A forward view of the global economy and financial markets

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Contents

	Page
Comment: Tide Power	2
Asset Allocation	3
Markets at a Glance	4
Quick Facts	6
Current Tax Facts	6

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Tide Power

"Tides so what tides do – they Turn"
Derek Landy (Irish Author)

Source: Wikipedia

2022 has been a year that we will find hard to forget. The end of the second Elizabethan age in the UK, the first major ground conflict in Europe since 1945 and an energy crisis in the West that matches the oil crisis of the nineteen seventies. The invasion of the Ukraine directly led to an energy crisis as wholesale gas prices gas rocketed with Russia effectively cutting off gas exports to the European Union. This forced countries such as Germany to buy gas from other sources, driving prices up.

This crisis has led to a sharp increase in inflation that in turn has seen interest rates rise. In the UK the Government is spending billions on a support package to both households and businesses following the rise in the cost of utilities to unaffordable levels. The cost of transportation and storage also rose which inevitably forced the price of goods and services up.

In spite of the UK not relying on Russian gas or oil to anything like the extent of Germany or Italy, the UK has still seen its cost of energy rise just as much. In the last twenty years the UK has made great strides to diversify its energy production away from fossil fuels by investing in wind and solar power but the sun does not always shine and wind does not always blow. In August and September 2021 calm weather caused wind energy generation to 60% below the seasonal average.

However, the UK does have a massive coastline with two totally predictable high and low tides each day. Harnessing the power of tides would seem to be the best long-term solution to reducing our reliance on energy generated by fossil fuels. Water is hundreds of times denser than air, which makes tidal energy more powerful than wind. It is more efficient than wind or solar energy due to its relatively density and produces no greenhouse gasses or other waste, making it an attractive energy source.

So why hasn't the Government investment in tidal power? The stated disadvantages are the high costs of construction, limited locations, a negative impact on marine life forms and the variable intensity of sea waves. Against this, the clear advantages are that tidal power is renewable and reliable. It is certainly environmentally friendly and it is predictable and easy to maintain.

Building large barrages and then tunneling water flow to power turbines is expensive and would block seaways but we now have a better solution which is to use tidal streams with sunk turbines that work in much the same way as wind turbines. So far tidal stream turbines have been installed on the seabed but some new designs connect turbines to a floating structure which makes it much easier to maintain.

The construction of tidal stream power projects has been delayed as it has to be established that the turbines will not significantly harm the environment. A recent study by Aquatic Conservation in the Pentland Firth showed that porpoises swam away from the turbine blades.

The cost of nuclear power stations and the unreliability of wind and solar should make the development of tidal stream power a no brainer for the UK Government as a vital source of green energy. At the moment government funding rules dictate that tidal stream projects must bid for support against projects using cheaper technologies that have less potential to reduce costs in the future. Floating offshore wind farms would face a similar dilemma, but have been guaranteed separate funding by the government, giving it a route to market and cost reduction. No surprise then that the government supports a short-term option that can be delivered quickly so that they can boast about their environmental credentials rather than going for a better lasting solution that will save huge amounts of money over the long term.

Richard Harper
Head of Asset Allocation
GHC Capital Markets Limited

Asset Allocation

In which **Tim Harris**, the Chair of our Asset Allocation Committee, describes the factors influencing our latest Asset Allocation decisions

Markets are pricing that interest rates will fall back in the second half of 2023

The recent performance of markets reflects the hope that better news is around the corner. They prefer to ignore the data that the global economy is in a downshift in growth and facing prolonged high-interest rates, they discount the hope that interest rates will peak within the next six months, central banks will apply themselves to loosening monetary policy, and growth will resume. Markets interpreted Fed Chairman Powell's latest speech as evidence that the Fed was willing to slow the pace of rate tightening and move to a pause in rate hikes. Chair Powell's 'Fed speak' has not changed the fact that the Fed is concerned that interest rates are still a long way short of a level that would ordinarily lead to cutting.

It is more likely that rates will peak and stay a high level for much of 2023

Global inflation may have peaked, but there is little comfort for central bankers that inflation will reach their much lower targets anytime soon. In the US, the real Fed funds rate remains well below the rate of inflation. Central banks usually only tame inflation when policy interest rates are above the inflation rate. It is wishful thinking that central banks can tame inflation with a few rate increases that do not create slack in the economy. The US unemployment rate is at a 30-year low of 3.7%, which is effectively full employment. The lack of slack in the labour market is pushing wages higher; the US labour report showed average hourly wage earnings growing at 5.1% - a significant surprise to the upside versus market expectations.

The Fed's comments have been fairly consistent of late, expressing the view that rates will move higher and stay at that level for longer. The market begs to differ, pricing that the Fed funds rate would peak below 5% and that policy rates would be on their way down through the second half of 2023. By contrast, policy rates in the Eurozone are expected to peak in the middle of next year below 3%, but stay there for the balance of the year. Rates in the UK are expected to reach 4%. Hence the dollar has come under pressure, unwinding most of its extraordinary summer gains on a trade-weighted basis. A 10% rise in the gold price has accompanied profit-taking in the dollar. Gold is a valuable asset in dollar cash management. Switching from dollar cash to gold at the peak of the dollar's trade-weighted performance would have been a valuable source of added value – easily said in hindsight, but food for thought if we see further spikes in the dollar in coming months.

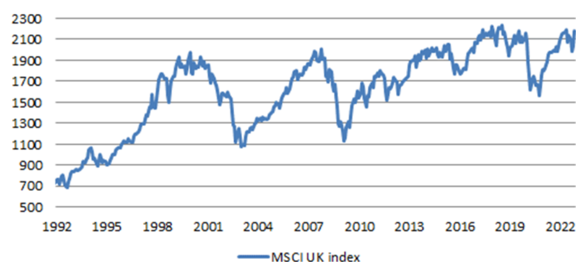
As slack is created in the global economy, this will put corporate earnings forecasts at risk

Central banks will only conquer inflation if rises in interest rates dampen global economic activity. Recent business surveys are pointing to a sharp slowdown through November. JPMorgan's global manufacturing output survey has dropped to "a level rarely seen outside of a recession". Analysts' US corporate profits forecasts rolled over in July and have been on a downward trajectory ever since. In November analysts cut their aggregate earnings for the 500 largest US companies to a level marginally below where we started the year. In the coming months, we expect to see a material fall in analysts' earnings estimates. Investors should be preparing themselves for a 10%-plus drop in profits in 2023 as a typical outcome during a slump in economic growth.

Redeployment of cash should start with bonds, where valuations are closer to reasonable

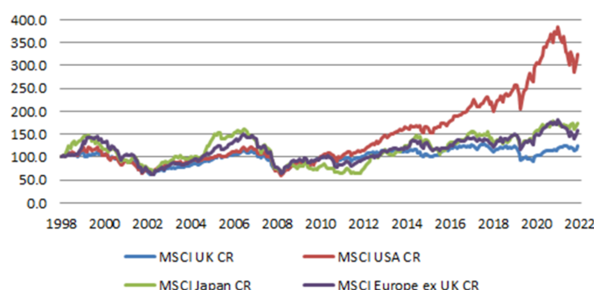
We are near a point when inflation is peaking. The UK's benchmark index is very volatile. Its defence is a cheap valuation after five years of relative underperformance and we keep an average weighting to UK equities in our portfolios. Some Asian equity markets are beginning to look more interesting following a tough year. China is now relaxing some of the more draconian restrictions on the mobility of citizens, which led to a 29% rally in Hong Kong's index in November. The challenge will be to see how the authorities deal with the very likely sharp rise in COVID cases. China has been a drag on global trade this year. Better times in 2023 would be a boon for investors.

Markets at a glance



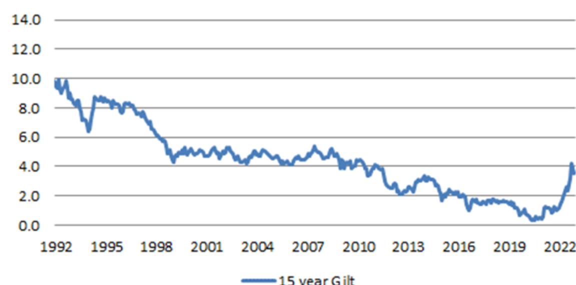
Source: Lipper for Investment Management

The UK market remains one of the better international equity market performers, being flat year-to-date after 3-4 years of underperformance against peers. This is despite the political volatility of Westminster. The market's relatively modest valuation and the resilient performance of leading international companies have allowed some relative catch up. Despite a strong earnings and cashflow recovery from the lows of the COVID crisis, inflation remains high and rates will not fall for some time. This raises investment hurdle rates, that will keep pressure on valuations, which may restrict gains in the near term.



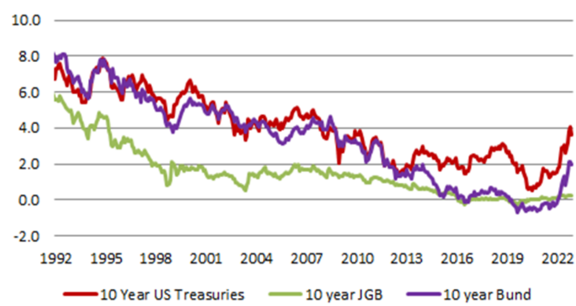
Source: Lipper for Investment Management

World equity markets have made modest rallies after a tough third quarter. In particular, China's revised COVID-policy has encouraged a revival across Asia. The challenge will be to see how the authorities deal with a likely sharp rise in COVID cases. Developed market central banks are now further down the monetary tightening route, which has held back equity valuations. However, we expect to see a material fall in analysts' earnings estimates in the coming months. For example, investors should prepare for a 10% drop in US profits in 2023 as a typical outcome during a slump in economic growth.



Source: Lipper for Investment Management

10-year gilt yields have rallied strongly from a peak above 4.0% to a recent 3.1%. Much of this is due to a restoration of government credibility after the infamous Kwarteng mini-Budget. However, all the major credit rating agencies have UK government debt on negative watch. Inflation fears still concern markets. These reflect shortages of materials and wage pressures, given labour shortages in sectors, such as retail and hospitality. Real gilt yields are negative, given high headline and core inflation. The Bank of England has promised a significant monetary policy response to recent fiscal expansion.



Source: Infront

Inflation may be near peaking, but government bond yields have typically peaked only shortly before the end of central bank tightening cycles and we expect most major central banks to continue hiking rates over at least the next 6 months. The increase in government bond yields, as well as the threat of slowing global economic growth, will keep corporate bonds, under pressure, although default experience is currently relatively modest. Bond markets will only sustainably turn a corner when tightening cycles draw to a close in 2023.

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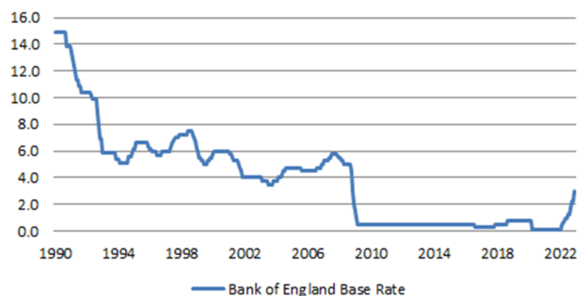
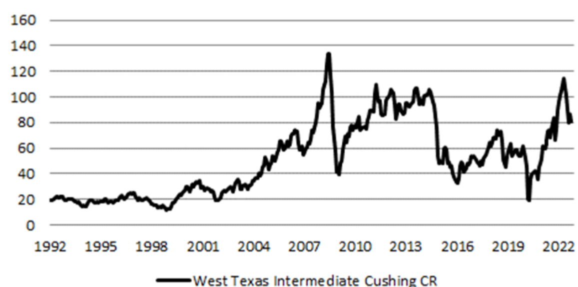


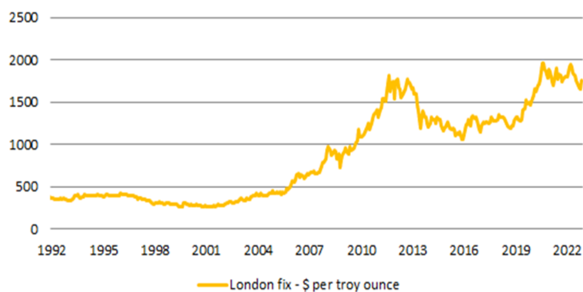
Source: Lipper for Investment Management

We forecast that the Bank of England will raise interest rates to a peak of 4.5% next year. Public sector strikes and pay demands risk inflation becoming rooted in the UK economy. The Bank of England may see the need to engineer an economic slowdown at a time of a tight labour market and high input prices. The Government's revised fiscal policy seems more in keeping with the Bank's philosophy than of recent. We expect the unemployment rate to remain low, wage growth to be high and the recent increases in prices to prove sticky. These will combine to keep inflation pressures elevated for a while and keep the Bank of England on a tightening tack.



Source: Lipper for Investment Management

Recent oil price declines are a result of market concerns about global economic growth, as well as COVID-related lockdowns in China that have reduced China's oil demand. Brent crude oil spot prices are on pace to average $101 per barrel in 2022. We expect that falling global inventories of oil in early 2023 will push Brent prices back above $90 per barrel in the new year. Although we expect some downward oil price pressure could emerge in the second half of 2023, based on rising oil inventories, that pressure will likely be balanced by the ongoing possibility of further supply disruptions or production growth.



Source: Lipper for Investment Management

Sentiment for gold investment has risen over the past two months, on higher inflation and increasing geopolitical risks surrounding Russia's invasion of Ukraine. After falling from a March high of $2,039 per oz, the price has recently rallied by 10% to exceed $1,800 per oz mark. Gold is a valuable asset in dollar cash management and that currency's recent weakness has fed into a stronger gold price. With global inflation still at highs, gold remains a source of real value. Despite macroeconomic and inflationary pressures, the global mined supply of gold and physical demand appear to be robust and in balance out to 2026.

Note that where an MSCI Index has been used for illustration. This has been sourced with permission from MSCI Inc.

Quick facts

ISA Allowance 2022/2023	Stocks & Shares ISA Cash ISA Junior ISA	£20,000 £20,000 £9,000
Pension Allowance 2022/2023	The limit is the greater of £3,600 and 100% of salary, subject to the annual allowance of £40,000 (unless money has been accessed through flexi drawdown in which case the annual allowance is limited to £4,000).	

Tax facts

Income Tax	Personal Allowance 2022/2023	Up to £12,570
	Basic Rate @ 20%	£12,571 to £50,270
	Higher Rate @ 40%	£50,271 to £150,000
	Additional Rate @ 45%	Over £150,000
	Married couple's allowance:	Minimum £3,530
	Older spouse born before 6 April 1935	Maximum £9,125
		Up to 10% of the appropriate Min/Max
Capital Gains Tax	Annual Exemption - Individuals	£12,300
	Basic Rate tax band (residential property)	18%
	Basic Rate tax band (other assets)	10%
	Higher Rate tax band (residential property)	28%
	Higher Rate tax band (other assets)	20%
	Business Asset Disposal Relief	10%
	Business Asset Disposal Relief limit of gains	£1,000,000
Inheritance Tax	Threshold up to £325,000	Nil
	Over £325,000	40%
Corporation Tax	Full Rate	19%
	Small Companies Rate (SCR)	19%

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