THE **CAMBRIDGE** WEEKLY

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Source: Matt, 27 Sep 2021

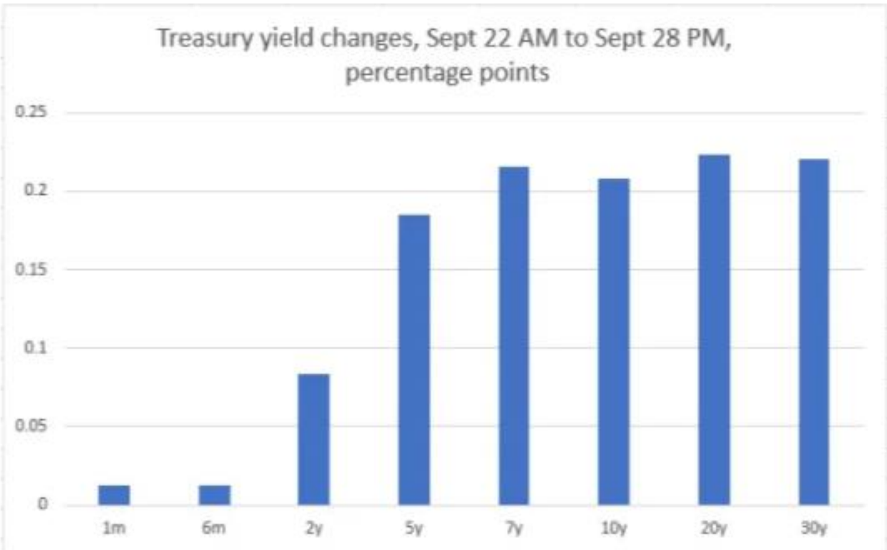
Rising yields are back

The energy bottlenecks we wrote about recently became rather more personal for the large proportion of the UK population that are motorists. In fairness, the UK's petrol station forecourt crisis has little to do with rising energy prices around the world, but with a more specific shortage of heavy goods vehicle (HGV) drivers, combined with the population's dwindling trust of UK institutions to foresee and resolve issues before they occur. This collective mistrust triggers the panic buying response, rather like with the toilet paper shortage of last year.

Source: Christian Adams, 29 Sep 2021

Nevertheless, a shortage of gas and oil around the globe leading to rising energy prices had commentators quick to drawing parallels with the 1970s oil shock. This was one source of debate amongst investors over the course of last week. More important, though, was that the topic of rising yields, which was making a comeback from Q1 of this year. This time, however, the narrative among equity investors was opposite. This time the reason cited for rising yields was not growth overheating, but the spectre of stagflation. As a result, stock markets ended September in just as unhappy a mood as they had been throughout the month.

This conclusion – fears of a faltering economic recovery due to more and more supply bottlenecks, coupled with rising prices, leading to persistent higher inflation – is understandable given the personal experiences of the last week. However, the bond market movements of the past week suggested quite a different narrative, namely that the rise of longer-term bond yields, rather than shorter ones (see chart below), confirms expectations of continued economic growth as expressed by central bank statements two weeks ago, while inflation pressure are seen as transitory.



Source: FT, 29 Sep 2021

Regardless, as we have noted here before, rising yields are seldom greeted positively by equity markets, so the month closed on a low for investors. Congruently with the bond markets though, the more yield-sensitive growth and tech sectors suffered more, while the long-unloved energy and cyclical value sectors fared relatively well.

So, despite the gloomy crisis talk, and stock markets having given back most of what they gained over August, the overall message was not an entirely negative one. The cyclical recovery is on track and with it a gradual upward normalisation of yields – even if there may be a bit of a hiatus over the coming months, as supply issues need to be resolved. Just as has been seen on the petrol garage forecourts, higher energy prices will dampen some of the joy of consumers returning to 'normal' public life and resumption of travel opportunities.

Significant factors in how well (or mediocre) the medium-term upswing turns out to be will include any changes in real earnings of the workforce (labour), and the extent to which business investment further reinforces demand and increases productivity levels in response to labour shortages. We cover this aspect in more detail in a separate article this week.

The other big story of last week was the German general election. As we anticipated, it did not turn into a market-moving event, despite the 16-year incumbent party losing out, after Angela Merkel decided to retire (the first time a sitting chancellor did not run again). The German electorate unequivocally voted for change, even though in a very German way: orderly and not too much change at once, please.

Most votes went to Germany's hitherto second-largest party, the left of centre Social Democratic Party (SPD). Its candidate for chancellor, Olaf Scholz, was Germany's finance minister during the pandemic under the grand coalition with Merkel's CDU. As well as representing continuity from the Merkel era, he also carried a bit of the 'Rishi Sunak' bonus, having been the politician seen to minimise financial hardship during the pandemic.

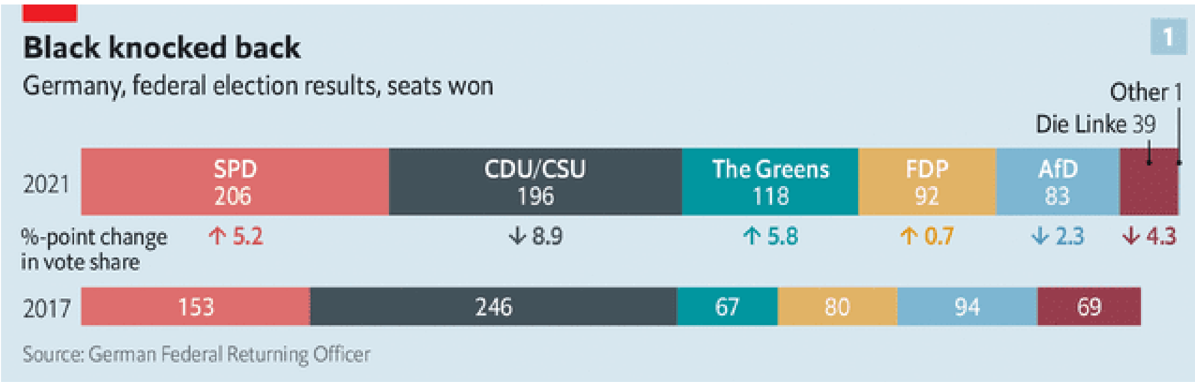
Furthermore, many young voters opted for the Green Party and the liberal-but-business-oriented Free Democratic Party (FDP), rather than for the more extreme outliers on the populist right and left (AfD and Die Linke). This makes a coalition between the SPD, Greens and FDP the most likely outcome of forthcoming coalition negotiations. If it indeed ends up that way, markets may be quite happy to see two forces for fiscally-driven change (SPD and Greens) being held in check by a party opposed to too much state intervention and tax rises. This sounds to us like an emerging change agenda the German way, which you can read more about in the next article.

Politics were also our closing point last week, with the US debt ceiling crisis temporarily averted –as we suggested in the article two weeks ago. As the crisis has not been resolved, markets have not (yet) rebounded in relief, but it is fair to say the downdraft in risk assets abated towards the end of last week.

As we said two weeks ago, such post-recovery periods that follow recession are often characterised colloquially as 'climbing the wall of worry'. But we take heart from last week's seeming shift in sentiment towards the cyclical recovery theme, even if the winter months may prove somewhat nerve-racking while supply chains are straightened out after the turbulences of the extraordinary efforts of keeping things 'on the road' during the pandemic.

Germany votes for change of the orderly kind

Germans want a change. That much is clear from last week's election result, which saw the ruling Christian Democratic Union (CDU/CSU) poll worse than ever before. Angela Merkel's CDU has ruled Germany since 2005, but claimed just 24.1% of votes on Sunday, a significant fall from the 32.9% achieved in 2017. Unfortunately, the exact change voters want is much less clear. The centre-left Social Democratic Party (SPD) won the greatest vote share, but at just 25.7%. This shows just how fragmented the electorate has become.



The Economist

Coalitions have been a permanent fixture of Germany's proportional democracy, but in the past the CDU and SPD garnered 80% of the vote between them and then entered a coalition with either the Liberal Democrats (FDP) or more recently the Greens (Die Grünen) as junior partners. Now, with the formerly two main parties only having 50% between them and four instead of just two smaller party factions beside them in the Bundestag, it could be a while before we know for sure which parties will form the government. Chancellor Merkel has led a grand coalition of the country's two main political parties for eight years, but the prospects of that continuing are ending with her reign. The SPD and CDU/CSU have just enough parliamentary seats together to form a majority, but both have said they do not want to continue their partnership. Olaf Scholz, the SPD candidate for Chancellor, has said the CDU should go into opposition after losing its top spot – and the grouping would hardly make good on Germany's call for change. Even combined, the parties failed to achieve a majority share of the vote.

Whatever government emerges is almost certain to include the next-biggest parties: the Greens and the Free Democratic Party (FDP, with yellow as the party colour). Both increased their vote share from 2017 (the Greens by an impressive 5.8% swing, making them the third-largest party in parliament, with 14.8%) and together represent more than a quarter of German voters. These are now the 'kingmakers' of German politics, and their respective leaders have been in talks last week about their plans for the next government.

This is odd for a few reasons. First, coalition talks are usually initiated by the winning party. That is the SPD, which greatly increased its vote share despite a rocky run-up to the election. Olaf Scholz (finance minister of the grand coalition) campaigned on a platform of personal leadership and Merkel-style political continuity. His victory suggests Germans back him to be Chancellor. But he gave his blessing to the Green-FDP talks, suggesting this was the first step on the route to a three-party coalition.

The strangest part, though, is the political gulf between the two smaller parties. The Greens want to raise taxes, increase environmental regulation and unleash a wave of fiscal investment. The FDP wants to lower taxes, stick to strict budget rules and let the free market address climate change problems. “Two worlds are colliding,” according to the Greens’ co-leader Robert Habeck.

Strange bedfellows perhaps, but leaders have said there is no way to avoid negotiations, and early signs suggest there is scope for agreement. Both parties campaigned on agendas of reform, environmental policy and modernisation, and succeeded in attracting a much larger share of young voters than the other parties. Though they disagree on how to address these challenges, they at least agree that the old status quo was not what voters wanted any more. Also, neither party is concerned with protecting the legacy of previous governments, giving them room for manoeuvre. Negotiations seem to be going well, judging by the joint ‘selfie’ posted by Green and FDP leaders last week. This was viewed as a formidable PR scoop, cementing the impression with voters that they will determine the next government, not one of the main parties.

German fiscal policy is the main political concern here for international investors. It is, unfortunately, also the main site of disagreement. Not only is the FDP committed to lowering taxes, but it is also firmly behind the ‘debt brake’, which limits the amount of government borrowing. This is incompatible with the Greens’ position – which calls for a loosening of fiscal policy as well as higher taxes for those on higher incomes.

The Greens’ environmental investment drive would need to be paid for one way or another – either through tax rises or increased debt. Party leaders have said they are willing to accept the debt brake, provided it is supplemented by a new investment rule. The FDP, meanwhile, suggests government funds could be diverted through other areas, and are eager to mobilise private capital through climate and infrastructure related tax breaks.

Germany’s future fiscal policy will likely be found somewhere in these murky waters. Exactly where will depend on who heads the coalition, with the CDU leaning more toward fiscal prudence and the SPD toward higher tax and spend. Political momentum and post-election opinion polls would suggest an SPD-led alliance – the so-called ‘traffic light coalition’ (red, yellow, green) – but agreement could be long away.

Whatever the case, we suspect negotiations to be guided by a few priorities: modernisation, green infrastructure and investment on the Greens’ side, and private sector engagement and lower taxes on the FDP side. That could prove a powerful recipe for growth. There is a sense that Europe’s largest economy has been held back by years of underinvestment and fiscal caution. Should this change, investors would become excited, not just about Germany’s prospects but Europe’s as a whole. Germany’s historically low bond yields, and comparatively small national debt pile, mean it has plenty of room to expand its budget for the right cause. Modernisation and environmental protection are as good reasons as any, a fact that both the Greens and FDP recognise.

International media coverage has been somewhat pessimistic about the election result – pointing to the loss of Merkel and a fractured political landscape in a country long-renowned for its stability.

But there are plenty of positives too. The fact that Olaf Scholz looks likely to be Chancellor only adds to this positivity. He is a veteran of government and is likely to retain the stability seen during the Merkel years. By his side would be politicians eager to make big changes and modernise Europe’s largest economy. These are all positive signs for markets to be excited about.

Business investment: why we care about capex

Throughout this year's recovery, consumption and household spending have been key factors to watch. Global growth can only continue if consumers are confident in their prospects – which is why we have been closely monitoring developments in employment and household savings rates. This is particularly important in the face of wavering economic sentiment and the likelihood of a difficult winter ahead.

Equally important is investment in the post-pandemic future. So far, governments have looked like the main architects of that investment drive. President Biden is planning a wave of infrastructure catch-up spending in the US, while British and European politicians are exploring similar measures with a focus on green infrastructure. Fiscal policy taking the initiative here makes sense. The combination of high private savings levels and historically low interest rates put governments in a good position to spark growth through public spending, while the cost of such investment remains low for the foreseeable future.

For a stable and sustained recovery, though, productive investment will need to come from the private sector too. Economic activity needs new technologies and avenues of production (particularly in the face of the daunting environmental challenges) and public spending can only go so far in providing it. When businesses focus on capital expenditure (capex), it is a sign that growth is self-sustaining. This is vital for ensuring a broad-based recovery – avoiding overreliance on consumer confidence or individual sectors.

Capex also indicates that businesses are confident about the future. There is little point investing in new products unless you think people will be able to buy them. So, if we see strong capex spending it follows that corporates are confident about the economic recovery. This is particularly important now, considering how the pandemic experience has altered perceptions of productivity and technology across society – from online infrastructure to the green transition.

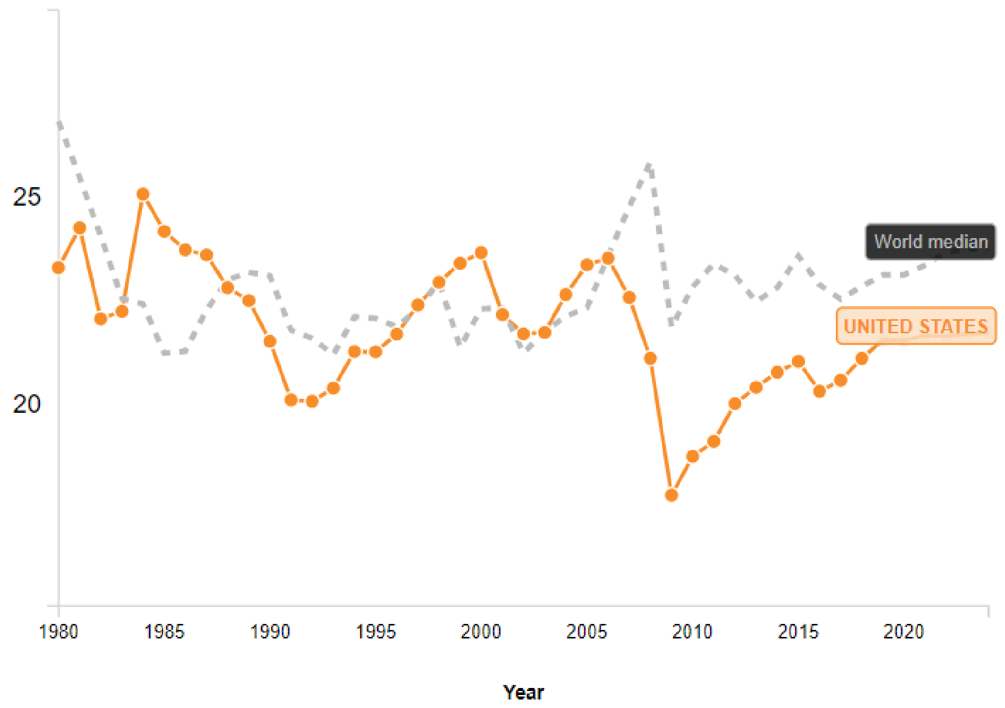
Corporate investment will also have a big impact on inflation and the labour market. Capex can sometimes be seen as a proxy for productivity growth – as businesses look for improvements to save on costs. For example, rising wages and a tight labour market might prompt a business to automate its production line and cut jobs – thereby pushing up unemployment while increasing productivity.

The relationship between capex, productivity and labour is particularly relevant right now. The financial pages have been filled with talk of 'stagflation' last week – the phenomenon of rapid inflation at the same time as slowing growth and rising unemployment. Given that unemployment tends to counteract inflation, and vice versa, this can usually only happen with a significant supply-side shock. The 1970s oil shock was a prime example of this, and newspapers have been quick to draw comparisons between then and Britain's current heating gas shortage.

We agree with most economists that this comparison is a little far-fetched. Short-term supply issues can bump up prices, but longer-term trends are usually dictated by demand, unless there are *structural* supply constraints (such as the oil cartel controlled by OPEC). Otherwise, we should expect rising prices to incentivise more capex, eventually pushing up productivity and keeping a lid on spiralling prices.

The positive part of this story is that productivity growth is the main driver of sustained real (inflation-adjusted) economic growth – lifting corporate earnings and (in their wake) investment returns as well as living standards. That is the theory, at least. In practice, displaced labour can cause big problems, as workers' skillsets effectively become stranded assets, requiring further investment in retraining.

Still, capex is an important part of any dynamic economy. In fact, capex – or the lack thereof – was one of the main disappointments of the decade after the global financial crisis (GFC). The chart below shows US and global capex as a percentage of GDP. Corporate investment took a big hit following the financial crash and has been tepid ever since. This has gone hand-in-hand with a post-GFC slowing of productivity, and a relatively stagnant global economy.



Source: Worldbank, IMF

Fortunately, last year's recession has not shown the same capex drop-off. Projected corporate investment for 2020 is broadly in line with the year before, and the expected 2021 figures already show a pick-up. This has been matched by the rapid US recovery earlier this year. Even though other growth indicators have wobbled recently, should investment stay at a decent level, it bodes well for the future.

There is perhaps a worry that capex spending has been quite unbalanced. Most of the capex recovery has gone into information technology (IT), while other sectors have seen their corporate investment levels fall. Optimists would say IT investment is the most needed – particularly for the so-called green revolution ahead. As written before though, new technologies still need more materials and old-fashioned infrastructure to work. Fortunately, governments seem eager to provide on the infrastructure side.

As such, the outlook is mostly positive, even though capex intentions have dropped off recently. Companies flush with cash – like the US mega-tech sector – can fund spending out of their reserves or have access to raising funds at low yields in capital markets. Others must resort to bank loans. The outlook for those companies is unfortunately less positive, with bank loans not recovering as much since early 2020.

The main risk to the overall picture is what the current supply shock might mean for investment intentions. As noted, the energy crisis and widespread supply bottlenecks this year are mostly one-off affairs, unlikely to cause elevated inflation over the longer-term. Short-term price shocks can still have a big impact on confidence, though. Should price issues eat too much into corporate profit margins, it will make companies less likely to invest – weighing down on future growth prospects. For now, companies seem to be absorbing the costs, but this is something we will be keeping a close eye on.

Global Equity Markets

Market	Fri 15:49	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7017	-0.5	-35	⇘	⇗
FTSE 250	22926	-2.9	-683	⇘	↗
FTSE AS	4023	-1.0	-39	⇘	↗
FTSE Small	7410	-1.7	-127	⇘	↗
CAC	6505	-2.0	-133	↘	↗
DAX	15136	-2.6	-396	↘	↗
Dow	33920	-2.5	-878	↘	↗
S&P 500	4293	-3.6	-162	⇘	↗
Nasdaq	14397	-4.3	-650	⇘	↗
Nikkei	28771	-4.9	-1478	⇗	↗
MSCI World	3007	-3.1	-97	⇘	↗
CSI 300	4866	+0.3	+13	⇘	→
MSCI EM	1253	-0.9	-12	⇘	→

Top 5 Gainers

Company	%
Royal Dutch Shell	+7.4
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Rolls-Royce	+7.2
Glencore	+6.1
BP	+5.4

Top 5 Decliners

Company	%
Renishaw	-12.6
AVEVA	-10.4
Admiral	-8.6
Halma	-7.8
Spirax-Sarco	-7.7

Currencies

Pair	last	%1W
USD/GBP	1.354	-1.0
GBP/EUR	0.857	+0.1
USD/EUR	1.16	-1.0
JPY/USD	110.95	-0.2
CNY/USD	6.44	+0.2
Bitcoin/$	47,131	+8.0

Commodities

Cmdty	last	%1W
Oil	78.08	-0.0
Gold	1758.7	+0.5
Silver	22.47	+0.2
Copper	416.9	-2.8
Aluminium	2858.5	-3.1
Soft Cmdties	228.7	+1.3

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	15.3	12.3	14.2
FTSE 250	2.4	15.5	24.0	16.0
FTSE AS	3.8	15.2	13.3	14.4
FTSE Small x Inv_Tsts	2.0	12.9	18.8	15.5
CAC	2.3	20.8	15.6	15.0
DAX	2.2	15.2	14.9	13.5
Dow	1.8	19.0	18.4	16.5
S&P 500	1.4	24.3	21.3	17.6
Nasdaq	0.7	29.4	31.8	23.0
Nikkei	1.5	15.4	17.2	17.7
MSCI World	1.7	21.2	19.4	16.6
CSI 300	1.9	16.0	15.1	12.5
MSCI EM	2.4	13.8	13.2	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.00	+0.08
UK 15-Yr	1.23	+0.10
US 10-Yr	1.48	+0.03
French 10-Yr	0.12	+0.01
German 10-Yr	-0.23	-0.00
Japanese 10-Yr	0.06	+0.00

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.23	1.28
3-yr Fixed Rate	1.41	1.48
5-yr Fixed Rate	1.40	1.45
10-yr Fixed Rate	2.59	2.59
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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INVESTMENTS LIMITED

4th October 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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