CAMBRIDGE
INVESTMENTS LIMITED

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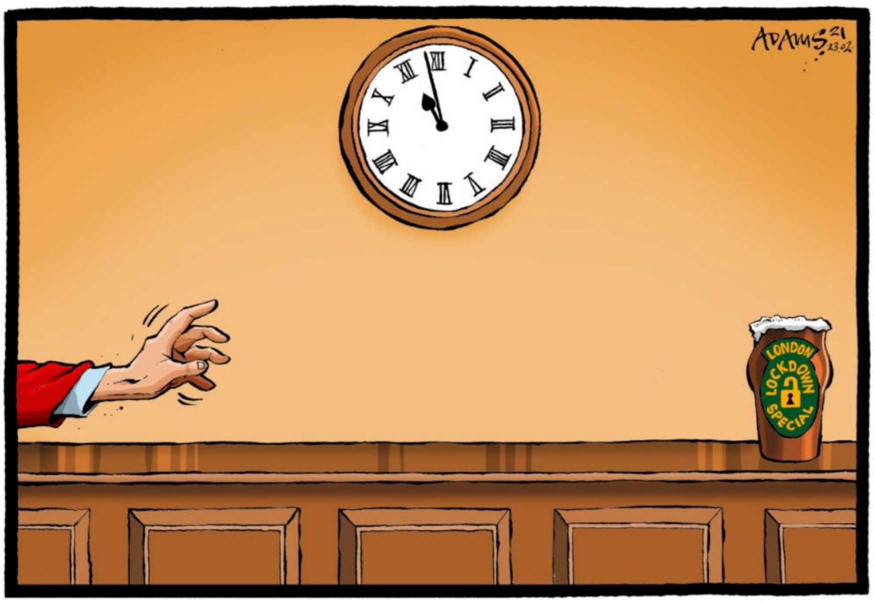
Lothar Mentel

Lead Investment Adviser to Cambridge



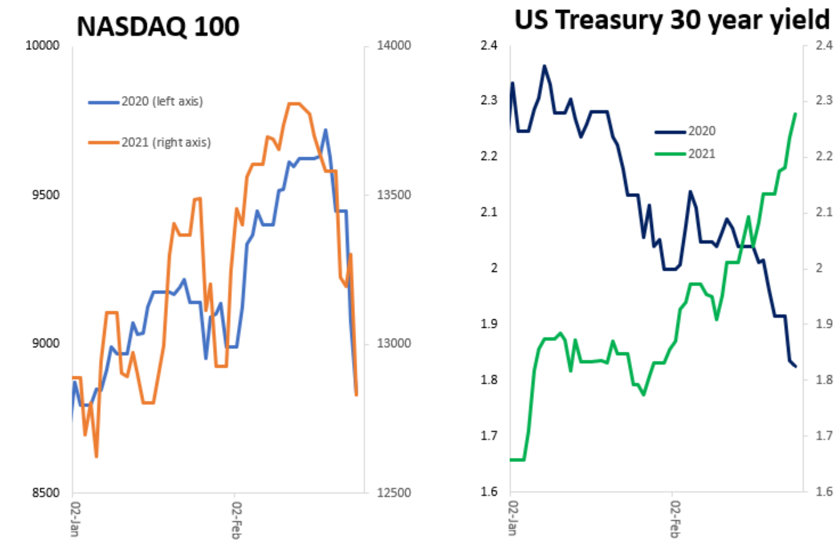
Source: Christian Adams, 23 February 2021

Earnings look set to stabilise wobbling markets

Last year, equity markets started to wobble around this time. For example, on 19 February 2020, the NASDAQ 100 closed at an all-time high of 9718.73 before sliding back as the far-reaching implications of the pandemic started taking their toll.

This year, the pattern of moves has been similar, with the same index closing at another all-time high of 13807.7 on 12 February 2021. As of Thursday's close last week, it was at 12828.31, 7.1% down from its high and back at almost exactly the same level as we started the year.

The NASDAQ moves look to be similar between then and now, but we could not be experiencing a more different set of circumstances. That distinction is apparent when one looks at US long-dated bond yields. As the charts below show, they have been going in opposing directions, driven by a starkly different outlook for the US and global economy.



Source: Bloomberg, Tatton IM

The outlook for this year has been steadily improving, which has fed through to market expectations for corporate earnings. On 24 January 2020, at the peak of expectations last year, 12 months earnings for the S&P 500 were expected to be $177. Of course, the pandemic put paid to those hopes. But in a remarkable turnaround, earnings for the next 12 months are, according to some analysts, expected to be only $1 lower, at $176. In comparison, after the global financial crisis of 2008-09, it took two and a half years for earnings expectations to return to their pre-crash level.

Which begs the question: "If earnings expectations and long yields are where they were last year, why would market levels be different"? With the S&P 500 about 13% higher than last year's early peak, that means the price-to-earnings ratio is above 22 times the next 12 month's expected earnings, versus just below 19 times last year.

The answer may partly lie in equities' element of inflation protection. Fixed income bond yields have gone back to last year's levels. Real yields (on those US Treasuries with inflation protection, known as TIPS) rose sharply last week but are still at least 0.3% lower than last year's levels.

The other aspect is in enhanced expectations of earnings growth beyond next year. Last weekend, US Treasury Secretary Janet Yellen effectively promised: to spend until jobs are at least as plentiful as they were in 2019; to spend on infrastructure; and to keep spending at least until everybody is sure it's all going to happen. Alongside statements from US Federal Reserve (Fed) Chairman Jerome Powell about keeping support going, the message is staying positive for longer than has been the case in other recessions.

As is inevitable, there are many commentators now saying the support will be too much, that the US economy will run too hot. In a sense, both Yellen and Powell must hope that the commentators will get even more vocal, since an important part of building confidence has to come from a stream of economic positivity. However, it may be that bond investors will get spooked enough to force a rise in yields which threatens to be too costly for the economy, and really tightens financial conditions. At that point, the Fed may have to provide more than warm words.

Also last week, we saw the European Central Bank telling us it is worried that financial conditions may be getting too tight for a more fragile European economy. ECB President Christine Lagarde previously told us to expect support, and that was followed up last week by Chief Economist Philip Lane implying that "flexibility" was needed in the ECB's bond purchases. Flexibility can only translate to more buying. Euro bond yields have moved up, but significantly less than in the US.

It is entirely possible that US long bond yields can go higher. A weak uptake of a new issue US bond auction last Thursday did not help, and foreign demand for US bonds appears to have stalled for now. However, having promised support, it would seem unlikely that the Yellen/Powell axis will make the policy mistake of over-promising support. Things may remain a bit volatile for now, but it seems likely that yields will stabilise at levels which are not likely to damage equity markets much further.

However, there is a twist. The other part of Yellen's promise was to raise corporate taxes to 28%. We cover corporate taxation in an article below. Suffice to say, this is damaging to those companies expected to be super-profitable over the long-term, namely the mega-cap winners of the last year. We think this is the other contributor to the NASDAQ's recent underperformance. As in 2017, when Donald Trump's tax cuts provided a sharp boost to those companies, this has some potential to provide a drag.

So, the wobbles in equity markets, at least currently, revolve around how yields affect valuations. But for long-term investors, it is always really about earnings, and those remain well supported. Indeed, there's every chance earnings will continue to be pushed up. Therefore, we won't get too worried unless yield levels rise enough to really start impacting the real economy. We think that central banks are unlikely to make such a policy error.

Will the IPO feast leave some investors with indigestion?

Not long ago, market commentators were debating why companies seemed to want to stay private. Back in 2015 and 2016, Initial Public Offerings (IPOs) fell substantially, with newer start-ups preferring to stay off the market. Now, that trend has reversed entirely. After opening back up in the second half of last year, the IPO market sprung to life for the remainder of 2020, and there has been no let up so far this year. Not only have a staggering number of new companies come to market in recent months, but many have floated with exorbitant valuations.

Just like the wider stock market since April, newly public companies have generated some impressive returns for investors. This is despite the worst global recession on record, and so much uncertainty on when or how many of these companies can generate a profit. Such high volumes and lofty valuations are making some investors nervous. An IPO frenzy can often be a sign of financial bubbles forming – as some might remember all too well from the early 2000s. On the other hand, the appetite for budding young businesses clearly reflects optimism about the global economic recovery. So, is the IPO glut a sign of doom or boom ahead?

Clearly, one cannot disentangle the IPO action we have seen from the wider trends we saw in equities last year. Despite an indefinite economic shutdown, major stock market indices rallied to new highs – with a particular focus on the booming US tech sector (looking at you, Tesla). High prices coupled with dwindling revenues sent valuations – in terms of price over earnings per share – skyrocketing. This is an extremely enticing backdrop for new companies, which can offer return-seekers the promise of growth unavailable elsewhere.

It is no surprise that many start-ups capitalised on this opportunity – or that investors were ready to hand it to them. But there were also sector-specific reasons encouraging businesses to come to market. A massive chunk of the new IPOs have come in internet-based technology or platform services, which, in the era of work-play-and-eat-from-home, were extremely well-placed.

New tech companies have had an exceptionally good environment for raising capital. Extraordinary support from central banks has pinned interest rates down to non-existent levels and flooded markets with liquidity. With the risk-free rate of return pushed down so low, the present value of future earnings for companies gets pushed higher. Those businesses that also do not require social interaction to make a profit got a great boost.

It is particularly interesting that the feast of recent IPOs comes after the famine of recent years. For some time, it looked like private equity had become the dominant mode of finance for younger companies. These trends are likely related, with companies that had held off before suddenly picking their moment to come to market.

The IPO surge also comes with a boom in the use of special purpose acquisition vehicles (SPACs), which are new listings formed with the sole purpose of funding a merger or acquisition. They are sometimes called 'blank cheque' companies, as they have no business operations but come to public markets with the intention of merging or acquiring a company with the IPO proceeds. Last year, the number of SPAC IPOs was more than three times the previous record – and the first week of this year set a new weekly record.

Many have questioned whether the SPAC boom can continue, and also challenged their use by private equity firms to generate fees more quickly, but for now it shows no sign of letting up. Just like with IPOs generally, we are in an extremely favourable environment for these shell company acquisitions. Interest rates and opportunity costs are low, with most of the IPO cash placed in safe assets like US Treasuries.

The long-term future of SPACs is less certain. The shell companies can take up to two years to take over their targets, with money being returned to shareholders if the acquisition is unsuccessful and the process looks less profitable than investors had hoped. Analysis shows that average returns after the merger are much lower than before. Meanwhile, their legal structure allows certain shareholders – those that hold for some time before the merger is announced – to have beneficial investment treatment. As time goes by, this feature may get more airtime and lead to a change in the structure of the SPACs, particularly if the winding down of the IPO boom causes pain for some investors. There could also be some examination of the fact that the target companies – which without the SPAC would most likely go through a traditional IPO with prospectus if they wanted to go public – are subject to less scrutiny.

If and when the use of SPACs winds down, the IPO market is likely to do the same, but that does not mean it is a bubble waiting to burst. Taking a more cautious view, we suspect the frenzied IPO market action could well be coming to a close, but not spectacularly. Further, it could be that some of the IPOs are successful because there is still an abundance of excess cash looking for a home.

Ultimately though, an end to the sugar rush does not mean sustained weakness ahead. Most of the recent IPOs came from sectors like IT, technology or biotech. These are structurally strong areas which are certainly not going to go away any time soon – and the long-term tailwinds are still pushing them along. New companies in these areas will always need financing, and investors have shown they are willing to provide it – either through private equity or through IPOs.

Corporate taxation becomes a global fixation

It would be some understatement to say that Rishi Sunak had an interesting start to life as Chancellor of the Exchequer. Less than a month into the job, Sunak delivered his first Budget as the UK economy was closing it shutters and a black hole in public finances was expanding. One year on, his second Budget looks to be just as eventful. The immediate priority is clearly to continue emergency support for the general public, but with the government's roadmap to normality now firmly in place, all eyes are on Sunak's plans for a post-pandemic recovery.

The focus of media speculation so far has been how the Treasury plans to pay the mountainous bill left by lockdown measures. Sunak has been no stranger to fiscally hawkish rhetoric throughout the pandemic, mentioning on several occasions that taxes may need to rise, or spending will come down as the world opens up. According to multiple sources, the Chancellor will use the latest budget to propose a rise in the UK's corporation tax rate.

Last week, we wrote that tightening fiscal policy at this point made little sense from an economic perspective. Pushing money out into the economy through extraordinary spending measures, only to then reel it back in through increased taxation, could be extremely damaging to the short-term recovery, particularly if it comes while restrictions are still in place. So, why is 11 Downing Street supposedly so intent on raising business rates?

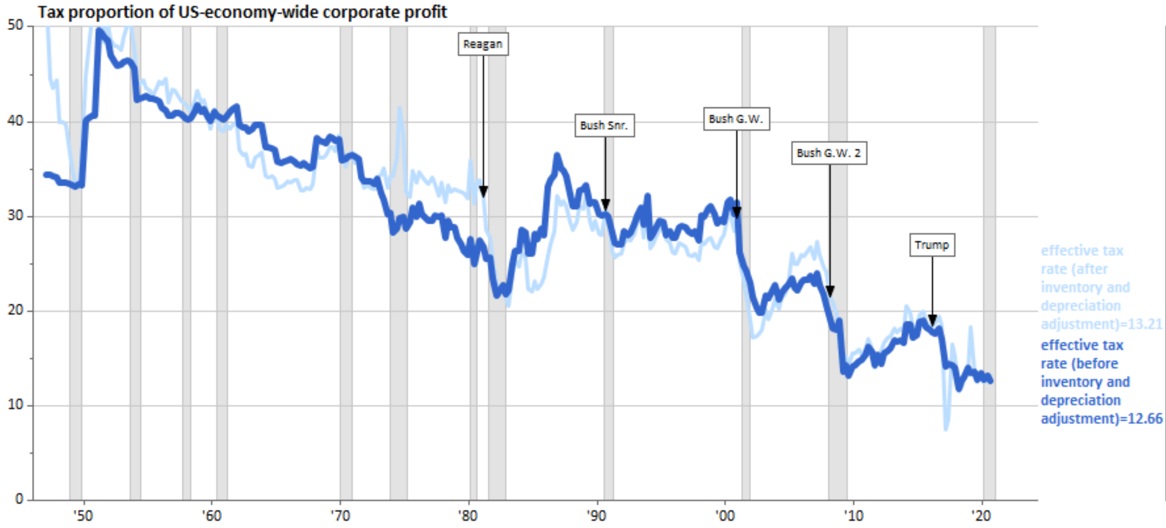
First of all, while this is still only speculation, Sunak's often hawkish noises over the past 12 months have rarely translated into actual policy. We do not want to get into a policy guessing game, but we expect more or less the same in this Budget. More fundamentally however, changing the corporate tax regime is not necessarily the same thing as tightening fiscal policy.

It is telling that, according to the Financial Times, Sunak will use a suggested corporate tax hike in the US as explicit justification for the same move here. There, US Treasury Secretary Janet Yellen has plans to raise America's business rates from 21% to 28%. But while the Biden administration cites the need to fund an expansive $1.9 trillion stimulus package as one of its reasons for the move, officials have also argued for it on political grounds. Aside from the economics, politicians – and certainly the public – want big business to pay its fair share.

They have a point. Regardless of what one thinks about the benefits of relative levels of corporate taxation, businesses on a global scale have undeniably had a good run in tax terms for quite some time. Globalisation has allowed multinational companies to base themselves practically wherever they like, leading to international competition on tax rates. The result has been a consistent steady decline of corporate tax rates, down to a 24% official rate in the US, 19% in the UK and as low as 12% in Ireland.

Those official rates do not tell the whole story either. Only a business's profits can be taxed, but global corporations often work very hard to disguise or reinvest profits to avoid a hefty bill. In the US for example, when including supposedly unprofitable companies, the effective tax rate is estimated to have fallen to just 12%, down from around 30% in the 1980s. Moreover, since corporate tax rates are flat – unlike progressive income tax – those businesses with more resources to devote to corporate tax structuring end up paying significantly less as a percentage of what they earn. This is effectively a tax bonus that comes with being a large multinational company – as we often see in controversies around Amazon, Google and the US technology mega-caps. This has created significant political pressure that has only been amplified by the pandemic. The big winners have continued to win big, while the rest have struggled.

US Overall Corporate Tax Rate



Source: Factset, Tatton IM, US BEA

With public opinion now firmly behind them, US politicians sense an opportunity to go after tax-clever corporates. Given that multinationals are the target, this is an issue that can only be addressed on a global scale – to avoid another race to the bottom on tax rates. Rishi Sunak citing potential US tax changes to justify his own is a great example of this, but we can see it happening almost everywhere. Add to this the European Union's continued discussion of a financial transaction tax, and the Australian government's recent payment spat with Facebook, and it seems the taxation tide is turning. Global corporates may have little room to hide.

Such a move, and the political reasoning behind it, is crucially different to a worldwide fiscal tightening. Governments are not taking money out of the economy just to balance their own budgets, but are rather trying to force a redistribution from the winners of the pandemic to the losers. Rishi Sunak will no doubt talk about the need to retain competitive tax rates and responsible spending to placate his Conservative peers in this post-Brexit environment, but the fact remains that public spending and investment remains extremely high, while the Bank of England is committed to financing the deficit indefinitely. The same is true all over the developed world.

From an investment perspective, this means the relative losers from this worldwide political move will be the big winners from before. Amazon, Google and Facebook are unlikely to enjoy the same ability to leverage their size and international reach for a smaller tax bill than they once were. We suspect this is one of the reasons behind the recent underperformance in the US tech-heavy Nasdaq – which last year soared to uncharted heights. On top of that, rising yields mean that discounting future cash-flow does not generate quite the same amount in terms of present day share value anymore.

Of course, this is entirely different from saying that the benefits of being a large multinational will disappear. Such companies still have influence and access to economies of scale that others could only dream of. What it does mean is that, once fiscal policy does eventually tighten – whenever that might be – global corporates are likely to be the ones it tightens around.

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1st March 2021

Global Equity Markets

Market	Fri 15:50	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6494	-2.0	-130	↘	↗
FTSE 250	20986	-0.2	-49	→	↗
FTSE AS	3711	-1.6	-59	↘	↗
FTSE Small	6486	-0.1	-9	→	↗
CAC	5708	-1.1	-65	→	↗
DAX	13801	-1.4	-192	→	↗
Dow	31110	-1.2	-384	→	↗
S&P 500	3823	-2.1	-84	→	↗
Nasdaq	13211	-4.8	-663	→	↗
Nikkei	28966	-4.2	-1270	⬀	↗
MSCI World	2760	-1.6	-46	→	↗
CSI 300	5337	-7.6	-442	⬀	↗
MSCI EM	1384	-3.2	-46	⬀	↗

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
TUI	+20.9	Scot Mtge Inv Trust	-15.8
easyJet	+19.2	Ocado	-13.6
Int'l Consol Air	+15.4	Rightmove	-11.2
Carnival	+8.3	Auto Trader	-9.0
Land Securities	+8.2	Experian	-8.2

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.397	-0.3	Oil	66.17	+5.2
GBP/EUR	0.868	-0.4	Gold	1729.4	-3.1
USD/EUR	1.21	+0.1	Silver	26.47	-3.0
JPY/USD	106.49	-1.0	Copper	415.0	+1.9
CNY/USD	6.48	-0.3	Aluminium	2235.0	+4.6
Bitcoin/$	47,712	-14.2	Soft Cmdties	446.3	+0.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.78	+0.08
UK 15-Yr	1.13	+0.20
US 10-Yr	1.50	+0.16
French 10-Yr	-0.04	+0.02
German 10-Yr	-0.29	+0.02
Japanese 10-Yr	0.16	+0.05

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.3	19.5	14.6	14.0
FTSE 250	1.8	18.2	22.2	15.2
FTSE AS	3.0	19.2	16.6	14.1
FTSE Small x Inv_Tsts	1.6	18.2	-	14.8
CAC	1.9	22.0	18.1	14.5
DAX	2.5	22.0	15.4	13.2
Dow	1.9	21.7	20.5	16.0
S&P 500	1.5	27.0	22.3	17.0
Nasdaq	0.7	33.9	32.6	22.0
Nikkei	1.4	27.0	23.1	17.4
MSCI World	1.8	25.3	21.0	16.1
CSI 300	1.6	19.5	14.7	12.4
MSCI EM	1.8	21.7	16.3	12.3

UK Mortgage Rates

Mortgage Rates	Feb	Jan
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.75	1.78
3-yr Fixed Rate	2.08	2.06
5-yr Fixed Rate	1.93	1.96
10-yr Fixed Rate	2.53	2.53
Standard Variable	3.62	3.62

* 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

1st March 2021

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.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE