CAMBRIDGE
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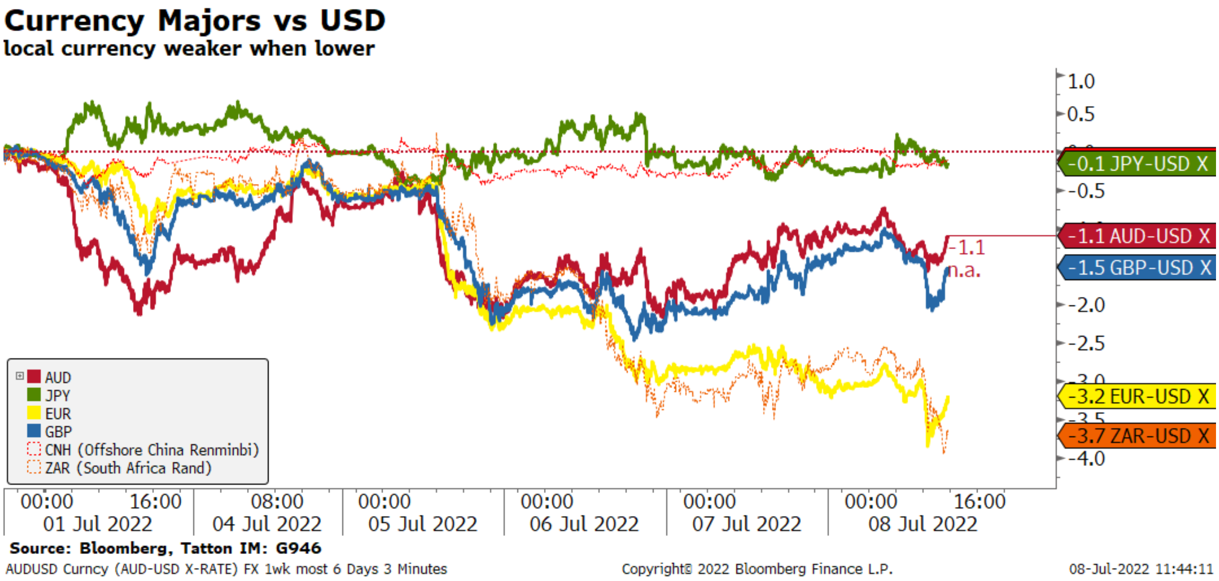
Markets not reflecting public fear

The murder of past Japanese Prime Minister Abe is a reminder of how much we should value our public servants and politicians. We should be grateful to all our politicians that they are prepared to do a job we need so much. Whether they are exercising high office or merely representing us, they are invested with great expectation, much responsibility but little immediate power to meet those expectations. Few of them are self-serving, but all are at risk because they must be prepared to disagree publicly with other people in our society. Here, we remember Jo Cox and David Amess.

The sad news from Japan adds to turbulent political news both in the UK and internationally. However, against this background markets were benign. In the UK, it felt like market moves were linked to ructions in the Cabinet. However, in reality, sterling fared better through the week than the euro. The chart below shows various currencies' change in value against the US dollar over the week from Friday 1st July to Friday 8th July:



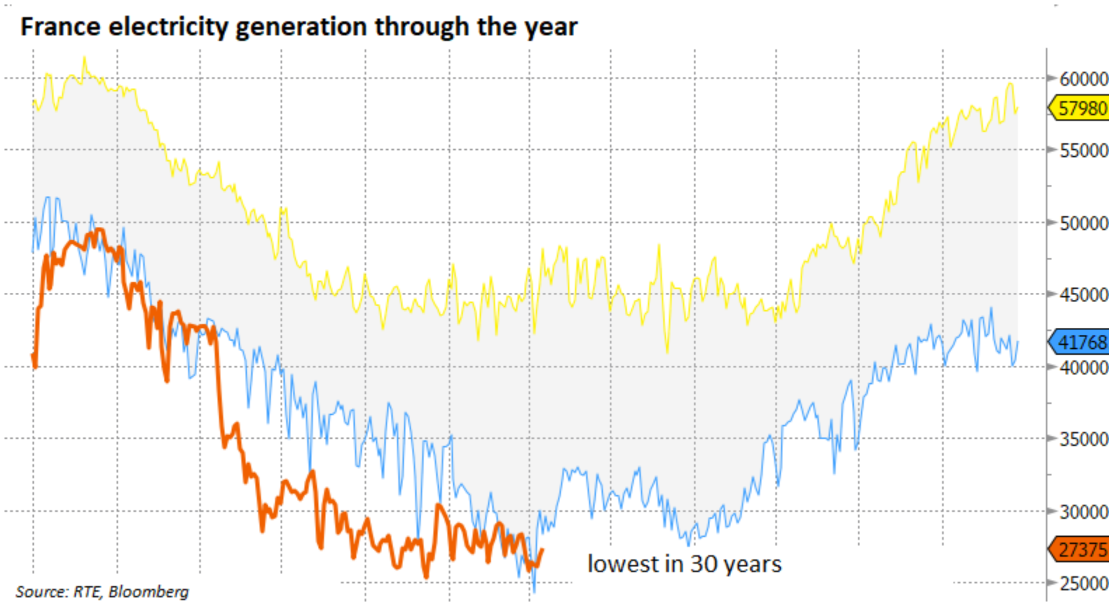
There is no doubt the outlook for the UK economy remains difficult and we write more about this in an article below. The situation limits the upside for domestically focused companies making up much of the mid-caps in the FTSE250. Meanwhile, the FTSE100 index held up reasonably well, although the materials sector came under pressure along with the fall in industrial metals.

Fears for Europe continue to worsen, driven by the current awful situation surrounding European energy prices. Two weeks' ago, we pointed out how Europe's gas and electricity prices had surged, especially for contracts covering this coming winter. Last week, the price situation worsened.

This has led to both French and German governments stepping in to save energy distributors. The German energy distributor-generator Uniper will be rescued with a government package, probably of around €8-9 billion. The rescue will potentially involve the German government taking an equity stake but also lending the company most of the proceeds (in the same manner as happened for Lufthansa during the pandemic – the government got its equity stake at a discount to the market price at the time).

Perhaps of even greater importance are the travails of electricity generator, Électricité de France (EDF). Only 16% of the company was privately owned, but now the French government has decided it will be fully nationalised (again). This will stabilise EDF's enormous debt and allow the government to control the prices charged to French customers, which had threatened to bankrupt many local manufacturers and other energy-dependent businesses.

It may not solve the problem in terms of generating enough electricity. Russia is constraining gas supplies, but France's problems revolve around the lack of rainfall in the Alps and poor maintenance over many years. The drought has brought river levels to low levels and those rivers are used as the cooling water supply for EDF's old nuclear reactors. Output is the lowest in 30 years:



Elsewhere, Bloomberg reported on 2 July that "Italy is set to spend almost 40 billion euros subsidising energy bills for consumers, while the UK put down some £37 billion to ease the impact on consumers. The nationalisation of Bulb alone will cost consumers about £2.2 billion".

For markets however, the issue is whether businesses, especially manufacturers, will be immunised. Most are currently forced to pay market rates. As we mentioned last week, manufacturers' average energy proportion of overall costs in 2019 was about 12%. This winter, electricity will be around four times that price. So, even if consumers are not hit directly by electricity price rises, they will face further inflation in goods. Businesses will almost certainly see sales volumes declines.

That would mean a Europe-wide recession, an outcome clearly being priced now by markets.

However, there is some good news coming from markets. The fall in bond yields (both fixed and 'real') is not surprising, given the context, but provides some respite. More surprising, perhaps, is that general credit spreads are finishing the week broadly unchanged after spiking higher in the middle of last week. They're still signalling a recession, but the government actions are giving hope that a pandemic-like response for businesses is in the offing. Meanwhile, the declines in industrial metal and agricultural commodity prices are alleviating some inflationary concerns.

Risk assets in the US are stabilising as well following the sharp downswing in longer-dated bond yields. While the move came about because of growth concerns, it also seems that a number of investors have bought back into bonds after being considerably underweight for a long period. Credit spreads also came down quite sharply, about 0.1% in yield falls for investment-grade credits.

Finally, China is stepping up its fiscal push into the autumn with about $220 billion of new credit being raised by local governments. The swing-round in growth in China following the lockdowns has been as strong as could possibly have been expected and is set to go further. At this rate, China may well reach the 5.5% yearly growth target for 2022, despite running at a near 10% annualised decline for the second quarter.

Market sentiment will depend greatly on the outturn for Europe. The Nord Stream pipeline annual maintenance shutdown finishes on 21 July and investors will be hoping Gazprom will resume a full supply after the unscheduled reductions that began in June. However, last week, French and German governments' willingness to step in to bail out the energy companies, as well as protect consumers and businesses certainly helped. As long as investors (and perhaps the European Central Bank) are willing to fund the increase in debt, Europe may be able to see this through without devastating economic damage.

A month of negatives: June monthly market returns review

Asset Class	Index	June	3 Months	12 months	2021	5-yr rolling annualised
Equities	FTSE 100 (UK)	-5.5	-3.7	5.8	18.4	4.1
	FTSE4Good 50 (UK Ethical Index)	-5.6	-4.4	3.4	13.0	0.6
	MSCI Europe ex-UK	-7.0	-8.7	-10.6	16.7	3.9
	S&P 500 (USA)	-4.8	-9.0	17	29.9	12.8
	NASDAQ (US Technology)	-5.2	-15.7	-12.9	23.3	13.5
	Nikkei 225 (Japan)	-4.4	-7.4	-8.9	2.6	5.7
	MSCI All Countries World	-5.0	-8.6	-4.2	19.6	7.0
	MSCI Emerging Markets	-3.1	-4.0	-15.0	-1.6	2.2
Bonds	FTSE Gilts All Stocks	-1.8	-7.4	-13.6	-5.2	-0.7
	£-Sterling Corporate Bond Index	-3.6	-7.8	-14.5	-3.2	0.1
	Barclays Global Aggregate Bond Index	0.4	-0.5	-3.6	-3.8	0.8
Commodities	Goldman Sachs Commodity Index	-4.2	10.6	65.0	41.6	11.7
	Brent Crude Oil Price	-2.1	12.9	66.2	51.5	17.5
	LBMA Spot Gold Price	1.5	2.3	17.5	-2.9	7.8
Inflation	UK Consumer Price Index (annual rate)	0.7	3.2	8.5	5.4	-
Cash rates	Libor 3 month GBP	0.1	0.1	0.2	0.0	0.5
Property	UK Commercial Property (IA Sector)*	0.6	1.7	10.6	7.4	2.8

Source: Morningstar Direct as at 30/06/22. * to end of previous month (31/05/22). All returns in GBP.

June was not a strong month for global equities, which declined 5% for UK£ sterling investors on the back of worries around an upcoming global recession. In fact, the first six months of 2022 proved to be the worst first half of the year in more than 50 years for major equity markets. The negative sentiment was mainly driven by further tightening monetary policy measures and attempts by most of the major central banks to tame inflation.

Government bonds were hit as markets moved to price in significant further interest rate hikes, on top of what had already been announced. Rates are expected to rise in the US, UK and Europe into next year – adding to the pressure on equity valuations and dampening the outlook for economic growth. Fears of recession remain front of mind, as the cost-of-living squeeze hit consumer confidence and their pockets, as central banks made efforts to control inflation.

For the UK, unemployment remains low, but so does consumer confidence. Negative real wage growth, rising mortgage costs and higher food and energy prices all helped push UK equities into the red in June. Despite the particularly strong first half of the year compared to other major markets, UK equities finished the month down 5.5% and 1% year-to-date

Europe lagged other key equity markets, dropping 7%, with the ECB signalling plans to hike interest rates in July, while energy prices continuing their upward momentum. European consumer confidence has also fallen dramatically. The biggest risk to the Eurozone economy is the reduction in gas supplies coming from Russia. Prices are up and there are genuine fears of energy rationing, which would have severe consequences for the European economy.

US equities fell 4.8%, with the technology sector down 5.2%. Further rises in yields following the hawkish policy announcements from the US Federal Reserve (Fed) continued to harm valuations for growth companies. The Fed now looks likely to raise interest rates by 0.75% by the end of the year to combat inflation. While US unemployment remains low and wage growth has been strong, consumer sentiment has fallen sharply. The Fed forecasts unemployment will need to rise to just above 4% to bring inflation down. However, the market is clearly worried that getting inflation under control could require unemployment to rise much higher, as has historically been the case.

Higher interest rates are starting to weigh on economic activity. US house prices are almost 40% higher than January 2020, and 30-year fixed mortgage rates having risen from below 3% to nearly 6%. At the same time, home sales are declining (it appears unlikely we will see a repeat of the last housing crisis as 95% of Americans today are on long-term fixed rate mortgages, compared with only 80% in 2007).

Emerging Market equities dropped 3.1% in June. However, China saw a bounce back following the easing of some strict Covid lockdown measures. The Chinese Centre for Disease Control and Prevention reported that of 33,000 patients hospitalised with Omicron, only 22 had developed severe illness, all of whom were over 60 and had pre-existing medical conditions. China may yet remove the lockdowns that have severely affected economic activity this year. Further, Chinese monetary policy is easing compared to the rest of the world, which should assist its economic recovery. This was reflected in returns and the expansion of the manufacturing and services sectors' activity in June.

One positive that emerged in June was that oil prices ended the month lower for the first time in 2022. While this was driven by fears of slowing global consumption, a knock-on effect could see inflationary fears ease in the current climate.

In summary, market risks remain, but markets have already fallen a long way. Timing the market – selling now and buying cheaper at a later date – would require an ability that few professional investors, let alone retail investors, have historically been able to do. We therefore remain compelled to ride through this period.

UK government crashes but markets shrug

At the time of writing, Boris Johnson is still Prime Minister in name, if not in substance. The slow-motion collapse of his government dramatically picked up pace last Tuesday night, with the sudden resignations of Rishi Sunak and Sajid Javid and coincided with a sharp fall in sterling against the US dollar.

A paralysed government is clearly a serious issue at any time. When inflation is rampant and real economic growth has deteriorated, one might expect it to be the worst possible time. And yet, capital markets barely registered the move. The value of sterling, the clearest barometer of market views on the UK's relative prospects, fell slightly against the dollar last Tuesday. But virtually all of that decline came during the day's trading, before the resignations of Sunak and Javid. On Wednesday, as chaos descended on Westminster, sterling floated down, then up, then back down again. As the FT asked: "Have all sterling traders gone to see the tennis at Wimbledon?"

Not quite. Currency traders are not ignorant of Downing Street's political upheaval, but they may be indifferent. A simple rationalisation might be that Johnson's demise has long been telegraphed, and so former allies finally gathering for his execution is not big news. Last month's narrow win in the vote of no confidence never really felt like a victory, and the writing has not so much been on the wall as all over the national news.

This narrative has a ring of truth, but it misses a deeper point. There was a time when sterling's value seemed at the whim of Parliament, where every currency trader had a paid subscription to Westminster's soap opera. Johnson himself once single-handedly knocked 2% from sterling's value in a day when he came out as a Brexiteer in 2016 – that level of influence carried over for much of his early time in office.

Things are different now. While markets once evaluated Britain's prospects by the relative hardness of its Brexit and its likely impacts, there is a sense now that the damage is done. The UK has the highest inflation rate in the G7 and one of the worst growth outlooks. While energy and commodity price rises are not because of severing ties with the European Union (EU), the frictions with our largest trading partner have exacerbated the global supply chain issues.

But the biggest impact has been on our labour market. Employment economist Tom Diconarry explains: "For many years, UK businesses relied on skilled, and semi-skilled labour which was easily accessed from Europe. This boosted the productive capacity of the UK economy in the medium-term but disincentivised businesses in helping provide or fund the training for youngsters to fill those jobs. Brexit severely impaired businesses' ability to get the workers they needed in the near-term and couldn't suddenly make our youngsters skilled. It will take time and money (which inevitably will be less abundant) to put in place the training structures that the UK needs. Most importantly, it will take a coordinated approach led by a far-sighted government".

This structural impediment is in addition to the world's problems. Last week, the Bank of England (BoE) issued yet another dire warning on economic prospects. According to Governor Andrew Bailey, "Since the last financial stability report, the global economic outlook has deteriorated markedly". Deterioration now seems to be a trend in BoE guidance, with recession either looming or already underway.

So, there is a sense that change of government either will not or cannot change much about the near-term situation. There is no obvious visionary successor to Johnson in the Conservative Party; indeed, none of the frontrunners has a substantially different economic vision to the seemingly outgoing Prime Minister. The current policy dialogue remains focused on the short-term. Whoever ends up in charge of the Treasury come Autumn will likely want to bring in further tax cuts – but the space to do so has arguably already been exhausted by Sunak. Beyond which, any new measures will likely have minimal impact.

This seems to be the working hypothesis for currency traders, who see little change to the BoE's outlook over the short-term. However, some risks might be underappreciated. While a full-scale loosening of fiscal policy anytime soon is unlikely, it is by no means out of the question – particularly given the uncertainty over who might end up at Number 10. That would force the BoE into more short-term interest rate hikes than currently priced (the market now expects another 0.75% over the next three meetings). While the sum of the fiscal easing and monetary tightening may end up being neutral for the UK economy, retail banks are tightening up loans against worsening balance sheets, and this would probably not help.

For sterling, tighter monetary policy might add some upward pressure, perhaps more than cancelling out negative economic effects. However, recent history has shown there is little currency upside when the BoE tightens. With the Fed raising rates faster and with the UK at an economic disadvantage, investors have been unwilling to buy sterling-denominated assets, even as rates go up.

Indeed, sterling will only start to move decisively higher should the UK's potential (non-inflationary) growth prospects improve. The deterioration in relative productivity is most obvious when looking at the current account deficit. In Q2, the UK's imbalance widened to 4.2% of GDP on an annual basis, up from 2.6% in Q1. This means Britain is effectively reliant on foreign capital to fund its deficit, and even more so than it was before.

For almost all the last century, the UK benefitted from a positive flow of investment income. Our stock of overseas assets brought in more than we paid out on our liabilities. Now, in addition to buying more goods and services than we sell abroad, we have to pay out interest and dividends. This introduces a huge risk to financial stability, as a sudden flight of capital would leave the system exposed. More inflation and a widening government deficit could trigger such an exodus.

Moving "beyond Brexit" is critical to the UK's prospects, but few think a new Conservative leader can. That is why we are keeping an eye on the incoming government's fiscal policy. We do not expect it to materially affect the UK's position, but there is a tail risk that cannot be ignored. For sterling, this is balanced against the short-term upward pressure it could bring from a more aggressive BoE. All in all, the risks are finely balanced, if a little uncomfortable. The muted currency market response to last week's chaos is therefore perhaps fitting.

Global Equity Markets

Market	Fri 13:43	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7145	-0.3	-24	⇘	→
FTSE 250	18810	+0.9	+174	↘	↘
FTSE AS	3935	-0.1	-5	⇘	→
FTSE Small	6270	+0.3	+17	↘	↘
CAC	5998	+1.1	+67	↘	⇘
DAX	12923	+0.9	+110	↘	↘
Dow	31385	+1.1	+355	→	⇘
S&P 500	3903	+2.2	+84	→	↘
Nasdaq	11621	+4.0	+443	⇗	↘
Nikkei	26517	+2.2	+582	→	↘
MSCI World	2602	+1.6	+42	⇘	↘
CSI 300	4429	-0.8	-38	⇘	↘
MSCI EM	994	+0.2	+2	⇘	↘

Top 5 Gainers

Company	%
Auto Trader	+8.4
Ashtead	+7.0
Airtel Africa	+6.8
Scot Mtge Inv Trust	+6.7
Dechra Pharmaceut	+6.4

Top 5 Decliners

Company	%
Entain	-14.4
Fresnillo	-9.2
Persimmon	-6.1
Centrica	-5.9
Stan Chartered	-5.2

Currencies

Pair	last	%1W
USD/GBP	1.198	-1.0
GBP/EUR	0.846	+1.8
USD/EUR	1.01	-2.7
JPY/USD	136.40	-0.9
CNY/USD	6.70	-0.0
Bitcoin/$	21,337	+11.5

Commodities

Cmdty	last	%1W
Oil	104.13	-6.7
Gold	1739.1	-4.0
Silver	19.18	-3.5
Copper	351.9	-5.3
Aluminium	2442.5	-0.1
Soft Cmdties	225.8	+0.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	11.7	9.6	14.3
FTSE 250	3.3	10.1	13.2	16.3
FTSE AS	4.0	11.4	10.0	14.5
FTSE Small x Inv_Tsts	3.3	7.4	10.9	15.4
CAC	3.2	13.1	10.3	15.3
DAX	3.6	11.5	10.6	13.8
Dow	2.1	16.2	16.5	16.9
S&P 500	1.6	19.0	17.0	18.2
Nasdaq	0.9	21.6	24.3	24.1
Nikkei	2.1	15.2	14.8	17.8
MSCI World	2.2	15.6	15.2	17.1
CSI 300	1.9	15.4	14.2	12.8
MSCI EM	3.0	9.8	11.3	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.17	+0.09
UK 15-Yr	2.56	+0.10
US 10-Yr	3.07	+0.19
French 10-Yr	1.84	+0.05
German 10-Yr	1.31	+0.08
Japanese 10-Yr	0.24	+0.02

UK Mortgage Rates

Mortgage Rates	Jul	Jun
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.88	2.78
3-yr Fixed Rate	2.97	2.81
5-yr Fixed Rate	2.90	2.80
10-yr Fixed Rate	3.28	3.13
Standard Variable	4.38	4.35

* 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

If anybody wants to be added or removed from the distribution list, please email
enquiries@cambridgeinvestments.co.uk

CAMBRIDGE INVESTMENTS LIMITED

11th July 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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