CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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Delicate equilibrium

All eyes were on the world's central bankers last week, who were guests of the US Federal Reserve (Fed) at its annual conference in Jackson Hole, Wyoming. Markets were particularly eager to hear what Fed chair Jay Powell had to say – hoping that his speech would give hints on the direction of US and global monetary policy. Market expectations of a mildly hawkish tone, with a repeated focus on controlling inflation and cooling wage demands ultimately proved not too far from the mark.

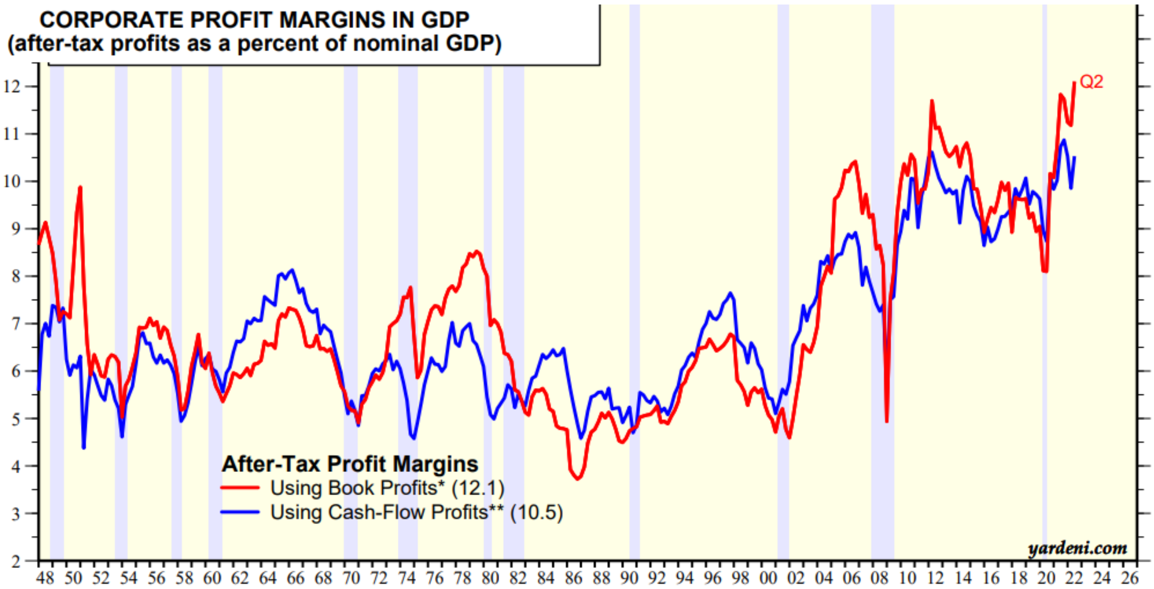
This is a scenario that investors were eager to avoid. Equities rallied last month on the back of improved valuation metrics, which were themselves propelled by falling bond yields, making stocks more attractive by comparison. But bond market positivity was in large part down to shifting expectations of central banks towards a less hawkish stance. A weakening global economy and cooling prices, the thought goes, will necessitate a softer approach from the Fed. Unfortunately, Jay Powell's speech confirmed that the Fed is not ready to take its foot off the brake pedal just yet.

Jangling nerves meant a pullback in markets last week. This was widely anticipated, and perhaps the fall was shallower than one might have expected, given the weakening global economic outlook. Growth expectations have declined significantly due to the energy price shock (Europe/UK) and the increased cost of finance from higher interest rates (US). This is now reflected in business sentiment, as well as very clearly in consumer confidence levels.

The UK has been particularly hard hit by the latest news of a near doubling of Ofgem's energy price cap for the winter months. The arrival of a new prime minister must surely bring more government support for households. The difficulty – as trailing leadership candidate Rishi Sunak points out – is in giving aid to the worst-off without boosting overall demand too much. The latter would worsen the supply side problems and keep inflation soaring. This is likely in France, with its blanket household subsidy, and it could well be the same in the UK if the new government opted for a fixed energy price cap instead of direct support payments ('handouts').

Even with government help, households will inevitably struggle. In this situation, the key policy objective is to ensure people are not hit with the double whammy of job insecurity on top of the energy price shock. That is a significant threat, given the current difficulties facing businesses. There is no price cap for businesses, meaning energy costs have increased several times over. Providing support for those businesses – particularly small and medium sized enterprises – is imperative in the months ahead. This is akin to the situation at the start of the pandemic: without help, small businesses will have to shed staff or face total collapse.

In the US, cost pressures are less intense, as the energy market is less dependent on Russia, and therefore less sensitive to Putin's war on Ukraine. Even so, US consumer and now also business confidence has taken a downturn, signalling a slowdown in growth. But despite the gloom, profit margins have held up nicely across the Atlantic. In fact, recent data shows US corporate profit margins expanding to their best ever 'book profit' level in the second quarter of 2022. Cash flow is still remarkably strong, giving companies a big buffer for the difficult times ahead.



* Tax-accounting basis as reported to IRS.
** Book profits including Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj), which restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Bureau of Economic Analysis.

Yardeni Research, Inc.

However, the strength of corporate America will undoubtedly be politically unpopular, particularly if, after inflation, household incomes continue to suffer as a result of central bank action. Powell and his team will be well aware of this and might, therefore, think corporate profits can take a harder hit from tightening monetary policy. While this is unlikely to make credit spreads (the difference between government and corporate bond yields) too wide, it would make things more difficult for US businesses, and reverse the goodwill we have seen in markets.

So, are investors sleepwalking into a downturn? Some certainly are taking that view – backed up by those considerable headwinds for the global economy and an apparent underappreciation of risks. We see things slightly differently. We suspect that this year's downward stock market volatility has led to a fragile equilibrium between the negative impact on earnings and the positive reaction that could come from central banks. Should the Fed prove successful in engineering an inflation busting slowdown in the labour market without an economic crash landing, there will be less upward pressure on bonds.

'Delicate' is the key word here. The fine balance of risks and rewards does not mean we expect markets to trade sideways. Rather, we expect a continuation of the volatility we have seen this year. Particularly interesting is what this means for different investment styles. So called 'growth' stocks, like big tech companies, are usually heavily dependent on bond yields, as they are long-duration assets and therefore sensitive to assessments of long-term risk premia. But bond yields are clearly no longer the only driving factor behind these stocks.

The biggest growth companies – Amazon, Netflix, Microsoft and Apple, to name a few – have unquestionably come of age and are now by far the biggest players in their respective sectors. This means that their growth is not so much at the expense of old businesses, but rather a reflection of the market as a whole. These days, they are much more exposed to the ups and downs of the economic cycle. This creates new dynamics and new avenues for growth and investment returns. For the discerning investor, this delicate equilibrium could be full of opportunities.

Strategies to mitigate Europe's energy crisis

Europe is in trouble. Recent data points to a contraction of the continent's economy, and businesses expect dire times ahead. The root cause is plain to see: a critical lack of energy supplies. Russia's invasion of Ukraine and the subsequent western sanctions regime have had a huge impact on global energy markets, but nowhere has this been as pronounced as in Europe. Natural gas, which provided a quarter of the energy used by the European Union (EU) in 2020, is around eight times more expensive in Europe than in the US.

European reliance on (cheap) Russian energy imports is one of the biggest problems policymakers have grappled with this year. Earlier this month, Germany's top network regulator warned it needed to cut its gas use by a fifth to avoid a crippling winter shortage . That is despite major efforts to increase supply from non-Russian sources, including liquified natural gas (LNG) imports from the US. Gazprom's recent decision to halt its European exports has put even more pressure on politicians to source their energy from elsewhere.

Policymakers are also grappling with the flipside of this problem: how can the EU reduce its reliance on Russia without damaging its climate transition goals? Europe is still committed to its "fit for 55" target, which prescribes a 55% reduction in emissions (against 1990 levels) by the end of this decade. But the current supply is increasingly pushing nations toward alternative fossil fuels, not alternatives *to* fossil fuels. Last week, Germany's Uniper announced it would restart its coal-fired plant to make up for a shortfall in Russian gas.

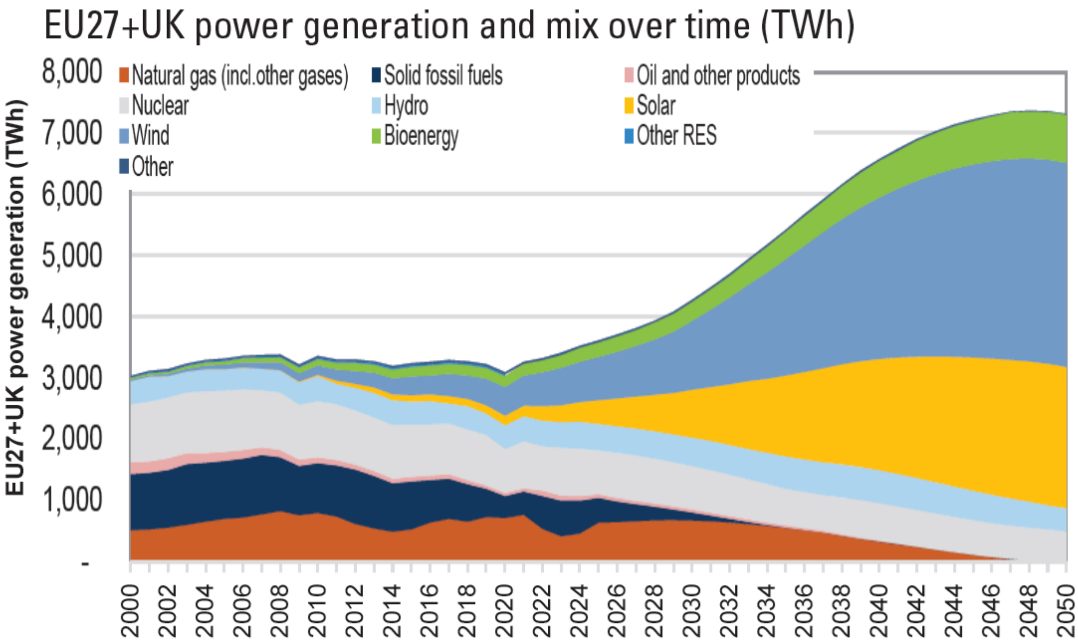
According to analysis from Goldman Sachs, European demand for fossil fuels will fall dramatically over the next decade and become a negligible fraction by 2050 if it sticks to its net-zero goals.

Oil consumption is expected to drop off quickly, and substitutes for Russian oil are readily available over the medium term. Gas is more difficult, particularly considering targets to reduce Russian imports by two-thirds in the short term and completely by 2030. Even with a sizeable fall in demand, Europe faces a significant gas shortfall, which will need to be filled with imports from elsewhere.

Goldmans thinks the EU will have to sign significantly more LNG contracts, covering 10-15-year periods. Reluctance to do so over the past 15 years – as these contracts are more costly – has left the region reliant on pipeline gas, solidifying its dependence on Russia. Over the longer term, LNG will be supplemented by a much bigger role for renewable energy and green hydrogen (Germany recently signed a deal to import wind-produced hydrogen from Canada). But that requires €10 trillion of infrastructure investments before 2050. Moreover, while Goldmans expects this figure to be recouped through the rapid reduction of net import payments to the energy exporting nations, the short-term push toward alternative fossil fuel sources could derail such investment.

Generally, you would expect sky-high commodity prices to incentivise investment in production, leading to supply increases further down the line. But this conflicts with the stated CO_2 emission reduction aims of virtually all major economies.

The result is producers not wanting to drill more, despite the fact they could make a lot of short-term money by doing so. We see this ahead of the OPEC+ meeting on 5 September, with Saudi Arabia and other members talking about cutting supplies further to protect prices, even though oil is still trading at around $100 per barrel. Of course, this is further complicated by reinvigorated attempts by the US to make Iran's oil available by reinstating the nuclear energy pact, a situation which is deeply disliked by the Sunni majority states such as Saudi Arabia.



Source: Eurostat (historical), Goldman Sachs Global Investment Research

Heading into the winter, the energy outlook is harsh for Europe. Policymakers have discussed rationing and power outages at length, but there are no coordinated plans from the EU yet. That has resulted in the eye-watering energy prices we are currently seeing, which could well go higher if countries cannot agree to formally suppress demand.

In lieu of central edicts, the market is left to do its own energy rationing – as firms or consumers get priced out. Politicians have been quick to signal their support for households in all of this, but help for businesses has been less forthcoming. In the UK, supermarket chain Iceland is finding access to funding difficult, judging by the performance of its bonds and the cuts to its credit rating. Iceland has explicitly blamed unbearable commercial energy prices for its predicament. In Germany, the economics ministry is working on a support scheme for companies suffering from high gas import prices, but this currently seems to apply predominantly to gas supply chains, and less to the wider economic corporate infrastructure.

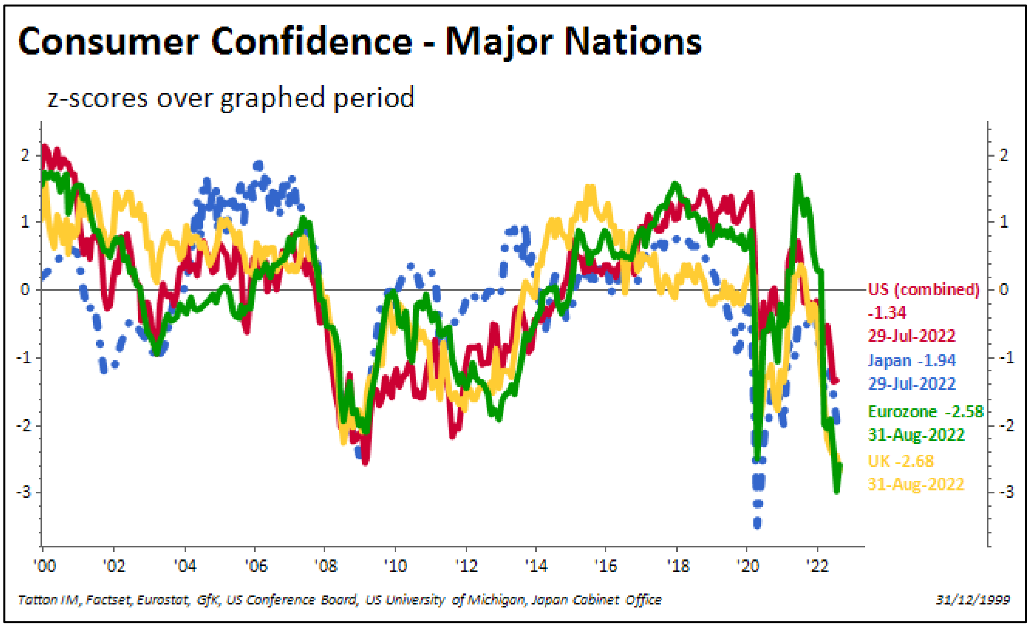
All across Europe, businesses face worsening conditions. Sales have already slowed somewhat, and inventories of goods have risen. Europe may already be in a recession, and business sentiment surveys now firmly point toward contraction in the second half of 2022, while corporate debt is showing severe signs of stress.

If politicians want to avoid a harsh economic winter, they have only limited options. EU leaders have already given way on near-term green targets. They could bow to Russian pressure and ultimately give up some of its support for Ukraine. Aside from being politically unpopular, that would greatly upset relations with the US, and plunge the region into deeper uncertainty. As such, we think this is unlikely.

The much likelier outcome is centralised rationing policies, designed to support production as well as households. These have already been touted, and increasingly look inevitable as we head into the winter. Anything can happen of course, as physically, gas is available. For now, it looks likely that Putin would keep using gas supply as a weapon in his hybrid warfare. This will have to mean a coordinated response among EU member states, and the details could be hard to pin down. But this is ultimately what businesses – particularly smaller ones – need to survive. Until that comes, we expect European nations will have a very difficult autumn and winter. European stock markets have already anticipated a distinct deterioration of the economic environment with their falls since the invasion of Ukraine. However, they have not priced in unmitigated economic disaster.

Business sentiment has taken a hit

Sentiment surveys of consumers and businesses have a good track record of predicting the economic outlook. This is true on both a regional and global basis, so investors pay close attention to the latest data. August's data paints a not-so-pretty picture for the world economy. Consumers everywhere are not confident, and have not been so for some months. This is particularly true for Europe, where confidence measures continue to languish near or at record lows. At least the European Commission consumer confidence survey didn't fall further, remaining around the lowest level ever. However, for the UK, the GfK consumer confidence survey for August recorded a new record low of -44. This translates as 2.68 standard deviations below the average for this century, and is shown on the chart below:



Interestingly, perceptions of personal financial situations were weak but perceptions of the adequacy of savings bounced back quite sharply and remain in positive territory. Apparently, individuals with savings feel reasonably protected against the forthcoming energy price rises.

Business confidence surveys, in the form of the Purchasing Managers' Indices (PMIs), are even more timely than the consumer confidence data, with a dual release of data each month. The initial 'flash' estimate is released near the end of every month, after about 70% of the survey data is collected. Last week's flash data for August across developed markets showed the 'all-industry' or composite PMI fall to 47.3 (aggregated by JP Morgan in the table below):

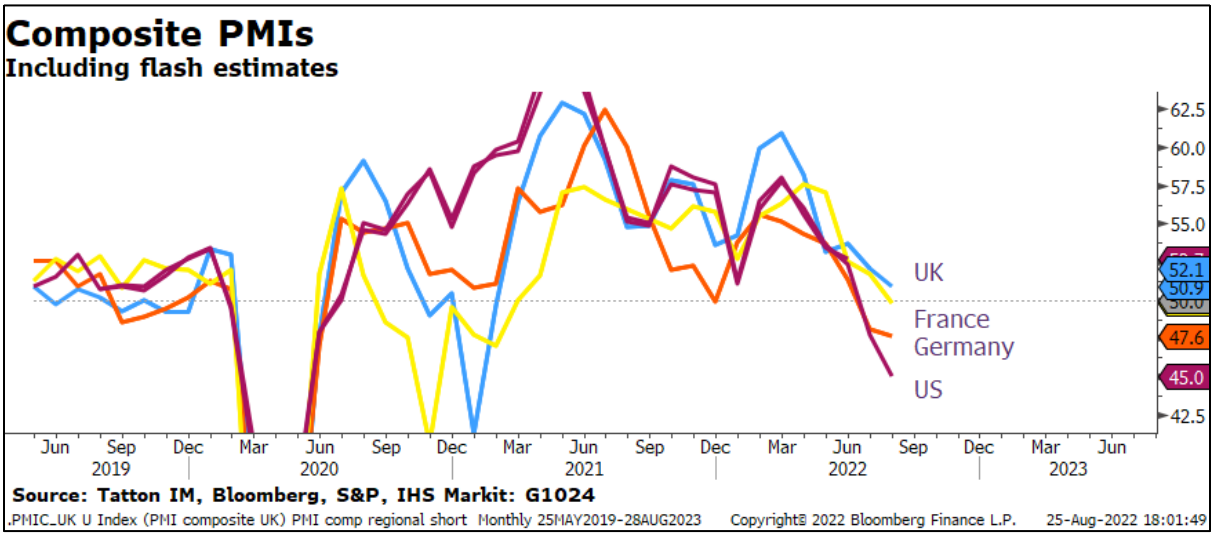
J.P. Morgan PMI, Developed Markets

DI, sa; August preliminary based on flash reports

		Apr	May	Jun	Jul	Aug
Output	Total	55.5	53.7	52.5	49.0	47.3
	Manufacturing	54.1	53.1	50.0	48.6	47.9
	Services	55.8	53.9	53.1	49.1	47.1
New orders	Total	55.3	54.1	50.2	50.1	49.0
	Manufacturing	54.8	52.4	48.0	46.9	46.7
	Services	55.4	54.6	50.6	50.8	49.5
Employment	Total	55.2	55.5	54.7	53.5	52.0
	Manufacturing	53.3	54.0	53.2	52.4	51.0
	Services	55.7	55.9	55.1	53.8	52.3
Future output	Total	65.4	66.6	61.1	59.4	61.5
	Manufacturing	64.5	63.1	59.2	58.6	60.7
	Services	65.6	67.5	61.6	59.6	61.6
Output prices	Total	69.5	66.2	63.6	61.4	60.1
	Manufacturing	74.0	72.3	69.4	66.3	63.5
	Services	68.4	64.7	62.2	60.2	59.3

Source: J.P. Morgan, S&P Global

The regional breakdown was even more surprising. Europe, despite its recent economic malaise, generally fared better than the US, as the chart below also indicates:



Relative to manufacturing, service industry confidence had been holding up relatively well in the first half of 2022, but the August service PMI data was notably weaker than expected. Perhaps this outcome brings the service PMIs more into line with the declining consumer confidence.

On the other hand, through the past month, data sourced from actual activity (known as 'hard' data) has actually kept relatively robust. In its Wednesday Economic Briefing last week, JP Morgan noted that, except for the UK, country measures of economic activity are running stronger than previous expectations.

This is true even for Europe, which may seem odd. It appears that, despite large energy price rises for consumers and businesses, most have been able to cope so far. Perhaps businesses are more aware of the sharp rises due in the months ahead. German's IFO Business Climate Index data showed a significant worsening of expectations, while the current business indicator remained stable. For consumers, their spending is holding up despite the constant depressing news flow. Perhaps they are confident European governments will continue to take steps to alleviate consumer bills. Importantly, jobs are still secure. Firms seldom make significant staff changes in the summer months, partly because doing so takes a lot of management effort.

In the US, where the labour market is less regulated, there has been talk of layoffs among tech companies. Generally, the largest of these are talking about slowing hiring rather than cuts, but some well-known names have been cutting back in non-tech areas such as marketing. Amazon laid off warehouse employees, and Microsoft cut its LinkedIn events team. Another point of evidence for this turn in fortunes is that in tech-heavy California, July tax revenue was 12% below expectations (mostly sales and income tax, which admittedly can be quite variable).

Nevertheless, across developed markets, companies are not yet giving indications that they want to reduce their workforce. The employment components remain above the 50 neutral level (see previous table by JPM).

Last week's PMI data did not include China, as its data collectors do not publish flash estimates. Instead, they wait for the full release which will arrive in the first days of September. Last month, China's service PMI data improved sharply and, given the flash PMI weakness of so many other areas, it will be hoped this resilience can be maintained.

The PMIs have been a good leading indicator for activity, and have been signalling a deteriorating environment for the past three months. That has worsened with this month's output and new orders PMI data. As we emerge from a long hot summer, we are hoping employment remains resilient, but not as overly tight as it has been. This will hopefully mean that the future output data signals a stabilisation of confidence for both consumers and businesses. This, coincidently, is also what the relative stability in capital markets is indicating as a consensus expectation.

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30th August 2022

Global Equity Markets

Market	Fri 15:05	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	7474	-1.0	-77	↗	→
FTSE 250	19320	-2.9	-568	↘	↘
FTSE AS	4103	-1.3	-55	↘	→
FTSE Small	6419	-2.5	-165	↘	↘
CAC	6345	-2.3	-151	↘	↘
DAX	13197	-2.6	-347	↘	↘
Dow	33325	-1.1	-382	↘	↘
S&P 500	4196	-0.8	-33	↘	↘
Nasdaq	12644	-0.5	-61	↘	↘
Nikkei	28641	-1.0	-289	↘	↘
MSCI World	2768	-0.7	-19	↘	↘
CSI 300	4108	-1.0	-44	↘	↘
MSCI EM	1003	+0.2	+2	↘	↘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Harbour Energy	+24.3	Ocado	-14.3
AVEVA	+22.5	JD Sports Fashion	-9.4
Antofagasta	+5.6	Hargreaves Lansdown	-9.3
Anglo American	+5.0	Persimmon	-9.3
Glencore	+4.0	B&M European Value Re	-8.8

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.189	+0.5	Oil	98.96	+2.3
GBP/EUR	0.848	+0.0	Gold	1755.0	+0.5
USD/EUR	1.008	+0.5	Silver	19.41	+1.9
JPY/USD	136.62	+0.3	Copper	374.9	+2.3
CNY/USD	6.86	-0.6	Aluminium	2433.5	+1.3
Bitcoin/$	21,471	+0.3	Soft Cmdties	226.4	+2.8

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.60	+0.18
UK 15-Yr	2.97	+0.22
US 10-Yr	3.03	+0.05
French 10-Yr	2.02	+0.21
German 10-Yr	1.40	+0.17
Japanese 10-Yr	0.22	+0.02

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	10.6	9.5	14.3
FTSE 250	3.3	8.5	13.4	16.3
FTSE AS	3.7	10.2	9.8	14.5
FTSE Small x Inv_Tsts	3.4	7.5	11.1	15.3
CAC	3.0	12.4	10.3	15.2
DAX	3.5	12.7	10.9	13.8
Dow	2.0	17.3	17.8	17.0
S&P 500	1.6	20.0	18.5	18.3
Nasdaq	0.8	24.0	27.8	24.3
Nikkei	1.9	15.8	16.0	17.8
MSCI World	2.1	16.5	16.3	17.1
CSI 300	2.2	14.1	13.3	12.8
MSCI EM	3.2	10.0	11.5	12.7

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	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	4.38

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* 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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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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