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Source: Hedgeye, 8 June 2019

Market vertigo galore

Last week we wrote how the ‘sell in May and go away’ maxim has historically not shown much merit for investors. At the end of last week, some of our readers may have looked back at those sentences ruefully. Markets have certainly lost a bit of that exuberance displayed in recent weeks. However, the risen inflation expectations that have been blamed for the sell-off, are now merely – at last – reflecting what the US Federal Reserve (Fed) had told markets to expect since the beginning of the year. Moreover, the global economy continues to motor towards a post pandemic recovery boom. Therefore, we view this sell-off as more to do with market participants experiencing a wave of vertigo, rather than a fundamental change of direction.

Another COVID variant scare may be bubbling up, but – without being experts – we can only hope it is likely to go the way of the Kent, Brazil and South Africa strains. The vaccination programme is almost certainly the cause of the impressive decline in bad outcomes from infections of all strands, and that means we are heading for some normality.

Even so, across the globe, the disruption of the past year is still readily apparent. The passage to normality is not smooth and some of the costs are, quite literally, becoming evident. Some of this has led to last week’s downdraft in risk asset markets. If the press is to be believed, almost all of the volatility was caused by the US consumer price inflation (CPI) print of 4.2% year-on-year. Somehow, the narrative has become about the Fed losing control, despite us all knowing that the events of the past 12 months would likely result in inflation of around 4% at mid-year. Taking that into account, core CPI has actually just about got back to trend.

Some components – used cars for example, which we take a short look at below, or food, which we covered last week – may have had a sharp rally (both at +20%) and outsized impact on US prices this quarter, but in this context, it would be unwise to confuse volatility with trend. As we laid out last week, for higher prices to stick, wages have to rise to compensate consumers for the higher prices the disruption has created – through some near-term changes in the wider structure of relative prices to one another. At the moment, and until there is proper visibility on the longer-term state of the job markets in the western world, most people will be content to make sure they are working, rather than immediately pressing for wage rises. Worries about inflation will become sticky if workers are in short supply for a longish period. We are just too early in the healing process for central bankers or markets to know.

Meanwhile, retail sales showed weakness rather than strength, an outcome which strongly suggests the response to price rises from consumers is to pull back a bit. It certainly isn't one that says the spending validates price rises. There is little sign here of sustained further rises in inflation expectations, and the lack of movement in the prices for inflation-linked bonds tell us that markets see it likewise – but that would clearly not have fitted journalists' search for a narrative behind last week's equity market wobble.

Yields of conventional bonds moved up somewhat in the US. But then, yields moved up as much in Europe, where the inflation figures were absolutely in line with expectations at an average of slightly below 2%.

Despite the press focusing on the inflation story, markets were probably just suffering a bit of a vertigo from over-exuberance in the previous weeks. Another probable contributor could be that hedge funds are quite extended in overall risk positions, and that the availability of 'prime-broker' financing by investment banks has become slightly less liquid in the aftermath of Archegos and Greensill. Retail investor flows into equities continue to be positive in comparison to hedge fund sales. However, these have reduced from the heady days of the first quarter.

China continues to be a bit of a growth party-pooper. We have been saying for some time that the Chinese policy response has been comparatively tight. There was some sign that the new lunar year holidays presaged a bit of spending, but last week's data has poured more cold water on that hope. Total Social Financing growth (year-on-year) fell back to +11.7% and M2 money supply growth to +8.1%, which may sound high, but returns it to the lowish levels (by Chinese standards) seen before 2020. Chinese markets seem to be under pressure, and stand in contrast to the good performance of other emerging markets.

Used car market revs up as car buyers wait for 'green' light

A year ago, car rental company Hertz was on its knees, forced into bankruptcy amid longstanding problems and the sudden shock from the COVID-19-induced demand collapse, leaving it with few options and fewer funds. At the time, a ragtag bunch of retail investors bid up the stock in the suspicion markets had sunk it too far, and Hertz could come through its Chapter 11 bankruptcy filing and proceedings without too much pain. Oh, how everyone laughed. It was seen as another case of irrational exuberance from the newly-minted retail investing public – albeit before Reddit and GameStop made irrational exuberance 'cool'.

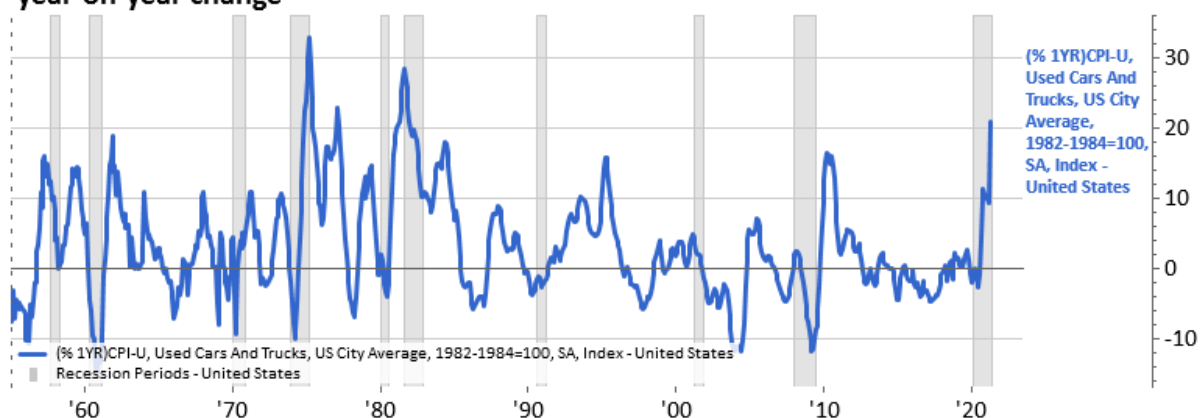
Now, Hertz has been bought out of bankruptcy by a consortium of capital managers – in a deal that gives the reorganised company an enterprise value of \$7.43 billion. In fact, it turned out to be quite a dramatic battle for control of the company, with multiple groups vying for ownership in a contest that seemed unimaginable just a few months ago. According to the new owners, shareholders will see a recovery of about \$8 a share. A decent bit of business, as it turns out.

We should not get carried away with the underdog narrative. The claimed \$8 price is contentious at best, and buyers of the stock last year would have been realistically better off investing in many other parts of 2020's rallying equity market. What's more, one of the reasons Hertz managed to survive reorganisation is because it used the money investors gave it wisely, positioning for an economic recovery that would come after the massive drop off in demand last Spring. It just so happens that the recovery was quicker than expected, to Hertz's benefit. In particular, what triggered the company's collapse – a fall in the value of its fleet of cars – was short-lived, and prices were already rebounding by this time last year.

That rebound has kept going ever since, to the point where used car prices have seen an astounding rally to an over 20% increase over the last 12 months. The chart below shows price inflation in the US used car market. Prices have shot up, prompted by a flurry of activity and huge demand for pre-owned vehicles. It is not only Americans that are eager to buy: a recent report shows online traffic from used car buyers in the UK shot up 36% last month, together with a 7.1% year-on-year jump in postings on Auto Trader.

US used car inflation

year-on-year change



Source: Factset, Tatton IM, BLS

In recent decades, vehicle demand has become a key indicator for overall economic activity, so it is quite astonishing to see such high levels while still barely out of the deepest global recession on record. But the trend in the used car market needs unpacking. The pick-up in second-hand purchases has been accompanied by a drop-off in demand for new vehicles – to the detriment of the old automotive manufacturers (a booming Tesla notwithstanding).

Consumers are choosing ‘nearly new’ for a number of reasons. Firstly, they are cheaper, and with so much uncertainty over the last year, a splurge on a new car seems off-putting for many. To add to this, well-publicised supply chain issues suffered by car manufacturers – stemming from a global shortage of microchips – have pushed the prices on new cars up further, while projected delivery dates have been disappearing into the horizon. The collapse of Hertz (and the struggles of other rental companies) meant far fewer ex-rentals became available in the used car markets, creating issues of short supply issues there as well.

These were short-term factors, but they compounded longer-term fears too. Both consumers and car companies are increasingly aware of the limited future for fossil-fuelled cars, and the push toward greener technology and tighter environmental regulation has only increased during the pandemic.

Car manufacturers, especially the old ‘incumbents’, are spending vast amounts on research and development amid the push towards net-zero carbon emissions. Electric and other non-carbon vehicles are increasingly available, but the downside is that the R&D cost is borne by the early-ish adopters. Electric vehicles (EVs) still cost a significant amount more than the petrol equivalent. Compare the basic Renault Zoe with the basic Clio. Even including a government charging grant, the Zoe costs £27,600 (including battery purchase) versus £16,200 for the Clio. Although fuel costs will be lower, you have to drive a long way to make up for it (and, of course, EVs don’t currently lend themselves to driving big distances in one go!).

Motorists are likely to be wary of handing over a hefty sum for an internal combustion engine car that will become obsolete in a few years. The technology behind EVs is improving at a rapid pace, with newer models able to travel further and charge quicker, but that rapid change might well be part of the problem. Renault used to lease the battery to its Zoe owners, but now it makes them buy it. At such a huge expense, car buyers want to know their purchase will last a long time, and not be overtaken by a new model, or fall victim to new regulations a few short years down the road.

At the regulatory level, more clarity about overall infrastructure, such as the distribution of charging points and standard requirements is required. Among electric models, there are many components for which standards are not close to being set – and it is still an open question even whether hydrogen-electric hybrid vehicles will win out over all electric – in other words, it’s still unclear which automobile technology will be ‘VHS’ and which will be ‘Betamax’ . Heavy goods vehicles are much more likely to favour hydrogen. Dual hydrogen and electric infrastructures will add to the costs, in which case it may be better for all vehicles to go for hydrogen, especially given fossil fuel stations and forecourts have a much higher resemblance with the infrastructure we may need for hydrogen vehicles than the electric charging infrastructure requirements.

This creates a huge headache for all the other parties involved in car purchases, such as financiers and insurers. Over the last decade, car financing has been a booming source of credit growth – with lenders keen to hand money out and package the debt up into asset-backed securities. But if lenders are uncertain about the shelf life of the assets, they will be much less willing to fork out the money. Last week, the Green Finance Institute assembled a coalition of independent experts and UK companies in the finance, automotive, energy and infrastructure sectors. It aims to improve the general access to the huge amount of credit financing necessary for the transition to zero emission vehicles.

However, such initiatives highlight that the transition is difficult. So, a used car – even one with many more miles on the clock – suits nicely as a temporary solution. For now, this is benefitting used car dealers and renters like Hertz. The short-term factors will clear up eventually as life returns to normal, but the longer-term problems will last until policymakers give more clarity.

Global Equity Markets				Technical		Top 5 Gainers		Top 5 Decliners			
Market	Fri 15:54	% 1 Week*	1 W	Short	Medium	Company	%	Company	%		
FTSE 100	7030	-1.4	-100	↗	↗	M&G	+10.0	Flutter Ents	-12.6		
FTSE 250	22303	-2.1	-472	↗	↗	Ashtead	+3.7	Just Eat Takeaway.com N	-12.5		
FTSE AS	4005	-1.5	-62	↗	↗	Lloyds Bank	+3.4	Renishaw	-12.4		
FTSE Small	7111	-1.3	-95	↗	↗	J Sainsbury	+3.2	Int'l Consol Air	-7.7		
CAC	6371	-0.2	-15	↗	↗	SSE	+3.2	Scot Mtge Inv Trust	-7.0		
DAX	15373	-0.2	-27	↗	↗	Currencies		Commodities			
Dow	34260	-1.5	-518	↗	↗	Pair	last	%1W	Comdty	last	%1W
S&P 500	4158	-1.8	-75	↗	↗	USD/GBP	1.408	+0.7	Oil	68.22	-0.1
Nasdaq	13352	-2.9	-400	↗	↗	GBP/EUR	0.862	+1.0	Gold	1837.2	+0.3
Nikkei	28084	-4.3	-1273	↘	↗	USD/EUR	1.21	-0.3	Silver	27.31	-0.5
MSCI World	2892	-2.9	-87	↗	↗	JPY/USD	109.44	-0.8	Copper	470.9	-1.2
CSI 300	5111	+2.3	+115	→	↗	CNY/USD	6.44	-0.1	Aluminium	2451.5	-1.5
MSCI EM	1293	-4.1	-56	→	↗	Bitcoin/\$	51,326	-11.0	Soft Cmdties	445.0	-1.4

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	19.4	14.1	14.1
FTSE 250	1.9	19.1	22.8	15.5
FTSE AS	3.1	19.3	15.0	14.2
FTSE Small x Inv_Tsts	1.5	19.4	-	15.1
CAC	1.9	25.1	18.2	14.7
DAX	2.4	18.1	15.7	13.3
Dow	1.7	21.9	20.6	16.2
S&P 500	1.4	26.8	22.6	17.3
Nasdaq	0.7	31.7	31.4	22.4
Nikkei	1.5	17.8	19.6	17.5
MSCI World	1.7	23.9	20.2	16.3
CSI 300	1.7	16.7	14.3	12.4
MSCI EM	2.0	17.1	13.9	12.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.87	+0.09
UK 15-Yr	1.24	+0.10
US 10-Yr	1.64	+0.06
French 10-Yr	0.27	+0.10
German 10-Yr	-0.12	+0.09
Japanese 10-Yr	0.09	+0.00

UK Mortgage Rates

Mortgage Rates	May	Apr
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.52	1.55
3-yr Fixed Rate	1.67	1.68
5-yr Fixed Rate	1.74	1.75
10-yr Fixed Rate	2.55	2.54
Standard Variable	3.61	3.61

* The % 1 week relates to the weekly index closing, rather than our Friday p.m. snapshot values

** LTM = last 12 months' (trailing) earnings;

***NTM = Next 12 months estimated (forward) earnings

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

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