

Investment Views



NOVEMBER 2022

PRODUCED BY BUTTERFIELD

Strategy:

A Very Different Cycle

Fixed Income:

Pivot Talk

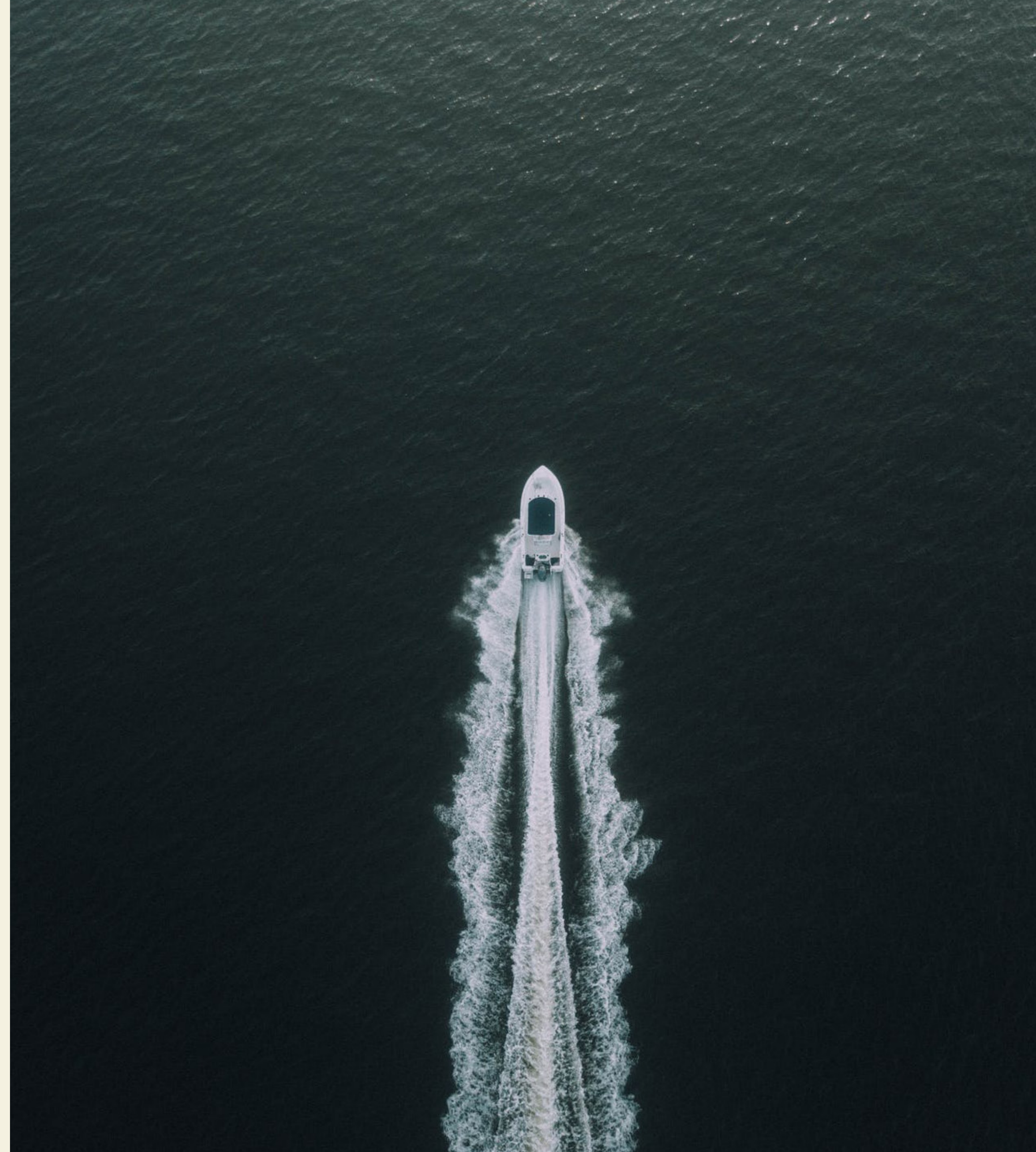
Equities:

Winners and Losers in Q3 Earnings



A Very Different Cycle

Good news has been thin on the ground this year and this has made for a particularly challenging investment environment. The return of inflation for the first time in decades has been negative for a wide range of financial assets. The rise in bond yields has been so pronounced that for the first time since October 2008, Global Bonds now yield more than Global Equities. The yield on the BoA/ICE Global Bond Index has risen from 2.44% to 3.0%, while dividend yields have risen from 2.42% to 2.48%.



Equities have upside from earnings growth whereas bonds do not. Earning a higher yield on equities provided an unusual environment where interest rates were held low but investors took time to regain confidence in equity markets after the pain suffered during the Global Financial Crisis. The return of inflation and concurrent rise in bond yields has materially changed the global investment environment. JP Morgan's recently released annual Long-Term Capital Market Assumptions Report describes how "the world of easy policy and abundant capital, which drove broad-based asset appreciation in the 2010s, has been replaced by a world where capital is rationed via the financial markets".

It is no coincidence that the most speculative areas of markets have been hit hardest. Non-profitable companies promising positive cash flow further into the future are worse off than companies generating positive cash flow today. The primary purpose of capital markets is to match those with savings, such as households and institutions, with businesses raising capital for investment and expenses. In an environment where speculation becomes dominant this purpose can be forgotten, but the rise in interest rates has provided a reminder that markets are ultimately about allocating capital. This process has been painful, but is beneficial in the long-term as investments are assessed with closer scrutiny.

The combination of pandemic distortions, the immense policy response to the pandemic and the commodity shock associated with the Russia-Ukraine conflict has made this economy cycle very different to a usual cycle. This has had important implications for markets as the usual playbook of style behaviour throughout the cycle has been turned on its head.

0.56%

The percentage the yield on the BoA/ICE Global Bond Index has risen - from 2.44% to 3.0%.

As we approach the end of the year, attention will turn to the outlook for 2023 and the rate at which inflation falls back down towards central banks targets will be in very close focus.

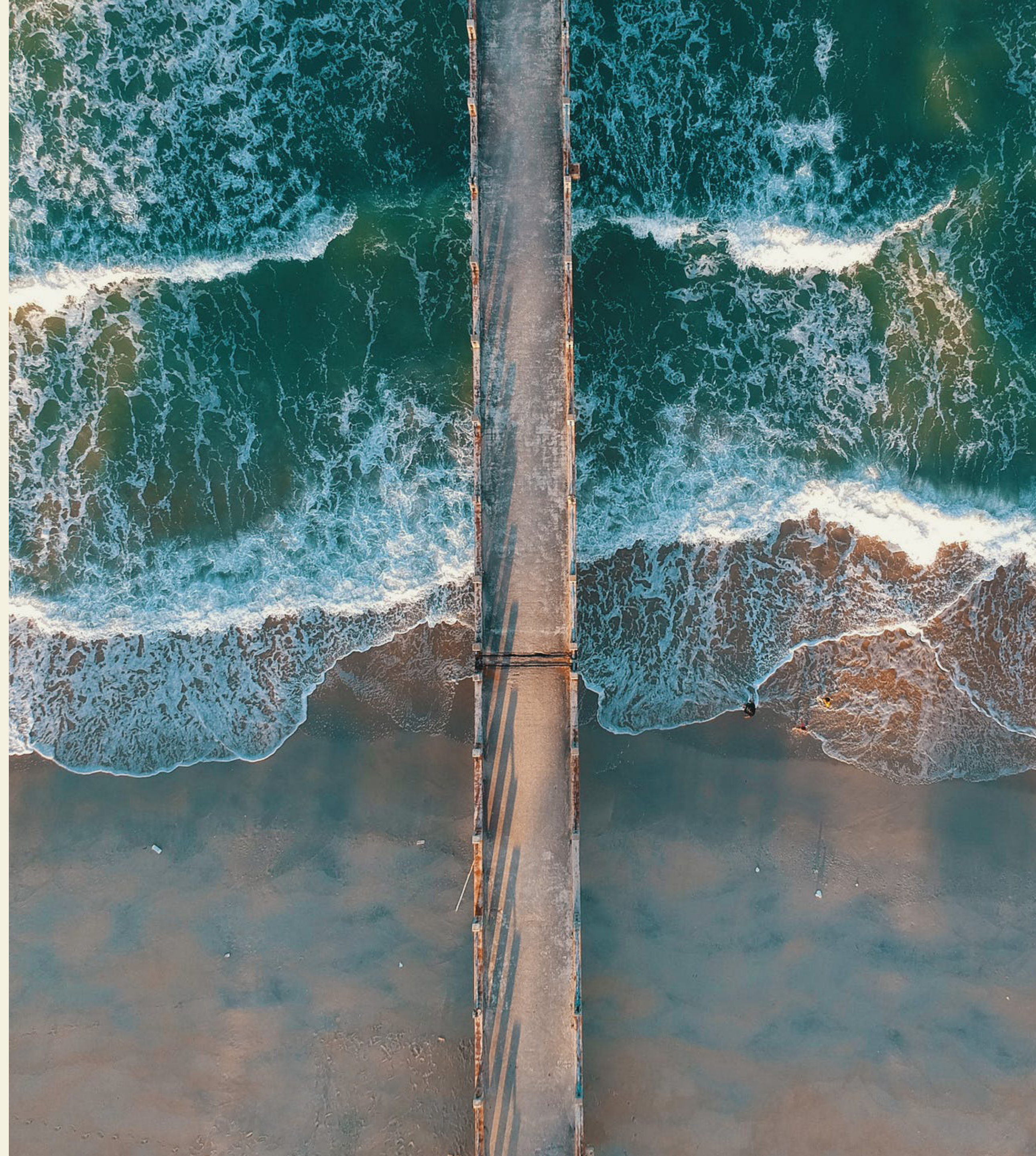


STRATEGY

Typically, as economic growth weakens, Quality stocks (unusually exhibiting low debt and stable earnings) and Growth stocks outperform, whereas Value stocks underperform. However, this year Value has been outperforming while Growth and Quality stocks have struggled. At a sector level, some traditionally defensive areas of the market have held up relatively well, with Consumer Staples, Health Care and Utilities outperforming the broader market. Against a backdrop of high inflation, the Energy sector has been a better diversifier than Fixed Income, which is a departure from the type of market relationships seen over recent decades. As we approach the end of the year, attention will turn to the outlook for 2023 and the rate at which inflation falls back down towards central banks targets will be in very close focus.

Pivot Talk

A sense of calm returned to markets during October. Real interest rates, following the substantial move upwards that we witnessed in September, declined and this boosted risk assets globally. Fixed Income investors are also growing more confident that a ‘pivot’ (where the Federal Reserve signals that they are more willing to either slow or stop raising interest rates) may well be communicated shortly. This has led to nominal bond yields stabilising with the 10-year US Treasury ending the month at 4.05%, a much slower increase than previous months. However, inflation expectations, especially at the short end of the yield curve, surged with 2-year breakevens increasing by +87bps.



This bounce in inflation expectations and risk assets will not be welcomed by the Federal Reserve, given that the services component of headline CPI remains sticky and elevated; financial conditions need to remain tight. US interest rates increased by 75 basis points (bps) in November, for the fourth consecutive time and, assuming an additional 50bps in December, this would take the upper bound of the US base rate to 4.50% by year end. This is a truly enormous bout of monetary policy tightening given that in January US base rates sat in the 0-0.25% range. Our view is that it is too early to talk pivot, but we expect by year-end the Federal Reserve will have received enough evidence of weaker economic data that a pause in base rates may well be justified. However, a reduction in base rates is a very long way off; base rates will remain much higher for longer in a break from the post-Lehman investment playbook.

The risk on rally led to average investment grade credit spreads rallying by -20bps and high yield -90bps, closely following similar returns in equity markets. Volatility continues to remain elevated, with the MOVE index (which measures implied volatility in the bond market) rising to 148 significantly above the 5-year average of 69. This reflects the uncertainty surrounding not just the path of inflation, but also the reaction function of global central banks. The US dollar weakened as Europe and the UK rallied after last month's policy induced volatility. In addition, the Canadian dollar also appreciated as economic data has been much stronger than expected. In Asia, the continued gradual improvement in Chinese economic data failed to boost the renminbi and local risk assets as political turmoil dominated. The Japanese yen remains unloved with a move to 150 vs the US dollar (the weakest since 1990) during October but with a strengthening economy, minor inflation pressures - where core YoY inflation is an anaemic +0.9% - and a slowing global economy, any strengthening momentum will be bought aggressively in the months ahead.

87bps

The amount inflation expectations surged.

4.50%

The US base rate by year end.

4.05%

The amount that the 10-year US Treasury ended the month.

Although data released in October showed that US GDP rebounded with Q3 real annualised growth at +2.6% - ending the technical two quarter recession - if we strip out volatile components, 'core' growth was just +0.1% and has been declining for four quarters in a row. Government spending, imports and residential investment (with the US housing market in the process of an extremely rapid adjustment as mortgage rates hit 7.2%) are a drag on growth and may provide fuel for a bond rally in 2023.

Slowing global growth is tolerable if accompanied by slowing inflation and cheap valuations.

As the economy moves closer to a potential recession and a pivot by the Federal Reserve still several months away at best, we are mindful of growth sensitive risks within our portfolios and only hold risk if the rewards are sufficient. As a result, in our US dollar bond funds we continue to have ample dry powder in US Treasuries and cash. However, current valuations within the lower grade parts of the Fixed Income market, where investment grade bonds yield 6% and high yield 9%, are leaving us keen to deploy capital as risk adjusted returns relative to equities are very attractive and fully price in a small recession in the US. For now, we wait for a catalyst. Slowing global growth is tolerable if accompanied by slowing inflation and cheap valuations. We have one but now we must wait for the other.

Winners and Losers in Q3 Earnings

Global equity markets bounced in October, countering the market's downward year-to-date trend. Developed markets rallied +7.1%, with all the major industry sectors posting positive returns. The strongest performing sectors were Energy (+20%, with index heavyweights Exxon Mobil and Chevron both up more than +25%), Industrials (+10%), Financials (with Banks +10%) and Health Care, while laggards included Consumer Discretionary and Communication Services (driven by Meta's -31% drop). Emerging markets declined -2.6%, with China falling another -17% (bringing year to date to -43%) as the





7.1%

The amount that developed markets rallied.

EQUITIES

Party Congress cemented President Xi Jinping’s control and health officials vowed to “unswervingly” stick to China’s zero-Covid policy – disappointing market hopes for positive announcements around economic reopening.

A significant portion of third quarter earnings growth was attributable to the Energy sector. Including Energy, the S&P 500’s earnings per share are still running ahead of projections made at the start of the year. Outside of Energy, only Utilities and Real Estate (generally considered defensive) have risen thus far in 2022, along with Materials, where estimates have begun to fall as metals prices reduce.

On the October laggards, much of the underperformance was driven by prominent Mega Cap stocks. Communication Services was dragged down by the -31% plummet in Meta (the parent of Facebook, Instagram, and WhatsApp) and a less striking -1% decline in Alphabet (Google’s parent). Both disappointed the market with weaker than expected cost containment, which protects earnings in an environment of slowing economic growth. Meta had already been grappling with both a contraction in advertising spending due to economic uncertainty and a change in Apple’s privacy policy that made social media ads less effective. Meta now project operating losses within their Reality Labs division will get “significantly” worse, an area they continue to invest in heavily. Consumer Discretionary was hurt by declines of -9% in Amazon and -14% in Tesla. Amazon’s earnings were stronger than forecast but their stock subsequently fell because of their gloomy outlook for sales in the upcoming holiday season.

Stocks had a discount applied to them, which markets pared back as third quarter earnings announcements were not as bad as anticipated. A similar reaction followed the second quarter earnings season which were generally interpreted as surprisingly adequate, and that helped drive the 17% bear market rally over the summer. Uncertainty persists for both the fourth quarter and 2023. The Federal Reserve’s interest rate increases are likely to push up unemployment. Consumption may slow significantly if people start to lose their jobs in significant numbers. Until now, consumers have been willing to turn to credit cards to maintain their purchasing power, but that will likely slow if savings decline and confidence on employment status becomes less certain.

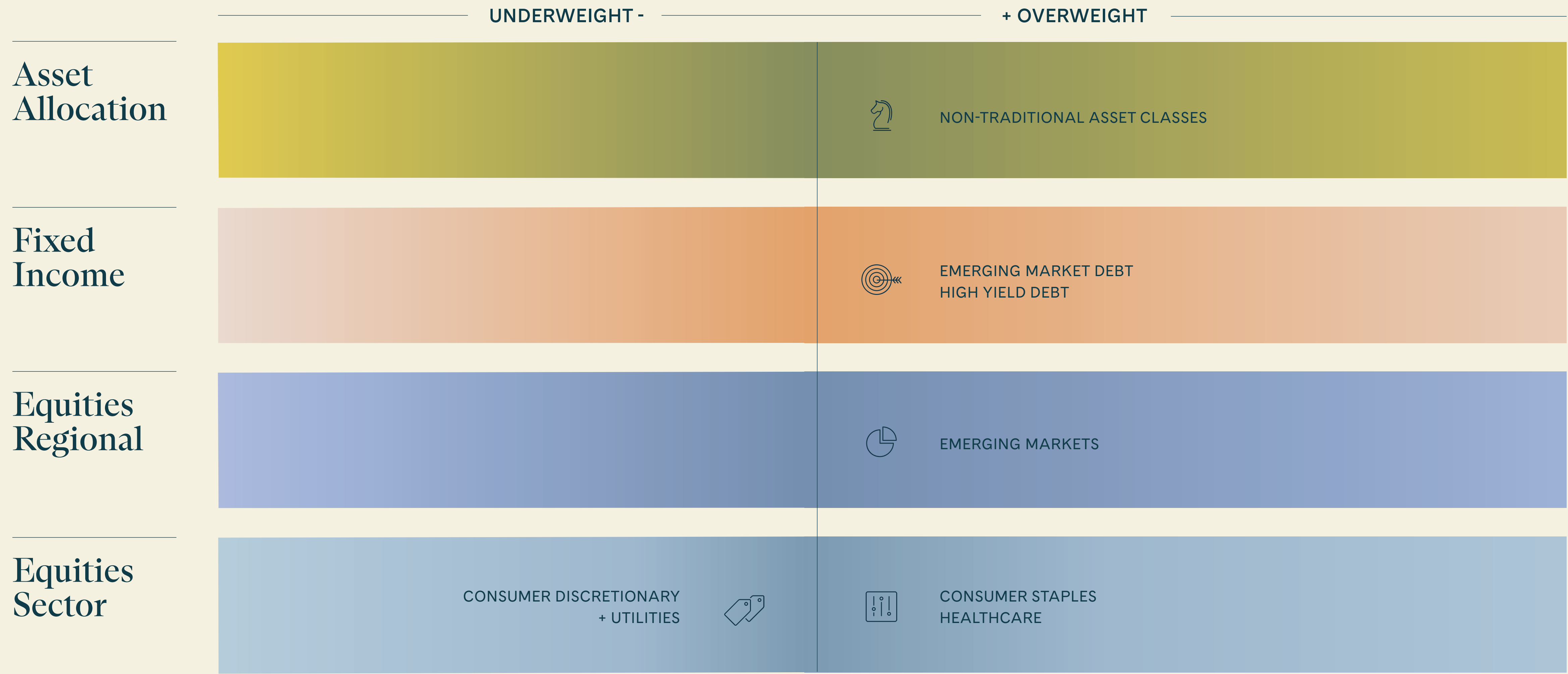


A significant portion of third quarter earnings growth was attributable to the Energy sector.



Global Asset Allocation

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



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