THE **CAMBRIDGE** WEEKLY

10 June 2019

Lothar Mentel

Lead Investment Adviser to Cambridge

Source: Hedgeye; Bulls and Bears nervously eye the central bank's willingness to help out markets again; 7 June 2019

The return of the central bank put?

Stock markets had a very good week – for all the wrong reasons. Economic data reports confirmed that 2018's US economic expansion is rapidly decelerating towards outright stagnation as companies appear to batten down the hatches in anticipation of an all-out trade war, not only with China but now also with neighbour Mexico. Central banks, which until recently had been firmly on an interest hiking path, downgraded their near term growth forecasts and assured capital markets that they are willing to consider reversing monetary policy fully and to counter slowing growth with rate cuts or even a restart of QE.

The reason stock markets rallied on the bad economic news was that the central bank announcements indicated to them that monetary policy stimulus would once again come to support them – as it did during most of the 10 years since the global financial crisis (this is what is referred to as the 'central bank put'). And while the economic slowdown more or less forces them to help inflate asset price valuations, many market participants still consider it quite likely that the reason for the slow down – the trade war – will end before it can seriously derail the remaining global economic growth dynamics.

Such a combination of renewed benign monetary conditions, and a boost of sentiment and pent up demand-release from a winding down trade war, could create a truly 'Goldilocks' period of re-accelerating growth, fuelling stock markets through corporate profit growth. Unfortunately, the assumption of an end to the trade war depends crucially on the Trump administration (which cannot be described as predictable) – even if all rational arguments tell us that a Trump, seeking re-election, will do everything to re-accelerate the US economy before the 2020 election year.

CAMBRIDGE
INVESTMENTS LIMITED

10th June 2019

After a weak May in terms of asset class returns (see the table below), the good start to June is welcome, but it does feel uncomfortable and fragile. Stock market valuations will continue to feel very vulnerable, until some re-assurance emerges that a trade deal between the US and China is likely over the next three months, and that Trump will keep the other looming trade conflicts (Mexico, Europe, Japan) to a minimum, which will please his electorate without particularly restricting trade.

In such an environment of binary outcomes it is near impossible to establish conviction behind any particular portfolio positioning because downside risk and upside opportunities appear finely balanced. We are therefore content for the moment with our neutral asset allocation and slight underweight to US stock markets.

Asset Class Returns at the end of May 2019

Asset Class	Index	May	YTD	2018
Equities	FTSE 100 (UK)	-3.2	8.8	-8.7
	FTSE4Good 50 (UK Ethical Index)	-2.4	7.3	-9.2
	MSCI Europe ex-UK	-2.5	10.0	-9.9
	S&P 500 (USA)	-3.9	11.9	1.6
	Nikkei 225 (Japan)	-1.1	4.9	-7.5
	MSCI All Countries World	-3.5	10.2	-3.8
	MSCI Emerging Markets	-5.2	5.2	-9.3
Bonds	FTSE Gilts All Stocks	2.5	4.6	0.6
	£-Sterling Corporate Bond Index	0.5	5.6	-2.2
	Barclays Global Aggregate Bond Index	4.2	4.4	4.9
Commodities	Goldman Sachs Commodity Index	-5.5	9.7	-8.5
	Brent Crude Oil Price	-11.2	16.4	-14.5
	LBMA Spot Gold Price	3.6	2.2	5.0
Inflation	UK Consumer Price Index (annual rate)*	0.6	0.5	2.1
Cash rates	Libor 3 month GBP	0.1	0.4	0.6
Property	UK Commercial Property (IA Sector)*	0.0	0.3	2.9

Data sourced from Morningstar Direct as at 31/05/19. * to end of previous month (30/04/19). All returns in GBP

Are Woodford's woes the death knell for active management?

As many of our readers will have seen in the headlines, Neil Woodford suspended his flagship Equity Income fund this week in an attempt to slow customer outflows and avoid a fire sale of illiquid stocks. We will not go over old ground in this update but suffice it to say, we believe this was the right decision and in the best interests of remaining investors.

Instead, we want to understand why this happened, what its impact might be for the industry and how, at Cambridge, we work to avoid being caught in situations such as this.

First of all, the why:

Neil Woodford is not the first 'star' fund manager to fall from grace and almost certainly will not be the last. Many of you will remember Peter Young's infamous court appearance, Anthony Bolton's failed attempt to repeat his UK success in China, and Bernie Madoff's Ponzi scheme. Now, we're not saying these cases are the same in their level of criminality or morality, but there are a few common threads, namely large funds with a single star manager being sold directly to retail investors on the back of strong past performance. Without oversight, the interests of manager and investor can quickly become misaligned.

Stars don't become stars without a reason: they are there through hard work and skill. However, at the point they are shining brightest it is hard not to be tempted to monetise this status, selling directly to consumers to gather more and more assets whether that is sensible or not. This becomes compounded when asset gathering is mutually beneficial for both the fund manager and the platform doing the marketing and providing exclusive access in fee terms.

It is somewhat easier to sell a famous face or name to retail investors than a convoluted but well-balanced strategy with somewhat boring risk controls. It is also much more exciting to talk about a portfolio with positions in innovative medical firms on the verge of great breakthroughs, or in privately-owned technology stocks tipped to be the next big thing. Unfortunately this means these funds tend to be held more by retail investors than by institutions. Retail investment, however, tends to be less sticky and may not subject the manager to the same level of scrutiny.

It takes a unique sort of person to avoid the over-confidence that comes with being put on such a pedestal, and to correctly balance the trade-off between personal gain (delivered by asset growth) and investor gain (delivered by fund performance), and also to avoid the temptation to increase exposure to positions which would otherwise allow them to live up to their legendary status, despite the risks. Egoism often comes with wealth and reputation, and managers start to believe their own hype. They believe *they are* not wrong in their stock selection and portfolio positioning – the market is wrong or the risk team is too blindly regimented – and the market will come round to their way of thinking eventually.

What might the impact be for the industry?

Another well publicised scandal involving financial services is not great for the industry as a whole. Especially when it becomes a bit of a witch-hunt: highlighting Woodford's lavish lifestyle and contrasting this with stories of those with hard earned savings locked in the fund. Mainstream media has a habit of putting people up on a pedestal one minute and cutting them down the next. You can't blame them, they have clicks to collect.

In terms of the event's wider impact on the market however, we expect the fallout to be relatively well contained. The steps taken by Woodford (to allow his positions to be sold down in an orderly fashion) is sensible and the majority of his small cap positions are not widely held (or held in large proportions) by other active managers.

There may be more regulation to come on how funds are marketed directly to retail investors. Platforms such as Hargreaves Lansdown offering pseudo-advice through services such as their Wealth 50 may come under greater scrutiny. Hargreaves' share price has fallen ca 15% on the back of this possibility.

The reputation of star managers has certainly taken a knock and Neil Woodford is unlikely to recover. However, we believe this is not the death knell for active management, in fact quite the opposite. It highlights the importance of professional financial advice and portfolio oversight through discretionary management. The ability to access and question fund managers is simply not available to individual savers. The collective expertise and experience of professional investors is crucial in holding mangers to account.

What do we do to avoid such events?

We sold Woodford's fund back in 2016, before any of his performance woes began to bite. It would be disingenuous to say we foresaw the scale of underperformance, outflows and subsequent suspension. However, we did have concerns about how reluctant Woodford was to meet institutional buyers and how much his exposure to less liquid small caps and private equity was increasing. We also had concerns at the time about how much more 'free' Woodford was, now that he could invest with conviction and without the restrictions placed upon him by Invesco's risk and compliance teams.

Ultimately the style drift, the liquidity mismatch between a daily traded fund and the underlying holdings, and the lack of a well-formed, independent risk team led to our departure.

At Cambridge we meet the managers we invest in regularly. We aim to fully understand their processes and strategy and, importantly, assess what checks and balances are in place to help prevent many negative but inherently human characteristics or behavioural biases.

We stress the importance of assessing a fund objectively rather than on reputation or past performance alone. Bigger and more popular does not necessarily mean better. Fund analysis is not simply a matter of ticking the boxes: instead questions need to be tailored for the situation in hand. Can an independent risk team truly be independent when the fund manager also pays their wages?

We assess the composition of a fund's investor base. Funds held by mainly retail investors or single large institutions are more likely to see their assets under management quickly evaporate. This is not always a problem, but a risk which needs to be carefully managed if the fund holds fewer liquid assets.

We avoid funds with a liquidity mismatch (for example daily traded physical property and private equity funds), and we monitor the underlying liquidity in each of our funds.

We monitor fund flows and total assets to ascertain whether a fund is subscale or too large for the proposed objective. We also continuously monitor a manager's positioning to ensure he/she is sticking to the original proposition. Any manager that's not willing to offer complete transparency on holdings is a red flag.

Incorrect decisions and periods of underperformance happen to active managers all the time. They are paid to take risks and cannot always get it right – this is forgivable. But style drift and strategy changes which are designed to regain lost performance, or to cater for ever growing AuM, and which serve only to line the fund manager's pockets, these are manager actions that cannot be tolerated.

Markets pricing in steep rate cuts

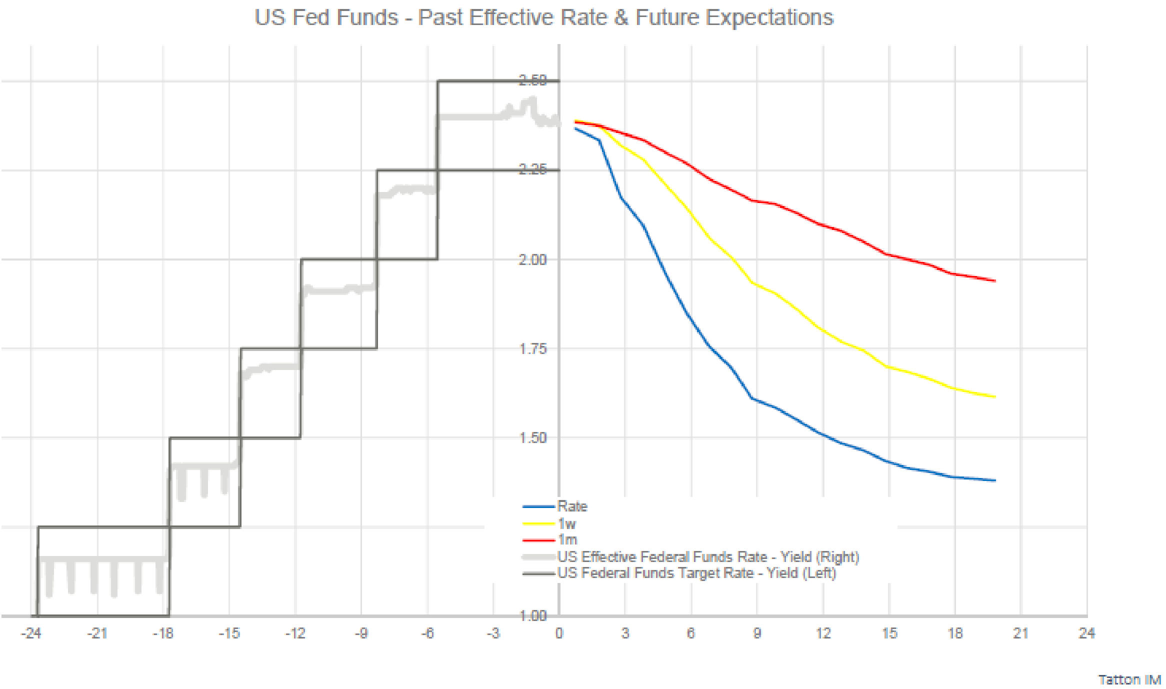
The US Federal Reserve (Fed) seems to be becoming more dovish by the day. It was only months ago that the Fed was signalling it would continue the 'normalisation' of interest rates away from their historic lows. But now talk of low inflation, economic weakness and the need for accommodative monetary policy dominate the 'Fedspeak'. This week, a number of the Fed's regional governors voiced their concerns: Fed governor Brainard said the Fed was prepared to sustain growth by adjusting policy, while governor Evans – head of the Chicago Fed and a voting member of the Federal Open Markets Committee (FOMC) – told reporters that low inflation is itself grounds for more monetary accommodation.

Fed Chair Jerome Powell has also had a dovish tone. His recent comments on inflation have erred on the more cautious side. Reuters noted this week that Powell had dropped his usual call for the Fed to be "patient" in rate decisions, and the Wall Street Journal went as far as to say that the Fed's 'up or down' debate was over. Reportedly, the FOMC have already decided their next rate move will be a cut; the only questions are when, and by how much?

Some commentators have suggested this change of tone has been more political than economic. President Trump has made his disapproval of Fed policy well known during his time in the White House. He went as far as calling Powell "crazy" for continuing to raise rates. This led Bloomberg's John Authers to claim that Trump had bullied the Fed into his preferred policy.

From our point of view, this is unfair on the central bank. The Fed's move away from monetary tightening has gone hand in hand with a marked slowdown in both the US and global economies. US growth has been slowing for some time. Even disregarding politics, the case for further rate rises has all but disappeared. And judging by the most recent data, you would be hard-pressed to make a case for even holding them still.

That seems to be the expectation of capital markets at least. The chart below shows the implied market expectations for US interest rates (blue line) over the next 21 months – contrasted with where they were a week ago (yellow line) and a month ago (red line). As you can see, current expectations are well



below where they were a month ago, and have fallen significantly even in the last week alone. Markets are now pricing in that the Fed will cut rates at the same pace that it raised them – roughly one 0.25% cut every quarter. That would be a remarkable turnaround for the Fed.

The change in expectations is partly down to the noise coming out of the Fed itself; a dovish sounding Fed naturally leads people to expect dovishness. But we think it is also a reflection of wider expectations for the economy. Under Powell, the Fed has changed from the previous forward guidance model – where the FOMC would give a clear indication of where they expect rates to be over the longer-term – to being much more dependent on the incoming data. And that data has been far from encouraging.

While US growth has been slowing for some time, there were two main factors that kept the Fed on a hiking course: near term inflation showed little sign of falling back, and the labour market remained tight (which was expected to spur future wage inflation). Now the picture looks very different. Rising oil prices have masked weak core inflation to make overall inflation seem relatively strong. But with oil prices now stalling, overall inflation is left looking weak again.

Meanwhile, the US labour market is showing significant signs of weakness. According to two different measures, the private sector added just 27k or 75k jobs in May. That is well below April's nearly 300k and the lowest gain since March 2010. According to JPMorgan analysts, the report could mean the labour market is weakening more than anticipated. And other data seems to corroborate this: the IHS Markit Services PMI (measuring business sentiment) fell 2.1 points to 50.9 (indicating stagnation) last month, with business confidence now the lowest in three years.

Bearing this in mind, a rate cut (or several) from the Fed should not be surprising. The good news is that the Fed's expected dovishness has helped bring some positivity back to capital markets. At the end of last year, central bank tightening – and the drying of liquidity that came with it – was one of the main fear stories for markets. With monetary policy now expected to loosen, some confidence is returning.

But we should be cautious here. Markets already expect the Fed to cut rates as quickly as they reasonably could. And any sign that they will not do so – even if they cut at a slower pace – is likely to upset investors. What's more, despite loosening financial conditions, any scenario where the Fed cuts as quickly or more quickly than currently expected would not be a positive for risk assets, because it would have to be accompanied by significant weakness in the economy.

That makes markets vulnerable. From here, it is likely that positive (or at least neutral) economic data will be needed to keep the good mood going. We are in a precarious situation: markets are supported by bad data (because of its effect on the Fed) while also needing it to get better. Things are not yet in dire territory, but we need to tread lightly.

US antitrust authorities discover size of US tech giants

America's technology giants are finally facing a backlash. This week, it was announced that tech companies like Alphabet (more commonly known as Google) and Facebook will face an antitrust investigation from the US House of Representatives. The probe, announced on Monday by congressman David Cicilline, will look into whether the Silicon Valley stars have become too big, stifling competition and harming consumers.

The news comes after a number of developments threaten to rein in the tech industry. The Trump administration has also signalled that it plans to draft new antitrust legislation covering Amazon, Apple, Google and Facebook. And just last month, Apple lost a landmark case in the US Supreme Court – which ruled that iPhone users in the US can file a class-action lawsuit against Apple for its monopolistic practices (forcing consumers to use its "app" store, from which it takes a cut of sales). Monopoly – whether the tech giants have it, and what to do about it – has become a hot topic. So, what does this mean for a tech industry which has enjoyed incredible growth in recent years?

No one denies that tech giants like Apple, Google, Facebook and Amazon are, well, giant. In a matter of decades they have gone from plucky internet start-ups to the largest and most powerful companies in the world. In the past, many of these companies may have been called conglomerates – with their hands in a number of different sectors. But the integration they enjoy, enabled by new technology (which in many cases, they invented), allows them to operate their services as one. That also makes their monopolistic practices potentially more damaging to consumers.

How did they get so big? Each of the tech giants has its own story, but virtually all of them followed the same pattern: for a long period, they were given unprecedented access to very cheap capital at lofty stock valuations. Capital was so cheap for them because investors were willing to tolerate minimal earnings, so long as the companies delivered growth. And the companies certainly held up their end of the bargain.

Amazon, for example, reinvests a large chunk of its profits in new technologies and business ventures, rather than handing them to shareholders. In the past, shareholders may have demanded some earnings, rather than believing in the grand plan of a charismatic CEO. This is partly due to the corporate structure in place (Amazon's Jeff Bezos retains voting power over his ex-wife's shares, for example). But it is also down to continual reinvestment and expansion. This gives their business units a leg up and also the ability not to rely on Amazon as the sole buyer of their services.

Acquisitions have also been a key strategy. Facebook, for example, have made a habit out of gobbling up rivals or businesses with opportunity for expansion – such as WhatsApp, Instagram and Oculus VR. This has made them the undisputed champions of social media.

All of these factors have caught the attention of lawmakers. On announcing the probe, congressman Cicilline – who leads the House's top antitrust subcommittee – declared that the "Internet is broken," and that "people have recognized there are some real dangers here". The political tide is turning against the tech giants. And with another US election on the horizon, it is only going to grow stronger. In a time when polarisation between the Republicans and Democrats is as high as it has ever been, addressing the dominance of Silicon Valley is a point of rare bipartisanship.

Of course, given the extensive funding the tech giants have, they will no doubt fight tooth and nail to diminish any impact of new legislation – through lobbying, legal battles, or otherwise. But that can only go so far, and it now seems very likely that some form of competition law governing the tech sector will come about. The key questions are whether and how it will actually help consumers.

In the past, the breaking up of monopolies has often made little difference to the consumer experience. Take Standard Oil for example: in the end, petrol is still just petrol. But there is a good chance things could be different now. In some of the cases, consumers arguably benefit from the tech monopolies. Facebook and WhatsApp, for example, are only useful because so many use Facebook and WhatsApp. Google and some of the others may have a harder time arguing this, but consumers do tend to prefer the ease of a single provider for phone, apps, tablet etc. You would be hard-pressed to make the case that Amazon's size has increased consumer costs. In their case, their massive size has made them competitors in lots of different markets, rather than monopolising one alone.

But there are other aspects to consider. Amazon may not have made prices higher for end consumers, but they have arguably squeezed end producers substantially. And Facebook's issues – such as the Cambridge Analytica scandal – have been well-publicised. Regulators also have to ask themselves if charging structures (explicit or more subtle, such as personal data) are being abused by these companies. One of the main reasons further antitrust legislation could be needed is precisely because these issues do not fall under the remit of established antitrust laws. The new technologies involved have thrown up issues that did not exist before.

It is hard to say exactly what impact any potential changes will have on consumers. But for the tech giants themselves, it presents a problem. The 'Wild West' age of the internet seems to be coming to an end, and that could threaten the rampant growth story. The good news for them is that history has shown that political and regulatory change is often an immensely slow process – especially for complex companies like these (just watch Congress's confused questioning of Mark Zuckerberg).

In terms of share prices, the fact that these stories are being announced may not be such an issue in the short term – beyond their one day sell-off last week. It is unclear what the end result might be, and in any case it will likely be years into the future. However, with Primaries campaigning set to begin in the US in autumn, it is likely that the policy newsflow will become more and more worrying for the tech companies. Despite the strong economy of the past few years, the profits of small business have stagnated, while the FAANGs (Facebook, Apple, Amazon, Netflix, Google) have roared ahead. That paints a target on their backs, and the political concerns around them may come to outweigh their perceived benefits.

Unfortunately, all of this is happening at a time when capital markets are already looking vulnerable. While the effect of actual legislation may be far away, if investors are feeling easily spooked, an anti-tech political story could be enough to send their share prices the wrong way.

CAMBRIDGE
INVESTMENTS LIMITED

10th June 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7331.9	2.4	170.2	↗
FTSE 250	19232.4	1.4	262.1	↗
FTSE AS	4008.2	2.1	84.3	↗
FTSE Small	5575.7	0.4	20.3	↗
CAC	5364.1	3.0	156.4	↗
DAX	12045.4	2.7	318.5	↗
Dow	25979.8	4.7	1164.8	↗
S&P 500	2875.0	4.5	123.0	↗
Nasdaq	7415.5	4.0	287.6	↗
Nikkei	20884.7	1.4	283.5	↗
MSCI World	2104.2	2.8	57.9	↗
MSCI EM	1002.8	0.5	4.8	↗

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.9	17.3	12.8	13.3x
FTSE 250	3.3	24.3	13.4	14.2x
FTSE AS	4.6	18.4	12.9	13.4x
FTSE Small	3.6	-	16.6	14.1x
CAC	3.4	18	14	13.4x
DAX	3.3	15.9	13	12.6x
Dow	2.3	16.6	16.1	14.8x
S&P 500	1.9	18.8	17.2	15.9x
Nasdaq	1.1	23.4	20.7	17.9x
Nikkei	2.2	15.5	14.9	18.4x
MSCI World	2.6	17.6	15.8	15.2x
MSCI EM	2.9	13.1	12.4	12.1x

Top 5 Gainers / Top 5 Decliners

COMPANY	%	COMPANY	%
British American Toba	9.2	Hargreaves Lansdwn	-14.4
Imperial Brands	8.3	Ocado Group	-6.8
Evraz	7.7	Taylor Wimpey	-4.7
BT Group	6.9	NMC Health	-2.4
Rolls-Royce Holdings	5.7	Kingfisher	-2.1

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.27	0.87	OIL	63.3	-1.8
USD/EUR	1.13	1.41	GOLD	1340.9	2.7
JPY/USD	108.14	0.14	SILVER	15.0	3.0
GBP/EUR	0.89	-0.55	COPPER	262.7	-0.5
CNY/USD	6.91	-0.11	ALUMIN	1776.0	-0.3

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	0.813	-8.2	-0.07
US 10-Yr	2.086	-1.8	-0.04
French 10-Yr	0.085	-59.5	-0.13
German 10-Yr	-0.257	-27.2	-0.06
Japanese 10-Yr	-0.120	-27.7	-0.03

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.66
3-yr Fixed Rate	1.80
5-yr Fixed Rate	1.98
Standard Variable	4.29
10-yr Fixed Rate	2.61

* 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!

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

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

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD