Portfolio Monthly Report - December 2022

Situation

In 2022 global shares suffered their second worst decline since 1974 with a fall of -20% as measured by the MSCI world index. However, in the USA the technology companies as measured by the Nasdaq, the darling of the last few years, was down -33%. Europe did better, but it was still down at year end -12%, although at the end of September it touched -20%. Bonds did just as poorly with UK government bonds (Gilts) declining by -23% and the Euro Bond future down by a similar -22%. The latter is now at the same price as in 2011. All the gains in over a decade, lost in one year. It is claimed that bonds are safer than shares, but not last year!

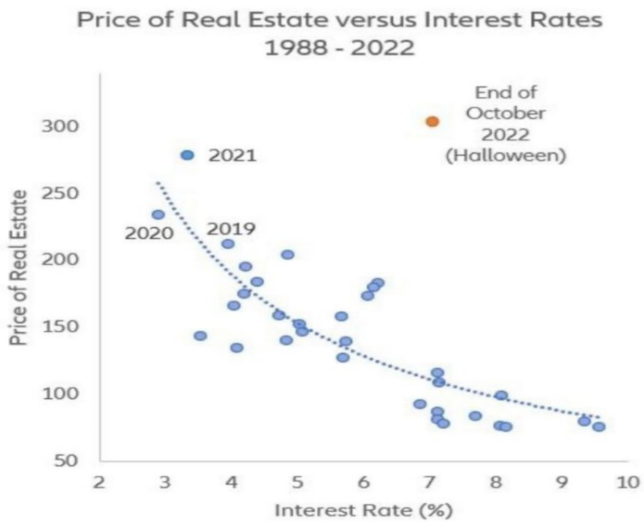
We are not indexing trackers and did much better than the main markets. All Euro and Sterling portfolios were positive for the year, some in double figures. A reasonable return for a normal year, but very good for a year like 2022.

The reason for such a poor year in the investment world is the central bank's policy response to rising inflation. The inflation target is 2% in most countries and as it rose well above that level central banks started to raise interest rates. In the USA they went up from effectively zero to over 4% in less than one year. In Euroland they went from negative to mildly positive and the bank of England also raised rates during the year. While the absolute numbers are low the speed of the rises is new. But with inflation still in the 8% range there is a view rates need to rise further to reclaim the inflation target of 2% per year. If this happens 2023 will suffer a serious global recession.

The question for 2023 is, therefore, will a recession happen and secondly, most importantly, what will be the policy response by the central banks?

Looking at my report last month (Nov 2022) it showed the interest rate curve for the USA and Germany where an inversion is very clear. This points to a recession in 2023. If investors are buying ten year bonds with lower rates than over night deposits it is because they expect over night rates to drop substantially and soon. The only reason for over night rates to do that is if a recession is demanding central banks do something and all they can do is lower the over night deposit rate.

Another factor which can lead to a recession is a collapse in the housing market. Western economies have housing and construction as a key element for growth, activity and consumption. Simply put, if house values rise, consumers then feel rich and spend money, creating activity. If they fall they reduce activity and spend less. The chart below shows the housing situation in the USA.



Price of Real Estate: S&P CoreLogic Case-Shiller U.S. Index.
Interest Rate: US 30 Year Fixed Mortgage Rate.

Clearly, something has to change to bring the situation into line with normal times. Either prices fall by 50% or rates drop. It will probably be a mixture of both. The same is true in the UK and Germany, where house prices are very high compared to interest rates and even more so compared to wages.

Another factor to consider in 2023 is the war in Ukraine. It has already put pressure on energy prices in Europe as the policy response has been to ban Russian energy exports. Up to now only natural gas was impacted but from December 2022 oil and others products have controls. This is not good for European business and risks recession. My concern is that the conflict will expand once the weather improves and that will further expand geopolitical concerns. Statesmanship is clearly lacking on all sides.

An economic recession is a situation where economic activity slows down. Less business, less trade, less sales, less profits and higher unemployment. I well remember the 1970s when this was the situation in the UK. But this need not be a problem for investors. Some companies do well. Some sectors do well. Some commodities do well and here I am thinking about gold.

If rates do fall, as a result of central bank action, as a result of recession, as a result of the points above then in the search for a safe haven gold comes into focus. Russia and China could add to this mix by exchanging oil for gold to avoid the US dollar. Since both are not on good terms with the USA I expect they are considering how they can avoid trading oil in US dollars.

Whatever happens in 2023 we can do well provided we avoid passive index tracking. As the first paragraph points out, it is not a low risk investment strategy and we can do better.

All the best for 2023.

Tim 9 January 2023