CAMBRIDGE
INVESTMENTS LIMITED

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Christian Adams: Where's Boris, 20 August 2020

Fed leaves bond investors with that sinking feeling

Capital markets were mostly steady – if a bit on edge – last week, as they have been for most of August. At least the US maintained positivity, although the extent of gains were not spectacular. Even so, both the Nasdaq and S&P 500 indices surpassed their February peaks in midweek trading, leaving the stock market nosedive of March a distant memory. Tech giant Apple made headlines by becoming the first company in history to climb to a $2 trillion market cap (we write more about this in a separate article below). And all of this after the world economy has experienced its deepest, most widespread, recession ever.

We should not mistake the continued equity rally with increased optimism about the economy itself. Cyclical stocks and the more cyclical regions made gains last week, but that cyclical rally petered out yet again last week, with investor capital instead flowing once more towards the US tech super-caps.

The FTSE100 slipped back below 6,000 again, disappointingly after the latest round of Brexit negotiations ended seemingly no closer to a deal than before. That also took Sterling down as well.

The main factors underpinning this impressive market rally are still around: mildly positive risk sentiment and abundant liquidity from the world's central banks. Investors may want to believe that the great reflation is nigh, but they are struggling to convince themselves. The flash Purchasing Manager Indices (PMI) data for the US and UK were upbeat, whereas the Eurozone told a rather mixed story.

Both US manufacturing and services PMI data beat the 50 neutral level and economist estimates, posting 53.6 and 54.8 respectively. UK data was even better, with the Markit/CIPS services PMI surprisingly strong at 60.1. Maybe eating out is indeed helping out.

In the Eurozone, only France's manufacturing PMI data indicated contraction, at 49.0, but almost all disappointed and by quite a large degree. Eurozone services had been expected to be 54.5 and were indicated at 50.1.

In recent years, PMIs have had quite some impact on markets, being the most credibly cogent and up-to-the-moment data. As we have mentioned in previous notes, this year has seen them supplanted by data plucked from more high-frequency providers. Data from Apple, Google and other internet data gatherers have been made available on a pro bono basis. Thus, the PMIs had only a mild effect on their release since the indicators had been mixed of late.

Anecdotal reports from the continent have confirmed that schools are starting up again, even though virus case numbers seem to have risen. They say that parents are quite keen to offload their kids and that the schools are willing to take them. In less than two weeks' time, the UK will be going through a similar phase, and this will probably be a key time for Europe's economy. We expect this data will start to be very important through the next four weeks.

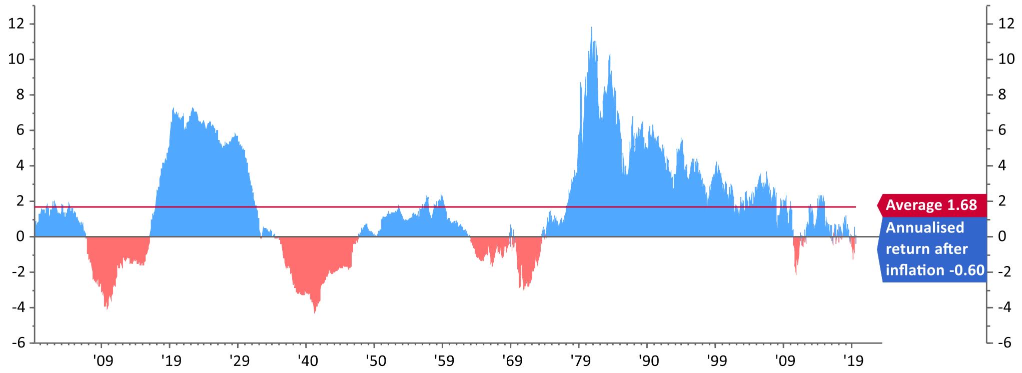
As for the pro bono high frequency data, Apple, Google and other providers may well want to see revenue being generated soon from their proprietary data (even if it's actually yours and mine). We touch on their behaviours in a separate article.

That brings us to the most noteworthy story of last week in market terms. Wednesday saw the release of the minutes from the US Federal Reserve (Fed's) latest Federal Open Market Committee (FOMC) meeting, in what should have been a dull affair. We already knew from Fed chair Jerome Powell's announcement that the central bank wanted to keep interest rates at their current non-existent levels while ploughing capital into the system for the foreseeable future. Nevertheless, one seemingly innocuous comment sent capital markets into a minor tantrum: "many participants judged that yield caps and targets were not warranted in the current environment but should remain an option." This suggests the Fed is not as committed to controlling the yield curve in government bonds as markets would like it to be.

As John Authers notes in his Bloomberg article of Thursday, this is interesting because markets are behaving as though central bank yield curve control is already here – and will be around for some time. Previous quantitative easing (QE) interventions by the Fed (following the financial crash and ensuing stagnant decade) had the effect of calming the gyrations in bond markets. But this current round of QE is not so much calming volatility as completely crushing it – pegging bond yields down at historic lows and not allowing them to move an inch.

US 10-Year Treasury Holding Returns After Inflation

Returns with 10-years of future inflation - equivalent to effective TIPs returns
Last 10 years using current CPI as estimate



Source: Factset, Tatton IM, Federal Reserve, Case-Shiller

The Fed's asset purchases themselves have clearly had a huge impact in achieving this. But arguably just important has been the central bank's message: bond yields are weighed down with an anchor that will not go away. Indeed, the FOMC's latest minutes suggest committee members want to "frame communications regarding the Committee's ongoing asset purchases more in terms of their role in fostering accommodative financial conditions and supporting economic recovery." That is, the Fed sees its liquidity injections as a tool to bolster the economy, not just as an emergency stabiliser for financial markets.

One of the main ways these liquidity injections have aided the economy is by allowing the US government practically unlimited leeway in its spending plans. The Fed has been reluctant to allow short-term cash rates to fall below zero – through fear of its effect on banks and savers. But importantly, it has ensured that the US Treasury can issue bonds at a rate lower than inflation.

Even if it doesn't officially hold nominal bond yields below a particular rate, allowing inflation to possibly overshoot its 2% target gives the government the ability to borrow money at negative real (inflation adjusted) interest rates. Sure enough, last week we saw a historical moment from the Treasury: the auction of its latest inflation protected bonds sold at a negative yield – despite a wave of new issuance.

This is the first time the US government has explicitly sold a 30-year inflation-linked bond (first issued in 1998, a relatively new invention for the US) with a negative yield, but it is not the first time that US real yields have turned negative.

Following World War II, the Fed began a policy of so-called "financial repression", where bond yields were pegged down to allow the government to pay off its war debts – while inflation soared in the post-war boom. If you had held a nominal US government bond for that period, your investment returns would have been well below inflation – since nominal yields had nowhere to go. But if it were possible to buy an inflation-linked bond then, the investment returns would have been much higher. Inflation-linked bonds get a capital gain from the fall in real yields, whereas the nominal bond does not.

This is important, as bonds are the standard way of offsetting risk in investment portfolios (since equities' loss is often government bonds' gain). But if nominal bonds' price movement are limited – by central banks effectively capping both the upside and downside to yields – then they can fail to give that offset. Clearly, we would prefer to hold the kinds of bonds that can do well, and given that central banks are committed to pegging down yields even in the face of inflation, inflation-linked bonds seem like the best option.

Of course, the flipside to this argument is that central bank policy is largely determined by the economic and financial environment. Since we are in the deepest global recession in history, financial repression from the Fed and others seems warranted. But if the recovery does come through quicker and stronger than expected – and inflation does indeed overshoot the 2% target – things could change quickly. That is still hugely unlikely in the short-term, but is something we need to watch out for.

The central banks of the world will meet over the coming week, albeit virtually, at the annual Jackson Hole Symposium. The Fed will probably reveal some more details of its major review, with Powell's keynote speech on Thursday. Most expect that it will commit to allowing an overshooting of the 2% target with an indication that it would prefer inflation somewhat above rather than below the target.

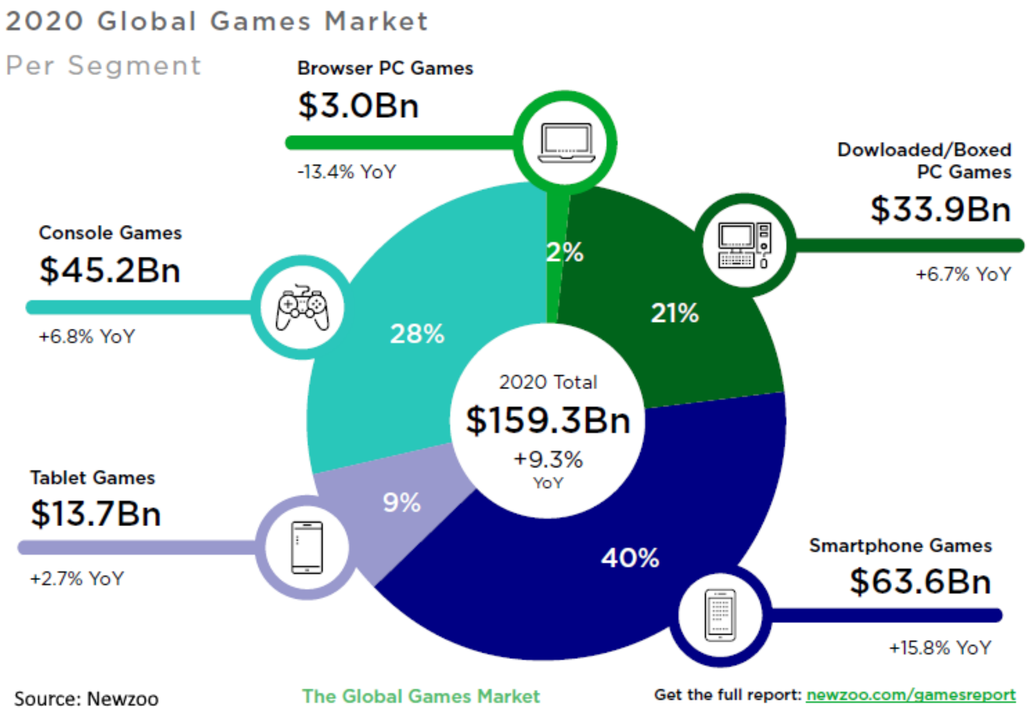
As one can see from the chart above, this might mean private investors start to believe their fixed coupon bonds will be a sure-fire loss. If that happens, the Fed may have to take up what those investors don't want. QE will be here to stay.

Apple finds itself fighting an Epic battle

And Apple wept, seeing as it had no more worlds left to conquer. In 2018, Apple made history by becoming the first private company valued over $1 trillion. That milestone was 42 years in the making; but just two years later, Apple is worth double that. To make that feat even more incredible, the meteoric ascent to its second trillion took Apple just 21 weeks from its lows in March. History's biggest company, of course, had a helping hand from a bullish stock market swimming in liquidity. But the sight of a corporate giant doubling its worth – while the global economy fell into its sharpest recession ever – speaks for itself.

Like many of its fellow tech giants, Apple has received an overwhelming vote of confidence from investors during the pandemic. From an investment perspective, even more astonishing than its market cap milestone is the valuation level it has reached along the way. Apple's share price is now just under 36 times its expected earnings for 2020. The last time it reached that valuation level was on the eve of the iPhone's first release – an event which ushered in Apple's greatest period of growth. Back then, investors saw the explosion of profit growth that was to come. Now, given its sheer size in the market, it is hard to see where growth of that calibre could even come from.

Apple is not a rising star, but the biggest in the sky. And lately, that has attracted competition from the kind of corporate disruptors that Apple once characterised itself. In the past two weeks, it has received a great deal of criticism from the gaming community, its fastest-growing customer base. First, Apple announced it would not allow cloud gaming services from rivals Microsoft and Google onto its systems. Then, it made the bold move of removing the hugely popular game Fortnite from its App store, provoking an immediate anti-trust lawsuit from the game's creator, Epic Games.



Mobile gaming is now biggest earner of all the channels for gaming. The following is from *Newzoo*, in its annual review published at the end of June: "By the end of 2020, more than 92 million new players from emerging markets will have entered the [mobile gaming] ecosystem, most of them via mobile. One of the key contributing factors is the ongoing growth of hyper-casual mobile games. The accessibility of these titles—through simple gameplay, little-to-no waiting time, and ad-based monetization—allows anyone to play and enjoy. Chinese game companies, in particular, are leading the change for mobile, finding new revenues and success in the wake of 2018's nine-month-long licensing freeze."

Newzoo goes on to mention Fortnite in particular: "Game worlds are experimenting with experiences that go beyond the game itself. Fortnite famously hosted one concert last year, and in the first six months of 2020 alone, we have seen global entertainers host concerts in Fortnite in front of millions, a late-night talk show host an episode via Animal Crossing, people celebrating weddings and graduations in game worlds, and more."

Let's take these two moves in turn. The decision to ban Epic's cloud gaming services – where games are streamed directly to phones through a third-party app, rather than bought on Apple's iOS store – was not unexpected but still controversial. Apple's official reasoning is that cloud services give customers access to a library of games that it cannot review individually, and so cannot subject to its stringent rules. But few buy this excuse. If a game can get revenue without going through the App store, Apple is unable to take its

30% cut. This led to derision even from usually friendly sources, with *AppleInsider* magazine calling it "consumer hostile".

The move also incited the chain of events leading to Fortnite's removal. In a bold and flagrant violation of Apple's rules, Epic Games allowed Fortnite players to make cheaper in-game purchases directly to its system, bypassing the App store's fee and passing the savings onto consumers. Fortnite was then swiftly and predictably removed from Apple's system – exactly the reaction Epic was trying to provoke. Epic then immediately launched a lawsuit against Apple (as well as Google, which also removed Fortnite for the same reason), as well as a high-profile social media campaign.

These two developments showcase how much Apple's image has changed from the plucky tech start-up it presented a few decades ago. In its viral takedown of the world's largest company, Epic parodied Apple's famous "1984" Macintosh launch advert, showing a dimly lit room of corporate zombies watching a broadcast of an Apple boasting about its exploitation of consumers – only for a Fortnite character to smash the screen and reveal the text: "Epic Games has defied the App Store monopoly. In retaliation, Apple is blocking Fornite from a billion devices. Join the fight to stop 2020 from becoming '1984.'"

There is some irony in Epic Games, said to be 49% owned by Chinese tech giants Tencent, using Orwellian imagery to deride another company. But nonetheless, the point stands: in the last two decades, Apple has become a gatekeeper of virtually all forms of media by dominating the platforms people use to consume it. This has allowed it to squeeze independent providers for profits – a feat it has pulled off masterfully – but has also gained Apple the 'Big Bad Business' label along the way.

Apple is not the only major tech name accused of muscling in on software providers. According to the Analysis Group consultancy Microsoft, Google, Amazon, and Samsung all aim to take a similar 30% cut from those using their software/services distribution platforms.

The stranglehold on the content platform is exactly what Epic and cloud-based gaming services threaten to break. Gaming is the biggest category of any app store, the gaming industry as a whole was valued at $151 billion last year and is expected to grow nearly 13% per year between now and 2027. Fortnite alone has 130 million regular players, most of whom are in the ideal demographic of young, wealthy consumers representing strong future cashflows. That Apple would do anything they can to keep their grip on this revenue is entirely unsurprising.

Whether or not it will succeed is another matter. The social media backlash against Apple has already begun – greatly encouraged by Epic and its outspoken CEO. And companies know full well that social media revolts can lead to widespread consumer revolt. By desperately trying to cling on to its cash cow, Apple may have already pushed it away.

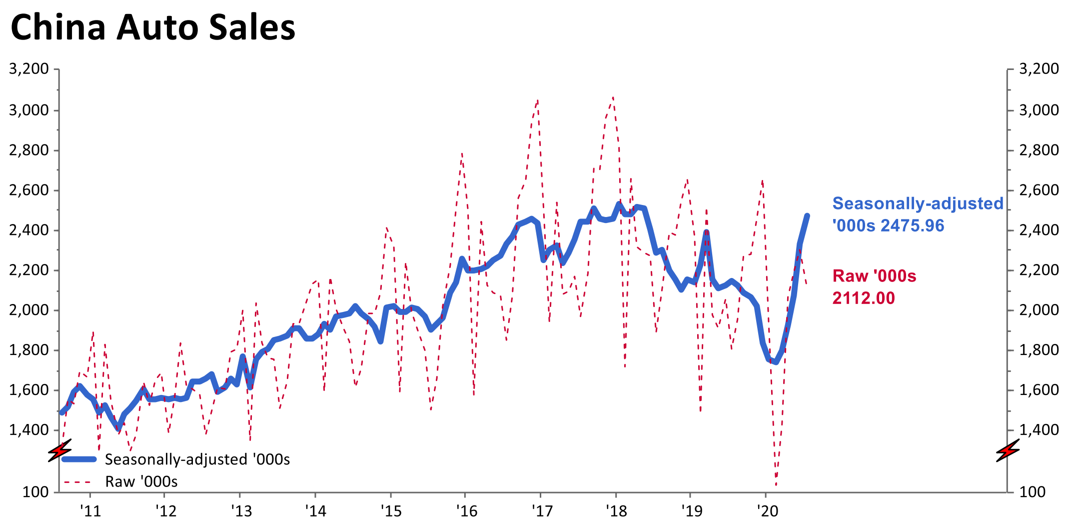
Three decades ago, Japanese tech giant Sony achieved a similar level of market domination to what Apple has now. But a failure to keep up with current trends and insurgent upstarts like Apple was its undoing – sliding slowly away from their peak and never recovering. In opting for centralised control in an increasingly decentralised digital market, Apple may be doing the same now. It is too early to tell whether the writing is on the wall for the world's largest company. But at an astonishing $2 trillion peak and a heady valuation level, it is worth having a look.

Auto-recovery: turnaround or short-term bounce?

Like most industries, the automotive sector has been hit hard by the pandemic. Carmakers were already struggling well before the first COVID case came in, with changes to emissions regulations, a global manufacturing downturn and structural shifts in demand providing fierce headwinds. A global economic shutdown then came at the worst time it could, as stay-at-home orders and evaporating incomes choked off any hopes of a quick turnaround in fortunes. Data from the world's seven largest car markets showed new auto sales were down 21% year-on-year in June, with the US and Europe registering sales numbers of -26.4% and -24.4% respectively.

In normal times, these figures would be enough to make carmakers weep. But the latest data in fact show signs of recovery. The nosedive in sales numbers hit its floor in April, registering a year-on-year fall of more than 40% across the major markets, and since then there has been palpable improvement – with the latest figures even positively surprising analysts. Goldman Sachs data for the US shows seasonally-adjusted light vehicle sales improved 11% in July (though the raw year-on-year figures still showed a 12% decline), and key European markets like France and Spain are into positive outright growth figures (+4% and +1% respectively).

China, the biggest market for autos, has bounced hard. Seasonally adjusted, July sales were running at +17% year-on-year, and while pent-up demand may decrease in the next few months, this represents a significant improvement. The chart below shows the actual unit numbers:

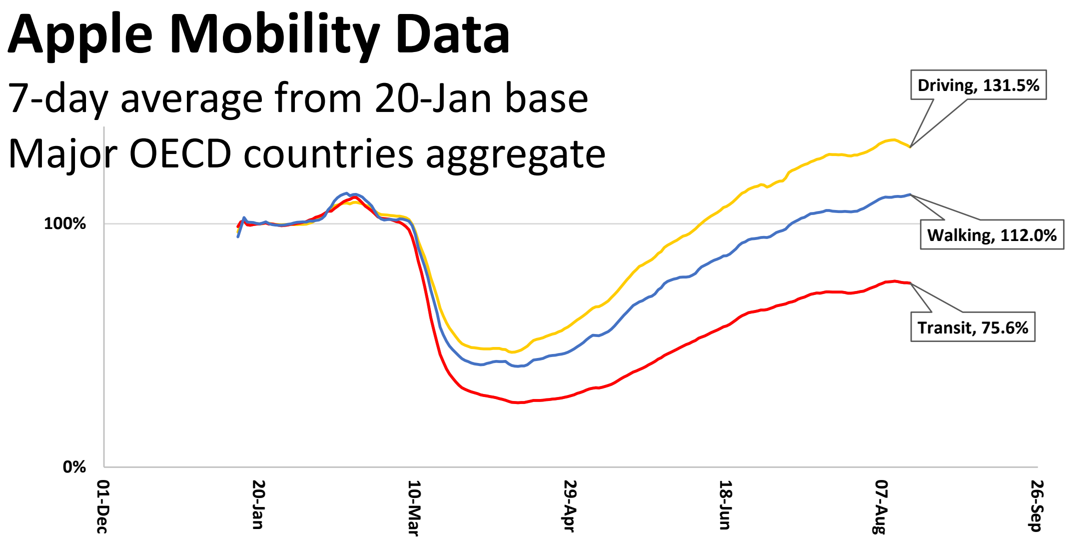


Source: Factset, Tatton IM, China Association of Automobile Manufacturers

In the US and Europe, the sales trajectory undoubtedly looks positive. With lockdowns continually easing – and virtually non-existent in some areas – economic activity has picked up markedly from its lows, causing a general rebound in demand which is buoying car companies. Much of that demand was pent-up through the lockdown months and is now being released in waves. And, at the same time, governments – particularly in Europe – are using a number of measures to incentivise purchases.

The pandemic curbed car sales early on, it now looks like autos are getting a COVID boost. With the public now discouraged from using public transport – through government mandate or personal safety concerns – driving is the main option. We can see this in the data on second-hand car sales. In areas with extensive public transport systems, sales have shot up, while in places without, sales have mostly flatlined or declined. This also ties in with a theme we have written about a great deal lately: how COVID containment measures have led to a shift away from densely populated cities.

Residential prices are rising outside cities – and falling inside cities – in a number of countries. New York and London seem particularly affected. It may last for some time given that many office-based businesses have discovered that remote working can be more productive for both employees and employer.



Source: Apple, Tatton IM

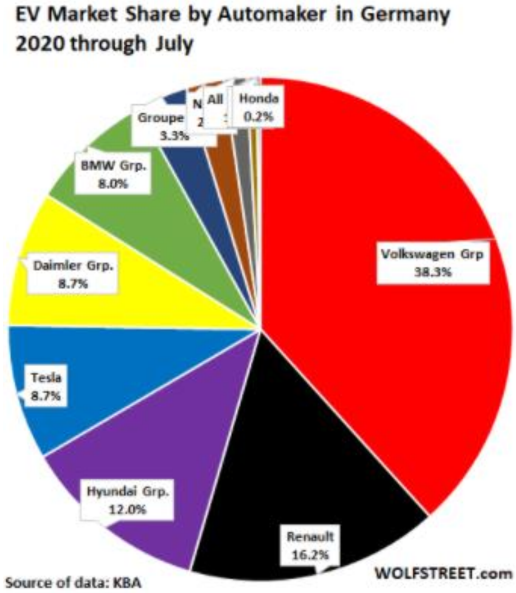
Even so, at least in its current form, this pandemic will not be around forever – and some of the above factors may be temporary. This is certainly true for pent-up demand and government-induced purchases, which will likely dry up sooner rather than later. If the public eventually climbs back on board city trains and buses, demand for cars may come down. Of course, when the positive demand effects of the pandemic wear off, the negative effects – social restrictions or depressed incomes – are likely to wear off too, which will help the situation overall.

The bigger challenges for the industry will still come from environmental concerns. Since the beginning of the year, new European Union regulations have required producers to drastically limit the average CO_2 output of their cars – translating into a 21% reduction in emissions from their 2018 figures. If they are unable to, the industry could potentially lose around €33 billion a year in fines – with European pursuing green policies unphased by COVID pressures.

To meet the new rules, carmakers have predictably been turning to either full electric vehicles or hybrids. Varied and uneven incentive policies across Europe, as well as consumer reaction, have hampered widespread adoption (with battery-powered electric cars making up just 1.7% of European sales in October 2019). But many car companies planned to make 2020 the year they push hard into electric. COVID has unsurprisingly spoiled those plans, and so carmakers have turned to purchasing US emissions credits from Tesla.

This, combined with the company's high-tech focus, is one of the reasons why Tesla is one of the few car companies whose share price has fared well through the pandemic. In fact, Tesla's run of four quarters of profit (which makes it eligible for the S&P500) has come from Carbon Tax Credit sales. This year's Q2 generated $428 million in regulatory (Carbon Tax credit) sales, pushing it into profit of $104 million. Tesla's buyers included General Motors and Fiat Chrysler.

As the chart below shows, Tesla has only a small share of the European car market, and yet has become the biggest carmaker in the world by market cap. Tesla design its own software, hardware and batteries – and seem willing to provide this to other electric carmakers. As such, even if the company fails to gain a big share of the market any time sooner, investors are confident it will still take a healthy chunk of the profits when the electric market takes off.



However, it is possible that the pandemic experience could dissuade producers from relying on external providers for parts. We have already heard reports that, due to supply chain disruption from COVID, manufacturers have been unable to get production running, leaving the car market in undersupply. Even when things return to something like normal, companies might want to produce much more inhouse to avoid a repeat of those problems. What exactly that will mean for the autos sector – and the future of electric vehicles in particular – is hard to say. For now, carmakers are seeing a welcome rebound. But given their recent experience, they will be wary of how long it can go on for.

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24th August 2020

Global Equity Markets

Market	Fri 15:35	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5984.2	-1.7	-105.9	⬂	⬊
FTSE 250	17508	-1.3	-227.4	→	⬊
FTSE AS	3341.7	-1.7	-56.2	⬂	⬊
FTSE Small	5066.3	-1.5	-75.5	→	⬂
CAC	4877.9	-1.7	-85.1	⬂	⬊
DAX	12727.2	-1.3	-174.2	→	→
Dow	27784	-0.5	-147.1	⬈	→
S&P 500	3385.9	0.4	13.0	⬈	⬈
Nasdaq	11303.7	2.6	284.4	⬈	⬈
Nikkei	22920.3	-1.6	-369.1	⬀	→
MSCI World	2389.2	0.2	5.0	⬈	⬀
MSCI EM	1080.5	-1.2	-12.6	⬈	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Persimmon	5.1	StanLife-Aberdeen	-9.0
Scot Mtge Inv Trust	4.4	Stan Chartered	-7.1
Ocado	3.9	Evraz	-6.9
Assoc. Brit. Foods	2.4	Pearson	-6.4
London Stock Exch	2.4	BP	-6.4

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.310	0.1	Oil	44.36	-1.0
GBP/EUR	0.899	0.7	Gold	1931.3	-0.7
USD/EUR	1.18	-0.6	Silver	26.48	0.1
JPY/USD	106.05	0.5	Copper	290.9	1.7
CNY/USD	6.92	0.4	Aluminium	1789.5	1.5
Bitcoin/$	11,713	-0.5	Soft Cmdties	361.6	-0.9

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.22	-0.02
UK 15-Yr	0.48	-0.02
US 10-Yr	0.64	-0.07
French 10-Yr	-0.20	-0.07
German 10-Yr	-0.50	-0.08
Japanese 10-Yr	0.03	-0.02

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	64.6	19.6	13.6
FTSE 250	2.9	47.7	27.2	14.6
FTSE AS	3.9	69.6	20.5	13.7
FTSE Small	3.8	23.4	-	13.8
CAC	2.2	43.1	24.7	13.8
DAX	2.6	37.9	19.9	12.8
Dow	2.3	23.6	24.9	15.5
S&P 500	1.8	26.4	26.1	16.5
Nasdaq	0.8	37.3	32.6	18.7
Nikkei	1.9	37.0	23.1	17.0
MSCI World	2.1	28.7	24.2	15.6
MSCI EM	2.4	18.9	17.5	12.1

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	2.19	2.19
2-yr Fixed Rate	1.45	1.42
3-yr Fixed Rate	1.71	1.68
5-yr Fixed Rate	1.70	1.68
10-yr Fixed Rate	2.37	2.38
Standard Variable	3.66	3.66

* 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

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24th August 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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