THE **CAMBRIDGE** WEEKLY

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New COVID variant flattens 'Black Friday' feeling

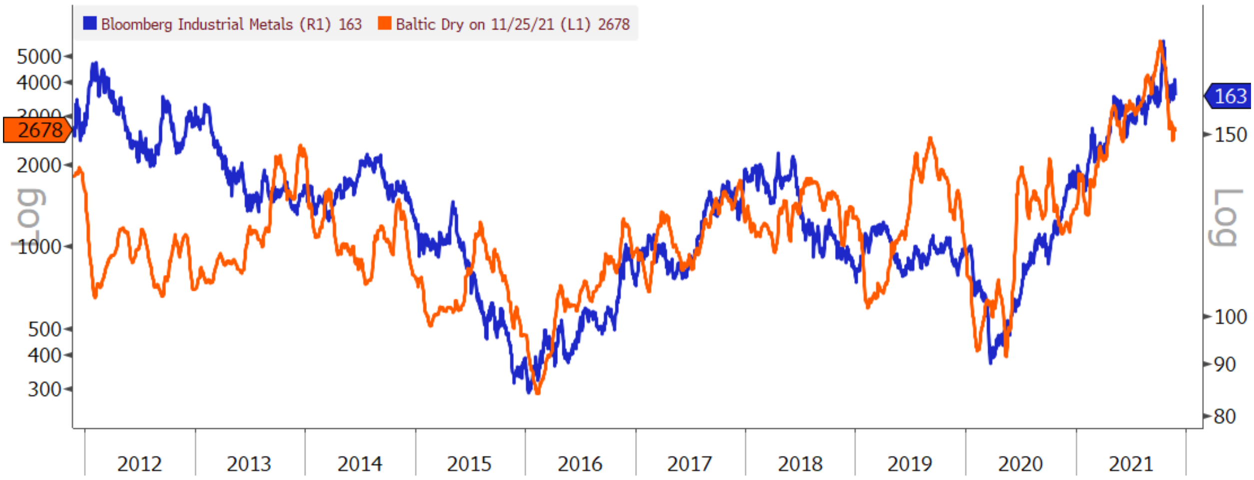
It was a Thanksgiving week of mixed news. The European COVID case surge was surpassed in negative impact by the fears of a new variant emanating from South Africa. US markets hit new highs just before the holiday, but Black Friday felt a bit dark. In itself, a new variant is not surprising. New variants are always a risk, but each of the past ones has been dealt with by the vaccines. Still, we cannot be complacent, and the next few days will be subject to uncertainty as the world waits for more information.

Almost all market moves seem to be in line with the expectation of a hit to global growth. Government bond yields fell, although corporate bonds were less in favour because of credit risk concerns; oil, metal and equity markets retrenched. Travel and leisure companies were especially hard hit. The one slight oddity was that the US dollar fell, rather than continuing its recent rally.

In the US, former president Donald Trump has indicated intentions to campaign for the 2024 election which, in turn, has pushed the Democrats to suggest Joe Biden will fight for another term. It's probably too early really to know, and the mid-terms will be much more important. Biden is making headway now on both fiscal packages, which may aid his flagging approval rating but, right now, markets are betting on a gridlocked Senate and House. Of course, in general, many investors see that as a positive.

Indeed, there's good reason to think that the global economy is on a bit of a roll. In the US, the weekly data on unemployment showed the lowest (single week) number of initial claims since 1968. The labour market has shifted into an even higher gear. Employment globally is strong, corporate confidence about sales is very positive, while there are signs that supply chain issues are easing up. There may not be enough truck drivers, but the container ships are moving more easily. One indicator is the Baltic Dry index (below) which seems to have peaked, and which may indicate a bit of potential slack in commodity prices.

Freight rates and industrial metals



Source: Bloomberg, Tatton IM, Baltic Exchange: G326
BCOMIN Index (Bloomberg Industrial Metals Subindex) Baltic Dry + Metals Daily 23NOV2011-26NOV2021 Copyright© 2021 Bloomberg Finance L.P. 26-Nov-2021 14:22:07

However, the minutes from the last US Federal Reserve (Fed) meeting gave markets further reason to expect some attempt to exert a firmer grip on monetary policy in December, as does Jerome Powell's reappointment as Chairman. The 6% year-on-year consumer price inflation is also testament to that and, as we've said before, the Fed's policy is far from tight. Meanwhile, the European Central Bank (ECB) has followed the Fed's earlier playbook in indicating a change to bond buying sometime in the future, but not for now. The ECB has a fixed envelope related to pandemic buying: the Pandemic Emergency Purchase Programme (PEPP) which is widely expected to be wound down. However, the Asset Purchase Programme (APP) already in place before the pandemic is expected to be increased to €40 billion, to ensure that the tapering is smoother.

But even a slight flex of the major central banks' hand may affect markets. Perhaps we're already seeing that in the prices of the more speculative assets. Bitcoin is going through another more volatile period, as is Tesla. Meanwhile, some of the 'profitless' smaller US growth stocks (early-stage companies which are yet to get into the black) have seen an exit of investors after a very strong run through 2021.

Global equity market breadth has narrowed as well. The recent winners have been the US mega-caps. Outside of these stocks, equity prices have been marking time. And, after the Q3 earnings season, US equity analysts have become less positive, with downgrades outnumbering upgrades for the first time since the start of the pandemic. Thus, the slow-moving policy tempo may coincide with the faster-moving virus news and lead to increased volatility. With markets still only just off their highs, there are plenty of profits in this year's bag, and a big temptation to book it before trading volumes get too low.

Regarding global politics, we look at the new German coalition in the next article. Its formation was expected, but the good-natured approach offers hope for stability and pragmatism, while also making headway in green initiatives.

Last week, the euro weakened faster than the yen, which had previously been the leading decliner of the past three weeks. The yen is a bit of a conundrum. Japan has a structural current account surplus which one would usually associate with a strong (expensive) currency. The biggest factor in that surplus is a corporate sector which chooses to hoard rather than spend. It ought to drive investment capex, which ought to lead to strong profitability. But it hasn't yet. We take a look at the yen and some implications of the incoming prime minister's new fiscal package in the second article.

Asia has been a global growth weak spot, courtesy of China's policy mix. Now, for the first time in a year, we have some positive signs. Admittedly Tencent was the subject of more regulatory pressure again. However, the People's Bank of China has been increasing liquidity and the government appears to be back on a spending path. A rapprochement of sorts between the US and China could help trade, in which case there could be a welcome boost to real activity and a further easing of supply chain issues in the new year. In short, near-term wobbles may be present at the start of December, but with little to worry us too greatly.

Germany's traffic light coalition starts revving up

After two months of negotiations, Germany's traffic light coalition government is set to go. Chancellor-to-be Olaf Scholz announced last Wednesday that an agreement had been reached between his own Social Democratic Party (SPD), the Greens and the Free Democratic Party (FDP). It will be Germany's first three-way coalition since the 1950s, and will see Scholz succeed Europe's foremost political stalwart Angela Merkel next month.

The result seems monumental and fairly ordinary all at the same time. September's election saw Germany's two main political parties (Scholz's SPD and Merkel's Christian Democratic Union) secure less than half of the popular vote for the first time in the modern era. Meanwhile, the combined vote share of the Greens and the FDP – traditionally smaller parties – made them the kingmakers in any coalition plans. For all the spirit of change, though, the coalition will be led by a party with plenty of recent governmental experience in the SPD. And with Scholz having plenty of federal government experience, Germany has a Chancellor who styles himself as the continuity candidate from the Merkel years.

The deal sets out some lofty goals. Scholz promised a "decade of investment" under the new government that would bring "the biggest industrial modernisation of Germany in more than 100 years". Climate change is top of the long-term agenda, with leaders pledging to make Europe's largest economy coal-free by 2030 – eight years earlier than planned – and to have 80% of the country's electricity renewably generated by the same time. This will involve a revamp of German infrastructure – itself a main focus of the parties. Those parties also suggested they were thinking about a floor in carbon pricing of at least €60 per tonne on a national level. Establishing floors in carbon pricing is seen as an essential feature for a functioning market – even if in the wake of COP26, the current European Union (EU) carbon price is above the €60 level. Also, a global carbon price does not yet exist, so the German government seems to have decided to at least do its homework. How much of proposed investment projects get translated into action, especially on the green transition side, is another matter.

Politicians also promised to bolster worker protections in last Wednesday's press conference, including a higher minimum wage of €12 per hour (currently set at €9.6). This is a one-off increase and a special commission will be appointed to decide further increases.

Germany's foreign policy had been dominated by outgoing Chancellor Merkel's style. Her leadership advocated for continuous de-escalation by keeping international communication channels open, although her critics have suggested the defence of democratic values may have suffered a bit. The new coalition has determined to be more assertive when dealing with Russia and China, and realistically Germany will keep considering its economic interests while (of course) co-ordinating with its European partners. But France would probably be happy to go along with a more distinctive European approach to international relations. European neighbours may also hope the new German government (which has yet to be sworn into office) will allow for more wiggle room on budgetary questions, especially as the European Stability and Growth Pact, which stipulates the stability of deficits and public debt, is being renegotiated.

While leaders focused on longer-term plans in the coalition's announcement, its number one priority can be nothing other than addressing Germany's worsening COVID crisis. It is telling that the formation of a new government was not the top story in German press last week. That distinction went to the grim news that Germany has surpassed 100,000 deaths from the virus, with cases still surging and the prospect of a difficult winter ahead.

Merkel reportedly pushed for a short national lockdown early last week, only for incoming politicians to push back. According to tabloid Bild, coalition leaders would prefer to wait and see if the previous week's tighter COVID restrictions will have an impact on transmission rates. But further restrictions are certainly possible, and the threat is noticeably weighing down economic sentiment. The news of a new – and potentially more aggressive – South African mutation could potentially add another dimension.

From an investment perspective, Scholz's longer-term focus is nevertheless understandable. COVID containment will grab headlines over the winter, but should fade through next year – at which point the economic recovery and green transition will take centre stage. Coalition leaders seem to have made a strong start here, securing an agreement quickly by German standards. Even so, its initial plans have been made out as either too radical or not radical enough, depending on where one stands, with less optimistic commentators focusing on the lack of concrete details. The rapid expansion of renewable energy plants and increased digitalisation need a huge injection of public spending, which all parties have provisionally committed to. But there is a glaring omission in the agreement on where these public funds will come from.

Coalition partners have agreed to expand social spending, restore Germany's constitutional debt limit from 2023 and hold back on tax rises. This gives little headroom for tweaks to broad strokes fiscal policy. However, people have been pointing to ways to circumvent the 'debt brake' balanced budget amendment, or to even amend it (it would need a two-thirds majority in parliament for it to be suspended). And while left-leaning members of government have talked up the prospects of special concessions or loopholes (such as investment funds kept separate from the government's main balance sheet), it remains questionable how much money can be generated to fulfil infrastructure promises. So, beyond last week's announcements, further intra-governmental negotiations are likely to be necessary to flesh out details – or otherwise inaction may be more prevalent than hoped for.

Political difference are the heart of the problem. The fiscally-conservative FDP campaigned on a platform of low taxes and reduced borrowing, while the Greens and SPD sought fiscal stimulus and redistribution. There is simply no way to increase spending without raising taxes or taking on more debt – or indeed cutting expenditure elsewhere. The latter can be painful, especially in an environment where a large share of the population feels left behind. Germany would also certainly benefit from reforms to simplify its administrative procedures and potentially make savings; as much as this makes sense, these kind of reforms tend to be laborious and not always straightforward to implement. So, while party leaders have surprised everyone with how well-mannered they seem to get along, they will have to keep working on pragmatic outcomes to generate change.

The well-known potential stumbling block is that as part of the deal, the fiscally hawkish FDP have been given control of the finance ministry. This will likely lead to FDP politicians frustrating their coalition partners when it comes to spending decisions, and could well result in confrontation down the line. The SPD and (particularly) the Greens are eager to work their way around tight purse strings with clever policy tools, but even these actions are likely to anger FDP voters.

The irony of the situation is that – judging from bond markets – there has never been a better time to loosen fiscal policy. The green transition needs capital investment, and the pandemic has prompted governments across Europe and the world to loosen budgetary constraints. Meanwhile, yields on ten-year German government bonds are in negative territory. With investors willing to pay Berlin to take their money, no major economy has as much room for fiscal expansion as Germany. But as we have seen time and again, fiscal prudence is a powerful force in German politics – we should not be surprised if it scuppers significant spending again.

That said, both the tone and the content of negotiations are encouraging. Coalition deals can take months to strike and – given the political chasm between some of the members – one might have expected bitter and drawn-out talks. Instead, many potentially thorny issues have been settled quickly, and politicians have presented a coherent and consistent vision of government – even on contentious points like China's human rights record.

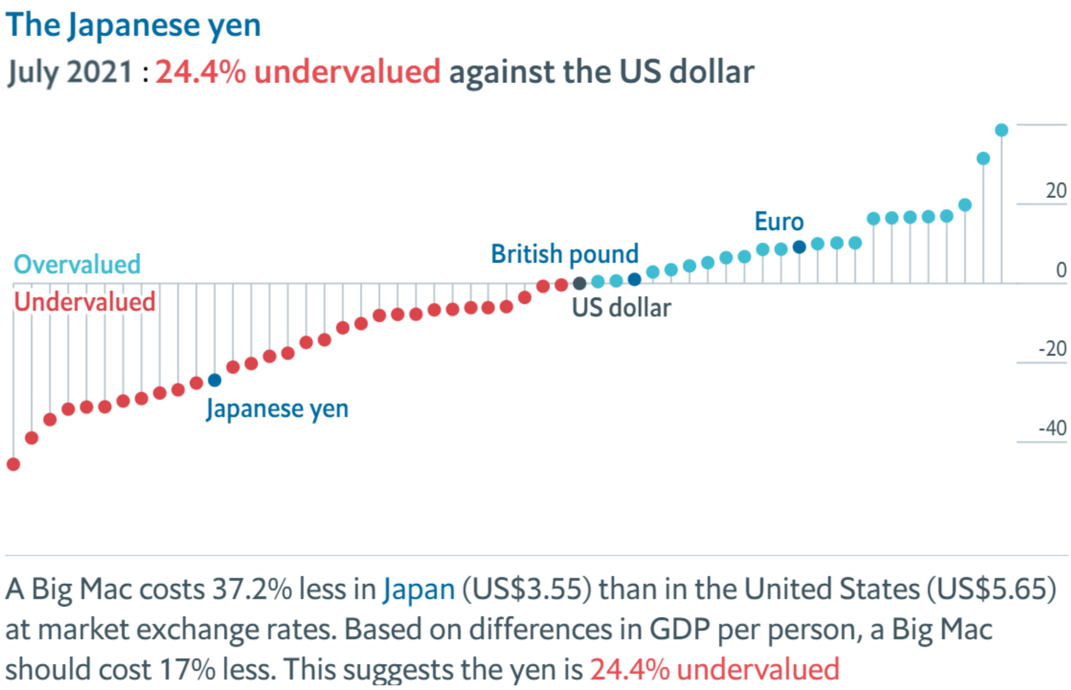
Throughout all of this, Germany's new leaders have appeared more pragmatic than idealistic. That is a good sign, as is the aforementioned fiscal headroom. Many voters will undoubtedly be disappointed with whatever compromise comes. But with four years until the next election, leaders might consider that a risk worth taking.

Japan makes another bid for economic blast-off

Regular readers will know that currency values – in particular the US dollar – are a key ingredient for our investment outlook. How 'expensive' or 'cheap' the dollar is against its peers has a big impact on businesses, equities and bonds throughout the world. On that front, we note that the last few weeks have seen a moderate uptick for the US currency. Moderate against *most* major currencies, at least, but one particular pairing stands out. Against the yen, the dollar has been trending consistently upward throughout the year. At the time of writing, $1 will buy you just over 115JPY. That is the most expensive the dollar has been (or, conversely, the cheapest the yen has been) since 2017. That is quite some cheapening for Japan's currency.

A few things might explain this at first glance, for example, currency values are sometimes seen as a reflection of the market's confidence in an economy. While Japan had fewer strains on its health system than most nations throughout the pandemic, it did not gain much from the global bounceback, especially in comparison to the US economy's impressive recovery from the lows experienced last year. Also, let's not forget Japan has had notoriously sluggish growth for years.

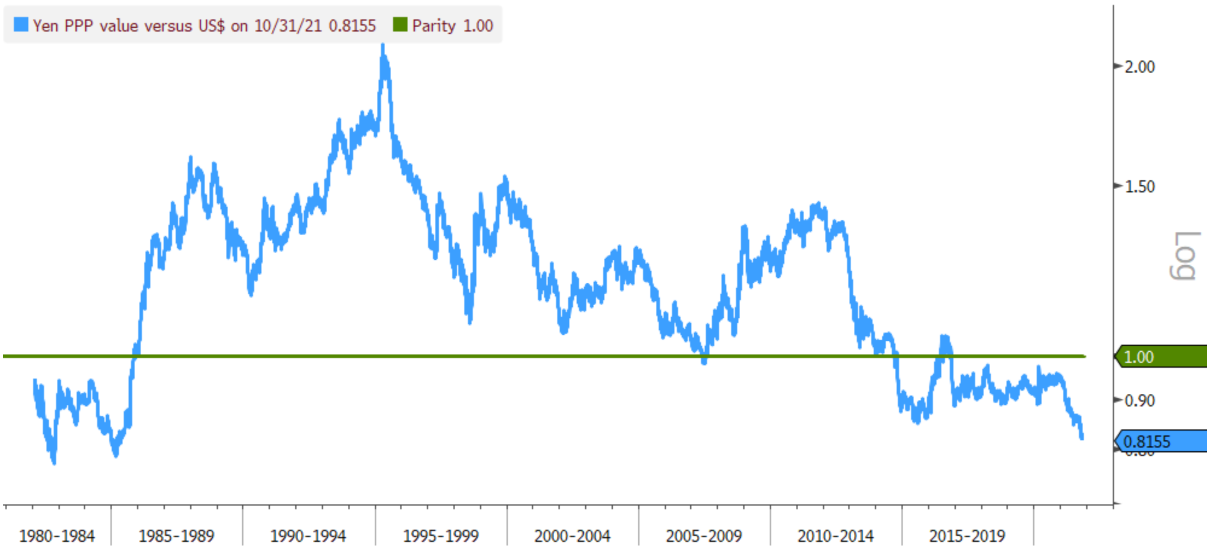
There is a perplexing element to this currency trend, though. It seems reasonable to expect to be able to buy equivalent goods and services across economies – referred to as purchasing power parity (PPP). An intuitive version of this The Economist's "Big Mac Index". One might want to adjust for how much people earn in different countries, and the Economist helpfully does this as well. Below, the Economist's chart shows the situation as it was in July, when the rate was around 110JPY/$.



Source: The Economist, Tatton IM

Japan has had low inflation for a long time. As a consequence, Japan's purchasing power relative to countries with historically higher inflation – such as the US – has increased. All else being equal, this would suggest the yen should climb in value against countries with higher inflation. But we have seen the opposite. According to our calculations, the yen is now as cheap on a PPP basis as it was in the 1980s – right before it soared in value against the dollar. Below is the historical chart using the OECD's GDP-based PPP measure (adjusted using Bloomberg's inflation-based measures) and our calculations.

USDJPY current market versus purchasing power parity
OECD/Bloomberg PPP estimates, based on GDP baskets (latest adjusted by CPI inflation)



Source: Bloomberg, Tatton IM, OECD: G590
BPPPCPJP Index (Japan Purchasing Power Parity (PPP) Exchange Rate CPI) USDJPY vs BBG PPP Daily 25NOV1980-26NOV2021 Copyright© 2021 Bloomberg Finance L.P. 26-Nov-2021 12:00:02

We should note that PPP is not the most reliable predictor of future currency moves – in the short term at least. Interesting in this case, though, is that Japan also has a strong current account balance (exports minus imports). That should mean more money is flowing into the country than out – putting upward pressure on the currency. But again, we see the opposite. In short, the yen looks very cheap, with not much to explain why.

The simplest reason would be that investors think the return on Japanese assets will be lower than elsewhere – most likely due to lower economic growth. When comparing the country against similar major economies in absolute terms, that seems like a fair assessment. Which begs the question: are Japan's prospects dim enough to vindicate such cheap valuations?

Here the answer is much less clear. Due to well-documented demographic problems, dated infrastructure and stubbornly high savings rates, Japan has a history of disappointing economic growth. But recently, we have seen encouraging news. Last week, new Prime Minister Fumio Kishida announced a fiscal stimulus package worth 56 trillion yen ($490 billion) – a record amount part-funded by a wave of new bond issuance. The package includes everything from COVID support and climate change initiatives to technology and defence.

As seen through the pandemic and beyond, investors love to get excited about government stimulus. Before we get ahead of ourselves, we should remember the similar excitement over former Prime Minister Shinzo Abe's so-called 'three arrows' – which promised fiscal largesse, monetary injections and structural reform, but underwhelmed on all counts. Critics have already pointed out Kishida's figure flatters to deceive in terms of new spending.

More importantly, there are issues, not just with the total amount but in ensuring it is effective. Japan's high savings rate is a stumbling block that numerous policymakers have run into down the years. We saw this last year, when a significant chunk of government support ended up in savings rather than consumer spending – reducing the knock-on effects of spending and diminishing the so-called fiscal multiplier for growth. For Kishida's current stimulus, Bloomberg has estimated a fiscal multiplier as low as 0.1%, drastically reducing the impact it could have on overall growth.

These are certainly valid concerns, but there are reasons to be hopeful. One of the biggest part of the new premier's plans is defence spending. This has been historically lacking for Japan in the post-war period (demilitarisation was previously part of the constitution) but recent governments have sought to increase the nation's defence budget – prompted by US pressure and rising geopolitical tensions with China. Kishida has promised to raise the proportion of GDP spent on defence from 1% to 2%.

It may sound counterintuitive, but defence spending can have a big knock-on effect on growth prospects. Historically, military spending has been one of the biggest contributors to overall research and development, particularly in technology. For Japan specifically, where savings are high and productivity improvements are hard to come by, government-led investment in technology is likely to be a source of growth down the line – and there is a fair chance that is where defence spending will end up.

Longer-term problems persist, however, such as an aging population increasingly in need of costly care and a corporate preference for saving. The latter is itself a target of reform by the new government – and early signs are encouraging – but it remains to be seen how effective reforms will be. Medium-term growth dynamics are likely to be driven by spending, though. The first-round effects from government stimulus are positive on their own, but the potential second-round effects on productivity and investment could be a big source of optimism. If this can also prompt capital flow back toward Japan, we could see a cascade effect as markets revise their valuations of Japanese assets. That is a big 'if', but it is one we will be keeping a close eye on.

Global Equity Markets

Market	Fri 15:43	%1Week*	1 W	Technical Short	Technical Medium
FTSE 100	7074	-2.1	-149	→	↗
FTSE 250	22699	-3.4	-793	→	↗
FTSE AS	4039	-2.3	-96	→	↗
FTSE Small	7218	-3.1	-229	↘	↗
CAC	6767	-4.8	-345	↗	↗
DAX	15362	-4.9	-798	→	↗
Dow	34920	-2.7	-951	→	↗
S&P 500	4619	-1.8	-85	↗	↗
Nasdaq	15572	-2.6	-422	↗	↗
Nikkei	28752	-2.9	-847	↗	→
MSCI World	3202	-0.5	-17	↗	↗
CSI300	4860	-0.6	-30	→	↘
MSCI EM	1255	-1.1	-15	→	↘

Top 5 Gainers

Company	%
B&M European Valu	+4.1
BHP	+4.1
United Utilities	+3.9
Intertek	+3.9
Severn Trent	+3.5

Top 5 Decliners

Company	%
Renishaw	-11.1
Int'l Consol Air	-10.8
Flutter Ents	-10.1
Rolls-Royce	-9.3
Prudential	-8.9

Currencies

Pair	last	%1W
USD/GBP	1.334	-0.8
GBP/EUR	0.848	-1.1
USD/EUR	1.13	+0.2
JPY/USD	113.20	+0.7
CNY/USD	6.39	-0.1
Bitcoin/$	54,481	-8.5

Commodities

Cmdty	last	%1W
Oil	74.55	-5.5
Gold	1798.4	-2.6
Silver	23.26	-5.5
Copper	430.4	-0.0
Aluminium	2717.5	+3.9
Soft Cmdties	247.0	+1.9

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	14.8	12.0	14.2
FTSE 250	2.5	14.9	19.1	16.1
FTSE AS	3.7	14.6	12.7	14.4
FTSE Small x Inv_Tsts	2.2	11.4	16.4	15.6
CAC	2.2	19.3	15.6	15.0
DAX	2.1	14.5	14.5	13.6
Dow	1.8	18.2	18.0	16.6
S&P 500	1.3	24.4	22.1	17.8
Nasdaq	0.6	29.1	34.1	23.2
Nikkei	1.7	15.6	17.5	17.7
MSCI World	1.7	21.2	20.2	16.7
CSI 300	1.8	15.5	15.5	12.6
MSCI EM	2.4	12.6	13.2	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.82	-0.06
UK 15-Yr	1.00	-0.08
US 10-Yr	1.49	-0.05
French 10-Yr	0.03	+0.03
German 10-Yr	-0.34	+0.01
Japanese 10-Yr	0.07	-0.01

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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29th November 2021

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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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