Investment Outlook

A monthly round-up of global markets and trends

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Investment outlook

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Risks and opportunities during an energy crisis

Liz Truss, the new Prime Minister, presented her Government's energy policy in early September at a time when the UK (and much of Europe) faces its worst energy crisis since the 1970s. Indeed, with fossil fuel supply struggling to match demand, stock markets continued to whipsaw as Western democracies and Russia issue tit-for-tat responses over the war in Ukraine. Last month, the G7 nations agreed to impose a price cap on Russian oil. In contrast, the EU stepped back from a bloc-wide cap, preferring to focus on negotiating with key alternative suppliers. Regardless of the feasibility of a price cap on Russian oil exports, the EU has already announced bans on all Russian seaborn crude oil imports into the bloc and all refined oil products (e.g. gasoline, fuel oil, diesel), which start on 5 December 2022 and 5 February 2023, respectively. The Kremlin responded robustly. First it announced that Russia would not sell oil to countries that abide by the price cap. Second, it turned off the Nord Stream 1 gas pipeline, making it more difficult for EU countries to build-up gas inventories before the winter. Subsequently there have been explosions along the Nord Stream 1 and 2 pipelines making it impossible for supply to return anytime soon.

The sanctions against Russia will lead to further unintended consequences for both households and firms. Through their indirect and direct dependence on Russian energy, the UK and the rest of Europe are experiencing elevated gas and electricity prices and the risk of energy rationing. As a result, the UK Government has intervened in energy markets to reduce the cost to households and business. In her maiden speech in the Commons, PM Truss announced an energy package that fixes most household bills at around £2,500 (based on typical usage) for two years.[1] The package also includes 'equivalent support' for businesses for the next six months. However, even accounting for the guarantee, energy bills in the next year are still likely to be double the level they were in 2021, which will drag on household income and company profits.

While energy subsidies should provide some short-term relief to households and businesses, the removal of price signals creates less incentive to conserve energy usage. Moreover, the Conservatives, who are well behind Labour in opinion polls, may find it difficult to end such policy support if energy prices remain high. The EU has also proposed measures to subsidise energy bills. With consumption being subsidised demand will be higher meaning prices could also remain high for all European countries.

Essentially, the UK Government has provided a blank cheque that is dependent on future wholesale energy prices. While the full cost is not yet known, early estimates place it around half the cost of pandemic interventions, which totalled £376 billion.[2] Should gas and power prices be sustained at a high level, the national debt will grow faster. Much of this debt financing will depend on the willingness of foreign investors to buy more government debt and rollover existing gilts.

In addition to energy support, on 23 September Kwasi Kwarteng, the new Chancellor, presented his mini-budget. This marked a major shift in UK fiscal policy with his plan requiring £400 billion (including energy support) additional borrowing over the next five years.[3] The response by UK financial markets has been significant. So far this year, traders have sent the value of sterling and gilts sharply lower in September, leading the Bank of England to intervene to stabilize the market– see Market Highlights section.

The problem for households and businesses in the UK is that a weaker currency will raise import prices for goods and services. Not only could this sustain the cost-of-living crisis, but it complicates the job of central bankers trying to bring down inflation. In short, the Government's expansionary fiscal policy could force the Bank of England to raise rates to a level that puts the economy under strain.

Another consideration for markets: geopolitics

It is increasingly clear that the trust between Europe and the US on one side, and China and Russia on the other, continues to deteriorate. With China in an uneasy alliance with Russia, global trade (including energy) and cross-border capital flows could continue to be disrupted in the future, potentially leading to structurally-higher inflation and interest rates. The rest of the world seems to be hedging their bets as to how this all pans out. For instance, OPEC, usually a supporter of the West, has recently ignored calls from the US and Europe to raise crude oil supply and cut production. This could be, in part, due to the shift in focus to renewables by western democracies over the past decade or so.

The events this year demonstrate that the transition from fossil fuels is likely to be slower than expected. Meanwhile this threat to energy security may increase investment into domestic renewable energy over the long term.

For investors, the macro and geopolitical backdrop suggests that energy prices could remain high. While this is a risk for the broader market, it creates an opportunity for oil and gas stocks. Earnings Per Share (EPS) for the sector is up 80%[4] relative to the market since reaching a trough in May 2020, yet the share prices for the sector are only up 40%[5]. So, despite the gloom of higher energy bills this winter, oil and gas stocks could continue to be a bright spot in investor portfolios.

Sources:

[1] ifs.org.uk/articles/response-energy-price-guarantee

[2] *Thatcher would be turning in her grave: how the Tories embraced state intervention*, David Smith, Sunday Times, 11 September 2022

[3] resolutionfoundation.org/press-releases/chancellor-announces-largest-tax-cuts-in-50-years-driving-a-411-billion-borrowing-surge-that-will-break-the-fiscal-rules

[4] Refinitiv/Evelyn Partners

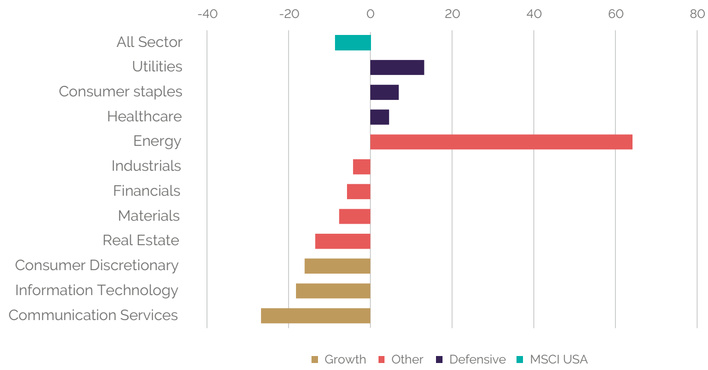
[5] Refinitiv/Evelyn Partners

Market highlights

Equities: sectoral rotation in equities

The MSCI USA index is down 8.8% in the year to 30 September in sterling terms (it's down 24.8% in dollar terms as the dollar has appreciated against sterling). With inflation proving stickier than expected, the Federal Reserve (Fed) has remained hawkish (i.e. in favour of interest rate hikes), despite the economic consequences. Base interest rates currently sit at 3-3.25% in the US, with further rate hikes expected this year and in 2023. Part of the reason for the relative underperformance of the US equity market is that it has a high exposure to rate sensitive 'growth' sectors, such as information technology, communication services and consumer discretionary. These sectors have poorly performed year to date, whereas less rate sensitive 'value' sectors such as healthcare, consumer staples, materials and energy have been the relative out performers. This is in stark contrast to the latter half of last decade where the low interest rate environment helped propel the growth sector to record highs.

Year-to-date MSCI USA total returns by sector (%), GBP terms

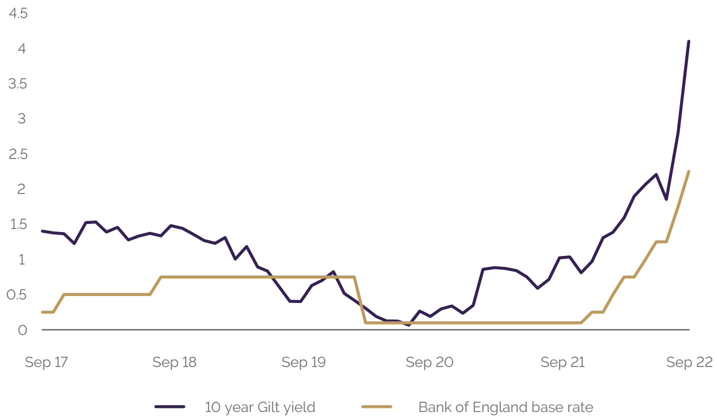


Source: Refintiv Datastream/Evelyn Partners Investment Management LLP, data as at 30 September 2022

Fixed income: rising gilt yields

The rise in UK government borrowing that is needed to fund the tax cuts and spending programmes announced in September's mini-budget has spooked financial markets. The UK, with its large trade deficit, is reliant on foreign investors to buy gilts (UK government debt). Yields and interest rates are strongly correlated, and investors are expecting the Bank of England to increase rates by more than previously forecasted. This caused bond yields to rise sharply (and the prices lower), as seen in the chart opposite. This move meant UK pension funds had to sell liquid assets (particularly gilts) to settle collateral calls. To prevent the situation from spiralling, the Bank of England stepped in to provide emergency liquidity, which seemed to calm market fears, at least in the short term.

10-year gilt yield and Bank of England base rate (%)

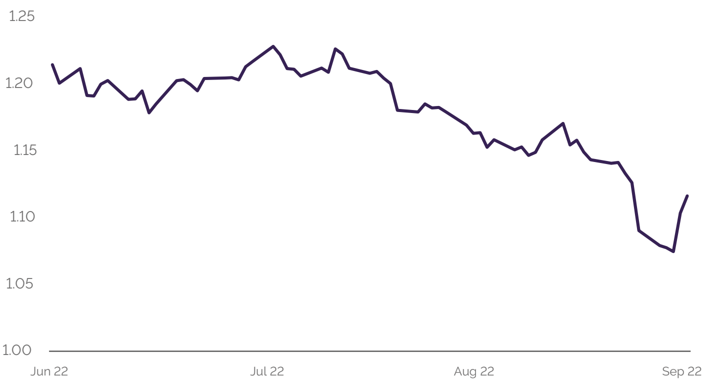


Source: Gavekal, Refinitiv Datastream/Evelyn Partners Investment Management LLP, data as at 30 September 2022

Currencies and commodities: volatility in sterling

The US dollar hit multi-decade highs against sterling, euro, and the yen last month. The greenback's history as a 'safe haven' currency during times of economic uncertainty and the Federal Reserve's continued interest rate hikes has seen it become more attractive to investors. Sterling has fared considerably worse than its peers over the last few weeks. Liz Truss, and her newly appointed Chancellor, Kwasi Kwarteng, set out a range of fiscal changes, including an energy price cap and a larger than expected cut to tax rates. These announcements sent shockwaves through the markets and saw the pound sink to its lowest level on record; it bottomed out at just above $1.03 in the early hours of 26 September. The Bank of England warns it may raise interest rates in the future, and news they would temporarily begin buying long-dated gilts reassured investors and prompted a slight recovery. Sterling closed out the month at $1.12.

GBP/USD exchange rate ($)



Source: Refinitiv DataStream/Evelyn Partners Investment Management LLP, data as at 30 September 2022

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	-5.7	1.5	-3.7	53.1
MSCI UK	-5.0	-2.9	3.8	14.2
MSCI UK Broad	-5.8	-3.9	-2.5	9.9
MSCI USA	-5.4	3.7	0.0	86.5
MSCI Europe ex UK	-4.8	-2.0	-12.1	17.1
MSCI Japan	-6.4	0.6	-14.3	18.6
MSCI Asia Pacific ex Japan	-6.8	-0.8	-1.8	24.4
MSCI Emerging Markets	-7.9	-3.6	-12.8	11.8
Bonds				
iBoxx GBP Gilts	-8.8	-14.0	-24.8	-16.8
iBoxx USD Treasuries	0.6	4.0	4.8	18.7
iBoxx GBP Corporate	-8.7	-11.5	-23.6	-11.2
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-8.1	-22.8	12.9	54.1
Gold ($/ounce)	-2.7	-7.4	-4.9	30.4
GBP/USD	-4.1	-8.1	-17.2	-16.8
GBP/EUR	-1.5	-1.9	-2.1	0.4
EUR/USD	-2.6	-6.3	-15.5	-17.1
USD/JPY	4.4	6.5	29.7	28.6

Market commentary

Equity markets fell in September, as US inflation remained sticky and the Fed's hawkish rhetoric signalled the continuation of interest rate increases. Global markets were down 5.7% on the month, and the MSCI USA index was down 5.4%, both in sterling terms. These falls were cushioned by the weakening pound which fell 4.1% versus the US dollar following the tax cuts announced during the UK's mini-budget. UK equities were similarly down on the month. Tensions over the Russia-Ukraine conflict continue to heighten with Russia's annexation of four regions of Ukraine following referendums. MSCI Europe ex UK was down 4.8% on the month and 12.1% on the year, both in sterling terms. As global financial and geopolitical risks rose, gold outperformed equities, down only 2.7% in sterling terms. Although markets have been gloomy throughout September, some key lead indicators such as market derived inflation expectations show that US reported inflation could peak in the coming months.

Key macro data	Latest	2022 Consensus forecast	Spot rates	30-Sep	Yields (%)	30-Sep
UK GDP (YoY%)	4.4	3.50	GBP/USD	1.10	MSCI UK	4.16
UK CPI Inflation (YoY%)	9.9	9.00	GBP/Euro	1.14	MSCI UK broad	4.11
Bank of England Base	2.25	3.45	Euro/USD	0.98	10 Year Gilt	4.10

The market commentary, values and charts as at 30 September 2022. Total returns in sterling.
Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.
Source: Refinitiv Datastream/Bloomberg

Important information

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

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