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Lothar Mentel

Lead Investment Adviser to Cambridge

To yield or not to yield

Last week, stocks and bonds were still bruised from the 'hawkish pause'. The US Federal Reserve (Fed) announced last Wednesday that it would hold interest rates steady at 5.25-5.5% but threw in some stern forward guidance to dispel any doubts it might be easing off. Fed Chair Jay Powell's talking points were much the same as they have been for the better part of two years: the US economy is still strong, inflation is too high, and consistently tighter monetary policy will be needed for the foreseeable future. The central bank backed up its words with its 'dots plot' projection that showed another rate rise this year and holding steady in 2024. It was a reaffirmation of Powell's commitment to keeping rates higher for longer.

Bond yields spiked on the back of the news. Ten-year US Treasury yields touched above 4.5% during early Friday trading – the highest level in 16 years. The move up in risk-free rates naturally makes equities look less attractive by comparison, sparking a sharp drop off in the S&P 500. There are concerns that equity valuations in terms of price-to-earnings multiples look vulnerable, especially after such strong performance for most of this year. Longer-term growth assets – typically more sensitive to interest rate moves – are therefore under threat again. With sluggish global growth all limiting the upside of company earnings and a 'higher for longer' monetary policy, investors are starting to wonder whether fixed income assets like bonds, with their now attractive yields, are better value than stocks.

As ever, there are both positives and negatives to draw from this. The pressure on equity valuations last year was an overheating inflation story, whereas this year the issue is more precisely real (inflation-adjusted) bond yields. Central banks move these up to compress growth potential and cool the economy – as the Fed has made clear it is doing – and so they can obviously be hard to cope with in the short-term. On the other hand, real yields moving so high and staying there without immediate economic detriment suggests that the 'equilibrium rate' at which growth is neither helped nor hindered has increased. That effectively means markets or the central bank expect stronger growth and dynamism over the long term.

The Fed clearly feels it underestimated the equilibrium rate in the past, backed up by the surprising resilience of US businesses and consumers. It is now apparent companies can generate higher medium-term returns in this tight financing environment than anyone previously thought, which justifies keeping borrowing rates high. But at the same time, higher rates inevitably hurt those that rely on financing – as happened for firms with lower credit ratings last year, and as anyone having to remortgage soon will be keenly aware.

US tech stocks embodied this mixed outlook. As long duration assets (pay back only far down the line), it is no surprise that tech valuations would be knocked by a move up in forward rate expectations, especially considering they were arguably already stretched. But the Artificial Intelligence (AI) investment craze is predicated on the longer-term earnings potential that comes from innovation and productivity enhancements. Those themes are unaffected by short-term yield moves which is why, despite a noticeable pull back in tech last week, stock prices are still comfortably up year-to-date and well above the depths of 2022. We talk more about tech in a separate article.

That is a sector-specific story, but the take-home message applies to all risk assets. Even though, in the current environment, it looks like bonds offer equal returns with fewer risks than equities, ultimately the long-term earning potential – and specifically above-inflation returns – will always be skewed toward riskier assets. Moreover, judging when things will turn is practically impossible to call, particularly in the unchartered waters of post-pandemic monetary policy. The prudent thing to do in these cases is usually to just focus on the long term.

That being said, there is certainly a short-term case to be made for bonds. Having gone through the sharpest rate rise cycle in a generation, it is incredible how many market players have been able to keep going despite the negative returns on carry trades (coming from the inverted yield curve – short rates being higher than long rates). But this becomes less sustainable the longer 'higher for longer' goes on. That could spell trouble for borrowers and volatility down the line.

Then there is the fact that oil prices have increased so sharply, rising above $90 per barrel (pb) in the last few weeks. When crude oil prices shot up last year, those higher prices were sustained by the fact there was so much capital around – pushing up inflation in the classic sense of lowering the value of money. The current oil spike, on the other hand, is very clearly a case of supply manipulation and producer pricing power. In that sense it acts as a tax on growth – as we discuss in a separate article below. Over the medium-term, we should expect higher oil prices to have the same effect as rate rises.

In which case, we would expect yields (and oil) to come down – thereby making the current low bond prices look attractive. This is already happening in the UK, where inflation is finally on a clear downward path and growth prospects are dwindling. The Bank of England also opted to hold interest rates steady last week, but unlike the Fed there was no real suggestion of further tightening ahead. Sterling sank to a six-month low which, together with higher oil prices, will boost headline inflation in the short-term. But gilt yields continue to fall back, a recognition that core inflation (stripping out volatile elements like food and energy) will likely be pressed down by these developments.

Britain's bond and currency movements have meant its stock market has actually led the way this month. Returns are less impressive when we take currency effects into account, but overall things look stable for sterling investors, with less pressure on equity valuations. Lower yields are, of course, a consequence of lower growth prospects, but they will be a big help for businesses and consumers. The US, by contrast, faces tighter conditions but better economic prospects. Each case might will be unpleasant for some, but neither should cause panic.

Trojan Horse tech

The Artificial Intelligence (AI) theme is hard to get a handle on from an investment perspective. In one sense, the potential for generative AI to aid countless people and businesses is obvious. But in another, the stock market boom for AI-related companies has at times looked like irrational exuberance. We are not at dotcom levels of hype (yet), but 'machine learning' and 'language models' have reached corporate buzzword status. Are these new technologies a revolution waiting to happen, or a bubble waiting to burst? Answering that question requires a deep understanding of both the intricacies of cutting-edge computer science and financial markets – areas that unfortunately tend to have little overlap.

The heart of the issue is how to properly value innovation, which is by its very nature unpredictable. Tesla, for example, has a market capitalisation of $847.58 billion at the time of writing.

That is higher than the market cap of the next ten most valuable car companies combined. But it ranks eighth among the world's carmakers for revenue, with turnover a little over a quarter of Volkswagen. As a specialist electric vehicle (EV) carmaker, revenues are expected to grow substantially over the next decade. But even so, no one realistically expects Tesla to justify the valuation differential over other manufacturers on earnings fundamentals alone, for the foreseeable future at least.

In that sense, it might be easy to conclude Tesla is overvalued. But that assumes we should value the company like we would any other carmaker – albeit an exclusively electric one. There is a strong case to be made that focusing just on car sales – present or future – misses the bigger picture. The computer hardware and software Tesla puts into its cars is unlike any in the past and lays the groundwork for fully autonomous driving if and when it has become safe enough for regulation to allow it. If Tesla really won that race – and other carmakers argue it will not – then it would be much, much more than just the leading EV manufacturer. Such is the nature of investing in innovation.

The larger prize for Tesla could be embedding fully autonomous software and services into nearly all types of transportation and adjacent industries – a market Morgan Stanley estimates could be worth $10 trillion in the future. Viewed from that perspective, revenues from car sales are not the goal but just a means to an end, generating the cash flow needed to invest in long-term expansion.

This is a Trojan Horse-style strategy: entering a new market to fund a longer-term objective of changing the market altogether. The release of Apple's first iPhone had this effect. At the time, RIM's BlackBerry dominated business communications and mobile email, only to be made effectively irrelevant by an all-in-one device that created a new standard for smartphones. In doing so, Apple also condemned their own iPod sales which had been so profitable. As founder Steve Jobs remarked, "if you don't cannibalise yourself, someone else will".

Companies have been working on AI for decades and its potential was never exactly a secret, quite the opposite in fact, given that most of the building blocks are open source. Yet it took the release of ChatGPT with its generative language model to really kickstart the financial push in AI's direction. What changed then was not the technology itself, but the perception of what it could do and how close we might be to world-altering changes.

From a business perspective, the obvious benefits come from productivity growth. This has been one of the hardest things to find for more than a decade, low productivity being one of the key reasons behind the period of low growth following 2008's Global Financial Crisis. Even in big tech, which has long been home to eye-watering stock valuations, there was a feeling some time ago that genuine innovation was lacking – particularly in stagnating markets like smartphones. The AI excitement changed all of that, even if productivity improvements take time to filter through.

Of course, the fact that AI technologies will almost certainly create lots of new revenue streams in the future does not mean all the market valuations, especially on a stock level, are justified. The development of the internet was probably the most significant technological development in living memory, but the fact it was genuinely transformative does not negate the fact that markets got ahead of themselves back in 1999/2000. So much money flowed into companies on the basis of buzzwords alone and, after the dotcom bubble burst, it took nearly 20 years for sector-wide valuations to reach their previous peaks. Certainly, back then, tech companies were missing revenues and earnings, whereas now, tech and platform companies are among the biggest and often cash rich, and debt light.

The AI craze does not look like the dotcom bubble, when anything tech kept rallying. Last week's share price pullback for chip designer Arm, following its successful IPO the previous week, is a good example. The company's revenues are more focused on older tech like smartphones, but its owners SoftBank have certainly tried to play up the (not unwarranted) connection to future technologies involving generative AI and cloud computing. If markets were truly in the throes of irrational exuberance, you would expect even a tenuous connection to the buzzwords might be enough to draw in piles of cash.

The words "generative AI" are certainly good for the share price, but overall market appetite is fairly contained, historically speaking. This has surely something to do with the wider financial backdrop too. Interest rates have risen at the fastest pace in a generation, while global growth and near-term demand prospects look weak. In a way, perhaps this forces markets to make a longer-term evaluation.

The question, as ever, is how businesses will turn the current technologies into future earnings. And of course, knowing *which* companies might do so best would be nice too. Innovation needs funding, and so a certain amount of hype is necessary (even if the funding comes from public sources, ideas need to be sold to policymakers). But overexcitement needs to be contained. Time will tell who the winners will be, and especially whether incumbents will reap the benefits, or whether newcomers can shake up the equity market. For now though, having a 'beacon of hope' for what may generate real growth over the next decade is to be welcomed by investors.

Readers who are intrigued how Generative AI differs from previous IT concepts, may find the attached animated (and free) article published in the Financial Times of interest (including some of the comments underneath the article):

https://ig.ft.com/generative-ai/

Oil rises; inflation comeback or just bump?

Oil's rise since the summer has been impressive. Barely above $70 per barrel (pb) in June, crude prices hit $90pb earlier this month and show no signs of stopping. International benchmark Brent hit $94pb during last Tuesday's trading, the highest level since October last year, when markets and the world economy were still reeling from the Russian war shock. Higher oil prices can be tough at the best of times but are a major headache for central bankers fighting stubbornly high inflation. European Central Bank (ECB) President Christine Lagarde specifically referenced higher commodity prices when it unexpectedly raised interest rates two weeks ago.

Wider commodity markets are not really the issue, though. One of the most notable things about the summer's oil rally is how disconnected crude prices have become from other commodities. Metals, for example, have stayed steady, thanks to slowing global growth and hence weaker demand. But for oil, supply-side news dominates. In early September, Russia and Saudi Arabia surprised energy markets by extending their voluntary production cuts – of a combined 1.3 million barrels per day – until the end of the year.

Forward markets now imply a near 50/50 chance of crude staying above $90pb into next year (as Goldman Sachs notes), and some think it could go higher. Last week, Goldman Sachs raised its one year forecast for Brent to $100pb. “The key reason is that significantly lower OPEC supply and higher demand more than offset significantly higher US supply”, analysts noted.

Higher oil prices are a challenge for markets as well as policymakers. It lifts headline inflation at a time when it is still uncomfortably high and acts as a tax on consumers and certain businesses. Energy stocks and oil producing nations naturally benefit, but businesses that are unable to pass on costs will take another hit. Morgan Stanley estimate that the inflationary effect of a $20pb increase like the one seen since June would be a 0.5% addition to eurozone inflation. Not an astounding figure after the year we have had, but still an uncomfortable contribution.

Sustained inflation means tighter central banks too, raising yields and making risk assets less attractive by comparison. There is some suggestion that central banks should not be overly concerned, since oil’s historic pass-through to core inflation (excluding volatile elements like food and energy) is more subdued, and headline figures might therefore fade. But the self-reported tightening biases of the ECB and the US Federal Reserve (Fed) should dispel that notion.

One of the big new dynamics of the post-pandemic economy is how quickly supply-side inflation has metastasized into wider price pressures. With labour markets tight and inflation expectations (up to recently) high, consumers and businesses are now quick to react to higher price signals. Fuel prices are the most visible of these signals. Tight capacity – not just in oil and commodity markets but throughout the economy – means second-round inflation effects are now much more likely. As central bankers are keenly aware, the inflation genie is only just now getting back into the bottle, and hence higher oil prices are keenly noticed.

The ‘higher for longer’ mantra on rates is already weighing on market sentiment. US equities have eased so far this month, and once again gave ground last week. While this is not directly to do with oil’s rise, investors are nervous about rising yields, which just got vindicated by the Fed’s hawkish pause. As economists expected, the Fed left benchmark interests unchanged at last Wednesday’s meeting, but following hawkish remarks by the Fed chair in the presentation afterwards has increased markets’ nervousness about both the possibility of another hike down the line, and how long the central bank will keep rates in restrictive territory. Anything that keeps inflation high will add to those nerves.

In this environment, there is a worry that riskier asset classes start to look expensive. US credit and equity are prime examples, with the S&P 500 up by more than 16% year-to-date while credit spread yield premiums have remained low for borrowing companies. This rally makes sense in relative terms: the US economy has remained strong in the face of adversity in 2023, with both businesses and consumers proving resilient. But the combination of high interest rates and higher energy prices could disrupt this. Businesses facing higher costs and dwindling demand would see their earnings expectations lowered. While this would most likely be more of a stretched out process, forward price-to-earnings ratios would then look very stretched, threatening a stock market pullback.

On the other hand, should higher oil prices dampen consumer spending, this could lessen the Fed’s impetus to raise rates or keep them high. The Fed’s own research suggests that an oil price increase of 10% takes

16 basis points off consumption and 14 from gross domestic product (GDP). Compressing consumption and economic activity is the goal of interest rate rises, so in that sense higher oil prices could be doing the Fed's job for it. Headline US inflation increased in August for the second time in a row. The 3.7% figure was boosted by higher gasoline prices, but like the ECB many commentators think the Fed will look through the headline figures to core inflation. The latter came down last month, as it has consistently in the past year.

Again though, we should be cautious about jumping to conclusions. Core US inflation came in at 4.3% in August, which would still be well above the Fed's 2% target if it translated directly into future inflation. While the trend is pointing down, the Fed will not want anything to disrupt this – as higher fuel prices surely could. The key point to watch is whether higher oil prices have a bigger effect on consumption and activity, or as a price signal for consumers. Markets nervously await the answer.

CAMBRIDGE
INVESTMENTS LIMITED

25th September 2023

Global Equity Markets				Technical	Valuations			
Market	Fri 14:31	% 1 Week	% 1 Week in sterling terms	Short Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7700	-0.1	-0.1	→ →	3.9	11.0	10.6	13.3
UK FTSE 250	18635	-0.8	-0.8	→ →	3.8	12.5	10.9	14.5
UK FTSE All-Share	4181	-0.2	-0.2	→ →	3.9	11.1	10.5	13.4
UK FTSE Small	6169	+0.7	+0.7	→ →	5.2	8.6	5.9	12.6
France CAC 40	7183	-2.7	-1.6	→ →	3.3	12.0	11.6	14.1
Germany DAX 40	15555	-2.1	-1.1	→ →	3.7	11.3	10.5	12.9
US Dow	34130	-1.4	-0.2	→ ⇗	2.1	18.6	16.5	16.5
US S&P 500	4338	-2.5	-1.3	→ ↗	1.6	19.7	18.2	17.7
US NASDAQ comp	13317	-2.9	-1.7	→ ↗	0.8	28.4	24.6	23.1
Japan Nikkei 225	32402	-2.3	-1.4	→ ↗	1.9	18.4	17.6	16.8
World Bloomberg	1553	-2.2	-1.0	⇗ ↗	2.2	14.5	14.0	13.8
China mainland	3739	+0.8	+1.7	→ ⇗	2.1	17.4	16.3	16.4
Emerging Bloomberg	1087	-1.7	-0.5	→ ⇘	2.6	12.4	11.1	12.1

Top 6 Gainers		Bottom 6 Decliners		Fixed Income		
Company	%1W	Company	%1W	Govt bond	%Yield	1 wk chg
Marks & Spencer	+8.0	Ocado	-11.9	UK Govt 10yr Gilt	+4.28	-0.06
Hargreaves Lansdown	+6.6	Halma	-9.5	UK Govt 15yr Gilt	+4.58	-0.01
Lloyds Banking	+6.2	Burberry	-7.7	US Govt 10yr Treasury	+4.48	+0.16
JD Sports Fashion	+4.6	Entain	-7.3	France Govt 10yr OAT	+3.31	+0.10
Barratt Developments	+3.1	Kingfisher	-6.9	Germany Govt 10yr Bund	+2.76	+0.10
HSBC Holdings	+3.1	Melrose Industries	-6.9	Japan Govt 20yr JGB	+1.46	+0.03

Currencies			Commodities			UK Mortgage Rate Estimates		
Pair	last	%1W	Cmdty	last	%1W	Rates (LTV c.75%)	22-Sep	23-Aug
USD per GBP	1.226	-1.2	Oil Brent $:bl	94.55	+1.9	UK BoE base rate	5.25	5.25
GBP per EUR	0.869	+1.1	Gold $:oz	1926.5	+0.1	2yr fixed	6.06	6.25
USD per EUR	1.065	-0.2	Silver $:oz	23.65	+2.2	3yr fixed	5.77	5.94
JPY per USD	148.33	+0.3	Copper $:lb	368.65	-2.0	5yr fixed	5.40	5.72
CNY per USD	7.299	+0.3	Alumnm $:mt	2185.0	+0.0	10yr fixed	5.35	5.19
USD per Bitcoin	26,587	+0.6	S&P crops	253.37	-0.4	Standard variable	7.85	7.60

22/09/2023
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

Source: Bloomberg, Factset, Reuters

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk

Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

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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.

LOTHAR MENTEL

www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk

Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE