THE **CAMBRIDGE** WEEKLY

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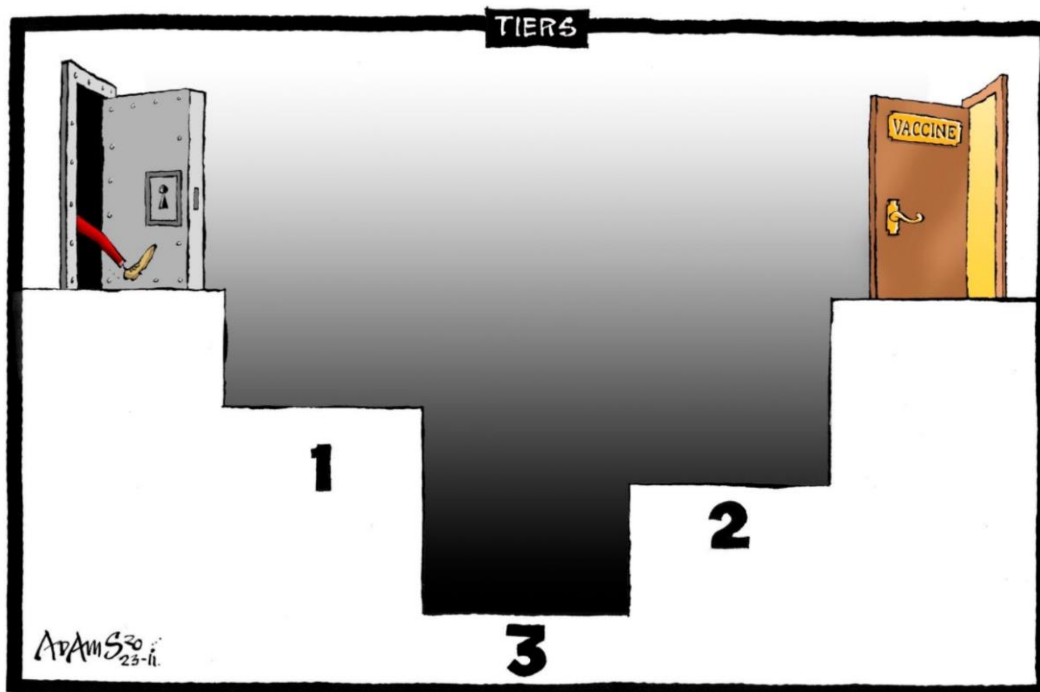


2020 Advent Calendar, Christian Adams,23 Nov 2020

Fiscal floundering

During a week when global stock markets continued their more gradual upwards trend, government policy was in full focus, but offered little in support. For the UK, it looks like 'out of the frying pan into the fire' when official lockdown ends on Wednesday, with the vast majority of England under tighter restrictions than before – and for an indefinite period of time. Before that, the Chancellor of the Exchequer Rishi Sunak delivered his Autumn spending review in sombre style. The UK's "economic emergency has only just begun" warned Sunak, adding that debt-financed pandemic spending is "clearly unsustainable".

Sunak's downbeat tone was backed up by a report from the Office for Budget Responsibility (OBR), which forecasted a £30 billion hole in public finances by the middle of the decade. As well as plunging Britain into its deepest recession in over 300 years (although perhaps also the shortest), government borrowing is set to rise to its highest level in peacetime. In typical belt-tightening fashion, the Chancellor added: "We have a responsibility, once the economy recovers, to return to a sustainable fiscal position,"

This hints at tax rises or spending cuts over the medium and long-term, but Sunak made no comment on which of these he would prefer. The Institute for Fiscal Studies (IFS) nonetheless took the November outlook at its word, and is predicting more than a £10 billion a year cut to departmental spending plans from next year and beyond. The IFS is also assuming that emergency pandemic spending will end next year, as well as the temporary increase in Universal Credit.

However, all of that is also assuming that Brexit negotiations deliver a happy ending for the UK. According to the OBR: "The Treasury, understandably, could not provide clarity on the ultimate outcome of negotiations, and we continue to base our forecast on the assumption that a deal is reached". We discuss Brexit developments in a separate article below but, needless to say, if no deal with our largest trading partner is forthcoming, the UK's fiscal and economic outlook will be considerably worse.

As we have written before, fiscal conservatism at this time would likely be disastrous for the economic recovery. With swathes of the population still unable to go about their business as usual, cutting off support would choke any semblance of a recovery, and undermine compliance with COVID restrictions out of sheer necessity to survive. And, with central banks pinning down bond yields at historic lows, the future costs of not spending enough now is much higher than the danger of spending too much (as evidenced by capital markets rewarding those countries committed to decisive fiscal support). The Chancellor will no doubt be aware of this, which begs the question: What is driving his mixed fiscal messages?

We suspect that, unlike what has been suggested, Sunak's fiscal floundering is neither ideological nor purely indecisive, but tactically political. With the crisis dragging on, the Treasury must toe a fine line. On the one hand, it must convince the population it will offer unlimited support through the pandemic. On the other, it must convince capital markets and the money-trusting public that the government and the Bank of England are not running a money-printing scheme – or at least not one any bigger than comparable nations. If it fails on the first count, confidence will plummet, unemployment will spike and a full-blown 'classical' recession will ensue. If it fails on the second, it risks undermining confidence in its currency value – leading to financial instability which leads to a similar outcome.

The first risk is most certainly the more pressing. As such, we expect the government will borrow, the BoE will buy debt in similar proportions with money only they can create, and we can all just keep our fingers crossed that the recovery strategy works, and that our economic growth can outgrow the risen debt and burden it may bring much further down the line. In the meantime, government hints at fiscal restraint need to be seen as an expectation setting tool more than forward guidance.

Turning to the US, Republican politicians appear even more hawkish than British Conservatives. To make matters worse, this is happening just as infection rates are spiking as the second wave is spreading across the country. The Republican Party congratulated itself on passing the CARES Act in March, which provided capital to the US Federal Reserve (Fed) for business loans and increased unemployment benefits. Loans were underutilised in America's first wave, but unemployment benefits provided a crucial backstop, helping build household precautionary savings.

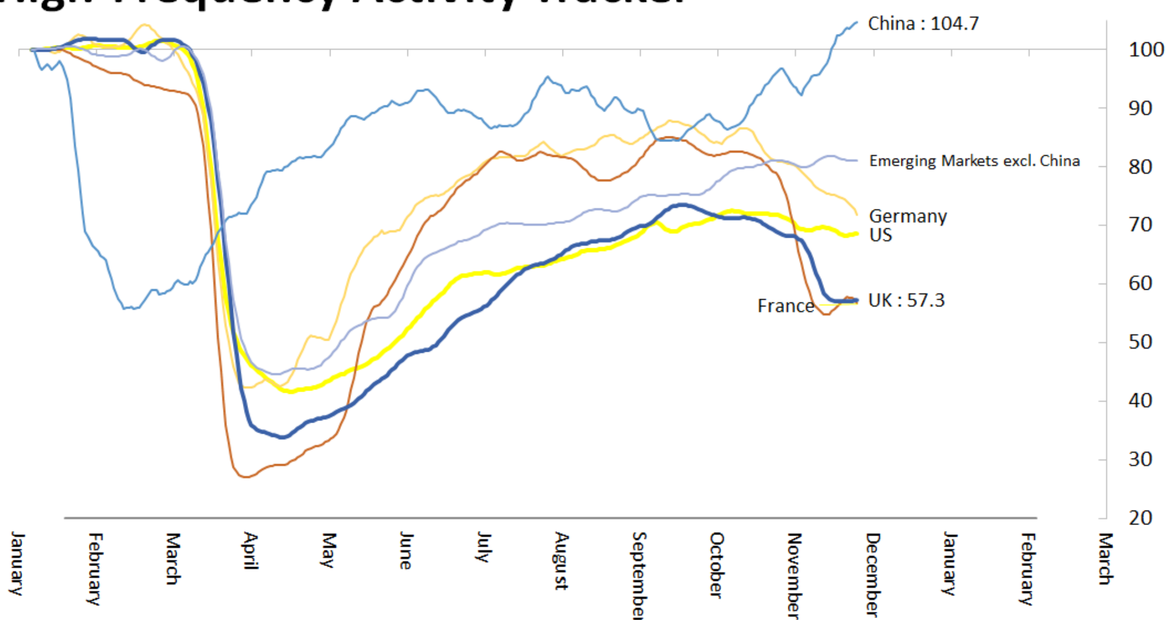
Both are now set to be substantially reduced or removed at the end of the year – despite the widespread surge of the virus. The resilience of the US stock market is a good sign for economic expectations, as are the Fed's statements that it will continue giving support, despite the removal of some backstop funds. Meanwhile, promising vaccine news gives hope that further support may not be needed for the recovery to get underway. Currency markets tell a different story, however. The dollar moved sharply lower against the Euro last week, suggesting a more subdued outlook for the US economy.

In Europe, despite political obstacles to the recovery plan (as covered last week), fiscal expenditure is increasing. Having extended its lockdown to 20 December, Germany is set to borrow €180 billion in 2021, compared to the €96 billion predicted in the summer. Net borrowing will be slightly less than this year's

€217 billion record, but such is the strength of Germany's fiscal position that this will translate into just under €500 billion in total crisis spending.

With the German government agreeing more emergency aid to businesses and increased vaccine spending, the support will likely spill over to the rest of Europe (and the world). European fiscal spending is backed by substantial support from the European Central Bank (ECB). In her recent speech to the European Parliament, ECB President Christine Lagarde was forthright that increased support is a must. It will therefore continue to conduct stimulus through more bond-buying, with the €750 billion Pandemic Emergency Purchase likely to rise to offset the new debt next year, and more subsidies to European banks to lend via the targeted longer-term refinancing operations (TLTRO) facility.

It is a peculiar turn of events that leaves Europe – usually the fiscal miser of the developed world – as the most promising area in terms of government support spending. Both US and UK governments would do well to take note – with the world still under heavy restrictions amid the deepest recession on record, a decisive and sustained economic recovery, not a balanced budget should be the focus of governments.



The high frequency tracker tells the story. Europe has wilted in the face of the Autumn virus surge, with Germany's swoon explaining its fiscal actions last week. The US will probably follow the decline as the second wave takes hold there too, even if it is not likely to suffer a repeat of the spring. Meanwhile, China is in full economic recovery mode. Yet, this has led to a classic situation for markets. Having anticipated the growth, markets are facing the possibility that China's policy reactions may now be starting to work against more equity upside.

The unexpected default of three state-owned enterprises, the rise in both short-term and long-term interest rates, and the strength of the Renminbi, have tightened China's financial conditions, whereas they continue to ease elsewhere. This does not mean economic growth is about to turn. Far from it, the fiscal spending continues strongly. However, away from its own spending, the Chinese government has recently been surprisingly swift in "correcting" 2020 support policies which might cause future systemic instability. In particular, earlier in the year authorities pushed banks to lend indiscriminately to small and mid-sized enterprises to stimulate the recovery beyond their own fiscal stimulus. Now they are pushing for discrimination and recognition of loan losses.

We are at an early stage, but when policy tightens, stock markets may not perform in line with an economy's growth. Investors who focused their investment allocations solely on China may soon be disappointed to find that China's market-friendly 'goldilocks economy', is giving way to more measured market valuation drivers, even if that is for very different reasons than elsewhere.

This time, Brexit really does mean Brexit

In the strangest year in recent memory, one news story serves as a timeless constant: "Brexit talks remain deadlocked", according to the FT's headline last week (which could have been from any point in the last four and a half years). European Commission President Ursula von der Leyen told the European Parliament it was still impossible to predict whether Brussels could reach a trade deal with the UK. With Britain's transition agreement with the European Union (EU) set to end on 1 January, reports suggest growing frustration in Brussels. "These are decisive days for our negotiations with the UK" lamented the President, "but frankly I cannot tell you today if, in the end, there will be a deal."

Having sailed past deadlines, crunch talks and other 'last gasp' moments, negotiations are now deep into extra time. Boris Johnson suspended talks last month after his self-imposed mid-October deadline passed, accusing the EU of not being serious enough. The Prime Minister wants a "fundamental" shift on the European side, but even conciliatory figures like Chancellor Angela Merkel are resolute that the EU will not sacrifice principles and interests.

There is little time left. A deal would need to be ratified by the European Parliament's last session, on 14 December. MEPs would need time to go over the details. The end of this month is the real deadline, and that presents a massive challenge.

Even so, capital markets are as calm as can be. The FTSE 100 has moved sideways for the last couple of weeks, after the vaccine news from Pfizer-Biontech, and is still trading near the top of its post-pandemic range. The value of sterling, meanwhile, has increased through the month – even against the value of the Euro. Markets seem unphased by the apparent looming dread.

In large part, this is because investors do not believe – even as we race toward the cliff edge – that a no-deal Brexit is possible. Exiting the EU empty-handed after more than four years of negotiations would be – in Johnson's own words – a massive failure of statecraft. Analyses from economists, listed in the OBR report last week, indicates the potential growth cost to the UK:

Estimates of the long run effect on GDP of additional barriers on trade with the EU

	Per cent		
Organisation	FTA	WTO	Difference
Mayer et al (2018)	-2.4	-2.9	-0.5
Netherlands CPB (2016)	-3.4	-4.1	-0.7
UK in a Changing Europe (2019)	-2.5	-3.3	-0.8
Felbermayr et al (2018)	-1.8	-3.2	-1.4
Bank of England (2019)	-3.5	-5.0	-1.5
UK in a Changing Europe (2019)	-6.4	-8.1	-1.7
NIESR (2018)	-3.8	-5.5	-1.7
IMF (2018)	-2.0	-3.8	-1.8
Whitehall Study (2018)	-4.9	-7.6	-2.7
Netherlands CPB (2016)	-5.9	-8.7	-2.8
World Bank (2017)	-10.0	-13.0	-3.0
IMF (2018)	-3.3	-6.4	-3.1
OECD (2016)	-2.7	-7.7	-5.0
Average	**-4.0**	**-6.1**	**-2.1**

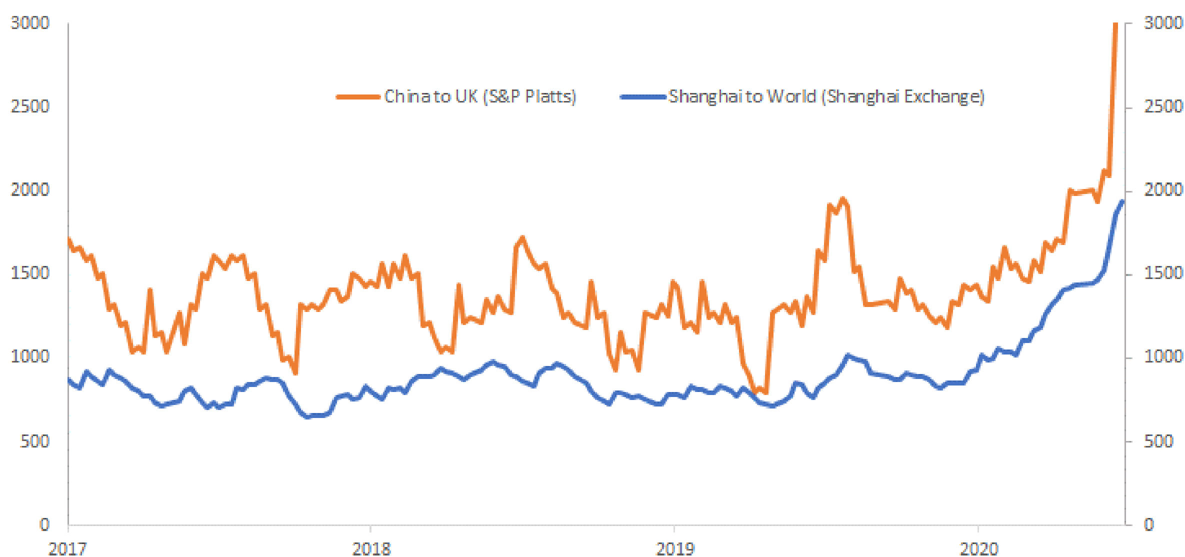
A trade deal is in the interest of both sides, and no powerful interests oppose it. Despite some specific quibbles, every EU member state wants an agreement in principle, and a no-deal scenario would harm manufacturing and trade exposed areas most – an area the government would like to revive.

It is also worth recalling that the UK's international finance sector is not included in the current set of negotiations. Here, separate talks focus on the EU granting equivalence to UK financial services. This would be a welcome development for the City of London, but is well below the regulatory ease it enjoyed under EU rules. In other words, the City will experience a lasting dent to its pan-European activities in any case, and that has been apparent for a while. On their part, EU negotiators have form in executing deadline-day deals. In past trade negotiations, the European Commission has made counting down the clock a central tactic. Johnson and his government, meanwhile, have consistently tried to push the line of a 'credible threat'. Brinkmanship should therefore be no surprise.

However, there is another reason UK markets look unphased. Most of the bad news has already been priced in. British equities have been unloved by international investors for years (even pre-Brexit vote) and there is only so much damage that Brexit uncertainties can do. British and European businesses have already been forced to make divorce plans, partly because governments have told them it is necessary, partly because the negotiating strategy of "credible threat" has, funnily enough, created a credible threat. Most goods traders are bracing themselves for new bureaucracy at the ports. Some manufacturers have moved plant operations. Closer to home, we have seen multiple stories of financial institutions planning moves to the continent. Goldman Sachs, for example, is launching a base for European share trading in Paris.

If businesses have already prepared for the worst, even a 'skinny' Brexit deal could be a small victory, a prospect that has given sterling some pep in recent weeks, but that doesn't mean a positive outcome for the UK economy. In terms of overall economic activity, almost any deal will still see trade subject to regulatory conformity checks at the border. Delays and administrative burdens are inevitable. The Bank of England's Decision Maker Panel survey (which gathers information from the chief financial officers of small, medium and large UK businesses) for October reports that over a third of firms are either only partially prepared, or not prepared at all. Even if an agreement is successfully concluded, some short-term disruption, especially to exports, remains a downside risk. The Bank's latest forecast assumes such disruption would reduce GDP by around 1 per cent in the first quarter of 2021, with the best hope being that the disruption will not last too long. Still, we could see higher import inflation over the short to medium-term.

In fact, even before the year-end, UK imports are suffering from incredibly high shipping costs. This has been attributed to Brexit by the media, alongside pictures of lorry parks at the border, with importers looking to rush goods in before the year-end deadline. However, this is somewhat misleading, as the increase in global shipping costs is predominantly virus-related. China's early resumption of activity has prompted almost a 50% jump in shipping prices from China to the rest of the world. UK prices have increased similarly, within a big chunk of demand for material goods during the pandemic.



Of course, the Brexit dash will have almost certainly have had some impact. But we should be careful to distinguish short-term cost-push inflation – coming from lack of spare capacity – and some structural inflation that could come about from Brexit. Indeed, we may actually see a fall in virus-related inflation even as structural pressures push it up.

One can tell a similar story for UK assets. The unpopularity of UK stocks over the past two years has been strongly linked to Brexit scares, but there are other structural reasons why the FTSE 100 is not at the top of investor buy lists. It is dominated by old-industry energy companies and financials still struggling in a low-yield, COVID world. Washing away Brexit uncertainties should help – as it should the real economy. But whatever happens on 31 December, it will not be the end of market woes for the UK.

Tesla jolts into S&P 500

The electric car maker Tesla's stock performance this year has been – in an analogy that will no doubt please Elon Musk – a rocket in flight. At the time of writing, Tesla shares are up nearly eight-fold since the COVID sell-off in March, making it the most valuable car company in the world. And last week, the electric carmaker reached an important milestone. On 21st December, Tesla will make its debut on the S&P 500 index, after S&P Dow Jones Indices announced it would include the group on the US equity benchmark.

The index might as well roll out the red carpet while they are at it. Upon entry, Elon Musk's company is set to become the fifth or sixth largest in the index – with a current market cap of nearly $550 billion. With the way Tesla has been moving over the last 12 months, that figure could be way off being accurate by the time of reading.

For many, it will be confusing why one of the most valuable companies in the world has only just been allowed into a group supposed to contain America's 500 biggest stocks. But S&P membership is not just about size alone. In order to join the club, companies must have a market cap of at least $8.2 billion, be highly liquid, have a public float of at least 10% of its shares outstanding and (here's the kicker) *it must have been profitable over the most recent quarterly and yearly periods.* Tesla – a company whose value is based much more on its future than its present – had struggled to meet the profitability standard before now.

For Tesla, joining the club is so much more than a status play. As one of the world's leading stock indices, there is around $11 trillion indexed or benchmarked to the S&P. When rebalances occur in the next few months, passive funds tracking the US stock market through the S&P500 will have to buy around $70 billion of Tesla stock.

Moreover, it is not just index-based funds that will have to start buying Tesla. Once it is in the S&P, mutual funds benchmarked against the index, and who are not already holding Tesla, will have to either make a decision to underweight the company or buy it. Goldman Sachs estimates that, if the large cap mutual funds they track moved to a neutral position on Tesla, it would mean a further $8 billion of buying pressure going toward the company.

The anticipation of this buying pressure has put investors into a frenzy, with Tesla's share price pushing up more than 40% since the announcement. According to Refinitiv, the trade volumes for Tesla's stock have averaged about $26 billion per session since the announcement. That is more than Amazon and Apple – 2020's other big winners – combined over the same period.

Among financial analysts, Tesla inspires adoration and scepticism in equal measure. No one doubts the company produces good quality electric cars, desired by many in a market set to expand massively in the coming decades. The question, as ever, is whether the currently still small-scale producer can live up to its lofty stock valuation anytime soon. Despite 2020 being a great year for Tesla's output, it will still generate

less than 10% of Ford's revenue and less than 5% of Volkswagen's (according to Bloomberg aggregates of analysts' forecasts).

This scepticism over short-term profitability was another reason why Tesla has only just gained entry to the big leagues. Its application to join the S&P was rejected as recently as September, even after it had met the index's 12-month profitability condition. But this time around, the S&P's oversight committee finally decided to allow Tesla in.

The whole story is enough to make one question what indices are there for in the first place. On the face of it, the S&P 500 is just supposed to track the aggregate stock movements of America's biggest companies. But the fact it excludes some in that group is a reflection of the index's other function, namely that it is not just a measure of market performance, but is also an investment tool in itself.

The profitability rule in particular was a reaction to the early 2000s dotcom bubble, when media-savvy start-ups with no real profit plans reached astronomical valuations on the basis of market euphoria. Again, at first glance this is reasonable enough, but the Tesla case shows how it can lead to some bizarre situations.

The very point of passive investing is arguably to leave it up to the market to decide whether companies are good enough (following the 'collective wisdom of the markets'). And whether one agrees with Tesla's lofty valuation or not, clearly the market view is that Tesla has a profitable future. Why should an index committee get to say otherwise?

This point is particularly stark bearing in mind the year we have had. Swathes of S&P companies have failed to produce a profit this year, but few are in danger of losing their index status. Only allowing in profit-makers, then letting them make losses as they please, looks arbitrary at best – especially given the reinvestment drive of growth-intensive strategies that so many of the world's largest companies pursue. It seems likely the Tesla episode will prompt some soul-searching in the S&P, with a possible further review of entry conditions. Excluding bubble-bound start-ups seems reasonable enough, but excluding the world's most valuable carmaker, much less so.

On a deeper level, what the episode also highlights is that passive investing is not always so passive. Indices are built in a variety of ways, and often tell very different stories. European indices, like the German Dax and Italian MIB, hold arguably too few names to be deemed truly market representative, and thus are not tracked too heavily with assets. For investors focused on broader market coverage, there are also 'uninvestable' indices like the Dow Jones and the Nikkei – which are weighted by price rather than market cap. Which index is being tracked is therefore an important decision.

According to Martyn Hole at Capital Group: "Where a company is listed is pretty much irrelevant in today's situation". He argues that instead of focusing on where companies are listed, stock pickers should look to where they make their money. MSCI (one of the global index leaders), for example, includes foreign-listed companies in its home country indices. As home country and the area of cash flow generation is not always the same, some (actively managed) regional funds explicitly reserve the right to include companies in an index universe outside of the region.

This situation throws up another challenge for passive investors. If you hold a fund tracking the S&P 500, you will be a forced buyer of all the stocks the committee decides to list come 21 December. Active stock pickers are aware of this, and can therefore win big by gobbling up companies such as Tesla in advance.

This is the reverse of the problem previously discussed regarding the scandal-ridden Wirecard, which was part of the Dax. Here, active managers were able to sell the stock long before it dropped out of the index, when it became apparent that opaque accounting was very likely underpinning unrealistic valuations. Active managers have manoeuvrability in these situations. This is, after all, what justifies their higher fee charges.

It is, as ever, swings and roundabouts. One need not change an entire investment strategy because of a booming Tesla stock – but it pays to be aware of the downsides too, however you choose to put your money to work.

CAMBRIDGE INVESTMENTS LIMITED

30th November 2020

Global Equity Markets

Market	Fri 17:03	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6367.6	+0.3	+16.1	↗	↘
FTSE 250	19463	-0.2	-44.3	↗	↘
FTSE AS	3593.7	+0.2	+7.2	↗	↘
FTSE Small	5912.5	+1.1	+66.4	↗	→
CAC	5598.2	+1.9	+102.3	↗	⇘
DAX	13335.7	+1.5	+198.4	⇗	→
Dow	29890	+1.4	+406.7	↗	→
S&P 500	3639.4	+1.6	+57.5	↗	⇗
Nasdaq	12199.3	+2.5	+294.6	↗	↗
Nikkei	26644.7	+3.9	+1010.4	↗	↗
MSCI World	2590.2	+2.0	+50.1	↗	⇗
MSCI EM	1229.6	+1.7	+20.3	↗	↗

Top 5 Gainers

Company	%
Carnival	+21.5
TUI	+18.7
easyJet	+14.5
Micro Focus Int'l	+11.9
John Wood	+10.8

Top 5 Decliners

Company	%
Experian	-11.0
Intertek	-10.4
Spirax-Sarco	-7.7
Halma	-6.8
AstraZeneca	-6.6

Currencies

Pair	last	%1W
USD/GBP	1.331	+0.2
GBP/EUR	0.898	-0.7
USD/EUR	1.20	+0.8
JPY/USD	104.06	-0.2
CNY/USD	6.58	-0.2
Bitcoin/$	16,795	-9.7

Commodities

Cmdty	last	%1W
Oil	47.99	+6.7
Gold	1785.2	-4.6
Silver	22.64	-6.4
Copper	339.6	+6.1
Aluminium	1976.0	-0.8
Soft Cmdties	385.2	-1.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.28	-0.02
UK 15-Yr	0.51	-0.03
US 10-Yr	0.85	+0.02
French 10-Yr	-0.35	+0.00
German 10-Yr	-0.59	-0.01
Japanese 10-Yr	0.03	+0.02

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	18.9	20.9	13.8
FTSE 250	2.1	16.0	26.9	14.9
FTSE AS	3.2	18.2	21.9	13.9
FTSE Small	2.7	17.2	-	13.7
CAC	1.9	22.6	28.5	14.2
DAX	2.7	22.9	19.7	13.0
Dow	2.1	22.0	24.6	15.8
S&P 500	1.6	26.3	25.9	16.8
Nasdaq	0.7	36.7	31.9	19.1
Nikkei	1.6	27.7	25.5	17.2
MSCI World	1.9	25.0	24.8	15.9
MSCI EM	2.1	19.3	19.0	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

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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.

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