# THE **CAMBRIDGE** WEEKLY

## 25 March 2019


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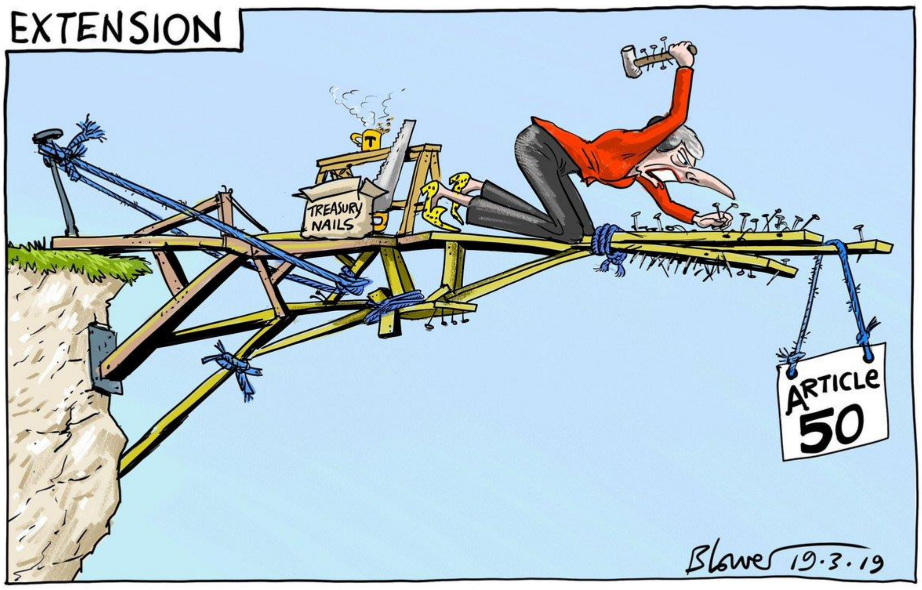



*Patrick Blower - T May's precarious Brexit extension*

## Brinkmanship and extensions

Every few months, I spend a few days of the week travelling across the UK with Cambridge's relationship management team updating regional gatherings of financial advisers. This time around, it was not surprising to find most of the conference rooms filled with anxiety about the risk that Brexit may bring to their clients' investments. Our market update presentation only touched on Brexit towards the end, where we had somewhat reluctantly dedicated a slide to the possible investment outcomes of various scenarios. But we put most attention on the latest global monetary and economic developments.

It may seem imprudent to UK investors that we are seemingly so blasé about the heightening political Brexit drama, and spend much more time watching the latest data points from China's economy, and studying in far more detail the latest policy releases from the US central bank, the Federal Reserve (US Fed). In a private capacity, that is certainly not true in my case, particularly when you have strong roots in both the UK and the European mainland.

Compared to the wider investment community however, our concern over Brexit outcomes is higher than average. That is what it looks like from currency and stock markets at least, which reacted so much more to the latest economic assessment of the US Fed than to the UK seemingly drifting closer and closer towards a disorderly Brexit. £-Sterling lost comparatively little on the disconcerting news that the UK Prime Minister and EU27 leaders had agreed to what at first seemed like a blackmail of Parliament to either agree the government's exit treaty (which they had already overwhelmingly rejected twice) or face a disorderly Brexit that would hurt the UK's short-term economic health and wealth very considerably.

The fact of the matter is that the EU's granting of the Brexit deadline extension and in case 'the deal' is rejected a third time, permitting Parliament to take control to find an alternative solution supports professional investors' view that, when push comes to shove, a majority of MP's will support whichever motion will cause the least harm to their country and constituents. It appears almost not to matter whether in the end this means that 'the deal' somehow passes when presented for the third time, or whether Parliament itself takes control of the further process and forces a lengthy Brexit rethink by taking up the EU's offer to pursue a  different exit route. Importantly, even before the deadline extension, capital markets have displayed astonishing confidence that a disorderly Brexit will be averted.

Unfortunately, capital markets do not have a crystal ball and, as the Greek Euro crisis of spring 2015 proved, they are not always as proficient in foreseeing political developments as their players may want to believe. This time, the probability that they are correctly anticipating that the two sides will not push the conflict over the precipice (not even temporarily as the EU did in the case of Greece in May 2015) is much higher, given that – compared to then – so much more is at stake for so many more voters across the EU. A massive pan-European crisis just weeks before the European parliament elections in May 2019, and a recessionary shock which would cause unnecessary hardship on both sides, seem irrational.

Whether the Brexit-opposing majority of the UK's political class (as well as the business and academic community) will dare to force the UK public into a lengthy rethink of their 2016 Brexit vote, or will defer such debate to the coming two years of trade negotiations under provision of 'the deal' framework, is currently unclear. Despite all the very unnerving brinkmanship and shouting from all sides, it looks like we are heading for a softer Brexit than many thought possible, even if the small risk of a crash Brexit has ever so slightly increased (as the clock runs down and the margin for error gets smaller).

We will end our assessment of the Brexit risk here, but would like to point out that thus far both our prediction that the decision would be taken right to the wire and that March 29 would not mark the Brexit date have so far proven correct.

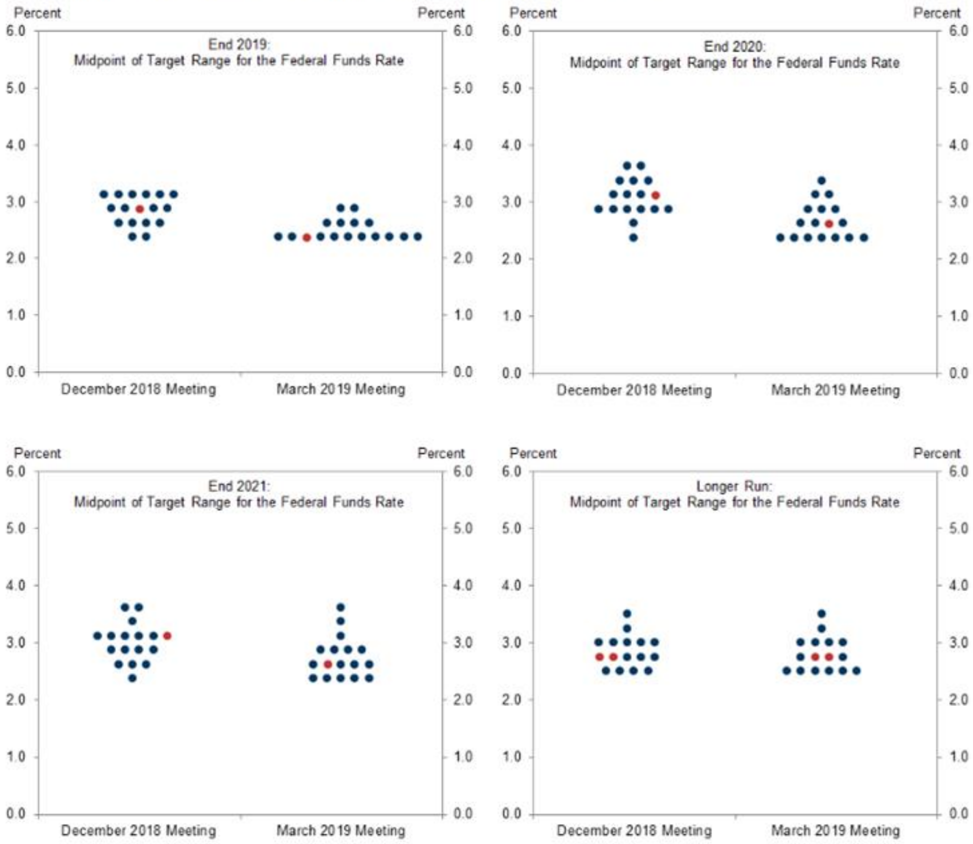
The more important 'extension' from an investor's perspective had nothing to do with Brexit but instead the US Fed's decision to return to a less restrictive monetary policy than had been followed for the past two years, and thereby 'extend' the era of low(ish) interest rates. It may look like a normal dovish turn, but their pausing of further interest rate rises and liquidity withdrawal (by 'retiring' money through QT sales of government bonds they had bought under their QE program) amount to a fundamental policy shift. In light of continued tight labour markets and the resultant upward wage pressures, the Fed is signalling that they are now more focused on stimulating economic growth than preventing future inflation.

After more than 30 years, this is very significant for investors. It has the potential to re-accelerate US economic growth and to weaken the US$ enough to stimulate global trade, after the 2018 slowdown it suffered from a strengthening dollar and hawkish Fed. That stock markets fell in the aftermath on Friday, erasing the week's gains and a bit more, was a consequence of the Fed's lower US growth forecast, which coincided with evidence from Europe and the US that the economy is indeed slowing. As usual, it will take the 'fast brigade' a little longer to get their heads around major policy changes. But initially, all change seems unnerving.

## US Fed's change of course perhaps more fundamental than expected

The Federal Reserve surprised markets on Wednesday by announcing that they no longer expect any more rate rises this year, and only one next year. At the end of their two-day meeting in Washington, members of the Federal Open Markets Committee (FOMC) voted unanimously to keep rates in the 2.25-2.5% range – as widely expected – but made waves by significantly changing their "dots plot ", a setting-out of where each member expects their policy rate to be at points in the future.

**The Median Dot Now Shows No Hikes in 2019 and 1 Hike in 2020**




Note: Red dots denote median.

Source: Federal Reserve Board, Goldman Sachs Global Investment Research

The huge dovish shift was prompted by waning growth in the US and worldwide, and increasing scepticism about the direction of the economy. Just six months ago, Fed policy seemed to suggest a return to the 'old normal', where inflation would pick up again, spurred by growth, and thus require higher rates to prevent overheating. Now the situation looks entirely different. Neither actual nor expected inflation has risen. Despite unemployment falling to near record lows, the members of the FOMC worry they could undershoot the 2% inflation target again.

All of this has forced the Fed to reconsider not just its current outlook for the US economy, but what effect its monetary policy framework is having.

Criticism had been aplenty for a while from differing viewpoints. Some point out that, over the last decade, extraordinarily accommodative monetary policy (historically low rates and abundant liquidity through central bank asset purchases - QE) may have inflated asset prices and interest rate-sensitive sectors without clearly achieving any real inflationary pressure,

Others say that the Fed, the ECB and others have habitually reacted too quickly over a long period to potential inflation, setting rates at a level which holds down not just inflation but also growth over the long-term.

In particular, detractors have characterised the Fed as being overly sensitive to wage inflation. According to standard economic theory, tightness in the labour market should lead to higher wages (the Phillips curve model), which then feeds back into price inflation as producers hike the prices of their goods in order to defend their profit margins against the higher input costs caused by the rise in labour expenses. This has historically created self-enforcing inflation expectations that lead to ever rising rates of inflation. Wage rises are only "allowable" , i.e.. do not automatically push up inflation, if workers' demands are offset by increases in productivity which keep the overall cost of production stable. So, if wages go up without any near-term productivity increase, the central bank has to raise interest rates in order to decelerate the rate of economic growth by encouraging more saving and less borrowing, which in turn reduces the demand for labour.

The tricky issue in this is that productivity-enhancing business investment (usually referred to as capital expenditure or "capex") will only go up if there is enough incentive to invest. Capex depends on funding costs remaining relatively low and a relatively certain business outlook for the future at the same time as wages reaching the tipping point which will make capex worthwhile. But if the political environment creates uncertainty in the business outlook (think trade wars/Brexit) and the central bank raises rates (and therefore financing costs) every time wages start to grow, we get the opposite scenario. Why would you pay to purchase new machines when funding costs are high, the payback is uncertain and additional workers can achieve increased production in the short term at a similar unit cost?

This presents a real problem for central bankers. Their current framework tells them that labour market tightness will lead to runaway inflation if left unchecked. But reacting to that tightness while political uncertainty undermines longer term investment payback expectations can scupper productivity – the only impetus for real growth – and lead to stagnation. We believe that these considerations are largely what has prompted the Fed to make such a dramatic shift. The rate setters are not just changing their current view: they are changing the reaction *function*.

In other words, we think the FOMC has become more dovish not just because of their outlook but probably because of a shift in their framework. This latest shift is a signal that labour market tightness will be tolerated even if it leads to wage inflation. Indeed, they will hope that it will lead to wage inflation. The Fed is acknowledging that the balance of risks means that inflation should run hot to get the wider economy going.

The Fed is also acknowledging their relative lack of knowledge. In the past, policymakers had more information about the economy available to them than any other market participants. That often led to investors reading Fed signals as signals about the economy itself. But with technological increases making research widely available, that's no longer the case. Fed chairman Jay Powell already signalled this some time ago by repeatedly stressing that monetary policy would be responsive to both incoming data and market-based signals, and would not just proceed according to the FOMC's preordained plan. The market changes its longer-term view to fit the current data and expected scenarios. What does the Fed know that we do not? According to them, not a lot.

Many say that the Fed and other central banks should never have embarked on their QE bond-purchase programs. Meanwhile, quite a few say that the Fed's bond sales (QT) during 2018 played a large part in pushing up medium and long-term rates, which was key in slowing the economy more than expected. (There are some who say both…)

It is clear that the most interest rate-sensitive sectors – autos and housing – were the weakest areas of activity by the end of 2018. That's probably also why the Fed announced a pause to their bond sale program, which Powell had previously described as being on "automatic pilot".

The Fed will halt QT-driven sales of treasuries by September. That news has already caused both longer bonds and equities to rally, with yields falling 7-12 basis percentage points for bond maturities from 5 years out to 30. Crucially, real yields fell by more than nominal bonds, meaning that inflation expectations have increased (though admittedly not by much).

It is likely that the movement in bonds is a sign of things to come. If the Fed really is admitting it has no special knowledge and will react to incoming data the same as everyone else. That makes the outlook for bonds more volatile. It probably also indicates that the long-term expected equilibrium rates for growth and inflation will be settling quite a bit higher than current levels (if the Fed's policy is more successful) or quite a bit lower (if it is not), but not somewhere in the middle.

Meanwhile, for the medium-term, the path for yields could keep going lower as we figure out just how long the Fed is willing to keep interest rates substantially below nominal growth. This should compress shorter yields which would result in a steeper yield curve.

The other big question is how this will impact the US dollar. For a long period the dollar has been strong and expensive. $1 buys you less in the US than ¥111 buys in Japan – which is what has to be paid to buy $1. A more dovish Fed could see the value of the dollar drop significantly.

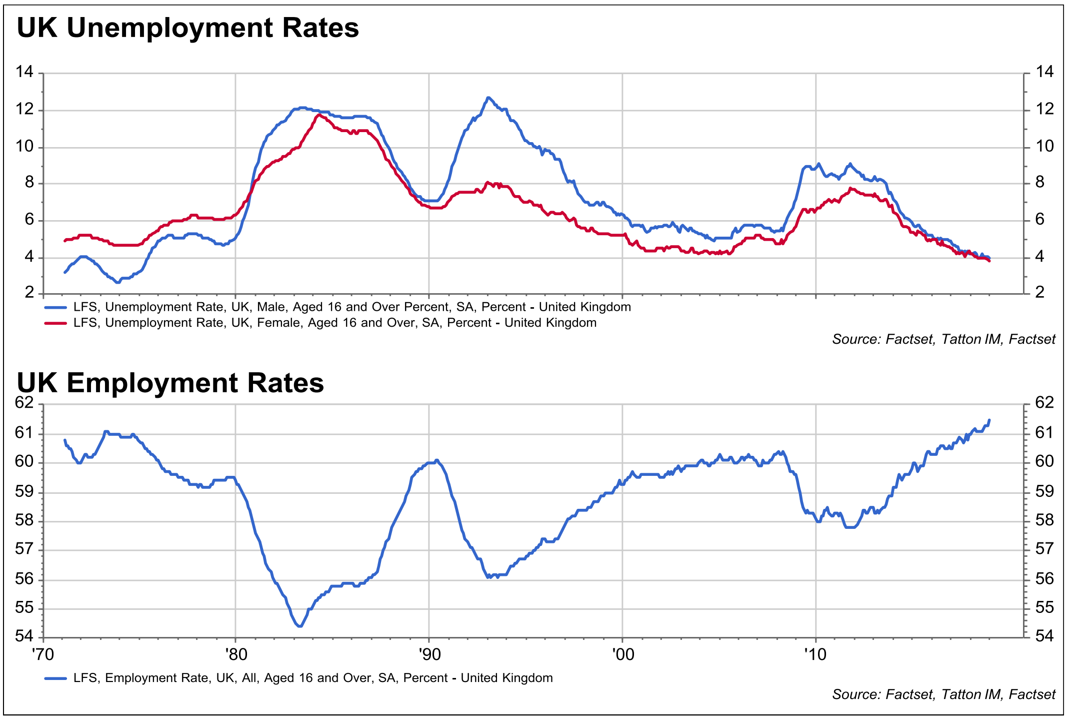
Both the currency and the bond markets have been more volatile immediately following the FOMC. The dollar fell (mostly against the Yen), while bond yields dropped sharply (-10 to -15bps). Should these moves gain momentum, it could actually force the Fed to raise rates later this year (against everyone's expectations), because a weaker dollar has the tendency to stimulate the economy and increase prices on imported goods. Such dollar weakness and rebounding US growth would be a very positive scenario for the rest of the world, especially emerging markets, who were seriously hurt by the dollar's previous strength.

With the Fed no longer deemed to be omniscient (decidedly a fallen god in some people's eyes), the bond and currency markets could be facing a prolonged period of volatility, while participants veer between markedly different scenarios. In itself that might add to uncertainties for risk assets.

However, an easier Fed policy framework is only a negative if the resulting interest moves are sharper over time – leading to non-responsiveness to economic conditions and a boom-bust outcome. The new framework seems to have responsiveness as a cornerstone. It should be a good thing.

# Brexit 2019: The Only Game in Town

This week's economic data tells us that Brexit pessimism has not yet hit the consumer. Compared to the dreary political backdrop, the economic news-flow has looked positively sunny. Unemployment has fallen to its lowest level in 44 years, personal tax receipts (for the start of the year) have been unexpectedly high, public sector borrowing has improved, and even UK retail – the perennial "dead man walking" – is not faring that badly. Sales volumes were up 0.4% over February (versus January), comfortably beating the

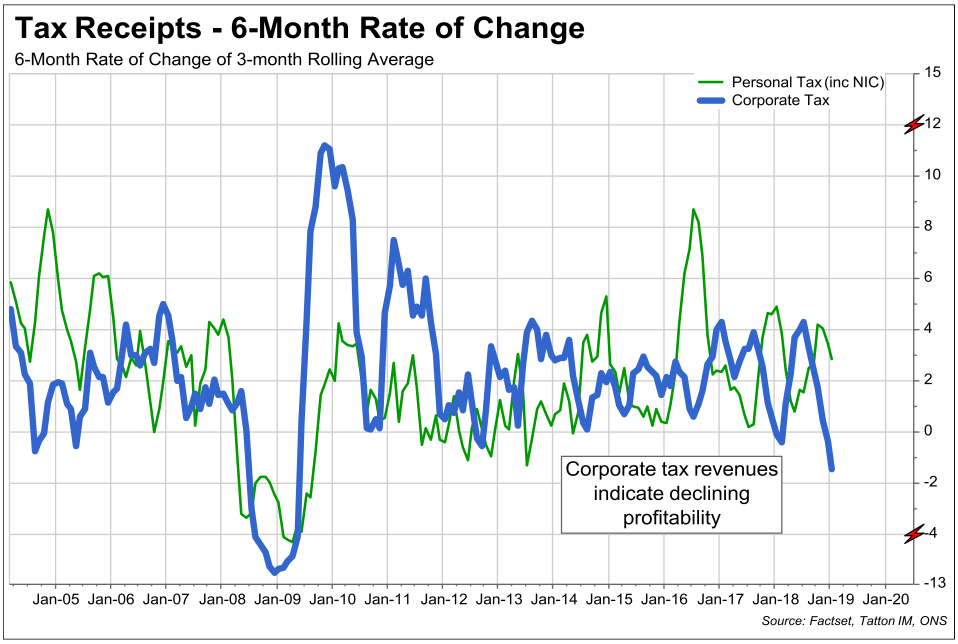



-0.4% analysts expected.

British consumers, whose spending accounts for around two thirds of UK GDP, do not seem to see any reason to change their shopping behaviours while the political walls are caving in around them – unless of course it is a consequence of pre-Brexit stock-piling. Their demand is being supported by a tight labour market which – according to our research providers – shows every sign of getting even tighter, while a recent drop-off in inflation has helped relative buying power. If credit conditions remain loose and – crucially – the economic peril of a no-deal Brexit is avoided, one might expect consumer demand to improve further.

There is a downside to the upbeat consumer behaviour, though: its effect on Britain's trade deficit. As we wrote last week, the UK's trade deficit (exports minus imports) gives us reason to think that sterling needs to weaken regardless of the Brexit outcome. Exports have stagnated while consumer demand is pushing up imports (especially with the EU), so the trade balance is widening further. This suggests to us that, even in the event of an economically positive Brexit outcome, it is hard to see any upside for sterling in the medium term. And if we do indeed fall off the no-deal cliff-edge, more sterling weakness is practically a certainty.

Not so positive is the evidence that companies are getting squeezed. While personal tax revenues show continued growth, corporate tax revenues have swung to a seasonally-adjusted decline (our calculation, shown in the next chart). It could be that profits are becoming more volatile amid the uncertainty and a fluctuating currency. In itself, volatility is not helpful and a downswing in corporate profitability just ahead




of more instability is even less helpful.

But none of this is getting much media airtime at the moment. In the UK there is only one subject dominating social media, the television, our papers, and taxi driver chit chat.

As Theresa May has dutifully informed us, we are all tired of it. Unfortunately, it won't go away any time soon. Because, despite being nearly three years since Britain voted to leave the EU, we are hardly any closer to knowing the outcome. What we do know is that a 29th March exit is no longer viable - though it realistically has not been for some time as we have explained here for some weeks. At the time of writing, European leaders have granted the Prime Minister a short (or very short) stay of execution for the UK depending on whether or not she can get Parliament behind her unloved deal at her third attempt.

Unlike most MPs she is adamant that an extension to Brexit cannot be any longer than three months. According to May, Britain must leave the EU on 22 May come hell or high water- or lose the trust of the British people forever. In her speech to the nation on Wednesday night, the Prime Minister presented Parliament with two exit routes: her way (the so-called Strasbourg agreement she negotiated) or the highway (no deal).

This ultimatum is supposed to serve two purposes: to pressure MPs into accepting her deal and to divert blame for a potential crash Brexit away from her and onto those playing "political games" (of which she is apparently not one). Unfortunately for May – and the entire country – neither of those goals seems to have been achieved.

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We wrote some time ago that the central risk for the UK is that political stalemate would lead us into a no-deal scenario that nobody wants. Without question, that risk has increased since last week.

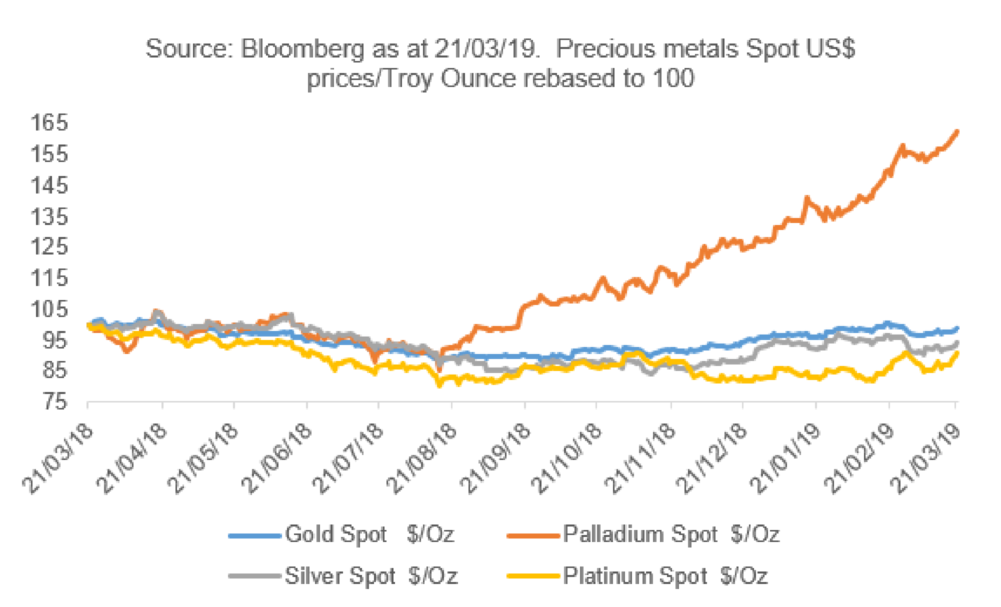
Parliament's motion 'ruling out' a no-deal Brexit made a longer extension (with a view to a renegotiation, second referendum or election) look likely. The Prime Minister's actions have all but scuppered those chances. But they also have not significantly helped the chances of her own deal. If MPs' reactions are anything to go by, she has only alienated them further by trying to pit the public against Parliament.

It is possible that May's rhetoric against MPs could unite Parliament against her in a bid to take control of Brexit proceedings. In that case, the full range of scenarios would open up again: a longer delay, a revoking of article 50, a second referendum, an election etc.

But those looking for MPs to sweep in and save the day should not get their hopes up. European leaders' condition for the granted extension is that Parliament approves the same deal that has been shot down twice already. According to France's foreign minister, no-deal Brexit has become a "central scenario". Whether these words are brinkmanship or not, we have to concede that the avoidance of a crash Brexit now depends – uncomfortably – on MPs preventing it.

Asset markets agree too. After showing some strength in recent weeks (due to Brexit looking softer and softer) £-sterling weakened 1.3% against the euro and 1% against the dollar following the news. This is especially significant considering that recent dovish announcements from the Federal Reserve put the dollar down about 1% on a trade-weighted basis. Average UK government bond yields also fell from 1.16% to 1.10%, with investors now slightly less sure of Britain's growth prospects post-Brexit.

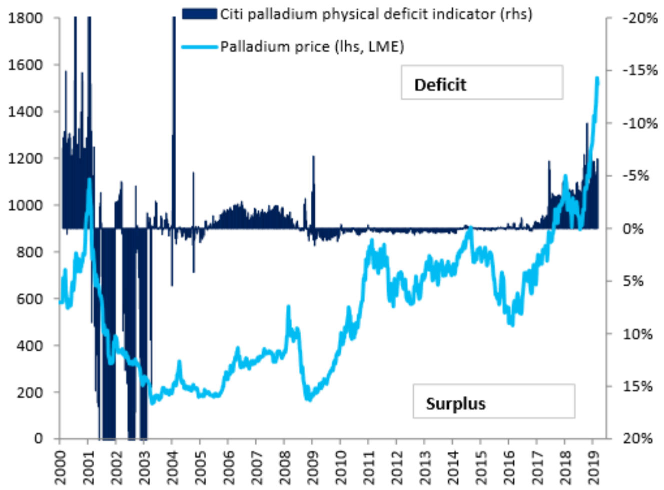
On balance, the UK's current economic position is mildly positive. But it will still be ignored by markets. This is because it does not matter how healthy you are when there's a sword dangling over your head, held only by a hair. On the Brexit front, things look as uncomfortable now as ever. We can only hope that no-deal brinkmanship is just that, but that makes each passing day riskier as the time-margin for error become ever tighter.




## A look at what's driving precious metals

Palladium's meteoric 62% surge over the past 12 months – soaring to a record high of $1600 an ounce – has left investors scratching their collective heads. Palladium's rise stands in stark contrast to small falls seen in the rest of the precious metals complex, like gold (-1%), platinum (-9%) and silver (-6%).

Global supply concerns and rising Chinese industrial demand appear to be behind palladium's price movements. The Chinese government's policy shift towards improving the environment and reducing airborne pollutive emissions, particularly from cars, has forced domestic producers into fitting more advanced catalytic converters that meet ever tougher emission regulations.




Source: LME, SHFE, CME, SMM, Citi Research

Continual gains over the past six months have enticed traders to buy palladium inventory, leading to a deficit of actual palladium. This has resulted in the tightest demand and supply balance in almost two decades, according to Citigroup's commodity desk.

Typically, industrial metal demand is strongly and positively correlated with global economic activity and the fortunes of the car industry. This makes palladium's negatively correlated rise (from tighter markets) more impressive. It came against a backdrop of general weakness in risk asset prices, wider macro data and falling car sales during 2018.

Price increases come as a welcome relief for palladium producers, who have faced a challenging environment over the past decade. The rally has pushed producer profit margins to the highest level since 2011, but it usually takes some time for sustained producer confidence to return.

Some analysts already comment we should not expect to see producers lift output in the near term. Firstly, as noted above, these are the first stronger margins in some time and the industry is still reeling from an extended period of low profitability and will therefore be weighing the risks of capacity-increasing investment even more carefully.

Secondly, the lead time to expand production can often be measured in years, rather than months, pushing any response out in to the future. Production is highly concentrated in just two countries facing different issues: Russia (US sanctions) and South Africa (labour disputes and power disruptions), who collectively account for 85% of global production.

Additionally, Russia is mulling over a possible ban on precious scrap metal exports, potentially increasing supply/demand tightness and supporting prices. Russia alone accounts for 22% of all palladium output, led by company NorNickel.

Higher palladium prices have heaped extra costs on the global auto sector – already under pressure as consumers are delaying purchases, perhaps confused by new emission regulations. Falling auto sales appear not to have negatively impacted palladium prices, as tight global supplies have supported pricing.

The rally in palladium prices has increased costs for auto makers by an estimated $5.4 billion globally. As a quick reminder, palladium (46th on periodic table) is 30x rarer than gold (79th) and can absorb up to 90% of harmful emissions, making it popular for use in catalytic converters.

Higher prices are likely to incentivise substitution with platinum (78th), which is cheaper on a relative basis, while being chemically similar to palladium (it's part of the platinum group of metals – PGM). Such a move could save car makers around $3.5 billion globally and result in lower palladium prices longer-term.

But before anyone gets too excited about the short-term prospects for platinum prices, it typically takes 2-3 years for substitution to significantly impact supplies here as well.

Platinum supplies are currently well balanced, erring on the side of surpluses. So, we wouldn't be surprised to see early news of possible substitution providing some positive support for platinum, or at least taking some of the palladium price premium out of the market.

The fact remains that the physical palladium market remains tight and could take some years for substitution to bite. However, the longer higher prices persist, the more the threat of substitution rises. And any such move would need to be of the order of around 5-10% of global usage by automakers to start demand/supply rebalancing.

The dynamics of zinc prices during 2018 give us some idea of what could be in store for palladium. Zinc prices declined over 30% on weakening demand over the summer last year, despite supplies of zinc remaining in deficit.

Palladium's movements are also a warning for investors. Commodity markets often have their own distinct pricing fundamentals, making the investment case for such assets more opaque. Prices can move suddenly and unexpectedly, exacerbated by rapid shifts in 'hot money' chasing the price movements. Price shifts can be especially brutal if any underlying drivers and macro/risk asset-correlations quickly flip.

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## Global Equity Markets

| MARKET | FRI, 16:30 | % 1 WEEK* | 1 W | TECHNICAL |
|---|---|---|---|---|
| FTSE 100 | 7207.6 | -0.3 | -20.7 | ↘ |
| FTSE 250 | 18998.5 | -2.5 | -492.6 | ↘ |
| FTSE AS | 3942.6 | -0.6 | -25.7 | ↘ |
| FTSE Small | 5458.4 | -0.5 | -26.1 | ↘ |
| CAC | 5269.9 | -2.5 | -135.4 | ↘ |
| DAX | 11364.2 | -2.8 | -321.5 | ↘ |
| Dow | 25612.0 | -0.9 | -236.9 | ↘ |
| S&P 500 | 2809.2 | -0.5 | -13.3 | ↘ |
| Nasdaq | 7379.7 | 1.0 | 72.8 | ↘ |
| Nikkei | 21627.3 | 1.6 | 340.3 | ↘ |
| MSCI World | 2127.9 | 0.9 | 19.2 | ↘ |
| MSCI EM | 1069.7 | 1.2 | 12.4 | ↘ |

## Global Equity Market - Valuations

| MARKET | DIV YLD % | LTM** PE | NTM*** PE | 10Y AVG |
|---|---|---|---|---|
| FTSE 100 | 4.9 | 17.0x | 12.8x | 13.2x |
| FTSE 250 | 3.4 | 23.0x | 13.3x | 14.1x |
| FTSE AS | 4.7 | 17.9x | 12.9x | 13.4x |
| FTSE Small | 3.9 | 65.5x | 11.4x | 14.0x |
| CAC | 3.3 | 17.7x | 13.7x | 13.4x |
| DAX | 3.2 | 15.0x | 12.5x | 12.6x |
| Dow | 2.3 | 16.3x | 15.6x | 15.0x |
| S&P 500 | 2 | 18.6x | 16.9x | 15.9x |
| Nasdaq | 1.1 | 23.4x | 20.5x | 17.8x |
| Nikkei | 2.1 | 16.0x | 15.8x | 19.0x |
| MSCI World | 2.5 | 17.6x | 15.8x | 15.2x |
| MSCI EM | 2.7 | 13.1x | 12.7x | 12.1x |

## Top 5 Gainers / Top 5 Losers

| COMPANY | % | COMPANY | % |
|---|---|---|---|
| Ocado Group | 9.8 | NMC Health | -8.7 |
| Hikma Pharma | 7.6 | easyJet | -8.1 |
| J Sainsbury | 5.8 | RBS | -7.7 |
| DCC | 3.6 | Persimmon | -6.8 |
| GlaxoSmithKline | 3.6 | Barclays | -6.3 |

## Currencies / Commodities

| PRICE | LAST | %1W | CMDTY | LAST | %1W |
|---|---|---|---|---|---|
| USD/GBP | 1.32 | -0.74 | OIL | 66.3 | -1.3 |
| USD/EUR | 1.13 | -0.34 | GOLD | 1312.3 | 0.8 |
| JPY/USD | 109.97 | 1.37 | SILVER | 15.4 | 0.8 |
| GBP/EUR | 0.86 | -0.43 | COPPER | 283.5 | -2.4 |
| CNY/USD | 6.72 | -0.07 | ALUMIN | 1899.5 | -0.2 |

## Fixed Income

| GOVT BOND | %YIELD | % 1W | 1 W YIELD |
|---|---|---|---|
| UK 10-Yr | 1.0 | -16.3 | -0.20 |
| US 10-Yr | 2.5 | -5.2 | -0.14 |
| French 10-Yr | 0.4 | -22.9 | -0.11 |
| German 10-Yr | 0.0 | -117.9 | -0.10 |
| Japanese 10-Yr | -0.1 | -102.9 | -0.04 |

## UK Mortgage Rates

| MORTGAGE BENCHMARK RATES | RATE % |
|---|---|
| Base Rate Tracker | 2.53 |
| 2-yr Fixed Rate | 1.73 |
| 3-yr Fixed Rate | 1.93 |
| 5-yr Fixed Rate | 2.05 |
| Standard Variable | 4.31 |
| 10-yr Fixed Rate | 2.48 |

* 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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**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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