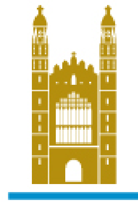

THE **CAMBRIDGE** WEEKLY

1 August 2022

Lothar Mentel

Lead Investment Adviser to Cambridge

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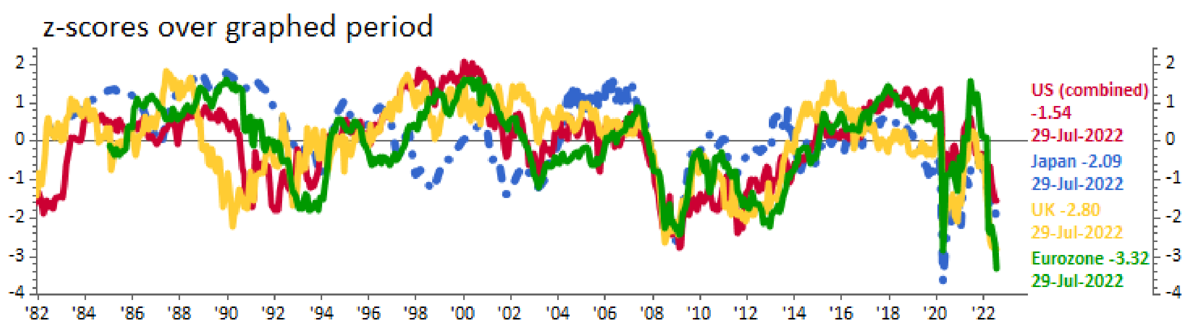
Positive returns amidst negative sentiment

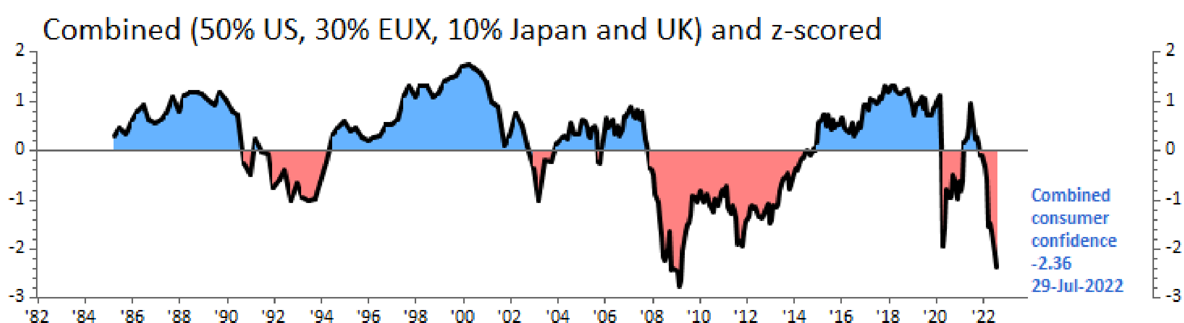
For a second consecutive quarter, the US economy shrank in real terms. Yet the US Federal Reserve (Fed) raised interest rates by another 0.75% last Wednesday because the US economy is too strong. We write, in a separate article below, about how the inflation picture is progressing.

The most usual narrative we hear among the contributors to our research process is that US inflation is sticky. Steven Bell is now Chief Economist of Columbia Threadneedle (after the old Foreign & Colonial investment house was sold by Bank of Montreal) and has been a well-respected City economist for many years. He sees that the drivers of inflation in the US are different to Continental Europe and Asia – the labour market is fundamentally tighter. This viewpoint is shared by Freya Beamish at TS Lombard. Both see that a "proper" recession is most likely; a bout of labour market weakness during the next few months.

Steven Bell thinks that might be towards the end of this year and Freya Beamish sees it more in 2023. Their bearishness seems aligned with consumer confidence measures, which have been awful across the world – in a way that is comparable to both the 2008-9 period and worse than the onset of the pandemic:

Consumer Confidence - Major Nations





Tatton IM, Factset, Eurostat, GfK, US Conference Board, US University of Michigan, Japan Cabinet Office *29/07/2022*

Europe is clearly in a worse dilemma than other areas and much of the news worsened last week. Eurozone inflation for June was higher (marginally) than expected at 8.9% year-on-year. It will be even worse for July because energy prices just keep rising. Russia, via Gazprom, did exactly what was feared and came up with an excuse not to deliver as much natural gas to Germany as was promised. Gas prices went up to new records. We are undoubtedly in a 'cold' war again.

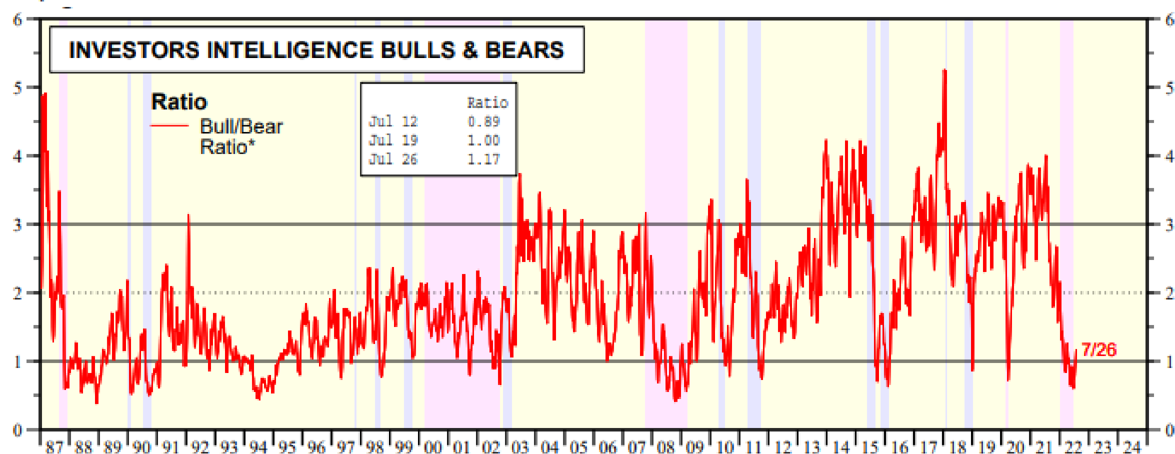
Europe's 'plan' to cut gas use by 15% until 2023 is important. But, as we said last week, the strategy is leaving it to individual nations to find ways to implement the target. As of now, no concrete plans have been proposed by any country. We only know caps will focus the reduction on industry, and that households will not face cuts, even if they are not shielded from price rises.

Until we see how businesses can be protected for this winter, investors will be worried about the potential for unbearable costs. And as small businesses across Europe found during the pandemic, there will be no comfort for them if aid is made in the form of loans, since it will not be possible to make up for lost revenue from foregone sales and production.

Yet, despite all the bearishness, markets put in a stonking performance last week. Pretty much all equity and bond markets ended with asset prices at higher levels. In particular, corporate bonds did well, even in Europe. Given that much of the fear in markets revolves around a potential credit crunch through Europe's winter, many commentators have seen this as probably only a temporary respite.

We write about uncertainty in another of the articles below. What is interesting in last week's price action is that when uncertainty in markets is at fairly extreme levels (we would definitely say that is the case now), price action can become more important in investor decision-making.

At no point do we, as individuals, know everything. According to efficient market theory, the price of any asset is the sum of all knowledge about that asset. However, we can't be sure how much we personally know. When the world is getting riskier, it's natural for investors to want to have less risk exposure. The chart below is taken from Ed Yardeni's work, showing his calculation of the ratio of Bulls to Bears in the US equity market as defined by Investor Intelligence:



When investors get bearish, they end up with fewer risk assets in portfolios than normal. Thus, when prices start to improve, they are left wondering whether other investors know more than they do. Some institutional investors are measured on their quarterly, or even monthly performance, and can end up

having to go back to a more neutral position, even though they have no new information other than the price.

Investors have been both bearish and uncertain for a long time, even though valuations on many assets have become substantially cheaper. Last week, as we approached the month-end, perhaps it's not surprising that we ended up in what looked like a classic 'short squeeze'.

When investor sentiment is poor, it can be quite difficult for markets to fall further without the news getting much worse. So, while there were stories which worried us, much of it told us essentially what we already knew (like the inflation data and the US GDP data) or had good reason to expect (such as the slow Russia gas supply). On the positive side, Jerome Powell sounded less hawkish than expected after the US interest rate rise. Meanwhile China's politburo pressed for more support for their economy.

A bull market isn't likely to set in anytime soon and, almost certainly, not until the energy price squeeze dissipates. Nevertheless, perhaps last week, it felt like it wasn't getting worse.

Markets trust in the Fed's tinkering

You are running a bath. The water shoots out icy cool the moment you turn the tap, and you wait for it to get hotter. The tub fills with tepid water and you start to get impatient – it has been a long day – so you turn the tap as hot as it will go. For a millisecond, you reach the perfect temperature, but that bliss quickly passes as the heat keeps rising. You turn the tap back and it is soon too cold again; switch the other way and it is yet again too hot. There is an annoyingly long lag between turning the tap and actually achieving the right temperature – so you repeat the back and forth until you get out of the tub, making it a much less relaxing experience than you hoped.

As surely no one has ever said before, central banking is like bath time. Policymakers have a small set of dials they can turn to make the economy hotter or colder, and they use them to find the perfect temperature. But the lag between policy and growth means the sweet spot is tough to find. Keep the heat on too long and people accuse you of being 'behind the curve'. Tighten too early and everybody panics about a 'policy mistake'. The Fed spent much of last year worrying about the first problem, while the aggressive interest rate rises this year led to some – albeit only a few – concerns about the second.

Last week, the Fed continued its tightening agenda, pushing interest rates up another 0.75%. Capital markets expected as much, following a 0.5% rise in May and the first 0.75% bump in June. The big news came from the post-meeting press conference, where Fed chair Jay Powell hinted at a change of tack. As the Fed continues to tighten policy, "it will likely become appropriate to slow the pace of increases", he said.

That comment buoyed markets. Short-term bonds rallied and the S&P 500 gained 2.6% in last Wednesday's trading. The Nasdaq – dominated by America's big tech companies which are highly sensitive to interest rates – gained 4.1%. Judging from these moves, the market consensus seems to be that the Fed will reach 'peak' interest rates soon and likely cut them in less than a year. Goldman Sachs' Chief Investment Officer Ashish Shah put it succinctly: "We're past peak hawkishness … their speed going forward will be slower".

The Fed has good reason to do so, judging by the latest economic data. Demand has clearly slowed, and US GDP contracted in inflation-adjusted ('real') terms in the first half of this year, which would meet some people's definition of a recession. Admittedly, Powell pre-emptively noted that, even if the US economy

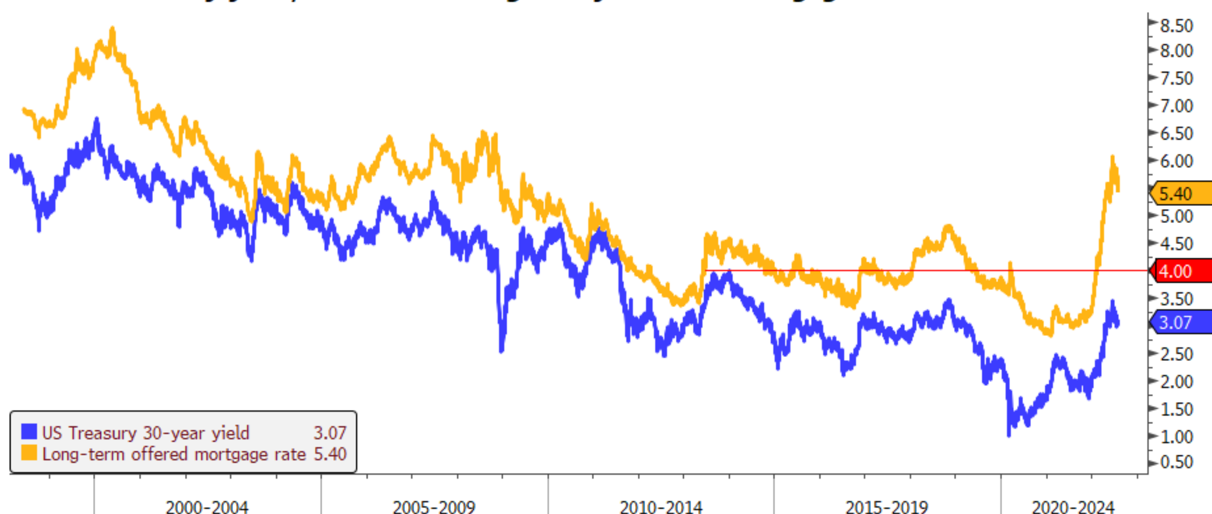
had been in a technical recession for the first half of this year, it would not be a contraction in any normal sense of the word. Even so, the economy is clearly slowing down. After months of tightening, the water has definitely cooled.

The big question for the Fed, and indeed all of us, is what this means for inflation. In normal circumstances, it would be a no-brainer that slowing growth – let alone potential recession – would translate into slower price rises. But the current global stagflation is no normal circumstance. Sharp supply shortages need to be met with equally sharp demand contractions for prices to stay stable. And, with unemployment still at historically low levels, the Fed is concerned with stopping the damaging wage-price spiral above all else.

Even here though, signs look good. Or rather, they look bad, which is good. Inventory data on US retailers and wholesalers show a significant uptick in inventories. While retailers have a bit to go before their stock levels match pre-pandemic levels, wholesalers have higher inventory levels relative to trend than at any point in the last 30 years. On the flipside, retail inventories are significantly lower – the latter having come down from high points earlier in the year. This suggests that final consumer demand has fallen more sharply than expected, causing retailers to reduce their orders and leaving wholesalers with unwanted supply. That is bad news for them, but it points to a sharp reversal of the supply-demand imbalance seen last year. To back this up anecdotally, we have seen evidence of big discount sales – including the recent Amazon Prime day, where online prices were slashed by up to 80% for popular goods.

One of the biggest sources of US inflation over the past couple of years has been the housing market, particularly outside of the big cities. This drove a strong period for residential construction, adding to the 2021 growth spurt and driving up lumber prices (an indicator of housing construction). In the past couple of weeks, lumber prices have taken a downturn. This suggests slowing activity which, considering the construction sector is a huge employer, will likely have big knock-on effects for overall inflation.

There are also signs that previous house price rises are now themselves acting as inflation dampeners. Mortgage providers have been upping their rates and tightening lending standards for fear of recession and the dearth of payments that might bring. This suggests lenders think house prices are unsustainable in the current environment. Mortgage rates have fallen quite sharply in the past month but are still well above



5%. Residential construction will likely struggle to rally from here, putting downward pressure on both growth and inflation.

The Fed's actions have undoubtedly contributed to these trends and will continue to do so. The problem, as noted, is that monetary policy works on a long lag. Further tightening from this point will not bring down growth and inflation in the next couple of months but rather next year and beyond. If futures markets are right, inflation is already set to come down quite sharply to a much more normal level by then. Any extra tightening the Fed does in that time will likely bring down future growth more than it will tame short-term price rises.

Powell and his team are aware of this, and this is probably one of the main reasons their rhetoric is now moderating. The global economy has been softening rapidly recently, with serious problems in Europe (and China, although that may be turning positive). Still, real demand is not likely to improve in the second half of 2022. Indeed, it probably won't improve until the energy squeeze is over.

This is not to say the Fed is done with rate rises, but that its aggressive stance has likely peaked. Policymakers are still turning the tap, but might soon start to worry about cooling too much. For now, we take comfort that markets believe them to be setting the temperature as right as they can.

Thoughts on risk and uncertainty

As the last few years have made painfully clear, we live in an uncertain world. Events that no one thought could happen seem to be regular occurrences these days, to our collective dismay. Investing through interesting times can be a blessing and a curse, the same as living through them. Like any choice, we try to make our investment decisions based on a firm understanding of possible scenarios and their relative likelihoods. When huge once-in-a-lifetime events happen, we often need to evaluate how firm that understanding really is. When several such events happen in quick succession, that sense of uncertainty can creep higher.

Uncertainty here is not the same as risk – though we certainly find a lot of both right now. In economics and investment, the distinction between risk and uncertainty is one of the most important concepts to understand. The popular version of this is that risks are what you know you do not know, while uncertainty is what you do not know at all.

A bit more precisely, a risky decision is one in which the outcome is not known, but the probability distribution of possible outcomes is. An uncertain decision is one where neither the outcome nor the probability distribution is known at the outset. You cannot know how a coin will land, but you at least know it is a 50-50 chance. By contrast, you do not know how long the piece of string in my pocket is and – without a comprehensive assessment of all the lengths of all the pieces of string – you cannot know how likely it is to be any given length.

As an aside, there is sometimes a third category added to the classic risk-uncertainty distinction: ambiguity. Definitions vary, but decisions under ambiguity are usually thought of as ones where you have a probability distribution, but you have less than full confidence that it is the right distribution (i.e., that you have evaluated all the probabilities correctly). Think of a case where you are pretty sure the probabilities are bell-shaped – the most likely outcomes are clustered around a middle – but you have little information about the tail risks.

Investment decisions are usually made by evaluating risks against potential rewards. Standard rational choice theory tells us to do this by choosing the option which carries the highest expected value – calculated by multiplying the absolute value of an outcome with its probability. This basic formula can be modified to account for risk aversion, where one might prefer likely outcomes with smaller expected values over riskier outcomes with higher ones. Levels of risk aversion are the basis for 'risk profiles' in investment portfolios.

Those are decisions under risk – but as we say, this is an uncertain world. Some risks we can be pretty sure about, but uncertainty is the norm for investment as much as everyday life. Take the simple coin-flip: I approach you and offer you £2 if it lands heads, provided you pay me £1 if it lands tails. This seems like a very good bet – but only if you know it is genuine. Perhaps it is a weighted coin, I am a fraudster, or perhaps I am a sleeper agent programmed to rob bystanders when I hear the codeword "heads".

How likely are these scenarios? Not very – but impossible to put a firm number on. These kinds of uncertainties were a big topic of conversation around the 2008 global financial crisis. "Black Swans" – a phrase popularised by Nassim Nicholas Taleb in his book of the same name – are unpredictable and underestimated events that have a huge impact on capital markets and the wider world. According to Taleb, these unknown unknowns characterise most of the major developments in human history, and we need to prepare for them even if we cannot know exactly how.

In investment terms, this might mean a more balanced pool of (hopefully) uncorrelated assets. This is exactly what diversification is aimed at, ensuring overall portfolios are as shock resistant as possible. Of course, the problem with unknown unknowns is that they are so very unknown – and so there is only so much you can do to account for them. This can be a worrying thought, particularly when the tail risks are so damaging and our understanding of them so poor.

In these situations, the crucial thing to remember is that avoiding decisions for fear of uncertainty is itself a decision, and usually a very costly one. We might not know all the possible outcomes or how likely they are for sure, but such is the human condition. And ignoring the likely outcomes because you are unsure about them is just as bad – if not worse – than ignoring the hard-to-quantify tail risks.

Probability judgements being fallible also means they are subject to revision. Standardly, any new information should be fed into our calculation via 'Bayes' rule' (the equation for conditional probabilities) to get a new assessment of likelihoods. Of course, this only works if we already have some notion of the 'prior' probabilities, which, for uncertain outcomes, we often do not. But if we really have no information, then it seems any probability judgement is as good as any other – as long as we update it with any new information.

Highly risk-averse investors sometimes adopt unconventional strategies based on preparing for potential shocks, usually involving minimising exposure to assets that might be considered most at risk. There is nothing wrong with this, but one has to understand that – if the unknown unknowns do not strike – they will likely be worse off than an investor who stuck with a standard risk-reward framework. The key thing is, as ever, to take new information into account when it comes. With that, the world should get a little less uncertain each day.

CAMBRIDGE
INVESTMENTS LIMITED

1st August 2022

Global Equity Markets

Market	Fri 15:16	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7424	+2.0	+147	→	→
FTSE 250	20163	+1.7	+339	⇗	↘
FTSE AS	4108	+2.0	+79	→	→
FTSE Small	6504	+1.6	+102	→	↘
CAC	6463	+4.0	+247	↗	⇘
DAX	13496	+1.8	+242	→	↘
Dow	32656	+2.4	+756	↗	⇘
S&P 500	4110	+3.7	+149	↗	↘
Nasdaq	12330	+4.2	+496	↗	↘
Nikkei	27802	-0.4	-113	→	→
MSCI World	2710	+2.2	+59	⇗	↘
CSI 300	4170	-1.6	-68	↘	↘
MSCI EM	998	+0.7	+7	↘	↘

Top 5 Gainers

Company	%
Anglo American	+11.1
NatWest	+10.4
Fresnillo	+10.0
Harbour Energy	+10.0
Admiral	+10.0

Top 5 Decliners

Company	%
Smith & Nephew	-11.2
JD Sports Fashion	-9.8
BT	-8.4
Avast	-7.7
Vodafone	-5.8

Currencies

Pair	last	%1W
USD/GBP	1.209	+0.8
GBP/EUR	0.841	+1.2
USD/EUR	1.02	-0.5
JPY/USD	134.12	+1.5
CNY/USD	6.75	+0.0
Bitcoin/$	24,138	+6.3

Commodities

Cmdty	last	%1W
Oil	110.27	+6.9
Gold	1757.0	+1.7
Silver	20.12	+8.2
Copper	351.9	+5.1
Aluminium	2456.0	+1.5
Soft Cmdties	217.9	+1.1

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	10.4	10.1	14.3
FTSE 250	3.1	7.4	14.4	16.3
FTSE AS	3.8	9.9	10.6	14.5
FTSE Small x Inv_Tsts	3.2	7.4	11.4	15.3
CAC	3.0	12.6	11.0	15.2
DAX	3.4	12.4	11.2	13.7
Dow	2.0	17.4	17.4	16.9
S&P 500	1.6	20.1	18.0	18.2
Nasdaq	0.8	22.8	26.1	24.2
Nikkei	2.0	15.7	15.5	17.8
MSCI World	2.1	16.3	16.0	17.1
CSI 300	2.1	14.6	13.4	12.8
MSCI EM	3.1	10.0	11.5	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.88	-0.06
UK 15-Yr	2.33	-0.11
US 10-Yr	2.68	-0.07
French 10-Yr	1.41	-0.21
German 10-Yr	0.85	-0.18
Japanese 10-Yr	0.19	-0.03

UK Mortgage Rates

Mortgage Rates	Jul	Jun
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.88	2.78
3-yr Fixed Rate	2.97	2.81
5-yr Fixed Rate	2.90	2.80
10-yr Fixed Rate	3.28	3.13
Standard Variable	4.38	4.35

* 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

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel

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