Market Commentary October

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Overview

While the summer months passed with little incident, the onset of autumn has brought with it a distinct chill as several threats conspire to knock markets off the consistent recovery path that they have followed since the trough of the COVID recession. While we have stated on several occasions recently that it would be unrealistic to expect equity markets in particular, to continue to deliver positive returns at such a phenomenal rate, we also recognise that such periods of greater volatility can be unnerving, particularly when accompanied by predictions of much steeper declines. In this section we will cover the main topics of concern, which are the extraordinary squeeze in the market for natural gas and the potential for tighter monetary policy.

When energy price rises start to make headline news, it makes for uncomfortable reading. Economic recessions in the 1970s, early 1980s, early 1990s and even the financial crisis itself were all associated to some degree with a rising oil price, even if the circumstances of each period were different. The first three examples resulted mainly from supply disruptions in the Middle East stemming from geopolitical unrest. The last one was more a function of very strong demand, notably from China as it grew rapidly, even if, of course, the financial crisis was ultimately triggered by an unwinding of the leverage in the American property and financial sectors.

There are two separate issues to consider when it comes to the effect of energy prices. The most immediate is the fact that, in an unchanged income environment, higher prices divert spending power from other goods and services, and, indeed, from savings. It's a bit like a tax rise. That has a dampening effect on overall activity. To some degree the world has been shielded from the worst effects of higher oil prices when they did prevail in recent decades thanks to the fact that the energy intensity of the global economy has declined. This has been a result of improved fuel efficiency and a greater share of activity being driven by services. Furthermore, a growing share of electricity generation has been from renewable resources, such as wind and solar, as well as from cheap, abundant natural gas. The latter, while still being a source of carbon emissions, has been viewed as a suitable fuel for smoothing the transition to a less carbon-intensive world.

However, we are now discovering the downside of becoming more reliant on natural gas, as burgeoning demand from re-opening economies has run into supply constraints. Even if these constraints appear to be relatively cyclical, the dash for scarce resources to keep the lights on has resulted in an epic price squeeze, with the price of gas multiplying several times this year. Inventories, which were not fully replenished following last winter, are much lower than normal;

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current supplies from the United States were disrupted by Hurricane Ida; cargoes of liquefied natural gas usually bound for Europe have been diverted to higher bidders in Asia; and the UK, which has seen a bigger squeeze than anyone else, has suffered its own specific problems, as detailed in the UK section below. And all of this before we have reached the colder temperatures of winter: natural gas is the main source of fuel for central heating boilers.

One important lesson to arise from this episode is that the transition to a cleaner energy world is unlikely to be straightforward. Disappointingly, we might well see backwards steps being taken as electricity generators switch to using oil and coal as less costly fuels. Even so, the underlying trend should remain towards carbon neutrality. But these energy price spikes pose a major conundrum for central banks, whose policy pronouncements will now take on even greater significance. The US Federal Reserve and the Bank of England have recently made it clear that tighter monetary policy is coming sooner rather than later, initially in the form of a running down of asset purchase programmes to be followed later by higher interest rates. A handful of central banks, including those of Norway and New Zealand, have already taken the first steps in raising interest rates. These moves are currently characterised as a shift away from the emergency settings of the COVID crisis, which we might describe as taking the foot off the accelerator rather than slamming on the brakes.

However, rising energy prices will become a major factor in further boosting consumer price indices at a time when other supply chain disruptions – ranging from shortages of computer chips to a lack of container shipping capacity – are already forcing prices upwards. Worries will be compounded by labour shortages in several sectors of the economy. Brexit is partially to blame in the UK, but it is clear from the experiences of many other countries that there are widespread skills gaps, and that many employees have re-evaluated their lifestyle choices during COVID, with some exiting the labour market permanently.

While governments are happy to promote higher wages as a source of greater spending power, central bankers are eyeing the risk of the development of a wage/price spiral which leads to more persistent, higher inflation. For now, the majority of central banks continue to stick to the "transitory inflation" line, but the risk they face is that inflation expectations continue to rise and become stuck at higher levels. Should that persuade them to impose a more aggressive monetary policy response, then we face the prospect of reduced growth expectations.

Markets – US

One regular feature of the US political scene is the wrangling over the amount of money that the government is allowed to borrow. No doubt with good intentions, a "debt ceiling" was imposed for the first time in 1917, but it has had to be raised, on average, more than once every year since then. For example, although the presidency of Ronald Reagan is remembered as one during which "big government" was reduced in its scope, the debt ceiling was raised eighteen times under his watch. Since then, we have experienced three US debt crises. The first, in 1995, ensued from Congress not approving the federal budget and it led to a shutdown of various government services. The 2011 crisis witnessed a downgrade of the investment rating of US Treasury bonds and increased volatility in financial markets generally. The 2013 crisis saw further shutdowns of government functions before the situation was resolved. We are faced with a similar threat now, and there are echoes of previous circumstances, with Republican politicians once again pushing back against Democratic spending plans, claiming to be the party of fiscal conservatism despite having scattered government funds around like confetti during their most recent period of control. Interestingly, during all three previous crises, it has been the Republicans whose approval ratings with voters declined, as they were deemed to be to blame for not passing legislation. One thing is clear from past crises, though, and that is that the servicing of government debt by way of repayments and interest will be prioritised, and that forcing a debt default would be very much a tactic of last resort.

UK

The UK's current energy crisis is more acute than in other regions as several factors converge. Some of the problem is structural, some cyclical and potentially temporary in nature. First, the structure of the UK energy supply market is very different to that in other countries, in that smaller suppliers were historically encouraged to provide more competition to the "Big Six" incumbents. Sadly, it has become apparent that their structures are not sufficiently robust to withstand the extreme movement in gas prices that we have seen, with many failing. The price squeeze itself, as detailed above, is a global phenomenon, with surging demand meeting low inventories and disrupted supplies. But the UK's situation is exacerbated by the fact that sources of renewable electricity generation, such as wind and solar farms, have not enjoyed optimal operating conditions, with both wind speeds and hours of sunshine falling below seasonal averages. This has placed greater demand on gas-fired power stations. The UK's primary gas storage asset, a vast depleted gas field beneath the North Sea, has been decommissioned since 2017, leaving limited reserves to fall back on. At the same time, shortages of fuel at petrol stations sparked panic buying. But this is a completely different phenomenon, with the shortages being a result of a lack of tanker drivers as opposed to a lack of petrol. This should be a much easier problem to resolve, although has necessitated the involvement of army-trained drivers. But both situations are easily conflated into one large crisis and will play their part in potentially increasing expectations for future levels of inflation.

Europe

Germany's recent federal elections are most notable, perhaps, for the lack of ripples they have caused in the European political pond despite the lack of a resolution. Angela Merkel remains the Chancellor as we await the outcome of coalition negotiations between the main parties, a process that could take months. But it is testament to the view that change will only be incremental that investors have demanded no apparent increase in risk premium to hold the country's assets. The party with the largest share of the vote, for the first time since 2002, is the Social Democrat Party led by Olaf Scholz, who was finance minister in the outgoing coalition cabinet. However, it is by no means certain that he will become the next Chancellor, even if he is very much the favourite. It would not be impossible for the Christian Democrat/Christian Social Union combination to form a three-way coalition with the Green Party and the Free Democrats if the SPD is unable to reach its own agreements with the smaller parties. But the market is already braced for (at least) a three-way coalition, as neither the SPD nor the CDU/CSU parties have declared themselves keen to continue to govern as a "grand coalition". The green agenda will certainly be advanced by the almost inevitable inclusion of the Green Party, but the probable inclusion of the liberal Free Democrats will temper any radical policy moves. Indeed, the electorate showed its distaste for extreme policy promises by confining both Die Linke (the furthest to the left) and Alternative for Germany (the most right-wing) parties to the margins, although both will still have parliamentary representation.

Emerging Markets

Our most recent commentaries on emerging markets have focused almost exclusively on the tightening regulatory regime in China and the institution of a "Common Prosperity Plan". While we believe that the actions of the Chinese Communist Party are designed to iron out at least some of the country's social inequalities and to lay the foundations for more sustainable (if less spectacular) growth, there is little doubt that they are causing disruption in the short term. Even so, it is not unusual to hear commentators in the West suggesting that governments in developed markets might like to follow China's lead in some areas of the economy were it not for the inconvenience of having to court popularity at the ballot box and to solicit funds from large businesses. The latest victim of the CCP's more stringent approach is the giant (primarily) real estate company Evergrande, which, at the time of writing, teeters on the brink of bankruptcy. In some ways, this has been a predictable outcome ever since the CCP set out its "three red lines" policy in early 2020 to curtail excess leverage in the property sector. Even so, there has always been a possibility that Evergrande might be able to restructure itself and avoid its worst fate. That now seems to be improbable, but the extreme threat of this leading to China's "Lehman Moment" appears exaggerated. There is little motive that we can see for the government deliberately to create a crisis, especially when COVID has not been fully suppressed and we are in the teeth of an energy price squeeze. Claims that Chinese markets are now "uninvestible" should begin to excite investors with any contrarian inclinations.

Fixed Income

For the second time in 2021 government bond yields are on a rising trend having spent most of the spring and summer heading lower. The first quarter of the year saw yields rise in anticipation of economic reopening as a result of accelerating vaccine distribution. In that this represented a recovery from the COVID recession, it was seen as a good thing and a shift back towards a more normal yield environment. The increasing prevalence of the Delta variant put a brake on the recovery, but just as that problem started to recede energy prices began to leap upwards. Movements in energy prices (especially oil) have long been associated with shifts in inflation expectations, a phenomenon that has very strong roots in the 1970s, when the oil embargo imposed on the West by Arab states triggered a classic price/wage inflation spiral. Although correlation models have spent the following four decades slavishly expecting the same outcome, it has rarely been the case, partially because the world's spending on oil as a percentage of overall economic activity failed to reach the same heights, but also because of the dwindling power of organised labour and improved productivity. It remains unclear which way the balance will tip this time, with many economists of the opinion that demographic and technology trends will continue to exert a more disinflationary force while many politicians think that higher wages will reflect well on them when it comes to re-election.

UK Gilts have delivered a total return of -1.84% over the last three months and -6.81% over the last year. Index-Linked Gilts returned 2.21% and 0.01% over the same respective periods. Emerging Market sovereign bonds produced a total return of 1.69% in sterling over the three months to end September (-1.58% over 12m). Global High Yield bonds delivered 2.08% (4.98% over 12m).

Conclusion and Outlook

The fact that this is all happening when Western economies appeared to be recovering from the worst effects of the Delta variant wave is, to say the least, disappointing. Although we never subscribed to the "Roaring Twenties" narrative, which envisaged an extended period of unconstrained excess as we all celebrated still being alive, we were more confident that activity could remain at elevated levels as excess savings were released. But while there is plenty of evidence of decent demand, the real problems are on the supply side of the economy. As long as these problems are temporary – and we believe that they generally are – then the ability of good quality companies to continue to generate strong returns in the long term should not be greatly compromised, and we take comfort from the fact that our research process emphasises the durability of returns over ephemeral attractions.

However, we cannot ignore the fact that short-term risks have risen, although much will depend on the willingness of central banks to tolerate a period of higher inflation, which will, in turn, depend upon the development of consumers' expectations for future levels of inflation. At the same time, as has been the case for a while, the ability to generate income and to compound positive real returns for balanced portfolio investors require the ownership of assets such as equities, which are more volatile by nature. We continue to believe that investors who do not face immediate demands on their cash should remain fully invested for the longer term but braced for the ride to remain a bumpy one for the next few months.

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