CAMBRIDGE
INVESTMENTS LIMITED

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Data versus Davos

Last week, global capital markets resumed their volatile path of last year, as the positive sentiment, driven by expectations of an imminent and significant onset of rate cuts, began to wane somewhat. The combination of a distinct slowing in the downward trajectory of inflation, paired with increasing confirmation that economic conditions are more on the up than down (at least in the US), have made it even less probable that rates will be cut soon and fast. As a result, some investors have begun to face up to the very distinct possibility that bond yields may have undershot during the end of 2023 euphoria, and that rates may only begin to be cut later and then more slowly. In other words 'lower, slower' seems to be replacing last October's 'higher for longer' narrative.

Consequentially, bond yields have risen again during the past week, led by more rises in the US Treasury market. In the US, in another replay of 2023, US mega-caps were notable performers and the Nasdaq Composite regained the 15,000 level. However, equities overall have generally drifted downwards with smaller caps under pressure. Non-US markets also declined.

Those that follow financial media channels may suspect these changing expectations may be a result of chatter emerging from the Davos World Economic Forum – the annual gathering of the global political and business elite. Well, when nobody had heard of the annual Davos meeting, this small group of incredibly influential investors, experts and politicians indeed mattered. Now it has become way too visible to be important. The gathering has journalists all over it, and (almost) every utterance is communicated to us immediately. Therefore, nothing new of any great value can be said. Last week, central bankers were in full view, telling audiences that rates will be cut but not to expect too much and too quick. There was a general sense of a mildly hawkish conservatism, driven by a view that not too much was wrong with the world just now. Meanwhile, various business leaders said it is tough out there, but we should be optimistic.

In the world of facts and figures, JP Morgan Research tells us global companies are reporting lacklustre results for the last quarter of 2023 and giving similarly tepid forward guidance. It's still the early stages of the reporting cycle, with just 6% of S&P 500 companies having reported, mostly banks, consumer and industrials. The usual majority (66%) are beating analyst expectations on earnings, but only 50% are beating on revenues and stocks are underperforming after reporting. Bank results have been mixed, while consumer names are seeing less US spending power as households' cash savings decrease.

Revenue 'beats' may be not as positive as hoped, but expectations for US companies are still strong, driven mostly by US domestic demand. Even now, revenue expectations for the next 12 months are climbing from one month ago, at a pace which – if sustained – would deliver a 7.3% annual rise. That's still in excess of the long-term (20-year) average of 5.3% per year.

Higher US income brackets are still outspending the lower ones, but results from other important global companies which rely on demand beyond the US borders, such as FedEx (logistics) and Delta (airlines), are challenging the notion that there is a global upswing in the business cycle.

JP Morgan expects decelerating growth in Asia/China to remain a risk for global high-end consumer brands (they point to companies such as LVMH, Kering, Burberry, Swatch and Nike). And, whereas revenue expectations are strong in the US, Eurozone-listed company revenue expectations are now declining relative to one month ago at an annualised -7% pace. That's a stark difference.

Over the longer term, tech and artificial intelligence (AI) stocks are at risk of unwinding last year's rise in valuations if the costly capital investments do not yield the promised incremental earnings stream or productivity boost in coming quarters. However, these stocks are currently still outperforming, and that's most apparent in the mega-cap Nasdaq names.

So, investors are reasonably confident about US economic growth remaining robust. but are less certain anywhere beyond North America, and the data appears to back this up. For example, last week's release of December's US retail sales data showed higher-than-expected spending value of +0.6% versus November. The opposite happened in the UK, where the seasonally-adjusted value of goods showed a fallback of -3.6% from November. The downbeat sales activity seems to be at odds with the inflation data. Consumer price inflation rose 0.6% month-on-month, which surprised economists.

We have noted previously that the job of seasonal data adjustment has become increasingly difficult in the past few years. This may be due to the pandemic and its impacts, but the variability of data has increased. Changes in retail habits seem to have accelerated, driven by new norms in online shopping such as Black Friday offers (which appear to have driven a lot of November's UK retail sales).

We wrote of this apparent divergence last week, and there seems little to stop the trend. At its heart is the success of the 'America First' policies conducted by both Trump and Biden. Global companies like Microsoft, Alphabet (Google), Apple and Amazon have reaped the profits of access to the global markets, but have been encouraged to move their capital and the majority of investment in new production back to the US, while purchases of goods and services from outside the American continent has been discouraged.

This protectionist agenda has been accelerated by the (almost certainly correct) perception of security risks from China, Russia, Iran, and other bad actors. However, it has had significant direct and indirect impacts elsewhere, with Europe (including the UK) clearly suffering. As this year progresses, the noise from the US election will raise prospects of even more of the same types of policy given the perceptions of near-term success.

Yet, the US is not immune to the negative potential impacts of protectionism. While its current account balance has decreased relative to gross domestic product (GDP), it continues to consume more than it produces, and requires foreign investment to fund that balance. As we write in our second article this week, the US government also operates with a large funding deficit, larger than all major areas except for Japan, and one that is set to grow, whereas others are likely to fall in the next decade.

The US cannot continue indefinitely to expect others to fund its lifestyle without an equalisation in approach at some point. Failing that, there is a growing danger of more overt protectionist policies spreading across the world, and not just from China. The current divergence in economic fortunes is likely to clash with the US election agenda, where neither side has any incentive to extol the virtues of internationalism and free-trade. Commentators tend to give opinions on Biden and Trump's potential impacts on US assets, but Europe could be the most affected. This is especially so if US overseas defence spending is cut hard at the same time as US companies are given another tax boost.

While clearly a concern for investors for the medium to longer term, last week's return of seemingly indecisive markets while yields began to rise again had little to do with that, but all with the observation expressed at the top. Namely, there is a creeping realisation that the inherent impatience of markets has once again led to expectations of unrealistic timeframes and dimensions around the potential rates 'reward' on falling inflation. Does that indicate that market sentiment has reversed, and investors are no longer looking optimistically into the future? No, not at all from what we can see and have hopefully laid out above. A dose of realism into how long it may actually take for economic and market fortunes to be sustainably positive again may well offer up some short term investment opportunities, particularly while markets have re-entered range-bound terrain.

Understanding national debt and deficits' sustainability limits

Government bond yields are crucial to any investment outlook. The last few months of 2023 saw an astounding rally in bond prices – the inverse of yields – once capital markets started predicting interest rate cuts. That lowered the so called 'risk-free' rate of return and pushed up stocks virtually everywhere. The first few weeks of 2024 have seen a pullback in bonds, and hence equities have had a bumpier ride.

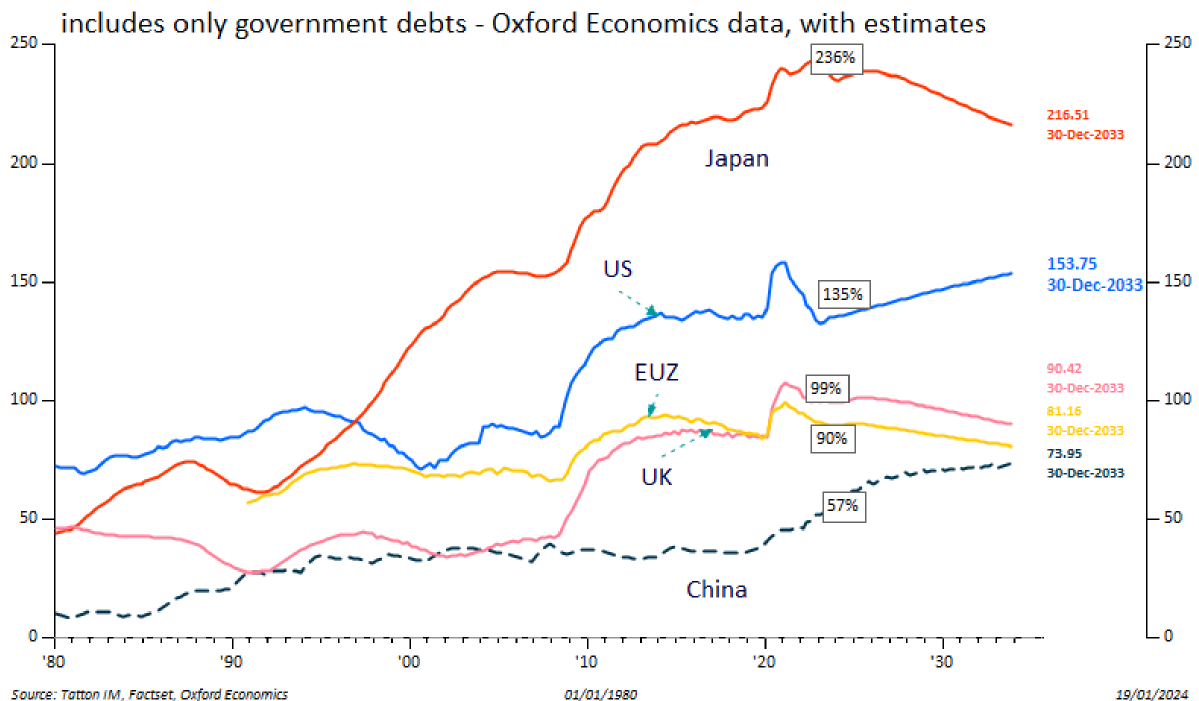
As the risk-free rate, yields are generally determined (in secondary markets at least) by the expected outlook for growth, inflation and interest rates. They are risk-free in the sense that governments can always – at least in theory – pay back the sums borrowed, if only because they can print more money. But rates fluctuate dramatically based on multiple risk factors and, in reality, governments have to act like responsible borrowers if they want funding to stay available.

National fiscal positions are therefore another key factor for yields. For developed economies, these are generally ignored for short-term bond movements, but can have massive impacts over the long term or in crises (Greece, Italy and the euro crisis being the most prominent developed economy example). How fiscal factors actually affect governments' borrowing power is a disputed and often very political topic.

As a rule of thumb, we know that ongoing borrowing – in terms of fiscal *deficits* – is generally more important than total outstanding debt, given the new borrowing can be greater than available investor funds. There are also worries about any government's ability to service the new debts. Generally, an increase in borrowing which is greater than general economic growth is seen as problematic. However, rising deficits are not always bad. In the early stages of the pandemic, when governments increased spending to previously unimaginable levels to fund emergency support schemes, bond investors saw debt-financed spending as positive, since this support was crucial to maintaining future economic stability and growth.

In general, if borrowing is stable as a proportion of economic activity and – crucially – that activity is expected to grow, governments can have ongoing fiscal deficits without worrying bondholders. But if the deficit-to-GDP ratio worsens without the economy growing, that is a sign of trouble. Like any borrower, sustained deficits should increase a government's cost of capital, meaning a sustained move up in yields.

At the moment, fiscal deficits are high by historical standards and rising over the long-term. This is not the short-term funding gap we saw in the pandemic, but a sustained push toward looser fiscal policy, and it is happening across virtually all major economies. With bonds currently in limbo, understanding countries' fiscal positions – and whether they might lead to instability – is key. Even though rising deficits can be seen across the world, the outlook varies by region – most consequentially between the US and Europe.

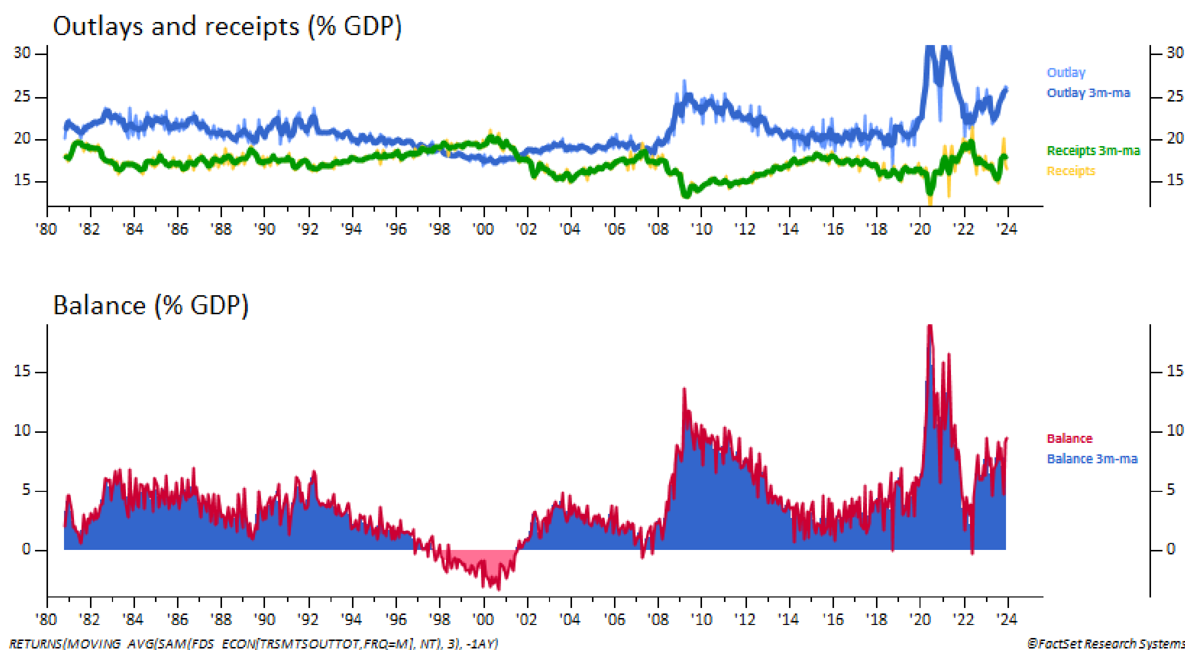


US deficit position and challenge

Deficit increases are more apparent in the US than anywhere else. This is partly just because the US is the largest economy in the world, and the US Treasury is the biggest national borrower – so people notice when it asks for more. But the trend toward fiscal expansion over the last decade is undeniable, and exceeds the growth in the US economy. This became very apparent during Donald Trump's presidency, when dramatic tax cuts drained the Treasury's coffers.

The Republican Party has a reputation for favouring fiscal conservatism – most famously with the 'Tea Party' movement that opposed basically all spending during the Obama administration. Trump captured the hearts of many former Tea Partygoers, but simultaneously abandoned any pretence toward deficit reduction. Coming late in America's then growth cycle, Trump's tax cuts meant the US entered the pandemic with already stretched debt metrics.

Deficit spending has continued and grown under President Biden. Some of this is a hangover from pandemic-era policies, but even after those have faded there has been a substantial increase in the gap between federal tax receipts and spending. The US government is running a cumulative deficit of $509 billion for the 2024 fiscal year so far, $94 billion more than in the same period in the prior fiscal year. Tax receipts are growing, thanks to the enduring strength of the underlying economy, but outlays are growing faster.



As the chart above shows, the US fiscal deficit (as a percentage of GDP) is now not far from its peak after the Global Financial Crisis. Moreover, the government's spending is greater than at that point. That was an extraordinary period of financial and economic contraction that necessitated emergency spending. The global cost-of-living crisis has impacted Americans (though not as much as this side of the Atlantic), but few would argue that the US economy needs "emergency" support as it did 15 years ago.

Heading into election season, the fiscal deficit will likely be an avenue of attack against Biden. This will probably happen regardless of which Republican candidate ends up on the ballot, even though Trump's own fiscal record is clearly questionable. Fiscally conservative rhetoric will be heard – even perhaps from the more centrist Democrats – but that does not guarantee fiscally conservative policy.

We wrote some months ago that it is an open question how fiscally conservative the current Republican Party will be, if or when it holds power. But a significant increase in the deficit is very unlikely regardless of who wins the presidential election – if only because fiscal metrics are already so stretched.

Tax cuts are, once again, expected to be a Republican priority. The UK "Trussonomics" experience (promising tax cuts without clarity on how they are to be funded) should mean that politicians will probably need to indicate significant spending cuts. Achieving a deficit reduction when combined with tax cuts would mean a massive scaling back of federal spending, which may be unpopular with many voters.

However, even a static deficit would mean a pullback in the fiscal impetus (the effect of fiscal spending on underlying growth), and cuts in government programmes ,such as welfare and Medicaid, would probably have a quicker negative impact on activity than the positive effect that tax cuts would deliver. Indeed, the tax cuts would probably raise the savings rate, potentially with a significant dampener on growth.

Sustained fiscal expansion is one of the main reasons why US growth remained surprisingly strong last year. It is almost inevitable that this impetus will reverse, but a sharp change in outlays could make things extremely difficult. Some analysts have argued on this basis that the US economy will struggle in 2024. The flipside of this, though, is that the Federal Reserve (Fed) has made clear its intention to cut rates, bringing down short-term yields and lowering immediate borrowing costs. That would constitute a substantial relief in terms of interest expense for the Treasury, since it has done a lot of its borrowing through short-term markets.

That move to short-term funding was in part because longer-term yields had become prohibitively expensive. But that expensiveness was in part down to an oversupply of bonds – too much borrowing from the Treasury. It was these factors that led to the US losing its last remaining AAA credit rating, for example. Shifting to short-term funding is reasonable if we expect inflation and interest rates to come down – as the Fed has indicated. There is a chance, though, that rates and real (inflation-adjusted) yields remain high for some time and that puts America's fiscal position in danger.

The deficit will have to come down, but that could be very damaging for the economy. It is unlikely to cause a recession – particularly if the Fed eases as it intends to – but it would likely mean less favourable conditions for US assets. This would threaten the long-term outperformance of the US relative to other regions. Its fiscal position could become a growing concern.

The European Monetary Union's new deficit management framework

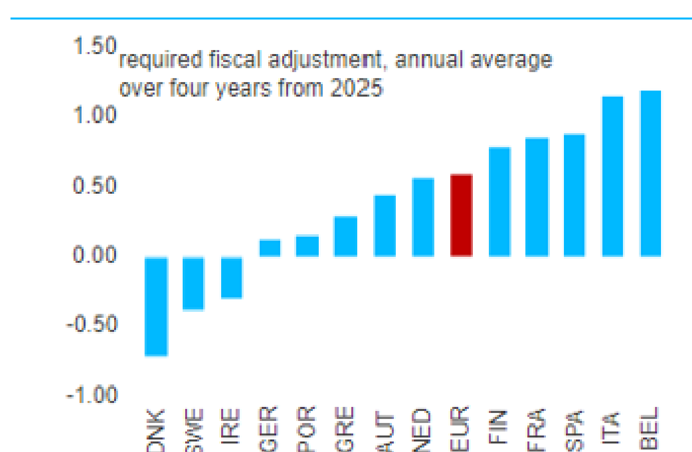
Despite some major crises over the years, European countries are generally more fiscally conservative than the US. This is by design: the Eurozone's fiscal sustainability rules prohibit debt or deficits above certain levels. We can debate how effectively or evenly these are enforced (Germany was the first to violate the Maastricht Treaty's fiscal rules), but their existence has reined in some excesses.

After a long process and significant compromise, these rules were reformed at the end of last year. One of the central ideas of the reform was to evaluate national debt sustainability on a more individual basis – rather than the old 'one-size-fits-all', which really fit hardly any – and that principle survived arduous negotiations. Fiscally conservative countries like Germany managed to include tight deficit adjustment 'safeguards' for high-deficit or high-debt nations, which will be difficult to implement in times of crisis (usually the only times such safeguards are needed).

Governments of historically profligate nations, meanwhile, achieved concessions which have only a short-term benefit. France won a concession on deficit adjustment that means countries can exclude interest payments from the adjustment calculation until 2027 (conveniently the year of France's next presidential election). Italy negotiated a seven-year period in which to carry out its own debt reforms.

The end result is a thoroughly European compromise: kick the can down the road and let future politicians deal with the inevitable crisis negotiations. The Italian government will be happy that new fiscal rules do not deprive it of spending power or investment in the short term, but within half a decade it could face a debt adjustment procedure even harsher than previous ones. Earlier debt-related feuds between Rome and Brussels have generated significant anti-European sentiment and populist support in Italy, looming over its economy all the while. These root problems are, yet again delayed, not solved.

The political impact of fiscal deficits seems a bigger issue for Europe than fiscal sustainability itself. The average required annual fiscal adjustment for European countries under the new rules amounts to removing 0.5% of GDP each year. That is significant, but arguably less than the fiscal adjustment required in the US to ensure fiscal stability. The adjustment required for certain core nations, though, could be very onerous.



Source: Breughel Institute

France, Spain, Italy and Belgium have to make significant changes from next year and beyond. In the last decade, populism has grown dramatically in each of these countries. France already has perennial social unrest. With economies so weak after Covid, the Ukraine war and cost of living crises, European-enforced cuts could well lead to exit rhetoric in the EU's core nations. We have seen close-up how damaging this can be for economic prospects and domestic asset values.

That said, fiscal hawks – traditionally found in Germany – might soften their positions. Germany's required fiscal adjustment is comparatively mild, but still implies fiscal tightening in the years ahead. This would be fine if the underlying economy was strong, but the German economy is clearly in recession and needs support. Indeed, the entire Eurozone is operating at or close to recession, which would suggest fiscal loosening rather than tightening.

This is unlikely to come immediately, but once interest rates have fallen (and hence financing costs for governments are lower), European governments might re-evaluate. Europe's fiscal policy is likely to remain tight this year, but – as usual – this is more down to political resistance than financial or economic conditions.

Over the medium and longer-term, a steady increase in deficits seems likely for the Eurozone overall. This is not just about individual nations, but central funds like the Next Generation EU project and the broader green transition. This is unlikely to hurt European bond yields in the short term – at least compared to US Treasuries – since the supply-demand balance still has significant leeway.

Europe's lack of political cohesion creates rigidities which have multiple impacts, such as uncertain and slow responses from politicians. Thus, the lack of ability of a matching fiscal response to the "America First" policy (of both Trump and Biden) has been a factor in Europe's manufacturing weakness. On the other hand, it does lead to a potential benefit in a lower government debt burden, resulting in a comparatively better funding position for European business investment. Nevertheless, what could damage European bonds is any hint of another euro crisis. As per usual, and what we just mentioned, this is much more likely to come from political conflict than from debt metrics themselves. Europe's fiscal position itself is much less of a concern than across the Atlantic, but the political structures for dealing with it are much weaker on the continent.

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Global Equity Markets	19-Jan			Technical	Valuations			
Market	much	% 1 Week	% 1 Week in sterling terms	Short Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7471	-2.3	-2.3	→ →	4.1	10.6	10.5	13.3
UK FTSE 250	18903	-2.1	-2.1	↗ →	3.6	11.3	10.8	14.4
UK FTSE All-Share	4085	-2.3	-2.3	↗ →	4.0	10.7	10.5	13.4
UK FTSE Small	6216	-1.7	-1.7	↗ →	5.9	9.4	7.9	12.4
France CAC 40	7372	-1.2	-1.3	↗ →	3.1	12.2	12.2	14.1
Germany DAX 40	16538	-1.1	-1.2	↗ →	3.2	11.3	11.2	12.9
US Dow	37557	-0.6	+0.2	↗ ↗	2.0	17.9	17.6	16.6
US S&P 500	4792	-0.1	+0.7	↗ →	1.5	20.3	19.7	17.8
US NASDAQ comp	15116	+0.7	+1.5	↗ →	0.8	27.8	26.5	23.3
Japan Nikkei 225	35989	+1.2	-0.6	↗ →	1.7	21.6	19.4	16.8
World Bloomberg	1674	-0.9	-0.1	↗ →	2.2	14.7	14.1	13.8
China mainland	3262	-0.8	-0.4	↗ →	2.0	17.7	17.3	16.5
Emerging Bloomberg	1088	-2.4	-1.7	↘ ↘	2.9	10.1	10.0	12.1

Top 6 Gainers		Bottom 6 Decliners		Fixed Income		
Company	%	Company	%	Govt bond	%Yield	1 wk chg
Flutter Entertainment	+23.3	Ocado	-16.7	UK Govt 10yr Gilt	+3.94	+0.16
RELX	+2.5	Fresnillo	-9.5	UK Govt 15yr Gilt	+4.32	+0.18
InterContinental Hotels	+2.3	Glencore	-8.3	US Govt 10yr Treasury	+4.16	+0.22
Smith & Nephew	+2.3	B&M European Value Retail SA	-8.0	France Govt 10yr OAT	+2.84	+0.17
IMI	+1.5	Lloyds Banking	-7.3	Germany Govt 10yr Bund	+2.34	+0.17
3i	+1.3	Centrica	-7.2	Japan Govt 20yr JGB	+1.48	+0.16

Currencies			Commodities			UK Mortgage Rate Estimates		
Pair	last	%1W	Cmdty	last	%1W	Rates (LTV c.75%, no fee)	19-Jan	20-Dec
USD per GBP	1.267	-0.8	Oil Brent $:bl	79.5	-0.4	UK BoE base rate	5.25	5.25
GBP per EUR	0.858	-0.1	Gold $:oz	2030.5	-1.4	2yr fixed	4.93	5.28
USD per EUR	1.088	-0.9	Silver $:oz	22.7	-3.1	3yr fixed	4.72	5.27
JPY per USD	148.32	+2.6	Copper $:lb	377.2	-0.5	5yr fixed	4.35	4.88
CNY per USD	7.192	+0.4	Alumnm $:mt	2138.2	-2.3	10yr fixed	4.56	4.92
USD per Bitcoin	41,011	-10.4	S&P soft crops	237.7	+3.4	Standard variable	8.03	8.03

19/01/2024
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

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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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