JOHNSTON CARMICHAEL WEALTH

Market Update

October 2022

SQUARE MILE INVESTMENT SERVICES

A market and economic commentary on the third quarter of 2022

Economic Backdrop

- The latest figures for Consumer Price Inflation and Retail Price Inflation (which includes mortgages) in the UK are 9.9% and 12.3% respectively. The introduction of the Energy Price Guarantee should prevent inflation soaring much higher, but the recent weakness of the pound increases the cost of everything that has to be imported.
- We remain confident that inflation will soon begin to fall but the great unknown is where it will settle. Labour markets remain tight, giving workers significant bargaining power over wages. The risk of a wage price inflation spiral becoming embedded remains.
- Central banks, led by the US Federal Reserve, have made it clear that bringing inflation under control is their number one priority and have become more aggressive in raising interest rates. It is now being forecasted that interest rates in the UK could reach 5% or even higher.
- Rising mortgage rates and other increases in the cost of living are taking their toll on consumer spending, which is a big component of economic growth. The consensus that economies will muddle through, and that any recessions will be shallow and short-lived, may prove to be too complacent.

Stock Markets

- Global stock markets see-sawed violently in the latest three-month period but finished with losses for the third quarter in a row. Year-to-date global stock market indices have fallen by 21% in local currency terms.
- Although we certainly understand the anguish being suffered by investors, it should be remembered that equities are long-term investments. Volatility and periodic losses go hand in hand with the superior returns that equities have provided over time.
- The UK and Japanese markets once again proved the most resilient in the third quarter, the UK continuing to benefit from its heavy weighting in large multinational companies whose profits have been boosted by the weakness of the pound.
- The declines in stock markets so far this year can mainly be attributed to falling valuations as bond yields have soared. Looking ahead, we believe that corporate profits will become the main driver of share prices.
- Against a challenging economic backdrop, we expect investors to become more and more discerning and stock selection to be increasingly important. Passive managers have trumped active managers over the last year but that pendulum may be about to swing back.
- In portfolios which use actively managed funds, we are emphasising exposure to high quality companies with strong balance sheets and dominant market positions, whose revenues and profits should prove the most resilient in any economic downturn.

Bond Markets

- The rout in bond markets accelerated in the third quarter as central banks signalled that interest rates would continue to rise until inflation is tamed. The re-pricing of bond markets from the absurdly low yields resulting from years of distortion from negligible interest rates and continuous bond buying by central banks has been brutal in both speed and scale.
- The UK gilt market was also sent into a tailspin after the new Chancellor announced a raft of tax cuts which appear to be unfunded and may need to be paid for by yet more government borrowing. The Bank of England was forced to step in to stabilise the gilt market after a meltdown in prices in late September threatened the solvency of defined benefit pension funds.
- After years of offering only miserly returns, yields have risen to levels at which bonds now have some attractions and can perhaps once again be considered as genuine alternatives to equities and cash deposits.

Currencies

- There was no stopping the rise of the US dollar in the last quarter as the US Federal Reserve continued to raise interest rates more aggressively than other central banks. Year-to-date, the dollar has appreciated by 14% against the euro, by 18% against the pound and by 26% against the Japanese yen. These are colossal moves in the exchange rates of major currencies. With many goods, such as oil, priced in dollars the strength of the US currency is making the battle against inflation in other countries even harder.

Alternative Investments

- Despite its reputation as a hedge against inflation, the price of gold continued to fall in the third quarter and is now down by 9% year-to-date in dollar terms. In sterling terms, however, it is up by 10% so far this year. At its current price, gold is not without attractions if you believe that inflation will settle well above the 2% target set by most central banks.
- The price of bitcoin has been unusually stable over the last few months but at the end of September was still 71% below its all-time high set just ten months earlier. The concept of bitcoin is not without its attractions but this has been completely

undermined by the speculative frenzy which developed in cryptocurrency markets in the era of ultra-cheap money. Credibility may never be restored.

- It remains Groundhog Day for daily dealing UK property funds, with the Regulator still to make and deliver any decision about the future of the sector. This stems from the obvious mismatch between funds which offer daily dealing and pricing to investors and the illiquidity and frequency of pricing of the bricks-and-mortar properties in which the funds invest. Both issues could be laid bare if the UK enters a severe recession.

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