CAMBRIDGE
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THE **CAMBRIDGE** WEEKLY

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A small predicament

Last week's investor focus was dominated by May's central bank rate decisions, with the weaker spots in US (regional bank) markets continuing to rumble just beneath the surface. Australia's Reserve Bank made the start on Tuesday, surprising most commentators by raising its cash target policy rate again, up 0.25% to 3.85%. It had been expected to hold steady. This proved the only surprise policy move; both the US and Eurozone central banks also raised rates by 0.25% to 5.25% and 3.25% respectively but this was in line with expectations. In the UK, we await the Bank of England (BoE) decision this week, with its Monetary Policy Committee (MPC) also expected to raise rates by 0.25% to bring the UK's base rate to 4.5%.

Both Jerome Powell at the US Federal Reserve (Fed) and Christine Lagarde at the European Central Bank (ECB) managed the neat trick of sounding hawkishly dovish. That balance has helped to maintain a sense of calm and, together with a mildly cautious positioning among the institutional investor base, this meant a steadying of markets. Economic sentiment data and corporate earnings news flow have been positive enough to offset fears that financial conditions (the ability to secure finance at a reasonable rate) are getting too tight for comfort.

Indeed, the US economic data on the jobs market keeps sending positive signals. The first week of the month brings the overall US employment data in the form of new jobs created (aka non-farm payroll) which downright refuses to show weakness. Revisions for previous months were negative but not massively. Cyclical sectors did show some job losses, but these were made up for by gains in sectors which have had difficulties in recruiting in past years – health and education particularly. That means the resilience is there and gaps opening on the cyclical side are being filled by other sectors and those hiring sectors are not especially rate sensitive.

And, for us, rate sensitivity is what it's all about. Households are currently not sensitive to short-term rates, given the pandemic payments meant short-term borrowing got paid down, while long-term mortgages were refinanced at very low rates (more so in the US than elsewhere). Jobs being still plentiful, consumption remains at healthy levels although no longer buoyed by the 'excess' savings from the pandemic payments.

This is how far last week's good news story extends, because rate sensitivity is much more apparent in the world of small businesses, in real estate, and among private equity – all areas that matter greatly in the overall economy. JP Morgan's buyout/rescue of First Republic Bank helped sentiment at the start of last week, but this was short-lived. With PacWest and Western Alliance coming under pressure next, the woes of US regional banks continued up until a Friday bounce (although they are small in comparison to Silicon Valley Bank and First Republic).

Perhaps more important, but maybe less remarked on, the major listed private equity firms are doing less well. Carlyle gave investors a real surprise, with first quarter distributable revenue (aka profits) missing estimates by 10%. As can happen when a new chief executive arrives, it did feel like a bit of a 'kitchen-sink' job, with Harvey Schwartz telling his troops he intends to instil discipline.

Private equity (i.e., not stock market listed) has been massively aided by a long period of cheap debt which has given their early-stage high growth-potential (and therefore mostly tech) firms time to blossom. The speed of rate rises has abruptly curtailed this environment. The graph below shows the Bloomberg North America Listed Private Equity index relative to the S&P 500 (with 100 being the start of the pandemic period) with the US rates development at the bottom:

The relative gains from 2020/2021 have been lost, because the problem for these groups is that the era of cheap money is over. Investors can earn a reasonable 5% in US dollars and 4% on sterling without trying. It may have been reasonable when cash returned nothing, but why would you now tie up your money in the illiquid and opaque funds created by the private equity industry?

Despite what central bankers told us last week about not being done quite yet, markets expect that short-term rates will be on hold now for a time. There is much debate about when they will be forced to lower them again. However, for those under mounting pressure from the increased cost of finance, their deteriorating environment will not improve until short-term rates have come back down. Our best guess is that the rate (in US terms) is around 3.5%, which is near the recent historical averages of outstanding bond financing.

Economic sentiment and jobs data tells us that consumers are still okay, and the earnings reports tell us large firms are also okay. This more visible evidence is not sending the monetary policy setters a signal to ease. However, the rate-sensitive small and mid-sized firms are not easily visible in any data. The quarterly US bank lending survey published yesterday showed another worsening of credit conditions. Indeed, the ECB's version published last week showed credit conditions worsening markedly, despite the help coming from falls in energy prices.

Risk assets have done reasonably well in recent weeks, as global growth indicators improved through the first quarter. Recently these growth indicators have become more mixed again but, in the most important area of jobs, they remain buoyant. That means the central banks will be reluctant to ease off and supply the rate cuts which are already discounted in the bond markets. Small and mid-sized firms may be able to catch occasional small breaths but have been squeezed for a long period now and are running out of oxygen. The most timely signal to cut rates comes when, for those firms, it's already too late – default and bankruptcy indicators lag until the moment they pick up but then they come in a rush. Time is getting shorter. If central banks wait for a clear decline in inflation, it will probably be too late for quite a lot of small firms.

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April review – deceivingly calm

April was a mild month in capital markets. While most developed world equity indices gained in sterling terms, the rises were very slight. When including emerging markets via the MSCI All-Country World index, it was very close to flat at -0.2%. Middling is not such a bad thing though, especially considering some of the positive returns in previous months. April's sideways trading effectively meant global equity investors held on to gains from earlier in the year, with global stocks gaining 5% year-to-date (YTD) in sterling terms. Particular YTD standouts were the NASDAQ Composite, climbing 12.1%, and Europe ex-UK rising 11.2%. The table below shows April returns for UK-based investors across key regions and asset classes.

Asset Class	Index	April	YTD	12 months	2022	5-yr rolling annualised
Equities	UK Large Cap	3.4	7.1	8.2	4.7	4.9
	UK Ethical Large Cap	3.3	6.6	3.8	1.1	1.8
	Europe ex-UK	2.1	11.2	13.0	-7.6	7.1
	US Large Cap	-0.1	4.5	2.5	-7.8	13.5
	US Technology Large Cap	-1.6	12.1	-0.1	-24.0	12.6
	Japan	-1.3	2.0	4.2	-6.1	5.7
	Global Stocks	-0.2	4.2	1.9	-8.1	7.0
	Emerging Markets	-2.7	-1.6	-6.6	-10.0	-1.0
Bonds	UK Gilts All Stocks	-1.7	0.4	-15.3	-23.8	-3.2
	£-Sterling Corporate Bond Index	0.3	2.6	-7.4	-18.4	-0.6
	Global Aggregate Bond Index	-1.2	-1.0	-2.4	-5.7	0.9
Commodities	Commodity Index	-2.4	-9.7	-15.2	41.9	3.7
	Brent Crude Oil Price	-1.1	-10.5	-25.1	24.4	1.5
	Spot Gold Price	-1.4	4.7	3.4	12.1	8.5
Inflation	UK Consumer Price Index (annual rate)	1.9	-	7.4	10.5	-
Cash rates	SONIA 3-Month	0.3	1.2	2.2	1.1	0.8
Property	UK Commercial Property (IA Sector)*	-0.5	-	-11.7	-7.8	-N/A

Source: Morningstar Direct as at 30/04/23. * to end of previous month (31/03/23). All returns in GBP.

On the month itself, the UK was the major standout. We are dealing with relatively small figures across the board, so it would be a stretch to call this a grand vote of investor confidence. But it is notable gains were fairly even among Britain's large and small cap businesses, as well as some showing an improvement in sterling-denominated corporate bonds. This suggests UK economic sentiment is improving after a

prolonged period of pessimism. House prices also rose unexpectedly last month after an easing of borrowing costs, and consumer confidence figures were the highest in more than a year. We should not get ahead of ourselves in terms of Britain's economic prospects, but these are undoubtedly encouraging signs.

Elsewhere, there was very little to note in terms of headline market moves, but this itself was quite significant given the context. In March, the collapse of several regional US banks led to some panic among investors. With the underlying economy already weakening, and central banks still tightening policy aggressively, many investors were concerned about a potential financial crisis, bringing further falls in confidence and liquidity. Financial conditions have certainly tightened to some extent, with banks more cautious about lending to smaller businesses.

The relative calm of April assuaged some of the deeper fears, however. Global bond yields fell, albeit only slightly, while even corporate borrowing costs eased. Average market volatility was lower in April than in any month since 2021, and investor flows into fixed income bonds remained solid. Fears could well flare up again – evidenced by the recent bankruptcy of US retailer Bed Bath & Beyond and renewed pressure on smaller regional US banks – but the overall mood was resilient. This has been backed up by the belief that central banks will finally loosen their grips this year, motivated by a decline in inflation rather than financial instability.

Growth indicators are still surprisingly strong, relative to weakened expectations. Last month saw the start of an important corporate earnings season, with companies revealing their Q1 results. There were positive surprises for the first time in a while, as well as upward revisions to future earnings forecasts. Despite the month's NASDAQ fall, technology stock earnings fared well, although this was concentrated among the older and larger players rather than the small start-ups. Cost-cutting, which has been much publicised following some high-profile job losses, was a factor – but so too were better-than-expected revenues. This gave companies plenty of support, in terms of both equity and credit.

European businesses had some notable positive surprises, reinforcing the sense that Europe's economy is over the worst of its problems. Investors see the European outlook as now even more favourable than the US, where labour markets are still too tight for comfort for the Federal Reserve (Fed) – despite it having nominally lower inflation numbers. Throughout April, the dollar slid in value against the euro, continuing the trend from the previous month. In fact, the euro is now at its highest dollar value since April 2022, when the war in Ukraine was hammering the continent's outlook. This helped support European stock valuations in sterling terms.

The only notable fall came from emerging market stocks, which slid -2.7% in sterling terms. This was largely to do with a mid-month sell-off for Chinese equities, as investors seemed to doubt the nation's growth prospects. Previously, confidence in China's post-pandemic bounce had been extremely high, with both domestic and foreign investors buying into Beijing's promises of opening up, stimulus and economic boom. The change of heart might have had something to do with the news that Guizhou, one of China's poorest and most indebted regions, is close to bankruptcy, and could need significant help from the central government. This is less to do with Guizhou itself, which is a relatively small part of the country's overall economy, but as a signal of the financial health of China's regional governments. The province has since

signed an agreement with China's top state-owned distressed debt manager, a sign Beijing wants to quash any problems before they begin.

Curiously, the stock market sell-off came immediately after the release of official gross domestic product (GDP) figures for Q1. These figures were much more positive than expected, showing the world's second-largest economy expanded 4.5% in annualised terms. But investors fear these results will remove the policy impetus behind China's growth spurt – evidenced by a People's Bank of China briefing which suggested interest rates would not be cut.

This backs up a trend of overseas investors losing their appetite for Chinese stocks. Inflows were huge at the start of the year, but there is an increasing belief the party has already ended. We do not quite share this assessment. This particular Chinese growth spurt is certainly unlike those before it, with less of a focus on commodity-intensive building. However, that does not mean it will be less powerful. Beijing is likely to continue its policy support, but with a focus on consumer demand. This seems to have been effective so far and has even benefitted China's major trading partners (such as European luxury goods makers).

China is perhaps the only major economy where growth looks unreservedly strong. Developed western markets continue to chug along, in some cases much slower than before. The key question is whether this lethargy will be enough to justify a new interest rate cycle.

Central banks slowing but not pivoting

A raft of vitally important central bank meetings took place last week. The Fed met on Wednesday, followed by the European Central Bank (ECB) on Thursday, and the Bank of England (BoE) will meet on Thursday 11th May. The world's monetary policymakers are trying to solve the twin afflictions of slowing (or in some cases, negative) growth and stubbornly high inflation. As expected, all three raised interest rates again – a sign – if anyone needed it – that the inflation fight is not yet over. For capital markets, though, more important are the signals for the future of monetary policies. The perception that policymakers might loosen their grip has been one of the biggest factors underlying market positivity this year. Central bank watch is therefore important as ever.

US Federal Reserve

The Fed was widely expected to delivery another 0.25% rate hike in its May meeting, and its Federal Open Markets Committee (FOMC) did not disappoint. US benchmark interest rates are now in the 5-5.25% range, breaking the 5% level for the first time since before the 2008 Global Financial Crisis. That is quite incredible when you consider rates were at just 0.25% little over a year ago, making the last 12 months the most aggressive period of monetary tightening in a generation.

Rate hikes slow the economy and, after hitting the brakes hard, the FOMC has certainly eased off. The Fed delivered a 0.75% hike in four consecutive meetings through 2022, slowing to quarter-point jumps in its last two. Expectations are that the FOMC will take a break at their next meeting, with the implied market outlook suggesting no more rate rises for the rest of the year. This is backed up by work from the Fed's

own researchers suggesting US growth will turn negative this year. On top of the Fed's own tightening, the collapse of several regional banks has left many small businesses struggling to secure adequate funding. This has put Fed Chair Jay Powell under both economic and political pressure (from Democratic Party lawmakers) to stop raising rates for the rest of this cycle.

Powell would never seal the Fed's fate by pre-committing to a particular interest rate level, but he can point to what policymakers hope or expect to see in order to pause. Undoubtedly, global input prices are easing, both in terms of energy and supply chain costs (shipping freight prices have fallen substantially, for example). This helps the Fed's cause, but America's deeper inflation problem has always been a domestic one.

Above all, the FOMC will continue to focus on the labour market, which has proved confoundingly resilient over the last year, and could still threaten the wage-price spiral that Powell is so worried about. The US jobs market has undoubtedly slowed and has arguably come into balance with the Fed's ideal 'full employment rate' (the rate at which the number of unemployed is equal to the number of jobs available on an ongoing basis). Unemployment remains historically low, but the FOMC will take heart in the fact that the overall participation rate (the percentage of working age population seeking work) has increased.

Powell does not believe the inflation fight is already won. But the particular stress on small and medium-sized businesses – originating from the banking crisis – certainly affords the FOMC some extra leeway. It could well be that economic tightening – which historically has always lagged rate rises by some 6-12 months, is already locked in, in which case the Fed would have little need to raise rates further. Should that happen, the market assumption will be that the Fed should start gently easing, perhaps as soon as later this year. We would caution against getting too excited about this idea; it will likely only happen if the economy materially worsens.

European Central Bank

Analysts were split on what exactly the ECB would do at its Thursday meeting – raise interest rates by another 0.5% or slow slightly to just a quarter point rise, so the decision to raise its three key interest rates by 0.25% to 3.75%, 4.00% and 3.25% respectively, was a mildly dovish outcome.

Still, Europe has been a little behind its British and American counterparts in the fight against inflation. Unlike the US, labour market tightness has not been as pronounced at the aggregate level. Instead, historic inflation has all been about the war, the withdrawal of Russian gas supplies and an energy crisis. Given these fears have eased after a warmer-than-expected winter and improvements in gas storage, one might think Europe's inflation problem has blown itself out.

As we have argued before though, Europe still has a domestic wage inflation problem – just one that is not so obvious, thanks to the fragmented nature of the continent's labour market. So-called 'periphery' nations – particularly former Soviet-aligned countries – have acted as wage inflation dampeners for decades, giving Europe a large supply of young and often skilled workers with historically lower wage demands. That process has dwindled recently, thanks to equalising effects. Tightness in peripheral labour markets is now significantly adding to overall inflation pressures.

On the flipside, the ECB's policy tightening arguably has more direct effect on its economy than the Fed – thanks to the greater importance of the banking system in overall lending – meaning it may not need to raise rates as drastically to fight inflation. Europe's financial system has been remarkably stable in this episode compared to previous ones, but companies are being hit with the double whammy of rising short-term rates and the removal of long-term financial supports, such as the targeted longer-term refinancing operations (TLTROs).

The fallback in energy prices has allowed for much more positivity in Europe, but this is offset by the massive increase in the cost of financing. Given the financial pressures on particularly smaller firms, it is reasonable to think the ECB might pause its rate rising cycle too. That should further support optimism around Europe – which has been in abundance this year.

The cautionary note for this optimism is that, as usual, there are great lags with ECB policy. Just as the internal slowdown is now feeding through in the US, we should expect the European economy to weaken into the second half of this year, although sometime after the US. Ultimately, inflation is unlikely to fall unless growth weakens too. The fragmented nature of the European Union, with vastly different political imperatives, makes ECB President Christine Lagarde's job of finding the right balance extremely difficult. The ECB has been good at liquidity management for many years but navigating competing economic needs to find the right rate policy mix is a much more difficult task. It will likely be the defining struggle of her tenure at the ECB.

Bank of England

The BoE is in a very similar situation to the Fed. Inflation has proven stubbornly high and policymakers are deeply concerned about tightness in the labour market. Governor Andrew Bailey is fully expected to deliver another 0.25% rate rise this week, but economists predict this will be the last hike of the current cycle.

Unlike the US, UK inflation – which was still in double figures at 10.1% in March – is not being sustained by surprisingly persistent growth. Economic activity has been weak (although perhaps not as weak as some had expected). Unemployment has recently started climbing – albeit at a very slow rate. Instead, consumers are repeatedly battered by seemingly external price rises, first from energy and now from food. BoE economist Huw Pill recently attracted heavy political criticism for suggesting workers and employers need to show restraint in wage negotiations and accept that the energy crisis has made everyone worse off.

Much of the criticism focused on the fact that wage increases do not appear to be one of the bigger contributors to inflation, while 'defensive' margin increases by companies arguably are. We wrote recently that there is some truth to this, and this threatens the inflation spiral Pill and Bailey fear all the same. It is clear, however, that the BoE sees the labour market as something within its control, while other aspects like corporate profits are the remit of the UK government.

In any case, UK inflation should continue to come down from here; the economy is simply too weak to sustain such high levels. This is despite a recent halting of the fall in house prices, as well as the highest consumer confidence figures in more than a year. Even with this positivity, there is little steam to push UK prices higher in the months ahead. Indeed, while economists forecast for 2023's year-on-year consumer

price index (CPI) inflation rate to be above 6%, the inflation swap market (used by pension funds) now sees CPI inflation at only 2.3% by the end of April 2024. Economists are probably overly pessimistic.

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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	7757	-1.1	-1.1	→	↗	4.3	10.8	10.6	13.3
UK FTSE 250	19350	+0.4	+0.4	↘	↗	3.4	12.8	12.0	14.6
UK FTSE All-Share	4229	-0.9	-0.9	→	↗	4.1	11.0	10.7	13.5
UK FTSE Small	6216	+0.7	+0.7	↘	→	3.8	8.7	8.2	13.1
France CAC 40	7411	-1.2	-2.4	→	↗	3.0	12.8	12.5	14.1
Germany DAX 40	15898	+0.4	-0.8	→	↗	3.5	11.8	11.4	13.0
US Dow	33434	+0.1	-0.9	→	→	2.1	17.7	16.8	16.4
US S&P 500	4099	+0.5	-0.6	→	↗	1.7	18.9	18.0	17.5
US NASDAQ comp	12071	+0.9	-0.2	→	↗	0.9	27.5	25.0	22.7
Japan Nikkei 225	29158	+1.9	+0.2	↗	→	2.0	16.8	16.6	16.7
World Bloomberg	1510	+0.4	-0.7	↗	→	2.4	13.2	13.1	13.8
China mainland	4017	+1.4	+0.5	→	↗	2.2	16.6	16.0	16.3
Emerging Bloomberg	1107	+0.7	-0.4	→	↗	2.4	12.3	11.7	12.0

Top 6 Gainers

Company	%
Persimmon	+6.2
Halma	+5.2
Prudential	+4.1
Coca-Cola HBC AG	+3.9
London Stock Exchange	+3.7
Rentokil Initial	+3.7

Bottom 6 Decliners

Company	%
Glencore	-7.3
RELX	-7.1
RS GROUP	-7.1
BP	-5.9
Barclays	-5.7
WPP	-5.7

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+3.76	+0.01
UK Govt 15yr Gilt	+4.03	+0.00
US Govt 10yr Treasury	+3.43	-0.06
France Govt 10yr OAT	+2.86	-0.15
Germany Govt 10yr Bund	+2.27	-0.17
Japan Govt 20yr JGB	+1.03	+0.03

Currencies

Pair	last	%1W
USD per GBP	1.259	+1.1
GBP per EUR	0.873	-1.2
USD per EUR	1.099	-0.2
JPY per USD	134.77	+0.6
CNY per USD	6.918	-0.2
USD per Bitcoin	29,029	+0.5

Commodities

Cmdty	last	%1W
Oil Brent $:bl	75.1	-3.9
Gold $:oz	2011.0	+1.5
Silver $:oz	25.5	+3.6
Copper $:lb	388.4	+0.4
Alumnm $:mt	2283.3	-1.7
S&P soft crops	249.8	-1.9

UK Mortgage Rate Estimates

Rates (LTV c.75%)	05-May	05-Apr
UK BoE base rate	4.25	4.25
2yr fixed	5.48	4.76
3yr fixed	5.25	4.55
5yr fixed	4.87	4.27
10yr fixed	4.78	4.36
Standard variable	7.22	7.22

05/05/2023
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

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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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