THE **CAMBRIDGE** WEEKLY

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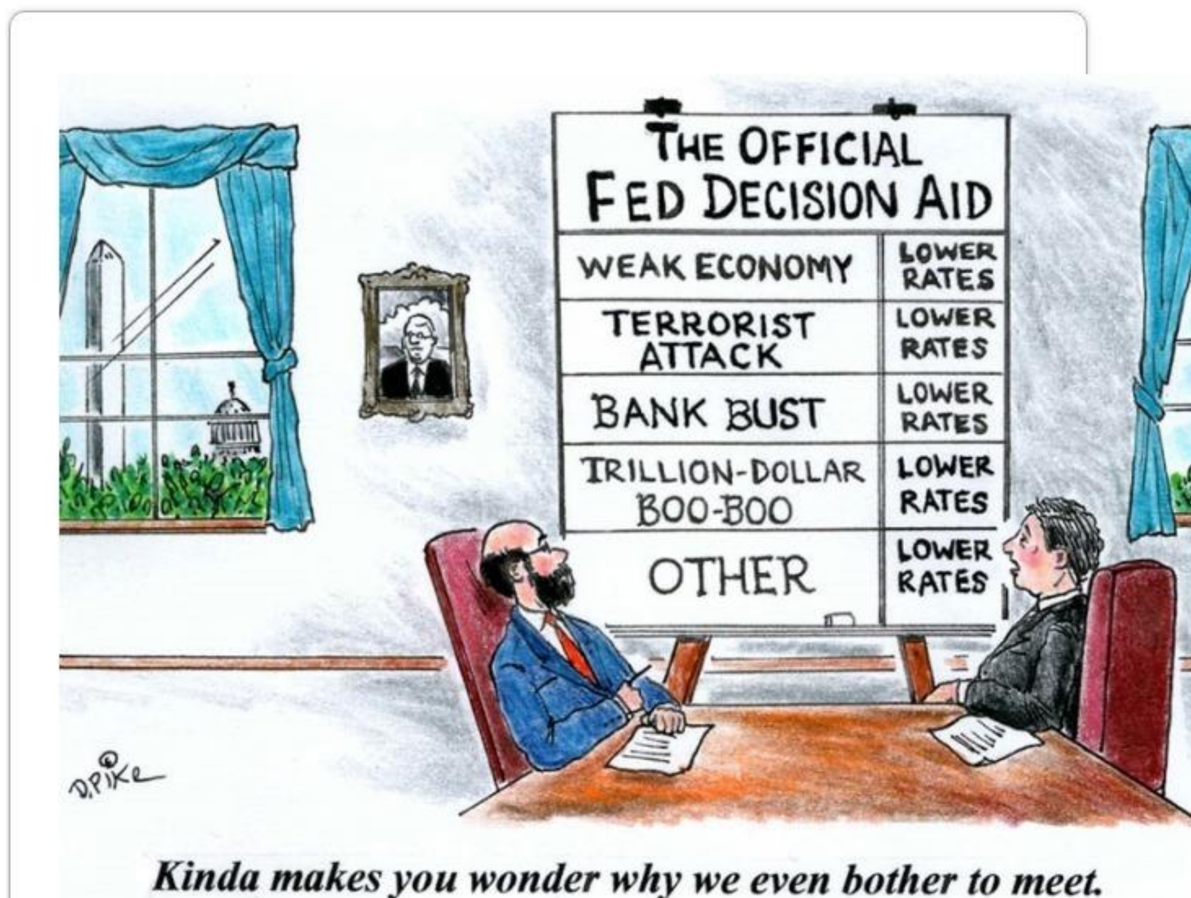


Kinda makes you wonder why we even bother to meet.

The Elephant and the Little Old Lady: A tale of two Central Banks

It was the best of times, it was the worst of times. Dickens' immortal line roughly sums up the differing actions of two of the world's major central banks this week. In the US, the Federal Reserve looked at a stable and growing economy more vibrant than most around the globe and with very few domestic risks: they decided to cut interest rates. Back at home, the Bank of England foresaw a sluggish and shaky economy with looming dangers and a 33% chance of recession: they decided to leave interest rates unchanged.

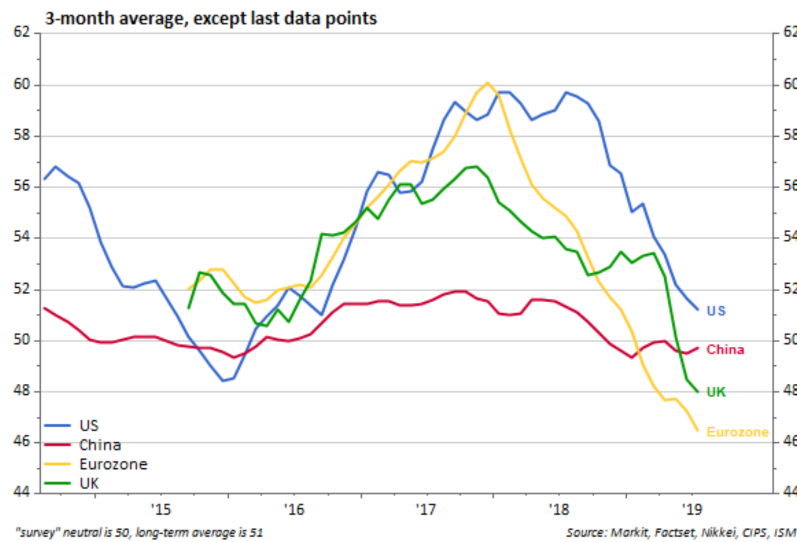
It appears that up is down, black is white and central banks have decided to rewrite decades of monetary wisdom. Well, not quite. The different approaches of the Fed and the BoE reflect the very different purview that policymakers are taking. The Fed has much more room to manoeuvre than the BoE, with their benchmark funds rate some 1.5% above the BoE's, even after the latest cut. And the Fed has come to believe that their remit extends much further than that of the BoE: it is effectively the world's central bank. Their statement and subsequent press conference acknowledged as much. They remain the elephant. Meanwhile the BoE has moved from centre-stage, in the mid-2000s, to the periphery of Europe. The old lady of Threadneedle Street is not ageing well.

None of the central banks' actions was unexpected. An aggressive pace of Fed rate cuts has been priced in by capital markets for a while now. Anything else would have caused an upset. In fact, the initial market

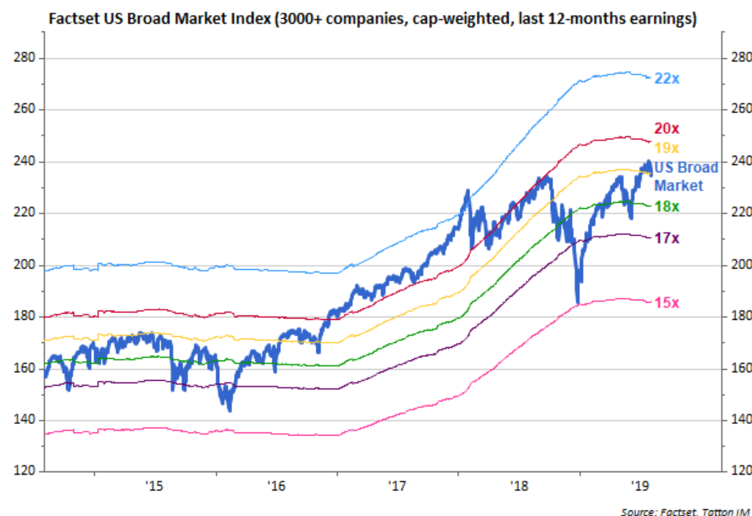
reaction suggests they expected more – in terms of outlook at least. US equities fell, while bond yields and the USD went up – though these moves were later reversed. The initial disappointment came from the fact that the Fed signalled that further liquidity would be economy-dependent rather than guaranteed. According to JP Morgan Research, we should not expect another rate cut if the US economy improves between now and September.

But market expectations could themselves influence the Fed's decision. Steven Blitz (of TS Lombard, a research group to which we subscribe) suspects that the shape of the US yield curve between 3-months to 10-years (the plot of US Treasury bond yields at different maturity dates) will be the Fed's guide. By the beginning of September, if the curve is slightly positive (3 -month rates below 10-year yields), a rate cut will happen but no more should be expected. If it is inverted, more rate cuts will be forthcoming. Still, he suspects that implied market interest rate expectations of three rate cuts over the next twelve months are too aggressive, as he sees an upcoming economic rebound.

From our point of view, we don't expect market expectations to change until a global economic rebound is clear in the data. And the latest data are showing no signs of that yet: this week's Purchasing Manager Index sentiment surveys were stable or weak again.



Equity markets are likely to remain no better than range-bound until economies improve. We've reached a stage of "equilibrating". In the past two months, weak economic data have caused investors to expect more money to be injected into the economy. The chart below shows that Price-to-Earnings ratios were supported or pushed to higher levels (via a decline in the discount rate which increases the future value of dividends, and a hope that stimulus would cause greater growth in those future dividends). The broad market is trading around 19 x last year's reported earnings, a bit above the 10-year average. However, if the Fed is likely to decrease rates only if economic growth is weaker than expected, the discount rate benefit is offset by the probability of disappointing profits and dividends.



Back to the UK. In a now all too familiar headline, sterling had a dreadful week. The new Prime Minister bolstered his Brexit credentials by announcing a cabinet full of hardliners, boosting the likelihood of a no-deal Brexit and sinking the value of the pound in the process. But none of this fazed equities: UK-listed stocks outperformed other markets – even after adjusting for the fall in sterling – up until Thursday.

There will inevitably be more gloomy Brexit headlines, but it seems a lot of pessimism has been built in. UK markets could even outperform if investors become less optimistic about other regions.

In global news, the US-China trade war rages on. At one level, Donald Trump seemed to be currying favour with Xi Jinping in referring to the Hong Kong protests as "riots", which gained positive responses from Chinese media.

But the high-level trade talks in Shanghai lasted half a day and came to nothing, despite US Treasury Secretary Steve Mnuchin and Robert Lighthizer (Trump's top trade negotiator) attending. Neither side foresaw a speedy resolution, but the tariff announcement (made overnight Thursday 1st) shows how badly it all went. The threat to impose a 10% tariff on a new list of imports by September 1st has been met by much stronger responses from the Chinese. Both sides have become entrenched in their positions, with no movement to close the gaps.

Trump may see China as currently in a weak position. The latest PMIs were not terrible but still stuck well below the neutral level of 50 (see chart above). Stock markets are underperforming, and autos sales are still weak. The situation has forced another "small" bank bailout by the government, and the People's Bank of China is clearly concerned – promising to provide near term liquidity (particularly for small businesses) but trying not to fuel the growing property bubble. An easing of trade pressure would help China.

For Trump, however, this may be counterproductive. The value of the Renminbi is a key signal of China's willingness to negotiate (stable means willing). It moved sharply weaker overnight, towards the Y7/$. This situation seems to have caught investors out, especially in those regions deemed to be most at risk. Most markets went lower on the news, with Asian emerging markets taking a sharp hit.

Even so, with a US election on the horizon, it's possible that President Trump could still be looking for another trade truce – if not a deal – before next spring.

As we and others have suggested, the other side to that could be Trump setting his crosshairs on another target: Europe. TS Lombard has even suggested that the president might intervene in currency markets to weaken the value of the dollar against the euro – thereby giving American exporters a price advantage. Given the dire state of the European economy, with the latest data showing continued weakness, that would be an extremely aggressive and potentially devastating move. The very threat of it may be enough to stir European politicians into action – prompting a fiscal response at long last. Regardless of what else happens, that would be a welcome development for the EU economy.

Despite all this, political risks and economic disappointments have not yet sunk market sentiment. Instead, for the past few weeks, central bank policy has dominated investment news. That speaks volumes about the fragility of the underlying economy. We will need to see genuine growth coming through soon to justify markets going even higher– not a huge ask, and a relatively positive US earnings season gives some reason to be upbeat. But with recent data being disappointing, we are resolutely neutral.

Turkey's Monetary Regime

'Stability' is not a word you tend to associate with Turkey. Back in the mid-18th century, the great European powers often debated "the eastern question": what to do about the original "sick man of

Europe". The reign of current President Recep Tayyip Erdogan has also been characterised by political ailments: democratic backsliding, erosion of civil liberties, increased economic intervention, military skirmishes and a series of high-profile international disputes.

For investors, all of these make Turkey a risky place to do business. This was made painfully obvious last summer, when the Turkish Lira sunk to all-time lows against the USD, stock markets nosedived and inflation sky-rocketed. But for a while capital markets' main concern has been the president's penchant for interfering in monetary policy. Strongman Erdogan fancies himself as a monetary theorist – pushing the heterodox economic theory that high interest rates cause, rather than contain, inflation.

His influence on central bank decisions has always been clear enough, but earlier this month he surprised markets by firing central bank governor Murat Cetinkaya. Cetinkaya's three years at the helm drew criticism from financial commentators – accusing him of politically motivated interest rate cuts – but even his pace of cuts wasn't fast enough for the president. His replacement, Murat Uysal, has already slashed rates by 4.25% and signalled that further cuts are on the way. As well he might, given his predecessor was sacked because he "wouldn't follow instructions".

Capital markets tend not to like political interference in monetary policy. But this time, no one seems to have told capital markets that. The Lira fell the day of Cetinkaya's departure, but since then has rebounded – and then some. After Uysal's first rate cut, the currency actually rose 3%. At the time of writing, $1 will buy you 5.57 Turkish Lira – its highest value since the beginning of April.

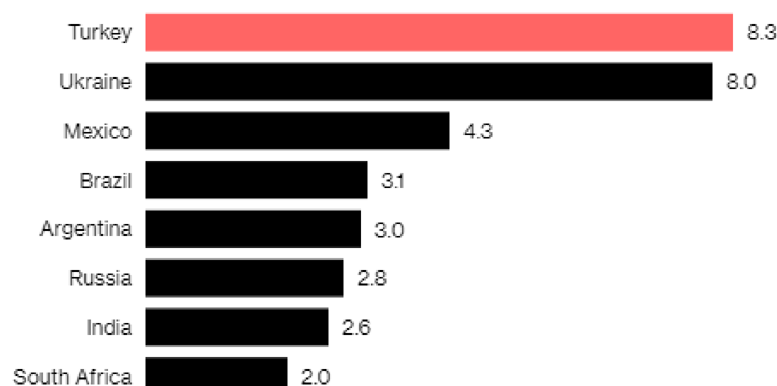
Could it be that investors buy into Erdogan's theory on monetary policy? In the past, the president has declared himself the "enemy of interest rates". Contrary to conventional theory, he argues that higher borrowing rates are passed on to consumers because companies raise their prices.

He's not alone in questioning conventional views. A number of economic theories have attracted criticism: the Phillips curve (the supposed inverse relationship between unemployment and inflation) seems to have broken down. The era of stubbornly low inflation despite historically low interest rates has led many to reconsider the old ways, most notably at the US Federal Reserve. Even for developing economies, recent IMF research has suggested that crushingly high interest rates can be destabilising.

But whether this is behind markets' show of confidence in Turkey is another issue. You don't have to believe in Erdoganomics to believe in Turkey as an investment proposition. The recent fall in inflation has left Turkey with the highest real (inflation-adjusted) interest rate in the world. And with falling rates, a low base effect (given the economic setbacks Turkey has already faced) and a government poised to crank up public spending, the country looks due a growth spurt in the short term. As with other emerging markets, the carry trade – borrowing cheaply in developed markets and investing in high growth EMs – is looking increasingly attractive.

Time to Cut

Turkey boasts the highest real rate in the world as inflation slows



Source: Bloomberg
Real rates are calculated using the year-over-year change in the headline figure for consumer prices.

There are, of course, dangers to this approach. EMs tend to do well when global growth is strong and the dollar is weak, neither of which is true now. And yield-chasers have been stung by bouts of Turkish instability in the past, last summer being the prime example. Even now, the threat of US sanctions – in response to the government's purchase of the Russian S-400 system – looms. In typical Erdogan fashion, the president responded to these threats by making some of his own: the country may have to "rethink" their purchases of $10bn worth of Boeing aircraft if the US follows through.

But the dangers could be overcome. Internationally, Turkey benefits from being a key ally in a tumultuous region. That fact has got them off the hook for questionable behaviour many times in the past. Barring any major incidences, they will likely be let off again.

Even if they aren't, there are ways of investing in Turkey that protect against such risks. Governor Uysal has vowed to preserve "a reasonable rate of real return" on government bonds. Judging by his past comments, what he has in mind is a return comparable to his EM peers in South Korea, South Africa and Brazil. The current trading price puts this at around 3.5% for the 5-year bond – meaning that investors will get a 3.5% return *plus* whatever the inflation rate is in that time.

This makes the bond a very attractive proposition. The inflation link provides a natural hedge against the biggest risk involved in EM assets: currency devaluation. If the Lira falls, inflation should rise (through import prices) and bond returns with them. And given the bond is issued in local currency, there is little-to-no default risk: they can always print more money.

If the central bank keeps up its commitment to maintain real interest rates – and it is an 'if' – the only real risk is the currency falling but inflation failing to match it. That would only happen if the internal economy was weak enough to cancel out import inflation. With an erratic strongman as president, that is always a possibility. But at the moment, it seems unlikely. Against the odds, for the time-being at least, the country has found some investment stability.

![Cambridge Investments Limited]

5th August 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7439.0	-1.5	-110.1	→
FTSE 250	19380	-2.4	-477.5	→
FTSE AS	4058.0	-1.6	-66.1	→
FTSE Small	5487.9	-1.4	-75.3	→
CAC	5405.0	-3.7	-205.1	→
DAX	11931.9	-3.9	-488.1	→
Dow	26456	-2.7	-736.9	→
S&P 500	2937.0	-2.9	-88.9	→
Nasdaq	7732.6	-3.5	-284.3	⬀
Nikkei	21087.2	-2.6	-571.0	→
MSCI World	2173.2	-1.9	-42.5	→
MSCI EM	1024.6	-2.3	-24.1	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	18	12.7	13.3
FTSE 250	3.4	26.3	13.7	14.2
FTSE AS	4.6	19.1	12.7	13.4
FTSE Small	3.7	51	-	14
CAC	3.4	18.8	14.3	13.5
DAX	3.3	19	13.9	12.5
Dow	2.2	17.4	17.1	14.9
S&P 500	1.9	19.1	17.7	15.9
Nasdaq	1	23.9	21.4	17.9
Nikkei	2.2	15.8	15.2	17.9
MSCI World	2.5	18.3	16.4	15.2
MSCI EM	2.9	13.8	12.7	12

Top 5 Gainers / Top 5 Decliners

COMPANY	%	COMPANY	%
London Stock Exch	21.0	Fresnillo	-22.7
Rentokil Initial	7.3	Centrica	-15.9
Smith & Nephew	5.8	St James's Place	-12.0
AstraZeneca	4.9	RBS	-11.5
Next	4.6	Mondi	-11.3

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.215	-1.9	Oil	62.61	-1.3
GBP/EUR	0.914	-1.7	Gold	1441.0	1.6
USD/EUR	1.11	-0.2	Silver	16.21	-1.2
JPY/USD	106.76	1.8	Copper	259.4	-3.1
CNY/USD	6.935	-0.8	Aluminium	1780.0	-2.5

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	0.69	-6.4	-0.05
UK 15-Yr	1.05	-2.0	-0.02
US 10-Yr	2.07	0.7	0.02
French 10-Yr	-0.12	-75.4	-0.05
German 10-Yr	-0.38	-16.0	-0.05
Japanese 10-Yr	-0.15	-12.1	-0.02

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!

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

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

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