CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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Lothar Mentel

Lead Investment Adviser to Cambridge

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Uncomfortable opening-up to new normal, Bob Moran, 16 July 2020

Discomfort of disappearing safety nets

The summer season has started in earnest and yet, unsurprisingly, this year everything feels different. Most of us are relieved restrictions are easing, meaning we can go about our lives more like how we were used to until a few months ago. While in lockdown, many may have reasonably expected that – in return for our sacrifices – we would emerge into a post-COVID environment, with the virus no longer a threat, and with normalities resumed.

Sadly, until a vaccine becomes available[1], normality remains a fair way off. Instead, we must content ourselves with a still-uncomfortably restricted new normal, without knowing for certain when it will end. This discomfort is not confined to our personal lives, but equally affects the economy, the jobs market and capital markets.

For now, capital markets appear at ease with the safety nets governments and central banks have provided. Our most relevant barometer in that respect is not the stock markets, but the corporate credit markets. Changes in what companies have to pay on what they borrow provides us with a fairly good indication whether the 'wisdom of the masses' of financial analysts signposts an increase in expectations of corporate defaults in the near future. On that front, conditions remain as calm as one could wish for under the circumstances.

Nevertheless, as governments give notice on the gradual removal of the support schemes that helped to bridge the void of forced economic inactivity for western societies and prevented widespread economic hardship, there is an increasing feeling of unease. This stems from a lack of scientific consensus on how

[1] There has been encouraging vaccine-related news during the past week, making many hopeful that an effective inoculation may be ready for deployment before the end of 2020, rather than only in 2021.

quickly economic activity should be increased without suffering a return of the epidemic that would force many to return to self-isolation.

It is also not just governments that are forcing us out of the comfort of their safety nets. Despite assurances of continued emergency monetary support, central banks have also slowed the drip-feed of ever more liquidity. This leaves everyone in a slightly uncomfortable state of limbo between the relative economic safety of the extraordinary policy measures and a return to the harsh forces of the market economy. Currently, there is undeniably a v-shaped bounce back of economic activity, but because of the huge levels of near-term uncertainty over the further direction of the economic recovery, the jobs market has turned sour and government investment programme announcements are needed to bolster the negligible industry demand for capital goods.

Stock and bond markets have remained unperturbed about the growing risk that what was an 'ordered recession' may turn into a classic recessionary state of corporate defaults and mass unemployment, and have continued to inch upwards. However, China's recent upward surge in stock markets turned into an abrupt downward reversal over the past week, as it became clear that much of the resurging economic growth there is due to government stimulus, while consumers and businesses remain very cautious to spend. The US consumer recovery may well show a very similar pattern soon, as the Southern and Western states experience a delayed but nevertheless full brunt of first wave infections, with perhaps half of the US returning to the confinement of their homes.

As we discussed last week, the UK is lagging its European neighbours in its return to increased mobility and economic activity. This seems reasonable given the epidemic took hold of the UK later and it has therefore not yet receded as far as across the Channel. However, this does not explain the distinct lagging behind of the UK's stock market. This is more likely the result of the additional uncertainties of Brexit putting off – at least international investors – from returning with their capital.

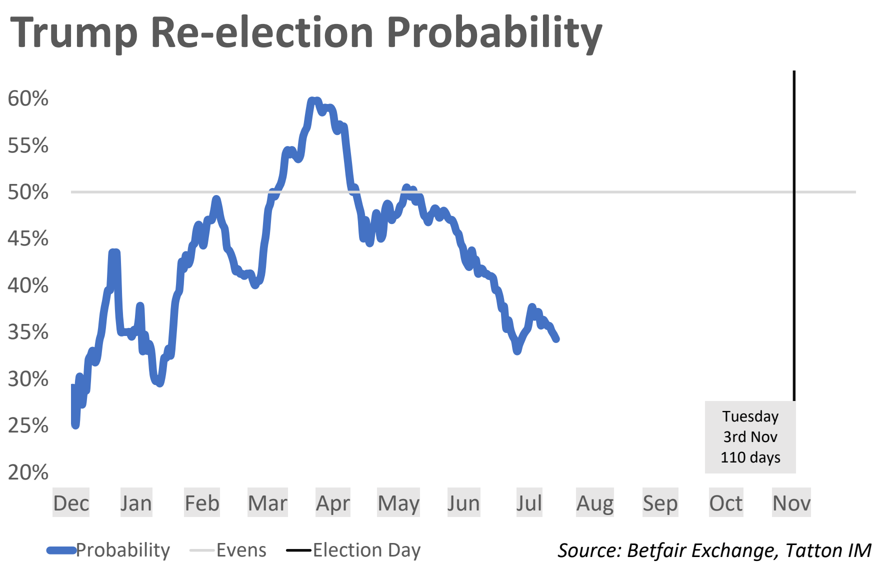
While clearly a headwind for the UK (expressed in our investment strategy with a distinct UK underweight), there have been some notable Brexit developments over the course of the week. First, Apple won its appeal to overturn a European Commission ruling that claimed Ireland had failed to claim €13 billion in taxes. This result strengthens the position of differentiated corporate tax rates across the European Union (EU). Second, German and French fiscal stimulus package announcements increase the level of economic intervention and disparity of these packages across member states considerably. Both developments will make it harder to argue that the UK will have to continue to adhere to EU harmonisation rules in return for preferential market access, especially when the individual EU member states are themselves drifting away from the purist market economy ideal in their own industrial and tax policies.

The noise coming from both parties as we approach the UK's self-imposed negotiation deadline of the end of July can be disheartening and worrying. On the other hand, it needs to be remembered that politicians are now more than ever depending on a strong economic recovery in order to assume re-election. An accidental hard Brexit at the end of the year would vastly exacerbate the economic hardship for regions that are already bound to suffer most from the COVID recession – in the UK namely the industrialised North with its 'Red Wall' constituencies. We are therefore optimistic that the threat will remain restricted to verbal 'propaganda', but also fear that COVID will cause the exit process to continue to suffer from procrastination and delay. Although not a disaster like a hard Brexit, this would be an enduring and continued barrier to business growth, as we have experienced since the 2016 referendum. The only positive

COVID has brought in this respect is that, with its negotiating partners all facing their own respective domestic uncertainty, the UK's government has the opportunity to deploy many more economic support parameters to counter its own homemade headwinds.

US election: Joe is no longer Biden his time

Americans head to the polls in just under four months, and as we edge ever closer to the election, presumptive Democrat nominee Joe Biden's lead over Donald Trump has grown steadily wider. According to the latest figures from FiveThirtyEight, the former Vice President has the support of 50.3% of the US public, while the current President is polling at just 41.2%. The somewhat arcane Electoral College system means that lead is not insurmountable, but opinion polls in several key swing states have consistently placed Biden ahead of his rival for some time. This has been reflected in betting markets' implied probability of a Trump victory (see chart below) – which hit a high of 60% at the end of March, but has steadily declined since then, sinking to current lows of around 35%.



The conventional wisdom is that capital markets like Republicans and dislike Democrats. Trump himself has often alluded to stock market performance as a reflection of his Presidential performance, frequently talking up markets throughout his term.

The post-Nixon Republican policy recipe has included a big pinch of tax cuts and deregulation, while the Democrats' has been more or less the exact opposite. Sure enough, these traditional partisan priorities are reflected in this year's candidates. Trump made large tax cuts a central policy of his first term in office, while Joe Biden has promised to partially reverse that cut should he win in November. But there are complications to this conventional picture. First, the pandemic and its consequences are now the top issues for voters, with other concerns fading into the background. What's more, despite the apparent political chasm, the two political parties are strikingly similar on many of the key issues for markets.

The Democrats have now joined Republicans in both being explicitly anti-China, wanting to focus less on free trade and more on industrial policy, and agreeing that some kind of fiscal easing is needed. On the fiscal side, Biden's investment and infrastructure improvement plans look more ambitious than his opponent's – potentially to the economy's benefit. And beyond policy, Trump's erraticism has often made investors squeamish over the last four years, with the President often flip-flopping on big decisions at the push of a tweet.

Last week, Biden announced a $2 trillion spending plan for his first four years in office (the details came last Tuesday). Crucially, these measures come on top of emergency support schemes, and are focused on long-term issues like clean energy, productivity and domestic industrial policy. This massive infrastructure push – as well its green tint – surprised even the more progressive wing of the Democratic party, many of whom had pegged Biden as a status quo centrist. It also received significant support from party moderates, the media, business, even from centrist Republicans. The US economy has been suffering from a crumbling and outdated infrastructure for years, and while Trump has repeatedly pledged to spruce up the nation's infrastructure, he has yet to make good on his promises.

Meanwhile, capital markets have been nonchalant about the election odds. While Biden's chances of victory have improved substantially over the last few months, the rally in equities has continued. Despite all the pandemic and political fear and uncertainty around, the S&P 500 is now back up to where it was towards the end of last year, having risen an astonishing 44% since the lows of March.

Even supposedly 'tax sensitive' US stocks have been relatively unaffected by Biden's now impressive lead. These firms saw the biggest increase in corporate earnings following Trump's 2017 tax cut, and would seemingly have the most to lose from Biden's hiking of the effective corporate tax rate. Researchers at Goldman Sachs put this down to the uncertainty around future policy. Goldman Sachs currently estimates that Biden would lift the tax rate for S&P 500 companies by about 4%, which in turn would knock about 5% off profits. Before the Biden spending proposals were made public, Goldman Sachs estimated there would be a further 5% due to a tax-rise-induced slower economy.

We suspect that current market prices reflect at least some tax rise prospects, however. Investors know that Biden would claim back a chunk of corporate profits in tax (most likely concentrated in the large tech companies, which have so far managed to avoid significant taxation). And, with the former VP now odds-on for the election, it would be quite a stretch to imagine that current equity prices are completely discounting the chance of a tax hike. Perhaps the prevalent view is that efforts to restart the post-COVID economy would prevent a Democrat-led administration being able to completely reverse Trump's corporate tax 'gifts', which would risk undoing much of the US Federal Reserve's monetary stimulus support. Corporate tax as a proportion of total tax revenue thus could remain the same for the time being, but corporate taxation rules may instead become more central to industrial policy – and more closely tied to the investment and infrastructure aims.

There are other reasons for markets' sanguine take on a Biden presidency too. While some of Trump's policies have undoubtedly been a boon for corporates, he has little room to enact more of the same. Over the last four years, he has already handed markets all the gifts he can. Further tax cuts might be seen as handing money to those who already have it.

It is interesting that Biden has come out with a plan of this size. Until now, his campaign tactics have largely been to lay low and soak up votes from a public increasingly dissatisfied with or embarrassed by their president. This has allowed him to say relatively little on the policy front, while Trump makes his own problems. It seems to be working. According to FiveThirtyEight's poll, the proportion of Biden supporters who are strongly anti-Trump is 80%, while the proportion of Trump supporters who are strongly anti-Biden is under 54%. Much is made of the supposed enthusiasm of Trump voters, and the comparative apathy of Biden voters. But Biden supporters are in fact very enthusiastic; they are just enthusiastically against the President.

In his first major policy announcement, Biden has come out swinging. It might have been easy to simply toe the centrist line and wait for more White House slip-ups. Instead, he has nailed his progressive colours to the mast on taxation, fiscal spending and climate change. As the election gets closer, we should expect more of the same. The market is therefore likely to become more sensitive to Biden's policy plan announcements. At the same time, any significant coronavirus development (be it positive or negative) is likely to 'trump' political developments, even if the latter are bound to have a long-term impact on the US electorate and geopolitics.

Sector rotation or just a timely recalibration?

Investment professionals have many different methods for slicing up the investment world. Typically, we tend to group assets together in terms of region, asset class or sector. Looking at things sector by sector is helpful for judging what to overweight and when, since different industries will react differently to underlying economic conditions (for example, technology or 'growth' companies tend to do well early in the economic cycle, and not as well later on), but breaking down the entire global economy by sectors can be misleading. In our globalised world, industries' progress across different regions is often correlated, but nations' diverging economic backdrops means this is not always the case.

The financial sector is a good example. In the US, the financial sector is largely driven by investment banking revenues – which ties bank profits closely to capital markets. Likewise, corporate financing in the US is often conducted through corporate bond markets rather than traditional bank loans. This is a different set-up to Europe, where large investment banks are sparse and traditional banking is much more prevalent. In line with this, European firms often get their finance through the usual banking routes. These disparities can lead to vastly different sector performances: Last week, JPMorgan, Morgan Stanley and Goldman Sachs all comfortably beat earnings expectations for the last quarter – significantly boosting US financials.

The US and Europe also differ in their materials sectors. US construction only makes up 4% of the US materials sector, while in Europe it is 11%. The US sector is instead heavily dominated by chemical producers, which account for almost half of the overall index. Contrast this with the UK, where metals and mining industries tend to dominate, and we see that the fortunes of companies that happen to be listed together are often not that closely correlated.

These regional differences have attracted the most attention in the technology sector, which has long been the superstar of stock markets. Huge amounts of capital has flowed into the sector in recent years, but a disproportionate amount has gone to the mega-caps in Silicon Valley. Indeed, a trend that has generated much attention throughout the current crisis is that US tech companies - despite being already at extended (i.e risky) valuation levels – seem to have achieved a 'safe haven' status. They are now not just seen as growth engines, but as reliable earnings providers. We should note, however, that some of the stocks that have benefitted the most from governments' "stay at home" orders are, in fact, classified in the non-tech sector: Amazon is classed as a consumer discretionary company, while Google and Facebook are listed as communication firms.

During the past week, we have noticed an interesting change. Investors have rotated away from the big lockdown winners towards some previously unloved sectors. Laggards like energy and industrials have found some buyers – in line with their better-than-expected recent earnings reports. The chart below shows some of the biggest surprises from the recent earnings season, including industrials and financials.

Source Equity Index | Name SPX | Range Current Season | Periodicity Quarter

S&P 500 INDEX | Range CQ2 Ending: 5/16/2020 - 8/15/2020

Surprise | Growth

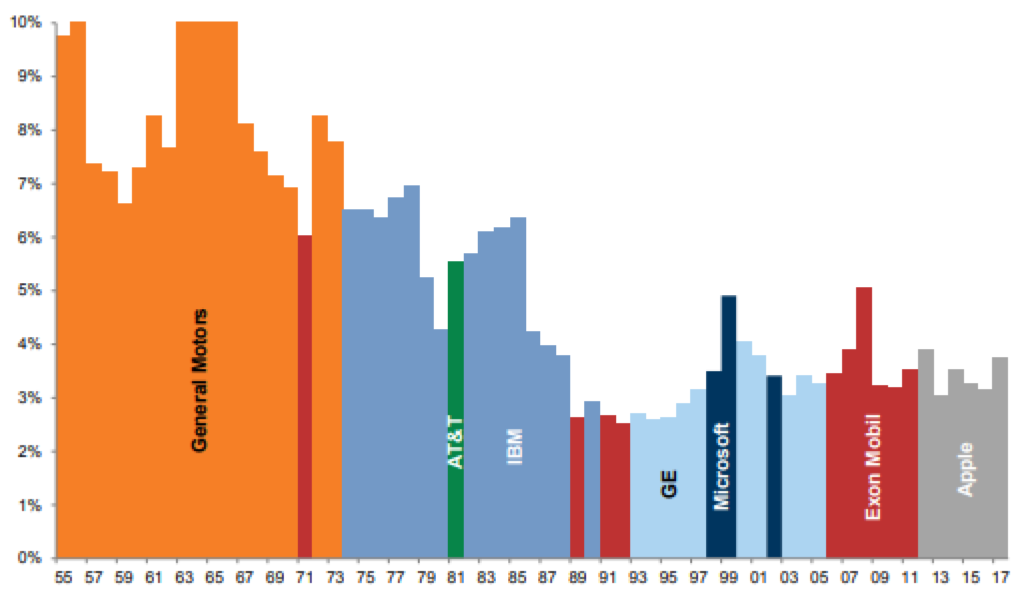
Sector (GICS)	Reported	Sales Surprise	Earnings Surprise
11) All Securities	36 / 498	-0.76%	20.47%
12) > Energy	0 / 26		
13) > Materials	0 / 28		
14) > Industrials	4 / 72	-33.22%	35.13%
15) > Consumer Discretionary	6 / 59	-3.98%	79.78%
16) > Consumer Staples	6 / 32	-1.37%	-12.47%
17) > Health Care	3 / 62	0.04%	25.70%
18) > Financials	12 / 65	6.83%	42.22%
19) > Information Technology	5 / 71	-1.07%	4.09%
20) > Communication Services	0 / 22		
21) > Utilities	0 / 28		
22) > Real Estate	0 / 31		

We see this rotation away from the previous superstars as a healthy development. While the US tech mega-caps undoubtedly have much to offer investors, in recent months many have reached valuations (price over earnings) and market cap levels which look hard to justify. A rebalancing of capital towards other parts of the economy is therefore a welcome development.

Some have argued that the flood of money into the tech sector in recent years is a standard market response to what seems like another industrial revolution. In most cases where companies emerge with new technologies that come to dominate economic activity, we tend to see a concentration of capital in

Exhibit 24: Largest company in terms of market value in the S&P 500 in each year since 1974

% Market Cap (% Net Income before 1974)



Source: Fortune 500, Datastream, Goldman Sachs Global Investment Research those new companies. The chart above shows the market cap of each era's largest US company as a percentage of the overall S&P 500 (the chart stops in 2018 and does not include the current development).

Two years down the line, the likes of Apple have extended their market share, together with some of its fellow mega-caps: the three largest US companies – Apple, Microsoft and Amazon – now all account for around 6% of the S&P 500 each (!). This is a level of company concentration not seen since the 1980s, when IBM and AT&T were market leaders. Today, technology and communication services companies in the US account for nearly 40% of the overall stock market. This is an astonishing level of market concentration, even if you believe in the secular shift story of the 'new economy'.

With any large structural economic shift, there still needs to be a productive underlying economy to make it work. Without the fertile ground of the 'old economy', newer companies with nascent technologies cannot thrive. Even if information technologies and virtual products are the future, people will still need food, travel and clothes. In other words, even the vanguards of the new age need a stable economic environment to work in. As such, even if we are not witnessing another 'great rotation' away from the big tech superstars, intense market concentration cannot go on forever.

Secular shifts are important, but sometimes need recalibration in terms of sector domination and adjustment of (still positive) earnings outlooks. In this context, not only economic and growth orientation is important, but regulation is an element which can alter companies' earnings outlook. We are keeping a watchful eye on the US elections and European musings over a future tech tax.

History tells us that while some of the largest short term stock market gains were made in individual sectors, the same holds true for some of the biggest and longest-lasting losses and drawdown periods, as those who suffered from the aftermath of the dot-com bubble at the beginning of the century – and the commodities rally only a few years ago – will attest. So, while we are glad there is more earnings substance behind many of the tech sector darlings of 2020, from an investment perspective, it nevertheless highlights again the importance of diversification.

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Global Equity Markets

Market	Fri 15:18	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6286.9	3.1	191.5	⬀	⬊
FTSE 250	17317	0.8	137.5	→	⬊
FTSE AS	3470.1	2.7	90.4	⬀	⬊
FTSE Small	5033.3	0.5	24.0	⬀	⬂
CAC	5054.0	1.7	83.5	⬈	⬂
DAX	12916.3	2.2	282.6	⬈	⬀
Dow	26711	2.4	635.3	⬈	→
S&P 500	3218.9	1.1	33.8	⬈	⬈
Nasdaq	10470.9	-1.4	-146.5	⬈	⬈
Nikkei	22696.4	1.8	405.6	⬀	⬀
MSCI World	2288.8	1.3	29.2	⬈	⬀
MSCI EM	1046.0	-2.2	-23.2	⬈	⬀

Top 5 Gainers

Company	%
Fresnillo	14.4
John Wood	12.3
Flutter Ents	10.7
AstraZeneca	8.2
SSE	8.1

Top 5 Decliners

Company	%
Micro Focus Int'l	-8.6
Burberry	-5.0
Brit-AM Tobacco	-2.7
Taylor Wimpey	-2.6
British Land	-2.0

Currencies

Pair	last	%1W
USD/GBP	1.253	-0.7
GBP/EUR	0.913	-1.9
USD/EUR	1.14	1.2
JPY/USD	107.16	-0.2
CNY/USD	7.00	0.1
Bitcoin/$	9,157	-0.8

Commodities

Cmdty	last	%1W
Oil	42.96	-0.6
Gold	1806.7	0.4
Silver	19.27	3.0
Copper	288.2	-0.2
Aluminium	1670.5	0.4
Soft Cmdties	330.0	0.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.16	+0.01
UK 15-Yr	0.38	+0.01
US 10-Yr	0.62	-0.02
French 10-Yr	-0.14	-0.00
German 10-Yr	-0.45	+0.01
Japanese 10-Yr	0.02	-0.00

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.3	22.6	19.4	13.5
FTSE 250	3.0	27.2	24.8	14.4
FTSE AS	4.1	24.0	21.2	13.6
FTSE Small	3.9	13.1	-	13.8
CAC	2.2	20.3	24.0	13.7
DAX	2.5	24.5	20.4	12.7
Dow	2.4	19.8	24.0	15.3
S&P 500	1.9	23.2	25.7	16.4
Nasdaq	0.8	33.4	31.3	18.5
Nikkei	1.9	27.7	22.3	16.9
MSCI World	2.2	22.5	23.8	15.5
MSCI EM	2.5	17.1	16.9	12.0

UK Mortgage Rates

Mortgage Rates	Feb	Jan
Base Rate Tracker	2.19	2.19
2-yr Fixed Rate	1.41	1.42
3-yr Fixed Rate	1.66	1.67
5-yr Fixed Rate	1.70	1.68
10-yr Fixed Rate	2.37	2.38
Standard Variable	3.66	3.66

* 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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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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Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | CB1 Business Centre, 20 Station Road, Cambridge, CB1 2JD