THE **CAMBRIDGE** WEEKLY

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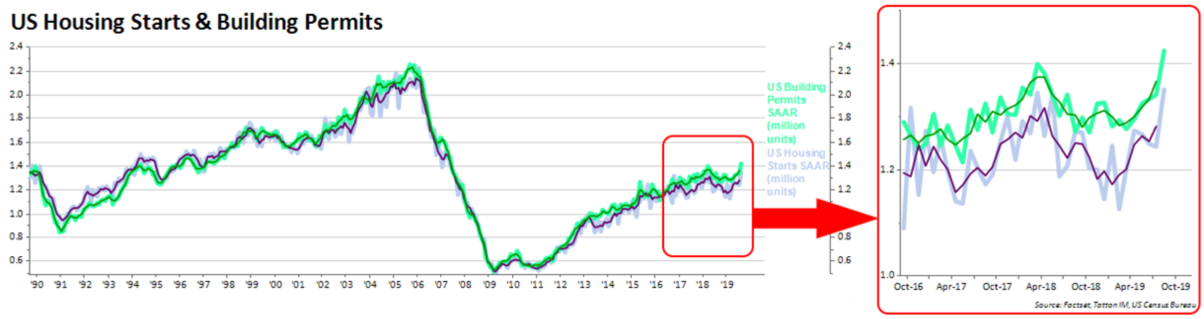
Source: Hedgeye, Chinese macro data disappointments 18 Sep 2019

Diverging economic trends - catalyst for trade war resolution?

We know from conversations with some of our portfolio investors and financial advisers that the investing UK public is currently almost entirely focused on every twist and turn of the Brexit drama. However, with the 'back-stops' which parliament has forced upon the Brexit-determined Johnson government, there is in our view still only a fairly low probability that the ongoing process will lead to an economically disruptive no-deal withdrawal scenario. Until matters become clearer on that front, global developments are therefore far more relevant for professional investors

For the last four weeks, we have been saying that markets are broadly in balance. Equities have gone as far as the current economic environment will let them while yields are no longer declining to push up their relative attractiveness any further. And from here on, we will need to see an improvement in the underlying economy to see markets push higher. Fortunately, this week saw the release of some key data points which help us assess the health of the global economy. Unfortunately, they pointed in very different directions. We are seeing considerably diverging fortunes in two of the world's most important economies: the US and China.

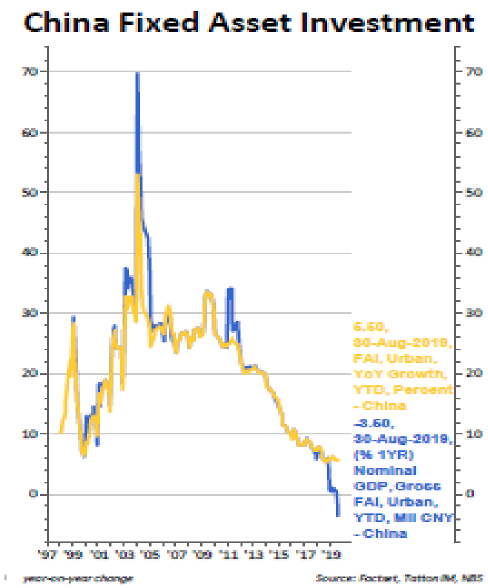
In the US, things look positive. The number of housing starts (new homes being built) has notably picked up. And this is significant for a number of reasons. It shows both that companies are willing to invest in building and that consumers are willing to buy. Furthermore, that consumer strength most likely comes from both job stability (thanks to a strong labour market) and easier access to credit through lower interest rates. The fall in interest rates on mortgages is mainly due to the fall earlier in the year in long-dated US government bonds – as US mortgages tend to be long-term fixed interest. In fact, the increase in housing starts has tracked, near enough, what you would expect from the earlier fall in yields.

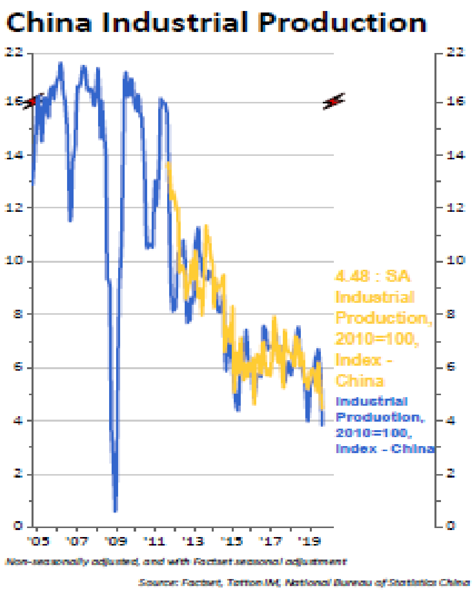


That unfortunately means that they will probably slow from here. The increased demand for borrowing will most likely stop those long-term rates from falling any lower – as well as the recent rise in 30-year Treasury yields. But regardless, it paints an overall healthy picture.

When we combine that with the enormous corporate bond issuance seen over the last few weeks, it looks even better. Estimates are that US businesses have raised around $128bn in debt over the last month – a staggering amount. The hope is that this glut of new credit will be put to work as some much-needed corporate investment. But that hope may be a little premature. Judging from company statements, only around 5% of the total debt raised will be used for investment – almost all the rest will just be used to refinance old previous loans. Even within the $6.5bn earmarked for investment, nearly half is set to be used as working capital (expanding regular operations like building inventory) with just under $3.4bn set aside for actual business/capital investment (capex). Still, even without a significant bump in business investment, economic fundamentals in the US look good.

In China, it is a completely different story. The world's second largest economy has been going through an economic slowdown for some time now, and despite substantial stimulus measures from the government, all the signs suggest that the squeeze is continuing. Wherever you look, activity is dropping off (as shown by the fall in fixed asset investment and industrial production in the chart below).





The private (business) sector seems to be going through a similar episode to earlier in the year, when enterprises were finding it difficult to get access to credit. The worrying part is that this is happening in spite of Beijing's efforts to get more funding to small and medium sized businesses. Their earlier clampdown on the shadow banking sector seems to have had a bigger effect than they can handle – as shown by the continued struggles of regional banks and local state-owned enterprises. China is undergoing a classic credit crunch, where businesses cannot find money and the economy suffers as weak businesses go bust and the expansion of stronger businesses stutters.

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Those struggles might explain another one of the week's biggest news stories. On Monday, US repo rates – the interbank lending rate financial institutions borrow at when they need short-term cash – spiked to around 10%, prompting the US central bank (Federal Reserve) to directly enter money markets and inject $75bn into the financial system. The Fed has not had to do that since the Financial Crisis, suggesting there is a worrying shortage of available cash. This can happen when certain big players are in serious trouble and need cash to cover their positions, but struggle to get it as other financial institutions are reluctant to lend to them. There are many good reasons originating in the US for this sudden liquidity squeeze, but it could also be that Chinese banks are in exactly the position described above. We cover this in more detail in a separate article below.

For now, it suffices to say we are stuck with a mixed bag. On the one hand, growth (and thus demand) coming from the US could be just what the global economy needs to get it out of its 2019 'go-slow' state. On the other, deflation and credit troubles in China could be just the thing to push it the other way.

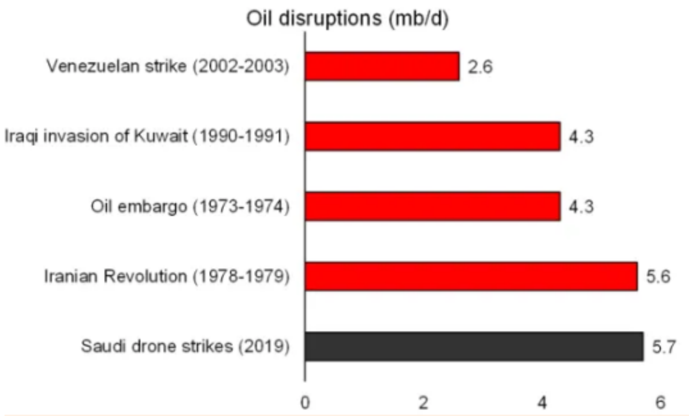
One positive to draw from this is that the weaker China becomes, the more likely they are to push for an end to Donald Trump's trade war. That would remove one of markets' biggest worries, and potentially pave the way for yet another bump-up in equities. Thankfully, things seem to be heading that way. China has appeared conciliatory in recent weeks, and electoral pressures at home could convince Trump he needs to make a deal. Certainly, the removal of China hard-liner John Bolton from the Trump administration makes this more likely.

Until such a deal does happen, however, the mixed data will largely determine where markets go. We are, yet again, in a balance.

2019's half-day oil shudder

The attack on Saudi Arabia's largest crude oil processing plant last weekend has understandably caused quite a stir. On Saturday, a series of missiles hit the Abquaiq processing centre – which prepares almost 70% of Saudi Arabia's oil for export – knocking out a key piece of the Kingdom's production.

The Financial Times wrote that the attacks "have exposed the soft underbelly of the global energy market". According to estimates, the disruption equates to supply loss of around 5.7mn barrels a day – more than 5% of the world's total (see chart below). And though Saudi officials have been quick to reassure markets, oil experts suggested that it could take months to restore full production to the facility – described as "the most important oil in the world" by a former energy adviser to George W. Bush.



Source: UniCredit, Largest oil disruptions in history, 16 Sep 2019

We have seen significant fallout already. Saudi Arabia and their American allies were quick to point the finger at regional rival Iran. Yemen's Houthi rebels (who are currently at war with Saudi forces) claimed responsibility, but doubts have been raised over their ability to execute such a precision air strike. President Trump called Iran's denial of involvement a "big lie" and said US forces were "locked and loaded" ready for a response.

Beyond the initial supply disruption, an escalation of tensions in the Middle East would likely dampen sentiment in oil markets. Fortunately, nobody seems to have told oil markets that. Despite an initial move higher, oil prices have been mostly unaffected by the drama.

That may sound like an odd thing to say, given that Brent crude, the world's main oil benchmark, spiked as much as 20% higher after trading opened in Asia on Monday – posting the largest single day percentage gain since Saddam Hussein invaded Kuwait in the 1990s. But Monday's closing price for Brent was a slightly less headline-grabbing $69 per barrel, and even those gains were significantly clawed back later in the week. Wednesday and Thursday saw Brent prices come back down below $64pb, and prices at the time of writing are sitting around where they were at the end of July. Those are fairly ordinary numbers, considering global oil markets' historical price reaction to previous supply losses of a 5% magnitude. So, why are oil traders so unfazed about the situation?

The initial correction probably has something to do with the Saudis' attempts to reassure markets. On Tuesday, the Kingdom's newly appointed energy minister Prince Abdulaziz bin Salman announced that oil production would be back up to normal levels by the end of the month. The minister – who is the half-brother of de facto ruler Crown Prince Mohammed bin Salman – claims that Saudi output would be at 11mn barrels per day by the end of September and 12mn by the end of November. National Petroleum giant Saudi Aramco has risen "like phoenix from the ashes" since the attack and will soon be operating as normal, he said.

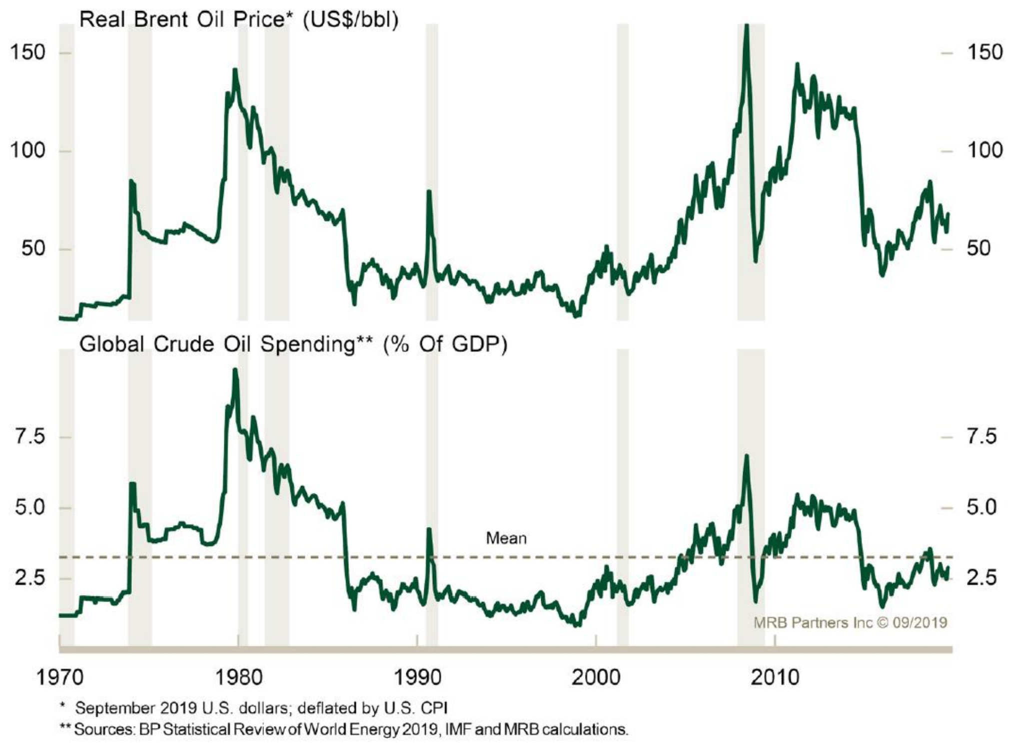
Whether the Saudis can live up to those lofty claims remains to be seen. But more certain is that, compared to previous episodes of supply disruption, this time the global oil market is still closer to oversupply than shortage. In other words, the global economy has enough oil supply to weather this hit to production. Just last week, the International Energy Agency (IEA) warned that a growing oil surplus would push prices lower next year. "While the relentless stock-builds we have seen since early 2018 have halted, this is temporary," The IEA predict that surging production from OPEC+ (including Russia) will soon see oil markets "returning to a significant surplus and placing pressure on prices."

The pressure was already on Saudi Arabia, OPEC's de facto leader, to deepen the cartel's production cuts. The latest hit to their production capabilities could well just act as a counterbalance to burgeoning supply. In fact, the price hike caused by the attacks could even be a boon for Saudi Arabia, who have been struggling to implement supply restraints for years to ensure their main export remains profitable.

Even with the attacks laying bare the risks in the Middle East, the Kingdom is pressing ahead with the IPO of Saudi Aramco. Indeed, one of the officials' main tasks in handling the situation has been trying to convince the world that Aramco remains a foremost investment opportunity. Despite estimates putting it as the world's most profitable company, analysts think that the oil giant's value is significantly below the $2tn toted by Saudi officials.

With a global shift away from fossil fuels, there are question marks over the company's sustainability. And with this latest attack showing Saudi Arabia's vulnerability, there are now question marks over its reliability too. Chairman Yasir Rumayyan insists that "the IPO will continue as is", but the added geopolitical risk will make finding buyers to match their valuation target difficult. According to Steffen Hertog at the London School of Economics (LSE), "The vulnerability was always there but no one ever took it very seriously. But now they are."

Regardless, Aramco's troubles are unlikely to be reflected in the oil market as a whole. If their claims of an imminent return to full production prove to be too optimistic (and they look it) we may well see the oil price remain elevated in the short term. But the glut conditions that have built up over the past few years mean prices are unlikely to stay too high for too long. And even at the more elevated levels reached this week, the oil price is unlikely to act as a major economic drag. The risk factor is not as great as during historic oil price shocks, given the relatively benign level of current oil prices, both in historical context (adjusted for inflation), but also as a percentage of Global GDP (See chart below from our research partners MRB)

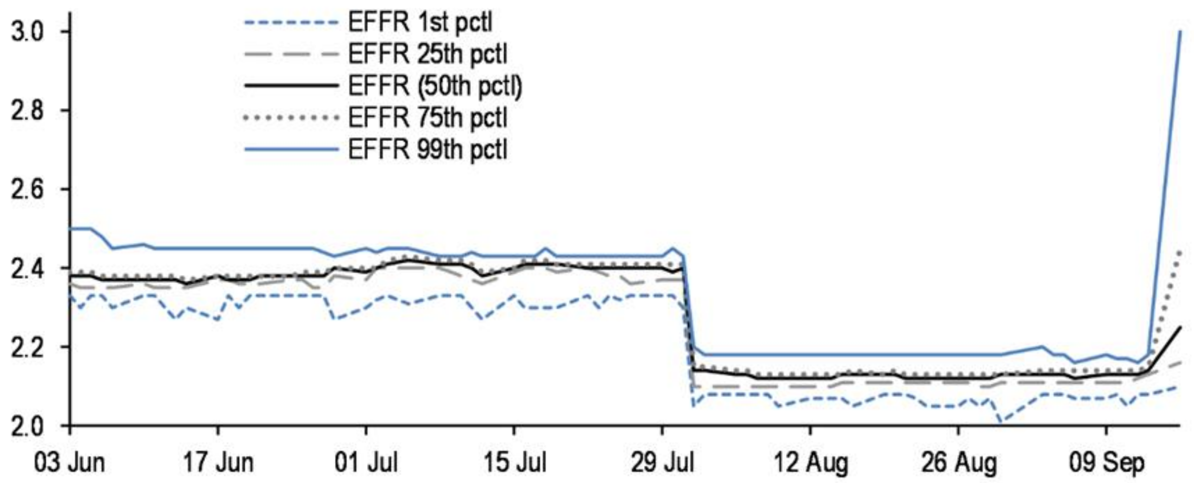


Don't fear the Repo?

The timing could not have been worse for the Federal Reserve. Just as the US central bank was about to assuage capital markets by cutting interest rates once more, they seemed to lose control of a key part of the financial system. Earlier this week, US money markets were shocked by a surge in repo rates – the interest rate for short-term interbank lending (comparable to what LIBOR used to be) – after financial institutions came up short of cash. The situation forced the Fed to inject an unusually large amount of short term liquidity into the financial system via an "open market operation" to calm things down.

A bit of background:

Repurchase or 'repo' rates are the means by which banks and other financial institutions move money around to meet short term cash requirements. Banks generally hold most of their reserves in government securities – as regulators deem these 'risk free' and they (usually) have a higher return than holding cash. But bonds cannot be used for immediate flows and transactions, like withdrawal of customer deposits. So, rather than selling their bond reserves (which would be cumbersome and cause transaction costs) banks often borrow cash, using the bonds as collateral, from repo markets. It used to be done on a sale-and-repurchase basis – hence "repo". Nowadays the rates are quoted in terms of the



Source: New York Fed, J.P. Morgan

interest rate on the cash borrowed.

Naturally, repo (borrowing) rates will be much higher if everyone needs cash at the same time. To stop this happening, central banks inject cash into the system as and when required. This can happen – particularly around important regulatory dates such as quarter and year-ends.

It is less usual for there to be unforeseen market developments. When it happens, it can be that the banks are not informed of depositor moves ahead of time. However, past experience – especially during the 2008/2009 Financial Crisis - has shown that it can be a sign of stress in the financial system: certain commercial banks' usual lending sources being reluctant to extend credit, fearing they will not be paid back.

Tuesday's episode was sharp, with the general collateral repo rate climbing to 10% for some of the trades. In turn, this forced the Effective Fed Funds Rate (EFFR) upper target (2.25% on Tuesday) to be breached – very embarrassing given that it was about to be cut and not raised on Wednesday.

As already mentioned, the liquidity shortfall was so big that the New York Fed announced a $75bn open market operation on Tuesday morning, with further cash injections coming later in the week. The last time the Fed was forced to delve into money markets by this much was just before the collapse of Bear

Stearns, and then again Lehman Brothers, over 10 years ago. Inevitably, rumours of a similarly seismic event did the rounds.

The most plausible reasons are not so scary.

This week saw an important corporate tax deadline – which usually drains around $100bn in bank reserves. This has a knock-on effect for the financial system, as money market funds (MMFs – which invest in short term money market instruments) tend to experience large outflows due to corporate investors needing cash to pay their tax bills. The average MMF outflows around September tax dates is about $30bn.

Of course, all of this is common enough occurrence. What made the difference this time around is that, just as financial institutions scrambled to get their required cash, a huge payment fell due to the US Treasury after the issuance of new US government bonds the previous week. $54bn of US Treasury bond purchases settled for payment on Monday – tipping the market into imbalance.

Current bond market trends meant that this effect was then amplified. Bank balance sheets (the primary dealers of repo) have been elevated with treasuries and drained of surplus cash, since the bond market turned more bullish at the end of last September. What is more, there has been a change in the setup of money markets themselves – with MMFs now financing $1.28tn of dealer collateral, a $332bn increase on last year. All of this culminated in a significant contraction of repo cash supply, just when repo demand was spiking.

It is important to point out that none of these factors suggest financial institutions might be struggling – certainly no way near to the extent during the financial crisis and also for very different causes. In fact, Tuesday's open market operation, when the Fed waded in with their headline-grabbing $75bn, was undersubscribed: they were offering more cash than banks actually needed.

It does, however, highlight a broader issue in the financial system. There may have been specific reasons for this week's supply-demand mismatch, but that it could happen at all is a worrying sign. "The underlying problem is that there isn't enough liquidity in the system to satisfy the demand and the job of the central bank is to provide such liquidity," according to former Fed economist Roberto Perli.

Commentators have suggested that the solution would be for the Fed to inject cash on a more long-term basis, through an expansion of their balance sheet. "Quantitative-easing-lite" or "QE-lite" is the phrase being widely used. This is misleading, because QE is intended to stimulate the wider economy, whereas this would simply be to ensure there is sufficient money in circulation to satisfy the needs of a growing economy. That is, after all, a central bank's first responsibility, and has always been.

If central banks fail to react, we will probably see similar issues come up again – especially around year-end or quarter-end dates. That does not necessarily mean that the banks are in trouble. But if unchecked, it could still pose a serious problem for financial markets and the wider economy.

Meanwhile, there *are* still concerns that there may be an institution or institutions under stress. As of today, Friday, the general collateral rate is in normal territory, at the top of target band (1.75% - 2% after Wednesday's interest rate cut). Even so, the Fed has had to inject liquidity for four days. While Tuesday's injection was greater than needed, $75bn has not been enough.

Bloomberg commented that "cross currency basis -- which show floating-rate payments in different currencies -- the premium for the Australian dollar over its U.S. counterpart collapsed by the most in eight years during Asian trading hours".

If there is an institution under stress, it is likely to be hiding somewhere in Asia, and be China-related. Signs of economic woes have been growing, while Chinese institutions have seen credit-spreads widen. Interestingly, they appear to be quite keen to get the funding, even at the more penal rates.

We will be watching developments closely.

CAMBRIDGE INVESTMENTS LIMITED

23rd September 2019

Global Equity Markets

Market	FRI 15:47	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7364.6	-0.0	-2.9	→	⬀
FTSE 250	20128	-0.3	-68.1	↗	↗
FTSE AS	4049.8	-0.1	-3.5	→	⬀
FTSE Small	5510.4	-0.0	-1.8	→	⬀
CAC	5692.1	0.6	36.7	↗	↗
DAX	12479.4	0.1	10.9	↗	↗
Dow	27162	-0.2	-57.0	⬀	↗
S&P 500	3015.0	0.3	7.6	⬀	↗
Nasdaq	7898.8	0.1	5.9	⬀	↗
Nikkei	22079.1	1.5	319.5	↗	→
MSCI World	2204.7	-0.1	-1.1	⬀	↗
MSCI EM	1016.6	-1.0	-10.0	→	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Hikma Pharma	5.9	Evraz	-9.0
SSE	5.0	Smurfit Kappa	-7.8
AstraZeneca	4.9	Mondi	-6.6
Micro Focus Int'l	4.4	DS Smith	-6.1
BT	4.4	St James's Place	-5.8

Currencies

Pair	last	%1W
USD/GBP	1.250	-0.0
GBP/EUR	0.881	0.6
USD/EUR	1.10	-0.6
JPY/USD	107.97	0.1
CNY/USD	7.091	-0.2

Commodities

Cmdty	last	%1W
Oil	64.82	7.6
Gold	1504.0	1.0
Silver	17.83	2.2
Copper	259.7	-3.1
Aluminium	1800.0	-0.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.6	-0.1
UK 15-Yr	0.8	-0.1
US 10-Yr	1.8	-0.1
French 10-Yr	-0.2	-0.1
German 10-Yr	-0.5	-0.1
Japanese 10-Yr	-0.2	-0.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.1	17.9	13.1	13.2
FTSE 250	3.3	25.7	14.5	14.2
FTSE AS	4.7	19.1	13.1	13.4
FTSE Small	3.8	235.3	-	14.0
CAC	3.2	19.6	15.2	13.4
DAX	3.2	20.8	14.5	12.5
Dow	2.3	18.1	18.0	14.9
S&P 500	1.9	19.7	18.3	15.9
Nasdaq	1.0	24.5	21.9	17.9
Nikkei	2.1	15.7	16.0	17.8
MSCI World	2.5	18.8	16.8	15.2
MSCI EM	2.9	13.6	13.1	12.0

UK Mortgage Rates

Mortgage Rates	Estimate	Jul	Jun
Base Rate Tracker	2.56	2.56	2.56
2-yr Fixed Rate	1.67	1.64	1.66
3-yr Fixed Rate	1.79	1.75	1.77
5-yr Fixed Rate	1.97	1.92	1.96
10-yr Fixed Rate	10-yr Fixed Rate	2.66	2.61
Standard Variable	4.30	4.30	4.30

* 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

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23rd September 2019

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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