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Competing policy measures leave markets worried

The last two weeks have been sobering for investors world-wide, with all major markets (including bond markets) falling between 5% and 10%. This has come after an encouraging recovery rally over the summer that was driven by falling oil prices, which fuelled expectations that the worst of the inflationary headwinds were behind us, allowing central banks to pause their aggressive monetary tightening course, and that a turnaround in economic fortunes was therefore imminent.

However, following the late-August Economic Symposium meeting of central bankers held at Jackson, the realisation has set in that such hopes were premature, and the summer rally proved no more than a bear market rally (see also our separate article that discusses the timing of recovery rallies). Since then, central bankers have resumed their aggressive rate hiking, taking us back to interest rates between 2.5% and 3.5% (UK, US) that we have not had to contend with for 15 years. On top of this, markets have also had to come to terms with politicians' actions to counter rising economic headwinds that have been at complete odds with the decades-long preceding era of fiscal prudence. If that was not enough, a cornered Vladmir Putin cranked up his war rhetoric, with his retreating troops increasingly making him look a loser, thereby increasing the likelihood of much longer-lasting geopolitical uncertainty.

When there is a meaningful shift in those parameters market participants have grown accustomed to over significant time periods, it is perhaps not surprising they feel uncertainty rising and as a result are inclined to reduce their market risk exposures.

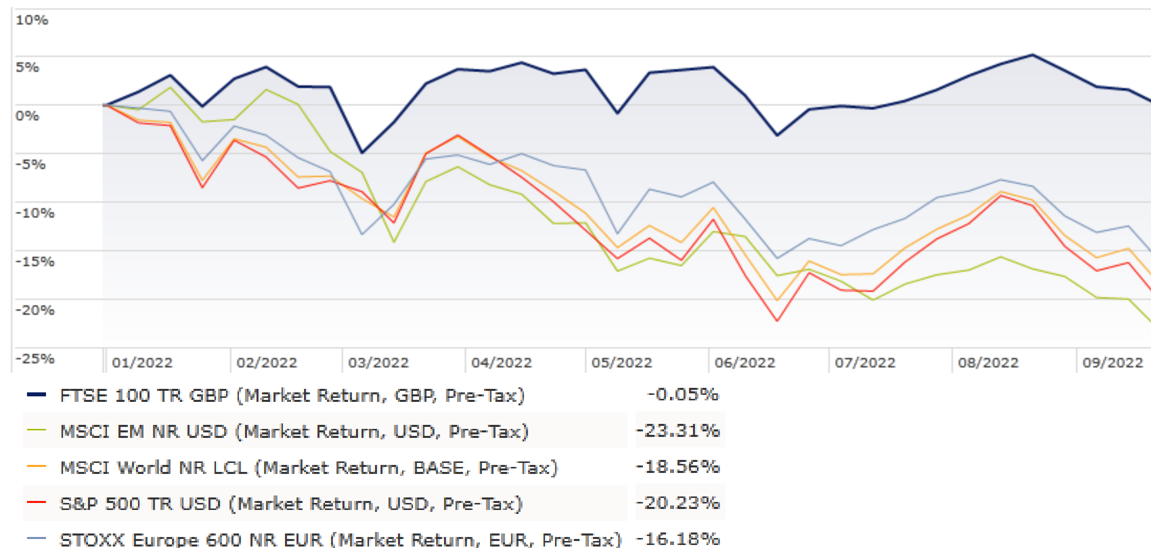
Taking a step back, it is undeniable that this downcycle has likely not reached its trough yet. Therefore, hopes for the usually very rewarding recovery rally have proven premature. On the other hand, it appears that a number of elements that made up the cocktail of formidable downdraft headwinds have gone beyond their lows, and indeed point toward markets reaching the capitulation level sooner rather than later. The energy price shock is receding as the price of oil continues to fall, and is now trading a good 40% lower than at its peak, while fiscal countermeasures announced across wider European markets should soften the blow, not only for consumers but also businesses.

Whether the aggressive fiscal counter cyclical measures announced by the UK's new Chancellor – the most generous consumer and business energy support subsidies across Europe and the largest package of tax cuts in 40 years – will arrest the UK's current decline toward recession is questionable. However, we note that this fiscal largesse also stands in stark contrast to the austerity that followed the Global Financial Crisis (GFC) recession, which led to a decade of subdued growth. One consequence from it is all but certain though: the feared decline in corporate earnings, and thus the running dry of stock market 'fuel', should now be smaller than had been feared.

Where does this leave us (and fearful investors) of what may lie ahead? Markets are right to accept that we are not out of the woods yet, but at the same time we suggest this latest bout of downdraft is getting us increasingly closer to where markets may be pricing in more bad news than actually lies ahead – in other words, what is also known as capitulation and usually the turning point. As outlined in the second article this week, the ongoing economic downturn has the format of a classic, relatively short cyclical one, with few elements that would make us fearful it will turn into a long-lasting structural recession.

Against this backdrop, it is essential for investors to hold their nerve and not risk missing the onset of the recovery rally, which in such cases has historically front-loaded much of the returns available from the ensuing bull market period. This time, being 'in the market' may be even more crucial given higher interest rates and bond yields may well lead to overall lower average return levels during the next cycle.

Recessions, bear market rallies and recoveries



Source: Morningstar, TattonIM, 22 Sep 2022

It always looks darkest before the dawn. In times of market turbulence, investors cling to that simple saying as hope for a rebound. The economy is cyclical, and often severe downturns sow the seeds of their own recovery. We could certainly do with those seeds sprouting at the moment; so far, 2022 has been one of the worst years for stock market returns in a long time. Despite a recovery from the lows in June, the S&P 500 is down just over 20% year-to-date. The bear market has swiped down hard on equity and bond prices this year. Investors are understandably searching for signs of the new bull market beginning.

Fortunately, history suggests that, once markets touch their lows, the rebound is sharp, powerful and often pre-loaded with the bulk of the returns of the next bull market. Unfortunately, the difference between a genuine turnaround and short relief rally is incredibly difficult to judge in the moment. False dawns are common – we saw this when the midsummer rally in global equity prices collapsed into the end of August – but are to be expected. After all, if market troughs were predictable, everyone would buy just before they happen – making them not troughs at all.

Still, understanding the dynamics of market transitions is crucial for any investor. These often depend on the causes of the initial downturn and the global economic backdrop at the time. As we have in the past often written or illustrated in Cambridge's market update presentations, bear markets can be categorised into three different types: structural, cyclical and event-driven.

Event-driven bear markets are exactly what they sound like: downturns caused by one-off shocks to the system. These are typically exogenous (external), in that they are not primarily effects of the global

economy's usual dynamics. The sharp sell-off in March 2020 when the pandemic struck is an obvious example. Seemingly out of nowhere, the world was plunged into an unprecedented shutdown, causing global equity prices to almost half in a single month.

One-off shocks can be incredibly sharp, but are usually short. By the summer of 2020, the S&P had already rallied above its pre-pandemic peak, and the rest of the year was pretty smooth sailing for investors. Quick recoveries reflect the fact that economic fundamentals have not changed too much, with sell-offs instead being caused by intense risk aversion (or indeed temporary events) – which can easily and rapidly turn around.

Cyclical bear markets are usually more protracted and meaningful. They reflect the changing winds of the global economy, and are typically marked by rising interest rates or looming recessions. These bear markets start when growth and inflation run hot enough to make central banks tighten the money supply, thereby pushing up bond yields and subsequently lowering equity valuations, while economic growth reverses as the higher cost of finance destroys consumer and business demand. They end when inflation loses its momentum and central banks loosen their grip – reversing the valuation shifts and optimism and growth returns. Cyclical downturns are typically longer than one-off shocks, but the time from peak to trough can vary greatly.

Structural bear markets are by far the worst. They reflect imbalances and instabilities that have been allowed to grow in financial markets and/or the economy. While the downturns typically begin with the bursting of certain asset bubbles, the unwinding process can be long and painful, and full recovery can take many years. The global financial crisis of 2007-08 is a key example, as corporate leverage spiralled through opaque debt instruments, only to come crashing down after the housing market took a turn. The 2000-2003 bursting of the dot-com bubble, and the 1992 deflation of Japan's property and general asset bubble are other well-known examples. The 1929 crash is a more harrowing one – the recovery took several years and it preceded the Great Depression.

So, which type of bear market are we in now? A year ago, we hoped the global inflation spike was a one-off (or series of one-offs) that, although sharp, would fairly quickly fade when supply chain issues cleared up. But the last 12 months have made it clear this is not a one-off event, and we are now in one of the latter two scenarios, as a follow-up to COVID as an external shock event. Each downturn is certainly different, but the current episode is truly remarkable: an external shock triggering a shift in various sectors, be it in the labour market or global supply chains. Tight labour markets and high inflation after a period of strong growth force central banks into aggressive action to prevent the forming of a self-perpetuating wage-price spiral, pushing economies into a cyclical downturn. Some of those changed elements may well stay with us for longer, and represent signs of structural shifts – for example global energy supplies as the world addresses global warming, and labour market dynamics as economic migration and globalisation decrease for a whole host of reasons.

We are probably in a cyclical downturn centred in the US, with significant elements of exogenous shock dynamics across wider Europe, due to the energy price shock induced by the war between Russia and Ukraine. Backing this up is the absence of significant structural mis-balances. The relatively low levels of overall financial leverage compared to previous crises, and a stable financial system (in large part down to post-Global Financial Crisis reforms) reduce the likelihood that the current downturn becomes structural and long lasting (see above). As we have written before, household and business balance sheets are healthy,

meaning there is room to withstand higher interest rates without a collapse in demand or a big credit crunch causing a general liquidity crisis. That will not stop a recession, but it can at least limit the fallout.

However, balance sheets can only withstand so much pressure, and the more aggressive central banks get, the more likely defaults will follow. The crucial question is how long will inflationary pressures last? The answer to that differs by region. The US is dealing with an internal labour market problem, which will hopefully be cooled by an aggressive Fed. Europe, meanwhile, is struggling with an intense energy shortage on top of its post-pandemic hangover. Investment in alternative energy sources and changes to the market structure will help in the long term, but they are unlikely to have an effect in the short-to-medium term.

Whatever the case, the investment backdrop after this crisis fades will be different to the last few decades. Since the 1980s, globalisation, deregulation and the continually falling cost of capital (and bond yields) have led to higher equity valuations and capital-led growth. These trends now appear to be in reverse. This will likely mean structurally lower valuations and hence lower aggregate returns over the coming cycle. On the other hand, it might also lead to greater investment in productivity and higher rewards for shrewd stock-pickers.

In our view, these factors could have an impact on the current cycle too, rather than just the long-term outlook. If inflation pressures prove more sticky than expected, central banks will not be able to ease off as quickly as they would have before. This could make the current downturn more drawn out. The current pick-up in risk-reward dynamics, particularly in the US, is a welcome sight – but we suspect more will have to come for a sustained recovery. As ever though, investors tempted to time the market do so at their own risk. When the rebound comes, we should expect historic precedent to play out once again, because investors know the eventual market recovery will be sharp and sudden. Missing out has historically done more damage to portfolios than riding out the bear market.

Utilities companies suffering an identity crisis

Utility companies have been in the news a great deal over the last few months. Energy supplies in the UK and Europe have become the focal point of the global economy's struggles, as consumers grapple with spiralling costs. Meanwhile, British Gas owner Centrica reported record profits just two months ago. Calls for a windfall tax on utilities – as Downing Street ultimately resolved to do for oil companies – have been blaring ever since. Two weeks ago, Centrica's management jumped before they were pushed: it volunteered to cap its profits in a bid to help households.

In Europe, the energy shortage is even more pronounced. Germany is feeling Russia's gas supply squeeze more than anywhere else, and Europe's largest economy is set to ration heat and power this winter. On Wednesday, the German government reached a deal to nationalise Uniper, Germany's largest natural gas provider. Germany will buy the 56% share held by Finnish state-owned company Fortum for €500 million – leaving the government with a 98.5% stake.

A much larger €8 billion will be injected directly into the business, to help cope with gas-related losses which, according to Fortum, have reached nearly €8.5 billion. Germany had already given the gas importer €15 billion in a bailout rescue package in July, but its prospects have only worsened since then. Uniper is Germany's biggest importer of Russian gas, but has had to source alternative supply from the open market,

following Russia's decision to shut off Nord Stream pipeline supplies into Europe. According to Fortum, Uniper "cannot continue to fulfil its role as a critical provider of security of supply as a privately-owned company".

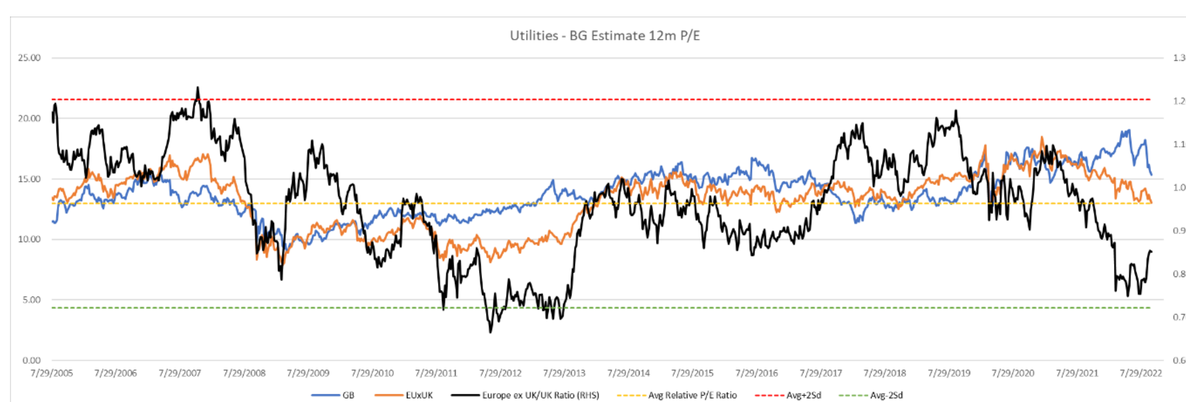
This is the German government's biggest step in dealing with the energy crisis yet. The final relief package could reach into the tens of billions, given Uniper's credit needs under an increasingly dire outlook. It also sets the stage for further nationalisations: the German government is also reportedly in advanced talks to buy VNG, another huge gas importer, and is trying to reach agreements on alternative energy sources.

The fortunes of Germany's gas providers seem vastly different from Britain's major players. But even Centrica, with its much-maligned profits, is currently negotiating billions in new credit. At the start of this month, shortly before its voluntary profit cap announcement, the utilities provider engaged banks to secure financing to meet huge collateral demands for its forward price hedging position, apparently also as a precautionary measure. While there are no signs of immediate stress, it shows how volatility and soaring wholesale gas prices are weighing down even the well-off companies.

Higher energy prices mean electricity providers must stump up larger collateral payments. These take a toll on energy companies' liquidity positions, leading to fears of financial contagion. Finland and Sweden have already announced emergency financing measures for electricity generating companies, to stop the problem spreading to the financial sector.

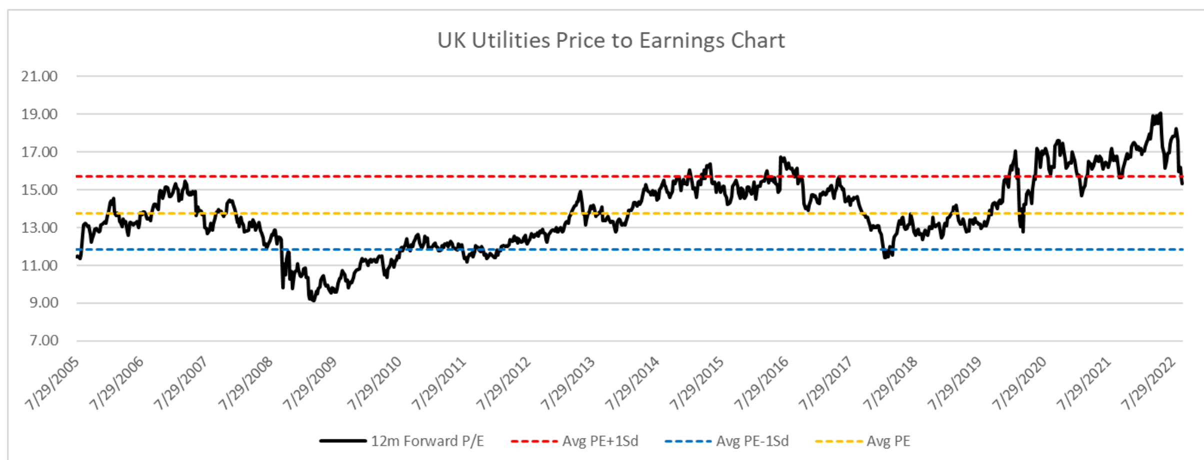
These issues impact the way we think about utilities as investment assets. Traditionally, utilities are considered a defensive investment, providing a regular and dependable stream of profits without much volatility or opportunity for expansion. Price volatility and its debt implications change that picture – this is visible in diverse utility performance between Europe and the UK. In Europe, dependence on expensive gas imports is much more pronounced, and reflected in lower valuations.

As the first of the following three charts shows, European ex UK utilities (black line) have recovered somewhat from extreme lows against the UK:



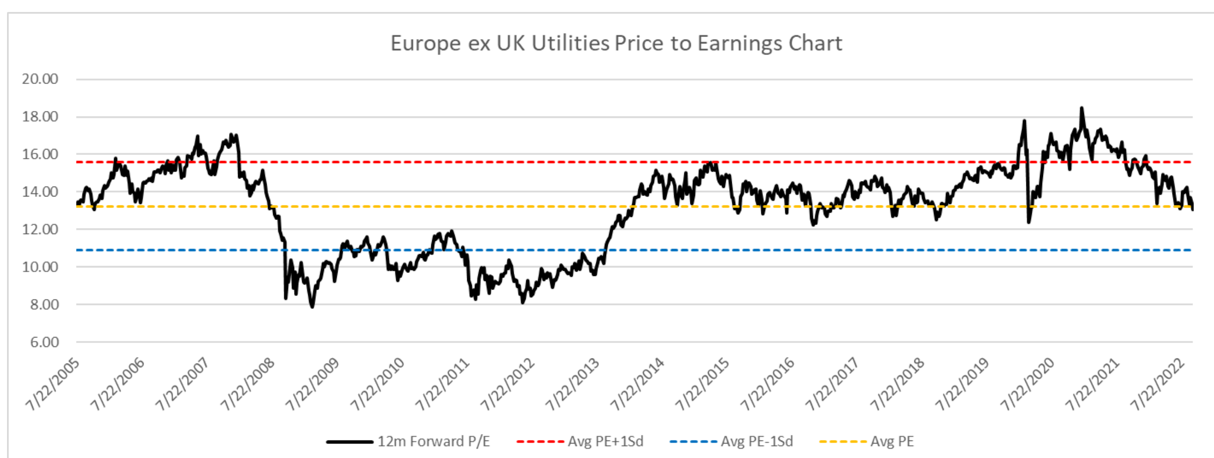
Source: TattonIM, Bloomberg, 23 Sep 2022

UK utilities are at the upper range of their historical valuation range:



Source: TattonIM, Bloomberg

European utilities just trade at their long-term average:



Source: TattonIM, Bloomberg

The fallout from Russia's invasion of Ukraine is clearly a big driving factor – shaking up the structure of European and global energy markets. But underlying this is also the trend towards renewable energy sources. Uniper came about from EON's pooling of old coal and gas assets in 2016, which was itself a result of the German government's strategic shift to wind and solar energy production. The underinvestment in traditional utilities left the sector vulnerable, a problem exposed by Russia's halting of gas supplies.

This might also go some way to explaining the differing fortunes of utilities. Those generating energy from renewable sources have not seen their costs rise anything like those burning coal and gas, but they are all selling onto the same market, meaning profits for renewable generators skyrocket while others struggle. The shift makes it increasingly difficult to distinguish between straightforward utilities – the traditional middle-men – and upstream energy providers. This is one of the main reasons the European Union (EU) has recently sought to decouple downstream energy prices (electricity) from wholesale gas prices.

These considerations also have a bearing on the debate around windfall taxes. Centrica making sky-high profits while households struggle is politically unpopular, but the benefits to one company have to be seen

in the context of an aggregate downturn for the sector. In a recent report, Goldman Sachs estimated that taxing utilities' entire aggregate profit margin would cover just 1% of the expected rise in energy bills facing households. Regardless of any ethical questions about utility profits, taxing them seems unlikely to solve the problem at hand.

Excessive windfall taxes would also structurally lower the incentive for private sector energy investment, however. It is hard to say what effect this would have in the context of volatile and uncertain energy markets, but it is hardly productive in terms of creating more dependable and lower cost energy supply. This is not to say that the sector should be left alone – far from it – but that other measures, such as price caps, rationing and restructuring the overall market are likely to be more effective. EU lawmakers seem to agree with this analysis, as reports suggest they are planning to recommend the elimination of windfall taxes and the introduction of price caps.

We are certainly entering a period of increased government intervention for the utilities sector. Ideally, this would come in the form of efficient regulation that keeps basic market mechanisms in place, rather than direct state involvement which tends to lead to inefficiencies down the line. Authorities have understood that utilities are a vital element in the energy transition, and therefore fears of the imposition of higher (windfall) taxes may not be as pronounced any more. That would make utilities once again the solid defensive equity sector that we are used to, and may also explain why they continue to trade in the upper band of their historical valuation ranges.

Global Equity Markets

Market	Fri 16:31	% 1Week*	1 W	Technical Short	Technical Medium
FTSE 100	7028	-3.5	-254	↘	→
FTSE 250	18017	-4.6	-869	↘	↘
FTSE AS	3854	-3.7	-146	↘	⇘
FTSE Small	6088	-3.6	-226	↘	↘
CAC	5789	-4.7	-288	↘	↘
DAX	12294	-3.5	-447	↘	↘
Dow	29594	-4.0	-1228	↘	↘
S&P 500	3698	-4.5	-175	↘	↘
Nasdaq	10870	-5.1	-579	↘	↘
Nikkei	27154	-2.4	-665	⇘	⇘
MSCI World	2489	-3.1	-80	↘	↘
CSI 300	3856	-1.9	-77	↘	↘
MSCI EM	923	-2.3	-22	↘	↘

Top 5 Gainers

Company	%
AVEVA	+4.6
BAE Systems	+3.1
Halma	+1.5
Unilever	+1.4
Diageo	+0.4

Top 5 Decliners

Company	%
JD Sports Fashion	-16.8
Ocado	-14.6
Land Securities	-13.6
Intermediate Capital	-13.3
Dechra Pharmaceuticals	-12.5

Currencies

Pair	last	%1W
USD/GBP	1.092	-4.4
GBP/EUR	0.890	-1.5
USD/EUR	0.972	-3.0
JPY/USD	143.19	-0.2
CNY/USD	7.128	-2.0
Bitcoin/$	18,828	-4.5

Commodities

Cmdty	last	%1W
Oil	86.44	-5.4
Gold	1647.4	-1.7
Silver	18.857	-3.7
Copper	336.5	-5.5
Aluminium	2228.5	-3.4
Soft Cmdties	223.12	+1.5

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	10.1	8.6	14.3
FTSE 250	3.7	8.0	12.7	16.4
FTSE AS	3.9	9.7	9.0	14.5
FTSE Small x Inv_Tsts	3.9	6.5	9.5	15.4
CAC	3.4	11.3	9.2	15.2
DAX	3.8	11.8	10.1	13.7
Dow	2.3	15.4	15.8	17.0
S&P 500	1.8	17.7	16.6	18.3
Nasdaq	0.9	20.7	24.4	24.3
Nikkei	2.1	15.0	14.8	17.8
MSCI World	2.3	14.8	14.9	17.1
CSI 300	2.3	13.1	12.6	12.8
MSCI EM	3.4	9.3	10.9	12.7

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	3.82	+0.68
UK 15-Yr	4.06	+0.59
US 10-Yr	3.73	+0.28
French 10-Yr	2.60	+0.30
German 10-Yr	2.03	+0.27
Japanese 10-Yr	0.24	-0.02

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate	2.25	1.75
2-yr Fixed Rate	3.64	3.60
3-yr Fixed Rate	3.74	3.61
5-yr Fixed Rate	3.61	3.56
10-yr Fixed Rate	3.73	3.70
Standard Variable	4.89	4.82

* 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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