THE **CAMBRIDGE** WEEKLY

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Politicians predicament, Bob Moran; 4 Oct 2020

Baffling market optimism

Following the unsteadiness of September, markets have further regained their composure and continue to drift upwards. This stands in stark contrast to the flow of bad news. The White House, centre of power for the mighty US, has become a COVID hotspot, similar to many regions across Europe and the UK. Meanwhile, the Brexit negotiation noises have been loud enough to make those worried about the economic impact of the pandemic even more ill.

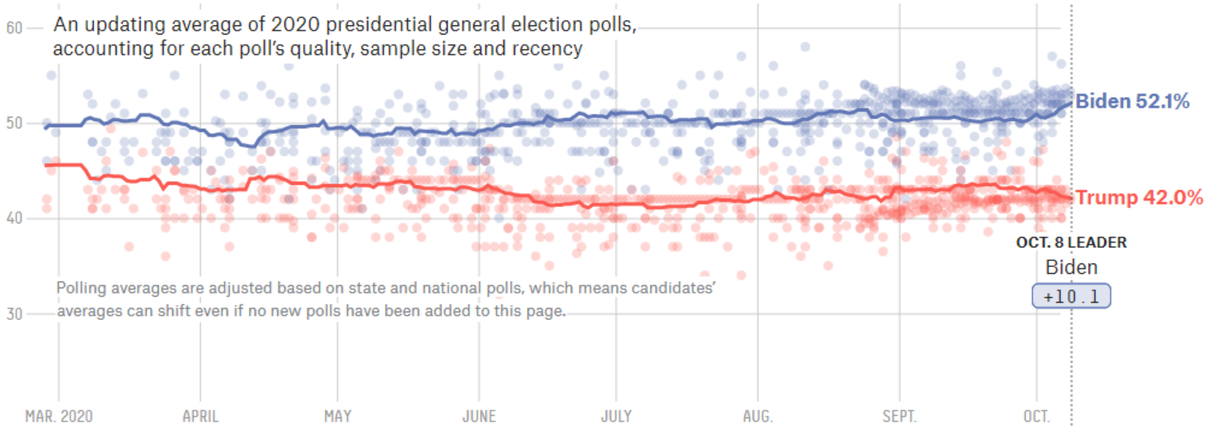
And if the nation was split over Brexit, then the debate over the right way to deal with the second wave of the pandemic is drawing yet more dividing lines. Our own Chancellor is said to be very much against a further drag on the economy, while many other MPs are against renewed restrictions on freedoms. Enforcement of social distancing is proving much less effective, especially when trying to do it locally. Rishi Sunak is right to be worried by the stalling of the growth rebound across the UK's service-sector dominated economy, even though similar scenes are playing out across Europe and, perhaps to a slightly lesser degree, in the US.

But markets everywhere are behaving as if none of this really matters. Almost every capital market-based indicator (that we look at) tells us investors are increasingly confident about an upward path for economic growth over the medium term.

Long-maturity bond yields have risen across the board, five basis points (bps) in Germany and France, 15 bps points in the UK and a substantial 20 bps in the US – usually a sure sign that things are looking up, not down.

These signals go beyond the auspicious government bond markets. Credit spreads – the premium companies pay on their loan capital versus the government – have declined somewhat. Stocks that thrive when the economy rebounds (cyclicals) have also performed well, beating the more defensive large-cap growth stocks of the 'Big Tech' world, previously the favourite 'fear-trade' investment during the stock market recovery. Globally, small- and mid-sized stocks have outperformed large caps, a trend which has been going on for over a month.

As we first discussed last week, behind it all is a rather unexpected driver. Global investors seem - somewhat unexpectedly - to be warming up to the prospect of the Democratic Party sweeping the board in November's elections. Last week saw the US opinion polls signalling a widening advantage for Joe Biden in the Presidential race, plus a potential Democrat takeover of the Senate (as well as retaining the House of Representatives).



Source: FiveThirtyEight

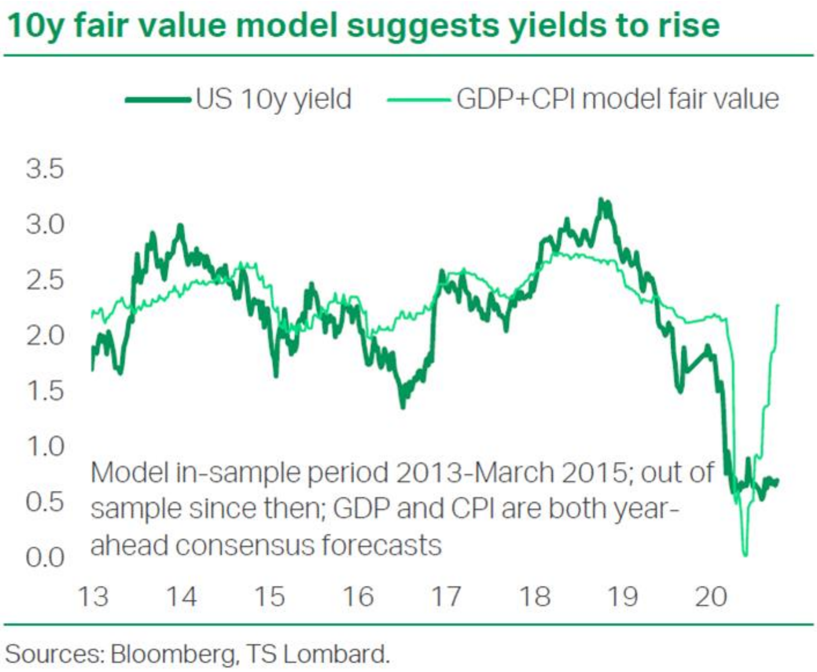
If this were to come about, the Democrats would have at least two years to enact their Keynesian program of pump-priming the US economy back to its former health through government spending and investment. The perception seems to be that the other elements of their programme – higher taxation on larger companies and a further 2% income tax on the wealthiest individuals (as well as an end to the regulatory 'wild-west' of the tech giants, which we explore in greater depth in the article below) would cause a rebalancing of corporate profits but, on balance, would enhance the sum total of economic growth. As an added bonus for the world, this may lower the value of the US$. A Trump defeat should also ensure greater visibility of White House trade policies – and much less disruption – which together with a lower US$ have the potential to kick-start a much-needed global trade cycle.

Interestingly, equity markets have coped well with what has been the sharpest rise in yields for some weeks, given that the rise brings with it some less than positive aspects for equities. Namely, higher yields would challenge the notion that equities are 'the only show in town' which has been helped support historically high equity valuations, while also challenging the longer-term viability of many debt-laden companies. So, any rise beyond the normal day-to-day volatility might cause a derating.

This leads us to looking at the other fundamental of equity valuations: earnings. As research from US investment bank JP Morgan has pointed out, while it is still very early in the run of results for the Q3 company reporting season, so far there have been no horrible surprises. Equity analysts have responded to the reasonable start by raising sales and earnings expectations. In other words, the starting point for profits is stable and next year's earnings growth visibility is improving. This may be more than enough to offset the downward pressure on valuations from a rise in long yields.

Of course, this particularly benefits more cyclical companies, where the valuation advantage comes from the nearer-term (i.e. three to five years) rather than the more long-term time horizon of growth companies. For the short- to medium-term, the discount rates (yields) have hardly moved and can be expected to be held low by central banks in almost any scenario, in order to ensure that interest rate policy does not derail the economic stimulus efforts of the governments' fiscal programs.

An important component here is that most economists and investors (us included) do not seem to fear that huge government spending will result in big rises in the cost of the debt, because it seems reasonable to assume that economic growth in the near to medium term – and taxes receipts in its wake – will exceed the interest that governments are required to pay. Researcher TS Lombard shows this is in its model of ten-year US Treasury yields relative to economic growth and inflation. It assumes that the Fed behaves as it did up to 2015:



The 'bond vigilantes' may be a rare species these days, but they can still be spotted and they would now point out that even under this scenario, the longer-term perspective would still be bleak. This is simply because under this orthodox scenario, where central banks keep only the short- to medium-term yields low through their forward guidance in rates, the further out maturity yields would still be pushed higher. This could result in the worst of both worlds: a much-enlarged government burden and arduous company debt levels, which would likely ramp-up fears over corporate defaults and destablise capital markets.

Therefore, the fact that markets are currently not panicking over the beginning rise in longer-term yields tells us that markets are also taking the US Federal Reserve (Fed) Chairman Jerome Powell at his word; that the Fed will respond benevolently to more issuance of both government and corporate debt when it wants to borrow to invest. But the only way to achieve that is for the Fed to look beyond its traditional interest setting policy tools. This requires long-term commitment to capping longer-term yields by means of – yes, you guessed it – quantitative easing. Or, in practical terms, by purchasing longer-term debt, rather than leaving it to the forces of supply and demand in the freedom of capital markets to determine what the yield should be.

Some will criticise this as an irresponsible undermining of capital market freedom, and an erosion of the public trust in value of money through sustained financial repression, long beyond the pressures of the COVID-19 crisis. Others will describe it as the only way to return the global economy to a sustained growth path, by dealing with the universally-raised debt levels around the world in the same way that western societies did with their war debts after World War II.

This process is called a "terming-out", through the issuance of multi-decade maturity debt. In our view, this would be a hugely positive signal, and is one which we think will have to come. The ultimate causes for the risen debts may be different to war periods, but the potential aftermath/after-effects appear very similar. On this basis, we would expect that our free market economies with their relative financial stability are just as unlikely to come to an end, if we deal with the challenge in a similar manner now, as they did in the 25 years that followed WWII.

UK and EU

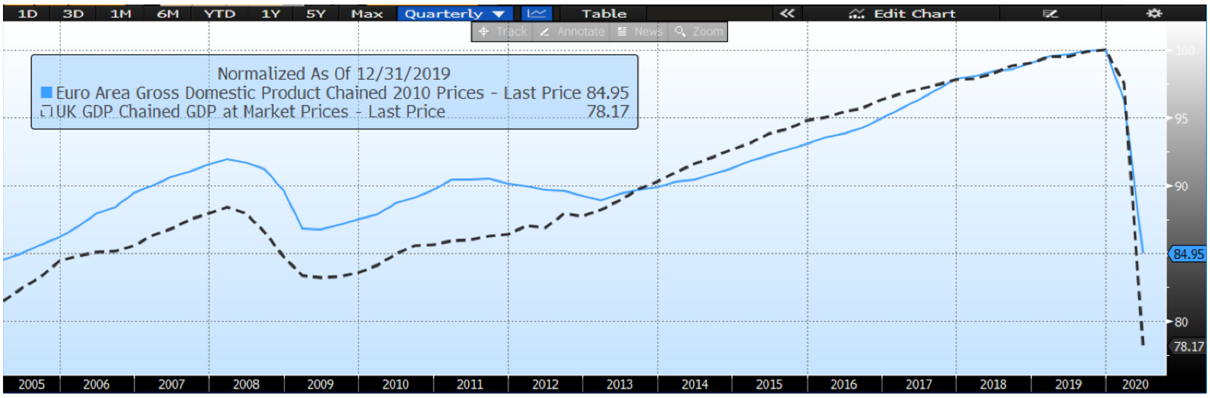
It may be the hundredth time saying this, but despite the all-dominating focus on COVID, it is now also Brexit crunch time, given the UK government rejected the offer of a further extension when the lockdown 'sabotaged' the already tight negotiation schedule. Britain's official transition period of EU membership still only lasts until the end of this year, and, according to Boris Johnson, any deal needs to be agreed by next week if it is to take effect on 1 January. European Union (EU) leaders will convene for a European Council session on 15th October, and the Prime Minister has made it clear: "If we can't agree by then, then I do not see that there will be a free trade agreement between us, and we should both accept that and move on".

The government has repeatedly tried to beef up its negotiating position with the 'credible threat' of a no-deal scenario. But recent noises from Whitehall have been more conciliatory. Reports suggest there has been a breakthrough on state aid – an issue so emotive the government felt it may need to break international law over. Hot topics remain on areas like fisheries, an area of low economic impact (but a key Brexiteer talking point), and a relatively high emotional value in parts of the EU; and even here negotiators seem hopeful. Michael Gove has gone as far as to say he sees a 66% probability of a deal happening before next week.

Gove's positivity seems to have fed through to currency markets. Sterling was able to stabilise its recovery from September lows, and the options market has been similarly positive. So currency markets are at least somewhat hopeful. Indeed, there are plenty of reasons to be.

All countries involved are still labouring under the economic pains of the global pandemic, which has frozen businesses and put individuals in desperate need of support. Ensuring stability of trade terms with our nearest and dearest trading partners, rather than opening a second 'front' for the wider economy, is therefore even more vital than it was before. This goes for politicians in both Westminster and Brussels. The incentive to strike an agreement has become even greater, so we expect rational heads will prevail.

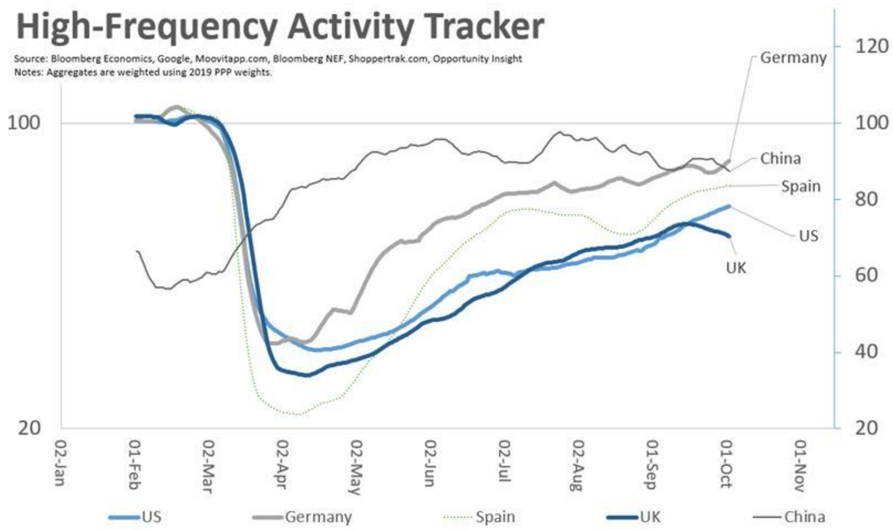
That said, the incentive is not quite equal on both sides of the Channel. Over the last five years, much has been said about the "who needs whom more?" dilemma, but it cannot be denied that Britain has fared worse than its neighbours through the pandemic. Not only has the UK seen more cases, deaths and longer-lasting restrictions than most on the continent, its economy has been much harder hit. UK economic activity contracted 20% in the second quarter of 2020, significantly worse than the 12% fall in the Eurozone. Last Friday's release of GDP figures for August GDP revealed month-on-month growth of just 2.1%, also below expectations. The chart below shows how much lost output the UK has experienced compared to the eurozone since the beginning of the year.



Source: Bloomberg, Tatton IM, 9 Oct 2020

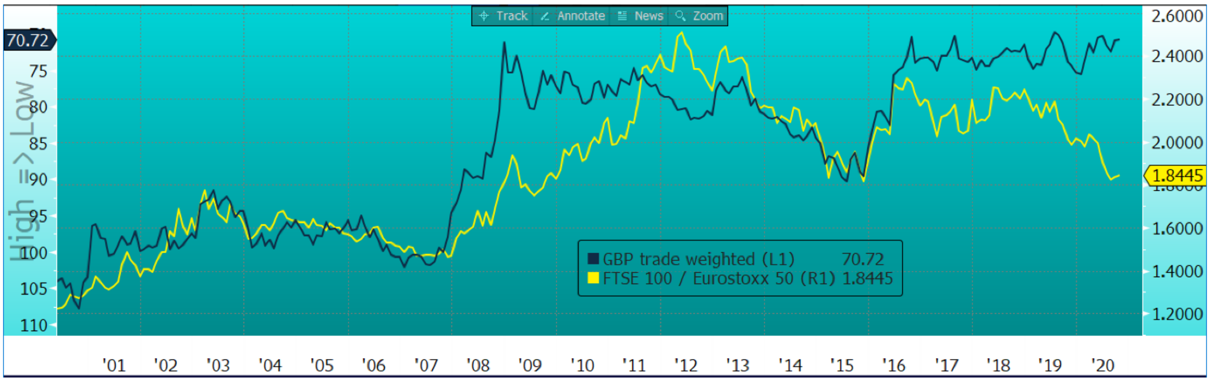
However, different timelines mean the chart doesn't tell the full story. The UK went into lockdown comparatively slower than most European nations and, as such, was slower coming out. While Europeans started venturing outside again during Q2, Britain was still in the height of lockdown. The UK economy had a marginally better Q1 than the Eurozone, declining 2.5% compared to Europe's 3.7% fall. Nevertheless, the UK clearly fell to deeper depths than European nations in this recession, and has been slower to bounce back also.

The high-frequency data shows a similarly dour picture for Britain. Bloomberg's activity tracker – compiling data on personal travel and expenditure – suggests Britons have been slower on the road back to normal than most others in developed nations. Germany, France, Italy and Spain all began getting people moving



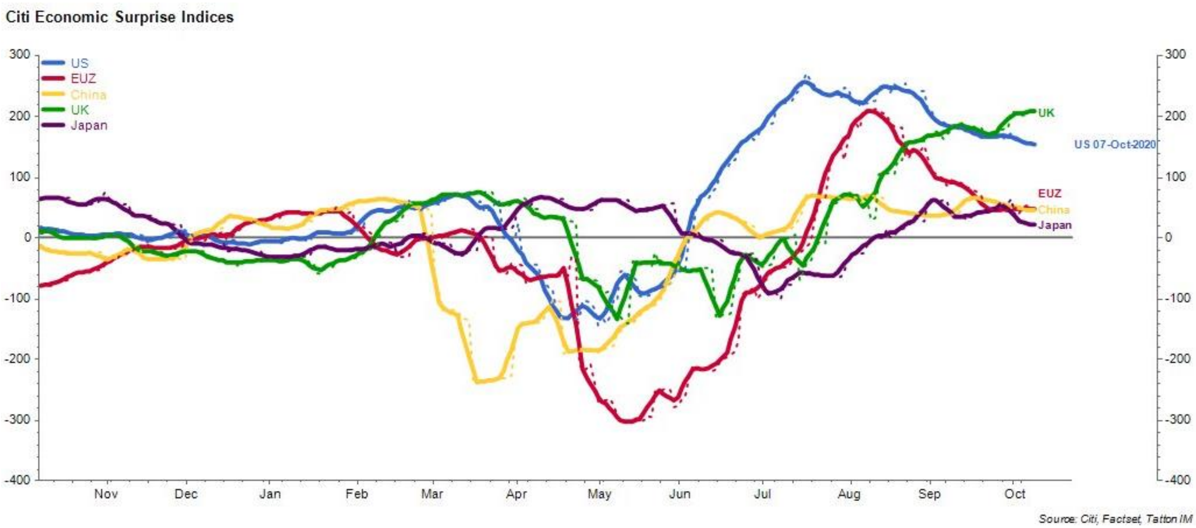
earlier and faster. Whitehall introducing new restrictions, both locally and nationally, it is unlikely this will change any time soon.

These differences have also been reflected in capital markets. While both British and European equity markets took a battering in March's frenzied global sell-off, the recovery rally for European companies has been somewhat steeper. The FTSE 100 is currently around 20% up from its trough, while the Euro Stoxx 50 sits 36% above its March lows. Both have had a much tougher 2020 than the world-beating US stock market; and certainly the somewhat 'old school' cyclical composition of the FTSE 100 sector (energy, materials and financials) has played its part in what's been a disappointing year. But there is also some evidence that investors are attaching a Brexit risk premium: the FTSE 100 has failed to rise on a weaker sterling (relative to the Eurostoxx 50), which tended to be one of its typical reaction functions.



Source: Bloomberg, Tatton IM, 9 Oct 2020

However, there are some bright spots for the UK. Employment, the cornerstone of Britain's consumption-led economy, is still holding up reasonably well, according to official statistics. September saw the strongest monthly increase in hiring in almost two years. In all regions except London – which is still languishing – hiring activity and intentions are looking positive. What's more, economic surprise indices for the UK are now performing better than most major economies. In the Eurozone, the initial recovery hopes have tailed



off, with the strong bounce-back losing steam. In the UK, a slower recovery suggests there are still plenty of positive surprises for economists, as shown in the chart above.

The same is true for business sentiment surveys, which have tailed off in Europe but are holding strong here. With new restrictions coming into force, and a still greatly uncertain virus outlook, it is far too early to get excited about Britain's recovery prospects. But if Brexit worries can be put to bed, after plaguing both business and investor sentiment for years, it would go some way to improving things. Posturing aside, the incentive to strike a deal is certainly there for both sides.

Busting the Big Five of 'Big Tech'

The US technology sector is full of winners. For years now, the growth-intensive strategies of the Silicon Valley mega-caps have driven an astonishing rise to wealth, power and influence. Taking advantage of new and uncharted territory, they have achieved a level of dominance in their various markets that we have not seen for decades. In that respect, 2020 has been a great year for the 'big five': Amazon, Apple, Alphabet (Google), Microsoft and Facebook. Online services have clearly been growing in importance for decades, but having the world under 'house arrest' has supercharged this trend. In just six months, a good few years' worth of switching to internet services has happened. People all over the world have relied on those five companies for shopping, communication, entertainment, business and social interaction.

This pandemic has done wonders for their stock prices. A few months ago, Apple made history, becoming the first company valued at more than $2 trillion, and back in June, the big five were worth over 22% of the entire S&P 500.

But while investors have been unequivocal in their support, this market dominance has not escaped criticism. Controversies around Facebook's electioneering, Amazon's poor workplace standards and Apple's monopolistic practices have dirtied big tech's 'do-no-harm' public image. And, with these companies wielding huge amounts of power in their respective domains, the public backlash has increasingly spilt into the political sphere. The wild west of new and unregulated tech markets feels ripe to be tamed by politicians, with tighter rules surely set to come.

Judging by a report last week from the US House Judiciary Committee, things could look very different for tech companies when that regulation arrives. In the report, the US Democratic party laid out its vision for reining in four of the big five. Lawmakers argued Amazon, Facebook, Alphabet and Apple all held monopoly power in their fields. "To put it simply, companies that once were scrappy, underdog startups that challenged the status quo have become monopolies we last saw in the era of oil barons and railroad tycoons," write the subcommittee.

There was one notable absentee from the list: Microsoft. Being cynical, one might put this down to its importance, or the political clout of its senior management. But there is a fairly substantial difference the way Microsoft operates compared to the other four. For one, it does not leverage its 'gatekeeper' status in the way those others do. It is also more entwined with the US Department of Defence, having been awarded several multi-billion-dollar cloud computing contracts by the Pentagon.

The Democrats have offered detailed and extensive proposals for challenging the monopolies of these tech tycoons. They want to beef up antitrust law to force more competitive practices, including: requiring online marketplaces to be independently-run businesses or establishing rules for how these marketplaces can run; blocking online platforms from 'playing favourites' with content providers; requiring users to carry information from one platform to another; directing antitrust enforcers to assume tech acquisitions are anticompetitive; and allowing news publishers collective bargaining with online platforms.

All of these would have huge impacts on how the big four are run, but possibly one of the most important could be the provisions against favouritism. Not only would this take the gatekeeping power away from tech companies, it could effectively require them to hive off and separate parts of their businesses, as online platforms would not be allowed to give their own content preferential treatment.

The Democrats were keen to stress this would be less of a regulatory overhaul and more a way of updating existing antitrust rules for a new setting, rather than hampering firms' business plans. The existing rules are more aimed at stopping big tech firms from disadvantaging consumers by using their monopolistic powers to dictate prices, whereas last Friday's issue is one of 'monopsonic' powers. This refers to companies that are the dominating buyers in certain sectors, which allows them to squeeze everyone else in their supply chain and rob them of their profit margins. But from the big tech perspective, the problem is that squeezing everyone else often *is* the business plan.

By rapidly building scale, firms have been able to dominate their respective spheres and use their leverage to suppress competition. Not all these companies are the same in this respect, but part of the issue for regulators is that – as hinted at above – this is not the way we traditionally think about the problem of monopoly. Monopolies in the past have been hoarders and price-setters, hurting consumers. But Amazon are not hiking prices for consumers – far from it. Instead, while the online retailer has been able to lower prices for consumers, they have also pushed down prices paid to end-producers. Regulators are now perking up to the idea that this new style of monopoly is not as benevolent as it may have seemed. And, without its ability to exert price pressure in this way, big tech could lose some of its shine.

Of course, this would involve the report's proposals actually being adopted. If the Democrats were to take a clean sweep in next month's election – winning the Presidency, the House and the Senate – this would start to look very likely.

Republicans also have issues with these companies but have declined to sign the report. A few share the concerns about monopoly, but most are more convinced that these firms have a left-wing bias in their monitoring of social media platforms. Any power that the Republicans retain post-election will therefore complicate matters.

Even so, the political backlash against big tech is clearly a bipartisan issue, and we note the timing of this report is crucial. It comes just before an election and after months of severe upheaval where news of Apple's incredible stock price and Jeff Bezos' huge wealth increase got plenty of airtime, while the vulnerable suffered. But it also comes as the big four have started changing as well. Over the past two years (but even more so this year) Apple, Amazon, Google and Facebook have started generating a huge amount of free cash flow. That is, they have stopped focusing as much on reinvesting every $ for growth and are focusing instead more on generating profits.

These are effectively the signs of businesses maturing. The fact that a more comprehensive regulatory environment is also set to come could change the way America's tech superstars are seen. These companies still are – and will continue to be – huge winners. But if capital markets and the economy itself became less concentrated in them, that would surely be a positive.

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12th October 2020

Global Equity Markets

Market	Fri 15:45	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6014.1	+1.9	+112.0	→	↘
FTSE 250	18068	+3.9	+672.3	⬀	↘
FTSE AS	3377.0	+2.3	+75.6	→	↘
FTSE Small	5248.5	+3.7	+188.7	⬀	↘
CAC	4934.9	+2.3	+110.1	→	↘
DAX	13015.1	+2.6	+326.1	→	→
Dow	28495	+2.9	+812.5	⬀	→
S&P 500	3459.6	+3.3	+111.1	→	⬀
Nasdaq	11521.8	+4.0	+446.7	→	↗
Nikkei	23619.7	+2.6	+589.8	⬀	→
MSCI World	2427.4	+2.7	+65.0	→	→
MSCI EM	1117.4	+3.3	+35.7	⬀	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Rolls-Royce	+86.8	Ocado	-10.4
Melrose	+12.4	Hargreaves Lansdown	-5.2
Int'l Consol Air	+12.2	Intertek	-4.2
Micro Focus Int'l	+11.0	RELX	-3.6
Taylor Wimpey	+10.5	Mondi	-3.5

Currencies

Pair	last	%1W
USD/GBP	1.299	+0.4
GBP/EUR	0.910	-0.5
USD/EUR	1.18	+0.9
JPY/USD	105.67	-0.4
CNY/USD	6.69	+1.4
Bitcoin/$	11,072	+5.0

Commodities

Cmdty	last	%1W
Oil	43.07	+9.7
Gold	1927.2	+1.4
Silver	24.75	+4.3
Copper	306.1	+2.8
Aluminium	1804.5	+3.7
Soft Cmdties	363.8	+1.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.27	+0.02
UK 15-Yr	0.51	+0.03
US 10-Yr	0.76	+0.06
French 10-Yr	-0.28	-0.02
German 10-Yr	-0.54	-0.01
Japanese 10-Yr	0.04	+0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	19.2	19.6	13.7
FTSE 250	2.5	15.4	23.7	14.8
FTSE AS	3.6	18.3	20.5	13.8
FTSE Small	3.3	17.5	-	13.8
CAC	2.2	20.2	25.3	14.1
DAX	2.8	22.4	20.2	12.9
Dow	2.2	22.6	24.3	15.6
S&P 500	1.7	25.7	25.8	16.6
Nasdaq	0.8	36.3	31.4	18.9
Nikkei	1.7	23.6	23.6	17.1
MSCI World	2.0	24.0	24.3	15.8
MSCI EM	2.2	17.6	18.1	12.1

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.74	1.65
3-yr Fixed Rate	1.86	1.83
5-yr Fixed Rate	1.92	1.85
10-yr Fixed Rate	2.45	2.42
Standard Variable	3.50	3.54

* 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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12th October 2020

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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