THE **CAMBRIDGE** WEEKLY

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DISCLAIMER

Graeme Keyes on Brexit date according to the Mayan calendar, 26 March 2019, PCGL

29 March 2019 – quarter end

The vexed date has come and gone, as we had suggested, but not quite in the manner we had expected. While the population widely blames Parliament and the political class in general for the Brexit execution debacle, MPs are just as divided as the entire nation over the UK's 2016 decision to quit the European Union. The consequence is that as the number of possible options for an orderly exit rapidly reduces day by day, the 'overtime' required to solve the impasse through an extension has increased substantially over the course of the week.

This is frustrating and costly for all who were expecting the return of some level of planning certainty, particularly the business community. But it probably reflects fairly on what is at stake for the nation and how passionate so many people feel about it.

Observing the news media coverage across Continental Europe and the US and comparing to that in the UK, it is striking that the British press appears to expect a softer Brexit by the day. Whereas, the foreign press (and politicians for that matter) interpret British politicians' indecisiveness and running down of the clock as a sure sign of a no-deal outcome becoming ever more probable.

At Cambridge, we would side with the UK press and continue to find support for this view in the reaction and state of financial markets. Risk asset markets around the world – including the UK – closed the week higher and even the value of £-Sterling hardly budged following the third and probably final defeat of the government's withdrawal treaty by Parliament. The market's quarter end marker was nonpostponeable beyond 29 Mar 2019 and the results tally delivered a remarkable reversal of the last quarter of 2018. Stock markets around the world posted healthy gains of up to 10% and thereby very nearly recovered the previous quarter's losses. With bonds having rallied as well, corporate debtors are feeling relieved, after rising costs of debt caused pressure last year.

Remarkably, the financial analyst community seems similarly divided over whether the falling bond yields are a positive or negative signal for the 2019 development path of the global economy - as the UK is over its Brexit path. Many economists see it as a credit stimulus for the economy and expect a re-acceleration after the recent global slowdown. On the other hand, many investment strategists interpret it as the bond markets (once again) calling the end of this drawn-out economic cycle.

Unfortunately, at this point the jury is out. Much will hinge on sentiment swings of consumers and businesses. In China sentiment remains on an upswing, as we point out and comment on in a separate article this week. Europe is at the other end of the spectrum, as it still suffers from 2018's decline in global trade and recent Brexit angst. The US is somewhere in between, with declining sentiment readings from very elevated levels as last year's fiscal sugar rush is waning, and the prolonged government shut down and unresolved trade war with China have begun to take their toll.

In our assessment, the current juncture has many similarities with the aftermath of the previous market corrections that followed temporary economic slowdowns in 2013 and 2015/2016. In both instances, the easing of credit market tensions together with fiscal counter measures by China proved sufficient to stabilise the global economy and put it back on the growth path.

It seems likely that the same will happen again over the coming quarters, perhaps further helped by a no longer strengthening US$. However, history only rhymes but rarely repeats and so there are risks and opportunities in our central case. The political outcomes of Trump's trade war and Brexit are one set of crucial variables; central bank policy and an orderly credit market are the other.

As noted, we are more optimistic than pessimistic about the political side. It seems likely that positive political outcomes will cause a catch-up in demand, which should make up for the damage that has already been done. On the credit market side, we have to concede that vulnerabilities to the world economy from the next credit default cycle are much larger than they have been historically. This is a consequence of the much higher levels of debt, rather than equity finance volumes that the past decade of ultra-low interest rates has led to. Central banks were and are aware that their extraordinary monetary measures would cause this negative side effect. That is why central bank policy has been so much more reactive to moves in credit markets than would otherwise be the case.

Unfortunately, the over-selling in markets last year shows they are scared of the size of the credit market and the risks it brings too. This means that while central banks are determined to defuse the credit market risk over time through gradual normalisation of their monetary policy, they will from time to time overshoot their targets as they manoeuvre in uncharted territory – as happened last year. Volatility episodes like the last two quarters are therefore likely to repeat. And with every setback, the time to normalisation extends into the future. This shorter term cyclicality has the potential to perpetuate the ongoing prolonged cycle much further than previous cycles. However, it is equally possible that a future bout of volatility causes irreparable damage and the ensuing mass corporate defaults lead to a global recession on a par with the Global Financial Crisis (GFC).

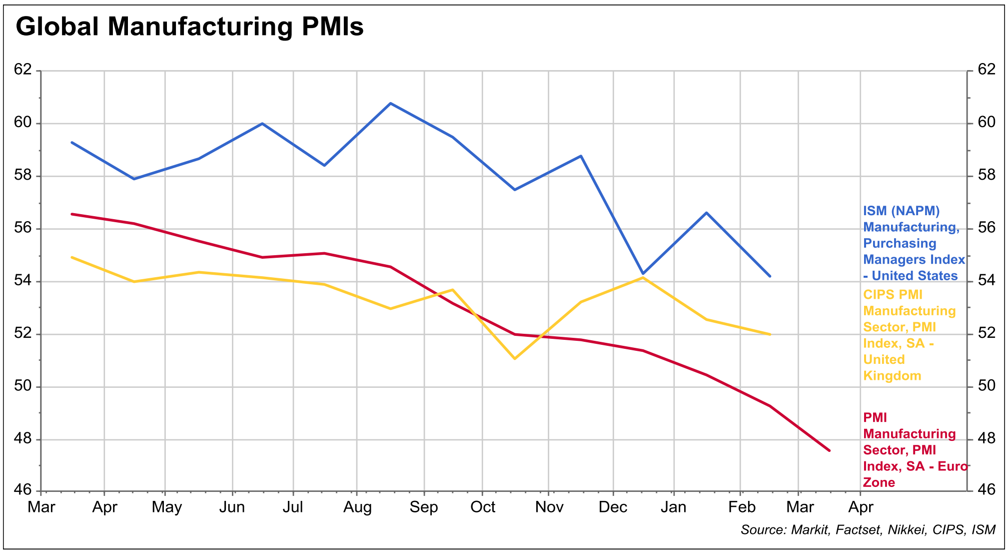
To close on a positive, banks are today far better capitalised as a consequence of the GFC and it is therefore less likely that we will once again be faced with a near collapse of the financial system.

The EU: rocks and hard places

We have been positive on the mid and long-term case for European equities, and we remain so. However, recent economic data suggests that Europe is (back) in trouble. This presents a challenge to our view, so it's worth looking at in more detail. Let's run through the worries before we get to a more positive perspective.

Brexit continues to exacerbate (or cause, depending on the point of view) internal Eurozone (EZ) destabilisation. It has definitely become a greater concern for Europe since the start of the year. The looming shake-up of the European trade framework of the past four decades appears to be worrying businesses and individuals to the extent that domestic cash-piling by companies is noticeably boosting money supply. That rise in liquidity unfortunately appears to be at the expense of business investment, while European (German, really) individual savings rates are going higher, despite already being the highest in the developed world.

The Eurozone's flash purchasing managers' index for manufacturing fell to 47.7 in March, down from 49.3 in February and well below the expected 49.5 figure. It is the worst reading for EZ manufacturing in over five years. The Services PMI, while mildly better, also recorded a decline – falling to 52.7 from 52.8 last month. All of this left the composite EZ PMI at 51.3, with manufacturers' plight dragging down sentiment



to near multiyear lows.

For reference, PMIs measure business confidence. In theory, any reading above 50 is supposed to indicate expansion and anything below that the opposite. In practice however, readings only slightly above 50 point to stagnation. What's more, often the direction of change in PMIs tells us more about where an economy's heading than the actual numbers themselves. For the EZ, things look bleak no matter what way we spin it. Business sentiment is dire, and it is getting worse.

It is the continent's two largest economies that are showing most weakness. France's composite PMI fell to 48.7 in March, while Germany's factory sector put in a miserable PMI figure of 44.7. There are some excuses: *gilets jaunes* protestors have likely hindered French output considerably, and a global downturn in demand for cars has hit the all-important German automotive industry particularly hard. Still, even taking into account these exceptions, the economies are lethargic.

European data has been lagging for the better part of a year. But one of the most notable things about this weakness is how quickly EZ prospects have deteriorated. At the beginning of the year, we wrote that, despite uninspiring data, European growth could be fairly strong this year. This assessment was based mainly on two considerations: Firstly, a pickup in global industrial demand – led by extensive fiscal stimulus in China – would give European exporters a much-needed boost. Secondly, growing political pressure across the continent would lead to a fiscal loosening in EZ countries, pushing up demand on the continent.

Now, both are less likely. Fiscal stimulus in China is genuine and could well help drag the country out of its economic slowdown. But unlike previous fiscal measures, Beijing's current program is focused on stimulating domestic consumption and improving conditions for small businesses, rather than funding vast infrastructure projects and the large state-owned enterprises (SOEs). In the past, the EZ was a major beneficiary of China's huge industrial demand and the global growth it spurred. A switch in demand to consumer goods may help European high-end producers somewhat, but they already have significant market share. Chinese policy is designed to have domestic consumption filled by domestic producers. Meanwhile, European machine/capital goods producers may not get the boost of previous Chinese expansionary episodes.

That's not so good for the EZ, which is markedly sensitive to external demand and growth.

Europe has had a problem generating domestic demand since the financial crisis. Its consumers have a tendency to over-save and the political fabric of the EU makes it difficult for governments to pick up the slack with fiscal spending. A few months ago, it looked as though pressure was building to loosen the EU's stringent budget rules. There were protesters in France calling for an improvement in living standards, a new heir apparent to Angela Merkel, risks from a disorderly Brexit and a rising threat of populism across the continent. This made fiscal expansion look likely, giving politicians a sharp stick to get to grips with the EZ's chronic problems.

But perhaps the stick was more like a twig. President Macron's attempts at building a common fiscal framework were watered down beyond recognition and then rejected by budget hawks in the Benelux nations. Earlier this month, the OECD said that Germany, the Netherlands and a range of other countries had "ample fiscal space" to increase spending, which could boost long-term EZ GDP. But Germany's (and many others') obsession with balanced budgets make even a moderate increase look unlikely. As ever, it looks like the obvious choice will be blocked by political stubbornness.

Can the ECB help?

During previous crises and downturns, as governments across the continent tightened their purse-strings to the detriment of the economy, the ECB's extraordinary measures – negative real interest rates and huge asset purchases through QE – were one of the few things keeping Europe ticking over. But with the current downturn, the central bank has nowhere to turn.

It cannot lower interest rates any more. Banks cannot make money in a "zero-bound" environment; they are unable to lower deposit rates but can only lend at very low rates. They can't make the spread. And as is evidenced by the rise in corporate cash levels, companies have stopped borrowing as growth and sentiment has fallen.

Perhaps the ECB could change its mind on ending QE purchases? Even if the ECB wanted to, there are effectively no bonds left for it to buy without them breaking their own rules. Government borrowing in countries like Germany is so low that there is not enough bond supply to increase purchases, and EU laws allow the ECB to buy only German government debt now, having filled the quotas of the other countries' bond stocks already. The rules prevent the bank from purchasing more of the block's riskier bonds. Effectively, the ECB is out of ammo at a time it might be desperately needed.

At this point, the market's fear is that the ECB's only path, short of getting politicians and the national central banks to weaken the bond purchase rules, is to let the economy slide towards crisis. Therein lies the heart of Europe's problems. Its political structure is so rigid that change – whether it's fiscal, monetary or otherwise – can only be achieved when it is already too late.

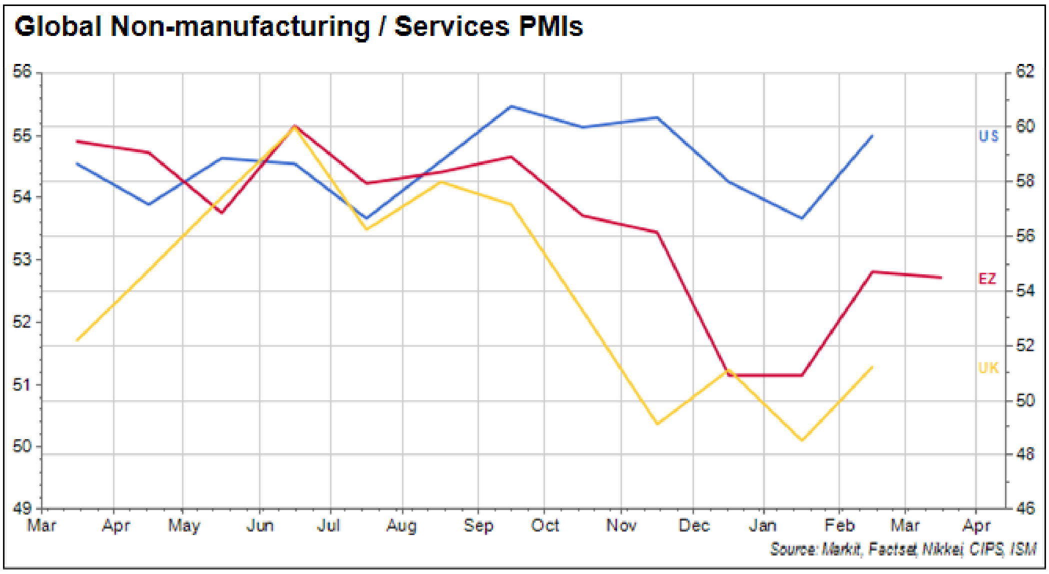
Two rocks, two hard places: Brexit's internal destabilisation, European fiscal rules, internally-focussed policy in China, and an EU run by groups who cannot change except in crisis. It looks a bit bleak, and the €-Euro has weakened during last week, despite the US Fed's dovishness.

However, there is still a bull case. The rise in money supply in both the Eurozone and US adds liquidity to markets and suggests there is buying power for equities. Meanwhile, it's typical for EU equities to rally over the mid-term when US equity sentiment is low and the EU economy looks weak, as this has more often than not marked a turning point.

Here's a quote from Citi (the US investment bank) equity strategists from last week:

"Our analysis at the start of 2019 highlighted a strong enhanced buy signal for European equities… The median 12-month European equity return has been +27%, when both indicators *[as mentioned above]* were at depressed levels, with a win ratio of 98%... There has been little investor participation. Our "Don't Panic" median pathway suggests there are further gains ahead in the coming 6-9 months."

The weak economic data is skewed towards manufacturing. The service PMIs have weakened only slightly, and those are more indicative of consumption patterns (see chart below). Employment levels are strong and resilient, which will support consumption. And, despite a similar current weakness in China, we expect Chinese stimulus to help, albeit not as much as in previous episodes.



Our positive view on the Europe allocation was driven in large part by its cheap valuations and that has not changed. While it may seem that Brexit has turned into a 'Groundhog-Day' nightmare, there are good reasons to believe that, over the coming months, some level of certainty will be re-established. This, together with a rebound of global trade on the back of a weaker US$, should lead to a release of pent-up demand not only in Europe, but from around the world.

Together with lower bond yields and higher liquidity that have typically been good news for equities, we still believe this will result in stronger total returns for the area than may now be available in the US.

China rally, more sentiment than hard data

2019 has been a good year so far for Chinese stocks. Since the end of 2018, the Shanghai composite index has risen almost 24%. In the same timeframe, the tech-heavy Shenzhen composite has shot up almost 37%. This is a stark contrast to last year, when the double whammy of a slowing economy and President Trump's trade war sent Chinese equities into tailspin. Now, investors seem hopeful that both of these are changing for the better.

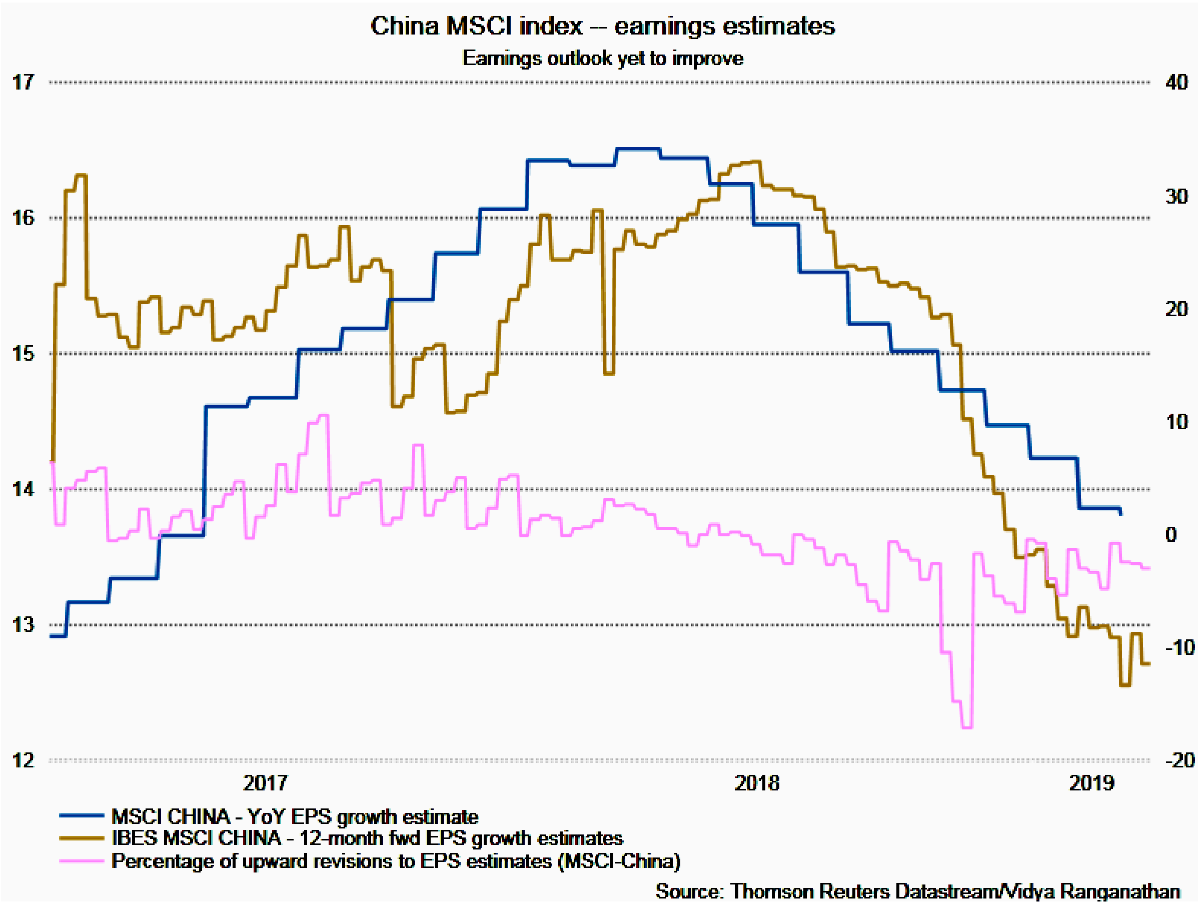
This optimism is being sustained by two things: firstly, trade talks between the world's two largest economies have looked positive in the past few months. This Friday saw the conclusion of high-level negotiations in Beijing – with US Treasury Secretary Steve Mnuchin meeting Chinese Vice Premier Liu He for the first time – which sent both the Shanghai and Shenzhen composites up over 3%.

Secondly, and in our view more importantly, the government is committed to a hefty program of fiscal and monetary stimulus. We have already seen large tax cuts and a loosening of monetary policy from the central bank, and it looks as though there is more on the way. This has excited investors, who are betting Beijing's measures will have enough pulling power to drag China's economy out of the slowdown.

The only problem is that, as yet, this optimism does not look justified by the economic data flow. It is no secret that China's economy has come off the boil somewhat. The government's entirely necessary crackdown on the shadow banking sector and their aim to deleverage the country's debt-laden economy left a liquidity shortage last year that caused serious problems for many private companies. Even according to official figures (which are dubious at best) Chinese growth in 2018 was its lowest in 28 years. And at this year's meeting of the National People's Congress (China's highest legislative body) the growth target was set at just 6-6.5%, below the targets of previous years.

More pertinently for investors, the most recent data is not yet showing many signs of improvement. Industrial profits fell 14% in January to February, after a fall of just 1.9% in December. Growth in sales revenue also moderated, showing slower industrial activity. What's more, mainland Chinese companies have just begun reporting their earnings for 2018, and what we have seen so far is not too inspiring.

63% of Chinese firms missed their expected earnings last year. And looking forward, analysts are issuing more downgrades than upgrades for corporate earnings – even taking Beijing's stimulus measures into account. As the chart below shows, the outlook for earnings is not yet showing any sign of bottoming



out.

The slowdown in growth is still putting private sector companies under a great deal of strain. While some of this pressure is coming from the sales side, we are also seeing evidence that profit margins have taken a hit. A tight labour market is putting upward pressure on wages, but this has not yet filtered through into a growth rebound from consumer demand. Companies are facing increased costs without much growth in sales, causing profits to come under pressure.

So why are Chinese equities still roaring ahead when the underlying economy is not yet showing signs of a recovery? In a word: sentiment. Last year, investor sentiment and risk appetite fell considerably, not just in China but around the world, as fears of a looming global slowdown took hold. But now, that sentiment appears to be turning much more positive for China. Investors have faith that Beijing's measures will provide significant support for the economy and for equities. According to a report by China International Capital Corporation Limited, "The impact from Beijing's tax cuts and expenses reductions in 2019 will be between 150-400 billion yuan ($22.4 - 59.6 billion) on the A-share market, accounting for 4-9 percent of their net profits,"

However, as we have written before, there is danger in thinking the government's latest stimulus episode will be as mighty as the ones before. Back in 2015/16, a similar slowdown had the government generating huge amounts of additional demand for its economy, mainly through large-scale infrastructure projects and the big state-owned enterprises (SOEs). But while there is undoubtedly some push towards infrastructure spending this time as well, the current stimulus push appears far more focused on helping smaller businesses (who have been left without access to capital following the shadow banking crackdown) and on generating domestic consumption. This means that, while we should expect stronger consumer demand to support the country's private sector which is more services and "tech-heavy", this round of stimulus is unlikely to cause a significant bounce-back in industrial activity.

So, the operative question is of course: is the current equity rally justified? In some respects, yes. In generating more consumption, Beijing's measures should significantly help company profitability. China's technology sector in particular will likely be a significant beneficiary. But the key point for us is that the most significant effects of the government's program may not be felt for some time. They are clearly pushing ahead with their reform agenda to shift the economy away from SOE and export dominance towards domestic demand. Beijing's efforts are more aimed at a change in the sources of growth rather than causing a growth spurt.

For Chinese equities, that means we may not have seen the bottom for earnings yet. We anticipate that the optimism that allows a valuation (price-to-earnings ratio) rise to offset further falls will be key, and that will require a turn in economic data soon. We will be watching this space.

Yield curve's predictive powers dissected

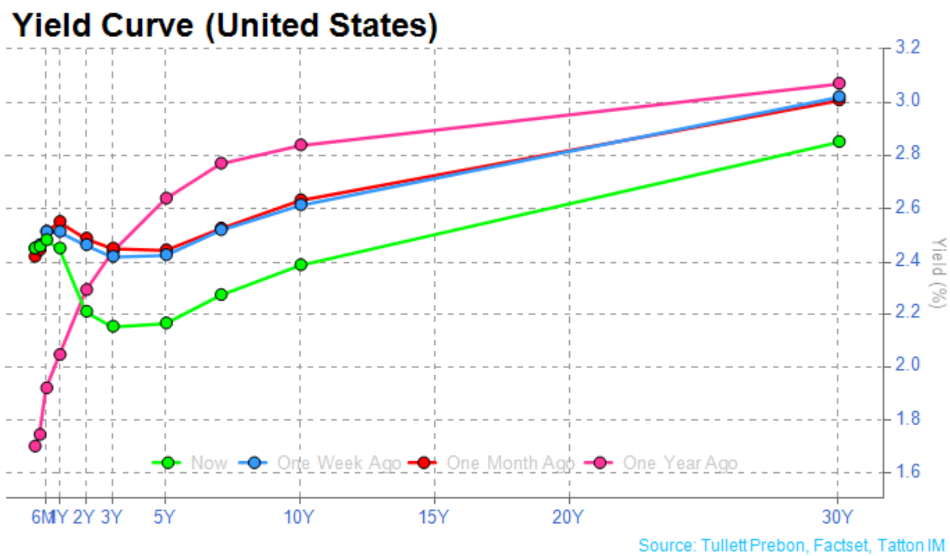
Those seeking distraction from UK's domestic woes will have noticed a lot of attention over the past weeks about the US yield curve and its various inversions along different maturity profiles: 10y-3m, 5y-2y, and a few others.

What this actually means is that bond investors can get a higher yield when lending their money to the US Government for a short period than a long time. As an example, currently bond holders are compensated the same (per year), for being tied in for 1 year as 10.

In general, we expect this curve to be upward sloping – i.e. higher yields for longer maturity bonds – for a few reasons: there is a risk (think inconvenience) premium required by investors to lend for longer, there is less trading in longer-dated securities (making them trade at a discount) and (most importantly) longer rates factor in expectations for future rates, growth and inflation. When things are going well, investors generally expect future interest rates to increase to curb excess inflation in the future. When things are going badly, the curve will occasionally invert, in expectation of rate cuts. For example, at the end of March 2000, the 2y rate was 6.5% while everything longer was below this level.

We have written here before that the shape of the US yield curve is closely watched by many equity investors, because over the past decades every recessionary period was preceded by an inversion of the yield curve. However, it is worth noting that the onset of the recession was on average only a good 30 months after the inversion occurred and such periods delivered some of the strongest stock market returns. Nevertheless, market participants get very anxious about inversions, in part because the inversion period before the GFC was shorter. Current curve anxiety is especially high, given the current market cycle has been one of the longest in history.

So, what is the market pricing in now? Below we can see how the shape of the yield curve has changed from a year ago (pink line) to a month ago (red line), and where it sits as at 28th March (green line).



We can see a major drop recently in the yield curve from 6 months onwards, particularly the middle part, where we see an inversion. The market has digested some recent disappointing data releases, a lack of progress on the political front (China trade negotiations), and the change in rhetoric from the US central bank (the Fed). The Fed's turnaround has had a particularly big impact, as they indicated a potential return of a more supportive policy, despite its inflation potential. Markets have now priced in roughly two rate cuts between now and mid-2020.

Even compared to European bonds (using German government bonds – Bunds – for comparison) Treasuries have seen yields plummet in the middle of the curve. Bunds make an interesting comparison, as they have also been affected by weaker economic data and a deteriorating outlook, thanks to trade tensions and exposure to a slowing China.

However, the unusual shape in the curve in the form of a partial inversion indicates the market does not think monetary policy has turned as far as far as it seems. From 3 years out, the curve resumes an upward trajectory.

This move from the Federal Reserve has evidently had a large impact on US markets. It has also impacted bond yields across the globe, which have seen yield curves flatten over the last month. Investors are taking cues from the Fed that the global monetary tightening cycle may be over for now. For example, Chinese and Korean curves both also flattened over the last month.

China has embarked on some stimulative measures, albeit in a different form to those after the Global Financial Crisis (GFC) – more on the tax (cut) side, than on (increasing) government spending which we have seen previously. China continues to pivot towards more consumption from its own citizens and away from centralised infrastructure spending fuelling GDP. All this seems to chime with the Fed's outlook that, while things are not deteriorating apace, we are probably past the era of improving conditions for now. Hopes that we had gone back to the 'old normal' of higher growth and steady inflation as seen pre-GFC now appear premature. At least the Fed have manoeuvred themselves to a place where there is scope for rate cuts should things deteriorate. Either that or they do not want to shock asset markets by confounding expectation.

In conclusion then, we sense a consensus amongst market strategists with our view that for the moment the yield curve inversion is nothing to get particularly worried about, on the basis that it is only a partial inversion and indicates what has been accepted wisdom for months. That is that the US economy is coming off its fiscal stimulus "sugar-high" that Trump's tax cuts created for 2018. This will probably see a return of the previous slow-growth environment, which equates to a temporary economic downturn that in turn requires less or no monetary tightening by the central bank, or even a temporary reversal. This is precisely what the yield curve shape indicates – no more, no less. It certainly does not indicate a looming economic Armageddon.

CAMBRIDGE
INVESTMENTS LIMITED

1st April 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7279.2	1.0	71.6	↗
FTSE 250	19117.5	0.6	119.0	↗
FTSE AS	3978.3	0.9	35.7	↗
FTSE Small	5466.4	0.1	8.0	↗
CAC	5350.5	1.5	80.6	↗
DAX	11526.0	1.4	161.9	↗
Dow	25868.9	1.4	366.6	↗
S&P 500	2827.0	0.9	26.3	↗
Nasdaq	7362.5	0.5	36.4	↗
Nikkei	21205.8	-1.9	-421.5	↗
MSCI World	2095.2	0.0	0.4	↗
MSCI EM	1045.2	-1.4	-14.4	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.9	17.1x	13.0x	13.2x
FTSE 250	3.3	23.6x	13.4x	14.1x
FTSE AS	4.6	18.1x	13.0x	13.4x
FTSE Small	3.9	73.1x	-	14.0x
CAC	3.3	17.9x	13.9x	13.4x
DAX	3.2	14.5x	12.7x	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	23.3x	20.5x	17.8x
Nikkei	2.1	15.6x	15.4x	19.0x
MSCI World	2.5	17.4x	15.6x	15.2x
MSCI EM	2.7	12.8x	12.5x	12.1x

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
Ocado Group	11.2	Carnival	-9.0
GVC Holdings	7.7	Ferguson	-7.3
Burberry Group	6.3	John Wood Group	-7.0
Rio Tinto	5.4	TUI AG	-6.3
Hargreaves Lansdown	5.1	NMC Health	-5.8

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	-1.57	OIL	68.4	2.0
USD/EUR	1.12	-0.69	GOLD	1295.5	-1.4
JPY/USD	110.81	-0.80	SILVER	15.1	-1.8
GBP/EUR	0.86	-0.87	COPPER	293.4	3.5
CNY/USD	6.71	0.09	ALUMIN	1903.0	0.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.000	-1.4	-0.01
US 10-Yr	2.409	-1.2	-0.03
French 10-Yr	0.318	-10.2	-0.04
German 10-Yr	-0.070	-366.7	-0.06
Japanese 10-Yr	-0.081	-17.4	-0.01

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.

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