INVESTMENT OUTLOOK Q4 - 2022

WHEN GOOD ECONOMIC NEWS IS BAD NEWS FOR CENTRAL BANKS FIGHTING INFLATION

Resilient economic conditions allow central banks to be more aggressive in tightening policy to deal with inflation. This implies that a “good news is bad news” dynamic may prevail, whereby risk assets weaken — even though economic conditions are more favourable than anticipated. Global equity and bond markets are broadly in the same dire straits as they were when we last updated you in August. US indices are in bear market territory, nearing their lowest mark for the year. Closer to home, the FTSE 100 is down over 5%, with the more domestically focused FTSE 250 down 25%, too. Bonds – which are having their worst year since 1949 – officially entered their own bear market during the summer and continue to lurch violently. The once reliable 60/40 portfolio strategy has tanked over 20% during the course of the year —and is shaping up to rival the losses of 2008. We’ve touched on the reasons why it’s been such a challenging year for investors in our monthly updates. War continues in Ukraine and, alongside the despicable humanitarian impact, financial markets most dependent upon Russian energy imports – Europe and, to a lesser extent, the UK – are ruffled. The UK’s ‘mini budget’ fiasco wreaked havoc for gilts and sterling, with recent reversals restoring a semblance of calm —at least for the time being. With the Communist Party of China wrapping up its 20th national congress, there is no let up in its zero-COVID policy, and trouble in its property market continues to simmer. In recent downturns, global markets have benefitted from a resilient China and its ability to sustain some global growth. That is not the case this time.

The main culprit for global markets discontent? Inflation. And the cure being dispensed by central banks to fight it? Aggressive interest rate hikes. If anything, inflation seems to be getting stickier; consequently, it’s likely rate hikes will continue well into 2023 (even if growth slows). Indeed, recent minutes from various central bank monetary committee meetings convey this tough stance, with policy makers fully committed to reducing inflation even if it takes its toll on growth. Realistically, the only way this hiking ends or reverses early, is with the onset of a recession — not exactly reassuring, I’m afraid. On the economic data front, however, there are rays of light: strong labour markets – unemployment across developed markets is close to all-time lows – and impressive corporate earnings. Frustratingly, this good news is actually bad news for policy makers trying to curb inflation, as it necessitates a doubling down on their rate hike efforts. This “good news is bad news” dynamic may prevail, whereby risk assets such as stocks weaken — even though economic conditions are more favourable than anticipated. Heads or tails, and the market loses this toss, regardless.

ACTIVE ASSET ALLOCATION MANAGEMENT

Our responsibility as long-term investors, means we must focus on both what could go wrong — as well as what can go right. We have been very active this year in making changes we believe will stabilise your Plan’s performance, whilst ensuring we are positioned for growth once the markets turn. With this dynamic at play – and market participant nerves being sufficiently jarred – we remain vigilant and alive to the uncertain investment outlook. Risk levels continue to be actively monitored and managed — and are likely to change as the data changes. We have taken the opportunity to reduce the risk assets in your Plans multiple times this year. We remain comfortable that our current positioning offers some defence against further market declines, whilst at the same time being poised for the eventual market turn. Given our views of growth over the longer term, our preference will favour allocating to equities in your Plans. We will therefore work to reinstate your risk weighting –particularly towards the US over time – and when the data supports this move. Your Plan is currently overweight UK equities, whilst being relatively neutral to Japan, Emerging Markets and APAC. Plans are underweight US, and European equities compared to the MSCI All Countries Index. Regarding bond weights, Plans have an overall short duration bias to limit interest rate sensitivity i.e., the possibility of further interest rate rises, which will negatively impact bond prices in the short term. Finally, we have moved to an overweight cash position compared to our long run Strategic Asset Allocation, to have the dry powder available to redeploy into equities when the time comes.

This document has been prepared by Wealthify’s Investment team and the opinions expressed here are theirs.

TOP RISKS

Global Recession

The tightening monetary and fiscal conditions to date are beginning to have a real – and negative – impact on households. Ever-increasing price pressures for consumers tilt the probability of recession higher. The question now is likely what type of recession: shallow or deep. We are leaning towards the former.

Inflation and Policy Uncertainty

Major central banks have been quite explicit of late, calling for higher rates to quell inflation — even whilst accepting the inevitable negative impact on growth that these actions will have. Expect rates to continue to rise well into 2023.

Russia Ukraine Crisis

With no end in sight, the threat of escalations remains as the war squeezes commodity and energy markets.

New covid-19 variants are vaccine resistant.

Whilst inflation levels are the primary focus for stock markets currently, COVID-19 has not gone away, and indeed case numbers are stubbornly rising again. Markets will remain highly vigilant.

China Risks

The global economy is now coming to terms with the notion that China will not ride to the rescue in the next global slow down, as it has been able to do so previously. China is experiencing its own slowdown, which has been amplified by some self-destructive policies —not least its ongoing Zero-Covid policy, which is having a detrimental impact. on its domestic economy.

INVESTMENT TYPE	OUTLOOK	RATIONALE
SHARES		
UK	+	There is no doubt that the UK is suffering uniquely from a political risk premium, caused by the chaos of a previously announced – and now reversed – bundle of unfunded tax cuts. With another new Prime Minister (the third in eight weeks), some market calm has returned. However, UK shares face a gloomy economic outlook and lingering negativity driven by Brexit, which has seen UK investors seek offshore investments. This is surprising, given UK shares have a heavy weighting to overseas earnings, at around 70% for FTSE-100 and around 50% for FTSE-250. While the outlook has deteriorated, UK shares remain both comparatively and historically cheap.
US	+	US policy makers delivered a comparatively stronger fiscal and monetary response than expected, supporting the economic recovery from COVID-19. This led to surging demand which, combined with disruptions in supply chains and commodity markets, has led to soaring inflation. The US Fed has moved aggressively to contain and anchor inflation, which has raised recession risks and, in turn, near term downside risks to corporate earnings. US stock valuations have moderated drastically and, given the greater economic resilience, we are positive on the long-term outlook for US shares relative to other markets.
Europe ex UK	-	The fallout from Russia restricting energy supplies to the region is live – the EU depends on Russia for a quarter of all its energy needs – and will likely have a negative impact on the regions GDP. Soaring inflation –driven largely by energy commodity inflation – has stirred the European Central Bank (ECB), with the bank poised to bring the Eurozone out of negative rates (a monetary position it has held since 2014). This is also likely to affect longer-term economic growth; as the region is a major exporter to China, it remains at risk to further US-China trade tensions, and a possible China slowdown in the short term.
Japan	=	The Bank of Japan (BoJ) is one of the few central banks still following easy monetary policy. Imported inflation on the energy and commodity front – as well as COVID-19 lockdowns – have seen pedestrian demand. Easy monetary policy to support the economy has led to significant yen weakness in recent times. The yen has weakened against the US dollar to levels not seen since 1998, as US interest rates have increased rapidly. A loosening of strict Covid border restrictions would bring a much-needed boost to the economy and, with valuations currently low and the yen at these levels, Japanese equities offer an interesting diversification option across developed markets.
Emerging Markets	+	Whilst the Emerging markets (EM) monetary tightening cycle is advanced, more aggressive U.S. rates expectations than previously forecasted will have an impact on EM equity valuations. China –a key component of this grouping – will detract from performance in the near term. With no let-up in sight to its zero-Covid policy, and trouble in its property market simmering, we are not bullish on China's immediate prospects — but remain constructive on the region's long-term prospects.
Asia Pacific ex Japan	+	The region is geographically and economically removed from the conflict in Europe, whilst inflation is less of an issue. In the more immediate term, it is likely to be negatively impacted from a deteriorating China story. Risks related to China –which include domestic (property market troubles and regulatory crackdowns) and foreign (US-China relations) – remain noteworthy near-term risks, but we remain constructive on the region's long-term prospects.
FIXED INCOME		
Government Bonds		
UK	=	UK government bonds (gilts) have come under increasing pressure after a long period of supportive monetary conditions. The cycle appears to have taken a sharp turn in 2022, with soaring inflation taking hold. Recent political chaos has introduced an unfortunate political risk premium to gilts, which may take some time to work itself out of pricing. There remains considerable uncertainty, and market volatility, of how far the Bank of England will go in terms of rate rises to combat inflation given the negative economic outlook. As a result, we have maintained our balanced exposure to the interest rate sensitive assets, with a longer-term bias toward short duration assets.
US	=	Investors have become increasingly concerned about rampant inflation and how the Fed will engineer anchored inflation while avoiding a recession. Fed officials have made it clear that inflation is their core focus, with aggressive rate hikes planned and delivered upon. This has led to sharply rising yields and volatility, reflecting the uncertainty of a soft landing. Despite near-term uncertainty, we took the opportunity to increase our allocation to duration at significantly higher yields, providing greater portfolio diversification capital protection.
Europe ex UK	-	Eurozone government bonds remain at risk due to a long period of overvaluation and continued distortion by Quantitative Easing. Soaring inflation is increasingly forcing the hand of the ECB to consider rate hikes which will negatively impact the asset class. Concern still surrounds the long-term debt sustainability of the periphery compared to the core.
Japan	-	Japanese bonds offer little income, remaining severely distorted due to the BoJ's "Yield Curve Control" program. While the BoJ might alter this program, there's little expectation for significant medium-term change.
Emerging Markets	=	With a US recession on the horizon, we remain cautious on emerging market currencies and continue to support our underweight position. Buoyed by the aggressive interest rate hikes and consistently hawkish comments from Fed officials, EMD has suffered deeper losses than the peak loss during the 2008 GFC (Great Financial Crisis). With tighter financial conditions and further dollar strength expected, we look for opportunities to add to this volatile asset class in the medium term.
Corporate Credit		
UK	=	The planned gradual unwinding of the BoE's expanded bond buying program announced in May will see declining support for corporate credit. This, combined with near term economic headwinds, have seen spreads widen. Given the uncertainty of the economic outlook, we are reluctant to increase our position at this stage.
US	=	Quantitative tightening and rising rates have seen spreads expand, as the economic outlook impacts expectations for corporate earnings driving investors to seek higher yields to take on corporate risk. As with other regions, we prefer Investment Grade over High Yield, which we think will remain mostly insulated.
Europe ex UK	-	The ECB's planned quantitative tightening and interest rate hikes against a worsening economic backdrop make these bonds uncompelling, particularly compared to shares.
Japan	-	Like Japanese government bonds, Japanese corporate bond prices have been distorted by QE. We prefer share exposure, especially while Abenomics continues.
Alternatives & Thematics		
Environmental	+	Companies focused on reducing their environmental impact often have a competitive advantage due to greater resource efficiency, leading to lower costs. They may also experience lower downside risks due to more robust corporate governance, and this can support greater diversification benefits.
Global Real Estate	=	Even though Covid-19 placed real estate under pressure, we now see this strain easing. The retail sector's woes are well documented, but a sectorally and regionally diverse portfolio remains fundamentally appealing given constrained supply and still low-interest real rates — which also provide a buffer.