CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

15 August 2022

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Fear of missing out

Investors are feeling FOMO: the "fear of missing out" once again. Last week was a continuation of the trend from the start of July – which has seen a significant boost to both bond and equity markets. Curiously, the good feeling among investors seems unaffected by the bad news all around. Inflation is roaring ahead, and consumers are struggling to keep up, central banks are intent on crushing price pressures with aggressive monetary policy and talk of a global recession abounds. The growth slowdown is already being felt by companies. This year's second quarter earnings showed a downgrade in forward-looking estimates for the next 12 months. And yet, stock markets continue to rally.

Naturally, falling earnings and rising stock prices mean equity valuations – on a price-to-earnings ratio – have climbed higher. This is a reflection of increased risk appetite. On our model, equity valuations have two major components, both of which are to do with borrowing and the cost of finance: real (inflation-adjusted) yields and corporate credit spreads (the difference between government and corporate bond yields). We have written before about the move down in credit spreads, and how it shows increased confidence in company prospects. This is essentially a sign that markets do not expect an imminent recession – for the US at least (still the world's leading economy) – despite media headlines to the contrary.

Equally important has been the fall in real yields. At the start of August, inflation-adjusted yields on 10-year US Treasuries once again sank to almost zero, and they are still well below their mid-June peak. This is largely down to shifting impressions of US Federal Reserve (Fed) policy. But it also shows investors are confident in the stability of financial assets, and in the Fed's ability to promote a healthy US economy.

The key question is whether the macroeconomic backdrop has improved enough to justify this view. Markets are certainly betting it has, but we are not as convinced. As we have written before, such optimism can cause an underappreciation of risks – of which there are still many. Since the onset of the pandemic, the global economy has fluctuated between too hot and too cold. This has led to intense supply-side problems, and spots of severe economic weakness.

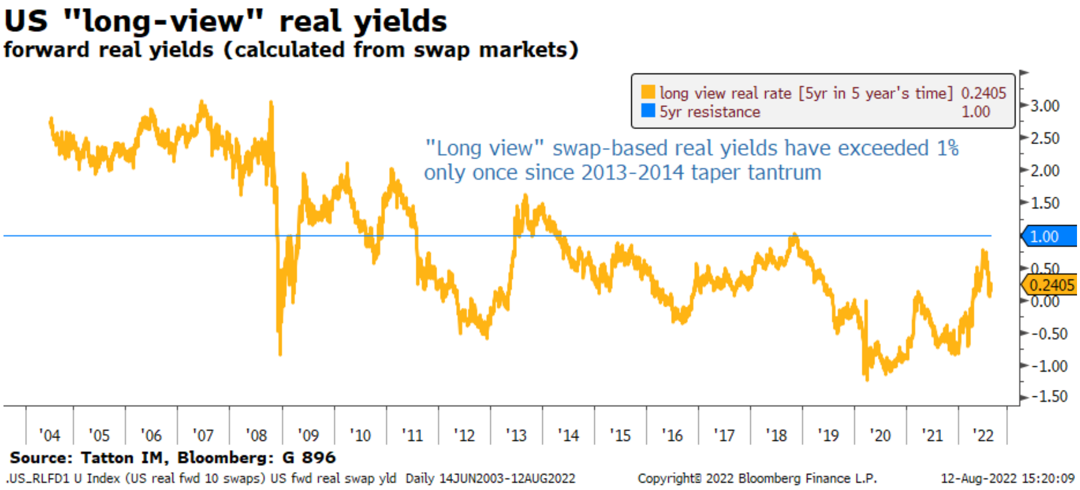
We should note that this is very different to what we saw before the pandemic. Over the last 30 years – and especially since the Global Financial Crisis (GFC) – the global economy has been in a near-perpetual state of oversupply. There were many reasons for this (China's ascendency and supercharged output chief among them), but the result was that economic management – by governments or central banks – was largely about encouraging demand.

Due to the coronavirus hangover, undersupply is the big issue of the day. Policymakers' demand-side techniques are ill-equipped to deal with such supply issues, and large fluctuations have ensued. We can see this in the recent movements in metals prices, which have quickly turned from weakness to strength. Similarly, oil, which was falling back towards the $90 per barrel threshold, has now broken back above $100.

In the past, when faced with looming recessions, central banks would try to stimulate demand until supply overhangs receded. But now the inflation genie is out of the bottle such growth-oriented policies are a huge risk for price stability. This is a nightmare for investors, who, at times, seem not to know how to react. Every time inflation pressures fall back slightly, the prevailing mood in markets seems to be "thank god that's over!".

The pandemic presented unique threats to global supply chains. But it also revealed that the wider trend of global undersupply had perhaps come to a natural end. China and other emerging markets have long pursued policies to boost domestic demand and become less export-dependent. Even before coronavirus gripped the world, such policies looked to have succeeded. At the same time, western labour markets severely tightened, due to historic underinvestment in education and harsher stances on immigration.

In such an environment, we would expect the 'natural' real yield to be closer to 1%, above the post-GFC norm but still below the historical average. Current US "long view/natural" real yields have fallen to around 0.25%, and therefore have ample room to rise as the chart below shows. Unless energy and labour market problems dissipate, a return to the zero real yields of the post GFC-era seems unlikely.



We believe this is important for equity valuations. It means that stock market strength will have to come from improvement in earnings, rather than just improving sentiment and lower yields. And with the economic problems facing us in the short term, that might be hard to come by. The passage of new fiscal policies for more sustainable infrastructure in the US gives credence to the view that the world's largest economy might avoid recession altogether – or at least that any downturn will be brief and shallow. But while this is a positive for growth, it is likely to put even more upward pressure on longer-term real yields.

We have never agreed with the doomsayers, and we still do not think that a global recession is inevitable (though recessions in the UK and Europe are all but certain). At the same time though, we are slightly uncomfortable with the level of optimism implied by current equity values. The jury is still out for the short-term – and the long-term picture is likely to be very different.

The summer lull has probably helped prop up market sentiment somewhat. With many away on holiday, it is much easier for traders to convince themselves that everything is rosy. This happens to coincide with a two-month break in Fed meetings too, with the next one scheduled for the end of September. When that does come around, we should expect the Fed to have a renewed zeal for taming prices, which could provide a wake-up call for markets. We should enjoy the sunshine while it lasts, but future market improvements will need to be based on more than just the summer breeze.

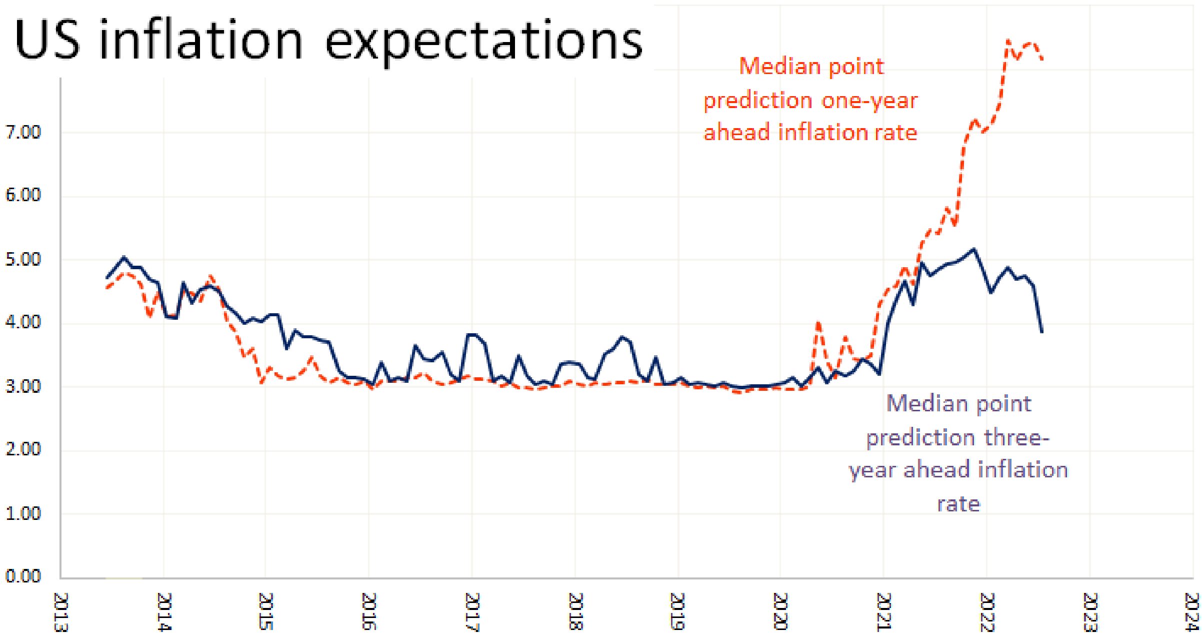
US inflation expectations

Behind the recent optimism in capital markets has been talk of the 'peaks': peak inflation and peak interest rates. How high will these peaks be, and when will they come? Stocks and bonds started to rally last month, and equities have continued in the growing belief that the US economy may have passed the inflation summit and is fast approaching an interest rate summit.

Bond markets currently suggest that inflation will be under control by the start of next year. Price rises for US consumer goods and services are still racing ahead of the US Federal Reserve's (Fed) 2% inflation target as last week's release of July's consumer price inflation (CPI) data showed – "core" CPI was recorded at 8.5% year-on-year versus prices (core is after the volatile food and gasoline prices are filtered out). Due to the recent slump in oil prices the month-on-month rate was around 0.3% which, when annualised, is equivalent to a 3.8% year-on-year pace. Obviously, if that is maintained, the year-on-year figure will drop significantly but still not yet down to the Fed's implicit 2% - 2.5% target.

This is good news for investors, as it is seen as alleviating the pressure on the Fed to remain hawkish. Such expectations are behind the recent falls in government and corporate bond yields which, we believe, were a big factor in July's stock market gains.

However, the job of central banks is not really about containing particular bouts of price rises. It is about the maintenance of confidence in their currency, as a medium to long-term store of value. Consumer inflation expectations are tightly linked to this. If people think prices will keep rising, they are more likely to ask for higher wages or seek higher paying jobs while upping their short-term spending. This is why persistently high inflation is so problematic for the Fed, even if it is primarily supply-driven: after a while, inflation fuels inflationary behaviour – the dreaded wage-price spiral. But the signs are good on that basis too. The chart below shows a survey of consumers' inflation expectations over one (red dotted line) and three-year periods.



Source: Tatton IM, Survey of Consumer Expectations, © 2013-22 Federal Reserve Bank of New York (FRBNY). The SCE data are available without charge at www.newyorkfed.org and may be used subject to license terms posted there.

Consumers still think prices will jump substantially over the next year, but the outlook has moderated in recent months. Arguably more important is the three-year prediction, which has come down substantially. Self-reported consumer expectations tend to be exaggerated (the survey predicted consistent 3% inflation from 2015 to 2020, during which time actual CPI barely got above 2%) but they are a good indicator of direction. Americans now think inflation is primarily a short-term problem, with prices stabilising over the next few years.

This is great news for the Fed. The current inflationary period has had huge impacts on consumer and business behaviour, the most important of which is what people do with their savings. When prices are rising rapidly, households and businesses lose trust in standard financial assets (like cash deposits or bonds) as a store of value. This encourages spending on non-financial assets, thereby increasing demand further. We saw this over the last year, when households ran down their savings, increased short-term spending and bought properties.

Along with the fall-back in long-term inflation expectations, asset valuations have improved. Corporate bonds were under particular pressure a few months ago but have improved substantially – along with a general build-up in savings and a fall in risk premia (the return investors demand for a given level of risk). This suggests trust in financial assets is returning. Demand for such assets has increased, helping returns across the board.

This backs up a theme we have discussed a lot recently: faith in the Fed. Bond markets show that investors expect sharp monetary tightening in the next few months, but also that this will bring prices under control sooner rather than later. The survey data above now suggests consumers believe this story too. While prices are still very high and increasing, the Fed has managed to convince everyone that the storm will soon calm.

The most impressive part of this is that, for all the doom and gloom seen in the media, investors do not expect a recession up ahead. On a price-to-earnings basis, equity valuations have increased. This is particularly so for growth stocks, which are usually considered longer duration assets and are much more sensitive to changing interest rates. This is even despite falling earnings expectations over the last year. As we wrote last week, markets are betting the Fed will achieve a perfect landing, taming inflation pressures without causing a contraction in the economy.

Admittedly, the Fed has had some help. The outlook for global growth – and hence global demand – has been hammered by intense problems in China and Europe. Both are suffering through weak periods, which are expected to drastically reduce global demand for oil. This is vital since gasoline prices are arguably the most significant component of US inflation. In the last weeks, oil prices have fallen back significantly. If ever a central bank was to nail the perfect landing, these are the signs it would need to see.

However, as we also noted last week, the fact that markets are so confident is itself a cause for concern. Perfect landings are incredibly hard to achieve, and there are still significant risks to the outlook. The problem is not that the Fed is unlikely to get things right, but that markets have priced in such a high probability of success that any deviation could be devastating. We like to see stock market optimism as much as anyone, but only when it comes with a thorough appreciation of the risks to future corporate earnings. Oil prices are one such risk.

We still see the long-term outlook for energy prices as lacklustre, even though current profits are astronomical. Oil prices have fallen back, but any further reduction will be hard to achieve in the short term. China might be weak currently but is likely to improve towards the end of this year. That will increase global demand for crude oil, which could hit US households just as they are starting to gain confidence.

That would force the Fed to continue on its tightening path, dampening hopes of a monetary reversal. Such a situation could cause serious problems in the next couple of months, particularly for businesses required to refinance during that period. In general, the summer months tend to be quiet in markets, which has helped maintain optimism. Should traders come back from their holidays to negative news flow, another period of volatility looks likely. Inflation expectations are certainly improving as we had expected, but we are not out of the woods yet.

Fiscal firepower in UK's inflation fight

Britain's cost-of-living crisis has dominated the Conservative Party's leadership election. The increasingly bitter race to replace Boris Johnson has seen a host of promises from candidates on taxes, energy bills and welfare payments. Rishi Sunak accused frontrunner Liz Truss of a U-turn on energy bills last week, after the former Foreign Secretary denied she had ruled out extra support. Sunak – the 'tax now, cut later' candidate – plans to give households increased emergency support payments if he finds himself in 10 Downing Street. Truss seemed to suggest her government's support would only come through tax and National Insurance cuts, deriding "handouts" last Tuesday. A day later, Truss denied this meant she had ruled out additional support, while reiterating her preference for tax cuts.

Rapid inflation will be the main problem facing whoever wins the Tory leadership. How they deal with it will almost certainly make or break their party's chances at the next election. The stakes are high, and so far, the debate has focused on whether tax cuts or government spending are the best means of supporting people. During the last economic crisis, the furlough scheme and emergency loans were rolled-out to keep the country afloat. They were a great success in that respect (preventing mass bankruptcies and unemployment) so, now that households are once again in peril, will there be an equivalent policy package?

The first thing to point out is that, while both economically damaging, a lockdown and a cost-of-living crisis are vastly different beasts. In the beginning of the pandemic, the biggest threat facing the global economy was a drastic fall in consumer demand. Across the world, furlough schemes were intended to fill the black hole that would have opened in personal incomes. This worked, perhaps even too well – on the whole, households built their savings throughout lockdowns, while aggregate supply contracted to meet falling demand.

That – along with unforeseen shocks like Russia's invasion of Ukraine – is one of the main factors behind the current inflation crisis. Once economies opened up, consumers had ample savings to fall back on – meaning demand could pick up where it left off – and more. But the supply-side issues created by the pandemic persisted. This combination led to incredible growth numbers last year, but also pushed up prices dramatically. The fallout from Russia's aggression, and the oil sanctions that followed, supercharged this process and forced central banks into full-throttle monetary tightening.

The challenge now is that the global economy does not have enough supply to match demand. This is a worldwide problem – but is exacerbated by regional discrepancies (Europe's reliance on Russian gas and Britain's Brexit struggles). The uncomfortable part is that support for inflation-hit consumers would amount to propping up demand, thereby making the inflation crisis worse. Tax cuts and increased spending are two sides of the same coin in this respect, expanding fiscal policy and adding more fuel to price rises.

In a recent article, senior figures from the Institute for Fiscal Studies describe how Truss' promised tax cuts are ultimately unsustainable without a reduction in public spending somewhere down the line. All Tory leadership candidates emphasised the need for strong growth and the supposed 'fiscal headroom' of £30 billion, but there are serious flaws in these points.

For starters, that £30 billion would be easily eaten up by either a fall in tax revenues or a modest rise in unemployment payments. Considering the UK is set for a lengthy recession, both of those are likely. More generally, promoting short-term growth right now is at odds with taming inflation. The two forces generally keep each other in check, but Britain is now bracing for a recession coupled with persistently high inflation. This essentially means supply is so constrained that even economic contraction – and hence falling demand – is not quite enough to get short-term prices under control.

Faced with these intense pressures, what can any government do? In Europe, most governments have adopted some form of price caps, tax cuts or both. These have had varying levels of success. Germany's reduction of fuel duty was five times bigger than Britain's equivalent, while policymakers also introduced a €9-a-month ticket for all public transport, valid from June until the end of this month. These measures brought headline consumer inflation down to 7.5% in July, from June's 7.6%. But these are ultimately methods of propping up demand, and economists have warned that price pressures are likely to come back stronger in the winter.

Legal price caps on energy are a way of crushing inflation by force, but the flipside of this will almost certainly not be the much-needed reduction in energy demand, which is crucial in the case of restricted supply. There is already talk about potential blackouts or communal heating measures across Europe in the winter. Whether these types of measures are better than price increases forcing reductions of energy consumption are debatable – but they should help to reduce the *perception* of inflation. As we write in another article this week, inflation expectations are a crucial part of the longer-term outlook for prices, and so this benefit should not be discounted. Equally, most observers are likely to agree that there should be support for hardest-hit households, but most of the support schemes cover a wider range of consumers.

Again, the fundamental problem comes down to the lack of supply. Right now, we are seeing this in energy markets, but the issue is a general one for the UK and has a longer-term characteristic. As both Tory leadership candidates are keen to point out, low productivity has held Britain's economy back for well over a decade. This is down to a lack of investment, as well as deep-rooted problems in the labour market. Britain's sluggish labour participation rate has gained attention in this regard, but equally problematic is the shortage of skilled workers.

This is not a short-term issue, though the effects of it are very much being felt now. A simple solution would be to increase immigration, but that seems unlikely in the political environment. Over the longer-term, investment in better education is another solution, but that is at odds with the government's (even Rishi Sunak's) desire to cut taxes as soon as practical. Or alternatively, other areas would need cutbacks. One way or another, supply and demand will have to be brought into balance. If that does not mean investing in more supply (particularly of skilled workers), it will have to mean crushing demand. The more the government shies away from this, the more aggressive the Bank of England will have to get.

Global Equity Markets

Market	Fri 15:19	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7491	+0.7	+51	⬀	→
FTSE 250	20313	+1.3	+261	↗	↘
FTSE AS	4145	+0.8	+33	↗	→
FTSE Small	6628	+1.7	+108	↗	↘
CAC	6552	+1.2	+80	↗	⬂
DAX	13787	+1.6	+213	↗	↘
Dow	33452	+2.0	+648	↗	⬂
S&P 500	4230	+2.1	+85	↗	↘
Nasdaq	12892	+1.9	+235	↗	↘
Nikkei	28547	+2.2	+615	↗	⬂
MSCI World	2802	+1.8	+50	↗	↘
CSI 300	4191	+0.8	+34	→	↘
MSCI EM	1014	+1.1	+11	→	↘

Top 5 Gainers

Company	%
Flutter Ents	+22.2
Aviva	+15.9
Admiral	+15.9
Mondi	+15.3
Hargreaves Lansdo	+10.9

Top 5 Decliners

Company	%
GlaxoSmithKline	-13.3
Airtel Africa	-5.9
Centrica	-4.4
Hikma Pharma	-3.5
Antofagasta	-3.1

Currencies

Pair	last	%1W
USD/GBP	1.212	+0.3
GBP/EUR	0.847	-0.4
USD/EUR	1.03	+0.8
JPY/USD	133.72	+1.0
CNY/USD	6.74	+0.3
Bitcoin/$	24,138	+6.3

Commodities

Cmdty	last	%1W
Oil	97.44	+2.7
Gold	1791.8	+0.9
Silver	20.53	+3.2
Copper	365.2	+2.8
Aluminium	2520.5	+4.9
Soft Cmdties	217.9	+1.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	9.8	9.7	14.3
FTSE 250	3.1	9.2	14.5	16.4
FTSE AS	3.8	9.7	10.1	14.5
FTSE Small x Inv_Tsts	3.2	8.0	11.7	15.4
CAC	2.9	12.6	10.8	15.2
DAX	3.4	13.2	11.3	13.8
Dow	2.0	17.4	17.8	17.0
S&P 500	1.5	20.1	18.6	18.3
Nasdaq	0.8	24.4	27.9	24.3
Nikkei	2.0	15.8	16.1	17.8
MSCI World	2.1	16.6	16.4	17.1
CSI 300	2.1	14.6	13.5	12.8
MSCI EM	3.1	10.1	11.5	12.7

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.10	+0.05
UK 15-Yr	2.51	+0.11
US 10-Yr	2.87	+0.04
French 10-Yr	1.55	+0.06
German 10-Yr	0.98	+0.03
Japanese 10-Yr	0.19	+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

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15th August 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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