CAMBRIDGE
INVESTMENTS LIMITED

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DISCLAIMER

'You're in luck, Charlie – St Peter ALWAYS preferred the Stones to the Beatles'

You will be missed Charlie Watts, Source: Paul Thomas, 26 August 2021

Fed tapering: the 'how' matters more than 'when'

Questions over when and how the US Federal Reserve (Fed) would begin tapering its monthly securities purchases has been much talked about over the last few months. But ahead of last Friday's keynote speech at the Jackson Hole symposium, questions have been shifting increasingly towards 'how' the Fed tapers, instead of 'when'. On Friday we got an answer, of sorts. Fed Chair Jerome Powell confirmed the Fed could begin reducing monthly bond purchases sometime this year, given the US economy has met the self-imposed test of "substantial further progress" towards its inflation objective, and after "clear progress" from the US labour market. Powell also suggested the Fed would like to conclude its bond buying programme before raising interest rates, underlining the lack of a mechanical connection between tapering asset purchases and starting with rate hikes.

It may be surprising that a central bank could scale back security purchases just as the economic momentum weakens, fiscal stimulus wanes, and societies at large are still in the process of finding a way to live with the virus as it becomes endemic. At the same time, finding a way back to normality also inevitably means waving goodbye to extraordinary policy support measures. As a reminder, currently the Fed purchases to the tune of $120 billion per month ($80 billion of US Treasuries and $40 billion in Mortgage-Backed Securities).

Something which should buffer the immediate liquidity hit to markets is that the Fed 'overproduces' liquidity. Money markets cannot absorb the Fed's purchases unless interest rates fall to zero or below (we wrote about this in a previous weekly). Currently the Fed drains via reverse repo operations (to the tune of $1.4 trillion). Should the Fed begin to purchase less, some liquidity can easily be released back into the market.

Of course, beyond almost mechanical liquidity effects, markets trade on signals and policy expectations. Given present economic uncertainties, it is vital the Fed maintains confidence in the economic recovery. In this sense, a short and sharp taper could be counterproductive, hence the wording from Powell around "carefully assessing incoming data and the evolving risks". Tapering to a conclusion by the end of Q1 2022 (as suggested by James Bullard) appears too harsh, and the more market-friendly approach is to present a pragmatic policy stance that remains flexible enough to make any necessary adjustments, should the outlook deteriorate from where we are now.

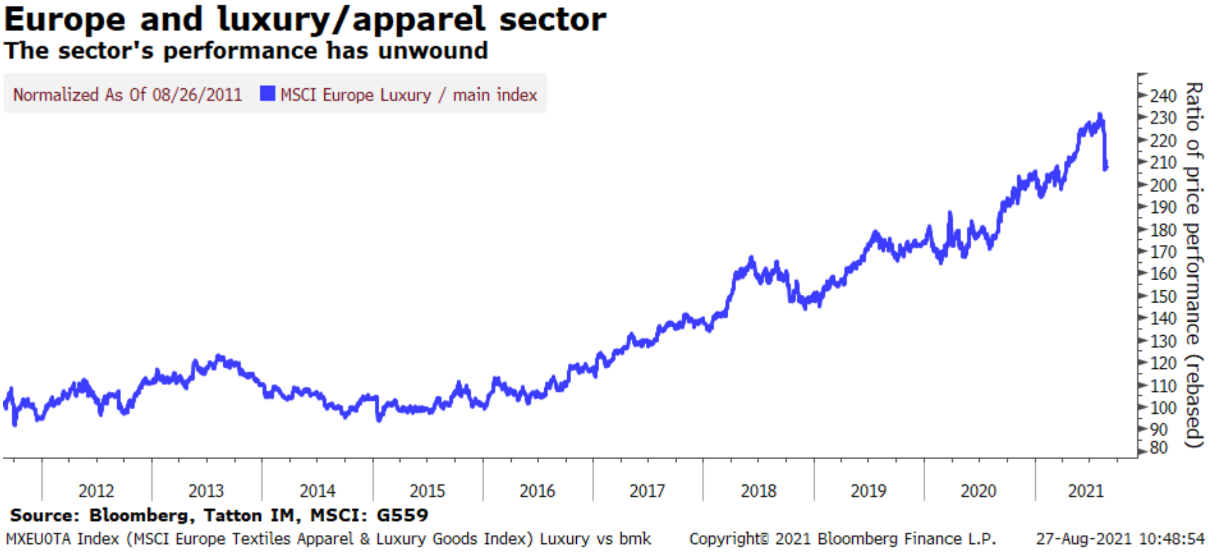
The Fed will never tell you, but not only ahead of Friday's keynote speech from Chair Jerome Powell but also further out, the Fed should keep a close eye on the shape of the US Treasury curve. Given the current stage of economic recovery (this is not yet a mature recovery phase), a further flattening is undesirable. The 2-10-year spread (difference in the yield) has already tightened over the last couple of months, as Fed members have talked about bringing forward their expectations for higher policy rates. Now, it has to decouple tapering from rate expectations – currently money markets expect a lift-off for rates in Q1 2023, and nothing from Powell today contradicted this view.

In the following article we explain why the US equity market could stomach slightly higher real rates in response to fewer Fed purchases. Further out, financial markets will increasingly react to the earnings outlook, as the pure policy impetus begins wane. The global economy is also currently still in a transition phase, and whether a self-sustained recovery can be engineered remains open to question. In this case, it may not only be the expensive cash-rich companies that thrive, but also those trading at lower multiples currently.

Another area that occupied people's minds last week was the intertwining outlook for the US and the rest of the world. The first guidepost for any central bank is domestic conditions, and for the Fed, namely the labour market. But over the past few years, the Fed has opened-up to global developments and vice versa. For example, the European Central Bank has already made it clear it would react should Fed policy action create negative spillovers into the Eurozone.

The most obvious translation of Fed policy into the rest of the world is the US Dollar. Should it appreciate too much, this not only tightens financial conditions in the US, but also in Emerging Markets (EM), which again underlines the need for a measured exit from quantitative easing. But for now, the risk of a rising US Dollar persists. This may also explain why 'cheap' EM equities have not attracted broad-based buying from global investors.

And of course, China's regulatory drive has been another defining element. As China's property conglomerate Evergrande appears to edge closer to a resolution process (which sometimes can signal a bottom), other areas stay very much 'live' in China. Following the crackdown on finance and big tech names recently, it has been the turn of luxury goods to react to China's drive towards equality. The fear is that a crackdown on the wealthy may signal lower sales and margin figures, which saw European luxury brands sell-off sharply. Our final article this week explores the singularly Chinese concept of "common prosperity", which is guiding regulatory action across a multitude of sectors. While any transition phase is painful, it is worth keeping in mind that a broad-based rise in living standards could also signal greater volumes – even if the style of luxury products may have to adjust.



Markets can take a bit of tapering

After a tough 18 months, US Federal Reserve (Fed) members were probably looking forward to a scenic mountain retreat in Wyoming. Unfortunately for them, this year's Jackson Hole symposium – the annual who's who of monetary policy – was, once again, not actually in Jackson Hole. The weekend's meeting, billed as the biggest event on the central banking calendar, was moved online at the last minute, as the Delta variant storms across the US.

Fed chair Jerome Powell will be all too aware of the risks posed by Delta. Like the rest of us, Fed officials were hoping vaccinations would pave the way for normalisation, and a return of economic growth, only for the variant to seemingly keep a lid on activity. And yet, in some ways the Delta spread makes Powell's job a little simpler – in the short-term at least.

This is because the Fed is in a sticky situation. On the one hand, policymakers are well aware that the vast monetary support they provided through the pandemic was – and still is – crucial. On the other, getting back to normal means ending those extraordinary measures, and the pressure is growing on Powell to give some indication of when this will come. A rise in Delta cases could perhaps delay that question for now.

The underlying problem is the mixed signals from the US economy. Widespread supply shortages suggest inflation pressure that normally accompanies economic overheating, but recent economic data has shown a distinct loss of momentum. To complicate matters, Fed policy has itself put so much liquidity into the financial system that policymakers themselves recently resorted to draining it out via reverse repo operations that show no sign of abating in size.

These factors add some urgency to the great taper conundrum: When and how quickly will the Fed unwind its substantial asset purchases?

The received wisdom is that capital markets will not enjoy the process of tapering. This was famously the case in 2013, when the threat of taking away the markets' financial goodies sent them into a 'taper tantrum' sell-off; this was especially obvious with a sharp rise in US real yields while the S&P 500 index was better able to handle the situation. Similar fears have been floating this year, with investors fearful of a too-early withdrawal of support.

The rationale for this is sound. The Fed's mass bond purchases are what anchors real (inflation-adjusted) bond yields, thereby lowering the 'risk-free' rate of return and making risky assets look more attractive. A rise in real yields earlier this year caused jitters in equity markets – with investors already on edge over the stretched valuations (in terms of historical price-to-expected-earnings ratios) for stocks.

This reflects market action in the last few months. With growth looking slower, and the Fed giving no indication of when it will reign in support, real yields fell into the summer. At the same time, expectations of earnings growth looked increasingly strong. Markets took the earnings news well, and climbed higher – but not as high as they might have.

This suggests that, if anything, real yields have fallen a little too low, and have room to rise without negatively impacting equity markets. That gives the Fed room to slow down its bond purchases without fear of fallout. In other words, markets can probably withstand a bit of tapering.

We should emphasise the word "*bit*" here. While the S&P looks cheap on this basis, the difference is small, and with thin trading volumes over the summer months, we should not rule out investors getting spooked over the prospect of major changes. We wrote recently that we could well see jitters and short-term volatility in the near-term, and our assessment has not changed substantially.

It should, nevertheless, be comforting for the Fed. As long as earnings yields stay reasonably positive in the near future, a small rise in bond yields (not interest rates! and most likely less than 0.25%) should not prove too much of a distraction. And it offers a much-needed reprieve, given the stalling of employment growth and dwindling confidence in the underlying economy. Given all these other factors, it will be important for the Fed to avoid any policy shock – but rather proceed with a gradual approach indicative of flexibility.

Confidence is a precious commodity. Investors and businesses usually feel more confident in the economy when the Fed does also. Without clear growth signals from the underlying economy, the wiggle room in markets means it can project that confidence.

China's common prosperity challenge

China's Communist Party has a knack for unsettling investors. In the past, this largely came from the state's sometimes haphazard approach to market interventions – with sudden policy changes causing shocks. Officials have upped the tempo of these interventions in recent times, from technology crackdowns and sudden cancellations of stock market initial public offerings (IPOs) to sweeping changes in the private education sector. The speed and wide range of corporate crackdowns this year has added another layer to investors' concerns: that they are part of a coordinated plan to roll-back 30 years of market reforms and return to a socialism with more, shall we say, *traditional* Chinese characteristics.

President Xi Jinping gave substantial weight to this narrative last week. After a meeting of the Financial and Economic Affairs Commission, China's paramount leader affirmed that more focus would be put on achieving "common prosperity for all", after decades of allowing certain people or groups to "get rich first". Xi was clear that this would involve a stronger "regulation of high incomes", the clearest signal yet that clampdowns would be extended to achieve broader social goals.

The "common prosperity" line is nothing new for China's Communist Party. Indeed, the concept is one of the central tenets of Chinese communism, and has been sought in different ways by generations of leaders. Under Mao, common prosperity was put in opposition to private enterprise, and was part of campaign of public ownership and state-led industrialisation. Deng Xiaoping had a vastly different interpretation, symbolising the break from Maoism that defined China's reform period. For Deng, inequality was an acceptable first step on the road to common prosperity, encouraging private enterprise to increase the country's total wealth before attempting to divide it evenly. The shift was solidified at the start of the 21st century, when private business owners were allowed to join the party ranks.

The move toward equality overgrowth was not started by Xi. His predecessor, Hu Jintao, reformed labour laws and established China's social security system, emphasising that common prosperity still had to be common for all. But the drive increased under Xi, with an expansion of social provisions and a focus on poverty reduction and environmental protection. Though Xi mentioned "common prosperity" only sporadically in speeches during his first few years, the frequency picked up dramatically in 2020. Continuing that trend, his use of the phrase has more than doubled so far this year.

This has coincided with a widespread crackdown on China's big and powerful private companies. This began with an extended campaign against the technology sector, but property developers and financial institutions have also found themselves at the sharp end of the Party's attacks. Just last month, Beijing announced that tutoring companies that taught the national curriculum would no longer be allowed to return profits to shareholders, turning the entire private education sector into a non-profit.

These actions mark a change from previous equality drives. Social security provisions were established to allow China's poor to share in its growth, but the recent crackdowns are focused on limiting how and where companies can make profit in the first place. The recognition of this trend has greatly concerned international investors – who fear it marks a return to Maoism and a war against the private economy. Western commentators have gone as far as to say it makes China now "uninvestable".

We disagree. The 'war on profit' narrative misses the mark on both *ideological* and *macro-policy* grounds.

In ideological terms, it is a mistake to think the Party is returning to Maoism. Another way of interpreting the emphasis on common prosperity is as a continuation of the reform project started by Deng. The party has pursued a vision of shared growth and prosperity since the 1980s, the main stages of which were rapid growth followed by redistribution. There was little wealth to redistribute 40 years ago, but now China is one of the largest and most technologically advanced economies in the world. This does not mean the Party is no longer interested in growth or private profit, but rather that it now feels in a position to pursue more equitable growth. Private enterprise still has a huge role to play, but companies will not be allowed to profit at the perceived expense of Chinese society.

In macro-policy terms, it is impossible to understand the current drive without understanding Xi's other policy goals. These can broadly be categorised into two camps: financial stabilisation and rivalry with the US. Financial stabilisation involves unwinding the nation's large debt pile, rebalancing capital flows and avoiding asset bubbles – all the while ensuring sustainable growth. The US rivalry involves shoring up its technology production and decreasing its reliance on American capital and goods demand.

On the ground, these broad policy goals all become intertwined. The property crackdown is partly driven by poverty concerns, but also by asset inflation and debt sustainability. Likewise, the crackdown on tech investment is partly driven by social worries, and partly by a desire to keep its tech sector out of US hands. All these aims are important to the Party, but none have a decisive say in the matter.

From this perspective, the recent policy drive arguably improves China's long-term investment outlook. The state wants to restructure its economy so it is more financially stable, domestically driven, and has broader-based growth. New regulations that help these aims will likely lead to a more diversified economy, with multiple drivers of growth.

None of this is to say that we should be wholly positive about China. The risks to private enterprise are still very apparent, and with an opaque decision-making process, China's performance will at the very least be unpredictable. When thinking about long-term growth, another question is also how a heavily state-directed system can generate sufficient creativity and innovation. However, the more immediate risk is that markets over-interpret the government's actions, leading to fragile sentiment and high volatility. There will, no doubt, be more disorderly transitions ahead, particularly as we approach the 2022 Party conference.

But while these factors make China risky, they certainly do not make it uninvestable. Indeed, the hope is that these changes will lead to a more balanced and stable economy in the future – to the benefit of citizens as well as foreign investors. That is, after all, what common prosperity is all about.

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31st August 2021

Global Equity Markets

Market	Fri 15:55	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7147	+0.8	+59	→	➚
FTSE 250	24018	+1.1	+268	➚	➚
FTSE AS	4119	+0.9	+36	→	➚
FTSE Small	7589	+1.2	+87	⬀	➚
CAC	6674	+0.7	+48	⬀	➚
DAX	15835	+0.2	+26	→	➚
Dow	35445	+0.9	+325	→	➚
S&P 500	4502	+1.4	+60	⬀	➚
Nasdaq	15094	+2.6	+379	⬀	➚
Nikkei	27641	+2.3	+628	→	⬀
MSCI World	3110	+1.0	+30	→	➚
CSI 300	4827	+1.2	+58	⬂	⬀
MSCI EM	1266	+3.7	+45	⬂	⬀

Top 5 Gainers

Company	%
Evraz	+9.0
Anglo American	+7.7
Glencore	+7.5
Ocado	+6.1
Rolls-Royce	+5.4

Top 5 Decliners

Company	%
Just Eat Takeaway.com N	-4.7
National Grid	-4.3
United Utilities	-3.4
Severn Trent	-3.2
SSE	-2.9

Currencies

Pair	last	%1W
USD/GBP	1.374	+0.9
GBP/EUR	0.858	+0.2
USD/EUR	1.18	+0.8
JPY/USD	109.95	-0.2
CNY/USD	6.47	+0.5
Bitcoin/$	48,436	+0.0

Commodities

Cmdty	last	%1W
Oil	72.39	+11.1
Gold	1807.6	+1.5
Silver	23.95	+4.0
Copper	430.9	+4.2
Aluminium	2619.5	+2.9
Soft Cmdties	477.8	+1.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	15.6	12.7	14.1
FTSE 250	2.2	17.7	25.5	15.8
FTSE AS	3.5	15.7	13.8	14.3
FTSE Small x Inv_Tsts	1.8	15.0	18.8	15.3
CAC	2.2	21.8	16.5	14.9
DAX	2.3	14.8	14.6	13.4
Dow	1.7	20.0	19.2	16.4
S&P 500	1.3	25.5	22.3	17.5
Nasdaq	0.6	31.5	33.0	22.8
Nikkei	1.6	14.8	16.9	17.6
MSCI World	1.7	22.0	20.0	16.5
CSI 300	1.9	16.4	14.8	12.5
MSCI EM	2.3	14.5	13.2	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.58	+0.06
UK 15-Yr	0.88	+0.06
US 10-Yr	1.32	+0.06
French 10-Yr	-0.06	+0.09
German 10-Yr	-0.42	+0.08
Japanese 10-Yr	0.03	+0.02

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.30	1.37
3-yr Fixed Rate	1.52	1.60
5-yr Fixed Rate	1.48	1.56
10-yr Fixed Rate	2.58	2.58
Standard Variable	3.61	3.61

* 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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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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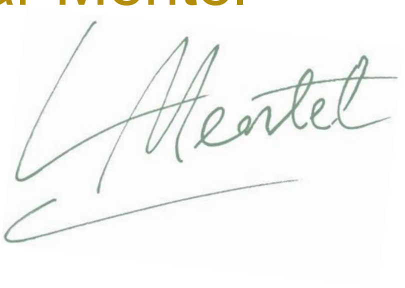

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