THE **CAMBRIDGE** WEEKLY

21 February 2022

Lothar Mentel

Lead Investment Adviser to Cambridge

DISCLAIMER

This material has been written on behalf of Cambridge Investments Ltd and is for information purposes only and must not be considered as financial advice.

We always recommend that you seek financial advice before making any financial decisions. The value of your investments can go down as well as up and you may get back less than you originally invested.

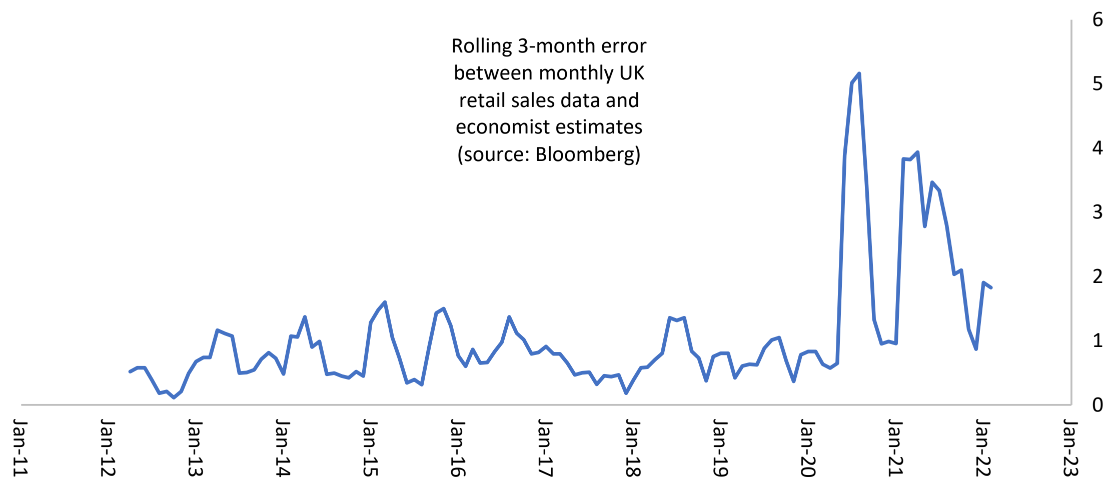
Please note: All calls to and from our landlines and mobiles are recorded to meet regulatory requirements.

Investors anxious for storms to blow over

Another turbulent week in global stock markets on the back of little in terms of new news, but plenty of speculation of what may lie ahead. At the end of last week, real storms disrupted our lives while markets continue to brace for what may, or may not, come to pass.

The tense situation between the Ukraine and Russia is not affecting consumers that much, either here or in the US, except for the extension to elevated energy prices. This comes despite an easing on the supply side which has manifested itself in even further declines in the forward prices of oil in the futures markets. Compared to that, the end to 2021 was a disappointment, with the rise in virus cases clearly putting a dampener on activity. January sales rebounded strongly, as fears subsided and February is likely to be good as well.

This element of post-virus 'bounce back' means gauging underlying trends is still difficult. As the chart below illustrates, economists are currently getting their spring forecasts much more wrong than before (we do forgive them for 2020!). The extent of the 'noise' means it is dangerous to assume we have much conviction around what the medium-term situation really is going to be like. However, we have some reason to believe there will once again be a spring recovery phase in the economy that is underestimated.



Source: Bloomberg, Tatton IM, ONS

What we do know as is that the monetary and fiscal policy support environment has tightened, even though the water is still choppy from the pandemic shock. In this week's final article ('Build Back Better' bites the dust), we discuss how the mood is changing in US politics regarding fiscal policy, and that inflation dynamics have made fiscal austerity an attractive proposition again to many voters. In this context, the US rate setter's Federal Reserve's Open Markets Committee (FOMC) meeting minutes from January were published last week, and provided more insight into current policy thinking. The minutes underlined how the central bank has become much more hawkish in the past three months, however, the details revealed signs of flexibility. The FOMC restated that it felt the longer-term situation for interest rates was still biased towards low rates rather than high. It also indicated it remains flexible in the face of data, an important restatement given that the noise level remains high. It remains very important for the global economy, and

for markets, that the US Federal Reserve (Fed) is not entrenched in a hawkish view, or even gone on 'autopilot' in terms of rate rises.

The 1970s discussion about the 'wage-price spiral' is now morphing into a debate about 'wage-margin-price spiral'. This is especially pertinent in the US. US company profit margins tend to be higher than other regions, and that is before one takes into account lower corporate tax rates in the US.

Despite current strong retail sales, it may be that the effects of inflation, rising interest rates and much-reduced government handouts are reducing consumers' spending ability - in other words demand - already. Should this feed through into slowing revenue growth, companies will be much more circumspect in their hiring, which will feed back into a slowdown in wage growth.

Consumers across the developed world have spent a huge amount on imports and have drawn down on the savings made through the past two years. In the aftermath of the pandemic, a return to purchasing services will slow the import drag, but a likely key determinant in how much they spend will be how certain they feel about being able to replenish their savings down the line.

There is still probably more room for consumers to draw down savings, but confidence levels will have to be stable in the coming months for that to happen. In the US, the University of Michigan consumer sentiment survey was very downbeat. On the other hand, similar surveys in Europe have shown a much rosier picture. This week will see the release of the IHS Markit Purchasing Manager Index Surveys around the world, and they will be examined closely for indications of consumer behaviour and for any possible divergence across regions. At the moment, it looks as though those economies where gushing consumer demand has caused the most inflation pressures are increasingly seeing a lowering of the temperature on the demand side (US), while those with less pressure on wages (Europe), may see consumers more happily looking forward to a spring with fewer restrictions of movement. Whether this means central banks will find less reason to rush their tightening in the face of improving data and the cyclical rotation remains to be seen, but you can rest assured we shall keep our readers posted.

Why UK stock markets are an unexpected ray of sunshine

It has been a difficult year so far for equity investors. Stock markets have fallen in most major economies, prompted by monetary tightening at the US Federal Reserve (Fed), geopolitical tensions in Ukraine and a cost-of-living crisis hitting consumers across the globe. The S&P 500 index is down 8% year-to-date, while the MSCI World index has fallen 7%. That is the global picture at least. At home, things look a little different. The FTSE 100 stands out as one of the few major indices to post a positive return so far this year. Granted, the 2% gain is not much, but it shows a rare bout of outperformance from Britain's biggest companies.

Domestic investors might therefore be a little puzzled about their overall portfolio performances. Here, we should point out that investment portfolios (such as ours) are globally diversified, meaning they are much more driven by worldwide trends than national ones. This is a good thing, as it makes investments less susceptible to specific regional or sectoral risks. Recent history tells us as much: Britain's stock market may have had a better start to the year than most, but UK equities have underperformed the MSCI World index every year since 2011.

Still, the current positive streak is noteworthy. It might be tempting to see this as a reflection of Britain's economic prospects. With Brexit drama behind us and Covid concerns fading – so the thought goes – the UK is well placed to get a head start on post-pandemic growth. We saw the same optimism a year ago, when UK vaccination rates took an early lead on the US and Europe, pushing up the value of sterling and projecting a decent growth story ahead.

That positive spin needs some tempering. Though it no longer makes headlines, Brexit is still making life difficult for many businesses – with the latest data showing a fall in British exports to Germany. Meanwhile, any Covid optimism is tempered by a cost-of-living crisis that will constrain demand and limit growth ahead. On the policy side, both the government and the Bank of England are tightening their belts. We can see this in currency moves. Unlike a year ago, when sterling rallied against the euro, it has been broadly flat this time around – albeit with a slight uptick.

If not economic optimism, then, what has pushed up UK equities this year? First and foremost, it is the sectoral composition of the FTSE 100, which is driven by large international companies with limited exposure to the UK market. This is why, a few years ago, the FTSE 100 performed well in sterling terms despite Brexit pessimism.

The FTSE 100 has a large energy and materials component, both sectors boosted by the recent commodity boom. Owing to a prolonged upswing in oil prices, BP recently reported record profits, while mining companies have been similarly supported. Energy and commodity companies are cyclical in nature, doing well when global activity is strong and vice versa. The same is true for banks – which benefit from an

environment of rising interest rates. These are precisely the companies that dominate Britain's major indices – giving UK investors a cyclical boost.

By the same token, the FTSE has a relatively small technology component. This is in stark contrast to the US, where the Silicon Valley mega-caps dominate. While the likes of Google and Amazon benefited handsomely during the pandemic, the changing tide of the global cycle has made life more difficult for platform companies recently. Those with a heavy growth focus are considered longer-term investments, and rising interest rates make such longer-duration assets less attractive. The UK, with a much smaller tech component, is therefore less susceptible to this shift.

This context is vital. Britain's sectoral make-up is helping it now, but it was a hindrance for much of the last two years. For example, the FTSE 100 climbed 14% in 2021, compared to the S&P 500's rise of 27%. On a longer-term basis, the MSCI UK index has barely moved since 2015, while global stocks have nearly doubled in that time.

Historic underperformance has had a big impact on equity valuations. UK stocks have been unloved by global investors since before the Brexit referendum, while earnings for large companies have grown in line with the underlying sectors. Green investments also mean that money flows shied away from indices dominated by energy and materials. The result is the MSCI UK index trading at roughly 12 times its companies' forward earnings. By contrast, the MSCI World index has a price-to-earnings multiple of 18. The figure is slightly higher for popular investment destinations like the US.

Although UK equities look very cheap compared to global peers, this has been the case for some time, with international investors reluctant to buy in. Brexit fears were likely a big part of this, via its currency impact, as was the general perception that the US had better growth potential. That perception seems to be changing. JPMorgan recently upgraded the UK to overweight in its portfolios. Global financial conditions are once again a big factor. With rates rising and growth slowing, investors are exiting high growth businesses and looking for bargains. At the moment, there are few bargains as big as the FTSE 100.

How long this can continue is unclear. Cheap valuations can only take companies so far, as the higher the price the less cheap it becomes. As always, we are focused on achieving sustainable long-term portfolio growth rather than chasing short-term arbitrage. For that, globally well-diversified portfolios, with tactical asset allocation management combined with thorough portfolio construction principles, continue to present a better investment approach.

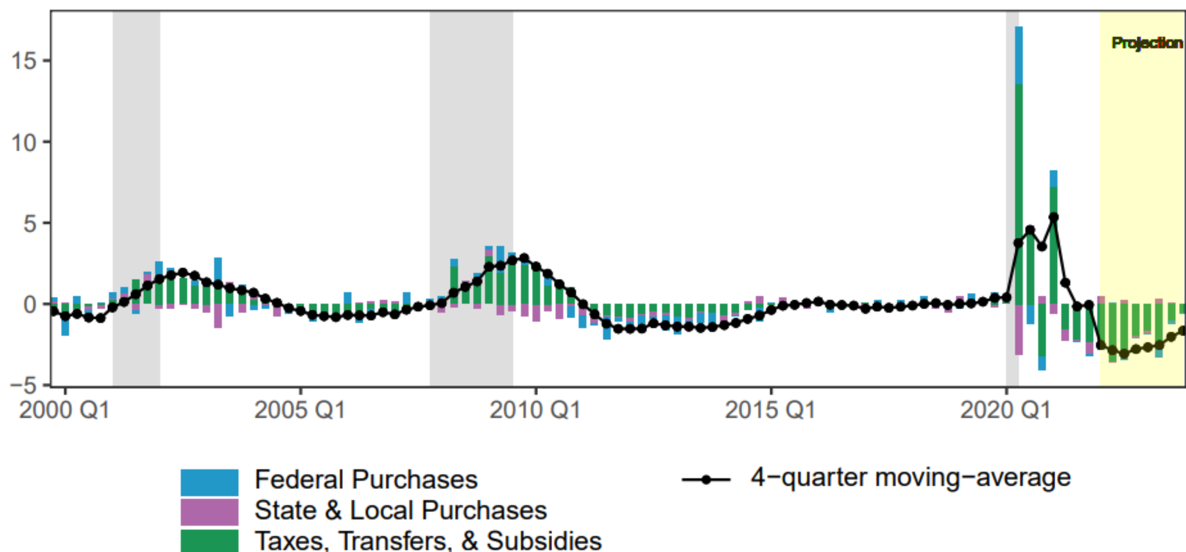
'Build Back Better' bites the dust

US President Joe Biden's 'Build Back Better' Act is dead, according to Democratic Senator Joe Manchin. He should know, since Manchin effectively killed it. Biden's $1.75 trillion fiscal plan was the great hope for progressives in America's ruling party – promising 'soft' infrastructure spending, environmental transition and strong growth in the years ahead. Many investors were equally excited, hoping a large and sustained fiscal injection would prolong the post-pandemic recovery. With an evenly divided US Senate, Biden needed all his troops onside to push the plan forward. When Manchin publicly retracted his support (even for his own watered-down version of Biden's bill), there was little more the White House could do.

As we have written before, Democrat lawmakers have scrambled to change tack. Tax reform (such as reversing large parts of Donald Trump's tax cuts) and antitrust legislation have been floated, as have multiple plans to address spiralling costs hitting Americans. Democrats are worried that whatever legislation they can pass must be made law before the mid-term elections later this year, where the Republican party is expected to make significant gains in the House and Senate. After that, passing any kind of expansionary fiscal bill would become much harder.

This is a far cry from a year ago. In the midst of the pandemic, western governments unleashed huge amounts of fiscal support – without which lockdown recessions would likely have crippled economies for a generation. But not all the proposed spending was stopgap support. In the US, as well as in Britain and Europe, a political consensus seemed to emerge that heavy public investment was needed over the longer term, to address longstanding problems of climate change and stagnant living conditions. The 'Build Back Better' Act was a big part of that positive story. Everyone expected spending commitments to be watered down, but its wholesale rejection is surprising – and throws significant doubt on longer-term fiscal stimulus prospects in the US.

We should be careful to specify what we mean here. We have written before about the fiscal impulse on growth, and how it turned negative late last year. This is a measure of how much government spending contributes to real GDP growth – and fluctuations are common. When the US first locked down in Q2 2020, fiscal policy contributed an eye-watering 13.9% to growth (according to the Hutchins Center Fiscal Impact Measure pictured below):



Source: Hutchins Center calculations from Bureau of Economic Analysis and Congressional Budget Office data; grey shaded areas indicate recessions and yellow shaded areas indicate projection.

This figure then bounced around for the next year as America went through its cycle of lockdown and release. A general relaxation of restrictions has naturally brought down government support payments in the last 12 months, resulting in the yearly average turning negative for the first time since the pandemic

began. This is to be expected. After public spending played such a huge role, some fiscal drag is inevitable as the economy normalises.

However, what we have seen over recent weeks is a significant pullback in the expectations of longer-term fiscal expansion. Democrat lawmakers are hoping they might be able to pass certain parts of 'Build Back Better' with a piecemeal approach – such as some more spending on some of America's crumbling infrastructure, in addition to Biden's other bill which passed last year. But the bigger and more transformative parts of the bill, like those on adult education, are unlikely to pass. There is still some hope that there will be measures on Climate Change, which recalcitrant Democrat Senators Manchin and Kyrstin Sinema have in the past said they would support.

Instead, old concerns over national debt are coming to the fore again. Manchin – who reportedly keeps a running total of US debt – insists any fiscal plans need to target deficit reduction. While this is not new, his newfound power in the Senate (with some Democrats suggesting they should "give him the pen" on spending legislation) means fiscal conservatism is once again a powerful force in Washington.

There are two pieces of important context here. First, persistent inflation has warped perceptions of what is politically possible. It was hoped the global inflation shock would only be 'transitory', but continued supply disruption has embedded expectations of rising prices. The Fed is so concerned by this it has gone full steam ahead with its monetary tightening even as the US economy may be slowing. Politically, this has been a win for the fiscal conservatives; price rises hit home with American voters, and 'inefficient' public largesse is an easy scapegoat. Heading into the mid-terms, this will be a powerful weapon to wield against any perceived profligacy.

Second, the leadership of the Republican party is coalescing against any fiscal laxity. The Trump years saw a huge U-turn in Republican fiscal policy. Hard-line fiscal hawks who spent years fighting against Obama's spending plans lined up behind Trump as he loosened fiscal policy dramatically. This was popular with blue-collar Republican voters and, for a few years, it seemed America's political ground was shifting away from Reagan-era policies toward something like the Keynesian consensus that came before.

But Trump's 2020 defeat prompted some soul-searching. The former president undoubtedly has a great deal of influence in the 'Grand Old Party' (GOP), but there are signs his grip on the party is loosening. His preferred candidates in Republican primaries are facing difficult battles heading into the next election, and critics within the party are becoming more vocal. And, while the Democratic Party tries to formulate its newest policy offerings, Republicans largely suspect that inflation and government debt could be a vote-winner.

In our view, this is a strong hint at the medium and long-term future of US fiscal policy. Republicans are expected to make gains in November, meaning any future plans will require their input. More likely, it will mean gridlock. Investment spending looked like the winning message for the last few years – accelerated by the pandemic – but it seems the tides are turning, and de facto austerity is once again in the ascendency.

Biden and the Democrats will continue to push the regulation and oversight agenda, an area that has potential to make the private sector work more for the general benefit of the US citizens, especially in respect of climate change. We should expect a lot more action in this area over the second half of Biden's first term, and some of the largest US companies could be affected. Meanwhile, the Republicans will also continue their very effective strategy of blocking appointments to national agencies.

From a longer-term investment perspective, this may mean growth disappointment. It comes as the Fed pushes forward with interest rate hikes and balance sheet reduction, and means that both monetary and fiscal policy will be less supportive of growth. On the other hand, if austerity does come through, we suspect the Fed will reverse its more hawkish stance. In any case, a tighter-than-expected US fiscal policy in the years ahead may well mean a less rosy outlook for US growth.

CAMBRIDGE INVESTMENTS LIMITED

21st February 2022

Global Equity Markets

Market	Fri 15:54	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7519	-1.9	-142	→	⇗
FTSE 250	21399	-2.9	-650	↘	→
FTSE AS	4199	-2.0	-87	→	⇗
FTSE Small	7081	-2.3	-163	↘	→
CAC	6920	-1.3	-91	⇘	↗
DAX	15029	-2.6	-396	↘	→
Dow	34127	-1.8	-611	↘	→
S&P 500	4362	-1.3	-57	↘	⇗
Nasdaq	13544	-1.8	-247	↘	⇗
Nikkei	27122	-2.1	-574	↘	→
MSCI World	3009	-1.0	-30	↘	⇗
CSI 300	4651	+1.1	+50	→	→
MSCI EM	1243	+0.2	+2	→	→

Top 5 Gainers

Company	%
Fresnillo	+9.9
Reckitt Benckiser	+7.7
Polymetal Internationa	+5.5
SSE	+4.7
AstraZeneca	+3.5

Top 5 Decliners

Company	%
AVEVA	-9.2
NatWest	-7.5
Barclays	-7.3
Flutter Ents	-6.7
Int'l Consol Air	-6.6

Currencies

Pair	last	%1W
USD/GBP	1.358	+0.1
GBP/EUR	0.834	+0.3
USD/EUR	1.13	-0.2
JPY/USD	115.09	+0.3
CNY/USD	6.33	+0.5
Bitcoin/$	39,582	-6.3

Commodities

Cmdty	last	%1W
Oil	92.88	-1.7
Gold	1894.2	+1.9
Silver	23.92	+1.4
Copper	453.7	+0.7
Aluminium	3268.0	+0.5
Soft Cmdties	229.6	-0.5

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	13.7	12.1	14.3
FTSE 250	2.7	14.0	15.4	16.2
FTSE AS	3.3	13.9	12.4	14.5
FTSE Small x Inv_Tsts	2.4	10.8	12.9	15.7
CAC	2.2	17.1	13.8	15.2
DAX	2.2	14.1	13.4	13.7
Dow	1.9	17.1	18.0	16.7
S&P 500	1.4	21.8	19.6	18.0
Nasdaq	0.7	22.9	27.2	23.7
Nikkei	1.8	15.0	16.6	17.8
MSCI World	1.8	18.7	17.9	16.9
CSI 300	1.7	15.9	13.8	12.7
MSCI EM	2.5	12.5	12.6	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.38	-0.17
UK 15-Yr	1.54	-0.15
US 10-Yr	1.93	-0.01
French 10-Yr	0.69	-0.08
German 10-Yr	0.20	-0.09
Japanese 10-Yr	0.22	-0.02

UK Mortgage Rates

Mortgage Rates	Jan	Dec
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.56	1.53
3-yr Fixed Rate	1.53	1.52
5-yr Fixed Rate	1.59	1.54
10-yr Fixed Rate	2.49	2.51
Standard Variable	3.63	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

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.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE