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'I'm not sure about the new mascot'

Source: Matt, 20 April 2021

'Risk on' pauses while the real world keeps accelerating

Equity markets finally paused in their upward trend last week, with the most speculative assets like Bitcoin experiencing their first serious setback since February. It was hard to pin the cause on any one specific development, although falling oil prices got their share of blame. The earnings season was certainly not at fault, with reported sales and earnings growth in the US outstripping already optimistic expectations, while bond market action likewise continued its newfound supportive stance that we wrote about last week.

More likely it was a more general dampening of investor sentiment in the face of increasingly cautionary reports from investment bank analysts about overheating markets, alongside a powerful resurgence of COVID in India. Plus, there were headlines on tax hikes for investors, as well as mounting levels of government intervention in the free market economy to slow the climate crisis, and even an abortive football 'coup' of sorts. We cover the intervention aspect in a separate article this week and discuss the news on investor taxation here.

Last Thursday, unconfirmed but very plausible, news emerged that the Biden administration is proposing to tax the capital gains of US citizens whose annual incomes already exceed $1 million at the top ordinary income tax rate of 39.6% (43.4%, adding the existing 3.8% tax on net investment income tax which is ostensibly for Obamacare). This is seen as an opening gambit and Goldman Sachs expects Congress will settle on a more modest increase of around 28%, probably effective from the start of 2022. This tax hike is really aimed at business owners and top executives, who use shares as a way of paying themselves, thereby avoiding income tax. The loophole in the tax system (a feature, rather than a bug) led investment industry icon Warren Buffet to highlight the absurdity of him being taxed at a lower rate of tax than his secretary.

The tax will not affect UK tax-domiciled investors directly, but will particularly impact the US private equity sector, and could have some impact on ordinary US stockholders of the major listed companies. Even so, the effect on the desire to hold stocks will be marginal for the vast majority of US citizens who are either below the $1 million income threshold, or hold shares through their investments via the pension tax wrapper (401K) system. Historical observations from previous capital gains tax (CGT) rises show that stock markets have usually risen following an increase, but traded more sideways than up in the run-up, as investors crystalised gains under the lower tax rate and then reinvested.

For UK investors, much more important will be whether our own government takes the opportunity to follow suit – which given the noises ahead of the last Budget seems relatively likely. More decisive for US stock prices, however, will be the efforts to increase the tax take from companies directly. One might think that the Biden Administration is using CGT as a means of keeping up the pressure to get the corporate tax rise through.

As a result, we continue to be somewhat wary of the largest stocks that would be most greatly affected by the increase in effective tax rates, given they have been most effective in utilising the existing loopholes.

So, should one head for smaller companies? Smaller stocks have performed very well over the past 12 months. Companies that have fared particularly well are those which currently have relatively little profit but are expected to be grow strongly over the coming two years. In other words, growth stocks. This is not only true for the US, as investment bank JP Morgan recently wrote about the outperformance of small and mid-cap growth companies globally, pointing out that the difference in valuation levels (P/E ratios) between growth and value stocks has reached levels similar to those of the heady days of the dotcom era at the beginning of the century.

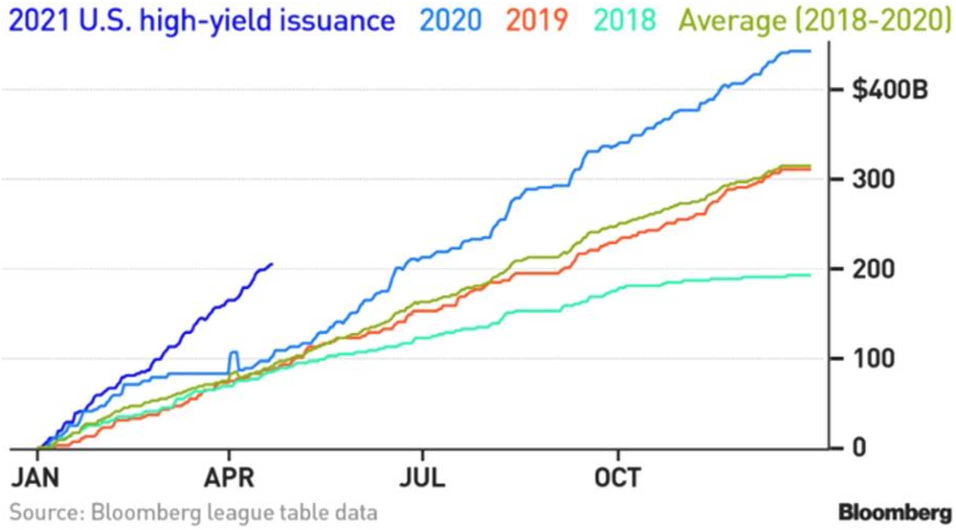
JP Morgan ends up being outright bearish about these growth stocks, because it believes their inherent earnings growth expectations have become too stretched, especially as a lot of earnings growth is already forthcoming, a view we broadly share.

However, we think that the level of real interest rates (i.e., nominal interest minus the rate of inflation as priced by the inflation-linked government bond markets) relative to ongoing earnings are probably more important. That ratio has remained fairly stable over the past few years of strong stock market gains, but declined in real yields. We will explore that dynamic in more depth in the next few weeks.

Turning back to the here and now, we wrote last week about how companies built up their defensive financial liquidity buffers at the start of the pandemic, and how that has fed through to lower than expected demand for bank loans now. The results of US banks confirmed that, and now the European Central Bank's quarterly Loan Officer Survey (released last week) points to much the same thing. French and Spanish banks are seeing slow demand for funds from companies, though Germany is faring slightly better (the American version from the US Federal Reserve (Fed) will be published on 3 May).

Bank loans tend to be the source of funding for smaller companies, while large companies access loan funding more cheaply through capital markets directly, which points us towards recent bond issuance data. Relatively, in both the US and Europe, Bloomberg's data on new bond issuance shows a much stronger level of demand for funds than is seen via loans, especially in the sub-investment grade area.

The chart below shows this year's pace of US issuance in comparison to the previous four years:



Looking at the US specifically, where loan data is more readily available, the sum of bank loan and bond amounts outstanding has started to rise since the start of the year, with bond issuance exceeding another round of bank loan pay-downs, thus resulting in a net increase of overall loan finance.

That's good news for the US economy. It shows that firms are probably confident, actively looking for finance despite having quite high levels of liquidity and markets receptive enough to their demands that they can afford to side-step the banks. Capital expenditure indications are very strong, which indicates firms are spending some of their excess liquidity (as long as they can get the equipment, given the shortage of semiconductor chips).

Meanwhile, the tightening in the labour market is leading to greater consumer confidence, and that is creating a house price and house-building boom (we cover aspects of this in our second article this week). Ongoing demand for mortgages is stronger than one might have expected, given the recent rise in the long-dated fixed income yields.

Eventually, rising total private sector credit demand will become an upward force on yields again, and the spurt of bond issues in March – together with continued mortgage demand – appears to have been behind last month's sharp rise in yields, and the resultant downswing in US treasury bond prices.

When do central banks start to get worried about private sector credit demand fuelling an overheating of the economy? Right now, we are still only at the start of a demand upswing, so we do not expect policymakers will begin feel the heat for many months yet, but it will be worth us watching events closely.

Has COVID reduced government intervention thresholds?

Last week saw an astounding few days in the sporting world, and if you don't want to see the scores, look away now. After a renegade bunch of Europe's biggest football clubs announced plans to break away to build their own league, only for the whole enterprise to fall apart as quickly as it appeared – after an alliance of fans, football authorities, media outlets and even the UK government expressed their disdain. One-nil to the fans, or so the media narrative goes.

The epic fail of the football fat-cats is perhaps a romanticised view of things. Events may have gone differently had the club owners offered a slice of the promised profits to the big sports media outlets and organisations. But whatever the case, two parts of the story stick out. First, it was incredible to see so many disparate groups – fans and political parties of all stripes, together with sports professionals and major media executives – agree so strongly. Second, and perhaps more astounding, was the speed and force of the British government's response, effectively pledging to use legal and legislative tools to prevent anything like this happening again.

From an investment perspective, that spirit of interventionism is significant. The Super League drama is certainly a special case – a hugely popular national institution being threatened by what many see as simple greed – and one that gives politicians ample opportunity to score points. But it is part of a trend reversal in politics both here and across the world. Since the 1980s, laissez-faire 'neoliberalism' has been the default mode of Western government, and successive politicians have been reluctant to step into free market affairs. But such interventions are increasingly being seen as a standard part of the government toolbox. From big-tech busting to vaccine rollouts and even sport, political deference to the private sector is drying up fast.

Nowhere is this more apparent than in environmental policy. Last week, leaders from 40 of the world's largest economies joined a virtual summit on ways to tackle climate change on a global scale. Ahead of talks, the British government has been keen to show its ambition in terms of cutting emissions, pledging that, by 2035, UK emissions would be 78% lower than in 1990. But it was Joe Biden that stole the headlines last Thursday, promising to half America's emissions by the end of the decade. This effectively doubles the previous US target and could be hugely significant – coming from the world's second-largest CO^2 emitter.

Grand statements on climate change have been a common theme from world leaders for several decades, but the intent from the current generation seems more wholehearted. What is interesting in the proposals is not just the big targets, but how they plan on reaching them. Both here and across the Atlantic, policymakers have drawn up measures to invest heavily in green infrastructure, including detailed plans on insulating homes, alternative energy sources and much more.

Beyond the government-led investment, though, is a firm recognition that the private sector and private capital will be needed to push forward the huge global transition. Ahead of the summit, US climate envoy John Kerry revealed US banks have committed $4.15 trillion of investment to fund low carbon projects by 2030, while US asset managers have pledged over $19 trillion. Kerry told the *Financial Times* that, if all goes well at the summit, economies accounting for around 60% of global GDP would be committed to net-zero emissions by 2050.

Kerry, along with US Treasury Secretary Janet Yellen, has also thrown American weight behind the new Glasgow Financial Alliance for Net Zero – snappily abbreviated Gfanz – a group of 160 private companies from all over the world that has promised to cut the carbon footprint of their investments. Gfanz, chaired by former Bank of England Governor Mark Carney, represents banks and businesses with over $70 trillion in assets.

It is hard to overstate how important the global financial system is for the fight against climate change. Governments can spend big on green infrastructure all they like, but polluting projects will continue to go ahead as long as there is financial incentive to do so. This problem has caused more than $3.8 trillion to flow into fossil fuel projects since the Paris Agreement was signed in 2015. To make the changes promised, we will need to see a structural shift from global companies beyond what any one government is capable of doing. And ultimately, that will only happen if it becomes more profitable to invest in green energy than in polluting industries.

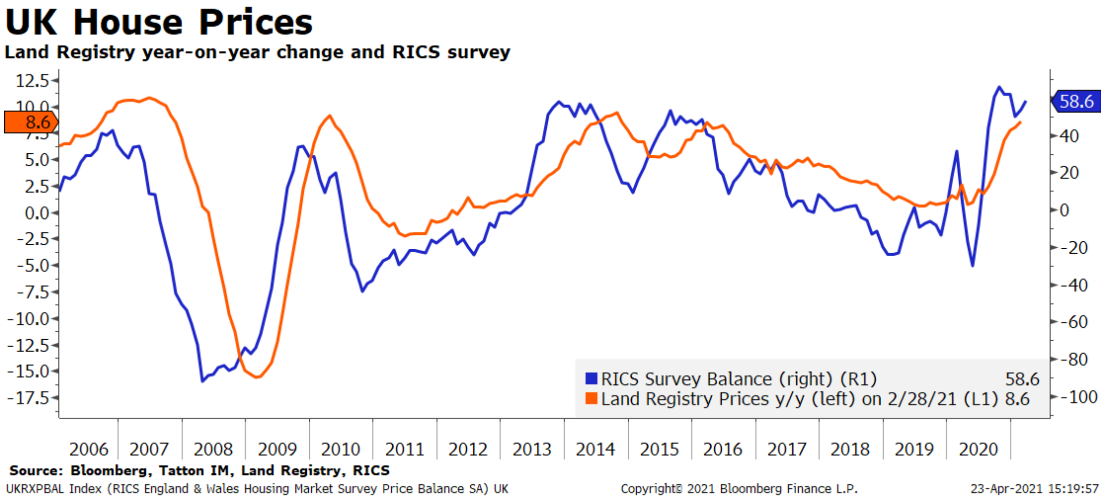
That is precisely what global leaders' current plans are aimed at. Carbon taxes and subsidies for green projects are nothing new, but by drawing up detailed governance systems for emissions, governments are clearly trying to disincentivise fossil fuel activities as much as possible, while pushing the incentives into greener energy. The plans are far from perfect, and there are a host of teething issues – from coordinating international 'taxonomies' to the widespread 'greenwashing' attempts to conceal emission statistics. But from a purely investment perspective, what it tells us is that the trend toward environmental or ethical investment is going full steam ahead.

In recent years, we have seen a huge uptick in demand for ESG (environmental, social and governance) investments. Part of this is down to growing ethical concerns from investors, but another part is simply that markets think ESG investments will be profitable down the line. If the green revolution really is upon us, they could well be right. And now that we are seeing governments intervene on an unprecedented scale to help the shift, their relative attractiveness should grow. Against this positive backdrop – and with interventionist politicians eager to support them – environmental companies have a real sporting chance.

Housing market: still hot property

Markets and the public are eagerly anticipating the economic recovery, when last year's lockdown bust will make way for the post-pandemic boom in growth. A combination of incredibly supportive monetary and fiscal policy, together with a rapid vaccination programme in the UK and US (and now belatedly picking up steam in Europe), has led to widespread expectations of growth in activity and price inflation. We are beginning to see signs of this coming through in actual data, but one area where the boom already seems in full swing is the housing market. House prices have been surprisingly well-supported throughout the crisis, with ultra-low interest rates and favourable policies (in the UK, namely the government's stamp duty suspension) providing the backdrop for strength. Meanwhile, emergency fiscal spending has bridged the funding gap for households and supported incomes at decent levels – despite the deepest recession on record.

All of this has resulted in a notable rise in property prices. Last week's data in the UK was reported as being slightly disappointing, with the Land Registry saying that the average house sale price had slipped during February from January's level. This had been foreshadowed by the Halifax index showing a similar move. However, the yearly change still moved up to 8.6%yy, the best since mid-2014, while the RICS House Price Balance Survey suggested renewed positivity from estate agents, signalling continued upside.



In Australia, property prices have shot up so much that the government is concerned about the runaway market and what it could do for consumers. House prices there had a pretty bad patch during 2018-2019, as commodity prices were under pressure during the Trump trade wars, but the Australian CoreLogic median house price index hit a startling 3% rise month-on-month in March, the highest rise since the heady days before 1990.

On the one hand, a booming property market is good news for the recovery – pushing up consumer balance sheets and therefore encouraging consumption. But on the other hand, if property prices spike too high and too soon, it will stretch affordability – particularly for those with low incomes that have been hit hardest by the recession – and potentially cause the house market to get toppy.

This is true virtually everywhere across the developed world, with some countries seeing increases to levels higher than ever before. In Australia, for example, property prices have shot up so much that the government is concerned about the runaway market and what it could do for consumers. On the one hand, a booming property market is good news for the recovery, pushing up consumer balance sheets and therefore encouraging consumption. But on the other, if property prices spike too high and too soon, it will stretch affordability – particularly for those with low incomes that have been hit hardest by the recession – and potentially cause the market to get 'toppy'.

Looking forward, there are reasons to be positive, including a continuation of the supportive policy environment. House prices can only rise if incomes are sustained. Eventually, this will come from the overall recovery and the growth it will bring. But in the meantime, the substantial monetary and fiscal stimulus of the pandemic will be needed. On the fiscal side, the worry is that governments could withdraw support too soon – an idea already being floated by politicians concerned about ballooning national debts. Should that happen, the recovery could be set back, to the detriment of property prices. Here, we note that policy support in the US seems to be shifting to supporting (lower) household incomes, and that in February the

US Federal Reserve (Fed) stepped up its mortgage security buying to hold mortgage rates down, when government bond yields saw a rather steep rebound. All this is pointing to further support.

The continuation of loose monetary policy is even more vital, but recent price moves create a problem for central banks. They must continue to keep financial conditions easy and support the wider recovery, but they are all too wary of how their actions can create asset price bubbles. We saw this problem in the decade after the financial crisis, when abundant liquidity caused capital to flow into certain markets and inflate prices with undesired side effects, for example in the commodity sector.

In theory, central bankers could respond to these worries by pointing out that they – or other policy makers – have macro-prudential policies in place to deal with imbalances. In most cases, this would mean governments and regulators would need to join the effort to stop certain asset types from overheating, whether that means tightening lending standards or raising taxes. Without those additional policies, central bankers are left trying to fine-tune markets with a bazooka.

Markets have been excited and concerned in equal measure about the recovery, and the prophesised return of inflation. In house prices, as well as certain other asset markets, we are already seeing this inflation. But the latter does not necessarily lead to the former, and it remains to be seen when consumer demand-led price rises, accommodated by wage rises, leads to the return of structural inflation – and even whether rising property prices will be a help or a hindrance to it. The data we have from the UK is a little 'noisy' on this issue, but we can speculate as to the most likely scenarios.

If consumers have a huge level of debt outstanding on their property – through low-deposit mortgages or loans with variable rates – they have less money available to spend on discretionary goods – especially when rates go up. Ultimately, we would suggest that the issue is not so much about whether asset price spikes lead to consumer inflation, but whether the overall policy framework is fit for purpose. That is, whether policy is strong enough to lift overall economic growth – from which increased pricing power and inflation will naturally follow.

What we do know is that housing activity does have a direct effect on construction, which creates jobs and growth, as construction activity gets counted straight into GDP numbers. From a pragmatic point of view, politicians and policymakers are likely to be intensely focused on GDP figures, and so the building angle might be all that is needed to get them keen on house price rises. Certainly, we already see politicians promoting infrastructure spending – particularly green infrastructure – on the basis of the jobs it will bring. In the UK particularly, there is a great deal of 'green upgrades', from insulation to energy, that could be carried out across the nation for a relatively low cost.

Policymakers tend to only get involved when one of two situations arise. First, when household balance sheets are showing signs of excessive leverage, regulators tend to step in to decrease risk. Second, when burgeoning asset values cause a damaging increase in inequality – whereby construction and public investment programmes can be a useful remedy. Which of these happens remains to be seen, but the housing market is showing no signs of slowing down just yet.

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26th April 2021

Global Equity Markets

Market	Fri 15:21	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	6921	-1.4	-99	↗	↗
FTSE 250	22333	-0.8	-189	↗	↗
FTSE AS	3956	-1.3	-51	↗	↗
FTSE Small	7108	-0.0	-3	↗	↗
CAC	6244	-0.7	-44	↗	↗
DAX	15234	-1.5	-226	↗	↗
Dow	33891	-0.9	-309	↗	↗
S&P 500	4156	-0.7	-30	↗	↗
Nasdaq	13924	-0.9	-128	↗	↗
Nikkei	29021	-2.2	-663	→	↗
MSCI World	2924	-1.0	-29	↗	↗
CSI 300	5135	+3.4	+169	→	↗
MSCI EM	1341	-0.5	-7	→	↗

Top 5 Gainers

Company	%
Polymetal Internationa	+4.7
Johnson Matthey	+3.7
AVEVA	+3.4
Entain	+3.0
Avast	+2.7

Top 5 Decliners

Company	%
Melrose	-8.8
Informa	-8.7
Imperial Brands	-6.5
Int'l Consol Air	-6.5
Brit-AM Tobacco	-6.3

Currencies

Pair	last	%1W
USD/GBP	1.386	+0.2
GBP/EUR	0.870	-0.5
USD/EUR	1.21	+0.6
JPY/USD	107.98	+0.8
CNY/USD	6.50	+0.4
Bitcoin/$	49,502	-20.2

Commodities

Cmdty	last	%1W
Oil	66.10	-1.0
Gold	1771.0	-0.3
Silver	25.87	-0.4
Copper	432.0	+3.6
Aluminium	2363.0	+1.0
Soft Cmdties	444.4	+0.2

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.5	20.8	14.3	14.0
FTSE 250	1.8	18.9	23.0	15.4
FTSE AS	3.2	20.4	15.2	14.2
FTSE Small x Inv_Tsts	1.4	20.0	-	15.0
CAC	1.8	25.1	18.3	14.6
DAX	2.3	22.6	16.3	13.3
Dow	1.8	21.4	20.7	16.1
S&P 500	1.4	28.2	23.4	17.2
Nasdaq	0.7	36.0	34.7	22.2
Nikkei	1.4	27.1	20.9	17.5
MSCI World	1.7	26.0	21.1	16.3
CSI 300	1.7	18.3	14.3	12.4
MSCI EM	1.9	20.0	15.1	12.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.76	-0.01
UK 15-Yr	1.11	-0.01
US 10-Yr	1.58	-0.00
French 10-Yr	0.09	+0.10
German 10-Yr	-0.25	+0.01
Japanese 10-Yr	0.07	-0.02

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.62	1.73
3-yr Fixed Rate	1.72	1.90
5-yr Fixed Rate	1.80	1.89
10-yr Fixed Rate	2.53	2.53
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

If anybody wants to be added or removed from the distribution list, please email
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CAMBRIDGE INVESTMENTS LIMITED

26th April 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.

Lothar Mentel