Close Brothers
Asset Management

Investor Insights

A WORLD OF WORRIES: DESPITE THE RISKS TO ASSETS, OPPORTUNITIES EMERGE FOR INVESTORS

Introduction

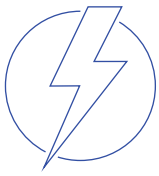
In this edition of Investor Insights we cover the following:

A world of worries: global economy

Asset markets are facing rising political risk, higher inflation, slowing growth and tightening monetary policy, but opportunities are emerging.

Investment implications: challenges and opportunities

Despite the significant challenges facing the global economy, opportunities for investors still exist and diversification is key.



Russia Ukraine conflict: the impact on energy

The conflict has compounded Europe's energy shortage crisis and made the pursuit of climate targets even more difficult. We share our insights on the energy trilemma and potential solutions.

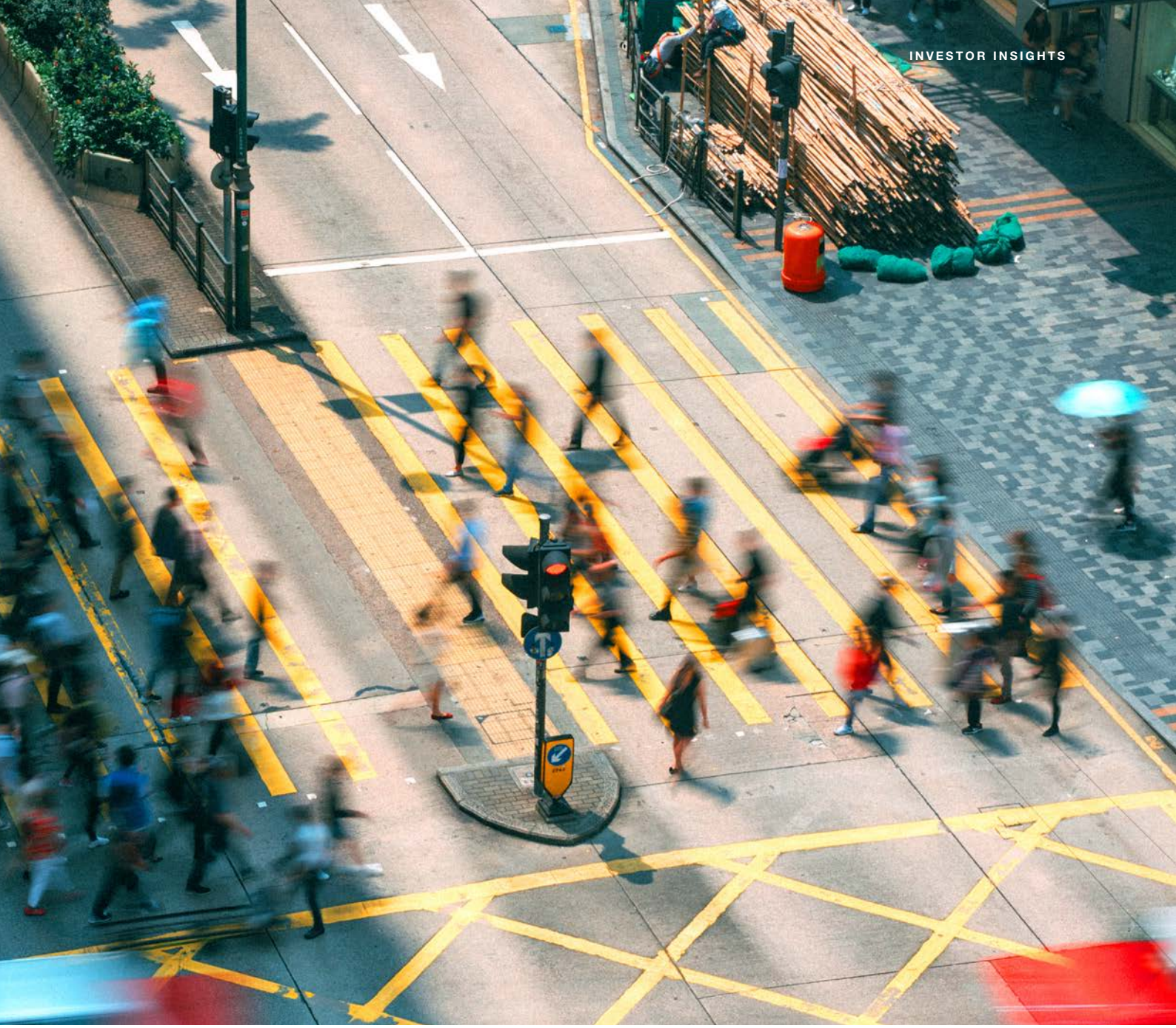
A world of worries

So far, 2022 has proved a challenging year for markets and for the global economy. Asset markets have faced rising political risk, higher inflation, slowing growth and tightening monetary policy. Against this backdrop, both equities and bonds have suffered. In this report we consider the risks to assets, and the opportunities emerging for investors.

Asset markets have faced stark declines so far in 2022. At the mid-way point of the year, the end of June, the MSCI World Global Equity Index was down more than -20% in sterling terms since the start of the year. The main developed market government bond indices also faced falls of -10-15%. Behind these declines lie a number of investor worries.

POLITICAL RISK

Russia's invasion of Ukraine has caused tragic loss of life and has stoked existing geopolitical tensions, undermining the longstanding détente between Russia and NATO countries, including those in Europe. Political uncertainty undermines investor confidence but the hostilities' economic impact has also been tangible. A combination of western sanctions, Ukrainian disruptions, and Russian disengagement has limited the flow of Russian and Ukrainian goods into the global economy. Given Russia's dominance as an exporter of energy and grains, this has caused price surges and the prospect of supply shortages, especially as winter approaches.



HIGHER INFLATION

For the first time since the Global Financial Crisis, the main developed markets central banks are facing a sustained period of high inflation. Inflation was already showing signs of strength in 2021, when easing social restrictions and the hangover of generous fiscal transfers boosted demand, butting up against a constrained supply economy.

Russia's invasion served to amplify this tightness in commodity markets, sending food and energy prices higher. These price surges have in turn encouraged workers to seek higher wages, sending labour costs higher. Employers must absorb these higher costs, squeezing profit margins, or pass them onto consumers.

TIGHTENING MONETARY POLICY

While the very-high rates of inflation we are seeing in many developed markets is mostly due to outsized moves in energy and food prices, tight labour markets, rapid wage growth and elevated inflation expectations have arguably been a source of greater concern to central banks, given the risk that these factors form a self-reinforcing wage-price spiral. Central banks across developed markets have embarked on tightening monetary policy, with more tightening expected. In time, this is likely to cool economic growth, undermining inflation.

RECESSION RISKS

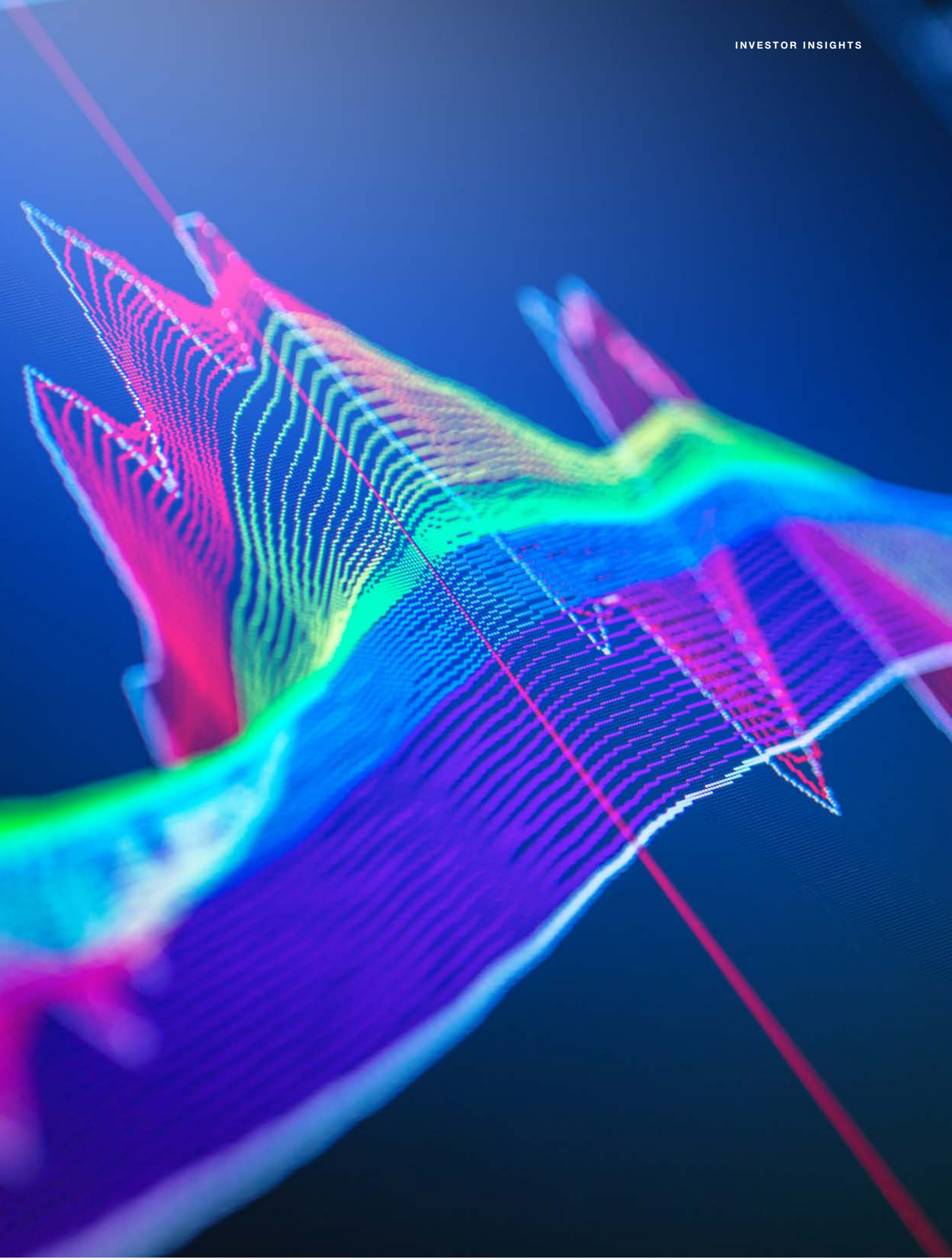
In addition to higher interest rates cooling growth, high inflation has been shrinking real incomes. While workers have sought higher wages, few will have achieved pay growth that matched the rate of inflation, leaving aggregate real pay growth negative. Given that real consumption spending moves with real income growth, consumption spending is likely to fall unless households fully supplement income by running down their savings and running up credit.

Aside from the challenges of inflation, Europe also faces the risk of a shortfall in energy this winter. Gas flows into Europe from Russia via the Nord Stream 1 pipeline have been cut, nominally due to maintenance. Europe must build gas reserves now in order to avoid a shortage this winter, which will only be possible if the pipeline comes back online very soon. An energy shortage would see government intervention in energy prices, and even rationing, with industry bearing the brunt, weighing on growth.

GLOBAL OUTLOOK

Elsewhere in the world, China continues to experience slow growth, with social restrictions and a struggling real estate market weighing on the economy. Beijing is expected to announce a more nuanced health code towards the end of the year, but in the meantime, the economy bears the scars of stringent social restrictions in recent months. In addition, weakness in the real estate sector persists, precipitated by financial reforms reintroduced in 2021. China's government has introduced sizable fiscal stimulus for infrastructure projects to boost growth in the near term, but the real estate sector still poses a risk to China's financial sector.

Europe must build gas reserves now in order to avoid a shortage this winter



Investment implications

CHALLENGES

Undoubtedly, there are a number of significant challenges facing investors and the global economy. Chief amongst these are the risk of higher interest rates and the risk of lower growth.

Higher rates

Higher interest rates undermine the value of bonds and other assets, such as equities, because of the role bonds play in their valuation. Because of this, the prospect of bond yields rising higher is weighing on markets broadly, especially assets with greater sensitivity to interest rates, such as long-dated bonds and equities with high rates of expected long-term growth.

WEAKER GROWTH

Growth forecasts indicate that GDP growth, on average, will be lower in 2022 than it was in 2021. In addition, growth forecasts have been falling as the year has progressed. Given that, in aggregate, earnings growth is connected to GDP growth, this provides a headwind to earnings growth, especially for those businesses that are sensitive to changes in GDP, in both a positive and negative direction. On the plus side, business earnings are related to nominal rather than real GDP growth. This means that, in an environment where real growth is low but inflation is high, inflation will boost nominal growth and therefore earnings.

OPPORTUNITIES

Finding an inflection point

We continue to expect interest rates to rise, and so assets may face further valuation pressure. However, markets have now priced in significant interest rate rises. This decreases the scope for more than expected tightening, and increases the scope for rates to rise by less than the market has anticipated.

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The US Federal Reserve remains a globally important rate setter. The degree of further Fed tightening, in our view, hinges on how rapidly the US economy and labour market cools. A rapid slowdown in the economy would, in time, translate into weaker labour demand, and this in turn would give the Fed more confidence that core inflation will cool.

Attractive valuations

Given that asset values have repriced lower, many assets are now trading on more attractive valuations. In the bond space, where many bonds have offered very low or negative yields for years, investors can now pick up reasonable yields. Similarly, within equities, even some companies that have attractive long term prospects are trading on much less demanding valuation multiples. While there could be continued headwinds in the near-term, many of these assets may be attractive on a longer-term basis.

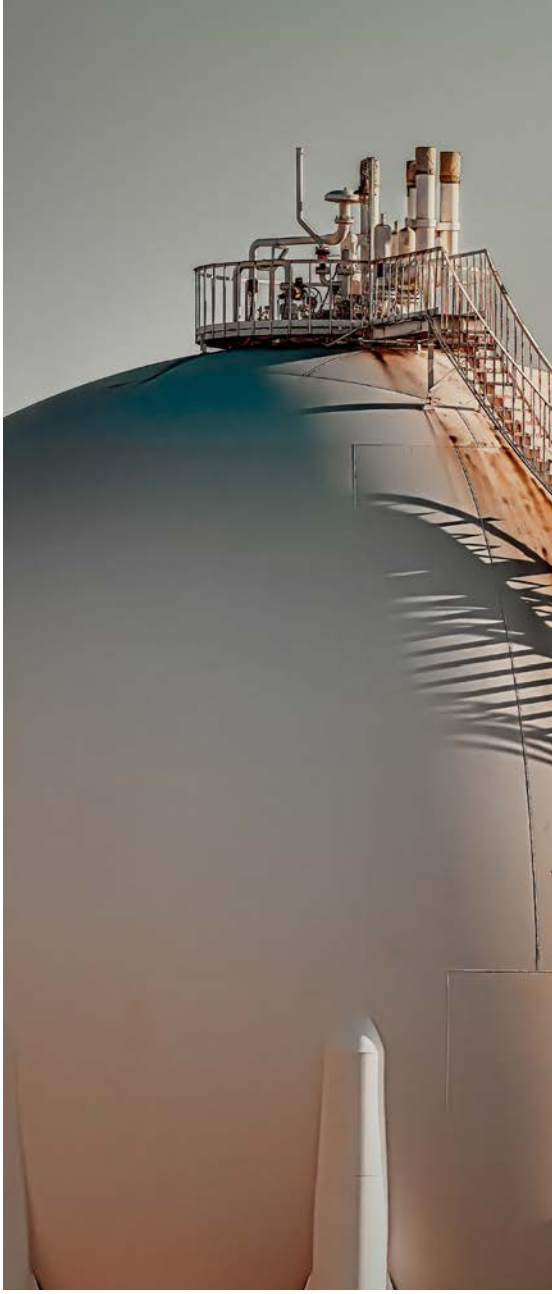
OUR VIEW

In recent months, the challenges facing the global economy have intensified. With this in mind, overall we have become more cautious in our outlook for equities, given the challenges presented by higher interest rates as well as weaker growth and geopolitical risk.

This change is most pronounced in those areas of the equity market most exposed to the global economy, including Europe and emerging markets. With bonds, we remain cautious, given the prospect of monetary policy tightening further, but we now see greater value in this space, and selective opportunities.

Diversification remains a key pillar of our investment approach and alternatives continue to play an important role in portfolio construction. Recent volatility has been broad reaching and we continue to prioritise securities with low cross-asset correlation, and attractive inflation-hedging characteristics.

As ever, we continue to focus on the long-term prospects of businesses, favouring quality companies at attractive prices. The dramatic price action we have seen in 2022 presents an opportunity for the selective investor to identify good businesses that have been brought down in value with the broader market.



Russia Ukraine conflict: the impact on energy

The conflict has compounded Europe's energy shortage crisis and made the pursuit of climate targets even more difficult. The Intergovernmental Panel on Climate Change (IPCC) is clear that an immediate reduction in fossil fuel production and use is needed to prevent irreversible damage. Global emissions are back to pre-pandemic levels, so action is critical.

Since the invasion, western countries have been distancing themselves from Russian fossil fuels and whilst there is hope this will accelerate the transition to cleaner alternatives, it isn't an easy switch. For countries with a traditionally large dependence on Russian gas, transitioning is a major issue as it takes both time and money. Affected countries, such as the UK, have turned to coal production as a short-term solution to protect energy supplies, temporarily derailing the energy transition.

Coal-fired power has increased since 2020 so the need for an energy transition has never been so acute. The shortages are causing crippling energy prices across the world.

Long-term distancing for Russian fossil fuels will have two outcomes.

Firstly, it will accelerate the energy transition to cleaner alternatives. Secondly, it will improve the energy interdependency of European countries and consequently energy security.

Coal-fired power has increased since 2020 so the need for an energy transition has never been so acute

THE ENERGY TRILEMMA: SUSTAINABILITY, SECURITY AND AFFORDABILITY

The benefits of decarbonising are greatly reduced if the security and affordability of energy isn't protected. A rapid energy transition would likely exacerbate, or put more people into energy poverty through higher prices and/or lack of access to reliable energy. This coupled with the fact that the infrastructure and solutions needed for the energy transition requires materials and labour, which can be expensive, ultimately makes energy less affordable for the end consumer.

Energy from renewables, such as wind and solar, can be less reliable than fossil fuels because of their intermittency. A sole reliance on these renewables, without sufficient energy storage capability, could therefore reduce energy security causing disruption to people's livelihoods and business operations.

However, these energy security and affordability concerns should not detract from the immediacy of climate change. The IPCC's latest report states that the world is unlikely to keep global warming below 1.5°C which creates significant consequences such as increased severe weather events and the breakdown of biological pathways. The balancing act of energy sustainability, security and affordability - 'the energy trilemma' is an ongoing debate.

COP27 will take place in Egypt in November and whilst we haven't seen any significant reductions in absolute greenhouse gas emissions, there has been an increase in commitments. As we move forward in the energy transition it is essential that we frame sustainability as a balance between environmental, social and economic factors for the long-term prosperity of people and the world.

THE ENERGY TRILEMMA: SOLUTIONS

There are numerous plans suggested by various organisations that chart how the world can reach net-zero by 2050. It's clear that the use of fossil fuels needs to decrease over time but the extent to which they do differs from plan to plan and this has wide reaching effects on energy security and affordability.

The number of industries, solutions and technologies involved in the energy transition is vast given its pervasiveness across the economy, but in order to satisfy the energy trilemma, there needs to be a focus on solutions that are economically viable, technologically ready and effective.

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In the context of finite political attention, energy shortages and inflated prices, it would be sensible for policy and sustainable finance to focus on readily available solutions, rather than those that cause unintended social or environmental harm, or are uneconomical or unproven. This includes building insulation, nature-based solutions and renewables.

In addition, the solutions considered need to take into account the continued surging demand and an increasing emissions per capita. As the world's remaining carbon budget comes under strain, we must explore offsetting solutions, as the IPCC indicates.

Nature-based solutions, including afforestation and reforestation, will be a key part of the energy transition not only because we are likely to overshoot the remaining carbon budget but because the number of net-zero commitments and the requirements for carbon-offsets continue to grow.

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