CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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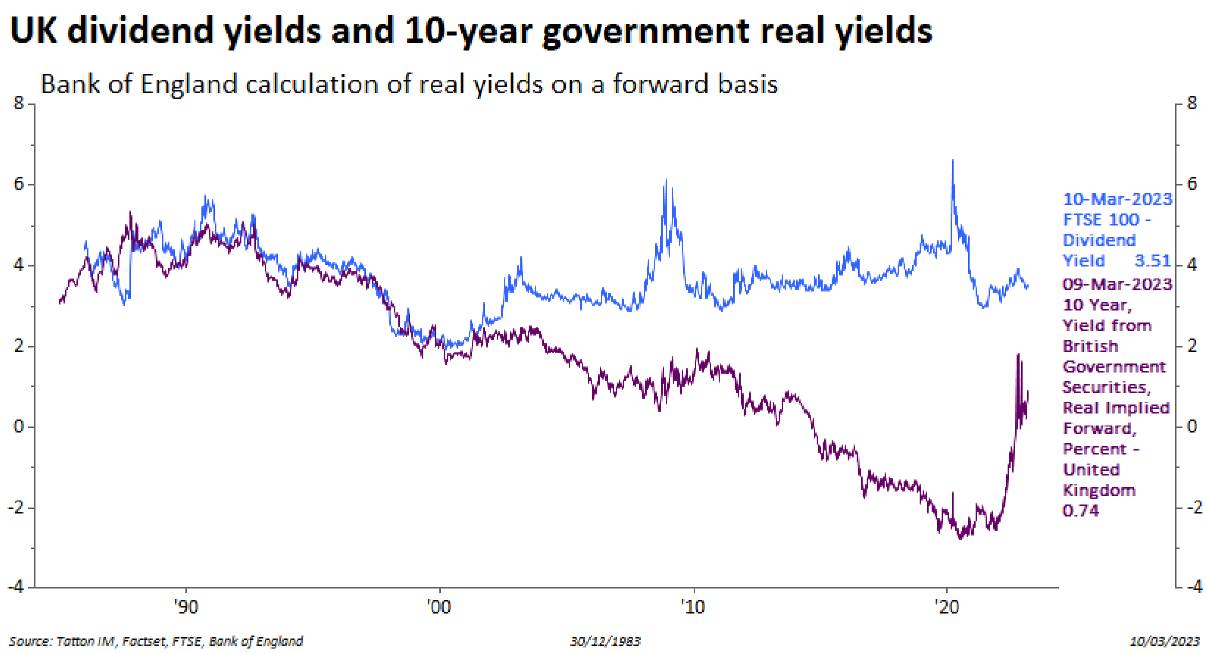
Market wrestling

For weeks we have been talking of an equity market that is relatively expensive in comparison to bond markets, especially government bond markets. Below is a chart which tracks the dividend yield of the FTSE 100 (calculated from 12-month trailing dividends), together with the market-estimated real return (after inflation has been subtracted) of the 10-year gilt calculated by the BoE. It is reasonable to think of dividend yields as an inflation-adjusted (or real) yield, given that companies pay dividends out of profits which are made after inflation-affected input costs.

Importantly, over the long-term, dividend growth will be in line with earnings growth and that is usually in line with nominal economic growth. It will outstrip the growth in retail prices.

If we were to start this chart just five years ago, we would see a decline in dividend yields and a sharp rise in government real yields. One could expect dividend yields to rise to maintain the premium, and that would, in the short-term, mostly be achieved through lower equity prices – which hurts capital values. But over the period from 1986 to the start of this century, the relationship looks completely different. Dividend returns from stocks were in line with real yields from government bonds, except that equity investors got the growth in the value of the stocks on top. The two periods are very different and, certainly, there are reasons to think that the 20th century relationship could return. While from dividend yield perspective equities are on the expensive side, they are not expensive relative to government bond yields in a wider historical context.



Valuation arguments are never the best guide to short-term stock market performance. However, valuations often guide how professional investors position between asset classes over the shorter-term. Risks to expected earnings and corporate default levels this year will be a headwind for equities and high yield bonds. Gauges of market sentiment published by researchers like Bank of America show how equity market bearishness amongst institutional investors has been quite high and for quite a long period.

US investment bank Morgan Stanley has noted the discrepancy between institutional investor risk-off positioning and actual market resilience this year. As a result, it has – as of last Monday - altered its short-term investment view back to bullish (as it did last autumn before the last rally), anticipating stock markets could start to rise despite their longer-term bearish outlook.

Morgan Stanley has a point, given many investors are at risk of underperforming their benchmarks because they are weighted towards cash. Being out of the market for an extended period makes those active institutional investors twitchy, so they tend to jump the other way on any sign that market action is not aligning with their expectations – particularly as each (reporting) quarter comes to an end. Being underweight equities is a potentially 'crowded' trade. As we head towards the new tax year, there may be a tendency to want to move back to neutral.

But, of course, we should also acknowledge that there are many good reasons for investors to be fearful, given profits might face a tough time during the rest of the year, which may eventually undermine the enthusiasm of the cohorts of casual investors who are perhaps not as driven by economic data analysis. We write below about the expectations for rate rises in the UK, in Europe and the US over the next two weeks. Compared to a month ago, most investors expect rates to be quite a bit higher by the summer. Of course, this is because economic growth has been more resilient, which should help this quarter's profits to be better than expected.

Nevertheless, those higher rates will stress some weaker companies and more will default than otherwise. For the broad markets, the question then becomes whether this process becomes disruptive for the whole economy, which is when risks shift from being 'idiosyncratic' (company specific) to being 'systemic'. In this context, the most dangerous times are when banks are on the brink.

The news last week that California-based Silicon Valley Bank (SVB) had gotten into difficulties gave the markets a big wobble and might have caused the opposite to what Morgan Stanley was basing its short-term change of strategy on, namely a larger number of investors got a fright that the economy may not after all pull through largely unscathed. We note in the article below that US Federal Reserve (Fed) Chair Jerome Powell's testimony to Congress changed his tone from quite hawkish to somewhat more diffident between last Tuesday and Wednesday. We can assume he would have been informed of SVB's cash call before Thursday's announcement.

SVB is part of a group of companies large enough to be in the S&P 500, so it isn't small. It seems to have been caught up in the cryptocurrency travails after its crypto unit, Silvergate, was shut out of the market. At the same time, SVB is not noted for being a large lender, so it is not likely to be significant in providing liquidity finance to companies and thus being systemically important for the US economy.

Even though SVB's troubles appear entirely idiosyncratic, banks across the board were hit hard last week after a good run this year. Investors will be trying to judge whether banks are still a good thing given the general rise in rates and yields is known to be beneficial for profits, but the negative yield spread between what they have to pay deposit holders (short maturities) and what they receive for longer-term loans is not. Should higher overall yields lead to non-performing loans suddenly ballooning, this all has the potential to turn a positive sector story into quite the opposite. We have been somewhat surprised by this 'sudden' insight in markets, given the negative yield curve spread has persisted for some months now (and so have higher lending costs for businesses). It seems sometimes that many of today's capital market actors still have to get their heads around the dynamics that high yields and higher rates of inflation bring with them.

The Fed's judgement on this seemingly outsized market reaction will be important as it will undoubtedly affect views on future rate moves. Its members have now moved into the pre-meeting quiet period but that only applies to the rate-setting committee, so there may still be information flowing from the Financial Stability section.

Looking back at previous bouts of rate tightening, they have happened before, and one should not over-estimate the immediate impact of such episodes. Equally, last week's events signal that stress is starting to be revealed – a domino has fallen, and others might well get knocked over.

Still, the Fed's rate-setters will also look at another economic news items of last week and may note that the jobs market remains astoundingly strong and wonder when the weakness of Californian tech-related entities will mean an easing in the labour market.

For the first time in what seems a very long time, we have had a week where government bond prices have risen while equity prices have fallen. Equities initially would be supported on the valuation side by the fall in yields (the opposite of what happened last year, when yields rose and rose) but the concern that crept in last week was: when will it be more important if profit forecasts are downgraded because of emerging stresses? Certainly, it is possible that these first cracks in the wider credit markets have increased the systemic risk level, and much will depend on the views of the (somewhat unknown) group of risk overweight investors over this week. For the moment, they seem to be more inclined to hold on to their conviction of inflation-beating longer-term returns from equities and look beyond the shorter-term pain of stagnating and temporarily falling corporate earnings. We feel the coming weeks will prove quite insightful for us with regards to which of the market sentiment sides will succeed in this year's market wrestle.

Central bank watch: March rate hikes await

Despite the flare-up of worries regarding smaller tech-focused US financials from Silicon Valley, spring rate rises are on the cards this month. Over the next 14 days, the European Central Bank (ECB), the US Federal Reserve (Fed) and the Bank of England (BoE) have their respective rate setting meetings. In Asia, the Bank of Japan (BoJ) convened on Friday 10th March, for what was Haruhiko Kuroda's last outing as governor. Perhaps because it was more of a ceremonial meeting, it was brief, and no change resulted. Interestingly though, despite recent expectations of removing the yield curve control policy (to do so would be a form of tightening), the BoJ statement pointed towards signs of growth weakness. That makes it the outlier of the group.

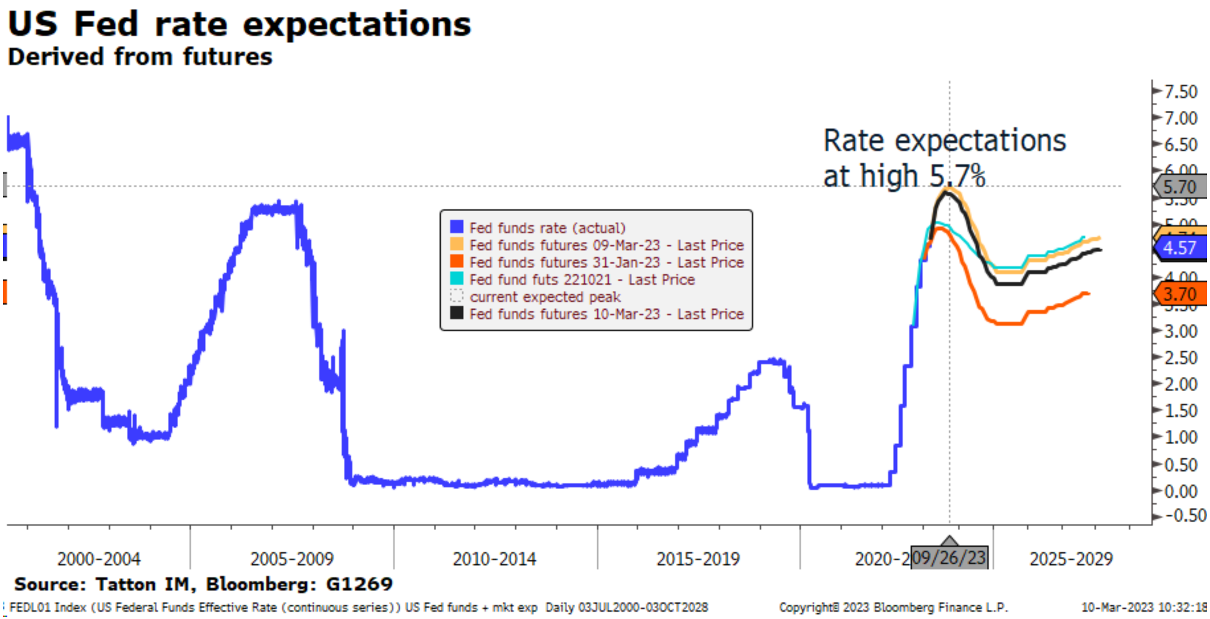
In the US, UK and Europe, hawkish policy moves to further reign in growth to fight inflation are expected. In this latest round of the great inflation fight, all three western central banks are likely to raise benchmark interest rates. We survey the lead-up to these important meetings here.

Fed

Fed leaders are used to their words being heavily scrutinised. For Chair Jerome Powell, this meant recent appearances before the House of Representatives and Senate. His remarks to lawmakers – that the US economy was running stronger than expected, which may necessitate tighter measures than those currently pencilled in – shifted near-term US interest rate expectations (yellow line in chart below, versus the orange line).

It was interesting that Powell's tone changed from urgently hawkish when talking to the Congressional Committee to more diffident the next day before the Senate Committee. The difficulties facing the Silicon Valley Bank had become apparent and, inevitably, banking resilience is at the heart of the Fed's existence (resulting in the shift to the black line in the chart).

In one sense, his talking points are well-rehearsed: growth continues to come through, consumers are resilient and – above all – the US labour market is extremely tight, with all these factors skewing inflation risks to the upside.



The surprising part is that Powell still has to say this after a year-long campaign of monetary tightening. Since May 2022, US short-term interest rates (as measured by the secured overnight rate) have gone from barely above zero to nearly 4.55% (blue line in the chart). The 5% barrier will probably be breached after the 22nd March meeting. This has been the root of the almighty upset in bond markets and general capital market pains last year. Yet, the effect on the underlying economy has been surprisingly small. The US, along with the rest of the world, is clearly growing at a slower pace than it was from late 2021 to early 2022. But its resilience – particularly the jobs market – has been confounding most economists.

At the end of last month, a slew of data releases showed inflation pressures were still very present in the world's largest economy. For all the talk of looming recession, the US economy still added jobs in January, while retail sales were strong. The Fed's preferred inflation measurement, the personal consumption expenditures (PCE) price index, rose 0.6% in January, up from a 0.2% increase in the previous month. With these improvements, markets began to suspect the Fed might have to resume its aggressive tightening. And after Powell's comments to Congress, implied market expectations are now of a 0.5% hike in March, speeding up again after the previous 0.25% rise. Thereafter rates are expected to continue to rise at least another 0.5% by June.

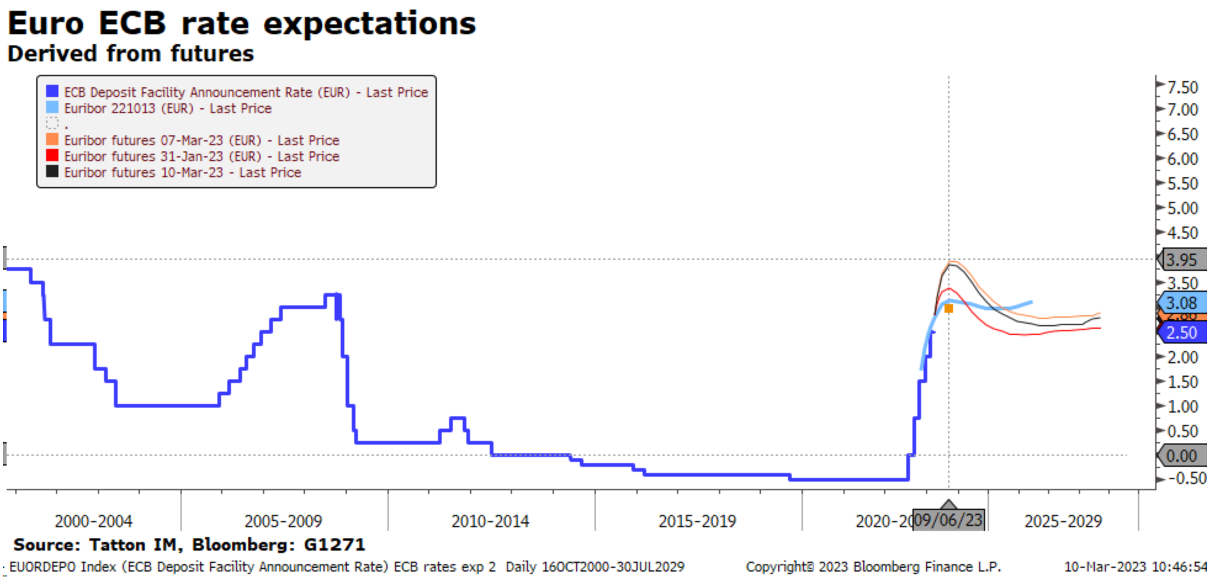
Bloomberg Economics thinks that the 22nd March rate hike is more likely to be 0.25%, citing unknowns in the most recent data, monetary policy lags and the presence of more dovish (preferring lower rates) members than Powell on the Fed's policy committee. Their view will be enhanced by the new information about Californian banking troubles. Also, it may well be that February data, when released, shows a slightly cooler economy than in January.

We nevertheless think the Fed will want to send a signal with a 0.5% hike, at least for this meeting, and that is what money markets expect as well. The data we already have is enough to make members think they must do more to contain inflation. As ever, they will look intensely at the labour market, which is still stubbornly strong. They will also be wary of consumer and business confidence, which has rebounded after the recent fall back in global input prices.

Interestingly, the BoE's own Catherine Mann pointed out last week that the Fed still has leeway to tighten policy by different means than interest rates, via its balance sheet reduction (Quantitative Tightening/QT). Considering the move downwards in long maturity bond yields this year, QT could be a more effective – and potentially less disruptive – way of containing inflation. We note that the actual monetary effect of such a move – in terms of central liquidity – would probably be quite small. The symbolic effect would nonetheless be large and could have a big effect on bond and equity markets.

ECB

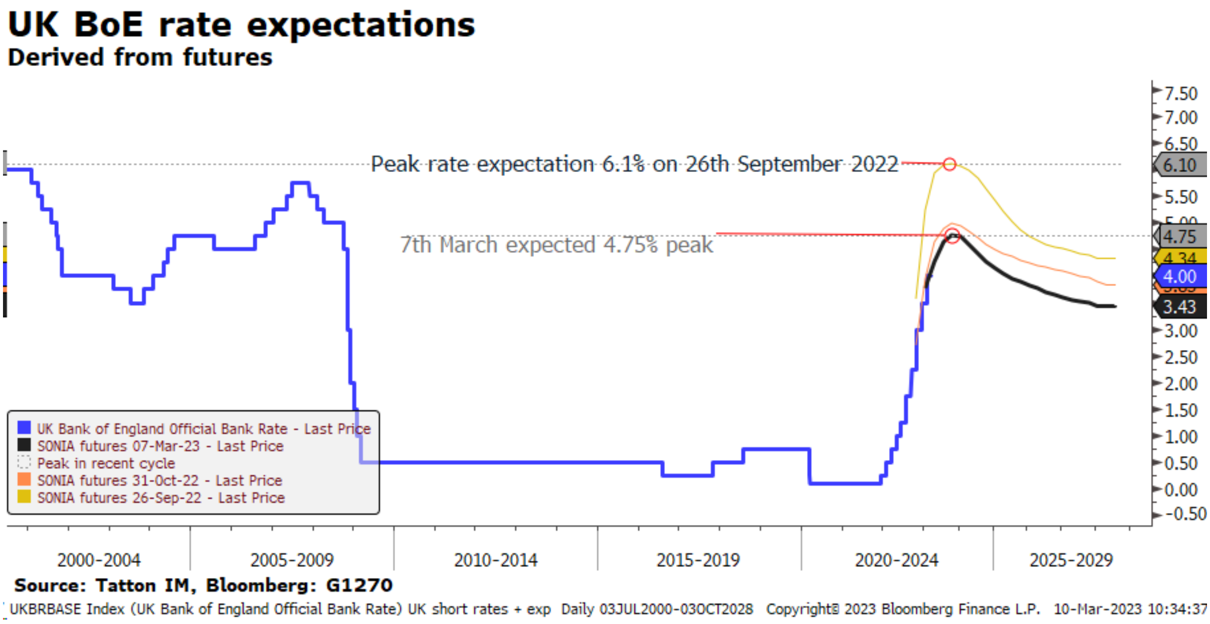
The ECB will be the first of the three major central banks to convene this month on Thursday 16th March and is also expected to deliver a 0.5% rise. This had already been signalled at its last meeting, and little since then has challenged these expectations. In fact, like the US (though to a lesser extent), the EU economy has been surprisingly resilient. Consumers and businesses are buoyed by the fall back in energy prices, while Eurozone unemployment is still close to its lowest ever levels.



We do not expect these movements to make the ECB more hawkish than it already is though, in any material sense at least. Growth and domestic demand are strong, but this is offset by falling energy prices. Given energy – and input costs more generally – were Europe's biggest direct inflationary pressure, price action this year has brought respite. This has also been helped by an increase in the value of the euro, making imports cheaper.

Markets currently expect the ECB's terminal rate to be 4%, implying cumulative rate rises of 1% after the end of March. If anything, we suspect this might be a difficult target to reach. Growth is much more fragile in Europe than in the US, and its businesses are much more sensitive to short-term interest rates. If anything, once European rates go higher than 3.5%, we might hear calls to maintain or even loosen monetary policy from the business sector. The ECB are not done raising rates, but that situation might not last for long.

BoE



While interest rate expectations have climbed in the US, the UK has moved in the other direction. Like Europe, this is largely down to external factors, with energy prices no longer the burden they were last year. That has led to a belief – shared by some BoE members – that inflation may have already peaked in Britain. This peak will not yet be felt by households but will eventually filter through. Accordingly, consumer and business confidence has improved a little lately.

Even better, these improvements do not come with any significant added inflation pressures. Peak UK rate expectations are now at 4.75%, substantially lower than the 6% terminal rate implied by markets last September. That outlook was a result of the bond market mayhem that came with Liz Truss' mini-budget 'experiment' that doomed her premiership, so some pullback was always likely. Nevertheless, peak expectations are now substantially lower than in the US, which is an astounding turnaround.

Reportedly, BoE policymakers are currently debating whether to undershoot those market expectations. The last rate-setting meeting had two dissenting votes, and last week an external member of the BoE publicly made the case that rates should be held at the current 4% level. These are all improvements, but we should not be under any illusion about the UK economy at large. The reason rates can be lower in the UK is because the internal growth impetus (which is generating inflation in the US) is just not there. Less inflation and lower-than-expected rates are a silver lining, but sadly nobody should interpret this as strength.

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13th March 2023

Global Equity Markets

Market	Fri 14:31	% 1 Week*	Technical: % 1 Week in sterling terms	Technical: Short Medium	Valuations: Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7741	-2.2	-2.2	→ ⬀	4.3	10.3	10.3	13.4
UK FTSE 250	19353	-2.6	-2.6	⬂ →	3.5	13.3	12.4	0.0
UK FTSE All-Share	4223	-2.2	-2.2	→ →	4.1	10.5	10.5	0.0
UK FTSE Small	6283	-2.6	-2.6	⬂ ⬂	3.9	10.3	10.8	0.0
France CAC 40	7215	-0.4	-0.9	⬀ ⬈	2.9	12.2	12.5	0.0
Germany DAX 40	15421	+1.1	+0.5	⬀ ⬀	3.6	11.7	11.5	0.0
US Dow	32149	-1.7	-2.7	⬂ →	2.2	17.1	16.4	0.0
US S&P 500	3907	-0.6	-1.6	⬂ ⬂	1.8	17.7	17.5	0.0
US NASDAQ comp	11308	+0.2	-0.8	→ ⬂	1.0	25.1	24.6	0.0
Japan Nikkei 225	28144	+0.8	+0.9	⬈ ⬀	2.1	16.5	16.3	0.0
World Bloomberg	1453	-0.6	-1.6	⬈ ⬀	2.5	13.3	13.1	0.0
China mainland	3967	-4.0	-5.1	→ ⬂	2.2	16.1	15.9	0.0
Emerging Bloomberg	1091	-1.7	-2.7	⬊ →	2.4	11.8	11.5	0.0

Top 6 Gainers: Company	%	Bottom 6 Decliners: Company	%	Fixed Income: Govt bond	%Yield	1 W CH
Flutter Entertainment	+5.8	Admiral	-11.9	UK Govt 10yr Gilt	+3.60	-0.28
BT	+4.3	Ocado	-11.2	UK Govt 15yr Gilt	+3.89	-0.29
United Utilities	+4.0	Barclays	-9.6	US Govt 10yr Treasury	+3.75	-0.32
Informa	+3.9	Beazley	-8.9	France Govt 10yr OAT	+2.96	-0.25
Rolls-Royce Holdings	+3.4	Pearson	-7.7	Germany Govt 10yr Bund	+2.46	-0.28
National Grid	+3.2	British Land Co	-7.4	Japan Govt 20yr JGB	+1.21	-0.02

Currencies: Pair	last	%1W	Commodities: Cmdty	last	%1W	UK Mortgage Rate Estimates: Rates (LTV c.75%)	10-Mar	08-Feb
USD : GBP	1.205	+1.0	Oil Brent $:bl	81.7	-3.2	UK BoE base rate	4.00	4.00
GBP : EUR	0.884	-0.5	Gold $:oz	1850.3	+0.9	2yr fixed	5.90	5.17
USD : EUR	1.065	+0.5	Silver $:oz	20.6	-0.6	3yr fixed	5.76	4.92
JPY : USD	135.33	-1.1	Copper $:lb	404.2	-0.9	5yr fixed	5.55	4.69
CNY : USD	6.935	+0.2	Alumnm $:mt	2283.0	-3.4	10yr fixed	5.43	4.87
USD : Bitcoin	19,996	-14.2	S&P soft crops	227.7	-0.9	Standard variable	7.02	6.66

10/03/2023
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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13th March 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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