Macro Outlook Summary

September 2022

Sometimes it helps to recap the past few months to give context to what is happening now.

The market recovery in July didn't last long and with hindsight was clearly a bear market rally.

With ongoing inflationary pressures and strong economic data in August the bear market resumed, but behind the headline losses of -4% to -5% for equity markets the big story was government bonds. From the 1st August steadily through the month 10Yr government bond yields in the US and Europe clicked higher as investors re-evaluated the likely path of interest rates given ongoing inflationary pressures. By any measure it was a dramatic but largely un-noticed move. The US 10Yr moved from 2.6% to 3.1% while Germany rose from 0.8% to 1.5% and the UK from 1.8% to 2.8%. In terms of capital loss this equates to -4.5% in the US and -9% for Germany and the UK in August alone. Far worse than equities.

Government bond markets didn't quite go into meltdown, but they were close, with worse to come. Inevitably credit suffered in proportion while equities and commodities fell. The iTraxx Europe index, a measure of European IG Credit spreads widened from 100 to 120bps. The US equivalent index widened from 80 to 92bps. Given the rising baseline of government bond yields this spread widening added to the pain and made for a terrible month in credit which is exactly the scenario we painted in May.

Data from the real economy reconfirmed US labour market strength and ongoing inflationary pressures especially in Europe. In August US non-farm payrolls came in at +528k versus an estimate of +250k, while the UK inflation rate rose from 9.9% to 10.1% and arguably triggered the MPC to implement a 50bps rate hike bringing rates to 1.75%. This was the only central bank meeting in August.

And so into September. US 10Yr yields have moved from 3.1% to nudge 4.0%, Germany from 1.5% to 2.25% and, not to disappoint, the UK from 2.8% to a recent peak of 4.5%. Year to date losses from these assets are now truly shocking: US -20%, Germany -22% and the UK -30%! In one meltdown these 'safe haven' assets of government bonds have lost more money than equities. Quite a performance.

As we have repeatedly pointed out, sovereign bonds have been mispriced and dangerous ever since the programme of QE was implemented to manipulate yields down to artificially ultra-low levels. As a result, and for many years government bonds have not conformed to their classification of low risk. If this were an isolated case of market manipulation by governments, then it would not be so bad but the yields set by sovereign bonds underpin all other capital markets and this move to higher interest rate structures around the world will not be without its consequences. That is of course why central banks manipulated yields down in the first place. But the bet they were making was that inflation would never return in 1970's style which of course has turned out to be a serious misjudgement. The writing is clearly on the wall for those willing to read.

Equities have not yet adjusted in price enough to be consistent with these non-transitory higher interest rate structures and slowing economic growth outlooks. As a consequence of the fight to suppress inflation a recession of some magnitude grows ever more likely even in that most resilient of economies, the US.

And in reaction to all of this, investor sentiment is shifting once again. In the first half, especially up to May investment portfolios held a mixed set of assets where not all were not down. From that point the narrative changed as central banks addressed their rate hiking duties in earnest to combat inflation which was visibly spreading into the fabric of every economy. The fear of recession hit commodity investments hard and in recent months as the oil price has fallen even that theme has lost its shine. Crude is down -18% in September and now only up +5% YTD. While the energy crisis is far from over and gas prices remain sky high, most investors have given back their earlier gains from the space whilst enduring horrendous volatility. Bonds, credit and equities are all down on the year and in some cases dramatically so. FX exposure to the USD for non-US investors would have helped but for US investors an allocation to the Nikkei in Japan which is only down -2.5% YTD would have been killed by Yen weakness where the USD-JPY has moved from 115 in January to 145 now. At this juncture it is hard to find any capital market investment that is positive for the year.

The latest casualty of this unfolding bear market is real estate where various commentators see price hesitation and imminent price falls. For commercial real estate everyone knows that their troubles began with the outbreak of Covid but with near zero cost loans in the past two years residential has boomed. Now confronted by much higher finance costs and a weakening economic outlook the rosy glow from residential real estate has waned and such forecasts seem likely to be right.

With a shrinking list of exceptions, investors with traditionally allocated portfolios to the end of September are down on the year and this has driven the changing investor perception and confidence we now witness. Eventually bear markets lead to investor capitulation and liquidation. We haven't got there yet but there is a strong sense in the market that this is coming. Every investment advisor engaging with their clients and reviewing their long only investments in equities and bonds which are now all under water is hearing the same question: 'what should I do?'. Some will stick while others will sell, but as market performance gets worse into year-end so the capitulation process plays out.

One of the few bright spots remaining are selected alternative investment funds. We focus on absolute returns and building portfolios around alternative investment strategies. Our investment returns don't depend on rising markets or suffer in falling markets and this is shown by our Funds generating positive returns for the year with our customary low volatility. We believe we are well positioned to make further gains going into the final quarter of the year.