PORTFOLIO MONTHLY REPORT – November 2022

Situation

One of the indicators for the health of the global economy is the yield curve. Central banks fix their overnight interest rate, but they cannot fix the interest rate on long term government bonds. That is decided in the bond markets as investors, such as pension fund, insurance companies, sovereign wealth fund etc. bid for bonds. There are bonds with close maturity dates and bonds with much longer maturity dates. The benchmark is the 10 year bond and different countries have different rates according to how attractive the bond market sees them. Global bond markets are larger than the stock markets and form a key element in the investment world.

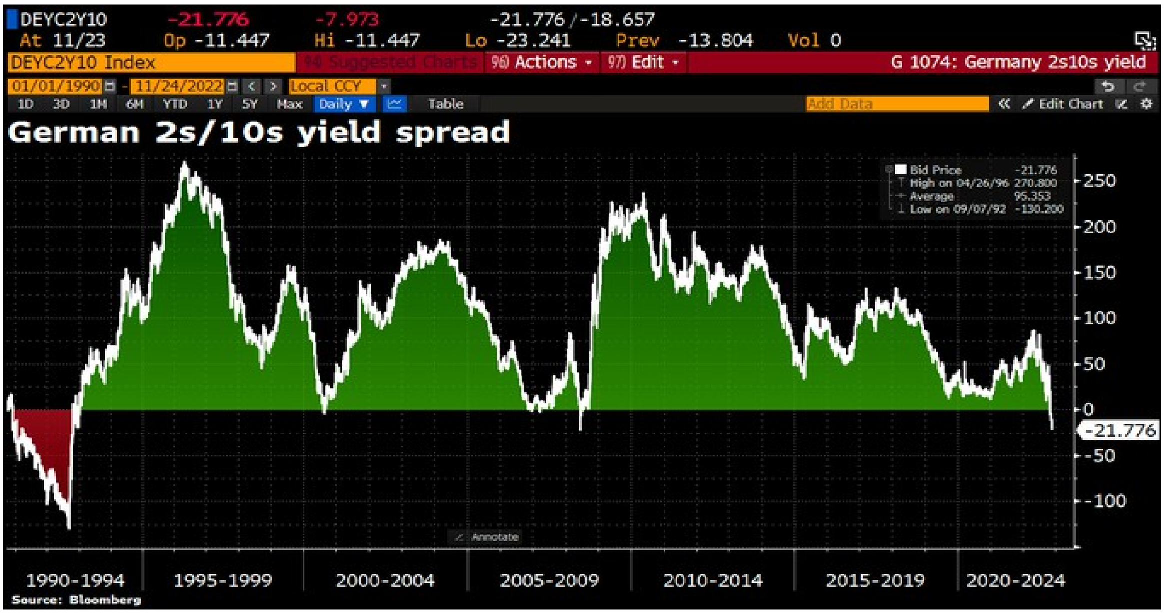
Usually the more years left to maturity the higher the interest rate. This is logical as there is more risk over a longer period and therefore one expects a higher return. Therefore the rate on the 2 year bond is lower than the rate on the 10 year bond. But something has recently happened. Look at the chart below which compares the rate on the US 2 year bond with the 10 year bond. It has gone negative. (The US 2 yr rate was last week 4.29% while the 10 yr was 3.49%)

That means investors are bidding up the price of the 10 year bond and the yield down because they see it as more attractive than the 2 year bond. Why would they do that? Because they think central banks will lower over night rates soon and they want to lock in a high rate for 10 years.

At the moment the main investment theme is that inflation in most countries is too high and central banks are raising rates to combat rising prices by suppressing demand. Speakers from the US central bank talk about ever higher rates and the same is true from the ECB and the Bank of England etc. but the bond markets do not believe them.

Why would they stop raising rates or even start lowering them and the answer is simple. The global economy goes into a recession. That is economic growth slows and then goes negative. Businesses see less activity, less sales and less profits. Unemployment rises and central banks will then do what they always do at such times and that is lower overnight interest rates.

This unusual situation for the 2 and 10 year bonds is not just a feature of the US bond market. Below is the German bond market and here again the spread has just gone negative, implying a major slowdown in Germany, the largest economy in Europe. (The German 2 yr rate last week was 2.1% while the 10 yr was 1.85%)



This year has been terrible for the bond markets because rising rates make them less attractive and so they have fallen in value. One of our fund managers made a 107% return in the first 9 months of the year holding assets that grow in value when bonds fall in value.

That has now all changed and the negative 2 to 10 year spread highlights the fact that the bond markets are concerned about the risk of recession. But inflation is still a problem so we may see headlines talking about Stagflation, which was a feature of the 1970s.

On the other hand the IMF in its latest report (October 2022) sees growth next year. For the advanced economies at 1.1% and 3.7% for emerging economies giving a total global growth projection of 2.7% (in real terms) for 2023.

With such uncertainty it makes sense to hold a widely diversified mix of investments providing a wide range of opportunities for 2023.

Best wishes for Christmas and a Happy New Year.

Tim 5 December 2022