THE **CAMBRIDGE** WEEKLY

12 JUNE 2023

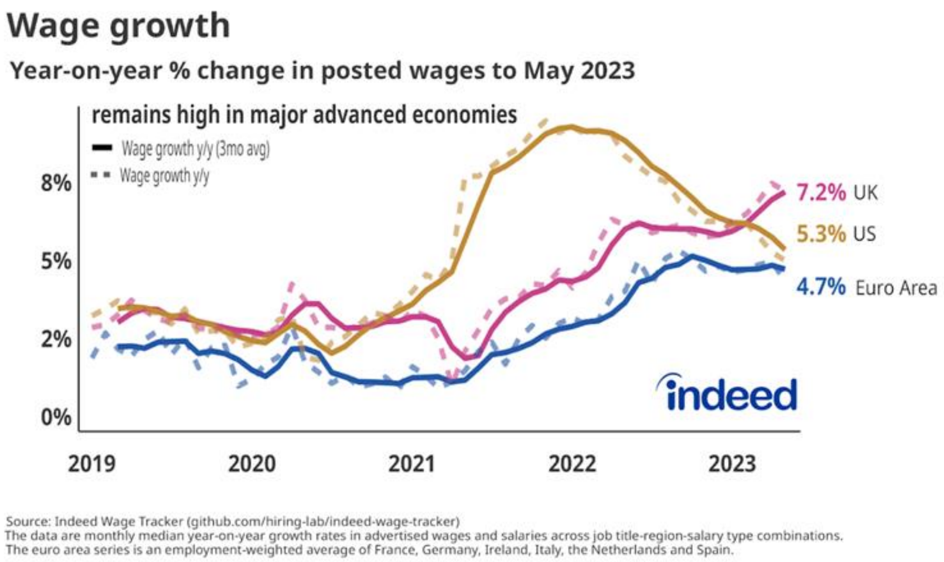
Lothar Mentel

Lead Investment Adviser to Cambridge

Immaculate disinflation sentiment cheers investors

Another positive week in global stock markets, which seemed unremarkable given it has been fairly good since the beginning of May. However, looking more closely – as we do – two market dynamics tell us more market participants are warming up to the narrative that bringing inflation under control, while still achieving a soft landing for the global economy, may be what 2023 brings. First, stock market gains over the past two weeks have been spreading to the mid and small-cap market segments, rather than coming from just a handful of mega-cap stocks. Second, falling inflation expectations mean recent yield rises in the UK have bumped up real yields, which can be interpreted as a sign of rising confidence.

This may all seem somewhat implausible against the ongoing data flow which suggests second-round effects would keep inflation persistently sticky. UK wage growth, according to online recruitment agency Indeed, has moved up to 7.2% year-on-year, roughly tracking core consumer price inflation (after the more volatile food and energy components are stripped out). Taken at face value, this would make the Bank of England particularly worried, and likely cause them to continue raising rates, which would be perilous for the medium-term prospects of the UK economy.



So, the conclusion that the recent rise in yields for gilts and other sterling-denominated bonds back to last autumn's levels (as we reported last week) may be due to worsening inflation expectations seems reasonable. Except that index-linked gilt yields rose almost as much up until the start of June. Indeed, it has been the rise in UK long-term real yields which has been moving other markets.

While fixed interest bond investors have been hurt by falling UK bond prices (which fall when yields rise), the rise in real yields could be signalling that global investors see better prospects for the UK economy and its companies over the medium to long-term. This view is supported by the other market dynamic of the smaller-cap and UK-centric FTSE 250 outperforming the more globally influenced FTSE 100 since the end of April, while sterling's trade-weighted index continues its rise which began after the trough of last year's Truss-Kwarteng mini-budget debacle.

So, although yields are almost as uncomfortably high as those dark October days, this time the markets do not seem to point to the UK as an inflation-ridden basket case. While the voting intention surveys tell us Keir Starmer could outshine Tony Blair's 1997 General Election victory, the political focus on competence and detail (from both sides of the political divide) is perhaps improving perceptions of the UK. Sunak's constant efforts to improve (trade) relations with our US and European allies may not win an election, but it is nonetheless valuable for our collective future and positively noted amongst investors.

Beyond the UK, the same could until recently not be said about US mid and small-caps as they were languishing amid the artificial intelligence (AI) ChatGPT craze and a rush for defensive mega-caps. Interestingly, June has so far seen something of a reversal here too, with the Russell 2000 mostly small-cap index rising about 8%, versus 4% for the mega tech-heavy NASDAQ 100. Europe also saw a similar move. Stocks of companies in cyclical sectors have generally done better, all of which suggests investors are gaining confidence that the headwinds to growth are turning towards tailwinds, which should prevent a recession. There are good reasons to think this might be the case. Globally, inflation driving excess demand and constrained supply capacity are no longer apparent.

Perhaps this is most evident in the oil market, where the Saudi commitment the previous week to cut production had no discernible effect on oil prices – perhaps because the cut may have been merely to offset an unseen increase in production from Russia. Backing this view up, last week saw trade and price data from China which indicated a sharp fall in energy costs but apparently an increase in volumes.

That same May data showed a further fall in overall producer prices (now running at -4.6% year-on-year versus April's -3.6%). Other Chinese data hints that domestic services demand is holding up, but global goods demand is hitting manufacturing exporters.

The overall situation has been enough to induce another policy move by the Chinese authorities, this time to ask banks to reduce interest payments to depositors (to which the banks are most happy to oblige) and to indicate a round of equity market support. There is plenty of liquidity in China, but depressed investor confidence has made valuations there notably cheap, so we may be in for a sharp bounce in Chinese equities should the authorities succeed.

Further China policy easing will be another tailwind, and not just for China. However, until the developed world inflation picture really improves, it is hard to share the recent market optimism as central banks will feel obliged to keep adding to the headwinds through further rate rises. Last week, the central banks of both Canada and Australia surprised markets by raising rates another 0.25%. Canada's pause since March proved to be just that, rather than the beginning of a reversal, while Australia hiked its rates again amid high wage pressure and labour shortages.

This week it could be the turn of the US Federal Reserve (Fed). Its Federal Open Market Committee will meet on Wednesday, and this time they are also due to provide us with another 'dots plot' survey, which indicates officials' expectation for setting rates over the coming quarters. Markets have come to expect another rate rise, if not this week, then in July.

For what it's worth, we are not so sure. The Indeed jobs data mentioned also has more timely weekly jobs posting numbers, helpfully split into 47 different business sectors. In the last two weeks, the vast majority have shown a decline, and at a quickening pace. As noted last week, May's payroll survey showed a sharp jump in the number of people employed but was quite downbeat in other areas, and the unemployment rate rose to 3.7%.

Another factor that may stay the Fed's hand is the resumption of US Treasury financing after the debt ceiling resolution. It may seem arcane but the central bank's current account must be replenished – by issuing large amounts of short-term government debt at competitive rates – and that could drag money away from those rather stressed US regional banks. After March's unnerving (and economy damaging) episode, another rate rise now risks worsening the situation and causing a second round of bank failures.

We wrote last week that optimists had gained the upper hand over the pessimists and last week's market gains tell a similar story. It seems that while markets are never without their worries even the pessimists may find it difficult to be apocalyptic when the sun shines.

May review – room for improvement but on the right track

Looking at aggregate returns for last month, you might think May was a dull affair for capital markets. In sterling terms, global equities were practically flat, gaining just 0.3%. This matches the small climb seen over the last three months: sterling investors saw the value of their global stock holdings grow 1% through the spring. But the seemingly prosaic headline figures hide some stark variation and nerve-wracking volatility. Markets bounced from fear to excitement and back, with the biggest concerns coming from the US debt ceiling drama and disappointing Chinese growth. As ever, the interplay between growth, inflation and expectations for central bank policy were key – leading to some regions and sectors being much more harshly punished than others. The table below shows returns for May across major regions and asset classes.

Asset Class	Index	May	YTD	12 months	2022	5-yr rolling annualised
Equities	UK Large Cap	-4.9	1.8	1.7	4.7	3.2
	UK Ethical Large Cap	-4.3	1.9	-1.3	1.1	0.6
	Europe ex-UK	-4.3	6.4	8.1	-7.6	6.8
	US Large Cap	1.9	6.4	4.7	-7.8	12.6
	US Technology Large Cap	7.4	20.4	9.9	-24.0	12.7
	Japan	3.3	5.4	6.3	-6.1	7.0
	Global Stocks	0.3	4.5	2.6	-8.1	6.8
	Emerging Markets	-0.3	-1.9	-6.9	-10.0	-0.7
Bonds	UK Gilts All Stocks	-3.4	-3.1	-15.7	-23.8	-4.2
	£-Sterling Corporate Bond Index	-2.4	0.2	-8.4	-18.4	-1.1
	Global Aggregate Bond Index	-0.5	2.5	-2.3	-12.2	-0.0
Commodities	Commodity Index	-4.8	-14.0	-22.8	41.9	2.2
	Brent Crude Oil Price	-8.3	-18.0	-36.1	24.4	-1.3
	Spot Gold Price	0.2	4.9	6.8	12.1	8.5
Inflation	UK Consumer Price Index (annual rate)*	2.0	-	8.0	10.5	-
Cash rates	SONIA 3-Month	0.3	1.5	2.5	1.1	0.9
Property	Global REITs	-2.3	-4.2	-12.5	-14.8	2.6

Source: Morningstar Direct as at 31/05/23. * to end of previous month (30/04/23). All returns in GBP.

UK investors will be more aware than anyone of last month's volatility and dispersion, as UK large-cap equities were among the worst performers of any developed market, falling 4.9% in May. Previously, the FTSE 100 had shrugged off much of the wider pessimism around the UK economy, evidenced by the index's strong performance in April. Persistent inflation and continued monetary tightening undid that goodwill, though. UK inflation fell in April, but not as much as expected – pushing the Bank of England (BoE) to issue more harsh warnings on interest rate rises. As markets digested the sharply higher rate probability, ten-year gilt yields rose near to the disastrous highs of October last year.

Though Britain fell furthest, European equities were not far behind, dropping 4.3% in sterling terms. That was despite some positive economic developments over the month, mainly around falling energy prices. The rapid drop-off in wholesale natural gas prices has been extremely welcome for European policymakers, leading to some unexpectedly low inflation numbers recently. Positivity even led to a record high for Germany's DAX index mid-month. But as we wrote recently, tightening labour markets (particularly in Europe's so-called periphery nations) and poor fiscal metrics will be keeping monetary policy tight. However, despite a similar monthly fall, European stocks are down by a much smaller 1.2% over three months.

Elsewhere, emerging market equities fell 0.3% in May. But this muted, virtually sideways trading should probably be seen as a win, given the disappointment around China. The world's second-largest economy – and by far the biggest component of MSCI's EM index – has been struggling under the weight of expectation for months now. It was hoped that the post-Covid reopening, and growth-supportive policies from Beijing, would turbocharge the Chinese economy in a similar way to the west's post-pandemic growth spurt. But recent data has proved much weaker than expected, leading to a stock market reversal. China's CSI 300 index fell nearly 6% in May, losses which have not been reversed since. Disappointing trade data was also a factor behind the aforementioned poor performance in Europe. The upcoming visit of US Secretary of State Antony Blinken – the first since the 'spy balloon incident' some months ago – could at least be a sign that relations with China's largest trading partner might improve. Beijing certainly has every incentive to pursue that improvement now.

On the other end, May's standout performer was Japan, with the TOPIX index rising 3.3% in sterling terms. Mid-May, it reached its highest value in 33 years – a feat it bettered last week. Moreover, the rally was broad-based across sectors, pumped up by improved consumer sentiment, optimism around manufacturing and – perhaps most importantly – growth in the technology sector. The world's third-largest economy looks perhaps the brightest it has since its market bubble burst three decades ago, something we dedicate a separate article to this week.

For all the Japan-specific hype, it is no surprise that its technology sector was one of the biggest return drivers. In the US, the S&P 500 rose 1.9% through May in sterling terms but, once again, the headline figure hides a huge amount of sectoral variation. Large technology stocks in the NASDAQ index stormed out in front of their market peers, returning 7.4%. In part, this reflects better-than-expected earnings results and the feeling that US interest rates are approaching their peak (since tech stocks are long-duration and therefore extremely sensitive to interest rates). But US tech investors seem to have also been swept up by the artificial intelligence (AI) craze. Since the release of ChatGPT a few months ago, investment has poured into AI-related companies – whether direct or indirect.

US large-cap tech stocks have gained 10.6% over the last three months and are up a staggering 20.4% since the start of the year. More favourable financial conditions are again a huge factor behind this, but the current AI drive – and crucially, its public visibility – has brought back a sense of long-term optimism in a sector which some saw as too concentrated or stagnant.

This is understandable, but as ever we add a note of caution. Productivity improvements are the ultimate drivers of long-term growth and should be celebrated, but short-term market mania can often be a detriment to those improvements. One only need look at cryptocurrencies over the last few years – or the dotcom bubble decades ago – to see these dangers. Hopefully, improving expectations for US monetary policy will keep the goodwill going in capital markets. After numerous financial and economic woes in the last year, an overexcitement problem would not be any help.

Japan's new rising sun?

Japan is having a moment. Over the last three months, Japan's stock market has been the best performing of all the headline regions we keep track of, in sterling terms at least. In the middle of May, the TOPIX index made a rare appearance in the UK financial media for reaching its highest level since the asset bubble burst in 1989. From the start of June, it has taken another leg up, rallying strongly last Monday and Tuesday, then moderating a little after that.

At the same time, the world's third-largest economy beat economists' expectations to record a 1.6% annualised expansion in the first quarter of this year. This meant Japan exited the technical recession – defined as two consecutive quarters of zero or negative growth - it was in for the second half of 2022. Inflation, something that has been virtually absent in Japan for more than three decades, came in at 3.5% in April – coming down from the 40-year high of 4.3% in January. Many investors, both foreign and domestic, expect wage growth will follow. For these reasons and more, markets are more positive about Japan than they have been for a generation.

Celebrating inflation might sound odd, given western economies are desperately fighting price increases. But deflation has been one of Japan's biggest problems during its stagnant period, reinforcing savings habits and holding back investment and growth. Inflation has now been running above the Bank of Japan (BoJ) 2% target for 13 months. But while these sustained price pressures are extremely unusual in Japan, the 3.5% April figure is hardly a cause for concern.

The comparative lack of runaway inflation allows the BoJ much more leeway than its global peers. Its interest rates have stayed anchored below 0%, in sharp contrast to the aggressive tightening seen in the US. Lately there have been signs of a rise in the BoJ's balance sheet. For foreign investors, this has helped underpin the belief that Japan is a safe haven in a risky world. In that sense, Japan's recent reputation as a slow but steady economy has been a benefit – compared to the recession risks in the US and Europe, as well as the recent disappointment around China's post-Covid rebound. The China factor is particularly interesting, as it seems many investors are using Japanese assets to gain exposure to Chinese growth without taking on the risks inherent in its assets.

From a long-term investment perspective, though, the most important change in Japan is its corporate reform drive and ensuing improvements in profitability. The Kishida administration is enacting plans for a "new form of capitalism" and hopes to double asset income, with the middle class encouraged to move low-yielding savings into high-return assets. Meanwhile, corporate bodies have become much more accepting of foreign activist investors – which have previously been culturally taboo.

Share buyback announcements hit a record in the 2022 fiscal year. The biggest example of these was printing conglomerate Dai Nippon, owned by foreign firm Elliott Management, which issued around $2.2 billion worth in share buybacks, nearly a quarter of its market cap. Corporate profits also hit a record high last year, while the Tokyo Stock Exchange has been pressuring companies to return more money to shareholders.

The rise in profitability has been one of the most important factors behind Japan's resurgence. For so long, it has been seen as a graveyard for corporate returns. Higher inflation and structural corporate changes have enabled not just high profits now, but higher margins and therefore profit expectations for the future. As a symbol of investors' changing attitudes to Japan, Warren Buffet's Berkshire Hathaway reportedly increased its Japanese holdings recently.

Before getting carried away, we note Japan has generated similar hype in the past, only for market rallies to peter out when the economy inevitably disappoints. Current detractors point to the fact that inflation is mostly coming from global factors, rather than domestic price pressures, as well as Japan's cyclical sensitivity. Ties with China have been a positive for Japan in the past, but China's recently disappointing growth has turned this factor into a negative for now.

Interestingly, according to data from FactSet and Bloomberg, the rise in profitability across a broad index of Japanese stocks has gone hand-in-hand with the recent slide in the value of the yen. When you translate profits and sales revenues into dollars, it takes away almost all the aggregate level growth seen recently. Some have therefore argued that Japanese profitability is only a consequence of the falling currency value, and not a sign of genuine underlying improvement.

This is an important counterpoint to market optimism, but it is much too simplistic to say this is the whole story. The rise in profitability is not just linked to exporters but is broad-based across the whole economy. That means domestic companies – with inputs and sales all counted in yen – have seen similar improvements to their bottom lines. With the home bias among Japanese consumers, we would not expect this if currency depreciation was the only factor at play.

Turning this story on its head, one could just as well argue it is a positive that Japanese profits have kept up in dollar terms – something that has been difficult in the past. Moreover, the fall in the yen will have secondary impacts on Japanese exporters, making their products more attractive. If this continues with domestic corporate improvements and economic optimism – as seems to be the case at the moment – it will only strengthen the case for Japan as an investment destination. Japan always does best when it is outward facing and connected to the global economy. Thankfully, its policymakers and company directors now seem to recognise that fact.

CAMBRIDGE
INVESTMENTS LIMITED

12th June 2023

Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Short Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7556	-0.3	-0.3	→ →	4.2	10.4	10.3	13.3
UK FTSE 250	19047	-0.4	-0.4	→ →	3.5	12.5	11.6	14.6
UK FTSE All-Share	4129	-0.3	-0.3	→ →	4.1	10.6	10.4	13.5
UK FTSE Small	6256	+0.6	+0.6	→ →	3.8	9.6	8.4	12.9
France CAC 40	7209	-0.5	-0.9	→ ⬀	3.2	12.3	11.9	14.1
Germany DAX 40	15967	-0.3	-0.6	↗ ⬀	3.6	11.3	10.8	12.9
US Dow	33794	+1.5	+1.1	⬀ →	2.1	17.9	16.8	16.4
US S&P 500	4303	+1.1	+0.8	↗ ⬀	1.6	19.6	18.6	17.5
US NASDAQ comp	13294	+0.6	+0.3	↗ ↗	0.8	29.4	26.3	22.9
Japan Nikkei 225	32195	+2.3	+1.8	↗ ⬀	1.9	18.7	18.2	16.7
World Bloomberg	1555	+1.0	+0.7	↗ ⬀	2.3	14.0	13.8	13.8
China mainland	3837	-0.7	-1.8	↗ →	2.1	17.3	16.6	16.4
Emerging Bloomberg	1120	+1.1	+0.8	⬂ →	2.4	11.9	11.1	12.0

Top 6 Gainers

Company	%
Ashtead	+7.0
Melrose Industries	+6.6
Hargreaves Lansdown	+6.5
Ocado	+6.2
abrdn	+5.7
Airtel Africa	+2.7

Bottom 6 Decliners

Company	%
Croda International	-15.0
Endeavour Mining	-8.0
JD Sports Fashion	-7.2
Beazley	-6.3
Flutter Entertainment	-4.5
J Sainsbury	-4.4

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.25	+0.11
UK Govt 15yr Gilt	+4.48	+0.09
US Govt 10yr Treasury	+3.75	+0.13
France Govt 10yr OAT	+2.94	+0.09
Germany Govt 10yr Bund	+2.39	+0.10
Japan Govt 20yr JGB	+1.02	-0.01

Currencies

Pair	last	%1W
USD per GBP	1.258	+0.3
GBP per EUR	0.856	-0.4
USD per EUR	1.077	-0.0
JPY per USD	139.30	+0.2
CNY per USD	7.132	+0.9
USD per Bitcoin	26,665	-1.7

Commodities

Cmdty	last	%1W
Oil Brent $:bl	75.8	-0.5
Gold $:oz	1962.4	-0.7
Silver $:oz	24.2	+1.2
Copper $:lb	379.3	+1.2
Alumnm $:mt	2222.3	-2.5
S&P soft crops	250.9	+2.7

UK Mortgage Rate Estimates

Rates (LTV c.75%)	09-Jun	10-May
UK BoE base rate	4.50	4.25
2yr fixed	6.15	4.63
3yr fixed	5.92	4.39
5yr fixed	5.45	4.17
10yr fixed	5.25	4.34
Standard variable	7.44	7.35

09/06/2023
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

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.

LOTHAR MENTEL