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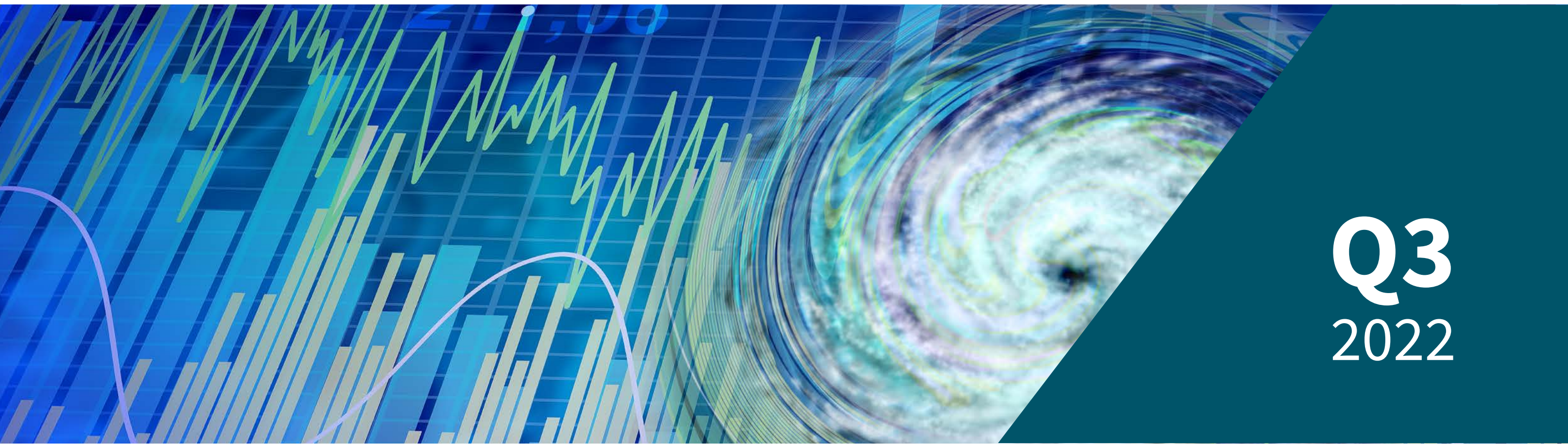
# Investment Commentary




## Overview

Q3 2022 may well go down in history as one of the most momentous quarters in our time. September was particularly extraordinary. The most significant event was the sad death of Her Majesty Queen Elizabeth II, an omnipresence in most of our lives. Her reign of over 70 years showed an incredible dedication to service, duty and resilience through good times and bad, and her funeral exemplified the fine tradition of pageantry for which the UK is renowned.

Other events occasioned rather less pride. After the resignation of Boris Johnson, the Conservative Party elected a new and inexperienced Prime Minister in Liz Truss, who, with her Chancellor, Kwasi Kwarteng, succeeded in creating unprecedented volatility in the currency and government bond markets. Meanwhile, the Russian war in Ukraine persisted, with Vladimir Putin raising the terrifying possibility of a nuclear strike as his ambitions there continue to falter.

At the time of writing, it is hard to tell if we are in the eye of the storm or if it has passed. The new government's unfunded proposal of tax cuts alongside a growth agenda has seen sterling touch an all-time low against the dollar and unprecedented volatility in the bond market. The latter has been exacerbated by a pension industry that, to most of us, appears to be a glorified Ponzi scheme. Liability-Driven Investment schemes, using derivatives to enhance returns, were not expected to be tested by extreme volatility – but they have been, and they have been found wanting.

Reading our domestic press, one can be forgiven for thinking that the financial problems of the world are exclusive to the UK. In fact, rising inflation and the consequent increases in interest rates are global issues. The causes, some of which cannot be controlled by monetary policy, are well rehearsed. Overstimulation during the Covid shutdown has led to strong demand, while supply-side constraints have worsened the problem. With both countries major producers of many essential commodities, Russia's invasion of Ukraine has worsened the situation. It must, however, be said that many key commodity prices have fallen over the quarter as economic prospects decline.

The monetary response has been to increase interest rates. In the USA this has been by increments of 0.75%, ending the quarter at 3.25%. The UK has moved more cautiously – but persistently – to reach 2.25%, while the ECB is in catchup mode, reaching just 1.25%. Of the major developed economies, only Japan remains unchanged, at -0.1%. These moves are bringing about a slowdown, with most Purchasing Manager Indices around the world slipping below 50 and into contraction as recession beckons.

The following table sets out the market movements over the past quarter.

| Index | 30/06/2022 | 30/09/2022 | Change |
|---|---|---|---|
| CBOE UK 100 | 715 | 689 | -3.6% |
| CBOE UK All Companies | 12,586 | 12,028 | -4.4% |
| CBOE UK 250 | 16,306 | 14,650 | -10.2% |
| MSCI Private Balanced | 1,665 | 1,606 | -3.5% |
| MSCI Private Growth | 1,805 | 1,770 | -1.9% |

## Macro-economic picture

As can be seen from the table above, all asset prices suffered falls over the quarter. What has been unusual is that, historically, when equities (risk assets) have fallen government bonds (safe assets) have risen. However, this time – and for the year – gilts have performed far worse than equities as the long bond bull run comes to an end. The 10-year yield in the UK rose from 2.2% to 4.1% over the quarter, while the equivalent in the USA moved from 3.0% to 3.7%.

As we have commented before, the leading UK equity indices appear an anomaly. The top 100 shares show a fall of 6.7% this year, while most other major markets around the world are in bear market territory (falls of over 20%). We have explained that the composition of the UK indices has seen the biggest companies, by and large, rise in price this year. However, taking an equally weighted index of these same 100 companies (i.e. each constituent counts the same), the return over the past 12 months has been -18.7%.

For most of the quarter the UK market performed reasonably well – until the government's mini-budget knocked everything off course. The market was down 5.4% in September. As bond yields have risen and mortgage rates have climbed, sectors most closely aligned to these have fallen heavily. Housebuilders, already weak, fell more than a quarter, the property sector fell by a fifth, and even the telecom sector was down 22%. Only the oil sector (+7%) continued its serene climb upwards. Medium-sized and smaller-sized companies continued to underperform their larger peers.

## Outlook

It is likely that markets will remain volatile in the short term. Looking further ahead, it could well be that peak inflation has now been reached as commodity and energy prices turn down in reaction to an undoubted world economic slowdown. Most developed stock markets are trading in bear market territory, and many share prices have fallen to the extent that they are already discounting future profit downgrades. If bond markets consolidate at current yield levels, as the rate of inflation subsides, compression in share price ratings should ease. Most bull markets begin during a recession and end at the top of an economic cycle. We also expect further takeover activity as overseas investors take advantage of the weakness of sterling. For long-term investors, attractive undervalued situations are beginning to appear on the radar.

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