THE **CAMBRIDGE** WEEKLY

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Lothar Mentel

Lead Investment Adviser to Cambridge

DISCLAIMER

Mood swings

For some time, bond and equity markets have been experiencing teenager-like mood swings. As February ended and March began, government bond yields continued their march higher to levels last seen last autumn, when stock markets tumbled as a result. Yet, this time, stock markets have ricocheted between optimism, namely the surprising resilience of consumer demand and resulting relative company earnings stability, and pessimism that the same economic resilience will keep inflation pressures high, forcing central banks to keep raising rates higher for longer, which undermines valuations and said resilience.

For equity and bond markets, the last week of February was not so good, as the inflation focus dominated, whereas last week, focus shifted back to more positive growth indicators, resulting in an improvement at least for equity markets. China's equity market – which was a drag the previous week – was in a happier place last week. We talk about China in a separate article below. Meanwhile, the bad mood in the pan-European bond market worsened last week. While Europe's economy has avoided an outright energy crisis, and delivered some positive economic updates, the unfortunate result of this is a creeping back up of inflation. Closer to home, the UK saw the prospect of recovering trade relations with its largest trading partner on the back of the positively perceived 'Windsor Framework' proposals for solving the Northern Ireland trade and sovereignty conflict.

We observe that, of late, markets are behaving in a less predictable fashion than in the ten years or so between the Great Financial Crisis and the Covid outbreak . During that period, investors became used to the idea that "rates can rise, but equities remain robust" because periods of rising rates were few and the rise in rates was small. It took only a small amount of tightening and economic slowdown to remind households that their jobs may be at risk and that a new job (at comparable pay) could be tough to find. Analysts would say that although there might be mini-economic cycles, the global economy was broadly operating below potential output – or in their jargon 'with deflationary slack' – as spare capacity could always easily be called up.

It may be that the monetary policies of the 2010s did a good job in stoking demand but did little to stoke productive investment to increase capacity, that the spare capacity was labour and, just before the pandemic struck, it had finally become scarce. It may also be that the virus had a significant impact in reducing the global economy's spare productive capacity, as businesses have become keen to diversify their supply chain dependencies.

In the 2010s, growth could pick up without signs of inflation, but the 2020s are proving different. The latest Purchasing Managers' Index (PMI) reports of business expectations showed that global growth had returned in February but that it (quite literally) came at a cost. Despite falling energy prices, input cost pressures rose, a sign that even the smallest amount of growth takes us back to a position where there is little or no spare capacity. That view was backed up by German, French and Spanish inflation data which showed a surprising rebound, especially given that companies' energy bills should have fallen somewhat.

For the central banks, therefore, this information has been enough to warrant another round of warnings that rates will probably have to go higher and stay there for longer. In the US, there is growing talk of a return of a jumbo 0.5% rate rise step on 22nd March. The European Central Bank (ECB) had already told us rates would rise by 0.5% on 16th March but could be tempted to go to a deposit rate of 3.25%, a rise of 0.75%.

On the back of this, bond yields rose again, with ten-year US Treasuries decisively breaching 4% for the first time since last November and German ten-year Bunds for the first time up to 2.7%. It is worth remembering that it was only a year ago that German yields stopped being negative.

Higher government bond yields are problematic for other asset classes since they form an important part of market valuations. However, on the stock-specific side, analysts form a view on each stock's price by looking at the expected profit flow. Should that expected profit flow start to improve because growth is improving, it might be that the higher degree of confidence offsets the effect of higher yields marking down the value of longer profit streams.

Indeed, last week, investors seemed to have become less worried about demand falling off a cliff. Even with the impact of higher yields, confidence in the resilience of economies and household spending has improved – in terms of that looming recession, we are not even close to a downwards spiral.

We have sympathy with this view. When one looks back at equity valuations of 20 years ago, the breadth of corporate profitability was strong amid the higher yields of the time. That confidence in the resilience of an economy which had a broad balance between supply and demand, allowed investors to expect more certainty in profit growth. We think that the stronger confidence was key in allowing equity valuations to be higher (more expensive) than now.

In recent weeks, we have talked about how equities are expensively valued which makes them riskier. But, as you can tell, we are mindful they might only be expensive in terms of the last 20 years, a short period in the general history of investment.

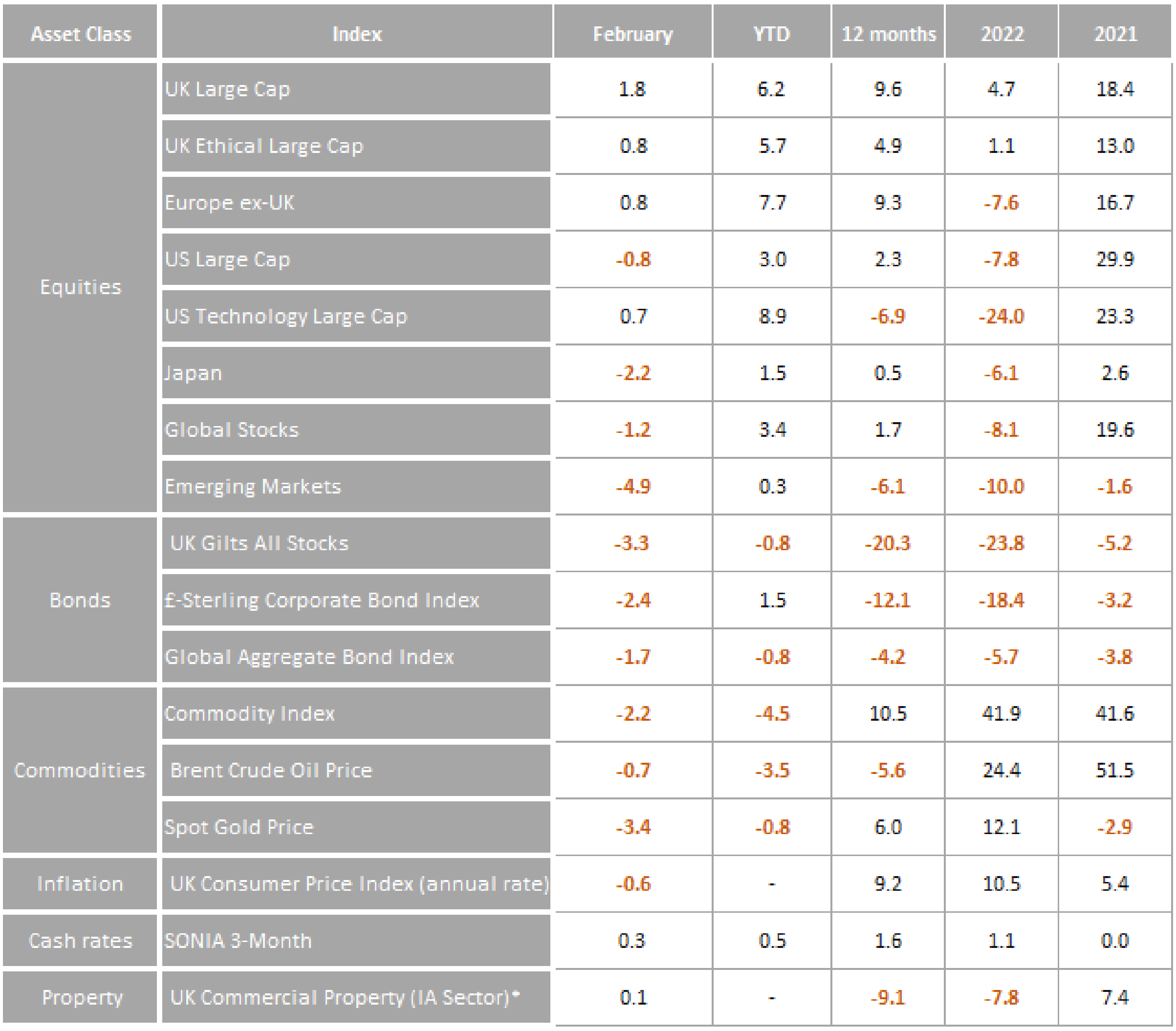
Equally, we know that saying "it's different this time" is a dangerous thing. Equity markets are still in a risky position, particularly if consumer demand were to eventually buckle and corporates were no longer able to maintain profits. However, if profit growth confidence is starting to improve – as we had some reason to believe last week – then we could see reasonable upside from current levels.

We cover February's asset class performance below. We also write about China, where the National People's Congress began yesterday. Away from the points we cover, we will be watching for rhetoric about Taiwan and Ukraine. There is no doubt both will be discussed, but the key issue is whether the west is put in a more difficult position in the near-term. We think Beijing will be careful to avoid inflaming a damaging rise in tensions now, just as growth seems to be re-establishing. However, we know that they have often surprised us as well.

6th March 2023

February 2023 review - growth proves resilient, but so does inflation

Last month proved a mixed bag for global investors. On the one hand, British and European assets had another decent month, buoyed by lower-than-expected energy prices and noticeably lower inflation numbers. This fed into the narrative of a slow but sustained recovery, allowing investors to wave goodbye to the woes of last year and look ahead to stable growth ahead. On the other hand, US and emerging market assets had a bad month, after bond yields rose yet again – pushing down equity valuations – and the speed of the Chinese economy reopening disappointed expectations. This led to an overall fall in global equities and bonds, which were down 1.2% and 1.7% respectively in sterling terms. These factors suggest we are far from in the clear. Growth is still slowing but not enough to suppress inflation sufficiently to have central banks relenting from further rounds of rate hikes. We may have climbed out of the depths, but the road ahead is long and arduous. The table below shows February's returns across major asset classes and regions.



Asset Class	Index	February	YTD	12 months	2022	2021
Equities	UK Large Cap	1.8	6.2	9.6	4.7	18.4
	UK Ethical Large Cap	0.8	5.7	4.9	1.1	13.0
	Europe ex-UK	0.8	7.7	9.3	-7.6	16.7
	US Large Cap	-0.8	3.0	2.3	-7.8	29.9
	US Technology Large Cap	0.7	8.9	-6.9	-24.0	23.3
	Japan	-2.2	1.5	0.5	-6.1	2.6
	Global Stocks	-1.2	3.4	1.7	-8.1	19.6
	Emerging Markets	-4.9	0.3	-6.1	-10.0	-1.6
Bonds	UK Gilts All Stocks	-3.3	-0.8	-20.3	-23.8	-5.2
	£-Sterling Corporate Bond Index	-2.4	1.5	-12.1	-18.4	-3.2
	Global Aggregate Bond Index	-1.7	-0.8	-4.2	-5.7	-3.8
Commodities	Commodity Index	-2.2	-4.5	10.5	41.9	41.6
	Brent Crude Oil Price	-0.7	-3.5	-5.6	24.4	51.5
	Spot Gold Price	-3.4	-0.8	6.0	12.1	-2.9
Inflation	UK Consumer Price Index (annual rate)	-0.6	-	9.2	10.5	5.4
Cash rates	SONIA 3-Month	0.3	0.5	1.6	1.1	0.0
Property	UK Commercial Property (IA Sector)*	0.1	-	-9.1	-7.8	7.4

Source: Morningstar Direct as at 28/02/23. * to end of previous month (31/01/23). All returns in GBP.

UK-listed large company equities were the brightest of the bunch. The FTSE 100 gained 1.8% in February, following an impressive January rally. Over the first two months of the year, Britain's benchmark stock index is up 6.2%. This is made more impressive by the fact that the UK was one of the few stock markets to post positive returns in 2022 – despite intense negativity around the domestic economy and the almighty October bond market blowout after the Truss/Kwarteng budget 'experiment'. In fact, the index broke above the 8,000 mark for the first time in its history toward the end of the month. Those gains have pulled back slightly since, but we are still trading close to all-time highs.

We should not read this directly as a vote of confidence in the British economy. UK large caps are unusually disconnected from the domestic economy, owing to the presence of many big multinationals, particularly in energy. That said, the wider economy has benefitted greatly from the recent fallback in wholesale gas prices. While these have not yet filtered through to households, businesses will already be seeing lower energy bills, giving them some breathing space and preventing the need to jack prices up further. The FTSE 250, pooling a larger group of UK companies with a higher domestic proportion, also climbed in February – albeit by a smaller 0.4%.

The Bank of England (BoE) has already said lower energy prices will be a big help in the fight against inflation. Markets assume it will have to raise rates substantially higher to combat price increases but, on the last day of the month, Governor Andrew Bailey was equivocal: "At this stage, I would caution against suggesting either that we are done with increasing bank rates, or that we will inevitably need to do more."

The even bigger beneficiary of falling energy prices and the avoidance of blackouts is Europe. European equities were up 0.8% in February, meaning the stock market has gained an impressive 7.7% year-to-date in sterling terms. There were dire expectations for the continent this winter, but warmer weather, energy substitutions and improvements in storage capacity have made for a much brighter picture. It is not just current gas prices which have given relief either: futures prices for next winter have now also moved down substantially. European energy is still much more expensive than it was 18 months ago, but we appear to be through the very worst of the crisis.

Across the Atlantic, energy supplies were never as grave a concern. While that helped the US economy and its capital markets last year, it also means the US has little to gain from energy price reprieve. This is reflected in the fact that the S&P 500 fell 0.8% in February, after already underperforming European stocks in January. Just like last year, the negativity stemmed from bond markets, where both US Treasury yields and corporate spreads (the premium of corporate over government yields) increased.

The US economy remains surprisingly strong, despite talk of an oncoming recession for more than a year now. While pay increases have levelled off and there have been some high-profile layoffs, the labour market remains extremely tight. This means that job cuts are mostly being absorbed by new offers elsewhere, keeping overall unemployment very low. That, in turn, means consumers still have available income, keeping demand and sentiment strong.

This is not just a US phenomenon. Although the UK & Europe are not as strong as the US, consumers and businesses appear more resilient than expected. Labour markets are also tight here and may be contributing to inflation pressures which remain stubbornly persistent and are expected to keep the central banks in tightening stances for longer than anticipated at the end of 2022. Last month, this came through in the 1.7% fall in the Global Aggregate Bond Index (hedged into sterling) as yields rose to reflect higher for longer inflation and interest rate expectations.

The other big story of the year has been China's phantom rebound. In the first few weeks of 2023, expectations were high for the world's second-largest economy, as it finally emerges from three years of zero-Covid policy. As yet though, the expected strong rebound has been elusive. Last month, global investors apparently decided they had been overly optimistic on Chinese growth and pulled back the impressive gains that Chinese stocks picked up from December. This led to a 4.9% fall in emerging market equities in sterling terms – while China's stock market declined 6.8%.

We devote a separate article to Chinese growth dynamics below. For now, it suffices to say that China being slow off the mark does not mean it will not get going. On the first day of March, for example, Chinese equities jumped again, erasing much of February's falls, following the report of a decade-high in manufacturing business optimism.

Finally, we note that daily trading volatility declined for bond and equity markets, hitting the lowest levels for the last 12 months by mid-month before rising in the final days. Easing geopolitical and thereby energy price concerns have probably played a part, but while markets have finally digested the bond market upheaval from last year, the last day of the month saw ten-year bond yields rising sharply again. While we cannot expect plain sailing ahead – as US losses last month showed – the already higher yields probably limit further yield rises. This, in turn, suggests market volatility will be lower, relative to last year.

China – when is a bounce not a bounce

Chinese growth had been one of the biggest feel-good factors of the year so far. At the end of last year, President Xi Jinping reversed three years of zero-Covid policy, finally opening up the world's second-largest economy and allowing its more than 1.4 billion population to move freely again. Investors were as shocked as they were delighted: Chinese equity markets rallied hard on the expectation of a strong recovery in consumer demand. At the same time, authorities in Beijing softened key policies for the ailing property sector and committed to significant fiscal and monetary stimulus. All in all, it was a rapid change from wholly restrictive policies to strongly pro-growth ones. Global investors got excited about a Chinese post-pandemic bounce that could be even bigger than what we saw in the west two years ago.

Those expectations have tempered as the year has gone on. China's stock rally tailed off at the end of January. The CSI 300 – mainland China's benchmark equity index – traded sideways through all of February, while Hong Kong's Hang Seng Index fell by more than 6%. We wrote a few weeks ago that global commodity prices – particularly industrial metals – have been subdued or negative for most of the year. This is the opposite of what one would expect from an environment of strong Chinese growth, suggesting there are few signs of the heralded recovery yet.

That Chinese growth is a vital part of the world economy is arguably truer now than ever before, partly due to its size but also because of the current relative weakness of the western world. For global investors, positivity around China has been one of the few bright spots in an otherwise challenging environment. Fear of disappointment is therefore understandable. So, should we be worried about China's recent lack of spark?

The short answer is not yet. Some commentators are already looking for deeper explanations for China's disappointment, such as the (supposedly) lower savings base that consumers have to work with, compared with western counterparts in 2021. But we said from the beginning that China's rebound would take a while to come through, and that Chinese authorities in any case are not looking for a growth rebound based on a liquidity bonanza. The first two months of the year in China are dominated by the Lunar New Year and subsequent Spring Festival, during which time shops and factories tend to stay shut.

Sure enough, the start of March has seen some overwhelmingly positive signs. The release of February Purchasing Managers' Indices (PMIs) shows the best reading for the manufacturing sector in more than a decade. This was well above economist expectations and suggests that manufacturers are very positive about the near-term. Likewise, high-frequency data like mobility figures are extremely positive, suggesting citizens are taking the opportunity to travel. While it remains to be seen how this will impact the hard data later on, the signs are exactly what we would expect from a strong demand-led rebound.

Unfortunately, though, pent-up consumer demand is not the whole story. As well as a break from zero-Covid, Chinese positivity was prompted by a change of fortunes for the property sector. Developers were suffering after the crisis at Evergrande, and found funding hard to come by, thanks to Beijing's crackdown on private sector lending. This crackdown appeared to be over last year, as lending requirements for businesses were loosened.

Providing a floor for the property market was a necessary policy move for Chinese leaders. At the same time, leverage and shadow banking remains a thorn in their side from a longer-term perspective. In line with this, President Xi has recently made a raft of new appointments to economic and financial regulatory positions. Many of these new appointees are well-known conservatives with reputations for hard-line policies and crackdowns on financial institutions. At the same time, there are increasing reports of executives of prominent financial companies being detained or "disappeared" by authorities. We will know more about this after the National People's Congress, which began on Sunday 5th March. For now, though, there are signs Beijing may be embarking on another crackdown, this time across the financial sector. It may well be that the 'nature' of it is closer to the anti-corruption campaign President Xi embarked on at the beginning of his tenure, as opposed to deep regulatory changes.

So, all in all, this appears in keeping with Xi's previous 'purging' and deleveraging drives, as well as the president's longstanding adherence to "common prosperity". This essentially comes through as removing wealth from extremely rich individuals or private companies, with the stated aim of using it to promote social welfare. It can involve seizures of assets, some adverse regulatory conditions, and direct actions against leaders of those enterprises.

Current corruption patterns seem to evolve around preferential placement of private funds in investment projects, and some financial institutions appear to play an assisting role in this practice. At the same time, these financial institutions are vitally important to property sector funding, and private companies more generally. These financial institutions in turn play a fundamental role in local government financing. Local government expenditures in turn account for a substantial part of China's overall fiscal outlay, but there is usually a mismatch between centrally allocated funds and local spending commitments. This financing hole is often plugged with two things: debt and land sales.

In order to prevent swelling debt piles and local fiscal crises, regional governments sell their land to property developers to generate capital. However, in recent years, property companies have themselves been struggling for cash. That has meant a massive fall in revenues from land sales. And since the economy has been weak (and hence local tax rises are unfeasible), that has forced local governments to borrow more.

This increase is reflected in the official balance sheet records, but the real increase is almost certainly much higher. Many local governments set up financing vehicles to plug their budgetary holes but keep these off the books so as to make things more presentable for the higher ups. That money usually comes from various sources outside of the main banks.

Ironically, deleveraging and financial crackdowns are part of Xi's drive for stability in China but pushing too hard too soon could massively destabilise things. Central authorities will no doubt be aware of some of these issues, but we have seen how Chinese ideology can often trump pragmatism and short-term growth.

We suspect that funding troubles – for property companies and local governments – are one of the reasons why China's bounce has been underwhelming. If there is a broad and deep crackdown ahead, it would be a mismatch with Beijing's stated growth drive. While the consumer demand bounce is definitely coming, we will have to keep a close watch on measures which could undermine confidence at least in the short-term, even if authorities believe they act for the greater good.

CAMBRIDGE
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6th March 2023

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	7928	-0.0	→	⇗	4.2	10.6	10.8	14.5
UK FTSE 250	19901	+0.1	→	→	3.3	13.7	12.9	17.0
UK FTSE All-Share	4328	+0.0	→	→	4.1	12.0	11.0	14.9
UK FTSE Small	6480	-0.1	→	→	3.9	10.5	14.6	18.5
France CAC 40	7337	-0.1	⬈	⬈	2.9	12.8	12.9	15.3
Germany DAX 40	15541	+0.1	⇗	⇗	3.5	11.7	12.4	14.2
US Dow	33092	-0.2	⇘	→	2.1	19.6	17.0	17.9
US S&P 500	3997	-0.6	→	→	1.7	19.1	18.1	18.8
US NASDAQ comp	11517	-1.0	⬈	→	0.9	33.3	25.6	26.2
Japan Nikkei 225	27927	+1.7	⬈	→	2.1	22.9	16.7	20.1
World MSCI	2720	+0.5	→	→	2.2	17.1	16.3	17.7
China mainland	4131	+1.7	⬊	⇘	2.3	14.7	14.5	13.3
Emerging MSCI	980	+0.8	⬊	⇘	3.2	12.2	10.9	11.8

Top 6 Gainers

Company	%
Rolls-Royce Holdings	+12.6
M&G	+10.0
abrdn	+9.5
CRH	+9.5
Weir	+8.2
Glencore	+5.4

Bottom 6 Decliners

Company	%
Ocado	-13.4
Persimmon	-11.4
Admiral	-5.9
Intertek	-5.7
International Consolidated Air	-4.7
Haleon	-4.5

Fixed Income

Govt bond	%Yield	1 W CH
UK Govt 10yr Gilt	+3.84	+0.20
UK Govt 15yr Gilt	+4.14	+0.15
US Govt 10yr Treasury	+3.98	+0.05
France Govt 10yr OAT	+3.19	+0.19
Germany Govt 10yr Bund	+2.70	+0.18
Japan Govt 20yr JGB	+1.24	-0.05

Currencies

Pair	last	%1W
USD : GBP	1.200	-0.4
GBP : EUR	0.885	+0.5
USD : EUR	1.062	+0.1
JPY : USD	136.03	+0.7
CNY : USD	6.906	+0.2
USD : Bitcoin	22,397	-7.0

Commodities

Cmdty	last	%1W
Oil Brent $:bl	83.2	+0.9
Gold $:oz	1843.7	+0.9
Silver $:oz	21.0	-2.8
Copper $:lb	411.2	+4.0
Alumnm $:mt	2362.3	-0.0
S&P soft crops	228.4	+0.2

UK Mortgage Rate Estimates

Rates (LTV c.75%)	03-Mar	01-Feb
UK BoE base rate	4.00	3.50
2yr fixed	5.78	5.17
3yr fixed	5.65	4.93
5yr fixed	5.47	4.68
10yr fixed	5.39	4.86
Standard variable	6.66	6.66

03/03/2023
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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www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk

Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE

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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