Weekly Digest

15 July 2019

The weekly insight into world stock markets

Investec Wealth & Investment

Dire Strait

And it's "hats off" today to… whoever invented the Personal Video Recorder, allowing sports fans to watch the cricket World Cup final in almost real time alongside the Wimbledon final while skipping adverts and the (not many) boring bits. For a few blissful hours I didn't think of Donald Trump or Brexit, which is ample support for the "feel-good factor" that economists associate with national victories. Whether New Zealand and Switzerland fall into recessions remains to be seen.

It's back to the harsh realities of the world on a Monday, and today's title refers to the Strait of Hormuz, the body of water that leads from the Persian Gulf to the Indian Ocean. Much of the oil and gas that is sourced and refined in Saudi Arabia, Kuwait, Iraq, Iran, Qatar and the United Arab Emirates has to be transported via the Strait to its end markets. It is estimated that around 30% of global sea-borne crude oil takes this route, although if one accounts for oil that is shifted through pipelines on dry land the overall exposure is slightly below 20%. Even so, it is easy to see how a closure of the Strait could have a big impact on global oil supplies, and therefore prices. I have seen one study that suggests, using regression analysis, that just a 1 million barrel per day (which is about 1%) swing in supply versus demand can move the oil price by 30%.

We have noted in the past that higher energy prices tend to act like a tax on consumers, diverting their spending from less essential goods and services, and although higher prices can also encourage more investment by the oil industry, the net effect on growth tends to be negative. Indeed, recessions in the 1970's, 80's and 90's were all associated with rising oil prices resulting from strife in the Middle East, although much of the effect can also be attributed to central banks raising interest rates to neutralise the inflationary effect of higher oil prices. Even now a tight correlation persists between the market-derived forecast for inflation five to ten years ahead and the current movement in the oil price, although in reality there is little predictive capacity. At least central banks are a bit cannier today about "looking through" the short-term effects of higher energy prices if the underlying economic situation is weak. The European Central Bank learnt this lesson the hard way in 2011 when it raised interest rates in the face of a recovering oil price when the euro zone was already heading into its crisis.

Why do I bring this up now? President Trump's withdrawal of the US from the 2015 Iran nuclear deal and the imposition of new sanctions has encouraged Iran to retaliate by threatening to disrupt traffic through the Strait of Hormuz. It has attacked two oil tankers, shot down a US surveillance drone and attempted to divert a British tanker into its own territorial waters. The latter incident, possibly in retaliation for the seizure of an Iranian oil tanker in Gibraltar, led to the intervention of a British naval frigate. This is another example of the effects of Donald Trump's capricious policy decision-making, and supports our opinion that markets need to build in a political "risk premium" to account for the possibility of escalation. This is especially so when one of Trump's main motivations appears to be a visceral loathing of his predecessor Barack Obama and his legacy as much as any clearly thought-out policy. I note that the latest round of emails leaked from our now-departed ambassador to the US backs up this contention.

The beneficiaries of higher oil prices are, of course, oil producing companies, who benefit from higher prices while their costs remain relatively stable. The industry had already been making itself more profitable and cash-generative following the oil price collapse in 2015/16, so higher prices are the icing on the cake. However, investing in the sector is becoming more complicated owing to the effect of fossil fuel use on the climate. Index provider FTSE Russell (owner of the familiar FTSE 100) has decided to become investors' moral guardian by designating oil and gas producers as "non-renewable energy". The world's largest wealth fund, owned by the Norwegian government (or should that be its citizens?) is excluding oil exploration and production companies from its portfolios. Ironically, this could produce higher returns for investors who are less sensitive to such issues. Long-term data on returns from the Tobacco sector, for example, have shown that its constituents delivered superior returns in part because they were consistently undervalued by the market owing to their "sin" status. Another irony is that "Big Oil" is also one of the biggest investors in renewable technologies, and so raising its cost of capital could be counterproductive.

There is no doubt that overlaying environmental, governance and social factors onto portfolios (ESG for short) is becoming an increasingly important consideration. I'm all for that if it makes the world a better place for employees and consumers, but I am concerned that vocal minorities making effective use of social media can have a disproportionately large influence. I am also worried that the ESG bandwagon will inevitably encourage a panoply of ESG-labelled funds which will filter clients' money into a narrow list of compliant companies, creating the danger of overvaluation. Some providers are already promoting such funds on the basis of historic outperformance, but the history is too short to prove that claim – it might just be a function of the most recent cycle. Quite what the equivalent of adding ".com" or "bitcoin" is in this instance, I'm not sure, but you can also be sure that some companies will attempt to position themselves as ESG-friendly on the flimsiest of credentials. We are currently undertaking a detailed review of this whole trend, and I will report back when we have conclusions.

John Wyn-Evans
Head of Investment Strategy

FTSE 100 Weekly Winners

Barratt Developments	9.2%
John Wood Group	6.7%
Smurfit Kappa Group	5.2%
Imperial Brands	3.7%
Persimmon	3.5%
Taylor Wimpey	3.3%
Berkeley Group Holdings	3.3%

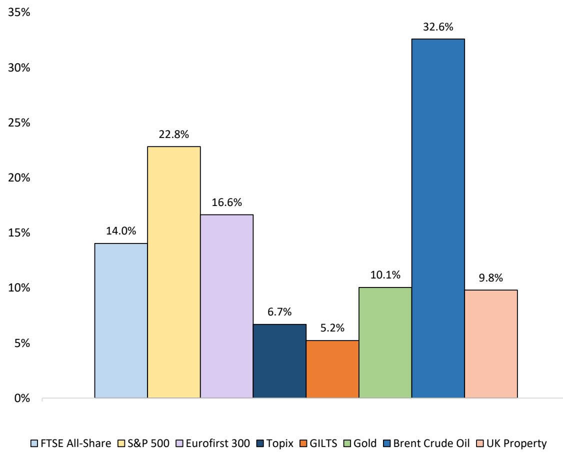
Source:FactSet

FTSE 100 Weekly Losers

Micro Focus International	-16.0%
GVC Holdings	-11.4%
NMC Health	-10.1%
Ocado Group	-6.7%
Coca-Cola HBC AG	-4.7%
JUST EAT	-4.7%
TUI AG	-4.4%

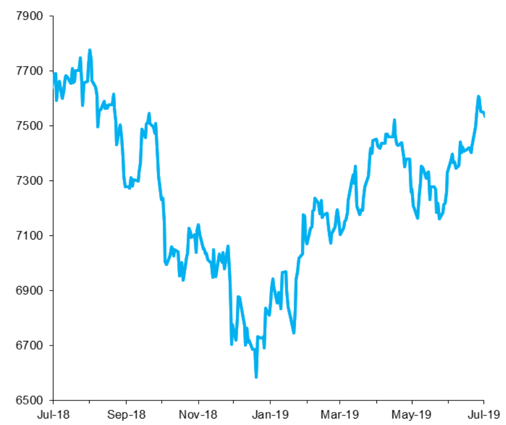
Source: FactSet

Year to Date Market Performance



Source: FactSet

FTSE 100 Index, Past 12 Months



Source: FactSet

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