THE **CAMBRIDGE** WEEKLY

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Markets give thanks

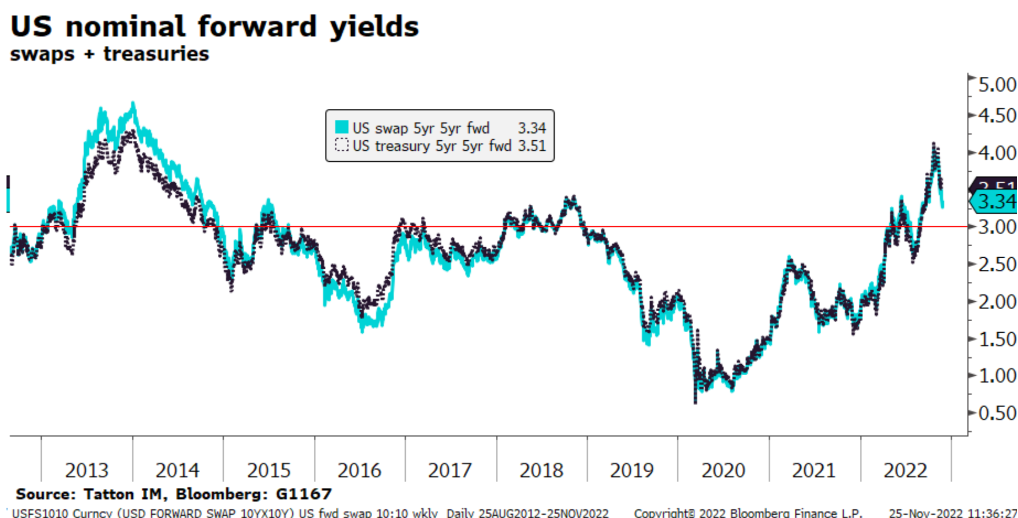
The last week of November is generally a quiet one for markets. Many professional investors head back to family homes in the days before Thanksgiving and will have already closed down their risk positions for the year. Few like to be exposed to markets when there are lower trading volumes in December, and this may be one of the reasons why US equity markets tend to enjoy a seasonal boost in the last quarter.

This year's Thanksgiving lead up has been a good one, and not just for equities. Government and corporate bonds have all recently gone up in price. This suggests the professionals had been more pessimistic about the growth/inflation dynamic than appears warranted now and, as a result, they have rapidly reversed their risk underweight positions.

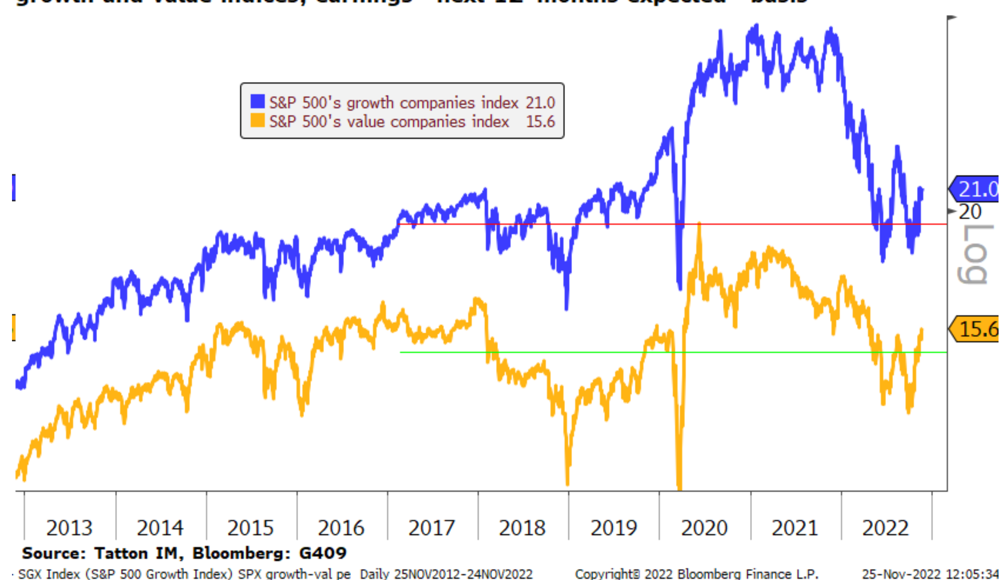
We track several indicators of how the markets are thinking about the global and regional economies' medium-term future, and it is reasonably clear to us that the recent declines in both actual inflation data and the continued falls in the raw material cost inputs has changed the investor perceptions of medium-term risks. The release of the minutes from the Federal Open Markets Committee's (FOMC, US central bank rate setters) 2nd November meeting provided documented evidence that the voting members now see a case for a tempering of hawkishness (raising rates ever further) over coming meetings.

That increase in visibility is good for markets. Interest rate markets responded, but neither by lowering the estimation of the short-term rate peak, nor when they anticipate this to occur. The US Fed funds rate is still seen as hitting 5% early in the second quarter of 2023, with cuts being priced in for some point in Q3 or Q4.

What has changed more markedly is the 'terminal rate', the medium-to-long-term rate markets foresee as being the end point for rates in this new cycle. One way to measure this is by comparing five-year and ten-year US Treasury bonds. Here is the chart of how this 'terminal rate' has moved over the past ten years:



If one thinks that the US and the world are returning to the same situation as in the years before the pandemic, there is some room for this yield to continue to fall, given in 2017-2018 it was around 3%. That asset-price 'Goldilocks' era back then had low inflation and low growth, a regime where certainty of long-term cashflows was valuable. This year, equity valuations have swung down dramatically from the extremes of the pandemic period as yields rose. It is not impossible that they may return to those heights, but few of us would want a return of that situation. But unlike bonds, which still have a bit to go to match 2017-2018, the price-to-earnings valuations of stock markets (based on aggregated analysts' company projections for the next twelve months) never went below the 2017-2018 levels, and have now started to move up again as this chart indicates:



The Q3 earnings results season was hard for tech companies especially. Despite the usual near-term manipulation by companies in order to 'beat' expectations, analysts now see growth companies' earnings some 9% below the peak level they foresaw back in June.

So, given stock markets have risen regardless, equity investors appear to be more positive about the future than bond investors. They expect earnings growth to either rebound next year, or for the following years to be more profitable than usual.

The problem with this view is that should growth rebound in the nearer-term, it will be difficult for the Fed to give us much dovishness. As a result, yields would probably rise – not fall further – and that would undermine valuations from the other end of the valuation equation. Earnings might go up, but rising yields would put the PE multiple of their price over earnings under pressure to fall.

Still, market sentiment does seem to have improved a lot from a month ago. Despite the potential for shock from the cryptocurrency market, US retail investors appear to be heading back into the equity market. Indeed, perhaps they have given up on the promise of fanciful riches from speculation in new currencies and would rather invest in the more certain profits of companies. And after the summer, when

savings were being drawn down to pay for sky-high prices on goods and services, it seems people have got some spare cash to put into markets. November retail volume flows have been the best in two years for small and mid-caps, according to J.P. Morgan's flow data. Total retail market volume was back at 20% of overall order flow, the best since the heady days of late 2020.

For us, one of the most interesting dynamics in capital markets this year has been the decline in corporate high-yield bond issuance. At one stage this year, the amount of US bonds outstanding within the high-yield US Bloomberg bond index was declining at a 20% year-on-year rate. Even now the index is shrinking at a 10% rate. Maybe companies are generating enough cash flow to pay down debt without having to raise finance. More likely, they are awaiting a better opportunity to issue debt, when investors are more optimistic and willing to buy at a yield expense less than the levels seen a couple of months ago. The index yield peaked just shy of 10% at the end of September. An opportunity to issue more may be around the corner, as we are now down 1.5%, at 8.5%.

The balance sheet management of larger companies has improved dramatically in this century, but as every mortgage holder knows, there is no avoiding the need to refinance when debt reaches maturity: delays in issuance can therefore only go on for so long. We expect to see pre-Christmas issuance pick up, but many will try to wait into 2023. Investors, with enhanced appetite for high yielding bonds, may be happy to pick up new supply and their demand may keep corporate bond yields contained. It will be very interesting to see how their appetites continue into the new year, when issuance picks up beyond the point of demand saturation – the recent suppression of yields because of the mismatch of supply and demand may well come to an end.

We now turn to another remarkable return dynamic of 2022: the impact of currencies/Foreign Exchange movements. Looking at the market data table at the bottom of this edition of the Cambridge Weekly, the FTSE 100 was up on the week, and as of last Friday, by about +1.2%. The best performing equity index in the table is the S&P 500, at +1.6%. And yet, when you look at your portfolio, the HSBC S&P 500 tracker fund shows no change. How on earth has a tracker underperformed by 1.6% in a week? The answer is that the fund is denominated in £-sterling and the US dollar has gone down versus sterling by about -1.5% since the previous Friday's close.

In fact, for much of this year, and contrary to what we experience now, while stock markets have been weak, sterling's value has also fallen. Even though US equities were down from the start of the year, UK-based investors were cushioned by the rising value of the dollar. Indeed, towards the end of August, the combination of currency and stock markets meant that while the S&P 500 was down 9.2%, in sterling terms it appeared to have risen by 1.7%! The dubious benefit of a weak currency is that overseas equity assets go up even when they are not going up, or even slightly down.

The reverse has been happening since a new Prime Minister became certain. From the lows of the end of September, sterling has rallied some 10%, as has the S&P 500. So, since 30th September, the GBP-denominated HSBC S&P 500 Tracker Fund has risen only by about 1% (as of last Thursday close).

Currency volatility can sometimes be an issue for investors and overseas assets are often thought of as raising risks. However, as has happened this year, overseas assets can also reduce the risks and volatility of a portfolio. More importantly, the biggest benefit comes from the much greater diversification of global companies.

Having said all of that, the UK FTSE 100 is on course to being one of the best performing major markets for 2022 in sterling terms. It is currently eclipsed only by the Indian stock market, which is about 2.5% ahead in net total return terms according to Bloomberg indices. Given the current turmoil and economic pessimism, who would have thought the UK stock market would do so well?

A last word on China, which we talked about last week in a hopeful manner. While moving away from its 'zero-Covid' policy was inevitable, the transition was never likely to be smooth. Chinese authorities' relentless past messaging about the dangers of the virus spreading may have been useful in gaining acceptance of the stringent lockdowns, but now those fears are a big impediment to opening up. It is going to be challenging, for sure, and our experience has been that some aspects (like the rise in long-term mental illness) will be uncovered at levels which were never expected. Nevertheless, there is no real alternative and so we expect China to gradually open up, even if that is interspersed by many renewed regional short-term lockdowns.

PMIs paint a gloomy picture for businesses

Regular readers will know that Purchaser Manager Indices (PMIs) surveys are important surveys of business sentiment. These surveys measure businesses' own assessments of whether conditions will improve or worsen in the near future, then aggregate the results for a mark out of 100. These surveys have been a surprisingly reliable indicator of future growth, where marks above 50 indicate expansion, and anything below that points to contraction.

Across the latest PMI surveys for Europe and the US, companies are showing a high degree of pessimism. For November, every single European and American PMI we monitor came in below 50.

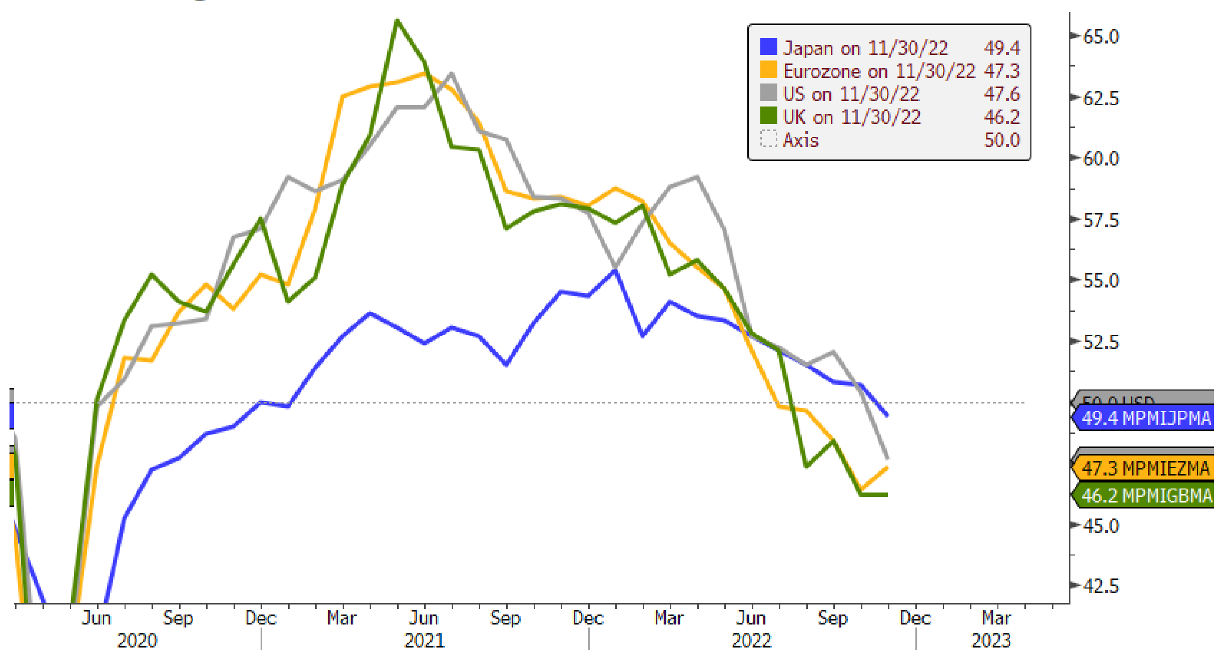
This is more confirmation, if any was needed, that times are tough. However, we should note that there was nevertheless a fair amount of good news in last week's PMI releases. As well as the absolute reading, there are two crucial things to look out for in PMI data: how sentiment compares to the recent past, and how it compares to economists' expectations. On both of these fronts, there were some bright spots, particularly coming from Europe.

Economists expected the Eurozone PMI for the manufacturing sector would be again lower at 46, down 0.4 points from the previous month. In fact, European manufacturers posted a more upbeat reading of 47.3. Likewise, Europe's services sector PMI came in at 48.6, matching last month's reading and beating expectations of 48. The Eurozone's composite figure beat both expectations and last month's figure with a reading of 47.8.

Clearly, these are not levels to get too excited about – they still point to a dreary picture in absolute terms. But they indicate a surprising amount of resilience from European businesses. That is hugely significant, given the overwhelming negativity on the continent. Even Germany, struggling with an acute energy crisis and facing rationing this winter, managed to beat expectations across the board. At 46.6, the German composite PMI is still firmly in contraction territory, but this still marks an improvement from October, whereas economists expected a continued decline.

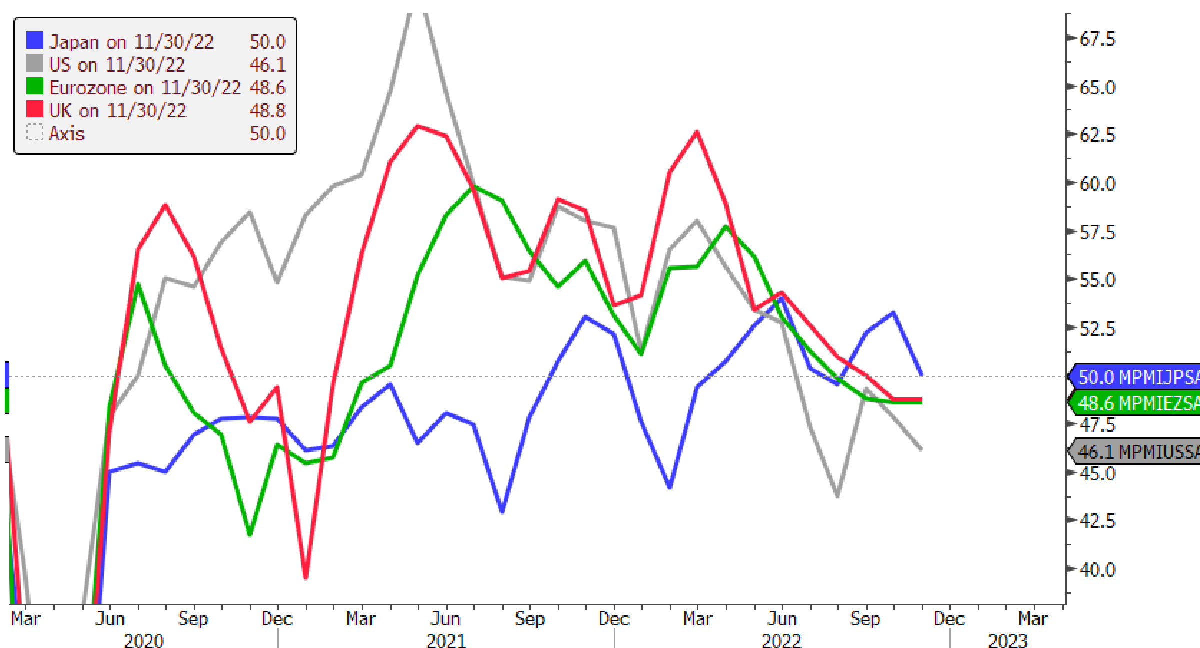
France did not manage to beat expectations or last month's figures overall, posting a 48.8 composite PMI against predictions of 49.4. This weakness came from the services sector, where sentiment has been (slightly) positive until just this month. Manufacturing, on the other hand, was notably above dire expectations of 47, coming in at 49.1. Services tend to lag manufacturing, which has more immediate impact from goods inflation and consumer demand. The rebound in manufacturing sentiment is therefore a good sign.

A slight rebound in Europe – from poor levels – fits with other data we have seen recently. Europe's greatest problem is the energy shortage, exacerbated by its (former) reliance on Russian natural gas. But gas prices peaked some weeks ago and perhaps have begun to settle at a lower rate. The balance between supply and demand is likely to remain tight, and there will probably still be worries this winter if the weather cools substantially, although any improvement is welcome. In fact, full gas storage in Germany tends to last for about two months (of course weather-dependent), so as March/April comes onto the horizon, the focus will then shift to next winter, and how Europe can fill storage again, this time possibly with no Russian gas at all. Stock markets seem to have cottoned on to this seemingly more manageable situation – with European stocks rallying consistently for more than a month.



S&P Global: Regional PMIs

Services



Source: Bloomberg, Tatton IM, S&P Global, Caixin, Jibun, CIPS: G662

MPMIJPSA Index (Jibun Bank Japan Service PMI Business Activity SA) Service PMIs Markit Monthly 28AUG2019-30MAR2023 Copyright© 2022 Bloomberg Finance L.P. 24-Nov-2022 17:19:26

A quick look at the charts above should suggest a note of caution with these figures. Volatility means we should not read too much into single releases. But they are a vital part of the wider picture. The UK, for example, has seen so much negativity in recent months that one might have thought – as economists certainly did – businesses would be feeling more despondent than usual. But UK PMIs across the board surpassed those expectations. Curiously, results for manufacturing, services and the aggregate reading were all practically unchanged from last month. While this is not exactly cause for celebration, it does suggest British businesses are not yet as pessimistic as the government and the Bank of England would suggest.

Japan experienced tepid growth in the post-pandemic months, while Europe and the US were very strong. Perhaps Japan has a similar dynamic in reverse, with some resilience in both manufacturing and services. Still, while both manufacturing and services were stronger than anticipated, they are no longer signalling growth.

The biggest surprise of all, however, comes from the US. At times this year, the world's largest economy looked like its only real source of growth, maintaining a decent cruising speed while the rest of the world fell behind. Even though the US economy has slowed in recent months, economists expected only a mild decline. The November flash data was therefore quite worrisome: US PMIs came in well below expectations across the board, showing a sharp drop-off from last month.

Manufacturing sentiment was expected to stay exactly neutral at 50, but instead came in at a decidedly downbeat 47.6. The predictions for the services sector were slightly worse at 48, but even that proved too optimistic, as US firms posted a 46.1 figure. This left the composite figure at 46.3, well below expectations and also October's reading. It is difficult to make cross-country comparisons with the absolute figures, but even so, the fact that the aggregate reading for the US was below even struggling Germany is remarkable.

There are plenty of reasons for slowing economic growth in the US. The Fed is raising interest rates hard and fast, businesses are suffering from lower foreign demand and consumers have much lower savings to fall back on than a year ago. Moreover, manufacturers are generally more sensitive to rises in interest rates, due to the operating capital required for both input materials and produced goods. That said, US 'hard' data – tallies of things like retail sales and labour markets – have been more encouraging than the PMIs indicate. It may be that US businesses are more affected by the combination of recent global economic weakness and the impact of a strong US dollar.

If this is the case, the weak US PMIs may rebound somewhat given the mild signals of some global resilience, and recent currency moves which have seen notable sterling, euro and yen strength against the -at long last - weakening dollar.

The factors have been in play for some time though, and do not clearly explain the accelerated slide. Perhaps the belief in America's growth exceptionalism – that it stays strong while others fall back – may be dissipating.

The PMIs suggest we may be entering a new phase of the global slowdown. Before, the focus was on hard input cost pressures and which region might be worst affected. Now, the problem may be more about employment and wage inflation and lagged effects of monetary tightening. While labour markets are tight around the world, the US jobs market is particularly tight, forcing the Fed to be more aggressive than most. This is perhaps a sign that the much-discussed 'engineered recession' could be upon us – to the relative benefit of Europe and the relative detriment of the US. We continue this discussion in the article below.

Continued labour market tightness keeps pressures

Remember when inflation was supposed to be 'transitory'? In the heady days of mid-2021, when lockdowns were easing across the developed world, a slew of bottlenecks in global supply chains saw prices climb quicker than at any point since the global financial crisis of 2008. Most analysts – us included – thought these were teething problems in the post-pandemic recovery: sharp, but ultimately short. But in October 2022, the UK recorded 11.1% annual inflation, the highest level in over four decades. Prices continue to rise all over the world, despite intense central bank efforts at containing them.

To be fair to ourselves and others, few foresaw the reach of the impacts. The pandemic and its recovery created a myriad of sector-specific supply problems, each of which individually might not have been so bad, but the sum of which was highly inflationary. Then came the biggest European conflict since the Second World War, and the biggest global energy shock since the 1970s' oil crisis.

Reflecting on last year's 'transitory' debate is useful for more than just finger-pointing. When the global inflation spike began, most of the causes looked short term because they were acute supply-side problems. Typically, the solution to these is a short-term demand adjustment coupled with an increase in supply-side investment (due to the added incentive of higher prices). All else being equal, that should bring things back into equilibrium over the medium term – which limits how long such inflation pressures can go on for.

As far as last year's supply bottlenecks go, this has indeed proven true. A shortage of microchips was one of the big factors underlying an initial bout of goods inflation – but this has now more than cleared up. The latest data from Taiwan, home of the world's largest chip producer, now shows an oversupply of chips.

Even commodities – boosted dramatically by Russia's invasion of Ukraine – have come back down markedly in recent months. European natural gas prices are now well below the peak of earlier in the year, while Brent crude oil prices are below where they were on the eve of the invasion.

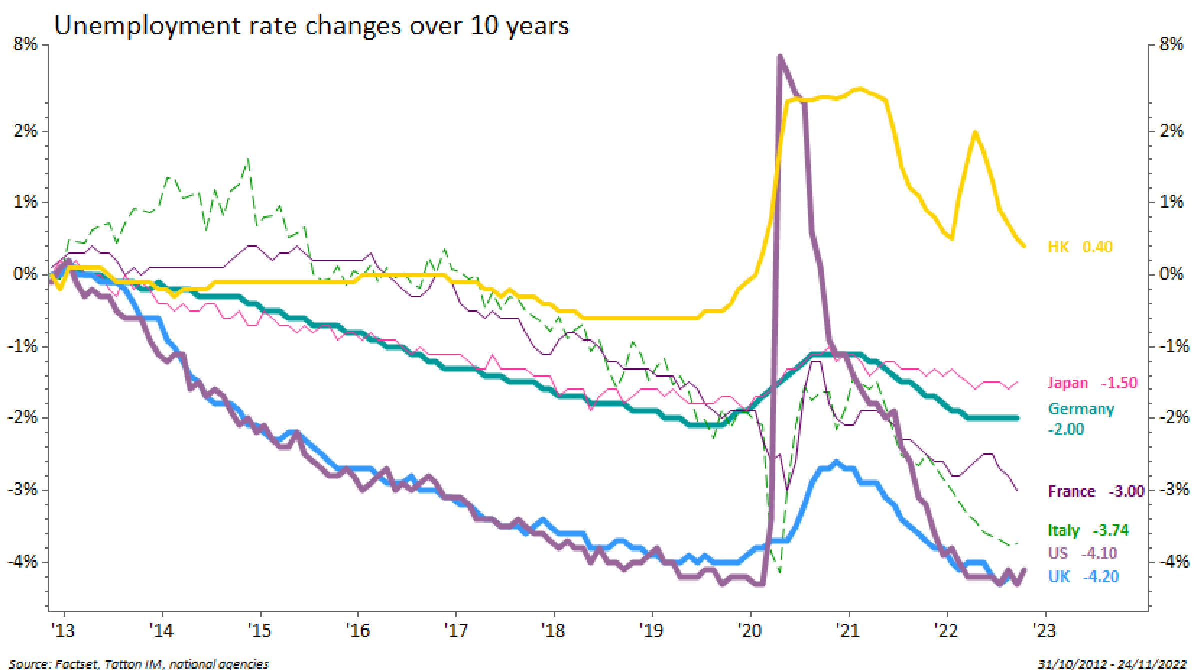
There are still some issues in the supply of goods and materials, but these are no longer driving decades-high inflation. Instead, the main problem is an acute shortage of labour supply. After a short burst higher during lockdowns, unemployment has sunk to near record lows in the US and across Europe. During which time, companies from a wide range of sectors have reported difficulty in finding workers.

Even with slowing growth and generally pessimistic outlooks from companies (see the article above on business sentiment), labour shortages continue. This is a particular issue in the US, where wage pressures have stayed high despite aggressive monetary tightening from the Fed. US employers added 261,000 extra jobs in October alone, after similar figures over the previous two months.

This may come as a surprise, given the high-profile reports of job losses across key US industries. Tech giants like Amazon and Meta made headlines recently by announcing a wave of job cuts and hiring freezes. But these news stories are not a good guide to overall employment trends. First, tech sector job openings remain well above their pre-pandemic peak. And more importantly, the US mega-tech sector accounts for a rather small part of overall US employment.

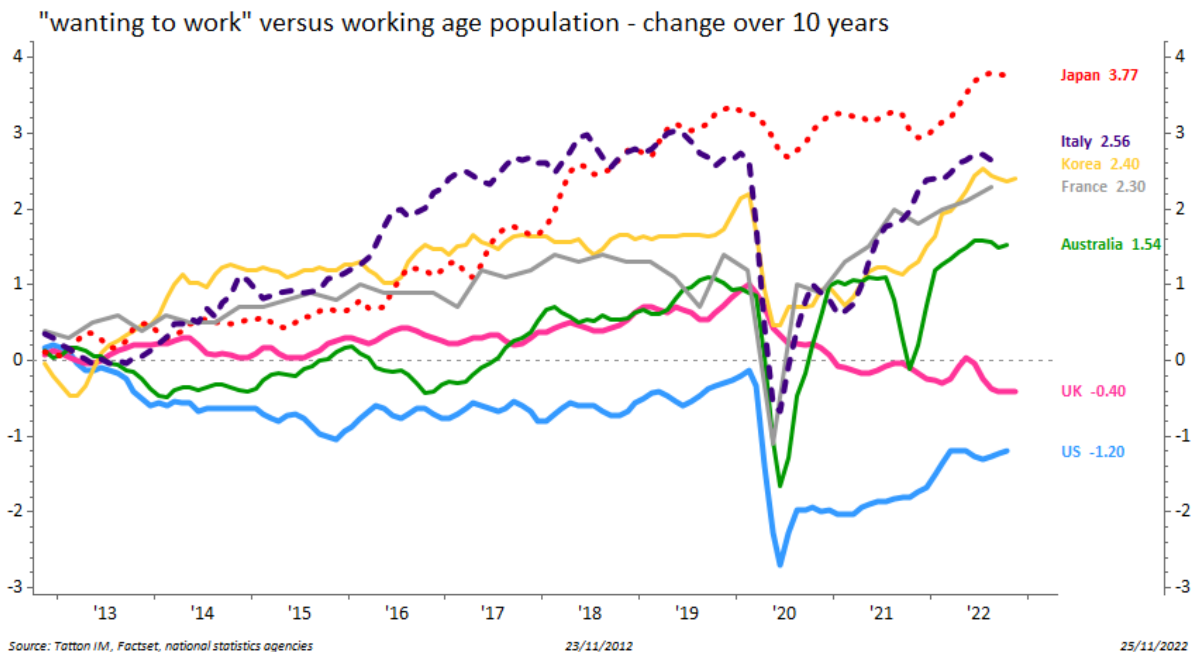
Cyclical factors have contributed to the labour market squeeze. But the problem that policymakers now realise is that labour shortages appear to be structural. Over the past five years, governments (especially the UK and US) have moved towards tighter immigration controls, with the explicit aim of preventing employment competition for domestic workers. This is despite persistently low unemployment that stretches back far beyond the pandemic (see the chart below).

Global Region Employment Markets

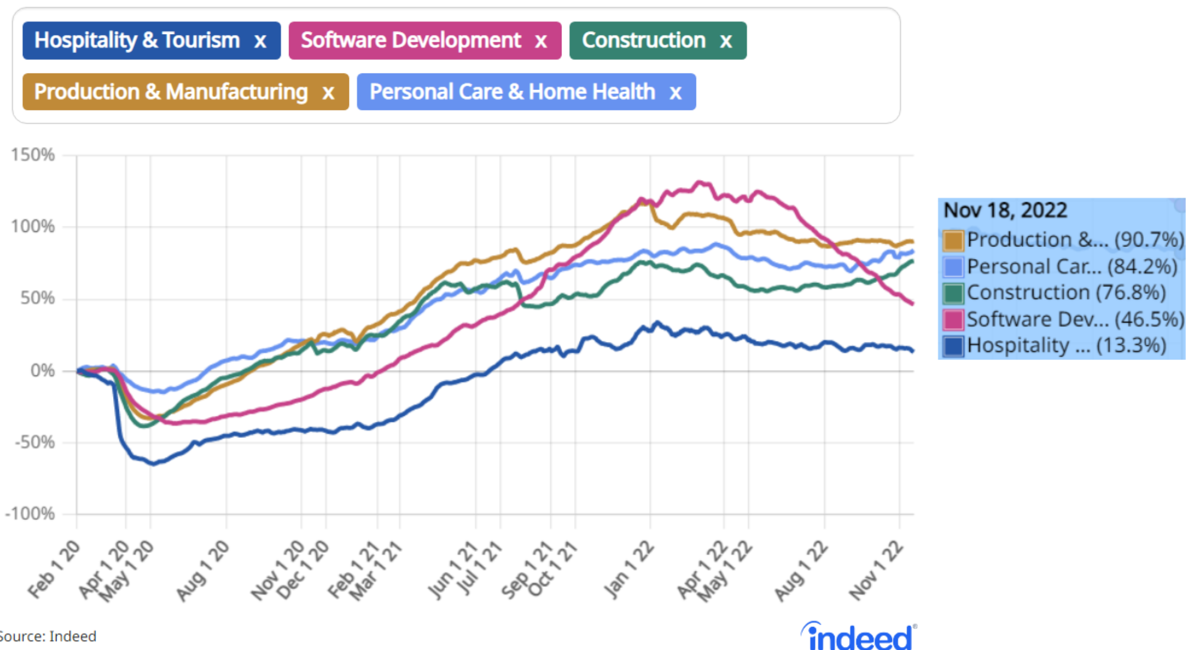


The result is a disconnect between what businesses and politicians say about jobs. We see this here in the UK: The Confederation of British Industry (CBI) recently pleaded with Rishi Sunak's government to ease migration controls, while policy continues to move in the opposite direction.

The pandemic exacerbated problems which appear to afflict the US and UK in particular. Covid struck as Brexit was enacted as policy. That exodus of European workers is highly unlikely to be reversed. Long-term health problems also increased dramatically, lowering the participation rate (the proportion of working age people willing and able to work). Again, this is particularly so in the UK, and the Bank of England admitted some months ago it was unsure of the underlying reasons. Data from the Office for National Statistics (ONS) suggests retirement has increased but also that our youngsters are reluctant to join the measured workforce. Other countries do not seem to have as great an issue, and it is something requiring urgent structural remedy.



In the US, the reduction in participation has made firms reluctant to fire workers, even in the face of intense cost pressures. This is likely a hangover from the pandemic too – companies were too quick to lay off employees when Covid struck, particularly in 'lesser-skilled' positions, only to find they had to offer higher wages to lure employees back. This will still be fresh in the mind of many managers.



In some respects, labour market pressures have fallen back recently. The (US) Richmond Fed, for example, recently reported that wage increases have come back down, and slowing consumer demand suggests this will continue. But the underlying structural pressures remain. Well before the pandemic, unemployment was low without leading to wage increases or productivity investments. Companies became used to this dynamic, only to now realise it cannot go on forever. Since labour conditions were already so tight, workers had leverage in their wage demands – perhaps more leverage than they or anyone else realised pre-pandemic. This creates a difficult situation for central banks, and especially the Fed. Last week, the minutes from the Federal Open Markets Committee (FOMC) 2nd November meeting showed most committee members expect to slow the pace of interest rate rises and falling input price inflation backs this up. The next meeting is less than three weeks away, on 14th December.

Several high-profile tech-related firms in the US have announced job cuts in recent days. As the chart above shows (from Hiring Labs, part of Indeed), there has been a notable decline in tech jobs. However, these firms are by no means substantial employers. Other sectors which are more labour-intensive appear keener to find workers. Manufacturing, construction and personal health are actually stepping up attempts to hire.

At the lower end of the pay scales, there are still more jobs on offer than willing participants.

The underlying structure of the labour market is still such that wage-inflation could return quickly. Policymakers will be focused on the festive period ahead, to see how resilient consumer demand is. Anyone expecting the Fed or the Bank of England to ease off soon might be disappointed.

CAMBRIDGE
INVESTMENTS LIMITED

28th November 2022

Global Equity Markets

Market	Fri 16:13	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7479	+1.3	+93	↗	→
FTSE 250	19516	+1.2	+233	↗	↘
FTSE AS	4108	+1.3	+51	↗	→
FTSE Small	6235	+1.4	+89	↗	↘
CAC	6708	+1.0	+63	↗	→
DAX	14534	+0.7	+102	↗	⇘
Dow	34370	+1.8	+624	↗	→
S&P 500	4034	+1.7	+68	↗	⇘
Nasdaq	11243	+0.9	+97	↗	↘
Nikkei	28283	+1.4	+383	↗	⇗
MSCI World	2698	+1.5	+40	↗	↘
CSI 300	3776	-0.7	-26	↗	↘
MSCI EM	939	-0.4	-4	↗	↘

Top 5 Gainers

Company	%
Harbour Energy	+5.5
Vodafone	+5.0
Ocado	+4.6
Prudential	+4.1
Scottish Mortgage I	+3.3

Bottom 5 Decliners

Company	%
Frasers	-7.8
Rolls-Royce Holdings	-6.1
Glencore	-5.1
BAE Systems	-4.5
Entain	-4.4

Currencies

Pair	last	%1W
USD/GBP	1.209	+1.7
GBP/EUR	0.860	-0.9
USD/EUR	1.040	+0.7
JPY/USD	139.21	-0.8
CNY/USD	7.165	+0.6
Bitcoin/$	16,459	-0.4

Commodities

Cmdty	last	%1W
Oil	85.03	-3.0
Gold	1751.1	+0.0
Silver	21.382	+2.1
Copper	362.3	-0.3
Aluminium	2367.5	-2.6
Soft Cmdties	216.67	-0.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	11.4	9.5	14.5
FTSE 250	3.5	14.3	12.7	16.9
FTSE AS	3.7	12.1	10.0	15.0
FTSE Small x Inv_Tsts	3.8	9.9	11.3	18.8
CAC	2.9	10.9	10.9	15.3
DAX	3.2	11.8	12.1	14.2
Dow	2.0	19.1	18.8	17.7
S&P 500	1.7	19.0	18.4	18.7
Nasdaq	0.9	29.4	27.9	25.8
Nikkei	2.1	22.3	20.4	20.1
MSCI World	2.1	17.2	16.6	17.6
CSI 300	2.4	13.5	12.8	13.3
MSCI EM	3.3	11.6	10.7	11.6

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	3.13	-0.11
UK 15-Yr	3.47	-0.09
US 10-Yr	3.72	-0.11
French 10-Yr	2.44	-0.05
German 10-Yr	1.98	-0.04
Japanese 10-Yr	0.25	+0.01

UK Mortgage Rates

Mortgage Rates (LTV c.75%)	25-Nov	26-Oct
Base Rate	3.00	2.25
2-yr Fixed Rate	5.66	4.17
3-yr Fixed Rate	5.55	4.46
5-yr Fixed Rate	5.35	3.96
10-yr Fixed Rate	5.08	4.21
Standard Variable	5.42	5.10

* 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.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel