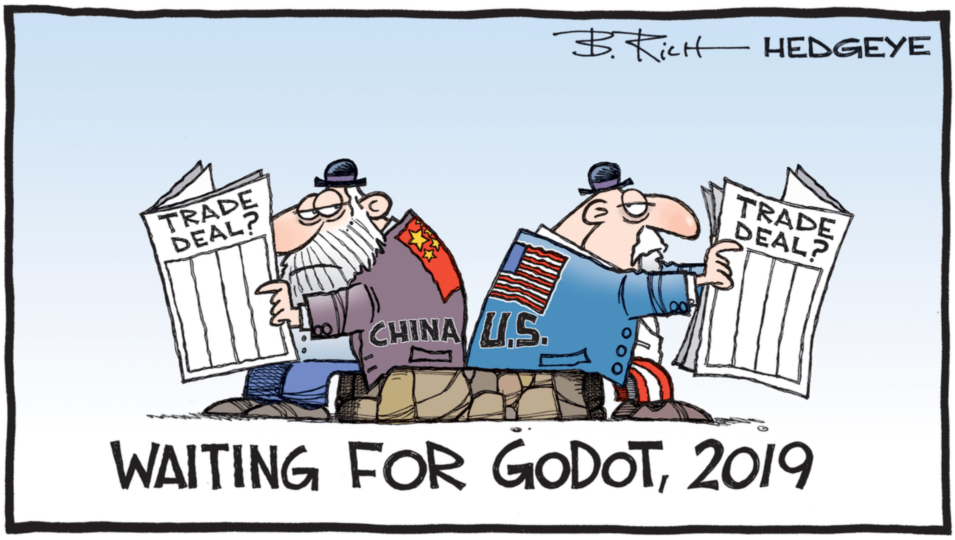
CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

8 July 2019

Lothar Mentel

Lead Investment Adviser to Cambridge



Source: Hedgeye – The anticipated US-China trade deal is long overdue, 25 June 2019

Liquidity drives stock markets to new highs – for how long?

The highly anticipated meeting between US President Trump and China's President Xi Jinping at the G20 summit in Osaka came and went - with somewhat of a damp squib outcome compared to some sky-high expectations of an end to the ongoing trade war. Yet the mere intention to re-engage in trade negotiations and not engage in further proliferation of trade hostilities appeared enough to push many equity markets around the world to new historical highs.

We would however caution against such rash conclusions. We deem it highly probable that stock markets had already priced in a resolution of the trade conflict before the autumn and simply saw this view confirmed. On the other hand, what is and has been driving risk asset valuations higher since the beginning of the year is the prospect of central banks restarting monetary easing through rate cuts and further QE (quantitative easing) as global economic activity levels have slowed markedly and companies have struggled to deliver any substantial profit growth.

This stands in stark contrast to 2018 which was characterised by double digit profit growth, but also central banks' steady rate rises and QT (quantitative tightening) which in the end resulted in the Q4/2018 market correction. It seems that despite their very best efforts, even 10 years after the Global Financial Crisis forced central banks to engage extraordinary monetary support measures, capital markets remain more driven by a change of direction in monetary policy than corporate fortunes. It is therefore far more likely that the positive start to July, that followed a very strong June, was much more driven by the news of Mario Draghi's successor in the post of president of the European Central Bank (ECB).

It had been feared that the German monetary easing opponent and head of the Germany's central bank (Deutsche Bundesbank), Jens Weidmann, would win the race for the nomination. The news that Christine Lagarde, the IMF's head and staunch supporter of Draghi's monetary support policies would be appointed instead, therefore brought relief and surprise to capital markets. Lagarde's appointment seemed to ensure that the ECB's hinted restart of quantitative easing would indeed outlive Draghi's presidency and could once again provide the seemingly so vital flow of additional monetary global liquidity that had accompanied the 2016/2017 stock market rally.

All who now expect the equity market 'melt-up' to continue on the back of the anticipated monetary 'fuel' injection, need to take a step back and ask for how long investors will be willing to ignore deteriorating economic fundamentals and rely on the monetary soothing.

During previous periods of monetary policy success (in this, now the longest global economic cycle) corporate earnings had previously fallen steeply and had therefore much headroom to recover. Or credit availability had tightened so much that the central bank reprieve made a considerable difference for businesses. This time around, neither is the case and it is not obvious who, apart from capital markets, will benefit from a return of ultra-low cost of finance – while the negative side effects are most likely to return.

We have therefore entered an uncomfortable period during which market valuations have every (monetary) reason to grind higher, while there will eventually come a point when investors will be disappointed by the lack of corporate profit growth to underpin their higher valuation levels with proportionate dividends or at least cash flow. Unfortunately there is no good indicator for the length of such a period, but central banks are now on notice by capital markets to follow through on their hints, or risk an almighty disappointment which would in itself worsen the economic environment towards recession, from what currently still only amounts to (the third) mid-cycle slowdown.

In such an environment of fragile balance between hope and fear, we are satisfied to have pursued our investment positioning that has neither banked on a continuation of the ongoing rally, nor cut investment exposure in anticipation that markets may eventually face a rude awakening. Our neutral asset allocation in alignment with portfolio investors' chosen risk profiles has generated very decent returns during 2019, which means that all portfolio types have now recovered beyond their previous high points of late August 2018.

We are cautiously optimistic that the global economy will, just as before, return from near stagnation back to steady yet slow growth. This should prevent the rude market awakening referred to above, even if this might mean that there is not much further upside to equity market returns on top of the double-digit levels that have been achieved thus far (see returns table below). At the same time, in such an environment it is not possible to argue convincingly for risk exposure overweight, without risking long-term investor performance in return for short-term outperformance kudos for the investment team.

Asset Class Returns at the end of June 2019

Asset Class	Index	June	YTD	12 months
Equities	FTSE 100 (UK)	3.2	13.1	1.60
	FTSE4Good 50 (UK Ethical Index)	3.0	11.5	2.2
	MSCI Europe ex-UK	5.5	17.0	7.30
	S&P 500 (USA)	4.5	18.6	14.5
	Nikkei 225 (Japan)	2.4	7.8	-0.6
	MSCI All Countries World	4.6	16.3	9.7
	MSCI Emerging Markets	5.5	10.7	5.0
Bonds	FTSE Gilts All Stocks	0.3	4.7	4.9
	£-Sterling Corporate Bond Index	1.7	7.3	6.9
	Barclays Global Aggregate Bond Index	1.7	5.6	9.8
Commodities	Goldman Sachs Commodity Index	-0.1	13.4	-8.2
	Brent Crude Oil Price	-2.0	20.4	-15.2
	LBMA Spot Gold Price	9.5	10.3	17.20
Inflation	UK Consumer Price Index (annual rate)*	0.9	0.8	1.7
Cash rates	Libor 3 month GBP	0.1	0.5	0.8
Property	UK Commercial Property (IA Sector)*	-0.1	0.4	0.9

Data sourced from Morningstar Direct as at 30/06/19. * to end of previous month (31/05/19).
All returns in £-GBP

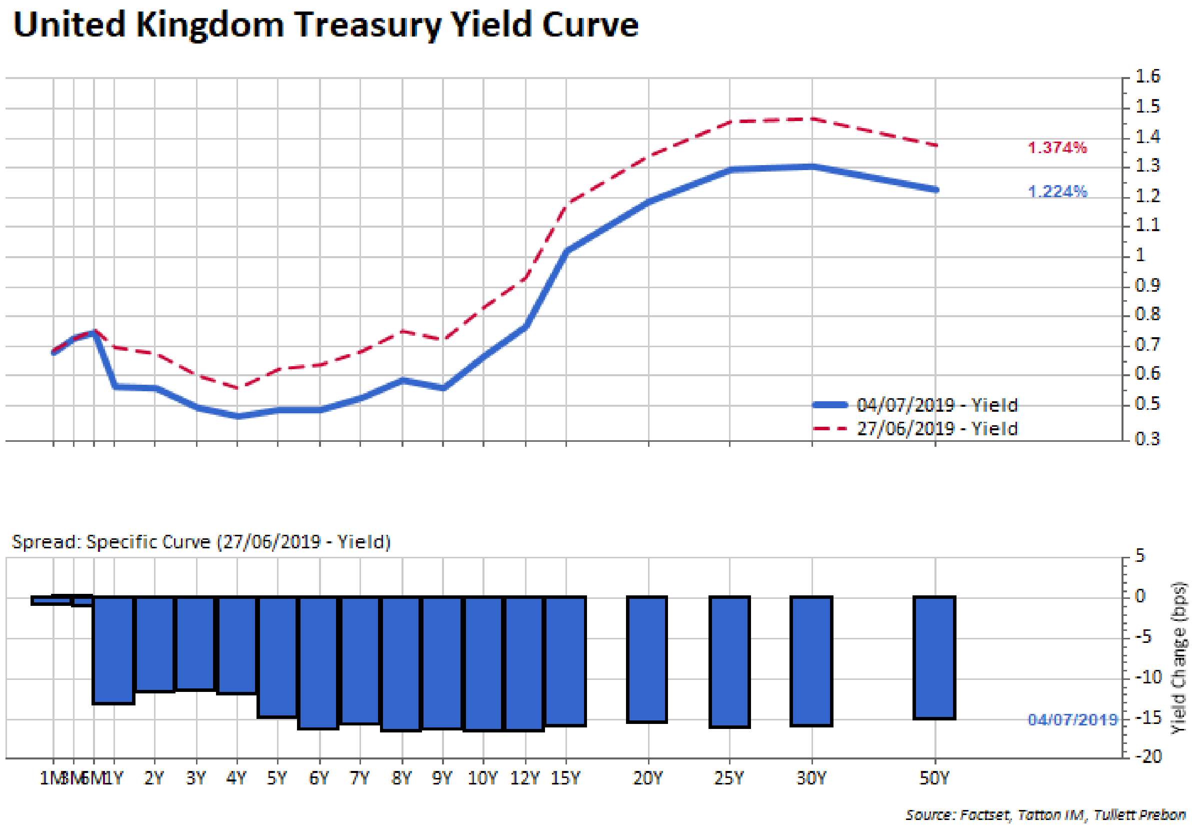
Follow the money - central banks' money

Only during moments of panic during the 1980s to the early 2000s would we worry about Herr Pohl of the Bundesbank or Alan Greenspan at the US Fed. Markets preferred it when monetary policy makers only set the longer-term framework, but otherwise played second fiddle to business fundamentals.

Since the late 2000s the impact of monetary policy has become significantly more important to the world's economy. Inevitably the people making the policy are the subject of a lot of discussion, and not just among financiers.

Mark Carney has been in the limelight following the referendum, as Governor of the Bank of England and chair of the Monetary Policy Committee. His predecessor, Mervyn (now Lord) King, achieved prominence only in the aftermath of the 2008-9 financial crisis. However, Brexit is clearly about the institutions involved in our economic life and so the leader of one of them inevitably gets pushed to the fore.

Twenty years ago, a speech in Bournemouth from the governor at the time, Eddie George, would have been at best marginally newsworthy. This week Mark Carney managed to cause a sharp rally in UK equities, a drop of 0.15% in yield for most Gilts (see chart) and another bout of weakness in £-Sterling.



He said "a global trade war and a no-deal Brexit remain growing possibilities not certainties" but caveated that "monetary policy must address the consequences of such uncertainty for the behaviour of businesses, households and financial markets… In some jurisdictions, the impact may warrant a near term policy response as insurance to maintain the expansion."

While ostensibly about other central banks (almost certainly the US Federal Reserve), this was taken as indicating that a UK rate cut is on the cards. The reasoning appears to revolve around the current market view that any currency bloc cutting rates will then see its currency fall (a view actively endorsed by President Trump). The argument is that if the US cuts rates later this month, as we expect, other nations must follow suit swiftly or face tighter financial conditions because of the relative rise in their own currency while their rates remain higher.

Traders also took into account that recently released UK economy data does seem to have worsened. The CIPS Purchasing Manager Survey for June reported that services were dropping back to an index level of 50.2, only a whisker above the stagnation level of 50 (these indices have set range from 0-100). Worse still, the construction dispersion index plummeted to contraction level of 43.1.

This statement about other central banks and their reasons for action do not have to read that way and run counter to the guidance that MPC members gave in their testimony to the Finance Committee in the previous week. But such is the strength of belief in a coordinated global central bank easing that the merest hint of a rationale was enough to spark equity and bond price rises.

The governor has been in the post since July 2013, and had his tenure extended by the Treasury to 2020 in order to help support a "smooth exit" from the European Union. He was originally set to depart last week at the end of June, but Carney will now almost certainly not leave the post before 31 January 2020, still amidst the possibly difficult economic consequences of exit from the European Union. Among the leading candidates to succeed him are: BoE chief economist Andy Haldane, deputy governor Ben Broadbent, Manoush Shafiq, head of the London School of Economics, and the Financial Conduct Authority chief, Andrew Bailey.

As current MPC members, Haldane and Broadbent are relatively known quantities in terms of policy slant, being seen as mildly hawkish. However, Bailey and other non-economists are seen as viable, particularly given the international trend towards communicators rather than technicians being at the helm of major central banks. Teasing out their policy thoughts will become a preoccupation for gilts traders.

Although Christine Lagarde has been the leader of the International Monetary Fund through a difficult period, her near-certain appointment this week to head the European Central Bank was a bit of a surprise to many, given she is a lawyer by profession and would not claim to be an economist or central banker.

What seems to have happened is that the smaller nations wanted a pragmatic consensus builder. They pushed back against Germany's choice of the hawkish economist, Jens Weidmann, President of the Bundesbank. It suggests that even the EU's hugely imperfect political decision mechanisms can occasionally produce quite different and more democratic outcomes than the big movers and shakers at the top had lined up.

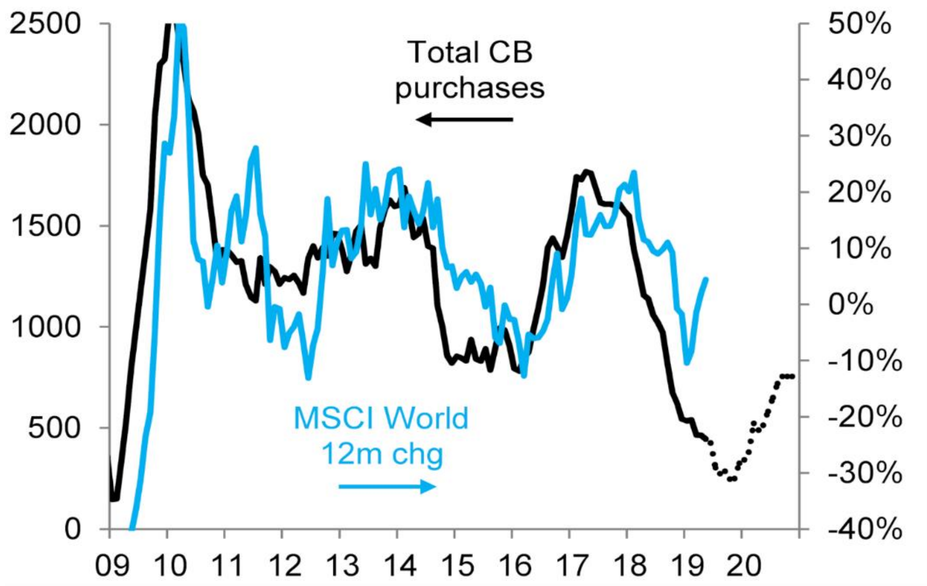
Mario Draghi, the outgoing ECB President, will be gratified. As we wrote a couple weeks ago, he appeared to be trying to bounce the ECB into another round of quantitative easing (QE), a tactic that could easily be revoked immediately after his departure. So Lagarde's past strong support for his "whatever it takes" approach to managing the European debt crisis signals continuation.

As Goldman Sachs note, she was a vocal advocate for bold and pre-emptive ECB easing in 2013-14 and argued in 2015 that QE and negative interest rates had done much to "stave off the threat of deflation and support weak demand." She has argued that ECB policy should remain supportive until "private demand has fully recovered" and that the more conventional policies should be adjusted well before assets are sold.

On the day the Outright Monetary Transactions (OMT, the ECB's term for QE) were announced, she welcomed the new framework as "an important step" and later stated that this became the "turning point" in the Euro crisis, holding the "currency union together." She has argued that the crisis raised the spectre of "catastrophic outcomes for Europe" and that "radical solutions" were needed.

This may not be well received by President Trump, worried as he is about currency competition. The slight weakening of the US dollar has been reversed in recent days and, at the time of writing, the Euro is trading at $1.12/€, down about 2% on the week.

However, a likely return of ECB quantitative easing has been a large part of optimism in global equities and for that, Trump ought to be grateful. As Matt King of Citi Research pointed out last week, expected rises in overall central bank balance sheets have been strongly associated with equity market performance – not just in the country where the QE liquidity originates - as his charts indicate below:



Source: Matt King - The Power Of The Doves, Citi Research (dotted line is Citi forecast), national central banks.

We believe the recent strong performance of risk assets has been in expectation of future liquidity easing, causing those investors who are currently sitting on cash to put it to work before the central banks start their buying (and therefore cause the value of their holdings to decline further). Valuations have become more expensive, given that the rise in prices has actually occurred at the same time as companies have been guiding analysts to expect softer profits through the rest of the year. But renewed lows in cash and bond yields mean that equities still give a risky but higher current yield. The thinking is that if recession is not around the corner, falling near-term profits will not matter too much.

Property & Private Equity – Do they offer diversification?

Leading on from our article on diversification last week, we aim to start sharing more insights on alternative investments and our approaches to assessing their value in investment portfolio construction. Many investors seek to diversify their portfolio through alternative investments, hoping to reduce capital volatility without losing investment return potential. These come in several forms: Real Estate (bricks & mortar property), Hedge Funds, Private Equity (PE), commodities, Infrastructure, and increasingly even more exotic real assets such as wines and art.

With alternatives there are a vast number of factors that need to be assessed in order to understand the makeup of the investment. Some are more general and might be elements to look at relative to standard asset classes, for example returns, volatility, correlation to traditional asset classes and liquidity. Others are more specific to alternatives, such as how to gain access to the investments, how various elements are priced, the amount of leverage used, the value derived from that leverage, the sectoral makeup of the investments, and the potential benefits that good management could have on values as well. We aim to do a series of articles looking at all these factors. Our focus here will be on Private Equity, but we will supplement it with other alternative investments where appropriate. This article aims to look specifically at correlation to equities, including comments on leverage and pricing.

Private Equity is one of largest and recently most popular alternative asset classes, with a market size of roughly $5.8tn in 2018. Private Equity comprises of capital that is not listed on a public exchange. It consists of privately-owned companies and often involves the process of purchasing all of the shares of a publicly owned company in order to take it private. This is known as a buyout. In the first six months of the year the value of leveraged buyouts was $256bn, the second largest first half of a year on record. The other key form is that of Venture Capital, providing seeding and follow-on investment to very small companies, which have the potential to grow into something far greater than their current size.

There are a couple of different ways of investing in Private Equity: either through listed investments or unlisted investments. Unlisted investments are the more traditional way through which people will have invested in PE. It involves investing in a fund, usually with a multi-million pound minimum investment, which takes the capital raised and directly invests it in companies. Investment is regularly locked up for a very long period of time, meaning fund investors have no access to the invested capital – often for 10 years or longer. They only benefit when the manager of the fund sells the holdings and starts providing redemptions.

The other option is listed Private Equity investments, either through a listed direct investment Private Equity vehicle (which provides exposure to the specific companies that the fund is invested in), or via a fund of funds style (investing in multiple listed private equity funds/companies and therefore a greater range of underlying companies, business sectors and regions). These Private Equity companies invest directly in unlisted companies. They are far more liquid, as they themselves are traded daily.

However, being priced on the principle of supply and demand, the share price of these listed investment vehicles could vary somewhat from the net asset value (NAV) of the funds they invest in, based on a number of factors including general investor sentiment towards the expected longer-term performance. These private equity companies are not to be confused with investing in the shares of a Private Equity investment management house, such as Blackstone, where returns are driven by the success of the group itself, largely driven by the fees it receives for the management of its investments.

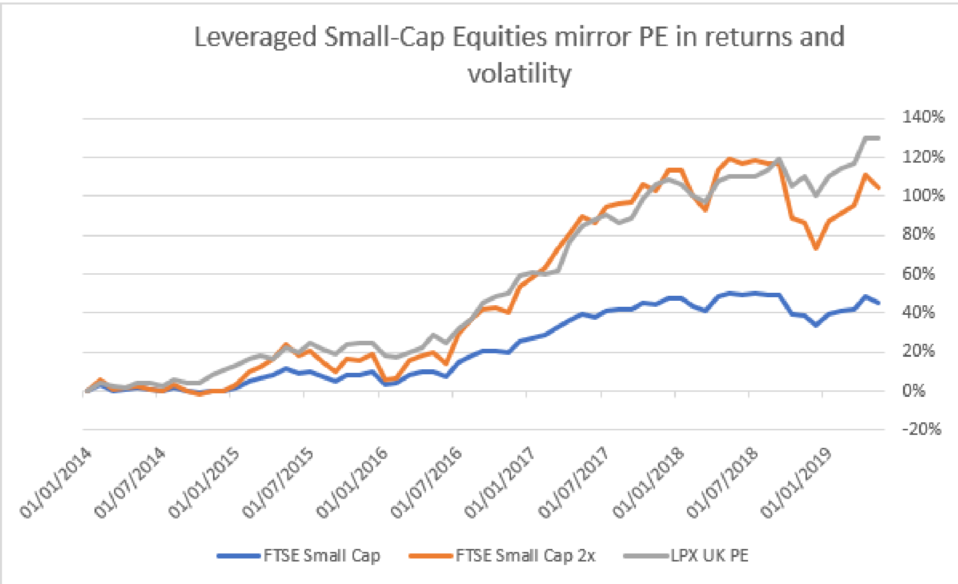
Due to its accessibility through the listed route, Private Equity is an increasingly common component of portfolios. However we question whether it has as many diversifying benefits as Private Equity sales representatives claim.

First, we assess the correlation of PE to that of listed equities and in particular UK small cap equities, which informs us how well this alternative asset class can act as a portfolio diversifier.

	FTSE Small Cap	*UK PE*
FTSE Small Cap	1	
UK PE	0.7945	1

Source: Tatton IM, Bloomberg

The table above shows a correlation of 0.8 between FTSE Small Cap returns and UK listed Private Equity returns since 2014 (1 signals an exact positive correlation, 0 means no correlation whatsoever between returns). We therefore find a significant relationship in terms of the direction of price movements between PE and small-cap equities – a clear counter indicator to the diversification aim.

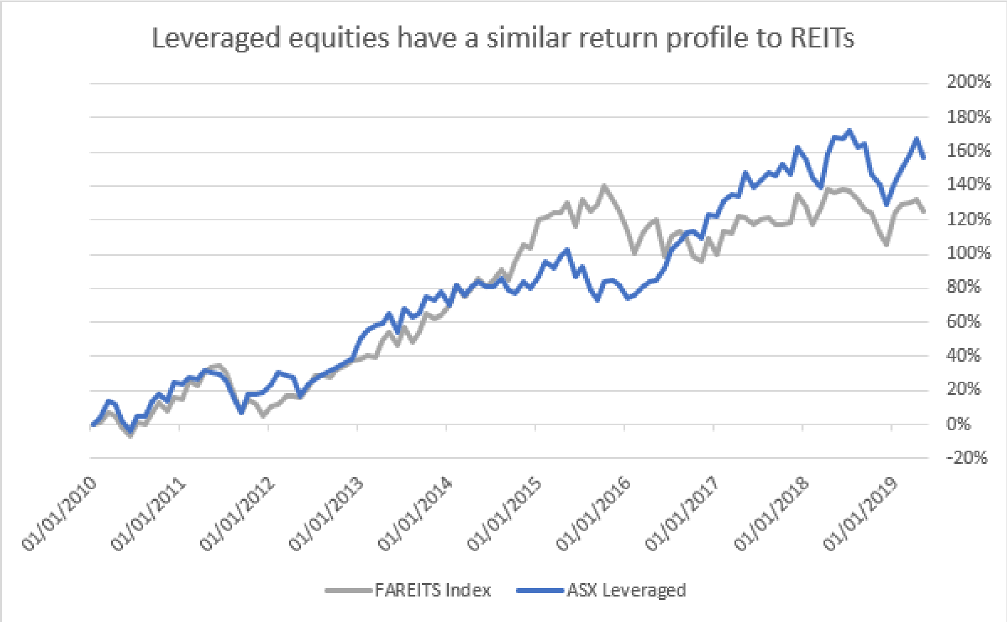


Source: Tatton IM, Bloomberg

Secondly, we look at the return profile since 2014 of small-caps vs PE. Private Equity funds are able to use leverage in order to purchase holdings, meaning they are allowed to borrow, or raise debt, in order to fund their transactions, and thus 'turbo-charge' the returns of equity holders. Leverage is particularly common in buyout type transactions (where publicly listed companies are taken private).

The chart above shows three lines. The blue line is the return of UK small-cap equities since 2014, the grey line is an index of the top 22 UK PE investment trusts. If we artificially leverage the small cap holdings to a similar degree that a PE fund would be leveraged (roughly 2x) then we see an extremely similar return profile. Effectively meaning you can gain very similar returns simply by doubling or gearing the exposure to small-cap equities.

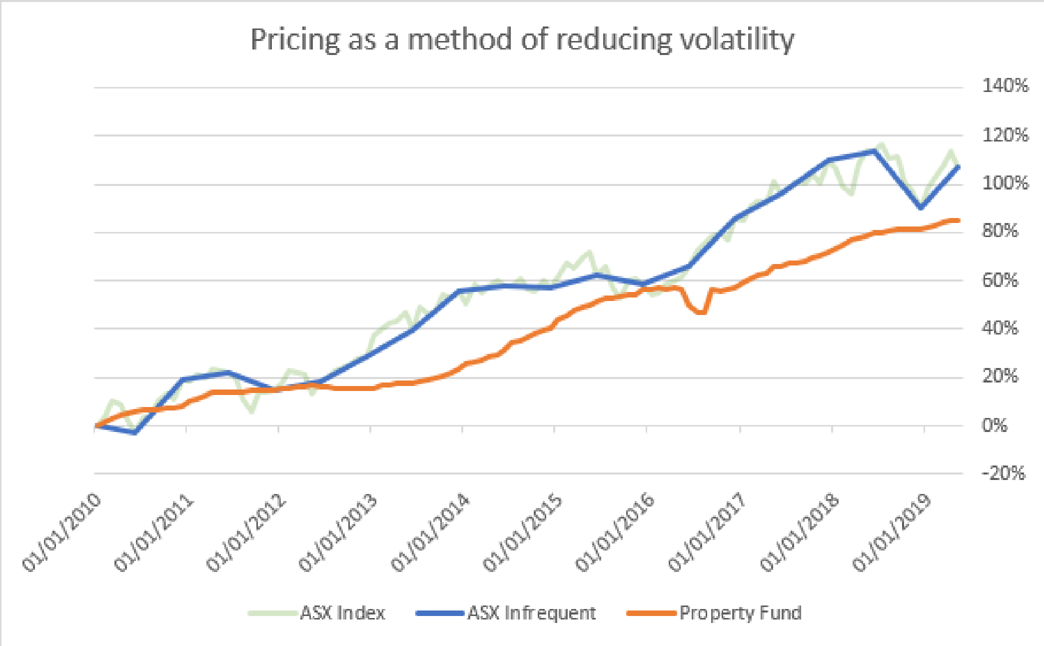
We see a similar phenomenon in Real Estate, another of the largest groups of Alternative Investments with a market size of $8.5tn globally. The graph below shows the FTSE REITS (Real Estate Investment Trusts) index. Again, Real Estate trusts have an element of leverage with them, due to the nature of the assets they hold. They are able to take out debt on the assets and use this to purchase additional property. It tends to be lower than PE at about 1.33x. If we apply the same leverage to the FTSE All-Share index, again you see a very similar return profile.



Source: Tatton IM, Bloomberg

The charts above, however, only show listed PE trusts and listed REITS, because the return volatility similarity only arises with listed PE investment instruments which are marked to market daily. As mentioned before, PE and Real Estate firms use unlisted PE funds or direct investment property funds, as a way to suggest improved performance or improved rationale for investing. Because the unlisted funds are priced significantly less frequently, maybe once every month, quarter or even every half year, the volatility in the value of their holdings is extremely low compared to daily priced assets. They sometimes use this infrequent pricing argument to claim that the fund has a superior Sharpe ratio (the ratio of a fund's returns over its volatility, i.e. the standard deviation of returns/the oscillation around the average return). This however is simply a mirage in the sense that returns are extremely similar when looking at a pool of funds, yet volatility is much subdued because of the infrequent pricing. If their holdings were valued daily, we would see similar fluctuations to those listed PE funds, and in turn to those of equities.

Looking at the chart below, we compare the FTSE All-Share index (ASX) with one unlisted Real Estate fund - the monthly All-Share return line is the faint green line. The blue line that sits on top is the returns line. If the All-Share index was priced only every 6 months, volatility appears greatly reduced, similar to that of the infrequently valued Real Estate fund. In this case performance does differ somewhat but here we are assessing one specific fund and therefore its holdings are particularly unique and it is not leveraged



like the REITS.

Source: Tatton IM, Bloomberg

In summary, we look in detail at the makeup of various alternative investments, not simply at the risk-return profile. By assessing the underlying structures and approaches that form these investment options, we seek to understand the actual diversification that the underlying assets themselves contribute to portfolio construction. This usually requires assets which are driven by very different risks, or an investment strategy which enables a diversifying position to be taken (long short equity hedge funds for example). Hopefully we have shown that the correlation of PE and Real Estate with equities is high and the supposed diversification advantages are simply a product of the pricing mechanism used to value these investments. We could argue they are equities in disguise.

CAMBRIDGE INVESTMENTS LIMITED

8th July 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7553.1	1.7	127.5	↘
FTSE 250	19655.3	1.0	193.2	↘
FTSE AS	4120.5	1.6	63.6	↘
FTSE Small	5608.9	0.7	38.8	↘
CAC	5593.7	1.0	54.7	↘
DAX	12568.5	1.4	169.7	↘
Dow	26860.7	1.3	334.2	↘
S&P 500	2975.5	1.7	50.6	↘
Nasdaq	7803.1	1.9	146.0	↘
Nikkei	21746.4	2.2	470.5	↘
MSCI World	2215.2	1.7	36.8	↘
MSCI EM	1064.6	0.9	9.8	↘

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	17.9	13.1	13.3x
FTSE 250	3.4	24.7	13.9	14.2x
FTSE AS	4.5	18.8	13.2	13.4x
FTSE Small	3.7	-	16.4	14.1x
CAC	3.3	18.8	14.7	13.5x
DAX	3.1	16.6	13.9	12.6x
Dow	2.2	17.2	16.7	14.9x
S&P 500	1.9	19.6	17.9	15.9x
Nasdaq	1.0	25	21.8	17.9x
Nikkei	2.1	16.2	15.5	18.2x
MSCI World	2.4	18.6	16.5	15.2x
MSCI EM	2.7	13.9	13.1	12.0x

Top 5 Gainers / Top 5 Decliners

COMPANY	%	COMPANY	%
Flutter Entertainment	14.1	Evraz	-5.4
British American Tobac	8.5	Antofagasta	-5.0
John Wood Group	7.8	Anglo American	-4.8
easyJet	7.7	Croda International	-4.7
Imperial Brands	6.2	Coca-Cola HBC AG	-4.3

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.25	-1.50	OIL	64.1	-3.6
USD/EUR	1.12	-1.38	GOLD	1396.6	-0.9
JPY/USD	108.55	-0.64	SILVER	15.0	-2.1
GBP/EUR	0.90	-0.12	COPPER	265.4	-2.2
CNY/USD	6.89	-0.39	ALUMIN	1807.0	0.9

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	0.738	-11.4	-0.10
UK 15-Yr	1.080	-9.0	-0.11
US 10-Yr	2.048	2.1	0.04
French 10-Yr	-0.084	-1580.0	-0.08
German 10-Yr	-0.363	-11.0	-0.04
Japanese 10-Yr	-0.155	1.899	0.003

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.65
3-yr Fixed Rate	1.79
5-yr Fixed Rate	1.97
Standard Variable	4.30
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