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Source: KAL, People's Republic of China celebrates its 70th birthday, while Hong Kong's people rebel against it, 4 Oct 2019

Stall speed economy fears spreading

Once again, politics took our breath away during this first week of October. Donald Trump appeared to live-stream ever more evidence for his own impeachment, while the UK's Boris Johnson ricocheted in his Brexit language between "last and final offer", "a genuine attempt to bridge the chasm" and "broad landing zone in which I believe a deal can begin to take shape".

However, this was only at the periphery of what drove stock markets around the world into another sudden sharp correction after what had been an undeniably pleasing September for risk assets (see the monthly risk asset returns table further down). What triggered the sell-off was an array of disappointing business sentiment readings. These led to a sudden realisation that neither the US economy nor the global services sector are any longer immune to the ongoing economic slowdown in manufacturing. A slowdown that started with China's clamp down on its shadow banking sector, spread via slowing global car demand (on environmental concerns) and has recently been further exacerbated by falling business demand caused by uncertainty from Trump's trade wars and Europe's Brexit malaise.

Up until now, most western economies had not slowed below the merely weak GDP growth figures that we had become used to since the 2008/2009 Global Financial Crisis. This was partly because the manufacturing sector is these days of a far lesser importance in developed economies than it used to be. But it was also because the ongoing reluctance of businesses to invest towards productivity enhancements – due to various uncertainties – has kept the labour markets tight, which has underpinned wages, consumer confidence and thus the services sector where we spend most of our household's money these days.

Asset Class	Index	September	YTD
Equities	FTSE 100 (UK)	3.0	14.3
	FTSE4Good 50 (UK Ethical Index)	2.7	12.1
	MSCI Europe ex-UK	1.0	18.9
	S&P 500 (USA)	0.7	24.6
	Nikkei 225 (Japan)	2.8	14.8
	MSCI All Countries World	0.9	20.1
	MSCI Emerging Markets	0.7	9.4
Bonds	FTSE Gilts All Stocks	0.5	11.2
	£-Sterling Corporate Bond Index	0.0	11.2
	Barclays Global Aggregate Bond Index	-2.2	9.9
Commodities	Goldman Sachs Commodity Index	0.6	12.2
	Brent Crude Oil Price	-1.2	13.8
	LBMA Spot Gold Price	-3.7	20.0
Inflation	UK Consumer Price Index (annual rate)*	0.4	1.2
Cash rates	Libor 3 month GBP	0.1	0.7
Property	UK Commercial Property (IA Sector)*	-0.5	0.0

Data sourced from Morningstar Direct as at 30/09/19. * to end of previous month (31/08/19).

The US had escaped the global slowdown altogether so far. Whether that was because of the Trump administration's massive fiscal stimulus through the 2018 tax cuts or because of their globally leading technology sector acting as a phenomenal attractor of global demand is widely debated. Last week's reports of accelerating declines in US manufacturing and service sector outlook gauges brought this to an abrupt end and with it the last hopes that at least the last quarter of 2019 would see an acceleration of economic activity around the world and not yet another slowdown.

Solid and better than expected US job growth numbers on Friday rekindled the hopes for the economic stabilisation narrative and stock markets recovered some of their earlier falls.

What this episode demonstrates once again is that both the global economy and capital markets are finely balanced between fear and hope. Fear that the already slowing growth around the globe is grinding to a halt, leading to a recession. And hope that politicians will be forced to sort out the trade friction mess they have created sooner rather than later, which should unleash meaningful amounts of pent up business and consumer demand for manufactured goods which – leading to an economic rebound.

Various studies by central banks and economics institutes suggest that the ongoing uncertainty has already been around for too long to reasonably expect a swift bounce back of demand. In order for late 2019 to mark the turning point for global growth, we are in desperate need of some indication that global demand growth will return, or that political progress will be enough to improve business sentiment. Otherwise, the 'blip' could well become a lasting downturn.

Unfortunately, the political news flow of the week has not been overly optimistic. Time is running out to support expectations of a fast turnaround, while the economic evidence is pointing more and more towards a gradual but steady slowdown towards a dangerous stall speed.

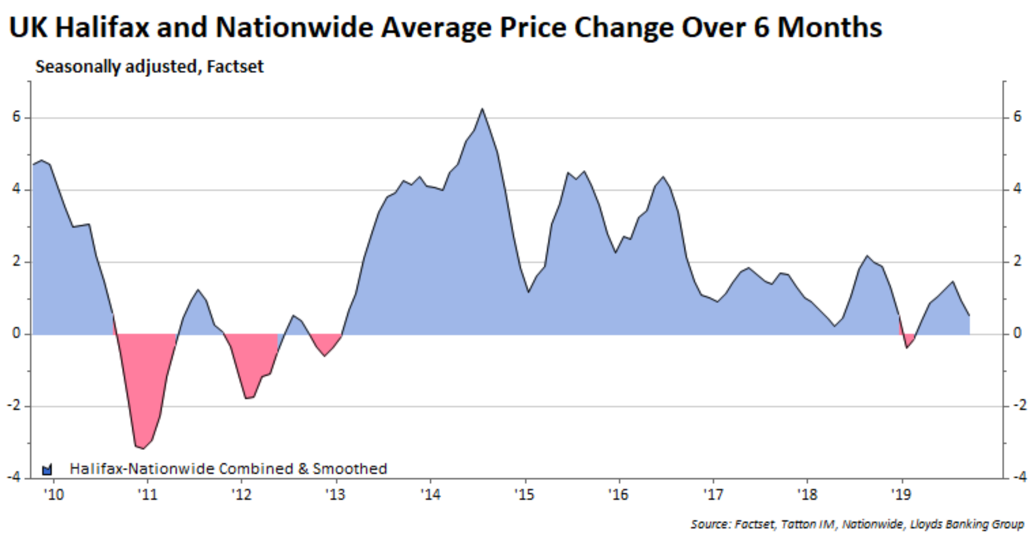
UK economy finally buckling – a little

For UK investors – and indeed the public generally – Brexit tops the list of concerns. That is to be expected of course, given the importance of our future relationship with our nearest and dearest trading partners. Unfortunately, it often seems like the only difference between what we know now and what we knew in June 2016 is that we are further along the knife-edge. We profess no special knowledge about the political whirring of Westminster or Brussels. To assess the likely impacts Brexit could have – and has already had – on the British economy, we first need to understand the state it is in.

Let's take a step back. At the beginning of the year, we wrote that the UK economy was far from hopeless. Certainly, looming Brexit uncertainty had soured business confidence and investment – which could be clearly seen in the data on growth, wages and inflation at the time. But we argued that the apocalyptic scenario implied by Q4 2018 equity valuations was off the mark, and that there were enough bright spots to keep Britain ticking along, albeit slowly.

Two positives particularly stood out: the health of manufactured exports and the tightness of the labour market. The low value of £-Sterling has been a positive for manufacturers ever since the referendum result, making their prices more competitive internationally. Historically low unemployment, meanwhile, suggested that consumer confidence and thereby consumer demand should remain high – even if Brexit effects made wage rises unlikely. These factors were even enough to keep the Bank of England insisting that they would likely raise interest rates – though we and many others thought this was always unlikely.

Sure enough, for the first half of the year this positive(ish) scenario seemed to pan out. Even the housing market – which has been lacklustre at best for the last few years – managed to overcome Brexit fears and underlying structural issues to see growth. Prices rose around 2% in the first six months of the year, with the regions outside of London and the Southeast above 5%. This was undoubtedly supported by low mortgage rates and the confidence of the British consumer, who stayed relatively upbeat despite



businesses doing the opposite.

However, all good things come to an end. As we went into the summer, it became clear that consumer confidence was dropping off. This was despite employment figures remaining high and was likely more driven by ever more aggressive politics worsening Brexit fears and a dreary business outlook. House prices subsequently failed to stay on their uptrend, and consumer demand fell considerably. Businesses, which were already pessimistic over Brexit, downgraded their outlooks even further on the back of this weak demand.

That brings us to the present. The September PMI indicator (measuring business sentiment) for the services sector came in at just 49.5 – indicating contraction and below the expected 50.3 (50 marks the watershed between growth and contraction). What makes that reading worse is that it shows a downward trend from the previous month's 50.6. Manufacturing, meanwhile, is not picking up any of the slack. The reading here was 48.3, which, despite being above expectations, makes for a fifth consecutive month of contraction. Businesses are clearly struggling – and they are doing so despite a big discount in the value of £-Sterling.

The situation has forced the Bank of England to give up on their professed hawkishness (favouring higher rates) and admit that their next rate move is likely to be down, rather than up. Even Michael Saunders – recognised as the most hawkish member of the Monetary Policy Committee – admitted as much. Our central bank is reluctantly acknowledging that serious measures are needed to steer away from a recession we may already be in.

Of course, recognising the economic challenges we face is not the same as ringing the doomsday bell. Recent data has undoubtedly been disappointing, but the economic fundamentals still have not changed too much. Despite the struggles of manufacturers, the low value of £-Sterling is still a boon for exporters, even if they are worried about Brexit. The likely reason we have not seen much demand for British goods is the weakness of the global and European economies. If this was to change – and some extension or suitably soft Brexit deal was secured – Britain's exporters, manufacturers and service providers would be well placed to take advantage, leading to an economic rebound.

However, one of the key things to note is that, even if Brexit was resolved in the best possible way (in terms of trade policy), we should not expect it to be plain sailing economically. Unfortunately, the work done by the Bank of England suggests that the nature of the damage affects our ability to rebuild economic confidence. In such a scenario, both business and consumer demand would likely take some time to rebound, regardless of the outcome. The entire Brexit process has probably affected the economy and the UK consumer more deeply than any quick fix can solve.

PMIs: Rotation or weakness?

2019 has not been kind to global manufacturers. The global slowdown in economic activity has constrained demand and left them with extremely little room for profit – as shown in the recent low readings for Producer Price Inflation (PPI), which can be seen as a measure of company pricing power. This has contrasted with the fate of the services industry, which – while not zooming ahead – has registered decent enough data to not be a major source of concern for the global economy. But last week, it looked as though that trend might be changing.

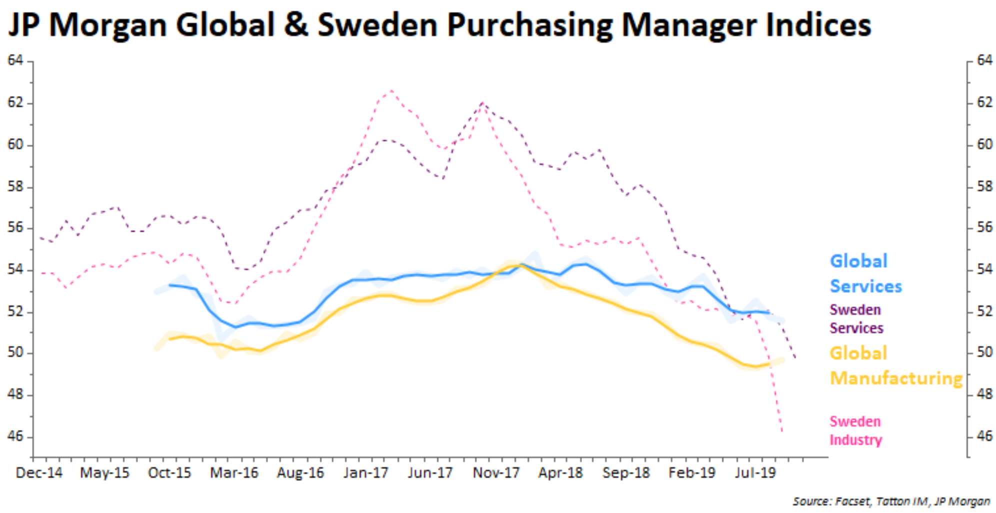
Purchasing Managers' Indices (PMIs) are among the most important indicators for gauging the health of an economy. They measure business sentiment through self-reported surveys, and compile an overall score out of 100, where any reading above 50 is supposed to indicate expansion and any reading below indicating contraction (in reality the 'neutral' level is slightly above 50). PMIs are leading indicators in their own right – suggesting growth or contraction up ahead – but often the more significant factor is the direction or rate of change in them.

As we wrote last week, initial readings were disappointing for the services sector, with PMIs coming in below expectations (and below the previous month) in the US and the Eurozone. Manufacturing, meanwhile, seemed to show a slight bounce – with several better than expected readings. The explanation proffered by some commentators was that this was a classic case of inventory adjustment: the weakness in manufacturing is spilling over to the services sector, while at the same time, latent demand in the economy is boosting manufacturers by soaking up their depleted inventories (which have moved lower in response to slowing global growth). We are seeing rotation – so the argument goes – but not outright weakness.

Unfortunately, this week's data does not quite fit with that story. The September manufacturing PMI for the Eurozone came in at 45.7, firmly in contraction territory. And while this figure was (barely) above expectations of 45.7, it makes for an eighth consecutive month of contraction and the lowest reading in seven years.

Looking under the bonnet makes things no easier for the Eurozone either. France, Italy and Spain all disappointed economist expectations. And while French manufacturers can point to a second consecutive month in the 50+ territory, their 50.1 reading is hardly anything to get excited about. Germany was the worst of the bunch by some distance, with a PMI of just 41.7. The lights are flickering in Europe's powerhouse; September's figure is the country's lowest since June 2009. Perhaps worse was that Germany's overall composite PMI showed contraction for the first time in six years – prompting recession fears in the Eurozone's largest economy.

One PMI in particular stood out, and not for good reasons: Sweden's. The reason Sweden is important is its seen as a leading indicator for the rest of Europe. The Scandinavian country has been called 'the canary in the coalmine' for the Eurozone economy, with European producers following its lead some months down the line. According to Andreas Steno Larsen of Nordea Bank, "It is Europe's most open economy and it acts as a bellwether for the world."



Sweden's manufacturing sector dropped substantially to 46.3 in September – the largest monthly drop since 2008. What makes that worse is that economists were expecting a healthy expansion of 52.

If the Swedish data does turn out to be the harbinger of doom for Eurozone manufacturers, that would change the picture substantially. Instead of a rotation from services strength back to manufacturing strength, we would be in a situation of all-round weakness. Granted, the struggles of the Eurozone may not translate to wider problems for global manufacturers. But with the global economy already stuck in a slowdown, it is hard to see where more fuel for the fire would come from.

As we have written many times before, China is facing severe economic problems of its own. The same is true for many emerging markets, while Japan seems to be teetering on the edge of another recession. The US has led the pack among developed economies for a while now, but with their own economy coming off the boil, powering global growth forward would be a tough ask.

All of this is without mentioning trade policy. Brexit and (more importantly for the global economy) Donald Trump's trade wars have undoubtedly weighed on producers and businesses. With the services sector looking less positive and manufacturing failing to recover (yet), negative trade developments could be enough to send the fragile economy into reverse.

By the same token, however, positive trade developments could well be enough to do the opposite. As we wrote last week, trade policy will be vital in plotting the course for the world economy over the next few months. If we get a positive surprise, we should expect business sentiment to turn around quickly – particularly manufacturing. Until then, we will not know whether this really is a rotation after all, or something more worrying.

Has monetary policy finally run out of 'ammunition'?

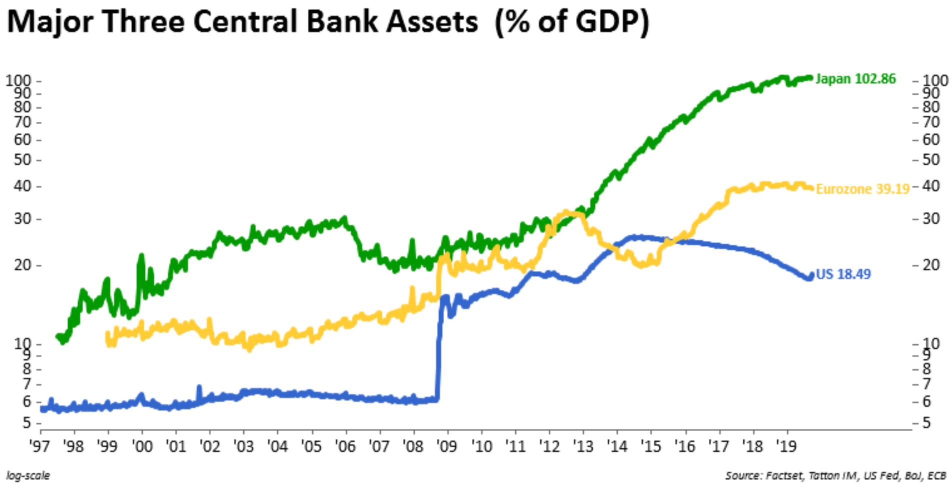
Economists who take the view that there are structural problems with the world's developed economies often refer to the issues as "Japanisation".

That's because Japan has faced many of the same issues earlier than the rest of the world. The experimental policies pursued by their government and central bank have provided valuable evidence for the current global situation. Indeed, one of the reasons Ben Bernanke was made the US Federal Reserve's Chairman at the time around the financial crisis was that he was a noted expert on the effectiveness of Japan's monetary policy.

Well before the start of the 2008-9 crisis, the Japanese were the first to enact major policy shifts. In response to the 1990s "lost decade", the government was the first to massively increase government debt, and the Bank of Japan (BoJ) was the first central bank to enact "quantitative easing" (QE), increasing the money in circulation by buying relatively large amounts of the same government bonds. The BoJ was also the first major central bank to extend QE purchasing to riskier assets like equities (in the form of Exchange-Traded Funds – though the Swiss can claim to be the first).

As global growth declined through this year, it was expected that central banks would return to government bond buying. And sure enough, last month Mario Draghi committed the ECB to resume the policy.

However, for commercial banks, the depression of long maturity interest rates damages a main source of profitability, and banks are the major source of lending in both the Eurozone and Japan. So, Draghi's last



act was not totally achieved by consensus.

Interestingly, over the last couple of weeks, the BoJ has begun signalling that it will not follow the same path. Given the way in which they have led, this is potentially big news. Various board members, and especially Governor Kuroda, have indicated that the maturities beyond 10 years will no longer be bought. Bond prices have fallen, with that move accelerating this week when the government pension fund said it too would be reducing long maturity holdings (ostensibly in favour of currency-hedged overseas bonds – but we cannot be entirely sure).

Often, Japanese statements are not completely clear, so one should look at what they do as much as what they say. Recent BoJ purchases show a steady increase in equity ETF purchases. However, there is a greater overall tapering of government bond purchases, and this is focused on shorter maturities.

This looks like a major shift. If the negative consequences of QE have become too much for Japan, it will aid those opposed to a resumption both in the ECB and more importantly in the US Fed. It will also place a greater onus on governments to provide stimulus, though it usually takes longer for politicians to act – and certainly to spend.

And for markets, participants are sensing that, while yields would still probably fall in response to further economic weakness, they cannot count on the move being as supportive for equity valuations as before.

Everybody is now watching to see who in the Fed and the ECB shows signs of following the Japanese again.

CAMBRIDGE
INVESTMENTS LIMITED

7th October 2019

Global Equity Markets

Market	FRI 15:31	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7153.4	-3.7	-272.8	→	⬀
FTSE 250	19453	-2.6	-518.2	⬀	➚
FTSE AS	3931.3	-3.4	-140.0	→	⬀
FTSE Small	5386.1	-1.8	-100.5	→	⬀
CAC	5484.0	-2.8	-156.6	⬀	➚
DAX	11990.8	-2.4	-297.8	⬀	➚
Dow	26352	-1.7	-468.1	→	➚
S&P 500	2930.8	-1.0	-31.0	→	➚
Nasdaq	7687.0	0.1	5.4	→	➚
Nikkei	21410.2	-2.1	-468.7	➚	⬀
MSCI World	2131.4	-2.0	-44.2	→	➚
MSCI EM	992.3	-0.9	-9.2	⬀	⬀

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Flutter Ents	7.6	Hargreaves Lansdown	-13.0
Imperial Brands	2.9	Evraz	-10.2
GVC	1.8	NMC Health	-9.7
SSE	1.2	Kingfisher	-8.7
London Stock Exch	0.3	John Wood	-8.6

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.229	-0.0	Oil	58.73	-5.1
GBP/EUR	0.893	-0.4	Gold	1506.7	0.6
USD/EUR	1.10	0.4	Silver	17.51	-0.2
JPY/USD	106.91	0.9	Copper	254.5	-2.0
CNY/USD	7.148	-0.4	Aluminium	1718.0	-1.1

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.4	-0.1
UK 15-Yr	0.7	-0.0
US 10-Yr	1.5	-0.2
French 10-Yr	-0.3	-0.0
German 10-Yr	-0.6	-0.0
Japanese 10-Yr	-0.2	0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.1	17.4	12.7	13.2
FTSE 250	3.9	22.6	13.6	14.2
FTSE AS	4.9	18.2	12.7	13.4
FTSE Small	3.8	150.7	-	14.0
CAC	3.4	18.8	14.6	13.4
DAX	3.3	19.5	13.9	12.5
Dow	2.3	17.6	17.3	14.9
S&P 500	2.0	19.3	17.7	15.9
Nasdaq	1.1	24.2	21.1	17.9
Nikkei	2.0	15.3	15.7	17.6
MSCI World	2.5	18.2	16.3	15.2
MSCI EM	3.0	13.2	12.9	12.0

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	2.56	2.53
2-yr Fixed Rate	1.64	1.65
3-yr Fixed Rate	1.75	1.76
5-yr Fixed Rate	1.92	1.94
10-yr Fixed Rate	2.61	2.61
Standard Variable	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!
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7th October 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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