THE **CAMBRIDGE** WEEKLY

5 September 2022

Lothar Mentel

Lead Investment Adviser to Cambridge

DISCLAIMER

This material has been written on behalf of Cambridge Investments Ltd and is for information purposes only and must not be considered as financial advice.

We always recommend that you seek financial advice before making any financial decisions. The value of your investments can go down as well as up and you may get back less than you originally invested.

Please note: All calls to and from our landlines and mobiles are recorded to meet regulatory requirements.

Waiting for policy action

The summer is nearing its end and with it the return of the more typical English late summer climes. It may feel as if markets have taken a hint with their 5-day downdraft until last Thursday, although most outsiders will look at last week's media frenzy and blame the tumble on the truly intimidating outlook for energy bills during the winter heating season. However, as we lay out in this week's August returns review, negative market sentiment has been driven more by returning fears that the US Federal Reserve (Fed) will be forced to raise rates for longer, due to much improved economic fortunes across the pond. The delicate equilibrium we wrote about last week has clearly once again been disturbed as we entered the new month.

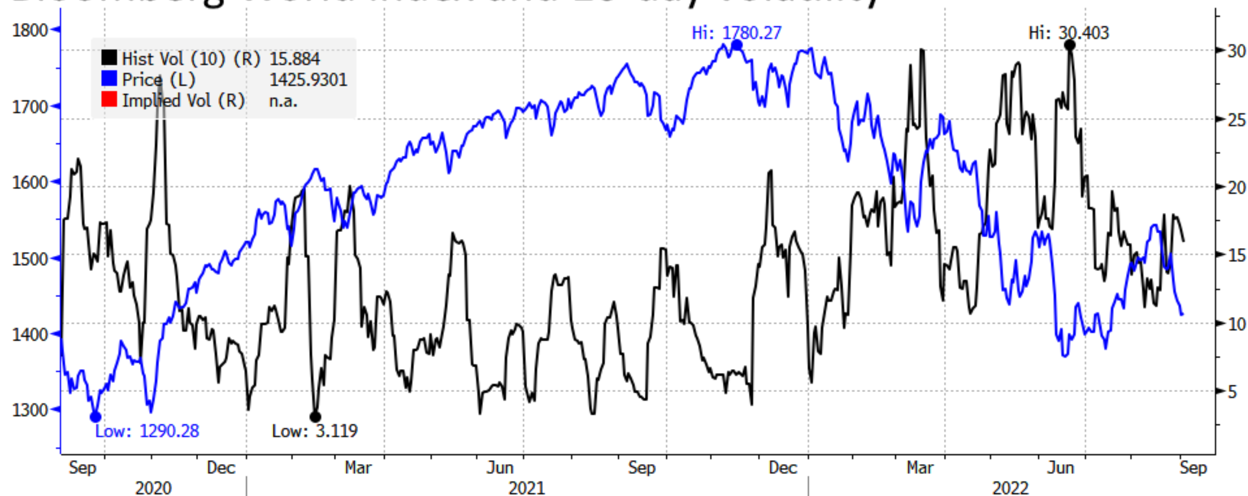
It hasn't helped that while unacceptable cost shock pressures have become very apparent for households and businesses across all of Europe, very little concerted action has been announced in response. In the UK, all eyes are on the new incoming Prime Minister, while the European Union (EU) is held up by the complexity of the matter itself paired with the structural slowness of policy makers to make any decisions. This leaves businesses and households feeling more vulnerable than perhaps necessary. The energy supply shortfall that needs to be overcome by lower demand is estimated to be around 10-15%, which at current price levels will be massively overshot, and lead to an unnecessarily excessive economic and mental health burden to everyone across wider Europe.

Markets' price mechanism is an incredibly effective tool to bring supply and demand back into balance, but in this case, it seems to deliver more than is actually required. Governments will need to devise a policy framework that combines the incentivisation that the price mechanism provides, with means of soft (incentivised) energy rationing that achieves the same supply-demand equilibrium, but without the hardship that unnecessarily excessive price signals would cause for households and businesses.

Turning to recent market action in more detail, we observe a certain peculiarity in recent equity market moves. Usually, when markets fall, intraday volatility also rises. When markets rise, those small intraday ranges are generally quite low; markets creep higher and bounce down from time to time.

The past few days have seen markets fall and daily volatility has picked up, but to a much lesser extent than during the falls of earlier in the year. The chart below shows the Bloomberg World equity index and its 10-day volatility (the blue is price, black is volatility):

Bloomberg World index and 10-day volatility



Copyright© 2022 Bloomberg Finance L.P. 02-Sep-2022 13:13:40

Source: Tatton IM, Bloomberg

The falls in equity markets have been accompanied by falls in government and corporate bonds, much as when happened at the beginning of 2022 and again in June. However, because of the reduced intraday volatility levels there is much less of a sense as back then that monetary liquidity is draining. Indeed, the US retail investor sellers of that period appear to be either less important or less scared.

Looking ahead, seasonally, September is the most difficult month of the year. Investors will therefore not be holding their breath for a reversal of August's falls – even though past seasonality trends have not provided particularly helpful guidance during 2022. However, either way, we are not pessimistic. In fact, this brings us back to what we mentioned at the beginning, which is that one of the main sources of equity market weakness this year has been the rise in US bond yields. Last week, those yields bounced back up after the Fed said it remained more concerned about labour market tightness above anything else. As a result, the US survey of new jobs created (non-farm payroll data) remain the most-watched metric for investors. Of course, bad employment news will be good news for equity prices, since it is a necessary condition for the Fed to become less hawkish. August data published last Friday showed a rise of 315,000 jobs, still well ahead of the average 185,000 jobs per month of the 2010-2019 decade. This is an 'improvement' over July's 528,000 new jobs number, but indicates that the Fed is unlikely to pivot on near-term policy anytime soon.

For Europe, energy prices remain the focal point and last week we finally had some good news. First, oil prices moved back towards the lower levels seen before Russia's Ukraine invasion. This is probably not because the G-7 finance ministers pledged to try to cap the price paid for Russia's oil – the pledge actually coincided with a short rally. The overall fall was more likely due to the deteriorating short-term economic outlook and the prospect of access to Iran's oil should the Biden administration succeed in negotiating a nuclear deal.

But it is not oil that matters so much for Europe. Russia (officially Gazprom) shut down the flow through the Nord Stream pipeline and blamed sanctions and Siemens for "maintenance" issues. While the flow was scheduled to restart on Saturday (3rd September) morning, a Gazprom statement said: "*maintenance of the units must be carried out approximately every one-and-a-half months. As a result, new repairs may be required as early as mid-October. However, the cessation of gas pumping is likely even earlier in the event of turbine breakdowns due to increased load*". As Andrew Bishop of Signum Global Advisors tells us, that is a pretty clear indication of what Russia is intending to do – needle Europe's public with continued supply disruption holding prices high, while not shutting of the gas supply completely to retain the leverage over European politics.

Yet, gas and electricity prices both managed to fall meaningfully last week, leading to stabilisation in both the euro and European equity markets. Germany's second floating liquid natural gas terminal is set to come online in the Autumn. The move towards another three terminals is underway and Robert Habeck, Germany's Minister for Economic Affairs and Climate Action, hinted there may even be another one. CNBC and the German power industry association BDEW report that during August, Norway has become Germany's biggest supplier of gas, providing almost 38% of German consumption. The Netherlands is now the second-biggest supplier, delivering roughly 24%. Russia has fallen to about 10% (from 60% a year ago). Seasonally, August has the lowest gas consumption of the year, and this stepdown in consumption has been important in reducing dependence on Russia. By June, Eurostat data shows that Germany had reduced its consumption by nearly 20% still. On our calculation, if the cut in absolute consumption was maintained even as consumption rises into the winter months (rather than being proportional), this would still be a 12% reduction. With further supply increases, it might be enough to mean no more price rises for businesses, the key metric for equity markets.

August review, a story of two halves

Asset Class	Index	August 2022	3 Months	YTD	12 months	5-yr rolling (annualised)
Equities	FTSE 100 (UK)	-1.1	-3.1	1.6	6.2	-N/A
	FTSE4Good 50 (UK Ethical Index)	-2.8	-4.9	-0.7	3.2	0.4
	MSCI Europe ex-UK	-2.1	-4.3	-13.0	-11.7	4.6
	S&P 500 (USA)	0.3	4.1	-2.4	5.0	14.1
	NASDAQ (US Technology)	-0.2	6.2	-11.6	-7.7	14.0
	Nikkei 225 (Japan)	1.9	2.8	-4.4	-4.1	6.8
	MSCI All Countries World	0.7	2.2	-4.3	-0.5	7.0
	MSCI Emerging Markets	5.0	1.3	-4.0	-7.5	0.6
Bonds	FTSE Gilts All Stocks	-7.6	-6.9	-18.6	-19.7	-2.2
	£-Sterling Corporate Bond Index	-	-	-	-	-N/A
	Barclays Global Aggregate Bond Index	0.5	2.8	-1.7	-2.6	0.6
Commodities	Goldman Sachs Commodity Index	1.8	-2.7	53.8	68.2	10.2
	Brent Crude Oil Price	-3.8	-10.4	43.1	57.9	12.6
	LBMA Spot Gold Price	1.8	1.3	10.9	13.1	5.6
Inflation	UK Consumer Price Index (annual rate)	1.4	1.4	6.5	9.3	-
Cash rates	Libor 3 month GBP	0.0	0.2	0.3	0.3	0.5
Property	UK Commercial Property (IA Sector)*	0.0	0.2	4.8	9.1	-N/A

Source: Morningstar Direct as at 31/08/22. * to end of previous month (31/07/22). All returns in GBP.

After a promising start, in the end, August turned into a rough ride in capital markets. Equity markets across the world took a downturn, and bond yields rose once more, putting downward pressure on bond prices. British bonds were particularly hard hit, with the FTSE Gilts All Stocks losing 7.6% on the month. For UK investors, global stocks actually generated positive returns in sterling terms. This may come as a surprise for those watching the doom and gloom headlines, but it was almost entirely down to currency moves. Sterling had a torrid month, losing a substantial amount of its value against the US dollar, which made overseas holdings more valuable for UK investors.

The last few weeks marked a change from the previous month. July was good for investors, as markets took a more positive view of the bond outlook. This was driven by an expectation that the US Federal Reserve (Fed) would revise its aggressive policy stance, a view that was backed up by lower oil prices, falling inflation expectations and (seemingly) from comments by Fed chair Jay Powell that Fed policy tightness may be nearing its apex.

While July's positivity initially carried over into August, it soon became clear that the Fed was not going to ease its hawkishness any time soon. Fed members announced they were still focused on the tightness of the US labour market, showing a strong concern for fighting inflation. Data showed America's jobs market was indeed very strong, with a startling 528,000 jobs added to the non-farm payroll at the start of the month, while falling oil prices took the pressure off the discretionary spending budgets of US consumers.

There was no official Fed meeting this month, but the spotlight was still on Powell for his speech at the central bankers' summer summit in Jackson Hole, Wyoming. Powell made it clear that markets

misinterpreted his comments back in July and to expect plateauing rates for 2023, rather than an early peak. Markets reacted strongly from then on, convinced that the Fed will remain hawkish until labour markets ease, and nothing policymakers have said or done yet has softened this view.

Both nominal and real (inflation-adjusted) bond yields subsequently rose, nearly reaching the highs seen in June. This was a clear signal that markets believed in the Fed's ability to bring inflation back under control, even at the expense of economic growth. This shift was largely responsible for the equities downturn. Just as the falling 'risk-free' rate made stocks more attractive in July, its reversal put a dampener on market sentiment. This also led to some interesting market dynamics: value stocks once again outperformed growth by around 2% globally, while small caps performed fairly well relative to large cap companies (with the exception of the UK).

Unsurprisingly, the energy sector was the month's best performer, with the anticipation of extreme supply-side problems during the winter causing a huge spike in prices, and profits. At the regional level, Emerging Markets (EM) were the best performing region, with the MSCI EM index climbing 5% in sterling terms (more or less flat in local currency terms). This is somewhat surprising, given the pessimism surrounding the global economy. Some of the outperformance could be explained by commodity strength, but this was challenged by the fact that commodities outside of natural gas did not improve in August. We dedicate a separate article this week to EM trends.

Gas prices remain a major problem for the UK and Europe. Russia halted supply of NordStream gas in the middle of August and, while this came as a surprise, it is surely a precursor to continued supply disruption in the Autumn, as Russia continues to use its energy pipelines into Europe as a means of influencing public opinion. Russian President Vladimir Putin will have been satisfied to see rising European energy prices as the big story of the month, as energy inflation pushed higher and higher. Unfortunately, a recession here and on the continent is now all but inevitable, at least if supply-side issues continue – more or less as markets had already anticipated earlier in the year.

Despite the Fed's inflation concerns, the US is in a very different situation. Its apparent stability in the face of trouble elsewhere led to a sharp rise in the value of the dollar, backed up by a general risk-off move by global investors, in turn lessening the price-push impact of import prices. Together with the still strong labour market, this helped to bring back demand-led inflation fears of overheating consumer and business demand. On the other hand, sterling and the euro suffered, compounding import-driven price rises and thereby the market weaknesses in wider Europe. These supply-side price shock issues have forced the Bank of England (BoE) and European Central Bank (ECB) to take a tougher stance on inflation fighting, despite the immense weakness their economies face into autumn and winter. So, even though for very different reasons and differing fortunes, all the major central banks are looking hawkish.

China was also in the news in August, for all the wrong reasons. The air and naval blockade of Taiwan has been worrying enough on its own, but it also signals a worsening relationship with the US. Rumour has it that President Biden tacitly approved congress leader Nancy Pelosi's visit to Taiwan, a move that infuriated the Chinese leadership. Poor relations between the world's two biggest economies is not good news, particular at such a dire moment for global growth.

In the short term, the property market is more important for China. The real estate sector is still unstable, and the slow-motion collapse of property developer giant Evergrande (and others) is still reverberating

around China's economy. This has led to property price falls and so knocked on to lower consumer confidence.

President Xi Jinping and his politburo are reluctant to reignite rises in already unaffordable property valuations. However, policy moves in other areas became even more aggressive through the month, with another $300 billion spending programme for this year on top of the $2,300 billion already scheduled (compare that to Biden's $1,100 billion infrastructure programme, due to be spread over 10 years). Having slid through the early part of August, China's equity markets managed to stabilise and outperform in the second half of the month.

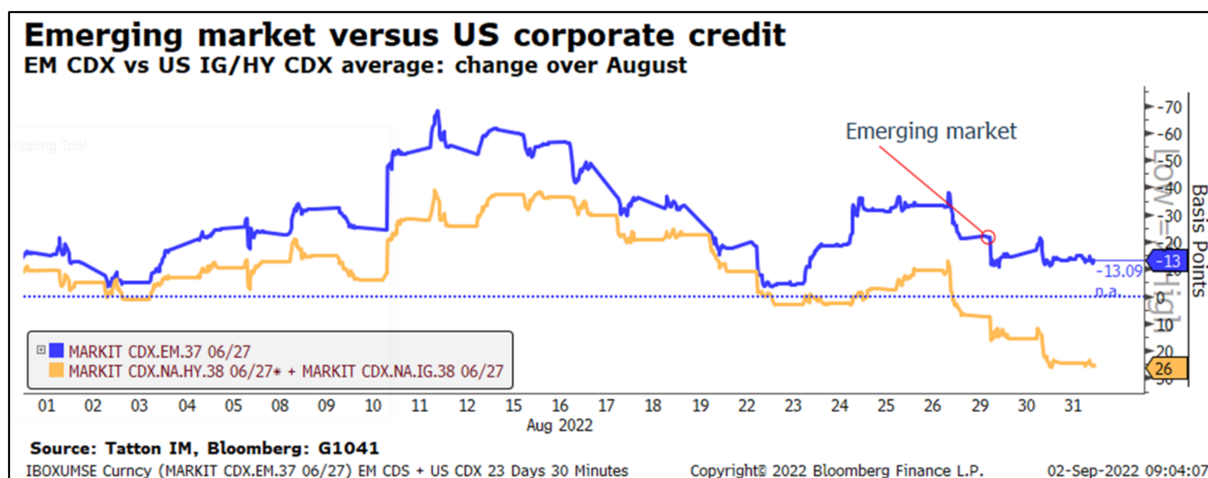
In summary then, while the third quarter has so far produced positive returns for UK investors on the back of the strong July performance, market dynamics at the end of August and the beginning of September do remind us a lot of June's dire straits. It means that markets are anticipating much of what is expected to hit the economy and businesses in the coming months. Any improvement in the level of uncertainty around the European gas crisis, the US labour market tightness easing, and China digging itself out of its slowdown should provide significant and sudden market upside from current levels.

The opposite is obviously true for matters going in the other direction. As we wrote just last week, while a short, shallow recession is all but priced in, near-term economic disaster is not. Contrary to the prevailing media temperature, we see little to suggest disaster unless new 'unknown unknowns' unfold on the negative side of this equation. On the positive side, the prospect of imminent government policy action to soften the blow of sky-high energy prices could turn the dial, as did the news that Germany's gas dependency on Russia had declined from 60% to under 10% compared to August last year, while reduced gas demand should ease some of the pressures in gas markets.

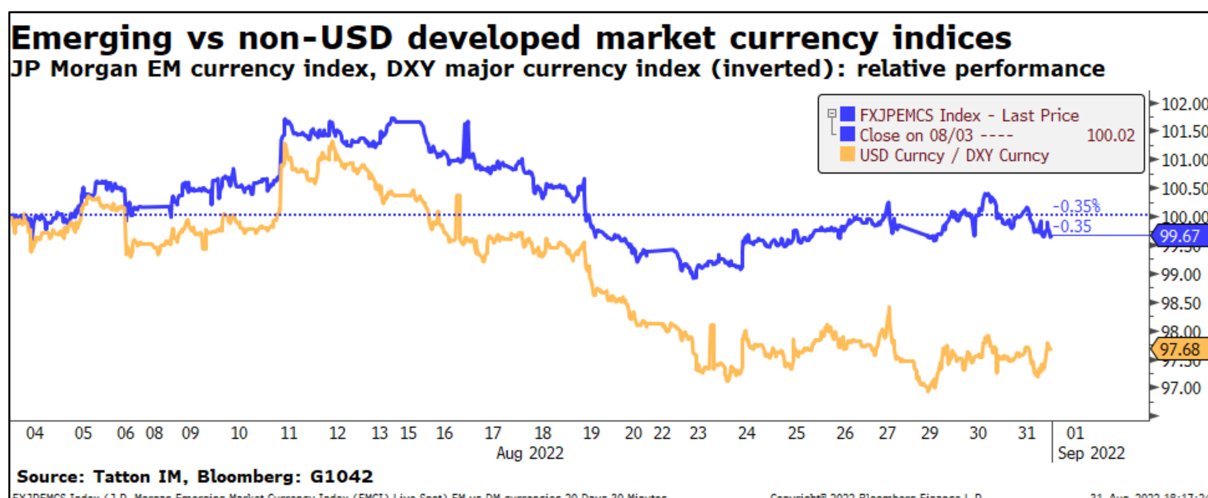
Emerging Markets enjoying time in the sun

Recent sterling weakness has led to some unflattering assessments of the UK investment market. Reliance on outside investment (which has not been forthcoming for several years) and a floundering currency have invited comparisons to EMs, which tend to be at the whim of market sentiment and the global economic cycle. The same has been said of Europe, as the continent faces extreme energy supply pressures and a looming recession.

Funnily enough though, the targets of those comparisons – EMs – have fared quite well recently. Relatively speaking, that is. EM equities and bonds finished August down overall (up though from a £-sterling perspective due to the mentioned UK currency weakness), in what was a difficult month for global investment assets. But the fall was quite mild, compared to a more drastic downturn in US corporate credit, as seen in the first chart below.



Developed market currencies outside of the US also had a significant fall, with the blue line tracking EM currencies vs. the US dollar, while the yellow line shows the same for developed markets. The UK becoming more like an EM? We should be so lucky.



Traditionally, EMs are very cyclical – expanding in times of global growth and falling back during the global economy's low points. But while the world is undeniably in a slowdown (which became only more apparent over the month) EMs have not suffered as one would usually expect.

At first glance, high energy prices would be a likely explanation. EMs are often reliant on commodity exports, meaning that high prices for raw materials can deliver a big boost. But the flaw in this argument is that the energy crunch is primarily in the natural gas market, specifically around Europe. EMs as a whole do not have a great exposure to European gas prices, and are unlikely to benefit from the supply-side tightness there. Energy issues have lately not been reflected in oil and metals prices, for example, which both had a lacklustre month. By comparison, food exporters such as Brazil have done well, despite the apparent fallback in developed world consumer demand.

Granted, from a longer-term perspective, commodities are in a good position. Price pressures are significantly higher than before the pandemic, and those forces are unlikely to dissipate any time soon. Pessimists point to a looming global recession and structural shake-ups from Russia's war on Ukraine, which could undermine demand for commodities and thereby damage EMs. But the structural backdrop is still supportive of commodity prices – particularly for metals.

The global green transition is a powerful force underlying metals demand. New renewable energy requires metals both for capture (steel to build wind turbines) and storage (reactive metals for batteries). Indonesia is a country that could particularly benefit from this secular shift.

A prolonged period of commodity strength and a favourable outlook have allowed many EMs to improve their trade balances. Potentially weak commodity demand could undermine some of that improvement, but many EMs have the additional benefit of proactive monetary policy last year. Latin American countries in particular began aggressively tightening interest rates in late 2021, and now have a fair chance of avoiding recessions, as it gives them room for easing much earlier than developed countries.

Interestingly, Brazil was the best equity market performer in August, despite the fact that its trade balance did not improve. This could be because the benefits of higher commodity prices have already been spent, as the government prepares for an election in October. Populist President Bolsonaro is likely to lose to former socialist president Lula, but will certainly not go down without a fight, and a policy flourish could be on the cards in the months ahead.

Conversely, South Africa was one of the worst performing EMs last month, after faring well in the months before. Metals are South Africa's main exports, meaning that the fall in platinum prices was damaging. But unlike Brazil, South Africa's political reform agenda is still on track, and President Ramaphosa's administration has brought stability that could not have been imagined under previous incumbent Zuma.

EM has always been known for being diverse, and this is still the case. Some EM economies, in response to sovereign crises in the 90s, have redefined their macro balances. FX reserves are higher, lots of governments have reverted to issuing in local currency (rather than in USD), and funding has moved away from the short term. And needless to say, an economy like China has just become an entity of its own, whether labelled EM or not. It also sits oddly that South Korea is still in the EM equity basket.

Compare, for example, the so-called 'frontier' economies of Ghana and Sri Lanka. These countries are behaving much more as you would expect for EMs – faced with intense debt problems and severely

constrained by the slowing global economy. The EM success stories, on the other hand, have done well to keep their debt burdens in local currency terms, giving them much more control and reducing their exposure to US dollar strength.

Despite the positives noted above, anxiety lingers for EM investors. EMs have certainly held up better than expected, but what this means for the future outlook is deeply uncertain. Ultimately, the key factor is how bad the global economy gets. For all of the doom and gloom lately, nominal growth has held up well across the world. And while we are certainly in a slowdown, there is no global recession yet, and hence no significant pullback in commodity demand. In fact, fiscal stimulus is forthcoming in the US, Europe, China and Brazil, which will bolster growth in the months ahead. This is likely to lead to further monetary tightening from major central banks in developed markets, as has already been signalled.

That scenario will be the real test for EMs. We will see whether EM success is structural and genuine, or just a fluke. The worst could be yet to come for developing economies, but things are at least looking positively different for some EMs for now.

CAMBRIDGE INVESTMENTS LIMITED

5th September 2022

Global Equity Markets

Market	Fri 16:48	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7281	-2.7	-199	⇗	→
FTSE 250	18853	-2.1	-405	↘	↘
FTSE AS	3998	-2.6	-105	↘	→
FTSE Small	6291	-2.0	-127	↘	↘
CAC	6168	-1.7	-107	↘	↘
DAX	13050	+0.6	+79	↘	↘
Dow	32013	-0.8	-270	↘	⇘
S&P 500	4013	-1.1	-45	↘	↘
Nasdaq	11924	-1.8	-218	↘	↘
Nikkei	27651	-3.5	-991	↘	→
MSCI World	2610	-3.1	-84	↘	↘
CSI 300	4024	-2.0	-84	↘	↘
MSCI EM	976	-3.0	-30	↘	↘

Top 5 Gainers

Company	%
Smith & Nephew	+5.4
JD Sports Fashion	+5.3
Smurfit Kappa	+3.0
AVEVA	+2.7
Avast	+2.7

Top 5 Decliners

Company	%
Glencore	-10.2
Bunzl	-9.7
Endeavour Mining	-8.2
Ocado	-7.8
SSE	-7.6

Currencies

Pair	last	%1W
USD/GBP	1.157	-1.5
GBP/EUR	0.867	-2.1
USD/EUR	1.003	+0.6
JPY/USD	140.13	-1.8
CNY/USD	6.900	-0.4
Bitcoin/$	20,358	+1.8

Commodities

Cmdty	last	%1W
Oil	94.04	-6.9
Gold	1715.7	-1.3
Silver	18.205	-3.7
Copper	346.1	-6.4
Aluminium	2295.0	-5.6
Soft Cmdties	224.47	-0.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	10.3	9.1	14.3
FTSE 250	3.4	8.2	13.0	16.4
FTSE AS	3.9	10.0	9.5	14.5
FTSE Small x Inv_Tsts	3.5	7.3	11.0	15.4
CAC	3.1	12.0	9.9	15.2
DAX	3.6	12.6	10.7	13.8
Dow	2.1	16.7	17.1	17.0
S&P 500	1.6	19.1	17.7	18.3
Nasdaq	0.9	22.7	26.4	24.3
Nikkei	2.0	15.2	15.2	17.8
MSCI World	2.2	15.6	15.5	17.1
CSI 300	2.2	13.7	13.0	12.8
MSCI EM	3.3	9.8	11.3	12.7

02/09/2022 16:35:29

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.92	+0.32
UK 15-Yr	3.34	+0.36
US 10-Yr	3.23	+0.19
French 10-Yr	2.15	+0.13
German 10-Yr	1.53	+0.14
Japanese 10-Yr	0.24	+0.02

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate	1.75	1.50
2-yr Fixed Rate	3.51	3.29
3-yr Fixed Rate	3.31	3.20
5-yr Fixed Rate	3.45	3.26
10-yr Fixed Rate	3.72	3.59
Standard Variable	4.54	4.50

* 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

5th September 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