CAMBRIDGE
INVESTMENTS LIMITED

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'Of COURSE I can't say if you'll have a summer holiday – I have my limits'

Source: Paul Thomas on an uncertain summer, 12 February 2021

No UK double dip, but much talk of bubbles

'Worst recession in 300 years' was how UK media framed Friday's release of UK GDP growth data for the last quarter of 2020. They were also quick to point out that the -9.9% full-year number was far worse than any other major industrialised nation around the world. What they only reported far further down in their articles was that compared to Q3, the economy had grown +1% in the last quarter of 2020, meaningfully above economists' expectations of +0.5%. Some had expected contraction and a 'double-dip' recession of two consecutive quarters of negative growth (since this current quarter will see a contraction of around -2.5% because of lockdown). That's no longer on the cards as Q2 is highly likely to rebound sharply (current estimates are for +5%).

The media also failed to mention that, in the UK, the public sector's contribution to GDP is now accounted for by public sector output (education lessons delivered, medical operations performed, etc.) rather than – as measured by the rest of the world – wages paid. This has been shown to have made a difference in magnitude quite similar to the UK's apparent GDP underperformance.

Regardless, following the stock market's strong outperformance over the last two months of 2020, these last two months the UK appears to have fallen back into its previous rut of under-performance compared to international peers. Given the forward-looking nature of stock markets, this will hardly have been caused by last year's dire GDP numbers. Therefore, the question is what has changed compared to the pre-Christmas period? Is it the Brexit reality, is it declining vaccine dividend prospects or might it be UK companies' high dependence on the cyclical end of the global economy?

As usual, the answer is not so straightforward. At least the relative strengthening in £-sterling throughout would suggest international investors still believe the UK should have a near-term advantage of being the global vaccination leader among high population countries. On the other hand, the delay in the onset of the post-pandemic recovery due to slow vaccine rollouts elsewhere has also delayed (although not reduced the extent of) global cyclical recovery expectations, which may have acted as a dampener for the UK's multinationals.

Among the more domestic-oriented market segments, however, optimism has faded. This is due to mixed messages from the government about what should happen once all those individuals classified as 'COVID vulnerable' have been vaccinated, and infection as well as fatality numbers fall back to where they were last summer. Boris Johnson's message, not to book any summer holidays yet, was the culmination of the government's muddled messaging to a population tired of lockdown and desperately seeking clarification on when freedoms will be granted.

Despite continued assurances about being led by the science, it would appear the government did not consider the scientific logic that it may be impossible to completely eradicate the COVID-19 virus – even once the majority of the population has been vaccinated. Epidemiologists like microbiologist professor Paul Hunter (University of East Anglia and World Health Organisation adviser) have gone on record with the BBC stating we will have to learn to live with the virus. Hunter also explained that previous virus strands (pre COVID-19) have always lost, not gained, in their level of danger to human health as they mutated. Vaccinations have continued to provide sufficient protection, even against the mutations, leading ultimately to having no more severity than seasonal flu.

It is understandable that governments want to prevent any further flip-flopping between relaxation of restrictions and continued lockdowns, but as Hunter suggested, there is little medical reason for continued strict travel restrictions once all those vulnerable to the early more lethal COVID-19 strands have been vaccinated. We will probably have to get used to regular rounds of COVID vaccinations every autumn. But at some point – and especially once the public health impact has been reduced to the level of the usual seasonal flu threat – societies must be allowed to return to a more normal life.

Across the Atlantic, the retail investor frenzy of "short-squeezing" stocks with the worst prospects (and therefore at the most shorted end of the market spectrum) has continued to recede, with the share price of the now-infamous GameStop falling further back towards where it started the year. Last week, their fancy was taken (yet again) by the melding of two great favourites. Bitcoin was back in the headlines after maverick entrepreneur Elon Musk's electric car company Tesla disclosed it had joined the Bitcoin mania with a substantial $1.5 billion balance sheet holding.

Not surprisingly, there are now regular voices equating the increasing frequency of these speculative bubbles and selective financial manias to harbingers of a general asset price bubble – gearing up to the predictable crash effect on markets further down the line. Our third article this week discusses in more detail the effects of this flow of money from various investor groups. Regarding what recent financial manias tell us about the state of wider markets, we would like to point to the aftermath of the Global Financial Crisis and the negative side effects of the first rounds of extraordinary monetary easing by central banks.

Back then, commodity markets were herded into a speculative bubble. When the bubble burst, it caused collateral damage to all those in manufacturing who supplied those sectors. It is an unfortunate fact that – just like any strong medicine – the very necessary and effective measures taken by central banks and governments to bridge the void opened by COVID come with some undesired side effects.

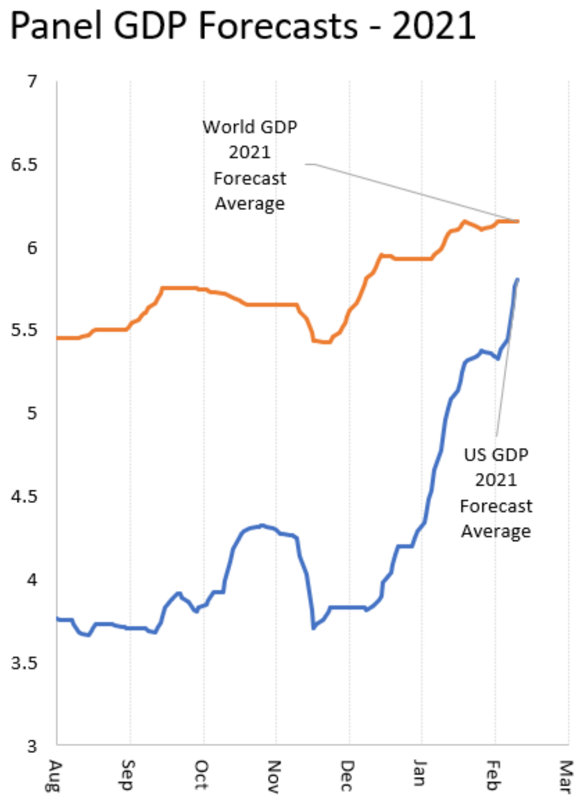
Therefore, the situation requires professional investors to be on their guard about localised asset bubbles. But as our other article this week lays out, current improvements in stock market sentiment are very squarely driven by improving expectations about the global economy, and therefore tethered to market valuation principles rather than speculative flights of fancy.

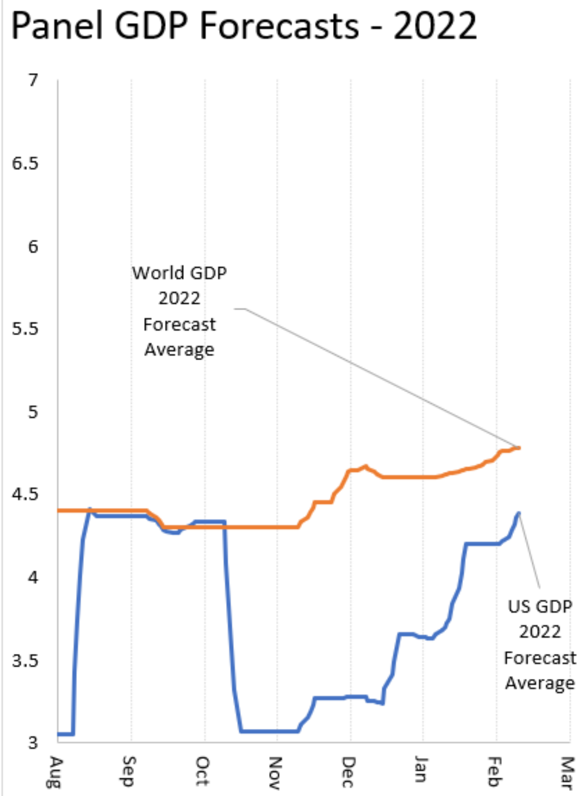
Global growth surprise

With vaccines being rolled out across the world, and substantial monetary and fiscal support for the foreseeable future, economic activity in the second half of this year is all but certain to be stronger than 2020. But much of this optimism has already been priced in. Just as last year saw the worst global recession on record paired with booming stock markets, the recovery this year might only match markets' lofty expectations.

For upside in equities to be supported from here, the economy and global corporate earnings will have to be at least as good as was expected at the beginning of the year. It is welcome news, then, that global growth estimates have been trending upwards.

Last week, the International Monetary Fund (IMF) revised its forecast for global growth in 2021 and now predicts an expansion of +5.5%, following a vaccine-powered surge in activity. In addition, last year's recession was not quite as deep as feared, according to the IMF's latest outlook. It now puts 2020's contraction at -3.5%, compared to the -4.4% expected in October, after growth momentum came in stronger than expected in the second half of the year. Our panel of investment bank forecasts are even more positive. For 2021, the global growth forecast average has moved up to +6.15%; for 2022, up to +4.8%. Both are driven by the sharp upward shift in US expectations.



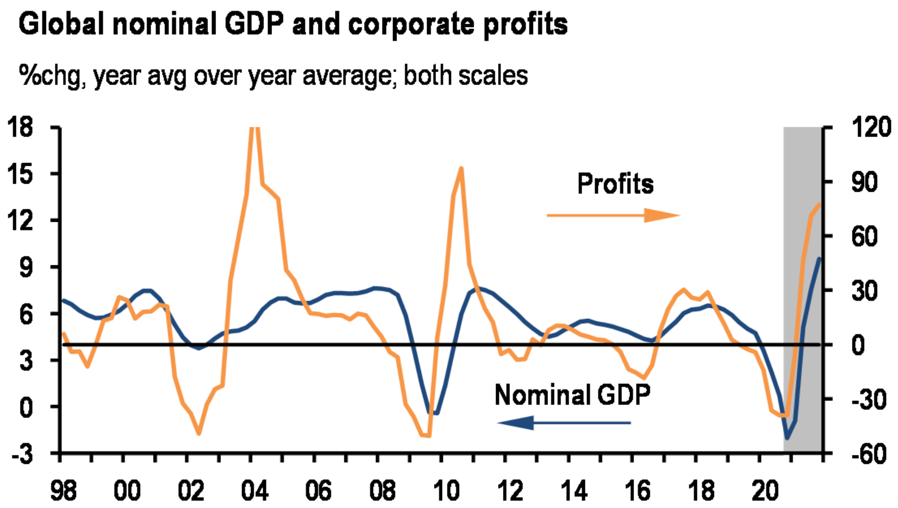


Source: Bloomberg, Tatton IM, Barclays, UBS, Deutsche Bank, Goldman Sachs

Business sentiment surveys are similarly positive. In the US, purchasing managers indices (PMIs) remain elevated for the manufacturing sector – indicating that businesses expect expansion – while expectations for the services sector have been rebounding. A deceleration in China is causing some concern for the global picture, but this is likely to be more than compensated for by an improving US picture. Anecdotally, a number of analysts we talk to have become extremely bullish about the US outlook this year and next.

This is reflected in the strong corporate earnings season. Despite the harsh Christmas period, and lockdowns across the UK, Europe and US, company profits in the last quarter of 2020 held up well. In terms of earnings per share (EPS), this reporting season has been one of the biggest positive surprises in the last 20 years. In the US, 82% of companies having reported so far have beaten consensus expectations, while 69% of companies have done so in Europe.

Things look even better when it comes to future expectations. In dollar terms, EPS estimates for 2021 and 2022 have improved across the board, though American companies beat their European and British peers by some distance. Still, JP Morgan suggests the global profit outlook is rosy. The IMF's 2021 global real growth forecast of +5.5% translates to a nominal forecast of +8.9% (for 2022, a nominal growth of +7.4%). Global EPS growth is likely to be strong, as its graph indicates:



Business expectations have clearly improved, and that positivity is rubbing off on investors. Policy support is a key pillar of this optimism, which is no doubt a reason for the US outperformance. We know that the US Federal Reserve (Fed) is committed to extraordinary monetary easing until further notice, but the Democratic Party's recent wins in the US Senate have added a substantial boost to fiscal expectations.

President Biden has made a $1.9 trillion COVID relief package his top legislative priority and market analysts now expect that he will be able to get at least $1.5 trillion of these fiscal measures sanctioned by Congress. Combined with the packages already put in place – including the $900 billion passed by Congress in December – this should give the American economy a huge tailwind. The Democrats are planning to hand out $1,400 payments to every citizen earning less than $75,000 (phase-out beyond $75k), while unemployment and other benefits will be expanded and extended. Raising the minimum wage to $15 per hour is one of the more controversial elements of the spending bill.

Beyond the current stimulus bill, which is more of a stop-gap, Biden has promised a significant boost to public infrastructure investment. This is likely to be subject to negotiations in March. For a longer-term investment horizon, this is an important element. Whilst infrastructure spending is notorious for taking a long time to feed into the economy, it could also have a more sustained long-term effect. Carbon emissions-reducing 'green infrastructure' is the top priority here, with Biden making environmental investment pledges a key part of his campaign. This should significantly aid the US to transition out of a carbon-based economy, boosting productivity and growth prospects along the way.

Infrastructure stimulus should also encourage private investment, with businesses seeking to capitalise on opportunities brought by the recovery. Here, the medium to long-term outlook is extremely positive.

With revenues decimated by the world's worst peacetime recession, productive business investment had been expected to fall dramatically – presaging economic woes further down the line. However, according to JP Morgan, business capital expenditure (capex) rebounded rapidly after the first wave of the pandemic, and has been extremely resilient through the second. Global capex (excluding China) reached pre-pandemic levels by the end of last year, and is expected to be 7% above that by the end of 2021.

This is clearly a big boost for the US economy, demonstrating that the 'animal spirits' of economic recovery are in full force. But it should also be a positive for the world. The world's largest economy tends to export its growth around the globe, by means of increased demand, meaning that global corporate profits and growth should be well supported.

Such is the optimism about the 'bounce-back' recovery that market focus has now moved onto what happens after it. News and media debates have intensified around the next innovation and investment cycle – with attention not just on virtual investment, but more tangible areas like biotech. The green revolution is another huge component of this, with governments and businesses now increasingly focused on environmentally friendly means of recovery.

It has been interesting to see the moves from big oil companies, which seem to have realised that investing in the green space is an 'adapt or die' moment. Royal Dutch Shell has claimed its carbon emissions and oil production has already peaked, and laid out a plan for a transition to clean energy production.

These are longer-term considerations, but it may not be long until they start majorly impacting market trends in the present. Despite the dour winter we are having, conditions remain extremely supportive for a strong rebound later in the year, as we all intend to catch up with what we have missed. The pandemic and its recovery have accelerated many trends present before, and investors are taking notice.

Looking for the bright side in markets

Even though economic prospects appear positive, for capital markets, it's always a bit more complicated. For investors, the main anxiety is that the economic positivity, based on vaccination hopes and fiscal support, is putting equities in a more precarious position. No one can deny that, on current price-to-earnings ratios, stocks look expensive relative to history. This is not much of a surprise – after all, it is what you would expect when you combine the deepest global recession on record with a year-long market rally.

Current equity prices are based on the eagerly anticipated future, rather than the impaired present. But the risk of being wrong is still quite high and, at the moment, the payout for that risk (the risk premium ~ the average amount of expected corporate earnings relative to the share price) is low. Goldman Sachs research notes that global investor sentiment is in a 'risk-on' phase, with a great deal of cash having already flowed into stock markets.

At the policy level, support provided by the world's central banks should not be underestimated. By flooding markets with liquidity, central banks have pushed down the cost of capital. This has the biggest impact on the least risky assets, government bonds, and flows through to reducing the risks of corporate default. With a lower cost of capital, businesses are able to resume internal investment sooner, which should raise their prospective return. Less overall risk, and at least stable profit growth, should mean investors will accept lower risk premia, and/or buy riskier assets.

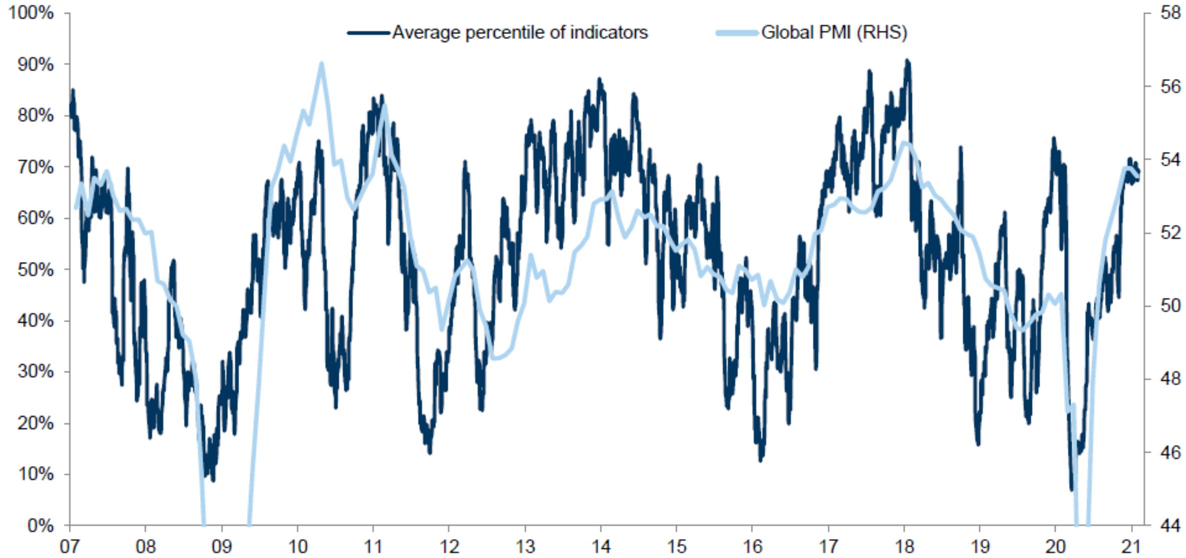
The Fed has effectively committed to maintaining an expansionary bias well beyond the end of the pandemic, pumping capital into the US Treasury bond market at an extraordinary pace. In a normal recovery, rising growth prospects would lead to rising real yields on bonds – thereby increasing the risk-free rate and making equities relatively less attractive again. That will not happen this time, in the short-term at least. So, positive surprises in the economy have a very good chance of translating directly into equity price rises, rather than being absorbed by rising interest rate costs.

Of course, private investors might want to sell their (ultra-low yielding) bonds to buy equities, a flow which initially helps equity prices but – as a consequence of the resulting lower demand for bonds – runs the risk of raising the cost of capital (yields) too early. This would kill the expected rise in profits, especially while companies still carry large debt loads from the recent recession. While government bond yields have indeed risen in recent months, central banks will have been comforted by the fall in credit spreads (the risk premium yield amount corporates have to pay above the government bond rate) which have offset government bond yield rises. However, they will watch bond market moves closely, and we expect they will intervene if yields rise sharply.

Goldman Sachs has been looking at indicators of various investors' risk appetite. These indicators provide reasonable confirmation that US retail investors have become a far more significant influence in market moves. Over the last year, personal incomes have been bolstered through government transfers, while personal spending has been constrained. The consequent rise in savings has also led to some interesting events, including the soaring rally of Tesla and, last month, the shock surge upwards in GameStop's share price. That price activity led to turmoil among hedge funds, many of which were shorting GameStop and similar stock targets of the online forum Reddit community. It is telling that those hedge funds losses and following spike in volatility have already been quickly adjusted for, with markets recovering without any wider contagion.

One might think this would lead to capitulation from the pessimists, and investors of all hues would now be positioned too heavily towards equities. But, as the graph below shows, from a historical perspective, the overall positioning towards equities as expressed by their *'Average percentile of indicators'* is in line with the economic positivity. And, although one might expect growth optimism to wane, a recession is often followed by a longer period of growth, especially if policy support is maintained rather than curtailed early.

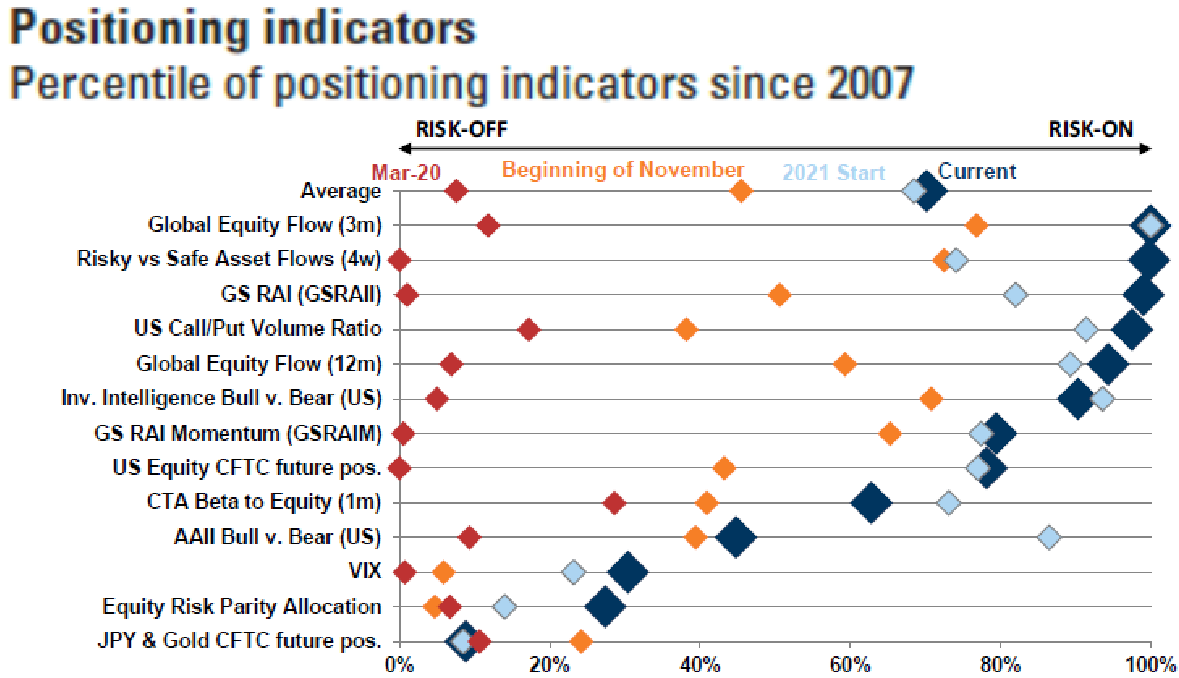
Positioning indicators can stay elevated if economic activity data remain supportive



Source: EPFR, Haver Analytics, Goldman Sachs Global Investment Research

The dark blue graph line is an aggregate of various indicators. Goldman Sachs also makes the case that the components show there are still some big players waiting to join the party. While fund inflows into risk assets have been extremely strong recently ($250 billion since November), this comes after a period of sustained outflows, amounting to $700 billion since 2018. There is still a significant amount of capital sitting in money market funds which, if utilised, would provide further support for equity prices.

Some types of institutional investor are more "mechanical" than others. According to Goldmans, some quantitative strategies such as risk parity, price momentum (often known as CTA) and option volatility sellers (VIX) have quite a lot of room to buy more equity risk. A sustained rise in prices (especially if it was relatively steady) would cause them to increase their positions, as the graph below indicates:



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

Last week, the retail crowd (among others) was once again trading into Bitcoin, after the Tesla executive board announced it had accumulated a $1.5 billion digital currency position. We will not get into the pros and cons of Bitcoin or cryptocurrency generally, however it is notable that Tesla's announcement led to such a surge in its own share price. CEO Elon Musk has become something of an icon for the online retail investor crowd, and seems to have the ability to sway piles of fast money into assets with little more than a tweet.

Goldmans makes a good case that other investors may join in. However, Bitcoin could just as easily go the other way as well – as it has so often over the past years – given it remains merely a speculative trading asset, one which neither fulfils the minimum requirements of a currency nor that of a yield-bearing investment.

Newer technologies have made personal investing much easier, and retail presence is now a serious factor to consider for market moves. The conditions for retail inflows remain positive at the moment – bolstered by increased fiscal support in the US. But as we move into the second half of the year, and the global economy begins to reopen, this could well change. Much has been made of the 'exit strategy' for policymakers – with both governments and central banks forced to handle their tapering of support policies sooner or later. Something similar can be said for individuals and households, whose short-term savings have contributed substantially to market optimism over the last year.

We could well end up in the counterintuitive scenario where – when the recovery comes into full swing – it could prove to be a negative for markets. Once people are spending the money that might otherwise find its way into markets, a substantial source of liquidity could dry up. Fortunately, this is likely to be offset by the re-emergence of institutional investors keen to join in the cyclical investment rotation. Whether it will be enough to prevent net outflows is hard to say.

Overall, the conditions for a continued uptrend in markets remains, for now. At the very least, it seems unlikely that we will see sustained downward pressure from here. Policy and sentiment remain hugely supportive, and the economic backdrop equally has a long way to go - up. When that 'de-mob happy' recovery actually kicks in, though, things become harder to predict.

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15th February 2021

Global Equity Markets

Market	Fri 15:50	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6573	+1.3	+84	→	⬈
FTSE 250	21014	-0.3	-53	⬀	⬈
FTSE AS	3746	+1.0	+37	→	⬈
FTSE Small	6495	+0.3	+17	⬈	⬈
CAC	5703	+0.8	+44	⬀	⬈
DAX	14049	-0.1	-8	⬀	⬈
Dow	31419	+0.9	+271	⬈	⬈
S&P 500	3923	+0.9	+36	⬈	⬈
Nasdaq	14031	+1.3	+175	⬈	⬈
Nikkei	29520	+4.2	+1178	⬈	⬈
MSCI World	2807	+1.2	+34	⬈	⬈
CSI 300	5808	+5.9	+323	⬈	⬈
MSCI EM	1428	+2.3	+33	⬈	⬈

Top 5 Gainers

Company	%
Prudential	+8.8
Anglo American	+7.1
Rio Tinto	+5.7
DS Smith	+5.5
Pearson	+5.2

Top 5 Decliners

Company	%
easyJet	-9.2
Ocado	-8.2
Carnival	-7.8
TUI	-6.7
Int'l Consol Air	-6.5

Currencies

Pair	last	%1W
USD/GBP	1.385	+0.8
GBP/EUR	0.875	+0.2
USD/EUR	1.21	+0.6
JPY/USD	104.97	+0.4
CNY/USD	6.46	+0.1
Bitcoin/$	47,210	+24.7

Commodities

Cmdty	last	%1W
Oil	61.65	+3.9
Gold	1827.9	+0.8
Silver	27.37	+1.7
Copper	377.3	+4.0
Aluminium	2079.5	+4.3
Soft Cmdties	429.6	+2.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.52	+0.04
UK 15-Yr	0.75	+0.04
US 10-Yr	1.18	+0.02
French 10-Yr	-0.20	+0.03
German 10-Yr	-0.43	+0.02
Japanese 10-Yr	0.07	+0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.2	19.7	14.8	14.0
FTSE 250	1.8	19.1	22.0	15.2
FTSE AS	2.9	19.4	16.7	14.1
FTSE Small x Inv_Tsts	1.6	18.4	-	15.1
CAC	1.9	23.1	18.0	14.5
DAX	2.5	23.9	15.8	13.2
Dow	1.9	22.0	20.8	16.0
S&P 500	1.5	27.9	23.0	17.0
Nasdaq	0.7	36.0	34.6	21.9
Nikkei	1.4	27.8	24.6	17.4
MSCI World	1.7	26.1	21.6	16.1
CSI 300	1.5	21.3	16.0	12.4
MSCI EM	1.7	21.9	16.9	12.3

UK Mortgage Rates

Mortgage Rates	Feb	Jan
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.75	1.78
3-yr Fixed Rate	2.08	2.06
5-yr Fixed Rate	1.93	1.96
10-yr Fixed Rate	2.53	2.53
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

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel