CAMBRIDGE
INVESTMENTS LIMITED

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Markets caught between hoping and dreading

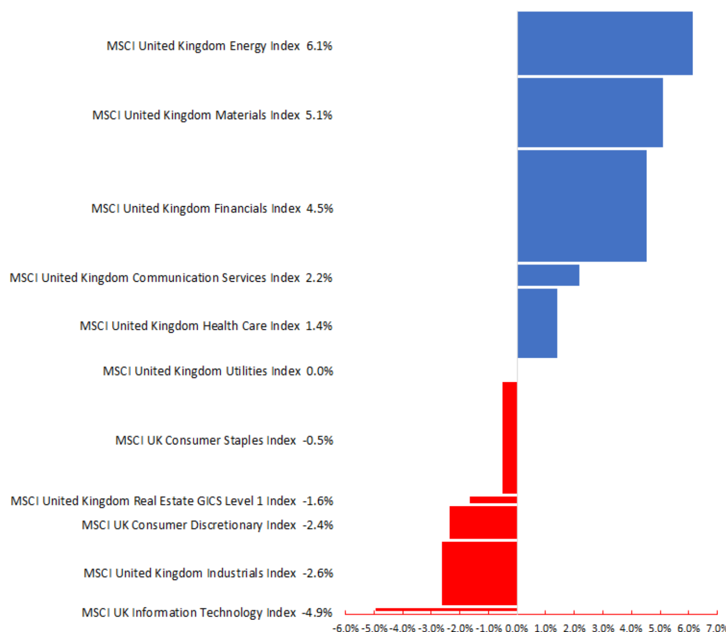
London was a tale of two cities last week: Panic in Whitehall but calm in the City. The scandals seem to keep coming for Boris Johnson, with several Tory MPs openly calling for his resignation. Betting markets now have the Prime Minister odds-on to resign this year, and discussion is rife about the government's future. But capital markets took no notice. Indeed, UK assets outperformed on the week, with both the FTSE 100 and the value of sterling finishing higher.

UK markets have been on a good run for over a month now, while the odds of a prime ministerial change have climbed the whole time. This does not suggest investors want Johnson out, but it does suggest they are indifferent on the matter. What markets are happy about is the latest COVID numbers, as well as the government's response. Officials have been lax in their response to the omicron variant (compared to previous waves and other countries at least) and it now seems case numbers are falling, without tighter restrictions ever being imposed. Perhaps markets sense a change of Prime Minister would have little effect on this policy, so positivity has been unaffected by Downing Street drama. With cases falling and high levels of immunity, Britain's economy could do well this year – and currency markets seem to agree.

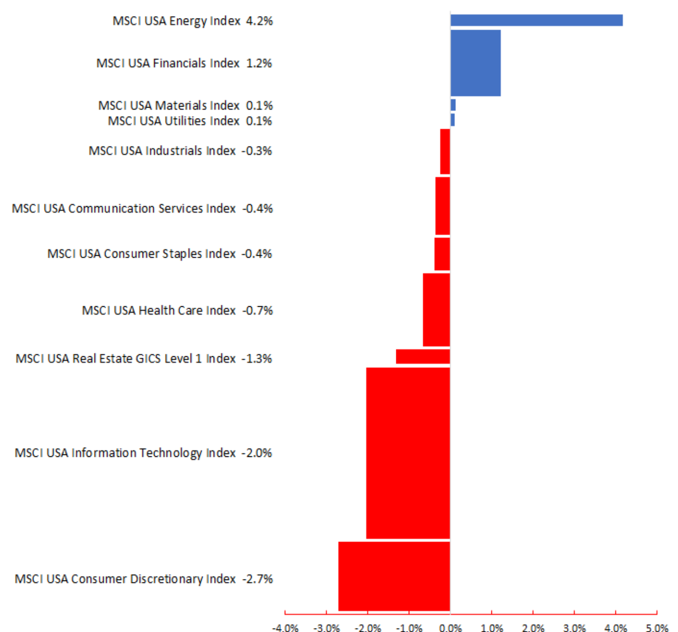
The UK's outperformance – which is still ongoing at the time of writing – has also been helped by a rapid sectoral shift. This change in industry fortunes has been a feature of markets around the world last week. The chart below shows the broad sectors of the UK on the left and the US on the right, with the bars' width showing their index weight.

UK and US equity sector indices 5-day moves (local currency)

MSCI United Kingdom



MSCI USA

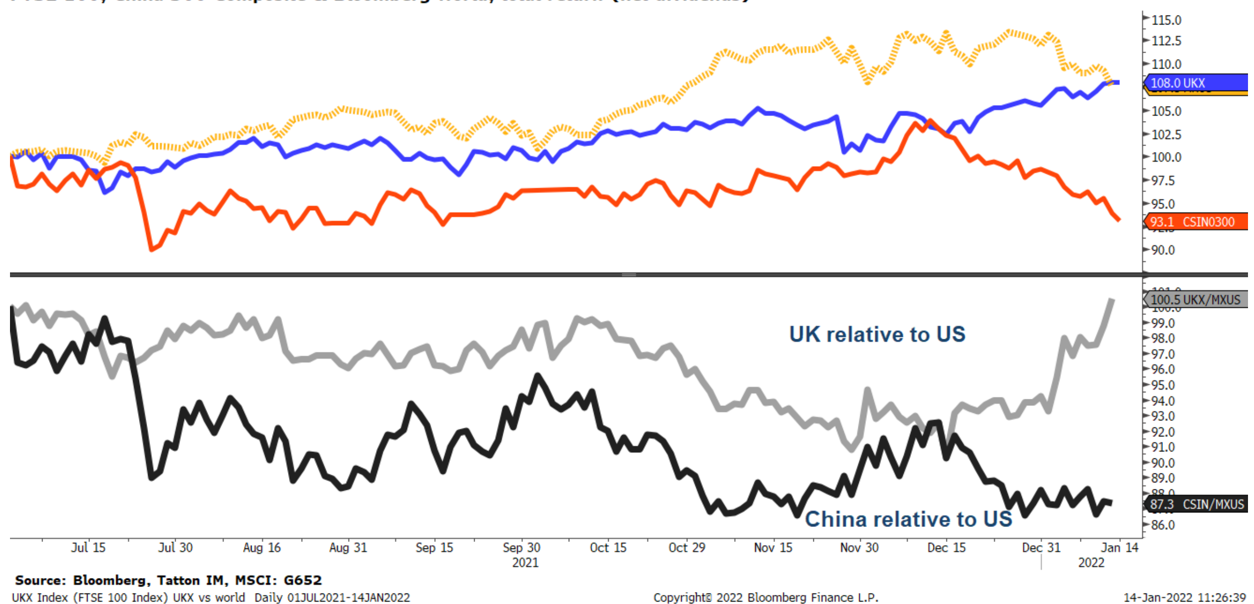


Source: Bloomberg, Tatton IM, MSCI: UK is in GBP, USA in USD

We should point out that short-term index comparisons can be misleading, given trading times differ across the world. Nevertheless, broadly one can see that energy, materials and financials outperformed other sectors in both the US and UK, while IT and consumer discretionary underperformed (apologies for the

small font of this chart!). This goes some way to explaining why UK equities as a whole outperformed the US – as America's stock market has a large technology component (and Amazon being part of consumer discretionaries).

As we mentioned, currency values also had a big impact – with sterling gaining on the dollar. But even against other major currencies, the dollar also fell throughout last week, which added to the regional performance difference. The chart below shows the relative index performances (in sterling terms) over the last six months – with China's stock market added in for comparison. A lot has happened in that time, but we believe that the spread of omicron has been at the heart of these moves.



The rapid transmission of omicron – and particularly its ability to infect vaccinated people – was a big concern for markets in December. But as we wrote back then, this variant could end up being a boon for the global economy if proven less deadly and offering greater immune protection once those infected have recovered (regardless of whether they were vaccinated or not). This is not to downplay the threat it poses to clinically vulnerable and/or the unvaccinated, but only to say it could change the pandemic from a global emergency to a long-term endemic illness, more like the flu.

It is still early days, but data from the UK and other heavily affected areas backs up this hypothesis. Moreover, Downing Street's unwillingness to impose heavier restrictions has meant economic activity has stayed reasonably strong – meaning the recovery in growth can continue through this year. Things could be very different in other regions – particularly those with low vaccination rates and high levels of obesity and clinical illness – but it is a positive signal for global growth.

It suggests the global growth cycle – which has stalled and spluttered through numerous COVID waves – might finally become sustainable. Investors seem to agree, as the aforementioned equity market shift shows. Unfortunately, the last couple of days have seen a slight reversal. Long-term bond yields tailed off toward the end of last week, while global equities struggled to find support.

Much of this is down to disappointing economic data. US retail sales in December were well below expectations, as sales value declined 1.9% (seasonally adjusted) and an even worse 2.5% month-on-month after stripping out fuel and car purchases. When you also consider inflation is at its highest in decades, it will mean a fall in real disposable incomes and suppressed demand.

For equities, that has seen investors swing from anticipating sustained global growth, to factoring in markedly slower earnings growth as consumer demand subsides. The flipside of this is that the problem looks like more US-based than global. In that case, we would expect US equities – particularly the mega-cap tech names – to fare less well than over the last two years. For now, UK and European equity performance backs this up – with this side of the Atlantic likely to exit the omicron slowdown earlier and experience another year of a marked activity upswing in the spring.

As the chart earlier showed, China has also underperformed. Much of this is to do with policy, as Beijing's crackdowns have made many headlines. The Chinese government still appears to be pursuing a zero-COVID policy, and with omicron proving incredibly infectious, this means harsh lockdowns are happening while economic activity is still suppressed.

The State Council cabinet met early last week and acknowledged the slowdown, promising to increase the spending of money already raised last year, and to raise more debt (in local government bonds) to spend quickly. But China's banks are reluctant to purchase more of this debt, despite 'strong' encouragement from local authorities. Last year, banks thought they had financed well-supported local government 'financing vehicles', only to find they had been duped by corrupt officials, with credit officers then blamed for not doing their job. They are (understandably) anxious about doing so again.

Plus, after Beijing's crackdown on Evergrande and other large companies, credit demand has slowed more than the authorities intended. The Chinese government will do what it can to stimulate more activity, but this will be hard to do while maintaining lockdown policies. Overall, it means China's weak period could continue. That is a concern for the global economy. Supply chain problems were extremely damaging last year, pushing up inflation to uncomfortable levels. We expect many of these short-term problems to drop away this year, but if Chinese production slows dramatically, it will only add to the supply side pressure. That is one of the biggest threats to the positive cyclical view. For now, we do not expect it to overwhelm market positivity – but we will need to stay wary.

The ups and downs of last week's stock market action is a fair reflection of the competing economic dynamics still at play, and discussed at length here before. Threats from rising yields and inflation pressures on one side, and support from a sustained economic recovery on the other. This could well bring about an overdue market rotation and the chance to turn a page – moving away from the darlings of the pandemic and into the cyclical recovery plays that have been shunned, but will see demand increase when COVID no longer dominates our lives. For now, we cannot be certain which way 2022 is going to tilt, but the latest market signal – together with the rapid reduction of infection numbers in London – means a more pleasing springtime is looking more probable.

Multi-faceted inflation

We may have barely begun 2022, but the US Federal Reserve (Fed) looks more determined than ever to keep its new year's resolution. "Transitory" – the 2021 word of the year in capital markets – was officially retired by Fed chair Jay Powell back in November, and officials have talked tough on fighting inflation ever since. Patrick Harper, president of the Fed's Philadelphia branch, was the latest to let out a hawkish cry last week, when he gave his support for raising interest rates in March. Current inflation levels are "very high, very bad", according to Harper, who is even "open to more" than three rate hikes this year should US prices continue to jump. His concerns echo Powell's, who used his Senate confirmation hearing last week to warn of the "severe threat" price instability poses to the US economy. Data released the day after the hearing seemed to underline Powell's concern: inflation as measured by the consumer prices index (CPI) reached 7% year-on-year in December, a step up from November's 6.8% and the highest annual figure since 1982.

A March rate hike now looks all but certain, and officials are also eager to reduce the Fed's sizeable QE driven balance sheet soon after. This inflation-fighting spirit marks a significant change from most of last year, when Powell spent months persuading markets that despite rising inflation the Fed would only ever so slightly tighten monetary policy. Now it appears, the tightening cycle – including the "run off" process where proceeds of the Fed's maturing QE holdings are not reinvested – will happen "sooner and faster" than the last time it happened in 2017.

It seems the T-word is not just retired, but dead and buried. However, this may prove hasty. While many economists were concerned about the Fed's nonchalance around rising prices, at least some of the intense inflation pressures of last year could still be short-lived.

The transitory inflation debate has always had two components: short-term price pressures arising from pandemic-related quirks, and the longer-term structural trends that will set the course for the global economy afterwards. Last year, the doves argued short-term issues would subside, while structural inflation pressures would not be enough to embed price rises.

We now know the first point was overly optimistic. Supply chain problems have lasted longer, and bitten harder, than many expected, while worker shortages – from COVID or otherwise – have been widespread. Commodity prices rose consistently through 2021, feeding through into sustained price increases for consumers. Prolonged pressures have had a big impact on people's expectations too, with businesses and consumers preparing for higher costs this year (particularly on energy).

But despite these perceptions, short-term inflation pressures finally appear to be easing. Input prices have already slowed down considerably, and at this stage in the cycle we are unlikely to see a repeat of last year's commodity boom. Oil is a possible exception – with supply driven by geopolitical interests – but even here prices arguably have little room to climb (OPEC+ members and US shale producers have a strong incentive to increase supply as prices rise).

This is not to say input costs will stop rising altogether – or let alone go the other way. But momentum has definitely slowed, and we appear to be past the peak. The same could be true for supply chain bottlenecks, which the New York Fed argues "have peaked and might start to moderate somewhat going forward". We acknowledge that cost pressures emanating from China's COVID-related lockdowns could

still be an unwelcome component; however, seasonality brings a lull in goods shipping and energy demand. If the outbreak is reasonably short-lived (as it has been elsewhere), the timing will be fortunate.

Short-term pressures from demand also look less inflationary. Fiscal spending has been a crucial component of US growth throughout the pandemic, after giving a huge boost to savings. But the fiscal boost dropped dramatically in the later stages of 2021. According to the Brookings Institution's Fiscal Impact measure, fiscal policy is expected to be a drag on the economy through to 2023 – even including the government's infrastructure spending. Meanwhile, President Biden's "Build Back Better" programme has hit a major political roadblock, and little extra spending is expected to be passed this year.

These factors are already filtering through to consumer prices. In the US, December's annual CPI increase was the highest in decades – and was supported by rising prices across the board. But the month-on-month increase was more muted at 0.5%, down from 0.8% in November. Energy prices – which have a lagged impact on other goods – fell 0.4% from the month before. None of this suggests inflation will fade or reverse, but it shows momentum is slowing. If supply problems continue to clear and demand growth subsides, we are sure to see less price action later this year.

However, those on the other side of the "transitory" debate would point out there is more than just COVID problems to consider. Labour participation rates have dropped markedly throughout the pandemic, many argue irreversibly, while governments and businesses have altered supply chains to become more regionally focused. Meanwhile, the global green transition has generated a great deal of investment, but implementing environmental changes will inevitably prove costly. These structural factors could push prices upwards not just now, but over the long term.

Central bankers seem to have shifted their thinking here. The Fed's "transitory" argument last year was largely based on the notion that the US economy was in a transition phase, after which structural pressures would not keep inflation high over the long-term. Now, the Fed has decided there has been a permanent shift upwards. But how big that shift will be remains to be seen.

The main factor to watch is the labour market. Even before the pandemic, global labour supply was stalling as many regions became less open to immigration. With furlough and work-from-home orders over the last two years, additional pressure has come from many deciding to hold out for better jobs or retire altogether. This is likely to change should savings decline or wages improve, but we still do not know when – or by how much – this will happen.

Immediate pressure is likely to subside throughout the year. If it does, inflation expectations will cool – as will the urgency around monetary tightening. Beyond that point, the makeup of the post-pandemic labour market should be much clearer. "Team transitory" may have taken a beating over the last few months, but some of their points could still prove right in the end.

Democrats' Margin Call

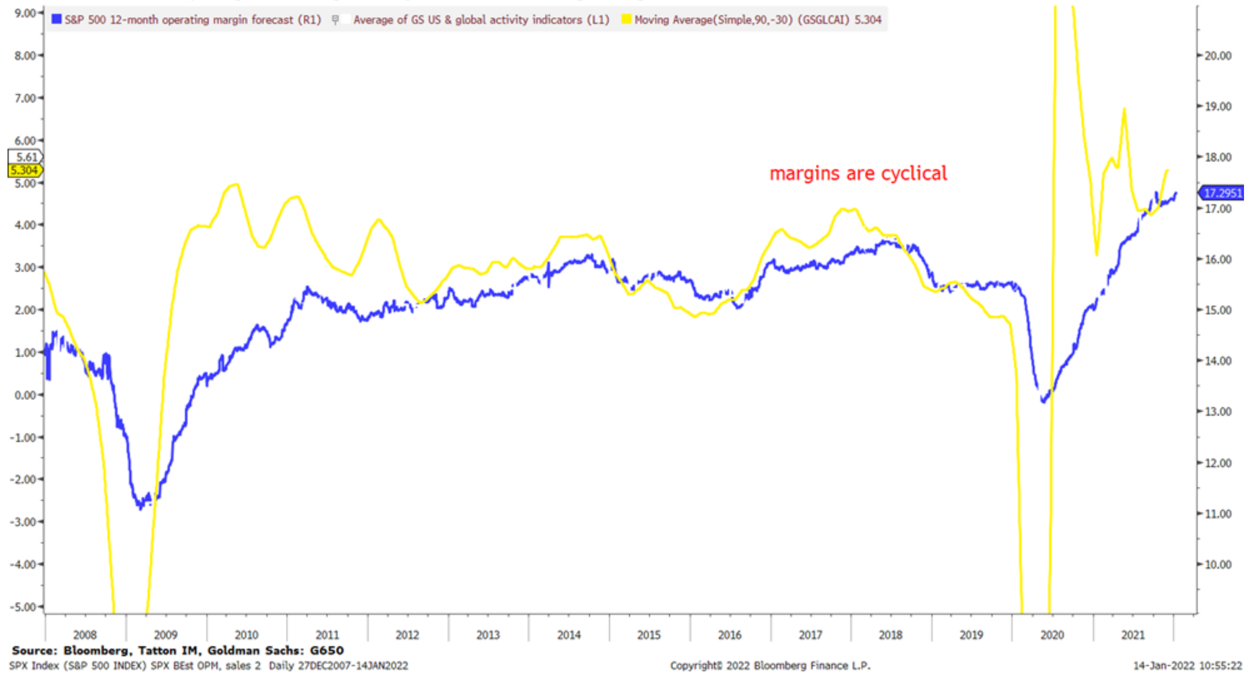
Media reports on Jay Powell's re-confirmation as Fed chair spoke a great deal about his tough inflation stance. Less discussed is the fact that Powell had a tough time himself when appearing before the US Senate. The Fed chair gained four more years, but not without a grilling from Democratic Party Senator Elizabeth Warren. The Massachusetts Senator took Powell to task over an insider trading scandal that has engulfed the Fed in recent months, and appeared to patronise him with an 'econ 101' lesson on competitive pricing.

On the latter, Warren argued that anticompetitive behaviour among the largest US firms is leading to higher prices for consumers – the exact thing Powell and his team are so concerned about. Fed officials have warned for months that higher costs around the world will lead to surging inflation. But if businesses are able to pass on their input costs, Warren continued, their profit margins would be unaffected. Indeed, profit margins for large US companies have increased dramatically over the last 18 months, and have been stable at historically high levels in the last quarter. This, Warren suggested heavily, indicates an extreme lack of competition.

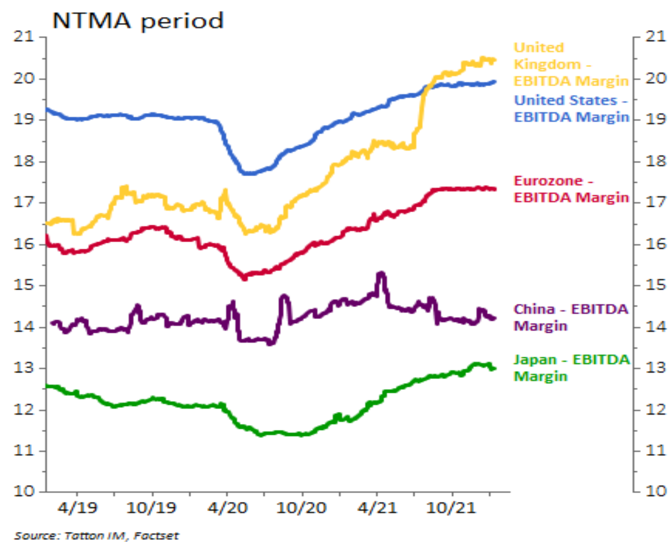
What should we make of this? Our starting point for this discussion is that input costs have indeed shot up across the globe. At the same time, growth has rebounded strongly from the depths of the pandemic, bringing resurgent demand across most major economies. Higher input costs and growing demand is a recipe for high inflation, as we have already seen in the US, UK and (to a lesser extent) Europe.

Strong growth means an increase in sales. But many companies (primarily goods producers) have a relatively low marginal cost on additional output. So, a pick-up in sales usually brings an increase in profit margins, in the short term at least. We saw this last year for US companies – a fact that some commentators have used against Warren's argument. Powell suggested as much in response to the Senator, claiming strong margin growth might reflect "incredibly strong" demand, meaning corporations "are raising prices because they can".

Operating margins (EBIT/revenues) are almost always helped by economic growth, and the phenomenal COVID bounceback growth of 2020 and 2021 has been no exception. The chart below indicates S&P 500 margins have kept in line with growth (proxied by the Goldman Sachs US current activity indicator):



The cyclical argument has a problem though. Input costs are high globally, affecting companies from Hanoi to Houston. But consumer price inflation – and indeed profit margins – are not. Western developed nations have recorded some of the highest consumer inflation numbers in decades, while price rises in China and Japan have been much more muted. Likewise, as the chart below shows, company profit margins have increased dramatically throughout the pandemic in the US, UK and Europe, while they have been tamer in Japan and – particularly – China.



Some of that disparity is down to relative growth levels. The US recorded stellar growth last year, while China's growth was much more in line with pre-pandemic levels. But that does not tell the whole story. China still recorded strong growth (in absolute terms) and its producers had to pay significantly more for

materials last year, but profit margins remained steady, and consumers were not hit by dramatic price increases.

Government policy certainly played a big part. Beijing cracked down hard on large parts of its private sector last year, compressing profits to the point of making some industries legally unprofitable. Officials pursued a growth strategy that boosted exports and internal demand while preventing corporates from gaining much pricing power.

The People's Republic is an extreme case, and Beijing's policies generated plenty of damaging problems in 2021, but it makes an interesting comparison to the US. The very fact that US corporates could take advantage of strong demand to bolster profit margins shows the pricing power they have. Senator Warren's point – which she and other Democrats have made many times – is that this pricing power comes from excessive concentration among America's largest companies.

Last week's release of US inflation data does not ostensibly support this notion. The CPI data for December – which recorded its biggest year-on-year jump since 1982 – is not broken down in a way that immediately shows the US mega-caps, like Apple or Amazon, are driving consumer prices substantially higher. Goods prices are still a sizeable contributor, some 2% of the 7% total, but other areas contribute more; energy, used cars and "owner-occupied" rents. Most commentaries focus on rents especially. However, in comparison to times past, goods prices are rising faster now than at any time in the past 10 years.

That perhaps misses something. The classic understanding of a monopoly is that it harms consumers by restricting competition and forcing them to accept higher prices. For all the complaints about the concentration of corporate America over the last two decades, there has been little evidence of this kind of price fixing. But what we have seen is (1) larger companies amassing ever greater market shares and (2) suppliers being forced to accept lower sales prices or increased distribution costs as companies like Amazon are the major routes to market. Now, there is another change happening. These larger companies are no longer pushing inflation down. Online retail, for example, has historically been able to undercut physical retailers, but the latest inflation data shows just as big a rise in online prices.

In other words, while Amazon's market share came from its ability to undercut competitors, it now has so much market share that it no longer needs to. These companies now seem to have a huge amount of pricing power, which has allowed them to increase profit margins to historic highs even while input costs increase.

It is debatable whether the US mega-caps have really reached that critical mass. The important point is that Warren and many senior Democrats think they have. And while politicians have rallied against monopolistic behaviour for years, the current inflation spike means that in the eyes of the voters they now appear to have credible evidence.

We suspect this will lead to a renewed antitrust drive from the Biden administration in 2022. Chances of passing the President's 'Build Back Better' fiscal package are slim in the short-term, in large part because centrist lawmakers like Democrat Senator Joe Manchin worry it could lead to higher inflation. If the administration can blame inflation on corporate greed instead, it could become a powerful weapon going into the mid-term elections.

This could be another reason for the recent underperformance of the mega-caps. The secular tailwind might have become a headwind, and the stellar performance of America's mega-tech sector is no longer assured. Whether or not these companies are controlling prices, the perception is that record high margins are unsustainable – and Warren wants to make sure they come down.

Global Equity Markets

Market	Fri 15:53	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7550	+0.9	+65	↗	⇗
FTSE 250	22762	-2.5	-591	→	→
FTSE AS	4260	+0.3	+11	↗	⇗
FTSE Small	7403	-0.3	-26	⇗	⇗
CAC	7144	-1.0	-75	↗	↗
DAX	15898	-0.3	-49	↗	⇗
Dow	35797	-1.2	-435	⇗	⇗
S&P 500	4643	-0.7	-34	→	↗
Nasdaq	14774	-1.1	-162	⇘	↗
Nikkei	28124	-1.3	-364	⇘	⇘
MSCI World	3182	+0.1	+5	→	↗
CSI 300	4727	-2.0	-96	⇗	⇘
MSCI EM	1263	+3.0	+37	⇗	⇘

Top 5 Gainers

Company	%
Just Eat Takeaway.com	+8.1
Brit-AM Tobacco	+7.5
BP	+7.4
Stan Chartered	+7.4
HSBC	+7.1

Top 5 Decliners

Company	%
Croda Int'l	-11.2
Spirax-Sarco	-11.0
Taylor Wimpey	-10.6
Halma	-10.4
JD Sports Fashion	-10.0

Currencies

Pair	last	%1W
USD/GBP	1.368	+0.7
GBP/EUR	0.836	+0.0
USD/EUR	1.14	+0.6
JPY/USD	113.80	+1.5
CNY/USD	6.35	+0.4
Bitcoin/$	43,042	+1.7

Commodities

Cmdty	last	%1W
Oil	85.30	+4.3
Gold	1820.6	+1.3
Silver	22.94	+2.6
Copper	444.3	+0.7
Aluminium	2952.0	+1.0
Soft Cmdties	227.8	-0.5

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	15.8	12.5	14.3
FTSE 250	2.5	14.7	16.3	16.2
FTSE AS	3.5	15.5	12.9	14.4
FTSE Small x Inv_Tsts	2.2	11.5	13.9	15.7
CAC	2.1	20.5	15.1	15.1
DAX	2.1	14.8	14.3	13.7
Dow	1.8	18.6	18.9	16.7
S&P 500	1.3	24.5	21.1	17.9
Nasdaq	0.7	28.0	30.0	23.5
Nikkei	1.7	15.2	17.4	17.8
MSCI World	1.7	21.2	19.2	16.9
CSI 300	1.7	16.1	14.0	12.6
MSCI EM	2.4	12.9	12.9	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.14	-0.04
UK 15-Yr	1.31	-0.04
US 10-Yr	1.75	-0.01
French 10-Yr	0.33	+0.04
German 10-Yr	-0.05	-0.01
Japanese 10-Yr	0.14	+0.00

UK Mortgage Rates

Mortgage Rates	Jan	Dec
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.56	1.53
3-yr Fixed Rate	1.53	1.52
5-yr Fixed Rate	1.59	1.54
10-yr Fixed Rate	2.55	2.56
Standard Variable	3.63	3.62

* 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.

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