CAMBRIDGE
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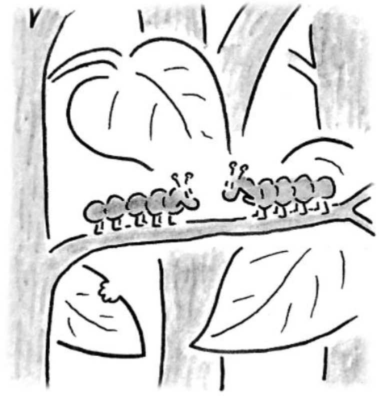


'And then, after months, they emerge from lockdown looking fatter, hairier and much worse than before'

Source: Matt, 15 February 2021

One year on – who would have thought

One year ago, on 19th February 2020, stock markets hit their pre-pandemic high. Over the five weeks that followed, markets plunged in the most extreme global market crash ever known, as the world accepted that COVID-19 was a threat of unprecedented dimensions. Looking back, it seems impossible anyone could have even broadly predicted what would happen over the following 12 months. The best – and the worst – that defines the human race emerged, and we can all agree 2020 is now one of those 'before and after' markers, like World War I and World War II, that we use to map the progression of collective society.

At the same time, it is worth observing that some of the basic forecasts we made during the most tumultuous weeks of February and March 2020 have proven quite accurate, particularly that this would not be a classic recessionary period, but one that could potentially prove far more short-lived than seemed possible back then. That has certainly been the case, and while our assertions that globally diversified investment portfolios without specific style biases were likely to weather the storm well – which they clearly did – we neither foresaw nor dared to hope just how brief the capital market disruption would be. Nor could we foresee just how long, and how severely, the pandemic would disrupt our daily lives.

We would suggest that learnings from the global financial crisis of 2008/2009, and the impaired growth dynamics that followed, led to the extraordinarily timely and decisive policy actions undertaken in March and April of last year. Admittedly, there are sectors that have nevertheless suffered severely, and may take years to recover. However, without the combined efforts of monetary policy from central banks and government-led fiscal support measures, it is highly unlikely that just 12 months later there would have been a near consensus expectation among economists that a substantial recovery, if not economic boom, would follow.

Paradoxically, just like a year ago, that means that there is a significant change in investment dynamics ahead. Market commentators are snappily summarising this as the 'return of the reflation trade'. Over the past week, we again got a glimpse of what may lay ahead, when the FTSE 100 index jumped more than 2.5% in a day, while most other stock markets chalked up far more modest moves. As commented before, the top end of the UK stock market is full of companies that are highly depended on cyclical economic forces in the global economy, like energy, resources and banks.

When the oil price climbed due to anticipation of a strengthening cyclical recovery and a looming supply shortage after a cold spell hit America's southern oil exploration heartlands, this struck many professional investors as a sign that the cyclical recovery is gaining momentum that will benefit last year's least loved sectors, some of which still linger close to their 12-month lows.

In this context, 'reflation' simply means a reversal of deflation, and signals a change in the direction of travel in bond yields. Indeed, the bigger market movement of the week was a rise in yields across global regions and maturities (yes, far more meaningful than Bitcoin breaking through the $50,000 barrier for the first time). Markets are beginning to expect the recovery in demand will be strong enough to push up general price levels of goods and services, with the resulting risk of this turning into structural inflation proving sufficient for bond holders to demand higher yields.

As we have written before, a normalisation of bond yields is not a bad thing *per se*, except that if they rise quicker than corporate profits rebound it they can smother the recovery. More importantly for investors, it means long maturity bonds lose in capital value and equities are no longer 'the only show in town'. The last time yields spiked was the last week of January, although this time equities did not react anywhere nearly as negatively across the board. But make no mistake, the reflation trade theme also spells trouble for those companies that have benefitted from falling yields. These 'COVID-darlings' with ever rising valuation levels over the past year – particularly low capital-intensive growth and tech stocks – are now facing headwinds that can only be overcome by offsetting earnings growth.

Such rotational forces are market dynamics that we positioned our portfolios for since last autumn. They may well become the bigger contributors to portfolio returns compared to overall market levels, which recovered last year in anticipation of the economic recovery that is only just starting. Bond investors may therefore not have much to look forward to, but investors with diversified portfolios should once again be best positioned for the changing fortunes in global capital markets. We will certainly make sure to manage portfolios through the changing winds. Just as we tilted them last year towards a slight growth bias, and kept them equity overweight, we have now shifted portfolios in favour of the cyclical recovery theme. With central banks determined to counter rising yield pressures to prevent a slow recovery that would stifle the impact of its policy response, we think it is still too early to take the next step, which would anticipate a sustained rebound of stocks most benefitting from higher yields – namely choosing value over growth. However, if higher economic growth persists beyond the initial rebound, and becomes firmly entrenched, then a further rotation is on the cards.

Policymakers reacted in timely fashion last year because of what they learned a decade earlier. This year, they appear content to remain on the same course, and – when it comes to post-recession stimulus measures –would prefer to err on the side of largesse rather than thrift. The aim appears to be a much more pronounced growth trajectory which would not just benefit the few, but would help all levels of society to overcome the frictions and divisions that now appear as disruptive to the economy as perhaps inflation was in bygone eras.

Should the post-pandemic recovery succeed (echoing the post-1945 US expansion) and we see economic growth rather than stagflation prevail, then investors should continue to see decent returns from rising corporate earnings that effectively neutralise the headwind effect of rising yields. This leaves the question of how to pay for it all, and the rising fears amongst non-economists and non-central bankers about the long-term perils of ever-growing public debt mountains. We have therefore this week dedicated an in-depth article on this topic.

Fear facing complacency over rising debt

Desperate times call for desperate measures. The global economy has been ravaged by the pandemic, struggling under the cycle of lockdowns and rising virus fatalities for a year now. The forced shutdown of entire business sectors has led to the deepest global recession on record – with increasing numbers of affected businesses closing their shutters for good. Thankfully, the economic policy response to this crisis has been decisive. Central banks across the developed world have embarked on extraordinary asset purchase programmes that have kept borrowing costs suppressed, while governments are plugging the income gap with spending measures not seen before in peacetime.

Few would deny that these measures are necessary. Without governments supporting businesses and individuals through lockdown, incomes (and as a result demand) would plummet, leading to mass insolvencies. Without central banks buying the debt to fund those programmes, borrowing costs would spiral – turning the March 2020 stock market turmoil into a disastrous global financial crisis which would have made 2008's crisis look benign by comparison. That said, historic and unprecedented policy intervention makes politicians and the public understandably nervous.

Media headlines are filled with ever-larger spending numbers. With US politicians debating a $1.9 trillion US fiscal package and more, the twin spectres of debt and deficit are getting a lot of airtime. The underlying assumption is that these immense debt loads will need to be paid for somehow – either by higher taxes, austerity or, worse, sovereign debt crises.

First, we should remind ourselves that the "how do we pay for it?" question should not get in the way that support needs to be provided by authorities that impose restrictions to save lives. That's at least the current consensus in the developed world, and along this line of thinking, economists and policy experts agree that a world with lockdowns and deficit spending leads to better long-term economic outcomes than one with lockdowns and no deficit spending. For now, the global recession is an artificial one forced by government-imposed closures. But, without furlough schemes and emergency loans supporting incomes, the unemployment and default rates would skyrocket, depressing aggregate demand and landing us in a 'classical' recession – and a vicious one at that.

Second, while growing government debt piles will force *some* kind of adjustment at *some* point in the future, it is not true that exclusively tax rises or austerity can tackle debt in the long run. Public finances are a delicate equation, comprising tax receipts (and outlays), borrowing costs, and long-term growth prospects.

A growing economy means higher tax receipts at the same tax rates, just as a declining economy automatically leads to lower receipts. As long as the cost of new borrowing is below expected nominal long-term rates of GDP growth, the money governments take in should outpace the money they hand over to bondholders. Expanding this to the overall debt situation of a country, its treasury can run a primary deficit (annual budget shortfall before debt financing) without increasing the debt-to-GDP burden, for as long as interest paid on the debt is below nominal GDP growth rates (this all holds to varying degrees, depending on the depth of the primary deficit, etc). Even the International Monetary Fund – previously the world's pre-eminent budget hawk – recommends developed nations borrow their way through this crisis, as the alternative would lead to even higher debt and lower growth over the long term.

Of course, this means low borrowing costs are the crucial factor. Here, the worry is that large national debt puts governments at the mercy of bond vigilantes, who can force bond yields higher by selling the debt of countries perceived to have unsustainable budgets. There are two things to consider here. First, bond markets only punish fiscal fecklessness when a nation's finances are *worse* than others – and for now everyone is more or less in the same boat. Second, predominant buyers of government debt across the developed world are currently central banks, not private institutions.

This is an extraordinary situation. With governments committed to debt-funded spending, and central banks committed to practically unlimited bond purchases, the end result is effectively fiscal policy by printing press. Such monetarisation of government deficits makes many uncomfortable – conjuring up images of hyperinflationary Germany in the 1920s and Zimbabwe in the 2000s - but those worries need to be put into context. With restrictions suppressing activity all over the world, runaway inflation is hardly a present concern. And, when the economic ice age starts to thaw, there will be plenty of supply keen to soak up the returning private sector demand, while monetary and fiscal expansion will undoubtedly be tapered back.

Interestingly, and contrary to perceived 'bond-vigilante' rationale, over the last year we noted that capital markets seemed to even be rewarding free-spending nations rather than punishing them. Those countries announcing looser monetary and fiscal policy saw their currencies appreciate, suggesting investors also accept that copious emergency support is preferable to parsimony from politicians.

This does have its limits. More recently, bond yields across the developed world have risen on the back of increased inflation expectations for the post-pandemic world. A stronger than expected economy at the end of last year, coupled with renewed fiscal zeal in the US, has led investors to expect a more rapid recovery once the world opens up – leading to higher inflation expectations in the medium and long term. This could make things difficult for governments, as higher debt costs will mean either more limited spending power or higher and potentially unsustainable debt-to-GDP ratios in the long-term (as explained above). Below is a table where we show the upper limit for yields to maintain stable debt/ GDP for the world's major economies in three years' time, based on IMF growth, inflation and fiscal expectations.

	US	Japan	China	UK	Germany	France	Italy
Based on IMF projections							
Upper limit for yield to stabilize public debt/GDP ratio in the medium run	**1.3**	**0.9**	**-4.7**	**-0.3**	**5.1**	**0.2**	**3.0**
Current 5 year yield	0.6	-0.1	3.1	0.1	-0.6	-0.6	-0.0
Current 10 year yield	1.3	0.1	3.2	0.6	-0.4	-0.1	0.6
Medium term assumptions							
Inflation rate (%)	2.1	0.8	2.6	1.9	1.5	1.2	1.0
Real growth (%)	2.3	1.2	5.7	1.9	1.8	2.3	1.7
Nominal rate growth (%)	4.4	2.0	8.3	3.8	3.3	3.5	2.7
Primary balance* (% of GDP)	-4.0	-2.8	-8.9	-4.6	1.2	-3.8	0.3
Gross public debt to GDP (% of GDP)	135.2	262.8	74.6	115.3	65.5	121.3	154.9
Current							
Inflation rate (%, 2020)	1.5	-0.1	2.9	0.8	0.5	0.5	0.1
Real growth (%, 2020)	-3.4	-5.1	2.3	-10.0	-5.4	-9.0	-9.2
Nominal rate growth (%, 2020)	-1.9	-5.2	5.2	-9.2	-4.9	-8.6	-9.1
Primary balance* (% of GDP, 2020)	-16.7	-13.9	-10.9	-15.5	-7.6	-9.5	-9.4
Gross public debt to GDP (% of GDP, 2020)	131.2	266.2	61.7	108.0	73.3	118.7	161.8
Average debt maturity **	5.3	7.6	6.4	14.8	6.6	8.1	6.9

** General government ** Bloomberg tradeable debt securities*

As evident, many nations are either at, or approaching this level. A word of caution is that the table compares the sustainable interest paid on the overall stock of debt with current spot market yields. But it nevertheless gives us a rough estimate of how much room there is for yields to rise, given fiscal projections.

The two defining factors here are nominal GDP growth and the primary balance. The most elegant way to grow out of debt is most likely to increase potential GDP growth and inflation. Higher inflation may not please the older generation, but is nevertheless effective in lowering the debt/GDP ratio (of course not rampant inflation, which undermines planning confidence and thereby growth). Improving the primary balance, the balance of a government's receipts and expenses while ignoring interest payments, can already prove a bit more painful, but is a powerful tool. This is when governments will start talking about raising taxes and cutting spending. While this may sound like good old austerity (higher taxes or cutting government spending), since the aftermath of the '08 global financial crisis authorities have tried to move more towards 'smart austerity', which targets inefficiencies in public systems. This sounds politically more palatable, but may be harder to implement as it requires structural reforms.

In the current situation, reverting to any form of austerity does not appear like the smart option, given this reduces the demand side which all other policy measures are trying to stimulate while the virus-induced wounds are still apparent. While we all hope for higher nominal GDP growth, in the meantime there is the option to keep the pressure off governments by suppressing borrowing costs with the help of central banks. What this means is that we may well be in for another extended round of 'financial repression' (last seen post-2008) from the world's central banks, namely huge asset purchases crushing bond yields and forcing the 'risk free' rate of return down. In that environment, inflation-protected assets like equities can do very well.

Italy's Super Mario off to a strong start

In the midst of political and economic crises, the Italian president has asked an economist named Mario to form a technocratic government – a headline that works today as well as it did back in 2011. But despite the numerous parallels between Mario Draghi's recent appointment to Italy's top job and the appointment of Mario Monti ten years ago (both inherited a spiralling national debt pile from a controversial prime minister), the current premier has something none of his modern predecessors have enjoyed: an outstanding reputation in international capital markets. Mario Draghi, the former European Central Bank president that Paul Krugman once described as "the greatest central banker of modern times", takes leadership of a country and economy in turmoil, but markets are certainly confident that he can do "whatever it takes" yet again.

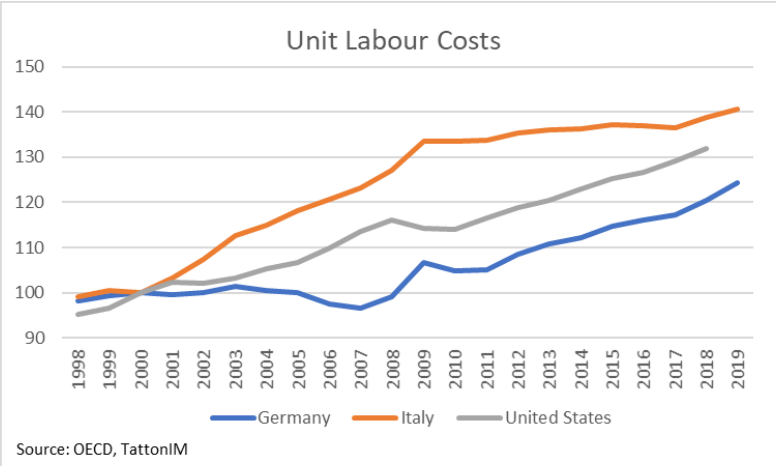
Following the resignation of prime minister Giuseppe Conte, and the collapse of Italy's last coalition government, Draghi was asked to steer the country out of crisis. Italian bonds rallied and yields fell as a result, as investors became optimistic about the former central banker's turnaround management skills. Such is Draghi's prestige, Bloomberg reported he "took less than a week to turn the political system on its head and boost the country's standing in financial markets".

The boost is sorely needed. Italy has been one of the worst affected countries during the pandemic, with one of the highest death tolls and multiple damaging lockdowns, but the country's problems go well beyond the virus. The Eurozone's third largest economy has struggled with low productivity and growth for over a decade. Its sizable government debt pile continues to grow, and its banking sector is burdened with swathes of non-performing loans – preventing it from engaging in productive lending.

There are many reasons for this. A prolonged hangover from the financial crisis, a cumbersome legal and governance system and multiple budget confrontations with the European Union, but the end result is that Italy has underperformed its European and global peers for more than 20 years. After decades of stagnation, Italy's real GDP is now smaller than it was in 2000 (the chart below compares GDP development for Italy (white line) with Germany (yellow) and the US (green).

Source: Bloomberg, Tatton Investment Management, 19 Feb 2021

Despite that non-existent growth, labour costs have continued to rise – meaning Italian businesses lack competitive edge – with less money was available for business investment. As the chart below shows, Italy's unit labour costs have risen higher than both Germany and the US over the last two decades.



Italy also has one of the highest debt-to-GDP ratios in the Eurozone, with government debt totalling almost 160% of its economy. In the past, Brussels has pressured Italian leaders to enact cost-cutting reforms and trim public spending. But spending is not the main problem. Contrary to what is sometimes portrayed in the media, the Italian government is not a particularly generous spender. In fact, politicians in Rome have proven themselves very prudent fiscal spenders over the years, with a primary budget balance better than most European peers. Indeed, until the pandemic hit, Italy has had a consistent history of running a primary budget surplus.

The reason for Italy's large national debt is not so much the money it is handing out, but the potential tax receipts it can take it. Economists rate the country's medium-term growth prospects as zero at best – with some even expecting Italy to contract. Without a strong impetus for growth, Italians are trapped under debt built up in the past – on both the private and public side (see previous article for the debt dynamics from economic growth).

Addressing the cost competitiveness issue could certainly help spur activity, but Italy's malaise goes deeper. It has a heavy bureaucracy and a slow judicial system, which has made bankruptcies in particular a nightmare to resolve. Italy also suffers from a dearth of research and development, which puts a great dampener on productivity growth. This goes hand in hand with Italy's lack of digital infrastructure and IT adaption, as well as problems in the education system. Some of the malaise is summarised in the fact that in the World Bank's Ease of Doing Business index, China has overtaken Italy.

The banking system is another formidable problem. Not only are Italy's banks ailing under the weight of historic non-performing loans, but their fragmentation also makes it difficult for small and medium-sized businesses to access adequate financing. All in all, these factors make it extremely difficult for Italian businesses to grow.

This is the task that Draghi faces: a country and continent in crisis in need of deep structural reform. Fortunately, those are circumstances the former ECB president will be familiar with. His priority will be to utilise the money available from the EU's recovery fund, which he has wasted no time in addressing. After winning confidence votes in Italy's parliament, Draghi raised optimism about the prospect for productive public investment: "For the first time in many years, the state can make significant investments with the only restriction that they be made well, meaning that they increase the growth of the country and therefore contribute also to making our debt sustainable,"

Crucially, Draghi understands debt management is about more than just cost-cutting, highlighting that, with bond yields as low as they are, "it is not interest rates that determine the sustainability of public debt, it is the growth rate of a country" (again refer to previous article).

This is hardly a new argument, but Draghi has the reputation and the opportunity to enact reforms and boost growth more than his predecessors could manage. Italy is currently benefitting from immense support from the ECB, but that support will eventually run out – threatening to cause a jump in Italian bond yields. Now is the window for reform, while bond yields are pinned down and EU budget rules temporarily suspended. Markets, at least, seem confident that he can do it.

Source: Bloomberg, Tatton Investment Management, 19 Feb 2021

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Global Equity Markets

Market	Fri 16:12	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6644	+0.8	+54	⬀	➚
FTSE 250	21066	+0.1	+29	⬀	➚
FTSE AS	3780	+0.7	+25	⬀	➚
FTSE Small	6514	-0.0	-2	➚	➚
CAC	5782	+1.4	+78	➚	➚
DAX	14006	-0.3	-44	⬀	➚
Dow	31624	+0.6	+193	⬀	➚
S&P 500	3930	+0.3	+14	➚	➚
Nasdaq	13966	-0.4	-60	➚	➚
Nikkei	30018	+1.7	+498	➚	➚
MSCI World	2803	-0.6	-16	➚	➚
CSI 300	5779	+5.4	+295	➚	➚
MSCI EM	1425	-0.3	-4	➚	➚

Top 5 Gainers

Company	%
Antofagasta	+20.1
Carnival	+14.5
Glencore	+12.2
TUI	+12.0
Int'l Consol Air	+10.2

Top 5 Decliners

Company	%
Tesco	-24.8
Hargreaves Lansdown	-8.1
Micro Focus Int'l	-8.0
Imperial Brands	-6.2
RELX	-5.3

Currencies

Pair	last	%1W
USD/GBP	1.401	+1.2
GBP/EUR	0.866	+1.1
USD/EUR	1.21	+0.1
JPY/USD	105.56	-0.6
CNY/USD	6.46	+0.0
Bitcoin/$	53,965	+12.6

Commodities

Cmdty	last	%1W
Oil	63.52	+1.7
Gold	1787.3	-2.0
Silver	27.48	+0.4
Copper	405.1	+7.4
Aluminium	2137.5	+2.8
Soft Cmdties	442.6	+3.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.2	19.3	15.0	14.0
FTSE 250	1.8	18.8	22.0	15.2
FTSE AS	3.0	19.3	16.9	14.1
FTSE Small x Inv_Tsts	1.6	18.2	-	15.1
CAC	1.9	22.4	18.2	14.5
DAX	2.5	22.2	15.7	13.2
Dow	1.9	22.3	20.9	16.0
S&P 500	1.5	27.9	23.0	17.0
Nasdaq	0.7	35.8	34.4	21.9
Nikkei	1.4	28.1	24.4	17.4
MSCI World	1.7	25.9	21.5	16.1
CSI 300	1.5	21.2	16.0	12.4
MSCI EM	1.7	22.4	16.8	12.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.68	+0.16
UK 15-Yr	0.92	+0.17
US 10-Yr	1.32	+0.12
French 10-Yr	-0.07	+0.13
German 10-Yr	-0.32	+0.11
Japanese 10-Yr	0.11	+0.04

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

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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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