Market 2 Market

A forward view of the global economy and financial markets

June 2024

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It's an Effluent Business

"There's plenty of water in the universe without life, but nowhere is there life without water."
Sylvia Earle (American Marine Biologist)

Source: Wikipedia

The recent financial troubles of Thames Water have brought into broad daylight both the poor state of finances and the appalling environmental performance of the water companies of England.

This is an industry where one can be overcome by statistics which are easily manipulated depending on your point of view with regards to privatised utility companies. The ten regional water companies in England were sold off by the government in 1989. These companies were monopolies, and the successor companies are still monopolies, whereas Scottish Water is publicly owned and Welsh Water is a not-for-profit company.

The water system in the UK needed major investment in 1989 to reduce leaks and improve the quality and capacity of the sewage system. The idea was to allow the new privately-owned companies to raise money and spend it wisely on new infrastructure. This would be both efficient and save the taxpayer lots of money.

Ofwat was created at the same time to be the economic regulator of the water industry. One of the duties of Ofwat is to "to protect the interests of consumers, wherever appropriate by promoting effective competition". One immediately becomes suspicious of just what Ofwat is about when you read that statement, which is pretty woolly and clearly alludes to competition which is not possible and never has been since the privatisation in 1989.

The situation in 2024 is that 70% of our water companies are at least 70% owned by foreign shareholders. These shareholders are not investing in UK water companies because they want to see our rivers free from pollution or because they really care about the quality of our drinking water. They want a financial return by way of capital gain or income from dividends. In April 2023 water firms had paid out £1.4 billion in dividends in the financial year, Ofwat has also been tasked to allow dividends to rise by CPIH, which is the Consumer Prices index including owner occupiers' housing costs. CPIH rose by 2.8% in the twelve months to May 2024 down from 7.9% last year. No wonder foreign pension funds want to buy into our water companies with dividend rates rising with inflation and companies able to increase prices to customers who cannot go to another provider.

The bad news is that in 2023 water companies released raw sewage into our rivers and coastline for 3.6 million hours. Water companies say that it was because we had the sixth wettest year since records began. However, 7 in 10 major sewage leaks in 2023 were caused by leaky pipes or lack capacity at sewage treatment works which were unable to cope with demand.

The really bad news is that Ofwat raised concerns about the financial resources of 5 water companies stating that over 50% of these companies' debts were linked to the RPI inflation rate which is higher than the CPIH. In the tax year 2022-23 water companies made pre-tax profits of £1.7 billion, up 8% from tax year 2019-2020. Since 2018 water companies have made a total of £4.2 billion in pre-tax profits.

So, what has gone wrong? I would suggest a combination of poor management, poor regulation and a failure by government to ensure that water companies are operating in the best interests of the population of England. The next Government will need to make radical changes to the whole of the water industry in England and have a careful think about how a public utility as important as water is managed. It would also be nice to be able to have a swim without being poisoned.

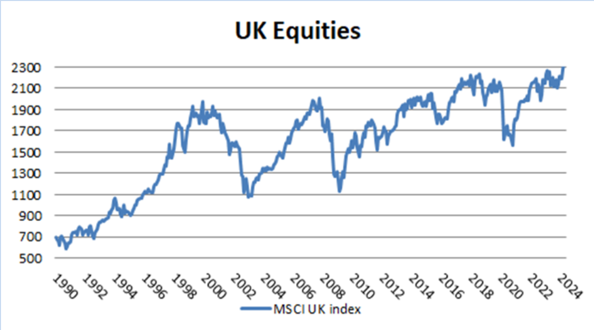
Richard Harper
Head of Asset Allocation
GHC Capital Markets Limited

Asset Allocation

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

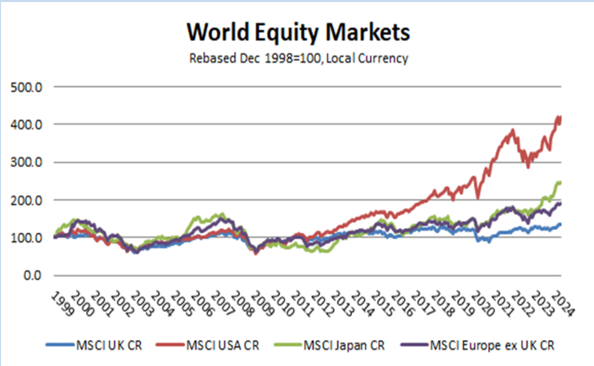
Global growth is defying the pressure of higher interest rates	It is proving stronger and more durable than most forecasters had expected. At the same time, stubborn inflation has spoiled market expectations for material interest rate cuts. Nonetheless, global equities have returned over 10% so far this year. Over the past six months, economists have marked up their 2024 projections for global real GDP growth from about 2.5% to 3% and lowered forecasts for Federal Reserve rate cuts from seven to just two and Bank of England cuts to not much this year. Once-skeptical investors and policymakers have come to acknowledge that the economy is not just resilient, it is actually quite robust. And over a long-term horizon, the potential economic impact of artificial intelligence (AI) could be substantial — perhaps even transformative.
Higher growth, higher policy rates and bond yields, higher equity valuations	In fact, a set of key market and macroeconomic variables (inflation excepted) across developed economies, from unemployment rates to yields on short-term government bonds, to corporate profit margins, look as healthy as they have in decades. We expect global equities will raise portfolio returns through the rest of the year. At the same time, more onerous financing costs create the potential for attractive returns in credit, but discounts in mid-cap equities, real estate and private equity assets. Our portfolios are fully invested, while also alert to the potential risks facing a strong global economy in a fragile world. Geopolitical risk is top of mind for investors. The possibility of worsening global conflict — whether a regional war in the Middle East or an intensification of what is already the biggest land war in Europe since World War II — cannot be dismissed. US elections in November could have significant economic and market implications, which no one can predict with certainty. The relationship between the United States and China, the world's two largest economies and trading partners, seems to be in a state of inexorable decay.
A strong economy	In the United States, the recent trend in real growth has been around 3%, the unemployment rate has been below 4% for the last two years (a near-record streak), and inflation has fallen from its 2022 peak to a more tolerable (if above target) rate of around 3%. European growth is perking up after an energy price and interest rate shock, while global manufacturing could finally be turning higher. From a markets perspective, global equities rose 20% over the past year, and safe, short-term government bonds offer positive real yields.
Higher bond yields in a strong economy	We expect bond yields to hold at current high levels. Fundamentally, sovereign bond yields reflect investor expectations of future central bank policy rates, the growth and inflation outlook, and a risk premium to incorporate everything else. Given our view of higher policy rates, continued global growth and sticky inflation, we believe bond yields of all maturities will likely trade in a higher range than they did in the post–global financial crisis (GFC) era. Expectations for central bank policy have also shifted. Recession risk is relatively low, and there is a risk of entrenched inflation, so the chances of a deep global central bank easing cycle seem low. But we do believe the turn in global monetary policy means that bond yields have already seen their peaks for this cycle.
Higher equity prices and valuations in a strong economy	Large-cap equities should benefit from stronger earnings growth and inflation pass-through. Equities can benefit during inflationary environments because companies can raise their prices while keeping their costs under control. Further, history suggests that equities return nearly 15% per year on average when inflation runs between 2% and 3%. Even when inflation runs between 3% and 4%, average annual returns are over 8%. The inflation hedge that equities can provide will be more valuable to investors in a higher growth, higher inflation environment than it was in the post-GFC period. While US equities trade on (tech-driven) high PEs, the valuations of most European and Asian markets remain quite modest by historic standards. Earnings growth should power stock markets to new highs. Beyond relative valuations, other important factors underpin elevated equity valuations. The return on equity for the S&P 500, a measure of how efficiently companies generate income for shareholders, is now 19%, five percentage points above the long-term average. Further, many companies in the index return up to 75% of their annual earnings directly to shareholders through dividends and buybacks, double the average from 1977 to 2003.

Markets at a Glance



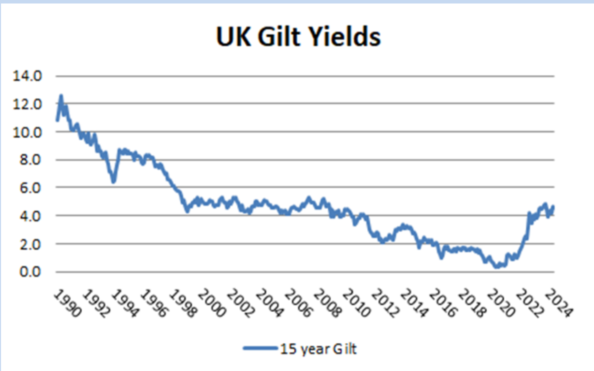
Source: Lipper for Investment Management

The UK will vote on July 4. Labour is currently leading in the polls by around 20 points, ahead of the Conservatives. Historically, there has been no clear early reaction from equities to a Labour win (if we take out both 1974 elections). Also, the relative equity performance during the overall government terms has been similar for Labour and Conservative governments. Each election has different outcomes by sector, with no consistent patterns. Policies and the economic backdrop at the time are likely to be the main drivers. The earnings performance of UK corporates remain strong. We forecast the FTSE 100 to end 2025 close to 9,000, corresponding to total returns of around 30%.



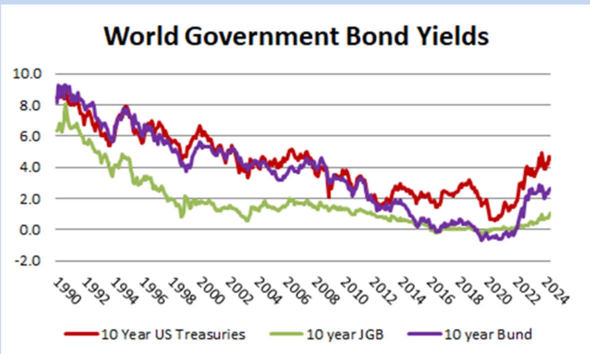
Source: Lipper for Investment Management

This year has seen the emergence of a much more eclectic and diverse selection of styles, markets and sectors that have started to outperform. This environment has favoured the outperformance of leading large-cap US Technology stocks alongside US Utilities and European Banks. Diversification matters and we favour broad geographic diversification with a tilt to Japan and Europe. We like Technology, but also recommend diversifying into other Quality Growth sectors — strong balance sheet, high margin and stable earnings growth companies. We forecast the S&P 500 to end 2024 at 5,800, about 6% above its current level.



Source: Lipper for Investment Management

Political uncertainty has been a feature of the UK economic landscape for the last decade, and while foreign ownership of Gilts has been steady, the 2022 LDI-crisis was a clear example where elevated policy uncertainty translated into Gilt outflows and higher yields. Given the relatively narrow range of macroeconomic outcomes from the current election, policy uncertainty is lower this time around, which implies that there is unlikely to be a worsening in capital flows, and that there could be room for improvement. With inflation likely to moderate slowly, a weakening labour market and quantitative tightening past its peak, we think the outlook for Gilts is positive versus other major bond markets. We forecast the 10-year gilt yield to fall to 3.25% by the end of the year.



Source: Infront

Despite a modest shift in the Fed's tone pointing in favour of further rate spread divergence between the US and Europe, the change in pricing is broadly limited across short dated US and Euro Area bonds. This may partly be due to geopolitical concerns. Despite inflation risks, the ECB has now made one interest rate cut, which seems enough for the time being. We are confident that inflation is on its way down in most major DMs, so expect that central banks will loosen monetary policy and bond yields will fall. We forecast the 10-year Treasury yield to fall to 3.75% by the end of 2024.

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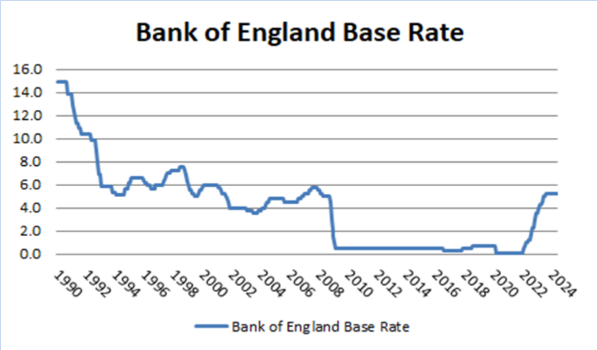
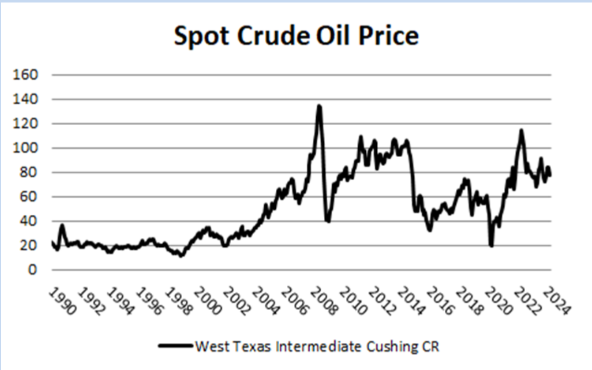


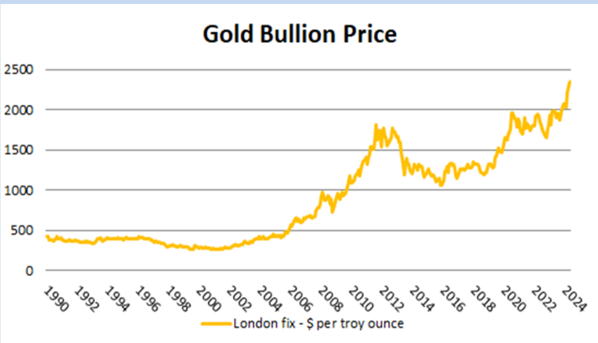
Source: Lipper for Investment Management

Expectations of interest rate cuts are moving further to the back of 2024. Estimates of the neutral bank rate suggest to us that the Bank of England will cut rates down to 3.5% in 2025 from a current 5.25% in order to reach a balanced policy stance. CPI inflation has trended lower, which eases wage growth pressures and the economy is still softer than potential. While the above might argue for rate cuts in the second half, the Bank will be mindful not to reignite inflation pressures in the aftermath of the UK election and future government programmes.



Source: Lipper for Investment Management

Energy typically offers the largest protection against inflation of the asset classes, with the strongest real returns across assets when inflation surprises to the upside. The inflation protection tends to be broader for energy than for gold, because energy typically covers both supply shocks (e.g. the Russia supply shock in 2022) and demand shocks (e.g. China's booming economy in the 2000s). While refined oil products remain the most important commodity for global consumer prices, the 2022 jumps in European and Asian natural gas prices illustrate the significant inflation hedging benefits of natural gas. This may also be more compatible with ESG goals of investors. We expect solid 2024 oil demand growth of 1.5m barrels/day and our Brent forecasts are $86 for 2024H2.



Source: Lipper for Investment Management

The gold price continues to rally. The traditional fair value of gold would connect the usual catalysts – real rates, growth expectations and the dollar – to flows and the price. Gold typically guards against high inflation and large upside inflation surprises, caused by losses in central bank credibility (e.g. through the late 1970s) and geopolitical supply shocks (throughout the 1970s). Gold, however, is typically not a strong performer in response to positive demand shocks if the central bank responds quickly with higher rates. None of those traditional factors adequately explain the speed and scale of the gold price move so far this year. But we see strong incremental flows into EM central bank buying, maybe driven by geopolitical concerns.

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

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