THE **CAMBRIDGE** WEEKLY

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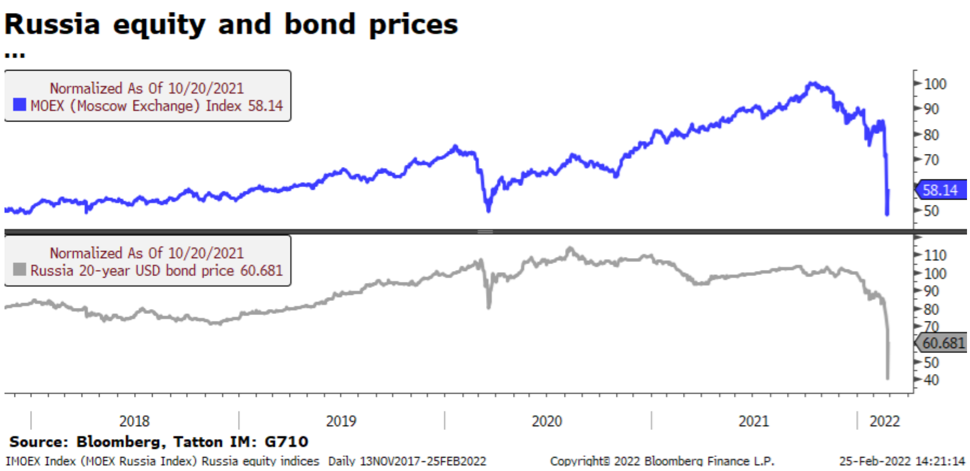
Back to the past

As noted in our update on Friday, the global political theatre that Putin's invasion of Ukraine brought about marks a paradigm shift that must not be underestimated, and is probably as defining as the opening up of the Soviet Union under Gorbachev in the mid-1980s.

As this week's title suggests, for some of us it invokes memories of the cold war era of the West vs the USSR in the '70s and '80s. It is even more remarkable then, that stock markets have rallied back to roughly where they stood this time last week. The same cannot be said about Russian asset prices, which have roughly halved since last autumn as the chart below illustrates. Perhaps this indicates who markets believe will ultimately pay for Putin's megalomania.



Our special updates of the last two weeks emphasised that recent history of armed conflict did not foreshadow particularly destructive episodes of capital market performance. This year, of course, we are experiencing an additional and unexpected effect. Markets have been under considerable pressure since the beginning of the year as pandemic-prompted governmental and central bank policy support is wound down. Markets have possibly reacted less negatively to the unfolding situation in Ukraine than one would anticipate, because they suspect the external shock of this geopolitical event may slow down, or even reverse, the withdrawal of policy support for a while longer.

Turning to the negative economic impacts that may necessitate such policy support extensions, the European Central Bank's (ECB) chief economist Philip Lane said he expects 2022 Eurozone GDP to be lower by about -0.4%, with a severe scenario reducing GDP by close to 1.0%. A mild scenario could even mean events in Ukraine have no impact. His assessment is mainly because of the cost of energy.

The cost of energy in 2022, and possibly beyond, will much depend on the level of sanctions imposed on Russia. In this context, economists talk about 'moral hazard', the need for our economic and financial systems to impose costs on people that behave immorally. Unfortunately, those costs are borne not just by the instigators – but will be felt by individuals and companies as well. It can feel wrong, but share prices will be higher if the West decides not to impose sanctions too heavily.

The markets remain focused on sanctions that hint at Europe's weak spot: energy and metals prices. Putin's strategy of constraining supply during this winter, thereby creating a cost-of-living crisis, appears to have worked well for him. Current sanctions do not extend to Russian energy giant Gazprom and, perhaps unsurprisingly, gas imports from Russia though Ukraine's pipelines are up (see chart below).

Meanwhile, Brent crude, which rose to $104 per barrel (pb) immediately after the invasion began, fell back to last Monday's level of $97pb. Longer-dated futures have also retrenched. March 2023 Brent is indicated at $83.5pb, down from $86.5pb.

Part of this is because it is likely Iran may be allowed to re-enter the global oil market. The Nuclear Agreement may well be reinstated after former US president Trump pulled the Western world out and imposed moral hazard sanctions on Iran. As a result, and perhaps somewhat bizarrely, we could end up with an anomalous situation: fewer sanctions globally than before the Ukraine invasion began.

We are used to central banks being nimble and governments being lead-footed. Last Friday, things looked a bit different. Defence stocks were doing rather well. British Aerospace had risen more than 11% from Wednesday's close. The rationale focuses on Germany's reaction to the current situation. Germany is highly sensitised towards Russia's behaviour, as an actively belligerent Russia changes all estimations of Germany's defence needs. We should expect that Germany will feel very differently about government deficit expansion and its armed forces in the new scenario.

Yet, Europe's main defence companies are in Germany and the UK. Throughout the past decade, Europe's pleas for Germany to save less and spend more have proved unsuccessful. Now things may be changing, and quickly. So, if we have fewer sanctions and fiscal expansion, we could end up with higher, not lower, growth in Europe.

Turning to China – the other main global economic power which could allow Russia to escape the pain of Western sanctions – has indicated it sees no benefit in sanctions, although it has "paused" oil tanker shipments. While President Xi urged Putin to negotiate with Ukraine's government, (and ahead of the Russian announcement of talks), there was little mention of the conflict in Chinese media. Much more to the fore was the news that the Xi-led Politburo has vowed to strengthen policies to stabilise the Chinese economy this year. Ahead of annual legislative meetings scheduled for this week, the Politburo called for stronger prevention of financial risks, after a review of the current situation and progress towards government targets. The People's Bank of China has also been increasing liquidity again during the past week, and signs are that regulatory pressure is being reversed on consumer tech companies like Alibaba and on residential property builders.

However, Hong Kong is now in the midst of a full-blown Covid outbreak. On Friday, 21,979 cases were reported, which makes this now a larger outbreak of Covid than the original outbreak in Wuhan at the beginning of 2020. Should China's leadership decide to stick with its zero-Covid policy, a significant economic slowdown in China may limit the support that may otherwise be extended towards Russia.

Not to lose sight of the wider economic picture beyond the Ukraine shock, our third article covers the encouraging 'flash' Purchasing Manager Indices (PMIs) published last week. In the US, direct consumer confidence indexes have been weak, but interestingly, the PMI data suggests consumer attitudes are possibly more buoyant. Friday's personal spending and income data backs that up. US households may be worried about inflation, but they kept spending – and saving less – in January. Another bright spot was that inflation expectations declined (the five-year expectation dipped to 3.0% from 3.1%). The mood of consumers seems to have soured since the beginning of the year, with falling US equities leading to a decline in personal wealth, while mortgage rates and prices have been going up. Even so, it appears that unless the jobs markets turn negative, consumers are likely to remain resilient in their spending habits.

The relationship psychodrama that has been playing out between a Putin-led relatively isolated Russia and with much of the rest of the world has been a major step back in terms of global political cooperation. However, the limited immediate options for moral hazard retaliation by the West (because of its gas dependency on Russia) mean that the events could quite possibly at first lead to more positive policy measures for the global economy. This is because the only way to penalise Russia for its actions, prevent it from further territorial expansion and deprive it of the necessary funding, is to significantly increase military and alternative energy supply funding in Western Europe. This could indeed serve as a stimulus for Europe's economy, and restrict the Ukraine crisis to a regional conflict that is unlikely to reverse the global economic upswing taking place.

As investment professionals, weeks like the last one require us to remain clear-eyed and objective – often as catastrophic events unfold. We hope that our readers understand that we have used these pages to look beyond the humanitarian impact, to explore the financial implications that our investors require from us.

Bond market inferences

Markets shook after the Ukraine crisis reached boiling point last Thursday, as the broad sell-off in equities suggested a 'risk-off' passage in capital markets. This was backed up by moves in bond markets, where the price of government debt increased as the demand for safe assets rose. Before the current tensions, yields (moving inverse of bond prices) were climbing steadily throughout the year – pushed up by the prospect of a sharp tightening of monetary policy. But now we are seeing a stabilisation of this trend, with yields coming down from the peak reached two weeks ago.

However, given the negative scope of geopolitical events, government bond moves have nevertheless been relatively muted. Below the surface, we can see a few intriguing developments. Expectations for central bank tightening, especially in Europe, have been pared back, even while inflation expectations have continued to rise. In other words, markets are treating the upcoming rise in inflation through higher commodity prices as a 'cost shock' lowering growth, and therefore less likely to result in lasting structural inflation. Widening credit spreads point in the same direction (i.e., what non-government borrowers must pay above the rate the government pays). At the same time, we take some comfort that liquidity in government bond markets has been good, and the absolute change in yield levels and expectations has stayed within past trading volatility ranges. This is markedly more stable and positive than the market reaction to spreading Covid uncertainty two years ago.

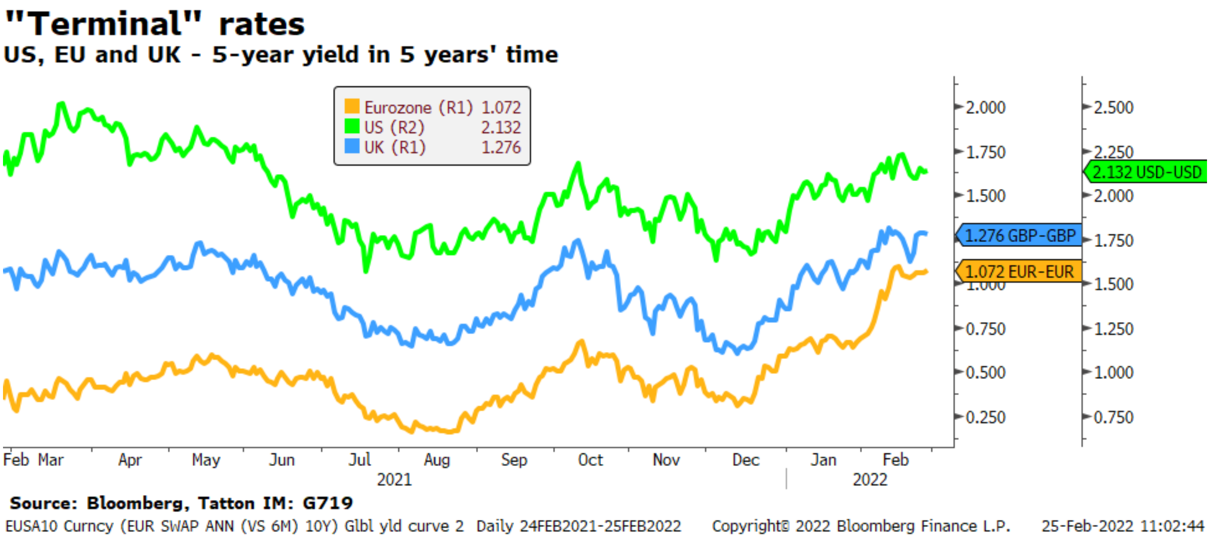
The 'risk-off' mood was best reflected in widening corporate credit spreads. This was visible across the maturity curve in the credit quality segments of investment grade and high yield, with (lower credit quality) high yield naturally reacting stronger to risk events than its investment grade counterpart. This is not surprising after a week where perceptions of risk increased with a jolt, which in turn weighed on businesses' cost of financing.

As ever, bond traders are trying to gauge the outlook for growth, inflation and central bank policy. Judging from the yield curve (the difference between long and short-term maturity government bonds), as of Thursday, long-end yields (longer maturities) had moved down more than the front end (shorter maturities). Our read of this move is that markets turned less negative on the prospect of quantitative tightening, meaning they expect central banks to be less aggressive in reducing their balance sheets, and thereby the severity of monetary tightening (which puts less upward pressure on yields).

The UK stood out among the major markets. This had less to do with geopolitics than the release of the Bank of England's (BoE) Monetary Policy Committee (MPC) minutes. The MPC's vote to raise interest rates at its last meeting was portrayed as much more finely balanced between 0.25% and 0.5% than expected, leaving markets with a more dovish interpretation of the BoE's policymaking.

Earlier in the year, hawkish messaging from central bankers pushed up rate expectations in developed markets, particularly in the UK and US. Those regions have now seen the biggest shift in policy outlook. By the end of Thursday, market forecasts for interest rates at the end of this year were 0.1-0.2% lower for the UK and the US than they were last week. Implied rates have hardly moved in Europe, but the market implied rate hike schedule had already been scaled down in the run-up to the Ukraine crisis. Markets now barely expect a rate move in Europe in 2022.

The pace of tightening is not the only thing to change. As we have written before, faster rate hikes do not necessarily mean higher interest rates over the long-term, and vice versa. But the general flattening of yield curves implies that markets expect a slower pace *and* a lower peak after this tightening cycle. The US yield curve is particularly flat. This implies traders still expect the US Federal Reserve (Fed) to raise rates relatively quickly, but to leave them at 2.1% once they get there. Not only do markets expect the European Central Bank (ECB) to be slower, but the implied peak is a stable rate of just 1.0% (see chart below).



As well as interest rates, bond markets have also shifted their inflation expectations. Inflation-linked government bond yields have fallen faster than fixed income debt, meaning the difference between real (inflation-adjusted) yields and nominal yields has widened. This suggests a pick-up in inflation expectations, likely from the spike in oil prices and the fallout from Russian sanctions.

It seems investors are eager to buy inflation-linked bonds. Germany's inflation-linked 10-year yield has fallen 0.25% since Wednesday morning alone, putting real rates at -2.05%. UK 'linkers' fell by a smaller 0.05%, but are still down to -1.85%. This difference could be attributed to how each country will be impacted by sanctions against Russian gas. Germany receives a very considerable proportion of its natural gas from Russia, while the UK's dependence is much smaller. This is quite an unusual situation, as the UK has often gone through periods with higher inflation, meaning that its real rates settled below Germany's.

The Ukraine crisis has brought huge volatility across most regions and assets – bond markets included. But despite large price moves, we have not seen signs of trading liquidity stress. Bonds are still being actively traded and in large volumes, meaning enough cash is flowing to make the global financial system tick. That is a positive sign at least, since liquidity stress is the hallmark of financial crises.

Moreover, even though bonds have been volatile, the current phase has not seen a big spike in measures of volatility. These had already risen since the start of the year, as markets braced for a much more hawkish Fed policy. Central bankers will, no doubt, be worried about the current market correction, but will be pleased investors are not scrambling for cash.

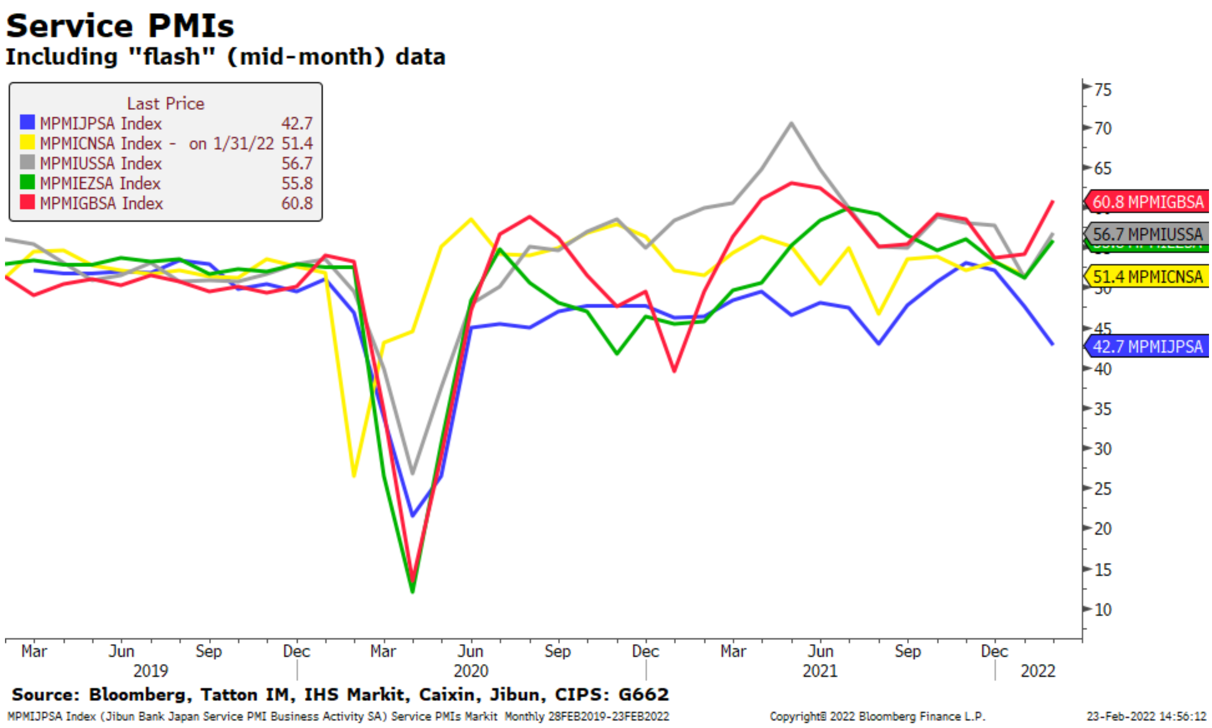
That is what we saw in the sharp pandemic sell-off of March 2020, as risk aversion reached fever pitch and markets went into meltdown. Avoiding a repeat will be a top priority for central bankers – meaning that calmer messaging is likely to be in store.

Flash PMIs suggest a more promising path

Amid the concern regarding Ukraine, investors might have missed some positive economic data that would normally have been front and centre of market news. In data collected during early February, as the Omicron wave died down across the US and Europe, business sentiment improved substantially. This is according to the latest 'Flash' Purchasing Managers Indices (PMIs), which measure business confidence across a range of factors and return a score out of 100 (where a score above 50 indicates expansion). The US manufacturing sector registered a two-month high of 57.5 in the latest survey, while the Services Business Activity Index came in at 56.7 – also a two-month high.

Regular readers will know we pay close attention to PMIs, which are a reliable indicator of near-term economic growth. This is because they are closely tied to businesses' investment decisions. Manufacturers make decisions about capital investment over the long and short term, such as whether to build new plants or simply stock higher inventories. These decisions have a big impact on wider economic growth, and firms are more likely to invest when they feel confident.

On the other side, service businesses make investment decisions around technology and labour – and are more likely to hire and invest into their cost base when their outlook is strong. For that reason, services PMIs are more closely related to consumer sentiment, and can even be used as a proxy measure for the latter. As the world recovers from the pandemic, the ebbs and flows of consumer sentiment will have a huge impact on the economy, making service PMIs a crucial investment indicator.



At the height of lockdown, monetary and fiscal support allowed households to build savings, despite widespread job insecurity. Now, as job insecurity has been replaced by widespread staff shortages – and a return of more normal activity levels – those savings piles are being drawn down as support winds down.

Whether the recent rapid price rises have been accommodated and propelled by the consumers surplus savings, or whether the savings drawdown has merely been exacerbated by the price rises, is debateable. In any case, inflation expectations may have become ingrained after the prolonged global supply shock. In this environment, consumers could once again be nervous about spending if they think their jobs are on the line. That means the labour market must be robust if we are to see further growth.

An uptick in PMIs is therefore a welcome sign. Growth slowed sharply toward the end of last year, as the spread of Omicron, tighter central bank policy and a looming shock to disposable incomes from skyrocketing household energy costs weighed down on the economy. But this wave of the virus slowed into the beginning of the year, and case rates and hospitalisations continue to fall across the UK, US and Europe. JPMorgan's mobility data shows a normalisation in all those regions, which should lead to a wider economic recovery. Rebounding PMIs provide solid evidence this is now happening.

Oil prices add a sour note to this sweet story. Fuel prices have been a huge component of the rise of input costs, affecting businesses and consumers at every stage of the chain. Brent crude oil is now at its highest price since 2014 (just over $98 per barrel at the time of writing) and geopolitical tensions mean it could go higher.

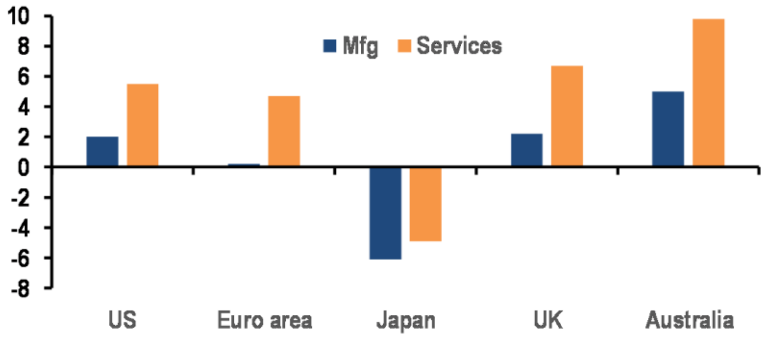
That said, other inflation pressures seem to be abating. Supply chain problems have cleared up this year, according to the Fed. This backs up recent reports that supply bottlenecks are easing. Should this trend continue, it would lead to a slowdown in inflation – even if oil prices continue to rise. This is unlikely to mean falling or even stationary prices, but it should mean an end to the rapid inflation we saw last year.

The major Asian economies are the exception to this. Supply chain problems continue in Japan, while China is struggling to find a way out of its growth slowdown. China has stuck to its zero-Covid policy despite its high vaccination rate, and the cycle of lockdown and release is taking a toll. On top of that, policy tightness (China's central bank was unique among major economies by tightening during the pandemic) and intermittent government crackdowns have weighed on investor sentiment. There are signs of loosening on the policy front, but the world's second-largest economy is not out of the woods – and will likely need a turnaround in Covid fortunes before things improve.

Japan is also lagging, as the next chart shows. A relatively low rate of booster jabs (compared to other developed markets) has resulted in more hospitalisations. Supply pressures are compounding the problem, with businesses struggling to find workers. This has resulted in a slowdown for both manufacturing and

Change in February flash output PMIs by DM economy

points, change from prior month



Source: IHS Markit, J.P. Morgan

services sectors. In general, Asian unemployment is still higher than before the pandemic – whereas Western nations have seen jobless rates fall below pre-pandemic levels. On the positive side, it is likely Omicron will fade sooner rather than later. After that, we should expect Asia to experience the same bounce that Europe and the US are now.

Businesses may expect consumers to be confident, but polls of consumers have yet to be as rosy. TS Lombard point out that more direct measures – such as the University of Michigan survey – are still depressed. The cost-of-living crisis has had a big impact on sentiment, and this is only worsened by the continued spike in oil prices. We should, therefore, be cautious before calling this the turnaround point.

At the very least though, a pick-up in business confidence should improve the jobs market, which will ease the cost pressures facing consumers. We suspect this will lead to an increase in the other confidence measures further down the line. One crucial point here is the labour market stress we saw last year – the so-called 'great resignation'. For growth to continue at a decent pace – and inflation to come down from dangerous levels – a big section of those who left the labour market will need to return. Dwindling savings rates and the return of reliable childcare availability could prompt this, but we must wait and see. If they do, it will help contain labour costs and bring down fears that supply side price rises will turn into lasting, structural inflation.

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28th February 2022

Global Equity Markets

Market	Fri 15:51	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7478	-0.5	-36	→	→
FTSE 250	20852	-2.4	-511	⬊	⬊
FTSE AS	4160	-0.9	-36	⬂	→
FTSE Small	6882	-2.9	-202	⬊	⬂
CAC	6732	-2.9	-198	⬊	→
DAX	14504	-3.6	-538	⬊	⬂
Dow	33670	-1.9	-642	⬊	→
S&P 500	4334	-1.0	-46	⬊	→
Nasdaq	13539	-1.3	-178	⬊	→
Nikkei	26477	-2.8	-756	⬊	⬂
MSCI World	2906	-2.6	-78	⬊	→
CSI 300	4573	-1.7	-78	⬊	⬊
MSCI EM	1155	-6.2	-77	⬊	⬊

Top 5 Gainers

Company	%
Smith & Nephew	+9.4
Pearson	+8.7
BAE Systems	+8.7
Anglo American	+5.1
Rightmove	+4.9

Top 5 Decliners

Company	%
Polymetal International	-36.4
Evraz	-26.0
Hargreaves Lansdown	-12.6
Coca-Cola HBC	-11.8
Rolls-Royce	-10.0

Currencies

Pair	last	%1W
USD/GBP	1.342	-1.3
GBP/EUR	0.838	-0.6
USD/EUR	1.12	-0.7
JPY/USD	115.55	-0.5
CNY/USD	6.32	+0.1
Bitcoin/$	39,475	+3.2

Commodities

Cmdty	last	%1W
Oil	97.12	+3.8
Gold	1889.6	-0.5
Silver	24.04	+0.5
Copper	449.1	-0.7
Aluminium	3394.5	+3.9
Soft Cmdties	#N/A N/A	#N/A N/A

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.5	13.7	11.9	14.3
FTSE 250	2.8	13.4	15.0	16.2
FTSE AS	3.4	12.2	12.2	14.5
FTSE Small x Inv_Tsts	2.5	1.4	12.6	15.7
CAC	2.2	15.2	13.3	15.2
DAX	2.3	12.7	12.9	13.7
Dow	1.9	16.9	17.7	16.7
S&P 500	1.4	21.5	19.4	18.0
Nasdaq	0.7	24.3	27.3	23.7
Nikkei	1.8	14.6	16.2	17.8
MSCI World	1.9	17.8	17.3	16.9
CSI 300	1.8	15.6	13.6	12.7
MSCI EM	2.7	11.6	11.7	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.44	+0.06
UK 15-Yr	1.64	+0.10
US 10-Yr	1.96	+0.03
French 10-Yr	0.69	+0.00
German 10-Yr	0.21	+0.02
Japanese 10-Yr	0.21	-0.01

UK Mortgage Rates

Mortgage Rates	Jan	Dec
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.56	1.53
3-yr Fixed Rate	1.53	1.52
5-yr Fixed Rate	1.59	1.54
10-yr Fixed Rate	2.49	2.51
Standard Variable	3.63	3.62

* 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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28th February 2022

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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