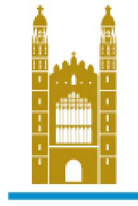

CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

27 February 2023

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Balancing acts

Last week saw global stock markets give back a portion of the gains made in the first few days of February. Still, since the start of the year, global stocks have made a total return of around 5% in £-sterling terms (Source: Bloomberg).

Over the past fortnight, market participants have come to accept inflation – and in its wake interest rates – will stay higher for longer than previously anticipated. As a result, rising bond yields have been one factor pushing equity markets lower. Still, this rise in yields has come about because of positive economic growth stories rather than stagflation fears. The monthly preliminary Purchasing Manager Index (PMI) data, which informs us about changes in business sentiment, last week pointed to surprising strength, especially within services. The service sector is most closely linked to consumption, and so it added to the positive indications from January's strong employment and retail sales data.

The resilience of households is striking, but not really surprising, given the buoyancy of jobs markets across the western industrialised world. In the US, seasonally adjusted initial claims (the weekly count of people applying for unemployment insurance) remained below 200,000. A normal level (when the job offers and seekers are in balance) is around 300,000. A similar situation is being seen here in the UK and Europe. However, as we discussed last week, despite the tightness in labour markets there is a growing sense that inflation is not in any upward wage-price spiral.

Consumption is being underpinned by the solid jobs markets, but not by household borrowing, nor by reducing savings. Spending growth is solid and sustainable rather than booming, and therefore unlikely to be overly inflationary.

Meanwhile, the shortage of workers is causing many businesses to maintain or even increase capital expenditure. Notably, given the cost of capital is quite a bit higher than in recent years, companies are not funding these business investments out of expensive borrowing. Instead, they are funding the expenditure out of cost-cutting and retained profits (i.e., by cutting dividends).

To put it another way, to retain their competitive position, companies are facing a profit margin squeeze until their business investments begin to pay off, which may go on for some time. The upside to this story is that wage growth is unlikely to cause a price spiral because it is being offset by margin compression, as companies are no longer able to pass on price rises without risking loss of market share. Inflation should hence remain contained, if not especially low. Once central banks, especially the US Federal Reserve (Fed), acknowledge the absence of a spiral, they can focus less on tight labour markets and so begin to ease interest rate pressure – even if that occurs later than anticipated at the beginning of the year.

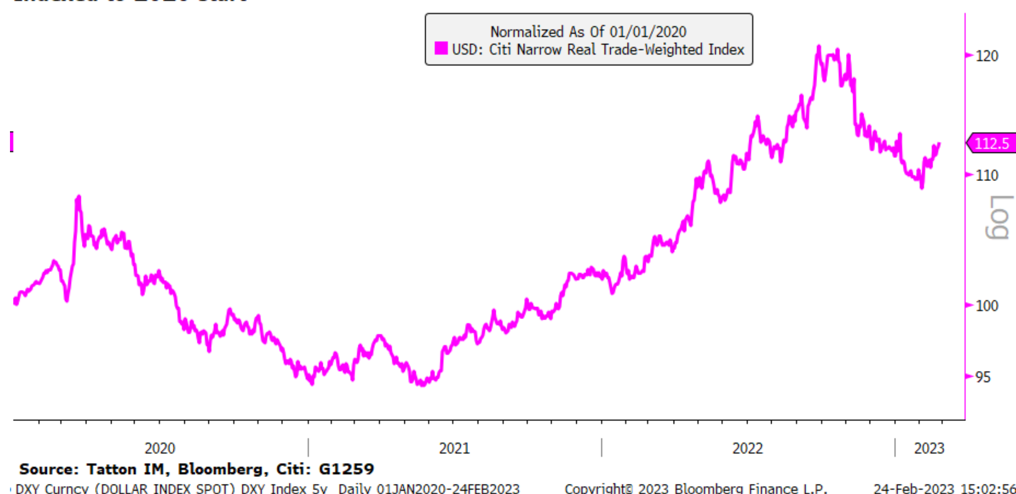
For equity markets, such a scenario is not terrible news, but is not exactly good news either. Rising revenues but falling profit margins is a recipe for little or no growth in earnings. Moreover, since the scenario is one of overcoming supply-side issues, this is a medium-term rather than a short-term issue. And by retaining part of those earnings, the pay-out to investors through dividends and buybacks is likely to be weaker, at least until the cost of finance comes down. Nevertheless, stagnant to slightly falling earnings but increased business investment over a period is still much preferable to a severe earnings recession on the back of collapsing demand.

The announcement of dividend cuts by miners like BHP and Rio Tinto is typical of such cyclical companies. Chip maker Intel's dividend cut was more shocking. Many will point to competitor NVIDIA's standout performance to say that Intel's woes are idiosyncratic, but we feel that such defensive behaviour is becoming normal across sectors.

While current absolute equity valuations are not stretched compared to more recent history, they are stretched in comparison to bond yields and longer-term history. While valuations are rarely a guide to short-term market performance, it is worth remembering that high valuations are equivalent to expecting good earnings and dividend growth. When companies disappoint, investors will be reluctant to hold those stocks and when new data releases challenge the narrative outlined above, markets are prone to short sharp sell-offs.

To this end, risk indicators have risen in the past week. For us, one of the key indicators is the US dollar, still considered a safe haven asset. Therefore, global risk assets tend to fare better when the dollar is in a bit of a decline, and that was the situation for November through to January.

As February has progressed, the dollar has strengthened. The biggest driver of the moves appears to be China, with weakness in the renminbi. The surprise caused by the end of the zero-tolerance policy to Covid cases generated a bounce in optimism, but a bounce in the economy seems to be taking longer than hoped. As we discussed last week, activity may start getting stronger when spring arrives, but we acknowledge that global metals and energy price falls are not a great sign.



In this state of suspension, however, more positive forces may return to the fore this week. We discuss structural changes to European and US natural gas price dynamics in a separate article below. The steep price falls are good news for Europe if they can be sustained, as currently higher than average gas storage reserves lead us to expect. One key aspect is that Russia is no longer able to squeeze gas prices in the same way, it has used up its power-play of withholding gas supply. Of course, that raises the prospect that Putin might feel the need to use other weapons. His "state of the nation" speech repeated threats of nuclear war much as he did last year. However, with fewer levers to pull, perhaps we should be more wary of these threats than before.

To summarise, it looks as though the big threat to market valuations of a deep and sustained recessionary period – as anticipated at the market lows of last autumn – has passed and given way to a more moderate outlook. This does not mean it is all plain sailing for investors to return to previous market highs, as large cohorts of US private investors appear to expect, if we read recent retail liquidity flows correctly. Instead, we expect the 'tug-of-war' between the different scenarios of this fairly unusual slowdown scenario to persist until spring is in full flow. As long as labour markets continue to be resilient, weakening global growth scenarios should only result in short-term volatility and/or a gradual grinding lower of markets as experienced in February so far. Meanwhile, improving risk indicators should lead to the resumption of a grinding higher of risk assets as seen in January. Patience will once again be of the essence for the long-term investor, while for their investment managers, continued scrutiny in assessing and identifying the relative winners and losers from the gradually unfolding scenarios will be the order of the day.

Inconclusive recession indicators leave markets guessing

Recession talk has been rife over the last year. On the comedown from the post-pandemic sugar rush, demand has slowed in all developed markets, while interest rates have risen to levels last seen more than ten years ago, and supply-side crises threaten economic stability. Media commentators – and even some policymakers – are telling investors and the public to brace for an upcoming global recession. These calls are backed up by many classic contraction signals: bond market upheaval, compressed business sentiment and mortgage credit stress depressing housing market activity. Contrary to this though, several key indicators are suggesting things are not so dire: employment is strong, consumer demand is resilient and equity valuations are still relatively high. With all these mixed signals, what should we make of recession chances?

A big part of the difficulty in forecasting recessions is that the target is not clear. Despite the R-word being one of the most used in the economic vocabulary, there is no definitive agreement about what it means. The most commonly used technical definition is two consecutive quarters of declining gross domestic product (GDP) in real terms (i.e., after subtracting inflation) and quarterly growth. However, this definition is often viewed as too narrow.

If we use the standard annualised quarterly figures, we get some counterintuitive results. By this definition, the US economy was in recession over the first six months of 2022. Meanwhile, the UK narrowly avoided technical recession in the second half of last year. By virtually all other accounts though, the US was strong throughout 2022 – and significantly stronger than the sluggish UK. The Eurozone – plagued by an energy crisis and extremely negative sentiment – plodded along at a stable rate for all last year. Going back to the pandemic though, the Eurozone had two distinct recessions in 2020 according to the standard metric, punctuated by a short and sharp growth spurt of 12.4% in the third quarter.

The trouble, as with any measurement in economics, is lining up the technical definition with the events we intuitively think should happen in a recession. A general fall in activity is one, but so too is declining profitability, increased defaults and rising unemployment. None of those hallmarks were seen in the US' technical recession last year – quite the opposite actually – and there is no immediate sign this will change, perhaps with the exception of profitability. Europe and the UK, meanwhile, face different profitability questions. Although gas prices have come off last year's highs, they are still elevated and hence continue

being a cost burden. In the meantime, labour markets remain tight, keeping employment high and consumer demand fairly stable.

The difficulty in pinning down the meaning of a recession is reflected in the difficulty of knowing what its warning signs are. One of the most well-known predictors of recession is the shape of the yield curve – the difference in maturity between long and short-term government bonds. In a healthy growing economy, the curve should slope upward, as investors expect a stronger economy in the future and therefore demand higher returns when lending over the long-term. When investors expect the economy to be weaker in the future than it is now, the reverse happens. The US yield curve has inverted only a handful of times in the last half century. Every single one was followed by a recession.

The US curve is currently inverted steeper than at any point since the 1980s, as short-term (three-month) deposit rates, and two-year government yields, are significantly higher than the 10-year yield on US Treasury bonds. But this does not mean a recession is guaranteed, much less imminent. For starters, the time lag between inversion and recession is long and variable, historically speaking. And in any case, the effects of rapid inflation and aggressive monetary tightening are severely distorting bond market dynamics. That makes classic signals like these much harder to interpret.

What complicates matters is that the yield curve is not just a predictor of recession but can be a cause too. This is because banks generally make their profits from the term spread – by collecting deposits at the short end and lending out at the long end. So, when the curve is inverted, this trade becomes unprofitable, banks stop lending as freely, and the economy becomes starved of capital. But that relationship only holds if banks are the most important source of funding for most of the economy. Over the past two decades, banks have become much less important as sources of capital, as it has become much easier for companies to tap debt markets directly by issuing corporate bonds.

This points us in the right direction though; availability of capital is one of the most important factors for economic growth or contraction. In that respect, we tend to focus heavily on corporate credit spreads (the yield premium corporates have to pay over the government), as these are intrinsically linked to spending, default rates and therefore employment. Credit spreads do indeed reliably spike before and during recessions. But interestingly, the highest credit spreads tend to come when a recession is already at its nadir, which, if anything, can be seen as a sign of recovery ahead.

For that reason, we look more closely at the rate of change in credit spreads rather than absolute levels. When credit spreads rise rapidly, it suggests that we are in or on the brink of recession, with all the regular hallmarks of defaults, unemployment and falling activity. The chart below shows this dynamic over the past 20 years for Global High Yield bonds (Junk) in white and Investment Grade bonds in green – with red shaded periods indicating recession.

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Source: Tatton IM, Bloomberg, 24 Feb 2023

It also shows that global credit spreads did indeed spike last year. This is unsurprising, given the rapid tightening of global monetary policy, and it perhaps goes some way to explaining why many of the classic recession indicators were flashing red. However, the pace of that increase was not as troublesome as previous episodes. In fact, since the end of last year, credit spreads around the world have trended downwards. This suggests conditions are not immediately going to turn sour and explains some of the more positive indicators we are seeing, such as relatively high equity valuations.

There are caveats to this. Taking global averages can overlook a great deal of regional variation, and that dispersion can have big effects. China, for example, is effectively now working on a different cycle to western developed markets, making it harder to fully grasp the global picture. Moreover, absolute funding rates still matter, even if the rate of change has a more pronounced effect. This is particularly important after the year we just had: not only did credit spreads widen, but base yields rose at the fastest pace in a generation, meaning absolute credit conditions are by all historical means still extremely difficult. But we should take heart in the recent fallback in credit spreads. We are still on recession watch, but the alarms are not sounding yet.

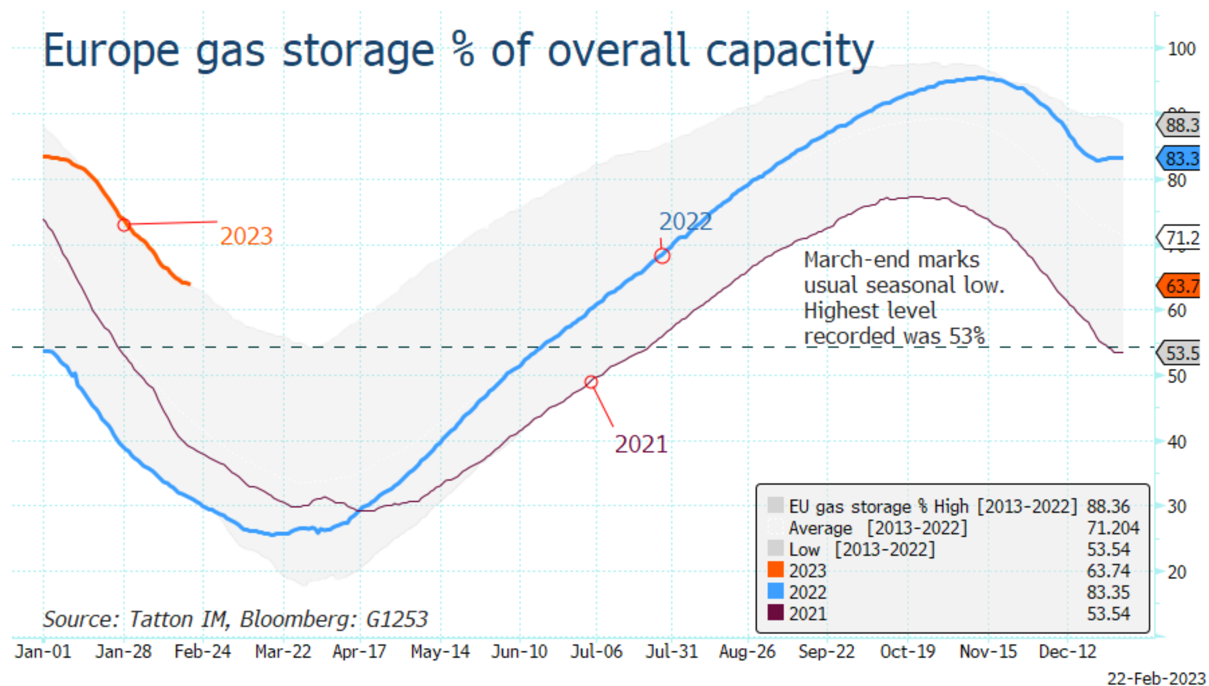
European gas prices

Britons are bracing for another energy price hike next month. The government's energy price guarantee – currently at £2,500 per year per household – will rise to £3,000 in March, unless the Treasury's plans change. That seems unlikely, despite pressure from major industry players. Last week, Emma Pinchbeck, chief executive of Energy UK, argued it is "essential that that support stays in place" until the autumn, when Ofgem's price cap is expected to be significantly lower. Chancellor Jeremy Hunt was unmoved though. The recent fallback in wholesale gas prices – which should give the Treasury some breathing room – will only have a "marginal" benefit to public finances, according to Hunt.

That is debatable, depending on how you look at spending on the policy. The government's guarantee is designed to limit household energy bills by paying the difference between the guaranteed limit and the total that would have been the case under Ofgem's price cap. For the period from January to April 2023, the price cap would have put typical household bills at £4,279, substantially above the £2,500 and £3,000 the government subsidy has made possible. But the energy regulator announced a new level this week – as a consequence of fallen wholesale prices – of £3,280 per year.

However, the market prices for natural gas are expected to continue to decline quite substantially and, by the summer, the price cap is expected to fall below the government's guarantee to around £2,200. That would represent a significant saving for the government. The previous week, European natural gas became cheaper than at any point since the summer of 2021, six months before Russia's invasion of Ukraine and the subsequent upheaval in international energy markets. On Friday, benchmark prices fell below €50 per megawatt hour – having reached €300 as recently as August last year. Gas is still expensive by historical standards, but the 85% fall over the last six months is phenomenal. Crucially, energy supplies – particularly those from Russia – are no longer the immediate threat to British and European economic stability that they seemed for much of last year.

A warmer than expected winter was a big help, as were the efforts of businesses to limit usage and source alternative means of power. But above all, inventory and storage dynamics have pushed prices down the hardest. The chart below shows the seasonal changes in storage levels – as a percentage of total capacity – for liquified natural gas (LNG). In the build-up to the Ukraine war, Europe's storage levels were some of the lowest (seasonally adjusted) in a decade. A year later, the opposite is true.



Generally, changes in storage levels are driven by expected changes in supply and demand. If demand is expected to fall, producers will anticipate future prices to be lower than they are now. That incentivises running down inventories, as these can be sold at a high price now and replenished at a lower price later. Likewise, lower demand now and higher demand (and prices) later incentivises building up stocks. Since gas demand is largely weather-dependent, that leads to a seasonal pattern where suppliers start building their inventories in the spring and start draining them in the autumn.

Sanctions against Russia – and Moscow subsequently cutting Europe off its gas – upended this pattern. At the end of 2021, suppliers thought prices would come down, having been elevated since the start of the pandemic. When demand instead massively outstripped limited supply, inventories became severely depleted. In the summer, when analysts predicted a winter of blackouts and rationing ahead, fearful suppliers were forced to build much larger inventories for security.

The dreaded winter of discontent turned out to be nowhere near as bad as predicted. Analysis from Morgan Stanley suggests European gas consumption was 22% below the seasonal average in January. Even adjusting for the warmer weather, demand was 14% lower than what would be expected at this time of year. The shortfall is not only big but growing too, down from a 10% weather-adjusted fall in December. Much of this seems to be down to a change in the energy mix, with a 20% increase in wind power generation.

At the same time, imports of LNG remain historically high. With only a few weeks of winter left to go, Morgan Stanley thinks this will lead to European storage being 59% full at the start of spring. That is when suppliers usually start building stocks, meaning we could soon be in a position of oversupply. In fact, should current inflows continue, Europe could run out of storage capacity by August. If that happened, it would likely send spot prices crashing – just as a similar dynamic did for crude oil in 2020 (when short-term US oil prices turned briefly negative).

To avoid this, governments may actually need to start incentivising demand rather than constraining it. Falling energy prices should do that, but it remains to be seen how much of the demand shortfall is

structural (owing to a move away from fossil fuels) rather than caused by the supply shock. We should certainly expect demand to pick up – relative to seasonal patterns at least – but the gas markets certainly look poised for further price falls.

The crucial thing is what this means for the long-term picture. That is still very unclear, but we have noticed an interesting trend in terms of the relationship between European and US energy markets. Currently, European gas prices are about six times those in the US. This difference is huge, but substantially below the 16 times multiplier seen at the peak of Europe's energy crisis. Moreover, while that gap was largely driven by European volatility, the difference now seems to have stabilised, with American prices falling in step with Europe. That suggests a structural change in Europe's energy flows towards those from across the Atlantic, rather than Russian. This could have meaningful consequences in the future, with the flow of shipped LNG from North America now becoming the major driver of European and US natural gas prices.

As for UK household bills, falling prices will unfortunately take some time to filter through. But it is only a matter of time, and the effect on budgets should be roughly proportional to the fall in wholesale prices. That means, if gas does tumble by more than expected – as is very possible – bills should be lower too. For growth, inflation and people more generally, that would be a welcome relief during the next colder season.

Global Equity Markets

Market	Fri 14:31	% 1 Week*	Technical: Short	Technical: Medium	Valuations: Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7891	-1.2	⬀	⬀	3.6	11.4	10.4	14.5
UK FTSE 250	19738	-1.7	→	→	3.4	13.6	12.8	17.0
UK FTSE All-Share	4306	-1.3	⬀	⬀	3.6	11.9	10.8	14.9
UK FTSE Small	6449	-1.8	→	→	3.9	10.0	14.5	18.5
France CAC 40	7229	-1.5	↗	↗	2.9	12.8	12.9	15.3
Germany DAX 40	15280	-1.1	↗	↗	3.4	12.5	12.0	14.2
US Dow	32761	-3.2	⬂	⬀	2.1	19.5	17.0	17.8
US S&P 500	3959	-3.5	→	→	1.7	19.2	18.2	18.8
US NASDAQ comp	11399	-4.3	↗	→	0.9	32.5	25.8	26.1
Japan Nikkei 225	27453	-0.9	↗	→	2.2	22.5	16.2	20.1
World MSCI	2737	-1.5	⬀	→	2.2	17.2	16.4	17.7
China mainland	4061	+0.7	→	→	2.3	14.5	14.3	13.3
Emerging MSCI	988	-1.2	→	→	3.2	12.3	7.3	11.8

Top 6 Gainers

Company	%
Rolls-Royce Holdings	+22.0
M&G	+6.9
Smith & Nephew	+5.7
Coca-Cola HBC AG	+4.0
Standard Chartered	+3.7
BAE Systems	+3.6

Bottom 6 Decliners

Company	%
Anglo American	-10.1
Antofagasta	-8.8
International Consolidated Air	-8.1
Scottish Mortgage Investment	-7.7
NatWest	-7.1
Prudential	-6.6

Fixed Income

Govt bond	%Yield	1 W CH
UK Govt 10yr Gilt	+3.67	+0.14
UK Govt 15yr Gilt	+4.02	+0.13
US Govt 10yr Treasury	+3.96	+0.12
France Govt 10yr OAT	+3.04	+0.07
Germany Govt 10yr Bund	+2.56	+0.05
Japan Govt 20yr JGB	+1.28	-0.06

Currencies

Pair	last	%1W
USD : GBP	1.194	-0.4
GBP : EUR	0.883	-0.8
USD : EUR	1.054	-1.2
JPY : USD	136.42	+1.6
CNY : USD	6.960	+1.4
USD : Bitcoin	23,774	-2.6

Commodities

Cmdty	last	%1W
Oil Brent $:bl	81.3	-4.9
Gold $:oz	1812.1	-1.1
Silver $:oz	21.0	-2.4
Copper $:lb	396.3	-2.3
Alumnm $:mt	2363.0	-0.2
S&P soft crops	229.9	+1.9

UK Mortgage Rate Estimates

Rates (LTV c.75%)	24-Feb	25-Jan
UK BoE base rate	4.00	3.50
2yr fixed	5.62	5.43
3yr fixed	5.48	5.31
5yr fixed	5.33	5.05
10yr fixed	5.27	4.99
Standard variable	6.41	6.41

24/02/2023
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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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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