THE **CAMBRIDGE** WEEKLY

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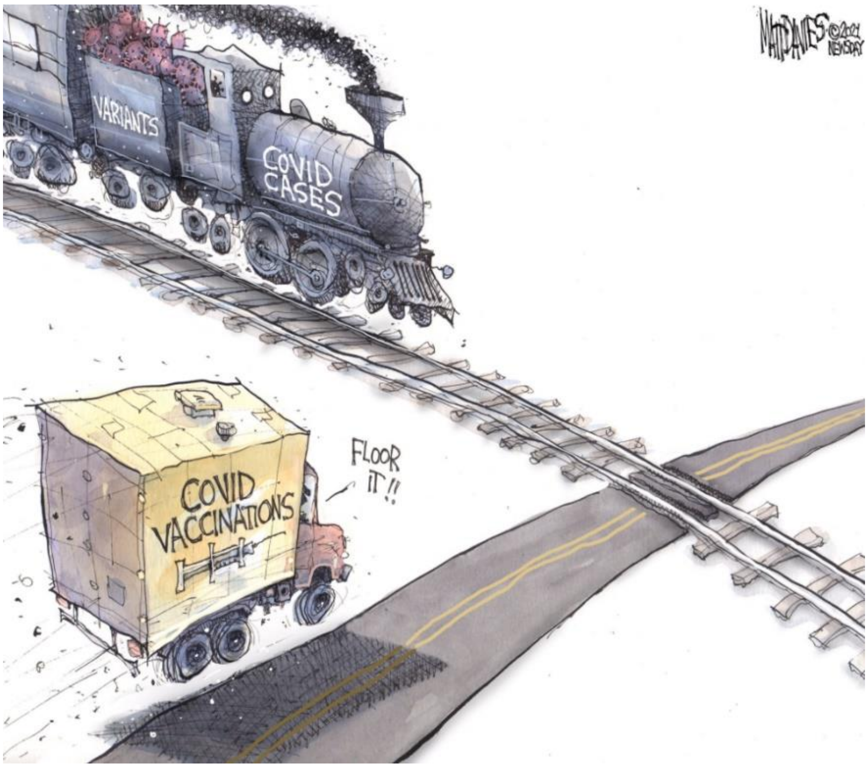


Visualisation of the outlook, Source: Matt Davies, 9 April 2021

New bond news gives green light for equity investors

We usually start by summarising equity market action over the course of the past week. Last week, it was developments in the bond markets that may be of more significance for investors, over the fact that equities continued to do well. Last Thursday, yields of long maturity bonds across global developed markets fell quite sharply, at the same time as economic data showed resoundingly strong activity. As readers will know from previous editions, bond yields tend to rise in response to an improving economic outlook – sometimes far enough to even undermine lofty equity valuations, due to added competition they bring to the returns equation for investors.

So, Thursday's somewhat counterintuitive market action was a very good signal for equity markets, which duly went to new highs in the US. The FTSE100 still lags, but broke through 7000 on Friday – continuing on its path to recovery.

Some might consider this as a sort of victory for the central banks. Perhaps they have at last succeeded in convincing investors that policy will remain reactive, but without tightening too soon after growth rebounds. Central banks have, after all, been telling us they only intend to withdraw support once the automatic recovery boom has run its course and a sustained growth paths is materialising – which may take us well into 2022.

Although the UK took a sizeable step towards normality last week, it is also clear that most people have been discouraged by snow-bound pub gardens to enjoy spending too long socialising outdoors. The weather does not help us believe greatly in staycation holidays either. However, market dynamics tell us that the economic climate in the UK is more amenable than the weather.

Last week gave us the first opportunity to examine the corporate results earnings season for the first quarter this year. While, on the face of it, signals from the US banks look extremely encouraging for the near-term economic outlook, there were some elements of disappointment in their respective statements for credit demand, which have not been as positive as some may have expected. We go into why, counterintuitively perhaps, this is good news both for banks and the economy in one of our in-depth articles.

In the US, the historically strong growth indicators still cannot yet tell us whether the current pace can be sustained or even will accelerate further. What we can tell is that equity analysts have recently upped 2021 full year corporate earnings estimates sharply, but have been more cautious for 2022. Those are barely changed since the start of the current quarter.

What analysts around the world have been doing is increasing their longer-term (generally three-four years' hence) estimates. Indeed, research provider Factset's aggregates of longer-term growth projections are uniformly at the strongest levels since the start of the data in 2001. Where longer-term forecasts are concerned, analysts tend to follow markets rather than lead. In other words, one can see the high corporate growth levels as needed to justify current market levels. There is another way to read it: analysts tend to underestimate earnings rebounds, especially during strong economic growth periods, and these longer-term projections are perhaps signalling only that analysts expect to upgrade nearer-term earnings.

For us though, we continue to be marginally more focused on geopolitical rumblings. US president Biden's ramping up of sanctions on Russia last week, which were expected by political insiders, were imposed after the hacking of the US cyber security and software company SolarWinds last year. The sanctions themselves are more damaging for Russia than the Skripal poisoning sanctions imposed by Trump in 2019, but are small in comparison to the benefit that Biden's fiscal boost brings for oil prices, and hence Russian oil revenues.

Nevertheless, it signals that Biden understands his international adversaries are trying to test his mettle, and whether he is as much of a foreign policy dove as he apparently was while part of the Obama administration. Last week's demonstration of a clear willingness to impose consequences on harmful actions might give those adversaries their answer. With China literally and figuratively pushing its boundaries, and Russia following suit with its military build-up at Ukraine's borders, Biden's sanctions are perhaps a warning shot in that direction as well.

We are not expecting a repeat of events like the Crimea annexation, but beyond the testing of Biden's foreign policy stance, some see Russia's actions as pointing to a weakening in Putin's popularity, with elections of sorts not too far away. The Putin of 15 years ago may have calculated that Russia's best interests involved a quiet tactical retreat. Older leaders tend to prioritise more personal incentives towards their legacies, which can lead to more erratic outcomes. This might particularly be the case here, if last year's speculation about Putin's health has some basis.

We still do not think this will end badly, or that markets will react negatively if tensions between the US and Russia worsen. It is in neither side's interests to push their actions to the point of no return. Putin will probably continue with all multilateral engagements – such as the online Earth Day Summit that Biden is convening this week (which, it seems, Xi Jinping of China will also be taking part in). His contribution will be closely watched. The Russians have said they will delay a bilateral summit with Biden and have threatened to pull out, but political analyst Christopher Granville of our research partners TS Lombard thinks Putin will probably engage.

The lesson of 2020 is that one should guard against complacency. Last year, the virus was in the news several weeks before markets identified it as a formidable risk. So, as always, we can build a wall of worry. Valuations are still high, and require uninterrupted good growth for a reasonably long time. Geopolitics may cloud things over sooner or later. Still, particularly if the weather warms up, vaccinations continue to reduce the public health impact of the virus, and the economy continues to re-accelerate, there are several good reasons to be cheerful.

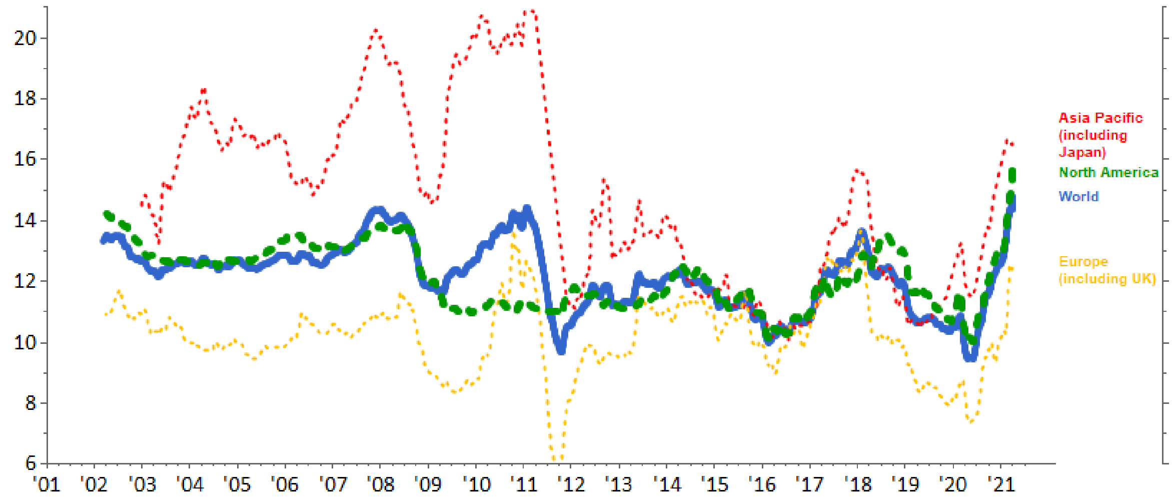
Are we due a 'gangbusters' earnings season?

As parts of the world economy slowly opens up, capital markets are pushing ever higher. That investor optimism has been a mainstay since the dramatic sell-off a year ago, driven by huge amounts of monetary and fiscal support, and the hope that global growth will come through in full force after the pandemic. But after the year we have had – the deepest global recession on record - this optimism has left assets at eye-watering valuations. Coming into this year, markets were not just hoping for a strong recovery in 2021; they were expecting it. Economically speaking, the first few months of the year have been much the same as 2020 – with businesses and consumers on hold until lockdowns can be eased. But eventually, markets will need more than just wishful thinking. And, as we move through the year, the need for solid performance to back up investor optimism will become more pressing.

That is why corporate earnings results are now (and always) so important. In the US, quarterly reports are beginning to filter through, showing how companies fared over the first three months of the year and – crucially – what they expect in the near future. Reports for the UK and Europe will soon follow suit. To put it mildly, analyst expectations for this US earnings season are very positive. Earnings per share (EPS) for the S&P500 are expected to post 23.8% year-on-year growth for Q1. This would be nearly 5x the average growth pace of the past ten years, and cannot be dismissed as driven by a base effect, given in the US, the respective first quarter of last year was still largely unaffected by the pandemic.

While this means that the level of earnings growth currently forecast by analysts is quite phenomenal, we are inclined to agree with the market verdict: Investors should expect overwhelmingly strong numbers. As the chart on the next page illustrates, the positive prospect is not limited to the US but can be observed for much of the developed world. Moreover, this tells us that we are in a highly unusual situation. Optimism about growth has increased at the same time as earnings have already rebounded. Usually, optimism is highest at the start – not in the middle or at the end - of the actual earnings recovery.

Global equity EPS long-term growth expectations



Source: Facstet, Tatton IM

In terms of actual results, the information we get from earnings reports is somewhat limited. At the best of times, results are backwards looking, and so, barring any huge surprises, should be more or less factored into equity prices. Now, there is the added complication of an economic shutdown for most of the year so far (still ongoing in Europe), making these backwards-looking indicators even less indicative of what is to come.

Where reports are hugely important, though, is in the accompanying statements and forward guidance. These tell us what companies expect from the next few months and beyond, and given the strong growth rebound expected in the next few quarters, forward guidance is key.

So far, we have seen a raft of results and statements from the big American banks, including JPMorgan, Wells Fargo, Bank of America and Citigroup. Profit results and outlooks have been strong, but multiple banks reported a drop in loan demand in Q1. Total loans fell 15% for Wells Fargo in the year to March, and 4% for JPMorgan.

Falling credit demand is usually a bad sign for banks and, indeed, the news caused a slight drop in share prices when it came out. But bank executives are taking it as a good sign. It shows that consumers and businesses are in top shape financially, with borrowers on the whole paying down debts during the pandemic rather than taking on more. This is a far cry from what was feared a year ago, when markets were frightened of widespread defaults.

Extraordinary support from governments and central banks has played a huge role in this. Through stimulus checks, income support and generous business loans, many have been able to save a great deal over the last year. Meanwhile, historically easy monetary policy has kept interest rates low and debt markets awash with liquidity. This has led many businesses to delve into public markets for cash, rather than going through traditional bank loans.

JPMorgan now reports that its loans are at 44% of its deposits, down from 57% the same time last year. That leaves businesses and consumers with a substantial amount of leeway financially – just as the economy is starting up again. The end result is that, coming out of the pandemic, banks will be eager to lend and everyone will be eager to spend, a very positive sign for the economy – underlining the positive outlook from bank executives. The fact that JPMorgan is issuing record amounts of new bonds to bolster its capacity to lend provides good evidence for this.

On a more general note, if the rest of the earnings season is as positive as currently expected (and it usually is better than expectations), it could do a lot of good for markets. As mentioned, rising equity prices amid a frozen economy has sent valuations (in terms of earnings per share) sky high. If earnings rise in line, those ratios will be brought down towards much more normal levels. Even though none of this should come as a surprise to investors, it should at least take some of the pressure off and alleviate the valuation vertigo we have seen in some pockets of the market.

Further down the line, so much depends on what the US Federal Reserve (Fed) will do as growth and inflation come back in force. The Fed has been as clear as it can be that monetary policy will remain accommodative for the foreseeable future, but markets are currently expecting that supercharged inflation will cause policymakers to tighten sooner than planned. Rising growth and price rises are all but a certainty, as the Fed is well aware, but the key question is whether it will stick with the narrative that price rises will prove transitory (rather than lead to structural inflation pressures through excessive wage rises) and hold their nerve.

From our perspective, we expect policymakers to stay firm, at least for now. The Fed's recent policy framework change has moved it to a structurally looser regime, and every signal so far has been that it means what it says. For equities, this is a huge positive, and we should expect even more strong results to follow.

Markets shrug off German political drama

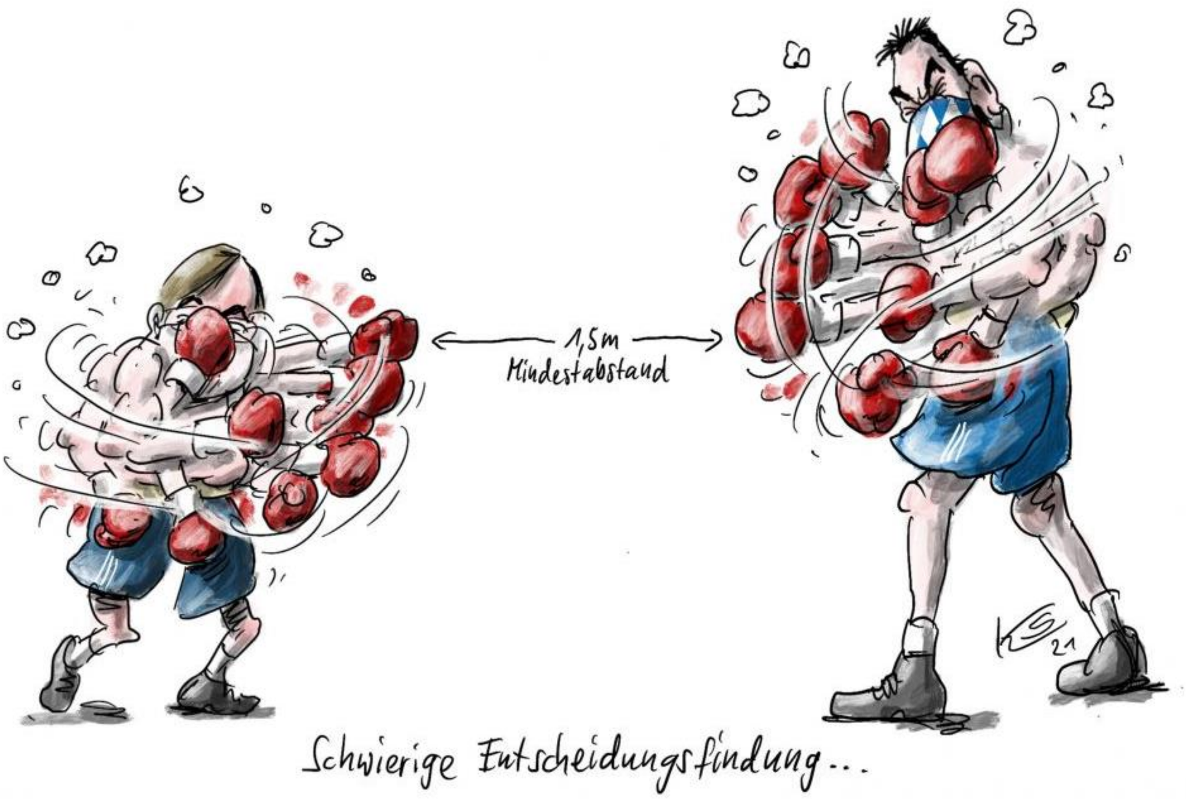
For well over a decade, Germany's political system has looked the picture of stability. Chancellor Angela Merkel has reigned for so long she is often considered the de facto leader of Europe as well as its largest nation – her tenure marked and prolonged by a history of compromise and coalition with Germany's other leading parties. In recent years, this has stood in stark contrast to Britain, where four general elections in five years and constant Brexit drama was followed by a particularly hard pandemic experience, littered with scandals.

Now, though, those tables seem to have turned. A rapid vaccine rollout and subsequent easing of restrictions has significantly cooled the pressure on Boris Johnson's government. Meanwhile, Germany's vaccination programme – just like the wider EU's – has been notoriously slow, causing a recent spike in infections and another tightening of restrictions. Many German politicians have joined in the vaccine blame game, threatening a rift in supply chains. And, in the midst of all this, the country's leading parties have fractured over their political future – with only five months to go until general elections that will determine Merkel's successor.

After 16 years in charge, Merkel is set to resign as Chancellor in September, creating a rift over who should succeed her. Merkel's Christian Democratic Union (CDU) has backed its leader and North Rhine-Westphalia's prime minister Armin Laschet to take charge, but its Bavarian sister party the Christian Social Union (CSU) wants Bavarian prime minister Markus Söder to lead them into the election. Laschet has unanimous support of the CDU's governing executive, but Söder is not backing down. His support extends well beyond his Bavarian base, namely in the broader CDU membership, as well as the broader German population. To illustrate even more the particularity the centre right finds itself in: in Germany's post war history, a CSU/Bavarian chancellor candidate has never succeeded, but now finds widespread approval in opinion surveys – likely in response to his robust COVID management, including border closures.

Leaders are aware that now could be a dangerous time for infighting. The pandemic is taking its toll on Germany. Intensive care units are rapidly filling up and the disappointing vaccine rollout has put pressure on the longstanding grand coalition government of CDU/CSU and Social Democratic Party (SPD). "We can no longer spend all our time dealing with our internal party issues," Laschet recently told reporters.

But the issue is more than just an opportunistic power struggle. Laschet has the backing of CDU leadership, but others in the party are concerned he will hurt their chances in September, given he is more of a centrist moderate than Söder, who also appeals to some of the populist right. Following their own 'COVID sleaze' scandal, the CDU/CSU coalition has sunk in national opinion polls recently, and Söder is much more popular than Laschet with voters.



"Difficult decision making", Source Klaus Stuttmann, 11 April 2021

Underlying the drama is an anxiety that the political landscape has shifted away from the CDU – partly due to the pandemic, but stretching back much further – leaving the party looking stagnant. Merkel's status-quo centrism has long been appealing to German voters, but the shake-up of recent times has prompted many to look at other options. The Green Party, 30 years ago on the fringes of German politics, has become the new home for urban liberals and the now well-educated children from working class families. This has left the SPD ailing and promoted the Greens to be Germany's second-largest party – and looking increasingly likely to be playing a role in forming its next government.

Meanwhile, the populist far-right party Alternative for Germany (AfD) remains a sizable force in German politics, while support for the old centre and business-friendly Free Democratic Party (FDP) has dried up considerably. Far-left party Die Linke – descended from the former communist party that governed East Germany – is currently polling just under 10% of the national vote, and could well form a part of a left-wing coalition if things go their way.

These moves are not quite as radical as they may seem. German governments are invariably coalitions, usually leaning heavily toward centrist compromise, and the Greens have proved themselves surprisingly moderate and pragmatic when in achieved power. Going back before the reign of Merkel, the Greens were the junior partner in the German government from 1998 to 2005, when SPD chancellor Gerhard Schroeder painfully modernised Germany's inflexible labour market through structural reform with his 'Agenda 2000' programme. But come September, Merkel will be gone, and in her place will be a German leadership lacking Merkel's ability and experience to unite the nation and exert leadership in the EU.

So far, capital markets have shown complete indifference to German political drama, which is not so surprising. Europe has plenty of other issues on its plate and political developments in the continent's largest economy usually have minimal impact on asset values. That is partly because, in the post-war period, consensus-driven Germany avoided stark shifts in one direction or the other. It is still early days in the election campaign, but a left coalition made from the Greens, Die Linke and SPD may well shift priorities towards citizens and away from corporates. At the same time, initiatives around climate change may gather momentum, which could open up new business opportunities. Such a programme may just reflect wider global tendencies – the current US government certainly presents a shift to the left. As for Europe, it is worth noting that a left coalition would be at least as pro-European as the current grand coalition or a CDU/CSU-Green coalition.

From a pragmatic point of view, a more pressing concern for markets is the situation Germany finds itself in with the European Recovery Fund – a landmark agreement designed under Germany's EU Council leadership that allows Brussels to bridge the funding gap between now and the post-pandemic world. Germany's Constitutional Court had to suspend the approval process in response to a citizen association's legal complaint. Given the deal already passed through the German legislature, political shifts might not matter too much. But for now Germany, the EU and markets are in suspension, awaiting the German Constitutional Court's judgement. As always, a key consideration will be to what extent the German parliament can influence the design of the European Recovery Fund.

The wider context of all this is a German economy that continues to struggle. The country's leading research institutes recently cut their 2021 growth forecasts from 4.7% down to 3.7%, prompted by the delayed recovery because of continued lockdowns due to a third wave of the pandemic. A comparison to the UK is again illuminating here. Early in the pandemic, Germany looked much more stable – and its economy much more resilient – than sluggish Britain, but recent economic forecasts have been overwhelmingly positive on the UK, while Germany's internal outlook has deteriorated.

All of this is certainly cause for concern – or at least recognition – from markets. But we should temper the German negativity somewhat. Ultimately, the vaccine struggles should only be temporary, and will fade away once supply ramps up. Meanwhile, even with a compressed growth outlook, business sentiment in Germany is holding up extremely well according to the latest surveys – thanks to a strong global recovery. The same is true for the UK, given its 'vaccine dividend', but with one crucial difference. Due to the recent strength of sterling, financial conditions in Britain are relatively tight, while they remain incredibly loose in Germany. This at least is good news for Europe, whose currency depreciation could well make it a beneficiary of its own failure. Much to watch, then, but not all of it bad.

CAMBRIDGE
INVESTMENTS LIMITED

19th April 2021

Global Equity Markets

Market	Fri 15:18	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7014	+1.4	+99	↗	↗
FTSE 250	22496	+1.1	+245	↗	↗
FTSE AS	4004	+1.4	+54	↗	↗
FTSE Small	7104	+1.4	+96	↗	↗
CAC	6290	+2.0	+121	↗	↗
DAX	15445	+1.4	+211	↗	↗
Dow	34159	+1.1	+359	↗	↗
S&P 500	4180	+1.2	+51	↗	↗
Nasdaq	14025	+0.9	+125	↗	↗
Nikkei	29683	-0.3	-85	⬀	↗
MSCI World	2942	+1.1	+32	↗	↗
CSI 300	4966	-1.4	-69	→	↗
MSCI EM	1341	+0.2	+2	→	↗

Top 5 Gainers

Company	%
Just Eat Takeaway.com	+8.8
Antofagasta	+7.9
Weir/The	+6.9
Polymetal Internationa	+6.8
Rio Tinto	+6.3

Top 5 Decliners

Company	%
Legal & General	-6.2
Rolls-Royce	-6.0
StanLife-Aberdeen	-4.3
Tesco	-2.7
SSE	-2.5

Currencies

Pair	last	%1W
USD/GBP	1.382	+0.8
GBP/EUR	0.868	+0.1
USD/EUR	1.20	+0.7
JPY/USD	108.78	+0.8
CNY/USD	6.52	+0.5
Bitcoin/$	61,541	+5.5

Commodities

Cmdty	last	%1W
Oil	66.61	+5.8
Gold	1780.5	+2.1
Silver	26.07	+3.2
Copper	419.4	+3.8
Aluminium	2339.0	+2.5
Soft Cmdties	438.6	+4.5

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	21.0	14.6	14.0
FTSE 250	1.8	19.1	23.3	15.4
FTSE AS	3.1	20.6	15.5	14.2
FTSE Small x Inv_Tsts	1.4	19.8	-	15.0
CAC	1.7	25.2	18.5	14.6
DAX	2.3	23.0	16.8	13.3
Dow	1.7	21.5	21.0	16.1
S&P 500	1.4	28.6	23.8	17.2
Nasdaq	0.7	36.7	35.1	22.2
Nikkei	1.3	27.6	21.5	17.5
MSCI World	1.7	26.5	21.5	16.2
CSI 300	1.7	17.9	13.5	12.4
MSCI EM	1.9	18.4	15.2	12.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.76	-0.02
UK 15-Yr	1.12	-0.02
US 10-Yr	1.57	-0.09
French 10-Yr	-0.02	+0.02
German 10-Yr	-0.27	+0.03
Japanese 10-Yr	0.09	-0.02

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

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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.

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