THE **CAMBRIDGE** WEEKLY

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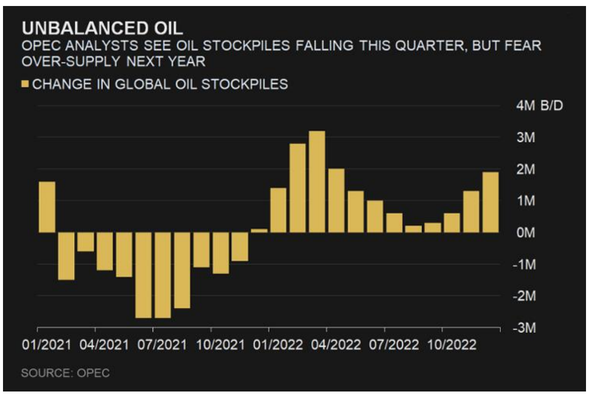
'Come on, Andrew – you're British, unemployed and Boris wants us ALL back at work'

Source: Matt, 27 Sep 2021

Economy hits an air pocket

October has carried on where September left off, with quite a bit of daily up and down for markets, but with a slight downwards trend. We deliver our end-of-month review of September in this week's second article. For UK readers, the lack of positive vibe in stock markets is probably unsurprising, with petrol last week only slowly returning to being a commodity – rather than a scarcity – but with many staple goods still not as readily available as consumers expect them to be.

Overall though, during a week when European gas prices briefly hit a new record high, there was also the impression that this Autumn's energy crisis sustained some equilibrium. On the one hand, Russia's President Putin indicated that gas deliveries could be increased in a 'quid pro quo' for speeding up the administrative processes towards putting the completed Nord Stream 2 gas pipeline under the Baltic Sea into operation. On the other, for those keen observers, it was obvious that OPEC expects oil supply to outstrip demand again as early as January 2022 (left hand chart below). The market's forward pricing curve of oil confirms this view by anticipating much reduced oil prices in the future, as the right-hand chart illustrates.



Source: OPEC

Source: TattonIM, Bloomberg

Some politic tensions were also eased further last week, although we are not referring to the jokes in Boris Johnson's Conservative Party conference speech. In the US, the willingness of Congressional politicians to avert another imminent government shutdown – by agreeing to raise the debt ceiling until December – was greeted with relief, taken positively by the markets and perhaps interpreted as a sign for more conciliatory behaviours towards the end of the year. In Europe, German coalition negotiations progressed much faster than anticipated, with public opinion swinging decisively behind a so-called 'traffic light' coalition between the Social Democrats, The Free Liberals and the Greens. Even Italy is looking more optimistic about the future than usual, with prime minister Mario Draghi, winning increasing backing from the electorate for his strategy of structural reform, feathered by fiscal support, and facing little challenge from the rest of the European Union (EU) over his plans for increasing Italy's deficit again. Bond yields continued to support this narrative of future growth, with a continued gradual rise of yields in the longer maturity brackets.

That said, the short-term outlook feels increasingly uninspiring. Last Friday's much-awaited US employment numbers failed to meet expectations (adding just 194,000 new jobs), even though the unemployment rate fell notably from 5.2% to 4.8%. Equity markets rose following the announcement, seemingly willing to 'see the glass half-full' in terms of not putting any more upward pressure on wages, which would in turn keep the US Federal Reserve (Fed) from tightening monetary conditions, as markets have been fearing since the beginning of September.

Fears of an imminent default of Chinese giant property developer Evergrande subsided over the past week, but were unhelpfully replaced by mounting military tensions surrounding Taiwan. China therefore remains on the 'watch' list, even though optimists will point out all this means more forthcoming fiscal and monetary support than recently projected.

So, given recent events, do we expect a swift return to the 'Goldilocks' upwards path investors enjoyed over the summer months? Sadly, not quite, even if our view that this cycle still has much time ahead has been reinforced. Compared to expectations early in the year, however, the second half of 2021 is not quite shaping up to see the cycle picking up speed again following the initial economic bounce-back. That means corporate earnings are unlikely to continue to expand as rapidly as expected, and with yields still rising in expectation of growth further down the line, this will keep the pressure on equity valuations.

We are, therefore, seeing less favourable conditions over the coming months in terms of broader market upside. Instead, we expect the rotational theme from earlier in the year to play out, with better investment returns available from rotating portfolios towards those styles and regions that have more upside potential during this particular phase of the cycle than the market at large.

September market review: Autumn chill for the economy

September brought the summer joy in markets to an abrupt end. Investors were nervous about China's largest property developer Evergrande defaulting on its debt triggering a Chinese financial crisis (Which it did not). Added to this were worse-than-expected macroeconomic data and rising inflation leading to fears of higher interest rates. US and UK government bond yields increased as central bankers reasserted their commitment to reducing emergency monetary support measures but also pricing in rising inflation, as supply bottlenecks appearing longer lasting than had been anticipated.

Asset Class	Index	September	3 Months	6 months	YTD	12 months	2020
Equities	FTSE 100 (UK)	-0.2	2.0	7.7	13.1	25.4	-10.2
	FTSE4Good 50 (UK Ethical Index)	-0.7	0.2	4.5	7.9	17.7	-13.2
	MSCI Europe ex-UK	-3.6	0.5	8.2	11.0	20.9	8.8
	S&P 500 (USA)	-2.7	3.1	11.7	17.5	24.6	14.5
	NASDAQ (US Technology)	-3.3	2.2	12.0	14.2	24.9	40.9
	Nikkei 225 (Japan)	4.9	7.1	6.7	7.4	17.0	11.4
	MSCI All Countries World	-2.1	1.4	8.7	12.7	22.2	13.0
	MSCI Emerging Markets	-2.0	-5.8	-1.2	0.1	13.3	15.0
Bonds	FTSE Gilts All Stocks	-3.7	-1.8	-0.2	-7.4	-6.8	7.9
	£-Sterling Corporate Bond Index	-2.3	-1.0	0.9	-3.5	0.3	8.4
	Barclays Global Aggregate Bond Index	0.3	1.5	2.8	-2.7	-5.0	6.3
Commodities	Goldman Sachs Commodity Index	8.2	7.8	24.6	40.2	51.8	-26.0
	Brent Crude Oil Price	11.6	7.5	27.7	53.3	77.5	-23.9
	LBMA Spot Gold Price	-2.6	2.0	6.2	-6.2	-10.9	20.8
Inflation	UK Consumer Price Index (annual rate)*	0.7	0.7	2.4	2.7	2.8	3.3
Cash rates	Libor 3 month GBP	0.0	0.0	0.0	0.0	0.1	0.5
Property	UK Commercial Property (IA Sector)*	0.7	1.6	3.2	3.2	2.8	-0.7

Source: Morningstar Direct as at 30/09/21. * to end of previous month (31/08/21). All returns in GBP.

Global equities ended the month 2.1% lower in sterling terms (reversing much of the gains of August) as a slowing of corporate earnings expectations, inflation, rising bond yields and spikes in energy prices put pressure on markets.

The main US market returned -2.7% (-3.3% for the US technology sector) as the US Federal Reserve (Fed) announced it will likely begin tapering its asset purchase programme before the end of the year and drive down future purchases to zero by the middle of 2022. Rising yields affected the more yield-sensitive growth and tech sectors, while the energy and cyclical value sectors led the market. Elsewhere, Japanese equities bucked the negative trend thanks to an improving COVID-19 vaccination programme, which meant Japan's 'state of emergency' was lifted in September for the first time since April.

On the other hand, the commodity and banking-focused main UK equity market ended the month with a 0.2% decline, naturally benefitting from the energy supply constraints and the change in monetary policy (banks) in the UK. Other global markets were also negative, Europe returned -3.6% as it continued to lag other global economies out of recession. Emerging Markets equities returned -2%, as concerns over Evergrande's debt crisis kept Chinese equities in the red, with continued uncertainty over its bond payments.

While the Fed indicated tapering may begin as early as November, reiterating comments on a strong jobs market, ongoing economic growth, and transitory inflation, the members of the Federal Open Markets Committee also suggested rising interest rates might not be as far away as markets would hope. Out of 18 Fed officials, nine said they expect rates to be raised by the end of 2022, up from seven officials in June. In the UK, the BoE's Monetary Policy Committee said no immediate action was needed to quell inflation, although recent price news had strengthened the case for "modest tightening of policy" over the next few years. However, uncertainty around rates continued, with the BoE unwilling to rule out a hike this year.

Looking ahead, the persistence of the more infectious Delta variant, elevated inflation, supply chain blockages and spiralling raw material prices are increasingly dampening the previously upbeat sentiment. With the political standoff in the US over its debt ceiling, possible contagion from the collapse of Evergrande, and imminent tapering from the Fed, we will be watching markets very carefully in the last quarter. However, it can be easy – perhaps too easy – to look around the world and only look at the 'wall of worries' we face. Investors should not lose sight of the significant long-term positives of seemingly strengthening economic growth, alongside rising business investment and robust corporate profit momentum demonstrated by companies across the globe.

Trust in UK plc appears to be in short supply

Panic at petrol pumps and pig populations culled – it has been another painful week for Britons. Supply shortages have been a feature of the world's post-pandemic recovery, but rarely have such issues been as acutely felt as in the UK right now. There are a few explanations for this. Brexit effects have teamed up with pandemic shocks to squeeze the UK labour market particularly hard – mainly in areas with previously high proportions of migrant workers. Problems have been compounded by what seems to be a peculiarly British present-day penchant for panic-buying. Economists have speculated that this bandwagon effect might itself be a consequence of people's perception of the crisis, and confidence in the government's ability to manage it (or rather lack thereof). In any case, this perfect storm leaves the nation with more acute supply crunches than elsewhere, and sharp demand spikes to match them.

That is, naturally, a strong recipe for inflation. We have seen as much in the recent data, with the consumer price index (CPI) inflation jumping to 3.2% in August. This was a 1.2 percentage point increase on the month before – the largest uptick since the Bank of England (BoE) gained its independence 23 years ago. Last month, BoE officials said they expect inflation to rise to 4% by the end of the year. All of this comes before the latest supply problems sweeping the country, which will only turn the heat up more.

Prime Minister Boris Johnson has been quick to play down the negative aspects of the story. According to him, empty supermarket shelves and packed fuel station forecourts are just teething issues on the way to a more productive economy that pays its workers better ("a giant waking up"?). In an interview last week, Johnson also told the BBC that wages are rising fast, particularly in previously low-paid areas. The last points are true. The Office for National Statistics reported a significant annual wage jump in the second quarter of this year. The BoE, meanwhile, estimates current wage growth in the private sector at around 4%, well above pre-pandemic levels. In short-staffed industries the increases are even larger, with hourly wages for some goods vehicle drivers increasing as much as 15% this year.

Boris Johnson's positive spin on all of this is more contentious, though. Inflation can be a very positive sign of an expanding economy – prompting wage hikes and overall growth. But that growth is almost always spurred by strong demand, rather than limited supply. As we have written many times recently, supply constraints can cause short-term spikes in inflation, but a cyclical uptick can only come when consumers and businesses feel confident about their future spending power.

In this respect, it is worth noting that pay rises have been extremely unevenly spread. Wage increases for drivers or abattoir workers might get the headlines, but average pay growth across all sectors has been much more modest. The BoE found recently that understaffed industries are seeing individual pay increases of up to 40%, but typical settlements are only at 2-3%. According to Governor Andrew Bailey: "The dispersion of pay growth has risen quite markedly – so for the high numbers we read about, there are also low ones,"

Wage increases for the previously low paid are a good thing. Indeed, tightening the labour market for low paid British workers was one of the Brexiteers' main arguments in the run-up to 2016's referendum. In the best-case scenario, it would mean a more equitable wealth distribution and a more dynamic, broad-based economy.

The trouble is if specific wage increases come at the expense of incomes elsewhere. Public sector pay, which Johnson's government froze in response to the pandemic, is a prime example. Outside of NHS workers, everyone from teachers to civil servants has seen their pay capped this year – while workers in other industries are seeing significant gains. Many public sector workers are on the lower end of Britain's income spectrum, and so the recent localised pay spikes do not necessarily mean an improvement in equality.

For wider economic growth, these disparities are important. While pay rises are good for some, inflation affects everyone. Combined with the government's National Insurance hike, this means an increase in household costs across the board. For those who have seen their pay stagnate – or rise by less than inflation – that translates into a decrease in real disposable income.

Supply issues and their knock-on effects will have an impact on overall growth. The BoE revised its Q3 growth estimate down to 2.1% from 2.9% last month, citing supply constraints as the main cause. With supply problems only tightening since then, further downgrades could be in store for the rest of the year.

The longer-term perspective is a little more mixed. In areas with shortages, businesses are unlikely to keep increasing wages if it eats into their profit margins. Instead, producers will have a strong incentive to invest in automation technologies – as we are already seeing in the hospitality sector. If that happens, it will weaken workers' bargaining power in exactly those areas where wages are currently spiking.

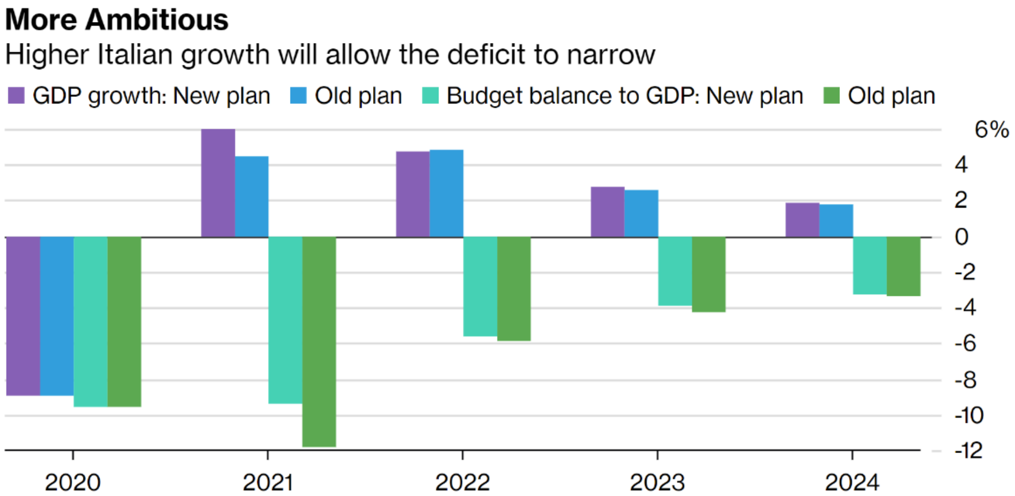
Source: Financial Times, 5/10/2021, The challenge of unlocking the UK's low productivity

For overall growth, though, automation and improvements in productivity are a good thing. It translates into lower costs for consumers and, after the low productivity growth of the last decade, that will be a welcome sign. In the best-case scenario, this could mean wage increases for the low-paid and productivity improvements for everyone else. In the worst-case, wage hikes would be a one-off and everyone would be hit with higher costs. We expect the longer-term outcome to be somewhere in the middle. The data produced in the next few months will be vital for figuring out where Britain lands. However, should wage and price rises indeed turn out to have been one-offs, then the 'washing through' of the 2021 rises after a year could mean that the current talk of stagflation may quickly become replaced in 2022 by lack of growth and disinflation.

Italy may have the leader to achieve its growth ambitions

Since the global financial crisis, there have been numerous political efforts to revive the sleeping beauty Italy. The (once) strong industrial base in the North and wider economy needs oxygen, but has long been held back by an enormous administrative apparatus, regulation, fractured banking system, and (some may say) many years of austerity. After almost decades of hopes rising and fading, an international heavyweight took on the task: Mr "Whatever it takes" himself, former European Central Bank (ECB) President Mario Draghi.

As Italian Prime Minister, Draghi has adopted a twin approach: push for difficult structural reforms, while also administering a fiscal boost. This is different from the past, when Italy was careful to preserve its fiscal surplus (excluding interest rate payments for its past debt) to keep financial markets' trust and to keep the peace with Brussels. The planned fiscal boost comes from two sources: using the European Union (EU) pandemic recovery fund, while also running a fiscal deficit. The former is smart use of money, the latter is challenging the EU status quo. Brussels has started a consultation of the Stability and Growth Pact (SGP), and Draghi's fiscal plans have already made clear where he stands: soften the fiscal straight jacket. Draghi has already earned a reputation in Italy as the person 'nobody can say no to' – let's see how other EU nations respond.



Source: Italy's government

Politically, the domestic tide seems to be turning for Draghi, too. A series of important local elections took place across Italy in the last few weeks, and the results should please the Prime Minister. Centre-left candidates won on the first round of voting in the financial capital Milan, Naples and Bologna. Centre-left mayoral candidates are also on course for victory in Rome and Turin, once second round voting is complete. It shows a dramatic decline for the anti-establishment 5-Star movement, which built on local victories in Rome and Turin to become the largest parliamentary party in 2018.

The results are a setback for Italy's right-wing alliance, including the populist League, Brothers of Italy and Silvio Berlusconi's Forza Italia. Nevertheless, the conservative alliance, headed by League leader and former Deputy Prime Minister Matteo Salvini, is still ahead in national polls. And while these are only local votes (in the big cities, where Italy's far-right is less popular), they are positives for Draghi's government. Despite his technocratic appointment and push for reform, there is no sign of popular revolt against the Prime Minister.

That will be important in the months ahead. Draghi is going full-steam ahead in his policy drive – highlighted by a €3 billion pledge to help poorer households through the energy crisis this winter. In the face of energy price rises as high as 30-40%, Draghi has promised no tax rises in the short-term – even while nearby countries raise business and income taxes. In typically resolute style, Draghi told the country that: "This is a time when money needs to be given, not taken."

Even more significant are his longer-term plans for tax reform. Draghi plans to revamp how Italian businesses and individual incomes are taxed by changing the calculation rules. These are not designed to change levels of taxation but are part of a modernising agenda to streamline the overall system. Crucially, his tax plans are needed for Italy to be eligible for around €200 billion in EU recovery funds. These include significant plans for long-term investment, with a special focus on transitioning the country to green energy. And as research advisers Capital Economics recently noted (source: FT), that spending scope exceeds Joe Biden's US infrastructure-focused jobs plan as a share of GDP.

Draghi's reform push is also a signal for his partners in government. Tax issues have been a sore point within the coalition government, with Matteo Salvini's League expressing strong discontent – so much so that League politicians did not take part in a recent cabinet meeting on the matter. The disagreement led Draghi to delay measures coming into practice until 2026, but the message is clear: the Prime Minister intends to push forward with reform with or without League's support.

Salvini's defeat in local elections will only strengthen Draghi's hand. Markets are likely to take comfort in Draghi's resolve over the short-term, but reform will mean little if it is reversed by far-right populists a few years down the line. This is particularly true for Draghi's other main target of reform: Italy's notoriously slow bureaucracy. A sluggish court system has been cited as one of the main factors holding back the Italian economy for a decade. Past premiers have tried and failed to change it around, but Draghi has made it a priority. Importantly, there is a sense the former ECB governor – with his vast experience and reputation – may succeed where others could not. He leads a fractured government plagued with deep divisions, but one that has a strong mandate to deliver change.

Draghi's reputation, especially outside of Italy, is arguably his greatest weapon. Politicians in both Rome and Brussels have a hard time saying no to the person who 'saved the Euro', allowing him to push for reform at home while simultaneously asking for leeway in Europe. If Italian voters back him too, he will have a good chance of addressing Italy's longstanding problems.

The danger, however, is that Italy's hopes of reform are pinned on Draghi alone. President Sergio Mattarella is set to retire next year, with Draghi touted as a likely replacement. If that happens, the premiership will fall to someone without his ability to balance European and Italian demands. The options do not inspire confidence, particularly if Salvini or one of his allies gains enough support. For now, markets are pleased with Italy's progress. But we should be wary of putting the country's eggs in one man's basket.

Global Equity Markets

Market	Fri 15:49	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7017	-0.5	-35	⇘	⇗
FTSE 250	22926	-2.9	-683	⇘	↗
FTSE AS	4023	-1.0	-39	⇘	↗
FTSE Small	7410	-1.7	-127	⇘	↗
CAC	6505	-2.0	-133	↘	↗
DAX	15136	-2.6	-396	↘	↗
Dow	33920	-2.5	-878	↘	↗
S&P 500	4293	-3.6	-162	⇘	↗
Nasdaq	14397	-4.3	-650	⇘	↗
Nikkei	28771	-4.9	-1478	⇗	↗
MSCI World	3007	-3.1	-97	⇘	↗
CSI 300	4866	+0.3	+13	⇘	→
MSCI EM	1253	-0.9	-12	⇘	→

Top 5 Gainers

Company	%
Royal Dutch Shell	+7.4
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Rolls-Royce	+7.2
Glencore	+6.1
BP	+5.4

Top 5 Decliners

Company	%
Renishaw	-12.6
AVEVA	-10.4
Admiral	-8.6
Halma	-7.8
Spirax-Sarco	-7.7

Currencies

Pair	last	%1W
USD/GBP	1.354	-1.0
GBP/EUR	0.857	+0.1
USD/EUR	1.16	-1.0
JPY/USD	110.95	-0.2
CNY/USD	6.44	+0.2
Bitcoin/$	47,131	+8.0

Commodities

Cmdty	last	%1W
Oil	78.08	-0.0
Gold	1758.7	+0.5
Silver	22.47	+0.2
Copper	416.9	-2.8
Aluminium	2858.5	-3.1
Soft Cmdties	228.7	+1.3

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	15.3	12.3	14.2
FTSE 250	2.4	15.5	24.0	16.0
FTSE AS	3.8	15.2	13.3	14.4
FTSE Small x Inv_Tsts	2.0	12.9	18.8	15.5
CAC	2.3	20.8	15.6	15.0
DAX	2.2	15.2	14.9	13.5
Dow	1.8	19.0	18.4	16.5
S&P 500	1.4	24.3	21.3	17.6
Nasdaq	0.7	29.4	31.8	23.0
Nikkei	1.5	15.4	17.2	17.7
MSCI World	1.7	21.2	19.4	16.6
CSI 300	1.9	16.0	15.1	12.5
MSCI EM	2.4	13.8	13.2	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.00	+0.08
UK 15-Yr	1.23	+0.10
US 10-Yr	1.48	+0.03
French 10-Yr	0.12	+0.01
German 10-Yr	-0.23	-0.00
Japanese 10-Yr	0.06	+0.00

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.23	1.28
3-yr Fixed Rate	1.41	1.48
5-yr Fixed Rate	1.40	1.45
10-yr Fixed Rate	2.59	2.59
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

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CAMBRIDGE
INVESTMENTS LIMITED

11th October 2021

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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