Investec

OUT OF THE ORDINARY

06 December 2022

Market commentary

John Wyn-Evans
Head of investment strategy

Overview

November delivered a second consecutive month of gains for balanced portfolio investors. And whereas the positive correlation between equities and bonds had been destructive for the first nine months of the year, it has, for now, become more of a tailwind, with both asset classes gaining ground.

Deutsche Bank's monitor of 38 different assets revealed that only three were in negative territory during the month. These were Brazil's equity market (succumbing to profit-taking following the Presidential election, but still positive and the best performer this year); and both versions of the oil price (Brent and West Texas Intermediate), as investors priced in weaker short-term demand as well as the potential effects of the EU's intended price cap on Russian oil exports.

Whereas October's gains were characterised by a feeling that things could not get any worse, last month's advances were driven more by the sentiment that things were set to get in terms of what drives markets. The key moment was the release of October's US inflation data. While a headline consumer price index increase of 7.7% still looked lofty relative to the experience of the last few years, it came in below expectations of 7.9% (something that has only happened on one other occasion this year) and was deemed to offer proof that the peak of annual inflation has been reached. The market then made a huge leap forward and started to discount the possibility that the Federal Reserve will be able to slow the pace of policy rate increases – the much-anticipated "pivot".

The market reaction was immediate and aggressive. The flagship US S&P500 equity index rose 5.6% on the day, the ten-year Treasury bond yield fell from 4.1% to 3.8% and the dollar sold off sharply. Interestingly, although many other markets followed the directional shift, they could not match the magnitude of the move, suggesting specific cyclical and structural issues. One would be the positioning of investors in US financial assets, with short positions being squeezed. Another could be the increasing use of very short-dated call options to exploit expected volatility over the release of key economic data or events. These phenomena were also cited later in the month following a speech by Fed Chair Jerome Powell, in which he suggested the possibility that the Fed would indeed be able to contemplate a slower pace of tightening at December's meeting. On the day of that speech, the S&P500 rose by 3.5% on much higher-than-average turnover.

The net monthly gain for the S&P500 was 5.4%, meaning that, in aggregate, the other trading days provided a negative return of around 4%. Moves such as the ones we are witnessing are features of bear market rallies, and it remains our opinion that we are in one now – the fifth of the year so far – and not the beginning of a new bull market. More on which later.

The impact of events in China

Another key driver of greater optimism arose out of a dark period in China. The aspect relating to its Zero-Covid policy is covered in greater depth in the Emerging Markets section below. Expectations of a broader re-opening of the economy within the next few months are rising. China's authorities also appear to be trying to draw a line under the weakness that has prevailed in the real estate sector. It is now almost a year since property developer Evergrande declared a default on some of its debt instruments. It might have been the biggest casualty of the government's crackdown on speculation, but it was neither the only one nor the last. Activity has slowed down dramatically in the construction industry and house prices are falling in China. The government unveiled a 16-point plan to lubricate the market, largely involving ordering banks to lend money to financially constrained developers to enable them to complete residential projects and to deliver them to buyers who have already paid. That's excellent news for the buyers, although hardly absolves the developers from their existing debts. Neither is it clear how the banks will turn a profit on these loans, which is one of the reasons why the banking sector continues to trade at a substantial discount to net asset value. Such are the joys of being controlled by the state.

The impact of the Autumn Statement

From a more domestic UK perspective, it's nice to be able to report that we have the same Prime Minister and Chancellor of the Exchequer that we did when writing last month's commentary. The latter delivered the big set piece of the month in the shape of the Autumn Statement, and that is covered in more detail in the UK section below. Suffice to say at this point that the objective of settling nerves and calming markets was met.

How optimistic are we?

I alluded earlier to the fact that despite what seems to be a confluence of better news and rising asset prices, we are not yet ready to commit ourselves to the belief that we have embarked upon a new bull market. Why is that? The two main reasons pertain to liquidity and growth, both of which we believe will continue to create headwinds for a few months yet. While optimism is growing that central banks will decide to be less aggressive with their policy tightening, it is still tightening, either in the form of higher interest rates or shrinking balance sheets (Quantitative Tightening). For example, the futures market is pricing in a peak US Fed Funds rate close to 5% vs 4% now. In the UK, the current bank rate of 3% is expected to rise to around 4.5%. And it's the same in Europe, where the ECB is forecast to have to almost double rates from a current 1.5% to close to 3%. No doubt markets always try to look past these peaks, and, indeed, rate curves are already sniffing out rate reductions later in 2023, but it is pretty much unheard of for equity bull markets to begin before the rate cycle has actually peaked.

On the growth front, there is more bad news ahead as the effects of higher rates and higher prices filter through to weaker demand. We believe that this will finally lead to pressure on corporate earnings. An environment of tighter liquidity and weaker growth tends not be one in which risk assets can prosper for long.

However, not to end on too gloomy a note, we also see the case for a sunnier outlook later in 2023, and valuations, especially outside the US, have been beaten down to more attractive levels. Thus, the continued "cautious not fearful" attitude that we have carried through the Autumn.

Markets – US

To most people's surprise, the Democrats retained control of the Senate in the mid-term elections. However, they did lose the House of Representatives, although by a narrower margin than expected. Given that many of the Republican candidates backed by former President Donald Trump failed to gain office, this was seen as a repudiation by marginal voters of Trump's views. Even so, Trump has since announced his intention to run again in 2024. It is rare for a challenger to declare this early, and the decision to do so has been viewed by some as an attempt to draw attention away from the person that many believe will emerge as the Party's favoured candidate, Ron DeSantis. He was returned as the Governor of Florida with a landslide majority. Should Mr DeSantis prevail in 2024, things promise to get interesting. In his position as Governor, he has just ordered the withdrawal of $2bn of the state's investments from investment manager Blackrock on account of its support of ESG policies and investments.

UK

Following the disastrous "mini" Budget in September, investors were understandably cautious ahead of the Autumn Statement. This event was seen as being crucial for the Conservative Party to put the missteps of the Truss government behind it and to present a more responsible attitude towards the management of the country's finances. The contents of the statement, delivered by Chancellor Jeremy Hunt, ticked all the boxes in terms of building broader confidence, but it was not exactly friendly to individual investors. Future cuts to tax allowances for both dividend income and capital gains were announced, putting even more value on tax-sheltered vehicles such as ISAs and SIPPs. Even so, plans to cut costs in the public sector were largely loaded into the second half of the budget period stretching out to 2027/28, meaning that the government will attempt to postpone the greatest pain until the next Parliament, assuming that it goes the full distance before calling an election in late 2024. So much has happened in the last two years that it would be something of a surprise if everything plays out as forecast. It certainly appears as though the UK is either already in or shortly will be in recession. There are also tests for both the government and households to come in the form of an increasing number of strikes scheduled for the coming weeks. Key service-providers including nurses, ambulance drivers, postmen and rail workers are amongst those raising the threat of a "winter of discontent".

Europe

Remarkably, sentiment surveys of both businesses and consumers in Europe ticked up during November. Much of this might have been on account of the weather. A mild October and early November meant that expensively accumulated inventories of natural gas were not drawn down for heating purposes. This encouraged the thought that blackouts and industry closures will not be required this winter. Already, though, the race is on to make sure that bigger problems do not emerge next winter (2023/24). By then, barring a dramatic positive turn of events in Ukraine, there will have been less supply making its way into Europe from Russia, and it is also plausible that competition for resources will have heated up as China emerges from its self-imposed period of slow growth (see below). Liquid Natural Gas facilities are being built and deals are being struck to secure imports. A notable deal was signed between Germany and Qatar, just days after Germany's football team had made a pre-match protest at the football World Cup against the Qatari government's attitude towards human rights and inclusivity. Fittingly, the Germans have a word that perfectly captures this dilemma – Realpolitik. As countries around the world vie for scarce resources that cannot always be found in the most convenient locations, many more such decisions will have to be made.

Emerging Markets

China continues to draw investors' attention, and not necessarily for good reasons. The ongoing restrictions imposed on the population owing to the country's zero-Covid policy finally led to protests. These were triggered, at least in part, by the deaths of residents of an apartment building in the city of Urumqi. The victims were reportedly unable to exit the building and firefighters found it equally difficult to gain access. Reports from China also suggested disquiet among viewers of the football World Cup who were able to see large crowds of unmasked supporters enjoying the event in close proximity to each other – this despite the best efforts of Chinese TV producers to edit out the crowd shots.

President Xi's triumphant appointment to the role for an unprecedented third five-year term (and effectively perpetuity) suddenly met calls for him to resign. The history of uprisings in modern China suggests limited tolerance, whether one looks at the reaction to the demonstrations in Tiananmen Square in 1989 or to more recent protests in Hong Kong. Even so, the unwritten pact between the countries' citizens and its government, which supports the Communist Party in return for improving living standards and wealth creation opportunities, is being severely tested. We see little prospect of a collapse of the Party, but there are signs that the authorities are willing to start opening up the economy again, even if only gradually, with a twenty-point plan having been published on how to exit zero-Covid. The market's reaction to potential for this plan being implemented could be seen in the rebound of both regional stock markets and commodities. The Financial Times's Lex Column recently published a comment which ended thus: "The question is whether the Chinese market as a whole is becoming un-investible." The word "un-investible" always excites the antennae of investors with contrarian instincts. If 2023 brings peak inflation, peak interest rates and a weaker US dollar, as many suggest it will, then Emerging Markets look attractive. Even so, we would be wary of expecting China's growth to return to its pre-pandemic levels.

Fixed Income

Bond yields continued to fall in November, slowly leaving behind the trauma of the first global bond bear market for seven decades. At its worst in October, the Bloomberg Global Aggregate Index (which accounts for the whole Investment Grade market), was down more than 25% from its peak at the beginning of 2021 and down almost 22% during 2022. A respectable recovery of 9% still leaves it 19% from its peak. The key point, though, is that yields are much more attractive, in nominal terms at least. The ten-year Gilt yield is now 3.1% vs a cycle low of just 0.08% in mid-2020 (although nowhere near the peak of 4.5% briefly hit during the LDI-crisis at the end of September). Similarly, ten-year US Treasuries now offer a yield of 3.5% against a trough of 0.5%, while investors in German ten-year Bunds can wallow in a yield of 1.9% against a low of minus 0.85%. These yields finally offer balanced portfolio investors a bit more in the way of risk diversification.

UK Gilts have delivered a total return of -2.50% over the last three months and -22.7% over the last year. Index-Linked Gilts returned -8.19% and -34.2% over the same respective periods. Emerging Market sovereign bonds produced a total return of -1.19% in sterling over the three months to end November (-6.93% over 12m). Global High Yield bonds delivered -0.53% (-1.87% over 12m) in sterling.

Conclusion and Outlook

The titles of our strategy presentations over the last year have all alluded more to the risks than the rewards of investing. A year ago, it was “Booms, Bottlenecks and Beyond”. In the Spring it was “Tricky Transitions”. Over the summer and into autumn it developed into “Cautious, Not Fearful”. The working title for the current series is “More Bumps in The Road”. We have mentioned them above. But at least they appear to be bumps rather than a cliff to drive off, and so we remain in a mood to increase equity risk in portfolios rather than to reduce it at this stage in the cycle.

One thing to bear in mind, as winter progresses, is that financial markets will almost inevitably begin to rally before the economy bottoms out. It will be paramount to disengage one’s investment brain from the gloom and doom that will dominate newspapers, websites and the Twittersphere.

Investec

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.