CAMBRIDGE
INVESTMENTS LIMITED

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A bumpy road to somewhere

It has been an all-action year so far. Global equity markets have been in a downward trend since the end of 2021, led by US stocks. America's mega-cap tech companies that were so loved throughout the pandemic have taken the biggest hit – with the tech-heavy Nasdaq falling nearly 10% in January. The change of fortunes was made abundantly clear last Friday morning after stock market darling Netflix plummeted 20% in pre-market trading after a warning on subscriber growth. UK equities seemed immune to the downturn in the first two weeks of the year, but that changed last week as the FTSE 100 joined the broader fall.

The global economy has been similarly tumultuous. There are early indications that the intense supply-side pressures we saw last year are easing – with input costs no longer spiking and supply chains freeing up. But that shows little sign yet of feeding through into inflation data. Prices are still spiking across most major economies, and consumers face a daunting shock to their real disposable incomes in the next few months. Meanwhile, growth is slowing, and central banks are removing their emergency support (more on this in a separate article).

All of this is without mentioning politics. The inescapable rollercoaster ride that is Boris Johnson's premiership rattles on – but for how much longer is impossible to say. The pressure on the Prime Minister continues to build as MPs defect or denounce him and fresh allegations emerge. What we can be confident about is the fact that investors are unphased either way. Judging by market moves, the UK economy is not expected to be much affected by change in Downing Street – even if the government's COVID policies are a source of market optimism.

That may seem an odd expectation, given the position the government is in. 'Partygate' is the highest profile problem for the Tories, but just as worrying for them is the cost-of-living crisis around the corner. The squeeze on real incomes will almost certainly see them lose some support from the 'red wall' voters gained from Labour in 2019. Meanwhile, plans to raise taxes to their highest level in decades does not play well to their traditional base. Any new leader is likely to face calls for a snap General Election, and with the explosive combination mentioned, there is no telling how that could end.

At the same time, though, markets' indifference to Westminster drama is understandable. There is still a fair (though diminishing) chance that the Prime Minister will weather the storm. Or, if he doesn't, that a continuity candidate replaces him, and no snap election is called. The status quo would then be restored and current events would be forgotten.

On a bigger geopolitical scale, all eyes are on Russian-Ukrainian tensions with its repercussions on the relationship with NATO members. The threat of destabilising conflict is significant, and Russian financial markets have reacted negatively. Government bond spreads have widened, and the stock market underperformed its Western peers. Global markets seem more pre-occupied with their own troubles though, as the big pandemic winners adjust their earnings outlook to a world without stay-at-home policies, and most importantly, the tightening stance from the US Federal Reserve (Fed). All in all, it seems global markets expect the significant political volatility will not affect the status quo.

Russia was one of the many emerging markets (EM) that tightened monetary policy last year in response to soaring inflation. But as inflation stabilises or drops back, EM central banks will be able to stop or even reverse interest rate rises. Barring a global risk-off move toward a stronger US dollar, this would be an attractive backdrop for EM debt. Russia is a case in point here: its yield curve (the difference between short and long-term debt) has inverted, which suggests markets think the tightening cycle is close to its peak.

	Curve Id	1Y	2Y	3Y	5Y	7Y	10Y	15Y
11)	I326	9.795	9.610	9.685	9.615	9.555	9.405	9.270

The global economy can often still thrive with emerging markets lagging, but there is one notable exception: China. Though classed as an EM, it has such weight in the global economy that its economic development sifts into the rest of the world. In response to a continued slowdown in growth and a weak housing market, China continued easing policy last week by cutting interest rates. Onshore and offshore Chinese equities welcomed this move, and promptly outperformed their Western market peers. Indeed, on a price-to-earnings basis, Chinese equities are trading at a steep discount compared to developed markets.

We suspect Western economies are living through the last bout of COVID-induced distortions. If so, the coming quarters will reveal the genuine underlying pace of growth, and hence companies' long-term earnings potential. The transition phase will bring both pros and cons for markets. On the plus side, fewer virus restrictions will be a boon for those industries that have struggled in the last two years, particularly services, while input cost pressures should subside. On the other hand, real disposable incomes will be hit with higher prices, while monetary and fiscal tightening will add to the squeeze on businesses and consumers.

As the growth cycle matures, markets will adjust toward higher real interest rates, not just in the US but across most major economies. This is all part of the road back to normal, but after so long on emergency support, there will inevitably be bumps along the way.

We can see as much in the cyclical rotation of assets. Sectors that are highly sensitive to real interest rates did very well through the pandemic, but now those same sectors are under pressure. Long duration investments like technology and consumer discretionary companies have underperformed this year, as stretched valuations limit their growth potential. As economies open up, sectors will converge towards their new position within the ecosystem.

We have every reason to think this new ecosystem will be a healthy one – with many opportunities for growth. Changing conditions are likely to bring more volatility, as we have plainly seen so far this year. But volatility along the way does not mean we will end up in a worse place. It could be a bumpy road, but the destination should still be a good one.

Earnings outlook

Investors could do with some good news. Inflation pressures continue to bite harder than expected while central banks press forward with their plans for tightening policy. But amid the market fears over global growth, hard data from companies can often provide some respite. As ever, the corporate earnings season for the last quarter of 2021 is an important one.

Reporting is in its early days, but the results so far are decidedly mixed. Figures are largely in line with expectations, with no major surprises on earnings growth, sales, or forward guidance. Regular readers will know that earnings 'surprises' are often a deliberate tactic: companies have a habit of lowering expectations so they can beat them on results day, giving a boost to share prices. No positive surprises then should probably be seen as slightly negative news.

In the US, much of the action has been driven by banks, which have recorded some decent but underwhelming results. Those that have reported so far have generally beaten estimates, but have been weighed down by concerns over investment banking revenues and higher pay affecting cost-income ratios. JPMorgan and Goldman Sachs reported some higher-than-expected costs, but these do not appear to be industry-wide trends. More traditional banking activity may perform better in a rising interest rate environment. Overall growth is expected to be healthy, but the outlook for the next few quarters shows a marked slowdown from the stellar figures in the first half of 2021.

SPX Index | Table | Export | Settings | Earnings Analysis
Range Current Season | CQ4 Ending: 11/16/2021 - 2/15/2022 | Periodicity Quarter
S&P 500 INDEX
Surprise | Growth

Sector (GICS)	Reported	Sales Surprise	Earnings Surprise
11) All Securities	64 / 500	2.34%	8.96%
12) > Energy	3 / 21	6.85%	3.63%
13) > Materials	1 / 28	3.15%	8.43%
14) > Industrials	10 / 72	2.84%	25.19%
15) > Consumer Discretionary	6 / 60	3.86%	5.68%
16) > Consumer Staples	7 / 32	2.26%	6.25%
17) > Health Care	2 / 64	1.10%	3.74%
18) > Financials	28 / 67	2.02%	9.49%
19) > Information Technology	5 / 76	2.68%	5.11%
20) > Communication Services	1 / 23	-0.03%	64.60%
21) > Utilities	0 / 28		
22) > Real Estate	1 / 29	6.51%	1.82%

Range Current Season | CQ4 Ending: 11/16/2021 - 2/15/2022 | Periodicity Quarter
STXE 600 (EUR) Pr
Surprise | Growth

Sector (GICS)	Reported	Sales Surprise	Earnings Surprise
11) All Securities	19 / 446	23.94%	-4.12%
12) > Energy	0 / 14		
13) > Materials	2 / 38	1.90%	0.72%
14) > Industrials	3 / 88	1.53%	-100.00%
15) > Consumer Discretionary	5 / 47	6.19%	
16) > Consumer Staples	4 / 35	2.08%	
17) > Health Care	0 / 43		
18) > Financials	3 / 67	1118.09%	36.15%
19) > Information Technology	2 / 32	0.98%	16.68%
20) > Communication Services	0 / 33		
21) > Utilities	0 / 25		
22) > Real Estate	0 / 24		

Across all sectors, most companies have yet to report, but what we have seen so far looks fair. Again, the picture emerging is one of deceleration – as firms come away from the giddy COVID recovery last year. This is in line with our outlook for 2022: the rush of recovery is petering out, and with that economic growth figures seem to have peaked.

That is not necessarily a worry for markets or the economy. A year of lockdowns saw the biggest drop in global activity recorded, and the recovery from those depths returned equally large growth figures. But most major economies are now at or above their pre-pandemic GDP levels – so further growth will inevitably look much more ordinary. The big question now is what the world economy's cruising speed will be. Central banks have grappled with this conundrum for the better part of two years. The cautious approach from the US Federal Reserve (Fed) last year suggested policymakers thought the economy still needed help. But after inflation spiked higher and higher, officials changed course dramatically. According to its latest communications, the Fed is planning at least three interest rate hikes this year, along with a sizable reduction in its balance sheet later in the year.

For now, investors and market watchers are undecided on whether this is too harsh an approach. On the bullish side, some argue markets have enough resilience to withstand a monetary tightening – especially if Omicron proves to be the natural end to the COVID emergency. JPMorgan takes this view, predicting not

only that Q4 earnings estimates are too low, but that 2022 will surprise the upside. To back this up, analysts point to profit margins. Rising input costs were a concern for many companies last year, but profit margins remained strong. JPMorgan expects this to remain the case.

Those on the bearish side highlight the risks that Fed tightening and slower short-term growth could pose. In 2018, it hiked rates four times and reduced its total assets amid positive US and global growth. That cocktail did not immediately harm capital markets, but the drying up of liquidity created unease – and the ensuing volatility caused markets to swing downwards in the second half of the year.

That episode is instructive. Equity markets are highly sensitive to changes in real (inflation-adjusted) bond yields, which set the 'risk-free' rate of return. Even if investors are positive about growth, rising real yields will inevitably lower the attractiveness of stocks. That makes high valuations – like we see now – difficult to maintain. And while this does not stop equities from rallying overall, it does mean volatility is likely.

Market bears might also point out that the underlying growth picture is arguably worse now than it was then. Activity remains strong, but as we point out, growth seems to have peaked – with some analysts suggesting a slowdown in corporate earnings from here. In the worst-case scenario, growth would slow even more than expected – either from Omicron, continued supply chain problems, or tightness in China – while central banks pushed ahead with the tightening cycle. That would be a worrying combination, and while unlikely, it is a downside risk we need to be wary of.

The counterargument to the above is that the Fed, for all its tough talk, will adapt to the situation as it changes. Officials are serious about fighting inflation, but will be 'smart' enough to avoid a hard landing. So, Fed pronouncements may be at their hawkish peak, and also the pricing for rates this year (to top this we'd need +50 basis points of Fed fund increases in March, of which talk may emanate getting closer to the date).

January has been difficult for US equities so far, in part driven by a sell-off in bond markets. While it is not the Fed's job to keep equities elevated, it has an important influence (particularly in the US) on household consumption. In this sense, an equity 'hard landing' would not be welcome. In a broader inflation context, it is also worth keeping in mind that the supply side problems officials are so worried about are improving. By the Fed's own measures, supply congestion appears to have peaked, and input costs arguably have little upside. The tight labour market as participation rates remain low is the focus.

Our best guess is somewhere in the middle of the optimistic and pessimistic cases. With growth slowing and the Fed (for now) tightening, we are likely to see more volatility in earnings, equity values and, indeed, the real economy. It is still too early to call this the end of the cycle though, and we expect sustained growth on the horizon.

'Just-in-case' supply chains

Inflation continues to soar around the world. We wrote last week about how its persistence has driven 'team transitory' into retreat – as central banks now scramble to tighten monetary policy and choke off price rises. The strangest part of this, though, is that the argument for transitory inflation was a sound one. Most agree that soaring prices over the past 18 months have come from varied and unique supply-side issues across the world (even if against a backdrop of growing demand) and history tells us that these disruptions are usually short-lived.

To our collective surprise, supply chain problems have been anything but brief during the pandemic. The scale and longevity of these disruptions have made them a significant and unexpected problem for policymakers. Supply hold-ups are nothing new; shutdowns, warehouse fires, and regional shortages have always been a factor in the delicate global economy. But never have these problems been so ubiquitous since the start of post-war globalisation.

Some problems are particular to the pandemic – as rising infections cause worker shortages in key areas around the world. The COVID factor has also exacerbated pre-existing issues the same way, but some problems are of their own kind. Microchip shortages in 2020 and lower oil production caused shockwaves throughout all kinds of goods markets in the last two years. Whatever the cause, we have seen sustained pressure on global supply at a time when demand growth was at its highest in decades (thanks to lockdown base effects).

A prolonged period of trouble like this naturally leads to some soul searching, for both politicians and businesses. Since at least the 1980s, rapid globalisation has driven suppliers toward a 'just-in-time' model of delivery. This relies on each part of the supply chain running like clockwork – which brings risk if individual links break, but those risks are mitigated by access to a vast global market.

Persistent global supply pressures, however, are a major risk to that model. The longer these go on, the more people question whether we are better off moving to a 'just-in-case' model – where inventories are held as back up. Politicians suggested this idea long before the pandemic (indeed, it is the basis for the European Union (EU) Common Agricultural Policy), but COVID has pressed the issue, meaning we could see more regulation around inventories for suppliers deemed 'essential'.

How private companies react is at least as important. Congested supply creates huge problems for businesses, not only by pushing up costs but by creating high backlogs, inventory imbalances and eventually frustrated customers – which can lead to a quick loss of market share. The most obvious short-term solution to these problems is building higher inventories, something many businesses attempted last year which, in some cases, exacerbated supply pressures further up the chain.

A longer-term solution firms might try is moving to simpler supply chains altogether, either through local sourcing (at a possibly higher price) or vertical integration. These can be more costly, which in the past was enough to discourage businesses from taking a just-in-case approach. But if it allows firms to take frustrated customers from their just-in-time competitors, the cost would be more than worth it. This is borne out by stock markets: since March 2020, companies positively exposed to supply chain management have outperformed those negatively exposed.

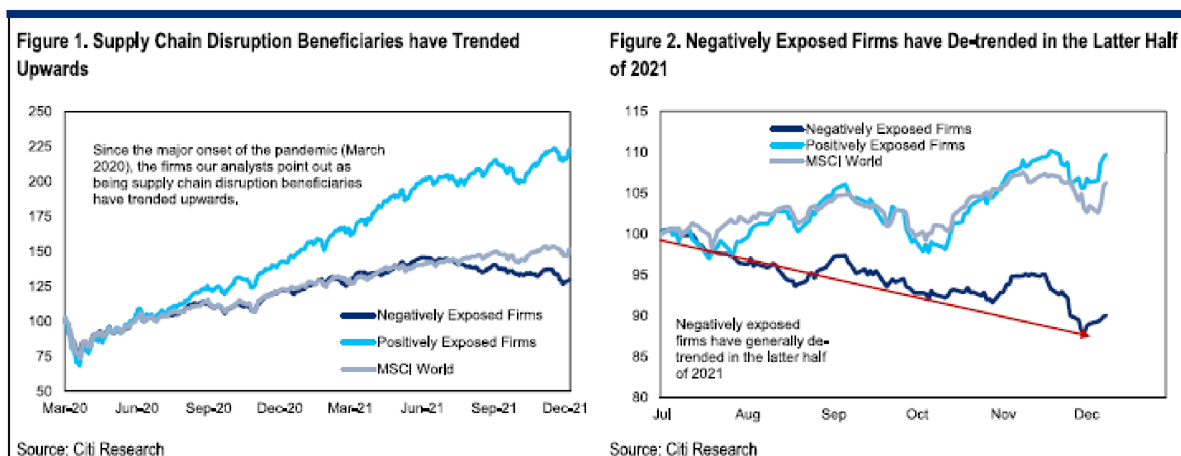

Figure 1. Supply Chain Disruption Beneficiaries have Trended Upwards

Source: Citi Research

Figure 2. Negatively Exposed Firms have De-trended in the Latter Half of 2021

Source: Citi Research

The same data shows that firms with multiple suppliers have been more exposed to global problems than those with fewer suppliers. If supply chain problems persist over the next year, consumer staples and discretionary companies (with more suppliers from a variety of sectors) could be at risk, while financials and healthcare firms could stand to gain (they tend to benefit from in-sector supply).

If enough companies switched to a just-in-case model, it would lead to a significant structural change for global markets. If companies run higher inventories over the medium or long-term, it will create a drag on earnings. This would reduce asset turnover and in turn lower companies' return on equity. As mentioned, there could be strong incentives to bear this higher cost if it means increasing market share, but the end result is a market structure that returns less than investors have come to expect. Given the exceptionally high profit margins and equity valuations (by historical standards) that investors have seen in recent years, this could take some getting used to.

With high inflation also in the mix, these factors could push companies toward increasing their debt load. Companies have been deleveraging over the last two years, but higher inventories mean more capital is needed for regular operations – which could lead to a boost in corporate credit demand. Despite the recent political backlash against market concentration, vertical integration could also lead to an even higher concentration – as companies merge or buy each other out in search of simpler supply chains.

We are unlikely to see this restructuring in the short-term, though we have already seen inventory building in some sectors. But the longer-term story also has a caveat. The significant change in the supply structure will be hard to sustain without policy changes. Input costs and supply disruptions are already slowing down, and despite their longevity it is hard to argue they will be a permanent feature of the global economy. Corporates are likely to be mindful of a well-diversified supply chain, and (at least to a certain degree) just-in-time models will persist in the mix – unless governments step in to discourage it.

The backlash against globalisation has been going on for years, started in earnest by the votes for Brexit and Donald Trump. That political force shows no sign of stopping, with the Biden administration trying to onshore production of semiconductors and batteries to avoid supply problems. The same is true in Europe with the "European Chips Act". We expect this to continue, but it could clash with governments' other priorities – such as reducing living costs or, in the US, attempting to break up large companies. The latter has already impacted the value of the US mega-caps. If politicians continue to push for regional supply chains and vertical integration, they might want to be careful what they wish for.

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24th January 2022

Global Equity Markets

Market	Fri 15:51	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7474	-0.9	-69	↗	⬀
FTSE 250	22236	-2.2	-508	→	→
FTSE AS	4207	-1.2	-49	⬀	⬀
FTSE Small	7268	-1.7	-127	→	→
CAC	7037	-1.5	-106	↗	↗
DAX	15522	-2.3	-362	⬀	⬀
Dow	34775	-3.7	-1338	→	→
S&P 500	4456	-4.4	-203	→	⬀
Nasdaq	14084	-4.9	-723	↘	⬀
Nikkei	27522	-2.1	-602	→	⬂
MSCI World	3082	-2.9	-91	→	⬀
CSI 300	4779	+1.1	+53	⬀	⬂
MSCI EM	1256	-0.1	-2	⬀	⬂

Top 5 Gainers

Company	%
Burberry	+11.4
Pearson	+8.6
Polymetal Internationa	+5.4
Antofagasta	+5.0
BT	+4.3

Top 5 Decliners

Company	%
Ashtead	-11.2
Barclays	-7.7
Evraz	-7.3
Melrose	-7.2
Unilever	-6.8

Currencies

Pair	last	%1W
USD/GBP	1.356	-0.9
GBP/EUR	0.837	-0.3
USD/EUR	1.13	-0.5
JPY/USD	113.67	+0.5
CNY/USD	6.34	+0.2
Bitcoin/$	38,812	-9.7

Commodities

Cmdty	last	%1W
Oil	87.84	+2.1
Gold	1834.6	+0.9
Silver	24.36	+6.1
Copper	456.1	+0.3
Aluminium	3111.0	+5.4
Soft Cmdties	235.8	+2.4

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	15.6	12.3	14.3
FTSE 250	2.5	14.4	16.0	16.2
FTSE AS	3.6	15.3	12.7	14.4
FTSE Small x Inv_Tsts	2.3	11.4	13.8	15.7
CAC	2.1	20.1	14.8	15.1
DAX	2.1	14.4	13.9	13.7
Dow	1.8	18.0	18.4	16.7
S&P 500	1.4	23.5	20.2	17.9
Nasdaq	0.7	26.7	28.6	23.5
Nikkei	1.7	14.9	16.9	17.8
MSCI World	1.7	20.4	18.5	16.9
CSI 300	1.7	16.3	14.2	12.6
MSCI EM	2.4	12.8	12.7	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.16	+0.01
UK 15-Yr	1.32	+0.00
US 10-Yr	1.76	-0.03
French 10-Yr	0.33	-0.01
German 10-Yr	-0.07	-0.03
Japanese 10-Yr	0.14	-0.01

UK Mortgage Rates

Mortgage Rates	Jan	Dec
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.56	1.53
3-yr Fixed Rate	1.53	1.52
5-yr Fixed Rate	1.59	1.54
10-yr Fixed Rate	2.55	2.56
Standard Variable	3.63	3.62

* 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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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.

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