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Investment review – End Q3 2022

30 September 2022

The solid recovery in global stockmarkets over the summer months, after the sharp sell-off in the first half of 2022, has petered out as the third quarter has drawn to a close. Lately, financial markets have come under renewed pressure from higher-than-expected inflation, interest rates and the threat of weaker corporate earnings, whilst locally the UK government's actions have thrown currency and bond markets into disarray.

On a slightly brighter note, the recent market adjustments have caused some healthy, and somewhat overdue, re-focusing on investment fundamentals: strategies with a bias towards higher quality, less expensive growth companies in more economically-resilient sectors have generally fared better than those still feeding off a world of low interest rates and liquidity; the period has also highlighted the benefits of early defensive positioning within bond markets and diversions into alternative investments that have been able to run in an entirely different direction to the crowd. Making good headway during the past quarter has been difficult, but it is at least pleasing to have come through the recent turbulence relatively unscathed.

Tighter conditions, but pandemic influences easing

It is clear that higher levels of inflation are now prompting central banks to get much more on the front foot by acting more aggressively, and sooner, than originally forecast in terms of raising interest rates. The backdrop has therefore altered from a few months ago. Government handouts, energy price caps and stimulus packages are helpful, but consumers and businesses are now having to come to terms with tighter financial conditions generally. The spikes in inflation are not just confined to energy and food prices – it has broadened out as businesses pass on higher energy, transportation and labour costs.

It is, though, pleasing to see an improvement in some of the pandemic influences on the global economy – the cost of shipping raw materials around the world has fallen, suggesting that supply chain bottlenecks are improving, whilst high frequency data such as hotel reservations, restaurant bookings and traffic volumes have also improved over the summer months. Levels of employment are also back to, or better than, pre-pandemic levels. However, China's continued lockdowns and strict zero-COVID measures are weighing more than expected on the global economy. Furthermore, the war in Ukraine continues to complicate the outlook for inflation and especially clouds the economic prospects of those regions more reliant upon Russian energy.

Potential for recessionary conditions

Joining all the dots together, the global economy is under more strain, and it is now quite possible that recessionary conditions will be reported in several regions over the coming months. Some economies, such as the UK and others in continental Europe, may be there already. However, we expect periods of negative economic output to be relatively short-lived – positive levels of global GDP growth are still expected for this year as a whole, and in 2023, albeit more muted compared to pre-Ukraine war predictions.

Interest rates and close to peak inflation

Tighter monetary conditions are likely to address inflation quite quickly and it is possible that we could be at, or quite close to, peak inflation already. The price of crude oil has fallen by around 30% from its high level in June and the prices of other commodities and raw materials have also been falling over the summer months. For inflation to remain consistently high it will require *current* inflation to remain at extreme levels too.

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This is unlikely to be the case and therefore forecasts for inflation petering out quite quickly later this year and into next – from a combination of weaker activity, tighter policy and natural base effects – seem reasonable. That said, inflation is still likely to settle at a higher level than anticipated earlier in the year, and above central banks' targets. For the time being, interest rates are likely to remain on an upward trajectory until either recessionary concerns or signs of progress on tackling inflation become much more evident. We still view the period of needing tighter policy as being relatively short-lived, with interest rates likely to recede again quite quickly when inflation and economic growth show signs of meaningful moderation. The clear challenge for monetary authorities, however, will be the timing of their pivot from controlling inflation to maintaining economic momentum, so the risk of policy error remains high. The uncertainty over this balancing act is unlikely to be easy for financial markets in the short term.

We are hopeful that a range of global support packages and fiscal loosening initiatives should help ease the pain, but they are likely to place additional strains on the finances of those economies already weakened by the global pandemic – this may therefore inhibit their economic recovery. As a result, the US and Asian economies do still seem better placed to withstand the near-term challenges, whilst the UK and several continental European economies could be further weakened by them. We are therefore comfortable maintaining our current geographic biases to equity positioning, including commitments to global infrastructure assets and businesses exposed to important environmental and climate change initiatives such as the US Inflation Reduction Act. We are also happy to maintain exposure to the US dollar which, aside from its status as a broad safe-haven currency, should retain its strength whilst the US Federal Reserve remains in policy tightening mode.

Valuations already factoring in uncertainty

Stockmarkets could continue to be jostled into the year-end by the uncertainty over the pace of monetary tightening and the impact on corporate earnings from tighter conditions and reduced consumer spending. But stockmarket valuations do already factor in a great deal of this uncertainty and in some regions are significantly lower than their 25-year averages. Even in the US, valuations have come back within a more acceptable range, particularly if the expensive 'tech' index heavyweights are excluded. Critical for market support, however, will be the extent to which company earnings meet, or preferably exceed, analysts' forecasts. The main risk is that markets are not actually as cheap as meets the eye, being propped up by profits that have yet to see any meaningful downward adjustment.

UK government's SOS

Some economies, including both businesses and consumers, currently need more help than others in the present climate. The UK is a stand out example, but the negative reaction to the UK government's unashamedly pro-growth 'mini-budget' has been dramatic to say the least. Markets can already see through the glossy headlines of personal and corporate tax cuts and broad initiatives to stimulate growth in the economy, knowing that the measures will undoubtedly mean more borrowing and, in all likelihood, more inflation and higher interest rates for longer. The pound has taken a massive hit after a torrid summer, at one point hitting an all-time low against the US dollar, whilst borrowing costs, as represented by government bond yields, have risen sharply. The government clearly hopes that the measures announced will boost the economy sufficiently quickly to raise tax revenues and improve the fiscal position. But markets know that these handouts have a big price attached to them and the benefits will not come evenly – some are multi-year initiatives that will do little to ease the short-term economic pain. Furthermore, there are still many external factors outside the Chancellor's control that are influencing the cost pressures being felt by consumers and businesses.

All in all, the UK government's announcements are being viewed by the world as a high-risk strategy to reinvigorate an economy already close to being on its knees. The government's gamble also comes at a time when the Bank of England's Monetary Policy Committee has said that it will "respond forcefully, as necessary" to return inflation to a sustainable level of 2% by pushing up interest rates.

But these are unprecedented times: further down the corridors of Threadneedle Street the wild gyrations in bond markets, and the implications for pension funds in particular, have now forced the UK's central bank to intervene to buy up the government's debt, just as it was planning the opposite. This action has the potential to confuse markets by bringing into question who is actually in charge of the UK economy's destiny. The government does not have long to prove its new strategy, and may yet need to turn to other measures, such as cutting spending or raising taxes elsewhere, in order to keep its books from going seriously into the red.

Time will tell whether the recently-announced measures create a shallower or deeper hole from which the UK economy must extricate itself. The UK is, of course, not alone in needing to address its economic weakness, but unlike many other countries and regions it is having to do so from a weaker post-pandemic base position. Even before the Chancellor's pro-growth initiatives, the size of the UK economy was not expected to recover its pre-pandemic level until late 2023 – we await the government's revised economic forecasts, currently scheduled for late November, but it is highly likely that the recovery timeline will have slipped further. Meanwhile, other economies, particularly in Asia, are continuing to increase their slice of the global economic pie.

Potential for M&A activity

As we have noted previously, our concerns over the fragility of the UK economy are reflected in our muted UK stockmarket positioning. We are in no hurry to alter this stance, despite what appears to be some very attractive value based on the multiple of corporate earnings at which UK companies trade internationally. This 'cheapness', along with the weakness in the pound, has not escaped the attention of international predators, hence merger and acquisition ('M&A') activity is on the rise. Historically, much of this action has typically been focused on medium- and smaller-sized companies, but looking down the share-ownership registers of some of the UK's largest-listed companies it is not difficult to find more activist names appearing. So, this could be the precursor to some larger corporate activity to come.

Big M&A deals do, however, often rely on cheap finance and leverage, so with interest rates on the rise, lending conditions becoming tighter and exit routes narrowing the door for opportunistic dealmaking may close quite quickly. That said, those entities with cash-heavy balance sheets are in a strong position to pick off their weaker competitors, potentially at knock-down prices. This is not a reason to get overly excited about the UK stockmarket, but it does add a little comfort and might add an extra component of return to the exposure we have retained. Fundamentally, however, our preference is for the active managers we own to prioritise investment in healthy, quality business franchises with strong balance sheets and pricing power rather than in distressed and vulnerable companies with a potential takeover sign above their door. Waiting for deep value to be released can be a very painful and lengthy exercise, but if deals do come along for our underlying managers then it will be a bonus for clients and potentially assist with some longer-term re-rating of the UK stockmarket. At present, there is little else to raise the UK stockmarket's general appeal other than via active, stockpicking, funds such as the ones we are accessing.

Bond markets proving a challenge

With higher prices continuing to squeeze living standards worldwide, taming inflation has become the clear priority for central banks. It will undoubtedly have economic costs, but delaying action is not an option. It is quite possible that the authorities will oversteer in their quest to bring things under control, stopping some economies abruptly in their tracks barely before they have seen any meaningful light at the end of the post-pandemic tunnel. Against this backdrop of rising inflation and higher interest rates, fixed interest markets have in many cases been even more challenged than stockmarkets this year. As we have noted before, it has largely been a question of damage limitation from this asset class, but we are pleased that the early steps we took to both reduce fixed interest exposure (diverting money into genuinely 'alternative' investment funds) and decrease the sensitivity to rising inflation and interest rates have helped avoid some of the heavier losses from this asset class in the year to date.

But time and markets do not stand still, and we are now looking into the future to a point where the current headwinds for fixed interest investments might become tailwinds. Shorter-duration positioning has largely done its job and opportunities are now appearing further along the yield curve, especially in sovereign bonds, after significant reactions to higher inflation, a tighter monetary framework and governments' economic policy. Difficult conditions in this asset class could continue near-term, but tactical opportunities for repositioning are now emerging. Some of our underlying strategic bond fund managers are already beginning to reposition their portfolios to take advantage of the more attractive investment opportunities in fixed interest markets – we are similarly looking to make some subtle shifts in emphasis to remove some of the defensive biases, particularly now that economic growth is slowing, inflation is showing signs of peaking and the actions of central banks are beginning to take effect.

At some point the coast may become much clearer for fixed interest markets, potentially leading to a fundamentally higher allocation, but until then we are very comfortable with the allocations to the range of highly liquid alternative investment funds. These have exhibited low levels of volatility during this year's market turbulence and are producing solid returns, acting as effective risk management tools and a replacement for fixed interest, especially in those mandates that do not have the appetite for full stockmarket risk.

Taking a longer-term view

We are not blind to the fact that continued volatility in financial markets could remain in place for a while, but feel that sitting tight and riding out this period of uncertainty, taking a longer-term view, will prove a more worthwhile strategy than getting whipsawed by shorter-term conjecture, which is plentiful at present.

Within stockmarkets our preference is to maintain our tilts to more economically-resilient regions and to a range of underlying managers that can access all investment styles – being tilted too much to either extreme of 'growth' or 'value' does not seem sensible, for example. In this environment we want active managers to focus on quality companies with strong balance sheets, dominant franchises and pricing power that can withstand the pressures of higher interest rates and inflation, and come through the other side of this uncertain period in a stronger position than they entered it. Furthermore, whilst maintaining our high-level positioning to different asset classes, we are also focusing on active management within each area. This has been particularly necessary and effective since the pandemic unfolded and our expected activity within fixed interest investments is another good example of reappraisal leading to action, particularly as this complex economic and market scene continues to evolve.

Risk warnings

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