THE **CAMBRIDGE** WEEKLY

8 April 2019

Lothar Mentel

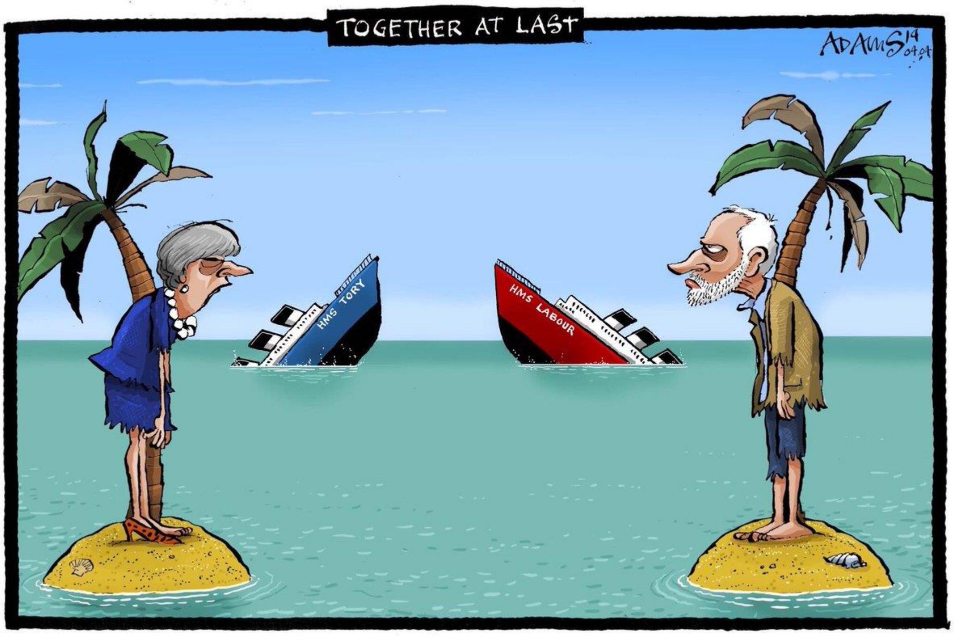
Lead Investment Adviser to Cambridge

DISCLAIMER

This material has been written on behalf of Cambridge Investments Ltd and is for information purposes only and must not be considered as financial advice.

We always recommend that you seek financial advice before making any financial decisions. The value of your investments can go down as well as up and you may get back less than you originally invested.

Please note: All calls to and from our landlines and mobiles are recorded to meet regulatory requirements.



Christian Adams, government of national unity? 4 April 2019, Source PCGL

Happy 10th birthday, choppy bull market

Frustrating political divisions have drowned out the 10th anniversary of what many have called the most unloved equity bull market in history. Broad based equity market investors (those who held their nerve) have enjoyed annualised returns of over 10% since that frightful March 2009. This is quite extraordinary given the low investor confidence and general lack of exuberance this bull run was characterised by. It must have felt just as extraordinary for the big winners of the previous decade – hedge fund investors. To their surprise, plain, vanilla, low cost investments of diversified equity funds generated superior returns, despite being generally accessible for the 'average Joe' and not coming with excessive fees.

The past 12 months have proven once again that this long-lasting cycle is somewhat different to previous investor experiences. The comparatively slow but consistent rate of global economic expansion over the past decade, that has been accompanied by very low interest rates and yields, has been particularly profitable for businesses, but less so for their employees. This unusual environment has not been conducive for the rise of exuberant confidence that in the past led to the relatively shorter cycles of boom and bust. Instead, due to the fragile confidence levels, even smaller economic slowdowns have led to excessive declines in short term investor confidence. The ensuing rapid declines in risk asset valuations appeared to be purgatory. And through the parallel fall in the cost of loan capital and other input price, they laid the base for the next upswing in economic activity, corporate profits and stock market valuations.

This pattern appears to be applicable to the past 12 months as well. Corporate credit has become cheaper again, central banks and select governments have provided stimulus measures for the economy and the fear of losing wealth has once again turned into fear of losing out on the substantial positive returns that materialised since the beginning of the year. So, capital markets have staged another extraordinary recovery rally as our asset returns table below documents.

Asset Class	Index	YTD	2018
Equities	FTSE 100 (UK)	9.5	-8.7
	FTSE4Good 50 (UK Ethical Index)	7.0	-9.2
	MSCI Europe ex-UK	7.4	-11.9
	S&P 500 (USA)	11.1	1.6
	Nikkei 225 (Japan)	3.6	-2.2
	MSCI All Countries World	9.2	-6.4
	MSCI Emerging Markets	10.5	-11.5
Bonds	FTSE Gilts All Stocks	3.4	0.6
	£-Sterling Corporate Bond Index	4.8	-2.2
	Barclays Global Aggregate Bond Index	-0.1	4.9
Commodities	Goldman Sachs Commodity Index	12.4	-8.5
	Brent Crude Oil Price	22.8	-14.5
	LBMA Spot Gold Price	-1.5	5.0
Inflation	UK Consumer Price Index (annual rate)*	-0.8	2.1
Cash rates	Libor 3 month GBP	0.2	0.6
Property	UK Commercial Property (IA Sector)*	0.3	2.9

Data sourced from Morningstar Direct as at 31/03/19. All returns in GBP

*** to end of previous month (28/02/19)**

As we wrote last week, history rhymes but does not necessarily repeat. But it is interesting to note that more and more market commentators are suggesting that various feeble signs of not-so-bad economic data are actually the green shoots of the next mini upswing in this drawn out cycle. We do not disagree, but have stated here before that the longer this cycle lasts the higher the nervousness that the end is near and the more pronounced the sell-off episodes become.

For the coming months, however, there are many indications that the economy and markets are likely to follow a similar path to the various previous episodes and trade in calmer and more positive terms than what we experienced over 2018.

Politics may appear to pose a significant risk to this benign scenario, particularly from a UK perspective. But there were signs over the past week that the bigger political issue – the trade war between the USA and China – is slowly but steadily drifting towards a resolution. Consequently, stock markets around the world closed the week higher on the improved trading prospects and continued to more or less ignore the UK's Brexit impasse.

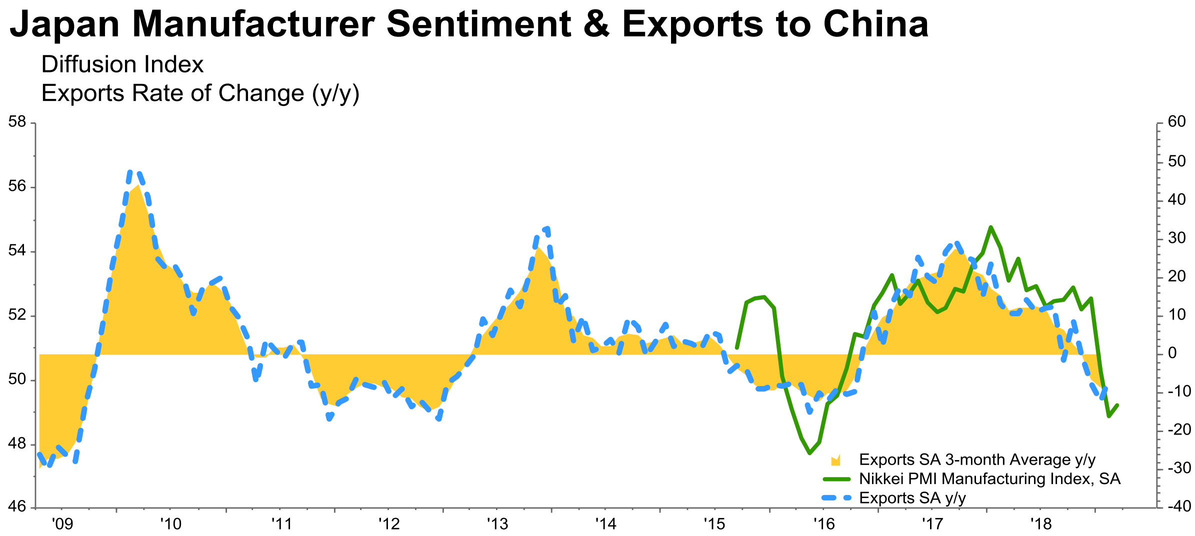
This is most probably because there is a firm belief that politicians between the UK and the remaining EU will prevent a disorderly Brexit scenario even if we seem precariously close to the precipice. As we have suggested before, a longer than envisaged extension to the actual leaving date seems the most probable course of action, as is a softer form of Brexit which preserves the membership in the Common Market but exits the political framework – at least for the time being. There is still much work needed to get there, but there were signs that both sides appear to have the will to do so, rather than letting the more radical operators take control.

Japan's output gap is actually a positive sign

The recent data on Japan's economy has been mixed, to say the least. The latest readings on the purchasing managers indices (PMIs) point to stagnation or worse. Last month, the Nikkei Composite PMI fell to 50.4, from 50.7 in February, its lowest level in two and a half years. PMIs are a survey measure for business sentiment, and usually provide quite a good idea about the future direction of economic growth in the short term. Any reading above 50 is supposed to indicate expansion – and anything below the opposite – but, in reality, the 'neutral' level is thought to be a little higher than 50.

The drop in overall sentiment reflects the falls in both the country's manufacturing and services sectors. The services PMI, while still decent, edged down 0.3 points to 52.0 last month. The real blow came from the manufacturing sector, which posted a PMI reading of 49.2. The figure was actually revised up slightly (initial estimates were of a repeat of February's 48.9) but it still puts Japan's manufacturers in contraction territory.

That seems mostly negative, so why do we use the word "mixed"? Well, for starters, it is worth bearing in mind that Japan's manufacturing plight is hardly unique. A global slowdown in economic activity has caused problems for manufacturers the world over. For the Japanese in particular, China's economic slowdown has had a big impact. Exports to the world's second-largest economy have slumped, and China-focused companies have been forced to slash profit forecasts.



Source: Factset, Tatton IM, Customs Japan

But it is not all bad news. According to the latest estimates from the Bank of Japan (BoJ), Japan's *output gap* rose to 2.2% in the last quarter of 2018. The '*output gap*' is a measure of how much an economy is producing in relation to how much it *could* produce if it was at so-called maximum efficiency, expressed as the percentage difference between actual and 'potential' GDP. Any deviation from maximum efficiency has its drawbacks, but a negative output gap usually indicates a lack of demand and slowing activity, while a positive gap indicates high levels of demand and can eventually lead to inflation pressures and overheating.

A positive output gap essentially means that the economy is generating output above its actual capacity, usually due to a tightening labour market or a supply shortfall. For Japan – a country which has been mired in disinflationary stagnation for decades – the slightly positive supply gap is, well, positive. The BoJ's 2.2% figure for Q4 is well above the 1.3% figure in Q3, representing the biggest tightening in 26 years. The last time Japan saw an output gap this large, the economy was still in the throes of its infamous asset-inflation bubble in the late 1980's.

All else being equal, this should signal a pick-up in the country's stubbornly low inflation rate. And yet, the BoJ is expected, later this month, to unveil its lowest two-year inflation forecast in years. This is because, despite the tightness, two things are keeping a lid on economic activity: deteriorating business sentiment and the overseas risks from a slowing China. According to sources close to the bank, BoJ members are particularly concerned that weakness in Chinese demand could derail Japan's export-led recovery. This probably means they will maintain their dovish (low interest rates) stance for now.

Last month, BoJ members maintained their view that Japan would reach the elusive 2% inflation target in the second half of this year. In the April review, the likelihood of this scenario panning out – and what to do if it does not – will undoubtedly be the hot topic. Whatever the case, any signal towards tightening is very unlikely, even with the positive output gap.

For Japan overall, that is a big plus. While the economy has not been inspiring over the last few years, the BoJ's extraordinary policies have helped. Dependence on China has hurt the country recently, but importantly China's weakness has not yet hurt businesses' capital expenditure (capex) in Japan. And with the output gap pointing to a tight economy, there could be impetus for even more capex to increase productivity and overcome the tight labour market. That would be a huge positive.

The key point here is that, while the external side of the equation (China, global growth) has been unkind to Japan, the internal situation looks good. The labour market remains tight, businesses are willing to invest and – thanks to the BoJ – capital should stay available for a while. If China or the rest of the world see a turnaround of fortunes later in the year (which the BoJ banked on at its March meeting), Japan is very well poised to take advantage.

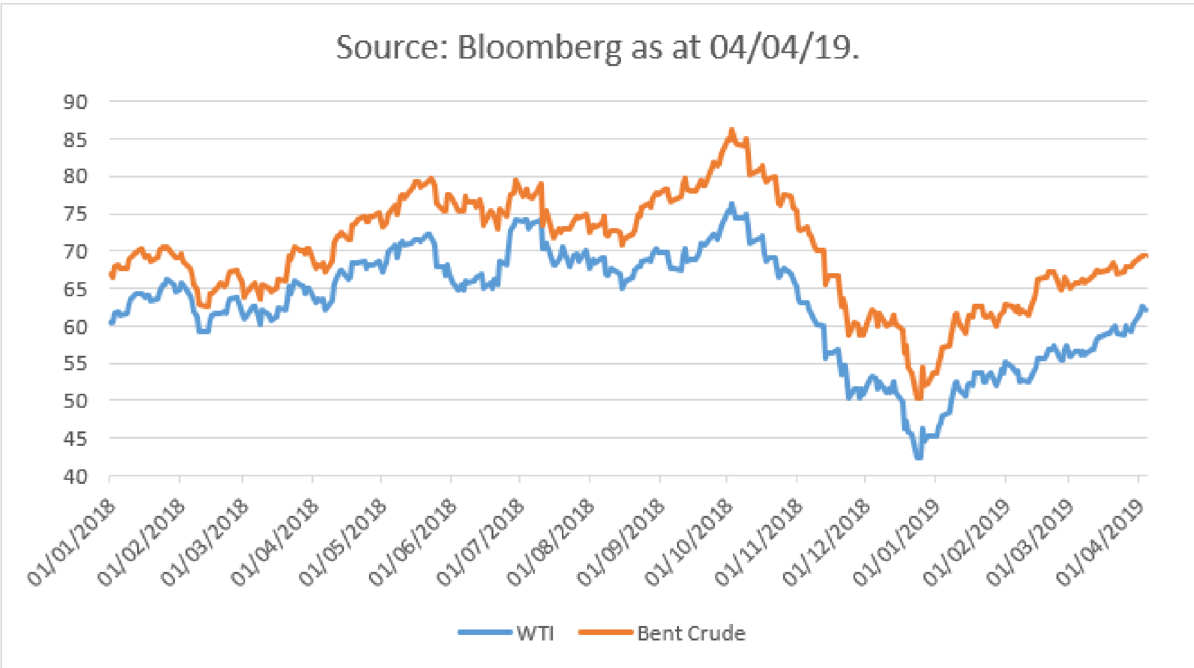
Unfortunately, as we have written here before, the prospects of that are a bit mixed. The government in Beijing is indeed running a hefty stimulus program to drag China out of the slowdown, and it could well be effective as we move into the end of the year. But unlike previous stimuli aimed heavily at industrial activity and the state-owned enterprises, the current measures are more focused on generating consumer demand and rebalancing the economy, which generates less external demand. As we wrote last week with regards to Europe, that makes Beijing's measures less beneficial for the traditional exporters to China.

Nevertheless, increased consumer demand from China should be of some help for Japan. And given its healthy internal situation, that makes us positive on Japan. Unlike the EU, it is not plagued with as many structural or political issues. And unlike the US, it is not coming off the boil from a bout of high growth. That makes us think that, despite some mixed data recently, Japan might well be in for a good year.

Oil in the headlines - again

Regular readers will know that we cover changes in the oil price quite frequently, due to the commodity's standing as a key macro-economic variable that has the power to both propel and slow the global economy.

Last year, after a period of somewhat moderate oil prices around the $50 per barrel (/bbl) mark, oil prices rose to over $75/bbl, only to then even more quickly decline back to $45/bbl. Oil speculators had once again misread the global supply and demand developments and caused unhelpful price volatility for the global economy – and losses for themselves. We suggested back then that there was little to suggest that the oil price would once again collapse as it had done in early 2016, but would instead gradually



return to its previous trading range.

Since the beginning of the year, oil has risen swiftly and investors are once again wondering whether we might see oil back at the $100/bbl level which caused so many problems between 2011 and 2014

The main driver of the rally has been expectation of a tightening supply side, with political and policy volatility seen in both Saudi Arabia and Venezuela. Saudi Arabia pushed hard to have OPEC's meeting brought forward to June, where the restoration of last year's output cut will probably be discussed. Meanwhile, the political and economic crisis in Venezuela goes on unabated. The country with the largest known oil reserves is still suffering from energy cuts.

This week, news from the demand side has also helped to push up speculative demand. A sharp rise in Chinese PMI manufacturing data this week (which saw its biggest increase since 2012) coupled with positivity around the US-China trade talks, helped fuel the latest ramp-up in the price of oil. Meanwhile, we have already seen the previous over-supply evaporate after a seasonal downturn in US crude inventories.

However, we think this rally may end sooner rather than later. Beyond the geopolitical tug-of-war, other factors are changing that could see oil prices reach a peak in the near term. Markets have priced in more supportive prospects for oil, just as we are beginning to see some less supportive news come out. For example, despite the downturn in US inventories, the infrastructural bottleneck that capped US output growth last year has largely disappeared. So, just as back in 2013/2014, we are likely to see US fracking oil fields becoming major swing suppliers again. And they are highly flexible with respect to marginal demand changes.

Unless we see a significant upward change in the economic outlook, it is hard to see how any additional positive news can occur that has not already been taken into account in the current oil price. Instead, there are early signs that headwinds are building that could limit its potential upside. For example, the International Energy Agency (IEA) has started to issue downgrades to the oil outlook in line with the weaker manufacturing PMI seen globally during Q1.

But even with a limited upside, we cannot expect to see any sudden falls either, given the stabilising impact of US shale which can be turned on and off very quickly. That means that overall, we may now be entering a period of consolidation, despite the significant returns witnessed during Q1 2019. This should also limit the impact of rising energy prices on inflation, providing another level of support to central banks such as ECB and the US Federal Reserve who have moved, once again, to a more dovish stance on interest rates.

What is also noticeable in the sector is the more focused engagement seen by companies and fund houses regarding energy. Royal Dutch Shell has announced that it is leaving one of the largest US oil industry groups due to conflicting views over climate policy. From next year, Shell is not renewing its membership of the American Fuel & Petrochemical Manufacturers (AFPM) Association, which represents nearly 300 US oil refiners and chemicals producers. The association is opposed to a carbon tax or other levies on greenhouse gas emissions, in contrast to Shell policy goals.

Over the medium term, the higher CO_2 awareness in the western world could lead to the oil price reducing its correlation with changing economic activity levels. However, this prospect lies far further ahead than the current oil price movements, which are for this year more likely to be dampened once again by US supply increases, rather than CO_2-driven demand reductions.

Knowing what's under the bonnet!

One of the many questions asked in today's Brexit turmoil is how the UK stock market continues to rally in lock step with other global stock markets, despite the biggest political crisis in decades.

Given how political uncertainty over Brexit has recently held back long-term business projects, it is not surprising that domestically-focused UK companies have underperformed those with overseas revenues since 2016. The main explanation offered for this has been the value of £-Sterling: the weak pound has boosted the value of overseas revenues relative to domestic ones. Undoubtedly, £-Sterling has been a sensitive barometer to Brexit sentiment, gaining when we seem to move towards a softer Brexit and losing when we move towards a harder one. With the significant overall fall in the UK's currency since the 2016 referendum, multi-national companies have benefited for a while now.

But as we head for a potential conclusion to the Brexit drama, it is also worth understanding the underlying strategies UK investment funds are employing that could be impacted by the Brexit outcome.

One way to view this is through the revenue exposure. The Investment Association sector definitions for UK equity funds only dictate that they must have at least 80% of total assets invested in UK listed companies, but they do not define any limits on where the revenue originates from. Therefore, there needs to be a further deep-dive analysis of UK funds' current holdings to get a clearer idea of their strategy.

Compared to the FTSE All Share index, 85% of UK equity funds (including UK equity income, large cap and flexi cap) have a higher revenue exposure than the index of 27.7%, which means that nearly 70% of revenues from stocks held in these funds are earned outside the UK. A fund that has holdings with a lower UK revenue exposure to the index or its peers is likely to be better positioned to deal with a hard or no Brexit (assuming the result also sees a further depreciation of £-Sterling). Equally, in a soft or remain scenario, a fund that has a higher domestic revenue exposure is more likely to outperform its peers and the index (assuming again that £-sterling appreciates). If Brexit is postponed for a long period, i.e. beyond a few months, expect the current underperformance of UK domestic-driven companies to continue.

Given the current level of uncertainty, one of the questions we are frequently asked is why we are no longer holding an underweight UK equity position. In short, UK investment assets have been discounted by international investors more than appears justified, given there is still a lot to be positive about regarding the UK economy. Putting aside the better-than-expected February UK manufacturing PMI data (with the rise mostly attributed to stockpiling ahead of the UK exit from Europe) there are other underlying factors that provide support to all three parts of the UK economy: the consumer, the government and business.

One of these supports is tax receipts. Current data suggests that, for the third year, growth in tax receipts has exceeded the growth in nominal GDP, based on self-assessed income tax. This, alongside record levels of employment and improvement in wage growth, points towards a healthy UK consumer who has pent-up spending potential. It obviously also has a positive impact on the government's public finances, with the money from tax receipts covering the day-to-day spending for the first time since 2002.

For businesses, a pickup in consumer spending could be a further positive. Businesses have also benefited from the reduction in the rate of corporation tax. What is not so clearly picked up in the UK data is the benefit to the economy from start-ups and small businesses. In a lot of cases, the biggest initial investment for these companies is people. Salaries are captured in the UK GDP data but until these companies begin to make money, the initial losses are accounted for as a negative contribution.

In 2012, the UK government launched the "Start-up loan scheme" which saw a record increase every year in new business start-ups: from 484,224 in 2012 to 657,790 in 2016. Despite a fall back in the number of new businesses between 2017 and 2018, there were 5.6 million small businesses in the UK at the start of 2018. Given the above-mentioned salary pre-funding, the contribution to the UK economy from these businesses is likely to have been underestimated. This should support the economy alongside more talked-about data such as the unemployment rate and the accommodative stance of the Bank of England.

There are trading uncertainties to be concerned about in the UK, but there is a strong economic base of small domestic and large multi-national businesses which should help growth despite the headwinds, and it will be like a coiled spring if and when the uncertainties subside.

For now, at Cambridge we have a neutral UK equity exposure and our fund selection also offers a neutral stance regarding our UK funds revenue exposure, which we believe is the most adequate positioning given the prevailing balance of opportunities and risks. With such an uncertain future, having a neutral weighting and waiting to see what the results are can be a more prudent stance, especially as one of the key goals of investing is also guardianship of clients' capital. What is also clear is that there is enough resilience and pent-up opportunity in the economy to justify not currently having an underweight position in this asset class. We are glad that, thus far, the relative performance of UK risk assets has proven us right, ever since last summer, when we took off our previous portfolio underweight position in UK equities.

CAMBRIDGE
INVESTMENTS LIMITED

8th April 2019

Global Equity Markets

MARKET	FRI, 16:30	% 1 WEEK*	1 W	TECHNICAL
FTSE 100	7446.9	2.3	167.7	→
FTSE 250	19538.3	2.2	420.8	→
FTSE AS	4067.4	2.2	89.2	→
FTSE Small	5521.5	1.0	55.2	→
CAC	5476.2	2.3	125.7	→
DAX	12009.8	4.2	483.7	→
Dow	26414.4	1.9	485.7	→
S&P 500	2889.6	1.9	55.2	→
Nasdaq	7573.6	2.6	194.8	→
Nikkei	21807.5	2.8	601.7	→
MSCI World	2142.8	1.7	35.0	→
MSCI EM	1080.7	2.1	22.6	→

Global Equity Market - Valuations

MARKET	DIV YLD %	LTM** PE	NTM*** PE	10Y AVG
FTSE 100	4.8	17.5	13	13.3
FTSE 250	3.2	24.6	13.5	14.1
FTSE AS	4.5	18.5	13	13.4
FTSE Small	3.9	80.3	10.7	14
CAC	3.2	18.4	14.2	13.4
DAX	3.1	15.1	13.2	12.6
Dow	2.2	16.7	16	14.9
S&P 500	1.9	19	17.4	15.9
Nasdaq	1.0	24	21.1	17.8
Nikkei	2.1	16	15	18.7
MSCI World	2.5	17.7	15.9	15.2
MSCI EM	2.7	13.2	12.7	12.1

Top 5 Gainers / Top 5 Losers

COMPANY	%	COMPANY	%
NMC Health	10.6	EasyJet	-5.2
Hargreaves Lansdown	10.4	Direct Line Insurance	-3.6
Smurfit Kappa Group	9.7	Centrica	-3.1
Ashtead Group	9.7	SSE	-2.6
Prudential	9.3	British American Tob	-2.3

Currencies / Commodities

PRICE	LAST	%1W	CMDTY	LAST	%1W
USD/GBP	1.30	-0.20	OIL	70.0	2.3
USD/EUR	1.12	0.01	GOLD	1292.1	0.0
JPY/USD	111.72	-0.77	SILVER	15.1	0.1
GBP/EUR	0.86	-0.20	COPPER	289.2	-1.5
CNY/USD	6.72	0.33	ALUMIN	1895.0	-0.4

Fixed Income

GOVT BOND	%YIELD	% 1W	1 W YIELD
UK 10-Yr	1.116	11.6	0.12
US 10-Yr	2.503	4.1	0.10
French 10-Yr	0.362	13.8	0.04
German 10-Yr	0.007	110.0	0.08
Japanese 10-Yr	-0.029	64.2	0.05

UK Mortgage Rates

MORTGAGE BENCHMARK RATES	RATE %
Base Rate Tracker	2.57
2-yr Fixed Rate	1.68
3-yr Fixed Rate	2.00
5-yr Fixed Rate	2.04
Standard Variable	4.27
10-yr Fixed Rate	2.58

* 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!

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

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.

Lothar Mentel