CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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Swiss parochialism backfires

March continues to provide investors with the opposite of the 'steady-as-she-goes' environment of January and February. News last week of consumer price inflation in the UK rising again, the US Federal Reserve (Fed) and the Bank of England (BoE) raising rates again, despite the banking sector fall-out of the past two weeks, and banks in Europe still fighting loss of trust pressures, proved sufficient to have stock and bond markets continue their rollercoaster ride of late.

This came after the global banking sector turmoil calmed down at the beginning of last week, as Swiss authorities appeared to resolve their very own crisis around Credit Suisse, through a classic 'shotgun' marriage with the remaining Swiss banking heavyweight UBS (more about the potential flaws of this later). It also helped that monetary authorities' pledges of support appeared to recognise their share of responsibility for the banking sector pressures that have arisen. This time those burdens are not from reckless lending as in 2008/2009's global financial crisis, but instead the value decline in their long-term fixed interest asset portfolios, much in the same way as some private investors had been shocked by losses in their own ultra-conservative government bond portfolios. As we know, this is collateral damage from central banks waging war against inflation through their steep rate hiking policies of the past 12 months.

For a few days, stock markets and bond yields recovered somewhat. Then, central bank sympathy seemed to wane, when, once again, they raised interest rates, even if with dovish undertones. Fed chair Jay Powell acknowledged that the stresses on banks are likely to tighten financial conditions and thereby reduce inflation drivers far more effectively and rapidly than its own steep interest rise journey had achieved thus far and, as a result, the need for further rate rises may decline or even cease to exist. Given it was aggressive monetary tightening that had weakened banks' capital base, the obstinance of the rate decision saw focus inevitably return to banks akin to Credit Suisse, which were seen to have been similarly weakened by poor past management, or with meaningful exposure to the ailing US office property sector. Germany's Deutsche and Commerzbank came under renewed pressure, as well as some French and Italian banks.

In this context, the manner in which the Swiss authorities hammered out the conditions of the UBS takeover of Credit Suisse may well have amplified the returning weakness. From our perspective, we started last week not with relief, but with an alarming bang. Our concern, shared by many other finance professionals, came from the manner of the Credit Suisse 'rescue', as it involved the explosive destruction of value for the holders of the bank's Additional Tier 1 (AT1) bonds (also known as contingent convertible 'CoCo' bonds), while Credit Suisse equity shareholders were spared a similar fate. Organised by the Swiss Financial Market Supervisory Authority (FINMA), the Swiss National Bank (SNB) and UBS, this preferential treatment of equity over bond holders is without precedent and seemed to conspire by using the opaqueness of the specific legal wording of Credit Suisse's AT1 bond prospectus.

It is true that the demise of Credit Suisse would have wiped out much of its Tier 1 capital anyway, which would have included the capital value of the AT1 bonds, but also its equity holders. When Spain's Banco Popular Español was declared insolvent in 2017, holders of equity, AT1 bonds and Tier 2 subordinated debt all lost their capital. The bank was subsequently bought by Santander.

The principle is not that the AT1 bond holders should be protected from loss, it is that the risk-bearing seniority across the capital structure needs to be upheld if the aim of the 'shotgun marriage' is to re-establish trust in the sector. Common equity holders get to have all the upside as they are the last to get paid out of proceeds should a company (or bank) fail. Preference shareholders have a priority claim over common shares on the company's assets and earnings. European country regulators chose to have AT1 bonds rather than the US choice of preference shares.

The Swiss authorities denied what bond investors had good reason to believe would be the case. In the years following the global financial crisis, and after changes to capital structure rules, the authorities made no attempt to clarify the loose wordings for the AT1 bonds that Credit Suisse, UBS and other Swiss banks issued. As a result, those banks benefitted from a lower rate of interest on their bonds than would have been the case had bond holders known they would carry the same – or in this case more – risk than equity holders.

The European Central Bank, to its credit, issued a statement last Monday stating it would respect the market's general understanding of bank capital structures. This likely helped calm markets, even as capital market experts fumed and became deeply concerned.

At this point, we should make clear we have no particular 'skin in the game' here. Our investment portfolios and funds have very minimal exposure directly to these issues, if any – and where we do, it is mostly through index tracker funds. The point is rather that instead of re-establishing trust among banking sector clients and investors, the Swiss authorities destabilised market structure, increased uncertainty, and decreased investor risk appetite, supposedly in the name of speed of action and financial stability. What is even more suspect is that they also chose between investor groups of differing (inter)nationality. According to Bloomberg, Credit Suisse's non-Swiss equity holdings were about 87%, and for UBS about 64%. However, in both cases the AT1 issues are almost entirely owned by non-Swiss institutions.

The aftermath still reverberates around markets, and we predict that the previous weekend's decisions have substantially eroded the Swiss banking sector's international standing. Despite the ECB's assurances over the treatment of AT1 bonds across the Eurozone, Deutsche Bank came under increasing pressure through last week. And yet, as we said at the start, the western central banks raised rates over the past two weeks regardless, in the name of fighting inflation. Is the current disturbance enough for them to change tack?

We note that this month's signals from the bond market, in the form of steep declines in shorter maturity bond yields, certainly imply they think exactly that. Moreover, reading between the lines, it seems the Fed and the BoE may also be alive to the possibility. The 'dots plot' charts of the expected future path of interest rates may not be liked by the members of the Federal Open Market Committee (FOMC), but it still contains their combined estimates of where they think rates will be in the future. Those dots have not moved perceptibly in the past three months, which means they are moving closer to the rate cuts embedded in their 2024 view. The language in that statement also signalled, in our view, a pause in rate rises now and a potential swift move to rate cuts.

Likewise, as we discuss below, the BoE was put in a difficult position by the inflation data for February. Governor Andrew Bailey's call for corporate 'price setters' to be restrained is, we think, clearly aimed at the supermarkets' attempts to regain margin. He has not directly named-and-shamed them, but we could see stories in the media identifying the behaviour.

The aforementioned short rate expectations continue to fall substantially as markets expect the focus to shift decisively away from inflation and towards financial stability. However, markets may still be in an uncomfortable bind regarding employment data, which arrives this week. Jobs could still lag a downturn enough to remain strong, even when central banks become convinced they have done enough to contain the dreaded wage-price spiral.

The FOMC's statement talked of long lags in the economy, as did Andrew Bailey. But both may have to tell us clearly that they are not so employment-data-dependent (as they told us for the last 12 months) if we are to think they will be responsive to a nascent credit crunch. If they do, the currently happy government bond bulls will be even more pleased, while yield-driven valuation pressures on equities should subside.

Banking sector rout hits the little guys

The last few weeks have been a rollercoaster for investors across capital markets. Long-term fears of rate hikes, still-present inflation and potential recession set the scene for nervous market action, which then saw the collapse of several regional US banks. The US stock market corrected sharply in early March amid fears of financial contagion. But when short-term stability came in the form of a bailout for depositors of Silicon Valley Bank (SVB), fears sailed across the Atlantic, docking at the Credit Suisse headquarters. Policymakers stepped in again, temporarily calming market nerves, preventing further bank runs and stabilising credit conditions somewhat.

On Wednesday, we were reminded of why we were nervous in the first place: the US Federal Reserve (Fed) raised interest rates again, unmoved by the recent banking sector turmoil. Despite some dovish overtones – the rise was only a 0.25% step up and Fed Chair Jay Powell suggested he may soon call time on the tightening campaign – US markets once again sold off. After all this commotion, it is quite incredible that, at the time of writing, the S&P 500 is just 1.9% down from where it was a month ago, while the tech-heavy NASDAQ is even showing a positive return of around 2%.

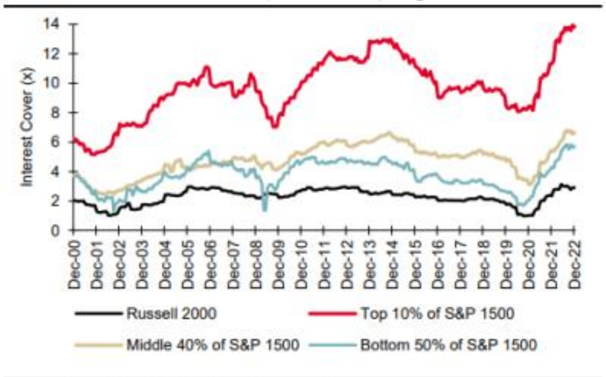
As noted last week, a rate rise cycle as dramatic as the one we are in – as necessary as it may be to get inflation back under control – is bound to reveal cracks in the system. Policymakers are tasked with ensuring these cracks do not shatter and, judging by the relative calm last week, they are doing well so far.

But no matter how much you mitigate systemic risks, each bank run increases the chances of other bank runs. Probably almost every bank, no matter how well positioned, will, as a consequence, take precautionary action. Lenders are likely to be more cautious, reducing capital available to corporations. As such, analysts at Citigroup think a general credit crunch in corporate America is now all but certain.

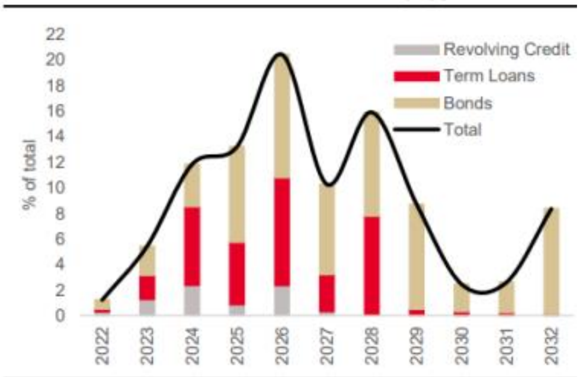
Last week we wrote that small and micro-cap firms are being particularly hard hit. This is intuitive: storms are always worse for smaller boats. And we are already seeing this play out, with investors pulling out of small businesses. In particular, positions in highly leveraged companies have plummeted through March. Credit spreads – the premium companies have to pay for borrowing above those the government enjoys – are now expected to see their largest monthly increase since last September.

The most obvious reason that leverage pressure is greater on smaller companies is that they tend to take out bigger loans relative to their stable revenue in order to grow their business. But another factor is how interest rate costs compare to overall profitability. The charts below show one such measure from analysts at French bank Société Générale, which measures interest costs relative to earnings before interest.

Interest cover in US Smallcaps remains low (EBIT versus interest cost by market cap segment)



Russell 2000 ex-financials debt schedule by type



Source: SG Cross Asset Research/Equity Quant, Factset

Smaller firms spend a much larger percentage of their earnings on interest payments. According to Bloomberg, at the end of 2022 the average pre-tax (and interest) earnings of Russell 2000 stocks were just three times interest costs, compared to fourteen times for the 150 largest companies in the S&P 500. With a slowing economy, profit estimates for smaller companies are falling too, while rate rises push up costs – quickly eating from both sides into that three times interest cost cover. The recent woes for US banks significantly add to these pressures, causing a big uptick in credit costs which could prove fatal for many smaller businesses.

More regional banks will inevitably come under pressure after the collapse of SVB. These benefitted greatly from the 2018 removal of provisions in the Dodd-Frank Act, which previously limited to whom they could extend loans. They used this extra flexibility to extend loans to smaller companies, particularly those in the property sector. Like many other high-yielding enterprises, there was a great boom when surplus liquidity was abundant during the pandemic. And as we have seen with the likes of FTX (Crypto), SVB (tech sector client base) and many others, these dynamics are coming around to bite them now.

Companies that rely on regional banks for funding will be very worried. According to Bloomberg, US commercial property owners will see nearly $400 billion of debt mature this year, requiring refinancing, with another $500 billion set to mature in 2024. With the financial and economic backdrop as it is, many could struggle to find banks willing to provide new loans. Those that find refinancing will do so at sharply higher costs.

Office owners in particular are under threat. Higher interest costs always hurt commercial property, but the post-pandemic rise in remote working has also dramatically hampered longer-term profitability. This was happening long before the current banking stresses, as major banks reduced their exposures to office debt. That meant smaller regional banks stepping in to fill the hole – but those are the banks now under stress themselves.

These problems could spread. Bloomberg report that nearly a quarter of the US commercial property loans set to mature this year are linked to offices. We have also seen significant pressure on UK commercial property recently, with Goldman Sachs cutting its rating of British Land. Those with exposure to London property – particularly office space in the City – are having the hardest time. The sheer amount of debt outstanding means there will inevitably be knock-on effects should troubles mount.

These might not be contained to strictly small caps either. In a recent report, Morgan Stanley noted that even investment grade non-financial credits are facing pressures. Unexpected bank runs have pushed up general credit stress, which has reduced overall profitability as well as increasing interest costs. This is worst at the weaker end of the investment grade spectrum (BBB), where the same leverage dynamics mentioned above are playing out.

Those scarred by memories of 2008 will no doubt be alarmed by problems spreading higher up the credit chain. But we maintain our broad assessment from last week: this classic liquidity squeeze will cause problems for many, but systemic failure is highly unlikely. As we say, policymakers are doing a good job of filling in the cracks before anything shatters. We welcome the relative calm of last week but would add a note of caution. Further troubles are inevitable, perhaps even for bigger players (Germany's Deutsche Bank is now coming under pressure). We should have a safe landing in the end, but the rollercoaster is not finished yet.

UK inflation shocker

Britons got an unwelcome surprise last week. Inflation, as measured by the Consumer Prices Index (CPI), climbed 10.4% year-on-year in February, higher than January's 10.1% figure and above economists' expectations. Before this news, things were looking better for the UK economy, albeit only slightly. Falling fuel prices, easing global input costs and a small but consistent slide in monthly inflation had suggested 'peak' inflation was behind us, a view even endorsed by the Bank of England (BoE). Market rumours were that the central bank might slow down or even suspend its interest rate rising cycle in response. The latest data poured cold water on those suggestions. To account for stubbornly high inflation, capital markets' implied rates expectation moved up swiftly after the data release and correctly predicted the BoE's actual rates increase by 0.25% on Thursday.

Food, drink and clothing were the main culprits for this unexpected rise. According to the Office for National Statistics (ONS), food and non-alcoholic drink prices rose 18% in February, the fastest pace in 45 years. This was despite food prices outside of the UK generally falling over the last few months, suggesting this particular problem is specifically British. Surging food prices are especially damaging for lower income households, who spend a higher percentage of their income on food and drink.

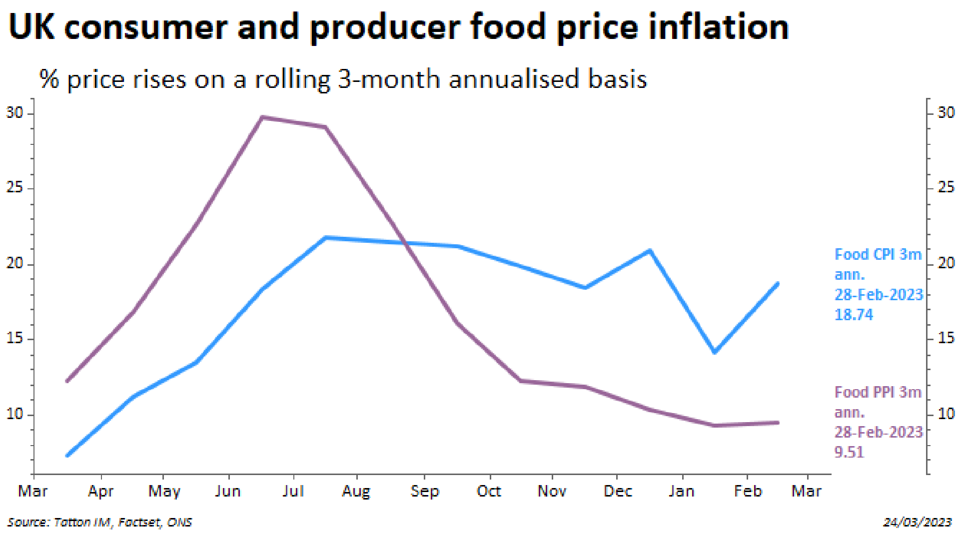
Even disregarding the food element though, prices were still higher than expected. Core inflation – which strips out more volatile elements like food and fuel – came in at 6.2%, higher than January's 5.8%. This is a measure the BoE pays close attention to, as it is thought to be an indicator of deeper, more persistent, 'stickier' inflationary trends. Along those same lines, inflation in the services sector rose to 6.6% from 6.0% the month before.

The BoE was concerned enough to raise the base rate to 4.25%. Since prices started soaring, policymakers' biggest concern has been the threat of a wage-price spiral, where employees react to higher prices with higher wage demands, which in turn cause businesses to raise prices again.

Prices for services are particularly sensitive to wages, meaning its significant increase is a sign of stronger-than-expected wage pressures. But despite the fear around wages, it is significant that we have seen relatively marginal impacts on overall inflation.

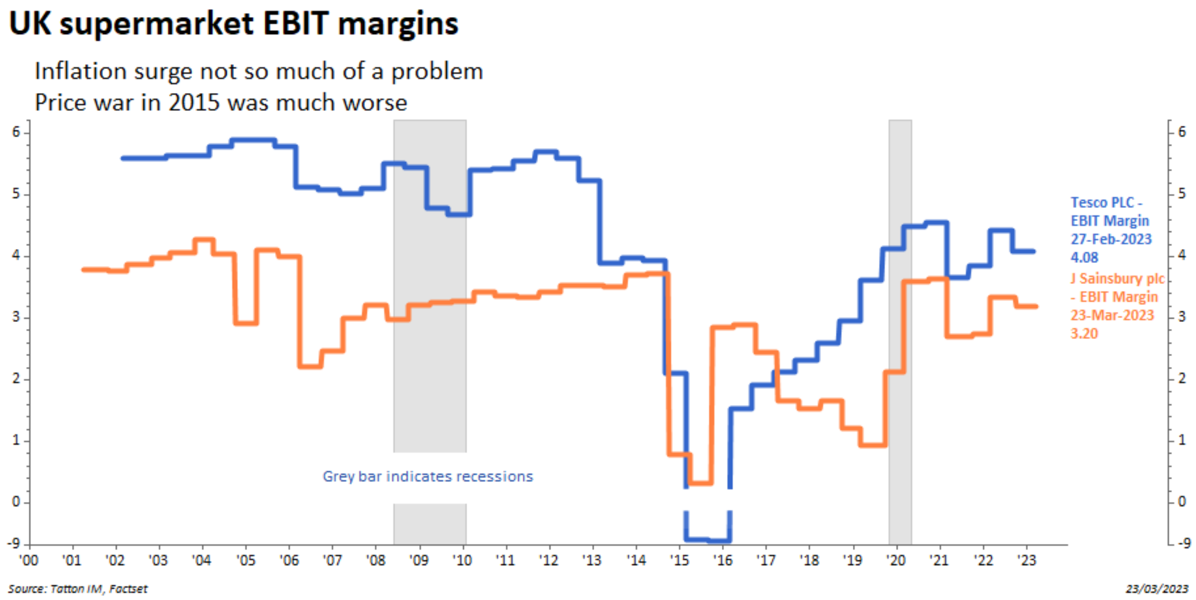
However, the rise in food and clothing prices is notable. Food and non-alcoholic drinks had a mammoth 18% year-on-year rise in February. Before now, price increases for such consumer goods appeared mainly to be the result of input cost pressures, with few goods sellers increasing their overall profit margins. For intermediaries, like supermarkets, the global inflation surge even compressed their margins somewhat, as they were not passing through all input price increases.

At the same time as the CPI data is released, we get producer price data. The chart below shows a comparison of the food price components for consumers and producers, on a rolling annualised three-month change basis. Both are still rising, but end prices are still surging while intermediate costs are moderating somewhat.



We think this is a sign companies – particularly supermarkets – are taking the opportunity to rebuild their profit margins. The reason they can do this without losing too many customers is that consumers have maintained elevated inflation expectations, thanks to a long period of rising prices.

This may be good news for investors in supermarket shares, but less good news for consumers. If the supermarkets tell us they're doing well in their next reports, one might expect more than a little pushback.



This is basically the definition of a price spiral: prices rise because prices have risen, because purchasers are primed to accept the increased cost. This concerns the BoE as once inflation expectations have become embedded, businesses, employees and consumers will keep reacting off one another, and the central bank will lose the anchor which keeps prices stable. This part of a central banker's job is not explicitly stated but is hugely important: dampening people's *expectations* of inflation, rather than just dampening economic activity altogether.

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Despite the bad news this month, there is some good news. The BoE published its quarterly survey data on inflation expectations over the next year, which shows people are perceiving a slower pace of price rises. This feeds through into price-setting mechanisms, both explicitly in terms of wage negotiations and implicitly for product price-setting. The recently agreed pay deal for NHS workers, which ups pay by 5%, is less than current inflation but perhaps the settlement is a sign these forces are having an effect.

Much of the fall in surveyed expectations is down to falling global input costs, particularly energy. As written before, lower wholesale gas prices will take a while to be felt by households. But when they are felt, there will be a big impact on how people think about inflation. The same is true for housing costs, which are greatly impacted by bond and credit markets. These spiked during the 'mini-budget' crisis last October but have since stabilised in a slight downward trend.

This is reflected in another of the ONS' inflation measures, the CPI including housing (CPIH). Like other inflation measures, the CPIH unexpectedly rose in February, but the 9.2% figure was below headline CPI. The housing component is detracting from overall inflation rather than contributing to it.

As we say, these figures are important not just by themselves, but because of the way they factor into various different price-setting mechanisms. But a complicating factor here is that many of the official rules for uprating prices (including wages) are done by reference to retail price inflation (RPI), instead of CPI. Whereas CPI is calculated to take account of substitution effects (whereby price rises cause consumers to switch purchases), RPI does not. For that and other mathematical formula reasons, RPI figures are consistently above CPI or CPIH – coming in at 13.8% in February.

In many areas, price-setting bodies are legally required to use RPI as a measure. In a sense, this embeds structurally higher estimations of inflation – thereby putting upward pressure on inflation expectations, and unhelpfully contributing to a potential wage-price spiral. Fortunately, many now use CPI or some variant for these reasons, and RPI is set to be replaced by CPIH in official uses by 2030. That will help the long-term picture for inflation expectations. For now, the BoE has to grapple with the fact that inflation remains stubbornly high, and expectations still have to come down. Further rate rises are likely but, given the fragility of the UK economy, it has a difficult path ahead. BOE Governor Andrew Bailey's appearance on BBC Radio 4's Today programme on Friday – warning businesses against margin improving price hikes – is perhaps a sign of it stepping up in its role as influencer in the coming months.

CAMBRIDGE INVESTMENTS LIMITED

27th March 2023

Global Equity Markets — Technical — Valuations

Market	Fri 14:31	% 1 Week*	% 1 Week in sterling terms	Short Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7395	+0.4	+0.4	↘ ↗	4.4	10.0	10.0	13.3
UK FTSE 250	18485	-0.7	-0.7	↘ →	3.7	12.7	11.9	16.3
UK FTSE All-Share	4035	+0.2	+0.2	↘ ↗	4.3	10.3	10.1	13.5
UK FTSE Small	6018	-1.3	-1.3	↘ →	3.9	9.9	10.2	13.1
France CAC 40	7004	+0.7	+1.1	↘ ↗	3.0	12.0	12.1	14.1
Germany DAX 40	14936	+0.7	+1.1	↘ ↗	3.6	11.4	11.2	12.9
US Dow	32018	+1.1	-0.3	↘ ↗	2.2	17.0	16.2	16.3
US S&P 500	3940	+1.6	+0.2	↘ ↗	1.7	18.0	17.5	17.4
US NASDAQ comp	11755	+2.8	+1.4	→ ↗	0.9	26.4	25.0	22.7
Japan Nikkei 225	27385	+1.4	+1.3	→ →	2.2	16.1	16.1	16.8
World Bloomberg	1453	+1.9	+0.5	→ ↗	2.6	12.9	12.7	13.8
China mainland	4027	+1.7	+1.0	↘ ↗	2.2	16.1	15.8	16.3
Emerging Bloomberg	1100	+3.1	+1.7	↘ ↘	2.4	12.0	11.6	12.0

Top 6 Gainers

Company	%
Beazley	+7.3
Endeavour Mining	+7.1
BAE Systems	+6.3
Antofagasta	+6.2
Glencore	+6.2
London Stock Exchange	+5.9

Bottom 6 Decliners

Company	%
British Land Co	-8.7
Standard Chartered	-6.9
Kingfisher	-6.3
Barclays	-5.2
UNITE	-5.2
Land Securities	-5.0

Fixed Income

Govt bond	%Yield	1 W CH
UK Govt 10yr Gilt	+3.27	-0.01
UK Govt 15yr Gilt	+3.61	+0.01
US Govt 10yr Treasury	+3.37	-0.02
France Govt 10yr OAT	+2.64	-0.06
Germany Govt 10yr Bund	+2.11	-0.03
Japan Govt 20yr JGB	+1.07	+0.01

Currencies

Pair	last	%1W
USD : GBP	1.223	+1.3
GBP : EUR	0.880	+0.4
USD : EUR	1.076	+1.7
JPY : USD	130.56	-1.3
CNY : USD	6.870	-0.5
USD : Bitcoin	28,225	+13.2

Commodities

Cmdty	last	%1W
Oil Brent $:bl	74.5	+3.2
Gold $:oz	1993.3	+3.4
Silver $:oz	23.3	+6.9
Copper $:lb	409.1	+4.5
Alumnm $:mt	2294.0	+2.6
S&P soft crops	221.1	-0.0

UK Mortgage Rate Estimates

Rates (LTV c.75%)	24-Mar	22-Feb
UK BoE base rate	4.25	4.00
2yr fixed	5.45	5.17
3yr fixed	5.35	4.92
5yr fixed	5.18	4.69
10yr fixed	5.07	4.87
Standard variable	7.02	6.66

24/03/2023
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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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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