CAMBRIDGE
INVESTMENTS LIMITED

THE **CAMBRIDGE** WEEKLY

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Positioning for the energy price shock

Global capital markets continued their wild ride last week, as market participants struggled to gauge by how much would Putin's barbaric war on Ukraine dismantle their 2022 outlook for the global economy. Wild equity market swings are usually the focal point for investors when major upheaval occurs, but this time the oil price has been front and centre. The rising cost of energy has become the key economic variable derailled by Putin's actions. This week we dedicate a separate article to what has changed (but also what probably has not changed) in terms of the medium-term outlook for the price of oil.

The diversified nature of the multi-asset portfolios Cambridge runs for our investors means that the impact of market swings is somewhat softened. After recent market resilience in light of the very worst imaginable uncertainties and shocks to the global economy as the COVID pandemic brought us, we have had much lower volumes of concerned investor calls than one would have expected only a few years ago.

In our view, such a 'let's wait and see' attitude is wholly appropriate given the circumstances. Our longer-term investors and followers have learned over the years that markets are quite prone to overshooting and also that, once the dust settles, market positives always emerge. Given globally diversified multi-asset portfolios give investors access to the long-term growth potential of the entire global economy, then as long as we continue to believe this global economy will continue to exist and grow – just as we did two years ago – then we should believe portfolio returns will recover and continue on their gradual upward grind.

At Cambridge, we started the year with a cautiously optimistic outlook, noting the backdrop of another post-lockdown surge in economic activity, but with central bank and government support on the wane, while persistent inflation was eroding household spending power. Despite the shock of Russia's war on Ukraine, and the energy price shockwave it has brought us, much of this continues to hold true, although we have to accept that some element of our cautiously optimistic outlook will now suffer delays and may also be less pronounced. There is also a risk of another brief recessionary period, should the war drag on and/or central bank policy setters opt to fight energy price inflation with sharp interest rate rises.

Our positive medium-term economic outlook led us to look through the short-term slowdown caused by the omicron COVID wave. Our main concern was that the rise in fixed interest bond yields would continue, result in poor contributions from the risk-mitigating allocations to bonds in our portfolios. As a result, we maintained our equity overweight, not because we felt particularly bullish about equities, but because during inflationary periods, stock market investments provide the most effective defence against the purchasing power-undermining dynamics of price inflation. In such situations, equities become the only clear source of positive returns, while bonds rebuild their contribution potential as yields rise.

Of course, and with the benefit of hindsight, we would have fared better had we held both an underweight to equities and Europe. Yet, as last week's very significant rebound in European share prices has once again shown, it is fiendishly difficult to time such short-term market disparities and diversions without running the risk of losing valuable long-term growth potential.

As a result, we are happy our current portfolio positioning will achieve our goal of protecting investors' portfolio values from the negative impact of inflation, while harnessing the most promising sources of return potential available in the current market environment.

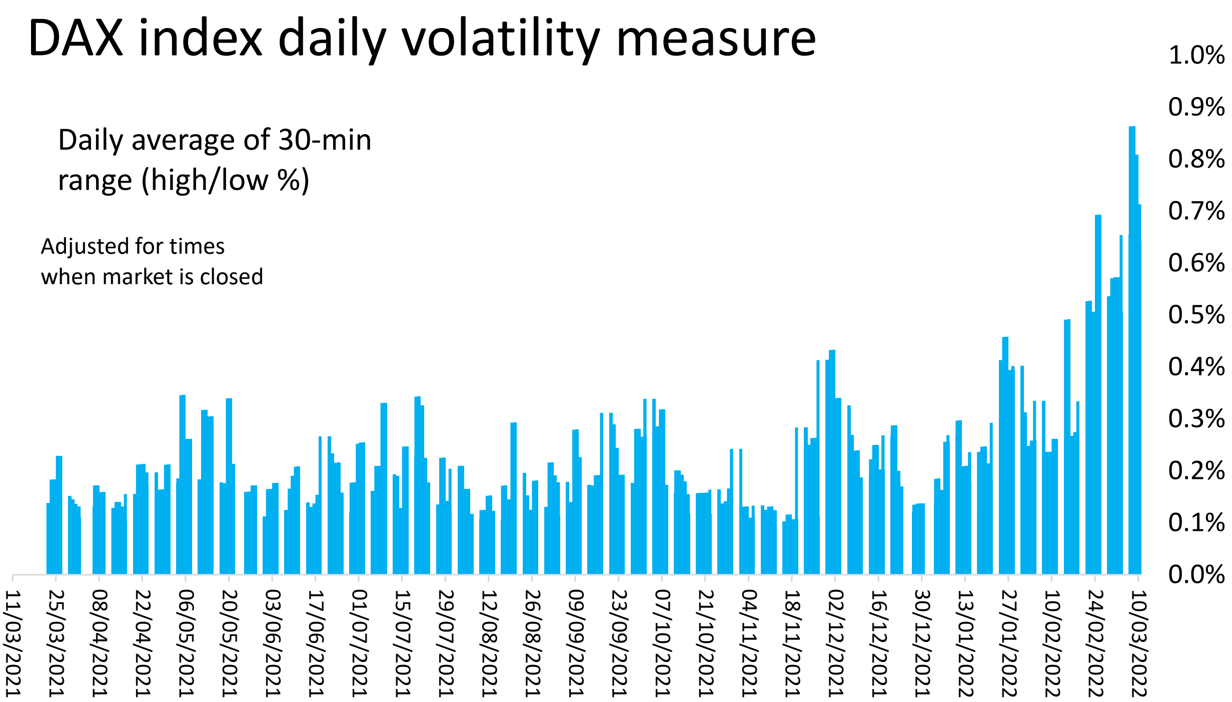
This does not mean we have chosen to ignore risks that the economic environment could still fundamentally deteriorate and then necessitate repositioning portfolios to a more risk-off stance. We are closely monitoring how much the energy price cost shock will drive down projected corporate earnings as well as the likelihood that central banks might repeat their 1973 policy error of hiking rates rather than supporting the economy through a temporary rough patch. These headwinds will have to be weighed up against the likely tailwinds of the concerted public policy response to beef up defence spending, and much more accelerated fiscal investment initiatives into the energy transition project that not only reduce Europe's energy dependency on Russia, but also the global dependency on fossil fuels that ultimately endanger the planet.

We have seen various investment indicators signalling that we may have reached 'buy' territory. However, we also know that when near-term uncertainty is determined by dictators, one should not count on the markets having completed their correction journey.

For those who need to make the decision to invest cash (or not), experience has taught us that a drip-feeding of cash into markets, when assets are available at considerable discounts, has been one of the most effective ways for investors to turn negative short-term volatility into long-term growth for their portfolios. Conversely, choosing to wait on the side lines until all uncertainties have vanished, usually equates to considerable loss of opportunity.

Market and investment activity update

For the last few weeks, we have regularly had to caveat our commentary with the phrase "as we write". The chart below shows how much the German DAX benchmark equity index (which tracks the top 40 German companies) has on average moved every 30 minutes over the past year:



Source: Bloomberg, Tatton IM

Markets go up and down, but in the past week the DAX has moved up and down every 30 minutes on average about 0.75%. On Friday, for example, President Putin said that the Ukraine-Russia talks taking place in Turkey have "positive movement". Within five minutes, the DAX rose 3%.

Last Monday morning, the German and French equity indices had underperformed the US market by 10% on a year-to-date basis. By Thursday afternoon, the markets were back to near-equal performance. For any long-term investor, changing portfolios in this environment is a difficult and potentially costly process. For us, we will still go through our thorough decision-making processes, but must be prepared to change our thoughts and decisions quickly if necessary.

Events which are negative for markets may not always mean that markets end up being negative. That is because those events cause reactions. During the first months of the pandemic, central banks eased policy, cutting interest rates and flooding the financial system with liquidity, while governments borrowed huge sums in order to provide emergency income to households and businesses. The speed of the reaction in the early months of 2020 was remarkable; the US recession was the shortest on record at just two months.

Although the Great Financial Crisis of 2008/2009 was ended by similar policy reactions, they were slower in coming. The recession took 18 months and was the longest of the post-war period. The US Federal Reserve (Fed) initially saw the crisis as a specific issue in the financial sector, and that there was not enough 'moral hazard' for individual firms found to have behaved badly. It was unwilling to use the 'Fed Put', the idea that Fed policy would protect risk takers by supporting risk asset prices.

The Federal Open Markets Committee meets this week, and will almost certainly raise rates by at least 0.25%. Its bond buying quantitative easing operations ceased last week. Although the war in Ukraine have ensured markets expect a more cautious approach at this meeting, US inflation as measured by the consumer prices index (CPI) has been rising at an unchecked 6% annualised rate for the past three months.

For the Fed and all other developed world central banks, the conundrum is this: is real demand going to be so adversely affected by the upswing in non-labour (energy) costs that they should wait for the cost shock to play out on dampening further general price rise, or should they fear that the non-labour costs will feed back into wage demands amid a tight jobs market?

The Fed will want to be perceived as fighting inflation, if last week's European Central Bank (ECB) council meeting is any guide. Given the much greater proximity and impact of the war, most economists expected a rather dovish outcome, but the ECB turned more hawkish. Its bond purchases are now set to finish before October and a rate rise could happen at the same time.

Judging by ECB President Christine Lagarde's demeanour in the press conference, the meeting might well have been rather fractious. She tried to "sell" the idea that the ECB retains more flexibility and is more data-dependent now. However, the bond markets didn't think that was the outcome. 2-year bond yields rose 0.125% during the announcement.

So, there is some risk that the aftermath of commodity and energy price rises drives a medium-term fall in buying power (demand) for businesses and consumers, which reduces inflation from becoming structural but might be ignored for some time by the central banks. In a sense, we think of it as 'policy exhaustion risk', or the risk of an outright central bank policy error.

In the US, and possibly also in the UK, fiscal policy latitude also seems to be limited. However, there is much hope for Europe that the fiscal policies are not exhausted but positively enlivened by the current events. France's President Macron (now extremely likely to win a second presidency) advocated another round of mutual bond issuance to cover more European defence and green investment. It was not immediately welcomed by all, so it will take more effort, but it seems likely Europe's fiscal policies will remain accommodative for some time.

This leads to a scenario of a slowing economy for the short-term but with Europe at the least rebounding strongly in the medium-term. Much of the short term depends on what happens in Ukraine and in the commodity and energy markets. Thereafter, it may be about government largesse. Unfortunately, central banks seem – at least for now – to be less responsive than usual, or have more conviction that this war – and the sanctions that come with it – will end much sooner than almost anyone else.

Meanwhile… COVID. Is it still a problem? The US is set to end its mask mandate (for public transport and other public areas) this month. Here in the UK, case numbers are rising again, although case severity is still muted and has been reported to be below seasonal flu (even if infection numbers are significantly higher still).

At the same time, China mainland's cases have topped 1,000 per day. According to Bloomberg, the current epicentre of the outbreak is in north China's Jilin Province. Its state capital Changchun (about the same population as London) has locked down. Of more importance for global trade is Shanghai. Last week it had (only) two 'community' cases – those not explainable by contact with carriers from elsewhere.

Currently, the disease's severity is much reduced compared to the initial outbreak in Wuhan. Of the current cases, 70% show no symptoms, possibly because China embarked on a more widespread and effective vaccination programme. There were rumours that the central authority's zero tolerance policy approach was softening.

Bloomberg also reported that Premier Li Keqiang, the second-ranking leader of China's Communist Party, has called on the world to work more closely to create the conditions for a return to post-pandemic 'normal' living conditions. With Friday's press conference marking the end of the annual National People's Congress in Beijing, Li said officials will work to make China's response more scientific and targeted, to maintain the normal functioning of everyday life and supply chains.

As a result, it is still too soon to assess whether China will continue on its reopening course or prescribe another painful lockdown period to its economy.

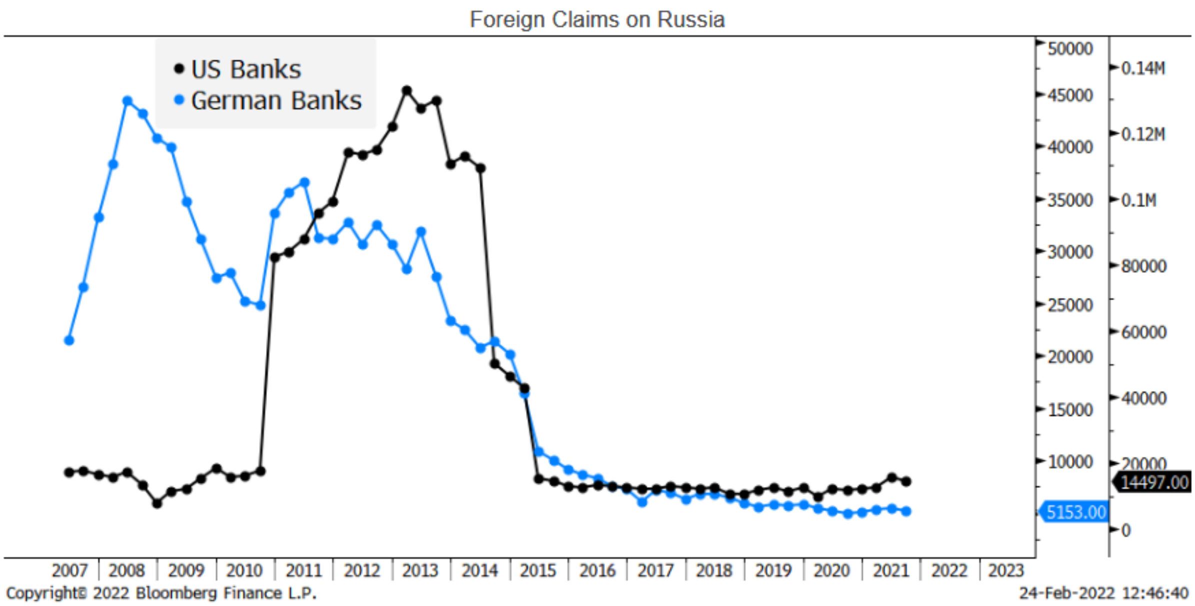
Russia vs the global financial system

Russia's unprovoked invasion of Ukraine continues to dominate financial news as much as it does politics. Western sanctions have so far pushed oil and gas prices to eye-watering levels, caused the removal of Russian assets from capital market indices and led to a wave of asset freezes for oligarchs with links to the Kremlin. Major equity indices have taken a beating in that time, with the Euro Stoxx 50 down sharply since late February, and the S&P 500 and FTSE 100 having suffered as well. There was some reprieve for investors from Wednesday onwards, as all those indices rebounded. But this may ultimately still prove short-lived, as market participants clearly continue to be concerned about the fallout from war.

As we wrote last week, the removal of all Russian assets from major Western investment funds is no easy task. Thankfully, given Russia's economy only makes up around 3% of global GDP (making it smaller than South Korea) most investors' direct exposure to Russia was small before the invasion, meaning removals (or frozen assets with zero-valuations) should not have a major systemic impact on overall portfolio values. The larger impact on the world economy undoubtedly comes from the commodity side, as markets and policymakers scramble to figure out how higher oil and gas prices will affect the global economy. We devote a separate article to that topic this week.

Nonetheless, such a big shakeup inevitably has wide-ranging consequences on the global financial system. Stranded Russian assets can cause blockages in the world's financial plumbing, leading some commentators to warn of systemic weakness and contagion from Putin's war. In a note to clients, Credit Suisse strategist Zoltan Pozsar went further, suggesting the crisis could threaten global financial stability, comparing Russian commodities to toxic US subprime mortgage collateralised debt obligations (CDOs) in 2008. Back then, widespread systemic risk was brought to the fore by slowing growth, effectively bursting markets as the big players began to crumble.

We disagree with this type of scaremongering, and respond by pointing out the current situation is very different to the great financial crisis of 2008/2009. Western banks do have Russian debt on their books, but it is ultimately at low, systematically non-relevant levels. In fact, many institutions drastically reduced Russian exposure after Putin's annexation of Crimea in 2014, and since then, holdings have remained low. This is as true for European banks as it is for the US, as the chart below shows.



What's more, the banking system is much sturdier now than it was 14 years ago. Due to extensive regulatory changes, risks are now much more transparent and manageable. If Russia defaulted on its debt, some investors would undoubtedly take a hit, but a series of toppling dominos is unlikely. Commentators have warned about another "Lehman moment" many times over the years (most recently from China's Evergrande crisis) but we have fortunately never had to relive that experience.

But as always, shocks find their way through the system. This time the focus is on another transmission channel: namely the Russian commodities now being shunned by Western buyers. This can cause both huge price swings, and also collateral issues – particularly if the underlying asset for the collateral (for a loan) was a Russian commodity which now is difficult to price. Another issue is that institutions may have been on the wrong side of a trade and have no alternative but to realise significant losses. In other words, 'counterparty risk' – the risk that the other side of a trade is unable to fulfil its obligations and is a factor in any trade – has made its return. Properly evaluating counterparty risk is most problematic when there are long chains of counterparties rather than a central clearing system.

Today's commodity markets are full of these extended chains, from financiers to producers, intermediaries, speculators and end users. These chains will break down if any transaction along the way fails, either because the money is not there, or the goods are not delivered. In the current situation, both sides of the trade are at risk. And, given Russia is a big player in commodity markets, there may well be many counterparty chains that are disrupted, leading to some big price movements.

This kind of fragility can often push prices up, as it ends up destabilising supply. Some of the recent rises in commodity prices are likely to do with this. Nickel, which rose to a record price of $100,000 per ton on Tuesday, is a prime example. Prices rose initially from fears of sanctions on Russia, which produces 10% of the world's nickel alone. This action squeezed short-sellers betting against the metal, and the covering of those large positions sent prices rocketing.

Anecdotally, one of those short sellers was Xiang Guangdu, the Chinese owner of Tsingshan Holdings Company, the world's largest nickel producer. Xiang, known as 'Big Shot', built a short position on nickel last year because he believed the surge in prices would fade, and wanted to hedge his company's position. The tycoon was then caught out by Russia's invasion, with price rises causing losses of $2 billion on Monday alone.

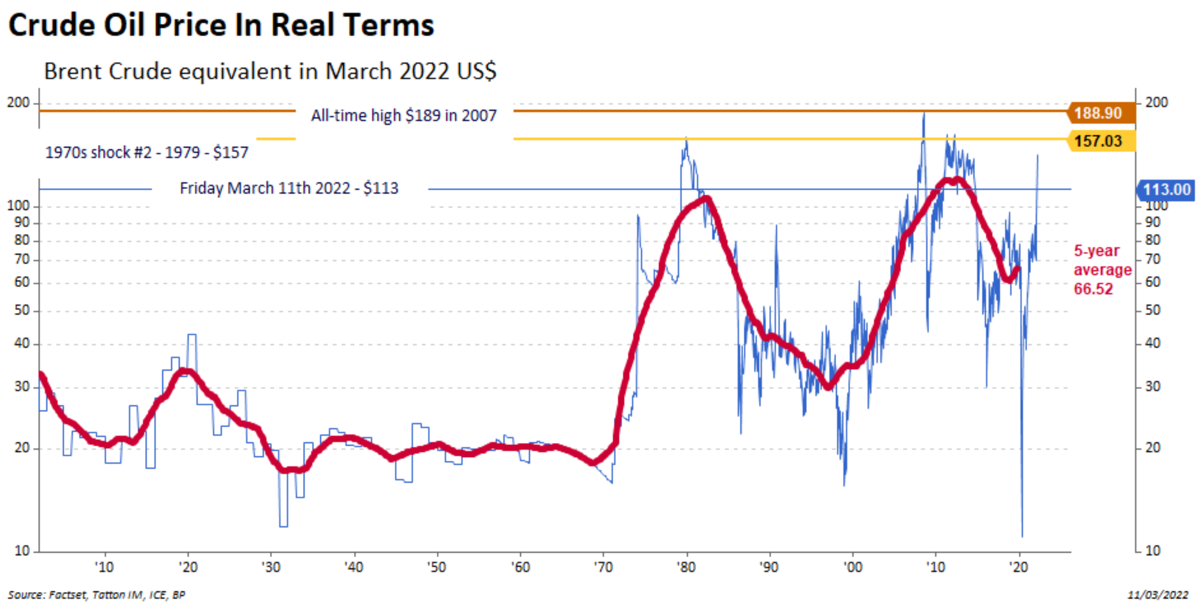
As the world's largest nickel producer, Tsingshan should clearly benefit from a sustained pick up in nickel prices (the firm recorded more than $40 billion in annual revenue over the last two years). But the losses it sustained on its hedging position will be a major blow to short-term cashflow. It is unclear how much of a risk this is to the company, though Xiang has told bankers Tsingshan will still be able to meet its obligations. Given the Chinese government's interest in keeping commodity markets stable, it would likely step in to prevent a default if the situation required.

Tsingshan's problems could therefore just be a short-term blip, but they highlight the fragility of commodity financing. Commodity producers hedge against price falls all the time, but when these bets go as badly as Xiang's, it presents a serious threat to cashflow. It means companies that should otherwise be in very healthy positions suddenly have an increased default risk – increasing counterparty risk all through the chain and putting further pressure on supply.

Price volatility exposes other fragile counterparties. This then leads to traders and financiers reducing counterparty limits, creating liquidity problems, and in the worst-case scenario ultimately insolvency. While banks' overall exposure to Russia is relatively small, destabilisation in commodity markets can have a damaging impact. We do not expect this risk to be systemic, but it is one we will keep watching closely over the next few weeks.

Oil dynamics

Oil price moves in 2022 have been astounding if not unprecedented. Having started the year at around $80, during trading last Tuesday, a barrel of Brent crude oil cost more than $130, before coming back down to just under $128 as trading closed. That is the highest global oil price in a decade, as western sanctions on Russia put the world's fuel supply under threat. The chart below shows the long history of oil prices since 1900, in today's price terms adjusted for US$ inflation:

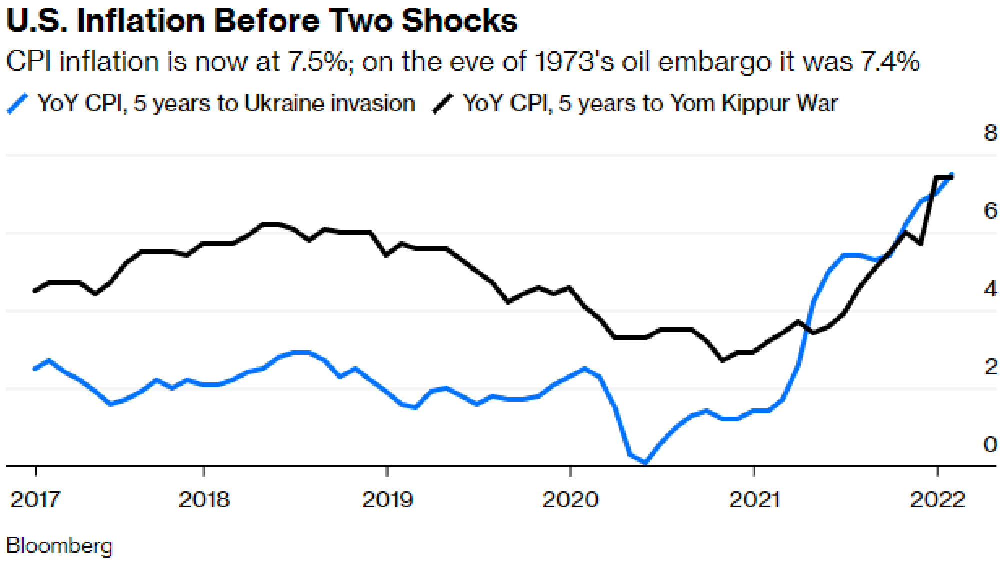


Prices fell back last Wednesday to $111 per barrel, after the United Arab Emirates' (UAE) US ambassador announced his government would be encouraging members of OPEC (Organization of Petroleum Exporting Countries) to increase production. At the time of writing on Friday morning prices remained around the $111 mark, despite UAE's energy minister reaffirming on Thursday the country's commitment to production limits agreed with OPEC+ (which includes Russia).

Crude's continued rally is so strong that it is a topic of everyday conversation. Higher petrol prices are hitting consumers across the world, with Royal Dutch Shell announcing last week it would no longer buy Russian oil or gas. Last Tuesday, one of the UK's most senior energy experts even recommended British drivers should limit their speed to 55mph in a bid to lessen dependence on Russia's oil. This comes on the back of import bans from both the US and UK.

When tanks rolled into Ukraine two weeks ago, the sentiment in Western media was that it heralded a paradigm shift in geopolitics and the economy. High profile sanctions against household names like Roman Abramovich's Chelsea Football Club back up this idea, but it is what happens in oil and gas markets that will undoubtedly have the biggest impact on markets and the economy. Writing for Bloomberg, the well-regarded financial journalist John Authers draws the comparison between this episode and the oil shock of 1973 – which sent prices rocketing and brought about the now infamous 'stagflation' – slowing economic growth and rising inflation – era.

That shock was also brought about by a war: The Yom Kippur war, when a coalition of Arab states led by Egypt and Syria initiated a surprise invasion of Israel. Saudi Arabia and its allies imposed an embargo on Western countries that supported Israel, causing the price of crude to triple by the time the embargo ended in 1974. The background inflationary environment was also very similar to now, as the chart below from Bloomberg shows.



However, rather than being a temporary shock, the rise led to a longer-term step up in prices, followed by another surge five years later, and long-term implications for inflation, energy policy and the global economy. Crucially, current sanctions are self-imposed rather than coming from suppliers and there is a much lower global energy dependency on oil today, meaning they could have less force. US President Biden is resolute now, but this could be a different story should surging prices at the pump threaten his party's popularity. The same could be true if sanctions do their intended job and Putin's invasion ends. Assuming the invasion keeps going and Western governments stand by their sanctions, structural changes to the global energy mix similar to the 1970s are very possible.

Whether that means a huge and permanent step up in oil prices is a different matter, though. As politicians ween their countries off Russian oil, their top priority is finding other fuel sources. President Biden has reportedly tried to call leaders in Saudi Arabia and UAE to loosen OPEC's production controls (though both have turned him down, according to the *Wall Street Journal*), and the US has even opened diplomatic channels with Venezuela, a Russian ally with the world's largest oil reserves.

The Biden administration has also called for US shale producers to increase their output, with energy secretary Jennifer Granholm telling energy companies last week: "That means you producing more right now, where and if you can". Meanwhile, UK Prime Minister Boris Johnson is reportedly considering lifting the UK's ban on fracking. This is a huge shift in both countries' energy policies. Biden was keen to emphasise his green ambitions in the run up to the 2020 election, while Johnson's Conservative government had previously resisted calls from backbench MPs to end the fracking ban.

There is significant debate around how effective these measures will be at securing enough oil supply. Industry analysts have warned about US producers' lack of capacity, and production increases from Saudi Arabia or UAE would require a breakdown of OPEC+ agreements. Biden's cold relationship with Saudi Crown Prince Mohammed bin Salman is a sticking point for the latter.

What it does mean, though, is that these changes are likely to result in higher total production of oil around the globe than before the invasion began – even if some Russian production is shut down to account for reduced demand. In the context of decade highs for crude prices, that is significant. When we also bear in mind that the European Union (EU), India and China – some of the largest buyers of Russian oil – have yet to ban Russian energy imports (and may never do so), it brings into question whether oil can keep its recent price gains for long.

For now, there have been reports of a 'buyers strike' from those concerned about delivery being complicated by legal action. But, if fears of indirect risks fade, Moscow will likely not struggle to find buyers for its oil and gas, even if it has to offer it at a discount to new buyers. Russia will have to redirect much of its production but, currently, the bans do not prevent Russian oil from entering the global market in the way that the sanctions on Iran did. With prices already so high, it is difficult to imagine China, one of the world's biggest oil importers, not increasing its purchases of Russian oil. Moreover, with governments telling producers to ramp up, we could well end up with a much larger global oil supply than currently feared, even if this takes some months.

The crucial point will be how OPEC and its Saudi leaders react. They clearly have a strong interest in a higher oil price, but that is only if they can still sell it. With fuel and overall inflation now so high, we are quickly approaching the point where price destroys demand and ultimately dampens global economic activity. That is not in OPEC's interest, and further oil increases will therefore raise the incentive to loosen controls.

Of course, it depends on what happens next in the Ukraine crisis. Further escalation will undoubtedly put more pressure on Russia's remaining buyers to introduce sanctions, while stabilisation or hope of a ceasefire will be a positive for supply. Unless anything drastic happens, we should therefore not expect anything like the quadrupling of prices seen in 1973.

CAMBRIDGE INVESTMENTS LIMITED

14th March 2022

Global Equity Markets

Market	Fri 15:20	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7162	+2.5	+175	↘	→
FTSE 250	20217	+4.3	+830	↘	↘
FTSE AS	3992	+2.8	+108	↘	→
FTSE Small	6618	+2.4	+153	↘	↘
CAC	6284	+3.7	+222	↘	⇘
DAX	13709	+4.7	+615	↘	↘
Dow	33328	-0.9	-286	⇘	⇘
S&P 500	4259	-1.6	-70	⇘	→
Nasdaq	13079	-1.8	-234	↘	→
Nikkei	25163	-3.2	-823	↘	↘
MSCI World	2872	-0.9	-25	↘	→
CSI 300	4307	-4.2	-190	↘	↘
MSCI EM	1103	-3.7	-42	↘	↘

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Evraz	+34.8	B&M European Value Ret	-8.4
Pearson	+28.4	Rio Tinto	-7.8
Weir/The	+26.1	RELX	-6.6
M&G	+22.4	Persimmon	-6.1
Flutter Ents	+12.2	Renishaw	-4.7

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.309	-1.1	Oil	111.20	-5.9
GBP/EUR	0.838	-1.4	Gold	1973.8	+0.2
USD/EUR	1.10	+0.3	Silver	25.78	+0.3
JPY/USD	116.90	-1.8	Copper	463.2	-6.0
CNY/USD	6.34	-0.3	Aluminium	3427.5	-7.8
Bitcoin/$	39,170	+0.4	Soft Cmdties	232.3	-0.7

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	13.2	11.1	14.3
FTSE 250	2.9	12.0	14.3	16.2
FTSE AS	3.7	11.7	11.4	14.5
FTSE Small x Inv_Tsts	2.6	1.3	11.6	15.3
CAC	2.4	14.3	12.2	15.2
DAX	2.5	11.9	12.2	13.7
Dow	1.9	16.7	17.5	16.8
S&P 500	1.4	21.1	19.0	18.0
Nasdaq	0.8	24.5	26.7	23.7
Nikkei	1.9	13.9	15.2	17.7
MSCI World	1.9	17.6	17.1	17.0
CSI 300	1.9	14.7	12.8	12.7
MSCI EM	2.6	11.9	12.1	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.51	+0.30
UK 15-Yr	1.70	+0.27
US 10-Yr	2.00	+0.27
French 10-Yr	0.75	+0.32
German 10-Yr	0.27	+0.34
Japanese 10-Yr	0.19	+0.02

UK Mortgage Rates

Mortgage Rates	Mar	Feb
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.76	1.67
3-yr Fixed Rate	1.79	1.69
5-yr Fixed Rate	1.79	1.70
10-yr Fixed Rate	2.22	2.28
Standard Variable	3.83	3.79

* 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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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

Lothar Mentel