CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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'It's this damned Jersey fishing war. I'm afraid you've been called up'

Source: Matt, 6 May 2021

Sell in May and go away?

The traditional stock market adage of 'sell in May and go away' is back in vogue again this year, after the first four months of 2021 brought healthy returns to investors with equity exposure. Of course, historic return observations have rarely been good predictors of future returns, and this year has hardly followed the traditional pattern. May has made an encouraging start, with stock markets only briefly spooked by former US Fed Chair Janet Yellen's prediction that yields would likely have to rise to prevent economic overheating. However, overheating fears might have cooled slightly, after the announcement on Friday that the US labour market added just 266,000 jobs last month, compared to the 770,000 new jobs added in March. Some analysts were expecting the new jobs number to reach one million.

The somewhat downbeat announcement caused long bond yields to fall initially (which increases bond value), which caused equities to rise sharply. However, the concern that employment in the US is still shy of pre-pandemic levels could spark fresh worries that labour shortages are holding back the recovery. Nevertheless, the prospect of the inevitable price-push from the reopening morphing into outright inflation – spoiling the party through rapidly rising bond yields – remains the predominant investor scare story. We cover rising inflation pressures, especially on food, in a separate article.

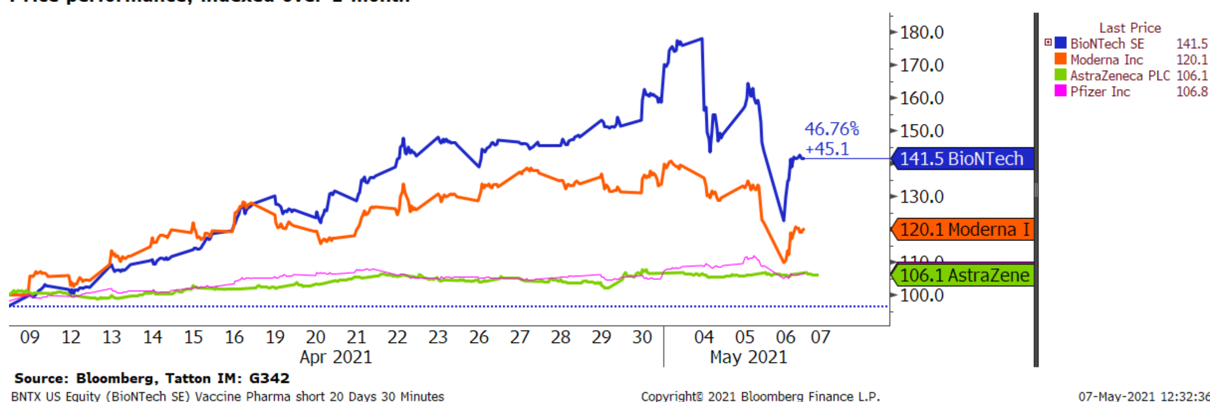
Aside from the British and French navies being deployed off the coast of Jersey, the UK media spent most of last week more occupied with local elections and what the results mean for the future of the United Kingdom. While we leave such conclusions to the political commentators, we look at the state of the UK economy, and gauge the view of capital markets on what future opportunities may present. We can only say so much at this point: The currency market, which has offered an incorruptible political critique since Brexit, is telling us that nothing has changed – yet.

Of more immediate relevance for the investment community has been the Biden administration's backing of a World Trade Organisation proposal for a waiver of the rules protecting the intellectual property behind the COVID vaccines. That sent shares of American and European vaccine makers tumbling last Wednesday.

BioNTech US-traded depository receipts (the main traded share – the German equity is unlisted) dropped initially about 30%, US-based Moderna was off about 20%, but Pfizer Inc. shares fell only about 3% (see chart below).

COVID-related pharmaceuticals

Price performance, indexed over 1 month



Moderna and BioNTech are new-ish research houses, rather than drug producers. They don't have a big backlog of patents, so the treatment of intellectual property and patents is extremely important to them. Goldman Sachs viewed the proposals as non-material for Moderna, which had already stated it would not enforce COVID-19 vaccine-related patents during the pandemic and that its intellectual property was embedded in its immense manufacturing know-how, resources and personnel requirements. Even so, it took a big hit, as did BioNTech, which has less protection than Moderna.

Germany, home of BioNTech, felt compelled to oppose the proposed waiver, Spain is backing it. The US decision may feel highly specific to the pandemic, but the issue of who benefits, and how, from medical research is extremely important. The values of Tech and Pharma are intrinsically bound up in the ownership of knowledge and international patents, which exist over 20 years, and many on the left have suggested reform is needed. China was thought the most likely to create risk for companies because of its lax policing. Now it may be that the US has released the political genie from the bottle.

We suspect that a time-bound pragmatic solution for delivering the COVID vaccine to the less well-off parts of the world will be found, but that companies will in future be limited in the profits they can make from research breakthroughs that were part-funded by the public – AstraZeneca seemed to have understood that from the start.

A broadening recovery - April 2021 in review

Asset Class	Index	April	YTD	12 months	2020	3-yr rolling annualised	5-yr rolling annualised
Equities	FTSE 100 (UK)	4.1	9.3	22.2	-10.2	1.4	6.3
	FTSE4Good 50 (UK Ethical Index)	3.9	7.2	16.2	-13.2	-1.2	2.9
	MSCI Europe ex-UK	4.2	6.8	33.3	8.8	8.2	8.9
	S&P 500 (USA)	5.0	10.4	33.0	14.5	18.5	18.8
	NASDAQ (US Technology)	5.1	7.2	44.2	40.9	26.7	25.2
	Nikkei 225 (Japan)	-1.9	-1.3	19.0	11.4	5.5	9.6
	MSCI All Countries World	4.0	7.8	32.8	13.0	13.3	13.9
	MSCI Emerging Markets	2.1	3.5	35.5	15.0	7.5	12.5
Bonds	FTSE Gilts All Stocks	0.5	-6.7	-7.8	7.9	3.0	3.3
	£-Sterling Corporate Bond Index	0.8	-3.6	4.4	8.4	4.9	5.2
	Barclays Global Aggregate Bond Index	0.9	-4.5	-5.3	6.3	3.6	3.8
Commodities	Goldman Sachs Commodity Index	7.9	21.3	64.0	-26.0	-4.0	0.8
	Brent Crude Oil Price	6.0	27.2	129.7	-23.9	-3.7	7.1
	LBMA Spot Gold Price	4.6	-8.0	-6.5	20.8	10.3	6.8
Inflation	UK Consumer Price Index (annual rate)*	0.3	0.2	0.9	0.8	-	-
Cash rates	Libor 3 month GBP	0.0	0.0	0.2	0.5	0.6	0.5
Property	UK Commercial Property (IA Sector)*	-0.2	-0.1	-1.5	-3.8	-1.1	0.6

Data sourced from Morningstar Direct as at 30/04/21. * to end of previous month (31/03/21). All returns in GBP.

After the fairly volatile first quarter, April brought more decisively positive stock market returns, while bonds paused their losing streak. The main April takeaways for investors were threefold. First, improving economic sentiment would no longer push up bond yields, therefore easing the competition for sources of yield that had become the main headwind for equities in the first quarter. Second, strongly rising commodity prices and annual corporate earnings growth touching 50% provided solid evidence that recent equity market optimism had an increasingly solid base in the real economy. Third, the regional picture remains changeable, with Europe no longer significantly trailing the US, whereas last year's regional darlings in East Asia (especially the Chinese and Japanese markets) have become this year's laggards.

The rotational forces that set back the US tech giants in the first quarter eased, confirming the view that their valuations have become increasingly correlated with bond valuations. However, despite returning a set of astonishingly strong Q1 earnings results, they still no longer lead markets. Meanwhile, the sheer number of company earnings which continue to beat even the high bar of lofty analyst forecasts is testament to the breadth of the 2021 stock market positivity, and suggests further reasons to remain optimistic in the medium-term.

In regional terms, the US led market gains, rising 5%, with Europe and the UK following closely behind, up 4.2% and 4.1%. Emerging Markets posted a respectable 2% gain in April, given the aggregate was dragged down by flat to negative returns from China. Meanwhile the 1.9% decline in Japanese stocks had as much to do with proximity to China, as with a pick-up in domestic COVID cases, rather than any suggestion of underlying weakness.

The modest gain in global bonds snapped a streak of declines, as central banks appeared to finally have their message heard that they are in no rush to roll back monetary stimulus, and want to see actual rather than just forecasted progress.

In return terms, the biggest story in April was the major rise in commodity prices across the board, with agricultural prices in particular hitting multi-year highs. Copper, a key industrial bellwether, topped the leader board with a +12.1% increase, taking it to its highest level in a decade. The increase was aided by continued hopes for the global economic recovery as the vaccine rollout proceeds, as well as the fact that copper stands to benefit from a wave of fiscal support underpinning fresh spending on infrastructure and clean energy goals. Meanwhile, oil prices maintained their existing lead for the year-to-date (YTD), with both the US (West Texas) and international (Brent) benchmarks moving higher, to take their US dollar YTD gains to +31% and +29.8%, respectively. As with copper, hopes for a strong recovery after the pandemic have supported gains, with oil set to be in demand as economies open up once again.

Overall, there was little for investors to dislike about returns in April. Central bank support looks set to continue, fiscal support from governments is increasing, particularly with the new US administration determined to recapture its world leader status and reputation as the engine of global growth – a position which it effectively forfeited to China after the global financial crisis. Company earnings and profit margins are expanding, and the economic data suggests a decisive post-pandemic rebound is firmly on the cards.

As always, there are various serious risks and 'unknown unknowns' capable of spoiling the party, but at this point the biggest question for investors is whether the economic recovery will simply return us to the status quo before the pandemic, or whether the opportunity for governments to build society back better, stronger and greener, will be seized, putting us in a fundamentally better place than we were before the pandemic.

The UK bounces back – or is it all just politics?

There has been a great political awakening across the world in recent years. The issues of the day have become visceral divisions. These arguments have had significant impacts on all aspects of our lives, including capital markets.

In the UK, this has been most evidently played out in the great Brexit drama which, aside from its impacts on foreign investment and asset valuations, has been the main driving force behind the value of Sterling.

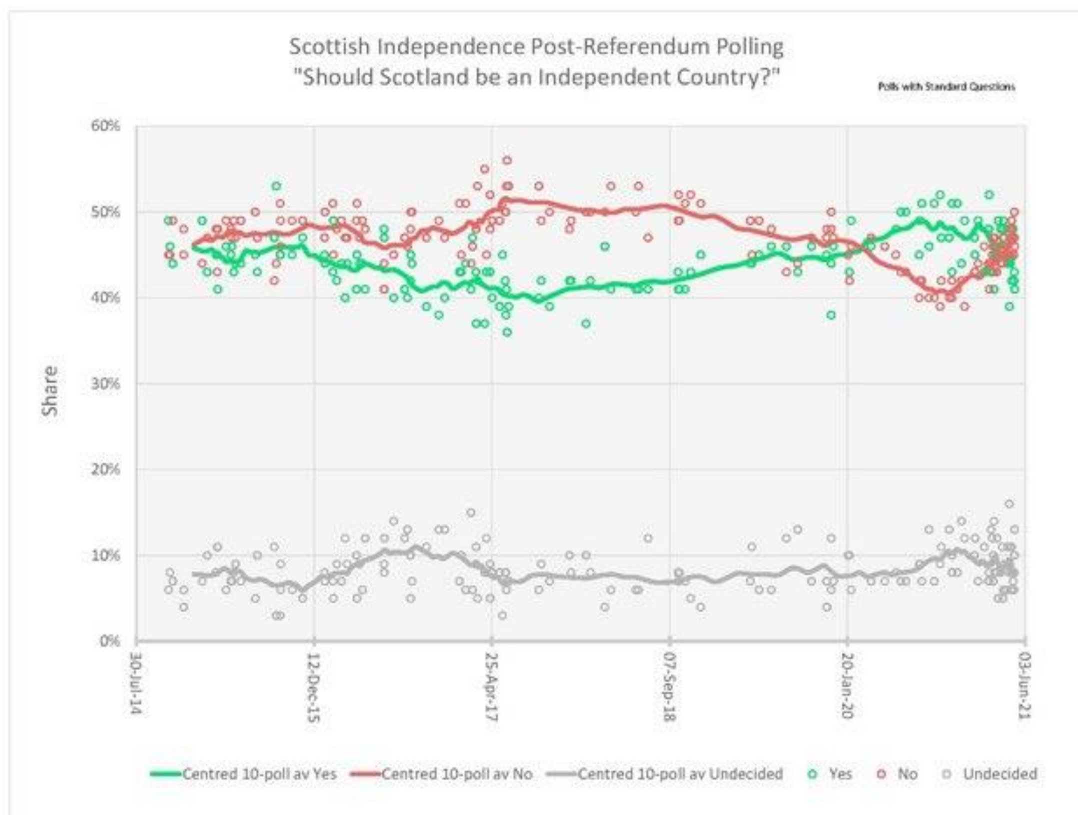
The government assures us that Brexit is now a settled affair (Jersey fishing rows, Northern Ireland's trade position and ongoing negotiations about the services sector notwithstanding). Therefore, market commentators have turned their attention towards a familiar political story: devolution and the potential break-up of the Union. Last week, Britain headed into elections that might have some meaningful impact in that respect.

First, the Conservative Party by-election victory in former Labour stronghold Hartlepool will have roused Prime Minister Boris Johnson from his despondency. He remains fond of red walls, even if his fiancée isn't. The voters attracted to Johnson seem to see a politician whose failings are small enough to make him human, and they perceive he has delivered on their issues so far.

On Friday Sterling strengthened back towards its recent highs against both the US Dollar and the Euro. However, probably of greater importance is what would usually be considered the more humdrum local elections. The added spice is that they could set the stage for several independence pushes, from Scotland to Northern Ireland and even Wales.

To remind ourselves, it is less than seven years since the last Scottish independence referendum. On 18th September 2014, the people of Scotland decisively answered the question, "Should Scotland be an independent country?" The "No" side won with 2,001,926 (55.3%) versus "Yes" at 1,617,989 (44.7%). The turnout of 84.6% was the UK's highest since the January 1910 "universal suffrage" general election.

We will not get involved in musing whether the regional outcomes indicate that referenda are more or less likely, let alone whether any referendum might see a vote for independence. We would note, though, that the regional responses to coronavirus through 2020 meant the Scots accorded their regional government a much higher approval rating, which fed into support for independence, as the chart below indicates. However, it also shows that recent dynamics have begun to reverse the position.



Source: Wikipedia, 6 April 2021

While Brexit may be a source of rancour in Scotland and Northern Ireland, it also highlighted the enormous costs which come from separation. The argument that Brexit has changed the nature of the Union – and that the central government should revisit the independence question – is also not likely to carry weight. Perhaps oddly, the Johnson government seems not that fond of "letting the people be heard" just now.

It has been interesting to note how sensitised UK markets have been to the political news-flow over the last few years – something we are still seeing now and should expect to continue. Currency markets appear not to be expecting earthshattering changes to the shape of the Union. Indeed, although commentators have made much of this story, in reality Sterling has been rather insensitive to the election news.

In the past, short-term moves in the Sterling exchange rate have been more directly influenced by central bank announcements than British politics. However, it would be hard to discern much influence at the moment here either, despite the Bank of England (BoE) holding its own vote last week.

The BoE's Monetary Policy Committee (MPC) voted in favour of maintaining interest rates at the current 0.1% level, as well as continuing its £875 billion target for bond purchases. MPC members did opt to reduce the pace of those monthly bond purchases to £3.4 billion a week – down from the current £4.4 billion a week – to be reviewed again at the next MPC meeting in August. But with the overall target still standing, policymakers assured us this would not materially change anything, with which we agree.

Markets shrugging off this news is therefore not much of a surprise. After the deepest recession on record, and with an economic recovery still in its infancy, all expectations are that the BoE will keep interest rates flatlining and liquidity flowing for the foreseeable future. In fact, the biggest surprise was a dissenting vote from the MPC's outgoing chief economist Andy Haldane, who voted to reduce the asset purchase target by £50 billion, arguing that the growth objectives had been reached and that the current policy response needed to be trimmed. Haldane's dissent will be his last before leaving the BoE, having made a name for himself as a contrarian. Still, it was enough for former MPC member Danny Blanchflower to call him a "blithering idiot" on Twitter. Who said monetary policy was boring?

Haldane's departure should mean less drama and more consistent messaging at the BoE, but we also suspect that it sets up the MPC for a more dovish stance (preferring lower rates). Despite holding policy steady, it delivered a substantial upgrade to growth forecasts for this year – up to 7.3% from 5.1%. This comes as other parts of the growth picture are also improving, including a doubling of how much savings the BoE expects to be used during the post lockdown bounce-back, and a much more favourable global growth outlook. Much like in the US, BoE guidance suggests it will consider tightening policy once inflation is consistently at or above its 2% target. According to its own forecasts, this means interest rates will follow the path currently discounted by the market, and likely stay on hold until at least 2023.

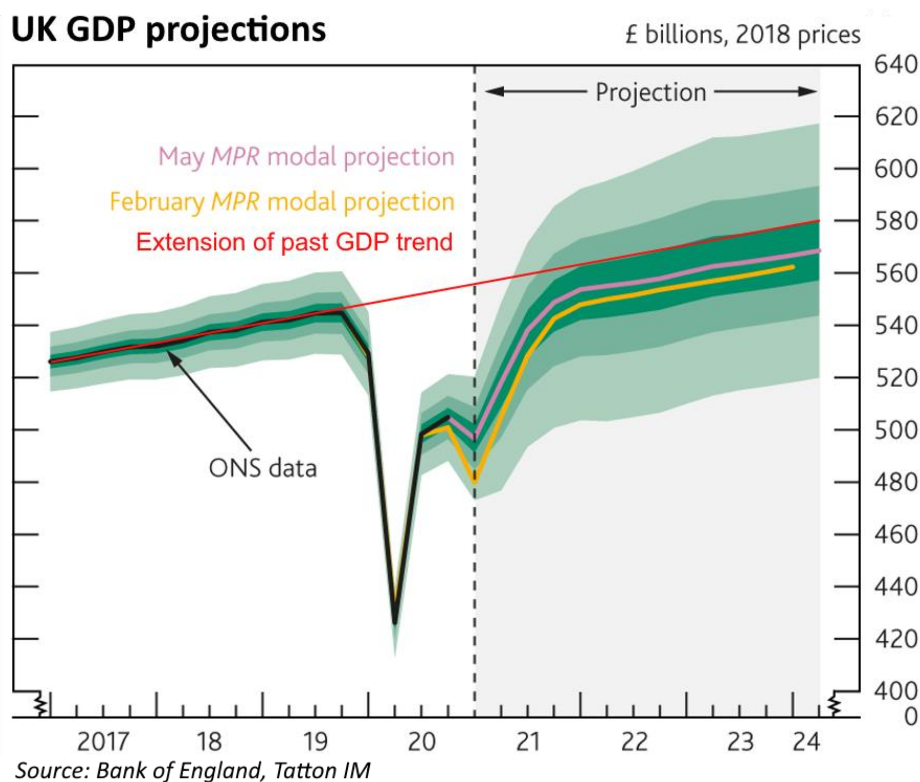
Despite the US Federal Reserve (Fed) officially changing its policy response framework last year favouring a bias toward loosening policy (with less emphasis on inflation and more on employment), the BoE maintains the same framework as before. However, the reality is that it cannot resist the wider change in global monetary policy; where the Fed leads, other central banks tend to follow. But we suspect the BoE's stance also reflects a less rosy picture of the UK economy than it lets on. Despite the upgrade to short-term growth, when looking at longer-term forecasts we can see policymakers expect the economy to remain below its pre-pandemic trend for many years. According to its outlook from 2023 and beyond, the UK's output gap will drop to 0%, meaning a permanent drop in activity compared to what was expected at the beginning of 2020. Our calculations put that at around 2.5% of lost GDP.

There could be several reasons for this. At the simplest level, we could take this as a sign that the BoE expects long-term scarring effects of COVID to hamper the UK economy indefinitely. But the downgrades

could also be Brexit-related. With less immigration and higher barriers to investment, expected growth would likely have taken a hit even without the impact of the pandemic.

We suspect policymakers have 'neglected' to be specific about the reasons for the drop-off because of their political savvy. The BoE was greatly criticised in the run-up and aftermath to the Brexit referendum, after downgraded growth forecasts were derided in the media as part of 'project fear'. Former Governor Mark Carney came in for particular criticism for his public musings, which Andrew Bailey is no doubt keen to avoid.

The flipside to this, however, is that the BoE could well be sending the government its own message on the economy. Reading between the lines of its forecasts, the MPC clearly believes that greater investment – both public and private – is needed to make up for what has been lost because of Brexit. This is likely to become even more of an issue once COVID effects fade and the recovery gets underway, but the BoE can only do so much to stimulate business investment. At a certain point, fiscal policy as well as trade policy progress will need to take some of the pressure off.



Paradoxically, any political news that damages the value of Sterling could end up helping the BoE. We have written before that, despite its continued easing, financial conditions in the UK are actually tight relative to global peers – in large part because of the recent strength of Sterling. If it comes back down – for better or worse – that would go some way to easing conditions. After all, once again, there is only so much the MPC can do.

Food inflation

Inflation is the watchword in capital markets these days. With vaccines rolling out across the developed world, and policymakers pouring trillions in stimulus into their economies, investors are expecting rapid growth for the rest of this year and beyond. Those heightened growth expectations have brought expectations of rising prices with them. Nowhere is this truer than in the US, where several multi-trillion Dollar fiscal packages are coming into force, while the Fed is keeping monetary policy at historically loose levels, and just as the economy opens up again. All of this has led to markets expecting growth and inflation to be supercharged when the pandemic eases.

Inflation forecasts have even caused some recent teething issues in markets. While the Fed is showing no sign of backing down from its substantial stimulus programme, investors are concerned that rapidly rising prices will force the Fed's hand – tapering asset purchases or even raising interest rates too soon. Last week, fears were compounded by cautionary comments made during an economic seminar by US Treasury Secretary (and former Fed Chair) Janet Yellen. In her words: "It may be that interest rates will have to rise somewhat to make sure that our economy doesn't overheat".

Two things should be noted about Yellen's supposed warning. First, it is a statement of the obvious. When growth returns and price inflation displaces disinflation fears, then 0% interest rates are no longer warranted under standard monetary policy. Second, Yellen has no power to actually influence interest rates. Despite being a former Fed Chair herself, her thoughts are no more reflective of current Fed plans than anyone else's. Nevertheless, investors were spooked by her 'intervention', and markets that are particularly sensitive to interest rates – such as the tech-heavy Nasdaq Index – sold off.

Yellen's comments may be unimportant in the grand scheme, but the reaction was telling. It shows markets are increasingly anxious about inflation and higher interest rates, and what this means for the economy. According to research from Bank of America, "inflation" mentions in company reports during this earnings season are quadruple what they were a year ago, while some have mentioned the possibility of hyper-inflation in the near-term. From a corporate perspective, the underlying question is to what extent inflation could put profit margins under pressure, especially if companies are not able to pass on higher prices. Meanwhile, Berkshire Hathaway CEO and legendary investor Warren Buffet told shareholders last week that his companies are seeing "very substantial inflation," adding that "people are raising prices to us and it's being accepted."

We discussed last week what soaring inflation expectations could mean for equity valuations. What we are noticing now is that the inflation story is moving from being a future prospect up for discussion among investors, to a mainstream topic for the general public. This is because we have already seen a substantial pick-up in one of the inflation components that most noticeably impacts consumers: food prices. According to the UN, global food prices have been climbing for 11 months straight, and prices in aggregate are now at the most expensive level since 2014.

There are several reasons for this recent hike in food prices, but most of them seem to come from the supply side. Soft commodities of all types have rallied in recent weeks, from grains to sugar, which have increased costs for producers. In Africa, various geopolitical issues have disrupted supply chains, while in South America and parts of Asia, weather-related difficulties have affected harvests and the pandemic continues to create problems for producers. Brazil, the world's second-largest producer of corn and

soybeans, is currently experiencing a drought just as virus numbers are spiking again. When we combine these various difficulties with China's recent crop-buying spree, global food supply looks incredibly tight.

We need to be careful when interpreting food price inflation, though. For emerging markets and those in the developed world on the lowest incomes, food prices are hugely significant, as they make up a bigger proportion of overall non-discretionary expenditure. This makes rapid food inflation a real social and political problem – particularly as low income consumers have been the worst hit, and the least able to save, during the pandemic. But for most in the developed world, food price inflation tends to be 'transitory':

It can cause a spike in costs, but one that will probably be short-lived.

From an investment perspective, food prices need to be seen in the context of commodities in general. Just like energy, food prices tend to be highly volatile and are often dictated more by short-term supply issues than macroeconomic trends. This is why many measures of 'core' inflation tend to strip them out to get a better picture of the structural drivers of price inflation.

None of this is to say that food price inflation is unimportant. Even in developed markets, rising food prices can have a profound psychological effect on consumers, increasing their expectations for overall inflation and thereby changing spending habits. What's more, as with any supply-led or 'cost-push' price movements, the key question is whether it will translate into a more sustained rise in inflation. Ultimately, that conundrum boils down to whether consumers can afford it, without having to make cuts elsewhere. In other words, if wages rise in parallel to rising prices, those prices will stick.

We are not yet in a position to tell whether higher prices will affect demand in the short-term, but there are reasons to think consumers will not have to cut back on discretionary spending elsewhere and continue to buy. Consumers in the developed world have, in aggregate, increased their savings during the pandemic, are in a good position financially and very likely have an increased propensity to spend and make up for enjoyment missed out on over the last year. At the same time, employment measures continue to improve – particularly in the US – leading to a sustained pick-up in consumer confidence.

That presents a problem for central banks. If higher prices meet healthy demand – initially funded by surplus savings and later by rising wages – it can translate into a more sustained rise in inflation which, eventually, will have to be met by a policy tightening. If the demand is not there to meet higher prices, it could lead to a short-term downturn which, if central banks *do* respond to by tightening, could choke off the recovery before it has begun.

On the other hand, if supply bottlenecks are speedily unlocked by a return of the surplus capacities that marred the pre-pandemic global economy, and the labour market returns to its previous state, the near-term price-push may indeed turn out to have only been transitory. Focus then would return to the underlying strength of the economy and labour market to gauge the inflation outlook. In the meantime, central bankers will be watching the issue – and choosing their words – extremely carefully, while markets continue to second-guess their every move.

CAMBRIDGE INVESTMENTS LIMITED

10th May 2021

Global Equity Markets

Market	Fri 15:35	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7126	+2.4	+165	↗	↗
FTSE 250	22735	+1.5	+342	↗	↗
FTSE AS	4063	+2.2	+86	↗	↗
FTSE Small	7200	+0.9	+62	↗	↗
CAC	6371	+1.6	+101	↗	↗
DAX	15374	+1.6	+238	↗	↗
Dow	34696	+2.4	+821	↗	↗
S&P 500	4232	+1.2	+51	↗	↗
Nasdaq	13815	-1.1	-148	↗	↗
Nikkei	29358	+0.8	+232	→	↗
MSCI World	2952	+0.5	+13	↗	↗
CSI 300	4996	-1.9	-94	→	↗
MSCI EM	1341	-0.5	-7	→	↗

Top 5 Gainers

Company	%
Fresnillo	+9.8
Imperial Brands	+9.4
Brit-AM Tobacco	+8.2
Anglo American	+8.1
Smurfit Kappa	+7.5

Top 5 Decliners

Company	%
Ocado	-9.5
AVEVA	-5.6
Admiral	-5.4
Scot Mtge Inv Trust	-4.7
Flutter Ents	-4.5

Currencies

Pair	last	%1W
USD/GBP	1.398	+1.1
GBP/EUR	0.869	+0.1
USD/EUR	1.21	+1.1
JPY/USD	108.60	+0.7
CNY/USD	6.44	+0.6
Bitcoin/$	57,223	+0.7

Commodities

Cmdty	last	%1W
Oil	67.82	+0.8
Gold	1832.0	+3.6
Silver	27.30	+5.3
Copper	474.0	+5.8
Aluminium	2488.5	+3.7
Soft Cmdties	449.3	+3.3

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	20.4	14.3	14.1
FTSE 250	1.8	19.4	23.4	15.4
FTSE AS	3.1	20.1	15.2	14.2
FTSE Small x Inv_Tsts	1.4	19.7	-	15.1
CAC	1.8	25.0	18.4	14.6
DAX	2.3	19.6	15.9	13.3
Dow	1.7	21.3	20.8	16.2
S&P 500	1.4	27.0	23.1	17.2
Nasdaq	0.7	32.5	32.4	22.3
Nikkei	1.4	25.8	20.9	17.5
MSCI World	1.7	24.7	20.7	16.3
CSI 300	1.7	16.3	13.9	12.4
MSCI EM	1.9	18.0	14.6	12.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.77	-0.08
UK 15-Yr	1.13	-0.06
US 10-Yr	1.55	-0.08
French 10-Yr	0.17	+0.01
German 10-Yr	-0.22	-0.02
Japanese 10-Yr	0.09	-0.01

UK Mortgage Rates

Mortgage Rates	Apr	Mar
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.56	1.60
3-yr Fixed Rate	1.68	1.70
5-yr Fixed Rate	1.75	1.78
10-yr Fixed Rate	2.55	2.54
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

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10th May 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.

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