Brewin Dolphin

Markets in a Minute

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Guy Foster, Chief Strategist, discusses the recent performance of the FTSE 100 and what sets it apart from other indices. Plus, Janet Mui, Head of Market Analysis, analyses recent US jobs data.

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Last week was tougher on equities, with most major equity markets seeing some retrenchment. The FTSE 100 was one of the better performing markets, although the difference is minimal. The previous leaders, the NASDAQ and the TOPIX were the short-term laggards. All of which would seem fairly standard procedure for an equity bull market.

The FTSE 100 near all-time high

The FTSE 100 came within a whisker of an all-time high earlier in the week, rising through 8,000 on an intraday basis before easing back slightly. What is it that has been helping it recently? The broadening of the global equity rally away from seven big technology-enabled companies is clearly a factor. The critical sector to have picked up the market leadership baton has been energy.

The FTSE 100 is often seen as a key play on energy and mining as the sectors form a larger proportion of the UK equity market than they do of other regions; energy was the reason the FTSE 100 performed really well during 2022. More often than not, however, it gets lost in the noise of the FTSE 100's varied composition. The UK market has substantial weightings to cyclical sectors like energy and materials but also some very defensive sectors like tobacco, consumer staples, and pharma. So, it ends up being easier to define in terms of what it doesn't have, which is much of a technology sector.

Investing in energy felt frustrating during 2023. The oil price was weighed down by recession fears and company valuations did not seem to reflect fundamentals, because the sector has a huge amount to commend it.

A favourable capital cycle for oil

We have liked energy throughout this period, recognising that the way in which energy companies are being managed has fundamentally changed.

Historically, energy companies sought to grow. When the oil price was high, they would use it to justify embarking upon new energy projects, any of which would obviously be less profitable if the oil price was to sink back. However, this did not matter in the early 2000s when investors and industry experts would talk about the world reaching peak oil supply where the risks to oil prices were only to the upside.

Since then, the term 'peak oil' has become more associated with peak oil demand than supply. This shift of asymmetry of risk has left investors and company management much more cautious in their approach to capital investment. It will feel unintuitive to consider a sector to be attractive because of its downbeat long-term assessment of the addressable market, but there are good reasons to feel it will work well.

The solution to high oil prices is high oil prices, so the sage investors and industry experts are prone to joke. That's because, as was the case in the early 2000s, high oil prices cause companies to bring on new capacity (as discussed above), which then saturates the market and brings the price back down. Now imagine a world in which the dominant sentiment in the industry is about avoiding stranded assets and managing the transition.

Energy's place in a portfolio

The reluctance to invest, which that new environment creates, means that only the most profitable projects get actioned, while also supporting oil prices because less new supply comes online. That's obviously not a fictional scenario, it's what's happening now.

It's not all good news.

It means there is some upside risk to the oil price, coming not from lofty demand expectations but from more tangible undersupply, which means the world needs to transition away from fossil fuels fast in order for demand and supply to balance. In the meantime, the likelihood is a period of unusually profitable oil and gas supply. That could end up being unhelpful from an inflationary perspective, in which case deciding to have shunned those sectors from an investment perspective would feel particularly frustrating (as it would have been in 2022).

It means that energy companies lend themselves to inclusion in portfolios and are naturally complementary to secular growth stocks. These are often considered long duration, meaning a lot of their value is perceived to be generated a long way into the future. The most obvious problem with this is that it leaves a long period in which a peer can emerge to fight for market share and undermine the valuation. But a secondary risk factor is that long duration stocks, like long duration bonds, are sensitive to interest rate risks. This is much less the case for low duration sectors like energy, where the expectation is that companies make big profits and distribute them to shareholders rather than ploughing them into new investment.

On the other hand…

Of course there are risks. Companies could abandon their newfound capital discipline and revert to their bad old ways. They are also inclined towards investment in renewables, which will likely be lower returning in the future. Some balance between reinvestment and distribution of profits seems appropriate and seems to be achieved. We monitor a basket of major energy producers and found a less than 1% increase in capital expenditure and a slightly larger increase in production. At the same time, most players have increased share buybacks, dividends, or both, reflecting the shift of emphasis away from investment and towards distribution.

One last risk may occur to you reading these comments. Will companies be allowed to make substantial profits by underinvesting in their core business? The risk of windfall taxes always raises its head at such times. What is unusual is that in this instance, the windfall results from an international push by governments to slow and eventually stop investment in fossil fuel assets in order to slow the pace of climate change. This is perceived as being easier to achieve than slowing demand for fossil fuels, which would be done through ever higher fuel duties.

Fuel duties are highly political, such that the freezing of the motor fuel duty is now as much of a budget tradition as the red ministerial box that contains the chancellor's speech in the UK. UK taxes on fuel have been declining in recent years. Whilst hypocritical, could a future government impose a windfall tax on an industry that is making excess profits as a result of following a government-sanctioned initiative? Stranger things have happened. The risk is lower in the U.S., which makes a global basket of energy producers attractive relative to UK companies. That said, the impact of previous windfall taxes on UK producers' businesses have tended to be minor where those companies are global oil producers, because the tax only relates to the UK part of the business.

Is it unethical to invest in energy stocks? That is very much a personal choice. It seems clear that if transition is to be achieved, it will be through underinvestment in energy. That does not come without cost and high energy prices seem likely to be a necessary feature. Another owner might be tempted to see companies increase their investment.

Diversification: beloved by many, employed by few

Holding the stock of companies benefitting from secular long-term growth trends, such as cloud computing or artificial intelligence, alongside the stock of energy producers benefitting from engineered undercapacity in an industry we are trying to ween ourselves off, has obvious portfolio benefits. They provide returns at different times, meaning they perform differently and are subject to different risks.

However, relatively few fund managers follow this approach because energy is widely seen as a value sector, whereas technology is a growth sector. In some investors' minds, these are the investment equivalents of oil and water. It seems odd to miss out on the diversification benefits of mixing them. Why doesn't it happen?

An optimist would say this is because fund managers feel they will do their best work if focusing on a specific sector of the market and learning about that area in greater depth. It is certainly difficult for the generalist to achieve excess returns by spreading their net widely (knowing a little about a lot of things).

A sceptic would say fund managers tend to align to a specific risk factor, achieving high returns while that factor is in vogue, which investors misattribute to "alpha". One of the central challenges of fund analysis is distinguishing between true alpha and that which comes from following a specific style.

We believe getting sufficient depth of analysis across a sufficiently wide spectrum of industries can only be achieved through a level of teamwork and analyst enfranchisement that is unusual in the industry, where fund managers like to feel personally responsible for the investments in their portfolios.

Economic resilience continues

The recent outperformance of energy at a time when technology has been losing momentum presented the opportunity for this sojourn into the merits of energy within a balanced portfolio. We normally spend more time discussing the week's economic data.

Last week, the data was pretty good. Purchasing managers indices suggest the manufacturing recovery is gathering pace. Generally, this is true for services as well, although in the U.S. and UK there was some loss of momentum. It is too soon to determine whether this would form a new trend, and in the UK, where we have had two successive rounds of National Insurance cuts in quick succession, there are factors to support ongoing services consumption.

On this note, a succession of Federal Reserve speakers discussed last week the outlook for interest rates. They didn't do much to change the market's expectation for two or three cuts beginning in June. But they did suggest the inflation and economic data would need to confirm this course of action. At the moment, they don't seem to be doing so.

Inflation data have been a bit sticky (not coming down fast enough) while Friday's jobs report is a good example of the resilience of the U.S. economy. It provided another positive surprise, with an estimated 300,000 new jobs created during March (expectations were for 200,000) and upwards revisions to previous month's reports as well.

This is not an ideal situation for long duration equities, although over the last year they have managed to outperform despite higher expected interest rates. It does suggest resilient demand for energy.

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