THE **CAMBRIDGE** WEEKLY

3 JULY 2023

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A glass half-full half year

Halfway through 2023 and, all in all, things have been fair-to-middling for markets. We'll have a more detailed run-through of asset class performances in next week's Weekly, but an assessment of the changing economic and markets landscape over the quarter seems appropriate for this week's edition.

This second quarter ends amid positive sentiment towards global risk assets (UK assets have not fared quite as well), a surprising turnaround given it started with black clouds on the horizon, following March's US regional bank crisis. March had many investors thinking credit would tighten as banks would surely be scared to run out of money themselves. Looking back now, the evidence seems to be that a shift of client deposits to larger banks, alongside US Federal Reserve (Fed) actions, produced an effective easing. Not only did the Fed push liquidity into the system, but it also reduced risks for investors by expanding its deposit insurance cover terms. Some would say that, implicitly, the Fed told us that its response to possible financial system issues is to be swift and generous. So, if something looks like breaking, the Fed will step in to stop people getting hurt.

Put in those terms, of course no central banker would agree this was a reasonable assertion and reaffirm that they are undeterred in their determination to put the inflation genie firmly back in its bottle, even if this results in pain in some parts of the economy. However, markets no longer seem to wholly believe that to be the case, so during the quarter we have seen the relationship between bonds and equities change from how it was over 2022 and Q1 of 2023.

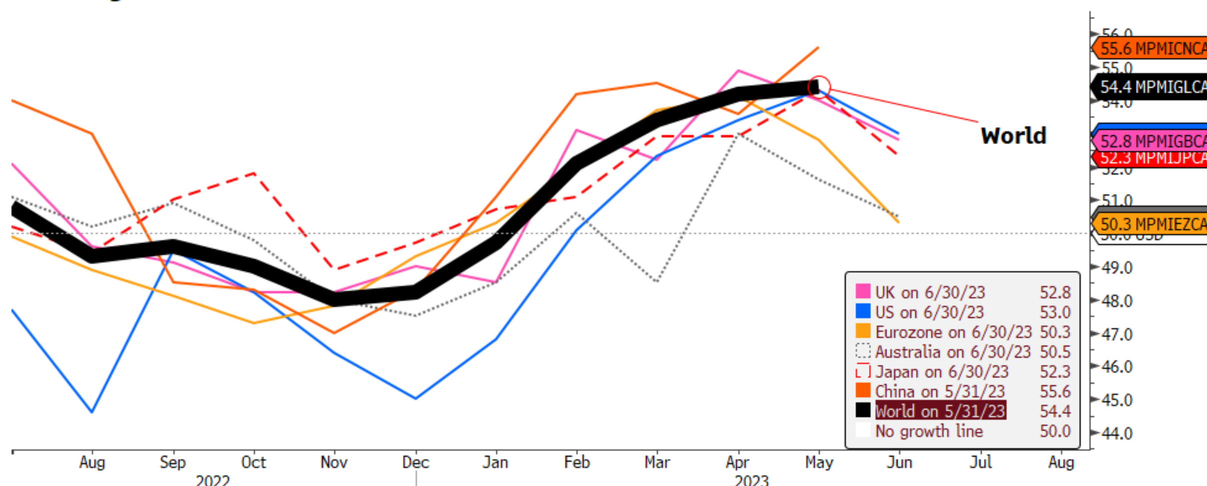
Back then, falls in bond prices (associated with expectations of rising short-term interest rates) went hand-in-hand with equity price falls, suggesting the process would end in tears for the economy. This quarter saw bond prices still under pressure (as yields rose again) but equity prices generally doing better regardless.

One reasonable explanation is that, globally, equity analysts have been raising their forecasts for company profits for the next 12 months through the course of this quarter. While the results from Q1 were better than initially expected, the track of upgrades was consistently stronger through the quarter. If the global economy were in a parlous state, this just would not have happened.

Somewhat contradictory, manufacturing sentiment (i.e., the outlook from businesses rather than the analysts covering them), has continued to show looming recession. This has been particularly evident in Europe, despite the easing of energy price pressures. However, service business sentiment has indicated reasonably solid growth, albeit most regional indices in aggregate have still shown a relative decline.

The overall composite indicators are more heavily weighted towards services and show that the global economy has been resilient. It also shows the resilience has been widespread as the chart below reflects, in which 50 marks the demarcation between growth and contraction.

Composite PMIs from S&P Global
Including flash estimates



Source: Tatton IM, Bloomberg, JP Morgan, S&P Global: G1166
.PMIC_UK F Index (PMI composite UK) PMI comp regional Monthly 01JUL2022-30AUG2023 Copyright© 2023 Bloomberg Finance L.P. 30-Jun-2023 13:38:31

June's purchasing managers' index (PMI) data does show a downturn, however. Services are gradually turning less positive and manufacturing more negative. Europe has been notable for quite a sharp decline across the board. China's June reading is estimated to slide back to about 52.8 which would probably mean a World Composite PMI reading of about 52.7.

We have mentioned before that markets have responded well to more earnings positivity from analysts, but the biggest change has been in their reaction to valuations. Developed world equity indices have doubled up on rising underlying profit expectations, with rises in the price-to-earnings multiples applied on top of those earnings.

This sign of increased investor optimism may perhaps be lack of pessimism, a sense that the downside is protected, following the experience in the aftermath of the US banking crisis. The European Central Bank (ECB) held its annual symposium in Portugal last week and leading central bankers from across the world spoke. The tone ranged from mild to bloody-clawed hawkishness. Bond yields duly reacted and moved higher, yet equities gave the event a 'whatever' shrug.

Part of that mood may be coming from the disjunct between 'hard' and 'soft' economic data. Hard data is derived from actual activity – such as jobs numbers, retail sales or durable goods orders. Soft data (like the PMI sentiment gauges above) is based on surveys of people's perceptions. The continued resilience of the hard data over PMI readings (manufacturing PMIs have been below 50 for a year now) is an indication that sentiment can be overly pessimistic, especially in times of changing circumstances.

However, that resilience also means core inflation (taking out food and energy) is not coming down noticeably now. Perhaps investors believe that the impacts of inflation may be less problematic for the financial and economic system than previously feared. Perhaps the central banks also think so. They certainly have not been as hawkish as their rhetoric. For example, Fed Chair Jerome Powell said last year that the

Federal Open Market Committee (FOMC) wanted US unemployment to rise to 4.5%. Since then, joblessness has moved up only 0.1% to 3.7%. In the UK, unemployment seems locked at 3.8%, while in the Eurozone it has declined from 2022's start rate of 7% to May 2023's 6.5%.

The words emanating from the ECB's meeting in Sintra convinced money markets to factor in more short-term rate rises last week. The Fed is expected to get to 5.5% (+1%) by September, and the Bank of England (BoE) to 6.25% (+1.25%) by March next year. The ECB's hawkishness seems to be refocusing on the pace of quantitative tightening however, rather than raising rates, which is an interesting move. This approach could be followed by the Fed. A faster decline in its balance sheet would pose some questions for risk assets, given it would be likely to push long-term yields higher once more, which as we know should put equity valuations under downward pressure.

The other intriguing aspect of this quarter has been the lack of corporate bankruptcies and default. In the US, following Silicon Valley Bank's demise, investors were on the lookout for signs of default contagion. Although there were a few, most would say that it did not become a problem.

In the UK, the same could have been said right up until the news last week concerning Thames Water.

The 2021 Bulb bankruptcy was an example of how a utility company can be caught between costs, competition and price caps. Given the circumstances, there was little made of the episode despite its size. Thames Water is potentially of a different order. Few people in London get their water services from another supplier. The perceptions of (reckless) behaviour of private equity actors in the story will be important, especially in relation to the state's infrastructure funding.

Perhaps most important will be the impacts on the current equity holders, which are generally pension funds. The company was privately held but that doesn't mean it won't cause contagion. While the pressure that UK pension funds faced during last October's index-linked gilt crisis may be seen as a different type of problem, many funds have large exposures to other infrastructure-related assets. It is possible this story will go on for some time and have surprising consequences. In itself, the Thames Water situation is not likely to precipitate a crisis. Nevertheless, large debtors with problems are things we should watch closely, as much perhaps as hitherto deemed ultra-safe infrastructure investments.

The heat of June is forecast to give way to a cooler July in Europe. We hope the relative calm experienced by equity markets in June will carry on regardless of the weather.

Markets don't listen to Wagner

Despite how much we might personify them, capital markets are not people. They do not care about the things real people care about. When a hotdog-vendor-turned-warlord and his band of mercenaries launches a coup against the world's most nuclear-equipped government, most people have an opinion. But markets do not bat an eyelid, apparently. After Yevgeny Prigozhin launched (and quickly retracted) his Wagner rebellion the previous weekend, global stocks and bonds did not budge. The biggest geopolitical event since the Ukraine war began was not even a blip for investors.

This is understandable as far as equities go. Russian assets were removed from westerners' investment universe as soon as Putin launched his invasion, and the remaining trade links between companies have been almost entirely dismantled since then. What is perhaps more surprising is that oil and gas markets were similarly unmoved. Brent, the international crude oil benchmark, closed trading last Monday at $74 per barrel, the exact same price it finished the previous Thursday. European natural gas prices were up slightly over the previous weekend but were right back where they started by Tuesday.

This is a far cry from a year ago, when Russia's military and political exploits felt like the dominant driver of global – and particularly European – energy prices. Brent crude nearly doubled in price during the build-up to Russia's war, while Dutch TTF, the European natural gas futures index, more than doubled in just the last two weeks of February 2022. The spikes were even greater when Russia cut the European Union (EU) off from pipeline imports.

There are a few reasons why energy markets' nonchalance might not be that surprising. The coup failed for one thing, leaving the status quo intact. In any case, there is no particular reason to think that whatever Russian political setup resulted from a mutiny would be more likely to constrain global energy supplies. More importantly, there is a sense in which the worst has already happened for European energy markets. Putin shut the tap last year in response to sanctions. Russian gas accounted for 53.8% of the EU's gas imports in mid-2021, but that figure was just 12.9% in November 2022.

This does not quite tell the whole story, though. Markets hate instability, and a Russian civil war could destabilise energy supplies again. And, while Europe is far less reliant on Russian gas than it was, it would be a big overstatement to say the continent is unaffected by Russia's supply situation. 12.9% of the EU's imports is no insignificant amount in absolute terms. Moreover, the fact that Russian supply is no longer going to the west does not mean it is unimportant for global energy markets. It is now clear that Russian oil and gas has made its way to Asia, whose imports from elsewhere have adjusted downward.

Interestingly, there was a European supply-side scare the previous week that had nothing to do with the Wagner rebellion. On Friday 23rd June, the Dutch government announced that Groningen natural gas field in the Northeast of the Netherlands would shut down from the start of October, following years of extraction-related earthquakes in the region. On the face of it, this is quite worrying news for Europe's energy security. Groningen is the EU's largest natural gas reserve, and hence news of its closure led to a spike in futures prices. In reality, though, extraction from the field has been minimal for years. And once the Dutch clarified it might still be drawn from if supplies dwindled, prices came back down.

These considerations back up what we have observed for some time: energy markets are no longer as sensitive to supply-side problems. Instead, demand – or lack thereof – seems to be the key consideration. Russia is perhaps the best example of this. Putin seemed to play a strong hand in cutting off European pipelines last year, but the latest flows of liquified natural gas from Russia suggest the Kremlin now needs to sell its fuel at least as much as Europeans need to buy it. In fact, with the unexpectedly large European fuel supplies last winter, it looks like the latest falls in Russian imports are as much a matter of slow demand as any political manoeuvring.

Saudi Arabia recently signalled it would further cut its oil production in response to weak global demand. This is believed to be in large part down to overproduction in Russia, as it tries to pump out supply for much-needed funding. With the ongoing slowdown in the global economy – and even looming recessions in many parts of the world – the biggest swing factor in energy markets is the lack of demand, rather than supply. This puts big suppliers like Russia in a much weaker position than they were a year ago.

Much has been written about Putin's weakness following the botched rebellion – backed up by Ukrainian peace discussions with a host of developing nations, including China. But in Russian history, failed coups have as much been a sign of strength as they have of weakness. We should not assume that either his grip on domestic power or desire to take Ukraine will be diminished by this. What all this does suggest, however, is that Russia can only afford to keep fighting for so long. That, together with Ukraine's dwindling counteroffensive, increases the likelihood of a ceasefire in the medium-term. Even a permanent ceasefire is of course not the same as an end to the war, but as history again shows, this is often how modern border conflicts play out.

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3rd July 2023

Global Equity Markets				Technical	Valuations			
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	7539	+1.2	+1.2	⬂ →	4.2	10.6	10.4	13.3
UK FTSE 250	18449	+1.8	+1.8	⬂ →	3.6	12.0	11.2	14.6
UK FTSE All-Share	4101	+1.3	+1.3	⬂ →	4.1	10.7	10.4	13.5
UK FTSE Small	6118	+0.2	+0.2	→ →	5.2	9.1	7.8	12.8
France CAC 40	7404	+3.8	+4.1	→ ↗	3.1	12.8	12.4	14.1
Germany DAX 40	16142	+2.5	+2.8	→ ↗	3.6	11.4	11.0	12.9
US Dow	34301	+1.8	+2.0	→ →	2.1	18.3	17.1	16.4
US S&P 500	4427	+1.9	+2.1	↗ ↗	1.6	20.4	19.2	17.6
US NASDAQ comp	13716	+1.7	+1.9	↗ ↗	0.8	30.5	27.0	22.9
Japan Nikkei 225	33098	+1.5	+0.5	↗ ↗	1.8	19.2	18.6	16.8
World Bloomberg	1586	+1.6	+1.8	↗ ↗	2.3	14.4	14.1	13.8
China mainland	3842	-0.6	-1.3	⬀ ↗	2.1	17.7	16.8	16.4
Emerging Bloomberg	1112	-0.4	-0.2	↘ →	2.5	12.0	11.1	12.0

Top 6 Gainers

Company	%
Barclays	+6.6
abrdn	+6.6
Sage	+6.4
Ocado	+6.4
Pershing Square Holdings	+5.6
Hargreaves Lansdown	+5.5

Bottom 6 Decliners

Company	%
United Utilities	-3.8
B&M European Value Retail SA	-3.8
Severn Trent	-3.8
Airtel Africa	-3.2
ConvaTec	-3.0
BT	-2.8

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.43	+0.18
UK Govt 15yr Gilt	+4.58	+0.15
US Govt 10yr Treasury	+3.83	+0.14
France Govt 10yr OAT	+2.98	+0.13
Germany Govt 10yr Bund	+2.43	+0.12
Japan Govt 20yr JGB	+1.00	+0.03

Currencies

Pair	last	%1W
USD per GBP	1.269	-0.2
GBP per EUR	0.859	+0.3
USD per EUR	1.091	+0.1
JPY per USD	144.50	+1.1
CNY per USD	7.257	+1.1
USD per Bitcoin	31,067	+3.2

Commodities

Cmdty	last	%1W
Oil Brent $:bl	74.7	+3.3
Gold $:oz	1913.5	-1.1
Silver $:oz	22.5	-0.0
Copper $:lb	372.8	-1.7
Alumnm $:mt	2130.8	-2.1
S&P soft crops	225.5	-4.5

UK Mortgage Rate Estimates

Rates (LTV c.75%)	30-Jun	31-May
UK BoE base rate	5.00	4.50
2yr fixed	6.81	4.73
3yr fixed	6.52	4.51
5yr fixed	5.89	4.29
10yr fixed	5.42	4.46
Standard variable	7.44	7.44

30/06/2023
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

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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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