FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 4 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** | - | 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 |

**Please Note:** The views expressed are those of the Investment Strategy Committee. They should not be taken as a personal recommendation to invest or refrain from investing.
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 negative quarter for markets **(FTSE World -4.88%)** despite a rally in July when markets started to price in 2023 interest rate cuts and hopes for a soft landing. Later uber-hawkish central bank comments took the legs out from underneath market rallies, as they strongly reinforced their commitment to fighting inflation through tightening. The Federal Reserve, European Central Bank and Bank of England all raised interest rates in the quarter. Emerging markets underperformed developed indices and Commodities generally declined.

US equities fell again in Q3 **(S&P 500-5.28%)** with the communications sector weak and consumer discretionary and energy more resilient. Early in the quarter the market rose as investors saw the possibility of interest rate cuts in 2023 due to slowing growth, but the Jackson Hole summit of central bankers in August brought the rally to a sharp halt. The Federal Reserve strongly reaffirmed its commitment to fighting inflation despite concerns for growth, sending stocks lower in the second half of the quarter. The Fed raised interest rates by 75 basis points (bps) to 3.25% in September; the third consecutive 75bps increase. Inflation rose again in August as the central banks preferred measure of inflation was up from 4.7% to 4.9% year on year. GDP data confirmed that the US economy is in a technical recession, falling by -0.6% year on year in Q2 after a -1.6% contraction in Q1. However, importantly for the Fed's strategy, employment data showed continued resilience, as the August non-farm payrolls report that showed 315,000 new jobs added that month despite the recessionary backdrop.

Eurozone shares fell sharply again **(FTSE World Europe ex UK -4.94%)** driven by the energy crisis, inflation and fears about economic growth. All sectors were negative. Energy costs continued to drive higher inflation, estimated at 10.0% in September, up from 9.1% in August. Nord Stream 1, the main pipeline supplying gas to Europe from Russia, was "closed for maintenance" in July, coming back onstream temporarily before Russia shut it down again in early September. This put further pressure on power generators, who will need to buy natural gas from higher cost sources, and worries increased regarding possible energy shortages over the winter. These worries sent the euro to a 20-year low versus the strong US dollar. GDP figures showed the eurozone economy grew by 0.7% quarter-on-quarter in Q2, while forward-looking indicators signalled a weakening economy. The purchasing managers' index (PMI) for September came in at 48.2, the third consecutive month below 50 indicating economic contraction. The European Central Bank raised interest rates in July and September, taking the deposit rate to 0.75% and joined in with the hawkish tone of other central banks

UK equities fell over the quarter **(FTSE All Share -4.50%).** September saw the death of Queen Elizabeth and the election of Liz Truss as new prime minister. After a period of national mourning, the latter event led to a period of extreme volatility after the announcement of a fiscal package which was poorly received by markets, sending sterling to an all-time low versus the US dollar and causing the Bank of England to intervene in Gilt markets. Sterling weakness was already an issue vs USD, as the US Central bank reiterated its intention to raising interest rates. Whilst negative for GBP the market looked favourably at the strong cashflow characteristics of the UK's large cap stocks, leading to outperformance for large multi-national consumer staples and energy companies. The very strong dollar was also positive for sentiment in these areas of the market given that such companies derive a large part of their revenues from overseas. In contrast, fears around the impact of rising energy bills on consumers was negative for retailers, travel and leisure, home construction and other domestically focused companies. This was exacerbated by the fiscal concerns resulting from the poorly received mini-budget.

The Japanese stock market ended the quarter lower **(TSE TOPIX -1.86%)** but was the best of a bad bunch amongst equity markets. The yen weakened almost continuously against the US dollar, breaking the 140 level for the first time since 1998. The interest rate differential with the US widened sharply as US rates rose and the BoJ left rates the same, a significant factor in the consistent weakening of the yen in 2022. On 22 September the Ministry of Finance intervened directly in currency markets when the yen was seen depreciating rapidly intra-day, the first such direct intervention in support of the yen since 1998. Yen weakness continued, closing the month at 144.6 to the dollar. Estimated GDP showed a quarter-on-quarter annualised growth rate of 2.2% - slightly below consensus expectations. Japan's inflation continued to rise with the headline rate reaching 3.0%, while the core rate, excluding fresh food and energy, reached 1.6%. Results announcements completed in August showed that profit momentum slowed from the previous quarter. Overall results were again ahead of expectations and profit margins appear to have remained resilient so far, despite increasing cost pressures. Market events were overshadowed by the assassination of former prime minister Shinzo Abe on 8 July. Mr Abe, who resigned in August 2020 was Japan's longest serving prime minister.

Asia ex Japan equities fell **(FTSE Asia Pacific ex Japan -9.78%)** ending as the worst performing developed market index for Q3 on investor concerns over rising inflation, higher interest rates and fears over a global slowdown. The war in Ukraine and ongoing tensions between China and Taiwan also weighed on sentiment during the quarter. China was the weakest index due to concerns over rising interest rates, as countries around the world battle soaring inflation and despite surprising September data showing Chinese factory activity expanding in August.

The alarming spread of Covid-19 in China weakened sentiment, due to fears of further zero-Covid lockdowns. Share prices in Taiwan, South Korea, Thailand, Singapore, Malaysia and Hong Kong fell as investors continued to sell riskier assets, for the safety of government bonds amid the threat of more interest rate hikes and economic recession. India ended the quarter in positive territory, despite concerns over the pace of interest rate hikes by the US Federal Reserve weighing on sentiment at the end of the quarter. Indonesia also ended the period in positive territory

Emerging market equities also fell sharply again in Q2 **(FTSE Emerging -8.94%)**, against a backdrop of slowing global growth, heightened inflationary pressure and rising interest rates. Poland, Hungary and Czech Republic were among the biggest decliners, as the Russian war in Ukraine escalated and led to an energy crisis in Europe and contributed to accelerating inflation. China underperformed as a slump in the property market weighed on investor sentiment, and the imposition of Covid-related lockdowns has negatively impacted domestic demand. Growth-sensitive north Asian markets, suffered as the outlook for global trade deteriorated. Turkey was the best performing market, (despite inflation over 80%) as the central bank cut interest rates twice during the quarter and the economy grows strongly. India and Indonesia also posted positive returns ahead of the broader index.

Bonds continued their sharp selloff. Government bond yields were generally higher **(FTSE World BIG Domestic Sovereign -4.18%),** with significant market volatility continuing as central banks and investors struggled with the persistent inflation and slowing growth themes. The Federal Reserve voted another 75 bps increase in September (the fifth interest rate in the year so far) taking the rate to between

3.0% and 3.25%. Chairman Powell reiterated the hawkish stance again after the Jackson Hole meeting and US 10-year yield rose from 2.97% to 3.83% in Q3. The UK's mini budget led to questions about the credibility of the government's fiscal framework and the gilt market suffered significant losses and the Bank of England intervened by temporarily buying long dated gilts. Sterling hit an all-time low of $1.03 in the closing days of the month before recouping some of its losses, settling back largely where it started. Bank of England Governor Andrew Bailey said that the BoE was monitoring developments in the financial markets "very closely". The UK 10-year yield increased from 2.24% to 4.15% and 2-year rose from 1.88% to 3.92%. The ECB raised interest rates by 75 bps in September, following a rise of 50 bps in July. Eurozone CPI landed at a record high of 10% year-on-year. The German 10-year yield increased from 1.34% to 2.11%.

Credit spreads widened across the global market, weighing heavily on market returns. The credit spread is the difference in yield between bonds of a similar maturity but with different credit quality. Global credit returns were poor as the market drawdown continued **(Bloomberg Global Aggregate – Corporates -6.47%)**, underperforming government bonds as spreads widened. Sterling investment grade and high yield were the worst performers (**Bloomberg Global High Yield -2.74%).** European investment grade and high yield, as well as emerging markets credit, fared better but were still negative **(JPM GBI-EM Global Composite -4.23%)** and Emerging market currencies weakened as investors fled to the US dollar on recession fears.

After a stellar start to the year, Commodities fell again in Q3 **(Bloomberg Commodity -4.11)** driven lower by weaker prices for energy, industrial metals and precious metals. Sharp falls in crude oil, Brent crude and unleaded gasoline offsetting higher prices for natural gas. In the industrial metals markets, prices for aluminium, copper and nickel were all lower while lead rose marginally. In precious metals, both gold and silver declined, and in agriculture, higher prices for wheat and corn balanced price falls for cotton, sugar, coffee and cocoa.

UK Commercial Property fell **(FE UK Property Proxy -3.68%).** 2022 has seen mixed conditions in the commercial property market, as investment and leasing markets digested the changed macro-economic backdrop. Initial indicators and anecdotal evidence suggest investors and occupiers are adapting to the reality of rising rates but are still generally remaining active. A recent RICS survey found that issues like Ukraine, inflation and rising build costs are replacing Covid as the leading concerns for the market. Moreover, in the last couple of months a number of property market indicators have pointed to a moderate deceleration in activity. The MSCI indices for industrial and Retail fell by -2.8% and -1.0% month-on-month in August 2022, both marking the second consecutive negative figure.

In Currencies the USD continued its strong run vs all currencies including Sterling **(USD +9.43%),** meaning it has appreciated by more than 20% vs GBP since the beginning of 2022. The USD strength was exacerbated by the markets adverse reaction to Truss and Kwarteng's mini-budget and as a result GBP also weakened vs the Euro **(EUR +2.18%)** and the Yen **(JPY + 2.18)**. 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…

*"Those who cannot remember the past are condemned to repeat it."* - **George Santayana**

The third quarter was a very volatile quarter for financial markets with an astonishingly wide set of declines across all the major asset classes. Indeed, after a dismal first half of the year, the vast majority of asset classes recorded a negative performance during Q3. This 'everything down market' weighs on multi-asset portfolios, with limited hiding places across the range of investable asset classes. As an indication, looking at US data back to 1928, there have been only 5 calendar years when equities (S&P500) and bonds (10-year US Treasury Bonds) have fallen together. 2022 is the only year in this history period when both are down more than 10% each. We still have a few months left in the year for this trend to be reversed, but the historical context highlights the very challenging times that we are currently experiencing in markets.

The US dollar has soared against the world's major currencies this year reaching a peak towards the end of the third quarter where the US Dollar Index (a measure of the USD vs a basket of major currencies) had risen nearly 19%. It reached parity with the euro in July for the first time in twenty years. It has touched 144 yen and after Truss and Kwarteng's ill-advised announcements, Sterling reached a historical low of 1.0379 to the dollar, surpassing the previous record set just before the 1985 Plaza Accord. Such dollar strength can pose problems for the rest of the global economy creating imbalances in the current account positions of trading countries, currency volatility and inflation.

The United States has been here before. In the early 1980s, the dollar surged by more than 50 percent against other major currencies with no signs of respite. The economic backdrop was comparable to today's—inflation was high, and some central banks remained reluctant to hike rates while others dared to do so. In response, the G5 nations struck a radical deal. The 1985 Plaza Accord created an mechanism for market intervention to return a surging dollar to normal levels when the normal market forces of supply and demand had failed. The United States, Japan, Germany, France, and the United Kingdom agreed to jointly intervene in the foreign exchange markets by selling dollars and thereby weaken it vs other major currencies. However, similar coordination is unlikely to happen again. Neither China, nor the original participants of the Plaza Accord, are willing to engage in such an agreement and especially Japan who blame the action in part for their lost decade.

While the word unprecedented has been used many times over the last few months, those with grey hair and long memories, or students of history will notice at least some echoes of the 70s in our current demise. War, energy price shocks, low unemployment, high inflation and excess demand were all factors in the 70s and into the 80s.

In this period, despite the rising background rates of inflation, high unemployment was deemed too big a price to pay to reduce inflation. Instead, a series of half-hearted measures to control the reported inflation rate were enacted, including modest interest rate hikes, price subsidies, and direct price controls but these measures failed to have any significant effect as it was excess demand which was driving inflation. The policies failed and the impact on bond markets was significant. It was not the 1973 OPEC oil price shock that destroyed bond prices, it was the persistent inflation of the late 1970s

During the mid-1970s, few politicians outside of Japan were prepared to admit that, following a slowdown in productivity growth and the oil shocks, the system simply could not grow its output as fast as people were trying to spend. Only once inflation had major electoral problem was the issue finally solved through creating deliberate demand recessions. Nothing else worked.

In 1981 364 economists wrote to the UK government heavily criticizing their decision to create a dis-inflationary recession, arguing that more fiscal support should be given to the economy despite inflation running into double-digits. The missive was sent at around the bottom in the UK economic cycle and within a few years the need to reduce demand relative to supply in order to control inflation became mainstream economics.

This time round, it wasn't a decision by OPEC that triggered soaring inflation, it was the invasion of Ukraine and Vladimir Putin's subsequent actions that heaped soaring energy prices on an already inflationary environment.

Now policymakers are in danger of echoing the 364 if they believe that we can somehow control inflation without any pain. There is no doubt that the Pandemic, Climate Change, BREXIT and geopolitics have negatively affected global output, but at the same time governments and central banks have thrown enormous amounts of money at the population to support demand and save their economies. However, those economies cannot meet that demand, which is why we are all struggling to find tradesmen, or source new cars and white goods. In simple terms, there is too much money chasing too few available goods and services - we are echoing the 70s and early 80s, struggling with the effects of excess demand.

Today we have talk of price caps and controls, subsidies, and attempts by central banks to control inflation without any pain in some sort of return to the post GFC Goldilocks scenario. We have also seen direct interference in the bond markets in Japan, the Eurozone and UK, but if policymakers continue on this path our concern is that they create a late 1970s outcome and persistent underlying inflation with severe negative implications on bond markets from late 2023 onwards.

Inflation is the result of too much demand relative to supply. But the favoured inflation measure, the CPI, is made up of subsistence goods (20%); durable goods (30%); and services (50%). We expect the rate of inflation in subsistence goods to fall in the year ahead and can also see that goods price inflation is moderating now as consumer confidence wanes and China's economy has slumped. We believe that the peak in goods price inflation is behind us, for now. Unfortunately the demand for services is strong and running at around 104% capacity, meaning service sector inflation rates are likely to stay high. We are reverting more toward the post GFC inflation picture with the goods components moderating service sector inflation, which may give central banks the signals they are seeking to slow, or even end their tightening cycle. This would be positive for bonds and equities, at least in the short term

Our concern is that recent behaviour suggests that central banks and governments lack a feel for the real economy and might overreact. If this proves to be the case, it is still very possible that they might over tighten and cause a more severe recession than is needed to tame inflation. On the flip side of that potential mistake, overstimulating the economy by easing too fast or increasing liquidity as they have done numerous times since the GFC, might bring back the inflation Genie before he has got comfortable back in the bottle. Policy error is our biggest concern at this time.

Looking for positives, global equity market valuations have now generally fallen below their 25-year averages. Even in the US, the market is currently trading on a price-to-earnings (P/E) ratio of 15.6 vs. a long- term average of 16.6. However, there is a note of caution in that these valuations are based on current consensus analyst forecasts for earnings growth, which are gradually being revised down. Therefore, we could still potentially see further declines in equities.

As we enter the fourth quarter, the global economy should continue to slow, and some economies will enter recession. The magnitude of this potential recession will partly depend on the effectiveness of policymakers and the impact of the energy crisis on households and businesses. Central banks are confronted with the biggest inflation shock since the 1970s, and at the time of writing, they seem set to continue to prioritise the fight against inflation over supporting growth. The key thing to watch out for is when that starts to change.

At times like these when we are in the teeth of the storm, we must remember that the equity market is a forward forecasting mechanism, that needs to see light at the end of the tunnel to start its recovery. The average US S&P 500 bear market in a normal recession has fallen -25%. If the falls to date on the S&P 500 are any guide, 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.

It seems that many stocks are now already pricing in a high probability of at least a moderate recession. Government bonds are also priced for a significant amount of further tightening. So, after a very difficult year so far for both stocks and bonds valuations now look more attractive for long term investors.

In a final attempt to add some positivity, next month we have the US midterm elections. In the 12-months following the midterms, US stocks have gone up every single year since 1942, with an average increase of 15%. I think we would all take that….

We recently read that maybe we have got to "peak hawkishness". It's too soon to say with any confidence but we continue to look for any change in central bank rhetoric over the coming weeks and months.

As always, we will be watching for any signs that the environment and sentiment are changing. If we feel that tactical moves are necessary and give a high chance of success, we will make them. This is far from our first Rodeo, and we know that patience, good decision making and trust in tried and tested processes is the best indicator of long term success.

If you would like more detail, or to discuss anything within this commentary, please do not hesitate to get in touch.

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