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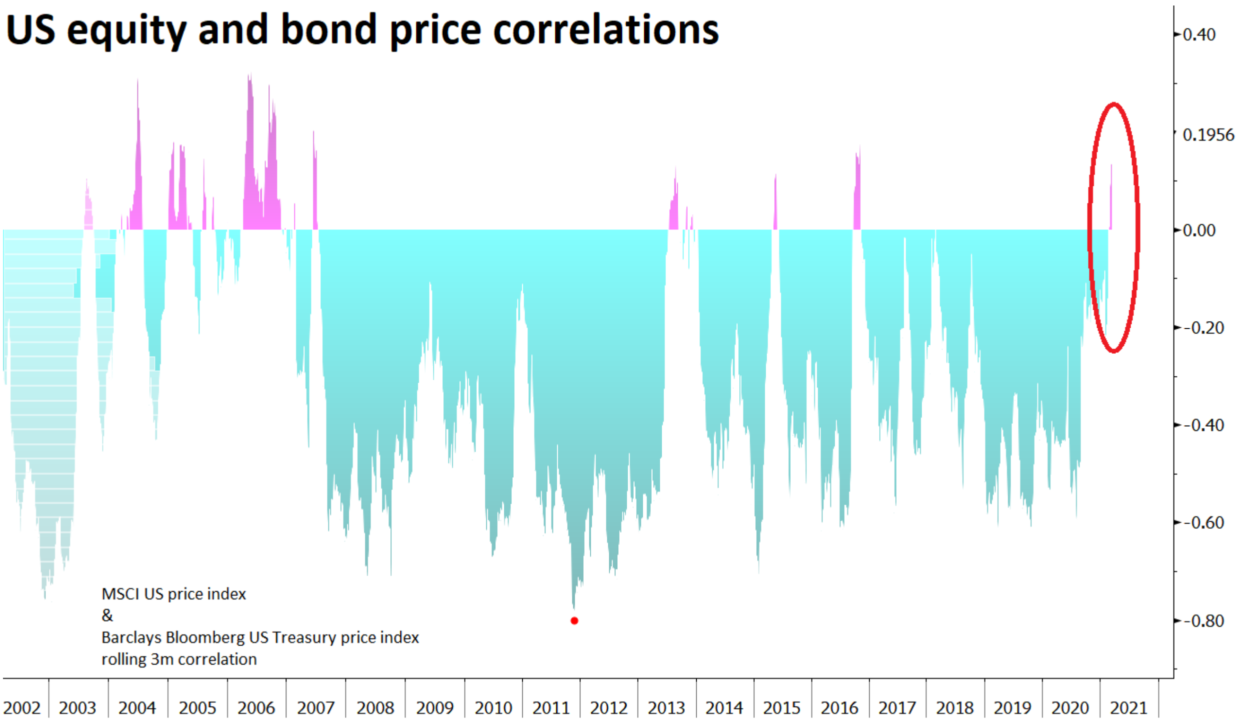
Better news is not always good news

Another good week for global equities, but a poor one for global bonds. Of course, that hides some disparity in the subsections that make up both markets. In the broadest sense, the US Federal Reserve (Fed) said interest rates will have to be higher (which we read as "higher than the market's expectations") and US Treasury yields have risen rapidly as a result. That has driven down bond values, due to the inverse relationship between yield and bond value movements. Equity investors, on the other hand, have been welcoming the de-escalation of energy price movements, to a greater extent than they feel concerned about the negative valuation impact higher yields also have on equity prices. We discuss the follow-through to other central banks in the separate articles below.

This type of market dynamic marks a bit of change. For much of this year, falling bond prices (and higher bond yields) have been associated with weaker equity markets due to the adverse valuation effect already mentioned. Indeed, the three-month rolling correlation between bond prices and equity prices recently became positive, which is a rare occurrence as the chart below shows (taking rolling three-month trading periods and observing how closely the daily moves align with each other). Here is the chart for US markets:



Source: Tatton IM, Bloomberg

Investors with predominantly bond holdings will take little comfort that equities bucked the trend last week and finally performed well while bonds have fallen. However, the rise in global bond yields does give room for bonds to provide more of a cushion, should economic growth falter again. The chart shows that (at least for the past 20 years) there have been only short periods when bonds and equities have been positively correlated.

Not all bonds did badly last week. Corporate bonds have had a hard time in recent months, as both credit spreads (the yield premium for corporate debt versus government debt) and underlying yields have both risen. However, last week, credit spreads declined, in line with equity risk premia – in other words, equity valuations got a bit more expensive.

A decline in the pricing of risk perhaps goes hand-in-hand with the feeling that geopolitical risks on resource prices have lessened. We have observed before that the start of a major conflict has often marked the point where the associated risks are most priced into markets. Equity markets have tended to perform well in the months afterwards, even if the conflict continues.

In the case of Russia's invasion of Ukraine, there are still several potential areas that could spell a resurgence of risks. However, strong and concerted policy efforts to contain the conflict's impacts on energy prices are bearing some fruit. Last Friday, European natural gas prices fell more than 10%, following a deal between the US and the European Union (EU) to boost the supply of American liquefied natural gas (LNG).

The US has agreed to supply an extra 15 billion cubic meters of gas as LNG to European countries by the end of 2022. That still leaves a lot of shortfall to cover, with the EU seeking to replace 101.5 billion cubic meters of Russian gas this year, while hoping to ensure storage is filled to a 90% level by October. However, as this agreement is not about the details of shipment, it is not entirely clear whether the extra gas will indeed reach the EU. Under the agreement, EU member states will commit to purchasing 50 billion cubic meters of US LNG per year until at least 2030. This is a way to get the EU to look past its carbon emission targets for a longish period, and ensure US producers have the commitment required to invest in production. It neatly allows Biden some room to continue his own domestic green push, trying to move US demand to greener energy sources, while still having external demand which keeps the US fossil fuel industry alive (and the lobbyists off his back).

Holding back energy prices from another destabilising bout of price rises is extremely important for markets, given that, as of late, central banks are no longer treating these inflationary events as something they can look past, having grown concerned that the extended period of rising prices may once again embed inflation expectations.

But even if energy prices stay stable, it is not clear that central bank inflation-fighting work will be done. Where workers are plentiful, and wage hikes are minimal, the price shock may remain just that and interest rates could remain lowish. This seems to be the case in Asia. It may also be the case that the larger EU nations (including the UK) are not seeing abnormal wage increases. However, the Fed is fretting that some labour market indicators (such as the Atlanta Fed Wage Tracker, which is now running at a 6% year-on-year level) continue to flash warnings. Job offers still look like they are outpacing the supply of labour.

Another aspect is that a new 'era of national security' may channel resources into less productive areas than has been the case since the fall of the Iron Curtain. That might mean inflation stays at a higher long-term level than markets have become used to. This may be more pronounced where defence spending has been lower – the EU has proportionally much more to spend and a greater willingness to do so now.

And, we are still not though the pandemic. Shanghai recorded a record of 1,609 cases last Friday. Bloomberg reports that the backlog of goods in the major ports of Shenzhen and Hong Kong has risen to its highest level in five months. Rising infections in Shanghai, meanwhile, have spurred fears that measures to combat the virus could affect the transport of goods to and from the world's biggest port.

Interestingly, China's restrictions to contain the fast-spreading omicron variant have hit supply chains, but have also hit fuel and other raw material consumption. Bloomberg reports that the many small independent Chinese oil refiners have reduced operating rates. While travel curbs have hindered the flow of raw materials, China has not yet reported output losses at major smelters, where production is usually protected by local governments to ensure security of supply, given their importance to regional economies. Goldman Sachs has reduced its forecasts Brent crude prices and Chinese oil consumption in the second quarter as, for the moment, the constraints appear to be acting to keep prices stable.

Still, China's imports and exports of commodities could also ultimately be at risk as ports become more congested because of the logistical disruptions caused by the lockdowns. There is also the likelihood of a similar sort of activity bounce-back seen elsewhere, after lockdowns are brought to an end.

In this apparently mixed picture, there is perhaps a somewhat difficult consistency. If risks such as Covid or the Ukraine war continue, risk premia are likely to remain higher than usual. But if risks decline (and with them, the markets' pricing of risk premia), central banks (and especially the Fed) will want to prevent the inflationary behaviour that is a consequence of raised inflation expectations from the rebounding demand hitting still restricted supply.

The good news is that during the past few months equity markets have built up quite a lot of risk premia, which can buffer the impact of rate rises. It remains to be seen how markets will react if rate expectations rise high enough to start to hurt the growth outlook. Or in other words, how long it will be until good news is once again at risk of turning into bad news for markets.

Bank of England the only fan of Sunak's spring budget?

Budget announcements are inherently political affairs. Even so, Rishi Sunak's Spring Statement was a particularly political broadcast. The Chancellor talked up the 5p per litre cut to fuel duty with the fervour of a vegetable market stallholder (by contrast, Germany just slashed a litre of petrol by 30 cents), as he did with the rise in the National Insurance Contributions threshold. Reminding MPs of his avowed fiscal responsibility, he noted the fuel tax cut would last for only one year. But Sunak saved his most crowd-pleasing (in terms of Tory MPs) announcement for last: the 1p cut to income tax, which will be brought in from 2024, timed to land just before the next General Election.

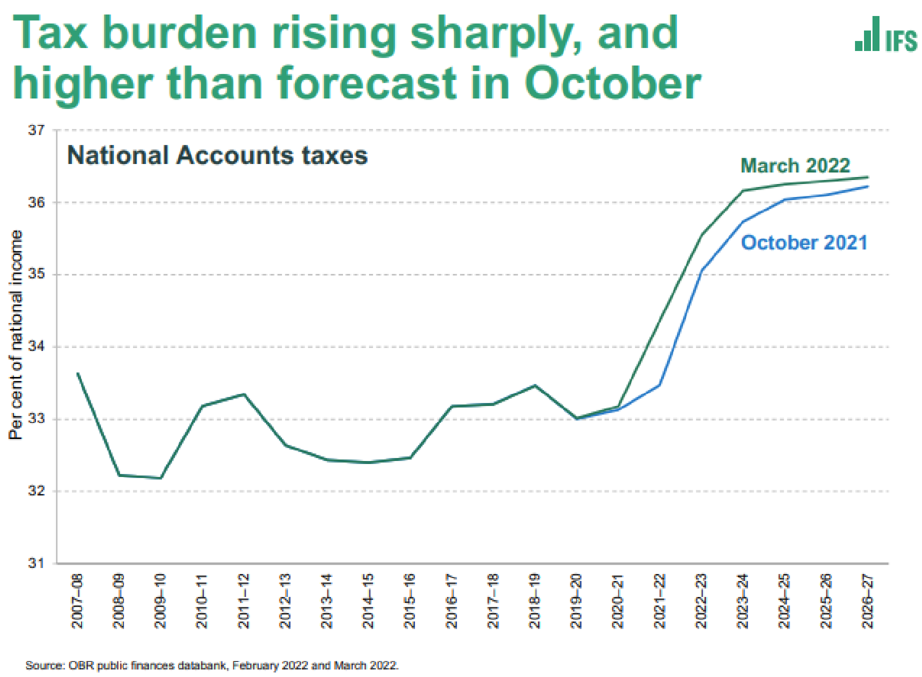
In truth, there were few new measures revealed – and even fewer that will have any short-term impact. But more interesting than the Chancellor's attempt to 'sell' this Budget was who he was selling it to. This was intended for Tory backbenchers first and foremost, who have been searching for evidence of Sunak's tax-cutting credentials for a long time, and with many still wary of the current leadership after the 'partygate' PR fiasco. But Sunak was also making a clear pitch to the Conservatives' electoral targets: lower paid workers who rely on cars. This was apparent from the policies as much as the rhetoric around them.

The National Insurance threshold will rise to £12,570, meaning those earning amounts around that level will see a fall in their overall contribution. But the other side of the equation is welfare spending, which naturally accrues more to those not in work than those in work. There was no increase in Universal Credit, meaning that the unemployed, students (facing higher loan repayments) and those on fixed income pensions will not receive comparable help. The cut to fuel duty underlines this distinction, as does the focus on "working families".

Coming against the backdrop of the highest levels of inflation in decades (now at 6.2%) most citizens face a dramatic fall in discretionary spending power. The Office for Budget Responsibility (OBR) estimates real household disposable incomes will fall by 2.2% this year, the biggest drop since records began in 1956.

The Chancellor insists that the £3,000 bump in the National Insurance threshold will cancel out his previously announced 1.25% rise in contributions for 70% of workers. But Sunak's claim that this amounts to "the biggest net cut in personal taxes in over a quarter of a century" was rejected by independent researchers at the Resolution Foundation and the Institute for Fiscal Studies (IFS). Resolution estimates total tax contributions will increase for seven out of eight workers. Only those earning £11,000-£13,500 will pay less National Insurance, while only those earning £49,100-£50,300 will pay less income tax in 2024. Most households will be 4% worse-off in real terms, while the poorest households will be 6% worse-off after inflation. IFS director Paul Johnson agrees that most will end up paying more, calling it "the effect of inflation and fiscal drag."

The IFS chart below shows how the overall tax burden will increase sharply and, despite the "giveaway", is greater than the Chancellor expected to take six months ago:



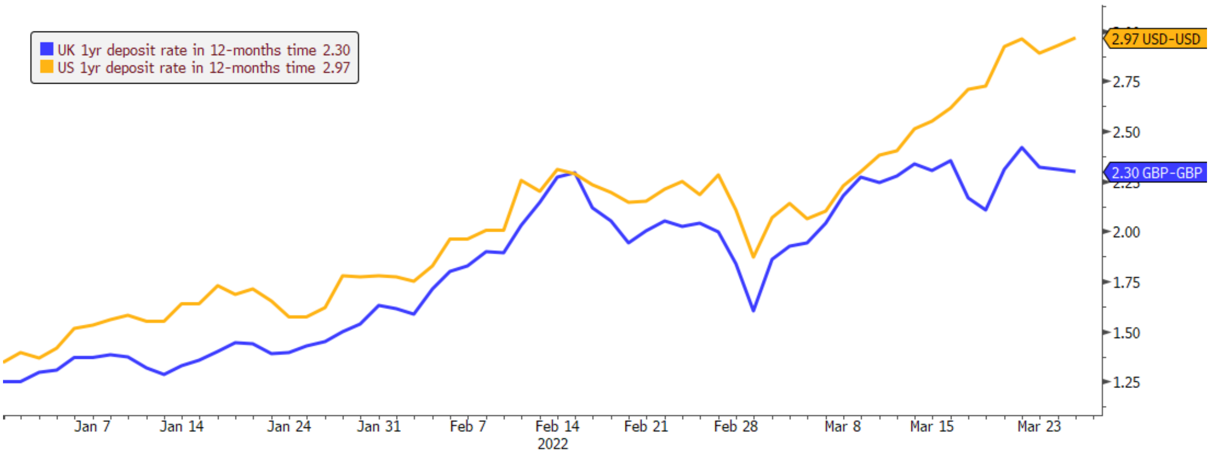
The Chancellor has long argued for fiscal restraint, reportedly insisting on tax rises even as Boris Johnson considered scrapping them some months ago. His Budget commentary on Wednesday was full of tax-cutting rhetoric, but the fiscal hawkishness ultimately shone through. The Treasury is continuing with fiscal tightening that began towards the end of last year, unaffected by the economic woes likely to hit Britain.

This is certainly the view of bond markets, where the UK inflation break-evens moved down last week – meaning less predicted economic growth. We have discussed before the effect of 'fiscal drag' on developed economies this year. Coming off the unprecedented bout of peacetime public spending, the winding down of various support measures has resulted in a big expansion of public debt. As such, while fiscal spending was a significant contributor to overall growth during the worst of the pandemic, it is now substantially net negative. This is true in the US and across Europe too, but Sunak has been faced with the pandemic occurring so soon after Brexit. The diminished public income means the tightening agenda will be particularly pronounced in the UK.

This will affect the UK's monetary policy, relative to others. Central banks around the world are battling against soaring inflation and have begun a sharp tightening cycle (though at different paces). Last year, the Bank of England (BoE) was at the forefront of this tightening, raising interest rates in December and signalling that further hikes would be needed. Indeed, the bank followed this up with another rate rise just last week, leaving benchmark interest rates at 0.75%.

Over that time, though, the market implied outlook for future monetary policy has softened. Markets no longer expect that the BoE need be as hawkish in taming inflation as the US Federal Reserve (Fed), for example (see chart below). We discuss central bank policy in a separate article, but this reversal is significant. The reason the BoE's expected outlook has softened is because of the tight fiscal situation facing Britain. Fiscal drag from the Treasury will act as a dampener on demand, reducing the overall demand-driven inflation pressure in the UK. This makes the inflation-fighting job easier for the BoE, thereby allowing policymakers to signal a lower path for future interest rates.

Interest rates in a year's time
1-year forward rates for US and UK



Source: Tatton IM, Bloomberg: G775
BPSWS2 Curncy (GBP SWAP (vs SONIA) 2Y) US UK 2y swap Daily 31DEC2021-25MAR2022 Copyright© 2022 Bloomberg Finance L.P. 25-Mar-2022 11:39:20

From a market perspective, this will make it hard for sterling to maintain the strength it showed against other currencies earlier this year. Tightening elsewhere should put upward pressure on the dollar or euro, while sterling is unlikely to be as supported.

A more accommodative BoE is also a positive for growth, but this is balanced against the negative impacts of fiscal and energy price drag. However the Chancellor tries to package this Budget, it shows a tighter fiscal stance ahead. And, while that will help contain inflation pressures, it could do the same to growth.

![Cambridge Investments Limited]

28th March 2022

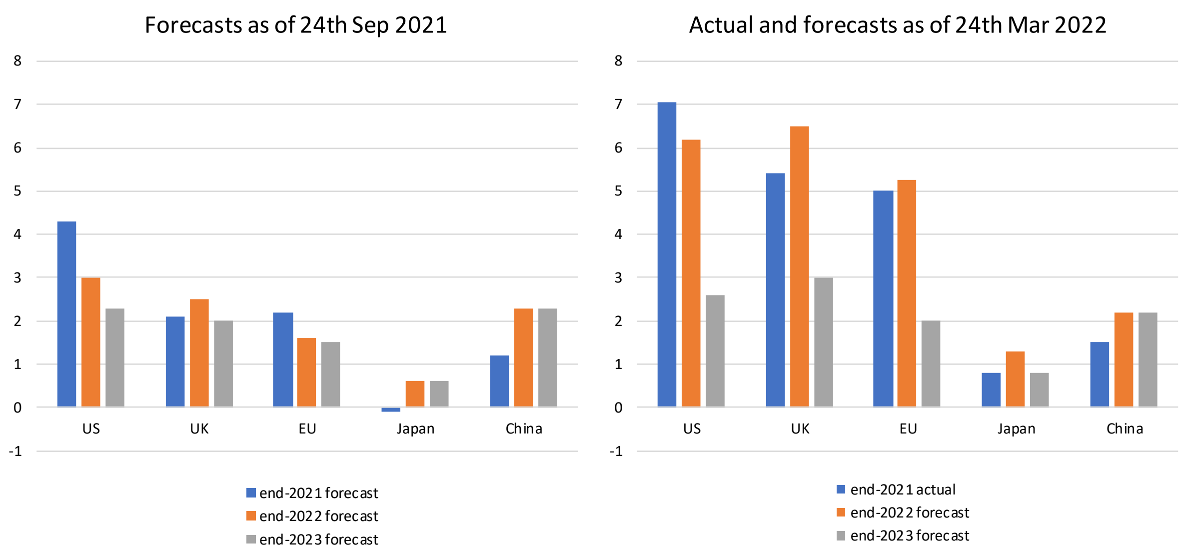
Central bank tightening: like the 1970s or the late 1940s?

Amid soaring global inflation, historical comparisons are increasingly used in commentary. Mentions of the 1970s are most common, with pundits pointing to immense supply-side shocks and dwindling growth prospects. 'Stagflation' – the unusual cocktail of rapidly rising prices and weak growth – has crossed the boundary from financial to popular news, prompted by the looming cost of living crisis. Comparison to an earlier episode – the post-war inflation of the 1940s – was also made by the FT last week. The economic disruption of the Second World War is indeed similar to the disruption caused by the pandemic, as is the ensuing boom in demand.

That episode had a nicer ending than the 70s version, as prices eventually slowed and only a mild recession ensued. Whether that will be the case now is debatable. We certainly expected a softer landing earlier in the year, as supply-chain bottlenecks appeared to be easing and the worst of Covid disruptions seemed well and truly behind us. But Russia's invasion of Ukraine changed the picture dramatically – as energy shortages and spiralling prices now dominate the agenda.

Central banks across the world are committed to containing runaway prices. But while almost all monetary policymakers are working to tame inflation, there are differences in how they do it. Understanding the diverging paths for monetary policy – particularly in developed countries – is essential for assessing each region's economic prospects.

Consumer Price Inflation (year-on-year) Consensus



Source: Tatton IM, Bloomberg

In the US, the Fed is on an aggressive path. This is a stark reversal from the softly-softly approach of last year, and each new release from the Fed seems to indicate a tighter outlook. The Federal Open Markets Committee (FOMC) raised interest rates another 0.25% at its most recent meeting, but chair Jay Powell appeared significantly more hawkish in his speeches afterwards. He twice proclaimed the Fed would have to "move expeditiously" to contain soaring inflation, having used the word "steadily" back in January.

The FOMC's 'dots plot' – which map out members' expectations of interest rates over the next few years – now shows seven rate hikes planned for this year. These are currently expected to be 0.25% rises, but Powell emphasised that some could be 0.5% hikes if inflation pressures do not subside. Goldman Sachs predicts that faster rate rises will occur in May and June, followed by seven quarter-point hikes leading up to the third quarter of 2023. That would put the Fed's benchmark rate at 3-3.25% by the end of next year.

Regardless of whether those predictions are right, the Fed is sending a clear signal of ramping up hawkishness. Powell also strongly suggested it would announce its balance sheet reduction in May (reversing quantitative easing though quantitative tightening), noting that the FOMC had made progress on its operational plans to do so. Shedding its stock of bonds will put significant upward pressure on real (inflation-adjusted) borrowing rates, which are a key determinant of asset prices and financial conditions generally. This is why Powell described the balance sheet reduction as "the equivalent of another rate increase".

A hawkish Fed is another reason for the late 70s comparison – when then Fed Chair Paul Volcker raised rates to eye-watering levels, causing a severe economic downturn. There is a big difference now, though. The Fed's planned rate rises are proactive rather than reactive, with the FOMC wanting to stop price pressures before they become embedded. Powell no doubt recognises that the current inflation boost is due to a variety of supply problems, which tend to be short term and not endemic, but likewise recognises the risk of them having a longer-term impact on inflation expectations. The aim is to nip the problem in the bud, rather than let it fester. This is not the 1970s – because the Fed is determined to make sure of it.

The European Central Bank (ECB) is in a different position. While it plans to exit its accommodative stance, it is significantly behind the Fed in its timeline, and only expects to stop its asset purchases in Q3, before pursuing a first rate hike some time after. The main question for ECB policymakers seems to be whether that is too much, rather than too little. Europe was in a weaker position than the US generally, but Ukraine has presented a particular problem. Given its energy dependence on Russia, the cost shock is likely to be more painful and will almost certainly create a bigger drag on demand.

At its March meeting, the ECB accelerated its tightening timeline, but indicated it would move slower if the outlook deteriorated. Russia's war will likely significantly hit European demand, and as such it should not be a surprise should the ECB's rate rising be delayed. On the other hand, policymakers will be aware of the danger the cost shock could have, particularly if demand fares better than expected and inflation expectations become embedded. As such, the ECB's policy conundrum is finely balanced.

In the UK, the monetary outlook looks a little softer. This is despite a recent inflation reading of 6.2% and the BoE's decision to raise rates again just last week. The Monetary Policy Committee voted 8-1 to raise by a quarter point – with the only dissenting vote being for leaving rates unchanged. Markets therefore interpreted the meeting as a dovish signal. As already noted, UK fiscal policy is distinctly tighter than developed market peers, which should act as a constraint on demand-driven inflation, thereby giving the BoE room to stay loose.

The world's central banks are tightening policy with varying degrees of vigour – but all are unmistakably tightening. The immense cost shock we are living through forces their hand in this regard. Central bankers seem determined to avoid another 1970s. However, even though tightening should deal with the spectre of stagflation, it is nevertheless an inhibitor to medium-term growth, by way of demand destruction. At the moment, it is not quite clear whether investors have actually woken up to that, or whether they believe central banks will blink at the very last minute.

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28th March 2022

Global Equity Markets

Market	Fri 14:48	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7496	+1.2	+92	→	⇗
FTSE 250	21011	-0.7	-145	⇘	⇘
FTSE AS	4173	+0.9	+37	→	→
FTSE Small	6868	+0.3	+19	⇘	⇘
CAC	6608	-0.2	-13	↘	→
DAX	14410	-0.0	-3	↘	↘
Dow	34915	+0.5	+160	→	→
S&P 500	4545	+1.8	+82	→	⇗
Nasdaq	14171	+2.0	+278	→	⇗
Nikkei	28150	+5.6	+1497	⇗	→
MSCI World	3041	+1.0	+31	→	→
CSI 300	4175	-2.1	-91	↘	↘
MSCI EM	1137	+1.2	+14	↘	↘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Polymetal Internationa	+52.1	Kingfisher	-10.2
BHP	+9.5	Barratt Devts	-9.1
Anglo American	+8.4	Taylor Wimpey	-8.5
BP	+7.9	Ocado	-8.2
Antofagasta	+6.9	Flutter Ents	-8.0

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.321	+0.3	Oil	117.08	+8.5
GBP/EUR	0.834	+0.5	Gold	1952.8	+1.6
USD/EUR	1.10	-0.3	Silver	25.44	+1.9
JPY/USD	121.99	-2.3	Copper	472.9	+0.8
CNY/USD	6.37	-0.1	Aluminium	3623.5	+7.1
Bitcoin/$	44,879	+8.6	Soft Cmdties	232.5	+1.7

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.7	14.1	11.5	14.3
FTSE 250	2.8	12.3	15.0	16.2
FTSE AS	3.5	12.3	11.8	14.5
FTSE Small x Inv_Tsts	2.5	1.4	10.9	15.3
CAC	2.3	14.9	12.7	15.2
DAX	2.4	14.3	12.6	13.7
Dow	1.8	17.6	18.2	16.8
S&P 500	1.4	22.6	20.2	18.0
Nasdaq	0.7	26.9	29.1	23.8
Nikkei	1.7	15.4	16.9	17.7
MSCI World	1.8	18.7	17.9	17.0
CSI 300	1.9	14.4	12.3	12.7
MSCI EM	2.5	12.2	12.4	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.69	+0.19
UK 15-Yr	1.91	+0.16
US 10-Yr	2.48	+0.33
French 10-Yr	1.01	+0.18
German 10-Yr	0.58	+0.20
Japanese 10-Yr	0.24	+0.03

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.76	1.67
3-yr Fixed Rate	1.79	1.69
5-yr Fixed Rate	1.79	1.70
10-yr Fixed Rate	2.22	2.28
Standard Variable	3.83	3.79

* 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 March 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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