CAMBRIDGE
INVESTMENTS LIMITED

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Football fever saves UK from recession

The new year is proving to be a happy one for almost all asset classes and regions. The FTSE 100's intraday all-time high of 7903.50 was less than 100 points away on Friday, and we were closer than we were the previous week. The global financial press tell us markets are stronger because we should be positive about a likely easing in monetary policy, and this easing should take place because – as business leaders say – conditions are awful.

And yet things are not that awful, not even here in the UK, where the economy appears to be limping along rather than totally broken down. Last Friday, the Office for National Statistics (ONS) reported that UK gross domestic product (GDP) unexpectedly rose 0.1% in November. Most economists had expected a small decline after growth in October.

According to the ONS, the Qatar World Cup marginally helped consumer-facing businesses and the impact of strikes was not severe. Services growth rose by a better than expected +0.2% on the month and was also revised up for October. There was little sign of weakening in the jobs market either, as recruitment agencies saw a gain of 2.1%.

However, physical production, especially manufacturing, declined more than expected and October's data were also revised down. The ONS said it could not put an exact figure on the economic cost of industrial action, and the impact is likely to be larger in December when most of the walkouts occurred. But, unless December's GDP figure falls more than 0.4%, the UK economy should avoid a technical recession in Q4 2022.

As for the impact of strikes, post and rail output fell by 4.7% and 3.1% respectively in November, and this spilled over to a wide range of other sectors, including wholesale trade and jewellery.

The World Cup meant sports activities saw a fall in output as people watched games rather than played them. The strikes didn't have such a great impact – people went out locally rather than into cities. Strong growth included telecoms and computer programming, and social work.

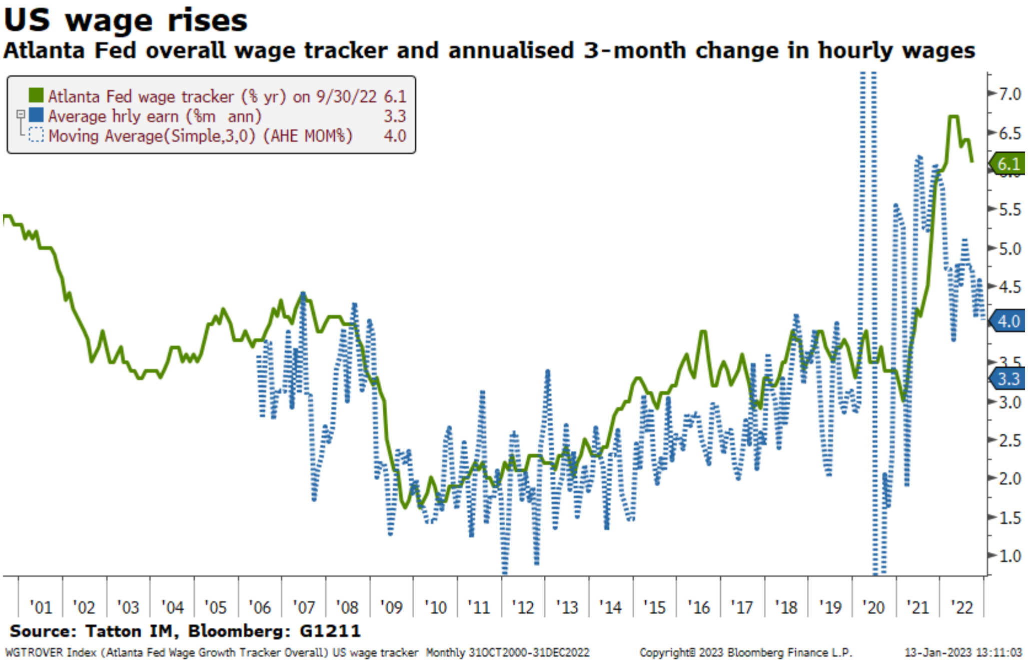
The Bank of England had anticipated a recession was already underway in 2022's second half, although their monetary policy views are more concerned with supply-side weakness, a problem which it sees lasting into 2024. Last Friday morning, Monetary Policy Committee (MPC) member Catherine Mann suggested the data might mean larger rate rises ahead.

The strength of recruitment still tells us that the dynamics that would generate a sharp painful recession may not be evident now, especially as energy prices have been heading downwards. Also, jobs are still available for those looking. That supports consumer spending as fewer people face the nasty shock of a large and sudden cut in income.

On the other hand, the days of large private sector wage rises appear behind us, with the likes of Amazon taking action to manage its warehouses – shutting venues where labour is expensive and difficult to find, while opening new ones where labour is more plentiful.

Yes, the strikes continue and look likely to get worse. However, even if public sector pay rises are awarded, it was a figuratively bloody battle to get them. Eventually, there will probably have to be some compromise from the government, but the cost of fighting means that a wage spiral is unlikely to take hold. Thus, pay rises are slowing even though there is no big upswing in the unemployment rate.

Across the pond, members of the US Federal Open Markets Committee (the equivalent to the UK's MPC) were also vocal that rates are still going up, although US bond investors believe the rate rises are nearly done. The slowing of wage rises is also apparent, as the average hourly earnings data showed in the previous week's nonfarm payrolls.



At the same time, few investors appear to believe a US recession is about to take hold. The bond market also tells us that fears of defaults in the credit market are declining, and that's a stronger indicator of recession fear than the much-commented yield curve inversion.

When JPMorgan released its 2022 Q4 results on Friday, its Chief Financial Officer Jeremy Barnum said it was still hiring and in growth mode. Indeed, his company will be happy that last week saw a massive splurge of bond issues across the world, given that the going was very slow for investment banks at the end of 2022. As mentioned last week, issuers were sidelined for much of last year while investors were building up cash. The first two weeks of January have been incredibly busy, with huge new issuance being met by "huger" investor demand. Last Wednesday, Bloomberg reported: "Demand for Europe's debt sales has topped half a trillion euros already this year, as investors seek to put money to work in bonds offering some of the highest yields in years. Investors have bid €530 billion, more than three times the €168 billion of issuance in Europe's syndicated primary market so far this month".

The US earnings season gets into full swing this week. Given the very pessimistic results of the various business surveys, one would think that these will be especially dire. However, so far it hasn't been too bad, and the large American banks have not been too downbeat (Matt King of Citi Research points out that business leaders can be too pessimistic):

Source: Conference Board, S&P, Citi Research

The direct measurements of economic activity have been weakish, and December's data is yet to be released in full. However, the 'soft' survey data, which tends to lead the 'hard' direct data, has been suggesting more weakness than has happened. And, indeed, the surveys in Europe and Asia show signs of getting less pessimistic.

Certainly, the fear that the world was close to some sort of economic precipice seems to have dwindled significantly. Investors may already be discounting a rosier picture, one where the nasty risks of 2022 seem to have ebbed quickly away. But the central bankers may need some convincing that a wage-price spiral is no longer a danger, given that as yet there is only the mildest of hints that the pressure has eased.

We've had two weeks of 'bad news is good news' helping the markets. For markets to go higher in the long-term, let's hope we have a run of 'good news is good news'.

Hot commodities

Last year was a strange one for commodity markets. Russia's invasion of Ukraine brought the biggest disruption to global energy supplies in a generation, causing oil and gas prices to soar over the first half of 2022. Sharply higher prices then destroyed demand and severely dampened the outlook for global growth. Oil and gas had a much weaker second half, as supply chains readjusted, and demand fell significantly. Even European gas prices, which rose to eye-watering levels after President Putin turned off the tap, are substantially lower than their mid-year peak. Policymakers, analysts and capital markets predicted a harsh winter for Europe, with heat and energy rationing amid acute undersupply. However, this winter is now predicted to be one of the continent's warmest on record, taking the edge off fuel prices and dampening the commodity outlook.

Commodities are highly cyclical. Strong global growth pushes up demand for raw materials, while slowing growth does the opposite. Since the Industrial Revolution, fossil fuels have been the main site of cyclical swings, as they literally fuel the world economy, but as the world tries to shift to renewable energy, other commodities are becoming vastly more important. Copper, iron and a host of rare earth metals are essential components of green technology – giving their prices a structural boost. Demand is still cyclical, meaning their short and medium-term outlook is hampered by slowing global growth.

That outlook is complicated by a couple of major factors. For starters, trading inventories for non-oil commodities are extremely low, and this is unlikely to change soon. Weak demand and high cost of finance has disincentivised holding raw materials. Stocks of copper and other metals fell dramatically from 2021 onwards, and now appear stuck down low.

The second and more important factor is China. Following many months of lockdown and private sector repression, Beijing has now suddenly pivoted to an extremely pro-growth policy mix. The zero-Covid policy is ending, restrictions on the property sector are vanishing, and the People's Bank of China is actively loosening monetary policy. This is about as big a boost as the government could possible muster – making China's domestic economy look like a coiled spring – and significantly improves the outlook for global commodities demand.

The pro-growth pivot is happening while western countries are pushing hard in the other direction. In Europe, the US and UK, central banks are aggressively tightening monetary policy to cool labour markets and get inflation under control. This will likely create a situation where, further into 2023, Chinese growth is roaring ahead while the developed world is in – or on the brink of – recession. This is more evidence that the world's second-largest economy is operating out of sync with developed markets. That, in itself, could have huge consequences in terms of how the global economy operates.

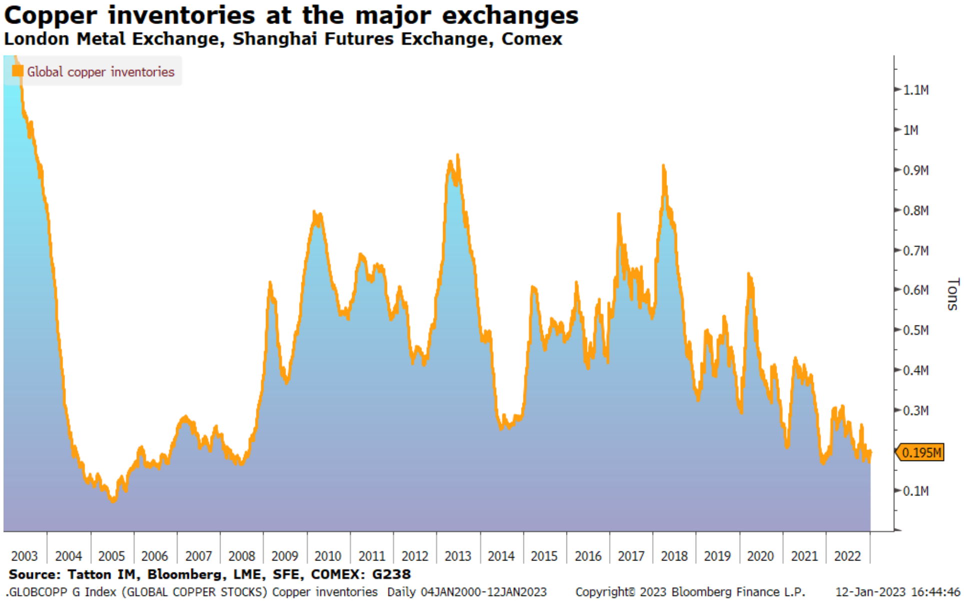
Expected Chinese growth dramatically changes the commodity outlook. There is likely to be a splurge of infrastructure building as we go through 2023, which will spark massive demand for raw materials. Other emerging markets, which have been hampered by slowing global growth and a strong US dollar, will benefit – particularly commodity exporters. Developed nations, meanwhile, could face a renewed bout of input-cost inflation. This could push central bankers into an even more hawkish position than they are currently – sparking renewed volatility in capital markets.

Chinese assets have rallied in the new year, and markets appear to be significantly frontrunning demand. Given Covid is still hampering activity, it could be some time before actual demand comes through. And given how much positivity is priced in, Citi Research suggests markets could be disappointed by Chinese growth. This would harm inflows into China and reinforce a negative outlook for commodities and inflation.

Citi has a point, but we suspect the risks are not around potential disappointment. As the western world emerged from lockdowns, markets and analysts underestimated how strongly demand would rebound. In the end, growth was incredibly strong and the supply side of the economy – both goods and labour – struggled to keep up.

China's post-Covid bounce could well be even stronger. More than 1.4 billion people have been under some form of restrictions for more than three years, suppressing a great deal of their regular economic activity. There is probably a massive amount of pent-up consumer demand waiting to be released. On top of this, the Chinese government is easing other key policy areas like construction and finance. Not only will people want to go out and spend, but businesses will be eager to undertake projects put on hold for years – and they will have the capital needed to do so.

It is true, however, that we may have to wait before such strong demand comes through. Covid infections are extremely high and, even without government restrictions, this will inevitably hamper movement until cases come down. The Lunar New Year festival in February – usually a very active period – will likely be significantly busier than last year, but the virus will probably keep activity at relatively subdued levels, and it might not be until warmer weather comes in March that we see a turnaround.



When it comes though, we expect China's growth to be extremely strong. Commodity prices have already risen in anticipation of this, but we suspect markets have further to go. Copper prices, for example, have increased 20% over the last month, in large part due to expectations for China. But this increase came from a low starting point, and it probably does not price in the full extent of China's upcoming building boom.

This hugely improves the global growth outlook for the second half of this year. The global economy was expected to be weak for the whole of 2023, with cost-of-living crises in the US and Europe destroying demand. Should Chinese demand counteract this drop-off, it could prove a double-edged sword. On the one hand, continuing global growth will be welcomed by investors. On the other, sustained high commodity prices will mean more monetary tightening. For better or worse, the world's second-largest economy seems to be operating on a completely different cycle from the west.

European wage inflation

In the previous week, the European Central Bank (ECB) got some respite. Eurozone inflation came in at a 9.2% annual rate in December, lower than November's figure and below economists' expectations. Price increases are still uncomfortably large, but inflation seems to be trending down for the first time since late 2020. Perhaps more encouraging is that 'core' inflation – a measure which excludes food and energy – is still a tad lower in the Eurozone than in the US. Core inflation is supposed to be more closely linked to internal demand dynamics, and therefore a good indicator of what inflation will be in the near future.

According to a recent ECB bulletin, demand pressures are lower in Europe than across the Atlantic and will continue to be so for the near-term, despite higher headline inflation.

This is unsurprising. Europe's inflation crisis is driven by soaring energy prices, a withdrawal symptom from quitting Russian gas cold turkey. US inflation, by contrast, is driven by labour supply shortages and strong domestic growth. One might think this gives the ECB some breathing space, perhaps slowing the pace of interest rate rises.

That would be wishful thinking, unfortunately. ECB President Christine Lagarde told markets in December that they should expect 0.5% rate rises "for a period of time". Economists expect her resolve will not be challenged by lower headline inflation. Even though it is lower than elsewhere, European core inflation is at its highest-ever level, and policymakers are still very worried about inflationary dynamics. Lagarde says these "are mainly related to fiscal measures and wage dynamics," and the ECB needs to tighten hard to counteract them.

Just like in the US and UK, wages are the biggest concern. Central bankers across the developed world dread the wage-price spiral, whereby inflation leads to higher wage demands, which lead to further inflation. The ECB wants to stamp this problem out before it begins, and markets fully believe it will do so. Implied market expectations now put Eurozone interest rates at around 3.5% in September 2023.

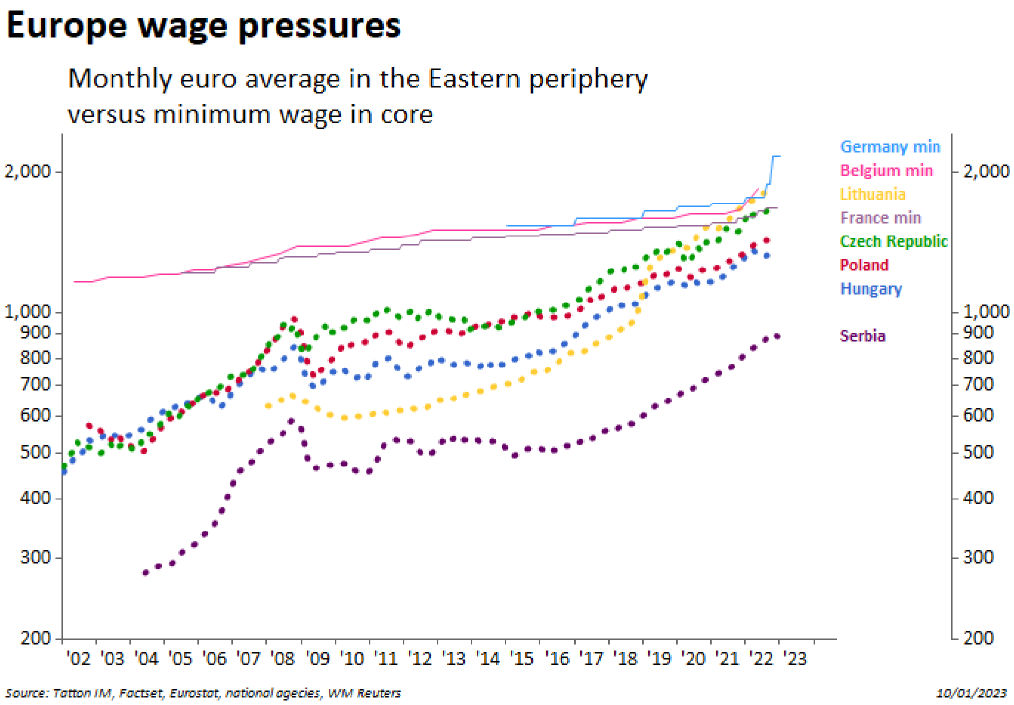
On the face of it though, this looks like an overreaction. Wage inflation in the US and UK is driven by record low unemployment and a stubbornly low participation rate (the percentage of the working age population in or seeking employment). Eurozone unemployment is also at a record low, but that record is a much higher 6.5%.

Even if the labour market continues to tighten, Europe's wage growth has historically been much more static than in the US or UK. This is usually thought to be down to generally sluggish growth, and more conservative wage-setting mechanisms. Germany's largest trade union IG Metall, for example, recently agreed a deal which will give its workers a pay rise of 5.2% from June 2023 – significantly below German inflation, but also above the ECB's inflation objective of 2.0%.

The participation rate problem does not look as bad in Europe either. The Eurozone labour force recovered to its pre-pandemic level by the third quarter of 2021. While this is still below pre-pandemic forecasts, it is significantly better than the UK, which has seen its overall labour force shrink since the start of 2020. Looking at just these factors, it is hard to argue that Europe's labour market is an inflationary hotbed.

The ECB continues to push ahead with rate rises nonetheless, to the point of actively constraining economic activity. The very fact it is doing so – while citing labour market dynamics as the reason – tells us there is more to the story.

Over the last three decades, the European Union has massively expanded its membership, which has in turn dramatically increased the size of the common labour market. This has had a particular impact on the former Soviet bloc countries, where wages were a fraction of western Europe's before joining. For so-called 'core' European nations, a massive influx of migration from the east kept wage growth low. For so-called 'peripheral' nations, the outflow of migration, together with new investment, pushed wages significantly higher. The result has been peripheral nations catching up quickly with the rest of Europe, as shown in the chart below:



This is to be expected. Joining in common European prosperity was the promise made to those eastern nations, and the fact wages and living standards have increased by so much, demonstrates that promise was (for the most part) kept. But if wage growth is heavily weighted towards countries with lower pay, more well-off countries thereby see less wage growth. This is exactly what has been happening over the last few decades.

However, as the chart shows, peripheral nations have made up significant ground on the core, to the point where many are at or below the pay level in France (in terms of minimum wage at least). That means peripheral nations are no longer the counterbalance to inflation in the core they once were. Moreover, many of these countries are outside of the Eurozone, meaning they are outside of the ECB's monetary remit, and yet vitally important to its policy goals. Though, arguably, this is often the case with immigration.

In the ECB's own bulletin, policymakers point to much lower-than-expected net migration flows since the pandemic, which has constrained the working age population. While the pandemic certainly had a big impact, the worry is that there has been an underlying structural change to the labour market. Increasingly equalising wages between the core and periphery nations (particularly those outside of the Eurozone), means the slack in Europe's labour market is gone. Moreover, this is coming to a head just as the continent goes through its biggest supply-side crisis since the Second World War.

The result is that, despite appearances, the ECB has a labour participation problem of its own. It is not as acute as that of the US, undoubtedly, but the worry is that there is little to no room for growth in Europe's working age population. That puts a structural limit on the labour supply, which could mean wage pressures stay stronger than they have before. Europe is not immune to labour market problems, so the ECB will be wary.

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	7833	+2.7	↗	→	3.6	11.0	9.8	14.5
UK FTSE 250	19909	+2.1	⇗	⇘	3.5	12.5	12.5	17.0
UK FTSE All-Share	4285	+2.6	↗	→	3.6	11.5	10.2	15.0
UK FTSE Small	6472	+1.8	⇗	⇘	3.8	10.5	13.0	18.8
France CAC 40	6999	+3.5	↗	⇗	3.1	11.0	11.1	15.3
Germany DAX 40	15072	+4.4	⇗	⇗	3.6	11.7	11.7	14.2
US Dow	33975	+2.9	→	→	2.1	18.5	18.3	17.8
US S&P 500	3955	+3.4	→	↘	1.7	18.0	17.6	18.8
US NASDAQ comp	10923	+5.3	⇘	↘	1.0	27.4	26.8	26.0
Japan Nikkei 225	25974	-1.4	↘	→	2.3	20.5	18.8	20.1
World MSCI	2595	-0.7	→	↘	2.3	16.5	15.8	17.7
China mainland	3981	+3.2	↗	↘	2.4	14.2	13.7	13.2
Emerging MSCI	984	+2.8	↗	↘	3.1	12.0	10.9	11.8

Top 6 Gainers		Bottom 6 Decliners		Fixed Income		
Company	%	Company	%	Govt bond	%Yield	1 W CH
JD Sports Fashion	+12.3	British American Tobacco	-6.4	UK Govt 10yr Gilt	+3.31	-0.24
International Consolidated Air	+11.7	Beazley	-4.0	UK Govt 15yr Gilt	+3.66	-0.26
St James's Place	+10.8	B&M European Value Retail SA	-3.4	US Govt 10yr Treasury	+3.46	-0.30
Berkeley Holdings	+10.2	Fresnillo	-2.8	France Govt 10yr OAT	+2.59	-0.26
Antofagasta	+10.0	Imperial Brands	-2.3	Germany Govt 10yr Bund	+2.13	-0.21
Whitbread	+9.3	BAE Systems	-2.1	Japan Govt 10yr JGB	+0.51	+0.08

Currencies			Commodities			UK Mortgage Rate Estimates		
Pair	last	%1W	Cmdty	last	%1W	Rates (LTV c.75%)	13-Jan	14-Dec
USD : GBP	1.218	+2.2	Oil Brent $:bl	84.5	+7.8	UK BoE base rate	3.50	3.00
GBP : EUR	0.887	+0.2	Gold $:oz	1902.8	+3.5	2yr fixed	5.76	5.97
USD : EUR	1.081	+2.4	Silver $:oz	23.8	+2.0	3yr fixed	5.66	5.66
JPY : USD	128.14	-4.1	Copper $:lb	416.3	+9.4	5yr fixed	5.51	5.49
CNY : USD	6.720	-2.3	Alumnm $:mt	2225.5	-5.4	10yr fixed	5.38	5.33
USD : Bitcoin	18,931	+12.6	S&P soft crops	213.6	-1.9	Standard variable	5.88	5.88

06/01/2023
Prices taken at 2:30pm today and 2:30pm 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

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16th January 2023

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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.

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