CAMBRIDGE
INVESTMENTS LIMITED

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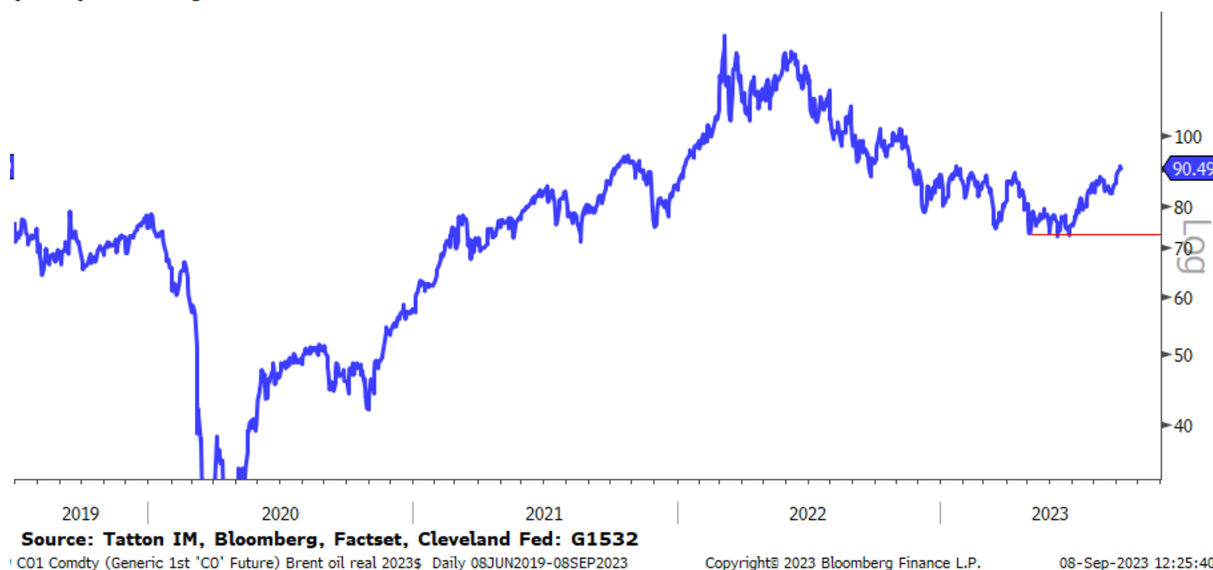
Energy in focus - oil prices up and an ill wind for renewables

Markets have been generally quiet at the start of September, but energy is again becoming an issue for equity and credit markets. Oil prices have risen since the start of the summer, with Brent crude having bounced along a bottom of $73 per barrel for the first half of 2023.



Compared to the wild swings of 2019 to 2022, it doesn't feel like much, and it has only affected market-based inflation expectations marginally. However, it has been a factor in pushing bond yields back above 4.2% in the US and German yields to 2.6%.

For Europe and for the UK, we are affected more by the swings in natural gas and electricity prices, both of which rose in August, supposedly because of strikes by liquid natural gas workers in Australia. However, much of the rise in near-term prices is driven by the seasonal variation in prices, with the passage into autumn meaning the nearer contracts now cover cooler months.

The 'inflation is over' narrative has been running for some time and appears to have stopped having an impact on bond yields some time ago. Now, the question for investors revolves around the reasons for a pick-up in oil prices. Is it just about a supply squeeze? If OPEC+ is manipulating prices higher but nothing else is changing, demand will swing down and there will be little inflation impact. Central banks will do what they have done in the past and pretty much ignore it.

But is it also an increase in global demand? After the previous week's somewhat negative economic data, last week painted a rosier picture, especially in the US. The Institute of Supply Management's diffusion indices were much better than expected across the board, rising to more positive levels against the expectation of falls to tepid levels.

In addition, China has continued to roll out policy announcements which suggest quite a marked response to the slowdown, albeit with a focus on detailed monetary easing and macro-prudential policies rather than on actual government spending.

Chinese export numbers have started to improve – possibly because of better global final demand, and possibly because stocks have been run down after having been overly built up when supply chains were at risk of disruption. China also appears to have run down some of their own stocks of inputs, so there are some signs of a pick-up in imports. The government will be looking for the turn in the external conditions to add to their internal policy measures. A meaningful rise to consumer confidence would boost not only goods and services, but bring housing market stability. The timing would be good as September and October are usually strong months for housing transactions in China.

The rise in oil prices is not enough to seriously create disturbance by itself, but US government bond yield levels are close enough to their recent highs to suggest a build-up of market tension.

In a sense, the risks for government bonds are higher because risks are lower elsewhere. Credit spreads rose slightly on the week but the extra return from higher coupons allows higher yielding bonds to outperform. The chart below shows how equity and higher credit risk have moved closely with each other and that their returns have been positive while government bonds have fallen back:

The improvement in risk appetite has spurred a flood of both equity and bond issuance in the US, although this is less apparent in Europe and the UK. Part of the reason, of course, is that companies we once thought of as domestic now see that US investors are offering them a lower cost of capital.

Returning to energy, no offshore wind projects won contracts in this year's annual auction for government subsidies last week, a significant setback for increasing capacity to 50 gigawatts by 2030. The *Financial Times* reported that Keith Anderson, chief executive of offshore wind developer Scottish Power, said the "economics simply did not stack up" and the results were a "wake-up call for the government".

It's not just the UK. There has been a marked change in sentiment towards the developed world's renewable energy companies. Orsted, (previously Danish Oil and Natural Gas) which is a leading player in wind power development, announced it was seriously considering abandoning its US wind power development projects unless the US government guarantees more support.

The Biden administration's clean-energy subsidy programme, which is part of the Inflation Reduction Act (IRA) is targeting wind electricity generation to go from nothing to 30 gigawatts by 2030. But developers needed to ensure that most components are US-made to take full advantage of the incentives, and that's proving hard to achieve.

Bloomberg reports that the firm "had a turbulent few months, with supply-chain glitches and soaring interest rates… Shares fell 8.3% last Tuesday, bringing the year-to-date decline to 37%".

Offshore farms may be critical to environmental goals but are capital and labour-intensive. Mads Nipper, Chief Executive of Orsted said that future projects need consumer prices for energy to increase. He said. "And if they don't, neither we nor any of our colleagues are going to build more offshore. It's very simple", sounding just like Keith Anderson.

At the same time, input costs have shot higher, partly because of the large size of the IRA. Similar large projects run by Vattenfall AB and Iberdrola SA have also been scrapped. This is putting some supply chain companies under substantial pressure.

The *Wall Street Journal* ran a sniffy opinion piece saying how government-led programmes like the IRA are a terrible idea, and that the companies involved have already received vast amounts of payouts. Of course, the WSJ is in the climate-change agnostic camp.

But they do have a point. Despite the IRA's enormous size and currently positive impact on US growth, if there is no political capacity to follow through in the face of difficulties, the wider environmental aims will not be achieved. Indeed, it may lead to the thought that they are unachievable, especially when its opponents are so numerous.

And one of the potentially difficult consequences is that the companies that now face problems are the ones widely owned by climate-change-focused ESG investors. Many recognise that their ESG principles are more important than any near-term investment return problems, but many also thought that the tide of history would ensure that these companies would always be winners. ESG investors, perhaps more so than others, will need to be prepared to stick it out for the long term.

August 2023 asset returns review

August was a dreary month in a few ways. Matching the UK's below-average temperatures, global asset market sentiment cooled into the end of summer. This translated into a 1.3% global equity drop in sterling terms, reversing a big chunk of July's gains.

The damper mood marked a change from what had been a fairly supportive environment for most of the spring and summer. Factors blamed for the pullback have been present for some time but became slightly

more visible: persistently high interest rates and a flattish global economy. Although economic data from Europe and China brought yet more disappointment, central bankers once again reaffirmed their commitment to inflation busting.

Over the month US stocks fell in dollar terms but were basically unchanged in sterling terms, thanks to the pound's slight decline against the dollar. A late rally was needed to get back flat levels too, after some mid-month volatility which saw the S&P 500 fall nearly 5% from peak to trough.

Sentiment recovered thanks to some stronger-than-expected earnings forecasts for the technology sector, as well as a mild cooling of the US labour market. Gains in the much-watched US non-farm payroll slowed, and unemployment rose to 3.8% of the available workforce (mostly because the potential workforce increased). Still, that is the highest level since early 2022. Markets hope this means lower inflation ahead, and hence an easing of interest rate pressures, but there are still signs of a shortage of workers in the American jobs markets and, as yet, the data is unlikely to change US Federal Reserve Chair Jay Powell's self-reported preference for higher interest rates. US companies and the overall economy are still strong – and the heralded 'soft landing' still looks on the cards for the world's largest economy without needing lower short-term rates. Over-excitement about the potential for lower rates has been investors' biggest pitfall this year.

The table below shows the full set of sterling index returns for August.

Asset Class	Index	August	3 Months	6 months	YTD
Equities	UK Large Cap	-2.5	1.2	-3.0	3.0
	UK Ethical Large Cap	-4.1	-1.9	-5.3	0.0
	Europe ex-UK	-2.5	1.6	0.4	8.1
	US Large Cap	-0.1	5.9	9.4	12.7
	US Technology Large Cap	-0.5	6.3	17.6	28.0
	Japan	-0.9	2.3	6.3	7.8
	Global Stocks	-1.3	4.3	5.4	9.0
	Emerging Markets	-4.7	1.2	-1.0	-0.7
Bonds	UK Gilts All Stocks	-0.4	-0.1	-2.4	-3.2
	£-Sterling Corporate Bond Index	-0.1	1.1	-0.3	1.2
	Global Aggregate Bond Index	-0.2	-0.3	1.8	2.3
Commodities	Commodity Index	2.1	13.7	2.4	-2.2
	Brent Crude Oil Price	3.2	17.0	-0.6	-4.1
	Spot Gold Price	0.9	-3.6	1.9	1.8
Inflation	UK Consumer Price Index (% Chg for period)*	-0.3	-0.3	2.4	2.9
Cash rates	SONIA 3-Month	0.4	1.2	2.2	2.7
Property	Global REITs	-1.6	1.0	-6.5	-2.8

Source: Morningstar Direct as at 31/08/23. * to end of previous month (31/07/23). All returns in GBP.

On the other end of the spectrum, Emerging Market (EM) equities were August's worst performers, with the MSCI EM index dropping 4.7% in sterling terms. China once again dominated the narrative; its economic and political disappointments have been a running theme for the year. However, the announcement of further government policy support for the ailing property sector toward the end of the month helped to shore up headline stock indices. All in all, though, foreign investors dumped around $12 billion in value of Chinese stocks in August, causing meaningful losses across wider EM indices. As we also wrote last week, headline figures disguise a fair amount of underlying variation. Indian equities actually performed better than all developed markets, thanks to its booming economy and some capital reallocation from China.

Closer to home, markets were also choppy. The UK and Eurozone both recorded stock market losses of 2.5% in sterling terms. Britain's housing market also took a hit, with Nationwide reporting a 5.3% year-on-year fall for August. The UK labour market is showing clear signs of deterioration, which – together with sharply higher mortgage rates – mean house prices could fall further into the autumn. It also means that inflation pressures continue to ease, but not as quickly as the Bank of England (BoE) would like. Policymakers tell us interest rates will stay higher for longer to squash wage pressures, despite a clearly weakening economy. It is unclear how much of this is just expectation management, though, as UK rates probably do have some room to fall in the not-too-distant future.

Europe's economic difficulties continued. Business sentiment surveys were well below expectations in August, while inflation was stubbornly high at 5.3% year-on-year. German inflation came in even higher, at 6.4% for the year to August, leading investors to bet on another rate rise from the European Central Bank (ECB) in September. This is despite dire business confidence numbers from the continent's largest economy. The manufacturing slump has now spread to the services sector, and economic bright spots are few and far between in the near term. The only real positive for Europe is that its equity valuations have not been elevated as much as those in the US – particularly after recent relative performances – and therefore stand to gain when investors start feeling confident again.

Fortunately, markets on the whole have taken these challenging conditions in their stride. Persistent inflation and a possibility that short rates will remain 'higher for longer' have rocked capital markets before; bond yields remain towards their recent highs yields and this impacts valuations in other assets like equities.

Yet, the bond price falls (the inverse of yield rises) through August were mild, considering the background conditions. In the UK, the gilts market saw overall prices fall a little more than other government bonds, but yields actually rose slightly less. The impact on the whole stock of gilts of a rise in yields is greater than for other bond markets because the average bond maturity is longer (the average time to maturity is nearly 13 years compared to less than nine years in Europe and less than eight years in the US).

The US notably saw its Fitch credit rating decline last month, but with only a small impact on its bonds. Likewise, the discussion over high long-term government debt (as we covered last week) had the potential to hurt bond markets, but investors seem not too concerned for the moment.

Oil prices bottomed in June and have been squeezing higher amid supply cuts from OPEC+ members. Crude oil dipped during mid-August but ended the month on a strong note. Wider energy prices (gas and electricity) were relatively stable after July's push higher. Industrial metals experienced a weaker trajectory

over the summer but also managed to rally somewhat into the last days. Interestingly, agricultural commodities continued to slide gently.

Certainly, oil's squeeze higher might become a concern for other asset classes as it could push up input costs and reignite an inflation spiral. But the year is progressing much better than feared, with robust company earnings and a base-effect-led down-trend in inflation.

Seasonally, September is the month least likely to be good for investors, but at least warm weather has finally reached Britain.

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11th September 2023

Global Equity Markets

Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Technical: Short Medium	Valuations: Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7450	-0.4	-0.4	→ ↘	4.1	10.7	10.3	13.3
UK FTSE 250	18422	-0.9	-0.9	→ ↘	3.6	12.4	11.1	14.5
UK FTSE All-Share	4059	-0.5	-0.5	→ ↘	4.0	10.8	10.3	13.4
UK FTSE Small	6053	-0.7	-0.7	→ ↘	5.2	7.9	5.8	12.6
France CAC 40	7227	-1.7	-1.5	→ →	3.2	12.2	11.8	14.1
Germany DAX 40	15732	-1.3	-1.2	↘ →	3.7	11.4	10.6	12.9
US Dow	34519	-1.2	+0.4	→ ↗	2.1	18.7	16.8	16.5
US S&P 500	4455	-1.8	-0.2	→ ↗	1.6	20.2	18.7	17.7
US NASDAQ comp	13768	-2.6	-1.1	→ ↗	0.8	29.4	25.6	23.1
Japan Nikkei 225	32525	-0.8	-0.9	→ ↗	1.9	18.6	17.8	16.8
World Bloomberg	1579	-1.8	-0.3	↗ ↗	2.2	14.4	14.0	13.8
China mainland	3740	-1.4	-1.3	→ ↗	2.0	17.7	16.7	16.4
Emerging Bloomberg	1094	-1.5	+0.1	→ ↘	2.6	12.3	11.1	12.1

Top 6 Gainers

Company	%1W
RELX	+5.3
Pearson	+4.7
Centrica	+4.5
Sage	+4.2
Weir	+3.5
BP	+3.0

Bottom 6 Decliners

Company	%1W
Smurfit Kappa	-9.3
Prudential	-7.8
DS Smith	-7.5
Ocado	-6.9
Ashtead	-6.5
Croda International	-6.3

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.43	+0.07
UK Govt 15yr Gilt	+4.67	+0.08
US Govt 10yr Treasury	+4.22	+0.12
France Govt 10yr OAT	+3.13	+0.12
Germany Govt 10yr Bund	+2.60	+0.10
Japan Govt 20yr JGB	+1.40	+0.05

Currencies

Pair	last	%1W
USD per GBP	1.249	-1.6
GBP per EUR	0.858	+0.1
USD per EUR	1.072	-1.4
JPY per USD	147.47	+1.8
CNY per USD	7.348	+1.4
USD per Bitcoin	25,870	-0.6

Commodities

Cmdty	last	%1W
Oil Brent $:bl	90.27	+2.7
Gold $:oz	1922.7	-1.3
Silver $:oz	22.99	-6.9
Copper $:lb	368.30	-2.4
Alumnm $:mt	2156.5	-0.8
S&P crops	248.99	-0.5

UK Mortgage Rate Estimates

Rates (LTV c.75%)	08-Sep	09-Aug
UK BoE base rate	5.25	5.25
2yr fixed	6.31	6.25
3yr fixed	6.04	5.94
5yr fixed	5.64	5.72
10yr fixed	5.49	5.19
Standard variable	7.85	7.60

08/09/2023
Prices taken at 2:30pm today and 2:30pm last Friday (where possible)
Bloomberg equity indices are similar to those published by MSCI
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of next 12 months earnings as forecast by analysts
Mortgage estimates are derived from sterling swaps markets

Source: Bloomberg, Factset, Reuters

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

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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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