CAMBRIDGE
INVESTMENTS LIMITED

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US economy slows to our pace

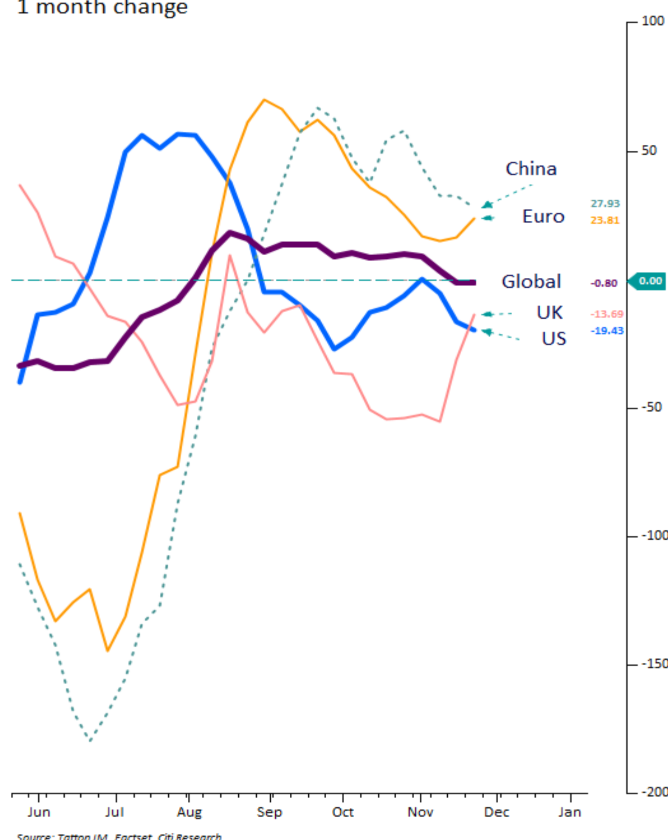
November remains a positive month in capital markets, although equities had a neutral week and longer bond prices have fallen back. UK government bonds (Gilts) have been the best performing bond market in the past few weeks, but the tax cuts announced in last Wednesday's Autumn Statement, although relatively minor, were enough to push the ten-year Gilt yield back up above 4.25% (rising yields mean falling bond prices).

Although it was a busy time for UK news, the US-centric nature of global markets means Thanksgiving week tends to be quiet. Things should pick up this week, but markets will likely be decreasingly busy over the next four weeks. However, a decline in trading activity doesn't necessarily mean quiet markets, particularly if a group of investors decides to move things around. If they want to buy, we can end up with a 'Santa rally'. If they are stressed and need to raise cash levels, we can get a nasty sell-off, such as what happened in 2018. It all depends on how investors perceive risks and opportunities evolving in the New Year.

Risk appetite wobbled in the run-up to the end of October, driven by falls in bond values, but right now there are few signs of stress after bond and equity market rallies. Price volatility has declined across the board, and option volatilities (a measure of expected volatility) have come down to low levels. The risk of owning market-traded assets has declined, and that slow process tends to lead to a gentle rise in risk asset prices.

But, as we mentioned last week, there is a potential problem with an environment where rising low-risk bond prices (and falling bond yields) are a driver of higher risk asset prices. Falling bond yields are mostly associated with some sense of a slowing economy and it appears that, on balance, the global economy may indeed have eased back. The good news is that although growth may be slowing somewhat, this phase may prove to be better balanced.

One way of discerning change is to compare economic data to economist forecasts. If things are picking up, economists will have underestimated the data; vice versa if things are slowing. Citi Research produces 'Surprise Indices' for each major area, and we show how major areas are tracking in the chart below:



Our version of the Citi indicators emphasises the rate of change by looking at index change over a month. Above zero is associated with acceleration, below zero with deceleration.

The US was pushing on in the summer months, but the impetus has fallen away during autumn; steady through October but having entered a slightly weaker phase again.

At the same time, the Eurozone and China have seen their impetus go from negative to positive and are hanging on. The UK remains disappointing but may be showing signs of heading to stabilisation.

Overall, growth changes are becoming similar and the US is much less out of kilter with the rest of the world. This has allowed US bond yields to fall back, taking the pressure off other bond markets.

Another big impact has been the follow-through in currencies. The US dollar has had another week of decline against most major currencies. Essentially, this reduces stress on companies and governments outside the US that have borrowed in US dollars (of which there are many) as it becomes easier and cheaper to get dollars to service those debts.

Another positive has been that commodity and energy prices are edging lower. They are lower in US dollar price terms, which also means cheaper prices in euro and sterling terms. It's not huge but every bit helps. It also helps Ukraine marginally that Russia will be getting less revenue.

Lastly, the truce between Hamas and Israel will be short term, but things have not gotten worse.

We mentioned that UK bond yields bounced last Thursday. Before the Autumn Statement, UK purchasing manager indices (PMIs) were better than expected. However, we shouldn't overstate their strength. An index level of 50 denotes zero growth, and manufacturing was at 46.7, services at 50.5. The composite was at 50.1. It represents an improvement but not growth.

Still, as FactSet's StreetAccount reports, many economists revised their interest rate views after the fiscal statement and better PMI data. Capital Economics said the Bank of England (BoE) would remain uneasy about the stickiness of inflation. Goldman Sachs highlighted policymakers might worry that the cut to National Insurance and rise in minimum wage could raise pay growth. They reiterated their view that a rate

cut is more likely in the third quarter of 2024 rather than the second quarter, while Citi Research moved their expectation of a rate cut from May to August.

We suspect that the tax giveaways are not likely to be that influential. Barclays announced lay-offs last Friday, and a slowing of the employment market will have a greater impact.

The Autumn Statement was notable for its focus on changes to Individual Savings Accounts (ISAs), welcome for almost all UK household savers. None of the changes seem contentious and should improve the environment for savings. The more important change to come is pension reform, and that remains in the consultation phase. It's true that the UK needs a much better private sector pension structure, and getting change broadly right is very important. Given the proximity of a General Election, cross-party support will be essential. Fortunately, the Sunak government and a putative Starmer government may well be reasonably aligned, so this consultation phase stands a good chance of resulting in beneficial change reasonably soon.

It was a week when right-wing politicians gained some notable ground. We write about Argentina, where the electorate voted to relinquish their currency (perhaps not surprising given 150% inflation) in a separate article. In the Netherlands, the Dutch electorate has also brought a right-wing prime minister to power, although Geert Wilders is less of a fan of relinquishing currency sovereignty. Elsewhere, the German government is dealing with a court ruling imposed an across-the-board budget freeze which could significantly compress its ability to spend, and could be as large as €800 billion. While this ruling will probably get sorted in due course, it may cause a shock along the lines of the recurring US debt ceiling issues.

Almost lastly, a reality soap opera drama unfolded surrounding OpenAI, the company that released ChatGPT and made generative artificial intelligence (AI) the biggest theme of 2023. This time it made headlines after the board ousted Chief Executive Officer (CEO) Sam Altman, but the drama only got more outlandish from there on. But this story is not just about AI, it is also about the G of ESG investing: Governance. We cover this also in a separate article.

Lastly, China's leaders are intent on rekindling economic vibrancy. Beijing has said it will allow banks to offer unsecured short-term loans to qualified developers for the first time. That list includes Country Garden, the largest and definitely most important developer, and a company that some had accused China's leadership as being intent on destroying. China and other Asian markets including Japan were the best performers last week.

The AI governance dilemma

The Silicon Valley soap opera keeps delivering. Recently, investor darling OpenAI shocked the world by suddenly firing superstar CEO Sam Altman for not being "consistently candid in his communications". One intriguing rumour was that OpenAI had made a step-change discovery in the field of general intelligence which had been kept from the board.

OpenAI is privately owned, so we don't know precisely its market value. Microsoft has a large investment, and its share price has risen during the course of the week at the same pace as the rest of the NASDAQ.

The bombshell of Altman's sacking threatened revolt on two fronts: investors who had committed billions to OpenAI in the wake of its ChatGPT release put pressure on the board to reverse its unpopular decision, while nearly all of the company's 770 employees threatened to follow Altman out the door. The board ploughed on, hiring Twitch co-founder Emmett Shear as interim chief executive.

OpenAI's biggest backer, Microsoft, took the opportunity to bring the ousted Altman in-house. The tech giant, which has poured $13 billion into OpenAI since 2019, hired Altman and former OpenAI chair Greg Brockman (also sacked), to lead a new advanced artificial intelligence (AI) research team. In the same breath, Microsoft committed to hiring any OpenAI staff that wanted to follow their former leader. Microsoft reportedly remains "committed to our partnership with OpenAI", according to Chief Executive Satya Nadella.

By Wednesday last week, Altman was back in charge of OpenAI and the board that had sacked him was gone.

The young tech executive is very popular at OpenAI and beyond. Just two weeks ago, Altman stood on stage at OpenAI's first developer conference and listed off the company's achievements to rapturous applause. When he invited Microsoft's Nadella onstage and asked how the tech giant felt about its investment, the latter just laughed and proclaimed: "we love you guys". This week Nadella proved how much, by first employing him after his sacking and then freeing him to retake his position at OpenAI.

Altman's status as the face of the AI investment boom was, and likely still is, assured. And yet, OpenAI's small board saw fit to fire him for reasons that remain opaque. Many have tried to cast the story as one of a daring entrepreneur coming up against overly cautious scientists – reflecting OpenAI's dual nature as both a researcher hoping to discover for the public interest, and a company trying to maximise returns for its investors.

By way of some background, OpenAI began as a non-profit organisation in 2015 with Sam Altman and Elon Musk serving as initial board members. In 2019, Sam Altman became the full-time CEO, with a new commercial arm being established.

Initially, the stated sole aim of OpenAI was to develop AI "safely" and for the benefit of humanity. However, the costs of developing and running cutting-edge technologies were so substantial that it needed much more investment. That required extensive private capital, which meant a good return on the capital which required commercialisation – and Altman was the ideal person for the job, having overseen a Silicon Valley tech incubator for years.

Even so, OpenAI's commercial arm was overseen by a non-profit oversight board, a hybrid structure that Altman called the "two tribes". Tribal relations were difficult; researchers repeatedly warned that unrestrained AI growth could destabilise wider society, while the business brains pointed to the need (and the opportunity) to make money.

OpenAI's remaining leadership insists that these issues were not the cause of Altman's removal. Insiders have hinted that communication between Altman and the board – along with the former's desire to set up separate business ventures like a high-tech microchip provider – lacked transparency and caused increasing frictions. On the other hand, one of the biggest employee concerns expressed in their letter demanding

Altman's reinstatement was that his removal jeopardises the mission to promote safe AI. Even so, OpenAI's then appointed (interim) chief Shear has publicly expressed concerns about the AI boom's human impact.

There are a couple of points worth making here. Firstly, we do not know exactly why Altman was sacked and that is, in itself, reflective of a poor board. Reportedly, only one person outside of the board was informed of the move before it happened, and the public displays of flip-flopping added much unnecessary uncertainty. Good old-fashioned incompetence is unfortunately never in short supply.

Secondly, OpenAI had a poor corporate governance structure. This episode is really about the proper alignment of incentives for corporate decision-makers. Boards of commercial companies are designed to maximise shareholder value while ensuring continuity. That means balancing employee and regulatory requirements. Non-profit boards can have varied and amorphous goals whose progress is often much harder to measure in concrete terms. It's difficult, but can be done if the goals and methods for achieving them are open and transparent. Ironically, openness doesn't appear to be something the OpenAI board is good at.

Regardless of whether Altman's sacking was ultimately down to these clashing incentives, there was certainly plenty of tension between revenue and promoting safe AI. The biggest constraint on technological innovation is resources. If you have enough resources, then the only way to constrain your innovators is to stop them doing their job. Good luck with that.

Making them work together clearly requires more attention and accountability than was on display here. And while OpenAI is a particularly clear example of conflicting priorities, they are arguably becoming more common thanks to the perceived need for socially conscious corporates and ESG investing.

These points are from the excellent market strategist Bill Blain:

- *In complex new businesses the expertise and experience of independents on the board is critical. OpenAI was short of both – and critically seems to have zero appreciation of the staff's ambitions or motivations.*
- *The need for oversight to ensure safety in new technologies, including AI, is clear. We need to design governance structures fit for purpose.*
- *Any company is only as good as the quality of its board.*

And even then it may not be enough. One does not have to be a doomsayer to realise the risks of unfettered AI proliferation. A technology so powerful, with poorly understood consequences, may not be possible for private groups to self-regulate or govern in the public interest. As one industry insider put it to us, "this isn't just better technology – we've made a new kind of nuclear weapon".

Even with clearer and tighter regulation, we can't be sure of a socially acceptable outcome when first-mover advantage means untold riches, near-untouchability and could be achieved in months, not years. Centralised research bodies are currently promised by various governments, and are sorely needed.

Can radical Milei bring stability to Argentina?

Voters in Argentina have never really been ones for moderation. After decades of on-off Peronist leaders – a populist ideology with strong economic intervention from the state – a far-right libertarian that wants to cut the state down with a "chainsaw" has won the presidency. Javier Milei, an economist, TV personality and self-proclaimed "anarcho-capitalist" won Argentina's run-off election by a surprisingly large margin last week, beating centre-left Sergio Massa – the current economy minister – by 56% to 44%.

Milei believes in unfettered market freedom and advocates substantial cuts to public spending. More radical ideas floated on the campaign trail have included loosening gun control, and allowing a private market for human organs. His fierce criticisms have extended beyond the Argentine political establishment to foreign governments, and he has promised to cut all ties with China and Brazil – Argentina's two largest trading partners. His populist leanings and maverick personality have earned him comparisons to Trump and Bolsonaro, but his message has always been more market oriented and less protectionist than either. The president-elect was defiant after the result: "the model of decadence has come to an end, there's no going back".

Exactly where Argentina is going to is another matter though. The new president promises swift and dramatic reforms to the economy, but enacting change in the sharply divided nation has long proven difficult. Milei, a relative political novice, lacks legislative support in Buenos Aires; his party fell well short of a congressional majority in October's elections. His toughest task will be quelling 143% annual inflation, while dealing with extremely high public debt and practically zero fiscal leeway. His election has been cast as a 'roll of the dice' by Argentines fed up with years of punishing inflation and worsening living standards, but many are predicting a difficult transition.

One of Milei's most consequential proposals, for international investors and its own population, is to scrap the Argentine peso and replace it with the US dollar and close the country's central bank (at least as a printer of money). This is designed to limit price rises and anchor people's inflation expectations by running the economy on a more trustworthy currency. South American neighbours Ecuador and El Salvador are also fully dollarised (1997 and 2000 respectively). Panama is considered dollarised as its 'Balboa' has been worth exactly $1 since its 1904 independence (perhaps the first and best example of a 'stablecoin').

Full dollarisation has never been tried for an economy as large as Argentina though – the continent's second biggest and a member of the G20. Argentina pursued a 'stablecoin' in the 1990s, when the peso was pegged to the dollar at a one-to-one rate, but couldn't resist printing its own pesos.

Dollarisation is a consequence of the fact that Buenos Aires could not control its own monetary base. The government asked – and got – the central bank to print pesos because it couldn't borrow enough to fund its repeated overspending. In reality, it wasn't borrowing from its own populace, it was borrowing from foreign investors who weren't lending in pesos, they were lending in hard currency. As we wrote recently, Argentina accounts for 30% of the entire outstanding debt of the International Monetary Fund (IMF), part of a long-term dysfunctional relationship with the Washington-based agency that acts as the bank of last resort to the global community.

But dollarisation is not a panacea. The reason why there are central banks with their own currencies is that economies have different economic cycles, and money-transfer systems. If money, trade, savings and social support are not easily transferable from one region to another, a single currency interest rate can be too low in one area and way too high in another. The Eurozone crisis came about because its country members had segregated fiscal policies but centralised monetary policy. Still, Europe's economies have at least strong trade links. Argentina is a long way away from the US. If Greeks struggle with interest rates tailored to Germans, one can only imagine how Argentines will feel when forced to bear American rates.

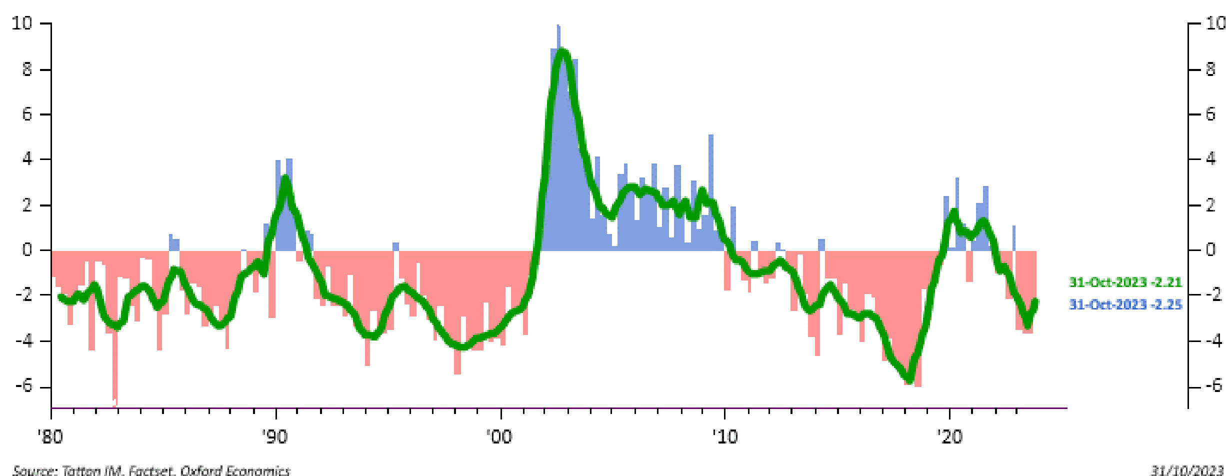
Currently the peso-dollar exchange is legally fixed at P350/$. However, many Argentinians already use US dollars and there are entire highstreets across the country which act as informal retail dollar-peso exchanges – the 'blue dollar' market – where the rate was P1070/$ last Wednesday.

In order to effect the change, the soon-to-be-gone central bank will have to commit to a rate somewhere close to this level, and then be able to have enough dollars in the system to fulfil the demand for cash. If Argentinians have enough confidence in their local banks to deposit their dollars (which they hold in actual paper cash), the central bank may have enough to go round.

Still, the estimated $300 million held by households is a very small amount. The transition to a dollar economy would be extremely difficult in the short term as Argentina's central bank has already burned through most of its foreign exchange reserves to preserve the peso's value, putting serious question marks over where Buenos Aires would find the dollars it needs. Even Milei's team have put the dollarisation float at $40 billion, money Buenos Aires simply does not have.

Economists are almost unanimous that dollarisation, if possible, would require further devaluation of the peso, but if such devaluation came suddenly, it would likely be seen as a betrayal by Milei voters. The other option is to return to the IMF (or possibly the US directly) with hands raised. But, if the fund were to agree, it would amount to a doubling of Argentina's already substantial debt pile. On its part, the IMF has expressed serious reservations about the feasibility of dollarisation.

The long-term point will have to be that Argentina must earn more dollars than it spends in order to build its internal monetary (dollar) base. The pandemic period was beneficial for commodity exporters and Argentina was no exception. Outside that period, it has not had a current account surplus in any year since 2010 (see chart below). Building a dollar pile means exporting more than importing, having a slower rate of growth than its trading partners. Argentina has got to hope its trading friends maintains strong demand in the next few years.



And yet, capital markets seem to have taken all of this in their stride. Argentina's dollar bonds have risen in price, from about 25% of face value to 30%, while the 'blue' exchange rate (the informal rate actually offered for dollar/peso swaps) has been fairly stable. This is despite dollarisation being one of the key policies that Milei refused to soften his stance on during the election. One could argue that investors are just excited to pick apart the remains of Milie's "chainsaw" cuts, but it at least suggests an expectation that Milei's policies will avoid an economic collapse that has loomed for years.

The unfortunate truth Argentines might well discover is that, while reforms are needed and dollarisation may indeed be possible, a populist firebrand might not be the person to deliver them. As we hinted above, enacting the policy likely requires a delicate approach to negotiations, and a real commitment to institutional stability. In resolution to the Greek debt crisis for example, perhaps the most important factor for outside investors was an end to hostile negotiations – almost regardless of what the actual resulting policies were. It is early days, but Milei's campaign gave little reason to think that his regime would bring that stability. The anarcho-capitalist that looks up to Trump and Bolsonaro, while attacking China, might struggle to get the results he promises.

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27th November 2023

Global Equity Markets	24-Nov			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	7466	-0.5	-0.5	→ →	4.0	10.9	10.3	13.3
UK FTSE 250	18412	-1.0	-1.0	→ →	3.8	12.1	10.7	14.4
UK FTSE All-Share	4066	-0.5	-0.5	→ →	4.0	11.0	10.3	13.4
UK FTSE Small	6082	+0.3	+0.3	→ →	5.6	10.5	7.5	12.5
France CAC 40	7288	+0.7	-0.2	→ →	3.2	12.2	11.9	14.1
Germany DAX 40	16017	+0.6	-0.3	→ →	3.6	11.3	10.9	12.9
US Dow	35315	+0.9	-0.4	→ →	2.1	19.4	16.8	16.6
US S&P 500	4554	+0.9	-0.4	→ ↗	1.5	20.5	18.8	17.7
US NASDAQ comp	14230	+0.9	-0.5	→ ↗	0.8	29.9	25.5	23.2
Japan Nikkei 225	33662	+0.2	-1.1	→ →	1.8	19.8	18.3	16.8
World Bloomberg	1609	+0.9	-0.5	→ ↗	2.3	14.3	13.7	13.8
China mainland	3540	-0.5	-0.9	→ →	2.0	17.9	16.7	16.5
Emerging Bloomberg	1099	+0.2	-1.1	↘ ↘	2.8	12.3	10.7	12.1

Top 6 Gainers		Bottom 6 Decliners		Fixed Income		
Company	%	Company	%	Govt bond	%Yield	1 wk chg
Sage	+12.5	Ashtead	-9.5	UK Govt 10yr Gilt	+4.29	+0.21
Diploma	+9.5	Kingfisher	-6.8	UK Govt 15yr Gilt	+4.61	+0.20
JD Sports Fashion	+6.9	Land Securities	-5.5	US Govt 10yr Treasury	+4.46	+0.03
London Stock Exchange	+3.9	Glencore	-5.2	France Govt 10yr OAT	+3.19	+0.05
Intertek	+3.9	International Consolidated Air	-5.2	Germany Govt 10yr Bund	+2.63	+0.06
Admiral	+3.2	St James's Place	-5.0	Japan Govt 20yr JGB	+1.50	+0.02

Currencies			Commodities			UK Mortgage Rate Estimates		
Pair	last	%1W	Cmdty	last	%1W	Rates (LTV c.75%, no fee)	24-Nov	25-Oct
USD per GBP	1.259	+1.4	Oil Brent $:bl	81.3	+3.1	UK BoE base rate	5.25	5.25
GBP per EUR	0.868	-0.9	Gold $:oz	2002.5	+0.9	2yr fixed	5.28	5.94
USD per EUR	1.093	+0.5	Silver $:oz	24.1	+1.1	3yr fixed	5.12	5.78
JPY per USD	149.54	-0.1	Copper $:lb	376.0	+1.1	5yr fixed	4.72	5.23
CNY per USD	7.154	-0.8	Alumnm $:mt	2201.8	+0.4	10yr fixed	5.07	5.11
USD per Bitcoin	37,658	+3.6	S&P soft crops	252.8	+0.2	Standard variable	8.01	7.93

24/11/2023
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

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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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