THE **CAMBRIDGE** WEEKLY

26 October 2020

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"Track or trace?"

Ken Pyne, 23 Oct 2020: COVID Halloween in the UK

Sunlit uplands or COVID gorge?

Halloween is around the corner and markets had plenty to frighten them last week. Across Europe, the second wave of infections has risen higher than the first. While new lockdown measures are less stringent this time (schools and businesses can remain open unless social distancing is impossible), shutting down social interactions, just as the service sector was finding its feet, has the potential to put the recovery back on hold.

Brexit rumblings continue to scare too, as the previous week's high tensions – as Boris Johnson told the nation to prepare for a 'no deal' – carried over. But the noise abated as both sides agreed a new mid-November deadline. Judging from last week's price moves, capital markets think the bluster on both sides is just that - currency and stock markets barely moved in response.

With good news so scarce, it is unsurprising that markets gave back some of October's early gains. Overall, prices continue to trade sideways, and are mostly flat since the beginning of September. Markets are in a holding pattern, waiting to see how the renewed virus uncertainty plays out. Underlying this, however, some notable economic trends are emerging (as we discuss in separate articles below).

At a regional level, China is still the big winner of 2020. Activity is now motoring ahead, and the world's second-largest economy is on course to be the only major nation to post positive growth numbers this year. Despite the dreary virus picture in Europe, Germany's most recent manufacturing flash Purchasing Manager's Index (PMI) (measuring business sentiment, where a reading above 50 indicates expansion) came in at 58.0. This is an increase on last month's 56.4, despite expectations of a fall. Car sales seem to be the cause of manufacturing optimism, as demand has picked up globally and particularly in, yes, China. The

services sector fared less well, and is now marginally below the neutral level, although the direction of travel is encouraging.

None of this is helping the UK economy. Here, PMIs are going in the opposite direction, which drove down stocks in the first half of last week. Declining sentiment is a clear sign that September's COVID restrictions are squeezing activity, especially in the services sector. Beyond this lies a number of domestic problems, Brexit being just one of them. Chancellor Rishi Sunak has stepped off the pedal in terms of fiscal backstop support – evidenced by his reluctance to commit more spending for businesses and employees in Manchester, and the spat with Mayor Andy Burnham.

Budget hawkishness at this time could be a devastating policy mistake – for both behavioural compliance and the economy. We suspect recent weakness in the UK market was mostly attributable to the government's fiscal floundering. Sure enough, after the Treasury's stance softened last Thursday, markets leapt back up on Friday. The sharpest economic downturn in modern history is not the time to worry about balanced budgets. Judging from the Bank of England's comments last week – suggesting it may have to resort to negative interest rates – central bankers agree. This is not a move the Monetary Policy Committee would take lightly, but could be necessary if no more fiscal support arrives.

Comparisons with the US are telling. America has undeniably fared better (economically speaking) in 2020, and markets are now looking favourably on its prospects. This is, in large part, down to the expectation of a Joe Biden presidential victory, followed by bigger fiscal stimulus programmes in 2021. Perhaps markets have begun to see monetary value in the containment of environmental risks and overall social cohesion (See the below article on green energy investments outperforming US Big Tech). There is also some suggestion that the biggest Biden downside for equities – an expected corporate tax hike – could be delayed.

In any case, US economic growth is still strong, certainly compared to Europe. We are now into the Q3 earnings season, and results are showing that – despite fears over the summer that markets were running on hot air – stocks are better underpinned than many had thought. To add to this, credit and liquidity conditions are holding up, suggesting mass default fears have been misplaced.

Of course, if the US economy is strong, then the Chinese economy is booming. Such is the economic optimism in China that authorities are now refocused on containing 'overheating' issues. The People's Bank of China (PBoC) is now confident enough to be raising interest rates, while also taking regulatory steps to cool the property market. In combination with a further opening up of its capital markets – through removal of currency controls - President Xi's administration seems keen to promote financial asset investment from domestic as well as international investors.

We will be keeping a particularly close eye on the publication of results from various pharmaceutical conglomerates at various stage three efficacy tests that are expected before the end of the month. Vaccines may well have a huge decisive impact in the race between East and West. Hints by UK's chief medical officer Chris Whitty that we "may have a few doses of a vaccine before Christmas" are encouraging, as distribution to the most vulnerable should allow governments across Europe to begin relaxing restrictions.

The indicators of the last quarter tell us that the global economy has every potential and capability to recover strongly, even if we get another quarter's delay, and that evidence for a meaningful 2021 bounce-back is becoming more evident.

What is not clear yet, but will merit watching closely, is whether the 'first in, first out' advantage China has gained in economic terms will lead to a more fundamental and accelerated paradigm shift, or at least a change in global importance between the old economies and the new, with China and other growing South East Asian economies at the centre.

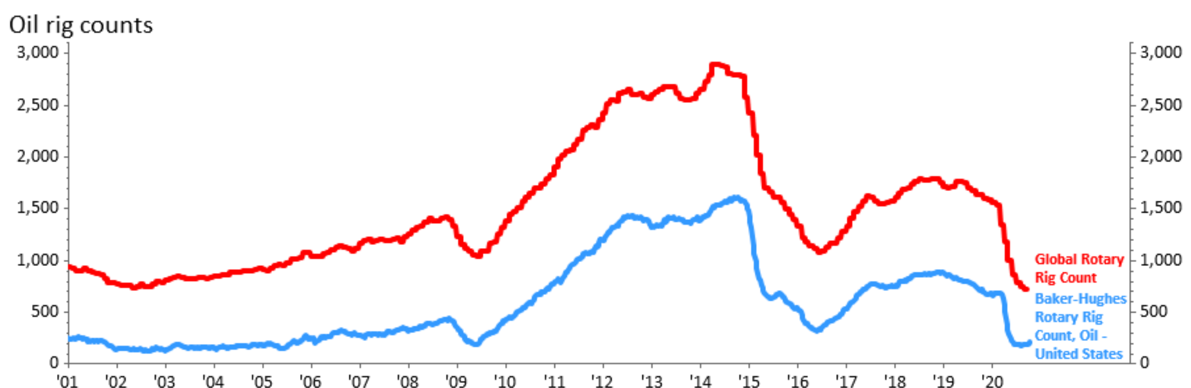
Canary in the oil well?

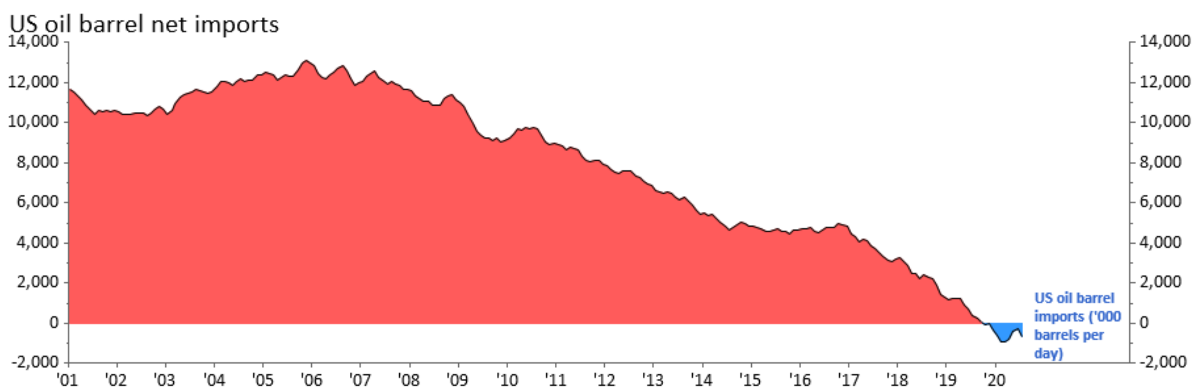
Back in February, tumbling oil prices were a harbinger of things to come. It became clear the world was heading for a crisis – one that would eventually force governments to shutter their economies and plunge the global economy into its deepest-ever recession on record. The economic ice age to come would severely hamper oil demand – often considered a proxy for global economic activity.

But demand issues were only one side of the story. OPEC+ members (Russia being the leading non-OPEC player) used this moment to break their accord on oil production. Crude oil supply flooded the market just as demand was drying up, causing an almighty drop in prices.

The strategy was rumoured to be an attempt at stopping the surge in US domestic oil production. As we wrote back then, shale oil drilling in the US (and Canada) had surged in the aftermath of the global financial crisis. In 2009, oil prices shot from $40 per barrel to $80 per barrel while the cost of borrowing was low for US oil companies. Shale drilling became immensely profitable overnight.

Oil Production



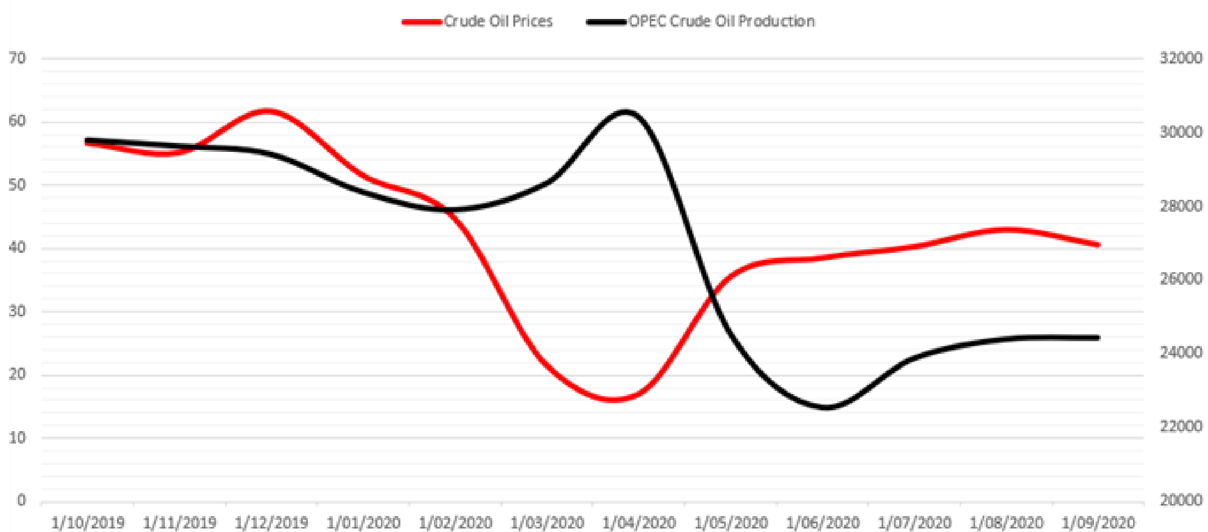


Source: Factset, Tatton IM, Baker-Hughes, US EIA

As the above charts show, the process changed the balance and dependencies in the global oil market fundamentally. It pivoted the oil (and metals) exporting nations towards China and away from their historic dependency on the US. By the beginning of this year, the US was *exporting* oil.

But the US oil rigs were heavily financially leveraged, with the breakeven price of most (at the time) probably above $50 per barrel. So, the members of OPEC+ were given a helping hand by the spring lockdown. If they couldn't avoid the demand collapse, perhaps they could use it to remove the competition. The culmination of this came in April, when Brent Crude prices hit a low of under $20 and WTI (the US equivalent benchmark) saw its most incredible price event in history. Spot prices turned negative, with oil traders willing to pay $37 per barrel to have contracts taken off their hands (so they didn't have to take physical delivery with nowhere to store it).

However, the side-effect on equity markets was equally huge. Investors were already spooked at the prospect of a global economic shutdown. This probably created a feedback-loop which exacerbated the nosedive in oil prices. Producers soon agreed immense production cuts to stabilise prices. Since June, spot prices for both Brent and WTI have hovered around the $40 per barrel mark, aided by the summer thaw in global economic activity. As the chart below shows, OPEC countries have even been able to increase production while maintaining a steady price level. Meanwhile, US producers have not reinstated lost rigs – the costs (especially debt costs) have been way too high.



Source: International Energy Agency (IEA), September 2020

With a reduction in global oil production capacity, one might have expected reasonable pricing power. The complication now is that, just like earlier in the year, rising virus cases across much of the western world are forcing governments to shut down activity once more. The International Energy Agency (IEA) has warned that tightening restrictions point to a fragile outlook for crude oil prices. We are already seeing this in oil-related products like distillates (including diesel and types of heating oil), where weak demand

from increased lockdown measures in Europe has caused a fall in demand. Unsold distillate inventories are now high, which is feeding through into a backup in crude inventories.

What is more, while producers have endeavoured to cut supply throughout the second half of the year, issues remain. A reduction in land-stored crude oil of four million barrels is expected in the fourth quarter of 2020 according to the IEA, but the organisation stresses that this "is happening from record levels".

OPEC+ is set to meet next month to discuss future production policies. Under the current agreement, the production ceiling is set to increase by 1.9 million barrels per day at the beginning of 2021. But "there is only limited headroom for the market to absorb extra supply in the next few months" according to the IEA. If oil producers can agree to retain production curbs at the meeting, prices should be stable, and any falls less dramatic than in March. Last Thursday, Russia (the main architect of the collapse) suggested a continuation of curbs. Still, they surprised the rest of OPEC+ in the spring, and that experience might caution against being confident of an agreement.

Oil could once again prove to be the proverbial canary in the coalmine for the global economy and capital markets. A repeat of oil price volatility could have an outsized impact on markets yet again, particularly given the importance of oil-related investors (the oil nations sovereign wealth funds) to the global financial system.

Being aware of the risk does not mean financial markets will suffer. The onset of the pandemic across the Western world came just as we entered spring, when energy for heating naturally was dropping and when – in a normal year – travel and industrial activity should have become the main components of oil demand. Now that we are heading into winter, heating oils for homes and workplaces will naturally be in high demand, even if other economic activity drops off.

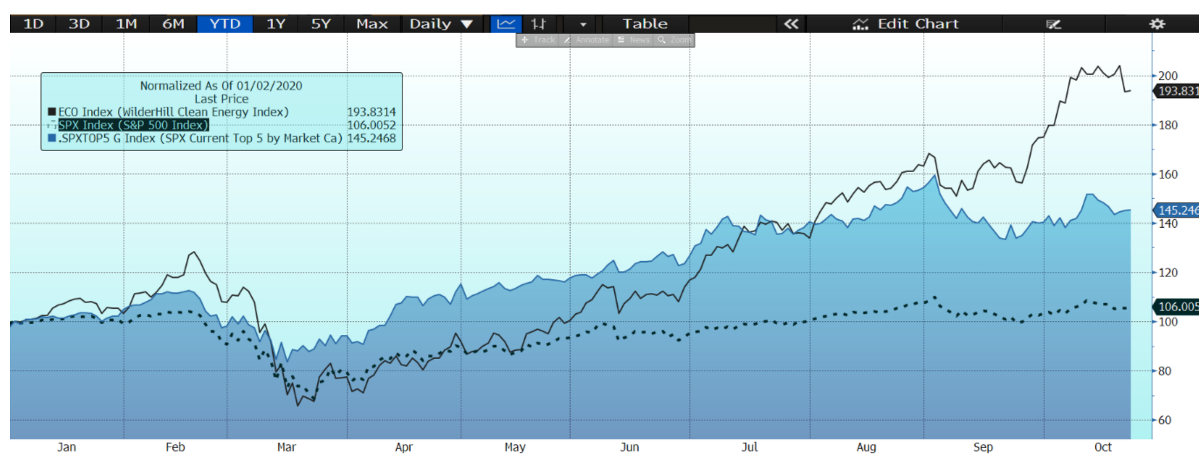
The overall global economic outlook is also different. The second wave of COVID has brought back a great deal of uncertainty for businesses and consumers, but we now know much more about the virus and how to combat it (both medically and socially) than back in March. There are significant economic positives on the horizon too, with vaccine development now looking a certainty for early next year at the latest, and continued fiscal and momentary support from authorities. Markets have certainly taken these positives on board and seem to be expecting 2021 to be a stellar year for growth – admittedly from extremely low levels in absolute terms. But even if you do not buy into the growth story, no one seriously expects next year to be as bad for growth as this one.

Much of the outlook for oil therefore depends on how much of a recovery you expect for 2021. And that leads on to a point often made (but seldom acknowledged) about oil prices: Even if short-term expectations cause market-damaging falls in oil, this is not necessarily a negative for the economy. Indeed, part of the growth outlook for next year is based on the idea of a cyclical rebound. A low oil price could well be a big positive for this cyclical story, with manufacturers and consumers benefitting from lower costs.

Overall, a drop in oil prices from current levels – even a dramatic one – is a possibility over the next few months. But outsized effects on the economy and capital markets are much less likely.

Green energy overtakes Tech's 'Big Five' as 2020 winners

Over the course of this year – and well before – we have grown used to the incredible outperformance of the US technology sector. Such is the size and strength of Silicon Valley that at times US mega-cap tech stocks have accounted for most price moves in the overall stock market. But tech has been far from the only 'winner' out of the pandemic, even if it has been the most noticeable. In fact, since global stock markets sunk to their depths in March, green stocks – those that stand to benefit from environmental regulation and the shift towards cleaner energy – have rivalled the performance of the five biggest tech stocks (Facebook, Apple, Amazon, Microsoft and Google). The chart below shows the price action of the US WilderHill Clean Energy Index – a modified equal dollar-weighted index of publicly-traded clean energy companies – against the performance of the S&P 500. As you can see, green stocks suffered heavier losses than the wider market in the early part of the year, but have since recovered all of those losses. In October, with expectations feeding into the market that candidate Joe Biden may win November's presidential election, it has clearly outperformed the S&P's mega-caps.



US WilderHill Clean Energy Index (solid black line) versus US S&P500 (dotted) and the US Tech Big Five (solid blue)
Source: Bloomberg, Tatton IM

This is somewhat surprising and, to some, may have come as a relief. When the pandemic began, one of the biggest questions was whether a fixation on dealing with the virus and its economic fallout would lead to a neglect of environmental or social issues. History certainly suggested environmental concerns would fall by the wayside. In the aftermath of the global financial crisis, environmental changes that had been prominent in the early 2000s were largely ignored in favour of dealing with a global economy in recession. Indeed, the WilderHill Index itself has never recovered to the levels it reached in 2007.

Things certainly look different this time around. Governments are keen to tie fiscal stimulus funding for the post-COVID economic recovery, which may have quite a long investment horizon, to environmental goals. Politicians and the voting public are rightly focused on building the world back up, and there is a distinct sense that this cannot be achieved through the old environmentally destructive means of the past. This is borne out both through market trends and public policy. Biden – now the clear election favourite – has promised a $2 trillion 'Green New Deal' package, while the European Union (EU)'s green recovery plan promises to put hundreds of millions of euros into a sustainable recovery from the pandemic. Private companies are joining in too, with JP Morgan pledging to help its clients achieve net-zero emissions in their investments by 2050.

This backdrop has been a particularly good one for ESG (Environmental, Social and Governance) investors, who choose portfolio stocks not only on the basis of profit outlook, but also on how well a company scores on those three categories. We should distinguish between ESG and straightforward environmental companies – as well as between ESG and 'Ethical' portfolios – but these categories are nonetheless related, and often affected by the same trends.

Investor demand is undeniably strong for ESG assets. In the third quarter of this year, green, social and sustainability bonds surpassed $1.3 trillion in cumulative sales, and the EU's pandemic recovery plan is expected to double the size of the ESG debt market next year. And, throughout the year, we have seen multiple initial public offerings from companies in the electric vehicle sector, with German electric charging company Compleo the latest to go public – with an initial market cap of €168 million.

However, with all this great performance, there is a growing debate about whether ESG stocks have now become too expensive on a valuation basis. Even if the underlying businesses are solid and have strong outlooks for the future, the expected return on ESG assets is, of course, dependent on where they are already. With prices bid up so high throughout the year – and returns comparable to the rampant tech sector – how much higher can or should ESG go?

This is not a debate with any easy answers. But there are reasons for positivity. The environmental sector is still below its pre-global financial crisis peak in price terms. And, with the inevitable drive towards cleaner energy and tighter environmental regulation, the long-term trend is very much in its favour. That is not to say that ESG stocks might not be subject to some profit-taking in the short-term, but a secular shift towards a green world is clearly better for green businesses than it is for those reliant on fossil fuels – which could well become stranded assets years down the line.

Policy is a vital component here. While there is a clear drive for environmental regulation and aid across most major economies, there is undeniably a long way to go. If politicians stay committed to the CO_2 reduction cause – and the growing pool of environmentally-aware voters suggests they should – we can expect much more in the future. As such, even though ESG stocks have seen a significant rally already, we could just be at the beginning of this trend.

It is also worth bearing in mind that investors are not just investing in ESG for the monetary gain. Empirical studies show ESG investors hold their selected stocks for much longer, and therefore the underlying stocks may not be as susceptible to short-term speculation. Choosing to put money in socially and environmentally-responsible stocks is more of a personal or ethical decision, rather than a straightforward investment one.

But this is something of a double-edged sword. On the one hand, it can make demand for ESG assets sticky, in that buyers are unlikely to be suddenly swayed *en masse* by changing profit narratives. On the other, any investment strategy which includes non-profit related goals is – by definition – less profitable over the extremely long-term. Global trends may sometimes line up with these goals in a way that is beneficial for ESG investors, but there is nothing to say that has to always be the case.

That should not be at all surprising. The simple point is that ESG or ethical investing aims at more than just profit, and so investors should be prepared to sacrifice potential profit sources to achieve their other goals. At the moment, that sacrifice is so small it is negligible, and current secular trends mean it may well continue. But we should emphasise that it is not *just* an investment decision.

CAMBRIDGE
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26th October 2020

Global Equity Markets

Market	Fri 14:50	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	5871.3	-0.8	-48.3	→	↘
FTSE 250	18113	+1.6	+290.4	↗	↘
FTSE AS	3315.1	-0.3	-10.5	→	↘
FTSE Small	5267.6	+1.5	+77.4	⇗	↘
CAC	4922.9	-0.3	-13.0	→	↘
DAX	12682.6	-1.8	-226.4	→	⇘
Dow	28383	-0.8	-223.2	→	→
S&P 500	3461.1	-0.7	-22.7	→	⇗
Nasdaq	11473.8	-1.7	-197.7	→	↗
Nikkei	23516.6	+0.5	+106.0	→	→
MSCI World	2421.0	-0.8	-19.1	→	→
MSCI EM	1136.5	+1.1	+12.5	⇗	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
easyJet	+16.7	Fresnillo	-9.0
TUI	+15.0	Pearson	-6.8
Carnival	+12.0	DCC	-6.3
Int'l Consol Air	+11.3	GVC	-5.5
Barclays	+9.8	DS Smith	-5.5

Currencies

Pair	last	%1W
USD/GBP	1.307	+1.2
GBP/EUR	0.906	+0.2
USD/EUR	1.18	+1.0
JPY/USD	104.77	+0.6
CNY/USD	6.68	+0.3
Bitcoin/$	12,963	+14.5

Commodities

Cmdty	last	%1W
Oil	42.47	-1.1
Gold	1907.8	+0.4
Silver	24.68	+2.2
Copper	313.9	+2.3
Aluminium	1846.5	-0.3
Soft Cmdties	374.6	+3.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.30	+0.11
UK 15-Yr	0.53	+0.12
US 10-Yr	0.85	+0.11
French 10-Yr	-0.29	+0.06
German 10-Yr	-0.56	+0.06
Japanese 10-Yr	0.04	+0.02

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	18.5	19.2	13.7
FTSE 250	2.4	15.8	24.0	14.8
FTSE AS	3.6	18.0	20.1	13.8
FTSE Small	3.3	15.5	-	13.7
CAC	2.2	20.3	25.6	14.1
DAX	2.9	21.8	19.1	13.0
Dow	2.2	21.1	23.7	15.7
S&P 500	1.7	25.3	25.5	16.7
Nasdaq	0.8	36.0	31.2	18.9
Nikkei	1.7	23.5	23.3	17.1
MSCI World	2.0	23.6	24.0	15.8
MSCI EM	2.2	17.8	18.1	12.1

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.74	1.65
3-yr Fixed Rate	1.86	1.83
5-yr Fixed Rate	1.92	1.85
10-yr Fixed Rate	2.45	2.42
Standard Variable	3.50	3.54

* 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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