MARKET UPDATE

Latest views from the investment team

Special Report: Q&A on market events

Given the unprecedented events of the last month, notably in the UK – we have used this month's note as an opportunity to do a Q&A on what client's may be thinking about. The last month has seen bond volatility surpass that of equities, as uncertainly on inflation and corresponding effect on interest rates has deepened. This has been particularly acute in the UK, as monetary and fiscal policy diverge.

How is inflation affecting my portfolio?

Inflation effects are having a large impact on portfolios this year and there are few hiding places to combat it. The issue is largely the effect that soaring inflation has on interest rates/the economy. Central banks have begun to act aggressively to combat inflation. Regular readers will know of our concern over central bank complacency on inflation last year and that has meant it has been left to become self-fulfilling and more entrenched. Raising interest rates, particularly at a fast and unexpected pace, have a significant destabilising effect on markets, for three main reasons:

1. It increases the discount rate for which stocks are valued – thus reducing valuations. This is a big reason why so-called "growth" stocks have been most hard hit this year.
2. It creates large amounts of uncertainty for markets on what will happen to the economy – and whether tightening of financial conditions will be recessionary (which is looking ever more likely).
3. Bonds are having their worst year on record as yields have risen (prices fallen) rapidly, from a very low base. Not only does this affect fixed income allocations negatively but makes bonds more attractive investments as yields rise, pulling money out of equities. For much of the last decade, bonds have appeared un-investible. But with yields at 4% for US Treasuries and 6.5% for short-dated investment grade corporate bonds, these have become potentially attractive once again.

What effect does the falling pound have on my investments?

Equities and bonds (together) have had one of their worst years' on record. UK investors have been cushioned somewhat by the fall in sterling – which is fine if you are not planning a trip to the US any time soon – as overseas equity holdings are non-sterling denominated, thus optically faring better when reported back in pounds. For example, if a US fund goes down 10% in US dollar terms, but the pound has fallen by 10%, the holding will show as flat for the period on valuations, as one is offsetting the other. The pound's weakness has also had an effect on some UK equities, notably large caps, where a greater portion of earnings are from overseas. This has helped UK equities (-7.8%) fare reasonably well this year, relative to global peers (-25.6%). The notable weighting in oil & gas, alongside healthcare and consumer staples (defensive sectors) has also helped the UK index.

How high will interest rates go in the UK?

Interest rate expectations are moving rapidly, following the crisis that has engulfed the UK in recent weeks. As of the 30th September, expectation of base rates in the UK for 1-5 years out is in the range of 5.0 – 6.0%, a huge increase from this time last year where it was in the region of 0.5% - 1.5%. We expected interest rates to continue to rise this year. We would expect some flattening out at the level priced in, not expecting yields to rise much beyond this.

How long do you see this new interest rate environment lasting?

We have written a lot in the last year of a paradigm shift in markets, away from the ultra-low-rate environment we saw 2010-2020 era, into a higher rate environment regime. Markets are now pricing in rates staying higher for longer, and we would concur with this. However, we believe there will be a lid on rates at the 5-6% level, with a pull back on rates in the next few years to the 3-4% level. We do not envisage a return to the 0-1% rate policy, even if inflation comes under control.

Is a recession an inevitability and if so what are you doing to protect my portfolio?

It is likely that the UK is already in a recession. The US has reported two negative quarters of GPD (Gross Domestic Product) growth, which is a definition of a technical recession. So, we think we can say with some degree of certainty now that we are in the midst of a global recession. However, in many ways, the post-pandemic inflation spurt resembles a post-war economic environment, where recessionary environments tend to be short lived.

With regard to investments, trying to time recessions (and market impact) is extremely difficult and not, generally, a profitable strategy. However, based off a sensible long-term strategic asset allocation, making shorter-term, tactical adjustments, can be prudent. We have made several changes to portfolios this year, on a tactical basis. Early in the year, we had a particularly negative view on inflation and corresponding effects on rates/bonds. Our action within the fixed income part of portfolios helped cushion falls. Within equities, we have had a cautious stance too, favouring quality and low volatility strategies. This has also been helpful. Whilst this has not led us to be immune from the falls, it has helped dampen the volatility and provide some protection. We continue to favour a cautious stance to risk broadly, into year end. As part of this, and following the unprecedented falls in fixed income assets, we have begun increasing allocations.

With deep uncertainty in markets at present, should I sell my portfolio and wait for a better time to buy back?

Given investor psychology, and the emotional attachment one places to losses, this is a perennial question we get when markets fall; and a perfectly reasonable one. Many studies have been done on this over the years and evidence points overwhelmingly to staying invested during periods of extended market falls/volatility, despite feeling uncomfortable at the time. The global financial crisis and the covid crisis are examples of more recent periods where this has occurred – and remaining invested during the peak of these crisis' has been prudent. Whilst the outlook looks particularly bleak for stocks over the next six months – they (markets) do a good job at discounting a lot of (in this case negative) news, with stocks historically bottoming 3-months before the end of a recession.

Are we over the worst of the market turmoil?

Historically (considering the last 50 years), equities have gone up at an annualised rate of around 10%. So, naturally, investors during bear markets are looking for a bottom (or close to a bottom) to become more positive again. There are various qualitative and quantitative measures investors can look at to help gauge when a market may have bottomed. One of these is exhaustion/capitulation in selling. We believe September saw this in some areas of the bond market (sovereign and high grade corporate), but not in equities or high yield fixed income. We are yet to see significant downgrades to earnings and mass outflows from equities. It is quite possible that this does not come (there is no capitulation element), but if this does occur, it would be a sign to us that we may be nearing a bottom.

Are there any signs to be positive about markets?

We thought we would finish on a more positive note. There are now certainly pockets of value. One thing that has caught our attention has been the yield on offer in investment grade corporate bonds – in the region of 6-7%. Stock valuations are now much more attractive and several equity regions (e.g. Europe, China) are pricing in a particularly bleak outlook. As mentioned above, we are not, at present, looking to increase risk back into portfolios – but will be looking for signs that markets might be bottoming in the months ahead – as well as looking for opportunities to pick up deeply discounted assets on attractive valuations for the long-term. We maintain our portfolio structure that includes a portion of real (inflation sensitive) assets, to provide as full diversification to investors as possible. With some parallels to the 1970's in the current environment, these exposures helped protect the real value of investors' wealth, alongside investment in equities, over the period.

ASSET ALLOCATION

Latest portfolio positioning and changes

Below is an indication of our current tactical asset allocation (TAA) for discretionary portfolios. This represents our shorter term (1-3 years) positioning in portfolios and corresponding deviations from our long-term strategic asset allocation (SAA). This is updated monthly, with any changes from the prior month illustrated.

Asset Allocation

Asset Class		Tactical View				
		-2	-1	0	1	2
Overall Risk (Defensive Vs Growth)				■		
Cash				■		
Fixed Income				■		
Fixed Income	UK Sovereign Bonds		■			
	Int. Sovereign Bonds			■		
	IG Corporate Bonds				■	
	Tactical Fixed Income			■		
Real Return				■		
Real Return	Inflation-Linked Bonds		■			
	Defensive Real Return				■	
Absolute Return				■		
Equities			■			
Equities	UK			■		
	Europe		■			
	US		■			
	EM/Asia			■		
	Japan				■	
	Tactical Equities				■	
Real Assets					■	
Real Assets	Infrastructure/Clean Energy				■	
	Property		■			
	Gold/Precious Metals		■			
	Tactical Real Assets				■	

Current Positioning

x Prior month

Positioning and changes

There have been no changes to our tactical asset allocation positioning in September, which remains as described below and illustrated opposite.

Within defensive assets, our fixed income allocation remains at neutral, as does our exposure to absolute return. US bond yields close to 4.0%, and corporate spreads relatively wide, makes fixed income relatively attractive once again, to merit a neutral weighting in portfolios. We do, however, remain biased to short duration bonds.

Within growth assets, we maintain a bias to real assets over conventional equities, for the current inflation backdrop. Within equities, we are underweight European equity exposure in favour of Japan. Both are big exporting regions and cyclical – however, from a valuation and diversification standpoint, Japan is more attractive in our view. The market can become detached from other developed nations. From a style perspective, our exposure remains biased to minimum volatility stocks and quality – which typically fare best in a downturn/recessionary environment.

For more information, please contact your adviser.

Disclaimer

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