THE **CAMBRIDGE** WEEKLY

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Christmas tidings of comfort, if not joy

Dear readers, this week's edition will be the final one for 2021 and we look forward to welcoming you back when we next publish on 10 January 2022. Looking back, the year has exceeded some expectations and underdelivered on others. In terms of our expectations for the economic recovery and capital market performance, 2021 has been better for investors than we dared to hope and forecast at this time last year. On the other hand, we are surely not alone in having hoped the vaccination drives that began one year ago would have ensured further progress in putting the pandemic behind us than where we are now.

The Omicron wave feels like a real setback to the trajectory towards normalisation of our everyday lives. Christmas plans are once again being altered radically, disappointing those expecting a return to their pre-pandemic travel habits. This is not just bad news in respect of our festive activities, but will undoubtedly dent seasonal revenues for retailers and the hospitality sectors.

Yet, over the past week, the Christmas messages we received from central banks was distinctly one of continued normalisation, or rather phasing out of the extraordinary monetary support put in place to see the economy through the worst of the pandemic's economic shutdowns. This tells us that their economists see the current Omicron episode as short-lived, and unlikely to have a material impact on the general upwards direction economies around the world have taken since the beginning of the year.

Benign market moves suggested that central bankers had once again successfully managed market expectation, and that most investors similarly see the Omicron episode as likely to be short-lived. However, politicians cannot afford to take a similarly optimistic 'wait and see' position, and will have to assume the worst, until science informs them of the actual impact on public health of this latest COVID mutation. Until then, prudence and politicians' natural self-interests dictate making every attempt to reduce transmission, even if it impacts economic activity in the short term.

The hit to consumer and business confidence will be the key follow through for next year. If this strain of the virus is more contagious and less dangerous for most individuals (for whatever reason), it will be important for businesses that they can see the politicians acknowledging the evolution, and adapting accordingly.

The major central banks told us about their expectations for growth in last week's meetings, and collectively see a reasonably strong growth path being maintained through 2022 and into 2023. This has enabled almost all of them to shift policy away from the current ultra-easiness. Perhaps the most uplifting aspect was that all central bank commentators considered the Omicron outbreak a bump, rather than a barrier. We discuss in more detail the Federal Reserve Open Market Committee's decisions below (where we also discuss how they may not always be as impressively successful as last week). However, the one central bank that is having a bit of an issue with aspects of its credibility is… the Bank of England (BoE).

The decision by the Monetary policy Committee (MPC) to raise rates last Thursday was a surprise (just as surprising as the decision to not raise rates in November). Yes, the increase was only 15 basis points (bps), taking the base rate from 0.1% to 0.25%, and we should take heart that the MPC too sees the Omicron episode as a temporary influence. One could point out that the BoE's bond-buying quantitative easing operation ended only very recently, and it needed to see if there was any impact before taking any further policy steps. Yet the BoE's briefing of the underlying situation for December differed very little from that in November and, subsequently, Governor Andrew Bailey seemed to indicate that the path to higher rates

was still in the future. In the words of Allan Monks of JP Morgan: *"It has been hard to read the BoE's reaction function of late, and while some members responded to the confusion surrounding the November meeting by saying less rather than more, that only added, in our view, to the difficulty in understanding what they were thinking in the run-up to this meeting… 2021 will not go down as the BoE's finest for clarity of communications, but at least 2022 brings hope".*

Much of the uncertainty seems to stem from whether inflation has the potential to become a bigger issue that central forecasts have indicated. So, does the UK have a more problematic inflation outlook than others? Are we on a path to much higher rates? Here's Allan Monks of JPM again: *"CPI is on track to climb to a peak of around 5.7% next April and remain close to 3% into 2023* [if there were to be no tightening]. *The BoE's forecasting model imply that 20bps of tightening would be necessary to reduce medium term inflation by 0.1%. This would imply (about) 120bps of tightening would be necessary to return inflation to target. While* [JPM's] *forecast does show this level being reached by end-2023, surprises could force the BoE to act faster."*

Right now, however, none of the UK markets are behaving as if there is a big problem brewing. Sterling is stable and the equity market has kept up. If anything, it may have started to outperform.

Another thought we take away from last week's juxtaposition of central bank direction compared to public health policy, is that monetary policymakers have seemingly – and with a certain amount of courage – moved towards a post-pandemic mindset. Meanwhile, politicians have continued to resort to very similar restriction of movement and crowd management policies, just as they have with every previous COVID wave and mutation. Eventually, politicians too will have to decide whether, on balance, it is still constructive to shut down vast parts of societal activities with every new variant. The question will be, at what level of public health impact we have reached the point when the virulence of the latest COVID mutation has become comparable to what we have always lived with, and accepted as the natural impact of what we know as seasonal flu.

Since we started the year with Brexit, it may be appropriate to close it also with a thought on Brexit. The outcome of the North Shropshire by-election provided a surprise and unwelcome 'Christmas gift' for the Johnson government, but perhaps also marked a shift in priorities that were not mentioned in Thursday night's victory speeches. The constituents of a previously staunchly Brexit-supporting constituency, perhaps inadvertently, voted for the only party committed to seeking the UK's eventual return to Europe - an ironic way to give Boris Johnson a bloody nose. Meanwhile, Jersey issued French trawlers with more fishing licenses, and the UK's Northern Ireland Protocol negotiating team conceded that the European Court of Justice may be the arbiter in matters which are considered under European law. Have we moved beyond the dogmatic Brexit and are about to see a more pragmatic way forward? The UK's economy would certainly be grateful, and provide a good basis for a solid return on such 'investment'.

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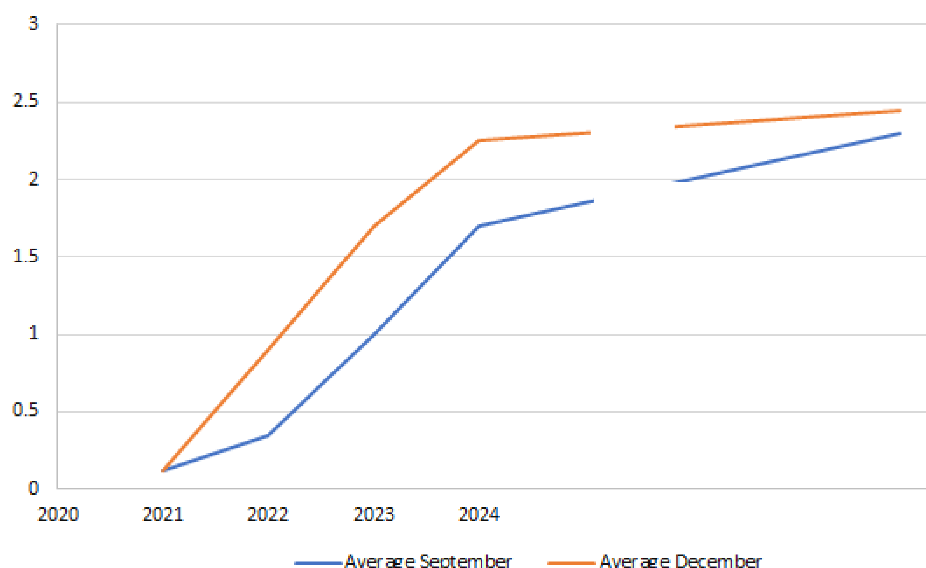
Fed puts faith in US economy

Kudos to the US Federal Reserve (Fed) for a seamless change of game plan. Throughout the pandemic, investors (ourselves included) held a lingering fear of ill-timed or ill-sized monetary policy tightening. Historically low interest rates and emergency support measures have helped to keep the economy above water for the last two years, making the onset of their removal a troubling thought. The inevitable finally came true last week: on Wednesday, Fed officials announced a doubling of bond-buying reductions (tapering) starting in January, and the expectation of no less than three interest rate rises to come in 2022. And yet, investors were not alarmed. Far from it, markets had a delightful afternoon – with the S&P 500 rising 1.6% and the tech-heavy Nasdaq jumping 2.2% – even if the rally subsequently fizzled out, as some short-covering price squeezes of those who had bet against the Fed, faded.

Fed chair, Jay Powell, seems to have a good relationship with capital markets, allowing him to taper asset purchases without the tantrum. And, as with any good relationship, communication is key. Powell and company have spent the whole of 2021 preparing markets for the taper, and when inflation expectations rose, Fed officials gradually but consistently fed in the notion that the pace of tapering could accelerate.

Last week's changes to the 'dot plot' (showing how policymakers expect rates to change over the next few years, see chart below) have brought the Fed's interest rate outlook more in line with the latest market expectations. Crucially, investors have not interpreted the Fed's change of pace as a change of destination: indicators of expected longer-term rates were unchanged or down, suggesting markets do not expect rates above 1.5% in the next few years. We have written before that a difficult part of the Fed's current job is convincing markets that the removal of emergency support should not be a sign of outright hawkishness, and it seems the central bank is doing this well.



Source: Federal Reserve Open Markets Committee, Tatton IM: lines indicate views in September and December 2021, the gap indicates the absence of expectation point between 2024 and the long term

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That said, officials could have made the case for liquidity management a little clearer. As noted previously, excess liquidity is a big reason for the Fed's tightening. Moves in money markets have shown that the financial system is close to having more liquidity than it knows what to do with, which could have destabilising consequences. Draining some of this liquidity through tighter policy therefore makes sense, and is a big part of the central bank's policy. But the Fed chose to focus more on inflation targeting in justifying its faster taper – perhaps because that is far more straightforward to communicate than how and why excess liquidity has manifested itself and become an issue.

However, we can – and should – also consider the effects on other sources of liquidity. Brokerages and market makers provide support for the smooth running of the financial system by keeping money flowing. But since regulation has changed since the global financial crisis, keeping an inventory of US Treasury bonds becomes more expensive – meaning brokers are less likely to step in at times of stress. That risk of stress increases as the Fed withdraws as the major buyer of those bonds, once again leaving the broader liquidity provision in the hand of the private sector. Hence, not only the Fed but also regulators are mulling over reforms as to how smooth liquidity conditions can be maintained. Pressure will likely build even more when the central bank becomes a net seller of bonds (Goldman Sachs analysts expect this will occur in the last quarter of 2022).

All of this restricts trading liquidity. That tends to lead to choppier markets, even if investors are largely optimistic. We should, therefore, expect increased volatility, especially at the short-term maturity end of bond markets. Compounding the issue further is the US government's upcoming fiscal plans, which will inevitably require lawmakers to raise the federal debt ceiling and issue more bonds. The result is an increase in bond supply at the same time as a drop-off in demand – putting downward pressure on prices (and upward pressure on yields).

These are the usual anxieties that come from stopping emergency treatment. As Powell would point out though, stopping treatment is a necessary part of recovery. We all knew that extraordinary support would have to end sometime – and a normal functioning economy should have the depth and dynamism to survive without it.

In this respect, the Fed's hawkish turn is a reflection of its positive economic assessment. Tellingly, it removed mention of average inflation targeting – which had previously allowed it to tolerate overshooting the 2% target. Judging by the latest forecasts, officials seem to have decided the pandemic 'transition phase' is over. According to Powell: "The economy is so much stronger now, so much closer to full employment, inflation is running well above target and growth is well above potential".

That is, transition in monetary terms at least. Whether businesses and individuals have enough underlying confidence in the real economy is a different matter, and will be the crucial theme for the next few quarters. Data continues to be positive, but the rapid rise of the Omicron variant poses risks and uncertainties to the global outlook. We have already seen tighter restrictions introduced in Germany, and other countries could follow suit over the winter.

Even without full-scale lockdowns, if COVID concerns worsen people's behaviour over the Christmas period will inevitably be different from before the pandemic. The travel and leisure industries are once again most at risk – especially if they are unable to tap into emergency support as before. Some have suggested Omicron could be a long-term boon for the global economy if early reports of lower severity

prove true. That may be the case, but decreased mobility or confidence over the next few months would still be bad for short-term growth.

Regardless, the Fed clearly sees enough of an upside in growth, employment and inflation to change its tune. The removal of emergency support means it is now up to the real economy to repay the central bank's fate. Also, a faster pace of tightening means strong and self-sustained growth will have to come faster too. On that front, private sector credit growth will be a key indicator to watch over the coming months. If private lenders can fill the hole left by fiscal and monetary support, the world economy will be in good shape.

Pressure now is on other central banks to communicate their plans. The Bank of England – which has had its own communication problems recently – raised rates already last week. The European Central Bank (ECB), meanwhile, is still pushing the "transitory" rhetoric on inflation. How long that can last remains to be seen. But the market's response to Fed tightening gives the ECB – and ourselves – confidence for the road ahead.

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Global Equity Markets

Market	Fri 15:16	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7246	-0.6	-46	→	⬀
FTSE 250	22683	-1.1	-244	→	⬀
FTSE AS	4117	-0.7	-30	→	⬀
FTSE Small	7229	-1.5	-111	⬂	⬀
CAC	6902	-1.3	-89	→	↗
DAX	15445	-1.1	-179	→	⬀
Dow	35351	-1.7	-620	→	↗
S&P 500	4614	-2.1	-98	→	↗
Nasdaq	15042	-3.8	-589	→	↗
Nikkei	28546	+0.4	+108	→	→
MSCI World	3167	-0.7	-21	→	↗
CSI 300	4955	-2.0	-100	⬂	↘
MSCI EM	1224	-1.2	-15	⬂	↘

Top 5 Gainers

Company	%
Ocado	+8.4
DCC	+7.2
Fresnillo	+6.2
AstraZeneca	+4.3
Renishaw	+4.0

Top 5 Decliners

Company	%
Rentokil Initial	-14.3
JD Sports Fashion	-9.4
Rolls-Royce	-7.2
Next	-6.2
BT	-5.9

Currencies

Pair	last	%1W
USD/GBP	1.327	-0.0
GBP/EUR	0.851	+0.2
USD/EUR	1.13	-0.2
JPY/USD	113.40	+0.0
CNY/USD	6.37	-0.1
Bitcoin/$	45,922	-8.1

Commodities

Cmdty	last	%1W
Oil	73.05	-2.8
Gold	1807.6	+1.4
Silver	22.48	+1.3
Copper	429.5	+0.3
Aluminium	2667.0	+1.5
Soft Cmdties	239.6	-0.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.76	+0.02
UK 15-Yr	0.96	+0.04
US 10-Yr	1.38	-0.10
French 10-Yr	-0.03	-0.03
German 10-Yr	-0.38	-0.04
Japanese 10-Yr	0.05	-0.01

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	15.1	12.1	14.2
FTSE 250	2.5	14.9	17.9	16.1
FTSE AS	3.6	14.9	12.7	14.4
FTSE Small x Inv_Tsts	2.3	11.1	15.8	15.6
CAC	2.2	19.7	15.7	15.1
DAX	2.1	14.4	14.3	13.6
Dow	1.8	18.5	18.2	16.6
S&P 500	1.3	24.4	21.9	17.8
Nasdaq	0.6	28.4	33.1	23.4
Nikkei	1.7	15.5	17.3	17.8
MSCI World	1.7	21.0	19.9	16.8
CSI 300	1.6	17.0	17.3	12.6
MSCI EM	2.5	12.5	13.1	12.6

UK Mortgage Rates

Mortgage Rates	Dec	Nov
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.52	1.35
3-yr Fixed Rate	1.52	1.26
5-yr Fixed Rate	1.52	1.35
10-yr Fixed Rate	2.57	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

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