THE **CAMBRIDGE** WEEKLY

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Dollar strength and divergence caps a dull week for investors

Despite the negative news flow, be it COVID or politics, UK consumers are proving their resilience once again, with both October retail demand and domestic consumer sentiment pointing up. Perhaps the buoyant jobs market is encouraging the UK public to be less concerned about inflationary pressures eating into their disposable incomes than some economists would expect, or it is equally possible that higher energy and food prices have not quite hit home yet.

Whatever the cause – and usually there are several – the UK microcosm neatly reflects the ongoing dispute about the current bout of inflation that continues to separate academics and investment analysts into opposition camps of 'permanent' and 'transitory'. The most recent elevated inflation readings of over 4% across Europe/UK, and over 6% in the US, seem to settle the argument in favour of 'permanent'. Interestingly, the 'transitory' camp has not given up, pointing towards all the anomalies that can be found everywhere in this unusual recovery.

Their most relevant themes are that inflation pressures have been driven by a significant shift in consumer demand – away from services towards physical goods – and the increased costs of energy while wage rises remain focused on a few very specific sectors (and typically the lowest paid). Given travel and general social activities can be expected to return as a more considerable proportion of consumer demand as the pandemic turns endemic over the coming year, and that energy supply shortages are expected to ease by the energy sector itself, it is not too hard to see where camp 'transitory' is coming from. Camp 'permanent' also appears to neglect the effect that higher prices and surging demand have on the 'animal spirits' of market economies, where all recent signs from the corporate world have been pointing towards a rapid ramping up of economic activity to satisfy demand before it changes its mind.

In our view, inflation pressures are real and more longer-lasting than anticipated, but they are also not surprising given the upheavals the global economic system has gone through while consumers are also suddenly displaying a very different demand function. However, we also expect many of the factors that are driving up this pressure now to reduce meaningfully over 2022. This should mean that the 2021 aggregate upward price push is likely to prove permanent, whereas inflation above 2-4% will not turn structural, but instead prove to have been a transitory element of the COVID recovery, and part of the awkward transition phase to a mid-cycle environment of economic expansion.

Capital markets appear to continue to have a similar view, with market-derived inflation expectations elevated for the near term, but then trending lower for the longer term. This observation segues neatly into the other major observations of the week, which was renewed strength of the US Dollar, especially against the Euro.

Long-time readers of The Cambridge Weekly may remember us writing in the past how the direction of inflation-adjusted yields in the US fixed interest markets have provided a decent indicator for the direction of the exchange rate (FX) of the Dollar. Well, recently this signpost has not been as useful, with the Dollar rising considerably despite US real yields falling. There have been many attempts made at rationalising this unusual behaviour, but it would appear to boil down to – you guessed it – COVID. The big up move by the Dollar last Friday morning, which took place as Austria became the first European country to reimpose a full lockdown, in a bid to arrest the rapid increase in new COVID cases, seemed to confirm our suspicion.

US Dollar strength appears to anticipate that the European Central Bank (ECB) will be forced to keep interest rates lower for longer than will be the case in the US. Since last year's COVID waves, the recovery of western economies had been progressing more or less in lockstep, but it seems this may be about to change as central banks start to diverge on their journey towards monetary normalisation. Unfortunately, this would not be great news for the cyclical rebound, as a strong Dollar has in the past always been a considerable headwind to global trade and especially the economic health of emerging markets.

As always, short-term market movements do not make a trend, but continued Dollar strength has the potential to slow the recovery more than is already priced in on the back of the existing headwinds discussed above.

Not surprisingly then, that investors experienced another dull week in terms of market movements, and it is entirely possible this might extend through to the pre-Christmas period. While dull is perhaps no bad thing as we move towards the end of what has been a very pleasing year for investors thus far, we would be saddened if we were robbed of the promise of the year-end joy that the seasonal Santa Rally brings at the end of the year.

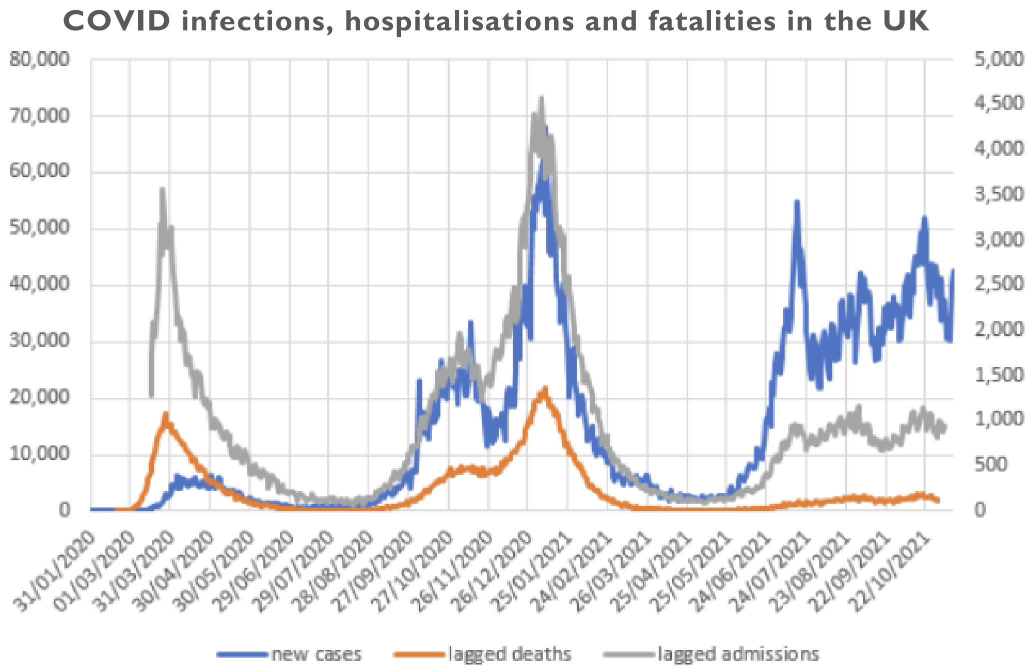
Low vaccination rates point to 'lower for longer' ECB interest rates

Could we be headed for another bleak COVID-wrecked winter? That certainly looks the direction of travel in continental Europe. Rising case numbers in Germany and Switzerland, while Austria imposed another full national lockdown have meant that Europe is once again considered the COVID epicentre, leading to fears that the "fourth wave" will cause considerable damage both to public health and the economy.

Early last week, the World Health Organization (WHO) announced that Europe was the only region in the world where COVID-related deaths are still rising. In its weekly report, the WHO also stated that of 3.3 million new infections most recently recorded, 2.1 million came from Europe. It also warned there could be another 500,000 more COVID-related deaths by February if urgent actions are not taken on the continent.

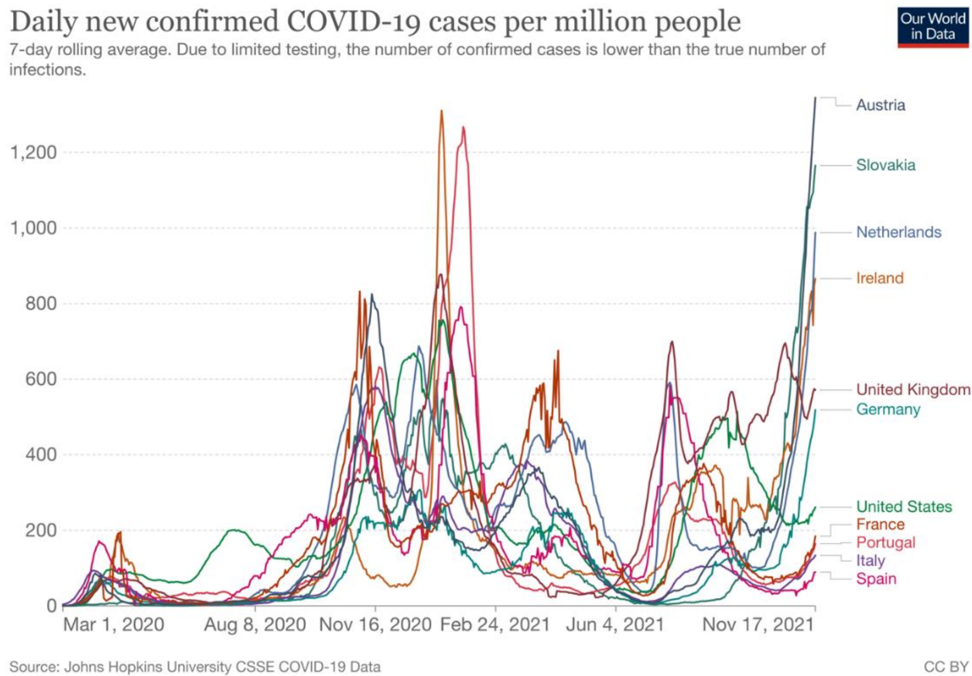
So, it's no surprise that restrictions are back on the agenda across many European nations, and the proportion of the population that remains unvaccinated appears to be the focus of attention. In Germany, outgoing Chancellor Angela Merkel admitted that the number of daily new infections "is higher than ever before… and the daily death toll is frightening". A decision to start charging fees for supervised COVID lateral flow tests has been reversed, and Merkel's government and state leaders met last week to discuss possible new nationwide restrictions. This comes after several states and cities already imposing stricter measures and requiring the public to show their vaccination status, and declaring whether they've recently recovered from the virus (known in Germany as the '2G rules': with '*geimpft*' meaning vaccinated and '*genesen*' meaning recently recovered). Failure to do so means being denied access to bars, restaurants and other public venues like cinemas or museums. Munich's Christmas market has already been cancelled – again.

Germany is not alone in experiencing a dramatic rise in cases. The Netherlands and Austria have reintroduced partial or full lockdowns, while Ireland has introduced a midnight curfew for bars, restaurants and clubs, just a month after opening everything up and declaring life was 'back to normal'. In France, more than 20,000 new confirmed cases on Wednesday saw its health minister warn that the country's own fifth COVID wave was picking up speed. The UK, by contrast, continues to see 35,000-40,000 new COVID cases per day, but has seen fatality numbers remain at levels comparable to autumn flu waves (See chart below).

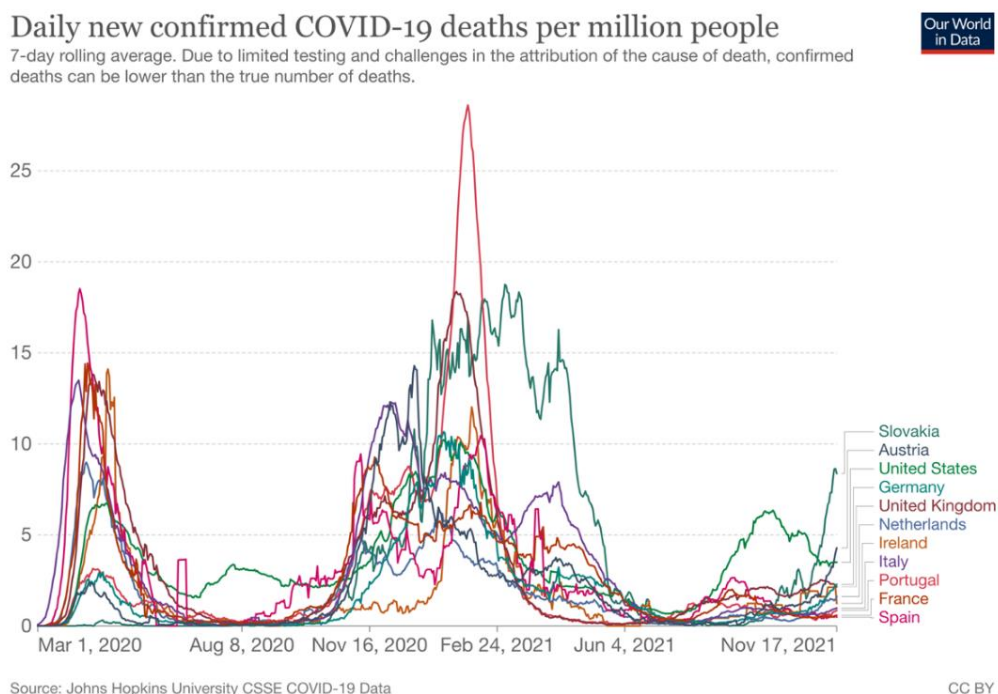


Source: UK Government, Tatton IM, 17/11/2021

As the next chart shows, Austria is suffering particularly heavily at present, with the highest infection rate



on the continent. Austria has a relatively low vaccination rate of roughly 65% of its total population (Germany's vaccination rate is a similarly unimpressive 67.3%, which is particularly poor when contrasted with the UK's 79.8% vaccination rate for everyone over the age of 12). After initially on Monday placing lockdown restrictions just on the two million unvaccinated Austrians, on Friday the Austrian government announced a full national lockdown lasting a minimum of 10 but potentially 20 days, threatening fines to those who break the rules.



Of course, the number of COVID-related deaths – as shown in the chart on the previous page – tells a different, and altogether more hopeful, story, with far fewer deaths than in months before vaccines were widespread. This makes sense, given that now most European adults are vaccinated, which affords the majority with significant protection against the worse effects of the virus. But even here the prognosis is less than optimistic. Looking again at Germany, the number of vaccinated people ending up in hospital is also on the rise, presenting a timely reminder that it is too simplistic to label this the "pandemic of the unvaccinated". COVID still takes a toll on the vaccinated but medically vulnerable too, particularly because vaccine efficacy seemingly appears to wane over time. As a result, efforts are now firmly underway to encourage more people to think of themselves as fully vaccinated only if they have received a third booster shot.

A redoubled effort to provide the vaccinated with a top-up looks like one of the best ways of preventing further national lockdowns, and minimising further economic disruptions. Last week, the Euro slipped to its lowest level in 16 months versus the Dollar, as investors started to come to terms with the idea that policy divergence – with the European Central Bank (EBC) on one side, and the Bank of England (BoE) and the US Federal Reserve (Fed) on the other – looks inevitable. While the BoE and Fed appear on course to lift interest rates over the next year, the ECB has stayed steadfast in its belief that accommodative policies are the right approach.

Indeed, the pressure on the BoE intensified last week after the Office for National Statistics reported that inflation measured by the Consumer Price Index (CPI) rose 4.2% in October – the highest level since November 2011. Markets are now pricing-in a 15 basis points interest rate rise in December. Meanwhile, in the US, last week CPI was recorded up 6.2% year-on-year for October, the highest inflation rate in more than 30 years.

But the ECB can point to a couple of key factors that make its decision to remain accommodative look the right call. For one, while Eurozone consumer prices have also accelerated – reaching a 13-year high of 4.1% in October – they are still not running as hot as in the US. Therefore, the pressure on the ECB to raise rates is considerably lower. Also, thanks to the ECB's years of undershooting its 2% inflation target, investor expectations of longer-term inflation are not quite as pronounced. And while the Fed policy guidance continues to move in a more hawkish direction, the ECB has to be careful to avoid any misstatements that could trigger a rise in borrowing costs for its more heavily indebted nations, such as Italy. Moreover, ECB President Christine Lagarde's insistence that tighter monetary policy for the Eurozone would do more harm than good appears to be getting through – markets are now pricing in just a 10 basis points interest rate rise in early 2023.

Even so, December's ECB meeting, where it is due to update its inflation forecasts through to 2024, will be keenly watched. The ECB has committed not to raise rates before it stops bond purchases through its €800 billion NextGenerationEU recovery fund, and as recently as October it was exploring raising the limit on the purchase of EU-issued bonds to provide it with additional flexibility. Now, currency traders will be waiting to see whether December's announcements suggest an end to the asset purchase programme in March, which may indicate that interest rate rises could yet happen sooner.

For now, much depends on how well EU member states manage to get their COVID case numbers under control. While it is still too early to tell whether the latest set of restrictions will lower the number of new cases and pressures on the health care system, it is becoming clear that tolerance for those who remain vaccine-hesitant is diminishing. But with most people willing to take up vaccine top-ups, and with the prospect of a new treatment for COVID soon to be available in pill form, conditions should improve in the longer-term, even if the run-up to Christmas this year is less festive than had previously been hoped.

Will banks be the comeback stars of 2022?

Inflation continues to dominate headlines, and has left market participants debating a plethora of topics, including the nature of 'transitory' or 'structural/permanent' inflationary pressures, what it means for the subsequent size and speed of interest rate increases, how far bond yields can continue to rise, and whether yields are reflecting the potential for central bank policy error.

But amid the fear and uncertainty, there is one sector that logically looks set to be a beneficiary of the new changing environment – one that has largely been out of favour since the Global Financial Crisis (GFC) ushered in the era of low inflation and low interest rates. We are talking about the financial sector, of course, and banks in particular. We have been watching this sector carefully over the last 18 months. As a cyclical sector, it has been earmarked to outperform as part of the rotation from the post-pandemic recovery into the mid-cycle stage.

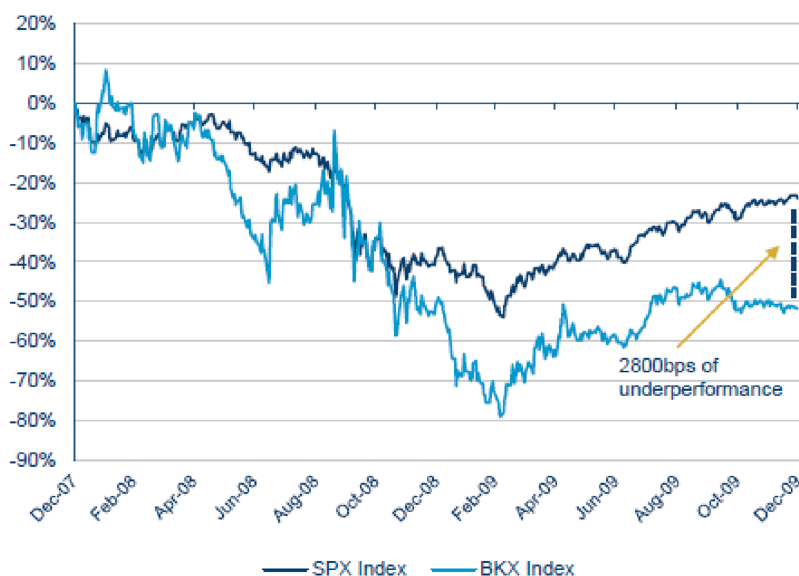


Chart 1, Source: Bloomberg & Polar Capital

The banking sector suffered for several reasons as the pandemic hit. These included the perception that banks would struggle to receive interest payments on their loan books as companies shut down and were unable to trade. In addition, regulators curtailed any dividend or share buybacks and coupled with the easing in fiscal and monetary policy, with interest rates in large parts of the world reaching historical lows, this led to the banking sector underperforming broader equity markets. But even more surprising was that the

relative underperformance of banks was even greater than the dramatic collapse during the GFC, as seen in charts 1 and 2.

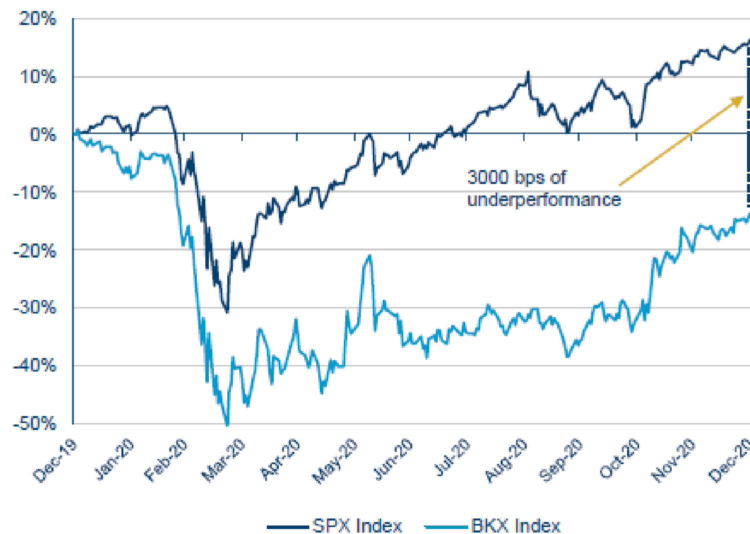


Chart 2 Source: Bloomberg & Polar Capital

The factors that helped drive this relative underperformance have now dispersed. Regulators have removed their restrictions – freeing-up banks to increase dividends and participant in share buybacks. Fears over loan losses have also dissipated as default rates have kept surprisingly low, thanks to the exceptional lockdown bridging support provided by governments. However, new accounting regulation has meant that during this crisis, banks were required to bring forward their provisions for loan losses. In the early stages of the pandemic, this led banks to significantly increase the reserves being put aside based on, in hindsight, extreme forecasts of economic contraction in growth. As these fears have proved unfounded, those provisions can now be redeployed.

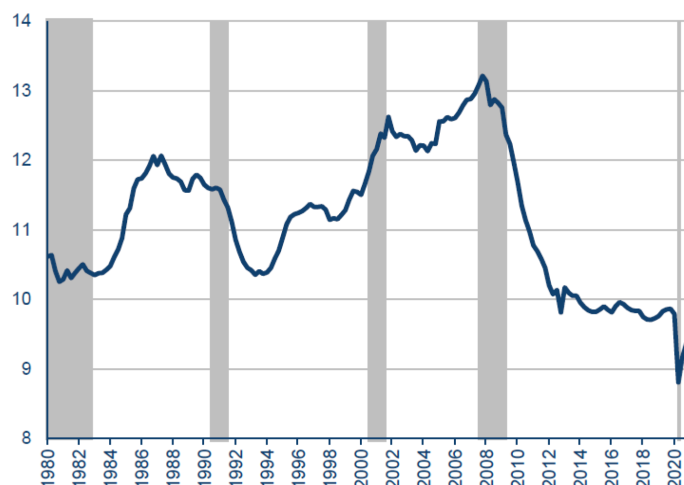


Chart 3; Source: Board of Governors of the Federal Reserve System (US) and Polar Capital

The loan asset quality of banks has also improved, particularly since the GFC, with household and corporate balance sheets healthier than at any point in the past 40 years, as seen in charts 3 and 4. Against this solid base, interest rates are estimated to need to rise an extraordinary amount (4-5%) before such monetary tightening would become a material threat to banks' loan books.

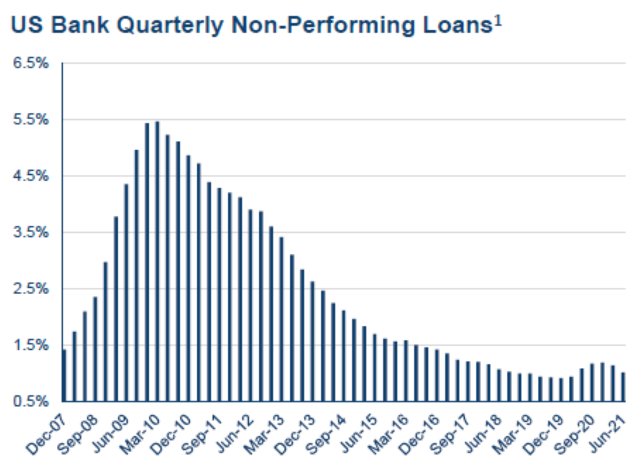


Chart 4; Source: FDIC, June 2021 and Polar Capital

From here, banks are conversely well-placed to become beneficiaries from gradually rising interest rates. Indeed, in the UK, we have already seen banks start to raise mortgage rates in anticipation of the first BOE rate hike, which, as we noted earlier, is now expected before the end of the year. Also, given the change in funding structure, where banks have benefited from robust cash deposit growth, which is often non-interest bearing, the opportunities for this sector are arguably even larger than in the past. The change in funding structure has been reflected in bank loan/deposit ratios. In the US, this ratio has fallen to 63% from 77% in 2019. If higher interest rates can then be applied, banks' earnings are likely to see a significant pick-up. To put some context on what this could mean, Polar Capital's financial analysts state that assuming a steady increase in US rates, a 1% rate rise would increase US bank earnings by 13% in Year 1 and that same rate rise would increase earnings on average by 20% in Year 2, with those Year 2 potential earning returns reflecting deposits and also the banks' loan book being repriced. This outlook is even more appealing for European banks with a 1% rate rise increasing earning on average by 24% in Year 2.

So, the fundamentals suggest significant opportunities now exist for this sector. But while we noted earlier that banks had suffered disproportionately during the first stage of the pandemic; the sector has also lagged, so far, in the reopening and recovery of the world economies reflected, in part, by the robust equity markets. This relative underperformance is again quite stark. Chart 5 (next page) shows banks are currently underperforming the broad equity recovery by a wide margin. So, plenty of potential to catch up.

Generally, this view applies globally but primarily to developed markets. Within emerging markets, banking exposure can provide important diversification to consumer stocks, but is currently tainted with ongoing friction in China's property development sector. Following the ongoing Evergrande default saga (last week S&P Global Ratings published a report that said default was "highly likely"), China is currently experiencing its own fears around toxic debt, and losses on property loans will hurt its banking sector, particularly those small and mid-tier banks where private companies own large stakes. Beyond the emerging market perspective, another word of caution would be that should central banks tighten too quickly and too far – by raising interest rates rather than tapering its bond buying programmes, then even the appeal of this sector would wane.

MSCI Banks vs MSCI ACWI (Jan '20 – Sept '21)

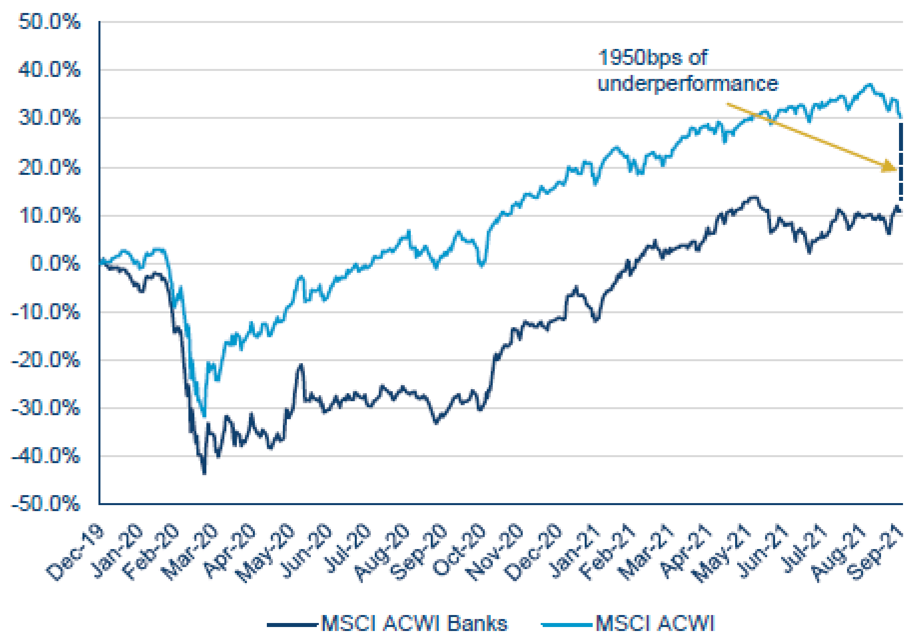


Chart 5; Source: Bloomberg, 30 September 2021, Polar Capital

But for this point of the economic cycle, as we are about to embark on a trend of rising interest rates, the banking sector provides a good example – and a reminder - that inflation and rising interest rates is not something to be feared, and is a necessary step on the path to economic recovery.

Global Equity Markets

Market	Fri 16:11	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	7222	-1.7	-126	⬀	↗
FTSE 250	23476	-0.3	-82	⬀	↗
FTSE AS	4134	-1.5	-61	⬀	↗
FTSE Small	7444	-1.0	-75	→	↗
CAC	7106	+0.2	+15	↗	↗
DAX	16160	+0.4	+65	↗	↗
Dow	35711	-1.1	-390	↗	↗
S&P 500	4708	+0.5	+25	↗	↗
Nasdaq	16094	+1.5	+233	↗	↗
Nikkei	29746	+0.5	+136	⬀	→
MSCI World	3226	+0.1	+3	↗	↗
CSI 300	4890	+0.0	+2	⬀	↘
MSCI EM	1274	-0.9	-12	⬀	↘

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	14.8	12.3	14.2
FTSE 250	2.4	15.6	19.8	16.1
FTSE AS	3.6	14.8	13.1	14.4
FTSE Small x Inv_Tsts	2.1	12.3	17.2	15.6
CAC	2.1	20.3	16.5	15.0
DAX	2.0	15.3	15.3	13.6
Dow	1.7	18.6	18.4	16.6
S&P 500	1.3	24.9	22.5	17.8
Nasdaq	0.6	30.0	35.1	23.3
Nikkei	1.6	16.2	18.1	17.7
MSCI World	1.7	21.4	20.3	16.7
CSI 300	1.8	15.6	15.6	12.5
MSCI EM	2.4	12.9	13.4	12.6

Top 5 Gainers

Company	%
Avast	+6.7
Sage	+6.2
Land Securities	+5.6
Rightmove	+5.5
Ocado	+5.4

Top 5 Decliners

Company	%
Int'l Consol Air	-9.8
Melrose	-6.6
Whitbread	-6.0
Assoc. Brit. Foods	-5.4
Kingfisher	-5.4

Currencies

Pair	last	%1W
USD/GBP	1.346	+0.4
GBP/EUR	0.841	+1.5
USD/EUR	1.13	-1.1
JPY/USD	113.88	+0.0
CNY/USD	6.39	-0.1
Bitcoin/$	57,998	-9.9

Commodities

Cmdty	last	%1W
Oil	78.75	-4.2
Gold	1858.1	-0.4
Silver	24.87	-1.8
Copper	439.4	-1.3
Aluminium	2616.0	-1.7
Soft Cmdties	242.1	+1.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.88	-0.04
UK 15-Yr	1.08	-0.02
US 10-Yr	1.53	-0.03
French 10-Yr	0.01	-0.09
German 10-Yr	-0.34	-0.08
Japanese 10-Yr	0.08	+0.00

UK Mortgage Rates

Mortgage Rates	Oct	Sep
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.20	1.23
3-yr Fixed Rate	1.20	1.37
5-yr Fixed Rate	1.29	1.37
10-yr Fixed Rate	2.60	2.60
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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INVESTMENTS LIMITED

22nd November 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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