THE CAMBRIDGE WEEKLY

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January surprises

"Welcome to 2023" said the note on the restaurant door. The door was shut, the lights were off, and another note explained that rail strikes meant staff and customers were unable to get there. All the venues in this City-of-London street were closed in a scene reminiscent of the height of the 2020 lockdown. Life can be tough in the battle for a fair share of the economy's revenue flow, and we cannot have been the only ones left feeling that the UK is off to one of the most subdued starts to a new year we can remember.

Yet, last week, the UK's main stock market – as represented by the FTSE 100 – achieved its best price level since April last year, surpassing the 17 January 2020 pre-Covid level of 7674.6. This leaves it less than 3% below the all-time high of 7877.5 reached on 22 May 2018. In total return terms (with gross dividends reinvested), the index is now at its highest ever, with an absolute return of 15.4% since that peak of May 2018.

It is not quite the same for UK plc as represented by the mid-cap stocks of the FTSE 250. They have shown a positive but small return, a total of 2.7% for the same period.

Those businesses represented in the FTSE 250 are more UK-centric than the FTSE 100 constituents, although one should not overstate it. The charts below show the indices' geographical make-up:

FTSE 250

Revenue Exposure By Country/Region

Total LTM Revenue £264.3B

	% of Tot. Rev.	% Chg (Y/Y)
United Kingdom+	**39.3**	0.3
Country Unspecified	**21.4**	-7.3
United States	**12.7**	12.0
Germany	**2.7**	-19.1
Mainland China	**1.9**	5.9
France	**1.5**	-20.0
Italy	**1.3**	0.6
Non-Operating Country	**1.2**	540.4

FTSE 100

Revenue Exposure By Country/Region

Total LTM Revenue £1,543.5B

	% of Tot. Rev.	% Chg (Y/Y)
United States	**24.9**	3.6
United Kingdom+	**20.6**	-16.4
Mainland China	**8.2**	13.9
Japan	**3.7**	16.3
Germany	**3.7**	1.8
India	**2.4**	7.8
France	**2.4**	-1.6
Hong Kong, China	**2.4**	4.2

Source: Tatton IM, Factset

The period of UK mid-cap underperformance is more closely aligned with the commencement of interest rate rises. One thinks of smaller firms being sought by investors for their earnings growth-orientation, but this comes with relatively higher financial gearing while revenues are more volatile. It means they can become stressed more quickly when rates rise and demand falls. This appears to have been anticipated by investors over the past 12 months.

Perhaps there is some light at the end of the rate tunnel. While year-on-year inflation data will continue to be uncomfortably elevated, the now more persistent decline in European energy costs is also happening here in the UK, and that will take some pressure off the Bank of England. Indeed, the UK's central bank may now be amongst the most dovish of developed world central banks, given that the Bank of Japan tightened policy just before the holidays.

With less valuation pressure from rising rate dynamics, more revenue positivity would be a great help for stocks in 2023. There may be good news on that front as well, given global consumer demand could recover sooner than previously thought.

To this end, European stock markets have had a great start to the year because energy prices have come down quite sharply, partly because of a bout of warmer weather. More importantly, Russia may be looking for a way out of its great mistake. Gas prices have continued to decline, particularly in the longer-dated contracts.

And now there is no doubt that China is exiting from its mistaken policy of trying to hide away from the virus. We write below about the sudden changes (so sudden that there were announcements being made about helping construction companies late on Friday afternoon). China's stock markets have bounced in a way reminiscent of the 2020 bounce in western markets, when an end to lockdowns appeared in sight, and there seems to be little to hold them back. Of course, the danger is that pressures on China's healthcare system engender a reversal of the opening up, but the levels of vaccination in the younger population are very high – as good as anywhere in the world. Even though there are likely to be many tragic deaths among the elderly, the awful fact is that there is now no way back from the path the Chinese leadership have embarked upon.

That should stoke global demand, providing a much-welcomed offset to slowing dynamism in western economies. Amongst those, the US is not slowing dramatically and is not likely to do so anytime soon. Friday's employment data showed a continuation of steady job gains and no compensating increase in the labour supply. Thus, the unemployment rate fell back from 3.6% to 3.5%. We have written before that the US Federal Reserve (Fed) is by now more focused on labour market tightness than outright price rises – for fear of second-round effects embedding inflation structurally in the economy. Not surprising then, that many Fed members were talking last week, with almost all saying they see rates heading above 5% and staying there. The market is having a hard time agreeing with this view, seeing the likelihood that rates will not go above 5% and will start falling before the year is out.

The losers in this situation are those most sensitive to interest rates. Households are not in a bad position generally, although they are clearly curtailing spending which would usually require financing. As a result,

Source: Tatton IM, Bloomberg, CME: G1203

LB1 Comdty (Generic 1st 'LB' Future) US lumber Daily 07OCT2010-06JAN2023 Copyright© 2023 Bloomberg Finance L.P. 06-Jan-2023 15:05:45

auto sales are weak, and house prices and construction continue to decline. As a key component of US house building, lumber prices falling back to pre-pandemic levels provide strong evidence for this.

This has led to the first consumer-focused high-profile bankruptcy in this rate cycle. Last week, Bed Bath & Beyond, famous in the US for providing beds, baths and other big-ticket items, announced it was pulling the plug (so to speak). It got caught with high leverage levels and failed to secure financing. Interestingly, it did not fail because of a lack of potential demand. Rather, it was unable to get the financing to buy inventory, which then meant its customers went elsewhere.

The Fed knows that this situation will be repeated for similar companies, but there is little it can do about it – the purgatory effect of the late cycle environment at work. Despite the headlines of layoffs coming from the likes of Amazon, there are too many firms that have been waiting to pick up workers. That will not include the mid cap companies with weak balance sheets, though. They are now the subjects for the phrase ‘the squeezed middle’. For us, this typical ‘late-cycle’ phase puts a premium on stock and credit selection, which was already the key determinant of outperformance during 2022.

Interestingly, these companies may well be few and far between, and credit market dynamics appear to be in better shape at the start of the year. However, this is one for us to watch closely over the coming weeks for signs of any broadening into a more systemic issue. For now, they actually improved last week, despite Bed Bath & Beyond’s demise. Credit spreads declined somewhat, helped by the rapidly improving situation in China. That provides a window of opportunity for many companies to issue bonds over the next few weeks and may help bring about a more relaxed start to the year than we saw in 2022.

December 2022 review

For global investors, December was a suitably drab end to a dreary year. The equity rally which had gained momentum since autumn lost steam coming into the winter months. For sterling investors, global equities lost 4.9% throughout December. This capped off fall of 8.1% for 2022 overall. Once again, rising yields, sharply tighter monetary policy, runaway inflation and slowing global growth conspired to make conditions extremely challenging. The table below shows the monthly, quarterly and year-end results across different asset classes. As you can see, and particularly compared to 2021, it was a pretty frosty Christmas after all.

Asset Class	Index	December	Q4-2022	2022	2021	5-yr rolling annualised
Equities	UK Large Cap	-1.5	8.7	4.7	18.4	3.3
	UK Ethical Large Cap	-1.2	7.8	1.1	13.0	0.2
	Europe ex-UK	-0.9	11.5	-7.6	16.7	4.6
	US Large Cap	-6.7	-0.2	-7.8	29.9	12.0
	US Technology Large Cap	-9.6	-7.9	-24.0	23.3	9.7
	Japan	-0.7	5.1	-6.1	2.6	3.4
	Global Stocks	-4.9	1.9	-8.1	19.6	5.2
	Emerging Markets	-2.4	1.8	-10.0	-1.6	-1.4
Bonds	UK Gilts All Stocks	-4.1	1.7	-23.8	-5.2	-3.4
	£-Sterling Corporate Bond Index	-1.7	7.2	-18.4	-3.2	-1.4
	Global Aggregate Bond Index	-0.5	-3.0	-5.7	-3.8	0.7
Commodities	Commodity Index	-2.4	-4.0	41.9	41.6	6.5
	Brent Crude Oil Price	-2.2	-6.4	24.4	51.5	5.1
	Spot Gold Price	2.0	0.5	12.1	-2.9	6.9
Inflation	UK Consumer Price Index (annual rate)	2.4	2.4	10.1	5.4	-
Cash rates	SONIA 3-Month	0.3	0.7	1.1	0.0	0.6
Property	UK Commercial Property (IA Sector)*	-4.4	-7.5	-6.2	7.4	-0.6

Source: Morningstar Direct as at 31/12/22. * to end of previous month (30/11/22). All returns in GBP.

Despite the apparent lack of merriment, equity markets did experience a "Santa rally" over the Christmas break. This refers to a strangely common trend where stocks climb in the last five trading days of a year and the first two trading days of the next. This time round, that period ran from 23 December to 4 January and saw the S&P 500 gain a modest 0.8%. That technically constitutes a Santa rally but is hardly one to ring sleigh bells for.

That lowly gain was entirely down to an early January bounce, as the readings for December were decidedly negative. Here in the UK, large cap equities finished the month down 1.5%. This was on the back of general pessimism about the UK economy, which finished the year with multiple negative data releases. The Bank of England continues to predict pain for Britain, while pushing ahead with its interest rate rises.

Despite this, the UK stock market recorded decent returns for the year overall. In fact, the UK was the only major developed economy to record positive equity returns in 2022. Unfortunately, we should not interpret this as confidence in the domestic economy. Many of the companies in the FTSE 100 derive their revenue streams from overseas, in particular from commodities, including energy. Those decent returns are largely due to this commodity exposure, combined with the weakness of sterling, which boosted the value of overseas revenues for UK companies.

Emerging markets (EMs) were also weak, declining 2.4% in sterling terms over the month. The environment for EM assets was extremely challenging in 2022, as they tend to be very sensitive to global monetary policy, the value of the dollar, and investor sentiment – all of which were under intense pressure throughout the year. Against that backdrop, many EMs looked quite resilient. Going forward, there could be more joy for EM assets, as China's zero-Covid policy finally seems to be over. We discuss the positives for Chinese growth in a separate article.

European stocks had a difficult month, losing 0.9% in sterling terms through December, making for an annual 7.6% loss overall. The European Central Bank (ECB) indicated further interest rate hikes were on the cards in 2023 after a resurgence of European inflation. This weighed on investor sentiment heavily.

Elsewhere, US equities dropped significantly in December. Large cap stocks lost 6.7% over the month, led by losses for the technology sector which were even greater at 9.6%. This was again a repeat of the 2022 trend. The S&P 500 lost 7.8% in sterling terms for the whole year, while the tech-heavy Nasdaq fell an astonishing 24%. Tech companies are usually considered growth or long-duration assets, making them sensitive to changes in interest rates. Last year saw the fastest pace of monetary tightening – and thus interest rate rises – in a generation. The end of 'easy money' was therefore bad news for the US tech sector.

On that front, the US Federal Reserve (Fed) announced another 0.5% interest rate hike in December, leaving its benchmark Fed funds rate in the 4.25%-4.5% range. Given that rates were at zero as recently as February, we witnessed a real paradigm shift in interest rate levels in 2022. The pace of monetary tightening was comparable to the inflationary period in the 1970s and early 80s. Back then though, interest rates began from a much higher starting point, and asset markets were no way near their current size and importance to the real economy. As discussed before, this means the Fed's aggressive tightening has a much larger impact today – even if the current absolute rate is still not high by long-term historical standards.

Bond markets felt the brunt of this impact. In 2022, yields rose at their fastest pace in decades, squeezed upward by a significant drain of liquidity. It meant bond valuations lost in just a year what they had accumulated in very extended valuations over the previous decade. Bond dynamics were also at the heart of everything that happened in equities last year, as rising real (inflation-adjusted) yields lowers the relative attractiveness of stocks, marking the end of the TINA ('there is no alternative') era for equity markets. Bond values suffered again in December, as central bankers made it known that the tightening cycle had longer to run. US Treasury yields rose through the month, despite negative economic news flow. We saw this in the UK, too. UK gilt values lost 23.8% in 2022, while December alone recorded a huge spike in volatility, reflected in global bond markets.

Destabilisation was a key theme of last year. Bond values are the bedrock against which other assets are valued, from stocks to credit and commodities. Rising bond yields mean widening credit spreads as the default risk in lending to companies increases – and lower equity valuations as TINA ends and the cost of capital increases. For portfolios, the usual counterbalance of bonds against equities did not play out in 2022, as the bedrock was too unstable. Fortunately, much of that volatility is already behind us now. Capital markets have had a whole year to digest sharply higher interest rates, which reversed some, but certainly not all of 2021's positive returns fireworks. While we are not entirely out of the woods, the year ahead should bring more normality in bond markets. It was not a very merry Christmas for investors, but the new year will hopefully be happier.

China's reopening bounce

Nobody expected a turnaround like this. A few months ago, the prospect of China ending its strict zero-Covid policy seemed like a fantasy. Over the holiday period, the new cabinet formed after the October Congress performed a notable 'volte-face'. The zero-Covid policy, which placed 1.4 billion citizens under repeated lockdowns for three years, was swept away. The National Health Commission (NHC) also downgraded the threat posed by Covid, announcing that those with positive tests were no longer required to quarantine at a central facility, and that daily virus tallies would no longer be reported. And since the previous weekend, inbound travellers to China no longer have to quarantine after entering the country.

It is hard to overstate how big a shift this is. While the economic and social harms of Beijing's zero-Covid policy have long been clear, it was thought the government had backed themselves into a corner. Low vaccination rates among the elderly and vulnerable, together with hard-line messaging on virus control, meant the Communist Party leadership could not change tack without damaging its reputation. Western commentators took last year's Party conference as confirmation of this: President Xi Jinping was appointed for an unprecedented third term with a cabinet of devout loyalists.

That things have changed so quickly speaks volumes. For starters, it shows how seriously Beijing takes the current economic struggles. Three years of the lockdown cycle have taken a severe toll on Chinese consumers, evidenced by December's surprisingly negative growth and sentiment data. Widespread protests at the end of last year were a vivid sign of frustrations, and no doubt spurred Party members to action.

The rapid turnaround also shows how bad our predictions of Chinese policy are. Not even the most optimistic outlook predicted an end to inbound quarantine this soon. This is just the latest episode of China catching western analysts off-guard. This time though, the surprise is a good one for investors. However, previous interventions – such as in property, financial markets and the tech sector – have been so damaging and unpredictable that some commentators labelled China "uninvestable". At Cambridge, we have never taken that view, but have always stressed that policy unpredictability adds significant extra risk for overseas investors.

The sudden easing shows that these risks are not always weighted to the downside. Following Xi's coronation at the October Party Congress, one of the biggest fears was that the pragmatic state-capitalist model, which has dominated Chinese politics since the reign of former Party Chair Deng Xiaoping, was coming to an end. Many of Xi's policies in recent years have looked more puritanical, including crackdowns on swathes of the private sector and even 'effeminate' men. But, revising Covid policy so soon after bad economic data and widespread protests, shows that pragmatism has not gone away.

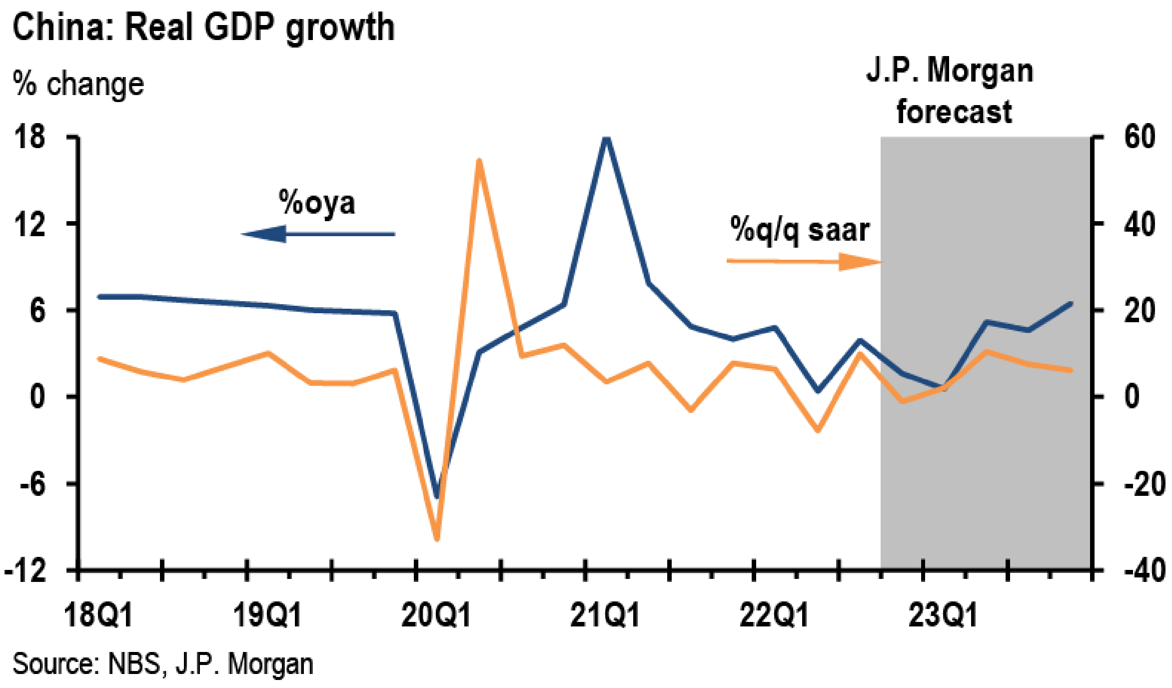
Other areas of policy are easing too. The Chinese government has loosened its grip on the property development sector, allowing for more building and borrowing. The People's Bank of China has announced targeted monetary stimulus to get the domestic economy roaring again. The government even approved billions in financing for Ant Financial – the fintech company whose initial public offering it crushed in 2020. The latter is particularly symbolic, given that move against the company started the current wave of private sector crackdowns.

On the international front, foreign relations – particularly with the US – look much calmer. This is especially after Xi indicated a coolness towards Russia during his meeting with Vladimir Putin before Christmas. In growth and trade terms, this is already bearing fruit. In the week before Christmas, Chinese and Australian officials met to discuss an easing of the fraught relations which had worsened considerably in the immediate aftermath of the virus outbreak. The iciness had reached a peak with China banning coal and wine imports and restricting iron imports, but the meeting has already resulted in new coal contracts being announced. Australian miner share prices have been reacting positively.

This is a potent policy mix. In 2021, the west's reopening led to a massive growth surge, the inflationary effects of which we are still feeling now. The demand boost was so strong because it was coupled with fiscal and monetary stimulus, meaning consumption was a coiled spring. The rebound could be even stronger in China. The world's most populous nation has suffered under restrictions for three years, its consumers still have savings to spend and can borrow cheaply (compared to the US, UK and Europe). The Chinese government is actively stoking demand while western policymakers are busy trying to stifle it – meaning foreign capital could well flow into China and multiply Beijing's efforts.

The effects will not be instant. In the very short term, China is still suffering from a severe Covid outbreak, with estimated cases in the hundreds of millions. Vaccination rates (which have improved among the vulnerable) should mean the overwhelming majority of cases are mild, but even so, deaths might well top one million over the winter. The spread will naturally lower mobility heading into the lunar new year in February, which could mean slower domestic demand at what is usually a bustling time. JPMorgan has revised down its China growth estimates for the first quarter of 2023 in light of these factors.

Growth after that point, though, is expected to be much stronger. The removal of zero-Covid brings forward the trough in activity and should mean that the virus becomes endemic – as it is in the west – much sooner. Analysts at JPMorgan now expect a big growth boost in the second quarter, followed by impressive returns for the rest of 2023. Judging from the year's early moves, markets seem to agree and anticipate as much. Chinese equities have rallied strongly into the beginning of the year, as investors look to take advantage of the prospect of a growth rebound.



That said, we know from experience that a post-Covid growth spurt can also have negative consequences. Surging demand while supply is still recovering creates huge inflation pressure. That is certainly a risk for China going forward, particularly through the winter, as Covid will inevitably lead to supply chain disruptions. China has not had anything like the inflation pressures we feel here, in large part because of its continued compression of activity. A reversal of that could mean policymakers have to suddenly tighten towards the end of this year, much like the Fed started at the end of 2021.

The flipside of this is that the world's second-largest economy still has plenty of capacity. While consumers were kept home for much of the last three years, manufacturers kept producing. That means Chinese businesses still have plenty of inventories to work through, lessening the immediate inflation pressure. However, a further boost to industrial activity will inevitably mean greater demand for raw materials, which will push up prices. This will likely be felt all around the world. Waning commodity prices have been a welcome sign for the world's central banks – offsetting domestic inflation pressures through the latter part of 2022. A boost in Chinese growth could reverse this trend and raise input costs before central bankers have won the battle with inflation expectations.

Nevertheless, a strong Chinese rebound is now extremely likely and that will be positive for global growth, offsetting the western monetary tightening that is likely to reach peak effect during 2023.

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9th January 2023

Global Equity Markets			Technical		Valuations			
Market	Fri 14:31	% 1 Week*	Short	Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7685	+2.6	↗	→	3.6	11.0	9.8	14.5
UK FTSE 250	19478	+3.1	→	⬂	3.5	12.5	12.5	16.9
UK FTSE All-Share	4203	+2.7	⬀	→	3.6	11.5	10.2	15.0
UK FTSE Small	6385	+2.6	⬀	⬂	3.8	10.5	13.0	18.8
France CAC 40	6806	+4.1	⬀	→	3.1	11.0	11.1	15.3
Germany DAX 40	14473	+3.3	→	→	3.6	11.7	11.7	14.2
US Dow	33200	+0.5	→	⬂	2.1	18.5	18.3	17.8
US S&P 500	3835	+0.6	⬂	↘	1.7	18.0	17.6	18.8
US NASDAQ comp	10352	+0.3	↘	↘	1.0	27.4	26.8	26.0
Japan Nikkei 225	25974	-1.4	↘	⬂	2.3	20.5	18.8	20.1
World MSCI	2595	-0.7	⬂	↘	2.3	16.5	15.8	17.7
China mainland	3981	+3.2	↗	↘	2.4	14.2	13.7	13.3
Emerging MSCI	984	+2.8	↗	↘	3.1	12.0	10.9	11.8

Top 6 Gainers

Company	%
JD Sports Fashion	+15.3
Ocado	+15.0
Next	+13.9
International Consolidated Air	+13.2
J Sainsbury	+12.7
Rolls-Royce Holdings	+12.4

Bottom 6 Decliners

Company	%
Glencore	-6.1
Centrica	-4.4
Haleon	-3.0
Pearson	-2.9
Rentokil Initial	-2.9
SSE	-2.8

Fixed Income

Govt bond	%Yield	1 W CH
UK Govt 10yr Gilt	+3.54	-0.16
UK Govt 15yr Gilt	+3.92	-0.09
US Govt 10yr Treasury	+3.70	-0.16
France Govt 10yr OAT	+2.78	-0.25
Germany Govt 10yr Bund	+2.27	-0.22
Japan Govt 10yr JGB	+0.51	+0.08

Currencies

Pair	last	%1W
USD : GBP	1.190	-1.3
GBP : EUR	0.884	-0.0
USD : EUR	1.052	-1.3
JPY : USD	133.68	+0.4
CNY : USD	6.851	-1.6
USD : Bitcoin	16,747	+0.7

Commodities

Cmdty	last	%1W
Oil Brent $:bl	80.0	-2.4
Gold $:oz	1846.8	+2.0
Silver $:oz	23.6	-1.6
Copper $:lb	385.4	+0.9
Alumnm $:mt	2225.5	-5.4
S&P soft crops	213.6	-1.9

UK Mortgage Rate Estimates

Rates (LTV c.75%)	06-Jan	07-Dec
UK BoE base rate	3.50	3.00
2yr fixed	5.76	5.97
3yr fixed	5.66	5.66
5yr fixed	5.51	5.49
10yr fixed	5.38	5.33
Standard variable	5.88	5.88

06/01/2023
Prices taken at 2:30pm today and last Friday (where possible)
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of median analyst forecasts for the next 12 months earnings
Mortgage estimates are derived from Sterling swaps markets

* 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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9th January 2023

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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