CAMBRIDGE
INVESTMENTS LIMITED

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Climbing the wall of worry - again

August continues to be what one would expect from the middle of the summer: quiet. Yet for investors, it is also pleasing that stock markets around the world are gradually nudging upwards, allowing them to remain relaxed wherever they have retreated to in these travel restricted times.

US stock markets have even been hitting highs again. Normally, this would feel like an exceptional time, but then sometimes our perceptions play tricks on us, and perhaps it is not as exceptional as some media commentators make it sound.

The table below shows the S&P 500, and how many days in a specific year it hit an all-time high. For 2021 the count is already at 47, and there have only been four years with new high days above 50: 1961, 1964,

The decades of S&P 500 daily highs - how many days in the year had a new all-time high

	1920	1930	1940	1950	1960	1970	1980	1990	2000	2010	2020	
0							24	6	4		33	
1					52			22			47	... annualised = 77 !
2						32	2	18				
3					11	3	29	16		45		
4				26	**62**			5		53		
5				46	37		43	**77**		10		
6				14	9		31	39		18		
7	1				14		47	45	9	**62**		
8	53			24	33			47		19		
9	43			27			13	35		35		

Source: Bloomberg, Tatton IM, Mirabaud - S&P 500 starts at the end of 1927

1995 and 2017. The 1990s run lasted 11 years, ending with the dot-com period. Should history repeat, or at least rhyme, and we are in the midst of the same, there is another three years to go.

Of course, such runs invariably come to an end, the great unknown, as always. As our regular readers know, we at Cambridge prefer to look at the economic and corporate earnings fundamentals and view past precedence and graph patterns only as sentiment influencers of the speculative parts of the markets. The phrase "climbing the wall of worry" was used frequently several years ago, but it seems entirely apposite again now.

Just like at previous similar waypoints in the past, we are entering a period of transition in this cycle of global economic expansion. We have most likely come to the end of a short period of very rapid and exceptionally high rates of corporate earnings growth, as economic activity bounced back, following the gradual lifting of pandemic restrictions. Growth is expected to continue, even if the sheer rate of growth will not be sustained at the high levels seen in the first half of the year. This should continue to provide a solid base for risk asset prices, so long as sudden moves in the bond markets do not upset the fine balance between sustained growth, and the relative valuation metrics that bond yields so heavily influence.

In this regard, capital markets appear to also have been shifting gear. There seems to be an acceptance that central banks may be right in their view that the current elevated levels of price inflation will prove temporary (more on the underlying argument in a separate article this week). This is evidenced by the textbook insight of negatively correlated bond and equity markets being re-established.

Nevertheless, transition periods when fast economic acceleration gives way to a more moderate pace of growth have also historically been choppy for investors, as sentiment is more likely to gyrate between confidence and fear. This is a particular issue for the richly-priced US equity market – particularly its mega-cap growth stocks – which is particularly vulnerable to a meaningful rise in government bond yields.

So, if and when the global growth momentum moderates, there is a risk that investor sentiment sours temporarily – at least until the fragile equilibrium between corporate earnings yields, and government bond yield levels, reasserts itself.

The global political class appears also ready to reassert itself, having seemingly grasped the historic opportunity to reaccelerate the world's economy back to a higher level of growth. There now seems the willpower to address the many areas of public underinvestment of the previous decade, be that basic infrastructure, education and professional training, or addressing the threats of man-made climate change.

In the European Union (EU), the fiscal investment programme under the 'NextGenerationEU' recovery plan is gaining momentum, as money is raised in capital markets. While not amounting to multiple trillions, like the proposals of the US administration of President Biden, it currently comes with a higher probability of being implemented.

Compared to the relative calm and quiet of European politics, in the US, legislators on Capitol Hill were working overtime to get their stimulus programme – or at least parts of it – on the way. We dedicate a separate article this week to the topic of Biden's stimulus packages, and their potential impact over the coming months. Unfortunately, there are still considerable political hurdles to be overcome and plenty of drama potential ahead, which is likely to stimulate more market choppiness than economic activity.

When we all return from our (non-traditional) summer breaks this September, we will gradually find out where things stand. Perhaps the transition will be towards much slower mid-cycle growth, or even a growth blip, or perhaps collective political will, combined with increasing business confidence, can open up a much more enticing recovery path for the remainder of the year. Until then, the current calm in markets is both rational and welcome.

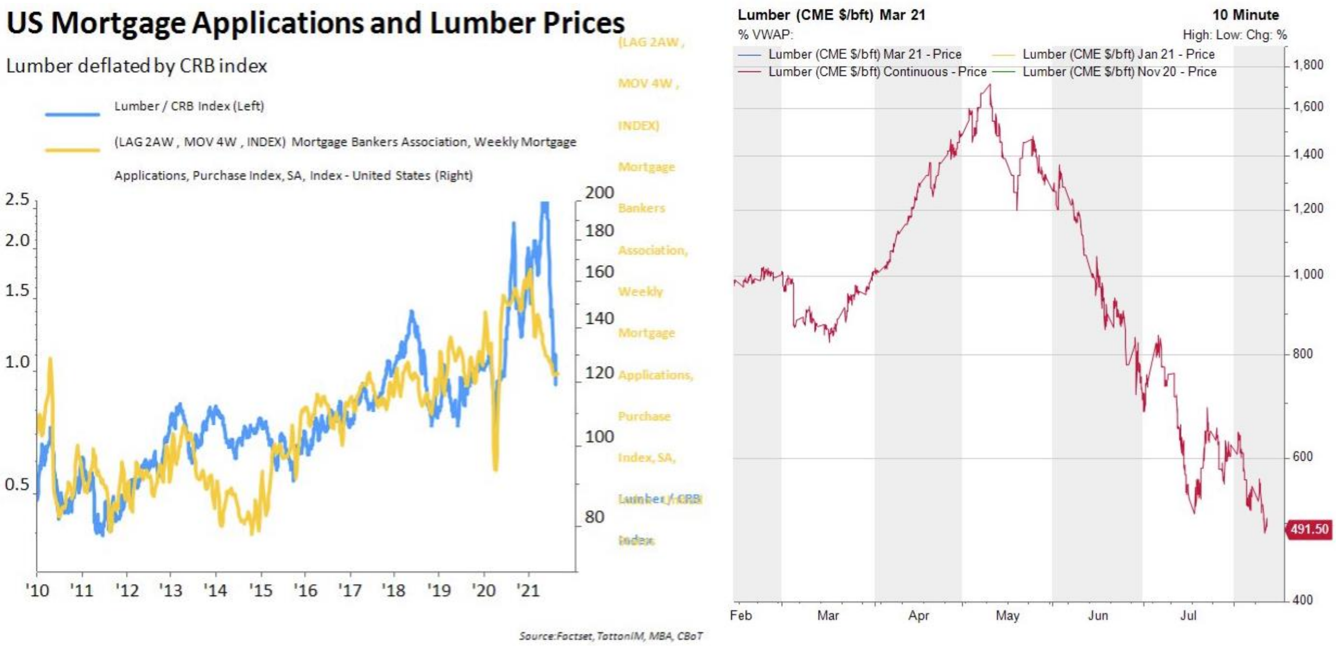
The transitory inflation argument

Given how often we have mentioned inflation in the Cambridge Weekly this year it will not be much of a surprise to readers that many see it as the main investment topic of 2021. With vaccines rolled out but supply disruptions still a widespread issue, market attention has once again turned to prices in the post-COVID world. Given the current backdrop this makes sense even to the lay investor – central banks all over the world are pinning down interest rates and pumping vast amounts of monetary liquidity into their economies. The US government, meanwhile, is touting a $4.1 trillion fiscal package to support growth (covered in the next article). All of this while the public emerges from lockdown having substantially built up savings, and businesses struggling to source workers at every turn.

House prices have been an inflation showcase this year. In the UK, the suspension of stamp duty helped support the market, while US housebuilders are reporting being unable to meet demand. Median prices on newly-built American homes reached $361,800 in June, 6.1% higher than a year ago, while housebuilders are reporting huge increases in sales volumes. This is despite the fact that the housing market did not experience a particular downturn during the pandemic, that would give rise to a bounce-back scenario. The flurry of activity is boosting share prices for builders. The S&P Select Industry Housebuilders Index has rallied 31% so far this year, outpacing the wider S&P 500's 18% gain.

Demand is supported by historically low long-term bond yields that improve affordability by pinning down mortgage rates, as well as the rising working from home arrangements pushing more people out of the cities into larger rural homes (see the US mortgage application chart on the left-hand panel below). These factors contributed to new home sales reaching multi-year highs at the end of 2020 and beginning of 2021. But while demand has certainly been strong during the recovery, the price jumps have much more to do with supply issues than anything else.

In fact, major housebuilders have sold more houses this year than they are able to build, creating waiting lists for new builds. Builders are now playing catch-up, and many have resorted to halting sales until more supply can be made available. Construction company D.R. Horton saw its sales fall 17% last quarter from a year earlier, after it was forced to stop selling homes it could not build. The situation is unprecedented for many in the industry. According to D.R. Horton chief executive David Auld: "We're managing through a market that none of us have ever seen," Supply problems encompass everything from labour shortages to an undersupply of materials and land. The incredible moves in US lumber prices seen earlier in the year are symbolic of these difficulties. Futures contracts for lumber reached an all-time high of $1,671 in May, as strong housebuilding demand clashed with various bottlenecks in the supply chain, such as wildfires across Canada, difficulty moving inventories, and a general shortage of US sawmill processing capacity. Builders' wood supplies became severely restricted and prices rocketed.



These are specific issues for the housing and lumber markets, but they echo issues we are seeing everywhere. There is a well-documented shortage of workers in the US, Europe and UK, as restaurants and hospitality businesses report being unable to find enough staff – particularly as many workers have to isolate. Equally well-reported has been the global shortage of microchips, having severe knock-on effects for everything from phones to the used car market. In Britain, you can see the severe impacts of these shortages just by going to the supermarket.

Despite ubiquitous supply issues, though, most of these come more from specific exceptional circumstances. With the Delta variant still causing severe problems across the world, such issues could continue for some time (evidenced by elevated shipping prices and China's recent (part) closure of a major port). But however bumpy these disruptions are, they are only temporary, and prices can be expected to normalise once suppliers adjust their supply chains to the risen demand.

Lumber is again a good example. Supply issues have eased substantially in recent months, causing prices to fall just as quick as they rose earlier in the year. Lumber futures are now at around $500, less than a third of the May highs (See the right-hand panel in the above chart). We have seen some anecdotal evidence that US-based companies bought a great deal of lumber from Europe which, despite causing its own supply issues on the continent, has eased the American shortages. Difficulties could still lie ahead, as the US government is reportedly considering increasing tariffs on Canadian wood, but prices are likely to remain around current levels.

Global supply issues are partly down to post-COVID teething problems, along with a host of standalone factors. The pandemic has had a big impact on how global supply chains are organised, and those changes will take time to work out. Ultimately, though, the substantial inflation numbers we have seen recently should prove transitory. Shifts occur in any transition period, and adjusting to the post-pandemic world is certainly that. As we have stated here before, we entered the COVID pandemic period with a latent global oversupply issue, paired with lacklustre demand holding back growth. So, once things settle, supply bottlenecks should ease.

Therefore, for the longer-term, we prefer to focus on the demand side to assess growth potential versus lasting inflationary pressures. On that front, the shortages seen in US markets are a positive sign. Despite US demand causing supply issues in Europe, the fact that US consumers and businesses are purchasing more than they can produce will support the global economy by effectively exporting demand – and thereby growth. The growth emanating from the US can then be used to lead a strong cyclical recovery in other regions.

This does mean, though, that the US current account deficit – money flowing out minus money flowing in – is likely to increase. We should expect this factor to put downward pressure on the value of the dollar over the medium term. A weak dollar is almost always supportive for global growth – particularly in emerging markets – which are further helped in such a scenario by stronger global growth lowering risk aversion, which often leads investors to consider non-USD assets. With any luck, it will create a healthy economic environment for when the much-discussed transition period ends.

US politics risk slowing the pace of the recovery

US politics can be a slog. Lawmakers in the US Senate debated the Democrat's budget resolution for 14 hours. Senators voted on 47 non-binding amendments during the marathon debate, as politicians on both sides piled on everything – from major legislative revisions to pet projects and symbolic gestures. Actually, 14 hours is rather a short time for such major legislation. The two central pieces of Biden's $4.1 trillion economic agenda made it through, though one had a much harder time than the other.

At the beginning of last week, a ten-year $1 trillion infrastructure bill, constructed by politicians from both parties, was passed with bipartisan support, in a rare show of agreement between Democrats and Republicans. It contains $550 billion of new spending and no tax increases. For more detail, please view this link. The blueprint for a larger $3.5 trillion plan squeaked through along party lines, and therefore much narrower margins. All 50 Democrat senators backed the plan, while 49 Republicans rejected it.

These are, at first glance, big positives for the US economy. Investors have been salivating over the prospects for Biden's fiscal plans since he entered the White House. The hope is (and was) that a huge boost of spending would not only propel America's recovery but also make the economic expansion more sustained, which would ensure a durable positive outlook for businesses. On that front, the plans seem to offer more than was even expected. According to Goldman Sachs, the budget outline includes more in debt-financed spending: $1.75 trillion over a ten-year period, when other analysts had expected only a $1 trillion boost.

Before getting too excited, we should point out that the vote was on a budget resolution, rather than a budget bill *per se*. While it does pave the way for a substantial increase in US Treasury spending, this is a long way from final passage. Budget resolutions are not new laws or policy programmes, but they can include ‘reconciliation’ measures which allow policy committees in Washington to effect spending and revenue.

While reconciliation measures are limited, the Democrats think they still give enough room to implement the President’s spending plans. The House of Representatives will be next up to vote on the resolution, something Speaker Nancy Pelosi has scheduled for 23 August. Republicans are expected to be set against the package, and so Democrat leaders will need nearly all of their lawmakers on board, given their party’s thin majority. If and when that hurdle is cleared, lawmakers in both chambers will write detailed proposals for the mammoth spending package, which will need to be voted on before anything becomes law.

If everything proceeds smoothly, the Democrats will instruct the various committees in the House and Senate to make specific proposals, with a non-binding deadline of 15 September. The resolution gives room for $1.7 trillion in spending, plus whatever amount that tax-writing committees can offset with tax increases or changes to Medicare. Analysts expect the Democrats will be able to agree around $1.5 trillion in tax increases, but even in that case, an extra $300 billion worth of budgetary offsets would need to be found.

There is some potential disappointment – and risk – for investors. Neither of the deals passed last week include any measures for changing the US national debt ceiling.

The debt ceiling is a legislative limit on the amount of outstanding debt the Treasury can have, and it has been a political football – and major market headache – many times over the years, because it requires support of 60 senators, rather than a simple majority of 50. When agreements on raising the ceiling cannot be reached, the Treasury fails to meet all its payment obligations. This has caused government shutdowns on several occasions and, at its worst, has threatened to push the world’s largest economy into (temporary) default. Any serious spending plans will need to raise or suspend the debt ceiling, making its omission uncomfortable for markets.

Congressional Democrats will have other chances to change the debt limit, but they need to act fast. The last day of September marks the expiry of the current debt-limit suspension, enacted in 2019. In order to keep government agencies running, lawmakers must either reach deals on all spending bills or enact a stop-gap bill. Republicans have already stated they have no intention on cooperating on raising the debt limit – which substantially raises the prospect of trouble up ahead.

It is virtually unthinkable that policymakers – even by Washington’s standards – would allow the government to default on its debt for what is essentially a point-scoring exercise. But there is a real possibility of disruption in early October, including a short government shutdown, and some fear has already spread in bond markets.

Even without a genuine shutdown, that fear could have negative impacts on capital markets should it continue. US Treasury yields have climbed over the past couple of weeks, but that is probably not because of the prospect of a bitter political battle. Over the slightly longer term, political obstinance could have the opposite effect on bond markets. Republicans have made it clear they will stand in the way of increasing deficit spending, and not all Democrats are on board with it either. But US yields are already close to historic lows, thanks to the extreme efforts of the Federal Reserve. If the Treasury ends up issuing less debt than currently expected, it could lead to an undersupply of bonds, which could force yields down.

Any constraint on the US government's ability to borrow is also a constraint on its ability to support growth. So, hampering fiscal spending will likely also have an impact on economic expectations. This could affect everything, from businesses' confidence to their ability to raise debt themselves, culminating in a dampening of the US outlook.

Of course, amid these looming troubles, we can still take heart in the ambitious fiscal plans. Gestures toward fiscal largesse, particularly in terms of infrastructure investment, will be taken well by markets. But political obstacles and a potential debt ceiling crisis would be bad news for the US economy, particularly with the recovery still fragile. It is certainly in no one's interest to create a crisis – but that unfortunately has not stopped US politicians before.

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16th August 2021

Global Equity Markets

Market	Fri 15:49	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7213	+1.3	+90	→	↗
FTSE 250	23810	+1.5	+353	↗	↗
FTSE AS	4143	+1.3	+54	→	↗
FTSE Small	7581	+1.5	+111	⬀	↗
CAC	6887	+1.0	+70	⬀	↗
DAX	15959	+1.3	+198	⬀	↗
Dow	35527	+0.9	+319	⬀	↗
S&P 500	4462	+0.6	+26	↗	↗
Nasdaq	14823	-0.1	-13	↗	↗
Nikkei	27977	+0.9	+249	⬂	↗
MSCI World	3116	+0.6	+18	⬀	↗
CSI 300	4946	+0.5	+24	↘	↗
MSCI EM	1291	-0.1	-2	↘	↗

Top 5 Gainers

Company	%
Flutter Ents	+12.2
Informa	+7.4
Aviva	+7.2
Prudential	+6.7
Admiral	+5.4

Top 5 Decliners

Company	%
Hargreaves Lansdown	-9.0
Rio Tinto	-6.6
Just Eat Takeaway.com N	-4.9
M&G	-4.9
Evraz	-4.7

Currencies

Pair	last	%1W
USD/GBP	1.385	-0.1
GBP/EUR	0.851	-0.4
USD/EUR	1.18	+0.3
JPY/USD	109.87	+0.3
CNY/USD	6.48	+0.1
Bitcoin/$	46,467	+5.9

Commodities

Cmdty	last	%1W
Oil	71.07	+0.5
Gold	1773.4	+0.6
Silver	23.76	-2.3
Copper	442.0	+1.6
Aluminium	2582.5	-0.2
Soft Cmdties	467.2	+3.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.5	16.0	13.0	14.1
FTSE 250	2.3	17.4	24.7	15.8
FTSE AS	3.3	16.0	14.0	14.3
FTSE Small x Inv_Tsts	1.8	15.7	19.0	15.3
CAC	2.1	22.6	17.1	14.9
DAX	2.3	15.0	14.8	13.4
Dow	1.7	20.4	19.5	16.4
S&P 500	1.3	25.5	22.3	17.5
Nasdaq	0.6	31.1	32.5	22.8
Nikkei	1.6	15.1	17.7	17.6
MSCI World	1.6	22.3	20.2	16.5
CSI 300	1.7	16.9	15.2	12.5
MSCI EM	2.1	15.3	13.5	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.58	-0.04
UK 15-Yr	0.86	-0.03
US 10-Yr	1.31	+0.01
French 10-Yr	-0.13	-0.01
German 10-Yr	-0.47	-0.01
Japanese 10-Yr	0.03	+0.02

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.30	1.37
3-yr Fixed Rate	1.52	1.60
5-yr Fixed Rate	1.48	1.56
10-yr Fixed Rate	2.58	2.58
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

If anybody wants to be added or removed from the distribution list, please email
enquiries@cambridgeinvestments.co.uk

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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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