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Investment review – End Q4 2022

December 2022

To say that it has been an eventful year would be quite an understatement: a devastating war in Europe; inflation at 40-year highs, an energy market shock on a par with that experienced in the 1970s; the death of the longest reigning monarch of any internationally-recognised sovereign state for over 300 years; and more pantomime in a British political summer than one would normally expect to see in a decade – seeing a lettuce have a longer shelf-life than our Prime Minister perhaps sums up what has been an unbelievable and extraordinary 12 months.

Whilst 2022 will be a year upon which most of us will not wish to dwell too much, it did have a reasonably promising start: some light was at last being seen at the end of the long pandemic tunnel, although the impact of continued manufacturing bottlenecks and supply-chain shortages were already causing upward adjustments to the inflation and interest rate outlook, mainly for western economies, at this time last year.

Early groundwork proved beneficial

Against that early-year backdrop, we envisaged a tougher environment for fixed interest securities, assets that typically struggle to cope with higher inflation and tighter monetary conditions. We also knew that the over-indulgence of 'growth' stocks, fed by low interest rates and plentiful capital, was unlikely to last. So, our early moves in late 2021 to prepare for the year ahead have proved beneficial: we reduced the sensitivity of any bond exposure to rising inflation and interest rates; we introduced infrastructure investments with their built-in inflation protection; and we maintained a healthy blend of 'growth' and 'value' styles in our stockmarket positioning. This action certainly put clients in a better place than many for what the rest of 2022, ultimately, had in store for us.

As we now know, Russia's full-scale invasion of Ukraine in February completely altered the inflation, monetary policy and economic outlook, particularly in Europe. Even the most bearish of inflation forecasts proved quite tame: in the space of a few months soaring energy and food prices pushed inflation to levels not seen since the 1980s. It meant further decisions were necessary about how best to allocate capital for both the short, medium and long term. We battened down more hatches in fixed interest markets, allocated more capital to alternative investments, reduced or eliminated exposure to what we saw as the most vulnerable economy to the energy crisis, Europe, and added to the more economically-resilient economies in Asia. We also held our positions in what has historically been the currency of choice in times of crisis, the US dollar.

So, whilst we could not have anticipated the war in Ukraine, or its far-reaching impact on the world economy, our earlier preparations for a period of more persistent post-pandemic inflation did at least mean we had some protection for what was to follow. However, whilst we might have reasonably expected that early groundwork to have added to 2021's solid returns, 2022 has turned out to be a year of damage limitation, i.e. avoiding the more severe falls in both bond and equity markets and seeking shelter, where possible, in alternative assets that have demonstrated low levels of volatility without compromising on things like access and liquidity. By and large, that is what we have done. However, in a year where UK government bonds have fallen almost 25%, global stockmarkets are down by almost 10% (in sterling terms), commercial property funds have blocked redemptions and cash (until very recently) has offered a very negative real return, then finding something to generate a positive outcome has been virtually impossible. Resorting to speculation would certainly have brought no joy either – leading cryptocurrency, Bitcoin, has seen its price fall by around 70% in 2022.

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No permanent damage done

The key to coping with years like the one just ending is to make sure that no permanent damage has been done and sufficient skin is left in the game to benefit from the recovery, when it comes. It gives us no pleasure to report investment losses in any calendar year, but we do feel we have avoided many of the trap doors with deep holes underneath them and from which it would be hard to clamber out. The investment textbooks guide us that strong long-term results come from the compounding of returns, but also that those returns do not come uniformly and can be significantly affected by the magnitude and timing of negative periods during that investment journey. Keeping a close eye on risk and adapting to changing events can help minimise potential losses and ensure longer-term objectives remain on track. It has not been a perfect decision-making year, but we gave it our best shot in the interests of protecting clients' wealth as best we could in extremely challenging circumstances.

What does the future hold?

So, with this difficult year now behind us, what can we expect for 2023? For starters, we can almost guarantee there will be little to cheer about in the papers this festive period. In the near term, the newsflow will be gloomy. In all likelihood, recession-talk will intensify as more economic data come through. But it will be important not to convince ourselves that we will be consigned to a lengthy period of malaise in every area. Indeed, the global economy is still expected to see growth next year, and the year after, even after factoring in recessionary conditions in some key economies.

Judging by most forecasts, it is likely that the US economy will enter a technical recession at some point during 2023, i.e. we will see at least two quarters of negative economic growth. The New York Fed Recession Indicator, which observes the spread between long- and short-term bond yields, historically has been a fairly accurate predictor of a recession occurring sometime within the following 12 to 18 months. It has been flashing red for a while. But, what the indicator does not really tell us is how deep any recession will be, or how long it will last. We know that the US Federal Reserve, along with other central banks, has its work cut out to navigate safely with its policy moves over the next few months and its messaging will also be critical to ensure financial market stability. But it is still possible that for the year as a whole, despite recessionary conditions part way through it, the US can engineer a small expansion in its economy. It will probably be tight, but still possible.

Don't let the UK's issues skew mood

The same cannot be expected, however, for the UK economy. November's Office of Budget Responsibility forecasts did not paint a pretty picture – it expects a decline in real GDP of 1.4% in 2023 and annualised growth of just 1.5% between now and 2027. According to the Organisation for Economic Co-operation and Development's latest forecasts, the UK economy is expected to be the worst performing economy in the G20 bar Russia over the next two years. Europe is also expected to have a weak economic trajectory, which means that all eyes will be on the likes of the US and Asia to keep the wheels of the global economy turning properly.

It is worth noting that the UK is a tiny slice of the global economic pie, so we should be careful that it does not skew our investment mood too much. The UK's share of global GDP, in purchasing power parity terms, was just 2.3% at the end of 2021, according to World Bank data. Furthermore, the UK stockmarket has just a 4% or so allocation within global share indices, such as the MSCI World Index. But the UK should certainly not be ignored from an investment perspective: it is, after all, still in the world's top ten as measured by share of global GDP, and arguably sits above all others in terms of the regulation and global connectivity of its financial services sector. Its stockmarket also hosts a large number of global, as opposed to UK-centric, businesses. One could argue therefore that the UK punches well above its weight on a number of fronts, including when it comes to allocating investment capital. We do still have an allocation to the UK stockmarket, despite giving it quite a haircut after the pandemic took hold, but constantly need to remind ourselves that the UK is dwarfed by the likes of China, the USA and India, which collectively account for over 40% of the global economy.

Asian economies in aggregate are expected to continue to forge ahead, with medium term annualised economic growth rates above 4% not out of the question. Some Asian markets, including China, are not yet sufficiently accessible for international investors, but the disparity in economic performance can only shunt economies like the UK, and other similarly-blighted European economies, further down the global economic tree.

We do need to be mindful of retaining some balance by allocating to accessible markets on the one hand and long term growth drivers on the other. Taking both the risks and opportunities into account, this still points to giving a significant bias towards fundamentally faster-growing, dynamic and in many cases developing economies, as tomorrow's growth stories are more likely to be born in economies exhibiting those characteristics. The UK won't be low down our investment agenda for ever and Europe's economies will not always be threatened by energy shortages. But for now, we feel better headway can be made by investing in the more entrepreneurial and economically resilient economies of the US and Asia respectively, so that is where the biases of our stockmarket commitments are likely to remain for the foreseeable future.

Bonds back in vogue again

It seems odd to be saying this after such a challenged year in fixed income markets, but this asset class could be where more of the action is over the coming months, particularly if inflation retreats as expected and interest rate rises are tempered, and eventually start to fall. Far from being the investment pariah, bonds could become the opportunity once again. Markets are already starting to interpret central bank rhetoric and latest data releases as meaning a slower pace of tightening and lower terminal levels of interest rates – this should ultimately be good for a range of risk assets but also for traditionally safe-haven investments such as bonds.

We can already see that US consumer price inflation has fallen for five consecutive months, and the US Federal Reserve has now dropped down a gear in terms of tightening its policy rate. This should be good news. Yet the financial market commentators are understandably still focused on the negativity of the immediate future and how consumers and the wider economy get through what looks like a harsh winter. Economically, we may be looking at some bleak months ahead, but before we know it markets will have moved on, looking more at 2024 than the immediate issues of 2023.

So, we have already opened up the next chapter of what has become a very complex investment playbook: recently, we have taken steps to modify, yet again, fixed interest exposures by taking advantage of attractive yields and pricing within corporate debt markets and generally lengthening the maturity of bond exposures. This action may seem counterintuitive against a backdrop of still rising rates and elevated inflation, but as with all investment, the best longer-term opportunities can often be found when the crowd is looking the other way.

A lot priced in

As to the future, we should be reassured that central banks will have more firepower to lower interest rates as inflation and various economies begin to falter. We should also remember that global stockmarkets have already priced in a lot of the anticipated fall in corporate profitability and are not generally trading at frothy multiples of future profits, particularly outside some of the big index heavyweights. It will not be an easy year ahead (do we ever say it will be?) but there is still a reasonable chance that things will not turn out quite as bad as many, typically 'glass half empty', commentators currently predict. Yes, the global economy is facing mounting challenges from a massive energy market shock, plus a cost-of-living crisis in many regions from rising inflation triggered initially by the Covid pandemic. And yes, there will be vulnerabilities exposed as interest rates are raised in the coming months. But soon, markets will start to consider the investment opportunities presented by a lower inflation and interest rate backdrop – it may seem hard to think about that scenario right now, but it is not implausible to expect the foundations on which a market recovery can be built to emerge during the coming year. That is not too long to wait and strengthens our argument for retaining stockmarket commitments at the upper end of the strategic ranges, whilst also dialling up some risk again within bond markets now that future conditions appear a lot safer.

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From recession to recovery

For much of 2022, the debate has intensified on how high interest rates will need to go before inflation is brought under control. So, too, has the talk of the likely recession during 2023. Soon, though, the financial press and analysts will be looking for something new to talk about. That could actually be positive things, some of which are already in view or could emerge quite soon. For example, it could be an easing of inflationary pressures as energy prices retreat, it could be calmer conditions in bond markets as the end of policy tightening draws a bit closer, or it could be companies maintaining margins and getting through this tough period in slightly better shape than already priced in by markets. It will be hard for financial broadcasters and commentators to wean themselves off recession-talk now they have nailed their colours to the mast, but it is not implausible, as already noted, to envisage some regions, including the mighty USA, experience quite mild recessionary conditions and for a different 'R' word – recovery – to begin entering the financial vernacular before we know it.

Time to stay committed

Trying to predict with some degree of accuracy the precise course of inflation and monetary policy for various economies over the year ahead is nigh on impossible. As sure as eggs is eggs, no-one will get it right, including central banks, given the wide number of variables. How will the unresolved Ukraine crisis influence food and energy price inflation, for instance, and what might be the economic implications of a more relaxed Chinese government vis à vis its Covid restrictions and vaccine policy? One thing seems fairly certain: by this time next year, the inflation and interest rate backdrop, particularly in western, developed economies, will look quite different from now. The transition to a climate where inflation is falling quite rapidly and policy tightening is being reversed will not be straightforward, so it will undoubtedly present further need for active management.

The year just ending has certainly kept us on our toes and 2023 is likely to be no different. But we do feel well-prepared for the challenges and opportunities that lie ahead. During times of peak negativity and newsflow, and when uncertainty rules the roost, it typically pays to hold one's nerve, stick to the fundamentals of investment whilst also looking for selected mis-priced assets and longer-term opportunities.

We believe that staying committed to a range of diversified assets, using managers with an active mindset who can do more of the day-to-day heavy lifting, should prove a more rewarding exercise in the medium to longer term than taking a more defensive stance. Financial market recoveries typically begin when the economic data are still pointing in a different direction, so we think being ready for that possibility, by taking a measured approach to the reallocation of risk, remains the most sensible approach – it should mean clients' wealth can both withstand the current challenges yet also enjoy good participation in the recovery when it arrives.

Risk warnings

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