CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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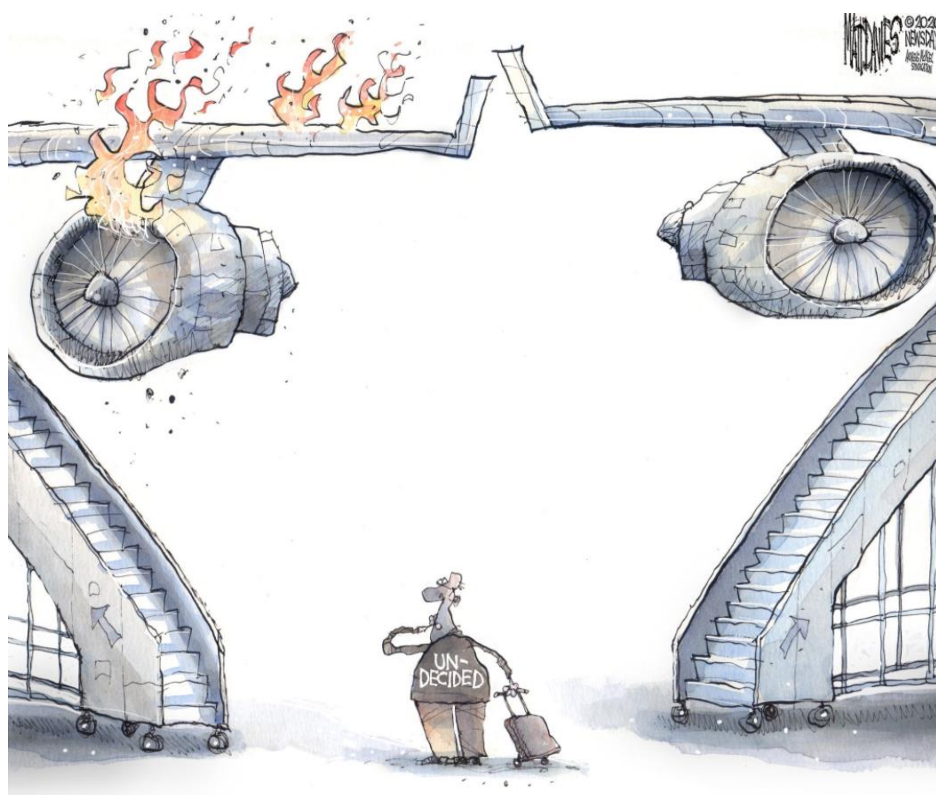


US presidential election, Matt Davies, October 22, 2020

Unsettled week ahead – or behind?

In the first article of The Cambridge Weekly we normally discuss the relevance of the weekly news flow for the development of our longer-term picture for our investors. Usually, our conclusion is that the noises of the week need to be put into perspective and not overinterpreted, because the long-term picture only very rarely changes abruptly. This week is different. The period we are in just now is one where the short term does have formidable influence on the longer term, so it is perhaps not surprising that capital markets as a whole were choppy over the past week.

The outcome of the US elections is keeping short-term market participants particularly trigger happy. Unhelpfully, this is exacerbated by the realisation that the severity of the COVID-19 second wave is no longer looking as benign as it did in September. Hospitalisations and fatalities among the old and infirm are rising at such an uncomfortable pace that critical care units could soon be struggling with capacity again. The economic impact of this second round of lockdowns may not be as severe as the first – because activity restrictions appear less blunt and all-encompassing – but nevertheless, the extraordinarily strong rates of economic recovery over the third quarter tell us very little about the next three months. As suggested last week, the recovery will pause and even dip into reverse for a little while, but the long-term picture of a strong 2021 will only fade if governments lose their confidence in bridging the gap once again. Central bankers and economists are still encouraging them to borrow and spend, but inevitably there will be many a politician whose natural instinct is to step on the fiscal brake instead.

In this respect policy announcements from European nations have been mixed, although it is encouraging to note that the usually so fiscally prudent Germany continues to lead by example, with a pledge to compensate affected businesses and the self-employed with government support of up to 75% of their turnover of the same period last year – as per last year's tax returns. The European Central Bank (ECB) proffered its support with a particularly forthright press conference, with plenty of hints that it will allow governments to use their fiscal tools to prevent lasting economic scarring.

Our suggestion last week that equity markets would take a lead from oil seem to have panned out. Brent crude oil fell below $40 per barrel because of a sharp rise in US physical storage as well as the European lockdown announcements. On the other hand, the continued stream of encouraging data releases about the strength of the Q3 economic recovery – paired with numerous optimistic hints from the pharmaceutical community that various vaccines in late-stage testing are likely to become available before year-end – served as support for equity valuations and meant that risk assets did not descend into freefall like they did back in February/March.

This leaves the Jekyll and Hyde characterisation of the US presidential election as the main source of uncertainty over the coming week. There are strong indications that the Democratic Party candidate Joe Biden will win the race against incumbent Donald Trump, but they are not decisive enough to dismiss memories of election night four years ago. Trump won against the odds, and indeed with a minority of the popular vote. This, together with the fear that the result may be close enough for Trump to reject conceding defeat – followed by a long and painful vote recount as seen in the election of 2000 (remember Florida's infamous 'hanging chads'?) – is what has markets really on edge.

In such an environment, it is not unreasonable to expect both the more risk-averse investors and speculative players to reduce their risk exposure by moving into cash until the storm has blown over and the dust settled. Lower equity markets at the end of last week are therefore much more rational relative to the shorter-term backdrop than much of the other market reactions we have recently experienced.

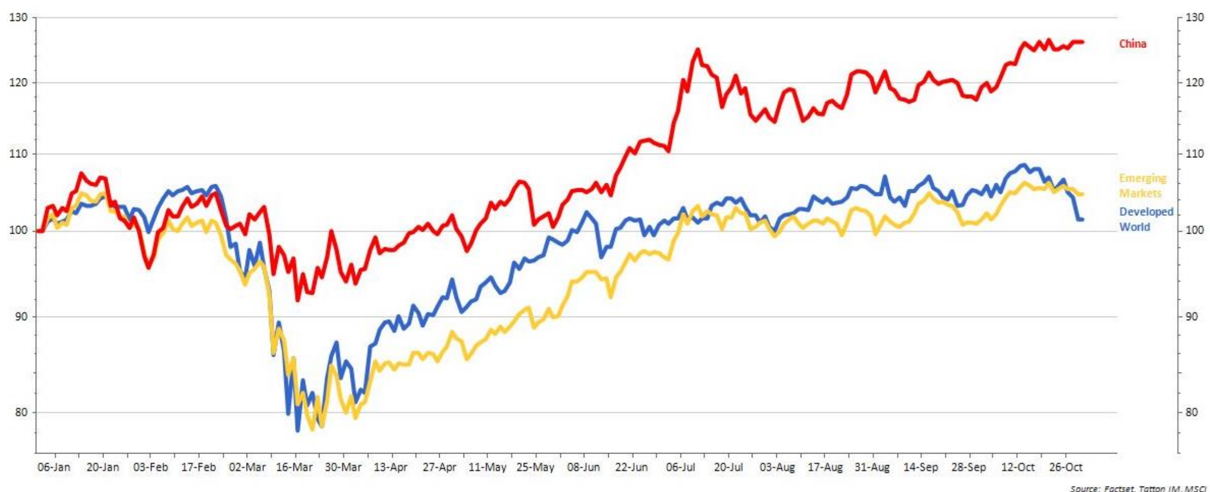
Fast-forward to the end of this week and, from an optimistic point of view, we might not only have certainty about the outcome of the US election, but may also see the release of the much-hinted-at positive results of the stage three vaccine test trials. This should lead the speculative and risk averse end of the market to re-engage, and for markets to continue in their gradual upwards direction, rather than the downward direction experienced over the last two weeks. The pessimistic perspective has the election resulting in chaos, or at least heightened uncertainty, and Europe's public health pressures increasing dramatically. Such an outcome would certainly cause more downside volatility in the short-term, but may also provide some attractive buying opportunities against the undiminished more positive longer-term time horizon the strong Q3 economic data suggested.

The current fluidity in markets has led us to wait until greater clarity emerges before progressing any changes at portfolio level to the Cambridge investment strategies. At present the risk of being out of the markets for the intended transacted amounts are elevated. Once these risks have diminished we will be looking to implement a rebalance of the portfolio strategies.

Investors bullish on China

As COVID fears rattled global asset markets last week, one country was notably absent from the sell-off. China's CSI 300 Index rallied in the midweek, while stocks across the US and Europe slid the other way. China's breakaway from the pack has been noticeable for some time – out of the major global indices only the NASDAQ has produced a higher return over 12 months. Chinese equities have been largely flat since the summer in local currency terms, but this stands in stark contrast to the volatility seen in the S&P 500, Eurostoxx 50 and – particularly – the beleaguered FTSE 100. Perhaps more importantly, the sideways motion in local currency translates into upward momentum when measured in other major global currencies. This is due to the immense recent strength of the Renminbi, which has been gaining value against the US Dollar since May. The chart below shows the year-to-date returns of Chinese equities against the rest of the world, measured in £-Sterling terms.

MSCI Total Return Indices in GBP



China's outperformance of the developed world in 2020 is impressive enough. But particularly notable is the decoupling of Chinese equities from those of wider emerging markets (EM). It means the rally in Chinese assets is not related to general EM or global sentiment; investors appear optimistic because of China itself.

They certainly have reason to be. Having gone through the COVID motions early, the world's most populous nation was already easing out of lockdown when the rest had just begun. This gave the economy a head start, which the Chinese government used to get both domestic consumption and production running again through extensive fiscal stimulus.

But the early start is just a small part of the story. A few months ago, we wrote that China's lockdown-easing bonus may be fading, as the European and US economies also began whirring again into the summer months. Now the situation looks completely different, with lockdown measures re-imposed in Europe and virus cases rising again across the Atlantic. The Communist Party was criticised for its harsh lockdown measures earlier in the year, but life is now much closer to normal in China, while disruptions in the West continue. For all the unsavoury elements of China's authoritarian regime, Western governments have envied its stability in 2020.

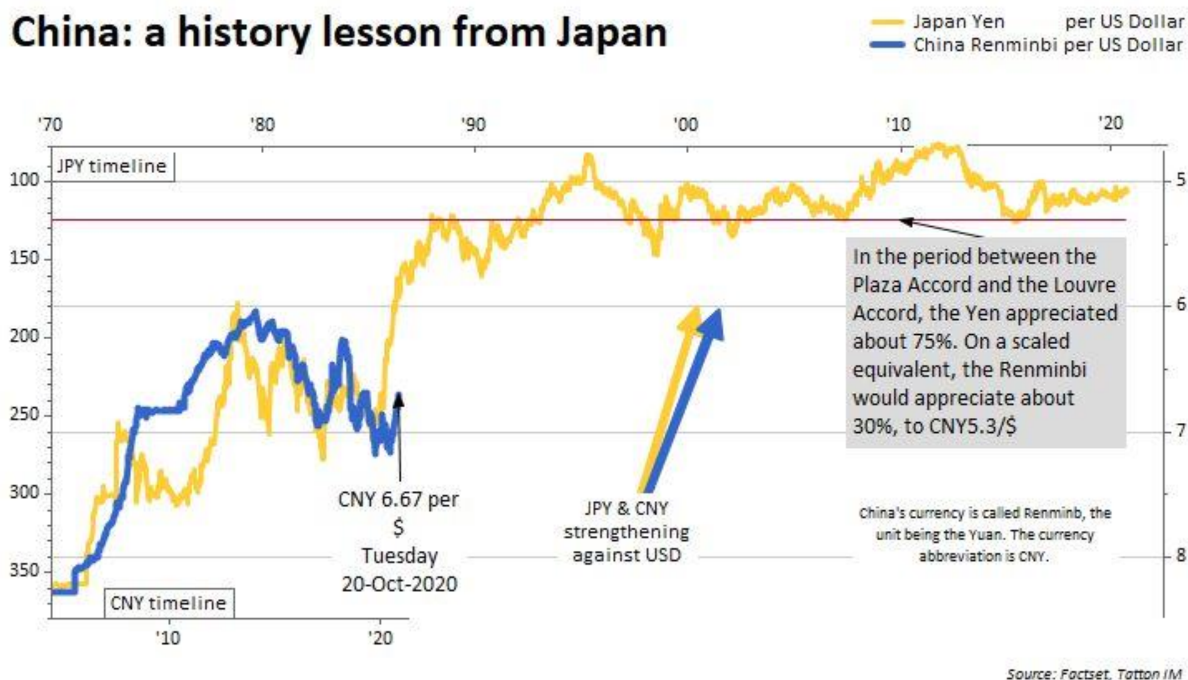
That stability is a key reason why China is one of the few major economies on course for positive growth figures this year. In 2019, heightening tensions with the US put pressure on China's economy and labour market. But the pandemic has flipped the situation. While GDP figures for the third quarter show China has already surpassed last year's economic activity levels, the US is not expected to pass that production mark until well into 2021.

Flattering comparisons like these have significant investment implications. In developed markets, deep recessions and extraordinary central bank measures have pegged government bond yields around zero. By comparison, the yield on ten-year Chinese debt has already climbed back above 3%. And the government is clearly willing to take advantage. Last week, China's new Bond Connect program was unveiled, allowing foreign investors to more easily buy Chinese government debt (or proxies through its policy banks and state-owned enterprises) in local currency.

In the past, the government was reluctant to open its asset markets to foreign capital. But the need for greater domestic consumption (instead of private household saving) – and the relative stability of the economy – has driven the need to encourage overseas investment capital, which The Party is now more than happy to receive. The investment case for China is therefore simple to make: It has stronger growth, more stability and higher yields than competitors in the Western world – and it is increasingly open for business.

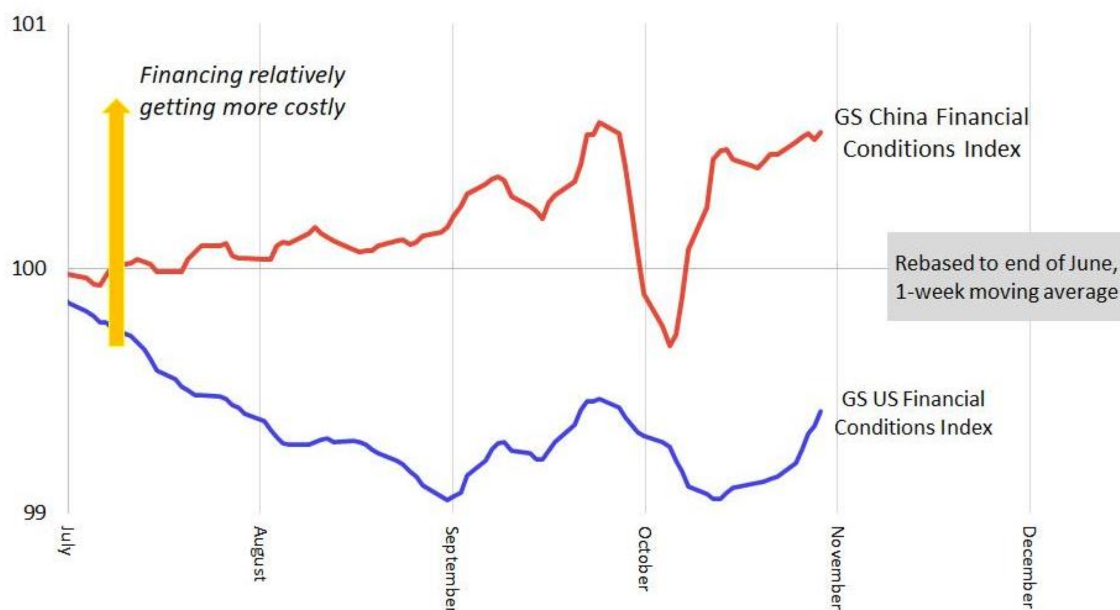
There are complications to this view, of course. The US-China trade war – and numerous human rights sanctions – has shown how significant geopolitical risks can be, and there are few signs these will abate over the medium term. But the recent strength of the ¥uan/Renminbi (CNY) suggests investors are willing to shrug them off for now.

We have written before that there are noteworthy parallels between China today and Japan in the 1980s. Back then, Japan was a rapidly industrialised nation with booming growth and an emerging middle class. This made it a popular place for global investors, causing the Yen to appreciate some 75% in the mid-1980s. As the chart below shows, the Renminbi's path has been eerily similar. And, with the same forces in play today, we could see China's currency appreciate from 6.7 CNY to the dollar now to around 5 CNY in the next few years.



In terms of China's economy and assets, that path clearly spells good things over the medium term. But allusions to 1980s' Japan inevitably conjure the spectre of 1990s Japan, where the bursting of a domestic asset price bubble caused a 'lost decade' of deflation and low growth. It would be quite a leap to predict the same for China, but the underlying signs are certainly there: A burgeoning credit market with rising asset prices and an aging population, leading to the same inverted age pyramid by 2050 as Japan has today. Another similarity can be seen with the way China is having to deal with non-performing loans.

On their part, Chinese authorities are striving to avoid that situation. It is telling that, while all other major central banks are committed to looser for longer in monetary policy, the People's Bank of China has tightened financial conditions in 2020 through a variety of monetary policy means, the aggregation of which is presented by Goldman Sachs Indices as shown in the chart below. The government has been aware of China's credit boom problems for some time, and even when trying to stimulate growth it has attempted to do so in a way that does not risk inflating the credit bubble. This is in stark contrast to 1980s Japan, where the central bank pursued expansionary monetary policies to combat a decline in export growth.



Source: Bloomberg, Tatton IM, Goldman Sachs

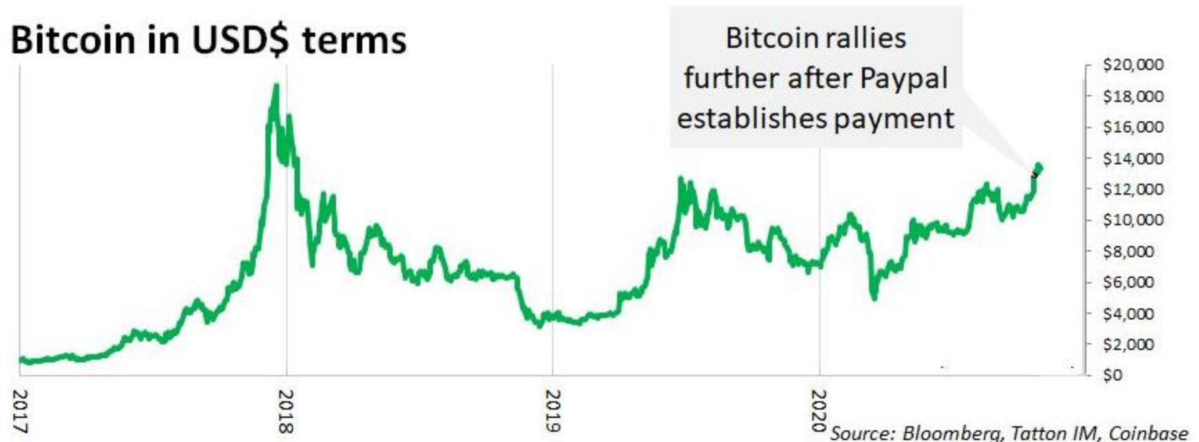
Whatever the long-term outlook, China is undoubtedly the big winner from 2020's COVID pandemic, and shows no sign of pulling back as we head into next year. The domestic political risks that arose from frictions with the inhabitants of Hong Kong but also other large conurbations, that we discussed a couple of weeks ago, appear to have been overwhelmed by positivity and resulting public support towards the Chinese leadership over its undeniable success in dealing with COVID compared to other political systems.

Political frictions with the West remain, and have been further fuelled by widespread public suspicion and discomfort amongst global consumers that the country where the pandemic originated should end up turning out to be the main beneficiary of the world's plight. The ability of the Chinese government to handle this conflict over the coming months and years now presents the main threat to China's outlook. But a less combative presence in the White House could make a big difference here, if only to add some consistency in trade negotiations. For now, despite the simmering public dislike for anything Chinese, investor optimism is not letting up – perhaps another similarity to Japan's position in the late 1980s.

Central Banks join the Crypto currency party

We have seen some impressive returns in capital markets since the depths of March. US equities stole the limelight for most of the year, soaring above their pre-crisis highs in the summer, but equally impressive has been the rally in some of the less traditional assets. On a percentage basis, Bitcoin – the much-hyped cryptocurrency – has delivered some of the best returns around over the last seven months. Worth around $5,000 per coin in mid-March, Bitcoin is currently trading around $13,500. The world's first cryptocurrency last saw such highs in 2019 – and only briefly. Before then, you would have to go back to the heady days of late 2017, just before the Bitcoin bubble burst, to see levels like these. But what makes the current rally

more impressive is its stability. Unlike in the past, this looks more like sustained optimism than a sudden spike of exuberance.



No assets split opinion quite like cryptocurrencies. Designed as decentralised networks of digital transactions, the prophets of cryptos see themselves as vanguards of the future – a future full of technological wizardry and devoid of middle-men bankers. Sceptics see cryptos as gold for geeks, or worse – an asset whose substance is purely speculative and verging on fraudulent. But regardless of where one stands, the importance of crypto and digital currencies is clearly growing. The total market for cryptocurrencies is now worth around $500 billion (and $200 billion excluding Bitcoin), and major vendors are increasingly accepting cryptocurrencies as legitimate forms of payment. The more general idea of a digital currency is also gaining traction among the world's central bankers, with 80% of the world's central banks reportedly investigating Central Bank Digital Currencies (CBDCs).

It is worth being level-headed about these issues. First, we should distinguish between Bitcoin itself, cryptocurrencies generally and CBDCs. Bitcoin was the first major crypto, and is still the most popular, but it is only one of many. Its architecture forms the basis of most other cryptos: Using a decentralised 'blockchain' system, transactions are recorded in a decentralised ledger distributed across a network of users, where each user is a node in the network. New Bitcoins are made through 'mining', where users perform computations that help secure and verify transaction information. The amount of Bitcoins that can be mined for a given set of computational problems halves every time 210,000 blocks are added to the system (on average every four years). This limits the total possible Bitcoins at 21 million, with 18.5m of them having been created already.

While other cryptos may use something similar, CBDCs are substantially different. Unlike the decentralised blockchain system, CBDCs are designed to be distributed and controlled by central banks. This makes them much like paper currency (notes and coins we use every day) – the only difference being that central banks can hand out the money digitally, without the intermediaries usually needed for digital transactions. While CBDCs are a hot topic of research in monetary policy, there are not yet any CBDCs in wide circulation.

When it comes to cryptos (and Bitcoin specifically) the accusation often levelled is that they are inappropriate as currencies because they have "no intrinsic value". This is somewhat rhetorical. Any currency, as a medium of exchange and store of value, only has value insofar as large groups of people are prepared to use it. But there is some truth in the accusation. Historical currencies usually have qualities that make it easy for people to value them: Gold is durable and has a natural scarcity, while fiat currencies are backed by state power to raise taxes and central bank control. In the crypto case, it is not clear what features of the 'currency' are supposed to stabilise people's valuations of it.

That lack of stability is arguably the main reason why cryptos have not gained widespread adoption. Bitcoin's value has increased tenfold since 2017 alone – with huge volatility along the way. While this trend might be exciting to return-seekers, it is hardly something you want in a currency. For any reliable medium of exchange, things today should cost roughly what they did yesterday. But throughout their existence, Bitcoin and the other major cryptos have traded much more like speculative assets than stable exchange mediums.

None of this is to suggest that Bitcoin or another crypto *couldn't* become a stable and widely accepted currency. If everyone is confident enough in the value of a crypto to use it for all the daily activities we need currency for, there is no reason why it cannot become one. But we are a long way off that point and, given that the current value of cryptos is based on expectations of their future acceptance, we are inclined to see short-term price moves as little more than speculation.

CBDCs are a different story. Given their central bank control, they are directly analogous to regular currency. The main difference being that they could do away with the need for intermediaries like banks or other financial institutions. Indeed, as central banks globally look deeper into the idea of using their own digital currency for the wider public, much thought goes into the structure that is needed to make sure households and companies can easily use the currency, while stability and trust into the digital coin is maintained. This is an important issue, as today's notes and coins (and indeed everybody's digital bank account with a bank) relies on trust in the financial system – and not just on gold sitting in the vaults of the Bank of England. Along those lines, much consideration goes into consequences the widespread use of a CBDC could have for the financial system.

In any event, existing commercial banks are taking those scenarios seriously and strategise about the impact it could have on their business models. Given most of their revenue in transactional banking these days comes from credit charges for authorised and unauthorised overdrafts (rather than transaction charges) this threat may be far less significant compared to near zero or even negative interest rates. For point-of-sale payment facilitators like VISA, Mastercard and American Express, the threat of CBDCs may be far more substantial.

Some of the problems we have seen in 2020 – the difficulty of getting money from central banks out to people who need it – would be much easier to solve with CBDCs, to the extent that the US congress even floated the idea of a "digital dollar" at the onset of the pandemic. In such a situation, a digital currency would come closer to a fiscal tool (or at least be at the intersection of central bank and government policy), similar to when governments send cheques per mail. In a 'new' world, this would be done electronically and could be more efficient to transfer stimulus into the wider economy. As such, crises like the one we are in could help bring us much closer to a digital currency world. But practical adoption issues are still huge, and while we seem to be already on the path, it's likely to be a long one.

So, the future of money may be digital, but in our view it is vital to distinguish central banks using digital means – as they have adjusted over centuries to adjust to technical progress – and purely private sector-driven digital coins. There are six widely accepted requirements that define 'useful' money (general acceptability, portability, durability, divisibility, scarcity and stability), and the latter still fails at least two crucial requirements – namely stability and general acceptability. We can debate whether portability is fulfilled, given save transactions are reliant on the availability of electricity and an electronic device. As such we would advise to take the technology surrounding 'cryptos' very serious but consider their qualification as the money of the future with a solid amount of caution.

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2nd November 2020

Global Equity Markets

Market	Fri 16:15	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5576.1	-4.8	-284.2	↘	↘
FTSE 250	17190	-5.1	-919.4	⇘	↘
FTSE AS	3149.9	-4.8	-160.5	↘	↘
FTSE Small	5088.8	-3.6	-192.5	→	↘
CAC	4585.3	-6.6	-324.4	↘	↘
DAX	11547.4	-8.7	-1098.4	↘	↘
Dow	26366	-7.0	-1969.5	↘	⇘
S&P 500	3255.1	-6.1	-210.3	⇘	→
Nasdaq	10923.9	-5.4	-624.4	→	↗
Nikkei	22977.1	-2.3	-539.5	→	→
MSCI World	2318.4	-4.6	-112.1	⇘	→
MSCI EM	1120.1	-1.4	-16.3	⇗	→

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	17.5	18.3	13.7
FTSE 250	2.5	15.0	22.9	14.8
FTSE AS	3.8	16.8	19.0	13.8
FTSE Small	3.4	15.0	-	13.7
CAC	2.4	19.0	23.5	14.1
DAX	3.2	20.3	17.4	13.0
Dow	2.3	19.6	21.9	15.7
S&P 500	1.8	23.7	23.8	16.7
Nasdaq	0.8	33.5	29.6	18.9
Nikkei	1.8	23.2	22.8	17.2
MSCI World	2.1	22.6	22.8	15.8
MSCI EM	2.2	17.5	17.9	12.2

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Flutter Ents	+4.8	Carnival	-17.2
Natwest	+0.9	Rolls-Royce	-16.9
HSBC	+0.8	Micro Focus Int'l	-16.5
DCC	+0.2	BAE Systems	-12.9
Royal Dutch Shell	-0.1	Prudential	-12.5

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.294	-0.7	Oil	37.47	-10.3
GBP/EUR	0.900	+1.1	Gold	1880.9	-1.1
USD/EUR	1.16	-1.8	Silver	23.60	-4.1
JPY/USD	104.53	+0.2	Copper	305.1	-2.5
CNY/USD	6.69	-0.1	Aluminium	1803.0	-2.4
Bitcoin/$	13,521	+4.5	Soft Cmdties	366.1	-2.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.26	-0.02
UK 15-Yr	0.49	-0.02
US 10-Yr	0.85	+0.01
French 10-Yr	-0.34	-0.04
German 10-Yr	-0.63	-0.05
Japanese 10-Yr	0.04	+0.00

UK Mortgage Rates

Mortgage Rates	Oct	Sep
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.74	1.65
3-yr Fixed Rate	1.86	1.83
5-yr Fixed Rate	1.92	1.85
10-yr Fixed Rate	2.45	2.42
Standard Variable	3.50	3.54

* 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
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2nd November 2020

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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