THE **CAMBRIDGE** WEEKLY

28 May 2019

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Source: Chris Adams - May fails on impossible task - 24 May 2019, PCGL

It is getting warmer

Unfortunately this headline is not intended to suggest that things are getting better, but rather that Donald Trump's trade war is heating up. In a way I feel reminded of the Cold War between the US and the USSR in my youth, when the odd skirmish or shot down spy plane reminded the world that things could get a lot worse.

The past week demonstrated as much in the trade war. The US indicated that China tech giant Huawei's mobile phones would be pretty useless without US software. China riposted straight away by reminding the US that their global technology leaders would be thrown into a similar existential crisis if China stopped access to their rare earths deposits, without which mobiles, computers and advanced batteries are hard, if not impossible to build (China is home to 90% of currently accessible deposit of rare earths).

A timely reminder that trade wars have no winners (and are hard, not easy to fight…!) and yet stock markets still only wobbled a little, but in no way were willing to price in the fact that this dispute could leave a considerable dent in corporate earnings, particularly those of the recent stock marked darlings in the US tech sector.

The positive take-away was that China kept its calm and did not remind the US President of its 'nuclear' option, which would be to devalue the ¥-Yuan/Renminbi towards and beyond 7¥ per US$. This would shift the trade war pain burden disproportionately towards the US economy and would tell us that despite the Huawei assault, the Chinese remain willing to talk. This is important, because Trump is also rapidly losing the position of strength he believed he had, as last year's positive economic momentum in the US economy is rapidly slowing down. The latest release of business sentiment indicators shows that the mood has soured very decisively over recent weeks.

The minutes of the last US central bank meeting did not help. Those who like to think that monetary policy easing by the US Fed will quickly come to the rescue were once again disappointed by the more hawkish than expected tone that left little room for imminent rate cuts. We suspect this has less to do with rate-setters misreading the economy, and more to do with their concerns that the shadow banking market is once again gaining ground in US credit provision, and is very hard to control with traditional central bank tools.

We are not the only ones who note that this looks suspiciously similar to last year's pre-correction environment, when a slowing economic outlook and a seemingly unresponsive central bank triggered the Q4 sell-off. For the moment these are only concerns, but should Trump be unable to put the trade war genie back in the bottle before the summer break, then the markets' bullish assumption that H2/2019 corporate earnings growth will be better than H1 will be disappointed, and could lead to a repeat of last year's correction.

The week's only muted negative response by capital markets suggests that a majority of investors still believe that the two sides are mainly posturing but are still aiming for a resolution at the G20 summit in late June. They may well be reading Donald Trump correctly and we know that he removes tariffs as fast as he puts them up, but the longer this stand-off lasts the higher the risk of further miscalculations on both sides. In a way the poor US data this past week was quite positive, as it increases the pressure on Trump to act, but unfortunately the relative calm of stock markets does not. We do hope that he will not escalate the matter so far that markets stage a riot, but after last week's events we cannot be so sure any longer that it might not happen over the coming weeks or months.

This would a very different type of correction than the earnings-related one mentioned earlier, in that it might not last very long and might lead to another even steeper recovery, should it spur politicians towards a timely resolution.

Against the backdrop of political turbulence in the UK this may all feel quite far removed and abstract, but clearly Brexit also centres around terms of trade. The final chapter of Theresa May's time as prime minister had many people worried about what might come next. This included the currency markets with £-Sterling duly falling a couple of percentage points further against the US$ and the €-Euro in anticipation of a higher probability of a harder Brexit.

I am not convinced I can follow this much repeated logic (both by domestic media, as well as across the Continent). The next Conservative leader to be chosen by the Tory party members will face the same dynamics in Parliament that had Theresa May's Brexit plans flounder. A more aggressive Brexiteer like Boris Johnson will therefore think twice before taking on this poisoned chalice. They may seek salvation in snap elections, but given most MPs (including Labour) will be reluctant to take such a step for fear of deselection, this move also seems less probable than many suggest.

The most likely outcome therefore would seem to me to be further extensions that eventually lead to another referendum, the outcome of which is much harder to predict than either side proclaims. The results of the European elections across the UK may provide further hints about possible future developments and we will therefore have to pick up the topic again next week

The taming of the comrade

Chris Adams; 3 Apr 2019

At the time of writing, Theresa May is still Prime Minister until she specifies the timings of her departure in June. But the odds of that still being true upon reading are perilously slim. Last week, we wrote that the PM had a sword dangling above her head, and that a bad result for the Conservative party in this week's European Parliament elections could be the thing to shake it loose. Now it seems she may not even survive long enough to see the results.

This week has seen a chain reaction take place in Downing Street. On Tuesday, Mrs May wrote a letter to opposition leader Jeremy Corbyn asserting her willingness "to compromise to deliver Brexit for the British people," and pleading for Mr Corbyn to do the same. Her Withdrawal Agreement Bill (WAB) has been modified after the three defeats it has faced in the House of Commons – largely to win the support of MPs across the benches.

In many ways, the fourth incarnation of the WAB is very similar to the Labour party's own Brexit stance: a temporary EU customs relationship until the next general election, protections for the environment and for workers' rights and even a potential parliamentary vote on a second referendum. It is so close in fact, that some members of her own Cabinet refuse to support it. Leader of the House of Commons Andrea Leadsom resigned on Wednesday, saying she no longer believes the government's approach will deliver Brexit.

The government's Brexit bill was then delayed even further, and – if at all - will not be published or debated until early June. But many of May's own MPs are calling for it to be abandoned, and her with it. And even if her flagship bill makes it to the floor of the Commons, its prospects are slim. Despite making considerable concessions to the Labour party, they (the Labour party) have already announced they will vote against it. And with the Brexit wing of the Tory party firmly against it, the WAB would almost certainly see a firm and final defeat.

The official Labour line is that May's proposal does not differ substantially enough from its previous form. But they may have other motives. Like everyone else in Westminster, Mr Corbyn can smell blood in the water. The Tory party is deeply divided, sinking in popularity and soon to have a change of leader. For all the Labour party's internal problems, it looks comparatively unified. To the Labour leadership, a Tory leadership election brings them one step closer to a general election they believe they can win.

That scenario is not so far-fetched. We would not put a bet on it, but the path to a Corbyn/Labour-led government within the next year is easy enough to see. This is a thought that has undoubtedly scared some of the business and financial commentators. In the wake of the last Labour conference, a senior business figure reportedly told the FT: "It is now very common to hear business people say they are more worried about the prospect of a Labour government than they are about Brexit."

There is no shortage of hyperbole surrounding the Labour leader. But it helps to keep a level head and think about what a Corbyn premiership would actually mean for markets and the economy. What policies would they actually be able to implement? And how would this affect things from an investment perspective?

For starters, it is worth bearing in mind that, while a Labour government is a real possibility, a Labour *majority* is very unlikely. The surge in support for the SNP over the past decade has robbed Labour of a vital heartland in Scotland, meaning they would have to win a majority in England (historically far more conservative than the other home nations) to secure an overall majority. Any Labour government is therefore likely to be propped up by either the SNP, the Liberal Democrats or both. This would likely quash some of Labour's more left-wing policies. (Those who remember David Cameron's warning about an Ed Miliband government allowing Scottish nationalists into power in 2015 will appreciate the irony here)

In the 2017 election, Labour's core pledges included a scrapping of tuition fees, renationalisation of the rail, water and energy sectors, higher tax rates for high earners and increased social spending. Of those, renationalisation and welfare spending seem the most likely (followed closely by tax rises and somewhat further by free tuition) under a coalition government. Discussion of their merits is too political for these pages, but suffice it to say that none of these would turn the UK into Venezuela or plunge us into a Greek-style crisis.

However, since Labour's surprise performance in that election, the more left-wing elements of the party (spearheaded by shadow chancellor John McDonnell) have grown a little bolder. At the party conference in September, Mr McDonnell announced a controversial plan to force large companies to hand over 10% of their shares to employees, as well as put workers on company boards.

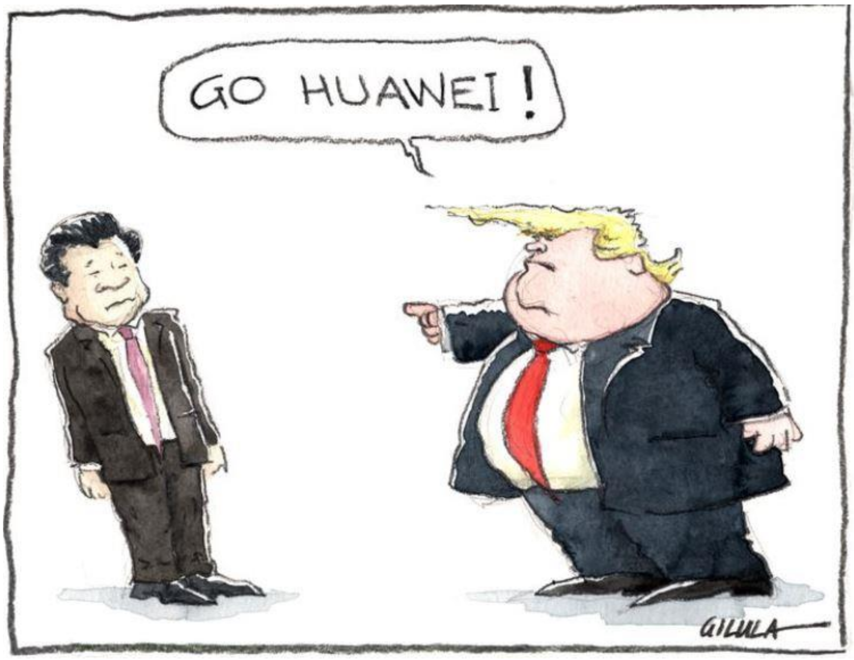
From an investment perspective, this is perhaps the most significant of Labour's policies. The prospect of having your stake in a company diluted by mandatory share transfers would make that stake less attractive – which could put downward pressure on UK stocks. But the 1% yearly transfer still should not be enough to substantially suppress share values over the long term. Still, when you add in Brexit complications and the pre-existing unpopularity of British stocks for overseas investors, it could make things difficult.

Policies like these could also have a significant short-term impact on UK markets. It is very likely that, in the event of a surprise Labour election victory, equity markets would throw another tantrum. Just like after the Brexit referendum result – when UK stocks broke the record for single-day falls – the immediate reaction would almost certainly be a sell-off. But short-term sell-offs like those are not usually indicative of longer-term returns. After the initial shock, the FTSE 100 enjoyed a decent run, while in the US the infamously short "Trump tantrum" was followed by a much longer "Trump rally".

Long-term stock market returns have much more to do with general economic conditions than with government policy. Of course, Corbyn's critics also suggest that economic conditions would deteriorate. A looser fiscal policy would lead to higher yields on debt and higher inflation, choking off growth – goes the argument. But we suspect this may be somewhat overstated. While you would expect Labour fiscal policy to be somewhat looser than the Tories', there are lots of factors we would expect to temper this: coalition partners, the more right-wing Labour MPs, the independent Office for Budget Responsibility and public opinion.

Then there are the other aspects to consider. The party has some interesting proposals for changes to the Bank of England – centred around giving the central bank a mandate for monitoring and encouraging productivity growth as well as inflation. After a decade of lethargic productivity and extraordinarily loose monetary policy, changes to the central bank's function might be what is needed.

And of course, Brexit: Labour's proposal for a continued customs union with the EU is about as soft a Brexit as possible. We will not go into the politics here but, from a business perspective, this is probably the best outcome – a continuation of the status quo – more or less.



Huawei, trade and geopolitics

Source: Gilula, Cartoon movement, May 2019

It would seem that there is more to the US-Sino trade negotiations than simple trade. Trump's stated objective in the trade war is to end China's unfair practices and to reduce the US's balance of payments deficit. And that may be true to a degree. So-called "Rust Belt" production and employment is key to Trump's 'Make America Great Again' promise to his electorate.

But some suspect a more sinister aim: continuing US technological superiority gained by restricting the development of Chinese industry and squeezing the supply chains of Chinese firms that are reliant on overseas products or services. On this reading of the situation, trade talks are just a cover. The rising pressure on telecom equipment giant Huawei – arguably China's flagship company – supports this view.

The US has accused Huawei of creating 'backdoors' in its products and software that would permit spying – hence the caution on the company's 5G network equipment and smartphones. But no such backdoor has ever been demonstrated. Governments around the world have studied Huawei's source code to look for possible backdoors and other nasties. Although they have found plenty of evidence of shoddy software engineering, they have not found any evidence of deliberately-introduced vulnerabilities. The latest report from the UK government's cyber security unit can be found here.

But that has not stopped the US taking action. In a one-two knock-out blow for Huawei's international ambitions, Google [in compliance with Trump putting Huawei on the banned Entity List] terminated Huawei's access to further updates of the Android smartphone operating system and to the Play application store. This effectively renders Huawei smartphones useless for users keen to keep their phones up to date with the latest Apps.

Then, on Wednesday, UK-based ARM Holdings (the supplier of the chip designs that power every single smartphone around the world) halted "all active contracts, support entitlements, and any pending engagements" with Huawei. A host of others like Intel and Qualcomm have also cut ties on Trump's orders, but Google and ARM will cut the deepest.

Until this week, Huawei's momentum appeared unstoppable, in its long march towards being the global number one. But losing access to both key pieces of technology within a week could do irreparable longer-term damage.

Its smartphone business has soared in recent years, increasing 50% year-on-year to 59 million units in the first quarter of 2019, despite declining overall sales globally. Huawei rapidly gained market share to take third spot and was quickly closing in on Apple's number 2 spot. In contrast, Samsung (number 1) and Apple saw sales decline 10% and 23% respectively in Q1.

Huawei shipped an astonishing 200 million smartphones in 2018, nearly all preloaded with Google's Android software. Today, Android is the world's most popular mobile operating system, accounting for almost 80% of all smartphones. But it's the loss of Google's own applications/services (Maps & Playstore) that may hurt future sales. Without access to these, a Huawei (or any other brand) is just a nice-looking paperweight.

It is worth noting that shares in Samsung have gained nearly 4% on the week – so investors could be betting that the Korean giant will benefit from Huawei's malaise. Huawei also makes laptops powered by Microsoft's Windows, which Trump might target next.

Huawei is confident it will have its own operating system "soon", but development of such software is not a trivial task. We might see a reverse-engineered version of the Open Source version of Android (ASOP), but right now there does not appear to be an imminent Plan B.

For Huawei, the damage to future sales may already have been done. Services like Google maps are powerful draws for customers, so Trump's ban might have introduced doubt in the mind of consumers: "what if I can't access my emails/YouTube/maps/etc…should I buy Samsung or Apple?"

It is only this week that the firm launched its Honor 20 handset in London, but already networks like Vodafone and EE are reviewing the inclusion of future releases of Huawei phones. EE has reportedly pulled Huawei's first 5G phone as it gears up to launch its next generation network this month in selected UK cities.

Huawei could see a large hit to both sales (top line) and profits (bottom line). The firm doesn't split out revenues by product type, but last year it hinted that the consumer unit accounted for around 48% of total sales. It's possible that Trump's ban could paralyse Huawei's smartphone and 5G network equipment business, as losing access to Google's vast ecosystem could cost Huawei all of its smartphone sales outside of China (where domestic apps dominate – so sales face less pressure), which analysts estimate account for 50% of all units sold.

That is just the software side. Huawei also has a rapidly growing chip production unit (HiSilicon). It has produced the *Baolong* 5000 (a domestically produced 5G modem) and the Kirin range of application processors. Both bits of technology rely on international partners or licensees, US firm Qualcomm on the modem side and ARM Holdings for the CPUs. Trump appears to be squeezing Huawei's global supply chains.

In response, Huawei said they recognised "the pressure some of [our partners] are under, as a result of politically motivated decisions", but that recognition may not stop its cash flow slowly grinding to a halt.

Some have speculated that this week's moves mark the start of a new technological 'cold war' and a fundamental reconfiguration of global trade.

In response, President Xi hinted at a possible export ban of rare earth elements. That's a hefty counter threat. China produces 95% of all the world's rare earths and the US (and all developed markets) are utterly reliant on these materials to make a variety of technological products. The share prices of China's rare earth producers were all 'limit up' on Tuesday.

The loss of these rare elements could be devastating for US tech firms, as they would be unable to make computer chips, sensors and batteries. China has used its advantage here before, with Japan in 2010 when the issue of the disputed Diaoyu/Senkaku islands flared up. China reduced the export quota of rare earths, used by Japanese carmakers like Toyota and by battery makers like Matsushita Electric's Panasonic unit for their electric vehicles and battery packs. Japan has been seeking alternative sources ever since then. Last year, Japanese scientists found a "semi-infinite" cache of rare earths on the seabed about 1000 miles from Tokyo.

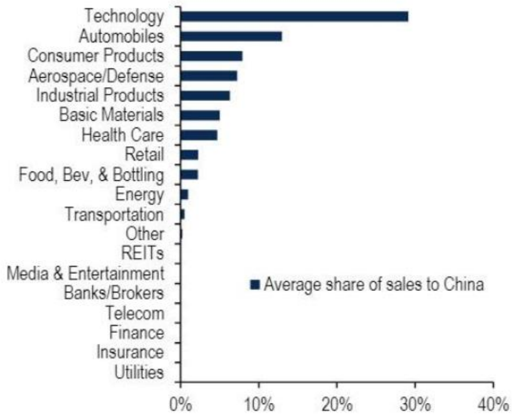
They found an estimated 16 million tons of rare-earth oxides, according to researchers. That's equivalent to 780 years' worth of yttrium supply, 620 years of europium, 420 years of terbium and 730 years of dysprosium. Its location and depth make it difficult to immediately access, but its very existence could limit China's ability to apply pressure using these materials in the longer-term.

In the shorter-term, China could seek to hurt the US via Apple, one of the world's most valuable companies, by pressuring the sale and production of iPhones. Goldman Sachs estimate that Apple's total China exposure is about 29% of Earnings Per Share.

Should China restrict iPhone production in any way, Apple might find it difficult to shift significant iPhone volume outside of China at short notice. But it might be China that ends up worse off – in terms of employment and technology – if Apple were to push production outside China on a more permanent basis. Any short-term restrictions could have longer-term consequences for Apple, given that Apple is believed to be ramping up for its iPhone 11 series in the autumn.

It is interesting that, for now, China has adopted a softer approach, with images appearing on local social media showing how it was 'shameful' for the Chinese to own an iPhone.

Figure 1: Sectors sensitive to China (Percentage of sales)



Source: BofA Merrill Lynch Global Research

Other firms such as Nike and Adidas penned a joint letter to President Trump calling proposed tariffs "catastrophic". Other sectors exposed to China include autos, consumer products (+luxury goods) and aerospace & defence.

Despite the apparent trade escalation, market reaction appears more cautious than outright fearful, with global equities (MSCI World) down just 0.8% in USD terms or 0.4% in GBP terms.

It remains to be seen if this week's developments are just further posturing by both the US and China, or indeed the opening salvo of a new tech cold war. These latest moves have exposed China's weakness. Despite its rapid advances over the decades, it still needs external expertise and production (Taiwan is key). Expect authorities to re-prioritise the development of domestic technologies.

Trump may have calculated that supply lines for western firms are likely to be short-term. But the longer-term hit to China is directly on production, and thus right across its economy, right at the most difficult phase of its economic transition away from the 'middle income trap'.

Either way, peace needs to be restored soon, before the situation escalates into a wider economic conflict involving sanctions and other measures. Investors may wish to tread carefully until then.

28th May 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7277.7	-1.0	-70.9	→
FTSE 250	19127.3	-1.9	-371.3	→
FTSE AS	3981.6	-1.1	-43.7	→
FTSE Small	5607.1	-0.2	-13.4	→
CAC	5316.5	-2.2	-121.7	→
DAX	12011.0	-1.9	-227.9	→
Dow	25538.8	-0.9	-225.2	→
S&P 500	2827.0	-1.1	-32.5	→
Nasdaq	7319.2	-2.5	-184.4	→
Nikkei	21117.2	-0.6	-132.9	→
MSCI World	2087.5	-1.4	-29.0	→
MSCI EM	984.8	-1.2	-11.6	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	5.1	17.2	12.7	13.3x
FTSE 250	3.4	24.7	13.3	14.1x
FTSE AS	4.8	18.3	12.7	13.4x
FTSE Small	3.7	-	11.6	14.0x
CAC	3.5	18.2	13.8	13.4x
DAX	3.2	16	13	12.6x
Dow	2.3	16.3	15.8	14.8x
S&P 500	2.0	18.5	17	15.9x
Nasdaq	1.1	23.1	20.4	17.9x
Nikkei	2.2	15.7	14.9	18.5x
MSCI World	2.6	17.3	15.5	15.2x
MSCI EM	2.9	12.5	12	12.1x

Top 5 Gainers / Top 5 Decliners

COMPANY	%	COMPANY	%
Evraz	6.6	TUI AG	-10.5
AstraZeneca	3.6	easyJet	-10.3
Smurfit Kappa Group	3.6	John Wood Group	-9.3
Micro Focus Inter.	3.1	Marks & Spencer	-8.0
Intertek Group	3.1	International Consoli	-8.0

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.27	-0.18	OIL	67.9	-6.0
USD/EUR	1.12	0.36	GOLD	1284.0	0.5
JPY/USD	109.37	0.65	SILVER	14.6	1.2
GBP/EUR	0.88	-0.50	COPPER	270.8	-1.5
CNY/USD	6.90	0.26	ALUMIN	1797.5	-3.4

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	0.956	-7.5	-0.08
US 10-Yr	2.319	-3.0	-0.07
French 10-Yr	0.282	-1.4	0.00
German 10-Yr	-0.117	-12.5	-0.01
Japanese 10-Yr	-0.070	-34.6	-0.02

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.67
3-yr Fixed Rate	1.98
5-yr Fixed Rate	2.03
Standard Variable	4.29
10-yr Fixed Rate	2.59

* 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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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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