THE **CAMBRIDGE** WEEKLY

23 November 2020

Lothar Mentel

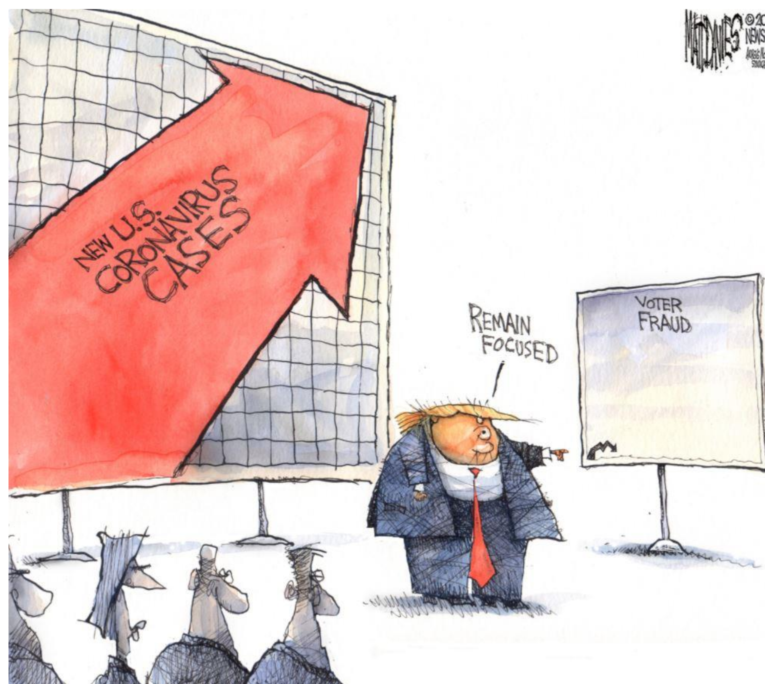
Lead Investment Adviser to Cambridge

DISCLAIMER

This material has been written on behalf of Cambridge Investments Ltd and is for information purposes only and must not be considered as financial advice.

We always recommend that you seek financial advice before making any financial decisions. The value of your investments can go down as well as up and you may get back less than you originally invested.

Please note: All calls to and from our landlines and mobiles are recorded to meet regulatory requirements.



Matt Davies, Second wave at inopportune moment, 11 Nov 2020

.

More tunnel before the light

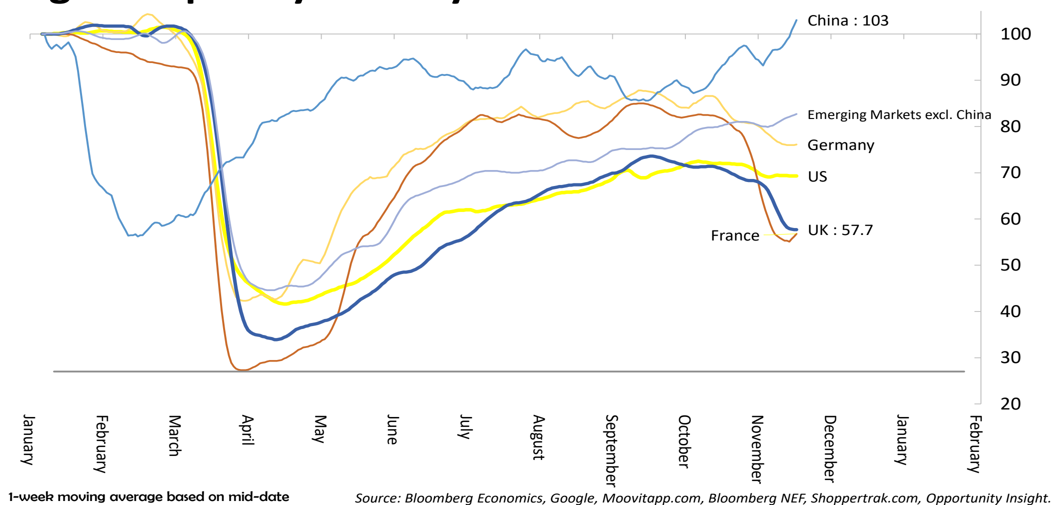
The November rally in stock markets finally petered out last week as it felt as if 'November finally got the memo about 2020'. This was despite further positive vaccine news that bolstered optimism for next year. Last Monday, US firm Moderna announced that phase 3 test results of its messenger RNA based vaccine had a 95% success rate, confirming that messenger vaccines work, after the Pfizer & BioNTech messenger vaccine – had also produced above 90% effectiveness a week earlier. The latter, two-shot vaccine, could start being given to the UK's vulnerable people before the end of this month, with the second dose being administered three weeks later. The early recipients may achieve the prospect of a proper Christmas with their families – updated rules permitting. Meanwhile the one-shot vaccine from Oxford/AstraZeneca is likely to begin distribution just after Christmas. By March, a million people a week could be receiving immunisation in the UK.

Still, the virus has not gone away just yet. The case numbers, which had been stabilising at the end of October, jumped meaningfully last week in many parts of the western world. That said, two weeks into the UK's second 'lockdown', and case numbers are returning back to the October-end levels and from there will almost certainly decline, much as they have done in France and Italy. As the high frequency activity tracker graphs below shows, France's activity is no longer contracting, and the UK is highly likely to follow suit.

But, as China's diverging curve shows, 'getting shot of the virus' is essential for a return to normality. The

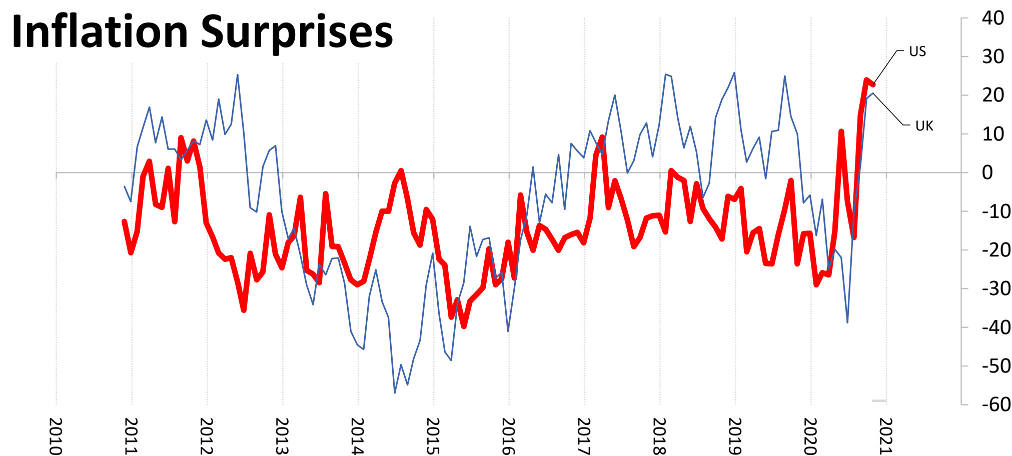
vaccines will almost certainly achieve general immunity next year and, probably more importantly, convince businesses and employees that they should not fear its return.

Nevertheless, resurging public health pressures across wider Europe and the US have now worsened enough to dampen the capital market euphoria of late, as it is becoming clear that despite the multiple vaccine good news stories, for the economy, households and government borrowing, the 2020 narrative of 'worse now, better later' is bound to be with us until at least the end of the year.



Beyond that, what might we be concerned about to spoil the perspective of a strong recovery in 2021? During a research (Zoom) meeting with Karen Ward, JP Morgan Asset Management's EMEA Chief Strategist (and frequent columnist for the Financial Times), she focused on her observation that recent consumer prices have risen more in the US (and the UK) than economists had expected. The chart below, plots the relative (not absolute) difference between expectations and actual readings. Karen stressed that this is not to say inflation is currently a problem, given the sharp slowdown in global activity and the rise in general unemployment. However, she pointed out that the supply-side disruptions (manufacturing, distribution, services) may be more extensive than realised.

As activity resumes through 2021, we might see more general inflation if production capacity growth does not keep pace with pent-up demand being released. There may also be some bottlenecks in sectors such as housing construction, where the pandemic has created secular changes in the things we want.



Actual inflation versus economist forecasts

Source: Bloomberg, Tatton IM, Citi Research

This could be bad news for those sectors that that were driven up by falling yields and lower inflation expectations, but it could be positive for the value/cyclical sectors that have been laggards over the past decade. The US National Association of Housebuilders' index of prospective buying shot up to a record high, albeit from very low levels in the Spring. If consumers become a bit more confident about employment prospects, then construction could become a strong driver for the economy. Although their capacity to surprise is remarkable, the tech darlings like Amazon will probably have a harder time competing in this area.

Another near-term market headwind is that despite the demise of the Trump campaign's lawsuit in Michigan, and the recount in Georgia having increased Biden's total votes, markets' political concerns in the US have not gone away. The fear is that the Biden presidency could see a reprise of the hawkish and obstructionist agenda enacted by the Republican-led Senate, similar to that experienced under the Obama administration. On Thursday, US Treasury Secretary Stephen Mnuchin pressed US Federal Reserve Chairman Jerome Powell to cease programmes lending to small businesses. Meanwhile, the Senate and President have blocked the passage of more fiscal stimulus, and on Wednesday, Senate Majority Leader Mitch McConnell sent everyone home for Thanksgiving, setting up a frantic December of negotiations when the Senate reconvenes.

Thanksgiving usually sees a huge migration in the US. This week's holiday will be different. The US second wave virus outbreak is not now about the Democrats' large cities. It is rising in every state except Hawaii and North Dakota. It might lead to the same sharp contraction in US activity as Europe is experiencing but this is not a sure thing, given the US reluctance in Republican dominated states to entertain any form of lockdown or even enforcement of mask wearing.

On the back of resulting dampened recovery and growth prospects, long-term yields tracked back down, indicating that the market has such concerns, and tech stocks – 2020's fear trade – regained some of their composure. Nevertheless, investors remain quite bullish in taking risk. According to the longstanding and

authoritative survey from Bank of America Securities (previously Merrill Lynch), global economic growth and profit expectations are running at a 20-year high. The "reopening rotation" into previously laggard ("oversold") sectors is likely to continue through this quarter, BofA believes. But for the more speculative end of the investment community, the suggestion is to 'sell the vaccine' in the coming weeks and months: "we're close to 'full bull'" is how they put it.

That probably means there is a growing chance of volatility as we head into December. Markets are liquid at the moment, but in the absence of a continuous flow of good news, it is possible that institutional investors could lock in rather unexpected 2020 profits and shut up shop earlier than usual this year. This could prove more likely to be a year-end consolidation than a (more concerning) correction – given the persistent expectation of much better times in 2021.

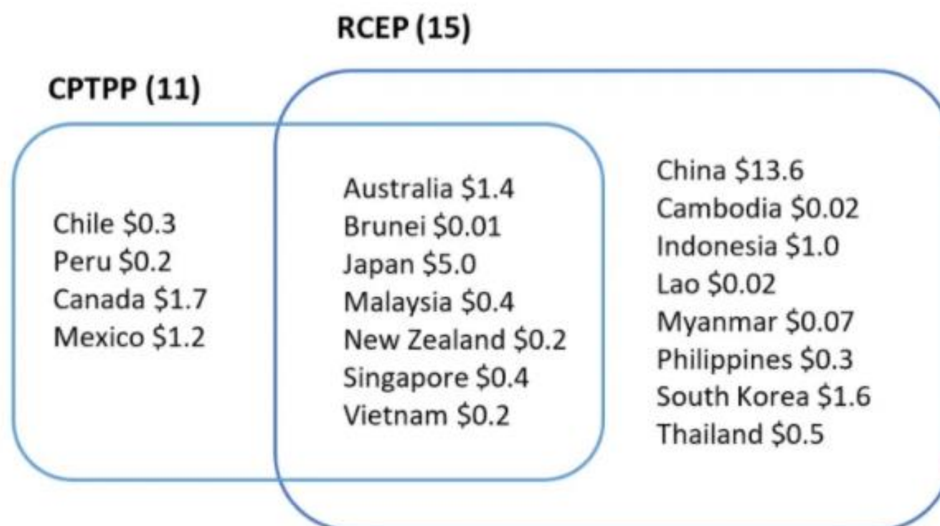
Despite the strong indications of China's growth, its stock and bond markets came under pressure last week after three unexpected corporate defaults of state-owned enterprises (SOEs). "State-Owned" does not mean central-government-backed. These firms are involved with local governments and the relationships are not "backed". A lot of these firms are at risk because President Xi Jinping is battling local states for power. This shakeout is a long-term positive for China, but has the possibility of causing a similar consolidation of Chinese risk asset markets as elsewhere, even if for quite different reasons.

Lastly, Brexit. A deal is rumoured to have entered the room through the back door, just as Dominic Cummings carries his box files out of the front. The absence of negative press briefings from either side, and the positivity of currency markets, provide some evidence that it may be more than rumours. However, as stated many a times before on these pages, do not expect that the timelines painted by politicians as "absolutely final" to be actually that – pan European negotiations never finish when they should – but conclude with some form of compromise, they almost always do.

New Asian trading bloc gets global respect

Bigger is better in trading blocs. And last Sunday, 15 East Asian countries signed an historic accord to form the world's largest trading bloc, containing a third of the world's population and accounting for around 30% of global GDP. The Regional Comprehensive Economic Partnership (RCEP) is bringing together the ten ASEAN members with their Northern and Southern neighbours in Asia-Pacific: China, Japan, South Korea, Australia and New Zealand. RCEP nations have now committed to lower tariffs progressively, counter protectionism, boost investment across borders and allow freer movement of goods within the region.

Members of RCEP and CPTPP



Source: Brookings Institute; Numbers represent 2018 GDP in trillions of US dollars

The RCEP is far from a union and, in terms of tariff slashing, it is not as comprehensive as the CPTPP (the 2018-born successor to the Trans-Pacific Partnership). But the sheer size of this new trading bloc – as well as its membership – makes it a significant economic step forward for the nations involved. Southeast Asian countries stand much to gain in the medium-term, while longer-term cooperation will benefit even the biggest nations in the RCEP, namely China and Japan.

It is hugely significant, for example, that a single trading bloc generating 30% of global GDP can exist without featuring either of the world's largest single markets, the US and EU. The RCEP and the CPTPP, which is also dominated by Southeast Asian nations, are the only major multilateral trade agreements to have been signed in the Donald Trump era. Trump famously withdrew from TPP negotiations in 2017, claiming America was getting a raw deal on the world stage. But as a result, both agreements now substantially increase the prospects for trade and economic integration within Asia itself.

According to the Washington-based Brookings Institute, the RCEP is expected to add around $209 billion per year to world incomes by 2030, and around $500 billion of turnover to world trade. Southeast Asia in particular stands to gain much. The region on its own should benefit by about $19 billion annually over the same period. Beyond those direct benefits, it gives a region with significant growth potential and a massive internal market (ASEAN has a population of 660 million) access to some of the largest domestic economies in the world – China, Japan and South Korea, as well as Australia. ASEAN countries will likely now have greater access to funds from China's Belt and Road Initiative, strengthening transport, energy and communication links. It's also worth noting that the RCEP's provisions on tariffs will be phased in over the next 20 years, so trade benefits will build-up over time.

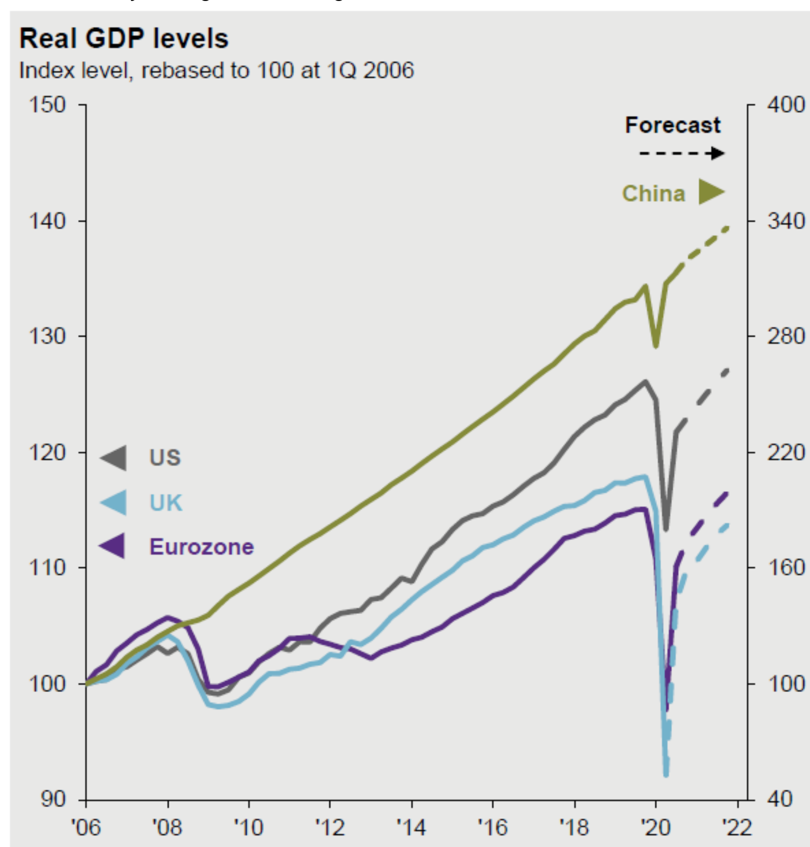
Over the long-term, the importance of the deal will likely be in what it signals, rather than what it has already delivered. While the RCEP does much to stimulate intra-Asian supply chains, however, details on improving intellectual property protection, labour laws, the environment and state intervention are lacking. What it does do, though, is commit East Asia's three largest economies to mutual integration for the first time in modern history.

Relations between China, Japan and South Korea have been fraught for the better part of a century. Although the benefits of economic integration in Northeast Asia have been obvious for years, it took significant brokering from ASEAN to get past bitter historical divisions. Last year, Japan confirmed that negotiations toward a trilateral free trade agreement between the three countries would begin as soon as the RCEP was signed. Earlier this month, China's President Xi Jinping promised to speed up negotiations with Japan and South Korea.

While neither Japan nor Korea may find it politically palatable to admit, both have benefitted massively from China's decades-long growth spurt. In recent years, China's transition from a labour-intensive export economy to one more focused on domestic consumption has seen growth spill over into its highly-developed neighbours. With the People's Republic now intent on generating business investment and attracting foreign capital, Japan in particular looks like an ideal partner. We suspect the recent rally in Japanese stocks may have something to do with this, with investors reassessing the country's growth prospects in light of a closer relationship with China.

We wrote recently that there is now a strong investment case for China in the near-term, even though risk considerations remain an obstacle. The world's second-largest economy went through its COVID shock early, and is now the only major economy on course to grow this year. Moreover, despite provoking numerous geopolitical tensions – particularly after crackdowns in Hong Kong and Xinjiang generated disdain and punitive measures from the US and EU – its political backdrop looks increasingly stable compared to the fractious environment in the West. With the creation of the RCEP, it now looks like East Asia is entering into a new phase of political and economic progress.

Source: BEA, Bloomberg, Eurostat, National Bureau of Statistics of China, ONS, J.P. Morgan Asset Management.



We suspect this will significantly increase capital flows into the region as and when global political tensions begin to abate, and that these forces will only increase should divisions in the US continue to hinder progress. On that front, while it is tempting to think the combative days of Trump's trade wars are behind us following his election defeat, this could prove somewhat hasty. Anti-China sentiment is a rare point of bipartisan support in Washington, and President-Elect Biden could well be in a difficult position if Trump spends his remaining days in office pointing the finger at China. For the Democratic party, all eyes are on January's Senate run-off elections in Georgia. The last thing an incoming Biden administration will want is to be seen as weak on the international stage.

Looking elsewhere, one of the most interesting points of the RCEP is what it will mean for India. Having been one of original brokers in RCEP negotiations, the Modi government pulled out of the deal two years ago, partly because of US pressure and partly because of its own conflicts with China. Politically, cooperation with China is a bitter pill to swallow in India. But if India remains outside of the RCEP, it risks falling behind its rapidly-growing neighbours. The rules allow India to join the RCEP at any time after it comes into effect and, if US politics allow it, we suspect the government to sign up at some point down the line.

Even if it does not, the RCEP has huge potential as a trading bloc. The combination of the China-Japan-Korea triumvirate together the rapidly-developing ASEAN has all the ingredients to be an economic powerhouse in the future. It may take years to see the effects, but make no mistake: RCEP could be a milestone in an eastward global economic transition.

EU's populist nations threaten to shoot themselves in the foot

For Europe, 2020 was supposed to be a fiscal awakening, with the pandemic putting paid to the issues that created the first Euro crisis; the Union's lack of fiscal integration, its inflexibility on budget rules and inability to handle payment crises. The crisis affected the whole continent, threatening to burden health services and leave swathes of the population in financial ruin, unless governments spent their way to the other side.

After extensive negotiations, a continent-wide €1.8tn spending package was agreed in the summer. EU negotiators struck a hard-fought deal with the European Parliament to create the EU recovery fund, together with the union's seven-year budget, was designed not just to plug the gap between now and normality, but to invest in a brighter, more sustainable and digital future afterwards.

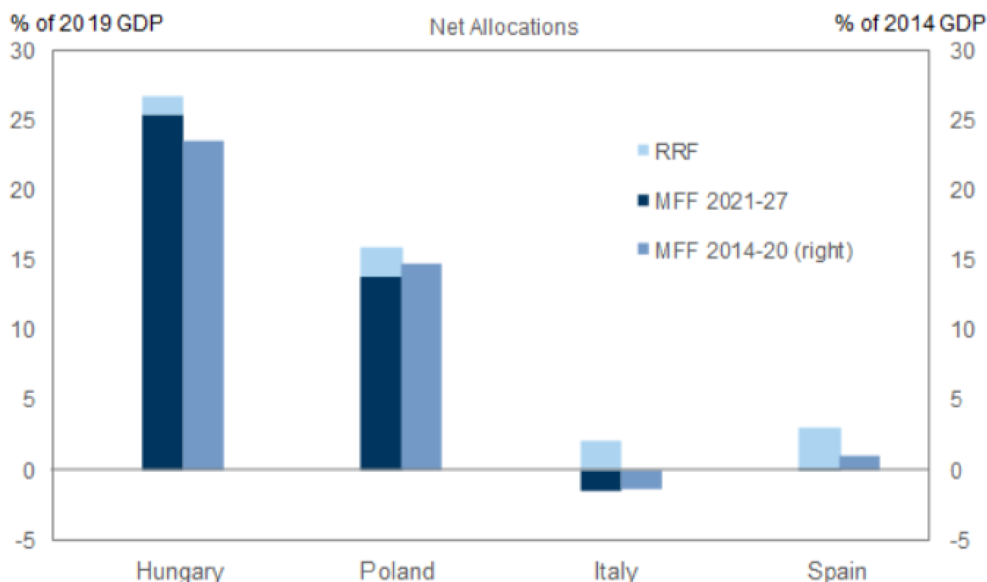
Now, at the final hurdle, the deal is in jeopardy again. Hungary and Poland are threatening to block the entire package. The two nations – both lead by far-right leaders accused of authoritarianism – have indicated that they will veto the spending package unless the critical 'rule of law' mechanism is removed.

As it stands, that mechanism allows the EU to suspend funding to member states that it believes are undermining its democratic values. The most pressing of these tenets is judicial independence, which politicians across Europe claim is under threat in Hungary and Poland. Poland's Law and Justice (PiS) party has instituted several reforms of the justice system since coming to power in 2015, aimed at giving the government greater power to appoint, discipline and remove judges. Meanwhile, Hungarian prime minister Viktor Orban has proudly declared his nation an "illiberal democracy" and has faced international scrutiny for his government's rollback of human rights and violations of EU and international law.

This is far from the first time these two countries have faced-off against Brussels on this issue. Legal challenges have been launched against both for their alleged breach of the "founding values" enshrined in the Treaty on the European Union. These challenges – the only cases of their kind to ever be brought against EU member states – are still ongoing.

The difference now is that the stakes are higher than they have ever been. Europe is in the middle of its second COVID wave, and economic activity is being suppressed by renewed lockdown measures. Many nations lack the social safety nets to deal with the widespread unemployment that an economic shutdown will bring, and existing EU budgetary rules prohibit deficit-financed spending at a time when it is needed most. The €750 billion recovery fund – together with the €1.1 trillion EU budget – would offer crucial respite. European Central Bank chair Christine Lagarde told the European Parliament (in no uncertain terms) that the package "must become operational without delay – this is critically important,"

The irony of the Hungarian-Polish blockade is that both are extremely dependent on EU funding. In 2018, EU spending amounted in Hungary and Poland to 5% and 3.4% of GDP respectively, and they are set to receive an estimated €180 billion in stimulus grants under current plans. Were Orban and Polish premier Mateusz Morawiecki to block the EU package, it would be to their detriment. This goes someway to explaining the muted reaction to the spat from markets. European bonds and currency are both trading around their recent highs, with commentators pointing to mutual interest as a reason to be hopeful of a compromise.



Source: Goldman Sachs Global Investment Research, Haver Analytics, European Commission

This is true, to a point. A deal is certainly in the national interest of Poland and Hungary. But we should be careful to distinguish this from the interest of their ruling politicians. In Poland, the justice minister is trying to outflank his prime minister on the hard right, creating a power struggle in which taking a hard line on Brussels could play well. And, while Orban's position in Hungary is strong, he is unlikely to agree to any package he sees as a threat to his party's rule.

Europe's authoritarians are also well aware that, when it comes to punishing democratic backsliding, Brussels' bark is worse than its bite. Together, both countries have been able to block punitive measures against the other, and Poland has even begun flouting judgements issued by the European Court of Justice. As such, Orban and Morawiecki might think this is a game of chicken they can win.

This time they could well be wrong. France is reportedly intent on pushing the deal forward, with or without them, and has suggested both could be excluded from a recovery plan if an agreement cannot be reached. Even if this does not sound encouraging, it fits into a French vision of further European integration, namely that European integration should move ahead between those that want it, even if that means leaving behind those that don't. In the past, German politicians have been set against this idea, worrying that it might create a multi-tier Europe which could deter outside investment.

Of course, a funding collapse would almost certainly be more off-putting to foreign investors than some regulatory disharmony. It therefore seems likely that, as very last resort, Germany would agree to excluding the dissenters if it meant saving the deal. In that case, Hungary and Poland would have no cards left to play – they would either have to take the deal or sacrifice billions in much-needed funding.

Some form of compromise would allow everyone to save face. In terms of its effect on the real economy, that the recovery funds are not set to come in until next year should lessen the short-term impact of any delay. A solution is still on the horizon – and with it signs of hope for Europe's fiscal future. But there's no doubt that two of Europe's leading authoritarians attempting to hold the EU to ransom is bad news for the union. Even if the threat to short-term support does not deter investors, the threat to long-term stability might.

CAMBRIDGE
INVESTMENTS LIMITED

23rd November 2020

Global Equity Markets

Market	Fri 16:30	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6348.3	+0.5	+31.9	↗	↘
FTSE 250	19503	+1.2	+233.4	↗	↘
FTSE AS	3585.1	+0.7	+24.8	↗	↘
FTSE Small	5848.3	+2.5	+144.6	↗	→
CAC	5494.0	+2.1	+113.8	↗	↘
DAX	13126.2	+0.4	+49.5	⇗	⇘
Dow	29376	-0.4	-103.9	↗	→
S&P 500	3575.2	-0.3	-9.9	↗	⇗
Nasdaq	11924.2	+0.8	+95.0	↗	↗
Nikkei	25527.4	+0.6	+141.5	↗	⇗
MSCI World	2546.3	+0.7	+17.0	↗	⇗
MSCI EM	1200.4	+1.0	+12.1	↗	⇗

Top 5 Gainers

Company	%
Micro Focus Int'l	+33.0
Taylor Wimpey	+12.2
TUI	+12.0
BAE Systems	+10.4
Imperial Brands	+9.8

Top 5 Decliners

Company	%
Sage	-12.6
Johnson Matthey	-7.1
Unilever	-6.3
Hargreaves Lansdown	-6.2
DCC	-5.7

Currencies

Pair	last	%1W
USD/GBP	1.329	+0.8
GBP/EUR	0.892	+0.6
USD/EUR	1.19	+0.2
JPY/USD	103.82	+0.8
CNY/USD	6.56	+0.7
Bitcoin/$	18,793	+15.3

Commodities

Cmdty	last	%1W
Oil	44.38	+3.7
Gold	1874.2	-0.8
Silver	24.34	-1.3
Copper	329.4	+3.6
Aluminium	1992.5	+3.2
Soft Cmdties	389.9	+2.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.30	-0.04
UK 15-Yr	0.54	-0.03
US 10-Yr	0.84	-0.06
French 10-Yr	-0.35	-0.04
German 10-Yr	-0.58	-0.04
Japanese 10-Yr	0.01	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	18.8	20.9	13.8
FTSE 250	2.2	16.6	27.1	14.9
FTSE AS	3.2	18.2	22.1	13.9
FTSE Small	2.8	17.2	-	13.7
CAC	2.0	22.4	28.0	14.2
DAX	2.8	22.6	19.5	13.0
Dow	2.1	21.9	24.2	15.7
S&P 500	1.7	25.9	25.5	16.8
Nasdaq	0.7	36.0	31.3	19.0
Nikkei	1.6	26.5	24.8	17.2
MSCI World	1.9	24.6	24.5	15.9
MSCI EM	2.1	18.9	18.7	12.2

UK Mortgage Rates

Mortgage Rates	Oct	Sep
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.85	1.79
3-yr Fixed Rate	2.00	1.92
5-yr Fixed Rate	2.02	1.97
10-yr Fixed Rate	2.50	2.48
Standard Variable	3.63	3.59

* 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

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

CAMBRIDGE
INVESTMENTS LIMITED

23rd November 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.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE