Investment Outlook

A monthly round-up of global markets and trends

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Investment outlook

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The impact on financial markets from the Israel-Hamas conflict

The tragic loss of innocent, civilian lives in the conflict and humanitarian crisis in Israel and Gaza is shocking and it's important to take the time to reflect on how this has impacted those who are affected by it. Our thoughts are first and foremost with them and it's during times like this that we're reminded of the world's fragility.

It's conflict and fragility that can, however, also have an impact on financial markets and investors. So far, these events have not had a major impact on wider global financial markets. This is largely because the affected region accounts for a small share of oil production and there has been no disruption to global energy supplies. However, should the conflict spread throughout the Middle East, the impact on the energy sector and broader financial markets could be material. While there are many unknown permutations in this highly volatile situation, there are three potential flashpoints that need monitoring.

1. A major Hezbollah attack against Northern Israel.

Hezbollah has a capable military force, and this would open-up a two-front war for Israel that could prove long lasting. Like Hamas, Hezbollah also has close links to Iran, one of the region's major powers. So this development could increase the risk of Iranian involvement in the conflict.

2. A strong response by Israel in Gaza (with or without US support).

This would increase the risk of the conflict spreading. For example, it could encourage Hezbollah to attack from the North or draw Iran into direct conflict with Israel.

3. Recovery of hostages.

It is believed that Hamas abducted over 200 hostages, with as many as 10 American citizens held captive.[1] Securing their release is a key goal of the Israeli and US governments. The memory of President Carter's failed attempt to recover citizens during the Iran hostage crisis in April 1980 illustrates the risks and uncertainty involved.

If instability does spread from the Israel-Hamas conflict it's likely to involve Iran, either via its proxies or directly. Under these scenarios, the response of Israel and the US will be crucial. Any direct Iranian involvement in the conflict would likely see a similarly direct US military response. The US could also impose sanctions on Iran, which may lead to a significant reduction in crude oil supply and upward pressure on global energy prices. Either option would likely lead to weakness in financial markets.

The Brent crude oil price has stabilised at a high level of around $90/barrel, following September's supply cuts led by Saudi Arabia and Russia, while global demand remains robust and the US Strategic Petroleum Reserve is at its lowest point since the mid-1980s.[2] This means that the oil market could be vulnerable to increased volatililty if the situation escalates. Nevertheless, balancing the risks coming out of the Middle East is an improving macro-economic picture.

Inflation continues to slow, easing the likelihood that central banks will have to raise interest rates. Global growth forecasts are holding up, though there is the possibility of a mild recession in developed economies given the rapid monetary policy tightening seen over the last couple of years.

Despite this, companies have been adept at taking advantage of solid labour markets and passing on rising costs to keep profit margins up. While headlines continue to focus on the risks, analysts remain upbeat on the prospects for company earnings: the consensus expects around 11% Earnings Per Share growth in both 2024 and 2025.[2] Nonetheless, the outlook for equities remains finely balanced as ongoing fundamental strength is set against a deliberately restrictive monetary policy environment. Provided that geopolitical risks do not escalate, there remains scope for equities to recover into year-end.

Rising challenges for renewables

Tackling carbon emissions is proving to be a significant challenge for governments around the world. While energy and carbon intensity have decreased over the years, increases in global economic activity and a rising population continue to lift overall carbon emissions, particularly in the developing world. As such, the need for renewable power has gained momentum as an alternative energy source to fossil fuels and to facilitate the desire for some countries to achieve their 'net zero' targets.

However, share prices in global renewable companies have corrected this year for arguably three reasons. First, there is uncertainty over public support and government commitments to reducing carbon emissions. A YouGov survey taken after changes proposed by UK Prime Minister Rishi Sunak in September showed that most people in the UK supported a delay in the ban of the sale of new petrol/diesel cars and new gas boilers, from 2030 to 2035.[3] Outside the UK, investors will be paying close attention to the US elections in a year's time to see whether Donald Trump is re-elected as president. Trump's comments generally do not support the renewables' theme. Second, some wind and solar projects are looking less economically viable due to rising costs, from higher prices of materials and increased borrowing rates. And third, there is a lack of global coordination of the energy transition. For instance, the US wants to cut China from its energy supply chain for geopolitical reasons, even though China leads in clean technology production, Washington is concerned about energy security and is uncomfortable with Beijing controlling the levers in supplying solar panels and batteries.

For the renewables theme to recover in the short term, lower inflation and interest rates are probably needed. For the long term, investors will be looking for a breakthrough in battery technology to store intermittent energy from wind and solar on top of a willingness of governments to work together to provide clean energy.

Sources:

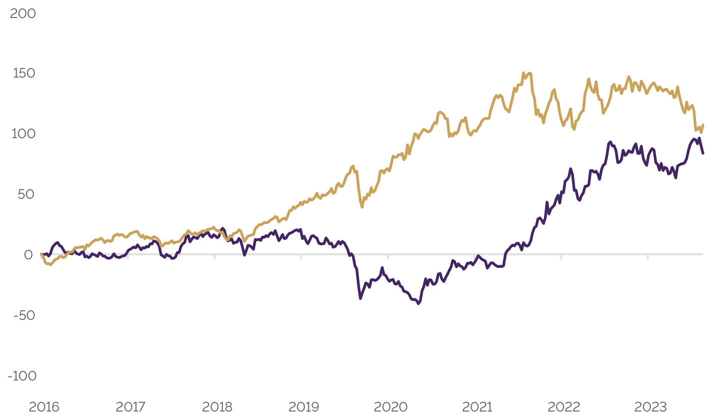
1 FT source: Israel 'preparing ground invasion' of Gaza, says Netanyahu 25 Oct 2023
2 LSEG Datastream/Evelyn Partners, data as at 31 Oct 2023
3 The Times/Climate Change Results 22 Sep 2023

Market highlights

Equities

The Evelyn Partners energy transition basket contains a set of companies that we believe will play a key role in enabling society to shift away from its dependence on fossil fuels. We also track a non-renewables basket, which contains our preferred traditional energy companies. Since the Paris Agreement (an international treaty on climate change) came into force in November 2016, the energy transition basket has outperformed the traditional oil and gas energy giants. This is partly due to increased government focus and investment into renewable energy production and infrastructure. However, over the last two years this performance gap has largely closed. Higher interest rates dragged on the share prices of these transition companies, whose lofty valuations are based on future earnings expectations. Meanwhile, traditional energy companies have benefited from an elevated oil price following Russia's invasion of Ukraine.

Evelyn Partners energy transition and non-renewable energy companies (percentage change)

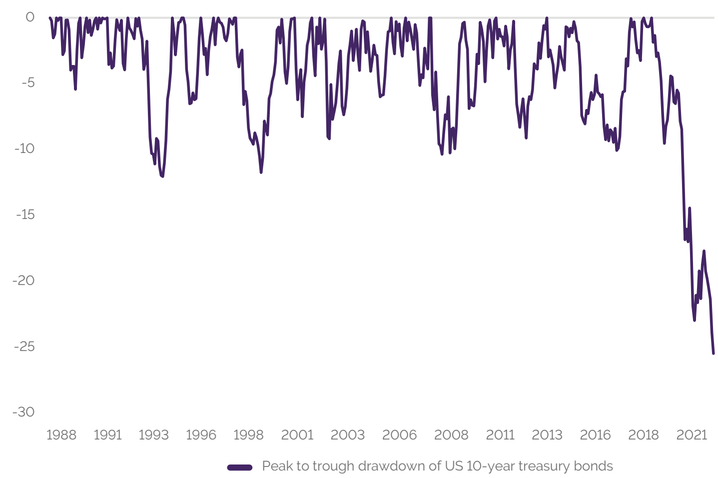


Source: LSEG Datastream/Evelyn Partners data as at 31 Oct 2023
Performance calculated as percentage change on a total return basis in GBP
Past Performance is not a guide to future performance

Fixed income

During the 2022 bond rout, yields were predominantly driven higher by changes in interest rate expectations. However, in recent months there have been additional factors at play. First, the rising issuance of bonds by the US Treasury to finance a large budget deficit. Second, strong US economic data has reduced the probability of a deep recession and allowed the Fed to keep interest rates higher for longer. As a result, the US 10-year treasury yield reached an intraday peak of just over 5% on 23 October, its highest level since July 2007.[1] Since yields are inversely related to bond prices, this has meant the US 10-year has seen one of its largest drawdowns in history. (A drawdown is defined as a peak-to-trough percentage decline in value.)

US 10-year treasury bond drawdown (percentage change)



Source: LSEG Datastream/Evelyn Partners data as at 31 Oct 2023
Performance calculated as percentage change on a total return basis in USD
Past yield figures provided should not be considered a reliable indicator of future performance.

Currencies and commodities

The Israel-Hamas conflict has so far had a relatively limited impact on the price of crude oil. Despite some initial price appreciation, the price has subsided and is now around what it was prior to the conflict. Nonetheless, if the war spills into neighbouring countries, or involves Iran directly, then this would be more disruptive for global energy markets. Iran is responsible for 3.8% of the world's crude oil supply and borders the Strait of Hormuz, through which around 20% of the world's total oil consumption transits.[2] The World Bank suggests that oil prices could hit \$150 a barrel if this conflict escalates. In comparison, the oil price spiked to around \$125 a barrel following western sanctions against Russia after its invasion of Ukraine.[3]

Crude oil price (\$/barrel)

Source: LSEG Datastream/Evelyn Partners data as at 31 Oct 2023
Past performance is not a guide to future performance.

Sources:
[1,2,3] LSEG Datastream/Evelyn Partners

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	-2.4	-4.1	5.4	54.7
MSCI UK	-3.6	-3.3	7.1	24.8
MSCI UK Broad	-4.0	-4.2	6.1	19.6
MSCI USA	-1.7	-2.9	4.4	77.0
MSCI Europe ex UK	-3.0	-6.6	11.6	41.9
MSCI Japan	-3.9	-3.1	11.2	23.9
MSCI Asia Pacific ex Japan	-3.9	-7.5	-0.2	21.0
MSCI Emerging Markets	-3.3	-6.8	5.6	16.1
Bonds				
iBoxx GBP Gilts	-0.5	-2.0	-6.5	-20.4
iBoxx USD Treasuries	-0.8	1.5	-5.9	3.8
iBoxx GBP Corporate	-0.1	-0.1	3.7	-4.1
Commodities and trade-weighted currencies				
Oil Brent Crude ($/barrel)	-8.3	2.3	-8.7	15.6
Gold ($/ounce)	7.5	1.4	21.9	64.2
GBP/USD	-0.6	-5.7	5.4	-5.0
GBP/EUR	-0.4	-1.6	-1.5	1.8
EUR/USD	-0.2	-4.1	6.9	-6.7
USD/JPY	1.5	6.6	1.9	34.2

Market commentary

October was a weak month for equities, with the MSCI All-Country World index declining 2.4% as higher bond yields took their toll on equity valuations. UK equities had a particularly weak month, as falling oil prices disproportionately impacted the UK index, which is heavily weighted towards energy companies.[1] Gold performed well, with the spot benchmark peaking at over $2,000/troy oz, as fears about an expanding conflict in the Middle East saw investors flock to the yellow metal.[2] The USD appreciated against all other major currencies as treasury yields continued to rise, increasing the flow of capital to the US.

Sources:
[1,2] LSEG Datastream/Evelyn Partners

Key macro data	Latest	2023 Consensus forecast	Spot rates	31-Oct	Yields (%)	31-Oct
UK GDP (YoY%)	0.56	0.40	GBP/USD	1.21	MSCI UK	4.21
UK CPI Inflation (YoY%)	6.70	7.40	GBP/Euro	1.15	MSCI UK broad	4.15
Bank of England Base	5.25	5.30	Euro/USD	1.06	10 Year Gilt	4.52

The market commentary, values and charts as at 31 October 2023. Total returns in sterling. Returns are shown on a total return (TR) basis ie including dividends reinvested (unless otherwise stated). Net return (NR) is total return including dividends reinvested after the deduction of withholding tax. Source: LSEG Datastream/Bloomberg

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