CAMBRIDGE
INVESTMENTS LIMITED

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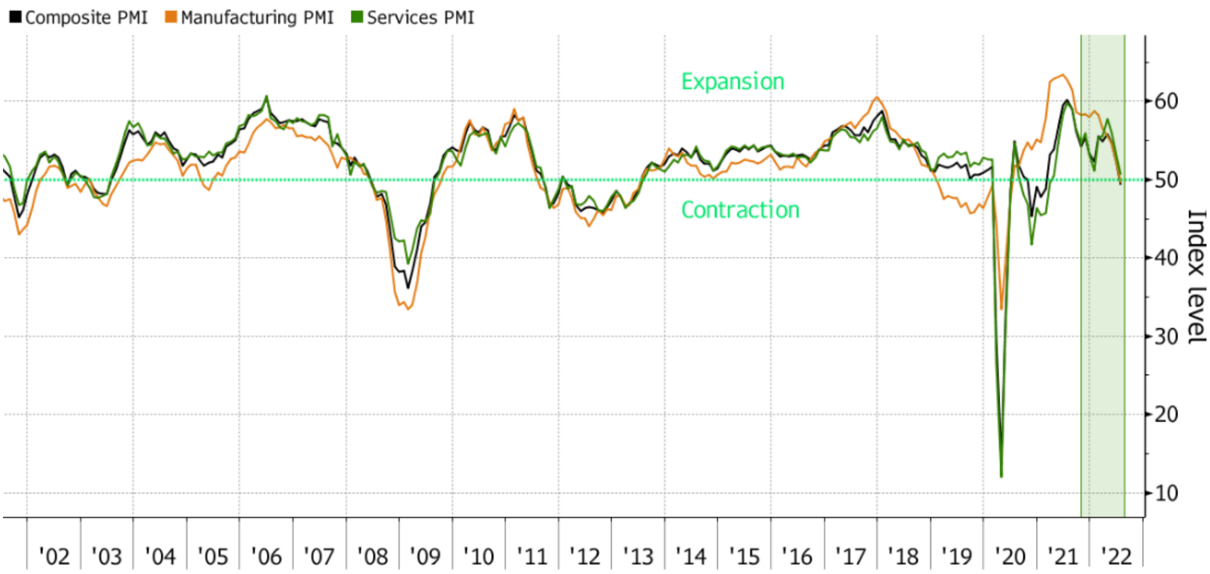
Economy weakens but central banks persevere

Global investors tend to be quite US-focused, as the world's largest economy has an outsized impact on trends across the world. Last week though, attention was on the other side of the Atlantic. European economic data caught the eyes of traders – and, unfortunately, not for the right reasons. Both consumer and business sentiment surveys indicated unexpected weakness, heralding a downturn across the continent.

The chart below shows the path of Purchasing Manager Indices (PMIs). They record business confidence (out of 100) across a range of categories. Readings above 50 tend to indicate that economic expansion lies ahead, while figures below that level point towards a contraction. The PMI's last week were not good for Europe. Each index was one or two points below the expected level, and the composite index (combining services and manufacturing) fell to 49.4. This would seem to signal that Europe is on the brink of a recession, if not already in the midst of one.

Unexpected Contraction

Euro-area economic activity shrinks for the first time since early 2021



Source: S&P Global

At the start of the year, there was a great deal of optimism about Europe's post-covid economy. It is hard to find such positive sentiment now. An ailing economy and perennial political divisions have been exacerbated by Russia's invasion of Ukraine. Given its reliance on Russian energy, the European Union is particularly susceptible to the war taking place on its borders and its energy insecurity has led to sharply higher inflation expectations.

Europe is not the only place where optimism has faded. In the US, the corporate earnings season is underway and has disappointed. There is no disaster apparent in the figures, but earnings expectations have taken a clear downturn – particularly for next year. American earnings are still expected to rise, but the path is flatlining. This is part of a global theme: growth and earnings are under pressure, with little signal that these will improve.

With all this doom and gloom, one might be surprised to learn that last week was a good one for equity markets. Despite lacklustre US earnings, the S&P 500 gained more than 4% on last Monday's level. Even more surprising is the Euro Stoxx 50, which was more than 3% up last week. Both indices are well above where they started at the beginning of July. Economies have weakened, but markets have rallied. How do we make sense of this conundrum?

The key factor here is not the weak economic data itself, but the policy response to it (or rather, the *expected* policy response). We cover the European Central Bank's (ECB) recent actions in a separate article this week, but the truncated version is as follows: the ECB measures are far from perfect, but there is a concerted effort to do something about energy price inflation and the knock-on effects on the wider economy. This is important, as strong and responsive institutions are essential for Europe's crisis response.

As for the US Federal Reserve, we can be fairly certain that policymakers will raise interest rates by another 0.75% at their meeting this week. There is a small chance the Fed could go even further, in an attempt to reach its 'peak' interest rate sooner. Again, we cover central bank expectations in a separate article on bond markets. But we note that discussion around peak rates – what and when they will be, and policy will evolve after that point – has proved a positive for capital markets.

Interestingly, recent policy announcements have shown a potential advantage for the ECB over the Fed. Monetary tightening tends to be a blunt instrument – hitting everything at once but damaging some parts more than others. But the ECB's new Transmission Protection Instrument will allow it to buy the bonds of weaker Euro nations, so that they maintain funding through this difficult period. This allows the Central Bank to raise rates more aggressively, while offsetting the impact for the worst off. There is even some suggestion that the Bank might buy corporate credit for the same reason – though the details are not known.

This has made it a good week for risk markets. With central bank help (particularly from the ECB), credit spreads – the difference between government and corporate bond yields – have fallen back sharply. This is despite weaker than expected economic data and aggressive monetary tightening. In our model for valuing risk assets, credit spreads are just as important as bond yields themselves. As such, falling credit spreads have helped prop up valuations, even though other factors (like earnings) have deteriorated.

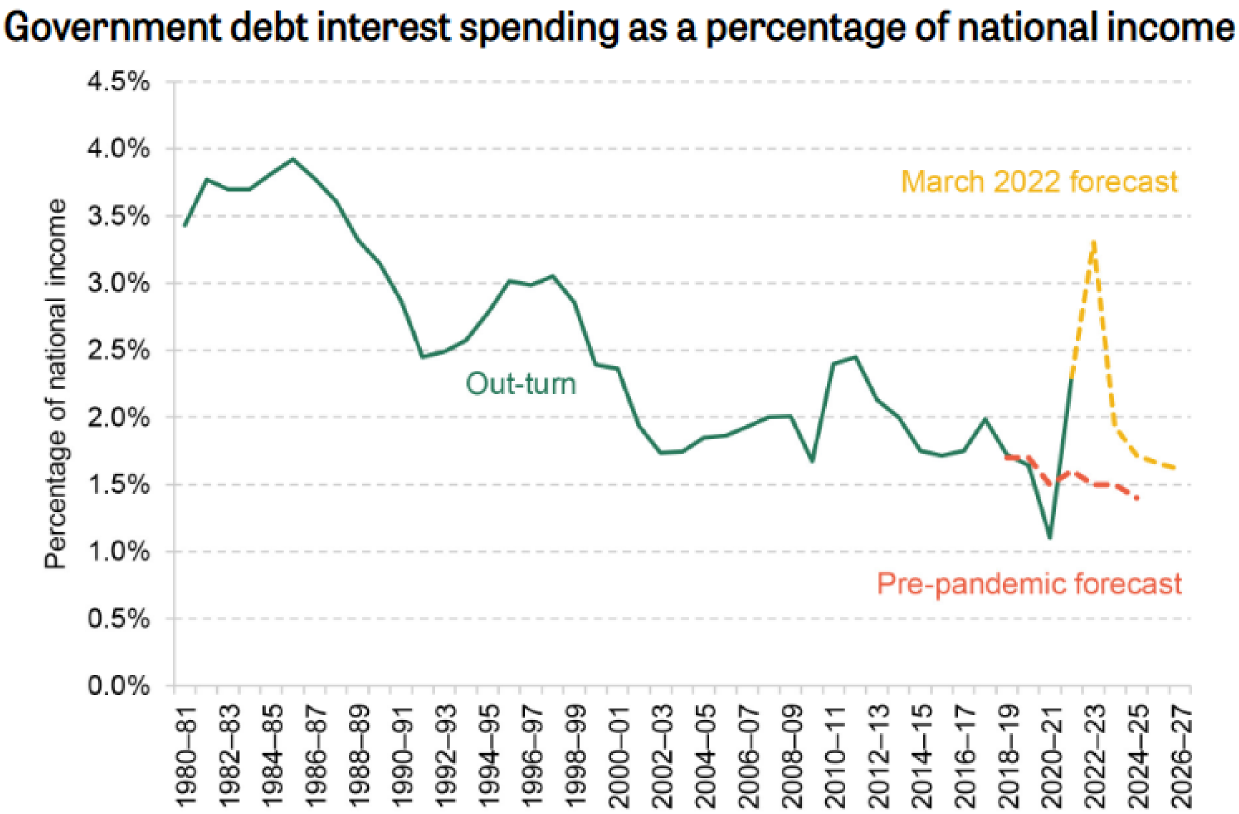
Of course, investors do not make all their decisions via complex valuation models. A more psychological or narrative-based explanation for why equity markets have improved, is that investors feel they are being given permission to do so. Earlier this year, it looked increasingly like the Fed would have to engineer stock market weakness in order to prevent the economy from overheating. That is, there was a sense that policymakers needed to depress asset prices to tame inflation. That narrative has now changed.

Sub-par growth in the economy has now taken a firm hold, it seems, partly through monetary tightening and partly through a global cost-of-living crisis, which is destroying demand. Investors suspect that central bankers can see the point being reached at which they no longer feel they have to suppress markets. They may be worried about the effects on companies (as we can see through their attempts to shore up credit spreads). Essentially, investors feel they no longer are the only ones to pay the price of slowing the economy.

This is a boost for markets. Central banks have instilled confidence over financial stability. In spite of the current inflation crisis, fears of widespread defaults have receded, and there is a sense that the fallout in capital markets will be limited. Talk of 'peak' rates and what will happen after them adds to this: things may be difficult now, but it may well soon be over, and investors stand to gain when it is.

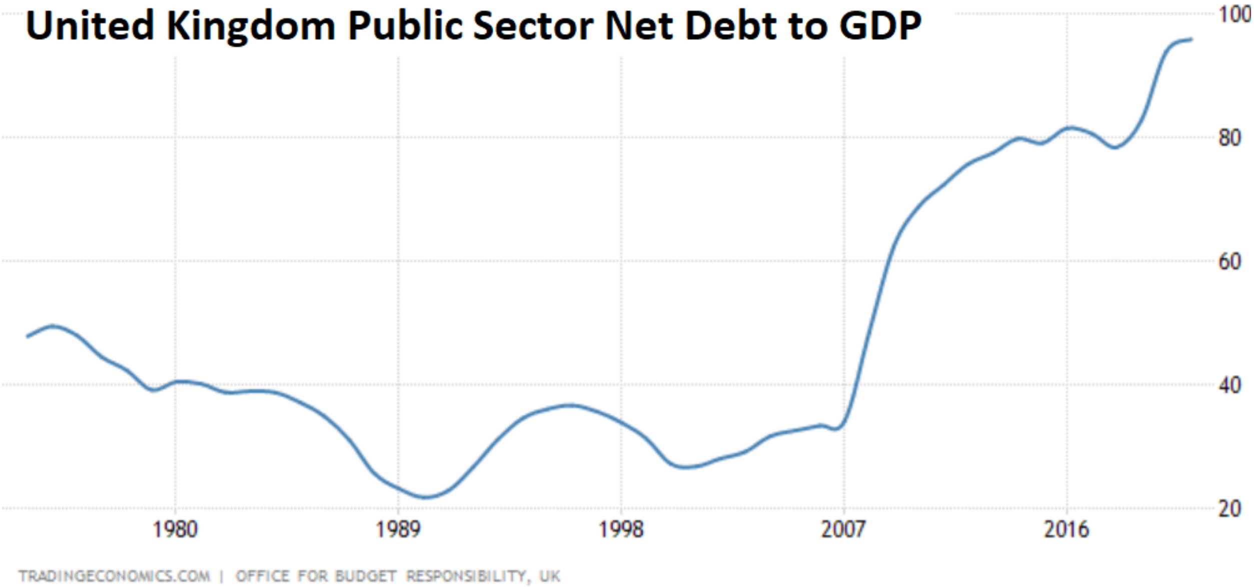
There's a lot of debate about UK tax policy at the moment. We certainly have no intention to take sides on political matters. It is interesting to see the final Conservative Party candidates, vying for the position of Prime Minister, seeking to take such polarised positions in such a debate. Of course, in a two-party system, the main parties are always coalitions of factions, but one wonders where this open disagreement will leave the present Government, following this fractious and protracted public confrontation.

In recent months, UK government finances have been doing better than the Office for Budget Responsibility had expected. However, what inflation gives (in terms of rising taxable bases such as VAT and rising earnings), it takes away with the other. Interest rates are going up and, unless inflation is brought under control, it could overwhelm the public finances. The data released on the 18th July, showed how interest costs have risen sharply, as part of our debt is funded through inflation-linked bonds. Of course, we also have to refinance maturing fixed debt. This data from the Institute for Fiscal Studies gives cause for concern.



Source: Office for Budget Responsibility, Public Finances Databank, https://obr.uk/data. Institute of Fiscal Studies

Debt expanded hugely during the pandemic period as the chart below shows (which excludes the debt issued to pay for the banks bought in the financial crisis):



So, now a smallish rise in interest costs has an outsize impact upon government finances, one can see why Rishi Sunak wants to argue for the public finances to be stabilised, before committing to reducing the overall tax burden. It is also not surprising that it will be difficult to pay down some of the debt without having higher taxes. A near-term tax giveaway would have to be followed by a return to higher taxes or a substantial reduction in public spending, including a reduction in public investment. In such circumstances, it would seem the levelling up agenda could well be in peril.

Economists, such as Dr Gerard Lyons, make the good point that setting the country on the path to sustained growth is the way to pay down debt. However, it is not clear that the private sector has the capacity to provide the investment engine needed (monetarism has been closely associated with hard-line distrust of public spending). Meanwhile, Liz Truss's supporters argue that we find ourselves currently in a war-like situation, which justifies higher public debt levels. Of course, a good proportion of the growth in the 1950s and 1960s came from government investment, and that is very precisely not what is being proposed now.

While equities may perform neutrally or even better, if Liz Truss were to win the race to be UK Prime Minister, sterling and bonds would probably struggle initially.

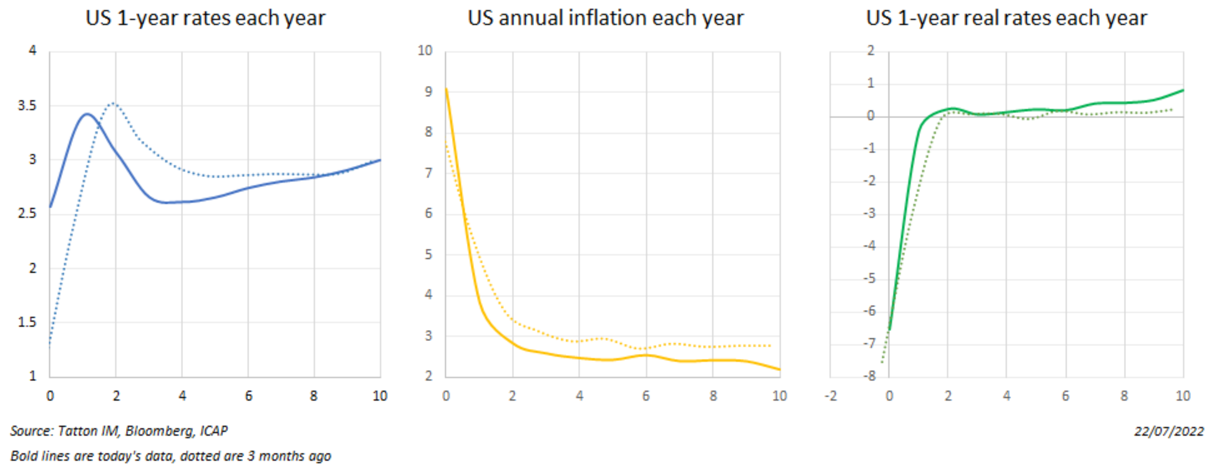
What do the bond markets tell us?

The impact of rising inflation has become a self-evident fact of life in 2022. An unexpected series of global cost shocks, coupled with tight labour markets across most of the developed world, has led to the kind of steep price rises not seen in a generation.

For most, there is, unfortunately, more bad news to come. Faced by faster than expected price hikes and aggressive countermeasures taken by central banks, capital markets have adjusted their expectations for inflation and interest rates. This is particularly noticeable, for instance, in the US dollar swaps market, where (nearly) risk free interest rates can be traded, and investors are able to hedge against future inflation expectations. Three months ago, the projected swap rate implied that the Federal Reserve (the US central bank) could hike interest rates to reach a peak of 3.5% next year. Now, that peak is forecast to be reached at the start of 2023, when rates could reach nearly 4%.

Interestingly, that shift in short to medium-term expectations, has not made a big difference to the long-term outlook. US interest rates are expected to rise quickly to reach a level above 3.75%, but then subside through next year and beyond, to fall below 3% in 2024 and then stay lower for years to come. Expected rates forecast for 2025 are actually lower now than they were three months ago. This suggests we face inflation spiking in the very near-term, followed by a weakening of the longer-term growth outlook. Crucially though, it also suggests market confidence in the Fed's abilities. The central bank is expected to squash inflation expectations faster and harder than had previously been anticipated, after which rates will be allowed to moderate.

Using this same swaps market data, we can also take an in-depth look at what this means for a range of major economies. The chart below shows the expected path of interest rates and inflation over the next decade (that is, where one-year rates are expected to be at each point in the next decade). They indicate the projected outlook for nominal interest rates, inflation and real (inflation-adjusted) rates. Bold lines indicate the current market expectations, and dotted lines the expectations from three months ago.

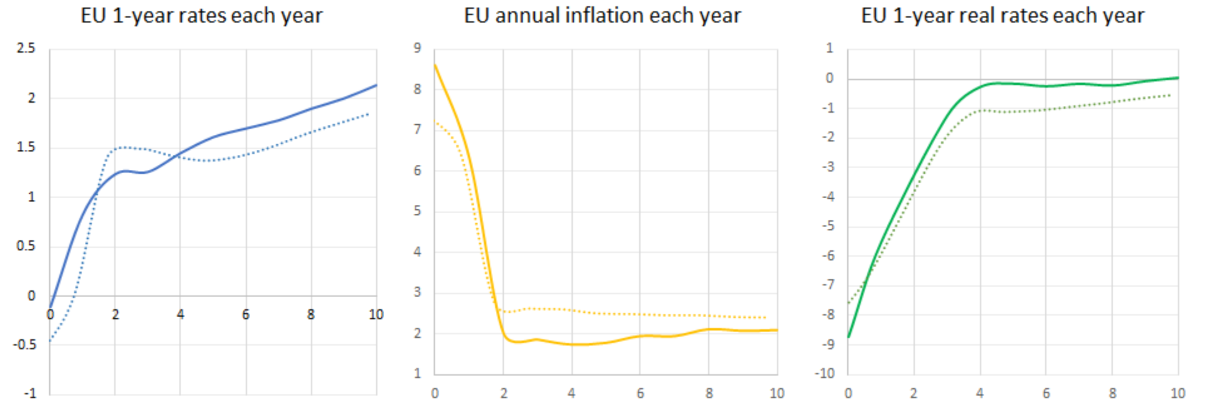


As the charts indicate, rate expectations have increased significantly for the next few months. This reflects the way in which the Fed has taken a more aggressive stance in its efforts to control prices. The bank has already hiked its funds rate by 0.75% and is expected to do so again this week. But this has also resulted in a sharp decrease in longer-term inflation expectations, which should allow the Fed to cut rates sooner to support growth.

For investors, the interesting part is what this does to the right-hand chart. While markets are pricing sharper rate cuts over the course of the next four years, benchmark rates are expected to stay comfortably above longer-term inflation. That means US real rates will be positive over the long-term. By historical standards, this is normal, but it is not something we have seen consistently throughout the present era of low rates and cheap money – which now stretches back for over a decade and more.

Since asset values, like stock and corporate bonds, are set with reference to the 'risk free' rate of return, this could have a big impact on investment returns over the next 10 years. That is not to say that equity returns in the USA are certain to struggle, but just that they would need to be driven by underlying business factors, and not just by easy access to (cheap) capital.

We believe a similar scenario can be found in other major markets apart from the USA, but with some important differences. The chart below shows the same indicators for rates and inflation in Europe.



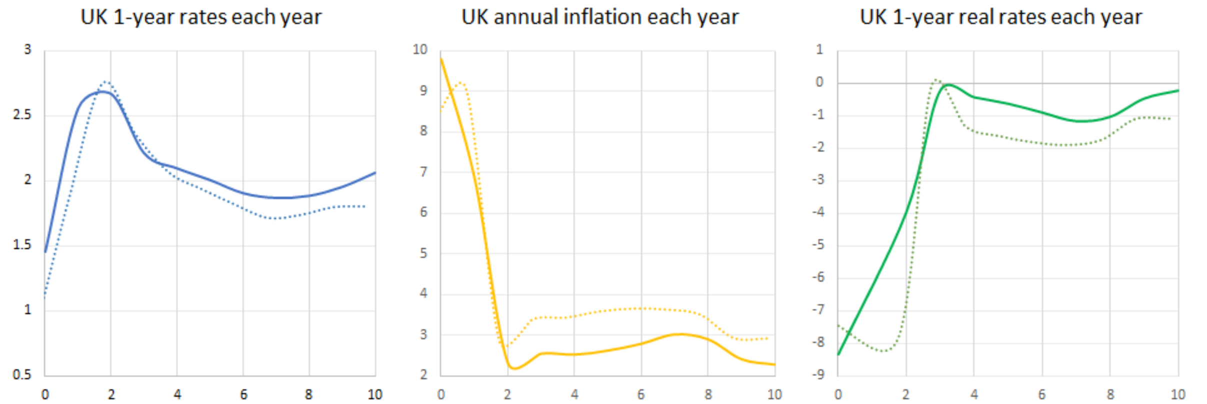
Source: Tatton IM, Bloomberg, ICAP *22/07/22*

Bold lines are today's data, dotted are 3 months ago

The ECB's rate-hiking path is substantially slower than that observed in the US, and markets currently see no peak in rates being reached over this entire period. Despite the continent's severe problems with external inflation driving cost pressures – owing to its reliance on Russian energy – markets once again predict a rapid decline in inflation pressures over the course of the next couple of years. Traders do not expect the ECB to keep real rates positive over the long-term, but rather hover at around 0%. This makes the market outlook still substantially more hawkish (preferring higher rates), than we have come to expect from the ECB.

Lower real rates in Europe are most likely a reflection of weaker growth prospects. It's striking that all the charts featured above show no obvious sign of recession; in a downturn, one might expect to see falling interest rates or negative real rates. But on other measures, the outlook is rather grim for the continent. We wrote recently that European credit markets are displaying sure signs of stress, with short-term corporate debt spiking above longer-term debt. This is usually an indication that widespread defaults are expected, which invariably leads to recession.

The UK outlook is similarly cloudy and uncertain. Much like the Fed, the Bank of England is now expected to reach peak interest rates at some point during next year, after which, investors believe, the BoE will need to cut rates fast and hard to get growth going again. It demonstrates the harsh inflationary pressures we face in the UK over the next few years, and the consequences for economic growth prospects. Inflation



Source: Tatton IM, Bloomberg, ICAP *22/07/2022*

Bold lines are today's data, dotted are 3 months ago, CPI estimated as RPI-0.8%

is forecast to have settled down by 2024, but, from then on, real rates are expected to stay negative. This is a sign that markets think Britain will need monetary support over the medium-term. It means the BoE, which is currently trying to crush inflation, will likely need to switch to growth support mode over the years to come.

The stability of rate expectations, after a year in each market, says one of two things. Either investors are confident in the central bank's ability to fight inflation – as in the US – or that the short-term rate outlook is highly volatile, and the central bank will need to react quickly. In the latter case, markets struggle to make judgements which extend much beyond a year. This is, arguably, the situation for Europe's prospects, backed up by its weak credit data.

The saving grace here, perhaps, is the strength seen in the prices for risk assets over last week. This has coincided with a fall back in credit spreads (the risk premium between corporate and government bond yields), which has relieved some of the financial pressure being felt by corporates. While it is too early to call this definitively as an endgame for Europe's troubles, recession indicators are no longer flashing quite as clearly. We will know more when we get further information on the extent of Europe's energy supplies – which should come this week. After that, markets should have a better idea on Europe's economic prospects.

The ECB carrot is back

The European Central Bank (ECB) raised interest rates by 0.5% points last Thursday, defying market expectations for a 0.25%-point increase. The deposit rate is now at 0%. To put this into an historical context, for the first time in eight years, banks will not be penalised with negative rates for parking money with the ECB.

Yet, it is important to remember, as we described in the previous article, investors are predominantly interested in what the 'peak' interest rate will be, once the tightening cycle is completed.

Indeed, ECB President Christine Lagarde used a similar argument to deflect criticism that the Central Bank had erred by signalling a hike of no more than 0.25%, by saying it was the peak that was all that mattered. Ms Lagarde implied, sharper rises now will allow for a lower peak further down the line. And importantly, simultaneously she put forward a new monetary tool designed to contain sovereign bond spreads (yield differences between different countries) in the eurozone – the Transmission Protection Instrument (TPI).

Country spreads have many of the characteristics of traditional corporate credit spreads. Credit spreads – the difference and risk premium between corporate and government bond yields – measure the difference in default probabilities. One important driver is always the level of rates. If the perception is that rapid action (on inflation now) can help dampen the peak in rates.

A similar rationale applies to the debt of peripheral eurozone nations, some of which are facing substantially higher yields. The ECB has been aware of this for some time and is worried that rate rises could have a magnified effect on the economies of these nations. It's that anxiety that has led to the announcement of its "anti-frag" tool.

Anti-fragmentation sounds scary, but this is technical jargon, which is not obviously a description of what it actually does. The Transmission Protection Instrument (TPI) sounds more like a car insurance policy than a tenet of monetary policy.

Despite the ECB having taken some time to define its operational scope, it was a disappointment to be given no operational details. We have been provided with broad structural guidelines, but no legal limitation on whose debt could be bought, nor details or levels on the amounts of those purchases.

Yet, there was some indication of the constraints being applied to the TPI, which, in spirit, are similar to previous eurozone macro programmes and serve to underline the conditionality of the support to be provided. The underlying motivation for the application of carrot and stick in the scheme is to encourage economic change in the countries being targeted. It's fair to say that the success so far seen in taking this approach, has been mixed at best.

In order to benefit from the TPI, a nation must not be subject to the EU's Excessive Deficit Procedure (EDP) or the EU's Excessive Imbalance Procedure, which the Commission uses to maintain the eurozone's fiscal rules. Public debt policy must be "sustainable" and "sound". In making these judgments, the ECB has said it will also take into account the views of other organisations, including the IMF.

The Economist weekly is taking a positive view of the advent of the TPI. It sees the ECB's unlimited latitude as helping to alleviate worries about levels of debt, particularly given that the ECB was clear it could buy private sector assets. The ECB "has claimed unlimited discretion to define these terms for itself. Ms Lagarde says the ECB as an institution has *sovereignty* to determine the eligibility criteria itself, a word not often heard from the mouths of central bankers".

In addition, "the ECB has therefore given itself the maximum room for manoeuvre in forestalling any repeat of the eurozone crisis, while handing to others the politically delicate task of deciding whether governments' fiscal policies are appropriate and their debt sustainable".

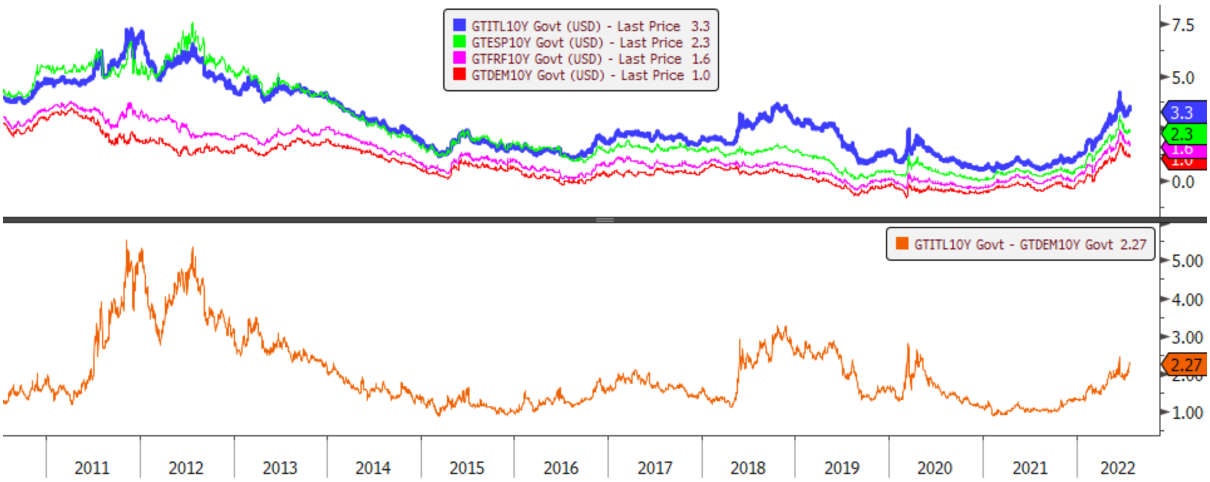
The Economist sees that, in a crisis, the ECB will hand over to the European Commission the difficult political decision whether to place a country into the EDP. The Commission will be unlikely to want to inflame a politically and economically volatile situation. So, yes, there may be a barrier for the Commission to commit a member state to an EDP procedure, but, equally, it seems, the TIP is meant to be a carrot for countries to keep running sound policies.

Within the corridors of the ECB in Frankfurt, there are few signs of a return to the bad old days of the eurozone debt crisis of a decade ago. That period did the eurozone absolutely no favours. Or, to put it another way, the current situation helps to demonstrate that the eurozone only works if all play roughly, but by the rules, as there is no prospect of automatic large scale fiscal transfers between countries. The ECB is the victim of insufficient care and consideration being given to the initial creation of Europe's monetary union, which means that the eurozone inevitably falls back in into the lap of the ECB when crisis strikes.

To ensure there is wiggle room in the implementation of the TPI, the terms and conditions of the new scheme are intentionally the subject of interpretation. Some might call it "constructive ambiguity." It means the policy will probably not be implemented to head off a crisis, but only to act after the fact. As Bank of France Governor Villeroy said last week, "We've clearly defined criteria and indicators that make it possible to be objective about a situation. But there's no automatic and mechanical threshold for activation or exclusion - nothing will replace the judgment of the Governing Council".

Following the announcement, the ECB stated that the current situation developing in Italy did not warrant any TPI action. The widening of Italy's credit spreads recently has been worrying but not catastrophic.

Eurozone nation 10-year yields
lower chart: spreads to Germany



Source: Tatton IM, Bloomberg, : G963
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Still, the fact that spreads widened on the announcement, probably indicates that the ECB needs to provide further clarity before another crisis strikes yet again. The traditional trajectory of modern Italian politics suggests a test will come soon, as any future government in Rome will have to pledge additional fiscal support for businesses and households, if energy prices remain at current levels.

Meanwhile, the Euro rallied last week. Immediately following the 0.5% rate rise announcement, it gained 0.5% only to slip back as markets indicated a slight sense of disappointment in the TPI. The single currency is likely to continue to be subjected to similar pressures while President Putin has the whip hand over Europe's energy supplies.

25th July 2022

Global Equity Markets

Market	Fri 16:15	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7292	+1.9	+133	↘	→
FTSE 250	19864	+5.5	+1030	↘	➘
FTSE AS	4037	+2.4	+96	↘	→
FTSE Small	6418	+3.4	+211	➘	➘
CAC	6226	+3.2	+190	↘	↘
DAX	13291	+3.3	+426	➘	➘
Dow	32079	+2.5	+790	↘	↘
S&P 500	3996	+3.4	+133	↘	➘
Nasdaq	11962	+4.5	+510	→	➘
Nikkei	27915	+4.8	+1271	→	→
MSCI World	2664	+3.7	+95	➘	➘
CSI 300	4238	-0.2	-10	➘	➘
MSCI EM	991	+3.0	+29	➘	➘

Top 5 Gainers

Company	%
JD Sports Fashion	+10.7
M&G	+10.0
Informa	+9.9
WPP	+9.6
Ashtead	+9.5

Top 5 Decliners

Company	%
Admiral	-7.9
Avast	-5.5
AstraZeneca	-3.2
DS Smith	-3.2
Reckitt Benckiser	-2.1

Currencies

Pair	last	%1W
USD/GBP	1.203	+1.5
GBP/EUR	0.850	+0.0
USD/EUR	1.02	+1.4
JPY/USD	136.22	+1.7
CNY/USD	6.75	+0.1
Bitcoin/$	23,481	+11.1

Commodities

Cmdty	last	%1W
Oil	104.57	+3.4
Gold	1731.5	+1.4
Silver	18.87	+0.8
Copper	337.0	+4.2
Aluminium	2420.5	+3.6
Soft Cmdties	222.4	-1.3

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	11.8	9.8	14.3
FTSE 250	3.1	10.8	14.0	16.3
FTSE AS	3.9	11.6	10.2	14.5
FTSE Small x Inv_Tsts	3.3	7.5	11.2	15.3
CAC	3.1	13.6	10.6	15.2
DAX	3.5	12.0	11.0	13.7
Dow	2.1	17.0	17.0	16.9
S&P 500	1.6	19.5	17.5	18.2
Nasdaq	0.8	22.2	25.2	24.2
Nikkei	2.0	15.9	15.6	17.8
MSCI World	2.1	16.0	15.7	17.1
CSI 300	2.0	14.8	13.6	12.8
MSCI EM	3.0	9.8	11.4	12.7

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.94	-0.15
UK 15-Yr	2.43	-0.14
US 10-Yr	2.79	-0.12
French 10-Yr	1.62	-0.13
German 10-Yr	1.03	-0.10
Japanese 10-Yr	0.22	-0.02

UK Mortgage Rates

Mortgage Rates	Jul	May
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.88	2.78
3-yr Fixed Rate	2.97	2.81
5-yr Fixed Rate	2.90	2.80
10-yr Fixed Rate	3.28	3.13
Standard Variable	4.38	4.35

* 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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25th July 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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