CAMBRIDGE
INVESTMENTS LIMITED

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Another inflation driver turns over

Last week's markets have, yet again, revolved around inflation, wages and profit margins. In the UK, we finally got a little of the good news that has been stoking US markets. Inflation wise, June turns out to have been not so bad. Inflation data showed a notable slowing while retail sales were perky, possibly because we were all 'pinky' from the hot weather.

Regarding inflation, Sam Tombs of Pantheon Macroeconomics described June's consumer price index (CPI) print of 7.9% year-on-year as being a watershed moment. He thinks this gives the Bank of England (BoE) Monetary Policy Committee (MPC) the green light to increase the Bank Rate by only 0.25% on 3 August, rather than by 0.50% (which last Tuesday's markets were pricing).

In addition, he said "the headline rate in June matched the Committee's forecast in May's Monetary Policy Report, a massive improvement from May's figures… and our seasonally-adjusted measure of the core CPI increased at a month-to-month annualised rate of 3.4% in June, well below the 8.1% average of the previous six months. Headline CPI inflation will probably average about 7% in Q3 and 4.5-to-5.0% in Q4". Tombs thinks there will only be one further 0.25% rise (in September) and expects the base rate will stay at 5.5% before falling back next year. We hope he is right.

Key to his view is that service inflation will follow the calming of goods prices. In normal times, this would be the usual relationship, however, services are still running above projections at an annualised 8.4% rate of inflation over the quarter. Even so, looking back a little further, service prices have underperformed good prices by 9% since 2019, and history shows service prices have always tended to move back up.

Nevertheless, UK equity markets stormed higher, egged on by sharp falls in medium-term gilt yields (and concomitant gilts price rises!). Sterling retreated from its recent highs against the US dollar, but UK stocks were closing the week leading the rest of the world higher - even in common UK sterling-based terms.

Ahead of this week's Federal Open Market Committee (FOMC) meeting on Wednesday 26 July, the US second quarter earnings season is providing as much information as the usual economic data. Tesla is a case in point. It is now engaged in a grab for market share, partly trying to win share from weaker western manufacturers, partly trying to defend itself against Chinese manufacturers that have over-produced and are finding domestic demand weaker than expected. (Beijing is preparing a set of support measures specifically for domestic electric vehicle producers - we write on China's real estate developer woes below).

Tesla withdrew its previous statement that margins would "remain among the highest in the industry," and a cautious commentary leaves the door open for another round of price cuts soon.

It's not just Tesla. Margins are coming under pressure across the board. They have weakened substantially in areas like freight and trucking. Sales growth is now expected to be tepid but general inventories are high. According to our calculations, they are substantially higher than is comfortable while financing rates are high.

As the first half of the earnings season has unfolded, we have seen US analysts moving their forecasts for 'top line' sales up in line with recent trends. In Europe, sales are expected to show no change. However, in both areas, profit margins are being revised down.

Large inventories are a big price depressant, especially if demand is waning, as prices are cut to reduce them. This is not just a phenomenon of western economies as we are seeing signs that China is also selling its goods more cheaply. We may get to talk of 'dumping' goods soon. All this is backed up by the sharp downswing in goods prices. If it were not for food prices, which are being propped up by weather and war, we might be in full-blown deflation territory.

However, as we noted earlier when discussing services in the UK, central banks will not know how they should treat labour's current exercising of its pricing power.

We have become used to the UK headlines about strikes. Rail strikes began over a year ago (the first was on 21 June 2022) and have become a feature of British life. Indeed, they have become a big factor in the work-from-home shift and, paradoxically, we believe the strikes are one of the reasons why London's property prices have been falling faster than elsewhere in the UK.

Interestingly, labour relations are also deteriorating in the US. The Teamsters Union activists are back and United Parcel Services (UPS) and other freight companies are being pressed. We write about this in the article about freight and inventories.

Members of the US Federal Reserve (Fed) are now in their quiet period but, recently we had two members positing almost diametrically opposite views. Richmond Fed Chief Tom Barkin said: "Inflation is too high. If you back off too soon, inflation comes back strong, which then requires the Fed to do even more."

Barkin said that a large part of what's keeping inflation elevated – as well as powering the rest of the economy – is a resilient labour market. Employers continue to add jobs at a robust pace and wage gains are still strong, enabling Americans to keep spending.

Against this, Chicago Fed Chief Austan Goolsbee said "Our…overriding goal right now is to get inflation down – we're going to succeed at it. And to do that without a recession would be a triumph, and that's the golden path – and I feel like we're on that golden path."

Goolsbee's golden path notes there are signs that companies have started to cut some costs, margin's and prices, but not cutting labour costs. His path requires that labour demands are responsive quickly to that underlying environment. But if the US turns out to have a more entrenched inflation path because labour relations have worsened it may face the same worries as have faced us here in the UK.

As the earnings season progresses, we appear to be in a new phase; one where companies have lost pricing power, but sales should hold up because they are not cutting labour aggressively. Gavekal Research refers to this phase as a disinflationary boom, a time when equity markets do reasonably well. One of the reasons equities can do well is because bond yields also tend to fall. That happened last week and, hopefully over the next two weeks, it can go further if the central banks will feel confident labour will respond to signs of lower inflation. We will be listening to what the Fed will be telling us this week very closely.

Chinese property developers are on their own

Last week, Chinese media carried stories of new policy action. On Wednesday, there were rumours of mortgage rate changes and property-focused efforts, but the policies were deemed to be small. and had little impact on markets. Indeed though the week, many property developer bonds plumbed new price lows for the year. Broad stock markets bounced on Friday but that was on news of policy support for electric vehicles, another recently beaten-up sector.

Everyone knows property giant Evergrande is in deep trouble. Since it defaulted on its debt two years ago, the world's most leveraged property developer has been in a lengthy restructuring process which, for the most part, has looked like artificial life support rather than a cure. Its slow-motion collapse has been a major part of China's property crisis and is a substantial drag on growth for the world's second largest economy. None of the property developer's problems should surprise us anymore, and yet, its latest announcements cannot help but make our collective eyes water. In just two years, Evergrande made losses of $81 billion.

The report covers 2021 and 2022 and has been delayed for so long in the hope of a sector rebound to soften the blow. The incredible losses are driven mostly by asset depreciation, thanks to sinking values in China's building industry. Analysts have suggested that the fact such dire figures are now being released shows an acceptance the hoped-for improvement is not coming anytime soon. As Brock Silvers of Kaiyuan Capital told the *Financial Times*, "The release of results seems to indicate that management and regulators have finally accepted that a housing rebound isn't imminent,"

Valuation losses are particularly nasty for companies as leveraged as Evergrande. It makes refinancing virtually impossible, leaving it forced to sell off parts (as creditors are urging with the Xian real estate arm). Its borrowing was exceptional even among China's credit-hungry property developers, but its struggles are affecting them all the same. On Wednesday, developers Dalian Wanda and Shui On saw the value of their dollar bonds fall to eight-month lows.

The property developers' financial problems are proving contagious as they are weighing down on consumer and business sentiment. As such, they have been at the heart of the weak post-lockdown rebound in Chinese consumption and that has led to rising savings rates and even weaker private sector activity. Hopes of a post-covid boom have well and truly evaporated, pushing down asset values which rallied into the start of this year.

Fresh losses and the threat of defaults have now pushed China's high-yield dollar bond market to the brink of distress. State-backed Sino-Ocean is now facing similar problems, recently suspending trading in a soon maturing bond because of "significant" uncertainty in repayment. No Chinese property developer looks safe.

Last Wednesday, the Chinese media carried reports that banks would be encouraged to cut mortgage rates to existing borrowers gradually. While rates have been cut before, Chinese households have a form of fixed rate rather than floating rates on their mortgage. Thus, rate cuts have little impact on consumers generally. Unless mechanisms are changed. Also, previous mortgage holders are restricted on the more generous rates even if they have paid off all debt. They are not considered to be first-time homebuyers in major cities, and so have the higher down-payments and more restrictive borrowing limits applied to those buying a second home, although this is precisely where talk circulated that amendments could come through.

But no official announcement was made. Rather, the reports stemmed from a paper issued by the People's Bank of China (PBOC). Meanwhile, locally there were mixed reports. Some banks were said to have "communicated with borrowers on interest rates of existing home mortgages". However, no guidance or rules were in place and some papers had to correct statements that banks had agreed to cut rates on existing home mortgage loans.

The move, if followed through, might ease big city property conditions although it would do little for lower tier cities. Even so, as CreditSights said, "it is unclear whether better home sales and additional funding for the property sector would translate to a lower default rate and better recovery because the developers are guided by the government to prioritize home deliveries rather than setting aside funds for debt repayment."

In truth, the Chinese government has seemed surprisingly uninterested in arresting the decline. The last few months have been horrendous for the ailing sector, but policy support has been minimal. Beijing has been pushing to authorise new share issuance, which has helped some developers raise cash. Analysts think it will have a minimal impact overall, though. New measures are mostly around extending previously announced support from November.

When Beijing announced that package in the Autumn, it looked like a major change of priorities in the Communist Party. Beforehand, the focus was on constraining a sector that was seen as irresponsibly debt-fuelled and unsustainable – a campaign that led to the current woes. The support offered back in November was tentative but a symbolic change, coming alongside Covid reopening to give a general sense of the authorities loosening their grip. But those policies have failed to deliver the kind of change that was desperately needed.

The intentions of those at the top of the Party – and particularly President Xi – are always hard to gage, but it increasingly feels like officials are willing to let the sector collapse. The view has long been that developers' financing is risky and unsustainable, and they certainly are not prepared to bailout risk-taking companies at any cost. It was telling that last week, amid general concerns around Chinese growth, the Party issued a vow to support China's private economy but made no mention of the ailing property sector. Officials promised to treat private companies and state-owned enterprises equally, but the concrete measures announced were mostly restatements of old policies.

If Beijing does let large developers go bankrupt, equity and foreign bondholders will be the least protected. The distress also has big implications for the China's banks – which are among the largest financial institutions in the world.

Worsening prospects for foreigners is the fact that Hong Kong, where most corporate bonds are issued, does not have a corporate rescue mechanism for insolvent companies like in the UK or US. Bondholders are left negotiating for their money individually, making the prospect of mass bankruptcies a bureaucratic as well as economic nightmare. Elements like this are key – other big countries have lived through property crises. Mostly, relief comes through mechanisms freeing up new money to circulate in the economy. This can come through organised debt renegotiations, bad banks, recapitalisation of entities that accept losses, etc. China seems to be reluctant to opt for systemic approach along any of those lines.

Incredibly, amid all of these problems, government speakers have been talking about shoring up sustainability through measures such as cutting fiscal deficits. This is remarkable in the current environment, essentially forcing all of the pain at once for its plan of restructuring the economy. Supporters would argue this approach will lead to a more resilient and sustainable system in the future, but it certainly means pain in the meantime. Coming at the same time as promises to boost growth, the position comes across as inconsistent.

Monetary policy has been somewhat more expansionary, though even here support has not been as forthcoming as hoped. More importantly, the effectiveness of any monetary support is seriously hampered by the unwillingness to help property developers. As mentioned, their financial struggles seriously impact banks, which will inevitably mean tighter lending conditions for everyone. That could well dampen any help that comes from the authorities. Lending is extremely difficult in this environment, which puts a limit on the effectiveness of money supply growth.

As we have moved through the year, China's economy and the government's support for the property sector have been disappointing to say the least. This is not to say that Beijing is against growth – both words and actions suggest the opposite. However, it wants growth in productive areas and property has become unproductive. It is determined to engender a systemic change and that is happening now, not later. Developers will probably not be given anything more than life support.

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24th 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	7666	+2.6	+2.6	↘ ↘	4.1	11.1	10.8	13.3
UK FTSE 250	19241	+3.3	+3.3	↘ ↘	3.5	12.9	11.8	14.6
UK FTSE All-Share	4185	+2.6	+2.6	↘ ↘	4.0	11.2	10.9	13.5
UK FTSE Small	6233	+2.1	+2.1	→ ↘	5.1	9.4	8.0	12.7
France CAC 40	7426	+0.4	+1.6	→ →	3.1	12.9	12.4	14.1
Germany DAX 40	16155	+0.1	+1.3	→ →	3.6	11.5	10.9	12.9
US Dow	35284	+2.1	+4.2	↗ →	2.0	19.0	17.5	16.4
US S&P 500	4549	+0.7	+2.7	↗ ↗	1.5	20.8	19.6	17.6
US NASDAQ comp	14139	-0.2	+1.7	↗ ↗	0.8	30.6	27.4	23.0
Japan Nikkei 225	32357	-0.3	-0.1	↗ ↗	1.9	18.5	17.9	16.8
World Bloomberg	1628	+0.1	+2.1	↗ ↗	2.3	14.1	13.8	13.8
China mainland	3822	-2.0	-0.5	↗ ↗	2.0	18.1	17.2	16.4
Emerging Bloomberg	1134	-1.3	+0.6	↘ ↘	2.6	12.1	11.2	12.0

Top 6 Gainers		Bottom 6 Decliners		Fixed Income		
Company	%	Company	%	Govt bond	%Yield	1 wk chg
Ocado	+12.9	Flutter Entertainment	-4.6	UK Govt 10yr Gilt	+4.27	-0.13
Barratt Developments	+11.0	Coca-Cola HBC AG	-1.9	UK Govt 15yr Gilt	+4.46	-0.14
Taylor Wimpey	+10.5	Prudential	-1.9	US Govt 10yr Treasury	+3.82	+0.04
Persimmon	+10.5	Rio Tinto	-1.6	France Govt 10yr OAT	+2.98	-0.04
Hargreaves Lansdown	+9.7	WPP	-1.2	Germany Govt 10yr Bund	+2.45	-0.04
Land Securities	+7.8	Entain	-1.0	Japan Govt 20yr JGB	+1.08	-0.04

Currencies			Commodities			UK Mortgage Rate Estimates		
Pair	last	%1W	Cmdty	last	%1W	Rates (LTV c.75%)	21-Jul	21-Jun
USD per GBP	1.285	-2.0	Oil Brent $:bl	80.3	-0.9	UK BoE base rate	5.00	4.50
GBP per EUR	0.866	+1.1	Gold $:oz	1963.2	+0.3	2yr fixed	6.64	4.73
USD per EUR	1.113	-0.9	Silver $:oz	24.7	-0.5	3yr fixed	6.33	4.51
JPY per USD	141.39	+1.9	Copper $:lb	379.8	-3.2	5yr fixed	5.82	4.29
CNY per USD	7.182	+0.6	Alumnm $:mt	2171.6	-3.0	10yr fixed	5.49	4.46
USD per Bitcoin	29,866	-4.2	S&P soft crops	240.9	+1.6	Standard variable	7.54	7.44

21/07/2023
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

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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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