THE **CAMBRIDGE** WEEKLY

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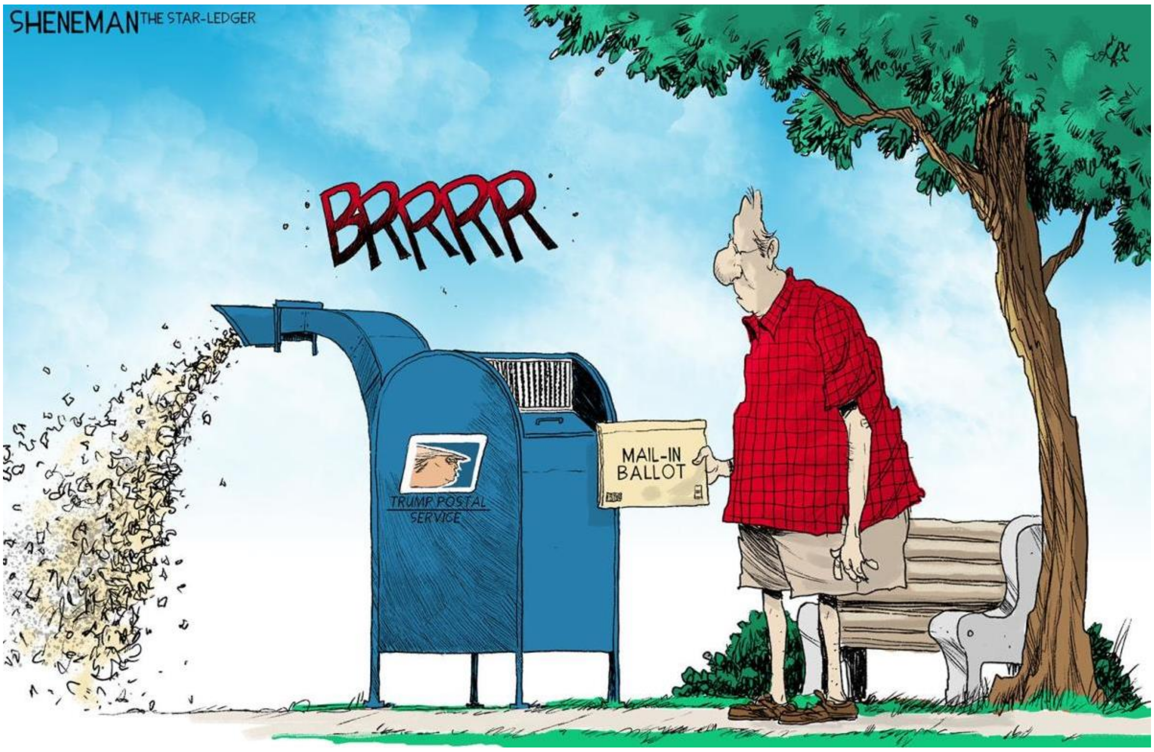


Drew Sheneman, 20 August 2020, The Star Ledge, New Jersey

Big tech gets bigger while the Fed takes the easy option

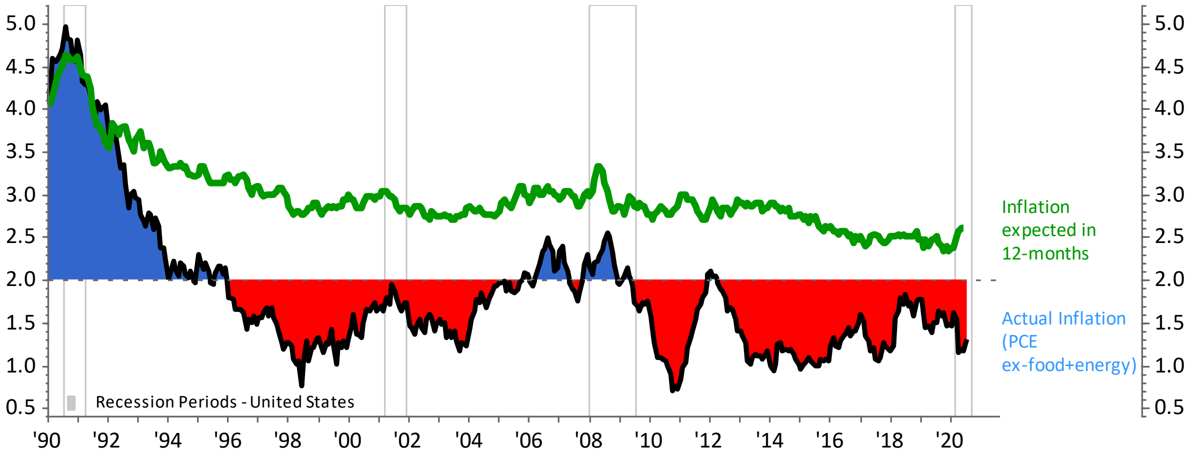
In a week where Donald Trump kicked off his re-election campaign in earnest, global investors showed it is indeed "America first". US equities continue to push at all-time highs, having recovered everything lost in March's frantic sell-off – and then some. If the stock market soaring to new heights while the world languishes in its deepest ever recession isn't staggering enough, we also note the US is accelerating away from its global peers. While the S&P 500 has gained an incredible 56% from its March lows, the UK's FTSE 100 has barely moved in the last few months – seemingly locked around the 6000 level. European and most other markets look similar, with US and global investors all giving the world's largest economy an overwhelming vote of confidence.

In particular, investors are bullish about America's big tech superstars, with the mega-cap tech sector emerging as an undisputed pandemic winner. We wrote last week about Apple's colossal $2 trillion market cap milestone, and since then the company moved to split its shares four to one. Incredibly, the rationale Apple gave for the move was that it could then achieve a broader investor base. That the most bought company in the world, and history's most valuable firm, wants to reach more investors begs belief, but it shows just how confident markets are about the US and its all-conquering tech giants.

That market optimism continues to be backed up by an abundance of liquidity. Last week's main market event was a speech from US Federal Reserve (Fed) Chair Jerome Powell, in which he – expectedly – announced a break from past Fed policy. From here on, it will allow inflation to rise above the 2% target for short periods of time, in the same way that inflation has often undershot that target. The announcement changes nothing right now, with the Fed holding interest rates at near-zero and pumping huge amounts of capital into the financial system. But it confirms what investors have suspected for some time: easy monetary policy is here to stay, even when the economy starts whirring again.

Inflation: Actual and Expected

US PCE Deflator (x-f&e) and Michigan Inflation Expectations



Source: Factset, Tatton IM, US BEA, Univ. of Michigan

Judging from the market reaction, Powell's speech was a success. Longer-dated bond yields rose somewhat, signalling greater market confidence in long-term economic growth. No doubt the rally in equity markets also had something to do with the Fed's change of tack. Officially, the Fed's mandate on inflation – the 2% annual target – has always implied it is symmetrical, with inflation overshoots in some years offsetting undershoots in others. But for the past few decades at least, the Fed has clearly shown a bias towards preventing inflation going higher than 2%.

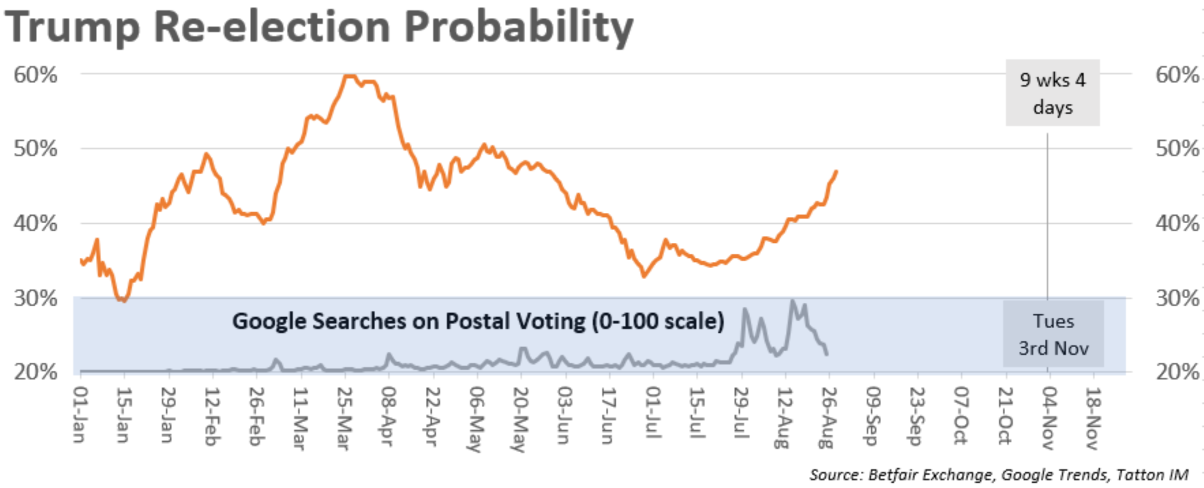
This can be seen in the way it has approached wage inflation. The other part of the Fed's dual mandate is to ensure full employment. But when the labour market has tightened in the past, and wages have started rising, the Fed has been quick to tighten monetary policy. As well as contributing to the disinflationary environment we have been stuck in for years, there is clearly a growing concern that this approach has also had a damaging impact on income inequality – with fighting inflation almost always coming ahead of bolstering employment.

The Fed's latest review shows a clear change of heart here. Rather than talking about a "deviation" from full employment, the Fed now talks about a "shortfall" in employment. This suggests the committee wants to go for full employment first and inflation containment later. And this means inflation could run higher than the 2% target – hopefully coupled with higher levels of nominal growth – for some time. With the new policy framework, the Fed is telling us it is in 'easy' mode for the long haul. As such, this could be an important turning point for monetary policy.

Given the deep global recession we are in, an easier Fed does not mean that the dollar will weaken immediately, or that US Treasury yields will spike anytime soon. But it does make the Fed the most flexible and accommodative central bank in the world right now – which should lead to a weaker dollar in the long run. It is also clearly a positive for the US as a whole, which might justify markets' American optimism.

The other beneficiary from all this optimism is Donald Trump. At the Republican National Convention last week, Trump and Vice President Pence firmly nailed their colours to the 'Law and Order' mast – painting a Biden presidency as route to violence, anarchy and moral decay. But for all of that strongman rhetoric, the President will be well aware that economic optimism – backed up by an accommodative Fed – is crucial to his re-election hopes. Of course, capital market optimism is not the same thing as optimism from the people on the streets. But there are signs that US consumer confidence is coming back too.

All of this has bolstered Trump's electoral hopes. Back in June, the President's campaign looked in tatters, with Biden barely having to say a word to gain his big lead in the polls. But that lead has since come down, and betting markets now put the election at near enough a 50-50 split. This change has undoubtedly also had a positive effect on capital markets. For all of his bluster, Donald Trump's agenda of tax cuts and deregulation has been a positive for corporates, so it is little surprise that they should do well out of his increased chances. With little over three months to go until Americans head to the polls, the campaign will hot up even more.



In other world news, last Friday saw the resignation of Japanese Premier Abe for health reasons. Given Abe's supportive economic measures over the years, markets' immediate reaction was negative – with Japanese stocks falling 1.6% and the Yen falling somewhat (though shortly bouncing back). As effective as Abe's economic policies may have been, we see little reason to think that his departure is a major blow. The government's policy is unlikely to change drastically in the short-term, and the opportunity for new blood is often a good thing.

Finally, closer to home, UK markets over the last week have matched the weather: soggy. Clearly, the next stage of our economic recovery depends on getting people back to work. There are no real signs that this is imminent, but the upcoming return to school is a key part of that. Unfortunately, it is almost certain that increased opening measures – especially the reopening of schools – will cause at least some boost in virus cases. But whether this affects economic or market expectations depends on how big a spike we see and, crucially, how deadly that increased case load turns out to be. This we cannot know until at least a few weeks into September.

Apple stock split has domino effect on indices and trackers

Yesterday (31 August), Apple split its shares four to one, meaning holders of Apple stock will have four shares trading at a price of $125 instead of one share at the current price of $500. This is Apple's fifth stock split, aimed at making the stock more accessible to new investors (it is possible to buy less than one share of some companies, but not easy).

A 'book-entry' change should not affect investor views of the total valuation of a company. After all, the holding of existing investors is not diluted – at the moment the split happens the company's market capitalisation is unchanged. But history shows that it can, at least temporarily. This seems to have been so for Apple last week.

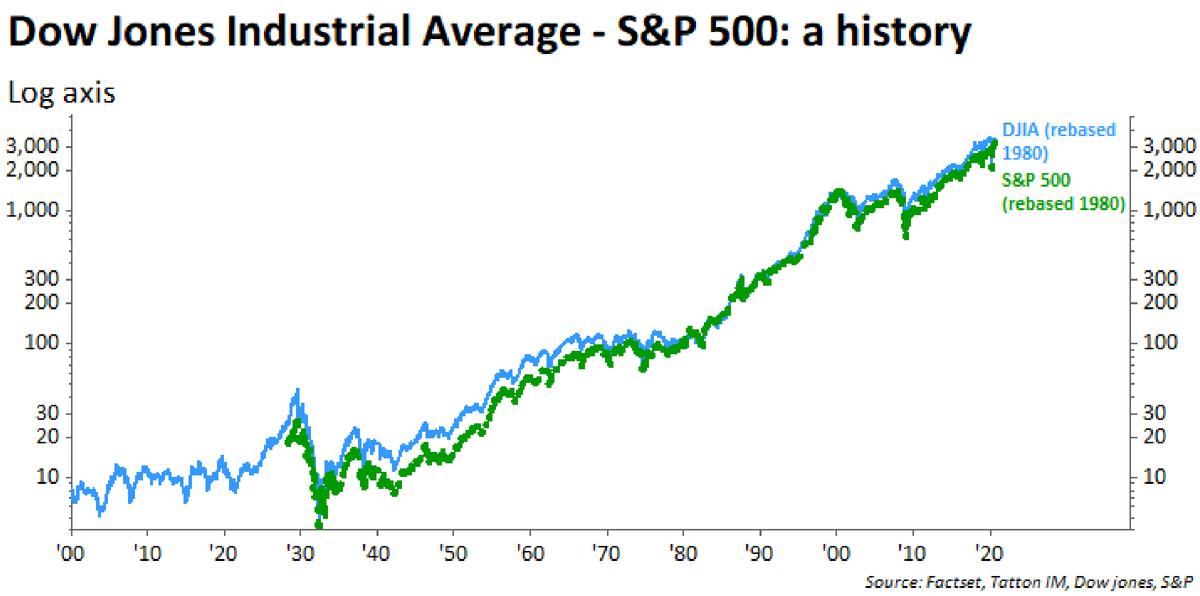
Apple's fairly normal corporate event has also had a major structural impact on America's oldest stock index: the Dow Jones Industrial Average (Dow). The Dow measures the performance of America's 30 largest companies, but because it does so on a price-weighted basis (explained below), Apple's split means that the company will receive a smaller representation

The Dow has a mechanism to deal with stock splits. However, Apple, and the booming US technology sector it leads, had become so dominant that the mechanism was inadequate, and a substantial index shake-up became necessary.

To offset the change, three stocks are being kicked out of the index, with another three set to take their place. The committee overseeing the Dow is giving the boot to pharmaceutical firm Pfizer and industrial company Raytheon, bringing in Amgen and Honeywell, respectively. But the big news is that ExxonMobil – a Dow participant for nearly 100 years – will be replaced by tech firm Salesforce.com. Exxon's exit is another signpost of its fall from grace: once the world's most valuable company at $575 billion back in 2007, the energy giant is now worth $180 billion.

The domino effect of Apple's change will trigger all the investments that track the Dow to automatically trade the affected stocks. Changing the constituents of a concentrated index like the Dow – based not on a company's performance, but on its decision to deliberately lower its share price – brings into question the value of the index as an indicator of economic health. What it also highlights is that the stocks in leading indices are not selected by algorithm, as one might expect, but by committee.

The Dow's committee made its changes to reflect the stock market dominance of mega-techs. It highlights how different a stock index's performance can be from its underlying parts. Despite being one of the most famous and recognisable indices in the world, as an investable asset the Dow has fallen some way behind its peers. Overall, the Dow is down 4.2% from its record highs in February, while the Nasdaq 100 – a much more tech focused index – is 20% higher than its pre-pandemic levels. Over a 20-year period, the performance has been in a similar range – Apple's share price drop will only re-enforce the Dow's 'underperformance'.



The difference in the performance of the Dow and the Nasdaq 100 is down to how they are calculated. The Dow is weighted by the price of individual stocks, rather than by the market cap of the underlying companies. It was originally calculated by totalling the per-share price of the stocks of each company in the index, then dividing this sum by the number of companies, but it is no longer this simple to calculate.

Although price weighted indices may have been useful at one point, many investment professionals now see such indices as unrealistic – and outdated – ways of measuring the market. An accusation that is perhaps not surprising, given the original methodology began in 1896. The 30 companies in the Dow are decided by committee and their selection does not seem to follow any consistent process, making it difficult to forecast what they will include.

Nonetheless, both the Dow and the Nikkei get a great deal of media coverage in their respective countries and internationally. From our perspective though, this seems to be more down to their history and longevity rather than their worth as investment tools.

By contrast, the S&P 500 is weighted primarily by market capitalisation (share price times number of shares), with a committee also deciding constituent stocks with other factors like liquidity, public float, sector classification, financial viability, and trading history. The Nasdaq Composite Index is also weighted by market cap, including all the stocks traded on the Nasdaq exchange and excluding financial institutions. Germany's DAX index is similar, but also incorporates order book volume as well as market cap.

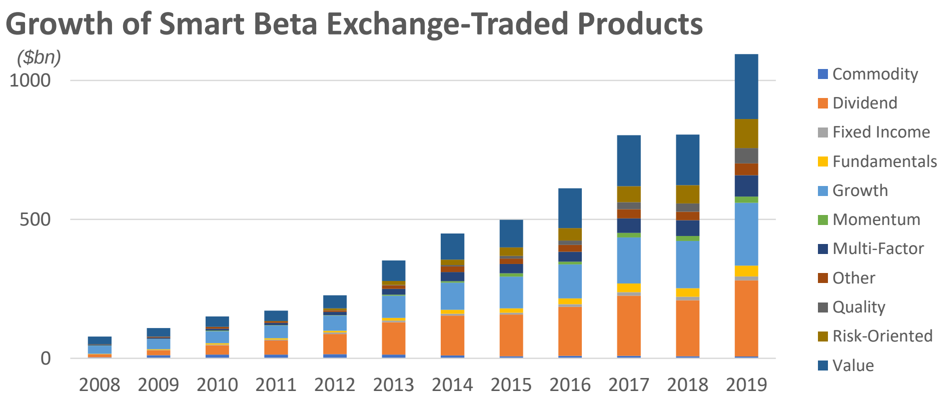
The different ways of calculating indices have their uses in terms of measuring market performance, but crucially, indices are not just about measuring market performance; they are about investing in the underlying stocks. In years gone by, investing in these assets would be achieved by a fund manager trying to replicate the performance of the index. Now, thanks to changes in technology, efficiency and the rise of exchange-traded funds (ETFs), investors can replicate an index's performance much more easily.

Indeed, there is a lot to be said for investment of this sort. Studies show that the average active fund manager – who picks their own stocks rather than investing in the broader market – underperforms the market once their fees are taken into account (which is unsurprising, given that the sum of investors are the market). This, coupled with easier access to a broader basket of stocks at a cheap price, has led to the rapid rise of passive investment funds.

Of course, not all benefit from this. Remember the Wirecard fraud scandal earlier this year? The assumption is that a bust company would automatically leave an index, but that's not necessarily the case. Deutsche Boerse, the stock exchange that listed Wirecard, had to change its own rules recently so that insolvent companies can be removed from the DAX with two trading days' notice. Wirecard was only removed last Monday, as Deutsche Boerse had to wait for its quarterly review. The new rule, could also make it difficult for fund managers to sell a certain stock in time.

The well-known downside to passive funds is that, while active managers fail to beat the market on average, passive funds can never beat the market, owing to their lack of flexibility or ability to react. It is also possible that the rise in passive funds has contributed to the outperformance of large stocks, which have larger weights in portfolios than active managers. As flows continue towards passive funds, the big stocks are supported, keeping their performance strong, creating more flows and so on. This is likely one of the reasons that America's tech superstars – Apple, Facebook, Amazon, Netflix, Microsoft and Alphabet (Google) – now account for more than a quarter of the entire S&P 500. That is an astounding level of stock market concentration. To return to the Dow, this is exactly the sort of performance it struggles to account for, given its price-weighting.

The Dow, as a way of investing, is probably a thing of the past. Its value lies almost entirely in that past, measuring the glory days of American investments since 1896.



Source: Morningstar, Tatton IM

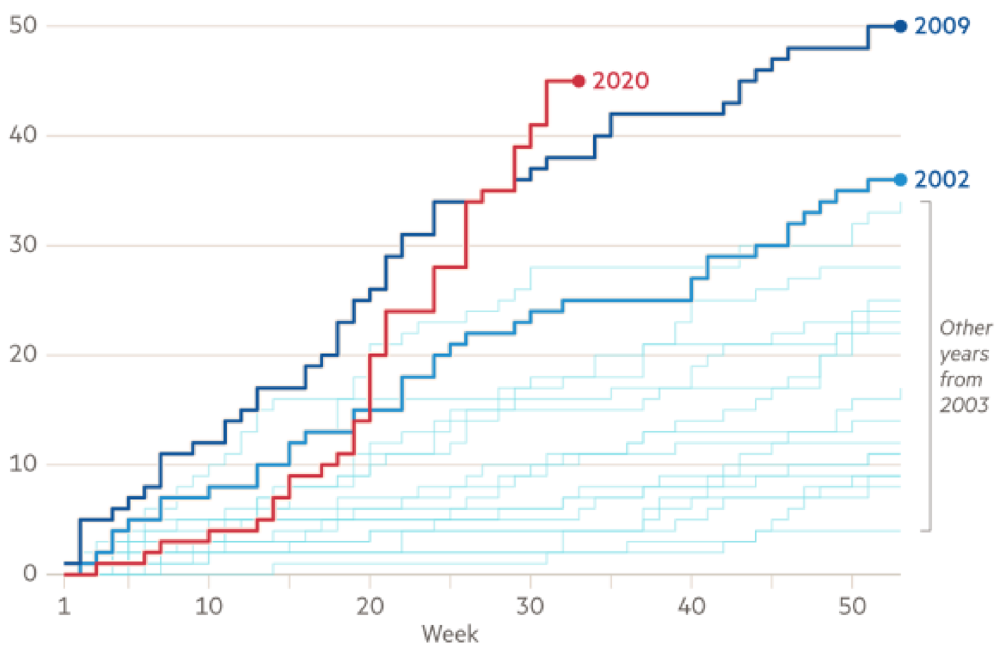
US bankruptcies: expected but not altogether undesirable

As we have written many times, the deepest global recession in the post-war period is no ordinary one. With activity suppressed by government diktat, it is hard to gauge how much of the plummet in demand is ‘real’ and how much is just a – hopefully short-term – virus response. To judge where the forced recession ends and the ‘classical’ recession begins, we need to pay close attention to the hallmark of all economic downturns: bankruptcy.

Recent news has been uncomfortable. Large corporate bankruptcies in the US are now running at a faster pace than ever. So far in 2020, 157 US companies with liabilities of more than $50 million have filed for Chapter 11 bankruptcy, beating the record-setting years after the dotcom and financial crises. Insolvencies among bigger businesses – those with liabilities over $ 1billion – have not yet reached the 2009 peak. As the chart below shows, the pace of the bankruptcy filings is running quicker than 11 years ago, with 45 big companies becoming insolvent already this year, and analysts expecting more to follow.

Covid-19 triggers a record wave of US corporate bankruptcies

Cumulative count of US companies with $1bn or more in liabilities filing for Chapter 11 bankruptcy



Data only account for lead case bankruptcy filings, which exclude the filings of major corporate subsidiaries. 2020 to Aug 17
Source: BankruptcyData.com
© FT

A few months ago, we saw the high-profile bankruptcy filing of car rental company Hertz, while other big American companies to file for bankruptcy include energy company Chesapeake and department store (and 118-year-old household name) JCPenney.

Clearly, a global pandemic and an economic shutdown makes normal operation difficult for any company, but the wave of bankruptcies we are seeing – despite trillions of dollars being poured into the economy through government aid programs – speaks volumes about the lasting impact of Covid-19. And with President Trump now set to cut the government's $600-a-week emergency unemployment support in half, bankruptcy filings are unlikely to let up anytime soon – especially if virus cases continue to spike across the US.

So, is this good or bad for the US economy? Charles Dumas of investment research group TS Lombard made some excellent points in a piece published last week, exploring why these bankruptcies are happening, and what effect they are likely to have.

Widespread bankruptcies among small or medium-sized businesses can be extremely detrimental to an economy – given the more direct impact on incomes – but for larger companies, allowing some to go under is not necessarily a bad thing. For an economy to show dynamism and growth, some level of 'creative destruction' – where unproductive or unsustainable companies die out and make room for more productive ones – is needed. Without celebrating the demise of Hertz and its ilk, at a certain point, businesses must be able to fail.

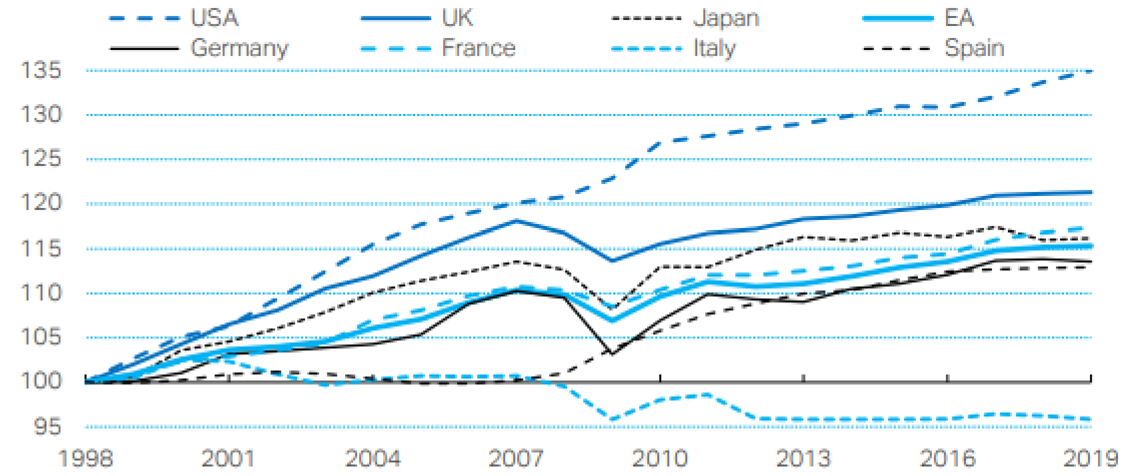
In fact, one of the main concerns with governments' blanket support measures has been that they would allow failing companies to carry on without a sustainable long-term business model. The pandemic may have been the nail in the coffin for Hertz and JCPenney, but both companies were struggling long before the first virus case arrived on America's shores. The fact these companies have been allowed to go under suggests creative destruction is still working.

As noted previously, the pandemic seems to be accelerating many themes that were already in play for a while. For example, the onset of the global economic shutdown coincided with a total collapse in oil prices and, sure enough, a big chunk of the US corporates filing for bankruptcy have been from the oil and gas industry. The trials and tribulations of the retail sector – with physical shops struggling to keep up with competition from Amazon and the like – have also been going on for over a decade now, so it is no surprise to see retailers struggling.

Arguably, the 12 years since the financial crisis and ensuing great recession have set the stage for a raft of corporate bankruptcies. For years, analysts have bemoaned 'zombie' companies that are kept afloat only by the cheap credit that the world's central bankers have created. Many also cite this as one of the reasons for the sluggish productivity growth seen over the last decade. With the economy unable to shake off its dead weight, growth could only grind upwards.

Indeed, bankruptcy law is perhaps one of the reasons the US economy has historically zoomed ahead of its developed world peers. Chapter 11 bankruptcy is not the end for a firm, but a reorganisation of its finances and business affairs. In fact, American businesses filing for Chapter 11 are often able to carry on trading, sometimes even coming back stronger than before. US bankruptcy law has apparently been so successful that policymakers in Europe and the UK have even tried to emulate it – to reproduce America's impressive productivity growth (see chart below).

Labour productivity, 1998 = 100



Source: OECD, TS Lombard

From an investment perspective, this productivity and focus on effective corporate structure has benefitted US markets. US corporate earnings growth have outperformed other regions over the long-term. Allowing companies to go bankrupt – but restructure operations to become more sustainable – could be a big part of this. As such – and as long as bankruptcies stay in the big business world rather than the small – a little creative destruction is nothing to be scared of.

Global Equity Markets

Market	Fri 15:41	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5975.5	-0.4	-26.4	→	↘
FTSE 250	17779	1.1	201.6	⇗	↘
FTSE AS	3347.8	-0.1	-4.4	→	↘
FTSE Small	5126.7	0.9	44.0	⇗	⇘
CAC	5002.2	2.2	105.8	→	↘
DAX	13015.0	2.0	250.2	⇗	→
Dow	28530	2.1	599.5	↗	→
S&P 500	3490.7	2.8	93.5	↗	↗
Nasdaq	11684.4	3.3	372.6	↗	↗
Nikkei	22882.7	-0.2	-37.7	⇗	→
MSCI World	2442.8	2.1	50.7	↗	⇗
MSCI EM	1117.2	2.3	25.4	↗	⇗

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	90.2	19.6	13.6
FTSE 250	2.9	50.2	27.7	14.6
FTSE AS	3.8	97.5	20.6	13.7
FTSE Small	3.8	34.8	-	13.8
CAC	2.2	44.6	25.5	13.9
DAX	2.5	40.9	21.3	12.8
Dow	2.3	24.2	25.6	15.5
S&P 500	1.7	27.2	26.8	16.5
Nasdaq	0.7	39.1	34.0	18.7
Nikkei	1.9	37.1	22.8	17.0
MSCI World	2.0	29.7	24.8	15.6
MSCI EM	2.3	19.9	18.0	12.1

Top 5 Gainers

Company	%
Carnival	13.7
John Wood	12.3
Int'l Consol Air	11.6
easyJet	11.3
WPP	7.5

Top 5 Decliners

Company	%
Rolls-Royce	-5.7
Hargreaves Lansdown	-4.2
National Grid	-3.8
CRH	-3.8
Severn Trent	-3.7

Currencies

Pair	last	%1W
USD/GBP	1.331	1.7
GBP/EUR	0.893	0.9
USD/EUR	1.19	0.8
JPY/USD	105.35	0.4
CNY/USD	6.87	0.8
Bitcoin/$	11,430	-1.6

Commodities

Cmdty	last	%1W
Oil	44.93	1.3
Gold	1957.7	0.9
Silver	27.48	2.6
Copper	299.1	2.5
Aluminium	1781.0	-0.5
Soft Cmdties	359.5	-0.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.31	+0.10
UK 15-Yr	0.56	+0.10
US 10-Yr	0.71	+0.09
French 10-Yr	-0.12	+0.09
German 10-Yr	-0.42	+0.09
Japanese 10-Yr	0.06	+0.03

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	2.19	2.19
2-yr Fixed Rate	1.45	1.42
3-yr Fixed Rate	1.71	1.68
5-yr Fixed Rate	1.70	1.68
10-yr Fixed Rate	2.37	2.38
Standard Variable	3.66	3.66

* 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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