CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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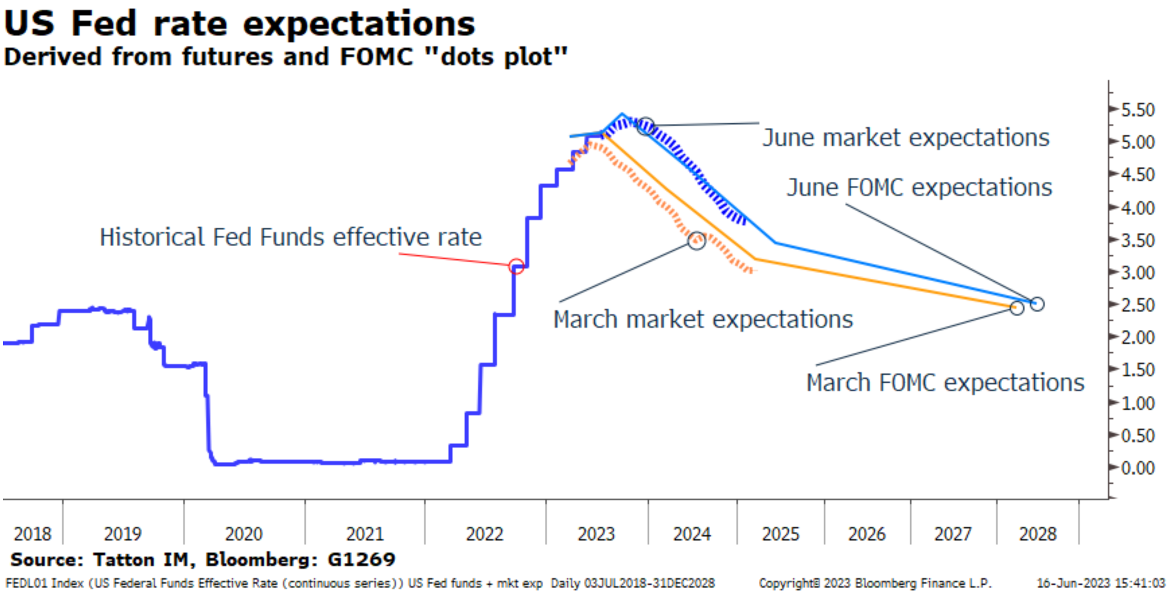
Market conundrum amid volatile growth

Last week saw equity markets move higher yet, despite central bank hawkishness. We had another 0.25% rate rise from the European Central Bank (ECB) and, although the US Federal Open Market Committee (FOMC) left rates unchanged, they gave us strong hints of at least another 0.25% hike in July. They also indicated their expectation for rates to stay higher for longer than many think.

The FOMC's 'dots plot' is published every quarter and shows how the US rate setters see the path of rates unfolding over the coming months and quarters. June's plot is markedly higher than the committee's estimates back in March, as per the chart below:



The backdrop to this change is that the 23 March meeting came in the days immediately following the Silicon Valley Bank demise, when many thought the financial system was close to a dangerous precipice, and that a rash of corporate bankruptcies were just moments away.

As a consequence, many among the FOMC thought that in order to regain stability in the financial system, rates might have to be lowered before the end of the year. In anticipation of worsening financial conditions, the Federal Reserve (Fed) had additionally already acted by pushing liquidity into the system and even considered giving all depositors a blanket guarantee on their checking accounts.

We can now see that those actions were effective. They reduced risks in the system and helped to stabilise confidence in banks and other finance houses. Indeed, now, if one were to look only at the US equity indices, you would think that confidence is brimming.

On 23 March, the S&P 500 stood at 4,000. It is now above 4,400, 10% higher. The S&P 500's expected earnings-per-share (on a next 12-month basis) have also risen, by a reasonably substantial 2%, although less than equity prices (Bloomberg calculated that analysts' estimated earnings-per-share was at $224.60 on 23 March; as of last Friday, Bloomberg calculates it at $228.90).

There have been rises in US Treasury yields and falls in credit spreads, both of which suggest a rise in confidence about the US economy. However, the economic data suggests a much more mixed picture. On the one hand, consumers remain pretty confident as inflation declines, wage gains start to outpace price rises and there is very little fear of losing their job. On the other hand, companies are not so sure and are no longer hiring as much nor increasing wages as quickly. Indeed, the pace of hiring seems to have slowed significantly in the past three months, and paid overtime has slumped, according to both government-sourced data and employment agencies such as Indeed. Also, almost all sectors are now affected, not just the IT sector.

Interestingly, business confidence survey data is swinging quite sharply. For example, the New York State purchasing manager index swung from May's -31.8 to June's +6.6, a change of over 38 points. Over the last six months, the index has swung more than 30 points month-on-month on average. The average pre-pandemic change was less than 10 points.

Outside the US, the economic picture is also mixed. The UK may be skirting recession rather than plunging and for similar reasons to the US – consumers feel confident that earned income is rising enough to allow them to continue to spend. Germany is in recession, but it is mild, and the decreasing demand is centred on businesses rather than consumers.

But the west's continued growth is not assured, precisely because our central banks still have more work to do to quell second-round inflation pressures from the self-enforcing dynamics of wage rises. The Fed and the ECB told us that last week, and unlike the Fed, the Bank of England (BoE) will most certainly raise UK rates this week. Yet, as we said earlier, markets appear to be behaving as if growth is set to rise sharply, despite institutional investor sentiment surveys showing only a little improvement in confidence.

It may be that a combination of circumstances has increased the pool of money available to be invested. While institutional investors are cautious on growth drivers, the increase in cash rates has stabilised savings ratios. People are spending but they also appear to be saving out of their rising incomes.

One interesting thought comes from Andrew Hunt Economics. Perhaps the March turbulence in the US financial system has created a boost to financial market liquidity. He thinks that the shift of deposits away from regional banks has left the larger banks with a conundrum about what to do with their increased deposits. The lending surveys tell us that banks wish to be cautious lenders, and that real economy borrowers are few and far between. However, the money may have found its way out to financial borrowers – such as hedge funds – that have decided to ride the up wave and fuel the markets with their buy orders.

It is very difficult to verify such a theory. However, we noted how expensive equity markets had become in May and, since then, it has become more extreme. The S&P 500 is now 28% more expensive than our historical model of earnings and yields would suggest, a level that has not occurred in over 20 years. Such an optimistic level is only justifiable if we are moving into a significantly higher real growth and inflation environment, as was the case during the second half of the 20th century. One would have to think that central banks will give up on constraining inflation to their targets through higher rates in the medium-term, a judgement which we think is way too early to make now.

While, of course, we welcome the rise in global markets, we think this 'pricing for perfection' will leave markets highly vulnerable to any adverse data points. In our view, investors would be well advised to search for quality in what they buy and exercise a little caution, rather than chasing the broad equity markets higher.

Against this optimistic outlook, and few signs of meaningful economic slowing, western central banks are raising rates – however, that's not the case in Asia. Last Friday, Bank of Japan Governor Kazuo Ueda maintained the easy policy regime. The yen weakened to the year's weakest point of Y141.5 against the USD. This comes after the People's Bank of China (PBoC) cut policy rates in the middle of last week. China's easing of policy is both monetary and fiscal, with the authorities promising to bring in as yet undefined measures to help the ailing property market. The PBoC also hinted at measures to push funds into the domestic equity markets. Chinese shares got a bit of a boost and ended last week as one of the better markets after a period of underperformance. We will discuss China in more detail next week.

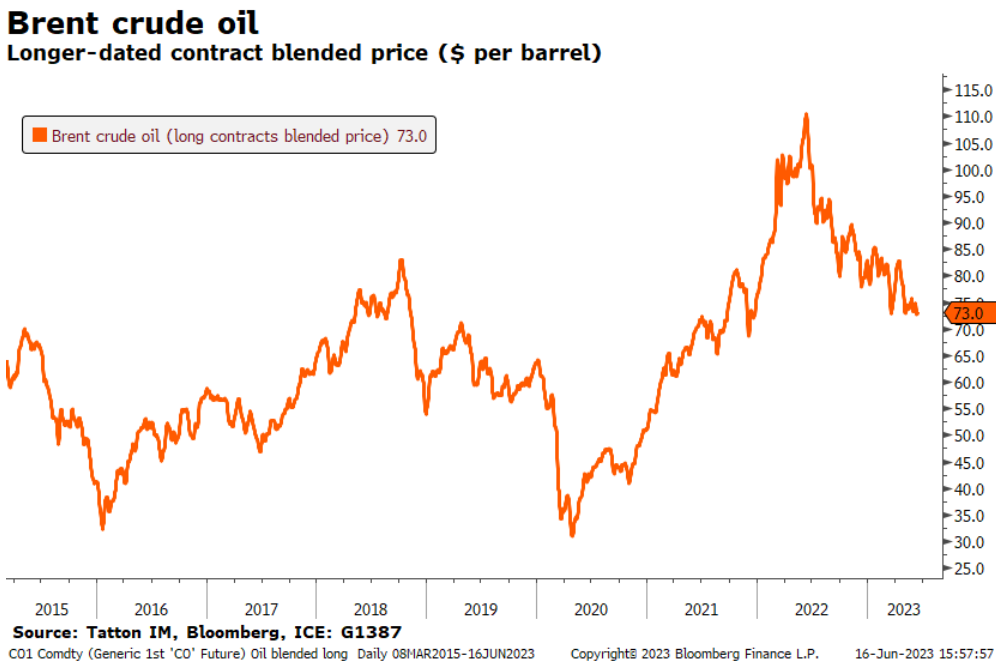
Back home, European gas prices rose quite sharply after the Netherlands announced the closure of the North Sea's largest gas field. Still gas prices have been falling through this year and the rise is minor so far. European equities remained positive but this turn bears watching. We cover oil demand in a separate article below.

Lastly, we return to our own central bank, the BoE. After wage rises were shown earlier last week to be rising much more sharply than elsewhere, a rise in base rates is again imminent. Long bond yields fell back a bit from midweek highs but are still now among the highest in developed countries. Against this, sterling is rising, which perhaps signals non-UK investors see those yields as attractive and staying high for longer than elsewhere.

For UK households with mortgage debts to service, it certainly is bad news and, while unlikely to lead to a UK property market crash, it will start to curtail disposable incomes. This will inevitably slow the still-buoyant demand for services, which is precisely what the BoE is aiming for to bring inflation under control. A self-regulating dynamic then, allowing the BoE to step off the brakes as soon as demand dwindles. Alas, all this happens with considerable time lags which are fiendishly hard to project and therefore very easy to get wrong. We do not envy the task in hand for central bankers at the moment.

Peak oil?

Oil prices took another step down in the early part of last week. Brent crude, the international oil benchmark, dropped to just $71 per barrel (pb) during Monday trading. Tuesday and Wednesday saw a slight recovery but, at the time of writing, prices are still below where they were the previous week. This is a continuation of the bear market since mid-April, as global growth pessimism and disappointments have filtered through into markets' expected energy demands. In truth, though, crude prices have been on a downward trend for a year. After a peak of more than $110pb in June 2022, oil demand has severely weakened and prices have consistently fallen, only occasionally punctuated by sputtering short-term relief rallies.



Some of this is down to supply chain kinks evening out. The disruption to global energy markets from Russia's invasion of Ukraine sent oil prices rocketing, but there is now clear evidence Russian supplies have largely been diverted to Asian buyers, supposedly creating a 'two-tier' market that balances out different sources of supply and demand. Since the end of 2022, Brent prices have been consistently lower than on the eve of Russia's invasion.

Weaker demand is the more important factor, though. The slowing of western economies has been apparent for some time, on the back of monetary tightening and cost of living crises. Tellingly, OPEC has had to reduce its output multiple times to prevent sharp price falls. Lately, the biggest disappointment has been China. The world's second-largest economy was expected to undergo an energy-intensive growth spurt following its reopening, but activity has continued to disappoint over the last few months. Both OPEC and the International Energy Agency (IEA) still expect Chinese oil demand to be a big factor in the second half of 2023, but many market analysts have their doubts.

Pessimism about Chinese growth overall is not the only reason for those doubts. Underlying the weak demand forecasts is a structural decoupling of economic activity from fossil fuels. While Beijing has pushed environmental policies for a long time, when China has most needed growth, its policymakers have generally resorted to energy-intensive sources like industrial production. This year, policy support has been much more focused on less carbon-heavy sources. Moreover, this decoupling is happening across the world – with US and European policymakers pushing hard toward green investment.

Citigroup's Ed Morse, talking to the *Financial Times* last week, pointed out the elasticity of oil demand – its reaction or proportionality to global growth – has greatly diminished since the pandemic, and is only going to fall further. The IEA admitted as much in a report published last Wednesday, where it predicted growth in global oil demand would peter out before the end of this decade. It expects additional crude oil demand of around 2.4 million barrels a day this year but expects that growth to slow to just 400,000 by 2028. That would leave the world's daily oil needs at 105.7 million barrels in five years – with growth coming mainly from petrochemical and aviation sectors.

However, the IEA expects global production capacity to grow to 111 million barrels per day over the same timeframe. If both predictions came true, that would mean 4.1 million spare barrels of crude per day, concentrated mainly in Saudi Arabia and the United Arab Emirates (UAE). If governments are serious about net zero emissions targets over the next five years, the IEA's predicted scenario would mean a structural oversupply with no real demand prospects – demand will dry up before oil reserves do.

This is unsurprising as a long-term scenario – analysts have prophesied 'peak oil' for decades – but the fact peak oil has entered into medium-term forecasts is significant. We wrote last year about how energy companies, despite taking in record profits through the Ukraine war, failed to generate much interest from investors (subsequently sending their price-to-earnings valuations to the sky). The looming structural oversupply was the biggest factor behind investors' reluctance; they saw energy companies as there for a good time, not a long time.

According to the IEA, though, the current investment (in production capacity, at least) is probably still too high. The agency expects upstream oil and gas investment to hit $528 million in 2023, the highest figure since 2015. It thinks this investment will cover medium-term demand and surpass "the amount that would be needed in a world that gets on track for net zero emissions."

There are a couple of different ways to interpret this. On the one hand, you might think – as the IEA seem to suggest – that there is currently overinvestment in oil and gas, which will result in an oversupply when regulatory and societal changes kick in, and potentially an array of stranded assets which could be damaging for the financial system. The seemingly quick uptake of electric vehicles in recent years, along with energy efficiency drives across all major sectors, backs up this interpretation. On the other hand, you might just think that markets do not believe net zero targets will actually be met. Environmental backsliding since the war in Ukraine started (particularly in the UK and Europe), as well as past failures to meet targets, back this up.

Neither are comfortable scenarios to be in, but the latter would clearly be worse for the world, seriously threatening to breach global temperature targets (either the 1.5°C rise above pre-industrial levels suggested by many scientists or the more liberal 2°C rise preferred by policymakers). As well as the obvious environmental and social crises, extreme weather would likely destroy productive capacity. That is to say, over the long-term, oil demand will have to come down one way or the other – through choice or circumstance. Short-term upsides in the oil price might still be had, but the longer-term pessimism is now definitely in view.

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19th June 2023

Global Equity Markets

Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Technical Short	Technical Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7648	+1.2	+1.2	→	→	4.1	10.7	10.5	13.3
UK FTSE 250	19094	+0.2	+0.2	→	→	3.5	12.5	11.7	14.6
UK FTSE All-Share	4173	+1.1	+1.1	→	→	4.0	10.8	10.6	13.5
UK FTSE Small	6269	+0.2	+0.2	↗	→	3.8	7.2	6.3	12.8
France CAC 40	7387	+2.5	+2.2	→	↗	3.1	12.7	12.3	14.1
Germany DAX 40	16406	+2.7	+2.5	↗	↗	3.5	11.5	11.1	12.9
US Dow	34508	+2.1	+0.1	↗	→	2.1	18.2	17.1	16.4
US S&P 500	4444	+3.3	+1.3	↗	↗	1.6	20.3	19.2	17.5
US NASDAQ comp	13856	+4.2	+2.2	↗	↗	0.8	30.3	27.1	22.9
Japan Nikkei 225	33543	+4.2	+0.6	↗	↗	1.8	19.6	19.1	16.8
World Bloomberg	1605	+3.2	+1.2	↗	↗	2.3	14.5	14.3	13.8
China mainland	3963	+3.3	+1.5	↗	↗	2.1	17.8	17.0	16.4
Emerging Bloomberg	1152	+2.9	+0.9	↘	→	2.4	12.3	11.5	12.0

Top 6 Gainers

Company	%
Ocado	+20.2
Glencore	+9.8
CRH	+7.3
Antofagasta	+6.1
Auto Trader	+5.7
Croda International	+5.4

Bottom 6 Decliners

Company	%
BT	-7.1
Hargreaves Lansdown	-4.6
Segro	-4.6
Admiral	-4.5
Barratt Developments	-4.1
Entain	-3.8

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.41	+0.16
UK Govt 15yr Gilt	+4.58	+0.10
US Govt 10yr Treasury	+3.77	+0.02
France Govt 10yr OAT	+2.99	+0.06
Germany Govt 10yr Bund	+2.49	+0.10
Japan Govt 20yr JGB	+1.00	-0.02

Currencies

Pair	last	%1W
USD per GBP	1.282	+1.9
GBP per EUR	0.854	-0.2
USD per EUR	1.095	+1.7
JPY per USD	141.39	+1.5
CNY per USD	7.122	-0.1
USD per Bitcoin	25,537	-4.2

Commodities

Cmdty	last	%1W
Oil Brent $:bl	75.8	-0.0
Gold $:oz	1958.0	-0.2
Silver $:oz	24.0	-1.0
Copper $:lb	390.2	+2.9
Alumnm $:mt	2213.7	-0.4
S&P soft crops	249.0	-0.2

UK Mortgage Rate Estimates

Rates (LTV c.75%)	16-Jun	17-May
UK BoE base rate	4.50	4.50
2yr fixed	6.33	4.63
3yr fixed	6.10	4.39
5yr fixed	5.60	4.17
10yr fixed	5.34	4.34
Standard variable	7.44	7.35

16/06/2023
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

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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.

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