CAMBRIDGE
INVESTMENTS LIMITED

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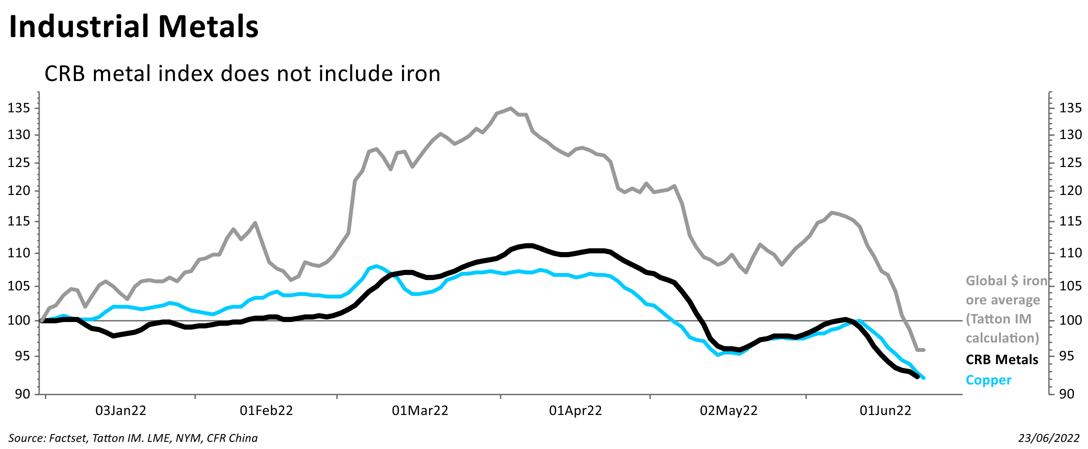
Public sentiment vs economic realities

Through much of this second quarter, the financial market narrative has been about inflation. Last week the Office for National Statistics (ONS) informed us that inflation as measured by the Consumer Price Index (CPI) rose from 9% in April to 9.1% in May, while the Retail Price Index (RPI) rose 11.7% compared to May 2021. UK inflation-linked benefits for 2023 – including pensions – will be determined by September's data sets, and means the state pension will almost certainly increase by more than 10%. This will make it increasingly difficult to hold down further pay demands, especially in the public sector. The UK data follows on from the US May CPI data which precipitated the 0.75% rise in US rates.

And yet, signs continue to indicate that the global supply-chain squeeze is abating, and the cost-push is passing by. As the chart below shows, having peaked at the start of the second quarter, the average prices for industrial metals are now below the price at the start of the year.



Energy prices have been stickier (especially in Europe) but crude oil prices came down sharply last week. Perhaps most hearteningly, there has also been a broad-based decline in agriculture prices since peaking around mid-May.

The downside to all of the good news is that it is accompanied by a bad-news narrative: "commodity prices are down because growth is weak". Last Thursday's initial (flash) Purchasing Manager Indices (PMIs) for major areas added to the gloom – showing a greater decline in optimism among businesses than economists forecasted one week ago. Composite PMIs were soft across the board, especially for the Eurozone. S&P Global reported that new orders for goods and services "stagnated, failing to rise for the first time since the recovery of demand began in March 2021".

Such a narrative is not surprising. The follow though of inflation sees people deciding they don't want to pay the price for goods, thereby reducing demand, and that means less activity and so less growth. The phrase "demand destruction" means exactly that.

Last Thursday, Bloomberg reported that US Federal Reserve (Fed) Chair Jerome Powell called his commitment to curbing inflation "unconditional", while another of his Fed colleagues backed raising interest rates by 75 basis points again in July, even as Democrats warned the Fed against triggering a recession. During his second day of semi-annual congressional testimony, Powell told the House Financial Services

Committee: "We have a labour market that is sort of unsustainably hot and we're very far from our inflation target" and that "We really need to restore price stability, get inflation back down to 2%, because without that we're not going to be able to have a sustained period of maximum employment".

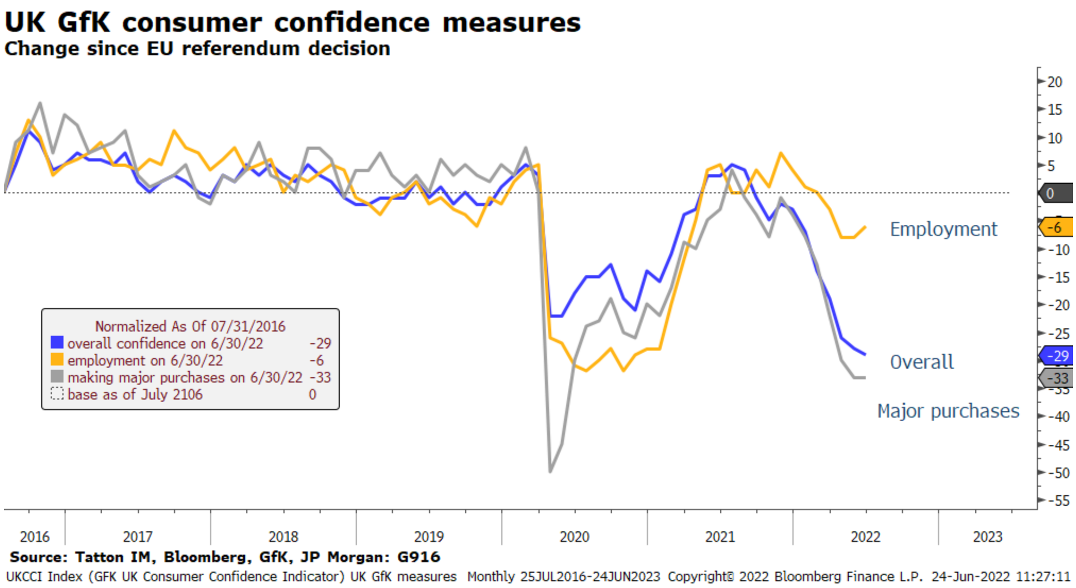
That tough talk may be what's needed to constrain spending, but the bond market now believes central banks will have finished hiking by early next year, and the expected peak in US interest rates will be lower than thought one week ago, down from 4% to 3.5%.

Is a global recession inevitable? Possibly. There is undoubtedly a slowdown underway now. There are two leading indicators, quite separate in their type, which suggest difficult times ahead.

The first is the US dollar monetary base, which has fallen back sharply. This may sound arcane but is drawing attention from many institutional investors. We'll discuss this in more depth next week.

Consumer confidence measures are more relatable to company profits, and the collapse in many regional measures has been striking. As an example, Friday's UK GfK consumer confidence measure showed that confidence has never been lower in its 49-year history, setting a new low for the second consecutive month, although employment sentiment improved slightly from May. We see a similar situation in other regions such as the US. (Thanks to Allan Monks of JP Morgan).

Business confidence has deteriorated from very positive levels, but is still at neutral rather than negative. While employment may worsen (it does lag confidence measures), it is unlikely to contract massively unless there is another shock to the global economy. There has been a slowing in hiring, but job cuts are few and far between just now, and employers will be reluctant to lose workers again, given how difficult it has been to recruit in the past two years.



There is also another possible reason for optimism. Market commentators have generally ascribed the fall in commodity prices to a lack of demand, supposedly centred on a weak Chinese economy. However, there could well be another factor in this – Russia. China and others, who are less concerned with the morals or politics of Russia's invasion of Ukraine, have quickly been sourcing supplies of raw materials.

We've seen estimates that China has been able to get the discounts for oil of about 30% and, according to Bloomberg, 55% of current supply is coming from Russia, up from about 30% last year.

Several indicators are showing China is rebounding after the COVID lockdowns. China's economy has clearly been weak this year, but stock markets have shown stability – even strength – while the rest of the world has been languishing. Beijing may not be pumping-in massive amounts of liquidity, but the Shanghai interbank three-month rate is down at 2% from 2.5% at the beginning of this year, meaning the People's Bank of China is cutting rates while the rest of the world raises them. China's continued trade with Russia may sustain Putin's war effort and heighten the chances of enforcing an energy squeeze on Europe. However, many will be relieved if the supply side of the world's economy shows signs of getting less tight.

Therefore, the sequencing of the slowdown is important. The fallback in input cost-price pressures is welcome and, clearly, it's a good thing that this is happening before firms have to set about cutting labour costs. This must lessen the chance that the slowdown will be prolonged.

What's more, central banks are only partially through their rate cycle, and they still have some degree of flexibility. They don't have to tighten if they believe cost pressures are abating enough – they just have to convince markets that they will do what is necessary.

Lastly, another source of optimism is likely to come through as we head into July. The Q2 earnings season should see reasonable profit growth. After a lot of downbeat forward guidance from firms that have been feeling the pinch, hopefully the reports will be a bit more upbeat.

So, in summary, there are positive aspects in the currently overwhelmingly negative media coverage. Markets are – once again – climbing the wall of worry and that is likely to persist through the summer. This doesn't feel like a positive, but a slowdown was inevitable. Previously we wanted to hear that central banks would do "what it takes" to control inflation. Now investors want them to be flexible enough not to overdo it.

It seems to us that rather than worrying about being in a technical recession or not, we can expect the downturn to generate static global profit growth through the rest of the year, before resuming a normal upward path through 2023. We cannot expect a meaningful equity market recovery until the soft patch is likely to end but, equally, the likely payoff is high enough to stay invested. We will be watching and assessing changes as intently as ever over the summer months.

Has the music stopped for private equity?

The SuperReturn International private equity conference in Berlin was quite the party in recent years. Back in November, the private equity industry's top executives were beaming at their successes through the pandemic. Historically low interest rates and abundant liquidity ensured a frenzy of dealmaking by private equity firms – leading to record profits at Blackstone, KKR, Apollo and Carlyle in 2021. But when the same group met again last week, the mood was entirely different. Instead of self-congratulations, this year's gathering was full of dire warnings: spiking inflation, a looming recession and a slowdown in fundraising. "This is a time of reckoning for our industry," lamented a sombre KKR executive.

Finding out what's changed requires taking a step back. Insiders rightly point out how the pandemic was a good time for private equity, but the sector's 'gilded age' really began after the global financial crisis in 2008. Since then, both the number of deals done, and their total value, have increased dramatically. This was also driven by loose monetary policy, as a decade of cheap credit made buyouts much easier. For the largest private equity firms, so-called 'dry powder' (uncalled capital ready to be used) has more than doubled since 2015.

The private equity business model works by taking equity investment and raising large amounts of debt. When a private equity fund takes over a business, it uses equity-backed loans to leverage its returns. This can yield high ongoing returns with relatively low levels of volatility – a mouth-watering recipe for investors.

It is no surprise that cheap financing is a boon for this type of investment. As well as increasing the amount of capital available for buyouts (taking stock market quoted companies private), loose monetary policy also pushes up equity valuations (by decreasing the 'risk-free' rate of government bond yields, thereby making stocks more attractive). Private equity firms tend to buy companies with a view to restructuring them and selling them on down the line. When valuations are high, the purchasing funds stand to make a much bigger profits on sales. However, the ability to find new target companies thrives when they are available at lower prices. In the end of course, yield levels are a defining factor in any situation, as this is a leverage construct.

By the same token, tighter monetary policy makes life difficult for private equity firms. Any asset sale requires a buyer and, since the global financial crisis, private equity funds have increasingly sold their assets on to other private equity funds, which tends to involve increasing overall debt. When financing costs go up, valuations go down and buyers become scarce, leaving the owners of leveraged assets potentially exposed.

Industry executives were fearful of this situation in early 2020, but lockdowns brought an unprecedented surge of monetary and fiscal support – increasing savings and generating impressive equity returns. Now though, the world's major central banks are in full tightening mode as they battle surging inflation. Even as the cost-of-living crisis eats into consumer and business demand, there is no suggestion central banks will ease up – meaning financial conditions are likely to only get tougher.

The chart below shows the price of private equity funds (or rather, fund-of-funds, where the latter is specially set up funding vehicles for companies' private equity purchases) relative to the value of their underlying assets. As you can see, the price-to-book ratio has moved down sharply since its peak in November, sitting at -37.6% at the time of writing.

LPX Funds of Funds NAV premium/discount
price-to-book ratio

Source: Tatton IM, LPX

The LPX Funds of Funds NAV P/D is diversified across private equity investment styles, financing styles and vintages.
The index is published in percentage figures where a negative index value represents a discount
and a positive index value a premium when compared to the fundamental NAV valuation.
The index is distributed to a broad array of data vendors with daily frequency.

An excellent article in the 21st June edition of the *Financial Times* titled "Selling to yourself" pointed out that some private equity funds reaching the end of their tenure (7-10 years generally) are now selling assets not to the funds of other private equity firms, but to their own newly-established funds. This presents obvious potential conflicts of interest, and is attracting the attention of regulators, such as the UK Financial Conduct Authority and the US Securities and Exchange Commission.

It is telling that private equity (where the buyout company is listed = general partner structure in a private equity deal) has underperformed the S&P 500 since the start of this year. Both have fallen significantly, but private equity firms in particular have struggled, with some UK and European managers underperforming the headline figures. This is indicative of how leveraged assets behave: in the good times, returns can be stellar, but when conditions change, things can quickly turn sour.

Among private equity managers, there is a sense that overconfidence is coming back to bite them. At last week's conference, one executive described a "crisis of value" originating from 14 years of easy money. "The excesses happened because valuations ran up and you had a whole new set of actors who came in that made the deal cycle a little bit too accelerated". The long upswing led to many deals being "mispriced" in certain sectors, drastically increasing the industry's debt levels. It is also notable that the peak for private equity's price-to-book ratio came in November – when executives were feeling confident at the 2021 SuperReturn conference.

All of this makes it hard to see an upside in the short or even medium term. Along with bond yields, credit spreads (the yield premium to what the government must pay) have been widening this year, making it difficult for private equity firms to purchase businesses from their peers. To stabilise the market, other buyers need to be found. But given how large private equity has become over the last 14 years, this is no easy task.

There is no immediate threat of distress for funds run by private equity firms – and certainly not for the larger players. But if financing costs for private equity target companies become overstretched for a more extended period, the sector could become more stressed. A more prolonged downturn could have a big impact on private equity investors, perhaps hitting the wider financial system. Pension funds and other long-term investors are the major holders of those assets (both the equity and the loan capital), and their first call is usually not the central bank (they don't have direct access to central bank money). Should contagion into other financial market sectors occur, central banks would be compelled to act for the sake of financial stability.

Even without significant systemic threats, the troubles of the private equity sector present a problem for investors more generally. These firms have become a main feature of the financial system, and should they come under extreme stress it would likely spell trouble for other markets. For private equity firms themselves, the reputation risk is big. If the 'low volatility, high returns' model is damaged, funding will be much harder to come by in the future. Most holders of private equity assets are not overly concerned right now. Our portfolios do not hold them directly and we believe any indirect exposure is insignificant. Nevertheless, potential impacts are significant, and we will be vigilant in the months ahead.

Emerging Market resilience is encouraging

It has been a tough year for investors so far. Interest rates and yield hurdles are rising, and liquidity is draining out of capital markets, putting downward pressure on virtually all asset classes. With a rise in risk premia (the returns investors demand for a given level of risk), riskier assets in particular have been hit hard. So far in 2022, emerging market (EM) bonds have suffered their worst losses since 1994 – with JPMorgan's dollar-denominated bond index falling 15% year-to-date.

EMs characteristically have plenty of their own problems – and this year has been no different, with idiosyncratic issues across China, Turkey and Latin America, as well as Russia's invasion of Ukraine providing a major roadblock for growth. As well as hits to Ukrainian production and sanctions against Russia, the war appeared to upend agricultural products, metals, oil and gas flows and leave the wider commodities market in flux. Investors have paid attention, and as of last month, $36 billion had flowed out of EM mutual and exchange traded funds this year, according to data from research provider EPFR.

This has had a negative impact on some EM currencies – none more so than the Turkish lira. Turkey's currency has lost more than 23% of its dollar value this year, amid further political controversy for its authoritarian president Recep Tayip Erdogan. Earlier this month, Erdogan vowed to cut interest rates again, despite inflation surging to more than 70%. The Turkish treasury responded with a new bond plan to ensure stability for the lira, but investors are yet to be convinced. Erdogan's policies are a major barrier to foreign capital, making it hard to see an upside.

In addition, Argentina continues to be on the edge of default and disaster, its currency falling nearly 17% this year. Argentina's government negotiated a $44 billion debt refinancing plan with the International Monetary Fund (IMF) in March, but its central bank is still failing to get short-term interest rates high enough to stop the ongoing devaluation.

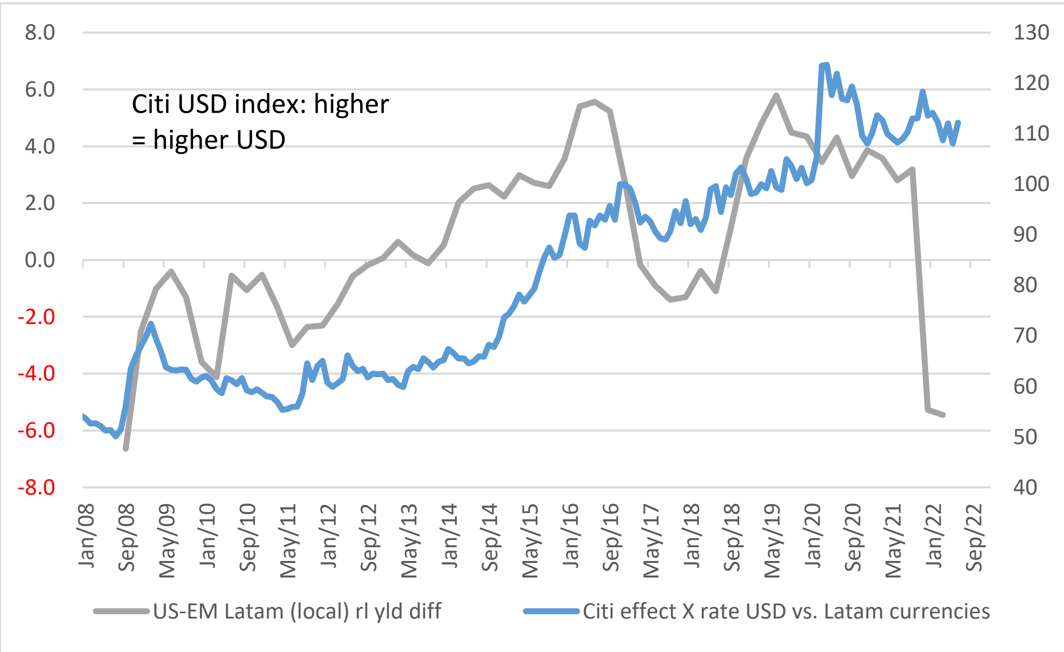
However, apart from these two, EM currencies have fared reasonably well this year. The most shockingly 'good' performance is perhaps the Russian rouble, which has managed a near-unbelievable turnaround over the last three months. Despite war and isolation from the west, the rouble has gained 96% against the dollar since March, making for more than a 40% gain year-to-date, as oil and gas revenues exploded but the country was unable to spend the riches because of the western sanctions. Of course, few western investors have wanted to (or been able to) profit from this under the sanctions.

While not as dramatic, several Latin American countries have seen positive returns against the dollar this year. Brazil, Mexico, Colombia and Peru have all seen their currencies gain since the start of 2022.

Latin America has faced more difficulties recently, though. Over the last month, commodity prices (excluding oil) have taken a hit, damaging the fortunes of exporting countries. This could be down to falling demand from the west, as consumers and businesses grapple with sharply higher prices. This would tie-in with the narrative of a looming global recession, spelling bad news for export-driven EMs.

However, we suspect price moves are more likely down to a rechannelling of Russian energy and metals towards China and India. With a heavy sanctions regime imposed by the west, Russian commodities are trading at a discount – and there is now good evidence they are finding willing buyers further to the east. While there is clearly some demand destruction due to the economic slowdown, a raft of fresh supply has brought prices down.

Tighter monetary policy across the globe is generally bad news for EMs, which suffer from higher debt payments. But many EMs started raising interest rates last year – particularly in Latin America. This has put them in a good position, backed up by the relative stability of currency values. Local EM debt has held up much better than hard currency, suggesting investors are confident of EMs' prospects. The chart below shows exchange rates and bond yield spreads between the US and Latin America. As yields have increased in the US, spreads have come significantly down.



Asia has been a different story, as lockdowns in China have curtailed demand. Asian currencies have generally struggled, with all of them falling against the dollar year-to-date. Interestingly, the weakest currency in the region is not an EM, but the Japanese yen – falling more than 15% year-to-date. Divergent monetary policy – with the Bank of Japan keeping rates low while the rest of the world tightens – is the main cause. Tellingly though, the next weakest Asian currencies are the South Korean won and the Taiwanese dollar. These are both classed as EMs, but in reality are much more similar to Japan in terms of development.

China's drastic economic slowdown weighs heavily on Asia's prospects. But like Japan, China has nothing like the inflation pressures we see in the west. This has allowed China's government to keep monetary and fiscal policy broadly supportive. The zero-COVID policy is clearly a negative, but with Li Keqiang recently suggesting a change of tack, the outlook for the world's second-largest economy could improve. Bond yields are currently lower in China than the US, providing a decent foundation for risk assets.

Overall, EMs have outperformed major developed markets this year. This is impressive considering the headwinds many countries have faced, and shows a level of resilience that will no doubt continue to be important. Moreover, many analysts suggest that with EMs much more oriented towards technology and services than in the past they are well positioned over the medium and long-term. The early inflation fighting in some EMs is certainly paying off, despite hiccups here and there. While EMs could be in for more pain should commodities worsen, the outlook is relatively positive, considering the difficult global backdrop.

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27th June 2022

Global Equity Markets

Market	Fri 14:36	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7139	+1.8	+123	⇘	→
FTSE 250	18980	+0.3	+54	↘	↘
FTSE AS	3938	+1.5	+56	⇘	⇘
FTSE Small	6306	-1.0	-63	↘	↘
CAC	6009	+2.1	+126	⇘	↘
DAX	13023	-0.8	-104	↘	↘
Dow	31014	+3.6	+1087	↘	↘
S&P 500	3829	+4.4	+162	↘	↘
Nasdaq	11449	+7.5	+803	↘	↘
Nikkei	26492	+2.0	+529	→	↘
MSCI World	2549	+2.5	+63	↘	↘
CSI 300	4395	+2.0	+86	⇘	↘
MSCI EM	995	-0.9	-9	⇘	↘

Top 5 Gainers

Company	%
JD Sports Fashion	+10.4
Rentokil Initial	+7.9
AstraZeneca	+7.8
Avast	+7.7
Hikma Pharma	+7.6

Top 5 Decliners

Company	%
Anglo American	-9.4
Antofagasta	-8.8
Rolls-Royce	-8.8
Weir/The	-8.1
Glencore	-6.0

Currencies

Pair	last	%1W
USD/GBP	1.228	+0.3
GBP/EUR	0.858	+0.0
USD/EUR	1.05	+0.4
JPY/USD	135.07	-0.0
CNY/USD	6.69	+0.4
Bitcoin/$	21,241	+3.1

Commodities

Cmdty	last	%1W
Oil	111.39	-1.5
Gold	1825.6	-0.8
Silver	20.83	-3.9
Copper	370.3	-9.9
Aluminium	2477.5	-1.1
Soft Cmdties	227.9	-1.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.2	11.7	9.9	14.3
FTSE 250	3.7	10.1	13.2	16.3
FTSE AS	4.1	11.4	10.2	14.5
FTSE Small x Inv_Tsts	3.2	7.5	10.5	15.3
CAC	3.2	13.1	10.6	15.2
DAX	3.6	11.6	10.7	13.7
Dow	2.1	15.9	16.2	16.9
S&P 500	1.7	18.6	16.8	18.2
Nasdaq	0.9	21.3	24.2	24.1
Nikkei	2.1	15.2	14.8	17.8
MSCI World	2.2	15.4	14.9	17.1
CSI 300	1.9	15.4	14.1	12.7
MSCI EM	3.0	9.9	11.2	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.31	-0.19
UK 15-Yr	2.59	-0.13
US 10-Yr	3.09	-0.14
French 10-Yr	1.99	-0.21
German 10-Yr	1.46	-0.20
Japanese 10-Yr	0.23	+0.00

UK Mortgage Rates

Mortgage Rates	Jun	May
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.63	2.52
3-yr Fixed Rate	2.57	2.43
5-yr Fixed Rate	2.63	2.51
10-yr Fixed Rate	2.86	2.80
Standard Variable	4.25	4.21

* 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.

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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