THE **CAMBRIDGE** WEEKLY

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Lothar Mentel

Lead Investment Adviser to Cambridge

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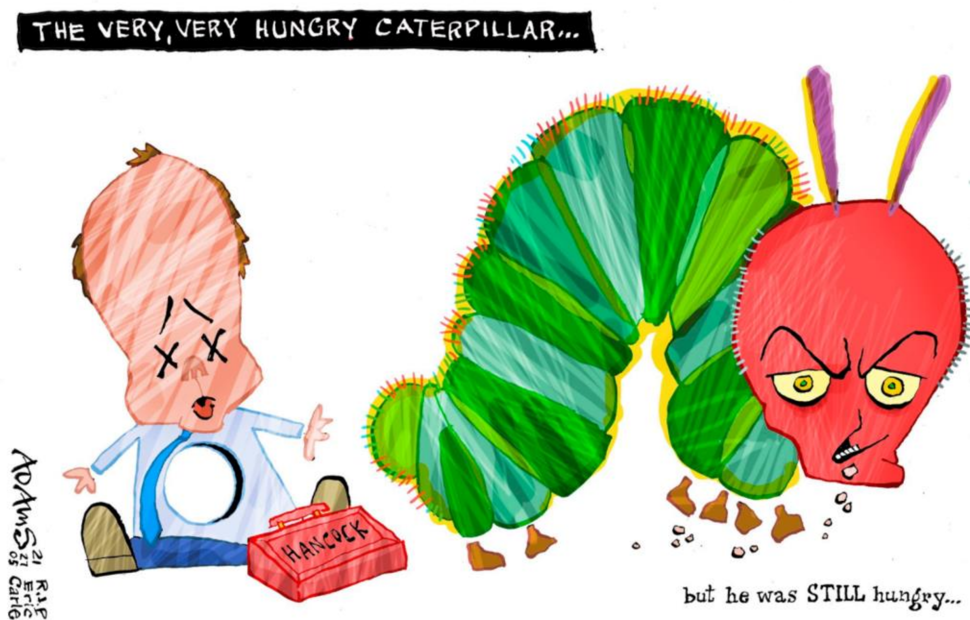


Source: Chris Adams, 27 May 2021

Touch of Goldilocks at the end of May

After a strong April, May felt somewhat of a mixed bag for investors, particularly when stock markets suffered a correction in the middle of the month. However, as the month drew to a close, it was mostly only cryptocurrency holders, and those who had banked on a warm and sunny May in Northern Europe, who were still feeling the pain. For globally diversified investors, May drew to a more amicable close, which counterintuitively has been driven by expectations of lower, not higher, growth.

The 2021 sell-off periods so far have all been driven by concerns that economic growth may return with such a vengeance that supply bottlenecks would cause inflationary pressures – which in turn would drive up bond yields, or press central banks to withdraw the 'punchbowl' of ultra-low rates, before a sustained recovery has been established. We discussed previously how the competition of higher bond yields raises the hurdle for equity valuations, which means that in order for share prices to remain high and rise further, corporate earnings growth has to top rising bond yields.

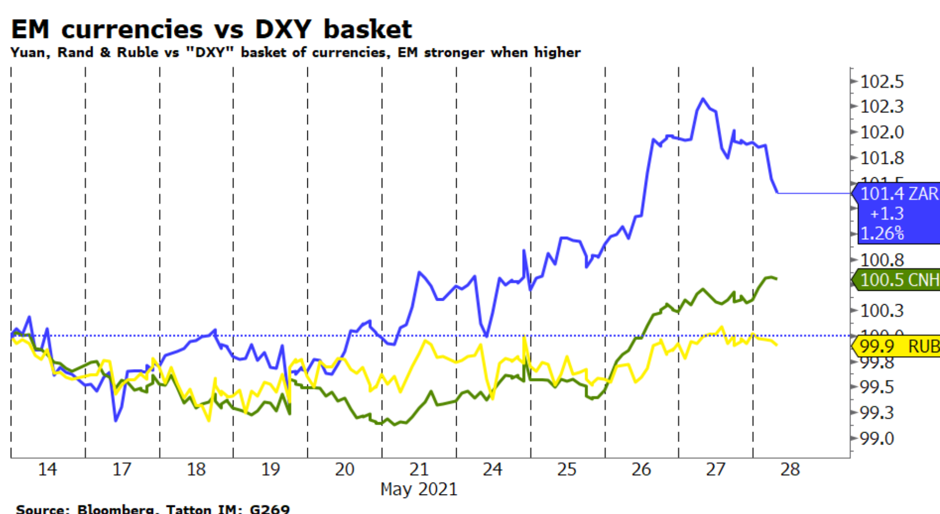
On both inflation and the potential for central bank error, the last weeks of May brought welcome relief to capital markets. The US Federal Reserve (Fed) struck the right tone with a very measured appraisal that made clear that it would neither be blind to the fragile nature of the post-pandemic recovery path, nor to the overheating risks should conditions improve faster than anticipated.

On inflation, various survey data points suggested inflation expectations have not increased, despite quite marked price rises for certain goods. Neither have wage rise expectations – which would allow higher price levels to persist and turn them into structural inflation. On economic overheating fears, the Biden administration's apparent willingness to settle for lower overall spending volumes, to expedite

Congressional approval of fiscal stimulus packages, lowered near-term growth expectations which therefore lowered the temperature there as well.

Political noises may have been higher over the past week, but the quieter tones from the economy were supportive for capital markets and allowed them to rise gradually.

Market-relevant political risks were apparent around both Russia and China. They have been for some time and only intermittently impact on their currency, bond and equity markets. So, last week was notable in that there were little or no discernible impacts. The Renminbi/Yuan strengthened and the Rouble was a tad stronger on the week as well. We also show the South African Rand in the chart below, strongest among emerging market currencies and a country we write about in one of this week's in-depth articles.



President Lukashenko of Belarus showed us all quite how much respect he affords to international rules, after an act of state-sponsored plane hijacking to secure the arrest of a Belarusian journalist. The nations north of Belarus are getting decidedly nervous but that fear is not shared by markets, which may have taken more note of how European Union (EU) member states were able to join forces quickly to express widespread condemnation.

China indicated yet again that markets are absolutely 'free' – as long as they do what the Chinese government wants. Cryptocurrencies and commodities bore the brunt of the tightening regulatory pressure at the start of last week. As we have discussed before, western investors appear to be somewhat ambivalent about domestic Chinese market interference. The new rules and oversight could be seen as over-the-top, but the west has regulation too. China's policymakers are determined to ensure domestic stability and recognise that their previous approach of direct "approve or deny" meant a near-free-for-all in any market they approved. Setting out boundaries through regulation is now seen as more preferable, and differs from the west only in the extremity of the punishment. If anything, such regulation could mean fairer treatment and more transparent markets for all investors. Foreign investor flows into Chinese assets appear to have picked up after the outflows of a couple of months ago.

Of course, there is an interesting conundrum at play. Tightening controls may also mean more stable but slower growth – which China is definitely showing some signs of. Interestingly, the strictures on commodity "speculators" seems to be because steel manufacturers have been caught in a bind.

The Chinese authorities are not just constraining the commodity markets; they are also constraining the demand. They have pulled back the availability of credit in the economy, after the immediate post-virus surge, and this could be a potential problem for wider markets. So-called 'credit impulse' (credit growth relative to overall GDP growth) is now negative, and will decline further. Despite all these containment measures, Chinese equities still enjoyed one of their best weeks for a while.

As a rather changeable May takes its leave, we can at least end the month with renewed optimism that meaningful – if uneven – progress is being made. Markets last week have shown a clear (although perhaps unsurprising) preference for stable, more profitable growth, rather than boom-and-bust.

Big changes for 'Big Oil'

You can wait your whole life for something to change, but when it does, blink and you will miss it. That is how it seemed for the energy industry last week, after several huge stories piled the pressure on 'Big Oil'.

First came an International Energy Agency (IEA) report imploring oil companies to stop all new fossil fuel projects from this year – suggesting this was the only way the world could meet its net-zero carbon target by 2050. Then, ExxonMobil shareholders backed a long-shot activist campaign to install two environmentalists on its board. In a similar vein, last Wednesday Chevron shareholders defied its board members to vote in favour of cutting the company's carbon footprint. Finally, Royal Dutch Shell lost a landmark legal case in the Netherlands, after a court ruled it must cut emissions faster and harder than it had planned.

Climate concerns are hardly new. But for all of the environmental initiatives pursued over the last few decades, energy companies have rarely had to face direct action over their emissions. Now, oil companies are facing intense pressure from international bodies, the legal system and their shareholders, all at the same time. When it rains, it pours.

Let us take these stories in turn. Royal Dutch Shell's legal loss comes from a small district court in The Hague, where Judge Larisa Alwin ordered it to ensure its emissions are 45% lower in 2030 than they were in 2019. The result will have "far-reaching consequences" for Shell, according to Judge Alwin, who cited its human rights obligation as the reason more drastic action was needed.

Legally speaking, it is hard to say what this result will mean for the future of the world's big polluters. The ruling is reportedly only binding in the Netherlands and, in any case, Shell has already signalled its intention to challenge the decision at a higher court. That challenge could well be successful. Judge Alwin essentially ruled that Shell was bound by the 2015 Paris Agreement to shoulder a bigger burden of emission slashing – as well as by human rights obligations. But as a non-signatory to that agreement, it is unclear whether the law can be applied to Shell.

Judging from Shell's share price, investors for now haven taken to a "wait and see" attitude. Even so, the ruling is more significant in what it symbolises than what it dictates. Human rights-based legal cases are increasingly being brought against polluting companies by pressure groups, and this is a high-profile case in which the strategy has worked. It could be a watershed moment for the energy industry, much like the first legal cases brought against big tobacco companies last century.

At the very least, it will embolden climate activists – who are gaining in prominence in the financial world. On this front, we suspect ExxonMobil's boardroom shake-up may prove even more significant. Exxon now has two dissident environmentalists in its boardroom – to the dismay of CEO Darren Woods. It is very rare for a company of Exxon's size to elect even one dissenting director. But a coalition of activist investors led by hedge fund Engine No.1 – which collectively owns less than 1% of Exxon's shares – managed to install two of its four candidates. They may even get a third after the final votes are counted.

In any case, the vote was quite an extraordinary display of investor power in the fight against climate change. Oil companies have grown accustomed to bad press over the years, and more recently, pressure from politicians. But they have usually been able to count on their profit-generating abilities to keep investors happy. Now, with a rising tide of environmental, social and governance (ESG) investing, companies are finding it increasingly difficult to attract capital without proving their environmental credentials.

The IEA report is likewise significant, coming from a traditional ally of the oil industry (set up in 1974 to keep a steady and affordable supply of oil flowing to the world). In terms of information, there is not much new in the report: Investment in new fossil fuel discovery needs to stop immediately if the world is to realistically meet its net-zero target by 2050, and renewable energy production has to ramp up massively. But the IEA's voice will add significant weight to the debate. Tellingly, the organisation has forecasted a $35 per barrel oil price by 2040, signalling that global demand for fossil fuels needs to fall greatly.

A great deal has to happen for that to come true – from legislation to societal changes – but the actions at Exxon and Chevron are a good sign of the investing public's appetite for change. In both, it is significant that investors have chosen to engage with polluters and change their behaviour, rather than straightforward divestment. In terms of changing incentives around fossil fuels, divestment is an important strategy, but there are dangers with it too.

As a recent FT article highlights, there is a risk that, rather than 'greenwashing' – companies becoming more sustainable to improve their image – companies could instead opt for 'brown-spinning' – where their heaviest-polluting parts are sold cheaply to hedge funds or private equity groups. When this happens, there is significantly less oversight, with private groups not required to disclose emission figures in the same way as public companies.

It is increasingly accepted that the energy sector and the real economy as a whole are in a transition phase towards the goal of net zero CO_2 emissions, which means that the cards are being reshuffled. Some big incumbents in the energy and utilities sectors will adapt and benefit from the evolution, given there are areas of the process where big corporations are needed for the organisational challenge. But there will most likely also be new players who break through with inventions, while tech firms will be vital, too. Those who fail to adjust risk turning into 'stranded assets', which is not only a risk for investors, but also for financial stability at large.

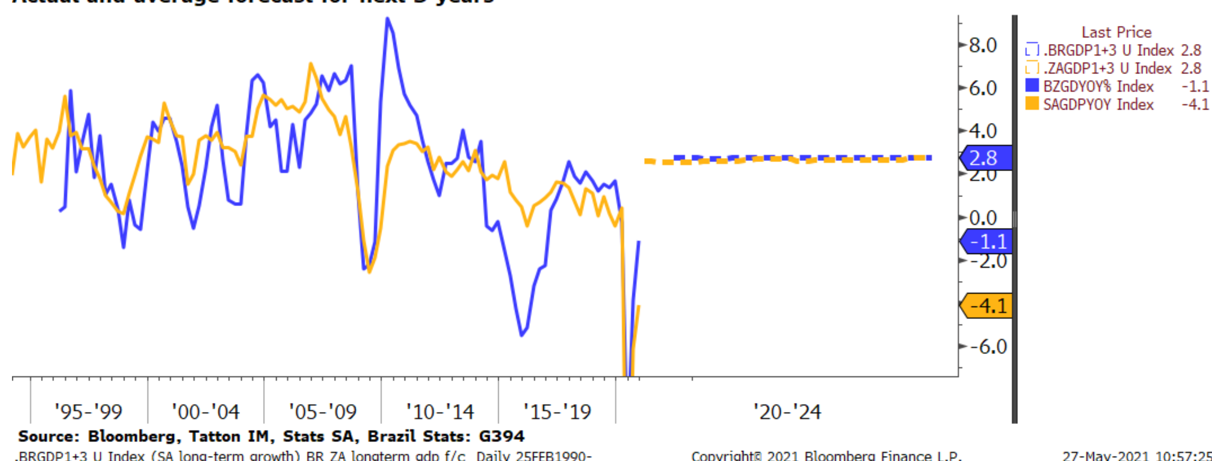
Investor engagement and activism will remain an important pillar in the process. But ultimately, there is only so much the ESG investing public can do. As we have written before, big structural changes require a change of incentives – and that can only come once a firm and consistent legal structure is in place. International discussions on CO_2 trading regulations and carbon border taxes are a good example of this, but are still in the early stages. Whatever the case, these issues are not going away, and after such an eventful week for Big Oil, it feels like change is bubbling up to the surface.

Brazil and South Africa – a tale of two BRIC countries

Those in the investment world are probably aware of the BRIC thesis brought forward by Goldman Sachs economist Jim O'Neill two decades ago. O'Neill suggested the high growth potential of emerging markets Brazil, Russia, India and China would ensure their weight in the world economy would rise substantially over the next ten years. But his prediction was about more than just backing the right horse. The belief was that, with the centre of global growth shifting, political institutions and the global order would have to shift too. Sure enough, by 2009, the largest four countries met regularly on a political level, and a year later, after intense lobbying, South Africa was invited to join the regular BRIC(S) summit.

With the benefit of hindsight, BRICS is not the most obvious of groupings, economically speaking. Each country has its own strengths and weaknesses that should make it unlikely they would rise and fall together. There are two, though, whose economic performance has been remarkably similar: Brazil and South Africa. This is a little surprising, given the distance and differences between the two countries. And yet, as the chart below shows, the trend in both country's growth levels has tracked incredibly closely over the last few decades – albeit with a bit more volatility on the Brazilian side.

Brazil & South Africa real GDP growth
Actual and average forecast for next 3 years



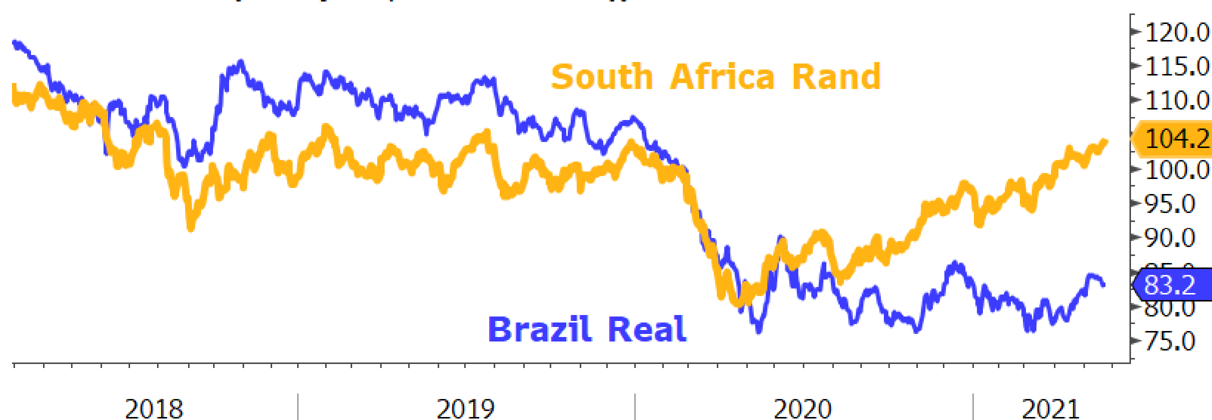
When looking at the composition of their economies, Brazil and South Africa are structurally very similar. Both are heavily dependent on commodities and semi-manufactured goods, making them sensitive to the promises and pitfalls of the commodity cycle. Brazil's primary commodities – including semi-precious and industrial metals, oil and food – make up 55% of its exports. Meanwhile, metals and minerals account for around 60% of South Africa's exports.

That commodity reliance is helping both countries right now. As we come out of the pandemic, markets are expecting a boom in global trade and infrastructure building (which we are already seeing in the US). This places global inflation at the top of the agenda for the first time in years. Domestically, inflation has and will likely continue to make some problems for many emerging markets. Brazil and South Africa are no exception here, but a bout of inflation – together with strong global demand – should be a boon in the medium term. In South Africa, the global commodity boom has brought on a surge of export growth – bolstering investor sentiment and strengthening currency values. Since the beginning of the year, the Rand

has clearly outperformed the Brazilian Real, even if the latter started gaining some ground over the last month.

Brazil and South Africa Currencies

Real effective rates (CPI-adjusted, indexed to Mar-20))



Source: Bloomberg, Tatton IM, JP Morgan: G382

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As with many emerging market countries, virus concerns have dampened optimism. This is particularly true for Brazil, which has the world's second highest official COVID death toll. Thankfully, in both Brazil and South Africa, case numbers and deaths have been on a continual downtrend since the winter and early spring peaks. Even more encouragingly, vaccination programmes in both countries are now well underway – greatly lessening the likelihood of a third wave. With falling virus cases and increasing vaccinations, both have been able to loosen restrictions – giving a much-needed boost to sentiment.

Positivity from international investors is creating a positive cycle. With restrictions easing and global growth looking supportive, money has flowed back into Brazil and South Africa – and that outside investment is itself boosting domestic growth expectations. This will be a big help for their governments in particular, as both have a similarly high debt-to-GDP ratio, and both have bond ratings just below investment grade.

One of the big positives is that both governments stepped in to provide substantial fiscal support through the pandemic – with Brazil using more of its perceived fiscal leeway than South Africa. But this factor brings one of the key differences (in investment terms) between them into focus. While political stability seems to be improving in South Africa – thereby support the growth outlook – the same cannot be said for Brazil.

South African President Cyril Ramaphosa recently strengthened his position by forcing his African National Congress (ANC) Party's secretary-general to step aside. Aside from merely expelling a former Zuma ally and potential rival, the move has been seen by many as a step forward in South Africa's anti-corruption campaign. Institutional stability are always crowd pleasers for emerging market investors, so Ramaphosa's actions have been good for economic sentiment and the stock market, which has locked in gains of around 14% since the beginning of the year.

In Brazil, meanwhile, equities have merely managed a 4% upside. Right-wing populist President Jair Bolsonaro is gearing up for another election campaign next year. The polarising figure came to power on a platform of anti-corruption a few years ago, but his tenure so far has been marked by controversies and corruption allegations of his own.

Investors recently feared he would pressure Brazil's central bank into keeping interest rates low – in a bid for political popularity. With domestic inflation pressures rearing, that would have been a bad sign. Fortunately, the central bank raised rates recently – making it clear it is focused on delivering price stability.

For markets, while Bolsonaro's biggest drawback is his unpredictability, there are also doubts as to the extent he can reform public finances and improve the country's languid tax base, which is half of South Africa's as a percentage of GDP. It is also incredibly complicated. According to Bank of Santander, in 2017 an average Brazilian company took nearly 2,000 worker hours to complete its annual tax return in comparison to 175 hours for a US company. Bolsonaro has recently tried to push forward reforms in this area, but has been limited by the country's political apparatus. And now it is entering an election phase, as with other economies in Latin America, doubts persist. As the incumbent, Bolsonaro may not be ideal, but the prospect of a 'left' leaning government – which may fail to put public finances on a more sustainable path – is not enticing for investors either.

The political difference is most likely why the Rand has performed 25% better than the Real in recent years. But in a world that is slowly recovering from the pandemic, and has high commodity prices, things look bright for both of the two smaller BRICS. However, their diverging paths illustrate once again how heterogenous emerging markets behave, with policy developments again playing a key role.

Global Equity Markets

Market	Fri 14:50	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7045	+0.4	+27	→	↗
FTSE 250	22740	+1.5	+341	⇗	↗
FTSE AS	4028	+0.6	+25	→	↗
FTSE Small	7251	+1.7	+121	⇗	↗
CAC	6485	+1.6	+99	↗	↗
DAX	15533	+1.1	+163	→	↗
Dow	34605	+1.2	+397	⇗	↗
S&P 500	4212	+1.4	+56	⇗	↗
Nasdaq	13810	+2.5	+339	→	↗
Nikkei	29149	+2.9	+832	⇘	↗
MSCI World	2971	+0.9	+28	⇗	↗
CSI 300	5321	+3.6	+187	→	↗
MSCI EM	1354	+1.8	+24	→	↗

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
AVEVA	+7.5	Intertek	-6.7
Melrose	+6.8	Evraz	-4.3
Entain	+5.3	Johnson Matthey	-4.2
JD Sports Fashion	+5.3	DCC	-3.9
Compass	+4.6	Royal Dutch Shell	-3.6

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.415	+0.0	Oil	69.75	+5.0
GBP/EUR	0.860	+0.1	Gold	1899.1	+0.9
USD/EUR	1.22	-0.1	Silver	27.79	+0.8
JPY/USD	110.02	-1.0	Copper	462.3	+2.8
CNY/USD	6.37	+1.0	Aluminium	2481.0	+3.5
Bitcoin/$	36,990	+4.9	Soft Cmdties	445.2	+1.9

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.3	19.2	14.1	14.1
FTSE 250	1.9	17.8	23.4	15.5
FTSE AS	3.0	18.9	15.0	14.2
FTSE Small x Inv_Tsts	1.4	19.0	-	15.1
CAC	2.1	25.4	18.4	14.7
DAX	2.4	18.4	15.6	13.3
Dow	1.7	21.8	20.5	16.2
S&P 500	1.4	26.8	22.6	17.3
Nasdaq	0.7	32.4	32.4	22.4
Nikkei	1.5	18.3	20.3	17.5
MSCI World	1.7	24.2	20.5	16.3
CSI 300	1.7	17.4	15.2	12.4
MSCI EM	1.9	17.6	14.5	12.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.80	-0.03
UK 15-Yr	1.15	-0.06
US 10-Yr	1.60	-0.03
French 10-Yr	0.18	-0.07
German 10-Yr	-0.18	-0.05
Japanese 10-Yr	0.08	unch

UK Mortgage Rates

Mortgage Rates	May	Apr
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.52	1.55
3-yr Fixed Rate	1.67	1.68
5-yr Fixed Rate	1.74	1.75
10-yr Fixed Rate	2.58	2.57
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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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 | Nine Hills Road, Cambridge CB2 1GE