CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

21 March 2022

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Changing tides

Last week we reminded portfolio investors of the importance of making sure that long-term investment decision-making is not overly influenced by short-term market fluctuations. Here at Cambridge, we aim to ensure portfolios remain positioned appropriately, and are fine-tuned when medium-term changes in the economic and market outlook either necessitate adjustments or indeed present new opportunities. The strong rebound in stock markets around the world over the past week has been a case in point.

With oil prices having rapidly fallen from over $130 per barrel (pb) back to around $100pb, it seems clear that the prospect and negative potential of an energy price shock discussed last week has dissipated, returning more optimistic sentiment to markets. While this is broadly true, there were other dynamics at play over the week worth mentioning.

First, it was not just the price of oil that declined steeply, but also heating gas and many of the other hard commodities that had previously driven the fear of a price shock derailing the recovery. So, was it simply the faltering of Russia's invasion of Ukraine and the rising probabilities of a near term peace settlement that reversed commodity prices? Well, it certainly was a major influence, but market observers suspect another reason for the strength of the reversal was that the sheer magnitude of recent volatility left so many of the more speculative commodity market participants seriously out of pocket (margin), and that appetite and liquidity available for further 'bets' just simply dried up. We also know that the direction of commodity market price movements has over the past decade increasingly been boosted and exacerbated by momentum-detecting trading algorithms. This means, once the 'price-tide' turns, the boosting dynamics go the other way, leading to the extremes of 2020's negative oil prices as well as this year's sky-high levels.

The question was therefore whether the inflation scare has now peaked and are more realistic expectations finding their way into capital market valuations? It certainly seemed so, after the lowering of market-implied inflation expectations decreased the historically extreme gap between equity and bond market real yields. However, there was also fear that the US or UK central banks could upset these decreasing market tensions with last week's interest rate announcements.

In the end, rate-setting committees on both sides of the Atlantic raised interest rates by just 0.25% as had been expected, while the US announcement hinted at an expectation of a strong economy which was taken positively by markets. However, reading between the lines, monetary policy tightening could still come to bite in 2022. This is because the longer the price shock of the past nine months carries on, the more this risks leading to an embedding of inflationary expectations, turning the transitory price shock into structural inflation. Therefore, while central banks are tightening monetary policy gently enough to not cause serious upset, they have also signalled that they are prepared to step up their actions should labour markets become too buoyant – even when price rise pressures dissipate later in the year, as currently widely expected.

They may not need to worry too much. We can already detect a certain labour market slackening in the US, and perhaps in the UK, as last week's mass sackings callously announced by P&O Ferries demonstrated. Price rises are also increasingly driven just by car fuel and gas prices and, from past experience, we know consumers have shown a tendency to look through those.

The wider price pressures from supply chain stresses have also recently reduced, but this is where the positive news flow of the past week ends, after China reacted to fast rising cases of the Omicron variant with widespread lockdowns. We dedicate a separate article this week to China's ever-changing economic and market outlook, but note here that over the shorter term, China's leadership appears keen to strongly support its domestic economy through this rough patch, especially so as President Xi will be seeking approval of a third term in office later in the year.

Beyond these observations about the drivers of last week's market actions, the most important aspect for the medium to long-term picture may not be Russia's war on Ukraine, but how the relationship between the US and China continues to develop against this backdrop. Presidents Biden and Xi held a two-hour call last Friday, ostensibly to discuss Russia's aggression, but beneath the surface both sides will be considering Taiwan, and how recent developments may have influenced China's own ambitions to increase their territorial reach.

We hope quiet and measured diplomacy will win the day, although Biden's camp is making somewhat provocative statements, which suggests the US may be taking a hard-line stance amid a sense of uncertainty about China's position.

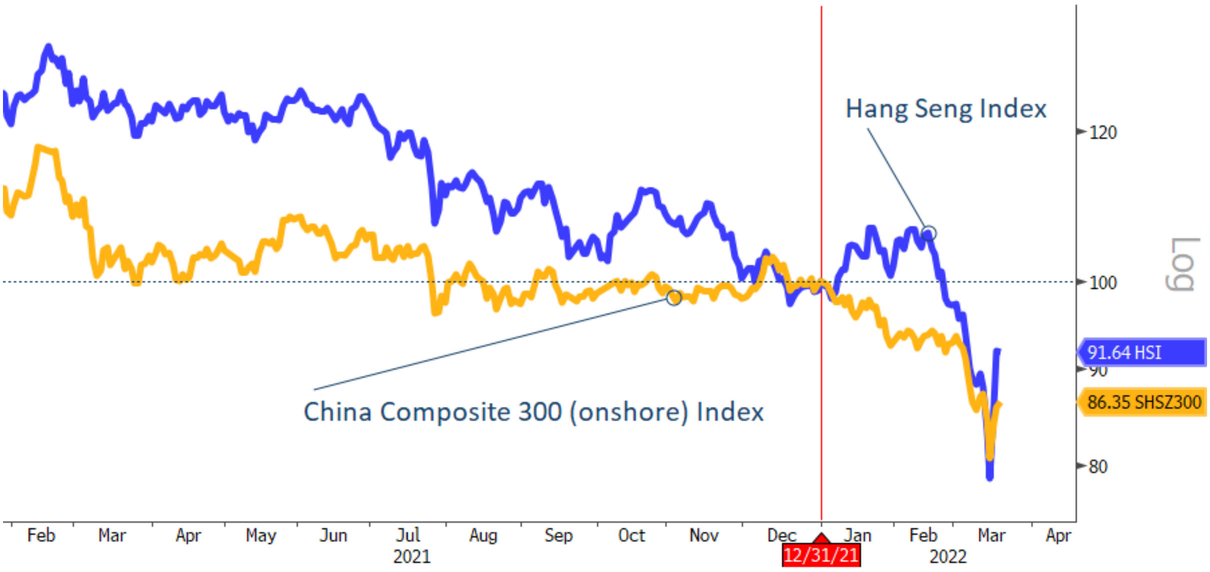
Behind all this is a very uneasy conclusion. If peace in Ukraine is to be achieved soon, it may only happen with some form of international acknowledgement that allows Russia to gain control of Donetsk, Luhansk and ultimately Crimea. China's claim on Taiwan is stronger than any that Russia has over these areas. Peace in Ukraine would therefore make Taiwan very nervous.

To end our top-level comments, we clearly welcome last week's market dynamics, but also acknowledge that market valuations for the forthcoming months will continue to be subject to many moving parts, with an almost equal probability for improvement or deterioration. Much will depend on continued easing of supply bottlenecks and consumers increasing their demand for services rather than goods as we leave another winter of COVID-restricted lives behind. For the positive post-pandemic economic impulses from this to feed through to risk asset returns, labour markets need to remain balanced enough to not force central banks to step up their still very measured monetary tightening in an attempt to put the inflation genie back into its proverbial bottle. We are monitoring this fragile balance intently, while being ready to react with portfolio adjustments should they prove required or opportune.

China benefits from the 'Beijing Put'

In case you missed it, Chinese stock markets went on a wild ride last week. Shanghai and Shenzhen listed companies on the CSI 300 index dropped 5% on Tuesday, while Hong Kong's benchmark Hang Seng index dropped almost 6% to its lowest level since 2016. This capped a torrid three trading days for corporate China, with the Hang Seng ending Tuesday's session down 21.3% year-to-date. Then came an almighty rebound on Wednesday: The CSI climbed 4.3%, while the Hang Seng jumped a whopping 9.1%. It was the latter's best trading day since 2008.

China and HK equity indices
Rebased to 100 as of 31-Dec-21



Source: Tatton IM, Bloomberg
HSI Index (Hang Seng Index) China HK equity indices Daily 31DEC2020-18MAR2022 Copyright© 2022 Bloomberg Finance L.P. 18-Mar-2022 07:49:33

The gains were even larger for China's tech giants. Alibaba added 27.3% to its share price in midweek trading, while ecommerce company JD.com surged 35.6%. But was the tech sector rally simply correcting the slump that preceded it? The precursor to the decline was the announcement from the US Securities and Exchange Commission (SEC) that five Chinese companies risked being delisted from US stock markets for failing to hand over proper audit documents. The turmoil caused Hang Seng's tech component to drop 21.7% in the three trading days up to Wednesday – a fall only recovered on Thursday.

The SEC ultimatum exacerbated investor fears, but it did not start them. Chinese equities had been in a downward trend since the beginning of last year – a sell-off that gained pace over the last few weeks. The backdrop of slowing growth in the world's second largest economy – as its property sector has become unhinged – a regulation trigger-happy interventionist government and the looming threat of lockdowns from Beijing's zero-COVID policy have all fractured confidence.

COVID is a particular concern. Hong Kong has recently seen some of the worst COVID death statistics of anywhere throughout the entire pandemic – as the city's seven-day average of deaths per million people reached 38. The mainland is now suffering similar problems, as it records its highest level of infections since the initial outbreak. Most of these new cases come from the Jilin province – home to 24 million people. Local authorities have now reintroduced tight restrictions, as have ten other cities and counties across the country. As of last Friday, cases were still surging, and now more broadly.

China's containment policies appear much less effective against the Omicron variant. Confused messaging on vaccines has left large sections of the population unprotected against COVID – particularly the most vulnerable. According to China's own Nation Health Commission (NHC), 87.8% of the mainland's population has received at least two jabs, but only 51% of the over-80s have received two or more. In Hong Kong, 60% of the elderly are unvaccinated.

The government's original zero-COVID policy has reached its limit and, in the short-term, authorities can only stem the tide through tighter restrictions, harming growth. Last Thursday, President Xi Jinping told the Communist Party's top decision-making body that China will "strive to achieve the maximum prevention and control effect at the least cost and minimize the impact of the epidemic on economic and social development". The NHC press conference used the term "Dynamic COVID Zero", a more targeted approach using more (better) vaccinations and testing.

Avoiding further lockdowns would be a positive for growth. And for now, growth seems to be top of the agenda, according to comments from officials. Vice Premier Liu He announced last Wednesday that Beijing would take measures to "boost the economy in the first quarter" and pursue "policies that are favourable to the market".

While Liu was light on detail, this kind of market reassurance has been rare in China in recent times. Indeed, it was what caused the dramatic stock market rally on Wednesday. An Asia-Pacific strategist from Citibank compared the comments to famous central bank interventions like Mario Draghi's "whatever it takes" speech: "It's not quite of that order of magnitude, but it's not that far away either".

If authorities are prepared to reinforce the reassurance with effective action to sustain profits, Chinese equities could have much to gain. Global markets have suffered a bad start to the year and China's stock markets have underperformed global markets. Moreover, Chinese markets struggled in 2021 compared to their western counterparts – ending the year down overall.

This has left Chinese equity valuations much lower than elsewhere, at the same time as the economy hopes to recover from its slump. If this recovery is backed up by firm policy support, China's lowly valuations could look like a bargain.

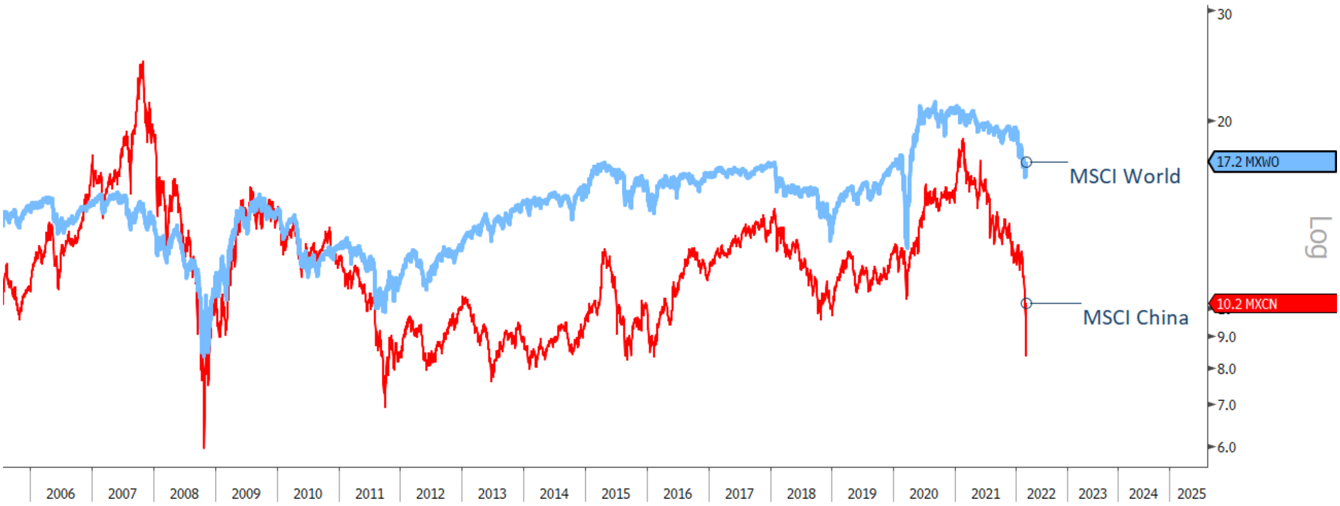
While it is hard to say how much policy will follow Liu's pledges, this is already a stark change to one year ago. Back then, the Communist Party was cracking down on the private sector, halting stock market IPOs, launching antitrust investigations and even making the entire education sector legally unprofitable. This was supposedly in the pursuit of "common prosperity", which implicitly stood in contrast to individual enrichment. Many in the west feared President Xi was waging a war on profit, making China's entire stock market virtually 'uninvestable'.

We wrote at the time that these fears were exaggerated. Common prosperity has been one of the Party's central tenets for decades, but how that translates into policy has always depended on the underlying economic picture. Beijing has undergone a recalibration in recent years – away from unfettered growth towards sustainability and equality. This has resulted in some erratic policy decisions, but it is a stretch to say profit is discouraged. To the contrary, authorities have gone to great lengths to ensure companies have healthy balance sheets. They have cracked down heavily on activities they perceive as speculative or excessive – as seen in the Evergrande property developer crisis – but officials have sought to balance these actions against promoting growth. This should be expected, given the vast size of China's private sector. As we see from the latest comments, when growth is under serious threat, Beijing is more likely to ease its grip.

Interventions still pose a great risk – and have the potential to create many stranded assets. But this is part of the risk assessment for Chinese investments, not a blanket barrier on them. The same is true for the threat of sanctions – a topic fired up by the Ukraine crisis. It is reasonable to worry that China's close political ties to Russia – or its ambitions in Taiwan – could increase the geopolitical risk around Chinese assets. But as we wrote recently, the reverse could also be true – China will not want to risk its trade with the west, and has already pushed for mediation. This could see Xi come out as a strong figure on the international stage, and bolster the domestic economy in the meantime. Friday's discussions between Xi and Biden will be important in how that situation evolves.

As volatility in China shows, its assets come with big risks and, in capital markets, that usually translates into higher risk premia. But with growth turning around and the government softening its stance, the higher risk could also come with great returns. Higher risk premia may require adjustments to investment calculations, making comparisons with the valuation multiples available within western markets less helpful (see chart below), but this should be seen as part and parcel of professional investment decision making, rather than a call to ignore China altogether.

China & World price-to-earnings ratio
MSCI, analysts estimates for the next 12 months



Source: Tatton IM, Bloomberg, MSCI: G762
MXCN Index (MSCI China Index) China HK equity indices Daily 31DEC2002-17MAR2023 Copyright© 2022 Bloomberg Finance L.P. 18-Mar-2022 12:35:45

Why ESG needs to be more than 'feel-good investing'

What makes a good investment? Usually, one with high returns and low risks. But the answer depends on what you mean by "good". If you want your money to do good as well as achieve decent returns – as an increasing number of investors do – this also means avoiding morally dubious assets or rewarding righteous ones. This increased the popularity of 'ethical' investment options some years ago, but people often disagree about what counts as ethical. This is where ESG investing – where assets are screened for their environmental, social and governance credentials – is supposed to help. ESG offers a clearer set of definitions and makes it easier to align with policy guidelines. Unsurprisingly, there has been a huge growth in ESG investments in recent years.

The only problem is that while the question has evolved, it has not really been answered. So what makes an ESG investment? You might reasonably think that polluting energy companies or military defence stocks would be excluded, and indeed many financial institutions have shunned these companies over the last few years. But this could be changing. Swedish bank SEB started a new sustainability policy last year that excluded defence stocks from its funds. The bank has now reversed this decision: from April, six of its funds will be allowed to buy defence stocks.

The U-turn has come from Russia's invasion of Ukraine – and the subsequent conversation around boosting western military spending. In the fog of war, Germany has announced a €100 billion investment in its military, while the European Union (EU) seems to have dropped proposals to deem defence companies unsustainable. Examples like SEB are few, but the debate has certainly begun.

This extends to energy companies too. With record high prices of oil and gas, the conversation around energy security is the loudest it has been since the 1970s – when Saudi Arabia started an oil embargo against countries in the west. In a complete turnaround from his electoral campaign, President Biden is now encouraging more oil and gas exploration in the US, while Britain's Conservative government is reportedly considering giving the green light to fracking. Germany – where the Green Party has a seat in government – is currently reactivating its coal plants.

Political debates filter through to the investment. Even before Putin's invasion, the European Commission added nuclear and gas energy companies to its sustainable finance taxonomy, provided specific conditions were met. While companies would be required to make sustainability disclosures, this would allow gas technologies to be considered as 'transitional'.

Interestingly, the energy security impulse has a different effect on different regions. As Europe uses fossil fuels for its energy, but has limited oil and gas reserves, it relies massively on imports,– as the fiasco around sanctions on Gazprom and the suspension of the Nord Stream 2 pipeline has demonstrated. Therefore, the drive toward energy security decreases the political incentive for fossil fuels and pushes lawmakers toward accelerating renewable projects. Last week, more than a hundred MEPs called on the European Commission to withdraw its 'transitional' label for gas, saying the invasion of Ukraine made these plans obsolete.

However, the US and UK have been forced to increase their immediate fossil fuel output. And while lawmakers claim this will not come at the expense of building green technology, the attractiveness of fossil fuel investments – when oil and gas prices are so high – will likely drag capital away from the green sector.

Last week, Republican-leaning Democratic Senator Joe Manchin opposed the nomination of Sarah Bloom Raskin for the US Federal Reserve's financial regulation role. Raskin was President Biden's pick, and has advocated making climate risks a mandatory part of corporate reports, along with financial stability risks emanating from climate change. Manchin, a continual thorn in Biden's side, claimed this would deter fossil fuel financing and undermine US energy needs. In a 50-50 split Senate, his opposition effectively killed her appointment, along with the chances of climate reporting regulation. This lack of clear regulation makes it harder to pin down which investments are allowed to use the ESG label.

This is all the more pressing because of the popularity of ESG funds, meaning that financial institutions have an incentive to use the label where they can. Climate-friendly indices have performed better in recent years than conventional ones, regardless of whether they give low or high weighting to the US. This only increases the appeal of ESG for investors.

However, the reason for this outperformance is more to do with the underlying biases of ESG-labelled companies than anything else. These companies are mostly investing in newer technologies for the future. As such, they have low or negative current profits with high expected returns in the future. This makes them growth stocks, which have performed well in the era of easy monetary policy. The end of this 'easy money' era is therefore a negative for such companies.

Because of how investors discount future cashflows, growth stocks are vulnerable when yields rise, as it puts pressure on their valuations. For example, ESG companies are usually not 'value' stocks with high near-term earnings. But value stocks like financials and energy utility companies are precisely the ones that benefit the most from a rising yield environment, meaning that such stocks are likely to outperform ESG. At the same time, it's worth noting that renewable energy stocks experienced a boost on the back of the Ukraine invasion.

All of which is to say, weaker returns this year from ESG stocks might have very little to do with a general reorientation toward energy security or defence, but instead just be an artefact of the overall growth to value rotation. The fact European renewable energy stocks stand to gain from energy independence is a case in point for this.

These matters are complicated by the debate around what gets included under ESG. Since this style of investing is driven by moral or political concerns, it is sensitive to political trends. Policymakers would do well to give firmer guidelines that investors can stick to – otherwise what makes a 'good' investment will remain too loosely defined.

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21st March 2022

Global Equity Markets

Market	Fri 15:53	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7395	+3.4	+240	→	↗
FTSE 250	21077	+4.3	+870	↘	↘
FTSE AS	4128	+3.5	+139	→	→
FTSE Small	6826	+3.1	+208	↘	↘
CAC	6609	+5.6	+348	➘	→
DAX	14350	+5.3	+722	➘	↘
Dow	34369	+4.3	+1425	→	→
S&P 500	4416	+5.0	+212	→	↗
Nasdaq	13733	+6.9	+889	→	→
Nikkei	26827	+6.6	+1665	→	↘
MSCI World	2981	+5.0	+141	→	→
CSI 300	4266	-0.9	-41	➘	➘
MSCI EM	1121	+3.2	+35	➘	➘

Top 5 Gainers

Company	%
Intermediate Capital	+13.3
Smurfit Kappa	+12.5
Ashtead	+12.1
Entain	+11.9
St James's Place	+11.6

Top 5 Decliners

Company	%
Polymetal International	-15.6
Avast	-11.2
Anglo American	-6.4
Glencore	-5.8
M&G	-3.4

Currencies

Pair	last	%1W
USD/GBP	1.317	+1.0
GBP/EUR	0.839	-0.2
USD/EUR	1.10	+1.2
JPY/USD	119.17	-1.6
CNY/USD	6.36	-0.3
Bitcoin/$	40,985	+5.9

Commodities

Cmdty	last	%1W
Oil	107.13	-4.9
Gold	1931.5	-2.9
Silver	25.01	-3.3
Copper	472.0	+2.2
Aluminium	3384.5	-1.3
Soft Cmdties	225.9	-2.9

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.49	+0.00
UK 15-Yr	1.74	+0.05
US 10-Yr	2.14	+0.15
French 10-Yr	0.82	+0.10
German 10-Yr	0.37	+0.12
Japanese 10-Yr	0.21	+0.02

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	13.7	11.4	14.3
FTSE 250	2.8	12.5	14.0	16.2
FTSE AS	3.6	12.1	11.7	14.5
FTSE Small x Inv_Tsts	2.5	1.3	12.0	15.3
CAC	2.3	15.1	12.8	15.2
DAX	2.4	14.0	12.9	13.7
Dow	1.9	17.3	18.0	16.8
S&P 500	1.4	21.9	19.6	18.0
Nasdaq	0.7	26.0	28.0	23.7
Nikkei	1.8	14.8	16.1	17.7
MSCI World	1.8	18.4	17.6	17.0
CSI 300	1.9	14.8	12.6	12.7
MSCI EM	2.5	12.1	12.2	12.6

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.76	1.67
3-yr Fixed Rate	1.79	1.69
5-yr Fixed Rate	1.79	1.70
10-yr Fixed Rate	2.22	2.28
Standard Variable	3.83	3.79

* 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

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21st March 2022

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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