CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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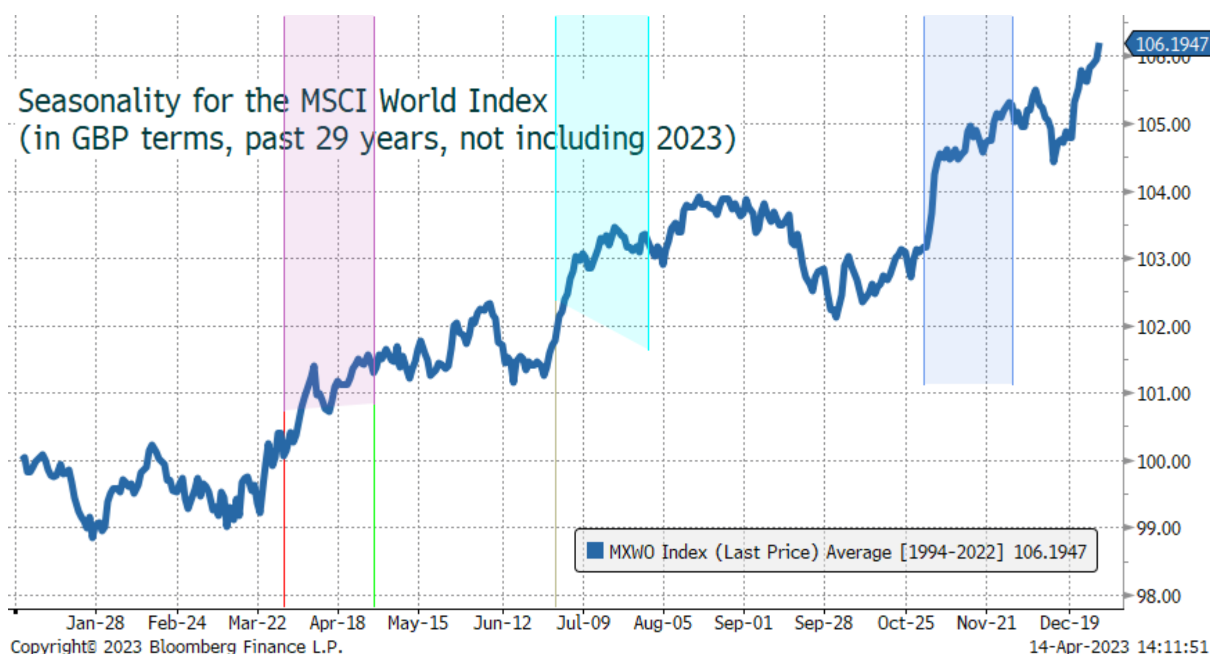
Return of calm bodes well for spring

Easter lies behind us and the second quarter of the year ahead. Considering how unnerving the first three months of the year were, UK investors in globally diversified multi-asset portfolios (akin to the ones we manage) have not fared too badly. Mildly positive returns across the risk spectrum tell the story of another risk storm having passed without sinking global capital markets. If readers feel like they have heard and read it before, then that's clearly the case. It's not hard to recall recent risk storms and market corrections, such as last autumn's government bond market upset, the summer's growth scare, and the market reaction to Russia's invasion of Ukraine, to name only three of the freshest ones.

With the latest market recovery having stock and bond markets retesting previous highs, the observed regularity of this wave-like market behaviour already has some market commentators jumping ahead to the old investor adage of 'sell in May and go away'. While there may be a startling regularity in recent market dynamics, suggesting short-term market timing as a viable investment strategy overlooks that there is a second wave pattern behind markets, namely the global economy and its prospects in the post-pandemic world. That world has been characterised by the back-and-forth of excessive supply and demand mismatches as consumer demand patterns and producer capacity was driven by what was, or rather was not, possible during the various stages of the pandemic. Paired with overzealous policy support the resulting over- and undershooting of economic parameters, especially inflation, this has created economic and monetary volatility which continues to be harder than usual to predict.

Focusing on the hard facts and figures of current economic activity and direction while markets go through another period of relative calm, therefore feels advisable. Likewise, it is worth taking some hints from seasons past, which we start with here. Statisticians that consider the way the world's equity markets move across the year note that the month of April has the best chance of delivering a positive return and the second-best chance of having the best performance (on average, November has been slightly better). If one includes the last week of March, then historically, at least, this is the best and least volatile period of the year.



Seasonality is an interesting dynamic and because most of the developed world lies in the temperate northern climes, spring really does have an influence. Human beings become less stressed as the days lengthen, the temperature rises, and the claustrophobia of winter departs.

If markets have calmed down after March's mini global banking crisis, it seems that the global political environment has also become more serene. If asked, few people would say they feel that risks are demonstrably lower but, while the news flow may have attention-grabbing headlines, the individual news stories are more mundane. Here in the UK, our politicians are working hard to be as boring as possible. China feels it has to react to Taiwan's President going to the US by conducting exercises off the island, but its response is less provocative than when Nancy Pelosi went to visit last year. France's President Macron ruffles feathers by talking to President Xi about a '*relation amicale*'. Meanwhile, US President Biden visits Northern and Southern Ireland and delivers an inevitable gaffe while talking about the benefits of peace. Additionally, Russia and Ukraine appear to have reached a stalemate in the terrible conflict.

Meanwhile, anecdotal evidence about the state of the economy is not cataclysmic. The western world's central banks are still telling us interest rates will remain high because of inflation, but Tesco cut the price of milk. Compared to last year, the western world's retail prices are 5-7% higher but, in Germany, prices between producers and wholesalers are now only about 2% higher than last year. In Asia, prices are not rising discernibly. Indeed, China's producer prices are 2.5% below last year's level.

Through 2021, the massive liquidity injections to stave off the pandemic had the effect of calming economies and markets. Since the start of 2022, the inflation after-effect waves this entailed, brought the aforementioned scare storms upon the world's economies and therefore also upon its bond and equity markets. But even here, the sheer scale of the movement waves in prices is now less worrisome.

US equity volatilities
S&P 500, 30-day actual and 3-month implied

Source: Tatton IM, Bloomberg: G1107
IBOXHYSE Curncy (MARKIT CDX.NA.HY.40 06/28) US equity vols Daily 27DEC2021-14APR2023 Copyright© 2023 Bloomberg Finance L.P. 14-Apr-2023 14:54:15

The chart above shows in yellow the actual one-month volatility of the S&P 500. The pink line shows the market's expected volatility for the index, which is the volatility used to price options. Both are now at their 12-month lows.

Historically, we are not suggesting that the volatilities shown here are low in comparison to the lows of the 2010s. In 2017, for example, the S&P actual one-month volatility remained below 10% for the whole year and got down to below 4% in that October. However, the process of moving from a higher volatility regime to a lower one tends to be associated with positive returns. Just mechanically, investors become less worried about putting cash to work in the markets. Equally, more sophisticated investors who use option hedging spend less of their returns on expensive options which, in turn, boosts returns.

Of course, as mentioned earlier, April is often not very volatile so predicting things will not be turbulent into the summer may be foolish. We point out in the articles below that the world's regions appear to be on a gentle economic upswing and that China's upswing is more than gentle, which is obviously a good thing. However, US weekly employment data has been weakening noticeably and, by our measure, is close to becoming a signal of recession. Meanwhile, UK employment has also weakened.

Across the western world, small companies continue to be stressed by high short-term lending costs, if they can get loans. Some no longer have access to loans at all. In the US, the profitless tech companies are still finding access to equity cash difficult to come by.

This suggests that until central banks are comfortable headline inflation no longer poses a threat, destabilising bankruptcies remain a strong possibility. Last week, we had mixed messages from US Federal Reserve (Fed) members, European Central Bankers and Bank of England Monetary Policy Committee (MPC) members. The mix has been either warnings about rate rises, or statements about 'wait-and-see'.

We are still yet to hear anyone proposing that cuts should be made. The all too predictable danger is that rate cuts are only discussed after economies have started falling. But to give central bankers their due, they have yet to induce recession despite the talk for the past year. Perhaps they can engineer a soft landing for the economy after all, by way of a return to lower, less damaging interest rates while inducing a less risk-averse attitude from banks and other sources of corporate credit towards borrowers.

In this regard, it is notable that larger banks are doing well, if last week's results from the likes of JP Morgan and Citi are anything to go by. While they tell us they are wary of lending, non-performing loans remain lowish rather than high (they have gone up but are actually not in recessionary territory). Meanwhile, depositors scarred from their recent small bank experience are content to receive less interest than the (large) banks make in the money markets in return. With credit spreads for lending even higher, the banks have capacity and a strong incentive to lend, despite the negative yield curve suggesting otherwise. It may well be that despite the demise of Silicon Valley Bank and others, the larger banks will ease credit standards ahead of the smaller ones, in order to cement market share gains. Thus, smaller companies may get a bit of help in coming months, even if the lopsidedness of the banking sector is bound to result in less competitive credit markets over the longer-term. The next loan officer survey will make interesting reading.

The renewed calm in markets is a positive for the prospects of a soft landing, while the stability and profitability shown by larger banks suggests that the narrow path towards a stable non-recessionary slowing is still being followed. As we have said before, the outlook feels delicately balanced at the moment and we therefore cannot say with conviction that there will not be slips. But we have lower volatility, and progress towards smaller 'waves' in markets and the economy. At the same time, the inflation genie is slowly being squeezed back into the proverbial bottle. This all bodes well – for now.

Mixed risk signals abound

The US dollar has been notably weak this year. This is the reverse of what we saw in 2022, when aggressive rate rises from the US Federal Reserve (Fed) and fears of a global economic slowdown pushed investors towards the world's reserve currency.

When looking at how strong or weak a currency is, one needs to look at its buying power versus not just one, but a number of other currencies. Economists like to pick the currencies of the main trading partners and vary the weights accorded to the currencies by the recent amounts of trade volumes. This is called a trade-weighted index. Investors tend to like something simpler. For the US dollar, most use the DXY index, a fixed blend of the euro, Japanese yen, sterling and three others. Unfortunately, though, in neither case does the index level provide much insight into any changes in the domestic purchasing power of the involved currencies. The information value of the DXY is limited to only telling us about the change in the purchasing power across currencies.

Between the start of 2022 and October, the DXY went from under 96 to just over 113 – one of the four big trend upswings which have occurred in the past 30 years. But since that peak in October, the DXY has come steadily down, touching just above the 100 level at the end of last week.

One widely held view of how to value currencies is that they should be based on relative current economic strength. That model would go some way to explaining why the dollar surged against its global peers last year, with the US economy continuing to expand strongly in spite of inflation and interest rate pressures, while Europe was ravaged by Russia's war on Ukraine and the energy crisis this entailed. On the flip side, looking for clear economic outperformers over the past quarters versus US growth to explain the US dollar weakness since, is a bit more challenging. Only China is clearly stronger, but that came after marked previous weakness and would therefore be interpreted more as a recovery bounce. Undeniably, the European economy is now in a better position than at the tail end of 2022 but is not stronger than the US. The US economy is slowing, but the balance of growth – particularly over the long-term – still looks well balanced. Of course, adding the element of lower risk aversion towards European assets and higher Eurozone interest rates into the mix explains a bit more coherently the recent rise in EUR-USD. The same rate rationale holds for GBP-USD.

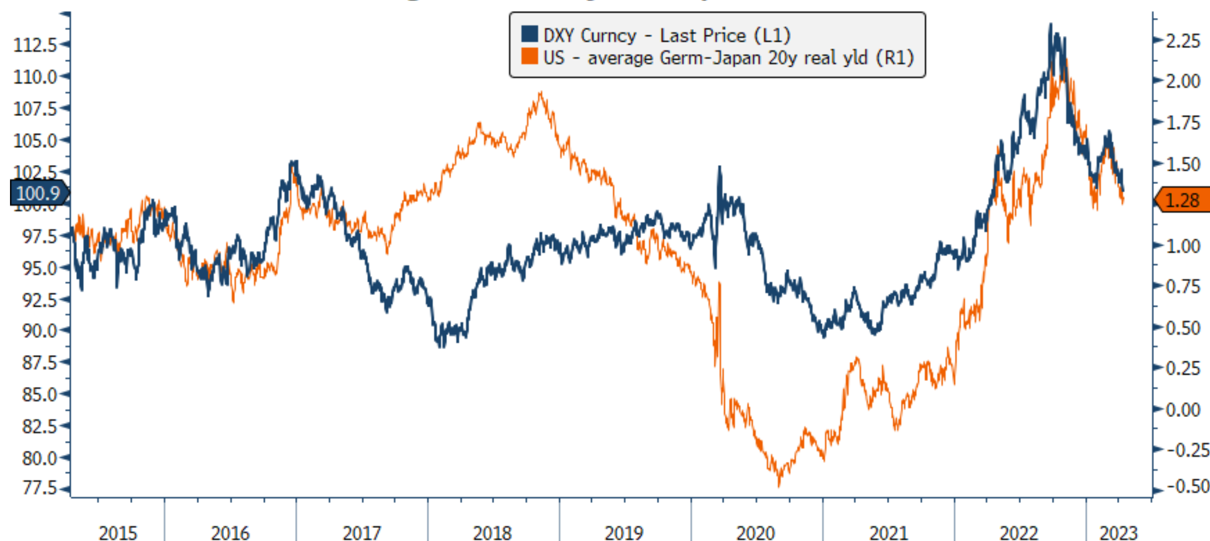
The US, like all the western world, is in an ongoing battle with inflation. Price increases effectively devalue the currency goods are priced in, so one might think this explains the dollar's reversal. But the problem with that explanation is that inflation is lower in the US than elsewhere. Annual inflation dropped to 5% last month, the lowest figure since 2021. In Europe, consumer prices rose nearly 7% over the past year. Meanwhile, after three declining months, the latest UK Consumer Price Index (CPI) inflation reading from February showed an increase to 10.4%. And yet both the euro and sterling have gained considerably against the dollar over the last few weeks, reaching levels last seen in May 2022.

Of course, as the world's reserve currency, dollar moves are affected by much more than economic fundamentals. Dollar assets, like US Treasury bills, are regarded as safe havens by investors. As such, the dollar tends to strengthen when markets fear weak global growth – one of the defining narratives of last year. By the same token, the dollar tends to weaken when markets are hopeful for the global economy, as other riskier assets become more attractive relative to those US safe havens. Economists therefore sometimes interpret dollar weakness as a sign of risk appetite.

At an abstract level, a risk-on move makes some sense in the current environment. We have had a sharp tightening of global monetary conditions, matched by sharp corrections in capital markets and a gradually slowing economy. Now that weakness is clearly coming through, investors are increasingly looking ahead to the next growth cycle. Indeed, Fed officials have even started hinting that interest rates might loosen in the near future.

The problem is that this rationale does not fit with the wider market moves we are seeing. The US stock market has bounced between optimism and fear for the last few months and has shown little recent sign of a sustained upturn, trading basically flat over the last two weeks.

Shifts in real (inflation-adjusted) government bond yields may be another explanation – as alluded to earlier in this article. Some investors see these rates as being indicators of future growth in different currency areas. A simplified view is what somebody is really left with as a rates investor after subtracting inflation.



As the above chart shows, the relationship was not so clear in the Trump years of 2017-2021, when trade policies might have skewed currency flows initially away from (and then towards) the dollar. However, this relationship may have been re-established. Certainly, recent history has shown the dollar and the spread 'co-moving' again, as was the case before the Trump years.

Gold– the historical safe-haven asset – has rallied strongly over the last month. But to make matters more confusing, so too have the recently 'not-so-safe' high-profile cryptocurrencies such as Bitcoin and Ethereum. Cryptocurrencies gained massively during the era of pandemic-induced liquidity, and subsequently had a reckoning when central banks tightened. As such, they are sometimes regarded as an indicator of risk appetite. The FTX debacle, and subsequent collapse of some US banks with ties to companies in the digital asset universe, decimated confidence in many of the smaller cryptocurrencies. Both Bitcoin and Ethereum, however, have had overwhelmingly positive returns over the first few months of this year, the latter up 55% in dollar terms and the former climbing an eye-watering 75%.

What should we make of these mixed signals? Looking at the current state of capital markets and the global economy, we have some doubt that dollar weakness and crypto strength should be interpreted solely as signs of general optimism. In the developed world, the fact that major areas increasing their (expected) real interest rate versus the dollar was certainly a factor, even more so as US real rates appear to have peaked. However, what adds to the usual currency drivers discussed so far is an intriguing and notable increase in non-dollar liquidity – primarily in China.

The Chinese government has wholeheartedly shifted to a pro-growth policy set-up this year, abandoning its zero-Covid policy and loosening commercial lending restrictions. This has buoyed expectations of a

post-pandemic boom in the world's second-largest economy, akin to what we saw in the western world through 2021-2022. We cover China in more detail in a separate article below, but the main dynamic to note for currency valuation purposes is how this has led to a dramatic pick-up in Chinese liquidity.

Due to capital restrictions, currency trading is very difficult for Chinese citizens and businesses, particularly for large amounts. As such, Chinese traders may not be moving US dollar earnings into the renminbi but buying physical or digital assets that can be traded in the US or Europe. Precious metals have historically been a big beneficiary of these trades, but in recent history there has also been a correlation between periods of Chinese liquidity or capital flight and movements in cryptocurrencies.

It is impossible to say for sure if that is happening now and how much it is contributing to US dollar weakness, but it would be one element explaining the upward pressure on Bitcoin and Ethereum. Optimism in Chinese markets also helps explain some of the dollar weakness versus the renminbi this year – as investors are more confident about China's near-term growth prospects than the US.

Of course, as the Trump years showed, the fragility of Chinese relations with the west could lead to market dislocation should things turn sour. We will certainly keep an eye on it. In the meantime, the lower dollar is good news for those countries whose currencies have gained, given their input prices from global trade in dollars have fallen, thereby reducing inflation pressures and improving their relative price competitiveness.

China's rebound accelerates, while Beijing postpones political agenda

At the start of the year, expectations were high for the Chinese economy. After years of stop-start lockdowns, Beijing pivoted away from its zero-Covid policy surprisingly quickly. At the same time, regulators eased up on the property sector and loosened financial conditions. Global investors recognised this as a potent mix for growth, which propelled a rally in China's stock market. We agreed with these strong predictions at the time but noted it could take a while for significant growth to come through – in part, because the populace had been scarred by Covid, weak global conditions and seasonal disruptions.

So far, our predictions have been broadly vindicated. Chinese equities rallied hard through January, but sentiment took a turn over the following months as tangible improvements remained elusive. Global investors started to fear China's post-pandemic boom was overbought, as the usual growth signals failed to materialise. That situation changed as we moved into the spring. Financial conditions have eased markedly over the last couple of months, with big increases in overall money supply and the much-watched total social financing numbers.

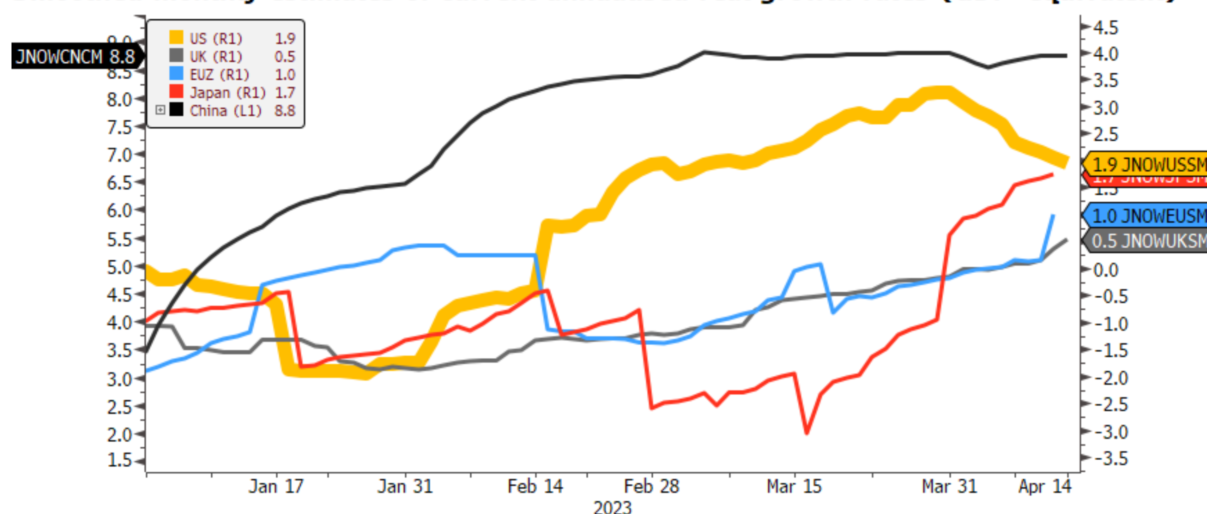
Things are undeniably looking better in the world's second-largest economy. We knew Beijing would provide plenty of fuel for growth in the form of liquidity injections and easier lending conditions, and signs are clear that this is now having a strong impact. The most recent business sentiment indicators, published at the end of March, showed a remarkable pick-up coming in the services sector. The non-manufacturing purchasing managers' index (PMI) came in at 58.2 last month, comfortably above economists' expectations

and the highest recorded figure since early 2011. A PMI above 50 indicates expansion, while anything below that level points to contraction. China's reading is currently the strongest of any major economy.

China's manufacturing sector is a little less buoyant, with March's figure at 51.9, down from 52.6 in February. This is suggestive of an uneven recovery, propelled more by consumer spending than industrial activity. That perhaps explains why the traditional markers of Chinese economic activity – like demand for industrial metals and shipping numbers – have not been as strong as in previous growth spurts.

JP Morgan Real Growth "Nowcasts"

Smoothed monthly estimates of current annualised real growth rates (GDP-equivalent)



Source: Bloomberg, Tatton IM, JP Morgan: G485

JNOWGLSM Index (JPMorgan Global Smoothed Monthly Nowcast (SMN)) JPM Nowcasts Main Daily 30DEC2022-14APR2023 Copyright© 2023 Bloomberg Finance L.P. 14-Apr-2023 11:30:36

That said, Chinese manufacturers are still feeling more confident than their global counterparts, and March's reading was above lacklustre expectations. Moreover, a demand-heavy rebound is exactly what we would expect in the current environment. We saw in the west how strong consumer demand can be when lockdowns ease – leading to both sharp undersupplies and inflation, which only now has started to ease. Manufacturing and industrial production were some of the few areas of the economy that authorities kept running throughout the pandemic. Services are, therefore, starting from a much lower base than manufacturers, which naturally leads to lopsided growth figures.

Global macroeconomic conditions also mean China's rebound will inevitably be more domestically focused. China is in the early stages of a new growth cycle, following years of corporate and individual repression. Western developed countries, by contrast, are in the very late stages of post-pandemic cycles, marked by tight monetary policy, inflation and weakening demand. The demand base for Chinese exports is therefore weaker, which decreases the pool of buyers manufacturers can market to.

Sure enough, trade between China and the west has been quite weak this year. Exports from the wider Asia-Pacific region have been weaker than expected, with a notable demand shortfall for Taiwanese semiconductors (a part of the computer chip inventory cycle we wrote about a couple of weeks ago). In February, the Baltic Dry Index (a measure of freight shipping activity) fell to its lowest level since the start

of the pandemic. It recovered somewhat in March – partly on the back of Chinese services strength – but is still range-bound at low levels, indicating that global trade remains weak.

With little inflationary pressure, a desire for domestic growth and muted external support, the People's Bank of China cut its reserve requirement ratio by another 25 basis points to 10.75% in March. This should encourage banks to lend more and comes on top of vast liquidity support handed out to struggling property developers last year. Officials are clearly not complacent in supporting growth, as evidenced by the Finance Vice Minister's plea for more fiscal support and tax cuts for small companies.

While policy conditions are extremely pro-growth, the Chinese government is fully aware that the recovery is fragile. This recognition is likely one of the reasons behind Beijing's recent détente with western leaders. French President Macron and European Commission President Ursula von der Leyen held a joint summit with President Xi Jinping last week, amid China's increased military activity in the Strait of Taiwan. Despite the harsh rhetoric between Chinese, US and European officials over the past few weeks, Beijing is clearly showing a desire to engage rather than pull out of difficult talks.

One of the most important things to understand about Chinese politics is that issues of national sovereignty – including Taiwan, Hong Kong and Xinjiang – are treated as non-negotiable by the Communist Party and are therefore ringfenced from economic considerations. That means that, while western observers might look at China's activity around Taiwan and conclude that its government is taking a hostile foreign policy attitude in general, the Chinese domestic perception is different. This is borne out now too: despite seemingly hostile relations, China's recent actions in trade disputes suggest the opposite, even with the US ramping up its technology embargo against China.

What this means is that, even if Beijing engages in sabre-rattling around Taiwan, we should still expect conciliatory tones in other areas. This is in large part because the Chinese economy still needs all the support it can get. And while western consumers struggle, the last thing China will want to do is erect further barriers to trade. Growth is set on an expansion path in China, both now and for the near future. President Xi will not want to crush the green shoots of a recovery. We should therefore expect pragmatism going forward.

So, the much-awaited economic recovery is now coming through in China, with more traction on the services side than in manufacturing. This is just the beginning of China's growth phase though, while downside risks linger as well. In comparison, the rest of the world looks less dynamic. One of the major downside risks is that a geopolitical escalation would threaten to undermine China's domestic recovery. As a consequence, China has some interest in keeping a constructive working relationship not just with its Asian neighbours and wider emerging markets, but also with western governments. Geopolitical tensions are therefore likely to linger in the background, but for now may not escalate to allow the economy to flourish and regain its pre-pandemic momentum.

CAMBRIDGE
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17th 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	7892	+2.1	+2.1	→	↗	4.2	10.9	10.7	13.3
UK FTSE 250	19296	+3.1	+3.1	↘	→	3.5	12.7	12.1	14.6
UK FTSE All-Share	4289	+2.3	+2.3	→	↗	4.1	11.0	10.8	13.5
UK FTSE Small	6222	+2.2	+2.2	↘	→	3.8	7.3	6.9	13.0
France CAC 40	7517	+2.6	+3.5	↗	↗	2.8	13.0	12.7	14.1
Germany DAX 40	15815	+1.7	+2.5	↗	↗	3.4	12.0	11.5	12.9
US Dow	33998	+1.7	+1.3	↗	↗	2.1	18.1	17.3	16.3
US S&P 500	4143	+1.5	+1.1	↗	↗	1.7	19.0	18.2	17.5
US NASDAQ comp	12123	+1.5	+1.1	↗	↗	0.9	27.5	25.3	22.7
Japan Nikkei 225	28462	+3.7	+2.1	↗	↗	2.0	16.4	16.2	16.8
World Bloomberg	1528	+1.8	+1.4	→	↗	2.4	12.8	12.7	13.8
China mainland	4092	-0.8	-0.8	↗	↗	2.2	16.9	16.3	16.3
Emerging Bloomberg	1130	+1.2	+0.8	→	↘	2.3	12.4	11.9	12.0

Top 6 Gainers

Company	%
Glencore	+8.9
Antofagasta	+8.7
Barratt Developments	+7.9
Schroders	+7.1
Kingfisher	+6.7
Taylor Wimpey	+6.6

Bottom 6 Decliners

Company	%
Beazley	-1.8
Severn Trent	-1.6
National Grid	-1.6
United Utilities	-1.5
UNITE	-1.2
Hiscox	-1.1

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+3.61	+0.19
UK Govt 15yr Gilt	+3.89	+0.19
US Govt 10yr Treasury	+3.50	+0.21
France Govt 10yr OAT	+2.97	+0.29
Germany Govt 10yr Bund	+2.39	+0.23
Japan Govt 20yr JGB	+1.08	+0.01

Currencies

Pair	last	%1W
USD per GBP	1.247	+0.4
GBP per EUR	0.884	+0.8
USD per EUR	1.102	+1.2
JPY per USD	133.07	+1.1
CNY per USD	6.860	-0.2
USD per Bitcoin	30,682	+10.0

Commodities

Cmdty	last	%1W
Oil Brent $:bl	86.6	+2.1
Gold $:oz	2023.8	+0.5
Silver $:oz	25.9	+4.5
Copper $:lb	417.5	+4.5
Alumnm $:mt	2331.0	-0.1
S&P soft crops	246.1	+4.5

UK Mortgage Rate Estimates

Rates (LTV c.75%)	14-Apr	15-Mar
UK BoE base rate	4.25	4.00
2yr fixed	5.57	4.82
3yr fixed	5.42	4.67
5yr fixed	5.25	4.38
10yr fixed	5.14	4.50
Standard variable	7.22	7.02

14/04/2023
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

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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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