FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 3 2022

Investment Strategy Committee Tactical Asset Allocation Views & Commentary

Tactical positions relate to the strategic allocations for our five risk rated portfolio benchmarks which power our investment process. They are expressed as in the key below.

- - Strong Underweight	- Underweight	N Neutral	+ Overweight	+ + Strong Overweight

Please contact us if you require further information.

ASSET CLASS	TACTICAL POSITION	COMMENTARY
Global Government Bond	+	We feel the Fed has been aggressively tightening in an already slowing economy and liquidity is already tight enough. If the hiking cycle ends sooner than expected, we will see returns from US Treasuries in coming months. We exit our Index Linked positions as we feel inflation has peaked
Investment Grade Bond	N	Company fundamentals are strong and while spreads over government bonds are tight, leaving little margin for error, this is still balanced by the scarcity of income producing assets. We expect our managers to search for yield and balance the credit risk to reduce potential volatility
High Yield Bond	-	We look to reduce credit risk of High Yield exposure as we see recessionary forces increase. Our managers are confident in their ability to select issues and robust credit analysis, but we reduce exposure here at this stage in the economic cycle. We will return as conditions become clearer
Emerging Market Bonds	-	Strong USD and lower liquidity is a headwind to the performance of EM local bonds. While the sector is at risk in the event of too much tightening, the higher yield is welcome when income is scarce. We are underweight and stay patient until valuations suggest we are well paid to take the risk
UK Equity	N	We maintain neutral exposure as UK has serious headwinds and uncertain leadership which has hit Sterling. Recession in the UK seems inevitable and a return to effective and believable fiscal policy is essential from the new Tory leadership if UK plc is to emerge stronger from the slowdown
Developed Market Equity	+ +	US stocks still favoured maintaining our exposure across style strategies but avoiding deep value and economically sensitive stocks as recession fears mount and economic headwinds challenge corporate profitability. Asia faces headwinds due to China slowdown. EZ faces energy shortages
Emerging Market Equity	N	Although valuations are lower, the China effect on surrounding markets is expected to be a headwind for EM in the short term. Strong USD hurts EM Equities as performance vs Developed markets tends to be inversely correlated with USD. Prices are starting to look cheap on most metrics
Commodities	N	We expect performance to moderate or turn down across the Commodity complex if recession plays out, demand slows, and supply side issues are solved. Gold has disappointed but it is usually a good hedge in tough times. Energy may buck the trend if the Ukraine crisis remains unresolved
UK Commercial Property	-	Industrial, warehousing and logistics favoured, with portfolio balance key. Retail and offices remain under pressure, and this may worsen as the economy stalls and the cost of living crisis continues. Sterling weakness may motivate international investors to return, which may be positive
Absolute Return	+ +	We continue to rely on this allocation to provide diversification, reduce portfolio volatility and provide downside protection. The combination of market neutral and macro strategies diversifies risk exposure, despite challenging market behaviour and hope macro strategies pay us back soon
Cash	+ +	We increase our cash weighting as market uncertainties and the future outlook for economic growth, interest rates, quantitative tightening, and market weakness suggests further volatility, before markets stabilise. Cash gives balance and some optionality in the event of further market falls

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Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements.

LOOKING BACK…

It has been another difficult quarter for markets after what had already been a tough start to the year **(FTSE World -14.55%)**. This is now the worst first half of the year for developed market equities in over 50 years and the worst start for the S&P 500 since the Cuban Missile Crisis in 1962. To make matters worse, government bonds have also been hit, failing to provide the protection that investors might normally expect as markets moved ahead of expected further increases in interest rates. Markets now expect interest rates to rise to 3.4%, 3% and 1.6% in the US, UK and Europe respectively, by next year. That increase in expectations for the path of interest rates has also contributed to a decline in equity valuations, along with concerns about the growth outlook. Recession fears have risen, due to the squeeze on consumers from higher prices and higher borrowing costs as the central banks seek to fight inflation.

US equities fell in Q2 **(S&P 500-16.45%)**. With investors focussed on inflation and the policy response from the Federal Reserve (Fed). The Fed made its initial rate hikes during the quarter, signalling that there would be more to come and that the task of bringing inflation down without triggering a recession would be challenging. The US economy has looked robust, but signs of a slowdown are emerging. The 'flash' US composite purchasing managers' index (PMI) fell from 53.6 to 51.2 in June, but the manufacturing component of the index fell sharply from 55.2 to a two-year low of 49.6. Only twice has this fallen by more than 5.6 points; during the pandemic in 2020 and the financial crisis in 2008. PCE (personal consumption expenditure) inflation, was unchanged at 6.3% in May. All equity sectors fell, although consumer staples and utilities were more resilient.

Eurozone shares fell sharply again **(FTSE World Europe ex UK -12.03%)** as the war in Ukraine led to concerns over gas shortages and Germany moved to phase two of its emergency energy plan, with the next phase including rationing gas to industrials and potentially households. Market expectations of ECB rate rises in July and September, along with higher inflation affected consumers. The consumer confidence measure fell to the lowest level since the beginning of the Pandemic reflecting concerns over the higher cost of living and possibility of recession. Energy and communication services did best, while information technology and real estate fell sharply. A flash estimate from Eurostat signalled inflation at 8.6% in June, up from 8.1% in May, with energy the biggest contributor to the rise.

UK equities fell over the quarter **(FTSE All Share -5.90%)** with economically sensitive areas of the market suffering late on amid rising recessionary risks. Large cap held up relatively well as traditionally defensive areas of the market outperformed, including the telecoms, healthcare and consumer staples sectors. Consumer discretionary sectors, such as retailers and housebuilders, performed particularly poorly, in line with other developed markets grappling with high levels of consumer price inflation. Small and mid-caps were hit due to a higher number of UK consumer focused companies, as fears of high inflation and cost of living crisis weighed on future earnings prospects and stock valuations. Chancellor Sunak unveiled additional measures to help households facing higher energy bills which are expected to offset some of the impact of higher energy prices later this year for the hardest hit UK households. The Bank of England increased interest rates with two consecutive 25 bps hikes moving the rate to 1.25% and warned of higher inflation to come, estimating peak CPI up from 10% to 11% for October.

The Japanese stock market ended the quarter lower **(TSE TOPIX -3.88%)** and the yen weakened sharply against the US dollar, breaching the 130 level for the first time in 20 years. Equities were driven by news flow on monetary policy, currency markets and concerns over the growing possibility of a US recession. Comments from the Fed pointed to a widening interest rate differential with Japan which was reinforced by the Bank of Japan's meeting on 18 April, confirming no change in policy. The yen's weakness coincided with an increase in inflation with May core CPI (excluding only fresh food) jumping to 2.1%. Corporate results season began in late April with fewer positive surprises than recently, and while some companies made very conservative forecasts, the tone of results and guidance was still slightly above expectations.

Asia ex Japan equities fell **(FTSE Asia Pacific ex Japan -8.02%)** as investor sentiment turned increasingly downbeat over global inflation and ongoing supply chain problems, accentuated by the war in Ukraine, which could tip the world into recession. South Korea was the worst-performing market, with financials, technology and energy stocks particularly badly hit amid recession fears. Taiwan was significantly lower on fears that the global malaise would weaken demand for its technology products. India, the Philippines, Singapore and Malaysia all recorded sharp declines in the quarter, mirroring the share price falls seen in global markets, while declines in Indonesia and Thailand were less severe. China was the only index market to end the quarter in positive territory, as Covid-19 lockdown measures started to be relaxed. Investor sentiment towards the country was also boosted after government data showed that factory activity in China grew in June. Meanwhile, additional economic support measures were announced. The authorities also outlined a significant reduction in quarantine for close contacts and visitors to China, which should help to ease supply issues even if the zero-Covid policy seems set to remain in place.

Emerging market equities also fell in Q2 **(FTSE Emerging -8.51%)**, outperforming developed market peers despite the headwind of US dollar strength. The Latin American markets of Colombia, Peru and Brazil were among the weakest performers due to a combination of rising global recession fears, domestic policy uncertainty, and weaker industrial metals prices, which contributed to declines in equities and currencies. Poland and Hungary both underperformed significantly, as geopolitical risks from Russia's invasion of neighbouring Ukraine persisted. Their central banks increased the pace of policy tightening, while in Hungary the government announced windfall taxes on banks and other large private companies. South Korea and Taiwan lagged as the outlook for global trade deteriorated. Conversely, China was the only emerging market to generate a positive return over the quarter.

Bonds continued their sharp selloff **(FTSE World BIG Domestic Sovereign -4.74%)** as data showed inflation rates in major economies continuing to run at multi-decade highs, with some central banks raising interest rates and others signalling their intention to hike soon. The quarter ended with mounting concerns over growth prospects, and even potentially recession later this year, which sparked a late quarter bond rally, slightly reducing negative returns. The Federal Reserve implemented a series of hikes, raising the policy rate by 75 basis points (bps) in June for the first time since 1994. At the same time, Fed officials cut 2022 growth forecasts. The US 10-year bond yield rose from 2.35% to 2.97% and the two-year yield from 2.33% to 2.93%. European yields were volatile as the ECB looked to end asset purchases early in Q3 and raise rates soon after, sparking a sharp sell-off in Italian yields in June. The ECB called an extraordinary meeting to discuss an "anti-fragmentation" programme likely entailing some form of support for heavily indebted nations to deal with concerns. The German 10-year yield increased from 0.55% to 1.37% with Italy's up from 2.04% to 3.39%, hitting as high as 4.27% in June. The Bank of England implemented further rate hikes, bringing the total to five in the current cycle, raising its inflation forecast to 11%. The UK 10-year yield increased from 1.61% to 2.24% and two-year rose from 1.36% to 1.88%.

In other fixed interest markets, corporate bonds suffered in the broad bond market sell-off **(Bloomberg Global Aggregate – Corporates -8.72%)**, underperforming government bonds as spreads widened markedly. With increasing concerns over the economic outlook, high yield credit was particularly hard hit (**Bloomberg Global High Yield -11.85%).** Emerging market (EM) bonds suffered (JPM GBI-EM Global Composite -6.69%) and EM currencies weakened as the US dollar performed well, benefiting from broad risk aversion.

After a stellar start to 2022, Commodities fell in Q2 **(Bloomberg Commodity -5.66%)** Despite higher energy prices, sharp price falls in the other components of the index led the index into negative territory for the quarter Energy led amid rising demand and supply constraints due to the Ukraine crisis. Industrial metals was the worst performing component, with sharp falls in prices over the quarter. Precious metals also suffered with silver significantly lower and falls for gold less severe. Within agriculture, prices for wheat, corn and cotton were all lower.

Despite increasing recession fears UK Commercial Property was positive **(FE UK Property Proxy +1.23%).** It will be interesting to see if this continues over the coming quarter, or whether this illustrates a slight pricing lag in this asset class.

In Currencies the USD continued its strong run vs all currencies including Sterling **(USD +7.89%),** meaning it has appreciated by more than 10% vs GBP since the beginning of 2022. Swiss Francs were also a safe haven in Q2 **(CHF +4.33%)**. GBP also weakened vs the Euro **(EUR +2.06%)** but rallied against the Yen **(-3.33 vs GBP)**. A weak Sterling increases the return for investments denominated in foreign currencies over the period.

Please Note: All quoted returns are on a price basis in local currency terms.

LOOKING FORWARD…

"This too shall pass" **– Abraham Lincoln**

The excitement of the re-opening trade in 2021 has begat the 'recession trade' in 2022, characterised by excessive liquidity and a tardy start to the hiking cycle by central banks in developed markets. This has left them way behind the curve having misread the inflation tea leaves, believing it to be transitory. To save face, they are moving rapidly ahead in tightening monetary policy at a time when inflation expectations are receding. This aggressive tightening plan is slowing the global economy, raising the probability of a global recession. Our core views/themes can be summarised below:

- We believe the market is not quite aware of the real risks of a global recession
- The Fed has been aggressively tightening into an already slowing global economy - a blunt instrument attacking a more complex problem
- The interest rate hiking cycle is going to be shorter than the market previously expected
- The last rate rise (75 bps) is likely to be in September, but is inflation dependent
- US Rates are very likely to be coming down by 2023
- We feel that that market liquidity is tighter than the Fed thinks that it is and therefore QT is not necessary
- Another $400 bn of Treasury issuance in the pipeline will tighten liquidity even further
- Policy error is a significant possibility
- We think inflation has probably peaked
- We think broad commodity prices have peaked
- Freight costs and supply issues seem to be improving very quickly
- Inflation will settle at above the Fed target rate
- Necessary change to the Asian economic model means that consistent goods price deflation will be a thing of the past
- We are concerned that the recession will be longer and deeper than currently considered

As central banks in the US, Europe, the UK, and China have been on different paths in their efforts to quell inflation, the probability, timing, and intensity of a recession will differ across each of these regions. Leading economic data clearly shows that economic momentum is fading quickly.

The Russia/Ukraine war exacerbated the energy crisis, fuelling higher global inflation. The uncertainty of the war and falling real income growth is evidently taking a toll on consumers across the globe. Geographical proximity and dependence on Russia for energy supplies, means recession risks are higher in Europe. With no end in sight to the conflict, expect higher energy prices to erode the purchasing power of the European consumer and any move to rationing energy supplies to business would be the final straw. The likelihood of recession in Europe has risen significantly and negative growth could start as early as the second half of 2022. The European Central Bank (ECB) is likely to step up the pace of interest rate rises, perhaps making 1% before year-end. The looming recession in the Eurozone alongside doubts about debt sustainability should restrain the ECB from going beyond the initial normalisation, keeping rates on hold in 2023.

In the US, the current economic dynamics appear consistent with a recession, indeed the less affluent are effectively already experiencing the symptoms of recession. While June payrolls came in at +372,000, exceeding expectations, US inflation rose 9.1% in a broad based advance in June. The inflation data will keep Fed officials on an aggressive policy course to rein in demand, despite unemployment remaining low at 3.6%. Historically, when average quarterly inflation rises above 5%, the probability of a recession over the next two years is above 60%, and when the unemployment rate drops below 4%, the probability of a recession over the next two years approaches 70%. Since 1955, there has never been a quarter with average inflation above 4% and unemployment below 5% that was not followed by a recession within the next two years. In Q1 2022, the US economy shrank by an annualised rate of 1.6%, signalling we might well be on our way to the technical definition of a recession.

With recession risks rising across all economies but with the exact timing and intensity remaining uncertain, investors need to be careful within their equity allocation. This is a difficult balance as traditionally defensive equities such as utilities, typically exhibit strong defensiveness in the form of low volatility and lower drawdown. However, the flip side of the coin is that they also exhibit limited upside potential in trending upward markets. This means that if you choose defensive plays, timing the point of entry and exit for this strategy is key to success, which is of course very difficult in practice. We do believe that it is possible to tilt a portfolio and make it more defensive whilst also participating in market rallies.

Style factors such as Quality or High Dividend tend to provide a more balanced risk return profile allowing for more versatility. They remain somewhat defensive, but they also can capture market upside very efficiently, which is the driver behind our recent tilt towards Quality styles and reliable dividend paying companies.

We believe that a core quality strategy is the cornerstone of a long term equity allocation and we have already called time on our “holiday” in value which was driven by the reflationary impetus to the economy after the introduction of vaccines. High quality companies exhibit an ‘all-weather’ behaviour that historically, has delivered a balance between growth over the long term, whilst protecting the portfolio during economic downturns.

We also believe that the US rate hiking cycle will be shorter than originally expected. Depending on the success of the fight against inflation, it is even possible that the last rate rise is in September due to the hiatus caused by the Jackson Hole conference. If there is insufficient evidence that inflation is in retreat, the Fed will likely continue with rate rises, but we feel this would be a policy error. The financial system is already tight enough to do the job of fighting inflation and again, the Fed seems to lack the common touch, unable to understand what is happening to global liquidity which has been part of the extreme USD strength over recent months. Post the Yellen years and drastic changes in personnel in the Federal Reserve system, the Fed has shut down communications and back door channels with the market, leaving them partially blind to what is going on at the economic coal face.

If they continue to tighten beyond September, the $400bn of Treasury issuance required in the Fall will suck further money out of the system, restricting USD liquidity and may be the last act that condemns the US to recession. We are in what may prove to be the most extreme monetary tightening since the 70’s, and US monetary growth could be the worst since the Great Depression. Coming as it does swiftly after a period of extremely loose monetary conditions, we risk going from feast to famine in very short order.

So, if the worst case becomes reality, what should we prepare for? A recession is defined as two consecutive periods of GDP decline, marking a consistent period of economic contraction. The last recession caused by an energy crisis lasted 16 months, and the U.S. economy has weathered 13 different recessions since World War II. On average, America's post-war recessions have lasted 10 months, the shortest in 2020 lasted 2 months and the longest (73-75 and 81-82) 16 months. Our economist Andrew Hunt is concerned that Fed policy error may create a recession that is deeper and longer than is currently being considered.

However, as we are always told, the equity market is a forward forecasting mechanism, so it requires light at the end of the tunnel to start its recovery. Using the US S&P 500 as our example, we can see that the average bear market in a normal recession is -25%, but balance sheet recessions (where severe damage to the balance sheet of businesses and households that forces them to save more and consume and invest less to pay down debt) have been worse.

If the falls to date on the S&P 500 are any guide (down as much as 21.8% in June), then history suggests that most of the pain has been felt, but only hindsight will give us an accurate picture of where the market finds its bottom. Timing the bottom of bear markets is fraught with peril and a strategy of phased buying is a sensible approach where cash is available.

Looking at fixed interest markets, if our views on the US rate cycle are correct then taking positions in US government bonds with some duration would be a sensible approach and we are adding these positions to our portfolios. Further, with USD/GBP at a historically low point, we feel that hedging positions is a sensible thing to consider.

For historical reference, in March 1972 Sterling bought 2.649 USD (a great time to holiday in the US!). Conversely, on 25th February 1985 Sterling only bought 1.054 USD. In 1985, inflation was rife and US interest rates were at 20% and the exchange rate was more about an exceptionally strong USD as it was about Sterling weakness. Perhaps there are echoes of this today…. The most recent low in GBP/USD was early in the pandemic when the FX rate dipped below 1.20 for a very short time which mirrors where we are as I write this piece. As a further reference point, these lows are below the FX rate at the depth of the Financial Crisis.

Can the GBP/USD go lower? Yes, of course. What is our core view at the moment? We feel that we are at the lower end of the trading range and that in the event that our economic views are correct, and also that the Tory leadership battle leads to a more predictable economic policy (hard to see it being worse than the rudderless current situation), then the environment is set for a resurgence of GBP vs USD, perhaps reversing some of the recent strong trend in time, especially if the interest rate differential narrows between the UK and US.

Clearly when we have been through the worst first half of the year for developed market equities in over 50 years, equity returns are hard to come by and this is compounded by aggressively increasing bond yields and inflation, which have hit bonds hard and removed the usual balance they provide to portfolios. Our job in difficult times is to do all we can to limit the damage and try to position portfolios for when sentiment changes.

We will keep on watching, waiting for any signs that the environment and sentiment are changing. If we feel that tactical moves give us a high chance of success, we will make them, but for the moment it is important to be patient and trust that what goes down will at some point go up. As Abraham Lincoln often said….. “This too shall pass”.

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