CAMBRIDGE INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

4 April 2022

Lothar Mentel

Lead Investment Adviser to Cambridge

DISCLAIMER

This material has been written on behalf of Cambridge Investments Ltd and is for information purposes only and must not be considered as financial advice.

We always recommend that you seek financial advice before making any financial decisions. The value of your investments can go down as well as up and you may get back less than you originally invested.

Please note: All calls to and from our landlines and mobiles are recorded to meet regulatory requirements.

4th April 2022

Yield curve inversion – no April fool

It is the beginning of April, but after living through the events of this quarter, few seem in the mood for the usual April fools' jokes. While UK consumers braced themselves for a surge in their cost of living – as the UK's energy price cap resets and rises a staggering 54% – investors experienced a quieter week last week, which once again saw gains in equity markets, while bond market valuations suffered from rising yields.

Our full review of the month and the quarter will follow next week, once the data has settled. But suffice to say, March's positive returns have only partially repaired what has not been a great quarter for investors. The two major events that drove the quarter – a sharp turn towards monetary hawkishness by the US Federal Reserve (Fed) and Russia's unprovoked war on Ukraine – now appear a little less frightening for investors, but their impact drags into the second quarter.

Compared to positivity with which 2022 started – with prospects of finally leaving the pandemic years behind us – these two events have certainly dimmed the near-term outlook for the global economy, as they have naturally increased the risk of a central bank error causing a recession, or at least an economic slowdown, because of a prolongation of increased energy prices. All this will make it more difficult for companies to improve their earnings, while further supply disruptions and spiking commodity prices have created inflationary pressures that central banks are ill-equipped to fight, without upsetting the economy.

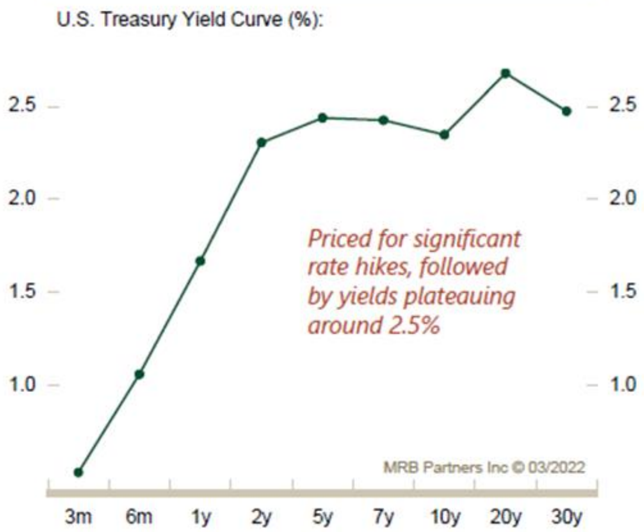
As always, there are also positive perspectives arising from adversity, but the major investments into energy security that were pledged by European governments over the past weeks will take time to feed through into economic activity. More important for the near term has been the US government's decision to release vast amounts of oil from their national reserves over the coming six months, which put further downward pressure on the oil price, with Brent crude now trading at around $105 per barrel, rather than the $130 level reached earlier in March.

US employment figures were also cause for positivity, with 430,000 new jobs added in March. This confirms the continued strength of the economy there, while the latest business sentiment figures from Europe tell a story of slowing growth, but still good momentum from before the start of Russia's war on Ukraine.

However, as we laid out last week, good news can, in the current environment, also turn into headwinds for markets. With price pressures still looming, it was perhaps unsurprising that longer term 10-year US government bond yields reached new cycle highs of over 2.5%, before falling back a little towards the end of the week.

The fast-changing yields have brought another popular spectre out of the 'scares cupboard', that of a yield curve inversion. Long-term readers of The Cambridge Weekly will know that inversions of the yield curve are feared by markets, because they have in the past often been closely followed by a recession. As the chart below shows, the US yield curve has inverted in the spectrum between 2 and 10 years of maturity but remains very steep between 0 and 2 years. This is important, and the reason why the current inversion has been dismissed by most market commentators, is because it is the inversion at the front end of the curve that has in the past been the preeminent recession warning light. It has also – rightly – been argued that the longer maturity end of the curve has been artificially suppressed by the Fed's extended QE purchases of those bonds.

Chart 1 The U.S. Treasury Curve Is Flat From 2-30 Years



Priced for significant rate hikes, followed by yields plateauing around 2.5%

MRB Partners Inc © 03/2022

While we agree with much of this, it unfortunately also adds another reason for pessimism that equity investors can add to the already very high 'wall of worries'. This, together with the increased equity valuation pressures from higher bond yields, makes current market levels on some of our metrics look more extended than at the beginning of the year, when the outlook was still far more positive. We are clearly pleased with the recovery markets have seen since the lows of the first quarter, but whether this will lead to a renewed sustained uptrend, rather than a range-bound sideways trading of markets, will be determined by developments both in global politics and monetary policy over the coming weeks and months. These developments are currently difficult to predict.

Energy security, one of the major economic uncertainties overshadowing Western Europe, experienced a fillip over the last week. Putin's threat to cut off gas supplies to Europe unless payment was made in roubles turned out to be more of an empty gesture aimed at his domestic audience, and a desperate attempt at creating support for Russia's currency at a time when its economy is plummeting. Given European customers will continue to be allowed to transfer euros which are only converted into roubles in Moscow, not much has changed. Except perhaps that there are not enough roubles to cover all transactions, which will require Russia's central bank to turn on the printing press. Whether that is a smart move, when inflation is already running at double digits and there is little to buy with roubles, is highly doubtful.

India/Russia trade surge is ‘strictly business’

Western coverage of the Ukraine crisis has recently heavily emphasised two trends: the seeming ineffectiveness of Russia’s military might and the fierce economic bite of the sanctions regime. Both factors put pressure on Russia, and its strongman president. Isolation is harming President Putin’s standing and, the thought goes, the longer it continues the weaker he becomes. Of course, the key assumption behind this is that Putin’s Russia is indeed isolated, with the world’s major players united against his unprovoked invasion.

From here, it is easy to overestimate the global opposition to the war in Ukraine. As we have written before, China is staying as neutral as it can get away with, offering to play a part in peace talks, while avoiding official sanctions. Joining China on the fence is its bitter rival India – which has huge economic ties to both the West and Russia.

India has abstained on all the major United Nations (UN) votes over Ukraine so far, first on the Security Council motion to condemn Russian aggression and then on the General Assembly vote for the same. In both cases, it was in a small minority. “India is on the side of peace,” according to Prime Minister Narendra Modi. But while 141 of the UN’s 193 members condemned the invasion, India declined to join them, with officials saying only they are “deeply disturbed”.

That deep disturbance seems not to have affected India’s energy companies. With the government in New Delhi showing little sign of signing up to the Western sanctions regime, the flow of Russian oil into India has skyrocketed over the last month. According to Reuters, India has bought around 13 million barrels of Russian oil since the invasion began on 24 February – compared with 16 million barrels over the whole of last year. The US has warned India that this surge in purchases could expose New Delhi to “great risk” of being caught in its sanctions, as officials prepare to step up enforcement. But this shows little sign of deterring the Modi administration.

India’s big refineries have faced difficulties financing their purchases of Russian oil, due to the extensive sanctions on Russia’s banks. From recent reports, though, the Indian government looks set to double-down rather than back down: India’s central bank is reportedly exploring plans for a rupee-rouble trade agreement with Moscow. This comes in response to the efforts to ban Russian institutions from the international payment system SWIFT, and would allow trade between the countries to strengthen, even as the West imposes sanctions.

This is a significant lifeline for Russia. Even China, its biggest buyer of oil and ‘strategic partner’, has yet to increase its purchases like India has. And while there was speculation that China’s CIPS payment system could be used to bypass Western sanctions, the US government has said there is no sign of this happening. India meanwhile – a US ally and the world’s third-largest consumer of oil – seems willing to deepen its economic ties with Russia.

There is a temptation to see these developments as an implicit endorsement from India – a friendly exchange between the countries’ respective nationalist leaders. But this is a little wide of the mark. India had strong relations with Moscow since Krushchev was in power and has remained neutral on Russia’s military engagements for decades – including during the 2014 annexation of Crimea, before Modi came to power. This is partly for historical reasons (India received substantial Soviet support during its war with Pakistan), but even now India is the world’s largest buyer of Russian weapons.

New Delhi undoubtedly has its reservations about its Russian relations – and has not hidden that fact in its communications. But politicians see little benefit in alienating Moscow or cutting itself off from vital imports. On the geopolitical front, India's political class firmly believe China presents the greater strategic threat – one which they see Russian support as key to managing. Over the shorter-term, the discount on Russian resources is simply too big to ignore.

Big oil importers like India have been grappling with surging prices for a year with little respite. Nearly 100 million Indians live in extreme poverty, a figure which could rise with further increases to the cost of living. Modi is extremely politically secure – his party having just won big in state elections – but his brand is built on improving social mobility and conditions for the working poor. Choosing to increase costs for the sake of a war between two foreign countries would likely be deeply unpopular.

This especially so considering the historic discount on Russian oil. Some commodity trading firms are now offering discounts of up to $30 per barrel on Urals blend – the Russian benchmark – compared to Brent crude. Samir N. Kapadia at consulting firm Vogel Group told CNBC: "India's motivations are economic, not political." The government just has little appetite for cutting its nose to spite someone else's face: "It's hard not to take a 20% discount on crude when you import 80-85% of your oil, particularly on the heels of the pandemic and global growth slowdown".

India recorded stellar growth last year and, from an investment perspective, its equities saw significant outperformance. But this has left them at record valuations, and the commodity price shock presents serious headwinds for India's economy. As a big importer, India is highly sensitive to commodity prices and concerns over 'stagflation' (high inflation and low growth). Goldman Sachs recently downgraded its assessment of India, suggesting headwinds are likely to persist, and a short-term correction could be on the way.

Financial and economic woes would no doubt worsen if the country got caught up in US sanctions. That could force New Delhi to reconsider its position, but for now, the commodity shock is pushing India closer to Russia rather than further away. If the West wants to ensure Moscow is truly isolated, it may need to pressure its allies too.

Japan: good value or value trap?

The Japanese yen had another torrid week last week. It closed more than 1% down against the dollar on Monday. And while the next few days saw a relief rally that wiped out last Monday's loss, it meant the yen finished March some 5.5% below its dollar valuation a few weeks ago. This came as Japan ended its financial year – typically a period of heavy volatility – but even so it was the currency's biggest monthly loss since 2016.

Investors are pointing their fingers at the Bank of Japan (BoJ), as it announced on Thursday a plan to buy government debt at a faster pace than before. That is, the BoJ elected to increase its asset purchases (quantitative easing) and keep a lid on medium-term borrowing costs. Let that sink in for a moment; for months now, the world's central banks have been fighting against rapid inflation by ratcheting up interest rates and shedding debt from their balance sheets. And yet, in Japan, central bankers are doing the complete opposite. Rather than a containment job, the BoJ is actively stoking activity.

In fact, this was just the latest in a series of exceptional efforts aimed at easing financial conditions. The BoJ has repeatedly affirmed its commitment to the yield curve control (YCC) policy, whereby it buys long-term bonds with the explicit aim of keeping maturity differentials at the desired level. This is in stark contrast to most other major central banks, which have allowed bond yields to rise substantially as the global cost shock filters through.

Economically speaking, this policy dispersion is understandable. Japan has notoriously low rates of growth and inflation – and this year has been no exception. Despite the global spike in commodity prices and other input costs, Japanese consumers have faced nothing like the cost pressures seen in the US and UK. Last year, while the rest of the world was in a growth spurt, Japanese inflation only climbed out of negative territory in October – coming in at 0.2% year-on-year. That figure has still not yet reached above 1%.

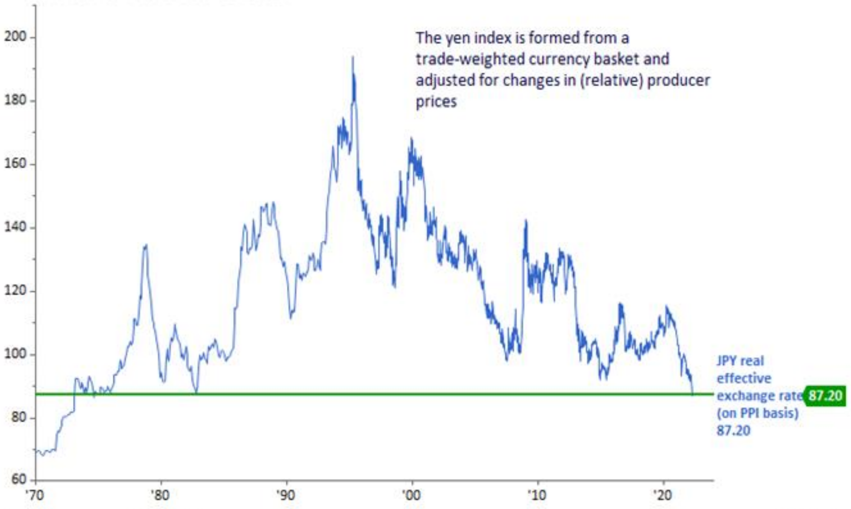
Spurring growth is still the BoJ's top priority, and its YCC policy is acting as an anchor on the yen. There is now a chasm between the BoJ's policy and that of the US Federal Reserve, which looks determined to tighten the screw on rising prices. This has led to a huge difference between nominal bond yields – making a yen-for-dollar trade extremely appealing.

Policy dispersion may explain the recent weakness, but in fact the yen has been losing ground on its peers throughout most of the pandemic. Coupled with the extreme downturn in March, this might make one think the yen was in an overvalued period which is now being corrected. After all, the yen has had similar episodes in the past, and with a historically sluggish economy, we perhaps should not be surprised.

The problem with this suggestion is that, on several important currency metrics, the opposite is true. On a real effective trade basis – adjusting for cost levels between different trading partners – the yen is the cheapest it has been against the dollar since 1982. Indeed, as the chart below shows, it is at a similar level to the 1970s – a period which sparked the dramatic exchange rate intervention from the US government.

Japanese Yen real effective rate

Index is rebased to 2014



The yen index is formed from a trade-weighted currency basket and adjusted for changes in (relative) producer prices

Source: Factset, Tatton IM, OECD, JP Morgan

31/03/2022

There are many ways to monitor the so-called equilibrium value of a currency (such as purchasing power parity) but one of the most impactful for future trends is the cost of equivalent labour. And on that basis, Japanese hourly labour costs have fallen substantially below those of the US. Nominally, US workers are paid an average of around $27 an hour, whereas in Japan the figure is $24. When you bear in mind the stark difference between inflation levels, that difference becomes huge.

Japan has a highly skilled labour force, lower wages than its developed market peers and – because of the BoJ's easiness – cheaper financing than almost anywhere. The profit potential should therefore be substantial, making Japan an incredibly attractive place for investors. And yet, investors continue to be downbeat on Japanese assets, as shown by the currency's immense weakness.

This is almost certainly down to historical precedent. The BoJ has had incredibly loose monetary policy for years, even decades, without spurring major growth in the economy. Moreover, the nation's corporate structure has often proved a major obstacle for foreign investors. Indeed, in the past the government has stepped in to limit foreign ownership of its companies.

That was the past though, and it need not be the future. Due to some high-profile corporate scandals, Japan has embarked on a series of substantial reforms recently. These have led to a more shareholder-friendly environment and have boosted the medium-term corporate profitability outlook. It should now be much easier to make money from Japanese companies than has been the case for decades. What's more, these companies are now much more open to foreign ownership – not only for public shares, but for private equity firms too.

This structural reform should support foreign direct investment, and thereby growth, over the long term. In the shorter term, it means there are many companies in Japan with highly competitive labour costs, highly trained workforces, easy access to financing and a solid corporate governance structure. That is a combination very hard to come by anywhere else in the world.

If Japan presented an opportunity before, the recent sell-off in the yen only adds to the appeal. The problem, as ever, is whether Japanese growth – domestic and export driven – will be strong enough to fulfil this promise. That is much less certain, given Japan's cyclical exposure and the global growth headwinds this year. But with the BoJ easing while everyone else tightens, there is a decent chance of domestic demand being stirred to action. We will have to watch closely, but after years of being a 'value trap', Japan looks good value.

4th April 2022

Global Equity Markets

				Technical	
Market	Fri 15:52	% 1 Week*	1 W	Short	Medium
FTSE 100	7062	+1.4	+98	→	⬀
FTSE 250	23639	-0.1	-20	↘	↗
FTSE AS	4068	+1.1	+45	↘	↗
FTSE Small	7544	+0.5	+37	↘	↗
CAC	6640	+1.1	+70	↘	↗
DAX	15526	+0.2	+36	↘	↗
Dow	34760	+0.5	+176	↘	↗
S&P 500	4445	+0.3	+12	↘	↗
Nasdaq	14985	-0.4	-59	↘	↗
Nikkei	30249	-0.9	-263	↘	↗
MSCI World	3106	+0.3	+10	↘	↗
CSI 300	4849	-0.4	-18	↘	→
MSCI EM	1273	-0.5	-7	↘	→

Top 5 Gainers		Top 5 Decliners	
Company	%	Company	%
Rolls-Royce	+20.8	Just Eat Takeaway.com N	-8.4
Int'l Consol Air	+17.4	Kingfisher	-8.0
Entain	+13.3	DS Smith	-4.9
AstraZeneca	+10.4	National Grid	-4.8
Royal Dutch Shell	+5.8	Schroders	-4.6

Currencies			Commodities		
Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.367	-0.5	Oil	77.68	+3.1
GBP/EUR	0.857	-0.4	Gold	1751.4	-0.2
USD/EUR	1.17	-0.1	Silver	22.42	+0.1
JPY/USD	110.68	-0.7	Copper	423.8	-0.2
CNY/USD	6.47	+0.0	Aluminium	2949.5	+2.4
Bitcoin/$	42,407	-10.9	Soft Cmdties	226.9	+2.2

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	15.5	12.5	14.2
FTSE 250	2.3	16.3	25.2	15.9
FTSE AS	3.7	15.4	13.6	14.3
FTSE Small x Inv_Tsts	1.9	13.3	19.1	15.4
CAC	2.2	21.2	16.0	14.9
DAX	2.1	15.6	15.3	13.5
Dow	1.8	19.5	18.8	16.4
S&P 500	1.3	25.2	22.0	17.6
Nasdaq	0.6	30.6	33.0	22.9
Nikkei	1.4	16.2	18.1	17.7
MSCI World	1.7	21.9	20.0	16.6
CSI 300	1.9	15.9	15.2	12.5
MSCI EM	2.4	14.0	13.3	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.93	+0.08
UK 15-Yr	1.13	+0.09
US 10-Yr	1.45	+0.09
French 10-Yr	0.11	+0.07
German 10-Yr	-0.23	+0.05
Japanese 10-Yr	0.06	+0.01

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.30	1.37
3-yr Fixed Rate	1.52	1.60
5-yr Fixed Rate	1.48	1.56
10-yr Fixed Rate	2.60	2.60
Standard Variable	3.61	3.61

* 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

If anybody wants to be added or removed from the distribution list, please email enquiries@cambridgeinvestments.co.uk

4th April 2022

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

L Mentel