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Investment Review

Q3 2022



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1. Summary

- UK government policy results in international disapproval
- 'Risk free' government bonds demonstrate historic levels of volatility
- The pound falls in value against the US dollar to the lowest level in almost 40 years
- Higher inflation set to become normalised

A very volatile Q3, thanks to former Chancellor Kwasi Kwarteng's 'mini-budget' in late September, caused disorder in UK financial markets, in particular within the highly liquid government bond market that many large pension funds rely upon to meet their liabilities. Without temporary intervention from the Bank of England there was the potential for a more widespread financial crisis. In the end, global outcry for the proposed policies cost the Chancellor and Prime Minister, Liz Truss, their jobs.

It seems likely when the new Chancellor Jeremy Hunt, having already reversed most of the proposed tax cuts, steps up to the plate and delivers the Autumn budget on 17th November (this time with expected independent analysis from the OBR) there will be far fewer surprises.

Despite the slowing economy, global share prices have been relatively poised compared to fixed interest investments this quarter, but for UK investors this has mostly been due to the weakness in the pound and the benefit received from holding overseas assets. The dominance of the US dollar looks set to continue as the US central bank leads from the front in continuing to raise interest rates to quell inflation.

Markets are set to remain choppy as negative headlines continue to come through and investors are well advised to remember that the temporary loss of value seen is very different from a permanent loss of capital.



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- This investment commentary review contains information and opinion on current economic and political positions and does not constitute advice.
- The information is provided in good faith and is believed to be accurate, but as some data is provided by third parties this can not be guaranteed.
- Past returns should not be seen as predictors of future returns.

2. Market Performance (Year to Date)

Asset Class	Index	Q3 2022	Year to Date
Hedge Funds	HFRX Global Hedge Fund	9.4%	15.8%
North America Shares	S&P 500	3.4%	-8.0%
World Shares	FTSE World ex UK	2.0%	-9.5%
Japanese Shares	TSE Topix	1.1%	-9.2%
Gold	S&P GSCI Gold Spot	0.2%	10.0%
European Shares	Euro STOXX 50	-1.8%	-17.4%
Commodities	S&P GSCI Commodities	-2.4%	47.8%
UK Shares	FTSE All Share	-3.5%	-7.9%
UK Commercial Property	FE UK Property Proxy	-3.7%	1.6%
Emerging Market Shares	MSCI Emerging Markets	-3.8%	-11.6%
Asia Pacific Shares	MSCI AC Asia Pacific ex Japan	-5.1%	-10.7%
Corporate Bonds	Bloomberg Sterling Aggregate Corporate	-12.0%	-24.5%
UK Gilts	Bloomberg Sterling Gilts	-13.6%	-26.4%

Performance Data: FE Analytics in GBP to 30/9/2022

UK Shares

The FTSE All Share has fallen the least this year compared to most major indices, with a total return -7.9%. Considerable interest has been given to the heavyweight oil majors results and the call on a windfall profit tax to contribute to the cost-of-living crisis. Shell announced its second highest global quarterly profit on record at £8.2bn, but because of investment into the North Sea oil fields, the company has made no UK profits and therefore paid no tax. Expect the way in which the windfall tax is applied to be reviewed under the new government.

Global Shares

North American shares performed best over Q3 when converted back to pounds rising +3.4% because of the significant rise in value of the US dollar. European shares remain very weak over the year -17.4% as the energy crisis feeds into a global economic slowdown. It has been interesting to note this year across many markets how quickly sentiment has pivoted. Meta (formerly Facebook) and Amazon for example, having seen huge share price gains during the pandemic, have fallen in value by -76% and -49% respectively from their all-time highs in mid-2021 due to falling profit expectations.

Recently the Chief Executive of the world's second largest shipping company Danish firm AP Moller-Maersk, considered a bellwether of global trade, commented that "we see a recession looming...every indicator we are looking at is flashing dark red"¹. It is quite clear that a recessionary environment is upon us and that firms are taking steps to plan for such an environment.

¹ Financial Times, 2nd November 2022, "Maersk warns global trade indicators at 'dark red' on looming recession.

2. Market Performance (Year to Date) cont.

Fixed Interest

The ill-thought out mini-budget caused huge disruption in the fixed interest market, in particular longer-dated gilts, leading to historic volatility in prices. The Bank of England (BoE) had to step in and become a temporary buyer of gilts to stop a wider liquidity crisis from emerging. The government were effectively providing large fiscal (spending) stimulus to an economy already dealing with high inflation, at a time when the BoE was pulling in the opposite direction and raising interest rates to slow activity. Market expectations of inflation and interest rates rapidly adjusted higher, leaving UK gilts -13.6% and by association corporate bonds -12% in the quarter alone.

Following the appointment of the latest Chancellor and Prime Minister, who reversed most of the earlier economic policies, the market has largely adjusted back to the position before the mini-budget with gilt and bond values seeing strong gains over recent weeks.

Property

With rising rates over the quarter, the question asked by property buyers moved from 'what do I want to buy, to what can I afford to buy?'. The Nationwide house price index slowed sharply in October, taking the annual growth rate from 9.5% to 7.2% with the building society highlighting that higher mortgage rates, already stretched affordability and broader cost of living inflation ensures further weakness going forward². This will likely spill over into the commercial property market in due course but, given the lower level of transactions, values have not yet adjusted downwards.

² Nationwide, October 2022, House Price Index.

3. Government v Markets

The result: markets win with a 44-day knockout. It has been an extraordinary period of political turmoil that has seen three prime ministers and two opposing economic agendas presented to the nation in just 4 months. Under former prime minister, Liz Truss, the agenda outlined was to 'grow, grow, grow' the UK economy by proposing £45bn of deficit funded tax cuts, piled on top of unavoidable spending to protect households and consumers from soaring energy prices.

Investors deemed this too high-risk a strategy and punished the government by pushing market borrowing costs higher, with the 10-year UK government bond yield rising by 1.2% over just three days, as can be seen in the chart below. This caused disruption in the longer-term gilt market that pensions funds need to fulfil their obligations, as well as halting new lending within the mortgage market, given the economic uncertainty.



US politician, James Carville famously said that if he were reincarnated he would “come back as the bond market, because you can intimidate everybody”. This is very apt for the present time, because markets really did make sufficient noise to cause a complete political U-turn. The latest government appointments of Jeremy Hunt and Rishi Sunak offered markets an olive branch and rates have fallen, providing minor respite to the mortgage market, as their agenda offers a steadier, albeit gloomier, outlook on the economy. The reality is that tax rises, rather than cuts, are in store to control the public purse, with announcements set for 17th November.

4. Is Inflation No Longer 'Transitory'?

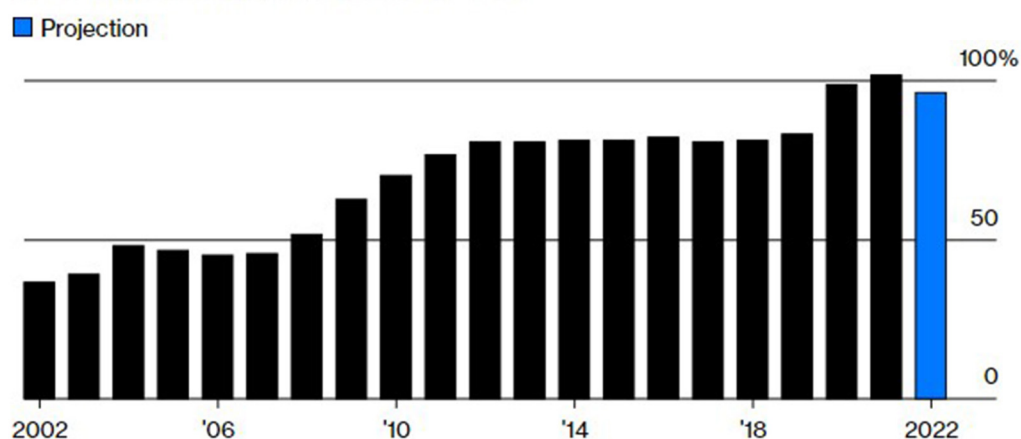
For a significant part of the recent period of rising prices in goods and services, officials from world central banks referred to the uptick in inflation as 'transitory'. This was understandable given that a fear of future inflation is sufficient to stoke inflation itself, so it was beneficial to keep expectations in check. Given that prices have continued to rise, the term has now largely been dropped. In September 2021 UK CPI was running at an annual rate of 3.1% whereas a year later the rate is 10.1%. We know that the headline rate of inflation will fall, as it cannot continue to rise at the prevailing rate indefinitely, but the question is to what level will it settle?

It is becoming increasingly likely that inflation will remain stubbornly higher than the BoE's target of 2% going forward. There are many known reasons to support higher structural inflation in the future, but these have arguably been brought on more rapidly, partly due to the economic impact of the pandemic:

- General demographic changes with more spenders than savers
- Workforce changes linked to the above with a smaller working population leading to higher wages
- Re-shoring of supply chains and move away from globalisation
- Green agenda investment requirements and demand for resources

It can be argued that governments have little option but to reduce their enormous borrowings from the 2008 financial crisis and 2020 pandemic, other than to allow some inflation into the system. In doing so the value of the economy grows hopefully at a rate faster than the public debt and therefore the all-important debt ratio improves. The International Monetary Fund (IMF) chart below shows the projection of US public debt to GDP falling as a result of the inflated economy, rather than because of any 'real' economic growth.

US Public Debt as a Share of GDP

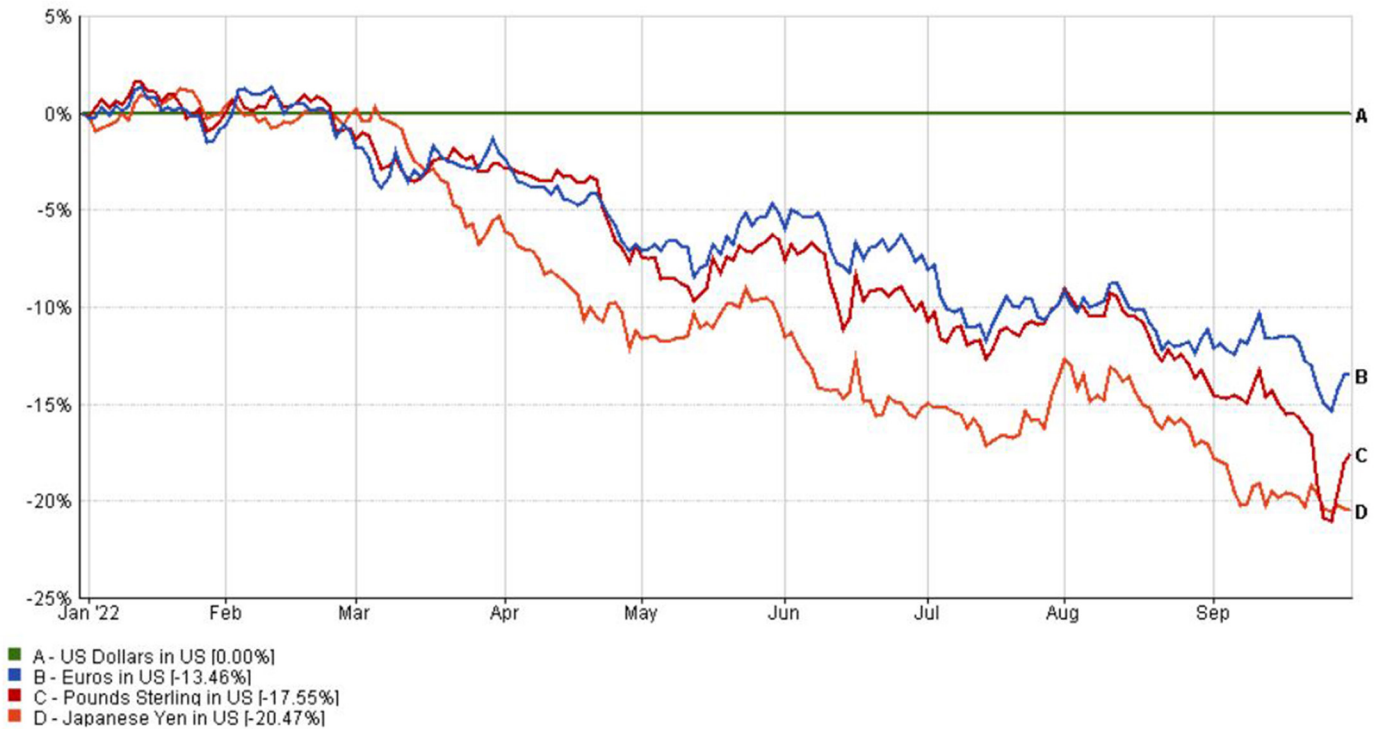


Source: International Monetary Fund

So, whilst interest rates have been moving higher to curb inflation, rates will invariably have an impact on slowing economic activity, which is needed as an element to get the debt balance under control. The motivation therefore appears to be allowing inflation to stay above target (or perhaps normalise a higher rate target) whilst keeping public spending at a lower level. Hence why the market reacted so badly to the growth plan of Liz Truss and insists upon Rishi Sunak controlling spending, otherwise the cost of borrowing will rise.

5. The Impact of the Rising US Dollar

The US dollar has risen year to date towards a 20-year high against most currencies, with the value growing 17% relative to the pound (it was over 20% higher following the mini-budget), 13% against the euro and 20% against the yen as shown on the chart below.



31/12/2021 - 30/09/2022 Data from FE fundinfo2022

This rapid increase has had a number of consequences. Firstly, for UK based investors it offsets the falling value of US investments, as the S&P 500 has returned -24% and Nasdaq 100 -32% year to date in local terms but -8% and -17% respectively in pounds. Secondly, given that 40% of world exports are traded in dollars, in particular energy and commodities that have also been impacted by the Ukraine war, for many countries the weakening of their own currencies has led to importing inflation as, on average, the estimated pass through of a 10% dollar rise into inflation is 1%³.

The reason for the dollar's rise is because the US central bank has been the most aggressive in raising interest rates, therefore capital around the world is able to get a higher return if holding dollars. Also, because the US is an energy exporter rather than importer, rising energy prices are relatively better for its economic growth prospects than other energy importing nations.

Presently it is hard to see the dollar's value rolling over. For that to happen the relative growth prospects of other economies needs to improve, US inflation needs to fall so the central bank can ease economic conditions, and finally global energy prices need to fall⁴. For now, given the weak global environment, investors will continue to see the US as the 'least dirty shirt in the laundry' and be content to hold US assets.

³ IMF, 14 October 2022, 'How countries should respond to the strong dollar'.

⁴ Economist, 8 September 2022, 'Why the dollar is strong and why that is a problem'.

6. Looking Forward

Even though the past quarter felt very eventful and full of noise and headlines, not much has changed in terms of the economic and market position from the end of the previous quarter. Market volatility remains, inflation is still stubborn, interest rates have further to rise, the economy is slowing and the public deficit requires proper attention (not additional and unavoidable spending via tax cuts).

Referring back to our Q2 review, one thing we did say was that we expected fixed interest values to stabilise, clearly not anticipating such a disastrous government economic agenda would cause further weakness. We stand by that comment however, believing that after initial tightening of interest rates they will eventually have to align with weaker economic growth and policy will loosen again.

Our evolving and strengthening view is that structurally higher inflation could well persist for a number of years to come and the BoE's inflation target may actually get adjusted in recognition of this away from the long-held 2% level. To state again as we did in Q2, global equities typically provide the best inflation hedge over a long enough time period and volatility is something that investors need to accept and manage, not avoid. It is important to remember that the temporary loss of value seen is very different to a permanent loss of capital.



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We do that by providing the financial planning and investment advice you need to secure your future.

We recognise that investors with similar risk profiles may have very different objectives, tax positions and personal circumstances so we adopt a bespoke approach in each case. There are no 'off the shelf' solutions.

We focus on choosing the right blend of assets, managing risk, and minimising tax and costs. Our investment philosophy is founded on a number of key principles which have served our clients well for more than 30 years:

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-  Understand and manage risk
-  Get the "investment recipe" right
-  Avoid market timing
-  Fear inflation
-  Manage tax and costs
-  Process is paramount

We believe you win by not losing and this core principle lies at the heart of our investment approach. To find out more, get in touch.



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