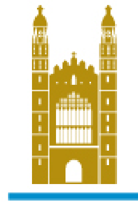

THE **CAMBRIDGE** WEEKLY

20 September 2021

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CAMBRIDGE
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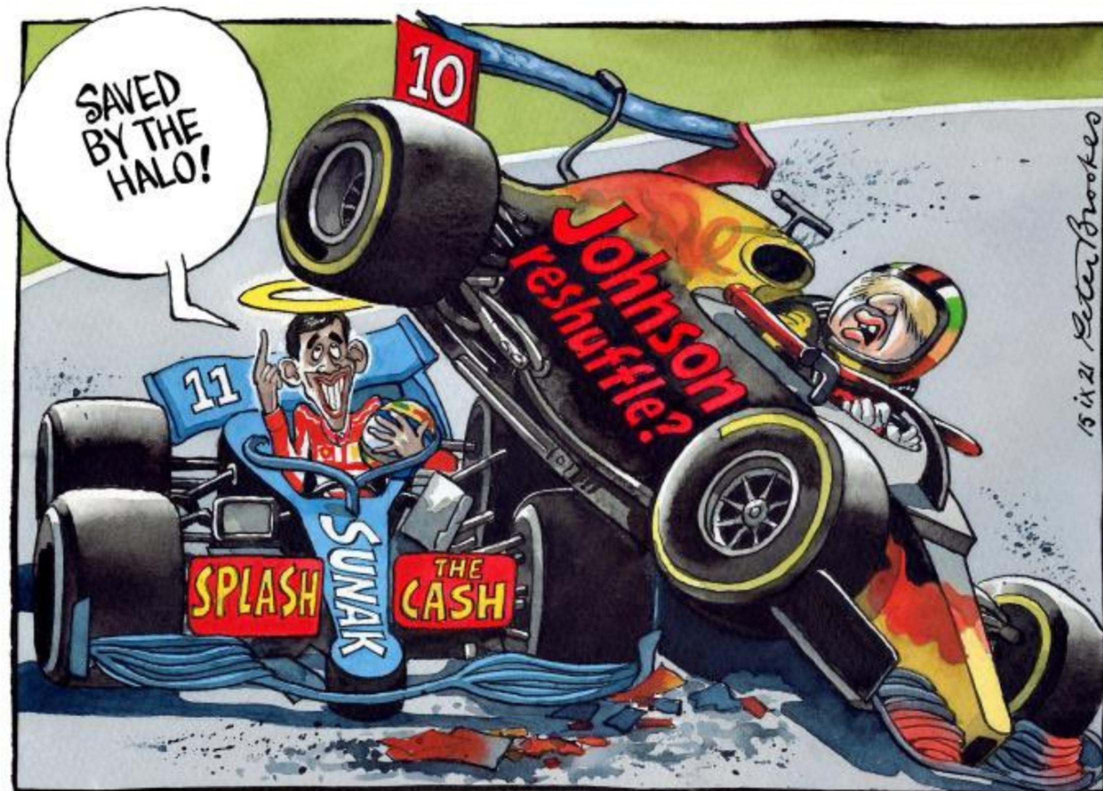
20th September 2021



UK Politics, Peter Brookes, 15 September 2021

End of the re-opening honeymoon

We are halfway through September and investors have not experienced a continuation of the positive returns picture of the summer months. This is despite COVID restrictions gradually lifting (not only in the UK) and an on-track economic recovery resulting in record numbers of jobs and demand outstripping supply in many places. Investment portfolios are only marginally down for the month, and still sitting on very healthy return cushions for the year so far. However, as noted in recent weeks, economic growth momentum has hit a bit of an air pocket, and talk has died down about the imminent arrival of the 'Roaring Twenties'.

Is it that the spreading of the vaccine-busting Delta variant and the persistent supply bottlenecks have reversed expectations of a better and stronger economic outlook? Well, not so fast. The disappointing geopolitical newflow (Afghanistan; last week's exclusively anglo-saxon nuclear submarine pact against China), does not apply to the global economic data flow.

A global shortage of labour, rising wages, and healthy corporate investment plans, may ring alarm bells with inflation hawks, but more level-headed economists attribute this to a confluence of indicators of persistent growth, not stagflation. As always, there are various threats to the positive scenario - last week the most keenly-debated threat was the rapidly rising cost of energy, which conjured up the spectre of a 1970's-type price shock. This week's Cambridge Weekly therefore features a special insight article

dedicated to why energy prices matter, but also notes how positive market forces have the ability to correct the cyclical overshooting of prices that is so characteristic for commodity markets.

The fact is that the recent phase of extraordinarily steep economic growth has now most likely come to an end. What follows now is a transition phase during which both households and businesses have to get used to once again standing on their own feet, as the fiscal and monetary support issued by governments and central banks is gradually withdrawn. Just as people have been feeling uneasy about getting back on crowded public transport and returning to their workplaces, this transition is just as likely to spread the sense of uncertainty.

In this environment, every dark cloud on the economic horizon can be viewed as a potential perfect storm that will surely see our fragile economic equilibrium collapse like a house of cards. It is undeniable that political and central bank leaders bear a larger than normal amount of responsibility for the future path of economic development, but the current state of the global economy is most likely less fragile than it might appear. With strong demand for labour strengthening consumers' purchasing power over and beyond the savings surpluses they have been able to build during the lockdown periods, and the climate challenge mobilising public and private investment, there is hardly anybody suggesting this cycle is already nearing the end.

That does not mean that the summer's 'Goldilocks' environment is about to return to capital markets. Corporate earnings expectation has recently moderated, while bond yields are likely to see further upwards pressures as price-driving supply bottlenecks persist, and with central banks inclined to reduce their yield-constraining support measures. This limits further upside for risk assets in 2021 over and beyond what has already been achieved so far, in anticipation of exactly the economic conditions we have arrived at.

On the other hand, just as markets had projected the recovery with their relentless buoyedness during the dark lockdown months of the year, they have also rotated towards sectors that thrive even when economic growth is not so rampant. On that front, various indicators suggest the negative sentiment turn may have already bottomed.

In the months ahead, much will hinge on the dynamics that define the interaction between bond yields and equity valuations. We continue to believe that at current depressed yield levels, equity valuations are not excessive even if they seem so in purely historical comparison terms. If, however, yields begin to rise more strongly than corporate earnings can outpace them, market conditions could become more unnerving again. At the moment we see not much indication that central banks are inclined to deviate from their view that current price inflation is transitory, but as we said earlier, every dark cloud at the moment…

We therefore expect that for the rest of the year investors may experience more of what we have seen so far in September – bumpy sidewards movement until the true likely upward trajectory of the economic recovery path becomes clearer and more acceptable again.

Energy special: Why energy prices matter right now

Though policymakers have debated the dangers of climate change for decades, the pace of real change has been historically slow. But many expect that pace to pick up considerably in the near future, accelerated by growing political discontent and kicked into overdrive by the pandemic. Across the developed world, governments and businesses are committing to a rapid reduction in emissions (nations representing 70% of global emissions are committed to net-zero by 2050 or 2060, according to the International Energy Agency (IEA)).

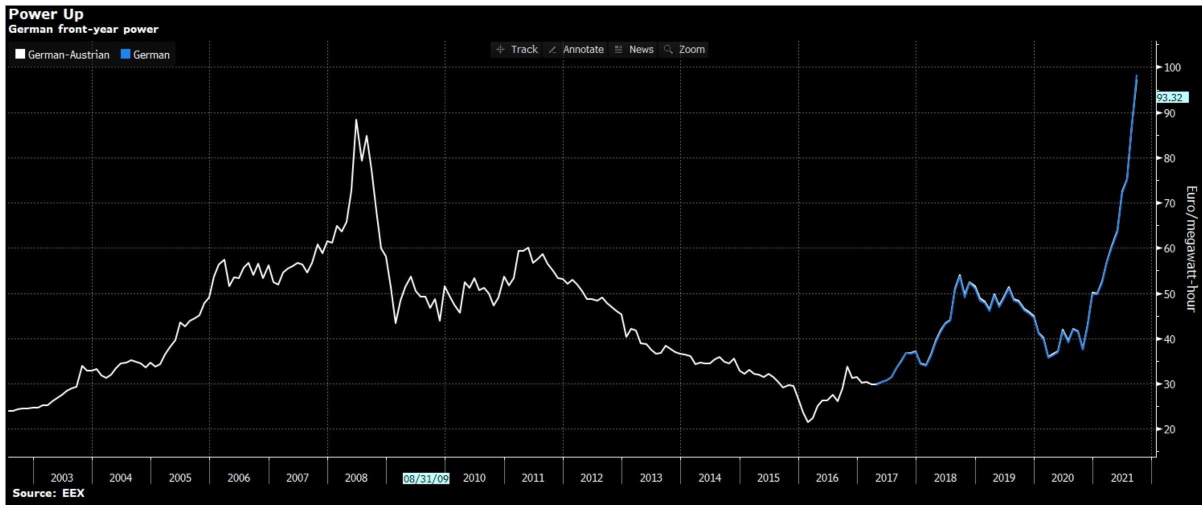
This is all part of the 'green recovery' touted by US President Biden and many European politicians. We have written before that the transition will need a vast mobilisation of resources, capital and innovation. The speed at which it all needs to happen means we are sure to see significant and sudden changes in the global economy, many of which are already becoming apparent.

Financial actors and regulators have a critical role to play here. Over the last few years, environmental, social and governance (ESG) focused investing has surged in popularity, with investors pouring enormous amounts of capital into green assets, leading to eye-watering valuations for the likes of Tesla. The relatively new carbon trading markets have also boomed over the last couple of years, increasing the price that companies have to pay for the right to pollute.

For regulators, carbon trading is a way of changing incentives to achieve one of their most important goals: aligning global capital behind the green transition. This is vital for ensuring the rapid change politicians envisage. But equally important for regulators is ensuring financial and economic stability – avoiding sudden crashes that could result from 'stranded assets'. As well as the economic harms such shocks could cause, we have seen across the developed world how easily downturns lead to populist movements that could threaten the green revolution altogether.

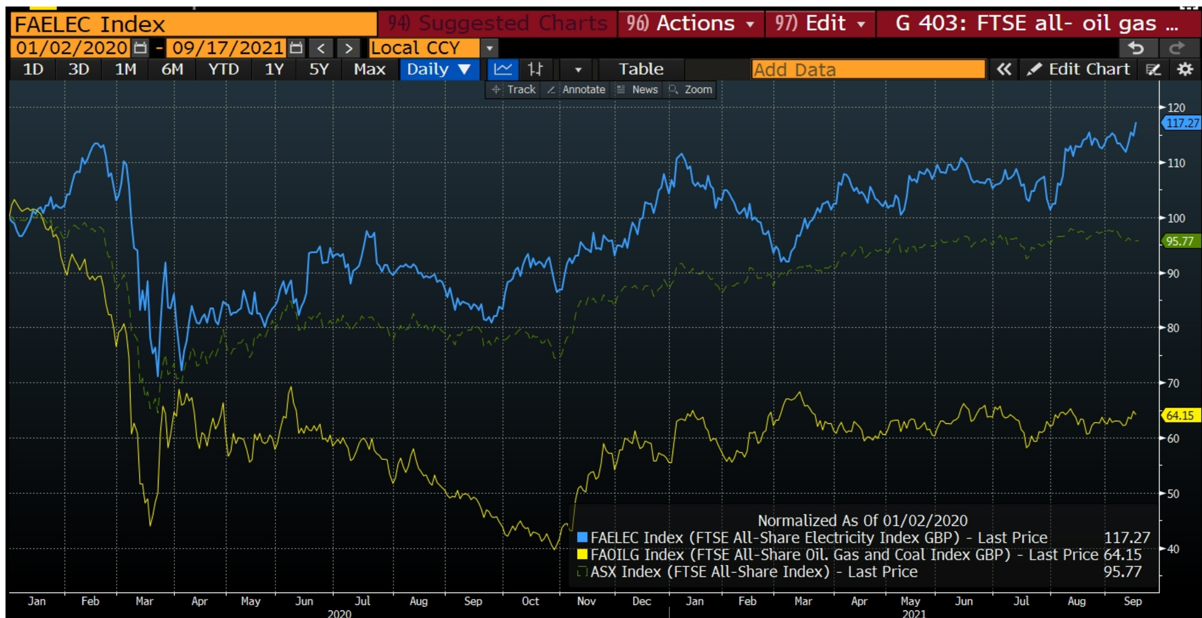
These factors mean the rapid transition we need is a difficult one. On the one hand, it offers plenty of opportunities for growth – in everything from commodities and energy to technology and services. On the other, rapid changes can also mean severe disruption to the existing infrastructure – in ways that investors and consumers might not be so happy with. Oil and gas companies are a good example of this.

Despite the demand for cleaner assets, and especially for metal and mineral input to build the greener infrastructure, 'dirtier' commodities are faring extremely well in price terms. Brent crude, the international oil benchmark, is currently at $75 per barrel, having climbed consistently since the first half of 2020. Gas and energy prices have driven electricity prices to record levels in Europe (see chart below) as post-lockdown demand meets tight supply.



Source: Bloomberg, Tatton IM, 17 September 2021

With oil prices high and global activity recovering strongly, old energy companies look very profitable. And yet, for the last few months, investors have not had much appetite for their shares. Until last week, that is. Despite a broad fall in UK equity prices, British energy companies saw their stock prices climb higher (this chart plots the UK's electricity and oil companies in blue and yellow, versus the main market in the dotted line).



Source: Bloomberg, Tatton IM, 17 September 2021

We suspect this could be a sign of things to come. The popularity of ESG investing has led investors to neglect dirty companies in favour of green assets. That is easy enough to do when green assets happen to be some of the fastest growing – as we saw throughout the pandemic. Sticking to environmental principles is harder when oil and gas companies are so profitable, and are available at bargain prices.

Higher oil prices and the potential for more investment in fossil fuel companies make for an uncomfortable situation ahead of COP26, where world leaders will lay out enhanced plans for achieving net-zero emissions. Policymakers will desperately want to avoid an energy supply shock, but will be equally keen

on maintaining the progress made since the Paris Agreement. Below, we discuss in more detail the complications – and implications – of the green transition, and what they mean for investment. We group these effects under cyclical and structural factors.

Cyclical factors

The global economic recovery is still fragile. Earlier in the year, investors and pundits grew excited at the post-COVID 'roaring 20s' supposedly in store once vaccines had been rolled-out. A slowing of economic activity across the developed world, and the rapid spread of the Delta variant have severely dampened those hopes, or at least has put them on hold. The global economy is not in bad shape – but growth is brittle and there are more than enough disruptions that could throw it off course.

That is the 'Catch-22' as far as the green recovery is concerned. Policymakers want the world to quit its addiction to fossil fuels, but giving up and going 'cold turkey' presents a serious risk to living standards. Global supply problems have been ubiquitous in recent months, massively pushing up inflation. The sharp bout of inflation is a negative for consumers, businesses and the global economy – taking away spending power and confidence at a time when it is vitally needed.

Rising energy prices is yet another supply-side shock, one that could be an even bigger dampener on growth. In the UK, inflation has already spiked on the back of widespread labour shortages. Now, households across are set to see their energy prices jump just ahead of winter, which is likely to leave many with substantially higher bills. Then there are the second-round effects of energy inflation, likely to push up prices across the board. This is a downside risk to the recovery, one that policymakers will desperately want to navigate safely.

Similar to the many other global supply problems, there are a host of one-off reasons why energy prices are rising. Natural gas producers in Norway and Russia have had severe temporary shortages, while fires and floods across Europe have forced parts of the energy grid into closure. OPEC's oil exporting nations are also continuing their self-imposed supply constraints in hope of pushing prices up further. All of this comes just as the world comes out of lockdown and demand is rebounding strongly – particularly in Asia.

These specific problems hint at a bigger issue, though. We mentioned that the drive toward greener investment had pushed investors out of energy stocks. At the same time, energy companies have slashed their capital expenditures (capex) for new production capacity. Much of this is down to looming net-zero targets, which mean new fossil fuel projects are less viable over the longer term. But many of the oil and gas giants have also been pressured into lowering debt levels and ensuring higher short-term dividend payments. This makes sense as a plan for an ageing industry, but the result has been a period of underinvestment in new production, and whatever capex there is tends to go toward greener projects which, as of yet, cannot provide a comparable level of ongoing supply stability as fossil fuel-based generation.

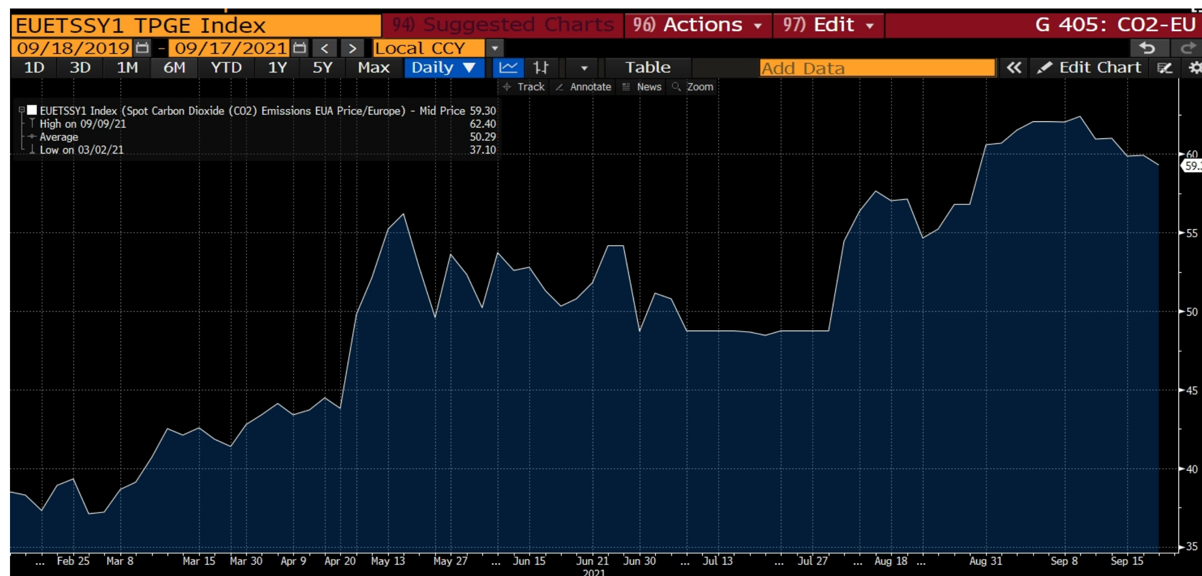
Leaving oil in the ground is clearly a good thing for the environment. But we are still far from the point where greener energy sources can meet the global economy's needs. So, current energy supply is unlikely to be enough to meet current demand levels – putting upward pressure on prices. This will harm consumer and (particularly) business confidence, heading into what will likely be a difficult winter. There are even reports that energy shortages in Europe could be enough to force rolling blackouts. This would lead to even further supply constraints, increasing inflation pressures and lowering consumers' purchasing power. In the end, much will be down to a factor nobody can influence: how harsh the winter will be.

As we say, this is a negative environment overall, but a potentially positive one for energy companies. That could be enough to push some ESG investors back into energy stocks, which continue to post healthy returns despite their relative unpopularity. As for the energy giants themselves, capex will be held back until they are confident new productions will generate a high enough return with an acceptable level of planning certainty. If oil and gas prices keep rising, eventually that higher threshold will be met and new fossil fuel projects will be implemented.

Structural factors

Cycles of under or overinvestment are common in commodity markets. New projects take a long time to come to fruition, while demand can increase or decrease rapidly. But the current period of underinvestment in energy production is different. Investors and companies are diverting their capital because of a permanent trend toward renewable energy. Even if energy companies decide returns are high enough to invest in new production, there is still a significant structural pressure against further fossil fuel exploration. That creates a long-term issue of undersupply, which we are seeing the effects of now.

At the same time, governments are keen to disincentivise oil and gas consumption by increasing the cost of emissions. Ahead of COP26, the European Commission has introduced plans to cut emissions 55% (compared to 1990 levels) by 2030, a strengthening of the 40% target set in 2018. These plans include ambitious carbon tariffs across the entire European Union, and a reduction of CO_2 credits released onto the carbon trading market – the largest and most developed of its kind in the world. This is sure to push carbon prices substantially higher (see chart below), adding to polluter's costs.



Source: Bloomberg, Tatton IM, 17 September 2021

All these factors could push energy prices higher over the long term. We have already mentioned what this could mean for the medium-term growth outlook: higher costs push down purchasing power for consumers and businesses, dampening confidence and lowering growth potential. Structurally higher energy prices make the economic outlook worse – resulting in a long-term erosion of real disposable income.

The crucial question is who bears the cost in this scenario. Unfortunately, the most likely answer is consumers, households and small businesses. In the UK, the energy regulator has already raised the price cap for household energy bills due to rising wholesale costs. At the same time, the government has tightened fiscal policy by raising National Insurance contributions. These factors together could lead to a sharp and sustained hike in costs, causing a reduction in real (inflation-adjusted) disposable incomes.

With lingering COVID uncertainties and the after-effects of Brexit still feeding through, consumer confidence could take a big hit. This is possibly even more so for businesses, which often do not have the benefit of capped energy prices and may be forced to raise prices and lose demand – after 18 months of uncertain conditions.

The UK is a good example of these issues, but the structural rise in energy prices will have global effects. If the above situation plays out, it could mean a further increase in inequality and social unrest – despite governments now seemingly on board with public investment.

The main counterpoint to this is whether (and when) technology adapts to deliver enough cheap renewable energy to meet global demand. Whatever the case, that point is some time away. But if rising energy prices do cause real social and economic harm in the meantime, we should expect a strong investment flow – both public and private – towards greener energy production.

We might also see strong investment flows toward supply-side production in general. For more than a decade, we have seen consumer demand-focused companies win big in investment terms. US tech giants like Apple, Amazon and Google are the prime example – having been the darlings of the stock market since the global financial crisis. Traditional industry has fared less well by comparison. But structural energy pressures could change this.

To achieve the green transition, we will need extensive investment in new technologies and material production. At the same time, the world's energy demands – together with supply constraints – gives energy companies immense power to set their prices. This is true for oil and gas, but this is even more so for commodity producers involved in green technologies (as we wrote last week). Given their huge reserves – and their incentive to diversify from fossil fuels – traditional energy companies are likely to be big capex spenders on this front. That makes energy producers – and industrial companies in general – ready for a revival. Meanwhile, pure tech companies that cater for both the consuming and producing part of the economy are likely to be steady companions in the energy transition, too. What's the big risk to this proposition? That platform companies take their piles of cash and disrupt traditional markets.

The green revolution brings many opportunities for positive change, but we need to be aware of the difficulties it could create. In the short-term, rising energy prices pose a threat to the fragile global recovery. Structural pressures mean these problems could persist over the long term, dampening confidence and global growth potential – as well as potentially worsening global inequality. These topics will feature heavily at COP26 in November, which investors should watch closely. In investment terms, the immediate impact is likely to be a flow back toward traditional energy companies – bucking the ESG trend of the last few years. Over the longer-term, structural pressures on energy prices could mean a return to industrial companies as one of the primary sources of growth.

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20th September 2021

Global Equity Markets

Market	Fri 15:59	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	6971	-0.8	-58	→	⬀
FTSE 250	23657	-0.3	-77	⬀	↗
FTSE AS	4027	-0.7	-29	→	↗
FTSE Small	7530	-0.3	-20	⬀	↗
CAC	6581	-1.2	-82	→	↗
DAX	15495	-0.7	-115	→	↗
Dow	34572	-0.1	-36	→	↗
S&P 500	4444	-0.3	-15	→	↗
Nasdaq	15041	-0.5	-74	⬀	↗
Nikkei	30500	+0.4	+118	↗	↗
MSCI World	3123	+0.0	+1	→	↗
CSI 300	4856	-3.1	-158	→	→
MSCI EM	1277	-2.5	-32	→	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
JD Sports Fashion	+7.2	Anglo American	-15.3
Flutter Ents	+6.2	Ocado	-9.7
Lloyds Bank	+5.4	BHP	-9.5
Pershing Square Holdi	+5.2	Rio Tinto	-8.6
Kingfisher	+5.1	Just Eat Takeaway.com N	-6.6

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.375	-0.6	Oil	74.84	+2.6
GBP/EUR	0.853	+0.1	Gold	1751.5	-2.0
USD/EUR	1.17	-0.7	Silver	22.46	-5.4
JPY/USD	109.97	-0.0	Copper	426.1	-4.2
CNY/USD	6.47	-0.4	Aluminium	2879.5	+1.4
Bitcoin/$	47,497	+5.3	Soft Cmdties	485.4	+0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	15.3	12.4	14.2
FTSE 250	2.3	16.9	25.2	15.9
FTSE AS	3.7	15.4	13.5	14.3
FTSE Small x Inv_Tsts	1.9	13.7	19.7	15.4
CAC	2.2	21.3	15.9	14.9
DAX	2.4	14.5	14.3	13.5
Dow	1.8	19.4	18.7	16.4
S&P 500	1.3	25.1	21.8	17.6
Nasdaq	0.6	30.8	32.9	22.9
Nikkei	1.4	16.3	18.3	17.7
MSCI World	1.7	22.1	20.0	16.6
CSI 300	1.9	15.9	15.2	12.5
MSCI EM	2.3	14.1	13.3	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.85	+0.09
UK 15-Yr	1.05	+0.08
US 10-Yr	1.38	+0.03
French 10-Yr	0.05	+0.05
German 10-Yr	-0.28	+0.05
Japanese 10-Yr	0.05	+0.01

UK Mortgage Rates

Mortgage Rates	Aug	Jul
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.30	1.37
3-yr Fixed Rate	1.52	1.60
5-yr Fixed Rate	1.48	1.56
10-yr Fixed Rate	2.60	2.60
Standard Variable	3.61	3.61

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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