THE **CAMBRIDGE** WEEKLY

18 March 2019

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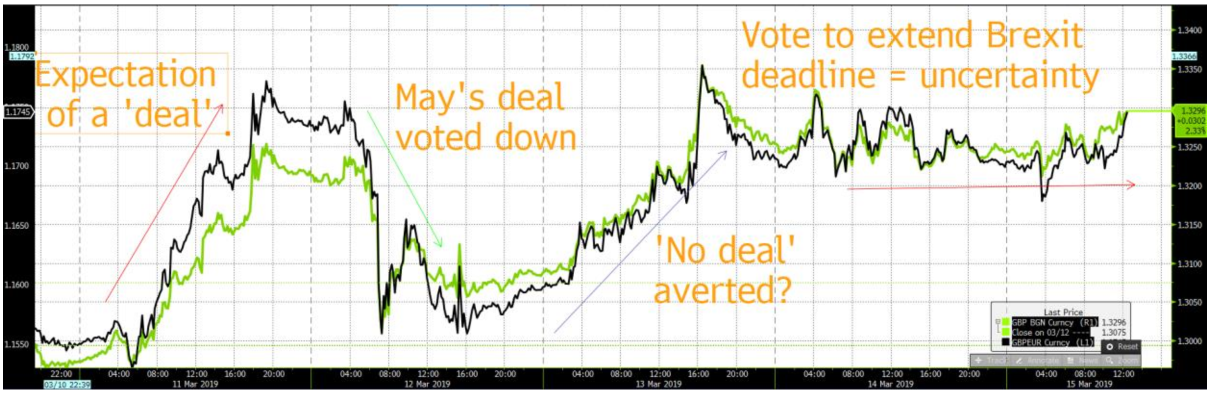


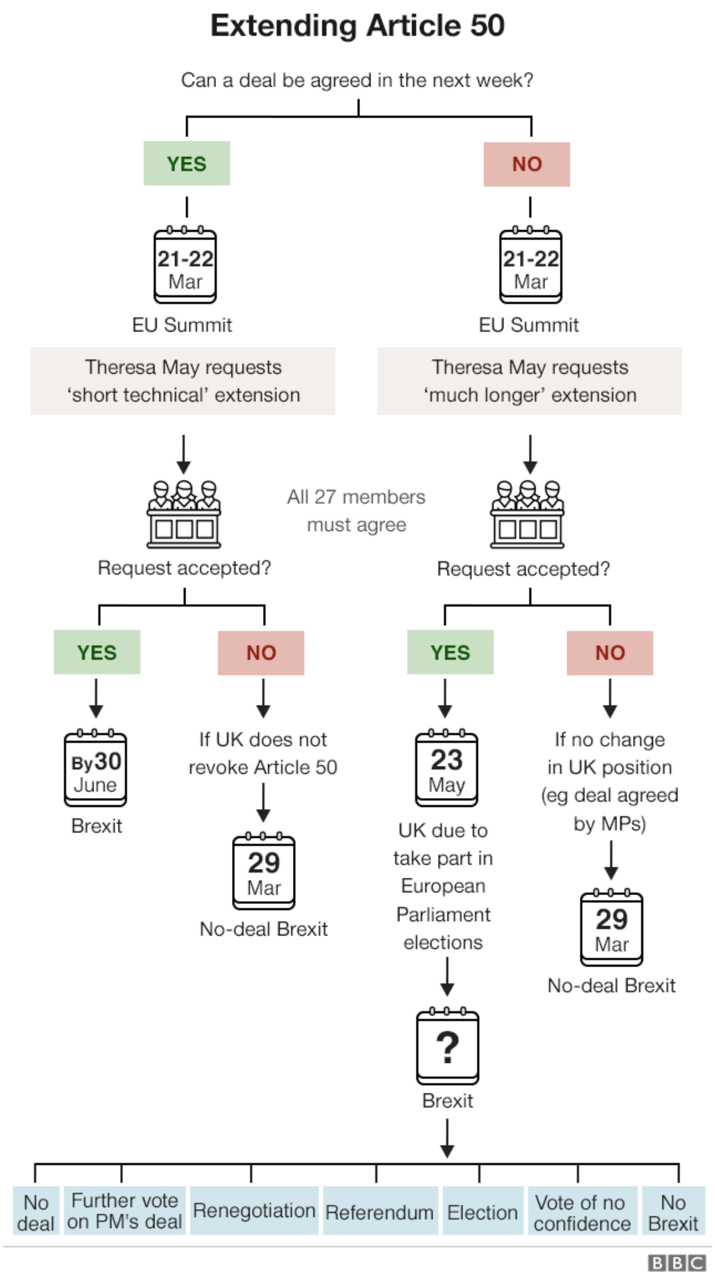
Source: GBPUSD (Green)/GBPEUR (Black) Bloomberg 15/3/2019

Bits & pieces

The febrile state of UK politics and its journalists might get you thinking that the UK markets were expiring as fast as the Brexit deadline. Certainly, there's been a bit of to-ing and fro-ing in the currency market although the moves were miniscule in comparison to the aftermath of the referendum (or the leaving of the exchange rate mechanism in 1992).

The events of this week seem to have been forecasted rather well by many; for months now the consensus central scenario has been a soft Brexit agreement with a delay in implementation;

The possible scenarios depend firstly on "Meaningful Vote 3" (MV3 as it has come to be called). Here's a helpful graphic from the BBC:



https://www.bbc.co.uk/news/uk-politics-46393399

The "Yes followed by yes" path or the "No-yes" path are the market's bets. Despite many words being expended on a possibility that the EU leaders would not be happy with an extension, it's unlikely that they would want to be cast as the authors of a no-deal exit.

Just like many 3rd movies in a series, MV3 has the same plot with the same lead actor as MV1 and MV2 and the markets think the twists will still end up with Liam Neeson winning.

A possible twist might be that any further sequel has a different lead actor.

A vote against MV3 would leave Theresa May in ostensibly the same position as before but with her party-political capital spent. She's been showing signs of leader-exhaustion (isolation from her own natural support) and we think MV3 failure might end her tenure. The Conservative Parliamentary Party has a hard-Brexit majority so a new leader would probably be of that hue, and May would find that difficult. At the same time, May's energy remarkable sense of duty might not be enough. Indeed, her other characteristic, dogged self-belief has been under siege since she failed to get any movement from the EU.

Sterling has been the clearest barometer of the market's Brexit assessment and we end the week with the Pound at a high. There are several reasons to think it may go higher, but we point out below that, as well as several dangers in the no-yes scenario, the UK's economy was not in the best of shapes before the Referendum. Whatever the outcome, the drama has impaired the economy further. Further upside for sterling is probably limited from here no matter what happens next.

Interserve did not gain shareholder support for its rescue plan and has gone into administration. It will operate "as normal", but extended administration is very difficult for an employment-intensive firm, especially one which has a problem finding suitable labour in a tight market. This also pressurises the buyers of its services. The Brexit issue may not be the only crisis for the government to have to deal with in the next few weeks.

Away from the UK, everything looks rather stable in markets. Equities have headed higher despite weakish data (mostly from China where industrial growth moved down to +5.4% year-on-year, significant in that a 6% floor was an article of policy until the recent congress). Everybody seems to be betting that global monetary and fiscal policy authorities are either at the point of reacting to weakness or have already begun.

Financial conditions have eased substantially, with the Fed leading the way in signalling dovishness. This has fed through to an increase in dollar-based lending across the globe, US broader monetary measures starting to expand, and funding signals like cross-currency basis swaps being at the easiest point in months.

All well and good. But.

We're getting back to valuation levels which look less good. Not bad, just not good. Meanwhile, the markets have gone back into "goldilocks" comfort territory – a dovish view of policy reaction functions amid soggy economic data. It's helped by the earnings report hiatus, the mid-month pause in economic data and strong fiscal year-end retail flows into ETFs.

A weakening in rhetoric coming from the US-China trade negotiation parties and a delay in a summit suggest we could be heading for a bit of a wobble over the next week or two.

Sterling and UK housing

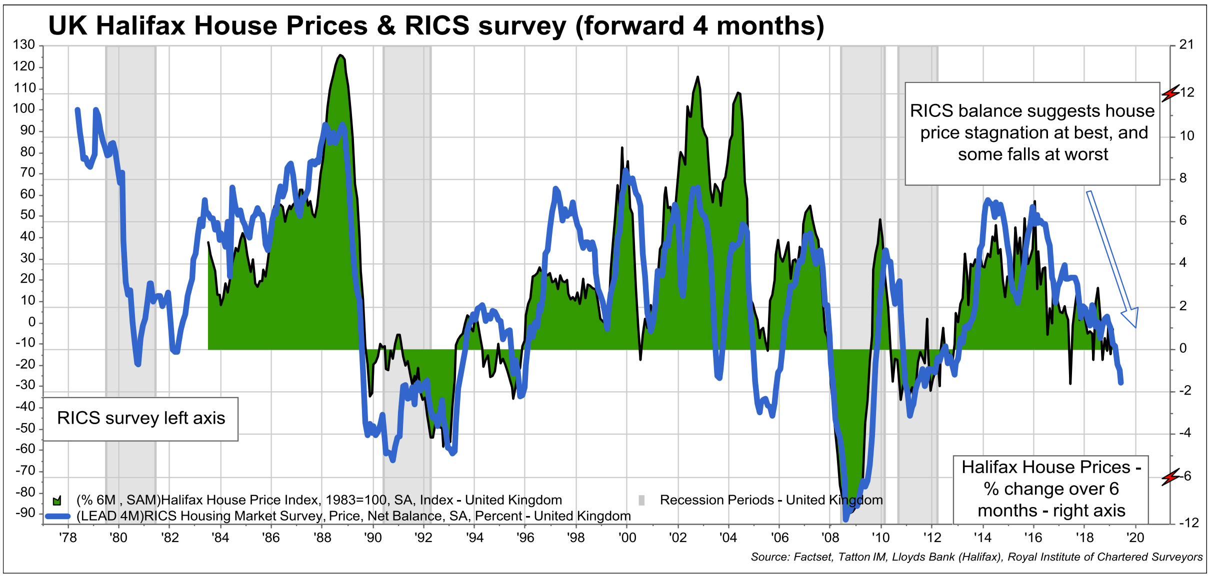
It's been another roller-coaster week for £-sterling. Of course, this won't surprise too many people given British politics over the last few days.

The narrowly-passed amendment 'blocking' a no-deal exit sent the value of £-sterling to a 9-month high against the dollar and a 2-year high against the euro (the £/€ chart has a 1-year horizon). Some of those gains were taken back on Thursday, with sterling falling 0.8% on the dollar, but the message from capital markets is clear: softer Brexit means higher sterling. Again, that should surprise no one. It's no exaggeration to say that Britain's currency value has been almost exclusively determined by its European divorce proceedings since before the referendum was called. But in our office, it has raised an interesting question: just how big is the pound's Brexit discount?

The argument that sterling is undervalued is straightforward. Brexit uncertainties plague the economy, holding back investment and depressing UK assets. If those uncertainties go away and natural investment levels return – and if Brexit ends up being so soft, we hardly feel it – we should expect a similar boost to the value of sterling. This is a fair point; markets undoubtedly have a Brexit bias against anything with a pound symbol in front of it.

But if Brexit disappeared tomorrow, would exactly would a fair equilibrium price for UK assets (and UK currency) be? It's no secret that the Brexit circus has already damaged Britain's economy, as many projections and GDP figures have already shown. It's hard to tell how much of the economy's poor performance is Brexit-related and how much isn't (indeed the distinction might seem a bit silly) but one area we can say with some confidence has taken a hit from Brexit is the housing market.

The latest survey from the Royal Institute of Chartered Surveyors (RICS) shows a continuing compression of house prices nationwide – a trend that has been going on for the last couple of years. RICS are forthright about how Brexit has affected the market. And yet, underneath the short-term impact of Brexit, there is a more significant story about housing. As we have written before, the biggest issue for house prices (both in the UK and across the world) is that affordability has become extremely



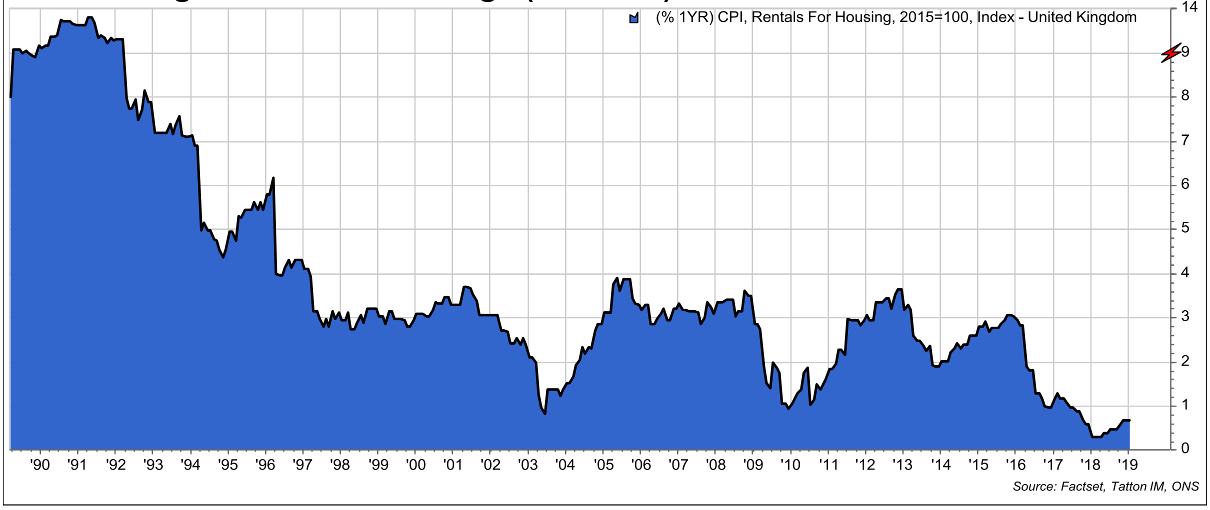
stretched, with decades of high price growth and much lower wage growth leaving property out of reach for many would-be buyers.

This is a structural issue. From the 1990s until now, labour compensation has grown more slowly than household net worth. Those who built up savings, especially in property, saw a healthy expansion of their balance sheets. Lower interest rates meant they could also leverage what they already had to buy more. Potential buyers are skewed towards the younger groups as they start families. Relatively this cohort has been less well paid particularly when the impact of student debt repayments is considered.

Meanwhile, the demographic effect of the aging of the baby-boomer group works the opposite way – houses being sold to fund retirement and other liabilities. House prices must fall to match what they can afford (particularly if circumstance forces owners to sell).

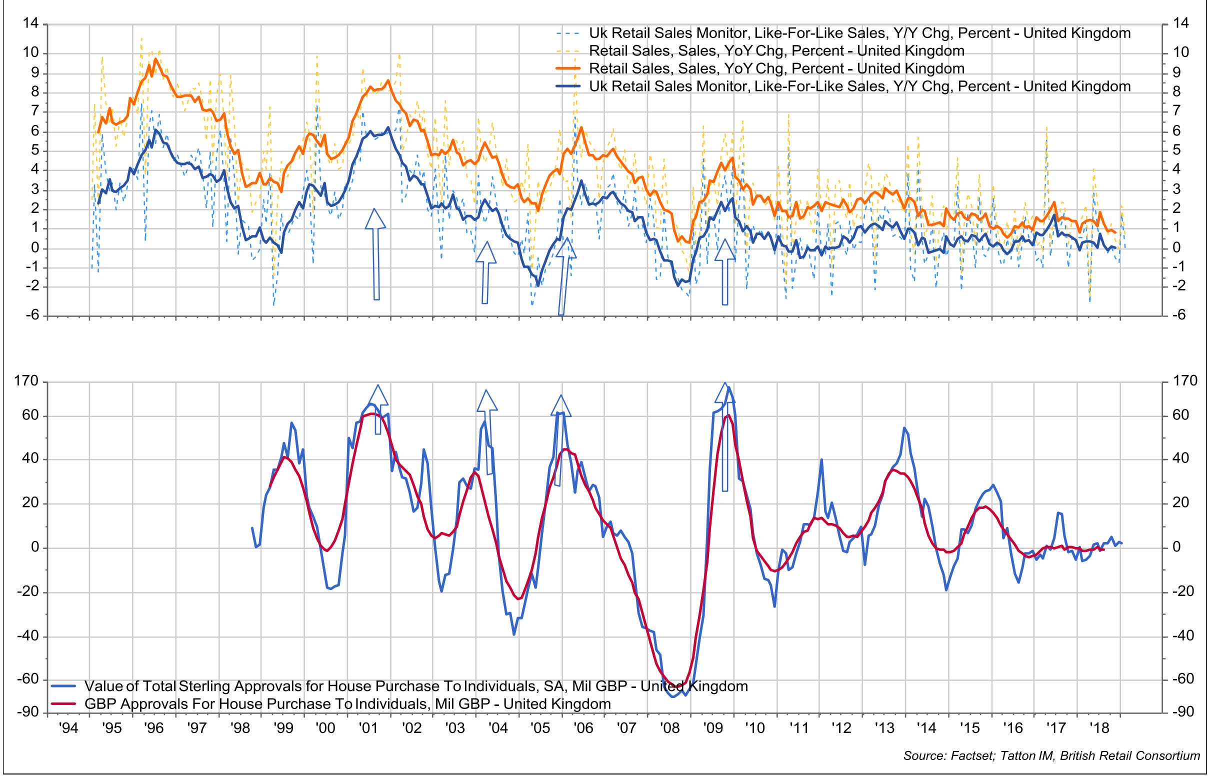
Lastly there's the lagged effect of low interest rates which created a "buy-to-let" splurge, with savers looking for assets with a (optically) high yield, spurred on by the view that property prices don't go down in the long-term and that there will always be tenants. Actual rental growth has also stagnated:

UK Housing - Actual Rent Change (from CPI)



Property price stagnation has a wide effect on the UK economy. British consumers have notoriously low savings rates. Because houses are assets that can be borrowed against, house price growth has had an oversized effect on consumption, as improving balance sheets make consumers feel they've got more savings and stability. We can see this effect in how consumption levels tend to rise and fall in line with mortgage approvals – which have incidentally flatlined since 2016.

UK BRC Sales Indices and Mortgage



Debt-fuelled or asset-backed consumption is also one of the main reasons Britain can run such a high current account deficit (exports minus imports). The UK has imported more than its exported ever since the 1980s, and in 2016 we had a record trade deficit of 5.8% of GDP. For reference, the US trade deficit that prompted Donald Trump to wage trade war is only 2.4% of GDP.

It's entirely possible to run a large current account deficit, even over a long period. But with falling investment (due to Brexit) and reduced consumer balance sheets (from falling house prices and stagnant real wages) it's hard to see how a gap of this size is sustainable. It's telling, for example, that in 2017 Britain's trade deficit fell to 4.1% – prompted by a much weaker currency. Weak sterling (particularly against the euro) gave exporters a price boost while putting off imports. In effect, Brexit has already helped rebalance Britain's economy away from demand-led to export-led growth, regardless of the eventual outcome. Arguably, it's a rebalance we needed.

It's also interesting that recent sterling strength has caused the trade deficit to widen again. We'd see this as indicating sterling quite close to an equilibrium level – and may be over it. From this perspective, sterling isn't undervalued at all, and may well be overvalued when considering just the trade fundamentals.

Of course, lots of things influence currency values; not just trade. Another reason the UK can run a large current account deficit is that we have a high level of inward investment. Sans Brexit, some of that would return for sure. And that means any move toward a soft or non-existent Brexit will almost certainly see a short-term bump for sterling. But it's not a given that all that investment would return. And even if it did, it may not be enough to settle the nation's balance of payments. A further move down for sterling could be the only way to do that. Say it quietly, but sterling may not be as cheap as it looks.

UK Inflation – shopping basket

This week saw the annual review of the "shopping basket" used in compiling the consumer price inflation index in the UK.

Consumers are directly affected by inflation of course. And there's many goods, services, and payments which are hard-wired to rise by an amount linked to inflation (or at least that's what the suppliers might like us to accept!); rail fares, mobile phone contracts, pensions for example. The Bank of England's goal of maintaining price stability is framed as 2% per year based on the consumer price index (CPI, more on this later).

Inflation may be a common-sense concept but defining it and measuring it is quite difficult. One problem is "substitution" – if the price of a rail ticket goes up, many people will drive instead. Another is "hedonic adjustment" or the accounting for quality changes; an OLED 4K Smart TV may cost more than an LCD standard definition TV but it's a better thing. On the other hand, no branch of Curry's will stock the latter anymore so the buyer of a simple TV may be forced to pay up for unwanted improvements. (Sometimes it's the other way round – tomatoes definitely tasted better when I was a kid!). Representative sampling is not easy; should goods be included in the assessment which are bought only occasionally such as TVs, or that not everyone can afford?

The measures themselves can differ. The consumer price indices have several different measures, CPI, CPIX and CPIH. CPIX is known as "core", which excludes food and energy from the main basket. CPIH goes the other way; CPI plus housing costs such as mortgages and rents, and council tax. These measures are consistent in methodology and calculation, being geometric and the Retail Price Index (RPI) which is a legacy measure which continues to have to be reported because of its use in long-term contracts, most importantly pensions and index-linked gilts (government bonds).

Undoubtedly though, you do need to start somewhere, to define a basket of goods and services, and monitor them assiduously. Currently the CPI index takes account of 180,000 separate price quotations collected every month covering around 700 representative consumer goods and services. These prices are collected in around 140 locations across the UK.

This year the basket has seen 16 items added whilst others have been modified. The changes include (in the technology subsection) the addition of a smart speaker, such as the Amazon Echo or Google Home; bakeware gets a nod, which the Office of National Statistics (ONS) reports has seen increase in spending possibly due to the success of various cookery programmes. Flavoured teas have been introduced, envelopes have been removed.

Beyond the additions to represent distinct sections the index has also added items to diversify the range of products in collected groupings. For example, an electric toothbrush has been added to improve the representation of electrical appliances in the personal care class. Other items have been introduced as a direct replacement, dinner plates have replaced crockery sets. Dog treats have been added in place of dry dog food, washing liquid or gel to replace washing powder and wheel alignment services replacing brake-fitting.

As for the actual path of inflation, during the last year we've seen CPI fall from 2.7% in January 2018 to 1.8% in January 2019. There are many, including some on the Bank of England's monetary policy committee, that see a rebound particularly if Brexit issues dissipate. Labour markets look tight which could cause wages to rise and rising oil & commodity prices could contribute to a resurgence in CPI.

A recent downswing in global inflation looks to be firmly centred around the Chinese slowdown, and that slowdown shows signs of reversing now. Meanwhile Japan's consumer price data this week made for interesting reading. For the first time in nearly three decades, Coca-Cola Japan is raising prices, Nissin cup noodles have seen a price increase of 4.8% (seriously large) and Starbucks Japan has raised its prices for the first time in eight years due to higher prices of milk, coffee, wages and distribution. These rises have not yet filtered through to official Japan CPI data, but it's clear that Japan has moved out of a deflationary environment. If the same drivers are seen in the UK CPI could rise and see a further squeeze on UK consumers.

The review did not deal with or propose adjustments to the old Retail Price Index. It has been known for a long time that this old measure was flawed when applied to rates of change (it's an arithmetic average, not a geometric average). The UK Statistics Authority has pointed out that these flaws cause a consistent overstatement of inflation. On average, the RPI year-on-year inflation rate is 0.7% higher than the CPI measure for the same basket of goods with the same price changes.

RPI remains in widespread use (as mentioned before), including for in long term contracts and the pricing of around £411bn of inflation linked bonds. This has caused problems for pension providers who feel that they have been forced to over-compensate older scheme members.

The most recent criticism came in January from the House of Lords Economic Affairs Committee. The published report did not hold back in its remarks noting that that those who hold RPI linked government bonds have received a windfall from taxpayers potentially of £1bn a year, whilst commuters, for example, have lost out as train fare increases are linked to RPI. The Lords report also took a dig at how inflation data is selectively implemented using the lower CPI when it comes to pay outs such as wage growth and the higher RPI when taking money from individuals such as fares.

Inevitably, the ONS has drawn criticism for failing to address these problems since some feel that a redefinition of RPI would be simpler than trying to change millions of individual contracts.

It appears that this is another can that will be kicked down the road for now - but it is an issue that at some point will need to be addressed.

Basket weightings – Source ONS

CPIH Items	Weightings in basket
Food & non-alcoholic beverages	8%
Alcohol & tobacco	3.2%
Clothing & footwear	5.7%
Housing & household services	29.8%
Furniture & household goods	5.2%
Health	2.2%
Transport	12.4%
Communication	2%
Recreation & culture	12.5%
Education	1.8%
Restaurants & hotels	9.8%
Miscellaneous goods & services	7.4%

30 years of the internet: New firms, profits and where to next

It's an understatement to say that the internet changed the world. 30 years ago this week (12 March 1989), British computer scientist Sir Tim Berners-Lee freely gave the world Hypertext Transfer Protocols (the "HTTP" bit at the start of any web address) enabling everyday users to navigate the new global communications network commonly known as the world wide web.

The history of what would become the internet began in the late 1960s, when Vint Cerf and Robert Kahn created the communication methods that make the internet possible. They built on the foundations of a 1964 paper by Paul Baran at the RAND Corporation detailing the need for a nuclear bomb proof communications network.

Sir Tim originally envisioned an open, free and decentralised system that supported an individual's right to privacy while enabling everyone to communicate. But he now believes the internet has lost sight of those early principles. In an open letter released on Monday, he warned of the "dysfunction" of today's internet.

Among his key concerns are that competition and innovation is being squeezed out by the growing dominance of a few players like Google and Facebook who run 'walled gardens' or ecosystems that users operate in.

Dubbed 'surveillance capitalism', firms can make supernormal profits by encroaching on a user's privacy (Facebook & Cambridge Analytica come to mind), knowing what each person says or does online and serving them ads based on their activity. Arguably, such a system incentivises the spread of misinformation ('fake news' or 'clickbait') an ever-growing problem today.

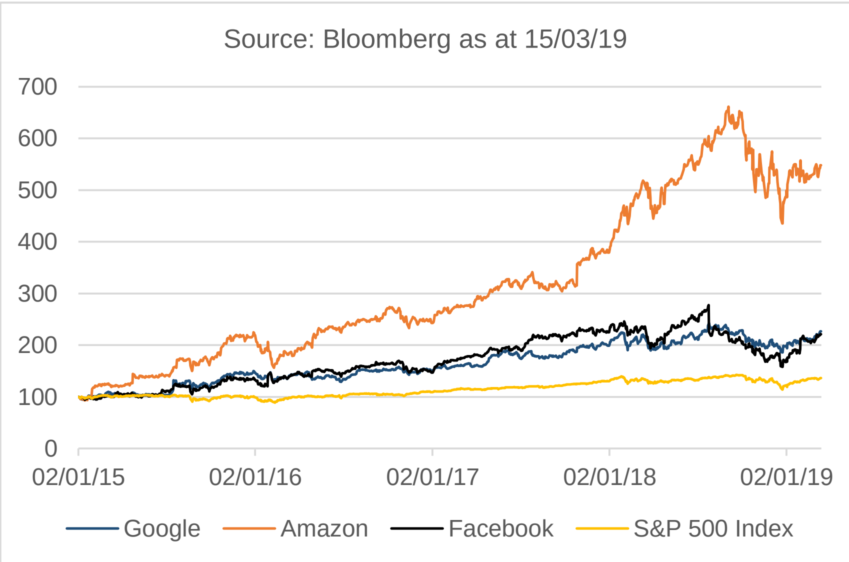
Exciting new innovations and potential competitive threats are quickly purchased or absorbed by the dominant players. While this provides these start-ups with access to capital to develop their technologies, it potentially limits wider adoption, leaving little for everyone else.

If anyone has doubts about big tech's power, then a few facts and figures should help. Each day, 3.7 billion humans generate 2.5 quintillion bytes of data. There are 2 billion monthly active users of Facebook. Google processes over 40,000 searches every second (3.5 billion a day) and 4.1 million YouTube videos are watched in a single minute.

70% of all internet traffic to other websites is dominated by Google and Facebook. Google's Android mobile operating system has an 85% global share. Google's Chrome web browser has a 60% worldwide share. Curiously, its new integrated ad-blocking feature (designed to remove annoying ads) blocks 3rd party ads but not its own. Amazon sells around $260,000 worth of stuff every single second, producing enormous cash flows that can help support other business areas it wants to grow. And the list goes on.

If just two companies control 70% of the traffic and act as gatekeepers – denying access when nebulous "community rules" are breached – then this goes against everything that the internet was meant to be.

Luckily, Sir Tim thinks he has a solution to get the internet back on track: a new "Contract for the Web" and the introduction of PODs (Personal Online Data store). He calls on governments to "translate laws and regulations" into the "digital age", in order to ensure the internet remains "competitive, innovative and open". It seems politicians are now ready to respond, particularly given that users are also voters and are growing increasingly unhappy with big tech on a range of issues: taxes, data use, etc.



It's clear that regulators and the legal system have failed to keep pace with technological developments, leaving new tech firms free to operate with apparent impunity in search of higher profits. Rapid profit growth fuelled large share price rises of 126% for Google, 448% for Amazon and 121% for Facebook, but just 49% for the S&P500 Index between the start of 2015 and 13/3/2019.

Aside from outsized share price gains in web-related tech stocks and wider equity markets over the past decade, investing itself has been revolutionised. Investment Platforms ('Fund supermarkets") made it vastly easier for an individual or their DFM, like us, to invest in a broader range of assets and then monitor their holdings on a real time basis.

The internet has also increased efficiency for financial advisers, enabling them reach and help more clients plan their financial futures. The web also enabled the creation of platform-based discretionary fund managers, who can adjust client portfolios and rapidly respond to changing market conditions.

The current configuration of the web's ecosystem only advances the business models of the dominant players, but this is now under increased regulatory scrutiny. The Facebook affair (Cambridge Analytica data misuse) and other such events could lead to new privacy laws, such as GDPR, that limit the amount of information a firm can collect about an individual and what it can do with that data.

This could have a negative impact on technology company valuations, especially if they can't use a person's data to generate continued rapid profit growth and higher potential costs from any regulatory/legal changes.

But these changes could take time to implement and tech savvy users are already sidestepping big tech. The mysteriously titled 'Dark web' might be a response to the growing intrusion of corporate monopolies in the privacy arena and a way for those looking to return the web to its decentralised laissez faire days.

Users employ sophisticated encryption tools like TOR, which mask an individual's identity and traceable activity to visit dark web sites – ones you won't find via a Google search.

The introduction of the blockchain and Bitcoin in 2009 are further examples of a desire to decentralise. In 2009, futurist and tech-entrepreneur David Siegel popularised the concept of the 'semantic web' or Web 3.0. The 'Pull' Web 3.0 concept turns today's internet on its head, where big tech are the central focus of the internet. The data your web activity generates is stored on their central servers ready to be exploited.

In a Pull world, the individual becomes the centre of their internet and everyone has a digital identity contained and controlled in a virtual wallet. Imagine you need a car insurance quote: today you go to a comparison site and wade through the results. But the semantic web would see you request a quote directly from your wallet and businesses will send quotes back to you making you more time efficient.

The last 30 years has seen the internet generate vast profits for both investors and businesses. But the time may have arrived for the web to adapt to users changing needs – coming full circle back towards decentralisation in the coming years. While this may impact the centralised dominant players of today, it need not limit the fortunes of those prepared for the coming changes.

CAMBRIDGE INVESTMENTS LIMITED

18th March 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7228.3	1.7	124.0	→
FTSE 250	19491.0	2.3	443.4	→
FTSE AS	3968.3	1.8	70.8	→
FTSE Small	5484.5	1.2	65.4	→
CAC	5405.3	3.3	174.1	→
DAX	11685.7	2.0	227.9	→
Dow	25913.7	1.8	463.4	→
S&P 500	2828.2	3.1	85.1	→
Nasdaq	7323.7	4.4	308.0	→
Nikkei	21450.9	2.0	425.3	→
MSCI World	2096.3	2.2	45.2	→
MSCI EM	1048.2	1.8	18.1	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.9	17.1x	12.8x	13.2x
FTSE 250	3.3	22.6x	13.9x	14.1x
FTSE AS	4.6	18.0x	12.9x	13.4x
FTSE Small	4	-	11.2x	14.0x
CAC	3.2	18.1x	13.9x	13.4x
DAX	3.1	14.6x	12.8x	12.6x
Dow	2.2	16.5x	15.7x	15.0x
S&P 500	1.9	18.6x	17.0x	15.9x
Nasdaq	1.1	23.1x	20.3x	17.8x
Nikkei	2.1	15.8x	15.6x	19.0x
MSCI World	2.5	17.4x	15.6x	15.2x
MSCI EM	2.8	12.9x	12.4x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Standard Life Aberde	11.1	GVC Holdings	-7.2
Schroders	8.0	Hikma Pharmaceuti	-4.7
easyJet	7.8	Anglo American	-2.4
Paddy Power Betfair	7.6	Intertek Group	-1.8
Prudential	7.1	Rentokil Initial	-1.8

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.33	2.16	OIL	67.0	2.0
USD/EUR	1.13	0.74	GOLD	1302.8	0.3
JPY/USD	111.50	-0.30	SILVER	15.3	-0.1
GBP/EUR	0.85	1.39	COPPER	290.5	0.4
CNY/USD	6.71	0.11	ALUMIN	1903.0	2.1

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.211	1.9	0.02
US 10-Yr	2.596	-1.2	-0.03
French 10-Yr	0.459	12.8	0.05
German 10-Yr	0.084	21.7	0.02
Japanese 10-Yr	-0.034	-3.0	0.00

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.53
2-yr Fixed Rate	1.73
3-yr Fixed Rate	1.93
5-yr Fixed Rate	2.05
Standard Variable	4.31
10-yr Fixed Rate	2.48

* 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