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Lothar Mentel

Lead Investment Adviser to Cambridge

Big tech stocks increase is 'artificial'

Last week we wrote that markets were facing growing risks. Since then, and at the time of writing, equity markets have generally headed higher. Japan has been enjoying a particularly good run with the Nikkei 225 making gains every day since last Wednesday. This has occurred despite some disappointing economic data and a weakening currency (we'll return to the currency moves in a moment). However, the most notable moves have been in US stocks, with the large-cap tech names doing very well in aggregate.

The earnings reports for Q1 have almost all been published, and have surpassed the usual 'better-than-expected' level. We all know companies manage to 'beat' the near-term expectations of bottom-up analysts, sometimes at the expense of the next quarter's forecasts. However, on a market-cap-weighted basis, developed world stocks have seen a return to earnings growth in the forecasts for the next 12 months. That's after six months of analysts seeing falls in earnings.

In Europe, HSBC analysts note that cyclical sectors have been the winner while real estate has been the laggard. They see a swing in momentum and their forecasts have improved through the late part of the earning season to about an 8% annualised growth rate. Still, the 2023 forecast as a whole is muted at just 1% compared to 2022. Companies continue to be hit by higher interest rates, and HSBC is concerned that the European Central Bank (ECB) may keep tightening financial conditions through the summer.

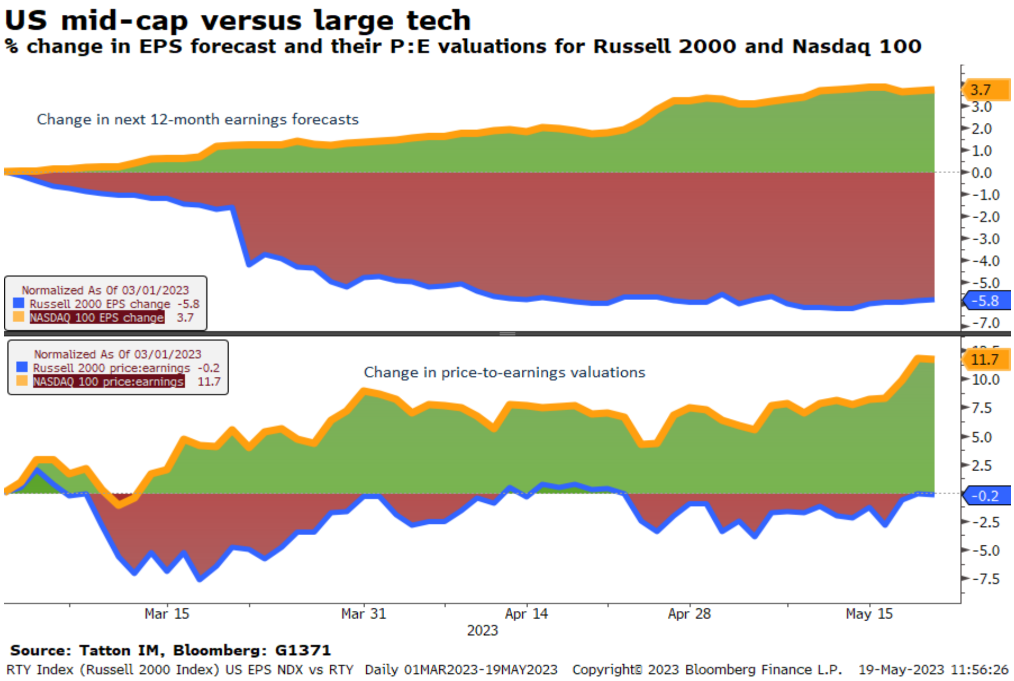
In the US, retailers have been discussing the continued softening of spending trends for big-ticket and other discretionary items. The pandemic reversal is till releasing pent-up demand for services, though, particularly when it comes to travel and entertainment.

But for both regions, what stands out as surprising is that 'top-line' revenues are better than expected. In Europe margins are still under pressure, but sales are substantially improved. In the US, both sales and margins have started to improve. That tallies with a more stable economic environment, especially for Europe where energy price declines have helped greatly. The improvement in global service sector purchasing manager indices (PMIs) also helps explain the corporate positivity. Meanwhile, Goldman Sachs notes that three themes have dominated earnings calls: banking stress, returning cash to shareholders, and artificial intelligence.

Exposure to regional banks, and potential impacts on credit availability, remains a focus for mid-caps and smaller companies. Most continue to want to pay back cash through share buybacks and dividends, although financials appear less keen.

Artificial intelligence (AI) is the hottest of topics. Although potentially encompassing many different aspects, most companies are talking about the use and development of chatbot (large language model engine) applications. Management teams talk about the potential business impact, current uses and plans for investments. Here there's a split. For some service companies, AI is a threat because, for the customer companies, it offers a great opportunity to cut costs. But, as Goldman Sachs noted in a discussion last Thursday, there are few companies for whom AI represents a direct profit opportunity. Goldmans suggests the main winners are hardware manufacturers at the cutting edge of fast computing, followed by the software techs that have investment capital - at least $1 billion in to put into research and development. And then you still need access to huge proprietary data.

It's no surprise then the stocks that have done best recently are hardware companies like NVIDIA and the behemoths: Microsoft, Amazon and Alphabet. The NASDAQ 100 contains many of these winners. The first panel of the chart below compares this index to the US Russell 2000 mid-cap index, showing earnings forecast changes since the start of this earnings season. The panel below shows the price-to-earnings multiples. For the NASDAQ 100, both earnings forecasts and the multiples have improved. For the more interest rate-sensitive mid-caps, both have declined.



The outperformance of large tech comes at a point when yields are not low, and have risen in recent days. As such, the move feels a bit like the start of the dotcom bubble, as Bank of America points out. However, for many investors, it is still a defensive move. The rise in US large cap techs is redolent of past times where risks to economic growth were substantial. And this week has seen other indications that investors are feeling a little downbeat.

The US dollar has moved quite sharply stronger after some weeks of weakening against most currencies. We write about this below. While there are several idiosyncratic reasons for emerging market currencies to soften, all except the Brazilian real have been on a downward path. The worst is the South African rand, 2022's equity market darling. China's renminbi also took a fall on Friday after the authorities signalled an acceptance of move through RMB 7/$. The scramble for offshore dollars seems to us to be a signal of tightening liquidity.

The good earnings results in the US – and especially Europe – are hopeful. Still, the underlying tightness of financial conditions for many companies remains, while the AI theme seems to be equivalent to a narrowing of profitability breadth, at least for the moment. The rise in equity markets is welcome and, if caused by a general improvement in profitability, all the better. We would feel a whole lot more optimistic if central banks were less hawkish.

Emerging market currencies suffer a downdraft

Global investors are nervous about the prospects for emerging markets (EM). EM currencies – which tend to best reflect the sentiment around underlying EM economies – sunk to a three-week low last Wednesday, as measured by MSCI's weighted index. The reasons for this pessimism are varied. At the high level, slower-than-expected growth in China is weighing on the outlook for EM demand, while financial stress in the US has reduced available capital and hit investor risk appetite. At the individual level, Turkey's election returned a stronger-than-expected showing for President Erdogan – an unpopular figure with international investors – while the energy crisis in South Africa has deepened. And importantly, South Africa's geopolitical tension with the US on suspected covert arms exports to Russia has made international investors nervous.

Waning confidence in EMs makes intuitive sense, given the global macroeconomic backdrop. Global growth has substantially weakened after a prolonged bout of undersupply and inflation, while central banks in developed markets have spent the last year tightening monetary policy at the fastest rate in a generation. The conventional wisdom says that EMs, home to cheaper but higher risk assets, do well when the world's economy is strong, and money is plentiful. Those sources of positivity have undoubtedly dried up over the last year-and-a-half.

This is not quite the whole story though. For much of 2022, EMs were subject to the pressures described above, and faced a challenging environment. This was particularly so given the immense strength of the US dollar, a factor that often hampers EM companies with large dollar-denominated debts. Hence, the broad

Developed and emerging-market currency baskets vs USD
DXY Index (inverted) & JP Morgan Emerging Market Currency Index

Source: Tatton IM, Bloomberg, JPMorgan: G211
FXJPEMCS Index (J.P. Morgan Emerging Market Currency Index (EMCI) Live Spot) EMFX Daily 17MAY2022-17MAY2023 Copyright© 2023 Bloomberg Finance L.P. 17-May-2023 15:00:33

basket of EM currencies weakened. But things changed last autumn, as the dollar started falling in value and EM sentiment began to shift.

China was the biggest reason. After Beijing abruptly ended its zero-Covid policy, growth expectations for the world's second-largest economy went into overdrive. Given the importance of Chinese growth for EMs – particularly for commodity exporting countries – EM currencies climbed against the dollar. The Brazilian real, one of the biggest EM commodity exporters, had a particularly sharp bounce against the dollar around October. The wider trend continued into the early part of this year, as the chart above shows.

Since then, sentiment has undoubtedly moderated. This led to basically steady EM currency values compared to the dollar over the last few months – which is not terrible considering the positive performance before. This month, though, EM sentiment has markedly declined. Again, China is the main driver. Strong economic expectations have been disappointed by recent data releases, which show the country is not growing as much as many had expected post-Covid.

Various indicators undershot expectations, from industrial production to retail sales. The numbers are still good in absolute terms, but international investors are increasingly worried that the China bounce – and by extension, EM growth – was overbought. One particularly sour note for commodity-exporting EMs is that Chinese industrial production is one of the economy's weakest and most disappointing areas. This is unlike previous Chinese growth spurts, which were heavily production focused and thereby pulled in significant demand for commodities. Current growth seems to be focused more on consumer demand, which may prove less helpful for wider EMs.

Then there is the plethora of individual issues. The surprisingly strong showing for Turkey's Erdogan in the first round of presidential voting last weekend increases the chances he will win the run-off vote later this month – a disappointing prospect. Erdogan has famously argued that higher interest rates cause higher inflation, contrary to global monetary orthodoxy. Ratings agencies have already warned that his "unsustainable" economic policies could cause yet another sell-off in the Turkish lira if continued.

The worst performing currency this year has been South Africa's rand, and it has sold off this month even more dramatically. Currently it is trading at just under R20 per $ and very near to its weakest level against sterling, above R24 per £. South Africa is dealing with an international relations crisis, deteriorating fiscal metrics and a severe energy shortage. Eskom, which has a monopoly on South Africa's electricity market, continues to struggle, with worsening rolling blackouts (known as 'load shedding'), and is reportedly in talks with a Chinese state-owned company to help resolve the issue. At the same time, news that South Africa may have supplied arms to Russia has threatened billions of dollars in exports to the US.

South Africa was one of the major commodity exporting countries that received a boost from expected Chinese demand, particularly in industrial metals. That has since subsided, and while it receives some benefit from the current demand for precious metals like gold, South Africa's current travails have seriously weakened economic prospects. In particular, the political fallout with the US could threaten to detach Africa's largest economy from the western world. This would not only turn markets even more against South Africa, but likely a downturn in wider EM assets.

So far this week, all but one of the emerging currencies that we follow, has fallen relative to the US dollar (the Brazilian Real is unchanged). This suggests the current move may not be about problems in individual nations. China's economic vibrancy is a bigger influence on emerging markets than any other and recent data has been underwhelming, causing some investors to re-evaluate the country's economic prospects.

It may also be about the US dollar itself. Since the start of the month, the dollar has climbed against both EM and developed currencies. There are signs of a reduction in the supply of dollars held outside of the US – as evidenced by the decline in cross currency basis swaps (signalling people are willing to pay more for dollars). The amount of dollars available worldwide has fallen, in large part thanks to the continued tightness in US financial conditions.

Should this trend continue, it would likely mean the much-discussed bout of dollar weakness could be coming to an end. Indeed, the Citi forex desk has recently cut its losses on their recommendation to be short of the dollar.

That would fit with the overall narrative of disappointing global growth and increased risk aversion among corporates and financials. Unfortunately, EMs may have to pay a bigger price than most for all this.

A closer look at the new wave of bankruptcies

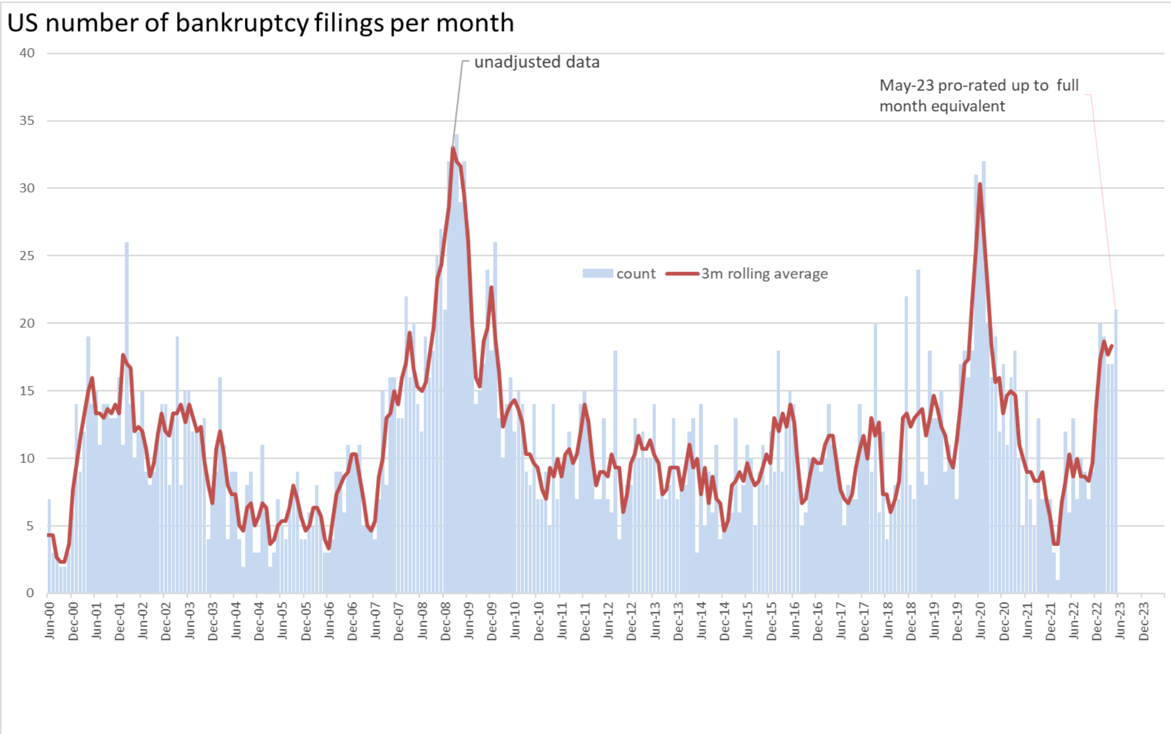
Bankruptcy famously happens slowly, then all at once. The popular misquotation of Hemingway (the character in question actually says "gradually, then suddenly" when asked how he went bankrupt) is about an individual business collapse, but it could just as well apply to the wider economy. A week ago, seven large US businesses filed for Chapter 11 bankruptcy, including names such as Envision Healthcare and Vice Media. According to Bloomberg, US courts are set to receive the highest number of large bankruptcy submissions for any week this year. Looking at US bankruptcy filings in total – including small caps – this year is on track to be the busiest since 2010.

Many are suggesting this is the beginning of a new wave of business failures – unlike anything seen since the Global Financial Crisis (GFC) of 2008. – with rapidly climbing interest rates, persistently high inflation and slowing consumer demand proving too much to handle. This potent combination seems to have been reinforced by the collapse of several US regional banks over the past few months, causing lenders to rein-in credit and leaving many companies without funding.

As noted previously, these problems are unfortunately worst for smaller businesses, which have seen financing costs go up by significantly more than large-caps. However, Bloomberg suggests the current wave of bankruptcies is also happening among large companies classed as those with more than $50 million in liabilities. The recent slew of failures was the biggest burst since Bloomberg started tracking this data 15 years ago.

This could be a sign problems are starting to creep up the chain. For a long time, analysts have predicted the eventual decline of so-called 'zombie companies', those with large debts and inefficient capital structures, which have only been able to survive because of the extraordinary era of cheap credit following the GFC. Monetary tightening was always going to be difficult for such companies, but the incredible pace of tightening over the last year – the sharpest US interest rate increases in a generation – has led to bankruptcies happening all at once.

As the chart below shows, the three-month rolling average for US bankruptcy filings (which strips out some monthly volatility) is now at its highest since the pandemic first hit. Moreover, pandemic-related bankruptcies were very different to those in normal times, especially as emergency support meant many companies that filed for Chapter 11 eventually recovered after lockdowns ended. Disregarding that period then, this looks like the worst wave of defaults since the GFC, and the trend shows little sign of slowing down. As defaults are one of the main hallmarks of recessions, this looks like very worrying news.



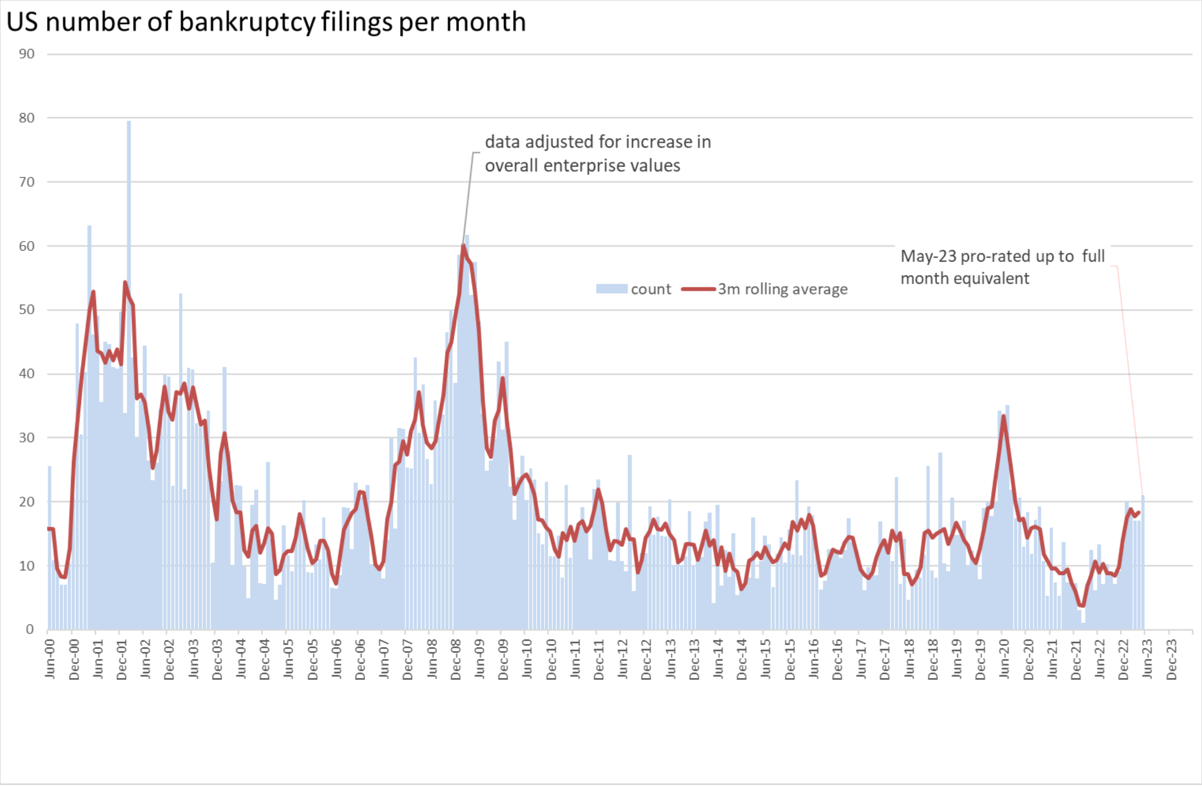
However, given how financial markets have developed over the last decade-and-a-half, the raw figures are arguably misleading. While the total number of US bankruptcies is extremely high, the total amount of debt which is subject to distress is quite low (as a percentage of total outstanding corporate debt). That backs up the idea that it is mainly smaller companies that are facing difficulties – even if there are lots of them. With that in mind, what should we make of Bloomberg's suggestion there are more *large* companies going bust now than at any time since the GFC?

The key thing is how one defines 'large'. A common way of thinking about this is those companies with more than $100 million in liabilities. But the problem with this threshold, is that it can give misleading results if applied evenly across the whole time period. The chart above goes back to 2000, since which time general price levels (in terms of the Consumer Prices Index (CPI)) have roughly doubled. Taking that into account would help, but that does not go far enough.

After the GFC, companies made some attempt to shrink their balance sheets briefly but, with corporate long-term interest rates declining and short-term rates near 0%, there was yet more substantial growth in capital, assets prices and debt. High asset valuations allowed big, medium and small businesses to accumulate debt. In that sense, over the period in question it became much easier for companies to reach the £100 million liability level. That means many more companies at the lower end of the 'large' categorisation, despite the total outstanding debt being heavily concentrated among the higher end.

Company balance sheets have dramatically increased since the GFC, by several orders of magnitude more than CPI inflation. We have to take this into account when talking about 'large' company bankruptcies. Exact estimates of this multiplier effect vary, but the chart below shows our estimate of the corrected trendline. In this version the bankruptcy wave looks significantly smaller than the GFC.

This suggests we are not yet in a default wave. And indeed, default rates are currently below past crisis times, and especially below the GFC level. However, the recent flurry involved companies with sizable liabilities, and may mark an expansion of the crunch which has afflicted smaller companies. As the total of impaired debt mounts, so the potential for contagion increases. The most likely time to announce a filing is over a weekend, so there could be a few bond and loan investors who don't get much rest in the near future.



Of course, this is still a very uncomfortable position – with the highest bankruptcy rates on our measure. Should financial conditions tighten further from here, it would inevitably mean more pain, which could certainly push us to crisis levels. It is important to think about the sectors that would likely be hardest hit in such a case: in 2008 it was financials, in 2015 it was energy companies and now it seems to be consumer discretionary. That makes sense given the stresses on consumers during this period, and the problems would likely only increase if unemployment climbed.

However, the adjusted trend shows we are certainly not at crisis levels yet. That is quite remarkable when you consider just how rapidly interest rates have increased over the past year, and the media doom and gloom around the economy – another sign of the US economy's surprising resilience. We are keeping a close eye on the situation and, if there is any silver lining, it will be that US interest rates will surely stop rising, perhaps falling by the end of the year. But if that does not happen, and rates keep rising, the bankruptcy wave could indeed become a tidal wave.

CAMBRIDGE INVESTMENTS LIMITED

22nd 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	7774	+0.3	+0.3	→	→	4.0	10.6	10.4	13.3
UK FTSE 250	19335	+0.4	+0.4	→	→	3.7	11.1	11.0	14.6
UK FTSE All-Share	4237	+0.3	+0.3	→	→	4.0	10.6	10.5	13.5
UK FTSE Small	6244	-0.1	-0.1	↘	→	3.8	8.6	8.1	13.0
France CAC 40	7509	+1.4	+1.2	→	↗	3.0	12.8	12.5	14.1
Germany DAX 40	16279	+2.4	+2.2	→	↗	3.5	11.8	11.3	12.9
US Dow	33571	+0.5	+1.2	→	→	2.1	17.8	16.8	16.4
US S&P 500	4207	+1.6	+2.3	→	→	1.6	19.3	18.4	17.5
US NASDAQ comp	12713	+2.9	+3.6	↗	↗	0.9	28.3	25.7	22.8
Japan Nikkei 225	30800	+4.8	+2.5	↗	→	2.0	18.0	17.6	16.7
World Bloomberg	1534	+1.0	+1.6	↗	→	2.4	13.8	13.6	13.8
China mainland	3945	+0.2	-0.0	→	↗	2.1	16.6	16.1	16.3
Emerging Bloomberg	1103	+0.1	+0.8	↘	→	0.0	12.2	11.5	12.0

Top 6 Gainers

Company	%
3i	+10.3
Ashtead	+8.4
Melrose Industries	+7.7
Rolls-Royce Holdings	+7.4
Compass	+6.7
Sage	+6.7

Bottom 6 Decliners

Company	%
Ocado	-13.7
Vodafone	-8.3
Croda International	-7.6
Burberry	-6.9
British Land Co	-6.7
National Grid	-4.9

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.08	+0.32
UK Govt 15yr Gilt	+4.37	+0.31
US Govt 10yr Treasury	+3.70	+0.30
France Govt 10yr OAT	+3.06	+0.23
Germany Govt 10yr Bund	+2.49	+0.23
Japan Govt 20yr JGB	+0.99	-0.02

Currencies

Pair	last	%1W
USD per GBP	1.244	-0.7
GBP per EUR	0.868	-0.2
USD per EUR	1.079	-0.9
JPY per USD	138.60	+2.8
CNY per USD	7.012	+0.9
USD per Bitcoin	26,906	+1.8

Commodities

Cmdty	last	%1W
Oil Brent $:bl	76.6	+1.5
Gold $:oz	1959.9	-2.9
Silver $:oz	23.6	-1.7
Copper $:lb	373.3	+0.4
Alumnm $:mt	2271.8	+3.4
S&P soft crops	252.1	+0.6

UK Mortgage Rate Estimates

Rates (LTV c.75%)	19-May	19-Apr
UK BoE base rate	4.50	4.25
2yr fixed	5.51	4.76
3yr fixed	5.29	4.55
5yr fixed	4.92	4.27
10yr fixed	4.87	4.36
Standard variable	7.41	7.22

19/05/2023
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

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk

Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE

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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