CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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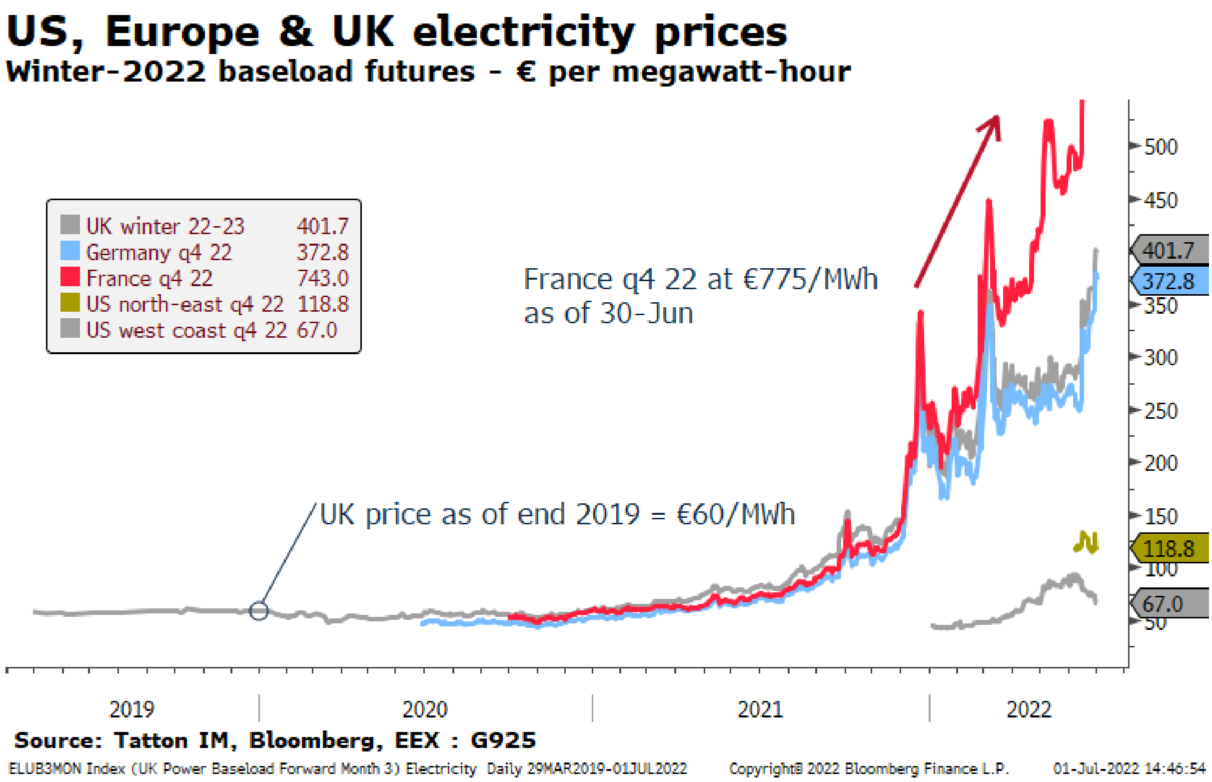
Energy price shock turns into central bank focal point

More than two years since the COVID virus hit Europe, it is clear that most peoples' livelihoods have been affected more by the policy 'medicine' than the virus itself. Of course, without those interventions which were needed until vaccinations become prevalent, it most likely would have been the other way around. As we start the second half of 2022, the excess monetary liquidity now draining from markets – the unavoidable consequence of those pandemic-fighting measures – is hitting the global real economy and thus lowered market valuations.

It also must be acknowledged that more than one threat has presented itself this year. If the world was merely facing the consequences of natural disaster, such as the virus, we would probably be heading towards normality by now. As we enter the second half of 2022, the energy price crisis caused by Russia's geopolitical provocations has likely turned into the biggest problem now. Russia's invasion of Ukraine is the most obvious aspect. For Europe, the impact is felt most clearly through the disruption to our energy markets.

The chart below shows how this coming winter's anticipated electricity prices for the US, Europe and UK compare. In 2019, across the western nations, energy (electricity, heating and petrol) was around 6% of household expenditure, similar for service businesses, and about 12% for manufacturing (US Bureau of Labor Statistics Consumer Expenditure Survey, ONS, Eurostat).



The past 12-month average for Germany has been about €180/MWh. Looking beyond the winter, Germany's electricity contract price for the whole of 2023 is at €290/MWh, and 2024 is at €190/MWh. Europe's dilemma is clear. Russia's hold on the price of energy appears significant and while those effects can be mitigated in the long-term, they are difficult to avoid in the near or even medium-term.

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This places considerable pressure on businesses and their profit margins. It also means that sales revenues are likely to suffer as consumers fret over their household budgets as the extra expenses diminish their savings. We write more about these effects on business lending through credit markets in an article below.

Although admittedly less than in Europe, US businesses and households are also under price pressures, as demonstrated by the latest personal consumption expenditure data. Consumers increased dollar spending in May versus April by just 0.2%, and bought less goods. Inflation adjusted (real) expenditure dropped by about 0.4%.

If businesses are not selling as much, they will be forced to hold back costs. Capital investment will be put on hold and only essential hiring will take place.

Markets already sense the slowing of growth is upon us, and it is being reflected in government bond yields. The ten-year US Treasury yield has moved back down to 2.90%, having traded briefly at 3.50% about two weeks ago.

This move has been matched by the fall in the German ten-year Bund from 1.90% to below 1.30%, and the UK ten-year Gilt from 2.73% to 2.13%. Although 0.6% may not sound a big number, in the context of today's bond markets it constitutes a substantial move.

And, as we mentioned last week, markets have shifted inflation expectations lower by about 0.3-0.4%. Rising energy costs would usually be associated with rises in inflation expectations. However, we are now observing a big shift – energy cost rises are having the same impact on markets as rising taxes.

Nevertheless, the rhetoric coming from the previous week's big central bank get-together in Portugal remained resolutely hawkish. But markets are already sensing that inflation-boosting growth is in the process of slowing quickly enough now to warrant a softening in central bank guidance towards the autumn. As for the other crucial inflation variable – tight labour markets – there are early signs of subsiding employment demand across western nations. When those are reasonably clear, central bankers may tell us they have succeeded in preventing supply chain disruptions, and the energy price shock from mutating into a vicious cycle of 1970's style structural inflation.

We expect that the European Central Bank (ECB) will still want to raise rates this month – there were several speakers at the Portugal meeting suggesting a 0.5% repo rate rise – and they may well keep going from there. Interestingly, however, these rate increases will happen while the ECB continues to purchase assets. What it takes with one hand, it gives with the other, and that rather incongruous policy is helping to hold back rising credit spreads in the weaker peripheral nations.

Still, the negative effects of the energy war Russia is waging on Europe may be softened somewhat for the weakest nations by such monetary policy moves. However, while European governments may want to turn on the fiscal taps to help households and businesses, the policy effectively channels money into Russia's war-chest, unless there is also an increase in energy supply from elsewhere.

This places the onus on fast expansion of tanker capacity to the US and others, and on building better political relationships with the Middle East and North Africa. Across the globe, there are major initiatives to secure new partnerships, coalitions, alliances, call them what you will. Maybe, for the UK and the EU, it will also provide an incentive to bury the hatchet, and return to a more pragmatic relationship model.

As always, we know that challenges usually drive change as well. Indeed, we write below about how China seems to be heading out of its recent trough. We know as well that risk also tends to mean greater potential returns. As we enter the second half of 2022, market participants are certainly downbeat, reflected in lower price-to-earnings multiples and higher credit spreads. A resolution of the conflict with Russia is very unlikely anytime soon, but securing other energy supplies is possible. If and when that happens, the headwinds blowing against the global economy should slacken considerably.

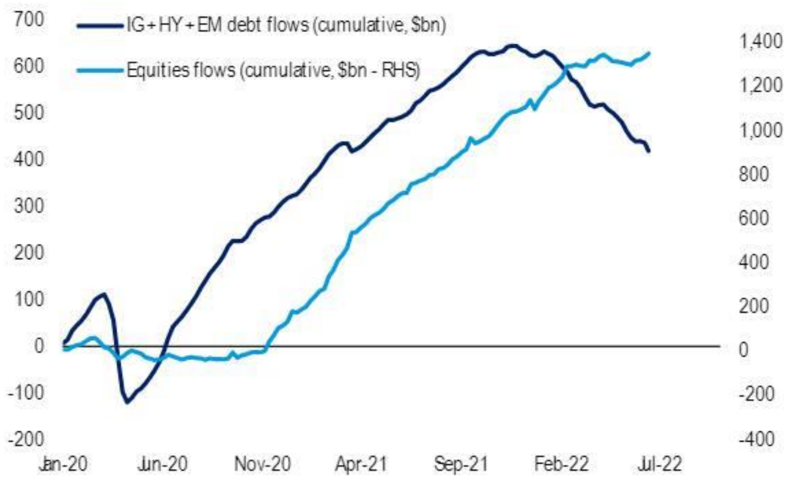
The Credit Crunch starts to bite

It has been a tough year for investors. Hit by the dual pressures of rising interest rates and a looming global recession, major equity indices have sold off considerably and government bond yields have spiked. But while stocks and sovereign bonds regularly make the headlines, the travails of corporate credit markets often have a much more direct impact on companies and, by extension, the economy. Things are not looking good in that regard – with the cost of financing increasing dramatically for many businesses.

Stagflation – where growth falls but prices still rise – is a particularly bitter recipe for corporate credit. On the one hand, central bank tightening pushes up the 'risk free' return of government bond yields and drains liquidity from the financial system. Since interest on loans is set by reference to bonds, the cost of private financing has to go up with it. With less liquidity around, credit spreads (the difference between credit and bond yields) also rise.

On the other hand, low or negative growth then hits businesses with the added punch: demand destruction pushes down profits, degrades balance sheets and credit spreads shoot even higher. For weaker or more indebted companies, this can often be a knockout blow. Defaults ensue, widening credit spreads again and beginning the recessionary cycle.

Chart 12: Capitulation has been in credit not equities
Credit vs Equity cumulative flows



Source: BofA Global Investment Strategy, EPFR

BofA GLOBAL RESEARCH

The hard times in corporate credit are exemplified by investment flows. The chart above is from Bank of America (BoA), showing the net fund flows for both equities and corporate bonds. Despite sinking stock markets this year, the amount of money invested in equities has increased, albeit very slightly. Credit markets, though, have haemorrhaged capital. According to BoA, $200 billion has flowed out of corporate bonds in 2022.

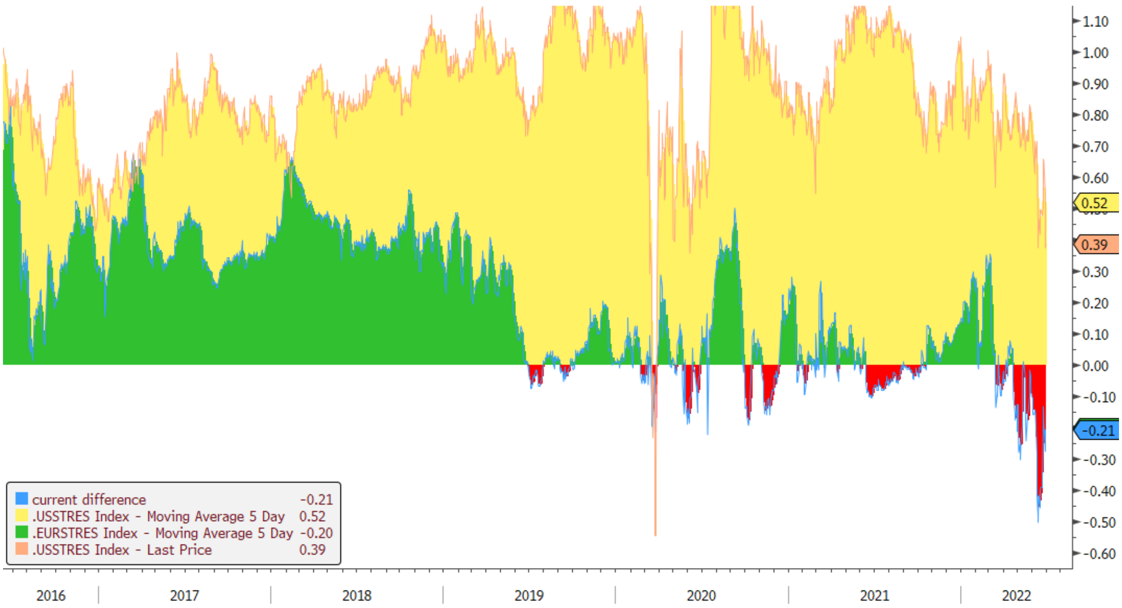
The squeeze looks widespread, affecting most sectors. Retailers, staples manufacturers have been hard hit, as companies are particularly sensitive to input costs. Dutch-based butter-type manufacturer Upfield (maker of 'I can't believe it's not butter') has seen its 2026-maturity bond fall to 53.3% of its 100% principal value.

French supermarket chain, Casino Guichard-Perrachon SA ,has seen its bonds fall from 80% to 67% of face value this month alone. This has had a dramatic effect on its stock price, which has almost halved from the start of the year.

Secular changes wrought by the pandemic have hit property. Last week, UK commercial property came under significant pressure, after BoA warned "real estate's glory days are numbered". City-centre office blocks are seeing little demand following changes in commuting habits. Landlords are doubly hit by rising borrowing costs which, BoA points out, are now "solidly higher than investment yields", a situation not seen since 2007. Low yields and ample liquidity have been one of the main driving forces behind expansion over the last decade.

However, the squeeze on margins is affecting almost all businesses. Regionally, Britain and Europe face higher energy prices than the rest of the world. The 2022/2023 winter futures markets for both gas and electricity are at very difficult levels (France's older nuclear power generators have had maintenance problems, and their electricity prices are double the already eye-watering levels of the UK and Germany).

Debt stress indicator
Europe single B spreads inverted from 2 to 5 years, US still positive



Source: Tatton IM, Bloomberg: G934
.EURSTRES U Index (EUROPE debt stress indicator) Debt stress indicator EU Daily 14JUN2016-30JUN2022 Copyright© 2022 Bloomberg Finance L.P. 30-Jun-2022 14:22:00

Moreover, the longer-term impact of the pandemic is also being felt broadly across sectors because of extra debt taken on during lockdowns. Given the interplay between debt, default and growth, credit stress is often a clear sign of looming recession. The chart above shows an indicator of this, based on the differences in credit spreads over a two and five-year period. Like yield curves for government bonds (the difference in bond yields over the short and long-term) corporate credit spreads are normally 'upward sloping' – spreads are usually higher at longer maturities. This changes when there is threat of defaults, as short-term debt becomes just as risky as long-term debt and creditors withdraw capital. Short-term spreads mechanically rise faster, pushing the 'yield curve' to or below zero.

Negative territory therefore indicates a heightened risk of widespread defaults and ensuing recession. As you can see, these signs are worsening across the US and Europe, but not equally. In the US (in yellow), credit has clearly weakened, but it is not yet near zero. But in Europe (green), markets see companies firmly in stressed territory, suggesting that a recession is coming.

This makes sense given the relative risks in each region. US consumers are being hit by inflation and companies are facing higher debt payments, but neither of these are yet at breaking point. In Europe, energy prices are much higher, and show little sign of coming down. Natural gas prices are nearly six times higher in Europe than they are across the Atlantic. And the squeeze is widespread across the continent, putting serious pressure on growth prospects.

For energy specifically, the UK is somewhere in the middle (with natural gas prices three-and-a half times those in the US, compared to seven times across Continental Europe). But unfortunately, like in Europe, energy prices are set to increase come winter. Besides which, Britain is facing its own cocktail of inflation and poor growth, which will certainly hamper creditworthiness.

Here and across the channel, the sirens of negative economic growth that define recessions are growing louder (indeed, we may already be at the beginning of one). Strangely enough, that may mean credit stress is approaching its peak, after which bonds should be due a better performance as spreads reduce again when actual default levels become fact-based rather than fear-based. That is the view of some distressed debt investors, who suspect this could be a good low point to buy in. A contrarian view perhaps, but, with any luck, enough investors will believe it to turn the market around.

China shrugs off Covid fears – but for how long?

Chinese President Xi Jinping travelled to Wuhan, the pandemic's epicentre, to deliver a speech on the importance of harsh Covid restrictions. That may sound like a headline from the start of 2020, but it happened last Tuesday. In a speech reaffirming the Communist Party's strict zero-Covid policy, Xi announced he would rather "temporarily sacrifice a little economic growth" than "harm people's health". Given how long the policy has been in place, one might wonder how temporary that sacrifice will be.

Last week, the party's Beijing secretary caused controversy when he reportedly published a notice claiming: "In the next five years, Beijing will unremittingly grasp the normalisation of epidemic prevention and control". Many of the city's residents responded angrily online, worrying that the regime of frequent mandatory testing – every two or three days – and sporadic lockdowns would continue over the long term.

Soon after the outcry, the reference to “five years” was removed from the notice, and state media outlets have not yet clarified its usage. But the message is still clear: China’s zero-Covid policy, an extreme outlier among nations’ late-stage pandemic strategies, is not changing anytime soon. This is despite its damaging effects on the economy and its unpopularity with the growing Chinese middle class.

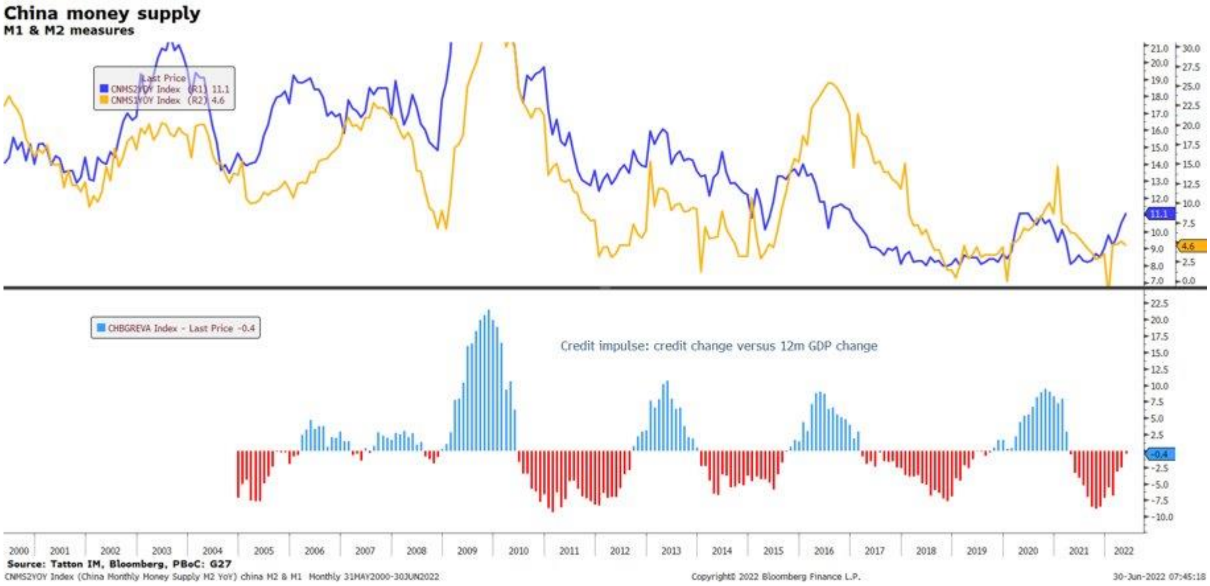
In early April, as more than 300 million citizens were under some form of lockdown, WeChat searches for emigrating out of China increased by 440%. Economists now expect Chinese GDP will contract in this quarter for only the second time in 30 years. China’s zero-Covid policy is undoubtedly the biggest headwind for its economy, and its indefinite continuation severely dampens the outlook.

It is curious, then, that Chinese equities are faring extremely well. The CSI 300 index has been on an upward trajectory for the last two months, and June looks set to deliver the best monthly returns in two years. Xi’s speech coincided with a slight pullback midweek, but even that had recovered by the end of last Thursday’s trading. If Chinese citizens are concerned with the zero-Covid policies, investors seem unphased.

Some have suggested this may be down to a softer Covid policy than meets the eye. Despite the President reiterating the party line, China’s State Council announced last week that the quarantine for international arrivals would be cut in half – down to seven days in a government facility, followed by three days at home. This comes a few weeks after the President himself declared that Covid containment must be balanced against economic growth – a sign of shifting priorities in Beijing.

We suspect other reasons for China’s stock market strength. Undoubtedly, officials are sending mixed signals on Covid policy – but a fundamental change of priorities is unlikely. Changing the party line is a difficult thing to do in China, and vaccination rates are still low among the elderly and vulnerable. The chances of a looser, more growth-oriented Covid strategy, are slim in the short-term at least.

Rather, we think investor optimism is down to policy changes in other areas, and early signs of returning domestic growth. Last week, the People’s Bank of China (PBoC) pledged to keep monetary policy accommodative as the economy recovers from its slowdown. This follows on the heels of earlier measures to loosen policy, and accordingly, we can already observe an impact: While the base central bank money supply (M1 / yellow line in chart below) has been largely flat for most of this year, credit and wider forms of money supply (M2 / blue line in the chart below) has been steadily moving up.



That increase is likely down to the PBoC's reserve ratio cuts, an important factor in boosting China's credit impulse (the contribution of credit to GDP). As the chart below the M1/M2 one shows, credit impulse took a downturn towards the end of last year, but has since recovered to near-neutral. Given the recent increase in M2, we should expect this to turn positive soon, representing a boost to the economy.

Beijing recently signalled it would also take a less severe approach to the tech sector, which suffered from crackdowns over the last two years. This is a positive turn, and indicates a general easing up of the Party's interventionism. One area where this could be particularly important is property development. The industry has suffered from the troubles at Evergrande and beyond, but recent data suggests construction activity has swung upwards. This is primarily due to easing of supply chain issues, but could also be an early sign that the government will take a lighter touch.

More generally, economic readings are improving. Recent surveys of business sentiment show a rebound from lockdown malaise, with the manufacturing purchasing manager's index (PMI) jumping to 50.2 in June, from 49.6 in May (a level of 50 or above indicates expansion). This move is broad-based too, with all major sub-components increasing. The non-manufacturing PMI (comprising services and construction) jumped to an even greater 54.7, up from 47.8 last month.

These signs point to an improvement in the world's second-largest economy. And with a supportive policy backdrop (for investment at least) we should expect the rebound to go further. We should not underestimate the headwinds that zero-Covid brings, but with virus cases decreasing through the summer months, short-term growth is likely to improve.

Over the longer-term, how China's Covid policy evolves will be crucial. Here, we note that virus restrictions – particularly those around travel – act as a *de facto* barrier to global integration. It could be coincidental, but it is significant that this is happening at the same time as China reorients itself away from the West. We see this in the government's continued cooperation with Russia, and its efforts to integrate Hong Kong into the mainland – thereby severing some of the city's global ties.

Understanding these trends is key to a long-term investment outlook, both for Chinese assets specifically and the country's impact on the global economy. And Beijing's zero-Covid policy is emblematic of them, making China an outlier. For now, investors seem to have shrugged off these concerns. But how long that can last is deeply uncertain.

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Global Equity Markets

Market	Fri 15:59	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7139	-1.0	-69	⇘	→
FTSE 250	18616	-2.7	-508	↘	↘
FTSE AS	3926	-1.2	-49	⇘	→
FTSE Small	6248	-1.7	-105	↘	↘
CAC	5913	-2.6	-160	↘	↘
DAX	12768	-2.7	-350	↘	↘
Dow	30674	-2.6	-827	↘	↘
S&P 500	3765	-3.8	-147	↘	↘
Nasdaq	11012	-5.1	-595	↘	↘
Nikkei	25936	-2.1	-556	→	↘
MSCI World	2546	-2.8	-73	↘	↘
CSI 300	4467	+1.6	+72	→	↘
MSCI EM	1001	-1.0	-11	→	↘

Top 5 Gainers

Company	%
BAE Systems	+6.7
Rolls-Royce	+5.4
Stan Chartered	+4.0
Prudential	+3.6
Spirax-Sarco	+3.4

Top 5 Decliners

Company	%
British Land	-10.4
abrdn plc	-9.7
Anglo American	-9.4
AVEVA	-9.3
Land Securities	-8.7

Currencies

Pair	last	%1W
USD/GBP	1.201	-2.1
GBP/EUR	0.865	-0.6
USD/EUR	1.04	-1.6
JPY/USD	135.27	-0.0
CNY/USD	6.71	-0.2
Bitcoin/$	21,809	-23.2

Commodities

Cmdty	last	%1W
Oil	110.50	-2.3
Gold	1804.8	-1.2
Silver	19.82	-6.4
Copper	359.1	-4.0
Aluminium	2445.5	-1.3
Soft Cmdties	229.5	-4.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.2	11.7	9.9	14.3
FTSE 250	3.7	10.1	13.0	16.3
FTSE AS	4.1	11.4	10.2	14.5
FTSE Small x Inv_Tsts	3.3	7.3	10.2	15.4
CAC	3.2	12.9	10.4	15.3
DAX	3.6	11.4	10.4	13.8
Dow	2.2	15.8	16.1	16.9
S&P 500	1.7	18.3	16.5	18.2
Nasdaq	0.9	20.6	23.4	24.1
Nikkei	2.1	14.9	14.5	17.8
MSCI World	2.2	15.2	14.9	17.1
CSI 300	1.9	15.6	14.4	12.7
MSCI EM	3.0	9.9	11.4	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.08	-0.23
UK 15-Yr	2.44	-0.15
US 10-Yr	2.88	-0.25
French 10-Yr	1.79	-0.18
German 10-Yr	1.22	-0.22
Japanese 10-Yr	0.23	-0.00

UK Mortgage Rates

Mortgage Rates	Jun	May
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.63	2.52
3-yr Fixed Rate	2.57	2.43
5-yr Fixed Rate	2.63	2.51
10-yr Fixed Rate	2.86	2.80
Standard Variable	4.25	4.21

* 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.

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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