Strategy & Outlook

MARKET UPDATE

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MORNINGSTAR

It was a month of 2 halves. Global Markets continue to be extremely volatile. The strong rally off the June lows continued for the first half of the month, driven by relief that Q2 earnings were not as bad as many feared, a more measured tone from Fed Chairman Powell, signs inflation was peaking (CPI report, collapsing US gasoline prices) and positioning (the pain trade was, and remains, higher).

The rally then ran out of steam, given the speed and size of the move higher, a pullback of some sort was inevitable. But peak illiquidity (late August), concerns of a bleak winter in Europe as gas prices went parabolic – which turned ECB commentary hawkish (just as prices peaked, at least in the short term), and renewed hawkishness from Powell at Jackson Hole, exacerbated the move lower.

US yields have moved higher again, the market was surprised by Powell's Jackson Hole comments, which were somewhat inconsistent with his comments at July's Fed meeting. He emphasised the risks from prematurely loosening policy and stated that restoring price stability may require keeping policy restrictive for some time. It appears that the Fed is once again behind the curve in a big way, in a mirror image to this time last year, when Fed officials were at pains not to appear hawkish when inflation threats were rising rapidly, we now have a Fed falling over themselves to sound as hawkish as possible, as inflation is easing (albeit from a high level). At June's Fed meeting Powell pointed out that they're not really interested anymore in making a distinction between headline and core inflation, for consumers, the logic being that it's not much comfort if core measures are cooling but gasoline prices remain very high. Well, US gasoline futures ended the month down ~45% from their June highs, ~15% below pre-invasion levels (prices at the pump follow with a lag). Another concern was inflation expectations becoming unanchored, expectations being heavily influenced by the price at the pump, and at the same time Powell was speaking we saw the University of Michigan inflation expectations ease. It is difficult to see a scenario where high inflation expectations become entrenched when commodities are collapsing, supply chains are normalising, and retailers are scrambling to clear inventory. The rise in rates to date has already slowed down the US housing market materially, but outside of this the data continues to point to a resilient US consumer.

In Europe, the outlook clearly revolves around gas/energy and is somewhat binary depending on how the war in Ukraine plays out. Russian gas exports to Europe have collapsed. In the event Russian supplies are completely cut off, Europe may not have sufficient gas to get through winter and further rationing of demand would have to occur in the industrial sector. Should supplies continue, even at reduced levels, the winter may be navigated without major state mandated rationing, given existing demand destruction and scope for LNG imports. That said, the overall European electricity market certainly requires reform and EU leaders are working on decoupling electricity prices from gas, which is the marginal unit and hence sets power prices currently. A large part of the cost base can generate electricity well below current prices, gas is only ~6% of Germanys energy mix for example, and while gas has a 20% share in total EU electricity generation, hydro, solar power, and wind are becoming more important in the mix. Therefore, it is possible that fears over European electricity prices can be eased materially by upcoming market reform and that we are close to peak uncertainty, we will also be watching closely as to how any reform impacts the outlook for renewables' profitability. Given the stronger than expected inflation data in Europe, and recent commentary, consensus now expects a 75bp hike from the ECB in September. While this may support the sagging Euro near-term, Europe remains all about energy.

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The Beyond the near-term issues this year's energy crisis has caused it has marked an inflection point for the Hydrogen sector, on top of the EU's repower programme in May, which set a target of 10mt of domestic renewable hydrogen production by 2030 and a further 10mt of imports. The Inflation Reduction Act in the US includes the largest hydrogen subsides we have seen globally to date - the new production tax credit is a game changer, pushing the breakeven of green hydrogen well below the key $2/kg level viewed as an important level to allow adoption at scale.

The issues facing the UK economy are as challenging as elsewhere, if not more, while some of the proposed responses or lack thereof - Liz Truss ruled out introducing any new taxes or rationing of energy this winter, while the BoE will potentially be stripped of its independence – stretch credulity. The UK's current account deficit continues to widen, of course Brexit doesn't help, while the budget deficit is large and set go grow larger, which will strain the current account further in the absence of increased saving from either households or corporates. A ballooning twin deficit, a large government debt bill coming due and a question over central bank independence is, to say the least, an unappealing cocktail for foreign capital and should lead to a weaker sterling and gilt market.

Poor liquidity is driving outsized moves in the oil market, initially an overshoot to the upside and then prices faded as it became obvious that there was no structural deficit, Russian oil continued to flow (and it is not certain that there is real political appetite for the formal EU embargo next year to cause a material supply reduction) and focus shifted to demand side risks and a potential Iran deal. While prices could overshoot on the way down as they did on the way up, recent Saudi comments and a minuscule quota increase for September on top of higher gas-to-oil switching demand mean it would be surprising to see a sustained move lower from here.

Positioning and Outlook

Despite the bearish narrative in the media and sell side, if earnings hold up, which, at least for companies with structural tailwinds such as decarbonisation or digitalisation seems likely (particularly as easing inflation will support margins), then many equites have already de-rated to multiples that are extremely attractive, in particular high-quality names, durable growth names, recent interest from activist investors highlighting some of these opportunities.

On top of the issues in China (property, Covid) we have outlined previously, the UK stands out as another region of outsized risks.

The funds had a disappointing end to the month. The MMA70/Managed fund was down 3.9%, while the MMA30 and MMA50 returned -3.2% and -3.4% respectively.

As for positioning we remain close to the top end of our growth allocation and are overweight US equities, but we are underweight the US dollar. We have reopened some positions in Europe, where valuations in some quality growth European names appear to more than reflect the near-term risks. Our hedges sit in broad index options and UK equities, having closed our Hong Kong hedge prior to the recent bounce on the back of renewed policy efforts and extreme positioning.

WARNING: Past performance is not a reliable guide to future performance.

WARNING: The value of your investment may go down as well as up.

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