THE **CAMBRIDGE** WEEKLY

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A dose of realism creeps in

Last week, the UK's leading stock market index, the FTSE 100, finally passed the psychologically important threshold of 8,000. And yet, after the strong start to the year in January, February has brought consolidation rather than a continued uptrend. We wrote last week that the prevailing 'Goldilocks' market sentiment of not-too-hot (growth, inflation), not-too-cold (rates coming down again soon) was replaced by a somewhat more realistic view that rates will in all likelihood have to stay higher for longer than previously hoped. This is because inflation is proving more persistent, despite goods and energy/commodity price rises indeed having proven to be transitory. However, tight labour markets have carried so-called second-round effects from last year's price shock into the 'stickier' areas of service and goods with a high service production component (e.g., food).

Commentators from the US Federal Reserve (Fed) and the European Central Bank (ECB) added further evidence to this view, as both said last week that they need to do more in their fight against inflation and they did not see any clear end yet. This came after US Consumer Price Index (CPI) inflation data had both good and bad news, whereas the Producer Price Index (PPI) inflation data showed a worrying uptick. Worrying, because falling raw material and energy costs were not enough to counterbalance price rises from rising labour and other input costs.

Global government bond yields rose quite sharply after the central bank comments. They are not yet making investors fear recession is imminent though. Credit spreads – for us, the best indicator of fears of a recession – rose slightly last week but are still close to the lowest levels of the past six months.

The slowly changing perspective for how soon or rather how long until rates and yields stop rising – and central banks will come off the growth 'brakes' – has not necessarily changed the long-term picture of a relatively benign economic slowdown.

What the past weeks' data points have done to market sentiment is inject a dose of realism. Beforehand, the equity markets pricing implied that the negative current earnings recession proves to be a very short-term phenomenon, and that aggregate profit growth resumes by, at latest, the second half of this year. Last week's rise in bond yield levels may push the resumption of profit growth out towards 2024, which makes equities once again look relatively expensive and therefore vulnerable to corrections.

This means that while we remain optimistic for the 2023 central scenario, we admit to being a bit more cautious for the near-term.

As mentioned at the beginning, the FTSE 100 gained a new all-time above 8,000 last week. Other markets had a decent enough week, but price action still feels directionless. Again, underlying profit expectations are not strong yet and investors are unlikely to turn optimistic again until central banks have clearly reached a point where tightening is done.

When stock markets as a whole are providing only limited upside perspective, actively seeking and tilting portfolios towards those areas that thrive under the changed circumstances is the job of investment managers like us. Last year's rotation from growth to value was a case in point. We would therefore like to share some interesting fund manager views of Steve Eisman, who gave an interview on Bloomberg TV last week. He has the honour of being the real-life Mark Baum, New York City character played by Steve

Carell in the 2015 film *The Big Short*, one of the perspicacious fund managers that identified the problems with the mortgage-backed securities markets before the Great Financial Crisis of 2008.

He believes that the investment world is entering a new paradigm, a model of understanding (or beliefs) of how investors will view the future of company structures and profitability. He thinks we are changing our judgment on the shape of likely future winners; some of the past winners will turn out to be also-rans. He reminds us that, in the 1990s, Jack Welch's General Electric Company (GE) was the darling; the S&P 500's No.1 in 1996 but now only 88th by market capitalisation.

His thoughts are particularly relevant now. In the past few weeks, 'growth' stocks have performed well after more than a year of underperforming 'value'. That performance coincided with a fall back in long-term yields. However, the correlation of growth stocks with yields has been less strong in recent times. Perhaps, for the now-dominant winners, their business models have reached a natural end; their growth was achieved by gaining market share from older-style rivals while having better margins than those rivals. As we discuss in one of our in-depth articles below, margins now appear to be under pressure. This also comes at a point where gaining market share is more difficult and costly since there are few obvious remaining rivals to pick off.

Perhaps this is a reminder that the 'style factor' approach to investment needs constant attention. Five years ago, we labelled certain companies as 'growth' but now they no longer fit the label. That also means that one person's list of stocks in the growth and value camps can differ substantially with somebody else's.

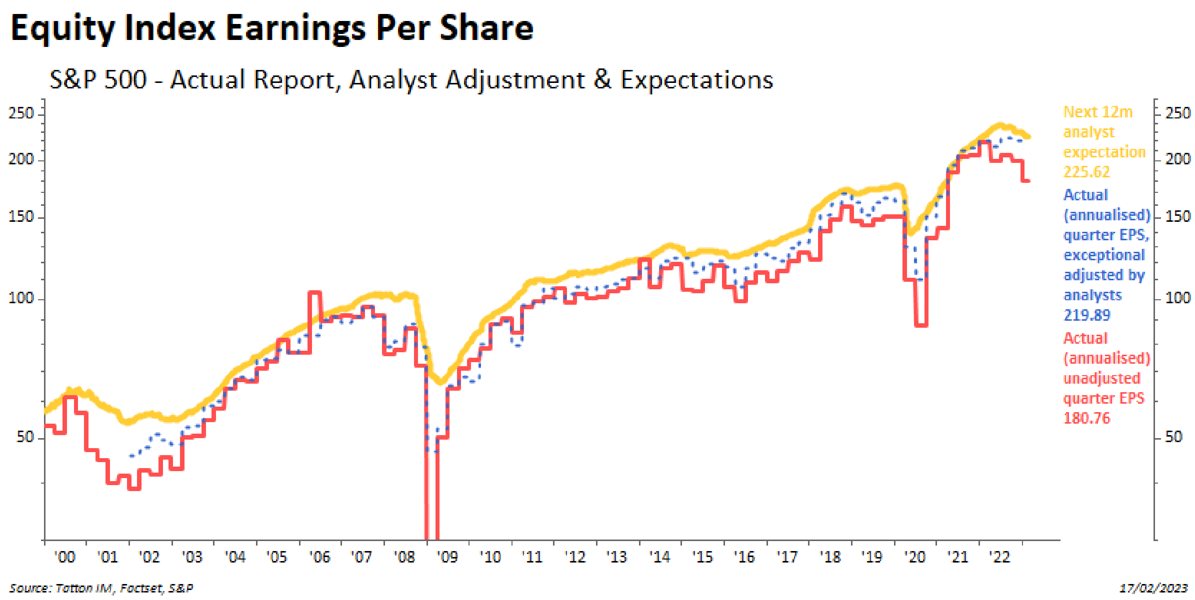
The business models that are likely to be sure-fire sources of growth are now not obvious. Everybody uses social media advertising. Meanwhile, the platform companies such as Alphabet (Google) face real questions over their size, much as GE did back in the 1990s. The political discussions on profit margins have grown much louder, just at the point where their very size creates organisational problems.

These are circumstances which may not favour a passive market-capitalisation investment approach while such a transition takes place. It might instead favour approaches based on other more complex fundamental metrics such as return on equity, which also suggests it might favour active stock selection.

Falling profit margins meet declining inflation

The last few company earnings reports for 2022 are trickling in, and at the aggregate level, they look pretty bad. US companies took a big hit in the last three months of the year, and overall profits are either lower or roughly the same as in 2021 – depending on which measure you use. The chart below shows a couple of these measures, as well as some earnings estimates for this year and 2024. The red line is a measure including so-called 'exceptionals' and shows that S&P 500 companies ended 2022 in an earnings recession, meaning 2022's earnings were lower than 2021. Adjusted figures (the broker report) were better but only slightly better.

Relative earnings growth for the next twelve months (the rest of 2023 and the start of 2024) has also been revised down, as the yellow line shows. For US equities, average earnings per share (EPS) is expected to grow by less than 4% compared to the 12 months just gone (after exceptionals have been adjusted). European companies are even more sluggish, projecting 2.1% growth. By comparison, the historical averages for both US and Europe are around 11% EPS growth year-on-year.



In the light of rising interest rates and consequent slowing growth across the world, investors are braced for recession. On the face of it, corporate results back up those signs. Still, sales growth slowed rather than fell in the fourth quarter of 2022. What caused the earnings declines were therefore compressing profit margins, which declined markedly. The simple explanation would be that wages and other input costs are growing faster than sales, while on the revenue side of the equation a certain level of price discounting has crept back in, following the extraordinary pricing power suppliers enjoyed during the initial post-pandemic period. That matches up with the general stagflation story, as well as with central bankers' concerns about potential wage-price spirals.

When we look a bit deeper though, this simple explanation does not quite hold up. The fall back in corporate profit margins came at the end of last year, but at that time inflation was falling back too. Input costs, particularly commodities, were flagging over the second half of 2022, as lower disposable incomes meant weak demand. By contrast, in late 2021 and early 2022 – when inflation pressures were growing rapidly – corporate profit margins were growing at a record pace.

Over the last two years, supply chain crises and – later – labour market tightness have been cited as the main drivers of ongoing inflation. However, a recent paper from the Kansas City branch of the US Federal Reserve (Fed) suggests a different story. According to them, growth in margins accounted for more than half of US inflation in 2021. By contrast, wage growth was at most a minor contributor to rising prices. This backs up the story we have seen in industries like energy, where huge price increases have been met with record profits for a handful of large providers.

The relationship between inflation and corporate profits is not straightforward, but in general you would expect inflation to cut into a company's profit margins. This is particularly so if demand slows at the same time, meaning higher costs but no corresponding increase in sales or ability to pass on cost increases through higher prices. We saw the opposite over the last couple of years. This is why many have suggested that market concentration and corporate greed are the biggest forces driving the current inflation spike: without healthy competition, monopolistic companies can drive up prices and maximise profits at the expense of consumers.

There is a problem with this explanation too, though. According to the Kansas City Fed, margin growth primarily occurred in the first half of 2021, and was fairly consistent across a variety of sectors. If market concentration were the primary reason behind rising prices, you would expect sectors with greater concentration, or where demand growth is more pronounced, to see higher inflation. And if companies were just being opportunistic, we would expect them to keep raising prices until demand plateaus. This does not seem to have happened, given that demand did not pull back sharply until late 2022, at which point profit margins were in retreat.

Margin growth seems to be driven more by fear than greed. Companies have been bracing for rising input costs. For many, that meant increasing their own selling prices while demand was still strong enough to sustain it. For others, that meant smoothing over input price shocks by increasing revenues in the short-term. The post-Covid episode seems to have differed from other potentially inflationary periods in that many companies appear to have raised prices on existing inventory rather than applying the price rises only to new stock.

This is not to say that consumers or policymakers should not worry about market concentration. Regardless of why companies wanted to raise prices, it is still significant that they could. Moreover, the realisation that they could raise prices without choking off too much demand might mean firmer pricing power down the line. But in terms of the current outlook, it is important that rising margins were primarily a defensive move, coming from a position of expected weakness rather than strength.

The opposite seems to be happening now, but for the same reasons. Profit margins are coming in, relieving a big chunk of the inflationary pressures we saw before. Whereas before, companies expected sharply higher costs and an okay short-term demand picture, now they see falling input costs and widespread talk of a recession. With sales growth already slowing, businesses likely feel the need to rein in prices – or at least hold them steady – to retain customers.

This whole process is the opposite of what we might expect in normal times. Profit margins are usually reactive to demand and inflation, meaning that a fall back in input prices should presage an increase in margins. But with margins now leading inflation instead of reacting to it, companies are not seeing this benefit. This is even more pronounced in Europe, where sales have been more volatile and cost pressures have been greater.

This dynamic is ongoing, but it is hard to say for how much longer. Proactive margin movements could be a hangover from the series of external shocks that hit the global economy over the last few years, as well as the rapid draining of liquidity by central banks. This could change if wages remain firm, increasing inflation and potentially compressing margins further. That is what central banks are worried about. If inflation pressures return, it is not clear that companies could repeat their 2022 price-setting behaviours.

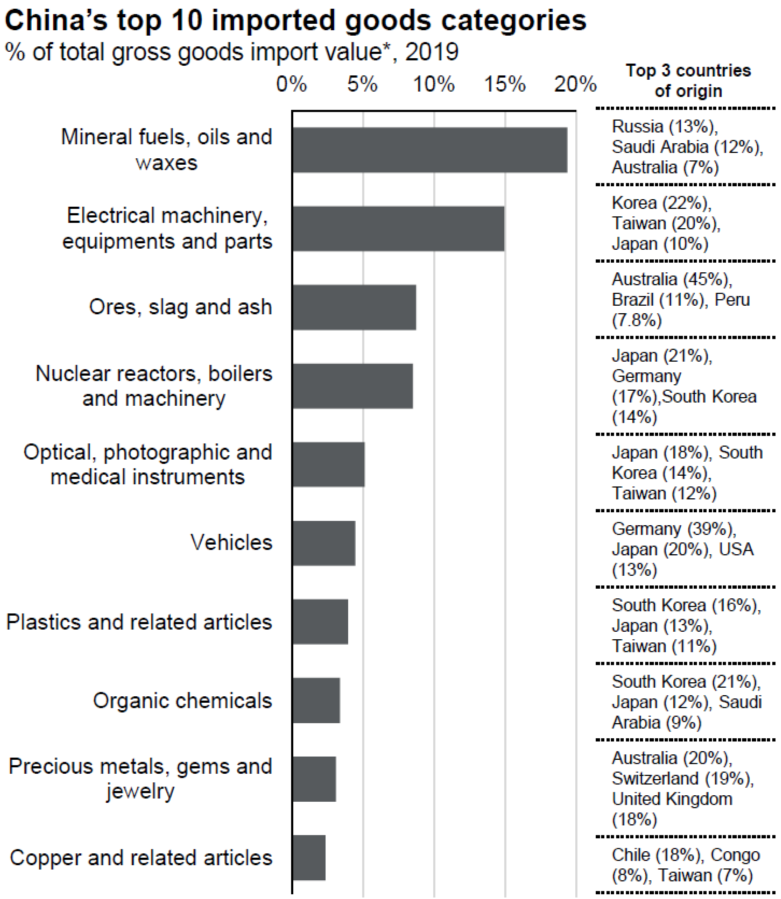
China post-pandemic reopening update

Chinese investment assets have managed quite a turnaround over the last few months. And the world's second-largest economy has moved on from being a laggard, with a failing property sector, to become one of the few bright spots for investors in a still-young 2023.

The stage for a reversal was set last autumn, with Chinese authorities' increasing desperation in providing substantial fiscal and monetary stimulus – including effective rescue packages for beleaguered property developers. Then, in late November, President Xi and the politburo abandoned the zero-Covid policy and then executed the re-opening with surprising speed. This created a buzz, with investors expecting China was in for a post-pandemic boom. Indeed, many people have come to think China's reopening bounce could be even stronger than the one we saw in the west.

Since November, China's benchmark CSI 300 Index has rallied by more than 15%, although gains over the last month have been harder to come by. Near-term confidence has probably been knocked by the spy balloon controversy, but markets are still clearly positive about Chinese growth this year. This is helping not only Chinese assets, but emerging markets more broadly. In fact, some market analysts have warned that buying into China's reopening is becoming a crowded trade. According to a Bank of America survey, global fund managers have increased their allocations to emerging markets for the third straight month.

A strong rebound in China's economy is usually a good thing for the world economy. When China has gone on growth spurts in the past, it has pulled in goods from around the world, leading to a substantial pick-up in demand. This effect has only grown over the years, as China's share of global gross domestic product (GDP) has increased. From 2013-2021, China accounted for about 30% of global growth on average, making it the largest single contributor. Below is a very helpful analysis, from J.P. Morgan Asset Management, of the goods which China imports most:



Source: J.P. Morgan Asset Management; NBER World Trade Flows, Observatory of Economic Complexity

When Beijing encourages more borrowing, it tends to focus initially on capital goods, especially production machinery and commodities. By value, demand for high-end machine tools sourced from developed markets like Germany, Japan or the US has tended to be bigger than for raw materials. However, the commodity demand is large relative to the overall global commodity markets. The result is a benefit for other emerging markets and support for commodity prices. And certain commodity prices – like industrial metals – are seen as a key indicator of the state of Chinese growth in the short and medium-term.

Despite the high degree of hope around China's bounce, commodities have lately been surprisingly subdued. Copper, the industrial metal most sensitive to Chinese construction and technology production, rose sharply towards the end of last year. Since then, however, that rally has reversed somewhat. The same is true for energy, which gained momentum after the end of zero-Covid but has since cooled.

This dynamic is also playing out across a range of industrial metals, including iron and palladium. Both are indicators of swings in the health of domestic vehicle demand. The fact palladium prices have come down is particularly interesting. While other metals point to the strength (or lack thereof) of Chinese industry, cars are more an indicator of consumer spending. Consumers appear to be slower than expected in regaining confidence.

In short, we have yet to see any conclusive signs of a strong post-Covid, post-regulatory crackdown bounce in China, despite the conducive conditions. Property developers are free to borrow and build again, while private companies are afforded much greater leeway.

And, after many months of lockdown cycles, consumers have built up savings and should have pent-up demand. Post-lockdown bounces in the west were in part due to households being able to build significant amounts of cash savings. However, according to Bloomberg's latest estimates, China's household excess savings are less than half of what was previously thought (based on deposits data). These should still be positive for growth but are nothing like the stock of savings that catapulted US demand in 2021.

Moreover, most of those savings are skewed towards richer citizens, who are less likely to spend them fully. Bloomberg details how the urban population accounts for the vast majority of pandemic savings, while the top 20% of earners account for nearly half of the total amount. With consumer sentiment having suffered over the last few years, it could take a big turnaround to get people spending. By contrast, the sheer availability of capital in the US and Europe made spending habits much easier to recover.

Meanwhile the housing market is stable rather than strong. The data for January shows that, on balance, households want to pay down existing mortgage debt rather than raise new mortgages. The housing policy support mechanisms are run regionally, with lower mortgage rates when the region's house prices start falling year-on-year. Fewer regions are experiencing falling prices now, which is the impact of regulating demand. Nevertheless, transactions and prices are no longer falling.

While households are being cautious with their finances, China's financial system is in better shape now than for some time. Businesses appear no longer as leveraged and are starting to rebuild profitability. There is evidence they are prepared to borrow again. Total social financing numbers have recently shown a big rise in credit demand.

We should not be worried yet that the 2023 Chinese growth spurt might fall short of expectations. When Beijing declared the end of zero-Covid, we argued it might take some time for the results to show, in part because of seasonal factors. China celebrated its Lunar New Year at the end of January and is only now coming to the end of its Spring Festival – a month usually reserved for spending time with family, often away from the big cities. We said earlier this year that March might be the time when we see growth begin in earnest, and that is still possible. In terms of background conditions, the reopening bounce is very much on: it might just take a little longer to get going.

CAMBRIDGE INVESTMENTS LIMITED

20th 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	7989	+0.7	↗	↗	3.6	11.4	10.7	14.5
UK FTSE 250	20120	-1.1	↗	→	3.3	13.8	13.0	17.0
UK FTSE All-Share	4364	+0.4	↗	↗	3.5	12.0	11.1	14.9
UK FTSE Small	6562	-0.8	↗	→	3.9	9.9	14.0	18.5
France CAC 40	7344	+1.9	↗	↗	2.9	11.8	12.1	15.3
Germany DAX 40	15446	-0.8	↗	↗	3.4	12.6	12.6	14.2
US Dow	33548	-1.9	→	⬀	2.1	19.9	17.3	17.9
US S&P 500	4066	-2.0	↗	⬀	1.7	19.5	18.6	18.8
US NASDAQ comp	11777	-2.2	↗	⬀	0.9	31.6	32.5	26.1
Japan Nikkei 225	27513	-0.6	↗	⬀	2.2	22.7	16.2	20.1
World MSCI	2791	+0.2	↗	⬀	2.1	17.8	17.5	17.7
China mainland	4035	-1.7	↗	→	2.3	14.2	14.1	13.3
Emerging MSCI	1011	-0.2	↗	→	3.1	12.5	11.2	11.8

Top 6 Gainers		Bottom 6 Decliners		Fixed Income		
Company	%	Company	%	Govt bond	%Yield	1 W CH
Vodafone	+10.9	Ocado	-12.3	UK Govt 10yr Gilt	+3.54	+0.28
BT	+7.0	Endeavour Mining	-9.5	UK Govt 15yr Gilt	+3.90	+0.26
Coca-Cola HBC AG	+6.9	Barclays	-9.0	US Govt 10yr Treasury	+3.89	+0.30
Flutter Entertainment	+5.8	Hargreaves Lansdown	-8.6	France Govt 10yr OAT	+2.94	+0.19
Airtel Africa	+5.1	NatWest	-6.7	Germany Govt 10yr Bund	+2.48	+0.19
BAE Systems	+5.1	Lloyds Banking	-5.2	Japan Govt 10yr JGB	+0.51	+0.01

Currencies			Commodities			UK Mortgage Rate Estimates		
Pair	last	%1W	Cmdty	last	%1W	Rates (LTV c.75%)	#N/A Requesting	18-Jan
USD : GBP	1.198	-1.7	Oil Brent $:bl	82.2	-2.2	UK BoE base rate	4.00	3.50
GBP : EUR	0.888	+0.4	Gold $:oz	1826.3	-3.1	2yr fixed	5.46	5.43
USD : EUR	1.065	-1.3	Silver $:oz	21.3	-5.1	3yr fixed	5.32	5.31
JPY : USD	134.53	+3.1	Copper $:lb	407.5	-0.5	5yr fixed	5.18	5.05
CNY : USD	6.877	+1.5	Alumnm $:mt	2366.8	-3.9	10yr fixed	5.14	4.99
USD : Bitcoin	23,913	+5.2	S&P soft crops	224.1	-1.2	Standard variable	6.41	6.41

17/02/2023
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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