CAMBRIDGE
INVESTMENTS LIMITED

# THE **CAMBRIDGE** WEEKLY

## 3 APRIL 2023


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## Markets put bank stress behind, but challenges remain

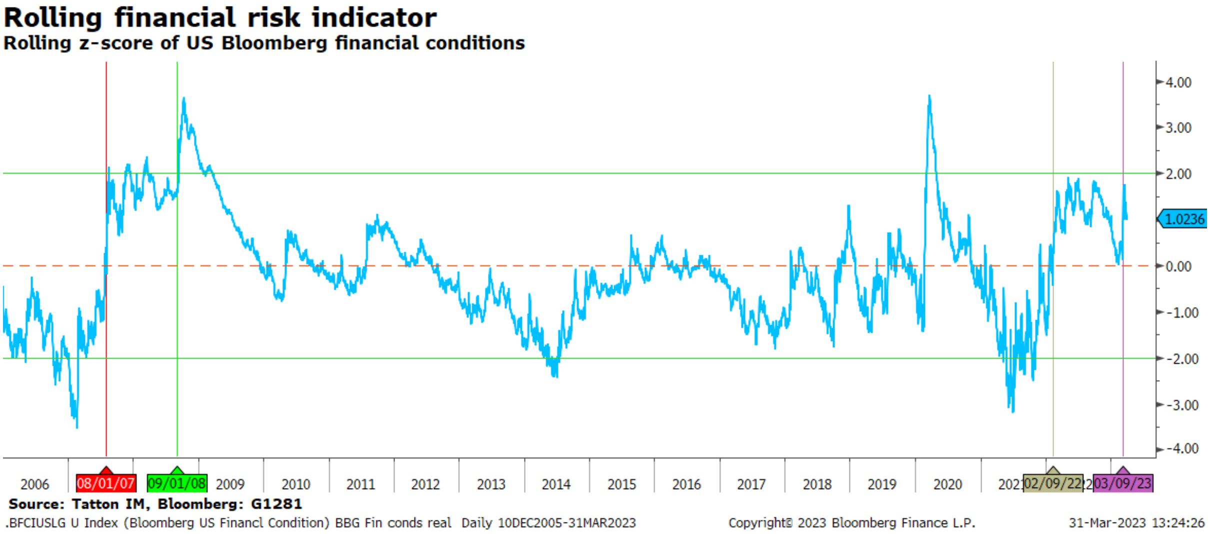
The first quarter of 2023 is now behind us, and while March ran the whole gamut of emotions for investors, we end the month (and quarter) on a fairly positive and quiet note. For the average UK investor who holds their investments in something not dissimilar to Cambridge's globally diversified range of risk profiled portfolios, the quarter ends at levels above, or at worst, fairly close to where they started the year, so not really a 'down' quarter after all.

Once again though, it been quite the journey – though nowhere near as epoch-changing as last year's Q1 invasion of Ukraine by Russia, which is still throwing some shadows at the economic parameters driving the economy and markets. We will provide a comprehensive summary of Q1 2023 next week.

Turning to the past week, it was oddly reassuring to see a return of a secular growth story, centred on artificial intelligence (AI). After the sheer necessity-driven healthcare and carbon reduction growth stories, it takes us back to the familiar investment paths of the past decade. Significant technological advancements and the change that progress presents are never brilliant for everyone, but investors like the sense of normalisation and prospect (more on this in a separate article this week).

The bank run fears that caused so much angst and downward volatility over March have quickly ebbed, allowing markets to mostly recover into positive territory for the year so far. We know that if these moments of banking sector stress do not create a domino effect within two weeks or so, then it becomes increasingly unlikely that those less-stable dominoes will be brought down this time. Instead, they will be making urgent attempts to put themselves in a less vulnerable position.

By our tightness measure of financial conditions, derived from Bloomberg's own indicator, things have actually been tight for 13 months now, since February 2022, when central banks began their tightening path (see chart below, tightness by this definition exists above the red dotted zero line). Looking back to previous tightening periods, in August 2007 the indicator signalled a similar tightening point, and remained tight through to the demise of Lehman Brothers, which marked the beginning of the depths of the Global Financial Crisis (GFC) in September 2008, some 13 months later. The memory of that timeline still haunts many institutional investors, and so from that perspective it is perhaps less surprising how significant their reaction to March's news flow was.




However, just because stock markets have proved relatively resilient this time, we should not assume the episode has passed without any further consequences. We must acknowledge from experience that the global financial system's 'immune system' is less strong after each attack and, as we know, right now the 'health' of the global economy is fairly vulnerable, due to the need to slow to get inflation back under control.

The challenge is, that despite the market pricing rate cuts by year-end, the real economy is not yet telling central banks to ease, unlike the months before 2008's crisis. Western central banks were already cutting rates – indeed last time the US Federal Reserve (Fed) started the cycle in September 2007. Now markets only expect rate cuts (in nine months' time) and only because of the expected credit tightening in the aftermath of the banking stress, gradually slowing economic growth and thereby inflation pressures – but not because the economy is already operating below capacity.

The prospect of credit default stress is apparent, but the catalyst to cut rates is not coming from the real economy data yet. It could be that the attempts by vulnerable companies to shore up their finances will lead to further cost cuts in demand – and eventually to jobs cuts – but there is still little sign of this happening in any significant way. Indeed, across much of the Western world, the business sentiment indicator, in the form of service sector purchasing manager surveys, has showed a return to growth levels (admittedly, the picture was worse in the capital-heavy manufacturing indices).

Last week's Western inflation data beyond the UK also showed small hints of decline, but only with weaker energy prices factored in. At the core level, second-round effects of last year's input price shock still saw prices rise as fast or a bit faster than the month before.

All this suggests the central banks' squeeze up in interest rates will not come off unless there is another incident which reignites fears of financial instability, which all policy institutions are very keen to avoid. We are therefore left with the slow-burn reduction of activity (and inflation) as we talked about in our outlook for 2023, written just before the year-end. Everyone is fighting to maintain their own margin, whether it is workers asking for pay rises or companies trying to eke out price rises without losing market share.

Interestingly, despite the sharp rise in write-down levels likely to come from March's bank failures, US write-down levels due to bankruptcy remain at lowish levels in comparison to financial conditions – another indication for a slow burn, rather than a fast cathartic turnaround.

The recovery rally in stock markets does tell us that market liquidity remains reasonably healthy. It also appears that the end of calendar quarter rebalancing has provoked some rather reluctant buying back of equities to cover underweight positions. Meanwhile, both government and corporate bond markets already became eerily subdued as last week drew to a close. As such, for capital markets as a whole, this week could be very quiet. Ahead of the Easter holidays, most of us would welcome that.

## Banking scare meets inflation pressures

Capital markets were notably calmer last week, following the sudden banking crises through most of the month. This was not so much that all is well again in the financial world – many are still scrambling to deal with the fallout from Credit Suisse's forced sale and Additional Tier 1 (AT1) bond write-off – but rather a case of no news being good news. As a result, the US stock market had a pretty pleasant week, while even the S&P banking index was healthily up over last week.

At the same time though, credit conditions at the lower end have become very challenging since several US regional banks collapsed, with lenders trying to reduce their risk exposure by handing out fewer loans. As we laid out last week, credit is particularly hard to come by for smaller companies with higher leverage ratios or weaker credit scores. Should those companies have a refinancing requirement, this increases their risk of default, which feeds back into the rates they are offered. This is clearest to see in long-term lending rates for businesses. The chart below shows the yields on corporate bonds across a range of credit ratings.

**US 10-year yields across credit spectrum**
**Bloomberg corporate ratings cohorts**


**Source: Tatton IM, Bloomberg: G1250**
BVABCY10 BVLI Index (USD US Composite A BVAL Yield) Credit rating bands Daily 16NOV2014-30MAR2024 Copyright© 2023 Bloomberg Finance L.P. 31-Mar-2023 16:45:21

As you can see, for many of the higher-rated credits (the lower down lines), things have stabilised after fear peaked earlier in the month. This was helped by a similar fall back in US Treasury yields. US bank failures, and subsequent turmoil in the financial system, have helped to ease underlying concerns about the extent of further interest rate rises. The Fed's mission to squash inflation meant it increased policy rates quickly and steeply, which ensured a rise in the cost of capital for everybody. This has led to tighter private sector lending conditions, now further exacerbated by banks' reluctance to lend after coming under pressure themselves.

With the financial system effectively taking over tightening from the Fed, markets now assume that policy rates will not need to rise greatly from here. Indeed, investors have built in expectations rates will fall by the end of the year. Given that corporate credit has two components – the 'risk free' rate of government bonds and the credit spread – this has eased conditions for companies with higher credit ratings, as also seen in the chart above.

So, we have reached that uncomfortable point for weaker corporate credits. Those with a single B rating or worse have been hit particularly hard, with single B spreads widening to around 5% above the government cost of borrowing. This means continued credit pressure despite the bailout for depositors in those failed US regional banks. As noted previously, weaker or more highly leveraged borrowers will likely bear the brunt of the current troubles, rather than the banks themselves. This is a concern for the underlying economy, as these smaller businesses usually provide the impetus for growth.

Nevertheless, last week's US high-yield bond market has had positive signals. Tuesday saw its first sale in more than three weeks, a $300 million bond for private equity owned Multi-Color Corp. The offering met with orders of more than $1 billion, leading to a final yield level of 9.5-9.75%, down from an initially quoted 10%. For those leveraged companies that can show investors their finances are solid enough to cope with current interest costs, there is pent-up investor demand and potentially another period of calm.

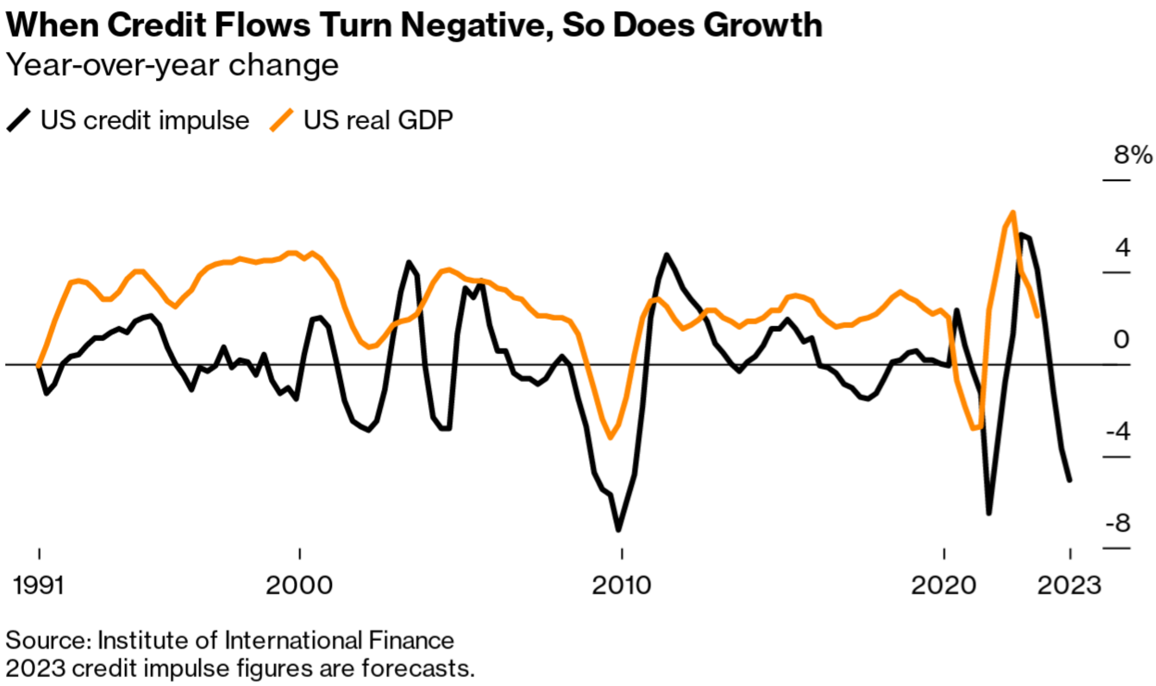
We should not get ahead of ourselves, though. According to Bloomberg, banking fears have split the high-yield market into distinct groups, dependent on the underlying default risk. CCC-rated corporate bonds, the riskiest of the bunch, are being shunned by investors, sending the demanded yields ever higher.

Toward the end of last year, we wrote that businesses were holding off on refinancing because of the dramatic increase in borrowing rates and general drop in investor risk appetite. That led to a distinct undersupply of corporate bonds, which we expected would come back when yields fell to more moderate levels. That is exactly what happened, and strong demand for corporate bonds needs to be taken in that context.

Should conditions stay calm for a while, and if growth improves and inflation moderates, then genuine risk appetite will surely return to the benefit of weaker credits. But it is far too early to say that is happening now. Companies do not want to refinance at higher levels, but with the amount that has been held back, it would only take a very slight decrease to tempt higher-yield borrowers back to the market. The apparently strong demand for weak credit would thereby be soaked up quite easily.

The deeper issues for corporate credit are clear from some historical comparisons. When the Global Financial Crisis hit in 2008, it sent long-term borrowing rates significantly higher for businesses. But, even before the crisis hit, weak growth and evaporating investor confidence had meant the Fed was already cutting its policy rate. This meant companies could borrow over the short-term at a level which was not onerous in comparison to their previous debt. It also helped those companies to avoid hefty refinancing costs and allowed them to go back for long-term credit later when corporate bond yields had come down. This effectively meant that the overall cost of borrowing remained manageable.

Now we are in a very different type of cycle. While growth is indeed slowing – and negative in some areas – the Fed and other central banks are still yet to reverse the aggressive tightening of short-term interest rates. The cost of both long-term and short-term borrowing has increased dramatically, and all maturities of borrowing are now well above the ten-year historic cost of corporate borrowing. Many companies will have no choice to refinance some borrowing, but most will also choose to cut back spending elsewhere.




This has a big impact on overall growth. The chart above, with calculations from the Institute of International Finance, shows the relationship between real growth and the credit impulse – a measure of the difference between credit growth and nominal gross domestic product (GDP). When it dips into negative, it means credit is acting as a drag on the economy rather than a spur for growth. Not every negative turn leads to a recession, but the current drag from credit is very significant in the historical context.

This essentially means the US economy (and indeed the wider global economy) is going through a deleveraging process – which usually leads to lower growth prospects. That might not be such a bad thing for long-term stability, but lower growth means weaker credit metrics for many companies, particularly those at the lower end. We welcome the recent calm, but weaker credits are surely still in for a rough ride.

## Is the microchip market heating up again?

The semiconductor industry has bounced between extremes over the last few years. The realities of lockdown indoor living and working created unprecedented demand for computer chips from businesses and consumers – the rush to upgrade equipment meant supplies were drained in 2020. The sudden tightening in the chip market had a powerful effect, pushing manufacturers' stock prices to dizzying heights.

But, last year, rapidly rising interest rates, slowing demand and inventory adjustments hit chipmakers hard. Many reversed direction, cutting jobs, operating costs and capacity. This was perhaps the clearest example of the post-pandemic boom-to-bust cycle: acute supply shortages turbocharged inflation and sent production into overdrive, only for those same factors to swing the supply-demand balance too far the other way once background conditions got tough.

These large swings can make it very difficult for any manufacturer to accurately predict levels of final demand, causing them to end up over- or underestimating how much to produce. In inventory terms, economists typically refer to this as the 'Bullwhip Effect', with the difficulty in forecasting production amounts rising the further away you go from the end user or customer of a product. This may leave some businesses with too much stock sometimes and not enough at others. This is the situation many retailers – such as Argos in the UK and Walmart and Target in the US – faced with large orders placed for items like garden furniture in early 2020. Companies later found customers had shifted their preferences as lockdowns eased, leaving them with stock to clear at reduced prices, which dented the share prices of many retailers.

The Bullwhip Effect has been evident for chipmakers too. From its peak in late December 2021 to its early October 2022 trough, the Philadelphia Semiconductor Index (SOX) fell 47%, significantly sharper than the 26% fall in the wider US stock market.

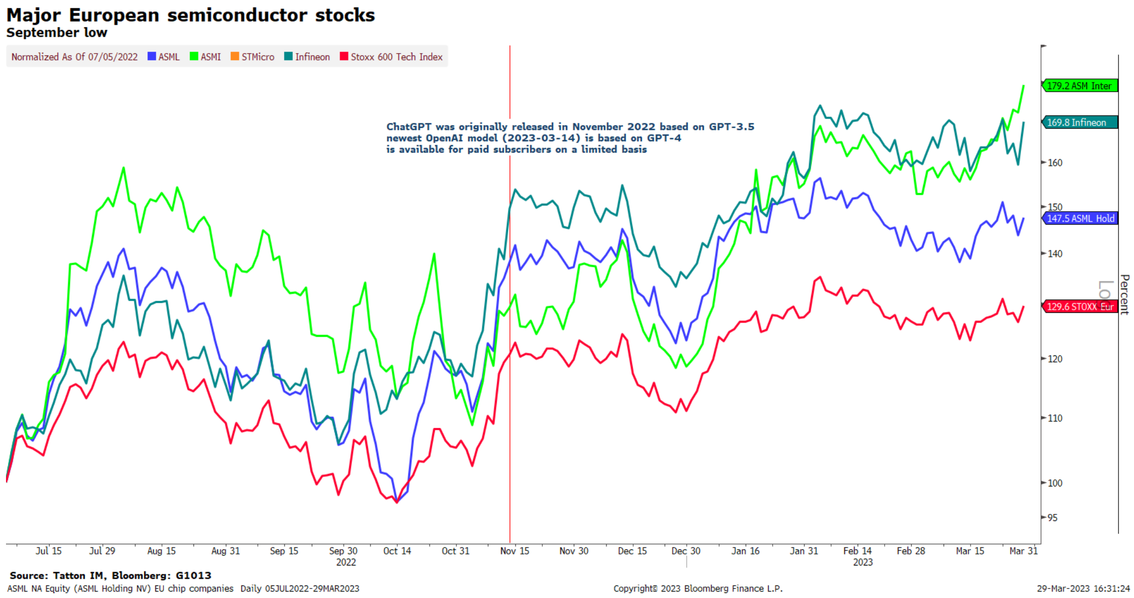
Judging by the latest earnings reports, these difficulties are still very present. Micron Technology, the largest American manufacturer of memory chips, revealed last week that revenues were down 53% year-on-year for the first three months of 2023. That was practically in line with estimates, but Micron also recorded a $1.43 billion drop in its inventory value. This was again down to slowing end demand for tech products and the substantial inventories still held by intermediary tech producers. Micron's adjusted net loss was $2.1 billion, translating to a loss-per-share more than double analyst estimates.

Despite the intense headwinds, though, Micron's stock price rose substantially after the report. It climbed more than 6% in Wednesday trading, as investors seemed to shrug off recent performance. This was down to better-than-expected forward guidance, in which CEO Sanjay Mehrota expressed hope for the near future. The company predicts its revenue will bottom in the current fiscal quarter, after which supply chain kinks will be worked out. According to Mehrota, "Customer inventories are getting better, and we expect gradual improvements to the industry's supply-demand balance."

Stocks rising on a slightly more bullish forecast fits the 'buy the rumour, sell the fact' mentality of markets. This is even more prevalent in the current market environment, where investors have been eagerly awaiting the end of this cycle (and the start of a new one) for nearly a year.

All this is accompanied by a looming technological shift among chipmakers, especially those on the leading-edge shift production lines over to newer, more advanced (i.e., ever-smaller) chips. It is not surprising chipmakers have been aggressively cutting production and running down inventories of these older 'larger' chips. Intermediaries have been doing the same to account for slowing end demand and supply overhang, but now it seems the two are coming into balance. Micron's report shows it is still in a cost-cutting process while demand is slowing, but if its forward estimates are right, profitability should improve in the near-term.

Even so, the optimism around Micron's stock is notable. Cyclical pickups are to be expected, but this comes amid a difficult few weeks in markets, rocked by banking woes, worsening corporate credit and stubborn inflation. The good feeling is not limited just to Micron either: since the end of last year, chipmaker stocks have been on a roll. This is despite prices for chips – particularly the older ones produced by Micron, primarily for use in automotives – continuing to slide.




The chart above shows recent stock price movements among Europe's biggest chipmakers. Cyclical adjustments are no doubt part of the story, but the current trend kicked-off with a sharp rally in early November. This was around the time OpenAI released the prototype of its ChatGPT program for general use.

The chatbot's ability to write detailed, knowledgeable and readable content on any given topic has garnered it a lot of attention in the media. It also dramatically pushed up the estimated valuation of OpenAI and similar companies, as well as driving substantial investment toward the artificial intelligence (AI) sector in general. Microsoft reportedly pledged another $10 billion of investment toward OpenAI in January, after which analysts have increasingly talked up the tech giant's prospects for future innovation.

The connection between ChatGPT and microchip revenues, particularly for older and less powerful models like those produced by Micron, might not be immediately obvious. The fact that big tech companies are investing heavily in AI and advanced computing techniques is nothing new, so in itself the release of a new chatbot should not drastically increase demand for chips.

Optically, though, it is a huge boost. For the last few years, there has been talk of stagnation in the tech industry – not in terms of revenue, but in terms of genuinely transformative innovation. The accusation has been that many of the biggest players had effectively run out of new ideas and investor attention had waned as a result.

In investment terms, this has led to further debate about whether tech companies – particularly those further up the supply chain, like chipmakers – should best be thought of as long-term growth assets or cyclical ones, similar to utilities. The visibility of innovations like ChatGPT is therefore extremely valuable from an investment perspective, as it reaffirms the industry's long-term growth prospects. While talk of AI is certainly nothing new, it would seem people had to 'see it before they could believe it'. Now they have seen it and used it, perhaps the proverbial lightbulb moment has occurred, and investors suddenly understand some of the early potential of generative AI on things such as productivity and profits.

This is truer for chipmakers involved in higher-end production, like Nvidia. Nvidia is a key supplier of chips for chatbots and has seen its stock more than double since the lows of October. The hope is that these developments provide a structural boost to demand, allowing chipmakers to escape some of the ups and downs that mark the global economic cycle. For investors, it changes how those companies are seen, which can further reinforce gains.

Cyclical stocks tend to do well when, after producers have cut capacity to meet expected near-term demand, investors have reason to believe the near-term demand's low point is within sight. When stock prices start to go higher, valuations based on low-point earnings look stretched. Chipmaker stocks may have been close to that point even before the AI surge. However, the combination of longer-term estimates of strength in earnings growth and lower discount rates has been especially powerful at this moment.

We cannot know yet quite how powerful the effect will be that AI has on equipment demand, but we can see from past experience that the narrative stays in place for a long time. And this particular type of narrative, one of a technology that competes with and displaces other high earning sectors over time, has been the basis for a good investment strategy over the past 20 years.

Some optimism is surely warranted. But the danger, as we see it, is that the structural forces are overestimated. While it is unsurprising that ChatGPT prompted a rally in chipmaker stocks, it is equally unsurprising this occurred while government bond yields were stabilising, and investors were getting excited about the prospect of looser monetary policy. Moreover, already we have seen high profile calls to more tightly regulate or even halt AI development – such as the open letter signed by Elon Musk and Steve Wozniak, among others. Certainly, the political appetite for public policy involvement in the tech sector has grown dramatically as tech has become synonymous with society's security. This is a battle set to run and run and as a result, investing into the already sky-high price-to-earnings chipmakers' stock may become the preserve of tech optimists.

3rd April 2023

Global Equity Markets

| Market | Fri 14:30 | % 1 Week* | % 1 Week in sterling terms | Technical Short | Technical Medium | Valuations Div YLD % | LTM PE | NTM PE | 10Y PE AVG |
|---|---|---|---|---|---|---|---|---|---|
| UK FTSE 100 | 7643 | +1.8 | +1.8 | ↘ | ↗ | 4.3 | 10.4 | 10.4 | 13.3 |
| UK FTSE 250 | 18937 | +1.1 | +1.1 | ↘ | → | 3.6 | 13.0 | 11.8 | 14.6 |
| UK FTSE All-Share | 4163 | +1.7 | +1.7 | ↘ | ↗ | 4.2 | 10.6 | 10.4 | 13.5 |
| UK FTSE Small | 6107 | +0.4 | +0.4 | ↘ | → | 3.8 | 7.3 | 6.8 | 13.1 |
| France CAC 40 | 7311 | +2.6 | +1.9 | ↗ | ↗ | 2.9 | 12.5 | 12.3 | 14.1 |
| Germany DAX 40 | 15610 | +2.7 | +2.0 | ↗ | ↗ | 3.4 | 11.9 | 11.5 | 12.9 |
| US Dow | 33006 | +2.2 | +1.7 | ↘ | ↗ | 2.1 | 17.5 | 16.8 | 16.3 |
| US S&P 500 | 4063 | +2.0 | +1.5 | → | ↗ | 1.7 | 18.6 | 17.9 | 17.4 |
| US NASDAQ comp | 12037 | +1.3 | +0.8 | ↗ | ↗ | 0.9 | 27.4 | 25.3 | 22.7 |
| Japan Nikkei 225 | 28078 | +2.3 | +0.3 | → | ↗ | 2.1 | 16.6 | 16.0 | 16.8 |
| World Bloomberg | 1499 | +2.0 | +1.5 | → | ↗ | 2.5 | 13.2 | 12.6 | 13.8 |
| China mainland | 4051 | +0.6 | -0.7 | → | ↗ | 2.2 | 16.5 | 16.0 | 16.3 |
| Emerging Bloomberg | 1121 | +1.3 | +0.8 | → | ↘ | 2.4 | 12.1 | 11.7 | 12.0 |

Top 6 Gainers

| Company | % |
|---|---|
| Ocado | +25.9 |
| M&G | +9.8 |
| Beazley | +9.6 |
| Burberry | +9.5 |
| International Consolidated Air | +9.0 |
| DCC | +8.7 |

Bottom 6 Decliners

| Company | % |
|---|---|
| Standard Chartered | -4.1 |
| Next | -3.7 |
| Smith & Nephew | -3.5 |
| Aviva | -2.2 |
| NatWest | -2.2 |
| abrdn | -2.1 |

Fixed Income

| Govt bond | %Yield | 1 W CH |
|---|---|---|
| UK Govt 10yr Gilt | +3.52 | +0.13 |
| UK Govt 15yr Gilt | +3.81 | +0.09 |
| US Govt 10yr Treasury | +3.52 | +0.06 |
| France Govt 10yr OAT | +2.83 | +0.09 |
| Germany Govt 10yr Bund | +2.33 | +0.10 |
| Japan Govt 20yr JGB | +1.03 | -0.05 |

Currencies

| Pair | last | %1W |
|---|---|---|
| USD per GBP | 1.238 | +0.5 |
| GBP per EUR | 0.879 | -0.6 |
| USD per EUR | 1.088 | -0.1 |
| JPY per USD | 133.04 | +1.4 |
| CNY per USD | 6.871 | +0.7 |
| USD per Bitcoin | 28,308 | +3.2 |

Commodities

| Cmdty | last | %1W |
|---|---|---|
| Oil Brent $:bl | 79.4 | +5.9 |
| Gold $:oz | 1981.5 | -0.1 |
| Silver $:oz | 24.0 | +3.8 |
| Copper $:lb | 407.9 | -0.5 |
| Alumnm $:mt | 2352.3 | +2.5 |
| S&P soft crops | 229.8 | +3.8 |

UK Mortgage Rate Estimates

| Rates (LTV c.75%) | 31-Mar | 01-Mar |
|---|---|---|
| UK BoE base rate | 4.25 | 4.00 |
| 2yr fixed | 5.51 | 4.82 |
| 3yr fixed | 5.37 | 4.67 |
| 5yr fixed | 5.19 | 4.38 |
| 10yr fixed | 5.08 | 4.50 |
| Standard variable | 7.02 | 7.02 |

31/03/2023
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

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

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3rd April 2023

**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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