THE **CAMBRIDGE** WEEKLY

15 November 2021

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China; Source: Christian Adams, 11 Nov 2021

Central banks struggle with messaging

Following five weeks of global equity markets inching higher every week, risk asset markets slowed even though, for once, economic data was actually offering reasons to believe that the worst of supply chain constraints may be behind us. From as far as we can make out, it was once again the bond markets that distracted stock markets. We feature a separate article this week on the topic, because we had the unusual combination of inflation adjusted yields falling and nominal yields rising slightly. What can be read into this, is that inflation concerns continue to rise, but there is now less of an offset through rising growth expectations.

If this single week's observation was to turn into a trend, this would be bad news for both bond as well as equity investors. We suspect though that market participants are currently struggling to get their collective heads around various slightly unusual factors that characterise this post pandemic lockdown recovery, and are quite different to previous economic rebounds.

We have written at length about the price and growth pressures the supply chain constraints have caused. Normally, it is overheating demand rather than struggling supply that causes inflationary pressures, but when economies are so radically switched off and on again, it appears that the resulting upheaval takes longer to settle than many had thought. Central banks are mandated to prevent inflation or risk losing their credibility, regardless what caused the inflation in the first place. As a result, and after the first inflation reading from the US of over 6%, there is now a growing concern that they will be forced to tighten monetary conditions, and cause a premature end of the economic cycle that is just getting going as flows of goods are beginning to normalise. That would indeed be bad for growth!

It looks as if these concerns are well founded because central banks have already signalled that they will reduce their monetary support for the economy. Unfortunately, they have not done the best job of helping markets to differentiate between the removal of their extraordinary pandemic support and outright monetary tightening. The extraordinary pandemic support in the form of quantitative easing that helped us get through the economic void of the lockdowns is no longer required. The private sector is now paying salaries again, ending the need for furlough support, so it therefore seems right to taper down those ongoing liquidity injections. Rate rises on the other hand would go beyond monetary normalisation to pre-pandemic conditions, but they are still only on the time horizon of sometime towards the end of next year.

The combination of slowing economic growth due to the supply chain issues, combined with the perceived prospect of monetary tightening, has led to bond markets pricing in much lower medium term growth expectations for the coming years than the previous consensus only a few months ago. As unusual as the specific circumstances of the current economic upswing are, just as commonplace are the concerns that accompany the transition from immediate recovery to mid-cycle – 'climbing the wall of worries' - as we have referred to before. However, the more upbeat economic news of the week has reinforced our assessment that this cycle is well entrenched, and more likely to surprise, with growth rates next year to the upside than the downside.

In other news, the COP26 in Glasgow has generated some interesting developments. Most important for us was the surprise announcement of a bi-lateral agreement between the US and China to cooperate in their endeavours to reduce global warming emissions. Being the two biggest emitters on the planet, this is not only great COP26 news, but is also providing hope that China may be slowly emerging from the isolation they have put themselves under since the pandemic started. This would therefore also be positive for China's contribution to global growth, which most (us included) had written down to 'negligible' for this cycle.

We also observe a growing positive momentum toward harnessing the might of capital markets in fighting climate change, which we welcome. However, the impression that has also come through at times that it is the responsibility of global investors to solve the climate challenge displays a certain naivety of the function of finance in society. If economic frameworks for addressing climate change are created that require funding, and also offer commercial opportunity, then the invisible hand of markets will be a powerful ally. Creating such a prerequisite framework is within the gift of global societies and the politicians they elect. Capital markets are a tool that can be very efficient in furthering collective aims of society, but they are not a parallel force to the political executive of societies that can fix problems on its own.

The bad kind of Inflation

We are in the middle of the biggest inflation bout in years as ubiquitous post lockdown supply issues are sending prices skyward. A recent report from the Bank of International Settlements suggests that this inflation has become self-reinforcing; Bottlenecks have caused suppliers to build buffers at multiple stages of the chain, exacerbating supply problems that drive prices. And yet, monetary policy in the developed world seems as loose as it has ever been.

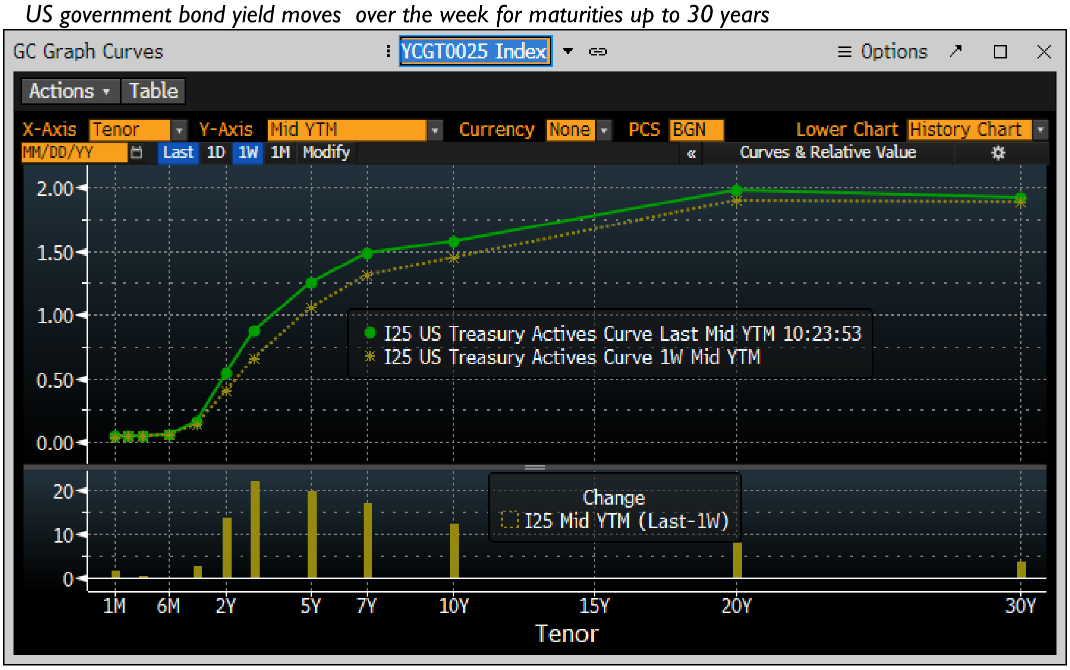
The US Federal Reserve has spent the last six months warning capital markets that the dreaded 'taper' – a reduction in the central bank's asset purchases – was coming. Even now, it is only being implemented little by little, and the Fed is at pains to reassure everyone that rate rises are far away. The Bank of England, which had been an outlier in its plans to raise interest rates, similarly backed away from a seemingly certain hike. Inflation is running ahead, but interest rates are not following it.

At this point, the 'transitory' argument is well-known. Supply issues are short-term as the global economy regains its footing, but their dampening effects on growth are likely to keep prices subdued beyond the next few months. The story gets a little harder to maintain each day inflation creeps upward, but central banks are holding steady for now.

As loose monetary policy is almost always a boon for markets, tightening policy is similarly a downer as the 'taper tantrum' of 2013 amply demonstrated. Strangely though, last week we saw signs of the opposite worry. Real yields (inflation-adjusted by subtracting market implied inflation expectations from nominal yield levels) for US Treasury bonds fell sharply last week, which is usually the result of increased demand for inflation linked bonds while there is less demand for conventional nominal bonds. This type of trading drives up inflation expectations as it shows markets have an increased belief in the risk of sustained inflation. As we have written before, real yields have been well below zero since the onset of the Covid crisis, but investors still seem eager to buy, so their money is protected against price rises.

The moves in real yields clearly indicate that the market expects more inflation. Often, higher inflation expectations can be taken as a positive sign – indicating a strong growth outlook - but action in other segments of the bond markets suggest investors are more scared than excited. The US treasury curve has been flattening during last week (see chart), indicating that markets have moderated their long-term growth expectations, and also discounted higher rates for the time period which is more directly influenced by policy action (2 to 5 yrs). If we take these signals at face-value, they imply a subdued economic view: rising inflation without structurally higher longer-term growth.

US government bond yield moves over the week for maturities up to 30 years



Source: Bloomberg, TattonIM

Persistent inflation would almost certainly cause central banks to raise rates faster than they would like. This is a worry for all, but particularly the Fed, which some believe has taken too long to tighten policy and could be forced into a catch-up next year. If that happens, it would be a lot to handle, making things difficult for capital markets and the real economy next year.

We have written before that concerns over 'stagflation', where growth slows but prices keep rising, are probably overdone. Market action last week suggests otherwise. Investors think inflation next year will be the bad kind, rather than the good, growth-positive kind. This makes life difficult for central bankers, not only do they need to support growth, they also need to convince markets that this support will not destabilise prices. If this happens, a Central Bank's credibility could be questioned.

Recently, it looked like the Fed were successfully managing this task. Policymakers announced they would start unwinding their asset purchases later in November, with little to no complaints from bond markets – a great achievement considering previous tapering responses. The difficulty was always going to be reining in emergency pandemic support, without disrupting the ongoing recovery, by inadvertently signalling a definitive policy shift to outright monetary tightening – by convincing markets not to extrapolate the current tapering into future rate rises.

This is complicated, however, by the fact that investors are not really sure what the future holds for Fed policy. After years of deliberation, the Fed significantly shifted its policy framework last year to become more supportive of employment growth over inflation containment. This just so happened to coincide with one of the biggest economic crises in living memory – forcing policymakers to give substantial support. As the background framework is new, it is hard to tell which policies are emergency measures, and which ones are part of the new normal.

This muddle is bound to cause issues. The current inflation scare in markets is likely one of them, but we could just as well see the opposite over the coming months: A small-scale taper tantrum that threatens wider equity markets. If markets sent confusing signals last week, it could be a result of their own confusion about the background environment.

We wrote last week that the Fed had managed a taper without the tantrum. A crucial caveat, though, is that this requires real yields to remain relatively stable, to avoid a general re-pricing of risk across asset classes. A year ago, we predicted that maintaining low real yields would be a top priority for the Fed – which would therefore allow growth to feed back into a normalising economy.

Eventually, though, this has to change. When economic cycles mature, interest rates and real yields must creep up. When that time should come, is up for debate, but already the fears around this prospect have changed. The Fed would not have allowed real yields to rise substantially a year ago, but there is perception that policymakers could tolerate a bit more now.

Sinking real yields last week suggest concern that support has gone on too long. The worst-case scenario would be if inflation expectations persisted while poor growth signals were coming through. That would increase the already substantial pressure on the Fed, and some timing inconsistencies could open up (but don't have to). For now, our interpretation of last week's bond moves could be entirely a false signal with other factors having caused the shift. As we say 'one week does not make a trend change' – but given how important bond yields are for equity valuations at the moment, we will observe closely how the Fed's new framework copes and where yield level go over the coming weeks.

China less isolated?

How quickly the narrative can change. Over the past few weeks, western media has been filled with talk of China's great retreat from the world. President Xi Jinping is one of the only major world leaders to not be present at COP26, despite his country having a larger share of global emissions than any other. This looked like the culmination of a trend going back beyond the pandemic. After decades of integration and opening up, China began closing its gates (literally, in terms of covid rules at least) and turning inward – pursuing self-reliance and a decoupling from the US-led world economy.

Last Wednesday, things suddenly looked different, when the Chinese and American climate envoys announced a rare joint declaration of environmental co-operation. Just a day later, President Xi warned Asia-Pacific leaders of the danger of international division. In a virtual summit of the Asia-Pacific Economic Cooperation summit (APEC), he lamented the attempts to "form small circles on geopolitical grounds" and the "Cold War" mentality of US-led partnerships.

At APEC, the President of China looked much more like the figure that strutted the stage at the 2017 Davos summit than the one so conspicuously absent in Glasgow last week. Back then, President Xi impressed politicians and financiers with an impassioned defence of globalisation – contrasting his leadership with the protectionism of then US President Donald Trump. While the old leaders might turn away, the message went, China still leads the charge.

However, the last two years seem to have dispelled that image. China now has one of the strictest border control regimes in the world, its President has not met another world leader in person since March 2020, and foreign executives are reportedly leaving the country en masse. The government's strict covid strategy (itself rumoured to be partly down to an undereffective vaccine program and little hospital capacity) is a part of this story – but only a part.

National self-reliance has long been a key target for the communist party, a target accelerated by the supply-chain worries throughout the pandemic. According to political science professor Jean-Pierre Cabestan, this is deeply connected to the party's desire to tighten control and specifically Xi's ongoing campaign to centralise and consolidate power. "There have been many forces at play in China for some time, all heading in the same direction: decoupling and isolating China".

For investors, isolationism is a part of Beijing's wider crackdown. The government has pursued a hard interventionist line in recent years, deleveraging its indebted private sector (a catalyst for property developer Evergrande's current woes), restructuring entire industries (such as banning profit in education) and even clamping down on "effeminate" men. Its strategic rivalry with the US being a big motivation for this tightening of control.

What should investors make of last week's apparent détente then? We should certainly not get carried away by the government's actions. Xi's APEC speech hit the right points, but it was clearly motivated by worries of encroachment by the US. And while American and Chinese officials spoke of "good faith", the declaration announced at COP26 contains little in the way of new commitments. Beijing committed to addressing its methane emissions, but some analysts have suggested this was a fairly easy concession for the government.

Nevertheless, attempts to shore up China's international image show that Beijing certainly cares about keeping up appearances. If asserting independence and self-reliance were Xi's main aims, we would not expect to see even surface level international cooperation.

We suspect that Beijing's mixed signals are due to complicated and conflicting factors. While self-reliance is certainly a facet of the party's vision, it has to be seen in the context of other aims: Long-term economic stability, reducing inequality and corruption, developing into a greener and more advanced nation, and Xi's personal consolidation of power. Some of these aims motivate isolation and crackdowns, others motivate openness and cooperation. For any given party policy, it is often hard to say which aim is the primary one.

Beijing's financial deleveraging efforts are a good example. For years, the government has fought against China's shadow banking sector and sought to discourage excessive debt or speculation. This has included keeping monetary policy relatively tight throughout the pandemic (compared to other major economies), with the aim achieving long-term financial stability. But if credit problems spiral – as they threaten to now with Evergrande – Beijing's efforts will be undermined. This has led to sporadic episodes of stimulus, as well what seems to be the current policy of containing the Evergrande threat – though we believe Chinese authorities will have to become more forthcoming to contain the wider fall-out from the property sector.

For Evergrande in particular, matters are complicated further when we consider the government's competing goals: Promoting equality and the environment (by clamping down on Evergrande's speculative building practices) and preventing private actors from gaining too much power. A few months ago, there were concerns that Beijing's interventionism was making China 'uninvestable'. But, as we pointed out then, the issue is more about a re-pricing of risk than avoiding China altogether. Xi still wants a vibrant private sector; he just does not want it more than his other goals.

Looking at China's current problems, we suspect that shoring up economic confidence will be a priority over the coming months. Crackdowns and crisis in the property sector have sent corporate borrowing costs substantially higher (up to 25% for Chinese junk bonds), and supply issues have caused severe disruption across the country. With a difficult winter ahead, officials will be deeply concerned by the threat of a nationwide downturn. An easing of financial or regulatory conditions would help to boost domestic confidence and attract international capital.

It may already be happening. The ride-hailing app Didi is currently planning to relaunch its services by the end of the year, anticipating that the government's cybersecurity probe will soon end. Meanwhile, the People's Bank of China has a keen eye on the troubles of its bond market – admittedly with little concrete action so far. A rapprochement with the US – and engagement with the wider world – could well be another part of this softening. If it works to lower investors' perceptions of risk in China, and that is a big if, it could mean we pass the low-point for Chinese assets.

15th November 2021

Global Equity Markets

Market	Fri 15:51	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7342	+0.5	+38	↗	↗
FTSE 250	23566	-0.1	-31	→	↗
FTSE AS	4192	+0.4	+16	⬀	↗
FTSE Small	7515	+0.1	+5	→	↗
CAC	7084	+0.6	+44	↗	↗
DAX	16090	+0.2	+36	⬀	↗
Dow	36027	-0.8	-301	⬀	↗
S&P 500	4659	-0.8	-38	↗	↗
Nasdaq	15789	-1.1	-183	↗	↗
Nikkei	29610	-0.0	-2	⬂	→
MSCI World	3202	-0.9	-30	⬀	↗
CSI 300	4888	+1.0	+46	→	⬂
MSCI EM	1281	+1.4	+17	→	⬂

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Auto Trader	+17.5	Johnson Matthey	-17.3
Polymetal Intl	+9.3	Int'l Consol Air	-7.8
Antofagasta	+8.3	Whitbread	-6.1
Fresnillo	+7.7	AstraZeneca	-5.8
Pearson	+7.0	InterCont'l Hotels	-5.7

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.340	-0.8	Oil	82.33	-0.5
GBP/EUR	0.854	+0.3	Gold	1860.5	+2.3
USD/EUR	1.14	-1.1	Silver	25.22	+4.4
JPY/USD	113.97	-0.5	Copper	442.5	+1.9
CNY/USD	6.38	+0.3	Aluminium	2660.0	+4.1
Bitcoin/$	63,118	+0.4	Soft Cmdties	235.1	+1.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.92	+0.07
UK 15-Yr	1.10	+0.09
US 10-Yr	1.56	+0.11
French 10-Yr	0.11	+0.05
German 10-Yr	-0.25	+0.03
Japanese 10-Yr	0.08	+0.02

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	15.4	12.5	14.2
FTSE 250	2.4	15.8	19.9	16.1
FTSE AS	3.6	15.1	13.2	14.4
FTSE Small x Inv_Tsts	2.1	12.5	17.2	15.6
CAC	2.1	20.2	16.6	15.0
DAX	2.0	15.3	15.3	13.6
Dow	1.7	18.8	18.7	16.6
S&P 500	1.3	24.7	22.4	17.7
Nasdaq	0.6	28.8	34.4	23.2
Nikkei	1.6	16.3	17.9	17.7
MSCI World	1.7	21.3	20.2	16.7
CSI 300	1.8	15.6	15.6	12.5
MSCI EM	2.4	13.1	13.4	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

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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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