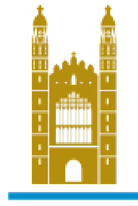

CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

26 JUNE 2023

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Markets catching up with reality

Following three weeks of 'not a lot of news' being good news for stock markets, bad news dented investor sentiment last week. This has coincided with some reversal of global liquidity, as the US government is once again stepping up fundraising to replenish its coffers and Pan-European business sentiment surveys ticked down. No surprise then, that risk assets experienced a mild sell-off that reversed some of June's gains. Hardest hit were China, Europe and the UK, but for inherently different reasons.

China suffered from a paucity of information. After having created much anticipation of policy action in early June, its central bank edged rates lower, while the government failed to announce any concrete support measures. China's equity market therefore unwound some of its recent outperformance. We write about the recent disappointment in the second article.

It was a 'big' week for the UK in information and sentiment terms. We write below about the UK's interest rate rise, inflation data and bond markets. There is no doubt the UK's data even had an impact on economist and investor views across other regions, but the UK's stubbornly high inflation now clearly stands out against its peers' falling rates of inflation.

Looking back over the past year-and-a-half, Europe, the UK and (to a slightly lesser extent) the US have faced very similar input cost pressure from rising energy, food, and commodity prices. Now the energy, food and commodity price pressures have eased, which has led some economists to predict a path of 'immaculate disinflation' – namely falling headline inflation, leading to falling inflation expectations, lower wage settlements, continued sustained profitability and growth – and the avoidance of recession.

But some economic research groups, such as Fathom Consulting, have been warning for months that the second and third-round effects of inflation caused by the initial shock of goods and energy prices were feeding through and should not be underestimated. Last week's data strengthens their case – particularly for the UK. Until recently, the west's experience of inflation was broadly similar. So too were the structural issues, with tight labour markets pitted against companies with strongholds on their markets and savings-rich consumers making up for spending less during the pandemic years. Therefore, why would the UK be different from other regions?

We have noted before how surveys of inflation expectations are helpful only to historians. What matters is inflationary behaviour. Some of this behaviour can be observed in wage negotiations (and the degree of conflict the parties are willing to withstand, usually seen as strikes), and actual price setting. Another is in the levels of borrowing. If a company can be confident that current levels of revenue and profit growth have stepped up despite inflation and rises in interest rates, they will borrow to grow their business.

The outstanding amount of corporate bonds (as calculated for Cambridge using data from the Bloomberg Barclays Global Corporate Aggregate Index) is shown from the start of 2020.

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26th June 2023

Global corporate bonds outstanding

Bloomberg Barclays Global Corporate Aggregate par value outstanding (Index)

Source: Tatton IM, Bloomberg: G1420

LGCPTRUU Index (Bloomberg Global Agg Corporate Total Return Index Value Unhedged USD) BBG gl corp agg outstand Daily 20JAN2020-23JUN2023 Copyright® 2023 Bloomberg Finance L.P. 23-Jun-2023 15:00:25

After a huge take of borrowing in the early part of 2022 amid the start of rate rises, we got to a high point in October. This was when global activity started to show responses to the rising rate pressure. Subsequently, companies pulled back, only to go on a spurt of borrowing at the start of 2023 and then again during May as bond yields and credit spreads temporarily fell back.

That coincides with the burst of liquidity in markets seen during the following weeks. Now, we know we shouldn't read too much into such indicators. Other signs from the loan markets and from the wider monetary measures tell us that things have been tighter, especially for smaller firms that have to raise debt through banks. However, we also shouldn't ignore them. The willingness to borrow suggests that, at least for the larger companies, they are willing to rollover their borrowing at the higher rates rather than try and reduce their debt piles significantly.

This poses a conundrum for the central banks, of course. They were very hopeful that input cost falls would lead to 'immaculate disinflation', but the UK experience says it might not happen for them. While the UK's situation is exacerbated by its own particular issues, there are enough issues in common for the UK data to be salutary for everybody.

That means central banks' stated bias towards more tightening should be seen as meaning at least one more round of rate rises. Liquidity, which moved up in the second quarter, is likely to be squeezed again through the summer. Against that backdrop, risk markets are unlikely to storm away.

However, despite the many discussions about loss of central bank credibility, long-term real yields (i.e., after subtracting inflation expectations) are stable at around 1%, with long-term market expectations of inflation between 2-2.5% (except for Japan). Meanwhile, credit spreads are at mid-to-lowish levels, thereby indicating few concerns of capital markets about a looming recession. These are indicators of stability and, in central bank terms, success.

We only have to look at Türkiye to see what central bank (and government) failure actually looks like. Following his election victory, Erdogan appointed a new economy tsar, Mehmet Simsek, who has persuaded the president that orthodoxy must be restored. Hopes were that this would mean getting rates up to near inflation levels (currently +40% year-on-year). Rates were raised from 8.5% to 15% last Thursday, and the Turkish lira slumped another 7% after the 20% decline following the election.

Sterling is not showing such a decline. In fact, during the last three months' inflation surge, sterling has strengthened.

If the resolution to the inflation problem lies in overcoming a structural shortness of labour – and in the UK's case free trade – then central banks cannot solve it with what's in their toolkit. Structural, supply-side problems can only be dealt with by far-sighted government policies in conjunction with a discouragement of inflationary demand-side behaviour. Of course, the former takes time and money, and it doesn't feel like we have a lot of either of those at the moment. Nevertheless, we hopefully have serious politicians with the staying power to see it through. The resilience of sterling and the positive real yields tell us markets are currently giving politicians (and central banks) the benefit of the doubt. However, this does not yet equate to a stable market environment based on the expectation of a return of sustained growth. Such fragile sentiment is therefore easily disturbed by wrong-footed political action or unanticipated data points, as was the case over last week.

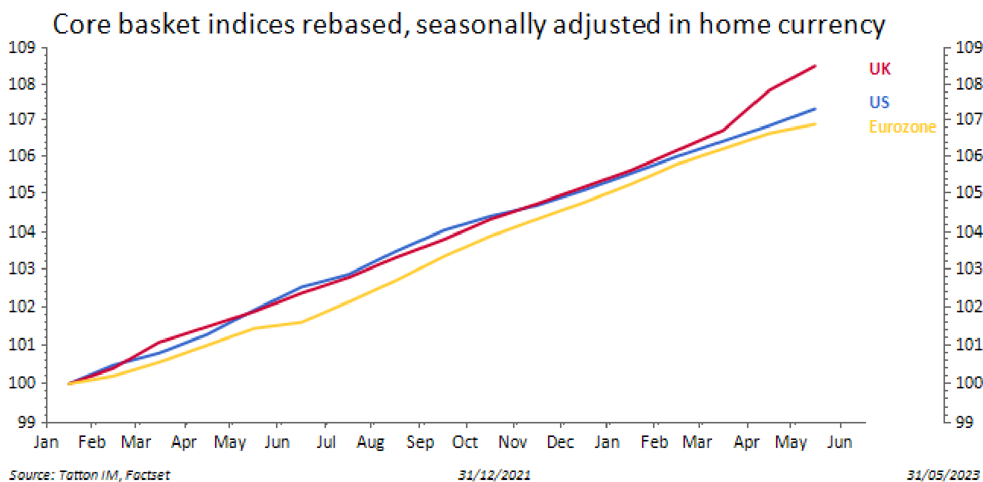
Bank of England caught in a bind

Last week's UK inflation report was grim reading. May's Consumer Price Index (CPI) level was 8.7% higher than a year ago, unchanged from April and the highest inflation reading of any G7 nation. It was yet another reminder, if anyone needed one, that the UK economy's problems need urgent attention.

Prices keep going up while growth prospects keep going down. At many points in the past few years, such stagflation prospects could be put down to extraordinary factors, like unprecedented global supply issues and the pandemic hangover. However, the impacts of those factors are diminishing. Global input prices are falling and – everywhere else – inflation is falling with it. Moreover, the 12-month rate comparison base is from a time (May 2022) when prices were already uncomfortably high. As explanations of the current inflations, external factors are not enough.

Britain's problems are mostly its own. Core CPI inflation, stripping out volatile items like food and energy, rose to 7.1% in May (versus prices in May 2022) – its highest year-on-year pace since 1992. The services sector was a big contributor, suggesting wage rises and business pricing power were two of the main drivers.

And the swing up in inflation is recent. The UK economy has remained stronger than expected, but that resilience is being translated into recorded inflation rather than growth. Below is a chart showing the passage of core prices (rather than the inflation rate) in the UK, US and Eurozone:



That is horrible news for the Bank of England (BoE), which has been rapidly raising rates in fear of this exact scenario. It seems the dreaded wage-price spiral – where wages react to prices and vice versa in a vicious cycle – may be upon us. The average wage/earnings data showed an acceleration to 7.2% year-on-year while market-cap-weighted corporate profit growth in the FTSE 350 has been at above 10% annualised for the past half-year.

Naturally, the news has mounted pressure on the BoE to raise rates further. Its Monetary Policy Committee (MPC) met last Thursday and announced another 0.5% rise – as well as indicating more were likely to come. But despite starting its rate hiking cycle earlier than most other central banks, accusations that the MPC is behind the curve on inflation – accusations that started late last year – are only growing louder.

In such a high-stakes scenario, finger-pointing is understandable – and few can deny the MPC has questions to answer about its policy response (along with central bankers around the world, perhaps). But, in truth, it is hard to say exactly what the BoE should be doing differently, at least over the last few months. Rate hikes have kept coming and the messaging has remained stern – with Governor Andrew Bailey even going as far as to implore citizens not to ask for wage rises.

Worryingly, the BoE's main tools for fighting inflation have proven ineffective. Interest rates compress borrowing through increasing the benchmark rate against which credit is priced. In particular, mortgage rates are highly sensitive to BoE policy, and hence – indirectly – so are house prices. But price increases have become somewhat detached from credit conditions. Individual wages and company profit margins seem to be the main driving forces, and both are impacted much more by supply expectations than borrowing rates.

After Wednesday's inflation data release, renowned economist Mohamed El-Erian wrote on Bloomberg that, over the long-term, bringing UK inflation under control cannot be achieved through rate rises alone. Supply-side changes are crucial, particularly for the post-Brexit era of an increasingly isolated labour and goods and services market. Productivity enhancements are a necessity, which requires improvement to

infrastructure and public services. None of these factors are within the BoE's control, and yet its 2% inflation target arguably cannot be achieved without them.

Expectations are that UK inflation will inevitably come down as we go through the year and demand is curtailed by the higher cost of borrowing, but economists now expect price increases to remain stubbornly high. JPMorgan (JPM) expects core inflation to stay around 7% through the rest of the summer, and to only fall to 6% by the end of this year. Headline inflation will almost certainly fall quicker, thanks to the falling energy price cap which will come into effect next month. Still, JPM puts headline inflation at 5% by the end of 2023. That is better than right now, but still well above the BoE's 2% target.

Unless something 'breaks', further rate rises are almost inevitable but, as we say, are no guarantee of short-term success in fighting inflation. What higher rates will do is squeeze everyone sensitive to borrowing conditions – from households and small businesses to the government – and that squeeze is done by raising their costs. Already, the Treasury's outstanding debt has gone above annual gross domestic product (GDP) for the first time in over 60 years, thanks largely to higher borrowing costs. Meanwhile, small businesses and mortgage payers are already struggling under intense financing costs. This does not bode well for house prices and consumer demand from disposable income.

Sharply higher mortgage rates are already eating into housing demand as house moves are being postponed, and any increase will only worsen the situation. Given how important house prices are to the UK economy, through the so-called balance sheet effect, it is no surprise analysts are saying the BoE will have to engineer a recession before it can get prices under control.

Comparisons to the 1970s, with its stagflation and striking unions, have been common over the last few years. But a better comparison for right now is arguably the early 1990s, when high inflation took a long time to filter through, government bond yields were elevated, and house prices declined over multiple years. Just like then, real (inflation-adjusted) gilt yields have stayed decisively positive, but level, while nominal yields have increased – suggesting a period of higher inflation and a longer period of weak growth, but not stagflation. We see this in the shape of the bond market across different maturities too: short-term yields have increased dramatically, while longer-term yields have been more muted. Indeed, by the end of last week they had fallen from the previous Friday's yields.

The one potential upside to this story is that UK yields now look very attractive by international standards. This is not surprising given the inflation situation, but it could well mean that gilts start to capture interest from overseas investors. If so, there would be two distinct benefits: domestic fixed income investors get better returns, and UK bonds (as well as sterling) have a price floor. That is not a lot of upside, but it is at least something.

To get anything more from the UK economy, serious supply-side reforms are needed, particularly around trade and movement of labour – both areas where there is little the BoE can do. The downsides from Brexit are now very clear, particularly in terms of labour supply and barriers to free trade. But unfortunately, policymakers have failed to make good on delivering the upside. We can only hope for improvement ahead.

Investor disappointment in lacklustre China continues

The Chinese economy has disappointed this year. By now, that much is certain – after investors' expectations of a post-Covid boom decisively fizzled out. China's benchmark stock index, the CSI 300, climbed high through the start of 2023 after Beijing abandoned its strict zero-Covid lockdown policy in December and in January announced a raft of supportive economic policies. But growth has failed to match them over the last six months. The world's second-largest economy recently recorded below-estimate figures for retail sales growth, industrial production and fixed asset investment, while youth unemployment rose to a record 20.8% in May. For investors, the prevailing opinion is that markets got ahead of themselves, with sentiment turning decisively since April. The CSI is now just flat (-0.2%) from the start of the year, while Hong Kong's Hang Seng index has fallen 4.5% in that time.

China's long-ailing property sector is not only the symbol of this malaise, but also one of the root causes. After an extremely difficult few years following the debt crisis at outsized property developer Evergrande, the future was finally looking brighter for China's large property developers. Borrowing restrictions were eased and demand-supportive policies were unveiled at the end of last year. But tangible improvements have proved elusive: companies have been unwilling or unable to build as quickly as expected, while final demand for property remains muted.

Despite the initial promise of liquidity, property developers are still strapped for cash. Chinese real estate investment fell 7.2% in the first five months of 2023, according to Bloomberg. That is worse than the expected 6.7% drop and continues the trend of decline. Property developers are reportedly focusing on finishing existing projects, rather than starting new ones. This is understandable given the previous difficulties on delivering finished developments (a problem that famously led to a mortgage payment strike during the pandemic), but it constrains housing supply.

Even with that supply constraint, though, Chinese house price growth is weak (though remaining at a high level). They gained just 0.1% in May, coming down from 0.3% in April. Weakness on the demand side is down to extremely stretched affordability metrics – particularly in the large tier-one cities. General lethargy in Chinese growth only worsens these problems. Despite the government's 16-point plan to rescue the property sector, announced in November to great reception, the overwhelming feeling is that more support is needed from Beijing.

Policymakers seem to prefer caution. Monetary policy has loosened this year, in the form of cuts to prime rates and reserve requirements, but growth policies have definitely not been full throttle. This too is understandable, given how many of the current problems stem from previous growth-oriented policies and accumulation of debt. In the decade after the global financial crisis, Beijing responded to domestic slowdowns with massive liquidity injections. These did the trick of turbocharging growth, but they also ballooned private sector debt and created numerous asset price bubbles – particularly in property. To avoid a repeat, Beijing seems more inclined to drip-feed liquidity into the system.

This approach should stabilise the property sector after the tumultuous pandemic years, but it could take some time. This is deeply problematic for short-term growth, as it is now clear that negative sentiment from the property sector woes is a serious drag on the overall economy. The Communist Party has made

clear that its focus is stimulating household demand and supporting growth industries like electric cars. But doing this will be harder while property companies are constraining growth.

For example, investors had hoped that, following monetary easing, capital expenditure (capex) would increase among non-property companies, even if developers struggled. This has not happened to the expected level. In particular, exporters buoyed by a positive trade surplus have been using their proceeds to pay down dollar-denominated debts, rather than investing in new production. This is clearly defensive behaviour, a sign that debt fears have spread well beyond the property sector. While it continues, China will be unable to reap the growth benefit from its strong trade figures.

Low confidence is a huge factor wherever you look in China. Consumer sentiment undoubtedly improved following the end of the psychologically damaging zero-Covid policy, but those improvements have since tapered off. Overall employment levels are holding steady, but the increase in youth unemployment has been surprising. Moreover, this does not look like a short-term cyclical problem: there is arguably a skills mismatch between young Chinese – who are more highly educated than any previous generation – and the jobs on offer, which are focused more in lower-paid or lower-skilled areas.

We cannot discount the 'scarring' effects of zero-Covid either. Around 1.4 billion Chinese were under some form of Covid restrictions for the better part of three years. It might take some time to trust that those times are truly over, and even more time to adjust spending and savings habits accordingly. We should also remember that Covid restrictions – particularly for international travel outside of Asia – have not been completely removed in China. While this only affects a small section of wealthy Chinese, these restrictions can be hugely symbolic.

The People's Bank of China responded to the youth unemployment figures by cutting its medium-term lending rate the previous week. This policy responsiveness is what markets are hoping for, but many worry it will not be enough. Further policy support was expected the previous weekend, for example, but markets were left disappointed. While growth is a priority for President Xi Jinping, it is clearly not the only priority, and the 'top brass' is hesitant to overreact for what could be a short-term blip. This is one of the big differences between Chinese economic management and that of western nations. While the political system here mandates near-term prosperity and therefore highly reactive policy, Xi Jinping will never be voted out of office through elections and can push through short-term struggles for the sake of a longer-term plan. The danger is that this long-term thinking starts to look like unwillingness – or worse, inability – to deal with the problems at hand.

The property sector troubles are arguably one such case. The problems have been clear for some time, and yet long-term solutions are still lacking. Growth will inevitably come, but how and when remains to be seen. From our perspective, the most interesting part of all this is how disconnected China has now become from western economic cycles. That is both good news and bad news: it means greater opportunities for diversification, but we can no longer expect China to pick up the slack from the west either.

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26th June 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	7450	-2.6	-2.6	→	→	4.2	10.5	10.3	13.3
UK FTSE 250	18127	-5.1	-5.1	→	→	3.6	11.2	10.5	14.6
UK FTSE All-Share	4050	-2.9	-2.9	→	→	4.1	10.6	10.3	13.5
UK FTSE Small	6106	-2.6	-2.6	→	→	5.2	9.1	7.8	12.8
France CAC 40	7135	-3.4	-3.1	→	⬀	3.3	12.3	11.9	14.1
Germany DAX 40	15753	-4.0	-3.7	⬀	↗	3.7	11.2	10.7	12.9
US Dow	33707	-2.3	-1.5	⬀	→	2.1	17.9	16.7	16.4
US S&P 500	4346	-2.2	-1.4	↗	↗	1.6	20.0	18.8	17.6
US NASDAQ comp	13486	-2.7	-1.9	↗	↗	0.8	29.8	26.5	22.9
Japan Nikkei 225	32605	-2.8	-3.0	↗	↗	1.9	19.1	18.5	16.8
World Bloomberg	1562	-2.7	-1.9	↗	↗	2.3	14.2	14.0	13.8
China mainland	3864	+0.0	-0.2	↗	⬀	2.1	17.6	16.8	16.4
Emerging Bloomberg	1116	-3.1	-2.3	→	→	2.4	12.0	11.2	12.0

Top 6 Gainers

Company	%
Ocado	+23.8
B&M European Value Retail SA	+3.6
CRH	+3.0
Associated British Foods	+3.0
Rolls-Royce Holdings	+2.9
GSK	+2.6

Bottom 6 Decliners

Company	%
DS Smith	-12.0
Anglo American	-11.5
NatWest	-10.9
Airtel Africa	-9.9
Persimmon	-9.4
Spirax-Sarco Engineering	-9.3

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.25	-0.16
UK Govt 15yr Gilt	+4.43	-0.15
US Govt 10yr Treasury	+3.69	-0.08
France Govt 10yr OAT	+2.85	-0.15
Germany Govt 10yr Bund	+2.32	-0.17
Japan Govt 20yr JGB	+0.97	-0.03

Currencies

Pair	last	%1W
USD per GBP	1.272	-0.8
GBP per EUR	0.857	+0.3
USD per EUR	1.090	-0.5
JPY per USD	142.86	+1.0
CNY per USD	7.180	+0.2
USD per Bitcoin	30,104	+17.9

Commodities

Cmdty	last	%1W
Oil Brent $:bl	72.4	-4.5
Gold $:oz	1935.4	-1.2
Silver $:oz	22.5	-6.1
Copper $:lb	379.3	-2.8
Alumnm $:mt	2176.8	-1.7
S&P soft crops	242.4	-3.4

UK Mortgage Rate Estimates

Rates (LTV c.75%)	23-Jun	24-May
UK BoE base rate	5.00	4.50
2yr fixed	6.60	4.63
3yr fixed	6.35	4.39
5yr fixed	5.79	4.17
10yr fixed	5.42	4.34
Standard variable	7.44	7.35

23/06/2023
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

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26th June 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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