2022 FULL YEAR INVESTMENT REVIEW

Summary

Mike Lea
Investment Director, FPC LLP
January 2022

- Taking risk in 2022 paid off (relatively) as world stock markets outperformed fixed interest.
- The UK stock market led the way on the back of large-cap energy, defence and financial sector performance.
- UK gilts and corporate bonds experienced extreme volatility from poor government communication.
- As a result, the pound fell by -26% against the US dollar before recovering -11% for the full year.

The past year saw the emergence of a new environment for investors. Rising global interest rates to curb inflation is pushing major economies into recession and suggesting 2023 will be challenging for companies and individuals alike.

We will see investors take a more cautious approach this year as company earnings come under pressure and the opportunity cost of investing in corporate bonds yielding over 5% garners attention for the first time in over a decade.

Inflation has likely already peaked in the UK in October with CPI at 11.1% but may fall stubbornly as workers flex their muscles in search of higher wages in particular in public services, which could cause continued pressure on prices.

Interest rates will continue to rise but at a more modest pace and talk of a potential easing later in the year may take place due to weaker economic data.

Financial markets will be ahead of the curve, and whilst we expect stock markets to potentially weaken in 2023, the bottom will be hit long before economic data provides evidence the worst of the recession has passed.

Market Data

(GBP, ranked by full-year performance)

Asset Class	Index	Q4 2022	Full Year 2022
Commodities	S&P GSCI Commodities	-4.0%	41.9%
Gold	S&P GSCI Gold Spot	1.6%	11.8%
Hedge Funds	HFRX Global Hedge Fund	-7.1%	7.6%
UK Shares	FTSE All Share	8.9%	0.3%
European Shares	Euro STOXX 50	15.8%	-4.4%
Japanese Shares	TSE Topix	5.1%	-4.5%
Asia Pacific Shares	MSCI AC Asia Pacific ex Japan	4.0%	-7.1%
World Shares	FTSE World ex UK	2.1%	-7.7%
North America Shares	S&P 500	-0.3%	-8.3%
UK Commercial Property	FE UK Property Proxy	-10.6%	-9.2%
Emerging Market Shares	MSCI Emerging Markets	1.8%	-10.0%
Corporate Bonds	Bloomberg Sterling Aggregate Corporate	6.9%	-19.3%
UK Gilts	Bloomberg Sterling Gilts	1.7%	-25.1%

Performance Data: FE Analytics in GBP to 30/12/2022

Full Year Review

It was an extraordinary year for investors who, for the first time in a decade, faced the realisation that the liquidity tap has been turned off. The free flow of cheap money, including quantitative easing (when central banks buy bonds to keep interest rates low) had been a driving force of investment markets since the financial crisis in 2008.

Undoubtedly, this liquidity in the system stoked asset price inflation and perhaps also some real economic activity that caused a modest tailwind to the inflationary environment we find ourselves in. But, the events of Brexit, Covid and the Ukraine war are the actual drivers of the sudden inflationary surge that forced central banks to push rates up quickly. The banks will claim a win here as inflation starts to fall, but their influence in putting the genie back in the bottle is questionable.

In GBP terms, the UK stock market outperformed global peers by holding its value for the year. High exposure to sectors such as energy, defence and financials helped support the market, but many investors will not have benefited unless they held a FTSE 100 tracker because of lower exposure in funds or exclusionary practices of oil and weapons. Furthermore, the collapse of GBP meant that overseas earnings were higher, to the benefit of the UK index.

Fixed interest yields surged with the UK 10 year gilt starting at 1%, peaking at 4.5% in September after the poorly communicated Truss/Kwarteng budget, before closing the year at 3.6%. The impact on capital values was record breaking, in particular on the longer dated bonds as holders miss the opportunity to benefit from higher interest rates available.

Commodities stole the show rising over 40% in the year but the price of many important commodities has since fallen sharply.

Reflecting back on our communications across 2022 and the main themes touched upon:

- Central bank conviction – in Q1 we showed the Bank of England inflation forecast rising from 5% to 7%. It eventually hit 11.1%.
- Commodity inflation – in Q2 we highlighted underlying commodity price inflation with Natural Gas prices peaking in June +144%. Gas has subsequently fallen -52% and is currently below 2021 levels (see chart below).
- USD strength – in Q3 we looked at the dominance of USD against most currencies (especially GBP). We said that US inflation needed to slow and global energy prices decline for the USD to lose value. These factors have taken hold surprisingly quickly, and the USD has fallen further than expected.

2023 has started positively as capital values across stock markets and fixed interest are performing well. This is encouraging and in response to peaking interest rate expectations and a consensus that the recession ahead is likely to be only modest. But we caution about continued strength this year given there is likely to be more negative news in the coming months.

Business Cycle

The UK, Eurozone and China are all likely in recession (though China is improving as zero-Covid policy ends) and the US appears to be going that way, which is significant being the engine of world trade. The Conference Board leading indicator index (LEI) for US activity is strongly negative, which has always signaled a recession in the past. This can be seen on the following chart with the leading indicators of business activity plotted against US real GDP (the grey columns in the chart on the next page indicate previous recessions).

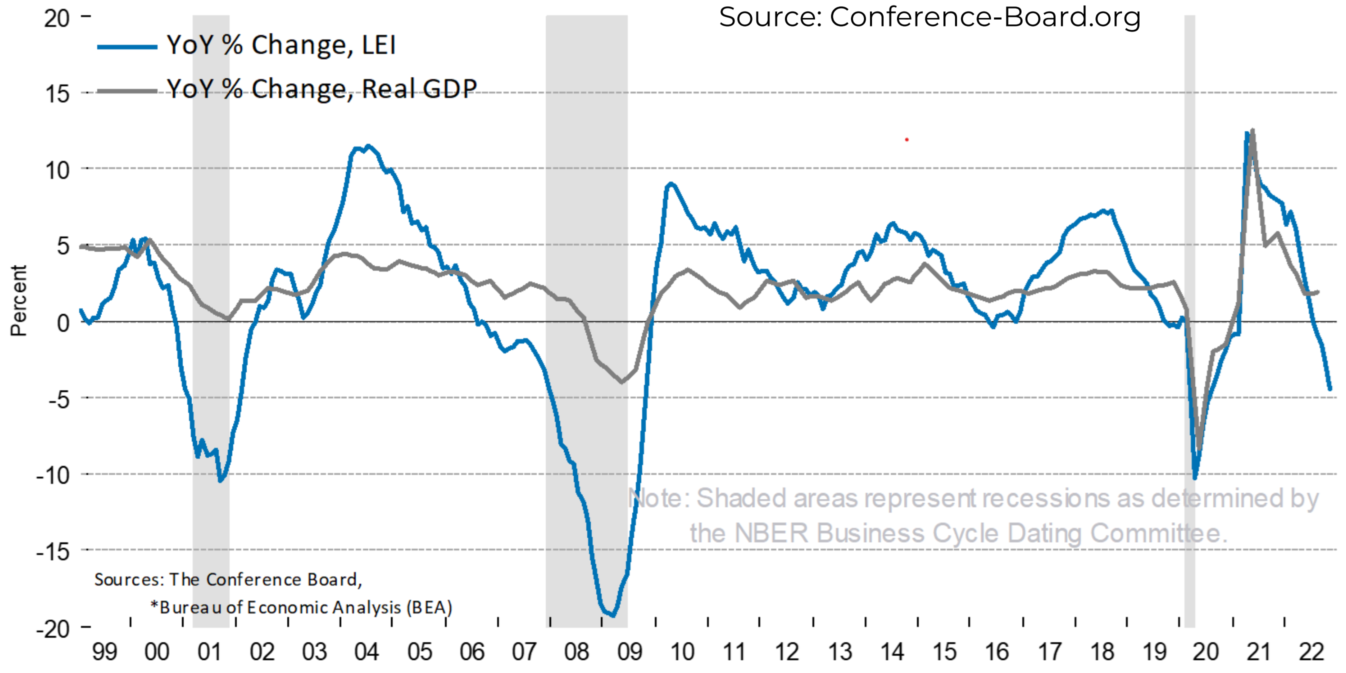
Towards the end of last year the International Monetary Fund (IMF) released its World Economic Outlook that showed advanced economies are set to grow by only 1.1% in 2023 as against 2.4% in 2022 and 5.2% coming out of the pandemic in 2021.

Clearly consumer demand and capital investment is currently being constrained however there is reason to think that the recession upon us could be a mild one.

The weakness we have seen does not follow the same path as the boom and bust of previous recessions. In addition, this is not a widespread financial system problem, as the banking sector has more capital reserves to ride out any downturn.

Further, households in aggregate remain buffered by the accumulation of savings and investments during the pandemic period. Our economic consultant Tricio suggests that US households have $2trn of excess cash in their accounts, which is significantly above trend. So even if recession does engulf the US the consumer should offer some mitigation.

Unfortunately, the UK has more structural issues to contend with as the growth path is estimated at only 0.3% this year according to the IMF. The power of the unions may well impact economic activity as they fight for inflation adjusted pay-rises for members, and the government does not seem ready to be committing to such high demands.



Saving & Borrowing

The shift of power away from borrowers towards lenders has been significant and sufficient to change dynamics in markets, in particular property. Behaviour amongst buyers moved from what they want to buy to what they can afford to buy.

Mortgage availability dried up in Q4 as lenders retreated with the surrounding uncertainty of market interest rates (the chart below shows the spike from 2% to 4.5%) and new lending is said to be at the lowest for three years.

Adding to the economic woes of the UK is how sensitive the property market is to the strength of household finances. With most mortgages on base rate trackers, or coming off 2 to 5 year fixed terms, there is a relatively swift squeeze on budgets (as opposed to the US where rates are tied up for 10-30 year terms).

Given that a more cautious conservative leadership is in charge markets regained stability, which has allowed banks and building societies to re-build confidence and come back to the market. Competitive pressure is nudging rates lower, but the panic period from Q4 would have caught some households out who fixed rates at around 6% fearing worse was to come.

On the other hand, the sun has come out for savers, who have been penalised for years. Commercial banks now offer 2.5-3% instant access and 4-5% fixed interest for a 12 month term.

Given that central banks are focusing upon employment (which is full and a lagging indicator) for determining if inflation is under control, there seems little reason for rates to start falling back at any time soon, unless a significant recession occurs.

Looking Forward

Our investment committee formally reviews our client asset allocation early in the calendar year and given the significant change in the landscape discussions may well lead to updated guidance.

Fixed interest yields are more attractive now than they have been for the last decade, except for when they were briefly higher in October last year. But, the question is whether yields are sufficient to provide a real return above inflation going forward.

It is thought that interest rate rises have a lag of 12-18 months as they impact different parts of the economy, so there remains negative news to come.

Back in July 2022 we felt that phasing any new investment should be considered given the instability of markets, and we believe that still to be the case.

Even though evidence suggests that lump sum investment performs better the majority of the time, our instinct is that phasing is currently more relevant to mitigate 'regret risk' of timing a single market entry point.

If you have any questions regarding our investment strategy please contact your adviser who will be happy to discuss further.

Contact Information

01704 571 777

info@fpc.co.uk

fpc.co.uk

Lancaster Terrace,
124 Station Road,
Ainsdale, Southport
PR8 3HL

Chartered Financial Planners