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Will a new PM be good news for investors?

Here at Cambridge, we rarely talk about UK politics in our deliberations on markets. That's not because we're not interested. Rather, it is because domestic politics have less of an effect on the broader global assets that we invest in on your behalf.

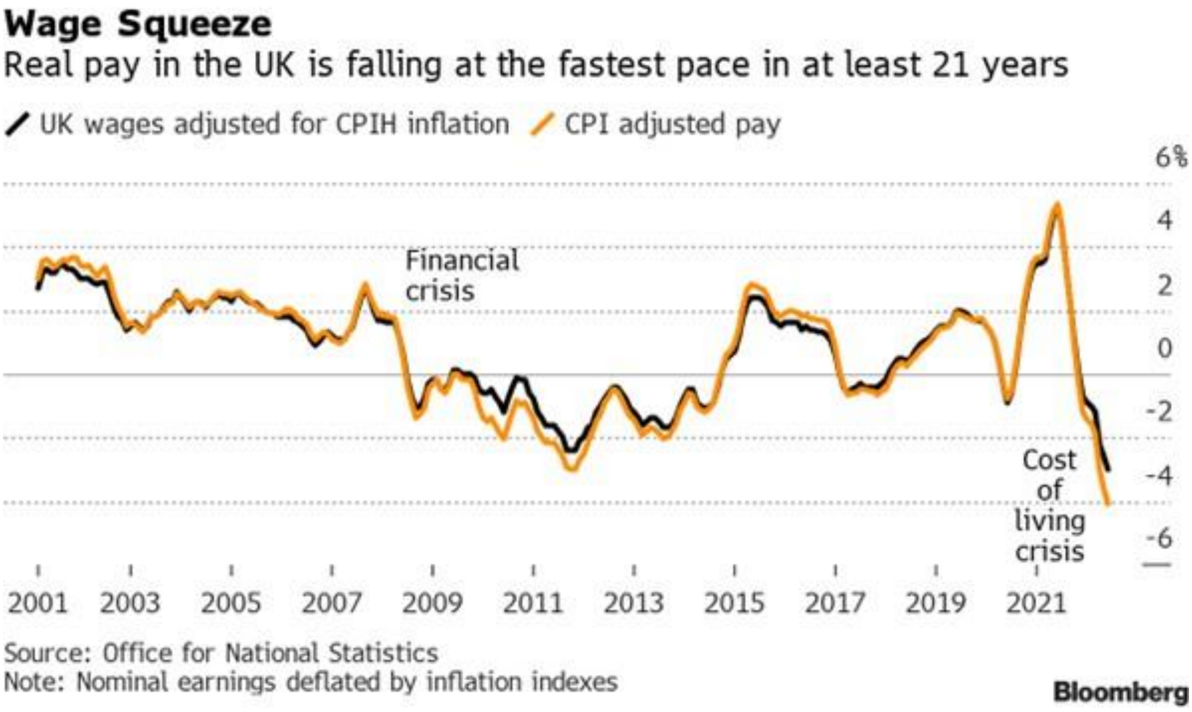
Yes, the FTSE 100 is an important component of those investments. However, many of the large- cap companies comprising the main UK index are global in nature. The vagaries of UK domestic demand are important, but not as important as the US, mainland Europe and China. Likewise, with bonds, most of the interest rates and credit risks are broadly global in nature. The most identifiable UK-based risk in Cambridge's portfolios revolves around Sterling. Even here, because the global equities we hold do not usually have any currency hedging, the performance of our portfolios tends to look better when Sterling is weaker.

It's almost certain that Liz Truss will win the Conservative Party leadership ballot and become the UK's next Prime Minister on Monday 5 September. According to Betfair Exchange, Rishi Sunak has only a 5% chance of victory. With most Conservative Party members having already cast their votes, it will take a cataclysm to derail Liz Truss's leadership bid.

She will face a difficult start. There is little doubt that the UK economy is in poor shape. The most obvious expression of this is consumer confidence, and the GfK Consumer Confidence Barometer is currently at -44, a move of three Standard Deviations. One reason is surely the reduction in the purchasing power of UK disposable incomes. Early last week, every news and media outlet ran the story that average real disposable income has fallen at its fastest rate in the 21st century. Below is Bloomberg's chart drawn from data from the Office for National Statistics, which shows wages adjusted for current inflation:

Consumers are reining-in effective spending. That is likely to worsen as the weather cools and the next massive change in energy prices is due. Without government action, UK household energy bills are set to rise about 80% in October, when the regulator Ofgem next lifts the limit on how much energy suppliers can charge. Consultancy company Auxilione notes that the window is closing for Ofgem to calculate what the cap will be. Average bills will likely near £3,600 a year when the new level for the three-month period beginning in October is announced next week, up from the £1,971 cap, which came into effect in April.

One can make a case that it's not all bad. When looking at current nominal wages, the recent growth path is rising at about an 8% annualised rate according to our calculations. The unemployment rate is around 3.8% and jobs are plentiful. People may feel hard done by, battling to get their wages up to damper the higher costs of living, but their employers still need the workers.



However, while jobs are being created, the pace of job creation has slowed, and consumers have already started to reduce spending in volume terms. That's evident in declining real GDP terms as well as in the retail spending data. However, for the Bank of England's Monetary Policy Committee (MPC), it is highly likely that the rise in wage growth accompanying the rise in consumer prices will force their hand. Another rate rise of at least 0.5% in September is as certain as Liz Truss's victory.

The market currently prices a rise in base rates to over 3.75% by March. The Bank of England will have its remit examined immediately by the new Truss regime, and this might be a source of worry for the currency market.

While we think it unlikely that the government would try to change the Bank of England's independence directly, currency traders may worry about greater political influence exerted on its decisions and analysis. Sterling has weakened both against a strong US Dollar and even a weak Euro, and fears of spiralling currency-induced inflation would be unhelpful.

At least we are not alone, the rest of Europe has similar concerns over inflation and energy. They too have faced a nasty lack of rainfall, but the Rhine river levels have started to rise after rain fell last week. Although natural gas and electricity prices continue to rise, oil prices have fallen substantially over the past few weeks.

Below, we write about China, which is also facing growth issues. As we write, Prime Minister Li has announced more support for Chinese companies, which will help support global growth levels.

Moreover, US growth remains strong, almost uncomfortably so. Investors are moving back to expecting more rate rises from the US Federal Reserve (Fed) but that is in response to solid signs of economic resilience, something which is welcome for a softer Europe and UK. Despite Europe and the UK's issues, the profit outlook for our global companies has remained positive, especially in Sterling and Euro terms. As we mentioned towards the start, globally-oriented portfolios can hold up reasonably well, even if the outlook domestically is gloomy.

The new Prime Minister will have a job on her (or possibly his) hands. We wish them well.

US Inflation Reduction Act reduces carbon emissions

Joe Biden has had a frustrating presidency. His ambitious fiscal plans have been repeatedly thwarted, both by Republican opposition and by those within his own party. So, it was something of a surprise that the commander-in-chief's $700 billion climate, health and tax package passed through the US House of Representatives last Friday. Having already cleared the Senate, the so- called Inflation Reduction Act landed on the White House desk for Biden's seal of approval last week.

The White House press team took a triumphant tone on the bill's passage: "President Biden and Congressional Democrats have worked together to deliver a historic legislative achievement that defeats special interests, delivers for American families, and grows the economy from the bottom and middle out".

Hyperbole aside, it is certainly a great political achievement. The bill's route through Congress was relatively clear – despite unanimous Republican opposition – as Democrat lawmakers seemed to put aside past differences. It is the first real victory for Biden, who has suffered numerous setbacks with previous initiatives. Senator Joe Manchin, the most prominent lawmaker on the right wing of the Democratic Party, had previously used his position in a 50/50 split Senate to hold a veto over the President's agenda. In a notable gesture, Biden handed Manchin his pen after signing the bill into law.

The title of the Inflation Reduction Act likely played a role in getting Manchin's cooperation. Previous spending plans had been blocked by the dissident senator because of their potential effects on the US Treasury's budget position. He shunned bills focused on jobs or economic growth, citing how fiscal expansion could increase inflation pressures and worsen the country's cost of living crisis. A balanced bill aimed at "Inflation Reduction" was seemingly much more palatable for Manchin.

In truth, it is an inflation reduction act in name only. The non-partisan Congressional Budget Office reported it will have a "negligible" effect on prices this year and next. It is designed to increase corporate tax revenue, constrain the pricing power of pharmaceutical companies, and increase incentives for green investment. According to Goldman Sachs, the act amounts to a fiscal tightening worth 0.1% of US GDP over the next ten years – making it essentially neutral.

Still, neutral is better than a spending boost for inflation pressures, leading Manchin to call the legislation a "balanced bill". Moreover, fiscal neutrality does not mean it will have little impact. Far from it, commentators have pointed out how new laws could have huge impacts on the US health and green energy sectors.

From next year, pharmaceutical companies will be required to issue rebates for above-inflation increases in the prices of Medicare (the federal health insurance programme for people over 65) drugs. From 2025, citizens benefitting from Medicare will have their costs capped at $2,000 per year. Beyond that, the US government will have the power to negotiate prices on top-selling drugs. These measures are expected to reduce revenue and earnings for pharmaceutical companies later this decade.

That could mean a big change for the healthcare sector, which has benefitted massively from its pricing power and political influence. In valuation terms, the bill has created a big discount in pharma stocks. Whether that is justified is debatable – especially considering some measures could be reversed by future administrations. Fundamentally though, we expect the regulatory pressures on pharmaceuticals to remain, constraining the longer-term outlook for the sector.

The Act's environmental provisions will likely have a bigger impact. Americans will be able to take advantage of tax credits to buy electric cars and solar panels for their homes, while the US government will invest heavily in renewable energy production and storage. The Act remarkably also introduces a tax credit for so-called green hydrogen, made via electrolysis of water using renewable energy. This is currently costlier and less popular than standard hydrogen production, which uses fossil fuels and releases large amounts of CO_2, but costs are expected to fall over the next decade.

According to Bloomberg's analysis, new tax credits will move forward the 'tipping point' at which green hydrogen becomes cheaper than its fossil fuel produced counterpart to 2025. In fact, should current trends continue, and the tax credits remain in place, the price of US green hydrogen could turn negative by the end of this decade. This will add an estimated $13 billion in funding for clean hydrogen projects, and massively ramp up incentives for private investment.

The actual subsidy could be far greater though. Credits are based on production and, if costs decline as rapidly as predicted, this could result in a huge surge which drains much more from the federal budget than currently expected. A similar situation occurred in the early days of the European solar market, where producers took advantage of subsidies and ultimately strained government budgets. This caused a sharp reversal in certain policies, which undermined confidence in the industry. If that scenario played out in the next ten years, the US would either have to U-turn on its current policies or loosen its fiscal position.

Problems down the line would likely be offset by growth and investment benefits though. A huge increase in hydrogen supply and demand would generate significant growth, and likely speed up the global green transition. Tax revenues would therefore increase, potentially paying for the policy's costs. This is particularly true considering the tax changes that the Act also brings. There will now be a 15% minimum tax rate on corporate profits, and a 1% excise tax on corporations.

From an investment point of view, the big positive is that the law invests heavily in long-term supply- side changes. Given the acute undersupply in the current global economy, that is welcome news. Of course, these will not affect short-term inflation – whatever the name suggests. But they set the tone for greater opportunity ahead. Whether all these measures stay in place in the years to come is uncertain, but the investment it could spur will have a big impact nonetheless.

China's leaders get worried

China continues to buck the trend in global monetary policy. While the world's major central banks are aggressively raising rates to fight runaway inflation, the People's Bank of China (PBoC) surprised us all by easing policy last week. It delivered a 0.1%pt cut to the medium-term lending rate, increasing funding to some financial institutions. It also cut the seven-day reverse repo rate by the same amount, and then injected CNY 2 billion into the financial system. Even avid watchers of PBoC policy were caught off guard; a poll of economists last week showed none predicting the move.

China's central bank has expressed concerns over inflation, but the world's second-largest economy has the lowest level of any major nation. Its monetary policy has diverged from the rest of the world because the key concern is weak domestic demand, emanating from its ailing property sector and sporadic Covid-induced lockdowns. The credit impulse – a measure of how much credit is contributing to overall GDP – has increased in recent months as a response, but not by a huge amount.

These cuts are significant and poor economic data for July appears to have been the spark. There was a fall in loan growth with July's new loans totalling 679 billion yuan, against an expected figure of 1.1 trillion. Total social financing – a broad measure of credit and liquidity – similarly disappointed, coming in at CNY 756 billion versus an anticipated 1.3 trillion. Elsewhere, industrial output, investment, retail sales, property sales and construction all showed signs of slowing growth or outright decline. Simply put, July was a very weak month.

This follows a particularly strong June. In the early summer, those same growth indicators beat expectations and pointed to a recovery from the recent malaise. JP Morgan's 'Nowcast' estimate for growth peaked in mid-July at an annualised rate of 14%. Back then, we suggested this could mark a turnaround for China, with Covid worries and property woes receding. However, July saw the estimated run-rate dropping back sharply again, going in the other direction. Was it just a false dawn?

We would suggest caution as the last two months' data show that while China is volatile, the Nowcast is still showing a run-rate above 7% as shown in the previous chart.

Headwinds are clearly still present. Businesses have been wary of further government crackdowns, which have at times threatened to make entire industries unprofitable.

The crackdown started with tech platform companies, but it has been the demise of property developers which has profoundly impacted the economy. Chinese domestic demand and personal borrowing is heavily tied to its property market. Citizens tend to have their savings linked to the value of their homes, meaning that house prices – or perceptions of house prices – can strongly influence spending and credit habits. The Communist Party, in trying to address unaffordable property values, has destabilised consumer confidence.

Recent government efforts to support the economy have focused on infrastructure spending and other centrally sponsored projects. However, this is not where China's economic problems lie. It is rather the private sector, and consumption in particular. The government has shied away from allowing the private sector credit growth that marked the previous growth spurts of 2009, 2012 and 2016.

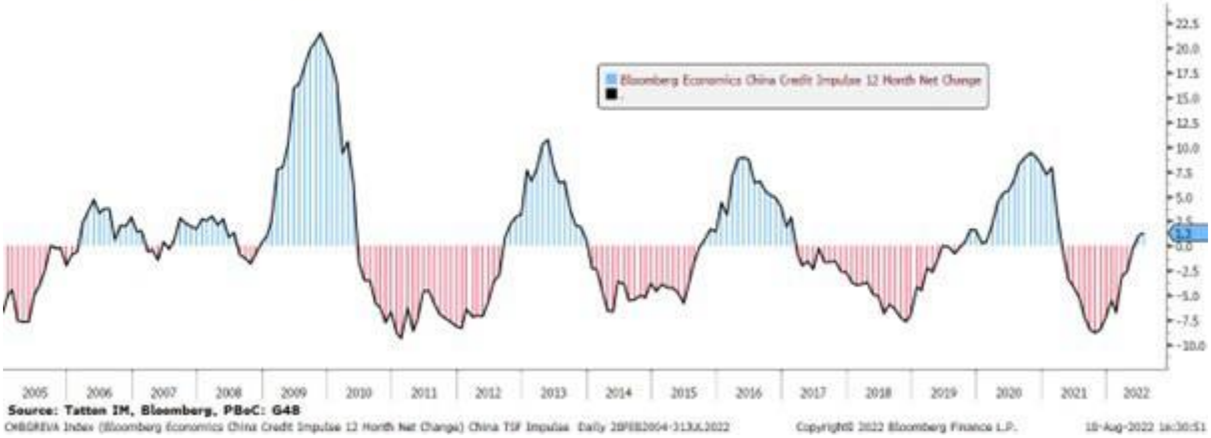
The 20th National Communist Party Congress will likely be held at the beginning of November, and is as big as they come. It is expected to be a formal consolidation of President Xi's increasing power, with the six other seats on the Politburo Standing Committee – a group of the most powerful men in China – set to be filled with Xi loyalists. As an affirmation of the President's authoritarianism and aggressive foreign policy, he needs a strong and vibrant economy. This is more than just a question of window dressing. Economic growth and common prosperity are the Party's side of its bargain with wider Chinese society, for which it gets unquestioned rule in return.

The current Standing Committee met to prepare for the Autumn Congress last weekend. July's dire performance was enough to drive them into action and further reverse their reluctance to support credit growth. The PBoC, which only the previous week had said inflation pressures prevented easing policy, cut its policy rates. In addition, the Renminbi moved weaker against the US Dollar on Monday, albeit a relatively small move of 1% and only in line with other currencies such as the Euro.

Another signal came in the form of direct assistance to property developers, as banks can now get government guarantees on loans to developers. This will be helpful in dealing with the fallout from the recent mortgage strike – where buyers refused to meet mortgage payments due to construction delays.

However, we should not ignore the other source of consumer disquiet. The zero-Covid policy has repeatedly put swathes of China under damaging lockdowns. Currently that policy remains in place, which means that while the repeated infections are tiny in number, currently over 25% of China's GDP is at risk of being locked down again (according to Bloomberg Economics' calculations on 17 August). The policy is harder to change, given it has become ingrained in the way the Party has governed for more than two years. But, for the populace in general, a change in this diktat is as important as any policy on property.

China TSF (Credit) Impulse



There may be signs that change is coming. The drive to get China's elderly and vulnerable population vaccinated has become more forceful and the rate of vaccination is now above 80%. Meanwhile, there are signs Hong Kong is being used as a testbed for a move towards the west's endemic' Covid policy. Therefore, the zero-Covid policy could be eased as we draw closer to the congress in Autumn.

For now, while economic volatility remains an impediment to consumers, growth is probably improving, while policy continues to ease. While Xi may still be reluctant to add to the credit impulse, he needs a buoyant consumer, and the incentives to give consumers that boost are strong.

CAMBRIDGE INVESTMENTS LIMITED

22nd August 2022

Global Equity Markets

Market	Fri 16:04	%1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7554	+0.7	+53	↗	→
FTSE 250	19933	-2.0	-406	↗	↘
FTSE AS	4160	+0.2	+10	↗	→
FTSE Small	6558	-0.9	-62	↗	↘
CAC	6506	-0.7	-48	↗	⇘
DAX	13557	-1.7	-239	↗	↘
Dow	33696	-0.2	-65	↗	⇘
S&P 500	4231	-1.1	-49	↗	⇘
Nasdaq	12697	-2.7	-350	↗	↘
Nikkei	28930	+1.3	+383	↗	→
MSCI World	2826	-0.3	-8	↗	↘
CSI 300	4151	-1.0	-40	→	↘
MSCI EM	1010	-0.7	-7	→	↘

Top 5 Gainers / Top 5 Decliners

Top 5 Gainers Company	%	Top 5 Decliners Company	%
RS GROUP	+5.2	abrdn plc	-9.5
AstraZeneca	+5.2	Persimmon	-8.8
London Stock Excha	+4.4	Mondi	-7.9
BP	+4.1	Aviva	-6.9
Harbour Energy	+4.1	AVEVA	-6.7

Currencies

Pair	last	%1W
USD/GBP	1.180	-2.8
GBP/EUR	0.851	-0.6
USD/EUR	1.00	-2.2
JPY/USD	137.07	-2.7
CNY/USD	6.82	-1.1
Bitcoin/$	21,329	-12.3

Commodities

Cmdty	last	%1W
Oil	96.38	-1.8
Gold	1749.3	-2.9
Silver	19.13	-8.2
Copper	364.8	-0.6
Aluminium	2403.0	-4.7
Soft Cmdties	217.4	-4.5

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	10.8	9.7	14.3
FTSE 250	3.2	8.9	14.1	16.4
FTSE AS	3.7	10.4	10.0	14.5
FTSE Small x Inv_Tsts	3.3	7.8	11.5	15.4
CAC	3.0	12.5	10.6	15.2
DAX	3.4	13.1	11.2	13.8
Dow	2.0	17.5	18.0	17.0
S&P 500	1.5	20.1	18.7	18.3
Nasdaq	0.8	24.1	27.8	24.3
Nikkei	1.9	15.9	16.2	17.8
MSCI World	2.0	16.8	16.6	17.1
CSI 300	2.1	14.4	13.4	12.8
MSCI EM	3.2	10.1	11.6	12.7

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.42	+0.31
UK 15-Yr	2.76	+0.23
US 10-Yr	2.99	+0.16
French 10-Yr	1.81	+0.26
German 10-Yr	1.23	+0.24
Japanese 10-Yr	0.20	+0.01

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	3.51	3.29
3-yr Fixed Rate	3.31	3.20
5-yr Fixed Rate	3.45	3.26
10-yr Fixed Rate	3.72	3.59
Standard Variable	4.54	4.50

* 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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22nd August 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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