MARKET COMMENTARY

Executive Summary

Much in the same way that last quarter began with a fleeting return of ‘risk on’ sentiment among the investment community, similar traits were seen across both equity and fixed-income markets during October.

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The reasons for this have been wide-ranging, from broadly robust corporate earnings in the US to some much-needed stability in our own domestic landscape, namely in the shape of a third Prime Minister and Chancellor in as many months. A key theme underpinning market activity has been the switch of focus away from the inflationary view that has dominated much of the year, to a more traditional recessionary one. In my recent podcast, I spoke about markets daring to dream about the prospect of interest rates normalising at some point in the not-too-distant future, and what that may bring. That said, the reality is that we remain in both uncertain and unprecedented times – so much so that just last week, the Collins Dictionary named ‘Permacrisis’ (that is, an extended period of instability and insecurity) as its 2022 word of the year. Given that 2022 has already dealt conflict, inflation, further climate change and political instability, Collins stated that they chose the word as it sums up quite succinctly just how truly awful 2022 has been for so many people.

Markets

Starting with global equities, developed markets returned aggregate growth of 7% during the month, meaning October was, second only to July, the best performing month this year to date. Both ‘growth’ (that this those that are not necessarily profitable today but aim to be in the future and are thus generally more sensitive to factors affecting long-term cash flows and sales growth prospects, such as higher interest rate environments) stocks and their ‘value’ (those in the more cyclical and lowly valued areas of the market perceived to be underappreciated) counterparts achieved healthy single-digit returns. Some asset classes that have thus far experienced a torrid year (such as global small-cap stocks and global Real Estate Investment Trusts) enjoyed notable reprieve during October. Of the major regions, there

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were relatively strong returns in the US, Europe, Japan, and the UK. By contrast, emerging markets returned negative growth of -3.1% on aggregate, largely due to China's significant detrimental contribution to the index.

In the US, despite inflation remaining high at 8.2%, hopes that we may well have already seen the peak earlier on in the year were supported by three consecutive months of marginal contraction leading into October. The US Federal Reserve is expected to continue with its plans to increase interest rates by 0.75% in early November and by a further 0.50% in December. Their ongoing stance to focus predominantly on tackling inflation levels (rather than on any form of economic growth) is often poorly received by markets. However, given the aforementioned inflation pattern and the fact that both US corporate balance sheets and jobs market are seemingly both healthier than initially feared, October saw strong returns across all three major US equity markets. That said, economic data remained mixed. Despite unemployment falling to a new record low of just 3.5%, issues remain in the US property market, with transaction rates in both the new and second-hand markets slowing during the month. Productivity figures in both manufacturing and services industries were also weak, with the former registering its lowest output since the early pandemic.

In Europe, bloc-wide plans to tackle the current energy crisis were generally well-received by markets, particularly given the long-term goal of reducing the region's reliance on energy supply from overseas. There were also country-specific drivers too, with Germany announcing a €200 billion support package for households and businesses. Despite a rare positive month for most major European markets, the macroeconomic backdrop provided a more sinister reading. Ongoing conflict and political issues showed no signs of resolution and economic data released during the month was also generally poor, with a slowdown in both manufacturing and service industry output. Unlike the US, Eurozone inflation continues to trend upwards and despite the European Central Bank announcing a further 0.75% rise late on in the month, this is generally being perceived as not enough to control the situation, with winter approaching and both energy and food prices still at uncharacteristically high levels.

Closer to home, our own markets have been relatively resilient compared to most this year, albeit with a large proportion of the performance being attributed to so-called 'sin stocks' (such as those that sit in sectors such as tobacco, defence and increasingly now, more traditional fossil fuels). There have been several factors at play – such as the energy price crisis and the fact that most are cash-generative, 'value' stocks, with transparent current earnings, thus proving popular with investors given uncertainty for longer-duration assets this year. As for October specifically, the aforementioned political changes following September's 'mini-budget' crisis have been well-received and taken as a sign of overdue and much-needed stability. Much like in the US and Europe, both our manufacturing and services outputs remain under pressure, whereas the UK inflation pattern generally sits somewhere between that of the US and Europe. Whilst there have been no obvious signs of a peak, we no longer appear to be experiencing the consecutive and consistent monthly increases still being seen on the continent. The Bank of England (BoE) are now expected to bring rates to circa 4.75% at some point in early 2023 – a notable reduction from the previous consensus figure closer to 6% a few months ago.

By contrast, the policies of both Japanese and Chinese governments are somewhat far more accommodative when it comes to dealing with inflation – particularly the former, who appear keen to support businesses and households in order to keep inflation below the 3% level. Despite the government's approach, given the cyclical nature of Japanese equity markets, they experienced some of the volatility from global price increases during October but ultimately benefited from the broader global equity rally. Despite pressure to pass costs onto the consumer, the Bank of Japan reiterated their stance towards the end of the month. Chinese equities were the standout poorest performer during the month, experiencing a sharp sell-off in both Chinese and Hong Kong-listed markets. There were several headwinds, although sat chief among them was the announcement that Premier Xi Jinping would be in power for another five years – leaving investors pondering an extension of the prevailing 'Zero Covid' policy and further pressure on already fractured international relations. Despite some strong returns from other Asian and emerging markets, the weak month and heavy weighting from China dragged down both on aggregate.

Fixed Income

Turning attention to the fixed-income market, global bonds returned an average of -1% during October, with mixed performance across regions and the credit quality spectrum. Given the sobering returns of -7% for the asset class during Q3, October's numbers have generally been viewed as sanguine. In the US, both Government and Investment Grade (that is those with a higher quality credit rating) suffered from interest rate rises (given the inverse relationship of yields and prices), with their lower quality High Yield counterparts outperforming. The yield of the 10-year US Treasury (often seen as a yardstick for medium to long-term investor sentiment and growth prospects) rose from 3.83% to 4.05%, with the shorter-dated 2-year counterpart remaining uncharacteristically higher, at 4.49%. UK Gilts were the standout performer, albeit from a low base, following the instatement of a new Prime Minister and Chancellor. The previously announced bond buyback programme from the BoE also broadly achieved its objective of stabilising the Index-Linked market following September's debacle. It was a far less eventful month for other major bond markets, such as in Europe and Japan, with both remaining broadly flat throughout the month.

And Finally

In order to draw some form of conclusion, whilst the pressure we have seen on the traditional 60/40 portfolio this year so far appeared to alleviate during the month, it is clear that the markets are yearning for more stability, which may or may not arrive before some form of 'reset'. Whilst months of positive market movements are welcomed by just about everyone in the investment community, we are mindful that we are still very much in the post-pandemic recovery phase and that just last quarter, the BoE came out with a rather sobering statement predicting a 16 month-long UK recession from Q4 into next year, as well as a 2% decline in UK GDP and inflation rising to somewhere in the region of 13%. The consensus is that the new political arrangements will have a positive effect on such domestic forecasts, however we are mindful that the most recent global outlook forecast from the International Monetary Fund shared the same levels of pessimism, broadly revising down prospects for global growth, insinuating that the worst is yet to come.

A final word on the UK – where we are expecting a government announcement mid-November, which will potentially introduce some measures that will add to the difficulties being experienced by households for some time. Some solace can be taken by the fact that new Prime Minister, Rishi Sunak, was Chancellor during the challenging times of the global pandemic, and there are some early signs to be more positive, such as our under-pressure currency rallying from a £1: $1.03 low to finish the month at the £1: $1.16 level. However, the collateral damage (for example, to the liability-driven investing (or LDI) pension market) from

September will no doubt take some time to be repaired. Like the US, our property market has also come under more pressure, namely in the shape of rescinded mortgage offers and large increases on the monthly repayments for those in floating or expired fixed rate arrangements. The commercial property and infrastructure sectors have also experienced a valuation rerating, with pressure on the realistic returns from long-term projects in elongated rising rate environments weighing heavily. The upshot saw a sharp downturn in traditional inflation-proof safe havens which saw some well-known real estate investment trusts trading in the market at prices close to a 45% discount to the net asset value of their underlying assets.

As for our own portfolios, we have not made too many changes given our long-term outlook. I have explained in several of my investment podcasts that we moved to shorten the duration (thus reducing the sensitivity to interest rates) of our fixed income allocation in Q1 and have resisted the temptation to lengthen this out back to neutral or long-dated, despite July seemingly lulling many into a false sense of security at the time and October arguably also presenting another opportunity to do so. Whereas some of our peers may have been holding large cash positions, we have instead opted for low-volatility alternative strategies which focus on capital preservation and better than cash return profiles – these unsurprisingly sit among some of our best contributors to performance so far this year. We have, however, recently taken advantage of the dollar strength and sterling weakness by moving some of our US equity allocation into a hedged version, with the aim of benefiting from upside potential as a result of any sort of normalisation in the FX rate. In summary, we are constantly reviewing what we hold, and indeed other available ways of adding to returns for clients within the given risk parameters, in tough market conditions.

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