CAMBRIDGE
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Lothar Mentel

Lead Investment Adviser to Cambridge

Not so bad? Almost good

December has begun on a positive footing for investors. A renewed pivot in sentiment, with market participants choosing to focus on the positives rather than the negatives, has brought the third extended market upswing of 2022, with various equity markets now trading above bear market territory again.

How the tides have changed over the past two months. After the last US interest rate rise back in early November, the US Federal Reserve (Fed) Chair Jerome Powell said, "We think that we have a way to go (sic), we have some ground to cover with interest rates before we get to that level of interest rates that we think is sufficiently restrictive". While Powell noted it was "very premature to be thinking about pausing", he also said it might be appropriate to slow the pace of increases "as soon as the next meeting or the one after that". Back then, investors were inclined to interpret that as rates continuing upwards and quickly. Bond and stock markets sold off in dismay.

But the previous week saw the release of the minutes of that November meeting and, this time around, investors appeared to want to find reasons to buy risk assets. The minutes were in line with the previous statement from Powell, but inflation data has turned less scary in the meantime. And with the news headlines full of stories of tech firm staff layoffs, signalling an easing of tight labour conditions, markets started to see an end to rate rises. Current interest rate futures have US interest rates peaking below 5% and with that peak brought forward to April next year (rather than above 5% in May/June). In other words, it is no longer premature to contemplate the Fed going easier or at least less aggressive at slowing the economy.

In addition, various members of the rate-setting Federal Open Markets Committee have been talking in a slightly dovish manner, so it is not surprising that markets were having a good old weekly run up. However, Friday's above-forecast US non-farm payroll data dealt a blow to the dovish narrative. While surrounding labour market data has shown reasonable signs of a slowdown, it is not yet feeding through to the most important US national labour market surveys. The US picked up another 263,000 employees, another outsized month of jobs growth. Meanwhile the unemployment rate stayed the same at 3.7%.

One can piece together a positive spin from this data. Lots of jobs being filled while the unemployment rate stays the same ought to mean more people returning to the labour market. Greater participation is a key part of non-inflationary growth and should be viewed very positively by both the Fed and markets.

Yet the measured participation rate actually fell! People in or seeking work went down from 62.2% to 62.1% of the working age population. Even worse, they worked fewer hours and the rate of growth of average hourly pay went up slightly to 5.1% year-on-year.

So, it's all very confusing. Market price action saw a sharp rise in bond yields, with the two-year US Treasury gaining 0.2% initially, up to a 4.4% yield. The S&P 500 initially sold off before regaining ground to close little changed on the day.

Despite Friday's volatility, markets have in fact been experiencing more stability in the past couple of weeks. We think this suggests investors have had more savings than earlier in the year and have been less fearful to invest them in risk assets. It also appears to be a wider phenomenon than just in the US. We suspect households have started to believe that financial savings, especially the less risky assets like bonds, offer better value than buying goods or holding cash. This is a better test of household inflation expectations than just asking people what they expect the rate of inflation to be next year: they are putting their money where their views are. Should bond yields rise again, or equities sell off, the attraction of increased prospective returns should mean that the savings rate would probably increase rather than decrease, a dynamic which would stabilise markets in the medium term.

More savings are likely to be met with more capital demand for those funds in the new year. A number of companies have delayed issuing bonds or loans, in the hope that yields and credit spreads will decline from the painfully expensive levels of a few weeks ago. Thus, with more bond supply becoming available, the current situation does not mean markets are likely to carry on rallying on the back of the recent increased investor demand. Neither does a higher savings rate mean stronger growth in the near term. But more liquidity is likely to reduce the sense of risk.

The changes in China's COVID policies – less broadly reported than the protests of lockdown-tired citizens – have helped its equity markets and added a fillip to other regions. We write about emerging markets below with a longer-term perspective. However, the near-term moves have been strong and a good proportion of the money flow into emerging markets has come from developed market investors.

It is still not all plain sailing though, while geopolitical risk lingers in the background. While China has not been the largest buyer of cheap Russian oil and gas supplies (the honours belong to India and Turkey), last week President Xi Jinping said China was willing to expand energy trade links with Russia in the future. So, even if the markets present good opportunities, the political risks of investing in China will remain apparent while the Xi regime remains in place.

We write about November's strong asset performance below. The best-performing developed market was the UK's FTSE 100, helped by good performance from the materials sector. Sterling's strength also helped performance at least relatively, since dollar-based assets rose but then had some of their value eroded because of the dollar's pullback.

Sterling has indeed had a pretty good run, back to \$1.22/£ and €1.167/£, a rise of 20% and 10% from the really depressing lows of early September. We can interpret this recovery to pre-Truss levels as markets having regained confidence in the general competence of the UK government. However, that was the easy part. Sterling's decline since the Brexit referendum had much to do with a diminishing growth outlook for the UK. Getting the growth outlook back onto a higher trajectory is going to be the hard part for politicians. Last week's Chester by-election result illustrated this challenge may not belong to a Tory government, and while Keir Starmer may be seen as good as any candidate for Prime Minster, the act of developing the next Labour manifesto into a credible agenda for growth rather than redistribution will be watched ever more closely.

The sentiment shift of this autumn – even before the economic pains of the winter have come through – is encouraging. However, it also means that regained market levels remain vulnerable to a whole host of factors that are fiendishly difficult to forecast – from central bank agendas and desire to reassert their credibility, to the geopolitics of China and Russia, to the level of consumer demand destruction from higher (energy) prices and interest rates that will eventually hurt corporate profits. Last week felt comfortably calm and, given we all deserve a peaceful Christmas, let us hope it stays that way. Alas, we would advise not to bet on it.

November review: A good run does not equal certain recovery - yet

A surprisingly warm November brought rays of sunshine to capital markets. All the major equity markets (tracked in the table below) saw positive returns, while government and corporate bond yields fell, pushing up bond valuations, and most currencies made gains against the US dollar.

Generally, global and regional financial conditions indicators eased meaningfully. Even so, for most developed market countries, strong equity returns in November were not enough to make up for total return losses for the year to date. Stock markets around the world are still down in sterling terms but the positive reversals have been substantial and broadly based. Among developed markets, the year's exceptional (and positive) performance comes from the UK, especially in the large cap FTSE 100.

Asset Class	Index	November	YTD	12 months	2021
Equities	FTSE 100 (UK)	7.1	6.3	11.3	18.4
	FTSE4Good 50 (UK Ethical Index)	7.3	2.3	7.3	13.0
	MSCI Europe ex-UK	7.8	-6.8	-3.2	16.7
	S&P 500 (USA)	2.1	-1.2	0.9	29.9
	NASDAQ (US Technology)	1.0	-16.0	-17.3	23.3
	MSCI Japan	6.0	-5.5	-5.9	2.6
	MSCI All Countries World	4.2	-3.3	-1.8	19.6
	MSCI Emerging Markets	11.0	-7.8	-8.3	-1.6
Bonds	FTSE Gilts All Stocks	2.8	-20.6	-22.7	-5.2
	£-Sterling Corporate Bond Index	4.2	-17.0	-17.9	-3.2
	Barclays Global Aggregate Bond Index	1.2	-5.3	-7.6	-3.8
Commodities	Goldman Sachs Commodity Index	-5.0	45.3	52.7	41.6
	Brent Crude Oil Price	-9.4	27.2	39.6	51.5
	LBMA Spot Gold Price	3.8	8.9	7.7	-2.9
Inflation	UK Consumer Price Index (annual rate)	2.5	9.7	10.2	5.4
Cash rates	SONIA 3-Month	0.2	0.8	0.8	0.0
Property	UK Commercial Property (IA Sector)*	-5.4	-3.3	-1.9	7.4

Source: Morningstar Direct as at 30/11/22. * to end of previous month (31/10/22). All returns in GBP.

The rally had already begun in October, after markets seemingly found their floor. That this was the low point will not surprise UK investors, who witnessed an earthquake in domestic bond markets after September's 'mini budget', which ruptured equities and sent sterling into nosedive. But the negativity was felt far beyond Britain's shores, as the S&P 500 fell to its lowest level (in dollar terms) since the start of 2021. The stability since then has been rewarded by investors. This is particularly true for the UK: both the FTSE 100 and the value of sterling have rallied impressively.

In fact, sterling had such a strong November that it offset overseas returns, in a reversal to the previous market dynamics. As the table above shows, the S&P gained a much milder 2.1% in sterling terms, while MSCI's world index posted 4.2%. Interestingly, the one region where returns still look impressive in sterling terms is emerging markets, whose stocks gained an incredible 11%, according to MSCI. Again, currencies played a big part. Rebounding sentiment around China meant the renminbi also had a strong November. Because of China's outsized share of overall EM assets, this made a huge difference to headline figures.

As has been the case for most of this year, bond market dynamics largely drove equity performance in November. Unlike the rest of the year though, this time it was a good thing. Bond prices rallied (meaning yields fell) all around the world, lowering the 'risk free' rate of return, making stocks more attractive. This helped valuation metrics across the board, pushing equities up further.

This year, bond traders have often prophesied the twin peaks – peaks in inflation and interest rates. When inflation looks under control, central banks will be able to loosen monetary policy, easing financial conditions and allowing another growth cycle to get underway. But there have been false dawns, such as the equity rally over the summer that fell back spectacularly into the autumn, once the US Federal Reserve (Fed) signalled it expects to keep raising rates hard and fast.

Now, the global economy appears to be over the worst of its supply side problems. This is backed up by November's fall in energy prices, particularly oil. House prices also came down across the developed world. Both of these are vital to consumers' inflation expectations, and can be a powerful signal that prices are no longer running wild.

Markets are ahead of consumers in their expectations, being firmly of the view that commodity and intermediate goods inflation has peaked. Across many regions, and especially in the US and Europe, consumer and producer inflation data were a little lower than expected, leading to the viewpoint that central banks would slow rate rises, and that the end of the tightening phase was now within sight. On balance, market participants expect rates to remain stable from next spring onwards, with the expected peak a little lower than believed at the start of November. Together with recent Fed signals that it is indeed highly likely to slow rate rises from its December meeting, this can be seen as markets now assigning a lower probability to central banks committing a policy error through overtightening relative to already declining demand levels.

Over the month, this helped sectors which had otherwise looked in a bad way and vice-versa. The energy-heavy Goldman Sachs Commodity Index suffered a downturn in November, owing to the fallback in oil prices, but commodities outside of oil fared well. The materials sector in particular had a good month, as broader global growth concerns lessened and commodity producers had better access to capital. The same was true for real estate investment trusts (REITs), which posted decent returns despite the recent fall in underlying property values that affected the UK Commercial Property index.

All of these are positive signs for the world economy. The outsized performance of energy companies this year has been a drag on overall growth, so the reversal of this trend is good news. Likewise, the prospect of changing tides of China's zero-Covid policy should deliver a great improvement, both for global demand and productive capacity. As we head towards the end of the year, there is a feeling that the dark days of 2022 are behind us.

One aspect of a fall in inflation is that household savings can be rebuilt, and this trend may well already be underway. When people expect inflation to stay high, they rush to buy goods and services before things get too expensive, especially if they sense the return on savings will be less than the rise in prices. This phenomenon was particularly pronounced in the recent cycle, and households disbursed a lot of the substantial savings piles during the pandemic.

Now, with inflation seemingly fading, financial assets are looking more like reliable stores of wealth again. Markets therefore have access to more capital and this is bringing stability, especially to bond markets.

Optimism is a good thing in markets, but we should tinge it with a note of caution. As noted, bond market dynamics were the biggest factor behind equity performance, and this is likely to continue. But yields fell partly because of a shortfall in corporate bond supply from new issuance. At the moment, companies are not especially keen on issuing new debt, in large part because rates have increased so much. The resulting undersupply, when met with renewed demand, led to government and corporate bonds falling back. This trend could reverse. The high yields of the autumn have given way to lower yields at the start of winter, which may be enough to tempt many issuers into the market. Greater investor appetite and better trading liquidity in markets is likely to increase bond supply, which may limit further falls in yields. If the backlog of refinancing is large, it could mean some upward pressure on yields and scare investors from taking more risk. The timing of market activity will also be important. December's markets are generally not so deep, and investors and issuers both may prefer to wait it out until the new year.

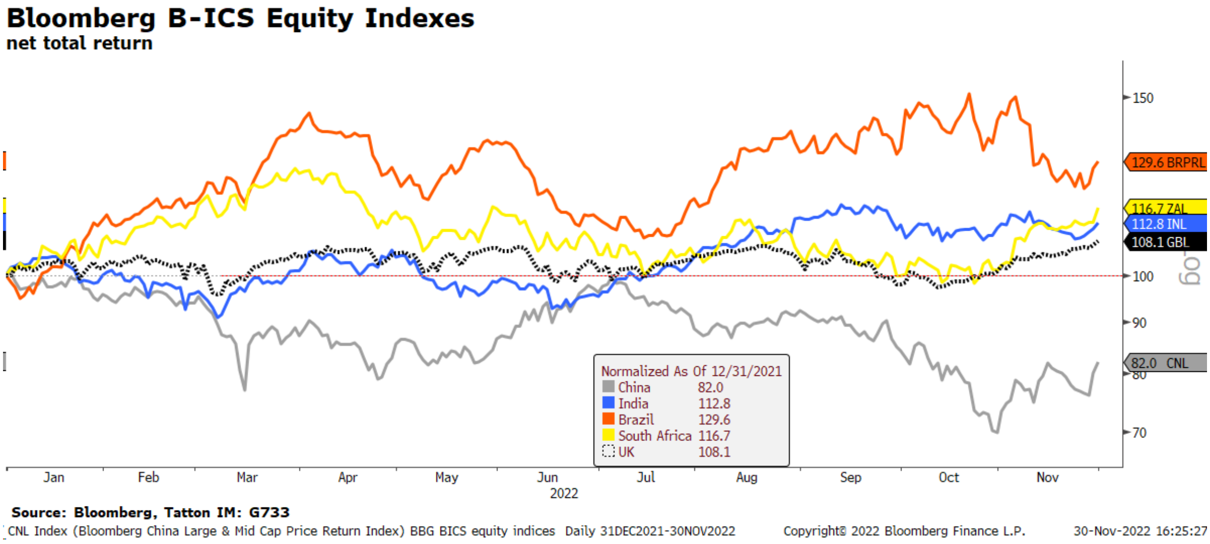
By our reckoning, bond markets have a relatively higher risk premium than equity markets and investors appear to be underweight in credit risk. They could be prepared to put more money to work in bond markets, which would go a long way in soaking up new issue supply. Heading into next year, the balance of bond supply and demand will be crucial for all capital markets.

Emerging markets still defying gravity

Emerging markets (EM) are usually very sensitive to the ebbs and flows of global growth. Investors see EM assets as high risk but potentially high reward, meaning buyers are plentiful when the going is good, and sparse when things look bleak. In that respect, this year could hardly have been more difficult for EMs: global growth has stalled, interest rates are rising at the quickest pace in a generation, and the US dollar has been exceptionally strong. Many of the larger EM companies have substantial dollar-denominated debts, so this can be a toxic mix for developing nations.

And yet, in many respects, EM assets have held up surprisingly well. This may sound strange, considering that MSCI's EM index has lost around 20% of its value this year, but context is key here. The S&P 500 has fallen by a similar amount in local currency terms, while the technology-heavy Nasdaq Index has fallen by nearly a third. The comparison to US tech stocks is particularly significant, since both are considered long-term growth assets that are highly sensitive to financial conditions. Tech stocks have taken the hit, but EMs have got off much easier.

In fact, the performance of EM equities is even more impressive when you remove China, an economy that dominates most EM indices and has suffered from its own specific challenges. The chart below shows year-to-date equity returns for the so-called BRICS (now known as B-ICS, after removing Russia, for obvious reasons) compared to the best performing developed market (which, incidentally, happens to be the gloom-ridden UK).



Everyone except China has done very well and generated positive returns. Brazil in particular has seen a lot of positivity, which is still ongoing despite investors' initial concerns about the return of left-wing President Lula. Strong commodity demand certainly helped as well. At the EM headline level though, all of these have been outweighed by negativity towards China. The world's second-largest economy has been crippled by Beijing's zero-Covid policy, along with a severe liquidity crunch in its property sector, and questions over the leadership style of its strongman President Xi.

With all this in the background – not to mention Russia's war on Ukraine – EMs could have seen a dramatic fall this year, and significantly underperformed their developed markets counterparts. The fact that most EMs have not is testament to their resilience. Local EM government debt has held up comparatively well (albeit down 10% year-to-date), compared with the global aggregate having given up almost 15% this year. We noted some time ago that EMs, particularly in Latin America, were not afforded the financial luxuries that developed nations had throughout the pandemic. While Western nations boosted government spending and dramatically loosened monetary policy, many EMs were forced to raise interest rates, came forward with a considerably smaller or no fiscal boost, and were early in their fight against inflation. The strongest positive impact of this prudence is visible in local EM government debt, while hard currency debt (mostly issued in USD) suffered more.

Developed nations have since caught up, but EMs like Brazil are enjoying the benefits of that early start. Central banks frontloaded their monetary tightening last year, allowing them much more leeway in 2022. Commodity exporters were also helped by rallying energy prices earlier in the year, but even EM nations without these exports have held up well. Underlying this has been a sustained improvement in economic fundamentals. Even though risk appetite has sunk this year, there is a sense that EM risks (excluding Russia and China) are themselves lower, at least compared to previous global downturns.

There is an oddity to this though. For half a decade, analysts have talked about the growing trend of 'deglobalisation': the fading or reversal of international trade, which had been marching forward since the 1980s. Most identify Donald Trump's trade wars or Brexit as early episodes in this saga, but the process was massively boosted by the pandemic. Covid exposed fragilities in global supply chains, particularly around medical supplies, which increased the incentive to 'onshore' production or development in key industries. Onshoring by western countries and the removal of trade links should be bad news for EMs, forcing a structural decline in exports.

In fact, on some measures, deglobalisation stretches back further than Trump. There is not much agreement on what 'globalisation' really amounts to in any measurable sense, making its negation similarly difficult to track. But researchers at TS Lombard identify a key aspect of it as the volume of global trade divided by world GDP. By this standard, globalisation peaked in 2008, and has since fallen back. In line with this observation, EM equities have consistently, on a multi-year basis since 2010, underperformed their US and even European ex UK counterparts.

TS Lombard point to two main drivers behind this deglobalisation trend: growing geopolitical risk and changing economic factors. The former was made abundantly clear this year, not only by Russia's invasion but the growing tensions between the US and China. The latter also has a lot to do with China, but for different reasons. China's meteoric rise in recent decades was initially down to its comparatively cheap labour and production costs. As the world's second-largest economy has matured, those costs have caught up with the developed world. If Chinese production is no longer cheap – and the geopolitical risks are higher – there is little incentive for companies to move there, other than tapping into the enormous Chinese market to sell their products.

Of course, moving out of China does not necessarily mean moving back home – and companies might just as well look for cheaper production sites around the world. This has happened to an extent; India and Vietnam have seen massive production growth. But this process takes time. The trade flows between the US and China, while lower than they were a few years ago, are still huge, and that capacity cannot be easily replaced. As TS Lombard note, Vietnam doubled its share of US toy imports from 2018 to 2021, but even so the total share is at just 6%.

Reducing trade with a behemoth like China is a *de facto* reduction in aggregate global trade, even if some countries benefit from reallocation. There are economic security concerns too. Increased labour costs are not the only thing pushing firms away from EM production hubs. The *stability* of production – and the need for diverse supply chains – are also crucial. Again, the pandemic heightened this need, pushing governments and firms to favour local sources. With climate change now wreaking havoc on many parts of the world, the need for diverse supply chains is unlikely to go away.

Again, none of this necessitates a reduction in global trade, if a restructuring will do just fine. Even if newfound (compared with end of Cold War 90s' attitudes), security concerns will most likely lead to a certain degree of onshoring. Significant productivity improvements in developed markets would also be a threat to any EM hoping to take the baton from China and step into the global production chain. This would need an investment surge in the developed world, though.

These are the key question that investors and policymakers must grapple with in the years ahead. Building trade links takes time, and there is a lot of political pressure to move production back onshore, rather than finding somewhere else. The good performance of EMs outside of China this year suggests globalisation is far from over, but whether the decline is permanent or temporary will depend on politics.

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5th December 2022

Global Equity Markets

Market	Fri 16:24	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	7554	+0.9	+68	↗	⇗
FTSE 250	19379	-0.9	-167	↗	⇘
FTSE AS	4139	+0.6	+26	↗	→
FTSE Small	6267	+0.4	+23	↗	⇘
CAC	6734	+0.3	+22	↗	→
DAX	14510	-0.2	-32	↗	→
Dow	34258	-0.3	-89	↗	→
S&P 500	4042	+0.4	+16	↗	⇘
Nasdaq	11384	+1.4	+158	↗	↘
Nikkei	27778	-1.8	-505	⇗	⇗
MSCI World	2738	+1.3	+35	↗	⇘
CSI 300	3871	+2.5	+95	↗	↘
MSCI EM	977	+3.8	+36	↗	↘

Top 5 Gainers

Company	%
BT	+5.1
Melrose Industries	+5.0
Admiral	+4.0
3i	+3.4
Pearson	+2.9

Bottom 5 Decliners

Company	%
Prudential	-8.5
Antofagasta	-5.7
Associated British Foods	-4.4
Glencore	-4.3
Rio Tinto	-3.6

Currencies

Pair	last	%1W
USD/GBP	1.226	+1.4
GBP/EUR	0.856	-0.4
USD/EUR	1.050	+1.0
JPY/USD	135.25	-2.8
CNY/USD	7.054	-1.6
Bitcoin/$	16,914	+2.4

Commodities

Cmdty	last	%1W
Oil	86.72	+3.7
Gold	1793.2	+2.2
Silver	23.059	+6.0
Copper	381.5	+5.2
Aluminium	2485.0	+5.2
Soft Cmdties	218.22	+1.2

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.7	11.5	9.6	14.5
FTSE 250	3.5	13.7	12.7	17.0
FTSE AS	3.7	12.2	10.1	15.0
FTSE Small x Inv_Tsts	3.8	10.0	11.5	18.8
CAC	2.9	10.9	10.9	15.3
DAX	3.2	11.8	12.1	14.2
Dow	2.0	19.3	19.0	17.8
S&P 500	1.7	19.2	18.7	18.7
Nasdaq	0.9	29.6	30.0	25.9
Nikkei	2.1	21.9	20.1	20.1
MSCI World	2.1	17.4	16.8	17.7
CSI 300	2.3	13.8	13.2	13.3
MSCI EM	3.2	12.0	11.0	11.6

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	3.16	+0.04
UK 15-Yr	3.54	+0.08
US 10-Yr	3.58	-0.10
French 10-Yr	2.31	-0.13
German 10-Yr	1.86	-0.12
Japanese 10-Yr	0.26	+0.00

UK Mortgage Rates

Mortgage Rates (LTV c.75%)	02-Dec	02-Nov
Base Rate	3.00	2.25
2-yr Fixed Rate	5.67	6.01
3-yr Fixed Rate	5.54	5.90
5-yr Fixed Rate	5.32	5.61
10-yr Fixed Rate	5.03	5.27
Standard Variable	5.42	5.42

* 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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www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE

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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

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk
Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE