CAMBRIDGE
INVESTMENTS LIMITED

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Goldilocks in the air

Recent macroeconomic data releases across the western world report declining rates of inflation and no longer overheating (but nevertheless still positive) economic growth. In the US, the important milestone of the rate of personal consumption expenditure inflation falling below the interest rate has been reached. Perhaps unsurprisingly then, the term 'Goldilocks' (not too hot, not too cold) has returned to the market narrative.

Still, following the last ten weeks of uptrend, capital markets had already priced in the good news and trended quite calmly but more or less sideways. Reassuringly, this comes despite further impending rate rises from central banks this week. But on the back of the 'Goldilocks' data picture, markets now price in for the US Federal Reserve (Fed), to further reduce the size of this rate rise from 0.5% to just 0.25% – and only for a further one or two more hikes to follow before then reversing quite quickly to rate cuts again later in the year.

Meanwhile, employment remains strong everywhere and even those laid off by the US mega-tech companies are finding new jobs quickly. Other early warning signals for recessions, such as elevated junk bond yields, are likewise not flashing red either. On the back of all this, the soft-landing narrative of central banks' – for the first time in history – being able to reverse inflation without causing a recession, continues to gain momentum among the market commentariat.

The sidewards trending markets tell us, however, that the current balance between the market bulls and bears remains fragile, because there are still major contradictions to the Goldilocks narrative beyond the next two calendar quarters. This is because pessimists can point at almost as many indicators for the likelihood of a distinct downturn as the optimists have *in petto* for a soft landing. This particularly relates to soft factors such as continued negative business expectations and negative revenue and profit guidance coming from companies currently reporting their Q4 2022 earnings. Most damning perhaps are the bond market signals themselves, which – as mentioned above – are expecting central bank rate cuts towards the end of the year, which together with an inverted yield curve have historically been quite reliable early warning signs for recessions ahead.

Instead of a sustained Goldilocks period, we see the current environment more as a temporary market truce, or period of 'wait-and-see' as the economic reality unfolds. This should provide evidence to tilt the balance of arguments in one direction or the other. In this respect, central bank actions and (just as important) their accompanying comments will be very closely observed this week, as will be further inflation figures and the full picture of Q4 2022 company earnings trends. As always, we monitor these signals very closely to decide when the time has come to steer portfolio compositions in one direction or the other.

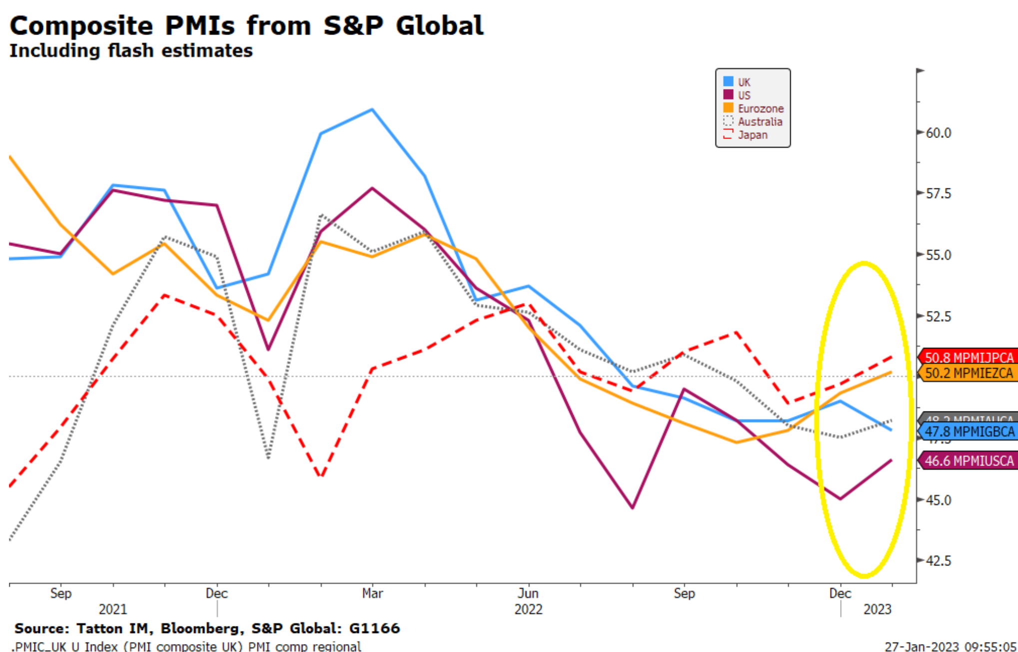
Turning to a brief update of notable changes we observed over last week, positive signals outweighed negative ones, but we would not yet speak of a clear trend in that direction: J.P. Morgan noted last Thursday night "data is consistent with the view that the global economy lost some momentum late last year, but that the risks of a near-term recession have diminished". US fourth quarter real GDP (adjusted for inflation and seasonally adjusted) grew +0.7% q/q (+2.9% annualised, the basis which US analysts always use), slightly above the consensus forecast of 2.6% annualised.

An inventory build-up pushed growth higher but may mean slower growth now. The US sold more goods abroad, which may signal global growth resilience, which is useful for the US as its domestic demand will

continue to decline as higher rates start to bite. Domestic private sector purchases rose a tiny 0.2% annualised (0.05% q/q) in Q4, the weakest in the post-pandemic period.

However, disposable income has started to rise again, strongly on a nominal basis at 6.5% annualised. The GDP measure of inflation (the Personal Consumption Expenditure Deflator) has fallen back to +3.2% annualised. With domestic spending growth as weak as stated above, but disposable income rising strongly, this indicates consumers have returned to building up financial savings – as we suspected from the flow of money into both bond and equity markets. Good income growth and slower price rises helps consumer confidence, which started to pick up into December.

As we reported before and above, business confidence slid globally throughout the fourth quarter, especially in the US. However, last week's 'flash' PMI data showed at least a levelling off, albeit still at weak levels below the neutral 50:



The global composite calculated by J.P. Morgan will be released when the final data comes out at the end of the month and, on last Thursday's data, it should rise from 48.2 to above 50 – back in growth territory.

The key component will be from China and indications are that things will be strong. Last week China celebrated the start of the Lunar New Year, and there are many stories of people desperate to travel to see their extended families but unable to get tickets. Like us, they worked during the lockdowns but were not able to have much of a personal life. There will be a lot of catching up as the spring ensues – a positive for economic growth as we will all remember well.

Auto sales are as key a part of Chinese economic data as it is in the west. Here though, after a bit of a bounce in 2022, things have looked weak if not absolutely dire. Final demand in the sector is short-term interest-rate-sensitive and that has been a problem. However, both new and used car prices have been falling as supply chains have eased considerably, most notably around semiconductor chips. The US GDP data contained a welcome indicator, a rise in real auto spending. The sector will be very important over the next few months if the slide in growth is to be reversed.

The auto sector is also very important for the UK. The news that car production has declined to the same levels as in the 1950s is not one that speaks of UK economic vibrance. This week, we have more rail strikes amid cutbacks in rail timetables and infrastructure disruptions that has put a halt to the recent 'return to working in the office' trend. Expect the UK public mood to be downbeat once more.

As has been the case over the past few months, the UK is somewhat trailing economic trends elsewhere in the western world, and consumers and private investors can be excused for not sharing in the more upbeat sentiment elsewhere. However, the more positive economic picture emerging in some of the most important markets for UK multinational companies, bodes well for the still comparatively cheap UK large cap stocks. The UK government clearly has a substantial to-do-list in its in-tray for those trading opportunities to materialise. So, the next stage of post-Brexit trade normalisation will be a key area to watch here, beyond the inflation, labour market and company earnings briefings elsewhere.

US debt ceiling showdown looms (again)

It is that time of year already. Decorations have come down, resolutions have been made and broken, and the US is hurtling toward a debt crisis – albeit an entirely avoidable one. The US government's total outstanding debt has once again hit the ceiling, a legal limit on how much the US Treasury can borrow. This limit is updated periodically by Congress and was most recently set at $31.4 trillion in December 2021. Secretary of the Treasury Janet Yellen announced earlier this month that this figure has been reached, meaning it will have to resort to "extraordinary measures" to make current cash reserves last.

Yellen's first contingency will be suspending reinvestments in various government accounts. Statute allows the Treasury to temporarily stop reinvesting its maturing securities, draining funding pots of liquidity, giving the government some breathing space. Those funds would have to be made whole when the Treasury can borrow again. The next step is to prioritise some payments over others, meaning federal employees and social security recipients could see their incomes paused. Finally comes the dreaded 'X-date': the government runs out of cash altogether and is forced to default on its debts. This would be the financial and economic equivalent of a major stroke, the severity of which increases the longer the government goes without funds.

Of course, there is a simple and obvious solution that would avoid any of these problems: Congress raising the debt ceiling. This should be a no-brainer, considering it is just a procedural financial constraint that does not affect spending commitments (which are agreed as part of separate budget bills; the debt ceiling merely dictates how much money is available to meet pre-existing policies). Indeed, for most of its history, the US debt ceiling was periodically raised without much argument from either side of Congress.

That changed in 2011, when Congressional Republicans refused to raise the ceiling until they got significant spending cuts from the Obama administration. It was a disaster, economically speaking. The US government avoided default by a couple of days, but brinkmanship led to its first ever credit rating downgrade, which brought volatility in capital markets and a loss of business confidence. Politically speaking though, it was a eureka moment for the Republican Party: lawmakers realised they could leverage the debt ceiling to get all manner of fiscal concessions from the White House. However, there appeared to be consensus later that in the eyes of voters, the debt ceiling showdown has no winners in the end, only losers.

Nevertheless, they have done so a few times since, though never as spectacularly as in 2011, perhaps as though to avoid the 'no-winner' outcome with the electorate. Trump's presidency was a temporary reprieve, as Republicans seemed to lose interest in balanced budgets and the Democrats proved less brazen than their opponents when out of government. The most recent showdowns during the Biden years were much quicker resolved too, as Congress seemed less concerned about spending during the pandemic.

Unfortunately, the debt ceiling fight this time could be more ferocious than at any point in the last decade. First, the unofficial Covid moratorium on budget balancing is long gone. Second, over the years, politicians and investors have become complacent that the other side of the equation will work out in the end – meaning risks are likely underappreciated. Finally, and perhaps most worryingly, the Republican Party is now at the mercy of its most radical members.

This last point is clear from the tortuous process the House of Representatives went through to elect their new speaker, Kevin McCarthy. Despite the Republicans holding a majority, it took fifteen rounds of voting and unprecedented concessions for McCarthy to get the backing of his own party, leaving him as weak as he could possibly be before starting the job. Among those concessions is the right for any single Congress member to call for a vote of 'no confidence' in the speaker. Also included was a commitment to not raise the debt ceiling without sweeping budget cuts.

Two things are clear from this: far-right House Republicans – the Trump wing – want to heavily restrict fiscal spending and nothing will pass through Congress without them. Both of these are somewhat counterintuitive, given Trump's fiscal record. When the former President was in the White House, his party did a 180-degree turn on fiscal discipline, believing massive borrowing was just the price to pay for extra tax cuts. And when Trump-endorsed candidates underperformed at November's mid-term elections, it looked like power had shifted away from the far-right of the Republican Party.

We should therefore be cautious in making big predictions about the direction of Republican policy. Nevertheless, the fact House Republicans are at least posturing toward hawkishness could have big impacts in the medium-term. President Biden has said he will offer no concessions in the debt ceiling fight, but this seems doubtful, especially considering many members of his own party will push for fiscal discipline. The White House also said it will not use executive powers to bypass a congressional debate on the debt ceiling – meaning compromise is inevitable.

A resolution will come eventually, and these background factors mean it is likely to skew fiscally hawkish. In that case though, the reduction in aggregate demand that such fiscal constraint would entail, would put downward pressure on Treasury yields – the reverse of what we usually see in debt ceiling standoffs. US yields have already been on this downward path for a few months, and we could see this continuing should the debate swing toward austerity. After a year of sharply higher yields and falling equity markets on valuation grounds, investors would appreciate this move.

We should be very cautious though. Even if the longer-term picture is positive for bond valuations, brinkmanship and bond congestion could be devastating in the short-term. Much depends on when the so-called X-date (when the US Treasury runs out of funds) will be, which will only be known once the outlook for tax revenues is clearer. In any case, the threat of default – even a brief, accidental one – with yields shooting up violently, will loom large over the US bond market, and could spook investors' fragile confidence.

We saw how damaging short-term disruption can be with the UK's own bond yield blowout last October. Even after confidence was restored, the effects on government debt spending, as well as household financing costs, persisted. This problem could be even more pronounced in the US. Interest rates are higher in the world's largest economy, and the relatively low taxation rates mean the government's income base is lower. With such a huge amount of debt outstanding, even a short-term rise in yields could adversely affect the US fiscal position for years to come.

Perhaps the most worrying part is that all of this is avoidable. Both sides know this, and yet neither seem particularly eager to avoid it. We suspect that the debt ceiling debate will become mainstream in the months ahead and could well make fiscal policy a defining issue for the next presidential election. That seems appropriate, given how much the economic backdrop has changed in recent years. The role of government spending in a post-pandemic world is an issue we should be talking about. The potential default of the world's largest economy is not.

LatAm common currency far from a Sur thing

Not many people think of the Eurozone as a role model of monetary stability. Perennial crises in Europe's currency union have ensured that much. For some though, stability is relative. When you go through 50 crises a year yourself, just one or two might look pretty good. Leaders in Brazil and Argentina seem to have had something like this thought process. According to reports from Buenos Aires, South America's two largest countries are set to announce preparations for a single common currency, which would become the world's second-largest currency union after the Eurozone.

Presidents from both countries published an opinion piece saying they were renewing discussions on the matter, which has been discussed in academic papers for decades. This comes ahead of the Community of Latin American and Caribbean States (CELAC) Summit in the Argentine capital. The Summit will bring together a large group of newly elected left-wing leaders, including Brazil's Lula, as well as controversial figures like Venezuelan President Maduro and Cuban leader Miguel Diaz-Canel.

The timing is deliberate. Brazil and Argentina want a common currency to start as a bilateral agreement between them, but with the aim of expanding it across the entire region. According to Argentine minister for the economy Sergio Massa: "It is Argentina and Brazil inviting the rest of the region".

There would be a lot to gain from such an initiative. Trade between the two countries is huge and still growing – with 21% more direct trade last year than in 2021. They are the main members of Mercosur (translation: 'Common Market of the South'), a South American trade bloc that includes Uruguay and Paraguay as full members, with seven more associate nations. Latin America as a whole represents just over 5% of global GDP, and many of its economies are expected to grow rapidly over the next few decades (Brazil is itself a member of the so-called BRICs).

There are huge stumbling blocks in the way of such a proposal, though. A monetary union requires converging economies with similar background conditions for growth, inflation and labour, with aligned fiscal policies and – to be crisis proof – joint issuance of public debt. The history of the euro tells us that the first three take a long time to produce, while the last two can be nigh impossible to ever get to – and even then, there can be huge divergences which threaten stability down the line. Massa is under no illusions

about how long this process would take. For now, the proposal is simply "a study of the mechanisms for trade integration," adding that "it's the first step on a long road which Latin America must travel".

That is quite the understatement. One look at the inflation figures should dispel any notion of convergence in the foreseeable future. Despite a global supply-side shock, Brazil managed to contain inflation to just 6% last year. In Argentina, the figure was 95%. The chasm comes from the sharply different monetary frameworks: Brazil has a floating exchange rate and an independent central bank. Argentina prints money when Argentina's president says so and interferes when its citizens want to use them to buy US dollars.

It was Brazil's central bank that effectively vetoed the idea in the past. Brazil has had its share of economic problems over the years, but nothing that comes close to the permacrisis of its southern neighbour. Argentina has defaulted on its national debt more times than most care to remember and has effectively been cut off from international debt markets since the last default in 2020.

Brazilian politicians and its public would likely baulk at the idea of tying their nation's finances to the profligate Argentina. It still owes $40 billion to the International Monetary Fund (IMF), while Brazil is a net creditor to the global financial system. Brazilian-Argentine economist Fabio Giambiagi criticised discussions as a "waste of time". Indeed, it is likely only because of the political sympathies of re-elected Lula that Brazil would seriously consider the proposal. But for all the buddying-up of their leaders, Brazil and Argentina's economies could hardly be more different.

Those at the CELAC Summit seemed to agree, as it became clear that plans for a common currency are not being seriously considered for the time being. Instead, the current plan is for the two countries to press ahead with developing a common unit of account. This would preserve the independence of Brazil's real and Argentina's peso – and hence their monetary policies – but create a new unit of value to facilitate trade between the two countries.

How this unit would be defined is unclear, as is how the common account unit would cope with fluctuating currency values between the two nations. If the peso fell much faster against the dollar than the real, for example, would the peso value of the unit change equally? If so, there would be little 'common' about the unit and not much point to it. But if not, Brazilians would have much less incentive to trade since the value of peso-denominated goods bought or sold would not reflect the real-denominated value.

Even so, there are certainly benefits for the two countries. Bilateral trade at the moment depends heavily on US dollar financing, meaning that traders are often at the whim of US economic policy. Rectifying that would increase cross-border efficiencies. It is also no surprise that this proposal is favoured more by the countries' left-wing politicians, despite its apparent focus on free trade. Freedom from US interference or economic power has long been a goal of the Latin American left.

For us, this is perhaps the most interesting part of these discussions. For a while now, we have observed a growing move against globalisation towards regionalisation. In the west, this has often been expressed by nationalist forces or those citing security concerns. But in South America, regionalisation is not pushing toward nationalism. Leaders want to reduce dependence on a global economy, but replace it with local regional blocs, rather than isolated nations.

That is what Brazil-Argentina integration points to. And even if no one else gets on board with a common currency or accounting unit, it is very likely that Latin American leaders will be swayed by the idea of stronger regional ties and less reliance on the US. Such integration often naturally leads to economic

convergence – perhaps making the common currency idea less senseless in the distant future. It is worth remembering, after all, the road that led to the euro. When the Treaty of Paris was first being discussed after the Second World War, the notion of a common European currency would no doubt have seemed equally fanciful.

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30th January 2023

Global Equity Markets

Market	Fri 14:31	% 1Week*	Technical Short	Technical Medium	Valuations Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7762	+0.2	⬀	→	3.6	12.3	10.3	14.1
UK FTSE 250	19919	+1.3	↗	⬂	3.3	13.2	13.2	16.3
UK FTSE All-Share	4254	+0.4	↗	→	3.6	12.7	10.6	14.4
UK FTSE Small	6544	+1.8	↗	⬂	3.8	10.8	10.8	15.2
France CAC 40	7078	+1.6	↗	⬀	3.0	11.8	12.3	15.2
Germany DAX 40	15102	+0.9	↗	⬀	3.4	12.5	12.2	13.7
US Dow	33952	+2.6	→	→	2.0	20.0	17.8	17.2
US S&P 500	4053	+3.7	⬀	⬂	1.7	19.8	18.3	18.4
US NASDAQ comp	11487	+5.4	↗	↘	0.9	50.7	25.1	24.6
Japan Nikkei 225	27383	+3.1	→	→	2.1	21.0	14.9	17.8
World MSCI	2778	+1.9	↗	⬂	2.2	17.2	16.3	17.2
China mainland	4182	+2.6	↗	→	2.3	15.0	12.3	12.9
Emerging MSCI	1052	+1.6	↗	→	3.0	12.2	12.7	12.7

Top 6 Gainers

Company	%
3i	+12.4
Lloyds Banking	+7.9
International Consolidated Air	+7.7
Entain	+7.3
Ashtead	+6.6
Burberry	+6.4

Bottom 6 Decliners

Company	%
Diageo	-8.1
AstraZeneca	-7.4
Ocado	-7.1
Experian	-4.9
London Stock Exchange PL	-3.5
Reckitt Benckiser	-3.4

Fixed Income

Govt bond	%Yield	1 W CH
UK Govt 10yr Gilt	+3.37	+0.05
UK Govt 15yr Gilt	+3.72	+0.09
US Govt 10yr Treasury	+3.55	+0.15
France Govt 10yr OAT	+2.73	+0.24
Germany Govt 10yr Bund	+2.26	+0.20
Japan Govt 10yr JGB	+0.49	+0.11

Currencies

Pair	last	%1W
USD : GBP	1.235	-0.0
GBP : EUR	0.878	+0.3
USD : EUR	1.085	+0.2
JPY : USD	129.93	+1.3
CNY : USD	6.785	+1.2
USD : Bitcoin	22,902	+10.2

Commodities

Cmdty	last	%1W
Oil Brent $:bl	88.4	+3.2
Gold $:oz	1924.7	+0.4
Silver $:oz	23.6	-0.0
Copper $:lb	424.6	+0.3
Alumnm $:mt	2609.8	+1.7
S&P soft crops	223.3	+4.0

UK Mortgage Rate Estimates

Rates (LTV c.75%)	27-Jan	28-Dec
UK BoE base rate	3.50	3.50
2yr fixed	5.42	5.97
3yr fixed	5.24	5.66
5yr fixed	5.10	5.49
10yr fixed	5.05	5.33
Standard variable	5.88	5.88

27/01/2023
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

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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