CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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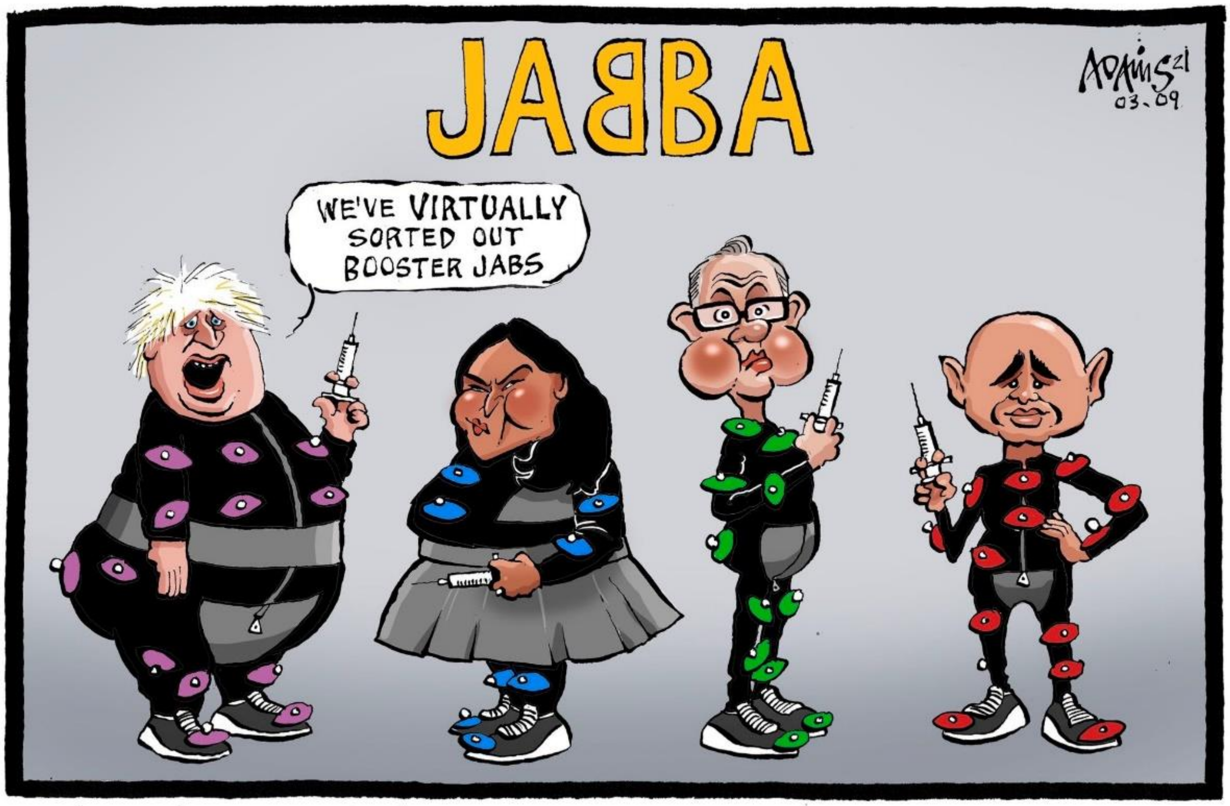


Booster jabs and ABBA Christian Adams, 3 September 2021

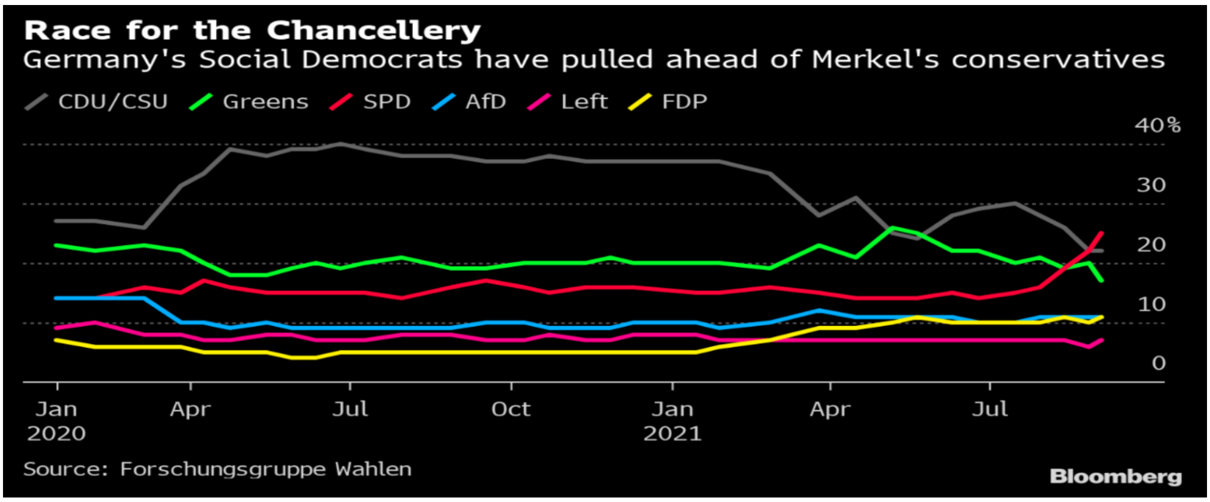
Politics and policy sit at the head of the table

Last week felt a bit like the whole month of August. Equity markets (North America and Europe) were in the green, and then last Friday expressed their disappointment over the weak US jobs report. Market participants discovered yet again their taste for cash-rich mega-caps in the US, especially after the previous week's Jackson Hole symposium. US Federal Reserve (Fed) Chair Jerome Powell made clear that tapering would happen in the foreseeable future, but was not hawkish in terms of timetable or pace. As we explained last week, much more depends on how the Fed chooses to scale back its security purchases, and less on the precise start date. Last Friday's US jobs report revealed the US economy created just 235,000 jobs in August, a steep decline on the 1.1 million created in July, and short of economist expectations by over half a million. The numbers appear to confirm that the US economy is still in a repair phase, which speaks in favour of a softer stimulus withdrawal. And, while Fed liquidity is important, the focus will firmly remain on fiscal support packages going forward.

Eurozone yields picked up as hawkish European Central Bank (ECB) members positioned themselves for their policy meeting this week. Their debate will focus on tapering the ECB's own Pandemic Emergency Purchase Programme (PEPP). We note that the PEPP is currently limited to EUR 1.85 trillion, so is not as open-ended as the Fed's initiative.

Europe, of course, has another significant event to look forward to. In three weeks, Germans will go to the polls, and the outcome of this year's federal elections could not be more open. For the past 16 years under Chancellor Angela Merkel, the biggest question facing the German electorate was which party would become the coalition junior partner. This time it looks like three parties will form the next government, with several combinations available.

The Social Democratic Party of Germany (SPD) has staged a rather phenomenal comeback, thanks to its leader Olaf Scholz, who enjoys the highest approval rating of all the candidates.



Several three-party coalitions are possible and, according to current polls, the options revolve around the SPD or Merkel's party, the Christian Democratic Union (CDU). The accepted wisdom is that the Green Party is likely to be part of the coalition, especially if the SPD refuses to team up with the CDU again. This means smaller parties may play the role of kingmakers, particularly the Liberal Free Democratic Party, which famously pulled out of coalition negotiations four years ago, or the socialist Die Linke ('The Left') party. The likely coalition options are as follows:

- SPD + FDP + Greens
- SPD + Die Linke + Greens
- CDU + FDP + Greens
- SPD + CDU + FDP

Negotiations are likely to be drawn out well beyond the results day, but much of the pre-election sabre rattling should give way to pragmatism. Still, there are a few key themes, the first being the debt brake that ensures public finances stability. The Greens would reform to include an exemption for structural investment needs. The FDP is less enthusiastic, and would not want to see higher taxes. Also, while the SPD could be seen as left-leaning, it's worth keeping in mind that Olaf Scholz belongs to the conservative wing of the party, and may be less in favour of full-swing Keynesian spending policies. Die Linke's main theme is that it wants to dissolve NATO, a rather sensitive topic in Germany.

What's the most likely post-election market impact? There may be a knee-jerk short-term reaction that then gives way to 'business as usual' as coalition negotiations kick-off. But as was clear with the Brexit result and the Trump tax cuts, policies do make an impact as they slowly feed into the economy.

Fixed income markets will be most sensitive to German spending programmes, and their bearing on the deficit. The German equity market depends much less on domestic consumption; hence the focus will be on corporate friendliness designed to ensure that exports can thrive. Traditional measures would be taxes and regulation, although the climate change debate means that a push towards an innovative policy framework with clear guidelines is increasingly important. The jury is out on which coalition combination will be most apt to respond to the challenge. But we do know that the Dax30 will expand its membership to ten more entrants in September – we discuss the changes in a separate article.

China's regulatory drive has been relentless in recent months, and the crackdown continued last week. Authorities summoned the most prominent members of ride-hailing platforms – such as Didi and Meituan – and warned them that unfair customer and employee practices needed improvement. The overall stock market impact was muted though, most likely as price-earnings ratios are already relatively depressed, and markets are starting to get used to the meaning of China's "common prosperity" drive.

But arguably, the most surprising political development last week was that Japan's Prime Minister Yoshihide Suga resigned over the government's COVID handling. Two former foreign ministers are in the race to replace him. Equity markets viewed this as a positive, calculating that it would increase the chances of additional fiscal stimulus. This may just bring us back to our opening thoughts – just as peak growth momentum wanes, policy stimulus is getting withdrawn, even if it is from exceptional levels. The business cycle will surely continue, but the transition phase can be tricky, especially for markets with elevated valuations.

August market review: plenty for markets to think about

Asset Class	Index	August	YTD	12 months	2020	3-yr rolling annualised	5-yr rolling annualised
Equities	FTSE 100 (UK)	2.1	13.3	23.6	-10.2	2.4	5.0
	FTSE4Good 50 (UK Ethical Index)	1.0	8.6	16.3	-13.2	-0.3	1.6
	MSCI Europe ex-UK	2.7	15.1	26.2	8.8	11.1	10.4
	S&P 500 (USA)	4.1	20.8	27.6	14.5	15.8	16.9
	NASDAQ (US Technology)	5.1	18.1	27.0	40.9	24.6	25.2
	Nikkei 225 (Japan)	4.1	2.4	16.7	11.4	7.3	10.4
	MSCI All Countries World	3.6	15.1	25.2	13.0	14.3	14.3
	MSCI Emerging Markets	3.7	2.1	17.8	15.0	9.9	10.4
Bonds	FTSE Gilts All Stocks	-0.8	-3.8	-1.8	7.9	3.8	1.5
	£-Sterling Corporate Bond Index	-0.1	-1.3	3.1	8.4	5.6	3.2
	Barclays Global Aggregate Bond In	0.6	-3.0	-2.2	6.3	2.6	1.5
Commodities	Goldman Sachs Commodity Index	-1.3	29.5	40.0	-26.0	-2.1	3.3
	Brent Crude Oil Price	-4.0	37.3	53.9	-23.9	-2.6	8.8
	LBMA Spot Gold Price	0.3	-5.7	-10.7	20.8	14.6	6.7
Inflation	UK Consumer Price Index (annual r	0.5	1.9	2.5	2.5	-	-
Cash rates	Libor 3 month GBP	0.0	0.0	0.1	0.5	0.5	0.5
Property	UK Commercial Property (IA Secto	1.4	2.4	2.1	-1.4	-0.6	2.5

Source: Morningstar Direct as at 31/08/21. * to end of previous month (31/07/21). All returns in GBP.

And just like that, the much-awaited summer is over. In the UK, as in the rest of the developed world, the mood was a little mixed. While the lifting of restrictions and rapid vaccination programmes seemed to give the public a much-needed boost, the equally rapid spread of the Delta variant caused great concern, and dampened the optimism built up in the spring. The Great British sunshine was notably milder in August than in July, a trend reflected in capital markets. Global equities climbed for a seventh consecutive month, with the MSCI World index posting a 3.6% gain in sterling terms. But this was partly down to currency effects, after sterling dropped in value against its major peers. In US dollar terms, global equities climbed a more modest 2.5%, showing steady if unspectacular returns.

Economic data was strong in the developed world. The restrictions that hampered activity for over a year continued to fade, supporting the strong recovery seen earlier in the year. Non-farm payrolls released at the beginning of the month showed the US economy added 943,000 jobs in July, the strongest figure in 11 months. Wage growth and inflation both strengthened too, adding to widespread reports of labour and supply shortages.

The UK posted similarly strong jobs data, with employment intentions and vacancies at record highs. Europe had a slower opening process than Britain or the US, and was therefore behind in growth terms. But August's data showed businesses are confident and inflation is strong.

These are all positive signs, but they are ultimately backwards-looking. More current data – business confidence surveys – showed the global economy coming off the boil. Purchasing managers indices (PMIs) recorded less positive figures in the US and UK, suggesting we have passed peak growth. Europe seems to be at its peak now.

This effectively confirms what investors already knew: the global recovery is strong but no longer improving. The added complication is the spread of the Delta variant, particularly now in emerging markets, where low vaccination rates make many countries vulnerable. When you combine these factors with the recent policy drama in China, investors could be forgiven for being nervous.

Even so, risk appetite was strong in August. All major equity indices posted positive returns in sterling terms, while government bond yields edged slightly higher. The US was once again the standout, with a 4.1% gain for the S&P 500 and a 5.1% gain for the technology-heavy Nasdaq. These results leave the S&P up 20.8% year-to-date, ahead of the 15.1% gain for the MSCI World.

The performance of the US tech giants was particularly impressive. After being the stock market darlings in 2020, high growth expectations pushed investors into smaller companies earlier this year. With growth expectations now waning and investors still eager to buy equities, tech stocks have reaped the benefit.

Growth stocks – and indeed equities more generally – also got a big helping hand from policymakers. US Federal Reserve (Fed) Chair Jerome Powell used his speech at the Jackson Hole conference of central bankers to strike a dovish tone last week. This calmed investors worried about the Fed's policy intentions. It will continue its extensive asset purchase programme for the foreseeable future, and there is still little sign of tapering any time soon.

The Fed is happy with the data it is seeing, and policymakers still believe the inflation pressures seen this year are transitory. Powell puts the price increases down to temporary factors from the recovery, such as the multitude of global supply bottlenecks. He also emphasised that the Fed's timeline for winding down its asset purchases is different to that for rate rises. Nevertheless, Fed officials expect the labour market to soon reach a point where it would justify tapering.

As we wrote last week, this should not necessarily worry investors. Based on our own analysis of equities, credit markets and bond yields, a slight rise in yields would not be so bad. In other words, capital markets can handle a little bit of tapering, so it is no surprise to see Powell suggesting it could happen soon. We will hear more at the Fed's meeting later this month, where officials will unveil their plans and latest forecasts.

Fiscal policy also proved supportive in August. The US Senate passed a bipartisan infrastructure bill containing $550 billion of new spending – which will now pass to the House of Representatives for further debate. House Democrats are reluctant to support it unless it is attached to Biden's much larger $3.5 trillion fiscal package. That could prove a hard sell, but the news is still positive. Whatever the case, the US is set to receive a big fiscal investment boost soon. The only question is how big it will be.

Commodity markets were a different story. Despite some impressive gains earlier in the year, the main US oil benchmarks fell in August, while other major commodities similarly struggled. This seems to be down to slowing demand from China, and the rapid spread of Delta across the developing world. This could well act against the inflation pressures we have seen throughout the year, and may end up being supportive for global growth.

All in all, August had little to surprise capital markets. There are certainly positive signs out there, but a turning over of growth, and the latest twist in the pandemic, could make things difficult for the rest of the year. Markets have upside left to find, but we should be prepared for choppy times ahead.

Germany's Dax goes for growth

The German stock market is getting a much-needed makeover. From mid-September, Germany's benchmark equity index – the Dax – will expanded from 30 constituents to 40. The old guard will be joined by the next ten largest German companies by market capitalisation, but only if those businesses meet the index's new profitability requirement. To get into Germany's elite club, new companies will need to have two years of positive earnings before tax and other deductibles. It should be a big boost for the new boys (if only on the branding side), though none have been officially confirmed yet. The list is likely to include established names like Airbus and Porsche, as well as newer firms such as Hello Fresh and Zalando.

The increase was decided last year, after index operator Deutsche Börse launched a consultation into the makeup of the benchmark. The consultation was itself a response to the PR disaster following the collapse of Wirecard. The payments company had elbowed Commerzbank out of Germany's top 30 only two years prior, only for its fraudulent practices to bring it crashing down in 2020. With so few constituents, the credibility of Dax was badly hurt by Wirecard – forcing Deutsche Börse to ask businesses what they would like to see changed.

There were some bold suggestions. Environmental, social and governance (ESG) criteria were proposed, in a bid to turn Germany's stock market green. At the other end of the spectrum, some participants floated the idea of letting in weapons manufacturers – currently banned from the index. Ultimately, Deutsche Börse went for the relatively conservative option of widening the index. This is evidenced by the fact that profitability rules will not apply to existing Dax members, while newer high growth companies – like Wirecard's replacement, Delivery Hero – would find entry harder.

Investors are nevertheless welcoming the change. Indeed, many see it as a much-needed modernisation. Wirecard's collapse may have prompted some soul searching in Germany's financial centres, but investors have long had complaints about the Dax. At just 30 companies, Germany's main benchmark has fewer members than those of France, Italy and Spain – and less than a third of the FTSE 100. That is despite the German economy being comfortably the biggest in Europe.

That narrow range of stocks makes the Dax much less reliable as an indicator of the German corporate culture. Together with lax governance standards, the index had been very susceptible to the troubles of individual companies – as Wirecard amply demonstrated. More companies, and greater standards, should therefore make it a better reflection of Germany.

The inclusion of smaller companies is another positive in this regard. An index too focused on established companies can fail to capture the growth and dynamism that mid- to small-cap businesses bring. And, given that markets have rewarded growth so handsomely in recent years, Deutsche Börse will be eager to benefit from it.

There is a danger in overstating these changes, though. Deutsche Börse has been criticised for not going far enough. While new members have to meet governance standards, in practice this means appointing an audit committee – something already required by German law. Also, according to corporate governance advocate Christian Strenger, the rule on profit figures "is too far away from real profitability", adding that it is "a missed opportunity in many ways".

Broader indices are generally better diversified, and therefore more likely to benefit from overall economic growth. But many of the touted new Dax members are subsidiaries or spin-offs of existing companies. For example, Siemens Healthineers, a recent spin-off of existing Dax 30 member Siemens, is likely to be added. Moreover, there are likely to be quite a few members of the Siemens family in the index: Siemens AG, Siemens Energy AG, while Infineon is a Siemens spin-off dating back to 1999. Equally, Porsche SE owns a majority stake in Volkswagen, and the Mercedes spin-off into Daimler Trucks could also make an entrance. So, some Dax family members will already know each other quite well.

That said, including smaller spin-offs is still better than not including them, and it gives more variety to the index. And to be fair, there are a few genuine newcomers, as we have noted. By the same token, any small-cap companies added to the large-cap index effectively means subtracting them from smaller indices. The MDAX index – which tracks the performance of Germany's mid-cap companies – will see its top ten members leave for the big leagues and will in future have just 50 members instead of 60.

All of this is to say that the equity reshuffle is ultimately just a small step for German investing. Membership is expanding and entry rules are being updated, but the current milestone is neither the beginning nor the end of Germany's financial modernisation. The process began last year with much bolder proposals, and more changes are certainly ahead, and the investment universe at large will be forced to come to terms with broad and pressing topics such as ESG and climate change.

We can still draw positives though. Tracking the Dax will reflect better the corporate base in Germany. The fact that the index will rebalance twice a year will also make it more attractive, as it means the index can incorporate performance changes more quickly. And, of course, in theory, smaller growth companies are meant to deliver superior returns. This can mostly be seen in Europe, especially when big cap belongs to traditional sectors such as auto, materials or pharma.

This observation also serves as a good reminder that US mega-caps have been bucking this trend over recent years. Platform and tech companies have expanded quickly, and cash-rich large-cap companies have outperformed their smaller counterparts. This rush into 'quality' companies has also seen a revival in Q2 of this year. As seen in the chart above, the S&P 500 has outperformed the Dax and MDax alike since the beginning of 2018.

So, updating an index structure is always welcome, but the most important feature of any index remains its constituents, and the wider performance of corporates in Germany.

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6th September 2021

Global Equity Markets

Market	Fri 13:08	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7176	+0.7	+51	⬀	↗
FTSE 250	24224	+1.1	+271	↗	↗
FTSE AS	4140	+0.8	+33	⬀	↗
FTSE Small	7642	+1.0	+77	↗	↗
CAC	6731	+0.7	+49	↗	↗
DAX	15849	-0.0	-3	→	↗
Dow	35444	+0.7	+231	⬀	↗
S&P 500	4537	+1.5	+67	↗	↗
Nasdaq	15331	+2.6	+385	↗	↗
Nikkei	29128	+5.4	+1487	↗	⬀
MSCI World	3161	+0.9	+28	↗	↗
CSI 300	4843	+0.3	+16	⬂	⬀
MSCI EM	1312	+3.1	+39	⬂	⬀

Top 5 Gainers

Company	%
Renishaw	+7.5
Weir/The	+5.9
St James's Place	+5.4
Ferguson	+4.1
British Land	+3.9

Top 5 Decliners

Company	%
B&M European Value Retai	-5.6
J Sainsbury	-4.9
Admiral	-4.7
BHP	-4.4
BT	-3.5

Currencies

Pair	last	%1W
USD/GBP	1.383	+0.5
GBP/EUR	0.858	+0.2
USD/EUR	1.19	+0.7
JPY/USD	109.93	+0.1
CNY/USD	6.45	-0.4
Bitcoin/$	50,219	+2.6

Commodities

Cmdty	last	%1W
Oil	73.46	+1.0
Gold	1815.5	-0.1
Silver	24.10	+0.3
Copper	428.0	-0.9
Aluminium	2695.0	+3.0
Soft Cmdties	487.7	+0.6

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	15.6	12.7	14.2
FTSE 250	2.2	17.9	25.4	15.9
FTSE AS	3.6	15.8	13.8	14.3
FTSE Small x Inv_Tsts	1.8	14.8	19.5	15.4
CAC	2.1	21.7	16.4	14.9
DAX	2.3	14.8	14.6	13.5
Dow	1.7	20.0	19.2	16.4
S&P 500	1.3	25.6	22.3	17.6
Nasdaq	0.6	31.8	33.1	22.9
Nikkei	1.5	15.6	17.6	17.7
MSCI World	1.7	22.3	20.3	16.6
CSI 300	1.9	15.9	15.1	12.5
MSCI EM	2.2	14.5	13.7	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.69	+0.12
UK 15-Yr	0.91	+0.04
US 10-Yr	1.29	-0.01
French 10-Yr	-0.03	+0.04
German 10-Yr	-0.38	+0.04
Japanese 10-Yr	0.04	+0.02

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.30	1.37
3-yr Fixed Rate	1.52	1.60
5-yr Fixed Rate	1.48	1.56
10-yr Fixed Rate	2.60	2.60
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

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

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6th September 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.

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