Investment Outlook

A monthly round-up of global markets and trends

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Investment outlook

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A 'good news is bad news' environment for markets

Last month, James Bond fans cheered the 60th anniversary of Dr. No, the first release of the classic movie series. Unfortunately, the same celebratory mood cannot be said for bond investors, as the spectre of inflation has knocked the living daylights out of the fixed income market this year. In terms of performance UK, US and eurozone government bonds have seen record price declines. Though they pale in comparison to the Austrian 100-year government bond that was issued just over two years ago: it is now down a staggering 71% from its peak at the end of 2020.[1] Essentially, the Austrian government pulled off an impressive trade by borrowing money at a coupon of 0.9% per annum before bond yields and inflation rose sharply.[2]

The poor performance of global equities this year can largely be linked to the sell-off seen in bonds. As fixed income assets begin to price in higher inflation, investors are increasingly demanding higher compensation (or real yields) to hold bonds. It is the tight link between real bond yields and the valuations of rate sensitive stocks that has dragged down the broader equity market. So as real yields rise, the value of equities fall. Rising geopolitical risk from a potential escalation in the war in Ukraine are an added headwind facing investors.

If bond (and equity) markets are to stabilise, we need to see a sufficient slowing in the US labour market to encourage the Federal Reserve (Fed) to ease back on its hawkish monetary policy stance. In other words, bad macroeconomic news is probably better for markets in this current environment than good news. To be specific, the labour data looks too strong for the Fed's liking. For instance, US non-farm payrolls gained 263k in September, far higher than the 30-year monthly average of 122k.[3] Essentially, the Fed is aiming to soften labour demand so that the risk of higher wage rates becoming entrenched in the economy – which would further stoke inflation – is reduced.

An issue for global markets is that as the Fed tightens monetary policy this increases the returns available on US fixed income assets. This in turn drives up the value of the US dollar as investors move capital to the US to take advantage of these higher returns. Some central banks have been forced to intervene in foreign exchange markets to prevent currency deprecation. For example, the Bank of Japan has intervened for the first time in 24 years to support the yen.

Meanwhile, the Bank of England was forced to buy gilts following the government's unfunded tax cuts under former Chancellor Kwasi Kwarteng's 'mini-budget', which has since been largely scrapped. The resignation of PM Truss and the reversal of her dash-for-growth policy, as well as her replacement by Rishi Sunak, should ease market concerns of running a too loose fiscal policy at a time of elevated inflation.

In short, we will probably need to see the Fed backtrack a little on its tight monetary stance for equities to recover from here. However, with US cost of living elevated, the bar for the data dependent Fed to ease back appears high.

An OPEC+ divot to a potential future Fed pivot

Organization of the Petroleum Exporting Countries, known as OPEC+, (which includes Russia) moved to cut crude oil output in October. What makes this a highly unusual decision is that the West had called on the Middle East-led oil cartel, and particularly the Saudis, to keep crude oil flowing during this energy shortage. President Biden had encouraged the Saudis not to cut output to alleviate pressure on his party (the Democrats) from elevated gasoline prices ahead of the 8 November mid-term elections.

The official reason given for the OPEC+ production cut is that it's a response to rising interest rates and declining global growth expectations in advanced economies. Nevertheless, it is possible that OPEC+ (egged on by Russia) is pushing back against the desire of the West to lower energy prices. After all, OPEC+ is a profit maximising oil cartel with material pricing power.

Moreover, the Saudis appear to be making it clear to the West that it views its long-term future with other developed economies and appears unconcerned about the military defence umbrella provided by the US. Saudi Arabia, along with Turkey, Egypt, Iran and Argentina, have already made their interest known in joining the 'BRICS' alliance of Brazil, Russia, India, China and South Africa. Perhaps the Saudis see this large economic grouping as a faster-growing alternative to the West, where governments are increasingly focused on the climate agenda. It could be argued that the Biden administration's shift away from fossil fuels has turned the Saudis into a hawkish, price maximising OPEC member having historically been a more dovish participant. Through the Saudi lens, it makes sense to take fossil fuel profits while they can as developed economies push towards net-zero carbon emissions.

In short, energy is increasingly becoming weaponised. The result is that crude oil prices have started to trend up again. This complicates the job of the Fed to stamp down hard on inflation and could delay the Fed pivoting to lower interest rates. As it stands, money markets forecast US short-term interest rates to peak at around 4.8% next year.[4] Should interest rate expectations stabilise it may provide an opportunity for equities to recover from deeply oversold levels and low valuations. Nevertheless, given the current uncertain environment, it probably makes sense to stay defensive during this energy crisis by owning sectors like healthcare, consumer staples and utilities.

Sources:
[1, 2, 3, 4] Refinitiv/Evelyn Partners

Market highlights

Equities

Equities continue to suffer this year against the current high-inflation and aggressive rate-hiking backdrop. Most noteworthy are the US 'mega-caps' (Facebook (Meta), Apple, Amazon, Microsoft, Google, and Tesla) often referred to as the FAAMGTs. Typically, these 'mega-cap' companies are highly rate sensitive because of their growth-orientated business models. They are currently down over 28% YTD, on a market cap-weighted basis. The performance of US 'mega-caps' has closely followed the real yield of the US 10-year treasury bonds with share prices falling as real yields have risen. Real yields are simply nominal yields net of inflation expectations. With the reported headline CPI inflation hovering well above the Fed's 2% target, the US Central Bank is expected to continue to raise rates into the new year. This has devalued the 'mega-caps', as investors discount their future earnings at a higher rate.

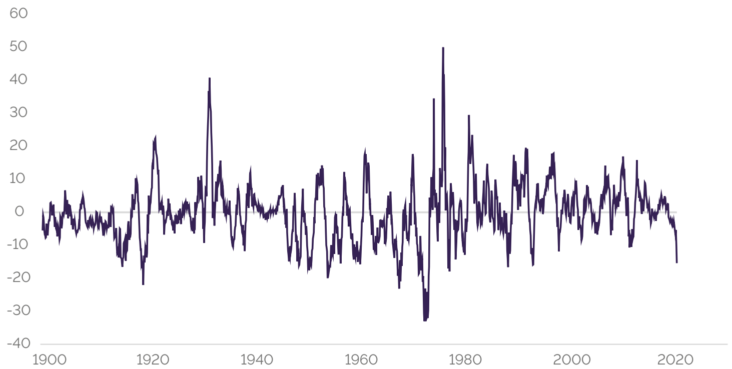
US mega cap performance and real 10-year yields (%)

Source: Refinitiv Datastream/Evelyn Partners Investment Management LLP, data as at 31 October 2022

Fixed income

The Bank of England's battle against inflation has seen them raise interest rates several times this year, causing bond yields to rise and prices to fall. At the peak of the gilt market sell off in September 2022, following the announcement of former prime minister Liz Truss' 'mini-budget', 10-year gilts saw some of their worst performance since the turn of the 20th Century. They have since recovered slightly following the reversal of several planned tax cuts and the new appointment of Rishi Sunak to Prime Minister, but 2022 is currently the 9th worst year since 1900 with 10-year gilts down over 15% at the end of October 2022. Long declines in gilt values are rare, the last time gilts declined for 20 consecutive months, as they now have, was during the 1970s.

10-year gilts prices since 1900 (annual percentage change)

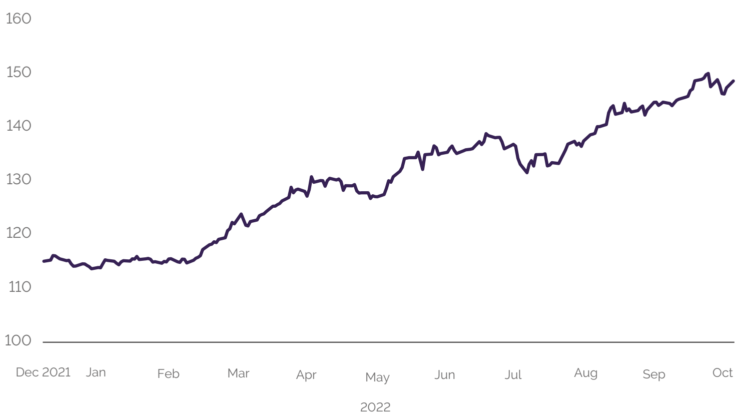


Source: Global Financial Data/Evelyn Partners Investment Management LLP, data as at 31 October 2022

Currencies and commodities

On 22 September the Bank of Japan (BoJ) stepped in to strengthen the Japanese yen (JPY) for the first time since 1998. This year the value of JPY had slipped 20% relative to the US dollar. Leading up to that decision on 22 September in an attempt to prevent the JPY from falling further, the BoJ sold US dollar reserves and purchased JPY. Currency interventions are rarely successful, and this move was no exception. The JPY has since slipped further hitting a 30-year low at 150 USD/JPY in mid-October. Japan is currently the only country in the world to maintain negative interest rates, with the BoJ's governor Haruhiko Kuroda stating there is no intention to raise rates for some time. The Fed has since raised interest rates by 75 basis points for the third consecutive time. In our view it is unlikely the JPY will strengthen significantly without a shift in monetary policy or further intervention.

Japanese Yen to US $



Source: Refinitiv DataStream/Evelyn Partners Investment Management LLP, data as at 31 October 2022

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	2.8	-2.3	-4.3	52.6
MSCI UK	2.8	-3.6	4.3	15.5
MSCI UK Broad	3.0	-5.0	-1.4	11.2
MSCI USA	4.7	-0.6	-0.6	88.9
MSCI Europe ex UK	4.3	-2.8	-11.0	20.3
MSCI Japan	-0.2	-4.8	-10.0	12.0
MSCI Asia Pacific ex Japan	-2.6	-6.7	-5.8	18.4
MSCI Emerging Markets	-6.0	-9.1	-17.5	0.4
Bonds				
iBoxx GBP Gilts	3.8	-13.1	-23.8	-13.8
iBoxx USD Treasuries	-4.6	-2.2	1.7	12.3
iBoxx GBP Corporate	4.6	-10.5	-20.4	-7.7
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	8.7	-12.9	13.6	56.8
Gold ($/ounce)	-2.2	-7.2	-7.8	29.0
GBP/USD	3.1	-5.4	-16.0	-13.3
GBP/EUR	2.2	-2.4	-1.7	2.2
EUR/USD	0.9	-3.1	-14.6	-15.2
USD/JPY	2.7	11.2	30.4	30.8

Market commentary

The MSCI all-country world index was up 2.8% in October on the back of better-than-expected Q3 earnings data. Looking further down the list we can see the developed markets of the UK, US, and Europe all performed well with the US being the best performing region, up 4.7% for the month. Emerging markets have struggled this month, down 6%, with the strength of the dollar forcing some emerging economies to raise interest rates. Gilts have staged a slight recovery with Rishi Sunak coming in to replace Liz Truss as Prime Minister, whilst Jeremy Hunt reversed most of the fiscal measures put forward in the 'mini-budget'. Gilts gained 3.8% on the month but are still down 23.8% on the year. Oil prices rose 8.7% in October after OPEC+ announced they were going to cut output by 2 million barrels a day. Sterling was up 3.1% versus the US dollar in October, supported by the arguably more fiscally responsible stance of the Rishi Sunak administration.

Key macro data	Latest	2022 Consensus forecast	Spot rates	31-Oct	Yields (%)	31-Oct
UK GDP (YoY%)	4.4	4.20	GBP/USD	1.15	MSCI UK	4.07
UK CPI Inflation (YoY%)	10.1	9.00	GBP/Euro	1.17	MSCI UK broad	3.99
Bank of England Base	2.25	3.65	Euro/USD	0.99	10 Year Gilt	3.53

The market commentary, values and charts as at 31 October 2022. Total returns in sterling.
Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.
Source: Refinitiv Datastream/Bloomberg

Important information

Sources

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