ROCQ CAPITAL

Third Quarter 2022

As in the first half of the year financial markets exhibited considerable volatility in the third quarter, notably in the last few weeks. A glance at the newspapers or nightly news provides a good pointer to what has been troubling investors all year: a squeeze on the cost of living, rising interest rates and ongoing geopolitical troubles from Ukraine to Taiwan. As a result of this, investor sentiment has been downbeat during the quarter but this has enabled markets to bounce quite powerfully for brief periods, such as in July and early August. However, overall it was a negative quarter with the final three weeks seeing considerable falls in asset markets and taking Q3 returns in local currency terms to -6.6% for the MSCI World index, -5.3% for the US S&P 500 and close to -4% for the FTSE 100 and the Eurostoxx 50 indices.

Inflation and its related impact remain the dominant themes in 2022. Predictions of the inflation rate peaking and declining have so far proved somewhat premature. Some supply-side pressures may be abating but procurement chains remain far from the levels of efficiency seen prior to 2020. The labour market is tight in most developed countries, notably the US, and until this changes via an economic slowdown there may be continued upward pressure on prices as wages continue to rise. UK and Eurozone inflation levels have each reached 10% and in the US it has hit around 9% and appears to be driven by a broad range of factors. Continental Europe and the UK are particularly vulnerable to rising energy prices and despite efforts to increase gas storage ahead of winter Russia's decision to suspend flows through the Nord Stream 1 pipeline in September saw prices rise sharply before falling towards the end of the month. Oil prices have subsided more consistently – down in each month of the quarter for a cumulative -23.4% for the first Brent crude futures contract – which is helpful, including in the US where the "price at the pump" can have a big effect on consumer confidence and spending on other goods.

In this environment, central banks are duty-bound to raise rates and if anything there has been a renewed vigour in their actions during the quarter. This can be expected, with a time lag, to end up hitting economic growth but for now inflation is the priority. The US Federal Reserve (Fed) raised its policy rate by a total of 1.5% during Q3, and the equivalent figures were +1% by the Bank of England and +1.25% by the European Central Bank. Further interest rate rises are expected and on an accelerating timescale compared with three months ago.

Liz Truss became the UK Prime Minister in September following the resignation of Boris Johnson in July and a few weeks of campaigning, marking her early days in office with a package to freeze energy bills. This represents a potentially huge fiscal expansion and an attempt to partly offset the negative impact of rising interest rates. This was only an hors d'oeuvre for a badly-received 'mini-budget' in late September that set out sweeping changes to taxation and other areas of economic policy. UK government bonds, already weakening in August as Truss's expenditure and tax cut plans spooked the markets, suffered huge falls in price as yields spiked dramatically, with intense selling occurring in response to the unfunded tax cuts and prospect of an increased supply of gilts. For the quarter as a whole, the total return of the UK broad gilts index was -12.9% as yields of all maturities jumped by astonishing amounts. This caused serious problems for large defined-benefit pension schemes, resulting in the Bank of England stepping in to purchase long-dated bonds to stabilise the market. Schemes have had to sell whatever they can to meet cash calls, which has put downward pressure on the prices of UK corporate bonds and equities.

The pound has been very weak against the dollar throughout the quarter, but not especially against other peers, as the US currency has appreciated strongly in response to the Fed's actions and a relatively robust American economy. Sterling lost 9% against the dollar but less than 2% against the euro.

In the US, President Biden won a couple of notable legislative victories this summer which will open the way to large investments in the semiconductor and renewable energy sectors. These could be significant in the long term and the US may emerge again as a leader in these important fields. On this time horizon, the US continues to look a more dynamic economy than Western Europe and Japan, with interesting investment opportunities as a result.

Outlook

For a sustained move higher in equity markets, evidence that inflation has decisively peaked is probably needed. This would give central banks confidence to cease raising rates and would encourage bond yields to drop, which should support stocks in higher growth sectors such as technology and healthcare. The official economic data and everyday experience suggest we are not at that point yet, and the path of inflation is extremely difficult to predict. However, with oil prices falling and mounting evidence that global supply chain disruption is easing we could start to see signs of this before the end of the year, especially if economic growth slows due to squeezed consumer spending. While the Fed appears fixated on headline rates of inflation, which are reported with a time lag, some of the more forward-looking measures have begun to fall quite markedly particularly in the housing market. More difficult to shake may be inflation psychology as many businesses have been able to raise prices and workers have been emboldened to seek higher pay, sometimes via industrial action.

There are a lot of well-publicised, challenging factors to contend with and it can be tempting to retreat into negativity when contemplating the difficulties facing businesses and households at present. However, investors are aware of these and market prices have corrected this year to reflect many of these risks – though the degree to which such factors are fully "in the price" is a matter of intense debate. Looking over a one-year horizon, or longer, we would reinforce the point made in our last quarterly commentary that we do seem to be at an attractive point for many stocks – and possibly now for some government bonds as well, which have suffered an exceptionally large sell-off this year. We have therefore retained what we see as a reasonable weighting in equities while continuing to complement this with our Alternatives allocation as a diversifier of risk and source of positive returns. Now does not seem the moment to make punchy bets on the future direction of markets or their current drivers, such as inflation, but rather to ensure we have a suitable blend of investments that can perform robustly and generate growth in a variety of environments.