THE **CAMBRIDGE** WEEKLY

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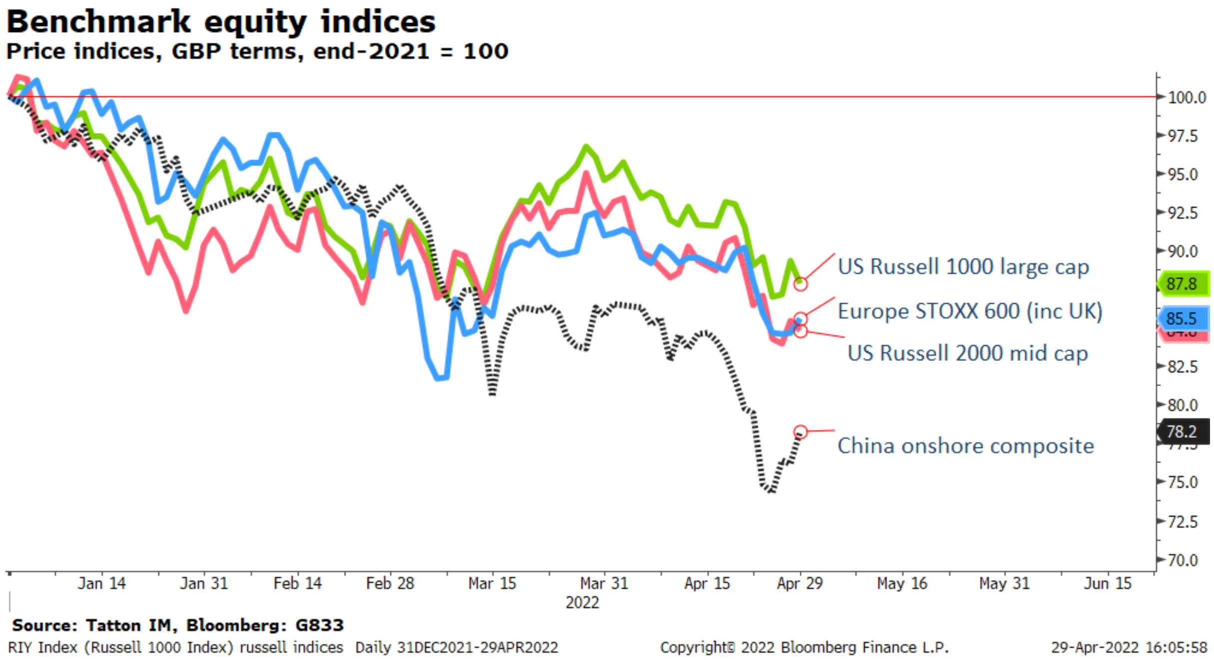
Range bound markets – despite the drama

Equity markets have been range-bound through the past few weeks, but it does not feel like it. Volatility is at its highest since the nasty period in March 2020, which always raises our perceptions of potential downside. But the volatility is not too surprising given the overall mix of news and economic data updates.

Amongst the up and down, China has weakened the most with its currency, the Renminbi/Yuan, deteriorating over the course of last week, in line with the slowing signals emanating from the stringent COVID lockdown talked of in last week's commentary (see chart below). At the other end of the spectrum, the US dollar's march upwards against all other currencies was last week's big story in global markets (see our separate currencies article below). This dollar appreciation is not helpful for global growth, as noted before, but it may help to cool inflation through lower US import prices where it matters most – in the US.



Most economic scholars would not expect the dollar to remain strong after the other big surprise of last week, which was that the US economy contracted -0.32% (seasonally-adjusted) in the first quarter. US economists quote this on an annualised rate of -1.4%.

As per usual, there are lots of caveats to the headline numbers. Nominal growth was +1.6%, (+6.5% annualised). Real growth (after subtracting inflation) would have been positive were it not for the large trade deficit (which counts as a negative for growth). In fact, nominal personal consumption – which is what truly counts for economic momentum – was up +2.4% (+9.9% annualised). Given first quarter data is also subject to huge seasonal adjustment factors– which is particularly difficult at present – we should therefore expect future revisions.

Taking the data at face value, it paints a picture of strong, not weak, US domestic demand. Indeed, it probably shows that the rest of the world slowed. At a stretch, it might indicate a global lessening of core inflation pressure.

Unfortunately, at the moment, inflation pressures are what drives market down days, and those pressures are coming from outside the core. Energy and hard commodities may be stabilising but food price pressures are re-emerging. Here it is not just Russia's war on Ukraine (Ukraine is the world's largest exporter of sunflower oil), but also a return of climate change-inflicted drought that has exacerbated a shortage in cooking oil. Domestic political pressure to deal with consumer prices has caused Indonesia to suspend palm oil exports.

Then there is the housing market, whose strength is good for consumer sentiment but is increasingly fanning the flames of general price inflation through the rental market. We write about the global phenomenon of rising house prices and rents in our second article below. Despite much higher interest rates, demand for mortgage and other credit is keeping the pressure on central banks – especially on the US Federal Reserve (Fed) to continue tightening.

Nobody should think that the US is a quarter away from recession (the usual definition being two quarters of negative growth). The Fed will perceive that real growth was weak because of its arch-enemy inflation. This week, they will raise rates by 0.5% and tell us that there is more to do, which may well lead to another market wobble – although if the accompanying guidance is no harsher than expected any wobble may prove short-lived.

Strong US nominal domestic demand is in line with the run of Q1 earnings reports which, on average are showing expansion and are coming in better than analysts expected (although we know analysts are always too downbeat). This would normally have us expecting more positive market returns than April has brought. Against that, the high-profile disappointments for some of the previous tech darlings are interesting. Apple and Microsoft did well, but the standout story was Amazon's quarterly loss.

Many readers will be aware of the story that the multi-billion-dollar write-down of Amazon's investment in electric-truck-maker Rivian was behind the quarterly loss of $7.56 per share (Bloomberg's analyst aggregate estimate earnings-per-share was +$8.40). At a wider level, the story is that Amazon is now so big that it is no longer a 'secular growth' stock, and its results depend on economic trends. So, there was 'good' news, namely that delivery speeds are "approaching pre-pandemic levels" and Amazon is "no longer chasing physical or staffing capacity".

Meanwhile, China appears to be trying to accelerate the policy shift, given it faces the fastest economic slowing in 30 years, thanks to the massive lockdowns created by its zero-COVID policy. Although some areas are said to be returning to normal, confidence this will hold is low and will remain low until the authorities move to more effective vaccination efforts. The Renminbi/Yuan was allowed to depreciate further from CNY 6.5 to 6.6/$ in an attempt to import more global demand.

Perhaps we should take comfort that China's travails may mean a less combative stance in geopolitical relations. It would have been more difficult for US President Biden to press for $33 billion of additional funding for Ukraine's war effort if US attention was being distracted towards Taiwan and the South China Seas.

Despite the lower equity market valuations and higher bond yields, our sense is that the current markets are not being pressured by the corporate earnings outlook. Fears of central bank policy mistakes can lead to pessimism but, historically, earnings growth remains positive well into tightening cycles. There has been a lot of talk that recession is "close at hand" but there is little in the data to suggest this. We await the Fed this week, but do not expect the earth to shake.

The essence of all the above is that investment returns are increasingly harder to come by. It is no longer enough to simply buy the biggest US tech companies (plus some crypto currencies) and feel super clever about it. As money has a price again – and tech stocks have to compete again with real life experience activities – successful investing is once again becoming a skill that requires considerable effort, rather than just executing trades by jumping on the latest bandwagon.

Currency markets: Theory versus practice

After climbing steadily higher for the better part of a year, the US dollar took a big jump last week. On Thursday, the world's reserve currency surged to its highest level in 20 years against a host of other major currencies. The dollar index – which measures the dollar's value against a basket of developed world currencies including the euro, yen and pound sterling – rose 1% on Thursday alone, taking it to just under 104. The dollar has now added 8% to its value this year, which presents a serious headwind for the global economic outlook and emerging markets in particular – which tend to have large dollar-denominated debts and pay for their imports and production inputs mostly in dollars.

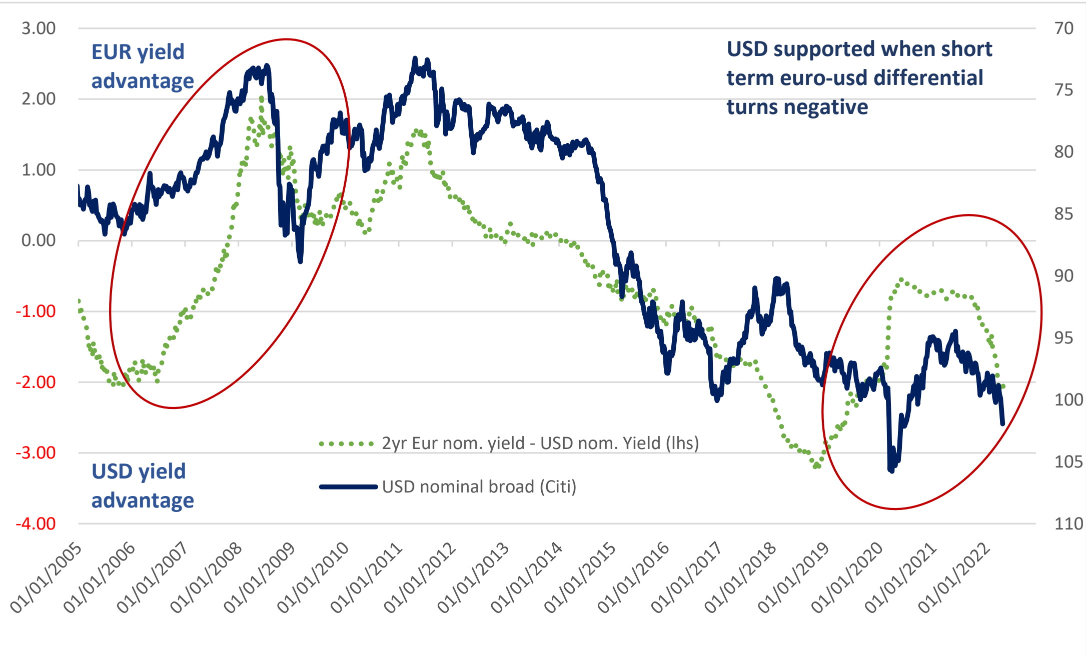
Source: Bloomberg, Tatton IM

Monetary policy is the most obvious cause of this continued strength. The US Federal Reserve (Fed) is on an aggressive tightening path, in the hope of taming runaway inflation. Interest rate rises of 0.5% are expected at each of the Fed's next three meetings, on top of the 0.25% increase delivered at the beginning of March. The world's other major central banks, meanwhile, have a much looser outlook. Thursday's dollar rally came after the Bank of Japan reiterated its promise to keep bond yields close to zero – forcing the yen to its weakest level in decades. Even if the European Central Bank (ECB) is expected to raise interest rates this year – market expectations of 90 basis point increases lags substantially behind the Fed's rate-raising path.

While this is the text book explanation for the recent currency market moves, the dollar's strength this year is still remarkable considering the economic backdrop. US GDP unexpectedly fell 1.4% (annualised) in the first quarter of this year, dragged down by external trade (exports minus imports), diminished government consumption and destocking. The world's largest economy has also the highest inflation rate of any major market – with March's reading coming in at a 40-year high of 8.5% (even if other major economies are not that far behind).

Part of the classic textbook theory is that currency value should be driven by growth and inflation prospects over the longer term. On that front, US growth has weakened, and comparatively higher inflation means the purchasing power of dollars has fallen by more than any of its global peers. One now needs more dollars to buy one unit of goods. This, so the purchasing power parity (PPP) approach goes, should put downward pressure on the dollar's value, and yet it is at its strongest level since the early 2000s, with little sign of coming down.

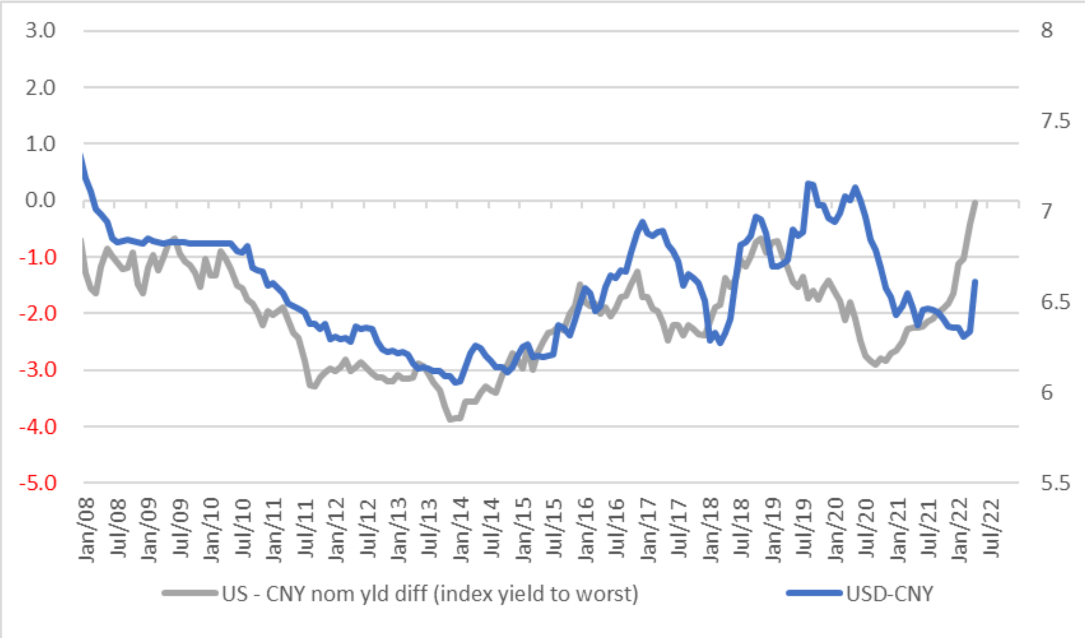
As mentioned, this is primarily down to Fed hawkishness, which is somewhat unconventional when the economy shrinks. Rising interest rates and a trimming of America's balance sheet put upward pressure on real (inflation-adjusted) bond yields. Yield disparity compared to bonds in other currency denominations makes US bonds more attractive – and short-term bond markets are one of the main drivers of short-term currency moves. As the chart below shows, the US real yield advantage (yield after inflation) over Eurozone bonds has increased dramatically. This is usually very supportive of the dollar.



Source: Bloomberg, Tatton IM; note reversed right hand axis – the lower the higher the USD value

There is little sign that this yield differential will revert any time soon. The Eurozone is facing its highest inflation levels in decades, but the energy crisis is a severe threat to living conditions and overall growth. While the ECB has tried to talk tough on keeping prices under control, the feeling among investors is that European policymakers cannot keep up with the Fed. Meanwhile, the Bank of Japan (BoJ) has committed itself to a lower for longer policy – implying that the vast spread between US and Japanese yields will continue to grow.

Turning from West to East, the exchange rate between the dollar and the Chinese yuan is increasingly important for currency markets, despite the yuan not being included in the dollar index's basket. It has strengthened considerably against the dollar over the last two years, but that trend has now sharply reversed.



Source: Bloomberg, Tatton IM

As the chart above shows, this correction was perhaps overdue, considering the nominal yield differential between the countries. US yields have been gaining on China since 2020, and with the nominal difference between the two now at around 0%, there is no longer a yield advantage in holding Chinese over US government bonds.

China has severe economic problems of its own – spiking COVID infections, a return to harsh lockdowns and a property market in disarray – all weighing heavily on its currency value. What's more, the Chinese government seems happy to let the yuan slide to boost exports and stimulate the economy. This is effectively an easing of monetary policy – standing in stark contrast to the Fed's hawkishness. Weakness in the world's second-largest economy has spread to other emerging market (EM) currencies, particularly in Asia (though this is also down to Japan).

The overall weakness in EM currencies hides significant disparity. Latin America (LatAm) is in a very different situation, as its central banks tightened policy aggressively last year, causing inflation to come down from its peak. There are still growth and inflation risks – particularly if Chinese commodity demand weakens further. But LatAm countries still have a large real yield buffer over US bonds, meaning a collapse in currency values is unlikely.

Dollar strength is itself a big problem for LatAm though, as many companies have large dollar-denominated debts. At the start of the year, investors seemed confident about EM prospects, as previous tightness and fewer inflation concerns meant central bankers had room to ease policy. Now, there is a much greater risk global growth and investor risk aversion rolls over. That would put immense pressure on EMs, making it extremely difficult for central banks to loosen.

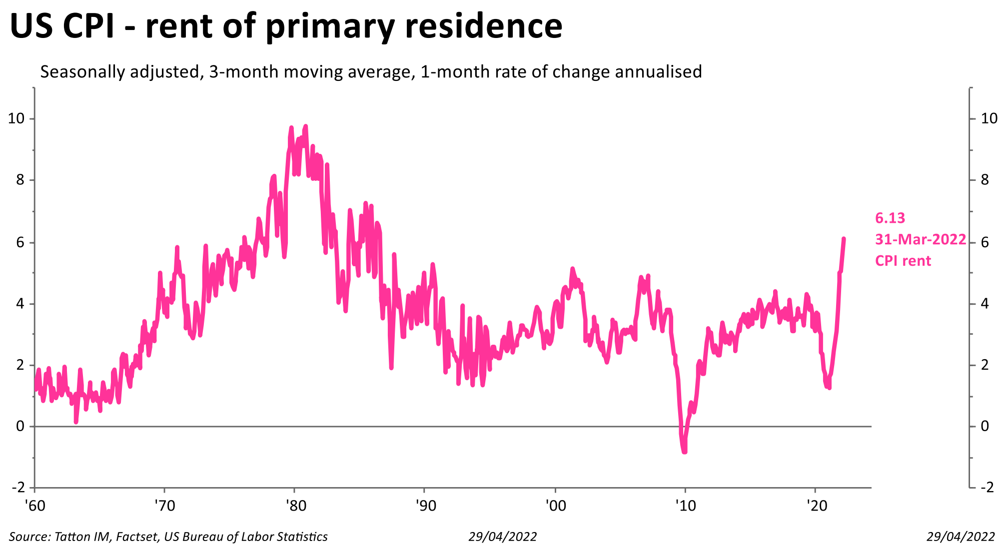
Unfortunately for EMs, their prospects are largely out of their hands. They will hope that dollar strength eases back – and perhaps can take comfort in the US' widening trade deficit, which sometimes (though certainly not always) precedes dollar weakness. Other signals are supportive of the dollar, including the shape of the US yield curve (the difference in yield between long and short-term bonds). After inverting earlier in the year, the curve is now very flat – often a positive for the dollar.

As well as an indicator of domestic growth prospects, the yield curve can also be seen as a proxy for how much US growth will leak out to the rest of the world. Currently, the suggestion is very little, and we would need positive news to see this change. A revival in growth momentum – or a signal of Fed loosening – could do the trick. That would steepen the curve and consequently weaken the dollar. This would bring much needed reprieve for global markets, but it may prove wishful thinking in the short run.

Soaring house prices keeping inflation pressures up

Post-COVID inflation has hit just about every area of our lives over the last year, and residential property is no exception. During 2020, we saw several news stories about landlords being under pressure to cut rents as city dwellers flocked to more rural areas to buy houses. That story reversed as house prices rose sharply. Now, despite some cities being less busy overall than 2019, returning tenant demand has meant surging rents. Meanwhile, house prices have been incredibly strong this year, with no sign of slowing down.

In the US, rents have been accelerating for the past 15 months. The consumer price index (CPI) component for primary residence rent has breached the 6% annualised rate (pictured below).

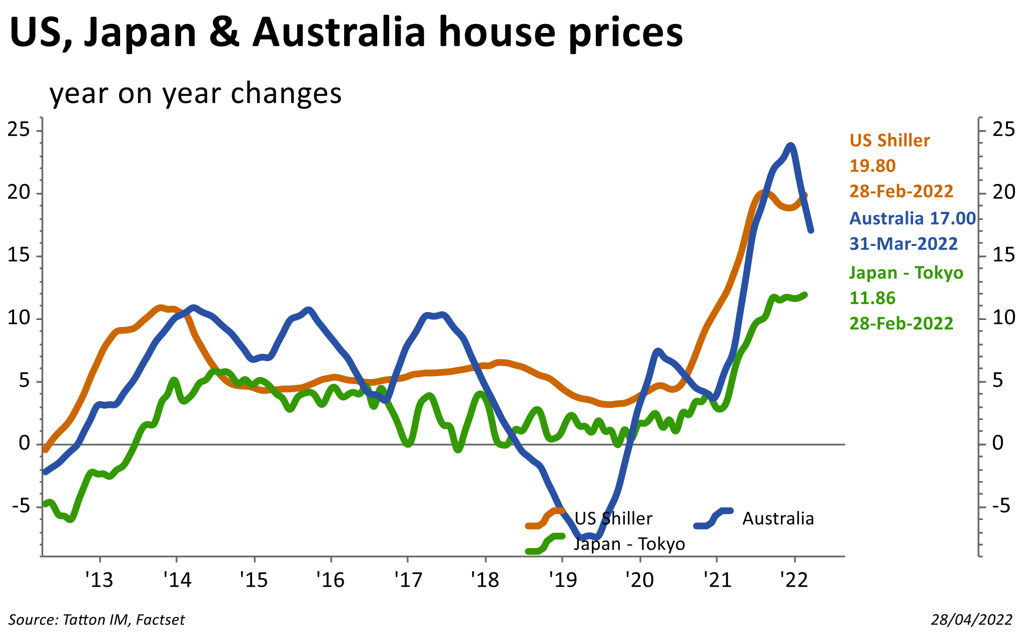


This is below the overall CPI, but evidence from brokers like apartmentlist.com suggest the 'actual' experience is more like 17% year-on-year, very close to current US house price inflation.

Last week saw the release of two major home price trackers for the US: the S&P Case-Shiller index and the FHFA house price index. Both reported record month-on-month increases. Prices in the Case-Shiller jumped 2.4% in February, smashing economist expectations of 1.5%. FHFA similarly beat expectations with

2.1%. The year-on-year figures also reached an all-time high of 20.2%, with particularly strong results in San Diego, Seattle and Los Angeles.

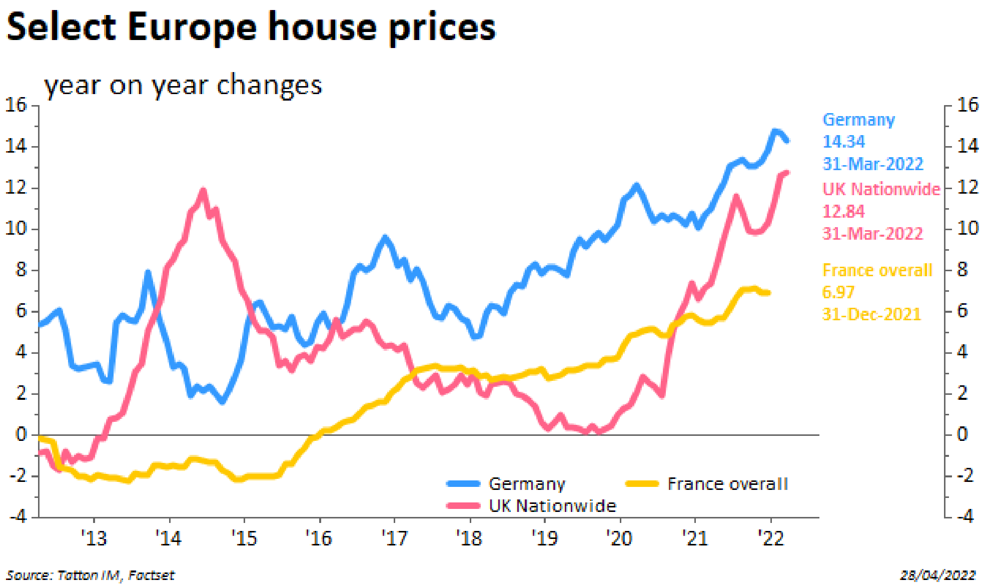
The US market is running at the strongest effective rate we have seen, despite GDP contracting 1.4% (annualised) in the first quarter of this year. The cost-of-living squeeze is clearly taking a toll on consumers and dampening demand, but that has had no effect on the housing market. Not a single region of the Case-Shiller index reported a fall in prices – highlighting that the increase is extremely broad based.



In Australia (shown with the US, in the above chart), the property market's lull following the commodity price falls of 2016 has fully reversed. It's now buoyant enough for policymakers to become concerned. The Royal Bank of Australia (RBA) has followed a wait-and-see approach on raising interest rates, but recent inflation has been stronger than expected, with some suggesting it could be forced to tighten policy earlier than expected. House prices are a huge part of this, with the magnitude of increase surprising.

Strength in house prices is far from limited to the US and Australia. The chart below shows year-on-year changes for the UK, France and Germany – all jumping upwards. Germany is a particular standout – perhaps surprisingly for those of us who think of housing market bubbles as a peculiarly Anglo-Saxon issue. The country's property market has a history of sluggishness, but prices have been consistently gaining for years now.

Europe faces a huge cost-of-living crisis due to its energy dependence on Russia. The hit to real disposable incomes would suggest a fall in housing demand, and yet the rally shows no sign of letting up – with the continent seeing its biggest house price increases since 2014. Germany's property strength is surprising both for its magnitude and longevity, with affordability now becoming extremely stretched.



The only major exception to this global phenomenon is China, which is dealing with a sharp economic slowdown and a self-made collapse in the property development sector. Prices of new homes are falling in the world's second-largest economy, but even there the market for existing houses is reasonably strong. It seems demand has shifted to older homes, where prices are still rising at a decent 7% year-on-year.

The property market is a big factor in central bankers' thinking, as the RBA's case shows. This is especially so now, with central banks scrambling to hold down runaway inflation. The link between house prices and inflation is not immediately obvious, however. As very illiquid assets, the short-term inflationary impact of rising house prices is murky. But the massive growth in buy-to-let properties over the last few decades – across virtually all major economies – has strengthened the link between property prices and rents. This means that more expensive homes quickly feed through into higher rents, increasing costs for consumers and hitting disposable income.

This presents a particular problem for central banks. Housing supply is slow to react to changes in demand (a big factor behind the spike in rents despite fewer people living and working in cities than pre-pandemic) meaning that price momentum tends to last. Surging prices often carry over for longer than other markets.

With a stronger link between housing and inflation, this means we are likely to see residential market impacts on inflation persisting for some time. That threat is why the RBA looks likely to increase interest rates soon, and it is no doubt a big part of the Fed's hawkish stance.

It is also why there is growing pressure on the ECB. Still far behind the Fed's schedule on raising rates, there are real doubts as to whether it can tighten policy while consumers face the sharpest cut in their real disposable incomes in decades. However, wage rises are also the highest in two decades, so the real wage decrease is about inflation.

With the housing market going from strength to strength, the ECB may have little choice but to tighten. In particular, the Bundesbank wants help to stem rising German house prices. Given the Bundesbank's immense influence over the ECB, markets are pricing around three rate hikes over the next year.

Central banks will hope that tighter monetary policy, as well as inflation itself, will put a dampener on the housing market. Higher interest rates increase mortgage costs, while house buyers have to take larger loans to value. That should lower demand.

Aside from this, higher input costs also make housebuilding less viable – and the squeeze on disposable incomes will ultimately cap rental demand. In most major markets, affordability of housing has clearly moved from 'fairly cheap' in 2019 to 'stretched' – which limits how much further prices can go.

Credit availability is equally important. Typically, mortgage availability is not especially sensitive to higher house prices. Although, across most countries, there have been signs of some tightening in credit standards, banks are more concerned about the stability of their borrowers' jobs, if jobs are stable, banks are happy. The UK has had restrictions on lenders since the financial crisis, which limit their ability to hand out riskier loans. The Bank of England looks likely to remove or alter these restrictions, but such structural policy changes take time. In that sense, it may need to take account of the regulatory easing by raising rates somewhat more than previously expected.

Overall, the biggest driver of the housing market is employment. If labour conditions are stable and employees are confident in their jobs, housing demand is well supported. While there may be early signs of a cooling in the employment market, it is still running hot. We are unlikely to see a major turnaround in house prices until that cools down. Until then, the market has huge momentum – and unfortunately, huge inflationary pressure too.

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INVESTMENTS LIMITED

3rd May 2022

Global Equity Markets

Market	Fri 15:50	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7531	+0.1	+9	↗	⇗
FTSE 250	20715	-0.8	-167	⇗	↘
FTSE AS	4179	-0.0	-2	↗	⇗
FTSE Small	6848	-0.5	-32	⇗	⇘
CAC	6536	-0.7	-46	↗	→
DAX	14073	-0.5	-69	⇗	↘
Dow	33540	-0.8	-271	→	→
S&P 500	4219	-1.2	-52	→	→
Nasdaq	12663	-1.4	-176	→	↘
Nikkei	26848	-2.6	-705	↗	→
MSCI World	2862	-0.7	-21	→	⇘
CSI 300	4016	+0.1	+3	⇘	↘
MSCI EM	1054	-2.0	-22	⇘	↘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Johnson Matthey	+16.8	AVEVA	-14.6
Stan Chartered	+7.0	Ocado	-12.7
Renishaw	+5.1	Ashtead	-10.2
Unilever	+4.8	Rolls-Royce	-9.9
Just Eat Takeaway.com	+4.6	JD Sports Fashion	-8.2

Currencies

Pair	last	%1W
USD/GBP	1.256	-2.2
GBP/EUR	0.840	+0.1
USD/EUR	1.05	-2.3
JPY/USD	129.65	-0.9
CNY/USD	6.61	-1.6
Bitcoin/$	38,951	-1.4

Commodities

Cmdty	last	%1W
Oil	110.11	+3.2
Gold	1911.8	-1.0
Silver	23.05	-4.5
Copper	440.7	-3.8
Aluminium	3031.5	-8.1
Soft Cmdties	231.6	-1.2

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.87	-0.10
UK 15-Yr	2.06	-0.06
US 10-Yr	2.87	-0.03
French 10-Yr	1.42	-0.00
German 10-Yr	0.90	-0.07
Japanese 10-Yr	0.23	-0.02

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	12.9	10.6	14.3
FTSE 250	2.9	12.0	14.3	16.3
FTSE AS	3.6	12.3	11.0	14.5
FTSE Small x Inv_Tsts	2.8	1.4	10.1	15.3
CAC	2.5	14.9	12.1	15.2
DAX	2.6	14.1	12.2	13.7
Dow	1.9	17.4	17.6	16.8
S&P 500	1.5	20.9	18.5	18.1
Nasdaq	0.8	23.8	26.1	23.9
Nikkei	2.0	14.5	14.8	17.7
MSCI World	1.9	17.7	16.8	17.0
CSI 300	2.0	13.6	12.1	12.7
MSCI EM	2.8	11.0	11.5	12.7

UK Mortgage Rates

Mortgage Rates	Apr	Mar
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.11	1.91
3-yr Fixed Rate	2.03	1.90
5-yr Fixed Rate	2.12	1.94
10-yr Fixed Rate	2.44	2.34
Standard Variable	3.99	3.95

* 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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3rd May 2022

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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