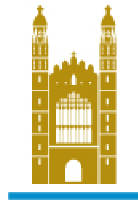

CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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The Fed at work and China snubs Putin

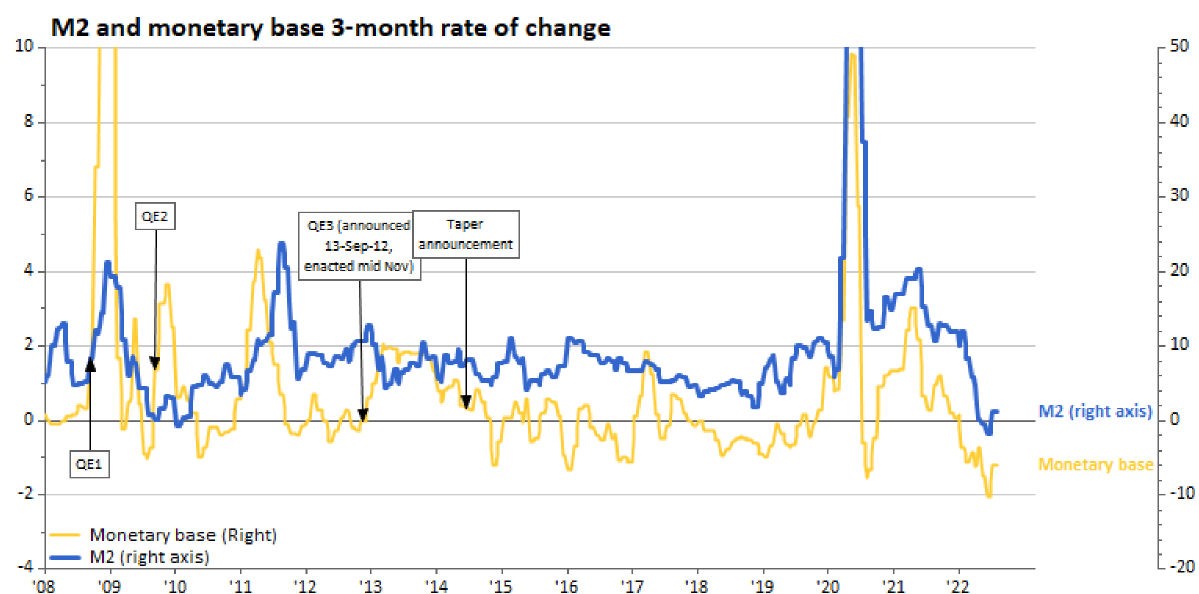
The consequences of a European war continue to dominate our economy and markets, as it does throughout Western Europe and, to some degree, Asia. Meanwhile, seemingly unaffected by the rest of the world, the US is blazing its own trail.

This is predominantly because US energy security means they do not face the same input cost pressures. Nevertheless, inflation remains a problem for the US Central Bank, the Fed. The August consumer price data reflected a fall back in oil-related pressures but tightness in the labour market continues to feed through. Therefore, and perhaps surprisingly, the US is faced with a more structural inflation issue through looming wage-price-spiral dynamics than Europe.

Labour clearly does wield some pricing power. A US rail strike, the first for 30 years, was called off last Thursday after a deal neared agreement. According to the BBC, it includes a 24% wage increase and $5,000 bonuses, as well as changes to existing policies on time off, which had been a crucial sticking point for workers.

The ability to pay the increases suggests that US companies have more cash-flow leeway. It also suggests that this Wednesday's meeting (21st) of the Federal Reserve Open Markets Committee will decide to raise rates to at least 0.75%. Some analysts, like investment bank Nomura, think they will raise the Fed Fund target rate by 1%pt to a 3.25-3.5% band. More importantly, few think US interest rates are close to the peak. That is now seen to be around 4.5%.

It does look like the Fed seemingly loosened its grip on the US economy during the summer and will now have to tighten harder, after the fallback in inflation expectations data perhaps allowed a bit of complacency. The money supply (M2) data showed some reacceleration over the past quarter as seen in the graph below:



It has been noticeable that private sector credit growth has been the driver, both on the corporate and the consumer side, while the government has reined in spending.

Equity markets fell back, as government bond yields rose. The 10-year treasury is within touching distance of yielding 3.5% while the 10-year "real" yield (after 10-year inflation expectations) has moved above 1%. Credit spreads, which had moved to quite low levels at the end of the previous week, rose although not to the highs seen in August. We write about the current relative resilience of US corporate credits in an article below.

Ray Dalio, co-CIO of renowned US investment managers Bridgewater Associates, ventured the opinion that the leading US market index, the S&P 500, would fall some 20% over time if long rates were to go to his expected level of 4.5% - 1% higher than in the UK amid continued inflation pressure. Our assessment is that, if he is right about a rise in long rates to 4.5%, it would definitely put more downward pressure on US stock valuations as bonds' attractiveness increases. However, the flip side of such a rise in yields would be produced by strong nominal earnings growth, while real yields would rise less overall, which would limit valuation pressures on equities. There would also be an offset from probable further strength in the US Dollar. Overall, even if Ray Dalio is proved right, in Sterling terms, the S&P 500 fall should be limited to within the region of 5-10%.

All that assumes that long rates do move up to that level. Clearly there is a trend to move higher, but we should also factor in the relative weakness of the rest of the world's economy. The US can be less affected for some time but not forever. While the US economy is stronger than expected, one should not overstate it. The summer bounce has been relatively muted amid a clear slowing, centred mostly on the West Coast and its tech companies. Meanwhile construction, the major economic driver for 2021, has slowed and is not rebounding given that mortgage rates remain at 6% and August retail sales disappointed.

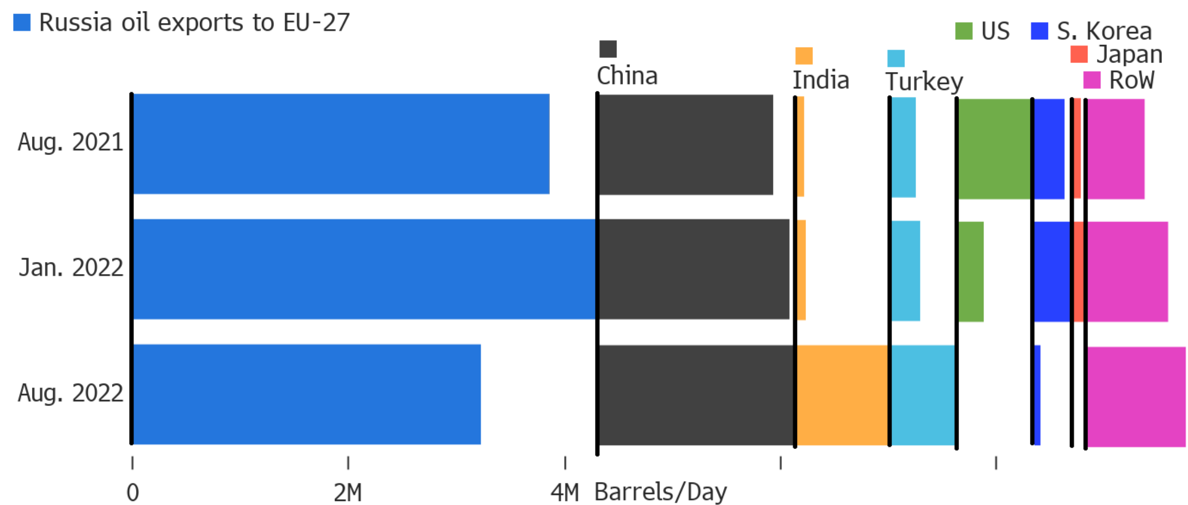
Seasonally, consumer spending picks up through the last quarter so the Fed will be anxious, waiting to see if consumers have just delayed their purchases. The Fed showed determination in the first part of the year and will probably reassert itself this week. We would be unsurprised by a 1% rate rise (rather than 0.75%) and think that, after last week's moves, the market is already prepared for the bigger move.

Elsewhere, international pressure on Vladimir Putin is growing from what might seem to be an unlikely source. He met China's Xi Jinping last week to cement their relationship, but it did not quite go to plan. Putin stridently supported China's position on Taiwan but there was no such reciprocation from Xi. Indeed, Xi reportedly expressed his concerns about Russia's war in Ukraine.

Before the meeting, some market analysts reported that relations between Russia and China were cooling rather than improving. Signum Global Advisors noted Chinese companies "have scaled down their exports, suspended deliveries or started winding down their operations on the Russian market altogether". This may seem at odds with the Chinese official rhetoric, but the private sector behaviour is being tacitly accepted.

China's recent domestic weakness may be on a path to some improvement, but it is slower than we expected. The policy crackdowns, that partly led to the compression, are being eased but China is deeply reliant on foreign demand for its goods. The US is pulling a huge amount of Chinese goods in, but Europe's slowdown is really hurting. China would really like Russia to cease its energy war.

Reluctance to validate Russia's actions is probably most evident in the data on energy imports. Bloomberg and Morgan Stanley published a chart last week which shows the changes in Russia's oil exports to various regions (we have adjusted it to show the country changes more clearly):



After the bad-tempered episode involving Taiwan and Nancy Pelosi, there appear to be efforts from both the US and China to calm relations. While it will not dissuade Putin from continuing the conflict, it may weaken his hand further.

In summary, while there are formidable headwinds to the global economy, which from time to time create particularly strong market reactions, there are likewise positives that balance the negatives in-between. We are still going through a post pandemic period that is characterised by increasing economic activity. However, because of the formidable disruptions of the past two years, this is neither happening in a straight line, nor does it happen without impacting yield levels as we had become used to over the past decade.

US corporate credit not yet stressed

Recession fears continue to dominate market headlines. This is most pronounced here in the UK and in Europe, where the energy crisis has made a downturn all-but inevitable. But investors are also worried about the outlook for the US, given it remains the preeminent global economic superpower. Declining business confidence and an aggressive Federal Reserve has led to fears that debt repayments will become too great, sending companies into bankruptcy. The US yield curve – measuring the difference in term payments between short and long-term government bonds – is still inverted, with investors getting paid less to lend over ten years than they do over two. This is often taken as a reliable recession indicator, as markets acknowledge the Fed forces them in the short-term into a high-rate environment – to slow the economy – which is seen above the long-run average.

Equity market moves suggest that investors buy into the doom and gloom story. US stocks have fallen over the last month and are down just under 20% year to date. The odd thing about this narrative, though, is that it seems at odds with what companies themselves are experiencing. If a recession was looming – especially one driven by rising interest rates and higher costs of financing – you would expect to see signs of stress in credit markets. And while spreads have certainly widened, acute stress in the market has been contained so far. We believe this is due to sound corporate balance sheet management, and a solid cash position that most corporates had built-up – also thanks to Covid buffers. Looking forward, a key variable will be when higher financing costs feed into debt servicing costs.

According to analysis from Goldman Sachs, profit margins and leverage ratios were resilient for US corporates over the first half of the year. In the first two quarters of 2022, margins for investment grade companies fell slightly, but were mostly flat. But this has to be taken in the context of historically high profit margins, as well as multiple economic headwinds throughout the year.

Even more astounding are the trends in sub-investment grade debt. According to Goldmans, the median high-yield company has increased its net margin every quarter since the end of 2020. High-yield leverage, i.e., by how much a company gears its balance sheet through borrowing, having come down dramatically throughout 2021, has shown little movement so far this year. In other words, high-yield debt is showing little to no signs of stress, while profits are continuing their upward trend.

The fact that high-yield credit in particular is doing so well speaks against imminent recession fears – or indeed, ex-post explains why the US is not in a broad recession, as witnessed by its solid labour market performance. In a typical downturn, rough waters sink the smaller ships first, forcing small and medium sized enterprises into default quicker than large-cap companies and overall cooling the labour market substantially as a result. As such, small business stress is a leading recession indicator. Judging by high-yield credit markets, small businesses are resilient – faring better, in fact, than their investment grade counterparts (see charts below).

Strong cashflows are the source of credit resilience. It is true that liquidity, in terms of cash to total asset ratios, has been falling for over a year – as one would expect in a rising interest rate cycle. Yet, those ratios are still well above where they were at the onset of the pandemic, with both investment grade and high-yield companies showing the same figures as in 2017. Crucially, this means that businesses so far have been

well capable of making debt repayments in spite of rising interest rates. As the charts below from Goldman Sachs show, interest coverage ratios are not yet showing cracks.

Exhibit 1: Net margin has decreased for US IG Firms in recent quarters, while net leverage has held steady
Median net margin and median net leverage over time for IG rated US firms

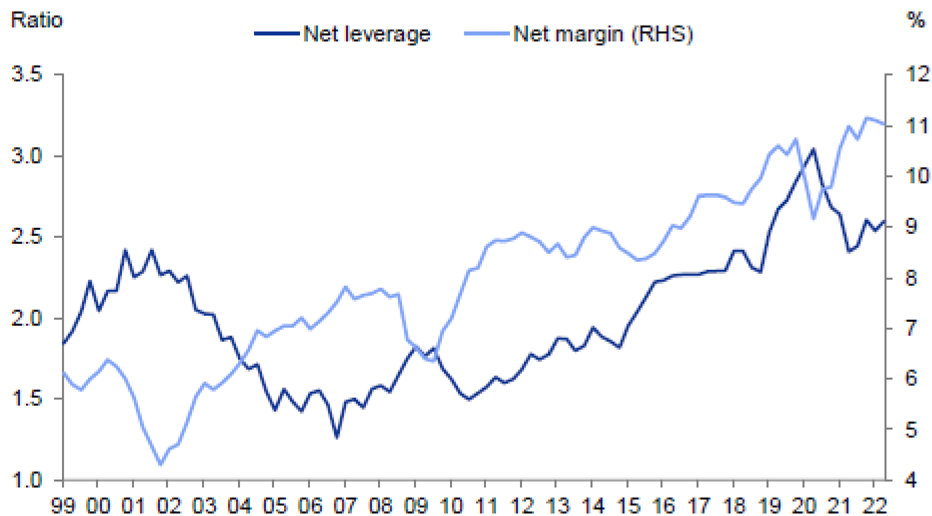
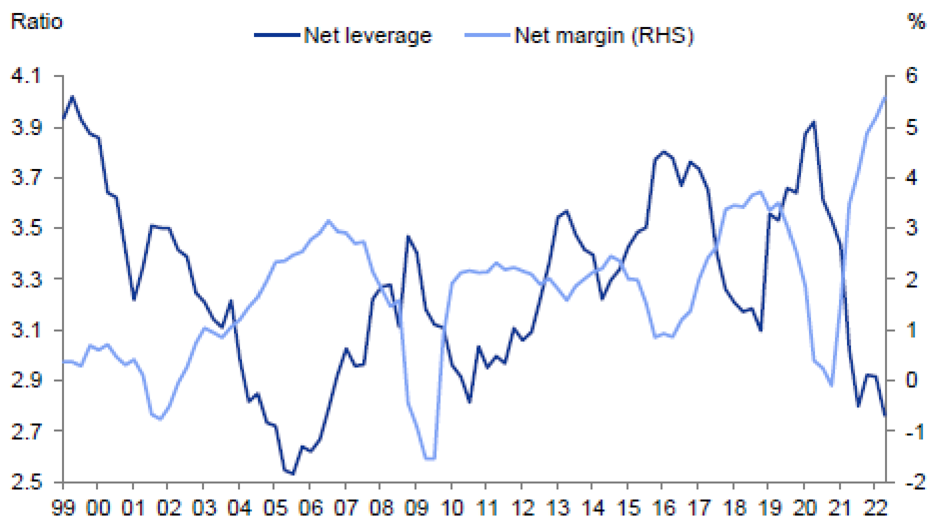


Exhibit 2: Net margin and net leverage have improved or held steady for US HY issuers
Median net margin and median net leverage over time for HY rated US firms



Source: FactSet, Goldman Sachs Global Investment Research

Businesses can sustain decent cash flows and make debt payments because of strong nominal growth. Perversely though, that strong nominal growth is also the reason for market pessimism – in a roundabout way. Global recession fears are centred around a slowdown in China and a sharp energy supply crunch in

Europe. However, for the US in particular, the potential recession story is entirely linked to inflation as a consequence of strong nominal growth, and what it means for Fed policy in terms of further rate hikes.

The world's largest economy is not suffering from as sharp supply-side issues as elsewhere, a situation which has been helped by the recent fallback in oil prices. Instead, inflation concerns come from America's tight labour market. The Fed is intent on cooling the jobs market to halt a damaging wage-price spiral. While this monetary aggression can be uncomfortable for markets, it ultimately comes from the strength of the US economy.

Credit spreads – the difference between corporate and government bond yields – have swung up and down over the last few weeks on the back of new inflation data. They widened after last week's release showed inflation still running hot, prompting expectations of more Fed tightening than had hitherto been anticipated. But the Fed is only tightening because the economy is strong, consumers are spending, and employment is holding up well.

All those factors are supportive for businesses. Without a particularly sharp cost shock – like the one we are seeing now in Europe – economic strength should allow companies to deal better with the rising cost of financing. As for recession indicators, we suspect that they are also down to global or technical factors, rather than a reflection of the US economy. The yield curve, for example, is skewed by the recent risk-off move from global investors – as many institutions are simply required to buy long-term US treasury bonds.

The run down in corporate savings is entirely reasonable too. As inflation goes up, companies have less of an incentive to hold cash. Provided that balance sheets are generally okay and there is no immediate danger of default, a healthy company would be expected to reduce its cash ratio in such an environment. In an ideal world, they would actually invest for the long-run future of their company. Rather than a sign of weakness then, it could be a sign of things going as they should.

None of this is to say that things could not turn for the worse. Sharp rate rises take a toll on businesses, and the risks are unevenly spread. Sectors like commercial real estate are particularly sensitive to interest rate moves and could be a sore spot if inflation continues to be strong, but there is no sign of immediate danger. It would likely take a significant weakening to create widespread default pressures.

By many measures, equities have been and remain expensive relative to credit – despite the market falls this year. You could read that pessimistically as a sign that stocks need to sink further, but you could also read it in reverse, as a sign that corporate credit is undervalued. This is backed up by balance sheet resilience among companies. Ultimately, the difference between the two scenarios is market sentiment, rather than underlying conditions. For better or worse, that sentiment will be a deciding factor in how corporate credit fares from here.

US midterm elections in the balance

After Britain's political shakeup, our attention turns across the Atlantic. The US midterm elections, when control of both Houses of Congress will be up for grabs, are less than two months away. The November polls are always worth viewing because, when America votes, the world watches.

Capital markets may not care much about the politics but are focused on "money" impacts, and some commentators have warned that the midterms could be a source of volatility in the coming weeks.

Biden's presidency has already faced a number of roadblocks despite Democrats' control of the executive and legislature. The 50-50 split in the Senate allows, in a tie-break, Vice President Kamala Harris has the casting vote, but the Democrats have not been unified enough to get all the senators into line and the Republican Senate leadership has been adroit in persuading centrist senators to rebel. Despite the Republicans having their own factions, Biden would find it much more difficult to divide them, so a Senate loss would mean two years of a lame duck presidency.

Keeping control of the Senate is the Democrats' priority and is achievable. The current expectation is that President Biden's Democratic Party will retain or even strengthen control of the Senate. However, the Republican Party is expected to snatch the House of Representatives away. According to forecasts from US opinion poll analyst, FiveThirtyEight, the Democrats' Senate chances are at 70%, and the Republicans' House chances at 73%. These odds are not indications of votes or seat shares, which are expected to be significantly tighter for both chambers. They are instead estimations of likely scenarios around the majority 'tipping points' – 50 seats in the Senate and 218 in the House.

A loss of both chambers would signal the end of Biden's policy push. Nevertheless, ceding the lower chamber would still frustrate Biden's agenda and compound the gridlock in Washington.

As recently as July, polling showed the Republican Party on track to win control of the Senate, so the Democrats are now in somewhat better cheer with their fortunes improving over the summer. We see the same trend in the House, albeit to a much lesser extent. A Republican victory looked a sure thing a few months ago, but the Democrats now have better than a quarter chance of retaining control.

The state of the economy is generally a good guide to the ruling party's fortunes. Consumer sentiment fell dramatically in the spring and summer, and the Democrats' approval rating unsurprisingly declined with it. However, commentators are not ascribing the recent improvement in Democrats' polling to things like a tight labour market.

The swing may be at least partly due to the Supreme Court's decision to overturn Roe v Wade, the landmark case which enabled nationwide access to abortion for the last 50 years. Trump-appointed conservative judges shifted the Supreme Court's balance which then allowed the change to happen.

The strike-down of Roe v Wade is unpopular at the national level. More worryingly for Republicans, it seems to have energised liberal voters. Last month, the heavily conservative state of Kansas voted against banning abortion by an 18-point margin. Thereafter, Democrats have since won two special elections and eaten into Republican votes at another two.

The results do not look like anomalies. Defeat in the Kansas referendum was driven by a higher-than-expected turnout and an increase in voter registration. Those trends are holding up elsewhere, even more so in Republican states where abortion access is under threat. Voter registration is skewing heavily female in traditionally conservative states, a sign that women's rights are likely to be near the top of the agenda come November. What's more, new voters are often underrepresented by pollsters, meaning that the swing towards the Democrats could be even bigger than it currently looks.

On their part, Republicans are hardly helping the party's wider chances. Last week, Republican senator Lindsey Graham proposed a federal ban on abortions after 15 weeks. Republican candidates and lawmakers have already tried to distance themselves from the proposal, aware of how it might hurt their own local electability.

Senate minority leader Mitch McConnell wants to steer the national conversation to inflation, the general economy and perceived "woke" liberal excesses. However, the elephant in the room is former President Trump. He continues to campaign despite having yet to declare his presidential intentions. Meanwhile, nearly 200 Republican candidates are still pushing the story that Biden stole the 2020 election. Yet, Trump-endorsed candidates are failing to make gains across the country. Perhaps it's because FBI investigations into Trump keep filling the news, to the detriment of his party's midterm chances.

FiveThirtyEight puts the chances of a Democrat clean sweep at 27%, a significant chance. Traditionally, Democrat control has been seen as bad for equity markets – the centre-left party being more likely to impose heavier taxes on corporations and investors. Biden has already enacted an increase in corporate (but not household) taxes in the August signing of the Inflation Reduction Act.

The more important side of the equation is how fiscal policy will affect the Federal Reserve's decisions. While Biden's landmark Inflation Reduction Act carves out a chunk of new spending for the worst off, increased corporate taxes and regulation on healthcare companies makes the bill fiscally neutral, according to most analysts. That's welcome news for the Fed, which is battling a wage-price spiral emanating from a tight labour market and a growth trajectory that refuses to slow much, if at all.

Where the Republicans stand on fiscal neutrality is unclear. Since Reagan, they have been proponents of low taxes but have not been averse to fiscal deficits. Some have bemoaned Biden's spending plans on the grounds of fiscal discipline, but the continued loyalty to Trumpism contradicts that narrative. Just like the Conservative Party here, it looks like tax cuts and growth are bigger priorities than budget discipline.

In reality, these midterms are not likely to change fiscal policy dramatically, particularly given the likelihood of a split and gridlocked legislature. There is more chance of some fiscal largesse if the Democrats hold both Houses of Congress, but they've achieved much of their agenda in the recent Inflation Reduction Act.

Both parties will soon shift their focus towards the Presidential elections in 2024. For markets, foreign relations could be the most important battleground, especially the relationship with China. Whether markets would prefer Democrats or Republicans in Congress is hard to say and the recent swings do not appear to have been a big factor in asset market moves. Rather than the fiscal deficit, it may be the trajectory for the current account deficit and the US Dollar that occupy investors' minds.

CAMBRIDGE INVESTMENTS LIMITED

20th September 2022

Global Equity Markets

Market	Fri 15:52	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7261	-1.2	-90	⬂	→
FTSE 250	18838	-1.8	-350	➘	➘
FTSE AS	3989	-1.3	-52	⬂	⬂
FTSE Small	6308	-0.5	-34	⬂	➘
CAC	6101	-1.8	-112	➘	➘
DAX	12786	-2.3	-302	➘	➘
Dow	30659	-4.6	-1492	➘	➘
S&P 500	3859	-5.1	-208	➘	➘
Nasdaq	11366	-6.2	-746	➘	➘
Nikkei	27568	-2.3	-647	→	→
MSCI World	2592	-3.4	-91	➘	➘
CSI 300	3933	-2.6	-105	⬂	➘
MSCI EM	959	-1.2	-12	⬂	➘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
NatWest	+4.9	Melrose Industries	-12.4
Lloyds Banking	+4.1	Ocado	-11.9
AVEVA	+3.4	Dechra Pharmaceuticals	-9.8
Admiral	+3.2	Halma	-7.6
Kingfisher	+3.0	Centrica	-7.0

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.143	-1.4	Oil	91.86	-1.1
GBP/EUR	0.877	-1.2	Gold	1677.8	-2.3
USD/EUR	1.003	-0.1	Silver	19.423	+3.0
JPY/USD	142.93	-0.3	Copper	355.6	-0.7
CNY/USD	6.996	-1.0	Aluminium	2307.5	+1.8
Bitcoin/$	19,677	-9.3	Soft Cmdties	219.82	-1.5

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	10.3	9.1	14.3
FTSE 250	3.5	8.3	13.0	16.4
FTSE AS	3.8	10.0	9.4	14.5
FTSE Small x Inv_Tsts	3.5	6.9	10.7	15.5
CAC	3.2	11.9	9.8	15.2
DAX	3.6	12.3	10.5	13.8
Dow	2.2	16.0	16.4	17.0
S&P 500	1.7	18.3	17.1	18.3
Nasdaq	0.9	21.5	25.4	24.3
Nikkei	2.0	15.2	15.0	17.8
MSCI World	2.2	15.4	15.4	17.1
CSI 300	2.2	13.3	12.9	12.8
MSCI EM	3.3	9.6	11.3	12.7

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	3.14	+0.05
UK 15-Yr	3.48	-0.01
US 10-Yr	3.44	+0.13
French 10-Yr	2.31	+0.05
German 10-Yr	1.77	+0.07
Japanese 10-Yr	0.26	+0.00

UK Mortgage Rates

Mortgage Rates	16-Sep	17-Aug
Base Rate	1.75	1.75
2-yr Fixed Rate	3.64	3.50
3-yr Fixed Rate	3.74	3.31
5-yr Fixed Rate	3.61	3.43
10-yr Fixed Rate	3.73	3.63
Standard Variable	4.89	4.55

* 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.

Lothar Mentel