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OUT OF THE ORDINARY

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Market commentary

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Overview

For the second consecutive month we find ourselves commenting on the arrival of a new Prime Minister and Chancellor of the Exchequer in Downing Street, which, to say the least, is an unusual state of affairs.

When we penned last month's commentary, storm clouds were gathering over most asset classes. The stock and bond markets' recovery in October mirrored the balmy climate that prevailed during the month, although there is still a very robust debate about whether investors can enjoy financial t-shirt weather for the rest of the winter. As has been the case for much of this year, everything will depend on inflation, central banks' reaction to it, and how that manifests itself in economic growth and corporate earnings.

The UK political situation

We begin this month's review with a look at the UK's political situation and how it affected markets. Although, at the margin, some blame could be placed at the door of the Bank of England for not having been sufficiently aggressive with its policy tightening at September's meeting (especially as the US Federal Reserve had surprised the market with a particularly hawkish shift the previous day), the evidence from markets, using foreign exchange rates and bond yields as the key markers, is that it was Kwasi Kwarteng's "mini" Budget that put the spark to whatever dry tinder was available. Almost every action the Conservative Party has taken since then has been in the name of reversing the damage.

Although some might argue that a policy built upon a lighter tax regime and aimed at promoting greater growth was laudable in its ambition, the final judgement was that it was lacking in fiscal credibility. Unfunded tax cuts combined with "hit and hope" growth expectations piled more pressure onto government finances already reeling from, first, the effects of Covid and, more recently, the need to cap energy prices. In the end, the only way to restore the government's credibility was to install new leadership, which the Tory Party mandarins achieved with creditable speed.

Anyone comparing today's currency and bond prices with those that prevailed before the Budget might struggle to see that much had happened in the interim, which is testimony to the regard that markets have for Sunak and Hunt. But this reputation has initially only been won on the promise of a much more conservative approach to policy which will entail both spending cuts and tax increases. The country will have to retrench before it is able to move forward.

No doubt other countries will have taken note. The so-called Bond Vigilantes, who are the market's enforcers of good financial behaviour, can move swiftly from one scene to the next. Governments challenge them at their peril, putting both their bond markets and currencies at risk. This should be good news from the perspective of financial stability, but it also probably means that those hoping for fiscal stimuli to kick-start growth are going to be disappointed.

If the fiscal levers are going to remain largely disengaged, the heavy lifting will have to be undertaken by monetary policy. Here too, though, it might be no more than wishful thinking to expect central banks to become more lenient. We have become used to them loosening policy at the drop of a hat when markets throw a tantrum, a mode of behaviour that can be traced back to the Fed's response to the stock market crash of 1987. What became known as the "Greenspan Put", in honour of the Fed's chairman at the time, was also ascribed to his successors, Ben Bernanke and Janet Yellen. In the winter of 2018/19, it evolved into the "(Jerome) Powell Pivot", which, while being more alliterative, also betrayed a sense of dissatisfaction at central bankers' unwillingness to allow cyclical excesses to dissipate.

Crucially, though, these reversals of policy all occurred when inflation was relatively benign. That is certainly not the case today. Central bankers are faced with a much greater challenge to keep expectations of future levels of inflation anchored when the current levels are so high. The stated intent is to take more economic pain today to avoid having to dish out even harsher medicine in the future. Much is made of the experience of the 1970s, when a failure to nip inflation in the bud culminated in the double-digit interest rates of the early 1980s. Nobody wants to endure that sort of pain again.

While a weak economy, rising unemployment and falling house prices might not be on most people's wish list, they are going to be an unavoidable part of the process of setting a base for the next growth phase. The good news is that markets have already gone a long way towards discounting this and, if history is any guide, they will also start to discount the recovery long before it is evident in the data.

Earnings reports

As we enter November, we are about halfway through the third quarter company reporting season. The overall level of earnings continues to rise, with energy companies leading the way thanks to higher oil and gas prices. Unsurprisingly, this has led to calls for windfall taxes on those profits, with President Biden describing the situation as one of "profiteering". While we believe that is too harsh a judgement, and probably one made with an eye on his approval ratings, we would not be surprised to see energy companies having to make a greater contribution to government finances for the collective good.

A more negative feature of the earnings season was the news from several of the US mega-cap technology companies. Alphabet (parent of Google), Meta (formerly Facebook), Amazon and Microsoft all disappointed. However, to paraphrase Tolstoy, they all disappointed in their own way. Alphabet's shortfall was largely the function of a decline in advertising revenue growth; Meta's problem was the scale of expenditure on the as yet unproven concept of the "metaverse", the virtual world in which Mark Zuckerberg, the founder and Chief Executive, believes we will all spend much more of our time in the future; Amazon warned of weaker consumption in the lead up to Christmas as well some slowdown in its Web Services arm; and Microsoft guided expectations lower owing to the knock-on effects of slowing sales in personal computers as well as higher energy costs in its Cloud business.

The shining light amongst these formerly market-leading stocks was Apple, which reported resilient sales in aggregate, supported by the launch of the new MacBook Air which features a fancy new proprietary chip design. But even they did not shine quite as brightly as in the past, prompting our analyst to describe the performance as "Absolutely lacklustre. Comparatively sparkling". This differentiated performance between what was for several years regarded as a homogenous group of stocks collectively known as the FAANGs (if one includes the fallen star Netflix) suggests that the concept of one tide lifting all boats is no longer going to be the easy route to gains from equity markets and that the art of stock-picking is set for a comeback.

Another thing that might be different in the years ahead is the potential return on safer assets. As this commentary is being written, the Bank of England has just raised the base rate to 3%, with markets suggesting a peak of around 4.6% next year. The Fed has also raised its overnight rate to 4%, with futures markets suggesting a terminal rate above 5%. Such levels have not been seen since before the financial crisis of 2008. Bond yields have also risen sharply. This leaves investors, particularly those with a greater aversion to risk, with alternative homes for their savings. As some in the market would have it, TINA (There Is No Alternative) has become TARA (There Are Real Alternatives). This adds to the toolkit that we can use for portfolio diversification.

US

We go to print just as the US mid-term elections are being held. It says a lot about the litany of other concerns that investors have that this political event has maintained a relatively low profile. Perhaps this is because one Donald Trump does not feature prominently in the proceedings for the first time since 2014. It could also be because investors feel they have little to fear from the outcome. Opinion polls have long since concluded that the Republicans will win back control of the House of Representatives. For a while it looked as though the Democrats would retain the Senate, but that element of Congress now also seems to be moving in the direction of the Republicans. The key point is that neither party will have complete control of all the levers of government. This has historically had a positive impact on markets thanks to the policy logjam that ensues: no new taxes or inflationary stimulus packages, for example. Of course, it does not preclude the sort of stand-off related to the federal budget ceiling that has, in the past, led to government services being shut down, and we remain mindful of such risks. We would also note that President Biden's order to release oil from the Strategic Petroleum Reserve carries all the hallmarks of an attempt to massage energy prices lower, and with them inflation, with a view to gaining voter approval. Should he halt the process once the count is in, we could see the oil price moving higher again.

UK

There has been an enormous divergence of performance between large and mid/small-cap indices this year which is indicative of the mess that the UK economy finds itself in, with even the Bank of England unable to conceal the fact that a recession is inevitable. While the FTSE 100 was down 4% in the 10 months to the end of October, the FTSE 250 (mid-cap) Index was down 24%, with the Small Cap Index down 22%. There are two key factors at work here. First, there is the currency exposure. Around three-quarters of the FTSE 100 Index components' revenues are generated overseas, with around a half of that in dollars (with the euro being the next most significant source). The strength of the dollar this year has provided a strong tailwind to profits translated into sterling. This has also helped sterling dividend income, because around half of the FTSE 100 dividends are declared in dollars. The second factor is that the mid and small-cap indices have a greater exposure to the domestic economy and, to make things worse, also tend to be more cyclically exposed to it. However, and more optimistically, according to data provided by Goldman Sachs, the FTSE 250 Index is now at the 5th percentile of long-term value (which means it has only very rarely been cheaper). Goldman also points out that a fall in the pound relative to the dollar of more than 10% (it's down 20% since mid-2021) tends to presage a sharp increase in bid activity from overseas buyers.

Europe

Europe remains in the teeth of the energy-driven cost-of-living crisis, although the immediate threat of shortages was lifted in October by exceptionally mild weather. This allowed gas storage facilities to remain untapped and increased confidence that the Continent will be able to operate relatively normally during the winter. With a third of

European companies having reported third-quarter earnings, the outcome has been robust to date. Around half have beaten earnings estimates and three-quarters have beaten sales forecasts, although the latter is very much down to the high inflation environment. But the fact that profits have not kept pace with revenues is indicative of margin pressures, and it is widely expected that earnings growth will decelerate sharply henceforth. Indeed, as the risk of recession increases, earnings will more probably decline again in 2023. Even so, with balance sheets remaining reasonably strong and the banking sector much better capitalised than in the past, we would not expect a recession to develop into a crisis unless some other, unforeseen, catalyst emerges.

Emerging Markets

The main events in Emerging Markets in October were both political. In Brazil, the democratic process delivered a new President in the form of Luiz Inacio Lula Da Silva (Lula) by a slim margin. Although Brazil's stock market and currency have been rare beacons of light in global financial markets this year, the increasingly autocratic style of former President Jair Bolsonaro was creating concern, and so investors seemed pleased to welcome Lula back to power. Whether he can repeat the magic of his first stint from 2003 to 2011 remains to be seen. Then, expectations were very low at the start of his first term, when he was seen as a dangerous socialist. He did tilt more towards the centre, but he was also helped by an unprecedented boom in demand for commodities from China, a factor that is less likely to develop in his favour this time. Meanwhile in China itself, a distinctly undemocratic process confirmed that President Xi will sit for a third term (and, indeed, possibly another thereafter). Investors were much less impressed with the more inward-looking tone of his speeches which emphasised a focus on security more than economic growth as well as a further commitment to "common prosperity", which effectively favours the redistribution of wealth. Sentiment towards China and Hong Kong has hit rock bottom and so there is potential for a bounce, especially if China relaxes its zero Covid policy. However, we remain wary of expecting growth trends to return to the status quo ante, in terms of either magnitude or composition.

Fixed Income

The UK Gilts market has recovered its poise following the stress that developed in September following a somewhat dovish Bank of England policy pronouncement which was followed by the disastrous "mini" Budget. Although the experience was traumatic, an optimistic view would be that the system survived the test and that the Bank of England succeeded in maintaining financial stability. We await details of the medium-term fiscal plan to be delivered by Chancellor Jeremy Hunt on 17 November and expect to see a balanced mixture of spending cuts and tax increases. Globally, sovereign debt and corporate credit yields hit new highs for the cycle during October as persistently high inflation continued to suggest a higher base rate environment, although they have since retreated from peak levels as investors weigh the risks of economies tipping into recession.

UK Gilts have delivered a total return of -12.4% over the last three months and -22.3% over the last year. Index-Linked Gilts returned -17.8% and -32.6% over the same respective periods. Emerging Market sovereign bonds produced a total return of -1.93% in sterling over the three months to end October (-9.11% over 12m). Global High Yield bonds delivered +0.92% (-1.84% over 12m) in sterling.

Conclusion and Outlook

Our "cautious, not fearful" approach to investing in recent months is playing out much as we expected. Tighter monetary policy and the risk of further weakness in economic growth and company earnings keeps markets firmly anchored, while poor sentiment and the eternal hope for a policy pivot towards a looser monetary stance continues to prevent equities from making substantial new lows. We believe that this market character could prevail through the winter as investors seek more certainty. The ride will not be particularly enjoyable and there will inevitably be some nasty bumps along the way.

However, we are confident that we are now experiencing a more traditional economic downcycle, and, by their very nature, these set up the circumstances for an eventual recovery as excesses are gradually wrung out of the system. Repetitive as it might sound, we continue to counsel that now is not the time to throw in the towel, and we anticipate being given opportunities to add more risk to portfolios in the coming months.

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