THE **CAMBRIDGE** WEEKLY

21 June 2021

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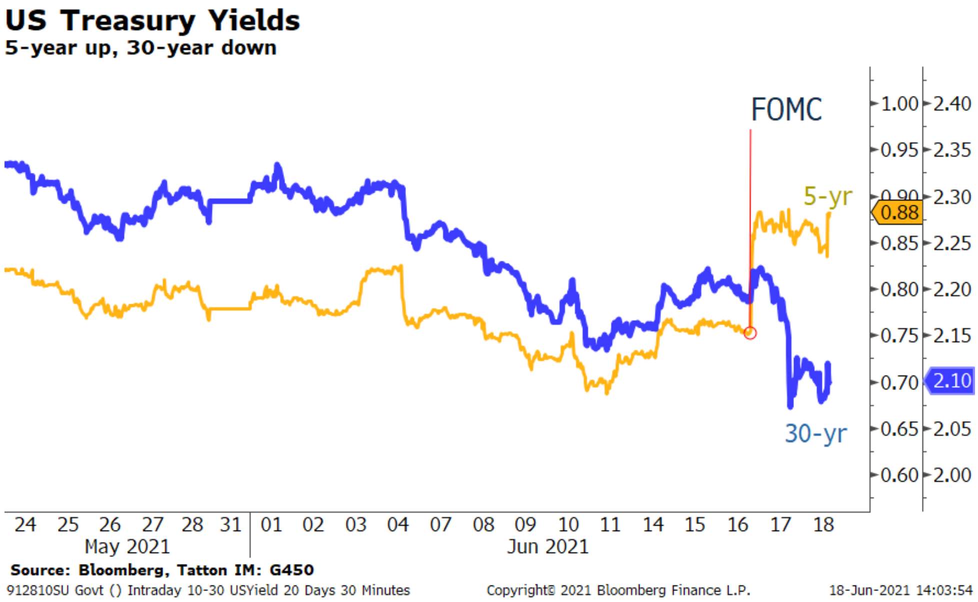
'The new trade deal means that Australian sheep can come to the UK and beat us at cricket'

Source: Matt,16 June 2021

Investors try to make sense of the Fed's 'dot-plot'

The biggest event of the week took place on Wednesday, as the US Federal Reserve (Fed) concluded its two-day Federal Open Markets Committee (FOMC) meeting, where it discussed economy policy and its latest projections on inflation and interest rates. Leading up to Wednesday, we were asking ourselves the question "what will the Fed change?". In essence the choices were "nothing", "a bit", or "more than a bit". All of us were somewhere between "nothing" and "a bit". The Fed delivered "a bit".

Yet the markets had some quite strong moves. The US Dollar rose sharply, by about 2% against most currencies. In bonds, the five-year yield rose to 0.88% from 0.75% and stayed there. The 30-year maturity bond rose to 2.22% but then reversed down to 2.10%.



Meanwhile, equity prices edged higher, with tech shares in the NASDAQ getting the biggest boost and heading up to all-time highs again.

Ahead of the FOMC meeting, US inflation data had been a bit stronger than expected, but still mostly explainable by temporary virus effects, employment data was reasonable, but showed a slower pace of improvement. Money markets remained awash with government, company and household cash. With the vaccination programme doing well and risks well contained, things were probably a bit better than expected at the previous meeting.

In his post-meeting press conference, Fed Chair Jerome Powell acknowledged that its so-called 'dot-plot' showed that there could be two rate hikes in 2023, with only a small likelihood of any rate rise next year. He sought to downplay its significance. He said the Fed expected solid employment improvement in the second half of 2021, and that inflation projections showed inflation back down to 2% by 2023. He also gave the gentlest of indications that bond purchases will slow at some indefinite point. (It also moved two minor interest rates up, but neither of them will tighten monetary policy).

The Fed's credibility is always a contentious topic, and this has been especially so after such a huge episode of money printing. Surely, the more they print, the less we should trust them? Isn't this the reason for Bitcoin? So, the sharp flattening is interesting, and continues the move lower in the "term premium" we mentioned last week. Real yields, as priced by inflation-linked bonds have stayed stable, which has resulted in market estimates of inflation going down a bit.

When you add in the rise in risk-asset prices, it all says that the Fed's credibility remains huge. The market is pricing the outcome that the Fed wants: higher inflation followed by stable inflation around the target; profitable companies; trust in the government's creditworthiness; an ability to keep the dollar's value not too weak, not too strong. Its moderate path is on track.

Of course, the Fed might make a policy mistake, but it may be more the markets' problem if inflation data is challenging. It's all very well saying price rises are transitory when consumer price inflation is at 3.5%, but if inflation is at 5% year-on-year, consumer inflation expectations may be less anchored. Half the market may think tightening is in order, the other half may think that would be a mistake. Whatever the Fed did, the market reaction could be substantial, if last week's moves are anything to go by.

Having sent some signals at this point, the Fed will probably not do anything further as we head through the summer. Investors, both retail and institutional, will probably be desperate to take the holiday denied to us all last year. Markets may get very quiet. However, headline inflation will almost certainly look like it is rising, while an improving global economy may involve money being taken out of savings. By the time we get to the end of August's big central bank get-together at Jackson Hole, there could be a lot of tension building up.

Of course, long-term investors shouldn't worry too much. The Fed indicated that things are going pretty well, and we think the Fed is credible. Of course, we reserve the right to change our minds in the future.

We write about China and Japan in articles below. In a discussion about the aftermath of the Toshiba news, we mention how Japan is often thought to be a large exporter but, in fact, is much less so than either the UK or Germany.

There's a fly in the ointment for the UK. The chart in the Japan article shows how exports have plummeted since the start of 2020, from around 32% to 25% relative to GDP. Of course, GDP is not up over the period, which tells us exports have been horrendous. At its heart is the fall-off in exports of services to Europe. There may well be impacts from COVID, but the Brexit process has left the UK in a weaker position, especially around the world of finance. The financial services balance had not worsened greatly as of the end of 2020, but we would usually see a big benefit from the improvement in financial activity in Europe. Instead, new capital raising is happening almost as much in Frankfurt as it is in London. The recent strength of sterling will be very difficult to sustain, if our current account balance does not improve in the next twelve months.

Plenty to celebrate for China's Communist Party

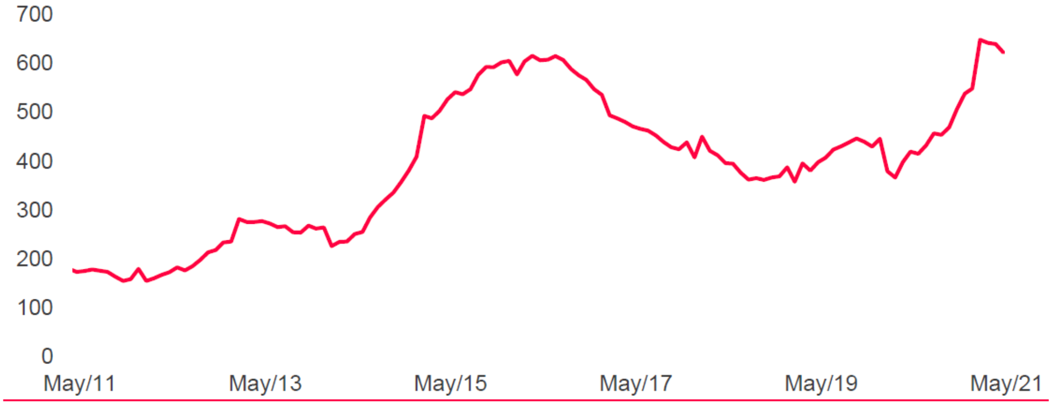
The Chinese Communist Party is about to turn 100. Celebrations and patriotic fervour are in store for the world's most populous nation on 1st July, marking a century for the party which has ruled mainland China from 1949. It began in a small house in Shanghai, a house which now flanks the entrance to one of the swankiest shopping areas in the city.

We can expect all the frills that usually come with China's important anniversaries: nationalistic broadcasts, emotive speeches from officials and – crucially – a tightening of the state's grip on daily life. Censors on WeChat and other platforms will go into overdrive, police will be out in greater numbers, and public security staff will start taking their job a little more seriously (which, as anyone who has been on a Beijing subway would know, is not hard).

Despite the upcoming celebrations, as we have written before, China has been cracking down again on risks in its financial system as well since the start of the year. There are good reasons for this. Multiple stimulus pushes from the government over the last decade, has created a huge growth in credit, a large section of which came from the secretive and unregulated shadow banking sector. That trend changed a few years ago, when authorities began a lengthy – and at times arduous – deleveraging process. That process has resumed as the pandemic has waned. While the rest of the world's major central banks have eased rates and unleashed a wave of historic monetary stimulus, the People's Bank of China has kept things relatively tight.

This has been a reflection of the Communist Party's priorities. Having built its reputation on strength, stability and prosperity, it seemed more interested in strengthening the financial system than trying to boost short-term growth – as shown in its recent relaxing of growth targets. Given this went on while the world was in its sharpest recession on record, it was a bold choice. But in fact, the Chinese economy was given a helping hand in this regard, as its exporters saw surprisingly strong demand throughout last year.

This is evidenced in the data on China's trade surplus (exports minus imports) which, as the chart below shows, rose to an all-time high earlier in the year. The strong external demand for Chinese goods has given officials a lot of security in dealing with the pandemic fallout, focusing instead on fixing internal issues while the global economy is rescued by others. At the end of last year, we suggested the government would be happy to let China be a passenger in the global recovery, only stepping on the accelerator if things elsewhere deteriorated.



Sources: CEIC, TS Lombard.

However, recent developments may force them to adjust that position. The chart also shows China's trade surplus dropping back recently, shrinking for the third consecutive month as growth in imports outpaced exports. This is not a consequence of weakening global demand though – perhaps the opposite. Commodity and shipping prices have been rallying this year, on the back of the strong global recovery, and a number of significant supply bottlenecks.

As a big commodity importer, Chinese producers have therefore been hit with much higher costs. Producer price inflation (PPI) rose to 6.8% in April, the highest level since 2017. That trend seems to have continued in May, with Chinese companies facing a surge in costs. Rising PPI is usually taken as a good sign for an economy, as it tends to mean a general upswing in demand for end goods and, as such, a boost to profits. At the moment, however, those rising costs are not being met with a similar rise in end prices.

Many exporters in China have fixed contracts that cannot be changed in the short-term, meaning an increase in costs cannot be immediately shifted onto purchasers. Whatever the case, the surge in PPI weighs on company profits – with Chinese authorities having a particular eye on small and medium-sized enterprises (SMEs). So, corporate profitability may be suffering, and in any case, authorities are not keen on seeing higher consumer price index (CPI) inflation, especially as domestic demand is sluggish.

Another notable twist, highlighted by TS Lombard Research, is that although their current contracts don't allow near-term change, internationally, Chinese corporates have currently strong pricing power, which historically was not the case. The difference now is that most of the other major producers in the region – Vietnam, Malaysia, Indonesia – are still in the mire of COVID restrictions, unable to vaccinate their populations fast enough and resorting to increased restrictions. This could leave China as the only game in town as far as production goes, giving it the power to up its prices in the coming months. There is indeed already evidence of rising Chinese export prices.

Chinse authorities have already reacted to the current rise in PPI by releasing some state metal reserves. This serves predominantly to quell speculation. More importantly, TS Lombard's research points out that the current difficulties could well be enough to make the Communist Party reconsider its policy tightness. A squeeze on profit margins would only constrict financial conditions further, which will harm SMEs in particular. The Chinese government has shown before that funding for smaller businesses is the priority in setting policy, so we suspect it may be inclined to let money flow more easily again. This is not to say that Beijing will have all hands on the pump, but higher input costs – and the pressure that puts on demand – should prompt a more accommodative policy in the second half of 2021.

Corporate profitability may see a boost, and domestic demand could face more favourable financing conditions. This would be quite a different scenario from the gloom feeling that surrounds Chinese equity markets at the moment – which after all have clearly underperformed their international peers since the beginning of the year.

In terms of international implications, for at least as long as COVID dominates our lives, China may keep some of its superior pricing power. Further out, as we noted some months ago, after decades of putting downward pressure on global prices, China could well become an exporter of inflation, as it moves away from cheap labour supply. This is the latest phase of the country's modernisation – one the hundred-year old party will no doubt be proud of – and it seems to be happening already.

Japan's latest corporate scandal bears traditional hallmarks

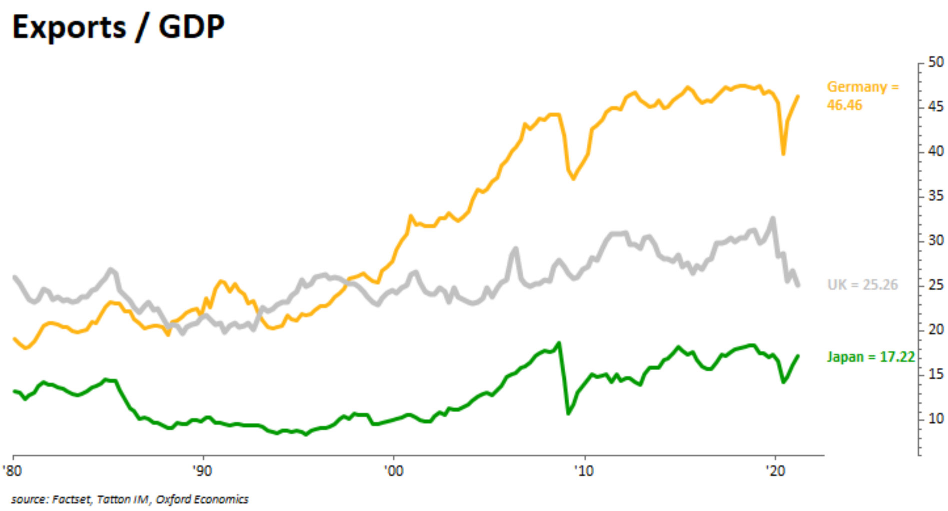
There are not many companies that embody their home countries quite like Toshiba. Founded nearly 150 years ago, the technology conglomerate has long been seen as a symbol of post-war Japan – big and sprawling, and with a technological prowess that lives up to its global reach. Today, very few would be flattered by that comparison – though it may well be just as accurate. After a bruising few years of scandal, the company that used to be one of the world's most valuable hit a new low last week. An independent investigation, launched in March after shareholders revolted against the board, found that Toshiba's management colluded with the Japanese government to suppress the rights of its large international investors.

The full report spares almost no one, from the company's former chief executive to the head of Japan's $1.6 trillion pension fund, and even Prime Minister Yoshihide Suga. According to the probe, Toshiba's annual general meeting (AGM) last year was a sham, with board members and government departments leaning on large shareholders to protect controversial former chief Nobuaki Kurumatani. He survived that vote – barely – but the report found that five million votes from Singapore-based 3D, one of Toshiba's biggest shareholders, had not even been counted.

The most embarrassing part of the story for Japan is that it comes after years of Toshiba promising to clean up its image and "transform the corporate culture". Accounting scandals, the collapse of its US nuclear business and getting booted from the main section of Tokyo's stock exchange prompted a restructuring a few years ago, after which the company hired its first foreign independent directors in 80 years. It was supposed to usher in a new era of good governance, not just for the tech giant but for corporate Japan altogether. But as the report makes clear, old habits die hard.

The episode paints a familiarly off-putting picture for Japan's international investors. Not only did the old guard pull in political favours to quash investor demands, they did so specifically against foreign shareholders trying to change the company. It shows an insular attitude where activist investors – particularly those from overseas – are seen as a foe to be guarded against.

There was a time when Japan was a major component of the global economy, providing high-tech manufacturing to the world and intricately tying its booming economy into the global fabric. After the well-documented stagnation of the last few decades, though, it failed to take any significant part in globalisation, remaining domestically focused, as the chart below indicates:



Exports account for around 17% of Japan's GDP, only slightly above its 1985 level. Germany – a competitor in terms of the profile of its exports – has an export ratio of 46%. Even the UK, which has seen a drop-off in its exports following Brexit and the pandemic, has a higher share of its economy externally focused, at 25%. In fact, among the developed nations, only the US – the largest domestic economy in the world by some distance – has a lower export component in the developed world.

That is not in itself a problem. But the flipside to Japan's subdued exports is that the country struggles to drive forward its own internal investment. Savings rates in Japan are notoriously high – and not just for households. Almost 50% of companies in the Topix1000 index have more cash on their balance sheets than debt. This can be a good thing – at least in times of stress – but it is a signal of an economy with few avenues for growth. If corporate Japan is sitting on piles of cash, it begs the question: is there nowhere that capital could be more productive?

This greatly affects the outlook for Japan's equity markets. On the face of it, there is a great deal of value that international investors can find in Japan. With the impressive stock market returns of the last year, we have seen valuations (in terms of earnings per share) become extremely stretched in the US. But there is very little sign of such overvaluation in Japanese stocks. And indeed, Japan's equity market looks cheap compared to the rest of the developed world on all of the major metrics.

But, valuations are just one consideration among many, though. One of the reasons US companies have reached such lofty prices is because they are seen as offering the best opportunity for growth over the long-term – with a booming economy and plenty of avenues for expansion. Japan, by comparison, looks sluggish, and its corporate earnings have been flatlining for some time.

The country's ageing population and structural problems are often raised as an explanation for this. But productivity or technological prowess are not the only factors. Arguably more important is the behaviours and strategies of companies – whether they seize opportunities, by investing in development, or acquiring different revenue streams.

There have been some improvements here recently. Corporate Japan's return on equity has been increasing, and Japanese companies have started giving more back to shareholders in the form of dividends or share buybacks. What's more, the fact that Japanese companies are so cash rich tells us that the potential is certainly there.

Former Prime Minister Shinzo Abe tried extensively to get Japan's economy whirring, with stimulus packages and promises of structural reform. But the missing ingredient seems to be attitude. Even with the balance sheet improvements and the returning of profits to investors, the question remains why Japanese businesses are not investing in research instead? The country could certainly do with productivity upgrades: reports emerged last year that companies were struggling with working from home, due to no one being in the office to stamp documents.

Those sorts of issues are not complicated to solve, and businesses have more than enough cash to do so. But as the Toshiba report shows, cultural issues repeatedly get in the way. The positive, one would hope, is that this episode gives the impetus to do what corporate Japan has long promised. Without that change, Toshiba will continue to symbolise the country for all the wrong reasons.

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21st June 2021

Global Equity Markets

Market	Fri 15:06	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7047	-1.2	-87	→	↗
FTSE 250	22369	-1.6	-365	→	↗
FTSE AS	4018	-1.2	-51	→	↗
FTSE Small	7267	-0.1	-11	→	↗
CAC	6590	-0.2	-11	↗	↗
DAX	15488	-1.3	-205	⬀	↗
Dow	33378	-3.2	-1102	→	↗
S&P 500	4188	-1.4	-60	→	↗
Nasdaq	14091	+0.2	+21	→	↗
Nikkei	28964	+0.1	+15	→	↗
MSCI World	2997	-0.5	-16	→	↗
CSI 300	5102	-3.2	-169	→	↗
MSCI EM	1363	-1.4	-19	→	↗

Top 5 Gainers

Company	%
Admiral	+4.7
BT	+4.3
Sage	+3.6
London Stock Exchang	+3.1
AVEVA	+2.7

Top 5 Decliners

Company	%
Anglo American	-11.3
Glencore	-9.5
Antofagasta	-7.4
Melrose	-7.0
Intermediate Capital	-6.5

Currencies

Pair	last	%1W
USD/GBP	1.383	-1.9
GBP/EUR	0.858	+0.0
USD/EUR	1.19	-2.0
JPY/USD	110.42	-0.7
CNY/USD	6.45	-0.8
Bitcoin/$	36,645	-6.7

Commodities

Cmdty	last	%1W
Oil	73.66	+1.3
Gold	1774.2	-5.5
Silver	26.02	-6.8
Copper	415.6	-8.4
Aluminium	2400.0	-3.1
Soft Cmdties	427.2	-4.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	18.9	13.8	14.1
FTSE 250	2.0	17.9	23.7	15.6
FTSE AS	3.1	18.7	14.7	14.2
FTSE Small x Inv_Tsts	1.6	18.7	-	15.2
CAC	2.1	25.7	18.3	14.7
DAX	2.4	18.3	15.5	13.3
Dow	1.8	20.9	19.6	16.2
S&P 500	1.4	26.6	22.2	17.3
Nasdaq	0.7	32.5	32.6	22.5
Nikkei	1.5	18.1	19.7	17.6
MSCI World	1.7	24.5	20.5	16.4
CSI 300	1.7	17.6	15.7	12.4
MSCI EM	2.0	15.2	14.5	12.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.77	+0.06
UK 15-Yr	1.09	+0.02
US 10-Yr	1.48	+0.03
French 10-Yr	0.16	+0.06
German 10-Yr	-0.20	+0.07
Japanese 10-Yr	0.06	+0.02

UK Mortgage Rates

Mortgage Rates	Jun	May
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.46	1.49
3-yr Fixed Rate	1.72	1.72
5-yr Fixed Rate	1.69	1.71
10-yr Fixed Rate	2.57	2.57
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
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21st June 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.

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