THE **CAMBRIDGE** WEEKLY

30 September 2019

Lothar Mentel

Lead Investment Adviser to Cambridge

Source: Hedgeye, US$ strength becoming a global economic drag 20 Sep 2019

Ominous US-Dollar strength

The unprecedented events unfolding in UK politics this week will have distracted many UK investors from developments in the wider world. But those global developments may well carry far greater significance for near-term return developments than the latest ructions in Westminster.

One of the week's most notable trends has been the strength of the US$. The dollar has gained around 1.2% against the €-Euro since the end of last week alone, and a similar amount against most other major currencies (with the notable exception of the Japanese ¥en). That strength is a continuation of what we have we seen since the beginning of the year: the US$ index – measuring the dollar against a basket of other currencies – is up over 3% since the start of 2019. And it comes despite the fact that the Federal Reserve has cut its interest rate twice this year already (which, all else being equal, should draw capital away from the US).

The strength over the year despite the Fed's rate cuts is likely a reflection of markets' sentiment on the global economy, which has slowed more markedly than the US economy. But the recent bump-up could be an even more worrying sign. A great deal of global financing is done in dollars, so when companies need to service or rollover their debt, it leads to greater demand for the currency. In times of stress – when refinancing debt becomes difficult as lenders are unwilling to extend credit – struggling businesses or banks may be forced to buy dollars to cover their positions, rather than borrow.

That feeds into one of our observations and articles of last week: the unexpected spike in US repo rates. We wrote that the spike in the rate at which banks borrow from one another could well be a sign of stress in the US or global financial system, as the Fed was unable to meet the short-term cash requirements of financial institutions. Many commentators put the episode down to quirks in the financial system: important tax dates in the US, a reduced Fed balance sheet and a swathe of new US treasury bonds needing to be absorbed by the market.

But it was enough for the Fed to decide they needed to intervene, by injecting considerable amounts of liquidity through their open market operations. The crucial thing to note now is that those operations have had to continue through to this week. And what's more, they have been oversubscribed nearly every day. This suggests that the need for dollars is even greater than it looked last week – that there really is stress in the financial system after all.

These episodes usually happen when one or several financial institutions face significant pressure. And as we wrote last week, the culprits may well be in China, not the US. The difficulties that Chinese banks are facing are clear to see – with the government's deleveraging efforts and the country's increasingly severe economic slowdown putting them under strain. Defaults or government takeovers among the smaller regional banks are becoming more common. If anyone is in dire need of short-term funding, it is likely to be them.

But even so, the explanation might not be so frightening after all. Next week is China's national day – marking the 70th anniversary of the establishment of the People's Republic. The country is set for an extended holiday break, meaning that the business and financial timetable for this week is similar to what we experienced at the end of the year. It could be that banks need to cover their positions before the extended break and that, once the holiday is over, things will return to normal. But we will not know until next week or the week after. Seeing how things develop in that time will be crucial.

For now, we will have to catalogue it with the other distress signals in the economy. One of the most notable of those is the worrying rise in company defaults and financial difficulties. A number of high-profile stories have emerged recently, from the collapse of holidaymaker Thomas Cook to WeWork's IPO being put on ice (and, this week, their celebrity CEO Adam Neumann being fired). According to certain reports, even luxury carmaker Aston Martin is facing severe problems, with rumours swirling of an upcoming default. All these companies have their own reasons for coming under pressure, but we should be acutely aware of how quickly specific problems can snowball into economy-wide ones – particularly at a time when markets are scrambling for dollar funding.

Worse still is that these issues are playing out against a backdrop of less-than-stellar economic data. This week's drop off in PMIs (measuring business sentiment) for the services sector suggests that the previous struggles in manufacturing may be spreading and impacting consumer sentiment. The underlying economic troubles should not be overstated, but they do suggest fragility, where a shock, financial or otherwise, could tip the balance into negative territory.

That is why policy is now in focus more than ever. Monetary policy on its own seems to have exhausted its effectiveness – as now publicly acknowledged by central bankers themselves. A boost from fiscal or trade policy is now needed more than ever if the global economy is to get back on track. In the UK, that would be some form of Brexit resolution – and preferably a good one. On that, we cannot say much more than has already been said by others: what happens will depend on the outcome of an election that now looks inevitable, where either a Conservative or Labour-led coalition government seems the most likely result.

For the rest of the world, the focus is much more on Donald Trump's trade wars. A trade deal being struck between the US and China could be just the thing needed to pull up business and market sentiment – to the benefit of the global economy. So, we take heart in the positive signs coming from Beijing, as well as the pre-agreement of a trade deal between the US and Japan. But it is not all good news: how the impeachment procedure against President Trump and upcoming military demonstrations in China will affect negotiations is hard to say. We talk about these issues in more detail in a separate article below.

Quantum computing breakthrough: supremacy achieved

Away from the usual market gyrations this week, something historic occurred in the computing world. Investors may come to remember 2019 as the birth of the quantum computing age, an era that could have profound longer-term implications for the global economy in terms of cryptography, computing power, telecommunications, finance, modelling and things we cannot yet imagine.

In a joint project with NASA, Google on Monday quietly announced it had achieved 'quantum supremacy'. In simple terms, supremacy means that a quantum computer has surpassed the regular computers found in your hand or on your desk today.

Google's 53 Qubit machine took just 200 seconds to "generate a set of binary digits and check their distribution was truly random". Performing the same calculation, even with all of Google's vast computing resources, would take the equivalent of 10,000 years and use up over 1 petawatt (10^{15} watts) of energy – about the same amount of energy found in the Gulf Stream, which keeps the UK's climate temperate.

While we should not expect to see quantum machines on our desks or in our hands anytime soon, Google's breakthrough is historic and profound. Much of the encryption that occurs over the internet for finance and shopping is at 256 bits. Scaling up Google's current 56 qubit machine to 256 might be two years away. But it would only take a quantum computer mere seconds to crack the encryption that underpins nearly $4 trillion of e-commerce transactions worldwide, to say nothing of other digital documents and government secrets, all of which could be easily bypassed. Quantum cryptography, in theory, is inherently secure, as only the particles or atoms entangled would receive any information.

Quantum computers could allow us to better model weather systems, create new materials, find medical treatments and cures, and run smart cities efficiently. Beyond the vast increase in computing power, quantum computing might also revolutionise communications with its capacity to overcome the delay lags of conventional means of communication.

Markets and investors may have simply missed Google's breakthrough this week. But make no mistake, the quantum age has begun. Its impact is unlikely to be felt immediately, but the next decade could bring vast changes to the global economy by opening entirely new investment opportunities. Let us not forget that just over two decades ago, Google did not exist, and 'search' was in its infancy. Today, the company is a global powerhouse and accounts for nearly 93% of all search volume worldwide. Spotting the opportunities of tomorrow may be as rewarding as the near 27% annualised return for Google itself.

All eyes on US – China trade truce

It was a disappointing week for economic news. Purchasing Managers' Indices (PMIs) – measuring business sentiment – were less than spectacular the world over. Particularly disappointing were the numbers for the services industry, which came in below expectations in the US and across the Eurozone. Manufacturing sentiment, which has long been languishing in contraction levels (below a 50 reading), actually registered a positive surprise. But the fall in services means the overall picture for businesses looks dreary.

This was perhaps to be expected. The slowdown in global growth hit manufacturers hard over the past year. Now, contagion is spreading to services, threatening to slow global activity even further. The crucial question, of course, is - what happens now?

The answer to that will depend heavily on what happens to demand – particularly business demand. With manufacturers' inventories having moved down (in response to the global slowdown) producers could see a bounce in orders if there is enough latent demand in the economy to deplete lower inventories. But, as we have written in previous weeks, the drop-off in profitability (as shown by the fall in producer price inflation) puts that in some doubt. And unless that final demand can materialise, things could well get worse.

For that reason, what happens next in the US-China trade war is of vital importance. Confidence is a key factor for demand, and Donald Trump's trade war has topped the list of concerns for businesses and investors (in the US at least) for nearly three years. If the world's two largest economies put pen to paper on a trade deal, both the markets and the underlying economy would be ripe for a step upwards, as pent-up demand is unleashed, and mothballed business investment projects are resurrected. If they do not (put pen to paper) it could lead to serious disappointment.

For the past month, markets have been moving up to near record levels on the back of trade optimism. And this week has seen more good news to fuel that uptrend. On Wednesday – just after signing a partial trade deal with Japan's Prime Minister – President Trump announced that a US-China trade deal "could happen sooner than you think". Meanwhile, the Chinese government has announced a tariff waiver for imports of US soybeans. Soybean levies were one of China's most significant retaliatory tariffs, but sources claimed this week that they will be suspended as a gesture of goodwill to US negotiators.

High-level negotiations are set to resume next month, where expectations will be high that an agreement, or at least some form of truce, can be reached. We have written before that the timing for a deal is good. Trump is heading into an election year with negative approval ratings and is in need of a political win. On the other side, the Chinese economy is in the midst of an almighty slowdown with no clear end in sight – despite substantial support measures from the government. In terms of economic interests, the incentive for trade armistice is strong.

Unfortunately, economic interests are far from the only factors at play. Negotiations over the past two and a half years have seen many false dawns, whether due to Trump's own inconsistency, conflicting interests in the White House or obstinacy from Beijing. It is too soon to think that this time will be different. While China-hardliner John Bolton has now left his post as National Security Adviser, Trump may still want to be seen as being tough on China – which would most likely play well with his electoral base, whatever the economic fallout.

And at the moment, the same is true for China. Next week will see the 70th anniversary celebration of the establishment of the People's Republic. Anniversary holidays are always big affairs, but the celebrations on Tuesday are expected to eclipse past years. In particular, there is bound to be a huge military parade – complete with a show of new offensive technologies.

If China is focused on showing off its military strength, it could be harder for Trump to spin trade negotiations as a positive. Painting China as the enemy – just as it tries to show off its capabilities – would play well into Trump's preferred image as a strong leader. It could also provide a welcome distraction from the impeachment procedure which the congressional Democrats have begun against the President.

All of these factors mean that the likelihood of a trade deal in the short term is finely balanced. The incentives are there for both sides, but so is the temptation to ignore them. We will know better in the next few weeks which way the pendulum is swinging.

As mentioned above, the consequences of no agreement being reached are unlikely to be good. But the consequences of a deal being struck could be very positive. One might think that the natural beneficiary of this would be the US – where economic data has consistently outperformed other major regions for some time. Indeed, good economic fundamentals and a positive trade surprise make for a good mix.

Interestingly, however, other regions could well benefit more. China's economy certainly seems to have suffered more from the trade war than the US's. Business sentiment and credit supply have been hit particularly hard. On that basis, it seems as though China has the most to gain from striking a trade deal. A lifting of tariffs could be the catalyst for a sustained turnaround in the world's second largest economy. And from its current position of weakness, one could argue China's economy has the most upside potential in the case of a trade deal.

The same logic could also apply to other emerging markets (EMs) and even the Eurozone – which have all been hit by China's slowing economy. A pickup in Chinese demand is always good news for EMs and the Eurozone. And like China, most EMs and Eurozone countries would be starting from a position of weakness relative to the US – meaning they could again have a higher upside.

Whatever happens, a resolution to the US-China trade war would be a big positive for markets and the economy, but as discussed, there are many reasons which prevent us from developing conviction that it will actually happen. For now, not just us, but the global capital markets as a whole hold their breath.

Insight article: Property investing

Because of the slow nature of property sales, open-ended property funds are among the most illiquid "liquid" funds around. This, unfortunately, can lead to rapid declines when investors get scared.

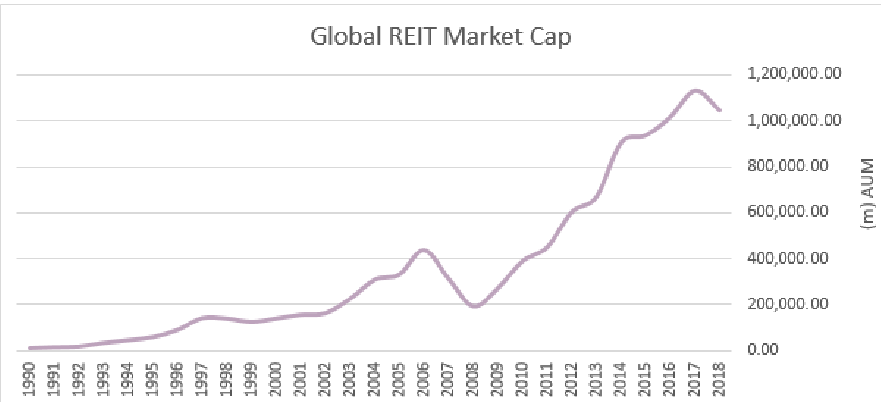
That is exactly what has happened this year, with UK property funds seeing outflows of around £2.2 billion in the first seven months. £417 million of that came in July alone. But interestingly, two funds accounted for 89% of July's outflows.

Recently, the outflows at one of the funds turned into a torrent. The manager ended up blocking redemptions ("gating") after the cash ran out, and offloading properties, including retail parks, offices and industrial property. Selling the assets in these funds at respectable prices (and not dumping them in a fire-sale) can take months. And the last gating happened only recently, after the June 2016 Brexit vote, when commercial real estate in the City of London crashed 6% and six commercial real estate funds suspended redemptions for months.

Since that episode, the FCA has said that if 20% of the portfolio's value is doubtful, gating should be automatic. As a strategy, some open-ended property funds are penalising investors who cash in their holdings by swinging fund prices from "offer" to "bid" more quickly, leaving investors who dare to sell the fund shouldering an average instant loss of around 6%. It is not because the value of the holdings changes (although that can be a consequence later) but that the fund becomes more like a closed-ended investment trust, trading at a discount to "book value".

Commercial property funds are also holding significantly more cash (19.5% up from 14.6% in 2016) in order to try serve as a buffer for these peaks in redemptions. But there are downsides to this. The increased cash buffer means there is less cash to invest in income-generating assets, which hampers returns through what we would refer to as 'cash drag'. Annualised average returns of this fund type were 4.4% over the three years to the end of June, down from 7.6% over the previous three years.

Real Estate Investment Trusts (REITs) offer an alternative to these strategies. REITs invest in property differently and have some distinct benefits over a private property fund. These benefits have made them one of the most common ways to invest in property globally, with a market capitalisation of $1.05tn.



Source: Reit.com

REITs are exempt from corporate tax, but are required to distribute over 90% of income as dividends. They yield twice as much as other stocks (US: 4.4% vs 2.2% - global: 5% vs 2.7%).

Because REITs are traded on equity exchanges, there is reasonable daily liquidity. They trade at varying discounts or premia to the book value (usually referred to as "net asset value" or NAV), and like the open-ended funds, during downturns, REITs have significant discounts. But at least investors know if the price is a relative-value bargain or not and, most importantly, they carry on trading.

There are structural differences. UK public property funds have little effective leverage, a consequence of the general regulatory framework. A good example is the Aviva Property PAIF. The fund's direct property holdings must not be mortgaged more than 20% at any time. It can hold indirect property via equity up to 40%, but generally has none. REITs on the other hand are geared, and levels can vary considerably. The typical levels are between 36-47%. The funds are generally focused investments, more like individual REITs.

A fund of REITs can bring significant diversification, and this is true of the iShares UK Property UCITS Exchange-Traded Fund (ETF). It has 25% in property company equity, the other 75% being the largest UK

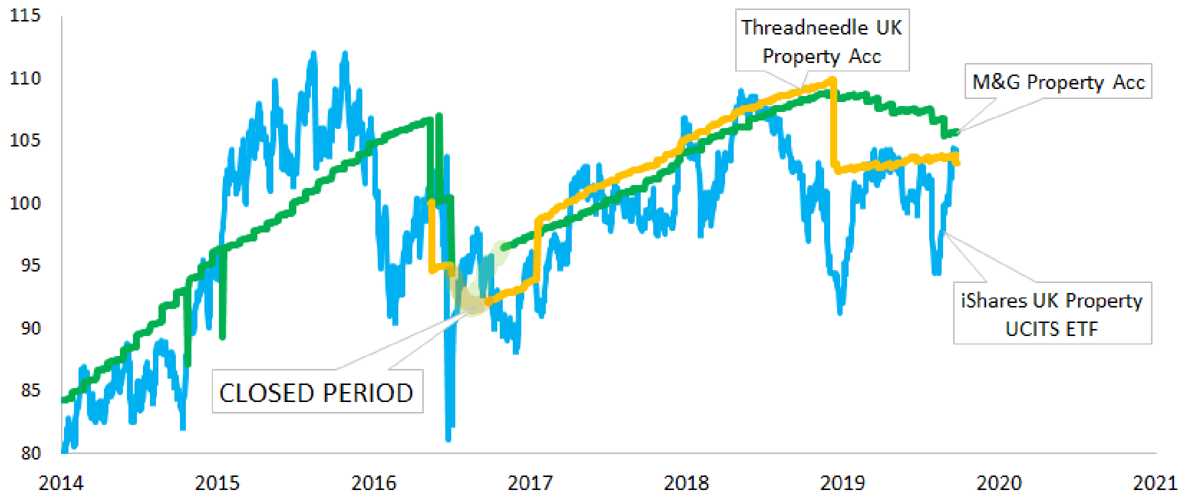
Total	£45,134	73.4
REIT	Market Cap	Weight (%)
SEGRO plc	£8,846	15.07
Land Securities Group PLC	£6,338	10.49
British Land Company PLC	£5,317	9.26
Derwent London plc	£3,718	5.69
Tritax Big Box REIT Plc	£2,571	4.44
Hammerson plc	£2,149	3.75
Shaftesbury PLC	£2,793	3.49
Great Portland Estates plc	£1,926	3.36
LondonMetric Property Plc	£1,824	3.05
Assura PLC	£1,696	2.91
Primary Health Properties PLC	£1,615	2.61
Workspace Group PLC	£1,719	2.19
LXI REIT PLC	£672	1.18
NewRiver REIT plc	£576	0.98
Custodian REIT PLC	£475	0.77
Target Healthcare REIT PLC	£437	0.74
Regional REIT Ltd.	£442	0.66
Hansteen Holdings PLC	£383	0.66
Intu Properties plc	£581	0.64
Triple Point Social Housing REIT Pl	£323	0.52
RDI REIT PLC	£423	0.47
Impact Healthcare REIT PLC	£309	0.41

Source: Factset, iShares, Tatton IM

REITs:

Compared to REITs, open-ended funds have lower effective charges, around 0.7% to 1%. The iShares REIT charges 0.4%, but that comes on top of the REIT management and administration charges, which we estimate to be about 1.2%. Thus, the total is 1.6%, double that of the open-ended funds.

UK Open-ended Property Funds vs. iShares UK REIT Fund



A simple chart of relative performance (with income accumulated) is telling:

Greater liquidity brings (apparent) volatility. Open-ended funds "feel" less worrying – until you are worried enough to think of selling. At that moment, you might face the big "swing" from offer-based pricing to bid-based pricing – or, worse, no bid at all for some time (the mid 2016 period shows the funds being closed for three and six months).

REITs holders would have been able to get out. Admittedly, the REITs' ETF bottomed 25% lower at the same time as the funds closed (perhaps no surprise) and investors who bought at that point would be feeling somewhat happier.

Perhaps the biggest takeaway is performance is similar. Both routes offer similar returns in the medium-term.

From our point of view, a fund of REITs is marginally a better construct, being broader and more transparent. Still, we think property is an equity sector investment, to be included in the equity component of a portfolio, not as an "alternative" investment.

We will discuss the outlook for property in the coming weeks.

CAMBRIDGE
INVESTMENTS LIMITED

30th September 2019

Global Equity Markets

Market	FRI 15:18	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7408.7	0.9	63.8	⬀	⬈
FTSE 250	19939	-1.1	-230.8	⬈	⬈
FTSE AS	4062.3	0.5	19.4	⬀	⬈
FTSE Small	5472.3	-1.0	-54.2	→	⬀
CAC	5627.6	-1.1	-63.2	⬈	⬈
DAX	12371.7	-0.8	-96.3	⬈	⬈
Dow	26916	-0.1	-19.0	⬀	⬈
S&P 500	2980.1	-0.4	-12.0	⬀	⬈
Nasdaq	7737.2	-1.1	-86.3	→	⬈
Nikkei	21878.9	-0.8	-165.5	⬈	⬀
MSCI World	2183.5	-0.6	-14.1	⬀	⬈
MSCI EM	1009.3	-1.2	-12.0	⬀	⬀

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
TUI	12.0	Imperial Brands	-18.1
easyJet	9.3	Pearson	-14.5
Reckitt Benck	5.6	John Wood	-10.5
Hikma Pharma	5.6	Carnival	-8.2
3i	5.4	Evraz	-5.0

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.233	-1.2	Oil	61.76	-3.9
GBP/EUR	0.888	-0.5	Gold	1493.9	-1.5
USD/EUR	1.09	-0.7	Silver	17.47	-2.9
JPY/USD	108.06	-0.5	Copper	259.5	0.2
CNY/USD	7.122	-0.4	Aluminium	1737.0	-3.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.5	-0.1
UK 15-Yr	0.7	-0.1
US 10-Yr	1.7	-0.0
French 10-Yr	-0.3	-0.1
German 10-Yr	-0.6	-0.1
Japanese 10-Yr	-0.2	-0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.9	18.0	13.2	13.2
FTSE 250	3.8	23.2	14.1	14.2
FTSE AS	4.7	18.8	13.1	13.4
FTSE Small	3.8	131.9	-	14.0
CAC	3.3	19.3	15.0	13.5
DAX	3.2	20.1	14.5	12.5
Dow	2.3	18.0	17.8	14.9
S&P 500	1.9	19.6	18.2	16.0
Nasdaq	1.0	24.3	21.6	17.9
Nikkei	2.0	15.5	15.8	17.8
MSCI World	2.5	18.6	16.7	15.2
MSCI EM	3.0	13.4	13.1	12.0

UK Mortgage Rates

Mortgage Rates	Estimate	Aug	Jul
Base Rate Tracker	2.56	2.56	2.56
2-yr Fixed Rate	1.66	1.64	1.66
3-yr Fixed Rate	1.78	1.75	1.77
5-yr Fixed Rate	1.95	1.92	1.96
10-yr Fixed Rate	2.64	2.61	0.00
Standard Variable	4.30	4.30	4.30

* 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

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD

CAMBRIDGE
INVESTMENTS LIMITED

30th September 2019

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD