A forward view of the global economy and financial markets

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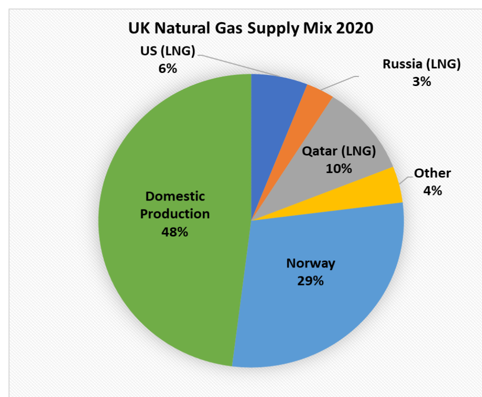
Ofgem and Household Energy Bills

"We believe that electricity exists, because the electric company keeps sending us bills for it, but we cannot figure out how it travels inside wires."
Dave Barry (US Journalist)

Source: Wikipedia

Millions of households in the UK received a shock when they saw that their electricity or gas bills were going through the roof. Ofgem (the Industry Regulator) increased the price cap by 54%, which in large measure reflects the increase in the wholesale price of gas. The war in the Ukraine has led to supplies of gas from Russia being much reduced while at the same time demand for gas has risen following the economic recovery post pandemic. The UK imports very little gas directly from Russia as can be seen from the pie chart below and only 37% of our electricity is produced from gas fired power stations. 42% of our electricity comes from low-carbon hydro, solar, wind and nuclear stations and an additional 7% from biomass, 2% from coal and the rest being imported.

So you may ask, why have our bills gone up in line with world wholesale gas prices?



Source: Graph by the US Energy Information Administration, based on data from Digest of UK Energy Statistics

The price we pay for electricity has to cover a number of costs. These include the cost of buying gas, supplying gas through pipes and electricity through wires and there are then a number of government policies designed to support vulnerable households and to reduce carbon emissions.

Wholesale spot market gas prices are for next day delivery whereas prices in the forward market allow companies to fix their buying costs months or even years ahead. The price cap for households on pre-payment metres was introduced in April 2017 and in 2019 for standard variable tariffs. These cover approximately 15 million households in the UK and Ofgem sets the maximum amount that companies can charge every six months with a two-month advance warning period.

The cost of delivering energy has risen as gas is burned in compressors, electricity is lost as heat as it travels along wires and there are balancing costs as power stations adjust output to keep the system stable. All these costs are linked to the price of gas so unless we change our system of power delivery we are subject to the vagaries of the wholesale price of gas.

So, what can be done to help households?

The now previous Chancellor, Rishi Sunak decided to give out cash to poorer households. This policy is inflationary and most households will spend the money on immediate needs rather than putting it aside for their energy bills. Another way of helping households might be to enforce a price freeze on energy bills in October with the government dealing directly with the energy companies. This would certainly be a better option in terms of inflation and it will mean that households will not be faced with another crippling rise in their energy bills just before the onset of winter.

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

The Federal Reserve means business

Just when the markets were running with the idea of a less aggressive pace of Fed tightening, publication of the minutes from the latest Federal Reserve policy meeting spooked them. In the Fed's words, "Many participants judged that a significant risk now facing the committee was that elevated inflation could become entrenched if the public began to question the resolve of the committee to adjust the stance of policy as warranted". They also made it clear that the anchoring of inflation expectations is more important than a potential slowdown in economic activity. Officials "recognised that policy firming could slow the pace of economic growth for a time, but they saw the return of inflation to 2% as critical to achieving maximum employment on a sustained basis".

The June US inflation report is showing headline inflation of 9.1%, the highest since 1981. The Fed seems therefore determined to get ahead of the curve and tighten policy to a point where it slows the US economy. In all likelihood, the next policy meeting will deliver a further 75 basis points increase in the Fed funds rate. The market has recently upped its expectation of future Fed funds rate increase by 25 basis points for the period to March 2023 and the US 10-year government bond yield has recently breached 3.0%. Despite the Federal Reserve's hawkish tones, there has actually been a recent hint of risk-on sentiments in the markets. Equity markets in the US, Europe and Japan have all managed to eke out positive returns at the start of the second half. However, we see this as noise amid still challenging conditions for the markets. Indeed, the US 10-year government bond yield pushing through 3.0% does not bode well for equities.

While any signs of a credit crunch would not be helpful, there is some evidence of increased investor interest in the high yield bond market. The global high yield index has seen the spread over government bonds narrow by 28 basis points since the half year. The performance of US high yield was even more impressive, with spreads narrower by a huge 58bps.

Have commodity prices peaked?

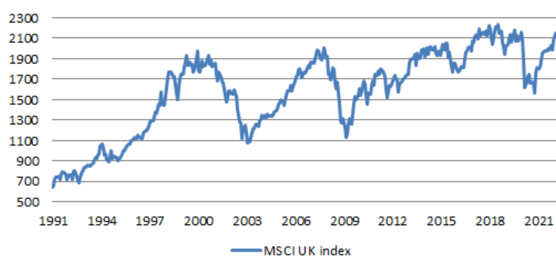
The European economy looks increasingly vulnerable to a further loss of momentum if Russia goes through with its threat to cut off energy supplies. The Bundesbank has forecast that German GDP could fall by as much as 6% in such a scenario. Thus, the euro currency continues to look very vulnerable to growth and energy crisis risks, with forecasts of the $/EUR falling to as low as €0.85, a level last seen in June 2001. That said, commodities prices may have reached a peak. Brent crude oil prices now trade around $100 per barrel versus a high of $137. We need to watch how oil prices will hold up, even if investors fear a recession. The Ukraine war is curbing Russian supply and there is limited ability of OPEC to meet its current production targets. In addition, recession risk will certainly weigh upon industrial metals prices, just as they have impacted equity prices.

UK political woes cloud the outlook

British Prime Minister Johnson's ousting brings the risk of a future UK policy mix further destabilising sterling, which has been under pressure in recent months. Two of the leading contenders for the UK PM's post have indicated that their economic policies could include a loosening fiscal policy. In that case, the Bank of England's Monetary Policy Committee would be likely to respond with even higher interest rates. Such a policy mix would take us back to the days of economic mismanagement of old. Sterling has fallen by 5% against the dollar since the half year stage. The slide, if it continues, can only exacerbate the inflation pressures on the UK economy. The last time that sterling was this weak was in 1985, when it hit $1.05.

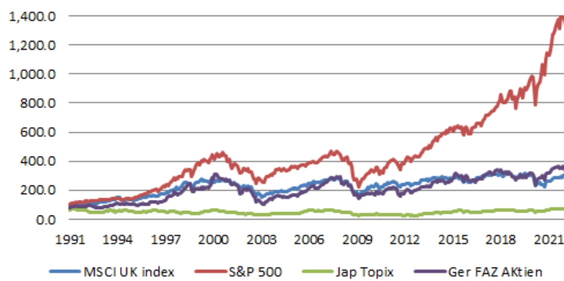
We continue to navigate the summer with a modest attitude to risk in our portfolios – with a short duration of bond holdings and keeping exposure to commodities and the value-based, previously underperforming UK equity market. Some exposure to UK real estate is proving a stabilising diversifier for portfolios. Valuations are more modest today, but we do not see sufficient catalysts for recovery in liquid markets at this stage.

Markets at a glance



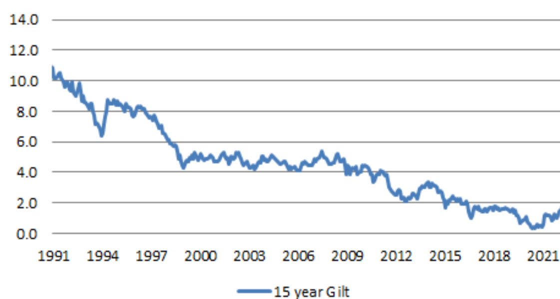
Source: Lipper for Investment Management

While the FTSE 100 index has lost almost 5% in price terms in the year to date, this is one of the better performances among global equity indices. The market's relatively modest valuation and the resilient performance of leading international companies have allowed some relative catch up after 3-4 years of UK underperformance against peers. However, the Ukraine war, inflation, supply chain disruptions and heightened security risks have led equity markets into a more volatile phase. Despite a strong earnings and cashflow recovery from the lows of the COVID crisis, rising inflation pressure implies more tightening of monetary policy this year. This raises investment hurdle rates, which will keep pressure on valuations. While the relative cheapness of UK equities leads us to expect the UK to play catch up to other developed markets, we note that the mid- and small-cap indices are generating worse returns.



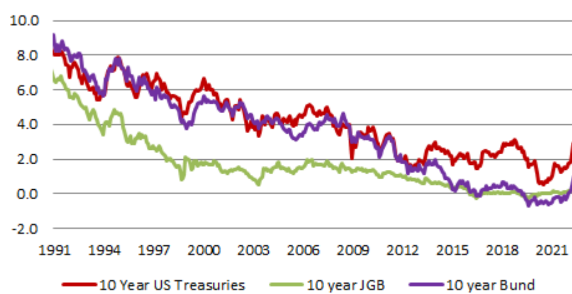
Source: Lipper for Investment Management

International equity markets in general carry higher valuations than the UK. Economic growth is weakening globally and headline inflation prints are rising towards the 10% level, which puts pressure on valuations at a time when earnings growth forecasts seem to be slowing. Central bank policy accommodation in Europe and the US is being moderated in light of inflation risks. The Ukraine war adds to commodity prices and supply chain disruptions. In the US, labour markets are tight and consumers are reining back spending. Japanese markets are encountering inflation for the first time in a generation. EM stocks are encountering logistical disruptions and price pressures, which combine with reduced investor risk appetite to overshadow equity markets through the coming months.



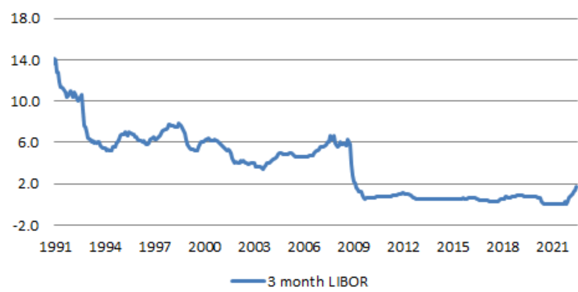
Source: Lipper for Investment Management

Gilt yields have now risen above 2.0% for the first time in six years, as the inflation cycle takes a grip on markets and consumers. Despite investors rotating to lower risk government securities in light of geopolitical risks, inflation concerns reflect shortages of materials and wage pressures, given labour shortages in sectors, such as retail and hospitality. Real gilt yields are very negative, given high headline and core inflation. Markets are concerned that the Bank of England is not on top of inflation management and will be looking closely at the risks of policy error, given the need to balance economic recovery and housing affordability against significant inflation risk. There is little worse for a government bond market than policy makers being behind the curve



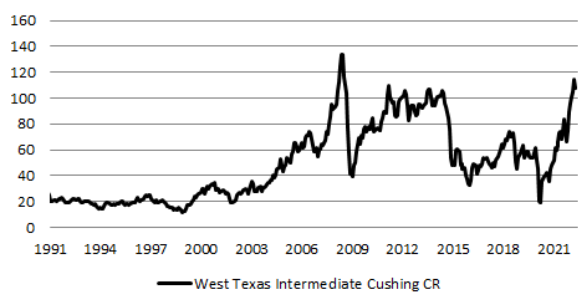
Source: Infront

We think the rises in global government bond yields have further to run. Government bond yields have typically peaked only shortly before the ends of central bank tightening cycles and we expect most major central banks to continue hiking rates over the next 12 months or so. The increase in government bond yields, as well as the threat of slowing global economic growth, will also keep corporate bonds, under pressure, although default experience is currently relatively modest. Aggressive rate tightening by the Fed is resulting in further strengthening of the US dollar against most currencies. Bond markets will only start to turn a corner when tightening cycles draw to a close, possibly a year away.



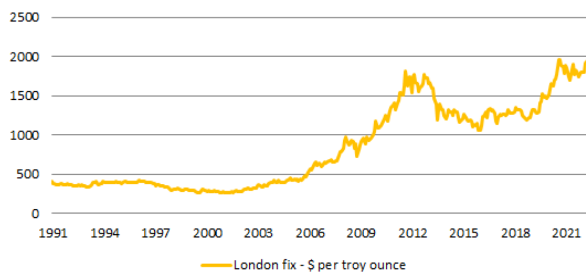
Source: Lipper for Investment Management

We forecast that the Bank of England will raise interest rates from 1.00% to 3.00% next year. There is a real risk of inflation becoming rooted in the UK economy and the Bank of England needs to be seen to be on top of policy. We think the economy will just about avoid a recession. But we also expect the unemployment rate to remain low, wage growth to be high and the recent increases in price and wage expectations 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

The oil price has eased back from its extreme highs. However, we think energy prices will stay relatively elevated this year, regardless of the outcome of the war in Ukraine, as the West makes plans to reduce its dependence on Russian energy. This process will disrupt existing supply chains and prove costly. Meanwhile, there is not much evidence that OPEC can increase supply in the short term. We expect the price of oil to ease back into 2023, as global supply responds to higher prices and demand growth slows. But there are major risks to the upside for energy prices given the uncertainty surrounding the war in Ukraine.



Source: Lipper for Investment Management

As a real asset, gold is a safe haven in times of geopolitical uncertainty and inflation risk. Physical demand for gold has remained strong and investors are looking to this asset for portfolio insurance at a time when risk assets are suffering. Central banks' gold purchases have remained strong on their view that gold is a valid asset for reserve management of inflation risk. Nonetheless, the spot price of gold has eased back 10% from peak levels, despite global inflation levels being so high. With real bond yields being negative, we would expect a real asset such as gold to generate support from investors.

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: Older spouse born before 6 April 1935	Minimum £3,530 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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