CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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Christian Adams, 5 Dec 2019, Election promises galore – or is it fiscal stimulus?

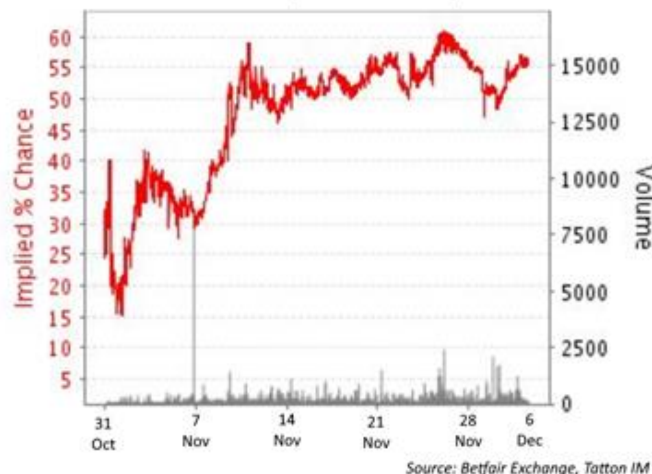
Wobbly kick-off to Festive Season

Capital markets have yet to enter into an early festive spirit. The first week of December made for a bad start in risk assets. As we have written before, expectations of future US-China trade relations are vital to market sentiment – and this week we saw a blow in that regard. President Trump indicated that a trade deal between the world's two largest economies might have to wait until after the presidential election (November 2020). Markets on the other hand (when judged by equity valuation levels vs. actual profit growth) have effectively priced in a deal in the next few weeks or months.

That disappointment will sting, given the current economic backdrop. We wrote last week that markets appear to be 'frontrunning' the economy by pricing in a more imminent recovery from the global economic slowdown than the economic data flow currently suggests. Equity valuations have risen close to where they were during the heady days of late 2017. Sure enough, stock markets around the globe fell 2-3% at the beginning of this week – testament to the fact that investors are feeling a little nervous about their optimism.

The year-end can make for a rather odd time in capital markets, as tighter liquidity conditions and the 'Santa Rally' phenomenon tend to drive returns more than underlying fundamentals. In particular, investment managers who may have missed out on the rally during the rest of the year often feel the need to join in. At the opposite end are investors – often institutional – who either have a requirement to hold specific cash levels at year-end, or are inclined to 'bank' the year's returns by crystalizing the gains. There are reasons for both positioning motivations, as it has indeed been a good year: Investors with globally diversified investment portfolios should have seen double-digit returns in 2019 – all barring those with the lowest risk profile.

Beyond the Trump-induced 'market wobble' (which was on the way of recovery by the weekend), one of the more interesting trends of the week was the strength of £-Sterling, despite (or perhaps because of) next week's election. For the last three and half years – and perhaps before that – currency valuation has been the primary method through which investors express their expectations on Brexit (their 'Brexpectations' if you will). The likelihood of a harder Brexit has forced sterling lower, while the prospects of a softer Brexit have driven it higher. But on the face of it, the current sterling rally has to do with the increased (implied) likelihood of a Conservative majority – despite Boris Johnson being the



hardest Brexiteer of all major party candidates.

The theory is that, with a sizable majority, Boris Johnson will be able to pursue a more pragmatic (softer) Brexit than some on the fringes of his party would prefer. There is perhaps some truth to this. But we believe a better explanation is the growing risk appetite among global investors. With investor risk appetite firmly returning, high-yielding assets are now in high demand, and UK credit and equity fits that bill. Since the 2016 Brexit referendum, British assets gradually became seriously undervalued compared to their global peers, so the general brightening of markets' global economic outlook has benefited them more than others. Perversely, the largest capital flows into British assets seem to be coming from European investors, with sterling's rally against the €-Euro outpacing its US-Dollar gains.

Brexit is still the spanner in the works for any potential sustained rally of UK risk assets, however. Oddly enough, the binary outcomes of next week's election (large Tory majority versus a hung parliament) are more positive on that front than those in the middle (a small majority or minority Tory government) given that the latter are the only outcomes where the Tory Brexiteers have much power. But given that we will know much more about this next week, we will refrain from delving into it too much. What we do expect is that – even if we get a surprise result of a hung parliament – any market volatility should be brief, as it was after the 2016 referendum. The inevitable compromises that would result from that would likely dawn on investors as a positive, at least as far as a pragmatic Brexit is concerned.

Taking a more global view, there is still a lot that could upset nervous markets. President Trump's preoccupation with impeachment and re-election is a negative for the global trade picture. So too is the

news that Chinese tech giant Huawei could be shut out of western payment systems. The US Congress is also following up its Hong Kong Human Rights and Democracy Act with an Uyghur Act against China's human rights abuses in Xinjiang. These are obviously important issues, but they dampen any prospect of a trade deal between the US and China – investors' biggest concern.

But the muted market reaction to Trump's "couldn't care less" trade deal attitude is revealing. As we wrote before, positive economic data needs to come through sooner or later to support the ongoing risk sentiment. And this week there were (tentative) signs that it will. The market expectation that 2020 will see a return of increasing growth rates across the global economy is increasingly supported by the dataflow. This will provide support for risk asset valuations, but will be bad news for safe-haven investments like government bonds – as lower levels of fear, together with a return of inflation pressures and growth prospects, make their meagre yields more painful to accept.

Global trade has indeed been hurt by Trump's trade wars. But the near-term resolution which markets were looking for may not even be needed now. If the sentiment-driven rally in risk assets morphs into a data-driven rally, we can have more confidence that it is sustainable. On this front, we take heart in some improvements in the autos sector – the previous laggard for all of this year. Current data indicates a running down of manufacturing inventories in Europe and Asia, suggesting a rebound in demand. This is in an early and fragile state, but it is a positive nonetheless.

As we have written before, the Christmas shopping season will be vital in showing markets whether their faith is justified. Seasonal effects make economic performance hard to judge around this time, but markets will be expecting an uplift, not a 'Scrooge Christmas'. We will have to wait and see. In the meantime, the next couple of weeks could be choppy for markets.

Avoiding liquidity risk, or property isn't liquid

How long does it take to buy a property? It depends who you ask, but most would say longer than a day. Transactions on properties are long, drawn out and sometimes torturous processes. However, when looking at open-ended UK property funds which offer daily liquidity in their fund units it would seem as if they can miraculously trade property daily. Like any open-ended fund that deals in illiquid assets, open-ended property funds offer investors the chance to hold long-term assets with relatively small minimum investments but without the fear of their money being locked up for extended time periods.

That is, until that daily trading is suspended and their money is trapped. This week, M&G Investments made headlines by announcing that its £2.5bn Property Portfolio Investment Fund – one of the largest in the country – was to be suspended after "unusually high and sustained outflows". According to M&G, investors spooked over Brexit uncertainties and the struggles of the UK retail sector were demanding their money faster than it could be provided. The fund, which deals in commercial UK property, could not sell quickly enough to get the money to those headed for the exit, giving M&G no choice but to block further withdrawals. Those who have been following the UK's investment fund sector for a while will know that property fund dealing suspensions happen relatively regularly. And if that past experience is any guide, it could well be months before investors see their cash returned. So the term 'open-ended property fund' is a bit of an oxymoron.

The story is portrayed in some quarters of the media as a sign of crisis in UK property. Brexit fears, struggling retailers and slowing global growth are weighing down sentiment in the property market. There is some truth to that. Property funds have seen a continual drip of outflows since the June 2016 referendum, at times turning into a flood. And the trials and tribulations of both the commercial and residential property markets in the UK have been well-documented. But we would point out that the underlying assets of UK property are, on the whole, faring reasonably. The most recent RICS survey showed residential property looking downbeat but with a brighter outlook. And while commercial property is a slightly different story, there is nothing to suggest an imminent 'Minsky moment' (also see chart at the end of this article for a market valuation of UK property).

For us, the main takeaway from M&G's troubles is that one should always be wary of funds investing in illiquid assets but promising daily liquidity. M&G property was one of the many UK-domiciled property funds – with a combined total value of £35bn – that had to suspend redemptions for months following the 2016 Brexit referendum. This year alone, UK property funds have experienced nearly £1bn in net outflows. When an investment fund in illiquid assets is sold as open-ended, the fear of being locked in by the collective (withdrawal) action of other, more reactive investors can lead to self-reinforcing outflows. And when the underlying assets are hard to trade quickly, this is a big problem. Beware of open-ended fund managers bearing gifts.

Managers from the UK's other main property funds are keen to stress that contagion will not spread. They claim to have enough cash on hand to meet withdrawal requests. Indeed they may do, but regulators have decided to take matters into their own hands. The FCA is set to announce a joint report with the Bank of England within the next three weeks detailing the steps they plan to take to protect investors when open-ended funds suspend redemptions.

Such measures would be welcome – though perhaps overdue. Anti-Brexit campaigner and manager of investment firm SCM Direct, Gina Miller, was critical of regulators on the matter: "Why on earth did the regulator, the FCA, and M&G allow these direct property funds to be marketed to retail investors given the fundamental mismatch between the underlying liquidity of its assets and the daily dealing of the fund?"

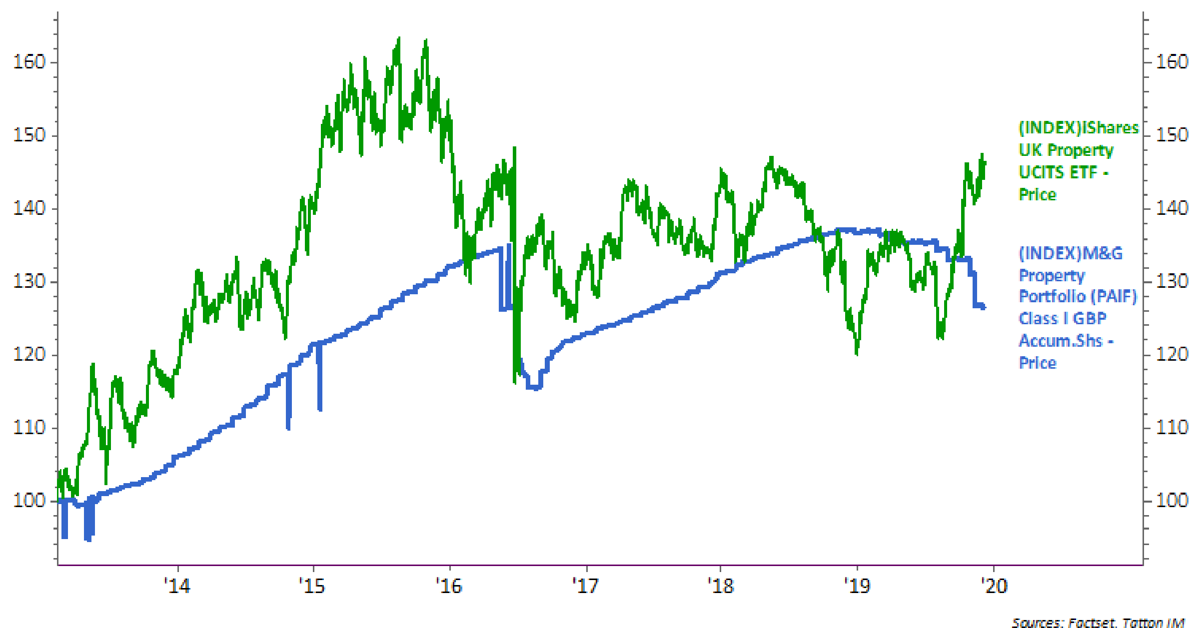
These troubles are far from confined to the property market of course. The issue of a liquidity mismatch sparked up over the summer when the Woodford Equity Income Fund – under the management of former investment superstar Neil Woodford – announced it was unable to meet redemption requests due to lack of liquidity of many investments the fund held, and that it would therefore be suspended. This was largely due to the fund's significant holdings in unquoted stocks, which could not be easily traded.

Investors are often attracted to such funds because they seem to be the elusive golden goose: an easily traded investment with high return potential but relatively little volatility. But that apparently low volatility is usually just a side effect of low levels of liquidity. An asset that is not regularly dealt in the markets does not have daily variation of pricing, and therefore appears to have a more stable price. But in reality this hides the real risk of illiquidity. As has often happened in the past, investors may end up being trapped when they would like to have their cash back the most.

Regulation could go some of the way to solving these problems. But it is hard to see how even a well-regulated market could preserve all of the supposed benefits on offer. For example, a recent report from Morningstar suggests that direct property funds are holding up to 30% of their portfolio in cash – with

cash levels high across the board. This would certainly help as far as outflows are concerned, but any protection which that offers would be a drag on potential returns, given cash (at least currently) does not yield enough to cover ongoing charges. Furthermore, only one of the 16 direct property funds in the UK offers rebates to investors if cash levels get too high. The need for the funds to hold cash in uncertain times is understandable, but it means that investors could be paying portfolio fees of up to 1.6% when up to a third of their money is in non-returning cash.

These are the extreme cases, but they highlight the underlying risk of funds of this sort. That is why we are usually unconvinced by the enticing volatility metrics on which they sell themselves. As ever, if an investment seems too good to be true, it probably is. The setup of these funds makes them enticingly easy to buy. But it takes time to buy and sell direct property, and retail investors can often exhibit a herd mentality. This creates a risk-return falsehood from which the financial regulator should protect lay



investors. The solutions are either to match the funds' unit dealing frequency to that of its underlying investments (moving to monthly or quarterly), or to stop the impression of low volatility altogether. This could be done by steering retail investors to the daily quoted variant of commercial property: closed-ended investment trusts or REITs – which unsurprisingly offer very similar investment returns over the longer term while displaying more realistic ongoing levels of volatility – as our chart below ably demonstrates.

Old and new oil price dynamics

After the turbulence of the last few years, oil prices have stayed mostly within a relatively narrow range – for the second half of the year at least. A slowing of global economic activity has been balanced off by some supply side disruptions and OPEC's attempts to limit production. This week, reports are that OPEC and other associated producers are moving closer to deeper production cuts, to prevent an oil

glut. The wider group, known as OPEC+, with Russia as the biggest non-OPEC producer, met in Vienna on Thursday to focus on a potential 400,000 barrels per day reduction.

Russia has yet to commit to the cuts, but news of the plan has already pushed up oil prices. At the time of writing, the international benchmark Brent crude is sitting at just under $64 per barrel, with WTI at just under $59. OPEC+ has been curbing supply since 2017 to combat rising output from the US – now the world's largest oil producer. The current calls for further cuts are due to still-booming output from American shale producers, joined now by increasing production from Brazil and Norway. If production carries on unabated, an oversupply of oil is expected next year, even if the global economy accelerates back to a normal rate.

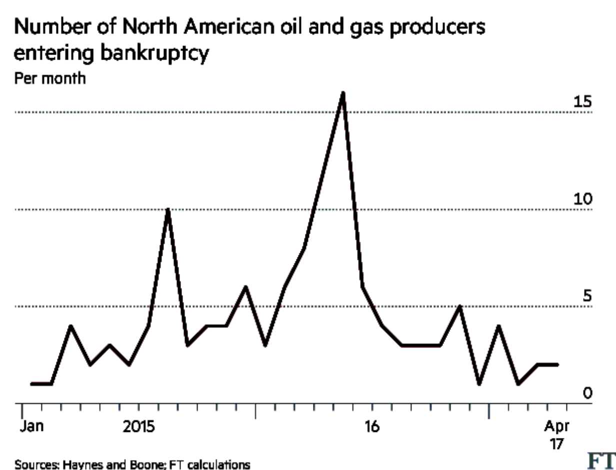
However, relationships are not so cosy. Saudi Arabia, OPEC's de facto leader, is angry with Russia, Iraq and Nigeria. In one presentation, a Saudi official accused the trio of failing to live up to the terms of the oil cartel's previous pact, in which all 14 OPEC nations and its 10 non-OPEC allies committed to their own reductions to generate a collective output curb of 1.4mn barrels a day.

Previously, the Saudis actually slowed their production in excess of their own targets to compensate for the excess output of others. But recent noise coming from the Kingdom suggests they are no longer willing to do so. Officials in Riyadh are furious that their efforts have resulted in oil prices merely holding within a range.

The Wall Street Journal reports that they are now reversing tactics, threatening to boost their own production if "some" OPEC nations continue to defy the group's diktats.

This surprisingly forceful ultimatum has a precedent. Back in November 2014, a similar situation led to the effective dissolution of OPEC as a cartel. Threatened – as now – by US shale producers, OPEC+ members upped their production and drove down prices to extreme lows, with the hope of squeezing out the new entrants to the oil market.

That plan failed, for a while at least. At the time, the Federal Reserve's quantitative easing was in full



swing, giving shale producers access to cheap financing from US high-yield bond investors. It was only in 2015/16, when the Fed began to tighten their historically loose monetary policy and to increase financing costs, that a number of producers started to go bust and the oil flow slowed.

Now, shale production has rebounded so strongly that the US has become a net exporter of oil in the past two months. Some of the surplus may be due to a seasonal fall in imports, so our chart below has seasonal adjustment. But even with that, it's clear the net balance will move into surplus shortly.

Having failed to destroy US shale, the Saudi strategy is to "optimise" the oil price instead. But they find themselves with decreasing amounts of control.

Reports are that Saudi Crown Prince Mohammed bin Salman is growing tired of indirectly boosting the budgets of countries that flout the pact. At the moment, however, the Saudis' threat is only that they will stop overcutting production to make up for others in the group, and instead stick to their original target, rather than ramping up production full throttle.

The stakes for Riyadh are huge: this spat comes just as the government is finalising the long-awaited stock market floatation (IPO) of its national oil company Saudi Aramco. Naturally, officials want to sell the company at its highest possible price – which needs a higher oil price. Analysts already suspect that the Saudis' hoped-for price is above market valuation. This is the crucial subtext to current oil discussions, with one delegate claiming that the Saudi position was "all about the IPO of Aramco."

The bitter irony of the whole situation is that, as the Saudis rage at their Iraqi allies for overproducing, there is one major oil-producing country signalling that it is in favour of deepening production cuts: Iraq is lead proposer of cuts now, and was all for them in the previous pact. Unfortunately for OPEC, it actually managed to increase production rather than cut it, and few trust it not to repeat the situation given its internal problems. Saudi Arabia has indicated that it would support the cut only if it received watertight guarantees that all involved would respect the deal.

Even with guarantees, production controls might fail. The major reason previous OPEC cuts worked as well as they did was that they occurred at the same time as production from Venezuela and Iran collapsed, having been subjected to damaging US sanctions.

Saudi Arabia may have no choice but to follow through with their threat and increase production, which would be sure to send oil prices tumbling and hurt Aramco's chances of a successful post IPO share price development. This is because, even under the new production cut target, the Saudis themselves would

not actually have to reduce their current output – as they are already overcompensating. As such, other countries have little incentive to follow through. This is only hindered further by demands from Russia that its natural gas production be exempt, and that cuts should only last until March.

All of this is about the supply side. In the past, demand for oil could be expected to continually increase with global economic expansion. But this is no longer a given. The current slowdown in global economic growth and structural changes are leading to a secular decline in oil demand. And there is very little OPEC or its allies can do about that. The reduced reliance on fossil fuel will benefit the world's economy and ecology, but is bad news for OPEC.

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9th December 2019

Global Equity Markets

Market	FRI 15:13	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7222.7	-1.7	-123.8	→	→
FTSE 250	20866	0.3	53.2	⬀	⬀
FTSE AS	4013.3	-1.3	-53.4	→	→
FTSE Small	5601.7	-0.3	-18.6	⬀	→
CAC	5866.7	-0.7	-38.5	⬈	⬈
DAX	13163.6	-0.6	-72.8	⬈	⬈
Dow	27963	-0.3	-88.4	⬈	⬀
S&P 500	3143.9	0.1	2.9	⬈	⬈
Nasdaq	8381.8	-0.3	-21.9	⬈	⬈
Nikkei	23354.4	0.3	60.5	⬀	⬀
MSCI World	2278.6	-0.6	-13.6	⬀	⬈
MSCI EM	1042.9	0.3	2.8	→	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
British Land	4.9	Glencore	-9.5
Antofagasta	3.8	TUI	-8.2
easyJet	3.8	John Wood	-7.6
M&S	3.6	Ocado	-7.4
J Sainsbury	2.7	Vodafone	-6.0

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.313	1.6	Oil	64.69	3.6
GBP/EUR	0.843	1.1	Gold	1461.2	-0.2
USD/EUR	1.11	0.4	Silver	16.61	-2.5
JPY/USD	108.79	0.6	Copper	268.2	1.5
CNY/USD	7.036	-0.1	Aluminium	1747.0	-0.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.8	0.1
UK 15-Yr	1.0	0.1
US 10-Yr	1.8	0.1
French 10-Yr	0.0	0.1
German 10-Yr	-0.3	0.1
Japanese 10-Yr	-0.0	0.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	5.0	17.5	13.4	13.2
FTSE 250	3.8	25.7	14.3	14.2
FTSE AS	4.7	18.6	13.5	13.4
FTSE Small	3.5	218.1	-	13.9
CAC	3.1	21.0	16.0	13.4
DAX	3.0	24.3	15.4	12.5
Dow	2.3	19.2	18.9	15.0
S&P 500	1.9	20.9	19.2	16.0
Nasdaq	1.0	26.1	23.1	18.0
Nikkei	1.9	18.6	17.9	17.3
MSCI World	2.4	19.9	17.6	15.2
MSCI EM	2.8	14.6	13.8	11.9

UK Mortgage Rates

Mortgage Rates	Nov	Oct
Base Rate Tracker	2.57	2.54
2-yr Fixed Rate	1.44	1.50
3-yr Fixed Rate	1.59	1.61
5-yr Fixed Rate	1.69	1.71
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.28	4.28

* 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.

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