CAMBRIDGE
INVESTMENTS LIMITED

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Source: Patrick Blower, 6 July 2021

Don't look down

Global equities have been on a pretty rapid ascent since the start of the year. Last week the world's investors had a bout of looking down, and a mild attack of vertigo. This dizziness has been prompted by some reasonable worries. Do we have enough food (earnings growth) to carry on? Is the strong tailwind (in the form of liquidity) about to turn into a headwind? Has one of our party (China) already started slipping back down?

We've been going through these thoughts in our quarterly investment committee meetings, and the main conclusion is that things are generally likely to remain supportive for markets. But that is not to say it will be a gentle and comforting climb up the hill.

We have good reason to think the current vaccines are – and will remain – effective. But with the ongoing increase in case numbers, and the Delta variant spreading across both vaccinated and unvaccinated regions, there is a chance of a mutation which could be less impacted by vaccines. Still, in our view, this is not the greatest risk to markets.

There is a potential for monetary and fiscal support to be removed too early, tightening financial conditions before we have moved beyond the COVID bounce. At its last meeting, the policy committee of the US Federal Reserve (Fed) made noises about interest rate moves coming into the far-end of its two-year horizon, and that bond purchases might be less necessary. However, some of the worries revolve around its operational ability, marshalling the day-to-day circulation of money in the US financial system.

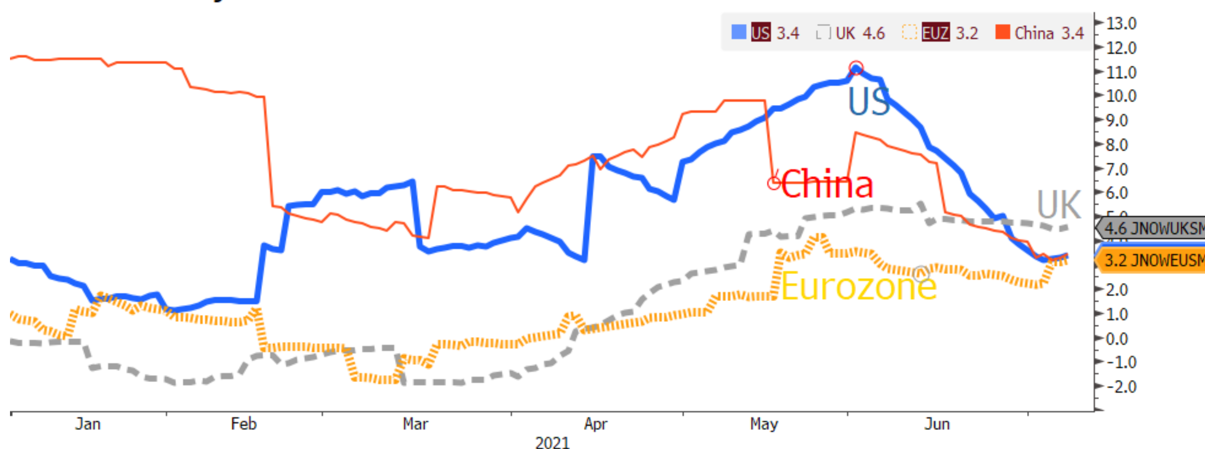
The slowing of US monetary growth is a mild worry for us. It's not that liquidity will tighten in an overall way but small disruptions can create risk vortices.

For the developed world, and particularly the US, the increase in the stock of savings has come from government cash handouts, and from the rise in asset price values. The US is going through another cash handout at the moment, with a disbursement of child support tax credits. This programme will be longer-lasting than federal support for unemployment, but is also the last of these sorts of payment.

Workers everywhere have been comfortable enough to not rush back into the workplace, but that period is ending. Jobs are plentiful across the developed world, but workers/consumers have shown a little wobble in confidence as they are faced with making sometimes uncomfortable choices. We think this will pass and is at the heart of the path towards normality, and a transition in the mid-phase of an economic growth cycle.

Nevertheless, this easing down from the very strong growth seen in April and May is a factor in slower growth of US earnings expectations, especially in cyclical companies. The chart below shows JP Morgan's current run rate of GDP growth estimates and how they've changed over 2021.

JP Morgan Current GDP Growth Trajectory
Smoothed Monthly



Source: Bloomberg, Tatton IM, JP Morgan: G485
JNOWUSSM Index (JPMorgan United States Smoothed Monthly Nowcast (SMN)) JPM Nowca Copyright© 2021 Bloomberg Finance L.P. 09-Jul-2021 14:28:16

Liquidity is still plentiful and, even if it is also slowing, it is not contracting. We think that the recent rise in risk aversion has rapidly translated into some quite sharp falls in longer bond yields. At one stage last week (Thursday 8th July), the 10-year US bond yield dropped to 1.25%, 30 basis points below the yield after the June Federal Open Market Committee (FOMC) meeting.

Bond yields elsewhere dropped, and virtually all developed world 10-year government bond yields are lower than a week ago by about 10 basis points (-0.1%). Interestingly, such moves have barely touched credit spreads, a situation which provides support for equities despite the slower growth expectations. Relative to corporate bonds, developed market equities look better value than they have done than at any time this year.

This is not true is in China. The slide in growth has been worrying, as much of it has been policy-induced. The sharp unwind of equity markets last week has come immediately after the 100-year Communist Party celebrations, and is fuelled by the authorities' compression of some large companies. Credit spreads have widened sharply here, unlike the rest of the world.

We had been expecting a reversal in policy direction, and so it came to pass when the People's Bank of China announced a further reduction in the capital banks need to provide for lending (known as the reserve requirement ratio). The rest of the year is likely to be a bit easier for a lot of the private sector, although perhaps not for companies or owners that become too visible.

Slower growth passages following on from the vibrant bounceback of opening up periods is to be expected. Market worries about central bank policies and declining liquidity growth are also likely to cause some volatility. It could be that a sharp feedback loop provokes worries about "wealth effects", especially in the US, where the more highly valued stocks are abundant.

However, we feel these worries are likely to prove temporary. Growth should stabilise at a strong level during the second half, buoyed particularly by an accelerating Europe. Global jobs growth should become entrenched at a strong level. Equities should remain well supported by continued upward earnings revisions, even if yields start heading somewhat higher again.

The greatest risks centre on hopes for continued global government policy support for investment in infrastructure, jobs markets and training. Investors have less scepticism than usual about governments' ability to drive the agenda, and the execution. There is no doubt such policies are needed, if profit and earnings opportunity are to generate growth above the insipid levels of the past decade. Markets are partially priced for such an outcome, and they could be disappointed.

A final note; we write about the private equity bidding for WM Morrison below. For the first time in a long time, a significant number of UK companies have begun to look more attractive in relative valuations than their European counterparts. This is important to private equity investors who have a lot of "dry powder" (their phrase for cash to waiting be deployed), and therefore currently find the larger targets to be quite attractive. Much depends on UK corporate bond yields remaining low but, should they do so, UK equities could see the end of this long period of under-performance.

We remain hopeful, and watchful.

Asset returns review: June 2021

Markets experienced another leg up in June, continuing a positive year for investors. It brings us to the end of another quarter in which good returns were found in almost all asset classes. In the first three months of this year, returns were plentiful but unevenly spread, with equities and riskier assets rallying while bonds struggled. Q2 was more equitable by contrast: investors holding more fixed interest bonds over equities also did well.

A calmer tone in bond markets was one of the big themes of the quarter. Rising yields and inflation scares marked the earlier part of the year, and the inflation story carried over into April and May. The negative effect higher bond yields would have on equities (by lowering their relative attractiveness) gave investors a sense of vertigo into early April, but as we progressed through the quarter markets came to terms with it. This was brought on by a sense that global growth is already cooling from a boil to a simmer. The previously booming US economy showed signs of slowing – albeit still to a decent level – while the growth drop-off in China was more pronounced than had been expected.

These dynamics had a big impact on currency markets. Expectations of a strong global recovery and inflation in the US had put downward pressure on the dollar beforehand, as investors became more confident about emerging markets and, particularly, the outlook for China's currency, the Renminbi (RMB). When the growth outlook moderated and China began to look weaker, those trends reversed. For international investors, China's deceleration was compounded by a sense of greater interventionism from the Communist Party. Beijing's clampdown culture is hardly anything new, but Q2 saw more intense pressure, not just in commodity markets but on currency selling and equities also. This attenuated growth expectations, as well as a pause in the RMB's long run of strength.

Slowing growth expectations pushed more risk-averse investors into safer assets over the last three months, favouring dollar assets – in particular the established large-cap US stocks. This benefitted the US tech giants the most, with the tech-heavy Nasdaq index recording one of the best performances in Q2.

The lessening of inflation fears was most visible in bond markets. Global bond yields peaked in the first half of Q2 before coming back down and settling at a stable level. This was essentially a calming of the global growth excitement, as well as a dissipation of monetary policy fears. Jitters came early on from a sense that central banks might be forced to raise rates or taper asset purchases sooner than expected, choking off the recovery just as it gets underway. Central bankers all over the world – but particularly the Fed – were eager to dispel these fears, reiterating that policy would remain supportive over the foreseeable future.

Nevertheless, last month we saw some indication that tightening is on the horizon. In its June meeting, the Fed signalled that a strong economy might allow it to move away from its emergency monetary support, with a rate rise coming possibly as early as 2022 – but more likely in 2023. This is sooner than markets had been expecting, and the news caused shorter-term US bond yields to rise while longer-term bond yields fell late in the quarter. This flattening of the yield curve is another signal of tempered growth expectations – though we cover the talk of policy tightening in a separate article below.

Even with the global economy coming off the boil, the macroeconomic environment still looks positive, particularly for developed markets. This can be seen in corporate bond spreads (the difference between government yields and corporate yields) which declined again and are heading to historic lows.

The end result of these moves has been a fickle mood in capital markets. We seem to be flip-flopping between the supposed 'Great Reflation Trade' and a return to the slow-but-steady outlook of the pre-pandemic world. The former favours cyclical assets, emerging markets and value stocks, while the latter favours bonds, growth stocks and the US tech giants. This indecisiveness has carried over into the second half of the year, and sentiment could quickly shift over the coming months.

On the positive side, the return of dividend pay-outs is a welcome sign along the road back to normal – giving positivity to the banking sector in particular. The early rally in commodities was another signal of normalisation in Q2, but this later fell back after China's efforts to curb what it sees as excessive speculation. Interestingly, the calming of reflation hopes seems not to have affected oil prices, which continued to rally throughout the quarter.

The rise of the Delta variant was perhaps the main public scare story, threatening the promised end to the pandemic. Fortunately, as the recent spike in British cases has shown, Delta outbreaks look much less worrying for countries with high vaccination rates. But developing countries, which have received far less of the vaccine stockpile than richer nations, are rightfully concerned. Emerging markets subsequently underperformed, hit with a double whammy of virus pessimism and tightening conditions in China.

This is perhaps another factor in the dampening of reflation hopes. In all, though, the outlook from here looks positive. Economic indicators are still high, albeit not at the astronomical levels we have seen before. Things are rolling over but that, after all, is what normalisation is about.

Asset Class	Index	June 2021	Q2 2021	YTD 2021	Last 12 months	2020	3-yr rolling annualised	5-yr rolling annualised
Equities	FTSE 100 (UK)	0.4	5.7	10.9	18	-10.2	1.1	5.6
	FTSE4Good 50 (UK Ethical Index)	-0.1	4.4	7.7	11.6	-13.2	-1.3	2.3
	MSCI Europe ex-UK	1.8	7.7	10.4	21.8	8.8	10.4	10.5
	S&P 500 (USA)	5.0	8.4	14.0	25.9	14.5	16.9	16.9
	NASDAQ (US Technology)	8.6	9.5	11.7	29.9	40.9	25.7	25.8
	Nikkei 225 (Japan)	2.6	-0.4	0.2	11.7	11.4	7.3	11.9
	MSCI All Countries World	4.3	7.3	11.1	24.6	13.0	14.6	14.6
	MSCI Emerging Markets	3.1	4.9	6.3	26.0	15.0	11.3	13.0
Bonds	FTSE Gilts All Stocks	0.7	1.7	-5.7	-6.2	7.9	3.0	2.0
	£-Sterling Corporate Bond Index	0.9	1.9	-2.5	2.9	8.4	5.4	4.7
	Barclays Global Aggregate Bond Index	2.0	1.2	-4.2	-8.2	6.3	2.7	1.7
Commodities	Goldman Sachs Commodity Index	7.3	15.6	30.0	40.8	-26.0	-2.7	1.7
	Brent Crude Oil Price	11.7	18.8	42.5	61.7	-23.9	-2.0	8.5
	LBMA Spot Gold Price	-4.4	4.7	-7.5	-10.7	20.8	12.0	5.9
Inflation	UK Consumer Price Index (annual rate)*	1.2	1.2	1.5	2.0	2.1	-	-
Cash rates	Libor 3 month GBP	0.0	0.0	0.0	0.1	0.5	0.6	0.5
Property	UK Commercial Property (IA Sector)*	0.2	0.6	0.6	0.1	-3.2	-0.8	1.8

Source: Morningstar Direct as at 30/06/21. * to end of previous month (31/05/21). All returns in GBP.

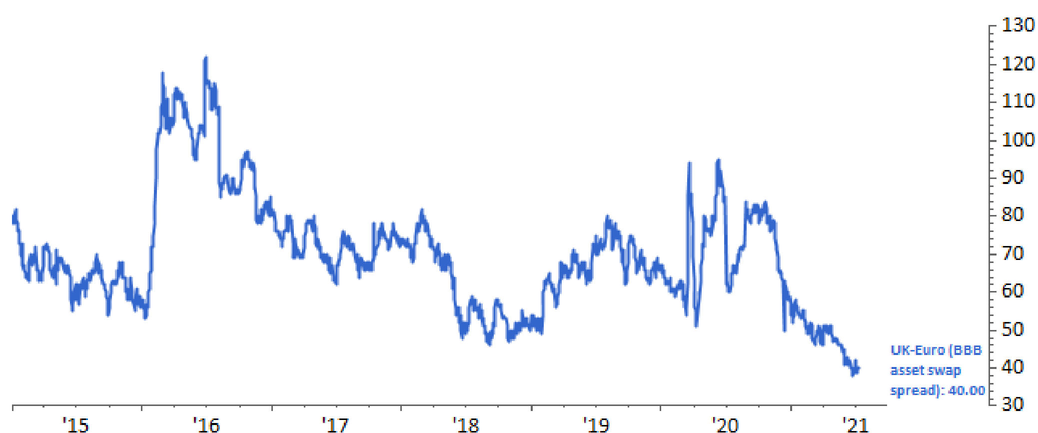
Private equity gets a good deal on UK plc

After weeks of courtship, supermarket chain Wm Morrison has at last picked a suitor. That's the official story at least. Morrisons began as a Bradford-based grocer, but after buying the Safeway chain of nationwide stores it expanded beyond Yorkshire to become the fourth supermarket chain behind Tesco, Sainsbury, and ASDA. Last week, a trio of private equity groups, led by the aptly named Fortress, struck a £9.5 billion deal to end the bidding war. The price accepted by the Morrisons board was a 42% mark-up from the company's share price before the takeover bidding began.

The bidding war was started by US private equity firm Clayton, Dubilier and Rice, which made a 230p per share offer last month. Morrisons stock surged after the "unsolicited" takeover attempt. The private equity group within Fortress (which is itself owned by SoftBank), then made their bid, joined by Canadian pension fund CPPIB and a division of Koch Industries. The accepted deal will see the private equity group pay 252p a share along with a 2p special dividend, valuing Morrisons' equity at £6.3 billion.

Bondholders, with £1.1 billion outstanding of Morrisons current debt of around £3 billion value, fared decidedly less well. The change of control and credit rating downgrade covenants are likely to be triggered on these issues, which sounds like a protection but really isn't. Indeed, the bonds would be redeemed early but only at a price of 100. For the 4.75% 2029 bond, this means that all of its premium is effectively lost, even more so than if the bond were to be just plain downgraded but not redeemed. The price fell from over 122 to below 105.

The credit side of the story may be the reason why private equity buyers have become much more interested in UK stocks. On 23 June, as part of the post-Walmart restructuring, the private equity owners of ASDA issued new debt. It was well received and signalled international investor appetite for riskier sterling debt. This marked a move towards normalisation in international credit markets after the post-Brexit vote period where UK credits were deemed riskier than their European and US counterparts.



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UK stocks have had lower price-to-equity ratios (put it another way, higher earnings yields) than their European counterparts for a long time, but that was offset by higher sterling corporate bond yields. The shift in relative markets has changed that in the past quarter.

For companies such as Morrisons, with good cashflow and other assets, this provided an incentive for private equity to move quickly. The saga is not quite over yet though. Some of Morrisons' shareholders have been pressuring the board to hold out for an offer closer to 270p a share, and other private equity buyers remain interested. Board members will be hoping that publicly accepting an acceptable bid will spark a more intense bidding war. Apollo Global Management, which lost out in the battle for rival chain Asda last year, has already announced it might make an offer, while CD&R is still weighing up a counterbid. There are even suggestions that Amazon – who partner with Morrisons for their British grocery operations – might be tempted into a bid.

Then there is the political hurdle. Morrisons has 122 years of history, and thousands of employees across the country, and politicians are anxious about what foreign private equity groups might do with it. Business secretary Kwasi Kwarteng is expected to meet Morrisons chair Andrew Higginson in the next few weeks, where he will ask for assurances on jobs, pensions and general operations. Legal & General Investment Management – a large shareholder in Wm Morrison – has publicly warned of what a takeover could mean. Private equity groups have a history of stripping their purchases of property and other assets, as well as piling them up with large amounts of debt.

On their part, Fortress and its backers have been at pains to dispel such fears. As part of the agreement, the investors agreed to safeguard pensions, keep the chain's headquarters in Bradford and maintain its £10 an hour minimum wage. It also played down suggestions it would sell off the supermarket's impressive property portfolio, with Fortress claiming that selling and leasing back Morrisons stores was not part of its plans.

If Fortress keeps its word, this would mark a change from the usual gameplan – and a surprising one in an era where investors are increasingly reluctant to take on ownership of large retail properties. It begs the question of why private equity investors are so interested in the supermarket chain and, more importantly, why they are interested *now*.

Morrisons is a fairly straightforward business proposition. Despite being unable to compete on the same scale as Britain's larger supermarket chains, its revenues and market share have been extremely stable in recent years. It is also a model of vertical integration: The company owns 85% of its stores, as well as a host of manufacturing and supply-chain assets. Under private ownership, these can all be levered while maintaining a dependable stream of income.

These factors were not enough to tempt private equity firms when the company went looking for suitors in 2014, however, and not much has changed about its business operations since then. What has changed is the wider circumstances. Coming out of the pandemic, Britain and the wider world are on the cusp of strong growth and inflation. Meanwhile, central banks are still pinning down interest rates and pumping out liquidity at historic levels. Money is cheap and growth prospects are high – but for how long no one is sure.

So, Britain's businesses represent a unique opportunity. Brexit uncertainties and subsequent sterling volatility have weighed down UK assets – particularly domestically-focused ones – for half a decade. The pandemic only compounded these issues, with Britain one of the worst hit nations in the world in both

health and economic terms. Investors' reluctance to buy anything with a pound sign has left UK plc looking mighty cheap compared to global peers. The FTSE 250 is currently trading at around 16.1 times next year's earnings expectations, while that figure is at 20.4 for the S&P 500 and 18.9 for the MSCI World Index.

Private equity firms see the stock market's loss as their gain. The UK has cheap companies and some of the highest medium-term growth expectations in the developed world. By gobbling them up they have an opportunity to restructure and profit away from the spotlight of public markets. A total of 345 buyout bids have already been launched for British businesses this year, 13 of them for listed companies. And there is surely more to come, with reports suggesting that Sainsbury's, Kingfisher and Marks & Spencer are prime takeover targets.

For US private equity buyers, there is a particular sense of urgency. Anxieties around when and how the Fed will change its course are encouraging firms to take money while they can. More pressingly, Joe Biden's proposed tax changes mean such deals are likely to be less profitable for financiers in the near future.

Private equity groups have a unique ability to cherry-pick when it comes to undervalued businesses, and UK plc has many that look ripe for picking. Politicians and public investors have many legitimate gripes with how they do so, and the effect it has on industry. It would therefore be no surprise if regulatory changes limited private equity's purchasing power in the future. But for now, this will only increase the urge to buyout British companies. We should expect more offers where Morrisons' came from.

CAMBRIDGE
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12th July 2021

Global Equity Markets

Market	Fri 15:23	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6919	+3.1	+205	↗	↗
FTSE 250	22190	+3.1	+672	↗	↗
FTSE AS	3948	+3.1	+117	↗	↗
FTSE Small	6978	+2.9	+198	↗	↗
CAC	6164	+1.6	+97	↗	↗
DAX	15221	+1.4	+213	↗	↗
Dow	33585	+1.3	+432	↗	↗
S&P 500	4102	+2.1	+83	↗	↗
Nasdaq	13796	+2.3	+316	→	↗
Nikkei	29768	-0.3	-86	→	↗
MSCI World	2896	+1.9	+54	⬀	↗
CSI 300	5035	-1.5	-75	↘	↗
MSCI EM	1343	+0.4	+5	↘	↗

Top 5 Gainers

Company	%
AVEVA	+10.1
Persimmon	+9.9
JD Sports Fashion	+9.9
Pershing Square Holdi	+8.6
Anglo American	+8.3

Top 5 Decliners

Company	%
Royal Dutch Shell	-1.4
Flutter Ents	-1.4
BT	-1.0
Aviva	-1.0
Stan Chartered	-0.4

Currencies

Pair	last	%1W
USD/GBP	1.373	-0.7
GBP/EUR	0.866	-1.8
USD/EUR	1.19	+1.1
JPY/USD	109.60	+1.0
CNY/USD	6.55	+0.2
Bitcoin/$	58,167	-0.9

Commodities

Cmdty	last	%1W
Oil	62.92	-3.0
Gold	1742.1	+0.8
Silver	25.20	+0.8
Copper	406.1	+1.8
Aluminium	2282.5	+2.3
Soft Cmdties	417.9	+1.4

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	20.7	14.4	14.0
FTSE 250	1.8	18.4	22.0	15.4
FTSE AS	3.1	20.2	15.2	14.2
FTSE Small x Inv_Tsts	1.4	20.1	-	15.0
CAC	1.7	24.6	18.4	14.6
DAX	2.3	22.7	16.7	13.3
Dow	1.8	23.3	21.5	16.1
S&P 500	1.4	29.0	23.5	17.2
Nasdaq	0.7	35.9	34.4	22.2
Nikkei	1.3	27.7	21.6	17.5
MSCI World	1.7	26.6	21.3	16.2
CSI 300	1.7	18.3	13.7	12.4
MSCI EM	1.9	20.4	15.4	12.4

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.78	-0.01
UK 15-Yr	1.14	-0.02
US 10-Yr	1.65	-0.07
French 10-Yr	-0.04	+0.04
German 10-Yr	-0.30	+0.03
Japanese 10-Yr	0.11	-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

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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.

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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