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INVESTMENTS LIMITED

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Are central banks transforming from hawks into doves?

Last week was like the other four weeks of 2023: dominated by central bank action, inflation, and despondency over the UK economy. Meanwhile, stock and bond markets stayed buoyant. The monthly US jobs report was a surprise which unsettled US markets on Friday, as investors looked to assess its implications for the Fed and interest rates in 2023.

The US employment report was probably not known to the Federal Open Market Committee (FOMC) when its members slowed the pace of rate rises in the middle of last week. January's wage growth showed some slowing to an annualised level of below 4% and more people came back into the workforce which backs the idea of inflation pressures calming down. However, the unemployment rate dropped again to 3.4%, having been expected to rise by most economists. The payroll rose by an almost unbelievable 517,000 while the previous data was revised up.

Such a report would almost certainly have caused a big sell-off in bonds and equities if market conditions were akin to those of the autumn. The limited reaction so far suggests that investors are still looking to deploy uninvested cash.

Last Wednesday, the US Federal Reserve (Fed) raised rates by 0.25% to a midpoint of 4.625%. On Thursday, the Bank of England (BoE) raised the base rate to 4.0%, and the European Central Bank (ECB) effectively raised its short-term rate by 1.0% to 3.0% (0.5% now and the second 0.5% in March). However, you could be forgiven for thinking they had all announced rate cuts, given the very positive reactions of both bond and equity markets.

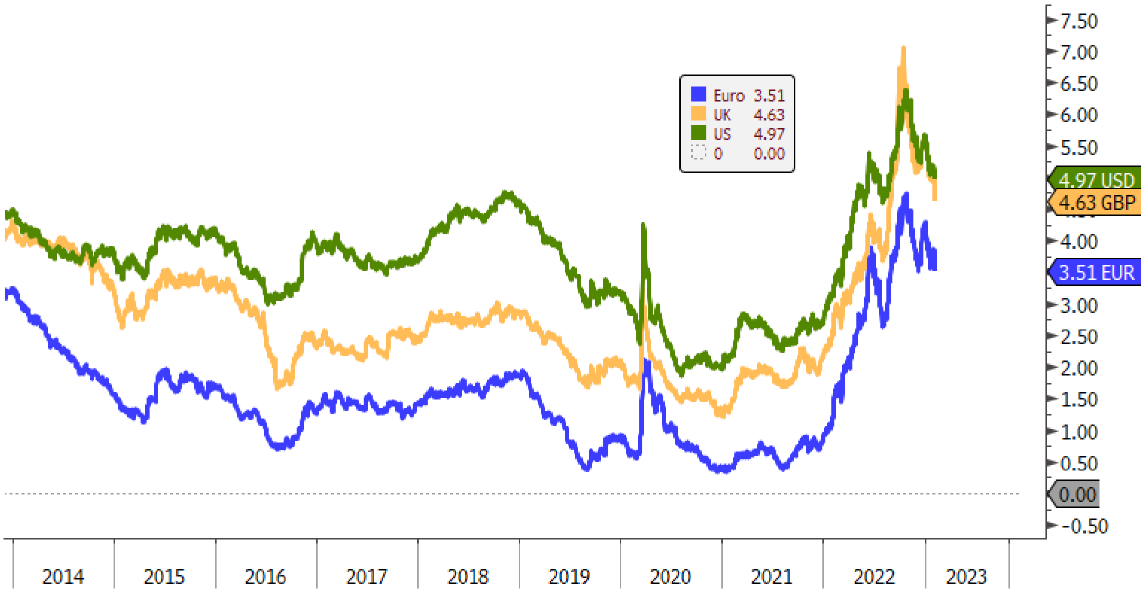
Investors have reason to hope monetary policy tightening impacts an economy more quickly than previously thought, as we discuss in one of the two articles below. Given that an end to the current tightening was signalled quite strongly by all three central banks, investors have an increasing belief that monetary policy-driven constraints on profitability are coming to an end in the nearer-term.

As ever, though, we suspect one should not get carried away by waves of positivity. Interest costs are still higher than before, and still have a bit further to go. Better news is that government bond yields have dropped sharply, and corporate bond yields have subsided even more, well below the nastiness of the October peak.

Nevertheless, non-financial investment grade 10-year bond yields are above the average levels for the previous ten years, even if we take out the pandemic period drop. US yields are about 1.0% higher whereas for both UK and Europe, corporate yields are still about 2.0% above the 10-year average.

The benefit of the recent fall in energy prices has fed through, but there is still a relative worsening of the terms of financing for Europe and the UK. For all areas, financing costs have risen and are unlikely to return to the pre-pandemic situation. Central banks are now more reluctant to use the extraordinary measures deployed then, given the inflation instability it seems to have brought about.

10-year BBB non-financial corporate yields



Source: Tatton IM, Bloomberg: G1232

BVCSEO10 BVLI Index (EUR EUR 10) US UK EU BBB nonfin 10 Daily 29NOV2013-03FEB2024 Copyright© 2023 Bloomberg Finance L.P. 03-Feb-2023 13:21:07

Bond markets have already built in that rates will be cut before the end of the year. Equity markets have either built in even more optimism, hoping either that economic growth will pass through into corporate profit growth or that central banks will be more aggressive than priced in cutting rates.

This optimism is quite extreme in historical terms when looking at the US equity and bond markets, according to Morgan Stanley's research. Currently, earnings yields are about the same as corporate bond yields. Morgan Stanley confirms that this situation has occurred three other times in the past 45 years: the 1987 crash, the 2000 dotcom peak and the 2008-2009 Global Financial Crisis. In order to invest in equities at these points, one should be expecting significant medium-term profit growth. In the 1987 and 2008 situations, it was possible to expect a market and economic rebound. In the 2000 case, the growth expectation was pure optimism.

There are good reasons to think that economic growth may rebound from here, but it feels less plausible that profit growth will be exceptional.

We had two reports on the UK economy last week, one from the International Monetary Fund (IMF) and the other from the BoE accompanying its rate decision. The IMF report was depressing reading but was very much in line with the gloomy BoE report published in the autumn. As is often the case, the IMF report felt out of date.

In contrast, at least for the nearer-term outlook, the improving inflation picture allowed the BoE to revise its growth projections up from autumn's report. However, it was more downbeat about the longer-term picture because of ongoing supply-side issues, mostly from skilled labour shortages. Potential (non-inflationary) real growth was revised down to 0.7% for 2024 and 2025.

For us, this suggests that the pound may find it tough staying strong. After the report was published, sterling dropped to $1.22 and weakened to below $1.21 on Friday. For UK investors, this highlights the importance of holding overseas assets in a long-term investment portfolio.

January 2023 review – a decent start, but more questions than answers

If investors were hoping for a turnaround in fortunes, they hardly could have asked for a better start to the year. While 2022 brought plenty of downpours, the first month of 2023 was all sunshine in capital markets. January's equity market returns were positive across all major economies – many spectacularly so. This was in large part down to the good feeling in bond markets, which saw yields fall and thus the relative attractiveness of equities increase. Across the major asset classes we monitor, only one had a down month: commodities. But given how commodity inflation terrorised the global economy last year, this was viewed as an unequivocally good thing. The table below shows a full list of returns:

Asset Class	Index	January
Equities	UK Large Cap	4.3
	UK Ethical Large Cap	4.8
	Europe ex-UK	6.8
	US Large Cap	3.8
	US Technology Large Cap	8.2
	Japan	3.8
	Global Stocks	4.7
	Emerging Markets	5.4
Bonds	UK Gilts All Stocks	2.6
	£-Sterling Corporate Bond Index	4.0
	Global Aggregate Bond Index	0.9
Commodities	Commodity Index	-2.4
	Brent Crude Oil Price	-2.8
	Spot Gold Price	2.7
Inflation	UK Consumer Price Index (annual rate)*	0.8
Cash rates	SONIA 3-Month	0.3
Property	UK Commercial Property (IA Sector)*	-3.0

Source: Morningstar Direct as at 31/01/23. * to end of previous month (31/12

In the UK, the FTSE 100 posted a healthy 4.3% increase, despite increasingly dreary economic forecasts. The IMF reported last Tuesday that it expects Britain to be the only major economy to shrink in 2023, faring worse than even Russia. UK equities – largely dominated by multinational companies with overseas earnings – were unaffected. In fact, the UK was the only major economy to see its stock market grow in 2022, thanks in large part to the prominence of energy and resource companies in the FTSE 100. Last year's returns were boosted by the low value of sterling though, while January's performance was accompanied by an increase in the pound's dollar value.

The good feeling was stronger elsewhere, with particular standouts being Europe and emerging markets (EM). European companies were boosted by the sense that they are over the hump of the continent's energy crisis, while EMs are benefitting from an unmistakable growth drive in China. The world's second-largest economy, having suffered under lockdowns and crackdowns for years, is now firmly on the path to opening up. This has helped sentiment not just around China, but around global growth in general.

US equities bounced strongly, with the broad S&P 500 Index climbing 6.3% in sterling terms. The broader market was outpaced by an impressive rally in the Nasdaq Composite Index, which ended January 10.7% higher. This reflected the strong rebound of investor interest in US tech stocks, which suffered last year from sharply higher interest rates and widening corporate credit spreads. Long-duration growth stocks like these are extremely sensitive to financial conditions, so it is little surprise that the recent loosening helped them just as much as last year's tightening hindered them. But tech stocks also got a boost from China, as the nation's tech sector had a stellar month, with spillover effects into the US.

Bond market dynamics were nonetheless a key component. In 2022, the Fed tightened monetary policy at the fastest pace in a generation, causing yields to rise and credit spreads to widen. Risk premia (the returns demanded for a given level of risk) subsequently fell, and equity markets saw an eye-watering drop in valuations. But yields have been falling ever since December, causing a substantial improvement in credit conditions. Global corporate bond prices (the inverse of yields) gained 2.2% in January alone, according to Bloomberg.

Behind this move are expectations for global monetary policy, and the Fed in particular. Sky-high inflation forced it to aggressively tighten policy in 2022, in the fear that overheating labour markets would lead to an unstoppable wage-price spiral. Over the last few months, global input prices – energy and commodities – have fallen back markedly, relieving some of the pressure. More importantly, there are signs that producer price inflation and wages have also fallen back. This has led to a 'job done' mentality in capital markets, which now expect the Fed to slow its rate rises and even reverse them later in the year. We discuss this more in a separate article.

There is a certain irony here. The reason markets expect the Fed to take its foot off the brakes is that US and global growth is weak, allowing inflation to cool. This pushes bond yields down, which has the technical effect of rising equity valuations, hence rallying stock markets. More importantly though, lower yields ease credit conditions, which improves the medium and long-term outlook for growth. In a sense, the very fact the economy is so weak is what gives investors the confidence we will avoid a deep recession.

We have seen this not just in falling credit spreads (the premium corporate borrowers have to pay compared to the government) but in the performance of rate-sensitive sectors. Tech is one example, but a clearer one is real estate. Property companies and funds were battered last year but have started 2023 in buoyant mood. Investors are looking past the pain of the current cycle to the joys of the next.

Risk premia across the board have benefitted. In fact, risk premia for many assets – like real estate – have now fallen so low that some valuations are starting to look expensive. This is the exact opposite of last year, and points to the fact that markets are now confident that the inflation crisis is behind us. This is a little precarious, given the much-discussed structural factors underlying higher inflation. The only conclusion we can draw is that markets expect the low inflation, mediocre growth regime of pre-pandemic times to return. Moreover, they are excited about it.

We should preach some caution here, as the effects of last year still have to be fully worked through. This is both in terms of downstream inflation (food prices, etc.) and short-term financing pain for companies. Businesses tend to go bust not when things first go bad, but when they stay bad for a while. The Indian group Adani Enterprises for example, has only just got into trouble, despite credit conditions tightening for more than a year.

On that front, we find it interesting the first half of January saw astonishing levels of corporate bond issuance. We had said before that companies which had held off refinancing might be tempted back into bond markets should yields fall, and this is precisely what happened. Fortunately, there was enough investor appetite to gobble up those issuances without destabilising credit markets – and issuance dropped off toward the end of the month. Bonds passed the first test of the year. Equity investors will be hoping they pass the next ones.

How long is the lag – or why is that lag suddenly shrinking?

Last year was 'the great tightening' for central banks. Interest rates in the US, UK and Eurozone rose at the fastest pace in a generation, sending bond yields skyward and draining capital markets of liquidity. Investors hope 2023 will be much milder. Central bankers in all three of those economies met last week – and all raised rates once more.

Last Wednesday saw a 0.25% hike of the Fed Funds rate to 4.625%. On Thursday, the BoE raised the base rate by 0.5% to 4.0% and the ECB also raised its deposit rate by an effective 1.0% (0.5% now and 0.5% at the next meeting in March) to reach a rate of 3.0%.

But expectations are that, in all three areas, inflation is on an inexorable and swift path lower, and that central banks will want to reverse this last phase of tightening quickly. Markets are excited about the prospect and have already discounted easing. With financial conditions loosening, the global economy may already have started its next growth cycle.

The inflation optimism is the main reason behind the global bond market rally that we have seen since December. In fact, investors not only expect an imminent peak in US, UK and European interest rates, but think they will start actively loosening monetary policy before the end of the year. Bond yields in all three areas fell after last week's rate rises, with the sharpest fall in Europe despite the rate rise being much larger. This reflects a 'job well done' attitude in markets: inflation is or will soon be under control, after which things can get back to normal.

To judge how accurate this view is, we need to know how inflation will develop over the next year and, in particular, how it will be impacted by monetary policy. Unfortunately, that is a very hard thing to figure out. Conventional economic wisdom tells us monetary policy has 'long and variable lags': rate rises, or cuts take a long time to filter through to the real economy, but exactly how long depends on a host of minute and unpredictable details. This idea was popularised by the 1970s monetarist school of thought, led by Milton Friedman.

It makes intuitive sense. Tighter monetary policy means higher borrowing costs, the obverse of which is a greater return on savings (and therefore potentially less spending), while growth and inflation are dictated by the balance of aggregate supply and demand. These are heavily interlinked, a complicated chain of reactions which take time to work through. Higher financing costs will only start to bite when enough actors are in need of more financing, and inflation will only come down once those actors reduce their demand by a high enough margin.

This is why monetary policy is so difficult, and central bankers often appear to tighten too hard – the intended choking of growth becomes an unintended harsh recession. It is also why some are pessimistic about global growth in 2023. Even if the Fed were to lower interest rates before the end of the year, weak growth or even recession could persist for a long time. In the past, macroeconomists have estimated the lag between monetary policy and inflation can take anywhere from one year to three. Now though, that conventional wisdom is being challenged and that analysis has been summarised by Dario Perkins of TS Lombard.

In the last few years, high-powered statistical studies have revisited the monetary policy 'shocks' (unanticipated changes) of the modern era and found their impact on aggregate demand has occurred in a matter of months not years. When that shock is a rise in rates, it can have disinflationary impacts even in the short-term. By the same token, rate cuts can stimulate activity quite quickly. Moreover, these recent studies show the policy lag time has been decreasing over the last few decades.

Perkins then speculates why the change may have occurred. In the past, interest rates took a while to affect the real economy because the primary mode of transmission was bank lending – an inherently slow-moving process. But over the last decade in particular, such lending has had a much smaller role. Highly traded corporate bond markets are much more important for businesses, while asset markets are much more important for households (as stock ownership is much higher).

These markets are much more sensitive to interest rates and investor sentiment. Moreover, capital markets have become more aligned to monetary policy over the last couple of decades. This is in part because central bankers are eager to communicate policy far in advance and remove sudden shocks, and in part because forecasting interest rates has become one of the biggest components of any investment portfolio. This results in a feedback loop where investors look for any clues in central bank announcements, and those announcements are tailored for a nervous investor audience.

Shorter lags can be both good and bad. TS Lombard takes an optimistic view, as loosening monetary policy could boost demand before the year is up. If the lag really is long, one could not expect any short-term recovery. If it is short, there is every chance the global economy will improve substantially in the second half of this year. Combine this with the strong growth boost we expect to see from China's post-COVID re-opening, and we could be in for a very decent ride.

The pessimistic view is that central banks might not loosen after all. The current expectation – backed up by comments from its members – is that the Fed now wants to wait-and-see how inflation plays out rather than committing to further tightening. But markets also expect inflation to fall to the Fed's 2.0% target, and for the US economy to avoid a deep recession. If the policy lag is shorter than expected, those things are unlikely to all be true at once.

In the US, inflation has fallen but not yet by enough and the Fed's main concern is still the tightness of the US labour market, and how this could lead to a damaging wage-price spiral. Data before Christmas showed the labour market cooling somewhat, but this trend is far from confirmed – and most recent data, in fact, suggests the opposite.

Ultimately, the question policymakers have to grapple with is how much growth can be allowed before it becomes inflationary? The structural evidence we have seen post-pandemic – from labour markets and increased regionalisation of global trade – suggests that bar is low. Moreover, if the lag between interest rates and inflation is shorter than expected, central banks will have more incentive to tighten in the short-term. Monetary policy transmission is highly complex, but we should not assume that means the job is already done.

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6th February 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	7870	+1.3	↗	⬀	3.6	11.2	10.1	14.5
UK FTSE 250	20492	+2.6	↗	→	3.2	13.8	13.2	17.0
UK FTSE All-Share	4322	+1.5	↗	→	3.5	11.9	10.5	15.0
UK FTSE Small	6627	+1.7	↗	→	3.8	11.1	13.9	18.6
France CAC 40	7155	+0.6	↗	↗	2.9	11.6	11.8	15.3
Germany DAX 40	15390	+1.7	↗	↗	3.4	12.6	12.8	14.2
US Dow	33929	+0.2	⬀	→	2.0	20.4	17.3	17.9
US S&P 500	4135	+2.1	↗	→	1.6	19.8	19.5	18.8
US NASDAQ comp	11979	+4.3	↗	⬂	0.9	32.6	31.6	26.1
Japan Nikkei 225	27509	+0.5	→	→	2.1	21.7	20.2	20.1
World MSCI	2848	+2.2	↗	→	2.1	18.2	17.5	17.7
China mainland	4142	-1.0	↗	→	2.3	14.8	14.5	13.3
Emerging MSCI	1046	-0.5	↗	→	3.0	12.9	11.4	11.8

Top 6 Gainers

Company	%
J Sainsbury	+11.4
JD Sports Fashion	+11.0
B&M European Value Retail SA	+10.0
WPP	+9.9
Johnson Matthey	+9.7
Ashtead	+8.1

Bottom 6 Decliners

Company	%
Fresnillo	-7.6
Anglo American	-6.3
Rolls-Royce Holdings	-5.7
Standard Chartered	-5.7
Antofagasta	-5.4
Rio Tinto	-4.0

Fixed Income

Govt bond	%Yield	1 W CH
UK Govt 10yr Gilt	+3.06	-0.23
UK Govt 15yr Gilt	+3.48	-0.16
US Govt 10yr Treasury	+3.52	+0.04
France Govt 10yr OAT	+2.64	+0.00
Germany Govt 10yr Bund	+2.20	+0.01
Japan Govt 10yr JGB	+0.50	+0.01

Currencies

Pair	last	%1W
USD : GBP	1.212	-2.3
GBP : EUR	0.896	+1.9
USD : EUR	1.085	-0.5
JPY : USD	130.44	+0.3
CNY : USD	6.779	-0.2
USD : Bitcoin	23,352	+0.6

Commodities

Cmdty	last	%1W
Oil Brent $:bl	82.4	-6.4
Gold $:oz	1879.5	-3.0
Silver $:oz	22.7	-6.1
Copper $:lb	409.2	-3.9
Alumnm $:mt	2587.0	-0.9
S&P soft crops	230.8	+2.6

UK Mortgage Rate Estimates

Rates (LTV c.75%)	03-Feb	04-Jan
UK BoE base rate	4.00	3.50
2yr fixed	5.34	5.43
3yr fixed	5.16	5.31
5yr fixed	5.03	5.05
10yr fixed	5.01	4.99
Standard variable	6.41	6.41

03/02/2023
Prices taken at 2:30pm today and 2:30pm 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

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

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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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