THE **CAMBRIDGE** WEEKLY

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Markets sour on news of resilient economy

Last week we commented how the second quarter's positive stock market returns were driven by a somewhat surprising improvement in investor sentiment. It's surprising for several reasons. At the end of March, fear was uppermost that the crisis facing US regional banks would lead to a serious deterioration in lending conditions and a more pronounced slowdown than previously anticipated. Surprising also because while bond yields rose, analyst forecasts of corporate profits did not change much beyond anticipating a period of stagnant growth (more on the last quarter in our June/Q2 asset returns review article in this edition).

But over last week, markets look to have abandoned this narrative. Positive US job growth figures have been blamed for a reversal in sentiment. Equity and bond markets have fallen, and bond yields have risen. So, why have investors shifted their views so suddenly to the downside, even though bond yields have not risen in any meaningful way when compared to the period between March and the end of June?

To make some sense of the latest market drama, let's remind ourselves of what the principal factors determining valuations and their direction of travel are. The primary driver of stock markets over the medium to long-term is the anticipated change in the profitability of stock market quoted businesses in aggregate. Improved corporate earnings, or just the prospect of better figures, can provide equity markets with momentum. A deterioration in earnings does the opposite. In the absence of other more immediate drivers, which we will discuss further down, the sequence of the different stages of the economic cycle usually determines the direction of travel of corporate earnings.

Secondarily, the overall level of valuations is driven by bond yields, which most simply put can be seen as the competition to equities, i.e., the higher they are, the higher the equity yield as a function of corporate earnings has to be to justify the same stock market level.

An interlinked element is central bank policy, which sets both levels of liquidity and interest rates. Central bank, or monetary policy shifts play a large role in whether the economy's contraction or expansion might be offset.

Such policy moves affect not just how much profit businesses can generate, they can also determine the length of an economic cycle. A short downswing means businesses can survive; a longer one can mean the opposite. The central bank ultimately determines whether the cost of capital and borrowing is high or low and therefore drives changes in business and consumer demand.

At times, it is not just the stage of the economic cycle and cost of money that determines the direction of the economy, but also government spending (fiscal policy) and/or external shocks like the COVID-19 pandemic. That's in part because governments can usually borrow when lenders are reluctant to loan money to businesses. Furthermore, cost of capital headwinds can be dealt with in a way that has little impact on earnings when growth is on a firmer footing. Last but not least, there is the issue of general monetary liquidity. If there is more money circulating in the economy than strictly required, then the extent of the market reaction can be much less pronounced than when liquidity is tight.

Where all these factors combine to determine capital market valuations, investor sentiment is the proverbial glue that brings all factors together to determine whether there is a positive or negative interpretation of the prevailing circumstances and how heavily the one or other of the four will impact market direction.

The change we experienced over last week was one of sentiment towards the future cost of capital. Up until the end of June, there was a growing expectation that at least the US central bank, the Federal Reserve, had, or was close to reaching the peak of their rate hiking cycle and that cost of capital as a result would not rise further, and indeed, was likely to start to fall over the coming 6-12 months.

Particularly hawkish statements from the Fed chair Jay Powell the previous week at the Sintra meeting in Portugal of central bankers began to challenge these expectations. Last week's data flow of continued tightness of the US labour markets which has been driving the second-round effects on inflation (wage-price spiral concerns), provided more evidence that the Fed may well not be done with raising rates and keeping the cost of money at current elevated levels for longer than had been anticipated. This, in turn, would mean that the other central banks who were expected to be following the Fed in due course, would now be even later.

So, in summary, not particularly much has changed on the hard data front over the past days, but on the contrary, a surprisingly strong US labour market report disturbed the fragile market balance we have written so often about over the past months. Whether this return of 'good economic news is bad news for market valuations' is enough to sour sentiment more permanently, remains to be seen. A second set of labour market data last Friday presented much less of an upward outlier, however confirmed that the US labour market remains just as tight as it was last month, with no signs of imminent turning.

As we described above, higher cost of capital can more easily be absorbed and carried by the economy when accompanied by decent growth and good levels of monetary liquidity. Both conditions remain broadly in place at the moment, which tells us that markets should continue to carry a higher probability of trading sideways than down over the summer. However, if the other effect of this economic resilience is a slowing or reversal of the recent steady decline in inflationary pressure from the input cost side (more on this in our dedicated article about global inflation this week), then the central banks may see themselves forced not only to raise rates ever higher. They may, indeed, perhaps also have to drain liquidity more drastically from capital markets by stepping up their monthly QT (quantitative tightening) programme of selling bonds against market liquidity from their still very extended balance sheets.

For the time being, positive sentiment may well prevail, but for market stability to remain that way, market participants will paradoxically be wishing for a continuation of the other side of last week's data flow, which presented an environment where services gradually start to follow the manufacturing sector into an economic soft patch.

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10th July 2023

June Review – improved market sentiment

The sunny month of June brought the feel-good factor back to capital markets. Global stocks climbed 3.1% higher over the course of the month in sterling terms, and UK investors saw most major equity indices finish the month in the black. These returns helped to round off the quarter and indeed, the first half of 2023. In the last six months, global equities have added 7.8% in sterling terms. Every major index that we track – barring MSCI's Emerging Market index – has made gains since the start of the year. As has been the theme of recent years, the US once again outperformed across each of those time periods. A resilient economy and improved monetary expectations have helped US companies, none more than BigTech. In the first half of the year, the tech-heavy Nasdaq index gained an incredible 25.2%. The table below shows June's results in full.

Asset Class	Index	June	Q2/2023	YTD	12 months	2022	5-yr rolling annualised
Equities	UK Large Cap	1.4	-0.3	3.2	9.1	4.7	3.6
	UK Ethical Large Cap	0.6	-0.7	2.3	5.2	-2.6	0.0
	Europe ex-UK	2.4	0.1	9.0	19.0	-7.6	7.4
	US Large Cap	3.9	5.8	10.6	14.2	-7.8	13.2
	US Technology Large Cap	4.0	9.9	25.2	20.5	-24.0	13.9
	Japan	1.5	3.5	6.9	12.8	-6.1	8.8
	Global Stocks	3.1	3.3	7.8	11.3	-8.1	8.1
	Emerging Markets	1.2	-1.9	-0.8	-2.8	-10.0	0.9
Bonds	UK Gilts All Stocks	-0.4	-5.4	-3.5	-14.5	-23.8	-4.2
	£-Sterling Corporate Bond Index	-1.2	-3.3	-1.1	-6.1	-18.4	-1.2
	Global Aggregate Bond Index	-0.1	-0.1	2.4	-0.8	-12.2	0.0
Commodities	Commodity Index	1.8	-5.4	-12.5	-18.1	41.9	2.8
	Brent Crude Oil Price	1.3	-8.2	-16.9	-33.9	24.4	-1.0
	Spot Gold Price	-5.3	-5.7	-0.6	1.0	12.1	8.8
Inflation	UK Consumer Price Index (annual rate)*	0.7	1.9	3.3	7.8	10.5	-
Cash rates	SONIA 3-Month	0.3	0.9	1.8	2.7	1.1	0.9
Property	Global REITs	0.5	-2.1	-3.2	-7.4	-14.8	2.1

Source: Morningstar Direct as at 30/06/23. * to end of previous month (31/05/23). All returns in GBP.

In terms of market movements, June continued and solidified some of the same trends we started to observe in May. Volatility, in particular, continued to fade as markets seem no longer driven by fears about less liquidity. This sense of ease, previously confined to large cap stocks (hence the overwhelming outperformance of US tech), seems to have become more broad-based, with smaller companies now also benefitting from the turnaround in investor confidence. Trade data from June seemed to confirm this trend, suggesting the global economy is more resilient than had been feared. This is unlike previous growth signals – which have usually been treated as inflationary and, therefore, a concern for stability. Instead, we are seeing signs of the proverbial 'soft landing', and markets are all too happy to jump on this good news.

Investor confidence even managed to provide some assistance to the beleaguered UK stock market, which gained 1.4% in June. The last three months have been bruising for British companies, thanks to stubbornly high inflation and the Bank of England's steely determination to crush it. But despite a worsening of inflation data and some aggressive signalling from the BoE, the FTSE 100 managed to finish the second quarter of the year down just 0.3%. Year-to-date returns are a healthy 3.2%. Even the looming collapse of Thames Water did not spook investors, although so far July's performance is proving less auspicious.

As global growth slows, and central banks tighten – at the fastest rate in a generation – tougher financing conditions and more corporate defaults seem inevitable. We saw this steady increase in credit stress over the last few months. June was no different, but this has not induced the sense of panic that had seemed possible in March. In fact, while aggregate corporate bond yields rose somewhat over the last month, this was entirely down to a corresponding rise in the government yields against which private debt is priced. Credit spreads – the difference between corporate and government bond yields, and therefore the most immediate credit stress indication – actually came down in June.

This is a curious sign. It suggests that investors see equities (or relatedly, their debt) as a better inflation protection than bonds. Since input prices are now firmly on a downward trend, growth and inflationary pressures from now on should feed through into higher profits. That has the dual effect of generally easing financial conditions and ending the stark bifurcation which had developed in stock markets. Whereas before it seemed only the biggest companies (and mainly those in the US) could weather the storm, there is now a sense of more widespread resilience.

Further evidence which backs up this trend has been the increase in real disposable incomes – though admittedly not by much. As we discuss in a separate article this week, the lowering of inflationary pressures has bolstered consumer spending power. At the same time, savings rates – which had been coming down after being built up during the pandemic – seem to be holding stable. That has allowed savings to flow into capital markets, particularly equities.

To the extent that recent market positivity is being built on this soft-landing scenario, though, we should remain cautious. Inflation coming down to more manageable levels, without destroying demand more than it has been already, relies on supply pressures continuing to abate. Nothing yet suggests to the contrary, but shocks are always possible. And if markets can be easily disrupted by external shocks, that in itself is a cause for concern. We talk more about this in our inflation article below.

On the topic of input prices, we note that commodities are stabilising after months of decline. The price of Brent crude oil gained 1.3% in sterling terms, while Goldman Sachs' wider commodity index returned 1.8% in June. This again is largely down to changes in the supply side, though there is some evidence of increased Chinese demand. The world's second largest economy has been by far the biggest disappointment of recent months, failing to live up to hopes of a post-Covid boom. Chinese growth is not actually weak in absolute terms – it so rarely is – but weaker than expected returns are hurting markets and revealing further weaknesses. In particular, there are now concerns over land prices (further fallout from the property woes) which could spiral into concerns about China's wider financial stability.

Yet, markets remain calm. For Chinese equities, weakness has been offset by supportive policy changes – in particular, from the People's Bank of China. In other assets, like real estate, previous weakness seems to have been offset by opportunistic buying activity. It bodes well that markets are in a positive mood, climbing on good news and taking the bad in their stride. We hope for more, but as ever, remain wary of overconfidence.

Global Inflation Update

Last month's Federal Reserve meeting was perplexing. On the one hand, the central bank did exactly what capital markets had been crying out for by keeping interest rates at their previous level. After tightening in ten consecutive meetings, this bit of respite looked to investors to be signalling peaking interest rates with easier times ahead. On the other, Fed chair Jerome Powell used his press conference to dispel any sense of excitement. Due to persistent inflationary pressures, he intimated that the Fed will likely need to raise rates two more times over the coming months. Markets had previously hoped for just one more hike, after which financial conditions might ease – but Powell and co. have now signalled any easing in rates will not come until 2024 at the earliest.

The mismatch of words and actions led some to call it the Fed's 'hawkish pause'. Powell defended this stance on the basis that the US economy and financial system needs time for the dust to settle and that inflationary pressures persist. This makes some sense given the upheaval witnessed in US markets over the last year: rates rose from near zero in March 2022 to above 5%. Partly as a result, major US regional banks have collapsed sending shockwaves across the financial system. While these considerations counsel against tightening too hard – and causing an unnecessarily painful recession – they do not negate the fact that the world's largest economy is still running hot.

The Fed also published updated forecasts for core inflation, based on the personal consumption indicators (PCE) index. It shows prices are expected to remain stubbornly high for some time. Officials now think core US inflation – currently at 4.7% – will fall to 3.9% by the end of this year. That is a slower decline than forecast back in March, when core PCE was expected to end the year at 3.6%. The Fed also thinks the core inflation spike will have a long tail, slowing to 2.6% by the end of next year and reaching 2.2% in 2025.

More hawkish Fed watchers suggest there is an inconsistency in opting for a 'wait and see' approach while the bank's own data suggests a higher path for inflation than before. While longer-term core PCE projections, if accurate, look to be more manageable than what we have experienced over the last few years, that would still mean higher than target inflation if fed through directly into the headline figures. Implicitly, the Fed is therefore saying it either expects not to have reached its 2% target for another two years, or it expects other factors – like input prices – to offset core price rises over that period.

A few of the capital market research institutions have recently suggested that the US inflation rate could fall faster than the Fed's predictions. Goldman Sachs, for example, points out that used car prices at auction have recently fallen by around 9% in the US, and they think this trend still has a long way to go. There is also a clear downward trajectory in real consumer spending (the number of goods being bought is still falling, even if their value has risen), while shortages seen in the US labour market look set to find a balance.

Over the past year, central banks have been extremely concerned about the second and third-round impact of input-cost inflation. The most prominent of these worries is the dreaded wage-price spiral, though the debate around price gouging has also grown increasingly fierce (one could argue these are instances of the same economic phenomenon). But in the US – as in Europe– we are seeing tentative signs of wage moderation. Interestingly, these are strongly correlated with not just a fall in headline inflation but a lowering of longer-term inflationary *expectations*.

This is the inverse consequence of these second-round effects. A year ago, persistently high inflation was causing people to demand higher pay, signals which fed back through into price setting in a worrisome loop. Now, with more stable longer-term horizons, workers look to be more comfortable about their potential spending power. This has been helped by a dramatic easing of myriad supply chain problems that blighted global trade through, and just after, the pandemic. Intermediaries are now largely acting as disinflationary forces too: Eurozone producer prices fell in the year to May 2023. That's the first outright decline since December 2020.

Disinflationary feedback loops are a nice prospect for investors, particularly those used to the long period of low growth, low rates and high valuations that ran up to the pandemic. But we should not get ahead of ourselves. While inflation is steadily falling around the world, it is dangerous to assume this trend can continue unchallenged. External supply shocks, which have become a fact of life over the past few years, are always possible. Perhaps more so now, thanks to the concerning prospect of continuing political upheaval and environmental degradation. Critically, second-round effects from any future potential shocks are likely to be bigger.

This was the lesson learnt from the period of stagflation seen in the 1970s: what might seem like simple supply-side shocks can have lasting consequences on how people react to changes in supply in the future. Central banks, like the ECB and (particularly) the Bank of England, seem keenly aware of this prospect. The ECB's latest inflation forecasts are above target until 2025, with core inflation being similarly long-lasting. This is predicated on continuing tightness within the European labour market – something not fully appreciated in discussions around economic projections for the Eurozone, as we have noted before.

While supply chain issues have certainly eased, we are already in a phase of supply contraction. Crucially, this is happening both at the source of production and further along the supply chain in the stocks of intermediaries. Chipmakers in Korea and Taiwan, for example, recently announced cutbacks not just in new production but existing production – that's a far cry from the pandemic chip shortage.

A leaner supply chain and a rundown of inventories is perhaps the natural reaction to weak global demand, but it makes the global economy more vulnerable to renewed supply shocks. It could also mean that the fall back seen in input prices – which has given a welcome reprieve to developed economies this year – could soon be coming to an end. If global growth stays steady, we may see renewed input price pressures before too long. Headline inflation is still falling thankfully, but we should be cautious about how long this can last.

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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	7251	-3.8	-3.8	↘	→	4.3	10.4	10.2	13.3
UK FTSE 250	17934	-2.8	-2.8	→	↘	3.7	11.8	10.9	14.6
UK FTSE All-Share	3952	-3.6	-3.6	↘	→	4.3	10.5	10.2	13.5
UK FTSE Small	6020	-1.6	-1.6	→	→	5.3	8.9	7.7	12.8
France CAC 40	7120	-3.8	-4.5	→	→	3.3	12.2	11.8	14.1
Germany DAX 40	15602	-3.3	-4.0	→	↗	3.7	11.1	10.6	12.9
US Dow	33785	-1.5	-2.2	→	→	2.1	18.0	16.8	16.4
US S&P 500	4399	-0.6	-1.4	↗	↗	1.6	20.1	19.1	17.6
US NASDAQ comp	13672	-0.3	-1.0	↗	↗	0.8	29.6	26.6	22.9
Japan Nikkei 225	32604	-1.5	-0.9	↗	↗	1.9	18.7	18.1	16.8
World Bloomberg	1568	-1.1	-1.9	↗	↗	2.3	14.1	13.8	13.8
China mainland	3826	-0.4	-0.7	↗	↗	2.1	17.5	16.7	16.4
Emerging Bloomberg	1102	-0.9	-1.6	↘	→	2.5	12.0	11.1	12.0

Top 6 Gainers

Company	%
Ocado	+2.8
DS Smith	+0.9
Coca-Cola HBC AG	+0.4
Mondi	+0.4
Smurfit Kappa	+0.3
Imperial Brands	+0.1

Bottom 6 Decliners

Company	%
AstraZeneca	-9.7
Smith & Nephew	-7.4
IMI	-7.0
Severn Trent	-6.5
Persimmon	-6.4
Beazley	-6.4

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.67	+0.23
UK Govt 15yr Gilt	+4.82	+0.25
US Govt 10yr Treasury	+4.05	+0.22
France Govt 10yr OAT	+3.18	+0.20
Germany Govt 10yr Bund	+2.63	+0.20
Japan Govt 20yr JGB	+1.03	+0.03

Currencies

Pair	last	%1W
USD per GBP	1.279	+0.7
GBP per EUR	0.854	-0.7
USD per EUR	1.091	+0.0
JPY per USD	142.66	-1.3
CNY per USD	7.230	-0.4
USD per Bitcoin	30,267	-2.6

Commodities

Cmdty	last	%1W
Oil Brent $:bl	76.5	+2.3
Gold $:oz	1923.7	+0.5
Silver $:oz	22.9	+1.6
Copper $:lb	374.5	+0.5
Alumnm $:mt	2091.5	-1.8
S&P soft crops	231.1	+0.9

UK Mortgage Rate Estimates

Rates (LTV c.75%)	07-Jul	07-Jun
UK BoE base rate	5.00	4.50
2yr fixed	7.00	4.73
3yr fixed	6.70	4.51
5yr fixed	6.04	4.29
10yr fixed	5.51	4.46
Standard variable	7.54	7.44

07/07/2023
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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