

Investment Views



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Strategy:

A Painful Quarter

Fixed Income:

A Conflict of Policy

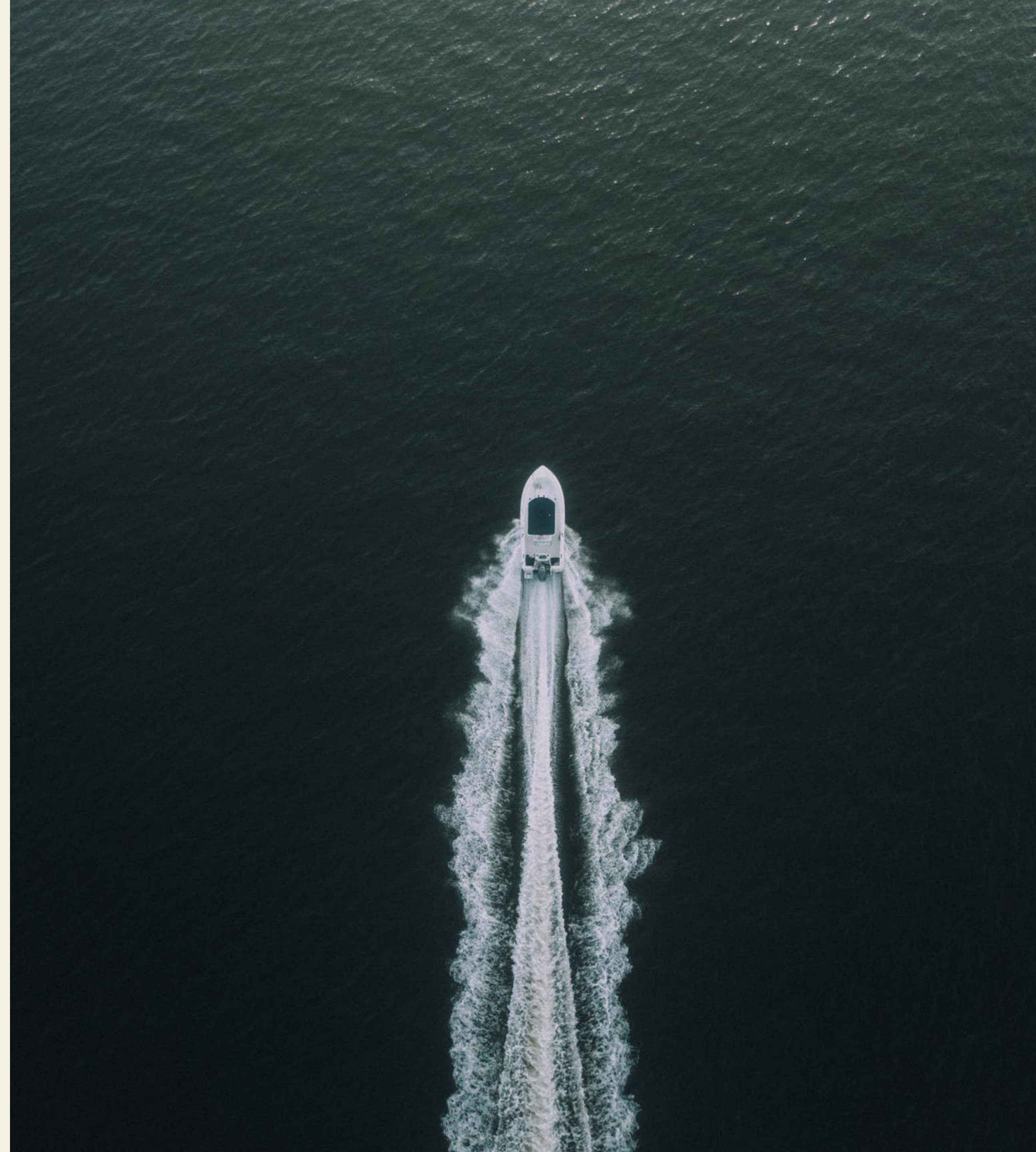
Equities:

A Lot of Headwinds

A Painful Quarter

The third quarter was a difficult one for financial markets, as both bonds and equities suffered due to persistent inflationary pressures and downgrades to global growth expectations. Multi-decade high inflation rates have forced central banks to tighten monetary policy through interest rate hikes and the removal of liquidity from the financial system. The biggest, fastest, and broadest global monetary tightening in more than 40 years has injected a high degree of volatility into financial markets.

The simultaneous weakness in both bonds and equities is a relatively unusual occurrence. Between 2009 and 2021 there was only one quarter, Q3 2018, when bonds (US Aggregate bonds) and equities (MSCI World in US dollar terms) were both down. However, prior to 1982, losses for both were more frequent due to inflation.



The last period of significant inflationary pressure in the US was in the 1970s and early 1980s, which ended with a determined effort, led by then Fed Chair Paul Volker, to squeeze inflation out of the system by raising interest rates significantly. This caused a painful recession but marked a structural peak in inflation, which then trended lower for the following three decades. The entry of China into the global trading system in the early 2000s then gave the global economy another disinflationary impulse, as hundreds of millions of productive and low-wage workers entered the global labour force.

This backdrop of low inflation and low interest rates was a “Goldilocks” period for financial markets. Bonds and equities both rose over time and were negatively correlated, so volatility was relatively low. A confluence of negative factors has made for a much weaker environment for financial markets and flipped the bond-equity correlation from negative to positive. In recent decades, central banks and governments could respond to economic weakness without causing much inflation, but elevated inflation now gives them a much more difficult trade-off between supporting growth and controlling inflation.

The pandemic, fiscal policy responses and Russia’s war on Ukraine have created a perfect storm for inflationary pressures. This has prompted some influential investors, such as BlackRock, to declare that “the Great Moderation – an era of steady growth and inflation – is over”.

The war in Ukraine, and the associated commodity price shock, came at a most inopportune time for global inflation. Goods price inflation has remained elevated and services inflation has picked up as the global economy, excluding China, reopened from the pandemic. Inflation has different primary drivers across different regions. The US has seen very strong demand through wage growth of 5-7%, while inflation in Europe has been more of a food and energy-related story.

5-7%

Wage growth in the US
in the third quarter.

The pandemic, fiscal policy responses and Russia’s war on Ukraine have created a perfect storm for inflationary pressures.



STRATEGY

The pickup in wage growth has reflected a better environment for labour, as workers have had more success in bargaining for higher wages than at any point in the past thirty years. However, the flipside to this is that corporate margins are under pressure from inflation as pricing power wanes. With economic growth forecasts being cut materially, it makes for a challenging environment for company earnings.

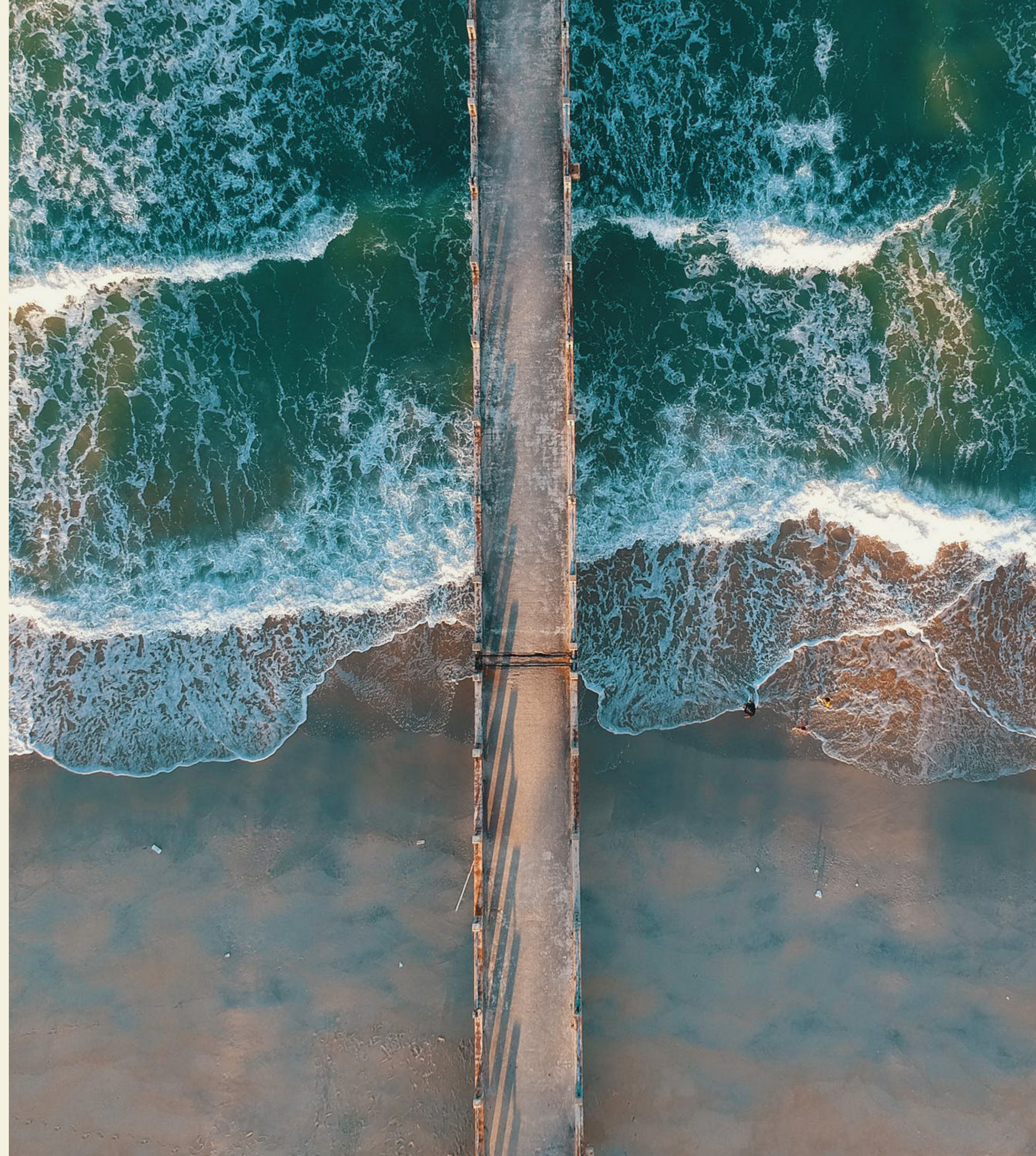
The energy price shock in Europe has required governments to provide support to both households and businesses to prevent utility bills from spiralling to unaffordable levels. However, with inflation close to double digits, the capacity for further government borrowing has been tested. This was particularly the case in the UK as energy support was announced alongside tax cuts, some of which had to be walked back given gyrations in financial markets.

Over the course of this year, we have taken a number of steps to make portfolios more defensive. Within equities we have added to traditionally more defensive sectors such as Consumer Staples and Healthcare, while trimming exposure to Consumer Discretionary and Financials. Within Fixed Income, we have reduced exposure to corporate credit. For portfolios with Alternatives we added exposure to agricultural commodities and within Equities we also increased exposure to the Energy sector. This has added good diversification to portfolios at a time when Bonds aren't providing the same defensiveness as they have in the past.

A Conflict of Policy

There was no let-up in bond market volatility in the third quarter, as mixed messaging by the Federal Reserve prompted risk assets to price in a more dovish path for short-term interest rates. This led to a rally in bond yields, credit spreads and equity markets. The five-year US Treasury yield fell to a low of 2.64% in August; a 95bps decrease since June. However, the moves we witnessed during July were almost completely reversed in August, which gave way to a renewed breakdown in correlation between global bond markets, credit and equity markets.

With central banks remaining committed to tighter monetary policy in order to contain inflation and with energy prices rising to levels that make a recession in Europe appear almost unavoidable, government borrowing is materially increasing the supply of bonds in an attempt to avoid a contraction in consumer spending.



This has provided a conflict, as elevated bond supply puts upward pressure on global bond yields, which will only be resolved when global growth weakens enough to slow demand and subsequently inflation, relieving pressure on central banks. The bad news is that we have likely already reached that point in Europe but solid US economic growth is providing a floor to global bond yields, leaving few options for fiscal policy to support growth in the immediate term.

With government bond supply increasing sharply, it is incredibly important that governments maintain some fiscal discipline and central banks maintain credibility on inflation. The UK government provided us with a lesson in September of the impact of losing such credibility, with gilt yields surging in response to large, poorly targeted and unfunded tax cuts. The increase in gilt yields and decline in sterling approached a level which threatened financial stability in the UK market and economy.

10-year gilt yields rose from 1.81% at the start of August to a high of 4.51% by the end of September and sterling almost reached parity versus the US dollar. This prompted the Bank of England to provide emergency support by purchasing long dated gilts in order to contain the volatility. Although this event was triggered by misguided fiscal policy, it also highlighted the fragility of global financial markets now that aggressive monetary policy is draining liquidity from the system.

Over the past quarter, economic data continues to deteriorate in Europe and the US, but overall has outperformed already bearish expectations. Global inflation data also show signs of weakening, with Chinese inflation declining sharply and growing evidence that US price pressures may have reached their peak. This is especially the case at the headline level and this has led to a decline in the level of inflation expectations imbedded into US Treasury yields, with the real (adjusted for inflation) US 2-year yield rising by +131 basis points since the start of July.

95bps

The amount the five-year US Treasury yield fell from June to August.

4.51%

In the UK market, 10-year gilt yields rose to a high by the end of September.

7.06%

The average US 30-year fixed mortgage rate - the highest since 2000.

In addition, further signs of the weakness in global growth can be found in the decline in oil (-25% in the third quarter), Copper (-8%), Iron Ore (-19%), Lumber (-36%) and the rapid decline in shipping container transit costs which have fallen back to 2020 levels. Looking ahead, the US economy will also have to digest 30-year average mortgage rates of 7.06% - the highest since 2000 – which has led to an increase in housing inventories in the Southern and Western US states.

Portfolio positioning continues to be defensive with an allocation to risk only maintained where we are rewarded.

During the quarter, in our US dollar bond Funds we reduced positions in high-quality fixed rate corporate bonds, such as Alphabet and Microsoft, and reinvested the proceeds into short dated US Treasuries where risk free yields of over 4% are available. Interest rate risk remains neutral as we balance more attractive US real yields, elevated short positioning and slowing global growth against the heightened volatility of long bonds, very high FX hedging costs and negative momentum.

With a US terminal rate of 4.5% fully priced into the bond market by the middle of 2023, in our US dollar bond Funds we also reduced our exposure to AAA-rated floating rate notes, which have largely escaped the drawdowns in global bond markets this year. The proceeds were reinvested into 2-3 Year US Treasuries, thereby locking in these base rate increases before they have happened and providing portfolios with a hedge for a more sustained slowdown in global growth in the months ahead.

A Lot of Headwinds

Global equity markets finished the third quarter down -6.2% in US dollar terms, despite an intra-quarter bear market rally in excess of +10%. Rallies during bear markets are common, with an average of three in each of the major market drawdowns experienced in the last 85 years. The rally at the start of the quarter was fuelled by a combination of better-than-feared second quarter earnings and more investors embracing a view that the Fed might pivot away from its anticipated path of rising interest rates.

The market's turn back downwards followed comments by Fed Chair Jerome Powell at the Jackson Hole symposium in August, which emphasised the Fed's determination to beat inflation and strongly pushed back on speculation that the Fed would pivot. An elevated US inflation reading in mid-September further reduced the chances of a dovish policy pivot and sent bond yields higher, equity markets lower and the US dollar stronger.

Central banks' aggressive policy responses to elevated inflation in the US and Europe are expected to constrain growth and increase the probability of recession, putting downward pressure on corporate earnings.





7.9%

The only sector with an increase in earnings estimates was Energy.

-7.3%

The FTSE 250 index fell in the third quarter.

EQUITIES

During the third quarter, analysts lowered their aggregate earnings estimates for the third quarter by -6.6% and for the fourth quarter by -4.5%. Downgrades to earnings estimates were broad based, with ten of the eleven sectors having their third quarter estimates lowered. Downgrades were led by Materials (-14.9%), Communication Services (-13.1%), and Consumer Discretionary (-11.9%). The only sector with an increase in earnings estimates was Energy (+7.9%).

In September's -9.3% global developed equity market decline, sectors which held up best included Health Care (-3.9%), Consumer Staples (-7.7%), and Financials (-8.2%). Laggards included Technology (-11.9%) and Industrials (-10.3%). In the third quarter, outperformers included Energy, which returned -1.1% and, perhaps surprisingly, Consumer Discretionary (+0.3%). Although, that was primarily due to bounces in sector heavyweights Amazon (+6.4%) and Tesla (+18.2%), both of which continue to lag the S&P500 year-to-date.

Third quarter laggards included Technology (-6.2%), which was driven mostly by index heavyweight Microsoft (-9.1%), and Real Estate (-11.5%) as rapidly rising interest rates put downward pressure on a sector with debt and exposure to the economic cycle. The Communication Services was weak (-12.9%) and this was largely attributable to Alphabet (-12.1%) and Meta (-15.9%), where CEO Mark Zuckerberg outlined plans to reduce headcount for the first time ever amid slowing user growth.

Volatility in currency markets has had a big impact on both investor portfolios and corporate profitability, as the US dollar appreciated significantly over the third quarter. For clients with portfolios denominated in sterling, this provided a cushion to the weakness in global equities, so much so that the MSCI World in sterling terms actually generated a positive return of +2.6%. However, the more domestically focussed FTSE 250 index returned -7.3% in the third quarter, which was much in line with the MSCI World in US dollar terms. While US dollar strength provided a tailwind to many investors outside the US, it provided a headwind to US-based

investors and companies. Around 40% of S&P 500 sales come from outside the US, so when these profits are translated back into US dollars, it makes for a more challenging environment for US corporate earnings.

Inventory management has also been a meaningful challenge for many businesses due to the nature of the pandemic shock and this has particularly been the case within the retail sector. The shutdown of the global economy and subsequent reopening made for significant shifts in demand between different goods and services at a time of supply chain disruption. Footwear and athletic apparel maker Nike's recent earnings highlighted the extent of these challenges, as products arrived later than usual, they were left with excess inventory in North America and had to resort to aggressive discounting to make room for new seasonal inventory. We have seen similar challenges at other retailers and this, along with US dollar strength, has put downward pressure on margins, which appear to have peaked for this cycle. Interestingly, we are yet to see this anecdotal evidence of retailer discounting reflected in the official inflation statistics, but this is likely coming and should provide some very welcome relief on the inflation front.

Emerging Markets sold off more than Developed Markets in the third quarter, with China falling -22%, lagging the -11% decline in broad Emerging Markets. A slowdown in China's vast real estate sector, along with Covid zero restrictions, has weighed on the world's second-largest economy for more than a year. Better news from China next year would help to provide some support to global growth. However, China is facing a number of simultaneous challenges and a structural growth slowdown, so likely won't lift the global economy out of its current malaise in the same way that it has in the past.

-22%

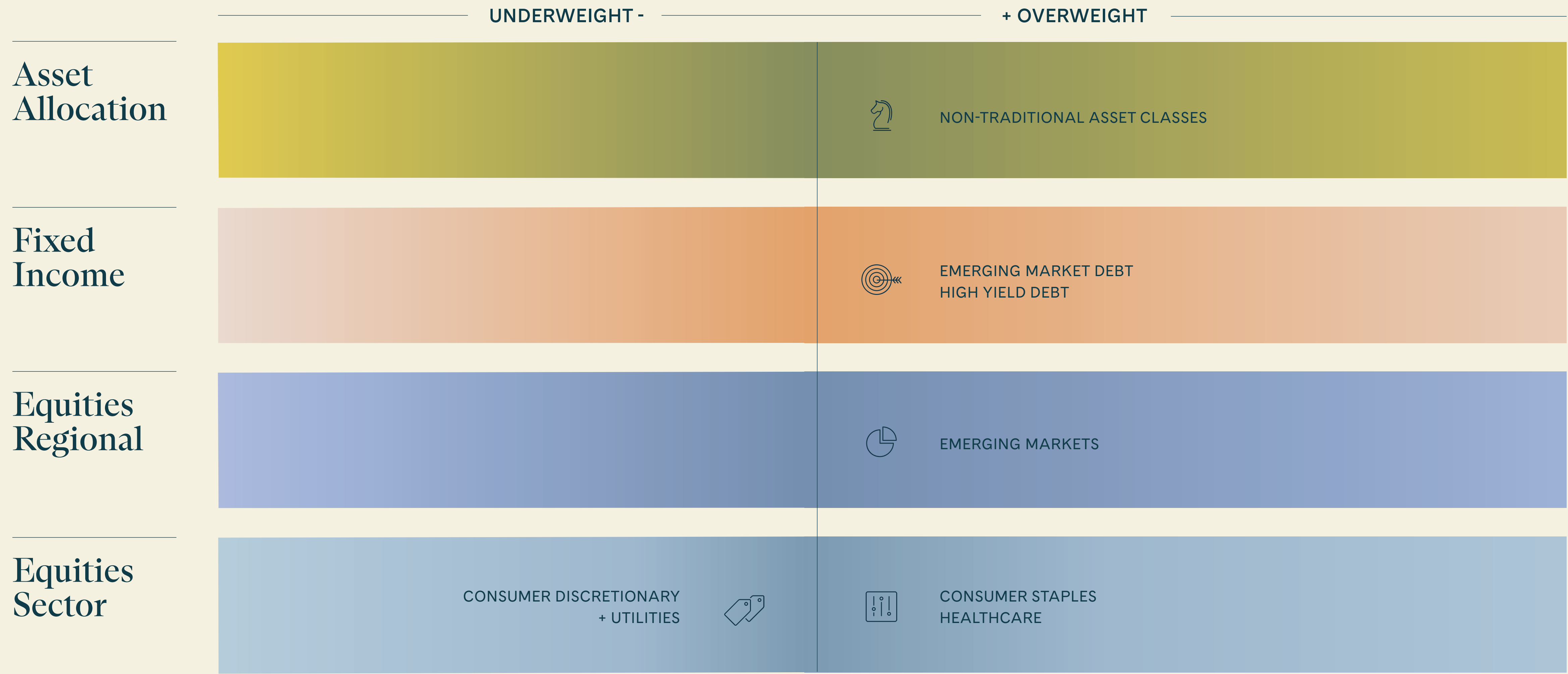
The amount China fell on the Developed Markets in the third quarter.

While US dollar strength provided a tailwind to many investors outside the US, it provided a headwind to US-based investors and companies.



Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy



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