THE **CAMBRIDGE** WEEKLY

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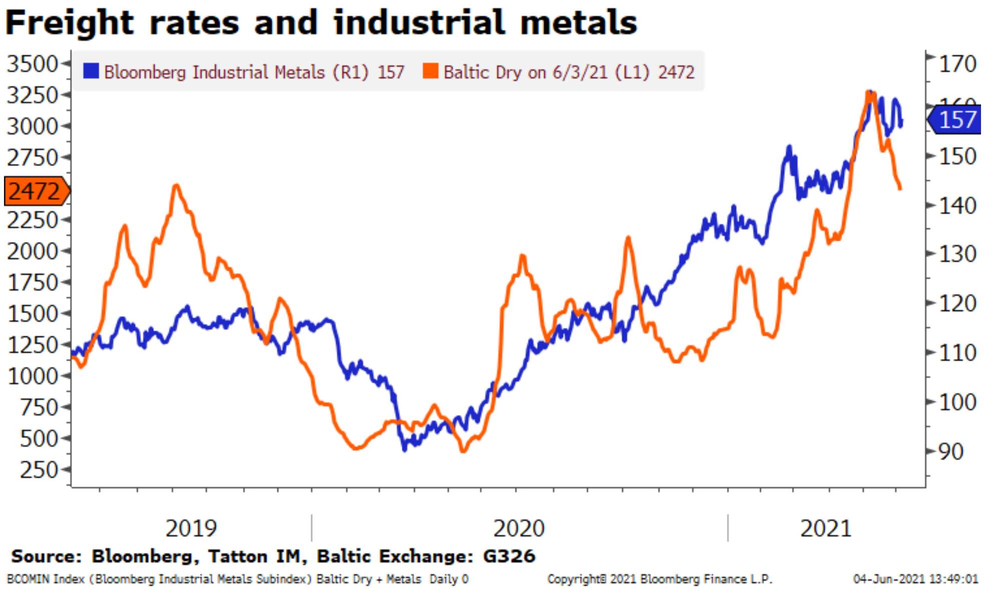
Going up sideways

May's returns numbers are in, and the headlines are as follows: a rotation from tech to financials – and from value to growth – as well as a bit more downward pressure on bonds. We have included our usual 'in review' table and monthly comments below. Overall, it was a quiet month.

After the sharp rise in economic growth expectations during the first four months of the year, economists in the US have grown used to a more measured pace of policy announcements, especially now that the Biden administration has passed its crucial 'first 100 days' yardstick. President Biden proposed a $6 trillion spend budget for 2022, which would have been unthinkable a few years ago. However, US politics has also reverted to its normal pattern when a Democrat is in the White House, with the Republicans just saying "no".

Regarding bonds, the US Federal Reserve (Fed) announced that, before autumn, it would start selling the $14 billion corporate bonds it bought last year, via an emergency lending facility. This is a tiny amount compared to the Fed's overall balance sheet, and had no impact on credit spreads, nor on other markets. As we have mentioned before, bond yields are much more stable now, and equity markets quite like these periods.

Corporate confidence remains elevated, as various Purchasing Manager Indices showed last week. Supplier delivery times are still long, and Chinese shipping prices have risen again during May. However, the Baltic Dry Index is showing signs of turning over from its recent highs, and metals prices have also slipped somewhat recently, which may indicate a little less global pressure on goods prices.



Last week, Morgan Stanley told us that analyst earnings expectations are stretched, and that some disappointment is around the corner. Improvements in the global economy are key to the earnings forecasts, and employment gains are the key to the global economy's progress. The US non-farm payroll (new jobs count) increased by 559,000, which was below expectations, but not disturbingly so. Equities rose a bit, while bonds were unchanged.

As investors, one of the challenges we face is to identify trends in the global economy, and then work out how to invest in the assets benefitting from those trends. One such trend could be a second phase of globalisation. The first phase was a big expansion of global trade into emerging nations. The second phase will be about those nations moving into a more developed framework.

Last week, the FT's David Pilling wrote about last year's statement from Ghana's president, that the world's second largest cocoa producer might consider stopping the export of cacao beans to Switzerland, one of the world's largest chocolate manufacturers. Essentially, Pilling makes the point that emerging economies will eventually 'emerge'. They will no longer need to rely on neo-colonial countries to gain some small part of the value chain. Rather, the people of that country will have the necessary skills and organisation to do it for themselves.

The exploitation of emerging market countries, rich in raw materials, has been going on for centuries. However, for modern food, oil, and mineral companies (such as Nestle, BP, Shell and Rio Tinto), the current global political climate looks especially challenging. Now the G7 appears on the brink of agreeing to a 15% "global minimum corporation tax", all global companies will probably have to face up to paying more tax. While this is mostly targeted at the tech platforms, it will have an impact on older companies as well. However, the emerging markets' rising confidence in their pricing power is a threat to their margins which may continue over a long period. Of course, that is in addition to the climate change pressures that are already coming to the fore.

To combat these pressures, companies will need to be prepared to change their cultures radically and swiftly. Some are making efforts, but have a long way to go. Still, these companies have become global giants through their ability to "get stuff done", especially when it comes to physical infrastructure. It is likely that the way we view these companies will change dramatically in the next few years, and change of that sort can be exciting and potentially profitable.

For the emerging nations, the improving governance structures which lead to pricing power is an all-round positive. The general deepening of their economies should benefit all domestic asset classes. Of course, no country's path can be smooth, but the focus on removal of corruption is an enormous gain. As in the 1990s, it may be that global growth will happen at the same time, but the reasons to be positive on emerging markets may lie elsewhere.

There is a worry about the inflationary impact this may bring to the established economies. Perhaps we shouldn't get too hung up about this, as such effects will take place over a long period. However, it would be fair to say that while the first phase of globalisation was disinflationary, the second phase will probably be mildly inflationary.

May 2021 in review

Asset Class	Index	May	May Volatility	YTD	12 months	2020	3-yr rolling annual-ised	5-yr rolling annual-ised
Equities	FTSE 100 (UK)	1.1	0.9	10.5	19.5	-10.2	0.9	6.5
	FTSE4Good 50 (UK Ethical Index)	0.5	0.9	7.8	13.3	-13.2	-1.6	3.0
	MSCI Europe ex-UK	1.5	1.0	8.4	25.5	8.8	9.4	9.0
	S&P 500 (USA)	-1.7	1.0	8.6	22.4	14.5	15.5	17.8
	NASDAQ (US Technology)	-4.0	1.4	2.9	26.9	40.9	23.9	23.9
	Nikkei 225 (Japan)	-1.1	1.1	-2.3	8.9	11.4	6.7	9.4
	MSCI All Countries World	-1.1	0.8	6.6	23.4	13.0	13.9	14.2
	MSCI Emerging Markets	-0.3	0.8	3.1	31.3	15.0	9.6	13.9
Bonds	FTSE Gilts All Stocks	0.4	0.4	-6.3	-7.4	7.9	2.6	3.0
	£-Sterling Corporate Bond Index	0.2	0.2	-3.4	3.7	8.4	4.9	5.0
	Barclays Global Aggregate Bond Index	-1.7	0.4	-6.1	-9.1	6.3	2.1	3.6
Commodi-ties	Goldman Sachs Commodity Index	-0.1	1.1	21.2	37.9	-26.0	-3.6	0.9
	Brent Crude Oil Price	0.3	1.7	27.6	57.9	-23.9	-4.0	6.6
	LBMA Spot Gold Price	4.2	0.6	-3.5	-4.4	20.8	13.2	9.3
Inflation	UK Consumer Price Index (annual rate)*	0.9	0.2	0.9	1.5	1.5	-	-
Cash rates	Libor 3 month GBP	0.0	0.0	0.0	0.1	0.5	0.6	0.5
Property	UK Commercial Property (IA Sector)*	0.2	0.0	0.3	-0.6	-3.5	-1.0	0.9

Data sourced from Morningstar Direct as at 31/05/21. * to end of previous month (30/04/21). All returns in GBP.

As discussed last week, the mid-May market correction created a somewhat mixed month. However, as the month ended, it was mostly only cryptocurrency holders that feel real pain. For globally diversified investors, May ended on a calmer footing. Global equities ended the month down 1.1% in sterling terms.

Regionally, Europe's markets led the way, rising 1.5%, as the continental vaccination programmes accelerated, businesses started reopening and economic activity picked up. Growing optimism was also evident with PMI surveys of business sentiment signalling growth prospects for the summer months.

In the UK, equities ended the month ahead 1.1%, now making it the best performing market, year to date, up 10.5%. In the US, inflation is now at 4.2% year-on-year, creating uneasiness around potential central bank intervention. Despite Fed reassurance, the S&P 500 main market declined 1.7% (-4% for the tech-heavy NASDAQ) on the back of increased inflationary pressure.

Overall, Emerging Markets ended the month with a small decline of 0.3%. China is focusing on tightening regulatory regimes – with specific reference to cryptocurrencies and commodities – which led to a small decline in equity values.

While 'sell in May and go away' is the traditional (pessimistic) wisdom, it appears optimism following the successful vaccination programme and pent-up consumer demand continues to support equities and summer expectations. In fact, there is rising optimism for stronger economic growth globally in the second half of 2021, especially for those countries making good progress on vaccination rates, and we expect that positivity to broaden out.

It would seem investors have moved on from the question of whether there will be growth. Now they are wondering just how strong it could be. This has led to uncertainty on just what central banks would do as a result of that strength. Higher inflation is causing nervousness, which some think could trigger interest rate increases and restrain the economic rebound prematurely. This certainly explains some of the market volatility in May. So far, central banks have stood firm and clearly indicated today's price rises are temporary, and mostly caused by COVID-disrupted supply chains, so these pressures should moderate as supplies of goods and services adjust over time.

Equities are positioned well against a backdrop of normalising inflation rates, and for businesses, stronger sales growth can help offset higher costs. Additionally, rising demand generally makes it easier to pass higher costs onto consumers, ensuring profit margins are not squeezed.

It is hard to deny that equity markets, especially those in the UK, have made a solid start to 2021. However, rising optimism should not lead to complacency, and we would not be entirely surprised if markets remain choppy in the near term. Overall, the path ahead looks brighter than it did last year, which should mean equity markets remaining positive for the medium term.

Conversation returns to fiscal deficits

The pandemic has been hard on everyone's budgets, and governments are no exception. Over the last year, we have seen politicians all over the world wrack up massive bills for their emergency fiscal support. Most of this has been funded by debt, pushing debt-to-GDP ratios significantly higher in most developed nations. Understandably, this has provoked fear over debt, how it will be paid off or will it spiral; can central banks continue to buy; and what it means for government budgets further down the line?

On the other hand, economists and capital markets seem unphased by this supposedly looming danger. This is surprising, given we have had more than a decade of 'balanced budget' rhetoric from politicians, especially on the European side.

The first thing to note, as we have pointed out here many times, is that the question of how emergency measures get paid should not stand in the way of the fact that they are needed. The virus and enforced closures created a black hole for businesses and consumers that needed filling, and without furlough, unemployment support and emergency loan measures for businesses, we would have been left with an economic disaster that could have been just as deadly as the virus on a grand scale.

And ultimately, the realities of the pandemic lessen the negative impact of increased government spending – like debt servicing and crowding out of the private sector. Debt costs are currently at historic lows, and after a total collapse in activity last year there was not much of a private sector to crowd out.

As the world starts to recover from the pandemic, and restrictions are eased, emergency fiscal support will peter out over the coming quarters – even if governments are allowing substantial leeway, as in the European Union (EU), where budgetary rules have been suspended for 2022. Politicians will be wary of tapering support too quickly and risking a fiscal cliff-edge scenario. If households and companies fear things to be slower in the medium-term, they'll save rather than invest and spend.

The regions most likely to face such a problem are the US and UK. In the US, though, emergency support has been channelled through extraordinary and time-limited measures – meaning a shock could be on the cards if they stop too abruptly. Thankfully, policymakers in the White House as well as at the Fed are keen to stop this from happening. Whatever the case, central banks will need to be there to lend a helping hand as fiscal programmes wind down.

The UK faces similar issues (although the scale of support was smaller than in the US) surrounding the run-off of furlough payments and rent holidays. In Europe, much of the pandemic support has come through established social security mechanisms which act in a more measured way. And even there, more generous tweaks of well-established schemes are set to phase out.

It is interesting that the current discussion about debt and fiscal support is framed as a return of Keynesianism by the media. The simplified version of Keynesian economics is that demand is the defining driver of the broad set-up. Governments can boost growth when savings are high and demand is low, and so fiscal policy should be countercyclical. But countercyclical policy usually means investing in the hard times and pulling back in the good times – with the latter of course proving much harder. Emergency COVID measures go a bit into this direction, but ultimately they are there to plug the income gap and avoid a disaster. Importantly, this past year has been a great example of why fiscal deficits are not necessarily about public investment.

However, at the same time, the pandemic has definitely shifted the conversation toward the need for investment in the broadest sense. We can see this most clearly in the US, where President Biden is working to unleash some of the biggest long-term fiscal stimulus the country has seen in decades. His $6 trillion 2022 budget proposals contained indications of an ongoing $1.3 trillion per year government deficit. Here in the UK too, Boris Johnson is keen to talk of the "levelling up" agenda, which implicitly carries budgetary costs.

The talk of public investment pre-dates the pandemic. Self-proclaimed socialist Bernie Sanders came close to a presidential nomination in 2016, while Donald Trump unveiled many policies designed to widen the fiscal deficit in the short term to boost growth. In Britain, the traditionally hawkish Conservative Party won the 2015 General Election with spending plans more ambitious than those of Ed Miliban d's Labour. All over the developed world, there is a sense that the years of austerity following the global financial crisis have also harmed some parts of the economy, most notably those that are vital to allow for productivity growth in the future.

The last year, dominated by the pandemic, certainly accelerated things. There is now a growing consensus for public investment based on two main factors: a widespread feeling that 'investment in the future' (for things like technology or education) has been neglected, and a sense that climate change leaves us with no choice.

In terms of long-term investment, the second factor will likely be more important. Former Bank of England Governor Mark Carney highlighted this back in 2015, when he pointed out that change required a shift of incentives in the financial system – and to waste no time in acting. In his words, "once climate change becomes a defining issue for financial stability, it may already be too late." This "tragedy of the horizon" refers to the fact that big costs in the future have to be addressed now. In this context, fiscal spending now to avoid a multiple future costs looks more balanced.

This is the context for Biden's green infrastructure plans. To avoid climate catastrophe, new technologies and infrastructure need to be built. Policymakers now almost all agree that this will not be achieved by market forces alone – at least not quickly enough. As noted before, these huge shifts require not only new and greener building, but effective and harmonised regulation, as well as transparency on CO_2 data.

We are now seeing this in discussion over CO_2 trading systems and carbon border taxes. Both will help the private sector play its part in the green revolution. Providing some level of investment security will be vital as merely public spending is unlikely to be enough to stem the bill (unless economies choose to go down the route of modern monetary theory). But more is needed to stabilise expectations for the future – whether that is over public infrastructure or technological progress.

We have already seen politicians gesturing toward how the bill gets paid further down the line. Making tax systems more progressive will be essential. A big part of that is making tax less avoidable.

Here in the UK, successive governments have been increasing taxes on 'unearned' income for years, and making further progress on that front will be unpopular enough to impinge on election results. The new front is on corporations and the tech companies that are seen as not paying their share to this point (the proposed global minimum for corporate tax being a prime example).

Since Biden's term started, major nations have moved towards a common position on corporate tax at a tremendous rate, and the finance ministers agreed to a 15% level on Saturday. It won't be the easiest thing to ensure that revenues are correctly ascribed. The key will concern unified action in barring access to customers for those companies that still attempt to avoid taxation.

Policymakers have to strike a fine balance – they want to quieten fears about long-term debt sustainability and inflation, without quashing the private sector's propensity to invest when it is most needed. For now, the conclusion, that most people seem to agree with, is that organising who pays the bill, and when, needs to be sorted – with everybody's time horizon being the most contentious part of the equation.

A picture emerges of rotation and momentum

There is plenty to be positive about in capital markets these days. With the world opening up and the global economy finding its feet again, equities are inching higher on gently improving earnings expectations. These are supported by stable – and historically low – interest rates and bond yields. As we have written before, in this scenario you would expect bond yields to gradually climb higher with economic growth, thereby making stocks less attractive by comparison. Central bank action has been decisive in stemming that flow, to the benefit of equity investors.

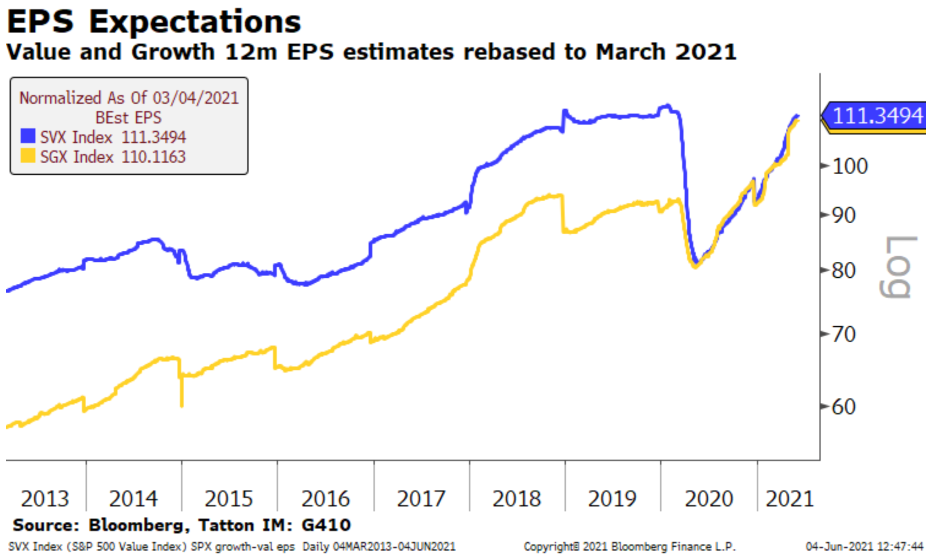
Nevertheless, stocks have clearly become 'cheaper' to some extent. Part of that is down to the fact that bond yields have not been totally immune to the rising tide of global growth, but part of it is just how valuations are calculated. Share prices climb when people expect higher earnings, so if earnings are improving in line with expectations, prices should be stable. And if earnings improve more than equity prices rise, then valuations – in terms of the price-to-earnings ratio – are clearly coming down.

That has happened to some extent. Even though the MSCI Developed World index has rallied to new all-time highs last week, the ratio of price-to-expected earnings (over the next 12 months) has fallen. At the beginning of April, prices were 20.6 times expected earnings, but the figure fell to 19.6 as of Wednesday evening.

The 'growth' and 'value' factors are a description of the stocks' relative fundamental characteristics. Growth indicates a measure of confidence in long-term rising profitability, whereas value focuses on nearer-term cashflows or the values of assets held by a company. These factors are not mutually exclusive, but they don't tend to crossover much.

There has been a cheapening among growth stocks. As John Authers of Bloomberg points out, "there is a lot of profit growth to go round at the moment". As the chart of the S&P500's Value and Growth subset indices on the next page shows, earnings per share estimates have been rising equally, pretty much from the low point last year.

Value companies now look as attractive as their growth peers. If you don't have to pin your hopes on growth some years into the future, why would you pay up-front for it? Tesla – its valuation dependent on profits which can only be achieved in the next decade – has been a prime example of this. The electric carmaker, which more than doubled in price from November to January, has fallen back over a third. Inevitably, its valuation is now (slightly less) stratospheric.



At the aggregate level, earnings expectations have continued to improve at a fast pace, but stock price gains have been keeping up – so why is the index getting cheaper? The cheapening of the tech giants does not explain all of the move in the index's overall price-to-earnings valuation. The answer comes not from the stocks themselves as much as the way they are included in the index. With markets rotating out of growth into value, the latter stocks see a bigger representation in major indices. Those companies generally have much lower price-to-earnings ratios, meaning that the aggregate index valuation comes down despite individual valuations remaining around the same.

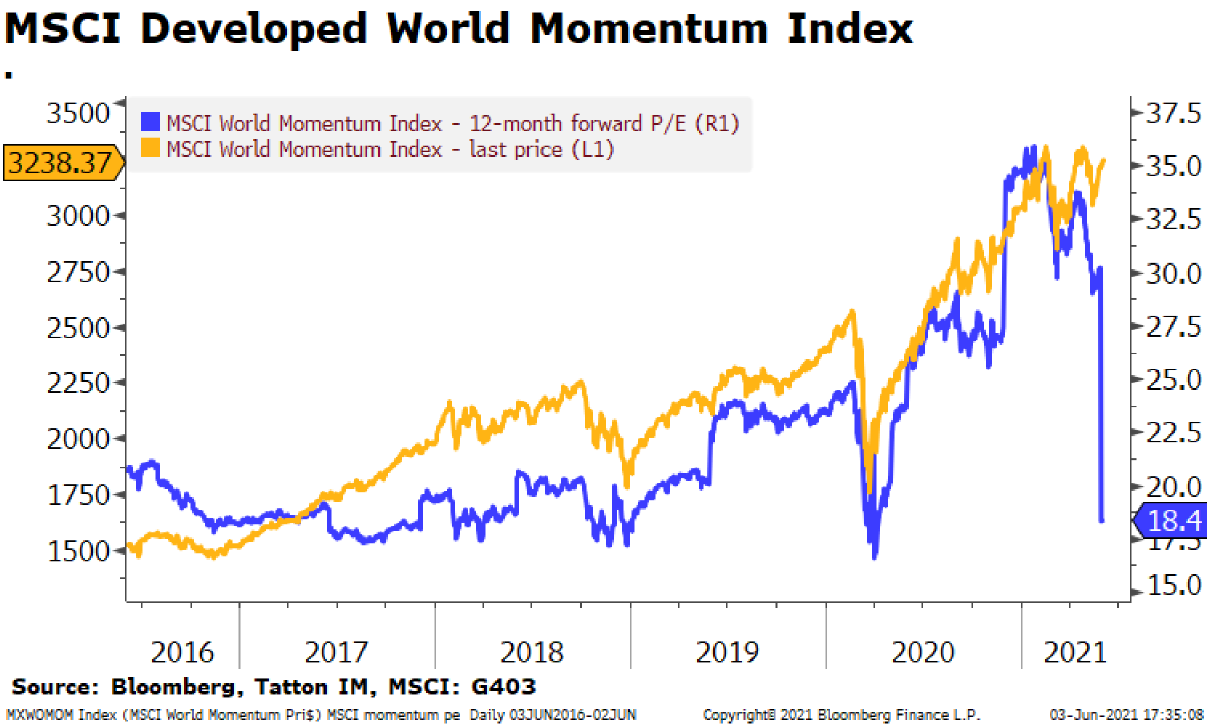
There is another interesting aspect happening among factors which are not necessarily split along the fundamental lines as growth and value. One of these is 'momentum', which is exactly what it sounds like. In 1993, researchers at UCLA found that investors buying those stocks which have done well, and selling those that have done poorly, stand a good chance of better returns (than the general market) over three months to a year.

Momentum stocks are found by looking at the rate of change over a specified period. Blackrock's iShares and MSCI together generate the World Momentum index, which evaluates stocks over six and 12-month periods. It tries to include those assets which are continuing to trend and avoid those seeing a shift in sentiment. To avoid loading up the index with volatile stocks, it evaluates price trends on a risk-adjusted basis. iShares and MSCI include stocks with the highest momentum scores, and weights them by a combination of their momentum score and market cap. They rebalance index constituents twice a year – although they will sometimes also rebalance when volatility strikes (as it did in last year's almighty COVID sell-off).

Picking those stocks which have done well before might sound like a simple or obvious idea, but theoretically speaking it is hard to explain why that should work. A company's future prospects *should* be already priced in at any given moment, so there is no particular reason why past performance would be an indicator of future performance. The phenomenon might be down to simple market inefficiencies and delayed price reactions, or a result of risk-pricing where investors are rewarded for bearing higher risk.

Whatever the case, the index's rebalance last month makes it clear what a huge rotation we have seen in wider markets. Now that it has been over a year since the market recovery began, we get a clearer picture of trends. Price action over the last 12 months still gives information technology shares a high score, but the big winners are financial companies.

Banks and the like are highly-sensitive to the economic cycle, so it makes sense they would receive a boost from recovering economic expectations. In fact, almost all cyclical sectors are up in score, while defensive sectors are down – with healthcare seeing another decline after being the largest weighted sector a year ago. To put it another way, cheap stocks are also momentum stocks – even if they see short bursts of high growth. This explains why the price-to-earnings ratio for the momentum index has dropped dramatically.



It is hard to say how long this trend will last. If this economic cycle is a brief one, momentum is unlikely to be a winning strategy – with growth stocks becoming more attractive again. At the same time, if confidence is high that the economy will keep expanding, momentum will be behind the more cyclical and value-oriented stocks. Thankfully, there is still plenty to be positive about.

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7th June 2021

Global Equity Markets

Market	Fri 15:40	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7056	+0.5	+37	→	↗
FTSE 250	22814	+0.7	+155	→	↗
FTSE AS	4036	+0.6	+23	→	↗
FTSE Small	7296	+0.8	+60	⬀	↗
CAC	6512	+0.4	+28	⬀	↗
DAX	15677	+1.0	+157	→	↗
Dow	34712	+0.7	+247	→	↗
S&P 500	4218	+0.4	+18	→	↗
Nasdaq	13789	+0.4	+53	⬂	↗
Nikkei	28942	-0.7	-208	⬂	↗
MSCI World	2973	-0.2	-6	→	↗
CSI 300	5282	-0.7	-39	⬀	↗
MSCI EM	1384	+1.7	+23	⬀	↗

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
BP	+4.7	B&M European Value Ret	-7.5
Admiral	+4.3	Kingfisher	-4.4
Johnson Matthey	+4.1	Fresnillo	-4.0
Scot Mtge Inv Trust	+4.0	National Grid	-3.2
Burberry	+3.9	Intertek	-3.1

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.418	-0.0	Oil	71.66	+2.9
GBP/EUR	0.858	+0.2	Gold	1894.4	-0.5
USD/EUR	1.22	-0.2	Silver	27.75	-0.7
JPY/USD	109.49	+0.3	Copper	452.1	-3.0
CNY/USD	6.40	-0.4	Aluminium	2405.0	+0.1
Bitcoin/$	36,685	+1.7	Soft Cmdties	449.3	-0.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.80	+0.00
UK 15-Yr	1.17	+0.02
US 10-Yr	1.57	-0.02
French 10-Yr	0.15	-0.02
German 10-Yr	-0.21	-0.03
Japanese 10-Yr	0.09	+0.00

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	19.1	13.8	14.1
FTSE 250	2.0	18.3	23.9	15.5
FTSE AS	3.1	18.8	14.8	14.2
FTSE Small x Inv_Tsts	1.5	19.3	-	15.2
CAC	2.1	25.5	18.4	14.7
DAX	2.3	18.5	15.8	13.3
Dow	1.7	21.7	20.4	16.2
S&P 500	1.4	26.8	22.5	17.3
Nasdaq	0.7	32.2	32.0	22.5
Nikkei	1.5	18.1	20.0	17.6
MSCI World	1.7	24.2	20.4	16.4
CSI 300	1.7	17.2	15.4	12.4
MSCI EM	1.9	15.4	14.9	12.4

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	2.58	2.57
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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7th June 2021

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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