THE **CAMBRIDGE** WEEKLY

3 February 2020

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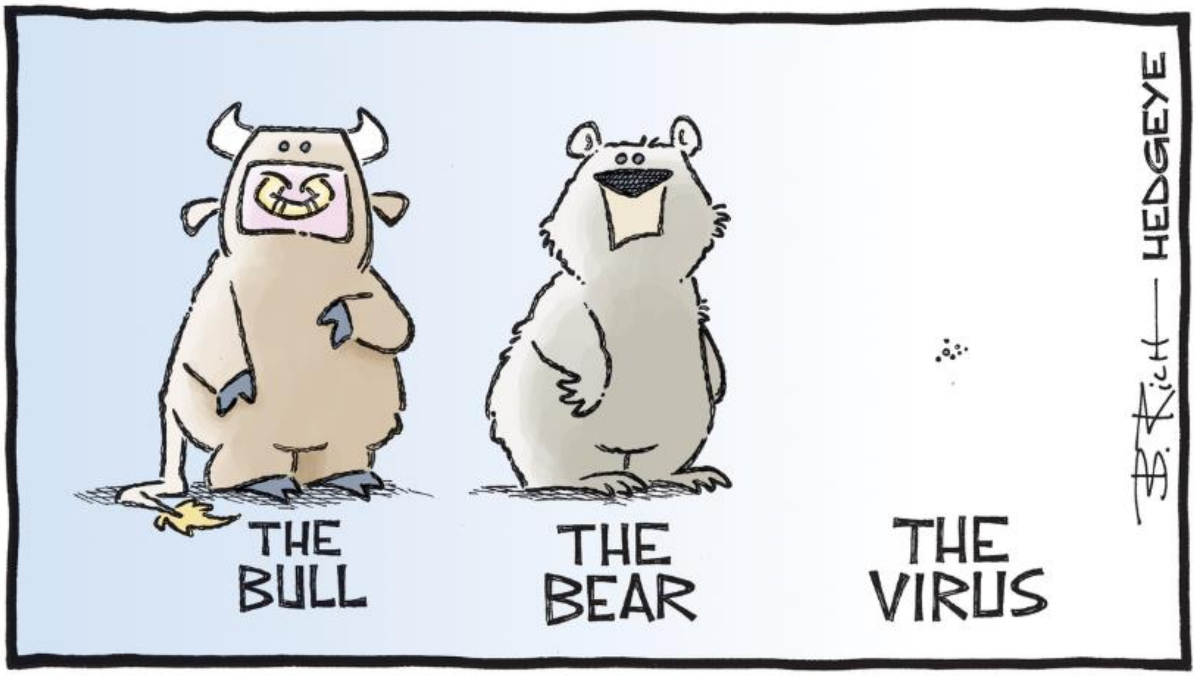


Source: Hedgeye, Bull, Bear and the Corona Virus, 29 January 2020

Headwinds and tailwinds

The events of the past few weeks have left some investors wondering whether we are witnessing a rapid deterioration of the erstwhile 'fair to potentially better than expected' 2020 outlook. In light of the Chinese Corona virus threat to all kinds of human activity, equity markets are at levels that could be pricing-in more positive developments than is now realistic to expect. On top of this, central banks appear to once again be moving to a less generous stance in supporting markets with additional liquidity. Brexit has also re-appeared on the business radar with a reminder that planning uncertainty may have reduced but has not disappeared.

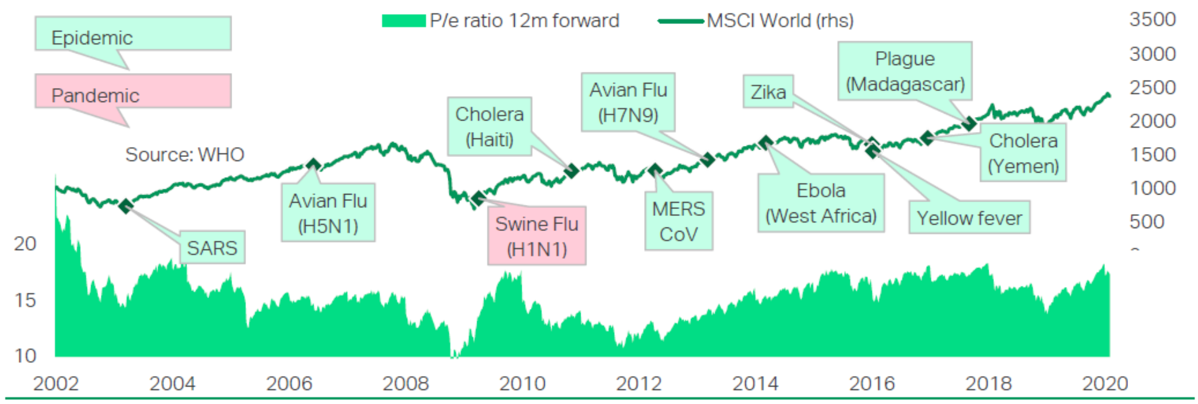
The downward movement of stock markets around the world since the Corona virus outbreak is a visible sign that investors suspect the restrictions that have been imposed to limit the spreading of the virus will dampen economic activity for a while.

The immense clampdown underway across China is unprecedented. In particular, it is disrupting supply chains, financial markets, and cash flow for businesses that were hoping for a change in fortune after a difficult 2019. Chinese smaller companies that are most vulnerable to bankruptcy may not survive unless they receive government help. The Chinese government is therefore expected to increase its economic stimulus package significantly beyond the levels it had initially deemed sufficient to overcome the 2019 growth slowdown.

Back to the virus, we would point concerned readers to our dedicated article in last week's edition (*Wuhan virus makes global markets sneeze*) and reiterate that attempts to stem its spread may prove a bigger problem for markets and economies than the illness itself.

It is nevertheless worth pointing out that every year, seasonal winter flu around the world causes severe illness for between 3-5 million people. Of that number, between 290,000 and 650,000 - predominantly those with previous health conditions – die as a consequence (Source WHO). It appears the Corona virus has a very similar impact across affected populations in China to the usual flu patterns, with the difference that it is new and therefore not covered in the available flu vaccinations. As we said last week, because of historical experience, humankind is prone to being overly fearful about fast-spreading viruses – even though it happens on an annual basis So far, scientists expect this virus to behave like other flu outbreaks which rise in December, peak in February and fade by April. Flu is always nasty, particularly for the already infirm, so we have a duty as a global society to do our best to prevent its spread.

Until proven differently, we have to assume that this viral flu will have similar effects on the global economy as previous ones, which was 'some' in the affected quarter but 'very little' over the course of the year. With the Chinese economic stimulus measures for 2020 now likely to become much more substantial than originally anticipated, this could provide significant demand stimulus for the global economy later in 2020, even though it would come at the price of more pain for the Chinese economy further down the line, when they will have to cope with the negative side effects such measures have inflicted on their economic structure in the past.



Source: MSCI, WHO, TS Lombard

We will refrain from spending much time on Brexit day today, as there is ample coverage everywhere else, but also because the real Brexit day will be 31 December 2020 at the earliest.

More important for the UK this week was that the Bank of England (BoE) – against expectations, including our own – refrained from cutting interest rates by 0.25%. No change was a big decision for the Bank of England's Monetary Policy Committee, so we comment on this in detail in a separate article. For the moment it has led to a strengthening of £-Sterling, which is good news for those going on winter holidays abroad, but not as good for UK businesses whose goods and services have become more expensive in export markets.

While the BoE decision seemed to confirm the view that central banks may be becoming less supportive, the same could not be said about the US central bank's decision-making this week. Even though the US Federal Reserve (Fed) also kept rates on hold as expected, they did not – as widely feared – cut back on the monetary support measures they had put in place last September. This response to a tightness in transactional cash levels had been widely attributed as one of the driving factors behind the stock market rally late last year, and therefore its removal was expected to cause some form of market upset. As it happened, the Fed acted very responsibly again and only signposted a reduction of this support for later in the year.

It was notable that the rate setters both in the UK and the US saw the global economy improving and becoming less fragile.

The big decisions being made currently are not about today's interest rates but about the nature of their goals and frameworks. Fundamental reviews are ongoing among the major central banks which could change the way they behave. Both the Fed and the ECB are aiming to deliver these around June. We think the central banks are likely to make changes which will be positive for economic growth, but which may also raise longer-term inflation expectations. Riskier assets like equities should do well in such an environment, especially in relation to bonds, which may fare less well.

In summary, the media storm over the spreading of the Corona virus made it an unnerving week for investors and this was certainly reflected in stock market activity. However, beyond the noise, we noted numerous improvements on previous concerns and headwinds which tell us, that once calm returns over this latest flu scare, the underlying economic and market picture is continuing on its improving path. The virus headwind may have stopped a surge in stock markets that had gone beyond reasonable valuation levels in some areas. This may be painful for some, but we see it as a healthy, cathartic market action which should lead to an improved foundation for the year ahead.

Bank of England in a bind

Central bank meetings are rarely riveting affairs. In the age of round-the-clock media coverage, central bankers are now just as dedicated to managing expectations as they are to monetary policy. Usually when interest rate decisions are made, 'forward guidance' has already signalled the intentions of policymakers, making the announcement itself feel like old news. So, the fact that Thursday's decision by the Bank of England (BoE) to keep interest rates on hold left some in our office genuinely surprised says a lot.

We were far from the only ones. Implied market odds put a quarter-point rate cut at 50/50, giving the announcement a genuine 'will-they-won't-they' suspense. Those 'doves' expecting a rate cut had plenty of evidence in their favour: a poor run of UK economic data, inflationary pressures that have mostly abated and increasingly dovish comments from many of the BoE's Monetary Policy Committee (MPC) members. On the 'hawkish' side, those preferring higher rates could point to receding Brexit uncertainties and a generally improving outlook for the global economy.

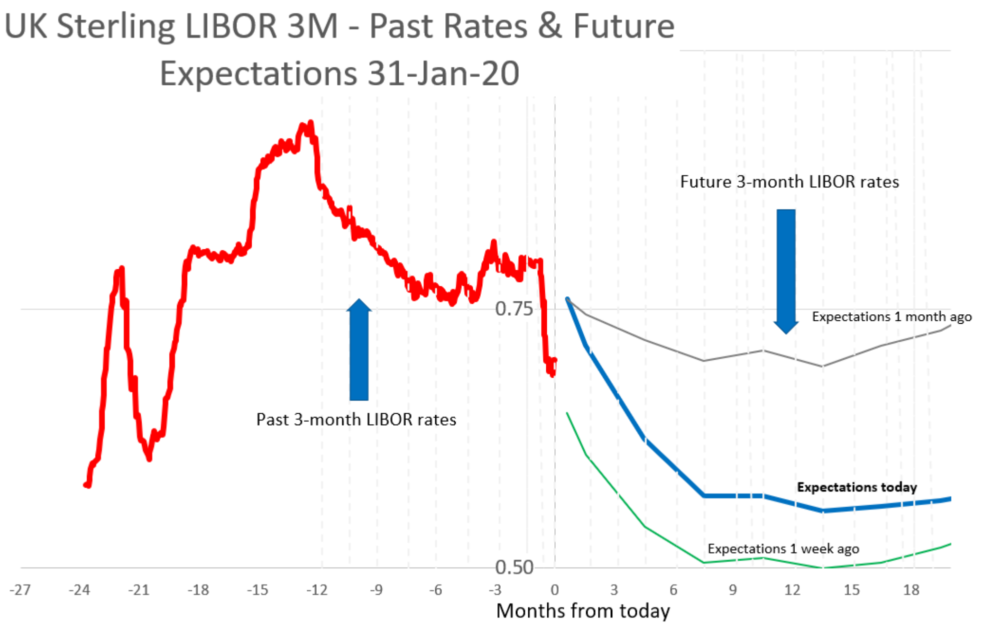
In the end, the hawks won. The MPC opted to hold benchmark interest rates at 0.75%. But there was something incongruous about their victory. Despite voting against a rate cut – by the exact same margin as the previous vote – the bank's accompanying statement read like an argument in favour. Inflation targeting, the BoE's key mandate, would suggest that interest rates are too high. The most recent inflation prints have disappointed, and the strength of £-Sterling since the election means this is unlikely to change. Economic data has been weak – particularly on consumption and business sentiment. The bank's own forecasts for both growth and inflation have come down substantially.

Among the reasons the MPC gave for the stasis was one which bears closer examination. A new assessment of the economy sees the room for further non-inflationary growth as limited. While they cited signs that the British economy had picked up since the dire days of November and early December, with the removal of political and economic uncertainties following Boris Johnson's election win a crucial factor, they cut the estimate of "potential" growth. According to their forecasts, even with monetary stimulus, the British economy simply does not have enough resources to drive productivity forward.

This means that loosening monetary policy – even slightly – would lead to a big spike in inflation further down the line. Outgoing governor Mark Carney told reporters after the decision: "There's a reduction and then a pick-up in the market curve that we have used for the forecast," which "leads to inflation being slightly above target at year three, so not consistent with the remit."

The bank is in a bind. Monetary growth is relatively low and has shown no acceleration, unlike other countries. Confidence measures may have bounced but actual spending data is weak. Left unchanged, current interest rates lead to below-target inflation. Yet, according to the BoE's models, a small reduction in interest rates now leads to an overshooting of inflation in the future. As seen in Japan and the Eurozone, bringing short term rates down or close to zero (the so-called 'zero-bound') has a bad effect on the profitability of the banking system. The hurdle to cut rates appears to be very high.

The hurdle was too high this time. However, the tenor of the MPC's commentary suggests that a rate cut further into the year is still distinctly possible. Previously, the BoE's stance was that when the time came to tighten monetary policy it would be "limited and gradual". Not only has the horizon for that tightening been pushed further out, the language has been updated to "modest". The difference, according to Carney, is that "gradual" implies multiple rate hikes, while "modest" does not, and with inflation now expected to remain below target until the end of 2021, markets still expect the bank's next move to be down rather than up. The chart on top of the next page, which plots the implied market expectations as per today, tell us that markets agree with MPC's view – for the moment.



Source: Factset, Tatton IM, ICE

We will leave you with an interesting little aside. This was Mark Carney's last rate-setting meeting before leaving the job in March. And it was a suitably dramatic and unpredictably exit for a man hailed upon his arrival as a 'rock-star central banker'.

After the previous meeting, the BoE was embarrassed by the discovery that a two-second lag between the audio and video feeds allowed time for some traders to be ahead of others during policy announcements. Meanwhile, attending journalists have been allowed to see the decisions and statements for two hours before the official release so that copy can be written. They have had to put up with being trapped in a high-security dungeon with policymakers until the announcement – with no phone or internet access. This time, there was a peculiarly high volume of buy orders placed on £-Sterling a whole 15 seconds before the bank's official rate announcement. When the announcement was made, the value of Sterling rose further, and those lucky traders made quite a bit of money. Again.

Perhaps there are those out there with an uncanny ability for 15-second prescience, or maybe someone in that meeting was up to something. How about that for 'forward guidance'?

Corporate earnings turning

As we have written in recent weeks, capital markets are in a delicate balance. On the one hand, hopes of a recovery in global growth keep pushing equity prices higher – helped by supportive central bankers the world over. On the other, the fact that the underlying real economy is (for now) struggling to live up to investors' lofty expectations has left valuations stretched. Equities are therefore vulnerable to the changing winds. The Corona virus scare currently gripping the world is exactly the sort of shock that could cause a sudden reversal – unless markets find other reasons to support the rally. In short, investors need something to get excited about.

A season of positive company earnings (profits) reports would help. Analysts at JP Morgan expect companies in the S&P 500 to deliver around a 4% upside earnings surprise in their announcements for the last quarter of 2019. The global economy was lethargic last year, but analysts expect growth in earnings-per-share to have stabilised in Q4 at a rate of 2.5% year-on-year. This would be a big improvement on the -1% fall seen during Q3. Revenue growth looks particularly positive, with S&P companies on track to deliver a healthy 4.5%.

Of the companies that have reported so far, the standout performers have mostly been the big names. Apple reported revenues 4% above analyst expectations, and smashed earnings-per-share forecasts by 10%. With the US-China trade war and the upcoming implementation of 5G technology, there were fears that iPhone sales would suffer. But sales of Apple's flagship smartphone – particularly in the Americas – proved to be the key upside driver.

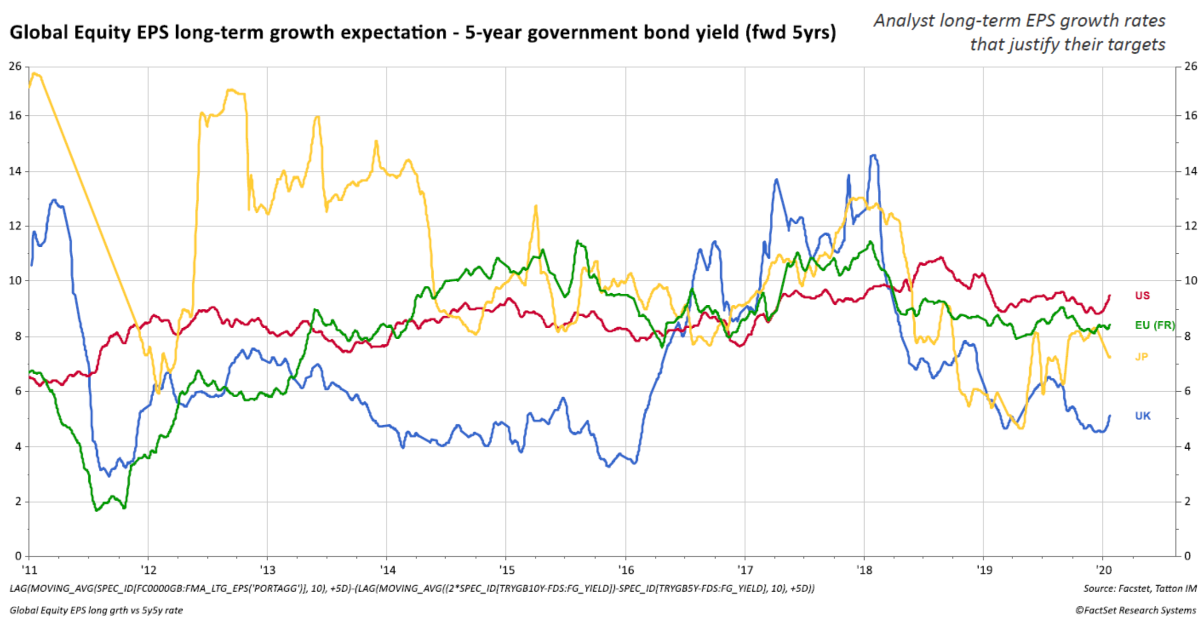
The 'surprise' metrics from earnings reports (the difference between expected figures and actual figures) can often be misleading. In recent years, companies have figured out that a positive surprise can be very useful for pushing up share prices, and so many intentionally guide their forecasts lower, only to 'beat' them and get a big reward from investors (even if in absolute terms their results may be down). Nevertheless, positive surprises for last quarter should not be sniffed at. From the annual comparison perspective, company profits had much to live up to after the stellar earnings seen in Q4 2018. These distorted base effects made it hard to post strong-looking figures. When adding in a slowing global economic backdrop and the dampening effects of Donald Trump's trade war, firms were facing a difficult environment.

Not all companies were up to the task, of course. The highest-profile disappointment came from Boeing, which posted its first annual loss in more than two decades. Its recent troubles have been well-documented, after two deadly crashes forced the company to ground its 737 aircraft. The bill for that ordeal is now expected to surpass $18bn, contributing to Boeing's $636mn loss for 2019.

Elsewhere, there was a notable disparity between the haves and the have nots. Large-cap companies continue to dominate the scene, while the earnings of small and mid-cap firms have come under more pressure. There is also a regional divide, with US companies faring much better than their European and Japanese counterparts.

In terms of equity markets, the reasons for optimism are effectively already priced in. The recent market rally has sent share prices so far above earnings multiples levels that anything less than exceptional looks like a disappointment. From our perspective, company expectations for this year will likely be more important than results for the end of 2019.

Fortunately, there is some cause for optimism on that front. JP Morgan expects that analyst expectations for 2020 will be revised higher and has projected earnings per share (EPS) growth above 5% year-on-year for the first half of the year, and above 10% for the second half. Overall, they expect revenue growth to accelerate to 6%.



Their optimism comes from the belief that – in line with general market expectations – economic growth has now bottomed out. The tariff fallout from the US-China trade war will likely continue to impact companies through the early months of this year, but as we move through the second and third quarters, those impacts should wear away. Although it lacked much actual content, the Phase One trade agreement between the US and China signalled that tit-for-tat tariff impositions were likely to end, creating a more certain environment for companies. As such, the pressure on profit margins should recede. JP Morgan now expects increased margins to be the key factor in earnings growth over the next two years.

We should not get ahead of ourselves, however. This positive scenario relies on the global economy chugging along relatively undisturbed until a growth spurt can kick in. Of course, the Corona virus outbreak – and the measures being taken by China to prevent it – threaten that. The Chinese economy has effectively 'closed shop' at a crucial juncture, frightening investors as much as the public. A positive earnings outlook is one potential remedy for investors' fears, but it is too soon to say whether it will be enough.

CAMBRIDGE INVESTMENTS LIMITED

3rd February 2020

Global Equity Markets

Market	FRI 15:38	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7305.5	-3.7	-280.5	→	→
FTSE 250	21237	-2.4	-526.9	→	↗
FTSE AS	4069.3	-3.4	-143.9	→	→
FTSE Small	5901.9	-1.7	-100.7	↗	↗
CAC	5824.9	-3.3	-199.3	→	↗
DAX	13041.8	-3.9	-534.9	→	↗
Dow	28515	-1.6	-475.0	→	⬈
S&P 500	3260.7	-1.1	-34.8	↗	⬈
Nasdaq	9073.3	-0.7	-68.2	⬈	⬈
Nikkei	23205.2	-2.6	-622.0	↘	→
MSCI World	2372.0	-1.0	-23.3	↗	⬈
MSCI EM	1072.8	-4.2	-46.6	→	→

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.8	18.6	13.1	13.3
FTSE 250	3.8	24.7	14.9	14.2
FTSE AS	4.6	19.6	13.3	13.4
FTSE Small	3.4	164.9	-	13.9
CAC	3.1	20.8	14.4	13.5
DAX	3.0	24.8	14.1	12.5
Dow	2.2	20.1	17.8	15.0
S&P 500	1.8	21.6	18.7	16.0
Nasdaq	0.9	28.0	23.3	18.0
Nikkei	1.9	18.7	17.7	17.2
MSCI World	2.3	20.6	17.4	15.2
MSCI EM	2.7	14.8	12.7	11.9

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Whitbread	4.3	Royal Dutch Shell	-8.7
Fresnillo	3.6	Royal Dutch Shell	-8.6
Reckitt Benck	2.5	Stan Chartered	-8.0
St James's Place	1.9	Carnival	-7.9
Unilever	1.8	Rio Tinto	-7.9

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.315	0.6	Oil	58.16	-4.2
GBP/EUR	0.841	0.2	Gold	1584.1	0.8
USD/EUR	1.11	0.3	Silver	17.97	-0.7
JPY/USD	108.70	0.5	Copper	251.2	-6.4
CNY/USD	6.94	-0.9	Aluminium	1731.0	-3.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.5	-0.0
UK 15-Yr	0.8	-0.0
US 10-Yr	1.5	-0.1
French 10-Yr	-0.2	-0.1
German 10-Yr	-0.4	-0.1
Japanese 10-Yr	-0.1	-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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3rd February 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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