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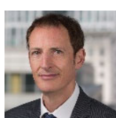
OUT OF THE ORDINARY

WEEKLY DIGEST | 18 October 2022

About Turn



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Right now, market commentary feels more than ever like live-action commentary on a sporting event, not least because the Prime Minister, in her role as manager, has been highly influenced by a baying crowd, draconian rules officials and a keen-eyed Video Assistant Referee and has to keep making substitutions to change completely the style of play.

Welcome to the crazy world of UK politics that is managing to keep even the threat of nuclear war off the front pages, and where the Daily Star offers a live video feed of a lettuce sitting next to a photograph of Prime Minister Liz Truss and asks which will last longer.

Although the situation in the UK managed to climb to the top of the International Monetary Fund's agenda last week, there are still plenty of other influences on markets that we need to keep an eye on, and I will comment on those after focusing on domestic matters because investing relies upon a global perspective.

What is the effect of recent UK developments?

Mindful of the fact that we are in a fast-changing situation, here is our latest evaluation of the situation in the UK. On Monday, the new Chancellor of the Exchequer, Jeremy Hunt, announced a massive reversal of the Truss administration's marquee fiscal policies, most of which had only been formally introduced three weeks earlier. It is calculated that around £32bn of the planned £45bn tax cuts were retracted. Furthermore, the Treasury also declared that it would only provide the currently planned energy support until April 2023 and undertake a review to find a more sustainable and targeted solution thereafter.

Markets expressed their approval for the about face, with sterling gaining ground against other major currencies. Bond markets also heaved a sigh of relief, with yields falling across the curve, something that should provide some help in the mortgage market too. The withdrawal of stimulus that could potentially have created more demand and inflation also means that there will be less pressure on the Bank of England to raise interest rates more aggressively into a weakening economy. On Friday, interest rate futures were discounting a peak base rate of 5.64% next year and that had fallen to 5.15% by Monday's close.

However, we would counsel against an outbreak of euphoria. The structural problems facing the government have been made clear for all to see and it remains difficult to see where cuts can be made to public spending. And if any cuts are confined to capital projects, that might only serve to hold back the country's productivity growth in the longer term.

As a final aside, keen players of the online game Wordle might be aware that TRUSS was the solution on 2 January 2022. The day before it was BOOST, which is what she was trying to do to the economy. The day after it was SIEGE, which I do not need to explain further. I wonder what other clues to the future lie buried in a list of five-letter words...

What is happening in the US?

Whether we like it or not, the US economy and the actions of the Federal Reserve (Fed) continue to dominate investor sentiment globally. As the Fed tightens policy, it tightens financial conditions through the transmission of policy through to the bond, equity and currency markets. Markets are currently lurching from one economic data point to the next, wondering what could influence Fed policy, with much attention paid to monthly employment and inflation statistics. The latest instalments of both of those, reported within the last ten days, provided little evidence that the Fed will be in a position to pause its rate rises, let alone "pivot" towards lower

rates. Just ahead of the last employment report (7 October 2022), interest rate futures were pricing in a peak Fed Funds rate of 4.58% next March. Now, following strong employment and higher-than-expected inflation (13 October 2022), that figure has risen to 4.92%. Indeed, yields are higher all through the curve.

Bond yields are most influential, perhaps, in setting mortgage rates, and the Great Financial Crisis (GFC) of 2008/09 is never far from people's minds when worries about the US housing market emerge. Here, I have good news and bad news. The good news is that some 90% of mortgages in the US are fixed for 15 to 30 years. This means that affordability for existing mortgagees will not be greatly affected (at least as long as they have a job) by the fact that the national average 30-year rate has risen in record time from 3.25% at the start of this year to 7.2%.

The bad news is that mortgages are not "portable", and therefore anyone who moves home will find themselves subject to a much higher rate. And that higher rate also massively reduces affordability for new buyers. These factors combined suggest greatly reduced activity in the US housing market, although not, it is hoped, the sort of forced selling that triggered the global financial crisis. I should also add that "cash out" refinancing of existing homes will also fall, thus removing a substantial source of funds used for both consumption and investment.

Unfortunately, the UK's housing market is not quite as well insulated. The good news is that only around 20% of mortgage rates are now "floating", but the fixed rate alternatives are usually set at either two years or five years. So, yes, there will be some respite, but not enough. Around 100,000 mortgages are coming up for refinancing every month, and, given where mortgage rates were between two and five years ago, households will be facing a sharp increase in monthly payments, believed to be, on average, around £280 for a new two-year fix.

Finally, what is happening in China?

Inflation and interest rates are of great importance in a cyclical sense, but the fate of China's relationship with the rest of the world might have much greater secular consequences. The big showpiece over the weekend was the beginning of China's quinquennial Communist National Party Congress, where delegates were treated to a two-hour, tone-setting opening speech by President Xi. The word we've seen most widely used to describe his words is "defiant", especially when it comes to the country's ambitions to reintegrate Taiwan. There was also a lot of chest-beating about technological progress in the face of tighter restrictions being imposed by the US. However hard President Trump might have been on China, his predecessor is, if anything, proving to be even more hawkish, especially when it comes to reducing China's access to critical semiconductor chip technology from the West.

Domestically, there seemed to be no evidence of a reversal of the zero-Covid policy that continues to disrupt normal activity. It won't be until next weekend that we get final confirmation of Xi's third term (which is expected to be a formality), the composition of the politburo and possibly the identity of a potential successor, although that is more of a long shot. All in all, though, there's nothing surprising so far, and certainly no sign of any rapprochement with the US.

Economic Commentary

FTSE 100 weekly winners

DS Smith Plc	10.0%
International Consolidated Airlines Group SA	8.5%
Next plc	6.1%
Ocado Group PLC	5.7%
Rentokil Initial plc	5.3%
Smurfit Kappa Group Plc	5.2%
ITV PLC	5.2%

FTSE 100 weekly losers

Just Eat Takeaway.com N.V.	-11.3%
Fresnillo PLC	-10.8%
Intermediate Capital Group plc	-7.3%
International Distributions Services PLC	-7.0%
Hargreaves Lansdown plc	-6.6%
BAE Systems plc	-6.5%
Anglo American plc	-6.5%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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