CAMBRIDGE
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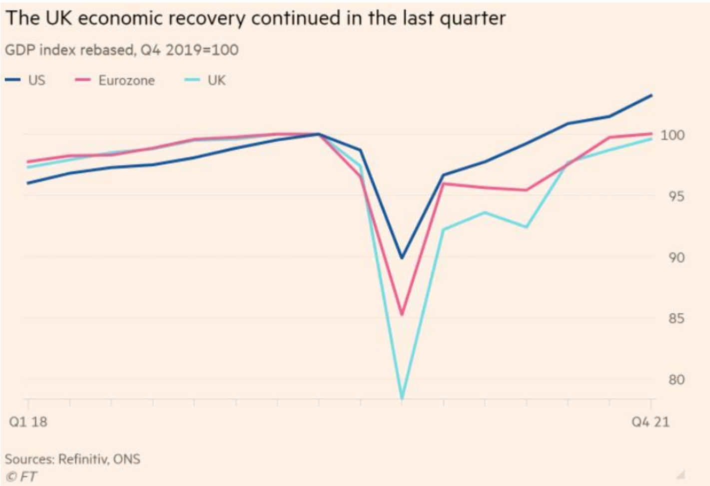
Investment climate change

Stock markets around the world continued their volatile trading pattern over the past week, although compared with January, trending slightly up rather than down. Bond markets, on the other hand, continued to retreat as yields continued to rise. This type of market action has now become characteristic for capital markets this year, as they experience their very own climate change, now that the coronavirus appears to have lost its lethal impact on the majority of the population.

We have written at length about the U-turn of the central banks, which have swung from downplaying (if not ignoring) inflationary pressures to seemingly becoming more concerned about fighting inflation than ensuring the continued wellbeing of the economy. Last week continued very much in the same vein, but several new data points are beginning to offer more clues into the direction of travel beyond central bank action.

In the UK, GDP growth of 7.5% was reported for 2021, which put the economy roughly back to where we were before the pandemic started back, this time two years ago. The chart below illustrates how the V-shaped recovery has not only taken place in the UK, but also Europe, while the US is the outlier that has surpassed the starting level. As we know, this was substantially achieved by larger and less targeted handouts by the US government, that resulted in a significant consumer demand boost. The increased levels of inflation are, to a large extent, the undesired side effect of this necessary, but hard to fine-tune, bridging support for the affected population.



The latest monthly inflation data for the US was therefore keenly awaited and, when it came in higher than hoped at (also) 7.5%, US stocks sold off as they quickly priced in that the US Fed will tighten and raise rates even faster than previously anticipated. Looking at the granular inflation data though, the strong market reaction felt counterintuitive, given all the major inflation-driving components of last year had continued to decline in their contribution, especially durable goods (the things we were most keen to order during the pandemic). What may have caused the negative surprise is that inflation appeared to have started 'leaking into' areas broadly unaffected by supply chain issues, and which are seen as more 'sticky' (not tending to reverse prices easily), especially the services sector.

On the other hand, there was some good news from the data on wage rises. While overall US wage growth has picked up to an uncomfortable 5%, this is very much concentrated among the very lowest earners.

While this means wage growth is not sustained across the whole of the labour market, it also suggests the forces of capitalism are currently addressing the problem of inequality that has become such a divisive force – not just for American society.

Given bond yields are now broadly back to where they stood before the pandemic, equities have not in fact performed too badly so far this month. It appears markets are getting their collective heads around the 'investment climate change', and one could argue that by now quite a lot of rising yield headwind has been priced in without causing the substantial 'damage' the doomsayers had predicted.

This may be, because the inflation headlines last week were flanked by more positive data from the real economy, which would also explain why implicit long-term growth expectations as expressed by certain parts of the bond markets (ten-year yields, ten-year forward) communicated increasing optimism as they did not mirror the negative vibes from the flattening of the yield curve as they usually do, but went the other way.

To this end, January monetary data from China indicated that the leadership there had once again opened the credit stimulus taps – which has in the past resulted in growth stimulus spilling over into the rest of the global economy. On the trade side, volumes improved in the stream of goods with China which should reduce supply chain issues and stimulate the Eurozone economy.

In the wider world of emerging markets, we may see similar central bank loosening tendencies as in China, given they have already been in a tightening cycle since early last year and are therefore far more likely at the end of it compared to western central banks. This would add to China's demand stimulus and bring positive growth impulses to global trade (we touch on this in this week's article on commodities).

In Europe and the UK, strong 2021 growth came about despite significant reductions in inventories. This means that the rebuilding of those inventories in 2022 should carry some of the 2021 demand boost into GDP growth this year. Most surprising, perhaps, was data showing that despite all post-Brexit trade regulation frictions, the trade volumes between continental Europe and the UK are returning to pre-Brexit levels. As observed in the past, when Europe's economy does well from resurgent global demand, so does the UK and, with the trade linkage seemingly healing, this is good news for domestic growth prospects.

Of course, not all is well and there are plenty of dark clouds still on the horizon, be they the cost-of-living challenge from energy prices reducing aggregate consumer demand, or Russia's President Putin still threatening to extend the fossil fuel shortage that is now the main driver of inflation. However, the overall mix of data last week provided positive evidence that the current economic slowdown may not be as deep-seated as feared, and that capital markets appear to expect subsiding inflationary pressures will also lower the pressures on central banks to tighten too fast and too soon. The Bank of England's chief economist's remarks last week to that end were positively received.

Judging from the significant relative moves between different sectors and investment styles like Growth and Value, the message of change in the investment climate appears to be getting through. Positive returns may no longer be as readily available across all asset classes, sectors and styles, but for those who analyse, search and skilfully anticipate the progress of this uncharted post-pandemic economic cycle, there should be ample opportunities (for more, please read our article on the dynamics of small cap equities).

Metal prices signal optimism – and a warning to speculators

Commodities stole the show in 2021. The post-lockdown boom meant plenty of demand for goods, ensuring plenty of demand for raw materials. Meanwhile, COVID complications and a host of production issues severely dampened supply. For most of us, recent fuel and energy price rises have been the clearest signs of soaring input costs, but the metals were the ones to get the lockdown party going.

Copper, aluminium, lithium and nickel – crucial elements in technology and infrastructure – all soared last year. Lithium was an incredible standout, with prices jumping around 500% between January 2021 and January 2022. Those good times have rolled into this year: aluminium shot up to $3,200 a tonne last week, its highest level since late 2008, while nickel jumped to a ten-year high last month.

Contrasting these with non-industrial metals is revealing. Gold exchange-traded funds (ETFs) suffered $9 billion of outflows last year, resulting in a downward trend. Silver saw a similar trajectory – while industrials spiked. As well as a general risk-on sentiment from investors (gold has long been considered a 'safe haven' asset), this shows a great deal of optimism about economic activity.

We have written before that many industrial metals are buoyed by both cyclical and structural factors. Growth spurts always increase demand for raw materials, but current trends point to a more fundamental shift. The global green transition requires a huge amount of industrial metals, in everything from building wind turbines to batteries and microchip materials. According to analysts at Bernstein, electric vehicles (EVs) use 45% more aluminium than internal combustion engines cars (ICE) – with EVs expected to make up half of all cars by 2035.

The drive toward greener infrastructure accelerated during the pandemic, with politicians across all major economies committing to massive carbon reductions over the coming years. This effectively guarantees a strong source of demand for relevant industrial metals.

Recognition of this fact is perhaps why the commodity boom continues even though growth optimism has weakened. For some time now, economic data has suggested slowing activity – partly a result of the disposable income shock felt by businesses and consumers around the world, as their energy bills have soared. At the same time, there are increasing signs that the intense supply chain pressures we saw in 2021 have peaked – which should lead to a fall in input cost inflation.

Industrial metals still look well supported, though. Aluminium's price action last week was spurred by reports of supply troubles, which have driven down inventories to multi-year lows. Goldman Sachs reported that stocks of aluminium are very low and that the warehoused inventory available for futures trading (known as 'visible' stocks) would fall to zero in the second half of this year. Citi Research claims copper trading inventories are in a similar position. And, while global activity may have come off the boil, the Chinese government's attempt to bolster its economy should underpin strong demand. Citi predicts China's stimulus could add another 20% to copper prices.

This looks like a very positive story of demand which, in turn, would suggest a vibrant global economy. But as noted, recent signals point to a noticeable (albeit not huge) slowdown. To us, these factors point to a mismatch between investor demand for industrial metals and demand from their end users. That is, traders are stockpiling materials in the fear of continued supply pressure. Indeed, inventory management is said to be at all-time extremes.

Financial Times columnist John Dizard makes this point with regard to lithium, which went from $9,600 per tonne (for lithium carbonate) at the beginning of last year to $50,000 last month. There are underlying supply-demand dynamics that support a price increase, but speculative traders pushed prices up to levels that look hard to justify. While there may be structural demand for the metal, speculators are likely to sell their inventories when prices stop rising.

We suspect there is a similar reasoning going on for many commodity traders. Inflation has been higher – and longer-lasting – than most had expected. This has ingrained inflation expectations to a large extent, and has pushed speculators to buy and hold commodities with the expectation of further price increases. But it is doubtful how much further input cost inflation can go. A big component of the aluminium price is the energy required to produce it – which has contributed to its rally. When fuel and energy inflation come off the boil – which we expect in the coming months – it will take away some of the pressure from aluminium prices.

China has already stepped in to quell speculative pressures. Last week, Beijing's top planning body, the National Development Reform Commission (NDRC) warned iron ore traders against false price disclosure. It was the NDRC's second intervention in iron ore markets in the last few weeks, and comes after multiple attempts to stop the rise in coal prices.

There is some tension in Beijing's approach to input prices. On the one hand, their environmental goals and distaste for speculation has caused them to clamp down on supply-side practices. On the other, their pursuit of growth has led them to increase domestic demand for materials. This makes interventions unpredictable. For our purposes though, this means we should expect further crackdowns in the coming months – with the potential to scare speculative traders and send commodity prices temporarily down in a variety of markets.

Most commodity trading houses are bullish for the nearer term, due to the undersupply problems, as well as structural support for demand. Overall, we agree that industrial metals are well supported, but we think there may be a bumpier road ahead. The speculative hoarding practices are likely to cease, either by force from the authorities or by a general easing of transportation and movement – which would allow raw materials to get to end users quicker. This could result in an adjustment of expectations, even if the underlying conditions remain the same.

Insight: small cap dynamics

We have seen some high-profile missteps for big companies recently. There were spectacular sell-offs for Meta (Facebook) and Netflix – two previous stock market darlings – after they posted disappointing results and outlook statements on profits and user growth. Last week, we wrote how these episodes underlie a change of fortunes for America's mega-caps. Investors poured into these stocks throughout the pandemic, but the move to an endemic virus situation (which requires less entertainment services from home), tightening monetary policy and possible market saturation problems have soured the picture somewhat.

With that in mind, it might seem strange that US large cap companies (those in the S&P 500) have nevertheless comfortably outperformed their small and mid-cap counterparts (in the Russell 2000) both over the last 12 months and so far this year. But looking at the overall economic picture, this makes sense: growth is slowing from strong levels and cheap money seeking returns (liquidity) is less abundant in the market (thanks to central bank tightening). Larger companies tend to perform better than smaller ones in this environment, especially if the large companies are cash-rich and the smaller ones more leveraged with borrowed money, as is the case in the US. In fact, Goldman Sachs expects the S&P 500 to outperform the Russell 2000 for the rest of the year.

Should investors be negative on small cap stocks then? The answer depends on what region you look at. While the broader cyclical trends favour small or large caps at different times, there is significant regional variation in how this plays out. The UK, for example, had a very different experience to the US last year. Its large cap companies underperformed small and mid-cap peers at the beginning of 2021. This was mainly down to Britain's sectoral composition, as the UK's largest index skews in favour of energy and financial companies. These have done well recently, but struggled a year ago.

The US stock market, on the other hand, is dominated by its large technology or platform companies. These companies benefitted greatly from the stay-at-home orders during the pandemic, the availability of cheap financing and the online orders of retail investors. The Silicon Valley giants are also flush with cash, while smaller US companies have higher leverage ratios. Recent talk from the US Federal Reserve (Fed) of raising interest rates and tapering its asset purchases certainly has downsides for the US mega-tech companies, but some smaller American firms will not be immune either. In the platform/tech space, investors are likely to be more granular in their assessment: how strong is the medium-term earnings outlook, are companies catering for social trends or deliver much needed technical ingredients?

We should also distinguish between the fate of small cap companies and the indices that represent them. The Russell 2000 is perhaps the best known small-cap index, but other small-cap indices have performed better over the last year. This is again in part due to its sectoral composition, with the S&P 600 – the US small cap index which has a different quality selection process for its stocks – performing better.

Still, economic growth is generally slowing (albeit to still decent levels), and the Fed is firmly on its tightening path. Small-cap performance is heavily tied to liquidity conditions and general risk friendliness in markets. This was a boon for the market when growth was rebounding strongly, and investors were pushing for the cyclical rotation. But that trend peaked in the first quarter of 2021 (the same time that business sentiment surveys reached their highest levels) and has come down since. This helps to explain the underperformance of small caps over the last year, and suggests indiscriminate upside will be difficult to come by. Despite slowing growth, ample stock-specific opportunities still exist. Investors will likely become more selective in their stock-picking and prefer small cap companies with more sound fundamentals.

Goldman Sachs expects smaller companies with high growth and profit margins to benefit as dispersion sets in. What counts as 'good or bad' here will also depend on valuations though. Small-cap valuations have declined sharply, but they are still historically stretched. Companies that are in a good profit position and have lower valuations should inevitably prove more popular.

Finding those gems is a different story, of course. This is hard to do if looking at broad indices like the Russell 2000, but investors would do well to pay attention to sectoral dispersion too. Companies involved in structurally supported industries – such as those involved in industrial commodities or green technology (see our other article this week) – stand to gain as long as overall growth remains decent. Attentive stock-pickers could do well in this environment, as overall conditions move against small caps, but growth opportunities remain.

Tighter financing conditions make things more difficult for smaller firms. From the investment side, it also means that broad 'risk-on' periods – as we saw earlier in the pandemic – are less likely. There is still plenty of upside to be found for lots of companies, but markets are likely to make a more granular assessment. This does not mean large cap companies are bound to outperform their smaller counterparts, but investors will need to pay more attention to their specifics.

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14th February 2022

Global Equity Markets

Market	Fri 15:57	%1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7661	+1.9	+145	⬀	⬀
FTSE 250	22052	+1.6	+340	↘	→
FTSE AS	4287	+1.9	+78	⬀	⬀
FTSE Small	7240	+1.3	+95	→	→
CAC	7019	+1.0	+68	→	↗
DAX	15436	+2.2	+337	⬂	→
Dow	35388	+0.8	+298	→	→
S&P 500	4502	+0.0	+1	↘	⬀
Nasdaq	14166	+0.5	+68	↘	⬀
Nikkei	27696	+1.7	+455	⬂	⬂
MSCI World	3088	+0.9	+27	⬂	⬀
CSI 300	4601	+0.8	+38	⬀	⬂
MSCI EM	1251	+2.5	+30	⬀	⬂

Top 5 Gainers

Company	%
Int'l Consol Air	+12.4
Antofagasta	+11.8
Informa	+10.9
Whitbread	+9.1
Entain	+8.0

Top 5 Decliners

Company	%
Evraz	-9.7
Ocado	-7.5
Spirax-Sarco	-6.6
Croda Int'l	-5.4
Just Eat Takeaway.con	-4.9

Currencies

Pair	last	%1W
USD/GBP	1.360	+0.5
GBP/EUR	0.838	+1.0
USD/EUR	1.14	-0.4
JPY/USD	115.86	-0.5
CNY/USD	6.35	+0.1
Bitcoin/$	43,623	+4.6

Commodities

Cmdty	last	%1W
Oil	93.01	-0.3
Gold	1835.9	+1.5
Silver	23.27	+3.4
Copper	450.7	+0.4
Aluminium	3250.5	+6.6
Soft Cmdties	232.4	+2.2

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.6	14.4	12.4	14.3
FTSE 250	2.6	14.5	16.0	16.2
FTSE AS	3.4	14.4	12.7	14.5
FTSE Small x Inv_Tsts	2.3	11.0	13.2	15.7
CAC	2.1	18.0	14.3	15.2
DAX	2.1	14.4	13.8	13.7
Dow	1.8	17.7	18.6	16.7
S&P 500	1.4	22.6	20.3	18.0
Nasdaq	0.7	25.9	28.5	23.6
Nikkei	1.7	15.3	17.0	17.8
MSCI World	1.8	19.4	18.4	16.9
CSI 300	1.8	15.7	13.7	12.7
MSCI EM	2.5	12.6	12.7	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.53	+0.11
UK 15-Yr	1.66	+0.13
US 10-Yr	2.03	+0.12
French 10-Yr	0.75	+0.10
German 10-Yr	0.28	+0.07
Japanese 10-Yr	0.23	+0.03

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	2.49	2.51
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

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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