THE **CAMBRIDGE** WEEKLY

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Lothar Mentel

Lead Investment Adviser to Cambridge

MATT

'I've liked coming back in and seeing colleagues, but I feel I got more done working from home'

The return to the office, Matt, 7 September 2021

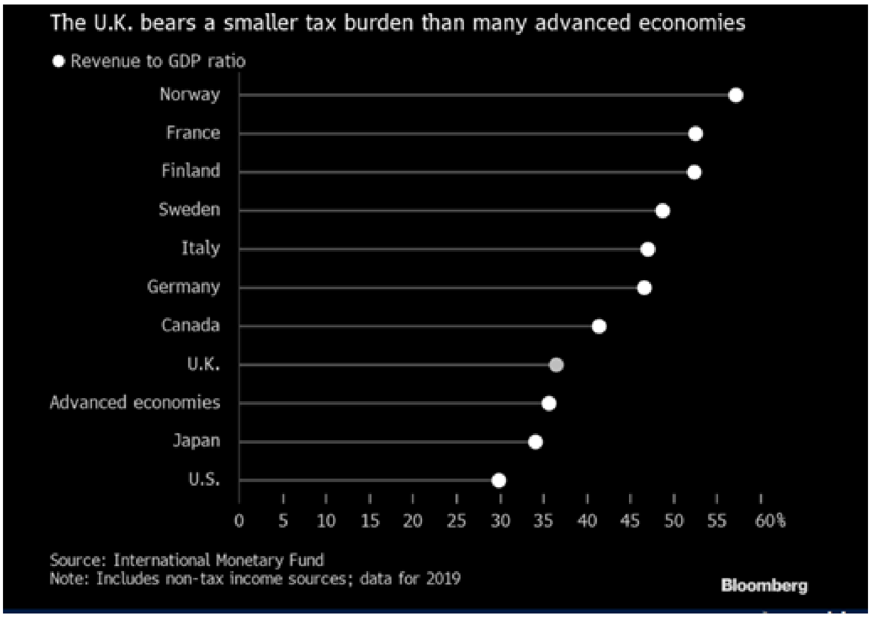
Paying for it - the major economies ponder their balance sheets

Recently we noted the increasing importance of fiscal policy, and sure enough last week the UK kicked-off the new school year with a big fiscal bang. National Insurance contributions are on the rise, along with a further tax charge on dividends to fund the NHS and social care over the next few years.

The trigger may have been the current COVID stress the NHS is under, but fundamentally this is a structural move. Across the global, healthcare systems and provisions for the elderly are under strain, as populations age and people live longer. In principle, we are in favour of government efforts to tackle these shortcomings. For the UK though, the grade for artistic execution is a bit underwhelming.

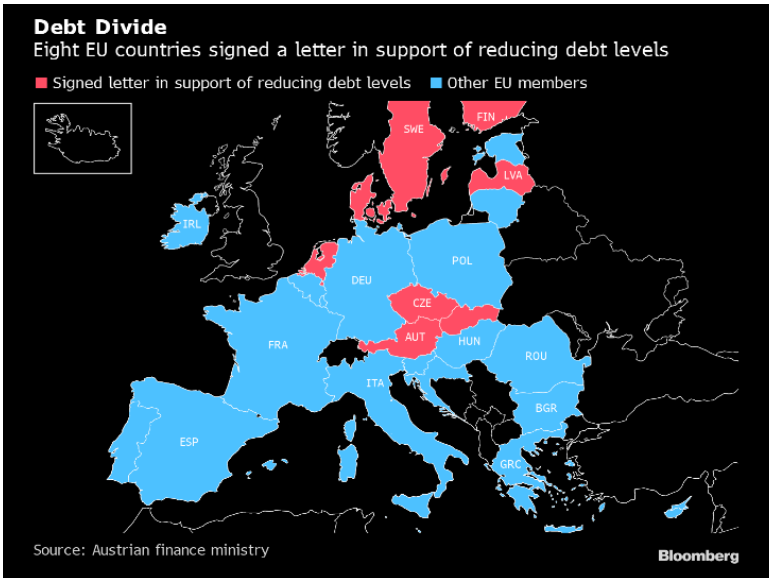
The UK government's measures are predominantly based on financial shifts – tax more to spend where needed. There is little intrinsic reform of the system. A debate about increasing efficiency in the NHS did not even take place. The social care reform predominantly targets financial aspects, and after the 2017 election debacle (when Theresa May's social care policy and subsequent u-turn caused "chaos and confusion"), owning a house keeps its advantageous status in the means testing exercise. So, we can forgive the younger, employed 'generation rent' population for feeling unfairly targeted yet again. Admittedly, taxes on dividends will rise too, although some companies could offset this with stronger share buyback schemes.

Generally speaking, the fiscal move bucks the 'smart austerity' trend which emerged after the global financial crisis and Eurozone debt crisis, whereby balancing the books should go hand-in-hand with structural reforms. Tax-and-spend feels somehow very continental European, even if in an international comparison, the UK tax burden is still relatively low, as the chart below shows.



More importantly, on a global basis, spending debates dominate, which keeps injecting nervousness into financial markets. In the middle of putting together multi-year spending packages, US Treasury Secretary Janet Yellen warned the US could run out of cash in October, after it hits the debt ceiling. Raising the debt ceiling is yet another political battle between Republicans and Democrats, as Republicans do not agree with the Democrats' plan to spend $3.5 trillion on social care. For now though, US fixed income markets have kept their calm – most likely assuming a compromise can be found.

Even European markets found some calm after a turbulent September so far for fixed income and equities. At last Thursday's news conference, following its monthly meeting, European Central Bank (ECB) President Christine Lagarde assured participants "the Lady isn't tapering" and postponed the debate around withdrawing stimulus programmes to December. Sure enough, another debate is kicking off, around the European Union's (EU) famous Stability and Growth Pact, which stipulates the criteria for debt sustainability. The European Commission will launch a review process, and countries will position themselves in the run-up. Smaller nations have already reacted and placed themselves firmly in the camp of debt reduction by sending a letter (see image below), whilst other suggestions revolve around the idea of excluding green investment spending from the fiscal criteria. For markets, the impact can range from negative or neutral to positive – provided the latter can be seen as efficient investment spending which ultimately improves productivity (something notoriously lacking for several years).



In the more immediate future, equity markets are preoccupied with the issue of supply constraints, where perception has moved on from it being a purely inflationary phenomenon, to a factor weighing on earnings. Indeed, US coatings producer PPG withdrew its earnings guidance for Q3 and full-year 2021, as disruptive commodity supply and patchy client demand from those impacted by chip shortages render the near-term too uncertain to call. Meanwhile, the CEO of Dutch paint company, Akzo Nobel, topped this uncertainty up by stating: "If you want to do some work around the house, get in the car and buy paint right now," as well as suggesting the raw material shortage "will probably be with us deep into the first half of 2022". While we keep underlining that this is a temporary phenomenon, the S&P materials index is down 1.6% on the week. We talk about the long-run outlook and effects of 'new' commodities in a separate article below.

Connecting the dots, markets are still focused on the themes of elevated valuations, an air pocket in economic growth and the removal of monetary stimulus. The Bank of England (BOE) presented itself again as a front-runner, with the market believing Governor Andrew Bailey's comments last week are all but good enough for pricing in a rate hike next year. At the same time, we see little evidence of an end to the business cycle. The long-run fiscal outlook, and economic investment activity, will be shaping the nature of long-run asset performance. It looks like the UK is adopting more of a conservative stance than Europe and the US, but we'll wait for the UK's Spending Review and Budget on 27 October for confirmation.

Commodities transition presents new challenges

The economic recovery has been good to commodity traders. This is seen in oil prices which, after sinking to extreme lows in early 2020, have gone from strength to strength – buoyed by hopes of rebounding global economic activity and supply constraints. But commodity gains extend well beyond oil prices. In fact, the pandemic has accelerated the global shift toward renewable energy, with politicians and pundits lauding the 'green recovery'. Technology, research and innovation are being directed toward this transition – to the great benefit of the commodities needed in green tech.

Changing regulation and a raft of green infrastructure projects are providing huge demand for raw materials – particularly battery minerals such as lithium (lithium-ion for electric vehicles). Unlike with oil, price moves in this sector are supported by structural factors that will persist over the long-term. We are used to oil demand being the main indicator of global economic activity, but that will not be the case forever.

A great deal of attention has been paid to what the green shift might mean for prices of different commodities. Policymakers have also started worrying about 'stranded' assets (like those related to oil) which will steadily drop in value down to zero – posing a threat to the wider financial system. But less emphasis has been placed on what it means for global supply chains. This is a critical question, because a change in material inputs naturally means a change in who the main producers are.

The world's oil and gas reserves are fairly well spread across the globe. Many of the essential minerals for green tech, by contrast, are extremely concentrated in particular areas. For example, the top three producing nations of lithium, cobalt and rare earth metals control well over a quarter of global output. In 2019, 70% of the world's cobalt came from the Democratic Republic of Congo, and China produced 60% of the world's rare earth metals.

Those are just the figures for raw materials. China has an even bigger share when it comes to processing, handling around 90% of the world's rare earth metals – as well as 35% of nickel processing.

The levels of concentration in commodity production have created an uncomfortable situation. Throughout the pandemic, politicians grew increasingly worried about complex but delicate global supply chains, and what might happen should they become disrupted. This has been evident in various supply bottlenecks this year, as well as the ongoing global microchip shortage emanating from Taiwan.

The often-complex nature of modern commodity production only makes things worse. A break in any one part of the chain could threaten the global economy altogether. That is without even mentioning the political dimension. Given the increasingly fraught relationship between the US and China, there remains a significant threat of sanctions or worse.

Diversifying production is therefore vital for making the global economy – and the green transition – more stable. New and varied commodity sources will need to be tapped, and while such operations are underway, they take a long time. According to the International Energy Agency (IEA), it takes mining projects an average of 16 years to start producing after the initial discovery.

Oil extraction has always had long lead times, too. But the crucial difference here was that producers were confident of the long-term viability of the projects, meaning investors were more than happy to fund them. With green technology developing rapidly, we are likely to see sudden spikes in demand that global suppliers will not be able to keep up with. If producers wait for deficits before pursuing new projects, it will mean sustained periods of undersupply – perhaps then followed by persistent oversupply. That creates huge volatility, which then can feed into production lines and ultimately financial markets.

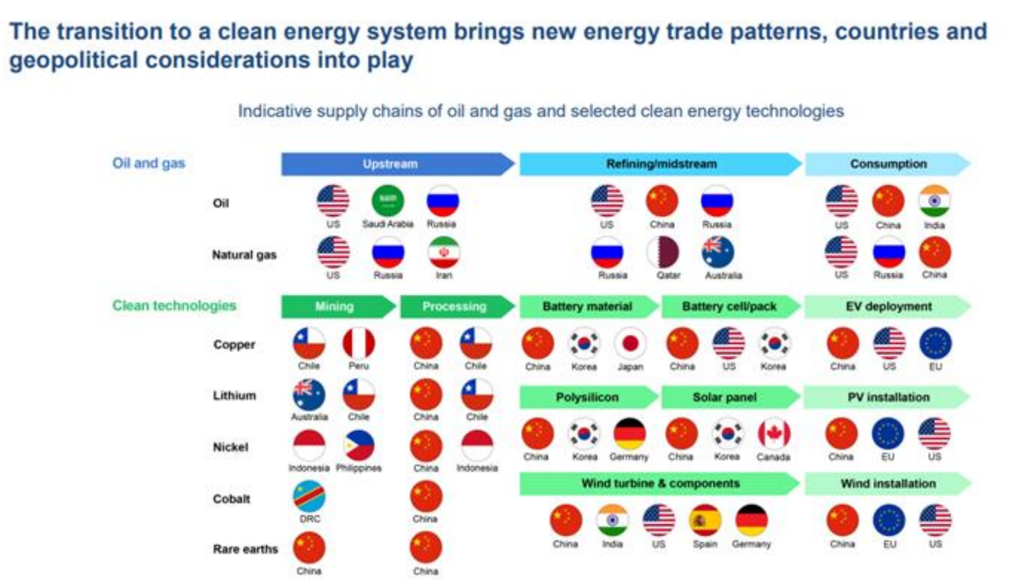
Of course, these problems highlight the importance of forward planning and clarity from policymakers. Any whiff of regulatory uncertainty discourages investment in production projects, once again making supplies tight. And, of course, technology in technology. Researchers are constantly finding new ways to produce batteries, microchips and the like. Who knows what materials will be the most in demand in 20 years – let alone 50, or more? As such, we could well see a prolonged period of sustained prices for 'green' commodity input.

There is a significant difference between demand for new commodities and oil demand. Oil demand is continuous: Any fossil-fuelled activity needs a constant stream of supply to continue. For greener technology, the key is enabling a system that stops the constant use of materials in favour of sustainable energy and, where possible, recycled materials.

Fragile supply chains and structural price pressures are nothing new, and oil shocks have brought down economies in the past. To the extent that oil is a production input (like in chemicals, plastics and many other areas), higher 'new' commodity prices will similarly feed into the production line – even if it will be more clearly visible on the material-input side of things. Should prices rise too much, corporates will face a profit squeeze if they can't pass it on to consumers.

The more intriguing aspect is the demand side coming from consumers. Currently, with high oil and gas prices, households see their real disposable income shrink. Petrol for the car becomes more expensive, as does heating oil and gas, and this is a continuous effect for as long as one consumes. With the energy transition, things are different. High commodity prices affect the production of new electric cars, but existing stock should continue to function just fine. This means that the economic feed-through will be different (for consumers, much less instantaneous), but when it does hit – such as buying a new or car – it's quite a chunky bill.

The green revolution could spark huge changes across the global economy. More than just replacing old materials with newer ones, the very structure of global markets is likely to shift. All of this requires careful attention from policymakers to ensure as orderly a transition as possible. But even with oversight teething issues are inevitable, which will only become more prominent in the years to come.



UK tightens its belt and holds its breath

The pandemic has been taxing, if you will forgive the pun. But it has been hard to escape the story of the week: Britons will face an extra 2.5 percentage points of tax from next year, after the government delivers 1.25% point hikes for both National Insurance contributions (employer and employees), and dividend pay-outs. The measures were contained in Boris Johnson's health and Health and Social Care Bill, which comfortably sailed through the House of Commons last week on a 319 to 248 vote. The government hopes to raise an extra £12 billion a year for the beleaguered NHS, while capping social care costs at £86,000 over an individual's lifetime.

Politically, the Bill's passage was a sight to behold. Only a handful of Conservative MPs rebelled against the Prime Minister, while Labour MPs opposed *en masse*. That is despite Johnson breaking a key election campaign pledge and raising Britain's tax burden to its highest level since 1950. The role reversal of the parties continues a trend witnessed a great deal from this government: pushing toward the traditionally Labour policies of tax and spend. The latest Bill introduces yet another large injection of fiscal spending, as well as Chancellor Rishi Sunak's second tax raising announcement in a year.

Boris Johnson was quick to point out the extraordinary circumstances. The pandemic delivered the sharpest recession on record while simultaneously putting the NHS under immense strain. The need for more resources and the worsening of the country's financial health should be no surprise. But that will give little comfort to those affected by the tax hike. For investors, it means a decrease in dividend income after a year and a half of depressed pay-outs. And for the public, it means a hit to wages just as the economy begins to recover.

Rishi Sunak already announced a hike to Income and Corporation Tax in his March Budget, but delayed their implementation until 2023. Back then, we wrote that the government faced a delicate balancing act - shoring up business and consumer confidence on the one hand, while appeasing fiscally hawkish MPs on the other. It was a 'spend now, tax later' approach – designed to squeeze out as much economic optimism as possible without abandoning the Tories' goal of long-term debt management.

The official story for the current tax hike is along the same lines. All of the tax money raised will go toward health and social costs, helping to cut lengthy waiting lists and reduce the burden on those in need. The Treasury has presented the bill as budget-neutral in that respect, meaning it should not take away from growth. We suspect the reality might be a little different. Higher tax rates will come into effect in April 2022, the same time the new funding starts flowing, while the cap on social care costs will not begin until late 2023. From a purely economic perspective, even if the spending benefits perfectly match the estimated tax revenues, disposable income will still take a hit in the short-term. And people may not immediately feel the benefits of the well-funded social system.

Moreover, tax increases can have a potentially significant impact on business and consumer confidence. Despite a sharp upturn from the depths of last year, economic growth and sentiment is still fragile. If people expect lower income in the near future, they will likely slow their current spending – causing a knock-on effect on economic activity.

This is compounded by a host of other worries, namely a spike in short-term inflation caused by Brexit and the pandemic; lower government pay-outs, such as the end of furlough and the suspension of the 'triple lock' on pensions; and COVID uncertainties heading into winter, which could push people to save more.

These factors lower expectations of real (inflation-adjusted) disposable income. An imminent tax hike delivers a further blow to those expectations.

To be clear, this is to say nothing about the political benefits of tax-and-spend policy. But the change amounts to quite a clear reversal from "we are here to support you in the crisis" to "it's time to pay us back" – a clear break from the cautious expansion the Treasury suggested in March. The timing of the announcement is therefore somewhat surprising.

At the height of the pandemic, there was a political consensus that fiscal expansion was necessary to stave off ruin. And, despite some concerns from debt-conscious backbenchers, this political will later extended to longer-term public investment to aid the recovery. Now, it seems the dial has turned back toward fiscal conservatism accompanied with little reform – even though the recovery is still nascent, and virus worries have not fully subsided. That is not supportive for growth, to say the least, especially when compared to the bigger fiscal packages in the US and (to a lesser extent) Europe.

Equally surprising are the latest mutterings from the Bank of England. Governor Andrew Bailey suggested last week that the minimal conditions for raising interest rates were met – and that the rate-setting committee was evenly split on a rate hike. This comes after the Bank appointed Huw Pill, a renowned monetarist, as its new chief economist, and suggests that a rise in interest rates could come as early as next year.

If it did, it would mean a *de facto* tightening of both monetary and (felt) tighter fiscal policy sooner than many would have expected. From the current data – as well as lingering Brexit difficulties – it is hard to see how Britain's economy justifies such a move. At the beginning of this year, we listed a premature policy tightening as one of the main risks to global growth, and the UK could be in for a double shot of it. We should not overreact to the threat this poses, but we should not underplay it either.

Global Equity Markets

Market	Fri 16:16	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	7028	-1.5	-111	→	⬀
FTSE 250	23775	-1.7	-420	⬀	⬈
FTSE AS	4057	-1.5	-64	→	⬈
FTSE Small	7558	-0.4	-30	⬀	⬈
CAC	6660	-0.4	-30	→	⬈
DAX	15615	-1.1	-167	→	⬈
Dow	34738	-2.0	-706	→	⬈
S&P 500	4487	-1.1	-50	→	⬈
Nasdaq	15240	-0.6	-92	⬀	⬈
Nikkei	30382	+4.3	+1254	⬈	⬈
MSCI World	3136	-0.9	-28	⬀	⬈
CSI 300	5014	+3.5	+170	→	⬀
MSCI EM	1300	-1.2	-16	→	⬀

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
B&M European Value I	+7.9	Melrose	-6.9
DS Smith	+3.2	Coca-Cola HBC	-6.8
Rightmove	+2.8	Int'l Consol Air	-6.3
Experian	+2.7	Polymetal International	-6.2
Scot Mtge Inv Trust	+2.1	Taylor Wimpey	-5.6

Currencies

Pair	last	%1W
USD/GBP	1.385	-0.2
GBP/EUR	0.854	+0.4
USD/EUR	1.18	-0.4
JPY/USD	109.88	-0.2
CNY/USD	6.44	+0.2
Bitcoin/$	45,172	-12.6

Commodities

Cmdty	last	%1W
Oil	72.80	+0.3
Gold	1796.0	-1.7
Silver	24.01	-2.9
Copper	442.9	+3.2
Aluminium	2839.5	+5.4
Soft Cmdties	485.4	+0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	15.2	12.4	14.2
FTSE 250	2.3	17.2	24.6	15.9
FTSE AS	3.7	15.4	13.5	14.3
FTSE Small x Inv_Tsts	1.9	14.4	19.9	15.4
CAC	2.2	21.5	16.1	14.9
DAX	2.4	14.6	14.4	13.5
Dow	1.8	19.6	18.8	16.4
S&P 500	1.3	25.4	22.1	17.6
Nasdaq	0.6	31.4	33.1	22.9
Nikkei	1.4	16.3	18.3	17.7
MSCI World	1.7	22.2	20.1	16.6
CSI 300	1.8	16.5	15.7	12.5
MSCI EM	2.2	14.4	13.5	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.75	+0.03
UK 15-Yr	0.96	+0.02
US 10-Yr	1.33	+0.01
French 10-Yr	-0.00	+0.01
German 10-Yr	-0.34	+0.03
Japanese 10-Yr	0.05	+0.01

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

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CAMBRIDGE INVESTMENTS LIMITED

13th 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.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE