CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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Slowing growth throws markets into a bind

Last Monday we wrote that markets were rising because bad economic news was good news in terms of lessening concerns over interest rate rises, beyond what is already expected and therefore priced in. Last week, various economic data releases in the US painted a very clear picture of a slowing US economy, from declining Christmas retail sales to industrial production. Even though this pushed long-term bond yields down further and had inflation expectations decline to a very benign 2%, markets this time took the bad news negatively, giving back some of the gains of the previous week.

December's bad report card may have more to do with the exceptional cold spell that hit much of the US, than an acceleration of the growth slowdown. Even so, investors clearly began to worry that the other key variable in equity valuations (future corporate profits) was about to come under more sustained downward pressure.

This tells us that markets may well have run out of positive momentum, and that it will be a tough ask for US markets to push higher on the back of receding rate rise fears only. In Europe, and even the UK, on the other hand, where macroeconomic data continues to come out 'not as bad as feared' but with price inflation also receding, stock markets had a much better week, even if the FTSE100 has still not managed to break through its all-time high it has neared over the past two weeks.

There was more good news globally. China says it is past the peak in Covid-related hospitalisations. Hong Kong authorities are even telling people with asymptomatic Covid infections to return to work. Ahead of this week's Lunar New Year celebrations, travelling has picked up to near normal levels. More and more research houses are pointing towards the increasing likelihood that China's re-opening will result in a similar growth surge as the western world experienced back in the spring of 2021, except with even more pent-up demand and cumulative savings in the hands of consumers after three years of harshly restricted public life.

This is where good economic news can turn into bad news again, because for energy and input prices to continue to fall, this resurgent demand must not have more than a minor impact on energy prices (see our separate article about falling producer input prices). Expectations of a more benign impact on global energy may not be an entirely unreasonable expectation given Russia's efforts in re-routing unsellable fossil fuels eastwards.

Turning to last week's annual World Economic Forum gathering of the world's movers and shakers in Davos, on Thursday, Ngozi Okonjo-Iweal, Director General of the World Trade Organisation, gave a rather downbeat assessment of global trade prospects. She warned of the problems created by "securing" supply chains. Certainly, justifying subsidies because of security concerns is a slippery slope. The US Inflation Reduction Act has myriad subsidies that concern its European trade partners. Europe's response is likely to be more subsidies, which creates problems both internally and externally.

But before we get too worried about further deterioration in global trade, we should note that the meeting between US Treasury Secretary Janet Yellen and her Chinese counterpart Liu He seemed to go well, with cordial – even friendly – dialogue. As we have commented before, China has of late performed not just a turnaround on Covid, it has also started to be a less annoying neighbour. In the vein of "no news", there have been no Taiwan provocations in the weeks following last year's Party Congress.

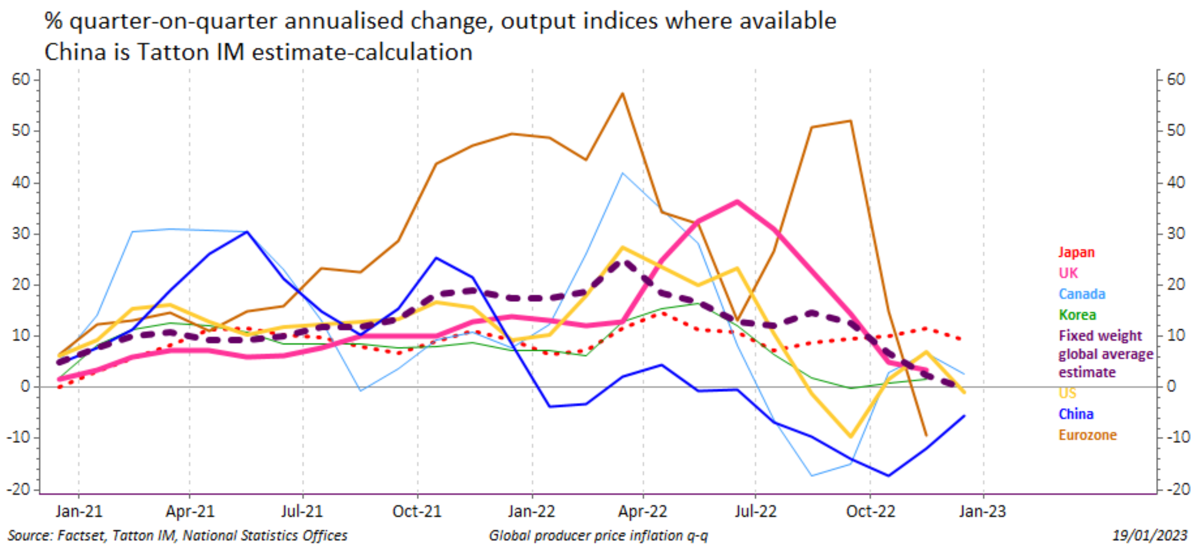
At the close of last week then, globally there was not very much news, which is good news in itself. We have become inured to bouts of cataclysm – natural and political – with journalists becoming celebrities themselves. It has felt rather boring of late as the economic reality outside the UK has simply plodded on. Since October, there has just been less news. This reduces the pricing of risk premia globally, and feeds back into a better investment environment. So, no news is good news....for now.

PPI pullback and the 'new normal' for inflation

Judging by capital market expectations, we are over the hump. The global inflation crisis of the last year and a half has peaked, and price increases are now expected to trend downward in the US, UK and Europe. US Treasury yields have fallen consistently since the beginning of November and are now back to where they were in September – just before the world had a UK-inspired bond rodeo. This implies lower growth and price expectations in the years ahead and comes on the back of a 6.5% December annual inflation reading in the US – its lowest in more than a year.

It is worth remembering that the world has been in a "bad news is good news" stage of its economic cycle (as slowing growth will take the pressure off central banks to keep raising rates) – at least this has been the market's perception over the last few weeks. With central banks tightening hard and fast across the developed world, investors are looking through the pain of this cycle to the joys of the next one, perhaps assuming this pain may turn out to be minor and quite short lived. The sooner this one ends the better, and so, signs of economic weakness are welcomed by markets. Lower inflation readings are backed up by both easing supply constraints and notably weaker demand. Global demand has slowed substantially, easing public pressure on central banks to bring demand-driven inflation down.

Of particular note is the fall in producer price inflation (PPI). While it mirrors and starts with commodity price changes, it also more tightly reflects businesses' pricing power across the whole value chain. It is therefore seen as a good indicator of the supply-demand balance. The chart below shows quarterly changes (annualised) in PPI over the last year for a few major world economies. As we can see, producer inflation is trending consistently down in most regions – particularly Europe – and has been for the last few months. The one exception is China which, after years of repeated lockdowns, finds itself only at the very beginning of the same recovery cycle that pushed up prices in other regions since the spring of 2021. All the same, Chinese PPI is starting from a much weaker position, deeply negative.



While the Covid-induced price shock that triggered this exceptionally strong run of elevated inflation is therefore turning into a diminishing issue, the US Federal Reserve (Fed), along with its peers, sees the prevention of a destructive wage-price spiral as their new priority. Therefore, central banks remain committed to tightening policy in spite of a weakening economy. Nevertheless, these PPI figures point to a very different scenario. Far from entrenched inflation, it looks like the US backdrop became disinflationary around September and has stayed that way into the new year.

In that time, global demand and price pressures have eased greatly. Energy prices – particularly for wholesale natural gas – have fallen substantially since November on the back of a much warmer winter than expected. Even Bank of England governor Andrew Bailey – a committed hawk in the global inflation fight – has admitted this makes the job much easier. He is now optimistic about an "easier path" out of inflation pressures.

Capital markets are buying into this optimism, but not everyone is convinced. Christian Ulbrich, chief executive of global real estate firm JLL, told the *Financial Times* last week from the Davos World Economic Forum that "fundamental trends" mean "inflation will stay persistently around 5%". This is reportedly a view shared by many of the movers and shakers in Davos, and it backs up commentary we are seeing quite widely in the financial media.

There is an emerging view that the old regime of 2% average inflation is gone and will be replaced by an average much closer to 4% over the long-term. The thought is that, due to structural changes in the global economy, central banks will no longer feasibly be able to target 2% inflation and will have to adjust their targets higher. This will mean structurally higher interest rates too – a far cry from what we saw in the period between the global financial crisis and the pandemic.

The long-term factor that most strongly drives this view is globalisation, or lack thereof. Since the 1980s, economies have become increasingly interconnected, putting a structural downward pressure on prices by increasing the available supply of goods and thereby indirect access to much cheaper labour. That process no longer looks guaranteed and is, arguably, going into reverse. This is partly due to longstanding political grievances which are delivering more protectionist politics, and partly due to concerns over supply chain

security. Trump's trade wars and Brexit are an example of the former, while Europe's move away from Russian gas is an example of the latter.

US-China trade tensions are a clear example of deglobalisation, but prospects for reconciliation have improved substantially in the last month or so. That brings us to the next corollary, however: China's integration into the world economy over recent decades has been a structural force holding inflation back. In simple terms, this was due to the cheapness of producing goods in China versus elsewhere.

This is no longer the case. Wages and production costs have increased dramatically in the world's second-largest economy, to the point where China is no longer a deflationary force. Quite the opposite, in fact, as strong Chinese growth generates demand for commodities. Now, when China goes on a growth binge, it puts upward pressure on global input costs.

This is certainly an upward force on global inflation, but whether this translates to structurally higher inflation in the long-term is another matter. On that front, we can only point out that moving to a regime of 4% annual inflation is not a simple matter. Inflation disproportionately affects lower income earners by destroying their purchasing power. To counteract this, the economy has to give disproportionate wage increases to the less well-off, or else inequality grows dramatically, with potentially disastrous political consequences.

That is fine as an economic model; it is how most western economies operated from the end of the Second World War up to the 1970s, a period of great improvement in living standards. But it means that returns to labour outpace returns to capital – which, in turn, means a structural barrier to equity market growth. Again, none of this is necessarily a bad thing – especially if it creates a more dynamic underlying economy with more growth from growing consumer demand – but investors have to recognise what a 4% annual inflation regime would mean. Davos attendees should be careful what they wish for.

Bank of Japan monetary easing: endgame or dawn of a new era?

Japan's bond market is faltering. Bank of Japan (BoJ) governor Haruhiko Kuroda, nearly at the end of his ten-year tenure, is committed to controlling the yield curve in his aim to stimulate the economy. Bond traders doubt he or his successor will be able to. The result is selling pressure on Japanese government bonds (JGBs), and the BoJ having to hoover up those sales to maintain its target. The fallout has affected currency and equity markets, creating a notable tightening of Japan's financial conditions.

Interestingly, tighter finances in Japan are at odds with the rest of the developed world, where conditions have eased over the last couple of months, as bond yields have receded from their October highs. But then, going it alone has never bothered the BoJ too much. Its policy of yield curve control – began by Kuroda in 2016 – is unlike any other central bank. Instead of committing to buying a fixed number of government bonds, the BoJ sets a yield target (currently at 0%) and will buy any amount of bonds necessary to meet it, with some fluctuation around the target. Yield curve control (YCC) has always had its doubters, but the policy worked surprisingly well for years, due to markets' beliefs about the credibility of the BoJ's promise and the stability of Japan's economy.

Cracks appeared last year, as sharply higher interest rates in the US made JGBs less attractive. Investors sold yen assets – many back to the BoJ – putting massive downward pressure on the currency. The surge

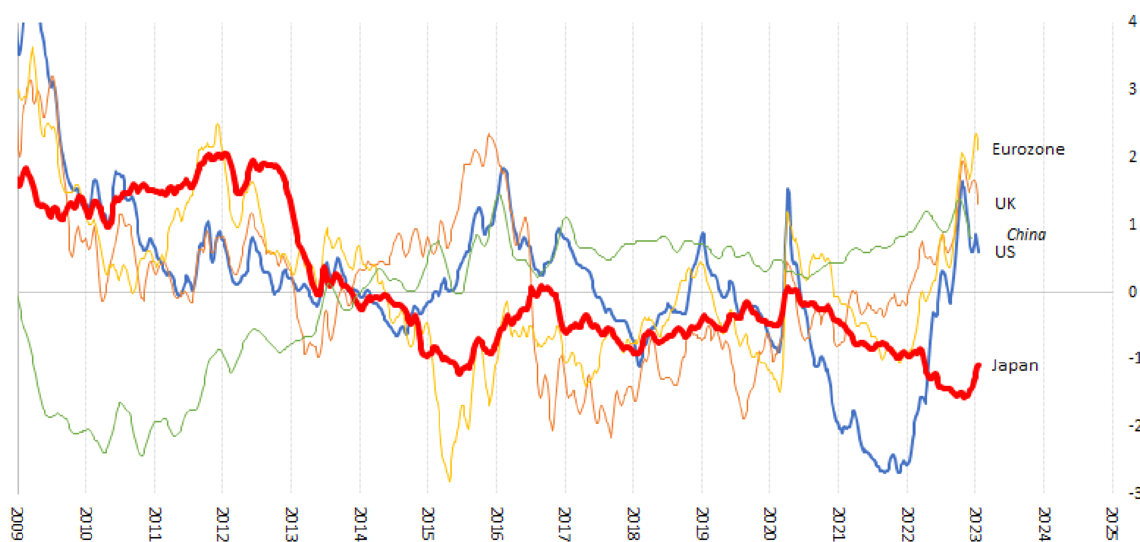
in global prices meant inflation had finally come to Japan too, leading to speculation that YCC would be abandoned. Bond traders thought this was all but confirmed in December, when the BoJ suddenly announced it would tolerate a 0.5% rise in ten-year JGB yields.

Kuroda used his penultimate meeting in charge to quash those expectations. No changes were announced, keeping interest rates at -0.1% and the ten-year yield target at 0%. The decision "sets the BoJ up for a protracted battle with the market," according to a J.P. Morgan strategist in Tokyo. The BoJ's longest-serving governor is sticking to his guns, but his successor might struggle to show the same resolve. Traders expect great selling pressure and a difficult decision ahead.

We do not expect policy to change drastically though. The BoJ is too big an institution to be moved by the changing of one of its guard, as important and respected a figure as he may be. Besides which, Japan has kept monetary policy consistently and significantly easier than anywhere else for very much longer than the west's period of extraordinary monetary easing brought about by the Global Financial Crisis. The chart below shows financial conditions across major economies for the last two decades. Japanese financial conditions have been stable, slow-moving, and extremely loose.

Goldman Sachs financial conditions indices

normalised from 2010 onwards



Source: Tatton IM, Bloomberg, Goldman Sachs *18 January 2023*

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The difficulty for the BoJ, regardless of who runs it, is that there is a mismatch between what suits the domestic economy and what suits external financing conditions. The western world has been facing extreme shortages: a shortage of energy in Europe, and a shortage of workers in the US. Japan has less pronounced problems, and also a different way of dealing with them. For instance, a labour shortage has not led to country-wide strikes from workers demanding higher wages. The BoJ itself expects core inflation (excluding fresh food and energy) to come in at around 1.8% in the fiscal year of 2023 (beginning this spring) and to decelerate slightly to 1.6% in the year after.

Such conditions require a different path for monetary policy, and Kuroda has successfully navigated it, up to now. Western central bankers fear inflation becoming embedded and spiralling out of control, but the

BoJ fears the exact opposite. For years, policymakers have been trying to spur Japanese growth and get inflation consistently higher. Now, the policy looks on the cusp of success. Turning back now would risk everything they have worked so hard to achieve – choking off growth and returning to the stagnant economy of the last few decades.

The biggest worry for the next BoJ governor is that markets might give them little option but to turn back. A consequence of the mismatch above is that the JGB market is becoming increasingly dysfunctional. Commitment to YCC – and a huge amount of bond buying to back it up – has meant there are little opportunities for trading profits, leading bond traders to exit their positions and move capital into higher-yielding US or European assets.

Kuroda's great success over the last year has been in limiting how much this dysfunction affects other parts of the financial system. Currency markets, while certainly active, have not been as volatile as one might expect from investors dumping bonds. And the fact the BoJ has followed through on its yield control commitment has meant the government's fiscal stance is barely affected by bond gyrations.

It is an open question, though, how much of this success stems from Kuroda's personal authority. Whoever takes over from Kuroda will undoubtedly share his dovish philosophy, wanting to keep financial conditions easy and maintain the YCC if possible. But markets will no doubt test the BoJ's resolve with renewed selling pressure on JGBs.

The BoJ already owns more than half of the outstanding JGBs – an unprecedented footprint for any central bank. The closer that percentage share gets to a hundred, the more questions will be asked about the viability of YCC. That will mean a greater likelihood of contagion, into currency, equity or even mortgage markets. At the extreme end, total BoJ ownership of the bond market would threaten faith in Japan's financial system itself. In such a case, stability would require that YCC be abandoned.

We do not expect that to happen, but it is the risk that the next BoJ governor will have to get to grips with. Over the long-term, Japan's economy looks in a good position, with improvements in profitability, wages and overall growth. Ties with China have improved too, which lessens the impact of US or European economic woes on Japan. If the BoJ can pull through the next test, better times could be ahead. Seeing off the next few months will be the tricky part.

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23rd January 2023

Global Equity Markets

Market	Fri 16:13	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7768	-1.0	-76	↗	→
FTSE 250	19713	-1.2	-240	→	↘
FTSE AS	4249	-1.0	-42	↗	→
FTSE Small	6451	-0.4	-27	↗	↘
CAC	6985	-0.5	-38	↗	↗
DAX	15015	-0.5	-71	↗	↗
Dow	33184	-2.9	-1006	↘	↘
S&P 500	3927	-1.4	-57	↘	➘
Nasdaq	10992	-0.1	-9	➘	➘
Nikkei	26554	+1.7	+434	➘	→
MSCI World	2685	-1.8	-50	→	➘
CSI 300	4182	+2.6	+107	➚	↘
MSCI EM	1028	-0.2	-2	➚	↘

Top 5 Gainers

Company	%
SSE	+4.9
Auto Trader	+4.3
Burberry	+4.1
InterContinental Hotels	+3.9
Rightmove	+3.8

Top 5 Decliners

Company	%
Dechra Pharmaceuticals	-7.7
Ocado	-7.5
Hargreaves Lansdown	-6.6
Scottish Mortgage Investmen	-5.6
Berkeley Holdings	-5.5

Currencies

Pair	last	%1W
USD/GBP	1.237	+1.2
GBP/EUR	0.876	+1.1
USD/EUR	1.084	+0.0
JPY/USD	129.93	-1.6
CNY/USD	6.785	-1.2
Bitcoin/$	21,207	+1.4

Commodities

Cmdty	last	%1W
Oil	86.52	+1.5
Gold	1925.3	+0.3
Silver	23.846	-1.7
Copper	426.1	+1.5
Aluminium	2587.5	+1.5
Soft Cmdties	212.22	+0.4

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.6	12.2	10.4	14.1
FTSE 250	3.4	10.5	12.9	16.3
FTSE AS	3.6	11.8	10.6	14.4
FTSE Small x Inv_Tsts	3.9	6.5	10.5	15.2
CAC	3.0	13.4	12.0	15.2
DAX	3.5	13.7	12.0	13.7
Dow	2.1	18.0	17.2	17.2
S&P 500	1.7	18.5	17.5	18.4
Nasdaq	1.0	21.1	23.8	24.6
Nikkei	2.2	14.3	14.4	17.8
MSCI World	2.2	16.0	15.6	17.2
CSI 300	2.3	14.4	12.3	12.9
MSCI EM	3.0	10.3	12.4	12.7

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	3.35	-0.02
UK 15-Yr	3.68	-0.03
US 10-Yr	3.49	-0.02
French 10-Yr	2.61	-0.02
German 10-Yr	2.17	+0.00
Japanese 10-Yr	0.39	-0.13

UK Mortgage Rates

Mortgage Rates (Nationwide)	20-Jan	21-Dec
Base Rate	3.50	3.50
2-yr Fixed Rate	5.90	5.97
3-yr Fixed Rate	6.00	5.66
5-yr Fixed Rate	5.80	5.49
10-yr Fixed Rate	5.50	5.33
Standard Variable	5.24	5.88

* 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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