CAMBRIDGE
INVESTMENTS LIMITED

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'I thought Boris promised that everything would be returning to normal'

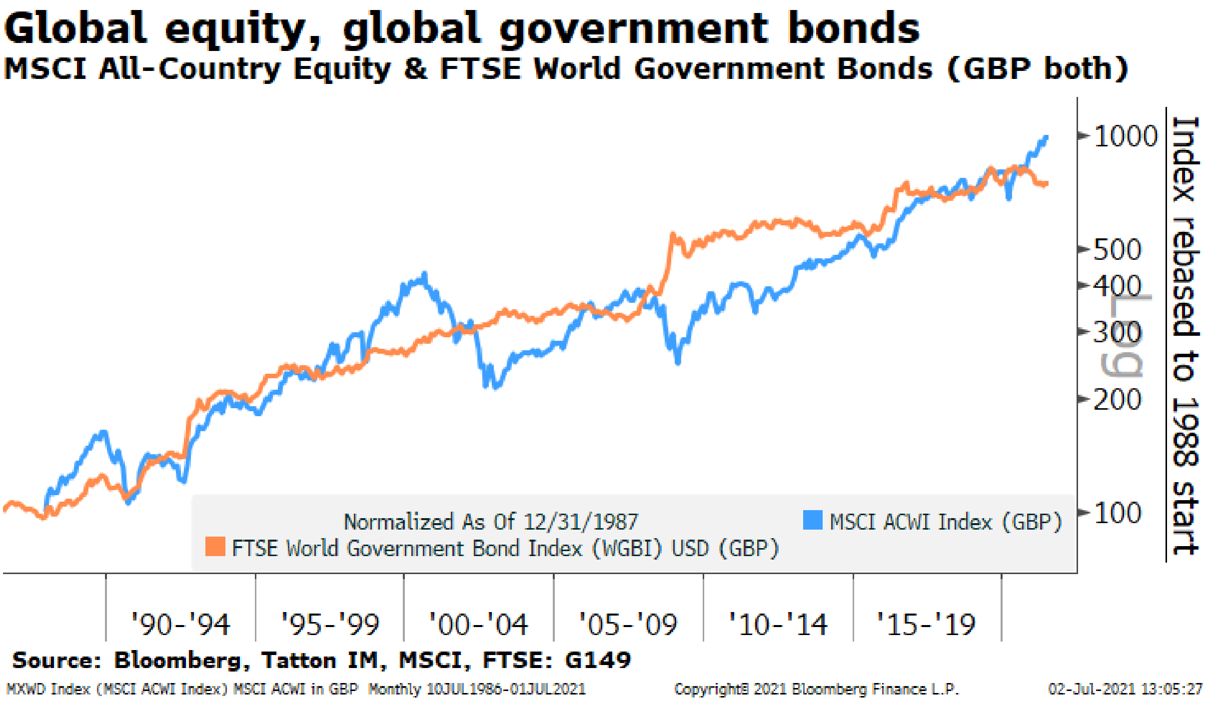
Source: Marr, 29 June 2021

Transition uncertainties

The great British summer may have struggled to materialise so far, but the end of the first half of the year always brings an element of sunny optimism. We will comment on market and investment returns in more detail next week, when the data has settled, but after what proved a quite decent 2020 for investors, the first half of 2021 has again left investors with plenty to be positive about. However, investors with a higher allocation to equities than bonds will have done much better than last year. Regular readers will know bond markets have been a decisive factor for stock markets this year, and while compared to the first quarter of 2021 they have calmed down, in the second quarter they remain a risk to lofty equity valuation levels.

On the back of calmer bond markets – and a significant rebound of the global economy – the second quarter saw many equity markets close at all-time highs. Meanwhile, despite a notable recovery rally in the second quarter, bond investors have not had it quite so good. This poses an important question against historical observations. Can equities continue their rise despite a lack of upside for bonds?

The timescale of the chart below may distort things, however, the return boost that the relentless decline in bond yields provided bond holders over the past 40 years has meant that, over this period, stock market returns did not come at the expense of bond markets. The 1950s and 60s looked very different. Then, yields continually rose and drove down bond valuations, while equities grew strongly. So perhaps we should pose the question differently: can the 2020s be like the 1950s and 60s?



It is certainly possible, but some of us may also remember the 1970s, when out of hand inflation drove bond yields up at a much higher rate than before, and stock markets suffered prolonged falls.

For the rest of this year, returns are more likely to be driven by the more immediate factor of the post-pandemic economic growth levels. On this point, the recent record highs in economic sentiment survey data from around the western world, confirmed that equity analysts have not been mistaken to expect exceptionally high 2021 corporate profit growth rates – which are underpinning stock market valuations (see also this week's article 'Global half-time review'). At the same time, concerns have subsided for now that runaway levels of inflation are poised to push up bond yields, and put equity valuations under pressure through rising discount factors for future earnings.

As we have noted over the past month, this environment of stock market positivity was driven by the expectation that the pandemic and its restrictions is gradually ebbing away, opening the path for an outsized economic catch-up rebound all the while central banks keep bond yields stable. However, the ebbing away of the pandemic also means the inevitable phasing out of the government and central bank support that bridged the past year's economic void. This introduces a significant – and potentially unnerving – period of transition, when the economy will have to stand on its own feet again.

Markets have already priced in much of the good to come from the pandemic really being behind us – at least in the west – and there may not be much patience if things do not improve in a straight upward line.

To be clear, it is our central case that the peak of the pandemic is now well behind us, and economic growth lies ahead, but we also expect to see bumps and humps on the way. For one, it has to be recognised that only the UK's public health has so far successfully weathered the onslaught of a far more infectious variant against a widely vaccinated population, while the rest of the world is still where the UK was only six weeks ago – reopening as the rate of infection has declined to very low numbers. It is entirely possible that the rest take their insights from the benign impact on the public health this latest COVID wave has had on the UK, but it is just as conceivable that once infections there rise again, those in charge of public health react with renewed stringent restrictions out of fear that their lower vaccination rates make the UK experience unapplicable.

This is just one example of the uncertainties that lie ahead as we transition to the post-pandemic environment, and it will make it very difficult for politicians and central bankers to calibrate the pace of withdrawing support. All the while, capital markets will fret over whether the remaining support level are too much – stoking inflation and yields – or too little, undermining the economic outlook and corporate earnings.

Our relatively positive outlook is anchored on two things. First, even as variant scares temporarily slow progress, vaccines have forced the pandemic to retreat. As a consequence, the strong economic bounce back is set to continue, even if there may be the odd setback in the process. Second, central banks are determined to avoid letting inflation pressures (that come with a strong rebound of demand against a not yet fully operational supply side) deter them on their path back to sustained economic growth. This should mean corporate earnings continue to grow as strongly as currently expected, supporting markets, while yield levels should remain contained – thereby not undermining equity valuation levels either.

But to quote ex-US defence secretary Donald Rumsfeld, who passed away at 88 last week, there are "known unknowns" and "unknown unknowns" to be mindful of. Just as in his assessment of terrorist threats back in 2002, we can only take into account the known unknowns and steer our investment management actions accordingly. The potential blows of the unknown unknowns are the risks investors have to mitigate through their personal investment risk profiles and resultant asset allocations – as the first quarter of 2020 so starkly reminded us.

Global half-time review

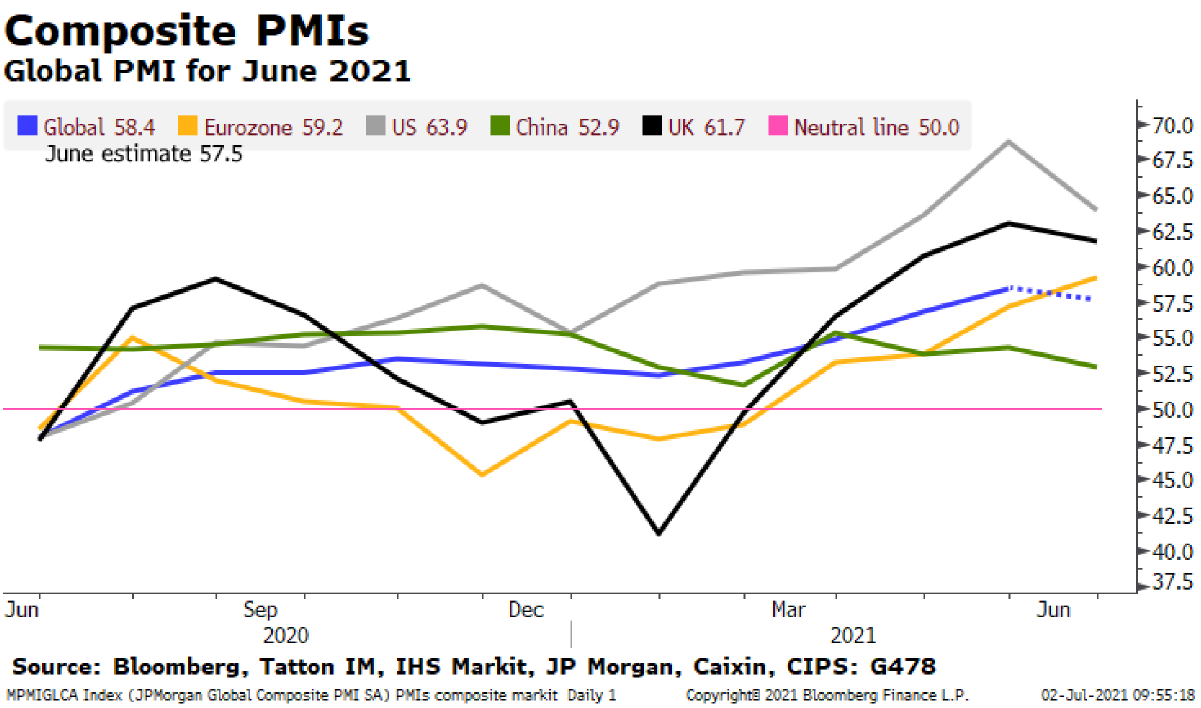
The jubilant scenes across England last week (or was it schadenfreude?) made for a nice ending to what was at times a miserable first half of the year. Even with cases rising on the back of a surging Delta variant, the vaccine rollout has all but ensured the next six months will not be as dreary as the earlier part of 2021. This positive outlook has found its way into equity markets, with major indices continuing their rally throughout the developed world. But for investors, the last six months have been overwhelmingly positive. Buoyed by the promise of rapid vaccinations and reopenings, capital markets looked through the early difficulties this year, and ahead to the strong economic recovery set to come.

This means that, with the recovery underway, markets are already at, or close to, their all-time highs. In normal times, a bout of growth (and subsequent inflation) would result in tightening monetary policy from central banks. And yet, central bankers around the world have been at pains to reassure the public they will keep rates low, and liquidity flowing, for the foreseeable future. Last week, Bank of England Governor Andrew Bailey used his Mansion House speech to hit back at claims from dissident ex-chief economist Andy Haldane, that policy would need to tighten. Bailey's confidently dovish tones are matched by those of his global peers and – perhaps more importantly – it looks like capital markets fully believe them.

This dovishness is not because central bankers are privately worried about the health of the recovery. Rather, it seems that monetary policymakers want to keep interest rates below the rate of inflation well into 2022. As we wrote at the beginning of the year, this would allow the global economy to get the full benefit of the recovery, without sapping away growth into increased savings.

This is important for equities, as it decreases the discount factor that gets applied to future earnings. And it leaves stock markets in a good position in the short to medium term; company earnings are expected to trend strongly upward into next year and beyond.

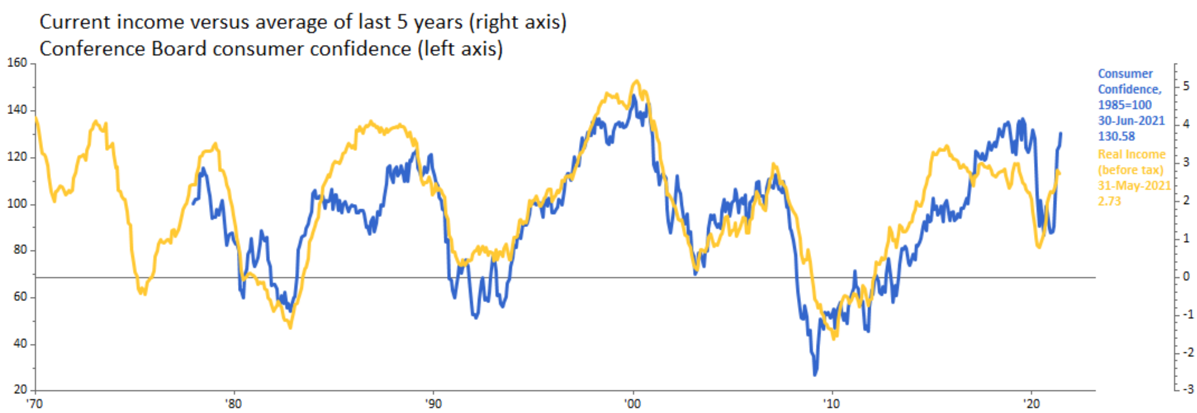
What's more, the recovery is no longer a long-term promise but a near-term reality. This can be seen most clearly in the latest business and consumer confidence surveys. Purchasing managers indices (PMIs – a measure of business sentiment) are coming in at very strong levels. The composite measures may have peaked but remain at strongly expansionary levels in the developed West. Asia is less buoyant, with China's policies being notably tighter.



For Europe, much of this has been driven by an easing of restrictions, with very positive consumer sentiment a particular highlight. Even those sectors relatively less affected by lockdowns are feeling upbeat.

In the US, consumer confidence has yet to return to pre-pandemic levels, but indicators suggest it is well on the way, albeit still with room for consumers to grow more confident. Though unemployment has fallen drastically from its pandemic peak, there is still some way to go before we reach the full employment target set by the US Federal Reserve (Fed) – despite many reports of difficulties securing workers. The chart below shows how important employment and wage growth is to consumer sentiment. Confidence levels are anticipating a strong job market and rising wages, and that is, in our opinion, likely to be the case.

US Consumer Confidence and Income



Source: Factset, Tatton IM, BEA, Conference Board

Labour market dynamics will be key to the next phase of the global recovery. In this respect, things differ either side of the Atlantic. Many European Union (EU) nations have 'automatic stabilisers' for unemployment benefits that kick in in times of stress – meaning they had to resort to smaller emergency support measures than in the US. Redundancies were therefore much less widespread in Europe, which could affect how people feel about their medium-term prospects.

This time, though, employment income does not tell the whole story. The US government unleashed a wave of fiscal support to help see Americans through the pandemic, meaning that despite an unprecedented uptick in unemployment, actual *disposable* income was largely maintained. As we have noted before, consumers on the whole managed to build their savings throughout the pandemic, leaving them with better balance sheet positions in aggregate than at the beginning of 2020.

On this basis, overall income levels saw a big jump throughout the pandemic. And yet, consumer confidence levels tracked downward. This is likely due to consumers being wary of their prospects through lockdowns and beyond, preferring to keep their extra money saved away.

That fiscal support is already beginning to fade as the economy opens up, and many commentators have feared we may be approaching a 'fiscal cliff' in the US if emergency measures are withdrawn too quickly or in a haphazard way. What this tells us is, once again, that the jobs market will be vital from here on. If things continue to improve, it could well motivate consumers to use their ample savings – greatly increasing demand. If things stall, they could become more fearful.

What it also tells us, however, is that the economy has been surprisingly resilient throughout the pandemic. The initial wave of lockdowns last March shook the world, but both businesses and the public seem to have taken the second (and in some cases third) waves of the virus in their stride. With an increasing sense that we are on the way out of the crisis, we should expect this situation to improve.

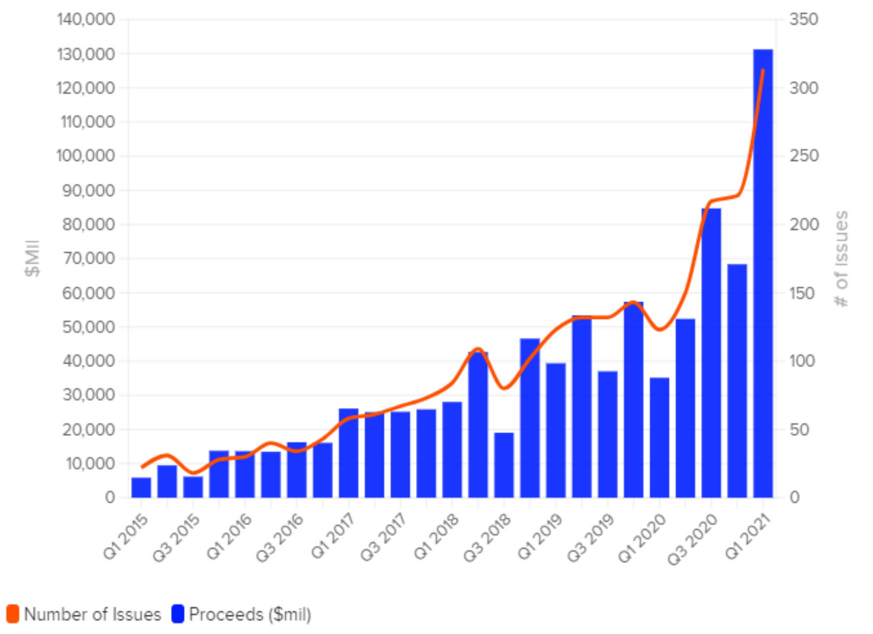
For markets, the main fear is that this positivity could lead to a premature tapering from central banks. On this, we note that the current transition period does create an air of uncertainty – which might make markets more sensitive to 'central bank speak'. We believe policymakers will ultimately want to lift their economies onto a sustainable growth path, but any signs of tweaks of policy have to be digested by the market. So, market reactions could be a bit choppy during this transition period.

This is not to say markets are in store for ever greater gains. As we go forward and into next year, historically low bond yields will be difficult to maintain while the economy is going strong – and an uptick in bond yields has the potential to make things difficult from a valuation standpoint as discussed at the beginning. But we are comforted by the fact that the real thing that would worry investors – faltering growth expectations – looks wholly unlikely.

Green Bonds oversight

One of the more notable capital market trends of the last few years is that investors are increasingly going green. We have seen this in the popularity of environmental, social and governance (ESG) investments among the retail crowd – Tesla's astronomical performance last year being a prime example. We wrote last week about the growing size and maturity of carbon trading markets, which force polluters to buy emission allowances and have become a genuine asset class of late. Another facet of this growing market environmentalism is what happens in debt markets.

Green bonds – bonds whose proceeds are earmarked for environmental projects – have grown exponentially in size and popularity over the last few years. In 2020, total issuance of green-labelled bonds was the highest it has ever been, and that record looks set to be broken again this year, after Q1 delivered the highest quarterly issuance on record. Funds devoted to green bonds have also gained traction, with $4.7 billion flowing into green bond funds in 2019, followed by $10 billion in 2020. Like many other ESG investments, the push to clean up capital markets' environmental footprint is making green bonds increasingly mainstream.



Source: Refinitiv Deals Data An LSEG Business REFINITIV

To give some background, green bonds were created to fund projects that aid the fight against climate change. The exact way they do this can differ, but it usually involves proceeds from bond sales being devoted to green projects – such as clean energy, emission reduction or sustainable building. They are closely linked to social bonds, where funds are used to cover social projects (loosely defined to cover things like affordable housing, clean drinking water or education). Likewise, so-called sustainable bonds are those where capital is raised for a combination of green and social projects.

The guidelines on green bonds were established in 2014 by the "Green Bond Principles" agreed by a consortium of investment banks. The principles emphasise transparency as a key part of the green bond market, imploring issuers to provide accurate information about how funds are used and the impact of projects. Two things need to be pointed out about the guidelines however: first, they are voluntary, and second, the exact meaning of 'green' is left to issuers to decide.

These points might call into question the eco credentials of the green bond market – especially considering recent concerns over 'greenwashing' by companies. There is no requirement to stick to the guidelines, and even if issuers do comply, there is much dispute over how green their standards really are (the current debate around the EU's classifying biomass as 'renewable' being a good example).

For now, though, it is hard to see how an alternative regime would function, due to the lack of overarching regulatory clarity on various technicalities. It is difficult to enforce involuntary rules without an exact agreement on what those rules are or should be. By the same token, without a multinational framework, issuers have little choice but to define project standards themselves. Here at least there has been some progress, with the Climate Bonds Initiative providing a sector-specific list of green definitions with help from scientists and industry experts.

Whatever the case, these problems have not affected the popularity of green bonds among investors, and they are increasingly seen as a good way to add environmental impact to a portfolio. Over the last few years, green bonds have also been shown to add returns over their standard bond counterparts. The Bloomberg Barclays Global Green Bond Index performed 0.6% better per year on average over the last three years. This has little to do with the relative benefits of green projects, though, and more to do with the structural makeup of the index. For example, green bonds had a steeper sell-off in March 2020, due to the larger presence of corporates relative to governments, but that same corporate presence drove greater returns later in the year.

Once confounding factors are stripped out, the green bond universe *should* perform roughly similarly to its conventional counterpart. This is because green bonds are priced according to the usual credit rating of their issuer, and so bonds from the same issuer will not be affected by their label. After all, while the funds that issuers get from bond sales might be earmarked for specific projects, the money to pay back the loan can come from any part of their balance sheet. This is designed to ensure green bonds are flat priced – that investors have no additional credit cost – while still delivering an environmental benefit.

Although green bonds are sold on the same credit profile as conventional bonds, there are still extra transaction costs involved. These come from the fact that issuers have to track, monitor and submit reporting on how the bond proceeds are being used – all of which is expensive. This boils down to a problem common to any kind of ESG investment: Oversight is always needed to ensure promises are actually being honoured. This is especially pressing when you consider reports that around 20% of green bonds do not fulfil the environmental obligations they are supposed to. This is a potential area for active management to be a differentiator, particularly in terms of the underlying green credentials of a portfolio of these bonds.

But oversight can eat into investment returns. In 2020, 89% of green bonds came with external reviews to check environmental standards, up from 82% the year before – but these reviews incur costs. For issuers of green bonds, the money spent on reviewing might well be outweighed by the benefits that come with the green label – from marketing opportunities to a wider investment base – all of which can add returns.

Investors do not have those same return benefits, however. To be clear, this is not to say that green bonds are not worth it – far from it – but only to point out that, where ethical or environmental concerns come into investment, they can interfere with straightforward returns. For those who want their capital to do more than just generate returns, this is often a price worth paying, but it is nonetheless something green investors need to remember.

Global Equity Markets

Market	Fri 16:21	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7123	-0.2	-14	→	↗
FTSE 250	22758	+0.5	+112	→	↗
FTSE AS	4066	-0.0	-2	→	↗
FTSE Small	7387	+0.5	+40	⬀	↗
CAC	6550	-1.1	-73	⬀	↗
DAX	15637	+0.2	+29	→	↗
Dow	34695	+0.8	+261	→	↗
S&P 500	4334	+1.3	+54	⬀	↗
Nasdaq	14564	+1.4	+204	↗	↗
Nikkei	28783	-1.0	-283	⬀	↗
MSCI World	3028	+0.1	+3	⬀	↗
CSI 300	5081	-3.0	-159	↗	↗
MSCI EM	1368	-0.8	-11	↗	↗

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.3	19.1	13.5	14.1
FTSE 250	2.0	17.9	24.3	15.6
FTSE AS	3.1	18.8	14.5	14.3
FTSE Small x Inv_Tsts	1.7	17.4	-	15.2
CAC	2.2	25.7	18.0	14.8
DAX	2.3	18.5	15.4	13.4
Dow	1.7	21.5	20.1	16.3
S&P 500	1.3	27.4	22.7	17.4
Nasdaq	0.6	33.5	33.3	22.6
Nikkei	1.5	18.0	19.2	17.6
MSCI World	1.7	24.6	20.6	16.4
CSI 300	1.7	17.5	15.7	12.4
MSCI EM	1.9	15.1	14.5	12.5

Top 5 Gainers

Company	%
Hikma Pharma	+5.5
Informa	+5.4
AVEVA	+4.4
Pershing Square Holdi	+4.0
Melrose	+4.0

Top 5 Decliners

Company	%
Burberry	-9.0
London Stock Exchange P	-4.9
BT	-4.8
Prudential	-4.0
Rolls-Royce	-3.9

Currencies

Pair	last	%1W
USD/GBP	1.380	-0.6
GBP/EUR	0.859	+0.1
USD/EUR	1.18	-0.7
JPY/USD	111.28	-0.5
CNY/USD	6.47	-0.3
Bitcoin/$	33,475	+2.6

Commodities

Cmdty	last	%1W
Oil	75.96	-0.3
Gold	1784.9	+0.2
Silver	26.42	+1.2
Copper	428.5	-0.2
Aluminium	2512.0	+3.0
Soft Cmdties	454.3	+3.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.71	-0.07
UK 15-Yr	1.05	-0.07
US 10-Yr	1.44	-0.09
French 10-Yr	0.09	-0.10
German 10-Yr	-0.24	-0.08
Japanese 10-Yr	0.05	-0.00

UK Mortgage Rates

Mortgage Rates	#VALUE!	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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5th July 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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