CAMBRIDGE
INVESTMENTS LIMITED

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Too hot, too cold

Investors' rough ride continued last week. Markets are being buffeted by the ups and downs of economic data and the resultant changing expectations for central banks. We had unexpectedly positive UK economic growth during May, while the continued decline in oil and general commodity prices (resources and food) paints a picture of receding inflation pressures.

On the negative side, China very nearly slid into recession territory in the second quarter of the year with GDP growing at just 0.4% - the second worst reading in 30 years (second only to the Q1 COVID quarter of 2020). However, as we write in more detail in a separate article this week, these negative readings, on top of the ongoing property crisis, have finally forced the Chinese leadership towards decisive stimulus action, which markets see as a positive.

In the US, it is a similar picture of hot and cold, just the other way around, as its oil and gas self-sufficiency has it far less exposed to the pressures of Russia's Ukraine war. Indeed, the latest 9.1% inflation reading for June was evidence that the US economy is still running far too hot for comfort for the inflation fighting central bank, the US Fed. While markets initially reacted negatively to the news by increasing rate hike expectation for July from 0.75% to a whopping 1%, this reversed last Friday. This was perhaps due to the fact that much of the rise was driven by the now falling price of oil. Nevertheless, some form of recession in the US is now market consensus, although the relative equanimity of stock and bond market valuations tells us that expectation is for the period of negative growth to be relatively short and shallow.

All this drives the current US dollar strength against other currencies, where last week it regained parity against the Euro for the first time since the turn of the century. Japan also faces energy issues, although being further away from the conflict, it looks stronger than Europe in some ways. We talk about the investment opportunities created by the legacy of assassinated former Prime Minister Abe in an article below.

Due to its oil and gas self-sufficiency, the US does not face the same exposure to Russia's invasion of Ukraine, which is at the heart of the US dollar's strength. Indeed, for the Fed, although they can see that US demand is important for a weakened world, the inflation data shows continued signs that pressure is shifting from goods to services and not slowing down fast enough for their liking.

Both consumer and producer prices were above expectations. Overall year-on-year CPI, at 9.1%, is yet to peak and the leaking into service prices is concerning. As mentioned, this led to an acceleration of rate rise expectations, which is typical in US hiking cycles, but even so, this is the fastest in 40 years. The peak in rates is still not expected to be reached until after the new year. Paradoxically, therefore, investors are likely to welcome any indications that the FOMC members will move aggressively now to convince people that inflation will not last, and the expected recession will, therefore, be even shorter and less painful. The next meeting and rate rise decision is on July 27th, with no further meeting until after the summer break on September 21st.

Our focus last week was on Europe because the price direction of natural gas and electricity here is up and therefore the exception to the global norm of the gradual decline mentioned above.

As Britain and southern Europe brace for an upcoming heatwave, the discussion in Europe is all about what happens when the weather gets cooler. Gas and electricity prices, inextricably linked, both spot and forward, ticked yet again higher last week than the previous week, albeit down from the highs of last Tuesday.

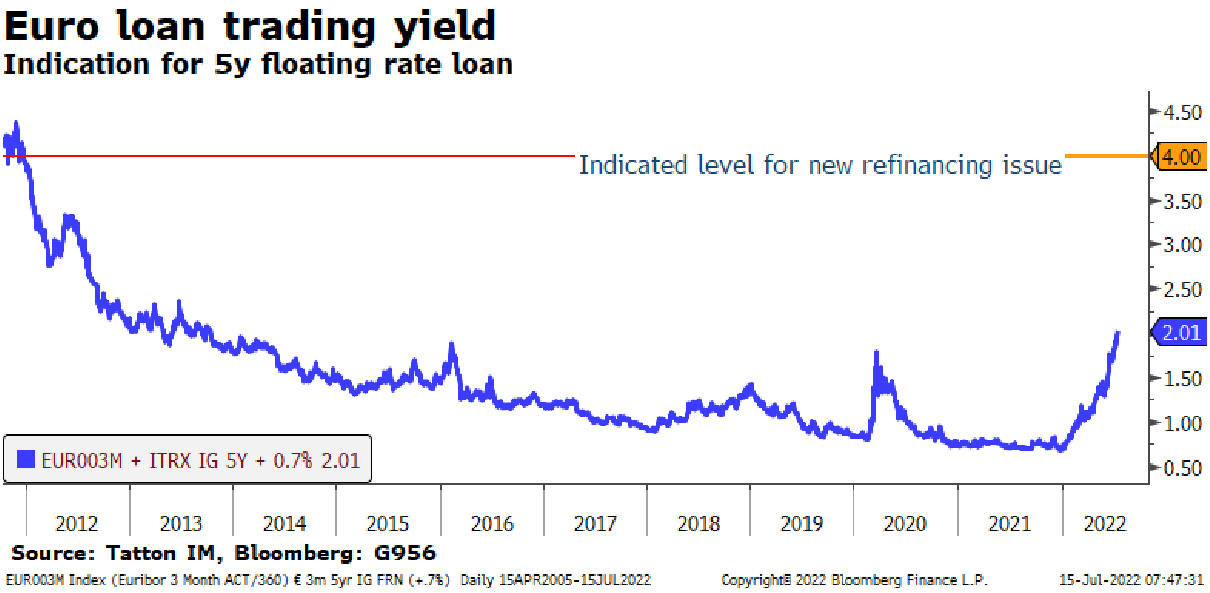
All this continues to feed into fears for Europe's businesses, especially the smaller ones that produce so much of the intermediate products which are the lifeblood of the economy. Worryingly, they are now additionally facing what looks like a classic credit crunch.

Supply chain financing and its variants was a hot topic back in the early days of 2021. Greensill Capital went bust in March last year, when its nefarious practices were exposed. The outcome of this, and other similar episodes, was that EU and UK regulators felt they had to adjust the regulation of securitised debt introduced in 2019 and put out consultation papers to introduce tougher standards.

The EU consultation will probably end by September, but already many involved in the industry appear to be concerned that the regulators will impose near-impossible restrictions on the arrangers.

This comes at a decidedly inopportune time. Mid and small-cap companies are paying inordinately high prices for electricity. The price to lock in supply across the winter is significantly higher still. Most are not on long-term fixed tariffs and will have to pay what the going spot rate is at the time. If a company's input costs go up, financing costs go up because their financial viability becomes more stressed. This makes banks and credit investors reluctant to lend – even before the regulations get more difficult.

The consequence is that Europe and the UK's SMEs may be facing a credit crunch. A crunch differs from more normal times in that the cost of raising debt or refinancing maturing debt is much higher than the traded level of existing debt. The chart below indicates the € 3-month yield trading level of a 5-year loan for a smallish investment-grade company in the secondary market (a 5-year tradeable loan that was issued some time ago). Investors would get a 2% running yield, up from 0.7%.



There is no getting round it – Russia's invasion of Ukraine is at the heart of Europe's issues. The pandemic weakened public finances in a bailout of households and, to a lesser extent, businesses. As a result, governments have much less fiscal headroom to address such issues and businesses, even if they could, cannot face another bout of loans through the winter.

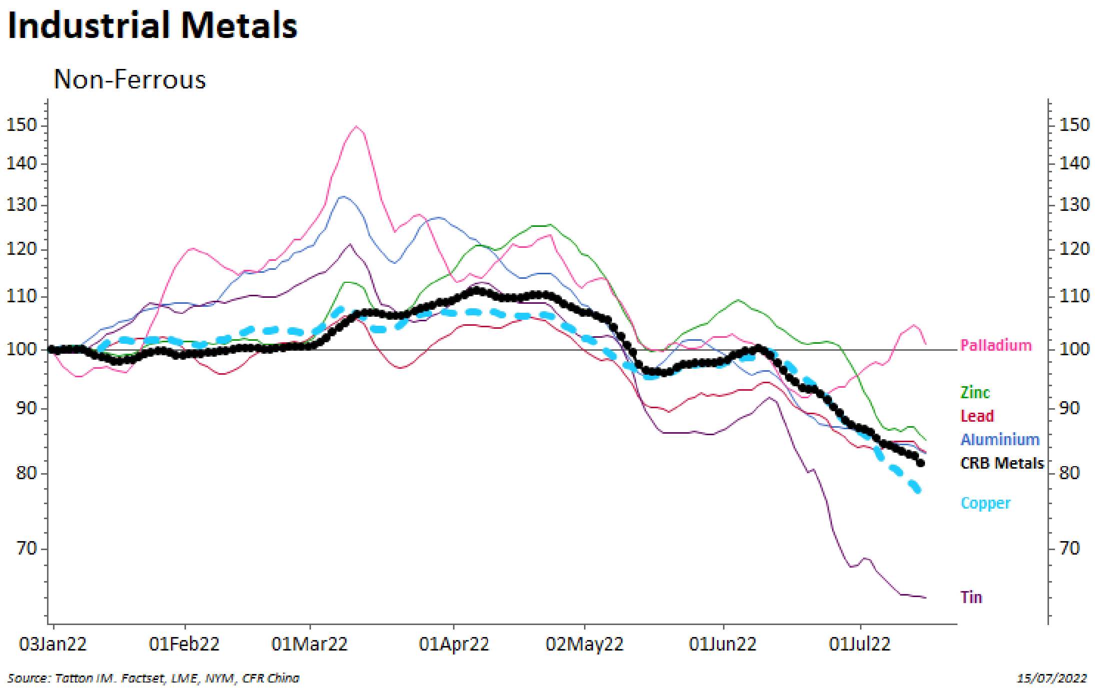
This is exemplified by Italy, where Mario Draghi's government is tottering because he is worried about weakening the country's fragile debt position through an even larger than already planned consumer and business support package. Meanwhile, the 5-Star party wants more support to be clearly on offer and it is easy to see why.

At the margin though, the outlook might be improving. The Canadians have released the serviced Nord Stream 1 turbines, the delay in delivery having caused the cut in gas supply, according to Russia. To defuse other tensions, Europe is decisively asking the Lithuanians to wave through supplies to the Kaliningrad Russian enclave and not wrongly applying the EU sanctions regime. Turkey (now officially being referred to as Türkiye) is enabling a face-to-face discussion between Ukraine and Russia, which might allow grain exports through the Black Sea.

But sanctions on Russia are not going to be removed and the war will continue. Russia is inching towards full control of the Donbas region, but the fight is bloody and reminds of WWI tactics. No one knows if the Russian leadership will halt if they achieve control of the region. So, the risks will continue, and the costs mount.

Like the pandemic response, Europe needs another coordinated response to prevent serious harm coming to its economy. To maintain financial market stability, the ECB has focused on its anti-fragmentation tool to support the finances of countries like Italy, but the governments must believe in it and be prepared to use it. To prevent the double whammy of a credit crunch, perhaps the ECB may need to step up purchases of securitised corporate (business) debt in the same way that the Fed bought mortgage-backed-securities in its quantitative easing program in 2020 and 2021.

Returning to the global picture, markets continue to worry that growth will have to be squeezed down further by central banks to get the genie of structural inflation back into the bottle. That worry is behind the fall in oil prices below $100pb. As mentioned, metals are also down and so are food (soft) commodities. Perhaps, paradoxically, that is fundamentally good news, as it lowers input costs and thereby takes pressure off the central banks to destroy demand in order to bring down inflation.

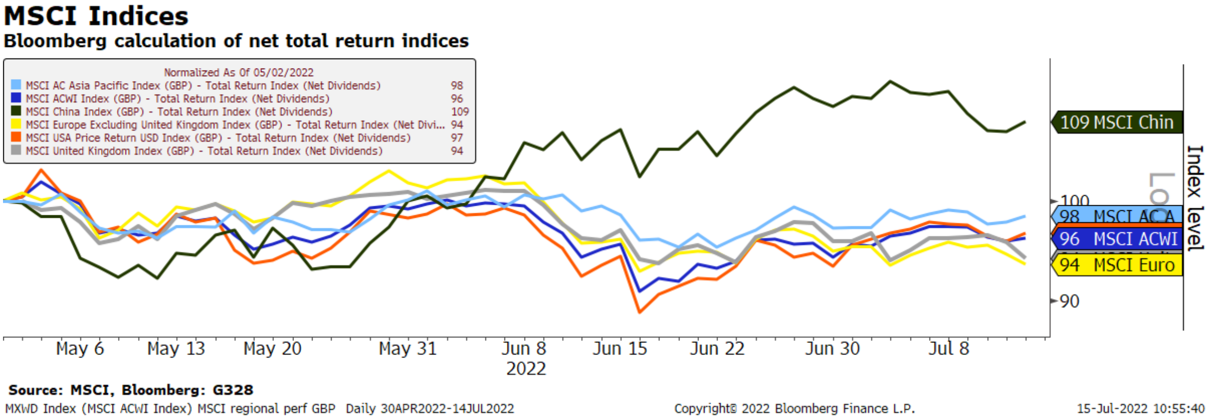


But for electricity, the issue is not demand but supply, much like at the onset of the pandemic in spring 2020 when factories had to shut down while consumers' demand remained. As the CEO of Shell said last week, in Europe, we may not be able to avert some form of near-term lockdown – aka power supply cuts. What we can do, as in the pandemic, is make sure our businesses do not pay all the price for our solidarity with Ukraine.

For investors, this multi-facetted and regionally differing picture opens opportunities for a change of regional emphasis in their portfolios. However, the somewhat monocausal risks to the pan-European economy also means that any improvement in the energy supply picture, or more decisive policy action on the issue, will likely result in a very fast reversal of asset prices. Abandoning what is, in valuation terms, still a highly attractive region, is therefore at investors' peril.

China's homebuyers on strike

Chinese equities have been the best regional performers for the past two months, as fear has given way to positivity. Concerns about over-regulation and then COVID lockdowns have receded, fiscal and monetary policy have become supportive and consumer spending is rebounding strongly after the extended lockdowns.



But the problems of the regulations and the lockdowns have still not yet been resolved. In particular, the woes surrounding property developers have spread again.

Chinese homebuyers are angry. Delayed construction projects have left many out of pocket, with nothing to show for it in terms of habitable housing, as cash-strapped property developers fail to make good on their promises. Frustrations reached fever pitch last week, pushing citizens to an astounding tactic: a strike on mortgage payments for unfinished properties. Last Monday, it was reported that buyers had stopped mortgage payments on 28 unfinished projects around the country. By midweek, the number was over 100 – spanning more than 50 cities.

The problem comes from the widespread Chinese practice of selling homes before they are built. Banks lend to homebuyers, who pass the money onto developers, which is used to aid construction. Unlike prebuilt property sales though, buyers receive no physical asset in the meantime. Developers have a commitment to deliver the property, but financial problems can delay or even halt construction altogether. Rising prices for raw materials are a good example, as costs can quickly spiral beyond the total presale funds. It is estimated that developers delivered just 60% of presold homes between 2013 and 2020. With the widespread property woes of the last two years, that figure is likely to be even lower now.

Withheld payments are a serious problem for China's property and banking sectors. Builders are still suffering from the fallout of Evergrande's crisis and the government's crackdown against debt-fuelled speculation. Indeed, the list of affected projects includes unfinished homes from Evergrande, as well as the struggling Sinic Holdings. Problems over the last two years have bruised developers' stock prices, which slid a further 2.7% in the middle of last week, according to Bloomberg.

Meanwhile, missed debt payments are bad news for Chinese banks, especially the smaller regional ones. Mortgages account for nearly 20% of all loans, and delayed projects make up 1% of China's total mortgage balance. According to ANZ, up to $220bn of mortgage loans are linked to unfinished residential property. If the payment strike continues, it would mean a huge increase in recorded defaults, leaving banks with a large pile of ostensibly non-performing loans on their books. These fears led investors to dump Chinese financial stocks, with the CSI 300 Bank Index falling 3.3% last Thursday.

Authorities are urgently moving to halt a spiral of financial instability. China's Ministry of Housing and Urban-Rural Development held emergency meetings with regulators and major Chinese banks last week, in the hope of ending the boycott. No resolutions were agreed, but regulators were asked to report on potential impacts. This comes as some banks have already begun tightening their lending restrictions.

The interest payment strike is unfortunate timing for China and its property sector. Through the first half of this year, the economy was severely constrained by Covid lockdowns and liquidity stress among developers. Sporadic regulatory crackdowns across swathes of the private sector – especially Chinese tech companies – have also held back investor sentiment for over a year. The headwinds have been impossible to escape, and officials have all but admitted that the 5.5% annual growth target for this year is unachievable.

Recently though, the winds seemed to change. Summer months have brought respite on the Covid front, and officials have said that future infections might be dealt with (somewhat) less harshly. On economic policy, the People's Bank of China (PBoC) has loosened conditions and allowed liquidity to flow into the system. After a long period of contraction, China's credit impulse – a measure of how much credit impacts growth – has climbed to neutral and is expected to turn positive in the months ahead. This turnaround even extended to the ailing property sector, with new loans fuelling activity and lifting developers from the depths fallen to earlier in the year.

A corporate credit crunch was only narrowly averted earlier this year and this latest credit market episode could derail China's recovery. Meanwhile, a depositor run on smaller regional banks would clearly be bad news. Beijing will be well aware of this, but its track record of addressing such issues over the last two years is a little disheartening in terms of policy accommodation. Unlike almost all major economies, China did not significantly loosen policy throughout the pandemic. Instead, led by Xi Jinping's drive to cleanse the system, Beijing took the opportunity to increase its deleveraging drive and clampdown on key industries. This was portrayed as a sign of economic strength, using export growth to keep the economy churning through lockdowns. The negative impacts have been clear for the last year though, as growth and sentiment have dwindled.

A recent loosening suggests this attitude is changing, however. At the Politburo's meeting in April, officials unveiled looser financial conditions, along with 33 comprehensive stimulus measures. This is already having an effect, with business sentiment surveys for June pointing toward expansion. Crucially, this shows that authorities are taking the growth slowdown seriously and are even willing to allow credit growth to stem the downturn.

Continuing in kind with the mortgage strike would be the path of least resistance. To stop the problem becoming a full-blown crisis, Beijing could provide financing for stressed banks and property developers, while strongly encouraging them to complete outstanding projects. Judging by comments from officials so far, something along those lines looks likely. Authorities are keen to ensure financial stability and would reportedly allow a rise in the private sector's overall leverage ratio (which Beijing has tried for years to bring down) for that to happen.

That would allow for greater credit expansion, give a boost to short-term construction and, ultimately, be a positive for growth. Crucially, that would turn a huge risk into a big boost for the economy. And while this is an optimistic scenario, the early signs suggest it could happen.

The mortgage boycott has depressed investor sentiment on China, pushing down equity values (particularly for banks and property developers). But if the resolution turns out to be more fuel for growth, we should expect a further rebound in asset prices. This mini crisis could well be a good buying opportunity. As ever, though, everything depends on how the government responds, and their interventions over the last two years are a testament to the risks that brings. Optimism has faded for now, but watch this space.

Abe's third - and last - arrow

The assassination of former Japanese Prime Minister Shinzo Abe ten days ago came as a shock to the world. Despite being out of office for nearly two years, the nation's longest serving premier had iconic status and great influence right up to his tragic death. Even without 8th July's gruesome scenes, Abe was destined to live long in the memory of Japanese citizens. He was a popular but polarising figure: an avowed nationalist, an ambitious reformer and a charismatic leader.

In economic terms, Abe's main legacy was his eponymous growth strategy, which promised to drag the world's third largest economy out of its decades-long stagnation. 'Abenomics' had three 'arrows' aimed at these targets: loose monetary policy, fiscal stimulus and structural reform. The first saw years of ultra-low interest rates and a massive asset-buying program by the Bank of Japan (BoJ), while the second led to increased infrastructure spending and cash handouts. The final arrow was supposed to hit productivity head on, by scaling back regulations and increasing labour participation – particularly among women.

The results were decidedly mixed. In his second term as prime minister, Abe oversaw consistent growth, a rise in exports and the lowest unemployment rates in decades. Women increasingly joined the workforce – crucial for a country with a shrinking population. But the record was steady rather than spectacular, and both the government and the BoJ missed their respective growth and inflation targets. In real (inflation-adjusted) terms, the economy fluctuated between expansion and contraction, averaging just 0.9% growth over Abe's eight years at the helm.

Abe's third arrow – structural reform – was by far the biggest disappointment of his plan. He came into office promising to cut red tape, encourage foreign investment and improve business structures. But nearly a decade later, Japan still has high trade barriers compared to its global peers, and corporate governance continues to hold companies back – though beneath the surface we can detect change. Without deep and broad-based reform, the monetary and fiscal impetus of Abenomics was severely constrained.

In truth, structural reform was always going to be the hardest target to hit. It includes many things outside of the government's control, from ingrained ownership structures to cultural attitudes. *Keiretsu*, the traditional structure of Japanese corporates which involves overlapping shareholders for a network of businesses, has roots going as far back as the 1600s. The family-ownership system it was based on drastically changed during Japan's post-war expansion, but the static monopolistic holding companies it spawned are still alive today.

Entrenched systems and interests proved too hard to overcome during Abe's tenure. And when his government did have opportunities to make big changes, it often disappointed. Japanese businesses are notoriously averse to foreign ownership – a fact the former premier tried to rectify through encouraging speeches to overseas investors. But at the same time, his government instituted tighter rules on foreigners buying up Japan Inc. Admittedly, this has become a bit of a global trend, especially with respect to Chinese capital finding its way into key Western sectors. Last year, senior government officials were accused of colluding with Toshiba to pressure foreign investors into shunning activist involvement against the company's management.

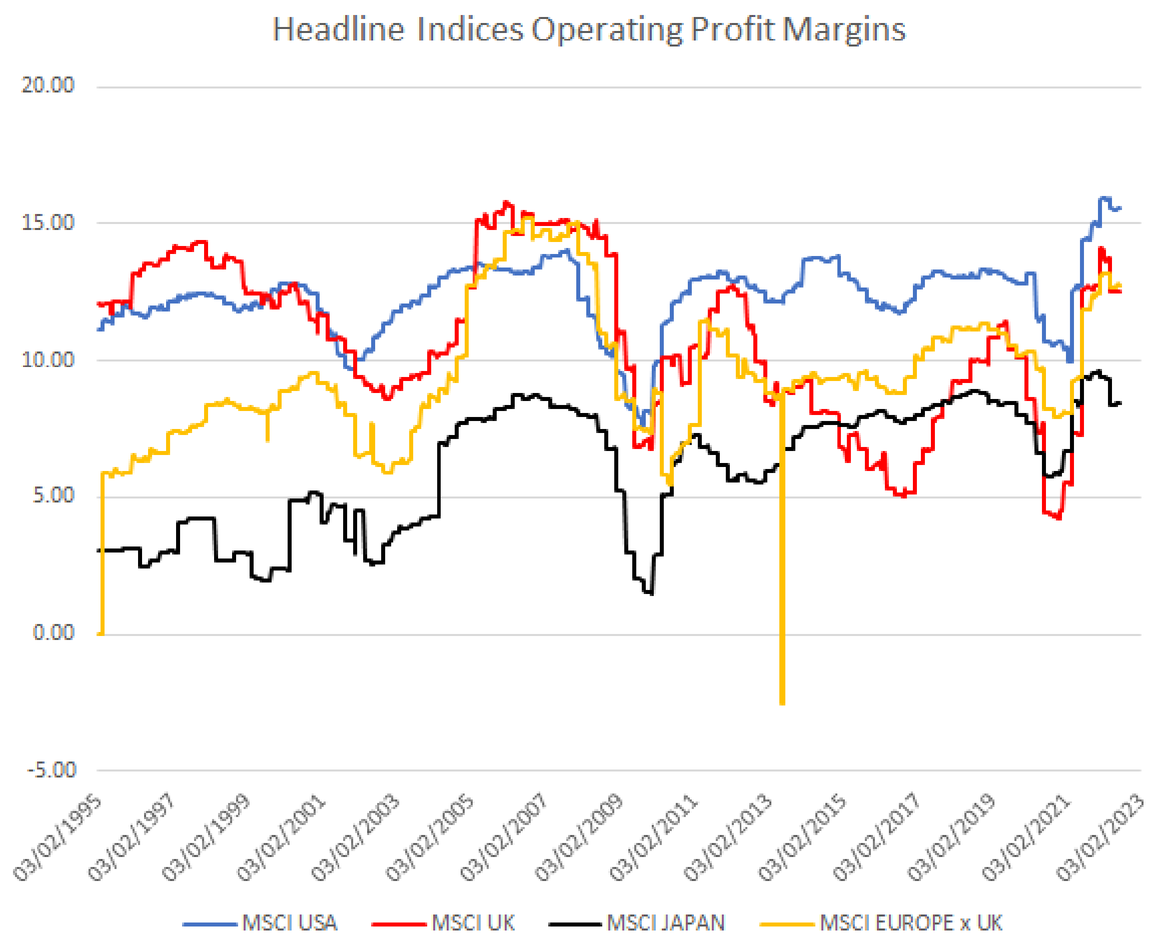
Abe's mixed record on foreign ownership is perhaps a reflection of conflicting values. On the one hand, Abe the reformer wanted to shake up Japan Inc and revitalise his country's ailing economy. To that end, Japan had to be open and attractive to foreign capital. On the other hand, his nationalist ideology meant restoring and protecting Japan's once-great status. That meant looking inwards, keeping the country for its citizens and ultimately swinging toward even more isolation. There are still remnants of this attitude today. Foreigners are encouraged to buy Japanese equities, but not to own companies outright.

That is the pessimistic view at least. The more positive interpretation of Abe's legacy is that big changes take time and may only be felt long after his time in charge. There is also some evidence, that micro changes in Japan drive corporate behaviour. Share buy backs are rising, and venture capital funding has steadily risen. On foreign ownership, there seems to be improvement too: last month, Toshiba shareholders voted in two board members from activist hedge funds, despite pushback from existing members. This makes the touted buyout from international private equity groups – including KKR, Blackstone and Bain – more likely. If the foreign purchase of such an iconic company goes ahead, it would be a big signal of Japan's openness to overseas investment.

In that case, foreign investors might well see Japan as an attractive destination. The BoJ is alone, among the developed world's major central banks, in maintaining its loose monetary policy. This leaves Japan with significantly lower financing costs than the US and has pushed the yen to its lowest dollar value in decades. Simply put, Japan is exceptionally cheap, which makes it especially attractive for foreign investors.

What's more, decades of stagnating wages have meant that Japanese workers are paid around 65% of what their US counterparts earn. That gives a huge price advantage. If companies believe they can get a similar or even comparable level of productivity from Japan's highly skilled workforce, they have every reason to invest capital in the country to shift production.

The 'if' is the crucial part, however. The very same stagnation means that Japan's record on productivity is uninspiring. This is exactly what Abe's third arrow aimed at, with disappointing results. Here though, we would point to the slow but steady pace of change in the Japanese corporate sector. We have already mentioned foreign ownership, but an equally big part is profitability. As the chart below shows, Japan's profitability has lagged its peers for a long time but has recently improved. We can also see that earnings



growth outstrips sales growth, signalling an improvement in productivity or cost management. It is unlikely to match the levels seen in the US but, with the country's assets trading at such a huge currency discount, there is significant near-term upside potential in shares and any amount of margin catch-up will be an added positive.

This is a sign that management structures are improving, albeit slowly. The fly in the ointment is that no one seems to really believe this improvement is true. But sentiment can shift quickly, particularly if private equity groups (themselves under severe pressure) go bargain hunting in Japan. Structural reform, the most disappointing but crucial part of Abe's three arrow legacy, might finally filter into corporates in a piecemeal manner. Sadly, he will not be around to see it – but his successors will, nevertheless, want to ensure its success.

CAMBRIDGE INVESTMENTS LIMITED

18th July 2022

Global Equity Markets

Market	Fri 15:19	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7135	-0.9	-62	↘	→
FTSE 250	18741	-0.9	-172	↘	↘
FTSE AS	3926	-0.9	-35	↘	↘
FTSE Small	6178	-1.4	-87	↘	↘
CAC	5991	-0.7	-43	↘	↘
DAX	12785	-1.8	-230	↘	↘
Dow	31219	-0.4	-120	↘	↘
S&P 500	3840	-1.5	-60	↘	↘
Nasdaq	11392	-2.1	-243	↘	↘
Nikkei	26788	+1.0	+271	→	→
MSCI World	2521	-3.2	-83	↘	↘
CSI 300	4249	-4.1	-180	↘	↘
MSCI EM	965	-3.4	-34	↘	↘

Top 5 Gainers

Company	%
Centrica	+9.3
Airtel Africa	+5.6
Avast	+5.1
Experian	+4.8
Compass	+4.3

Top 5 Decliners

Company	%
Admiral	-18.5
Ocado	-12.2
Antofagasta	-10.8
Anglo American	-10.1
BT	-8.8

Currencies

Pair	last	%1W
USD/GBP	1.186	-1.4
GBP/EUR	0.850	-0.4
USD/EUR	1.01	-1.1
JPY/USD	138.53	-1.8
CNY/USD	6.76	-0.9
Bitcoin/$	21,809	-23.2

Commodities

Cmdty	last	%1W
Oil	101.20	-5.4
Gold	1704.7	-2.2
Silver	18.56	-3.9
Copper	319.0	-9.7
Aluminium	2336.5	-4.3
Soft Cmdties	229.5	-4.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	11.7	9.4	14.3
FTSE 250	3.3	10.1	13.3	16.3
FTSE AS	4.0	11.3	9.7	14.5
FTSE Small x Inv_Tsts	3.4	7.3	10.7	15.3
CAC	3.2	13.1	10.2	15.2
DAX	3.6	11.4	10.6	13.8
Dow	2.1	16.1	16.5	16.9
S&P 500	1.7	18.7	16.8	18.2
Nasdaq	0.9	21.2	23.8	24.1
Nikkei	2.1	15.2	14.9	17.8
MSCI World	2.2	15.1	14.8	17.1
CSI 300	2.0	14.8	13.7	12.8
MSCI EM	3.1	9.5	11.1	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.07	-0.16
UK 15-Yr	2.55	-0.08
US 10-Yr	2.92	-0.16
French 10-Yr	1.74	-0.14
German 10-Yr	1.12	-0.22
Japanese 10-Yr	0.24	-0.01

UK Mortgage Rates

Mortgage Rates	Jul	Jun
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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The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel