THE FRY GROUP
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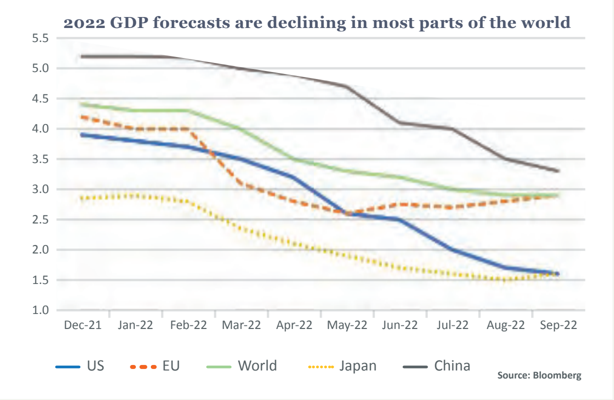
Quarterly Investment Update

OCTOBER 2022

Are we there yet?

A consistent theme in recent months has been investors trying to predict signs of peak inflation, hoping that Central Banks will then soften their existing approach to rate hikes. However, as August's US inflation showed, price levels remain elevated, as rising shelter and food costs offset a drop in gas prices. This led to a sharp sell-off across risk assets, with those of longer duration once again suffering the brunt. Another set-back to markets came towards the end of the quarter as former UK Prime Minister, Liz Truss, and ex-Chancellor, Kwasi Kwarteng, unveiled their new 'pro-growth' policies, including an unfunded reduction in the 45% tax rate for additional rate taxpayers. The resulting sell-off in longer-term gilts - intensified by Liability Driven Investment strategies - saw the Bank of England step in to buy gilt holdings to the tune of £65bn, undoing plans they previously had to start offloading them. Since then, the government has reversed a number of these proposals, with its credibility severely impacted, as the UK now prepares for its third Prime Minister in as many months.

In many ways the volatility seen over the third quarter is typical of the year with investors hoping to find the bottom of the sell-off, but proven wrong by persistent inflation. The key drivers of this remain Putin's war in Ukraine and the ongoing pursuit of zero-Covid in China both of which are also contributing to more structural levels of inflation such as wages.



Over the quarter, the MSCI World Index returned -4.4% (US Dollar terms), but the most significant negative performance came from Emerging Markets, which returned -11.6% (US Dollar terms).

The strength of the Dollar, due to the Federal Reserve's clear intent to tame inflation - as well as its relative insulation from events in Europe - typically has a negative impact on Emerging Markets, with a significant portion of their debts priced in Dollar.

Bonds – like equities – were also volatile through the quarter, with a significant rally early in the quarter and a dismal drop in the latter half. In the early part of the quarter high yields did well, largely following the strong recovery in the equity markets, before retreating by 10% from their peak levels.

UK gilts stand out for their extremely dismal performance during the quarter following Truss' aforementioned 'mini budget', which turned out to be anything but 'mini'.

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Market Focus

Global fixed income

In response to persistent inflation levels, the Federal Reserve (Fed) added another 75 basis points (bps) increase to existing rates in September, bringing the new Fed Funds Rate to 3.0% - 3.25%. Chair Jerome Powell stated that the Fed's outlook remains unchanged since the Jackson Hole meeting, and his committee has been resolute in wanting to target elevated inflation levels, even at the cost of impacting the economy. The US 10-year yield rose from 2.97% to 3.83% over the course of the quarter.

Monetary tightening is also evident across most other Central Banks, the one exception being Japan, which after years of stagflation is happy for a weak Yen to target higher inflation levels.

Much of the increase in UK yields came towards the end of the quarter, amidst the negative response to the new government's budgetary announcement, inducing a bout of severe selling pressure, particularly at the longer end of the yield curve where the 10-year moved from 3.15% to 4.4%, before settling to 4.1% by quarter end.

UK's 'mini budget' sees sharp sell-off in 10yr UK government bonds, as yields rose sharply

Source: Trading Economics

The ECB raised interest rates by 75 bps in September, following a rise of 50 bps in July after Eurozone CPI data, which showed a record high of 10% year-on-year. The German 10-year yield increased from 1.34% to 2.11%. This reflects a marked change in monetary policy over the last year – one year ago German Bund yields were still very much in negative territory.

Across credit markets, spreads widened amid fears that ongoing tighter monetary policy may undermine further economic growth prospects and returns were poor as the market drawdown continued. Sterling investment grade and high yield (the latter -18.7%, USD) were the worst performers, whilst European investment grade and high yield, as well as emerging markets credit, fared better but only on a relative basis as returns remained negative.

As ever with events this year, it is inflation – and its future direction of travel – that is dictating the current volatility across most major fixed income indices.

EQUITIES MARKET

United States

The US equity market posted a third consecutive quarter of losses, with the S&P 500 falling 5.28% in US Dollar terms in Q3. The Federal Reserve implemented their fifth interest rate hike for the year at the end of September, signalling their ongoing commitment to fighting inflation. In a reversal from Q2, large- and small-cap growth stocks outperformed value by 5.8% and 1.0% respectively. The consumer discretionary and energy sectors were the most resilient for the quarter, returning 4.13% and 1.16% respectively. On the other hand, the market's performance was dragged down by a -11.66% return from the real estate sector, fuelled by higher inflation and further interest rate hikes.

UK

The unveiling of the UK's mini budget at the end of the quarter was poorly received by markets, the FTSE 100 falling 4.0% for the quarter. Tax cut announcements added to inflationary concerns, which reached a 40-year high of 10.1% in July. This also triggered extreme market volatility, sending the Pound to lows of $1.035 against the Dollar. Consumer staples and energy companies outperformed, better placed to weather the inflationary environment, whilst the strong Dollar also benefiting these sectors due to overseas revenue streams being converted back into a weak Pound. However, British consumer confidence levels have slipped to lowest level since mid-1970s as the Central Bank attempts to cool rising costs.

Europe (excluding UK)

The Eurozone has faced further falls amid the energy crisis, inflation, and the outlook on economic growth. Due to the region's reliance on Russian oil and gas, the EU has been under pressure to unveil a solution, as worries over shortages rise. European stocks delivered negative returns of -5.1% in US Dollar terms. Late to follow other Central Banks, the ECB raised interest rates twice over the quarter, with the latest increase of 75 bps as Eurozone inflation hit highs of 10.1% in September.

Japan

The Japanese equity market performed well through July and August but ended the quarter down only 0.8% in local currency, but down 6.9% in US Dollar terms. Unlike other global Central Banks, the Bank of Japan has left monetary policy unchanged, widening the differential with the US and contributing to a considerable weakening of the Yen.

Asia (excluding Japan)

The market ended the quarter lower 13.8%, the main detractor being Chinese equities as even the slightest resurgence of cases prompted fears of further lockdowns, as its zero-Covid policy persists. Tensions between China and the US also heightened following Nancy Pelosi's visit to Taiwan. Weakness in the Chinese property market lingers, causing a further negative impact on domestic demand. South Korea and Taiwan's equity markets also ended the quarter down, due to costly tech exposure in a rising rate environment. In contrast, India is performing relatively well, up 6.5% for Q3, as the fall in crude prices boosted sentiment and the country faces better economic prospects than developed market counterparts.

Other emerging markets

Emerging market equities underperformed in the third quarter, returning -11.6% compared to developed markets of -6.19%, both in US Dollar terms. Emerging Europe were amongst the poorest performers, due in large part to the ongoing energy crisis. Few countries generated good returns, although Turkey performed well, cutting interest rates twice in the quarter to 12%, completely at odds with its inflation reaching 80% in August. Inflation eased for two consecutive months in Brazil, contributing to strong economic growth running up to the presidential election. Brazil's stock market has performed comparatively well so far this year as they have benefited from rising prices for a number of key commodity exports.

Currency

The US Dollar continues on its strongest run in 20 years, seeing the biggest quarterly rise in Q3 since early 2015. Following the announcement of additional rate tax cuts, and eventual reversal, Sterling ended the quarter at $1.11. The Japanese Ministry of Finance was driven to directly intervene in the currency markets at the end of September as the Yen had its weakest year since 1971, closing at 144.6 to the US Dollar. At this stage, whilst the Federal Reserve continues to target bringing down inflation and delivers uncompromising messages to that effect, it is difficult to see Dollar strength waning meaningfully.

Commodities

Due to the slowdown in global economic activity and business sentiment, most commodity sectors declined, with the S&P GCSI Index recording returns of -10.31% for the quarter. This weighed on industrial commodities as well as assets traditionally seen as safe-haven investments, like gold and silver, which ended the quarter at -8.0% and -7.1% respectively. Natural gas had the best returns up at 26.3%, however this was offset by weakening performance from crude oil and brent crude.

Conclusion

Financial markets continue to face the same challenges that confronted them at the start of the year, namely Russia's war in Ukraine, and persistence in China's zero-Covid policies, all within the backdrop of tightening fiscal and monetary policy. The subsequent volatility in markets, as investors try to gauge when peak inflation might be reached, illustrates the dangers of trying to time data points and 'fight the Fed'. Markets will likely keep a close eye on any improvement in data releases, or the easing of geopolitical tensions and supply constraints before any meaningful confidence returns.

Against this backdrop – and with the marked drawdown over the last nine months – conversations often turn to when a bottoming out might occur. The reality is that no one can know, and events seen this year demonstrate the difficulty in trying to do so. What we do know is that remaining invested, and focusing on the total return of markets (capital plus income) rather than just daily price movements, has historically proven the most successful strategy. The outlook for consumer and corporate sentiment is clearly still challenging, but with valuations looking increasingly attractive, there are certainly opportunities now which - with a medium to long term horizon – are starting to look compelling.

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