CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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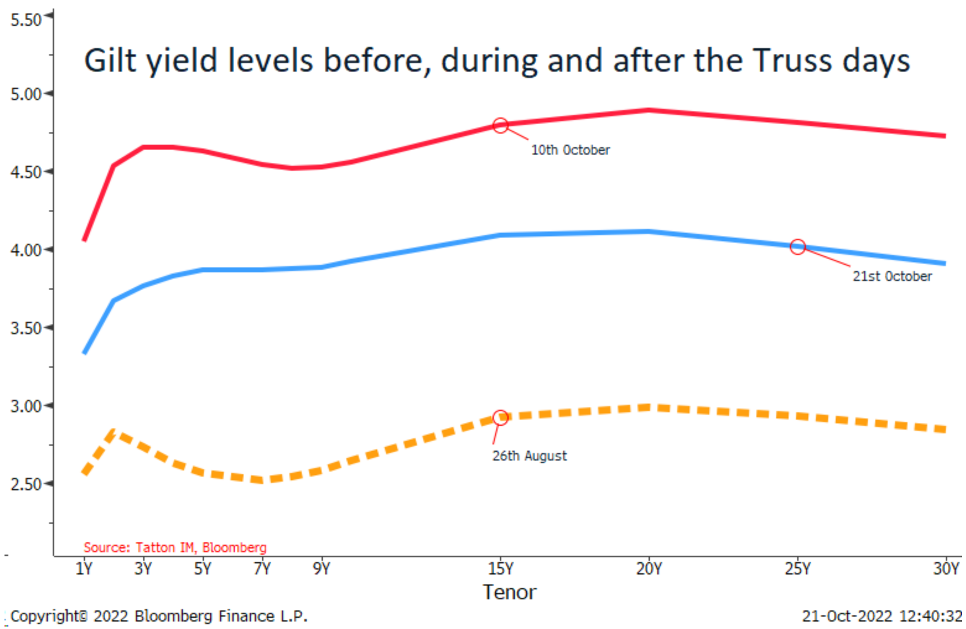
The world beyond the UK

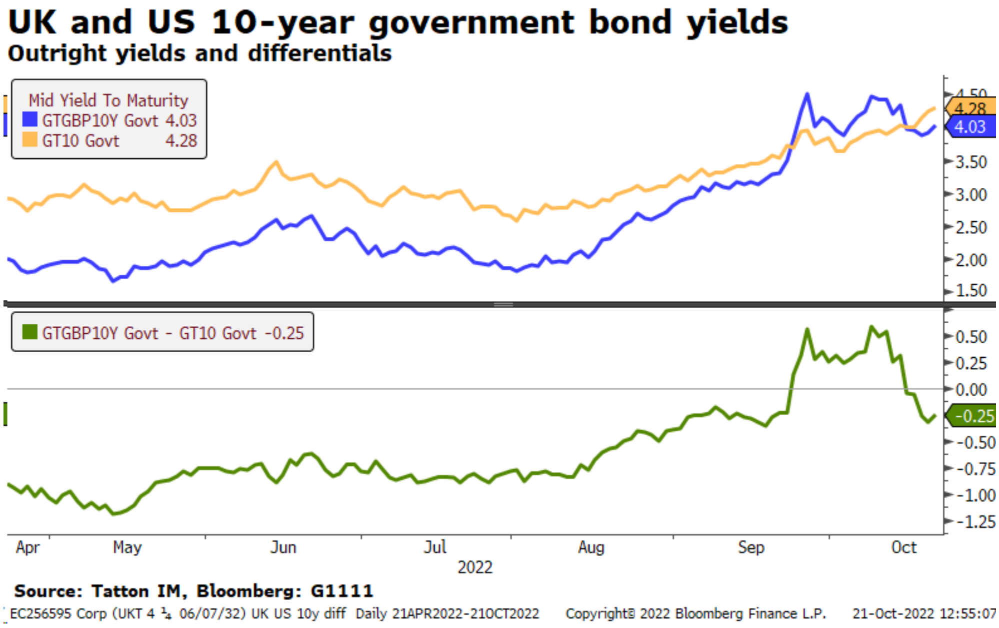
Given the volatility in UK politics last week, broader capital markets felt like a sea of calm in comparison. As far as the outcomes from the political side are concerned, markets had already priced in the upside on sterling, based on the belief unfunded tax cuts were no longer on the agenda, but not another leadership hiatus or even the possibility of an early general election. This perhaps explains that after initial cheers, sterling settled at where it had been against the US dollar before Liz Truss tendered her resignation.

On the other hand, the UK Government bond (Gilt) market was cheered by the successful revolt against fiscal largesse. Yields are not yet back to August levels, but then neither are US yields, despite the US not experiencing any fiscal policy upheaval. Indeed, US yields have again risen while the Gilt market has experienced a significant bounce in prices which, as we explain in much more detail in a separate bond primer article this week, means that Gilt yields have corrected downwards.

The chart below illustrates the wild and outsized movements in Gilt yields that the very short, but also very turbulent, reign of the Truss government bestowed on the UK. The three lines show the different yield levels over different maturity bands in years (Tenor) on 26th August (dashed yellow, before 'Trussonomics'), 10th October (red line, the highs of the Trussonomics implosion) and 21st October in blue, after the hapless Prime Minister had resigned.



However, as we said above and have written on these pages before, Truss' ill-advised fiscal policy unhelpfully boosted an uptrend in bond yields that had been well underway since the beginning of the year. As the comparison of 10-year yield levels between the US and UK in the upper panel of our second chart (below) shows, the uptrend had accelerated since Spring, but the gap of lower UK yields versus the US closed rapidly as the Conservative Party's leadership campaign progressed over the summer. It then jumped markedly after the former Chancellor's announcement of unfunded and unassessed tax cuts. How yields and yield differences will fare from here will (hopefully) now only partially depend on the further political developments in the UK, but much more on where the rate of inflation is heading and with it, economic activity levels. On the much-discussed and lamented loss of trust of international capital markets in the reliability of the UK and its institutions, last week demonstrated that while the UK is most certainly not immune from political mistakes, the system deals swiftly and reliably with failure.



Regarding price pressures on consumers, last week offered another little-noticed story in Europe, although this one is undoubtedly good news. Gas and electricity prices for near-term delivery (over the winter) have come down, as gas storage reserves have filled to higher levels and earlier than anticipated, while industrial demand has fallen much more quickly than thought possible.

At the same time, however, longer out prices are still elevated, which keeps the pressure on to find longer-term solutions to the Russian gas deficit. Finding new sources of gas and redistribution is now the priority. Back to the near-term, reports that at least 35 liquefied natural gas (LNG) tankers are waiting to unload into Spain and the UK is another factor driving prices lower. While these loads are waiting because of a lack of regasification berths, they are also not yet needed, partly because gas use has been lower than expected, with unseasonably warm weather helping the deliberate cuts in consumption, but even more so in the UK because of the lack of storage facilities in comparison to the European Union (EU) market.

There was further good news on the electricity front as Germany's Chancellor Scholz spoke a 'Machtwort' (meaning word of authority), and more or less forced his coalition partners to agree a temporary extension of the life of the three remaining German nuclear reactors over the winter.

This altogether lower temperature from the demand and the supply side in pan-European energy markets, has led to a sense that the probability and extent of downside scenarios have lessened. This in turn is taking fiscal support pressure off politicians and leaves markets anticipating less bad times ahead. Despite government-imposed price caps, there had been heightened fear of bankruptcies – which remains elevated, but the immediate danger is clearly receding as we note from falling European high yield credit rates for those firms with the lowest credit ratings.

Increasingly, scenario assessments, like the previous week's from Bloomberg's energy analysts, are circulating that are raising the possibility that Europe could find itself with a gas surplus should the coming winter prove warmer than usual. This would certainly be very good news for hard-pressed consumers, even though the boost to demand from the release of energy earmarked savings could fan broader inflation once again, and force the interest rate setting bodies in the European Central Bank (ECB) and Bank of England (BoE) to follow their US colleagues from the Federal Reserve (Fed) in their push for rates that markets anticipate nearing 5% at the end of the first quarter of next year.

Still on consumer price pressures, back in the UK, the fall-back in bond yield levels has led to expectations that mortgage rates will start to come down as early as this week. This should be a relief to some, even if it does not yet mean the period of yield rises has come to an end – just the excessive and UK-specific part of it.

UK inflation (as measured by the Consumer Prices Index) was interesting last week, with food and insurance leading the core (non-energy prices) back up to 10.1%. Both may be seeing lagged impacts from previous energy price rises – but also the shortage of available labour. Our food has become much more energy-intensive in recent years. Indeed, the lagged impacts of energy are still evident across the board. Overall, and compared to previous weeks, the market has been cheered by a lessening of the sense of crisis around Europe and the UK, even if the backward-looking economic data reports still look concerning.

On a global perspective, US interest rates continue to be the main focus. In the US, much less pronounced energy price rises have allowed the domestic economy to continue to motor on, while an even more pronounced shortage of skilled and unskilled labour has raised fears that the initial price shock from the supply side-driven goods shortage is steadily creeping into wages – thereby creating the dreaded wage-price spiral dynamic. Therefore, there was some relief last week when the 'Fed Beige Book' on the state of the US economy reported a widespread drop-off in demand and reductions in freight rates.

While we know that the eyes of US rate-setters are trained on any signs of an easing of tight labour market conditions, a balance between nominal economic growth (before subtracting the rate of inflation as applies in the calculation of national GDP growth rates) and interest rates has historically been observed during periods of price stability. The heart of the question is whether the nominal current activity growth is in line with rates.

As mentioned before, last week markets moved to anticipate a US interest rate peak of 5%. At the moment, that is still just below the current run rate of US nominal growth. We calculate this as 5.1% if we apply the JPMorgan Nowcast, which has US real (after inflation) growth running at less than 0.5% at the moment, and add US core CPI, which stands at an annualised 4.6%. That gives a current run rate nominal growth estimate of 5.1%.

When nominal growth slips below the Fed Funds (interest) rate, it offers a decent signal of a rate peak. These occurred in July 2006, June 2000 and January 1995. We are still some way off that in time terms, although the US growth trend appears to have finally reversed – the peak in Fed interest rates is seen by the market as being after March 2023. It may be a false signal as inflation and/or growth may not continue downwards as it currently seems. However, the balance of probability says the pressure on rates to go further is becoming more limited.

We believe US bond yields are not likely to move much higher because of the weakening nominal growth. That may not signal good news for the global economy in terms of aggregate demand, but we may be near the end of declines in asset valuations, and near a bottom for bonds.

Once inflation declines – and a softer US jobs market releases the pressure on US central bank rate-setters to keep raising rates towards 5%, this would afford bond yields some respite. Markets will certainly be happier should bond yields stop being one-way traffic – as the calmer markets of the past two weeks have shown. We are not quite there yet, but we are increasingly seeing signs that the peak in inflation, interest rate expectations and yields is getting closer, and with it a turn in market fortunes.

A primer on bond market mechanics

Bond market dynamics have been making headlines all year long. Following the UK fiscal policy chaos of the last few weeks, UK Government bonds (Gilts) have found some welcome stability, with yields falling below 4% since current Chancellor Jeremy Hunt reversed enough of Kwasi Kwarteng's ill-fated "mini-budget" to make it finally worthy of its name. Regular readers will know that bond yields and their volatility are an essential component of any investment outlook, but the recent attention and the pain experienced by bond holders has led to many questions over how this all hangs together.

Some puzzled clients have wondered how it is that bonds can be volatile – given that their entire nature is based on 'guaranteed' fixed amounts of money. After all, this is why bonds are called fixed interest investments.

The quality of that guarantee, in other words the creditworthiness of the bond issuer, can be a big component of performance. However, while riskier credits in the corporate world have been under pressure, the largest moves have taken place in the area of the bond market with the least (indeed no) credit risk, namely government-issued debt.

So, to provide a better understanding, let's look at single bonds and bond funds, while leaving aside any discussion about credit risk. If we use the Gilt issued on 13th October as an example for working our way through the dynamics of a bond between its principal, its coupons and its yield. The UK Treasury issued a (slightly under) 5-year bond with a 'coupon' of 4.125% (the interest, calculated as a percentage of the principal. The principal is the money paid back at maturity).

Anyone can buy a small or large part of the £4.4bn bond issue via their investment platform, online or at a local Post Office. Say someone buys enough of the bond to pay back £100 when it matures. All the payments until then are as described in the table below. (Note that the amount actually paid in is only £97.42 because the bond price at the time of issue was only 97.42% of the face value or 'principal' – we explain why further down).

Interest rate	4.125%		
	Days since last coupon	Coupon received	Principal
13/10/2022			-£97.42
29/01/2023	108	£1.22	
29/07/2023	181	£2.05	
29/01/2024	184	£2.08	
29/07/2024	182	£2.05	
29/01/2025	184	£2.07	
29/07/2025	181	£2.05	
29/01/2026	184	£2.08	
29/07/2026	181	£2.05	
29/01/2027	184	£2.08	£100.00

Payments are made every six months (and, because the first half-year coupon is assumed to be reinvested, the annualised rate is a little higher than 4.125%). However, Gilt yields are usually quoted on a semi-annual basis.

Indeed, because the actual purchase price was below the face value of the bond, our investor's actual *yield*, when relating all interest payments and the final payment of the principal to this lower amount, is 4.8%. The outlay to buy the bond never alters the payouts of interest and principal. These are clearly laid out in advance and – since the government pays in its own currency (which its central bank can print in the last resort) – they are guaranteed. This is why we refer to bond yields as the 'risk-free' rate of return.

One might wonder then: how on earth can bonds be volatile? And how can investors lose money? The answer is that, while the initial coupon is fixed, yields in the secondary market can fluctuate. Bond yields move all the time, with large volumes of bonds trading in the secondary market between the many investors.

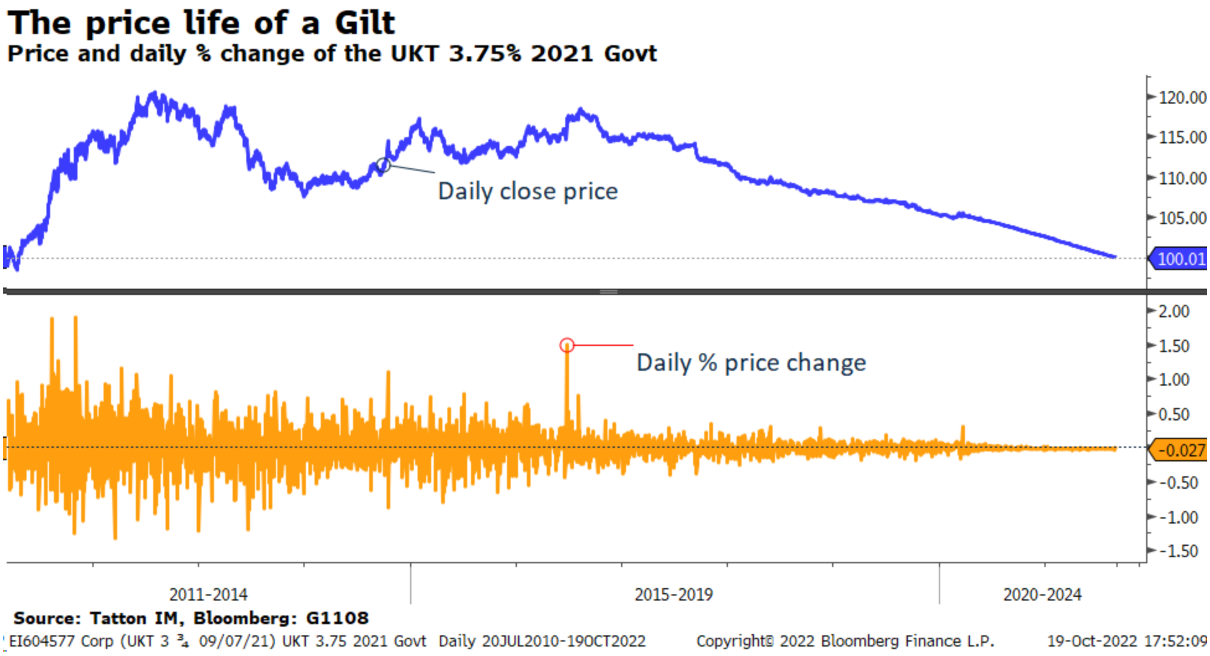
The balance between issuers and investors is perhaps even more important. Where a bond issuer wants or needs capital for their own investment, it will be because they see a higher growth rate on that investment than current bond yields. If inflation is expected to rise above bond yields, they may want to bring forward purchases of goods and other shorter-term capital outlays.

Likewise, when investment returns are falling, issuers are few and far between, but investors may still be keen to lock in fixed yields. Thus, the outlooks for growth and inflation are the most important factors in the level of bond yields.

So, in our example, the bond's current price and yield are set by somebody else's willingness to buy it. And since prices are the inverse of yields for bonds, this moves the interest rate. Indeed, the yield that market participants seek for a bond with our example's maturity profile has since come down to 4.05%, meaning it can now be sold for £100.30, giving us a nice £3 profit from the initial price. As yield levels have fallen, the value of the cashflow profile of our bond that was attached to a 4.125% coupon has increased, because now new issues would only be available with a coupon profile equating to 4.05%.

The price of every bond depends on the market yields for different maturity profiles on that day. If interest rates and yields fall, it makes our investment more valuable. We can cash out – giving us more capital – but then other bonds almost always see a similar change in yield. So, when we reinvest our increased capital, it comes with a lower rate of return. Indeed, the example of the 4.125% 2027 Gilt tells us that: £97.42 at a yield of 4.80% and £100.30 at 4.05% buy you the same bond, with the same future cashflows.

As we get closer to the bond's maturity date, bond price volatility goes down consistently, and the price heads inexorably towards 100% of the face value. We can see this in the chart below which looks at the price history of a Gilt which matured in 2021:



If we know we will need money on specific dates, we can line up a portfolio of bonds whose payment schedules match our cash timing needs. The portfolio will have price volatility which we do not need to worry about unless our cash timing requirements change, because the volatility will diminish over time.

Of course, most investors are not so sure of their cashflow needs and will want to reinvest some or all of the cashflow. This is where bond funds tend to be used. Bond funds are usually the biggest players in the market, and there are different types available.

A bond ladder fund (perhaps a better name would be bond escalator fund) buys bonds with maturity dates evenly spaced across months or years. As the bonds at the bottom of the ladder mature, it reinvests the proceeds into long bonds (maturity dates at the long end of the available spectrum) at the top of the ladder (or escalator). Thus, bond ladders have an almost static rather than a declining average maturity.

Then there are market-capitalisation funds, which buy into new bond issuances as they are offered and rebalance to match the market make-up. Here the maturity can vary depending on the maturity choices of the issuers, but they are still in the business of reinvesting capital, rather than being a simple 'run-off' scheme.

Since both types reinvest their capital into newer bonds, their volatility as a reaction to changing market-demanded yields does not diminish. They will remain constantly on the left-hand side of the volatility graph above. Thus, bond funds can feel quite different in outcome.

However, government bond and investment grade corporate bond funds have historically been much less volatile than equity funds. Current bond fund price volatility is unlike anything seen in modern markets, driven by the surge in global inflation, and following the prolonged period of falling inflation (higher inflation leads to higher yields demanded by investors to protect the purchasing power of their capital).

The UK's recent 'fiscal event' – and the chaos it unleashed even on *global* rather than simply UK investors – was an acute episode of this. But the problems run much deeper, owing to global inflation pressures and central bank efforts to contain them. After a long period of low or even negative yields, bond market volatility has returned with a vengeance. Its effects on equity markets are equally stark. At the time of writing, the S&P 500 has lost 23% in dollar terms since its January peak.

Of particular concern is that bond fund volatility has dwarfed the level of bond income for those funds. The global inflation spike has evoked memories of the 1970s, when inflation was much higher than now and developed world central banks tightened to much higher levels of interest rates. But the pain in markets is arguably worse now, owing to the systemic increase in bond holdings of the investing public. There were fewer bond investors then, and yield levels were structurally higher at the beginning of that episode than now.

For decades, ownership of financial assets has become much broader across the developed world. This has tied real economic growth much more closely to financial markets, as regular consumers feel more confident when their wealth is growing. This year has been dreadful in that respect, with volatility destabilising balance sheets and risk appetite.

However, for bond investors, underneath that volatility is a plethora of stable assets. As long as an investor continues to hold the bond fund, the bonds themselves will still deliver stable cashflows and a return of capital – whatever the price might say in the interim. The sad fact is that purchases of bonds and bond funds made during the low yield years (especially the pandemic years) can be thought of as 'locking in' those low yields for a duration of time equal to the average maturity profile that the combined bonds in the fund had at the time. The upside is that purchases made now will lock in yields not seen since the years before the financial crisis.

Future ongoing returns in bonds will (almost certainly) be higher than over the past 10 months. That makes bond ownership a more attractive prospect than it was. Rising yields decrease the current value of bond holdings – but they also provide higher returns if we buy them now. In other words, while bond purchases two years ago locked in yields/returns of near 0%, they now lock in yields between 3.5 and 4.5%.

Bond funds are not likely to recover quickly to the lofty values they were propelled to by ultra-low yields in years past. In particular, the near 0% yields of the early pandemic period are very unlikely to be repeated – indeed we strongly hope they will not.

As we have explained though, they will recover over time. Even Gilts with very low coupons will pay back at full face value. Looking at it another way, different to stocks, the downside of government bond valuations is limited and tied to the prevailing level of market yields – but so is their upside to just the yield when yield levels remain static.

The upside to the current situation is that the higher prevailing yield levels on bond funds mean their value will recover more quickly. If yield levels decline again, that time required will be shorter, if they rise further, then it will be longer. However, in comparison to equities, recovery periods for bonds tend to take far longer.

China: how much isolation can Xi afford?

Attention was on Beijing last week, which was hosting the 20th National Congress of the Chinese Communist Party. There is no bigger political event in the world, and in the most populous nation, so investors would do well to take note. Held every five years, the Congress decides key party posts – which in turn decide state, military and commercial appointments – and sets the policy agenda for the next half a decade. The biggest but least surprising thing to come out of this year's edition was the inevitable reappointment of Xi Jinping as leader.

It was certain because the Party removed the two-term limit amid Xi Jinping's incredible push for consolidation of power over the last decade. Unsurprising perhaps, but still hugely significant. Term limits on leadership have been the cornerstone of China's unofficial power sharing system since Deng Xiaoping's reforms, which themselves precipitated the nation's meteoric rise to economic and political power. Xi has done away with that system and become China's most powerful leader since Mao.

Beijing's authoritarianism, overseas influence and tensions with the West have increased dramatically throughout the President's tenure, particularly in recent years. The effective end of Hong Kong's independence – and its subsequent loss of status as a global finance hub – is emblematic of this. Plans to do the same to Taiwan now look closer than at any point since the civil war.

Despite his tone to the contrary, Xi still maintains that China's economic and technological development is the party's top priority. Things are looking, at best, mixed on that front.

The biggest brake on growth is Beijing's strict zero-COVID policy. China is still cycling through regional lockdowns every few months, while its housing market is still ailing from the slow-motion collapse of property developers such as Evergrande. Meanwhile, slowing developed world demand makes it difficult for China to export its way out of trouble.

It is easy to see why officials delayed the release of GDP data last week: people may not like what they see. Economists predict annual growth has slowed to 3.3%, the second-lowest figure in the last three decades (after 2020's initial lockdown year). This is deeply worrying for the party. Throughout the reform period, rapid growth and improving livelihoods have been the state's half of its Faustian bargain with the population. Without it, fears of a return to the popular uprisings of the late 1980s have resurfaced.

It might be disheartening, then, to hear Xi's priorities are more political than economic. Growth was slowing even before the pandemic, thanks to Beijing's deleveraging efforts and crackdown on the shadow banking sector. But that was at least an admirable goal – removing excessive debt and improving economic or financial stability. However, harsh crackdowns at home (both COVID- related and on corporates) and tough rhetoric against major trading partners – in the face of an economic slowdown – are a different matter. For some international investors, this has reignited fears that Beijing is – and will remain – anti-private sector.

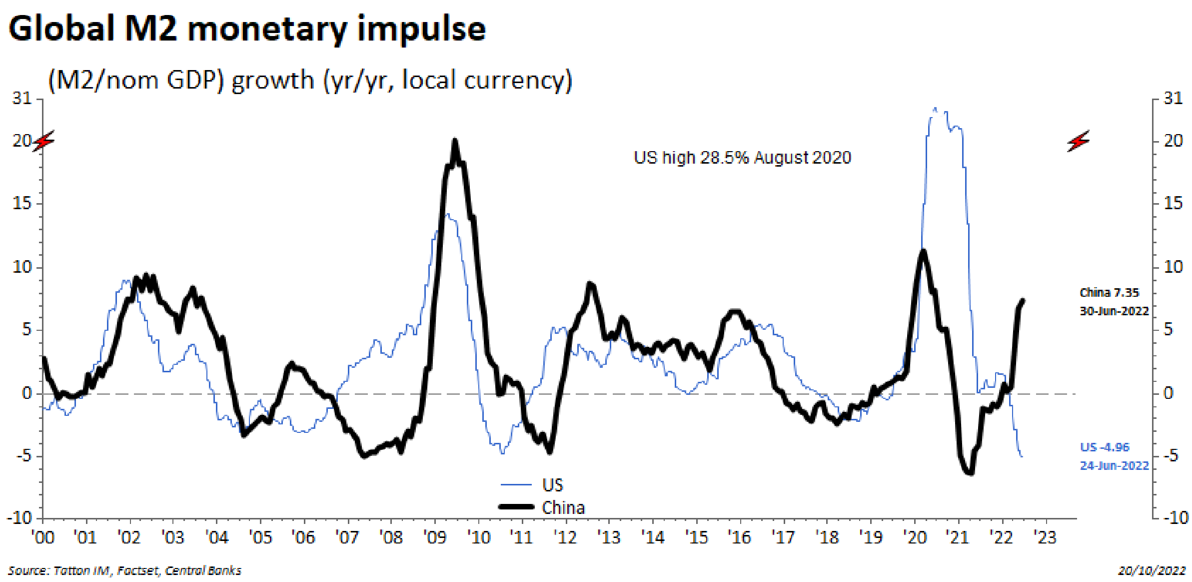
Taiwan is a different problem. China's National Congress is always a showcase of nationalist rhetoric but in some respects it had recently taken a conciliatory approach to the West. Its line on Ukraine has been delicate; not condemning Russia but making clear it does not view the action as helpful. So far, at least, China has not offered any direct or material support. In this respect, it is less problematic for the US and Europe than India, despite the latter being an explicit Western ally.

But, in his speech on 16th October, Xi was again clear about his ambitions regarding Taiwan, if not about any timescale. Observers suggested a heightened sense of urgency and that timescales for unification were being shortened. In his two-hour speech to Congress, Xi mentioned "security" 91 times, nearly double the amount referenced in his equivalent speech five years ago. By contrast, "economy" was mentioned just 60 times, according to Bloomberg analysis. National security has not been this much of a priority at any time in China's reform period.

Last Monday, the US announced a de facto embargo on selling high-end technology to China, pushing further the rivalry between the world's pre-eminent powers into something approaching a cold war. This hit tech stocks in the US but had a broader impact on Chinese stocks. If sustained, the effective ban on technology intellectual property transfer could have a severely limiting effect on long-term growth.

However, in the shorter term, it may not be a barrier to growth. In the last 20 years, economic policy has been driven much more by pragmatism than ideology, and it is possible to see current policy in that light. While officials have allowed some pain in the housing market, this has largely been part of efforts to deleverage the sector, with targeted support given when needed. Meanwhile, monetary policy is increasingly accommodative. Last week, for example, the People's Bank of China injected 500 billion yuan via its medium-term lending facility.

Importantly, monetary support is coming at a time when the Western world is tightening to choke off inflation (see chart below). This could result in a medium-term improvement in China's growth outlook at the same time as growth is slowing in the US and elsewhere. Zero-COVID is still the biggest hurdle, but if we see signs of that policy loosening early next year – which may well happen if vaccinations of the elderly continue and economic growth falters – then global investors could, in the short term, become very positive on China.



The longer-term picture is more complicated, driven by China's ageing population and its increasingly isolated position. Some analysts suggest we are moving into a structurally weaker period for China, where growth may average around 3% per year instead of the incredible 7% or 8% we have grown accustomed to. Even if true, base effects would mean that growth opportunities would still be very significant. China's estimated 2022 GDP is $18.3 trillion, meaning that 3% growth would add over $500 billion to the global economy – that is still more than China's total growth in 2016.

Economic growth is clearly no longer the Communist Party's only goal. This much should be expected, given rapid growth was always considered merely a step along the way to "common prosperity" for all. The fact it is not the *only* priority does not negate it still being a priority though. All the signs suggest that is still very much the case.

CAMBRIDGE INVESTMENTS LIMITED

24th October 2022

Global Equity Markets

Market	Fri 16:24	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6961	+1.5	+103	↘	⇘
FTSE 250	17220	+1.1	+187	↘	↘
FTSE AS	3793	+1.4	+53	↘	↘
FTSE Small	5733	+0.0	+3	↘	↘
CAC	6023	+1.5	+91	⇘	↘
DAX	12698	+2.1	+260	⇘	↘
Dow	30649	+3.4	+1014	⇘	↘
S&P 500	3680	+2.7	+96	↘	↘
Nasdaq	10671	+3.4	+349	↘	↘
Nikkei	26891	-0.7	-200	⇘	⇘
MSCI World	2429	+2.2	+53	↘	↘
CSI 300	3743	-2.6	-100	↘	↘
MSCI EM	865	+0.2	+1	↘	↘

Top 5 Gainers

Company	%
Smurfit Kappa	+8.3
abrdn plc	+7.2
Pershing Square Hc	+6.9
Ocado	+6.5
Antofagasta	+6.0

Top 5 Decliners

Company	%
Hargreaves Lansdown	-8.3
Auto Trader	-7.1
Centrica	-6.6
Hikma Pharmaceuticals	-4.9
Kingfisher	-4.3

Currencies

Pair	last	%1W
USD/GBP	1.122	+0.5
GBP/EUR	0.874	-0.5
USD/EUR	0.982	+1.0
JPY/USD	147.74	+0.6
CNY/USD	7.231	-0.5
Bitcoin/$	19,066	-1.4

Commodities

Cmdty	last	%1W
Oil	92.69	+1.2
Gold	1646.2	+0.1
Silver	18.944	+3.6
Copper	342.9	+0.2
Aluminium	2209.5	-6.4
Soft Cmdties	214.59	-2.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	10.0	8.7	14.2
FTSE 250	3.9	7.7	11.9	16.3
FTSE AS	4.0	9.5	8.9	14.5
FTSE Small x Inv_Tsts	4.1	5.8	8.8	15.6
CAC	3.2	11.8	9.6	15.2
DAX	3.7	12.2	10.2	13.7
Dow	2.2	16.5	16.4	17.0
S&P 500	1.8	17.6	16.5	18.3
Nasdaq	1.0	20.3	24.2	24.4
Nikkei	2.1	14.9	14.6	17.8
MSCI World	2.3	14.6	14.6	17.1
CSI 300	2.4	12.6	12.3	12.8
MSCI EM	3.5	8.7	10.6	12.7

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	4.07	-0.27
UK 15-Yr	4.31	-0.43
US 10-Yr	4.24	+0.22
French 10-Yr	2.99	+0.05
German 10-Yr	2.43	+0.09
Japanese 10-Yr	0.26	+0.01

UK Mortgage Rates

Mortgage Rates (Nationwide)	21-Oct	21-Sep
Base Rate	2.25	1.75
2-yr Fixed Rate	5.90	3.64
3-yr Fixed Rate	6.00	3.74
5-yr Fixed Rate	5.80	3.61
10-yr Fixed Rate	5.50	3.73
Standard Variable	5.24	4.89

* 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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CAMBRIDGE INVESTMENTS LIMITED

24th October 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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