# Market Update

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PARK HALL
Financial Services Limited

SQUARE MILE
INVESTMENT SERVICES

## MARKET UPDATE

### Economic Backdrop

- Inflation finally seems to be on the way down and we expect headline rates to fall further in the months ahead. More important, though, is where inflation settles in the medium term.
- Labour markets remain very tight and wages are rising by more than 5% p.a. in the US and 6% p.a. in the UK. This is the pressure point we are watching most closely as, absent improvements in productivity, this is what could sustain a wage price spiral.
- Interest rates are expected to peak at just over 4% in the UK and just over 5% in the US in the first half of 2023. Higher interest rates will take a toll on economic growth but rising unemployment may be the most effective way to curb wage inflation.
- We therefore expect the focus of attention amongst investors to shift from inflation to economic growth in 2023. There are clear risks to the prevailing consensus that any recessions will be mild, that inflation has been conquered and that interest rates will soon be on the way down again.

### Stock Markets

- Despite a spirited rally in the final quarter, global stock market indices fell by just over 15% in 2022, making it the worst year for equities since 2008.
- Whilst 2022 was an unfamiliar and distressing experience for many investors, it should be remembered that equities are long-term investments. Despite 2022's loss, global stock markets have still returned 20% (6.2% p.a.) over the last three years, 42% (7.2% p.a.) over the last five years and a staggering 167% (10.3% p.a.) over the last ten years.
- The declines in stock markets last year were predominantly due to rising interest rates and bond yields, which left share valuations looking overstretched and vulnerable. In general, corporate profits were healthy.
- The US stock market, with its heavy weighting in highly valued technology companies, fell by 19%. In contrast, the UK stock market, which is dominated by much more modestly valued oil companies, miners, banks and tobacco companies, eked out a tiny gain, but only if all-important dividends are included.
- Economic growth is measured in 'real' (i.e. after inflation) terms but corporate profits are reported in cash or nominal terms. It is therefore quite possible for corporate profits to grow in a recession, although control of wage inflation will be critical to protect margins.
- Companies with dominant market positions, and hence pricing power, and strong balance sheets will be best placed to weather any forthcoming economic downturn. We continue to emphasise those characteristics in portfolios which use actively managed funds.

### Bond Markets

- 2022 was truly an 'annus horribilis' for investors in bond markets as the outsized and excess returns they had enjoyed in more than a decade of bond buying by central banks (quantitative easing) and negligible interest rates were erased in the most brutal manner.
- UK government bonds ('gilts') maturing in 10 years time now offer a yield of about 3.6%, up from less than 1% at the beginning of 2022. The big question for investors is whether they should be now be increasing their exposure to bonds.
- Yields are still significantly lower than where they averaged in the decade before quantitative easing began and when inflation was also much lower than it is now. Although some attractive opportunities are now emerging, for example in high quality corporate bonds, we do not yet think that the case for increasing our overall exposure is compelling.

### Currencies

- Despite retracing some of its gains in the final three months of the year, the US dollar appreciated by 13% against the pound and by 7% against the euro in 2022. Despite the recent efforts of Mr Sunak and Mr Hunt to restore fiscal credibility after the disastrous Truss/Kwarteng reign, the UK faces formidable and financial challenges in the year ahead.  Currency markets are notoriously unpredictable, but we would not be surprised if exposure to foreign currencies is again beneficial to returns in 2023.

## Alternative Investments

- Given its reputation as a hedge against inflation, the fact that gold started and ended 2022 at almost exactly the same price (in dollars) in a year when inflation was rampant is a disappointing and perhaps surprising outcome. Long-term expectations of inflation continue to be benign so if you believe that inflation is likely to prove much stickier then gold is not without its attractions.
- The credibility of the cryptocurrency complex was dealt a further blow in November by the collapse of Bahamas-based exchange FTX amidst accusations of fraud and claims that up to US$8bn of investors' money may be missing. Cryptocurrencies sadly epitomise many of the worst features of the speculative bubble inflated by years of ultra-cheap money. Although it goes against the whole ethos of cryptocurrencies, greatly increased regulation may be the only way that credibility can ever be restored.
- The daily dealing UK property fund sector remains in limbo as another quarter has passed without the Regulator delivering any decision about the future of the sector.  Notwithstanding the prospects for the sector in a recession, our concerns remain about the mismatches in both the liquidity and the valuation frequency of daily dealing funds and the bricks-and-mortar properties in which they invest. This seems to us to be an asset class better suited to permanent capital in the form of stock exchange-traded investment trusts.