CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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Prospects of a warm spring

Another relatively quiet week meant a generally benign environment for risk assets. In our last Weekly, we discussed how low-volatility markets tend to rise, which prompted some questions from readers, so we'll explain our thoughts later in this article.

Focusing on the UK economy, Friday's data told us that while March was cold, the spring could be getting economically warmer. The morning's UK retail sales data for March marked another reduction in volumes, partly due to the cold weather, according to the Office for National Statistics (ONS). Not including fuel, the volume of retail goods sold in March dropped by 1% from February. Food price rises continue to outpace price rises in other goods (nobody is fooled by milk price cuts when the price of bananas rises more than 10%). However, the Chartered Institute of Procurement & Supply indices showed that services are on an upswing. The Services Purchasing Managers Index (PMI) survey rose surprisingly from 52.2 to 53.9. Services new orders are at 55.3 and the services employment index jumped two points to 52.0 to signal a stronger hiring upswing and higher pay settlements.

Manufacturing went in the other direction, with a disappointing fall again to 46.6, although expectations were more buoyant.

The press release said respondents for both manufacturing and services saw continued strong wage growth in April (key for pay settlements), and pay was blamed for rising output prices. In particular, prices rose in labour-intensive services, where output prices rose 1.7 points.

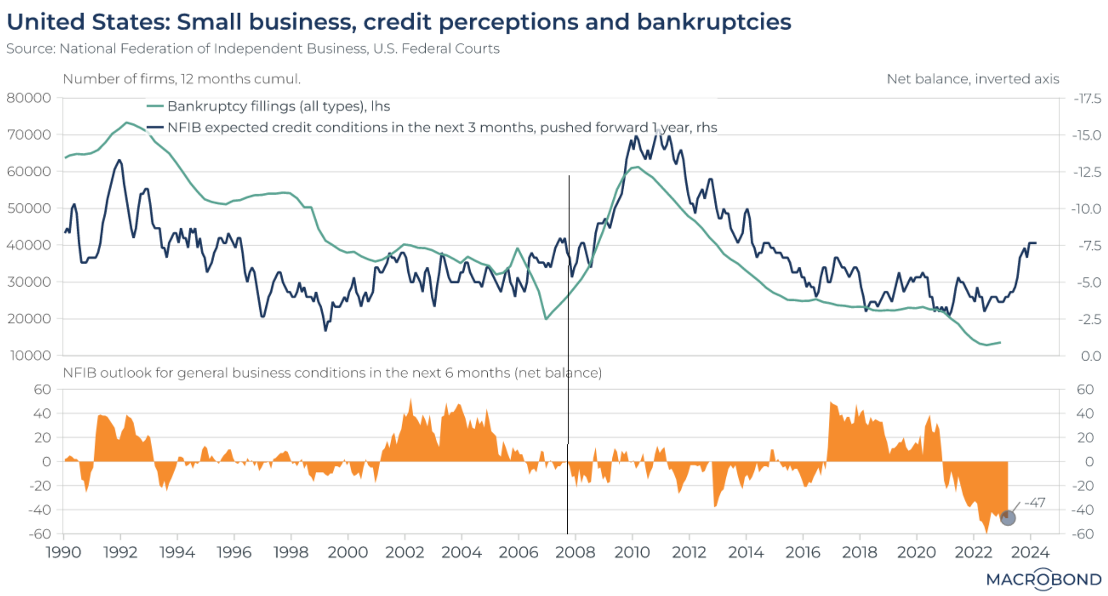
Pay settlements are probably a big reason for a substantial improvement in consumer confidence. The GfK Consumer Confidence Index rose sharply although -30 doesn't sound very confident. Historically, a better indicator is the rate of change of confidence, and this has sharply improved, from a 40-year low to a 40-year high according to our calculations.

Allan Monks of J.P. Morgan Research revised up his forecast for gross domestic product (GDP) growth this month to +0.3% (+1.3% annualised). Unfortunately, J.P. Morgan sees higher growth as adding further to inflation pressures. The labour shortage kicks in straight away, so even a fairly tepid level of growth of 1.3% annualised is enough to keep inflation above the 2% target.

The Bank of England (BoE) had expected second quarter growth would contract -0.35% (or 1.5% annualised), so last week's run of data will be significant, and probably ensures another rate hike on 11 May. Markets are already factoring in another 0.5% rise, something which both consumers and big businesses appear able to withstand, but which will squeeze smaller companies even further. Small cap indices remain under relative pressure.

Globally, manufacturing has had a hard time and the wider PMIs bore this out on Friday with one exception. At 45.5, the Eurozone index was weaker even than the UK measure. However, the US surprised by bobbing above the 50-neutral level to 50.2.

As we mentioned at the start, global risk assets have been grinding higher as perceptions of external risk ebb away. According to the quarterly earnings releases, bank non-performing loans are higher but not at recessionary levels. The stress on manufacturing companies and smaller companies continues, but we're not getting significant levels of failure. Indeed, in the US, bankruptcy filings are running at 30-year lows. It may be this is a precursor to a sharp step-up in filings as the below chart from Macrobond perhaps indicates. US management sentiment towards access to financing is pretty dire and at a level last seen ahead of the Great Financial Crisis (GFC). However, it should be noted that the change in sentiment is more akin to the early 2000s and that didn't result in significant failures generally. Of course, ultimately, neither time proved great for markets.



However, the chart also doesn't help in telling us when the stress might become too great. In the lead up to the GFC markets, the S&P 500 reached a peak in October 2007, at the point where we've added a line on the chart. Markets can grind higher even when stresses appear obvious.

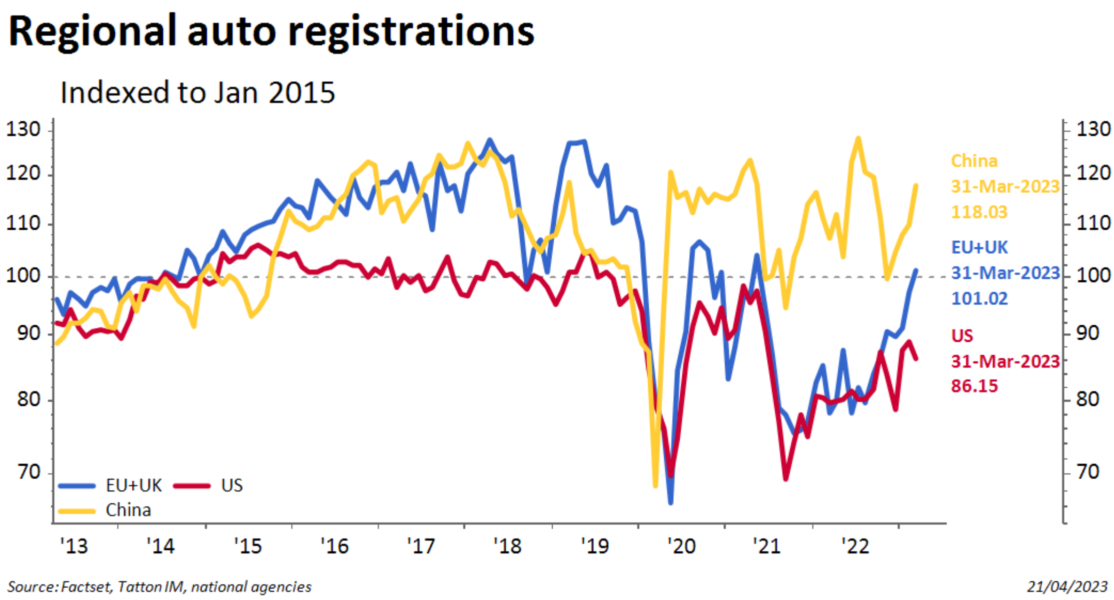
Market volatility continued to decline last week and, as we mentioned, this helps prices to grind higher. One reason is that the general 'carry', the current yield from bond coupons or equity dividends relative to the market price, is higher than in the past few years. In low volatility periods, carry can outweigh price movements, which means traders don't get paid to be short.

For us, until the battle to get inflation under control is won, central banks will keep applying pressure. They'll raise rates until the stress creates failures. The carry on riskier assets may look attractive relative to the low-price movements, but the stress isn't going away. Thus, this isn't a Goldilocks environment of low rates, low profitability but low stress. Valuations may get more expensive, but the risks are too high to justify being overweight.

Meanwhile, elsewhere, geopolitics remains ugly, but the Russia/Ukraine conflict is not deteriorating much. The US debt ceiling is looming but not imminent, and so all eyes are now trained on whether there are signs that the Q1 earnings decline marks the bottom of this decline cycle. There are signs that it might and others that it might not – more of that in the article below.

We also look at some aspects of US money market funds. The aftermath of the banking crisis is still with us. The US average bank deposit rate is at 0.7% while the average yield on money market funds is about 4.6%. Next week, we'll look at the UK versions of the money market funds.

Finally, returning to profit margins, it is notable that some firms have pricing-power and others do not. Where there are few players, such as UK supermarkets, margins can be maintained. There may be a couple of competitors like Lidl but, in general, consumers and suppliers have little effective choice. However, car manufacturers are abundant – at least 38 significant firms according to the Bloomberg Global Autos dashboard. Tesla has announced another slashing of prices, weaponizing its industry-leading margins. It may well lead to price cuts in new car prices and also the start of a consolidation phase in the industry.



Supply chain issues have declined, and deliveries have risen sharply. It may also be that demand is rebounding if consumer confidence is growing. The registration data shows positivity in China and Europe, less so in the US, where financing costs remain much higher. The sector is crucial to global growth, so the next few months will be especially interesting.

Open season on corporate earnings

Spring brings new beginnings, and corporate earnings reports. Companies have only just started reporting on their performance for the first three months of the year, but it looks like many of them could do with some new beginnings themselves. Just 17% of S&P 500 companies have posted quarterly results so far, and while results are mixed, they are generally better than consensus. For 86 companies, earnings are down

1% on the year, generating a surprise of 5%. Analyst expectations as of the end of March were even lower, predicting a 6.7% decline.

As ever, corporate earnings 'surprises' need to be taken with a pinch of salt. Companies – particularly in the US – tend to manage expectations by lowering their earnings guidance as their reporting date approaches. This is so actual results can beat estimates and deliver a nice boost to share prices. Over the last five years, S&P companies have beat quarterly earnings expectations by 8.4% on average. If that trend continued, we would expect a slightly positive year-on-year expansion in earnings – which is not what we are seeing so far. In fact, surprises are quite heterogeneous across sectors. Consumers discretionary got quite a boost from Casinos & Gaming, while homebuilders were able to deliver more than expected, too. Otherwise, Specialist Chemicals in materials were able to surprise substantially.

Range Current Season | CQ1 Ending: 2/16/2023 - 5/15/2023 | Periodicity Quarter

S&P 500 INDEX

Surprise | Growth

Sector (GICS)	Reported	Sales Surprise	Earnings Surprise
11) All Securities	86 / 500	1.89%	5.26%
12) > Energy	3 / 23	-3.74%	4.25%
13) > Materials	3 / 29	-1.55%	11.47%
14) > Industrials	13 / 73	-0.52%	7.70%
15) > Consumer Discretionary	10 / 53	4.09%	20.00%
16) > Consumer Staples	8 / 37	3.10%	5.67%
17) > Health Care	6 / 65	2.87%	5.75%
18) > Financials	30 / 73	2.52%	6.78%
19) > Information Technology	8 / 66	0.14%	-13.34%
20) > Communication Services	3 / 21	-0.24%	0.71%
21) > Utilities	0 / 30		
22) > Real Estate	2 / 30	0.44%	0.52%

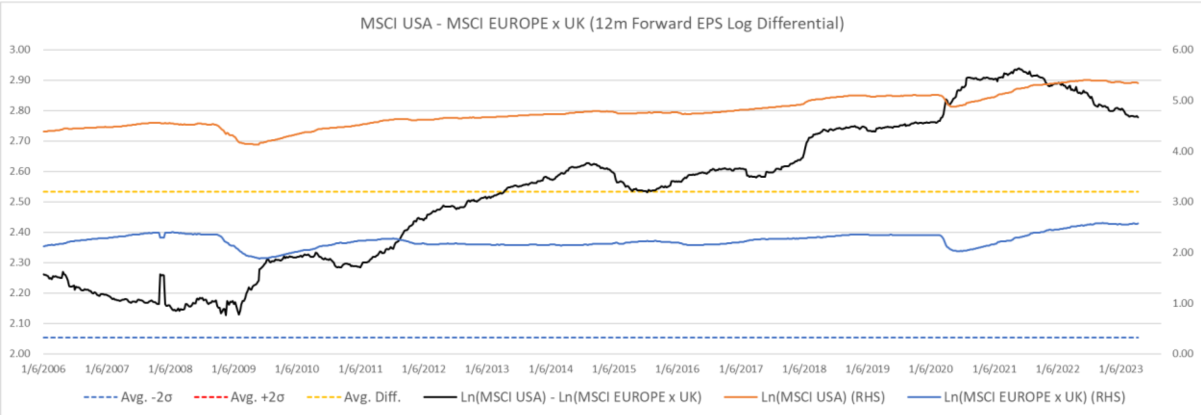
Source: Bloomberg, TattonIM

That said, recent earnings seasons have featured fewer nice surprises, and actual US earnings growth failed to beat expectations in the last two quarters of 2022. The only other time this happened in the last decade was Q1 2020, when the world went into lockdown. Struggles are to be expected, given the weight of economic pressures over the last 12 months. To cope with rapid inflation, US interest rates went from 0.25% in March 2022 to 5.0% last month. Sharply tighter financial conditions have (among other things) contributed to slowing consumer demand. These conditions are extremely tough for any company, and an earnings recession has long been predicted.

Interestingly, US stocks rallied quite considerably leading up to this earnings season, while earnings-per-share (EPS) estimates were muted. This happens during difficult periods, and especially the mature phase of a cycle, as investors oscillate between past weak news and hope that the future will be brighter (and hence due for a turn-around). But it makes it more difficult for equities to gain in the short-term, as valuations get pushed up. Sure enough, even though US equities have beaten drab expectations so far, the S&P traded mostly sideways over last week.

Downward revisions in the US stand in contrast to Europe, however. Very few European companies have reported quarterly earnings yet, but estimates have climbed in the first few months of the year, coming down only slightly through March. European EPS estimates for 2023 are currently flat, with sales holding up but profit margins coming under pressure. According to Goldman Sachs, this leaves European equities in a precarious position. Investors were negative about European corporate earnings in the latter half of last year, but those fears were not quite realised through a better-than-expected winter. Now that some positivity is priced in, Goldmans thinks disappointment could be ahead.

For share prices, historical earnings are much less important than the forward guidance companies announce. Forward EPS estimates (on a 12-month basis) are stagnating in both the US and Europe, a sign that no significant earnings recession is expected. But as the chart below shows, expectations are advancing at different rates, more slowly across the Atlantic than in Europe.



This momentum shift makes sense in light of the relative economic outlooks. Europe was hamstrung last year by Russia's invasion of Ukraine and the subsequent shortage of gas supplies. But even though supply-side problems sent inflation spiralling, the European Central Bank (ECB) held off raising interest rates until the second half of the year. The US, despite having no acute energy shortage, rapidly tightened rates to cool a seriously overheating labour market.

Despite all the talk of recession, the US economy was strong through much of last year and, according to analyst expectations, the genuine soft patch is yet to come with Q3 of this year being a low point. The situation is different in Europe, which has started to improve after a difficult period. That said, in equity terms, the bulk of European earnings and price outperformance came over the second half of 2022, as investors were expecting improvements from a poor position with much risk aversion being priced in.

By now, both regions have seen aggressive central bank action, Europe more recently. The effects are likely far from done though, as monetary policy has a lagged effect on the economy. This is a vitally important piece of context for positive earnings surprises and improving forward guidance: even if things were better than expected in the first quarter of this year, central bank action could trigger downturns further down the line.

Meanwhile, there is no comparable tightening agenda in Asia, where Japan continues to hold rates at zero and China has effectively loosened its monetary policy. This is helping to improve the relative earnings outlooks of Asia's two powerhouses, compared to the US. That should mean a more favourable path for earnings – particularly in China, where a post-pandemic bounce is already priced in – which should benefit equities. However, earnings increases in China are still muted compared to the US, as we wait for that promised boom.

If policy continues to diverge between the world's two largest economies though, earnings and equity performance will eventually follow suit. What happens now depends not just on the timing and size of China's recovery, but on the future path of US monetary policy, which is expected to ease in the not-to-distant future. Weak corporate results will actually help make that happen, but we will have to wait and see.

Are money market funds becoming a threat to banks?

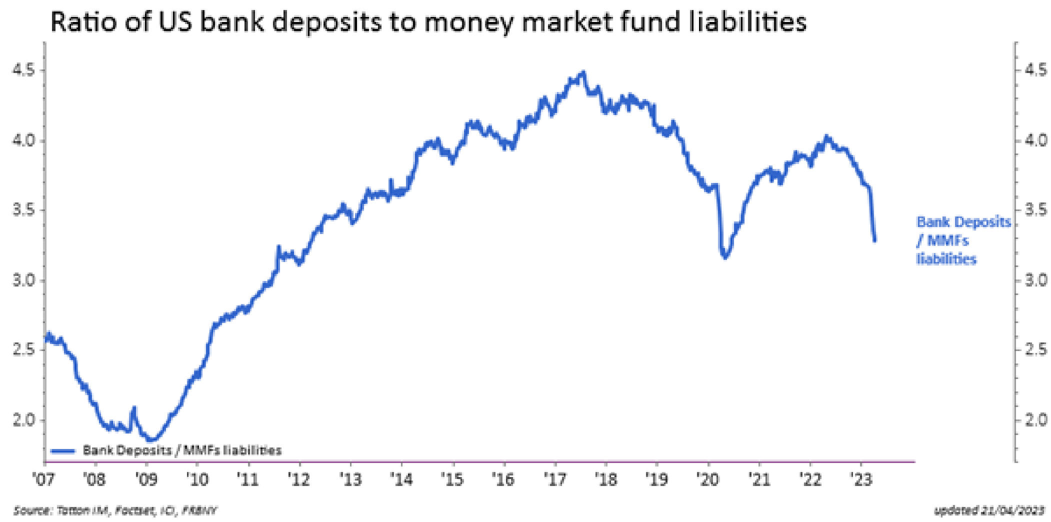
Where is the best place to keep your cash? If you want regular access – and to be sure it's worth at least the same as yesterday's value – you won't hold it as a long-term investment. Most people choose a bank account, where returns are generally lower than we would expect for investing in riskier assets, but that is just the price to pay for security and ease of access.

But, as the high-profile collapse of several US banks showed last month, that security may not actually be 'guaranteed'. In the aftermath of the failures of Silicon Valley Bank (SVB) and Signature Bank, American deposits have leaked out of commercial banks. Smaller regional banks have seen substantial outflows, but not all the cash has gone to larger banks. In this day and age, most people won't be keeping that money under their mattresses, so where did it go?

For many Americans, the answer has been money market funds (MMFs). According to data provider EPFR, over $440 billion has flooded into US MMFs since the start of March. This builds on strong inflows stretching back more than a year, thanks to the US Federal Reserve (Fed)'s aggressive monetary tightening and the higher interest rates it brought. According to the US Office of Financial Research, as of 31 March, MMFs had $5.7 trillion in assets. Data from the Investment Company Institute (ICI) puts it slightly lower, at $5.2 trillion. Meanwhile, the Fed reports all bank deposits at $17.25 trillion.

Given how much capital MMFs have drained from the banking system – so much that regional banks will have to seriously rein in lending – it is crucial that we understand their systemic importance.

US Money Market Funds and Bank Deposits



MMFs invest in highly liquid securities and contracts, and every holding must mature in less than 13 months. In aggregate, the average term of all the maturities must be less than 60 days. Currently, the most widely available US funds have maturity averages of 20 days or less.

The holdings are very restricted: US Treasury bills maturing in a year or less; repurchase agreements (short-term lending contracts backed by government bonds); certificates of bank deposits and bankers' acceptances; and very-high-grade short-term corporate lending known as commercial paper. They are investments, managed by the fund manager and regulated by the Securities and Exchange Commission, similar to the UK's Financial Conduct Authority. They do not have the Federal Deposit Insurance guarantee of principal, but their liquidity means investors can dip in and out like one would with a debit account, making them a viable alternative for people exiting the traditional banks.

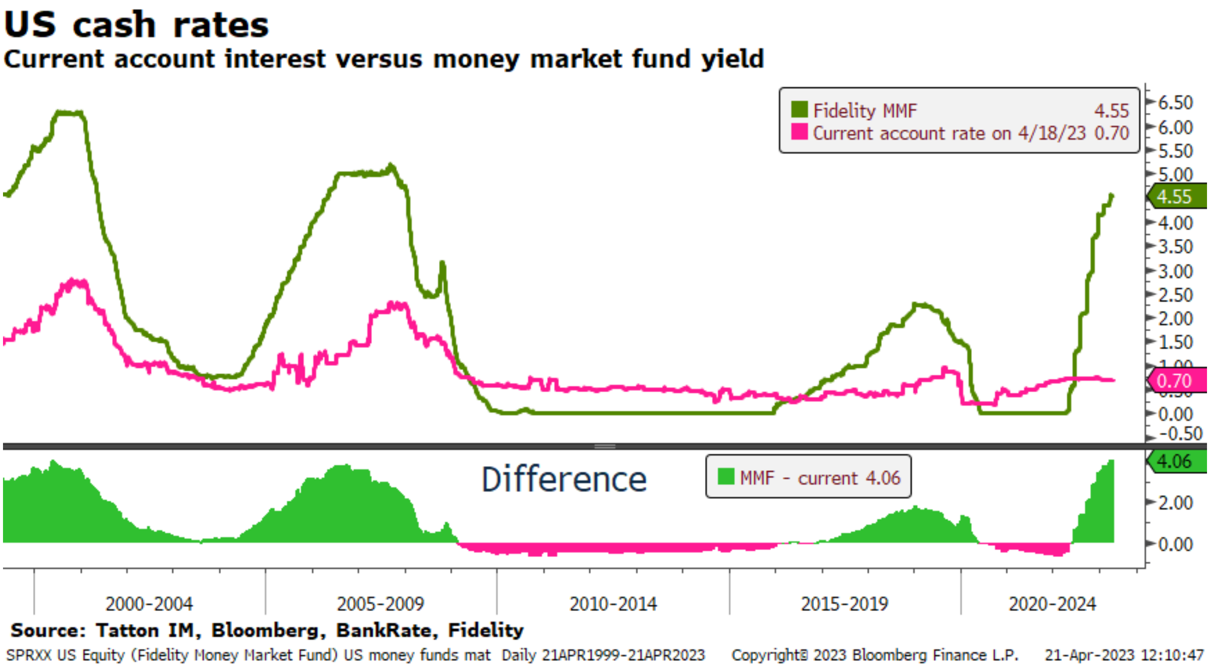
For some investors, the inherent diversification of the underlying fund portfolios is seen as a better risk than a deposit with a single bank. But the most important aspect is that MMFs offer higher interest rates than savings accounts. The larger banks have not had to work hard to get deposits and so, currently, MMFs can give customers an enticing premium while easily convincing the financially literate/wealthy that the risks are actually less. And the difference between bank deposit rates and those in MMFs has widened over the past year, partly because of the Fed's aggressive monetary tightening.

Last month, the Fed raised rates to 5.0%, but the latest data from Bankrate shows the average interest rate on US checking (current) accounts is just 0.7% and still less than 1.2% on its savings accounts. The Fed may raise its benchmark interest rate, but there is no direct mechanism that makes the deposit rate rise in lockstep. Indeed, in order to make a profit on deposits, commercial banks lend to smaller companies. For much of the time during a monetary tightening phase, banks prefer to curtail – rather than increase – exposure to their borrowers, so more deposits don't help.

In contrast, MMF yields are much more sensitive to rises in interest rates. The short-term US Treasuries and repo agreements they invest in are based on markets' current interest rate expectations and – because they are short-term – are continually reinvested at the latest rates. As investment vehicles, MMFs are built to pass these returns directly along to customers (minus their fees) and do not wish to have the discretion that banks have in setting deposit rates.

Depositors were already migrating to MMFs for these reasons, but this year's banking turmoil turned it into an exodus. March saw the biggest MMF inflows since the start of the pandemic, to the great benefit of the investment firms offering them. According to the *Financial Times*, inflows saw Goldman Sachs' MMF increase by 13% between 9 March (the day before SVB was taken over by US authorities) and 26 March. By contrast, small and mid-size banks have lost huge amounts in deposits and must now find other ways to make up gaps in funding (banks may not want new deposits for new loans but they need to maintain their deposit base in order to maintain existing loans).

We should note that banks offered much better rates relative to MMFs when the Fed kept short-term rates just above 0%, which resulted in significant flows to banks during this period. Below shows the history of rates offered by Fidelity's leading MMF and the average bank deposit rate (monitored and calculated by Bankrate):



The current higher returns offered by MMFs, together with chaos in the banking system, is almost a 'no-brainer', but there are some risks involved in their investments. Although the net asset value (NAV) of a US MMF is almost always quoted at $1, there have been occasional instances of 'breaking the buck', when the NAV is quoted below $1. In 1994, the Community Bankers U.S. Government Money Market Fund was liquidated at $0.96 per share, after it mismanaged derivative trading. In 2008, after the collapse of Lehman Brothers, the popular Reserve Primary Fund also broke the buck when much of the bank-related paper came under huge pressure. These instances led to new regulation restricting MMF's eligible investments and to generally more conservative investment practices from their managers.

At the start of the pandemic, the rapid drop in interest rate expectations led to prospective returns on MMFs dropping to zero or even negative which, along with wider market fears, causing rapid redemptions that threatened financial stability. To prevent instability, the Fed had to intervene with emergency lending, deliberately increasing the returns available to MMFs by increasing reverse repo rates.

Even now, there are concerns that the US debt ceiling showdown in Washington could lead to money market problems. The debt ceiling is a yearly political showdown which perennially threatens a default in the world's largest economy. Though no one really expects the US Treasury to default on its debt, brinkmanship could well cause a liquidity crunch – as it often does – which could make it harder for MMFs to buy or sell their assets, potentially leading to losses. Banks would point out that, even if none of these concerns are likely to materialise, these are threats that MMF investors would not be protected against – unlike traditional bank accounts. The Federal Deposit Insurance Corporation officially insures US depositors up to $250,000, though in reality the figure is probably higher, given how quickly the agency moved to protect depositors of the uninsured SVB.

That argument is a little misleading, though. In the event of a genuine run on MMFs, the Fed would almost certainly intervene to safeguard investor capital, in the same way that the authorities went beyond their official remit to protect SVB customers. The Fed showed as much during the pandemic, when they increased reverse repo rates to effectively guarantee a minimum level of returns for MMFs. The reason for this is simply that MMFs have become so systemically important that the US financial system would likely seize up without them. The result is that Fed protection gives MMFs some of the safest short-terms available.

There is an interesting conundrum for the economy and for the Fed, resulting from the recent growth in importance of MMFs. There is plenty of money sloshing around in MMFs, but no money is being created by the Fed (aside from the emergency provision for SVB). More importantly, the reduction of bank deposits also reduces the banks' role in money creation. Small and medium-sized banks were a big beneficiary of the flow of deposits in the past ten years, and in the first stages of the pandemic. However, since the beginning of the monetary tightening phase, they have been under pressure.

They have severely tightened lending restrictions, and this creates a serious risk of credit tightening in the near-term. But when things start to turn, banks play an important part in allowing money creation to feed a bounce in the economy. Currently, the Fed hopes to slow economic activity. But authorities will have to be wary of hitting growth too hard and they will need to keep a close eye on where people are storing their money. And when they want to see an acceleration, they will still need a vibrant bank lending system.

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24th April 2023

Global Equity Markets				Technical	Valuations			
Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Short Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7913	+1.0	+1.0	→ ↗	4.1	10.9	10.7	13.3
UK FTSE 250	19210	+0.8	+0.8	↘ ↗	3.5	12.7	12.1	14.6
UK FTSE All-Share	4296	+1.0	+1.0	→ ↗	4.1	11.0	10.8	13.5
UK FTSE Small	6197	+0.5	+0.5	↘ ↗	3.9	7.3	6.8	13.1
France CAC 40	7545	+1.0	+1.3	↗ ↗	2.8	13.0	12.7	14.1
Germany DAX 40	15799	+0.6	+0.9	↗ ↗	3.4	12.0	11.6	12.9
US Dow	33801	+0.3	+1.3	→ ↗	2.1	18.0	17.1	16.3
US S&P 500	4131	+0.6	+1.6	→ ↗	1.7	18.9	18.1	17.5
US NASDAQ comp	12043	+0.3	+1.2	↗ ↗	0.9	27.5	25.1	22.7
Japan Nikkei 225	28566	+1.5	+1.5	↗ →	2.0	16.4	16.2	16.8
World Bloomberg	1522	+0.2	+1.1	↗ →	2.4	12.9	12.8	13.8
China mainland	4033	-1.5	-0.9	→ ↗	2.2	16.9	16.3	16.3
Emerging Bloomberg	1110	-1.4	-0.5	→ ↗	2.3	12.3	11.8	12.0

Top 6 Gainers

Company	%
Melrose Industries	+139.7
Entain	+7.9
Imperial Brands	+7.1
RS GROUP	+6.3
Smith & Nephew	+5.9
Flutter Entertainment	+5.0

Bottom 6 Decliners

Company	%
Rio Tinto	-6.9
Fresnillo	-5.3
Antofagasta	-5.0
Anglo American	-4.1
JD Sports Fashion	-3.2
GSK	-2.9

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+3.73	+0.18
UK Govt 15yr Gilt	+4.00	+0.16
US Govt 10yr Treasury	+3.50	+0.12
France Govt 10yr OAT	+3.01	+0.08
Germany Govt 10yr Bund	+2.45	+0.09
Japan Govt 20yr JGB	+1.13	+0.05

Currencies

Pair	last	%1W
USD per GBP	1.241	-0.9
GBP per EUR	0.885	+0.3
USD per EUR	0.000	-100.0
JPY per USD	133.64	+1.0
CNY per USD	6.888	+0.2
USD per Bitcoin	28,205	-6.9

Commodities

Cmdty	last	%1W
Oil Brent $:bl	81.9	-5.8
Gold $:oz	1992.7	-2.3
Silver $:oz	25.3	-1.9
Copper $:lb	399.7	-3.1
Alumnm $:mt	2407.5	+3.3
S&P soft crops	249.1	+1.6

UK Mortgage Rate Estimates

Rates (LTV c.75%)	21-Apr	22-Mar
UK BoE base rate	4.25	4.00
2yr fixed	5.72	4.82
3yr fixed	5.55	4.67
5yr fixed	5.38	4.38
10yr fixed	5.28	4.50
Standard variable	7.22	7.02

21/04/2023
Prices taken at 2:30pm today and 2:30pm last Friday (where possible)
Bloomberg 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

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24th 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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