THE **CAMBRIDGE** WEEKLY

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Lothar Mentel

Lead Investment Adviser to Cambridge

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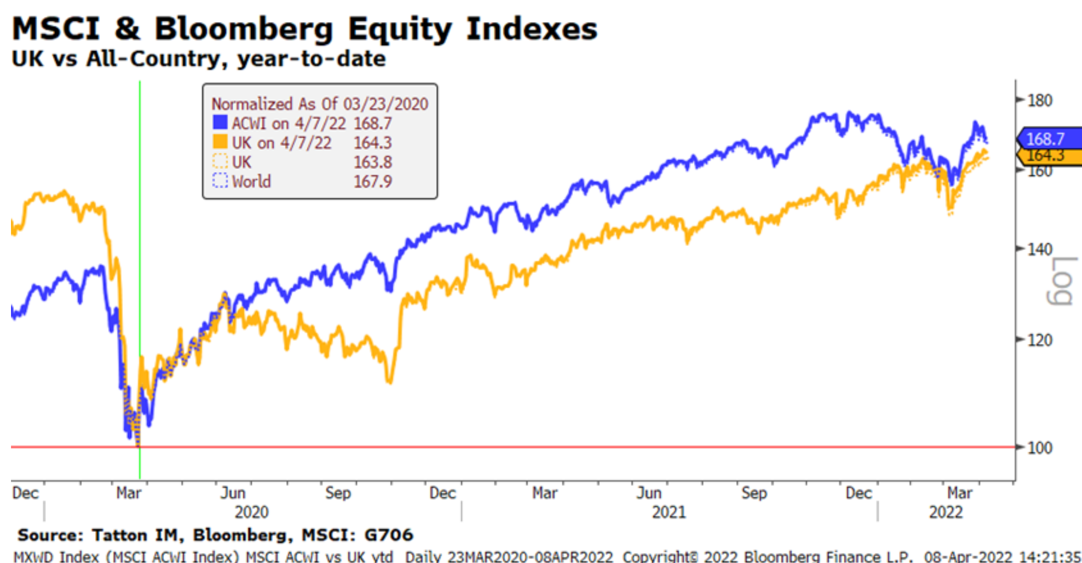
Q2 begins with QT top of the agenda

Are we entering a period of global equity market consolidation? The chart below shows global equity and UK equity total return indices from the onset of the pandemic to now.



In aggregate, global markets have managed a decent enough bounce since the onset of Vladimir Putin's invasion of Ukraine. Indeed, the awfulness of the news from the area has ceased to impact markets greatly. We have returned to worrying about the resurgence of COVID-19 in China, along with its impacts on the global supply chain and on overall global growth and worrying about the US Federal Reserve (Fed) and its plans for tightening US monetary policy.

Indeed, more than a month after the onset of hostilities, the 'hard' economic data has been on the positive side of expectations. Although confidence measures have taken a hit, mostly because of fears about inflation impacts, spending remains robust. March data showed the biggest monthly rise in US unsecured consumer credit, up a startling 11.3%. Meanwhile, there appears to be little impact on jobs. As long as this continues, company nominal earnings growth should remain positive. Looking at the track of analyst expectations into the Q1 reporting season, we note that margins were pulled back a bit, but revenue growth is expected to be robust. Thus, overall earnings expectations continue to be revised up marginally. Europe is faring less well, as one might expect, but has more pessimism built in.

When earnings rise, markets generally have a good time. However, valuations are under pressure because of a sharp rise in global government bond yields. The Fed and other central banks have been telling us for some time that we should expect rate rises and so the bond market has factored this into their valuations. We have an article below which looks at some of the aspects of yield levels.

Last week however, the Fed signalled how it intends to reduce its balance sheet. In the minutes of its most recent meeting, quantitative tightening (QT) was much talked about. The Fed plans to run down its $9 trillion balance by around $95 billion per month.

At the same time, little consensus has emerged about the impact of QT on financial markets. The announcement effect is generally seen as less powerful than when a splurge of liquidity is in the coming in the form of quantitative easing (QE), when the Fed buys debt in the market. At the same time, ten-year government bond yields have certainly been rising over the past couple of months, but it is unclear whether this is on the back of expected higher policy interest rates or QT.

There are a couple of stylised statements we can make, though. QT is hardly going to be a positive for financial asset prices. Of course, other positive factors, such as earnings momentum, can still mean that overall, financial markets stay in a positive mode. Nevertheless, in a cyclical set-up, QT will likely oscillate between being a neutral to negative factor. The longer QT lasts, the more liquidity gets drained from the financial system, and the more likely this is going to be negative. Structurally, some may even argue QT is needed to connect financial assets more with their fundamentals.

Other observers point to the flow effect of QT. The Fed will not be buying up debt anymore, therefore not only is the marginal buyer absent in the form of a price finding mechanism, but no new liquidity is being created to keep the system running smoothly. Here, matters (unfortunately) become a bit complicated in the current QT episode in the US. So much liquidity has been created, such that the Fed had to mop it up in form of reverse repos since last summer. It is parked in reverse repos, which in aggregate are worth close to $2 trillion.

So, there is the possibility that as the Fed shrink its balance sheet, the actual withdrawal of liquidity gets buffered by current excess liquidity being released back into the market. Much will depend on how the Fed sets interest rates on various deposit schemes that current market participants have with the Fed. We expect that more insight will arrive in May, when the Fed is expected to formally announce QT.

Meanwhile, the competing currents of earnings and interest rates are probably behind the apparent consolidation of global equity markets.

Although the FTSE 100 is yet to achieve the highest price of 7903.5 seen on 25 May 2018, the total return index (which includes the effect of reinvesting net dividends) went past that level decisively at the start of last October. Global equity indices (best represented by both the MSCI All-Country Index and the Bloomberg World Index), have outperformed the UK over that period, by about 30%, and by about 37% since the Brexit referendum. However, from the low point when the pandemic dragged equity markets to their nadir of February 2020, the UK's underperformance is now less than 3%.

Since the start of this year, rising metal and energy prices have benefitted UK stock prices substantially. With Shell, BP, Glencore, Rio Tinto and Anglo-American all in the top 10 of market capitalisation, the UK market has more in common with some emerging markets than the US and Europe. We write about winners and losers in the emerging markets in another article below.

However, last month, the commodity-related sectors trod water, while AstraZeneca stormed ahead after its results showed substantial research and development (R&D) success. It now tops the market cap list, with a weight in the index of 8.25%, just ahead of the combined Shell stocks. Concentration in the larger caps continues, with 50% of the index now in 11 stocks, down from 13 in 2018.

One aspect of the UK's performance is a sense that its most representative index has little to do with the domestic economy. Of the top 11 companies, none have substantial revenue exposure to the UK. The first and most UK-exposed is Lloyds Bank (15th with a 1.6% weight).

This past weekend saw the first vote in the French election. Le Pen has been making notable gains at the expense of Macron on the issue of inflation which, rather than Ukraine and any looming security threat, is the dominant issue on voters' minds. A narrowing of polls suggests the probability of Le Pen winning in the second-round run-off on 24 April could be as high as 20%. Macron is still likely to prevail, but this election is closer than previously envisaged.

There is an outside possibility of renewed EU fragmentation risks, which could put the ECB in a difficult position. However, even if Macron does prevail, there may be a building division within the European Central Bank Governing Council. The consensus which built after the eurozone crisis may be falling apart, and that could cause bond yields to head higher, especially for the periphery nations.

Behind the Curve

You may have heard about the shape of the US yield curve over the last couple of weeks. This is nothing more than a plot of the fixed term yields on government bonds at different maturities, and yet it is probably one of the most viewed graphs in the financial industry. In the past, an inversion of the curve – where short-term bond yields go above long-term yields – has been an astoundingly accurate predictor of economic downturns. Recently, the yield on ten-year US Treasuries sunk lower than the yield on two-year coupons. Every time that has happened in the post-war period, a recession occurred in the next 15-24 months.

That such a closely-watched warning signal has started flashing is understandably making investors nervous. Before we get into what it means though, some background would help. In large, developed economies, fixed income government debt is usually considered the 'risk-free' rate. As such, yields should – at least theoretically – reflect the market's best estimate of growth, inflation and central bank policy.

If investors expect a healthy economic expansion, the demanded level of future returns will be higher, and so the curve will slope upwards. If the curve slopes downwards, this means the medium or long-term economic outlook is worse than right now; that the economy is expected to grow less. The curve is not just a signal of confidence either. It also affects banks' ability to lend, as a positive difference between long-term lending rates and short-term deposit rates makes it easier to generate profit.

The reason it has now turned negative is once again the interplay between growth, inflation expectations and central bank policy. Runaway inflation in the developed world has forced central banks to dramatically tighten monetary policy – the Fed chief among them. Meanwhile, the supply shock and ensuing cost-of-living squeeze has brought down growth expectations.

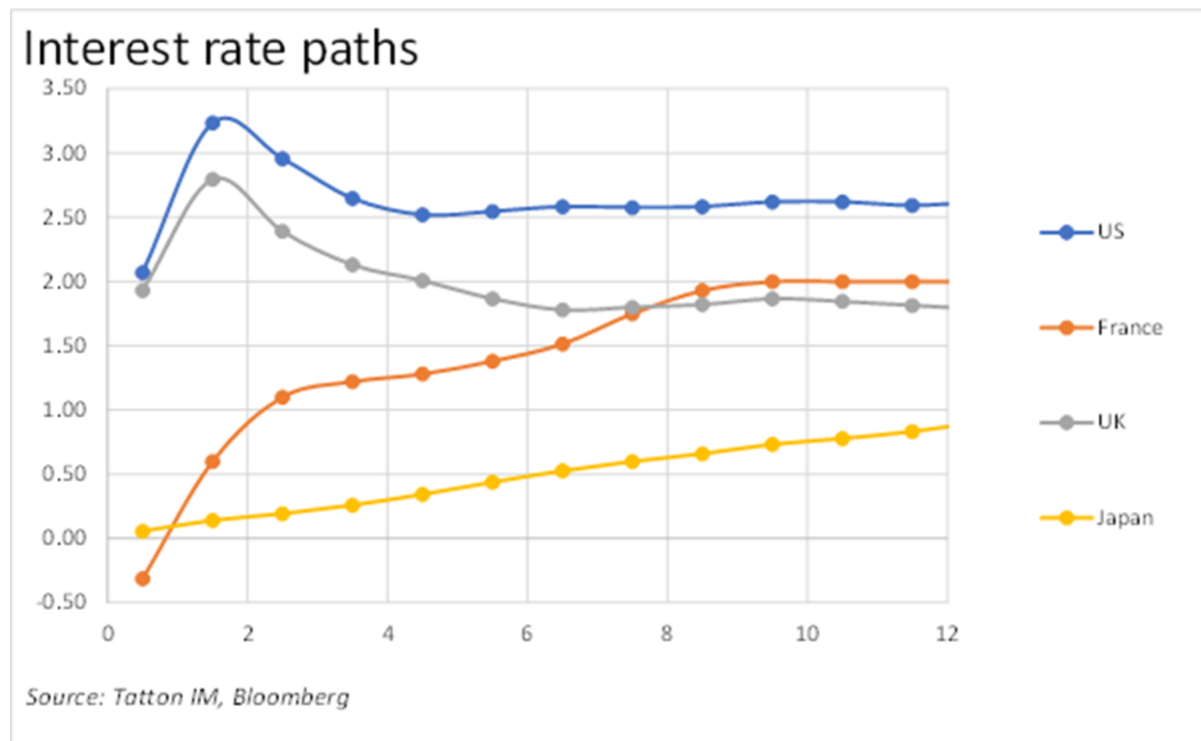
Last week saw the release of the minutes from the Fed's March meeting. They showed officials were finalising plans to reduce the bank's $9 trillion balance sheet by shedding bonds – a process that could start as early as May. The Fed will allow "run-off", whereby it stops reinvesting proceeds from maturing bonds,

to take billions off its balance sheet in the coming months; the pace mentioned in the minutes was of $95 billion per month ($60 billion in treasuries and $35 billion in mortgage-backed securities), which possibly would be phased in in the beginning.

That news increased ten-year yields modestly to 2.61%, but the Fed also revealed it was open to a more aggressive schedule for rate rises. Fed officials said high inflation could force it to push up rates by half a percentage point more than once this year – a sentiment echoed by incoming vice-chair Lael Brainard last week. As many commentators have pointed out this year, the Fed's rapid tightening path seems to be a recognition that monetary policy was "behind the curve" in terms of controlling inflation – which now requires a hefty readjustment.

In terms of the yield curve itself, although it is a surprisingly accurate indicator, it is not flawless and much less does it suggest a recession is imminent. On the contrary, a negative difference between ten and two-year Treasuries preceded almost every post-war US recession by at least 15 months. The only shorter timespan was between the 2019 inversion and the pandemic – a global recession which came from an unprecedented external shock.

Yield curves can be very informative, but in the short-term the more useful takeaway is what it says about expected interest rates. That is, the yield curve can tell us what monetary policy changes have been priced-in by the market. The chart below shows the expected interest rate paths of the US, UK, Eurozone and Japan, based on their current yield curves. (Note that this is *not* the same thing as the yield curves themselves).



The point of looking at these is not to give correct predictions about future interest rates – an impossible task beyond a few years. Instead, this indicates what investors think the 'neutral' interest rate will be over the long term – the one that allows for steady expansion. We can do a similar thing for real (inflation-

adjusted) yields, which incorporates market predictions about inflation. On that front, the US is the only major region expected to have positive real interest rates over the next few years. On that basis, it seems investors expect inflation to come under control quite quickly, after which we should see a return to the pre-pandemic economic environment. This matches economist expectations, which sees inflation settling around or below 3% in most developed economies by the end of next year.

This tells us that markets expect the Fed to raise rates hard and fast, and that this will succeed in bringing down inflation. Investors see the Fed increasing its policy rate to more than 3% next year, after which inflation will settle between 2-2.5%. That gives the Fed an all-important role in the global inflation fight – no other central bank is seen as needing to achieve a positive real rate of return on cash to control prices.

The implication is that the Fed will need to engineer a slowdown in growth by raising rates above short-term growth. The current debate is whether the Fed can engineer an economic soft landing, or whether its efforts to bring down inflation also causes a recession. But beyond those cyclical considerations, longer-dated rate expectations have been relatively stable lately – at least when considering the disruption such a policy reversal could have caused. Although bond markets have had a tough time this year, things would have been much tougher if they thought the Fed was not in control.

In that case, long-term rate expectations would be much more volatile, and investors would have to increase their risk premium – potentially destabilising the financial system. While this has not happened yet, it certainly could. It is worth noting that longer-term real rate expectations are extremely low by historical standards, presumably because markets expect central banks to be structurally more dovish than before the pandemic. If that changes, bond markets could have a very hard time. For now, the yield curve tells us that the Fed will bring down growth and inflation – with less reflection on structural shifts in the global growth and inflation trade-off.

Enigmatic emerging markets give investors plenty to think about

After a sharp recovery last month, Russia's rouble is no longer the world's worst performing currency this year. Far from it, in fact, having erased virtually all of the losses sustained since the invasion of Ukraine. The 'worst in class' moniker now goes to the Sri Lankan rupee, which has sunk an incredible 32% since the start of the year. Most astonishingly, the collapse has come entirely in the last month, after more than a year of stability in exchange markets.

In the dense media fog of war, Sri Lanka's torrid 2022 might have slipped under the radar. This is not for a lack of urgency or severity. Sri Lanka is facing its worst economic crisis since its independence in 1948. A fall in tourism revenue caused by the pandemic, a large foreign debt pile and an inability to service it with foreign capital has led to a financial and economic crisis. Some analysts say the government's plunge into chaos last week was caused by its mismanagement of these issues.

After announcing a national emergency two weeks ago, President Gotabaya Rajapaksa lifted the measures on Tuesday. This came after his entire cabinet – except for his older brother, the prime minister – resigned. The resignations included the finance minister that Rajapaksa had appointed only a day earlier.

Facing runaway inflation and shortages of food, power and medicine, Sri Lanka is looking to the International Monetary Fund (IMF) to stave off default and further disaster. Whether it can get more funding is doubtful.

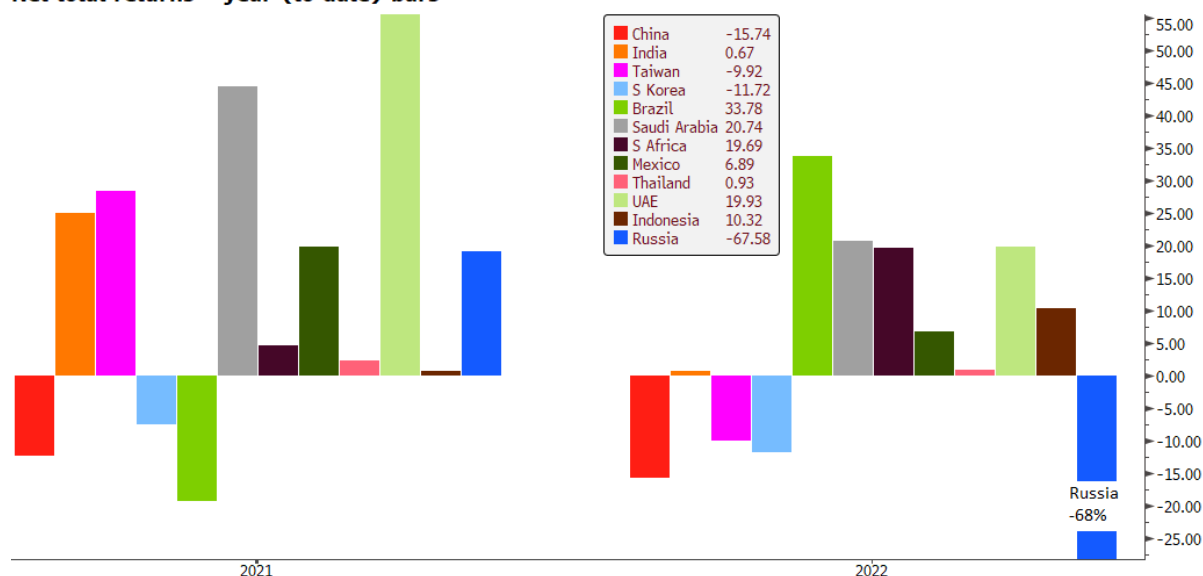
Moreover, if Sri Lanka does default on its large sovereign debt pile this year, it will likely not be the only emerging market to do so. Despite the recent improvements in the rouble, the growing list of sanctions on Russia push the country ever closer to default.

On Monday, the US Treasury said it would no longer allow Russia to make dollar payments on its debt through American banks. President Biden talked up the effects of the new sanctions, saying they would cause the Russian economy to "crumble". Such pronouncements from Washington are to be expected, but there is no doubt Russia will find it increasingly hard to meet debt payments on dollar-denominated bonds.

There is some debate about what constitutes a default in debt markets (for example, the 1998 Russian default was technically only on domestic debt, with a moratorium on foreign debt) and these distinctions are important for emerging market (EM) investors. But governments missing payments is not good news – whatever you call it. And when risks pile up, it tends to spell trouble for EMs more generally, not just in bond markets, but for equities too.

This is not so much because of direct financial contagion, but rather the effects on investor confidence and the wider global system. EM investors can be easily startled – particularly in the current environment. With high input costs, slowing global growth and a hawkish Fed, EMs face a challenging backdrop.

Some are rising to the challenge, however. Despite the above difficulties, Latin American (LatAM) equities have made considerable gains this year. The MSCI Latin American Index is up around 25% year-to-date at the time of writing, having finally recovered the dramatic losses seen through the pandemic. This performance is particularly impressive when you consider the sour mood in markets elsewhere. The S&P 500 has sunk 6.6% so far this year, while the MSCI world is down 6.9%.



Commodity price rises are a big part of this outperformance. Brazil is one of the world's largest producers of oil, iron and soya beans, while other EM nations produce more than their fair share of hard and soft commodities. The disruption caused by Russia's invasion of Ukraine – from oil and gas sanctions to Ukraine's mining and agriculture – has boosted demand for LatAm goods. But not all LatAm countries are commodity exporters, and even Chile and Peru – big oil importers – have fared well this year.

The positivity around EMs also has a lot to do with its constituents' relative position in the global economic cycle. While a tight Fed is usually a negative for EMs, central bankers in many of these countries are much further along their tightening cycle, having raised interest rates substantially last year. And with EM currencies underperforming so much in 2021, there is likely to be some relief ahead, even with the Fed on a hiking path.

These factors are a good reminder of how diverse EMs can be. Compare, for example, the positivity around LatAm with the prospects for EM Asia. Last year, Asian inflation was considerably lower than in LatAm countries, causing a divergence of central bank policy. But now with China's growth prospects dimming, and commodity exporters reaping the benefit, LatAm assets have caught up and are arguably in a better position.

This is not to say things are all rosy for the region, let alone for EMs more generally. Unfortunately, improving economic conditions have not been used to bolster governments' balance sheets – meaning there are still significant debt piles. Dollar-denominated debts can be particularly troublesome for EMs when financial conditions are tightening like they are now. In general, slower global growth will always present a big risk to EMs – meaning they will likely be vulnerable if we see a global recession.

Much depends on the general outlook for global growth. If you think the world will muddle through this slowdown relatively unscathed, EMs – particularly LatAm – are well placed. If not, they are at risk. But in any case, it all depends which regions you look at. As the crises in Russia and now Sri Lanka show, things can go horribly wrong. But as the outperformance of LatAm shows, a few bad apples do not always spoil the barrel.

CAMBRIDGE
INVESTMENTS LIMITED

11th April 2022

Global Equity Markets

Market	Fri 15:52	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7062	+1.4	+98	→	↗
FTSE 250	23639	-0.1	-20	↘	↗
FTSE AS	4068	+1.1	+45	↘	↗
FTSE Small	7544	+0.5	+37	↘	↗
CAC	6640	+1.1	+70	↘	↗
DAX	15526	+0.2	+36	↘	↗
Dow	34760	+0.5	+176	↘	↗
S&P 500	4445	+0.3	+12	↘	↗
Nasdaq	14985	-0.4	-59	↘	↗
Nikkei	30249	-0.9	-263	↘	↗
MSCI World	3106	+0.3	+10	↘	↗
CSI 300	4849	-0.4	-18	↘	→
MSCI EM	1273	-0.5	-7	↘	→

Top 5 Gainers

Company	%
Rolls-Royce	+20.8
Int'l Consol Air	+17.4
Entain	+13.3
AstraZeneca	+10.4
Royal Dutch Shell	+5.8

Top 5 Decliners

Company	%
Just Eat Takeaway.com N	-8.4
Kingfisher	-8.0
DS Smith	-4.9
National Grid	-4.8
Schroders	-4.6

Currencies

Pair	last	%1W
USD/GBP	1.367	-0.5
GBP/EUR	0.857	-0.4
USD/EUR	1.17	-0.1
JPY/USD	110.68	-0.7
CNY/USD	6.47	+0.0
Bitcoin/$	42,407	-10.9

Commodities

Cmdty	last	%1W
Oil	77.68	+3.1
Gold	1751.4	-0.2
Silver	22.42	+0.1
Copper	423.8	-0.2
Aluminium	2949.5	+2.4
Soft Cmdties	226.9	+2.2

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	15.5	12.5	14.2
FTSE 250	2.3	16.3	25.2	15.9
FTSE AS	3.7	15.4	13.6	14.3
FTSE Small x Inv_Tsts	1.9	13.3	19.1	15.4
CAC	2.2	21.2	16.0	14.9
DAX	2.1	15.6	15.3	13.5
Dow	1.8	19.5	18.8	16.4
S&P 500	1.3	25.2	22.0	17.6
Nasdaq	0.6	30.6	33.0	22.9
Nikkei	1.4	16.2	18.1	17.7
MSCI World	1.7	21.9	20.0	16.6
CSI 300	1.9	15.9	15.2	12.5
MSCI EM	2.4	14.0	13.3	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.93	+0.08
UK 15-Yr	1.13	+0.09
US 10-Yr	1.45	+0.09
French 10-Yr	0.11	+0.07
German 10-Yr	-0.23	+0.05
Japanese 10-Yr	0.06	+0.01

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.30	1.37
3-yr Fixed Rate	1.52	1.60
5-yr Fixed Rate	1.48	1.56
10-yr Fixed Rate	2.60	2.60
Standard Variable	3.61	3.61

* 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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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.

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Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE