THE **CAMBRIDGE** WEEKLY

21 October 2019

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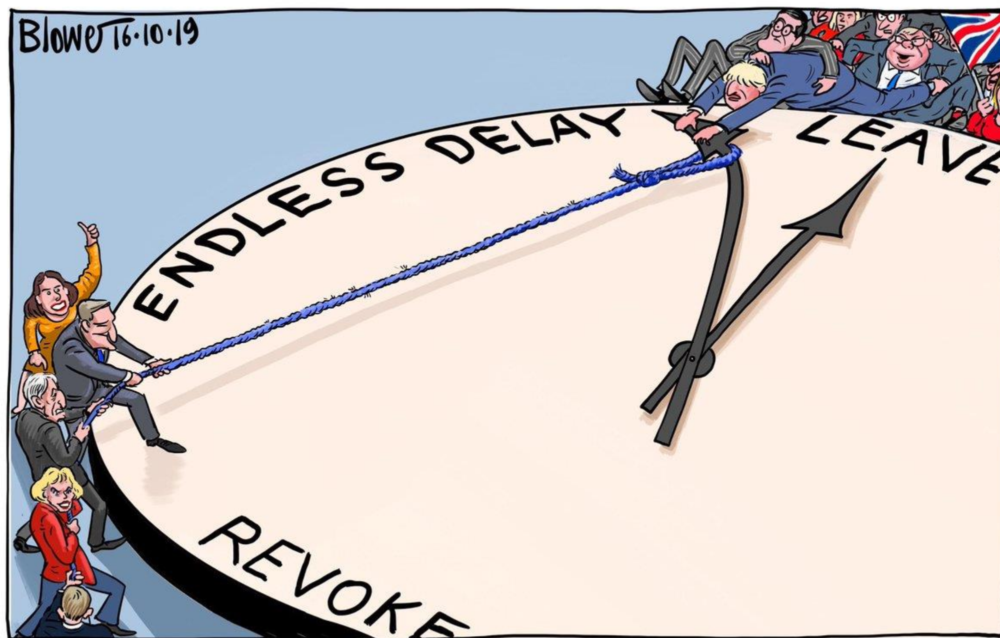


Source: Blower, The Brexit Tug of War continues, 16 October 2019

Brexit breakthrough versus Brexit fatigue

We have witnessed a second week of improving sentiment in global capital markets, with most equity markets trending higher and bond yields continuing their recovery. However, this was nowhere near the euphoria levels that appeared to grip UK and EU politicians after having secured consensus over another iteration of the UK's Withdrawal Agreement from the EU. It would have been reasonable to expect a significant rise in the UK asset prices (which are undervalued relative to their global peers), given so many commentators already celebrated the 'end of Brexit uncertainty'.

As it happened, it was once again the UK's £-Sterling which became the focal point of the shift in sentiment. Just as the currency fell after the Brexit referendum in June 2016, it now rallied – although at a slightly more subdued rate of +4-5%. Given that there continues to be great uncertainty whether the new Withdrawal Agreement bill will find sufficient support in Parliament, the currency appreciation seems to be a reflection of the likelihood of an imminent 'No-Deal' outcome: the implied probability is now near zero. For further currency upside, and a general reappreciation of UK assets, the UK economy would need to be freed from more of the 'uncertainty shackles' that Brexit has created.

At the time of writing on Friday, there is a consensus emerging that the Johnson government will lose the vote in Parliament on Saturday, but that the bill might still pass, subject to either a general election or a confirmatory referendum. This would explain why capital markets did not quite share in the general excitement that the Brexit years may be coming to an end. As we have stated before, 31 October 2019 is highly unlikely to really mark the end of the process, however it may mark the beginning of the end of the Brexit preparation process.

Avoidance of a No-Deal outcome and the return of some level of certainty about the future trading relationship the UK will have with its neighbours will be positive for the economy. However, there is the risk that policymakers' Brexit fatigue might lead to rash decisions without the necessary scrutiny, which could endanger the integrity of the UK as a union further down the line. Listening to and reading politicians' and journalists' interpretation of what is now on offer as a route to Brexit also makes us wonder whether there is a sufficient understanding about the potential costs and benefits of one choice over the other. The darkest days of the UK's Brexit crisis may be behind us, but it will take much more than a week for the darkness to disappear.

While the Brexit developments were clearly a positive for general economic and market sentiment, news-flow elsewhere was more mixed and therefore did not quite justify the further improvement in capital market outlook mentioned at the beginning. China posted its lowest quarterly GDP growth in 30 years (although its 'low' 6% growth rate would fill other countries with joy). Nevertheless, this increases the probability that the Chinese leadership will step up its stimulative policy measures – with at least some positive demand overspill to the rest of the world.

On the US side, the announcements of corporate earnings results for the third quarter have started. But they are overshadowed by nervousness that profits may have declined for a third consecutive quarter. The initial batch of results was somewhat encouraging, but further developments will have to be closely monitored.

More concerning was yet more erratic behaviour from president Trump, which has made an increasing number of observers doubt his state of mental health. We would not want to go quite as this far, but it does seem that more and more of those who used to restrain his immediate impulses have been pushed to the side. Either way, the recent behaviour increases the likelihood of further significant missteps like the Ukraine affair and of handing control of northern Syria to Russia. This in turn looks increasingly as if it will limit Trump's chances to even be the Republican's 2020 presidential nominee – let alone keep his office as President. Given he appears to have become more of a liability than an asset for the US economy, this may be seen as another positive political development of the past week.

Quarter 3 corporate results – why they matter even more this time

It's that time again. As we head into the last few months of the year, companies will soon announce their results for the third quarter of 2019 – in what could be a crucially important earnings (profits) season. We recently wrote that capital markets have used up all the goodwill they had, and that we would need to see tangible improvement in the underlying picture – either in the macroeconomic backdrop or in firms' fundamentals – to see a sustainable market rally. Stock markets in the US are once again near their all-time highs, despite two consecutive quarters of corporate earnings declines. If the results this time around are similarly disappointing, it is hard to see how markets could climb further up. But if they show a rebound, it could underwrite some renewed sentiment.

The expectations are, unfortunately, not too good. Estimates point to a possible year-on-year 4.6% fall in average earnings per share (EPS) for S&P 500 companies, with the energy and technology sectors predicted to be worst hit. A slowing global economy and worsening global trade conditions have hit businesses hard all over the world this year, most notably in the manufacturing sector. Those struggles

now look to have started seeping into the services side of the economy: surveys show a recent decline in service sector business sentiment. All of this has led to a significant downgrading of earnings results expectations for Q3.

As some commentators have pointed out, however, this could well have made company analysts a little too pessimistic. The fact that earnings downgrades have been so drastic provides ample opportunity for positive surprises, which are supportive of both business and market sentiment.

Indeed, the early results are a little more positive. Of the 11 S&P 500 companies that reported this week, just two of them have missed estimates, with all others beating them. The biggest positive surprises came from big names such as Johnson & Johnson, UnitedHealth and JP Morgan, who all exceeded expectations. Overall, according to the Earnings Scouting Report, 26 of the 34 S&P companies to have reported Q3 earnings posted positive EPS growth.

JP Morgan's beat is perhaps the most interesting of these. Banks and other financials were expected to fare poorly over Q3, due to a lowering of interest rates across the world. The yield curve inversion we saw earlier in the year (where long-term government bond rates fell below short-term and cash deposit rates) was expected to hamper profits. This is because banks traditionally make a fair share of their profits from the yield spread across bond maturities, by taking in deposits at the short end and lending out at the long end. So, the fact that JP Morgan nevertheless managed to post a positive result – as well as other financials like BlackRock, Citi and First Republic Bank – is significant.

Still, it has not been all fair weather for financials. Notably, the only two companies to miss earnings estimates were Goldman Sachs and Wells Fargo. Wells Fargo's miss particularly stood out – though they face their own specific difficulties.

With estimates as low as they are, positive surprises are to be expected. In fact, some commentators have worried that – with the bar so low and markets so high – company shares could be seriously punished if they do not post a positive surprise. According to Max Gokhman of Pacific Life Fund, the low bar for earnings means that "the penalty to not exceed it is significant".

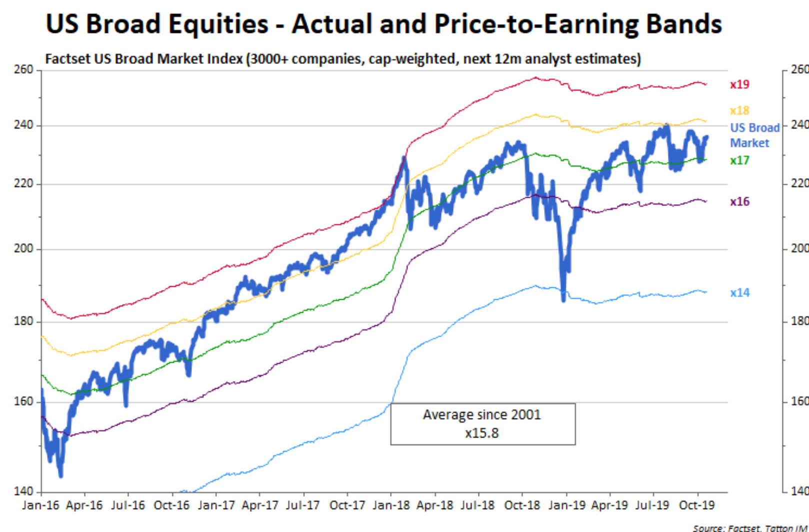
As some analysts have pointed out, the cycle of lowering EPS estimates throughout the quarter only to exceed them – and subsequently boost share prices – has become common for companies (in the US at least) over the past decade. Because of this, it is debatable how much attention one should pay to the beat/miss metrics – except for maybe predicting short-term stock market movements.

Probably more important will be the outlook statements from companies. As mentioned before, business sentiment across the world has been on a downward trend (particularly in Europe and Japan). With economic activity slowing as well, a turnaround in sentiment will be vitally important for any potential rebound. According to the researchers we subscribe to at *Macro Research Board* (MRB), while the outlook for Q3 earnings was too pessimistic, the outlook for next year's earnings is too optimistic. Current consensus forecasts are that S&P 500 companies will post 10% EPS growth next year. As MRB note in their report, "It is difficult to envision companies endorsing this forecast."

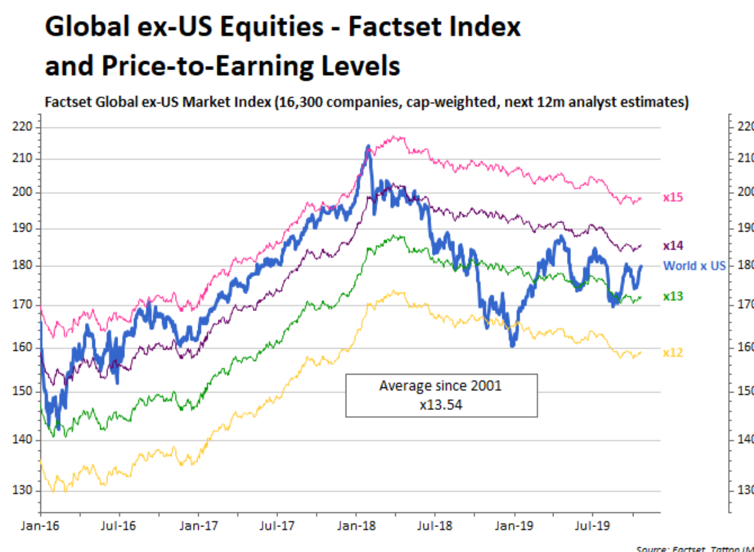
To a certain extent, we agree. As we have written before, whether or not we see a rebound in business activity and market sentiment depends largely on the outlook for global trade conditions. Markets have been riding high recently on the hopes that an end to the damaging US-China trade war could be around

the corner. But despite the apparent political progress, significant trade barriers remain – and there is significant political pressure in Washington to keep it that way.

But in terms of valuations, markets are not as exuberantly optimistic as they seem. Despite equities rising substantially since the beginning of the year, EPS multiples for US stocks are only at the levels seen at the beginning of last year – as shown in the chart below. The rise in valuations throughout the year is arguably still just a recovery from the sell-off at the end of 2018.



And when looking at a global picture, valuations look even less stretched. As can be seen in the chart below, global equities are still relatively 'cheap' compared to the last few years.



The lack of optimism expressed by these relatively lower valuation levels is why the outlook reports released this earnings season will be so vitally important. If earnings fare well in absolute terms – rather than just beating low expectations – then this should have a stabilising effect on stock markets. If outlook statements are at least somewhat supportive of the earlier 2020 earnings growth expectations, then this

would generate valuation headroom for markets. Alas, given the increased levels of political uncertainty around the world, it is hard to see company managements actually being tempted into overly optimistic outlooks.

We will be monitoring the earnings season progress with great interest and report back here.

Can China lead the way?

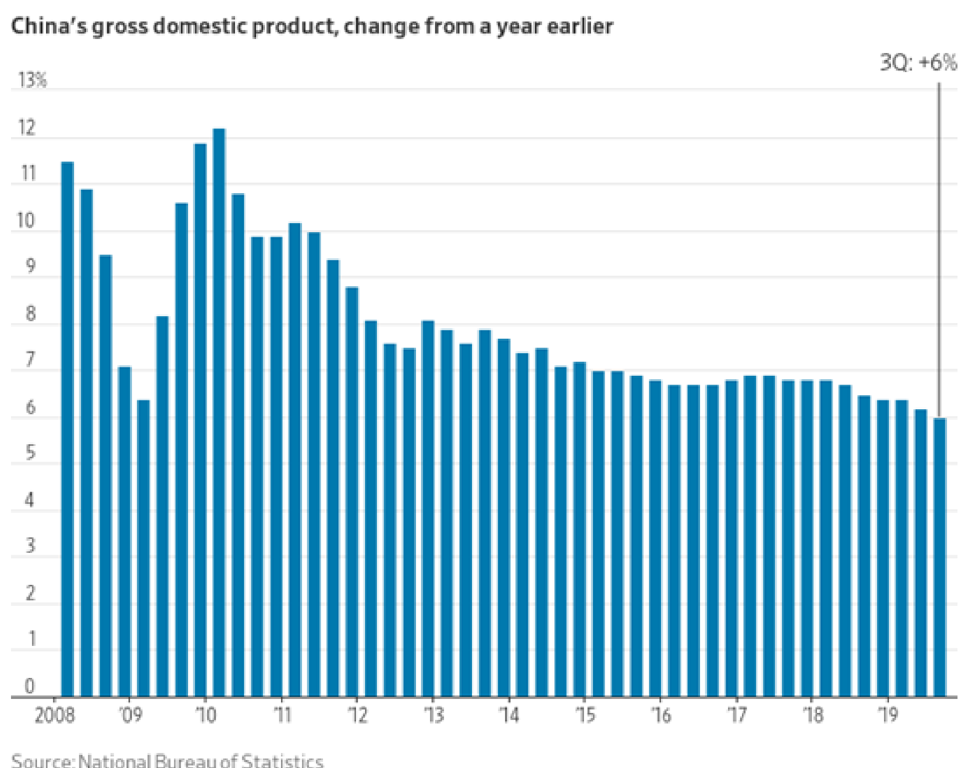
The People's Republic of China is now 70 years old. And its celebrations at the beginning of this month were certainly befitting of any 70th birthday. In Tiananmen Square, a sea of people gathered to watch President Xi Jinping declare the country's achievements from atop the Forbidden City – after a military parade through the streets of Beijing had shown the world China's advanced military might. The Communist Party's message is clear: China is stronger than ever.

The pomp belies their insecurity, however. For all the declarations, this has been a tough year for party officials. Their initial attempts to crackdown on the out-of-control shadow banking sector and unwind the country's growing credit bubble cut off vital liquidity for the economy. In the recent months, the ensuing slowdown has threatened to turn even worse. Meanwhile, the trade war with the US is hurting company profits. Worst of all for Beijing, the increasingly violent protests in Hong Kong have highlighted to the world the uglier side of Chinese rule.

Recent developments have brought them some respite. Friday's announcement of a temporary trade truce with the US will no doubt bring back some confidence (though it has not done so yet for China's stock market, which has traded slightly down throughout the week). And last week, we noted how the country's PMIs – measuring business sentiment – seem to have rebounded from the recent downtrend. The liquidity squeeze also seems to have subsided, with growth in infrastructure investment and even shadow financing.

But the problems are far from over. The US-China trade war is a delicate political situation, and we have seen many false dawns throughout President Trump's time in office. Beijing certainly seems committed to getting a deal – as shown in its commitment to suspend tariffs and to stop its currency from sliding against the value of the US$. But it faces a difficult negotiating partner. Even putting Trump's erratic behaviour to one side, it is unclear whether there is enough political will in Washington to get a compromise. Trump's administration might think that a deal would be a valuable political win going into an election, but it could just as easily prefer to be seen as tough on China – particularly with the Hong Kong drama getting airtime in American media. Even if Trump was removed from the White House – by impeachment or by election – there is no clear pro-China camp in either of America's major parties.

As for the domestic economy, we still cannot see signs of definitive improvement. Annualised GDP growth in the third quarter came in at 6%, at the lower end of the government's 6-6.5% target range and the lowest in three decades. And while factory output is expected to have picked up last month, automotive sales in China were down 6.6% in September, with car dealers calling it the "worst slump in a generation". In an even more worrying trend, recent data shows that corporate defaults have been more widespread than previously thought.



The government's concern about these trends is clearly shown in its willingness to open up the liquidity taps once more. The People's Bank of China unexpectedly injected RMB200bn ($28bn) into the banking system on Wednesday night – even after several attempts at monetary easing throughout the year. But worryingly for the bank, it is not clear that these cash injections are working. This week one anonymous official at a local government development fund told the media that they were running out of projects to invest in. "There are not many economically viable projects for us to take on," said the official.

There are signs that the troubles in the Chinese financial system are affecting wider markets around the world too. A few weeks ago, when US interbank repo rates spiked massively, traders and commentators were scratching their heads as to which financial institution was cash-strapped enough to send rates that high. At the time, we suggested that the scramble for dollars may have come from China, rather than the US. What is interesting to note since then is that, as the Federal Reserve has stepped in to inject liquidity into markets, we have seen a notable fall in the US$. This suggests that what was keeping it up before was an overseas need for dollars – most likely in emerging markets. If this is true, the most likely candidate would be China. This is, of course, tangential and hardly solid evidence. But if something like this story is correct, it suggests there is even more stress in the Chinese financial system than thought.

So far, it is not looking like a good birthday party for the world's second largest economy. But as ever, there is an upside. While China's debt pile is substantial, the nature of that debt (mostly held by state-owned enterprises that the government can fairly easily attend to) means that the government has plenty of leeway to ease conditions, and the signs are that it intends to use it.

Unfortunately, as we wrote last week, it is unlikely that the government would be inclined to stimulate the economy so much that the world could piggyback off the demand this generates – as it famously did

in 2009 and 2016. After all, those episodes got China into this mess in the first place. Stimulus will be much more domestically focused, so the upside for the global economy is limited.

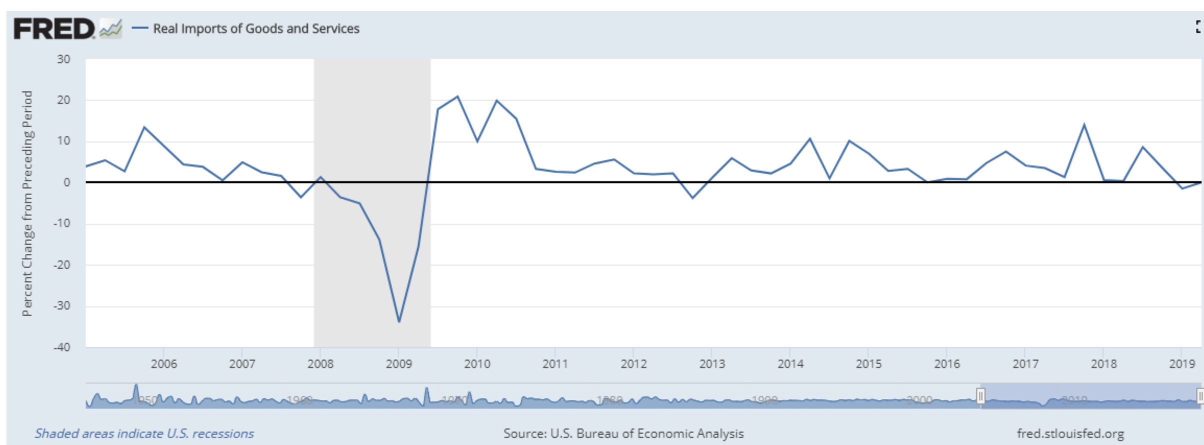
That being said, China is the second largest economy in the world and now inextricably linked to just about every economy on earth. As such, even its tamer, domestically focused stimulus is sure to have an impact around the globe. The more birthday presents Beijing hands to its own consumers and firms, the more likely we will get some too.

Declining US imports despite strong consumer confidence?

There has been a significant focus on the economic impact of the US-China trade war. It now looks clear that the trade conflict has worsened the slowdown in global growth, particularly from an export standpoint. But the discrepancy between US consumer confidence and US import data also bears closer examination.

In simple terms, consumer confidence is a barometer of an individual's propensity to either spend or save. If confidence is high, this should encourage individuals to spend, which in turn could have a positive impact on imports, as individuals buy more goods and services. However, Chart 1 shows this has not been the case and US imports have remained subdued. For the pessimists in the market (the bears) this could be another sign of underlying weakness in the economy, i.e. that consumer spending - a major component of GDP - is weakening and that the tide is turning.

<u>Chart 1:</u>

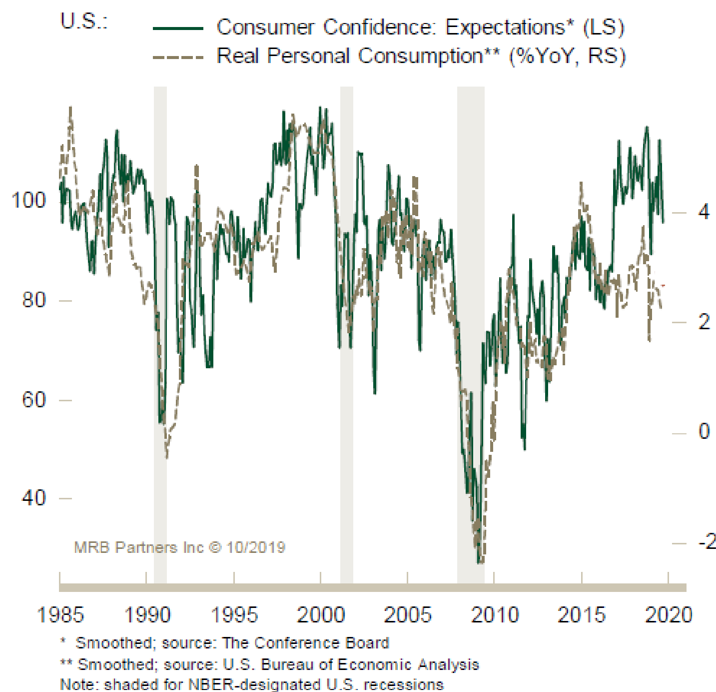


% change from quarterly 1 year ago – up to Q2 2019

But before we reach for another warning sign about an impending recession, a further analysis of what is currently driving this subdued rate is warranted. To do so we cannot get away from the impact of tariffs, which act as a tax on imported goods. The cost of that tax can be borne by either the consumer or the producer. Theory would suggest that the producers are more likely to bear this cost, especially if their products compete in a highly competitive market or if the consumer can exert buying power. With regards to the US-China trade war, this would be likely to happen if the US could find products from another country at the same or a cheaper price. Chinese producers would therefore be forced to reduce their selling prices or lose the business.

Initially, it was believed that in this trade war the producers (i.e. China) would have to absorb additional costs of the US tariffs into their margins if they did not want to lose out on market share in the world's largest economy. Thus, the consumer would still be buying the same product for the same price regardless of the tariffs, and imports would rise as consumers tend to spend more when confidence levels are high.

Chart 2:



However, as discussed above, this has turned out not to be the case. One of the clearest explanations for this divergence has come from the Amiti, Heise and Kwicklis work on "The Impact of Import Tariffs on US Domestic Prices" at the New York Federal Reserve – the New York branch of the US central bank.

Their work focused on the import tariffs applied by the US on circa $283 billion of US imports in 2018, ranging from 10% and 50% which impacted 12% of total imports. Supported by further research from Amiti, Itskhoki and Konings (2018) the study found that firstly domestic producers change their prices in response to changes in foreign prices, even if their own costs are unaffected – i.e. they raise their prices if prices of competing imported goods go up. Secondly, the producers focused on price filters (the impact of input-output linkages, for example) and higher input prices (such as the cost of steel on an item) would increase the overall costs of the product. Their study showed that small firms largely pass through the whole cost shock from rising input prices onto domestic prices. Larger firms, even though they are likely to have a lower cost "pass-through", also adjust their prices up. Consequently, for consumers, prices have gone up: subsequent research showed that the 2018 tariffs imposed an additional annual cost of $419 for a typical US household.

This increased cost on domestic prices in the US will go some way to explaining the subdued import data. And this import data, a lagging indicator, is unlikely to improve anytime soon if we use the currency as a further barometer. If a country imports more goods and services, it would generally have a negative

effect on the value of its domestic currency. But since Q2, the dollar has continued to grind higher. Consequently, both of the above tell us that the falling import volumes should not be seen as negative indicators for the state of the US economy, although consumers' frustration over higher prices may, over time, impact Trump's political standing with his electorate.

That said, with trade talks between the US and China ongoing, the economic scenario could change. As the Presidential election edges closer, Donald Trump needs the US economy to remain strong – and consumer spending is a key engine of American growth. In Q2 2019, personal consumption grew at a healthy, annualised rate of 4.6% with household debt remaining relatively low. However, recent data suggests that personal consumption growth may be challenged, going forward, if wage growth (which slowed from 3.2% to 2.9% in September) or employment trends change.

Another concern is this: even if tariffs are relaxed or removed, will prices be adjusted down to reflect this move? As we head into the seasonal sales period, and given the impact on prices from tariffs, this latest round of trade negotiations remains key and important for Trump. The New York Federal Reserve study suggested that adjustment in prices from tariff changes is quick (within three months) so any positive outcome to the talks could start to see a change in the current discrepancy. Importantly, if input costs fall and are passed through to prices, this could provide another positive impetus to the US consumer.

CAMBRIDGE INVESTMENTS LIMITED

21st October 2019

Global Equity Markets

Market	FRI 14:55	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7184.3	-0.9	-62.8	→	→
FTSE 250	20266	1.1	224.6	↗	↗
FTSE AS	3973.3	-0.5	-18.9	→	⬀
FTSE Small	5455.8	1.1	60.8	→	→
CAC	5643.5	-0.4	-22.0	⬀	↗
DAX	12660.7	1.2	149.0	↗	↗
Dow	26995	0.7	178.3	⬀	↗
S&P 500	2998.2	0.9	27.9	⬀	↗
Nasdaq	7941.8	1.2	97.9	⬀	↗
Nikkei	22492.7	4.4	940.7	↗	↗
MSCI World	2201.9	1.0	22.6	⬀	↗
MSCI EM	1028.4	1.7	16.8	↗	→

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.1	17.4	13.1	13.2
FTSE 250	3.8	23.6	14.4	14.2
FTSE AS	4.8	18.4	13.2	13.4
FTSE Small	3.8	138.6	-	14.0
CAC	3.3	19.4	15.1	13.4
DAX	3.1	22.0	14.8	12.5
Dow	2.3	18.2	18.0	14.9
S&P 500	1.9	19.8	18.2	15.9
Nasdaq	1.0	24.9	21.9	17.9
Nikkei	1.9	16.1	16.7	17.6
MSCI World	2.5	18.3	18.8	16.9
MSCI EM	2.9	13.7	13.4	12.0

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
M&S	7.7	Evraz	-11.1
British Land	7.3	Burberry	-6.6
RBS	7.2	BHP	-6.2
Land Securities	7.2	Hargreaves Lansdown	-6.0
Legal & General	6.0	Intertek	-5.5

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.288	1.7	Oil	59.89	-1.0
GBP/EUR	0.865	0.9	Gold	1491.1	0.1
USD/EUR	1.11	0.9	Silver	17.51	-0.2
JPY/USD	108.49	-0.2	Copper	263.1	0.1
CNY/USD	7.080	0.1	Aluminium	1727.0	-1.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.7	0.0
UK 15-Yr	0.9	0.0
US 10-Yr	1.8	0.0
French 10-Yr	-0.1	0.0
German 10-Yr	-0.4	0.1
Japanese 10-Yr	-0.1	0.0

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	2.62	2.59
2-yr Fixed Rate	1.56	1.59
3-yr Fixed Rate	1.66	1.71
5-yr Fixed Rate	1.80	1.85
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.29	4.29

* 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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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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