Mazars Wealth Management investment newsletter

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Foreword

The third quarter of the year saw markets start to second guess central banks' resolve to raise interest rates in order to combat inflation. Expectations of a change in monetary policy gathered momentum and caused a rally in global equities of over +11% in a five week period. Alas this proved to be a short-lived bear market rally as central banks, led by the US Federal Reserve, signalled their determination to stay the course with rate rises. By the end of the quarter equity markets had given up all of their gains and more, finishing with a loss of more than -5%. For a Sterling based investor this return was softened by the weakness of the Pound, particularly against the US Dollar, with returns being broadly flat for the period. Gilts, having suffered in the spring, continued to sell off significantly in the face of rate rises and a mini-budget which was not well received by markets.

Global inflation remained stubbornly high throughout the summer being driven primarily by energy and food prices. The cost of living pressures brought about by high energy prices in particular have led to a curious interaction between monetary and fiscal policy, where central banks are trying to slow growth to stop inflation becoming embedded in economies, whereas governments are stepping in to help households meet their basic bills. As ever, the lag between interest rate rises and their impact on the economy makes it impossible to know whether central banks will over-tighten and when they should cease raising rates. The expectation, given that central bankers fear inflation more than they fear a recession, is that we will end up with more hikes than necessary and the ensuing recession may be deeper than hoped for. For the US Federal Reserve, who lead the way with tightening policy, the strength of the US Dollar is a complicating factor which impacts many around the world, not least emerging market countries, and one which cannot be ignored despite them giving clear guidance on the domestic measures which will drive their decisions.

Despite central bank fears, markets remain optimistic that inflation will subside, and economists forecast that we are at or near the peak of price rises. These expectations are partly due to the base effect of energy price rises falling out of the calculation, but we can also look to the reopening of supply chains and Chinese producer price inflation as positives for the inflationary outlook. There are also recent indications that jobs markets, while still tight, are beginning to cool a little. Of course, the ongoing situation in Ukraine will continue to have an impact on commodity prices, and this remains an unpredictable element.

Inflation aside, there is plenty to keep market analysts busy. The UK's new government attempted a mini-budget which was far from 'mini', and which was such a departure from fiscal policy of the last 15 years that it took markets by surprise leading inevitably to a fall in Sterling and a rise in the cost of borrowing for the UK. In Europe, solidarity within the EU is once again challenged as governments pursue divergent policies for dealing with the energy crisis, with wealthier countries hesitant to fund a common approach. And finally, in China, problems around the indebtedness of property developers continues to slow growth, and has knock on effects for local government finances and the banking sector.

At our September meeting the Investment Committee voted to maintain our neutral position in equities, and to retain the more defensive nature of the underlying holdings. We recognise the current strength of the US Dollar and therefore took some profit on unhedged equity holdings and moved to neutral in bonds.

I hope you find this newsletter interesting and relevant to you, and I would very much welcome any feedback you may have. Please do feel free to get in touch with your thoughts either by phone on: **020 7063 4259**, or by email on: **david.baker@mazars.co.uk**.

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Economies and markets in brief

When will inflation peak?

The Bank of England raised rates by another 50 bps in September as they continue to fight inflation levels not seen in several decades, although some commentators had expected a rise of 75 bps. The BoE said that the UK economy may already be in recession, which indicates why they didn't go as far as they could. However, year-on-year effects mean that inflation expectations are already falling significantly, with the expected inflation over the next year a touch over 6%, well below the most recent YoY CPI figure of 9.9%. Long term forward expectations have barely budged, which implies that the recent spike in inflation hasn't caused the psyche of the UK public to expect permanent price rises. This follows a global pattern - Chinese PPI peaked last year and has been steadily falling, although export prices have continued to rise over 2022.

UK inflation expectations have fallen significantly

Inflation expectations, per cent

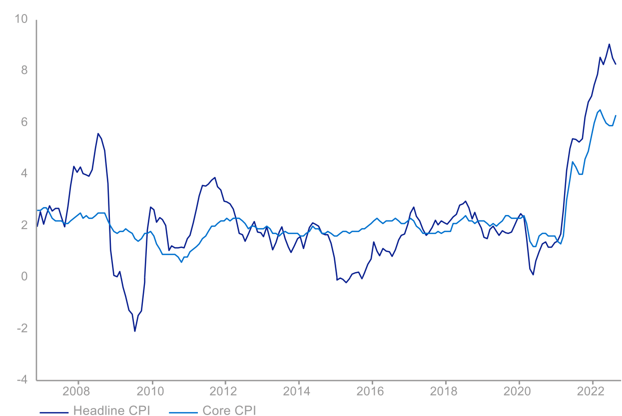
Source: Refinitiv Datastream

US Midterms

The US goes to the polls again in November to vote for members of the House and about a third of the Senate. Midterm elections have historically been difficult for the party which holds the Presidency. This year is expected to be no different, with Republicans favourites to win back the House, with high inflation making life very difficult for Democrats. That said, a shock Supreme Court ruling in June to nullify the right to abortion nationwide has since made life far more difficult for Republicans, who selected six of the nine justices. The most likely outcome of a divided Congress bodes ill for any meaningful legislation over the next two years and increases the risk of a government shut down. Taken too far this could see US defaults and significant market volatility. A split congress is likely largely priced into markets, however should Democrats pull off a shock then markets could well rally.

High US inflation is the main concern for voters in polls

Twelve-month percentage changes



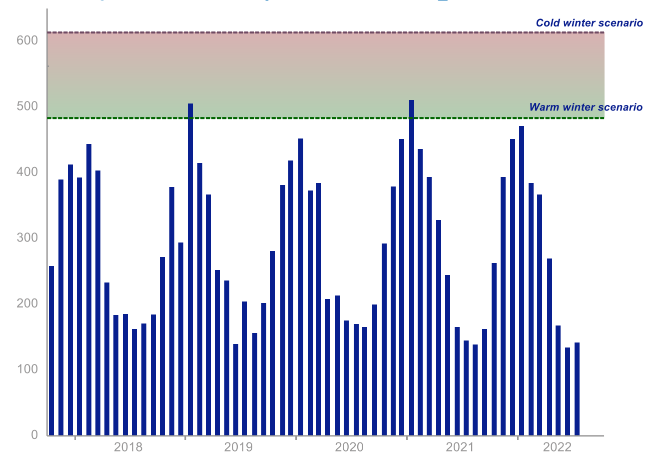
Source: Refinitiv Datastream

European gas supplies

There has been much concern over European energy supplies, or more specifically, a lack thereof. Due to its significant dependence on Russian gas, Germany has been caught directly in the crosshairs. German authorities appear reasonably well prepared to tackle the fast-approaching winter season, with total gas supplies having reached approximately 91% of capacity at just over 220TWh. However, this figure pales in comparison to historical gas consumption across the country. Even with the voluntary limitations on gas usage by German corporates in place, a cold winter will put significant pressure on energy suppliers to meet demand.

Germany's gas reserves won't be enough to stave off a cold winter

Germany, total consumption of natural gas, TWh



Source: Refinitiv Datastream

The shifting sands of UK fiscal policy

In this section, it was initially our intention to review the newly proposed ‘mini-budget’ and how the policy would have contrasted significantly from the previous Chancellor, Rishi Sunak’s intended course of action. We have had to change tack slightly, as the violent fracturing of UK bond markets, subsequent margin calls faced by UK pension funds and, to top it all off, the lobbying of Conservative party members against the measures, eventually forced the Government’s hand. In fact, our first iteration of this quarter’s newsletter included the following statement:

“Given the boldness of Kwasi Kwarteng’s statement one could be tempted to write-off the formula that determines how freely chancellors can implement spending. However, the reaction of the bond and UK currency markets says that is unlikely that the current trajectory can be maintained indefinitely.”

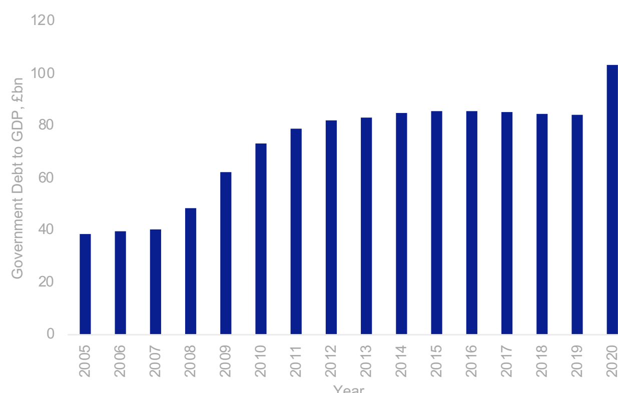
Since the financial crisis in 2008, the spending power of the Chancellor of the Exchequer has been determined by a combination of three factors: the mandate of the prime minster, the state of the UK economy and the prudence or largesse of the previous Chancellor. George Osborne inherited the Chancellor’s red briefcase when the UK economy was still reeling from the Global Financial Crisis and the UK government debt had ballooned. He used the mandates of David Cameron to enact some orthodox fiscal conservatism and fix the roof of UK finances while the economy recovered. Government spending was cut, and debt to GDP was brought down.

These three factors have influenced the decisions of each Chancellor since; Philip Hammond took up the post of Chancellor after the Brexit referendum and was able to use the fiscal prudence of George Osborne to fund a war chest to stimulate the economy, in light of the weakened mandate of Theresa May. In the wake of the Covid crisis, Rishi Sunak established himself as someone who would spend to support the economy during its time of need but would revert to orthodox Conservative fiscal policy once the pandemic subsided.

Kwasi Kwarteng’s stint as Chancellor was the second shortest in the history of the UK Government, truly highlighting how tumultuous the current UK fiscal situation is. It was inevitable that the planned fiscal stimulus would face resistance, as it abandoned the tried-and-tested approach to fiscal policy. Government debt had already been notably extended in the wake of the Covid-19 crisis and the funds required to provide both the extended energy support package and the planned unfunded tax cuts would have further increased the public debt. Yet the scale of the backlash was unprecedented. Sterling plummeted, reaching levels not seen since decimalisation in 1971.

UK debt has already risen significantly due to Covid

UK debt to GDP



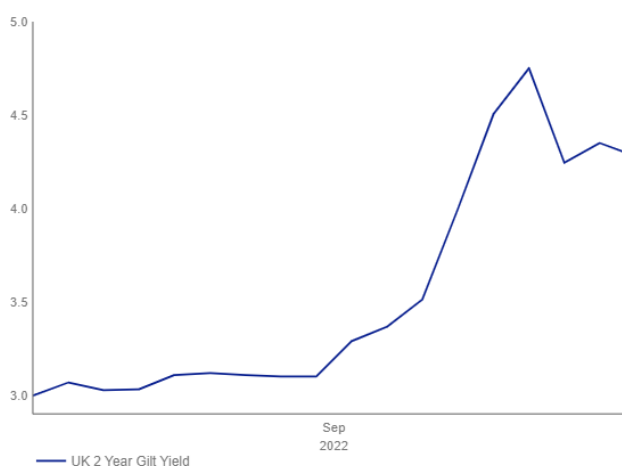
Source: IMF

Bond markets also convulsed as pension funds were forced to sell gilts en masse to cover their liabilities, forcing the Bank of England to step in.

The subsequent U-turn on the mini-budget may help to address the issue of ballooning government debt, yet the UK still faces severe structural issues. Low growth remains a prominent issue and financial stability risks are becoming increasingly pronounced. Whilst radical policies may be required to force changes, markets have demonstrated their abhorrence to surprises. As such, the new Chancellor, Jeremy Hunt, has adopted a more orthodox approach to fiscal policy during these challenging times.

Markets have reacted negatively to the ‘mini-budget’

Cost of UK government debt (%)



Source: Refinitiv Datastream

US large cap growth – In focus

We are making a change

In order to maintain a balance between growth and value stocks in our North American funds, we are introducing T. Rowe Price US Large Cap Growth. This fund will sit alongside value focused Dodge & Cox US Stock, and replace Artemis US Select.

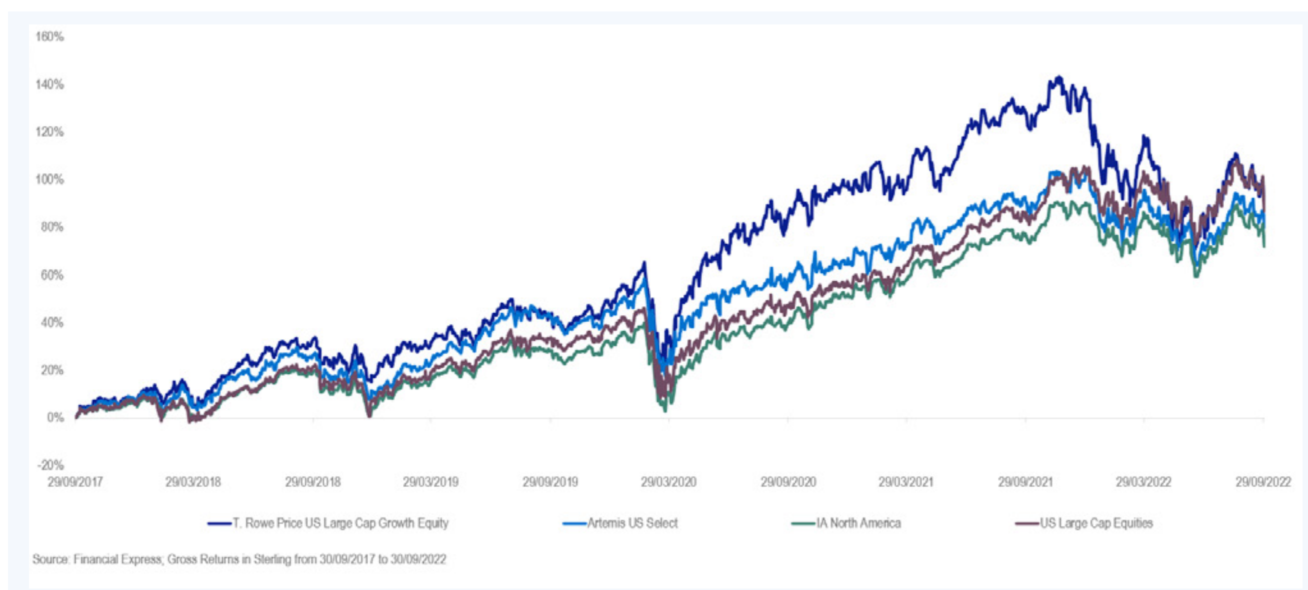
Why the change?

Artemis US Select was originally used as our main North American equity fund, however we have since added Dodge & Cox US Stock, which is a value focused strategy. As such we want our other North American large cap fund to have a greater growth focus to better complement Dodge & Cox. Recently, Artemis has moved closer to a core positioning from its long-term growth overweight, however, the fund has still lagged US large cap equities. We believe the manager and process work better when the fund is being run with more of a growth focus.

T. Rowe Price US Large Cap Growth is run by Taymour Tamaddon. Taymour is supported by a large team of analysts that have sector specialisms. The fund adopts a research driven, bottom-up approach to stock selection. As a part of their research, analysts review industry and company dynamics, management team quality, and financial fundamentals to identify those companies that will likely benefit from innovation/ disruption with business models that can generate high growth and high returns. Environmental, Social and Governance (ESG) considerations are also integrated into the fund's fundamental research process. The strategy is relatively concentrated (60-70 stocks), helping magnify the analysts' best ideas.

What is the impact?

T. Rowe Price US Large Cap Growth will replace Artemis US Select in our Balanced, Capital Growth and Adventurous models.



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