CAMBRIDGE
INVESTMENTS LIMITED

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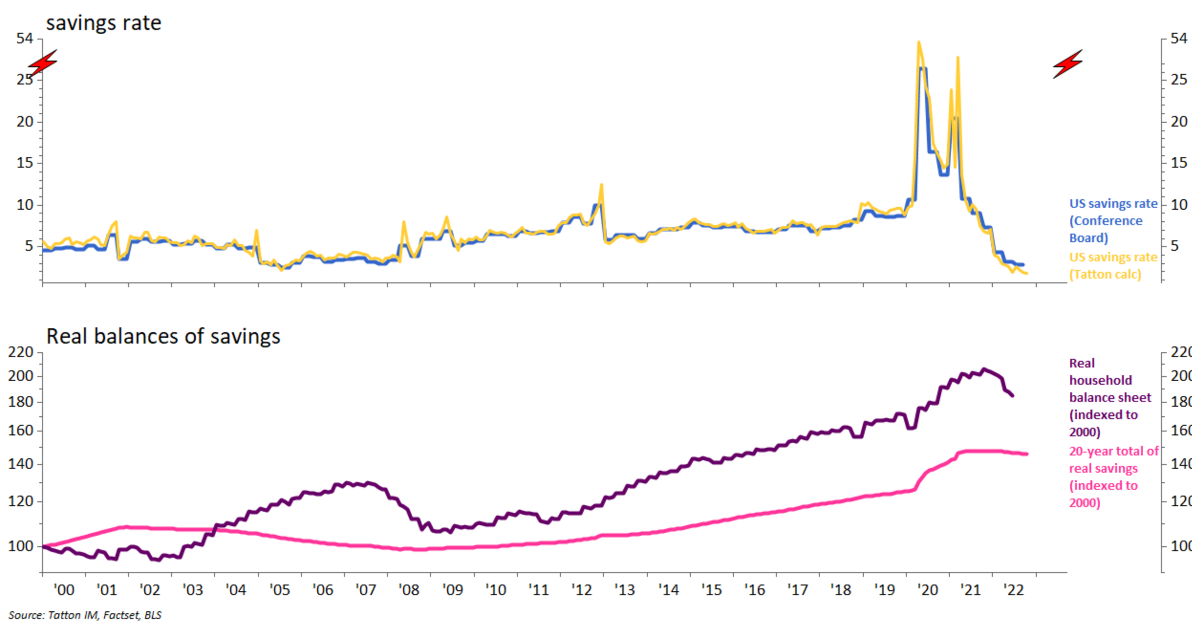
Fed up before Christmas

As the year comes to a close, some of the year's big trends have showed signs of stopping or even reversing. Are the current market moves really down to the market's concerns about interest rate policy? This year has been tumultuous in market terms, for equity markets and especially for bond markets. Focus has centred on the Fed. It has responded to inflation by raising rates, and we (and other commentators) think it will continue to battle against potential inflation.

Across the world, and especially in the US, there was an incredible flow of money into savings during 2020 and 2021. At the same time as the Fed was buying bonds to put on its balance sheet, households were receiving cash from the government which they couldn't spend on what they may have normally spend it on (e.g., holidays) – so they saved it.



The chart above shows the household savings rate (how much of ongoing disposable income is saved rather than spent) and then below is the household balance sheet relative to 20 years of real savings. This year has seen an unprecedented decline in the savings rate. Given the jump in the stock of savings beforehand, maybe that's not so surprising. Also, if households are sure the price of things will rise substantially but the return on savings will be much less large or certain, they'll buy things now, rather than saving for later. So, while they may not have taken money away from their savings, the usual flow has been much less apparent. And fund managers had become rather used to the idea that the incoming flow would be low.

However, the flow into savings may well have picked up in recent weeks. Surveys of inflation expectations have dropped back marginally but, equally, people seem to be buying less. If they are buying less, they may well be saving more, which means fund managers are having to buy. With low trading volumes and liquidity, as they are typical for this time of year as the seasonal holidays approach, those flows can have quite an impact.

Certainly, in the past two weeks, long-dated bond yields have moved down a lot, as a result of more buyer demand pushing up bond prices. One rationalisation has it that the Fed will 'pivot' in its policy of aggressive rate rises, which should make the extent and depth of the central bank- 'promoted' economic slowdown/recession less uncertain. Another has it that the Fed will stay hawkish, meaning a greater chance of recession. It may just be 'a few more buyers than sellers', for a number of different reasons. Taking a firm view right now on the underlying story might be somewhat spurious and therefore dangerous if it drives decisions.

But there is no denying that the market sentiment has become noticeably more buoyant. While things might change after the new year, when more bond supply may well become available, at Cambridge we can see the attitude of savers becoming more positive, which in itself is encouraging.

The Fed's rate setters (Federal Open Markets Committee) meet on Wednesday for the last time this year, and they will probably agree a 0.5% rate rise to a mid-level of 4.375%. It seems like 2022 has been all about the Fed and it still is, right up to Christmas! Rather than explore the many inconclusive explanations for the sentiment change, we shall wait to hear what the Fed says after its well-flagged rate rise to see how those pronouncements are interpreted before finalising our outlook for 2023. Maybe next year, they will be less important.

Gyrephobia: who's afraid of the wage-price spiral?

"Gyrephobia" is a fear of spirals, or anything in a spiral pattern. Well, not really; it is one of those concoctions of Greek words to make something that sounds like a legitimate phobia – and it may be something that no one has. Perhaps, on recent evidence, one might suspect the Fed's Open Market Committee (FOMC) members have a version of it.

All year long, Fed Chair Jerome Powell and his colleagues have warned that supply-side inflation needs to be stamped out as quick as possible to avoid the dreaded wage-price spiral. The fear has led them to tighten monetary policy at the quickest pace in a generation, and they still have some way to go. Even though signs point to a slowing global economy, policymakers maintain that further interest rate rises are ahead.

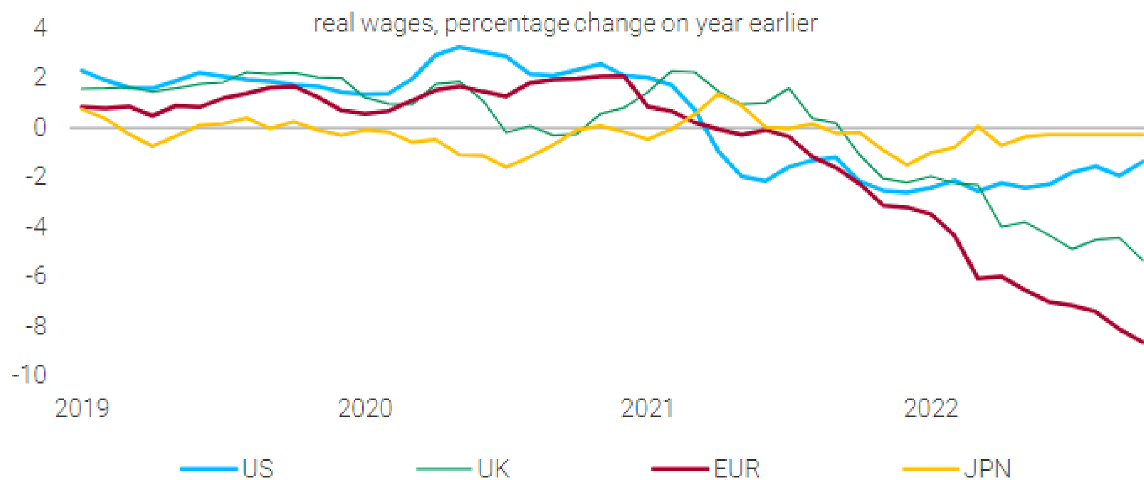
This is the same around the world, as central bankers grapple with intense supply-side pressures. But the Fed is one of the main central banks – the Bank of England being another – that is distinctly concerned about its domestic labour market, and the interplay between wages and inflation.

Although input pressures have noticeably eased, the Fed has said it wants to see unemployment rise to the "neutral" rate of around 4.5%. Otherwise, workers will seek wage rises to meet inflation – feeding back into higher prices. A scary spiral indeed.

In absolute terms, US wages have substantially increased in the post-pandemic period. But this increase has been less than overall inflation levels, meaning that the contribution to headlines inflation is less than other sources, energy prices being the key culprit. In real (inflation adjusted) terms, wages across developed markets have been falling since the middle of last year.

Dario Perkins of TS Lombard points out that wages have not "contributed to" the high inflation rate. This is not how most of us would interpret the situation, since it depends on how you define "contribute". In an obvious sense, nominal wage increases are more likely to be a factor in a higher inflation rate than if nominal wages stayed still. The fact that wages have not increased as much as headline inflation might tell us that wage rises are an effect of inflationary pressures, rather than a cause. Tight supply of goods is the obvious cause, but we can also point to delayed fiscal stimulus and savings drawdowns as pushing up demand. Higher wages look like a mere symptom by contrast.

Chart 2: With nominal wages failing to match inflation, real earnings have plunged



Source: TS Lombard estimates based on national data, deflated using headline inflation rates

Of course, the Fed is well aware of this. As Powell has communicated in multiple speeches, the worry is that wage increases will become dominant, the dreaded second-round effect of inflation. Policymakers are worried that higher inflation expectations will lead to a prolonged episode where real wages will continue to outgrow productivity, with excessive expectations leading to inflation becoming ingrained.

If this is happening, it will only become clear once short-term sources of inflation – war in Europe and supply bottlenecks – fade. In this respect, there are some signs of that happening in the US. As the above chart shows, the real wage trend has picked up in the US (though growth is still negative), and job openings are still stubbornly high.

Continued labour market tightness is the key reason central banks are worried about spirals. The rationale for why this should happen makes sense – and fits with central bankers' view of the economy as a machine with a few key levers but subject to external sources.

But it is still vitally important to ask whether Gyrephobia is justified. Bouts of inflation have happened many times and in different circumstances, but where is the evidence that inflation shocks actually lead to wage-price spirals, with or without tight labour markets? Can we identify those times which are most similar to the pandemic shock of the past two years?

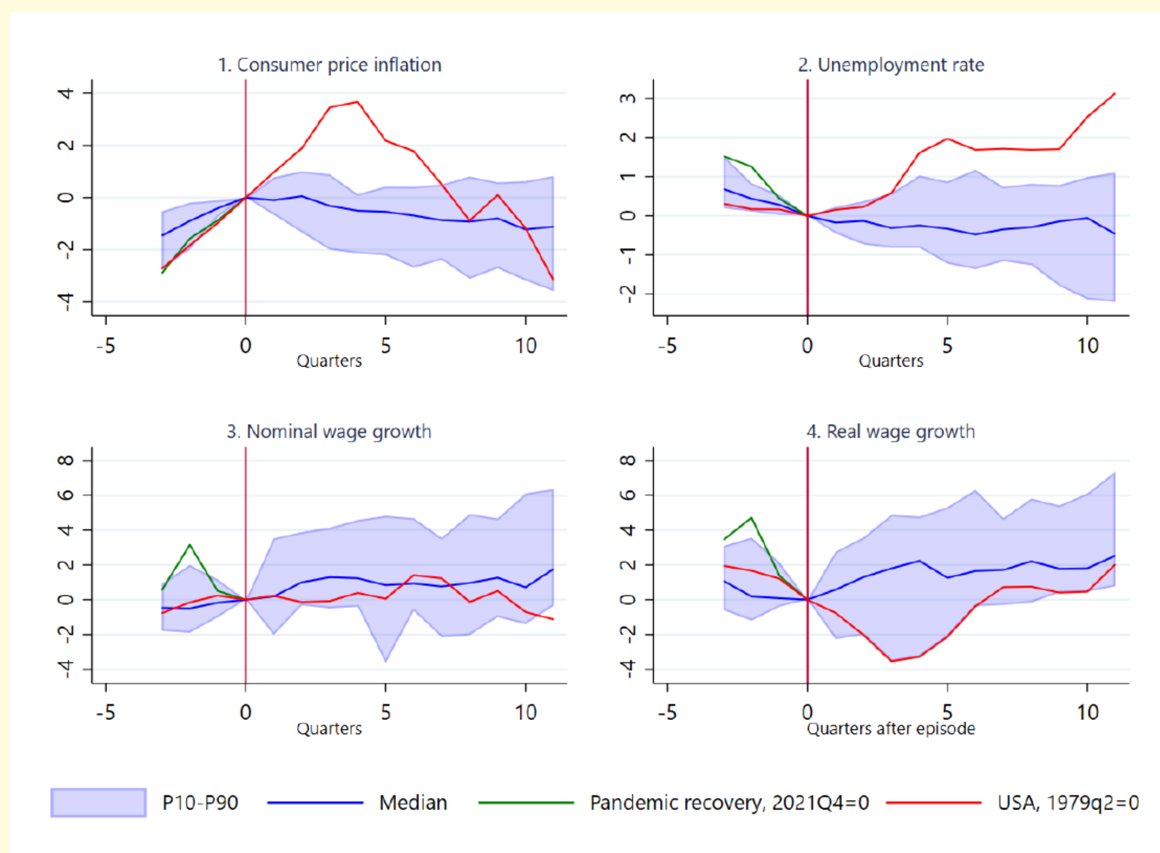
These are the questions that researchers at the International Monetary Fund (IMF) try to answer in a working paper released last month. Using long-term data from OECD (Organisation for Economic Co-operation and Development) economies, they define a potential spiral as a period where wages and inflation increase rapidly and then ask: does inflation stay high? If so, this would suggest wages and inflation tend to feed off each other. If not, this would suggest Gyrephobia is overblown. Perhaps surprisingly (for central bankers at least) history suggests the latter. In most instances, wage growth and inflation settled down fairly quickly, and genuine spirals were rare.

As Dario Perkins points out, Gyrephobia seems to be driven by the memory of the 1970s, an outlier occasion when wages and inflation really did feed off each other. Comparisons to the 70s have been widespread this year, with many suggesting that an oil and gas shock – together with tight labour markets – could herald a return of persistently high inflation. But a quick look at the details tells us this comparison is misleading. Back then, trade unions were significantly stronger in the western world, and linked their wage demands unquestioningly to inflation. For all the media coverage of strikes this year, unions simply do not have that same power.

Labour shortages before and since have not spiralled in the same way. Dario Perkins suggests that the period in the decade after the Second World War is more comparable to today, when inflation spiked and fell back rapidly.

Below are the graphs which aggregate the changes in inflation rates and labour markets derived from 22 episodes that IMF researchers identified as similar to the recent pandemic period. It also places, in red, the 1979 US episode. The main observation is how labour markets remain stable, both in employment rates and in real wage growth:

Figure 5.1: Changes in Macroeconomic Variables after Episodes Similar to 2021



(Percentage points differences relative to first quarter in which criteria are fulfilled)

Sources: International Labour Organization; Organisation for Economic Cooperation and Development; US Bureau of Economic Analysis; and IMF staff calculations.
Note: The chart shows the developments following episodes where at least three out of for last quarters has (1) accelerating prices, (2) positive nominal wage growth, (3) falling or constant real wages, and (4) declining or flat unemployment. Quarter 0 is the first period where the criteria hold. The outcomes are based on the 22 episodes identified in Table 5.1.

On the face of it, the IMF research should be good news for central bankers. Even if wage demands increase in the months ahead and unemployment stays low, this does not mean wages are spiralling out of control. Therefore, this should offer more leeway in interest rates.

Realistically though, this is not going to calm Powell's nerves. The Fed has said that labour market tightness is its main area of concern, and its rate raising ambitions will not be sated just by falling input costs. The worry for investors is that this tightening bias will go too far, plunging the economy into an unnecessarily deep recession.

Evidence for the emergence of a spiral is not yet backed up by the data but, of course, we won't know until after the event. In other words, if it is does happen, the central banks (especially the Fed) will have failed, and that means they have to err on the side of caution.

Moreover, we think the Fed's concerns about the possibility of a US spiral are legitimate given the enormous one-off boost to savings provided during the pandemic. This is the one factor not present (at least in the same degree) in other episodes. Already, this stock of spending power has kept consumption going substantially longer than would have occurred when confidence measures were as weak. The fact is that, for all the gloom, the US economy is still chugging along smoothly. As investors, perhaps the takeaway is that we should be fairly confident that inflation will not spiral out of control. It may still mean that the Fed will stay hawkish for longer than the market currently expects.

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12th December 2022

Global Equity Markets			Technical		Valuations			
Market	Fri 14:31	% 1 Week*	Short	Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7471	-1.0	↗	→	3.8	11.4	9.7	14.5
UK FTSE 250	18851	-2.8	↗	⇘	3.5	13.4	12.3	16.9
UK FTSE All-Share	4083	-1.3	↗	→	3.7	12.0	10.1	15.0
UK FTSE Small	6170	-1.4	↗	⇘	3.9	10.6	11.8	18.8
France CAC 40	6651	-1.3	↗	⇗	3.1	10.8	10.9	15.3
Germany DAX 40	14320	-1.2	↗	⇗	3.3	11.7	12.0	14.2
US Dow	33666	-1.3	↗	→	2.0	18.9	18.7	17.8
US S&P 500	3947	-2.1	↗	↘	1.7	18.7	18.1	18.7
US NASDAQ comp	11016	-2.8	⇗	↘	0.9	29.2	29.2	25.9
Japan Nikkei 225	27901	+0.4	⇗	→	2.1	22.0	20.1	20.1
World MSCI	2670	-2.3	↗	↘	2.2	17.0	16.2	17.7
China mainland	3998	+3.3	↗	↘	2.2	14.3	13.7	13.3
Emerging MSCI	969	-0.5	↗	↘	3.2	11.9	10.8	11.6

Top 6 Gainers

Company	%
Haleon	+9.6
Prudential	+5.9
DS Smith	+5.4
Rolls-Royce Holdings	+5.4
Rio Tinto	+5.2
Ocado	+4.3

Bottom 6 Decliners

Company	%
Frasers	-11.6
London Stock Exchange PL	-10.8
BT	-7.2
Vodafone	-6.4
Intermediate Capital	-6.1
Halma	-5.7

Fixed Income

Govt bond	%Yield	1 W CH
UK Govt 10yr Gilt	+3.14	+0.05
UK Govt 15yr Gilt	+3.53	+0.05
US Govt 10yr Treasury	+3.53	-0.05
France Govt 10yr OAT	+2.37	+0.08
Germany Govt 10yr Bund	+1.91	+0.08
Japan Govt 10yr JGB	+0.26	+0.00

Currencies

Pair	last	%1W
USD : GBP	1.226	+0.5
GBP : EUR	0.859	+0.0
USD : EUR	1.053	+0.5
JPY : USD	136.24	+0.6
CNY : USD	6.958	-1.3
Bitcoin : USD	17,098	+1.1

Commodities

Cmdty	last	%1W
Oil Brent $:bl	76.5	-12.2
Gold $:oz	1796.9	+0.7
Silver $:oz	23.3	+3.7
Copper $:lb	387.2	+0.6
Alumnm $:mt	2475.5	+0.5
S&P soft crops	216.5	-1.9

UK Mortgage Rate Estimates

Rates (LTV c.75%)	09-Dec	09-Nov
UK BoE base rate	3.00	3.00
2yr fixed	5.66	6.00
3yr fixed	5.50	5.90
5yr fixed	5.27	5.61
10yr fixed	5.01	5.20
Standard variable	5.88	5.41

09/12/2022
Prices taken at 2:30pm today and last Friday (where possible)
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of median analyst forecasts for the next 12 months earnings
Mortgage estimates are derived from Sterling swaps markets

* 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

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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