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Source: Peter Schrank's perspective of the Queue for 10 Downing Street; 27 May 2019, PCGL

Bond rally musings

It all seemed to make a lot of sense to the media commentators this past week: government bonds rallied and equity markets fell because investors no longer expect a return of meaningful global economic growth during 2019, and in the UK the probability of a hard Brexit has supposedly surged because The Brexit Party won the most votes in the UK's European elections. Taking a step back, both conclusions seem a little premature.

On the bond market side, yields have indeed fallen, which tends to indicate falling growth expectations and thus lower levels of expected inflation, for which investors expect yields to compensate. Recently however, inflation expectation changes have been closely correlated with oil price changes, which are not only driven by demand due to economic activity, but also by supply-side changes and by the ebb and flow of speculative demand positions. After the gradual rise in the oil price during the first four months of the year it has currently fallen back as Middle East tensions ease and the US shale oil producers increase their output. This price decline easily explains the recent fall in inflation expectations and thus the fall in longer term bond yields – if one is so inclined.

Last year, equity markets staged a marked correction triggered by fears that rising bond yields might cause a wave of corporate defaults that would put an end to the extended prevailing economic cycle (which did not happen). This year the fear is that Trump's trade wars will do the same through slumping global trade volumes. It is remarkable then that equity markets are still sitting on healthy 2019 gains, despite the declines over the course of May.

It has been argued that markets are misjudging the situation and that the trade war will carry on and will drive the global economy into recession. Admittedly there are indications that both sides - US and Chinese - are digging their heels in and preparing for a drawn-out economic conflict. On the other hand there are various other indicators that tell us they remain open to a negotiated solution, which would also be strongly supported by rational assumptions, for instance that Trump can only continue dreaming of a 2020 re-election if he does not drive the US economy into the ground in the meantime.

The better explanation for the (still) relatively sanguine equity markets is the various economic factors that have turned from headwinds to tailwinds over the past year. Lower yields and lower energy prices are a boon for the economy as they lower input costs for industry and increase the headroom for discretionary expenditure by households.

For the time being there appears to be a fragile balance between the two ever-present forces in capital markets – fear and greed. If Trump and Xi manage to agree new and improved trade terms before the end of the summer, then the current market conditions might be described as a loaded spring. If they indicate that economic hardship – at least temporarily – is the more promising route to long term prosperity (at least in their minds), then the markets are likely to riot – and potentially thereby force them into a rethink.

Given capital markets always look ahead and try to anticipate through valuation adjustments what is likely to happen before it actually does, it is entirely possible that they will become increasingly more volatile, as politicians engage in what feels like a gigantic game of "chicken". Broader economic sentiment may sour during this period, however – for the time being – lower global trade volumes are being counterbalanced by higher employment and higher service sector growth.

Returning to the second point at the beginning of the article, it would appear that an overwhelming majority of the participating UK electorate voted for parties that are aiming for no Brexit, a soft Brexit or another referendum. It is therefore hard to see how a new leader of the Conservative Party would be able to achieve anything closer to a compromise Brexit than the outgoing Prime Minister has been able to. General elections are regularly mentioned, but after last week's results it is hard to see how MPs could be enticed towards making that happen.

It would therefore seem that the Brexit date will be slipping further, and beyond October, unless the new Prime Minister indeed has the courage to choose the 'emergency exit' of another referendum to solve the enduring impasse. Then all options are open again, although if last week's election results are anything to go by, a hard Brexit would struggle to find a majority, now that the consequences of such a step have become somewhat clearer to more parts of the population.

The future of Modi's India

The largest democratic exercise ever attempted has now been completed. India's election took over a month and saw more than 600 million people cast their votes. In the end, the results were emphatic. Narendra Modi – leading the Hindu nationalist Bharatiya Janata Party – scored a landslide victory to secure his second term as Prime Minister. The BJP alone won 303 of the Lok Sabha's (the lower house of India's Parliament) 545 seats, while the right-wing alliance led by the BJP won 353.

Modi, who was sworn in this Thursday along with his cabinet, is a divisive figure in Indian politics, making his landslide victory all the more impressive. His Hindu nationalist agenda has raised concerns over the rights of India's many minorities, while his bold and sweeping reforms during his first term were often unpopular.

As well as weakening or abolishing many environmental and labour laws, Modi had two very high-profile policies which caused a great deal of disruption in India: the 2016 demonetisation and the reform of the goods and services tax. The demonetisation effort saw the sudden removal of the 500 and 1000 rupee notes from the country in an effort to promote the use of cashless payment systems and rob the shadow economy of one of its bases. The tax reform that followed, entailed a sudden implementation of a unified goods and services tax throughout all of India.

Few disagree that these were both good policy goals – especially the tax reform, replacing multiple different levies across India's many regions to create a single market. But both were heavily criticised for how they were handled, and the level of disruption they caused. According to analysts, these two incidents were the reason India's GDP growth dropped to a four-year low of 6.5% in 2017-18.

Indeed, the triumphant mood in the BJP is not reflected in the health of the economy. Growth in the last quarter of 2018 slowed to a 6.6% and then 5.8% annualised figure in Q1 2019, with incomes for the rural population increasingly under pressure. India's banking system – largely controlled by the state – is struggling under the weight of bad debts, and many non-bank financial companies are facing liquidity shortages.

Modi fought his first election on promises of growth, prosperity and reform. But in this year's election those promises were put on the backburner. Instead, security issues (ignited by the recent tensions with Pakistan in Kashmir) dominated. But capital markets seem to be hoping that the Prime Minister will refocus his attention on India's stuttering economy. The Sensex, India's stock market index, rose sharply on the news of Modi's emphatic win – recording its largest one-day rally in over three years.

Modi has shown he is capable of bold reform before, and the expectation is that, with such a large mandate, he will push forward harder towards the change India's economy needs. According to Prabodh Agrawal at IIFL Holdings, "These next five years could be a watershed for the Indian economy," and "The fact [that] they've got a stronger mandate should embolden [the BJP]."

We should not get carried away here however. While many investors are excited at the prospect of Modi's market-oriented measures, some are more cautious. "Don't confuse the scale and historic election victory as a leading indicator of the scale and scope of the likely macro reforms that are going to follow," says Rajeev Malik at Macroshanti.

Demonetisation and GST reform do grab headlines. But if you look a little deeper, Modi's record on market reform is not as radical as it may seem. Both the BJP's GST reform and the much-heralded bankruptcy law were already advocated by the previous government. And in many areas Modi has shown an unwillingness to make sweeping market-oriented changes. The most prominent of these is the banking sector, where state-run banks dominate.

In his 2014 campaign, Modi emphasised the importance of foreign direct investment into India. A shakeup of the banking sector – handing a larger role to the private sector – would help achieve that goal. So too would making India's central bank independent. But neither of these ideas were broached during Modi's first term, and neither look likely to happen in the next five years either.

Getting India out of its slowdown will be a high priority for the government, but analysts say that they lack the fiscal headroom to do so. Although the BJP has plans to increase public spending, a $12bn shortfall in tax collections – probably caused by the questionably executed GST reform – could rob them of the funds to do so.

There are also other parts of Modi's reign which are less exciting. Besides the criticism the PM has received for his attitude towards minorities, top economists and social scientists have recently decried the "politicisation" of India's statistics. In an open letter to the government back in March, they claimed that "Any statistics that cast an iota of doubt on the achievement of the government seem to get revised or suppressed on the basis of some questionable methodology," Things like this cast doubt on the credibility of India's economic reporting, and should be worrying for investors.

But still, markets are betting on the charismatic Modi to bring India up to its lofty potential. Despite ruffling a fair few feathers over the past five years, he has emerged stronger. No doubt this will reinvigorate his political will. What is certain is that, if Modi has the appetite for sweeping reform, he has the political capital to achieve it. And it will probably only increase when the BJP gains a majority in the upper house of parliament next year. The only question is whether he will use it.

Is Baoshang bank China's 'Northern Rock'?

For the first time in 18 years, the Chinese government has publicly taken over one of the country's banks. Last Friday, the China Banking and Insurance Regulatory Commission (CBIRC) announced it would take over Baoshang bank, a small city commercial bank in Inner Mongolia, for one year due to its "serious credit risk".

The move sent a shockwave through China's finance community and even global markets, with many unsure what to make of it. Not since China's financial crisis of the late 1990s has the government so publicly stepped in like this, raising fears that there may be hidden dangers in the financial system that could prove destabilising. What is more, although Beijing explicitly gave guarantees on the bank's interbank debt and corporate deposits (the first time they have ever done so) they only guaranteed up to RMB50m (£5.7m) per lender or customer. Usually, traders in the interbank market have assumed that the government implicitly guarantees large debts. But the fact that only a portion of the debt has been backed up by Beijing casts doubt on that assumption, which could lead to a crisis of confidence across China's financial system.

There are many parts to the Baoshang story that make it particularly interesting. In terms of assets, Baoshang is a very small part of China's banking system (0.23% according to Barclays research). And according to the most recent reports, on paper, things were going well. Back in 2017, Baoshang had a non-performing loan rate of just 1.68%, with RMB576m in assets. But the bank is part of a large conglomerate called Tomorrow Holdings, owned by billionaire fund manager Xiao Jianhua. Mr Xiao was well known for managing the assets of several high-ranking communist party members. But in 2017, Xiao was arrested in Hong Kong and charged with fraud and embezzlement – after which Baoshang's credit rating was cut.

Government sources said that Baoshang was functioning as a "cash machine" for Tomorrow Holdings, helping the conglomerate to raise financing of at least $21.7bn through illicit practices. That brings us to the operative question: is the Baoshang takeover about a corruption crackdown or a sign of stress within the Chinese banking system? If it is the first, there is seemingly little to worry about from a systemic point of view. If it is the second, it could be an early warning sign that things are even worse than thought.

The answer is probably somewhere in the middle, but exactly where is hard to say. It is noteworthy that Beijing allowed Baoshang's troubles to be publicised. Not since 2001 has the government *publicly* stepped in to take control of a bank, but they have secretly recapitalised struggling banks or have forced mergers with larger state entities on many occasions. This time, not only have Beijing announced their plans for Baoshang, but the bank regulator CBIRC and the central bank, the People's Bank of China (PBoC) have publicly raised concerns that there could be more stress in the financial system.

The PBoC noted that China's markets – which are very sensitive to changes in sentiment – could experience a liquidity shortage in the fallout. To combat this, on Wednesday the central bank announced an RMB270bn injection, the biggest open market operation this year. This clearly shows Beijing is concerned about the health of the financial system. But the fact they are being so public about it suggests they *want* a certain level of fear among financial institutions. The government's announcement of guaranteeing only up to RMB50m is the strongest example of this: they may be telling companies to expect some losses if things get worse.

They also seem to be explicitly acknowledging that the reported numbers are not to be entirely trusted. If you believe Baoshang's official accounts, they should not have a problem. Likewise, if you believe China's official statistics – with 6.5% growth and a non-performing loan rate of less than 1.5% – the financial system should be in rude health. But like everyone else, Baoshang relied heavily on the shadow banking sector. When Beijing began its current crackdown on shadow lending, the bank was forced to turn to the interbank lending market. But the government's deleveraging efforts and the ensuing economic slowdown caused liquidity to dry up there too, leaving Baoshang without anywhere to turn. Unfortunately, while much of the ailing bank's story is unique, that part is not.

The government does seem determined to stop a domino effect from happening. But the fact that this pressure is on the financial system just as Donald Trump's trade war is starting to bite will make things difficult. At the moment, Beijing must feel as though they are fighting a war on two fronts: abroad with Trump and at home with their small regional banks.

What makes matters worse is that these wars may require conflicting solutions. Stress in the financial system and an ongoing economic slowdown should make the PBoC think about cutting interest rates – to support struggling smaller businesses. But doing so could mean downward pressure on the Yuan. And given that accusations of "currency manipulation" have been one of Trump's main gripes with China, if the Yuan weakens it will no doubt harm trade negotiations. Indeed, Beijing has clearly been trying to hold its currency stable recently as a sign of good faith in negotiations.

That leaves the government in a difficult position. Keeping the currency stable is effectively tightening conditions for many Chinese producers hit by US tariffs, but at the moment it seems like the only option. But if Baoshang does prove to be just the first domino, that could change. For now, it looks like Baoshang was just a casualty of Beijing's clean-up program – perhaps even a planned one. However, the way the Chinese authorities appeared to play with the fire of contagion across their stretched financial system was breath-taking. We would not be surprised if it came somewhere between a demonstration of strength and a system resilience test.

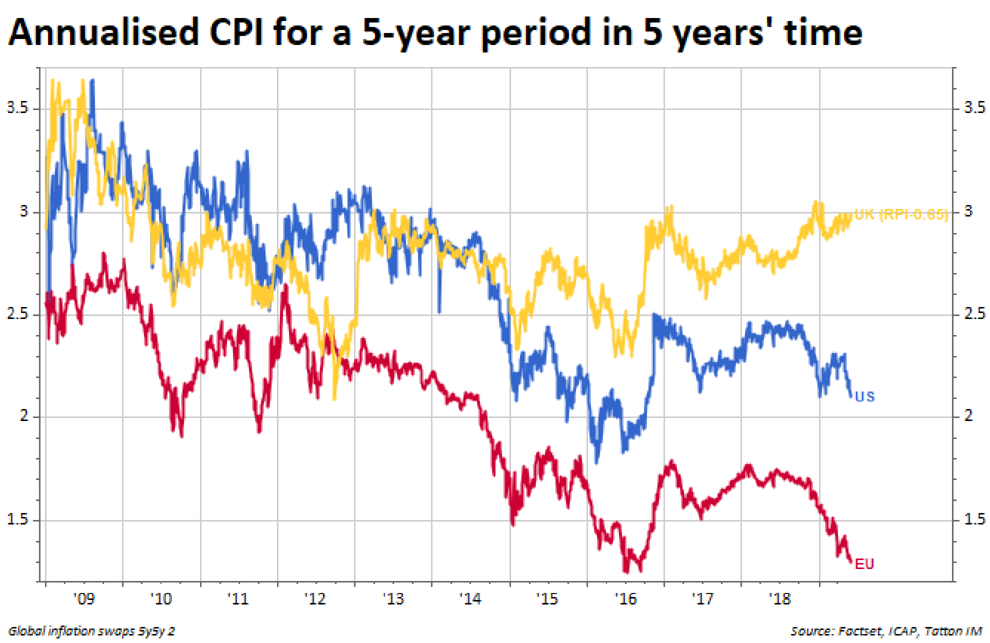
Insight article:

Brexit or UK pension funds to blame for rising UK inflation expectations?

Implied market expectations for long-term global inflation have been on a marked downtrend in recent months. These expectations are now close to their historic lows of the global economic slowdown of 2016. Back then, in the US, the expected average consumer price inflation (CPI) rate from five years forward (i.e. the yearly average inflation beyond 2021) dropped to as low as 1.9%. The Eurozone equivalent was 1.3%. In the UK, it was 2.3%.

Low inflation is usually accompanied by low real growth, and that was the case two years ago. In response, countries around the world enacted monetary and fiscal stimulus policy designed to jump start the lethargic economy. Seemingly, it worked: growth returned and reflation kicked in. By the end of the year, future inflation expectations were rising sharply.

The chart below shows the history of market-based inflation expectations (as measured by instruments



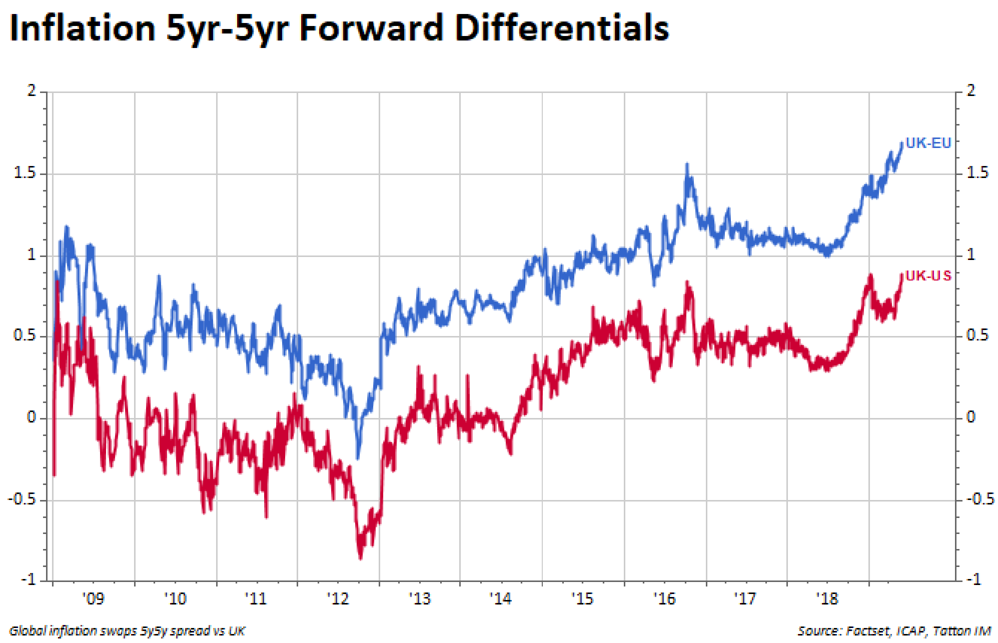
called "inflation swaps") from the depths of the financial crisis to the present day:

As you can see, the recovery was short-lived. Two years after those lows, the 'great reflation' appears to have fizzled out, inflation expectations are heading down again, and growth expectations with them. This is clear in the Eurozone, where we have returned to the 2016 low of 1.3% and in the US, where we are at 2.1%, only 0.3% above the low.

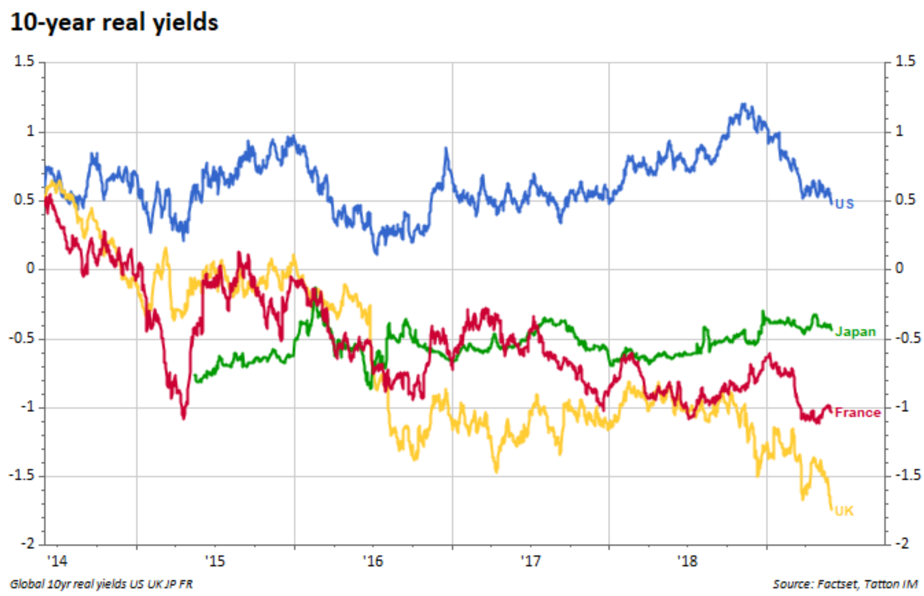
However, there is an exception: the UK. Here, markets are pricing long-term CPI inflation at around 3%. (Note here that we use the RPI-based measure and adjust it downwards by 0.65%, which is the average difference between the two measures).

We have not come close to the lows of 2016 (which were not quite as low as our brief "lowest lows" in 2012). Quite the opposite. We saw a spike in expectations following the Referendum. And while this was shortly matched by spiking expectations for the US and EU, ours have remained at elevated levels ever since.

Look at the differentials as shown in the next chart:



Because the Referendum spike in inflation expectations was quickly matched by the EU and US, the



differentials remained around the same levels – i.e. approximately 0.5 points higher than the US and around 1.15 points higher than the EU. But as you can see, things started to change significantly in the latter part of last year, leaving the differentials at new highs. As a consequence of these seemingly heightened inflation expectations, real yields have dropped more in the UK than elsewhere, with a sharp move in the past few days (the counter effect of the rise in the chart above):

This has meant that inflation-linked gilts (UK government bonds) have had a good time, running well ahead of their nominal equivalents. This is the reverse of other markets, where it was the fixed coupon government bonds that have performed best.

Why is this happening?

UK pension funds are the usual suspects when such UK-specific events occur. This is because legacy defined-benefit schemes remain underfunded in aggregate and, each time yields fall, they have to buy more bonds to protect themselves. Equities, the assets that should help them to achieve their targets, exacerbate the situation if they are falling as yields drop.

Here we have the on-going conundrum that bedevils the pension funds (some of the UK's biggest long-term investors. The current "net-asset-value" approach to investment heightens the sensitivity to current volatility. If things look risky, they have to cover their positions – usually exacerbating the problem.

In particular, the underfunded defined-benefit pensions liabilities move with inflation, since the pensions they pay are generally contractually linked to inflation (usually the retail price index). They may get a better expected return by buying fixed coupon Gilts, but they still have a risk if consumer prices rise, no matter what the reason.

Because of the current environment of uncertainty, there is a large risk that we will get repeated sterling falls and consequent spikes in import prices, raising average inflation. On the other hand, it could also be that pension funds banked some of their equity gains in the middle of last year and hedged the proceeds against inflation risk by buying index linkers.

So either way, the pension funds will have a big preference for inflation-linked bonds. Thus, there is higher demand for index-linkers, driving up their price, and because of the inverse relationship between movements in a bond's value and its yield, this is leading to yields falling more than nominals. That increase in yield spreads is mathematically the same as a rise in market-priced inflation expectations – thus creating a self-reinforcing driver of UK inflation expectations. Despite the fact the move in real yields has little to do with the actual level of inflation expectation increases.

The same rationale also means the pension funds would prefer overseas to UK equity investments, which puts downward pressure on demand for UK stocks.

However, all capital market-related evidence suggests that a long-term approach, that allows pension funds to seek the extra return which comes with riskier equity investment, is the way to reduce the volatility of outcomes in that longer term. If long-term investors define their risk as the size of the gap between what they need to achieve and what they are likely to achieve, investing in low return assets increases the size of that gap, and with a great degree of certainty. If they invest in equities instead of bonds, they may not know precisely what they will achieve, but they are more likely to at least move closer towards the target: the gap should narrow.

The supply of UK index-linkers is too small to accommodate the regulatory burden that the current UK pension framework imposes upon it, which leads to the overshooting of index linker price movements we observed at the beginning. For investors like us, this means that we observe the pay-out of index-linkers as irrationally low. The only way that index linkers can be good value is if the UK's inflation rate remains structurally higher than in the US or Europe for a prolonged period. If our inflation really was to stay higher for such a period, it would most likely mean that real growth will also be significantly higher. Therefore, equities would have a great run.

Still, because there are very few unencumbered holders of index-linkers, we should not expect the anomaly to resolve itself soon. This, on the other hand, means that we cannot conclude that markets predict that UK inflation will indeed be higher than elsewhere or that this entails superior growth. So, take market-derived inflation expectations with a pinch of salt. They do not always determine actual inflation.

CAMBRIDGE
INVESTMENTS LIMITED

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Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7161.7	-1.0	-69.3	↘
FTSE 250	18970.3	-0.3	-61.0	↘
FTSE AS	3923.9	-0.8	-33.1	↘
FTSE Small	5555.4	-0.3	-19.3	↘
CAC	5207.6	-2.0	-108.9	↘
DAX	11726.8	-2.4	-284.2	↘
Dow	24939.8	-2.2	-550.6	↘
S&P 500	2766.0	-2.0	-56.3	↘
Nasdaq	7169.0	-1.9	-138.9	↘
Nikkei	20601.2	-2.4	-516.0	↘
MSCI World	2066.5	-1.4	-28.5	↘
MSCI EM	994.9	0.8	8.3	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	5.1	16.9	12.4	13.3x
FTSE 250	3.4	23.9	13.2	14.1x
FTSE AS	4.8	18	12.5	13.4x
FTSE Small	3.6	-	11.7	14.0x
CAC	3.5	17.4	13.5	13.4x
DAX	3.3	15.6	12.7	12.6x
Dow	2.3	15.9	15.5	14.8x
S&P 500	2.0	18.1	16.6	15.9x
Nasdaq	1.1	22.7	20.1	17.9x
Nikkei	2.3	15.3	14.7	18.5x
MSCI World	2.6	17.3	15.5	15.2x
MSCI EM	2.9	13	12.3	12.1x

Top 5 Gainers / Top 5 Decliners

COMPANY	%	COMPANY	%
SSE	6.5	Imperial Brands	-7.1
Vodafone Group	4.9	British American Tob	-6.5
Severn Trent	4.3	John Wood Group	-6.1
United Utilities Group	4.1	easyJet	-6.0
GVC Holdings	3.2	International Consoli	-5.8

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.26	-0.74	OIL	64.6	-5.9
USD/EUR	1.12	-0.47	GOLD	1302.1	1.3
JPY/USD	108.64	0.62	SILVER	14.6	0.1
GBP/EUR	0.88	-0.24	COPPER	264.7	-1.5
CNY/USD	6.91	-0.07	ALUMIN	1782.0	0.2

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	0.886	-7.3	-0.07
US 10-Yr	2.170	-6.5	-0.15
French 10-Yr	0.210	-25.5	-0.07
German 10-Yr	-0.202	-72.7	-0.09
Japanese 10-Yr	-0.094	-34.3	-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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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