THE **CAMBRIDGE** WEEKLY

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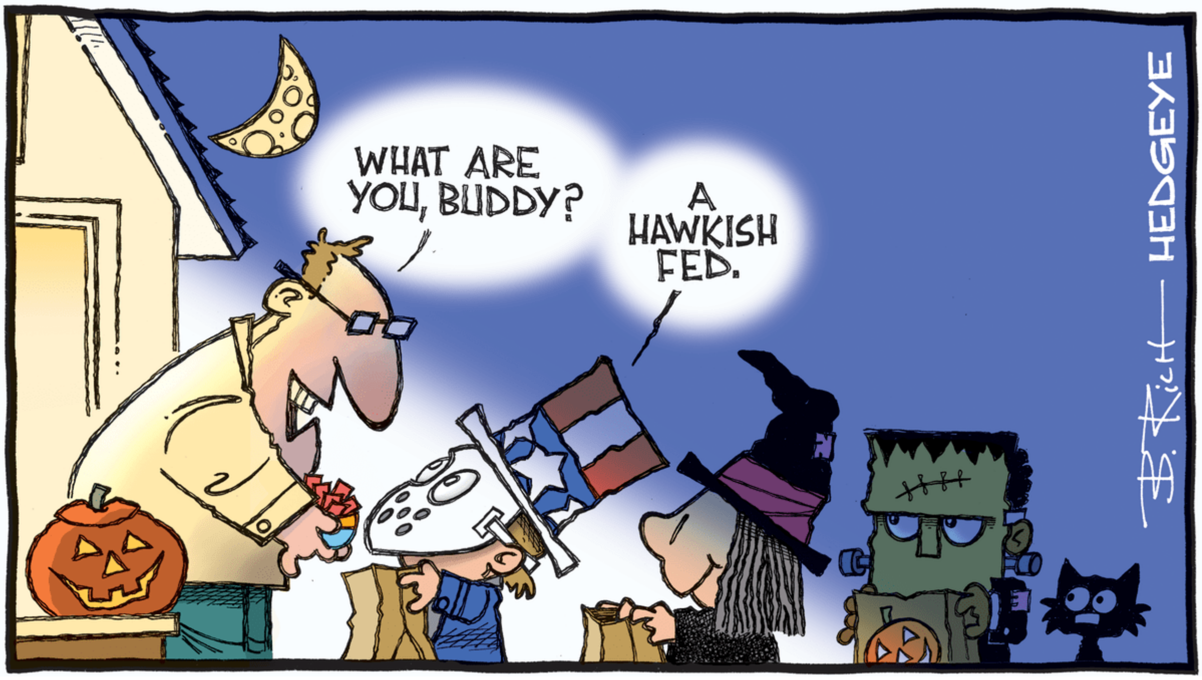
Lead Investment Adviser to Cambridge

4th November 2019



Hedgeye - 30 Oct 2019 - Hawkish US Federal Reserve only Halloween scare

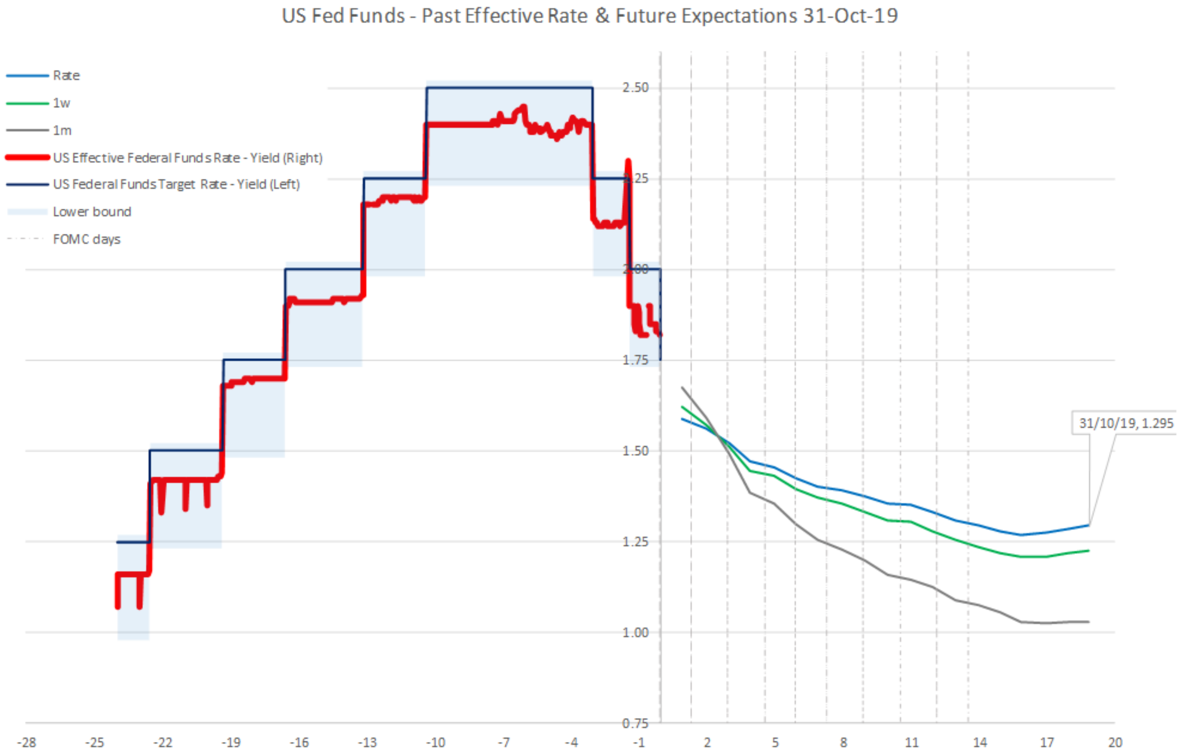
Crucial October period safely behind

October has ended: time to take stock of market and portfolio returns. In general, stock markets nudged up further while government bond yields recovered, eroding some of bonds' earlier valuation gains. For UK investors however, the roughly 5% gain of £-Sterling against other global currencies for once lowered the value of overseas investments and also put the overseas income-heavy FTSE under pressure. The end result was a flattish month where the overseas spending power of investors improved without particularly undermining their portfolio valuations. Year to date, 2019 continues to have been a good year for investment returns across all risk profiles, recording single to low double-digit figures with increasing levels of equity exposure. Despite October's dull returns, the one-year figures have improved markedly into positive territory, due to the base effect of last year's negative Q4 returns.

Historically, October is a month that more often than not has brought disappointment to risk asset investors. So there was a notable sigh of relief when the month ended without any major market upset.

This was despite central banks and politics providing ample opportunity to upset the proverbial apple cart. Central banks, as regular readers know, played a major role in 2019's positive return revival: their volte-face – from monetary tightening back to easing – improved market sentiment and catapulted market valuations upwards from their pessimistic levels. The US central bank's end of month rate decision and outlook statement was therefore very closely watched and anticipated, as there was the potential for an unbalanced announcement once again affecting sentiment. As it happened, the US central bankers seem to have been spot on with their actions and words.

The FOMC effectively managed to deliver a far more hawkish message than would have been acceptable to stock markets only a few months ago when a further series of rate cuts was priced in. While cutting rates a further 0.25% (as expected) to 1.5%, they also made clear that the series of 'insurance' cuts to aid the fragile economy has come to an end – for now at least. The slowing, but clearly not recessionary US economy is not struggling enough to warrant further monetary easing.



Source: Factset, Tatton IM, 1 November 2019

Market reaction was very muted, which most likely means the Fed succeeded in wording the statement such that it contained no particular surprises, after forward-pricing measures had already indicated that markets now expect just one further rate cut rather than three (see chart above).

The other part of this 'central bank' week was the passing of the baton at the European Central Bank from "Super" Mario Draghi to Christine Lagarde, former head of the IMF and the first ever female finance minister of any G7 country (France). Madame Lagarde fulfilled expectations even before she formally took control, when she said in a speech that there "isn't enough solidarity" across the Eurozone, adding "Those that have the room for manoeuvre, those that have a budget surplus, that's to say Germany, the Netherlands, why not use that budget surplus and invest in infrastructure? Why not invest in education? Why not invest in innovation, to allow for a better rebalancing?".

You may have read it here first and so may not be surprised that the 'ice' of fiscal austerity is slowly beginning to melt. Continental Europe has far greater 'fire power' in this department than the Anglo-Saxon world.

Whichever way we look at it, the doom and gloom of the 'inverted yield curve' that we commented on during the summer has lifted – whether this was central banks' doing or a more fundamental change in market sentiment as the growth slowdown appears to be troughing and governments warm to the idea of investing into their economies' productivity potential. It is most probably a result of both and the 'fear-of-fear' factor receding is an undeniably positive for market sentiment at a time when central banks are signalling that further rate cuts will probably do more harm than good. Lower rates for as long a time as we have had them stop banks from fulfilling their role as purveyors of credit to the economy more than they stimulate the economy through increased credit demand. The UK still shows inversion at the short end up to two years, which most likely has to do with – you guessed it – the B-word.

Speaking of Brexit, missing the so-dramatized 31 October Brexit deadline may heap derision on Boris Johnson and have many in the business sector sighing with relief that they do not have to go through the inevitable need for change. But the extension also prolongs the relative uncertainty for UK Plc and means that the business investment stalemate that undermines activity levels extends for another three months. £-Sterling did not give up its October gains, meaning the exchange rate appeared to have had the extension already priced in. This suggests that capital markets anticipate that the country is gradually moving towards Johnson's version of Brexit, with the general election not expected to fundamentally change that path. This would remove one of the major upset potentials for investors between now and the end of the year, unless the election outcome produces such a messy version of a hung parliament that capital markets feel forced to abandon their currently more sanguine approach. Since even the most versed political commentators suggest that the election outcome is all but impossible to predict (despite the substantial lead for Johnson in the polls) it would seem prudent not to 'bet' against one or the other outcome – which is precisely our position in Cambridge portfolios.

On the global politics front, the news flow from the US-China trade conflict is starting to feel more like a roller-coaster than 'Waiting for Godot'. The Trump administration seems to be in a state of schizophrenia, with representatives of the negotiation teams briefing an imminent resolution at the same time as bashing China relentlessly in public speeches. In addition to that, the impeachment noose is tightening around Trump's neck as Congress progresses the process with increasing momentum borne out of more and more damning evidence against the unorthodox president. Not surprisingly therefore, Chinese representatives publicly voiced doubts whether a trade deal was achievable with "this president". Just as with the UK, markets only took brief note before continuing trading on a more optimistic note – quite possibly anticipating that even if Trump's days are numbered, his successor would have every interest in progressing towards a resolution with the Chinese very swiftly – before the 2020 US presidential election takes hold.

In the real economy, the corporate results announcement season is progressing with earnings (profits) – as per the usual, historical observations – coming in better than expected at the start of the quarter. More importantly, US earnings growth has remained positive (just) and the outlook statements are more optimistic and positive than had been hoped for. European and Japanese companies are a touch less good, with earnings growth still lingering below the zero line. Of note however is that the much-shunned industrials are reporting better-than-expected results. Together with the macro economic data flow, this suggests that the manufacturing growth side of this latest mid-cycle slowdown may finally be troughing. In south east Asia we have even begun to see some improvements, while the US economy continues to slow – albeit from its previous position as the growth leader, thanks to Trump's 2017/2018 corporate tax cut.

To return to the calendar view of market action probabilities, we would not want to go as far as agreeing with those who cite historic precedent that, more often than not, a decent October heralds a strong finish to the year. However, we are pleased that we disregarded two pieces of conventional investor wisdom: 'sell in May and go away and don't return until St Leger Day' (second weekend in September), and 'avoid October when the medium-term outlook is clouded'.

China's unorthodox policy moves make sense – for China

It is hard to overstate how important growth is to China. The country's ascendance to economic powerhouse since the 1980s has been nothing short of phenomenal, but it has also been carefully orchestrated. The process of reform began with paramount leader Deng Xiaoping in the early 1980s but took off spectacularly at the end of the decade. For the communist party, growth was about more than just economic management. After the fall of the USSR and the horror of Tiananmen Square, the state struck a Faustian pact with its citizens: forget about liberty and we all get rich.

This is why growth targets are so important for party officials. And it is why the economic slowdown the country has been experiencing for over a year now is a particularly worrying sign. Beijing's crackdown on shadow banking and the country's gorged credit market has left the underlying economy drained of liquidity, putting private businesses under severe stress. The fact that this happened just as US tariffs began to bite only added to the pain. In recent months, the struggles of manufacturers and rising corporate defaults have made the problems plain to see.

Beijing has enacted a number of stimulus measures to stop growth from falling too low – including tax cuts and increased lending to small and medium sized businesses. As we have written before, Beijing has also shown a strong desire to strike a deal with the Trump administration that would end the trade war. It has opted to hold back on certain planned tariffs and prevent its currency from sliding against the US$ as a show of good faith.

That made it interesting to note this week that Beijing is starting to show a little more mettle. According to a Bloomberg report, officials now doubt that a comprehensive long-term trade deal is possible with the Trump administration, despite recent positive signals from discussions and news of a "phase one" agreement being signed. Private sources have claimed that the Chinese government will not budge on the thorniest issues in discussions – and is worried that President Trump's erratic nature makes him an unreliable negotiating partner.

The Chinese seem to have become frustrated with the many false dawns and policy reversals we have seen during Trump's three years in office. This week, US secretary of State Mike Pompeo went on record claiming that the US has woken up to how "truly hostile" China is to Western values. In a speech to the Hudson Institute, a conservative think tank in New York, Pompeo harshly criticised China's communist party and said that the US must confront them "head on". He then went on to criticise their human rights record and what he perceives as the government's unfair economic practices – a common talking point for President Trump.

Beijing now seem to have accepted that a long-term deal is not on the horizon. But crucially, they are only acknowledging that such a deal would be difficult with Trump at the helm. It is possible that officials are hoping that the President will be displaced – either by impeachment or election – soon enough that they will have a new negotiating partner to work with. This is an understandable stance, but it means that both sides of the trade war will be in it for a while longer – to the detriment of the global economy.

Arguably, however, the more important policy shift is domestic. At the party's long-awaited fourth plenum in Beijing this week, policymakers warned of "increasing risks and challenges at home and abroad". As mentioned, the last few months have seen the central government ease off in their deleveraging efforts, trying instead to support the struggling economy. This resulted recently in the state bailouts of small regional banks Jinzhou and Baoshang, who both faced severe financial pressure. But now, Beijing is instructing local governments to be the ones to intervene in future bank defaults, and to step up their deleveraging efforts.

Instead of revving the growth engines, containing financial risks now seems to be the party's top priority. This is most clearly seen in the recent actions of the People's Bank of China. Back in April, the PBoC promised to inject liquidity into the financial system at the beginning of each quarter. But Thursday was the last day of October, and bond traders were left wanting. Instead, the central bank has allowed short-term cash injections to mature, effectively draining 500bn RMB from the financial system.

All the while, high-profile corporate defaults continue. The recent default of steelmaker Xiwang group in particular has worried markets that default contagion may spread and worsen into a full-blown default cycle which tends to trigger recessions. The government's apparent indifference towards the situation – effectively tightening monetary policy as the economy struggles – only heightens those fears.

With President Xi having now centralised and consolidated power to a level not seen since the days of Mao, it is clear that growth is far from the party's main concern. In terms of economic management, this may well be a sensible approach to the policy challenges it faces. But it is unclear how low growth will be allowed to go. The recent 5.3% year-on-year contraction in industrial profits suggests that things will likely get worse before they get better. But a state whose legitimacy is rooted in bringing prosperity can only allow so much hardship. We can only wait and see where they draw the line.

For investors this is not necessarily all bad news, given an economy with improved governance under the caveat emptor principle should be inherently less volatile in its growth than the China we have known. On the other hand, the theme we have outlined over the course of this year continues – the global growth slowdown will this time not be reversed by yet another debt fuelled growth spurt from China.

Elizabeth Warren, the US' very own Corbyn scare?

Election fever is all around. While we gear up for a Christmas time vote here, pundits, pollsters and politicians across the Atlantic already have their sights set on 2020. There is sure to be plenty of drama leading up to next year's presidential vote – not least the fate of President Trump's impeachment proceedings. Assuming that he will be the Republican candidate, which is not a given, the current hot topic is which Democrat he will end up facing.

The current race for the Democrat nomination is the most crowded we have seen for a long time, with no fewer than 18 candidates vying for top spot. Former Vice President Joe Biden still leads the poll averages, as he has done for the entire campaign. But Senator Elizabeth Warren is close behind him (and several points ahead according to one recent outlier poll) and is the bookies' current favourite to win the nomination, with close to even odds.

The outcome is far from certain, but we suspect the current odds are well justified. She has a convincing lead in the early-voting states of Iowa and New Hampshire (which have often proved crucial in building a candidate's momentum) and also leads the pack in terms of second-choice polls. What's more, a recent survey found that 40% of Democrat voters consider her to have the best policies, well ahead of rivals Biden and Bernie Sanders.

If she did win the nomination, she would very likely also be the favourite to win the election itself. This would mark a monumental change in American politics. While she is not considered quite as radical as self-identified socialist Bernie Sanders, her proposals are substantially similar, and she has declared reshaping American capitalism an explicit goal.

The prospect of her presidency has been enough to make the powerful and plentiful of the business world voice their concerns. US hedge fund managers in particular have been vocal about their distaste for Warren. Paul Tudor Jones and Steve Cohen warned an investor conference in New York this week that the election of Warren would see the US stock market drop by around 25%, while another win for Donald Trump would see a significant bump up in the S&P 500. Given the unpredictability of politics, a bet either way could be "career ending" according to Cohen.

For her part, Warren is clearly enjoying the vitriol. Last month, CNBC ran an article about how Wall Street executives are scared of the Massachusetts senator's plans. She then quoted the article on Twitter with her response: "I'm Elizabeth Warren and I approve this message."

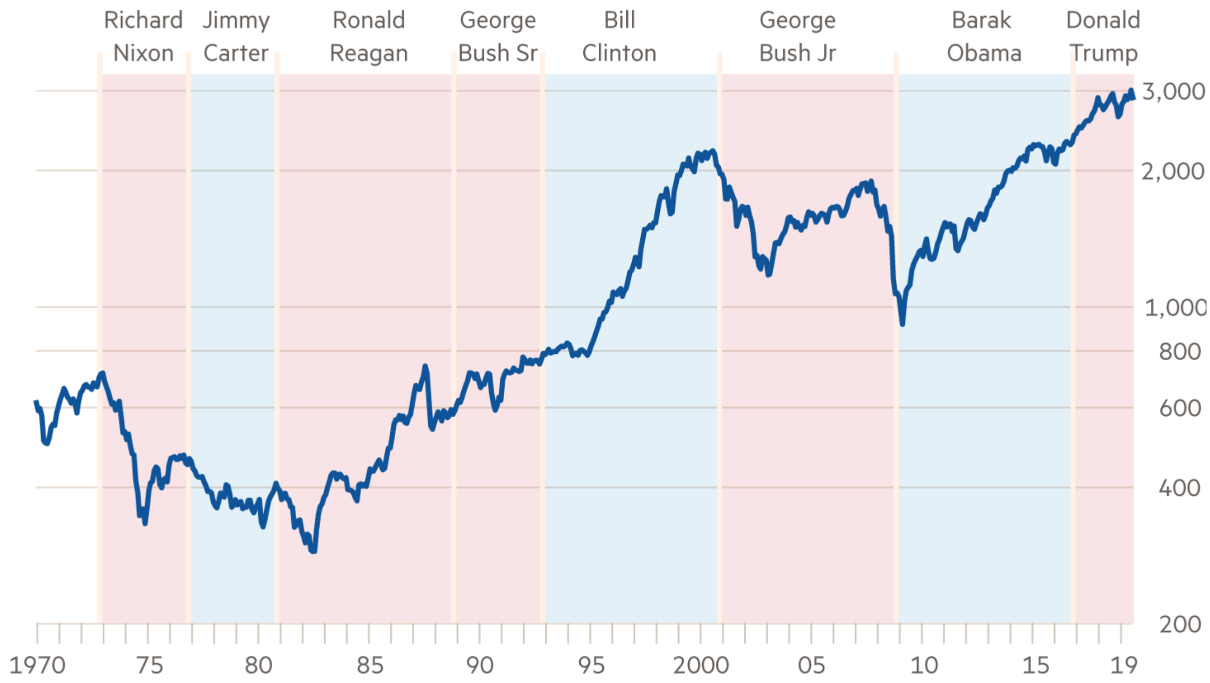
Given the increasing unpopularity of corporate elites and 'the so-called top 1%' in America, courting their dislike is clearly a good PR opportunity for Warren. But snappy soundbites aside, one has to be a little sceptical of the claims of a Warren-inspired financial apocalypse. Alarmist rhetoric is common in financial circles whenever a left-wing politician edges closer to power. Actual Armageddon when one of them wins is much less common.

A recent working paper from researchers at Chicago's Booth School of Business suggests that the average annual stock market return in the US under Democrat presidents is much higher than that under Republicans. "From 1927 to 2015, the average excess market return under Democratic presidents is 10.7% per year, whereas under Republican presidents, it is only −0.2% per year." GDP growth, meanwhile, shows a similar trend: US growth is on average 3.2% higher under Democrats than Republicans.

These figures should be taken with a pretty large pinch of salt. There are various confounding reasons why this might be – including the fact that the country tends to vote Democrat in the down times when

A Democrat president is good news for markets

S&P 500 index adjusted for inflation (log scale)



Source: Robert Schiller
© *FT*

there is more scope for growth. We would certainly not advise this to be read as a causal link between Democrat policies and economic or stock market growth. But what it does at least show is that the left scare in the US is often quite unfounded.

Of course, the Warren bears may think averages are all well and good, but that this time is different. To be sure, she is planning significant change. Along with breaking up large corporations and hiking taxes on top earners, Warren has promised a 2% annual wealth tax on net worth over $50mn, rising to 3% on fortunes over $3bn. Much of the money raised from this will go towards funding sweeping social programs, including her flagship Medicare-for-all proposal. The Economist has called her plans the most ambitious since Roosevelt's New Deal.

A few things are worth pointing out here. First of all, America's democratic system is notoriously difficult to navigate through. Excluding some implausibly large landslide victory for the Democrats in both Houses of Congress, any legislation passed by a Warren administration will be the result of a series of hard-fought compromises. As she is no doubt aware, the realities of congressional politics will inevitably water down her radicalism.

Secondly, it is worth taking the New Deal analogy seriously. The same concerns were raised back in the 1930s about Roosevelt's program. But now many economic historians point to those reforms as paving the way for the post-war economic boom that lasted until the 1970s – often labelled 'the golden age of capitalism'. It would be unrealistic to expect such a dramatic change from Warren, but as we wrote last week, even the world's central bankers have been calling for more fiscal action from politicians to support the economy. Moody Analytics has already run the numbers on some of Warren's main proposals and found an expected positive effect on growth.

Of course, there is still plenty of room for economic or political disagreement here. Certainly, some sectors would fare worse than others under a Warren presidency. And it is indeed possible that fear of higher taxes or corporate restructuring could lead to a market selloff. But the past few years have taught us that political scares in markets tend to be short-lived, and the rebound tends to be punishing for short sellers. Investors proclaim doom at their own peril.

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4th November 2019

Global Equity Markets

Market	FRI 15:25	% 1 Week*	1 W	Short (Technical)	Medium (Technical)
FTSE 100	7289.1	-0.5	-35.4	→	⬀
FTSE 250	20129	0.1	25.7	→	⬀
FTSE AS	4016.0	-0.4	-14.1	→	⬀
FTSE Small	5496.2	0.5	27.0	→	→
CAC	5767.5	0.8	45.3	→	➚
DAX	12970.8	0.6	76.2	➚	➚
Dow	27301	1.3	343.2	→	➚
S&P 500	3061.3	1.3	38.7	→	➚
Nasdaq	8139.2	1.4	110.0	⬀	➚
Nikkei	22850.8	0.2	51.0	⬀	➚
MSCI World	2233.5	0.5	10.8	→	➚
MSCI EM	1042.0	0.6	6.1	→	→

Top 5 Gainers

Company	%
Spirax-Sarco	5.5
Flutter Ents	5.3
Fresnillo	5.1
easyJet	4.7
Ashtead	4.2

Top 5 Decliners

Company	%
NMC Health	-10.2
Imperial Brands	-6.7
HSBC	-5.2
RBS	-4.7
Lloyds Bank	-4.5

Currencies

Pair	last	%1W
USD/GBP	1.295	1.0
GBP/EUR	0.862	0.1
USD/EUR	1.117	0.8
JPY/USD	108.06	0.6
CNY/USD	7.037	0.4

Commodities

Cmdty	last	%1W
Oil	60.67	-2.2
Gold	1510.6	0.4
Silver	18.05	0.1
Copper	264.8	-1.0
Aluminium	1755.0	1.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.0	17.8	13.3	13.2
FTSE 250	3.7	23.9	14.5	14.2
FTSE AS	4.7	18.8	13.4	13.4
FTSE Small	3.7	143.6	-	13.9
CAC	3.2	20.2	15.7	13.4
DAX	3.0	24.0	15.3	12.5
Dow	2.3	18.6	18.4	14.9
S&P 500	1.9	20.2	18.6	15.9
Nasdaq	1.0	25.3	22.3	17.9
Nikkei	2.0	16.5	17.0	17.5
MSCI World	2.5	19.2	17.1	15.2
MSCI EM	2.9	14.3	13.5	11.9

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.6	-0.0
UK 15-Yr	0.9	-0.0
US 10-Yr	1.7	-0.1
French 10-Yr	-0.1	-0.0
German 10-Yr	-0.4	-0.0
Japanese 10-Yr	-0.2	-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

For any questions, as always, please ask!

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4th November 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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