CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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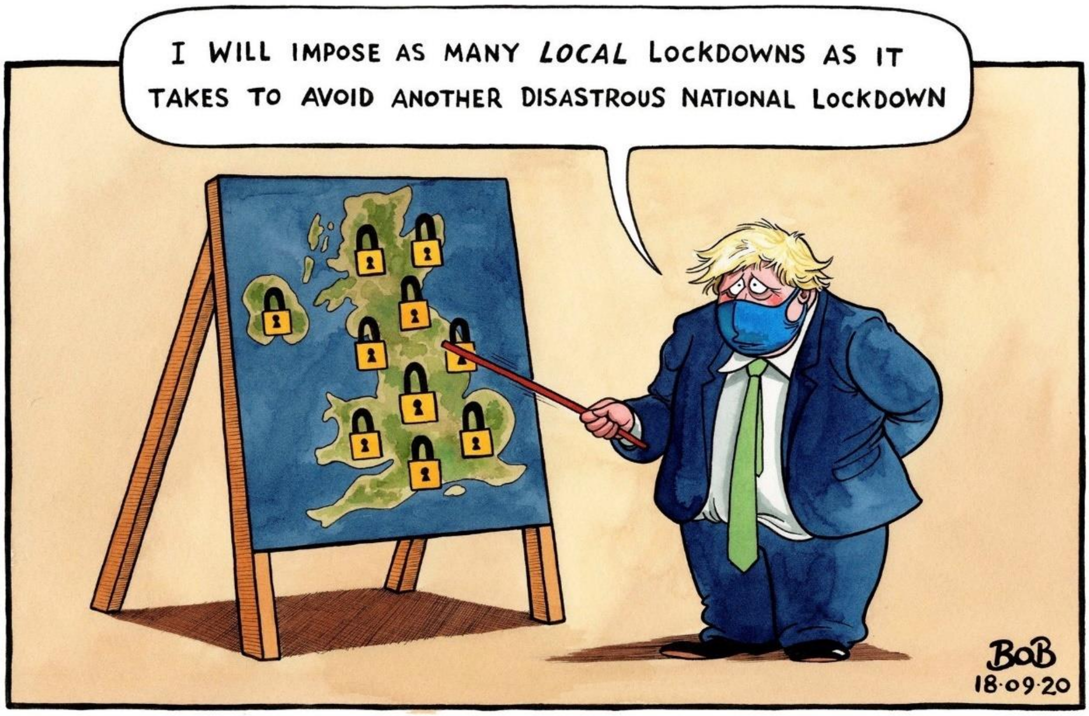


Bob Moran, 18 September 2020

Taking a step back to look forward

Stock markets have stabilised and started trading sideways, in a sign of healthy consolidation following their extraordinary recovery rally since late March. Notably, the darlings of the recovery, namely US large cap tech and growth stocks, are no longer the leaders. This bodes well for a gradual sentiment shift among investors. Capital is no longer piling into the 'fear trade' that saw investors flocking towards apparently virus-proof businesses of our new virtual, digital, stay-at-home existence. Instead, investors are buying into the return-to-normality trade of the more physical parts of the economy, like manufacturing.

Similarly, the resurface of political anxiety over Britain's post-Brexit trading conditions with the European Union (EU) has calmed over the week. For one, reports have emerged of negotiations progressing on one of the two remaining Brexit trade deal sticking points – fisheries. Full sovereignty over state aid decisions, the other make or break issue, also appears far less unsurmountable, since it transpired that with the previous week's free trade agreement with Japan, the UK government has already agreed to more stringent constraints on state aid than are currently the bone of contention with the EU.

In the US, the political establishment on both sides made it clear they would take a dim view to any future trade negotiations should the UK undermine the Northern Irish Good Friday agreement for the sake of Brexit. Therefore, it seems increasingly unlikely that the government's 'nuclear' negotiation option of breaking an international treaty has much life left in it.

Unfortunately, and despite these positive developments, the mood of UK private investors may well have become quite clouded again, due to the reintroduction of wide-ranging coronavirus constraints and concerns over what this may mean for the economy and stock markets. Have heavy dark clouds re-appeared on the horizon, then?

It is worth taking a step back to reflect, before making predictions based on our most recent experience (even if that is a very human approach). Just as we all underestimated what was ahead of us in March, we may now be overestimating what the second wave of infections could bring – and for how long. The facts tell us that the fear of what might happen drove the Covid containment measures, which then caused the economic slump. We would argue that if the public health impact across Europe and the UK back in March had been at as low a level (relative to the infection count) as it is at the moment, then much less severe containment actions would have been taken. The reason we are seeing the government reimpose soft lockdowns across large parts of the UK is a resurgence of the fear that severe cases and fatalities will return to April's levels.

While such action seems rational (even if still quite damaging to the economic recovery), the general levels of justified fear are likely to decline with every week that passes by without a repeat of April's public health pressures. Importantly, every week also takes us closer towards the formal licensing of COVID-19 vaccines. Here, reports that the German-US joint venture between BioNTech and Pfizer may be reaching approval and first roll-out by the end of October were the highlight of the week. This is considerably earlier than experts had dared to project, and provides a strong perspective for an alternative means of protecting those truly vulnerable to Covid, compared to restricting the lives of everyone. The UK's own Oxford University/AstraZeneca vaccine trial is also back on track after the health issue with one of its test patients was confirmed as an undiagnosed previous condition and therefore unrelated to the test vaccine.

The BioNTech/Pfizer project alone is projecting to have produced 100 million doses by the end of the year and we know that AstraZeneca is also already producing their vaccine at volume under the assumption (and business risk) that it will gain approval. This should mean that, starting from November, fears for those most at risk from COVID-19 should reduce materially, given their numbers are small compared to the entire population.

Based on the above, we suspect the near-term impact of the second wave may be far less than what it currently seems. If people across Europe continue to be able to keep the public heath impact as low as it has been in Spain and France, and the arrival of a vaccine remains on course, the fear currently driving the public response could dissipate quite rapidly.

Given the entirely new set of threats that 2020 has presented to us all, it is very understandable that we resort to guidance from our most recent experience. However, in this instance, this may not be the best advice for investors. For example, a number of virus-related uncertainties are beginning to approach the end of their natural life. With their expiry, a significant volume of pent-up activity could add suddenly to every aspect of the economy, as consumers behave similarly 'de-mob happy' as they did following past periods of wartime constraints. While much of the normalisation expectation has already been priced into financial assets since March, we can see from China's recent economic development that there is considerably more economic upside from a true Covid recovery than may be priced in presently. This is particularly true for all those sectors and companies shunned as the losers of the coronavirus crisis, and therefore present promising bounce-back potential. For the coming weeks, the team at Cambridge will therefore be focusing on realigning our investors' portfolios to the sector rotation dynamics that have historically followed severe recessionary periods. Beyond that, we will once again look at focusing on the previous uncertainties for investors. The US election and our own Brexit arrangements may well become the more important dynamics for us to assess in the last quarter of 2020. Fingers crossed.

Brexit bother as Boris's Mexican stand-off misfires

Having spent most of 2020 hoping things can get back to normal, Britain's political news over the last couple of weeks has left us thinking 'be careful what you wish for'. Stalling Brexit talks, political disarray and the potential for a full-blown constitutional crisis all created that familiar feeling of pre-pandemic times. Indeed, as if there was not enough déjà vu, parliamentary action even saw Ed Miliband standing in as leader of the opposition.

Jokes aside, the emphatic return of Brexit risks to Britain's economy and capital markets is clearly bad news. Those sympathetic to the government insist that the provisions laid out in the Internal Market Bill – allowing the government to unilaterally break international law – are just a negotiating tactic to establish a credible threat of 'no deal'. But reaction from the continent, and within Johnson's party itself, suggests this particular negotiating ploy is unlikely to pay off.

Even if it does, in the short-term it will cause great uncertainty over Britain's relations with its largest trading partner – not to mention the constitutional chaos it might bring (if passed in its current form, the bill would almost certainly be challenged in the Supreme Court). As we have seen over the last four years, uncertainty is highly detrimental to businesses and consumer expectations.

Accordingly, capital markets reacted swiftly to the news. After a strong run in recent months, sterling fell dramatically last week, sinking to €1.07 against the euro and $1.27 against the dollar – its deepest weekly fall since March. At the time, head of Lombard Odier's currency strategy Vasileios Gkionakis told the *Financial Times* that "The market is simply going through a rude awakening," readjusting for Brexit risks that seemed to clear over the summer.

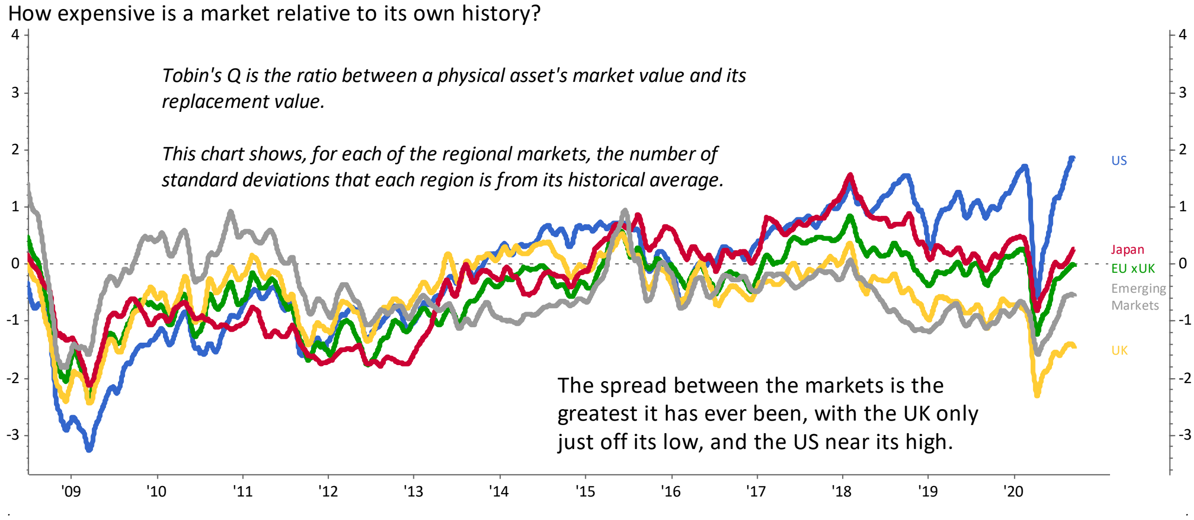
However, the sell-off was short lived. Throughout the past week, sterling has regained much of its losses against its global peers and, at the time of writing, sits around €1.10 and $1.29 against the euro and dollar respectively. UK equities made marginal gains the previous week – partly down to the weakness of sterling itself – and last week have edged slightly higher overall. Interestingly, Brexit turbulence gave investors a fright, but only briefly. For nearly five years, Britain's long and drawn-out divorce from Europe has been one of the main drivers of UK asset prices (and in the case of sterling, practically *the* driver). Now that we are again facing down a precarious Brexit deadline, why the nonchalance from global capital markets?

Put simply, we suspect it is the pandemic. With the world edging out of lockdown in recent months, the key question on the mind of most investors has been when the cyclical rally – backed by a recovering economy – will begin. Historically, UK equities (especially the FTSE 100) are extremely sensitive to cyclical forces – growing when global growth is strong and lagging when it is not. If growth – in its conventional 'analogue' rather than 'digital' shape – is indeed returning, it therefore bodes well for UK assets.

From this perspective, UK stocks look cheap. Even before Brexit, the UK was unloved by global investors. With political risks piled on, British assets have been consistently underbought relative to other major markets, resulting in UK stocks making up a much smaller portion of global investment portfolios than a decade ago. In valuation terms, UK stocks are currently trading at around 16.5x their expected future earnings on average, compared to around 19x for European stocks and well over 20x for US equities. It is even slightly below the global (excluding US) average at around 18x. Below is another way of looking at the valuations; Tobin's Q is akin to "price/book":

Tobin's Q: Z-score

How expensive is a market relative to its own history?



Source: Factset, Tatton IM

That relative undervaluation is – to an extent – justified. The prospect of a hard Brexit as the UK is still reeling from a total economic shutdown is a significant economic risk. But for the past few years, anxious investors at home and abroad have been selling UK assets. As such, even in the worst-case scenario of a chaotic 'no deal' Brexit, the immediate downside is limited. There are just not as many investors left to sell. This can be seen from the performance of the FTSE 100, which has traded mostly sideways for months.

When you combine the prospect of a global cyclical recovery, UK assets look like a bargain. Indeed, even if global investors remain pessimistic on UK equities, a rebound in global activity – and subsequent increase in company earnings – would mean that equity prices could rise without much of a change in valuations.

However, two things need to happen for this positive scenario. First, the cyclical rally has to materialise. While there are some emerging signs, it is simply too early to tell. Second, some kind of resolution to the Brexit drama needs to be found. For now, the dark cloud of a hard Brexit looms large over UK markets, making many investors uninterested even at cheap valuation levels. Threats to unilaterally break components of an already-agreed treaty do little to help them.

There are reasons for positivity, though. Reports last week suggest Britain is willing to deal with the thorny issue of fisheries more pragmatically in its negotiations with the EU. And, while much was made on the issue of full sovereignty in deciding state aid in the latest Brexit spat, the recently-agreed free trade agreement with Japan already commits Britain to stricter state aid restrictions than the ones that have caused the latest furore. Given a negotiation success towards the EU on the freedom to subsidise issue would therefore not actually result in any more leeway for the UK, this suggests the government may be willing to reconsider its position – leading to a swifter resolution.

For now, the barriers to an agreement seem to be mostly superficial. But as the last four years have shown, things can quickly take a turn for the worse. If an agreement can be reached – and if the cyclical rally does indeed begin – UK assets will be in a good position. Until then, we will all have to wait and see.

21st September 2020

Can the Fed redress a 40-year imbalance between workers and savers?

Who does monetary policy work for? The simple answer is everyone, but given that one of the defining aims of a central bank is to ensure monetary and financial stability, perhaps a more historically accurate answer is savers (owners of financial assets). Through interest rates and other means, central banks hope to provide a stable monetary base and steady rate of inflation – thereby ensuring individuals' savings maintain their value in the face of rising prices. Most monetary policymakers target inflation, but – unlike other central banks – the US Federal Reserve (Fed) has another objective in its 'dual mandate': ensuring full employment. Its explicit aim is to balance the needs of the US labour market and achieve stability in overall prices. As such, its monetary policy is supposed to work not just for savers but for workers too. Sometimes, though, one of the two goals will have to take precedence.

Lately, the balance of priorities has swung definitively toward workers, or rather towards employment income over income from financial assets. Last month, the Fed announced a new framework for monetary policy, opting for a 'symmetrical' inflation target of 2% over the long term. And last week, the Federal Open Markets Committee (FOMC) announced that it does not expect interest rates to rise above current non-existent levels until 2023. Crucially, chairman Jay Powell declared that the Fed would not consider lifting interest rates until full employment was achieved, and inflation was set to run above 2% for some time. By committing to a 'lower for longer' policy on interest rates (see chart below), the Fed has effectively said it will tolerate the economy running hot if that is what it takes to ensure jobs. In other words, to improve income levels from employment, the Fed is willing to undermine the purchasing power of savings where returns are more or less tied to their near 0% interest rates policy (i.e. bank deposits and government bonds) and thus below the 2% rate of inflation they will tolerate without intervention.

Source: US Federal Reserve, Bloomberg, 17 September 2020

In terms of short-term policy, it makes little difference. With the US economy still reeling from a global economic shutdown, everyone expected interest rates to stay at zero and for monetary policymakers to keep pumping liquidity into the financial system. Nonetheless, the framework change is significant, because it formalises a shift that began before the Covid crisis. Although setting a policy that works for both savers and workers has always been the Fed's mandate, for several decades now there has been a sense that the Fed has a disinflationary bias. In other words, some feel the Fed has favoured savers' interests over those of wage earners.

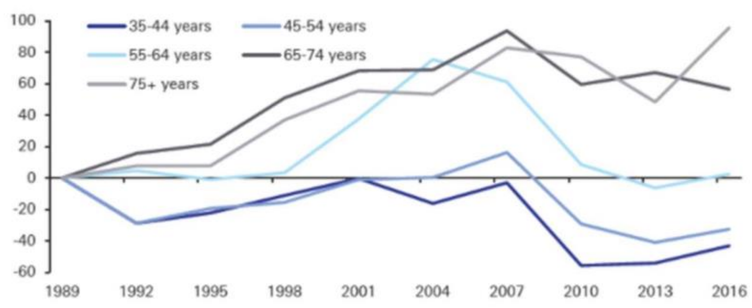
This stems from the historical observation that when employment had risen and signs of wage increases came through, the Fed was quick to quash what it saw as potential inflationary pressures. But over the years, the dangers of this approach have become increasingly apparent. As the experience of the post-financial crisis era has shown, low unemployment need not quickly cause higher inflation. The suspicion was that in the era of globalisation, employment was simply too weak to give workers the power to negotiate higher wages. By tightening monetary policy in response to rising employment, central banks have been accused of prioritising monetary stability over the labour market.

Part of the new framework from the Fed is a further recognition on its part that monetary policy is not politically neutral. In his annual speech at this year's virtual Jackson Hole conference of central bankers, Powell noted the problematic ways in which employment is counted. For the last ten years, the unemployment rate has fallen consistently. However, due to rising non-participation rates (people basically giving up trying to find work), overall employment has not seen a corresponding gain. The Fed Chairman went as far as to say that the 'real' unemployment rate might be 3% higher once these factors were taken into account.

The idea of monetary policy having adverse social effects is nothing new. Many have suggested that it was in fact the *looser* central bank policy that contributed to growing wealth inequality over the last decade, by inflating asset prices to benefit of those with capital, while working conditions stagnated. Traditional savers also felt left out as record low interest rates did not provide any stream of income. Looking over the longer term though, it is not just wealth and income inequality that has been boosted, but also a distinct increase in generational inequality.

To put this deep and complex topic into as simple terms as possible, with the onset of hyper-globalisation in the 1980s, the returns to labour fell significantly lower than the returns to capital. Naturally, this benefitted those already with capital – earned in the thriving post-war labour market – who could then afford to buy assets that would give them healthy returns down the line. With wage growth further suppressed by increasing global labour competition, this has left house prices and other financial assets out of reach for many younger people. The chart below shows that real (inflation adjusted) net worth among different age groups has diverged substantially since the late 1980s.

Figure 49: Percent change in US real median family net worth by age of head



Source : FRB Survey of Consumer Finances, Haver Analytics , Deutsche Bank

This generational divide of wealth has undoubtedly contributed to the increasingly wide political gap between old and young. The Fed, along with other central banks, is keen to avoid widening this gap through its policies. But monetary policymakers also recognise this is not something that can be achieved by central banks alone. In recent years, Powell and other central bankers have been actively pushing governments to expand their fiscal policies to improve the economy for all. The pandemic has only emboldened that drive, and massive spending programs now look like the norm throughout this crisis and beyond. Fiscal focus is also likely to shift from state-financed support and investment to income redistribution via taxes and transfers.

This shift to making monetary (and fiscal) policy work for wage earners should not scare investors. For yield seekers, rates can only rise on a sustained basis if the economy is strong enough, and financial asset markets can only thrive if there is a dynamic economy alongside them. After all, if one age group needs to sell its assets to fund their retirement, only to find no one in the younger generation has the money to buy them, those underlying assets will see a sharp and damaging price reversal. One way or another, imbalances will be corrected. But with a steady change of monetary framework and fiscal policy, that correction can be orderly and benign.

Here, we suspect, lies the deeper transition for the Fed. In the post-pandemic world, inflation may not only be a spur for growth, but also potentially a rebalancing tool between age groups. We are unlikely to see the effects of this framework take effect soon, but it seems the Fed has recognised the importance of wage earners feeling the benefit of its policies more strongly than it has over the past two decades. Monetary stability may otherwise prove to be a fool's errand if political and societal instability sewn by imbalances between the generations reaps destructive upheaval.

Global Equity Markets

Market	Fri 16:00	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6022.1	-0.2	-10.0	⇗	↘
FTSE 250	17546	-0.1	-9.7	⇗	↘
FTSE AS	3361.9	-0.1	-4.0	⇗	↘
FTSE Small	5154.8	+0.6	+28.9	↗	⇘
CAC	4986.1	-1.0	-48.0	↗	↘
DAX	13162.4	-0.3	-40.5	↗	→
Dow	27823	+0.6	+157.1	↗	→
S&P 500	3350.2	+0.3	+9.3	⇗	⇗
Nasdaq	10827.7	-0.2	-25.9	→	↗
Nikkei	23360.3	-0.2	-46.2	↗	→
MSCI World	2383.5	+0.7	+15.4	⇗	→
MSCI EM	1106.8	+1.4	+15.0	⇗	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Ocado	+23.6	TUI	-15.6
Hiscox	+20.5	Rolls-Royce	-13.7
M&S	+8.1	Carnival	-13.4
Experian	+6.6	Int'l Consol Air	-11.6
Next	+6.5	BP	-6.4

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.296	+1.3	Oil	43.38	+8.9
GBP/EUR	0.915	+1.1	Gold	1954.0	+0.7
USD/EUR	1.19	+0.1	Silver	26.93	+0.7
JPY/USD	104.34	+1.7	Copper	306.8	+1.1
CNY/USD	6.77	+0.9	Aluminium	1781.0	-0.5
Bitcoin/$	10,945	+6.0	Soft Cmdties	358.6	+3.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.18	-0.00
UK 15-Yr	0.42	-0.01
US 10-Yr	0.69	+0.02
French 10-Yr	-0.22	-0.03
German 10-Yr	-0.49	-0.01
Japanese 10-Yr	0.02	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	19.3	20.1	13.7
FTSE 250	2.7	16.0	27.8	14.7
FTSE AS	3.7	18.5	21.8	13.8
FTSE Small	3.6	15.9	-	13.8
CAC	2.2	20.4	25.9	14.0
DAX	2.6	22.8	21.5	12.9
Dow	2.3	22.1	24.3	15.6
S&P 500	1.8	24.9	25.5	16.6
Nasdaq	0.8	34.3	30.8	18.8
Nikkei	1.8	23.6	23.1	17.1
MSCI World	2.1	23.6	24.2	15.7
MSCI EM	2.3	16.3	17.9	12.1

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.59	1.49
3-yr Fixed Rate	1.81	1.75
5-yr Fixed Rate	1.79	1.74
10-yr Fixed Rate	2.39	2.39
Standard Variable	3.64	3.64

* 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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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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