Wealth Management

Market Views
October / November 2022

The events over the past month bring home the famous comment from President Clinton's Chief Strategist, James Carville. He famously said in the 90's; "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a 400-baseball hitter. But now I would want to come back as the bond market. You can intimidate everybody". The bond vigilante quote seems as a relevant now as it did then.

Outgoing Prime Minister Liz Truss ultimately resigned as result of a loss of confidence in markets, only lasting 45 days in office given the disastrous "mini-budget". The leadership election this time around was much shorter with Rishi Sunak appointed as PM within a week. His fiscal discipline stance has restored some order in the gilt market which now trades at yields below the mini budget.

While a 0.75% rate increase seemed to be consensus across the main Western central banks, the outlook they provided showed that they are each facing different challenges. In the US, rates moved to 4% and the Federal Reserve opened the door to slowing down the pace of hiking after adopting four 0.75% increases. However, they caveated that while they may slow down, they expect the terminal rate to be higher than what it previously was. The October CPI release, showing that price pressure rose less than anticipated, has driven a relief rally across bond and equity markets. While encouraging, several Fed members reinforced our view that we should not read too much from one data point. The labour market remains strong and retail sales showed a resilient consumer. This is likely to reinforce the Fed's resolve.

Across the pond, the Bank of England took rates to 3% and warned that the UK is in a recession that is likely to last for two years. This may curtail further rate increases, however, the state of the labour market and the potential for imported inflation to remain elevated means it might be necessary to raise rates further. The modest level of fiscal tightening announced by Chancellor Jeremy Hunt, may help limit further increases. Inflation printed at a 40-year high at 11.1%, helped materially by the energy price cap. Without it, it would have likely been at 13.8%. This shows the difficult balancing act facing the UK. Across the Channel, the European Central Bank has now brought rates to 1.5% and announced it was altering the terms on the lending facility which is likely to see banks repay them earlier. All three central banks are expected to raise rates by 0.5% in December but the path in 2023 is likely to diverge more meaningfully.

On the political front, to the surprise of many pollsters, the Democrats fared much better than expected. The 'Red Wave' that many predicted did not materialise. This is quite unusual as history tells us that the halfway mark between presidential elections is normally when the incumbent party struggles with voters. Despite Biden's low approval rating, and high inflation being at the center of the voters thinking, Republicans have failed to take control of the Senate. While they are predicted to take control of the house of representatives, it will be by one of the smallest swings in years. This of course is a big blow to Trumps' Presidential chances while boosting the chances of more traditional republicans such as Ron DeSantis.

The twentieth congress of the Chinese Communist Party (CCP) confirmed what had been expected; President Xi Jinping broke convention and was confirmed for a historic third term marking a step back towards imperialism. As such, decision-making will be more efficient than in the past five years, but it comes with rising key-person risk as institutional counter-balance is significantly diminished. We are seeing the policy pivot. For the first time, top leadership (in recent days) has softened their overarching narrative on Covid policy, and we are now seeing the beginning of the end of China's 'zero Covid policy', This, along with targeted stimulus to resuscitate the domestic property sector, should go some way in restoring confidence and growth in coming quarters.

Conclusion

Despite the turmoil of UK politics, now that fiscal policy is taking some of the brunt, this may not only stabilize the market but potentially curtail the need for more aggressive monetary policy. The move towards re-opening from China will likely ease further supply chain bottlenecks. While the worst of US inflation is likely behind us, the tight labour market may force policymakers to keep rates at elevated levels for some time. As such, we continue to favour quality businesses with a high degree of pricing power.

Market View Changes

- No changes

Currencies

US dollar	◀▶
Sterling	◀▶
Euro	◀▶

The US Dollar remains the reserve currency of the world and has benefited from its safe haven status. With the Fed set on an aggressive tightening path relative to other developed markets, we have seen the dollar remain strong relative to most other currencies. The latest inflation print, showing that price pressure is moderating, have driven some short covering thus unwinding some of this year's strength. The pound has recovered somewhat since the calamitous "mini-budget" and the subsequent Bank of England action. The expected fiscal tightening should result in less spending providing further support to the pound. The Euro has also suffered relative to the dollar for most of the year. However, given the level of gas storage and the mild weather; this has seen it bounce back above parity.

Fixed Income

Government Bonds	Conventional	Inflation-linked
UK Gilts	◀▶	▼
US Treasuries	◀▶	◀▶
German Bunds	◀▶	◀▶

The gilt market has staged a recovery given the new governments committed to fiscal conservativism which will likely see less gilt issuance. As such, gilts are trading around the levels prior to the "mini-budget". While all three major central banks raised rates by 0.75%, the messaging around future increases was very different. The pace of rate increases going forward is likely to moderate, resulting in some stability for the government bonds. Conventional bond yields are now looking to offer some value, however the amount of expected quantitative tightening is likely to continue to weigh on this market. While UK index linked gilts are trading at more reasonable levels than at the start of year, relative to the US counterparts, they still look rather expensive.

Investment Grade Corporate Bonds ◀▶

As central banks are now looking to normalise at a brisk pace, we have seen both government bond yields and credit spreads move higher. Despite the recent moves in bond markets, the Bank of England and the Fed are still looking to unwind their balance sheets. However, given the elevated yields on offer, this is likely to bring support to this market where we are seeing selective opportunities.

High Yield Credit ◀▶

As central banks continue on a tightening path, the risk of recession is growing. Whilst default rates have been benign, there is some fear that this may change as the economy slows. This may continue to weigh on high yield bonds for some time, but we are now starting to see better opportunities. We retain our neutral stance for the time being and continue to stress selectivity.

Emerging Market Debt

Local currency denominated debt	◀▶
Hard currency denominated debt	◀▶

With developed market central banks set to tighten policy, this generally weighs on emerging markets. Though, many emerging market central banks have already raised rates substantially, which is likely to result in a much smaller impact than previous hiking cycles. With China announcing measures to boost economic activity, this has seen its risks assets rebound. This could support its neighbouring countries. Furthermore, recent upheavals in Peru, Pakistan and Sri Lanka demonstrate the political risks from rising food and energy costs. Sri Lanka defaulted on its debt payments having been hit by a lack of tourist income during the pandemic and now high prices and political unrest. Therefore, we emphasise that selectivity remains as important as ever, and we retain our neutral stance across this diverse asset class.

Equities

UK Equity
The FTSE 100 index has been buoyed this year by its exposure to energy, materials, and a weaker pound. However, the UK market cannot be immune from world events and the rising tax burdens may discourage overseas interest. Nevertheless, the market continues to trade at valuations that look cheap compared to markets elsewhere in the world. This, combined with the lower Pound, should spur takeover interest by overseas buyers, given the opportunity to pick-up companies at discounted prices. That said, the UK domestic economy faces significant headwinds from higher energy costs and interest rate rises. The rise in mortgage costs may further constrain domestic consumer spending. However, the UK index is mostly made up of international companies that are less dependent on UK specific factors. Considering the mix of factors, we recommend a selective approach in this market.

Europe ex UK Equity
The European equity market has been particularly vulnerable to the impact of the war in Ukraine and has seen large moves in both directions driven by the news flow. On the grounds of valuation, the European market looks relatively attractive, but the risk of colder winter keeping energy cost elevated is a significant one. The Italian election result, with a right-wing coalition may prove challenging for the rest of Europe and The Euro. Europe’s ability to cushion the impact of the acute energy crisis is limited by higher interest rates and rising input costs.

US Equity
The ongoing volatility surrounding inflation and its impact on the long-term discount rate has continued to cause gyrations between cyclical and less-cyclical companies. While companies are broadly still seeing revenue growth, the outlook in the face of rising input costs and slowing demand may be more challenging. Whilst these factors are pushing the Fed further, the US consumer so far continues to be resilient. The mid-term elections resulted in a better-than-expected outcome for the Democrats. However, a divided house will limit the President’s ability to act in the second half of his term. The US market remains a source of attractive companies with good long-term prospects, with relatively high self-reliance in terms of energy and food supply.

Japan Equity
Unlike other central banks, the Bank of Japan has maintained its easy policy stance, despite it having the worst performing currency in the G10. Inflation, whilst above its target, remains well below the levels seen in other developed markets and as such the need to pivot monetary policy has remained less pressing. Whilst in local terms, its equity performance remains relatively muted, it has underperformed many peers on a dollar basis. Given moderate valuations and many export-focused companies, Japan could have room to perform should the global economic situation improve.

Asia ex Japan Equity
China is finally starting to emerge following a swathe of lockdowns over the past few months. It is now seeking to adopt a softer stance on lockdowns while also addressing the weakness in its property sector. The combination of fiscal and monetary support should see it more able to boost growth over the coming quarters. However, the risks of political business interference in China remains high, but this is cushioned by the cheap valuations relative to other markets. A growing China tends to provide support for the wider region. Domestic growth elsewhere has been strong as a result of earlier easing of restrictions. The lack of sanctions on Russia confirm that energy headwinds are less of an issue for some countries in the region. As such, we think the potential for long-term growth is higher than elsewhere.

Emerging Markets ex Asia Equity
Though the rise in commodity prices has a natural benefit for resource rich countries like Brazil, the war in Ukraine has highlighted how extreme the geopolitical risks may be. Food shortages and higher prices threaten political stability; we have already seen this in Peru, Pakistan, and Sri Lanka. Developing countries need continued foreign investment but events like this deter investors, compounding these risks. Despite this, long-term growth prospects for many emerging markets remain high. Hence, we continue to stress a highly selective approach in this diverse universe, emphasise its volatile nature and maintain our neutral stance.

Alternative Investments

Hedge Funds/Targeted Absolute Return
Given pronounced movements across interest rate expectations, this will undoubtedly weigh on financing costs which may temper some merger and acquisition (M&A) activity. Conversely, the elevated levels of interest rate volatility may

present opportunities elsewhere. On the regulatory side, geopolitical fronts mean that regulatory intervention has become more commonplace. This has tempered our enthusiasm for event-driven strategies. More broadly, when allocating to this space, we look for funds that could diversify returns away from the directionality of conventional bonds and equity markets. Nevertheless, we continue to stress the importance of finding the right vehicle and investment manager, which requires extensive due diligence on the strategy and fund.

Property

Rising borrowing costs may come to weigh on property markets globally. In the UK, the unwind of pension fund leveraged positions saw some open-ended property funds restrict redemptions. We continue to suggest that any exposure to property should be selective and closed-ended over open-ended vehicles are preferred, due to the liquidity mismatch. However, as pension funds have looked to access liquidity, closed-ended property funds (REITS) have suffered.

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