HARTLEY ROSS

AUTUMN OUTLOOK

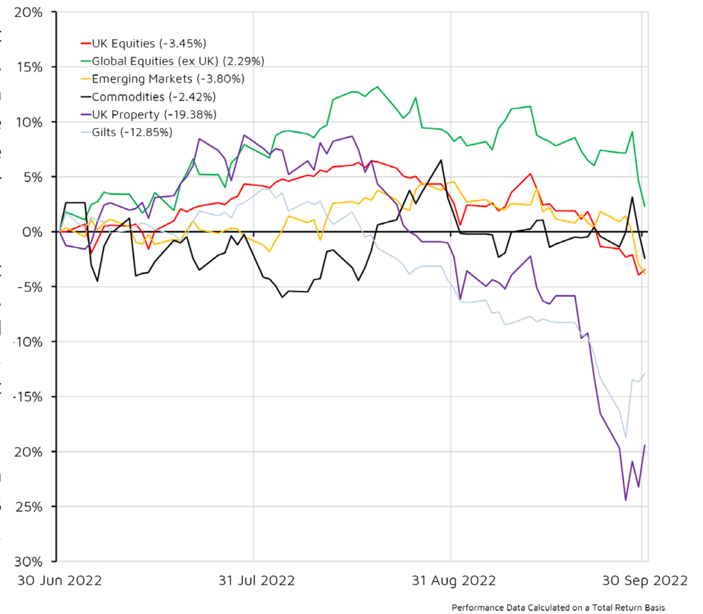
REVIEW OF THE PAST QUARTER:

The end of the quarter saw chancellor Kwasi Kwarteng's mini-Budget cause sterling to fluctuate wildly and UK government bonds to plummet. Investors were rattled by plans to pay for sweeping tax cuts through additional government borrowing. This raised the spectre of more inflation and caused investors to speculate about more aggressive interest rate rises as the Bank of England is forced to clamp down harder on rising prices and shore up confidence in sterling.

For most of this quarter markets have been caught between fear that higher inflation will drive interest rates ever higher and fear of recession. Markets have remained highly volatile as each inflation reading or central bank announcement has reshaped expectations. After a brief rally, government and corporate bonds have fallen steeply as markets adjust to expectations that interest rates will remain higher for longer.

Equities recovered some of the losses from the first half of the year, with growth companies doing well. Disappointing inflation numbers in the US and the fallout from the UK's tax cut plans triggered another decline, although US and Japanese equities held on to some gains.

The Chinese government has stepped up efforts to boost the economy and restore confidence to its property market but its commitment to zero-Covid has been a considerable drag on economic activity. China's slowdown helped oil prices ease and industrial metals have also fallen.



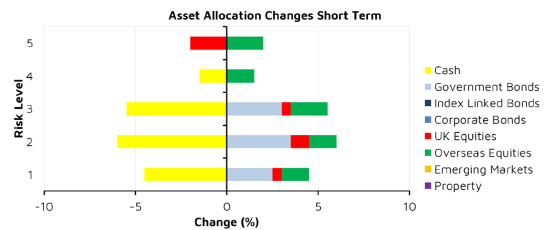
ASSET CLASS RETURNS

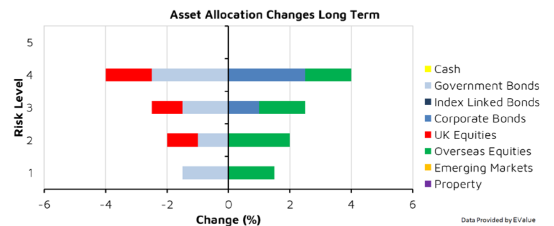
Cash	Government Bonds	Index Linked Bonds	Corporate Bonds	UK Equities	Overseas Equities	Emerging Markets	Property
+0.45%	-12.85%	-9.33%	-11.59%	-3.45%	+2.29%	-3.80%	-19.38%

THE ACTUARIAL VIEW:

Falling asset prices mean cheaper assets and overall expected returns have risen significantly. The impact on fixed-income assets means yields are higher and interest rate risks are less asymmetric. Cash returns should follow interest rates up, but asymmetry in interest rate risk (when rates are very low they can't fall far but can rise) is a positive for cash returns, so the improvement is a little less than for other fixed-income returns. Expectations for gilts are significantly higher in line with the rising yields and the rise of upside potential. Corporate bonds benefit from the same factors but also from the rise in spreads that mirrored the fall in equity prices.

Expectations for equity returns are generally up. In Western markets the outlook for the US has improved the most and, for the UK, the least. There have been structural changes in the Japanese market that make it look more European and so expectations are significantly reduced. A similar conclusion about emerging markets means we should discount their fundamentals less and, as a result, expectations rose significantly.





WHAT TO LOOK FOR IN THE NEXT QUARTER:

- **UK**: CPI data for September will be released on 19 October. The Monetary Policy Committee (MPC) announcements and minutes are set to be released on 3 November. Initial Q3 GDP data will be available on 11 November. August employment data is to be published on 11 October.
- **US**: There will be interest rate decisions from the Federal Open Market Committee (FOMC) on 2 November and 14 December. Minutes will be published three weeks after each decision. Inflation rates for September will be released on 13 October. Change in nonfarm Payrolls will be released on 7 October. Mid-term elections for the US Congress will be held on 8 November.
- **Eurozone**: A European Central Bank monetary policy meeting is scheduled for 27 October. Quarterly GDP flash data and October's inflation reading are set to be published on 31 October. Employment data for September is set to be published on 3 November.
- **Other Data**: The Brazilian general election is scheduled for 2 October. An oil cartel Opec meeting is on 5 October. China's 20th National Congress will be held on 16 October. Third quarter GDP for China will be released on 18 October. JPMorgan Global Composite PMI is set to be published on 5 October.

ASSET CLASS SCENARIOS:

UK EQUITY

Most Likely: Despite interest rate hikes, inflation remains stubbornly high. The country edges towards recession as manufacturing and services decline due to record-low consumer sentiment. Companies tied to consumers suffer but less sensitive areas like healthcare, staples and utilities should prove more defensive. Banks, whose profits are linked to interest rates, should continue to be supported.

Worst Case: Russia further restricts gas exports and prices skyrocket as the invasion of Ukraine drags on into winter. Aggressive rate hikes cause recession, send stocks and bonds plummeting and drive a spike in unemployment. This culminates in the collapse of an unexpected area of the market, leading to a run on the wider market. The UK should be defensive given the lower relative valuation levels, but investors will struggle to find any safe place to hide.

Best Case: Inflation begins to fall without a big hit to unemployment and GDP. This is helped by the government's intervention in energy markets. A peace agreement for Ukraine helps to cool energy and food prices. As more catalysts for a bull market materialise, outflows from UK equities are reversed. Smaller companies will stand to benefit the most from equity markets returning to sustained positive performance.

GLOBAL EQUITY

Most Likely: The US continues to raise rates to deal with inflation that has become entrenched in the system. Central banks will likely cause a slowdown in growth as they accept this as the cost of taming inflation. Defensive sectors like consumer staples and utilities outperform, with cyclical sectors like consumer discretionary and basic materials under pressure as the market prices in a downturn.

Worst Case: Russia cuts energy supplies to Europe, leading to power cuts and the shutdown of sections of industry. Global supply shortages intensify and inflation rises swiftly; and rising prices cause consumers to slash spending. Central banks hike interest rates to a level that causes a deep recession. Energy stocks dominate as prices go to extraordinary levels, and defensive sectors protect better than cyclical areas.

Best Case: An end to the conflict in Ukraine creates optimism that commodities will ease. Inflation cools and central banks are able to reduce the speed and size of interest rate hikes. Economic growth regains momentum, giving a boost to cyclical sectors, while technology stocks rise as the value of future earnings appears greater as inflation begins to recede.

EMERGING MARKET EQUITY

Most Likely: Countries and companies dependent on overseas financing continue to face pressure due to the stronger US dollar. Inflation can be an advantage for commodity-producing markets. However, others are heavily exposed to food imports and these countries will be pressured to continue to increase interest rates, crippling economic activity. Emerging markets are now trading at pronounced discounts to developed markets. This could represent an attractive entry point into the asset class.

Worst Case: Chinese equities continue to feel the effect of regulation and its struggling property market. Further waves of Covid-19 and resultant lockdowns drag on output. A Chinese invasion of Taiwan has the potential to create a global economic shock. While the magnitude of the risk is great, the probability of its occurrence is relatively low.

Best Case: Markets expect inflation to peak by the end of 2022. Interest rates are expected to remain elevated for longer, although a stagnation in rate rises or potential rate cuts would be extremely beneficial for emerging markets. Negative sentiment towards China further depresses valuations, representing an attractive entry point.

CASH

Most Likely: Yields available for money market instruments should improve as the Bank of England continues its interest rate hikes. Nevertheless, the pace of interest rate increases is likely to remain behind inflation and so returns adjusted for inflation is likely to stay negative. These instruments will also suffer from negative capital returns as their price moves inversely to yields.

Worst Case: If more signs of recessions appear, the Bank of England is likely to raise rates less aggressively, hence limiting the upside for money market funds. It will also mean that investors might revisit the case for UK government bonds as safe-haven assets, due to their sensitivity to interest rates. Cash instruments will therefore be a less compelling option for investors.

Best Case: In order to deal with the "mini" budget announced by the newly formed government, the Bank of England may surprise and further hike rates. If so, it is likely that the interest rate curve will steepen. This would improve the expected return from money market funds as managers can lock higher rates at longer maturity dates which may offset the loss from capital return. It would also mean cash will further help investors to protect from downside.

FIXED INCOME

Most Likely: Headline inflation falls due to the cap on household energy bills. However, the Bank of England continues to increase interest rates aggressively in order to control the stickier, core aspects of inflation. Economic fundamentals continue to weaken, which puts downward pressure on corporate bonds, but the safe haven status of government bonds helps to keep a lid on rising yields and falling prices.

Worst Case: Core inflation continues to rise putting pressure on wages and the Bank of England's rate hikes become more aggressive. The beginning of quantitative tightening, combined with heavy issuance to fund the government's energy package, increases the net supply of government bonds. This drives government bonds lower and the removal of market liquidity drives corporate bonds lower.

Best Case: Russia softens its stance on the Ukraine conflict and releases additional gas supplies to Europe. Combined with weakening domestic demand, this alleviates inflationary pressures and allows policy makers to prioritise recessionary risk and loosen monetary policy. Government and corporate bonds rally as a result.

PROPERTY

Most Likely: While recent performance of property companies has been disappointing, the sector has historically performed well in inflationary periods and landlords generally have pricing power. Going forward, favourable fundamentals and a rally in the broader equity market could help the shares of property companies, but macro issues are likely to continue to be a challenge.

Worst Case: Expectations for a weaker economic outlook negatively impact equities, particularly those with a dependence on the economic cycle, such as the property sector. The most economically sensitive sub-sectors – such as retail, offices and leisure – are particularly vulnerable. Rising bond yields continue to have a negative impact on company valuations.

Best Case: Property companies act as a good inflation hedge, helped by their strong pricing power and attractive dividend yields. Fundamentals remain strong in sub-sectors such as industrials, storage and healthcare, where supply and demand dynamics are favourable. Government bond yields stabilise or edge down, making shares in property companies more attractive on a relative basis.

Data Sourced from FE Analytics, and FactSet

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