CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

16 May 2022

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Bear market fear as another tech bubble deflates

To some investors it will seem the old investor adage of 'Sell in May and go away' has once again proven correct, especially when the US S&P500 fell within touching distance of that bear market threshold of -20% last week. However, what makes this particular market correction different to others experienced since the pandemic, is that it has disproportionally affected those risk assets considered safe havens when economic growth prospects faltered – namely US tech mega caps, and other tech names quoted on the NASDAQ.

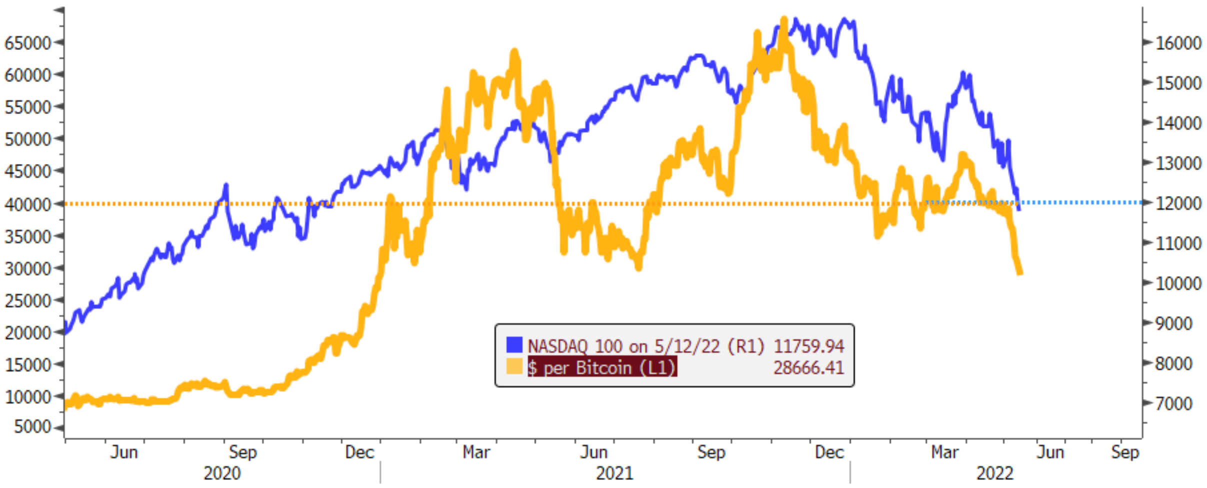
For such a long time, the prospect of a weak economic growth environment would mean buying large-cap US tech, because their secular growth potential (not dependent on general economic growth) would overwhelm any concern over falling earnings in near-term cycles. However, it seems the early post-COVID period has changed this dynamic. During lockdowns, cash flooded into the hands of small investors (especially in the US) who, stuck at home, spent their time trading stocks. They picked what they perceived as promising, and thereby created their own winners. That meant tech stocks, and a number of cryptocurrencies, including Bitcoin, Ethereum and Dogecoin.

Now, with the end of government funded payments, and the arrival of inflation triggering the cost-of-living crisis, excess cash from wages has turned into a deficit, while the cost of borrowing has gone up. Perhaps unsurprisingly, the value of those assets has been heading back towards their cost.

As a simple exercise we looked at the NASDAQ 100 index and Bitcoin. If an investor bought the equity index and Bitcoin in an equal amount every day from May 2020 to April 2021, their average cost across all purchases would be around an index level of 12,000 for the NASDAQ 100, and a Bitcoin valuation of $40,000.

NASDAQ 100 and Bitcoin

Dotted lines show average cost for investing a year ago



Source: Tatton IM, Bloomberg: G856

NDX Index (NASDAQ 100 Stock Index) NASDAQ comp Bitcoin Daily 10FEB2020-12MAY2022 Copyright© 2022 Bloomberg Finance L.P. 12-May-2022 19:05:04

As the chart above illustrates (with Bitcoin levels on the left-hand axis and the NASDAQ 100 level on the right), last week both instruments moved below those prices, which coincided with a sharp acceleration in downward pressure on both. Cryptocurrency holders suffered a particularly rude awakening last week, as the sharp falls shattered dreams of making a living, or even getting rich, from their trading activity. We look at how confidence in the world of cryptocurrency 'tokens' and 'stablecoins' was shaken last week in a separate article.

Through the reporting season for Q1 2022, several of the mega-cap tech firms have been telling investors that the change in the economic backdrop means that – due to their size and variable revenue base – they are no longer confident of their ability to simply outgrow such headwinds. For example, Netflix was hit a couple of weeks ago, as subscribers cancelled subscriptions to unburden household budgets to pay for more essential goods. Last week, ride-hailing app Uber told investors they too would be cutting costs. This seems significant; Uber's incremental cost base is now subject to the same inflation pressures as elsewhere.

Liquidity, or the perception of financial comfort (perhaps in the form of unrealised profits for some), may be drying up. We should therefore expect the travails of the US stock market to have quite an impact on consumer confidence, and ultimately in their willingness to spend. Given how rapid this has unfolded over the past few weeks, the US Federal Reserve (Fed) may feel that its tightening of monetary policy is at last having the desired disinflationary impact, by reining in gushing demand.

These dynamics have already manifested themselves in the bond market, which are indicating that inflation expectations have slipped back. We observe this from real returns on bonds (yields after inflation expectations) having remained broadly stable, while fixed rate yields have moved sharply down. That probably signals good economic news in the longer-term, and also good news for risk asset markets which, after the recent declines, no longer look overvalued, as their earnings yields have risen relative to bond yields.

At the beginning of April, when markets recovered from the shock of the invasion of Ukraine, we said markets felt priced for perfection. Now they appear priced and braced for the onset of a global recession. Those recession fears centre largely on the input price inflation from energy and food supply constraints, that are expected to force central banks to increase rates further, thereby choking off the post-pandemic economic recovery. In other words, market sentiment has likely slipped from one extreme to the other.

Yes, inflation readings are high, but they are no longer increasing. High energy prices are also having the effect of bringing idle production capacity of oil exporting countries back online. Only last week, volume figures from Iraq showed far higher export levels than OPEC's caps would have us expect. The 'invisible hand' of markets and economies is doing its job. More crucially, if current market pessimism stems from the cost-of-living crisis caused by the energy price shock, by autumn this concern may well be confined to those parts of Western Europe particularly dependent on Russian gas.

Of course, we have written before about China's difficulties in handling its COVID policies of late. Not only has it lowered Chinese consumer demand, but also productive capacity, which might bring supply issues back to the forefront. While uncertainties persist, it appears China is coming back online quicker than anticipated and, having been reluctant to offer Western-style economic support during the main pandemic period, China at last appears willing to embrace a much looser and accommodative policy stance.

This leaves the fallout from the bursting of the latest tech (and crypto) bubble to contend with. Those who remember the aftermath of the dot-com bubble in 2000, will know consumer demand dropped enough to cause a recession. There is some risk of this, although history has a tendency to rhyme rather than repeat. We entered this period with a surplus of savings and a surge in activity, as people were keen to return to normal spending habits they had to resist during the pandemic years. Should the setback in the tech and crypto markets subdue consumer demand, and also take the heat out of central bank rhetoric, then we may have reached a notable turning point for a decline in 2022's bond market headwinds.

All in all, the various economic data points of the week suggest there is some cause for optimism that the 'bear scare' may be running out of fuel. Not only have market valuations reached more 'normal' levels, but company valuations are also returning to more normal metrics based on facts and figures, rather than merely hopes, beliefs and self-enforcing herd mentalities.

The crypto fever breaks

A new technology excited the masses. Investors were stirred to action by the endless possibilities – and the fear of missing out on them. After the initial trailblazers soared, newer offerings sprung up every day and rapidly grew in price. But eventually, investors started to question what they were really buying into. What were the great promises of change and disruption based on? Fear spread that the answer was nothing at all – a mixture of impenetrable jargon and bravado, that somehow managed to build multi-million-dollar enterprises on sand. Panic ensued and markets crashed – and not just those involved in the new tech. The fallout threatened the wider economy and stripped a fledgling industry to its bones.

In case you are wondering, the above is a description of the dot-com bubble of the early 2000s. Speculation into poorly understood internet stocks pushed valuations beyond any reasonable assessment, and the correction bit hard. One could argue the same thing is happening now with cryptocurrencies, where a vicious bear market has knocked trillions of dollars from the value of the biggest digital coins. Indeed, this is the view of Brock Pierce, Chairman of the Bitcoin Foundation: "I think we are exactly where the tech industry was in 1999, 2000".

Bitcoin, the flag-bearer for cryptos, tumbled below $30,000 during midweek trading – its lowest value since last July. At the time of writing, it still sits just under that mark, meaning its value has fallen more than 50% since the peak last November. Bitcoin is far from the worst hit either. Ethereum has had a similar fate, while Dogecoin – a favourite of Elon Musk that began life as an internet meme – is teetering closer to total collapse (and was well off its peak before the current sell-off).

In fact, Bitcoin has fared comparatively better than its peers. According to the Financial Times' Wilshire gauge, the top five digital coins excluding bitcoin have fallen by more than 70% from November's market high, in what commentators and investors are calling the "crypto winter".

The exuberance that sent crypto prices skyward over the last few years is reminiscent of most asset bubbles throughout history. But just like with the dot-com bust 20 years ago, the catalyst for was a shift in policy. Central banks have flagged aggressively tighter monetary policy this year – the Fed chief among them. The bond sell-off this provoked led to a market-wide revaluation of risk assets. Although crypto promoters have branded their digital tokens as a hedge against inflation the boom/bust pattern they have followed suggest they currently trade closer to classic risk assets – or at worst as purely speculative ones.

Crypto sell-offs have happened before, and there is certainly no reason to think this is the end for the wider market. Nevertheless, this episode carries the hallmarks of a burst bubble – first in its wider effects on the financial system, and second in its potential to cause a deep rethink in the underlying market. One of the more worrying chills brought by the crypto winter is the fate of many so-called 'stablecoins'. These are designed to function differently from pure cryptocurrencies, in that their value is backed by more tangible assets to ensure lower volatility. Their main purpose is as a bridge between cryptos and more traditional currencies or assets – offering a safe place for traders to store cash between often-volatile digital transactions.

The stablecoin market made headlines last week after TerraUSD, an algorithm-based coin, unpegged from the dollar and fell as low as $0.30. This stablecoin has no tangible assets in the background, but created its own reserve currency called Luna. The bigger news came when Tether, a stablecoin used as a reference for swathes of the crypto market, fell below its peg value to just over $0.95. Unlike Terra, Tether claims to be backed by a basket of dollar-denominated assets, including a $40 billion war chest of US Treasury bonds. Executives at the company promised to defend the dollar peg at all costs, but declined to reveal the details of its asset pile – calling it the stablecoin's "secret sauce".

Much like short-term money markets or interbank lending, stablecoins keep the system running for cryptos. The fact that such high-profile names are faltering is therefore a worrying sign. It suggests that the fallout from the crypto winter could be much wider than just those who hold digital currencies. Last year, ratings agency Fitch warned that a run on stablecoins like Tether could destabilise short-term credit markets – as the company would be forced to sell its bonds into an already choppy market.

Many investors have already noticed an eerily close correlation between cryptocurrencies and the price of technology stocks, a pattern which has become more apparent this year. The tech-heavy Nasdaq index has sunk nearly 30% in 2022, largely in step with Bitcoin and other popular cryptos. A synchronised dive is perhaps understandable, given that both asset types are popular with retail investors, and are both susceptible to a rising interest rate environment. But it is significant when you consider how different attitudes were just a year ago. Then, cryptos were billed as the future of trade and a protection against inflation, while big tech was seen as a safe haven from faltering growth prospects. When push came to shove and the Fed got serious about fighting inflation, these notions changed rapidly.

We should end with perhaps a more optimistic comparison between crypto and the dot-com bubble. When the Nasdaq crashed in 2000, a massive amount of (paper) wealth was wiped out and many companies folded. But those that were left went on to become some of the most valuable in history. Once the phantoms cleared out of the market, Amazon, Google and their ilk had space to achieve the disruption that so many promised in the 1990s.

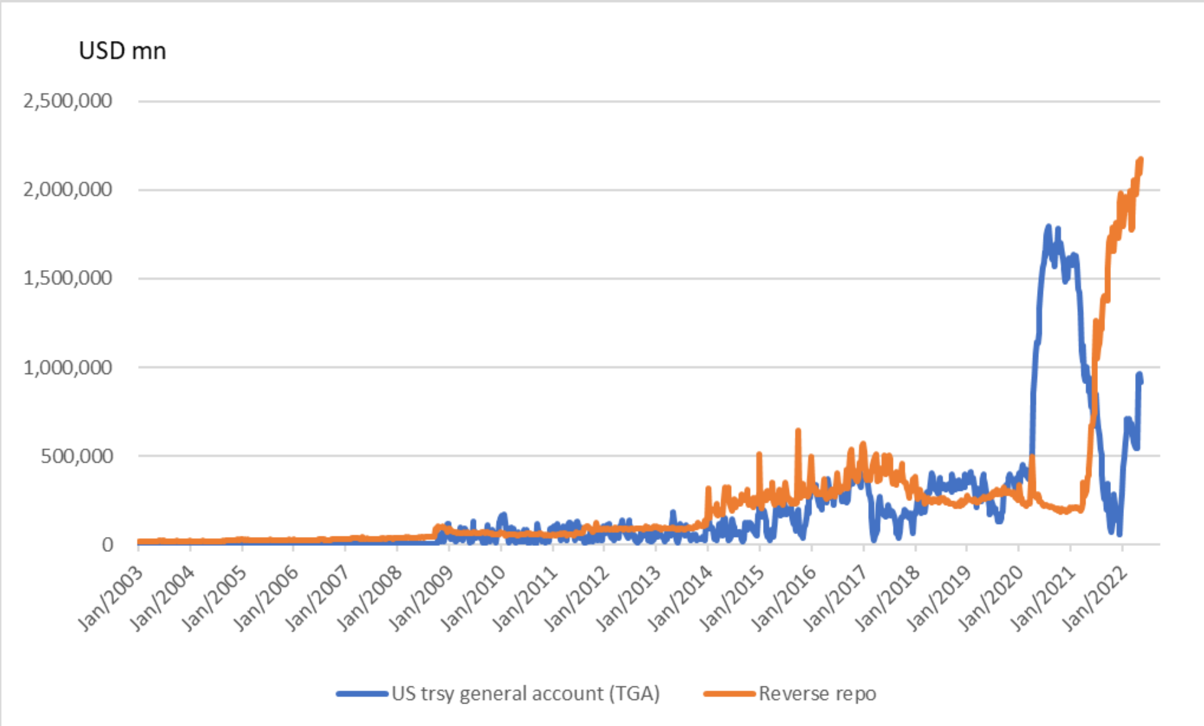
There is no doubt that the blockchain technology underlying cryptocurrencies could be genuinely transformative for the world. The problem up to now has been that the space is too crowded with false promises to reliably assess their prospects. There is obviously no guarantee that bitcoin or Ethereum will be the next Amazon, but they have a much better chance of getting there if there is a stable market around them. With any luck, that might be the spring that blooms from crypto's winter.

As QT unwinds QE – how worried should investors be?

We have noticed an astounding trend in the Fed's liquidity management recently. Now ready to embark on a full quantitative tightening (QT) mode, cuts to the balance sheet have been high on the agenda. But less well-reported are the reverse repurchase agreements (repos) that the Fed has been using since last summer to take liquidity out of markets. Reverse Repos held with the Fed – whereby it sells an asset under an agreement to buy it back after a short period of time – reached an all-time high in April. Total reverse repos are now well over $2 trillion (see chart below), while formal QT at $60 billion/month is only starting later this month. This trend has been building for around a year, but as the chart below confirms, it has marked a sudden and significant uptick from historical policy.

The Fed's massive bond purchases started flooding markets with cash in early 2020, highlighted by the huge build up in the US Treasury General Account (TGA) shown by the blue line in the chart. The problem is down to where the Fed's cash injections end up. When the Fed buys securities, these are written down on its balance sheet as assets. The question is where the cash generated by these transactions ends up on the liabilities side. It can often land with the government, thereby ending up in the TGA.

Source: Bloomberg, TattonIM, 12 May 2022



When the Fed conducts QE, the most 'natural' place for the cash to end up is in private sector banks' reserves with the Central Bank. A lot sits there currently, too. Especially in the beginning of QE, this measure shot up. Meaning there was more money in circulation (as banks could then use more of their other funds for lending or investment, or it reflected that asset holders had sold their US Treasuries to the Fed and then had cash available for different investments). This gave a significant (albeit sometimes choppy) upside to capital markets – and the economy at large – through lower cost of financing. But this money circulation peaked around the end of last year, and has fallen more recently. Indeed, QE cash injections were so high it created a problem of 'excess liquidity' –more money in circulation than the system could deal with. Excess liquidity is particularly problematic for short-term money markets, as occurred last year, when a reduction in the TGA created an oversupply of cash elsewhere, pushing down private sector money market rates close to 0%.

If this had continued (or indeed, if money market rates had turned negative), it would have destroyed any incentive to keep cash parked in those funds. Moreover, given money market funds are a crucial source of capital for the wider system, this could have resulted in huge instability.

Liquidity is a bit like engine fuel in this respect: injecting more will usually make things run quicker, but too much can cause overflow and clog the machine. Reverse repos are a way for the Fed to drain money and prevent such clogs. Reverse repos influence how much money is in free circulation, as money market funds – and not just banks – can make deposits here too. They involve private institutions temporarily returning cash to the Fed and getting a guaranteed return – the reverse repo rate. When the reverse repo rate is higher than other market rates, such as the Treasury bill rate (which is currently the case), private players are more likely to engage in repo agreements.

Last year's money market episode forced the Fed to increase its reverse repo rates – essentially offering higher returns for institutions parking their funds with the central bank. This was a way of draining the excess liquidity that the central bank had itself created – a sterilisation of its own QE programme.

As an aside, readers might wonder why the Fed has to go through this convoluted process at all. This is down to the prevalence of money markets in the US, which are a systemic feature and therefore need to be adjusted to keep things running smoothly. This is not the case in Europe, meaning negative short-term rates are less of an immediate threat to stability (though that causes its own problems).

Since that episode, the Fed has increased its reverse repo rates in lockstep with its benchmark interest rate. The current reverse repo rate is 0.8%, well above the return on a one-month Treasury bill (0.5%). This is basically a guaranteed return with zero risk, giving money market funds a huge incentive to park their cash with the Fed, rather than investing it in short-term government debt.

It is no surprise then, that reverse repo operations have increased recently. Currently, this amounts to a quarter of the Fed's outright security holdings, a huge figure which amounts to a significant tightening of financial conditions. The higher return with no risk is hard to ignore, but the fact so much has poured into reverse repo markets could also suggest markets are feeling risk averse.

Currently, the relative disincentive to buy short-term government debt is not a major problem for the US Treasury, due to its reduced financing needs in this post-COVID environment. That could well change when the US government has to refinance at higher rates though – bearing in mind that the current market yield is not equivalent to the effective rate paid by the Treasury on all of its outstanding debt. We have written many times about how important bond market moves are for the wider economy and financial system. So, the potential upheaval becomes more pressing the longer high rates prevail, especially in a cooling economic environment.

As the Fed ploughs ahead with its balance sheet reduction, it has two big choices on reverse repos. Keeping rates high will keep liquidity draining out of markets, and could be a very effective way of tightening financial conditions. On the other hand, it also maintains a level of distortion in money markets – and authorities may be more comfortable with a lower balance.

Lowering the reverse repo rate would be a way to increase liquidity in the market again even while formal QT is happening in parallel. This could be a valuable option later down the line if stress appears in money markets, and could possibly spill over into other asset classes. It would amount to a loosening of financial conditions, which is not something the Fed will want for as long as inflation has not come down. Ultimately, the Fed will have to let the build-up from its reverse repo operations drip feed back into the market if it wants to normalise conditions.

Given the Fed has already removed $2 trillion of liquidity through the reverse repo market, the initial phase of QT (~ USD50bn per month) in terms of direct liquidity impact is likely to be minor. Of course, the Fed will not be seen as a buyer in the treasury market anymore, but that process already started a couple of months ago.

On the other hand it is worth noting, that the Fed's rate rises and hawkish talk since late last year have had a far bigger impact on the wider cost of finance. What's more, the well-stocked reverse repo position should allow the Fed to counterbalance and – at times neutralise – the short-term effect QT may have on the liquidity balance going forward, just as it did the other way around during QE. Investors therefore may end up being far more focused on further rate hikes and Fed guidance around these hikes, then the actual onset of QT in June.

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16th May 2022

Global Equity Markets

Market	Fri 16:04	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7400	+0.2	+12	→	→
FTSE 250	19869	+0.2	+49	↘	↘
FTSE AS	4089	+0.1	+6	→	→
FTSE Small	6587	-1.1	-70	↘	↘
CAC	6340	+1.3	+81	⬂	⬂
DAX	13980	+2.2	+306	⬂	↘
Dow	32204	-2.1	-696	↘	↘
S&P 500	4017	-2.6	-106	↘	↘
Nasdaq	11754	-3.2	-391	↘	↘
Nikkei	26428	-2.1	-576	↘	⬂
MSCI World	2640	-4.4	-122	↘	↘
CSI 300	3989	+2.0	+80	↘	↘
MSCI EM	988	-4.2	-44	↘	↘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Coca-Cola HBC	+13.9	Antofagasta	-8.1
Compass	+8.8	Fresnillo	-7.1
Next	+8.1	Int'l Consol Air	-6.8
Kingfisher	+7.2	Polymetal International	-6.4
Phoenix Holdings	+6.7	Avast	-6.4

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.223	-0.9	Oil	111.09	-1.2
GBP/EUR	0.851	+0.5	Gold	1814.9	-3.7
USD/EUR	1.04	-1.4	Silver	21.01	-6.1
JPY/USD	129.28	+1.0	Copper	409.1	-4.0
CNY/USD	6.79	-1.8	Aluminium	2742.0	-6.0
Bitcoin/$	30,632	-10.5	Soft Cmdties	226.5	-1.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	12.3	10.3	14.3
FTSE 250	3.2	11.3	13.8	16.3
FTSE AS	3.8	9.9	10.6	14.5
FTSE Small x Inv_Tsts	3.1	0.8	9.4	15.3
CAC	2.7	13.8	11.4	15.2
DAX	3.2	12.8	11.7	13.7
Dow	2.0	16.6	16.9	16.8
S&P 500	1.6	19.5	17.6	18.2
Nasdaq	0.8	22.0	24.6	24.0
Nikkei	2.1	15.2	14.6	17.7
MSCI World	2.1	16.0	15.5	17.0
CSI 300	2.0	13.7	12.5	12.7
MSCI EM	2.9	10.1	10.9	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.74	-0.25
UK 15-Yr	2.02	-0.21
US 10-Yr	2.91	-0.22
French 10-Yr	1.47	-0.19
German 10-Yr	0.96	-0.18
Japanese 10-Yr	0.25	+0.00

UK Mortgage Rates

Mortgage Rates	May	Apr
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.35	2.24
3-yr Fixed Rate	2.26	2.15
5-yr Fixed Rate	2.36	2.25
10-yr Fixed Rate	2.68	2.58
Standard Variable	4.10	4.07

* 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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