



Markets Bulletin 18th October 2022

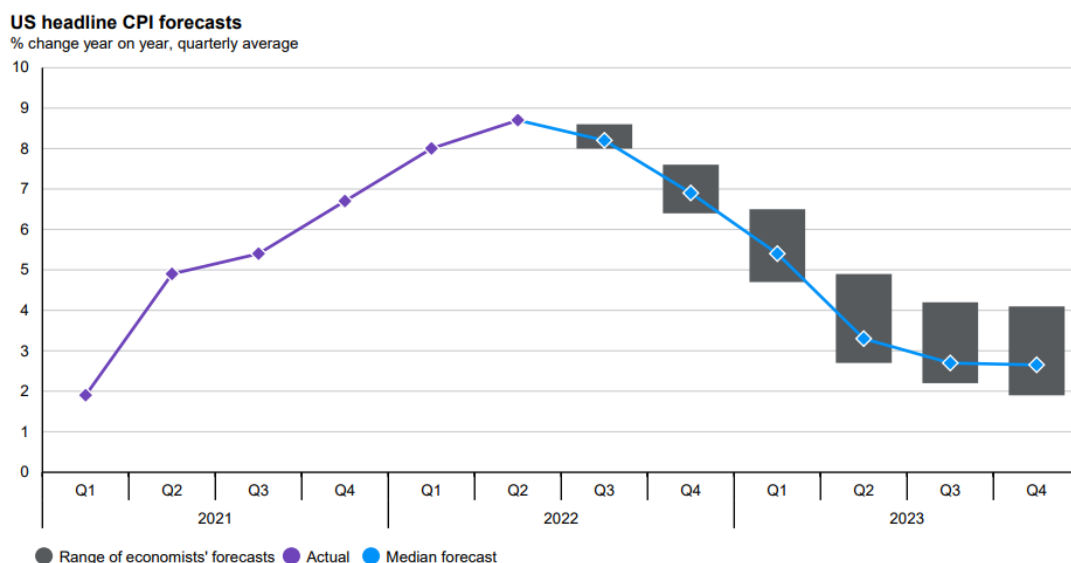
Within our market bulletins we tend to give you an insight into what has been happening in global markets and how this has affected the performance of our Advisory Portfolio Service portfolios. For this bulletin however, we shall try and give some insight into what is currently projected to happen for the remainder of the year and into next year. We shall also give greater detail on why we continue to hold certain sectors in our portfolios at this time of continued market turbulence.

Before looking at how markets and the economy are forecasted to behave over the coming months, it is worth taking a moment to explain the distinction between market performance and the macro environment. The main difference is that markets are forward looking in nature, so asset prices reflect investors expectations on future economic growth and corporate earnings.

The macro environment however is based around current or historic data and does not speculate on the future. Markets can however be irrational at times, as we have seen this year, and their mood reflects investor sentiment. Together, the macro enables us to better understand whether markets have diverged too far from fundamentals. Conversely, the pricing in the markets provides an indication of the macro outlook.

Markets this year have been dominated by the path of inflation and in particular the reaction of central banks as inflation readings have continued to rise. Central banks are now waiting for a meaningful decline in inflation readings before they 'pivot' and start to reduce interest rates. Once central banks, predominantly the Federal Reserve, start to significantly reduce interest rates we would expect to see markets stabilise and strengthen, as they focus on future growth. There remains a lot of uncertainty around the trajectory for inflation, as shown in the chart below.

U.S. Inflation Forecast



Source: Bloomberg, BLS, J.P. Morgan Asset Management – Data as of 30th September 2022



As the chart shows, there is a substantial variation in the speed that economists see the rate of U.S. inflation falling. By the end of quarter two 2023 some are projecting that inflation will be down below 3%, close to the Federal Reserve target rate of 2%. Others however expect the rate to be nearer 5% at that time. With the inflation reading only falling to 8.2% in September from the previous 8.3% and underlying inflationary pressures still accelerating, a rate of 5% at this time would seem more realistic.

As well as global inflation rates influencing markets, the performance of currencies against the U.S. dollar have also been making headlines. The U.S. dollar has been strengthening since the second quarter of 2021, but there has been a significant uptick in performance since the start of the war in Ukraine.

The U.S. does not need to import energy or food, so has not been as affected by the repercussions of the war in Ukraine in the same way as the UK and Europe. The Federal Reserve has by far been the most aggressive central bank in the developed world when it comes to bringing inflation under control, putting further pressure on the global economy and currencies. The U.S. dollar is also seen as a 'safe haven' at times of geo-political risk, which is very much heightened. As investors sell holdings in Europe and Emerging Markets to retreat to the U.S., they need U.S. dollars to be able to buy U.S. assets. This demand is in turn pushing up the value of the dollar.

It is worth noting that a strong dollar is not good news for U.S. companies that trade abroad, as their products become more expensive. This is expected to have a negative impact on company

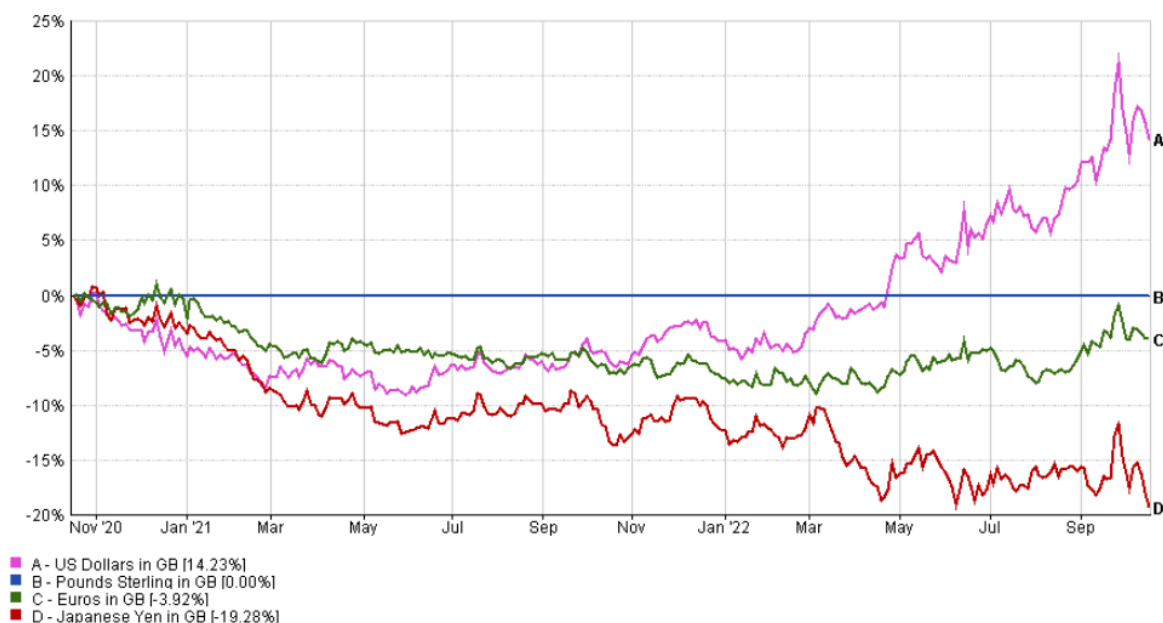
earnings that are being announced over the coming weeks.

If, however global risks were to subside or if other central banks started to put greater impetus on increasing interest rates, then the strength in the dollar could wane. This would in turn release some pressure on emerging market economies, many of which have to borrow in dollars, and also benefit holdings in this sector. It would also be positive for the earnings of companies trading abroad.

The U.S. dollar does remain strong at this time, but as the chart below shows the upward movement of the currency is showing signs of weakening. The chances of a recession in the U.S. are increasing, but how deep this will be is of course unknown. The current forecast is for a mild recession in the U.S. next year, which markets seem to have largely priced in. If inflation was however to remain higher for longer, then markets could react with further negativity.

Our portfolios continue to have significant exposure to the U.S. and this has been one of the strongest performing sectors this year. The U.S. markets could however fall further this year as some investors believe that earnings expectations remain over optimistic, due to the strength of the dollar and the distinct possibility of a global recession. These expectations should however adjust during the first quarter of next year, especially if the dollar weakens, at which time U.S. equities could show signs of recovering. The U.S. mid term elections are also taking place at the start of November, which could also have either positive or negative repercussions for markets, depending on the outcome.

Two Year Currency Comparison - U.S. Dollar Strength



16/10/2020 - 16/10/2022 Data from FE fundinfo 2022



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In late September the UK Chancellor, at the time, Kwasi Kwarteng announced a 'mini budget' in an attempt to kick start growth in the UK by reducing taxes and increasing government borrowing. This caused turmoil in UK markets with sterling falling significantly against the dollar, hitting an all time low of \$1.035, and sharp falls in the prices of UK Gilts caused the Bank of England to take emergency action due to a "material risk to UK financial stability". We provided greater details regarding this budget within our bulletin dated 29th September and the possible ramifications for the UK economy.

The fallout from this budget was not only felt across markets and financial institutions but was also catastrophic for the government. Last week saw prime minister Liz Truss take the decision to sack Kwarteng as chancellor and she appointed Jeremy Hunt in an attempt to salvage her premiership. The new chancellor has since announced that the majority of the tax cuts advised in the previous budget shall be reversed and that the two year energy support package, previously announced by the prime minister, shall now only last six months.

The government hopes that this 'U turn' in policy shall be sufficient to calm markets, and the initial reaction from markets has been positive. The concern is however that the initial taxation cuts and spending plans were the basis of the prime minister's economic policy and were essentially what got her in to office. It is therefore viewed by many that Kwasi Kwarteng was sacked for implementing her economic plans and her credibility as prime minister is being questioned.

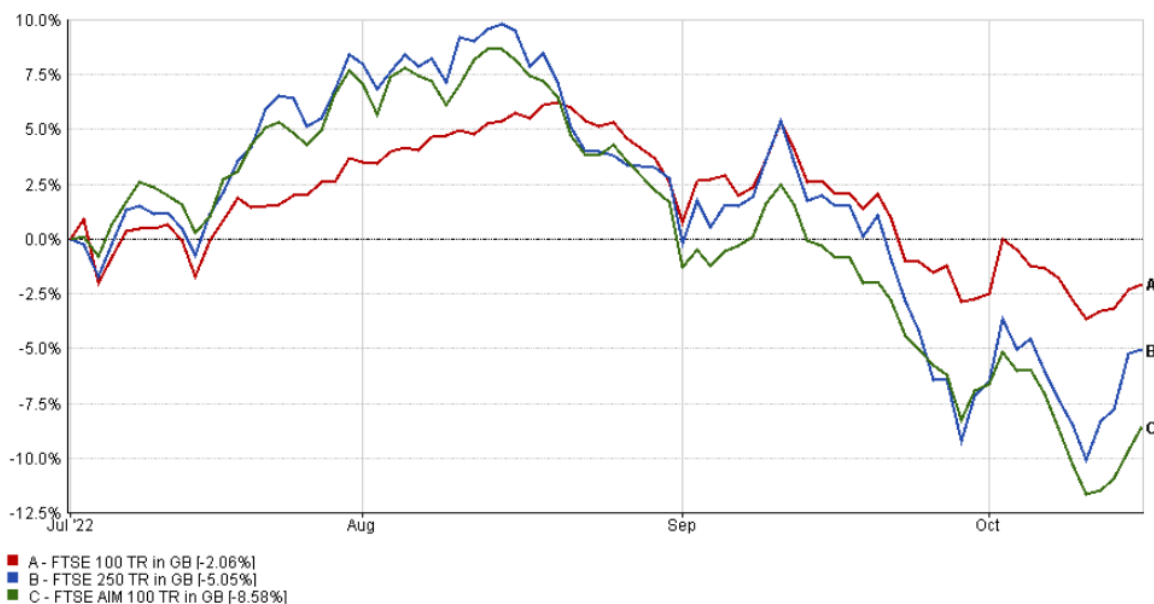
In the UK this year the FTSE 100 has been the strongest performer of the main UK indices, benefiting from its international exposure,

overweight to energy and oil companies and underweight to technology, which has de-rated as investors have become concerned about future global growth. Earlier in the year we increased our exposure to the FTSE 100 and reduced our exposure to the lower cap indices in the UK by reducing our UK Smaller Companies exposure, as this has significantly underperformed the FTSE 100.

We have however retained holdings in the lower cap market as when market sentiment becomes more settled and positive, we would expect this area of the UK market to outperform. The chart below compares the performance of the FTSE 100 to that of the FTSE 250 and FTSE AIM, which consist of smaller cap index listed companies in the UK. As can be seen, both of these indices have been notably more volatile than the FTSE 100. They did however outperform during July. During that month the Federal Reserve hiked interest rates by the expected 75 basis points. The Fed chair Jerome Powell did however subsequently comment that the pace of policy tightening was likely to relent and that the pace of increases may need slow down. This rhetoric was taken very positively by global markets and the sectors of the market that had been weighed down by the negative impact of rising interest rate expectations.

As can be seen from the chart this positive market sentiment did not last long as Jerome Powell backtracked the following month stating that the U.S. central bank would need to keep monetary policy tight "for some time" in a bid to tackle soaring inflation. This statement once again sent markets falling.

UK Market Performance 1st July 2022 - 17th October 2022



01/07/2022 - 18/10/2022 Data from FE fundinfo 2022

Past performance is only a guide and future yields cannot be guaranteed. Unit prices can fall as well as rise.



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Markets have not as yet recovered, but this is an example of how market sentiment is being influenced by comments from the Federal Reserve. Once they are satisfied that inflation in the U.S. is showing signs of stabilising and falling back, then they will start to reduce interest rates. Markets should then start to take their focus off of central banks and inflation and return to the underlying fundamentals, cashflows and future earnings potential of companies.

Looking towards Europe, concerns throughout this year have focused on the regions dependency on Russia for its gas and oil. As we approach winter there remains the distinct possibility that Europe could face an energy crisis with record gas prices and a lack of storage facilities.

During the summer we have seen supply disruptions from Russia including unscheduled maintenance on the Nord Stream1 pipeline. This was initially supposed to take three days to complete, but then escalated to a complete indefinite shut down of the main gas pipeline to Europe. This is now expected to remain closed until sanctions imposed by the west against Russia are lifted. More recently two gas pipelines from Russia to Europe were sabotaged with blame being laid at Russia's door, but no direct accusations were made.

Europe has since been importing Liquid Natural Gas (LNG) from the U.S., however with the U.S. dollar being so strong and the euro falling against the dollar, this has come at a high price. The E.U. did set itself a target of filling 85% of the total underground gas storage capacity before the winter and it is expected to hit this target. That said, gas levels across Europe are expected to be dangerously low by February 2023 and concerns are that the infrastructure is not in place to transfer gas from west to east within the bloc during the months of peak usage. If there is a hard and cold winter in Europe this year, then we could see energy levels deplete even quicker, which could lead to rationing of gas to both households and industry and energy related shut downs.

Inflation in Europe reached 9.1% year on year in August and could exceed 10% in the coming months. In this context, the European Central Bank has become more hawkish, hiking its policy rate by 0.75% in September, and it is now expected to increase rates by another 0.75% in October and by 0.5% in December, to bring them to 2% by year end. Interest rates in Europe are not expected to reach the level of those in the U.S. or UK over the coming months as the eurozone is expected to fall into a recession this winter anyway. The ECB is however still grappling with a high level of inflation, but bringing greater pain with excessive rate hikes should not be required.

We made a small reduction to our European exposure earlier in the year and continue to monitor our exposure to the sector. We have also increased our exposure to funds with a more defensive mandate which tend to have a lower downside during periods of volatility.

Asia's benign inflation backdrop compared with the West means that its central banks can afford to be more accommodative, as demonstrated by the surprise cuts by the People's Bank of China at the end of August. China's monetary policy is expected to continue to ease in at least the near term, supporting recovery from zero-Covid policy and the distress related to property sector reform.

At the time of writing the Chinese Communist party's 20th national congress is taking place, during which President Xi Jinping is expected to be confirmed as its leader for a third term. Expectations heading into the Congress have been muted, meaning any positive news around leadership positions or zero-Covid policy could provide an immediate boost to sentiment. Earnings in China are also expected to improve, as companies begin to enjoy a post-Covid recovery and lower commodity prices. It is worth noting that Chinese stocks have fallen a long way over the last 12-18 months, and therefore already have a lot of negativity already priced in.

Tensions between China and the U.S. have however intensified over the summer, specifically over China's increasingly aggressive rhetoric and actions towards Taiwan and the rapid modernisation of its military over the last ten years. Since then, the U.S. has announced an arms deal worth \$1.1 billion, which will see the U.S. supply seaborne military equipment to Taiwan. The U.S. has also introduced export restrictions designed to make it difficult for Chinese companies to obtain or manufacture advanced computer chips. In response during his opening speech at the national congress President Xi warned off the U.S. against further support for Taiwan stating that external forces, namely the U.S., would be responsible if China decided to invade Taiwan.

With the geo-political escalation between China, Taiwan and the U.S., it is easy to draw parallels with the Russian invasion of Ukraine. It is worth bearing in mind however that if China did invade Taiwan and sanctions were then enforced on China, as has been the case with Russia, then the economic ramifications for China would be significantly more substantial.

Our portfolios are exposed to China through our Emerging Market and Asia holdings. Many countries in these sectors have been ahead of the curve when combating inflation and started increasing interest rates much earlier than the developed world. Performance this year has been affected by the strength of the U.S. dollar, but if the dollar was to weaken, then these sectors and countries could benefit.

Enclosed with this bulletin you will find an additional document from the Directors of Burley Fox. This document gives greater detail in relation to some of the questions that our clients are asking regarding market and portfolio performance this year and what they should be doing at this time.



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Should you have any queries or concerns regarding the details in either of these bulletins, please do not hesitate to contact your Investment Director.

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