THE **CAMBRIDGE** WEEKLY

23 May 2022

Lothar Mentel

Lead Investment Adviser to Cambridge

Talking recession to fight inflation

It has been another rocky ride week for capital markets, with inflation talk increasingly turning into chatter of an 'inevitable' recession, prompting the most recent cohort of DIY retail investors to throw in the towel. However, the thin trading volumes, plus the fact there's no clear directional trend within stock markets, tells us institutional investors are staying put.

According to the most recent Bloomberg surveys, most of the leading economists in the US do not think a recession is imminent, and further evidence suggests inflation readings and high yield credit spreads have stabilised. So why is it that the media is full of recession talk, but long-term investors remain unconvinced?

Well, the recession talk has ramped up because central bankers have done such a good job in convincing us they are unafraid to choose inflation-fighting over growth support. US Federal Reserve (Fed) Chair Jay Powell confirmed it will keep raising rates until inflation is back under control. But this tough talk is not just confined to the Fed. Here in the UK, the Bank of England (BoE) Governor Andrew Bailey has been describing "apocalyptic" conditions, while Chief Economist Huw Pill's belief that inflation won't be brought under control before the end of the year, tells us of similar determination.

As we discuss in a separate article this week, such verbal machismo by central bankers, threatening worse to come (unless we cut back spending and/or refrain from asking for pay rises), may be considered by central banks as a more effective short-term strategy to fight inflation by curbing consumer demand, than the more blunt and time lagging instrument of a raft of rate hikes.

This is where economists and institutional investors may be taking their relative positivity from – the falling prospect of persistent rate rises ,and thereby the risk of recession, which would pull the rug from under corporate earnings growth. The headline inflation figures may have been a shock for the general public, but were widely expected by markets, and therefore priced in. The fact that inflation numbers did not overshoot expectations, and were very clearly driven by quite explicit components (rather than being structural), was enough to lower recession expectations. These expectations are often best taken from the yield premium that the lowest-quality corporate borrowers must pay for their finance. After rising sharply over the past four weeks, there has been little indication of this yield premium going up further.

So, is Huw Pill mistaken in his belief that inflation will continue to rise (and thereby force the BoE into more painful rate rises)? It bears repeating that this inflation episode is driven by supply disruptions and Russia's war on Ukraine, leading to demand exceeding supply. Meanwhile, the labour market is very tight, and consumers are willing to accept higher prices for non-essential goods, while they still have excess savings from the pandemic. This has created the real risk of inflation once again turning structural, which explains the fervour from central banker.

While no one can know where Russia's war will lead, we note that energy capacity and food supplies from other global regions are being redirected. For example, last week led to the UK having more liquified natural gas coming in than can be stored, used, or passed on to the continent. High prices create powerful incentives in a market economy, and this is no exception. Another is the incentive for the Chinese leadership to regain the economic initiative, after their 'Zero-COVID' strategy blunders left China seriously behind its growth targets. President Xi's government just announced a significant stimulus programme aimed at creating jobs by increasing manufacturing capacity. In the past, this increase in supply has had a deflationary impact on global markets in finished goods.

It seems that the aggressive messaging from central bankers has been successful in driving down demand, while global supply issues can be expected to continue to resolve. The European gas price issue may not be solvable before winter, but recent redirection efforts indicate that the longer-term fallout may be less than feared, while also stoking economic activity to prove to Vladimir Putin that Russia's energy exports are not indispensable.

The continuation of the previous week's story – of falling market implied inflation expectations that have taken bond yields down with them – has offered some evidence that the stagflation scare we read about in the media is mostly that. The price pressures we are all experiencing are unpleasant, but the economic and financial backdrop has much stronger parallels with the price pressures the US experienced just before the onset of the 'Golden Fifties', than the dire stagflation of the 1970s.

About Bailey's bleak outlook messaging

Andrew Bailey is feeling apocalyptic. Or at least, that is the word the Bank of England (BoE) Governor used to describe the outlook for Britain's food prices. Appearing before the House of Commons Treasury Committee last Monday, Bailey warned that the war in Ukraine could lead to significant food shortages, presenting "a major worry for this country". With prices soaring and growth expectations dimming by the day, Bailey was frank about the UK's prospects: "This is a bad situation to be in."

His choice of words was no doubt a little sensationalist, but then the latest economic data provided quite the sensation for some. Inflation, as measured by the UK Consumer Price Index (CPI), rose 9% year-on-year in April, while so-called 'core' CPI (excluding volatile components like food and energy) jumped to 6.2%. This means the UK has experienced larger price rises than any other G7 country, and they show little sign of slowing down. Despite last month's 69% annual increase in energy costs, Britons will not feel the full force of the ongoing energy shock until October, when the energy price cap is expected to be raised again. If this transpires, it would likely bump inflation up to 10% in the Autumn.

The hardest part to take in all of this is that inflation is not coming from a place of economic overheating. Some MPs criticised Bailey for not pre-empting price jumps and raising interest rates earlier, but the Governor rightly pointed to a series of significant and unrelenting supply-side shocks, ranging from COVID effects to Ukraine (and indeed, Brexit frictions) beyond the power of influence of a central bank. These factors mean the BoE predicts GDP will shrink next year – a recession in all but name. Negative growth with soaring prices will mean a severe contraction in people's spending power.

The lifting of Ofgem's household energy price cap was clearly a huge source of inflation in last month's data. But it was far from the only source. Within core inflation, restaurant and hotel prices also saw a big jump, mostly from the VAT increase (12.5% to 20%) in April. Transport, household furniture and clothing also had an outsized impact on the yearly figures.

April saw a sharp increase in food prices - up 1.66% on the previous month. This followed a near-zero month-on-month figure for March, and 0.84% in April last year. Ukraine – a big producer of grains such as wheat and sunflower oil – has struggled to export its crops since Russia's invasion, and the effects are now clearly filtering through. They are likely to continue, leading Bailey to highlight food as one of the biggest areas of concern for UK households.

Food makes up only 8.4% of UK households' spending, versus the median 17% for advanced economies. For all Bailey's talk of apocalypse, this bodes comparatively well for the UK if, as expected, global food prices continue to rise.

On that positive note, we should also point out that headline CPI was below economist expectations. That things were not quite as bad as predicted is not much consolation, in light of some of the highest inflation numbers on record. But the BoE will be looking for any sign of price moderation in the coming months, so downside inflation surprises will be welcomed. Core inflation, meanwhile, was in line with expectations.

Bailey and his team have little room for manoeuvre in their efforts to tame inflation. Global input prices have moderated in recent weeks, but persistent supply constraints, downstream effects and the problematic energy price cap mean that it is not unreasonable to expect that inflation will remain high for the rest of the year. The BoE is concerned inflation has spread to the services sector, becoming much more broad-based (sticky), and consumer expectations of long-run inflation have probably shifted higher.

Below, from JP Morgan, is the breakdown of inflation contributions:

Inflation heatmap

%m/m, sa

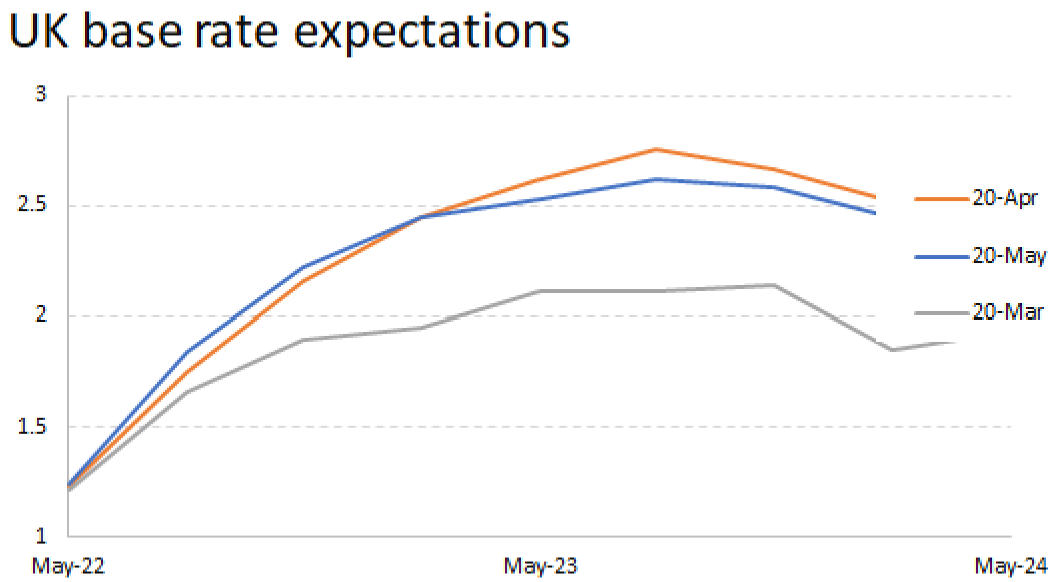
	Jan	Feb	Mar	Apr
Volatiles				
Liquid fuels	2.0	2.3	10.1	-1.1
Domestic energy	0.7	0.3	0.1	49.3
Food, non-alcoholic beverages	1.2	0.3	1.1	1.7
Alcohol and tobacco	-1.6	0.5	1.2	-2.5
Core goods	**0.9**	**0.5**	**0.6**	**0.2**
Clothing	1.1	0.4	1.5	0.9
Household goods	1.6	0.7	1.6	1.1
Water, maintenance & repair	0.2	0.2	0.7	2.1
Medical products	0.1	-0.2	0.1	0.2
Vehicles, spare parts	0.6	0.3	0.2	-0.4
Audio-visual goods	1.0	0.9	1.1	-1.6
Other recreational goods	-0.2	2.1	0.1	1.0
Miscellaneous goods	0.0	0.1	0.6	1.3
Core services	**0.4**	**0.3**	**0.7**	**0.8**
Actual rentals for housing	0.4	0.2	0.3	0.4
Primary housing services	2.3	0.0	0.3	2.1
Other housing services	1.4	0.5	0.3	0.7
Services for personal transport eq	0.5	1.0	0.0	0.9
Transport services	-0.8	0.2	1.4	-0.5
Transport insurance	6.4	-1.8	0.2	1.0
Communications	0.3	0.3	-0.3	3.1
Package holidays & accommodat	-1.2	1.1	1.9	0.8
Catering services	0.4	0.2	1.6	1.6
Non-catering recreational & persor	1.1	0.2	0.5	0.6
Miscellaneous services	-0.5	0.0	0.0	0.2
Medical services	0.6	0.4	0.7	0.2
Education	0.2	0.2	0.2	0.2

Source: J.P.Morgan

A labour market report last week showed unemployment is nearing its lowest level in 50 years and pay growth (including bonuses) is running strong. Bailey told MPs this has changed monetary policymakers' view of the labour market to "very tight", due in large part to long-term sickness removing 400,000 workers from the economy.

According to survey data, households and businesses now expect prices to keep rising at rapid pace for at least another year. A red-hot labour market and high price expectations are a recipe for a wage-price spiral, where higher wage demands loop back into higher prices and so on. This is compounded by market pricing, as financing costs go up for producers. So, according to Investec economist Sandra Horsfield: "the case for front-loading monetary tightening looks stronger by the day".

The BoE's Monetary Policy Committee (MPC) raised rates to 1% earlier this month, but a minority of committee members called for an even larger increase. Last week's labour market report will give support to the committee's hawks, and we expect the BoE to raise rates at back-to-back meetings through to August. That will take the base rate to 1.5% and the markets expect this rate will peak at 2.5% within the next 12 to 18 months. However, rate expectations have slightly decreased compared to a month ago, perhaps because the inflation data was not worse than expected.



Source: Tatton IM, Bloomberg... 20-May-2022

We wrote recently that the US Federal Reserve (Fed) may have to engineer a (hopefully short-term) recession in order to cool its overheating economy – by raising rates above the so-called 'neutral' level for growth. On his part, Bailey admitted that deliberately increasing unemployment to destroy demand was something the MPC would consider if needed. Inflation must get "back to target."

The wage-price spiral, rather than supply constraints on their own, is clearly the BoE's biggest challenge. While admitting there was little the MPC could do about 10% inflation in the short term, Bailey's openness to a deliberate recession shows where his priorities are. Input-cost inflation will inevitably come down as supply constraints pass through, but stopping the demand-side reaction is key and monetary policy on its own would take a long time to achieve that. Frightening the public with stark or even apocalyptic rhetoric may have a much more immediate impact on consumer demand. Consumers may decide now is not (yet) the time to spend all pandemic savings, and to instead increase their 'rainy day' fund until the economic outlook turns more positive. With any luck, the BoE's determination to fight inflation will ensure rate expectations do not get out of hand.

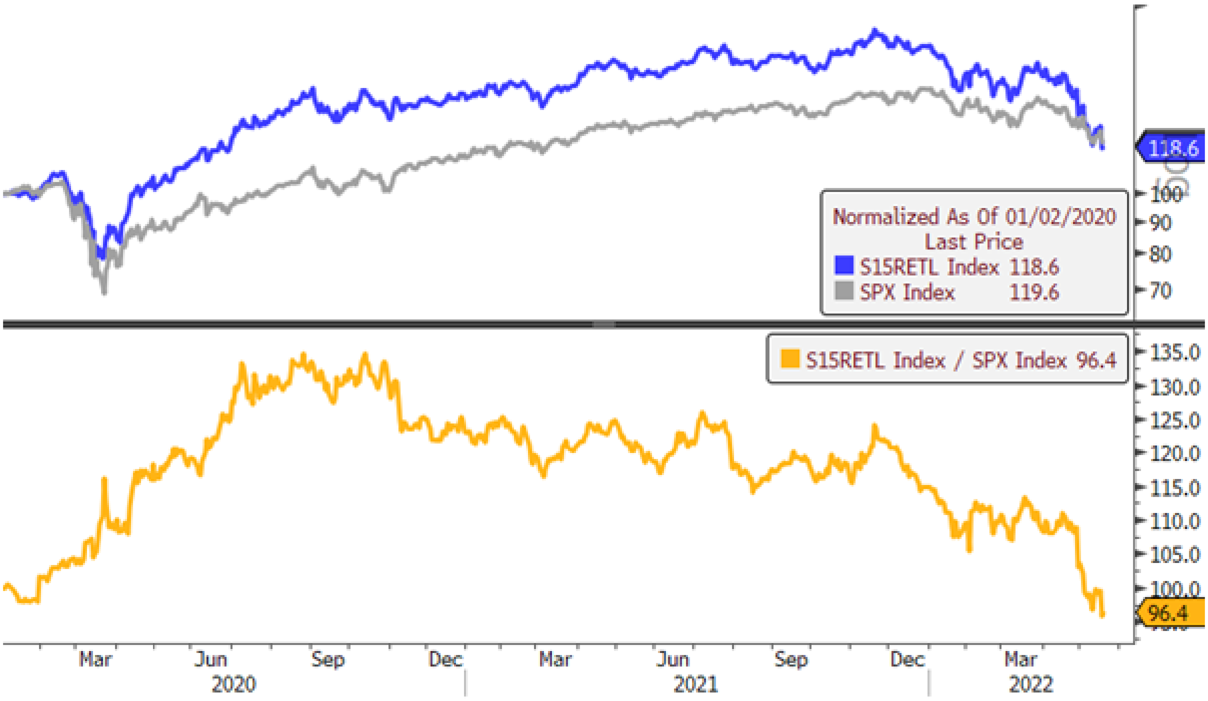
23rd May 2022

Retailers must start adapting to the new normal

US stocks took another step down last week. The S&P 500 found support early on, but last Wednesday brought sharp and sustained selling pressure. We have become used to tech stocks underperforming in this year's extended sell-off, but last week saw the downbeat investor sentiment spread into other sectors.

Walmart and Target – two of America's biggest retailers – struggled in particular. They recorded their worst weekly performances since 1987, falling 20% and 29% respectively after reporting their results. The S&P Supercomposite Retailing Index fell 8% on Wednesday alone.

US super retailers vs S&P500
Underperforming for 2022



Source: Tatton IM, Bloomberg: G867
S15RETL Index (S&P Supercomposite Retailing Industry Group GICS Level 2 Index) SPX super retailer Daily 01JAN2020-19MAY2022 Copyright© 2022 Bloomberg Finance L.P. 19-May-2022 18:01:33

Dour earnings reports seemingly drove investors to the exit. Both Walmart and Target missed their profit projections, recording weak sales growth of 2% and 4% compared to last year, while increasing their inventories by 32% and 43%. Increased supply-chain costs hit their margins, while poor post-pandemic inventory decisions meant unwanted items like TVs or kitchens had to be marked down heavily to make room for faster-moving goods. Department store Kohl's also lowered its guidance last Thursday, sending shares down as much as 7.3%.

Rising input costs are a problem for profit margins, but the surge in inventories point to a problem of retailers struggling to address changing preferences of the demand side. If sales are expanding at or above trend, cost increases are not so problematic, and profits generally hold up well. But the disappointing Q1 margin results show retailers are struggling to pass price hikes onto consumers, while consumer preferences are shifting from 'stay-at-home' essentials to 'going out' discretionary goods. Walmart said many of its customers were switching to cheaper brands, while some were scaling back non-essential purchases altogether. Retailers are paying more for their goods only to be left without as many willing buyers as expected.

This is a reverse of the last few years. Early in the pandemic, lockdowns pushed many consumers to switch their spending from services to goods – meaning retail demand held up well. When restrictions loosened, strong growth and widespread supply shortages meant people were desperate to buy what little goods they could get their hands on – and the biggest retailers with the biggest buying power had a strategic advantage in getting hold of those scarce items. Hence, the big retailers got a cyclical upswing in their profit margins.

Those forces are now working against the superstores. Rapid US inflation has weighed heavily on disposable incomes, meaning retail supplies for what were the most sought-after goods during the pandemic filled up just as demand started to weaken. Economic data is now reflecting this, with recent releases disappointing expectations. In a 'usual' cycle, this would ideally be offset by slowing input costs. But while this has happened in some commodities, huge global supply shocks, such as the Ukraine war, have kept cost pressures high.

In this environment, sliding margins are a particular problem for big retailers that rely on a high turnover. Consumption-related stocks have been hard hit, and those with the highest volumes – like Walmart and Target – the hardest of all.

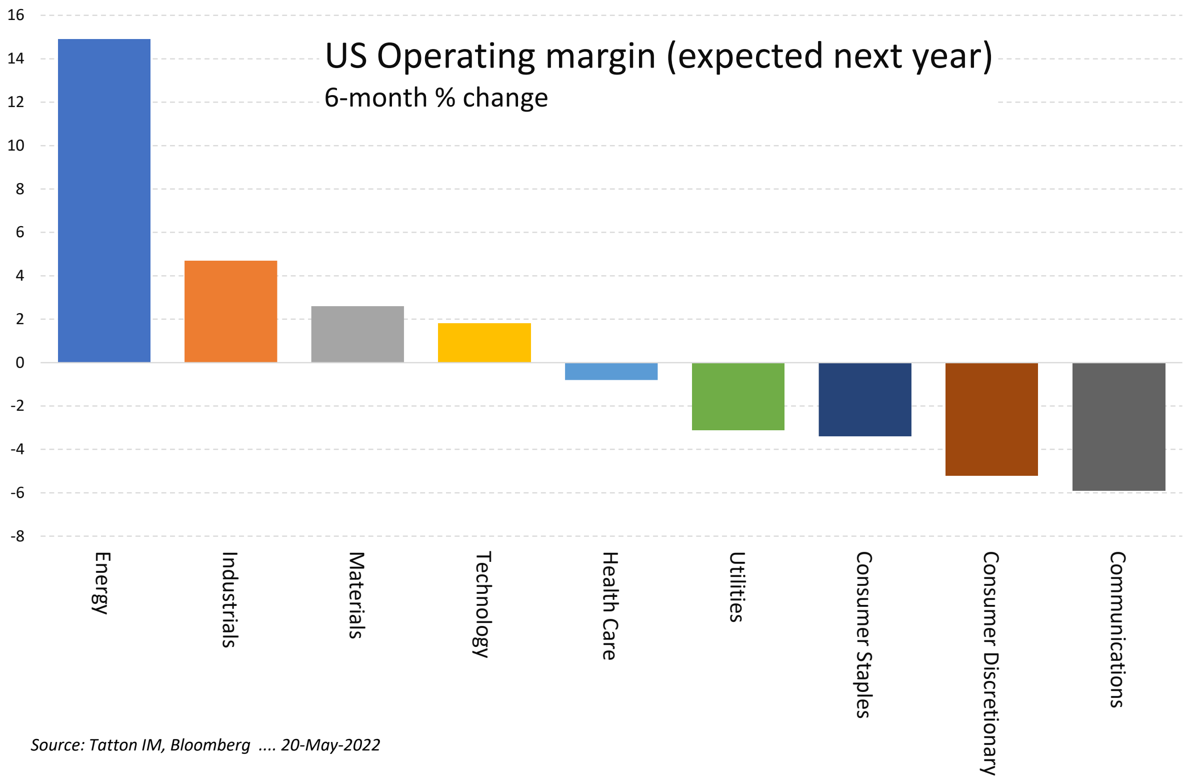
Profit margins generally rise and fall with the economic tide, so the waning fortunes of big retailers are understandable. Still, the fact that these companies' performances have been so sensitive to the economic cycle is unusual. Historically, these companies have been less affected by growth and contraction than those in sectors like construction or services. But as the previous chart shows, the outperformance and subsequent underperformance of retailers almost directly tracks the health of the US economy over the last two years.

As mentioned, the pandemic's effect on spending patterns is one reason. After such a big uptick for consumer items during lockdowns, base effects make current sales growth figures look very weak. Persistent supply chain issues are another huge reason, as when paired with sudden shift in consumer preferences is presenting retailers with the headache of constantly not having the right mix of goods on their shelves. Normally, slowing growth would destroy demand and ultimately create a supply glut, thereby bringing down input costs and offsetting some of the margin pressures. But the unprecedented series of global shocks seen over the last two years – from pandemic troubles and weather to Ukraine and China's slowdown – has kept inflation sky-high even in the face of depressed demand.

Continued global supply pressures have prevented prices from reaching equilibrium – demand continues to be greater than current supply. This is the dreaded 'stagflation' that made headlines last year, where low or negative growth is matched by stubbornly high inflation. Normally these forces keep each other in check, but the clogging of global supply chains has prevented this from happening.

This is a double whammy for consumers, who are getting hit with higher costs as well as fewer opportunities to grow their income. It also makes life more difficult for producers, who cannot pass on costs as easily without stamping on delicate demand. We are seeing this now in the effect on retail profit margins, but the same holds for many other industries. Companies always want to maintain their profits, but this is extremely difficult in the current scenario.

Impacts on expected margins vary across different sectors, of course. The chart below shows how analysts have changed their expectations for margins on a 'next-12-month' basis (we've excluded financials and real estate as margin calculations do not work so well in these sectors):



Source: Tatton IM, Bloomberg 20-May-2022

It is worth pointing out, that profit margins were exceptionally high before the current troubles. Big-name companies have been handsomely rewarded over the last two years, reflected in the impressive stock market returns through the pandemic. In the earlier period of the global supply shock, businesses were still largely able to pass on costs, meaning their bottom lines were safe. Now this is no longer the case. It seems that the poor results of big US retailers are a combination of poor inventory planning and consumers feeling the pinch on their discretionary spending. This suggests the easy times for big retailers are over and they will have to get used to lower margins.

For the time being, the jury is out on whether these margin pressures are already the first signs of a building stagflation dynamic, or are simply part of the post-pandemic normalisation process, a picture that is so much harder to see given the other factors currently in play. Overall, we attribute last week's shifts more to the ongoing rotation away from the pandemic winners, than as a harbinger of a new stagflation era.

CAMBRIDGE
INVESTMENTS LIMITED

23rd May 2022

Global Equity Markets

Market	Fri 15:50	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7420	+0.0	+2	→	→
FTSE 250	19924	+0.0	+2	↘	↘
FTSE AS	4101	+0.0	+2	⇘	→
FTSE Small	6621	+0.4	+27	↘	↘
CAC	6313	-0.8	-49	↘	⇘
DAX	14035	+0.1	+7	⇘	↘
Dow	31060	-3.5	-1137	↘	↘
S&P 500	3911	-2.8	-113	↘	↘
Nasdaq	11316	-4.1	-489	↘	↘
Nikkei	26739	+1.2	+311	⇘	⇘
MSCI World	2652	-1.8	-50	↘	↘
CSI 300	4078	+2.2	+89	↘	↘
MSCI EM	1015	+1.0	+10	↘	↘

Top 5 Gainers

Company	%
Glencore	+8.9
Fresnillo	+7.7
Anglo American	+7.6
Antofagasta	+6.3
Prudential	+5.5

Top 5 Decliners

Company	%
Aviva	-23.3
B&M European Value Ret	-8.6
DCC	-7.8
JD Sports Fashion	-7.2
Tesco	-6.9

Currencies

Pair	last	%1W
USD/GBP	1.247	+1.7
GBP/EUR	0.847	+0.3
USD/EUR	1.06	+1.4
JPY/USD	128.01	+0.9
CNY/USD	6.69	+1.5
Bitcoin/$	29,434	-5.1

Commodities

Cmdty	last	%1W
Oil	112.60	+0.9
Gold	1840.5	+1.6
Silver	21.72	+2.9
Copper	429.8	+2.8
Aluminium	2906.5	+6.0
Soft Cmdties	237.5	+3.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	12.3	10.4	14.3
FTSE 250	3.2	11.2	13.6	16.3
FTSE AS	3.9	11.0	10.6	14.5
FTSE Small x Inv_Tsts	3.1	1.5	9.5	15.3
CAC	2.7	13.8	11.3	15.2
DAX	3.3	12.5	11.7	13.7
Dow	2.1	16.0	16.3	16.8
S&P 500	1.6	19.0	17.2	18.2
Nasdaq	0.9	21.1	23.6	24.0
Nikkei	2.1	15.4	14.9	17.7
MSCI World	2.1	16.1	15.6	17.0
CSI 300	1.9	14.1	12.8	12.7
MSCI EM	2.9	10.4	11.2	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.89	+0.15
UK 15-Yr	2.15	+0.13
US 10-Yr	2.82	-0.10
French 10-Yr	1.47	+0.01
German 10-Yr	0.95	+0.00
Japanese 10-Yr	0.24	-0.00

UK Mortgage Rates

Mortgage Rates	May	Apr
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.35	2.24
3-yr Fixed Rate	2.26	2.15
5-yr Fixed Rate	2.36	2.25
10-yr Fixed Rate	2.68	2.58
Standard Variable	4.10	4.07

* 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

23rd May 2022

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.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE