THE **CAMBRIDGE** WEEKLY

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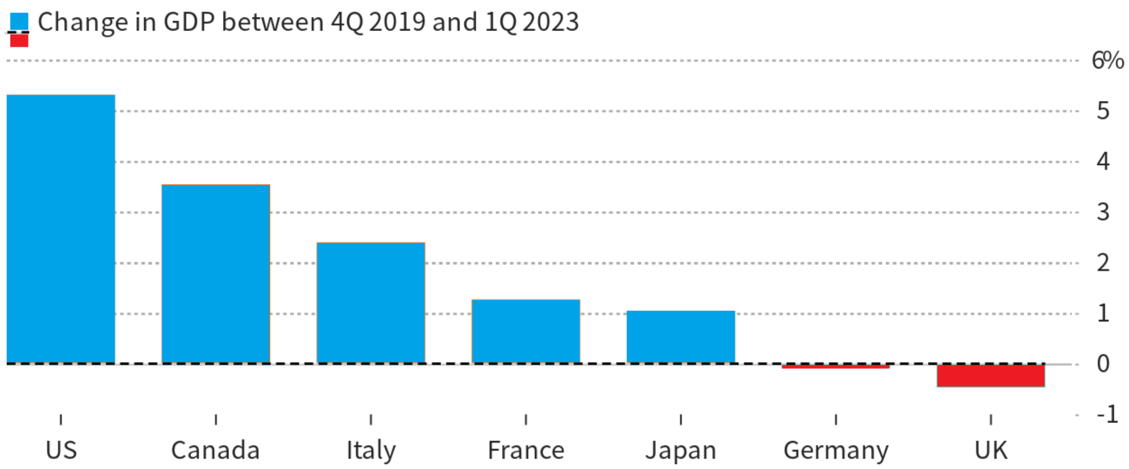
Trust the MPC to rain on May's parade

After a period where it felt like there was a shortage of news, things are hotting up. Both equity and bond markets are bearing up well generally but, in our estimation, underlying risks have increased since May started.

After the previous week's rate rises in the US and Europe, last week it was the turn of the Bank of England (BoE) to increase the UK base rate to 4.5%. While members of the Monetary Policy Committee (MPC) will have seen weak real growth data for first quarter of 2023 (+0.1% versus the previous quarter, with March slowing sharply by -0.3% versus February), BoE researchers raised their estimate for economic activity this year and no longer think there will be a recession. More importantly, they expect year-on-year inflation to take more time to slow, to remain above 8% as of June, and to finish 2023 at 5.1%. They say the risks are skewed towards inflation continuing to be high rather than below the BoE's 2% target.

Not everyone agrees with them. The independent MPC members, Silvana Tenreyro and Swati Dhingra, wanted no rate hike. Meanwhile Michael Saunders of Oxford Economics – a former independent MPC member, and a noted hawk in his time there – believes UK inflation is set on a downward trajectory. He thinks risks are skewed towards an undershoot of the target, and that this rate hike will probably be the last in this cycle.

The past three years have been tough for the UK. Below is a Bloomberg chart showing the total change in real gross domestic product (GDP) for European nations and Northern America.

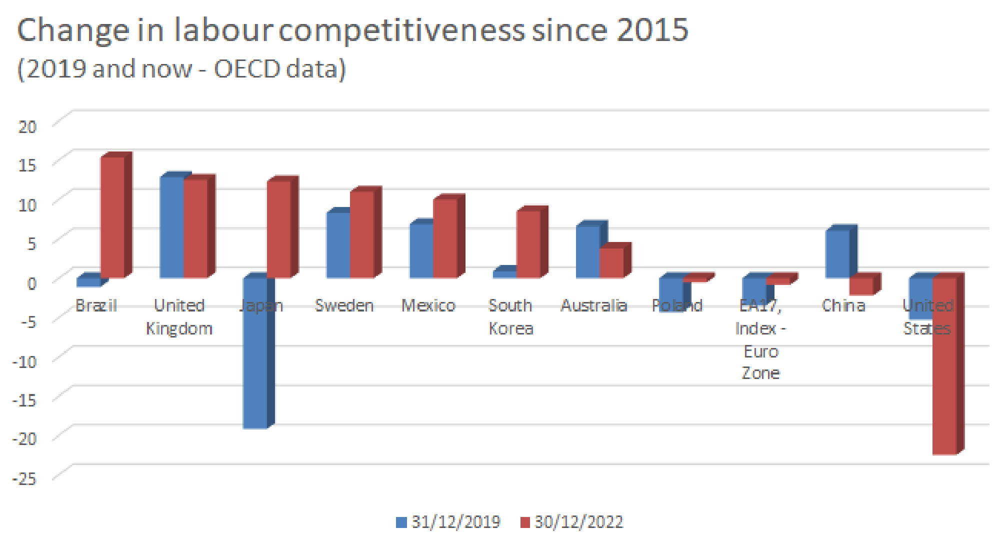


Source: ONS, statistics agencies
Note: Japan based on forecast for 1Q, Canada uses official indicative estimate

The fact is that over the past few years, the UK has faced production capacity issues which other countries have not. For various reasons, we have not had enough resources to fuel overall growth. The biggest resource shortage has been the skilled and unskilled people needed to do the work. The BoE still worries this is the case, which is why it sees inflation risks skewed to the upside and it's difficult to see how this will be resolved in the short to medium-term.

The problem, for all of us here, is how do we get to a situation where UK businesses can be globally competitive if workers of all stripes are not readily available? If labour gets paid more, the impact on businesses is to be less globally competitive, so there will be a steady outflow of jobs. Whole economy real growth will remain consequentially low. The data seems to tell us this may have been occurring, and the imbalance still exists.

There is reasonable evidence that UK wages have fallen. According to the OECD, we have gained labour competitiveness on a relative basis since 2015, although that hasn't change over the post-pandemic period. Below is a chart showing different countries and regions (Tatton IM adjustments from OECD data):



But there is a problem. That change in competitiveness means workers are paid less comparatively. The Japanese may feel poorer but, for their economy, it's a relatively good thing since those workers stay in Japan. Whereas in the UK, workers shift to better-paid areas. This is particularly so for highly skilled workers such as doctors. It doesn't solve the issue of lack of resources. Over the long-term, training our youngsters well (and retraining our not-so-youngsters) will have the biggest impact. Before then, a dose of realism about retaining and attracting skilled workers is important – that's not just about pay but about creating nice places to live.

Meanwhile, the environment for businesses in the developed world remains difficult. The rises in short-term rates have happened almost everywhere and at the same time. Indeed, apart from the early 1980s, there has never been such a period with virtually all central banks acting as if in concert. That unified action also means their policies have an unprecedented global impact, magnified by a more interlinked world than in the 1980s. We're sure that central bankers take into account the impact of each other's decisions and yet this final phase of rate rises could be viewed as coordinated overkill.

Money supply has been contracting in the western countries since the start of the year, and house prices have been falling in almost every region except Japan. Producer prices are heading into contractionary territory. Energy prices particularly are falling. And, in the US, the labour market indicators tell us the jobs market has moved to a weak rather than strong dynamic.

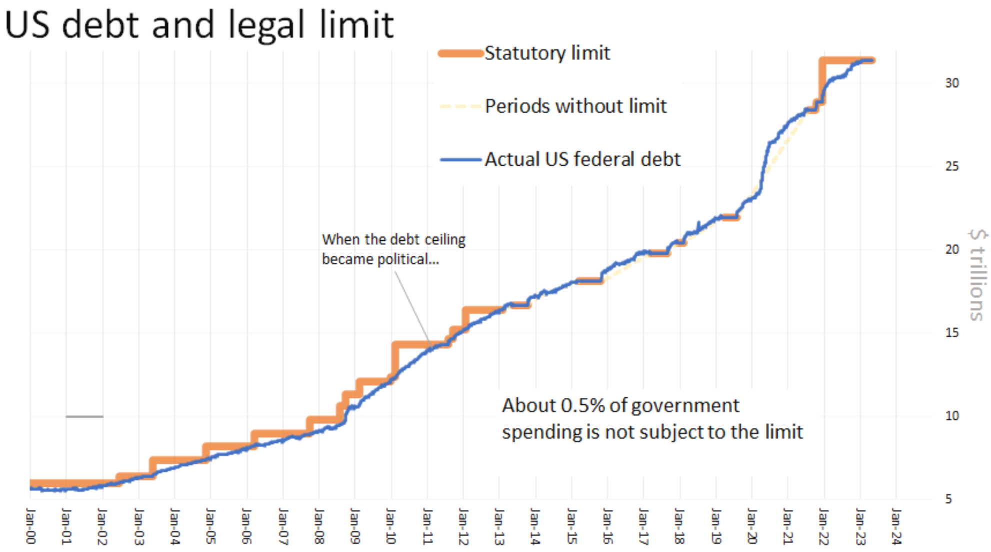
The US is always at the centre of global markets, so the possibility of the US government defaulting on its debt commands much attention. We write about some specifics below, but there is a wider aspect which we will touch on here. The strength of the western world has depended on the strength of its institutions, which are reliant on the ability to compromise. Recent years have seen the rise of division and that could be dangerous if carried too far. It will be important for the US and for the rest of the world that this situation does not occur. Despite both sides stating they have no latitude, President Biden has already indicated some leeway. In 2011, Obama gave ground, and a default did not occur, although equity markets had a rough ride. We are just over two weeks away from the first possible point of default. Let's hope for considered realism on both sides of the party divide.

US debt ceiling brinkmanship is nothing new

US Treasury Secretary Janet Yellen has warned that the federal government could default on its debt obligations very soon. Perhaps the odd thing is that this story does not feel like big news. This is at least the third occasion since 2011 that the possibility of a default has arisen as a consequence of not lifting the Congressional statutory limit on federal debt (colloquially known as the ceiling). The debt ceiling is not a limit on spending commitments, but rather on the government's ability to pay for them. Tax and spend measures are agreed separately in budget bills, the debt ceiling just limits how much money is available when the bill comes due. In theory, this should be a simple procedural task for legislators.

But whereas the federal budget approval process requires a simple majority, lifting the debt ceiling requires a 60-vote approval in the Senate, meaning the Democrat Party's 51-seat majority is not enough. Without any progress on lifting the ceiling, the Treasury must make increasingly harsh budgetary decisions as it slowly runs out of money. In the first instance, this involves running down the Treasury General Account (TGA), basically burning through all available cash. Next up are delays to those federal payments which are not time-critical (known as extraordinary measures). Finally comes the dreaded X-date, when the US is officially unable to meet its obligations. Benefits recipients, government employees, bills from private sector suppliers, interest payments and repayments of debt are all at risk. The government technically, legally defaults.

We said that lifting the debt ceiling should be a simple procedural task for legislators. And indeed, for most of the history of the debt ceiling as a legal mechanism, it was.



Source: Tatton IM, Bloomberg

From its institution in the 1940s, the debt ceiling had been occasionally used as a means of challenging the budget but that changed in 2011, when the Republican-controlled Congress used the debt ceiling as leverage to get budgetary concessions from the Obama administration. The results were economically disastrous, causing widespread government shutdowns, and with many US citizens going without much-needed payments. Investors grew increasingly nervous about the prospect of a US default, a fate avoided by a spending cut deal reached with just two days to go. Politically, though, it was an overwhelming success: the Republican Party discovered a great tactic for getting what it wants – one that lawmakers have used repeatedly over the last 12 years.

The Treasury hit the current debt ceiling – at $31.4 trillion – on 19 January. Since then, it has been steadily running down the ample funds in the TGA, buffered by tax receipts in April. Estimates for when the X-date falls due are varied, with the latest suggesting it could come in August. But Yellen has warned the government might be unable to meet all its obligations as early as 1 June. Last month, the Republican-controlled House of Representatives narrowly voted to raise the ceiling by $1.5 trillion, delaying the problem until next year. That bill has practically no chance of becoming law though, as it contained severe budgetary restrictions which Senate Democrats rejected.

President Biden held a meeting with Republican leaders last week in an attempt to break the deadlock, but no agreement was reached. Biden wants to 'take the threat of default off the table', but Republican House speaker Kevin McCarthy has said his party's position remains unchanged. As harmful as it could be for the American economy, both sides likely see some political value in running down the clock and upping the stakes.

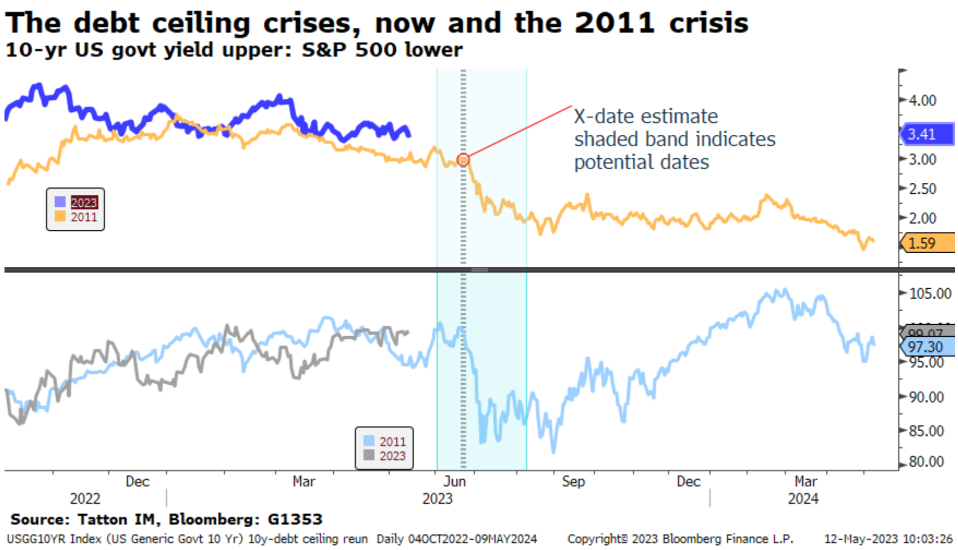
Some have downplayed the threat of a US default. For all the brinkmanship, US lawmakers will not want to bankrupt the government. Biden's suggested invoking of the 14th Amendment – which states the viability of US Treasury bonds cannot be in question – is a signal of how seriously he takes the situation. We mostly agree that reaching the X-date without an agreement is extremely unlikely but would only point out that brinkmanship can push things over the edge even when all participants do not mean it to.

In reality, even if lawmakers sleepwalked through the X-date with no agreement, the US would not really be a bankrupt nation in the eyes of global investors. Defaults happen when the borrower is unable to pay back their debts, not when they stubbornly threaten not to. For all the political and institutional fragility these episodes display, no one doubts that the government of the world's richest economy has the ability to pay back its debts.

Still, technical defaults can be very damaging. US Treasury bonds are the lifeblood of the global financial system – highly liquid and tradeable anywhere. Anything that affects this market will have big impacts on trading liquidity. This is so even if the effect is ultimately a technical or accounting phenomenon. Traders would have to adjust, and that could lead to volatility and dropping liquidity. Coming so soon after a regional banking crisis, that would be bad news for the US financial system.

Fortunately, Yellen has already drawn up plans for coping with this problem. The Treasury will reportedly extend the maturity and coupon payments on all bonds that come due on a day-by-day basis and will ensure that principal payments are made to whoever holds the bond at the actual payment time. This effectively means that bonds can still be traded as per normal, even if they are in technical default. As long as the delay is not huge – which is massively unlikely – the actual financial damage would be minimal. But even without a default, the current standoff may have financial and economic impacts. Should there be a default, it will almost certainly cause a lot of pain for a fragile economy.

In 2011, the proximity to a default caused US Treasury yields to fall (they might have been expected to rise given the prospect of a default) because it was felt there would be a sharp slowing of activity. The S&P 500 fell by over 18% in two weeks. It rallied weeks later as the stability returned. However, growth prospects were hurt for some time and part of the reason stocks rallied was that valuations were pushed higher because yields stayed lower.



Firstly, the Treasury's drawdown of the TGA means that no bonds are being issued but money is still flowing into the system. This is effectively a liquidity injection and is likely to be a boon for capital markets in the short-term, counteracting some of the tightening from the US Federal Reserve (Fed). After the situation is resolved though, we will see the TGA being built up again – effectively a liquidity drain. Secondly, those receiving federal payments will be made poorer, even if only temporarily. This could have a big impact on the economy in the short-term, cutting a vital source of demand as the US economy is already faltering.

While the media gets excited about the debt ceiling soap opera, realistically the US government's default risk is zero. More important is what happens between now and the X-date – particularly for federal employees. The issue will likely see a short-term resolution, but that sets up an interesting budget confrontation later in the year. As well as dictating actual federal spending, that could well set the agenda for next year's presidential election. The Republicans, like in 2011, are testing the electorate's appetite for government spending austerity.

European energy prices: the great reset?

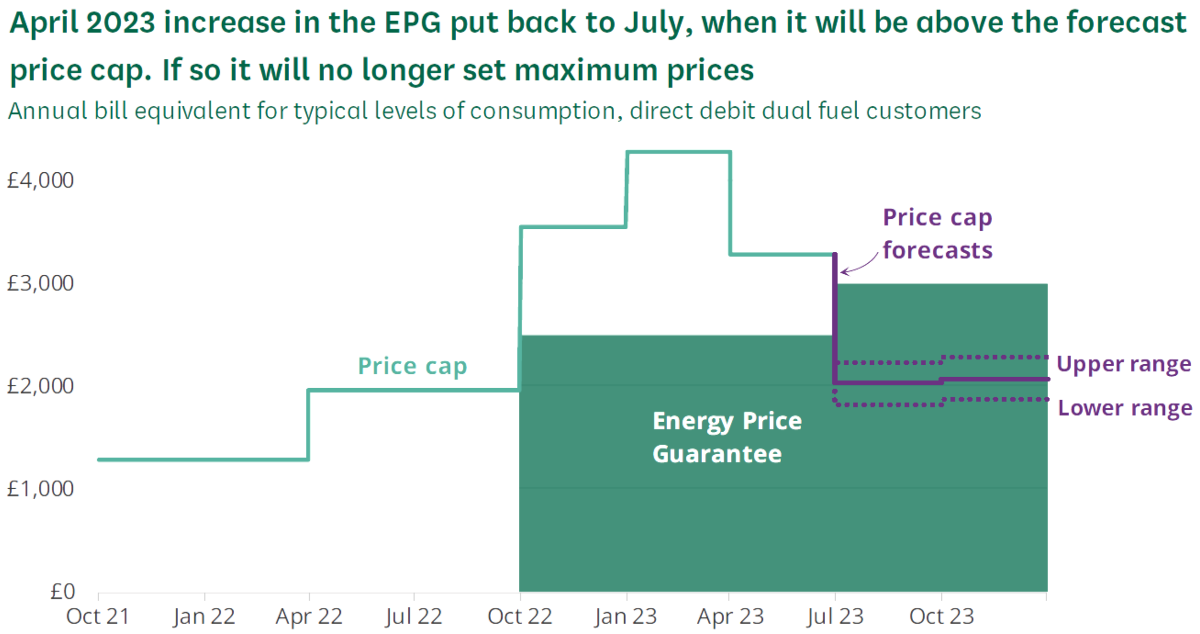
European energy is at its cheapest level in nearly two years. Last Friday, European gas – as measured by the Dutch gas hub (known as the Title Transfer Facility or TTF benchmark) – fell to just over €35 per megawatt hour (MWh). Prices rebounded a little over the previous weekend, but have since sunk back through last week, continuing this year's sustained downturn. Wholesale gas prices – the main determinant of energy costs for European households and businesses – have not been this cheap since July 2021, when Russia began constricting supply in the lead-up to its invasion of Ukraine. This comes on the back of improvements in non-Russian supply lines, reduced consumption behaviours and, above all, improved storage.

Softer global economic activity appears to be a reason for commodity weakness this year – not just in gas but oil too. Brent crude prices are currently at around $75 per barrel, down from a peak of over $110 last summer.

The removal of Covid restrictions has led to an economic rebound in China and previous Chinese growth spurts coincided with substantial commodity price rises. So why has this not happened so far this year, despite definitely positive growth in the world's second largest economy? Recent import data from China shows a decline in the value of oil and gas imports. Interestingly though, the volumes of oil being imported are still very high – just cheap. Indeed, the implication is that the prices are well below market. This is almost certainly because China is soaking up cheap oil on offer from Russia, which has ample supply but few willing customers in the west. We suspected this was going on for some time, and the latest data effectively confirms it. Global energy distribution has reset; the higher prices of 2022 have encouraged new sources of supply. The Russian reduction of energy supply to the world as a whole has proved temporary.

While few of us will be pleased that Russia is finding buyers for its gas and oil, it probably means that Europe's peak of the energy crisis – the worst in the post-war era – is now past. If so, the economic importance cannot be overstated; energy costs have hit businesses and households hard, severely constraining demand and productivity investment. Lower energy prices will also have a big impact on inflation, both current figures and future expectations.

As an aside, in the UK, the Ofgem price cap is expected to fall below the government's energy price guarantee (at £2,500 for typical households) by July, likely meaning an end to policy and the resumption of standard fixed energy deals.

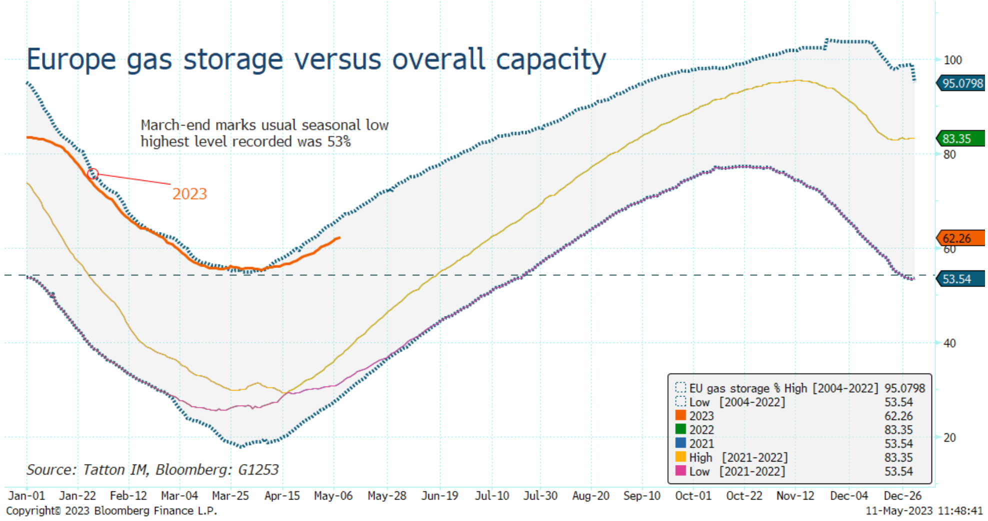


Source: Paul Bolton, House of Commons Library Research Briefing, 24 April 2023

Not everyone is convinced Europe's hardships are over, though. The pricing equilibrium is still more fragile than before the conflict, and the current balance has depended both on new supply routes and on demand reduction.

Recent analysis from Goldman Sachs forecasts a big jump in wholesale gas prices in the third quarter of this year, with TTF averaging €82MWh from July to October. Goldmans expects prices to go up from there too, potentially reaching €94MWh next winter and into the summer of 2024. And this is just their base outlook; risks are skewed upwards on their view, which could mean a tripling of current prices to more than €100MWh.

Underlying this forecast is an expected pickup in demand. Household energy conservation was a huge factor behind falling prices. In a warmer than expected winter, Europeans were surprisingly sparing in their gas usage, resulting in significantly higher storage levels than we have historically seen heading into the spring. The chart below shows storage as a percentage of overall capacity, relative to seasonal trends (the upper and lower bands). The start of spring is the low point for gas storage, after which the weather warms and supplies build. We are beginning this turnaround with storage levels above 60%, and much higher than 35% at the end of last winter.



However, Goldmans expect the price falls to disincentivise conservation efforts. As the chart above shows, while we were at record seasonal storage levels in April, the build-up has been slower than usual over the past few weeks. It is too early to call this a trend, but it makes sense that household or businesses would increase their gas usage as prices drop. Combine this with a need to avoid storage hitting 100% quickly (as this could destabilise energy markets through negative spot pricing) and we could well see a much slower storage build in the months ahead. That could leave supplies vulnerable heading into the autumn, when the seasonal drawdown begins. Goldmans see this leading to a supply deficit which could support prices. If this is coupled with increased demand from outside of Europe and 'winter weather risk', energy prices could climb rapidly.

It is worth pointing out a few things about this outlook. First, while gas prices of over €100MWh would clearly be a burden, it would still be a significant improvement on the crisis of last year, when gas prices peaked at well over €300MWh. Second, there is still a clear European effort to build capacity and supply for the long-term, which could skew prices lower if successful. Finally, it is debatable whether global demand is strong enough to push gas prices up that much anyway.

This is far from saying European businesses or policymakers should be complacent about energy prices. Even Goldmans' lower estimates would mean a big cost increase during a fragile time for the continent. Such complacency is arguably starting to undermine supply building efforts already, such as the major German energy firm RWE's recent exit from plans to build floating supply terminals in Germany due to local pressure from its environmental lobby. These problems are compounded by the fractured nature of the European Union (EU), which as so often might lead to conflicting approaches and national interests. It is notable, for example, that the gap between US and European gas prices has widened once more, after falling drastically earlier in the year.

So, the fall in global energy prices does not necessarily indicate weak global demand; it may be stronger than one might think from price action alone. After Russia began its war in Ukraine, we said global energy markets would drastically restructure, but without necessarily altering the fundamental balance of supply and demand. We are arguably seeing the results of this restructuring now. If so, it would mean downward price pressure is reaching an end. Europe's energy crisis has certainly improved, but the continent might still have a tough winter ahead.

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15th May 2023

Global Equity Markets

Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Technical Short Medium	Valuations Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7747	-0.1	-0.1	↘ ↗	4.0	10.6	10.5	13.3
UK FTSE 250	19259	-0.5	-0.5	↘ →	3.4	9.6	9.1	14.6
UK FTSE All-Share	4223	-0.2	-0.2	↘ →	4.0	10.5	10.3	13.5
UK FTSE Small	6249	+0.5	+0.5	↘ →	3.7	8.6	8.1	13.0
France CAC 40	7405	-0.1	-0.5	→ ↗	3.0	12.7	12.4	14.1
Germany DAX 40	15893	-0.0	-0.4	→ ↗	3.6	11.6	11.2	13.0
US Dow	33397	-0.1	+0.4	→ →	2.1	17.6	16.7	16.4
US S&P 500	4141	+1.0	+1.6	→ →	1.7	19.0	18.1	17.5
US NASDAQ comp	12350	+2.3	+2.9	→ ↗	0.9	27.5	25.0	22.8
Japan Nikkei 225	29388	+0.8	+1.3	↗ →	2.1	17.0	16.7	16.7
World Bloomberg	1520	+0.6	+1.2	↗ ↗	2.5	13.3	13.1	13.8
China mainland	3938	-2.0	-2.0	→ ↗	2.2	16.8	16.2	16.3
Emerging Bloomberg	1102	-0.5	+0.1	→ ↗	2.4	12.1	11.5	12.0

Top 6 Gainers

Company	%
Melrose Industries	+10.0
JD Sports Fashion	+9.2
ConvaTec	+5.5
International Consolidated Air	+4.6
3i	+4.2
WPP	+3.9

Bottom 6 Decliners

Company	%
Vodafone	-5.8
Land Securities	-5.3
British American Tobacco	-5.1
Airtel Africa	-5.0
Ocado	-4.7
InterContinental Hotels	-4.4

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+3.76	-0.00
UK Govt 15yr Gilt	+4.06	+0.03
US Govt 10yr Treasury	+3.40	-0.03
France Govt 10yr OAT	+2.83	-0.03
Germany Govt 10yr Bund	+2.25	-0.01
Japan Govt 20yr JGB	+1.01	-0.02

Currencies

Pair	last	%1W
USD per GBP	1.252	-0.6
GBP per EUR	0.870	-0.4
USD per EUR	1.089	-0.9
JPY per USD	134.79	+0.0
CNY per USD	6.950	+0.5
USD per Bitcoin	26,424	-9.0

Commodities

Cmdty	last	%1W
Oil Brent $:bl	75.5	+0.5
Gold $:oz	2018.6	+0.4
Silver $:oz	24.0	-5.8
Copper $:lb	372.3	-3.8
Alumnm $:mt	2197.5	-5.3
S&P soft crops	249.5	-0.1

UK Mortgage Rate Estimates

Rates (LTV c.75%)	12-May	12-Apr
UK BoE base rate	4.50	4.25
2yr fixed	5.46	4.76
3yr fixed	5.24	4.55
5yr fixed	4.86	4.27
10yr fixed	4.79	4.36
Standard variable	7.41	7.22

12/05/2023
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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15th May 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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