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MATT

'Our medal tally has doubled in 24 hours. If this trend continues, by mid August, everyone in the UK will be an Olympic champion'

Olympic medal pandemic, Matt, 27 July 2021

Mega techs under the cosh

After an unexciting July in terms of investment returns, August has made a strong start, with US job markets figures delivering a much-appreciated positive surprise on Friday, while corporate earnings reports continue to support elevated stock market levels across the Western world. The reporting period for the first quarter was very strong and this one has progressed in the same vein, although the pace of analyst upward revisions of earnings estimates has been tailing off, in comparison to last quarter's stellar upgrade path. Still, it has been nearly as good so far, with UK upgrades strongest this time (according to Factset's aggregates). We look at the UK in detail in a separate article, after an interesting Bank of England (BoE) Monetary Policy Committee meeting last week.

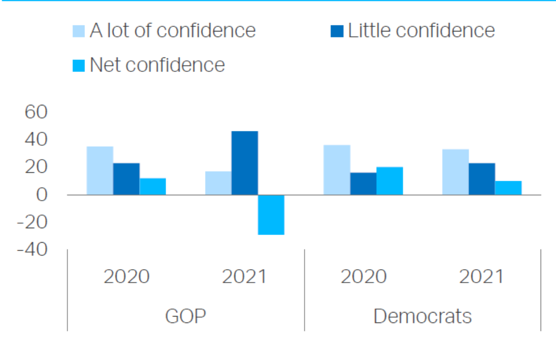
We have written at length recently about how rising bond yields can be a threat to stock market valuations, unless corporate earnings growth outpaces the yield growth headwind. Against that backdrop, the recent rise in earnings expectations, confirmed by the latest quarterly earnings season, has not generated as strong an equity market as might have been expected. In fact, while markets have risen somewhat, they have also become a little cheaper, as yields have fallen, while earnings have risen strongly. This is good news for investors, as it provides a bit of a buffer should yields rise again – a prospect that is still very much with us. Only last week, Citi Research noted that it expects a rise in US ten-year (long) yields from 1.1% to 2.0% into 2022.

Given that central banks are edging towards a reduction of (yield supressing) monetary support on the back of expected sustained growth, this anticipation of gradually higher long yields seems quite justified. Provided earnings expectations continue to rise – as they should if growth does become sustained – that is a recipe for generally stable equity prices rather than big moves either way. We would be happy to see valuation levels ease back further, as they did over the past months, as this would provide for better-based, more sustainable valuations, even when yields gradually normalise upwards.

Last week started with further indications that China is continuing its rapid pace of regulatory 'reform'. The previous week, online education companies were targeted. Last week, it was about the negative impacts of computer games, and monopoly in music rights. China's tech giant Tencent felt some pain, although it ended the week only about 5% lower than the start.

Chart 1: In a warning sign for investors, GOP confidence in Big Tech has plunged this year . . .

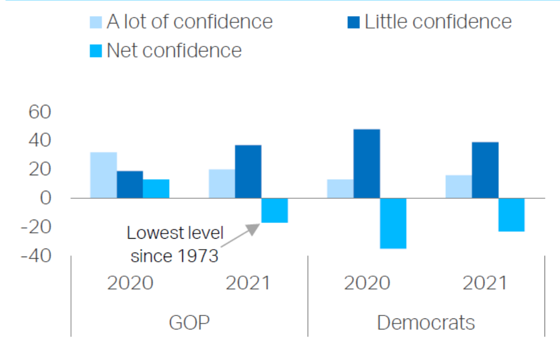
% / Poll dates: Jun-Jul



Source: Gallup.

Chart 2: . . . while its net confidence in Big Business hit an all-time low too

% / Poll dates: Jun-Jul



Source: Gallup.

The compression of Chinese tech giants, like AliBaba and Tencent, has been met in the US and UK with some cognitive dissonance. Many investors are wary of the impact of mega-techs like Amazon, believing that their behaviour has destroyed general profitability. Yet investors also find it difficult to think that the Chinese authorities' behaviour is about ensuring a level and fair playing field for its domestic businesses.

However, similar efforts are gathering steam, especially in the US. Remarkably perhaps, the push may be coming from the Republicans even more than the Democrats. Grace Fan of TS Lombard comments; *"Biden's recent nomination of a Google foe, Jonathan Kanter, to head the Justice Department's (DoJ) antitrust division confirms an inflection point in US antitrust regulation. For more than four decades, the consumer welfare standard has been the prevailing yardstick for US antitrust cases (the 'Chicago School'). As a result, M&A deals were usually approved when there appeared to be no grounds of concern about consumer interests (i.e. there was no burden of proof about consumers actually benefitting, but a lower bar that they would not be seriously harmed). However, Kanter and other critics who belong to the 'neo-Brandeis School' have argued that this standard is both inadequate for the digital age and one that has led to highly concentrated industries, hurting workers and consumers alike."*

This follows the April appointment of 32-year-old Professor Lina Khan to chair the Federal Trade Commission, which shares anti-trust enforcement with the DoJ. As a law student at Yale, Khan came to prominence with a research paper on Amazon.com that cast the online retail giant as a harmful monopoly, and argued for a rethink of antitrust enforcement.

Discussions about regulation are not the same as actual regulation. However, Biden has pushed various US agencies to act. His 9 July Executive Order called for 72 new measures across more than a dozen federal agencies, to curb excessive corporate consolidation. For tech firms, this means greater scrutiny of both past and future acquisitions (including nascent rivals), as well as new rules to prevent excessive data collection, surveillance, and 'unfair competition' in online marketplaces.

For tech businesses, the acquisitions have tended to be other US-based companies. For non-tech US businesses, it may mean looking outside the US for targets. Even then, the US blocked the AON/Willis Towers Watson merger despite it being a US/UK entity merger, because of the global nature of insurance brokerage.

Europe may not be so happy to see such approaches, although the UK government is likely to be a bit more welcoming. Lockheed Martin may not be able to buy Aerojet Rocketdyne, but Parker-Hannifin can buy Meggitt.

While this means China's regulatory approach may not end up being so different to the US or Europe, it does not mean China will automatically benefit from the apparent levelling of the playing field. Trump attacked Chinese companies like Huawei on security grounds and Biden is expanding, not reversing, this policy stance. Last week, a ban on investment for a further 59 Chinese companies was put into effect. Indeed, across a whole range of measures, Biden is stepping up the pressure.

Returning to the mega-techs of the US, they face headwinds across the board. Their revenues and reach are big enough to mean that the secular excess growth of the past 20 years may already be difficult to sustain going forward. At the same time, the now-attained relative certainty of their profits in the future also mean that higher yields affect their valuations more than the cyclicals; tax policies will be targeted towards their profits; their acquisitive business models face significant pushback.

Rather than being just talk, policy change appears to be underway. Indeed, the new appointees to the various US agencies will be under pressure to act from both sides of the US political divide. The US mega-tech companies have enjoyed an incredibly supportive policy environment, and there is an increasing belief it will prove challenging to sustain shareholder expectations for future growth levels. We should not write them off just yet, but as always, a broadly diversified portfolio has a better chance of benefitting from growth opportunities, wherever they are.

July review: a mixed month with a positive outlook

Asset Class	Index	July	YTD	12 months	2020
Equities	FTSE 100 (UK)	0.1	11	23.3	-10.2
	FTSE4Good 50 (UK Ethical Index)	-0.1	7.5	15.8	-13.2
	MSCI Europe ex-UK	1.5	12.0	25.6	8.8
	S&P 500 (USA)	1.7	16.0	28.8	14.5
	NASDAQ (US Technology)	0.5	12.3	29.8	40.9
	Nikkei 225 (Japan)	-1.9	-1.7	18.2	11.4
	MSCI All Countries World	0.0	11.2	25.7	13.0
	MSCI Emerging Markets	-7.3	-1.5	13.9	15.0
Bonds	FTSE Gilts All Stocks	2.8	-3.1	-4.0	7.9
	£-Sterling Corporate Bond Index	1.4	-1.1	2.4	8.4
	Barclays Global Aggregate Bond Index	0.7	-3.6	-4.9	6.3
Commodities	Goldman Sachs Commodity Index	0.9	31.2	45.4	-26.0
	Brent Crude Oil Price	0.4	43.1	63.6	-23.9
	LBMA Spot Gold Price	3.3	-5.0	-12.6	20.8
Inflation	UK Consumer Price Index (annual rate)*	1.1	2.0	2.1	2.6
Cash rates	Libor 3 month GBP	0.0	0.0	0.1	0.5
Property	UK Commercial Property (IA Sector)*	1.0	1.5	1.2	-2.3

Source: Morningstar Direct as at 31/07/21. * to end of previous month (30/06/21). All returns in GBP.

Most economies in the developed world have by now experienced a strong post-COVID rebound. Naturally, some of the elevated economic readings are set to cool as economies converge to a more natural mid-cycle growth path, and come to grips with a fourth wave of infections while under the relative protection of vaccinations. Governmental and central bank monetary support will be less forthcoming, even if the virus remains a feature of day-to-day life, especially on a global scale. Central banks, most notably the US Federal Reserve (Fed), but also the BoE have started thinking about withdrawing policy action but until that time comes, support is likely to remain ample. Markets have had to digest this environment in flux, a process that typically leads to volatility. Along those lines, bond yields have retraced much of their rapid advance earlier in the year.

Ultimately though, over the upcoming months, the expansion theme is set to dominate. Yield curves are likely to re-steepen, and the recovery will broaden out into more sectors and regions as the global lockdown tapers.

However, July was a mixed month for global equity markets, which ended flat as surges in Delta variant cases created uneasiness. In regional terms, Emerging Market equities fell -7.3%, mainly driven by significant underperformance of the Chinese market led by a regulatory crackdown on the education sector. Alongside this China's negative focus also included large technology companies – a major market component.

The European Central Bank (ECB) announced a new higher inflation target for the region and indicated that interest rates will stay at the current low levels for the foreseeable future. On the back of a significant economic rebound and with growth levels matching the US, European equities rose 1.5% in the month.

The US market also marked positive returns, supported by strong second quarter earnings and supportive policies as the Fed kept interest rates unchanged. The broad market gained 1.7% although the technology sector finished up only 0.5%, with big tech firms such as Amazon posting Q2 results below analyst expectations.

The more cyclical UK market closely tracked moves in commodities, ending in the green (just) with UK retail names lagging European counterparts. Markets are closely watching the bond markets which rose during the month (leading to falling yields), even though companies continue to report greater supply-led inflationary pressures.

Our traditionally widely-diversified investment allocations across regions, sectors and investment styles ensured our portfolios continued to perform well during July, with our fund selection and style selection additionally benefitting from our equity overweight.

UK: between policy support withdrawal and bounce-back upsurge

Three weeks since the long-awaited "Freedom Day", Britons are enjoying a pleasant, if somewhat overcast and dull, summer. The surprise drop-off in virus cases seems to have levelled off, but while the fact that numbers are not increasing is an encouraging sign, it remains to be seen whether this will be sustained. With the UK having vaccinated nearly all of its adult population, the pressures on public health are a fraction of what had been experienced during the first three waves. If this continues to hold, there is little to suggest a worsening in the months ahead. That is good news for the UK economy which, despite widespread complaints about the 'pingdemic', is recovering nicely.

There are major tests to come, but for now UK growth is bouncing back and the path ahead is promising. The Bank of England (BoE) underlined its support on Thursday with its Monetary Policy Committee voting 7-1 in favour of keeping interest rates where they are. In its accompanying report, Consumer Price Index

Chart 1.3: Unemployment projection based on market interest rate expectations, other policy measures as announced

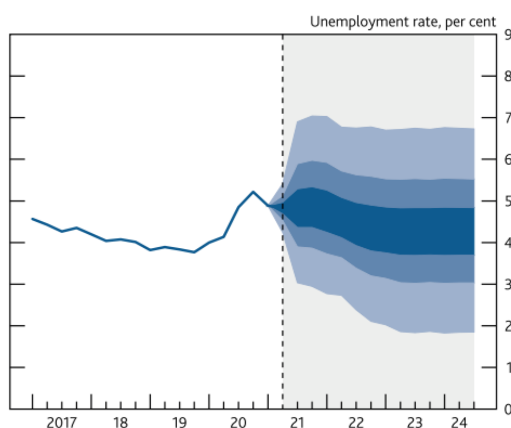
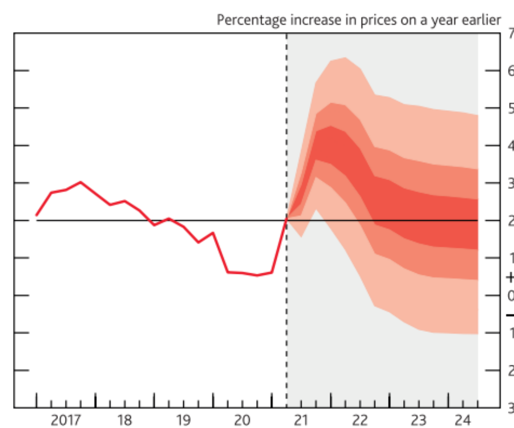


Chart 1.4: CPI inflation projection based on market interest rate expectations, other policy measures as announced



(CPI) inflation is forecast to rise through this year to 4% before dropping quickly in 2022, as the right-hand chart below from the report shows:

As the report notes: "The rise largely reflects the impact of the pandemic as the economy recovers. This has led to higher energy and goods prices, which in turn reflect rising commodity prices, transportation bottlenecks, constraints on production, and strong global demand for goods".

Unlike previous inflation bouts, this one seems driven more by domestic shortages. Despite difficulty in getting deliveries, the import price data up to June suggests prices have not increased particularly. This is a positive sign. Any final price rises will be added profit for someone in the UK – either employees or companies – which should help generate more growth.

We have pointed out before that policy support has been crucial throughout the pandemic. The BoE underlined the importance of the government's fiscal stimulus as the nation went through three lockdowns. But the monetary policy that the BoE itself provided has also been substantial. As most readers will suspect, both of these supports have their limits, either from planned expiries or from the law of diminishing returns while negative side effects increase. Even so, the BoE seems in no hurry to change its rate policy and its £895 billion bond purchase target is expected to remain in place until the end of the year.

However, the absolute limit on bond purchases effectively amounts to a tightening of policy. The BoE has changed its guidance on how it would reinvest the coupons received on its holdings of government debt, stopping a reinvestment when short-term rates reach 0.5% from the current 0.1%. The trigger to start selling these bonds has come down from 1.5% to 1.0%.

Perhaps surprisingly, BoE governor Andrew Bailey indicated that should policy need to be eased, negative interest rates would be the preferred tool used – instead of further quantitative easing (QE) through buying up government debt.

Of course, the BoE does not currently expect negative rates will be needed. Indeed, it now expects rates to start moving up next year, although only towards 0.5% by 2024. Bailey also said; "If we had stuck at 1.5% [as the short-term rate threshold for unwinding QE], that would be tantamount to saying we would never reduce the balance sheet."

Does that mean Bailey expects short-term rates will never rise above 1.5%? If the BoE is successful in achieving its 2% inflation target as an average rate, this would make it very unpopular, given it would ensure a constant loss of purchasing power for long-suffering savers. We suspect the governor was merely slightly imprecise with his choice of the word 'never'.

Despite this all leading to the perception that monetary policy will become less supportive, the "reaction function" framework is really designed to make central bank policy more predictable. Whether it succeeds in doing that is another matter, but it at least lowers the chance of a policy shock. The same cannot be said about fiscal policy, where we believe the bigger danger lies.

Now that COVID legal restrictions have been lifted, Chancellor Rishi Sunak will be reluctant to extend furlough payments or emergency loans. Should these dry up before the economy has found its feet, growth will take a hit. Stamp Duty relief is already set to end, and the government is likely to try reducing the deficit unless restrictions come back. The Office for Budget Responsibility will provide updated forecasts

to the Treasury at the end of October, and it is likely to report significant negative impacts on the government's finances.

The government recently delayed announcing its plans for social care after significant political pushback. This illustrates the difficulties facing the Treasury, with spending demands set to stay high for years to come against their reluctance to increase the deficit further or raise taxes in the short term. As a result, there is not much leeway for public spending, meaning that fiscal policy is unlikely to be an additional positive for growth as the recovery continues.

The return of the hospitality industry has lessened the number of workers on furlough, but there are still 1.9 million people signed up for the scheme. The strong labour demand we are seeing in the data is encouraging, although the BoE had expected around 500,000 to remain on furlough throughout the third quarter. Only a small fraction of these work in sectors still affected by restrictions, but the fact that so many are still reliant on a scheme that will run out sooner rather than later is a cause for concern.

Research from US bank Citi suggests UK unemployment will rise to 6.1% as furlough comes to an end. This contradicts the BoE, which now expects a level no higher than 4.9% (as Chart 1.3 shows). This is in part due to many people deciding not to re-enter the workforce, and the disparity between the two forecasts highlights the risk and uncertainty.

Consumer spending has also eased off in recent weeks, despite the usually supportive summer season. Some of that could be down to a post-football hangover, and the data does not cover much of the period following the lifting of lockdown restrictions.

The end of the Stamp Duty holiday is expected to impact housing activity substantially, but for consumers this is likely to be offset by the recent fall in mortgage rates. UK banks have seen £370 billion of net inflows in cash deposits since the start of 2020, with loans growing only by £100 billion over the same period. This has led to a substantial increase in excess deposits, which has pushed down mortgage pricing. That is bad news for banks, but should be a positive for house buyers as Stamp Duty returns.

Despite the challenges ahead, the British recovery is undeniably underway. This, together with a rapid vaccination programme, has been a key support for UK equities in recent weeks. But the solid performance of British stocks has been proportionally less than the improvement in analyst UK earnings expectations. The equity market has not kept pace with the improving earnings picture, nor have prices properly adjusted for the fall in bond yields (which make equities more attractive by comparison). This means UK equities have become cheaper in terms of price-to-earnings ratios.

This is partly due to the makeup of Britain's stock markets (12% of which comprises unloved BP and Shell) and is not unprecedented. But it does make the UK cheaper than its global peers. By our calculation, British stocks offer a 2% extra risk premium compared to the US (that's adjusting for the different sectoral compositions), with a smaller advantage over European equities. This suggests investors do not fully believe in the UK growth story, and are expecting the economy to disappoint in the coming months. The market may be pricing in a sharper fall in UK earnings than elsewhere in the world.

That is certainly possible, with pandemic scarring and the after-effects of Brexit still weighing down the economy. The positive, though, is that this is effectively priced in already, and so would not significantly impact British equities if it did really happen. On the flip side, if markets are wrong and UK earnings improve,

it would make UK assets look significantly cheaper than other major markets. That would be a boost for UK equities, which could deliver strong returns.

We will have to wait and see, but already we are seeing significant interest in British companies, both as M&A targets (such as the Parker-Hannifin/Meggitt proposal) and from private equity groups (Morrisons, etc.). After a period of introspection and isolation on the global stage, things could be about to change for the currently unloved UK market. There are pre- and post-pandemic challenges facing the UK economy, but it is at least on the right track.

Global Equity Markets

Market	Fri 15:15	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7121	+1.3	+89	→	↗
FTSE 250	23472	+2.3	+523	↗	↗
FTSE AS	4089	+1.5	+59	⬀	↗
FTSE Small	7490	+1.8	+131	⬀	↗
CAC	6812	+3.0	+199	⬀	↗
DAX	15780	+1.5	+236	⬀	↗
Dow	35200	+0.8	+264	↗	↗
S&P 500	4435	+0.9	+40	↗	↗
Nasdaq	14842	+1.2	+169	↗	↗
Nikkei	27820	+2.0	+536	⬂	↗
MSCI World	3102	+1.1	+33	↗	↗
CSI 300	4922	+2.3	+110	↘	↗
MSCI EM	1300	+1.7	+22	↘	↗

Top 5 Gainers

Company	%
Rolls-Royce	+12.8
Entain	+7.1
Stan Chartered	+6.4
SSE	+6.3
Natwest	+6.2

Top 5 Decliners

Company	%
Pearson	-8.0
Hikma Pharma	-6.9
Smiths	-6.4
Smith & Nephew	-6.2
Fresnillo	-3.1

Currencies

Pair	last	%1W
USD/GBP	1.387	-0.2
GBP/EUR	0.848	+0.7
USD/EUR	1.18	-0.9
JPY/USD	110.34	-0.6
CNY/USD	6.48	-0.3
Bitcoin/$	40,699	-1.4

Commodities

Cmdty	last	%1W
Oil	71.47	-6.4
Gold	1765.3	-2.7
Silver	24.28	-4.8
Copper	438.7	-2.1
Aluminium	2588.0	-0.1
Soft Cmdties	452.0	+2.6

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	15.8	12.9	14.1
FTSE 250	2.3	17.0	24.5	15.8
FTSE AS	3.1	15.9	13.9	14.3
FTSE Small x Inv_Tsts	1.8	17.6	18.5	15.3
CAC	2.1	22.3	17.2	14.8
DAX	2.3	15.7	14.8	13.4
Dow	1.7	19.8	19.3	16.4
S&P 500	1.3	25.3	22.3	17.5
Nasdaq	0.6	31.1	31.3	22.7
Nikkei	1.6	15.6	17.9	17.6
MSCI World	1.6	22.4	20.2	16.5
CSI 300	1.7	16.9	15.1	12.5
MSCI EM	2.1	15.7	13.6	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.60	+0.03
UK 15-Yr	0.88	+0.01
US 10-Yr	1.28	+0.06
French 10-Yr	-0.12	-0.01
German 10-Yr	-0.46	+0.01
Japanese 10-Yr	0.02	-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	2.58	2.58
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

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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