THE **CAMBRIDGE** WEEKLY

11 APRIL 2023

Lothar Mentel

Lead Investment Adviser to Cambridge

CAMBRIDGE
INVESTMENTS LIMITED

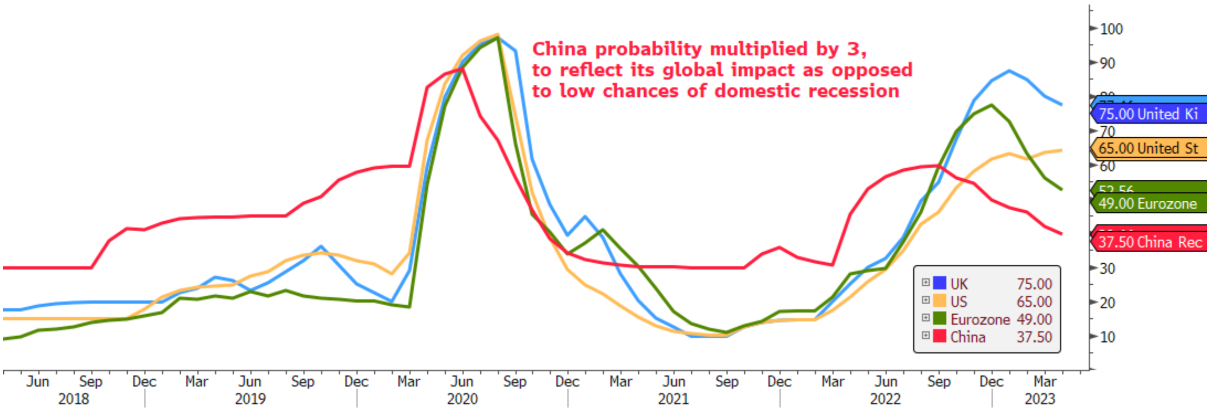
11th April 2023

Spring of hope following winter of doom?

This year began in anticipation of imminent global recession, but imminent did not mean immediate, and as the second quarter gets under way, the chances of a global recession may be less now than they were.

The chart below is Bloomberg's calculations of the chance of recession occurring within a year, for each region. As it hopefully shows, a combination of events in the first three months has reduced the likelihood of negative real growth occurring in the next 12 months in most regions.

Regional recession probabilities
Chances of a recession starting within a year from now



Source: Tatton IM, Bloomberg: G1314
ECRPGB 1Y Index (United Kingdom Recession Proba) Global recession fcs Monthly 12APR2018-06APR2023 Copyright© 2023 Bloomberg Finance L.P. 06-Apr-2023 14:26:40

The exception is the US, where chances have increased marginally. The most interesting outcome of this is that it may have reduced the chances of global recession even more.

The calculations are made as of the end of the month (we also smooth the data to show a clearer trend). March saw a flare-up of bank mistrust, which gave investors and capital markets an uncomfortable reminder of the 15th anniversary of the Global Financial Crisis (GFC). Bank lending was already tightening and events in March will have made it worse.

But rather than tipping things over the edge, markets have seen this as helping central banks in fighting inflation. Most price indicators still suggest a steady decline in goods prices. Against this, Europe and UK inflation was a bit sticky in March, and last year's price shock may still be feeding through to the service sector, which makes it even harder for central bankers to decide how to proceed and harder still for strategists to forecast.

However, if demand is slowing in the US, global inflation pressures will continue to reduce. In turn, this means not just that a peak in rates is in sight, but also a sharp reduction in future rate expectations. The two-year US Treasury yield peaked on 8 March at 5.07%. Two weeks later, it was at 3.56%. Such a fall in yields (over 1.5%) has not been seen since Black Monday in 1987.

Lower government bond yields lead to higher equity price-to-earnings valuations if all other factors are equal. However, a slowing economy is generally not good news on the corporate earnings front. The data from the US for the end of 2022 showed a sharp contraction in economy-wide corporate profits, with smaller enterprises under real pressure. The danger for the larger companies that comprise most of our investment universe is that they too could experience a worsening earnings environment.

Last week's crop of economic data has added to the evidence that higher rates in the US are indeed creating a more difficult environment than elsewhere. Industry has already been slowing, but rates are more keyed on services, which had been expending smartly. The Institute for Supply Management (ISM) data showed an unexpected fall, still at a mildly expansionary level of 51.2 but below the 'inflationary' level of 52.

Asia and Europe are showing stronger signs of economic spring thawing. China's data is indicating a slow but steadily improving rise from the depths of Covid restrictions, as we felt would be the case.

The dollar also took a hit last week, which may not be surprising given the economic backdrop. This has a general stabilising effect on the rest of the world's economy, and also helps to reduce inflationary pressures, and will also be a welcome impact for central banks, especially the European Central Bank (ECB).

Of course, this does not mean all is right with the world. After almost a decade-and-a-half of 'money for free' ultra-low cost of finance, there has been plenty of time and ample opportunity for misallocation of capital. As the Sage of Omaha (Warren Buffet) keeps reminding us: it is only when the tide goes out that we find out who has been swimming naked.

It may be that the weaker data from March was directly caused by the fears about banks. Those fears have passed quickly and nobody other than the banks' equity (and Additional Tier 1) holders have suffered – a very small group. As such, the forthcoming data could bounce back and, with it, inflation. In that case, we'll be back to square one, only with a weaker set of small businesses.

Investors may read from the pedestrian positive returns of their portfolios over Q1 (if they are invested in globally diversified multi-asset portfolios) that capital markets and their prospects have continued on a gradual path of improvement since Q4 2022. Herein lies the fragility and difficulty for the coming quarter: will a less bad economy and receding valuation pressures continue to provide support for stock and bond markets?

Will the lack of earnings mean unsustainable losses, further 'falling dominoes' or unrelenting central rate hikes lead to another market capitulation as witnessed last October? Right now, the risks feel finely balanced. Can inflation continue to decline, or will it take another financial sector blow-up to make central banks more dovish?

At this point, we are happy enough to have stocked up on long maturity bonds in portfolios when yields spiked higher, but otherwise remain neutral on risk as the second quarter of 2023 takes its course.

We hope you had a happy few days basking in spring warmth!

March and Q1 2023 asset class review

Asset Class	Index	March	3 Months	6 months	12 months	2022
Equities	UK Large Cap	-2.5	3.6	12.5	5.4	4.7
	UK Ethical Large Cap	-2.4	3.2	11.3	1.2	1.1
	Europe ex-UK	1.1	8.9	21.4	8.6	-7.6
	US Large Cap	1.5	4.6	4.4	-1.7	-7.8
	US Technology Large Cap	4.6	13.9	4.8	-7.7	-24.0
	Japan	1.8	3.3	8.6	0.9	-6.1
	Global Stocks	0.9	4.4	6.3	-1.4	-8.1
	Emerging Markets	0.9	1.1	3.0	-4.9	-10.0
Bonds	UK Gilts All Stocks	2.9	2.0	3.8	-16.3	-23.8
	£-Sterling Corporate Bond Index	0.8	2.3	9.6	-10.6	-18.4
	Global Aggregate Bond Index	1.0	0.2	-2.8	-2.1	-5.7
Commodities	Commodity Index	-3.1	-7.5	-11.2	-4.2	41.9
	Brent Crude Oil Price	-6.3	-9.5	-15.3	-18.8	24.4
	Spot Gold Price	7.0	5.5	6.1	8.8	12.1
Inflation	UK Consumer Price Index (annual rate)*	0.6	0.6	3.3	9.2	10.5
Cash rates	SONIA 3-Month	0.3	0.9	1.6	1.9	1.1
Property	UK Commercial Property (IA Sector)*	-0.4	-0.1	-9.1	-10.4	-7.8

Source: Morningstar Direct as at 31/03/23. * to end of previous month (28/02/23). All returns in GBP.

The first quarter of 2023 was one to be remembered for the sense of crisis, with markets heading upwards but seemingly towards a cliff edge. As March unfolded, fears grew that the cliff edge had been reached. Fortunately, it appeared that the drop was just a few feet down and the march upwards has continued.

For global equity markets, the year began positively after an awful 2022. European natural gas prices continued to decline throughout the quarter, with January alone seeing a 25% fall. Next winter's gas contracts are now about 30% below the end-2022 price levels.

Consumer confidence improved as households and small businesses became less fearful of energy-induced inflation. The resilience of the general jobs markets also kept consumer spending at reasonably normal levels.

In China, reopening meant a resumption firstly of domestic travel, which boosted services over the Chinese New Year. Then, a phased reopening of international travel boosted tourism, although this will take some time to feed through beyond South-East Asia.

However, hopes for a strong rebound in construction were not fulfilled immediately. A rebound in metals prices in early January was unwound somewhat in February. March saw a late rally, but only to January highs.

The global growth outlook felt generally better throughout the quarter in comparison to 2022. However, central banks remained worried about tight labour markets and the emergence of second-round effects from 2022's inflation surge. This meant that short-term interest rates were raised further, continuing at the general pace established in 2022.

The constraints placed on regional economies has been substantial for people and companies that needed more debt or other forms of capital. Residential and commercial mortgage applications had already fallen globally during the second half of 2022 and remained – or even worsened – during the quarter.

Bond issuance for larger companies rebounded, however, as longer maturity investment grade yields started to fall. Bonds were generally stable overall, although volatility remained high. While investors began to sense that the damage done to more vulnerable sectors was becoming significant, economic resilience meant investors were unsure whether the peak of rates was near at hand until we entered March. Bond yields traded between the October high and the December low. However, new bond issues were met with strong investor demand, despite fears over creditworthiness in weaker issuers. Demand rose substantially, especially for US Dollar investment grade bonds yielding above 5%.

The second week of March had a defining moment. The problems in cryptocurrency markets which had crystallised after FTX's demise led to a shutdown of Silvergate Bank, ostensibly because of its involvement in cryptocurrency exchange systems.

However, almost immediately, Silicon Valley Bank (SVB) experienced a sudden run, with almost all its depositors attempting to withdraw their money. The bank had experienced several of its start-up tech depositors having to drawdown on the equity monies raised in the past years, after tech funding dried up during 2022. The bank attempted to raise capital to offset the flows, but severely misjudged the perceptions of its actions. It sold a portfolio of US Treasuries (which were designed to be held to maturity) at a substantial loss. This convinced depositors the bank was experiencing a sudden collapse and so they rushed for the door *en masse*.

While the issues at SVB were quite specific to the bank, investors focused on possible problems with other US regional banks. In 2018, then-President Trump reduced the regulatory burden on these banks, which resulted in a significant increase in lending, particularly to commercial real estate companies. The pandemic's impact on this area has been awful and there appears to be little sign of any improvement. Indeed, commercial Real Estate Investment Trusts (REITs) across the globe continue to be shunned. British Land PLC, the UK REIT with 50% of its assets in the City of London, saw its share price hit badly in the last days of March. Meanwhile, private credit funds such as Blackstone's office REIT saw large investor selling.

Amid fears that financial stability was at risk, the Fed pumped liquidity into the US banking system, which stabilised investor fears quite quickly. While cash holders moved into money-market funds, big sums were deposited in the major banks.

In the past couple of years, Credit Suisse and Deutsche Bank have been troubled, so it was not surprising investors became concerned they would face further problems in this environment. Deutsche Bank came under pressure, but this passed quite quickly. However, for Credit Suisse, it was too late in attempts to overcome fundamental weaknesses. The Swiss authorities moved quickly to persuade UBS to take it over, the process becoming public just as Credit Suisse's share price collapsed. The rescue was not without drama, with holders of equity-like AT1 bonds having all their holdings completely written off.

These events could have created a domino effect, just as what happened in 2008. However, swift central bank action combined with general resilience of the financial system, therefore no new issues were immediately apparent.

While credit spreads moved out sharply, this was accompanied by a sharp fall in government bond yields. Markets moved to believe that central banks had now reached the peak in the rate rise cycle, and that economies would show only weak growth and inflation for the rest of the year, allowing the potential for rate cuts in fairly short order.

In turn, the easing of policy constraints helped equities, especially US larger companies, where the flow of earnings is relatively stable. Lower yields increase the current value of the more certain cashflow in the future.

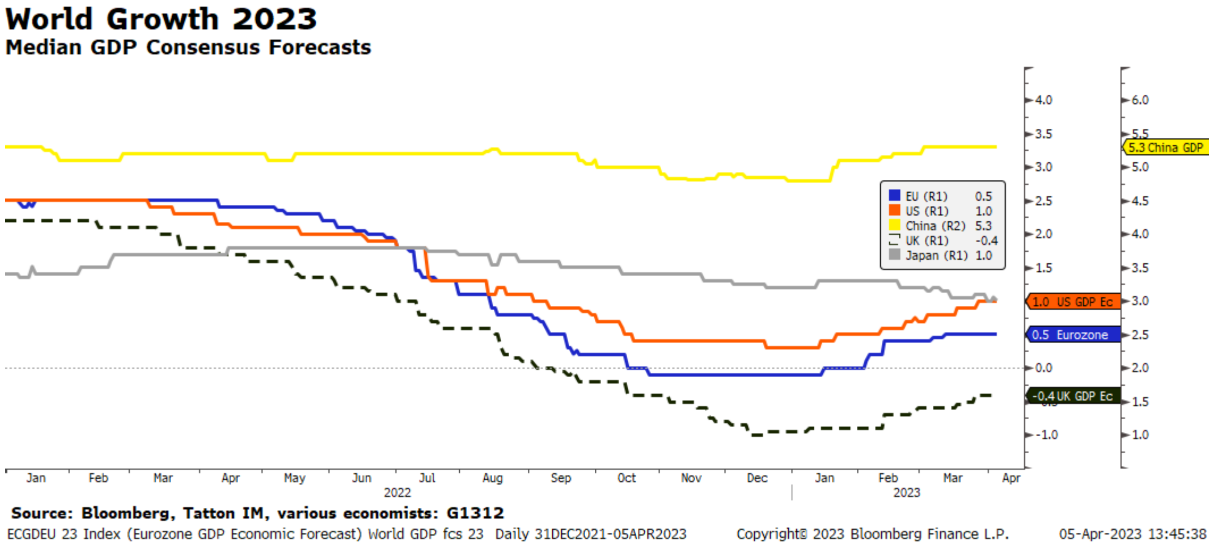
The other dynamic apparent during the quarter was the impact of artificial intelligence applications such as ChatGPT. The November release of that particular application led to a huge media frenzy and other competing applications being announced. Chip-related companies benefitted from the news flow through the quarter, and the price-to-current-earnings valuations on those stocks improved dramatically.

The tremors caused by the demise of SVB and Credit Suisse passed quite quickly. This led to perceptions that, while other banking failures may occur, the system and policy response was more robust than 15 years ago, and there was much less to fear. Nevertheless, for many small firms especially, access to capital is still difficult. The events of March could therefore still have impacts on future consumer and business confidence.

A brief assessment of the global economy

The predictions of imminent recession that pervaded economic forecasts last year have so far proved to be somewhat pessimistic. However, economists were generally opining that a stronger than expected 2022 would mean less strength in 2023, so forecasts for the first two quarters of this year were adjusted down.

But, yet again, the world's major regional economies continue to be more resilient than forecasts would suggest. The graph below tracks how economist estimates of 2023 growth have shifted over time:



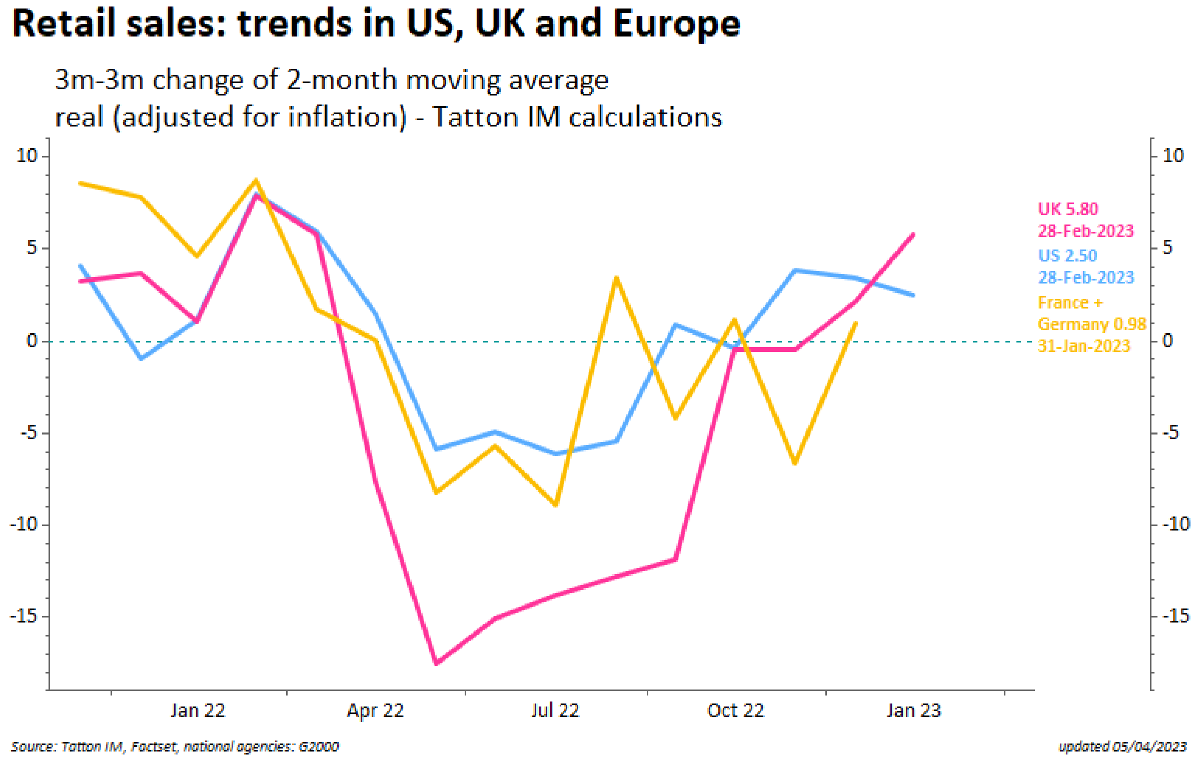
For us, the most notable improvement has been in the Eurozone where, by our calculation, economists now estimate the standalone Q1 to rise +0.5% quarter-on-quarter (qq), or 2.1% annualised. By comparison, the US is estimated to have risen by 0.3% qq or 1.3% annualised. The motivation for better expectations has come from falling gas and electricity prices. Energy prices move in tandem, and prices for both immediate use and for next winter contracts fell by about 30%.

The UK had a similar benefit and so estimates improved. However, they remain in recession territory.

In Asia, China's rebound has been slower than initial expectations after the removal of Covid restrictions, but travel freedoms have spread some of the benefit to the rest of Asia. Japan estimates saw some positivity, but optimism has faded a little, against the trend of other regions.

Overall, China's growth expectations were upgraded for this quarter. The next quarter's expectations have been upgraded substantially to a year-on-year growth level of above 7%.

The resilience appears to have come from the tightness of labour markets across the world. Firms may be under cost stress, but business has been steadyish and enough to make employers want to retain employees. Some businesses, mostly larger enterprises, have been able to pass rising costs on to their customers. Consumers bought a lot of things in 2021 and part of 2022. Now they are keener on socialising and travelling. Services have done well.

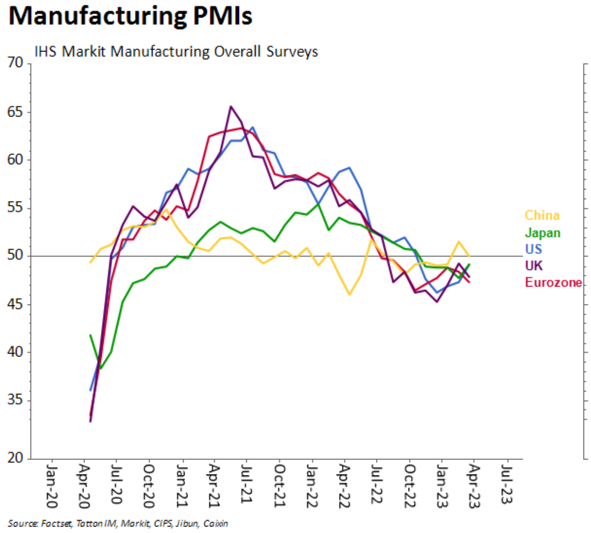


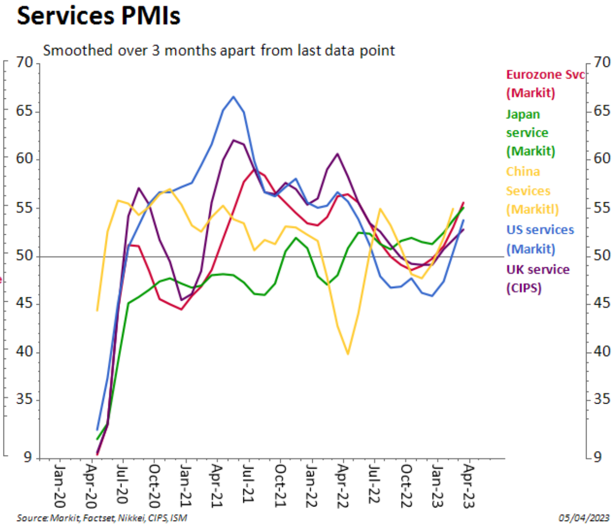
The chart above shows how retail sales have performed in Europe, US and UK. Although the data does not take us to the end of the quarter, consumption has been higher than inflation (real consumption) and we think it is remaining that way now.

Globally, the stock of household savings remains high, and the rise in interest rates has had a positive impact on savers in aggregate. Of course, low-income households have less savings both in absolute and relative terms.

However, the rise in interest rates has had its biggest negative impacts on people who were looking to buy their first house, and on smaller businesses and manufacturing businesses. These firms usually have higher capital stock requirements (plant, machinery and inventory) and tend to have more net debt than larger businesses.

While consumer confidence has generally improved, house prices remain under some pressure globally and construction has become quite subdued. Business confidence has also improved, and service businesses have become positive. Manufacturers are generally pessimistic still, even if things are not getting worse.





Last, the quarter's inflation data headed lower on a year-on-year basis, as input costs showed some actual declines. Both hard (metals) and soft (food) commodity prices followed energy prices lower. Meanwhile, the supply chain difficulties eased substantially, which led to lower delivery costs. But, despite the fall in input costs, inflation remained notably higher than central bank targets. The March consumer price inflation data for both Europe and the UK disappointed, remaining above 6%.

So, overall and in aggregate, the first quarter was a little better than expected. However, there are strong forces at work and the aggregate does not tell the story of those groups on the receiving end of the negative strong forces. The global economy is not growing significantly, and that makes the financial ecosystem somewhat fragile.

Perhaps economists remain more concerned about risks than resilience, so low expectations can still be beaten for the rest of the year. Much will depend on a resumption of progress towards lower inflation.

CAMBRIDGE
INVESTMENTS LIMITED

11th April 2023

Global Equity Markets

Market	Thu 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	7728	+1.5	+1.5	↘	↗	4.2	10.7	10.3	13.3
UK FTSE 250	18708	-0.9	-0.9	↘	→	3.6	12.0	11.7	14.6
UK FTSE All-Share	4195	+1.1	+1.1	↘	→	4.1	10.8	10.4	13.5
UK FTSE Small	6087	-0.1	-0.1	↘	↘	3.8	7.1	6.7	13.1
France CAC 40	7325	+1.0	+0.4	→	↗	2.9	12.6	12.3	14.1
Germany DAX 40	15554	+0.5	-0.1	→	↗	3.5	11.8	11.5	12.9
US Dow	33426	+1.6	+1.3	→	↗	2.1	17.7	16.9	16.3
US S&P 500	4081	+0.7	+0.3	→	↗	1.7	18.7	18.1	17.4
US NASDAQ comp	11943	-0.5	-0.9	→	↗	0.9	27.0	25.5	22.7
Japan Nikkei 225	27450	-0.8	-0.3	→	→	2.1	15.8	16.0	16.8
World Bloomberg	1502	+0.6	+0.2	→	↗	2.5	12.4	12.6	13.8
China mainland	4097	+2.3	+1.8	→	↗	2.2	16.6	16.1	16.3
Emerging Bloomberg	1116	+0.1	-0.3	→	↘	2.3	12.3	11.7	12.0

Top 6 Gainers

Company	%
Admiral	+9.7
Haleon	+8.5
GSK	+7.2
Fresnillo	+7.1
National Grid	+6.3
Endeavour Mining	+6.2

Bottom 6 Decliners

Company	%
Ashtead	-9.8
RS GROUP	-8.7
CRH	-7.1
JD Sports Fashion	-6.7
Kingfisher	-6.4
Melrose Industries	-5.9

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+3.42	-0.10
UK Govt 15yr Gilt	+3.70	-0.11
US Govt 10yr Treasury	+3.29	-0.29
France Govt 10yr OAT	+2.68	-0.22
Germany Govt 10yr Bund	+2.17	-0.22
Japan Govt 20yr JGB	+1.10	+0.09

Currencies

Pair	last	%1W
USD per GBP	1.242	+0.4
GBP per EUR	0.877	-0.6
USD per EUR	1.089	-0.2
JPY per USD	131.65	-0.8
CNY per USD	6.876	+0.0
USD per Bitcoin	27,898	-2.4

Commodities

Cmdty	last	%1W
Oil Brent $:bl	84.8	+7.6
Gold $:oz	2013.0	+2.3
Silver $:oz	24.8	+5.3
Copper $:lb	399.6	-2.5
Alumnm $:mt	2295.3	-2.2
S&P soft crops	235.5	+2.5

UK Mortgage Rate Estimates

Rates (LTV c.75%)	06-Apr	07-Mar
UK BoE base rate	4.25	4.00
2yr fixed	5.52	4.82
3yr fixed	5.37	4.67
5yr fixed	5.20	4.38
10yr fixed	5.08	4.50
Standard variable	7.02	7.02

06/04/2023
Prices taken at 2:30pm today and 2:30pm last Friday (where possible)
The Bloomberg World and Emerging Market equity indices are similar to those published by MSCI
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of next 12 months earnings as forecast by analysts
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

11th 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.

LOTHAR MENTEL

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk

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