THE **CAMBRIDGE** WEEKLY

30 May 2022

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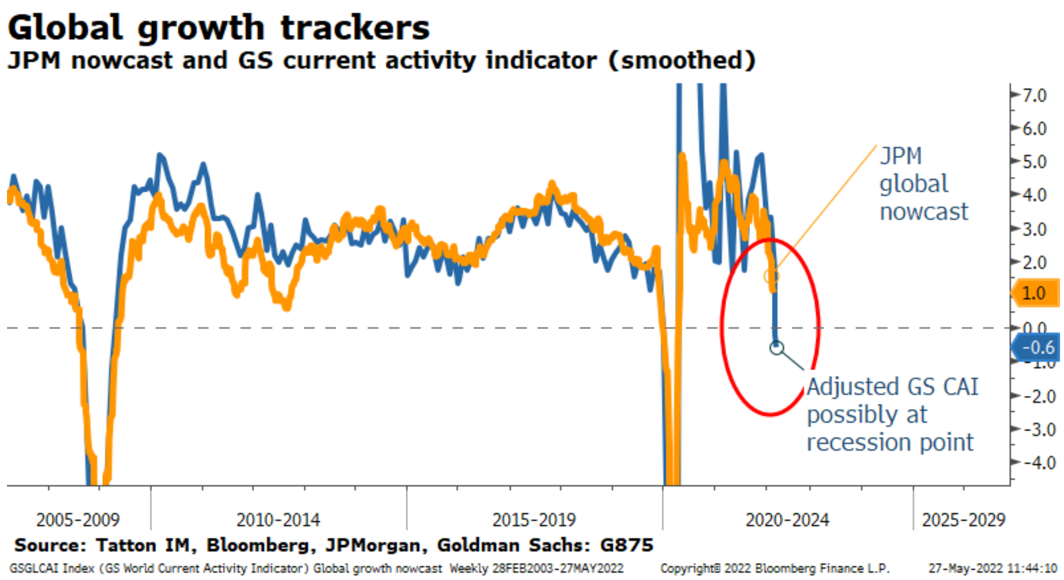
As recession talk subsides, inflation pressures increase

As we reach the final days of May, markets appear to be calming down. Stock markets achieved a positive week and credit spreads – the proverbial canary in the coalmine ahead of recessions – have come down sharply. So, are the concerns that have overshadowed capital markets in recent months starting to look less worrisome?

For most of May and April, declining global growth prospects have been worrying investors. There are various trackers of growth that we follow, and the graph below shows the GDP real growth 'Nowcast' from JP Morgan, and our adjusted version of Goldman Sachs' current activity indicator. The Goldman Sachs indicator tends to lead the JP Morgan Nowcast by a month or two.



Worryingly, both have been declining sharply and the unsmoothed Goldman Sachs indicator suggests that growth may have dipped below zero in May.

As we have outlined here before, investors have been mindful of three specific headwinds this year: (1) tightening central bank policy driving up yields (and thereby challenging valuation levels); (2) a prolonged cost-of-living crisis and persistently higher energy costs, eating into consumer spending (thereby driving down corporate profitability); and (3) China's economy slowing as it attempts to deflate its property bubble, while still grappling with COVID and widespread lockdowns.

So, what changed sentiment last week? On the central bank tightening side, investors may have been relieved by inferences from the most recent meeting of the Fed's (US Federal Reserve) Open Market Committee. Due to the US dollar's status as the predominant global currency, the Fed is *de facto* the world's central bank, even if it doesn't accept this title, and doesn't factor this into its policy objectives.

However, financial stability in the US is in the Fed's remit, and that is inevitably affected by global markets. While the Fed remains resolute in stating the current primacy of fighting inflation, the meeting minutes raise concerns about financial stability. For those searching for signs of when and how policy could become neutral, this is good news, as *"Concerns about financial stability"* are seen as equivalent to bringing back the fabled *"Fed Put"* (i.e. supporting capital markets through looser monetary policy). This inference may be jumping the gun, though.

Despite turbulence in the credit and equity markets, bank lending remains strong. And, as we note in a separate article on labour markets this week, the total of US vacancies and existing jobs almost certainly still exceeds the current workforce. However, there are good signs that things are cooling, while the real economy is far from chilly.

Jumping ahead to the third headwind, China has made a significant contribution to the sharp slowdown in global growth. Indeed, according to JP Morgan's Nowcasts, China is currently contracting at around 10%, almost as fast as it did in the early COVID lockdown stage.

China's apparent COVID policy success in 2020 seems to have led to complacency, and perhaps even a sense of invincibility. In fact, the return of the virus has shocked the Chinese economy when it was at its most fragile. In recent weeks, we have noted sharply slowing production levels, and how central authorities have been almost constantly announcing new stimulus measures. These measures appear to have been effective only in a limited sense. They've kept production up to some degree, but consumption has collapsed, especially in services.

China's prime minister, Li Keqiang, has been much more visible recently, while president Xi has stepped out of the limelight. At an emergency meeting held last Wednesday, Li was extraordinarily frank in front of thousands of local officials, and much more direct than the official readout published by state media suggested. Li made it clear the situation was dire, and that the politburo viewed this as a failure by his audience to enact the policies which had been issued in recent weeks. According to Bloomberg, Li listed objectives for local officials to focus on this year, and stated that growth is the key to solving all problems in the country, such as creating jobs, ensuring people's livelihood, and containing COVID.

In order to make sure the local officials comply, the central leadership State Council will send 'inspection teams' to 12 provinces to supervise the implementation of policies, the official Xinhua news agency posted on the government's website. The report didn't name the regions. Li was also clear that money was being made directly available to local governments, and that employment needed to happen quickly. Perhaps most importantly, Li said that local governments should balance COVID controls and economic growth.

It's been notable that China's financial conditions have been easing sharply over the past two weeks. With the quite extreme governmental policy push, it is not surprising investors are sensing that China's near-term outlook may finally be improving, and therefore the growth drag on the global economy may be diminishing.

Turning to the cost-of-living headwind from inflation, even after the reduction of wage pressures from cooling labour markets, developed world inflation expectations are still hugely influenced by energy costs. For policymakers, this is a massive policy conundrum, as well as a challenge from their voter base, and this is probably most apparent here in the UK. Here's a précis of the challenge:

- Energy companies are reluctant to build rigs, which may have a short production life, because of the need to constrain carbon emissions.
- There is too much demand for energy relative to constrained supply, and energy prices rise.
- Global conflict constrains supply further.
- Oil and gas prices rise further.
- Oil rigs start to be profitable enough to warrant developing them for a short production run.
- The rise in energy price rises is unbearable for the wider public, so instead of constraining demand, we take the energy company profits and subsidise demand.
- Oil rigs are no longer profitable enough to be built for the short-term.
- Demand is not reduced as subsidies help consumers to pay.
- Energy prices go up again.

This is simplistic, of course, and the UK is not the only country feeling this pressure. Still, there is little doubt that if Europe cannot reduce its fossil fuel demand, and wants to displace Russian energy from its supply, we need new sources of production. Otherwise, all we will do is create a new supply chain, which channels Russian fuel through a more costly and opaque route, paying shady intermediaries to get rich.

China's recent weakness has probably helped in lessening global inflation pressures. Industrial metals have fallen back somewhat, and it seemed energy prices might be moving the same way. However, oil prices have been heading back towards recent highs during the past week.

For the central banks, they need signals that overall demand has moved into line with supply, before they can think their inflation fighting is done. Energy demand is a big part of that signal.

Markets have taken comfort that economies have been cooling. Should China succeed in engineering a rebound, it may mean more production capacity for finished goods, thereby reducing price pressures from last year's supply chain issues. It may, however, mean rising energy demand, and the inadvertent return of energy and resource inflation pressures on the rest of the world.

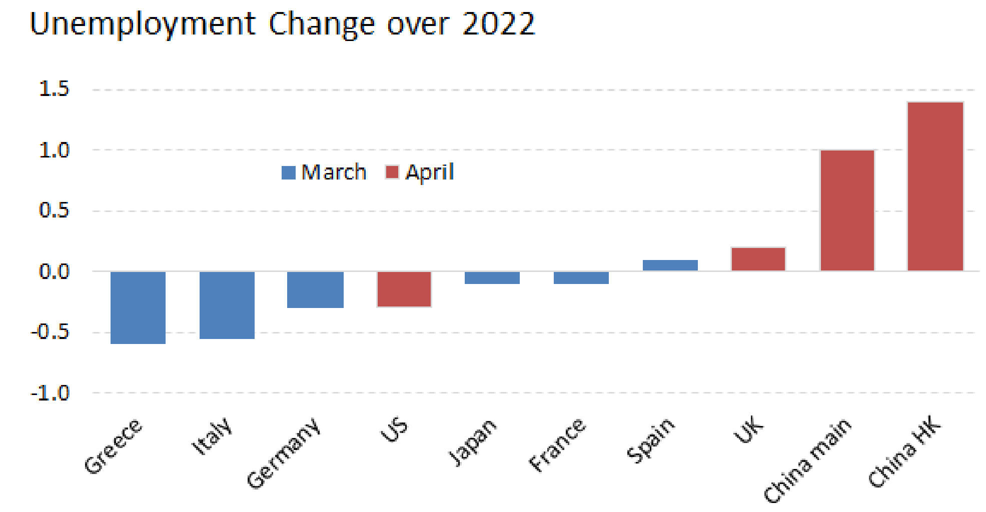
Last week, markets may have glimpsed the "Goldilocks" scenario – not too hot and not too cold – but nobody will be sure until the oil smoke drifts away.

Labour market dynamics

Last week brought some respite for investors. The S&P 500 rallied midweek, after some strong earnings (corporate profits) reports from US retailers. It was sorely needed. Capital markets have been falling all year on the back of growth concerns, and tighter monetary policy. The global economy has clearly lost its post-covid spark, and rapidly rising inflation is starting to eat into people's purchasing power. At the same time, the US Federal Reserve has signalled aggressively tighter monetary policy, raising borrowing costs for households and businesses. Other central banks have followed suit, with the Bank of England having raised interest rates twice already, and further hikes likely to come.

Central bankers are worried about what they see as overheating labour markets. This is especially so in the US, where the so-called 'great resignation' post-covid has left many companies unable to find workers. With costs going up so much, the fear is that more people will demand wage rises, pushing the economy into a spiral of higher inflation. We are seeing this in the UK too, as the BoE governor Andrew Bailey described to MPs recently.

Interestingly, while unemployment is low in the US and UK, the same is not true for China. This highlights just how weak the world's second largest economy is right now – which is itself a concern for global growth and inflation.



Source: Tatton IM, Factset

Central bankers are laser focused on labour market developments, and capital markets are in turn focused on central banks. Labour market developments are therefore crucial to watch, as it could lead to softer rhetoric from the Fed. Even if this does not amount to a U-turn on policy, it could buoy stock indices in the short-term.

Labour market dynamics have been strange over the last two years – with a shrinking of the workforce making it difficult for central bankers to properly assess their economies. Despite the lowest unemployment rate in 50 years, the UK's employment rate is still well below pre-pandemic levels. There are around 900,000 fewer people in work than the BoE expected before covid struck. Andrew Bailey blames this situation for Britain's stubbornly high inflation rate. Shortage of labour in the face of a supposedly looming recession, is a most unusual constellation the rate setters find themselves in.

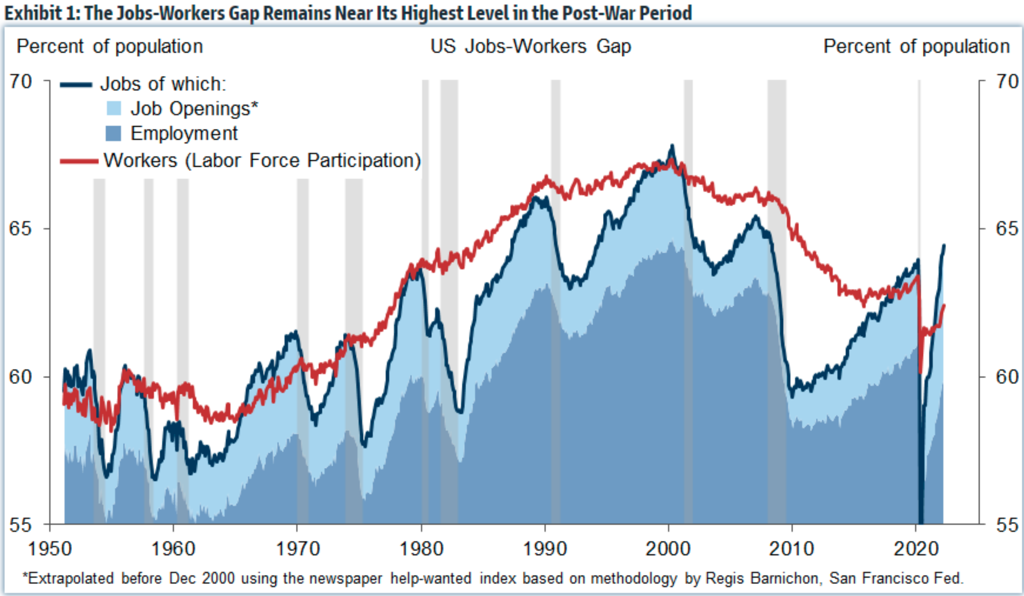
Most worryingly for the BoE, the persistence of this problem seems to be UK-specific - Britain now has the slowest growing employment rate out of the G7. The reasons for this seem to be a combination of chronic sickness, and a lack of access for foreign workers. Neither of these issues can be solved quickly, which makes them big concerns for the BoE.

In the US, the distortions of the labour market start to ease, but are not yet completely gone. There are certainly still less people employed than at the onset of the pandemic, but there are first signs that the gap between labour demand (this is companies looking for labour) and labour supply (people offering their workforce), is stabilising and on track to relax. The unemployment rate is not falling any more, and there are a few data pointing to less job openings. Signs of a cooling labour market is exactly what the Fed will be looking for.

Fed chair Jay Powell will be pleased to see this – even if it is too early to declare victory over an overheating labour market. Jobs coming off the boil lessens the need for tight monetary policy, meaning that further hawkishness is perhaps unwarranted. Unless there is another supply-side shock (which, after the years we have had, certainly should not be ruled out), the 0.75% interest rate hike that was suggested is unlikely.

Still, given the continued imbalance of labour supply and demand, the Fed will have to remain vigilant. Things are moving in the right direction, but the gap between jobs and workers is still too high, meaning another round of wage inflation is possible. Powell will need to see confirmation that the jobs market is getting back to normal, so there is no all-clear yet. Further improvement in the participation rate would be a good sign, as it would mean that the business cycle can continue at a steady pace.

Exhibit 1: The Jobs-Workers Gap Remains Near Its Highest Level in the Post-War Period



Source: US Bureau of Labor Statistics, The Conference Board, Goldman Sachs Global Investment Research

Indeed, increased participation is the only way the labour market could cool without many negative side-effects. If wage pressures decrease due to lower demand instead, that would mean businesses massively reining in their hiring. This would bring down inflation, but it would also increase unemployment, household incomes, and slow overall economic growth as demand declines.

This was the option being discussed a few months ago, when talk of an 'engineered recession' was rife. This would see the Fed raising interest rates deliberately above the so-called neutral level for stable growth, thereby contracting the economy. This would likely work to bring down inflation, but could cause a great deal of collateral damage in the process.

A similar discussion is going on now for the UK, with the BoE predicting a recession in all but name next year – after which growth and inflation are expected to stabilise. The rise in unemployment since the start of the year suggests that, while there still maybe shortages of workers in some sectors, the labour market has already begun to cool.

Still, in order to bring inflation back to sustainable levels, more available workers would be the most welcome solution. The problem is that participation is much harder for a central bank to control. Monetary policy affects unemployment and inflation by altering the money supply, and shifting incentives. But if the issue is instead one of health or immigration – a lack of able workers – there is not much monetary policy can do.

This is the issue central bankers are grappling with. Signs of improvement should be enough to ease off the hawkish policies, but without those they may be forced to tighten more aggressively. We should expect markets to respond positively to more signs of cooling then.

ESG – self certification greenwashing?

The debate around ESG investing flared up last week. At the FT's Moral Money Summit, a senior HSBC executive made a series of controversial comments about climate change, and its impact on the financial system. Stuart Kirk, head of HSBC's responsible investing team, told attendees that "Climate change is not a financial risk that we need to worry about." He went on to disparage environmental targets or criteria for investment firms. In a now infamous quote, Kirk asked "Who cares if Miami is six metres underwater in 100 years? Amsterdam has been six metres underwater for ages, and that's a really nice place."

His words understandably riled people. They were widely condemned in popular outlets, and Kirk was suspended by HSBC a few days afterwards. But some in the industry praised his speech, noting that it prompted debate on an important topic. According to the FT, multiple executives in attendance welcomed the challenge to "group think" in the ESG sector. The investment style, which includes criteria on environmental, social and governance factors, has grown rapidly in recent years, though popular understanding of its rules or conventions has been slower.

Funnily enough, Kirk's speech was arguably not the sector's biggest controversy this month. In the latest rebalancing of the S&P 500 ESG index, electric carmaker Tesla was excluded, while oil giant ExxonMobil was given the all-clear. "ESG is a scam," tweeted Tesla's eccentric chief Elon Musk. "It has been weaponized by phony social justice warriors."

S&P representatives were undeterred, however. The company insisted that it followed the usual rules and procedures of the index, with Tesla's lack of a low-carbon strategy proving an issue. There have also been high-profile claims of racial discrimination and poor working conditions at factories, which pushed Tesla into the bottom quarter of the S&P's ratings for the automotive industry.

Nevertheless, the fact that Tesla – a leading brand in low-carbon transport – was knocked off the index while Exxon remains, inevitably raises eyebrows. It highlights that ESG is not all about the "E", as is sometimes assumed. Environmental criteria are certainly important to ratings providers, but other considerations can be equally important.

S&P claim that its criteria are designed by consultation with investors on where they want to put their money. This usually excludes companies dealing in tobacco, small arms or pornography but, according to the FT, respondents supposedly do not support ditching the oil and gas industry altogether. There are other indices designed specifically for green investing – such as S&P's Net Zero 2050 Paris-Aligned.

The Tesla controversy also shows how inconsistent different ESG labels can be. Data on sales and profits are standardised, and there are clear regulations on what and how companies must report. This is not yet so for ESG metrics, where ratings agencies like S&P or MSCI have to come up with their own criteria and data points. This can lead to surprising results, which often do not match wider society's perceived values or expectations. One environmental campaign group recently found that just 10% of Germany's retail ESG funds are free from controversial investments.

This lack of consistency has been a challenge for investors for some time, so it is understandable that it is now coming under closer scrutiny. We are familiar with the term 'greenwashing', where companies artificially adhere to ESG principals, in order to raise capital on the back of stock prices surging in companies genuinely involved in the green transition, or those with a low carbon footprint. Doing good, and making money while you do, is attractive, and without a consistent framework to analyse how green a company actually is, creates a degree of scepticism about the sector as whole.

The recent upheaval in technology stocks, as well as surging commodity prices, has accelerated this. The underperformance of some ESG stocks has prompted discussion about the ratings criteria. Fund managers are also calling for clearer messaging to clients about the risks involved – so that they have a better idea of their own investment priorities.

There are certainly extra costs associated with ESG screening for investment managers. Part of Stuart Kirk's complaint about climate change was that there is extra work involved in making sure assets are compliant. Ratings agencies must collect extra data on a company's ESG metrics, while fund managers must decipher this data, and make sure it fits with their criteria. Despite the controversy, these comments struck a chord with asset managers. According to one, "ESG is in danger of becoming a bureaucratic tax on investors and shareholders,"

This extra work may well be necessary, but it creates costs which can weigh on returns, and investors need to see value for their decision to invest on their principles. This becomes a bigger issue when the ESG criteria are themselves criticised – as it leads to the fear that people are paying more for products that do not live up to their promises. As we have written before, this is why clearer rules and definitions are needed from regulators.

Without a consistent set of guidelines, rating ESG is up to the interpretation of companies or ratings agencies, which will inevitably differ and be influenced to varying degrees by commercial conflicts of interest. This can be problematic, as their interpretation, that focus on the corporate perspective, can well not seem the same from a societal perspective. Making these criteria transparent and consistent are necessary first steps, but the disconnect will continue if companies and Index providers are left to regulate themselves, and self-certify their achievements and progress.

This is not to say there is no value in S&P's or MSCI's ESG criteria. They can often overlap with what we want to achieve, and the data they collect on different companies is important to know and understand their level of engagement. But their interpretation is not the end of the story. Regulators need to provide clear rules for consistency and, until that point, the criteria they are using to judge a company's ESG credentials should continue to be scrutinised. This is what we try to do – but ultimately these issues need to be settled in conversation with investors. ESG guidelines are the starting point, but there is a long way still to go.

CAMBRIDGE
INVESTMENTS LIMITED

30th May 2022

Global Equity Markets

Market	Fri 15:29	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7588	+2.7	+198	→	⬀
FTSE 250	20391	+2.8	+555	⬂	➘
FTSE AS	4192	+2.6	+108	→	→
FTSE Small	6664	+0.9	+59	➘	➘
CAC	6511	+3.6	+226	→	→
DAX	14430	+3.2	+449	→	➘
Dow	32874	+5.2	+1612	➘	⬂
S&P 500	4125	+5.7	+224	➘	⬂
Nasdaq	12030	+5.9	+675	➘	➘
Nikkei	26782	+0.2	+43	→	→
MSCI World	2744	+3.3	+88	➘	➘
CSI 300	4001	-1.9	-76	➘	➘
MSCI EM	1023	-1.2	-12	➘	➘

Top 5 Gainers

Company	%
Ocado	+18.0
Intermediate Capital	+14.4
Barclays	+11.7
Melrose	+10.3
NatWest	+8.6

Top 5 Decliners

Company	%
Johnson Matthey	-9.5
SSE	-8.6
United Utilities	-8.2
Severn Trent	-6.2
Polymetal International	-4.0

Currencies

Pair	last	%1W
USD/GBP	1.264	+1.3
GBP/EUR	0.849	-0.4
USD/EUR	1.07	+1.6
JPY/USD	126.91	+0.8
CNY/USD	6.70	-0.1
Bitcoin/$	29,052	-2.9

Commodities

Cmdty	last	%1W
Oil	117.94	+4.8
Gold	1854.9	+0.5
Silver	22.16	+1.8
Copper	431.3	+0.7
Aluminium	2865.0	-1.4
Soft Cmdties	238.5	+0.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	12.5	10.6	14.3
FTSE 250	3.2	10.9	14.5	16.3
FTSE AS	3.8	12.2	10.9	14.5
FTSE Small x Inv_Tsts	3.1	7.9	9.7	15.3
CAC	2.9	14.2	11.6	15.2
DAX	3.2	12.8	12.0	13.7
Dow	2.0	16.9	17.2	16.8
S&P 500	1.5	20.0	18.2	18.2
Nasdaq	0.8	22.3	25.3	24.0
Nikkei	2.1	15.4	14.9	17.7
MSCI World	2.1	16.6	16.0	17.0
CSI 300	2.0	13.8	12.6	12.7
MSCI EM	2.9	10.5	11.3	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.91	+0.01
UK 15-Yr	2.19	+0.03
US 10-Yr	2.72	-0.06
French 10-Yr	1.47	+0.00
German 10-Yr	0.96	+0.01
Japanese 10-Yr	0.23	-0.01

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

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enquiries@cambridgeinvestments.co.uk

30th 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.

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