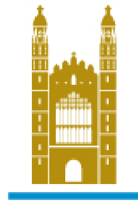

CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

13 February 2023

Lothar Mentel

Lead Investment Adviser to Cambridge

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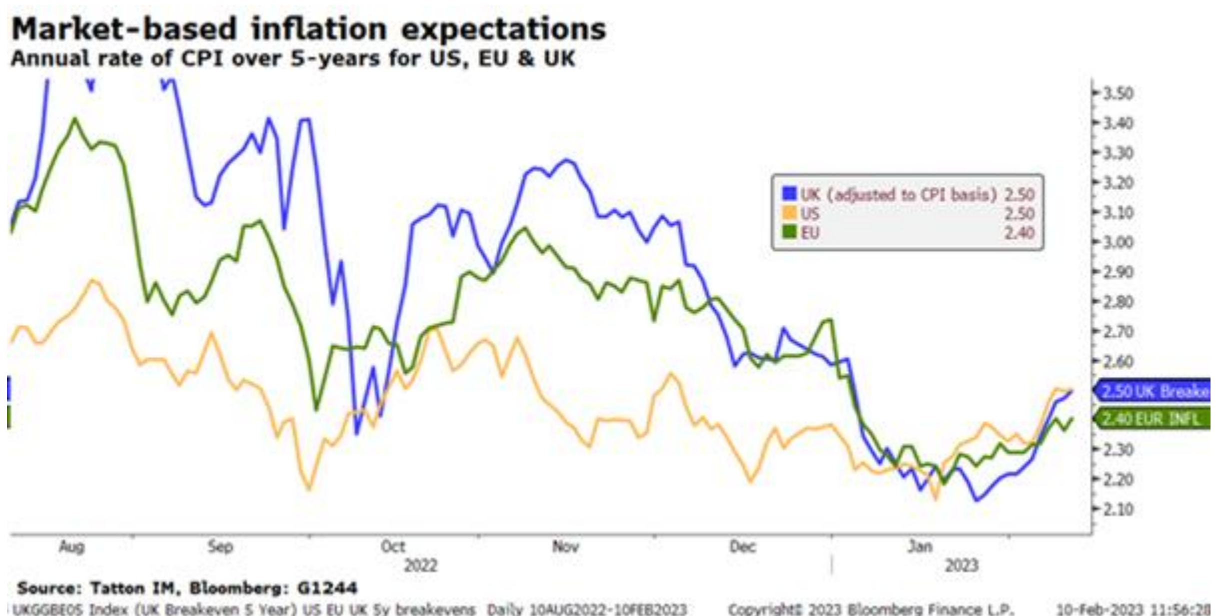
A challenging week brings investors back down to earth

Overall, UK bond and equity markets slipped back last week, despite the FTSE 100 edging higher until Thursday lunchtime when it reached a new all-time price high. Since the previous week's US employment data, the asset market rally has had a key component weaken. In January and early February, investors had spied a decline in longer-term inflation pressures, but investors have become less sure in recent days. In turn, expectations that central banks would move relatively quickly into neutral gear also declined. Catherine Mann, an independent member of the Bank of England's Monetary Policy Committee, warned that there were still more rate rises to come in the UK. Meanwhile, in the US, Federal Open Markets Committee members also told us that while the pace of rate rises may have slowed, the end is not clearly in sight.

These announcements were a major factor in halting the previously helpful rally in bonds. Shorter maturity yields have risen more than longer maturities, but yields are up (and so bond prices are down) somewhat. Whilst this move is nothing like the sell-off in bonds of 12 months ago, when western economies were still roaring ahead. For most investors, the question is whether growth this year and next year will be slow but steadyish, or will it be "too strong" and therefore forced to slow more dramatically by ever-tighter monetary policy? If we want an early path to lower interest rates and an early path to stable steady profitable growth, it is preferable to get weaker economic data now.



The UK's 2022 fourth quarter gross domestic product (GDP) data could not be described as strong although, contrary to expectations, it did not show a contraction. The quarter showed no real growth at all, while the mix was a little surprising with services weaker than expected while manufacturing was stronger. Indeed, it looks like the woes of auto-related industry may be less than feared. New car registrations in the UK are up by around 20% from last year's dire figures and, more importantly, aided by a similar bounce in the much larger European market.

As we come to the last part of the Q4 2022 earnings reports, the most notable outcome has been that analysts have become less positive about company earnings for this year. Compared to the last 12 months, for the S&P 500, the next 12 months' earnings per share (EPS) are expected to grow (on average) by less than 4%. In Europe, the STOXX 600 EPS growth is expected to be 2.1%. For both markets, the next 12 months' EPS is 11% higher than the rolling last 12 months. (Source: FactSet, analyst aggregates, estimates for last and next year on an estimate-comparable basis).

One might say this provides quite a lot of comfort for equity investors. A normalisation of the relationship might imply that equities can rally as the markets' EPS estimates are not building in any real growth.

We need to look at stock price as well, since that tells us what we're paying for those expected earnings. There is certainly room for analysts to revise their estimates up, but current valuations are expensive (after we factor in last year's rise in global bond yields). In both the US and European Union (EU) markets, on our calculation, earnings would have go up by about 15% from current estimates to get close to average. So, even if analysts do make upward revisions, a move back to an 11% growth for the next year would still mean expensive equities.

A sharp bounce in EPS growth is most likely after a sharp EPS fall, and those falls happen in recessions. While there's been much talk of an imminent recession, it hasn't occurred yet and many now think that any recession will be shallow at worst. But developed markets' EPS are not likely to grow significantly in the current environment, even if we think that China could produce much stronger demand as it comes out of lockdown.

While a fall in equity markets is a possibility, valuations are not a great guide to near-term market performance. We feel it leaves markets in a position that's more vulnerable if any shock were to come along. That said, one of the reasons why markets have rallied is that we haven't had any nasty shock for some time – Russia's invasion of Ukraine was the last serious one.

Markets could therefore plod along, eking out steady but small returns, while firms improve their cost bases amid slowish revenue growth alongside slowish economic growth. As we said at the start, further declines in bond yields and inflation expectations would be a big help.

Economic growth positivity has recently centred on China. Last week, the release of January's lending data was even more positive than buoyant expectations. Both companies and consumers have resumed borrowing, and this looks set to continue into the warmer months. While the spy balloon incident(s) will hopefully blow over, it does remind us that investing in China can be problematic. China continues to try to smooth its relationships with the rest of the world and is actually currently involved in a big diplomatic push in Australasia, so we do not expect there to be serious repercussions at least for the moment.

Nevertheless, we write about world trade, the World Trade Organisation (WTO) and regionalisation in a short article below. We also cover some of the economic consequences of the terrible tragedy in Türkiye (in case of any confusion over our spelling, in June 2022 the Turkish government asked the international community to adopt the Turkish spelling, a request which we are happy to accommodate on these pages also).

Lastly, a quick mention on energy prices. There is still a possibility of cold weather for this winter, but gas storage levels remain very high across Europe in comparison to past years. In France, the main gas supplier

estimated it will have storage at 40% capacity by winter-end, unless there are extremely freezing conditions substantially above normal. Gas and electricity prices continue to fall for next winter's contracts and are now only double the price of winter 2021, before Russia removed supply. That still may sound terrible, but to end this rather sombre leader on a more upbeat note, a return to near-normality now looks increasingly feasible.

Natural disaster hits Türkiye's economy too

In the wake of tragedy, talking about the economy can sound a little callous. The earthquake in Türkiye and Syria has tragically killed more than 21,000 people, and injured tens of thousands more. The scale of the devastation is not yet clear, but the real toll will likely be much higher, with hundreds of thousands displaced from their homes. Unfortunately, the global financial system does not stop to mourn. In the wake of the disaster, international investors sold Türkiye's Bist 100 Index at a rapid pace, culminating in a 7% fall last Wednesday morning. The negativity caused stock trading to be suspended for a five-day period and reflects deep concerns over the hit to Türkiye's productive capacity.

Those concerns matter, as growth and supply side shocks have very real impacts on people (as we have been made all too aware over the last few years). Factories, schools and commerce have been obliterated in East Anatolia. In the short-term, this could deprive millions of their livelihoods as well as their homes. Over the longer-term, rebuilding efforts will require resources and investment, which will mean smaller capacity for other things. In short, economic impacts are human impacts too.

These impacts could be amplified by the nation's already weak economy. President Erdoğan has already pledged $5.3 billion in emergency aid. Given the government is running a budget deficit, short-term funding will mean extra borrowing. This will likely come at a great cost; yields on 10-year Turkish bonds are at 11% right now and could go higher if more cash is needed.

More will definitely be required for rebuilding, which will be a long and arduous process. The affected regions accounted for around 10% of Türkiye's GDP in 2021, including major production centres and two shipping ports. Bloomberg estimates that short-term infrastructure costs will wipe out about 2.6% of Türkiye's GDP. Longer-term projects like housing construction will take the total significantly higher – as has been the case for previous earthquakes. In the end, this could mean a fiscal outlay equivalent to 5.5% of the economy, according to Bloomberg.

This will be a huge drain on public finances, which will in turn have a huge impact on the private sector. But private sector participants will have their own problems too. The banking sector has around $30 billion in loans to businesses or households in affected regions. If these are not written off by government decree, they will become non-performing debt for years to come. Either way, it will mean a substantial drag on banks' balance sheets, meaning they will not be able to lend as freely to those who need it. One only needs to look at the longstanding non-performing debt pile in Italy to see how this can hamper long-term growth prospects.

Natural catastrophes can have the effect of spurring growth and establishing sound infrastructures, but for this the economy needs to be able to deploy resources. Unfortunately, the background weakness in Türkiye's economy makes things more difficult. Erdoğan clashes with international markets are well

documented and have led to an inflation crisis in Türkiye which long predates global supply-side problems. The lira has been on a consistent nosedive for more than a decade; its dollar value today is a tenth of what it was in 2013. However, Türkiye has staged something of a recovery recently. Inflation, while still excruciatingly high, fell for the third consecutive month in January. The Bist 100 – having been the perennial underperformer for investors for years – was one of the best performing national stock markets in 2022, finishing almost 200% higher than it began.

A big part of that turnaround was the improving relationship between Erdoğan and his international counterparts. The president's strongman politics had previously isolated him from western leaders, but Russia's invasion of Ukraine changed things. The war increased solidarity among NATO members, bringing Erdoğan back into the fold. Moreover, his relationship with President Putin has proved beneficial, allowing him to act as a channel for talks between Russia and the west.

The destruction and its massive costs could undo these positive developments. Istanbul's stock market was in freefall before its 'circuit breaker' mechanisms were triggered. For international investors, the worry is that this could add to the risks in wider emerging markets (EM), either through economic dislocation or financial contagion.

On that front, it is worth noting that Türkiye is a very small component of EM assets, both in credit and equity terms. The effect on EM indices is therefore likely to be quite small, regardless of what happens in Türkiye. It is telling, for example, that EM investors seem to be much more concerned with the Adani scandal in India. In economic terms, natural disasters tend to be contained incidents: horrific for the countries in which they occur, but with limited spill-over beyond borders.

With any luck, the capital market fallout from the earthquake could be limited too. While the stock market is closed for a week, other indicators are not currently suggesting volatility in Turkish assets. Spreads on Turkish bonds (the difference between US and Türkiye yields) have barely moved, while the lira has remained static against the dollar in the days since the crisis.

Perhaps this is testament to the support that Türkiye now has in the international community. Natural disasters can generate a lot of support for the afflicted countries – both politically and financially in the form of aid. If there is any good to come from this at all, it will be that Erdoğan improves his relationship with western leaders. Regardless of his own politics, that will vastly improve the country's prospects of rebuilding. The people desperately need that help now.

Will trade die with the WTO?

The 1990s was a decade of hope and hubris. After the Fall of Communism, western politicians and intellectuals not only celebrated their Cold War victory but promised an era of unparalleled global growth and peace – guaranteed by the so-called 'golden arches' theory of international relations. The idea was that, if two countries can each support a network of McDonald's restaurants, they would have no interest in going to war with each other. Trade brings nations (their businesses and consumers) together, meaning everyone has too much to lose by killing one another.

This was never really a theory, in the academic sense, as much as a slogan – much like 'trickle-down' economics. But it certainly captured the sentiments of powerful people in Washington, London and Brussels. Nowadays, it is a bit of a joke among students of international relations. Global trade has grown dramatically over the last three decades. World peace has not matched it.

That trade links do not guarantee political allegiances is particularly clear at the moment, following the Chinese balloon incident. In terms of trade volumes, the US and China are bound so tightly together they cannot be pulled apart (not for want of trying). Yet tensions between the world's two largest economies are higher now than at any point since the 1989 Tiananmen Square massacre.

From our perspective, the interesting part of this is not that the golden arches were a mirage, but that the global economic order they helped support is now itself in question. The current state of the WTO is the perfect example of this trend. When it began in 1994, the WTO was the crowning achievement of western neoliberalism: an international regulator dedicated to lowering trade barriers around the world, opening up economies and creating a genuinely global market for goods, labour and services. Now, it's been in a comatose state for a few years, with some fearing disappearance will be the final outcome.

Members have not made any progress on new rules or treaties for more than two decades, and for the last few years, the WTO's court of appeal has not had the required number of judges. This means that trade disputes cannot be settled (assuming an appeal is launched), making the existing rules – which are supposed to forbid certain kinds of state subsidies and push toward lower international tariffs – completely unenforceable. Unless the court is rejuvenated, the world's WTO trade laws will just be scraps of paper.

Ironically, the US has been the main architect of the WTO's slow demise – despite previously being its biggest cheerleader. The cracks started to appear during the Obama administration, as key rulings went against Washington. Trump smashed those cracks wide open, declaring that the whole organisation only existed to siphon jobs from the US and to give China unfair advantages. President Biden has been less confrontational, but his administration continues to block the appointment of judges to make settlements possible again. Letting the WTO die now seems to be a rare point of bipartisan agreement in the US.

The latest White House policies suggest Biden will take full advantage of a world with fewer trade rules. The so-called Inflation Reduction Act (IRA), which passed in August after much cajoling of the President's party, promises to provide tax breaks or subsidies for clean energy companies, with a majority of the support tied to energy being produced in the US. On that front, American officials have been touring Europe not only in an attempt to calm the political waters with their European counterparts, but also to possibly persuade green tech companies to move across the Atlantic. After all, the IRA amounts to $370 billion over ten years. Coincidence or not: the dually-listed German gas giant Linde recently announced it would delist from the Frankfurt Stock Exchange and list exclusively in New York. Linde has a strong presence in the US in any case, but so have many 'infrastructure' players. Long-term investments often need big groups in the background with the capacity to handle these types of projects.

European politicians are reportedly furious with the flagrant attempts to give US companies a competitive advantage. But with the WTO crippled, they effectively have no recourse. The impasse seems to be making EU lawmakers question their own trade rules. Currently, these restrict subsidies and state investment to encourage greater competition. But last month, European Commission president Ursula von der Leyen told delegates in Davos that the EU "needs to be competitive with offers and incentives that are currently

available outside the European Union". If they follow through, it would likely mean a chain reaction where nations around the world put up higher and higher trade barriers in reaction to one another.

The question is, then, will world trade die with the WTO? This question has been a prominent one for the last few years, as part of the so-called deglobalisation debate. Part of the debate is around issues of supply security – exemplified by Europe's need to wean itself off Russian energy. Another aspect is political instability and social cohesion – exemplified by the Trump and Brexit votes of 2016, as well as China's increasing nationalism. Both of these were amplified by the pandemic and accompany a general trend of plateauing global trade volumes (as a percentage of world GDP).

As we have written before, the outlook is complicated. On the one hand, there are many structural forces pushing against globalisation, which will likely mean a reduction in the breadth of certain markets that we have come to think of as truly global – like energy, technology or food. On the other, a reduction in globalisation does not necessarily mean an increase in nationalisation. More likely is an increased reliance on regional trading blocs or supply chains. And needless to say, big nations such as the US and China are less in need of trading blocs than smaller nations – hence the EU's need to attract important trade players. In trade, either a counterpart has an exclusive input element which makes the trading partner indispensable, or the trading partner is big and can inflict pain.

Within these regional blocs, trade links are likely to become deeper, even if the links between regions become shallower. This process is already playing out in Asia, Africa and South America. There is a good chance it could lead to a renewed bout of European integration too, particularly if European leaders begin to think the US is no longer a dependable trade partner.

Then there are other forces that work on different timescales and could point in the opposite direction. On the long end, one could argue that globalisation has been steadily and reliably increasing since the 1500s, thanks to technologies which have allowed greater connectivity or mutual understanding. From that perspective, the current political backlash is little more than a blip. On the short end, a global recession will inevitably push people towards the cheapest resources, regardless of where they come from. The current slowdown in global growth could therefore lead to a reprieve in deglobalisation. Also, the tech-based world (namely the web) tends to be more global unless authorities limit access. And indeed, the web may become an area where ideological cousins move closer yet again, despite geographical distances.

Whatever the case, it is clear that the optimism from the WTO's founding days is long gone. Not only did trade not lead to peace and freedom, but it did not always lead to further trade either. But assuming the forces of globalisation are gone forever is just as naïve as assuming they will never go. World trade will not die with the WTO – even if it takes a hit.

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13th February 2023

Global Equity Markets

Market	Fri 14:31	% 1 Week*	Technical: Short	Technical: Medium	Valuations: Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7868	+0.5	↗	⇗	3.6	11.3	10.3	14.5
UK FTSE 250	19990	-2.3	↗	→	3.4	13.6	12.9	17.0
UK FTSE All-Share	4305	+0.0	↗	⇗	3.6	11.9	10.7	14.9
UK FTSE Small	6571	-0.7	↗	→	3.9	11.0	13.9	18.6
France CAC 40	7120	-0.6	↗	↗	2.9	11.6	11.7	15.3
Germany DAX 40	15346	-0.7	↗	↗	3.4	12.5	12.6	14.2
US Dow	33680	-1.1	→	→	2.0	20.1	17.2	17.9
US S&P 500	4075	-1.9	↗	→	1.7	19.3	19.4	18.8
US NASDAQ comp	11733	-2.6	↗	⇘	0.9	31.4	31.7	26.1
Japan Nikkei 225	27671	+0.6	↗	→	2.1	22.8	16.2	20.1
World MSCI	2791	-1.1	↗	→	2.1	17.8	17.4	17.7
China mainland	4106	-0.9	↗	→	2.3	14.7	14.4	13.3
Emerging MSCI	1025	-1.4	↗	→	3.0	12.7	11.3	11.8

Top 6 Gainers

Company	%
BP	+13.5
Airtel Africa	+13.5
AstraZeneca	+10.2
Standard Chartered	+9.6
GSK	+4.0
Shell	+4.0

Bottom 6 Decliners

Company	%
Entain	-15.1
Smurfit Kappa	-9.5
Segro	-8.8
Mondi	-7.2
Flutter Entertainment	-7.0
Ocado	-6.7

Fixed Income

Govt bond	%Yield	1 W CH
UK Govt 10yr Gilt	+3.34	+0.25
UK Govt 15yr Gilt	+3.71	+0.20
US Govt 10yr Treasury	+3.68	+0.33
France Govt 10yr OAT	+2.80	+0.25
Germany Govt 10yr Bund	+2.34	+0.24
Japan Govt 10yr JGB	+0.50	+0.01

Currencies

Pair	last	%1W
USD : GBP	1.211	-1.7
GBP : EUR	0.883	-0.7
USD : EUR	1.070	-2.3
JPY : USD	130.80	+2.1
CNY : USD	6.807	+1.2
USD : Bitcoin	21,839	-8.6

Commodities

Cmdty	last	%1W
Oil Brent $:bl	85.7	+3.7
Gold $:oz	1866.5	-4.0
Silver $:oz	22.2	-9.2
Copper $:lb	404.4	-3.1
Alumnm $:mt	2463.6	-4.8
S&P soft crops	226.6	+0.0

UK Mortgage Rate Estimates

Rates (LTV c.75%)	10-Feb	11-Jan
UK BoE base rate	4.00	3.50
2yr fixed	5.33	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

10/02/2023
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

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enquiries@cambridgeinvestments.co.uk

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

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