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OUT OF THE ORDINARY

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Dry Tinder Seeks A Spark

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The beginning of a new quarter might normally be a time to take a moment of quiet reflection on the one just passed, but events are unfolding so rapidly that it's hard to take a breath. The start of this week saw the scrapping of the cut in the top UK income tax rate and further rumblings of discontent in the financial sector, with Swiss banking giant Credit Suisse coming under further pressure to raise more capital. Bond markets continue to be unsettled by the

stresses in the pension industry as a result of margin calls on funds using Liability-Driven Investment strategies (LDI). And financial assets in aggregate remain under pressure from central monetary policy tightening, from which there seems very limited potential to step back for the present.

How have the markets performed?

Looking back at performance, monthly, quarterly and year-to-date figures make for grim reading. On a total return basis in dollars, the MSCI All-Countries World Index is -25.34% year-to-date, -6.71% for the third quarter and -9.53% for the past month. The Bloomberg Global Aggregate Index for Bonds is -19.89%, -6.94% and -5.14% respectively. That leaves the Bloomberg Global 60:40 Index (60% equities and 40% bonds – a typical balanced portfolio allocation) -22.99%, -6.32% and -7.60%. Not pretty. There have been a few places for balanced portfolio investors to hide, and one would have had to drive a coach and horses through any Suitability guard rails to be making substantial gains this year.

Just to rub it in, Deutsche Bank observes that only one non-currency asset of the 38 that they follow made a positive return in September and only one (a different one) in Q3, when measured in US dollars. *Answers at the end to give you time to ponder what they might have been.

If there is any solace at all for sterling-based investors, it is that the FTSE Private Investor Balanced Index (taken as a neutral proxy for the average wealth client, although not necessarily in line with the composition of our own benchmarks) has "only" lost 7.72% YTD, was flat over the quarter and -4.02% month-on-month, having benefited from non-UK assets' valuations being translated back into sterling at favourable rates. However, double-digit domestic inflation makes that a lot worse in real terms, and that major currency depreciation has dented overseas buying power even more, especially for anything on the other side of the Atlantic.

Can we rely on historical data in this environment?

Data miners are now presenting their thoughts for Q4, and it seems that the S&P500 has, on average, returned a positive 4% over the last two decades, while European equities have done even better over the last quarter century, with average gains of 4.5%. Still, whatever such historical evidence there is concerning year-end or "Santa Claus" rallies, we would caution that the averages have not been insightful so far this year. Remember the exhortation to "buy on the bullets" when Russia invaded Ukraine? Or to keep buying the S&P500 for at least nine months after the first yield curve inversion? The latest claim to land on this particular bonfire of predictions was that the S&P500 never makes new lows after retracing more than 50% of a fall greater than 20%. The S&P 500 made a new cycle low last week after making a 50%+ retracement in August.

What might the next steps be for investors?

Even so, given that our asset allocation process still recommends being underweight in equities, we know that at some point we will want to commit more capital to them as our preferred longer term investment asset class. They have come down a long way and many sentiment indicators are extremely negative. One has to start somewhere, although I need to set expectations at a reasonable level. Unless a miracle occurs and we bottom-tick the market, about the only thing I can be sure of is that we will appear to be wrong in some way. Either we will go early and suffer some initial losses; or we will miss the bottom and then look as though we are executing some sort of U-turn. In the former case we will still have fire power to buy into further distress at potentially even better valuation levels. If it's the latter, we will be making a decision with even greater conviction.

What can we learn from the last week's events?

We now move on to the twists and turns of the last week, in both markets and politics (which were to some degree interconnected). First, we need to look at the problems in the pensions industry which then transmitted themselves to bond (and equity) markets. Liability Driven Investment has been 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. Indeed, a handy way to fund redundancies was to offer very generous pension arrangements to employees well below retirement age.

Boots (the Chemist, now part of US-quoted Walgreen's Boots Alliance Inc, having passed through the hands of private equity) was the first high-profile adopter of LDI in 2001. Its then Head of Corporate Finance, John Ralfe, who was behind the move, has since become a vocal and much-quoted independent pensions consultant. 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.

As often is 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, but the Bank is only committed to making purchases for thirteen days up to a total of £65bn. It remains to be seen whether conditions then will prompt "the market" to test the Bank's resolve once more. Or the UK could have had its moment in the spotlight and the market will seek its next victim.

How challenging is the current climate?

Given the moves we have seen this year, including the rapid repricing of the cost of capital and the huge rise in the dollar, it is almost surprising that more things have not blown up. This is especially true in a financialised global economy carrying a huge debt burden. There have been a few canaries, and they all seem to share similar characteristics – financial derivatives, leverage and a duration mismatch causing margin calls and forced buying or selling of underlying assets. The first was the huge spike in the nickel price in early March; the second was the recent panic in European energy markets, which Sweden's finance minister labelled as a potential "Lehman moment". Now the LDI saga. And in the background, there has also been a steady deleveraging from hedge funds and retail investors using margin. There is a lot of dry tinder out there, but it is hard to know where the match is going to be applied.

By common consent, the man with the match in the case of LDI was Chancellor Kwarteng. By announcing £45bn of unfunded and (supposedly) permanent new tax cuts, he threw a spotlight on the UK's precarious fiscal position. It was not so much the debt-to-GDP ratio, which, as the government keeps pointing out, is currently the lowest amongst G7 countries, more the need to fund increased debt sales when the country is not a great domestic saver and has a current account deficit of around 8% of GDP. When former Bank of England Governor Mark Carney referred to the UK's need to rely "on the kindness of strangers", it was very much on account of this funding problem.

Sure, the Bank could just buy government debt and "solve" the problem (the Modern Monetary Theory concept), but that would just open a trapdoor under the pound, at least unless everyone else was doing the same thing. And if they were, such monetization of debt would spell potential doom for fiat currencies as we know them and trigger a stampede into real assets (such as real estate, gold and commodities in general – and maybe even certain crypto assets if the theories of their creators turn out to be correct).

Mr Kwarteng's Monday morning about turn on the plan to cut the 45p rate of income tax was welcomed by markets, although it only accounts for £2-3 billion of revenue. But it is certainly high theatre, and the Conservative Party has been put on notice.

Prime Minster Liz Truss already has a more unfavourable rating in opinion polls than Boris Johnson in his final days, scoring 55% disapproval and just 18% approval. Labour has gained a huge lead of as much as 33% in one poll, which, according to an analysis we have seen, would translate into the party winning 490 Parliamentary seats, with the Conservatives taking a mere 74. Even so, we might have to wait until January 2025 to find out, as the theoretical deadline for an election.

*And those positive return asset classes were Silver in September and Brazil's Bovespa equity index in the third quarter.

Economic Commentary

FTSE 100 weekly winners

Hikma Pharmaceuticals Plc	12.8%
Fresnillo PLC	11.4%
Just Eat Takeaway.com N.V.	11.3%
Burberry Group plc	10.3%
Antofagasta plc	7.0%
Ashtead Group plc	6.7%
Spirax-Sarco Engineering PLC	6.1%

FTSE 100 weekly losers

Barratt Developments PLC	-15.7%
Rightmove plc	-15.7%
Ocado Group PLC	-14.6%
Taylor Wimpey plc	-14.4%
Next plc	-12.5%
M&G Plc	-12.5%
Legal & General Group Plc	-12.1%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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