CAMBRIDGE
INVESTMENTS LIMITED

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Rate rises bouncing off 'Teflon' markets

Equity markets continue to be buoyant after the rate rises in Europe and the US. Some market participants have been calling this the 'Teflon market' because nothing sticks to it. We would rather think of it as a sort of running machine; no matter how steep the incline of the treadmill, markets seem able to keep running upwards.

We look at last week's rate rises – and where they leave rate expectations – in a separate article below, and we also touch on Thursday's Bank of England Monetary Policy Committee (MPC) meeting. Expectations remain for rate rises in the UK of 0.5% to 0.75% by the end of the year, with a 0.25% hike this week.

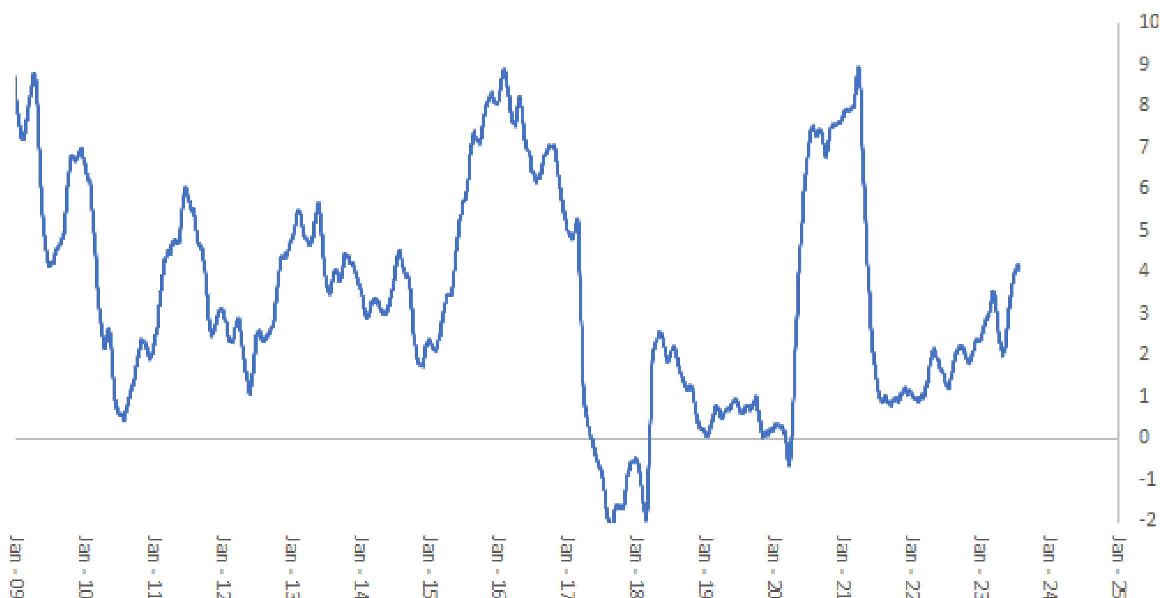
Last week, the central banks of the US and Eurozone – the Federal Open Market Committee (FOMC) and Governing Council of the European Central Bank (ECB) – both delivered as-expected rate hikes of 0.25%. Opinions are divided as to whether another increase will take place at the September meetings.

In Europe, credit conditions remain very difficult for smaller firms. The ECB's second quarter survey of banks tells us they are worsening in this third quarter. A similar situation is at play in the UK. The US bank survey is due out this week and may tell us that regional banks are also reluctant lenders.

However, credit conditions for the larger, more global firms seem to be generally improving. It has been a remarkable thing, watching their credit spreads come down. While the interest rate cost on newly issued debt is still way higher than debt taken on before the pandemic, there is no sign of a squeeze in the usual definition. Companies might have to pay a higher interest rate, but equally there are many investors willing to be providers of capital.

Indeed, we looked at the amount of debt in the Bloomberg Barclays US Corporate Aggregate Index (using the nominal or "par" value of those bonds). Below is a graph showing the year-on-year growth rate:

Year-on-year growth in US corporate debt "par" value



Source: Tatton IM, Bloomberg *27-Jul-2023*

We have considered the state of the corporate bond market previously and made the assertion that the increase in the interest cost of financing would be prohibitive, and that this would precipitate a reduction in the size of the market – essentially firms would choose to de-lever. Well, they could be reducing the relative size of debt in comparison to their reasonable revenues and profits. And overall, corporate debt has definitely declined relative to the size of the overall economy. However, in absolute terms, US corporate bond debt is increasing at a good clip. On a three-month annualised basis, it is growing at nearly 17%, and has been through the past three months.

We find this outcome really quite surprising. It may prove to be fairly short-lived, but it does suggest there is a solidity to corporate and confidence that isn't coming through in data such as the Purchasing Manager Indices (PMIs). Equally, the US gross domestic product (GDP) data showed good real growth (+2.4% annualised) and declining inflation (+2.2% annualised), with employment costs edging down to about +4.1% annualised. Consumption growth was mild, but consumer confidence continues to improve and is definitely stronger than surveyed corporate confidence. Could it get better?

One thing to note is that finally, and despite the decline in credit spreads, corporate financing rates are higher than the 4.6% annualised nominal growth rate. Beforehand, revenues were rising because of inflation, even for those companies that were not so competitive. Now we're into a period where inflation isn't high enough to bail those companies out. This applies to the US, but real growth is weaker in Europe and the UK, and although inflation appears stickier, overall nominal growth is coming down fast to meet the financing costs.

In a separate article, we give some thoughts on US and Europe company earnings at the halfway point through the season. Analysts seem to be indicating reasonable demand growth in US, more tepid in wider Europe, with margins in both areas under a bit of pressure. However, Eurozone margins have been in better shape. Generally, margins were reasonably stable (after taking out the highly cyclical energy and materials companies). It will be interesting to see how they hold up though the rest of the year.

The tech company earnings continue to support their high valuations and suggest they are benefitting from the sharp uptick in corporate capital expenditures, which comes from government-led policies in both the US and Europe. It is way too early to ascribe the profits to an artificial intelligence (AI)-led boom. As Bloomberg put it: "Google parent Alphabet Inc., Meta Platforms Inc. and Microsoft Corp. certainly talked about AI, but their post-report share moves showed investors are still primarily focused on the businesses that make them the most money — and that clearly won't be AI for a while."

Talking of monetary policy changes, one central bank seems to be starting a tightening process. Last Friday (28th July), the Bank of Japan indicated it would allow greater latitude in its "yield-curve-control" policy. The 10-year bond yield shot up. Actually it rose by 0.07% which, for hardy UK gilts investors, is a normal day. Japanese monetary policy will remain supportive. However, there are said to be quite a few hedge funds that have been buying local currency emerging market bonds and borrowing in (unhedged) Japanese yen. This 'carry' trade is fine as long as the JPY doesn't strengthen sharply. Of course, should many of them exit their trades, it could easily strengthen a lot.

Lastly, at the start of last week, Chinese markets rose sharply and maintained their early gains. After months of rumoured policy action, the leadership or "politburo" said something would happen, and despite few

details at least there was no doubt that action is intended. Most analysts do not expect the sorts of huge support measures seen at crisis points but, equally, the risks of instability have also diminished. It would be unusual for Chinese markets to head gently higher (rather than shooting upwards or plummeting downwards) but the circumstances suggest it might happen this time.

Peak rates: are we there yet?

Last week was an historic week for central banks. The US Federal Reserve (Fed) raised its benchmark interest rate to a range of 5.25-5.5%, the highest level in 22 years. The European Central Bank (ECB) followed last Thursday, also raising by 0.25% and matching its highest-ever rate of 3.75%. Both central banks left the door open for further action too. Despite the slowing pace of goods prices, monetary policymakers on both sides of the Atlantic are still wary of underlying inflation pressures and were coy about whether subsequent meetings would see further hikes.

Both rate rises broke new ground, but neither were surprising. The ECB's ninth consecutive hike was telegraphed far in advance, following warnings last time out that the Eurozone economy needed further cooling. The post-decision statement said that "Inflation continues to decline but is still expected to remain too high for too long", and that future decisions will be "data-dependent".

However, the statement's most notable assertion was about the effectiveness of its policy transmission through the economy: "The developments since the last meeting support the expectation that inflation will drop further over the remainder of the year… The past rate increases continue to be transmitted forcefully: financing conditions have tightened again and are increasingly dampening demand, which is an important factor in bringing inflation back to target."

ECB President Christine Lagarde was downbeat in her press conference, talking of a "deteriorated" economic outlook and that its decision-making Governing Council is open minded on another potential hike in September. Indeed, had the ECB softened its "too high for too long" theme, the rhetoric would sound as if it was biased towards easing.

The ECB's concentration of financial conditions was undoubtedly influenced by the second quarter ECB euro area bank lending survey, which confirmed credit conditions are tight for households, tighter for businesses and are still on a tightening path. In other words, things are tough. Investors took this onboard quickly and markets now expect no further rate rises, even after the release of relatively buoyant French gross domestic product (GDP) data last Friday, which the ECB will have seen beforehand.

The Fed's hike was also expected, but there were rumours that the Federal Open Markets Committee (FOMC) might already be finished in its cycle. The Fed paused at its last meeting and economic data has weakened since then, leading to minority suggestions of no change.

FOMC members unanimously voted for a rise nonetheless, though Chair Jay Powell noted growth had slowed. The FOMC pointed to labour market tightness and still above-target inflation as causes of concern, but the economy overall is growing "at a moderate pace". Some took this as mixed messaging since, in normal times, "moderate" growth would usually mean growth which is not inflationary. Now, the Fed is

suggesting something a little different: growth is around the mark usually seen as "potential" – thanks to a recent and notable slowing in consumption– but the supply-side is still too strongly tilted towards tightness (labour tightness and long-term under-investment in infrastructure).

Apart from indicating the rate rise, July's statement was almost completely unchanged from June's, albeit the descriptor of growth became "moderate", replacing "modest". Fed-watchers love to dissect every word from Powell or his team, but trying to differentiate between moderate and modest is surely over-analysis. The statement still indicates the bias towards additional firming of policy.

The hawks (those wanting higher rates) see the economy as still too hot, whereas the doves (wanting lower rates) see signs that things are cooling. In the FOMC, the two camps are evenly divided, although a noted hawk (James Bullard) said he will step down before the 20 September meeting. Economists at many of the large financial institutions have suggested last Wednesday's hike will be the last of the current cycle, and only a few still predict another rate rise in September. Implied market expectations still point to a closer call, though. Highly rate-sensitive bonds, such as short-term US Treasuries suggest just under a 50% chance that rates will go higher between September and November.

In any case, the consensus is that US interest rates are either at or very close to their peak, after which the Fed will hold steady or even loosen next year. This is unsurprising in one sense: inflation itself has come down, particularly 'core' prices excluding food and energy (which the Fed watches closely). As mentioned in a separate article, businesses themselves seem to be implying a disinflationary environment over the short-to-medium term.

The view does, however, seem to ignore what the Fed has been telling us for over a year now. FOMC members are deeply worried about labour market tightness, and at no point have they seen enough to soothe those worries. Moreover, the central bank has consistently got across a clear message that it will tolerate undershooting inflation – and doing collateral damage to jobs – if it means getting prices under control.

This hawkish stance impacts how the Fed reacts to new data. When Powell was asked about the lower consumer price index (CPI) inflation data from June, for example, he played it down as "only one report, one month's data". But this is a harsh way of characterising things. While certain measures have only started coming down close to target, other important measures – including the Fed's core non-housing services inflation – have been trending down strongly for months. The Fed is well aware of this of course but knows that saying so out loud would get everyone excited about a halt to rate rises.

There are also longer-term considerations. Implicit in the peak rates view is the idea that the global economy will return to its pre-pandemic pattern of lower growth and low inflation. As we have often pointed out, this is unlikely given the return of labour pricing power and the reaction of company profit margins. The resurgence of the unions, as evidenced by the US Teamsters Union latest pay deal with UPS, suggests the genie is out of the bottle.

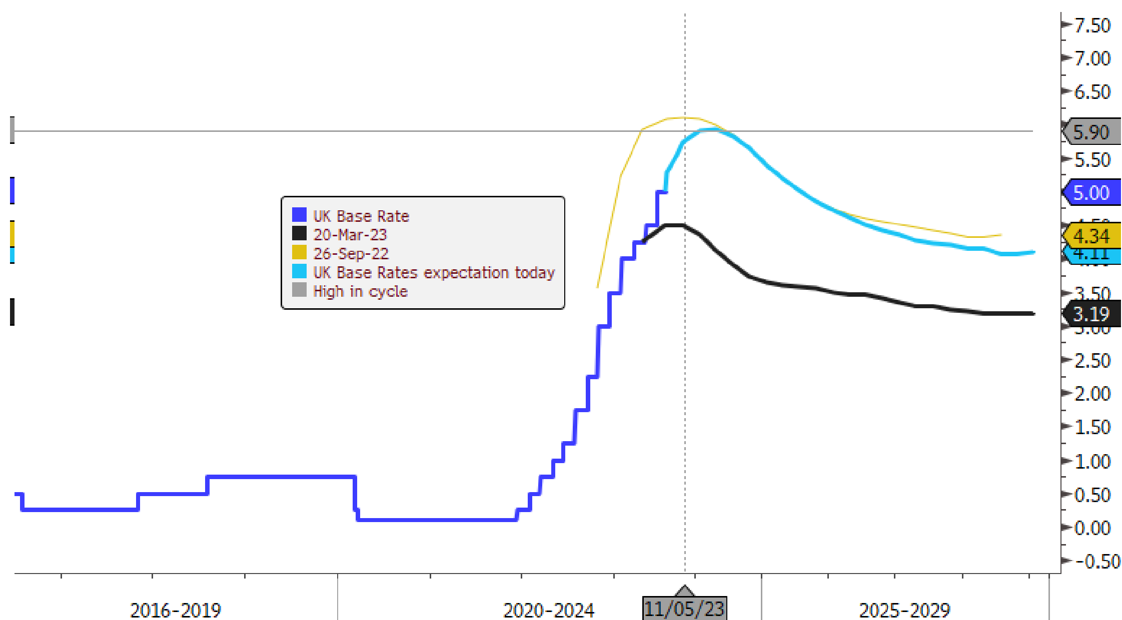
Despite the usual rhetoric, it is debatable how much wage rises directly feed through to inflation over the long term. They do, however, directly feed through into housing demand and – as private renters will be painfully away – housing demand has a huge impact on consumer inflation. That is both in terms of its direct impact to costs (for both businesses and consumers) and the large psychological impact on inflation

expectations. House prices have already started rising again after a brief reprieve – and the Fed will be very wary of this.

The situation is somewhat different in Europe. Despite inflation lingering longer in terms of headline figures, the underlying inflation pressures are weaker. This is not to say they are not there; as noted before, the tightening of labour markets in peripheral European Union (EU) nations is a concern. But the underlying European economy is just much weaker than the US, meaning price rises are tougher to sustain. We agree with the market that last week's ECB hike is the last for some time, although rates may not come down for some time.

Finally, we turn to the Bank of England's Monetary Policy Committee (MPC) on Thursday. Europe faces already tight monetary conditions and a slowing economy, and the same is true for the UK. The complicating factor for us is the severe structural supply-side shortages associated with Brexit and public infrastructure, which shifts the balance from real growth towards (measured) inflation.

As the below chart shows, UK rates are still expected to rise by 0.25% this week (3rd August), then again by 0.25% on 21st September and a final 0.25% around the year-end, before heading lower next year.



But the central bank meeting that matters most could well be the symposium taking place at Jackson Hole, Wyoming, next month. Like the previous meeting at Sintra, Portugal, these are important because they help central banks to understand how their own actions impact each other, and they have often set the tone for policy decisions some months ahead.

Finally last week, Chinese markets rose sharply and maintained the early gains. After months of rumoured policy action, the leadership or "politburo" said something would happen - details were typically few, but at least there was no doubt that action is intended. Most analysts do not expect the sort of huge support measures seen at crisis points but, equally, the risks of instability have also diminished. It would be unusual for Chinese markets to head gently higher (rather than shooting upwards or plummeting downwards) but the circumstances suggest it might happen this time.

Q2 earnings season update

Corporate earnings reports give companies the chance to put their money where their mouths are. Halfway through the current reporting season, positive results would go some way to soothing investors' lingering concerns. Economists see global growth as slow, financial conditions as tight, and the hoped for rebound in China being anaemic.

But this negativity can hardly be seen in capital markets. Stock markets in the US and Europe are significantly up this year. Optimists say this is a sign of resilient markets; pessimists say it means valuations are too high and ripe for a pullback.

While every earnings season is full of upbeat stories, the analysts' updates to their earnings forecasts have been a bit downbeat. Half of US companies were set to report earnings by the end of last week, and analyst projections have been cut somewhat in the last few weeks. Current expectations are for a 12% fall in Q2 earnings per share (EPS) for S&P 500 companies compared to a year earlier, with European companies seeing a 17% fall (according to JP Morgan). Full-year growth rates are also negative across both regions.

Stock market reaction has been fairly muted, though. Tech-related news has buoyed the larger companies, and the S&P 500 staying strong for much of last week. On a company-by-company basis, headline figures are less good. Energy and materials sectors are seeing sharp earnings expectations. Compared to the same period in 2022, one of the most significant changes in the global economic picture is lower falling commodity prices – thanks to an unwinding of the 2022 input price boom. Earnings projections are significantly improved when filtering out commodities, with median EPS expected to be basically unchanged from a year ago.

Those are the expectations, but actual results can differ quite a lot. Historically, there is a tendency for companies – particularly in the US – to gradually revise down expectations only to beat them and get a sentiment boost to share prices. That is exactly what we saw in the first quarter of this year and, as mentioned, analysts have been steadily cutting back expectations for a while. This sets the scene for a number of positive surprises, especially given the improvement of economic sentiment through Q2. Out of companies reporting already, most beat expectations in both the US and Europe.

US aggregate EPS growth is expected to be buoyant over the next 12 months compared to just-announced results, but that's because recent results have been disappointing. The last 12-months' earnings are running at about -3% versus the previous 12 months. That includes the mentioned dip for Q2 and a similarly weak Q3, before earnings come back up into the turn of the year. This is fairly unsurprising given the challenging economic environment. The interesting part is the divergence between sales and profit expectations. Sales are expected to hold up well, but analysts are cutting back margin expectations. This effectively means

businesses expect prices to be stagnant or lower. If so, we would be braced for a bout of disinflation, a far cry from what we have seen over the last two years.

The situation is a little different in Europe. Margin expectations have come down but are slightly positive after being under pressure for most of the year. Notably, sales expectations are also negative. This reflects the weaker position of European consumers relative to US counterparts, but it could also mean that prices stay elevated (even if not rising with the force they were) over the next few months. Eurozone economic data has worsened recently. Business sentiment surveys for both manufacturing and services sectors are weak. Services are also under pressure in the US, but manufacturers are positive about the future and PMIs (purchasing managers indices) point towards expansion.

Even so, the undoubted weakness of the global economy – compounded by continued disappointment from China, one of its most important growth engines – means there is room for interest rates to fall. In particular, the fact that businesses are signalling disinflation will give the Fed and the ECB (if not the BoE) pause. As noted in the previous article, central banks all remain concerned about the tightness of their labour markets but weaker profit margins help alleviate those concerns, and profit margins are the flipside of wages as far as inflation spirals go.

The Fed and other central banks are likely to give more conciliatory messages at September's meetings, which will help to bring down rate expectations and government bond yields. This will help equity valuations (in terms of price-to-earnings ratios), since falling yields mean more attractive stocks. Valuation support is crucial since, as we can see, earnings results and projections themselves are giving little to get overly excited about.

There is a worry that valuations cannot go much higher, given the strength of the US stock market this year and the weakness in earnings. But the performance of US equities is misleading. The S&P has gained nearly 20% in dollar terms year-to-date, but almost all of this has been driven by booming share prices for just eight companies. These are mostly the technology mega caps, who have been aided by the incredible boom in artificial intelligence (AI)-related investment.

One can certainly argue that those stocks – and US tech more widely – is overvalued. But the rest look in a much better position. Non-tech companies have lower earnings expectations and relatively muted valuations. The low bars for both mean that positive surprises and momentum are likely. If so, the stock market rally could become more broad-based – a welcome improvement.

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31st July 2023

Global Equity Markets

Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Technical Short Medium	Valuations Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7691	+0.3	+0.3	→ →	4.1	11.2	10.9	13.3
UK FTSE 250	19122	-0.6	-0.6	→ ⬂	3.5	12.8	11.7	14.6
UK FTSE All-Share	4193	+0.2	+0.2	→ →	4.0	11.3	10.9	13.5
UK FTSE Small	6268	+0.6	+0.6	→ ⬂	5.0	9.6	7.7	12.7
France CAC 40	7456	+0.4	-0.9	→ →	3.1	12.8	12.4	14.1
Germany DAX 40	16442	+1.8	+0.5	⬀ ⬀	3.5	11.7	11.1	12.9
US Dow	35470	+0.5	+0.5	↗ →	2.0	19.5	17.7	16.5
US S&P 500	4571	+0.5	+0.5	↗ ⬀	1.5	21.1	19.7	17.6
US NASDAQ comp	14196	+0.4	+0.4	↗ ↗	0.8	30.9	27.4	23.0
Japan Nikkei 225	32376	+0.1	+0.7	↗ ↗	1.9	18.8	18.1	16.8
World Bloomberg	1639	+0.7	+0.7	↗ ↗	2.3	14.2	13.8	13.8
China mainland	3993	+4.5	+4.8	↗ ⬀	2.0	18.2	17.3	16.4
Emerging Bloomberg	1165	+2.7	+2.6	→ ⬂	2.5	12.7	11.6	12.0

Top 6 Gainers

Company	%
Ocado	+40.5
Rolls-Royce Holdings	+24.5
Entain	+8.2
Airtel Africa	+6.7
Antofagasta	+6.2
Smurfit Kappa	+5.8

Bottom 6 Decliners

Company	%
St James's Place	-18.0
SSE	-6.2
Hargreaves Lansdown	-5.4
Barclays	-5.2
Compass	-4.5
Endeavour Mining	-4.2

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.35	+0.08
UK Govt 15yr Gilt	+4.54	+0.09
US Govt 10yr Treasury	+3.98	+0.17
France Govt 10yr OAT	+3.02	+0.05
Germany Govt 10yr Bund	+2.49	+0.04
Japan Govt 20yr JGB	+1.15	+0.07

Currencies

Pair	last	%1W
USD per GBP	1.285	+0.0
GBP per EUR	0.856	-1.2
USD per EUR	1.100	-1.2
JPY per USD	140.44	-0.7
CNY per USD	7.159	-0.3
USD per Bitcoin	29,288	-1.9

Commodities

Cmdty	last	%1W
Oil Brent $:bl	83.7	+4.2
Gold $:oz	1954.1	-0.5
Silver $:oz	24.2	-2.0
Copper $:lb	391.1	+2.8
Alumnm $:mt	2173.8	+0.1
S&P soft crops	241.0	-1.1

UK Mortgage Rate Estimates

Rates (LTV c.75%)	28-Jul	28-Jun
UK BoE base rate	5.00	5.00
2yr fixed	6.46	4.73
3yr fixed	6.13	4.51
5yr fixed	5.64	4.29
10yr fixed	5.36	4.46
Standard variable	7.54	7.44

28/07/2023
Prices taken at 2:30pm today and 2:30pm last Friday (where possible)
Bloomberg equity indices are similar to those published by MSCI
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of next 12 months earnings as forecast by analysts
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

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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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