THE **CAMBRIDGE** WEEKLY

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Hazy as Carbis Bay

The G7 meeting in St. Ives' Carbis Bay was rightly the centre of attention in the UK last week and looked to centre on Europe's leaders cosying up to a much more loveable US administration, at the same time as trying not to mention Brexit too much.

For markets, on the other hand, the big meeting happened the previous week, with G7 finance ministers the key participants. Top of the agenda was the Global Minimum Corporation Tax. The headlines talked about agreement on a 15% minimum tax level, but there was (and is) too little detail to know how directly this will affect the after-tax profits of the major global companies in the near or even medium-term. Therefore, the news had little impact on share prices, with European markets hitting new highs over the week. Indeed, the market narrative reversed from "it will be very important" to "this is just another damp squib".

It may be that in the world of global politics, big initiatives are always swallowed up by domestic short-term needs and little of importance happens in the end. However, our suspicion is that the Global Minimum Tax is something that will grow, rather than die. It is important to note that before Biden it did not even feature on this G7 summit's agenda, even if it has been one of the major areas of focus for most countries. Biden cannot hope to get any US corporate tax rises through without non-US taxpayers helping to close loopholes, and thereby foot some of the bill. With everybody else keen on getting a tax share of the US-centred digital economy, the announcement means incentives are firmly aligned in pushing this forward.

There are additional European incentives, where reducing tax competition within the block is a big gain. Even in the UK, Chancellor Rishi Sunak needs to find revenue. If concerted action can be established, he can join the initiative without damaging UK competitiveness. It is still likely to feel slow, but corporate tax rises for those multi-nationals that have been best at avoiding tax do not look like going away.

Beyond the G7 excitement, market attention is now trained on monetary policy, as we head into another round of important central bank meetings – just as investors have been revising growth expectations slightly downward, while inflation readings have been ramping up – as expected.

The European Central Bank (ECB) met last Thursday and increased the pace of bond purchases although it did not go so far as to tell us actually what that meant ("flexibly" and "with a steady hand" apparently). The market is pretty sure quantitative easing volumes will be increased only for a short period, probably slowing into the Autumn. While the ECB's decisions were described as unanimous, we suspect that the discussion may have been not so straightforward.

The 2023 increase in the core CPI (consumer price index, excluding the more volatile food and energy price movements) projection was at just 1.4%, still below the ECB's loose target of not quite 2%. When asked "why not get even more aggressive?", ECB president Christine Lagarde spun a story about how it has been revising projections up – an indication that it sees the balance of risks being towards marginally higher inflation.

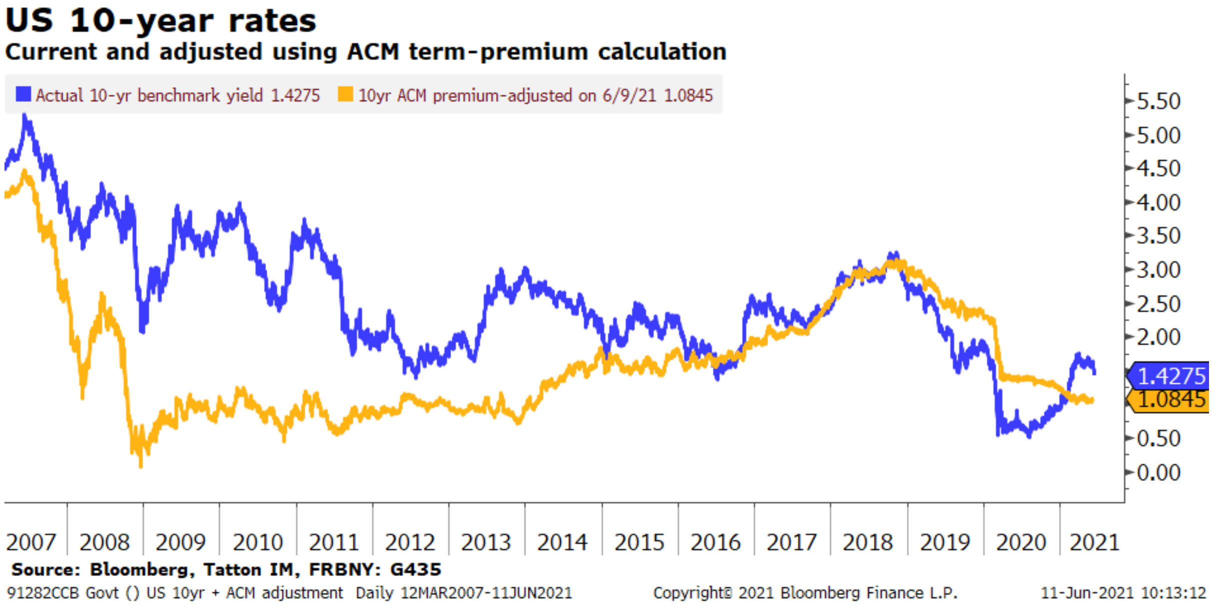
However, it appears that all central banks are now focused on employment and wages, especially in service sectors. Here, the ECB and the rest are in no doubt – labour needs to have more pricing power – most likely in order to stimulate and stabilise broad consumer demand.

Meanwhile US core CPI stepped up to 3.8% year-on-year, 0.3% more than anticipated. Bond yields rose briefly to 1.53% after the release and then pushed down again to 1.45% on Friday. In the table at the end of the last Cambridge Weekly, the US ten-year yield was 1.57%, and so US yields have been sliding since peaking on the penultimate day of March at 1.76% – despite inflation readings rising significantly since.

It would appear investors are toning down their rocket-like previous economic growth expectations, amid discussions about smaller infrastructure fiscal packages, as well as further delays to general post-pandemic 'demob happiness' due to the Delta variant of COVID. In this context, it is also notable that real wages growth has gone from very positive after last year's artificially pumping-up, to slightly negative since the start of the year. Meanwhile some US states are pulling back on unemployment payments, even before the federal government takes them away.

However, most of the US bond yield decline may just be attributable to a decline in "term-risk premium", the estimated excess return in holding ten-year US Treasury bonds in comparison to cash. The term-risk-premium seems to have come down, mostly because investors have become less worried about US Federal Reserve (Fed) losing control of inflation – and thus future bond yield increases – and have decided to go back to a more neutral duration. It also goes hand-in-hand with decline in current risk asset (equities) volatility.

There is a useful measure of that term-risk premium done by the Fed. If the ten-year rate has the premium knocked off, it has been around 1.1% and stable for since January.



It has not changed much, and that accords more with economic fundamentals, and with a very steady Fed, which is unlikely to upset the economic growth recovery path through pre-mature rate hikes. This does not mean the bond market is wrong in thinking that the economic fundamentals would justify somewhat higher interest rates than they are right now, but it does mean that, without a change in Fed rates, it is difficult for longer yields to sustain higher levels as were reached in March.

That is pretty good news for risk assets, up until the Fed changes things. It might do so this week, of course, but the market now seems to be thinking the timing for any early signal is more likely to be around the August Jackson Hole meeting.

With the threat of higher yields having dissipated for now, markets may well stay as calm and Goldilocks-like as they have been since mid-May. But at the same time, the growth fantasy rocket fuel that propelled them upwards since the autumn of 2020, is likewise dissipating. It would take a meaningful change in the economic recovery narrative or central banks' stance to upset this 'wait-and-see-but-remaining-quietly-confident' market attitude.

Interestingly, a potential change catalyst may be developing right under our eyes in the UK. No other nation with a similarly high rate of vaccination among its adult population has come under 'attack' of a more aggressive COVID-19 variant as the Delta mutation is proving to be. Should only infection rates among the not-yet-vaccinated younger population increase, but hospitalisations remain at levels comparable to conventional flu pandemics, this would give growth expectations another boost. The next few weeks will be crucial in this respect, so despite the warm weather's distraction potential, we will keep a very close eye on the implications of the latest virus developments in the UK to global growth projections.

Markets enter key transition phase

Change is in the air, and after the year-and-a-half we have had, that can only be a good thing. For capital markets – and indeed the public – this year's key question has been what happens as the virus fades and the global economy thaws. Much of the focus has been on inflation: We know the global economic recovery will result in a glut of price increases, but how big it will be, and how long it will last is dividing opinion (see our other article this week, for example). But inflation is far from the only unknown as we move through this transition phase.

On a wider scale, there are questions over what the post-pandemic economy will look like. We are already in the middle of a strong recovery, and it is reasonable to expect big changes in terms of economic dynamics from the pre-pandemic days. Investors who call this right stand to gain much. The rotation between different investment styles has been strong in markets this year, but commentators are now wondering which sectors will have the best chances, and when.

Last year, as the world was under house arrest and in the depths of the sharpest recession on record, the big winners were the US technology giants. It was unsurprising: Not only are they mega-cap companies with good long-term prospects, but they were already flush with cash and stood to gain the most from stay-at-home living and working.

In the Autumn, a cyclical rotation kicked in as vaccines, fiscal stimulus and pent-up demand promised a strong recovery on the horizon. Energy and financial companies performed well in this environment, with greater economic activity sure to spur energy prices, while strong financial market activity boosted investment banks' earnings. But that cyclical shift has waned recently. Sectors with a high exposure to global growth, like real estate and energy, have fared well over the last month – but then so too have tech-driven companies geared for the long-term future. The S&P 500's financial companies declined -0.24% over that period, while the information technology index saw a 0.7% gain.

Last week saw a continuation of those mixed signals. Healthcare, considered a highly defensive investment, has been the big winner over the last few days, with the index jumping 1.7%. But real estate has also leapt, up 1.5% for the week. These are very short-term moves, so we should not to read too much into them. But nonetheless, they paint the picture of a market that is unsure what it thinks.

Looking outside of the equity market gives a bit more of a clue of investor expectations. The ten-year yield on US Treasury bonds has been trending downward, and breakeven rates – a measure taking inflation into account – have plateaued or rolled over. Longer-term inflation expectations (five to ten years) have never quite made it to the levels seen post the global financial crisis, so there is currently little evidence in the market pointing to the economy overheating on a lasting basis.

We are clearly in a transition phase, and markets – just like the global economy – are still finding their rhythm. Everyone expects strong growth in the short term, but after that we will need to settle on a 'cruising speed' for the economy. Exactly what that speed is depends on many factors, not least how deep the COVID wounds are for different parts of the economy, and how much scarring will be there after they heal. This is the million-dollar question of course, and we will get a better picture of the outlook over the next few quarters.

The key thing to figure out is, how broad based will the long-term growth outlook be? Governments, central banks and even businesses are all geared up for big change ahead – climate investment being top of the agenda – but it remains to be seen whether economies can find a level that is deep and broad enough to lift all areas and sectors of the economy. This directly impacts how dispersed company earnings outlooks will be, and hence directly impacts expectations for different parts of equity markets, as well as capital markets as a whole.

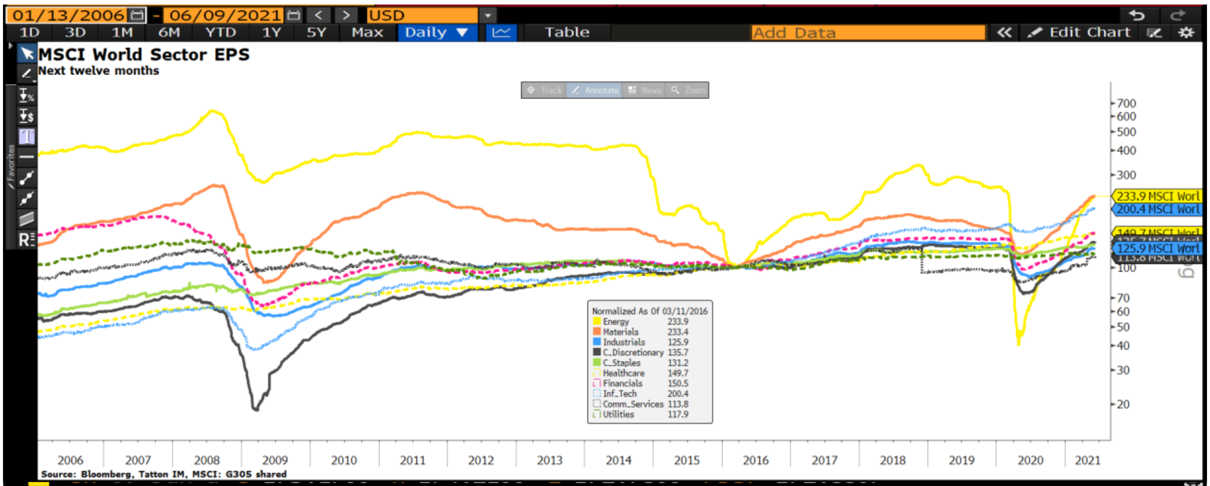
If a rising tide does indeed lift all boats, current conditions should translate into a complete healing of the beleaguered labour market – a continuation of the employment gains we are already seeing. This would certainly be good news for the broader growth outlook, but it would also suggest inflation will be with us for some time. Most central banks are currently expecting the inflation spike to be short-lived, prompted by returning activity and various global supply issues. But a continually tight labour market should mean continued wage expansion, meaning transitory inflation pressure turns structural, with prices pushed higher from both the demand and supply sides.

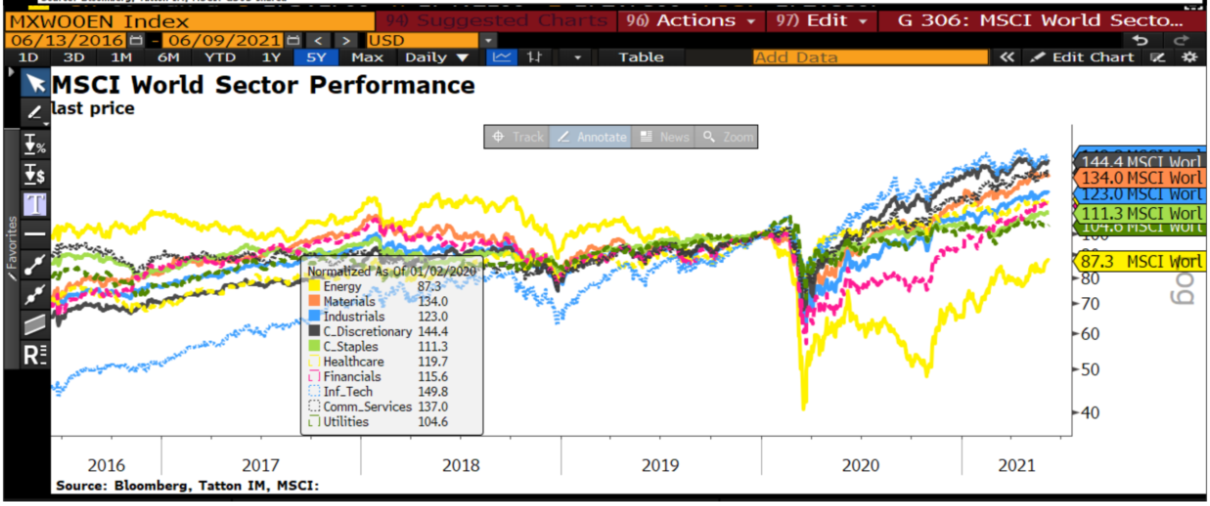
The traditional cyclical sectors, like banks and financials, would be well-supported by this environment. This could be so even if the initial recovery is uneven across the regions – which is currently happening thanks to rampant US growth. If demand from the US spreads into a recovery across other regions, cyclicals in emerging market regions will also benefit. That is the positive scenario; the less positive version is that the wider recovery fizzles out, generating only mild inflation pressures and not much upside in yields. That environment benefits companies with strong earnings and balance sheets – like the big tech companies that did so well last year.

Whatever happens will depend greatly on support from policymakers. As we have written before, fiscal investment and monetary support is needed not just to plug the COVID gap, but to generate enough long-term prospects for private sector investment. Fortunately, this seems like the plan for many governments – particularly the US.

Monetary support is perhaps even more crucial. The US Federal Reserve (Fed) knows it cannot withdraw its helping hand too soon, but lately the inflation conversation has shifted toward a fear it might let things run too hot. We do not expect overheating to be a significant risk over the medium term, but will not be surprised to find US rate setters signalling to markets that they are keeping a watchful eye on the risks of their policy stance should the economy do even better than expected. In any case, there are plenty of tools to deal with these problems as they emerge.

In terms of dispersion, we should also expect a steady normalisation of household savings later in the year to balance things out. Equity markets have been rocked greatly in recent months by wild swings from the retail investment public – highlighted by the huge move in GameStop stock. Such moves are by their nature extremely unpredictable – but we would expect their influence to wane as the public stops saving and starts spending on consumption. For now, we have more questions than answers – but we at least have a good idea of what to look for.





Is Haldane right on UK inflation?

A sunny couple of weeks has brought some much-needed positivity to the UK, but those hoping for a post-pandemic 'summer of love' might be disappointed. We are less than two weeks away from the last stop on the UK government's roadmap, but a lifting of all restrictions on 21 June is looking somewhat unlikely.

Each of us has our own view on the datapoint that matters. Of course, it is the cabinet ministers' decision and what 'matters' is prospective votes. The datapoint that gets the most airtime is virus cases, which have clearly risen despite another rapid vaccination push. The more transmissible Delta variant now comprises 91% of new infections.

The infection numbers are still relatively small, and deaths from COVID have yet to see a rise. The number of COVID patients in hospital is now at its highest since April, but admissions are rising at a lesser pace than in previous upswings, lagging the case data by around 10-12 days. Therefore, next week will be crucial to see whether the cases result in a repeat of January or not.

The government has been non-committal so far on what this might mean for the grand reopening, but it looks increasingly likely we will see at least some delay. This is bad news for many businesses, particularly those in the travel and leisure industry. Admittedly, any delay is infinitely better than a backslide – as the residents of Lancashire and Greater Manchester will tell you. But with the economy still finding its feet and many looking forward to the recovery, delays and complications are not good for an economy that – in normal times – relies so heavily on its consumer services sector.

As things stand, the UK economy has been doing well through the spring. According to the Office for National Statistics (ONS) growth data for April showed a rise of 2.3% which reversed all and more of the first quarter decline of 1.5%.

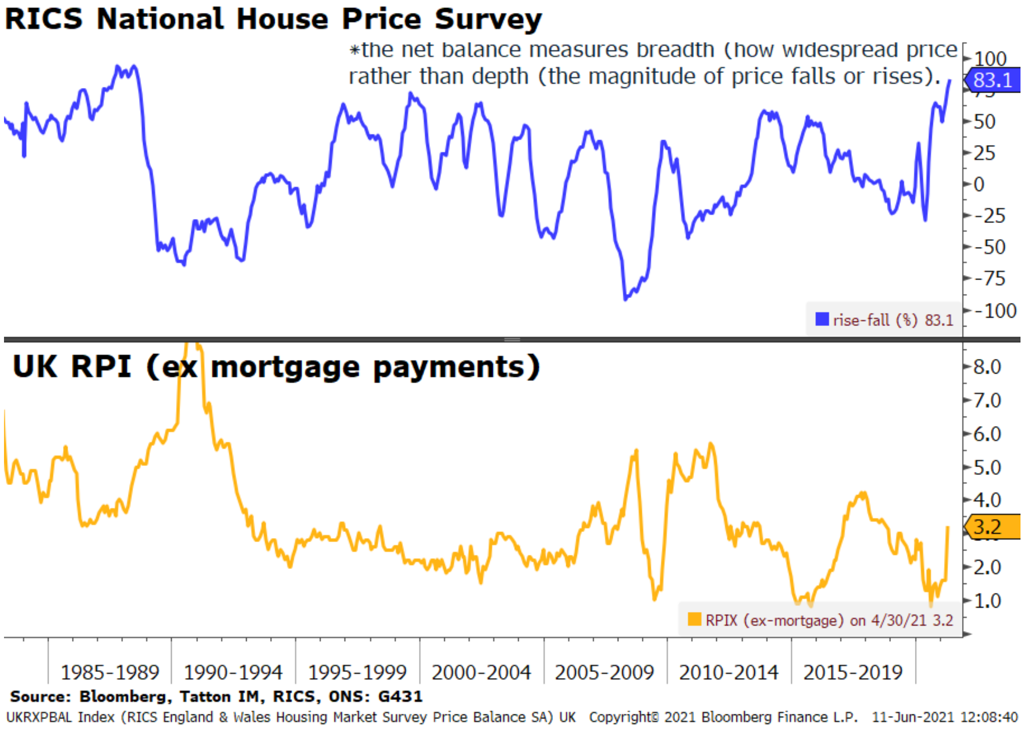
Andy Haldane, the outgoing chief economist to the Bank of England (BoE) – and its current chief provocateur – is worried about this strength. After describing UK growth as "gangbusters", he warned in a New Statesman article that rapid growth and inflation risked an overheating economy, which would force the BoE to tighten monetary policy hard and fast. Haldane, who was the only Monetary Policy Committee (MPC) member to vote for a slowing of asset purchases at its most recent meeting, said it risked making a "bad mistake" by not acting faster to quell runaway inflation.

Underlying Haldane's warning is the resurgence of UK growth prospects on the back of the impressive vaccine rollout. Backing him up last week, Goldman Sachs has pushed up its 2021 UK GDP growth estimate to 8.1% (although some reports quoted 7.8%). Even including more pessimistic economists in the Bloomberg survey, consensus estimates have risen above 6% this year. Looking to 2022, the consensus outlook looks even more impressive. While the US and Eurozone are expected to fall to around a 4% rate next year, the UK is predicted to expand by 5.5% – a growth figure matched only by China among the world's leading economies.

No one denies that this resurgence will come with an increase in inflation, least of all the BoE. The difference is that MPC members expect above-target inflation to be transitory, petering out as the economy finds its own feet. Haldane has a different view. He expects the glut of household savings built up this year to be unleashed while the world still struggles with multiple supply issues. The resulting spike in consumer prices, he warns, will be carried forward through increasing wage demands from employees – creating a cycle of rising inflation expectations that affect the medium and long-term.

Perhaps supporting his view, the ongoing rally in UK house prices shows no sign of letting up. The housing market is often described as a pillar of the UK economy, particularly since the 1980s. It is probably, in part, due to the impact on consumer demand through the balance sheet effect. People are thought more likely to borrow and spend if their stock of assets is rising in price. Of course, they might also just spend more on 'doing their new place up'.

Rising house prices have been said to be a leading indicator of inflation over the medium-term. It is quite difficult to see this in the data (as the chart below shows) but one reason may be that the BoE has acted pre-emptively to tighten policy, which has halted the inflationary follow-through. With 83% of estate agents currently expecting further jumps next year (the highest number since the 1980s), Haldane is certainly right that the MPC has a big call to make over the next few months.



The risks that Haldane highlights are not implausible. According to modelling from Dan Hanson of Bloomberg, a few minor tweaks to the BoE's assumptions could see a bigger and more prolonged bout of inflation – though he would still see Haldane's scenario being at the higher end of the outcomes.

Nevertheless, Haldane has faced criticism from other economists. A fundamental part of any sustainable economic recovery is a rebuilding of the employment market – and the UK is still very much in the middle of that process. Sam Tombs of Pantheon Macroeconomics points out that, even though many businesses are now back to operating at pre-pandemic capacity, they are still making use of the government's furlough scheme. This means many companies appear to have decided to retain surplus workforce while the cost is low. When emergency support drops away, we should expect to see more rotation in the labour market.

Any delay to Britain's reopening will only exacerbate those problems, as for many significant sectors it is still far too early to call an end to pandemic woes. For the housing market, we suspect the link between house prices and inflation will not be obvious in the coming months. One of the key drivers of house price growth for the past year has been the suspension of Stamp Duty, which is sure to end sooner rather than later. Besides which, one of the key reasons the housing market has been so well-supported is that pandemic savings have been funnelled into it. This means we are unlikely to have both a rally in housing and a wave of spending in the next year – the central assumptions of Haldane's runaway inflation scenario.

The final part to mention is one that, thankfully, we have written little about recently: Brexit. That the world went into lockdown just as Britain severed its ties with the European Union makes it extremely difficult to know how the UK economy will fare in the future. There has been a huge drop-off in exports, which will prove very damaging if it continues post-pandemic. However, at the moment, it is hard to determine whether most of that drop-off is due to the pandemic's restrictions, or due to Brexit. The answer is surely somewhere in the middle, but exactly where is unknown. Knowing that will be very important for the UK.

The sun may be shining for now, and Haldane could well have a point about sunburn, but the BoE has a characteristically British view of the weather. It will therefore be difficult for it to do anything other than choose to keep monetary policy loose for the foreseeable future.

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14th June 2021

Global Equity Markets

Market	Fri 15:58	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7136	+0.9	+67	⬀	↗
FTSE 250	22746	-0.4	-87	→	↗
FTSE AS	4070	+0.7	+27	⬀	↗
FTSE Small	7289	-0.2	-12	⬀	↗
CAC	6600	+1.3	+85	↗	↗
DAX	15683	-0.1	-10	⬀	↗
Dow	34430	-0.9	-326	→	↗
S&P 500	4239	+0.2	+9	→	↗
Nasdaq	14023	+1.5	+208	→	↗
Nikkei	28949	+0.0	+7	→	↗
MSCI World	3007	+0.3	+10	⬀	↗
CSI 300	5225	-1.1	-58	→	↗
MSCI EM	1379	-0.2	-3	→	↗

Top 5 Gainers

Company	%
Auto Trader	+11.5
BT	+8.6
Intermediate Capital	+5.9
Rightmove	+5.1
DS Smith	+4.8

Top 5 Decliners

Company	%
J Sainsbury	-4.9
Ashtead	-3.3
Renishaw	-3.2
Barratt Devts	-2.9
Ferguson	-2.7

Currencies

Pair	last	%1W
USD/GBP	1.412	-0.3
GBP/EUR	0.858	+0.2
USD/EUR	1.21	-0.5
JPY/USD	109.78	-0.2
CNY/USD	6.40	-0.0
Bitcoin/$	37,007	+2.9

Commodities

Cmdty	last	%1W
Oil	72.88	+1.4
Gold	1884.2	-0.4
Silver	28.21	+1.5
Copper	454.1	+0.3
Aluminium	2476.0	+3.0
Soft Cmdties	446.9	-1.9

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.3	19.2	14.0	14.1
FTSE 250	2.0	18.2	24.0	15.5
FTSE AS	3.1	19.0	14.9	14.2
FTSE Small x Inv_Tsts	1.5	#N/A N/A	-	15.2
CAC	2.1	25.8	18.5	14.7
DAX	2.3	18.5	15.7	13.3
Dow	1.7	21.6	20.2	16.3
S&P 500	1.4	26.9	22.5	17.3
Nasdaq	0.7	32.3	32.6	22.5
Nikkei	1.5	18.1	19.9	17.6
MSCI World	1.7	24.5	20.6	16.4
CSI 300	1.7	17.1	15.3	12.4
MSCI EM	1.9	15.3	14.7	12.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.72	-0.07
UK 15-Yr	1.08	-0.08
US 10-Yr	1.47	-0.09
French 10-Yr	0.10	-0.05
German 10-Yr	-0.27	-0.05
Japanese 10-Yr	0.04	-0.05

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

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14th 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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