THE **CAMBRIDGE** WEEKLY

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Source: Hedgeye, 26 August 2019

Fattening 'tails'

It does not happen often that market-moving news emerges after we have finished writing The Cambridge Weekly. Last week proved to be an exception. Having just commented on how politics and the prospect of fiscal easing by US and European governments had been taken positively by markets, Donald Trump released a Twitter tantrum which some have likened to him "livestreaming his own meltdown". The reason this specific tirade caused one of the largest and sharpest falls in the US stock market this year (the Dow Jones fell intraday by as much as 700 points, after markets had largely come to ignore his periodic outbursts), was because he announced further substantial tariff hikes against China.

This shocked markets for three reasons. Firstly, the imposition of tariffs is one of the few measures the US president can execute without the damage-limiting 'checks and balances' mechanism of US congress. Secondly, a previous Trump tweet of a postponement of the previous wave of tariff hikes had led to the impression that a trade deal might be forthcoming in the autumn. And third he referred to China's leader Xi and the US central bank chairman Powell as "enemies" of America.

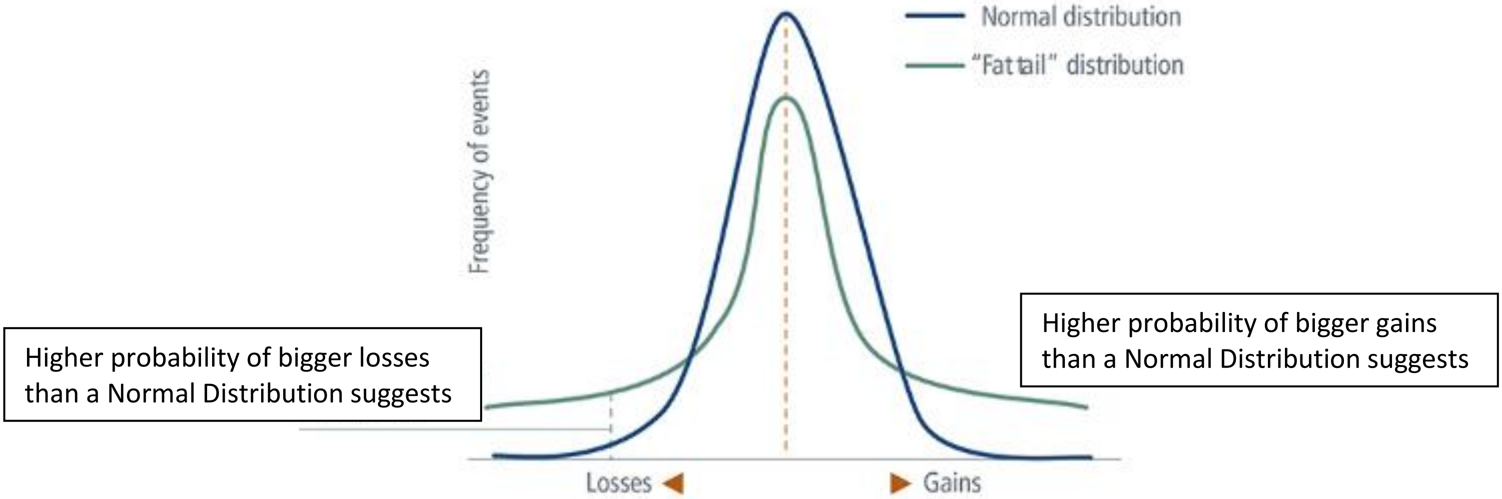
His various comments to the press and via tweets during the G7 summit at Biarritz – "he [Trump] may have second thoughts about his tariff announcement" and "other G7 leaders congratulate me on the state of the US economy, but ask why the American media hate my country so much" – all reinforced the image of a highly volatile individual who may be hard to trust or to be taken serious as a negotiation partner. No wonder markets rallied again, when the Chinese side was quoted that it was "willing to resolve trade war with calm attitude" and hinting it would not "retaliate for now".

The impression the UK's new leader gave over the course of the week could not have been more different to Trump's. Boris Johnson may have been ridiculed for displaying subservience towards the US president in Biarritz, but back at home he has proven to be a man with a plan *and* determination. His action to curtail parliament's ability to hold him and his government to account in the run up to the next Brexit deadline is highly questionable for a parliamentary democracy but compared to his predecessor he is clearly forcing the Brexit issue to be resolved. This will either be through some last-minute negotiation success that allows him to see the existing, but altered, withdrawal deal with the EU pass through parliament, or through forcing his opponents to bring down their own government, which would most likely lead to a general election before year-end.

Either way, Johnson would be unlikely to remain in power if he not only divided parliament, but also the country by forcing through a no-deal Brexit. The likelihood of a no-deal Brexit has therefore not necessarily increased and the relatively stable currency markets this week are evidence that this is a widely held belief. However, what the strengthening of £-Sterling over the course of August as a whole does tell us is that his political strategy (of allocating more funding towards the various areas that have suffered most under the years of austerity of his preceding Conservative governments) is welcomed by capital markets. Whether this is in preparation for a general election or to soften the onset of Brexit is undetermined, but it is certainly more constructive for the UK economy than the dithering of his predecessor.

It appears that the coming weeks will be unnerving and uncomfortable, but everything points to a rising probability that the extended era of uncertainty and fiscal austerity that has held back UK business is coming to an end. Whether that be a Johnson government or an opposition government uniting parliament towards one course or the other cannot be known, but he has made sure that the decision has become much harder to postpone.

For those wondering what this week's title has to do with what we have written, we need a brief detour into investment theory. Expectations of future investment returns – and historic observations tend to provide reasonable guidance for them – present themselves usually somewhat as illustrated below:



Source: PIMCO, August 2019

While many phenomena in natural science are approximated well by the mathematical construct of a normal distribution (blue line above), investment return distributions have over time more often proven to have 'fatter tails' than the normal distribution (see green curve above). Diversification across many different asset classes and longer minimum holding periods help greatly to reduce the 'fat tail' observation of individual investments over shorter time periods.

Over a shorter time horizon however, say the next 12 months, the return distribution of even well diversified portfolios will at times display the 'fat tail' shape. And this is precisely the effect politics are currently having on return forecasts for the next 12 months. If Trump and Brexit-related trade restrictions do not materialise then we can expect considerable upside potential as pent up business investment is unleashed and further stimulated by favourable credit conditions. If it all goes horribly wrong in politics (which it rarely does), then a worldwide recession is relatively likely, and consequentially investment returns will be bad until we emerge on the other side.

Boris Johnson forces opponents to 'put up or shut up'

"May you live in interesting times" is the apocryphal Chinese Curse. Just when we thought the Brexit tension could not get any higher, politicians find a way to surprise us. Boris Johnson's announcement that parliament will be suspended for five weeks leading up to mid-October – severely reducing the time to hold the government to account over its exit plan – has done just that. When he won the Conservative party leadership election and assumed the position of prime minister, he boldly declared that Britain would leave the EU on 31st October "do or die". Now, as we race towards the deadline with parliament seemingly unable to intervene, it looks like we might do so with the brakes cut.

Volumes of opinion and analysis have been written on this; adding to them here would achieve little. As ever, we try to focus on what scenarios we might get from this, and what they would mean for investments.

Many commentators draw the simple conclusion that Johnson's decision now makes a no-deal Brexit likely – where Britain would drop out of the EU without any agreement and revert to trading with its closest partners under WTO rules. The government is clear that it is prepared to exit the EU without an agreement on 31st October, and MPs (the majority of whom oppose a no-deal Brexit) are now less able to stop them.

But this argument is misleading. Brexiteers (Mr Johnson included) often lamented that Theresa May's negotiating tactics were hamstrung by her inability to build a 'credible threat' of taking the UK out of the EU without a deal. Since landing in Downing Street, Johnson has clearly tried to make that threat as credible as possible – repeating that he wants to reach an agreement with European negotiators but is prepared to leave without doing so. Up until now, it is not clear whether that threat has led to results, as EU officials still appear unwilling to renegotiate the terms they reached with May.

Johnson and his team reportedly believe that the reason for the Europeans' obstinacy is that they think that parliament will stop a no-deal Brexit in its tracks – neutralising his 'credible threat'. As such, it could be the prime minister is trying to show Michel Barnier and his colleagues that a no-deal could happen and his is the only game in town. But being able to play hardball does not mean an actual commitment to no-deal.

Of course, he is playing hardball with MPs as much as with the EU. MPs will return to the House of Commons for a few days before the PM's recess starts. Given that the Scottish court has declined to intervene, Johnson's opponents will probably be faced with a stark choice: accept the potential for Johnson's no-deal or stop him with a vote of no confidence.

If they opt for the latter, the lack of time probably implies accepting a Jeremy Corbyn-led caretaker government, another extension on Brexit and a general election (a proposition Johnson has already suggested). If Corbyn is not acceptable to a majority of MPs, a general election is almost bound to follow. In fact, sources close to No.10 have suggested that, if Boris Johnson does lose a vote of no confidence, he will ignore it and immediately seek to call an election. Overall, an election between now and the end of the year is looking increasingly likely.

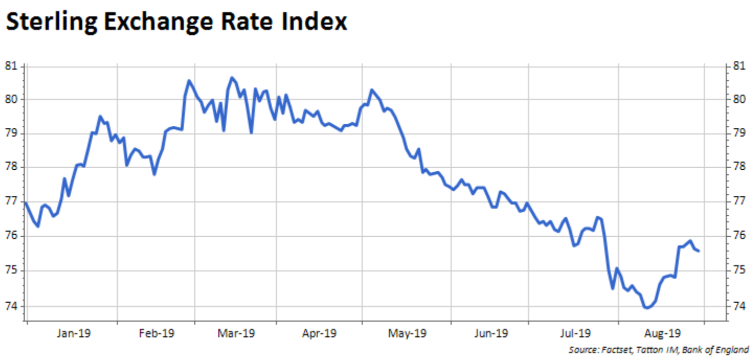
The government is still confident it could win a vote of no confidence – due to MPs' fear of a Corbyn-led government. And if it falls, other commentators have suggested that Johnson is unafraid of a general election – framing it as a 'people vs parliament' vote.

Since assuming office, Johnson's government has laid out policies reversing the austerity cuts enacted by previous Conservative governments, although Sajid Javid was keen (this week) to stress that government finances would not be allowed to worsen dramatically.

The strategy achieves the aim of increasing the chances of an election victory, limiting the lines of attack that helped the Labour party in the 2017 election. With the anti-Brexit vote split between several parties, the thought among Johnson's strategists seems to be that the populist anti-parliament sentiment will be enough to secure him a significant majority. However, from our point of view, an important aspect is that his election preparation tactics also ameliorate the bad consequences of any form of exit from the EU. We think that one of the reasons why markets responded negatively to a perceived rise in no-deal probability was that the previous administration made no serious effort to plan for it, thus making the potential consequences economically much worse.

And it may well be that the chances of no-deal have actually not changed much. In going "all in", the prime minister is forcing his opponents – both at home and in Europe – to put up or shut up. But that still does not make the worst outcome the most likely.

We take comfort in the fact that the value of sterling – the clearest indicator of general Brexit sentiment – barely moved (after the initial widely reported blip) in reaction to the news. Indeed, the Bank of England trade-weighted sterling index has had the best month since February:



Interesting times indeed, but not yet terrible ones.

Salvini's Italian Gambit backfires

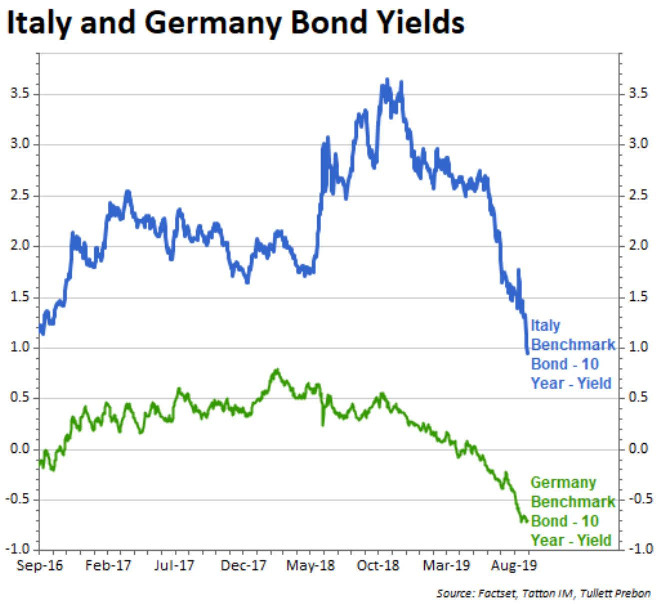
In a week like this, it is easy to feel as though Brexit is the only issue on people's minds – both here and across the English Channel. But as ever, politicians are often too preoccupied with their own (and their country's – hopefully) problems to worry about what is happening across borders. For European politicians, however, there is one country whose successive recalcitrant governments have repeatedly led to showdowns and headache-inducing confrontations. And it is not Britain. For years now, that prize has gone to Italy, the Eurozone's third largest economy and a founding member of the EU.

It should have been music to the ears of "Brusselite" politicians, then, that this week another Italian political crisis seems to have been averted. Earlier this month, Matteo Salvini, whose far-right party Lega Nord represents one half of the populist coalition that governed Italy from May last year, announced that he was breaking up the band and planning a vote of no confidence, with a view to holding snap elections. But this week, plans for a new coalition between the Five Star Movement (M5S – Lega Nord's old partners and the largest party in the Italian parliament) and the centre-left Democratic Party (PD) were announced. To top it off, the proposed coalition will be headed by the prime minister whom Salvini scorned for trying to bring down his own government: Giuseppe Conte.

To understand how Salvini managed to manoeuvre himself out of power, some background is required. Last year, Lega Nord and M5S – both anti-establishment parties with no prior history in government – agreed to form a coalition government after emerging as the two largest parties in the election, selecting an independent (Giuseppe Conte) to head the government as PM. Despite leading the smaller coalition party in terms of parliamentary seats, Salvini's highly populist anti-immigration stance as interior minister had him quickly become the most powerful figure in Rome – as Lega's standing in national opinion polls surged and M5S's declined. Many began to refer to him as Italy's de facto leader, setting up huge internal conflict with his coalition partners and with Conte.

With his eye on the opinion polls – which recently put Lega Nord far in front on 38% – the strongman fancied his odds in a snap election, which would see him lead a majority (or large minority) government as PM. That gamble has now backfired spectacularly. While the polling numbers may favour Salvini, the parliamentary arithmetic does not. Between them, M5S and PD have just enough seats in parliament to block Salvini out of power – and intend to do just that.

Markets have taken this as unequivocally good news. Italian bond yields, which shot up dramatically after the populist coalition came to power, have fallen to their lowest in three years (see chart below, upper line from May 2018). At the time of writing, the 10-year government bond carries a yield of around 1%, 0.5% lower than the equivalent maturity US bond (!). Since the last election and before, markets fear that a confrontation between Italy and the EU could lead to another eurozone crisis – only on a larger scale. But with Italian yields having come in so much (particularly the spread over German yields – in the chart, the difference between the upper and lower line) and the euro having strengthened, these fears are diminishing.



But the all-clear signal might be a little premature. There are still obstacles in the way of an M5S-PD coalition. While the two parties were bitter enemies historically (M5S began as a protest movement against the political establishment, including parties like PD) and they need to overcome disagreements on cabinet positions and a common legislative agenda. Even if they overcome these hurdles, there is a risk that the agreement could spark revolt among the parties' respective members. This would be most problematic for M5S – as the membership votes on any prospective coalition deal.

What's more, even if the two parties founded a stable government, confrontations with EU officials still look likely. The sticking point between Italy and Europe for the past few years (and beyond) has been the size of the budget deficit – with the EU demanding that Italy reduce its borrowing and Italian politicians arguing it is necessary to generate growth in their stagnant economy. And of the priorities that M5S and PD agreed upon, the standouts are: EU reform, greater fiscal autonomy, blocking a VAT rise, increasing spending, introducing a minimum wage and adopting a "Green New Deal". With their harsh budgetary rules, the eurocrats are unlikely to look fondly on any of these. And so to suggest that confrontations with Europe are over thanks to Salvini's exit is wishful thinking.

There are, however, other reasons for positivity here. As we wrote last week, Germany – Europe's foremost budget hawk – is itself considering a large fiscal boost, which should momentarily soften the EU Commission's stance on EU budgetary rules. Many other countries (including France) have suggested similar measures, and politicians on the continent have long bemoaned the bloc's rigid spending constraints. When you combine this with an already bleak economic outlook and the possibility of painful Brexit shocks, it seems likely that the eurocrats will finally allow governments a little fiscal wiggle-room.

Whether that will be enough to avoid another Italian showdown, however, is a different story. As we have written many times before, Italy is the perennial simmering crisis that often boils over. Politically, things look much brighter now. But don't be surprised if it spouts up again soon.

CAMBRIDGE
INVESTMENTS LIMITED

2nd September 2019

Global Equity Markets

Market	FRI 14:18	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7233.5	1.5	105.3	↘	→
FTSE 250	19419	1.1	213.2	→	↗
FTSE AS	3965.6	1.3	52.7	↘	→
FTSE Small	5381.6	-0.6	-32.1	↘	→
CAC	5497.4	3.2	170.5	→	⬈
DAX	11985.1	3.2	373.6	↘	↗
Dow	26362	0.4	110.0	↘	↗
S&P 500	2924.6	0.1	1.6	↘	⬈
Nasdaq	7702.3	-0.1	-5.1	↘	⬈
Nikkei	20704.4	0.0	-6.5	⬊	↘
MSCI World	2133.1	1.8	38.4	↘	↗
MSCI EM	970.1	-0.4	-3.6	⬊	→

Top 5 Gainers

Company	%
Fresnillo	10.5
Ocado	8.8
NMC Health	6.9
CRH	6.9
Centrica	6.7

Top 5 Decliners

Company	%
Micro Focus Int'l	-29.6
John Wood	-4.8
Brit-AM Tobacco	-2.7
Aviva	-2.1
Taylor Wimpey	-2.1

Currencies

Pair	last	%1W
USD/GBP	1.219	-0.6
GBP/EUR	0.906	0.4
USD/EUR	1.10	-0.9
JPY/USD	106.19	-0.8
CNY/USD	7.151	-0.8

Commodities

Cmdty	last	%1W
Oil	61.09	2.9
Gold	1526.5	0.0
Silver	18.39	5.5
Copper	255.2	0.9
Aluminium	1753.0	-1.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.46	-0.03
UK 15-Yr	0.68	-0.11
US 10-Yr	1.52	-0.02
French 10-Yr	-0.41	-0.04
German 10-Yr	-0.71	-0.03
Japanese 10-Yr	-0.27	-0.04

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.1	17.7	12.6	13.3
FTSE 250	3.4	25.6	13.8	14.2
FTSE AS	4.8	18.6	12.5	13.4
FTSE Small	3.9	46.4	-	14.0
CAC	3.4	19.2	14.7	13.5
DAX	3.3	19.9	14.0	12.6
Dow	2.3	17.6	17.4	14.9
S&P 500	1.9	19.1	17.7	15.9
Nasdaq	1.0	24.0	21.1	17.9
Nikkei	2.3	14.7	15.0	17.9
MSCI World	2.5	18.2	16.2	15.2
MSCI EM	3.0	13.0	12.6	12.0

UK Mortgage Rates

Mortgage Rates	Estimate	Jul	Jun
Base Rate Tracker	2.56	2.56	2.56
2-yr Fixed Rate	1.65	1.66	1.68
3-yr Fixed Rate	1.77	1.77	1.78
5-yr Fixed Rate	1.95	1.96	1.99
10-yr Fixed Rate	2.57	2.61	0.00
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

For any questions, as always, please ask!

If anybody wants to be added or removed from the distribution list, just send me an email.

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.

2nd September 2019

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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