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Capital markets and war

Last week saw the world most certainly taken a turn for the worse from a humanitarian point of view. Pictures of the atrocities committed in the Middle East, and indeed the timing, drew immediate parallels with the Yom Kippur War of October 1973, and the oil crisis that followed.

At this point, it is important to note that the movements of capital markets – and short-term impacts on investors – are of trivial importance compared to the loss of life and the immense human suffering the terrorists of Hamas have brought upon the civilian population of the region of Israel and Gaza. Commenting on the potential economic impacts triggered by Hamas' actions should only be a small side story to the events of the week. But this is what The Cambridge Weekly provides in its information niche to private investors, and this is also why we leave political context comment to those media outlets whose main purpose it is.

Anyone expecting markets to react adversely in recognition or sympathy will have been – as so many times before – disappointed. Markets react to immediate measurable impacts (Russian gas, for example) and longer-term changes to the status quo. But, as we have written before, human suffering is not part of markets' pricing parameters and indeed, as many commentators remarked last week, capital markets are not known as good predictors of changes to the geopolitical risk framework.

At the beginning of last week, the oil price rallied predictably by around 4% before falling back towards the end of last week, and the price move felt somewhat irrelevant following the previous week's 12% fall. Perhaps this was not overly surprising after all, given the unfolding tragedy seemed to remain confined to Israel and Gaza, rather than spreading to Iran and other Arab states, as many commentators suggested the main destabilisation aim of the terrorists had been. This may have been a contributor to the stability and even upwards trend in equity markets during most of last week. Overall though, and in comparison to historical precedent of stock market reactions to major geopolitical upsets (see the table below), the up-trending of markets seemed somewhat counterintuitive.

Stocks Usually Take Geopolitical Events In Stride
S&P 500 Index And Select Geopolitical Events

		S&P 500 Returns		Days	
Market Shock Events	Event Date	One Day	Total Drawdown	Bottom	Recovery
Pearl Harbor Attack	12/7/1941	(3.8%)	(19.8%)	143	307
N. Korean Invades S. Korea	6/25/1950	(5.4%)	(12.9%)	23	82
Hungarian Uprising	10/23/1956	(0.2%)	(0.8%)	3	4
Suez Crisis	10/29/1956	0.3%	(1.5%)	3	4
Cuban Missile Crisis	10/16/1962	(0.3%)	(6.6%)	8	18
Kennedy Assassination	11/22/1963	(2.8%)	(2.8%)	1	1
Gulf of Tonkin Incident	8/2/1964	(0.2%)	(2.2%)	25	41
Six-Day War	6/5/1967	(1.5%)	(1.5%)	1	2
Tet Offensive	1/30/1968	(0.5%)	(6.0%)	36	65
Munich Olympics	9/5/1972	(0.3%)	(4.3%)	42	57
Yom Kippur War	10/6/1973	0.3%	(0.6%)	5	6
Reagan Shooting	3/30/1981	(0.3%)	(0.3%)	1	2
Iraq's Invasion of Kuwait	8/2/1990	(1.1%)	(16.9%)	71	189
U.S. Terrorist Attacks	9/11/2001	(4.9%)	(11.6%)	11	31
Madrid Bombing	3/11/2004	(1.5%)	(2.9%)	14	20
London Subway Bombing	7/5/2005	0.9%	0.0%	1	4
Boston Marathon Bombing	4/15/2013	(2.3%)	(3.0%)	4	15
Bombing of Syria	4/7/2017	(0.1%)	(1.2%)	7	18
North Korea Missile Crisis	7/28/2017	(0.1%)	(1.5%)	14	36
Saudi Aramco Drone Strike	9/14/2019	(0.3%)	(4.0%)	19	41
Iranian General Killed In Airstrike	1/3/2020	(0.7%)	(0.7%)	1	5
U.S. Pulls Out of Afghanistan	8/30/2021	0.4%	(0.1%)	1	3
Escalation of Russia/Ukraine Conflict	2/17/2022	(2.1%)	(6.8%)	13	23
Israel-Hamas War	10/9/2023	0.3%	?	?	?
Average		(1.1%)	(4.7%)	19.4	42.3

Source: George Smith, LPL Finance, 11 Oct 2023

A more plausible explanation is that beyond the lack of an immediate economic impact as Putin's invasion of Ukraine had on natural gas supply, in this instance investors made different choices in their search for save haven – or at least less risky – assets. At a time when up-trending bond yields make the usual haven assets of US bonds more at risk to capital losses, the US mega-cap stocks rose as some investors appeared to prefer them to government bonds. Perhaps because they seem to have just as little credit default risk, but better upside potential – maybe even comparable to the characteristics of inflation-linked bonds.

And bonds, which the previous week were such a problem, have rallied. We made the point then that rises in yields were tightening financial conditions significantly. Last week, several members of the US Federal Reserve (Fed) said the same thing, and that this actually reduced the likelihood of further short rate rises. Benchmark US 10-year government bond yields helpfully fell back, at one stage almost to 4.5%. They pushed back up after September's US inflation numbers came out higher than expected last Thursday, suggesting a slowing of the recent downward inflation trend, but are still below the previous Friday's level.

At the end of last week, which for many felt as paradigm-shifting as the week of the 9/11 attacks, capital markets look as if they have already returned to being driven by the shift parameters we have discussed here over the past weeks. However, it would be wrong to conclude that markets are telling us that risks will remain contained. As said at the beginning, markets have very limited ability to price longer-term changes to the prevailing risk framework from geopolitical action. As the fourth column in the table above also shows, the initial, benign market reaction was in a few cases utterly mistaken, as the long period until recovery is testimony.

The coming days will be crucial in this respect. Should global political forces thwart the terrorists' intention of seeding short and long-term destabilisation in the wider Middle East, then focus will remain on the wholly unjustifiable human suffering their actions caused. If they succeed, then markets will have second thoughts. For the time being, our thoughts and prayers go out to all that have been affected by the violence and counter-violence, while we also observe that while there are certain parallels to 1973's Yom Kippur War, oil reserves and regionality of sources 50 years later are on a much more diversified and far more stable footing.

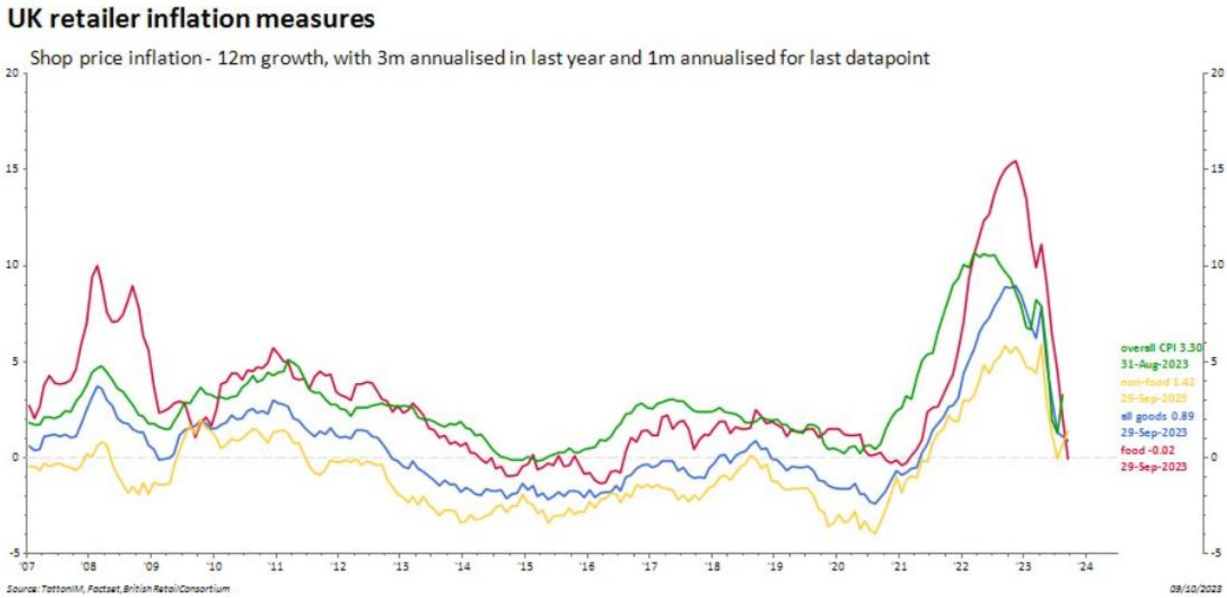
Bank of England winning against inflation expectations

Britain's inflation outlook was back in the spotlight (if it ever left) last week. The International Monetary Fund (IMF) published a gloomy report in which it forecasts high UK inflation into next year. It thinks prices will jump 7.7% year-on-year in 2023, and 3.7% in 2024. This is the highest predicted inflation rate of any G7 country, and it could mean another interest rate rise from the Bank of England (BoE), with UK rates staying well above peers to the end of this decade. This is despite the IMF downgrading Britain's growth forecast to just 0.6% in 2024 – the lowest of any developed nation.

The UK government tried to paint the IMF's predictions as overly pessimistic, with the Treasury arguing recent growth revisions had not been accounted for in its report. Reacting to the forecast last Tuesday, Chancellor Jeremy Hunt pointed to a higher long-term growth rate in the UK than in Europe's largest economies, and reiterated his stance that "we need to deal with inflation and do more to unlock growth". The IMF naturally rejected these suggestions, arguing that its growth forecasts were above the BoE's and factored in all available information.

In truth, there are some reasons to doubt the IMF's outlook. We can all agree that UK inflation has proven particularly persistent – compared to both other countries and our own history – but there has been a noticeable easing of price pressures in recent months. Headline consumer price index (CPI) inflation has been trending downwards since February, with the latest print of 6.7% in August. This is likely to come down further when September's figures are released, thanks to the food price spike tailing off and increased supermarket competition.

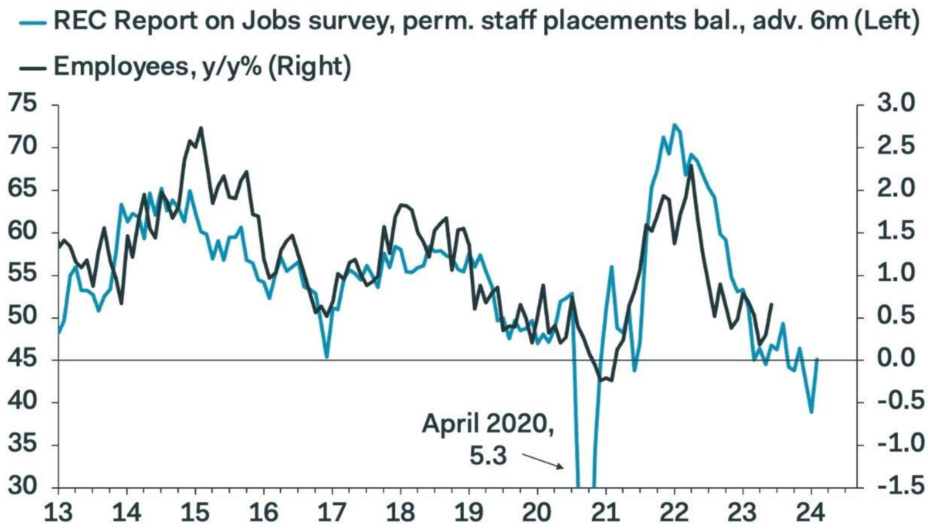
Of course, like all central banks, the BoE focuses much more on 'core' inflation – excluding more volatile elements like food and energy. Core CPI has been less encouraging this year, spiking through the spring after what initially looked like a cooldown. Core CPI inflation peaked at 7.1% year-on-year in May, but there has only been a very mild retreat since then. June and July both saw prints of 6.9%, while in August core inflation was still up at 6.2%.



The chart above illustrates nevertheless how fast and how far inflation rates have come down in the UK, even if this particular way of presenting the data somewhat overemphasises the most recent data points.

The problem with all these figures is that they are inherently backward looking. The BoE sets interest rates based on the expected prices into the future – but inflation rates, even core ones, very rarely simply carry forward. Central bankers are interested in backwards indicators like core inflation only to the extent they feed into future inflation pressures, primarily in the form of wage rise pressures. As the BoE has repeatedly emphasised, policymakers are worried about the tightness of the UK labour market and continuation of a wage-price spiral – one of the factors that pushed core inflation up again this year.

Average earnings increases have been high for some time (on a year-on-year basis at least). But lately these have cooled off somewhat. More importantly for future wage levels, employment levels have shown definite signs of slowing down. The chart below shows survey data on job placements and availability of employees – along with forward predications by from the UK's Recruitment and Employment Confederation (REC) for the next six months.



This is essentially a measure of employment expectations, where the horizontal line represents a labour market in balance – the relative number of workers and available jobs is such that neither group has excessive pricing power. As you can see, employment levels have moved much closer to balance through the year. Things remain tight – and indeed, there has been a small spike in recent months – but analysts expect the labour market to loosen significantly in the next few months, moving even below balance.

Researchers at Pantheon Macro suggest these figures are consistent with a 0.5 percentage point increase in the unemployment rate year-on-year. This should lead to month-on-month wage increase figures slowing into the end of this year. And given that keeping a lid on wages is the BoE's proclaimed goal in its inflation fight, this should mean the BoE has delivered its last rate rise of this cycle. Indeed – contrary to the IMF's warnings – some analysts think it could cut rates substantially by the end of 2024.

Implied market expectations also do not match up with the IMF's interest rate predictions. In line with the latest inflation and labour market data, bond markets are firmly pointing to the BoE keeping its benchmark rate static at November's meeting. That would mean two consecutive months of rates on hold and, if inflation comes down again in the meantime, as widely expected, it will send a strong message that the rate-hiking cycle is over.

This would also bring some relief to mortgage rates, which have already come down somewhat from a peak of nearly 6% on average in June and July. Strangely enough, higher mortgage rates have increased inflation pressures – on certain parts of the country at least – through their effect on the housing supply mix. In particular, higher mortgage repayments have forced some landlords to sell rental properties, thereby decreasing the rental supply. In that respect, mortgage relief is likely to ease some of the pressure on rents, meaning that interest rate stabilisation could well help the steady downward path of inflation.

The main hiccup in this story is global supply problems, which have unfortunately become a recurring theme in the post-pandemic world. The gas 'leak' in Finland and Estonia – and its impact on energy prices – is a prime example. Thankfully for Britons, the outbreak of further violence in the Middle East has not yet had any discernible impact on oil or energy prices – but it is much too early to tell whether that will continue to be the case. For now, at least, the BoE and its global peers can take comfort in how their policies have brought down inflation expectations. It has taken a long time, but central banks seem to have won out.

Argentina back in crisis

Last week we wrote about the state of Brazil's economy and its outlook, given South America's not insignificant share in global GDP. This week, we go further south and take a look at the not-so-fortunate Argentina, whose currency is suffering. Political drama is playing out against a backdrop of economic woes and is dragging the Argentine peso to the depths in black market trading. Argentina will have elections on 22nd October, and markets are bracing for the possible win of radical far-right candidate Javier Milei. Milei, an economist who adheres to anarcho-capitalism, wants to dollarise the country if elected. His strong polling has led many to fear that their pesos could soon become worthless, thereby prompting a run on the currency. With an official exchange peg of 365 pesos per dollar in place since August, most Argentines have to convert savings at black market trading venues. Exchange rates there were reported at over 1,000 pesos per dollar last Tuesday – the largest gap between official and unofficial rates on record.

In the article, we wrote about Brazil's recent strong performance and how it had gone some way to salvaging its historically poor reputation with international investors. That reputation is in part a reflection of general attitudes toward emerging markets in South America: the stereotypes are corruption, debt and currency crises, fiscal laxity and political instability. But if Brazil often gets unfairly labelled as such, it is in large part because it is tarred with the same brush as its southern neighbour.

The Peronist movement – including current President Alberto Fernandez – has dominated Argentina's political establishment since its current democracy was established in the 1980s. Its statist populist policies have contributed to various debt and international currency crises, with the country defaulting on its international sovereign debt three times since 2001. The election of free-marketeer Mauricio Macri in 2015 was originally well-received by international investors, but the right-wing president oversaw a similar period of political and economic stagnation before being kicked out in 2019.

Inflation and public debt rose under Macri too, including an ill-fated 100-year bond that was defaulted on just three years after issue. In fact, it was during Macri's tenure that Argentina received the biggest loan in the history of the IMF, a $56 billion credit line that still weighs extremely heavily on the nation's balance sheet.

In the years since, Buenos Aires has essentially been on a drip feed of debt rollovers from the IMF. The money has come with reform conditions attached, but these have usually been abandoned by the government when they prove unpopular. The most recent bailout came in August and included an inflation-inducing currency devaluation. Economy minister and Peronist presidential candidate Sergio Massa agreed to this condition and more, but then increased public spending and cut taxes anyway, just days after cashing the IMF's cheque.

The IMF seems to be in a bizarrely co-dependent relationship with Argentina. The country owes it $43.4bn in total, making it by far its biggest debtor with more than double the outstanding credit as next heavily-indebted Egypt. In fact, Argentina accounts for 30% of all the credit extended by the IMF, more than all the countries in sub-Saharan Africa combined. But the financer is often cast as an anti-democratic villain in Argentine politics, putting the public through punishing austerity measures merely to satisfy greedy international bondholders. Hence, politicians routinely break promises to the IMF, only to return to ask for more further down the line.

Buenos Aires stays in the dysfunctional relationship out of necessity – but why does the IMF not walk away? The answer, as so often with international institutions, is geopolitics. The IMF is unequivocally a US-dominated institution, headquartered in Washington and with the largest shareholders being America and its closest allies. And as the US has made abundantly clear over the last century, it cannot and will not tolerate South American nations falling into the orbit of global rivals. The rival in question, of course, is China.

In June, the People's Bank of China gave Buenos Aires an $18 billion swap line, which it immediately used to repay debts to the IMF. This 'borrow from Beijing to pay Washington' move has never happened in the 80-year history of the IMF. The significance of the event was clearly not lost on IMF officials or US politicians. Just two months later, it gave Argentina another $7.5 billion, despite it not meeting any of the payment conditions.

Argentina's flirtation with China hardly ended there, though. President Fernandez was in Beijing last week to ask for more money, while Argentina has been asked to join the BRICS group, which includes China and Russia. Officials in Washington are aware of the need to cut the cord on Argentina's struggling economy, but the idea of Argentina aligning with China is currently too scary to countenance.

They will no doubt be hoping that one of the right-wing candidates win in the upcoming elections. Both Milei and centre-right candidate Patricia Bullrich have come out against BRICS membership, and the former has gone as far as saying he would cut diplomatic ties with China altogether. Both promise pro-market reforms too, with Milei promising to "chainsaw" public spending. Paradoxically, the victory of an anti-China candidate could mean a harsher stance from the IMF toward Argentina, since it would effectively remove the threat of a breakaway. But the flipside is that more restrained spending would inevitably make the IMF happier.

Whatever the case, the outlook for Argentina is not good in the near term and certainly appears to be in juxtaposition to what we conveyed about Brazil. Either free marketeers get their way, and short-term pain comes for (hopefully) longer-term stability, or profligate governments continue to dip in and out of debt crises – sustained only by a lingering geopolitical threat of separation. EM stereotypes are often exaggerated, but Argentina might still be the most deserving of them.

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16th October 2023

Global Equity Markets

Market	Fri 14:30	% 1 Week	% 1 Week in sterling terms	Technical Short	Technical Medium	Valuations Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7643	+2.5	+2.5	↗	→	4.0	10.8	10.4	13.3
UK FTSE 250	17623	-0.3	-0.3	↘	↘	4.0	11.4	10.1	14.5
UK FTSE All-Share	4120	+2.1	+2.1	↗	→	4.0	10.8	10.3	13.4
UK FTSE Small	5910	+0.2	+0.2	→	↘	5.9	9.6	7.3	12.6
France CAC 40	7065	+0.8	+0.6	↘	↗	3.3	11.8	11.3	14.1
Germany DAX 40	15319	+1.4	+1.2	↘	↗	3.8	10.7	10.2	12.9
US Dow	33811	+2.2	+2.0	→	→	2.1	18.3	16.2	16.5
US S&P 500	4369	+2.6	+2.5	→	➚	1.6	19.5	18.1	17.7
US NASDAQ comp	13614	+2.9	+2.8	→	➚	0.8	28.6	24.8	23.2
Japan Nikkei 225	32270	+4.0	+3.2	↗	➚	1.8	18.7	17.7	16.8
World Bloomberg	1549	+2.5	+2.4	→	➚	2.2	14.0	13.5	13.8
China mainland	3663	-0.7	-0.8	→	➚	2.1	17.2	16.2	16.5
Emerging Bloomberg	1080	+2.3	+2.2	→	↘	2.7	12.2	10.8	12.1

Top 6 Gainers

Company	%
BP	+10.5
BAE Systems	+10.0
Endeavour Mining	+9.0
Shell	+8.2
United Utilities	+7.0
Severn Trent	+6.9

Bottom 6 Decliners

Company	%
St James's Place	-17.6
Croda International	-8.8
Spirax-Sarco Engineering	-8.7
Howden Joinery	-7.4
International Consolidated Air	-5.9
ConvaTec	-5.6

Fixed Income

Govt bond	%Yield	1 wk chg
UK Govt 10yr Gilt	+4.36	-0.20
UK Govt 15yr Gilt	+4.67	-0.20
US Govt 10yr Treasury	+4.61	-0.10
France Govt 10yr OAT	+3.35	-0.13
Germany Govt 10yr Bund	+2.73	-0.18
Japan Govt 20yr JGB	+1.53	-0.07

Currencies

Pair	last	%1W
USD per GBP	1.217	+0.2
GBP per EUR	0.865	-0.2
USD per EUR	1.052	-0.1
JPY per USD	149.61	+0.6
CNY per USD	7.305	+0.1
USD per Bitcoin	26,878	-4.2

Commodities

Cmdty	last	%1W
Oil Brent $:bl	89.2	+5.3
Gold $:oz	1909.2	+4.9
Silver $:oz	22.4	+6.2
Copper $:lb	357.7	-0.1
Alumnm $:mt	2172.8	-1.3
S&P soft crops	247.1	-0.8

UK Mortgage Rate Estimates

Rates (LTV c.75%)	13-Oct	13-Sep
UK BoE base rate	5.25	5.25
2yr fixed	6.49	6.21
3yr fixed	6.30	6.02
5yr fixed	6.11	5.52
10yr fixed	6.09	5.15
Standard variable	7.93	7.85

13/10/2023
Prices taken at 2:30pm today and 2:30pm last Friday (where possible)
The Bloomberg World and Emerging Market equity indices are similar to those published by MSCI
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of next 12 months earnings as forecast by analysts
Mortgage estimates are derived from sterling swaps markets

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16th October 2023

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Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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