CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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The resilience narrative comes under pressure

A potentially meaningful change in correlations happened last week. In recent times, a fall in yields (and therefore a rise in bond prices) would go alongside rises in equity prices, particularly the mega-cap growth consumer-related techs like Amazon, Alphabet (Google), Microsoft and Apple. Last Thursday, US Treasury long maturity yields started to retreat from highs but, this time, US stocks carried on lower. It was not just equities which weakened. In the credit markets, despite higher government bond prices, corporate bonds were flat to weaker, especially among the more indebted companies. If this new dynamic continues, it may signal a change in investor expectations regarding the resilience of US sales and earnings growth.

All through this year, the developed world's economic growth has been surprisingly robust, led by a remarkably resilient US. Indeed, the pace of growth actually picked up. US growth for the third quarter was strong. Real gross domestic product (GDP) growth came in at +4.9% (annualised and seasonally adjusted). The Atlanta Federal Reserve 'nowcast' had growth as high as +5.4%. Europe and the UK have been stronger than expected as well, but the third quarter has proved less positive.

The quarter's corporate results give us a different prism on recent growth and the outlook. Aspects of the results and company guidance suggest the near future may not be quite as positive (and it's noticeable that a number of companies have declined to publish any guidance at all).

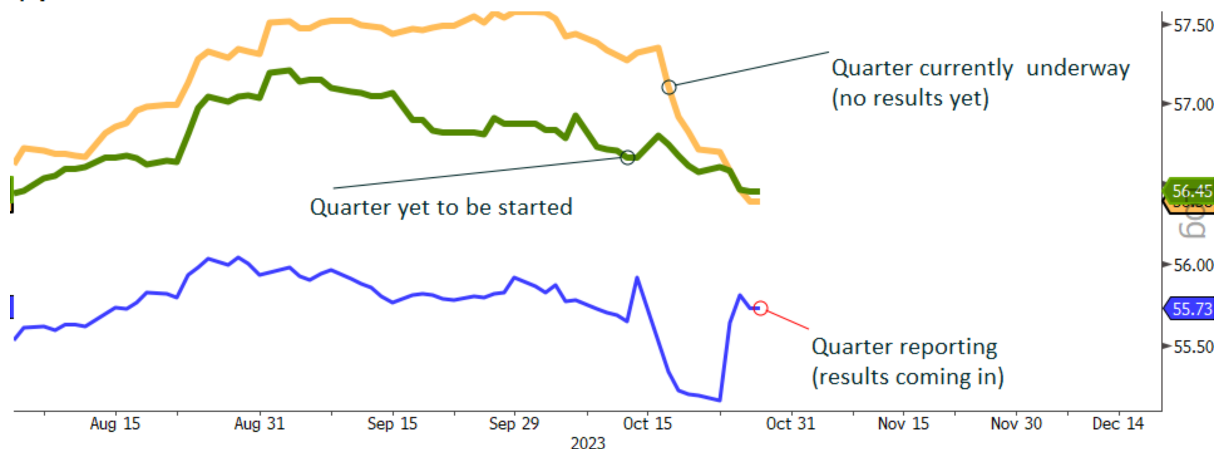
In particular, concerns are growing that the US consumer is running out of steam, or perhaps rather their confidence to run down their savings further. Market commentators have borrowed the name of the great film 'The Magnificent Seven' in referring to the largest seven (tech) growth companies in the S&P 500: Apple, Amazon, Alphabet, Microsoft, NVIDIA, Meta (Facebook), and Tesla. Slowing advertising suggests a slowing macro backdrop.

The July-September results at Amazon, Meta and Alphabet were seen as good but gone. Investors worried that the digital ad market is slowing. Meta disappointed (shares dropped more than 4%) after its executives warned of softer advertising spending, and whinged it was at the mercy of an uncertain economic environment. Alphabet slumped 9.5% last Wednesday. As its dominant search business matures, the cloud computing unit needs to take the lead on growth but the business line posted a smaller-than-expected profit. Meanwhile the smaller but previously high-flyer social media company Snap said it had limited visibility into revenue for the rest of the year.

Although Amazon now gathers most of its profit from cloud computing arm AWS, it remains classified as a global consumer discretionary company because its sales platform revenues still dominate. North American platform sales accounts for over 60% of total revenues. Its major swings in revenue and profit come from this area, making it a good bellwether for US consumption. In its results last week, Amazon also displayed a healthy past quarter, and yet the positive surprise still leaves the stock down on the week, and -17.5% from this year's 13th September high. To us, this seems an indicator of waning investor confidence in US consumption.

The early days of this reporting quarter have seen a marked decline in expectations for the quarter currently underway (Q4 2023), as the yellow line in the chart below shows.

S&P 500 earnings per share analyst forecasts
$ per share



Source: Tatton IM, Bloomberg: G1581
SPX Index (S&P 500 INDEX) SPX 2024 + 2025 Daily 13AUG2023-27DEC2023 Copyright© 2023 Bloomberg Finance L.P. 27-Oct-2023 13:19:26

An 'earnings recession' is where reported earnings (on a quarter versus same quarter of the previous year trailing basis) start to decline. The S&P 500 last had such a period in the summer and, despite the declining outlook (yellow line), it is highly unlikely that a return to an earnings recession will occur during this reporting quarter or, for that matter, the next quarter. However, the S&P 500's current valuation builds in at least normal (as in non-recessionary) profit growth, and that parameter of the valuation matrix feels like it may be coming under threat. The index valuation, by our rough calculation, is about 10% above the norm after accounting for (the risen competition from) bond yields.

The dominance of the Magnificent Seven over global equity markets also highlights a potential weakness. It is unsurprising the companies that have fared best in stock markets this year have had a large slice of the most robust part of the global economy, US consumption. Other parts of the world have been significantly lacklustre in comparison. We could see a period where US consumption retrenches somewhat while other areas become relatively stronger.

To that end, China's announcement last Tuesday of a finally huge fiscal expansion could be very important. Policy urgency, rather lacking through most of 2023, seems to have become almost panicky. This comes amid signs that the private sector remains under the cosh, especially in getting hold of US-dollar based financing given the now lofty yields that come with it.

While the developed world's stocks slid through the week, China's markets bounced substantially and, this time, not because of government 'guidance' to Chinese institutional investors to buy. We have seen such bouts of rebound after the many policy announcements through the year, all of which have fizzled out in a few days. This policy shift is undoubtedly stronger. We await to see if it will be enough to turn investor sentiment for more than the short-term.

The European Central Bank (ECB) met last Thursday and left rates unchanged. We write about this in a separate article. The meeting felt unremarkable in many ways; no rate or other policy changes, no change in the mantra that sticky inflation remains the main risk. And yet the underlying tone was much less strident. Interest rate markets now see that the ECB's policy is on hold and that the next move will be a cut as and when inflation is close to target and very likely to be well before the US Federal Reserve (Fed) starts to cut.

The other global rate setters of the Federal Open Markets Committee and the Bank of England (BoE) meet this week. The stalling of the oil price and other energy price rises also should allow the rate pause to continue. All ears will be on the respective statements and press conferences. We expect dovishness from the BoE given the slowing inflation environment, the easing of employment tightness and the weak house market.

That last component seems set to continue. Bloomberg reported that financial advisory firm Cornerstone Tax had surveyed 2,081 landlords and tenants, with the results indicating that UK landlords are feeling the squeeze from higher rates and more bureaucracy. They may be set to sell properties at triple the pace of two years ago. About 15% of rental property owners appeared likely to leave the market this year. The biggest headwind is higher borrowing costs as low interest fixed-rate deals expire making buy-to-let properties unaffordable.

The survey, one of the few tangible pieces of evidence, suggests supply of properties coming to market might increase. House prices have fallen about 5% from the peak so far and many expect a further 5% drop. Properties to let will decline, however, and keep rent at elevated levels.

What we take away from last week is that a certain level of realism took hold in the markets. This realism has displaced what seemed at times almost blind conviction that the resilience of the US consumer would mean that the top seven stocks of the US market would over most timeframes constitute the better return alternative to 5% yields from government bonds, regardless of the risk profile of the punting retail investor. While this has taken some shine off the 'Magnificent Seven', we should be clear that they are still in aggregate up 50% since the beginning of the year, while the rest of the US stock market has been flat.

It may not in itself constitute the beginning of distinct stock market correction such as experienced 25 years ago when the dot.com bubble burst. However, what it does potentially tell us is that the leadership of just a few market darlings is waning and a focus on real company earnings – rather than imagined future earnings – is taking place. That is not necessarily a bad thing for markets as long as there is the prospect for decent earnings on the horizon, as there currently is for 2024. The risk is that it leads to a more significant correction across those Magnificent Seven stocks and beyond, then US consumers (shareholders) could suddenly feel a lot less well-off, which has the potential to slow consumer demand much more quickly than required to stamp out the remnants of inflationary pressures. This would force central banks into slashing rates to stabilise the economic demand-supply balance much earlier than anticipated. This scenario is not the central one, but even with just a slowdown it does mean that the high long bond yields that have been locked into clients' investment portfolios will begin to shine a lot more than with just their yields.

Oil majors double down

Big oil companies have felt the urge to get bigger recently. In October alone we have seen two of the biggest acquisitions in the history of the oil and gas industry. Last Monday, Chevron announced it will purchase fossil fuel producer Hess for $53 billion, less than two weeks after rival ExxonMobil agreed a whopping $59.5 billion deal for Pioneer Natural Resources. The deals have remarkably similar profiles: two American supermajors each buying a US-based company in the production and exploration space for near-identical sums, paid for in both instances entirely in shares of the acquiring company, rather than cash.

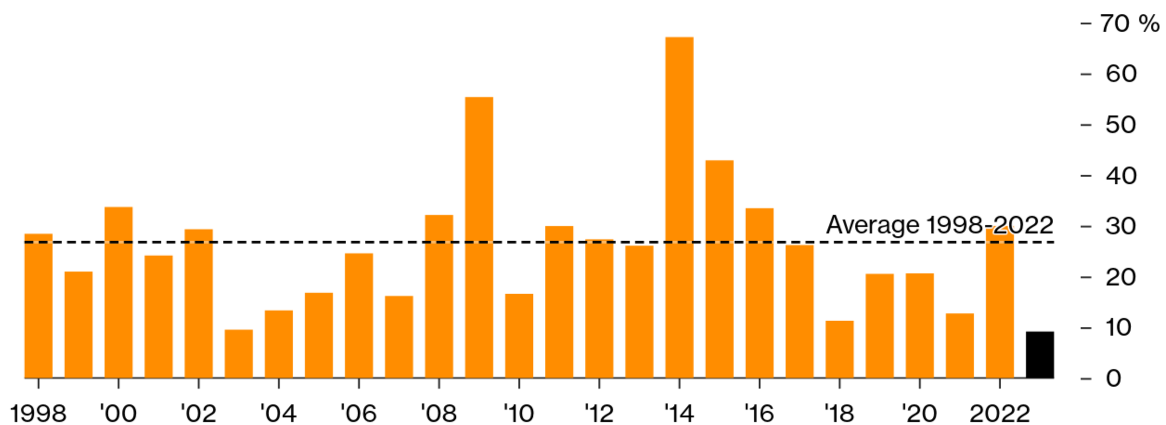
The megadeals have naturally caused stirs in the industry. Oil executives and benefactors have called it a sign of hunger and expectation in the sector. Contrary to the prevailing narrative of 'peak oil' in the near future, these moves are a "testament" to the fact that "hydrocarbons are here to stay" – according to Saudi energy minister Prince Abdulaziz bin Salman. Including net debt obligations acquired as part of their deals, the US oil giants together have committed more than $120 billion, an incredible sum to fork out if there was any suggestion of declining oil revenues in the foreseeable future. Chevron chief executive Mike Wirth agrees, suggesting anyone that thinks the world will soon wean itself off fossil fuels is kidding themselves: "you can build scenarios, but we live in the real world".

That was Wirth speaking to the *Financial Times* last month, and he has certainly put his money where his mouth is. 'Oil forever' naysayers are not just environmentalists or eco-tech bulls, though, and include global energy watchdog the International Energy Agency (IEA). The IEA has warned in recent years that oil and gas exploration needs to decline if the world is to have a chance of meeting its emission targets, and recently predicted that demand for fossil fuels will peak by the end of this decade. This forecast – predicated on half the world's electricity coming from renewables by 2030 – is not "remotely right", according to Wirth. OPEC, the Saudi-dominated oil cartel, instead thinks that oil demand will rise by 15% between now and 2045.

Oil companies or regimes are obviously not the ones to ask for an unbiased outlook. Clearly, corporates do not commit tens of billions without a moneymaking plan that can withstand shareholder scrutiny. But megadeals are not always a sign of confidence. Far from it, mergers and acquisitions are common in low-growth industries, providing the scale needed for defensive cover. Both Chevron and Exxon generated massive cash piles over the last few years, thanks to oil and gas price spikes. With oil consistently above $90 per barrel (thanks almost entirely to OPEC-plus supply controls) it makes sense to utilise their capital and leverage their elevated share prices. Rather than expansion, they might be consolidating for an uncertain future.

Energy M&A Premiums at 25-Year Low

North American energy deal making is red hot as Exxon Mobil and Chevron buy rivals. But so far this year, the sector is witnessing minuscule premiums



Source: Bloomberg

Bloomberg Opinion

This defensive interpretation is backed up by the fact that stock valuation premiums for recent oil and gas deals have been extremely small by historical standards. Pioneer sold for 9% above its market share price, while Hess Corporation accepted a 10% premium. According to Bloomberg, these figures are exactly in line with 2023's average oil and gas premiums paid above stock market valuations, but far below historical levels. There have been $270 billion worth of mergers and acquisitions in the North American energy sector year-to-date, but the average premium paid has been the lowest in 25 years at just above 9%. For comparison, the long-term average for that timeframe is 26.5%.

Before getting carried away, we also need to consider that the share prices of selling companies have increased dramatically in the last few years. Higher revenues from pricey oil and gas are clearly a part of it, but valuations are high compared to the underlying commodities. Hess shares are trading at price-to-earnings ratio of 20 times, for example, almost double the ratio for now parent-company Chevron. These valuations would be unthinkable if one expected a total collapse of oil demand in the next decade or so – as the more ambitious net-zero targets would seem to require.

There is probably a mix of motivations for these megadeals – partly defensive and partly bullish. This mixture has a lot to do with the particular environment that US oil majors find themselves in, certainly compared to global rivals. In the post-pandemic world, amid intense wars in Europe and the Middle East, energy security has become one of the top political priorities for every nation. This often manifests as energy independence – not relying on imports – and US politicians have clearly shifted to this way of thinking.

For the Biden administration, there is a clear push for the US to produce its own renewable energy, but there is also a recognition that oil and gas production should be supported in the short-term. The world's largest economy is in the fortunate position that it exports more energy than it imports, in large part due to the growth of the shale industry. Politicians know how important this position is both in terms of their short-term electoral prospects (non-reliance on imports is why US consumers paid orders of magnitude less than their European peers for natural gas last year) and their country's longer-term geopolitical aims. Ironically, by making sure energy is more affordable now, the US could manage a more successful energy transition – some cynics may say.

Promotion of the national oil champions is a part of this. According to Citi research, US oil supermajors trade at 40% higher valuations than European counterparts like BP and Shell, a wide gap by historical standards. Some of this is due to the general outperformance of US versus European stocks, but a significant amount is down to different perceptions of oil and gas companies either side of the Atlantic. European oil companies seem to be preparing for the global energy transition, while Americans are doubling down.

This is clearly influenced by differing geopolitical factors. Europe's quest for energy independence is inescapably tilted towards renewables: it has lots of capacity for solar, wind and hydro power (and relatively smaller distances for electric grids to cover) but little capacity to mine its own fossil fuels. The US has plenty of oil and gas, and its consumers are hesitant to change, particularly if that comes with higher short-term costs. For the world, we can hope that European reasoning wins out. Or that at least fossil fuel rich countries don't lose track of alternatives and CO2 neutralisation technology development in parallel.

Is the ECB turning dovish?

As widely expected, the European Central Bank (ECB) kept interest rates steady last week. Meeting in Athens last Thursday, policymakers maintained its deposit base rate at 4.0%, and its refinancing operations rate at 4.5%, after hiking for 10 consecutive meetings. The last year-and-a-half has delivered the sharpest rate-rise cycle in the history of the Eurozone, also prompted by the continent's worst energy supply crisis since the Second World War. The ECB has tightened aggressively despite non-existent economic growth during that time, but inflation has remained uncomfortably high.

Economic ills have put pressure on the ECB to slow, stop or even reverse its aggressive monetary tightening. Like most developed world central banks, the ECB is very worried about tightness in the labour market and the potential of the dreaded wage-price-spiral leading to persistent inflation (wages, profits and prices all increasing in response to each other). But wage rises in particular have been far outpaced by inflation in the Eurozone over the last year, meaning a sharp deterioration in household spending power, along with higher borrowing costs and a general dwindling of economic prospects. Speaking after the meeting, ECB President Christine Lagarde said growth is "likely to remain weak over the remainder of the year".

The ECB publishes their own economic forecasts which guides decisions.

Real GDP& other projections (annual % changes, unless otherwise indicated)

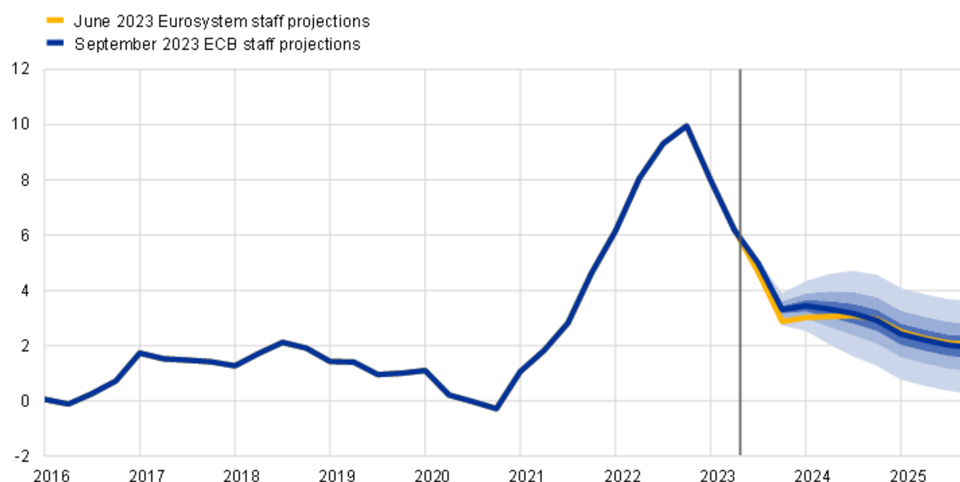
	September 2023					June 2023			
	2021	2022	2023	2024	2025	2022	2023	2024	2025
Real GDP	5.6	3.4	0.7	1.0	1.5	3.5	0.9	1.5	1.6
Private consumption	4.1	4.1	0.3	1.6	1.6	4.4	0.2	1.9	1.5
Government consumption	4.2	1.5	-0.1	1.1	1.4	1.4	0.0	1.1	1.4
Gross fixed capital formation	3.1	2.9	1.7	-0.4	1.4	3.8	1.5	1.1	2.1
Exports[1)]	11.3	7.3	1.3	2.5	3.1	7.4	2.7	3.4	3.2
Imports[1)]	8.9	8.1	0.3	2.5	3.1	8.4	1.4	3.4	3.2
Employment	1.5	2.3	1.2	0.2	0.2	2.3	1.3	0.5	0.4
Unemployment rate (percentage of labour force)	7.7	6.7	6.5	6.7	6.7	6.7	6.5	6.4	6.3
Current account balance (percentage of GDP)	2.8	-0.8	1.1	1.4	1.6	-1.1	1.1	1.5	1.6

Notes: Real GDP and components refer to seasonally and working day-adjusted data. Historical data may differ from the latest Eurostat publications owing to data releases after the cut-off date for the projections. Data are available for downloading, also at quarterly frequency, from the Macroeconomic Projection Database on the ECB website.
1) This includes intra-euro area trade.

As of the end of September, the ECB estimates that Eurozone's real (inflation-adjusted) 2023 gross domestic product (GDP) will expand a disappointing 0.7%, with the forecast falling from +0.9%. Germany was Europe's post-financial-crisis growth engine but is now expected to contract 0.4% this year in total, according to the European Commission.

Stagnation has been coupled with consistently falling inflation. Eurozone inflation was 4.3% year-on-year in September, the lowest figure since October 2021. While this is more than double the ECB's 2.0% target, the trend downward in headline inflation – from the excruciating 10.6% peak last October – has virtually been a mirror image of the spike before.

Euro area HICP inflation (annual % changes)



Notes: The vertical line indicates the start of the current projection horizon. The ranges shown around the central projections for HICP inflation are based on past projection errors, after adjustment for outliers. The bands, from darkest to lightest, depict the 30%, 60% and 90% probabilities that the outcome of HICP inflation will fall within the respective intervals

Along with ailing economies, European governments are hit with sharply higher borrowing costs. Global bond markets have sold off dramatically since the summer, thanks to growing expectations of interest rates staying higher for longer – itself a consequence of better-than-expected US economic data and hawkish messaging from the US Federal Reserve (Fed). Yields (the inverse of bond prices) have shot up: German 10-year yields, the benchmark for European bonds, are at just under 2.9% at the time of writing, up from less than 2.5% at the end of August. German yields were negative as recently as January 2022.

Yields on less favoured European bonds are significantly higher, such as 4.9% for the Italian 10-year. Overall, borrowing costs for European governments are the highest they have been since the Eurozone debt crisis in 2011. That event threatened to destroy the single currency and resulted in incredible monetary support from the ECB – but now the central bank is standing still. In fact, the ECB has been very active in reducing its balance sheet in this phase, probably even more so than its US counterpart, thanks to rolling off loans to banks from its balance sheet.

There are clear concerns that the economy is weakening but very few believe the ECB might ease policy in the near-term. In her press conference, Lagarde warned that inflation will likely stay "too high for too long", necessitating current rate levels "for a sufficiently long duration" – matching the 'higher for longer' rhetoric being pushed in the US. Policymakers are reasonably confident that price increases are coming under control, but – as the recent shift up in commodity prices and outbreak of another Middle Eastern war have shown – they are wary that externalities could turn for the worse, providing yet another input cost shock. Lagarde specifically mentioned the Israel-Hamas war's potential effects on energy.

Supply-side problems are conventionally thought to be 'cost-push' inflation – a shorter-run thing than 'demand-pull' inflation. But as we have written before, structural changes since the pandemic have made economies more sensitive to supply-side shocks, not least because of labour market tightness. That might

seem a strange thing to say in the European context, given the unemployment rate sits at 6.4% in the Eurozone (the lowest on record but still a significant amount of slack in absolute terms), but the fragmented nature of the continent's jobs market means that tightness in certain areas (like the so-called European Union periphery) can have an outsized impact on wage pressures. Over the last few years, the ECB has also made clear its concern for inflationary profit expansion – the flipside of the wage-price spiral, often ignored in British and US discussion.

That being said, Europe is clearly in a different place to the US, where growth, jobs and consumer sentiment have been incredibly resilient despite a barrage of global pressures. We wrote recently that this was largely down to Americans' willingness to draw on excess savings built up during the pandemic (though these are arguably dwindling, perhaps supporting the Fed's recent decision to keep rates on hold). In Europe – and the UK for that matter – wage growth is moderating and consumers are clearly not feeling too confident.

We suspect this will lessen the second-round sentiment impacts of supply-side inflation. One of the reasons the energy price shock from the Ukraine war caused such a tremendous and long-lasting inflation increase was that, with rates low at the time and hence money easy to come by, businesses and households were incentivised to buy now (before the higher energy prices fed through) – even if only to hold inventory. Put another way, if you expect inflation to go up by more than what you will pay in borrowing costs, it is a good idea to borrow. In stark contrast, rates are now so prohibitively high – and prospects for revenue growth so few – that the above has become an unviable strategy.

That lowers the sensitivity to particular price surges, as consumers and businesses often simply cannot afford to respond to them. The *monetary* impetus for inflation in Europe has fallen away, and there is no real economic impetus to replace it. A similar dynamic is taking hold in the UK – even if the Bank of England still has its hawks and hence might yet raise rates again. The US is not seeing this yet but, as we wrote previously, this is likely to change the more that excess savings come down. This side of the Atlantic, however, central bankers have every reason to turn dovish, and the evidence from this meeting is that they already have.

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30th October 2023

Global Equity Markets	27-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	7347	-1.1	-1.1	→ →	4.2	10.3	9.8	13.3
UK FTSE 250	16927	-0.9	-0.9	↘ ↘	4.1	10.8	9.6	14.5
UK FTSE All-Share	3961	-1.1	-1.1	↘ →	4.2	10.4	9.8	13.4
UK FTSE Small	5688	-1.8	-1.8	↘ →	6.0	9.8	7.1	12.6
France CAC 40	6855	+0.1	+0.0	↘ ↘	3.4	11.4	10.9	14.1
Germany DAX 40	14783	-0.6	-0.7	↘ →	4.0	10.3	9.8	12.9
US Dow	32739	-1.9	-1.9	↘ →	2.2	17.9	15.7	16.5
US S&P 500	4153	-2.8	-2.8	↘ →	1.7	18.7	17.3	17.7
US NASDAQ comp	12713	-3.3	-3.3	↘ ↗	0.9	27.1	23.3	23.2
Japan Nikkei 225	31013	-1.1	-1.0	↘ ↗	1.9	17.8	16.8	16.8
World Bloomberg	1479	-2.0	-2.0	→ ↗	2.3	13.7	13.1	13.8
China mainland	3562	+1.5	+1.5	↘ →	2.2	16.4	15.4	16.5
Emerging Bloomberg	1039	-0.4	-0.4	↘ ↘	2.7	11.9	10.4	12.1

Top 6 Gainers

Company	%
Rio Tinto	+5.6
Croda International	+5.2
Severn Trent	+5.1
Taylor Wimpey	+4.6
Barratt Developments	+4.5
Antofagasta	+4.4

Bottom 6 Decliners

Company	%
NatWest	-17.6
Standard Chartered	-14.8
Barclays	-11.2
Rentokil Initial	-9.6
Experian	-9.4
Reckitt Benckiser	-7.8

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.54	-0.13
UK Govt 15yr Gilt	+4.88	-0.12
US Govt 10yr Treasury	+4.86	-0.08
France Govt 10yr OAT	+3.45	-0.08
Germany Govt 10yr Bund	+2.83	-0.08
Japan Govt 20yr JGB	+1.67	+0.04

Currencies

Pair	last	%1W
USD per GBP	1.215	+0.0
GBP per EUR	0.871	-0.0
USD per EUR	1.058	-0.0
JPY per USD	149.70	-0.2
CNY per USD	7.318	+0.0
USD per Bitcoin	34,176	+15.9

Commodities

Cmdty	last	%1W
Oil Brent $:bl	89.1	-4.6
Gold $:oz	1983.3	+0.2
Silver $:oz	22.9	-1.1
Copper $:lb	365.2	+2.4
Alumnm $:mt	2192.3	+1.1
S&P soft crops	254.1	+0.5

UK Mortgage Rate Estimates

Rates (LTV c.75%)	27-Oct	27-Sep
UK BoE base rate	5.25	5.25
2yr fixed	5.64	6.21
3yr fixed	5.63	6.02
5yr fixed	5.17	5.52
10yr fixed	5.56	5.15
Standard variable	7.93	7.85

27/10/2023
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

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