Edition 27

Caves Quarterly

Q3 2022 Round Up

Darkest Before The Dawn

It was another volatile period which saw investor sentiment turn deeply negative, with both equities and government bonds moving lower after a short-lived summer relief rally. Geopolitical risk remained heightened with no sign of a ceasefire in the Ukrainian conflict, despite progress being made in pushing troops back and recapturing Russian-held regions over recent months.

The central themes driving markets over the third quarter continued to be concerns over rapidly rising interest rates, the risk of recession, elevated energy prices and the ability of global central banks to manage the threat of inflation against a backdrop of weaker demand and a deterioration of leading economic indicators. Hopes for a soft landing for the global economy all but disappeared following a higher-than-expected August US CPI print and decisively hawkish comments made by the US Federal Reserve (Fed) during their September policy meeting.

Recession across much of Europe, the UK and the US now looks increasingly likely as the main western central banks (the Fed, the Bank of England, and the European Central Bank) continue with aggressive rate hiking cycles in the face of slowing growth.

Closer to home, tributes poured in from around the world in response to the passing of Her Majesty Queen Elizabeth II, the UK's longest serving monarch. We also saw the Conservative Party leadership conclude, with Liz Truss defeating former Chancellor Rishi Sunak. In the weeks that followed, Truss announced a multibillion-pound energy support package to shield households from the cost-of-living crisis and her newly appointed Chancellor, Kwasi Kwarteng, delivered a 'fiscal event' aimed at stimulating the UK's flagging economy.

His 'budget that wasn't a budget', unveiled large unfunded tax cuts which sent shockwaves through financial markets as mortgage providers, struggling to make sense of longer-term funding costs, temporarily removed products from the marketplace. The BoE was forced to stage an emergency intervention in bond markets, as significant moves in gilt yields (the cost of borrowing for the UK government) posed what they described as a "material risk to financial stability".

Global Equities

The UK's FTSE All-Share Index registered a decline of 4.5% over the 3-month period. The Chancellor's fiscal package was poorly received in financial markets as gilt yields soared to their highest level since the global financial crisis and sterling fell to all-time lows ($1.035) against the US dollar.

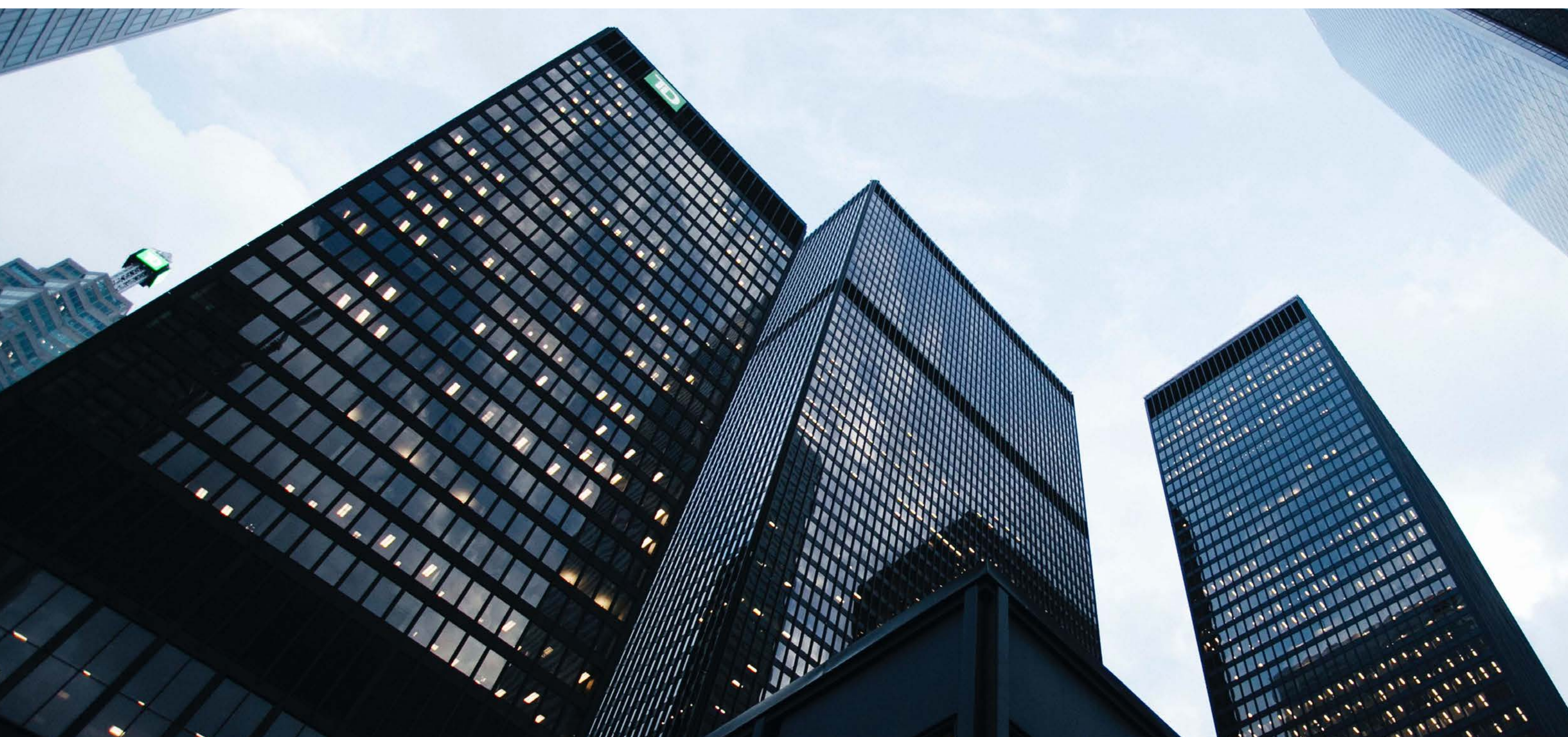
Fears around the impact of rising energy bills saw consumer confidence fall to record lows in September, weighing on sentiment towards more economically sensitive stock sectors and smaller companies operating across travel and leisure, retail, and housebuilding. As beneficiaries of weaker sterling, the large multi-national companies of the FTSE100 index that generate significant overseas revenue streams outperformed their domestically focused counterparts.

Having reaffirmed their commitment to squashing inflation at August's Jackson Hole summit, the Fed hiked by 75 basis points in September, taking the federal funds rate to 3.25%, its highest level since 2008. Whilst tighter monetary policy has proved effective in cooling down some areas of the economy, such as the housing market, inflation remains sticky, and the US labour market is red hot with two available job vacancies for every unemployed worker. Whilst inflation is expected to moderate in the coming months, substantial household income gains are putting pressure on the Fed to act now. Restrictive monetary policy is now widely expected and will see the Fed engineer an economic slowdown in a bid to deter consumer spending.

Concerns over the resilience of the US economy were reflected in markets with the S&P500 and Nasdaq indices down 5% and 8% respectively through the third quarter.

Turning to Europe, the bloc has been hit particularly hard by the fallout from Russian's invasion of Ukraine, with rising food prices and spiralling energy costs weighing heavy on consumer and business confidence. Economic data released over recent months pointed to a deceleration in growth across the region, but inflation remained stubbornly high, reaching 9.1% year on year in August. Russia terminated gas flows through the key Nord Stream 1 pipeline during September and government support packages to the tune of almost €400 billion were announced to ease the ongoing energy crisis. European equities, as represented by the Euro Stoxx 50 index, declined 4% over the quarter.

A prolonged crash in real estate markets, and a strict Covid-19 policy which has seen further lockdowns, travel restrictions, and mass testing is taking a heavy toll on China's spluttering economy. Retail sales have slowed and the government's regulatory crackdown on big technology companies has seen big layoffs with youth unemployment rising to almost 20% as a result. Beijing pledged economic support through rate cuts, tax breaks and large-scale infrastructure projects, but this was not sufficient to buoy financial markets, with the Hang Seng index registering a negative return of 21% over the 3-month period. Corporate earnings in Japan came in ahead of expectations, resulting in a period of relative outperformance for the Nikkei 225 index, which moved 2% lower since the end of June.



Fixed Interest

We have witnessed heightened volatility in global fixed income markets, with government bond yields moving higher and spreads widening in credit markets against a backdrop of hawkish central banks.

In what was a disappointing period for government bonds, the UK stood out as an underperformer, as gilt yields rose sharply in response to the energy support measures and the widely criticised tax cuts announced in the 'mini-budget'. The yield on the UK 10-Year Gilt increased from 2.24% to 4.10% over the third quarter. The US 10-Year Treasury Note yield rose from 3.02% to 3.83% over the same timeframe.

Sterling investment grade and high yield bonds were the worst performing sectors within global credit, as investors attached additional risk premia to UK debt markets. Whilst credit spreads have widened to reflect weaker economic growth prospects, spreads remain near long-term averages, which suggests the market in general is not yet priced for a full-blown recession.

Commercial Property

The real estate sector has been under intense pressure from rising bond yields and the market mood turned sour in August and September following a broadly positive first half of the year.

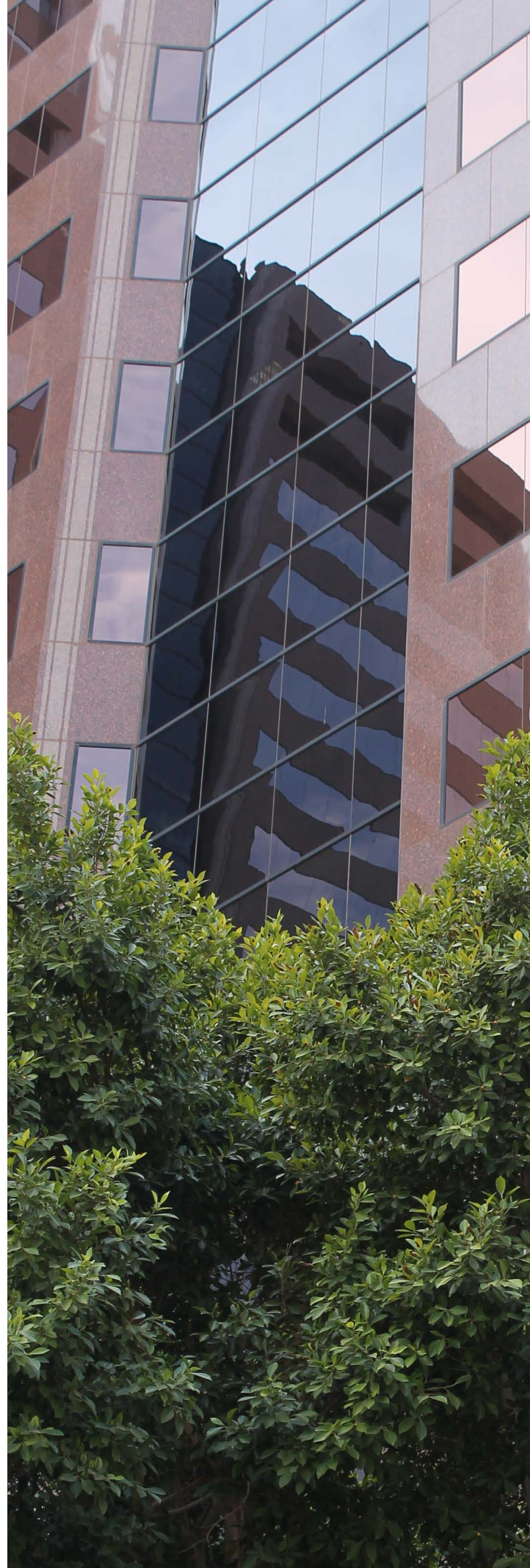
Rising gilt yields coincided with sharply widening discounts across the London-listed Real Estate Investment Trusts (REITs), as investors priced in higher discount rates, and ultimately higher yields, for investment vehicles with illiquid assets and irregular Net Asset Value (NAV) updates.

Alternatives

Commodities gave up some of their year-to-date returns with oil prices retreating on global recession worries.

Having started the period slightly below $115, the price of Brent oil ended the month of September at $85 per barrel. Expectations for OPEC+ (Organisation of the Petroleum Exporting Countries) production cuts provided support towards the end of Q3.

Precious metals struggled as non-interest-bearing assets (potential for capital gains only) such as gold have become increasingly neglected amid higher real yields. The record strength of the US dollar served as an additional headwind to gold, which closed out the third quarter at $1,685 an ounce.



Outlook

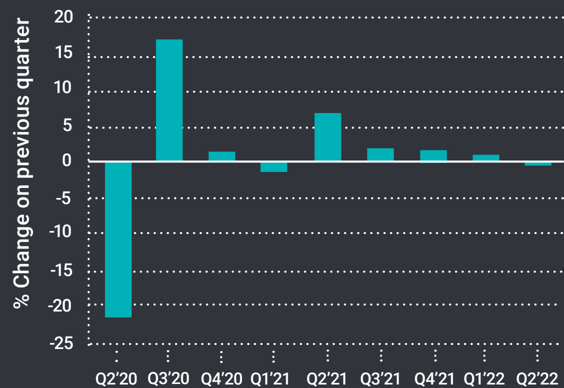
As we head into the final months of the year, recession across the eurozone and the UK is seemingly unavoidable and the probability of a similar outcome for the US economy is rising.

Given the very clear message from central banks that bringing inflation back in line remains the key priority, more short-term pain could be expected by way of earnings downgrades, profit warnings, corporate loan defaults and heightened market volatility.

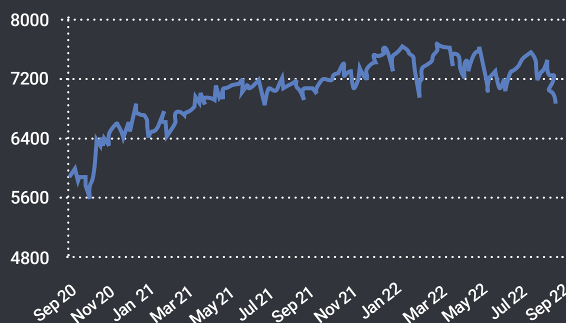
In a difficult year which has seen all major asset classes trend lower, positive returns have been hard to come by for investors. Whilst the outlook remains challenging, equities and bonds have repriced dramatically, providing some reassurance that Mr. Market may have already accounted for much of the bad news. In times of extreme market stress, it is not uncommon for investors to want to sell out of risk assets and seek safety in cash, waiting for an opportune time to reinvest. We would caution against this 'market timing' approach and remain fully invested in order to participate in the strong rebounds that have historically followed challenging market periods.

UK Consumer Prices Index (CPI)

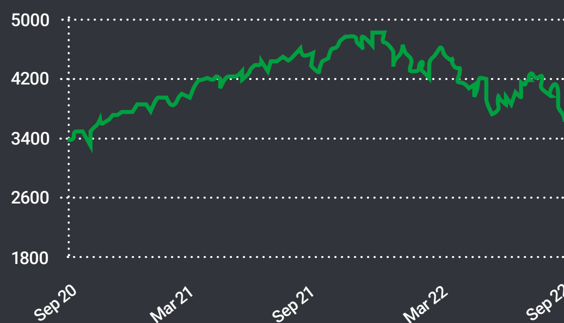
UK Gross Domestic Product



FTSE 100 Index



S&P 500 Index



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