CAMBRIDGE
INVESTMENTS LIMITED

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COP26 joins up (most) global leaders; Source: Morton Morland, 1 Nov 2021

No tantrum over this taper

October's positivity across global stock markets spilled over into the first week of November. That is with the exception of China, which appears to be increasingly isolating itself from the rest of the world. Not only was its leader very notably absent from the COP26 climate summit in Glasgow, but it is also choosing to let international bondholders bear the brunt of the ongoing financial woes of its property developers. No wonder then, that Chinese stocks have fallen thoroughly out of favour with investors this year.

Judging by what the UK media reported last week, investors should have been glued to the capital markets forums at COP26. While there were plenty of leaders from the biggest global investment companies present, it was once again the deliberations of central banks that captured the attention of investors.

While even better than expected corporate earnings reports have lifted the mood over the past week, there had been a lingering concern that central banks were about to make their first economic policy mistake in their efforts to manage the pandemic period. Faced with more persistent than anticipated inflationary pressures, it was feared that central bankers would blink and break from their stated course of keeping rates and monetary conditions very loose for longer. In particular, the Bank of England (BoE) had signalled since the summer that it was likely to raise rates to prevent inflationary tendencies taking hold. In the US, the Federal Reserve (Fed) had similarly signalled that it would start to reduce monthly liquidity injections by tapering them back down to zero by the summer of next year.

Given the market turmoil the mere mention of such tapering caused back in 2013, markets had been sufficiently nervous to cause movements in the bond markets that suggested a souring of the previously positive medium-term growth outlook (as we reported in October).

As it happened, the Fed did what it had signposted while it was the BoE that blinked, albeit in the other direction – by surprising markets by keeping rates where they were. It may seem that central banks are no longer acting in a concerted fashion, but that is not how it was perceived by the markets. Instead of a renewed taper tantrum, markets remained very calm and indeed took the actions of both central banks (and accompanying language) as confirmation of the previously more positive growth outlook. This manifested itself in rising yields in the longer maturity spectrum of the bond markets, indicating that markets no longer saw the central banks making an error.

This may appear more obvious in the case of the BoE than the Fed, given it held off from any form of tightening, whereas the Fed did not. Yet the message of both was convincingly similar: growth is expected to continue while inflation will very much remain on the radar and pressures should ease next year, once pandemic-induced supply shortages are overcome (for a deeper insight, see our separate article 'Central bank bait-and-switch').

Over the course of last week, economic data flow was also broadly supportive of this view, with the US posting a more positive than expected additional 531,000 new jobs during October, and with unemployment falling further to 4.6%.

With energy and commodity prices stablising, and in certain cases rolling over, there was a general calming air felt over the week, even though corporate earnings outlooks have recently not had so much positivity for equity investors. With yields having come down, and neither too much nor too little growth raising the spectre of neither overheating nor stagflation, all should be good? Well, almost, if it was not for some consumer sentiment readings also turning over, and the observation that inflation-adjusted yields (real yields) have remained stable throughout all this.

This tells us there is still enough to get markets worried again, given the historically-elevated valuation levels they are trading at. If real yields begin to rise in reflection of the improving economic outlook, with lower inflation pressures coming from energy, corporate earnings growth will have to crank up – or risk being left behind by the return of the competition of fixed interest bonds. Usually they do in such situations, but we can be certain that markets will fret about it.

On the side of COP26, big investor news appeared to be in the offing, when the alliance of investment managers led by former BoE Governor Mark Carney announced they now represented $130 trillion of assets that would support the transition towards net neutral CO2. You can read our views on the subject, and how it could shape efforts to transition toward a more sustainable – and unified – economy in the article titled: 'COP26: Good COP, bad COP'. If nothing else, the announcement suggests something more tangible to emerge from the summit than the 'climate-unfriendly 'hot air' that many had feared.

October 2021 – market review

Asset Class	Index	October	3 Months	YTD	12 months	2020
Equities	FTSE 100 (UK)	2.2	4.1	15.6	34.5	-10.2
	FTSE4Good 50 (UK Ethical Index)	2.5	2.8	10.5	26.5	-13.2
	MSCI Europe ex-UK	2.9	2.0	14.2	32.2	8.8
	S&P 500 (USA)	5.3	6.6	23.7	34.8	14.5
	NASDAQ (US Technology)	5.5	7.3	20.5	34.9	40.9
	Nikkei 225 (Japan)	-4.9	3.8	2.1	13.1	11.4
	MSCI All Countries World	3.4	4.8	16.5	29.5	13.0
	MSCI Emerging Markets	-0.7	0.9	-0.5	10.3	15.0
Bonds	FTSE Gilts All Stocks	2.2	-2.4	-5.4	-4.3	7.9
	£-Sterling Corporate Bond Index	0.4	-2.0	-3.1	0.5	8.4
	Barclays Global Aggregate Bond Index	-1.9	-1.0	-4.6	-6.8	6.3
Commodities	Goldman Sachs Commodity Index	4.1	11.2	45.9	63.8	-26.0
	Brent Crude Oil Price	5.2	12.6	61.2	108.1	-23.9
	LBMA Spot Gold Price	2.1	-0.9	-5.8	-10.2	20.8
Inflation	UK Consumer Price Index (annual rate)*	1.0	1.0	3.0	3.1	3.6
Cash rates	Libor 3 month GBP	0.0	0.0	0.0	0.0	0.5
Property	UK Commercial Property (IA Sector)*	0.9	1.3	3.7	3.6	-0.2

Source: Morningstar Direct as at 29/10/21. * to end of previous month (30/09/21). All returns in GBP.

In October, global stock markets seemingly broke out of their narrow trading range to end the month on a high note. The index tracking developed global markets rose 3.4% in GBP terms. Investors appeared to push aside the 'wall of worries', including fears over interest rate policy tightening, higher commodity prices, profit margin pressures, the resurgence of the Delta variant and regulatory changes in China.

Perhaps the underlying reasons for this optimism were a combination of generally better than expected third quarter company earnings (despite some individual disappointments, especially amongst the US mega techs). While we have seen economic data retreat from post-pandemic highs, this still provides an overall positive backdrop longer-term.

In equities, US markets, specifically technology shares were the month's strongest gainers with the tech-heavy Nasdaq up 5.5% and the S&P gaining 5.3% in GBP terms. Bonds were a mixed bag, with Gilts up 2.2% while global bonds were 1.9% lower. Overall, bonds and gold remain in negative territory on a year-to-date basis. Gold's near 6% loss in 2021 has left some commentators surprised, given its traditional inflation-hedging role and the above-target inflation readings this year. Some have suggested the puzzling performance can be explained by investors viewing cryptocurrencies like Bitcoin as providing a better inflation.

Oil has continued its upwards momentum, gaining 5.2% in October. For context, while oil prices have now more than doubled over the last 12 months and are now back to where it last traded between 2010 and 2014, forward prices for oil delivery next year indicate market expectations for prices not to remain at these elevated levels beyond the winter months.

Investors still have the second half of third-quarter corporate earnings (profits) reports to digest, but based on the results so far, further reassurance could be coming. That's not to say investors should be complacent, however, as the prospect of rising yields, or a COVID driven declining economic outlook, may still create tense moments that need closely watching as we head towards year-end.

COP26: Good COP, bad COP

The 26th meeting of the United Nation's uninspiringly-named Conference of the Parties (COP26) began last Sunday. Speeches on the threat of catastrophic climate change were perhaps fitting of the Halloween kick-off. With a week of deliberations and announcements still to come, politicians have already made plenty of promises to aid the urgently-needed global green transition. Policymakers have set or re-emphasised targets to phase out fossil fuels – particularly coal – as well as introducing mechanisms to prevent those who might bend the rules.

The International Financial Reporting Standards Foundation's (IFRS) newly-announced board on so-called 'greenwashing' is a good example. As the body responsible for international accounting standards, the IFRS is well aware of the tendency of private companies to shift or hide polluting practices. In a bid to prevent these practices (and introduce yet more acronyms to remember) the International Sustainability Standards Board (ISSB) will try to give clear and standardised guidelines to companies. The ISSB will consolidate existing authorities into a single set of standards "to meet investors' information needs". As we have written before, this is a crucial step.

Politicians, corporations and investors have long made the point that the regulation that defines financial frameworks must change in a concerted manner if global capital is to be mobilised to get behind the green transition. A lack of clear rules on what counts as 'green practices' is a major roadblock, disincentivising green investment and stalling long-term planning. Giving more consistent guidelines will help the world put its money where its leaders' mouths are. Of course, another question yet again is which countries and corporates subscribe to those standards.

On that point, one of the biggest headlines so far came from the Glasgow Financial Alliance for Net Zero (GFANZ). GFANZ is an alliance of private companies and net-zero initiatives headed by former BoE Governor Mark Carney, with the aim of making the investment world's assets greener. And this group does have quite the pile of assets. According to Carney, GFANZ has signed-up $130 trillion of private capital to commit to reaching net-zero emissions by 2050. That is more than the estimated market capitalisation of all the world's stock markets combined, and six times larger than US GDP.

To be clear, GFANZ is not a fund, nor is its money earmarked for environmental projects, as some media reports seemed to suggest. The $13 trillion figure represents the total assets of all signatory institutions, including banks, asset managers and insurers. Investment managers represent $57 trillion of that and banks $63 trillion, while the remaining $10 trillion comes from asset owners such as pension funds.

While the sheer size of the figure succeeds in grabbing attention, it is difficult not to be a little sceptical. Signatories are committed to setting emission reduction targets every five years, starting in 2030 and lasting until net-zero is (hopefully) achieved in 2050. In theory, that should mean the $130 trillion represents the current worth of all the assets that will be carbon-neutral in 30 years. GFANZ says this could deliver $100 trillion to help the fight against climate change in that time.

But it is hard to tell what the underlying makeup of signatories' assets is. And, given that banks and asset managers make up most of the group, it is very likely that some of the money is counted several times over – through lending chains or securitisation. What's more, GFANZ members have set net-zero targets for just 35%(!) of their assets so far. Those involved acknowledge that the total figure does not represent money going toward the green transition, but add that the aim is to align all the assets to net-zero further down the line.

This tactic has drawn criticism. Campaign groups have labelled GFANZ's climate commitments too tame and easy to bypass, and called for investment in fossil fuel exploration to stop altogether. That may seem a radical proposal, yet it is exactly the one endorsed by the International Energy Agency (IEA) which represents the biggest oil users of western industrialised nations in its roadmap for cutting emissions. According to the Financial Times, GFANZ members pushed back against the IEA's proposals – leading campaigners to further criticise their green credentials.

Misleading as the headline figure may be, Carney and GFANZ have succeeded where others failed in terms of creating positive momentum and mobilising capital for climate change. These efforts are likely to be bolstered – in the eyes of capital markets at least – by the recent appointment of Michael Bloomberg as GFANZ's co-chair. What's more, when you consider the ISSB's soon-to-be unified guidelines, GFANZ should have more power to effect change in the world's financial system.

The other half of that equation, of course, is government action. Much of what we have heard from COP26 has similarly disappointed campaigners. Last Thursday, 40 countries agreed to phase-out the use of coal in the coming decades, with developed economies aiming for the 2030s and developing nations aiming for the 2040s. A crucial caveat is the clause "or as soon as possible thereafter", marking significantly less ambition than the original 2030 deadline.

Even more undermining for the pledge is the fact that none of the world's three largest consumers of coal – China, India and the US – joined. The American absence was a little surprising, given President Biden's stated target of carbon-free electricity by 2035. But analysts speculate it is because the President's green pledges are deeply unpopular in coal-dependent US states, which likely contributed to his party's recent state governor election loss in Virginia.

It seems the problem for states is the same one as for companies. We all want everyone else to go green, as long as we do not have to ourselves, or at least do not have to give up our way of life. The spotlight is now on corporates as well as politicians, which has largely come through as a focus on public companies. As noted before, this can create a problem of 'brown-washing', where polluting enterprises are sold into private hands and simply put outside of public view. There are also justified concern that Emerging Markets risk losing out. Not only is their fiscal capacity more limited than that of the UK or US, their companies also tend to be more CO_2 heavy. If green ambitions are merely reflected in divestment, those companies most in need of capital to finance the green transition may not have access to it. Therefore, focus should

go towards sectoral transition plans, and some also suggest the creation of green special purpose vehicles (SPVs) for companies, making it clear that new capital goes into the 'green' arm of an enterprise. Alternatively, fossil-rich companies could spin off the 'brown' part of their business into a 'bad' entity, which could ultimately be wound down, while all the proceeds go to the greener core structure. This would be along the lines of BlackRock CEO Larry Fink's "bad bank" idea.

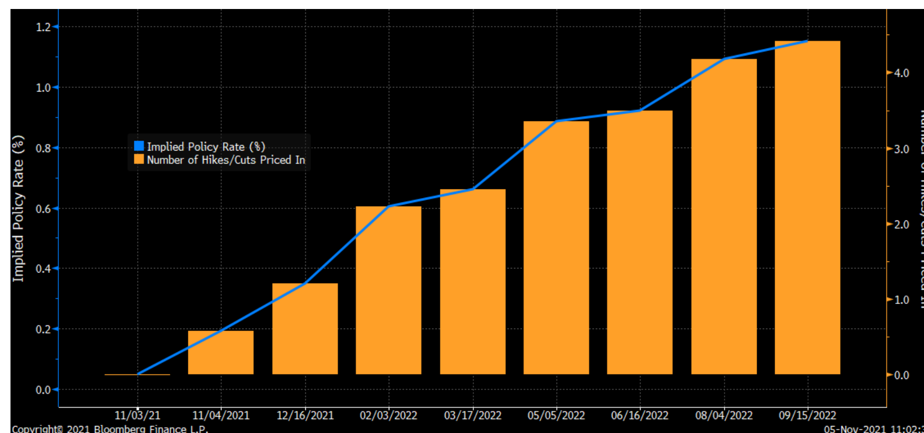
Last week, Larry Fink also called the discrepancy an opportunity for "the biggest capital market arbitrage in my lifetime". While this might be a little overstated, the concern is a valid one. The hope, though, is that the new financial groups set up to impose tighter standards – ISSB and GFANZ – can eventually be expanded to include all polluting industries, whether they have been brown spun or not. If those are high hopes, at least they will fit right in at COP26. So far, COP26 has not generated the big commitments – and the hard choices needed to underpin them – that many had hoped for. That said, a lot of positive momentum has been generated, which should at the very least help to align the efforts of capital markets in the coming years to unleash the 'invisible hand' of markets in efforts to limit climate change. Politicians are starting to wake up to the idea that society is demanding greater action from them (and that they risk being thrown out of office if they don't deliver), companies can therefore provide a valuable second pillar that encourages them to make harder pledges than they can make while acting on their own.

Central bank bait-and-switch

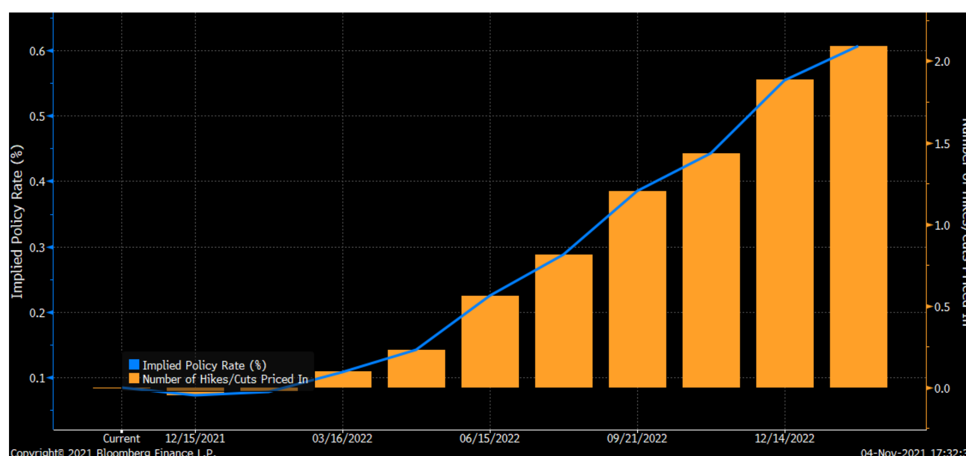
The trick is to always keep them guessing, you see. It works in entertainment, sport and – apparently – now monetary policy. That was what we learned last week from the BoE, whose policymakers kept interest rates on hold despite all signals to the contrary. If the intention was to catch markets off-guard, the plan worked perfectly. Sterling fell 1.2% last Thursday and short-term government bonds rallied, as investor expectations of tighter conditions in the UK were proven wrong.

Those expectations were well-founded. Just last month, Governor Andrew Bailey warned that the BoE "will have to act" to restrain the current inflation spike. Foolishly, investors interpreted this as suggesting the BoE would act. Bailey, on the other hand, claims he never specified when. He has since clarified his stance somewhat, telling reporters that rate rises would be needed "over the coming months". Perhaps the Governor took a page from the 'I never said we would stop for ice cream' book of central banking.

If you will forgive the sarcasm, the decision seems all the more perplexing when you consider that the BoE's own inflation forecast has risen to its highest level in a decade. It now expects inflation to reach 5% by Spring. In previous communications, officials gave the impression that rapidly rising inflation had become a key concern that would force them into a hike. Things have only escalated since then, but the Monetary Policy Committee (MPC) seems to have changed tack. The chart below shows rate expectations before the November policy meeting:



Not only that, but Bailey also suggested markets were wrong in their longer-term expectations for interest rates. Implied market expectations put rates at 1% or over by the end of next year, but the Governor revealed this would cause the BoE to undershoot its 2% inflation target over the medium-term. The chart below shows updated market expectations for the path of interest rates (note the different scaling of the left hand scale.



These days, good communication has become as important a part of central banking as interest rates themselves. Capital markets do not like a 'bait-and-switch' at the best of times, and this is especially true for monetary policy. For bond markets and the wider economy to run smoothly, reliable expectations of inflation and background financial conditions are vital. As such, the MPC's surprise resulted in "a chastening day for the market", according to Barclays' rate strategist Moyeen Islam: "The issue now becomes a degree of wariness about the Bank of England's communications."

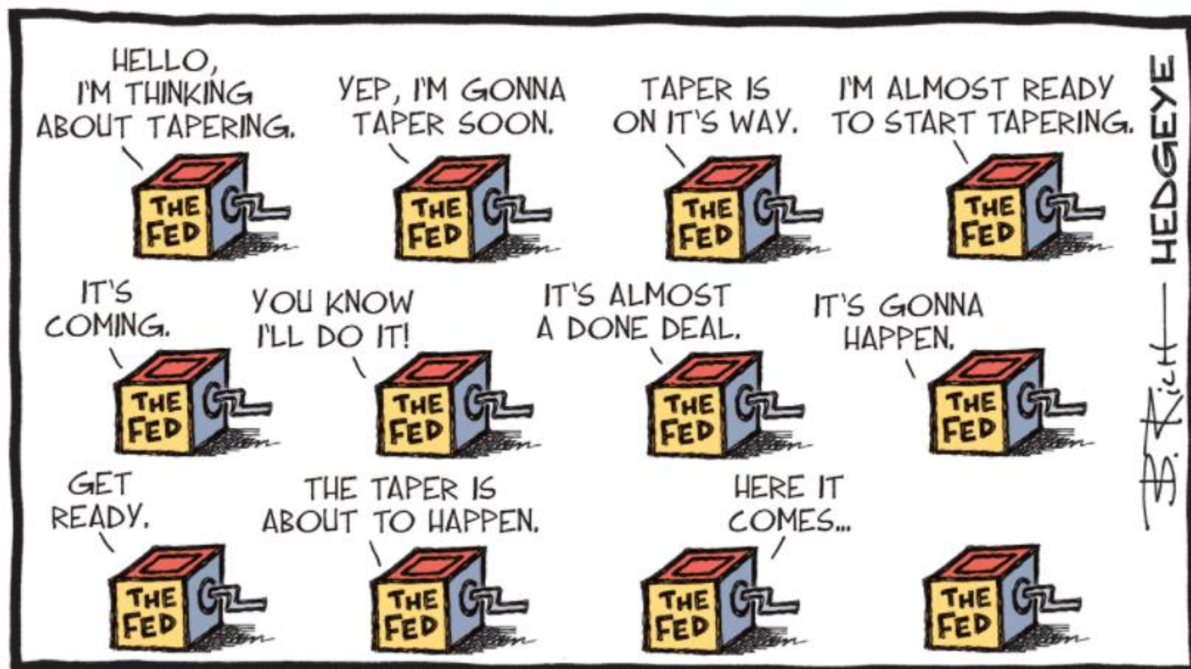
That said, while markets were certainly expecting a rate hike, they were not particularly happy about it. Looser monetary policy is, as we know, usually a boon for the bulls, because it increases the attractiveness of equities. But in this case, with so many country-specific headwinds facing the UK, the call had arguably been for a softer touch for the sake of the economy. As written many times before, rapidly rising inflation is to do with a confluence of domestic and international factors, but most of which stem from supply constraints. Inflation pressures from the supply side are usually much shorter-lived than those stemming from the demand side and, in any case, interest rate rises are likely to be less effective at curtailing supply-led inflation than demand-led, as the BoE Governor recently said himself.

The BoE seemed to recognise this at its most recent meeting, with the majority of members predicting high inflation "was still most likely to prove transitory". In particular, they noted that subdued growth and rising costs – both from inflation and tax changes – would cause a fall in real household incomes. And with Britons expected to have less spending power next year, inflation is likely to be more subdued toward the end of the year.

We agree with this assessment. When Bailey (seemingly) revealed his intention to raise interest rates last month, we said this could prove a policy error that might choke off the recovery prematurely. The difficulty facing central bankers, though, is how long to keep the economy on emergency support as it normalises. The global economy is still ultimately in a transition phase, and the problem for monetary policymakers is figuring out what it is transitioning to.

The Fed is a good example. Interestingly, Fed Chair Jay Powell announced last week that it would begin unwinding its $120 billion a week bond purchasing program. This is one of the biggest changes to Fed policy since the onset of the pandemic, and because it had been signposted by the Fed again and again it had investors worried for months. And yet, on the day, market reaction was virtually non-existent, with US bonds moving mostly sideways and equities continuing their climb.

The onset of Fed tightening – even the mention of it – has been known to cause market havoc in the past, such as the so-called 'taper tantrum' of 2013. But having the taper without the tantrum is not quite a sign of markets growing up. Rather, reaction was muted because investors seemingly have confidence in Powell's dovish approach. The Fed's emergency stimulus was always meant to be exactly that, but Powell still spent six months warning markets that it was coming. And even now, purchases will only be scaled back by $15 billion a month.



Source: Hedgeye, 3 November 2021

On interest rates, the Fed is even more cautious. Despite impressive US growth for parts of this year, spiking inflation and the promise of fiscal stimulus ahead, Powell insists it is far too early to think about a rate hike. Worries that rates may rise earlier than expected have weighed on markets recently, but Powell has reassured investors this is not yet in the bank's thinking. Previous Fed chairs would almost certainly be in rate hike territory by now. But since the change to the Fed's structural framework last year, Powell insists officials will stay the course until the economy reaches full employment and an average inflation level of 2% over time. This means the Fed can overshoot the 2% level after years of undershooting it.

Ultimately, though, the Fed faces the same problem as the BoE. Support cannot go on forever, but how and when it should be taken away is mightily tricky. The BoE has been somewhat more unorthodox in hinting at an early rate hike – but that is perhaps to do with the UK's lack of inflation undershooting in recent years. Regardless, the world's central banks need to take the patient out of intensive care sooner rather than later. For markets' sake – as observed in the US last week, we hope we at least get fair warning.

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8th November 2021

Global Equity Markets

Market	Fri 15:37	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7312	+1.0	+74	↗	↗
FTSE 250	23581	+2.1	+474	→	↗
FTSE AS	4179	+1.2	+50	⇗	↗
FTSE Small	7513	+1.3	+96	→	↗
CAC	7042	+3.1	+212	↗	↗
DAX	16064	+2.4	+375	⇗	↗
Dow	36387	+1.6	+568	↗	↗
S&P 500	4710	+2.3	+105	↗	↗
Nasdaq	16033	+3.5	+535	↗	↗
Nikkei	29612	+2.7	+791	⇘	⇗
MSCI World	3225	+1.6	+50	↗	↗
CSI 300	4842	-1.4	-66	→	⇘
MSCI EM	1268	+0.3	+4	→	⇘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
BT	+16.5	Flutter Ents	-8.6
Smith & Nephew	+9.4	Stan Chartered	-7.3
Rolls-Royce	+8.4	Barclays	-4.4
Int'l Consol Air	+8.2	J Sainsbury	-4.2
Assoc. Brit. Foods	+6.0	Ocado	-3.9

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.349	-1.4	Oil	82.78	-1.9
GBP/EUR	0.856	-1.3	Gold	1808.8	+1.4
USD/EUR	1.15	-0.1	Silver	24.05	+0.6
JPY/USD	113.52	+0.4	Copper	435.3	-0.3
CNY/USD	6.40	+0.1	Aluminium	2554.5	-7.0
Bitcoin/$	60,926	-0.1	Soft Cmdties	230.7	+2.0

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.84	-0.19
UK 15-Yr	1.01	-0.15
US 10-Yr	1.46	-0.10
French 10-Yr	0.07	-0.20
German 10-Yr	-0.28	-0.17
Japanese 10-Yr	0.06	-0.04

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	15.7	12.6	14.2
FTSE 250	2.4	15.6	19.8	16.1
FTSE AS	3.6	15.5	13.3	14.4
FTSE Small x Inv_Tsts	2.0	13.1	17.2	15.6
CAC	2.1	20.6	16.6	15.0
DAX	2.0	15.2	15.4	13.6
Dow	1.7	19.1	18.9	16.5
S&P 500	1.3	25.0	22.7	17.7
Nasdaq	0.6	30.0	34.9	23.2
Nikkei	1.6	15.3	17.9	17.7
MSCI World	1.7	21.6	20.4	16.7
CSI 300	1.9	15.4	15.4	12.5
MSCI EM	2.4	13.2	13.3	12.6

UK Mortgage Rates

Mortgage Rates	Oct	Sep
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.20	1.23
3-yr Fixed Rate	1.20	1.37
5-yr Fixed Rate	1.29	1.37
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

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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