CAMBRIDGE
INVESTMENTS LIMITED

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Finely balanced

Easter week was a bit mixed for investors – and this was not caused by fears that populist Marine Le Pen closing the gap to incumbent French president Emmanuel Macron may have heralded another major political upset in the 2nd and final round of the presidential elections. Nevertheless, at the top level of diversified multi-asset portfolios, the month of April has experienced a relatively mild downdraft from the heights of the recovery at the end of March. Underneath, however, big moves have taken place and some divergences have opened up.

Surprisingly positive corporate sentiment data across Europe last week indicated that consumer demand may not be as significantly impacted by the war in Ukraine as markets had been pricing in. On the other hand, there are signs in the US and the UK that consumers are feeling rather more pressure on their household budgets from rising energy and housing prices than anticipated.

The remarkable moves of the past fortnight have been in the bond markets, where government bonds have sold off to such an extent that real yields (after inflation) of longer maturity bonds are finally at the brink of turning positive. That markets are nevertheless down for the month, tells us that competing views remain in a fine balance. Rising yields have made market valuations relatively more expensive, but last week's activity appeared to focus more on a stagnating sales growth outlook, albeit with not much expectation that an economic slowdown will result in a prolonged recessionary episode. We discuss the two sides of the balance in the next article.

In more fundamental developments last week, we noted that the G20 finance ministers and central bank chiefs in Washington failed to issue a joint communique. US Treasury Secretary, Janet Yellen, also led a partial walkout from a session that featured Russian officials, in protest over their inclusion, given Moscow's invasion of Ukraine. In the current feverish geopolitical climate, the failure may be unsurprising, but it is still significant.

The Group of 20 first met in December 1999, to bring the biggest developed and emerging markets into a single forum to address key global challenges. It was a response to the debt-fuelled capital flight crises of the 1990s; 1994-5 Mexico, 1997 Asia, and 1998 Russia. The last (near) default of Russia triggered the collapse of Long-Term Capital Management in the autumn of 1998, which very nearly caused a global financial crisis. A globalising world meant the tighter G7, and the looser Bretton Woods system could no longer be enough to maintain stability.

Former US Treasury Secretary Larry Summers was in the Clinton administration throughout many of those 90s-era crises, and is now a Harvard University professor. Before the Washington meeting, on 14 April in Stephanie Flanders' Bloomberg podcast, he foreshadowed the G20 difficulties. He said that it's now a "very profound question" as to whether there are enough shared interests in mutual economic development and a determination to jointly solve problems to allow it to continue: *"Self-evidently, it is not the objective of most of the other members of the G-20 to support Russia's economic flourishing… It is a substantial question whether we are hoping for the success of the Chinese economy, and whether China is hoping for the success of our economy."*

Maybe. Last Tuesday night, China signalled its dependence on global trade, especially its dependence on the US, by allowing its currency to depreciate. We discuss this and its implications in a separate article below. Chairman Xi Jinping said he firmly opposed "decoupling", calling for stronger macro-economic coordination. While he implicitly criticised the US and Europe for this decoupling, it is abundantly clear that

China needs the West's demand significantly more than it needs Russia's raw materials. Xi's speech could be taken as a cry for help. And while the politicians of Pakistan, Indonesia and Thailand might prefer China's indifference to the West's interference in their internal affairs, China's almost audible creaking shows emerging market nations that they cannot depend on China alone. Not for demand, not for financing.

No matter how much autocratic leaders despise US 'hegemony', they must at the end of the day deliver prosperity to their people or risk being replaced. Imran Khan's removal as leader of Pakistan may be a signal.

The Ukraine war has brought Europe quickly towards the US, and now the developed West looks much more cohesive than it did just two months ago. The West's boundaries of acceptable behaviour being better identified, and now policed with sanctions. But as the world appears to be moving to a somewhat weaker overall growth path, the West should be careful not to keep inflicting pain. Away from the harsh words, behind the diplomatic veils, we should want to keep trade flowing and growing. While there is much angst over Europe's apparent failure to achieve a liberal Russia through expanded trade, we do not have an alternative to this philosophy that is more likely to succeed.

While the current US administration has often appeared no more conciliatory than the previous administration, we cannot know how events would have unfolded if Trump were still President. One suspects there would be even more drama. It would be difficult to imagine that European leaders would be as close to the US if Trump were in place. And the timing in which to rebuild relationships may not be long. The US Presidential electoral cycle will begin even before the midterms, and while Trump has no direct influence on Biden's policies, it will not be easy to be seen as friendly towards China, even though the world might need it.

The recent weakening of the Chinese Renminbi has also weakened the Japanese Yen again, as well as other Asian currencies. Everything else being equal, this might ease Asia financial conditions, especially if bond yields do not rise. But US dollar-strength tends to mean corporate access to US financing gets more restricted, and credit spreads (the yield premium paid over the most secure bonds) rise. China corporate spreads have been widening again, which is not surprising given the economy's weakness. However, there are fewer signs of stress in more specific Japanese indicators, such as the 'cross-currency basis swap'.

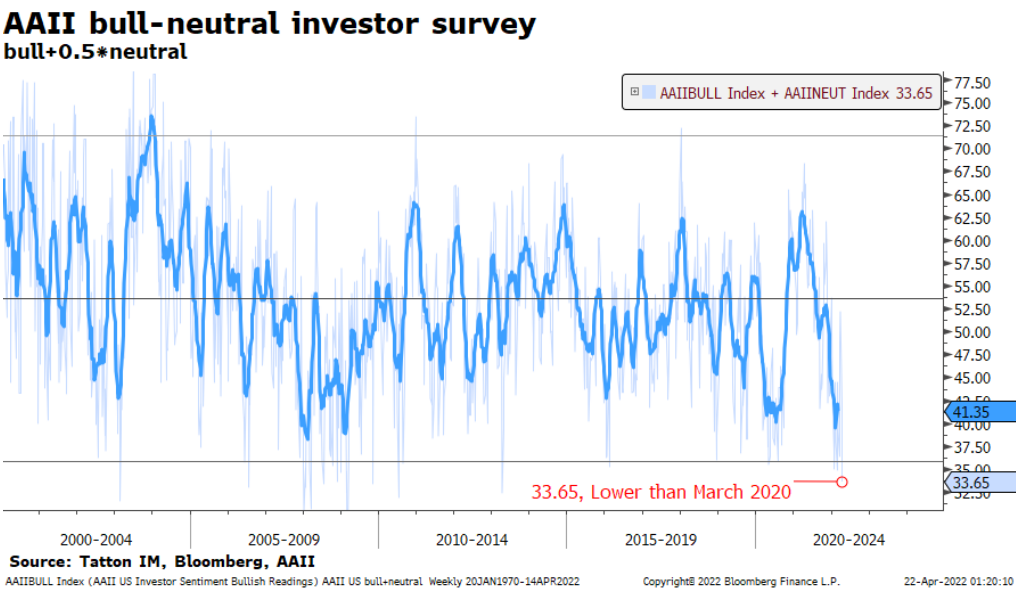
The obverse to the weaker Asian currencies is a stronger US dollar. At the margin, that ought to help provide a little bit of help to the US Federal Reserve (Fed), by tightening conditions and reducing some inflation pressure, due to falling import prices. However, you would not be able to read such thoughts in recent Fed official pronouncements. Fed official James Bullard intimated he was in favour of more than a 0.5% rate rise. The hawkishness was topped off by Fed Chair Jerome Powell giving credence to the idea of a series of 0.5% rises though this year. US short-term rates are now expected to be at 2.5% by the start of 2023.

The good news is that US ten-year bond yields hit a bit of a ceiling at 3% and have eased back since. UK and European yields have also dipped. However, this has not yet helped stocks, which have been reacting more to fears that global growth is facing all manner of headwinds.

In recent weeks, one would have expected rising bond yields and rising corporate credit spreads to have hurt equity prices. However, relative to bonds (real yields) the markets' valuations were a bit cheap beforehand, so relatively stable earnings projections meant equity markets kept valuations steady as well.

Unfortunately, as noted at the start, sales projections are starting to slide, which takes away the equity markets solidity.

Consequentially, investors have been getting less positive in recent weeks. As John Authers of Bloomberg (formerly with the FT) points out, US investors are as bearish as during the 2008 sell-off.



In itself, this is not a bearish signal. Indeed, some traders see this as a contrarian indicator which might signal a buying opportunity. For us, the weakening growth backdrop is more likely to be important. We are inclined to look through this, given the resilience of the US jobs market and Western households' still healthy savings.

Equity risk in balance: A tale of two outlooks

Capital markets are in a precarious position. The stellar growth coming out of the pandemic has dramatically slowed since last year, while supply-side problems and rampant inflation have continued. Cost pressures looked to be easing as we entered 2022, with global supply bottlenecks opening up. But Russia's invasion of Ukraine threw a spanner in the works, as have a new round of COVID-related lockdowns in China. More supply-side disruption – whether from the war itself or ensuing sanctions – turbocharged the rally in commodities and brought a prolonged bout of volatility in oil prices.

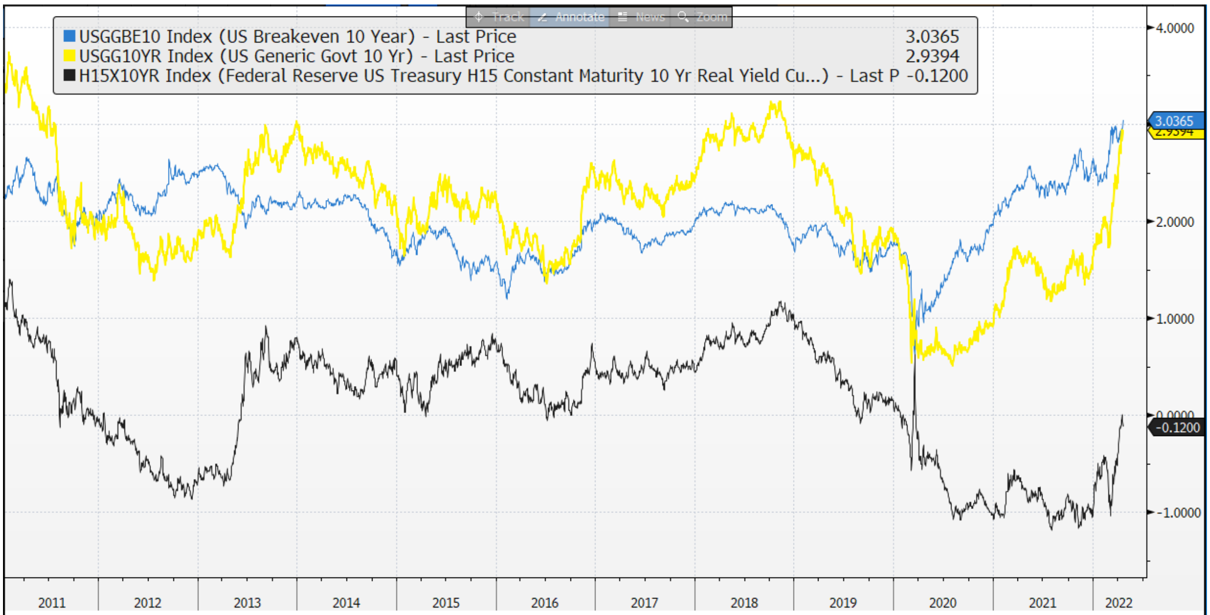
Central banks responded by outlining sharply tighter monetary policy, with the US Federal Reserve (Fed) pressing ahead with interest rate hikes, leading to frantic activity in bond markets. A few weeks ago, we saw an inversion of the US yield curve (the difference in yield between long and short-term bonds turning from a positive to a negative value), usually considered a recession warning. With US ten-year yields having almost doubled since the start of the year to nearly 3%, some large investors are suggesting that 'inflation mania' is overdone, and that bonds represent a bargain.

Given how important bond dynamics are to equity markets (as we described last week), 2022 has been similarly chaotic for stocks. The S&P 500 has flittered between sell-off and recovery, and returns are still down year-to-date. Historically, the midpoint of the economic cycle (as we are in now) can bring plenty of upside for equities, as earnings keep expanding. But this is no normal cycle. Central banks are already aggressively tightening from extraordinarily loose positions – which means equity valuations (in terms of price-to-earnings ratios) are still elevated and vulnerable. With market volatility and a deeply uncertain economic outlook, risks and rewards are finely balanced.

What would tip this balance one way or the other? Or, in practical terms, what would we have to see to move to either an underweight or overweight position on equities?

On the positive side, we note that a reset on inflation policy already seems to have happened. That is, while central banks were pushing a 'lower for longer' narrative throughout the pandemic, the reverse is true now. As we wrote recently, bond markets suggest that investors believe the Fed will ultimately get inflation under control, after which we should enter a stable growth environment and with inflation settling at just over 2%. If, as some data suggests, we are past the peak of input price inflation, central banks will no longer have to deal with extraordinary pressures, and can instead focus on containing wage pressures.

That would be a big step towards stable growth, and there certainly are signs that the economy is cooling. This has come from a combination of policy tightening and reduced demand – itself a result of cost pressures and falling real (inflation-adjusted) disposable incomes. Hopefully, this cooldown in the economy does not lead to a recessionary freeze. If not, the positive signs to look for will be a rally in bond prices (falling yields once more), or a fall in breakevens (which reflect inflation expectations). Some of the closely-watched metrics is US real yields (i.e., after inflation), as assessed by the market. They have risen to close to 0%, and typically turn positive when the Fed intends on tightening financing conditions within a cycle. Once such moves are digested by the market, and potentially a reset has occurred, one can start pondering a risk-on position for equities.



Source: Bloomberg, TattonIM

Of course, slipping into recession is the looming risk. The recent inversion of the US yield curve suggests this could happen – as yield inversion has reliably predicted almost every major recession in the post-war period (but also a few more that never happened). If the economy contracts, even briefly, it would likely mean a corporate earnings recession too. With valuations still elevated, equities would be under serious threat.

There are several routes that could lead us to recession, which we will have to look for closely. First, input cost pressures could remain elevated for longer than expected, and lead to a significant drop in demand. This seems unlikely given the clearing of some major supply bottlenecks, but many said the same a year ago and were surprised by how long these issues lasted. Second, and relatedly, inflation indicators themselves could prove sticky, causing inflation expectations to become ingrained and beginning a vicious cycle that central banks would be obliged to fight with yet higher rates.

Third, tightness in the labour market could also prove slower to adjust than expected – with labour supply not responding to demand and businesses being unable to cope. One consequence of such a situation could be labour hoarding. Despite deteriorating business conditions, companies keep labour or even hire more, and hence wage pressures remain elevated. In such a situation, it would be difficult for the Fed to ease policy, even as growth expectations falter. A recession would then ultimately ensue, as companies go under or start saving and consumer demand weakens. Ultimately of course, policy support would come through.

We do not see signs of this yet. However, to see us clear, the Fed would need to be confident that financial conditions have tightened enough to prevent overheating. This is what the rise in real rates is aimed at, but there is some way to go by historical standards. During the last cycle, US real rates rose to 1%, while currently they are at just below 0%.

To put it another way, we would have to be confident that equity valuations offer enough of a buffer, such that markets can stomach another rise in real rates. General metrics like global risk indicators can be useful for working this out. They work rather counterintuitively: when risk aversion is high, risky assets are more likely to have fallen and thereby offer a better bargain. Currently, Goldman Sachs' risk index is middling with respect to past trading, and thereby not providing strong guidance in that direction.

The value of the US dollar is also a key indicator of risk attitudes. As a 'safe haven' asset, it tends to be strong when investors are nervous, and weak when they feel lucky. So far this year, the dollar has appreciated somewhat, but not enough to indicate widespread fear. The signs are, perhaps uncomfortably, finely balanced. The risk/reward for equities is not as obvious as at the beginning of the recovery, when lots of bad news was already priced in. In such a situation, observing developments and market reaction to not always outright positive news may have its own merit.

China shifts policy – a little

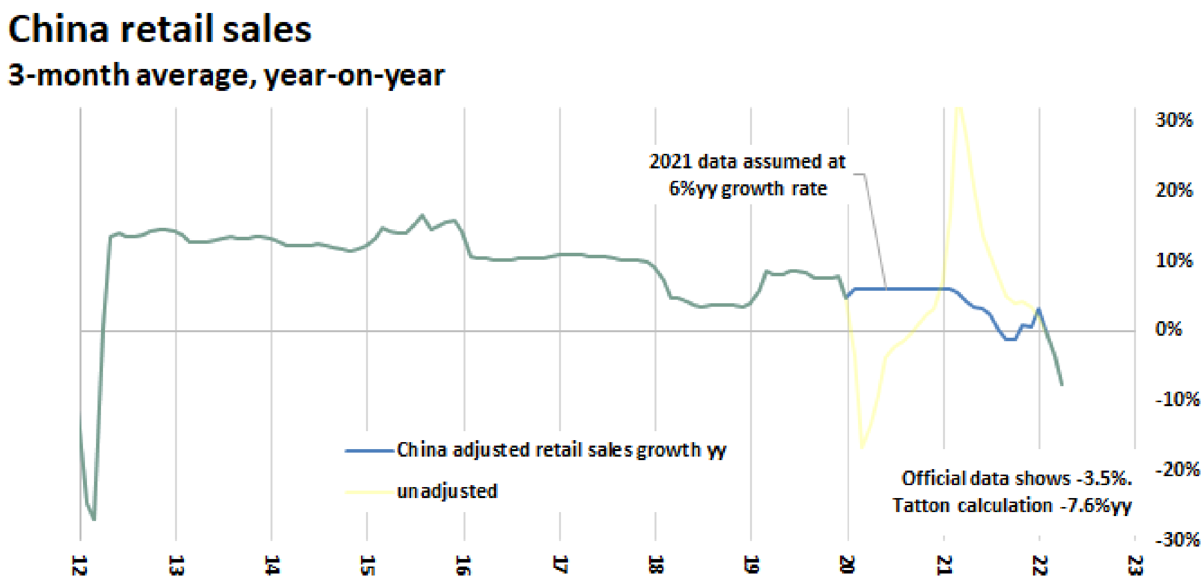
Chinese President Xi Jinping appeared typically resolute last week. In a keynote speech to the annual Boao Forum for Asia, Xi defended his government's zero-COVID approach – despite recent outbreaks forcing lockdowns across the country. He also delivered a thinly-veiled criticism of the US for its sanctions against Russia, lamenting the "long-arm jurisdiction" of the unilateral actions. As ever, Xi stopped short of signalling support for Russia's invasion of Ukraine, though he evoked the principle of "indivisible security" – a big talking point for Moscow. It was promotional material for the People's Republic: a defence of Beijing's policies and a projection of its vision for the world.

Underneath these promotions is a very different picture. While the Chinese government decries the West's actions against Russia, many businesses and institutions have de facto joined the sanctions regime for fear of getting caught in second-round restrictions. As written before, China's economic ties with the US and Europe are too important to risk.

This is especially so given the immense problems China is facing. Beijing's zero-COVID policy looks increasingly like an expensive but ineffective exercise, with China now experiencing its biggest wave of infections since the initial pandemic shock.

Shanghai may now be heading slowly out of the strict lockdown under which it has languished since March. However, severe case numbers spiked on Thursday and the city also reported more COVID deaths. China's most wealthy and numerous metropolitans (some 28 million) are experiencing food and medical shortages from restrictions – leading to explicit anger and even clashes with the police. The virus is also finding its way across the country. Guangdong is reported to have new cases.

The harsh economic impact of lockdowns is already showing up in the data. Overall, the world's second-largest economy grew faster than expected in the first quarter of 2022 – but the underlying figures show a dramatic slowdown in the last month. Unemployment came in at 5.8% in March, an increase on February's 5.5% and the highest level since May. Retail sales (in current value terms), meanwhile, contracted 3.5% year-on-year – significantly more than the expected 1.6% decline. We did our own calculation which shows an even worse situation with the three-month average at -7.6% year-on-year.

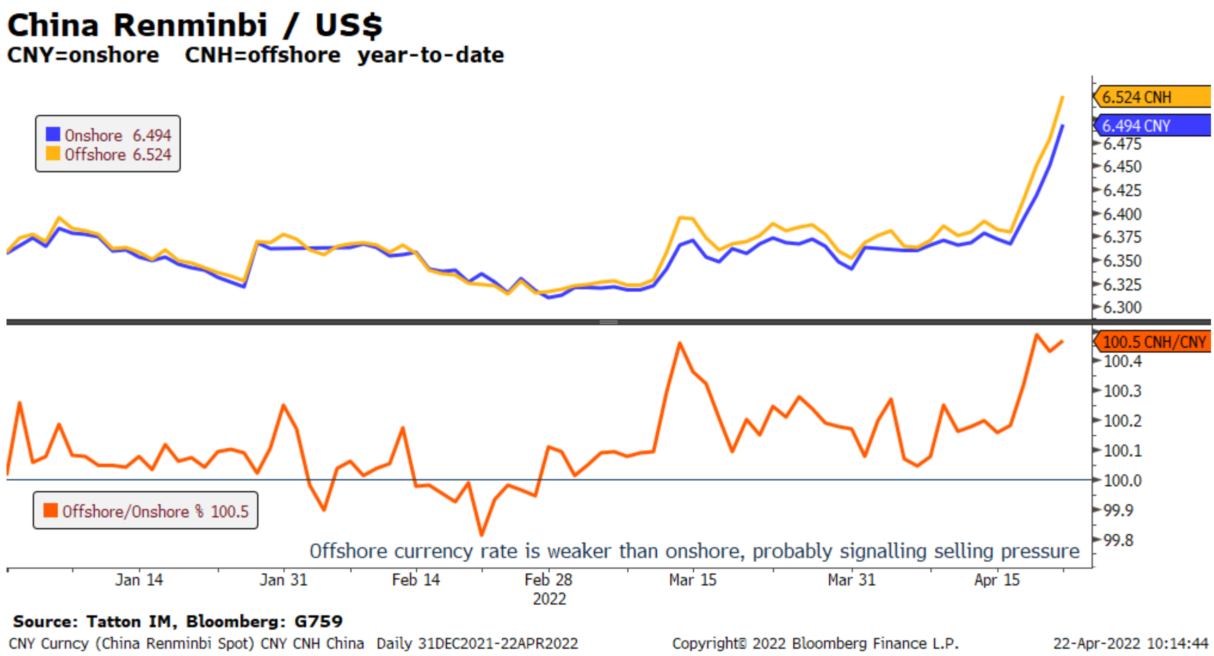


Source: Tatton IM, Factset, National Bureau of Statistics

In particular, woes continue for China's property market. After months of credit compression (which precipitated the crisis for Evergrande), Chinese property developers had hoped the usual post-new-year surge of buyers would provide decent cashflows would help meet looming debt payments. The COVID outbreak seems to have dashed those hopes, with the value of new home sales falling 29% year-on-year in March. That is the worst figure in nine months, and few are optimistic of a short-term reprieve.

Given the property market's importance to domestic demand (both from the household balance sheet effect – how wealthy people feel – and the more immediate consumption of new household goods) this is a bad sign for the China's economy. That, as well as other problems, is why many analysts have cut their forecasts for growth in 2022. Bank of America and UBS both now expect a 4.2% expansion this year, down from 4.8% and 5% respectively. Nomura is even more pessimistic at 3.9%.

The sharp slowdown has yet to prompt a rethink of COVID policy, but other policy areas have had to change. The People's Bank of China (PBoC) has effectively loosened policy but not by using interest rates. The bank lowered its daily fixing rate for the renminbi, allowing it to break through the 6.4 level against the dollar for the first time since November. Subsequently, the offshore renminbi has weakened beyond 6.5/$



The PBoC announced a very long list of measures (23 in all). It bolstered the government's finances, saying it would transfer $94 billion worth of "profits" to the central government by mid-April. The other measures were all designed to increased lending, but only for specific purposes. Interest rates were – unexpectedly – left unchanged.

The monetary policy loosening may be only slight but is still in sharp contrast to the US, where the Fed is tightening at full speed to constrain runaway inflation. This difference in central bank policy, as well as China's gloomy economic outlook, have caused foreign investors to dump Chinese bonds at a record pace. According to the FT, foreign debtholders sold a record $18 billion worth of yuan-denominated bonds in March, as rising US yields made Chinese debt less attractive. This has fed into equity markets too, with China's benchmark stock indices losing most of their March gains already.

The PBoC's long list of specific measures is emblematic of Beijing's ramshackle economic management in recent times. The government have tried to boost lending in some areas, while simultaneously reducing access to finance in others – most notably the property market. Rising global commodity prices convinced the government against monetary easing (due to the fear that it would ignite inflation pressures), though now that appears to be changing. Input cost inflation seems to have peaked, leading Beijing to think it can withstand some currency weakness.

The credit story is particularly interesting. China's government has been cracking down on excess leverage for years, causing several economic slowdowns along the way. These efforts came to a head when Evergrande – the world's most indebted property developer – began its collapse. The problems arising from this have caused sporadic episodes of credit impulse from the government, but officials are clearly hesitant to inflate the debt bubble any more.

The problem is, not doing so makes it extremely hard to meet Beijing's other great objective: stoking domestic demand. It seems to have miscalculated how much compression of the housing market would weigh on consumption. Together with periodic lockdowns, the weak housing market has taken a huge toll on consumption, making it very difficult to get out of the current slowdown.

This is a longstanding problem. As Michael Pettis, finance professor at Peking University, argues in the FT, Beijing is trying to boost the demand side using tools it built to boost the supply side. He notes that, while these policies "may direct consumption into favoured sectors, they cannot actually boost the role of consumption in driving growth". The only way to do that is with credit or fiscal expansion, which Beijing has been reluctant to do.

This means we should not expect Chinese domestic demand to be a driver of growth in the short term; once again, this will instead have to come from external demand. China's authorities are desperately trying to keep supply chain issues from halting the current flow of exports. But for now, the world's second-largest economy is in the passenger seat, as far as the global economy goes. This could mean the renminbi gets even weaker from here. And maybe President Xi will have to reconsider his resolute stance after all.

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25th April 2022

Global Equity Markets

Market	Fri 16:01	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7542	-0.5	-39	↗	⬀
FTSE 250	20935	-0.2	-50	↗	⬂
FTSE AS	4192	-0.5	-20	↗	⬀
FTSE Small	6892	-0.8	-56	↗	⬂
CAC	6579	+0.6	+37	↗	→
DAX	14171	+0.7	+94	↗	⬂
Dow	34301	-0.4	-150	⬀	→
S&P 500	4337	-1.3	-55	→	→
Nasdaq	13096	-1.9	-255	→	⬂
Nikkei	27105	+0.0	+12	↗	→
MSCI World	2960	+0.0	+0	⬀	→
CSI 300	4013	-4.2	-175	↘	↘
MSCI EM	1087	-2.3	-26	↘	↘

Top 5 Gainers

Company	%
Smurfit Kappa	+8.2
Smith & Nephew	+8.2
Ferguson	+7.1
CRH	+7.1
Int'l Consol Air	+6.5

Top 5 Decliners

Company	%
Anglo American	-15.5
Just Eat Takeaway.com N	-11.6
Glencore	-10.0
Antofagasta	-9.6
BHP	-9.3

Currencies

Pair	last	%1W
USD/GBP	1.285	-1.6
GBP/EUR	0.839	-1.3
USD/EUR	1.08	-0.3
JPY/USD	128.86	-1.9
CNY/USD	6.50	-2.0
Bitcoin/$	39,915	-0.9

Commodities

Cmdty	last	%1W
Oil	106.33	-4.8
Gold	1930.8	-2.4
Silver	24.16	-5.4
Copper	465.1	-1.5
Aluminium	3298.0	+0.9
Soft Cmdties	239.8	-0.6

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	14.1	10.9	14.3
FTSE 250	2.9	12.1	14.6	16.3
FTSE AS	3.6	12.3	11.3	14.5
FTSE Small x Inv_Tsts	2.7	1.4	10.5	15.3
CAC	2.4	15.1	12.4	15.2
DAX	2.5	14.2	12.4	13.7
Dow	1.9	17.8	17.9	16.8
S&P 500	1.4	21.6	19.1	18.1
Nasdaq	0.8	24.8	27.0	23.9
Nikkei	1.9	14.9	15.0	17.7
MSCI World	1.9	18.4	17.3	17.0
CSI 300	2.0	13.7	12.0	12.7
MSCI EM	2.7	11.2	11.6	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.97	+0.08
UK 15-Yr	2.12	+0.01
US 10-Yr	2.90	+0.08
French 10-Yr	1.42	+0.08
German 10-Yr	0.96	+0.12
Japanese 10-Yr	0.25	+0.01

UK Mortgage Rates

Mortgage Rates	Apr	Mar
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.11	1.91
3-yr Fixed Rate	2.03	1.90
5-yr Fixed Rate	2.12	1.94
10-yr Fixed Rate	2.44	2.34
Standard Variable	3.99	3.95

* 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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25th April 2022

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.

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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