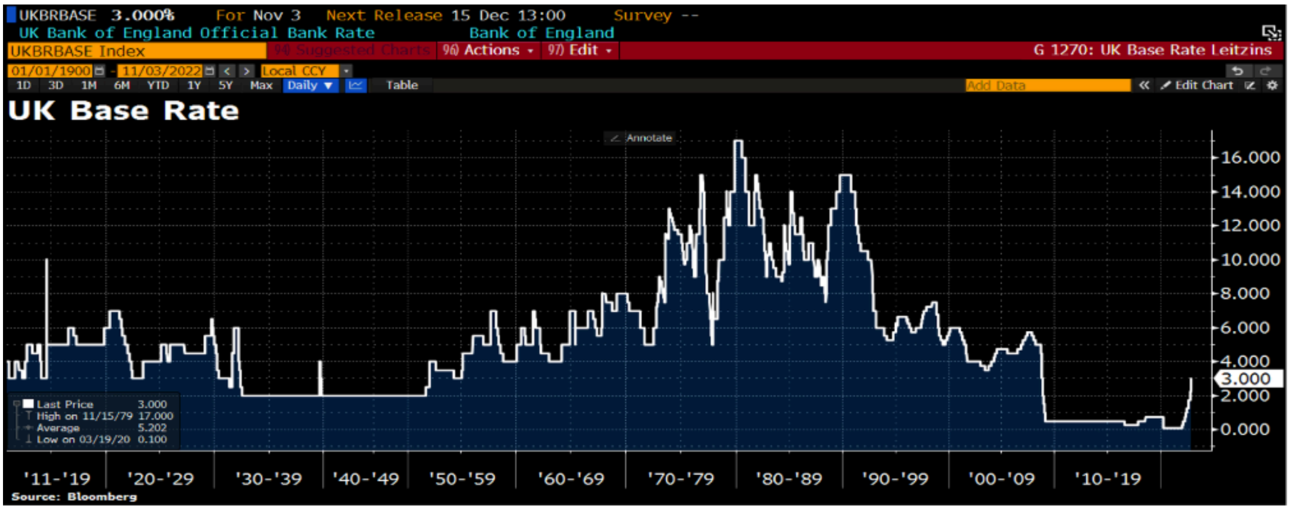
PORTFOLIO MONTHLY REPORT – October 2022

Situation

The central banks continue to raise interest rates, with the Federal Reserve, ECB and Bank of England all raising rates by 0.75% in the last week. The US rates are now 3.75%, the ECB 1.5% and the UK rates 3%. As you can see from the chart below they are still low in historical terms.



Raising rates in the classic policy response to higher inflation and as we have noted, inflation has rocketed over the last year to be around 9% to 10%. Given, interest rates usually rise to be higher than the inflation rate to quash inflation they might have to rise quite a bit from here. Which brings us to the big question of the moment: By how much and when will central banks stop raising rates?

The impact of raising rates certainly has a lag on the economy and so some argue that now is the time to pause and see what develops. Mortgage rates in the USA are now 7% for 30 years and in the UK 5 year mortgages are at over 6%, both double what they were one year ago. This is likely to reduce property prices, but perhaps not by much today rather in 2023. However, during the press conference the chairman of the US Federal Reserve stated it is much too early to talk about pausing rate rises.

Higher rates not only impact consumers and therefore demand but also stock market valuations. The USA market (S&P 500) is lower by -22% year to date and the "Tech" Nasdaq lower by -33%. Investors might not realise that they are invested in such markets but any US/Global fund will have a significant allocation to these indices. In fact they are often more concentrated than they realise.

In my November 2021 newsletter I pointed out how the USA market is dominated by the so called FAANGs stocks (Facebook, Amazon, Apple, Netflix and Google). Year to date they have returned respectively -73%, -46%, -22%, -55% and -42%, they have clearly lost their attraction.

The other feature of this year, which I have mentioned before, is the terrible time bonds have had. One of our fund managers made +100% in the first 9 months of the year, holding investments which benefitted from falls in the UK government bond (Gilts) market. Not only did they offer little yield and were highly over priced, but the political drama in Westminster reduced their attraction to buyers. That seems to have stabilised and there is a case to be made that bonds are again attractive.

Bonds have a fixed coupon or interest rate and so they do not like rising rates. They also do not like inflation and with both of these factors in place this last year, their prices have fallen. However, looking ahead into 2023 economic problems in the western economies look likely to continue and that is when bonds tend to do well.

Ever rising interest rates will at some point stop rising and perhaps inflation will not be so strong as we get into 2023. The base effect is going to help the monthly data as next spring and summer the base prices will be from this year. So rather than 9% inflation the number, year over year, it could be 4 or 5%. Not the targeted 2%, but better nonetheless. That is what the central banks are hoping for and then a bond yielding 6% starts to look attractive in real terms.

Of course different investors have different needs and time horizons. Some may now see opportunities in the FAANGS because they consider a recent low to be a good buying opportunity. Perhaps investors in the coming years will find that it is time to turn to away from “tech“ investments in favour of basic materials, real assets and assets that pay a cash dividend on a regular basis.

Best wishes

Tim 4 November 2022