CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

2 August 2021

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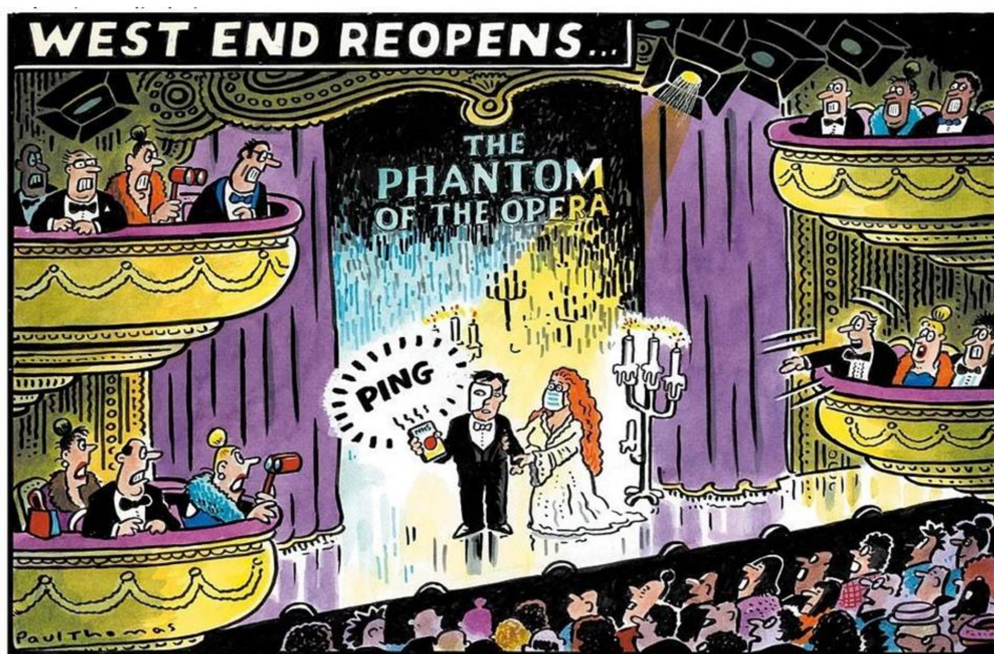
2nd August 2021



'It's Lloyd Webber's new version: The Phantom has to self-isolate beneath the opera house'

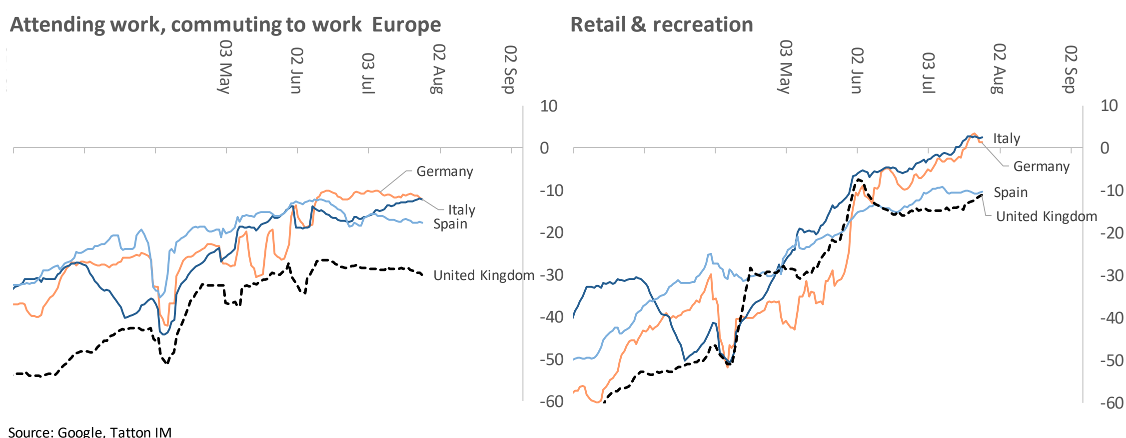
Curtain raiser, Paul Thomas, 29 July 2021

Summer lull as markets go through the motions

We wrote last week that fortunes could be changing on the COVID front, with UK case numbers showing a decline from their (possibly temporary) peak. Since then, the 7-day average for daily cases has fallen for the first time since Britain started reopening. It is far too early to say whether this marks a sustained turn for the better, but it has certainly brought some much-needed optimism. The good mood has spread to markets too, with UK assets outperforming global peers and sterling gaining against other currencies.

Despite the government's 'Freedom day', things are only slowly returning to normal. Google's mobility data shows the flow of Britons back into offices is still weak relative to the beginning of 2020 – though the UK had more centralised working in its major cities than other European nations. Some of this will undoubtedly be down to seasonal effects – with the summer holidays in full swing and workers enjoying the sunshine. We have noticed on our own team that holidays are being taken enthusiastically – something the government will have no doubt hoped for, to limit the virus spread, as restrictions are eased.

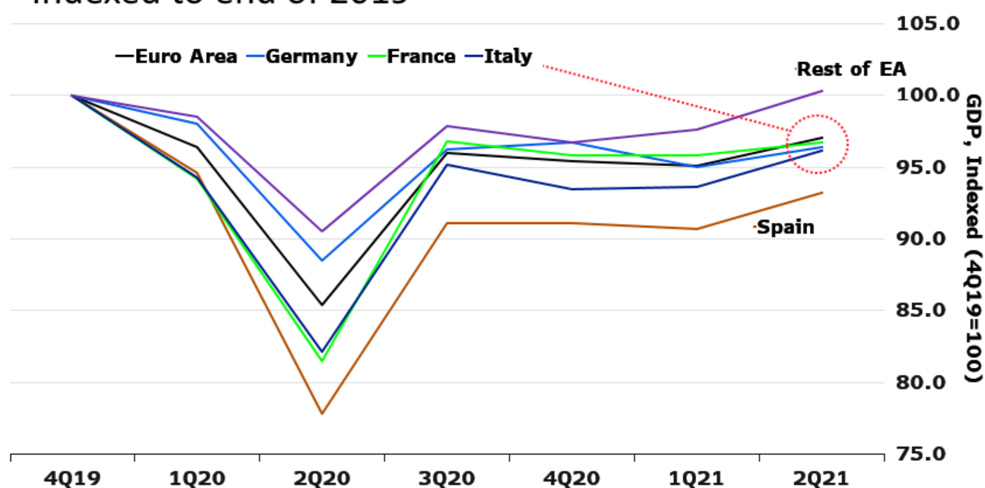
We will, therefore, have to wait before making any firm conclusions about what the post-pandemic future will look like, at least as far as office life goes. Still, it does certainly look for now that some commuters are reluctant to brave the roads and trains.



Source: Google, Tatton IM

That seems to be symptomatic of the wider economy which, despite the opening up and market positivity, has yet to fully click into gear. Britain's retail and recreation sectors appear to be lagging European counterparts, despite nearing population-wide vaccination rates.

That said, being close behind our continental neighbours is not such a bad thing, given the impressive economic rebound happening in Europe. Eurozone growth is continuing its recovery from the pandemic trough, with growth levels matching the US. JPMorgan noted last week that economic sentiment in Europe has jumped this month to the highest level since data collection began in 1985. This backs up the impressive sentiment surveys we saw last week, which recorded high levels of business and consumer confidence.



Source: Bloomberg, Tatton IM, Eurostat

Gains were led by Europe's three largest economies, Germany, France and Italy, where vaccine programmes are picking up pace. Infection rates spoiled the mood in other parts of the European Union (EU), as some countries with sharp increases in cases – such as the Netherlands – are reporting declines in growth. Spain countered this trend though, posting a gain in July, albeit not to the same extent as Europe's other major economies.

Manufacturing saw strong output expectations, with a new record low on the inventory index. Low stocks will support the recovery once supply constraints ease, with businesses gaining more pricing power. In the services sector, the forward-looking indicators look more mixed. The same is true for retail and consumer confidence, pointing to areas that may well take some time to get into the post-pandemic groove. Even there though, confidence is high in absolute terms, though employment intentions eased down from previously strong levels.

Other signs are good: capacity utilisation rose in both services and manufacturing, consistent with the improvement in output. On the flipside, we are seeing dramatic supply shortages in everything from staff to equipment and materials. This is a theme across virtually all developed economies, with reports of tight labour supply in the US, UK and Europe. For the Eurozone, quarterly readings probably hide an improvement after the end of June, and it is notable that shortages were reported before the start of the pandemic, which had only limited impacts on wage growth.

In the US, growth came in weaker than expected. This is likely down to the supply shortages we mentioned, with businesses finding it increasingly difficult to source goods and employees. Inventories were depleted in the latest data, and net imports rose substantially. Just like in the EU though, the restocking process should become a strong driver of growth in the second half of this year.

Whatever the case, the world's largest economy is now running at a reasonable pace, coming down from the stratospheric levels we saw earlier in its recovery. This slowing of US growth has impacted bond markets, with investors now putting less upward pressure on yields. This normalisation will give the US Federal Reserve (Fed) some leeway in pulling back its bond purchases. The July meeting showed Fed members inching towards this process, but August will likely see more firm proposals floated.

The slowing of growth expectations – together with the Fed's continued bond purchases – is having a huge impact on real (inflation-adjusted) yields. US Treasury yields have sunk to new depths in real terms, and their impact is spreading to other inflation-linked bond markets. Japan's real yields have similarly fallen. Real yields are a vital piece of the puzzle for any investment outlook, helping set expected returns relative risk and, therefore, having a big impact on price-to-earnings ratio.

Equity markets are therefore being supported by the fall in real yields. This comes despite a lacklustre quarterly earnings season compared to the last three quarters. Amazon, one of 2020's big winners, posted results below analyst expectations, leading to a 5% fall in price. Earnings expectations rose significantly when the growth outlook started improving earlier this year. They're still improving, but at a more normal rate, in line with the robust economic activity. It may feel slow, but compared to the 2013-2019 period, it will also remain robust through the rest of the year.

However, real yields are low compared to that likely robust real economic growth. As was the case in 2013, those low yields allow the Fed to act. They can taper in the expectation that real yields may rise, but still remain negative out to five years. This would be less supportive for equity markets and the Fed will have to be careful the rise does not become disorderly. Should it manage this well, earnings growth will remain intact, offsetting the yield rise. Nonetheless, it could mean tougher times ahead for equity markets, and they may spend some time treading water.

Last, but certainly not least, the biggest investment story of the week came from China, where the government decided to effectively turn its entire private education sector into a non-profit. This hurt a number of Chinese stocks with listings abroad, which we detail in the next article. From a broader perspective, scare stories like this one are not good news during a summer of thin trading volumes. With many away on their holidays, liquidity remains low. However, markets did rather well in last week's test, so perhaps we shouldn't worry greatly.

China's risks could bring greater reward

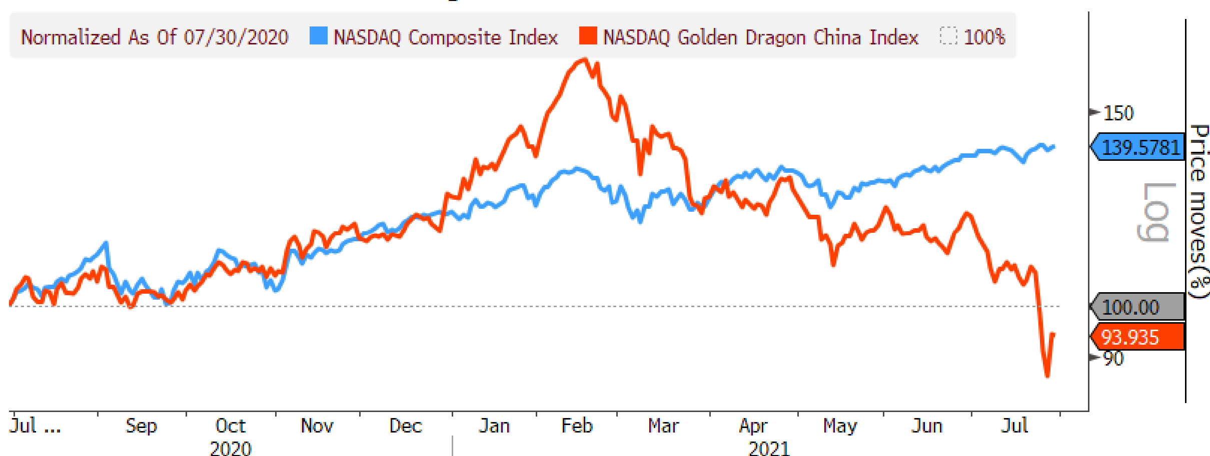
You have probably heard that the Chinese word for crisis is composed of symbols for both danger and opportunity. While this is a mistranslation, as well as being something of a cliché, nevertheless for investors, China has often proved the site of much danger and even more opportunity. The commotion in the Chinese education sector last week highlights the risk and reward pairing, but for the wrong reasons.

Private education has been one of China's biggest growth stories of the last few years, and that has attracted swathes of investors, especially from overseas. The sector was also one of the pandemic's big beneficiaries, with vast growth in online teaching and after-school tutoring propelling valuations of edu-tech firms. That all changed, when Bloomberg published a leaked report ahead of last weekend's announcement from Beijing. The sweeping reforms barred companies that teach the school curriculum from making profits, raising capital or going public.

Authorities say the move is designed to ease the burden on children and parents, address growing inequality and overhaul an education system that has been "hijacked by capital". Affected firms have all publicly supported the government's decision, but there is no doubt how devastating the change is for the $100 billion industry. Share prices in the three largest US-listed education companies – TAL Education, New Oriental Education and Gaotu Techedu – all plummeted during the previous Friday's trading, with further declines coming last Monday. TAL, which was valued at $59 billion in February, sank to $4 billion on the weekend.

The sell-off spread far beyond the education sector. China's big tech companies – many of whom are heavily invested in education and have faced their own confrontations with regulators – all saw sustained falls throughout the week. Major equity indices fell sharply in both Hong Kong and the mainland, with investors fearing a broader regulatory clampdown which could destabilise corporate China's profitability.

China-based NASDAQ stocks versus main index



Source: Bloomberg, Tatton IM: G516

CCMP Index (NASDAQ Composite Index) Golden Dragon BN Daily 30JUL2020-30JUN2021 Copyright© 2021 Bloomberg Finance L.P. 30-Jul-2021 12:06:27

Judging from media and market reaction, international investors are clearly in panic mode. Fears are centred on a particular legal structure that foreigners use to invest in Chinese companies, known as Variable Interest Entities (VIEs). These are essentially contracts between domestic Chinese firms and specially created offshore shell companies, whereby the latter agrees to reflect the former's books. Since foreigners are often not allowed to own certain Chinese companies outright, these provide a loophole for international capital to flow into corporate China. Access to VIEs is precisely what Beijing has banned for education firms, prompting concerns of a wider backlash against companies using them.

There are two deeper anxieties underlying the story. First, markets are concerned that Beijing is attacking VIEs as part of a wider campaign of financial decoupling – that China wants to boot out foreign capital and go its own way. Second, investors are worried that the education clampdown marks a return of hard-line Maoism. That is, investors fear that the Communist Party is turning against private property itself.

We have not seen anything to suggest these fears are justified. It is true that Beijing has stepped up its regulatory action this year, with a particular focus on large tech companies like Tencent and Alibaba. Moreover, it is almost certain this is being driven by the government's distaste of powerful private entities, and Xi Jinping's desire for tighter central control. But there is a world of difference between those aims and wholesale isolationism – let alone a rejection of profit altogether.

On the contrary, the Communist Party has been extremely eager to bolster profitability in recent months, loosening credit conditions and continuing its fiscal push for strong growth. Chinese regulators said as much themselves last week. Officials held a call with global investors, Wall Street executives and Chinese financial groups to reassure them the education ban was an isolated incident. Even if we wrote those promises off as cheap talk, the point stands: why would the government try to reassure BlackRock, Goldman Sachs and JPMorgan if it was uninterested in foreign capital? Equity markets certainly took the call as a good sign, with Chinese shares rebounding later in the week.

None of this is to say that the Party's penchant for intervention is good for investors. There is a myriad of reasons why President Xi might want to clamp down on private education firms, clawing back power and influence from private or foreign actors, addressing societal inequalities and diverting capital from a sector it might see as ultimately adding little value. Whatever reasons the Chinese government had, they clearly took precedence over the straightforward encouragement of external investment.

Those priorities could easily take precedence again, to the detriment of Chinese companies. The harder the Communist Party pushes for its objectives, the higher the risk that policy will be misinterpreted or over-extended. A similar situation occurred in 2018, when seemingly anti-market measures led to fears about the direction of China's reforms. Officials were haphazard in their policy application, leading to unintended consequences and a market sell-off. Many of those ingredients are present now, ensuring that policy mistakes have become a significant risk to consider for owners of Chinese assets. Those at the top of the Communist Party are not financial technocrats, and we have seen time and again how their directives at the national level can be detrimental for businesses. This increases the risk of policy mistakes at the macro level, all of which must be taken into account when evaluating the case for Chinese assets.

But profitability and the encouragement of foreign capital is still important to Beijing. If policymakers can increase profits while maintaining the government's broad policy goals, they will do so. Unlike in 2018, officials are working hard to offset any negative consequences by allowing interest rates to fall and reassuring investors. The background risk of default is also different, with credit conditions improving on last year. The current hype around VIEs shows how this can be a force for good. Beijing is upping its regulatory scrutiny of companies' foreign listings, but in doing so will likely end up granting official recognition to the VIE structure – which until now has existed only as a loophole. These changes increase the risk of disruption in the short term, but arguably lay the groundwork for a more stable investment landscape in the future.

China is pushing hard and fast for regulatory reform. The process is scaring international investors and some of that fear is a justified re-evaluation of the underlying risks. But this should not detract from the long-term story of Chinese growth, which may indeed be helped by the government's reforms. As such, the more pessimistic that markets feel about China, the more its assets may present an opportunity. Investing in Chinese equities right now would justifiably feel very risky. But the lower China's valuations sink, the higher the potential reward. For investors, crisis might well mean danger and opportunity after all.

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2nd August 2021

Global Equity Markets

Market	Fri 15:09	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7051	+0.3	+23	→	↗
FTSE 250	22973	+0.4	+90	→	↗
FTSE AS	4039	+0.3	+14	→	↗
FTSE Small	7342	+0.5	+35	→	↗
CAC	6642	+1.1	+73	→	↗
DAX	15600	-0.4	-69	→	↗
Dow	35024	-0.1	-38	→	↗
S&P 500	4409	-0.1	-3	⬀	↗
Nasdaq	14694	-1.0	-143	↗	↗
Nikkei	27284	-1.0	-264	↘	↗
MSCI World	3090	+0.6	+17	⬀	↗
CSI 300	4811	-5.5	-278	↘	↗
MSCI EM	1295	-1.2	-16	↘	↗

Top 5 Gainers

Company	%
Fresnillo	+10.3
Anglo American	+9.0
Rentokil Initial	+6.7
Royal Dutch Shell	+6.5
Royal Dutch Shell	+6.3

Top 5 Decliners

Company	%
Reckitt Benckiser	-12.0
Weir/The	-9.4
Intertek	-8.5
Smith & Nephew	-5.9
BT	-5.5

Currencies

Pair	last	%1W
USD/GBP	1.394	+1.4
GBP/EUR	0.852	+0.5
USD/EUR	1.19	+0.9
JPY/USD	109.67	+0.8
CNY/USD	6.46	+0.3
Bitcoin/$	39,037	+13.2

Commodities

Cmdty	last	%1W
Oil	76.36	+3.0
Gold	1825.4	+1.3
Silver	25.53	+1.4
Copper	451.0	+2.3
Aluminium	2591.5	+4.4
Soft Cmdties	449.3	-0.7

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	16.7	13.0	14.1
FTSE 250	2.3	17.2	24.3	15.7
FTSE AS	3.2	17.2	14.0	14.3
FTSE Small x Inv_Tsts	1.8	17.7	-	15.3
CAC	2.2	25.7	17.6	14.8
DAX	2.4	16.4	14.8	13.4
Dow	1.7	19.8	19.3	16.3
S&P 500	1.3	26.0	22.3	17.4
Nasdaq	0.6	31.9	32.7	22.7
Nikkei	1.6	16.5	17.9	17.6
MSCI World	1.6	23.4	20.4	16.5
CSI 300	1.8	16.6	14.6	12.5
MSCI EM	2.1	13.8	13.6	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.57	-0.02
UK 15-Yr	0.87	-0.01
US 10-Yr	1.23	-0.05
French 10-Yr	-0.10	-0.01
German 10-Yr	-0.45	-0.03
Japanese 10-Yr	0.02	+0.00

UK Mortgage Rates

Mortgage Rates	Jul	Jun
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.37	1.43
3-yr Fixed Rate	1.64	1.69
5-yr Fixed Rate	1.60	1.65
10-yr Fixed Rate	2.58	2.58
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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