Autumn 2022

market outlook.

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FINANCIAL AWARENESS

contents.

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The UK Economy

Changes in UK leadership and flip-flopping fiscal policy have resulted in heightened volatility in UK investment markets over the quarter, yet we believe underlying fundamentals and economic drivers remain the same.

The Bank of England (BoE) raised interest rates by 0.5% in September (to 2.25%), this was following larger moves in the US and Europe and fell short of expectations, consequently, it marked the start of a sharp fall in sterling.

Kwasi Kwarteng's 'mini-budget', put further pressure on sterling (pushing it close to parity with the US dollar), given his proposed tax cuts were unfunded, inflationary and unorthodox, with no supporting Office for Budget Responsibility (OBR) forecasts. Ultimately, his attempts at a huge fiscal giveaway backfired, both politically and in terms of market volatility and led to Kwarteng's departure and ultimately, the end of Liz Truss's tenure as Prime Minister.

Jeremy Hunt replaced Kwarteng as Chancellor and reversed most of the 'mini-budget' giveaways, which helped bring some order to markets and led to a bounce in sterling. Rishi Sunak replaced Liz Truss as Prime Minister and encouragingly has retained Jeremy Hunt as Chancellor of the Exchequer. Sunak was an advocate of budget responsibility in his initial campaign for Prime Minister and so working in tandem with Hunt, October's budget (initially dubbed the "growth plan") has been delayed until mid-November and is now expected to be a budget of fiscal restraint.

With UK Inflation still in double figures and unemployment at a 48-year low, the case remains strong for further interest rate rises from the BoE, however, as we enter the winter, pressures on the consumer will mount. Whilst the unit cost of energy is capped, consumption will increase and unit costs are significantly higher than 12 months ago. Consequently, with increased energy bills, coupled with higher finance payments (mortgage, loans, credit cards etc.) and the potential for fiscal tightening, UK consumers face an uncertain winter leaving little road for the BoE to continue raising rates aggressively, especially once inflation begins to roll over.

Whilst the UK consumer and therefore the economy may face a bleak winter, monetary and fiscal policy developments will determine the underlying strength of the UK economy.

From an equity market perspective, we believe the UK remains attractive, with plenty of long-term opportunities in multiple sectors for multiple economic outcomes.

The Japanese Economy

The announcement of a 29.1 trillion Yen (circa. £170bln) was welcome short-term support for the Japanese consumer as supply side driven commodity import pricing pressures were throttling the economy. However, the fundamental longer-term issues remain; inflation is still sitting at a meagre 3% and with nearly half of that being driven directly by supply side shocks to commodities, and despite an uplift in wages, deflation is still looming. So, whilst this fiscal spending package is a welcomed policy, seeing a capital injection to corporates incentivising wage growth, it is arguably deflationary in the short term, as the majority of the package is set to curb energy pricing. We have since seen the Bank of Japan Governor, Haruhiko Kuroda, further back loose monetary policy to stave off longer-term deflationary pressures.

October saw Japan reopen its borders to tourism for the first time in over 2 years, and with the weakened Yen compounding the attractiveness of Japan as a destination, domestic retail and leisure-focused corporates stand to benefit. Whilst a third of historic tourism is typically from China, and with Chinese travel for leisure yet to form part of the Chinese reopening story, this only compounds the longer-term valuation opportunities in these specific market caps and sectors.

Despite deflationary pressures and a tough wage growth environment driving further monetary policy stimulus in a world that is largely tightening policy-wise, small cap businesses that are supported by the recent stimulus package continue to look attractive. Even with a weakening Yen, businesses not driven by import costs have benefitted from the increase in domestic-led consumer spending following the recent Covid reopening. Given their compressed valuations and the under research in the sector, smaller companies within Japan look arguably stronger and more attractive than they ever have!

The Japanese economy largely remains disjointed and unhinged from its policy as despite over a decade's worth of record-level stimulus, a job to applicant ratio of 1:34 and climbing, natural wage growth which would drive a natural rate of inflation remains elusive. Consequently, coupled with volatility in its currency, long-term opportunity sets remain questionably modest.

The Emerging Markets & Asia Economy

China’s 5 yearly Communist Party Congress saw President Xi Jinping fix another 5-year term in power. Whilst broader markets sold off following the news that Xi had appointed ‘pro Xi’ supporters in key roles, this can be seen as a consistent political step amidst most world economic powers. This arguable distortion in markets was exacerbated by the fact that western markets not only read this as anti-US rhetoric but also as a doubling down of the hard Covid lockdown policy. However, with China not only halving quarantine periods and tightening the localisation of lockdowns since the start of the year, when coupled with the sign-off of public events (marathons and the World Badminton tournament), it appears a reopening is already occurring. With compression in market valuations of Chinese corporates driven largely in part by these factors, the potential market uplift once markets price the evidence in, is arguably the most attractive globally.

Whilst we have seen a compression in Chinese growth (GDP), Q3 GDP came in at 3.9%, considerably greater than the previous quarter’s data. Whilst it is less than what can be considered the ‘historic norm’ based on recent history, one must remember that this level of growth for any Western economy would be considered strong. One must also recall that this GDP data is backwards looking and comes with the backdrop of tough lockdown restrictions for an economy that is not only considered the manufacturing hub of the world, but also for an economy that is the second largest in the world and that has a population of circa 1.4 billion people.

Following a strong rally in global commodities this year, Latin American equities, dominated by Brazil, have had a strong run in 2022. With Brazil representing approximately 65% of the region's market capitalisation, its political instability in recent years introduced volatility. However, following October’s election that saw Lula Da Silva’s victory in the run for president, whilst his chequered past (involvement in the infamous Carwash scandal in Brazil) is controversial, a vote for Lula was a vote for a return to normality for Brazil, which is good for businesses. The compression in market valuations in recent years, when coupled with an element of political stability in key Latin American markets, makes investment opportunities attractive in relative terms.

In what was a strong year for Indian equities in 2021, the valuation retrenchment in early 2022 was largely expected. However, following Russia’s invasion of Ukraine and the subsequent commodity supply side shock to markets, India (and China) have capitalised on western sanctions on Russia. We have often talked about a redistribution mechanism easing oil and gas prices over time, and this is what we are beginning to see. With India being one of the world’s largest net oil importers, whilst one would have expected an explosion in inflation (whilst there has been an uplift), India is now securing oil at (in some instances) circa $40 per barrel. When coupled with government fuel subsidies, India’s inflation level sits at 7.41%, a meagre 1.4% uplift from January. This, in addition to taxation controls driven to protect the domestic consumer and insulate them from agricultural pricing pressures, positions quality Indian corporates well heading into 2023.

The US Economy

We have clearly seen an increasing rate rise cycle in the US this year. However, with this quarter seeing them only abstain in one month due to the Fed's (Federal Reserve Bank) summer closure in August, one must remember that at the beginning of the year, the expectation was that US interest rates would be well in excess of 4% by this time, yet they currently sit at 3.25% at the upper bound. Whilst the market disconnect has priced in a severe rate rise cycle, the Fed has raised rates at a slower pace than was expected. It is this disconnect that arguably breeds investment opportunity. We are already beginning to see the softening of the aggressive narrative from the Fed, and whilst we believe that central banks weren't necessarily increasing rates to combat inflation (as inflations supply-side driven nature has seen hiking rates largely ineffective), the pressures of a deepening recession means that the higher interest rate gives the Fed some monetary stimulus controls to ease economic pressures if needed.

One must remember that the makeup of US consumer debt is very different from other developed markets. The US can afford to increase interest rates due to the majority of their mortgages being on 25 or 30-year fixed term structures but the same is not true of Europe or the UK. As such, increased interest rates can serve to build up a normalised monetary policy tool kit, whilst having a lesser impact on affordability-based consumer spending than other regions. That being said, broader markets have arguably viewed most developed market central banks the same, but with the inability of many to shift rates as sharply in reality; this anomaly has presented a fair amount of valuation opportunity across many equity markets... awaiting the appropriate catalyst!

The tightening of monetary stimulus in the US, all be it at a slower pace than originally anticipated, has driven a relative US dollar strength. With the previous bullet point in mind, other regional central banks can't move as aggressively as the Fed, and as such, whilst it does not seem likely the dollar will strengthen massively from here, it offers an element of stability for investors. In addition, longer term dollar strength serves to impact exporters, which can be seen as a further reason why the Fed appears to be softening its tone on interest rate increases. That being said, the strong dollar benefits importers and the domestically-focused businesses, as such it seems likely, when coupled with the point in the economic cycle, smaller companies stand to benefit from the current backdrop.

With US Midterm elections due in November, and with US President Joe Biden on the political campaign trail in recent months largely to fend off a drop in approval ratings, it is widely expected to be a close contest. With Democrats currently controlling the House and the Senate, polls suggest Republicans are looking strong contenders for House control, with the Senate control closely run. Despite discontent, given recent political frictions and narrative with China causing market nervousness, it could be thought that the Democrats losing the majority in either the House or the Senate, or both, could be beneficial for investors. With a lot of domestic-level stimulus now ratified (the Inflation Reduction Act of 2022), and recent on-shoring growth policies such as the recent semiconductor chip controls (cutting China off from chips made anywhere in the world with US equipment) now in place, the Democrats losing absolute control will hinder US actions on most things. Some would argue this would introduce some much-needed stability. It is a widely held public view, even with hardened Democrats and Republicans, that splitting the house and senate control is in the best interest of the public. History suggests such a result could be a boost for sentiment and markets!

The European Economy

Despite domestic media loosening their focus on the war in Ukraine compared to earlier in the year, the resultant energy supply side restrictions driven by the sanctions imposed on Russia continue to tighten pressures on the European market, not only in terms of cost but in terms of supply itself. Whilst this is likely a shorter-term phenomenon in the grand scheme of things, we have seen in recent months, amongst other things, Germany reopen coal plants in order to fill the deficit gas provision from Russia (that represented approximately 45% of their gas supply). In addition, we saw Spain limit its heating and cooling system utilisation to 19 degrees and 27 degrees respectively. This comes in the wake of new EU legislation forcing member countries to reduce gas demand by 15% by April 2023.

With the above in mind, whilst valuations in Europe are arguably the most attractive globally at present, the catalyst to release the valuations will likely be the alleviation of the energy supply side pressures, which at present are alluding the European space. With that being said, it seems likely that the growing inflationary pressures seeing consumer prices hitting 9.9% in September will persist throughout winter. Whilst we believe supply side pressures will ease and the value makeup of the European market looks extremely attractive given the position in the cycle, the opportunity set does not look likely to play out over the winter period as consumers tighten their belts, and as expectation for ECB (European Central Bank) policy becomes more consistent.

In back to back meetings over the past quarter, the ECB has increased interest rates which have now risen 2.5% from a negative position earlier in the year. With the perceived 'hawkish' narrative coming from the ECB, coupled with the mounting pressure to curb inflation, it was easy to forget that the Euro was arguably their biggest worry. As we have seen around the globe, whether it be from the Federal Reserve in the US, the Bank of England, or other major central banks, due to the supply-side nature of the inflationary pressures, increasing the interest rates have had little to no direct effect on inflation. One could almost think that central banks have used narrative to manipulate inflation expectation, and the supply side inflation as an excuse to increase interest rates… when in actual fact, they are likely aware that increasing rates will have little impact but will give them monetary policy levers to pull should the recessionary pressures worsen.

To emphasize, increasing interest rates is a perfectly healthy mechanism in an economy, and one could argue western central banks have been clever to utilise the backdrop to get rates off the proverbial ground for the first time in 15 years!

Despite the short-term backdrop for inflation and the consumer weakening, and the pressure on debt to GDP for many European countries worsening in recent years, it is easy to forget that corporate valuations remain attractive, particularly given policy direction and the point in the economic cycle. With the makeup of the European markets populated primarily by value driven sectors such as financials, raising interest rates increases the profitability of the banks, a sector starved of profits since the financial crisis.

Fixed Interest

Fixed income markets had another volatile quarter, with both government debt and corporate bonds selling off. This is not specific to the UK market: the euro market and the US dollar market have also performed poorly this year. However, the UK market has in the last quarter been particularly volatile. This excessive volatility, relative to other developed markets, was largely driven by a reaction to government policy, exaggerated by technical issues around certain defined benefit pensions.

While the issues were complex, it is comforting that the Bank of England, and the government responded to the aggressive sell-off in bonds, with moves that stopped the sell-off from worsening. Sterling-denominated debt has since recovered substantially from the lows. While UK government fiscal policy is still not set, markets have appreciated the appointment of Jeremy Hunt as Chancellor, and seemingly a recommitment to respecting the bond market.

Despite this recovery, corporate bonds are still attractively priced, relative to government bonds, with the additional yield likely to compensate investors willing to hold through any near-term economic weakness and resulting market volatility.

Fixed income markets are offering headline yields that are much higher than they have been for a number of years, however, this is logical given the current high levels of inflation and should not be mistaken for exceptional value. Corporate bond pricing also represents the weakening of global economies we have already seen, combined with uncertain growth in the near term too.

It is important not to be overly attracted to headline valuations from fixed income markets. While valuations are at least superficially attractive, this needs to be balanced against an uncertain fundamental outlook, and a weak technical environment and compared to other opportunities.

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on 0800 049 2011, Monday to Friday 9am-5pm or you can email us at affinity.advise@wealthatwork.co.uk

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