OUT OF THE ORDINARY

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Market commentary

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Overview

We have a new King and a new Prime Minister, but neither bond nor equity markets had any such change in September, with the bear still mauling the bulls. Owing to the fact that the weakness of the pound in the last twelve months somewhat flatters investment outcomes when measured in sterling, it is more instructive to look at returns in dollar terms as a proxy for global investor experience.

On a total return basis in dollars, the MSCI All-Countries World Index is -25.3% year-to-date, -6.7% for the third quarter and -9.5% for the past month. The Bloomberg Global Aggregate Index for Bonds is -19.9%, -6.9% and -5.1% respectively. From its peak in early 2021 it is down 23.8%, which means that global bonds are suffering their first bear market for seventy years.

Bonds and equities constitute the core of mainstream balanced portfolios. Bloomberg replicates a typical 60:40 Equity/Bond portfolio, and its performance is predictably awful too: -23% YTD, -6.3% quarter-on-quarter and -7.6% month-on month. There really have been few places for balanced portfolio investors to hide, and one would have had to smash through Suitability guard rails to be making substantial gains this year.

Loyal readers will remember, we hope, that we have been warning about the potential development of such conditions for a few years. We were concerned that rising inflation (whenever it arrived) would lead to a situation where bonds and equities became positively correlated in terms of performance, but in a world of rising yields, leading to capital losses on both elements of portfolios. Although we anticipated this and positioned portfolios accordingly with higher weightings in uncorrelated alternative assets, we have to acknowledge that we could not do enough. However, we now judge that we are much closer to peak interest rate expectations, and that this will alleviate some of the pressure on bond yields and equity valuations.

Next, we will have to see how corporate earnings withstand the effects of high inflation and tightening financial conditions. We have been describing earnings as the "last shoe to drop", and they have been, in aggregate, remarkably resilient so far. A much clearer picture may emerge during the forthcoming third quarter reporting season.

There were four key events during September that merit specific comment. The first two took place in the United States and are closely related. They were the release of the Consumer Price Index (CPI) for August, followed by the latest meeting of the Federal Reserve Open Market Committee (FOMC) that sets monetary policy. Both the headline and core CPI printed above expectations, leading to concerns that the FOMC would be even more aggressive with its policy. In the event, it raised the Fed Funds rate by "only" 0.75%, but the sting was in the tail of the "Dot Plot" which illustrates the expectation of future interest rate levels by individual members. The median expectation for 2023 shot up 0.8% from June's plot to 4.6%, and there was no hint of a cut until at least 2024. "Higher for longer" was the new mantra, and markets took it badly.

Even so, the market was largely unprepared for the next shock, which was the fallout from the new UK Chancellor's mini budget. £45bn worth of unfunded permanent tax cuts drew attention to the UK's twin fiscal and current account deficits (see UK section below for more details), and Gilts and the pound became the victims as investors expressed their disapproval. This would have been a big enough shock in its own right, but it set other dominoes falling in a sequence that ended up with the Bank of England having to intervene to maintain financial stability in the country's pensions industry.

Although it has been widely covered in the financial (and mainstream) press, it is worth spending some time on what the problem was. Liability Driven Investment (LDI) has become an increasingly popular way to manage Defined Benefit pension schemes and has been around for several decades. It really started to gain traction around the turn of the millennium, when many pension funds enjoyed strong surpluses. Boots (the Chemist, now part of US-quoted Walgreen's Boots Alliance Inc) was the first high-profile adopter of LDI in the UK in 2001. The principal was to match pension fund assets with long-term liabilities (i.e. pensions promised) and to neutralise the risk of more volatile equity markets. This works very well, conceptually, for closed schemes that are fully funded, at least if one assumes that government bonds do not default. It has since turned into a market calculated to cover some £1.5 trillion of assets in the UK alone.

As is often the case, things are not as simple as they should be. For example, funds in deficit could leverage up their bonds to try to make equity-like returns. Then there was the need to hedge against falling bond yields. If yields fall, the discount rate applied to liabilities also falls which means that the net present value of those liabilities rises. Thus, LDI schemes took out swaps and hedges to protect themselves. This was prudent as long as yields were falling, which they have been consistently since the 1980s… until this year. While rising yields did help to bring down liabilities, they cut severely into asset values (especially as the bonds held tend to be of longer duration and therefore highly sensitive even to small interest rate moves). At the same time the interest rate swap contracts suddenly moved in the wrong direction, creating potential losses which led to calls for more margin from the sellers of those contracts (mainly big investment banks). Margin could be met by further injections of capital from the plan sponsor, but usually by selling down other portfolio assets. And given that the biggest asset class held is government bonds, that just created a negative feedback loop of bond selling, rising yields and more margin calls.

In reality, this was mainly a liquidity problem, but the speed with which it was unfolding threatened to turn it into a solvency problem, not only for pension funds but also for the government. Thus, the arm of the Bank of England tasked with maintaining financial stability stepped in to start buying long-dated Gilts, and this triggered a huge relief rally. So far, the truce is holding, and the Bank has not had to utilise its full firepower. Even so, the Bank has since seen fit to extend the duration of its buying programme into November and also to introduce further measures to guarantee liquidity to the banking system and to pension schemes in distress if required. It remains to be seen whether future conditions will prompt "the market" to test the Bank's resolve again now that the crack has opened.

Alternatively, the UK could have had its moment in the spotlight and the market will seek its next victim. The sound of hooves you might have heard was the mythical "Bond Vigilantes" riding into town. They are no more than an amorphous concept of like-minded bond investors, but when they move together they are a force to be reckoned with. Their initial attack on the Gilt market was a forceful warning to the Truss administration that the UK's fiscal house must be kept in order, or that there must at least be a credible plan. Mr Kwarteng beat a hasty retreat by reversing the plan to scrap the 45p tax rate, but he is on notice that his next iteration of the plan to return the country to a stronger growth trajectory must not be at the expense of a sustainable fiscal position.

Markets – US

As mentioned above, the US has a sticky inflation problem, and this is eliciting a strong response from the Federal Reserve (Fed). Despite this, there are only mixed signs that the economy is slowing down, notably in terms of the jobs market. Monthly Non-Farm Payrolls continue to grow well above the rate of 150,000 that in the past has signalled that the employment market is in balance. The unemployment rate remains pinned down at 3.7%, and wages are growing at more than 5% annually against a range of 2-3% for most of the pre-Covid decade. One reason for labour shortages is that many millions have left the labour force, either by choice (owing to retirement or lifestyle decisions) or by need (long-term illness or caring for dependents). Another is that the post-lockdown boom in demand for service employment (think leisure and travel) has created a shortage of workers. Then there is the fact that government policy is encouraging more manufacturing to be re-shored to the US. There is also talk of “labour hoarding”, as some employers retain workers who they might ordinarily lay off for fear of not being able to re-hire in future (at a sensible wage). The danger is, though, that both inflation and employment tend to be lagging indicators of activity, and that the Fed will continue to tighten policy long after a downturn has taken hold. If the Fed is over-zealous, it might end up finding itself having to cut rates much earlier than the projections of its current Dot Plot suggest. It’s too early to make a strong call either way yet, but the picture should become much clearer over the next few months.

UK

Huge volumes of water have flowed under the bridge in just the last month. The UK bade a respectful farewell to Her Majesty Queen Elizabeth II, and possibly not quite such a respectful one to former Prime Minister Boris Johnson. And while King Charles has been allowed quietly to get on with his new job, the new Prime Minister, Liz Truss, and her Chancellor, Kwasi Kwarteng, burst onto the scene with a host of new policies which triggered extreme volatility in currency and bond markets. As we have alluded to in the past, one problem that the UK faces is that it has substantial twin deficits that appear to be so persistent as to be structural rather than cyclical. The first is the fiscal deficit, meaning that government spends more than it generates in revenue. The second is the current account deficit, meaning that the country imports more goods and services than it exports. We are living beyond our means, although many years of near-zero interest rates have absolved us from facing up to the liabilities. The ructions in markets in late September were a warning shot from those whose investment is needed to fund these deficits. We have probably not seen the last of the volatility.

Europe

The energy crisis continues to ripple across Europe and shows up most clearly in inflation data. Headline consumer prices in the euro zone increased by 10% annually in August, the first time in the euro era that this measure has reached double digits. Core inflation is more subdued, but still at 4.8%, which is also a record. In Germany, Europe’s manufacturing powerhouse, input costs are an extraordinary 46% higher than a year ago. It is not clear that all these costs are being passed on to customers, suggesting further risk to profit margins. More encouragingly, the worst fears about shortages of natural gas during the winter have been alleviated as storage facilities have been filled to normal levels. Wholesale gas prices have halved since their peak in August, although they remain around ten times the level that prevailed pre-Covid. Owing to that elevated price level, governments on the Continent (as in the UK) are honour bound to provide support to consumers, given that a key element of high prices is the fact that sanctions have been imposed upon Russia. Germany, for example, has announced a €200 billion package. Consumer confidence is low, with indices across the euro zone hitting new all-time lows in the latest surveys. Are we approaching peak pessimism?

Emerging Markets

Continuing US dollar strength continues to weigh on the performance of Emerging Markets in general. Although the extent of EM debt denominated in dollars is not as great relative to the size of their economies as it has been historically, it remains substantial, and a stronger dollar increases potential liabilities, a factor that is exacerbated by rising interest rates when it comes to refinancing debts. To make matters worse, essential commodities tend to be priced in dollars, and many emerging countries are net importers of raw materials, with China being a key example. The Chinese Renminbi has hit multi-year lows against the dollar, although it failed to break through the crucial CNY 7.20 level that has held previously in 2019 and 2020. This was to some degree because the government stepped in to discourage speculation against the currency. It's not just the pound that has been under pressure. The better news for the EM complex is that inflation is less elevated than in most developed market economies. EMs were not as generous with either fiscal or monetary stimulus during the pandemic and are suffering from fewer imbalances between supply and demand. They were also quicker to begin to tighten monetary policy once the inflation threat was recognised. Looking ahead, this could allow greater stimulus to be applied if required in future. Even so, EMs really require a topping out of US dollar strength to prosper meaningfully.

Fixed Income

Government bond yields had been rising all year in response to concerted efforts to dampen inflation by raising interest rates and curtailing bond-buying programmes, but the extreme movements in September raised new alarms. We have already discussed the specific issues around LDI in the UK, but the short-lived panic was not confined to these shores. The US 10-year Treasury yield, which is the key driver of global financial asset values, briefly rose above 4%. To those with long memories, this might not seem egregious, but has to be put in the context of the yield having bottomed out at 0.5% in June 2020 and having still been as low as 1.5% at the beginning of 2021. With sovereign bonds having risen and with credit spreads having also widened, there are increasing attractions to both Investment Grade and High Yield credit. No doubt there is some default risk in the event that a severe global recession sets in, but that is not our central view at this time.

UK Gilts have delivered a total return of -12.85% over the last three months and -23.29% over the last year. Index-Linked Gilts returned -9.47% and -26.21% over the same respective periods. Emerging Market sovereign bonds produced a total return of +5.81% in sterling over the three months to end September (-3.03% over 12m). Global High Yield bonds delivered +3.88% (-7.98% over 12m) in sterling.

Conclusion and Outlook

Following three consecutive quarters of losses for bonds, equities and, consequently, balanced portfolios, the mood is predictably glum in investment circles. It has, in American Football parlance, been a year for playing defence rather than offence. But economies and markets move in cycles, and now is not the time to lose sight of the fact that the cycles will turn decisively in investors' favour at some point in the future. That might well require further interest rate rises and even recessions as central banks seek to stamp out elevated inflation, but equity and credit valuations have already gone a long way towards anticipating those events and government bonds also offer greater income attractions now.

One thing we are certain of is that it will be impossible to call the bottom, and anyone who claims to have done so should probably give more credit to luck than skill. We are increasingly minded to begin to increase equity and/or credit weightings because markets will start to anticipate the turn in economic fortunes long before they are evident in the data. One key aspect of being the custodian of others' wealth is to set realistic expectations. The chances are that we will start to increase risk either before the bottom is reached (in which case initial losses will be sustained on new purchases) or that we will wait until prices have already risen (which might look like a U-turn, and we all know how those are viewed these days!). But our decisions will be soundly based on a combination of value and market intelligence with an eye on our longer-term investment horizon.

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