THE **CAMBRIDGE** WEEKLY

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DISCLAIMER

Markets take good news in their stride

Last week, we noted how the absence of specifically good news meant markets reacted more negatively than expected to the relatively low probability of a US debt default. We pointed out that the more notable event of the week had been bond yields once again surging.

Last week, not only did we get a resolution to the US debt ceiling brinkmanship, but also the welcome news that inflation pressures across Europe were declining faster than expected, while the US jobs market remains paradoxically both vibrant and, at the same time, showing signs of slowing down (with unemployment going back up). Unsurprisingly stock markets staged a brief relief rally on the debt ceiling resolution, but began wobbling again when Chinese, US and European manufacturing sentiment data showed sure signs of contraction.

On the back of this, bond yields stopped their ascent and declined over the course of the week on the expectation that the economic headwinds in goods manufacturing should persuade central bankers to stop hiking rates. The extraordinarily robust US job market figures on Friday did not appear to change this narrative for bonds, while equities took the strong economic news as outright positive for a change. This came despite expectations for the first rate cut being yet again pushed out further into the future – now only expected for January 2024 (back in January this year it was implied for the middle of the year).

It is heartening to observe how much more, compared to last year, equity markets are taking the return to higher yield levels in their stride. Particularly notable is that the growth companies of the tech sector, whose valuations suffered substantially last year under rising yields, seem to no longer be seen as growth companies this year, but safe haven investments, almost regardless of how sky-high their valuations (versus actual earnings) are – perhaps as a longer-term structural play. Markets appear to accept that rates and yields are unlikely to come down in the very near future as inflation proves stickier than anticipated (see our separate article on Europe, where inflation is seemingly declining particularly quickly). Yet in combination with a still booming services sector compensating against the activity slowdown wave in manufacturing, the notion that the global economy will avoid a painful inflation-busting recession became once again the narrative of the week.

There is little doubt in our mind (and analysis) that higher rates and higher yields for longer will leave more collateral damage in their wake, with housing one such area we write about in more detail this week. However, the unique post-pandemic set of economic variables has created ample monetary liquidity constantly searching for a better return, paired with plentiful jobs – and a higher-than-usual debt resilience of the proverbial weak links of the economy – pushing out recession expectations ever further. Perhaps to the point where manufacturing's overstocking in reaction to the post-pandemic demand surge has worked its way through and the service sector catches up to the same demand saturation level that manufacturing has painfully experienced since last year.

Concerns over China's lacklustre reopening recovery have been weighing heavily on China's stock market and have been one of the major recent risks in the hope for a global economic soft landing. Last week's news that Beijing is working on a sizeable property sector support package seems to be precisely what investors were looking for, given the jump with which Chinese stock markets reacted to the news.

In all, it was a good week for the optimists, and to justify their equity buying they would point towards the wider market expectation that yields will fall in the medium-term, making equities more attractive versus bonds again (and therefore not worrying too much over the profits squeeze hiatus in the interim). As to the already seriously expensive US stock market, those optimists would argue this is mainly driven by those companies that will shape our society's future, and therefore justify the hefty premium.

Pessimists will point to the higher-for-longer risks emanating from high interest rates and lending costs eventually driving down demand (and profits), causing a recession-triggering debt default cycle. They might also point out that US tech firms will have to generate almighty profits in the future to justify the current valuation hype.

The 'jury' of high-ranking forecasters remain split, but the week held more for optimists than pessimists. Whether it will stay this way over the coming weeks remains uncertain and will, from week to week, be driven by the interaction between falling goods and resource prices, and the stickiness in core inflation driven by the ongoing labour shortage. Stay tuned.

UK's housing market under pressure

Britain's housing market has fared reasonably well over the last year or so, all things considered. There was some price stagnation through the middle of 2022 (as shown by the flat mid-year performance of the UK house price index), and an almighty wobble following Liz Truss's October mini-budget disaster, but neither of these were as bad as they could have been. Last year saw the sharpest rise in interest rates in a generation, while Britons' spending power fell drastically at the same time thanks to surging inflation. This double whammy could have dragged demand (and hence prices) down with it – particularly given the UK's stretched affordability metrics – but as of March, average UK house prices were 4.1% higher than a year before. The fallout from the mini-budget that rocked mortgages in the autumn proved short-term too, with lending and prices recovering in the following months.

That resilience, however, is being tested now. Figures released last week show that the number of homes sold in April was 25% lower than a year before, and 8% below the previous month's figure. Rapid interest rate rises – and the fear of more ahead – are now clearly having a big impact. Last week, UK lenders pulled out of almost 800 mortgage deals. The number of residential mortgage deals have fallen by almost 7% in one week alone.

The falling number of house purchases is concerning enough on its own, as thin volumes often precede falling prices – sometimes sharply. Reduced mortgage offerings dampen the outlook further, almost certainly reducing demand for residential property. So far, the housing market has managed to escape the gloom engulfing most other parts of the UK economy. This is unlikely to remain the case for long.

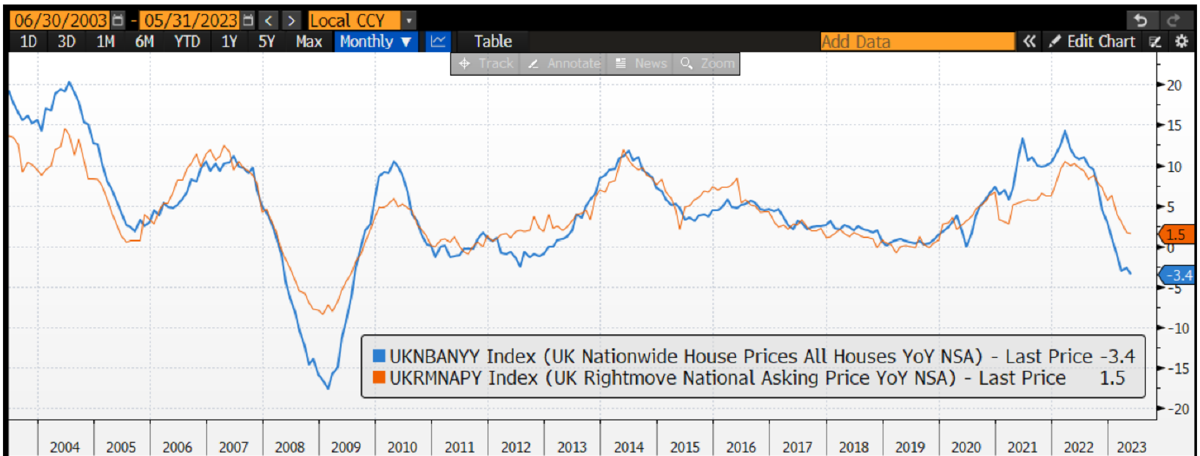
Rapid interest rate rises are by far the biggest concern. The Bank of England (BoE) delivered another hike recently to 4.5% and warned that its 2% inflation target is unlikely to be hit until 2025. This shift – following some relatively dovish tones earlier in the year – has raised markets' implied rate expectations to a peak of 5.3% by the end of 2023, according to Bloomberg. Even with that, the BoE expects annual inflation to remain as high as 5.1% come the end of the year, while April's inflation rate of 8.7% was above economists' expectations of 8.2%.

Higher rate expectations have caused a significant spike in government bond yields, with the UK's 10-year yield now topping 4% again, for the first time since last October. This in turn has forced banks and building societies to reassess their lending – leading to the dramatic mortgage constriction seen last week. Households looking for new mortgage deals are reportedly being told to expect fixed-rate deals well above 5%. According to Moneyfacts, the average rate on a two-year fixed mortgage went up four basis points over last week.

With these constraints, buyers will be much less able to afford house purchases. This would likely be a drawn-out process too, as the feed through from interest rates to actual purchases can take time. This explains why some sources, like property website Zoopla, are painting a much rosier picture of recent housing market trends. According to its analysis, the latest figures from this month suggest agreed home sales are at their highest point of the year so far, pushed up by prospective sellers returning to the market and prospective buyers regaining confidence.

Despite some rebound in activity, though, Zoopla reports that sellers are having to be 'realistic' in their asking prices, and nearly a fifth have had to cut their asking price by more than 5%. This chimes much more closely with what we see elsewhere, like reports that buyers are acutely aware of harsh economic and financial conditions. Interestingly, though, Zoopla suggests that higher mortgage rates themselves have only a limited impact on buyers, thanks to regulation introduced eight years ago which requires borrowers to prove they can withstand much higher repayments.

This regulation might make housing demand – and hence prices – a little more resilient than in previous downturns (certainly compared to 2008). But we suspect this will at most smooth any falls rather than materially reduce them. And thanks to stricter affordability measures, households may not default on their debt, but they can't spend the money in the real economy anymore, and therefore restrict overall spending. Mortgage and estate brokers agree that higher rates will inevitably hit demand hard – compounding the sudden shock of October. According to Mike Scott, chief analyst at estate agency Yopa, higher inflation and interest rate expectations will "mean that the housing market slowdown is likely to be longer and deeper than we originally anticipated."



Source: TattonIM, Bloomberg

To make matters worse, it is likely that the impact of rate rises on the housing market will increase over the rest of the year. Around 1.8 million households need to re-mortgage this year, and the majority of those have not yet done so. It is possible some are hoping rates will come down – or at least moderate – as the UK economy worsens. But all the latest communications from the BoE suggest the opposite. They are still extremely concerned about lingering inflation and are prepared to raise rates further if need be. When those households do re-mortgage, they could find themselves in an even worse situation. Given the improved mortgage criteria checks we mentioned, this should not lead to large scale distressed sales, but it will absorb discretionary spending ability which will hurt the wider economy

Nevertheless, this deterioration in affordability is likely to put downward pressure on prices, but we doubt falls will be drastic or long-lasting. Not drastic because of the persistent strength of the UK employment market, which is keeping people in their jobs, markedly different to previous comparable episodes. Not long-lasting simply because of structural weaknesses in the UK's housing supply, which prevents many building projects and means Britain's ratio of homes to people is among the lowest in western Europe. This partially explains why prices have been able to grow so dramatically despite increasingly stretched affordability. But while structural imbalances will alleviate downward pressure on prices, they are hardly anything to be pleased about. Like many structural imbalances in the UK, they are ultimately a barrier to long-term prosperity and a sign of malaise. The housing market's latest malaise is yet another example.

The Eurozone's inflation fight

Things turned out to be better in Europe than feared. In the run-up to last winter, the energy crisis was handled more efficiently than expected, which meant economic growth did not implode. Now, inflation numbers are coming down even more quickly across the continent than had been expected. German inflation fell to 6.3% in May, below the forecast figure of 6.8% and substantially lower than the previous month's 7.6%. France, meanwhile, saw annual price increases drop to a rate of 6%. For the Eurozone as a whole (6.1% year-on-year), inflation is back to levels seen at the beginning of last year. So, all looks bright, if it wasn't for the European Central Bank (ECB) having raised interest rates by 3.75% since last summer.

The good mood has excited some investors about Europe's prospects. Lower inflation will support households' real disposable income, most visible in Spain, where inflation unexpectedly dropped to near a two-year low. Spanish inflation is now running at just 2.9%, having stayed above 10% for three months last summer. Predictably, a dramatic reversal in energy prices is the main driver – especially for countries like Germany where little state intervention buffered prices hitting consumers. Over time, this should also feed through into wider goods and services to help alleviate second-round price pressures. Current core inflation readings of 5.3% are certainly still too high for central bankers targeting price stability around 2.0%. Not only households, but also energy-intensive companies must be relieved the war-driven energy crisis spared them the worst effects. With some relief, we can say that the worst of the European energy crisis is behind us, and surely not a moment too soon.

This was the good news. Another question to ask, similar to the US, is what is the price to pay to get inflation under control? European interest rates are currently the highest they have been since the Global Financial Crisis in 2008, following last year's rapid hikes to fight inflation. But the ECB's meeting last month delivered just a 0.25% hike, the smallest of this cycle and a signal that rates are approaching their peak.

News that inflation is falling faster than expected increases these expectations, with some investors now predicting the ECB could stop raising rates as soon as July. In any case, the market currently prices just about another 50 basis points from here.

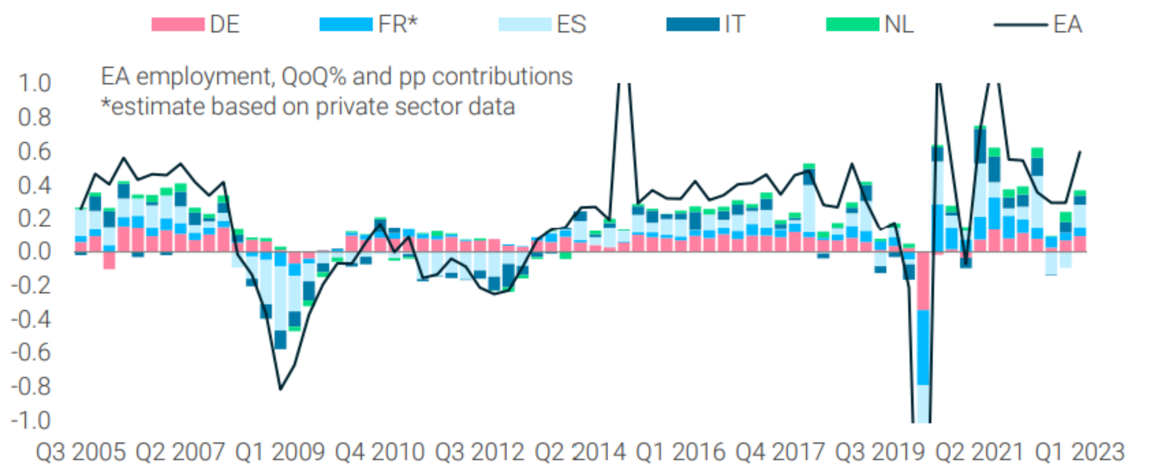
These are certainly encouraging signs, but we should not get ahead of ourselves. The ECB also watches core inflation – stripping out more volatile components like food and energy – which policymakers say they want to see lower before they ponder any easier monetary conditions. This measure will likely be a little slower to fall, as it is less sensitive to the dramatic energy price swings. There are still some big inflation pressures on the continent too, such as the higher-than-expected reading in Italy. Italian inflation fell to 8.1% in May from 8.7% previously – but this was still substantially above the 7.2% expected by economists.

The ECB's core concern is the dreaded wage-price spiral and the threat of the economy overheating. But diverging trends in the Eurozone economy make this a difficult problem to address at the aggregate level. For example, the outlook for European manufacturing is drastically different to that of the services sector, according to the latest business sentiment surveys. The Eurozone services purchasing managers index (PMI) – where a reading above 50 indicates expansion and vice versa – came in at a healthy 55.9 for May, but manufacturing recorded a dismal 44.6, below expectations and a sure sign of an ongoing contraction.

The two-track economy has implications for monetary policy. The data suggests manufacturing output prices closely follow input prices, albeit with some lag. Therefore, falling energy prices should give the ECB confidence that there is not much more inflation to worry about in manufacturing. Services, on the other hand, are showing much more persistent inflationary signs. Strong demand – a rebound from the winter cost-of-living contraction – has allowed service providers to up their prices, and higher wages are being passed on too.

The wage factor is a particular concern for the ECB. Like elsewhere, European monetary policymakers are concerned labour market tightness will enable a destabilising wage-price spiral. This may be surprising, given the Eurozone unemployment rate is currently at 6.5%, much higher than in the US or UK and, on the face of it, a sign that the labour market has room to tighten. As discussed here before, though, underlying this aggregate figure is significant labour tightening in the so-called 'peripheral' nations, particularly in central and eastern Europe. For decades, these nations provided significantly cheaper labour and hence tended to be a deflationary force on the Eurozone. But after years of catch up, they are no longer a deflationary force.

Chart 5: Further EA employment gains in Q1 keeps the ECB on its toes

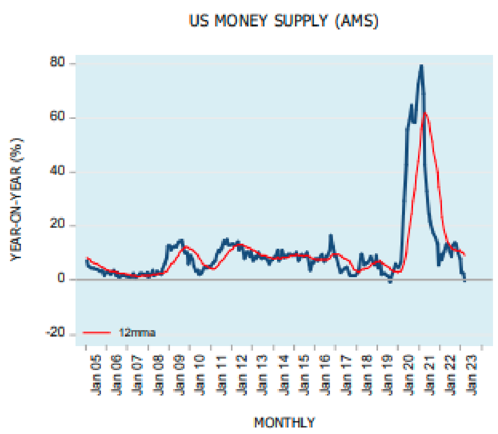


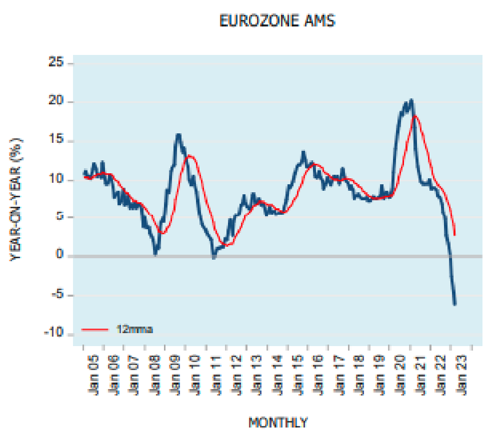
Sources: Eurostat, INSEE, Datastream, TS Lombard.

The chart above shows recent employment gains in Europe, which are fairly consistent across the region. The ECB pays great attention to these data points, as it considers a cooled labour market the key to taming underlying inflationary pressures, over the long-term at least. In that respect, the signals policymakers really care about – the 'sticky' prices – are not as positive as one might imagine from the headline data.

This is not to suggest that the ECB will follow the BoE's lead in nailing its hawkish colours to the mast, but merely to point out policymakers will probably be more cautious in believing the hype than some market participants. In particular, due to developments in services and wider labour market concerns, we expect the ECB to sacrifice medium-term economic growth for the sake of inflation fighting.

In a sense, this is clear already from the money supply data. The ECB has allowed European money to substantially contract – even compared to the US – despite its economy suffering from energy supply shortages and economic gloom (see chart below) . This attitude will continue until core inflation eases substantially. That could be as soon as the summer, but the ECB may still take some convincing.





Source: AAS research, May 2023

CAMBRIDGE
INVESTMENTS LIMITED

5th June 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	7578	-0.4	-0.4	↘ →	4.1	10.4	10.2	13.3
UK FTSE 250	19126	+1.8	+1.8	↘ →	3.5	12.5	11.7	14.6
UK FTSE All-Share	4141	-0.1	-0.1	↘ →	4.0	10.6	10.3	13.5
UK FTSE Small	6219	+0.7	+0.7	↘ →	3.8	9.6	8.4	12.8
France CAC 40	7247	-0.5	-1.6	→ ↗	3.2	12.4	12.1	14.1
Germany DAX 40	16015	+0.8	-0.2	→ ↗	3.6	11.4	10.9	12.9
US Dow	33306	+1.5	+0.0	→ →	2.1	17.8	16.7	16.4
US S&P 500	4254	+2.2	+0.8	↗ →	1.6	19.5	18.6	17.5
US NASDAQ comp	13216	+3.8	+2.3	↗ ↗	0.8	29.0	26.1	22.9
Japan Nikkei 225	31461	+1.4	+0.9	↗ ↗	1.9	18.3	17.9	16.7
World Bloomberg	1539	+1.8	+0.3	↗ ↗	2.4	13.8	13.6	13.8
China mainland	3862	+0.3	-1.2	↗ →	2.2	17.0	16.3	16.3
Emerging Bloomberg	1108	+1.1	-0.4	↘ →	2.5	11.9	11.2	12.0

Top 6 Gainers

Company	%
B&M European Value Retail SA	+16.8
Endeavour Mining	+11.8
Antofagasta	+7.9
Anglo American	+6.1
Airtel Africa	+5.6
JD Sports Fashion	+5.6

Bottom 6 Decliners

Company	%
Ocado	-12.9
Vodafone	-6.8
British American Tobacco	-5.4
Entain	-5.4
Diageo	-3.2
GSK	-2.9

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.14	-0.22
UK Govt 15yr Gilt	+4.39	-0.23
US Govt 10yr Treasury	+3.62	-0.21
France Govt 10yr OAT	+2.85	-0.27
Germany Govt 10yr Bund	+2.29	-0.25
Japan Govt 20yr JGB	+1.03	+0.01

Currencies

Pair	last	%1W
USD per GBP	1.254	+1.4
GBP per EUR	0.859	-1.0
USD per EUR	1.077	+0.4
JPY per USD	139.03	-0.8
CNY per USD	7.072	+0.1
USD per Bitcoin	27,122	+2.4

Commodities

Cmdty	last	%1W
Oil Brent $:bl	76.2	-1.2
Gold $:oz	1975.7	+1.4
Silver $:oz	23.9	+3.4
Copper $:lb	373.1	+4.2
Alumnm $:mt	2279.8	+4.2
S&P soft crops	245.4	+1.1

UK Mortgage Rate Estimates

Rates (LTV c.75%)	02-Jun	03-May
UK BoE base rate	4.50	4.25
2yr fixed	6.00	4.63
3yr fixed	5.78	4.38
5yr fixed	5.34	4.17
10yr fixed	5.20	4.38
Standard variable	7.41	7.41

6/2/2023
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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