CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

14 November 2022

Lothar Mentel

Lead Investment Adviser to Cambridge

Signs of 'peak inflation' emboldens markets

There were three big market-moving stories last week: the US midterm elections, the latest crash in the surreal world of crypto currencies, and the release of US inflation data for October. By last Friday, it was the lower-than-expected inflation data that dominated in terms of market activity. Last Thursday's report from the Bureau of Labor Statistics revealed annual consumer price index (CPI) inflation slowed to 7.7% in October, below the 8% expected by most economists, and the lowest level since January.

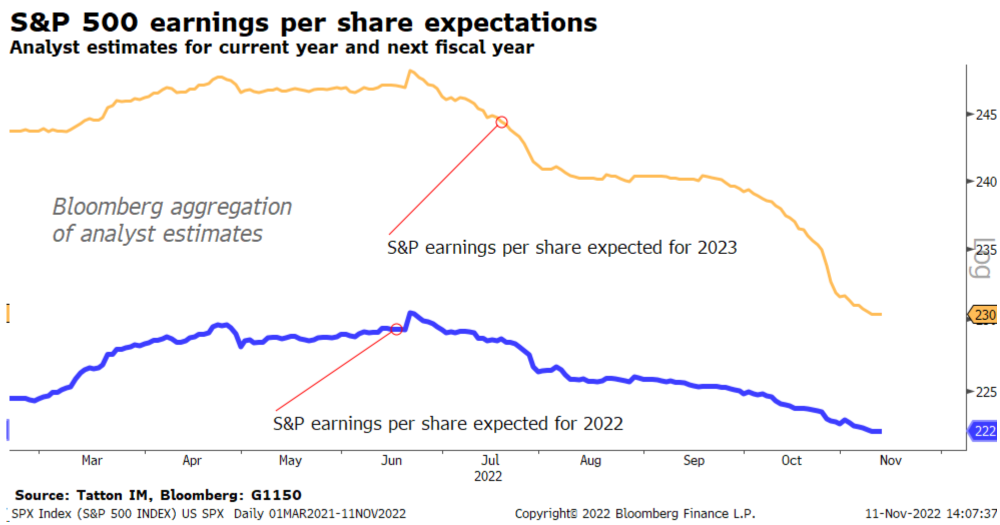
And so, for the first time this year it appeared that, for the US at least, rising inflation may be behind it. While it is still too early to assume the US Federal Reserve (Fed) will pivot away from its monetary tightening policy, the market euphoria following the data release was quite something. Not since the market confusion in the early days of the COVID pandemic have we witnessed so much movement in both equity and bond markets. Observers could have got the impression that all 2022 dominating market trends had reversed: the tech-led Nasdaq gained 7.5% and US Treasuries rallied as yields of 5 year to maturity bonds fell 0.3%. While we may not have reached the actual turning point in terms of turning market and economic tides, perhaps last week's activity confirms our suspicion that there is a widespread belief amongst market participants that the current economic downturn is more likely to be shorter and shallower than some scaremongers (including the Governor of the Bank of England) would like to suggest.

What has led to the slight decline in US consumer price inflation is a reversal of what started this inflationary episode more than a year ago, the changing prices of goods (rather than services). Supply chain disruptions have largely disappeared as time has allowed production processes to realign themselves. Freight prices have normalised, and China has once again become an exporter of disinflation – as producer price inflation there has fallen back to where it was one year ago. This, together with a 10% depreciation in the yuan/renminbi, has resulted in a sharp turn in external cost-push pressures for western consumers.

This is good news indeed for shoppers, especially with Christmas approaching, but is clearly no longer the primary focus of central banks, which as we laid out here before, are much more concerned about second order inflationary pressures, namely tight labour markets leading to a transmission of the initial price shock into more structural inflationary behaviour patterns. On top of that, central bankers are keen to curtail broader demand through the wealth effect, which means not letting higher asset markets have consumers feel wealthier and therefore drive spending on large ticket items like cars and housing.

Expectations that Fed Chair Jerome Powell will get more dovish are therefore premature until labour markets ease. Moreover, should the Fed raise rates at its December meeting by less than the 0.75% jumbo raise as in their last two meetings, Fed members may as well tell markets that they are indeed pivoting. So, it is likely and even probable that external cost pressures in the overall inflation dynamics will be easing over the coming weeks and months (goods prices in the US and energy prices in Europe), but that is not yet sufficient to realistically expect central banks to take their foot off the monetary brakes.

Anyway, the role of bond yields in the valuation of equities is only one side of the coin. The other – and over the medium term more profound side – is the development of corporate earnings, which have held up remarkably well over the course of 2022 thus far. Unfortunately, the flip side of falling inflation in goods and lower producer price inflation is that it tells us companies are now struggling to maintain their profit margins, which dovetails with company analysts' expectations of declining corporate profits. So, the underlying profit cycle is still not conducive, and US expected earnings for 2023 continue to fall (as the chart below illustrates) while the pace of downgrades has accelerated.



The market may believe the Fed will pivot but, if it does not, firms will get doubly squeezed – on their margins and the cost of finance.

This late stage of the cycle can be harsh, and a liquidity squeeze creates casualties. This is where the second big market news item comes in – turmoil in the crypto markets. Last week FTX, the second-largest crypto exchange, became a casualty of both crypto's defining feature (it's lack of regulation) and the less forgiving market environment after it became known that those involved in the company may have been less than truthful about their need for and access to (real) US dollar cash. It also turns out that diehard cryptocurrency traders still prefer the stability of the money created by their arch-enemies, the central banks.

For us, what is most interesting about this episode is that it had no discernible impact on general credit spreads – the proverbial canary in the coalmine of capital markets during economic downturns. Some talk of FTX as a "mini-Lehman", but (as of yet) nobody is reporting large exposures. This may change given that FTX's related hedge fund, Alameda Research, is likely to impact its prime brokers and some other hedge funds.

Instead, credit spreads have fallen a great deal, and more so in the derivatives known as credit default swaps. Fearful investors have been buying equity put options as insurance against further falls in equity markets and they have also been hedging both equity and credit risk using credit default swaps. These volatile market moves are perhaps a signal of uncertainty and changing fundamentals, but strongly rising markets have also put these fearful investors into a tight liquidity position, as they were faced with margin calls on their 'insurance contracts' and so the market volatility is probably also a signal that liquidity remains tight.

The US midterm elections were the third big news item of last week, but ultimately had a far smaller impact than had been expected, largely due to the surprisingly strong showing from the Democrats. We have dedicated a separate article to what the midterm results may tell us.

Readers will wonder why the negative Q3 UK GDP reading of negative 0.2% is not featuring as 4th in our list of events of last week. The answer is that was along expectations, perhaps a smidgeon better than feared and therefore not particularly market moving. Also, when nominal growth is running at annualised 10% due to inflation, all that such a very small real growth figure can tell us over and beyond statistical noise, is that the UK economy has likely stalled – which is hardly a surprise to any observer.

As we head towards the close of the year, when asset managers have a tendency to shut down exposures, last week's positive upturn certainly felt encouraging. However, investors should not expect 2022's market pressures to end here. The Fed's December meeting may well cause yet another turn in market sentiment and the underlying corporate profit development, coupled with thinning seasonal liquidity from institutional investors, leaves us bracing for more potential volatility before the year ends.

The outlook for asset markets over the medium term (into 2023) is improving. But 2023 is still some way off.

Republican 'red wave' ends up as merely a ripple

Americans went to the polls last week, for what some political commentators labelled the most important midterm elections in recent memory. Investors might feel differently – as direct market impacts are often small and hard to evaluate. The policy makeup of the world's largest economy is nonetheless a crucial factor in any investment outlook. This is especially so given the current state of US and world economies – with rising interest rates, tight labour conditions and sky-high inflation. These factors are heavily impacted by fiscal and foreign policy, giving Washington's lawmakers a key role.

Midterms – so called because they take place halfway through a sitting president's four-year term – are historically low-key affairs. The party of the incumbent president usually struggles and often loses control of one or both houses of Congress. This has happened in every midterm election since 2002, and going into polling day, a repeat was expected. Heavy losses were therefore expected for the Democratic party, owing to Joe Biden's unpopularity and soaring inflation. Republicans went as far as to predict a 'red wave', winning a large majority in the House of Representatives and taking control of the Senate.

Commentators sometimes suggest markets prefer Republicans in power, given the party's historical pro-business policies. But past performance data does not back up this blanket statement and it would be wrong to interpret last week's moves as a market endorsement. However, it is an interesting observation that US equities have historically done well when the legislature is in opposition to the president. The markets seem to prefer when governments cannot change much. In the days leading up to the vote, markets enjoyed a mildly bullish run, in the hope of a Republican controlled Congress being pitted against Joe Biden.

Republicans have underperformed those high hopes. They will probably win the 218 seats needed for a majority in the House of Representatives, but even that is not certain, with most of the still-to-be settled seats falling in the ‘toss-up’ category. In any case, the majority will be wafer thin, making it much harder to leverage congressional powers. Democrats have retained control of the Senate. The Democrats only required 50 seats for a majority (the Vice-President casts the tie-breaking vote), this tips things slightly in their favour.

This was an unwelcome surprise for capital markets and though the S&P 500 saw a huge gain last Wednesday, that was as a result of lower-than-expected inflation data. Beforehand, it was trading with a 2% loss from Tuesday’s close, as the Republican party’s underperformance became clear. The tech-heavy Nasdaq showed even more weakness, down 2.5%.

Investors crave stability, which drives a preference for the status quo. When Congress is controlled by a party other than the president’s, the result is (in the last decade at least) political gridlock. So, to the extent that markets expected a Republican Congress, they expected not much to get done in the next two years. Those expectations have been altered by a surprisingly resilient Democrat showing. Stock values adjusting down is therefore unsurprising.

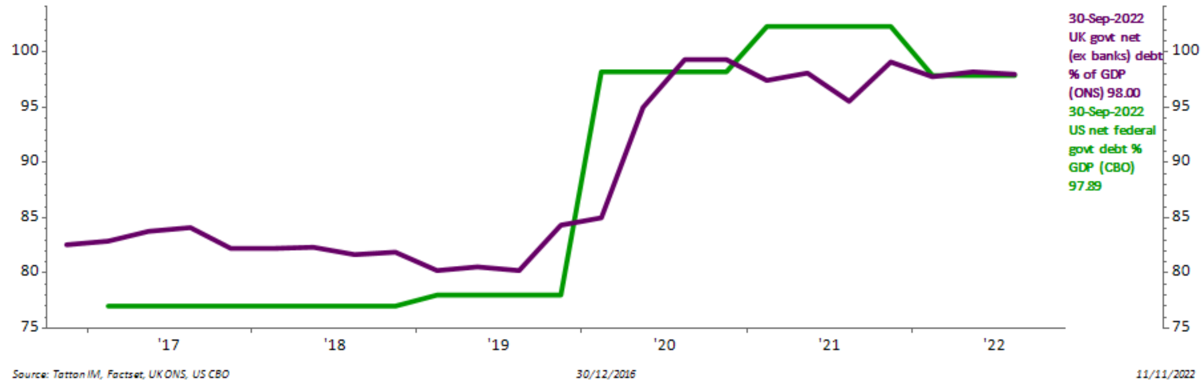
In particular, investors feel uneasy about the outlook for corporate taxes. The Biden administration managed to enact a 15% minimum tax rate for large corporations as part of the recent Inflation Reduction Act. It was thought that a Republican-controlled Congress might try to cut spending or taxes by using the US debt ceiling – a limit on the amount the US Treasury can borrow – as leverage.

Fiscal policy is the one key area where the US legislature can have a direct economic impact. But despite the market pull-back, it is not clear exactly what the election means in this regard. Markets generally like growth-oriented tax and spend policy, but the current inflationary backdrop means any additional growth pressure will likely be cancelled out by the US Federal Reserve (Fed). On that point, it is worth remembering that the Democrats have had nominal control for two years, but – apart from emergency COVID measures – have run a fairly tight fiscal policy, compared to other nations at least.

By contrast, when the Republicans last had control of both Congress and the White House, fiscal policy was significantly loosened. Donald Trump’s tax cuts were a boost for equity markets, but also increased the budget deficit at a time when overall growth was already quite strong. A repeat of that policy mix now would add more fuel to the inflationary fire, forcing the Fed to tighten interest rates more and cancelling out any fiscal gains.

That is exactly the problem we saw this side of the Atlantic during Liz Truss’s truncated premiership. Markets were clear that, regardless of lower corporate taxes, more debt – without a clear repayment plan – would be destabilising at this point of the cycle. In terms of gross government debt to GDP, the US is in about the same fiscal position as the UK but is helped by global investors’ huge fondness for dollar-denominated assets. This is based on the dollar being regarded as not only the currency of global trade but also as the global reserve currency. The chart below shows comparable measures of the gross government debt positions relative to GDP, with forecasts for the next five years. ‘About the same’ does not mean good though, and the situation could easily turn sour.

US & UK net government debt to GDP



For markets, the trouble is in judging what the different political parties want for fiscal policy. The Democrats have shown a desire to increase the overall tax base in line with spending proposals – coming out at fiscally neutral. While the Republicans clearly oppose tax rises, their position on the spending side is unclear.

Much of that question comes down to whoever gains the Republican presidential nomination in 2024. Trump is expected to announce his candidacy this week and, were he to be successful, some fear a return to fiscal indiscipline, especially in the face of slower growth. On the other hand, the unexpectedly poor performance of Republicans – particularly those linked to Trump himself – suggests the party may field someone else.

That someone would almost certainly be Ron DeSantis, the Florida Governor, who was re-elected with a massively increased majority last Tuesday. DeSantis is a Trumper in most senses but is perceived to be more likely to be a balanced-budget conservative than his forebear. His successful Florida re-election campaign was built around promises of sales-tax cuts targeted on everyday items, which would benefit the less well-paid. It is yet to be seen how the lower tax revenues will impact Florida's provision of public services. It would be difficult to achieve a similar policy at the federal government level, as sales tax is levied by the states, so the equivalent would be lower income tax.

Meanwhile, Biden and the Democrats gained a relative fillip from last week's voting and will be poring over the voter data and surveys to divine what were the key positives. It's likely that both distaste for Trump and the religious right's anti-abortion agenda created a backlash among women voters. If so, the Democrats will press on in attempts to fill judicial places and ensure the Republicans are seen as opponents.

On tax, they are likely to be quiet. Nevertheless, the recently passed Inflation Reduction Act reduced families' expenditures (especially medicine) but also raised taxes from top earners and companies in order to balance the books. That combination has not harmed them (yet) and is likely to be revisited.

In terms of candidate, usually a first-term president has an uncontested second shot, but many suspect Biden's age and frailty will prevent this. Trump's early entry into the Republican nomination race means the Democrats could wait to see how it plays out. They will have some advantage, especially if the Republican fight gets messy. Admittedly, the Democrats have no obvious centre-ground candidate themselves, and their own internal debate could threaten their electability.

Returning to capital markets, the current low tax base means US yields may be increasingly affected by the same issues that afflicted the UK recently. The fact that markets showed initial disappointment last Wednesday does not mean investors are rooting for a Republican candidate in two years' time. If that candidate turns out to be Donald Trump, the opposite might well be true. This is perhaps the real important issue for markets: what do these midterms mean for the future of the Republican party, and for US yields?

CAMBRIDGE INVESTMENTS LIMITED

14th November 2022

Global Equity Markets

Market	Fri 15:40	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7337	+4.1	+290	→	⬂
FTSE 250	18300	+2.1	+384	⬂	↘
FTSE AS	4001	+3.8	+146	→	⬂
FTSE Small	5955	+2.0	+116	↘	↘
CAC	6431	+2.5	+158	↗	↘
DAX	13455	+1.6	+211	↗	↘
Dow	32542	-1.0	-320	↗	⬂
S&P 500	3767	-3.4	-134	⬂	↘
Nasdaq	10514	-5.3	-588	↘	↘
Nikkei	27200	-0.5	-146	→	⬀
MSCI World	2468	-3.6	-93	⬂	↘
CSI 300	3767	+6.4	+226	↘	↘
MSCI EM	861	+1.8	+15	↘	↘

Top 5 Gainers

Company	%
Ocado	+34.9
Prudential	+14.9
Anglo American	+12.8
Rio Tinto	+12.8
HSBC Holdings	+11.2

Top 5 Decliners

Company	%
RS GROUP	-10.5
BT	-8.9
Croda International	-4.8
Rentokil Initial	-4.3
Experian	-3.6

Currencies

Pair	last	%1W
USD/GBP	1.134	-2.4
GBP/EUR	0.876	-2.1
USD/EUR	0.993	-0.3
JPY/USD	146.65	+0.6
CNY/USD	7.186	+0.9
Bitcoin/$	20,532	+7.0

Commodities

Cmdty	last	%1W
Oil	98.62	+3.0
Gold	1672.5	+1.7
Silver	20.535	+6.6
Copper	366.7	+6.9
Aluminium	2264.0	-1.0
Soft Cmdties	205.74	-4.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	11.1	9.1	14.6
FTSE 250	3.7	12.8	11.9	17.0
FTSE AS	3.8	11.6	9.4	15.0
FTSE Small x Inv_Tsts	4.0	9.2	10.2	19.1
CAC	3.0	10.3	10.2	15.3
DAX	3.5	11.7	11.7	14.2
Dow	2.1	17.8	17.5	17.7
S&P 500	1.8	17.8	16.8	18.7
Nasdaq	1.0	26.9	25.4	26.0
Nikkei	2.1	33.0	20.2	20.1
MSCI World	2.3	15.8	15.2	17.6
CSI 300	2.4	13.5	12.5	13.3
MSCI EM	3.5	9.9	9.8	11.6

04/11/2022 14:12:27

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	3.52	+0.04
UK 15-Yr	3.93	+0.12
US 10-Yr	4.12	+0.11
French 10-Yr	2.79	+0.18
German 10-Yr	2.26	+0.16
Japanese 10-Yr	0.26	+0.01

UK Mortgage Rates

Mortgage Rates (LTV c.75%)	04-Nov	05-Oct
Base Rate	3.00	2.25
2-yr Fixed Rate	5.75	4.17
3-yr Fixed Rate	5.71	4.46
5-yr Fixed Rate	5.59	3.96
10-yr Fixed Rate	5.41	4.21
Standard Variable	5.42	5.10

* 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

14th November 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.

Lothar Mentel

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE