CAMBRIDGE
INVESTMENTS LIMITED

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Recession fears creeping back

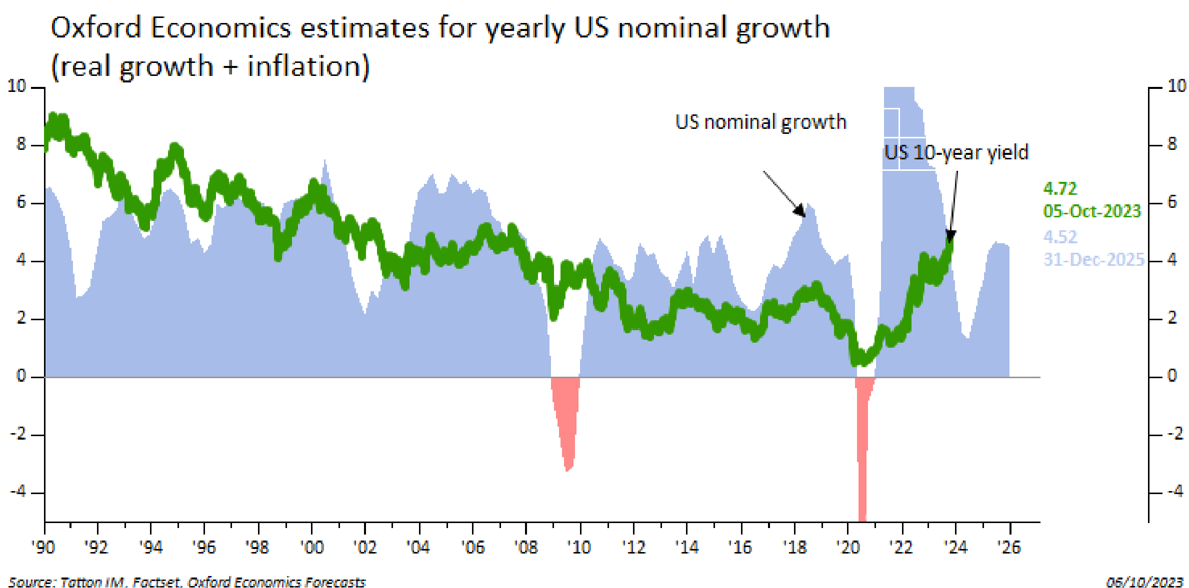
The balmy autumn temperatures have continued into October, but the market chill that has also carried through from September is more troubling. We discuss the asset class returns of the past month and quarter in our next article.

Financial markets are in one of those occasional periods where the world's economic realities do not quite seem to match what some asset price moves seem to want to tell us. Last week and continuing the trend from the previous week, we saw a further rise in global long bond yields despite some weakness signals from the global economy. The 10-year US Treasury benchmark hit a yield of 4.88% in early trading last Tuesday – the highest point in 15 years. Other government bond markets duly responded, although rose slightly less. Because of the inverse correlation between yields and bond valuations, this means that fixed-interest government bond prices fell. Subsequently, yields fell back from the highest levels but are now heading back towards their highs after another extremely strong US jobs report. Across the board, they are 0.15%-0.30% higher than the previous Friday, which equates to a fall in in the global bond index price of about 1.5%.

At the time of writing, global equity markets have broadly slipped by about 2.5% in GBP-sterling terms, mostly (we calculate) due to the valuation impact of rising bond yields, rather than pessimism over economic growth and any impact on earnings.

However, commodities have also come under pressure which does seem to be related to traders' fears that growth will be lower than previously anticipated. In particular, oil prices have reversed all of the rise seen in September. Brent spot crude fell 13.5% in just three trading days and is back to $85 per barrel, the same as on 29 August. Industrial metals, which actually fell in September, continued to decline about 4%. Commodity investors seem to be more downbeat about global growth than others.

Regular readers may at this point think, hang on …. Haven't we written in the past that bonds are supposed to be the best barometer of economic health? Don't yields rise when economies are doing well and fall when the economies are having a tough time? And they would be right. For much of the time, bond yields reflect the broad level of economic activity, both real growth and inflation (we refer to this aggregate as nominal growth). Below, we show a chart of the US 10-year Treasury yield (in green) and US nominal growth since 1990 with data and estimates from Oxford Economics:



Like most forecasters (and ourselves), Oxford Economics foresaw a US slowdown coming during 2023 and has been surprised (as we have) by its resilience. Indeed, there is no denying that the forecasts for a slowdown this year have proved wrong – in the US and even here in the UK. Global intermediate and finished goods trade has clearly slowed but demand for services has been solid. Economies that are more services-heavy have done better than expected (such as the US, UK and to some extent, Japan), those that are goods-based have done poorly (China, Germany, etc.). Services employ more people so the jobs market remains supportive, people remain reasonably confident and prepared to spend.

Nevertheless, a slowdown is still likely as the pace of fiscal stimulus wanes through next year. And the rise in yields makes a slowdown more likely, not less. For many people and for large businesses, their cost of new borrowing is more related to long-term rates than short (for example, US mortgages are 30-year fixed), so the squeeze is getting worse.

So why have bond yields gone up? We think that some (perhaps quite large) investors became overconfident about an 'imminent' slowdown earlier this year based on the economic sentiment indicators like the Purchasing Manager Indices (PMIs). Rarely do these indicators give false signals but this appears to be one of those times.

Some investors locked in what appeared to be attractive yields. For them, the latest yield increases constitute a missed opportunity but not much else. For investors that borrowed money to bet on falling yields on longer maturity bonds (as hedge funds can do), the price movements have been very painful and for an extended time. These are the most likely to capitulate now. The unwinding of their positions creates a price dynamic which says little about changed market expectations and much about past errors of judgment.

Other investors bought longer maturity bonds and sold equities, expecting a slowing economy leading to general falls in earnings expectations that would hurt stock markets. As it happened, the valuation impact from rising bond yields has hurt stock prices but not the earnings expectations side, as in general, equity analysts have held their 2024 forecasts for larger cap stocks steady. So the damage has been limited so far, generating only a lacklustre quarter for asset returns on the back of just the yield-driven valuations component. The Q3 earnings announcement season begins slowly this week but will build to a crescendo as we head into November, just as all the central banks make their next rate decisions. Earnings are likely to bear little in terms of negative surprises, but business leaders' forward guidance may force down analysts' 2024 earnings expectations.

Market volatility has shifted up across all asset classes which suggests global market liquidity is getting tighter - not surprising, given the continued drain by central banks and the substantial losses across bond markets and, to some extent, commodity markets. Tighter financial conditions make it more likely that growth will slow so we suspect that, in themselves and just like with oil, higher bond yields now probably mean lower bond yields later.

For equity and credit markets, it may be that bond yields plateau and then fall without too much impact. However, the tightening of liquidity is not a helpful signal and the risks of a sharper bout of volatility are clear. Bond yields will probably come down more so if risk assets are under pressure but that may this time be because economic weakness undermines earnings projections and equities would then find it difficult to rally substantially just on declining yields.

Ahead of the next round of rate meetings, central bankers could make things worse if their comments were seen as hawkish. However, inflation data is likely to be helpful rather than a hindrance, so we should perhaps expect them to sound slightly dovish in the next few days and weeks. We certainly hope so.

September 2023 asset returns review

September was a little rough for global investors. In aggregate, global equities fell through the month, with the US and Europe as its largest constituent declining. UK, Japan and Emerging Markets (EM) on the other hand finished mildly stronger.

It marked the end of a dreary third quarter, during which markets went backwards and economic risks became more salient. Last month's themes were largely what they have been since July: weakening global trade, an oil supply crunch (and hence higher prices), unrelenting central bank pressure and a strengthening dollar. Bonds continue to be under pressure despite the already much higher yields that now come with holding them. The table below shows sterling returns across various different regions and asset classes:

Asset Class	Index	September	Q3 2023	YTD	12 months
Equities	UK Large Cap	2.4	2.2	5.5	14.7
	UK Ethical Large Cap	2.4	-0.4	2.5	10.5
	Europe ex-UK	-1.3	-2.0	6.8	19.0
	US Large Cap	-1.1	0.8	11.4	11.2
	US Technology Large Cap	-2.2	0.1	25.3	15.3
	Japan	1.6	2.5	9.6	15.2
	Global Stocks	-0.5	0.6	8.5	10.5
	Emerging Markets	1.1	1.1	0.3	2.2
Bonds	UK Gilts All Stocks	-0.9	-0.6	-4.1	-2.5
	£-Sterling Corporate Bond Index	0.2	2.5	1.4	8.7
	Global Aggregate Bond Index	-1.8	-2.0	0.4	1.1
Commodities	Commodity Index	8.1	20.8	5.7	1.5
	Brent Crude Oil Price	10.2	27.4	5.8	-1.0
	Spot Gold Price	-0.1	2.4	1.8	2.3
Inflation	UK Consumer Price Index (% Chg for period	-0.1	-0.1	3.3	6.1
Cash rates	SONIA 3-Month	0.5	1.4	3.2	4.0
Property	Global REITs	-3.0	-2.6	-5.9	-6.7

Source: Morningstar Direct as at 30/09/23. * to end of previous month (31/08/23). All returns in GBP.

As the table shows, headline returns for UK investors do not look too bad: global stocks are only slightly down in sterling terms, and the UK large cap index actually gained on the month. But this hides significant currency volatility. Sterling lost nearly 4% of its value against the dollar in September and fell noticeably against an already weakened euro. Weakness in the UK economy, a perceived softening of the Bank of England's stance and overvalued terms of trade (as we have covered before) weighed against our currency for the entire quarter. The pound reached a high of $1.31 in mid-July, but this has come down to $1.21 at the time of writing. As has often been the case in recent years, though, a weaker currency helped the largely multinational UK large cap index, where revenues arise in currencies other than the pound.

The index, home to several energy companies, also benefitted from sharp rises in the price of oil. International benchmark Brent Crude climbed 10.2% in sterling terms last month, rounding off a phenomenal

quarter, which ended with crude prices 27.4% higher. Brent broke $90 per barrel in early September and only closed lower in early October. It was oil's strongest quarter since Q1 2022, when Russia's invasion of Ukraine upended global energy markets.

Naturally, the spike in oil resurfaced inflation concerns – coinciding with some aggressive central bank messaging and a significant increase in bond yields. As we commented recently, though, the longer-term effect of oil's rise might actually be disinflationary as it acts as another headwind to economic activity. Brent's rally is very clearly the result of supply constraints from Russia and Saudi Arabia, as overall global demand remains weak. We can see this in the performance of wider commodity prices, some of which (like metals) have been noticeably poor. In these situations, higher oil prices usually act as a tax on consumers and non-energy businesses, rather than a spur for further price increases. That is likely to mean constrained growth – and hence less pressure on prices – over the medium term.

That being said, bond markets have certainly not acted like inflation concerns are fading. Bond prices took a further step down in September, and indeed through all of Q3, as yields rose up to decade highs. US 10-year Treasury yields ended last month at nearly 4.6%, levels not seen since 2007. Japanese Government Bond yields nearly doubled to their highest point since 2013, while German Bunds topped 2.8%, a yield it last reached in 2011. Indeed, the bond sell-off was the main reason equities fared so miserably, with valuations moving down thanks to the sharp increase in 'risk free' rates. The mechanical effect of bond yields on equities is probably why the latter fell in almost a straight line – simply drifting lower as risk valuations adjusted, while earnings expectations remained broadly unchanged.

Bond markets were seen as – and perhaps still are – adjusting to the 'higher for longer' edict from central banks, rather than rekindling inflation concerns. Central bankers have long pushed the line that interest rates need to stay high to curtail structural inflation pressures, but it seems only in the last few months have professional bond investors and traders started believing them. The US Federal Reserve (Fed) signalled it would cut rates much more slowly than investors had priced in, catching out and sometimes forcing to unwind position those who had thought the cyclical high in bond yields had been reached early in the summer. This market repositioning is likely what pushed the US Treasury 10-year benchmark yield up to 4.8% at the time of writing.

The US economy in the meantime continues to be impressively resilient. Growth has clearly slowed and the labour market has now finally eased somewhat, but outright contraction looks unlikely in the short-term and headline inflation was rising again. With its rate rise pause, the Fed is essentially predicting a 'soft landing' for the US economy, meaning it can stop hiking rates but has no near-term need to cut them. The Fed's dots plot – a graph of where different policymakers expect interest rates to be out into the future – now shows a significantly shallowed decline over the next two years. The chasm between these expectations and those previously implied by bond markets corrected over Q3, and investors on the wrong side of this dynamic have paid the price.

Central bank guidance was not the only thing preoccupying bond traders, though. In August, ratings agency Fitch downgraded its rating of US Treasury bonds, depriving the US of its last remaining AAA rating. These events rarely have a direct impact on bond markets, but it was a timely reminder of America's deteriorating fiscal position. Last month, the Fed's tighter monetary stance was exacerbated by an avalanche of Treasury bond issuance. And as we wrote recently, the received view among bond analysts is that the US is on a

long-term trend toward debt expansion – starting with former President Trump and accelerating under President Biden.

Importantly, these bond market adjustments have not come at the expense of expected long-term growth prospects. Indeed, relative to other major economies, the US remains one of the safest bets for long-term earnings growth – particularly in light of its concentration of AI-related tech companies. With rates of return now tilted more heavily toward the US, this has caused the dollar to swell in value against global currencies. This is because of US stability – but the effect on the rest of the world will likely be instability. A stronger US dollar brings risks for markets and the non-US economy, regardless of why it comes about.

Brazil's new era / Brazil revisited

What do you think of when you think of Brazil? Okay, other than football, what do you think about? Investors, particularly those with experience of emerging markets, probably have some mixed connotations. As the 'B' in 'BRICS', South America's largest economy naturally has a lot of growth potential. Like many of its neighbours, it also has a bit of an unstable reputation. Many investors would ascribe to it all the regular Emerging Market hallmarks: high inflation, corruption and currency woes. South American countries also have a particular reputation for political frailty, fiscal excess and debt crises.

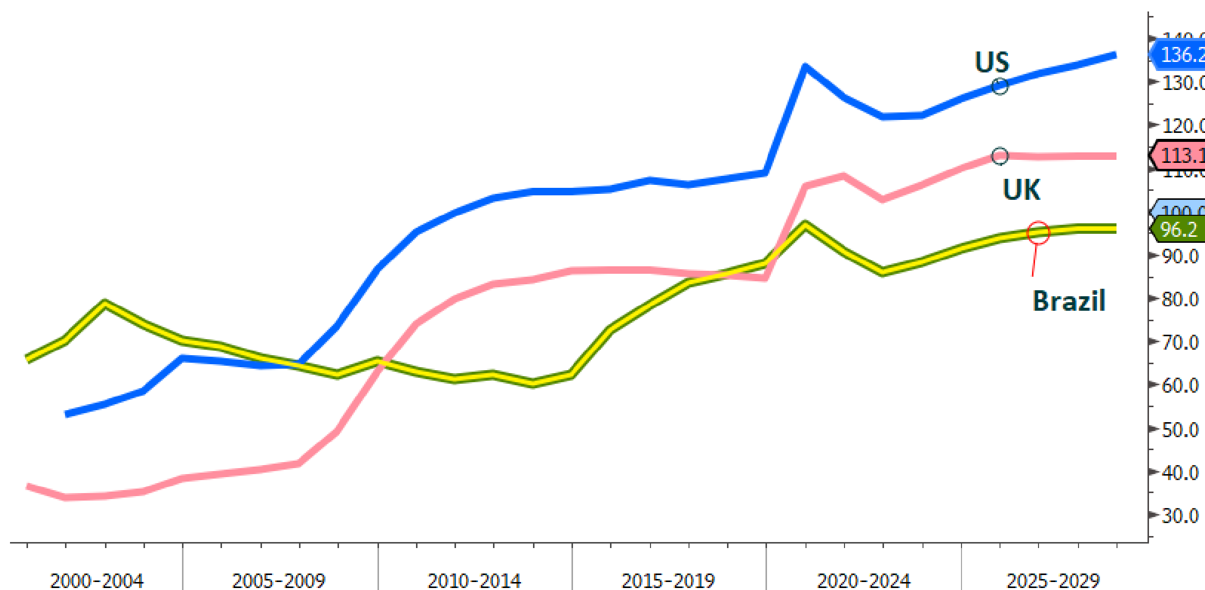
Certainly, Brazil has had its fair share of all of them. Those who have been around for a while might remember the hyperinflation crisis of the late 80s and early 90s. Brazilian inflation topped 70% month-on-month for the first three months of 1990 and took seven years to stabilise. From 1990 to 1994, it had four different national currencies rolled out in a series of unconventional and mostly unsuccessful plans to stem the crisis.

However, Brazil's economy has never come close to that level of chaos since, although it has certainly done enough to make investors squeamish on many occasions. This has included substantial borrowing and periodic bouts of relatively high inflation – coupled with perceived institutional and political instability – the presidency of right wing populist Jair Bolsonaro being the latest.

The Brazil of today, though, is quite far from those connotations. Like most countries, Brazil saw prices rise as it came out of the pandemic, but its inflation rate peaked in early 2022 and has come down considerably since. In fact, Brazil's consumer price index (CPI) inflation rate has been below the UK's every single month for more than a year, touching a low of 3.16% in June. Its government debt is fairly well contained too. Again, pandemic-era emergency spending forced an increase in the country's debt-to-GDP ratio, but the spike was much smaller than comparable jumps in the UK and US. As the chart below shows (data and

forecasts from the International Monetary Fund), its debt currently stands at just 96.2% of GDP, a figure that is expected to stay fairly stable in the years ahead.

National Gross Government Debt to GDP
IMF calculations and forecasts



Source: Tatton IM, Bloomberg: G1558

IGS%BRA Index (IMF Brazil General Government Gross Debt as a % of GDP) brazil debt/gdp Monthly 04JUL2000-31DEC2028 Copyright© 2023 Bloomberg Finance L.P. 03-Oct-2023 16:40:37

Improvements have not come at the expense of growth either. The pandemic was hard for Brazil, both politically and economically, but its growth since then has been reasonable, if not stellar. GDP growth has come in above 2% in all but one quarter since Q2 2021, the exception being a respectable 1.9% expansion in the last three months of 2022. Its most recent figure of 3.4% in the three months to June 2023 is impressive enough on its own, but even more so when one considers the broader global economic headwinds. Not only has global demand slowed and supply become tighter, but US interest rates have increased at the sharpest pace in a generation.

Tight US monetary policy and, relatedly, a more expensive dollar are usually considered very bad news for South American Emerging Markets. Not only do higher US returns pull investors away from Emerging Market assets, but dollar-denominated debts – which South American companies often hold – become more expensive. And yet, in this tightening cycle Brazil has proven remarkably resistant to the negative effects of US monetary policy. In fact, JP Morgan recently estimated that Brazil's sensitivity to US short rates and yields is less than any major Latin American economy. It is obviously impacted by US rates, but it appears no more so than some developed European economies.

At the start of the year, there were some fears that the re-elected President Lula (for a third term) would loosen fiscal policy dramatically, worsen inflation and send bond yields skyward. These were heightened when Lula publicly criticised the policy of Brazil's central bank and called for lower interest rates to support growth. But these have not materialised, and in fact Lula's recent rhetoric has been remarkably controlled – backing the balanced budget pledge and fiscal reduction targets of his under pressure finance minister

Fernando Haddad. In the spring, Brazil's 10-year yields fell from above 13.5% to below 11%. And while these have risen since, the step up has been closely in line with global bond market moves.

Undoubtedly, the fiscal control on public spending and monetary control on private debt growth comes at a cost and the next two quarters will feel substantially less 'growthy' to most Brazilians. This will test Lula's popularity and may bring pressure to ease. Of course, if global growth comes under significant pressure, an easing in one or both may be warranted.

But, while policy inevitably must be responsive, there is a growing sense that the path is one of stability and that could make this feel like a new era. The transition from far-right Bolsonaro to left-wing Lula was expected to be difficult and potentially violent, but in the end was remarkably smooth, all things considered. In particular, there was no significant Trump-style insurrection attempt, and Lula has proven surprisingly effective at pulling the different political factions together for compromise.

This is helping Brazil to be seen as a viable investment destination. Despite a challenging third quarter for global stock markets, Brazil's stock market is up 12.3% over the last six months in local currency terms. Its currency has not fared too poorly either – losing recently against the dollar as all global currencies have, but by no more so than the euro, for example. Part of the reason for this is the attractive real (inflation-adjusted) yields on offer in Brazil, which are aided by structural expectations for growth and inflation.

On that front, it is very likely that Brazil has been a beneficiary of western investors' exodus from Chinese assets this year. We wrote a while ago how India was benefitting from the perceived economic and political weakness in China, but the same can be said for South America's largest market. Indeed, in terms of trade reconfiguration, Brazil might end up being one of the biggest beneficiaries of US decoupling attempts from China – as Mexico has been to this point.

There is also a wider point to consider, which is that the world needs a politically and economically stable Brazil. This is not just because of its place within the continent (particularly relative to Argentina, a nation which is perhaps much more deserving of its profligate reputation) but because of its geographical features. As we saw during the later Bolsonaro years, a government that is unwilling or unable to stem the destruction of the Amazon rainforest is unequivocally bad news for the world. Whether that be because of a short-term industrial drive or longer-term political instability, western powers would do well to avoid it. Brazil is no longer the risky country it once was, and it is in everyone's interest to make sure it never is again.

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9th October 2023

Global Equity Markets	06-Oct			Technical	Valuations			
Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Short Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7486	-2.1	-2.1	→ →	4.0	10.6	10.2	13.3
UK FTSE 250	17657	-3.8	-3.8	⇘ →	3.9	11.6	10.2	14.5
UK FTSE All-Share	4049	-2.4	-2.4	→ →	4.0	10.7	10.2	13.4
UK FTSE Small	5891	-3.4	-3.4	→ →	5.5	9.8	7.4	12.6
France CAC 40	7031	-2.3	-2.3	⇘ →	3.3	11.7	11.3	14.1
Germany DAX 40	15137	-2.4	-2.4	↘ →	3.9	10.7	10.1	12.9
US Dow	33024	-2.4	-1.7	⇘ →	2.2	17.8	15.8	16.5
US S&P 500	4236	-2.2	-1.5	↘ →	1.6	19.0	17.7	17.7
US NASDAQ comp	13134	-1.5	-0.8	↘ ⇗	0.8	27.8	24.2	23.1
Japan Nikkei 225	31062	-2.1	-1.6	⇘ ↗	1.9	17.8	16.9	16.8
World Bloomberg	1506	-2.4	-1.7	→ ↗	2.2	13.8	13.3	13.8
China mainland	3690	+0.5	+0.8	↘ →	2.1	16.8	15.8	16.5
Emerging Bloomberg	1058	-1.7	-1.0	⇘ ⇘	2.6	12.3	10.9	12.1

Top 6 Gainers

Company	%
Tesco	+5.7
Aviva	+5.4
International Consolidated Air	+5.1
Frasers	+2.2
Experian	+2.0
RELX	+2.0

Bottom 6 Decliners

Company	%
SSE	-7.5
Fresnillo	-7.4
Ocado	-6.8
Anglo American	-6.7
Glencore	-6.6
Endeavour Mining	-6.5

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.61	+0.18
UK Govt 15yr Gilt	+4.92	+0.19
US Govt 10yr Treasury	+4.83	+0.31
France Govt 10yr OAT	+3.50	+0.12
Germany Govt 10yr Bund	+2.92	+0.09
Japan Govt 20yr JGB	+1.60	+0.12

Currencies

Pair	last	%1W
USD per GBP	1.216	-0.7
GBP per EUR	0.865	-0.0
USD per EUR	1.052	-0.7
JPY per USD	149.33	+0.1
CNY per USD	7.298	-0.1
USD per Bitcoin	27,427	+1.6

Commodities

Cmdty	last	%1W
Oil Brent $:bl	83.6	-12.3
Gold $:oz	1826.0	-2.6
Silver $:oz	21.5	-8.0
Copper $:lb	363.0	-3.5
Alumnm $:mt	2202.3	-2.5
S&P soft crops	245.7	-0.8

UK Mortgage Rate Estimates

Rates (LTV c.75%)	06-Oct	06-Sep
UK BoE base rate	5.25	5.25
2yr fixed	6.16	6.21
3yr fixed	5.92	6.02
5yr fixed	5.52	5.52
10yr fixed	5.48	5.15
Standard variable	7.93	7.85

06/10/2023
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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