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OUT OF THE ORDINARY

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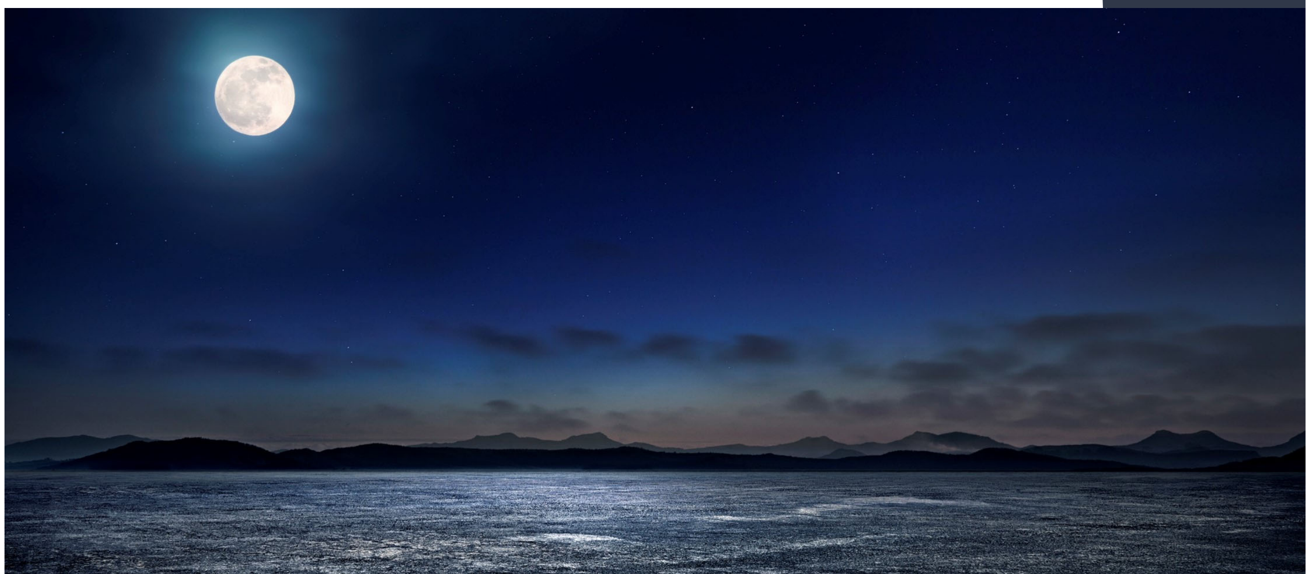
The Epilogue



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And so, we prepare to bid farewell to 2022. And also, at least from many investors' point of view, good riddance. There's always a danger of invoking the "dog ate my homework" school of excuses for the unavoidable when explaining the poor performance of a balanced portfolio, but the experience of this year needs to be put into context. Using data for the S&P 500 (and its forebears) and US 10-year Treasury Bonds (which represent the biggest and most

influential pools of global assets), 2022 is only the fifth year in the last century when neither equities nor bonds produced a positive total return. The other years were 1931, 1941, 1969 and 2018 (with the last one being pretty close to zero and therefore not especially punishing).

Perhaps we can console ourselves with the fact that the near-halving (-44%) of the main stock market index in 1931 was not repeated. Even though everyone immediately thinks of 1929 as the year of the Great Crash on Wall Street, equities only fell 8% that year because they had experienced a massive speculative boom during the first nine months. What about 1987, another "crash" year? The S&P 500 ended the year 6% higher and bondholders actually lost money. A portfolio invested 60% in equities and 40% in bonds managed to eke out small gains.

Perhaps this illustrates the folly of trying to package performance data neatly into annual chunks. And any current feelings of gloom could also highlight another trait of human fallibility, which is to anchor emotions to the most recent events. No doubt the citizens of France are now struggling to recall the euphoria of winning the football World Cup in 2018, whilst Argentinians have blissfully consigned the memory of Germany's late winner in 2014 to the dustbin of ancient history.

That being the case, we could do ourselves a favour by remembering that the years 2019-2021 produced the following total returns for the S&P 500 Index: 32%, 18% and 29%. Jeremy Siegel, Wharton Professor and author of Stocks for The Long Run, calculates that since 1800 US stocks have delivered annualised total returns of around 7% after taking inflation into account. Given that inflation averaged around 2% during that 2019-21 period, the "expected" compound nominal return from equities would have been around 30%, but was, in fact, almost exactly 100%.

Markets did get ahead of themselves in 2022, and that was reflected in our relatively cautious stance at the beginning of this year. In hindsight, we could have been a lot more defensive but, like most of the investment community, we underestimated the heights to which inflation would rise and, by extension, the magnitude and pace of interest rate increases undertaken by central banks globally. To our credit, though, neither did we get sucked into the optimistic narrative that central banks would "pivot" to looser policy at the first signs of stress in equity and credit markets. Thus, we have maintained a position that I have described as "cautious, not fearful" for the past few months.

No doubt, some individual fund managers have done exceptionally well this year. But they will also have backed very specific views in a manner of risk-taking that would not be permitted under any sort of wealth management risk mandate. And, as always, I am looking forward to Bloomberg journalist John Authers' Hindsight Capital annual review. This is an imaginary fund that every year invests in a handful of long/short pair trades which (with the benefit of hindsight) were plausible propositions at the beginning of the year and went on to deliver stellar performance.

If 2022 is almost behind us, what about 2023? The good news is that the last century has never seen two consecutive years of negative returns for both bonds and equities. However, there have been a few

occasions when a 60/40 portfolio failed to bounce back. The four years from 1929 to 1932 were especially grim, returning -3%, -13%, -27% and -2% to deliver compound capital destruction of 40%. But that was the start of the Great Depression. The next two-year period of consecutive negative returns was at the start of World War II in 1940 and 1941, and so not unexpected. Next, we jump ahead to 1973 and 1974, which featured the oil price shock, sharply rising inflation and the reversal of the "Nifty Fifty" era of equity market speculation which drove valuations to unsustainable levels. Finally, 2001 and 2002 both failed to produce a positive portfolio return entirely on account of falls in equities as the US fell into a recession and the Tech Boom unravelled (another occasion that echoes to the present situation – but bonds delivered gains in both years).

A pessimist could certainly make the case that many of the factors present in past instances of consecutive negative returns are present today: high inflation; a deflating tech bubble; even the threat of a World War. And that is recognised in market sentiment indices, fund manager surveys and many investment outlooks. Bloomberg has been running a survey of sell-side investment strategists since 1998, and now is the first time ever that the average expectation is for US equities to fall in the year ahead (something that has, in fact, happened eight times during the life of the survey, but never been predicted). It's only by a couple of percent, but a notable departure from history.

Even then, there is more than one way to reach the same destination. The majority are in the camp that sees economies weakening earlier and faster in the New Year. This will drive earnings per share lower and take equities down with them. Inflation will not be falling sufficiently quickly for central banks to loosen policy immediately. However, they will ultimately be forced at least to consider cutting rates again and this will be the cue for a strong rally from a lower base. This is the camp that we inhabit, hence our persistent shorter-term caution.

Another faction (and this one seems to be growing) believes that growth will be more resilient in the US (support from excess savings; capital expenditure on "reshoring" and green initiatives), Continental Europe (dodging the worst of the energy shortage risk; less leverage in housing markets) and China (re-opening post zero-Covid, plus other policy stimuli). In this scenario risk assets prosper through the first part of the year. However, stronger demand sustains higher inflation, meaning that central banks resume tightening later in the year, leading to more big falls.

Although both of those scenarios take us back to roughly where we will be at the beginning of 2023, the range of strategists' forecasts is the widest it has been since we entered 2009, which is a reflection of the underlying uncertainty. In late 2008, as I'm sure you will recall, we were still working through the effects of the bankruptcy of Lehman Brothers, the popping of the US housing bubble and the ripples which that created throughout the global financial system. We continue to believe that the systemic risks are much less great today, partly because the banking system is much better capitalised and regulated, and because central banks are more alive to the risk of liquidity evaporating from the system (one example being the Bank of England's swift intervention in the Gilts market in early October, when the LDI crisis blew up in the UK pension market).

For the record, US equities went on to gain 27% in 2009, which shows that resolution of uncertainty can be a powerful driver of positive returns. Much was dependent upon various factors such as the passing of a bill to "bail out" banks (TARP – the Troubled Asset Relief Programme), some more generous interpretations of accounting rules, notably regarding "mark-to-market" for assets held on banks' balance sheets, and the continued support of monetary policy.

"Path dependency" is a phrase you might hear bandied around a lot in the weeks and months ahead. It's a clever way of saying that we don't actually know what's going to happen because the outcome is dependent on any number of factors. For example, it's not rare to see US strategists calling for flat corporate earnings year-on-year in 2023 but then also saying that they could be down as much as 20% if there is a recession. By the same token that leaves forecasts for the S&P 500 as being "4000 if there is no recession, but as low as 3000 if there is".

Our general confidence in the resilience of the regulated banking system doesn't preclude some bombs going off in what is broadly described as the "shadow banking" industry, which includes stuff such as private equity, private debt, leveraged loans and buy now/pay later, but the key question will be whether the explosions cause domino effects through other parts of the financial system. We tend still to think not, although individual failures will undermine confidence.

Although there is no particular reason that the turn of the calendar should provide a turning point for markets, it is interesting that the last four new years have all been the prelude to a change of some sort. The end of 2018 saw risk assets sell off dramatically, as tighter monetary policy combined with a slowing economy and the worst fears of trade wars ignited by Donald Trump. This led to the (in)famous "Powell Pivot" in early 2019. He reversed gears, cut rates and sent equities sharply higher again.

Little did we know in late 2019 that a certain virus was on the loose in Wuhan, China, and I think we all remember what happened next. Late 2020 saw the beginnings of what I then termed the "BVB" trade, which stood for "Biden, Vaccine and Brexit". The incoming US President (apart from not being Donald Trump) was heading to the White House on a platform of increased fiscal stimulus; Covid vaccines had just been announced and we could see an end to confinement; and Brexit negotiations were finally reaching a conclusion before the UK finally parted from the EU at the end of the year following the transition period.

There were no such specific catalysts at the end of 2021, although the threat of inflation and higher interest rates were in the air. In any event, global equities made a decisive peak on the very first trading day of 2022 and have remained in a downtrend all year.

In the spirit of the season, I will end by trying to put a more optimistic gloss on things. Reasons to Be Cheerful: 1) Bear markets are always followed by Bull markets. Always have been, always will be 2) Equity markets tend to bottom-out during recessions, and so the time of maximum pessimism around the economy tends to be the best time to increase investment risk – don't forget that, when the newspaper headlines are screaming doom 3) Long-Term Capital Market

Assumptions (expected returns for individual asset classes and overall portfolios) are more generous now than they were at the beginning of this year, a fact which investors who are still contributing to their portfolios should be overjoyed about.

And, on those happy notes, it's time to sign off for the year. We will return to print on 10 January (barring some momentous event that demands more immediate comment) with the New Year edition of the Monthly Commentary which will provide a retrospective view on 2022 as well as more thoughts on what might happen next. I wish you all a happy and relaxing festive season and (hopefully) a more prosperous New Year. And thank you, as always, for reading.

Economic Commentary

FTSE 100 weekly winners

Standard Chartered PLC	3.0%
BAE Systems plc	1.8%
Hikma Pharmaceuticals Plc	1.5%
Johnson Matthey Plc	0.5%
Unilever PLC	0.4%
Pershing Square Holdings Ltd Public Class USD Accum.Shs	0.4%
AVEVA Group plc	0.3%

FTSE 100 weekly losers

Ocado Group PLC	-8.2%
ITV PLC	-8.1%
Rolls-Royce Holdings plc	-7.1%
Just Eat Takeaway.com N.V.	-5.8%
Bunzl plc	-5.6%
Entain PLC	-5.4%
Persimmon Plc	-5.4%

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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