INVESTMENT UPDATE

DECEMBER 2022

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I N V E S T M E N T U P D A T E

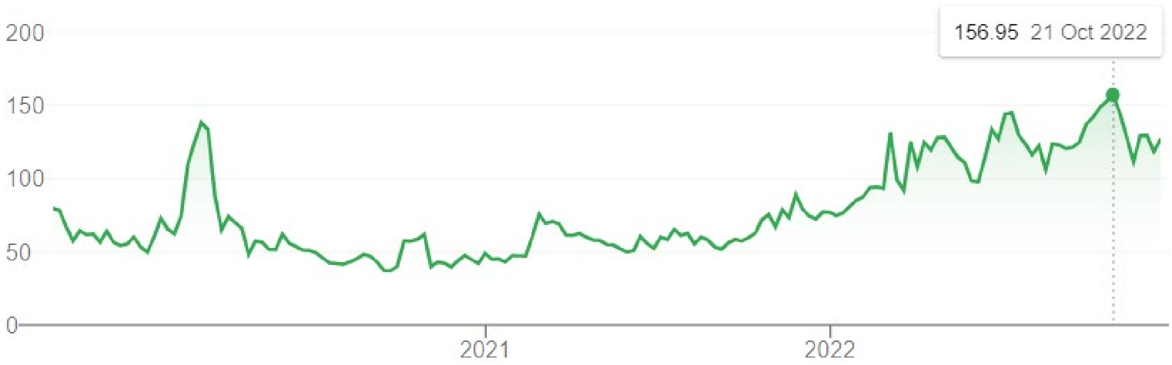
D E C E M B E R 2 2

INDEX	**LEVEL 31ST OCTOBER**	**LEVEL 30TH NOVEMBER**	**CHANGE**
S&P 500	3871	4080	+5.4%
FTSE 100	7094	7573	+6.75%
Euro Stoxx 600	412	440	+6.8%
Shanghai	2969	3151	+6.1%
US 10 Yr Treasury Yield	4%	3.7%	-0.30
UK 10 Yr Gilt Yield	3.5%	3.15%	-0.35
Bund 10 Yr	2.1%	1.94%	-0.16

November saw a continuance of the recovery in global equity markets, as investors increasingly took the view that inflation in the US has peaked and thus a potential for a peak in interest rates. This perception was aided by comments from the US Federal Reserve that they may slow the pace of interest rates in future. The returns from US holdings were dampened by a decline in the value of the dollar, following the improved expectations in inflation and interest rates, but Emerging markets were boosted, as a lower dollar is generally perceived as positive for emerging economies. As a consequence, we witnessed strong double-digit returns here.

We witnessed declines in core inflation in Europe, but in the UK, the annual inflation rate increased to 11.1% in October 2022. The reading came in higher than expectations of 10.7% and up from 10.1% in the previous month. This marks the highest inflation rate since October 1981 and is mainly driven by surging prices in housing and household services, notably gas and electricity.

Bond yields continued to decline through the month, which was positive for investor returns from the asset class. Most notable was the decline in UK bond yields, which have shown the most improvement, albeit from a government induced spike in interest rates. The 10-year gilt has seen rates decline from around 4.5% to nearly 3% since the change in government. The ICE MOVE index, which measures bond market volatility, declined from its peak in late October but, as the chart below shows, overall bond market volatility has increased significantly over the last twelve months, which has been reflected in the poor performance of the asset class.



Source: ICE 06/12/22

US core inflation for October came in at a lower than forecast 7.7%. However, whilst the pace of US inflation has declined it is expected that US interest rates will increase in December and January before pausing, but ultimately will exceed the prevailing rate of inflation before declining. The mid-term US elections proved to be more positive for the Democrats than many had forecast with the Republican "red wave" of Trumpism failing to materialise in any meaningful way. The Republicans have taken control of the House of Representatives after they passed the threshold of 218 seats. Democrats have retained control of the Senate by gaining the state of Pennsylvania from the Republicans. The Biden administration has pushed through much of its reform agenda early-on and so it is anticipated that there will be limited impacts for the remainder of the Presidential term.

In the UK, we are facing an inflation double-whammy of an energy supply shock and excess labour demand. The latter is a combination of the post-pandemic reduction in labour participation, and the impact of Brexit on migration. Although fiscal support has provided a cushion of sorts, real disposable incomes are declining. This will only be exacerbated as interest rates grind higher. We are seeing more concerns being raised about the state of the housing market. But low unemployment, low current arrears levels, higher personal savings levels, and overall better lending standards mean the housing industry is in a relatively robust position. So whilst there may be pressure in this area, it is not felt that a housing crash is the most likely outcome.

While the economic situation looks challenging, the UK stock market remains attractive. We've noted previously that the mix of industries represented in the FTSE have helped keep returns positive this year. Despite this outperformance, the UK market is still cheap when compared to other leading indices, and when compared to its own history.

In Europe, although natural gas prices have fallen a long way since the summer, they are still 6-7 times higher than they were before Russia's invasion of the Ukraine. (In the US, they're "only" twice as high.) The relatively mild weather so far this year has helped the region reach its gas storage targets well ahead of schedule, but the higher prices will nevertheless create a powerful headwind to consumer spending. Some of this will be offset by fiscal support packages that have been announced. But then higher costs imposed by interest rate hikes will come into play, exacerbating the energy cost impact. The ECB has a tricky – almost impossible – path to tread to minimise the looming recession.

In China, too, a tug-of-war is playing out. At least in this region though inflation is not one of the contestants. Here, the weakening economic growth picture is being countered by improving policy measures. The government finally seems to be willing to consider moving away from the zero-Covid policy that has hobbled large swathes of the country, and they are also providing support to the beleaguered property sector. These measures may help in the medium-term, but in the very near term, rising Covid cases are tempering that optimism. As previously mentioned, the "risk-on" Asian and Emerging Markets region rebounded very strongly in November but remain the worst performing markets this year.

Whilst it is a relief to see markets rallying after such a difficult year, there is general feeling that markets have got ahead of themselves. In the US, it should be noted that employment remains high and, unlike the UK, real incomes are expected to rise by 3% in 2023 (the opposite is expected in the UK), which is something the Federal reserve is more than aware of and why it has been talking tough on interest rates. It should be noted that we are nowhere near the target inflation rates of 2%. In addition, there is also doubt about the prospects for future US corporate earnings, as we see an expected slowdown in the US economy and there is a fear that analysts' forecasts are not truly reflecting this.

Consequently, both our portfolios and managed funds have maintained a cautious stance, perceiving the recovery in US equites to be a bear market rally. Whilst the US market offers fair value, it still cannot be regarded as cheap, especially if corporate earnings come under pressure. Portfolios cash levels continue to remain high, which should provide a buffer to any further declines and can be used a springboard should positive momentum be accelerated.

Rockhold Asset Management, with contribution from Alpha Beta Partners and Marlborough, December 2022

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