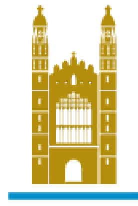

CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

17 JULY 2023

Lothar Mentel

Lead Investment Adviser to Cambridge

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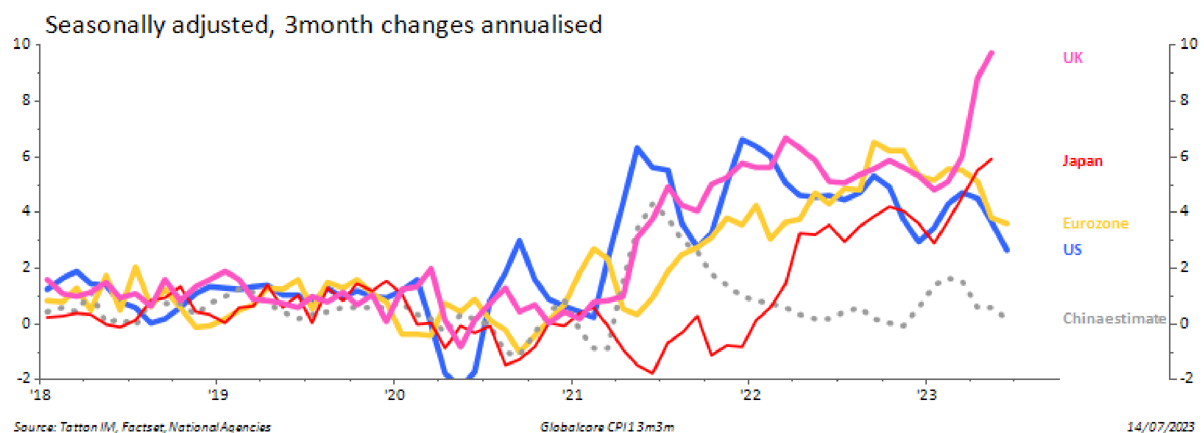
Core inflation slowdown equals an upbeat week for equity markets

We wrote last week that markets had come to expect another round of significant interest rate rises from central banks, and that risk assets such as equities were likely to come under some pressure. At the end of last week, however, equity markets rose sharply, with most more than reversing their losses of the previous week.

The driver of sentiment for both weeks has been estimates of how much central banks will have to move interest rates in the coming months. Those estimates are, in turn, driven by where inflation is and where it will get to over the next few months. Last week, investors were focused on how tight labour markets might keep underlying inflation pressures high, but the actual data published last week paints a rosier picture.

Regional core CPI rates



The above graph shows how regional core consumer price index (CPI) inflation rates have evolved through the pandemic period to now, showing the annualised change in prices on a three-month basis. In Europe and the US, June data show rates growing at their slowest rates since 2021. That's not so for the UK or, perhaps surprisingly, for Japan. For China we've estimated from the yearly data, and that is tracking to virtually no inflation.

The Q2 earnings season unofficially kicked off on Friday. July is seasonally a better month, as Q2 earnings are often a more consistent guide to company health than earnings in Q1. In the banking sector, earnings reports have been flooding in, and bottom-lines so far look predictably healthy. We write on some wider aspects of banks in separate article.

But earnings were not the reason for the positivity. The catalyst for the US stock market rally was the shift down in core inflation (with energy and food stripped out). Relatively good news had been anticipated after the difficult data recorded for May, but the details were seen as comforting across most components. In addition, cost pressures feeding through the production chain are also declining. US producer prices actually fell.

This is where the weakness in China comes in. Consumer prices are not rising, but its producer prices have been falling in absolute terms since the end of the winter. At the same time, weakness in the renminbi has meant prices in sterling or US dollars paid have been declining sharply. Even then, trade data shows pretty weak demand currently for Chinese goods, for a multitude of reasons.

So, for the moment, the disinflationary flow of other input costs has offset fears that workers have regained long-term pricing power. The idea is growing that wage demands in the US will slide back towards a 3% year-on-year growth, and towards 2% in Western Europe, because workers will be content with a moderate rise in disposable income. The UK experience seems to contradict this, but perhaps the US data foretells a better time to come here, and Rishi Sunak will be proved right.

For investments, quite a lot of consequences might flow from such a benign outcome. The venerable economist Anatole Kaletsky has long held the view that inflation would be sticky. As befits a thinker of note, last week he published some thoughts about what would happen if he was wrong. First, he noted that there was a stickiness in some US goods (rents, cars, travel costs) not to rise but to remain stable, which might help keep inflation from reaccelerating. He also noted that other more variable components, such as medical costs, were not showing signs of rising now. And base effects would lower the headline year-on-year rate, which might have the effect of reducing pressure from workers for more pay. Should US core inflation drop below 3% year-on-year by the end of this year (without an economic shock to raise unemployment more than about 0.3%), Kaletsky sees this as a very positive scenario. Disposable incomes would be solidly rising, having begun to do so already. He says: "if the worst inflation for 40 years can be overcome with the lowest real interest rate peak since the 1950s, and an economic slowdown so mild that it does not even increase unemployment, then assets valuations should move permanently to even higher levels than they reached in the Goldilocks decade before Covid".

"If low inflation returns in 2024, then easy money, full employment and fiscal profligacy would have survived a series of inflationary stress tests far worse than anything likely to hit the world economy in the years ahead".

"So asset valuations that were widely viewed as unsustainable in the long run will likely be priced even higher, because the ideal financial conditions of low inflation and near-zero real interest rates would have been empirically established as scientific laws of economics and permanent facts of life."

Kaletsky says, and one can tell from his tone, that he still thinks the best of all possible worlds is not the most likely outcome, and we have sympathy with his views. However, just as he has done, we continue to question our mildly conservative stance on equities.

For us, the positive scenario is akin to the 'Great Moderation' of the early 1990s, a period which saw dividend yields on equities fall substantially below government bond yields as very rapid globalisation gave a huge structural boost to corporate profits. There is an argument that globalisation's reversal (now often termed regionalisation) – and the consequent fiscal largesse of both US and European governments – is bringing about a similar episode. We're sceptical, but will have more to say on this in the future.

Returning to the global inflation picture and some nearer-term aspects, the greater inflationary picture both here and in Japan has generated bullishness over sterling and the yen. The Bank of England (BoE) is already widely seen as being hawkish but, last week, traders spied a possible change in the stance of the Bank of Japan (BoJ). They pushed longer bond yields up, and the ten-year yield is now sitting right on the upper limit of 0.5%. Other bonds are trading at higher yields which makes the yield on ten-year bonds somewhat anomalous.

The yen has fallen below Y140/$, which has got chart technical analysts all excited. The inverse of this, the US dollar's weakness, has perhaps wider implications for the global economy. A weaker dollar phase eases financing conditions for the rest of the world and, obviously, that's a welcome respite. Europe especially has shown signs of stress recently, despite the decline in energy prices (to only about 2.5 times where they were in 2019).

One other aspect is that the sterling value of US equity holdings isn't quite as buoyant as the US dollar price might suggest. We rarely hedge global equity holdings as the companies themselves have global revenues and costs. There are times when one might want to take a currency risk but we don't think, generally, this is best done by 'currency-hedging' equity holdings.

Greedflation or wage-price spiral?

It probably is not since the 1970s that inflation has been such a widespread topic in public discourse. This is because, of course, for decades – and particularly in the decade after 2008's Global Financial Crisis (GFC) – there was very little of it. Academics and some investors discussed it in a hypothetical sense, speculating how globalisation or financialisation might have affected the inflation/unemployment relationship, but this usually felt like pure intellectual curiosity. Things could hardly be more different now. People are obviously worried about rising prices for goods and services, and what might happen to their individual or collective spending power. But beyond that, there is a deep political interest in what causes inflation.

Opinions are split across two major camps: those who think corporate 'profiteering' is to blame for runaway prices, and those who think wages are the main cause. As you might imagine, the dividing line in these opinions is highly political. Those who want more pricing power for labour are inclined to say the former, while those who want more pricing power for capital say the latter. Professional opinions are also split though. Here in the UK, the BoE is adamant that wages are the biggest inflationary concern, whereas in Europe, policymakers are much more concerned about corporate profits. In the UK, this is now a hot button issue.

Last week, BoE Governor Andrew Bailey joined Chancellor Jeremy Hunt in calling on Britons to show restraint in their wage demands. This is the second time Bailey has intervened on this issue, having called for the similar restraint back in March. At the same time, Hunt has reportedly asked the BoE to scrutinise profits in the UK food industry, following accusations of 'price gouging' (the British Retail Consortium recently revealed food prices increased 14.6% in the year to June).

Unfortunately, it is virtually impossible to objectively say whether profits or wages are the bigger inflationary force. This is because they are two sides of the same coin, economically speaking. An inflation 'spiral' happens when price rises signal behaviours that lead to further price rises. Workers see their personal costs go up, so they charge more for their labour to maintain their spending power. Companies see their costs go up, so they raise prices to maintain their profit margins.

Which side of the equation you focus on depends on whatever view you have about what the returns to labour and capital should be. The BoE, for example, is more ambiguous than its continental counterpart on whether 'greedflation' drives inflation in the UK through profit margins. It argues wages are now a major driver for sticky inflation, evidenced by the news that regular pay (excluding bonuses) increased 7.3% in March to May, the highest figure on record when excluding the pandemic.

However, one could ask why should we think these figures are comparable? Implicit in the above is an assumption that, for corporate profits, non-inflationary means static profit margins, while for workers, non-inflationary means static nominal pay. Since margins are a measure of revenue that comes out as profit, this effectively assumes profit margins should be protected against inflation. But if we built in that inflation protection for wages, the story would be entirely different. Real (inflation-adjusted) earnings excluding bonuses have been negative in the UK since the tail end of 2021.

The point here is not that real earnings are more comparable to profit margins – there are issues with this too – but that any attempt to say which factor is more inflationary requires you to take a view about what the 'normal' or 'proper' distribution of labour and capital returns is. The European Central Bank (ECB), for example, recently declared corporate profits as the main factor behind 2022 inflation, backed up by analysis from the International Monetary Fund (IMF) of European goods markets. But this implicitly assumes that, in an inflation crisis, businesses should take a hit to their margins (though not necessarily their nominal absolute profits). ECB President Christine Lagarde said as much when she suggested 2023 would be a repeat unless European businesses were forced to absorb rising wage bills.

Of course, the UK is in a very different position to Europe – thanks in large part to the cutting of trade ties. The BoE's Chief Economist, Huw Pill, was criticised a few months ago for his assertion that both households and businesses "need to accept" they are poorer following various supply side crises. He was talking about energy supplies, but now that inflation has seemingly eased up everywhere but in the UK, his point is arguably more applicable to Brexit. Whatever way you slice it, there are no obvious economic villains in the UK inflation story. Regardless of who is or is not taking more than their fair share, it is an unfortunate fact that the pie has got smaller.

Why, then, is the BoE so adamant that wages are the big concern, while profits are not? Although messaging is an important part of a central bank's job, it is hard to see the Monetary Policy Committee's (MPC) focus on labour (and not profits) as non-political. This is not to say that the BoE prefers businesses to people, but just that the MPC seems to consider wages as its domain of influence, while profits are perhaps better left to the government, or market forces. That makes sense to a degree – but gives it more of a political tilt, particularly when it comes to press comments. And there is more behind the current dilemma: during the aforementioned 'Great Moderation' era, when inflation stuck comfortably around 2%, asking for wage restraint to keep inflation at target (around 2%) was not too painful, as real wage losses were less

pronounced in those times. But asking for wage constraint when inflation runs for a second year at a steep multiple of 2% is much more painful for employees. And hence unavoidably, a social and political component enters the equation, even if the BoE's prescribed medicine is the same as in the last two decades.

There has been a lot of talk recently about the return of labour pricing power – brought vividly to the imagination after nearly two years of widespread industrial action. In this sense, the sensitivity of inflation to employment has increased, which the BoE clearly sees as its main way of impacting the economy. But one could just as well argue there has been a return of corporate pricing power, following a long period of consolidation across nearly every major industry. This has led to wages and profits feeding off each other without either backing down – what should perhaps be called the 'wage-profit spiral'. Who should give in first is a political issue but, unless somebody does give in, we will keep talking about inflation for some years to come.

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17th July 2023

Global Equity Markets

Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Technical: Short Medium	Valuations: Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7475	+3.1	+3.1	↘ →	4.2	10.8	10.6	13.3
UK FTSE 250	18628	+3.9	+3.9	⇘ ⇘	3.6	12.4	11.4	14.6
UK FTSE All-Share	4077	+3.2	+3.2	↘ →	4.2	10.9	10.6	13.5
UK FTSE Small	6104	+1.4	+1.4	→ →	5.2	9.2	7.8	12.8
France CAC 40	7395	+3.9	+4.2	⇘ ⇗	3.2	12.8	12.3	14.1
Germany DAX 40	16133	+3.4	+3.8	→ ⇗	3.6	11.5	10.9	12.9
US Dow	34541	+2.2	-0.4	→ →	2.1	18.5	17.2	16.4
US S&P 500	4519	+2.7	+0.1	↗ ⇗	1.5	20.7	19.6	17.6
US NASDAQ comp	14173	+3.7	+1.0	↗ ↗	0.8	30.8	27.6	23.0
Japan Nikkei 225	32449	-0.5	-0.3	↗ ↗	1.9	18.6	18.0	16.8
World Bloomberg	1626	+3.7	+1.0	↗ ↗	2.3	14.0	13.7	13.8
China mainland	3899	+1.9	+0.5	⇗ ⇗	2.1	18.0	17.2	16.4
Emerging Bloomberg	1150	+4.3	+1.6	↘ →	2.5	12.2	11.3	12.0

Top 6 Gainers

Company	%
Persimmon	+9.7
Flutter Entertainment	+9.4
Antofagasta	+9.4
UNITE	+9.3
Smurfit Kappa	+8.9
JD Sports Fashion	+8.8

Bottom 6 Decliners

Company	%
Bunzl	-3.0
British American Tobacco	-1.4
International Consolidated Air	-1.2
Rolls-Royce Holdings	-0.1
Unilever	-0.0
GSK	+0.1

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.40	-0.27
UK Govt 15yr Gilt	+4.59	-0.23
US Govt 10yr Treasury	+3.78	-0.27
France Govt 10yr OAT	+3.01	-0.17
Germany Govt 10yr Bund	+2.49	-0.14
Japan Govt 20yr JGB	+1.12	+0.09

Currencies

Pair	last	%1W
USD per GBP	1.311	+2.6
GBP per EUR	0.857	+0.4
USD per EUR	1.123	+2.9
JPY per USD	138.81	-2.7
CNY per USD	7.141	-1.2
USD per Bitcoin	31,171	+3.0

Commodities

Cmdty	last	%1W
Oil Brent $:bl	81.0	+6.0
Gold $:oz	1956.7	+1.7
Silver $:oz	24.9	+8.6
Copper $:lb	392.2	+4.1
Alumnm $:mt	2239.0	+7.1
S&P soft crops	235.2	+0.6

UK Mortgage Rate Estimates

Rates (LTV c.75%)	14-Jul	14-Jun
UK BoE base rate	5.00	4.50
2yr fixed	6.85	4.73
3yr fixed	6.55	4.51
5yr fixed	6.01	4.29
10yr fixed	5.61	4.46
Standard variable	7.54	7.44

14/07/2023
Prices taken at 2:30pm today and 2:30pm last Friday (where possible)
Bloomberg equity indices are similar to those published by MSCI
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of next 12 months earnings as forecast by analysts
Mortgage estimates are derived from sterling swaps markets

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

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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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www.cambridgeinvestments.co.uk | enquiries@cambridgeinvestments.co.uk

Tel : 01223 365 656 | Nine Hills Road, Cambridge CB2 1GE