# THE **CAMBRIDGE** WEEKLY

## 28 June 2021

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*Source: Christian Adams, 24 June 2021*

## Moderating expectations

The seemingly never-ending pandemic-induced restrictions and uncertainty is making the forward planning of summer activities quite precarious and frustrating at times. That capital markets have recently borne fewer surprises than the planning of our summer holidays is a rare event and should be cherished – assuming it is not simply the calm before the next storm. Following the previous week's short-lived stock market sell-off – a reaction to the apparent acknowledgement from the US Federal Reserve (Fed) that the US economy may not require 'emergency-room' level interest rate suppression support for years to come – last week's main discussion point centred on whether and how much the US rate setters were divided in their outlook. The less debated point was the undeniable turning point of US central bank monetary policy. It changed direction from 'easing/dovish for the foreseeable future' to 'eventually tightening/hawkish perhaps as early as next year' and this did not cause similar capital market stresses as in 2013, when the Fed last signalled a medium-term change in direction which triggered the 'taper tantrum' market upset.

For investors, the stabilisation after the recent turbulences will, in all likelihood, mean their portfolios will end another month in 2021 with a positive return contribution.

Fed Chair Jerome Powell's very dovish remarks during his testimony to Congress suggest that, regardless of what the Federal Open Market Committee may have discussed – and almost no matter what happens in the near term – the doves will hold sway for a long time yet. As we said last week, the market will now wait for late August for news on possible reductions in central bank bond purchases.

In the UK, the messaging from the Bank of England was also as dovish as could be, in light of recent inflation surprises. There was much talk – like in the US – that current price rises were simply inflation of a transitory nature and, after a long period of undershooting rates of inflation, nothing to worry too much about. However, given the media obsession with inflation of late, we felt compelled to provide an inflation 'explainer' article this week, exploring why economists and central bankers are less worried than the wider public about inflation spiralling out of hand.

Compared to a few months ago, central bankers are in a better position now to defend their continued unconcerned stance. While the global recovery is still showing all signs of remaining on track, there are now far fewer likely surprises that could stoke fears of overheating. This is not hurting markets on average, but the more cyclical sectors have ceded ground again to the secular growth winners at the top of the NASDAQ. The tech-heavy US index edged to new highs almost every day last week, ensuring US markets are again outperforming global counterparts.

For us, the debate revolves around whether the economic growth story can move from the COVID rebound, into an extended run of investment. This would require sustained public investment, but we need to see private sector credit demand start picking up first, given how long public projects tend to take to get underway. There are small signs among consumers of increased borrowing, but companies are still lagging after last year's forced borrowing. Business investment intentions (capex) remain high across the world, constrained perhaps by supply limits, rather than lack of confidence in the sustainability of the recovery.

Public spending would still be a massive positive economic force. The European Union (EU) now has nearly all individual nations' spending plans for the huge 'Next Gen' €750 billion deal, with Italy's plan (under which it receives €191 billion) signed off last week. Funding the deal began in earnest recently, with a successful raising of €20 billion with a ten-year bond. The EU will issue as much as €200 billion each year to 2026, with maturities as long as 30 years, which will introduce a serious alternative to national bonds for investors.

Speaking of public funding and new investment assets, the drive to deliver substantial $CO_2$ reductions to stem global warming is making the market for carbon pollution certificates increasingly significant, while also creating some headaches for global trade. We include a separate article on the subject this week.

Back to fiscal stimulus, in the US, an infrastructure bill finally achieved bipartisan support last Thursday, which should see it being passed by Congress. With a total of $973 billion over five years, and $1.2 trillion if it can be extended to eight years, the agreement will mean new investments in the electrical grid, transit, roads and bridges, and other forms of infrastructure.

It leaves other softer components of President Biden's initial ($2.3 trillion) proposals (such as training) to be put in a separate bill, which Biden wants to be twinned with this bipartisan proposal. Funding will come from repurposed existing federal funds, public-private partnerships, stronger enforcement at the Internal Revenue Service, oil sales from the strategic petroleum reserve, and radio spectrum auction sales. We suspect that the biggest source would probably be the enforcement side, which may hurt some companies and high earners, but should help neutralise inflationary pressures at the same time.

Looking ahead to the rest of the summer, our expectation is that little market-moving economic news will come through. This would mean markets broadly trading sideways, but interspersed with the odd bout of worry, as well as hope about what the post-pandemic world will look like and bestow on investors.

## Inflation isn't always inflationary

The inflation discussion has become a little – well – *inflated* lately. 'The Great Reflation' has long been a popular counter-theme to the pandemic malaise among the market commentariat, but it feels as though volumes have been written about global price levels in the last few months alone. The big question is whether, as we come out of the pandemic, inflation will normalise or propagate. Everyone has an opinion, ranging from forecasts of deflationary sluggish and stubborn growth to a new age of supercharged prices on the back of an overheating economy. Most central banks are still feeling dovish about the post-pandemic world – preferring to describe price rises as transitory inflation, although last week the Fed appeared less certain how transitory such price rises are. Nevertheless, most major central banks in the developed world are keeping monetary policy loose, rather than pre-emptively choke off inflation and with it potentially a lasting economic recovery. Meanwhile, the Bank of England's outgoing chief economic (and eternal hawk) Andy Haldane has been warning of the hyperinflationary danger looming down this path.

On the surface, the inflationary forecasts make sense. One of the first things taught on a macroeconomics undergraduate course is that low interest rates and an increasing money supply will lead to rising inflation. For over a year, central banks have pegged rates down to 0% or less and bought eye-watering amounts of government bonds to force yields on longer bonds down as well, all while governments have handed out trillions in fiscal bridging support and restart stimulus to their COVID-ravaged economies. Some might call this debt monetisation (technically speaking it is, if never reversed) or – more pejoratively – 'money printing'. As the wheelbarrows of worthless cash in 1930s Germany or 2000s Zimbabwe showed us, it is easy to understand why this is alarming.

Things are not that simple, of course. Returning to the big question – whether inflation will be transitory – we would argue the phrasing is a little misleading. As we embark on the global economic recovery, we know three things for sure: (1) we are in a transition phase for the world economy, (2) inflation is spiking as growth comes back online and supply bottlenecks are inevitable, and (3) inflation over the long-term is highly unlikely to be as high as the current figures we are seeing. The third part is not based on any bold forecast, but just the fact that a sharp recovery from an even sharper downturn will always see higher growth numbers, due to base effects.

So, if by "transitory inflation" we simply mean inflation will fall from its current levels, then inflation will of course be transitory. But that is not what people usually mean. The real question is what the global economy will look like after the current transition is over. Will things go back to roughly what they were before – with low but steady price growth – or will we move to a new phase of structurally higher inflation?

Unfortunately, a definite answer to that would require a crystal ball. But we can give a brief overview of the factors that may swing it either way. Broadly speaking, inflation comes either from a *cost push* – where producers raise their prices due to supply constraints – or a *demand pull* – where higher consumer demand gives sellers more pricing power. Cost pushes usually come from shocks that limit or disrupt supply and are considered short-term effects. Demand pulls usually come from higher wages and a growing economy and are considered longer-term trends.

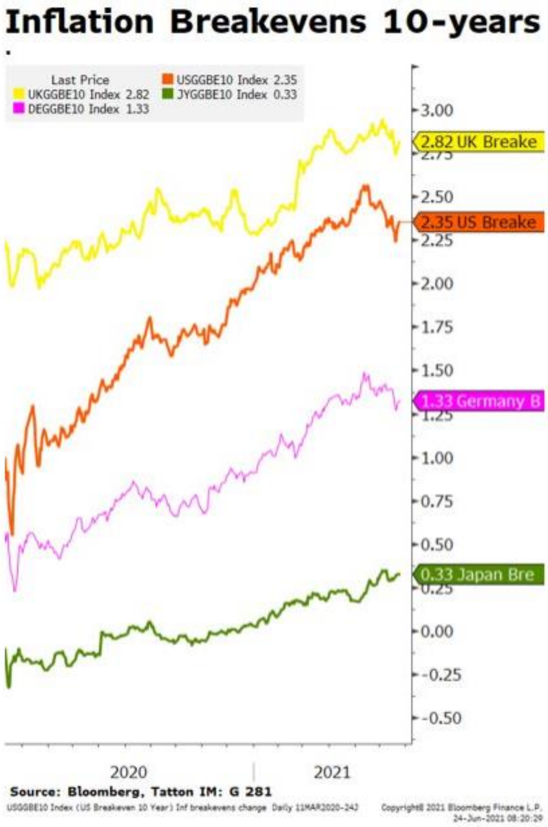
The current inflation picture has a mixture of both. We have seen several supply bottlenecks over the last year, from a tightening of oil production to a shortage of microchips. Some of these are COVID-related, some are not. At the same time, the global recovery is well underway, and demand for goods and services is picking up as restrictions loosen. What is more, fiscal stimulus throughout the pandemic has kept consumer balance sheets healthy, leading to an increase in available savings. People have more money to spend just as suppliers are seeing higher costs, so it is no surprise that prices are increasing.

The supply-side effects will be less pronounced over the coming months and years. That is not to say that chip shortages and Organization of the Petroleum Exporting Countries (OPEC) controls are about to disappear, but just that their shock factor will fade as we go through the year. The demand-side is more complicated. Savings rates still have some room to come down, but emergency fiscal measures are for emergencies only, and so the massive support measures will wind down as the recovery gains momentum. Markets are already worried about the 'fiscal cliff' we could see in the US and elsewhere if support ends before the economy has enough steam.

There are longer-term fiscal investments on the horizon. Biden's multi-trillion infrastructure plan, Boris Johnson's 'levelling up' agenda and the EU recovery fund, to name a few. But already politicians have suggested these need to be balanced over the long-term with higher taxes, primarily on corporations. So, while public investments could indeed boost growth, governments are not moving toward structurally higher deficits, which suggests that fiscal policy alone is unlikely to push inflation pressures out of control.

However, demand-side inflation is almost always a consequence of a tight labour market, leading to higher wages which allow consumers to carry on paying higher prices without adjustments to their demand. But, even though fiscal policy has been very successful in staving off mass unemployment, we are still a long way from the 'maximum employment' level that central banks aim for, and that would constitute tight labour markets. The recovery is underway, but the road ahead is long. For inflation to stay at a high level, consumers need to be confident about their future prospects – but that confidence takes a long time to build. Coming out of the sharpest global recession on record, it will not happen overnight.

Judging from recent market moves, investors seem to agree. Breakeven rates (an indicator of inflation expectations, see chart below) climbed earlier in the year as concerns spread of an overheating economy, but these have since flattened off. Similarly, while flows into cyclical stocks rose (those that stand to gain from higher prices) a few months ago, this trend has evened out lately, and the 'reflation' sectors have not been the biggest winners in recent weeks. In short, markets agree with central bankers: the recovery is going well, but it is too soon to worry about overheating.

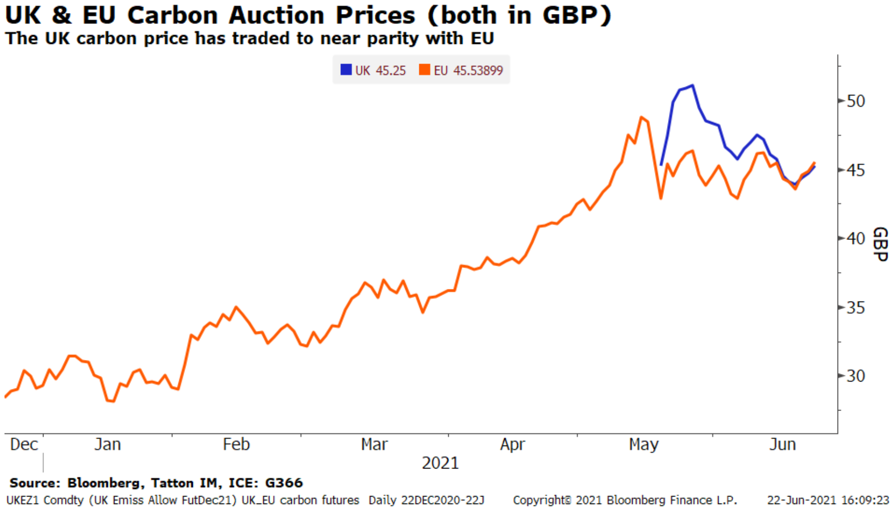



Interestingly, recent price rises could themselves act as dampeners on inflation. That may sound confusing, given inflation is nothing more than rising price levels. But when you consider where that inflation came from – supply-side constraints – it makes more sense. The fact that costs are going up means demand will fall. In other words, even though inflation is nothing more than rising prices, rising prices are not necessarily *inflationary*.

None of this is to write-off the prospect of more inflation. The post-pandemic economy could well run a little hotter than the pre-pandemic one – certainly if consumers spend more of their savings than currently expected. But it is still unlikely that inflation will stay at *dangerous* levels over the long-term. A continued increase in global prices is a risk, but it is far from a certainty that after years of undershooting, even a slightly more than transitory period of overshooting will herald the beginnings of an inflationary decade.

## Europe's green deal

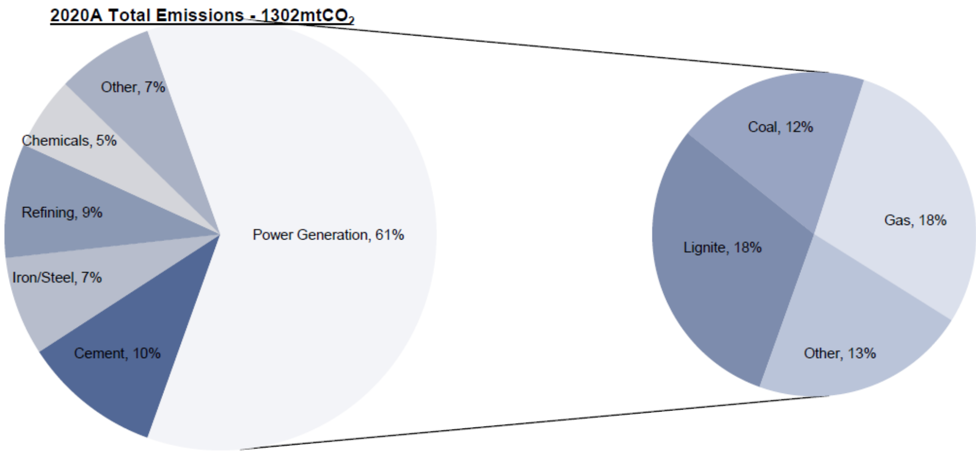
How much is a ton of $CO_2$ worth? Quite a lot these days, as it turns out. Amid the good mood in capital markets, there has been a notable rally in European and British carbon prices – with a ton of $CO_2$ (or equivalent emissions) now purchasable for around €55. That is a 60% increase from back in November, and an almighty jump from just a few years ago. For those unfamiliar with the intricacies of emissions trading, this begs the question: why on Earth would anyone pay for a ton of carbon?




The answer lies in the EU's Emissions Trading System (ETS), a financial market set up to allocate polluting rights to European companies (Switzerland's system was separate but is fungible with the EU system; Brexit has meant the UK ETS has become separate, but is almost exactly the same and will become fungible). It is, in fact, a central part of Europe's ambitious plans to tackle climate change, and the largest carbon trading market in the world. The basic idea is that polluters must own a certificate for every ton of $CO_2$ they emit. These allowances are auctioned off by the European Commission every day – with the total supply determined by the EU's environmental targets.

The buyers of the allowances come from different sectors. The main buyers are those that must have the credits to emit energy, and utilities companies and the industrial firms covered by the rules.

**Exhibit 1: Power sector contributes 61% of total emissions**
Breakdown of 2020 total emissions within the EU ETS

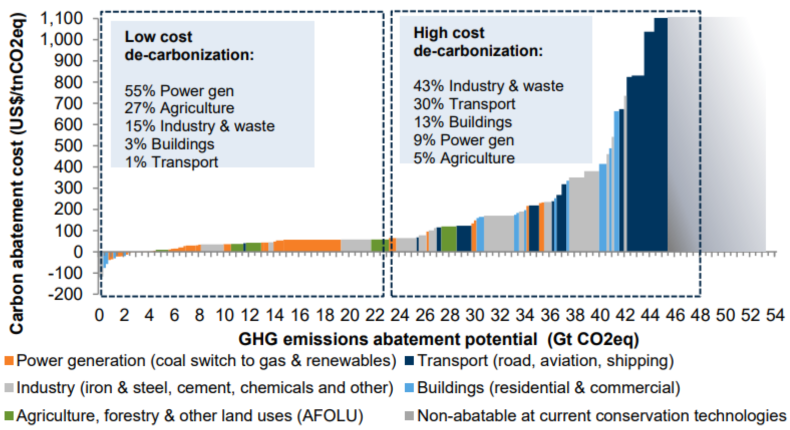



Source: Goldman Sachs Global Investment Research, European Environment Agency

For energy and industrial companies, the reason for buying carbon credits is straightforward – to carry on their usual polluting activities. In that sense, carbon credits are a lot like an emissions tax – designed to put the social and environmental cost of emissions onto the producers themselves and incentivise them to reduce them as much as economically viable.

There is another set of voluntary buyers: firms not covered by the rules, for example financial companies and investors. The inclusion of voluntary buyers, especially financial buyers, makes the ETS operate entirely different to a tax. Investment funds are not required to hold allowances. They may have environmental goals, but are probably still seeking to make a profit by trading with polluters, or speculating on future prices. That extra demand drives up prices and makes the ETS a commodity market like any other – where prices are determined by the balance of supply and (now increased) demand, factoring in future expectations.

**Exhibit 2: Low cost de-carbonization is dominated by power generation today, while transport and industry are challenging...**
2020 conservation carbon abatement cost curve for anthropogenic GHG emissions, based on current technologies and current costs




Source: Goldman Sachs Global Investment Research

From an environmental policy perspective, this is a vital feature. One of the issues with applying a flat tax on emissions is that it effectively sets the price of polluting for all industries at once – disregarding the relative difficulty that producers might have to find cleaner alternatives. With the ETS, companies that are technologically unable to go greener will have a much higher price tolerance for carbon credits, while those for whom greener production may be only marginally more expensive will be incentivised to switch. All the while, the Commission can dictate total emissions through the amount it auctions.

Investment in carbon credits is becoming increasingly mainstream, and for good reason. Given the total supply is set by the EU's political targets, many feel the price is simply a one-way bet. This makes a vast change from when the ETS was first introduced in 2005. Back then, a huge stock of allowances was merely handed out to energy and industrial companies, giving them little incentive to buy more and holding prices down. Industrial firms still receive free permits regularly, but the amount handed out has been drastically reined-in in recent years.

The Commission feels it needs to keep handing out free passes to companies to stop them from simply moving abroad, which leads to the biggest hole in the ETS. It disadvantages European firms against international rivals with less stringent standards, encouraging 'carbon leaking' – where production is simply moved across borders. But here, the Commission has a new plan: The Carbon Border Adjustment Mechanism (CBAM).

The plan, set to be unveiled next month, is to tax global competitors at the EU border for the carbon they produce. Officials in Brussels hope the tax will protect European industry at the same time as prompting producers around the world to go greener. Detractors call the CBAM an unfair tariff – one that could open the EU to legal action at the World Trade Organization (WTO). But supporters deem it the opposite – a way of levelling the playing field against unfair advantages worldwide.

CBAM is designed to correct for the carbon leakage that the ETS allows, but the biggest problem is how it will combine with one of ETS' central features: free permits. The EU plans to hand out around $374 billion-worth of free permits (at current prices) to European companies this year. WTO officials, meanwhile, are clear that any combination of CBAM and free permits would be a violation of its rules and would see the tax challenged as a tariff in court. According to former WTO chief Pascal Lamy: "The rule is very simple: no double compensation".

European industry leaders are adamant that free allowances must continue and will oppose any measures that see them lose their permits. That creates a headache for EU officials, who may well have to dilute the proposals to get them past lawsuits from other nations. A similar situation occurred last decade, when Brussels tried to include airlines in the ETS, only to have it shot down by retaliatory threats from the US, Brazil, Russia and China.

Even so, we should expect a renewed zeal from European lawmakers on this front. As part of the EU's Green Deal, the bloc has pledged to reduce its total emissions by 55% of 1990 levels by 2030 and reach full carbon neutrality by the middle of the decade. The plan is much more ambitious than anything we have seen from Brussels before and, with the added support of a more environmentally oriented US President, it is likely the EU will approach any new legislation more firmly.

From an investment perspective, the interesting part of this is how it feeds into the growing deglobalisation movement experienced over the last five years. The reasons for Donald Trump's trade wars and tariffs were wholly different to the CBAM, but from a trade perspective, the result is the same. After decades of globalisation and increased trade, we are now moving increasingly toward regionalisation – whether that be for nationalist, security (in light of COVID) or indeed environmental reasons.

It may well be that, once these measures are introduced, we could see them being used for more stereotypical protectionist goals – such as regional job protection. This would be a long-term inflationary pressure and could significantly change the structure of the global economy. Regionalisation might well be another political objective which some voters want. Those voters may not be natural bedfellows with the environmentalists, but the outcome may help them pay the price for decarbonisation.

Global Equity Markets

| Market | Fri 14:51 | % 1 Week* | 1 W | Technical Short | Technical Medium |
|---|---|---|---|---|---|
| FTSE 100 | 7130 | +1.6 | +113 | → | ➚ |
| FTSE 250 | 22608 | +1.3 | +284 | → | ➚ |
| FTSE AS | 4064 | +1.5 | +62 | → | ➚ |
| FTSE Small | 7332 | +1.3 | +96 | → | ➚ |
| CAC | 6610 | +0.6 | +41 | ⬀ | ➚ |
| DAX | 15568 | +0.8 | +120 | → | ➚ |
| Dow | 34373 | +3.3 | +1083 | → | ➚ |
| S&P 500 | 4275 | +2.6 | +109 | → | ➚ |
| Nasdaq | 14343 | +2.2 | +313 | ➚ | ➚ |
| Nikkei | 29066 | +0.4 | +102 | → | ➚ |
| MSCI World | 3013 | +2.0 | +59 | → | ➚ |
| CSI 300 | 5240 | +2.7 | +138 | → | ➚ |
| MSCI EM | 1367 | +0.5 | +6 | → | ➚ |

Top 5 Gainers

| Company | % |
|---|---|
| Anglo American | +10.5 |
| Ashtead | +8.2 |
| JD Sports Fashion | +8.0 |
| BHP | +6.9 |
| Royal Dutch Shell | +6.8 |

Top 5 Decliners

| Company | % |
|---|---|
| Int'l Consol Air | -5.2 |
| Phoenix Holdings | -4.8 |
| Vodafone | -4.0 |
| Informa | -3.6 |
| United Utilities | -3.3 |

Currencies

| Pair | last | %1W |
|---|---|---|
| USD/GBP | 1.392 | +0.8 |
| GBP/EUR | 0.860 | -0.1 |
| USD/EUR | 1.20 | +0.9 |
| JPY/USD | 110.57 | -0.3 |
| CNY/USD | 6.45 | +0.0 |
| Bitcoin/$ | 33,038 | -7.8 |

Commodities

| Cmdty | last | %1W |
|---|---|---|
| Oil | 75.80 | +3.1 |
| Gold | 1786.9 | +1.3 |
| Silver | 26.18 | +1.5 |
| Copper | 428.4 | +3.0 |
| Aluminium | 2440.0 | +1.7 |
| Soft Cmdties | 434.5 | +1.7 |

Global Equity Market - Valuations

| Market | Div YLD % | LTM PE | NTM PE | 10Y AVG |
|---|---|---|---|---|
| FTSE 100 | 3.3 | 19.1 | 13.9 | 14.1 |
| FTSE 250 | 2.0 | 18.0 | 24.5 | 15.6 |
| FTSE AS | 3.1 | 18.9 | 14.8 | 14.2 |
| FTSE Small x Inv_Tsts | 1.7 | 17.4 | - | 15.2 |
| CAC | 2.2 | 25.9 | 18.3 | 14.7 |
| DAX | 2.4 | 18.5 | 15.5 | 13.3 |
| Dow | 1.8 | 21.4 | 20.1 | 16.3 |
| S&P 500 | 1.4 | 27.1 | 22.6 | 17.3 |
| Nasdaq | 0.7 | 32.9 | 33.4 | 22.5 |
| Nikkei | 1.5 | 18.2 | 19.5 | 17.6 |
| MSCI World | 1.7 | 24.5 | 20.6 | 16.4 |
| CSI 300 | 1.6 | 18.1 | 16.2 | 12.4 |
| MSCI EM | 2.0 | 15.2 | 14.6 | 12.4 |

Fixed Income

| Govt bond | %Yield | 1 W CH |
|---|---|---|
| UK 10-Yr | 0.76 | +0.00 |
| UK 15-Yr | 1.10 | +0.02 |
| US 10-Yr | 1.50 | +0.06 |
| French 10-Yr | 0.18 | +0.02 |
| German 10-Yr | -0.17 | +0.03 |
| Japanese 10-Yr | 0.05 | -0.01 |

UK Mortgage Rates

| Mortgage Rates | Jun | May |
|---|---|---|
| Base Rate Tracker | 1.50 | 1.50 |
| 2-yr Fixed Rate | 1.46 | 1.49 |
| 3-yr Fixed Rate | 1.72 | 1.72 |
| 5-yr Fixed Rate | 1.69 | 1.71 |
| 10-yr Fixed Rate | 2.57 | 2.57 |
| 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.**

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