THE **CAMBRIDGE** WEEKLY

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Lothar Mentel

Lead Investment Adviser to Cambridge

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Bob Moran, 1 Mar 2018, Political Cartoon Gallery in London

£-Sterling 'applauds' prospect of Brexit delay

The last week of February was void of significant economic or monetary market drivers, which left global investors to observe the political news-flow. The US President and UK's Theresa May were therefore quickly identified as the cause of the two more significant market actions: The UK's £-Sterling rallying to levels not often seen since the fateful Brexit referendum in 2016, and China's stock market recording a 6% advance on Monday which propelled it decisively into bull-market territory with its near 25% gain since January.

The jump in the UK's currency is renewed evidence of how little capital markets are looking forward to the UK leaving the EU. It took no more than the mere prospect of a temporary delay of the Brexit date to lead to an appreciation of everything priced in £-Sterling. Although most probably it was a combination of an even lower probability of a No-Deal Brexit and an expectation that any delay will lead to softer-than-anticipated terms of divorce. What is not so clear is whether market participants realise (and have therefore priced in) the fact that even if the May government's deal was somehow passed by a majority in Parliament, uncertainty over the eventual terms of trade would remain during the two years of ensuing trade negotiations.

The appreciation of the UK's currency and thereby national worth is a welcome sign of approval from international capital markets that most of the UK's political class now appears determined to avoid a disorderly Brexit. However, the negative effect it had for UK- based investors put a slight final week dampener on otherwise quite favourable February asset returns as shown in the table below. As the value of the domestic currency rises, the value of any holdings in other currencies has to necessarily

decline. Unfortunately, this also holds true for many of the UK's largest stock market quoted companies as much of their ongoing revenue is generated outside the UK. In what was otherwise a quiet and unremarkable week in the main global markets, we saw the value of the UK's FTSE decline, as did investment portfolios (in £-Sterling terms) with investments overseas. But as the table below illustrates this was not enough to reverse the overall positive trend of February which thereby marked the second month in a row with positive returns. Not quite enough to erase the 2018 disappointment, but at least

Asset Class	Index	February	YTD	2018	12 months
Equities	FTSE 100 (UK)	2.3	6.0	-8.7	2.1
	FTSE4Good 50 (UK Ethical Index)	1.5	4.3	-9.2	0.2
	MSCI Europe ex-UK	2.2	5.2	-11.9	-5.9
	S&P 500 (USA)	2.1	6.7	1.6	8.4
	Nikkei 225 (Japan)	-0.4	0.9	-2.2	-1.8
	MSCI All Countries World	1.5	6.2	-6.4	0.4
	MSCI Emerging Markets	-0.9	6.9	-11.5	-7.8
Bonds	FTSE Gilts All Stocks	-0.9	0.2	0.6	2.5
	£-Sterling Corporate Bond Index	0.2	2.3	-2.2	1.9
	Barclays Global Aggregate Bond Index	-1.7	-3.3	4.9	3.0
Commodities	Goldman Sachs Commodity Index	2.7	8.3	-8.5	1.0
	Brent Crude Oil Price	7.8	18.0	-14.5	6.1
	LBMA Spot Gold Price	-0.9	-1.0	5.0	4.0
Inflation	UK Consumer Price Index (annual rate)*	-	-	2.1	2.2
Cash rates	Libor 3 month GBP	0.1	0.2	0.6	0.7
Property	UK Commercial Property (IA Sector)*	-	-	2.9	2.4

taking risk assets back to levels which will turn many 12-month views positive.

*Source: Morningstar Direct. * to end of previous month (31/01/19). All returns in GBP as per 28 Feb 2019*

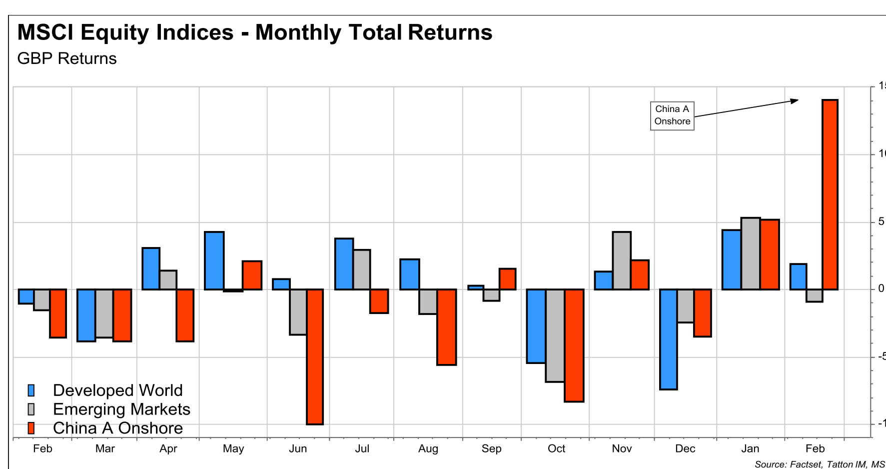
As for US politics, there are increasing signs that President Trump will push for a trade settlement with China in the near term, even if that means a compromise here or there. It was perhaps because this potential success story was within his grasp that he was willing to play hardball with North Korea's leader and dictator. While both sides were keen to dampen any fears that the failure of these negotiations would return the world swiftly to the geopolitical tensions of a year ago, India and Pakistan did everything to remind the world that the Korean peninsula is not the only military hotspot on the planet. With India in the midst of a national election campaign this is certainly one to be watched, especially as the slowing Indian economy will deprive the governing party of a strong base from which to promote its re-election.

After two months of positive returns, but also persistently slowing global growth momentum, it is reasonable to expect that March will see the return of increased levels of market volatility. Following the recovery rally and with reducing expectations of future corporate earnings growth there is now less upside in equity markets. What is therefore needed is some positive news which will brighten the

economic horizon once again. The past week's upward surge in both the Chinese stock market as well as the UK's £-Sterling provides evidence that market sentiment is receptive to a more positive political narrative. With global economic conditions in 2019 proving much more stable than expected at the end of last year, one has to hope that politicians understand and grasp their potential for a positive impact on near-term economic prosperity and begin to act more constructively than of late.

Insight: China's Bull market drivers

It has been a good year so far for Chinese markets. After the dramatic twists and turns of developed world equities over the past few months, the world's second largest economy fell off many investors' radars. We had a holiday, then they had a holiday. It turns out Chinese equities have had a holiday too. The CSI 300 index – containing the largest stocks on the Shanghai and Shenzhen exchanges – is now up around 24% from the lows seen in early January. For the month of February alone, China's onshore A shares (as measured by MSCI) returned 14% in £-Sterling terms (as shown in the chart below).



That puts Chinese stocks firmly into bull market territory, defined as a 20% gain from trough to peak, as well as making it the best-performing regional equity market this year. The CSI 300 broke that barrier on Monday, after a sensational day of trading saw it bump up 5.9%. The trigger for the rally, according to the financial press, was Donald Trump. On Sunday, President Trump tweeted that his administration would postpone the scheduled tariff increase on $200bn worth of Chinese imports, citing "substantial progress" in trade talks. The tariff hike, which was planned for March 1st, will now be suspended "until further notice" according to US Trade Representative Robert Lighthizer.

But there is far more to China's story than Trump. The President's announcement no doubt soothed some investors, but a softer position from the White House was arguably already reflected in prices. And besides, those who think this latest gesture means we have a clear path to a trade deal still do not understand 'dear Donald'.

In any case, while trade optimism may have been a catalyst, Monday's surge seems to be part of a far bigger reaction. Even equities in sectors completely unrelated to trade increased as much as 5%, and trading volumes for the CSI 300 rose to their highest levels in almost a year.

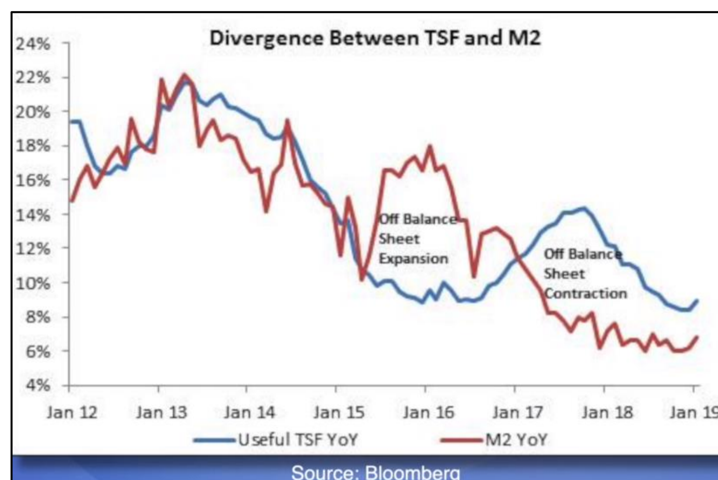
This paints a very different picture to last year. China's economic slowdown and market decline was one of the main investment themes of 2018. What began as a government crackdown on shadow banking and an attempt to deleverage China's credit-gorged economy, eventually became a drastic tightening of liquidity, which caused – for Chinese standards at least - a dramatic slowdown in the underlying economy. That slowdown worried officials in Beijing, who have since rolled out multiple monetary and fiscal stimulus measures to try and get China's growth engines roaring once more.

On the monetary side, the People's Bank of China (PBoC) last month injected a record amount of liquidity into the financial system. The official story was that the money was needed to keep up with demand during the busy Chinese New Year holiday period. But even taking seasonality into account, the PBoC's liquidity injection was huge. The government also has tax cuts and other stimuli on the way, and the PBoC has now removed the word "neutral" from its policy description. None of this looks like a government trying its hardest to deleverage the economy.

The fact these measures (especially the bank's liquidity injection) have coincided with an incredibly sudden bull market surge might make you think China's equity moves are all about liquidity. But that is also not quite the whole story. According to research from Citi (the US bank), the expansion in Chinese liquidity is a mirage. While total social financing (TSF) has indeed risen, TSF is not, well, total. Much of the liquidity previously provided by the shadow banking sector (which has dried up after the government's crackdown) is not even included in TSF measures.

Overseas loans in 'hard currency' and domestic wealth products are not included either. And all of these have been hit hard by increased regulation over the last couple of years, with overseas financing falling dramatically. This new regulation shifted wealth management products back on to bank balance sheet banks who were already using their full regulatory capital allowances. So, the relaxation of capital requirements we saw last year did little more than allow banks to cope with the shift.

Banks were able to buy up the big increase in local government bonds and thereby provided funding to local authorities, but loans to the private sector did not increase much. Overall, the expansion of on-the-books capital has just about soaked up the contraction of off-the-books capital from the shadow banking sector. Financial conditions remain tight, as shown in the chart below comparing TSF to actual money



supply (M2):

So why are Chinese equities outpacing the rest? For starters, it is worth bearing in mind just how volatile Chinese markets can be. Even after the recent bull run, the CSI 300 is still well below where it was a year ago. Given how low Chinese stocks sank last year, it is not too surprising that their recovery would be more dramatic.

But there are some genuine reasons behind the current rally. Confidence seems to have returned for investors who last year fled emerging markets (EMs) in droves. Foreigners poured $9bn into mainland Chinese equities last month, setting a record for monthly inflows. And the Chinese themselves are clearly feeling confident too, judging by the CSI 300's trading volumes. A more dovish Federal Reserve and a softening of US trade tensions have also helped sentiment greatly.

China's CSI 300 stock market index since 2006; Source: Bloomberg/FT.com, 1 March 2019

In the underlying economy, the government's measures should also provide support. As we wrote last month, Beijing has shown it is committed to stoking consumer demand and reforming its financial system, both of which are positives.

For wider EMs, this is good news. Last year, EMs were hit by a perfect storm: capital outflows, due to US economic strength and a tightening Federal Reserve; a strong US$, which pushed up their dollar-denominated debts; and falling demand from a slowing China. Now, all those issues have improved. That is very probably why EM equities have also shot up this year (albeit not to the same extent as Chinese stocks). Say it quietly, but after a torrid 2018, this year the clouds could be clearing for EMs.

Of course, we should be cautious here. While things may be looking more positive than they did last year, neither China nor wider EMs are out of the woods yet. Recent economic momentum data from China has been disappointing, showing that the slowdown has longer to run. And many EMs are, as ever, still plagued by political or structural issues.

For a sustained expansion in China, we'll likely need further falls in Chinese interest rates, a fall in the value of RMB or (most likely) both. One of the interesting things about China's economic slowdown is that against rational expectations its currency has remained fairly strong throughout. However, this could be more political than economic; Beijing might not want to incur US wrath (currency 'manipulation' has

long been one of Trump's great talking points) and their accusation that China is helping to stimulate their economy through a beggar-thy-neighbour approach of unilateral currency devaluation. Or it could have something to do with the US importers stockpiling Chinese goods before higher tariffs are feared to come in, pushing up demand for RMB. Whatever the case, currency strength has not helped China during the slowdown, China being used to exporting its way to growth.

Without either of these two additional stimulus measures, optimism on China could dissipate into the spring. If it happened it has the potential to take EM optimism with it too. Nevertheless, the bounce-back in confidence is significant. With any luck, it could spark a sustained rally and be a serious boon. China is not quite back to running at full speed, but it is at least on the right track.

£-Sterling rally- a message?

As we have written before, one asset class that reflects the sentiment of Brexit news flow in a very timely manner is £-Sterling. In a week where most markets remained stagnant, £-Sterling has jumped into life. From a technical chart perspective, 'Cable' (as London's traders refer to the £/$ cross rate) which started the week at 1.3060 has gone through a key price level (or barrier) at 1.3200. This move also broke through a medium-term (£-Sterling weakness) trend line dating back to March 2018.

The moves this week may be quite significant. Sterling is strong against other currencies: against the €-Euro, £-Sterling has reached its highest level since May 2017. The turn in Sterling since the start of the year has now accelerated, with a 4.5% return over the last two weeks.

Despite the delay in the promised "meaningful" vote, Prime Minister May committed to hold two further votes should her Brexit deal fail to get enough support, the last of which would allow Parliament to vote for a Brexit postponement. Sterling's upward shift no doubt indicates global investor views that the

prospect of a no deal on March 29th has shifted further into the background.

(Source: CMC Markets, 1 Mar 2019)

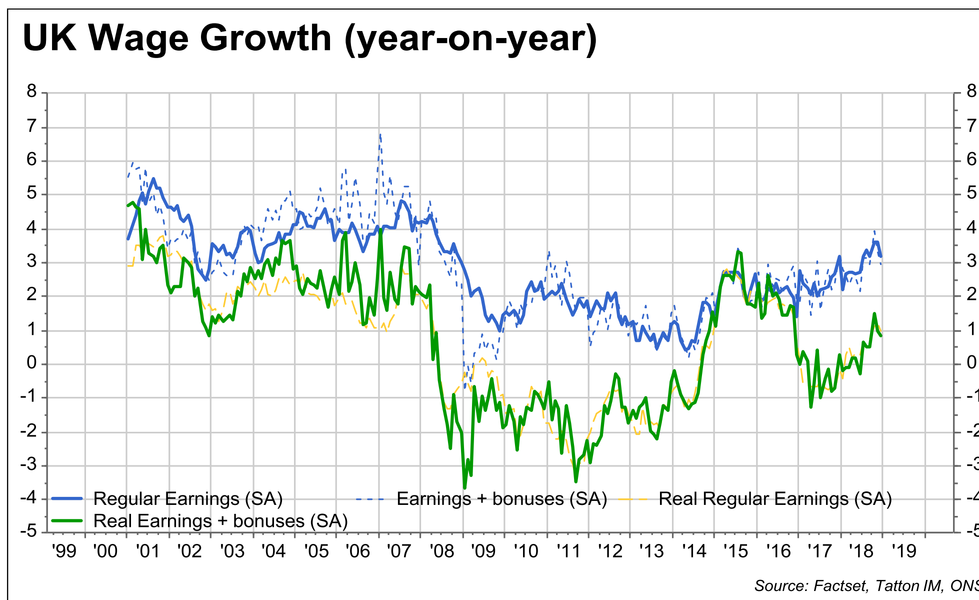
The rise in £-Sterling has seen some "translational" downward pressure exerted on the FTSE 100 during the week. Most of FTSE 100 companies are global players, and their foreign revenues had been beneficiaries of £-Sterling weakness (I.e. when the £ falls, the value of non-£ revenues increases in £ terms).

So, can the sterling rally continue?

Sterling could strengthen further in the short-term purely because momentum is growing. It may not require much Brexit news. Both domestic and foreign investors appear to be underweight in UK assets, and have started to unwind some of the hedges they had put in place in case of a no-deal Brexit at the end of March. This could lead to 'cable' potentially extending its rally up to the next barrier level of 1.3480.

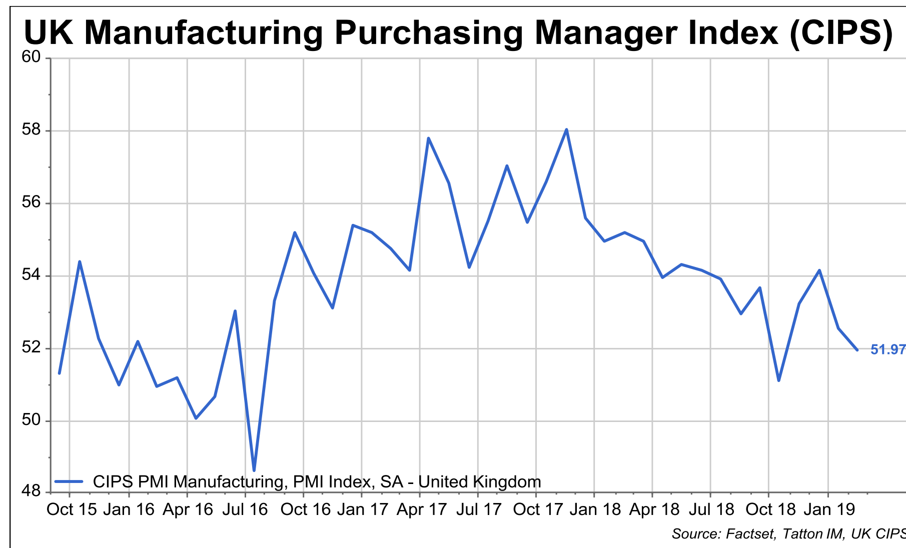
That would still be a significant move, in that it is likely that the UK economy is not inherently strong enough to withstand the negative price competitiveness effects of a rise in the currency beyond that level.

And the economic data flow has already provided a mixed picture. On the positive side, the UK labour market remains tight despite the headline job losses from car and other manufacturers. Wages remain supported by the ongoing shortage of qualified labour: year-over-year growth in average weekly wages reached a 10-year high in December. Recently inflation has started to edge lower and this has seen real wage growth turn positive in the latter part of 2018.



Mortgage lending data has begun to show improvement. Although the total value fell slightly, the number of house purchase mortgage approvals by main high street banks rose in January. This may be an early sign of some buoyancy in house prices.

In negative contrast, this week we have seen evidence of a further deterioration in business confidence and a postponement of a Brexit conclusion is only likely to continue to depress business sentiment further, delaying both investment and hiring decisions.



There are no easy outcomes to look forward to and even though a No-Deal scenario may have faded it does not mean that we might not still reach this point ultimately under an Article 50 extension.

This still uncertain outlook is reflected in the wide range of currency forecasts from different research houses. If it comes to a No-Deal then it is the consensus that £-Sterling is likely to depreciate below $1.15. If we continue to move towards a softer-than-anticipated Brexit, then £-Sterling could extend its rally towards $1.40. Relatively, from here, sterling is slightly more limited on the upside than on the downside.

Given this range of outcomes and the mixed economic data, the recent rally since December in UK equity markets has resulted in equity valuations heading back from cheap towards fair value. We maintain our neutral position regarding the UK and look to other asset classes and regions to provide more obvious medium-term opportunities until the 'Brexit-mist' clears.

Folding phones: Asian tech takes centre stage

This year's Mobile World Congress (MWC) in Barcelona contained the usual one-upmanship typical of the telecoms industry: Whose 5G was fastest? (Huawei with 2.3Gbps downlink or Qualcomm with 5Gbps). Who had the most cameras on a smartphone? (the Nokia 9 has five in a pentagonal array for those counting). Which phone had the highest screen- to- body ratio? (Samsung S10 with 88%). We even saw the launch of a new category: super expensive foldable screen phones.

But 2019's event saw a more significant change. This is the year that industry innovation, experimentation and creativity visibly shifted from the West towards Asia – specifically South Korea (Samsung) and China (Huawei and Xiaomi). How did we get here?

After a decade of rapid growth, smartphone sales have stagnated, and adoption has plateaued. Research firm GfK said smartphone volumes declined 3% in 2018 to 1.44 billion units. Total sales remained stable, passing $522 billion, as rising sales volumes of higher-priced premium phones offset volume declines. 12% of all phones sold cost over $800 – up from 9% in 2017. 46% of sales were in the $150-$400 price range, up from 44% in 2017. This segment has tighter margins and is now increasingly dominated by lower-cost Chinese brands.

According to GfK, consumers want "fewer, but higher quality" items and are willing to pay a higher price for a better overall experience. Apple's iPhone scores well here. But the smartphone novelty has worn off, now that almost everyone has one.

Incremental improvements are no longer stimulating demand. Rectangular touchscreen slabs look similar regardless of brand or the year bought. Today a £100 smartphone offers a similar experience to that of a higher-priced phone. This is Apple's biggest hurdle. Western brands defined the trajectory of the industry over the past decade. But now influence is shifting eastward.

By adopting the 'fast follower' strategy, Asian brands like Samsung, Huawei and Xiaomi arguably caught up with western designs around late 2017 and are now roughly on a par with Apple in terms of technology.

In some cases, they are the only ones to offer specific technology: Samsung is the only large manufacturer offering a device with an electronic pen (the Note series).

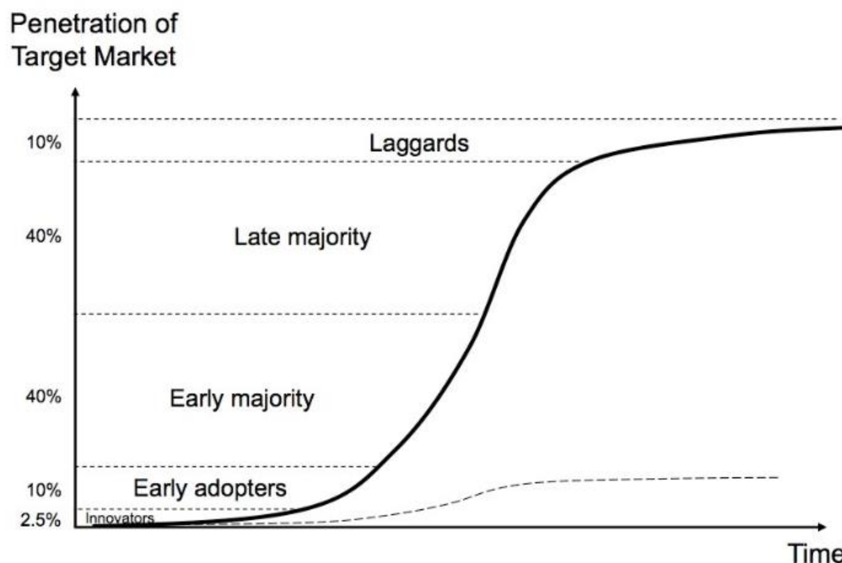
In fact, some technology experts suggest that Apple's iPhone X (10th Anniversary edition) would not be possible without Samsung's technology – particularly the shaped OLED (Organic Light Emitting Diode) screen and fast embedded UFS (Universal Flash Storage) memory chips.

Rapid advances at Samsung, Huawei and Xiaomi have eroded Apple's (and to some extent the West's) perceived technology lead. Unfortunately for Apple, these Asian brands are taking the next radical step ahead of everyone else: folding phones.

Samsung (Galaxy Fold, a 4G device) and Huawei (Mate X, including 5G) are the only two high market share manufacturers to publicly show off folding phones (though Xiaomi's CEO Lei Jun 'leaked' a video of its upcoming product). As the first of their kind, Samsung and Huawei's products are bursting with advanced technology, but these come with a premium price: £1,500 for the Fold and £2,000 for the Mate X.

Each has a complex hinge and a newer flexible OLED screen to ensure no creasing in real- world use. The Galaxy Fold has a 4.6-inch outer screen for use when folded and a 7.3-inch inner screen when unfolded. The Mate X takes a slightly different approach: a single 8-inch screen that folds in half to become a two-sided phone.

Imagine taking a call on the go using a smaller outer screen but unfolding the phone on a train to watch a video or browse the web for more comfortable viewing. Incidentally, this puts another nail in the coffin of the already shrinking tablet computer sector (just 33 million were sold in 2018). It is like asking a



photographer what the best camera is: clearly, it is the one she has with her.

Source: Investaura Management Consultants, 2017

Given the higher price, Samsung and Huawei's folding phones will have limited production runs, appealing more to a consumer group called 'innovators' and tech geeks looking for the most advanced product. (There are five key consumer segments each with purchasing motivations: innovators, early adopters, early majority, late majority, laggards – seen in the chart above.)

Indeed, not everyone is currently convinced folding phones are the future. Some believe it is a short-lived gimmick. But the mere existence of advanced folding phones could create a 'halo' or aspirational effect around the rest of Samsung and Huawei's products, helping boost overall demand for those brands. This is exactly the ploy Apple has used, first with the iPod, then the iPhone, in order to help sales of its Mac laptop and desktop computers.

If foldable phones catch on and gain momentum, it might put increasing pressure on companies without such devices, primarily Apple. It is possible that both Samsung and Huawei initially limit or decline to provide competitors like Apple with access to their folding screen technology, further leaving the smartphone pioneer behind.

Given the limited audience, foldables are unlikely to impact sales and profits early on, but they could impact consumer perceptions. Perhaps that is entirely the point: Asian brands want to drive home the 'fact' or at least embed the perception that Asian technology is more advanced than western. Their message is that if you want the 'best' smartphone, then you should have a Samsung, Huawei or Xiaomi, etc, not an iPhone.

Foldables could well become the norm over the next five years as prices fall. If current trends continue, Asian brands will too.

CAMBRIDGE
INVESTMENTS LIMITED

4th March 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7106.7	-1.0	-71.9	↗
FTSE 250	19399.7	0.7	130.1	↗
FTSE AS	3911.1	-0.7	-27.0	↗
FTSE Small	5464.0	0.4	21.8	↗
CAC	5265.2	0.9	49.3	↗
DAX	11601.7	1.3	144.0	↗
Dow	25944.6	-0.3	-87.3	↗
S&P 500	2791.2	-0.1	-1.4	↗
Nasdaq	7112.5	0.3	21.9	↗
Nikkei	21602.7	0.8	177.2	↗
MSCI World	2085.8	-0.1	-1.1	↗
MSCI EM	1051.0	-0.7	-7.7	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	16.9x	12.6x	13.2x
FTSE 250	3.5	26.7x	13.7x	14.1x
FTSE AS	4.6	18.0x	12.7x	13.4x
FTSE Small	4	-	11.0x	14.0x
CAC	3.3	17.6x	13.5x	13.4x
DAX	3.1	14.4x	12.6x	12.6x
Dow	2.2	16.5x	15.7x	15.0x
S&P 500	2	18.4x	16.7x	15.9x
Nasdaq	1.1	22.5x	19.7x	17.8x
Nikkei	2.1	15.9x	15.7x	19.0x
MSCI World	2.5	17.2x	15.4x	15.2x
MSCI EM	2.8	12.7x	12.2x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Ocado Group	16.7	RELX	-9.0
Taylor Wimpey	7.3	Rolls-Royce Holdings	-7.8
GVC Holdings	6.1	Pearson	-6.8
Standard Life Aberd.	5.5	International Consoli	-6.5
Kingfisher	5.1	BT Group	-6.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.32	1.27	OIL	65.1	-3.1
USD/EUR	1.14	0.35	GOLD	1301.5	-2.1
JPY/USD	111.90	-1.08	SILVER	15.3	-3.9
GBP/EUR	0.86	0.88	COPPER	294.0	-0.4
CNY/USD	6.71	0.11	ALUMIN	1911.0	0.3

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.3	11.9	0.14
US 10-Yr	2.7	3.2	0.09
French 10-Yr	0.6	12.0	0.06
German 10-Yr	0.2	90.6	0.09
Japanese 10-Yr	0.0	81.1	0.03

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.34
2-yr Fixed Rate	1.72
3-yr Fixed Rate	1.80
5-yr Fixed Rate	2.05
Standard Variable	4.48
10-yr Fixed Rate	2.66

* 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

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The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel