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US slows, Europe's winter outlook improves, UK back to start

The most turbulent October experienced by UK bond markets since 2008 is drawing to an end and one could easily get the impression nothing of significance happened. Sterling is back to where it traded just before that fateful 23 September 'fiscal event', and bond yields are likewise roughly back to where they started in autumn. This is good news: it shows the UK still has effective institutions capable of reversing errors and preventing major collateral damage. Unfortunately, though, some of its credibility in international capital markets has been lost. As a result, the government's fiscal headroom of what it can and cannot do when the absolute need arises has most likely reduced.

Rishi Sunak's new government is seen as one where the Treasury is firmly in charge and fiscal prudence, rather than fiscal experiments, dictates the agenda. For evidence of this, the 'interim' Chancellor retained his job, and the old Chancellor is now Prime Minister. The next balancing act will be to not overdo the other side of fiscal policy, namely austerity. A difficult winter still lies ahead for consumers and businesses as higher prices, and an ongoing energy price shock, stretch budgets to breaking point. Should the energy price shock prove temporary, then, under these circumstances, only the government can soften the blow through time-limited support measures. We have dedicated our second article this week to an assessment of the UK's newfound (old) position.

On the energy price side, in the early part of last week, equity markets and corporate bond markets on both sides of the Atlantic were buoyed by near-term energy price falls. European and UK corporate bond credit spreads (the additional yield over government bonds) declined quite sharply, which was welcome relief.

We mentioned the current oversupply of liquid natural gas (LNG) in an article last Monday. Over the week, gas spot prices staged a mini-repeat (if only for minutes) of the negative oil prices seen in the US in April 2020 and for the same reason – completely full local storage – while LNG tankers were waiting outside harbours to unload.

Stores are full because there is not a lot of storage for liquified gas in the first place, and the current warm weather has reduced the need for heating. We are not out of the woods yet, as a colder than average winter would substantially reduce those stores, given even fully stocked, pan-European storage capacity covers only two months of use.

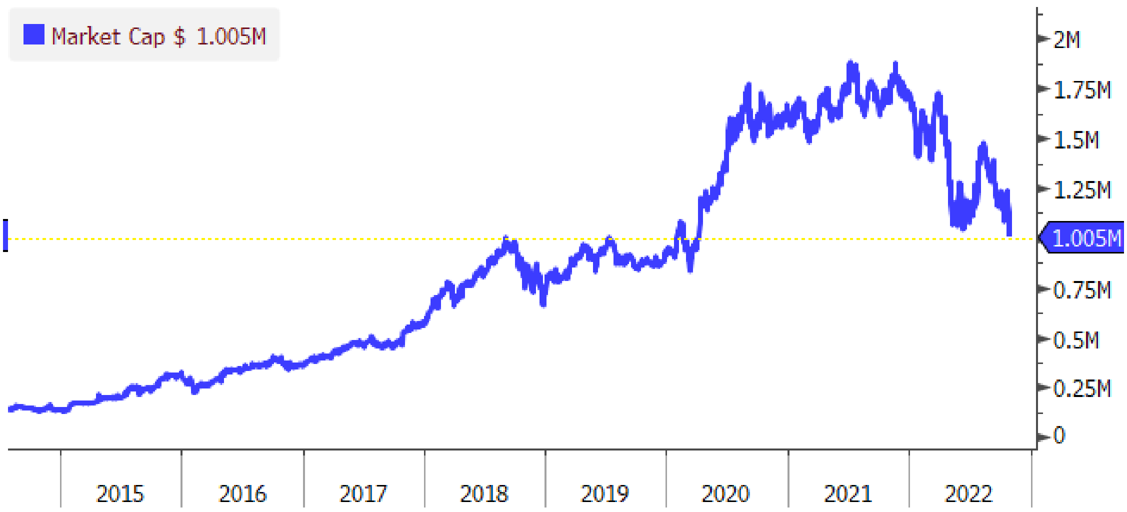
We should not be too dismissive of the fall in gas prices, however. The influx of tankers shows that the redistribution of global gas to cover the loss of Russian supply has been achieved sooner than most had expected. Full-year 2023 gas price indications (as per forward contracts) now stand at EUR 79 per MWH. This is still three times what they were last October, but down 20% since the end of September and half the peak price from the end of August.

Last week's economic data, however, painted a gloomy picture - albeit with some mildly positive growth surprises and no further deterioration in outlook. Europe's consumer sentiment is depressed but perhaps by less than feared. Business sentiment, as measured by the 'flash' purchasing manager indices (PMIs) for October, were generally below 50 for both services and manufacturing, indicating likely contraction in the next few months. France was the only notable exception. European services were slightly better than manufacturing. Service surveys tend to track consumer confidence more closely and it appears European consumer confidence is holding up despite the buffeting of energy price moves. This may also explain why flash Q3 GDP figures for Germany and France showed a slight expansion rather than the expected contraction. The economic resilience of the past months is encouraging.

However, US consumers seem to have grown pessimistic, and more so than in Europe. This is despite quarterly GDP growth unexpectedly increasing to 2.6%. This was mostly due to the impact of energy exports, while the demand across businesses and consumers declined. The Conference Board's highly regarded index of Consumer Confidence slipped, as did the service PMI. The tight employment picture of plentiful jobs may be easing, although the reduction in households' perceived wealth from sliding stock markets may have had quite an impact as well. We saw a similar situation in the spring.

But perhaps the biggest indicator of a US slowdown came from Q3 corporate earnings announcements last week. Microsoft said both business and consumer demand for PCs was declining after the two bumper pandemic years. Perhaps most importantly, Amazon spoke of rising costs and slower economic growth. Its margins have come under strong pressure and now sales are growing at a tepid level. The days of ripping competitors to shreds have gone. Amazon opened last Friday's trading down 11% from Thursday's close, its market capitalisation now hovering around $1 trillion.

Amazon market capitalisation



Source: Tatton IM, Bloomberg: G1127

AMZN UW Equity (Amazon.com Inc) Amazon mkt cap Daily 29JUL2014-28OCT2022 Copyright© 2022 Bloomberg Finance L.P. 28-Oct-2022 15:33:49

And yet mid and small cap US stocks have been faring better, helped by a cheapening of finance. Indeed, the dynamic of the slowing of exceptional US growth has allowed 10-year US Treasury yields to fall below 4%, having traded at 4.33% a week ago. And, despite the European Central Bank raising rates by 0.75% last Thursday, European and UK bond yields have also fallen by similar amounts.

The European/US growth imbalance appears to be easing (at least in terms of perception). And the US dollar, after weeks of rising against other major currencies, has slipped back, giving some prospect of easing global financial conditions. However, worries about this imbalance will not disappear just because of a few datapoints. As noted earlier, we had a similar situation in the late spring months – but perhaps there are more indicators of US slowing than was the case then, particularly in the earnings reports.

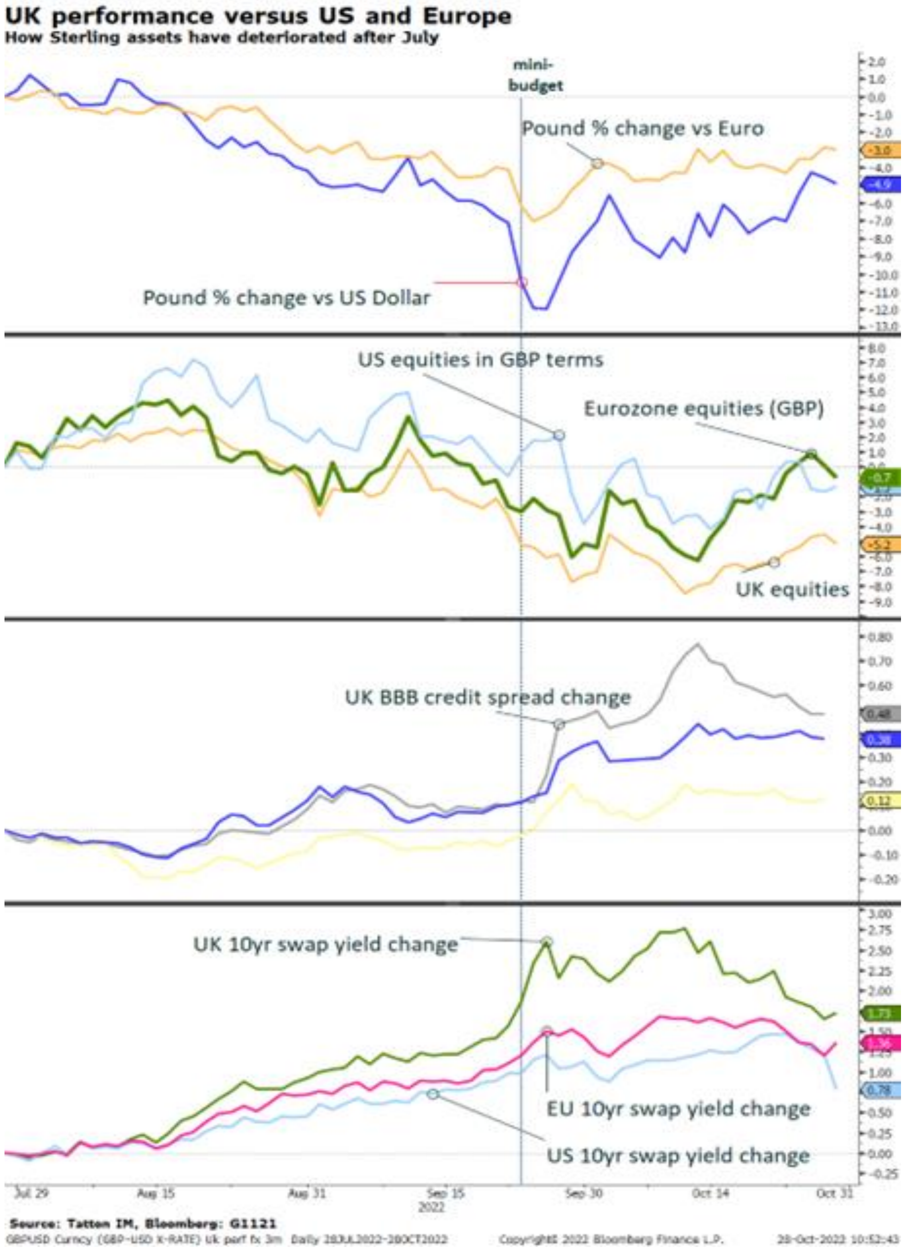
We ended last week at a slightly odd juncture; that a fall in one of the world's largest companies is actually good news. For US equities, the environment is one of declining medium-term earnings expectations but improving valuations. This occurs more often in the midst of recession rather than before the start, but the old adage reminds us that history does not repeat itself, but it often rhymes. Over the coming weeks, we cannot expect news of inflation and economic headwinds to recede at once, but with the growing signs of the transatlantic misbalance narrowing, the outlook is no longer deteriorating. In our world, this is similar to saying it is darkest just before the dawn.

After fiscal fiasco is Britain back on the straight and narrow?

After fiscal fiasco is Britain back on the straight and narrow? Throughout her short and not so sweet premiership, Liz Truss and her team pushed the narrative that global forces were to blame for the chaos in markets. The band kept playing this tune even as the ship was sinking. Indeed, Truss used her last Prime Minister's Questions to tell MPs that sky-high inflation and rising interest rates were because of the Ukraine war and global energy supplies. While nobody seemed particularly convinced, there is certainly some truth to this. Government and corporate credit conditions had deteriorated markedly over the last few months. And while sterling fell sharply, the continued strength of the US dollar against every other currency has been an inescapable part of the story.

The former Prime Minister's fiscal plans played a big part of the acute crisis, of course. The impression of Britain turning into a fiscal profligate put pressure on weak spots that were already there. The global supply squeeze has lowered confidence in the world economy and led to a significant tightening of monetary policy, ensuring capital is more expensive and harder to get. Everywhere outside of the US – which we cover in the next article – has suffered a contraction in the supply of capital. Truss's answer was to greatly increase the UK government's demand for capital, sending markets into tailspin.

The charts below show the relative (poor) performance of UK assets against the US and Europe since the start of the Tory leadership contest in July.



After the not-so-mini-budget, UK equities are still underperforming considerably, while yields have come back down and sterling is back up – albeit still worse than where they were in the summer. For us, the most interesting comparison is not with the US, which has proven extremely resilient against global headwinds, but against the rest of Europe.

The energy supply crunch is even more pronounced across the Channel – particularly in Germany, which used to rely on Russian gas for an outsized portion of its electricity. Before the Truss premiership, UK assets showed a strong correlation with Europe, both in currency terms and in credit conditions. But this was smashed by Kwasi Kwarteng's fiscal event. Interestingly, investors were particularly concerned about UK government and corporate debt, despite Germany likewise unveiling a huge fiscal boost in the middle of a supply squeeze. However, Germany runs a current account surplus, meaning it depends less on foreign capital. On top, Germany also has a history of being able to deliver fiscal primary surpluses (spending lower than income), even if during the COVID years, and the current episode, the balance tipped into a clear deficit. So, there is a trust element, with markets wondering whether governments are capable enough to turn around the budgetary situation they engineer. In the case of the UK under Truss, it appears markets opted for a no confidence vote based on a lack of credibility.

Now that Jeremy Hunt and Rishi Sunak have reversed all of those decisions, British assets are more stable. Truss wanted to give tax cuts to both businesses and individuals and use borrowing to offset the difference. This effectively meant giving money to the private sector in the hope that it would produce short-term growth. The problem was that rising interest rates would negate any funding benefits that consumers and businesses might receive, by way of higher mortgage and business loan servicing burdens.

We have not seen Sunak and Jeremy Hunt's plans yet and won't until 17 November, after the Halloween Budget was pushed back. That the delay did not upset bond traders is itself a sign of confidence. Clearly, the new Prime Minister is taking a hugely different approach than his predecessor. Instead of boosting growth by giving money to the private sector – and hoping we/they know what to do with it – he wants to offer policies targeting the areas where government spending makes a difference. At the same time, Sunak promises a return to Boris Johnson's 2019 election manifesto, investing public funds in areas most likely to produce medium and long-term growth – all while keeping public finances in check.

This plan is much closer to those we see in Europe. And sure enough, they seem to have brought UK assets much more in line with Europe's. Sterling has gained against the Euro, UK yields have come closer to Eurozone debt and – in particular – UK corporate credit spreads are now only slightly higher than Eurozone counterparts. Going back to the summer, Britain's underperformance is still visible, and much clearer against the US, but Sunak's 'adult in the room' persona has definitely assuaged some market fears.

For gilt traders, the focus will be on the Office for Budget Responsibility's (OBR) forecasts, which will be released on 23 November shortly after the mid-November Autumn Statement. Given Hunt and Sunak's indications, budget plans will be fiscally tight over the five-year period although we should probably expect a neutral – or even slightly positive – position in the nearer term. The UK's fiscal position will undoubtedly show deterioration. Yields have risen sharply, forcing the government to pay more on its debt. The OBR's overall forecast will certainly look worse, the key question being by how much.

A big part of that deterioration is the global forces that Truss was so keen to blame. But the fact remains that UK assets have underperformed its closest peers, and that underperformance will have a material impact on fiscal policy headroom over the medium term. Brexit has cast a long shadow over the UK economy for several years and will remain a weakness until trading relations with our closest neighbours improve. That structural weakness and uncertainty means businesses and consumers are less resilient when hit by external shocks. The mini-budget was one such shock, severely damaging mortgage rates. This cannot be undone quickly, and therefore adds another headwind to Britain's long-term prospects.

While we should not overestimate the benefit to UK assets from the return of UK fiscal prudence, we certainly should not *underestimate* it either. The new government has brought financial stability and, while the benefits of this are often hard to pinpoint, it is infinitely better than the alternative, as the public just had to learn the hard way. The Bank of England's emergency intervention to save pension funds is a case in point. We are no longer fighting for the scraps of global capital.

This takes the heat off the UK for the time being, which is a relief not just for us but the wider world. One of the most notable parts of the crisis a month ago was how a UK-specific problem was able to knock down global markets. Not only did sterling weaken, but the dollar gained against other currencies too, as a potential British financial crisis added to the global economic risks. Now that it is behind us, foreign investors have one less thing to worry about.

We hope that this Sunak stability carries over into relations with the European Union (EU), which we see as crucial in determining Britain's long-term economic prospects. An end to extreme volatility is welcome, but we should not be under any illusions – the UK is still in a fundamentally weaker position than it was at the end of spring.

How strong can the dollar go?

US currency strength has been one of the defining features of this year. For UK investors, this was made painfully clear at the end of last month, when sterling was dragged to its lowest ever value against the dollar. Markets have since stabilised but even so, the dollar is still up by more than 16% against the pound this year. While part of that is UK weakness, US strength is the much more prominent story for global investors. The dollar has floated at or above parity with the euro for more than a month now, while the dollar index – a broad measure of its value against a basket of other currencies – has gained some 14% in 2022.

The proximate cause is quite simple. The world's reserve currency enjoys a so-called 'exorbitant privilege'. One aspect of that privilege is its safe haven status. Even in normal times, the dollar benefits from the pockets of turmoil around the world as the 'go-to' banknote for owners of capital in distress. This year has seen plenty of distress. War, slowing global growth and a myriad of other risks have pushed investors into the security of dollar assets. This would be a significant force even if the US economy was weak but, to the contrary, US growth has held up much better than other major markets (of course, partly fuelled by the capital inflow). So much so that the US Federal Reserve (Fed) has had to tighten policy harder than most – pulling even more capital in through higher interest rates.

In one sense, capital inflows make inflation containment easier for the Fed, as rising global input costs – of which there are plenty – get offset by cheaper foreign currencies. On the other hand, they also support asset values and keep credit conditions supportive for businesses. This is supportive of growth, as we can see in US comparative outperformance. The danger is that domestic US labour market dynamics keep running hot, threatening a wage price spiral. The Fed is very conscious of this risk and has made it clear rates will need to actively constrict activity, and see that reflected in a tighter labour market, before it loosens its grip.

It may seem odd to say that American assets are supported by capital flows, considering US stocks have lost nearly 20% in local currency terms for the year to date. But the strength of the dollar has insulated foreign investors from equity weakness, and these losses have been considerably smaller from the perspective of investors based in other currencies, with the S&P 500 falling only just over 6% in sterling terms. Relatively, US credit spreads have held up better than elsewhere, while the equity risk premium – the return investors demand for a given level of risk – has been remarkably stable, where elsewhere it has fallen significantly.

This continued strength points to a deeper trend than the ebbs and flows of the world economy. Since at least 2016, the forces of globalisation have gone into reverse in a way not seen since the 1970s. Brexit is a symptom of this, but Donald Trump's trade wars were much more significant factors for global trade. His internal policies repatriated vast amounts of dollars and resources that were previously held offshore, while his combative style with major trading partners disincentivised companies from investing in stronger trade links.

These trends have continued beyond the Trump presidency. Those that thought President Biden would take a more conciliatory tone on these issues have been proven resoundingly wrong. Sanctions against Russia and its allies are one part of this, but his aggressive stance on China is a much bigger part. The previous week, the White House announced a de facto embargo on selling high-end technology to Chinese companies – a major escalation of tensions between the world's two largest economies.

At the same time, China has been steadily reversing its opening up reforms and cracking down on its own private sector. Last week, the Chinese renminbi hit its lowest value against the dollar since 2007, after the Communist party's 20th National Congress ended with the appointment of hard-line Xi Jinping loyalists to the Politburo. This led to some of the largest capital outflows that modern China has ever seen, much of which ended up back in dollar assets.

With globalisation receding, investors are starting to fear they could be left with stranded assets. We saw that earlier this year, when dramatic sanctions against Russia reduced the overseas value of Russian holdings to practically zero in an instant. In such a situation, the question stops being about return on investment and more about return *of* investment. These concerns have been building for years, underpinning a strong secular push towards US assets.

In a well-connected and open world, trade and capital flows (and hence currency values) should be determined by relative goods and services prices, relative growth prospects, and, finally, asset valuations. When the world is at risk of fracturing, those metrics become less important. The flipside of this for the US, though, is that it starts to look very expensive on those normal metrics. This is precisely what we see now: US equities have higher valuations than elsewhere (meaning the outright risk-reward ratios are lower) and costs (in particular, labour) are significantly higher.

How long can this continue? Should risks to global trade persist, and growth dynamics across the world keep deteriorating, investors will put even more of their money in US assets. But given how much of those headwinds are already priced in, it is worth bearing in mind what that situation would look like: a dramatic slowing of cross-border trade, and the US becoming practically the only source of substantial global growth.

That is unlikely, but even if it did happen, the US economy would eventually have to slow, as its trading partners become so poor they cannot afford to buy American exports. We are already seeing these dynamics. US companies make around 30% of their earnings overseas, and the number is over 50% for the tech sector. These companies therefore depend on global demand for US goods, but that demand is seriously undermined by falling global growth and a strong dollar.

This argument is not exactly new. The US has been more expensive than the rest of the world for some time, and yet investors have proven no less eager to hold dollar assets. Geopolitical tensions are what drive this desire – and as long as they remain elevated, a reversal of dollar strength will be hard to sustain. At the very least though, we suspect that the *pace* of the dollar's ascent is at or near its peak. The global economy cannot afford it any other way.

Global Equity Markets

Market	Fri 16:01	% 1 Week*	1 W	Technical: Short	Technical: Medium
FTSE 100	7042	+1.0	+72	↘	⇘
FTSE 250	17917	+4.1	+710	↘	↘
FTSE AS	3853	+1.5	+56	↘	↘
FTSE Small	5838	+1.7	+95	↘	↘
CAC	6275	+4.0	+239	→	↘
DAX	13242	+4.0	+511	→	↘
Dow	32658	+5.1	+1576	→	⇘
S&P 500	3867	+3.0	+114	↘	↘
Nasdaq	10998	+1.3	+139	↘	↘
Nikkei	27105	+0.8	+215	⇘	→
MSCI World	2524	+2.5	+61	↘	↘
CSI 300	3541	-5.4	-202	↘	↘
MSCI EM	859	-0.6	-6	↘	↘

Top 5 Gainers

Company	%
Melrose Industries	+12.7
Land Securities	+9.3
Centrica	+8.6
Rentokil Initial	+8.2
Barratt Developmei	+8.0

Top 5 Decliners

Company	%
Prudential	-10.3
Standard Chartered	-8.9
HSBC Holdings	-7.9
Airtel Africa	-7.5
Rio Tinto	-6.6

Currencies

Pair	last	%1W
USD/GBP	1.158	+2.5
GBP/EUR	0.859	+1.7
USD/EUR	0.994	+0.8
JPY/USD	147.48	+0.1
CNY/USD	7.253	-0.3
Bitcoin/$	20,532	+7.0

Commodities

Cmdty	last	%1W
Oil	95.96	+2.6
Gold	1642.7	-0.9
Silver	19.105	-1.6
Copper	343.6	-1.1
Aluminium	2287.5	+3.5
Soft Cmdties	205.74	-4.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	9.7	8.9	14.2
FTSE 250	3.7	8.0	12.5	16.3
FTSE AS	3.9	9.4	9.2	14.5
FTSE Small x Inv_Tsts	4.0	6.0	9.0	15.4
CAC	3.1	11.9	10.0	15.2
DAX	3.5	12.6	10.6	13.7
Dow	2.1	17.5	17.6	17.0
S&P 500	1.7	18.5	17.3	18.3
Nasdaq	0.9	21.0	24.9	24.4
Nikkei	2.1	14.9	14.7	17.8
MSCI World	2.2	15.1	15.2	17.1
CSI 300	2.5	12.0	11.6	12.8
MSCI EM	2.8	8.8	10.5	12.7

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Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	3.43	-0.63
UK 15-Yr	3.76	-0.55
US 10-Yr	3.96	-0.26
French 10-Yr	2.58	-0.39
German 10-Yr	2.07	-0.34
Japanese 10-Yr	0.25	-0.01

UK Mortgage Rates

Mortgage Rates (LTV c.75%)	28-Oct	28-Sep
Base Rate	2.25	2.25
2-yr Fixed Rate	5.86	3.64
3-yr Fixed Rate	5.77	3.74
5-yr Fixed Rate	5.53	3.61
10-yr Fixed Rate	5.22	3.73
Standard Variable	5.10	4.89

* 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.

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