THE **CAMBRIDGE** WEEKLY

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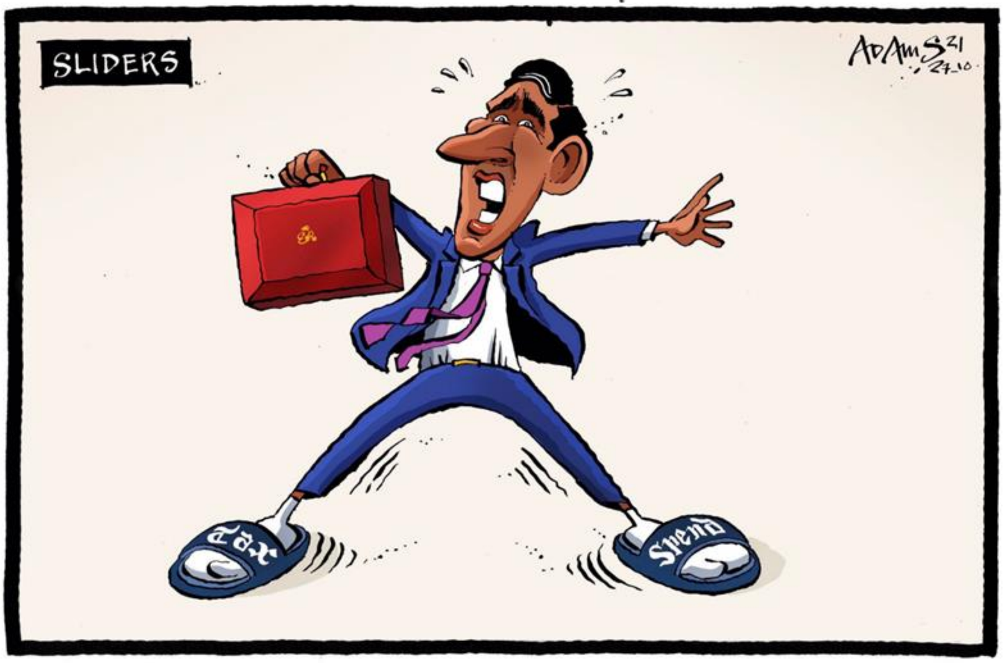
Global political leadership, Patrick Blower 22 Sep 2021



UK budget splits; Source: Christian Adams, 27 Oct 2021

Bond markets give central bankers a telling off

Last week was generally positive for capital markets, although with one notable difference – this time bond investors were allowed to join in. Just as energy prices started stabilising, corporate earnings results proved less supportive than in recent weeks, while macroeconomic data continued documenting the anticipated slowdown of the global economy. This resulted in a slight deterioration of investors' growth expectations for next year, which was not enough to rob equity markets of medium-term support but sufficient to move bond markets. As we have written here so often recently, bond markets are currently quite influential.

With current inflation pressures proving more stubborn than the central banks' transitory description has us think, short-term yields rose, whereas longer maturity yields (more susceptible to weaker growth expectations) fell quite noticeably. Gone are the heady days of the first half of the year, when talk of the onset of a 'roaring twenties' decade saw growth expectations go overboard and longer maturity yields rise so uncomfortably fast that equity investors started to fear their competition. Last week, it was the other way around; falling bond yields gave equity holders comfort that even more benign corporate profit growth rates might still shine relative to what is available in bond yields.

While central banks like the European Central Bank (ECB) continued to repeat their mantra of lower rates for longer, bond markets told them in no uncertain terms to wake up and smell the coffee – and of inflation eating away even more at their meagre-to-negative yields. Only the central bank of Brazil has bowed to the pressure so far, but with a 1.5% rate hike, they certainly set the mark of what is possible.

We should always refrain from reading too much into one week of capital market movements, but the UK's Budget announcements were a case in point. No matter how much Chancellor Rishi Sunak tried to portray his Budget as one of fiscal expansion to get the economy back onto a better growth trajectory, commentators and markets looked through the short-term fiscal easing and focused on the medium-term tightening through rising taxes. The unwinding of pandemic support programmes constitutes a formidable challenge to governments around the world, because unless the private sector picks up the slack at the same rate as governments remove the support, it becomes a drag on the combined demand that drives the economy.

The biggest fiscal support expectations were always centred on the US, and here at least there appeared to be some light at the end of the tunnel as political negotiations progressed. But however you look at the picture as a whole, with the monetary tightening that is taking place – courtesy of the bond markets pre-empting what central banks are loath to do – the fiscal easing that would counterbalance this (and also put global economic growth onto a more even keel) is not as forthcoming as expected and telegraphed earlier in the year.

Those who were expecting investment programmes to counter climate change to tip the fiscal spending balance for the economy are eagerly looking to the COP26 gathering of world leaders in Glasgow over the coming fortnight. We are not holding our breath for any big breakthroughs and announcements, but would very much like to see the current talk around creating more reliable investment frameworks converted into meaningful action and progress. It is all very well to call for the 'invisible hand' of markets to help fix the problem, but unless leadership is forthcoming in creating a reliable globally-binding framework in which investors gain more planning security, then announcements by big investment groups may prove just as toothless now as political leaders aspirational CO^2 reduction announcements did at past COP meetings.

None of last week's events and insights were in any way earth-shattering or deeply worrying for investors. They simply suggest that the economic upside (and therefore the investment upside) was last week seen as more limited than previously anticipated. There are plenty of voices reminding us this is all still part of the 'climbing the wall of worries' narrative discussed here before.

We would largely agree, but as with the threat of climate change counter action, time is of the essence if we want to experience a brighter future than the ten years behind us.

Rishi Sunak tries to look large

Rishi Sunak is on a mission to cut taxes. The Chancellor of the Exchequer feels so strongly about this mission that he describes it as a "moral" one. He is – as he reminded MPs in his Autumn Budget last week – a small-state conservative at heart, with a desire to lower taxes and stop the inexorable growth of public spending. But if the mission is to trim the Treasury's waistline, the diet only starts tomorrow. Today is the feast. Because in the same speech where Sunak talked up his fiscal conservatism, he announced the highest levels of public spending since the 1970s (with the exception of the time since the pandemic), coupled with Britain's highest taxes since the 1950s.

Total government spending will account for 41.6% of UK GDP by the 2026-27 fiscal year. That is below the 45% we will see in 2021-22, and significantly below the 53.1% reached in the height of the pandemic. But while the Chancellor boasted these facts as a show of the government's shrinking fiscal footprint, the result is, nevertheless, long-term tax and spend figures well above pre-pandemic levels.

The government already outlined plans to raise corporation taxes and freeze tax thresholds back in March. And next year, the new health and social care levy will increase National Insurance contributions for the public. These tax increases help the government cover its significant new spending plans. The Treasury is now able to oversee a 4% yearly rise in health spending over the next three years without squeezing funding from other departments. This means previously planned boosts in non-health related spending – announced in 2020 but clawed back in March this year – can go ahead.

Changing economic forecasts have significantly impacted the Treasury's new spending plans. Earlier this year, the Office for Budget Responsibility (OBR) predicted significant economic 'scarring' from the pandemic, leaving a gaping hole in public finances that Sunak was anxious to fill. The fiscal watchdog has now lowered its estimates of the post-covid drag on tax revenues, giving the government more headroom.

The interesting part is what the Chancellor has done with that headroom. He could have reversed tax rises, but instead chose to bolster public coffers and bring down regular borrowing over the longer-term. This constitutes a marked change from his predecessors. In the aftermath of the global financial crisis, the Conservative government spent years slashing public spending despite recovering tax revenues – a process which only gradually wound down under chancellors Phillip Hammond and Sajid Javid. But the current plans are about as far from austerity thinking as possible. Sunak might want to appear in the George Osbourne school of fiscal policy, but his policies look closer to Gordon Brown.

The capital market response to this budget has been interesting. Short-term bond yields in the UK have been driven up – reflecting a boost to growth expectations. But further out, bond yields have fallen, suggesting investors are either less confident about long-term growth prospects or expect the government having to tap capital markets less, or likely a combination of both. This has resulted in a flattening of the yield curve – the difference between bonds of different maturities.

A crucial element to this, well-noted by the Chancellor, is inflation. A plethora of global supply constraints have teamed up with domestic problems to deliver a sharp spike in prices. Inflation is expected to peak at 4.4% in the second quarter of 2022, well above the level forecasted back in March.

The OBR agrees with many economists that the inflation spike will be relatively short-lived, but there are concerns that elevated prices could persist.

The Bank of England (BoE) seems to share these concerns. At its latest meeting, officials strongly suggested they would raise interest rates by the end of the year to combat rising prices. An increase in public spending will only raise inflation expectations further in the short-term, giving the BoE more reason to act. But as we wrote two weeks ago, on growth, a tightening of monetary policy could have an offsetting impact to the government's fiscal easing, hitting demand over the medium-term.

Sunak's fiscal announcement could also impact the longer-term outlook. While big spending announcements have been made, the fact they are coupled with tax increases means the money coming over the next few years does not, on balance, amount to a significant loosening of fiscal policy. At the height of lockdown, the government was happy to spend big, and bond markets were happy to let them. That support – and its overall effect on fiscal impetus – is winding down. As Martin Sandbu wrote in the FT last week, the result in the short term is a significant fiscal tightening compared to the past 18 months.

This is far from just a British problem. In the US, the Democratic Party is struggling to find a common voice on fiscal policy, despite President Biden announcing a new tax and spend framework last week. All the while, there is an ongoing fight about the US debt ceiling, which limits the administration's ability to borrow, regardless of spending plans already agreed and legislated through the annual budget. As COVID support programmes are wound down – but new fiscal support for the economic restart is delayed – this results is an historically large 'fiscal drag' on the US economy. According to the Brookings Institution's Hutchins Center, America's fiscal policy is currently reducing growth by 2-3 percentage points, and the effect is expected to continue for the next two years (this projection for now does not include new fiscal spending, notably the Build Back Better (BBB) initiative).

In Europe, the European Union (EU) growth and stability pact – which sets strict limits on how much nations are allowed to borrow – is suspended for 2022. This is a positive for supporting growth, but the rules will come back into force the following year – and what form they will take is not yet clear. If the first announcements of what should become Germany's new government is anything to go by, we should not expect fiscal largesse.

There was excitement that the 'traffic light coalition' (comprising the Social Democrats, Greens, and the Free Democratic Party) might loosen the country's stringent budgetary rules and make space for fiscal expansion. But the coalition negotiations starting point has now been agreed to be a return to constitutional debt limits. And, while politicians have been light on financing details, the FDP campaigned against any tax rises – suggesting fiscal investment will be contained.

According to estimates from the International Monetary Fund, the UK's fiscal contraction is currently bigger than most – which is mostly a consequence of the largess of the past 18 months coming to an end as furlough, business support and various pandemic related health sector measures are ending . The Chancellor's new Budget has somewhat helped this cliff-edge situation for the shorter term, but after that a tightening of the belt still looms large. The hope is that fiscal policy can still be proactive and investmentstimulating – supported by the OBR's prediction of 'tax-led' (!) growth. But as the Chancellor reminds us, his long-term aim is to cut taxes. That would only be possible if he received further tax windfalls from the Treasury like he received since the March Budget. Rising energy and resource prices are very unwelcome in this respect, given they divert money from the Treasury to overseas suppliers. Whether the UK's economy can still outgrow fiscal realities that the Chancellor elected to dodge this time around remains to be seen.

COP26: For market support the world needs its leaders to lead

The 2021 United Nations Climate Change Conference, known as COP26, began on Sunday. In September, Boris Johnson told world leaders at the UN that "it is easy being green" and referenced Kermit the Frog to reinforce his point. But on Monday, he was downplaying expectations by telling schoolchildren and reporters in Downing Street that it was "touch and go" whether COP26 would deliver any sort of climate change breakthrough.

The mood darkened further during the past week after it was announced that the $100 billion of climate finance promised by developed countries in 2005 – pledged to help developing countries adapt to climate change – had not been met by the original deadline of 2020, and would most likely not be reached until 2023.

Next came another stark warning from the UN, ratcheting up the pressure on COP26 attendees. It declared climate goals are off track and emissions rise could lead to 2.7C warming. Some countries, notably China and India, have not updated their emissions reduction pledges ahead of the summit. Other nations, including Brazil, have submitted weaker pledges than were outlined in their original commitments. As one of the UN delegates succinctly put it: "Unless more progress is made in the next fortnight, we will all be in trouble."

We don't have a crystal ball of course, so it's impossible to make any predictions of what progress will indeed be made over the next couple of weeks, if any. That said, news flow last week presented a few ideas on what to look out for.

For example, COP26 could deliver what's being labelled a "methane moment", after another 25 countries joined the US and EU-led initiative to drastically cut global methane emissions by 30% from their 2020 levels by 2030. That takes the total number of countries backing the pledge to 34, although again, Brazil, India and China are conspicuous by their absence. This is a positive development. While carbon dioxide (CO^2) is the biggest contributor towards human-made global warming, methane runs a significant second. According to the International Panel on Climate Change, methane contributed to about 0.5°C of warming between 2010 and 2019 relative to 1850-1900 levels, whereas carbon dioxide produced about 0.7°C of warming over the same period.

Although carbon dioxide gas stays in the atmosphere for longer, methane is considered some 28 times more potent in global warming terms, as its properties trap more heat.

Another initiative to look out for over the next fortnight could be further developments made on carbon pricing. Carbon pricing programmes usually involve countries taxing polluters' carbon emissions, or 'cap and trade' systems that effectively limit a company's level of emissions before costs become prohibitive.

International business groups are pushing for an international carbon price strategy to be unveiled at COP26, to prevent the bewildering patchwork collection of local policies they are struggling to contend with now. The World Bank recently identified 64 different carbon pricing initiatives across 45 countries. Disappointingly, the World Bank says these initiatives cover less than 22% of global carbon emissions, and most schemes use carbon prices too low to incentivise heavy emitters to change their business models.

Carbon trading schemes rely on private market mechanisms to attach a price to a tonne of CO^2. Usually, governments set an economy-wide allowance (or per sector) and issue permits. If a company needs more permits, it has to purchase them in the CO^2 market. It is a highly effective set-up (first applied in the early 1990s to reduce US sulphur emissions in the most cost-effective way), provided it comes equipped with a functioning framework. Recurring issues are that too many permits are issued, and hence the trading price drops close to zero. Remedies to this include issuing fewer permits or, as California has decided, introducing a floor, which is then a carbon tax that the government levies. Besides poorly set-up trading mechanisms, control and enforcement mechanisms also tend to be too weak. What really seems to be lacking, on top of it, is international co-ordination on such schemes, which renders them currently to be somewhat akin (and globally ineffective) as domestic stock markets that operate under capital controls.

Getting a majority of countries to agree to some sort of carbon pricing framework looks like a tall order. A carbon price that is high enough to limit rising temperatures to no more than 2°C from pre-industrial times is considered unworkable by the likes of the US, China and India. The EU, however, has been more forward-thinking, adopting its own 'carbon-border adjustment mechanism'. This would mean companies importing goods – such as steel, aluminium, fertiliser, cement or electricity – into the EU would have to buy carbon certificates that reflect the same carbon prices faced by European producers under the EU's emissions trading system. However, even this scheme has been criticised, with detractors suggesting it could lead producers from developing nations to sell into other markets with lower standards, hindering climate action.

The UK is not a member of the EU's mechanism, which is perhaps another example of the somewhat muddled response from the UK government. At COP26, Boris Johnson will plead with the international community to make significant pledges to cut carbon emissions. Yet on Thursday, Rishi Sunak's Autumn Budget drew criticism for measures that would make it cheaper to take domestic flights. Sunak also continued the time-honoured practice of freezing fuel duty (a freeze that has remained firmly in place since 2010), which has the net result of making car travel less expensive than more environmentally sustainable alternatives. According to the Office for Budget Responsibility, this year's fuel duty freeze alone will mean an additional 450 million litres of fossil fuels purchased over the next five years. Such mixed messages certainly make alignment difficult.

When it comes to tackling climate change, every action has a reaction, and risks creating losers as well as winners. Which leads us to another key theme that emerged last week: divestment. Last Tuesday, Europe's biggest pension fund, ABP of the Netherlands, announced plans to divest €15 billion worth of fossil fuel assets by early 2023. The fund said it doesn't expect the decision to hurt long-term returns and added that the move will allow it to unveil a more ambitious CO2 reduction goal next year. Also on Tuesday, several UK faith institutions, announced an en masse $4.2 billion divestment from coal, oil and gas companies. Six cities, including host city Glasgow, have also said they will sign formal commitments to dispose of their fossil fuel assets in the future. According to the DivestInvest lobby group, that helps to bring the totals committed to be divested by asset managers on behalf of their investors to a stunning £39 trillion in the next few years.

Unsurprisingly, fossil fuel producers have spoken out against the hidden dangers of divestment. Coal producer Glencore argued that the movement was counterproductive, as it would force them to dispose of their assets and place them in the hands of less responsible owners ('brown-washing'). Other producers have pointed out that it is better to allow these assets to run down, and that companies that demonstrate engagement on addressing the climate agenda should still be deemed worthy of investment. They do have a point. After all, divestment arguably just means gains are being pushed elsewhere and perhaps towards investors without CO2 reduction aims at all, and that will most likely have unforeseen and unintended consequences.

Unceremoniously dumping fossil fuels might well be a 'quick win' for funds that are keen to decarbonise their portfolios – although whether this has a net positive effect on the environment – as discussed above – is another matter entirely. It changes the dynamics of capital markets, certainly, but without addressing the underlying problem. After all, selling the stocks themselves doesn't reduce the demand – or use – of fossil fuels. Instead, it's likely to just make stocks more volatile, and therefore tradeable. Without government action, and policy on a global scale, that discourages the use of fossil fuels, there will always be a demand for 'dirty fuels' to be met by someone.

The markets will always look towards global leaders to provide them with the framework in which they can successfully operate. If we think green investment is still the missing piece of the puzzle, and we want the market to help solve this problem, we need a framework that is clear, transparent and can be relied on to be here to stay to provide the planning certainty that is so crucial for successful longer-term investments. At the same time, from an investment point of view, it's important to recognise that climate change is not a sector-by-sector issue. The whole of the economy has to 'green up', while accepting the risk of stranded assets and that there will be losers as well as winners.

Climate change is a global problem that requires a truly global approach. The key point regarding COP26 is that big events like these can – and must – be used to create common frameworks. So far, governments have been walking a political tightrope in terms of making the right noises about dealing with climate change, but without making the hard choices that a genuine commitment demands, or without being honest about what a fully transitioned global economy would look like – for better or worse. We can't keep having it both ways.

CAMBRIDGE
INVESTMENTS LIMITED

1st November 2021

Global Equity Markets

Market	Fri 16:13	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7225	+0.3	+26	⬀	⬀
FTSE 250	23108	+0.8	+176	⬂	↗
FTSE AS	4126	+0.4	+17	→	⬀
FTSE Small	7412	-0.1	-10	→	↗
CAC	6806	+1.1	+77	⬀	↗
DAX	15645	+0.7	+102	→	↗
Dow	35788	+0.3	+111	⬀	↗
S&P 500	4585	+0.9	+44	⬀	↗
Nasdaq	15415	+2.2	+325	→	↗
Nikkei	28893	+0.3	+88	↘	→
MSCI World	3179	+0.9	+28	→	↗
CSI 300	4909	-1.0	-51	⬂	↘
MSCI EM	1276	-1.3	-17	⬂	↘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
WPP	+10.7	Just Eat Takeaway.cor	-8.7
Reckitt Benckiser	+7.5	London Stock Exchang	-7.1
Compass	+7.0	BAE Systems	-6.6
GlaxoSmithKline	+6.2	Fresnillo	-6.2
InterCont'l Hotels	+4.9	Admiral	-5.8

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.370	-0.4	Oil	84.21	-1.5
GBP/EUR	0.844	-0.3	Gold	1778.2	-0.8
USD/EUR	1.16	-0.7	Silver	23.86	-1.9
JPY/USD	114.00	+0.4	Copper	435.9	-3.1
CNY/USD	6.40	+0.3	Aluminium	2746.5	-5.6
Bitcoin/$	61,886	+1.2	Soft Cmdties	227.0	+1.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.05	-0.10
UK 15-Yr	1.17	-0.15
US 10-Yr	1.57	-0.06
French 10-Yr	0.28	+0.05
German 10-Yr	-0.10	+0.01
Japanese 10-Yr	0.10	+0.00

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	15.3	12.7	14.2
FTSE 250	2.4	15.4	19.8	16.0
FTSE AS	3.6	14.9	13.4	14.4
FTSE Small x Inv_Tsts	2.0	6.2	16.6	15.5
CAC	2.2	20.2	16.2	15.0
DAX	2.1	14.9	15.1	13.5
Dow	1.7	19.2	18.7	16.5
S&P 500	1.3	24.9	22.3	17.7
Nasdaq	0.6	29.3	33.8	23.1
Nikkei	1.6	15.3	17.5	17.7
MSCI World	1.7	21.7	20.2	16.7
CSI 300	1.9	15.9	15.5	12.5
MSCI EM	2.4	13.6	13.4	12.5

UK Mortgage Rates

Mortgage Rates	Oct	Sep
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.20	1.23
3-yr Fixed Rate	1.20	1.37
5-yr Fixed Rate	1.29	1.37
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

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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