Close Brothers
Asset Management

Investor Insights

ON THE BORDERLINE: INVESTORS NAVIGATE THE UNSETTLED GLOBAL MARKET CONDITIONS

Introduction

In this edition of Investor Insights we cover the following:

Economic poles
The outlook for growth in the world's two largest economies continues to have a profound effect on the global economy from zero-Covid but not zero-growth in China and the charge of the 'hike' brigade in the US.

The global energy crunch
With a renewed focus on energy availability in Europe, gas prices at record highs and the drive for net-zero targets, not forgetting the Russia and Ukraine conflict, Energy has become a big issue.

The metaverse
Technological transformation remains a key long-term growth theme.
The metaverse is becoming a key investment theme for businesses as well as investors. Discover more on where virtual reality becomes, reality.

INVESTOR INSIGHTS

Two economic poles – the US and China

The outlook for growth in the world's two largest economies continues to have a profound effect on the global economy.

CHINA, ZERO-COVID BUT NOT ZERO-GROWTH

China is currently facing a wave of infections of the omicron variant of the coronavirus, and social restrictions are taking a toll on the economy. Since the early days of the pandemic, China has adopted a 'zero-Covid' policy, seeking to eliminate cases by employing stringent social restrictions in response to even a few cases. While this has kept cases low and contained outbreaks, it has also meant frequent and far-reaching disruption to the manufacturing and service economy.

Given the heavy burden on the economy of these measures, policy makers were testing lighter disease control methods, and there was some hope that China may be stepping away from 'zero-Covid' policies. However, a cluster of cases that started in Tianjin had taken hold of Shanghai by April, overwhelming contact-tracing capacity and requiring a broad lockdown. Many businesses did introduce 'closed-loop' working practices, whereby workers live in their work premises, but Shanghai's industrial output still fell by 7.5% year on year in April. New cases in Shanghai are now in decline, and re-opening is underway. While cases have increased in Beijing, an early and aggressive policy response appears to have contained cases.

While the easing of restrictions in Shanghai is positive news for China's economy, for as long as Beijing sticks to the 'zero-Covid' playbook, there is a risk that a new surge could hit the economy. Officials have acknowledged that 'zero-Covid' is not a permanent policy, but it is unlikely to be abandoned until the autumn for both political and practical reasons. Relaxing controls will require broader vaccination, which takes time. Officials are also reportedly anxious to avoid a further outbreak before the 20th National Congress of the Chinese Communist Party, taking place in October or November, at which Premier Xi Jinping is expected to renew and strengthen his leadership position.

Given the outlook for health policy, it is difficult to see how officials in Beijing can meet 2022's 5.5% GDP target, and the longer social restrictions remain in place, the greater the challenge. The current health crisis also comes in the wake of a raft of regulatory tightening in 2021, which continues to weigh heavily on the real estate sector. Forecasters have steadily been revising down growth forecasts but officials continue to introduce policies to support the economy. Regulatory tightening appears to have reached its limit, and real estate regulation has been relaxed, along with rules targeting the high tech 'platform economy'. Broader monetary and fiscal policy has also moved to a more accommodative stance, a policy made possible by the fact that inflation is still relatively low in China, due to the weak economy. Fiscal support includes the frontloading of government funding for infrastructure projects, which will face a lower financial threshold for approval.

While policy support should boost growth, the health situation continues to have a big impact on growth. We expect growth to improve in 2023, but are prepared for weakness to persist in 2022.

THE US – THE CHARGE OF THE 'HIKE' BRIGADE

2022 got off to a rocky start in the US, with a surge in coronavirus infections. However, higher vaccination rates and a health code tolerant of high cases and hospitalisations meant this had a shorter and shallower impact on the economy. Growth in the first quarter was -1.5% quarter-on-quarter annualised, but consumption spending was resilient and unemployment continues to fall.

The US labour market has been extremely strong year to date, with almost twice as many job vacancies as unemployed workers, and 65% more openings than before the pandemic. The tight labour market is encouraging movement between firms, boosting wage growth as competition for workers is high. Average hourly earnings growth is above 5%, and higher for job switchers.

We expect growth to improve in 2023, but are prepared for weakness to persist in 2022.

The current tightness of the labour market has given the US Federal Reserve ample reason to tighten monetary policy. The Federal Open Markets Committee has voted for two hikes so far – one of 0.25% and one of 0.50%, taking rates to 1%, and further hikes are expected. The Fed will also begin to shrink its balance sheet by selling the stock of treasuries and mortgage backed securities it holds. All in all, these measures are expected to have a cooling effect on the economy.

High inflation is also likely to cool the economy. As well as strength in the domestic US economy, inflation has been pushed up by high global prices, including energy. While wage growth is strong in the US, inflation is higher, reaching 8.5% year-on-year in March and 8.3% in April.

As a result, even with fast wage growth, real incomes are shrinking. This is likely to crimp consumer spending, though the buoyant labour market should give consumers confidence to run down savings or take on debt to maintain spending power.

High input and labour costs also impact businesses, who must pass on price increases or sacrifice margins. While margins are high on a historical basis, we expect businesses less able to pass on pricing to trim costs where they can in order to protect margins, with a growing wage bill likely to attract scrutiny. Given the current extraordinary tightness in the labour market, this should cool the economy rather than undermining it.

While inflation is currently high and the path of energy prices is somewhat uncertain, we expect headline inflation may already be falling, as the 'anniversary effect' begins to make year-on-year price comparisons more demanding.

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The global energy crunch

With a renewed focus on energy availability in Europe, gas prices at record highs and the drive for net-zero targets, not forgetting the Russia and Ukraine conflict, Energy has become a big issue.

CBAM's Investment Officer, Isabel Albarran recently met with Alejandro Velez, Senior Equity Analyst, to discuss the energy outlook.

Isabel Albarran,
Investment Officer

Alejandro Velez,
Senior Equity Analyst

Isabel Albarran (IA): In the last edition of Investor Insights we looked at the energy gap that was forming. Can you remind us what the causes were.

Alejandro Valez (AV): Global energy demand should grow at about 2% per year over the next decade but we won't have enough capacity to meet that. On top of this, we need to cut fossil fuel usage to meet the 2050 goal of reaching net-zero emissions but 80% of current global supply comes from fossil fuels. Given the capital intensity of renewable power compared to fossil fuel power, renewables are not an immediate or obvious solution. Plus energy policies has starved fossil fuels of capital, exacerbating shortages.

IA: How has the Russian invasion of Ukraine changed the dynamics?

AV: In short it makes a bad situation worse. Europe still needs a lot of gas and since summer 2021, European gas prices have been at record highs.

The Russian invasion has pushed gas prices even higher. Europe has woken up to the fact that Russia is their largest energy trading partner with almost 35% of European energy coming from Russia. The invasion has been a significant shock and the consequences will be felt for quite some time.

IA: What are those consequences going to be?

AV: There are many sanctions being imposed on Russia. Commodity exports are not yet included in these sanctions, however Europe has realised the need to cut the dependency on Russian gas imports, RePowerEU is the plan that provides the roadmap to achieve this. It calls for a 65% reduction of natural gas imports from Russia into the EU by the end of 2022 and a total elimination of these imports by the end of the decade.

The global energy crunch

The world's demand for energy is huge and renewable energy is still in it's infancy.

We consume **170,000** terawatt-hours of energy = 170,000,000,000,000,000,000 watts of power

Fossil Fuels makes up **80%** of demand

Energy consumption risen by **12%** over the last decade

It would take **22m** wind turbines to meet all current energy needs - a wind farm the size of Brazil

$300bn current global investment in renewable energy...

...to replace ONE unit of fossil fuel with ONE unit of renewable energy, takes **25 TIMES** the capital

IA: That's a very ambitious target. How is it going to be achieved?

AV: The plan calls for an increase of LNG imports from non-European and non-Russian countries, an increase of pipeline gas from Norway, North Africa and the Mediterranean, and an increase in efficiency to reduce demand, accelerating the deployment of renewables and increase local biomethane production.

IA: It's quite a complicated plan with a lot of different components. Is it workable?

AV: It could be but it depends on what sacrifices governments are willing to make because the actual cost could be quite high.

IA: Thinking about net-zero targets, obviously the energy debate has shifted from meeting those targets to meeting energy demand requirements. How has the outlook for net-zero changed?

AV: There's been a reintroduction of fossil fuel subsidies in countries such as Spain, Portugal, Germany, France and Italy so it's likely that Europe, as a whole, will be emitting more carbon next year and probably for the next few years.

I think pragmatism needs to prevail because the focus has to be on having enough energy and making it affordable so that well-being is not compromised. However, the commitment to net-zero remains and in the RePowerEU plan there is still an acceleration in investing in renewables and the phasing out of coal by 2030.

IA: With that acceleration in renewables investment there's presumably going to be an acceleration in the demand for the raw materials used to build that infrastructure. Are those resources available?

AV: Renewables are very capital intensive. To get one gigawatt of power from renewables compared to one gigawatt from fossil fuel, you need to invest 25 times the capital.

For example, a 100 MW wind farm requires around 30,000 tonnes of iron ore to produce the steel needed and 50,000 tonnes of concrete for the foundations, plus 900 tonnes of non-recyclable plastics. Europe's indigenous production of some of these materials is not enough. So one consequence of reducing Russian gas demand and dependency may mean that Europe will become more dependent on other non-European countries resources that will go into electrical vehicle batteries, solar panels and wind turbines.

Rising rates, softer growth

WHAT IS THE OUTLOOK FOR GROWTH IN 2022?

Global growth faces a number of challenges in 2022. Weaker growth in China provides less support to the global economy and higher interest rates in the US, coupled with dollar strength, means that the world faces a higher global interest rate. In addition, high inflation is undermining real income growth in many economies, with the potential for high energy and food prices to cause significant problems in some emerging markets especially. In Europe, reliance on Russian energy supply means that access to energy has the potential to be an issue this winter.

Reflecting these risks, global growth forecasts have been downgraded over the year to date. Nonetheless, economists continue to expect, on average, reasonable growth of 3.3% in 2022. While this is on the low side, it is by no means a recession.

There are a number of risks to this forecast, primarily in the form of policy decisions. Russia's war on Ukraine remains a key source of uncertainty, with a further escalation possible. The war may also reach a negotiated end, though we consider it likely that relations between Russia and the global west remain strained.

The outlook for Chinese growth is also uncertain. While we expect zero-Covid to end in 2022, it may not.

While the direction of US monetary policy is clear, the extent of tightening is less certain. While we expect some cooling in the economy and the labour market, domestic inflation may prove more persistent than expected, given the tightness in the labour market. Conversely, because the tightening impact of shrinking the balance sheet is unknown, it is unclear how far rates will need to rise to get on top of domestically generated inflation. This could mean that, longer term, rates rise by less than the market expects.

Year to date, tighter monetary policy has been punishing for markets, with few places to hide. Government bonds have fallen around 10% across the US, UK and Europe, as markets have repriced to reflect the probability that interest rates have further to rise.

This has also weighed on equities, chiefly regions such as the US, with a greater concentration of growth companies. These businesses derive a greater share of their current value from the expectation of earnings spanning far into the future, making them more sensitive to interest rates.

> Economists continue to expect, on average, reasonable growth of 3.3% in 2022.

In contrast, other segments of the equity market are more exposed to the health of the economy today, and downgrades to economic forecasts have weighed on these assets.

On balance, a more modest growth outlook provides less support for some cyclical sectors of the equity market, though we believe this is already reflected in prices to some degree. At the same time, the prospect, and indeed reality, of higher interest rates has put pressure on richly valued sectors of the market where future earnings growth is sensitive to discount rates. Given the outlook for growth, and the sharp re-rating that we have already seen in bonds, we are beginning to see more value in this long unloved sector.

While the prospect and indeed the reality of higher interest rates may continue to put pressure on growth stocks, the expectation of more muted growth may turn attention again to long-term growth drivers, now trading on more reasonable valuations.

The Metaverse: Where virtual reality becomes reality

Technological transformation remains a key long-term growth theme. The metaverse is becoming a key investment theme for businesses as well as investors.

WHAT IS THE METAVERSE?

The easiest way to explain the metaverse is that it's the next generation of the internet. It's a virtual three-dimensional digital environment where people can represent themselves graphically through an avatar, they can interact with each other, objects and the environment they are in.

There are similarities with computer games as both are visually rich with animated backdrops and provide an immersive experience. However, computer games are finite and although they can be elaborate, the metaverse is potentially going to be much more interoperable and connected.

WHAT CAN YOU DO IN THE METAVERSE?

If you want to jet off into space or relax on a tropical island, the metaverse can take you there. But, there are also more practical options and uses – from collaborating with colleagues in a meeting to shopping, viewing real estate plots or attending concerts.

Many large retail brands are already using the metaverse to develop brand awareness and engagement and to sell virtual garments. Many top artists have performed in the metaverse and Ed Sheeran and Dua Lipa are scheduled to perform later this year.

HOW PRODUCTS AND EXPERIENCES ARE PROTECTED IN THE METAVERSE

Virtual tags known as non-fungible tokens (NFT) protect metaverse purchases. So, if someone buys a pair of luxury digital trainers, the NFT means they are original, unique and theirs to keep.

One of the main attractions of metaverse products and experiences is that they are designed to be unique and are impossible to copy or counterfeit.

PURCHASING THINGS IN THE METAVERSE

Right now purchases are made with real money – this is a real business with money being made.

But money, as we know it today, may not necessarily be best suited to support the metaverse moving forward. There needs to be a trusted and interchangeable method of payment and many people hope that cryptocurrencies are the right solution. This is definitely an area to watch.

THE LEADING PLATFORMS

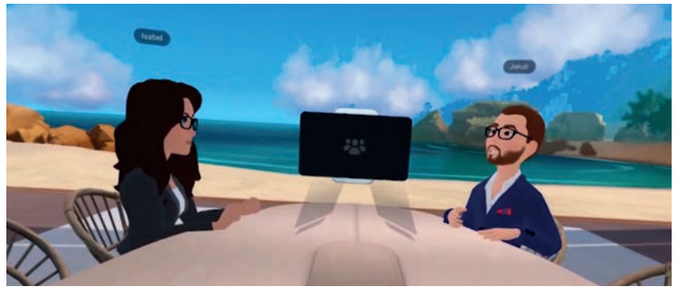
The metaverse is still in its infancy and it's too early to know how it will evolve, similarly to 30 years ago we didn't know how the Internet was going to evolve. Pre-internet tech giants such as IBM and Microsoft missed out on the Internet wave and a new generation of successful digital companies emerged - Amazon, Google and Facebook.

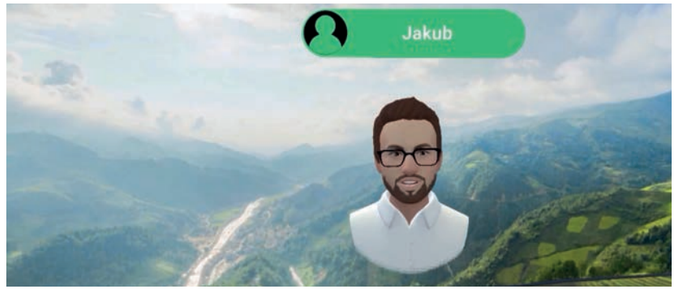
When the Internet became mobile, all eyes were on companies such as Nokia and Vodafone, but it was Apple with its iPhone, App Store and operating system, and Google with its Android operating systems, who became the gatekeepers to the mobile internet.

It is still too early to tell who is going to win the metaverse race, but it's a race worth following.

Experience the Metaverse

In our Spring Conference, our Investment Officer Isabel Albarran met Jakub Dubaniewicz, Senior Equity Analyst, to explore what the Metaverse Offers. **You can watch the conference here**





Investment implications

While we expect 2022 to be a less favourable year for growth, we do not see a recession as our base case. For investors, while the growth and inflation backdrop presents challenges, opportunities remain.

The combination of a weaker outlook for growth and higher interest rates offers less support for the broad equity market, though selective sectors and regions remain attractive. While, overall, we continue to see challenges for the fixed income sector, we are beginning to see value in some issues.

We see less support for equities closely tied to economic growth, though some sectors remain on attractive valuations. Given the prospect of higher rates, we believe it is a time for vigilance where valuation is concerned, as this could put pressure on price-to-earnings multiples, especially in growth orientated sectors. However, the shift to more stable growth and long-term GDP drivers should still support companies with structural growth advantages. We continue to believe that a number of structural changes are in play within the global economy, and that businesses exposed to these themes can make attractive investments.

So far this year we have seen turbulence in markets as they seek to grapple with a turning point in the interest rate cycle as Central Banks focus on inflation. Moments of market turbulence, when stocks in these - often richly valued sectors, are repriced lower, may present buying opportunities and it is important to maintain a longer-term investment horizon at such points of market volatility.

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