THE **CAMBRIDGE** WEEKLY

7 August 2023

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Expect the unexpected

July turned out to be another good month for portfolio investors as markets rose across the board, leaving only commodities and property investors in the red for the year. For more details on the month's returns picture, please refer to our July review in this week's edition.

That positivity feels somewhat remarkable, given that not much changed in the underlying economic fundamentals and that companies (in aggregate) reported lower profits compared both to last quarter and also a year ago. Nevertheless, general investor sentiment improved as inflation – the biggest headwind of the last year – continued to decline. Meanwhile, market analysts cheered on the widespread 'earnings beats' from quarterly corporate earnings reports.

These two points capture what is going on in the markets at the moment and also, in our view, why stock and bond markets started August with a wobble. Currently, it is not actual improvements in fundamentals that are pushing markets higher, but an expectation or hope that they will do so in the near future.

Falling rates of inflation across the board and worldwide has investors increasingly convinced that central banks will no longer feel obliged to push rates and yields higher still, and thereby limit the threat to stock market valuations that drove them down last year, when the rate hiking started. The noise from the ongoing quarterly reporting season of company results left them with the impression that earnings downgrades are equally a thing of the past, and while not going up significantly at the moment, at least they are not going down either. When bond yields suddenly ticked up over the last week, for reasons that were not immediately obvious, equity valuations reacted with a mild correction. The end of last week's US jobs data signalled perhaps a cooling of underlying inflation from the tight labour markets, and equity markets began to relax again.

So far so good, but as regular readers will know, we like to look a little deeper, to understand whether the prevailing trends have the potential to be sustained going forward.

Therefore, first a bit of an insight into how the quarterly phenomenon of 'earnings surprises/beats' comes about, and what the specific developments of the current round of quarterly beats actually tells us, then some more on the current interaction between bond and equity markets.

Over recent weeks, the market commentariat featured regular statements like these:

"A lot of these beats were priced in and as a result there's not a lot of excitement," said Michael Casper, an equity strategist with Bloomberg Intelligence.

Unsurprisingly, given such comments, many of us find the earnings season news flow confusing. Equity strategists, analysts and journalists talk about company results in terms of 'beats' and 'misses' which generally refer to profits but can also apply to sales revenues.

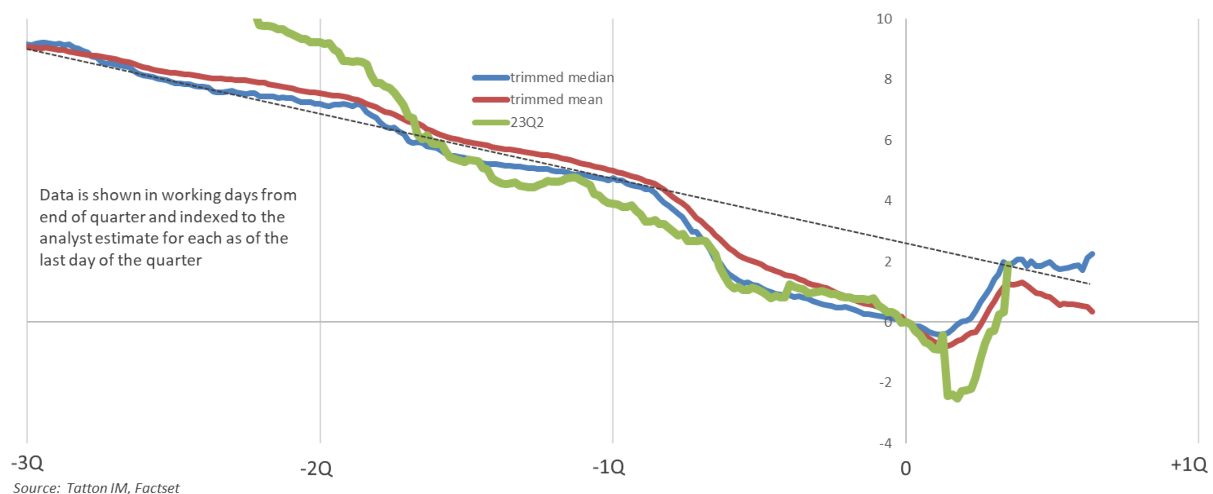
In the US, the quarter's reports fill the financial news headlines, and the general tone is rarely anything other than positive. Last Thursday night's release of Apple's results was a case in point. Apple told us that its profit was nearly 5% higher than analyst forecasts for the April-June quarter, and yet the share price fell by 2%. The bad news was that sales in the past quarter may have beaten (lowish) expectations but in absolute

terms were still down on the January-March quarter, and are expected to continue to decline in this July-September quarter.

So, what they give with the one hand, they take with the other. When we look back at the record of how this reporting season has gone, Apple will add to the aggregate ‘earnings beat’, but the offset is that there is a hit to next quarter’s expectations.

This pattern gets repeated quite often. Companies work hard to show profit in their past performance, but it is generally in managements’ interests to push down expectations for the near future, to shine with better than thus expected results at the end of the next quarter – especially if the past quarter’s performance can be explained by ‘one-off’ factors.

To evidence this behaviour, we have looked at the path of analysts’ aggregate earnings forecasts leading up to and then beyond the end of each quarter (over the past 20 years, with the global financial crisis and pandemic periods removed). The chart below shows the average track of aggregate estimates for the US Factset Index (around 3,000 US listed stocks, market-cap-weighted, and similar to the Russell 3000). The horizontal x-axis provides the timeline with ‘0’ marking the beginning of the actual reporting period start for the previous quarter. ‘-1Q’ therefore describes expectations as they stood at the beginning of a given quarter. The vertical y-axis shows how the aggregate earnings moves compared to the level as of the last calendar day of the quarter being forecasted. (So we can see that, compared to their predictions on June 30th 2023, when reporting was imminent, the analysts were predicting Q2 2023 earnings to be 9.2% higher on 31st December 2022, which declined to 3.9% when they looked at them again on 31st March 2023).



When analysts start their forecast (looking a year and a bit forward) they are too optimistic, so the forecasts fall at about 2% per quarter. Equally, in the final phase after the quarter has happened and the companies start reporting their results, analysts end up being too pessimistic. Companies generally manage to surprise them by about 2% in total. But here’s the rub; as companies give us the good news about the quarter just gone, they give us some ‘bad’ outlook news about the upcoming quarter. This, on average and perhaps

unsurprisingly, knocks the analysts estimates down by an additional 2%. The quarter just before the results has an average decline of 4% in total, 2% of which is regained in the results period.

This current reporting quarter has had some differences (a sharper deterioration during the early months of the year) but has followed the median path pretty well. So, as usual, results are beating the analyst final expectations, but are not beating compared to what we might expect at the beginning of the quarter.

One might think analysts would learn and adjust, but perhaps there is an incentive to be slightly pessimistic, especially as most analysts have more buy recommendations than holds and sells.

The fact that neither this quarter's earnings – nor the guidance for the next – is special is a problem for the market's price given the expensive valuations. Expensive valuations usually occur when the next few quarters can be expected to show strong growth – markets price in what is already on the horizon. We have had strong growth in the post-pandemic period partly because nominal revenues have been supported by both real economic growth and by high inflation. Now, a sharp decline in the pace of inflation isn't being offset by any substantial rise in real growth.

In summary then, all the reported 'beats' are not telling us that the outlook is improving, but at best that it is not getting worse, or in other words, ordinary earnings growth which would struggle to justify July's valuation dynamics.

When growth and inflation are slow, help has often come from falling bond yields. Equity valuations are supported as dividends can look attractive in comparison. But that is not what happened last week. As already noted, US bond yields have risen (which means prices have fallen).

The catalyst for bond price falls may have been the Fitch rating agency's downgrade of the US long-term foreign currency credit rating to AA+ but, since US Treasuries are NOT issued in a foreign currency, this shouldn't matter greatly. In addition, the much more influential Standard & Poors has had its US rating at AA+ since 2011.

It is more likely that the price falls are due to a non-market sentiment specific situation of 'more sellers than buyers'. The US Treasury surprised markets by selling substantially more new long-term bonds than expected, just as corporate borrowers have been shifting from high-cost short-term borrowing to longer-term financing (as we noted last week) and therefore – like the US government – also looked for more buyers of long-term bonds.

The struggles of the US bond market can have quite a big impact on the equity market, and this might occur even if the US Federal Reserve (Fed) was perceived to be close to finishing its tightening cycle. The yield curve inversion (the difference between short rates and long-term rates) has been extreme for some time, possibly because investors appear convinced that a recession might be imminent, or that elevated inflation is only temporary. Well, no recession has occurred and many of the other market metrics (such as corporate credit spreads) have been indicating quite the opposite – that recession risks have been receding.

The bond sell-off may not have an enormously long way to go, but investors are still wary after the huge capital losses of 2022. It may be that recent bond positivity is evaporating which could see the US ten-year

bond yield head above the 4.3% highs of the last year, an outcome that oddly might raise recession risks substantially.

Here in the UK, we are no stranger to bond price falls since last autumn's mini-budget disaster. Last Thursday, the Bank of England's Monetary Policy Committee (MPC) voted by a majority to raise rates by another 0.25%. Two independent members wanted 0.5%, the other two independents wanted no rate rise. The MPC said the current stance was "restrictive" but reiterated that "further tightening in monetary policy would be required".

Although the forecasts tended to indicate that the MPC saw inflation as difficult to shift, investors seem to perceive that the risks no longer as heavily skewed. Growth here and in Europe (extremely important for the UK) seem to be on a slower path than the US, especially recently. Although the UK government bond yield curve is inverted, UK (and Euro) bonds look cheaper than those in the US. All areas have seen some price falls but, when comparing bonds of similar maturity, UK Gilts and Euro government bonds have been relatively stable.

The previously-mentioned US non-farm payroll data of new jobs created over the month (being slightly weaker and below 200,000 new employees) has helped alleviate some of the pressure on US yields last Friday afternoon. Nevertheless, we suspect the technical expensiveness of US ten-year bonds could still have some further follow-through. It's not the end of the world, but equities could lose a bit of momentum. So, while we very much welcome the positive returns that July's upbeat sentiment brought for investors, this first week of August has once again demonstrated the fragility of optimism-driven valuations. As such, we expect markets and investors' fortunes to remain in fine balance and therefore volatile and sensitive to anything that has the potential to sway the current optimism one way or the other.

July review: optimism driven markets

While the British weather was dreary, July was all sunshine in capital markets. Global equities returned 2.4% in sterling terms and practically all major stock markets finished in the black. The recent bright spot has helped year-to-date returns too: the top equity indices we track are now all up from the start of 2023 in sterling terms, including previous laggards like emerging markets (EMs). Underlying this optimism has been the consistent slide in global inflation. Markets feel price pressures are much more manageable and, as such, expect central bankers can loosen their tight grips on financial conditions. The table below shows July's results in full.

Asset Class	Index	Jul-23	YTD	12 months	2022	5-yr rolling annualised
Equities	UK Large Cap	2.3	5.7	7.8	4.7	3.75
	UK Ethical Large Cap	1.3	4.3	3.2	1.1	0.9
	Europe ex-UK	1.7	10.9	15.1	**-7.6**	7.0
	US Large Cap	2.0	12.8	6.9	**-7.8**	12.6
	US Technology Large Cap	2.8	28.8	10.5	**-24.0**	14.3
	Japan	1.8	8.8	8.9	**-6.1**	8.7
	Global Stocks	2.4	10.4	6.8	**-8.1**	8.2
	Emerging Markets	5.0	4.2	2.5	**-10.0**	1.7
Bonds	UK Gilts All Stocks	0.8	**-2.7**	**-16.0**	**-23.8**	**-4.0**
	£-Sterling Corporate Bond Index	2.4	1.4	**-7.1**	**-18.4**	**-0.8**
	Global Aggregate Bond Index	0.0	2.4	**-3.2**	**-12.2**	**0.0**
Commodities	Commodity Index	9.4	**-4.3**	**-10.1**	41.9	5.6
	Brent Crude Oil Price	11.9	**-7.0**	**-22.3**	24.4	2.9
	Spot Gold Price	1.5	0.9	4.9	12.1	9.9
Inflation	UK Consumer Price Index (annual rate)*	0.8	3.4	7.3	10.5	-
Cash rates	SONIA 3-Month	0.4	2.2	3.1	1.1	1.0
Property	Global REITs	2.1	**-1.7**	**-12.5**	**-14.8**	2.2

Source: Morningstar Direct as at 31/07/23. * to end of previous month (30/06/23). All returns in GBP.

EM equities were the strongest performing through the month, gaining 5% in sterling terms. This is the opposite of what we have seen for most of the year. The strength of the US dollar (which hurts EM companies with large dollar-denominated debts), tight credit conditions and huge disappointment about China's lacklustre post-pandemic rebound previously meant investors were sour on EMs. But by the same token, a weakening dollar during July – on the back of cooler inflation figures – and new stimulus in China has renewed optimism.

There are certainly reasons to get excited, but we should, as ever, be cautious. EMs are still down over a six-month basis, and the rally is vulnerable to quick changes in sentiment. Short-term hopes are based on a less aggressive US Federal Reserve (Fed), and as such could be spoiled by inflation surprises or hawkish messaging. Longer-term hopes are pinned on a Chinese growth spurt, but post-Covid disappointments show this can be a dangerous bet. We have never doubted the potential of China's economy, but developments this year call into question whether the government is willing or able to unlock it. Should Beijing boost consumption by as much as it promises, EM and global growth will greatly benefit – but we will believe it when we see it.

July's best-performing developed market is also one with a disappointing recent growth record. The FTSE 100 gained 2.3% over the month, thanks to lower-than-expected inflation readings and better-than-expected economic data. Corporate earnings reports from Q2 were surprisingly decent, especially in the banking sector. UK inflation dropped to 7.9% in June, below expectations of 8.2%, while the much-watched 'core' inflation (excluding volatile elements like food and energy) dropped to 6.9%.

While the fall is encouraging, inflation is still much higher than in the US and Europe, and still almost 4x higher than the Bank of England (BoE) target of 2%. Even so, markets increasingly expect the BoE to back off in its tightening cycle. While the UK's labour market is tight, the economy is just too weak to stomach significant further tightening. This puts policymakers in an unenviable position, but as many have pointed out, it is both the government and the BoE that have overseen the structural deterioration of Britain's supply side. The latest signs offer much-needed relief, and are particularly helpful to large-cap stock valuations, which in the UK are somewhat disconnected from domestic growth.

US large cap stocks did not quite match their UK counterparts in sterling terms, but July's 2% gain came from a much higher base. Investors were buoyed by expectations of a 'soft landing', where inflation and interest rates come down, but growth stays resilient. That the world's largest economy recorded 3% inflation for June without dipping into recession (indeed, accelerating away from it in the first half of 2023) suggests this is a definite possibility. But we should not underestimate the Fed's resolve, or the lasting effects of inflation. The Fed has repeatedly affirmed its tightening bias, and as we have discussed before, the psychological impact of high inflation and a tight labour market could stop us from returning to the pre-pandemic norm of low growth and price stability.

Equity returns were thankfully more broad-based than earlier in the year, when large cap US tech stocks had basically all the growth there was to have (returning an incredible 28.8% year-to-date in sterling terms). US tech still managed to climb 2.8% in July though, in a sign that the artificial intelligence (AI) craze might still have some way to go. While tech valuations look stretched, though, uneven returns in the US mean the rest of its stock market is not as expensive – and hence not as vulnerable – as it might initially look.

European equities were a little more subdued, but still climbed a respectable 1.7%. As elsewhere, inflation cooled, coming down to 5.3% in July according to the latest estimates. Economic data was more disappointing, though. Business sentiment and manufacturing output were weak, even though growth surpassed expectations. The European Central Bank (ECB) raised rates again in July but, thanks to falling inflation and economic weakness, we expect policymakers to pause from now. If they do, on a currency-hedged basis, European bonds might stand to gain in the second half of this year. The Euro currency and European equities may have a more mixed outlook.

Of all the security markets listed above, the largest single return came from Brent crude oil prices, which were up 11.9% in July in sterling terms. This was followed close behind by the wider commodity index, gaining 9.8% on the month. There is some irony in this, given everything else said to this point. Markets' good mood is predicated on falling global inflation and resilient growth, which itself owes a lot to falling input prices (particularly energy). And yet, at the same time, those input prices rose rapidly during July.

With the volatility in commodity markets – and especially energy – we should not read too much into this. But it raises an interesting point: input prices are no longer sinking, and are in some cases expanding strongly, thanks to where we are in the inventory cycle. If this continues – and especially if demand stays resilient – it could upset the delicate balance that created markets' current optimism. As central bankers are keenly aware, a soft landing requires prices to stay soft.

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7th August 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	7512	-2.3	-2.3	→	→	4.2	10.8	10.6	13.3
UK FTSE 250	18842	-1.5	-1.5	→	↘	3.5	12.7	11.5	14.5
UK FTSE All-Share	4102	-2.2	-2.2	→	→	4.1	11.0	10.6	13.5
UK FTSE Small	6219	-0.8	-0.8	→	↘	5.0	8.1	6.6	12.7
France CAC 40	7276	-2.4	-1.6	→	→	3.2	12.4	12.0	14.1
Germany DAX 40	15856	-3.6	-2.8	→	→	3.6	11.3	10.7	12.9
US Dow	35297	-0.5	+0.1	↗	→	2.0	19.4	17.6	16.5
US S&P 500	4516	-1.2	-0.6	↗	↗	1.5	20.7	19.4	17.6
US NASDAQ comp	14044	-1.1	-0.5	↗	↗	0.8	30.2	26.9	23.0
Japan Nikkei 225	32139	-0.7	-1.1	↗	↗	1.9	18.5	17.8	16.8
World Bloomberg	1613	-1.6	-1.0	↗	↗	2.3	14.1	13.8	13.8
China mainland	4021	+0.7	+1.0	↗	↗	2.1	18.0	17.0	16.4
Emerging Bloomberg	1144	-1.8	-1.2	→	↘	2.5	12.8	11.7	12.0

Top 6 Gainers

Company	%
BAE Systems	+8.0
ConvaTec	+7.2
Rolls-Royce Holdings	+5.7
Centrica	+4.6
Weir	+3.1
Taylor Wimpey	+2.8

Bottom 6 Decliners

Company	%
Ocado	-11.5
Beazley	-10.9
BT	-8.5
Hargreaves Lansdown	-8.1
Fresnillo	-8.0
abrdn	-6.9

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.43	+0.07
UK Govt 15yr Gilt	+4.65	+0.11
US Govt 10yr Treasury	+4.13	+0.15
France Govt 10yr OAT	+3.12	+0.10
Germany Govt 10yr Bund	+2.59	+0.11
Japan Govt 20yr JGB	+1.34	+0.19

Currencies

Pair	last	%1W
USD per GBP	1.278	-0.6
GBP per EUR	0.863	+0.9
USD per EUR	1.102	+0.2
JPY per USD	141.84	+1.0
CNY per USD	7.176	+0.2
USD per Bitcoin	29,209	-0.3

Commodities

Cmdty	last	%1W
Oil Brent $:bl	85.6	+2.3
Gold $:oz	1943.3	-0.6
Silver $:oz	23.7	-2.3
Copper $:lb	385.3	-1.3
Alumnm $:mt	2188.0	+0.7
S&P crops	240.4	+1.2

UK Mortgage Rate Estimates

Rates (LTV c.75%)	04-Aug	05-Jul
UK BoE base rate	5.25	5.00
2yr fixed	6.40	5.50
3yr fixed	6.10	5.29
5yr fixed	5.63	4.95
10yr fixed	5.39	4.87
Standard variable	7.54	7.54

04/08/2023
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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7th August 2023

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