MONTHLY UPDATE

Latest views from the investment team

Some perspective

Rewind...In December 2020 there were US$18 trillion of negative yielding sovereign bonds. Fast forward to January 2023 and that number is finally zero. 2022 marked the worst year for returns in nominal (non inflation-linked) Government bonds in 230 years. The unwinding of the greatest and longest period of monetary recklessness in history will have lasting consequences that will possibly overwhelm policymakers with the possibility of big tail outcomes (positive and negative) increasing as they struggle to stay in front of risk events. This is not the rinse and repeat rate cutting market of the last three decades. Central banks are likely to continue to maintain higher rates and be reluctant to ease, meaning the cost of capital will stay higher for longer.

During that period, inflation has gone from being non-existent, to (supposedly) transitory, to entrenched. Central banks are now acting aggressively to bring inflation under control. Recent central bank communication suggests they are not likely to take their foot off the pedal until there are clear signs that their actions are proving effective in bringing down inflation. As we begin 2023, there are some signs that inflation is slowing. Recent data, especially in the US, has softened – but remain well above central bank targets. It is our view that inflation will continue to cool in the next 6-9 months, but that second round inflationary forces (on wages and price setting) could cause inflation to rise once again in 2024. We believe the Federal Reserve is aware of this and will likely be prepared to induce a recession in order to create labour market slack and curtail price pressures, but not go far enough to stop inflation re-establishing itself.

Whilst that all sounds rather gloomy, an inflationary environment in the region of 3-5% is not necessarily bad for investors. Indeed, after some of the inflation shocks of the 1970s, purposeful allocation to asset classes that fare well in such an environment were handsomely rewarded. These were principally *real* assets – such as commodities, infrastructure, property and gold. So-called "value" stocks also fared better than their "growth" counterparts, as investors pursued shorter term cash flows. Inflation-linked bonds were not available in the 1970s – until the UK introduced them in the 80s – but today also present a useful tool to investors in protecting the real value of capital.

So, whilst last year was all about protecting capital, we believe this year investors can look more positively at the prospects for growing capital.

Month by numbers

Change in various markets over the month:

Asset		Change/ Value
Equities		
UK	↑	**1.20%**
Europe	↓	**-1.70%**
US	↓	**-3.50%**
Emerging Markets	↓	**-3.50%**
Japan	↓	**-1.20%**
Bonds/Rates *Absolute change (%)		
UK Base Rates	↑	**0.25%** / 1.25%
Fed Funds Rate	↑	**0.50%** / 2.50%
UK 10-Year Yield	↓	**-1.70%** / 4.20%
US 10-Year Yield	↓	**-3.50%** / 3.95%
Currencies		
GBP/USD	↑	**0.25%** / 115.25
GBP/EUR	↑	**0.50%** / 110.25
DXY (USD Index)	↓	**-3.50%** / 1.11
Commodities		
Gold	↑	**5.20%** / $1650.25
Oil (Brent)	↑	**7.50%** / $95.40
Noteworthy		
Bitcoin	↑	**32.00%**
Natural Gas	↓	**-35.00%**

January

As of 31st December 2022

What does this mean for investors?

After a torrid year for equity and bond investors in 2022, we begin this year with a more constructive view on both asset classes, which clearly represent better value (on most valuation metrics). With that, we have increased equity exposure in portfolios back to neutral, from a largely underweight position in 2022. We believe 2023 will be a year where relative allocation within equity regions, styles and sectors will be rewarded. Regionally, we favour Emerging Markets and Japan, having recently increased exposure to both. We believe Emerging Markets offer attractive valuations and structural tailwinds, that are likely to persist in the medium term. There are signs that the US dollar may have peaked, which again supports the Emerging Market thesis. Japan offers investors useful diversification, notably with yen exposure (which remains undervalued). We think that US equity market dominance is over and that investors will look for better value options globally. Smaller companies offer an attractive entry point for long-term investors, at a steep discount to historic valuations. We retain our bias to quality stocks.

Q&A

What's on your mind?

Are we through the worst of the equity falls?

Global equities fell around 18% in US dollar terms in 2022. Sterling investor portfolios fared better, with GBP-USD weaking over the period. The UK market outperformed global equities with a bias to resources – one of the few sectors to register a positive return in 2022 – and more defensive sectors. Whilst it is clearly difficult to call the aggregate rise and fall in stock markets year on year, we think 2023 will present opportunities for capital to be made, through more focused allocations, rather than broad equity exposure.

Why is a weak pound good for UK investors?

Much has been spoken of UK multi-asset investors (including ourselves) benefiting over the last year because of a weak pound (GBP). We think it is important to clarify why this is, as it may seem counterintuitive for us to benefit as the value of our portfolio currency falls relative to, for example, the US dollar (USD). Simply put, a weaker pound leads to the USD becoming more valuable in sterling terms, therefore US equities (priced in dollars) also become more valuable. In 2022 this cushioned us as GBP fell around 11% against the dollar, whilst US equities fell around 19%. For us, in GBP terms, US equities only fell around 8%. A weaker pound also benefits UK equities. As British investors, we gain from this due to our natural investment bias towards UK assets relative to the global benchmark. The UK equity index is dominated by large multinational companies that are based in the UK but typically receive the bulk of their earnings from overseas. When reporting their financial performance, these companies convert these earnings back into GBP and so a weaker pound inflates these earnings, boosting the apparent profitability of UK listed companies and therefore increasing the value of the UK equity index.

For more information, please contact your adviser.

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