumption-based economy will have impacts. The emerging market commodity producers may see declining demand. For the developed Western world, the opportunity to supply finished high-end consumer goods and services will grow - if trade deals will allow.

CAMBRIDGE
INVESTMENTS LIMITED

7th January 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	6837.4	3.8	252.7	↗
FTSE 250	17795.9	4.1	705.4	↗
FTSE AS	3733.6	3.8	137.5	↗
FTSE Small	5204.3	2.3	115.3	↗
CAC	4737.1	3.0	138.5	↗
DAX	10767.7	1.3	133.9	↗
Dow	23297.5	0.7	158.7	↗
S&P 500	2517.4	1.1	28.5	↗
Nasdaq	6385.0	1.5	96.7	↗
Nikkei	19562.0	-3.0	-604.2	↗
MSCI World	1853.2	-0.5	-9.2	↗
MSCI EM	949.6	-0.3	-2.8	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	15.7x	11.6x	13.2x
FTSE 250	3.8	19.8x	12.0x	14.1x
FTSE AS	4.6	16.5x	11.6x	13.3x
FTSE Small	4.1	-	8.7x	13.9x
CAC	3.7	14.6x	11.7x	13.4x
DAX	3.3	11.9x	11.4x	12.5x
Dow	2.4	15.5x	13.9x	15.0x
S&P 500	2.1	17.2x	14.7x	15.8x
Nasdaq	1.2	21.0x	17.3x	17.8x
Nikkei	2.2	13.5x	14.1x	20.0x
MSCI World	2.8	15.3x	13.3x	15.2x
MSCI EM	3	11.4x	10.6x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Next	11.4	NMC Health	-2.7
John Wood Group	11.1	International Consoli	-2.3
Ocado Group	8.9	Reckitt Benckiser	-1.1
Schroders	8.2	Hiscox Ltd	-1.0
CRH	7.5	Diageo	-0.9

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.27	0.30	OIL	57.3	9.9
USD/EUR	1.14	-0.31	GOLD	1285.6	0.4
JPY/USD	108.32	1.80	SILVER	15.7	2.3
GBP/EUR	0.90	0.61	COPPER	264.4	-0.9
CNY/USD	6.87	0.14	ALUMIN	1835.0	-3.1

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.276	0.6	0.01
US 10-Yr	2.646	-2.6	-0.07
French 10-Yr	0.699	-1.5	-0.01
German 10-Yr	0.208	-14.1	-0.03
Japanese 10-Yr	-0.038	-1366.7	-0.04

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.

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