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— OUT OF THE ORDINARY

Market commentary



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Overview

In the last commentary we promised to dedicate more space this month to a discussion of climate change and to review the outcomes of the COP26 summit in Glasgow. Thus, this edition will have a different format from usual and the regional comment sections will be omitted. It will be back to business-as-usual next month, with a retrospective upon 2021, some thoughts about what might confront us in 2022, and an update on how we are positioned for potential outcomes.



All eyes on Omicron

Not for the first time in recent years, our good intentions have been overtaken by events, specifically the discovery of a new variant of the SARS-CoV2 coronavirus. Indeed, this variant, which was first sequenced in South Africa but did not necessarily evolve there, is serious enough to have been designated its own Greek letter: Omicron. The body that names these variants decided to skip over “Xi”. One wonders why...

Rightly, owing to its impact on daily activity and financial markets, we will give Omicron top billing this month. But in doing so, perhaps, we fall into the very trap that humanity does when it comes to its efforts to reduce carbon emissions and combat climate change – we focus too much on the here and now and not sufficiently on the future. After all, it’s easy to be more readily influenced by the more immediate threat of viral infection and social disruption than by the worry about something that is evolving over many years and well into the future.

At the time of publication, we are still in the foothills of our accumulation of knowledge about Omicron, but the revelation of its existence, which coincided with the Thanksgiving Holiday in the United States, briefly created turmoil in financial markets. Global equities, which were hovering close to all-time highs, fell back sharply, while government bonds, which had been under some pressure owing to the prospect of tighter monetary conditions, rallied strongly. And within equity markets there was a rapid unwinding of any residual optimism about the “reopening” trade, while those companies that tend to benefit from the curtailment of travel and in-person social activities found a renewed source of strength.

Markets have subsequently moved erratically dependent upon the latest news. One major source of uncertainty is the efficacy of existing vaccines against the new variant, and comments from the vaccine manufacturers themselves, which have ranged from downbeat to cautiously optimistic, have elicited some of the biggest market movements. But nobody has suggested that these vaccines will be useless. When one considers that just over a year ago, before the first vaccine trial results were made public, an efficacy rate of more than 50% commensurate with a typical flu vaccine – was deemed to be a success, the fact that anything much less than 90% efficacy is now going to be seen as a disappointment is testament to how expectations can quickly become anchored to the prevailing experience – yet another trait of human fallibility.

More positively, initial indications are that the symptoms associated with the new variant are no more (and potentially less) severe than

those experienced so far. Expert virologists opine that coronaviruses tend over time to become more infectious but less pernicious, thus maximising their opportunity to replicate but without killing off the hosts. If that is the case with Omicron, the world might be able to move on from the pandemic more quickly.

However, we are still faced with possibly several weeks of uncertainty, which will coincide with a period when markets are traditionally less liquid over the holiday season and investment banks' financial year-end. Discretion would appear to be the better part of valour in the immediate short-term, although we will always be on the lookout for opportunities that might arise owing to undue pessimism or unhelpful market conditions.

The impact of COP26

While it is not always highlighted, humankind's influence on the planet could well have had some part to play in the evolution of the original Wuhan strain of COVID. The encroachment of our lives into natural habitats has long been cited as a risk factor, although the veil of secrecy surrounding the breakout of COVID suggests that we might never know the truth. The destruction of natural habitats, with deforestation to the fore, was certainly high on the agenda at COP26, although most of the headlines were generated by initiatives to curb emissions of greenhouse gases.

It is worth reminding ourselves of the challenge that we still face when it comes to reducing emissions. More than eighty percent of the world's energy needs were met by fossil fuels (oil, gas and coal) in 2020 according to data published by BP. And while the output from cleaner renewable sources trebled over the previous decade, it still accounted for a meagre six percent of the total. There is undoubtedly strong and laudable momentum behind the transition to renewables, but we are already seeing one of the unintended consequences of the shift in the form of big imbalances in wholesale energy markets. A lack of renewable power output, courtesy of weather patterns that have fallen outside normal expectations, has placed extra demands on natural gas supplies just as the overall demand for fuel is rising as a result of increased global activity, with low existing inventories exacerbating the situation, and then a cold snap to boot. The price of natural gas in the UK has more than quadrupled this year, a factor already partially reflected in consumer price indices, with more increases likely to come when the retail energy price cap is lifted again next April.

So what did come out of COP26? Realistically, a lot of rousing calls to arms, but a dispiriting lack of action. One of the supposedly key initiatives to be decided upon ended up being watered down, and the

change of a single word was significant. A pact to “phase out” coal-fired power generation was diluted to “phase down”, with that dilution being driven by a coalition of what one might describe as vested interests: The United States (mainly a producer), India (mainly a consumer) and China (both). If it is difficult to persuade world leaders to grasp the nettle in such a public forum, one wonders how consumers are likely to respond.

On a more positive note, a pledge to reduce methane emissions by thirty percent from 2020 levels was welcomed. Methane’s greenhouse gas effect is as much as twenty-five times as great as that of carbon dioxide, according to the US Environmental Protection Agency. One reason that this pledge might have gained so much support is that many of today’s methane emissions are eminently avoidable without a great reduction in energy generation because many of them result from leaks in the gas production and transportation infrastructure.

And let’s applaud the evolution of technology in this effort, with new methods developed to “sniff out” these leaks making the task more achievable. Indeed, since the Paris Agreement was thrashed out at COP21 in 2016, technology has come a long way and alternative energy sources are generally much less costly per unit of output than they were five years ago. But we must also be aware that some of the key raw materials required for more electrification, including copper, lithium, cobalt and nickel are not infinite resources. And some of the world’s largest deposits are in inhospitable locations often lacking the standards of governance that one might wish to find.

To sum up the challenges that still lie ahead, it is estimated that global warming of around 1.1°C has already occurred*. The Paris Agreement declared an intention to limit warming to 1.5°C, but current activity puts the world on course to be 2.7° warmer by the end of this century. The International Energy Agency calculated that all the measures proposed by the end of COP26 will only limit warming to 1.8°, which means that many difficult decisions have still to be made. It is already clear that more extreme weather events are occurring at “only” 1.1°. That is a sobering thought when we consider the probable non-linear effects of the higher temperatures that appear to be inevitable. Support for the Paris goal of 1.5° was bolstered by the Glasgow Financial Alliance for Net Zero (GFANZ), a group representing banks, insurance companies and asset managers with \$130 trillion at their disposal. However, that good news comes with the caveat that past promises of spending tied to such targets have not been met.

*The Intergovernmental Panel on Climate Change (IPCC) measures global warming from the base average temperature for the period 1850-1900, which is defined as “pre-industrial”, and which is the most distant period for which meaningful global temperature data is available.

One of the strong messages from COP26 was that the cost of emitting carbon is going to have to rise to create an incentive to modify behaviour. Finland was the first country to introduce a carbon tax in 1990, but it is its neighbour Sweden that currently imposes the highest tax per metric tonne of carbon equivalent. The Swedish tax is SEK 1,200, equivalent to \$131. It was introduced in 1991 at SEK 250, and so consumers have at least had some time to adjust. The European Carbon Future is trading at €75 (\$85), having been only €32 at the start of this year. Indeed, it has jumped €16 since the start of COP26.

But for all the progress that this promises the global average cost of carbon is calculated to be around \$2.50 per tonne, and that stands against a widely held opinion that the cost is going to have to be as high as \$150 (and \$100 at a minimum) to start to make any real difference. We saw with the “yellow vest” protests in France that trying to change behaviour through taxation is difficult, to say the least. And there are many emerging economies (notably India) that still heavily subsidise fuel costs for their citizens to help promote growth and (perhaps more importantly) social equality. Not without some justification do such countries complain that the ladder of progress is being pulled up from them by richer countries before they have had a chance to climb it.

Logically, all of this suggests higher fuel costs for many, with citizens of developed countries perhaps having to carry an extra burden. However, the initial response to the need to fund COVID vaccines in the developing world hardly sets an encouraging precedent.

We do not wish to come over as pessimists (much less resigned to failure) when it comes to the challenge of climate change and the energy transition, more to highlight that nothing will be straightforward. Whether or not the phrase “the road to hell is paved with good intentions” can be attributed to Samuel Johnson, perhaps what he should have said is that the best of intentions can come with unintended negative consequences.

Inflation, interest rates and equities

One of the consequences of the energy transition, at least currently, has been rising fuel costs, as described earlier. The need to provide electricity when renewable capacity has been under pressure has seen demand for natural gas rise faster than supply. This has had a knock-on effect on oil and coal prices (with the latter’s price being squeezed higher in the key market of China owing to floods in that country and a dispute with Australia that has blocked imports of various raw materials including coal). Natural gas is also a key element in the production of fertiliser, and so costs to farmers have

been rising, helping to push crop prices higher when harvests had already been reduced because of unfavourable weather conditions. Some fertiliser production stopped completely as it became uneconomic, thus depriving the livestock farming community of a by-product, carbon dioxide, which is used in the process of slaughtering animals. Cue shortages of poultry and pork, in particular, and, yes, higher prices.

If we add the consequences of disrupted supply chains, it is not entirely surprising that consumer price indices are hitting multi-year highs in many countries. This has drawn the attention of central banks, who have gradually shifted their stance from relative insouciance to one of greater concern. While we have yet to see interest rates being raised in the UK, US or Europe, hints at tighter policy have been growing stronger, and the US Federal Reserve has announced that it will curtail its asset purchase programme in the coming months. It remains to be seen whether or not Omicron will change the script, but futures markets are now discounting almost three quarter-point interest rate rises in the US and the UK base rate to climb to 1.2% by the end of 2022. In the US, decision-making over interest rates has also become more political, with President Biden's popularity diminishing as fast as inflation climbs.

The net effect of all of this as we look forward to next year is that we are once again going to be facing a period of probable monetary policy tightening, which will, at the minimum, remove the tailwind that has propelled risk assets higher and possibly turn into a strong headwind. As we have commented in the past, much will depend on the levels of economic and earnings growth. The former is currently forecast to be maintained around the world above pre-pandemic trend levels throughout 2022 and 2023; and corporate profits have been strong, with margins exceptionally so. This combination of factors suggests the potential for a mild de-rating of equities offset by increased earnings and dividend payments, and therefore lower, but still positive returns, although likely to be achieved in a more volatile fashion. We will provide a more granular outlook in next month's commentary.

Fixed income assets

Sovereign bonds again proved their worth as risk-diversifying insurance assets at the end of November, when they delivered positive returns in the face of the discovery of the Omicron variant. Although we continue to find little long-term value in the asset class, it does have a role to play in a balanced portfolio for those looking to achieve less volatile returns. Even so, conventional bonds are still in negative total return territory for the year, while index-linked bonds have done much better, delivering positive

returns as a result of rising inflation expectations. Corporate credit has also been a positive contributor to portfolios this year, mainly thanks to the carry derived from the higher yields available, especially on High Yield product. However, spreads have widened again of late in a sign that investors are becoming more cautious about the interest rate environment and default risk.

UK Gilts have delivered a total return of 1.32% over the last three months and -0.99% over the last year. Index-Linked Gilts returned 6.31% and 10.29% over the same respective periods. Emerging Market sovereign bonds produced a total return of -3.65% in sterling over the three months to end November (-2.05% over 12m). Global High Yield bonds delivered 0.3% (2.52% over 12m).

Conclusion and Outlook

A well-worn stock market aphorism has it that “a bull market climbs a wall of worry”. The one that started in March 2020 from the COVID trough has certainly followed that path, as investors have continued to anticipate recovery, although a healthy dose of liquidity injected by central banks has also been beneficial. It might then be tempting, given all the outstanding worries (ranging from inflation and monetary policy tightening to geopolitics and climate change, to name but a few), to expect more of the same in 2022. However, it is that very tightening of liquidity combined with high valuations that makes us more cautious.

Having said that, good quality equities continue to offer the best prospects for longer-term growth, and they will remain at the core of balanced portfolios. Should there be material market weakness in the short-term, we would be inclined to deploy some of our dry powder. At the same time, we are widening the net further in search of assets that can produce positive returns while being less correlated to equity risk.

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