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More Uncertainty

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Uncertainty amid tragedy

It is never easy to write market commentary in the face of humanitarian tragedy. It's bad enough when it has been the result of what some might describe as "Acts of God", but even worse when it is human agency that has been the cause. That is very much the case with current events in Israel and Gaza, and our thoughts are very much with those involved in and affected by the situation.

Even so, as investment professionals we are compelled to view what is unfolding through the lens of financial outcomes. Anyone with access to no news, other than headline weekly financial market prices might be forgiven for thinking that the world was an unusually serene place last week. Bonds, equities and, by extension, balanced portfolios, ground out small gains and currency markets were relatively subdued in comparison to recent experience. That said, there were a few clues as to something more sinister lurking beneath the surface. The VIX volatility index ended the week at 19.32, approaching the 20 level that is often associated with greater stress in the US equity market. Small and mid-cap shares performed relatively poorly again as concerns about the risk of a sharper economic slowdown ahead persisted. And the price of gold, a traditional bolt hole, jumped more than 5%, admittedly after a period of distinct weakness.

What is happening in the oil market?

The biggest mover of the week was oil, with Brent crude up around 7.5%. All the gains came on Monday and Friday, but very little happened in between. The first move was the immediate reaction to the potential for wider conflict in the Middle East; the second to concerns ahead of the weekend that a ground attack by Israel into Gaza would draw in other actors, not least Iran-backed Hezbollah from Lebanon. It is clear from the diplomatic efforts being made that there is no desire amongst global superpowers (with perhaps one key exception) for the situation to escalate. And although humanitarian concerns should be at the forefront of all negotiations, it is clear that the risk of disruption to oil supplies, and what that might mean for inflation and already fragile global economic growth, is also a factor, especially just over a year away from the next US Presidential election.

Iran is the key focal point here. It is a major exporter of oil, currently supplying around 2% of daily needs to the rest of the world. It also effectively controls the Strait of Hormuz, or at least has the greatest capacity to hinder shipping through there. That could be much more serious, as around 20% of global oil supply makes its way through that stretch of water. If Iran is proved to have been complicit in the initial or subsequent attacks, then it could find itself subject to export sanctions once again. Thereafter it could retaliate. All of this is obviously in the realm of speculation, but we have to anticipate such scenarios.

To complicate the geopolitical picture, the events in Israel and Gaza threaten to divert both political attention and funds from Ukraine, suggesting that Russian President Putin might be quite happy to see things getting worse.

Why is there limited reaction?

And so, why have markets appeared so sanguine? Despite the obviously shocking numbers in terms of the initial casualties and the brutal nature and scale of the attacks, violent confrontation in the region has been part of the background narrative for decades, and so did not have the same shock factor as, for example, Russia's invasion of Ukraine. Neither is Israel a large exporter of essential commodities. And so, we await the result of current diplomacy, although with a still-cautious bias.

What else is affecting activity?

Elsewhere in financial markets last week, investors remained under the influence of the bond market, specifically the US bond market. An initial rally as investors sought safe havens ran into a headwind of supply, with a poorly received bond auction on Thursday pushing yields back up. The scale of potential supply of US government bonds has become an increasingly hot topic in recent weeks, with the size of the US fiscal deficit, running at around 8% of GDP this year, a cause for concern. To some degree, the market was shielded against this earlier in the year, on two fronts. First, the debt ceiling impasse meant that no new debt was issued for several months, during which period government spending was largely funded from the Treasury General Account. Once the debt ceiling was agreed, the TGA was rebuilt and current

spending was funded from an aggressive issuance of short-dated Treasury Bills. As the summer progressed, there was a shift back to longer-dated funding and this, along with the persistence of growth, impatience with the fall in inflation and tough talk from the Federal Reserve, has been a key driver of rising yields.

Fiscal deficits have two sides to them. There has been a lot of attention paid to the levels of spending by the Democrats, which have been driven by a combination of expansive policy decisions, the inflation-linked uprating of social security payments and, more recently, the rising interest bill. But less has been said about the income side of the equation. Tax receipts are already under pressure from financial markets, with capital gains tax receipts, especially, dwindling as markets deliver little by way of capital gain. Should a recession develop, that would eat further into income, especially from corporate taxes.

The recent rise in bond yields is playing out through the real yield, or the yield above expected inflation. If one takes the US 10-year real yield, effectively the global benchmark, this has risen from around 1.5% at the beginning of the year to a current 2.3%, having briefly flirted with 2.5% in the last couple of weeks. This introduces the slippery concept of the term premium, or the extra yield that investors might demand over and above expected base interest rates, to compensate for the risk of higher and more volatile inflation in future or for the threat of a greater supply of bonds. As with a lot of things in financial markets, the current term premium can be inferred from a combination of various inputs, but, in reality, can only be properly calculated on an ex-post basis. But the consensus opinion is that it's going up.

This has an important bearing on equity markets owing to the discount rate effect on net present values of future cash flows. The FT's Unhedged column specifically mentioned it on Monday in relation to the derating of Consumer Staples stocks, which are often considered to be "bond proxies" *. One could also observe it in the fact that Utilities – another sector whose performance tends to correlate strongly to bonds owing to long-term stable revenues – is the worst-performing sector in the US this year, having fallen 16%.

If only it were that simple. What about the duration effect? Shouldn't the longest-duration assets have been the worst performers? Not necessarily in the US, where big cap Tech has led the indices higher (although more speculative non-profitable companies have continued to struggle). It could be that expected growth, buoyed by optimism about AI, has outrun the higher discount rate. Or it could be the perceived relative safe haven status of unleveraged, high margin global leaders. Maybe it's the relentless flows into indexed funds. Probably a combination of all of them. But we continue to believe that this relentless upward grind of bond yields and de-rating of other high-quality equities will set up a very attractive longer term investment opportunity.

*There are other factors at work here, not least worries about the long-term effects on demand for their products which might be reduced by the widespread adoption of a new class of drugs (GLP-1s) that suppress the appetite and help lead to weight loss with positive impacts on long-term health. This is a subject worth returning to at a later date.

Question of the week:

Last week's question: When was Ice Hockey first played at the Winter Olympics? 1920

This week's question: Who won the 1920 US Presidential election?

Economic Commentary

This Week's Forthcoming Events

US	Empire State Index SA
US	Treasury Budget NSA
US	Retail Sales SA M/M
US	Capacity Utilisation NSA
US	Industrial Production SA M/M
US	Housing Starts SAAR
UK	CPI EU Harmonized NSA Y/Y
UK	PPI Output NSA Y/Y
UK	CPI Core NSA Y/Y
EU	Trade Balance SA
EU	CPI EU Harmonized Y/Y (Final)
EU	Germany PPI NSA Y/Y

UK – The 0.2% month-on-month rise in real GDP in August, following July's 0.6% contraction raised hopes once again that the economy has escaped a recession. But some of the strength of GDP in August was due to temporary factors, and timelier survey measures of activity point to another drop in September. Some of August's rise in GDP reflected the strikes ending in the education sector. Education output rose by 1.6% month-on-month after falling by 1.7% onht-on-month in July. Services output rose by 0.4% onth-on-month, but construction output fell by 0.5% month-on-month as heavy rainfall and lower than average temperatures delayed work. A 0.8% month-on-month fall in manufacturing output resulted in a 0.7% month-on-month drop in industrial production. The housing market will not offer much support for the wider economy. Mortgage demand continues to fall, and the latest RICS House Price Balance Index fell to a new cycle low of -69%. Rightmove reported national house prices to be down 0.8% on a year ago, which will be a lot lower in real terms.

US – The latest Consumer Price Index print delivered mostly bad news from a market perspective. The main story was that headline CPI came in at +0.40%, which was above the consensus of economists' forecasts at +0.3%, and also inflation swaps, which predicted +0.25%. It wasn't just the headline number that came in strong however, as the core CPI measure was running at +0.32%, with decent increases in some of the stickier categories too. It was also a broad-based move, as the Cleveland Fed's trimmed mean CPI measure (which excludes the biggest outliers) rose by 0.40%. And so, the data cemented the picture that inflation has been ticking up in recent months. Looking at just the last three months, the annualised rate of CPI is now at +4.9%, which is the highest it's been since August 2022. That's offering some pushback against the more positive inflation narrative from a couple of months ago. This news helped to push bond yields higher following a rally early in the week.

Europe – The latest Sentix Investor Confidence reading defied gloomy predictions by "only" falling from -21.5 to -21.9 versus an expected -24. But with aggregate financial conditions as tight as they have been at any time during the last decade, Europe remains on the back foot. Industrial Production (IP) for August came in at -5.1% year-on-year, but a brief perusal of the long-term chart shows that August is a notoriously poor month for IP data owing to extended holiday periods. Even so, there is very little positive momentum in the European economy at the moment outside some strong areas for tourism.

China – Total social financing credit in September was stronger than expected, at RMB 4.1tn versus consensus expectations of RMB 3.7tn. This was helped by strong government bond issuance and an increase in new household mortgages, suggesting that the boost from the recent easing in property policies is starting to kick in. There is potential for further monetary easing from the People's Bank of China, and additional fiscal stimulus, as suggested by recent press reports, could further help to support credit demand.

Economic Commentary

FTSE 100 weekly winners

Company	Change
BAE Systems plc	10.1%
BP p.l.c.	8.3%
United Utilities Group PLC	7.0%
Just Eat Takeaway.com N.V.	6.2%
Severn Trent Plc	5.9%
Fresnillo PLC	5.5%
Shell Plc	5.4%

FTSE 100 weekly losers

Company	Change
St. James's Place Plc	-20.7%
Spirax-Sarco Engineering PLC	-10.4%
Croda International Plc	-9.2%
JD Sports Fashion Plc	-8.6%
International Consolidated Airlines Group SA	-7.8%
Ocado Group PLC	-7.0%
Next plc	-5.0%

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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