THE **CAMBRIDGE** WEEKLY

15 April 2019

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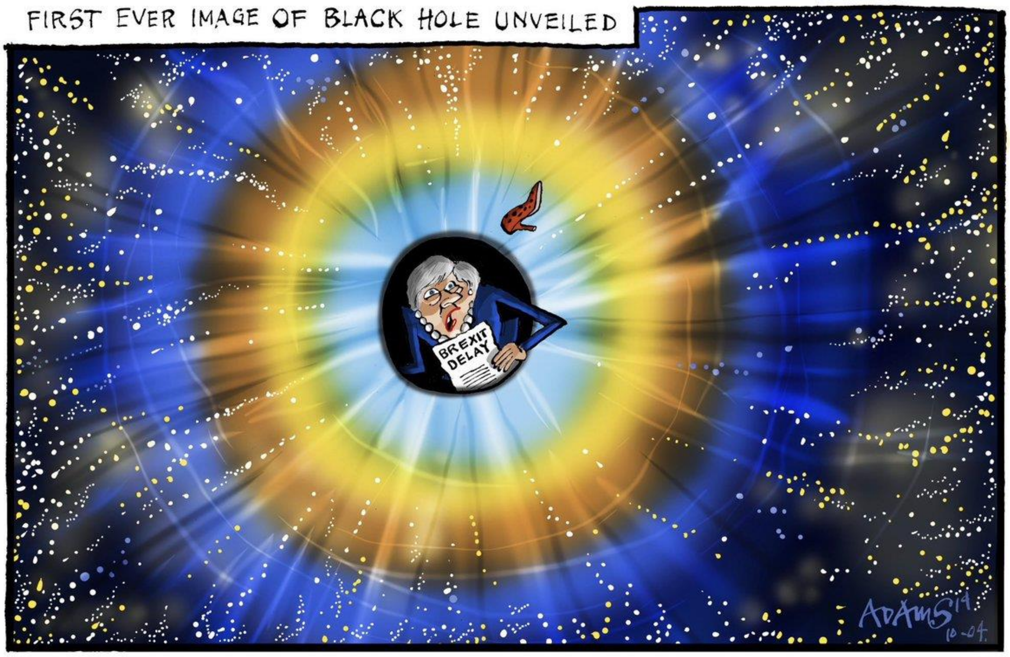
CAMBRIDGE
INVESTMENTS LIMITED

15th April 2019



Christian Adams' Brexit black hole; 10 Apr 2019; Source: PCGL

Brexit in-limbo aside sentiment is improving

Even though our prediction that Brexit would neither happen on 29 March nor 12 April has turned into reality, there seems little point in celebrating. Yes, the immediate threat of a cycle-ending shock event to the pan-European economy has been averted. However, the economic drag brought to the economy by this extension of uncertainty - continued deferment of business investment and potentially unnecessary worst-case preparations - has also simply been extended for six months. For the time being we are grateful that level-headedness has prevailed. This should help the UK economy to participate fully in the anticipated recovery of global trade volumes over the coming months - following the 2018 slump. On the other hand, the only way – or so it currently seems - to prevent the proponents of a ‘dirty break’ from the EU seizing power, may well lead to political instability as well. A confirmatory second referendum or a general election appears inevitable in order to break the deadlock in a parliament which of late is far less reflective of party politics and far more representative of a highly divided UK public.

For the time being we observe that capital markets in the end fully shared our expectation of a Brexit extension, and the recent rise in the value of £-Sterling against the €-Euro and the US$ reflected the rising probability of such an event, rather than a crash Brexit. When EU leaders emerged with their agreement to the Brexit extension there was virtually no currency movement. For our investment positioning this means that we are satisfied that holding on to a neutral exposure to UK investments was the prudent course of action.

Looking beyond the UK, as Cambridge’s investment team did during last week’s investment committee meeting, the picture of where capital markets may be heading has become slightly more optimistic but is still full of regional uncertainty.

The end-of-cycle doom-mongers in the market have become less vocal as the typical late cycle conditions (overheating economic activity, restrictive monetary policy signals from central banks) have reversed over the past 12 months. The global economic slowdown of 2018 is still in full swing but is now clearly just that – a slow-down in growth and not a recessionary growth contraction. In the recent past such conditions have persuaded investors to take a longer-term perspective on corporate earnings growth and look beyond one or two quarters of low or even negative growth, so as not to miss the upswing.

This leads to the situation (for many, hard to comprehend) of rising stock markets against the backdrop of poor corporate results. Following the (once again) impressive rebound of global stock markets since the beginning of the year (after overly pessimistic economic outlook views had led to excessive stock market losses in Q4/18), it is not unreasonable to expect that stock markets will continue to grind higher, although not with the same vehemence as during the Q1 recovery. Should stock markets get ahead of themselves and display signs of unwarranted exuberance as they did back in January 2018, then a resurgence of volatility is very likely, as investors bank their returns and anxiety re-emerges over valuation levels.

At a regional level the outlook is more complicated. The US stock markets have been the most vibrant during this entire episode and are once again more highly valued then their longer-term historical average. All other stock markets offer valuation levels below their long running averages and thus seemingly have more upside potential. It can be argued that the US market enjoys the higher valuation advantage for at least two reasons, namely it is overweight with global technology leaders who can command higher profit margins than most other sectors, and the region still runs at higher domestic growth levels.

On the other hand, the US has not yet experienced the slow down which the rest of the world has gone through. This is because US demand was artificially elevated by Donald Trump's late-cycle fiscal stimulus of corporate tax cuts and governmental deficit spending, which is now waning. Europe on the other hand has suffered from investor withdrawal due to its high dependency on global trade and - of late - the Brexit headwinds. As both of these factors are now abating, Europe's stock markets should have a considerably greater upside potential given their lower starting point.

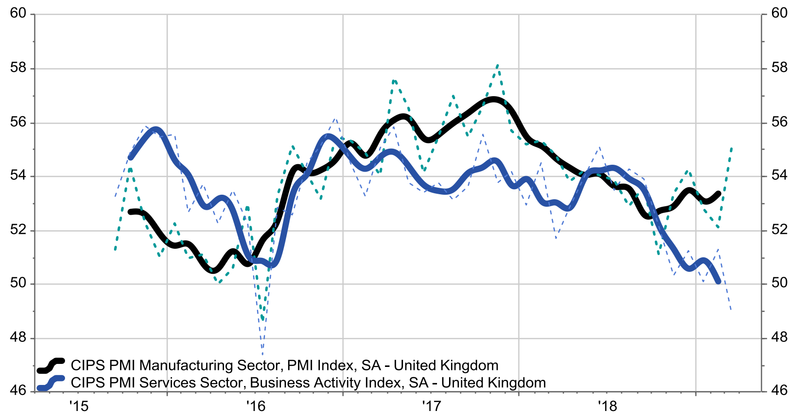
There are always risks to our various outlook scenarios and we are therefore constantly monitoring the data flow for confirmatory or contradictory indicators. The Q1 corporate earnings results season that has just started will provide us with valuable insights into the resilience of the corporate sector, and the management outlook statements will provide us with valuable micro-economic insights about their collective future expectations and sentiment.

We will be covering these in The Cambridge Weekly over the coming weeks – stay tuned.

Logic behind divergent UK business trends

Better than expected economic data from the UK for February delivered a positive surprise when business news otherwise was firmly overshadowed by Brexit concerns. UK GDP growth - as well as industrial production - was reported to be running at a higher rate than continental Europe, although the mighty UK services sector was not quite following in line. How can this be explained when the general impression of the past months has been that due to the looming Brexit, everything had come to a grinding halt?

UK Manufacturing and Services PMIs

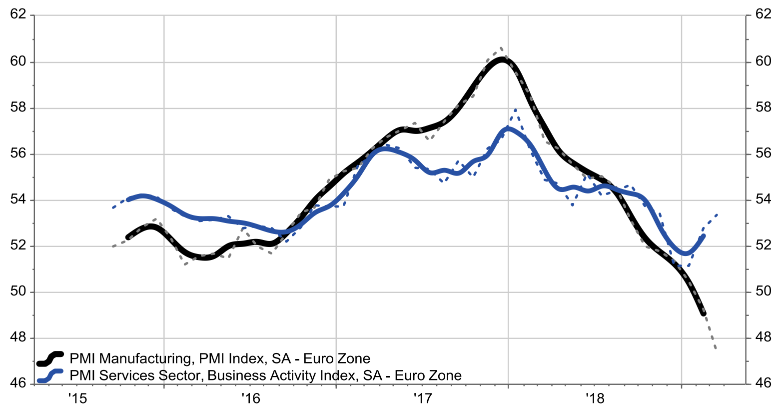


Source: Factset, Tatton IM, CIPS

The UK is - and will be - hugely dependent on its largest trading partner: the Eurozone. (One might say that it is not a single entity, but the single currency group can usefully be defined as such in economic terms). Regardless of whatever Brexit outcome we get, our economic fate is inevitably intertwined with our neighbours on the continent.

Be that as it may, an oddity has occurred over the past few months. Having tracked in a reasonably similar manner through 2015 to mid-2018, our regional paths of manufacturing and services appear to be diverging. In Europe, the services sector seems to be improving while manufacturers are taking a hit. In the UK, we are seeing the reverse.

Eurozone Manufacturing and Services PMIs



Source: Factset, Tatton IM, Markit IHS

One of the sources of that divergence is probably Brexit, which has grown ever more chaotic in its latter stages and impacted Britain's services sector. As we approached what appeared to be the deadline, the pressure on major service firms to change their circumstances grew.

In October, John Glen (Economic Secretary to the Treasury and City Minister) said that he agreed with Bank of England estimates that 5,000 financial services jobs will have moved to continental Europe by the time Britain was originally due to leave the European Union.

In January, Financial News said "Staff moves are already underway at large investment banks. Goldman Sachs, which eventually plans to move 700 jobs to Europe because of Brexit, has shifted around 80 bankers to the continent as part of a broader push in region, while up to 20 fixed income sales staff have been relocated to Paris. Morgan Stanley plans to have 50 bankers in Frankfurt as part of initial relocations, while Deutsche Bank, BNP Paribas, Credit Agricole, Societe Generale and UBS have all asked staff to move".

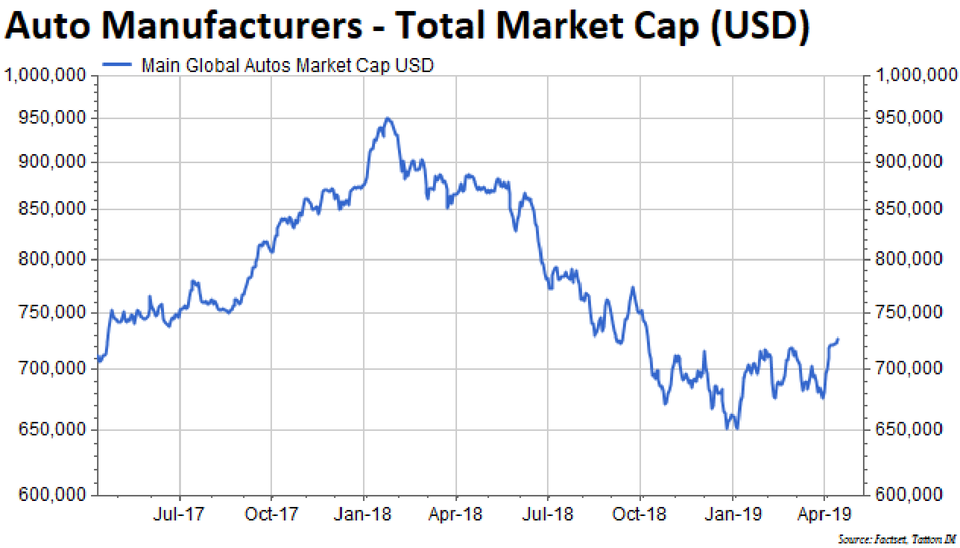
In February, the Institute of Directors said that 29% of firms in a survey of 1,200 members believed Brexit posed a significant risk to their operations in the UK and had either moved part of their businesses abroad already or were planning to do so. A large majority of firms represented by the IoD are service-related.

It is likely that the apparent exclusion of services from Theresa May's deal, and the constant political approach (delay and brinkmanship) used by all sides, exacerbated the problems for the services sector. Faced with the need to protect their shareholders' interests, businesses did enact moves.

Incidentally, that probably added to the pressure on London and South-East property prices, which then added to further pressure on UK domestic services. The comment section in The Royal Institute of Chartered Surveyors Residential Survey taken in March had Politics and/or Brexit as a factor in 95% of responses. It also mentioned that "stock levels *(instructions to sell)* are currently a little higher in London and the South East when compared with twelve months ago." However, the most recent RICS survey was more upbeat than the previous month's, while the Halifax property index has shown a pick-up in house prices in the past couple of months (the 3-month average is now around +2.5% y/y).

European services, on the other hand, will have had a partial fillip from this UK exodus, though it is likely that it will be relatively less than the UK's negative impact, and the transition effects will be delayed. The bigger influences are likely to come from a stable employment market, the positive impacts of a turnaround in financial markets, and continuingly strong residential prices.

Unfortunately, while Europe's service providers have fared okay, its manufacturers have not. The latest business sentiment surveys paint a dire picture for the sector, with activity slowing considerably. European manufacturing has been hit by the car-maker "special factor", a lot of which revolved around weakness in Chinese demand. The good news is that it looks as though this slowdown is turning around quite quickly, if the rebound in global auto-producer share prices is a sign (chart below). Although European makers are relative laggards, the picture has taken on a much rosier hue in the past couple of weeks.



That leads us to think that Europe could well be in for a better period in economy terms in the next few months, helping relieve some of the pressure on European banks (see the other article in the Weekly).

Meanwhile, British manufacturers are looking comparatively and surprisingly strong given the traditionally close ties with continental manufacturers. The resilience of UK manufacturing is good news given that auto manufacturing is still a big part of national production. The fact that this rise has happened despite the slight rise in sterling is also a good sign. Services continue to be the major part of the economy, but a healthy manufacturing sector helps continue a valuable rebalance towards the regions (which the regional house price outlooks continue to affirm).

But we should not get carried away here. Again, the latter stages of Brexit are likely to have had an impact on Britain's manufacturing data. It is quite likely that a large chunk of the rise in manufacturing is due to stockpiling effects, with companies trying to get orders in before the Brexit deadline. If this is the case, we could be in for a drop-off in activity in the coming months.

What is more, the extension of the negotiation period does not really help, especially if it involves a new referendum and/or an election. Rather, more uncertainty is likely to pressure businesses into seeking their own remedies, much of which involves biting the bullet and establishing outposts on the continent. Overall, house prices may stabilise which will help, but do not expect any sharp reversals in services' sentiment without an early and soft Brexit resolution.

ECB turns its eye to the banks

This week's European Central Bank (ECB) meeting was largely a non-event. The bank made no changes to its monetary policy, nor gave any definitive details on the policies announced last month. The ECB's benchmark refinancing rate (the rate at which banks can borrow from the ECB) will remain at 0% "at least through the end of 2019", while its controversial deposit rate of -0.4% will continue for now.

This was to be expected. The ECB's meeting last month saw some key policy decisions and a significant downgrade to economic forecasts. The bank now expects the Eurozone to grow just 1.1% this year, while the IMF was the latest organisation to cut its EZ forecasts on Tuesday. This pessimism – coupled with extremely weak European data recently – has left markets in complete agreement that EZ rates are going nowhere. Though the ECB has said rates will remain on hold until the end of the year, markets are pricing in no rate hikes until the middle of next year at the earliest.

The ECB is undoubtedly in a difficult situation. It has ended its extraordinary monetary stimulus (in the form of its QE asset purchase program) at a time when EZ growth is turning weaker. Its interest rates are already at or below the 'zero bound' and yet the underlying economy is barely showing signs of life. But despite this, ECB governor Mario Draghi was at pains to point out that the bank has not run out of fire-power. The ECB stands ready to "adjust all its instruments" if the economy continues to underperform, repeated Draghi throughout his press conference. He even suggested that the ECB would tolerate inflation above the 2% target level.

The "instruments" will probably include: the long-awaited Target Long-Term Refinancing Operations (TLTROs) for banks, and a possible tiered deposit rate system. TLTROs are the ECB's way of handing out refinancing credit to EZ banks at below market rates, the last round of which ended two years ago. Mr Draghi hinted that these instruments – which EZ banks have sorely needed since the end of QE – would be announced at the bank's June meeting.

A tiered deposit rate system – as first hinted by the governor last month – is supposedly a way of maintaining the benefits of negative interest rates while alleviating the harmful side effects. Ever since the ECB broke new ground in turning interest rates negative, critics have labelled it as effectively a tax on banks (as they have to pay the ECB to deposit money) amounting to around €7.5bn a year. A tiered deposit scheme, as used in Japan and Switzerland, would hand back some of that money.

Draghi and Co only hinted at the notion of tiered deposits and were light on the details about TLTROs. But it is clear that the health of the continent's banks is a top concern.

In a 'normal' economic environment, banks make money by taking short-term deposits and lending over the long term at higher interest rates – either by buying government bonds or lending privately. In doing so, they also fulfil a vital role for the economy: transforming short term savings into long term lending for businesses and private borrowers. But the era of extraordinary monetary policy has warped this function.

The money paid through negative rates has undoubtedly hurt profitability, but realistically it is only a small part of the problem. A larger part is the effect on government bond yields, which the ECB's QE program has compressed into often negative yields across the continent. With banks having to hold their reserves in the form of government bonds, this is costing them, rather than earning them at least a small amount. An even larger problem is actual loan rates in the economy. European banks cannot realistically offer their customers deposit rates at or below 0%, as the customers would just opt to keep their money in physical cash instead. By the same token, banks can only lend out at rates low enough to be attractive. But when interest rates are so low, that leaves very little room for profit.

Crucially, this is an economic problem, not a monetary one. Companies will not borrow at any interest rate when inflation and growth are so low – and that does not change if the ECB raises its own rates. That is why it is particularly troublesome that EZ credit demand is so weak. Despite record-low interest rates, EZ loan demand was flat at the beginning of the year, down from 9% growth at the end of last year

Demand for loans to businesses in the eurozone

Past three months, net %

Source: ECB Bank Lending Survey
© FT

and double-digit figures for most of the last three years.

According to Capital Economics economist Jack Allen, this weakness means that "the ECB will be forced to loosen monetary policy further". Maybe, but it is hard to say exactly what they could still do. Even if the bank wanted to start another round of QE, there is not a large enough supply of government bonds to meet its politically sensitive criteria. And increasing the credit supply will only go so far in trying to stoke credit demand. Unless consumers and businesses are confident in the economy and in their own position, they are unlikely to borrow regardless of availability and low interest.

This point about government bond supply hits at a deeper issue in the EZ. In a national economy, the simplest response to low interest rates, low growth and low credit demand would be for the government to temporarily take up the slack by borrowing and spending more. But due to the union's rigid political structure, fiscal policy across Europe has actually tightened recently.

Failing that, another solution would be for banks to soak up capital where it is cheap (i.e. in Germany) and use it where interest rates are higher (i.e. the periphery nations). But again, the EZ's barriers stop this from happening. For all the years of talk of a financial union within Europe, we are yet to see any effective Europe-wide banking mechanism. European banks are required to mostly buy their own national and private debt. It is telling, for example, that throughout the controversy around the Deutsche Bank - Commerzbank merger, the idea of a cross-border merger was never seriously pursued.

None of this is new. These are the same problems we have seen time and again in Europe. And time and again they are met with political obstinacy. In truth, this is the ECB's biggest problem. It is not that Draghi has already used his ammunition: it is that whenever the ECB was forced to save the day he had to bend the existing rules to create effective stimulus measures.

All this may give the impression that Europe is finding itself in a dead-end situation. However, this would only be the case if the EU's economy was at a point where it was entirely dependent on the ECB applying the strictest interpretation of the political rules to its policy measures. This is not currently the case. And as we know well from the past, the ECB is quite prepared to do "whatever it takes" to prevent looming disaster, even if that means ruffling a few feathers on the political side.

As it stands, it is encouraging to know that the ECB has the health of the banks at the centre of its agenda. And with TLTRO and other measures, we believe they will underpin banks' commercial viability sufficiently for the banking sector not to become a systemic threat for the economy. On the monetary side, the ECB may be well advised to leave policy levels unchanged, because the expected rebound of global demand and trade are likely to have a profoundly positive impact on Europe's export heavy economies. This should lead to a return of credit demand by businesses and consumers and create liquidity stimuli without further central bank action being required.

India heading into biggest elections on earth

Despite the looming April election, in March, the MSCI India stock market index posted a healthy 10.4% total return (in £-sterling terms) for the month, outperforming the MSCI World's 2.4% and the UK's FTSE All Shares' 2.7% by some margin. Last month's 15 best-performing investment funds in the UK's IA peer group were all Indian.

That stands in stark contrast to what we have seen since the start of the year. Throughout 2019, India has underperformed Brazil, Russia, India and China (known as the BRIC's - Chart 1). In the last quarter in particular, India has lagged behind the sharp rally seen in China and Brazil (Chart 2).

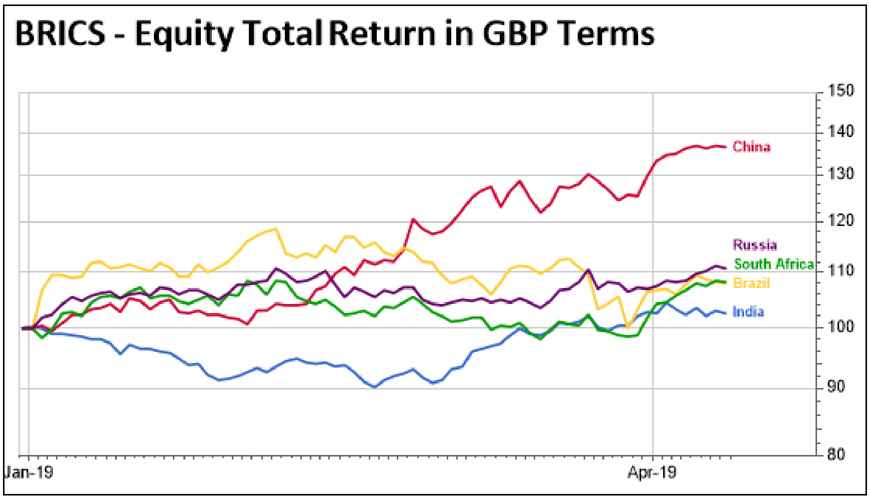


Chart 1

The underperformance is partly due to the escalation of tensions between India and Pakistan at the start of the year (both countries launched missile attacks against each other, and the threat of further military action between the bitter rivals looked its highest in years). This saw Indian equities lose 5.1% in January and fall another 1.1% in February. Consequently, some of March's sharp rebound was a catch-up resulting from an improvement in investor sentiment for emerging markets that occurred throughout Q1. In addition, the International Monetary Fund (IMF) has forecasted 7% growth in India in 2019, above their expectations for China (6.6%), Russia (2.3%) and Brazil (1.1%).

For the next six weeks, the background focus for India funds will be on the general election, which started on the 11th April. Unlike 2014, when Prime Minister Modi won a rare outright majority, this time Modi and his Bharatiya Janata Party (BJP) are expected to retain control but only with support of the National Democratic Alliance.

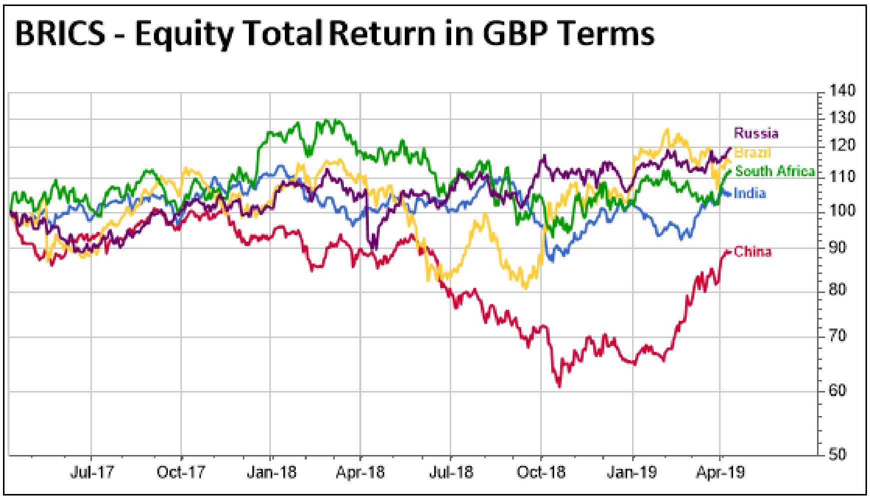


Chart 2

Modi came to power on a platform of being a moderniser and of creating a "new India", and through his tenure he has started to break through some of the old traditions, particularly in tax, cash use and gold.

Indians have long regarded gold as the surest store of wealth, with Indian households owning 23,000 tonnes, three times more than the bullion held by the American Federal Reserve. But shortly after he became Prime Minister, Modi's government launched a scheme in 2015 allowing investors to exchange gold for interest-bearing bonds and to receive the gold back when the bonds mature. The rise in the gold price (which reached a near five-year high in February) coupled with the fall in the Indian rupee to a near record-low versus the dollar, has made the domestic price of gold dearer. As such, demand has eventually started to wane.

Meanwhile, the goods and services tax introduced in 2017 created one indirect tax for the entire country, designed in part to ease the tax administration burden through standardisation. Although it has been difficult to implement, this has reduced the amount of red tape, and India has subsequently risen 65 places in the World Bank's ranking of countries with which it is easy to do business.

Other achievements have been India's consistent growth rate (in excess of 7%) for most of Modi's tenure, the curbing of inflation pressures (by removing some fuel subsidies), and the limiting of increases in the minimum prices of crops. His government has also supported the opening of bank accounts for the poor (with 350 million new accounts created, over half for women), improved payments systems, and a new bankruptcy law for firms. But given the backlog of bankruptcy cases, it is estimated this could take about six years to clear.

That said, it has not all been rosy. Unemployment has continued to rise, and the poor and farmers have been left largely frustrated as subsidies and development schemes failed to reach them. It is estimated that India has over 50 million people living in extreme poverty - according to the World Poverty Clock. This is particularly important for Modi and his BJP party, as almost 60% of India's poor live in the six states that provide 69% of the BJP seats. There have been no big reforms of land or labour markets, and there was short-term economic turmoil with the abrupt cancellation of high-denomination bank notes aimed at wiping out "black money" within the economy.

Underneath these developments, there has been an undercurrent of both political and religious tensions. Modi and the BJP have a focused Hindu agenda, which has been seen as offensive to the 190 million Muslims living in India. Modi has also resorted to politically expedient policies, removing the head of the central bank who had kept interest rates high and replacing him with a more compliant head who promptly cut them. India's banks are still largely in state hands and prone to lend to the well-connected. Worryingly for international investors, the government has either discontinued, revised or delayed some official data that did not provide a positive outlook. It has tried to prevent the publication of a new report on employment and it has also objected to the way revised GDP data was released.

But recent polls would suggest that Modi will survive as Prime Minister, with the electorate giving him a second term to fulfil his "new India" platform's promises. The main opposition party to the BJP – the Ghandi-led National Congress – decided to rule out joining other smaller opposition parties, therefore potentially splitting the vote. Currently, it is not expected that Modi will win an outright majority and his second term will see more checks and balances placed on him. With over 900 million voters and a seven-stage process, the results are not expected to be known until May 23rd.

If Modi does win a second term, international investors will be watching particularly closely to see whether the government can keep a lid on the religious tensions which Modi's populist side has stirred, and to what degree he will be able to continue with his reforms for economic modernisation. For investors the coming months could become a fork in the road. If Modi's administration chooses to focus on economic reform then international investor support can be expected to increase once more. However, should he persist with interfering with official data and stirring up tensions among domestic minorities and neighbours, then international investor support will most probably begin to wane.

15th April 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7437.1	-0.1	-9.8	→
FTSE 250	19711.7	0.9	173.4	→
FTSE AS	4069.9	0.1	2.5	→
FTSE Small	5568.0	0.8	46.5	→
CAC	5502.7	0.5	26.5	→
DAX	11999.9	-0.1	-98	→
Dow	26372.0	-0.2	-53.0	→
S&P 500	2901.0	0.3	8.3	→
Nasdaq	7616.0	0.5	37.2	→
Nikkei	21870.6	0.3	63.1	→
MSCI World	2147.6	-0.1	-2.2	→
MSCI EM	1087.5	0.2	2.4	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	17.5	13.1	13.3
FTSE 250	3.2	24.9	13.6	14.1
FTSE AS	4.5	18.5	13.1	13.4
FTSE Small	3.9	83.1	10.8	14
CAC	3.2	18.5	14.2	13.4
DAX	3.1	15.1	13.3	12.6
Dow	2.2	16.7	16.2	14.9
S&P 500	1.9	19.1	17.5	15.9
Nasdaq	1.0	24.1	21.3	17.8
Nikkei	2.1	16.1	15.1	18.7
MSCI World	2.5	17.8	16.0	15.2
MSCI EM	2.6	13.3	12.8	12.1

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
EasyJet PLC	8.7	Reckitt Benckiser	-7.5
GVC Holdings PLC	7.0	Standard Life A.	-5.1
Schroders PLC	6.5	Whitbread PLC	-3.8
TUI AG	4.9	Rolls-Royce Holdings	-3.8
Experian PLC	4.8	Aviva PLC	-2.9

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.31	0.35	OIL	71.5	1.6
USD/EUR	1.13	0.80	GOLD	1291.3	0.0
JPY/USD	112.02	-0.26	SILVER	15.0	-0.7
GBP/EUR	0.86	-0.43	COPPER	293.5	1.4
CNY/USD	6.70	0.20	ALUMIN	1860.0	-1.8

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.212	8.6	0.10
US 10-Yr	2.549	2.1	0.05
French 10-Yr	0.399	10.2	0.04
German 10-Yr	0.055	685.7	0.05
Japanese 10-Yr	-0.056	-93.1	-0.03

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.68
3-yr Fixed Rate	2.00
5-yr Fixed Rate	2.04
Standard Variable	4.27
10-yr Fixed Rate	2.58

* 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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