CAMBRIDGE
INVESTMENTS LIMITED

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Lothar Mentel

Lead Investment Adviser to Cambridge

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Global political leadership, Patrick Blower 22 Sep 2021

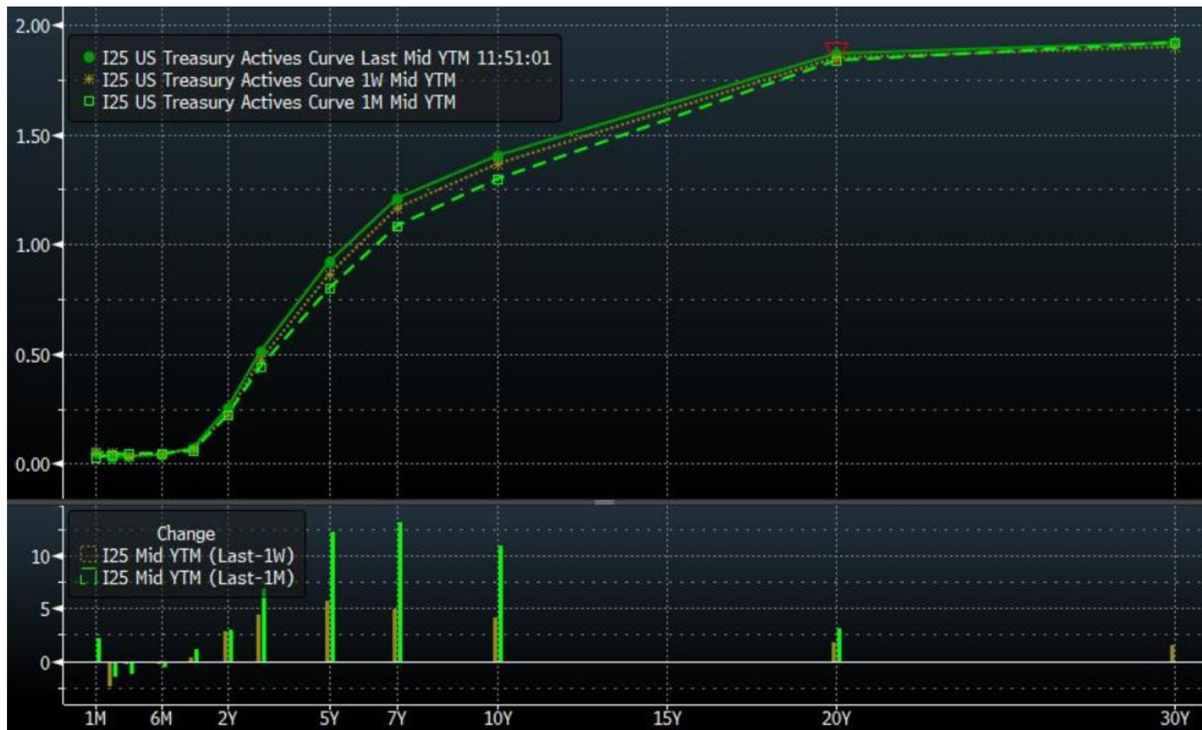
Wall of worry time

The UK received worrying economic news on multiple fronts last week, with several utility companies going under and the prospect of steep rises in winter heating costs, petrol stations running out of fuel, gaps on supermarket shelves, and the Bank of England signalling it may raise rates as early as December of this year. Globally, the news flow was not much better, with economic data confirming slowing rates of growth, and the imminent demise of China's largest property developer, causing journalists to cast their minds back to the Global Financial Crisis. If that was not disturbing enough, the US Federal Reserve (Fed) announced it will likely begin tapering its COVID-induced asset purchase programme (QE) before the end of the year, and then rapidly drive down future purchases to zero by the middle of 2022.

Against this unnerving backdrop in economic and central bank news flow, investors may have been surprised at how relatively unfazed stock prices (and capital markets more broadly) traded over the week. After falling sharply last Monday, stock markets recovered over the course of the week, and have merely continued their skittish sideways to slightly down movement that we already observed the previous Friday. Almost more important for investment managers though, was the stability in bond markets. Given the excited talk of a looming global credit market meltdown, and then central bank policy error, there was precious little movement in neither credit spreads nor the yield curve.

While the lack of movement in credit spreads tells us there is little expectation that contagion will spread from Evergrande/China around the world, the marginal steepening of the yield curve in the US (see chart below) tells us that capital markets are in broad agreement with central bankers that monetary stimulus

should and can be reduced from where we stand today, without undermining the longer-term growth outlook. This can be seen as evidence that central banks are succeeding in signalling confidence in the sustainability of recovery, which is positive as it stabilises the set of expectations that guide planning of all actors in the economy.



US government bond yield curve, 24 Sep vs. 1 week and 1 month ago; Source: Bloomberg, TattonIM

We cover the Evergrande story in detail in a separate article this week, which lays out the repercussions a default could have. The Chinese authorities are acting rationally if they let the company go under, despite the negative economic impact of a company of its size, as they are seeking to steer their economy onto a more diversified and stable economic growth path. However, their continued clampdown on the technology sector – further emphasised on Friday by declaring handling all cryptocurrency as illegal – makes us wonder how this suppression of creativity aligns with their aim of increasing China's domestic productivity (rather than export volumes) through a major innovation drive. Our belief that China will contribute little to incremental global growth this year and next has been further underpinned, but we note also that the Chinese authorities will continue to be forced to stimulate their economy, which should help to clear supply bottlenecks.

Returning to the unpleasant domestic news, the Bank of England has a reputation of talking hawkishly while acting dovishly. The fact it said it would continue its programme of extraordinary monetary easing – while at the same time tightening through an interest rate rise – has us wondering whether this is more of a warning shot towards the government. Given current upward price pressures are predominantly the result of labour shortages and regulatory failings in the energy sector, the government has the levers for remedial actions at its disposal.

Short-term pragmatism around work visas would go a long way in this respect, instead of dogmatically insisting on a longer-term solution of redeploying people to the workforce who have in the past not shown the required flexibility.

Taking a further step back, much of the current stress in the economy and supply of goods and services stems from supply bottlenecks which in market economies are usually temporary, unless unsuitable regulatory frameworks or physical destruction make it hard for entrepreneurs and businesses to 'follow the money'. In the current global environment – still disrupted by the pandemic – this may take a little longer. But given there was no physical destruction to productive resources, governments are at task to temporarily lower the regulatory hurdles that work well when flows of goods run smoothly, but now constitute obstacles.

Heeding the advice from experts to "fix the roof while the sun shines" and prepare for energy supply disruptions by maintaining more than seven days' worth of natural gas reserves, is another learning that politicians may want to take away from the exceptional price volatility that has driven the UK's energy sector to the wall. We would suggest that a mismatch of regulatory framework versus physical market reality is what caused last week's UK utility crunch, rather than a failing of markets. Those who remember the fall of Northern Rock at the dawn of the Global Financial Crisis may have already seen the parallels of being permitted to sell long-term fixed price contracts while being fully exposed to short-term price fluctuation (asset-liability mismatch), but without being required to hold the capital required to cover the losses should the 'bet' go wrong.

Let us close this week's reflections by turning to the next possible source of worries: Germany's general election yesterday, where voters decide on a new leader for their country. Given the fragmentation of the political party spectrum in Germany (as in most of Northern Europe) replacing Angela Merkel after 16 years in office will not be a straightforward affair. Various coalition permutations will be possible and have already been discussed, but the consensus seems that there will not be another 'grand coalition' between the Christian Democratic Union (CDU) and Social Democratic Party of Germany (SPD) just right and left of the political centre. We can therefore expect concern this week about German politics becoming a destabilising rather than stabilising factor in Europe. However, if the last 70 years are anything to go by, regardless of what shape the coalition ultimately takes, this seems rather unlikely.

Evergrande, challenge to Chinese leadership not Lehman's moment

Evergrande's 'riches to rags' story seems to be reaching its final chapter. The Chinese developer was the most valuable property company in the world a few years ago; now it is on the brink of bankruptcy. Its Hong Kong-listed shares have sunk more than 80% this year, and the sell-off shows no signs of letting up. Another sharp drop on Monday left the company's shares at their lowest since 2010, while its borrowing rates have shot in the other direction. Evergrande is likely to default on some of its bond payments imminently, putting a big question mark over its USD 300 billion worth of liabilities. There are doubts over Evergrande's ability to honour its interest payments due this month, let alone the USD 669 million in coupon payments for the rest of the year.

Evergrande's fall from grace has been spectacular. Synonymous with China's rapid growth over the last few years, rolling out high-rise apartments across the country for the rising middle class, it has now become a cautionary tale about China's bloated credit bubble. Many of those apartments were sold long before they were built, and rapid construction was fuelled by an eye-watering debt leverage ratio. Evergrande is one of China's biggest issuers of offshore US dollar bonds, and some sources put its liabilities at 80% of its total assets.

The firm's huge debt pile – and its large share of the Chinese property market – have led to widespread fears of financial contagion. Western commentators have labelled this China's "Lehman Moment", comparing it to the Lehman Brothers collapse that catalysed the global financial crisis. These worries have weighed down broader Chinese equities for weeks, but those fears have now spread – at least temporarily – to US stocks, with the S&P 500 experiencing its worst fall in months on Monday.

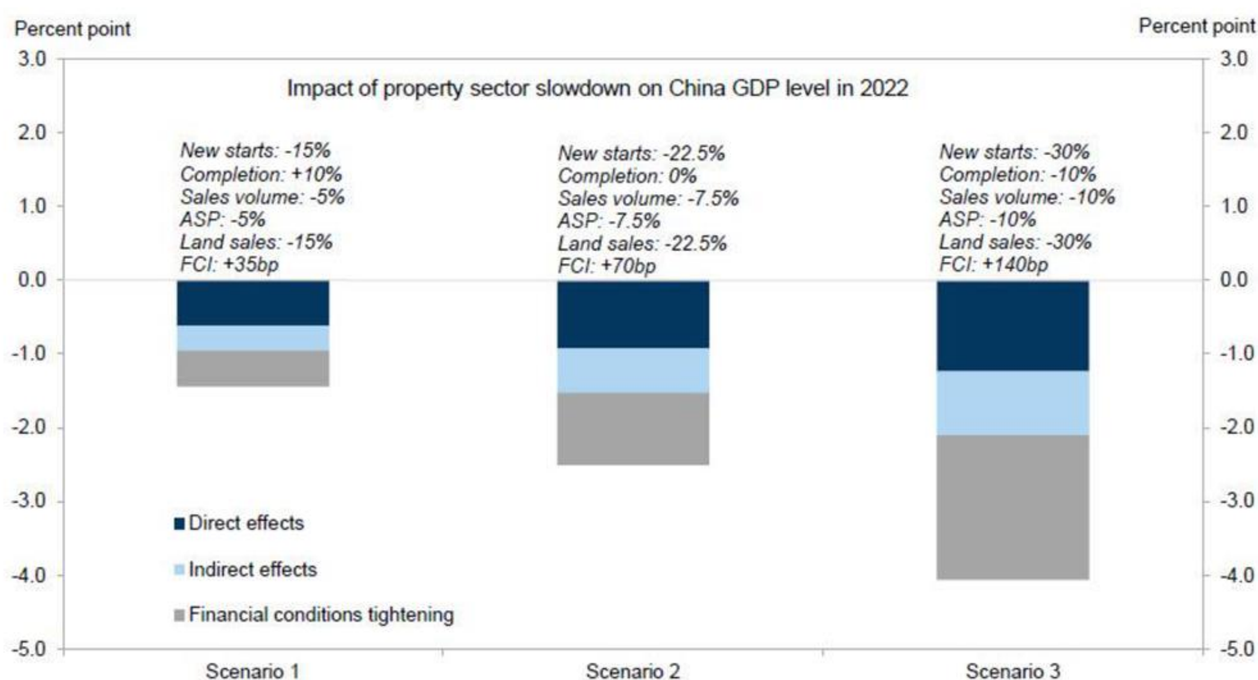
Fortunately, the Lehman comparison is far-fetched. As a large financial institution, Lehman's had a complex and highly speculative portfolio, with a network of creditors that stretched to every corner of the global system. Once people realised its assets were full of hot air, it left a hole in the world's financial fabric. Evergrande's assets and liabilities are far simpler and more tangible: most of its debt is in bank loans and bonds, and it appears to be less wrapped up and layered in structured products.

Not all of the asset unwind will be straightforward. Evergrande reportedly also sold wealth management products to retail clients to the tune of $6 billion, and sold unfinished property projects which attracted substantial anger from the Chinese public. The process to wind down Evergrande will be long and messy – but this is the nature of over-indebted entities. The key element is to contain contagion, as there is little one can do for the entity itself. At the same time, authorities – be it in the West or China – are mindful of moral hazard. Bailing out creditors too generously may set a bad example for similarly troubled companies, while being too firm leads to unnecessary social costs. The real risk in our view is that Chinese authorities, eagerly sticking to President Xi's common prosperity goal, overplay their hand on the moral hazard component.

China's state-run financial system makes bank runs and private financial collapse hugely unlikely. The People's Bank of China (PBoC) has an array of tools to ease general credit fears, and in the worst-case scenario the state can effectively force financial institutions to lend to one another. Officials in Beijing have shown they are willing to let investors in overreaching companies take a big hit but would not allow widespread financial collapse. Those negative on China have predicted many Lehman moments over the years, but like all of them, we suspect this one is exaggerated.

Of course, that is not to underplay the threat. China's property market accounts for 20% of its overall GDP, and around 60% of household wealth, and Evergrande is a systemically important player. The Chinese government will not want to let the crisis get out of hand, but debt cancellations – particularly for foreign investors – are likely. This could lead to further defaults from US dollar bond issuers, which would be a sign of systemic risk. Aside from the knock-on impact on investment, disruptions to the property sector will be a dampener on Chinese growth, all while the country still struggles to recover from the pandemic. Indeed, this may be the main take-away from the Evergrande story: China is in the middle of redefining its growth drivers and endeavours to becoming more independent from the property market. This year alone, it appears more than 400 new property regulations have been introduced (Goldman Sachs quoting Centaline), and in the midst of it, Evergrande restructures. Contagion into the rest of the World and

especially other emerging markets would likely come through in the form of diminished Chinese import demand and lower commodity prices.



Source: Wind, Haver Analytics, World Input-Output Database (2015), Goldman Sachs Global Investment Research

Construction and credit expansion have been a huge part of China's growth over the last few decades – generating a huge amount of demand and giving China a larger share of global growth than the US. In recent years, policymakers have become increasingly worried about the property sector. Developers have not only racked up massive debts, but have also built so many properties that China now has enough empty homes to house 90 million people. This has increased market nervousness that this could turn the property market from a driver of growth to a drag on it.

That is what led Beijing to introduce its "Three Red Lines" last year, mandating that property developers keep a 70% ceiling on liabilities to assets, a 100% cap on net debt to equity and maintain a one-to-one ratio of cash to short-term borrowing. Evergrande fell foul of these criteria – resulting in it no longer having access to local debt. Policymakers will most likely now sell off Evergrande's parts to other companies or local developers, allowing a serious hit for debt holders and possibly a total loss for shareholders.

There is an odd contradiction in Beijing's property policy here, though. While the state is clearly extremely concerned about debt and long-term stability, it is also worried about rapidly rising property prices and waning affordability. Letting Evergrande fail might help the former, but it is likely to exacerbate the latter, as the remaining developers refinancing will become more expensive as a result. Indeed, for all the talk of property oversupply, rising prices – particularly in the major cities – suggests the opposite problem.

These considerations lead us to two conclusions: First, whatever default Evergrande undergoes is likely to be orderly in the sense that contagion needs to be contained, with the PBoC injecting cash to ease wider liquidity problems. Second, and more generally, we suspect that the negative growth effects will lead to greater fiscal and monetary stimulus further down the line to counter the effect. Beijing has been cautious throughout the pandemic recovery, trying not to fan the credit flames any further, but doing so now could create extreme economic pain – something the Communist Party is usually desperate to avoid.

Markets will surely go through their ups and downs in assessing the Evergrande fallout. In the short term, answers to many questions may only come forward sparingly, especially as the first week of October is a national holiday in China, during which markets will be closed and authorities will be much less likely to intervene. It therefore makes sense not read too much into any short-term moves. Ultimately, the Communist Party will not let Evergrande spoil things for much longer.

US debt ceiling – an unwelcome evergreen

Political brinkmanship can be rather unpleasant for investors – and indeed the public. In the UK, we got a taste of it many times during Brexit. , but in the US, it is a part of the political fabric. Due to America's peculiar fiscal set-up, policymakers in Washington are required to vote to raise the country's debt ceiling – which puts a hard limit on Federal government spending, regardless that this spending was already given legislative approval through the annual budget. The perennial back and forth over spending measures is often a cause for concern for investors, and it is that time of year again.

On Tuesday, Democratic lawmakers in the House of Representatives passed a bill to extend the debt limit until the end of next year. The legislation will have a much harder time in the Senate though, where at least ten Republicans would need to back it for the bill to pass under normal measures. In the House, almost all Republicans voted against the budget policy, a sign that virtually no one is prepared to break party lines.

Without raising the debt ceiling, the US Treasury will be unable to meet its obligations and another government shutdown is likely to ensue.

US government gross debt as a percentage of GDP with IMF projections to 2026; Source: IMF, Bloomberg

The debt ceiling should be a relatively mundane legal tool. Changing the limit does not authorise any new federal spending, and it was originally designed to streamline the process of government borrowing. Before the first world war, Congress had to authorise all individual borrowing, even for bills lawmakers already passed. The debt ceiling automated this process and, for most of its history, raising its congressional limit was a rubber-stamping process.

That changed during the Obama years, when Republican lawmakers became hostile to virtually any action by the Democrats. Confrontations forced government shutdowns in 2011 and 2013. During the former, S&P downgraded the US government's credit rating for the first time in history – leading to a broad re-evaluation of asset prices and a short but sharp equity market sell-off. Concerns of a repeat led to a suspension of the debt ceiling in 2019 that lasted until July this year, with the US Treasury suspending investments in federal retirement funds to preserve its cash.

Despite these issues, markets have tended to see debt ceiling confrontations as storms in teacups. Lawmakers are aware that stopping payments to federal employees and defaulting on Treasury debt has viewed by the electorate as an incredible act of self-sabotage. Democrats are hoping that, as usual, this will be enough to force Republicans to back down. This time could be different though.

In the background are President Biden's ambitious fiscal plans, which include a proposed USD 3.5 trillion in extra social spending, measures to combat climate change and a slew of tax increases. Republicans are wholly against these plans and worry that buckling on the debt ceiling would imply their tacit consent.

Republicans are not the only ones with reservations either. Centrist Democrats in the House and Senate are reluctant to back the new tax and spend measures in their current form, demanding a smaller package with more modest tax increases. Moderates are also pushing for a separation of Biden's proposed plans on infrastructure and social care spending – something the left wing of the party has been opposed to, although this position seems to be softening.

The more fiscally-conservative Democrats will likely be confident they can achieve compromise, given the pushback from Republicans – and the looming threat that the latter could gain control of the House in next year's midterm elections. Some analysts estimate that compromise could push the total spending down as low as USD 1.5 trillion, which would be paid for over the long-term through modest tax increases.

Crucially, the 'costed' part the plans may ultimately not include climate change spending. This is because a sizeable faction of Democrats are proposing to exclude climate spending from the tax raise using 'dynamic scoring'. This is where policymakers factor in the net effect on growth – and hence tax revenues – to argue a policy is budget neutral. Republicans have used a similar tactic to justify tax cuts (The trickle-down theory espoused by multiple Republican presidents, for example), but the argument here is somewhat different. Rather than claiming climate investment will yield strong returns, Democrats argue that the cost of inaction on climate change would be so high that something must be done regardless of tax rises.

Republicans may not like that move, but will have a hard time arguing against it given their previous use of the tactic. In any case, it may be enough to break the internal logjam in the Democratic Party and motivate lawmakers to push through.

However, we suspect centrist Democrats might be overestimating their negotiating position. While Republicans are traditionally against budget deficits, they have shown over the last few years that their main concern is taxation. Fully-costed plans mean higher taxes in the long term. At the same time, many Republican-controlled states are likely to be big beneficiaries of increased spending, whether through infrastructure (and other) investment, or much-needed disaster relief.

This means we could see a peculiar situation in the next few weeks, with Republicans pushing for an increase in the budget deficit, while right-wing Democrats push for more modest and costed plans. Progressive Democrats would likely be on board with the former proposal and, given Biden's preference for bipartisanship, that could be the route his party opts for.

That would mean increased fiscal spending, with less of a hike in short-term taxes than initially thought. Judging by the recent mood in capital markets, investors now seem to expect that scenario. It would certainly be a positive for long-term growth. Debt ceiling debates are likely just a negotiating tactic in this wider discussion. The only problem is whether brinkmanship could spoil market sentiment in the meantime. We think that is unlikely, but it is a risk.

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27th September 2021

Global Equity Markets

Market	Fri 15:52	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7062	+1.4	+98	→	⬀
FTSE 250	23639	-0.1	-20	↘	↗
FTSE AS	4068	+1.1	+45	↘	↗
FTSE Small	7544	+0.5	+37	↘	↗
CAC	6640	+1.1	+70	↘	↗
DAX	15526	+0.2	+36	↘	↗
Dow	34760	+0.5	+176	↘	↗
S&P 500	4445	+0.3	+12	↘	↗
Nasdaq	14985	-0.4	-59	↘	↗
Nikkei	30249	-0.9	-263	↘	↗
MSCI World	3106	+0.3	+10	↘	↗
CSI 300	4849	-0.4	-18	↘	→
MSCI EM	1273	-0.5	-7	↘	→

Top 5 Gainers

Company	%
Rolls-Royce	+20.8
Int'l Consol Air	+17.4
Entain	+13.3
AstraZeneca	+10.4
Royal Dutch Shell	+5.8

Top 5 Decliners

Company	%
Just Eat Takeaway.com N	-8.4
Kingfisher	-8.0
DS Smith	-4.9
National Grid	-4.8
Schroders	-4.6

Currencies

Pair	last	%1W
USD/GBP	1.367	-0.5
GBP/EUR	0.857	-0.4
USD/EUR	1.17	-0.1
JPY/USD	110.68	-0.7
CNY/USD	6.47	+0.0
Bitcoin/$	42,407	-10.9

Commodities

Cmdty	last	%1W
Oil	77.68	+3.1
Gold	1751.4	-0.2
Silver	22.42	+0.1
Copper	423.8	-0.2
Aluminium	2949.5	+2.4
Soft Cmdties	226.9	+2.2

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	15.5	12.5	14.2
FTSE 250	2.3	16.3	25.2	15.9
FTSE AS	3.7	15.4	13.6	14.3
FTSE Small x Inv_Tsts	1.9	13.3	19.1	15.4
CAC	2.2	21.2	16.0	14.9
DAX	2.1	15.6	15.3	13.5
Dow	1.8	19.5	18.8	16.4
S&P 500	1.3	25.2	22.0	17.6
Nasdaq	0.6	30.6	33.0	22.9
Nikkei	1.4	16.2	18.1	17.7
MSCI World	1.7	21.9	20.0	16.6
CSI 300	1.9	15.9	15.2	12.5
MSCI EM	2.4	14.0	13.3	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.93	+0.08
UK 15-Yr	1.13	+0.09
US 10-Yr	1.45	+0.09
French 10-Yr	0.11	+0.07
German 10-Yr	-0.23	+0.05
Japanese 10-Yr	0.06	+0.01

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	2.60	2.60
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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Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE