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All central bank liquidity or improved outlook too?

Following the brief wobble after the escalation in tensions between the US and Iran, the risk appetite that drove the substantial stock market rally towards the end of last year has returned. With yet another good week in stock markets, full year return projections of a number of 2020 outlook reports by well regarded investment research institutions will looked stretched even before we reach the end of the first month.

Unsurprisingly, parallels are being drawn with January 2018, when stock markets were storming ahead with similar levels of upward momentum, touching very similar relative valuation levels, and looked just as over-extended in the US. That particular upward surge ended very quickly, as stock markets took fright from rising bond yields, leading to an overall disappointing year for investors – with the exception of the US.

For now, the strong market performance and extended valuation levels (in certain regions and sectors) is as far as the parallels with 2018 go, while the wider backdrop is substantially different. At the moment, capital markets are under the spell of a very substantial expansion of monetary liquidity, as the US central bank is in the process of easing a global shortage of US$ through the recent injection of $400bn of additional cash liquidity. The cash shortage appears to have been the consequence of post-Financial Crisis bank regulation tightening, which has led to banks hoarding rather than circulating cash. Back in 2017/2018, the opposite was true: in light of strong and synchronised economic growth around the world, central banks were in the process of tightening liquidity conditions.

This leads to the other remarkable difference: back then, the economy had expanded so strongly on the back of one-off stimulus measures in the US and China that a slowdown was a reasonable expectation. This time around, a considerable slump in economic activity lies behind us, but in the absence of recessionary signals we can reasonably expect an improvement in economic growth ahead.

The more disconcerting difference is that last year's market rally was entirely based on rising valuation multiples and not on rising corporate earnings, as had been the case in 2017/2018. More optimistic market analysts put this down to stock markets having overcorrected in 2018, because they were wrongly anticipating the end of the already prolonged cycle – and an ensuing global recession. Therefore, all that happened in 2019 was a countermove back to the previous valuation levels, when the slowdown did not turn into recession and the outlook improved in the expectation of another prolongation of the cycle.

The pessimists dismiss this argument by pointing out that markets' ups and downs have become determined by central banks' monetary stance. When the banks ease (i.e. expand the globally available monetary liquidity) markets go up, and when they tighten they come back down again.

Both arguments have merit, yet miss the finer points. The aftermath of the Financial Crisis has necessitated a prolonged period of extraordinary monetary ease which has changed the reaction function of capital markets to changes in interest rate levels. Simply put, when yields hover around 1.5%, then a 1% increase to 2.5% (=+66%) constitutes a far more material change in financing conditions than when yields move from 4.5% to 5.5% (+22%). Unsurprisingly therefore, central banks have struggled to recalibrate their monetary actions to adequate levels and markets have reacted in quite different patterns to monetary changes to what we have known historically – over- and undershooting regularly. For the moment, central banks have made it known that they will not turn to tightening conditions again until inflationary pressures have significantly overshot their 2% target. This should provide sufficient liquidity for markets to transact smoothly, while allowing longer term yield levels to rise gradually with rising economic growth rates, thereby increasing the difference between cash deposit and longer-term bond yields sufficiently for banks to be incentivised to lend more and support growth.

If the monetary and bond market backdrop gradually normalises as described above, then the (over-) valuation argument could gain validity and indeed leave certain regional markets (US) and sectors (tech/growth) at valuation levels which have historically not been sustainable.

This somewhat complex environment creates a difficult decision for us investment managers, given how difficult it is to forecast – especially the timing of changes.

We suspect that the top end of equity markets will enter a consolidation phase that could even take the form of a short-term correction, when the US central bank finishes its cash market intervention sometime in February. Given it has already signalled this will happen, it is hard to argue that this will surprise markets and therefore should have been priced in already.

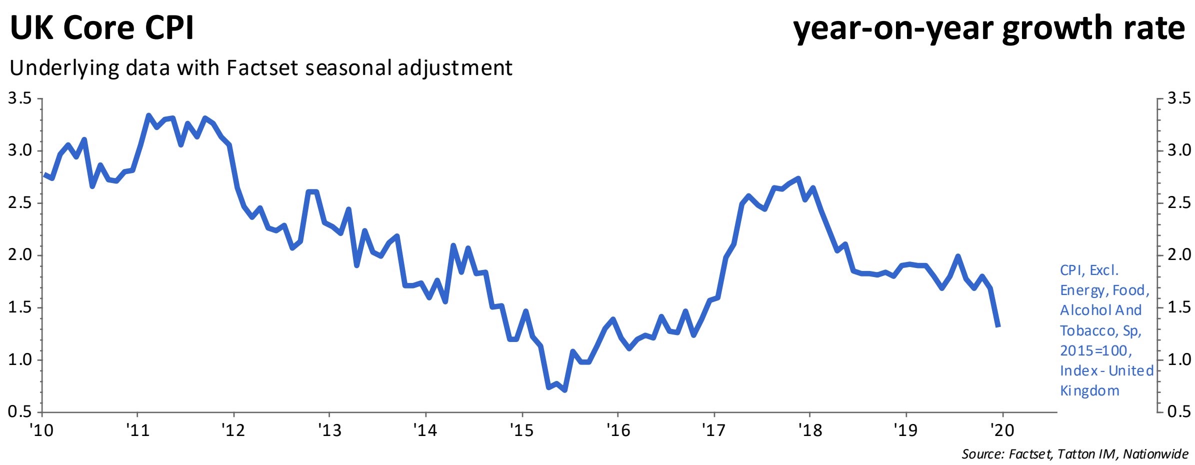
On the positive side, the signing of the first phase of the US–China trade agreement has the potential to improve the 2020 outlook more than its limited substance would suggest. Depending on how much it improves business sentiment both in China and the US, there is the real possibility that growth dynamics improve more significantly than recently anticipated. This would allow corporate earnings to edge higher and thereby valuation levels lower. We have seen it before and, given how unfazed markets were in reaction to the Middle East tensions, we are not convinced that a severe enough market correction is in the offing to warrant trying to find a lower entry point for any portfolio repositioning.

At Cambridge we navigate investment portfolios guided by the medium-term economic development, rather than short-term market timing. On the economic fundamentals we observe improving expectations and an increasing number of signals that lead us to believe that areas that have not done particularly well over the past years – such as emerging markets – will be the beneficiaries of improving global trade conditions. Against this backdrop bond yields fell to too low a level, especially now that a recession looks ever less likely. This puts lasting downward pressure on bonds with long maturities. In our next portfolio update we are therefore going to focus on those two areas while also looking to take some interim profits in those areas that have done particularly well in the recent rally.

Those who expected us to discuss the latest UK economic data flow and to deliberate on whether the Bank of England will cut rates at the end of the month should please open the attachment and turn to the aptly titled article "Bank of England to cut interest rates" in which we lay out why it is highly likely that interest rates will be reduced, back down to 0.5%, but why it is also unlikely that we will see more than one cut.

Bank of England to cut interest rates

The retail sales report for December was out on Friday 17th January (here). December 2019's sales value was 3.5% above that of December 2018. Unfortunately, the relatively recent phenomenon of Black Friday (and Cyber Monday) distorts the run of data, depending on when the surge happens in the month. Dec-2019's data included Black Friday, Dec-2018 didn't. Adjusting as best they can, the Office for National Statistics said sales value (not including fuel) increased a meagre 1.1% year-on-year. Even online sales were anaemic.



Some of this slow pace of sales value growth is down to low inflation. Core (excluding food and energy) price growth fell to just 1.3% year-on-year last month, well below the Bank of England's 2% target. That does not bode well for retailers' results, as low inflation may well be a sign they have been forced to cut their margins.

The uninspiring CPI (inflation) data came as governor Mark Carney told us the following:

"The economy has been sluggish, slack has been growing, and inflation is below target. Much hinges on the speed with which domestic confidence returns. As is entirely appropriate, there is a debate at the [monetary policy committee -MPC] over the relative merits of near-term stimulus to reinforce the expected recovery in U.K. growth and inflation," According to Carney, the BoE also has a set of tools with enough power to deliver the equivalent of a 2.5% cut in monetary easing (a hint that rates themselves would be unlikely to go below 0%).

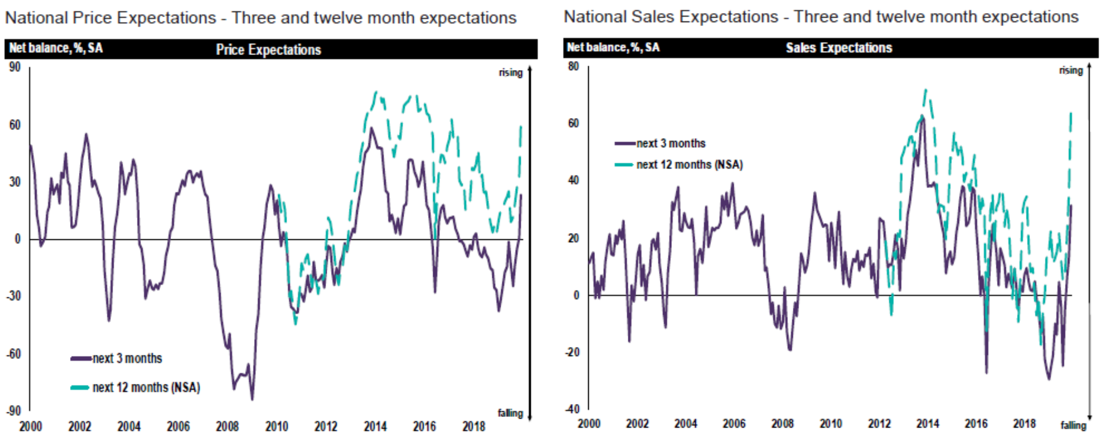
Carney is not the only MPC member feeling dovish. The central bank's base interest rate currently sits at the lowly figure of 0.75%, but recent comments suggest others are considering cutting rates, a move they last made in the wake of the Brexit referendum. Implied market chances of an end-of-January cut are now 70%.

Two MPC members, Michael Saunders and Jonathan Haskel, voted for a rate cut at the last meeting. Last week, Silvana Tenreyro said she may support a rate cut in the next few months. She was joined by another MPC member, Gertjan Vlieghe, at the weekend: "Personally I think it's been a close call, therefore it doesn't take much data to swing it one way or the other" he told the FT, adding that he needs to "see an imminent and significant improvement in the UK data to justify waiting a little bit longer."

There are certainly reasons to be hopeful for the economy. Given the circumstances, December's dreary data could well be a one-off. We entered the month hurtling towards a Brexit deadline without any clear idea of what future relations with our largest trading partner would be – or which government would be negotiating them. This uncertainty paralysed businesses, and most likely consumers too. The Black Friday sales happened before the election. A fair chunk of that uncertainty has now gone, and anecdotal evidence points to returning confidence.

Returning confidence has buoyed the housing market. The RICS residential housing survey (taken during December) showed prices slightly down, but "near-term price expectations were revised higher in all parts of the UK." The chart at the top of the next page shows expectations for prices and sales – and suggests there is pent up demand waiting to be released.

And the recent bump-up in the value of sterling suggests optimism is indeed returning. In general, the UK economy looks to be on a better track than it was at the torrid end of last year.



December 2019 © RICS Economics 2020

The only problem is that (despite the electorate's best efforts) the British economy is deeply tied to Europe's, where demand has been weak as a consequence of the global manufacturing and trade slump of 2019. Thriving business and consumer demand on the continent remains the most important factor for British industry. There are signs of a more positive sentiment in Europe as global trade is turning, but it is still too early to say for sure when and to what extent it will lead to improved activity levels.

MPC members are well aware of this, and so they may want to cut rates for added insurance. Even if domestic confidence jumps back to life, money supply growth is anaemic, inflation is low and the effective sterling exchange rate against the euro is 5% above where it was halfway through 2019 – when industrial confidence was already sliding.

The latter point is particularly important, given that a low sterling value has been the main factor supporting British exporters since the referendum result in 2016. With sterling now higher, British goods will become more expensive just as regulatory changes from Brexit start to kick in. This will lower demand for British exports at a time when economic recovery is still fragile.

We suspect that rates will be set with one eye on the currency value. Our trading partners have not (yet) seen post-Brexit Sterling weakness as a competitive – i.e. wilful - devaluation. It would be wise to take advantage of that while it lasts. The MPC can and probably will (and should, if needed) shortly allow the currency to take the strain again. We think there will be a rate cut of 0.25% on Thursday 30th January and that rates will stay at 0.5% for the rest of 2020.

US – China trade deal, more than a truce?

At long last, the US and China have put pen to paper on a trade deal. This week, the world's two largest economies have signed phase one of what negotiators – and global investors – hope will be a comprehensive and long-lasting agreement. Wednesday's signing ceremony was mostly a formality, with the interested public already aware of the agreement for a few weeks. But it did give President Trump and Liu He, China's top trade negotiator, a politically useful photoshoot inside the White House. In the unveiling of the 86-page document, Trump was typically boastful: "This is the biggest trade deal anybody has ever seen."

"The biggest deal [ ] ever seen" left markets mostly underwhelmed however. America's major stock indices rose marginally on Wednesday, while China's main Shanghai Composite index fell slightly. Traders' apathy here is not surprising, given the spirit of the agreement was already known ('buy the rumour, sell the fact' as the saying goes). But there is a debate among financial commentators whether the deal just flatters to deceive or whether it could lead to a far more meaningful recovery in global economic sentiment.

It is undeniable that, despite stretching to 86 pages and being prefaced by a long preamble, the document lacks meat on the bones. As the Financial Times put it, the phase one deal "leaves the US-China trade relationship in a much worse state than when Mr Trump took office." Trade barriers are certainly higher now than before Trump began building on them. But this is perhaps the wrong comparison. Phase one constitutes a semi-permanent truce in the US-China trade wars and has to be seen as the beginning of the process, not the result of it. And it does contain some substance, even if not as much as many had hoped.

The chapter on intellectual property affirms China's commitment to protecting intellectual property rights (which western politicians and businesses have repeatedly criticised China for breaching). Beyond this vague commitment are tighter measures against piracy and counterfeiting. There are also pledges to make it easier for US companies to pursue civil or criminal proceedings for theft of trade secrets, without divulging confidential business information.

This is followed by a chapter devoted to technology transfers – one of the Trump administration's main gripes with China. China pledged not to force American companies to hand over their technology in exchange for market access, or during M&A or investment transactions. But concrete details here were lacking. China already made this commitment when it joined the WTO, but has been repeatedly accused of breaking it, without much punishment.

The continued opening up of Chinese markets is another major theme, with chapters on both agriculture and financial services. Planned reforms are designed to make it easier for US farmers to export to China, while China's financial markets are to be opened up to US competition. For their part, US officials promised to do the same for Chinese financial companies.

The headline takeaway however was China's commitment to purchase $200bn more of US goods than it did in 2017. Trump has long lamented the US's trade deficit with China, so will likely see this as a victory – with the purchases distributed across the manufacturing, energy, agriculture and services sectors.

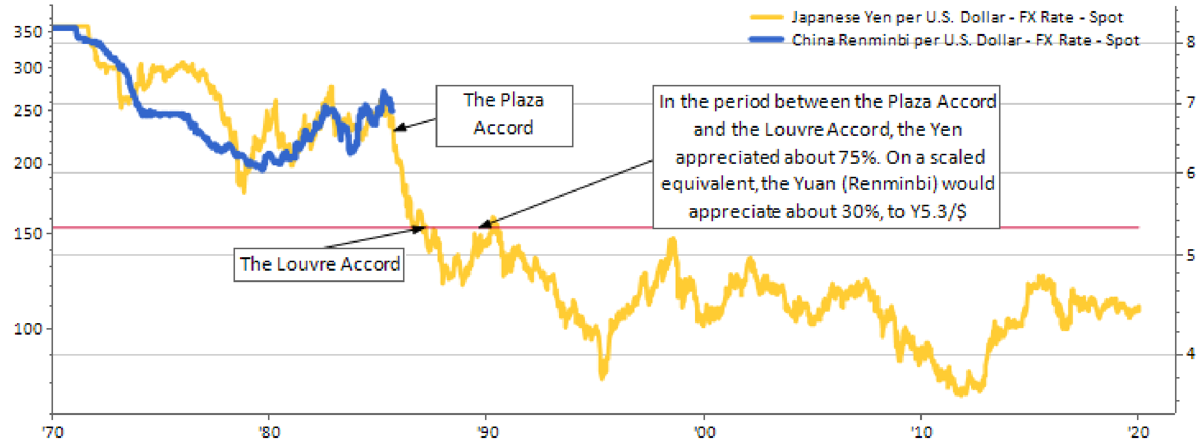
How exactly these measures are to be achieved or enforced is unclear. The agreement includes a commitment to regular meetings between officials to discuss alleged violations. But if disputes are not resolved, either side is allowed to resort to increased tariffs as long as the decision is taken in "good faith".

That leads us on to what was not said. There is no agreement within the phase-one deal on either the timeline or scale of tariff removal. Both of these are set to be covered in any phase-two agreement, but that could well be beyond the next US election in November, after which China could be negotiating with an entirely different US president.

Interestingly, there was scant mention of a currency agreement. We had thought that a commitment to hold the RMB stronger against the US dollar might be hinted at more clearly. The only clause on exchange rates was a reaffirmation from both sides of their commitments to the G20 and IMF, which prohibit them from deliberately devaluing their currencies.

Even so, on Friday morning China's State Administration of Foreign Exchange (SAFE) announced that China will make the Yuan more flexible to accommodate increasing net capital inflows. The spokesperson added that China expects its current account to maintain a small surplus in 2020. The press conference contained a warning to domestic enterprises to focus on main businesses and not to engage in currency "hedging". Indeed, the combination of both a current and capital account surplus must imply a stronger Renminbi, which Beijing acknowledges. The Chinese currency could have a strong run, not dissimilar to the Yen's path after the 1985 Plaza Accord, as the chart below suggests:

Similarities between Yen/$ and Renminbi - Yuan/$



Source: Factset, Tatton IM

(A note to readers: "Renminbi" is akin to "Sterling", whereas "Yuan" is a unit like "Pound". "Fen" is 1/100 of a "Yuan" like "pence", and one "Jiao" is 10 "Fen").

So, what exactly should we make of "the biggest trade deal anyone has ever seen"? Critics are correct that the phase-one deal is more gesture than substance. But we should not underestimate the power of gestures. Incremental agreements make it easier for both sides to come together on specific issues, without letting contentious points derail everything. Concrete measures may be lacking in phase one, but it sends powerful messages from the world's two largest economies: realism from China and pragmatism from the US. That bodes well for global trade.

Despite making most of the concessions with (as yet) little in return, China will most likely benefit more from this than their American counterparts – in the short-term at least. A slowing domestic economy and US tariffs have been holding back business sentiment on China. With things now looking a little brighter, foreign businesses will probably be more inclined to invest into the country. And now that they can do so through the opening up of financial access, the country could see capital flowing in – to the benefit of Chinese businesses. This itself would strengthen the RMB against the dollar, even without any formal agreement.

The one caveat to all of this is Trump. Consistency has never been his administration's strong suit – often flip-flopping between extreme aggression towards China and gentle accommodation in the space of a few tweets. Phase-two talks are in the pipeline, but we have little confidence that Trump would stick to them if things went against his wishes. In that case, gestures of agreement would be worthless.

For now, however, the deal has far more potential to do economic good than the sum of its parts. For one, the positive business sentiment is not limited to China. The US economy is not in as urgent need of improved business confidence. But as we pointed out over the last year, the trade war has done the same damage to US business investment as Brexit has to the Britain's. Business investment would also greatly help US companies struggling with the persistent labour shortage, thereby increasing productivity. Without investment, inflationary pressures are bound to return in 2020.

What's more, the expected strengthening of the Renminbi could be very good for the global economy. A strengthening Renminbi means a weakening US$. This is good news for global trade, as emerging markets always fare better under a weakening Dollar.

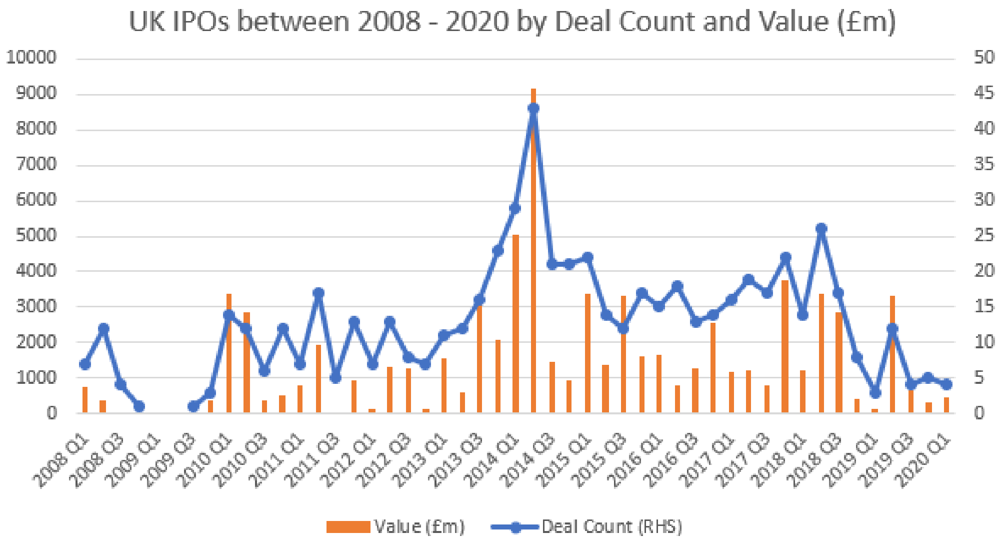
Unfortunately, the focus of the phase-one deal, namely China purchasing more goods from the US to the tune of $200bn, means that these trade volumes will simply be redirected from elsewhere. This is likely to be South America for the agricultural side and Europe and Japan for industrial goods. On the face of it, this is bad news for those regions. However, the muted stock market reaction to this news tells us that there is an expectation that complex economic network benefits (of a lower US$ and business demand stimulus on either side of the Pacific) will more than compensate for the crude redistribution of trade volumes under Trump's 'America First' slogan.

Shhhh It's Private - Private equity insight

During the heady days of the 1990s, the ultimate signal of start-up success was the initial public offering (IPO) of new shares at the stock exchange, rewarding founders, giving companies a new round of capital and announcing their arrival to the big-time. Roll forward to 2020 and the sound of the bell ringing is a lot quieter. Companies are snubbing public markets in favour of private funding.

According to data firm Dealogic, just 34 companies applied to be listed on the UK stock market over the last year, the lowest number since 2009. The amount of money raised from British IPOs was just over half the previous year, coming in at £3.7bn. At the same time as new listings are declining, more and more publicly listed companies are being taken off the market and turned private (see chart on next page).

This means the proportion of overall businesses that are publicly listed is declining – and not just in London. The number of listed companies in the UK has decreased substantially over the last two decades. Some brokers have stated that during 2019 they took more companies private than public. This is a trend we need to keep an eye on, since it limits opportunities for public investment.



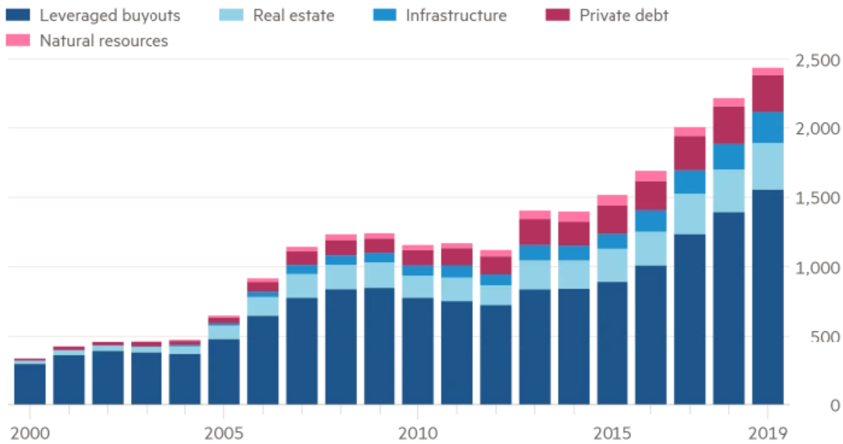
Businesses' shunning of the stock market is not due to a lack of demand for investment. Companies are still seeking capital, but the channel of investment has shifted to private equity (PE). Private equity funds have attracted many high-net-worth investors who had previously been seeking extraordinary returns from hedge funds but were left wanting following more than a decade of disappointing hedge fund sector performance.

As a result, PE firms' assets-under-management (AUM) have doubled in the last five years (from $2.2tn to $4.5tn) compared to just approximately 27% growth in the traditional listed global equity market capitalisation. When adjusted for underlying price changes, the last five years has seen developed market (ex US) listed equity expand just 5%. Assets in US listed equity have contracted over that time, falling 7.3%.

With new money to invest, the value of PE buyout deals worldwide hit $478bn in 2019, up from $460bn a year earlier and the highest amount for over a decade. But that flow of investment into PE funds may have forced PE managers to adjust their behaviour.

It seems buyout groups are willing to pay the premium as they look to deploy record amounts of raised capital. Deal making has been growing consistently for the last three years and shows no sign of letting up, given the high levels of capital raised, especially during 2016-2018.

Figure 1 - Dry Powder 2000 - 2019 ($bn)



Source: Preqin, FT

As the chart above shows, PE firms had nearly $2.5tn in uninvested money ('dry powder', as PE investors call it) last year. Over $1.5tn of that was earmarked for leveraged buyouts – where PE firms take public companies private – the highest year-end total on record. This capital, or at least a portion of this, needs to be put to work, with investors unhappy to be sitting on capital waiting to be called. And, of course, PE funds look to earn their 2 and 20 (2% annual management charge, 20% performance fee).

Almost all PE funds are established with a vintage or end-date. In the past, IPOs were the favoured route for PE ventures to realise the value at the close of each fund. Now they are much more likely to be sold on to other PE funds. Perhaps they are simply happy with asset performance within the confines of the private equity sector and therefore opting to keep them private and less exposed the daily trading pressures that public markets expose companies to.

A possible downside to this is that it could lead to all the good companies going private, while only the bad ones remain public. There is some debate over whether this is already happening. But while PE funds are interested in company profitability, they are also wary of valuations (price-to-earnings ratios) and may find it harder to borrow and to fund the privatisation of highly valued companies. This could explain partly why the value factor amongst stock selection styles has underperformed, with those companies deemed cheap being taken private rather than reverting to a mean valuation within public markets.

Whether we can expect to see the same deal volumes and fund raising through 2020 remains to be seen. This will partly depend on whether regulatory changes are made. Most areas of finance have come under scrutiny since the 2008 crisis, with the exception of Private Equity. But loading a company with debt in order to take it private doesn't look good in the eyes of the electorate, so it would not be a stretch to imagine at least some kind of reporting will be demanded of funds. In the US, Democratic presidential candidate Elizabeth Warren has already announced her "Stop Wall Street Looting" Act as part of her election campaign which would aim to make PE managers more responsible for the debts they place within the businesses they buy out.

PE firms have taken advantage of geo-political overhangs and pressures such as the "Brexit discount", buying 'good' companies at cheaper valuations. Similarly, and conversely, the IPO market has been somewhat subdued, as companies wait for improved outlooks (read valuations) before coming to market.

We remain unconvinced by the value of many PE propositions that operate under the “2 and 20” fee model that we know so well from the once flamboyant hedge fund sector. Hedge-fund investing turned from being the hottest show in town (1990s) to being desperately overcrowded (2000-2010). The PE sector faces the same risk. But for the time being, we welcome the additional liquidity the sector brings to certain segments of the capital markets.

CAMBRIDGE INVESTMENTS LIMITED

20th January 2020

Global Equity Markets

Market	FRI 16:51	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7674.6	1.1	86.7	↗	→
FTSE 250	21886	1.5	319.4	↗	↗
FTSE AS	4257.9	1.2	51.2	↗	⬀
FTSE Small	6066.2	1.7	99.4	↗	⬀
CAC	6100.7	1.1	63.6	⬀	↗
DAX	13526.1	0.3	42.8	⬀	↗
Dow	29320	1.7	496.3	↗	↗
S&P 500	3322.7	1.8	57.4	↗	↗
Nasdaq	9130.7	1.8	164.1	↗	↗
Nikkei	24041.3	1.3	301.4	⬀	↗
MSCI World	2406.2	1.2	28.5	↗	↗
MSCI EM	1140.6	0.6	7.0	↗	⬀

Top 5 Gainers

Company	%
NMC Health	15.4
Centrica	8.3
Taylor Wimpey	7.5
Evraz	7.1
Persimmon	6.8

Top 5 Decliners

Company	%
Pearson	-6.2
DS Smith	-4.6
RBS	-4.5
Mondi	-4.4
Prudential	-4.3

Currencies

Pair	last	%1W
USD/GBP	1.303	-0.3
GBP/EUR	0.852	-0.0
USD/EUR	1.11	-0.2
JPY/USD	110.15	-0.6
CNY/USD	6.86	0.9

Commodities

Cmdty	last	%1W
Oil	64.71	-0.4
Gold	1558.4	-0.3
Silver	18.04	-0.4
Copper	284.6	1.2
Aluminium	1812.0	0.5

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.6	18.6	13.7	13.2
FTSE 250	3.6	25.9	15.3	14.2
FTSE AS	4.4	19.7	13.7	13.4
FTSE Small	3.3	193.0	-	13.9
CAC	3.0	21.9	15.1	13.5
DAX	2.9	25.1	14.5	12.5
Dow	2.2	20.0	17.7	15.0
S&P 500	1.8	22.1	19.1	16.0
Nasdaq	0.9	28.9	23.8	18.0
Nikkei	1.9	19.2	18.3	17.2
MSCI World	2.3	21.0	17.6	15.2
MSCI EM	2.5	15.8	13.4	11.9

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.6	-0.1
UK 15-Yr	0.9	-0.1
US 10-Yr	1.8	0.0
French 10-Yr	0.0	0.0
German 10-Yr	-0.2	-0.0
Japanese 10-Yr	0.0	0.0

UK Mortgage Rates

Mortgage Rates	Dec	Nov
Base Rate Tracker	2.53	2.50
2-yr Fixed Rate	1.45	1.44
3-yr Fixed Rate	1.56	1.58
5-yr Fixed Rate	1.69	1.69
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

For any questions, as always, please ask!

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20th January 2020

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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