THE **CAMBRIDGE** WEEKLY

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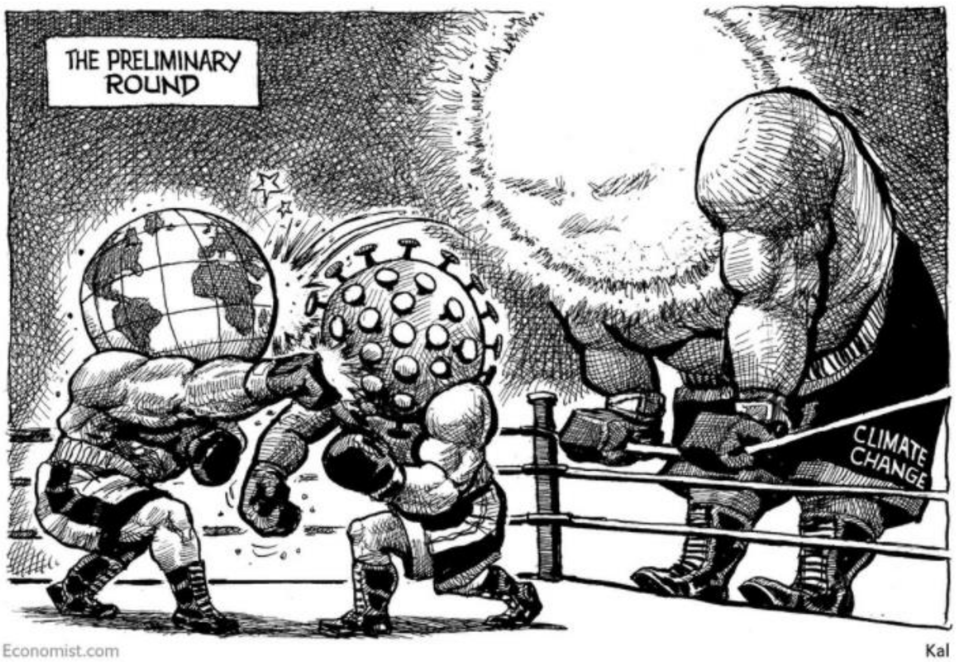


Mankind's next challenge, 23 April 2020

A high stakes game of principle chicken

This week's edition was meant to focus on our annual outlook for the coming year, while working under the assumption that the UK and Europe would by now be operating under a 'skinny' trade deal that would prevent tariff hurdles to trade while also dealing with the barriers to trade that come with operating under independent regulatory regimes. Alas, at the end of last week we reached a point where insistence on political principle appears to have overwhelmed the substance of rational argument.

Our 'deal' assumption was by no means a contrarian outlier. All of the 2021 outlook documents published by other research houses (and even government agencies like the Office for Budget Responsibility as well as the Confederation of British Industry) based their 2021 consensus forecasts on the assumption of ultimately logical behaviours of politicians. With the Northern Irish backstop hurdle having been resolved at the last minute – and if we accept that fisheries in GDP terms are more of a populist 'red herring' than a true dealbreaker – then it appears to be the provisions to ensure an ongoing level playing field in competition between companies that has really driven the negotiations to breaking point.

Those who have delved deeper into the political weeds here will know that if the inability to find a mutually-acceptable compromise on this matter results in a 'no-deal' outcome, the consequence will be the acceptance of immediate tariffs (from 1 Jan 2020) across the entire economy, along with many other restrictions to the free movement of goods, (financial) services and people. This will come in exchange for avoiding the quite theoretical risk of punitive tariffs on some goods, under theoretical circumstances, at some point in the future. Or, as trade experts like David Henig, UK director of the European Centre For International Political Economy, have put it: "The only reason this should scupper the trade deal talks is if one or both sides dug themselves in on a matter of principle."

Against this backdrop of unconcealed contravention of the 'do no harm' principle of political action, markets can be forgiven for still not believing (and remaining relatively calm) that such an economically irrational 'no-deal' is now the "very, very likely" outcome of the Brexit negotiations – as Prime Minister Johnson put it on Friday in a public address. While we accept we now have to look at the potential repercussions of such worst-case Brexit outcome, we remain in agreement with the muted market reaction that suggests there is still a higher probability of some form of a 'skinny' deal than conceding 'failure of statecraft'.

Steven Camley, 9 Dec 2020

Sadly, the UK now finds itself in a weaker negotiating position compared to last year. Having suffered a much worse COVID crisis than the European Union (EU), in terms of public health and economic impact, it is now at a serious disadvantage, with much less central bank and fiscal firepower than a newly-united Eurozone. So, whichever way this plays out in the end, the UK is bound to emerge weakened. To put it more succinctly: Britain cannot afford to be on less-than friendly terms with its neighbours just now. The only reason the 2021 consensus growth forecast for the UK in the appendix to our 2021 outlook sports a slightly larger percentage figure is because it is starting from a lower 2020 base. Also, all contributors had assumed an orderly Brexit.

As we often like to point out, even if the worst-case scenario should happen and we do have a disorderly Brexit, it will not be the end of the world, especially for investors in well-diversified investment portfolios. However, the average UK consumer will most likely feel poorer at the end of it. This is because the bulk of the negative surprise impact will once again find its expression in a fall in the value of £-Sterling which, together with the import tariffs and a general shortage of fresh produce, will lead to a cost price shock of as much as 5-10% depending on one's specific basket of shopping over the course of the year. This is unlikely to be balanced out by a commensurate increase in wages, leading to lower household purchasing power.

UK industry may suffer less, depending on whether the fall in Sterling increases the price competitiveness of UK exports to the EU on average by as much as EU tariffs make them more expensive. The main UK stock market – made up mostly of internationally-operating companies – is also likely to suffer less than many may fear, given its more limited exposure to the fate of the domestic economy. The same cannot be said for much of the small- and mid-cap markets, where UK-focused companies are bound to be held back by lower corporate profitability.

The other point to be mentioned is that even in the event of striking a deal at the very last minute, border control disruptions are now an inevitability, because not enough time remains to put the necessary processes into place in an orderly fashion. The difference is that in case of a trade deal outcome there is a high likelihood for both sides agreeing a 'technical' extension of the transition period for such matters to be put in pace, whereas an acrimonious outcome makes that far less likely.

Looking across the Atlantic, US politics has been moving in a (generally) more favourable way, although it seems an opportunity may have been missed last week. While President Trump's stubborn refusal to handover the presidency still dominates media headlines, markets were more swayed by progress on a year-end fiscal package. The government funding bill should pass today but that's merely to keep government services going, and is without any fiscal package tagged on.

The Democrats and Republicans are still negotiating four issues: a liability shield for business, aid for state and local governments, stimulus checks for all Americans and a boost in unemployment compensation for workers who have lost their jobs. The sum of these provisions would be more than $1 trillion (and unacceptable for many Republican senators) but three out of four might work, or perhaps a watered-down version of all four. Christmas very much depends on it. Last week's initial jobless claims figure rose for the first time since the summer, while the November employment growth numbers were less than hoped for, and neither includes the impact from the post-Thanksgiving virus surge. We think markets are betting that there is a better than 50% chance of something happening, and we think this is realistic. However, if events in the UK are to be our guide, things might get a bit hairy.

Perhaps less hairy will be the US Federal Reserve (Fed) meeting taking place on Wednesday 16 December. The Fed is not expected to increase asset purchases overall, but there are a lot of good reasons for them to buy longer-dated bonds. This dovish move is probably nearly fully expected by bond traders, given the Fed said the policy was discussed in its November meeting. The virus surge makes the policy update likely now, though some think it might be instituted in January.

In the Eurozone, the European Central Bank (ECB)'s €500 billion extension of its bond-buying Pandemic Emergency Purchase Programme (and maintenance of the programme into 2022) was in line with market expectations, although there was some minor grumbling that bank support (through its TLTRO-III operations) was less than needed. However, the ECB continues to signal flexibility in its approach, so if the vaccine bounce is not forthcoming, we would get more.

To finish this week's market and economic update, the UK woes are entirely of its own making and seem wholly avoidable. Globally, the picture for 2021 continues to brighten, even if the pandemic will make this winter much harsher than anybody could have anticipated a year ago. While 2020 has made something of a mockery of the prediction game, we remain hopeful that our 2021 Outlook gives an honest reflection of our expectations for the year ahead.

Outlook 2021

Overview

We usually begin our annual investment outlooks with a recap of the past 12 months, to see how our expectations from a year ago have fared. But the COVID shock smashed any hope of accurate predictions for 2020. Along with altering almost every aspect of our daily lives, the pandemic led to the sharpest global economic recession on record, with more than one-third of the world's population placed under lockdown. Despite the efforts of governments around the world, the global economic shutdown was not a short blip in the economic calendar, and businesses all over the world have suffered – many irreparably. Back in March, when it became abundantly clear that an economic shock was in the offing, capital markets panicked into a selling frenzy and global stock indices saw their largest falls since the 2008 financial crash.

In terms of the economic outlook for next year, the single biggest factor is how far we get along the road back to normal. The good news is that the scientific cavalry – in Boris Johnson's parlance – has arrived. The vaccine rollout has already begun in the UK, with others following swiftly. Medical professionals are at pains to stress this does not mean we can all gather for coronavirus 'V-day' celebrations, but the exit route is clearer, and much earlier, than science had dared to predict.

With that comes desperately needed respite. Barring catastrophes – and, after this year, we should not rule any out – growth will be positive, continuing the rebound begun in the summer of 2020. But it is unlikely to be as sharp as the post-decline bounce this year, with most forecasters putting next year's global absolute level of GDP still below that of 2019.

Economy Forecasts	2020		2021	
Consensus	Real GDP	CPI	Real GDP	CPI
World	-3.9	2.2	5.2	2.8
Emerging Economies	-0.8	3.4	5.0	3.4
North America	-3.9	1.3	3.8	2.0
Europe	-7.7	0.6	4.7	1.1
Asia Pacific	-0.6	1.8	4.9	1.9
Latin America	-6.7	7.9	4.3	8.8
Africa	-3.5	9.1	3.5	8.8
US	-3.6	1.2	3.7	1.9
Canada	-5.6	0.7	4.5	1.6
Germany	-5.6	0.4	4.0	1.3
France	-9.3	0.5	6.1	0.8
Italy	-9.0	-0.2	5.5	0.4
Spain	-11.6	-0.3	6.0	0.6
UK	-11.2	0.9	5.4	1.5
Switzerland	-4.0	-0.7	3.6	0.2
Sweden	-3.7	0.5	2.9	1.2
Russia	-3.9	3.3	3.0	3.6
Australia	-3.5	0.7	3.2	1.5
Japan	-5.3	0.0	2.6	0.1
China	2.0	2.7	8.2	1.7
Korea	-1.1	0.5	3.2	1.1
India	-9.0	6.2	9.0	4.4
Brazil	-4.7	3.1	3.5	3.4
Mexico	-9.1	3.5	3.5	3.6
South Africa	-8.1	3.3	3.6	3.8

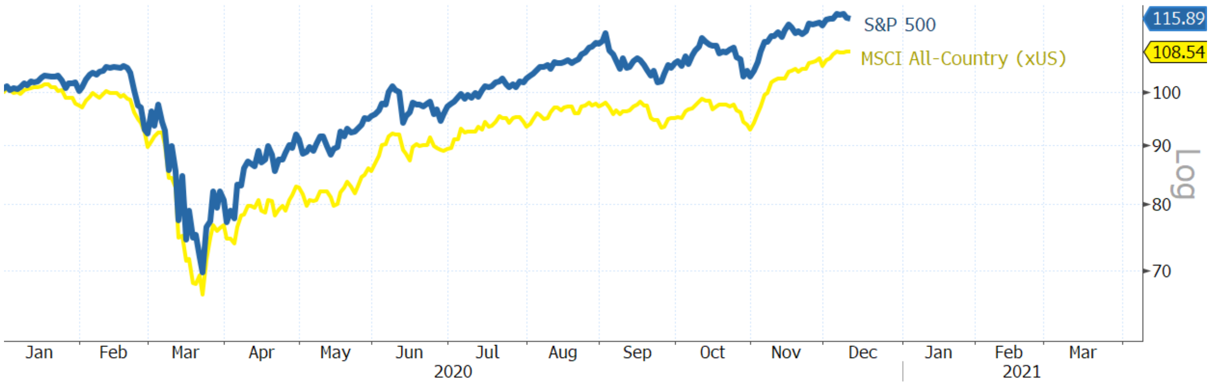
Source: Bloomberg
Institutional economist forecasts, median expectations as of beginning December 2020

Whatever happens, the post-pandemic world will be different to the pre-pandemic one. The virus has accelerated many secular trends already in play – the move to a digital economy chief among them. And the damage done to sectors like travel and leisure cannot be quickly undone, while the manufacturing sector has less to bounce back to this time, as it has not declined much since the second wave. These factors make it unlikely that we see another immediate 'everything-boom' like in the summer. Nevertheless, we should see strong economic activity momentum overall, making it all but certain that 2021 will be brighter than 2020.

We would note, however, that rebounding economies do not always mean rebounding stock markets. Investors had their panic in the early months of this year, but the great paradox of 2020 was that – as the world slumped into its deepest ever recession – equity markets rebounded relatively quickly back to pre-pandemic levels. From its lows in March, the S&P 500 has climbed around 64%, and is trading at all-time highs, while global stock markets at large are also trading above were they started the year (the UK being one of the few exceptions). Someone once said; "In the Grand Canyon, the view is above you. On Everest, it's below you." (We might add that it is difficult to see much at all if you are always surrounded by trees – which is probably how many investors feel!)

S&P 500 and All-Country MSCI

Gross total return indices, indexed to start of year



Source: Bloomberg, Tatton IM, S&P, MSCI

M2WDU Index (MSCI ACWI ex USA Gross Total Return USD Index) ACWI SPX gross t_ret Copyright© 2020 Bloomberg Finance L.P. 11-Dec-2020 14:21:00

These market moves were not just investor denialism. Since the frenzied March cash-grab, markets have been awash with liquidity, thanks to decisive and timely central bank intervention. There was also near-unanimous public support for governments to ramp up fiscal initiatives, to spend their way through the crisis. Perhaps because of lessons learned during the 2008-9 financial crisis, central banks reacted extraordinarily swiftly to create reserves (print money) and ensuring that cash funding did not become a scarce commodity, as initially feared by markets. This allowed governments to spend and previously viable companies to remain liquid (if not solvent/viable forever).

These policies meant household savings increased dramatically – especially in the US – to unprecedented levels, rather than succumbing to the pressures of the economic crisis. Central bank support also pinned government bond yields to non-existent levels, making risk assets the 'only game in town' for anybody seeking a return on their capital. In this environment, as long as you believe that the pandemic will end at some point – and that the economy will not suffer significant damage in terms of capacity in the meantime – buying equities makes sense. Simply put, "There Is No Alternative" (TINA for short).

Rationale aside, what this means is that a strong recovery in economic activity and company earnings is already priced in. After corporate earnings have tumbled while share prices have soared (albeit massively unequally), valuations (in terms of earnings per share) cannot feasibly go much higher. Even if the economy rebounds as most expect it to, this would only match what markets already presume. Upside in equities, then, would need to come from earnings growth *exceeding* expectations.

That puts markets in a delicate position. Any disappointment on the growth front – from lasting restrictions or psychological 'scarring' – will likely mean disappointment in prices. But there are certainly reasons for optimism. Both monetary and fiscal policy remain extremely supportive for now, and while we have already seen some fiscal floundering from politicians (the chorus of "how do we pay for it?" gaining volume), central bankers at least look like they will hold firm. Markets currently expect no movement in US policy interest rates for the next two years, and the pace of government bond purchases remains strong.

It is hard to overstate how important this could be for markets and the economy. In normal times, once a cyclical rebound appears established, interest rates would start creeping up, thereby raising the 'risk-free' rate and making investment less attractive. This takes the edge off the rebound – thereby lowering equity attractiveness. That is, after all, why central banks use rates to cool down overheating economies.

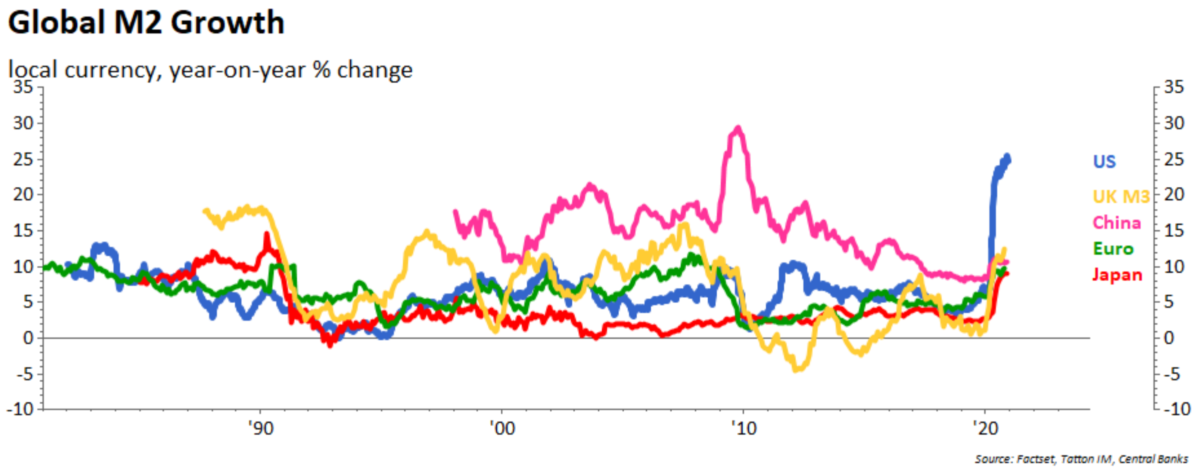
These considerations put policy centre-stage. This year, governments and central banks did a decent job of bridging the funding gap between now and normality. On the fiscal side, the positive signs have been that not only are politicians intent on steadying the ship, they also appear keen to ensure a strong post-pandemic re-acceleration of economic growth over and beyond the natural rebound through investment in vital infrastructure (green energy and technological improvements). Unfortunately, that fiscal drive has slowed somewhat in the developed world. In the US and UK, talk of rising taxes or shrinking public spending has put a sustained recovery in doubt, risking choking off private sector confidence before it can get going. To contrast, in a turn of events just about bizarre enough for 2020, the European Union is now the frontrunner for positive fiscal policy over the medium term.

We suspect that, if restrictions do ease and conditions look supportive, the public purse-strings will tighten and the fiscal investment plans for a more sustainable growth environment may gradually disappear off the political priority list as we move through the year. For the short term, this may not be all bad news given a fiscal bridge may not be necessary anymore (as people happily resume their social lives), but, in our view, an investment programme with a longer-term horizon would assure that the post-COVID rebound remains well established.

This makes monetary policy that stays its stated course all the more important. But old habits from central banks may die hard. If inflation emerges toward the end of 2021, policymakers could be tempted to mull exit strategies from monetary support – particularly if we see diminished economic capacity (supply-side shocks) struggling to meet increased consumer demand, leading to price rises.

But this time, things are different. Central banks (China apart) have committed to pinning down short rates for the foreseeable future, even as (perhaps if) employment and growth rates start to improve. We think that probably means central banks will also suppress longer-term rates from rising meaningfully, despite no explicit commitment from them.

Raising rates – even the suggestion of it – would be a policy mistake if it happened too soon. One of the most important factors for our outlook, then, is whether central banks can hold their nerve. If they stand by previous policy statements, and keep things loose despite improving conditions, so much the better for equities and the economy. If they do not, we will have a more conventional, lasting downturn to follow the



COVID recession.

As the chart above shows, the strongest impetus has been in US dollar money supply growth. The US dollar is the most important for global growth, but also operates with the longest lag. Our estimate is that the boost will not reach its strongest moment until well into the second half of 2021. Money supply growth's lagged impacts will mean Europe's growth will probably be strongest in the first half of 2021. In Asia, this year's boosts may begin to wear off by the spring, but the US dollar impacts should act as a support at that point.

For the real economy (non-government), low funding costs increase the likelihood that a company's margins will be strong, that return on investment will be good in the medium-term, and that growth in business confidence will create the usual cyclical feedback loop within the private sector.

For equity investments, it could mean that investors and analysts are underestimating the potential earnings growth from companies. In addition, if long yield rises are suppressed, equity valuations are more likely to be sustainable at their elevated level ('TINA'!) than would be usual in a normal cycle.

Both of those would be good news for stock markets. No matter what is already priced in, strong nominal growth with relatively static valuations is a positive for equity prices.

Regions

US

Policy is one of the most important factors for our global outlook, and nowhere exemplifies this better than the US. President Donald Trump earned worldwide derision for his mishandling of the pandemic, but in economic terms, American policymakers have had a decent year, especially in the early months. The US Federal Reserve (Fed) reacted swiftly and decisively to the crisis, setting short-term rates at zero and keeping long-term bond rates low through extensive asset purchases. The Fed has also bolstered private sector liquidity through emergency funding facilities – offering businesses a crucial lifeline through the economic shutdown.

Importantly, the Fed switched its framework to be more supportive of nominal growth (vs. real growth which is after inflation). It has always had two goals: controlling inflation and maintaining 'full' employment. But the order has reversed, with employment now the primary focus and inflation suppression demoted. This switch was years in the making but its timing (right at the point when activity was lowest) pushes the Fed into a different policy mix to that of the past 30 years.

This means 'lower for longer' on interest rates, and commitment to expansionary policies even in the face of returning growth. As noted, this is a boon for economic growth and for capital markets. Lowering funding costs for businesses amplifies the usual cyclical growth factors. And, by fixing equity valuation levels (by fixing the risk-free rate), it means positive earnings surprises translate into rising stock prices. As also noted, this puts the central bank centre-stage. If the Fed sticks to its promised framework, and keeps monetary policy loose, this will be an important positive. The danger is that policymakers blink in the face of a quicker-than-expected rebound. That the Fed recently allowed bond yields to rise somewhat is not the most comforting sign, although a policy freeze was to be expected during the late stage of the US election. We nonetheless expect Powell and co to hold their nerve in 2021.

US fiscal policy has been more of a mixed bag. In the early months, the US Treasury's response was constructive and instrumental in preventing widescale collapse. But as the year went on, bitter partisan divisions got in the way of much-needed support, and there is little chance of President Trump delivering any more than 'bridging stimulus' in his remaining 'lame-duck' days. With a new President come new possibilities however, and we take comfort in the fact that Joe Biden won on a platform of significant fiscal investment.

Politics could still get in the way though. While the fiscally liberal Democrats control the White House and House of Representatives, the more austere-minded Republican party is the favourite to retain control of the Senate. Two Senate seats – both in Georgia – are still up for grabs in January run-off elections and could swing the party majority. Polls put both seats neck-and-neck (with Democrats marginally ahead), but implied betting market odds and history based assessments favour the Republicans.

Assuming the Republicans retain the majority, the key question will be whether the party sets out to block the President-elect's agenda entirely – as during Obama's tenure – or work to achieve compromise. Recent form is not encouraging, but the incoming President has a good relationship with Senate Majority Leader Mitch McConnell, which could work to the Democrats' advantage. That scenario would push the US policy agenda toward the centre – backed up by Biden's decidedly moderate cabinet picks – but would still likely mean significant fiscal stimulus, without tax hikes in the medium term. This would be a huge positive for the economy, but hopes should be tempered. A partisan blockade is still a strong possibility – particularly if the Republican Party sees its future in its Trump-supporting base.

One area where Biden is likely to get his way is on environmental policy. The President-elect has pledged to immediately re-join the Paris Accord, and the green agenda has the support of many of the population-heavy state governments as well as more centrist Republicans – whose Senate votes will be easier to sway. The change in administration could have a big impact on the global green shift, with more focus on international coordination and the subsequent economic trends (around technology, commodities and energy) that come with this.

Many expect Biden to calm what has become an increasingly fractious international stage over the last four years. President Trump made China 'public enemy number one' from his first day in office, and started trade spats with virtually all of the world's major economies. A less erratic Commander-in-Chief will certainly be a positive, but it is not a given that Biden will undo Trump's anti-globalist agenda. Anti-China sentiment is a rare point of bipartisan consensus in Washington, and with the People's Republic picking up international condemnation on several occasions this year, there is no guarantee relations will improve.

We may have come to the end of the most divisive White House administration in recent memory, but politics still matters most for the US outlook.

UK

The main difficulty for the UK outlook is the same as it has been for the last five years – we do not know what future trading conditions will look like. The difference now is that those *future* trading conditions are nearly *present*. By the end of this year, big changes will happen one way or the other – whether that means some form of deal or not. Such is the roller-coaster of Brexit news that, by the time of reading, everything said here may be out of date. We have no special inside knowledge on Brexit negotiations, and the ever-shifting balance between rational economic reason and perceived political necessities, so let's stick to what we know.

Needless to say, erecting formidable barriers to trade with our largest trading partner would be an extreme negative for growth, at a time when the British economy is in the throes of its worst recession in hundreds of years. The same is true for the EU, albeit to a somewhat lesser extent. Both sides would be much worse off with a 'no deal' exit and, while there are still areas of clear disagreement, the disputed industries – fisheries foremost among them – are simply not big or influential enough to warrant sinking the whole process. The economic incentive to get a deal should be greater than the political hurdles in its way, and so on that basis alone we should expect something better than the very worst case to happen – even if we push it straight up to the cliff-edge.

It is important to stress, however, that even with a deal, conditions will be less conducive to trade than under full EU membership and as such still a negative for economic activity. The services sector – particularly finance – is likely to suffer, while job creation will be slow at best. What is more, to a large extent, the Brexit damage is already done. A cloud of uncertainty has hung over Britain for years, diverting business investment and hampering economic activity. Many companies have already made plans to move operations abroad, in an attempt to cut the uncertain UK out of the supply chain.

The flipside of this is that – whatever the outcome – we may already be at the low point in terms of Brexit's effect on Britain's economy and markets. The least we can say about the UK in 2021 is that there should be far more clarity on trading conditions. This will allow businesses and individuals to plan for the future – and if a better-than-expected deal is reached, it could lead to a positive surprise on growth. British equities have been so unloved by investors in recent years that it looks hard to justify their lowly relative valuations. Even if growth lags behind the rest of the world (as the Organisation for Economic Co-operation and

Development (OECD) and other forecasters expect it to) sentiment could well rebound when investors see that the UK is still breathing – with potential upside for asset prices.

Britain could also do with a helping hand from policymakers. Unfortunately, the outlook for both fiscal and monetary policy is mixed. The Bank of England has certainly played its part by lowering interest rates and providing liquidity through the pandemic, but it has been less forthright about its commitment to monetary easing than global peers. And, while the Treasury added a substantial fiscal boost in the early months, Chancellor Rishi Sunak has recently sounded increasingly hawkish. With bond yields at historic lows and a central bank willing to effectively 'monetise' any new debt spending, the government would do well to take advantage – not only to plug the gap between now and normal but to invest in productive infrastructure while it can. That it is reluctant to do so is a negative for domestic demand.

If fiscal policy flounders, demand will have to come from the private sector. One area where this could happen is in the residential property market. The increased focus on one's home setting through the experience of lockdown, together with pent-up savings and Stamp Duty relief have pushed demand up recently, and we expect this to continue into next year. The property market is a vital pillar of the UK economy, with higher prices boosting consumer demand (through the balance sheet effect) and having knock-on employment effects through housebuilding. We expect there to be a further suspension of Stamp Duty – hopefully extending the positive housing market dynamics.

Overall, however, it is still likely demand will be weaker in the UK than elsewhere – especially if the government turns hawkish on the spending front. But it may not matter as much for UK assets; they cannot get much cheaper and in the main market (FTSE) relies more on global than domestic revenues.

Europe

Europe (perhaps more specifically, Germany) has long been seen as the world's fiscal miser. Strict budgetary rules and the usual complaint of "monetary union without fiscal union" have stopped EU nations from spending their way out of past crises. But the pandemic has delivered a fiscal awakening for the EU. In the summer, a substantial centralised spending package was agreed for 2021 – while most nations have been allowed to support their citizens without threat of troika intervention. The agreement should not be overstated. It is far from signalling a full fiscal union, despite the EU issuing bonds as a joint Eurozone for the first time, rather than at the individual nation level. But the EU's budget – together with the post-pandemic recovery fund – amount to a substantial €1.8 trillion in spending, which could be vital in supporting economic recovery on the continent.

There will be inevitable impediments before the money gets spent, driven by the need to have constant consensus amongst the many nations. Still, needs must, and it is easier to get agreement when money is being handed out.

In a sign that the EU intends to strengthen its values-component of the EU, a new "rule-of-law" provision was introduced into its spending procedure. In response, Hungary and Poland initially vetoed the new budget and recovery fund, as its far-right authoritarian leaders suspected interference into domestic politics. An addendum that penalties could only be enacted after a ruling by the European Court of Justice brought the two countries back in line.

On the monetary side, policy will continue to be supportive, after the European Central Bank's announcement of a €500 billion extension to its bond-buying programme. In general, confidence in European policy is high. Despite continued lockdown measures, private sector sentiment is strong relative to actual activity – and Germany's extensive spending measures should provide a great engine for European growth in 2021.

The recent strength of the Euro suggests some of that optimism is now discounted, but if global growth rebounds strongly next year (particularly in Asia) that is a good environment for European assets to go beyond what is already priced in.

Nevertheless, the Hungary-Poland episode points back to the same old problem on the continent. Regional political interests often get in the way of common progress, and since each country has veto power there is little room for manoeuvre within the EU's formal structures. There are reasons to be optimistic about Europe's rebound next year, but structural problems, such as low potential growth and regional divergence, could get in the way again.

China

China is the only major economy on course to grow in 2020. Having gone through its lockdown hard and early, industrial and consumer activity was already rebounding while the rest of the world was still under restrictions. Such has been the strength of the world's second-largest economy that – unlike every developed nation – authorities have seen fit to *tighten* monetary policy this year. The government has been keen to hand out fiscal payments and boost domestic consumption, but the People's Bank of China has not been deterred from its mission of stabilising the nation's credit pile. We expect both of these to continue into next year. Beijing will want domestic demand to remain strong to decrease its export dependency – and has all the necessary tools to do so – but for money-supply growth to be kept under control. At the same time, rebounding global activity should beef up demand for Chinese exports – creating a positive cycle.

Authorities have room to be reactive, though, and how Chinese growth progresses will depend on what the rest of the world is doing. If global demand is strong, Beijing will likely be keen to soak up export demand and focus on deleveraging its domestic economy. If global growth disappoints, its focus will be even more on stimulating domestic activity, with less regard for containing credit growth. Anything in-between will see some mix of these policies. And this has wider implications for the global economy. China will only want to be the world's demand powerhouse if it has to be.

This policy mix should mean upward pressure on the value of the Renminbi. The currency has already been climbing against the dollar over the last few months, backed up both by a strong Chinese economy and increased demand for Chinese financial assets. China's asset markets are increasingly opening up, just at the point where its economic and domestic political stability is the envy of many in the West. Over the medium and long-term, these factors are supportive of the Renminbi, which could result in an upside of around 7% against the dollar in the next calendar year – the maximum amount that Chinese authorities tend to allow before intervening.

Short-term pressures are not so positive for the currency, however. China has been the focus of intense international criticism this year, over its continued human rights abuses in Xinjiang and effective crushing of any democratic rule in Hong Kong. Beijing seemed to want to sort out its affairs while the world was distracted – but that has not stopped significant anti-China forming blocs in the West's corridors of power. If it continues to act aggressively, this could lead to quick capital flight – particularly through its 'blind spot' over Taiwan. Should that happen, authorities will likely tighten capital controls, which would deflate much of the longer-term buying pressure for the Renminbi.

Economically speaking, the ingredients are all there for a return to strong Chinese growth. The difficulty lies in the political risk, both internationally in the form of potential sanctions, and domestically in the form of unexpected crackdowns. How Xi Jinping's relationship with Joe Biden develops through the year will be key to watch.

Emerging Markets

(Readers will note that, in economic terms, we are moving to consider China separately from other emerging markets. Over time, we expect that this will also mean considering China separately in investment terms.)

On an overall level, emerging markets have had a decent enough year. Despite the March sell-off, the MSCI Emerging Market Index is up from the start of 2020 and is currently trading close to its early 2018 high. But this overall picture hides significant dispersion. Naturally China, the largest single component of the index, is responsible for a fair chunk of that growth, as are other Asian nations like South Korea and Taiwan. Latin America, by contrast has lagged – even though commodity prices (which its constituent countries are extremely sensitive to) have been rising.

It is fair to say that Asian countries in general have had a decent pandemic, supported by China's early and substantial return to growth. South Korea and Taiwan also handled the spread of the virus well, and have been able to keep economic activity at a level considerably above the US and Europe. It was, of course, extremely helpful that both Korean and Taiwan stock markets have a big technology component. In economic and investment terms, much the same applies to the other large East Asian markets in 2021.

Latin America, the Middle East, Africa and the Indian sub-continent face a more complicated picture. In general, a global cyclical rebound with a weaker dollar is a strong positive for these emerging markets. But much depends on how well governments can continue to contain the spread of the virus, and whether they are able to provide fiscal support without spiking debt costs.

The commodities outlook adds another complication. Rebounding activity is always a positive for commodity producers, but it may not be the same commodities that benefit this time around. We expect the green agenda to be pushed hard in 2021, meaning commodities involved in green production – such as copper – will continue to benefit.

The carbon energy producers have had a difficult year, with the collapse in air travel having a significant effect. A bounce-back in tourism is highly likely, less so for business travel. But one should be wary of thinking that the acceleration in green investment is negative for these areas. Indeed, there is a strong argument that a 'greening' of these nations will have the most impact. Some countries with huge savings amassed through the carbon-intensive years, may deploy these increasingly in transformational investment.

Asset classes

Bonds

In the throes of the deepest-ever global recession, while central banks around the world are engaged in extensive 'financial repression' by crushing yields through bond purchases, our outlook for bond returns and investments might as well be summed up as: check back with us next year. We expect yields to remain around the historically lowest levels, and the movements in those yields to be historically small. However, swings in yields may well have an outsized impact on other asset classes.

At a slightly more detailed level, we expect government bond issuance will be substantial in the developed world – in the early part of the year at least – but that these will be quickly gobbled up by central banks, leaving yields with nowhere to go. Central bankers, by their own admission, are playing the global reflation game. As such, we do not expect them to react by tightening policy even when the early signs of growth or inflation start to come through. As we have highlighted, the possibility that they *do* react by tightening policy is one of the biggest risks for next year's outlook.

While overall yield levels should stay flat, there could be significant capital movement towards Asia, and China in particular. Beijing is making local currency investment into its bond markets easier for foreigners – with the recent announcement of a new class of EuroCNY bonds to be cleared via a joint Europe-Shanghai based clearing house. With a strong domestic economy and higher returns than in the developed world, these bonds are likely to be attractive and could generate further significant inflows into Chinese assets.

On the corporate bond side, credit spreads (the yield difference between corporate debt and the risk-free government rate) are already tight, and so further upside in bond values from further spread-driven yield reductions may be limited. But there are still pockets of laggards – mostly at the very high end of sub-investment grade debt, and in virus-stricken sectors such as travel and energy. Here there is room for upside, but there would have to be significant economic surprises – such as rapidly rebounding travel demand – to see it.

Equities

Our outlook for equities is set by three factors: the economic outlook, price moves up to this point, and central bank policy. As noted, we certainly expect a rebound in growth next year, but this does not necessarily mean a positive environment for equities. Equity valuations have been pushed sky high, and prices already include expectations of a strong global rebound.

In terms of earnings-per-share, significant growth in 2021 is already discounted by markets, especially in the areas that outperformed this year. Forward focus will therefore shift to 2022, when the recovery will (hopefully) be in full swing, and market moves next year will be more about rotation than broader trends. For equity prices to go up from here, growth needs to be *surprisingly* strong. There is some reason to think it might be.

For us, the biggest factor that makes the equity outlook positive is central bank policy. Since government bonds are being pinned down for the foreseeable future, equities have a perpetual yield advantage. As long as central bankers hold their nerve, this should mean that valuations will not decline as usual – meaning that any upside translates directly into price upside. As we have said, strong nominal growth with static valuations is a positive for equities.

Commodities

Commodities have a mixed outlook in 2021. Oil prices gave us one of the most extraordinary market events of the year in 2020, as West Texas Intermediate futures contracts fell to a negative price in April. Fears of oversupply and falling demand have beset the oil market throughout the pandemic, but prices have recently climbed above the $50 per barrel level on the back of positive vaccine news. In general, a global cyclical rebound should be good for oil – and commodities in general – but this is complicated by the pressing ahead of the green agenda for the reduction of CO_2 emissions. For oil, the biggest question is whether governments will simply want to reflate their economies next year no matter the environmental cost, or whether green politics will finally see a structural move down in oil demand. We may well get a combination, with oil going into undersupply early in the year but supply-demand dynamics shifting as the recovery progresses. Observers remain divided on when exactly this may come about.

Industrial and precious metals are currently at very high price levels, and so from that perspective are unlikely to have much upside. But here the green agenda changes things again – those metals used in green tech should see structural support – but when exactly this supports comes through is harder to say.

Property

Despite wider economic activity falling by its largest-ever margin, the housing market managed to hold up reasonably in 2020 – bolstered by significant savings and regulatory changes both in the US and UK (and to a lesser extent, Europe). These dynamics should continue to support prices, which will also be backed-up by historically low interest rates and banks keen to offer mortgages. The rebound in activity should also create some income growth – a big support for property prices.

However, price moves have not been, and are unlikely to be, equal. Big cities have come under severe pressure, as work-from-home trends have enabled buyers to opt for more distant places with better value for money. There may be some movement back towards cities next year, but even if mass vaccination goes smoothly and activity increases, the old city-centric growth story is unlikely to return soon.

Something similar can be said about commercial property, which has a substantially worse outlook than residential. In the UK, we have seen multiple high-profile high-street closures recently – and even pre-pandemic, trends were against physical stores. Likewise, office space in cities will likely be under sustained pressure.

Global Equity Markets

Market	Fri 15:18	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6564.1	+0.2	+13.9	↗	→
FTSE 250	19686	-2.5	-496.4	↗	→
FTSE AS	3690.4	-0.3	-11.9	↗	→
FTSE Small	5970.0	-2.2	-135.5	↗	↗
CAC	5524.5	-1.5	-84.7	↗	→
DAX	13148.8	-1.1	-150.2	↗	↗
Dow	29974	-0.8	-244.1	↗	↗
S&P 500	3656.8	-1.1	-42.3	↗	↗
Nasdaq	12376.4	-0.7	-87.9	↗	↗
Nikkei	26652.5	-0.4	-98.7	↗	↗
MSCI World	2628.6	-0.4	-11.1	↗	↗
MSCI EM	1255.0	+0.3	+4.0	↗	↗

Top 5 Gainers

Company	%
Micro Focus Int'l	+7.5
Imperial Brands	+7.2
Brit-AM Tobacco	+6.5
DS Smith	+6.5
Evraz	+6.3

Top 5 Decliners

Company	%
Persimmon	-13.3
TUI	-13.1
Lloyds Bank	-12.2
Berkeley	-11.1
Barratt Devts	-10.7

Currencies

Pair	last	%1W
USD/GBP	1.322	-1.9
GBP/EUR	0.917	-1.7
USD/EUR	1.21	-0.2
JPY/USD	103.91	+0.2
CNY/USD	6.55	-0.3
Bitcoin/$	18,074	-4.0

Commodities

Cmdty	last	%1W
Oil	50.20	+1.9
Gold	1846.5	+0.7
Silver	24.09	-0.1
Copper	350.0	-0.4
Aluminium	2060.0	+1.6
Soft Cmdties	376.9	-1.1

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.17	-0.18
UK 15-Yr	0.39	-0.19
US 10-Yr	0.88	-0.08
French 10-Yr	-0.38	-0.07
German 10-Yr	-0.63	-0.09
Japanese 10-Yr	0.01	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.2	19.7	21.6	13.9
FTSE 250	1.9	16.7	26.3	15.0
FTSE AS	3.0	19.0	22.1	14.0
FTSE Small x Inv_Tsts	2.1	16.0	-	35.5
CAC	2.0	22.1	28.0	14.3
DAX	2.8	22.5	19.2	13.1
Dow	2.1	21.9	24.6	15.8
S&P 500	1.7	26.3	25.9	16.8
Nasdaq	0.8	36.6	32.0	19.1
Nikkei	1.6	27.5	25.2	17.2
MSCI World	1.9	25.3	25.0	15.9
MSCI EM	2.0	19.9	19.5	12.2

UK Mortgage Rates

Mortgage Rates	Nov	Oct
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.83	1.84
3-yr Fixed Rate	2.05	2.03
5-yr Fixed Rate	2.02	2.02
10-yr Fixed Rate	2.50	2.48
Standard Variable	3.62	3.62

* 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

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

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