CAMBRIDGE
INVESTMENTS LIMITED

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Source: Patrick Blower, 30 March 2021

The first quarter of 2021 was no April fool

The fact is that the first quarter of 2021 has brought genuine good news for UK-based investors with exposure to global stock markets. Equity markets have generally resumed an upward trajectory, while low risk assets, especially long maturity bonds, have sustained meaningful losses. Fixed income yields have risen on an increasingly positive medium-term outlook for the global economy. This improvement in outlook, and reversal of bond markets, also meant the turn of fortunes between the winners and losers of the pandemic year of 2020 that began last October has continued.

These changing investment dynamics are reflected in the returns picture for investment portfolios of differing styles. The income portfolio range – with an investment universe dominated by value stocks – has now outperformed for two consecutive quarters. Admittedly, it will still take more quarters like this for it to catch up with more unconstrained strategies.

Meanwhile, with economic growth rising, individual companies are finding profit opportunities. This is feeding through to specific stocks, helping stock-picking fund managers to again outperform index tracking funds, enough in this case to catch up and get ahead of the tracker portfolios.

However, with the lowest risk portfolio strategies, the positivity of stock markets was not enough to compensate for fixed interest headwinds. Poor Q1 bond returns meant these portfolios missed out on another positive quarter, although on a 12-month perspective, all portfolios showed high double-digit returns – albeit from the market lows of last year

So, with the winter quarter behind us, spring is in the air, (as it should be) in the global economy and also broadly in capital markets, although we should guard against complacency. After all, benign investment returns have deflected from the fact that it has been yet another remarkable quarter, especially in the US. We cannot forget that it was early in this quarter, on 6th January, when the US Capitol was stormed and five people died.

Donald Trump is no longer the dominant force within US politics, and successor Joe Biden's reputation as a highly effective and seasoned political operator – in the traditional sense – has brought a welcome return to some sort of normalcy. We have grown accustomed to 'the first 100 days' as being the most active period in every US presidency and so far, Joe Biden and his administration seem determined to make every day count.

By 11 March, the $1.9 trillion American Rescue Act was passed. Its major component of direct payments to most adults of $1,400, along with $3,000 per child for lower income households, is almost complete. On the last day of the quarter, Biden's administration proposed $2.25 trillion of government-directed infrastructure spending spread over eight years, signposted as the first half of a ten-year $4 trillion investment programme.

Much akin to start-up investments in new corporate ventures, the ultimate aim is to create a bigger economy, one with the capacity to generate a higher return on the investment than the cost of finance. To lower societal divisions, companies are getting some benefit but (new) workers are intended to receive a big increase in their share of 'profits'. Relative to the size of the economy at the outset, government debt will rise over five years, but is expected to fall thereafter, as the economy should by then grow faster than the debt.

Funding the spending plan is the "Made In America Tax Plan", with far-reaching tax proposals. Raising the headline rate of corporate tax from 21% to 28% is only part of the story. Importantly, for the long-term health of not just the economy but the planet, it removes fossil-fuel subsidies, while – recognising the globalised economy – the plan also proposes a "minimum tax" targeting overseas profits.

For the largest companies in the US equity market, the proposals are hugely important. Tech companies have been especially adept at shifting the domicile where revenues are recognised, and Biden's proposal addresses this by taxing their overseas profits. This impinges on tax haven nations, so the US has flipped into being the greatest supporter of the Organisation for Co-operation and Economic Development (OECD), in its push against regional corporate tax competition.

Markets went higher, even among those stocks most likely to get taxed more. That may have been because the tax plans can (and will) be changed by the Senate and the House before becoming law. Even so, as happened in the run-up to Trump's 2017 Tax Cuts and Jobs Act, investors can underestimate the likelihood of passage, and its potential impacts.

Compared to our outlook at the end of last year, the global economy and capital markets have developed much as we had anticipated. The main unexpected element has been the delay to loosening restrictions, due to slower-than-expected progress of the vaccination campaign (most notably across Continental Europe) and the growing risk from virus mutations, even if this risk is not yet proven. We remain hopeful that the warmer weather is likely to reduce the spread of infections, and that the vaccination roll-out should significantly re-enforce this effect.

As the second quarter begins, we expect to see further economic improvements. Undoubtedly, we will continue to experience the side-effects that monetary and fiscal stimulus medicine carries with them, and which played out during the first quarter, At times this will be disconcerting again, but as long as the economy by and large remains on its expansion path, these should remain peripheral events.

Emerging Markets – post pandemic

Markets are excited, and expectant, for the global economic recovery later this year. As noted here many times, this brings changes in the prevailing investment parameters – the much-discussed cyclical rotation. Typically, emerging markets (EMs) do well in this environment: strong growth fuels demand for their products and the commodities they export, while financial conditions remain loose enough for companies to take advantage. For that reason, EMs are the classic global growth play.

Now, however, this story is a little more complicated. First, despite markets anticipating a strong recovery at the global level, growth expectations are concentrated on the US. While this in itself is a positive for EMs (as demand filters out) it has also led to a rise in the value of the US dollar in recent weeks – a negative for EM companies, as it raises the cost of their dollar-denominated debts.

Second, and perhaps more importantly, there are a number of different stories unfolding in various EM countries that dampen their particular growth picture. China has disappointed lately, led by a deliberate tightening of policy. The health crisis in Brazil, meanwhile, is well-documented, and is placing severe pressure on its far-right government. Meanwhile, far-right Turkey continues to frustrate investors with its erratic policy decisions, after President Erdogan fired his third central bank governor in succession, prompting even more selling of the Turkish lira.

Even so, none of this is to suggest that the overall EM outlook is bad. A strong global economy combined with fiscal largesse in the US is inevitably a good thing for EMs. Rather, the point is that the 'EM' label is not so useful at the moment. "Look at EMs individually, not as a whole" is everyday advice in the investment sphere, but it is arguably become much more relevant in recent years. The average correlation between EM equities fell substantially through the latter part of last year, and remains at a low level.

China is the perfect case in point. The world's most populous nation is a huge part of any EM investment allocation – with its assets making up more than half of the MSCI EM index. And yet, it is increasingly hard to argue why the world's second-largest economy (the largest, when adjusted for purchasing power), with an equity market nearly four times bigger than the UK's by market capitalisation, still deserves to be considered 'emerging'.

The People's Republic has seen rapid technological development over the last two decades, with Chinese companies climbing the value chain, and with a sizeable middle class. The average Chinese citizen is still not rich by developed world standards, but its economy does not behave anything like the stereotypical EM. Growth is increasingly driven by domestic demand and internal policy, with a much lower reliance on exports than in the past.

China's inward turn is unlike almost all economies outside of the US, and shows no sign of slowing down. While Donald Trump was president, US trade and foreign policy toward China became increasingly hostile, driving an increasingly isolationist response. The Biden administration has not let up this pressure, pushing China on contentious issues such as Hong Kong, Taiwan and many others. But it has been interesting to see the extent to which the breaking of ties has been pushed by the Chinese government itself. This has been accelerated by the pandemic, but President Xi clearly wants China to return to relying more on its own savings and institutions – as it did for most of its history.

In recent years, we have become accustomed to government-led stimulus creating huge Chinese growth and driving EMs – and the global economy – forward. This is not the case now. Authorities seem content to continue their deleveraging process and let China be a passenger in the global recovery. Leading the pack instead is the US, where a significant fiscal boost and rapid vaccination programme is pushing growth out to the world.

All of this is to say that China no longer behaves like an EM, and we should not even expect it to be strongly correlated with other EMs. Something similar can be said about neighbouring Taiwan and South Korea, which are extremely well developed and dominated by tech companies, and yet still count as 'emerging' in many asset allocations (the two make up the second and third largest share of MSCI EM stocks, for example). As such, it is hard to draw any high-level outlook on EMs, without first splitting out China – and perhaps its surrounding Asian nations also.

When taking China out of the mix, the case for EMs looks good. But even here there are many idiosyncracies. Turkey's political turmoil has made it virtually un-investable, while Brazil's struggles and Russia's diplomatic scandals continue to weigh them down respectively. Overall, inflation and growth are certainly returning across many EMs. This is a positive, but may create difficulties for central banks down the line. How they respond could be the key differentiator.

We are positive on EM-ex-China, but that does not mean we are negative about China or the wider EM market. It simply means the reasons to be positive on China are entirely different from the reasons to be positive about other EMs. After all, after decades of rapid growth and development, there is only so much 'emerging' left for China to do.

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6th April 2021

Global Equity Markets

Market	Thu 15:56	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6740	+1.0	+66	⬀	↗
FTSE 250	21759	+2.3	+481	⬀	↗
FTSE AS	3851	+1.2	+47	⬀	↗
FTSE Small	6814	+1.4	+97	↗	↗
CAC	6102	+2.5	+150	↗	↗
DAX	15104	+3.3	+482	↗	↗
Dow	33103	+1.5	+483	↗	↗
S&P 500	4006	+2.5	+97	→	↗
Nasdaq	13458	+3.7	+480	⬂	↗
Nikkei	29389	+2.3	+659	→	↗
MSCI World	2812	+1.3	+37	→	↗
CSI 300	5111	+3.7	+184	↘	↗
MSCI EM	1316	+2.2	+28	↘	↗

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	20.1	14.2	14.0
FTSE 250	1.8	18.1	23.1	15.3
FTSE AS	3.1	19.7	15.3	14.2
FTSE Small x Inv_Tsts	1.4	19.5	-	15.0
CAC	1.7	24.3	18.2	14.6
DAX	2.3	22.6	16.7	13.2
Dow	1.8	23.1	21.4	16.1
S&P 500	1.4	28.4	23.2	17.1
Nasdaq	0.7	34.9	33.7	22.2
Nikkei	1.3	27.4	21.8	17.5
MSCI World	1.7	25.9	21.2	16.2
CSI 300	1.7	18.6	13.9	12.4
MSCI EM	1.9	20.1	15.6	12.4

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Micro Focus Int'l	+15.4	Flutter Ents	-4.1
Centrica	+10.1	ITV	-2.8
Int'l Consol Air	+8.2	Barratt Devts	-2.3
easyJet	+7.7	DCC	-1.9
Melrose	+7.5	J Sainsbury	-1.6

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.383	+0.7	Oil	62.97	+1.6
GBP/EUR	0.850	+0.7	Gold	1729.0	+0.1
USD/EUR	1.18	-0.1	Silver	24.72	-1.4
JPY/USD	110.59	-1.3	Copper	397.8	-0.2
CNY/USD	6.57	-0.3	Aluminium	2212.0	-2.0
Bitcoin/$	59,071	+13.6	Soft Cmdties	410.9	-2.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.80	+0.07
UK 15-Yr	1.17	+0.08
US 10-Yr	1.68	+0.05
French 10-Yr	-0.08	+0.05
German 10-Yr	-0.33	+0.06
Japanese 10-Yr	0.11	+0.03

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.62	1.73
3-yr Fixed Rate	1.72	1.90
5-yr Fixed Rate	1.80	1.89
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

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

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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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