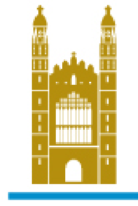

CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

2 MAY 2023

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Lead Investment Adviser to Cambridge

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Inflation running out of money

Over the past few weeks, we have observed how markets have been hanging in a fine balance, as evidenced by the rather directionless and decreasingly volatile bond, equity and currency markets. We are not the only ones who see it that way.

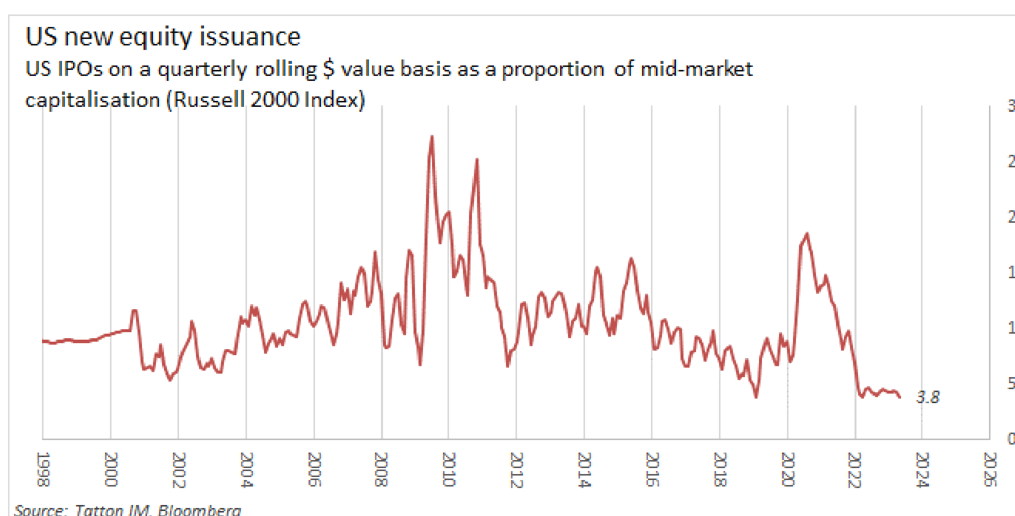
In particular, credit markets have been very stable or – as one could also interpret them – indecisive. There appears to be lots of investor demand for higher-yielding corporate bond securities without much new supply through issuance matching it. This demand overhang has cheapened credit spreads, or in lay terms, the premium that corporates pay over governments.

However, for corporates, the interest cost is not just about the credit spread. Compared to 18 months ago, the absolute yield cost of debt capital, even for governments, has very rapidly risen to levels not seen for a long time. Against this, inverted government bond yield curves of lower yields for longer maturity bonds may be signalling that markets expect central banks to cut interest rates in the not-so-distant future. With the current total cost of capital at any maturity still higher than the return on capital that many companies appear to expect over the longer-term, there is understandably little appetite among corporates to rollover existing debt, let alone create new finance. Instead, they appear to be collectively trying to sit out this yield high, hoping for better financing terms later in the year. We suspect many mortgage holders in the UK with their mortgage terms nearing expiry are having similar thoughts.

Back in the corporate world, for all those that need to raise equity finance, life is even more challenging.

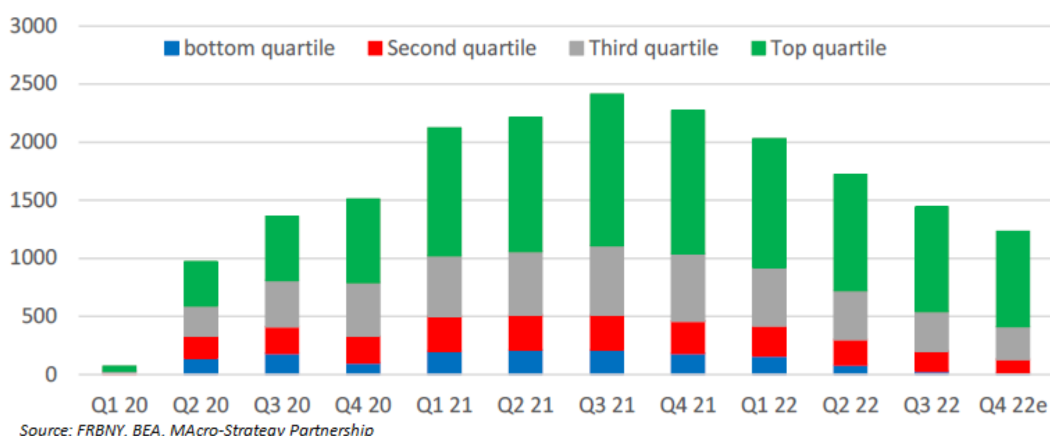
For new equity issuance or Initial Public Offerings (IPOs), the US is now the world's main venue. It used to be the UK, but that has changed in the past 20 years.

So, it is remarkable to see how quiet the demand to issue new equity capital has been. Below is a chart showing US IPOs as a proportion of the existing market capitalisation of the mid-cap Russell 2000 Index. We use Bloomberg's monthly tallies, on a rolling three-month average basis. The issuance level has been



at very low levels since the start of the US Federal Reserve (Fed's) monetary tightening and now is at 3.8% of the Russell 2000 overall market capitalisation. This is the lowest in the past 25 years, including the aftermath of the bursting of the dotcom era.

The pandemic period created a huge flood of liquidity which went out to individuals and companies. However, especially in the US, individuals were handed the money by the government, while companies had to borrow it. Some individuals went on to spend the windfall, others were savers. Perhaps inevitably, those who earned more before had less reason to spend the windfall. The chart below was initially developed by Fed analysts and has lately been updated by the Macrostrategy Partnership. It shows how the lower income quartile had probably spent most of the windfall savings by the end of last year. On the observable trend, the second quartile are probably almost done by now. The upper half probably still have their windfall.



Knowing this (and the US is here merely serving as the representative of all western economies), central banks have set interest rates deliberately high to stem any additional new supply of money while the windfall money flooded back into the real economy in the form of consumer spending.

For us, it is reasonably clear that the remaining windfall cash is not going to be spent – it will remain as savings. It is 'excess' savings which have to buy up the available assets. We should be clear that this skews the usual messages about risks. Investors are not buying because the investment risks are lower than usual – no, they have too much liquidity and fear the impact of inflation on their surplus savings. Indeed, the behaviour of companies we described at the start tells us – and all informed investors – that, at current economic activity levels, they don't think they can pay the going rate on capital. Their expected profit growth is low.

If activity is low and there's little left in windfall money to spend, why is inflation still high? Should central banks still worry that an inflation spiral has set in?

Last week's earnings reports, here in the UK, Europe and in the US, provide more evidence of companies trying to offset weak (often negative) volume growth by raising prices. Unilever and Procter & Gamble

were notable in this respect. Such behaviour has been termed 'greedflation' and given historical precedent, there may be some truth to this. However, as investors, we should recognise that we want companies to protect shareholder returns.

As indicated, such episodes are actually very typical as any economy slows down. Companies don't like to use whatever pricing power they have, but they will if they have to. Inflation almost always goes up at the start of economic slowdowns. The problem for companies is that their microeconomically rational behaviour has, in aggregate, disadvantageous macroeconomic consequences – 'the fallacy of composition' – given such individual defensive action slows the economy further since the buyers do not have any more money to spend.

We should hope that central banks recognise this as the last throes of a cycle, rather than worrying that the latest service sector-driven inflation data is indicative of a spiral. The windfalls are spent, activity is slowing, supply shortages are no longer an issue, and even the labour market has started to ease, while companies do not think they can return more than the rate of interest.

Short-term interest rates and long-term bond yields are clearly not in line with the private sector's ability to generate returns at current moderate activity levels. If economic activity levels fall further, that gap will grow, and companies will get more stressed. As we head into the next round of rate decisions, it will be important for companies – and the risk assets that represent them – that central banks tell us they recognise they have done enough and the growing need to turn. The Federal Reserve Open Markets Committee meets tomorrow, the European Central Bank on Thursday, and the Bank of England meets on Thursday 11 May.

We saw a sharp pick up in bond financing activity at the start of the year when yields dropped down, and it may be that yields are actually not so far away from a more comfortable cost of capital level for companies. Moreover, investors are not fretting greatly amid reasonable Q1 earnings reports. At least the larger companies are still generating growing, if not stellar, profits.

Market volatility picked up a bit last week but without market levels having changed a whole lot by the end of the week. Perhaps that's no surprise given the importance of the next two week's monetary policy decisions. The expectations are that we will get small rate rises but accompanied by the 'cooing of doves' – soothing sounds telling us that they expect inflation to cool and rates to be moved to less tight levels as inflation allows.

Therefore, contrary to the old stock market adage of 'sell in May and go away' it seems to us that 'let May's sway guide your way' may prove far better guidance for investors this year. We will certainly be monitoring central bank messaging, and the market perception of it, very closely.

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2nd May 2023

Cash and money market funds: part 2 – the UK

Any financial institution has to keep a certain amount of its assets in cash to allow for ongoing redemptions. Of course, the amount varies depending on the purpose of the institution: retail banks holding daily accessed deposits need lots of readily accessible cash, while long-term investors like Cambridge have lesser requirements. But we all need accessible liquidity, meaning there is a high demand for cash-like instruments and highly liquid assets.

What do we really mean by 'cash', though? Clearly, the finance sector does not keep stacks of coins under desks, ready to hand out to customers. In many cases, large institutions do not keep their cash in traditional bank deposits either, since these offer vanishingly few benefits. Moreover, traditional banks are not always guarantees of safety and stability, as the recent collapse of several regional US banks demonstrated. For these reason, retail and institutional investors are increasingly turning towards money market funds (MMFs) for their transactional cash requirements. These mutual funds invest in only the most liquid and low-volatility assets, like short-dated government bonds, repurchase agreements (short-term lending contracts secured by bonds) and, in some cases, high-grade short-term corporate credit.

We wrote about US MMFs last week, noting how popular and systemically important they have become and what this might mean for capital markets going forward. MMFs are particularly prominent in the US, due to its specific financial and regulatory structure, and have been for many years.

Today, money markets are a global phenomenon. As of late 2020, MMFs held over $5.3 trillion worldwide, $3.9 trillion of which came from institutional investors. More recent data is hard to come by, but we can only assume the current figure is much higher, given recent flows into MMFs.

The main selling point for any MMF is its ability to offer cash-like liquidity with better returns than a regular bank deposit. But given the focus on extremely safe assets, the actual differences in return – both between MMFs and deposits and between MMFs themselves – are naturally quite low. (Though, as noted last week, when base interest rates change as rapidly as they have, banks' slowness to adjust can create some pretty wide spreads). Even so, not all MMFs are the same, varying on expected duration, risk level, returns or accounting structure.

One reason for this variation is the different cash requirements of investors. In the past decade, bank current accounts have become accessible on a minute-by-minute basis (with some banks it's even possible to earn interest hourly). MMFs do not have the near-instantaneous withdrawal capabilities of a current account (or 'checking' account, for US citizens). For funds, settlement times for redemptions vary depending on whether the cash is earmarked for operational, reserve or strategic purposes. Traditional MMFs, investing in extremely short-dated government bonds, are the most suitable for giving daily liquidity, while longer time horizons allow for slightly fewer liquid assets – like high-grade corporate credit – and hence for slightly better returns.

The median settlement timeframe for Sterling-denominated MMFs is two days, although newer funds are either one day or same day. Still, most funds must always be ordered by a fixed point in the day (most usually around midday) and will always pay out at a fixed point in the day (usually around 4pm).

MMFs have specific accounting structures to ensure a stable net asset value (NAV), so that investors can be confident their share redemptions are at the quoted price. The Global Financial Crisis (GFC) of 2008, and the volatility it brought, led regulators to introduce new accounting methods for different kinds of MMFs. Constant NAV MMFs use amortised cost accounting for all fund assets, while variable or floating NAV MMFs use mark-to-market pricing for all their assets. The distinction impacts the volatility MMFs might experience or report, and there are also funds that mix these methods (with different accounting for assets under or over 75-day maturity).

In the US, retail or government MMFs can use a constant NAV method, but institutional MMFs can only use a floating NAV structure. There are similar regulations in Europe, but the key distinction is about short-term or standard MMFs, rather than retail versus institutional investors. For this reason, constant NAV MMFs are much more common in the US than in Europe. UK money markets still operate according to European Union regulations, so this also applies to Britain.

Even with technical differences in accounting, actual volatility is naturally extremely low. As an investment, MMFs are not insured risk-free like bank deposits. In extreme circumstances, that could mean receiving less than the full amount invested back (or returned slower than expected), but this is very unlikely even with floating NAV MMFs that invest in riskier assets like corporate debt. MMFs buy assets with maturities longer than a day, so may face liquidity problems on any given day, but this is offset by spreading purchases across different maturities.

Where they are vulnerable – like any financial institution – is in bank runs. If an MMF has significantly more money being withdrawn than the amount of assets that will mature over the agreed redemption time, it might have to sell at a loss. There was a big danger of this happening in the US at the start of the pandemic, as widespread market panic led to an incredible downturn and drying up of liquidity. The US Federal Reserve (Fed) intervened to stave off disaster, and regulators since then have been looking to stress-test MMFs for exactly these kinds of scenarios.

When picking which MMF(s) to invest in, there is often little to choose between them. This is down to the tight regulation around MMFs and their cash-like nature, which means returns are all within a tight band and risks all quite minor. But those fine risk margins can make a difference in extreme cases like 2008 or 2020. Of course, most investors will choose a fund with lower expenses. The variation in type and scope of MMFs leads to different managers charging different fees.

In the post-Brexit environment, some investors have been concerned about funds which are under European jurisdiction. For those that wish only to have a UK-regulated fund, there are only a few choices. Almost all funds are under Irish regulation, some under Luxembourg. The main reason appears to be that the jurisdiction can be costly for both investors and fund managers – Ireland remains the cheapest.

Interestingly, MMFs in the US can be quite expensive, despite their prominence and popularity with retail investors. Most MMFs in the US now charge around 0.5%, while the median figure is much closer to 0.15% in the UK. This is a positive for us as Sterling-based investors. MMFs do not compete much on performance, nor would we really want them to, as the incentive to up returns would go against the need for low risk, low volatility. But being competitive on price is exactly what you would want from cash-like assets.

Below is a table of fund managers running UK Sterling MMFs by asset size. We make no recommendation as to their suitability otherwise here:

MMF manager	Total of funds (£ bil)
Total UK Sterling MMFs	£429.2
Blackrock (including iShares)	£103.4
Legal & General Investment Mgmt Ltd	£36.3
Aviva Investors Global Services Ltd	£34.8
Aberdeen Asset Management	£31.3
JP Morgan Liquidity Funds	£29.5
Insight Investment	£28.5
Goldman Sachs Asset Management	£27.1
HSBC Asset Management	£21.4
Northern Trust	£16.9
DWS Investment S.A.	£16.5
Ignis Investment Services Limited	£15.8
Scottish Widows	£14.8
Morgan Stanley Investment Management	£12.2
Federated Investors UK	£9.4
BNY Mellon	£7.5
Royal London Asset Management Ltd.	£6.4
State Street Global Advisors	£4.3
BNP Paribas	£3.2
Fidelity Worldwide Investment Ltd	£3.0
Invesco UK Limited	£2.3
Canada Life Asset Mgmt	£1.7
CCLA Investment Mgmt Ltd	£1.5
Amundi	£1.1
Lombard Odier Asset Management	£0.2
Western Asset Management Company	£0.1

Source: Tatton IM, Bloomberg 27th April 2023

CAMBRIDGE INVESTMENTS LIMITED

2nd May 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	7836	-0.6	-0.6	→	⇗	4.2	10.9	10.7	13.3
UK FTSE 250	19380	+1.4	+1.4	⬊	⇗	3.5	12.9	12.3	14.6
UK FTSE All-Share	4266	-0.3	-0.3	→	⇗	4.1	11.0	10.8	13.5
UK FTSE Small	6202	+0.3	+0.3	⬊	→	3.9	8.6	8.1	13.0
France CAC 40	7451	-0.9	-1.0	⇗	⬈	2.9	12.8	12.5	14.1
Germany DAX 40	15836	+0.5	+0.4	→	⬈	3.4	12.0	11.5	13.0
US Dow	33755	+0.0	-0.4	→	→	2.1	18.0	17.1	16.4
US S&P 500	4131	+0.1	-0.3	→	⇗	1.7	19.0	18.1	17.5
US NASDAQ comp	12134	+0.7	+0.3	⇘	⇗	0.9	27.3	24.9	22.8
Japan Nikkei 225	28705	+0.1	-1.5	⇗	→	2.0	16.6	16.4	16.8
World Bloomberg	1517	-0.4	-0.8	⇗	→	2.4	13.1	12.9	13.8
China mainland	4029	-0.1	-1.2	→	⇗	2.2	16.8	16.2	16.3
Emerging Bloomberg	1105	-1.3	-1.8	⇘	⬈	2.4	12.4	11.9	12.0

Top 6 Gainers

Company	%
Airtel Africa	+10.5
Vodafone	+6.5
abrdn	+6.0
Persimmon	+6.0
Pearson	+5.9
Land Securities	+5.6

Bottom 6 Decliners

Company	%
Fresnillo	-10.4
Anglo American	-9.6
Legal & General	-7.9
Rio Tinto	-7.6
Glencore	-5.5
Antofagasta	-5.5

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+3.73	-0.06
UK Govt 15yr Gilt	+4.01	-0.06
US Govt 10yr Treasury	+3.44	-0.10
France Govt 10yr OAT	+2.92	-0.11
Germany Govt 10yr Bund	+2.35	-0.11
Japan Govt 20yr JGB	+1.00	-0.13

Currencies

Pair	last	%1W
USD per GBP	1.251	+0.4
GBP per EUR	0.880	-0.1
USD per EUR	1.101	+0.3
JPY per USD	135.96	+1.2
CNY per USD	6.914	+0.5
USD per Bitcoin	29,353	+2.0

Commodities

Cmdty	last	%1W
Oil Brent $:bl	78.7	-3.6
Gold $:oz	1988.7	-0.8
Silver $:oz	24.9	-1.5
Copper $:lb	385.8	-4.8
Alumnm $:mt	2316.0	-3.8
S&P soft crops	254.7	+3.3

UK Mortgage Rate Estimates

Rates (LTV c.75%)	28-Apr	29-Mar
UK BoE base rate	4.25	4.25
2yr fixed	5.49	4.82
3yr fixed	5.27	4.67
5yr fixed	4.89	4.38
10yr fixed	4.78	4.50
Standard variable	7.22	7.02

28/04/2023
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

* 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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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.

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