THE FRY GROUP
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Quarterly Investment Update

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New Year, new-found optimism?

There is no doubt that 2022 will go down on record as one of the most challenging for investors. A war in Ukraine (which very few people predicted) and a clear trend in rising inflation, led to most Central Banks responding with much more restrictive monetary policies. This challenge for investors was seen across most major asset classes – commodities being the one bright spot – with the MSCI World -18.1% (USD) and the Bloomberg Global Aggregate -16.25% (USD) for the year.

Towards the end of the last quarter inflationary pressure moderated somewhat with the US Consumer Price Index rising 7.1% over the previous 12 months, which was lower than the 7.3% economists had been expecting. Whether this is the start of a consistent downward trend in prices remains to be seen, but the expectation from some market participants is that this may elicit a softer approach regarding interest rate hikes from the Federal Reserve.

Finally, having been largely cut off from the world for the last three years, China has begun to dismantle its zero-Covid policy. Whilst there is likely to be some volatility as the country adopts this new mindset, the resurgent demand factor coming out of the country of 1.4 billion is likely to be deemed a positive for markets

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Market Focus

Global fixed income

At the end of 2022, the Federal Funds rate was in the range of 4.25% to 4.5%. The US Central Bank said that ongoing increases in the policy rate would be "appropriate", in order to ensure the Fed is restraining the economy enough to bring price growth under control.

The challenge for investors is trying to understand just how far the Federal Reserve is prepared to go in fighting inflation – they are clearly mindful of the mistake they made in deeming inflation 'transitory' in the summer of 2021.

In the UK, after a tumultuous September and October, which had seen the 10-year gilt yield rise to as much as 4.5% after the mini-budget disaster, the last two months saw much less volatility, with the figure around 3.5% at the end of the year. Data showed UK CPI inflation fell to 10.7% in November, from a 41-year high of 11.1% in October, but still remained well above the Central Bank's target of 2%.

In the Eurozone, inflation fell back into single digits in December, with the headline rate hitting 9.2%, after the annual price growth had exceeded 10% for the previous two months. Despite this, growth in the cost of services – typically an indicator for how long price pressures are likely to endure – accelerated in December. For the ECB to change approach, rate-setters are likely to want to see a substantial fall in the core rate as well as other measures of longer-term inflationary pressures, such as wage growth.

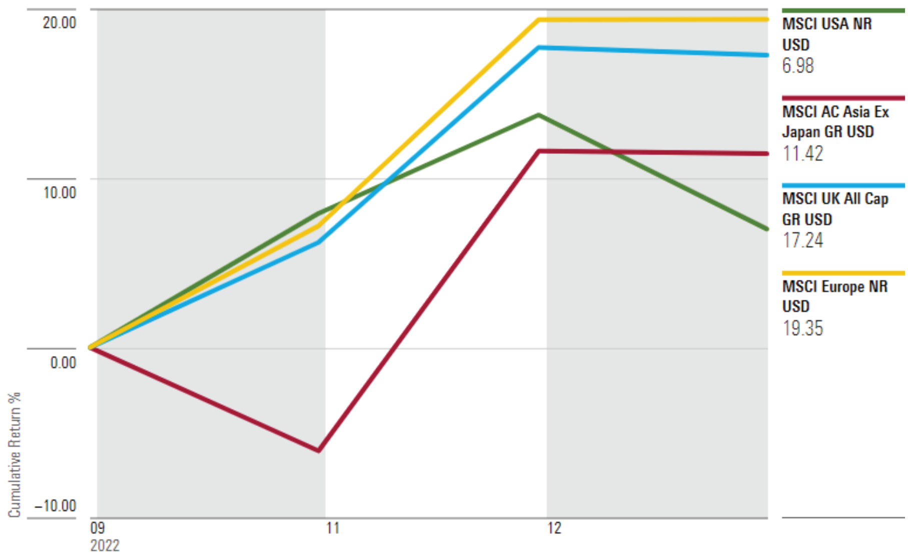
Across credit markets, the sell-off from 2022 has presented some attractive opportunities, particularly after a decade of low interest rates which squeezed returns from this asset class. Higher financing costs have started to impact economic growth and we should see interest rate-driven volatility in bond markets subside in 2023. With global credit yields at circa 7% (USD), there are clearly some better opportunities around than a year ago, albeit it is important to be careful in fund selection, as some regions are likely enter to a recession and certain sectors will likely be impacted by the delayed lag of interest rate rises.

EQUITIES MARKET

United States

The US equity market made robust gains in the last quarter of the year, returning +6.98% (USD). Annualised Q3 GDP for the US was confirmed at 3.2% in December, providing evidence of resilience in the economy. In response to the expectation of 'peak inflation', the Dollar has slipped 8% since late September. Energy stocks were helped by progress on the post-Covid economic reopening in China which increased energy demand expectations, whilst a weaker Dollar was also a tailwind for commodities, including oil and gas.

A POSITIVE QUARTER FOR GLOBAL EQUITIES – ALL RETURNS IN USD



Source: Morningstar Direct

UK

UK equities also gained over the quarter, helped in part by the country emerging from its September mini-budget crisis. Ten-year gilt yields - and in turn interest rate expectations – stabilised over the quarter, moving from a high of 4.5% in October to close out the year at 3.65%, lending better support to domestically focused areas of the UK equity market.

Europe (excluding UK)

Despite the challenging backdrop for Europe in 2022, with the war in Ukraine pushing energy prices sharply higher and interest rates moving from 0% at the start of the year to 2.5%, the fourth quarter proved more positive. As in other regions, equities were supported by the expectation that inflation might be on a downward trend, with annual inflation falling to 10.1% in November, from 10.6% in October. This led the European Central Bank to slow down increases in interest rates. Gains came from a variety of sectors, notably economically sensitive areas like energy, financials, industrials and consumer discretionary.

Japan

The market returned +3.3% (Yen) for the quarter, despite December being a weaker month than October and November. The main focus was the Bank of Japan's decision (in December), permitting the yield on the 10-year Japanese government bond to move 0.5% either side of its 0% target, wider than the previous 0.25%. That said, earnings reports for the third quarter were strong, particularly amongst larger cap companies, providing an overall positive return for the fourth quarter.

Asia (excluding Japan)

The MSCI AC Asia ex Japan returned +11.4% (USD) for quarter, with the main focus being China's announcement of a dismantling of its zero-Covid policies and a full reopening in January, providing a welcome relief to Emerging Markets after a disappointing year. Adding to the optimism were signs in the US of 'peak inflation' and subsequently a weaker Dollar, which typically helps companies who issue Dollar-denominated debt.

Other emerging markets

Latin American markets Peru and Colombia outperformed the broader index, whilst investors initially received Brazil's new President Luiz Inácio Lula da Silva well – during his previous Presidency between 2003 and 2010, equity markets had prospered. Since then, a deeper dive into his more interventionist policies regarding state-controlled companies has led to more volatility. South Korea and South Africa posted strong returns, with the latter boosted by President Ramaphosa's re-election as the President of the ruling African National Congress (ANC).

Currency

Dollar strength waned in the last quarter of 2022, as signs of 'peak inflation' led investment markets to anticipate a softer policy stance from the Federal Reserve going forward – this is at odds with chairman Powell and other members of his committee. Having reached its lowest point in almost forty years towards the end of the third quarter, Sterling stabilised against the Dollar to finish at 1.21, with investors welcoming the more fiscally prudent combination of Prime Minister Rishi Sunak and Chancellor, Jeremy Hunt. The Euro also finished the year stronger relative to Dollar, with the European Central Bank reaffirming their commitment to taming inflation.

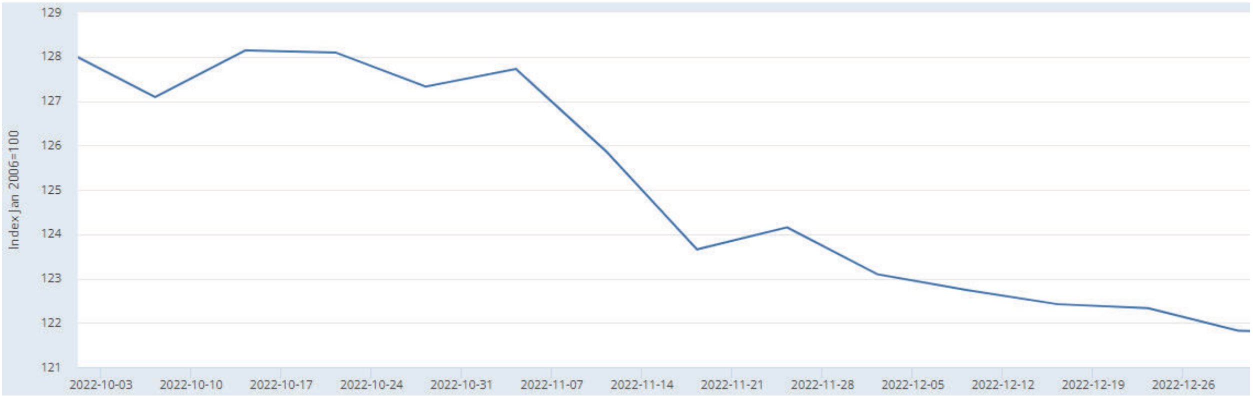
Commodities

The S&P GSCI Index recorded a positive performance in the fourth quarter, with sharply higher prices in the quarter for nickel, lead and copper – the latter often tied to the economic outlook for China. Base metals followed the fortunes of the global economy more tightly, with concerns about the risk of recession building in the middle of the year, and prices falling sharply. However, as 2022 drew to a close with GDP forecasts stabilising, prices started to rise again.

The price of Brent oil peaked in March at close to $130/ barrel. At year-end, from the lows of mid-December when Brent hit $76, prices rose to close off the year at $79.

Gold gave a flat absolute return for the year, albeit its strong performance in the fourth quarter - up close to 10% - was aided by a weaker Dollar.

TRADE WEIGHTED US DOLLAR INDEX – A WEAK QUARTER FOR THE DOLLAR



Source: Board of Governors of the Federal Reserve System (US)

Conclusion

2022 was a very tough year for investors. The dramatic sell-off across both equity and bond markets left very few hiding places. The combination of a war in Ukraine, elevated inflation levels and the subsequent response by Central Banks, shattered any illusion for a repeat of the strong investment performance seen in 2021.

The fourth quarter of 2022 can be viewed with tentative optimism. Inflation showed potential signs of peaking (albeit Central Banks will need to see a far clearer downward trend here), we saw some fiscal prudence returning to the UK and there was a dramatic turnaround in China's approach to Covid. Whilst we anticipate more volatility ahead, particularly as Q4 earnings start to show the potential impact of last year's interest rate rises, which typically lag between 12-24 months after the event, there is room for more positivity.

The marked sell-off across both equities and bonds has left certain regions looking attractive, particularly in Asia, whilst bond yields also now look a lot more appealing than they have done over the last 10 years. Empirical data shows us that, historically, markets have typically bounced back after negative years, and we remain optimistic that there are opportunities for that to happen again.

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