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Reading between the lines

After the resurging positive sentiment of past weeks, markets were last week once again showing signs of fragility – the mood was decidedly 'risk off'. We could characterise this as growth scepticism, or more wariness that inflation will require even stronger and swifter central bank policy tightening before it is effectively squeezed out. Last week's move towards monetary tightening from the European Central Bank (ECB) – even though long anticipated – provided the necessary headlines.

One way we anticipate market actions is to examine the different signals from different asset classes and markets, and consider what future scenarios might explain those moves. Early last week we saw pressure building in different areas. Oil prices returned to levels reached immediately after Russia's invasion of Ukraine. Fixed income government debt yields moved higher, with general corporate and lower credit yields rising faster. Market-implied inflation (Breakevens) expectations also rose in the US, although less obviously. The combination signalled expectations of higher interest rates – and over a longer period than expected before.

The simplest rationale for this would be that central banks might need to maintain higher rates than previously thought, to dampen demand growth down to match reduced global production capacity, and therein contain inflation. That would also see credit spreads (the extra yield that weaker corporate borrowers have to pay versus the government) rise, because bankruptcies would probably increase as weaker companies are unable to service their debt at higher yield levels.

The ECB 'tightened' its monetary policy last Thursday, and we cover some of this in an article below. Interest rates were unchanged, but ECB President Christine Lagarde "committed" that rates will rise by 0.25% at the next meeting in July, and that bond buying (quantitative easing) will also end (although there was no mention of actual bond sales, or quantitative tightening). Thereafter, Lagarde indicated the ECB's readiness to raise rates by 0.5% in September (with no August meeting), and probably by another 0.5% in October. From the current market rate of -0.5%, most economists expect the year-end traded rate to be around +0.75%.

Still, most commentary had it that the ECB was being more hawkish than expected. Real yields rose more sharply than those in the US, but the euro nevertheless weakened. The reason for this possibly lies in the way that most government euro assets are not risk-free. Due to the inherent structural weakness of the European Monetary Union, they carry a credit risk component (Italy and Greece), and the credit spread over less risky credit (like Germany) widens as nominal rates rise. Lagarde acknowledged this instability by talking of a new "spread control" tool, but nobody thinks there is ECB Governing Council consensus on this.

The lack of an ECB rate hike now does pose the question of "why not this month?" - that is rather difficult to answer, especially if the ECB is so certain of rate rises next month. Yes, it may wish to keep to previous statements, but its inflation forecasts keep going up and (the ECB's own economists say) all the risks lie towards higher inflation. It is like heading towards a cliff edge with a broken speedometer, and promising your passengers you won't brake too sharply.

There may be reasons to think the ECB's laggardly stance (pun intended) is intentional because most believe the underlying issues are 'global cost push', and that the policy that matters comes from the US Federal Reserve (Fed). In which case, policy compression is already underway.

US inflation data for May released last Friday worried some investors by being slightly above expectations (with monthly core consumer price index (CPI) inflation still rising at an annualised rate of 7%). As mentioned before, US ten-year Treasury yields had returned to above 3% last week. After initially retreating following the release of the inflation data, yields resumed their upward path. Perhaps investors are yet to be convinced inflationary pressures may have peaked.

Yet, we increasingly observe several good reasons to believe goods prices are being constrained – just look at the company earnings guidance for this quarter. US retailers Target and Walmart told markets about their over-stocking and, last week, Intel said computer hardware sales had turned disappointing. The pandemic has affected chip-related manufacturers especially. We devote a separate article this week to exploring just how cyclical the chip industry currently feels, and what the turn from supply famine to feast in this sector tells us about a possible balancing out of the post-pandemic supply-demand hangover.

Meanwhile in the UK, DFS revealed it was 'sitting' on a lot of sofas that are proving hard to shift. Financial market veterans will feel they have seen this story repeatedly down the years, with DFS moving from one administration episode to another. This perhaps indicates where the fragility in markets emanates from. As we pass from over-demand to over-stocking, some firms will face a sharp squeeze just as rates start to bite. From that perspective alone it appears entirely justified that credit spreads in Europe and the US have risen back to recent highs. This does not necessarily hint at a major economic downturn, but merely the self-cleansing process capital markets normally afflict on the weakest when money is scarce, and looking for the most efficient application (a factor suppressed over the past decade of plentiful cheap money).

So, while it may seem markets have headed back to the bearish sentiment of mid-May, from where we sit, things seem to be a little brighter. China's sharp policy actions have stabilised sentiment and as we'd hoped, the virus impacts appear to be waning quite quickly now – not just in China. Perhaps that puts some renewed pressure on commodity prices, but the fear that world trade would face another supply chain squeeze now seems less likely. Indeed, China's equity markets and credit spreads have been moving in the opposite direction to the western world. Given they were one of the focuses for previous investor bearishness, the turnaround is to be welcomed. And, as noted, the margin squeeze on goods sellers due to the spending pressures that have hit households from their fuel and energy bills, is also equivalent to a reduction in goods price inflation pressure.

The current upswing in market risk premia (as stock markets fall there is a higher earnings potential – a bit like the relationship of yields rising when bonds prices fall) seems to us to be more of a straight risk aversion – as more risk-averse investors find the exit – rather than about an actual worsening of the global macro picture.

Of course, this risk aversion might find a justification if energy prices are forced to rise more, or some other external threat emerges. But absent those shocks, last week's wobble is probably just that. As there is little in terms of historic precedent of post-pandemic normalisation periods, combined with a major war between one of the largest energy exporters and one of the largest food exporters, perceived uncertainty levels are high. But even while that is so, resilience levels and activity potential for the global economy have not been in as promising a state for a long time – as has the resilience of systemically important financial institutions.

May 2022: Monthly market returns review

Asset Class	Index	May	YTD	12 months	2021	5-yr rolling annualised
Equities	FTSE 100 (UK)	1.1	4.8	12.4	18.4	4.2
	FTSE4Good 50 (UK Ethical Index)	0.6	4.4	9.4	13.0	1.3
	MSCI Europe ex-UK	0.1	-9.0	-2.1	16.7	5.3
	S&P 500 (USA)	-0.2	-6.2	12.2	29.9	13.9
	NASDAQ (US Technology)	-2.3	-16.7	-0.2	23.3	15.3
	Nikkei 225 (Japan)	1.3	-7.0	-2.2	2.6	6.9
	MSCI All Countries World	-0.3	-6.3	5.1	19.6	9.0
	MSCI Emerging Markets	0.1	-5.2	-9.6	-1.6	3.8
Bonds	FTSE Gilts All Stocks	-3.0	-12.5	-11.4	-5.2	-0.8
	£-Sterling Corporate Bond Index	-1.3	-10.8	-10.6	-3.2	0.6
	Barclays Global Aggregate Bond Index	-0.1	-4.4	-2.1	-3.8	0.6
Commodities	Goldman Sachs Commodity Index	4.7	58.0	84.7	41.6	13.0
	Brent Crude Oil Price	7.5	59.7	89.7	51.5	17.9
	LBMA Spot Gold Price	-3.6	9.3	10.3	-2.9	8.0
Inflation	UK Consumer Price Index (annual rate)*	3.6	4.3	8.4	5.4	-
Cash rates	Libor 3 month GBP	0.1	0.1	0.1	0.0	0.5
Property	UK Commercial Property (IA Sector)*	1.9	3.9	11.0	7.4	2.9

Source: Morningstar Direct as at 31/05/22. * to end of previous month (30/04/22). All returns in GBP.

May was the definition of a rollercoaster month of capital market performance. Equity markets rose in the first few days of the month, followed by a rapid sell-off, eventually recovering to finish the month down 0.3%. Bond market returns ended up virtually flat after also correcting sharply before recovering. Even commodity prices could only gain a net 1% in May.

In regional terms, Japanese equities were the best performing equity market in May, rising 1.3%. In the UK, the heavily oil and gas-weighted FTSE 100 also ended the month in positive territory, up 1.1%, as oil prices climbed 7.5% over concerns around tight global supplies. The US equity market finished the month down just 0.2%. The US technology sector's struggle continued with a decline of 2.3%. European equities closed the month up only 0.1%, as did Emerging Market equities.

Markets remained under the influence of several interconnected headwinds: tightening monetary policies, higher living and energy costs undermining post-pandemic consumer spending, and slowing economic activity in China as a result of its continuing zero-COVID policy. The impact of the headwinds has been to slow growth indicators in the western world significantly, and in China they have all but collapsed. The first weeks of May were dominated by recession assumptions of 'when' rather than 'if'.

However, May was a long month in terms of sentiment and switched from an assumed recession to more optimism. Central bank action to tighten monetary policy and control inflation benefited from the market slump which helped its aim to cool the economy, leading to the hope that the Fed in particular would not step on the brakes any harder for the time being. However, range bound markets are likely to remain, until catalysts for better (or worse) economic and valuation dynamics emerge over the summer.

Monetary and fiscal policy – Giving with one hand, taking with the other

Boris Johnson's pyrrhic victory on last Monday's 'no-confidence' vote could have big implications for the UK economy. Not that you could tell from the market reaction: the FTSE 100 dropped ever so slightly in midweek, while sterling has stayed at the dollar value it was last Friday. But as the politicos were keen to point out, the Prime Minister's weakened position makes him much more amenable to the whims of his colleagues. Last Thursday, Johnson promised a flurry of policies to help Britons through the cost-of-living crisis – naming growth as his government's top priority.

We do not know yet what that will entail, but tax cuts will almost certainly be in the mix. Tory MPs from across the party have already come forward urging Johnson to ease the UK's tax burden – with rumoured leadership challenger Penny Mordaunt among them. Calls have even come from inside the cabinet, with Health Secretary Sajid Javid saying he would like to see his party "do more on tax cuts".

The Conservative Party leadership angered its base earlier this year when Chancellor Rishi Sunak brought in a wave of tax rises – making Britain's tax burden one of the highest of the G7 group of counties. Sunak has always insisted he is a tax-cutter at heart, but is operating under heavy budgetary constraints and spiralling inflation. Sunak suggested last week that more giveaways would come in the Autumn Budget, while insisting any plans needed to be paid for elsewhere. If the pressure continues to build on Johnson, though, the Chancellor may not have much of a choice. Backbench MPs are reportedly urging the Prime Minister to override the Treasury on cutting taxes, regardless of the inflationary impact. If this happens, it is unlikely to be matched by spending cuts, which could threaten another rebellion. As such, we should expect that the government will loosen fiscal policy in the coming months.

Let that sink in for a moment. Britain is currently seeing its highest inflation levels in 40 years – higher than any other G7 nation – and unemployment is the lowest it has been since the 1970s. Energy and goods supply is severely constrained, and with an excruciatingly tight labour market, we are on the cusp of a wage-price spiral. And amid all of this, the government is throwing more fuel on the fire by loosening fiscal policy.

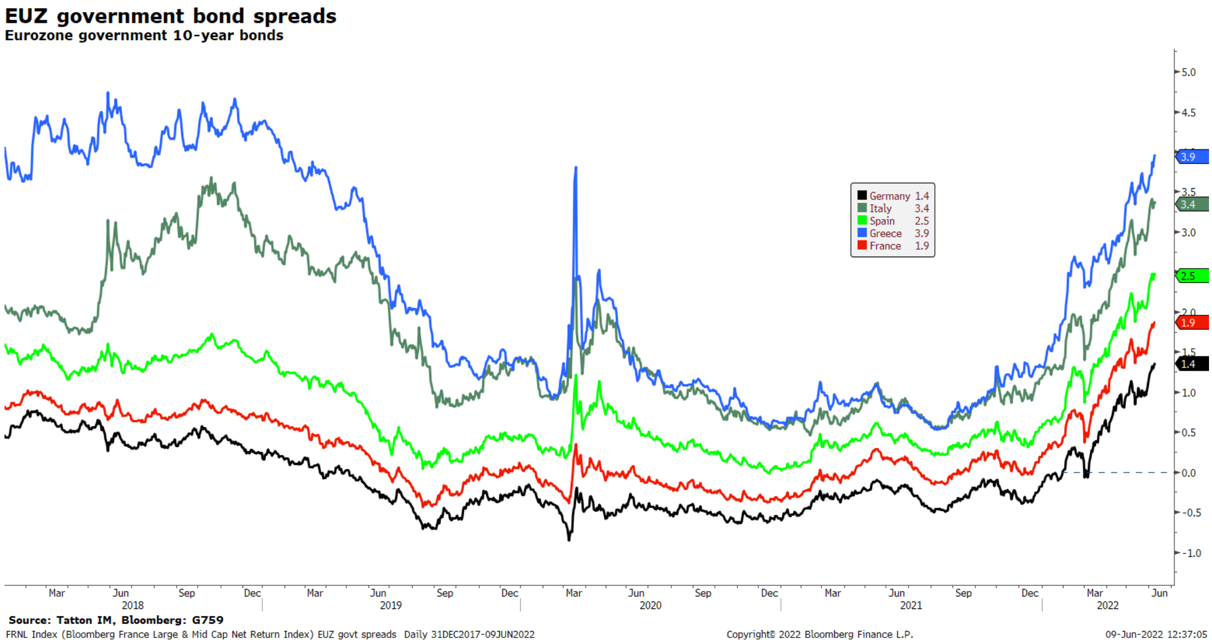
As politically and socially understandable as this may be, there is no question that such a move would increase inflationary pressures. And it puts the Bank of England (BoE) in a bind. In this environment, monetary policymakers simply cannot afford to balance growth prospects against price stability. Instead, they will have to tighten policy hard, raising interest rates and likely choking off growth potential.

Sunak effectively admitted this much in his speech to MPs a few weeks ago: "I know the governor and his team will take decisive action to get inflation back on target and ensure inflation expectations remain firmly anchored," with the implication presumably being 'because I certainly won't'. Fiscal pressures have only increased since that announcement, and the BoE will now be under intense pressure to raise interest rates again.

This combination of tight monetary and loose fiscal policy is far from confined to the UK either. Last Thursday, the European Central Bank (ECB) outlined its plans to stop further bond purchases next month and for negative interest rates to end by September. This will first come with a quarter-point hike in July, followed by a potentially larger increase two months later. This marks the end of an era for the ECB, which has kept policy extraordinarily loose for nearly a decade. At the same time, European Union (EU) lawmakers push ahead with their spending plans from the Recovery and Resilience Facility, which boosts fiscal transfers to member states.

More generally, it is a reversal of what we saw for more than a decade after the global financial crisis. In that time, we have seen incredibly easy financial conditions while governments have been reluctant to loosen the public purse-strings and in many cases applied outright fiscal austerity. Over the years, many called on politicians to match central banks' largesse. But the fact it is now happening while global inflation surges will no doubt make many uncomfortable.

The chart below shows how European bond yields have climbed dramatically this year. So too has the much-watched spread between German and Italian ten-year bond yields. But unlike previous episodes where this spread has widened, it has little to do with internal divisions on the continent – and is simply a reflection of bonds weakening across the board. The same is true in the UK, where ten-year yields have more than doubled year-to-date.



Rising interest rates and central bank tapering puts upward pressure on yields. But so too does loose fiscal policy, as higher government borrowing increases the bond supply competing for investor's buying interest. Both happening at the same time could mean dramatic upward pressure on yields – which is unlikely to stop anytime soon.

This could lead to several problems. For Europe in particular, rising bond yields challenge debt sustainability – meaning that once average yields surpass the rate of nominal GDP growth, national debt is at the risk of entering a self-enforcing debt spiral – as the interest on the outstanding debt grows faster than the tax receipts of the government. This increases the risk that peripheral nations face funding shortages, the very factor that set off the Eurozone debt crisis. ECB President Christine Lagarde is determined to avoid a repeat of this, by trying to prevent bond market fragmentation which would harm policy transmission. But she has also made clear that there are no predetermined trigger points for policy action, so the ECB will have to stay on its toes.

Rising bond yields also push up borrowing costs for consumers and businesses. If these increase too rapidly, widespread defaults become much more likely – the classic harbinger of recession. The silver lining to that thought is that increased borrowing costs act as a dampener on demand, pulling down inflation and lessening the need for higher interest rates. Yields are pushing up from extraordinarily low levels, so there could still be some way for bond yields to go before there is a significant risk of triggering a debt default cycle.

The BoE will certainly hope that is enough to tame price rises. With the UK economy forecast to be the second-worst performing in the G20 (behind only sanction-ravaged Russia) tighter monetary policy could mean severe pain for businesses and consumers. But with the government apparently pushing ahead with fiscal aid, the central bank has little choice. What the new policy mix means over the longer-term, we will have to wait and see.

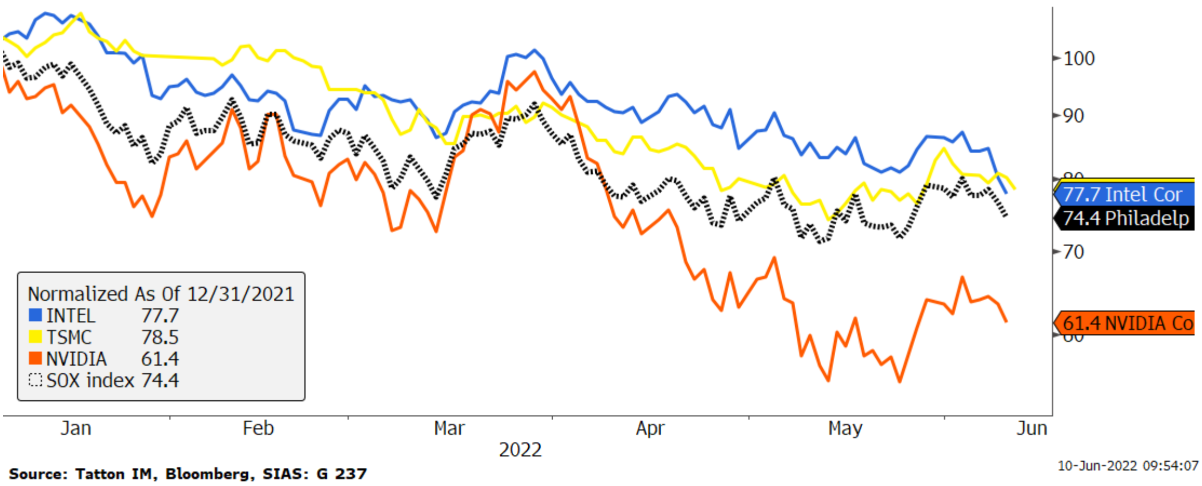
Chips, the new doctor copper

US technology giant Intel took a beating from investors last week, leading to a 5.3% fall in its share price on Wednesday. It came after projecting disappointing results for the second quarter. Intel reckons its profits will be around 70 cents a share, while revenue is expected to come in at $18 billion. This is below analysts' estimates of 82 cents per share profits and $18.5 billion in sales, and follows a disappointing first quarter of 2022, which saw falling revenues for its PC microchips.

Chief Executive Pat Gelsinger, brought in from VMWare just over a year ago, assured investors Intel can regain market share and grow its revenues, but the lack of progress has unnerved some. Its management insist decent growth forecasts for 2022 will be achieved, which would imply a stronger second half than previously expected. Investors are not so sure such optimism is warranted, unnerved by signs of faltering demand for PCs – Intel's largest revenue source. Demand shot up during the pandemic on the back of work-from-home patterns, but results have been lacklustre since.

Gelsinger has promised to correct the errors of his predecessors – which saw the once-leading company fall behind its global rivals. The makeover he started has been expensive, and investors are still waiting to see signs of it paying off. On their part, Intel executives say returning lockdowns in China have disrupted supply – making it harder to fulfil orders.

Global chip manufacturers
Relative price performance (all USD)



Source: Tatton IM, Bloomberg, SIAS: G 237

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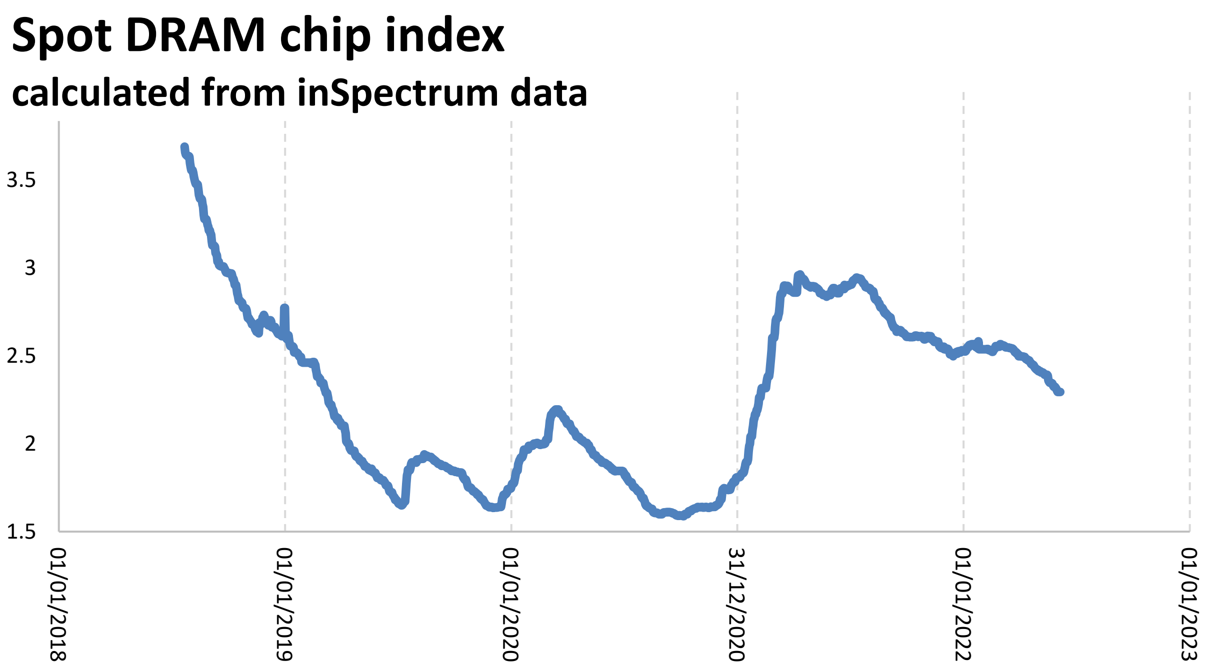
Relatively, the pandemic period has been bad for Intel, underperforming the Philadelphia SOX index (a good market capitalisation index of the major chip makers) by 60%. The two largest members of this index are NVIDIA and Taiwan Semiconductor Manufacturing Co (TSMC). NVIDIA has had a harder time this year, while TSMC's projections look strong. The world's most valuable chipmaker expects revenues to grow 30% overall this year, a jump from the near 25% growth of last year. This is despite widespread concerns that demand for computer chips is stalling from global economic and political factors: the war in Ukraine, Chinese lockdowns and a cost-of-living crisis across the developed world. TSMC officials are confident that "The current inflation has no direct impact on the semiconductor industry as the demand drop is mainly for consumer devices liked smartphones and PCs while [electric vehicle] (EV) demand is very strong and partially exceeds our supply capacity".

However, TSMC's projections seem at odds with actual chip price moves now. Readers may recall that microchip shortages were a significant part of supply chain bottlenecks over the last two years. Rapidly growing technology demand throughout the pandemic – and a series of supply shortages – had drastic knock-on effects for many industries. Last year, waiting times for games consoles and new cars were unheard of all over the world. Though not directly linked to the many other supply shortages we saw last year, rising prices for chips was in many ways an early signal of the current global inflation spiral.

TSMC claim these supply shortages continue. Wait times for semiconductor delivery hit a record high in May, and chipmakers are raising prices due to rising costs. But in other respects, the chip shortage seems much less pronounced. Companies in need of chips are reportedly starting to see relief and, more importantly, demand has plateaued. Apple, one of TSMC's best customers, is planning to keep its production of iPhones flat in 2022 – capping off a potential route for growth.

This comes as global growth is slowing significantly and inflation is eating into consumers' disposable incomes. Rapid price rises have also forced the hands of central banks, which are now tied into a rate-hiking cycle that will result in higher borrowing costs and less available capital (see previous article). The smartphone industry has struggled with these headwinds all year. But the pressures are broad-based, hitting demand for goods well beyond consumer electronics.

Then there is the direct evidence of chip prices. The Taiwanese chip exchange inSpectrum tracks the spot and contract prices of various 'commodity' chips used in devices from cars to mobiles to PCs. Contract prices (settled monthly) for the higher-power chips have been marginally weaker from the start of the year. It's notable that the lower end spot price chips (which price daily) showed strength in early 2020, even more strength in early 2021, but have been sliding this year even during the Chinese lockdowns.



Source: Tatton IM calculation, inSpectrum Inc, Bloomberg - 09-Jun-2022

This tells us that, despite manufacturer claims to the contrary, capital markets clearly believe chip demand is weaker than supply. In a dramatic reversal from the last two years, downstream goods producers are finding their inventories full. Where once there was extreme undersupply, stock markets indicate there is now oversupply.

This looks unlikely to change anytime soon, either. Slowing global growth and a cost-of-living crisis will hold back demand in the short term. And over the medium term, there are signs that supply will be boosted. TSMC is in the process of building a new fabricating plant in the US, while other chipmaking factories have already been approved.

Oscillating between under and oversupply is a regular feature of many markets, as the economic cycle incentivises building or depleting inventories along with global trends. The interesting thing for us is that these swings are usually a feature of commodity markets – not high-tech goods like semiconductors. And yet, over the last few years, chips have behaved like classic commodities.

This affects how we should evaluate companies like TSMC from an investment perspective. Tech companies are usually the prime example of 'long-duration' assets, which are held for their long-term growth potential rather than short-term price fluctuations. By contrast, commodities are the prime example of 'short-duration' assets. Chipmakers are clearly technology companies, but the goods they produce are acting like commodities. So, are they long or short duration?

Here, the answer depends on which part of the chip market you are talking about. When it comes to the development and production of cutting-edge chip technology, which requires years of investment and capacity to deliver, the long-duration aspect is more pronounced. But many goods do not require the latest chips, but older versions which are relatively simple to produce with minimal ongoing investment.

Companies like TSMC deal in both. Last year, we saw a shortage of older chips such as the ones required for cars. This was a classic case of supply-demand imbalance, and as such is more like what you see in the commodity space. But at the top end of the market, revenues are driven by long-term technology advances – the classic long-duration play.

Beyond the question of how we look at chip manufacturers from an investment perspective, the other takeaway from the easing of chip supply is perhaps this: just as chip shortages were the first sign last year of building supply chain disruptions, the easing of supply issues for 'commoditised' semiconductor chips now may well mean that price pressures from the supply shortage of goods might be behind us soon.

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Global Equity Markets

Market	Fri 16:05	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7327	-2.7	-206	⇘	⇗
FTSE 250	19714	-2.8	-559	↘	↘
FTSE AS	4052	-2.7	-112	⇘	→
FTSE Small	6627	-1.2	-80	⇘	↘
CAC	6197	-4.4	-288	↘	⇘
DAX	13789	-4.6	-671	⇘	↘
Dow	31532	-4.2	-1367	↘	⇘
S&P 500	3912	-4.8	-196	↘	↘
Nasdaq	11353	-5.5	-660	↘	↘
Nikkei	27824	+0.2	+63	⇗	→
MSCI World	2722	-2.1	-57	↘	↘
CSI 300	4239	+3.7	+149	→	↘
MSCI EM	1067	+0.6	+6	→	↘

Top 5 Gainers

Company	%
Melrose	+16.0
AVEVA	+9.3
Just Eat Takeaway.com	+7.3
Whitbread	+1.9
Severn Trent	+1.8

Top 5 Decliners

Company	%
Stan Chartered	-8.5
WPP	-8.3
3i	-7.1
CRH	-6.9
St James's Place	-6.6

Currencies

Pair	last	%1W
USD/GBP	1.234	-1.2
GBP/EUR	0.853	+0.6
USD/EUR	1.05	-1.8
JPY/USD	134.19	-2.5
CNY/USD	6.71	-0.7
Bitcoin/$	29,505	-1.4

Commodities

Cmdty	last	%1W
Oil	120.03	+0.3
Gold	1858.7	+0.4
Silver	21.85	-0.3
Copper	430.3	-3.8
Aluminium	2761.0	-0.9
Soft Cmdties	239.4	-1.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	12.1	10.2	14.3
FTSE 250	3.4	10.6	14.0	16.3
FTSE AS	4.0	11.8	10.6	14.5
FTSE Small x Inv_Tsts	3.4	7.9	9.9	15.3
CAC	3.1	13.5	10.9	15.2
DAX	3.4	12.2	11.5	13.8
Dow	2.1	16.2	16.5	16.9
S&P 500	1.6	19.0	17.1	18.2
Nasdaq	0.9	21.2	23.9	24.1
Nikkei	2.0	16.0	15.6	17.8
MSCI World	2.1	16.5	15.9	17.1
CSI 300	1.9	14.7	13.5	12.7
MSCI EM	2.8	10.4	11.7	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	2.42	+0.27
UK 15-Yr	2.61	+0.18
US 10-Yr	3.14	+0.21
French 10-Yr	2.09	+0.28
German 10-Yr	1.49	+0.22
Japanese 10-Yr	0.25	+0.02

UK Mortgage Rates

Mortgage Rates	May	Apr
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.35	2.24
3-yr Fixed Rate	2.26	2.15
5-yr Fixed Rate	2.36	2.25
10-yr Fixed Rate	2.68	2.58
Standard Variable	4.10	4.07

* 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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