THE **CAMBRIDGE** WEEKLY

8 August 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.

Markets bet on a perfect landing

Bad news filled the airwaves last week. Faltering global growth, higher inflation forecasts and rising interest rates set a dour tone – capped off by a geopolitical crisis in Taiwan. UK investors were struck by the Bank of England's dire warnings: a 13% inflation peak and a protracted recession are now in store for Britons, according to Governor Andrew Bailey. Predicted to last for five quarters, the looming UK recession is set to outlast the one following the global financial crisis in 2008/09.

For global investors, the more pressing issue is China's military bravado across the Taiwan Strait. Experts largely agree escalation is in nobody's interest but is still very possible. On Friday, Chinese officials announced an end to military and climate cooperation with the US. Further such moves would be damaging – particularly against the backdrop of a weak global economy.

With all that gloom, it might come as a surprise that capital markets are in good spirits. Since the start of July, equity prices have rallied, and bond yields have fallen. Markets have more or less recovered all their June losses. As we cover in our July review, almost all major stock indices we track had a positive month – with some seeing very substantial gains. So, why are investors so unfazed by the current bad news?

Judging from bond markets, the feeling is that we have reached peak global inflation, and consequently peak interest rate pressures on central banks. Oil prices have started falling and, as we cover in a separate article, the actions of oil producers themselves point to a belief that current prices are unsustainable. Supply chain bottlenecks clogged by the pandemic are also improving, while consumer demand has clearly taken a hit from the cost-of-living crisis.

The thought is that this will cause a reversal of central bank policy sooner than previously expected, with implied US rates peaking by the end of this year. Investors have essentially given central banks – particularly the US Federal Reserve (Fed) – a vote of confidence. Its policies are expected to prevent a dangerous wage-price spiral while maintaining the economy at a decent level. What's more, middle-class consumers still have considerable savings to fall back on, while jobs remain plentiful, and businesses are more financially sound than in previous downturns. Recessions in most regions are expected to be shallow and brief, while the US might avoid one altogether.

The problem with this view is that it contradicts what central bankers themselves are saying. Fed Chair Jerome Powell's speech the previous week gained praise for its seemingly dovish tones, but he still committed to raising rates and crushing inflation at all costs. The disparity is even more apparent in the UK, where Bank of England Governor Andrew Bailey and his team issued warnings as dire as they come.

We suspect that the alarmist lingo is more a warning than a genuine prediction. Monetary policy works on a very long lag, meaning that tweaks to interest rates now will only have an effect a year or so down the line. But if bond markets are to be believed, inflation will already be largely under control by then – meaning further tightening would be overkill. Central bankers want to tame inflation right now, and the only way they can think to do that is by affecting consumer and business behaviour. They will hope that pessimism will stop employees pushing for higher wages, bringing down cost pressures.

That is the best-case scenario, and the one markets are currently betting on. Such optimism in bond markets was the main reason for July's uptick in equity prices – as falling yields made stocks comparatively

more attractive. But that positivity is itself a little concerning, as it makes asset prices vulnerable to worse-than-expected news.

There are still many risks to the overall outlook, which are, arguably, not properly priced-in. Europe is particularly at risk, facing energy shortages and sharply higher costs this winter. This should bring consumer demand down further and eventually cool inflation, but that could take some time. The main source of Europe's woes is gas supplies, which are very hard to adjust in the short-term, and are highly susceptible to Russia's war in Ukraine. European businesses could be the hardest hit, as they have less sway over electoral outcomes and are therefore lower down on politician priority lists.

Markets nevertheless seem to think the inflation battle is already won, and there is a clear path to economic recovery. But none of that is certain, and there are many political obstacles that could get in the way. Governmental paralysis in Britain and Italy could prevent decisive policy action (Conservative MPs have already questioned the Bank of England's independence in response to its dire forecasts), while US-China tensions over Taiwan are a serious and perhaps under-appreciated risk to global growth. Negative news flow, particularly around energy supplies, could severely dampen market sentiment.

At the same time, the huge uncertainty around energy means things could turn out better than currently expected. Elevated gas prices in Europe have become the main concern to the global outlook, but there is very little information on when they might subside. Since it is purely a supply-side issue, we know that it will not last forever (as US gas costs are a fraction of Europe's) but is just a question of how long.

Broadly, we agree with the prevailing market sentiment that things are not as gloomy as central bankers would have us believe. At the same time though, policymakers have every reason to sound the alarm, as there are significant risks to the outlook. Given those risks do not seem to be fully understood or appreciated, we cannot yet assume that July's upswing is anything other than a temporary reprieve. We will be hoping it proves to be something more but will be watching company earnings closely from here. Cautious optimism seems the best approach.

CAMBRIDGE INVESTMENTS LIMITED

8th August 2022

July review: a recovery from June's pain, but markets still driven by yields

Asset Class	Index	July 2022	3 Months	2022 YTD	12 months	2021	5-yr rolling annualised
Equities	FTSE 100 (UK)	3.7	-1	2.7	9.6	18.4	-N/A
	FTSE4Good 50 (UK Ethical Index)	3.7	-1.5	2.1	7.3	13.0	1.0
	MSCI Europe ex-UK	5.1	-2.2	-11.1	-7.3	16.7	5.6
	S&P 500 (USA)	9.0	3.6	-2.7	9.0	29.9	14.7
	NASDAQ (US Technology)	12.2	3.9	-11.5	-2.8	23.3	15.4
	Nikkei 225 (Japan)	5.5	2.1	-6.2	-2.1	2.6	6.5
	MSCI All Countries World	6.8	1.2	-5.0	2.3	19.6	7.9
	MSCI Emerging Markets	-0.4	-3.5	-8.5	-8.7	-1.6	1.0
Bonds	FTSE Gilts All Stocks	2.6	-2.2	-11.8	-13.7	-5.2	-0.3
	£-Sterling Corporate Bond Index	3.5	-1.5	-10.9	-12.8	-3.2	0.6
	Barclays Global Aggregate Bond Index	1.9	2.3	-2.1	-2.4	-3.8	1.1
Commodities	Goldman Sachs Commodity Index	-0.2	0.1	51.1	63.1	41.6	10.7
	Brent Crude Oil Price	-4.8	0.1	48.8	57.5	51.5	14.5
	LBMA Spot Gold Price	-3.2	-5.3	7.6	9.9	-2.9	6.8
Inflation	UK Consumer Price Index (annual rate)*	1.5	1.5	5.9	9.4	5.4	-
Cash rates	Libor 3 month GBP	0.1	0.2	0.3	0.3	0.0	0.5
Property	UK Commercial Property (IA Sector)*	0.8	1.1	5.0	10.1	7.4	-N/A

Source: Morningstar Direct as at 31/07/22. * to end of previous month (30/06/22). All returns in GBP.

July was a great month for global investors. In sterling terms, the MSCI World Index climbed 6.8%, while bond yields fell across board, boosting bond values. Almost all the major equity indices we track saw significant gains with the exception of emerging market stocks, which traded mostly sideways but ended 0.4% down. Highlights came from the US, where the broad S&P 500 index jumped 9%. The Nasdaq – which houses America's technology giants – gained a whopping 12.2%. This alone went some way to generating the healthy returns seen at the global scale. Even so, more economically challenged regions like the UK and Europe fared well – with the FTSE 100 gaining 3.7% on the month.

In truth, July was a rare spot of sunshine in an otherwise dreary year. Despite positive monthly returns across most asset classes, the year-to-date figures are still significantly in the red. European equities have shed more than 11% this year, as has the US tech sector. The energy and resource-heavy FTSE 100 is the only major equity index to hold a net gain in 2022 so far. And this is largely due to the UK's historical underperformance: UK stocks are still below their pre-pandemic peak, while the US has outrun its own pre-pandemic peak by nearly a quarter.

The source of stock markets' recent joy is also the source of their previous woes: bond yields. Bonds have been hammered this year by rapid inflation and aggressive tightening from central banks. This sharp spike in yields (which are the inverse of prices) drove up the 'risk-free' rate of return and made equities relatively less attractive. But in July, this trend reversed. Both government bond yields and credit spreads (the risk

premium between corporate and government borrowing rates) came down, easing financial conditions and improving stock valuations.

Why has the mood shifted among bond traders? Some point to an easing of inflation concerns. Despite massive price increases still filtering through all over the world, there is certainly some evidence that input costs are cooling. Crude oil, which has jumped nearly 50% this year, fell in July. Overall, Goldman Sachs' Commodity Index registered a 0.2% fall last month. Prices for downstream goods are still increasing, but there are signs that consumer demand is tailing off faster than expected. Judging from bond markets, consumer inflation is set to peak around the end of this year and return to a more normal level soon after.

The main driver of market optimism, though, is the thought of how central banks might react. Weak economic data and talk of a looming global recession have shifted monetary policy expectations dramatically. Although the US Federal Reserve (Fed) raised interest rates sharply again the previous week, the tone of Fed Chair Jay Powell's speech was extremely well received by investors. As we wrote at the time, bond markets are now implying a near-term peak in rates, with cuts expected as soon as the first half of next year.

Poor economic data is the main evidence backing up this view. Monetary policy works on a substantial lag, and if markets are right that inflation is at (or close to) its peak, further aggression from central banks will do little to quell short-term price rises. Instead, Fed hawkishness will only serve to worsen growth in the future. Not wanting to unwittingly cause or worsen a potential recession down the line – the thought goes – the Fed is likely to loosen its grip.

As some commentators have pointed out, the trouble with this view is that it goes against what the central bank is itself saying. Powell hinted at a potential slowdown in rises at the last Fed meeting, but also reemphasised his commitment to bringing inflation down above all else. As Bloomberg's John Authers recently noted, investor optimism pushed real (inflation-adjusted) yields down to almost zero the previous week. This is despite clear signs from the Fed that it wants financial conditions – and real yields in particular – to tighten (rise) as it fights historic price rises.

The old adage goes that investors should never fight the Fed, but that increasingly looks like what bond traders are doing. One of the biggest conundrums here is that the rationale for Fed loosening is the poverty of economic data, and yet the recent rally in stocks and bonds suggests markets think the opposite. Bond markets are not currently signalling an imminent US or global recession, but the worry is that they expect the Fed to react as though there is one.

The answer is that markets seem to be betting on the proverbial 'soft landing', where a central bank manages to tame price pressures and slow growth without causing mass bankruptcies or outright recession. Economically speaking, this is certainly possible. Recent business sentiment surveys point to falling price pressures without a stepwise fall in output. Increases in labour participation throughout the year are similarly reassuring.

There are clear pockets of concern though. On Thursday 4th August, the Bank of England released yet another dire warning for the UK economy, predicting an extended recession coupled with sky-high inflation. In Europe, the energy crunch could turn to rolling blackouts come winter. And in China, the property market is still languishing, while geopolitical tensions are higher than ever. Whatever the chances of a soft landing for the US, they are much less so elsewhere.

Dislocation would undoubtedly put pressure on asset prices, which are still highly valued despite falling back this year. This means that a soft economic landing does not necessarily mean a soft one for asset prices. The former certainly helps the latter though, and we can hope that the current optimism will be enough to see us through. If so, July could be the start of a better 2022. If not, it will likely prove a false dawn.

Energy profits here for a good time, not a long time

Energy companies prefer not to be in the news. Executives likely feel that right now more than ever, with media and political pressure building on their latest earnings figures. Centrica, the owner of British Gas, recently reported profit growth of 500% year-on-year for the first half of 2022. Meanwhile, Shell posted its best ever quarterly profits for Q2 and BP its highest profits in 14 years for the same period. All of this comes while Britons face eye-watering rises in energy and fuel costs. Naturally, the disparity has led to a great deal of negative media coverage.

Of course, if they have to be in the news, the money must help. Centrica reinstated its dividend on the back of soaring revenues, paying out a total of £59 million to shareholders, while BP and Shell raised their dividends. US oil giants ExxonMobil and Chevron also posted record profits for Q2 of $17.9 billion and $11.6 billion respectively, to the delight of shareholders. Oil and gas prices, buoyed by pandemic supply issues and then catapulted skyward by Russia's invasion of Ukraine, have generated truly astonishing results for the world's biggest energy companies.

These profits have naturally benefitted share prices. On a net total return basis, unsurprisingly, Energy is the best performing sector over the last year, by some distance. Bloomberg's energy index is 28.4% up from a year ago. Utilities, the only other sector to post positive growth over that time, are up just 5.3% by comparison.

These moves are made all the more impressive by the negative equity market backdrop in that time. Central banks all over the world have pushed up bond yields by tightening monetary policy, challenging the status of equities as the 'only show in town' in terms of positive long-term returns. The rise in 'risk-free' rates has dampened equity valuations across virtually all industries, and energy is no exception. In fact, on a forward price-to-earnings ratio, energy company valuations have come down more than any other sector (!).

The fact that energy companies have posted the best returns while dropping to the lowest valuations is astonishing, and shows how sharp the recent energy price shock has been. But it also shows investors are much less optimistic about the long-term prospects for energy companies than current results might suggest. Some of this is down to the likely political response: the UK government has already announced a windfall tax on oil and gas companies, and the sharper the contrast between struggling households and booming energy giants gets, the more likely we are to see further taxes – and not just in the UK.

The deeper reason for falling energy valuations, though, are likely to be structural. Russia's war and the ensuing sanctions delivered the biggest price shock to global energy markets since the 1970s OPEC embargo. Oil and gas supply lines between Russia and the West have been battered and may not ever recover, leading to a sharp squeeze in prices. But over the longer-term, prices are less about what goes where and more about the balance of aggregate supply and demand.

That balance has not been fundamentally changed by Russia's invasion. Russia has a short-term interest in squeezing its European customers – particularly Germany, which has been one of the hardest hit by constrained gas supplies – but has no interest in reducing its oil and gas production over the long term. It has already found many willing buyers in Asia, and will inevitably want to get back to full production and export volumes when it can.

Then there is the demand side. The pandemic recovery saw a sharp burst of pent-up energy demand, but this has since cooled off significantly. With looming recession fears, this trend is set to continue. What's more, the incredible rise in energy prices is already destroying end demand. Come winter, this is likely to mean intense energy saving efforts – with communal heating and power-cuts already being discussed in Germany.

The current price shock will also have implications for the future. Fossil fuel investment measures have been drawn up for the UK and US – which will increase supply some years into the future. More importantly, there is a clear political drive toward increasing renewable or even nuclear energy production. Inevitably, this dampens the long-term outlook for oil and gas demand.

Fossil fuel producers are well aware of this. At their most recent meeting, OPEC+ countries agreed a minimal increase in production despite a seemingly huge price incentive to pump more. This suggests a recognition that current price levels are unsustainable in the face of rising interest rates, and a slowing global economy. On the current trajectory, oil supply is likely to outstrip demand within the next four years. As producers see it, increasing production now will just make them more vulnerable to lower prices in the future.

With this in mind, lowly valuations for booming energy companies are to be expected. Record oil and gas profits are here for a good time, but not a long time. This is most apparent for oil, which is much more easily transportable, meaning global markets will move into balance sooner rather than later, and last week's further declines in oil prices towards the $90 per barrel threshold are some evidence for this. Things are slightly more complicated for gas, where markets are much more regional due to the challenges of transportation. But even here, sky-high prices will destroy or re-direct demand one way or another and constitute a significant incentive to create additional transport capacity – bringing down prices over the long-term.

Monetary policy is a key element to this story. During oil shocks in the 1970s, central banks offset rising prices by loosening monetary policy. This effectively subsidised energy demand, embedding inflation and contributing massively to the rapid price increases experienced throughout the decade. Now, the mood among central bankers is precisely the opposite. They are aware of the pain inflation will cause consumers, but are determined to ensure price stability above all else.

That will make things difficult for households and businesses in the short term – particularly in heavily afflicted areas like Europe and the UK.

Global Equity Markets

Market	Fri 15:17	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7458	+0.5	+34	↗	→
FTSE 250	20103	-0.3	-62	↗	↘
FTSE AS	4121	+0.3	+14	↗	→
FTSE Small	6515	+0.4	+28	⇗	↘
CAC	6486	+0.6	+38	↗	⇘
DAX	13630	+1.1	+146	⇗	↘
Dow	32695	-0.5	-150	↗	⇘
S&P 500	4142	+0.3	+12	↗	↘
Nasdaq	12705	+2.5	+314	↗	↘
Nikkei	28176	+1.3	+374	↗	→
MSCI World	2762	+0.6	+15	↗	↘
CSI 300	4157	-0.3	-13	→	↘
MSCI EM	995	+0.1	+1	→	↘

Top 5 Gainers

Company	%
Avast	+48.0
Pearson	+17.3
Entain	+9.5
Ocado	+8.2
Stan Chartered	+8.0

Top 5 Decliners

Company	%
Melrose	-7.3
WPP	-6.6
Hikma Pharma	-6.2
Rolls-Royce	-6.0
Croda Int'l	-5.2

Currencies

Pair	last	%1W
USD/GBP	1.206	-0.9
GBP/EUR	0.844	-0.5
USD/EUR	1.02	-0.5
JPY/USD	135.34	-1.5
CNY/USD	6.76	-0.2
Bitcoin/$	23,232	-2.4

Commodities

Cmdty	last	%1W
Oil	95.40	-13.3
Gold	1776.3	+0.6
Silver	19.89	-2.3
Copper	355.8	-0.4
Aluminium	2403.0	-2.2
Soft Cmdties	217.1	+0.5

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	9.7	9.7	14.3
FTSE 250	3.2	9.4	14.2	16.4
FTSE AS	3.8	9.7	10.1	14.5
FTSE Small x Inv_Tsts	3.2	7.7	11.4	15.4
CAC	3.0	12.5	10.7	15.2
DAX	3.4	12.4	11.2	13.8
Dow	2.0	17.1	17.4	17.0
S&P 500	1.6	19.8	18.2	18.3
Nasdaq	0.8	23.9	27.2	24.3
Nikkei	2.0	15.6	15.7	17.8
MSCI World	2.1	16.3	16.2	17.1
CSI 300	2.1	14.5	13.4	12.8
MSCI EM	3.1	9.9	11.3	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.04	+0.18
UK 15-Yr	2.40	+0.08
US 10-Yr	2.84	+0.19
French 10-Yr	1.48	+0.10
German 10-Yr	0.94	+0.12
Japanese 10-Yr	0.17	-0.02

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	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

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