THE **CAMBRIDGE** WEEKLY

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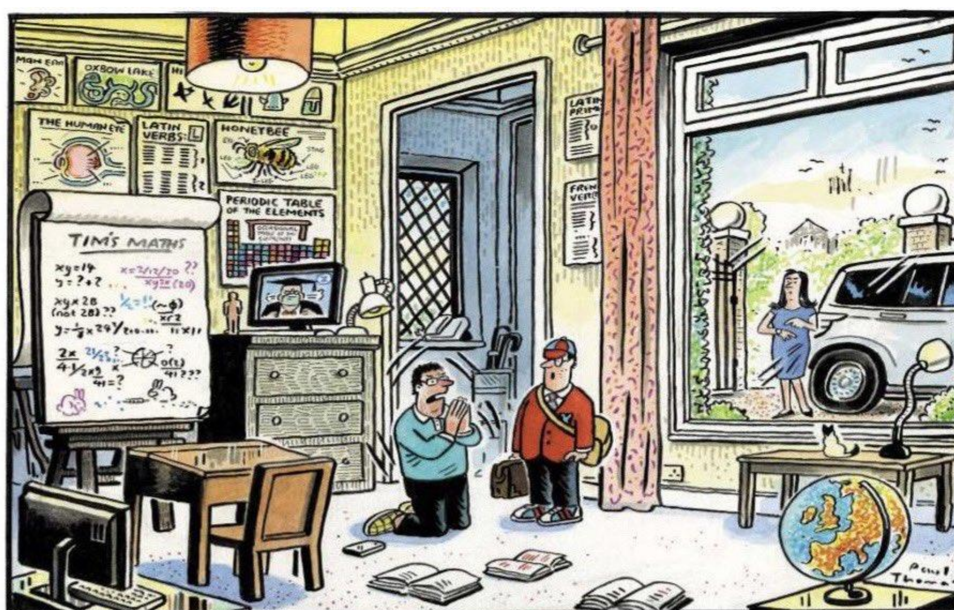


'Don't go back to school, son – your mother will make ME go back into the office'
School children leading UK's back into work drive, Paul Thomas, 2 September 2020

Market dynamic of a K-shaped recovery

Markets' summer holidays are over. Throughout August, risk assets made some impressive gains, while the global economy remained in its deepest ever recession. After equities were then catapulted to eye-watering valuation levels, the end of last week saw a sharp reversal. Last Thursday, the US' S&P 500 – which soared past its pre-pandemic highs in August's rally – saw its biggest sell-off since June. Apple, which made history a few weeks ago by becoming the first company valued over $2tn, lost $219bn in midweek trading alone.

Nevertheless, the summer has seen plenty of sunny days for capital markets. In Sterling terms, all major stock market indices posted positive monthly returns, with the MSCI world index jumping 4% throughout the month. This takes global equities past their pre-crisis levels to a positive return year-to-date. Bond yields jumped higher – and thereby drove down bond valuations - after the Federal Reserve's announcement that it would end its strict 2% inflation target in favour of a symmetrical average inflation target – allowing inflation to run hot in the short-term. Oil prices rose on the back of increased global demand, while safe-haven assets like gold sold-off from its impressive year-to-date run – both positives for economic and risk sentiment.

On a regional level, Japanese equities were the best of the bunch, with Japan's broad Nikkei 225 index registering a 5.5% gain on the month. Emerging market equities lagged at the other end, climbing just 0.2% through August. This makes for a mirror image of July, when EMs outperformed and Japan slumped.

Although the S&P 500 followed Japan closely with a 5.1% monthly return in sterling terms, this overall figure hides the huge divergence between US sectors. The NASDAQ – which is much more heavily weighted towards the American tech sector – climbed 7.5%, becoming August's best performing sector. Incredibly, that takes the NASDAQ's year-to-date return over 30%. The incredible performance of the US' mega-cap tech companies – and how concentrated the market rally has been on them – has led to some investors getting vertigo, worrying about climbing valuations as hitherto healthy underpinning earnings are

proportionally becoming ever smaller relative to share prices. This fear could well have been a part of last Thursday's sell-off.

Asset class returns at 31 August 2020

Asset Class	Index	August	YTD	12 months	3-yrs to 31/8 annualised	5-yrs to 31/8 annualised
Equities	NASDAQ (US Technology)	7.5	30.7	35.8	23.6	21.1
Equities	Nikkei 225 (Japan)	5.5	-2.7	0.2	3.0	3.0
Equities	S&P 500 (USA)	5.1	8.6	10.9	13.1	17.7
Equities	MSCI All Countries World	4.0	3.6	6.0	9.0	10.2
Commodities	Goldman Sachs Commodity Index	2.5	-31.6	-30.7	-7.3	-8.4
Equities	MSCI Europe ex-UK	2.2	-2.0	-0.1	2.8	4.0
Commodities	Brent Crude Oil Price	2.0	-32.1	-30.5	-5.0	-3.8
Equities	FTSE 100 (UK)	1.8	-19.0	-14.3	-3.3	3.1
Inflation	UK Consumer Price Index (annual rate	0.6	0.5	0.2	-	-
Equities	FTSE4Good 50 (UK Ethical Index)	0.5	-20.1	-16.5	-5.3	-0.3
Equities	MSCI Emerging Markets	0.2	-0.6	4.1	2.8	8.7
Cash rates	Libor 3 month GBP	0.0	0.5	0.7	0.7	0.6
Property	UK Commercial Property (IA Sector)*	-0.6	-3.5	-4.1	-N/A	-N/A
Bonds	£-Sterling Corporate Bond Index	-0.8	4.1	3.9	4.2	6.0
Bonds	Barclays Global Aggregate Bond Inde	-2.1	5.0	-4.0	2.6	7.0
Commodities	LBMA Spot Gold Price	-2.9	27.1	16.5	14.4	11.7
Bonds	FTSE Gilts All Stocks	-3.1	6.0	2.4	4.2	5.0

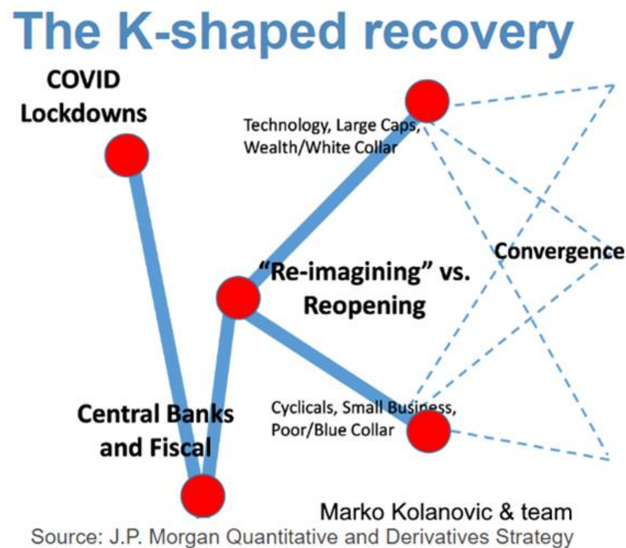
Data sourced from Morningstar Direct as at 31/08/20. * to end of previous month (31/07/20). All returns in GBP.

In fact, the distance between America's haves and have-nots becomes even more stark when comparing sectors on a regional basis. US equities, as a whole, have outperformed their global peers over the last three months. But at the sector level, non-US markets have outperformed their US counterparts in 8 out of the 11 major sectors. For the tech superstars and the consumer discretionary sector, the US is looking good. Not so much for everyone else.

This is an unhealthy sign. Much has been made of the supposed 'K-shaped' recovery we are seeing in stock markets, where the winners recover quickly from the economic crisis and the losers languish at their lows for much longer. We certainly see signs of this in the US market – and it does not bode well for overall stability.

The US still leads the world for now, but the underperformance of large sections of the American economy – combined with weakness in the US dollar – could be a sign that investors are starting to look elsewhere. For that rotation to happen, the dominance of US tech would need to end. But while last week's sell-off has pulled the superstars back, pronouncements on their fate are premature. The tech sector's current

run has drawn unfavourable comparisons to the dotcom bubble in terms of overvaluation, but there are crucial differences. Even if current big tech companies are overvalued, their underlying popularity is based on impressively strong and stable profits – unlike the overbought start-ups with non-existent revenues 20 years ago.



Source: J.P. Morgan Quantitative and Derivatives Strategy

None of this is to say that the rally in growth and big tech stocks will go on, of course. For us, the key thing to watch will be what happens on the monetary policy front. Throughout the pandemic, the world's central banks have supported the financial system through historically large liquidity injections. This has benefitted risk markets – as the non-existent yields on risk-free assets have made it a question of "where should I invest?" rather than "should I invest?". But over the last month, the pace of these liquidity injections has slowed (covered more in a separate article). If this continues – while the global economy still languishes – it is hard to see how the positivity in markets could be supported.

We suspected that this drop in the pace of central bank asset purchases would lead to choppy markets in August. As it turned out, the summer holidays proved calm and quiet. But market volatility could well come in September instead, and central banks' liquidity provision will be a key indicator to watch for that.

For now, the break in US tech's relentless rally actually comes as something of a relief. Given some early signs of a cyclical recovery – especially in Europe – a volatile September could be the precursor to a rotation away from US large tech, the market's current and seemingly only investment darling.

Overall, risk markets would be well supported if the 'liquidity trade' continues. Central bank and government support measures are easy to gauge: it is much harder to work out the consequences of the public health impact of the virus, and how we behave relative to this threat. Europe – including the UK – is without doubt now in the midst of a second wave, with the rate of infections in France and Spain now registering higher numbers than at the height of the pandemic back in April. Yet fatalities associated with COVID-19 have only marginally risen, compared to the lows of infections in the early days of July.

While governments have supported national health systems across Europe to be ready for a return of April's misery and tragic, they have repeatedly stated that they are not planning on a return of nationwide

economic activity lockdowns – most probably because the minimal impact on public health does not justify such a step. So, if the current state of the virus and/or our ability to deal with the illness continues to limit the wider health impact to what currently looks no more than a mild summer flu then it will be down to societies' changing behavioural response to the virus threat that will determine whether the economy will continue to rebound as strongly as it has over the summer, stall, or revert back to decline.

So September will be an even more crucial month than August. If the gradual return of children to classrooms and workers to offices that has taken place across Europe continues and takes hold in the UK as well, then the economy will continue to recover. If fear returns, then economic prospects will be much harder to foresee and so will the corporate earnings recovery. We believe that the positive scenario carries a higher probability than the fear scenario, but it is entirely possible that over the coming weeks, stock markets will be buffeted between these two opposing economic prospects. The roller coaster stock markets we experienced over the past week may therefore become much more frequent than it has over the summer months.

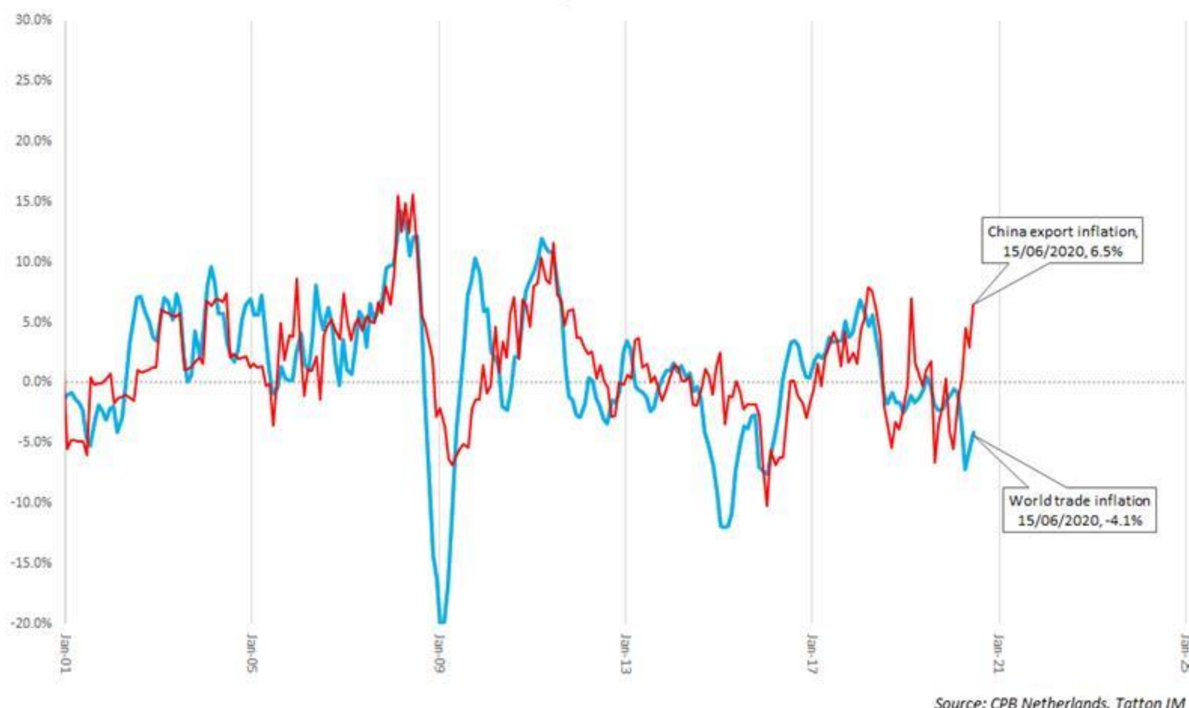
Inflation now a 'Made in China' product

We are in a new era for central bankers. Last week, US and global monetary policymakers convened for their annual Jackson Hole conference, headlined by a speech from US Federal Reserve (Fed) Chair Jerome Powell. But Powell's keynote address was noticeably different from previous years – and not just because neither speaker nor audience were actually in Jackson Hole. In a break from past policy, the Fed will do away with its strict target of 2% annual inflation and instead move to an average target – allowing more flexibility. US inflation will now be allowed to move above its 2% bound in the short-term, to compensate for the stubbornly low price growth we have seen for years. This means, in effect, that monetary policy will stay easy for the foreseeable future.

Judging by the capital market reaction, Powell's announcement has already gone some way to raising inflation expectations – if only marginally. But as the FT notes, it also raised questions about why central bankers have allowed inflation to stay so low for so long. A sluggish economy and slow price movement have been the hallmarks of the post-financial crash world, but even before then inflation was subdued. The chart below shows historic US inflation in terms of personal consumption expenditure (a measure preferred by the Fed), excluding food and energy prices (the most volatile components). As you can see, inflation has undershot the 2% target almost every year since the late 1990s.

One of the key reasons for this persistent disinflationary environment is the intense increase in globalisation – and in particular the rapid rise of China. Since joining the World Trade Organisation in 2001, global production has been increasingly outsourced to China, where abundant cheap labour, and a government willing and able to pump in resources, has driven down manufacturing costs dramatically. For two decades, the 'factory floor of the world' has been able to produce goods faster and cheaper than any of its global peers can compete with.

Aside from catapulting China's economy – now the largest in the world on a purchasing power basis – upwards, this has effectively put a cap on prices in developed economies. The chart below suggests that world trade inflation has become so intimately tied to Chinese exports that Chinese producers have almost



been able to dictate it. China has spent the last two decades exporting disinflation to the rest of the world, also as outsourcing to China meant that workers in developed markets had little bargaining power. And, as the last ten years of monetary policy has shown, there is little central bankers can do to prevent that.

What is also shows, however, is that despite the world sinking into its deepest recession in history, and global trade plummeting, growth in China's export prices has picked up. This is hugely significant. Like its global peers, China's economy has been hit hard by the pandemic – shuttering shops, factories and whole cities for months. But rather than grow its way out of it through cheap exports, China is focused on its domestic economy.

Of course, this has been building for some time. Due to rapid increases in technology, wages and living standards, the 'factory floor of the world' moniker has been outdated for a while. Throughout Xi Jinping's eight-year presidency, transitioning to a domestic demand-led economy – and giving citizens the 'Chinese dream' – has been one of the government's top priorities.

Geopolitics has accelerated this trend. Throughout Donald Trump's presidency, trade relations between the world's two largest economies have deteriorated significantly, with tit-for-tat tariffs and US sanctions hurting Chinese exporters. And tensions between the two countries show no sign of letting up, with the 'tough on China' policy a rare point of bipartisan agreement among both US political parties. This has made China's need for economic independence stark, forcing the government to push harder on the domestic investment and technology front.

Nevertheless, the current rise in Chinese export prices, coupled with the fact the Renminbi (CNY) has not weakened, is worth noting. While China led its currency appreciate in the wake of the global financial crisis, the 2015 episode, when the CNY devaluation triggered a global market sell-off, is still in everybody's memory. Back then, Chinese domestic financial stability was a major concern, whereas now authorities seem to have found more confidence. The domestic economy is seen as the major pillar, and one has to acknowledge that demand outside of China currently is hardly of great support, regardless of the value of its currency. Another motivation for a stronger CNY is most likely that it does not deliver an easy argument to the Trump administration to implement new measures against China.

So, China seems assured in its domestic recovery. Having gone through its lockdown earlier than most countries, and implementing draconian measures to avoid re-importation of the virus, it looks in a relatively good position– and its government is now focused on getting the economy going. Sanctions, further tariffs and the possibility of military confrontation remain big risks, but recent market action suggests that investors are relatively positive on China.

In terms of global inflation, we may be at the beginning of a sea-change too, even if it may take several years to feed through. The Fed is now trying its best to push inflation expectations higher over the long-term – with other central banks expected to follow suit. And this is happening just as one of the major secular causes of disinflation could be coming to an end. Undoubtedly, other developing countries will pick up the export slack to some extent – as we have already seeing with Vietnam's rapid manufacturing growth in recent years. But deflation is no longer 'Made in China', and that is a significant turning point. With the world in the depths of recession, short-term price growth is unlikely – but the structural forces of disinflation are fading.

August gets technical

Despite the sharp sell-off we saw into the end of last week, capital markets overall have cruised through the summer. The US stock market soared past its pre-pandemic highs, powered by America's mega-cap tech giants, while others (with the exception of Japan) saw more muted price action. With traders and the investing public away in the sun, August is usually a quiet month in terms of trading volumes. This can either lead to a spike in volatility – as buyers leave for the holiday – or it can smooth things over and calm the waters in markets. This time around, thankfully, it was the latter: Both implicit and explicit market volatility declined through the month – until last week's sell-off, that is.

The US market broke away from its peers over the month, with continued stellar performance. But the headline record numbers for the S&P 500 index paper over some serious divergence in American companies. While Silicon Valley continues to attract investors *en masse* – shown by Apple's incredible $2 trillion market cap milestone a few weeks ago – other industries and smaller businesses struggled. We can see this in the performance split between the S&P 500, tracking the performance of the largest US companies, and the smaller cap Russell 2000. The chart below shows the Russell 2000's stuttering rally.

This shows the lack of breadth in the US stock market moves. Momentum carried America's most-bought companies higher through the month, but this momentum petered out for the rest. For the Russell 2000, this sluggish pace led a 'double top', where the short rally into the end of August was not enough to break past the highs seen earlier in the month. The S&P 500, on the other hand, broke free of its moving averages and usual trading range into new highs, as shown in the chart below.

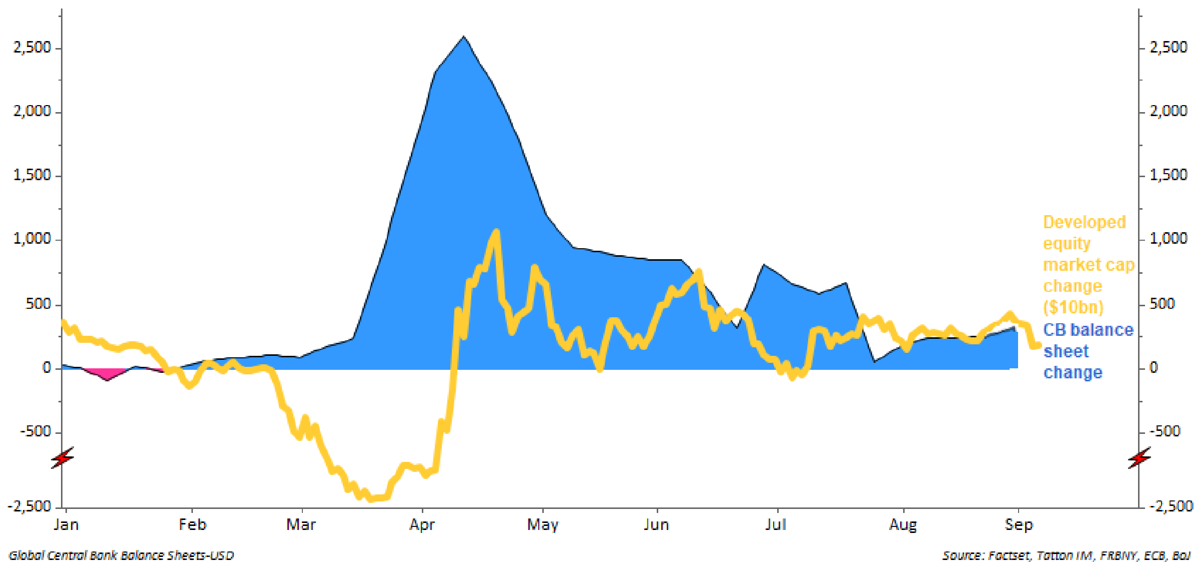
Of course, last week that rally saw a reversal. From a technical point of view, this was not so surprising. With stock markets skyrocketing as the world languishes in its deepest ever recession, many feel that equities are running on good will – and a generous dose of central bank liquidity – alone. Without economic fundamentals to lean on, investors have to take their cues from technical market measures.

One such key indicator is the Relative Strength Index (RSI), measuring the magnitude of an asset's recent price changes to show whether it is 'overbought' or 'oversold'. Towards the end of August, the S&P's rally saw it climb to historically high RSIs (the red outer range in the chart above). The market reached the mountain top, and – one way or another – something needed to topple off. A correction was therefore to be expected.

Interestingly, a similar episode occurred back in June, when the S&P's rally broke outside of its range only to come back down. That proved to be only a minor blip, with the US stock market powering ahead afterward. The key question is whether last week's pullback is just another technical slip, or something more significant. And for that, we have to look into the underlying conditions for the rally in the first place.

Clearly, one of the main drivers of the recent good times in equity markets has been the abundant liquidity provided by central banks. With accommodative monetary policy anchoring the cost of capital and the return on 'risk-free' assets down, risk assets benefit. Throughout August, a recent trend in the major central banks' balance sheets continued: direct purchases continue at a "cruising speed" of around 80 billion (in USD and EUR respectively) per four weeks, while little or reduced take-up of emergency programmes means the overall size of the Fed's assets has stalled. It shows that central banks have moved from emergency market intervention, where the Fed was the most aggressive, to more traditional quantitative easing (QE) policy, which involves lower purchase volumes.

Rolling 4-Week Changes: Central Bank Assets and Equity Markets



Central bank liquidity, of course, is never the whole story. August was also the month when fiscal handouts in the US began to slow. Federal unemployment support expired at the end of July and was replaced by a somewhat less generous scheme – leaving less money in the hands of the general public. Given how important retail investors have been to the impressive COVID recovery rally, a cut to incomes is also likely to affect stock markets.

Looking forward, attention will focus on how governments can continue to support the real economy. For most Americans, focus is increasingly on the furlough scheme and whether the government manages to find a suitable follow-on scheme. From an investment perspective, should the US situation become messier the closer we get to general elections, markets could well get much choppier over the coming weeks and months. If, at the same time, we see early signs of economic recovery, this may not be such a bad thing, with financial markets coming more into line with economic reality. If those signs do not come through, further fiscal or monetary action will almost certainly be needed.

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7th September 2020

Global Equity Markets

Market	Fri 16:20	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	5852.5	-2.5	-147.5	↘	↘
FTSE 250	17454	-1.7	-307.8	→	↘
FTSE AS	3281.8	-2.3	-76.1	↘	↘
FTSE Small	5096.5	-0.4	-18.1	→	↘
CAC	4994.4	-0.2	-8.5	→	↘
DAX	12944.6	-0.7	-88.6	→	→
Dow	28048	-2.1	-606.2	↗	→
S&P 500	3419.9	-2.5	-88.1	↗	↗
Nasdaq	11082.9	-5.2	-612.7	↗	↗
Nikkei	23205.4	+1.4	+322.8	⬀	→
MSCI World	2425.8	-1.3	-31.1	↗	⬀
MSCI EM	1108.9	-1.1	-12.7	↗	⬀

Top 5 Gainers

Company	%
Melrose	+11.8
Carnival	+11.3
Hikma Pharma	+4.8
Fresnillo	+4.7
Compass	+4.5

Top 5 Decliners

Company	%
Rolls-Royce	-12.0
Hiscox	-10.9
Flutter Ents	-10.4
Scot Mtge Inv Trust	-10.4
Pearson	-8.7

Currencies

Pair	last	%1W
USD/GBP	1.320	-1.0
GBP/EUR	0.894	-0.2
USD/EUR	1.18	-0.7
JPY/USD	106.38	-0.9
CNY/USD	6.84	+0.3
Bitcoin/$	10,335	-10.1

Commodities

Cmdty	last	%1W
Oil	43.09	-4.4
Gold	1926.5	-2.2
Silver	26.53	-3.9
Copper	300.5	+0.3
Aluminium	1780.0	+0.0
Soft Cmdties	354.2	-1.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.26	-0.05
UK 15-Yr	0.51	-0.05
US 10-Yr	0.67	-0.05
French 10-Yr	-0.17	-0.06
German 10-Yr	-0.47	-0.06
Japanese 10-Yr	0.04	-0.02

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	93.3	19.3	13.6
FTSE 250	2.8	50.1	26.6	14.6
FTSE AS	3.9	104.0	20.3	13.7
FTSE Small	3.8	58.5	-	13.8
CAC	2.2	46.2	26.0	13.9
DAX	2.7	40.5	21.2	12.9
Dow	2.2	24.2	24.4	15.5
S&P 500	1.8	26.6	26.1	16.5
Nasdaq	0.8	36.9	31.9	18.7
Nikkei	1.9	37.6	22.7	17.0
MSCI World	2.0	29.5	24.6	15.7
MSCI EM	2.3	20.1	18.1	12.1

UK Mortgage Rates

Mortgage Rates	Jul	Jun
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.45	1.42
3-yr Fixed Rate	1.71	1.68
5-yr Fixed Rate	1.70	1.69
10-yr Fixed Rate	2.32	2.34
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

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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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