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The Anatomy of a Bull and a Bear; Energy moves into the "Stratosphere"

In July and August positive sentiment returned with the rush of a summer breeze. It was welcome after a disastrous second quarter and first half of the year in markets. This was until late in the month when the Fed Meeting at Jackson Hole caused the wind to change and a cold front moved in again.

Just as markets have lurched from one extreme to the other, we lurched from a summer of no travel to a summer of travel gridlock. Bans on new short-haul flights from Heathrow, stranded baggage and cancelled flights became a new normal, but this surge in activity left Covid in the rear-view mirror for the most part (except in Asia). Elsewhere supply chains started to loosen, Covid numbers abated and a tentative return to the office took place.

Besides a lack of rainfall in the UK and the conservative leadership contest, summer so far has been dominated by news of energy prices, inflation, interest rate hikes and the big R – recession – whether it is with us and how long and severe it will be.

Looking around the world gave little solace. As interest rates topped 20% elsewhere in Europe and Covid shutdowns continued in Asia, the US continued to look like the only economic engine firing on more-or-less four cylinders. While this might bode well for dollar denominated assets, it continues to place a strain on the rest of the world economy which can now add imported inflation to the rest of its woes.

Highlights since the last quarterly update:

- **Inflation has not budged from the forefront of newspaper headlines and central bank deliberations. Figures remain high globally, although it continues to be difficult to**

decipher which parts of it will stick and which are more temporary – e.g. in the US energy prices fell back in July leading to a slightly lower headline inflation number, while in Europe energy prices looked set to surge without governmental intervention.

- **Interest rates continued to rise, with the US Fed raising rates for the fourth time this year (75 bps) in July while the Bank of England raised its rates to 1.75%, its sixth consecutive rate rise and the largest (50 bps) since 1985. Fixed income performance recovered somewhat in the summer months, but remains exposed to expectations of further rate rises, and overall volatility in rates.**
- **Employment numbers look increasingly precarious – as job openings fall and hiring slowdowns and layoffs pick up. To date this has been the one piece that has prevented a full-blown recessionary outlook. If the employment picture starts to turn it is likely to have severe repercussions for the consumer.**
- **As we noted last quarter, we continue to watch and wait for the winter energy surge. With energy caps expected to reach up to 3x their current levels and expectations for inflation in the UK reaching the teens (18.6% was the recent Citi number for January) this is perhaps the most critical barometer of consumer sentiment for the next few months.**
- **As we discuss later, energy security and pricing concerns have become existential for some economies and there is a real likelihood that this will jeopardize some initiatives around decarbonization and shifts to renewable energy. Despite (or maybe because of) the passing of the Inflation Reduction Act in the US, with its numerous provisions around climate initiatives, ESG has become increasingly weaponized in the US, with mainly Republican politicians set against it. We will watch this dispersion in industry responses very carefully.**

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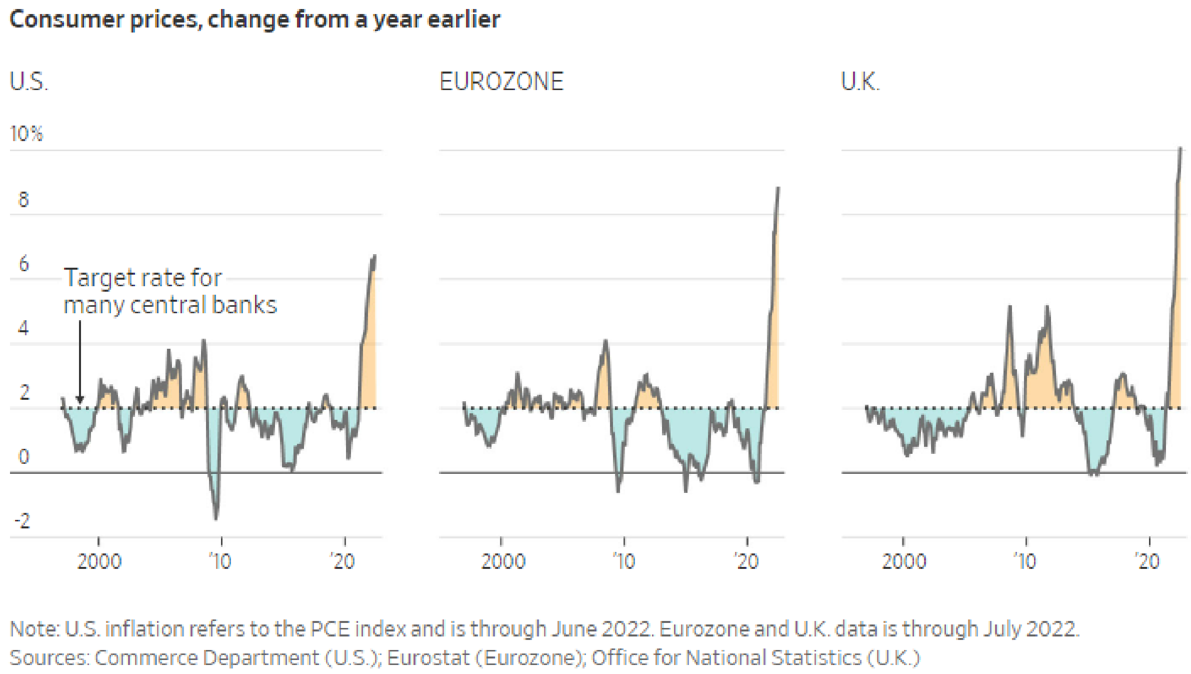
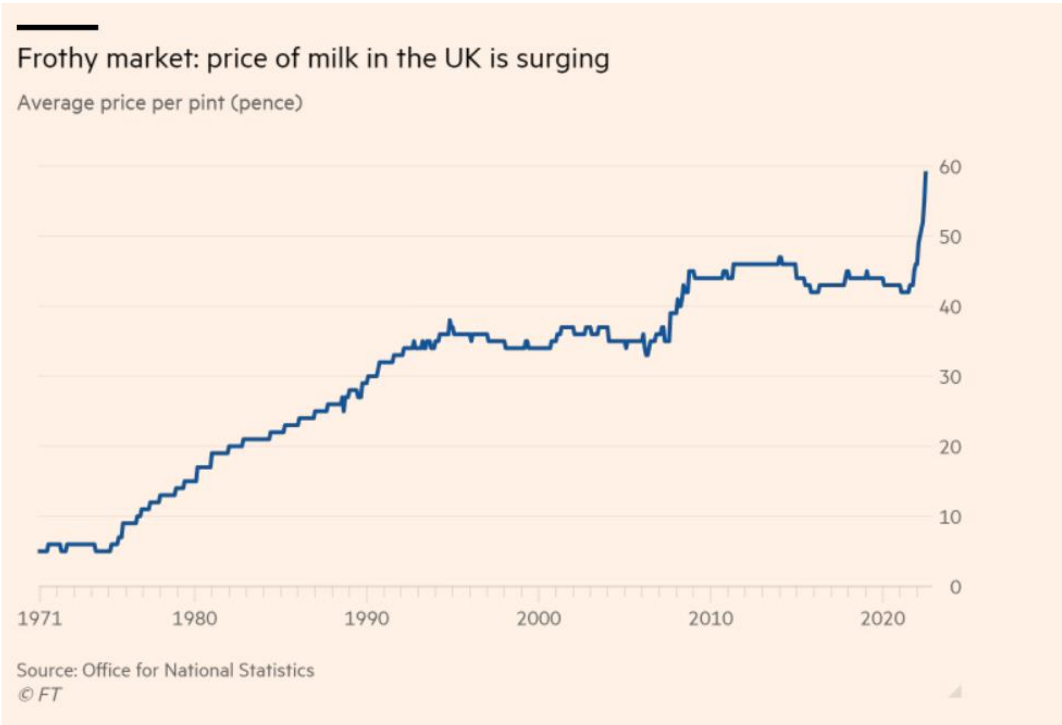
Current Macro Snapshot

Energy heads into the Stratosphere

UK inflation levels topped 10.1% in July, driven by a near doubling in wholesale gas prices – a direct economic effect of the war in Ukraine. The Bank of England now expects inflation to peak at 13.3% in October and not fall back to its 2% target until 2025. As discussed below, this commitment to target this inflation number "with no ifs or buts" was demonstrated by the Bank raising interest rates by 50 bps in early August for its sixth consecutive rate rise.

As the graphs below show, consumer prices have risen globally with a remarkably similar pattern, and even staples such as milk have recently broken out of largely range-bound price changes:





As the facts change . .

Although the Bank has been quick to revise its previous inflation expectations upwards in light of evidence of rising prices, other commentators have been even more pessimistic. Citi made news in late August by predicting a retail energy price cap of close to 3x the current level, and inflation reaching 18.6% in October, which compares only to the OPEC oil shock of 1979 when inflation reached 17.8%. This rise was described as "stratospheric" with an impact that could not be predicted, but in truth, the impact on lower income earners will be more severe – reflecting again the disproportionate impact of much of the Covid-induced hardship and, now, its aftermath.

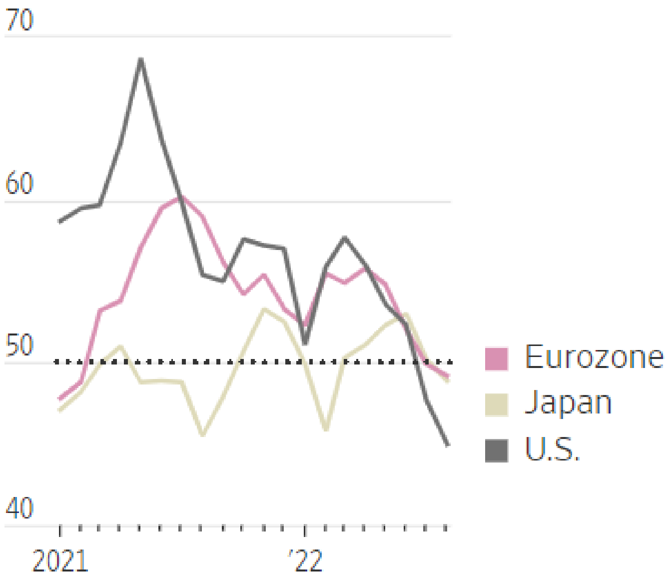
Due in part to energy, the inflation numbers globally continue to move starkly higher. There is a fascinating amount of dispersion within the numbers though. Inflation hit 8.9% in the Eurozone in July, although this masked dispersion from lower annual rates of 6.8% (France and Malta) and 8% (Finland) to higher rates in the Baltic state of Estonia (23.2%), Latvia (21.3%) and Lithuania (20.9%). Meanwhile levels in Turkey, outside the EU, but on the periphery, hit 80%, but were accompanied, somewhat unorthodoxly, by an interest rate cut. This dispersion presents the likelihood of an uneven response across the area to rising prices (e.g. France, due to its sizeable nuclear power industry, is much less dependent on Russian-sourced gas) and further fracturing of the economic picture in Europe.

Central Banks Invite Recession to the Dance

Having cycled through the "inflation is transitory" phase to "no ifs and buts", central banks have until now openly flirted with the possibility that their actions will cause a recession. In the US the Fed has focused on the probability of executing a "soft landing" while in the UK the Bank of England has been one of the first institutions to telegraph what they now say will be a protracted recession starting in the fourth quarter of 2022 and which will last up to 5 quarters. In other quarters the gloves are off now too, with the European Central Bank initiating its first rate rise in over a decade in July, lifting the Eurozone out of negative rate territory. Recognizing the divergent fortunes of certain member states it also announced a series of "anti-fragmentation tools" to allow it to shore up the most vulnerable economies by purchasing their debt in a limited number of circumstances.

But now central banks seem to be willing to do more than just flirt with recession. By persisting with rate rises (some as high as 75 bps in the case of the US) even despite a series of corporate profit warnings, a negative quarterly GDP print (US) and a weaker consumer, it is clear that they are willing to take economies even closer to recession – even "invite it to the dance". This is an exceedingly difficult needle to thread and as rates rise the strain on the consumer as well as corporate borrowers will only grow as mortgage rates rise as prices are doing the same. As the chart below shows, the purchasing managers index, typically an indicator of private sector business activity, has been sharply lower in recent months with a similar pattern globally.

Composite purchasing managers index



Note: Readings above 50 indicate an increase in activity, and below that threshold, a decline.
Sources: S&P Global; au Jibun Bank (Japan)

UK Economic Update – No Ifs or Buts

The outlook for the UK economy has moved from subdued to poor and the Bank of England in August predicted "significant deterioration" in the outlook not only in the UK but in the rest of Europe. The Monetary Policy Committee did note in its last meeting that the labour market remained tight, with vacancies at historically high levels and unemployment at only 3.8% (a 50 year low). Rises in pay were still lagging inflation, and as of late August job vacancies had started to fall slightly. A clear casualty of this bleak outlook has been Sterling, which has moved steadily weaker against the USD and the Euro over the past few weeks.

Other indicators such as factory output (which fell) and the services sector (modest expansion only) added to the sense of concern.

Individual Asset Class Performance.

- Equities
- Fixed income
- Other asset classes

Equities: Bull or Bear?

Equity Index	Year to date (August 26)	1 year
FTSE 100	0.58%	3.91%
S&P 500	-14.87%	-10.02%
Nasdaq	-22.39%	-19.75%
Dax (Europe)	-18.34%	-18.34%
Hang Seng	-13.79%	-20.62%
Shanghai Comp	-11.09%	-8.12%

Markets remain in the doldrums year to date and the sharp reaction to the Chairman of the US Fed's speech in Jackson Hole in late August eroded all of the positive returns for the month. As can be seen above, the FTSE 100 remains a bit of an outlier due to its industrial and export orientation. Asia has salvaged some of the year's performance to date and is looking somewhat stronger than mainland Europe.

Much of the debate in recent weeks has centered on whether or not the run up in equity markets was a "bear market rally" to be followed by further weakness or the beginning of a durable bull market after the indiscriminate sell-off of the first half of the year. There were a few indicators of interest: typically a bear market rally has lasted around 32 trading days, and the current one persisted for around 41 days.

The average rise from the bottom in an average bear market rally is 15%, and the rise from the bottom in this case was over 17%. Bear market rallies are typically narrow in terms of the number of stocks that drive it – more than 30% of the rise in the rally in the US was driven by Microsoft, Tesla, Amazon and Apple, while the US itself represented over 80% of the market rises globally. So this was reasonably broad, but not excessively so.

Given the economic outlook it is difficult at this juncture to say whether the current equity market strength will be durable. Cash on the sidelines, the massive sell-off in the first half and the fact the stock markets are typically leading indicators would suggest that stock markets have bottomed already. They cannot, however, point to a stable and secure future path and we do expect further volatility to be pronounced.

Fixed Income in the Cross-Hairs of Aggressive Monetary Policy

Although the activity in fixed income was more muted over the summer than in the first half of the year, it remains a negative returner for the year as investors wrestle with how the asset class is likely to behave in the current rate environment. The yield curve for US government bonds has been at times inverted, which is usually a bellwether for a recession – although this persisted even while equity markets were rising. It also reflected the doubt around the future direction of interest rates and the central bank commitment to follow through on attacking inflation by all means.

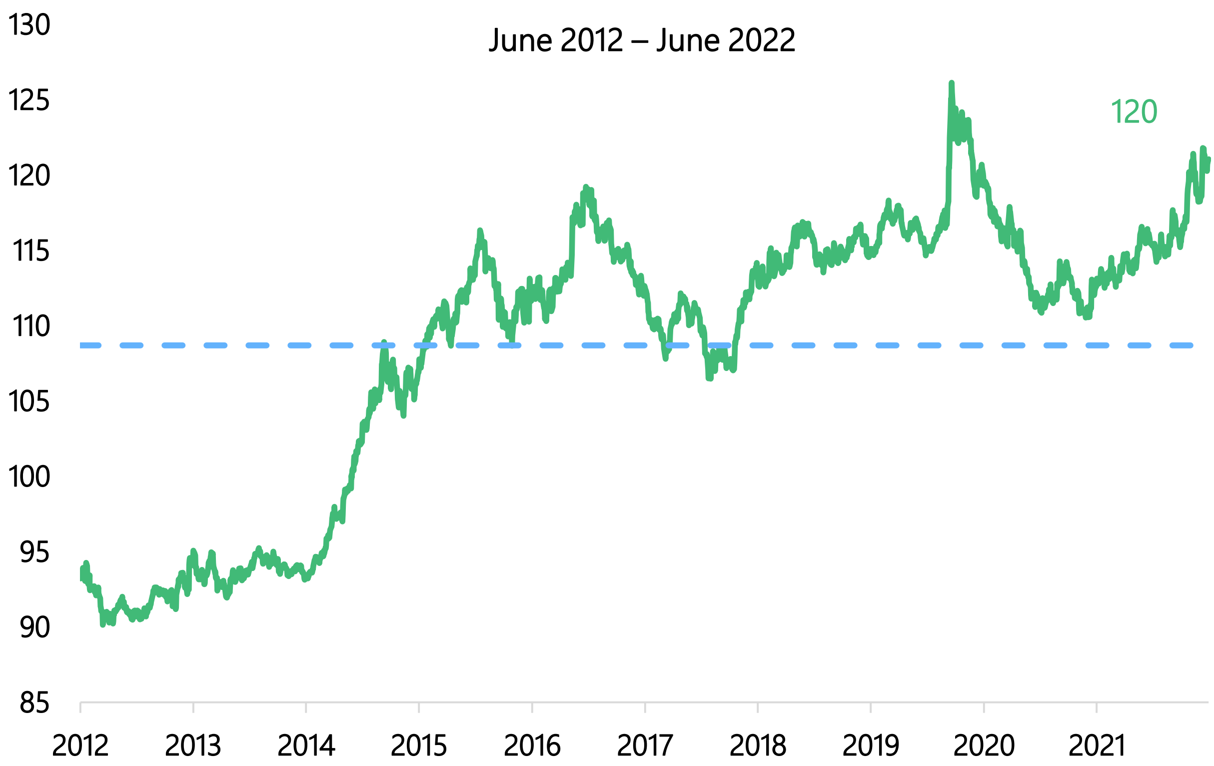
Other asset classes – Infrastructure Receives a Boost; Real Estate Under Fire

US infrastructure received a boost from the long-awaited passing of both the CHIPs Act and the Inflation Reduction Act in the US. Not only did this indicate an end to regulatory gridlock, but it promised up to $260 bn for areas designed to advance the energy transition which is expected to spark a wave of spending from both the public and private sectors. The CHIPS Act, by committing over $50 bn to chip production also raised the possibility of less reliance on Taiwan for this supply, which was welcomed given the recent geo-political tension in that area with respect to China.

Real estate seemed to be displaying fractures with economists predicting that prices of housing are "nowhere near the bottom" and exposed to both increasing supply and contracting demand due to higher mortgage rates and a consumer squeeze. This sits oddly with the widespread media coverage of severe housing shortages and distorted rental markets, and was even behind the sensational backing by a leading venture capitalist of a "WeWork" for residential homes in the US, a venture called "Flow", and started by infamous founder Adam Neumann.

Oil prices showed some recovery in late August but are still down around 14% in the past three months and below $100 as we write. While some of this is due to demand destruction the forecasts of lower demand and contracting economic growth going forward are definitely contributing to the price weakness.

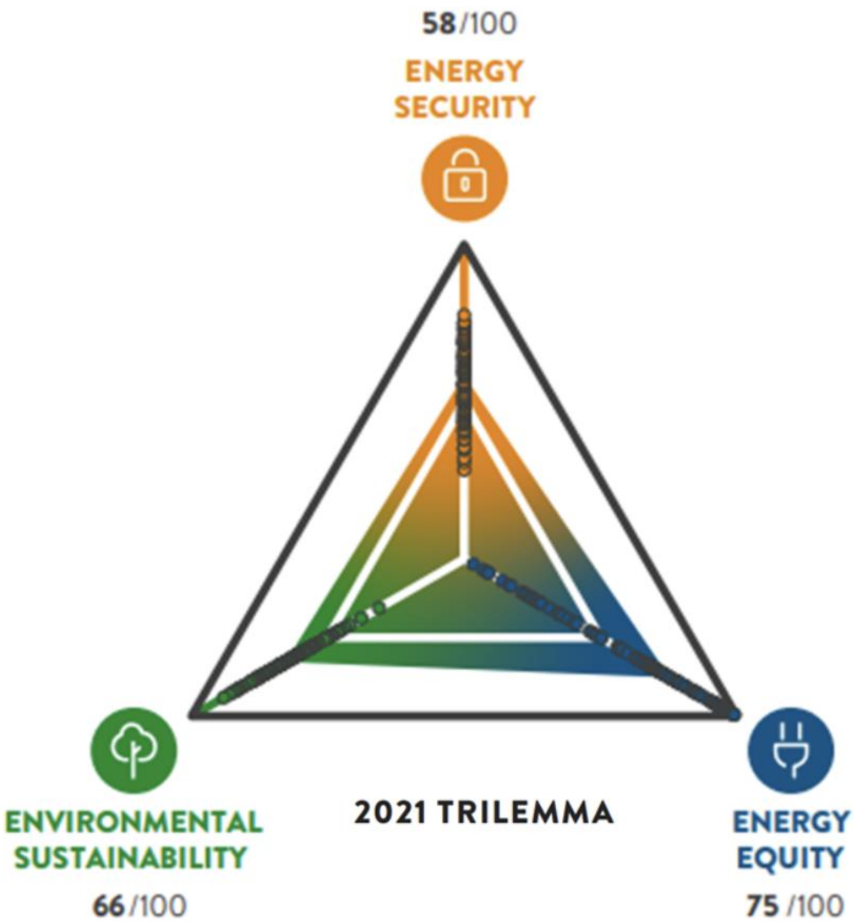
Currencies continue to trade near the extremes of their historic ranges, and as noted previously the ascent of the USD out of its historic range has been an unstoppable trend and can be seen here – the blue line indicates the long term average level with January 2006 = 100.



The Euro, like Sterling, has attracted exceptionally negative sentiment, as the chart below shows.

Spotlight: The Energy Trilemma

I recently recorded a podcast with Jason Mitchell of MAN Group – see here: https://www.fiftyfaceshub.com/156-jason-mitchell-of-man-group-on-the-energy-trilemma-indian-poetry-and-creating-a-sustainable-future/ in which he describes with extraordinary clarity the "energy trilemma" facing world governments. The energy trilemma is the three-pronged challenge of how to make energy **sustainable**, **affordable** and **secure** and involves the imperative of not creating a class of "energy poor" with the challenges of pursuing a de-carbonizing and net zero agenda. The war in Ukraine has brought the challenges of energy security – and pricing – firmly into focus, which may now possibly come at the expense of making energy sustainable.



The tension between the three objectives can at times lead to dissatisfied stakeholders – e.g. the recent Inflation Reduction Act in the US committed $260 bn for the energy transition, including incentives for consumers around electric vehicles and for manufacturers around clean hydrogen and wind and solar power as well as battery storage. But it also incentivized carbon capture and storage, which opponents suggest will extend the life of the fossil fuel industry in ways that aren't conducive to sustainability.

ESG is being increasingly weaponized too as "woke capitalism" in certain political quarters, and this may too erode the progress that has been made in integrating ESG risk factors across the investment process. It is expected that balancing the "energy trilemma" will be a dominant policy issue over coming months and years.

Outlook . . the "New, New, New Normal"

Last quarter we talked about the term "regime change" and how this was increasingly over-used in the context of today's macro backdrop. At one time an environment of "*lower for longer*" – low interest rates, low inflation and low growth was termed the "new normal" or even "new neutral". Then in the immediate aftermath of Covid it seemed that there was a "*New New Normal*" – the new paradigm of rising rates, steeply rising inflation and aggressive central banks. Markets reacted with shock and investors balked – as the start to the year showed.

Now that New Normal seems to have changed again – investors seem to have quickly adjusted to a reality of inflation in high single digits and in the US markets actually rallied when it looked as if the Fed would introduce merely a 50 bps rate rise in September, as opposed to the 75 bps one that had been expected. This was extraordinary. Is this normalization of higher inflation and higher rates – a *New New New Normal*?

In coming months we will be watching in particular:

- **What the winter brings in terms of energy pricing and consumer sentiment.** With inflation expectations rising sharply and concerns around the impact of energy prices, this will be a key factor to watch in terms of how it affects the outlook for consumer spending and the retail sector, as well as rent defaults.

- **Default watch.** With so many businesses still on edge after the emergence from Covid and the consumer no longer as "stimulated" or ebullient, the contraction in spending could rapidly send some companies into distress, and even default. This did not occur after Covid, maybe because the proverbial can was being kicked down the road. The long awaited "wave of defaults" could well start to arrive now.

- **Political and currency moves.** As was the case last quarter, the pending US mid-terms and UK conservative party leadership contest will reset the political stage in both areas, and even the outcomes are likely to be decided on the basis of economic policy. Both the Euro and the Pound have brushed with new lows in the past quarter and this fragility could linger into the rest of the year, bringing with it more imported inflation and economic weakness.

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August 29, 2022