RATHBONES

ROLLING RETURNS

REVIEW OF THE WEEK
11 DECEMBER 2023

A SANTA RALLY IS IN FULL SWING FOR STOCKS AND BONDS, CAPPING OFF A YEAR OF LARGE SWELLS FOR INVESTORS. WHILE RETURNS FLOW, CLIMATE POLICY IS EBBING AT COP28 IN DUBAI.

It has been a truly wild year. Markets have roiled like the sea, charging ahead, crashing back and surging higher once more.

The FTSE World Index of developed world companies is up almost 20% for the year so far (in dollar terms). But almost two-thirds of those returns have come in the last six weeks or so. Global stocks had been 20% up back in mid-summer as well, before sinking sharply into autumn. Many investors have been fickle and quick to rush one way and then the other, depending on the changing bearings of economic winds.

This has been particularly acute in the market for government bonds. The global benchmark 10-year US Treasury began the year yielding about 3.9% and is now trading around 4.3%. It got as low as 3.3% in May and as high as 5.0% in October. But that obscures many more ups and downs in between. These gyrations have directly affected the prices of global stocks because the yields of long-term government bonds are used to value company profits that are forecast to come years into the future. When the interest rate falls, the value of these far-off profits increases; when the rate rises, the value falls. Much of the recent, rampant 'Santa rally' in stock markets can be ascribed to the dramatic tumble in the 10-year US government bond yield since late October.

Not all of it though. Hopes that central bankers in general – and the US Federal Reserve in particular – will be able to return inflation to 2% without causing recessions ebbed and flowed all year. Recently, this optimism has been in full flow. The American economy grew at a phenomenal pace in the third quarter – even faster than first thought. It was revised up from 4.9% annualised to 5.2%. This strength is expected to fade in the fourth quarter and into 2024, however.

We believe this will be the start of a slide into mild recession as the extraordinarily aggressive interest rate hikes start to hit home. Yet not everyone agrees with us. Forecasts for company profits in the US suggest that the economy will slow but stop short of contraction. Well, it would have to avoid recession if S&P 500 companies are to increase their combined earnings by 12% in 2024, as forecast. That's substantially higher than the 8.4% average annual growth between 2013 and 2022. Famously, changes in interest rates take a very long and very variable amount of time to filter through to businesses and households. Our research suggests **we are in the midnight zone** for the post-pandemic spate of hikes.

After a run of stronger economic data, including better-than-expected American jobs growth and a jump in consumer confidence, central banks in the US, Europe and the UK are meeting again this week to decide on monetary policy. None of them is expected to change interest rates at the coming meetings, yet many investors are hoping central banks will cut interest rates within a quarter or two. Will central bankers upend these forecasts? Before they decide, November US inflation will be reported. It's expected to fall again by 10 basis points to 3.1%. We must wait a little longer to see the path of UK inflation – it's expected to fall by 60bps to 4.0% when it's released on 20 December.

While we think interest rate cuts are unlikely early next year, we do believe central bankers will start to reduce rates in the second quarter as economies begin to wobble. While there were a few strong bits of data last week, there has been a general downward drift in economic numbers for a while.

Being a Fair COP

Halfway through COP28 in Dubai, the delegates were still deadlocked on many of the main objectives for the international climate conference.

While it's not the first time that a major producer of oil and gas has hosted a COP conference, the United Arab Emirates hasn't exactly done a stellar job of mitigating the irony. Oil and gas are such a huge part of the world's energy resources that it defies reality to think we can simply switch them off overnight. There is a strong argument that these companies – and the governments that benefit from carbon-energy royalties – need to be part of the solution. However, using the climate conference as a forum for striking oil and gas deals is simply cynicism. That was the intention, according to official documents that were leaked ahead of the gathering.

Weaning ourselves from carbon-heavy energy will be difficult, but it is possible. A co-ordinated plan that the whole world can subscribe to is perhaps the biggest challenge for creating a low-carbon global economy. Any plan must be realistic, in terms of science, the technologies available and the economic implications on real people. It must be fair between advanced nations that have already polluted heavily in the past and emerging nations who are currently using carbon-heavy energy to improve their living standards. But it also needs to be fair to those countries that are being hit hardest by a changing climate and rising sea levels.

Broadly, these are the issues that are on the table of COP28. Unfortunately, progress has been tough.

One of the headline tasks for this year's conference is essentially reviewing a report card for how the global community has done since the Paris Agreement was signed in at COP21 in 2015. This agreement was the global promise to reduce carbon emissions to limit global warming to 1.5 degrees Celsius by 2100. Research released this year by the Intergovernmental Panel on Climate Change estimates that the planet's average temperature has already increased by 1.1 degrees and, based on current agreed national emission reduction targets, is on track to hit 3.2 degrees warmer by the end of the century.

This report card is known as the Global Stocktake and is meant to be a clear and honest assessment of nations' performance against their Nationally Determined Contributions (UN speak for promises to cut carbon). One week in, the discussion of what to do with this Stocktake has become deadlocked. This shouldn't necessarily be a blame-game sort of thing – it's supposed to be a measured and helpful way to review what's working and what isn't in the global effort to reduce emissions. It should form the basis for the next stage of carbon reduction targets and policies set by governments.

Much of the difficulty in gaining agreement about how to frame the Global Stocktake and come up with directions for member nations comes back to that idea of fairness. There is a large push to include a "phase-out" of oil and gas usage over a set timeframe. This is particularly popular in regions that are suffering badly from deadly extreme weather and rising water levels. But a phase-out is being blocked by other nations that are reliant on oil and gas revenues to pay the bills and live comfortably.

In reality, the phase-out of oil and gas is all but required if the world is going to limit climate change to just 1.5 degrees. If that is to happen, there must be some give and take. Those who need cheap energy to develop and become wealthier need to be able to tap cheap (or free) funding for building clean energy. This is another arm of the COP discussion. Developed nation governments have (after a two-year delay) delivered on the promise to put up $100 billion (£80bn) a year for use by poorer countries. But much more money will be required. Encouraging private investors to invest in these sorts of projects would go a long way in that regard. With economic uncertainty lingering, coming up with incentives may be stymied by wary governments labouring under larger debts than only a few years ago.

Finally, there's the acknowledgement that the world isn't on track to hit its goals. This also comes with the admission that a changing climate is causing serious damage and injury to many countries. Again, fairness dictates that they should be compensated for bearing the brunt of this communal issue. At last year's COP, in Egypt, it was agreed to create a Loss and Damage Fund. This time round, the discussion is about how it should be administered, who should pay into it, how much should they pay, and who should receive the money and when.

When it's all boiled down, the difficulty with COP and climate policy is a familiar one: the tragedy of the commons. When it's everyone's problem, it's no one's problem. If the world is to mitigate climate change, all nations must change together. **And as we change our habits**, there're plenty of **investment opportunities to consider**.

Thank you for investing with us over a wild year and for reading our weekly thoughts. We are taking a Christmas break and will be writing to you once more on 8 January. Happy holidays! If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you. For more on how we see the world and our views on 2024, **sign up for our next Investment Insights webinar** on 16 January.

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