Alpha Beta
PARTNERS

# INVESTMENT UPDATE

## NOVEMBER 2022

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An understanding of the economic and investment environment in which we operate is super critical to investing success and perhaps has rarely been more acute. As such we begin with a well-known quote from Ben Foster Wallace – two young fish swimming along happen to meet an older fish swimming the other way, who nods and says, "Morning guys, how's the water?" The two young fish swim on and then eventually one turns to the other and says, "What the hell is water?"

October has historically been a bad month for markets, some of us recall the 1987 crash. However, this time markets have proved a little more convivial with Europe +6% and the US +4% or thereabouts during the period. Of course, UK proved to be an outlier for specific domestic reasons. The unfunded so-called mini budget impacted fixed income and particularly Gilt markets in anything but a mini way. Gilt yields spiked higher and capital values plunged lower, turning the hitherto "risk free asset" into something akin to Bitcoin in terms of volatility. When volatility soars in such a way, a weak spot is typically found. The massive defined benefit pension schemes of local authorities, amongst others, were adversely impacted and ran a short-term risk of becoming insolvent. An extraordinary situation which brought unwelcome volatility to lower risk portfolios everywhere. Order is now largely back in place following the domestic upheaval.

Global market sentiment is bearish as inflation remains public enemy number one and interest rate policy around the world is inclined to tighten further to bring it to heel. We do feel inflation in US has peaked and the historically strong US dollar acts as a further brake. There are some signs of easing and the flow of goods throughout the economy continues to improve. Elsewhere, inflation remains persistent and at home, UK rose into double digit territory reminding us of the 1970s. Interest rate momentum is the fulcrum upon which sustainable progress for markets pivots and a closer examination follows.

As ever, what happens in the United States will set the scene further afield. The Federal Reserve remains the de facto global central bank and the US dollar the global reserve currency. We expect US rates to rise 0.75% in November, thereafter a rise of 0.5%, followed by at least a further 0.25% early in 2023. Interest rates in US are likely to peak around 5.00% and will effectively sit on top of inflation as it falls. We envisage a pause before the Federal Reserve finally pivots and begins to gradually ease monetary policy later in 2023. Equities are a super-efficient asset class and will likely begin to move positively ahead of time. Of course, this remains a dynamic situation and things can and do change. In the intervening period we expect to see more bear market rallies and reversions – beware of "fool's gold".

Economies are likely to continue slowing towards recessionary territory which historically has been an emphatic if somewhat brutal methodology by which to kill the inflation dragon – as shown in the chart that follows. We note the rapid slowdown of the US residential housing market, clearly linked to higher borrowing costs and increasingly less certain employment tenure.

**Does inflation come down with a recession?**
**History says: yes, big times.**

| Year* | # Months for CPI to slow to 2% | Peak CPI ahead of recession | Low in CPI after recession | Change in CPI (peak to trough) |
|---|---|---|---|---|
| 1923 | 6 | 3.6 | -0.6 | -4.2 |
| 1926 | 7 | 4.7 | -3.4 | -8.1 |
| 1929 | - | - | - | - |
| 1937 | 9 | 5.1 | -4.1 | -9.2 |
| 1945 | - | - | - | - |
| 1948 | 11 | 10.2 | -2.9 | -13.1 |
| 1953 | - | - | - | - |
| 1957 | 16 | 3.7 | 0.3 | -3.4 |
| 1960 | - | - | - | - |
| 1969 | 30 | 6.2 | 2.7 | -3.5 |
| 1974 | 24 | 12.3 | 4.9 | -7.4 |
| 1981 | 41 | 14.8 | 2.5 | -12.3 |
| 1990 | 16 | 6.3 | 2.6 | -3.7 |
| 2001 | 13 | 3.7 | 1.1 | -2.6 |
| 2008 | 5 | 5.6 | -2.1 | -7.7 |
| 2020 | - | - | - | - |
| 2022-2023? | ? | ? | ? | ? |

**Average (1922-2022)**

| # Months for CPI to slow to 2% | Peak CPI ahead of recession | Low in CPI after recession | Change in CPI (peak to trough) |
|---|---|---|---|
| 16.2 | 6.9 | 0.1 | -6.8 |

**Period colored in grey (and ignored for analysis) when CPI <3% entering the recession*

**Source:**
The Macro Compass

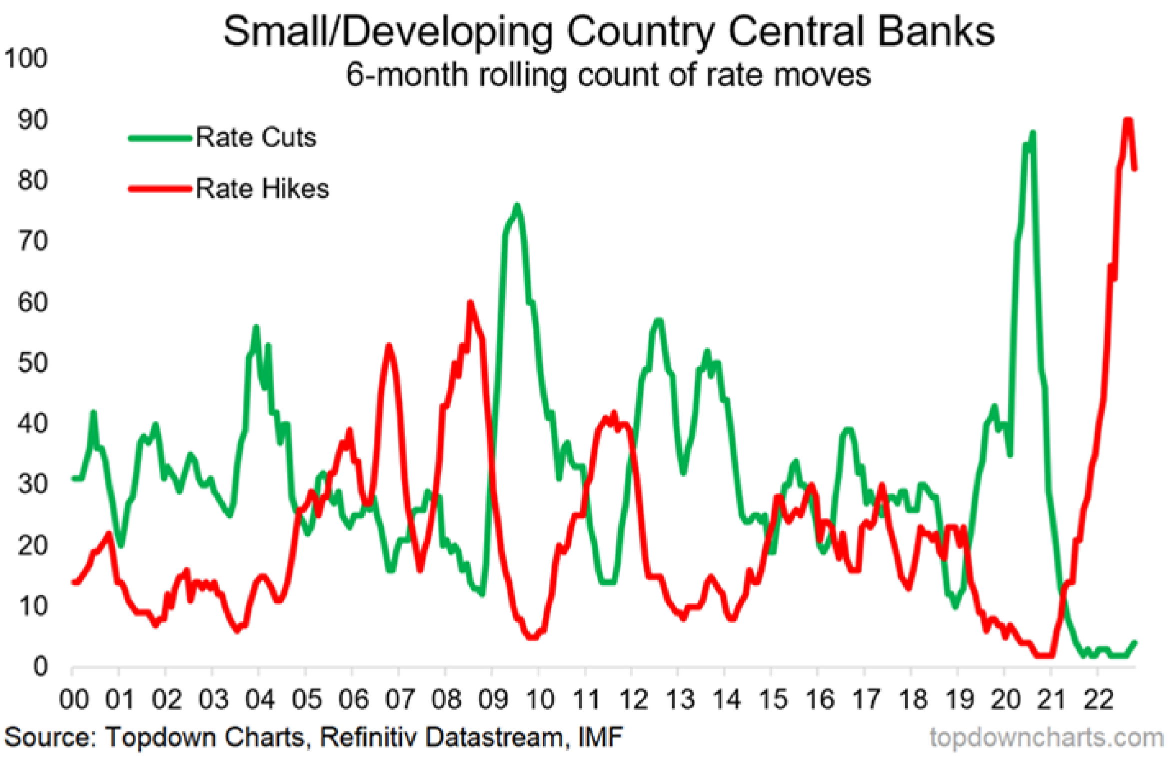
The latest earnings reports from US larger companies have been broadly positive at headline level, although revenues are trending lower. This has fed through to valuations although still not cheap by historic levels if one includes the 5 technology giants such as Microsoft and Apple. Beneath the surface however, many US companies are now trading at attractive valuations and exporters may be boosted further as the US dollar weakens into 2023 in direct relation with easing interest rate policy.

A warm autumn has eased panic around natural gas prices which have fallen sharply as storage facilities are full to the brim in Europe. The ECB are clearly mindful of the potential damage a steep economic slowdown aggravated by rising rates can bring. We noted a distinct change of tone in the summary and forward view presented by Mrs Lagarde (ECB President) following their most recent meeting.

We would expect more restrained interest rate moves in Europe compared to US because of a far weaker Eurozone economy. The Russo/Ukraine war appears to be bedding into an attrition phase during winter. Of course, this geopolitical risk impacts all major markets.

Meanwhile Japan continues to defend its low interest rate culture with ever-more yield curve control measures. This defensive strategy is working currently, and inflation remains broadly subdued although the yen trends weaker still against major currencies. Whilst worrying at some levels the boost for Japanese exporters is strong and positive. China's economy has already slowed significantly due to a range of factors including zero-tolerance Covid-19 lockdowns, a real estate debt crisis, political interventions in fast growth technology industries and a steady reshoring strategy from the US and other western governments. The Chinese Yuan appears to be steadily devaluing which will enhance export prospects and lower rates and economic stimuli are likely.

We track monetary policy interest rate moves across the developing nation central banks. This measure is used to detect the earliest signals that mainstream central bank policy, and of course particularly that of the Federal Reserve is showing early signs of peaking. So, it is very interesting to see the pace of rate hikes clearly peaking, and even the earliest stirring of the rate hike tracker line nudging down, as shown in the chart below. This helps us be more confident as we look further out and hopefully project this confidence to clients and investors.




**Source:** Trading View

Portfolios remain unaltered during the month with elevated cash levels and a defensive stance with higher levels of exposure to the US dollar. This positioning has benefitted performance in recent times. So, in conclusion, this remains a complex market and one where global economic synchronicity is less obvious than it once was. Returning to the Ben Foster Wallace quote – it is perhaps more important than ever to have a detailed knowledge and understanding of one's investment environment.

We retain a vivid focus on markets and their leading indicators.  Progress towards a resumed upward path is certainly underway, albeit at an early stage but with some positive indicators now detectable.

**Written by the Alpha Beta Investment Team.**

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defaqto EXPERT RATED DFM MPS on Platform 2022

defaqto EXPERT RATED DFM MPS (Platform) Family 2022

*The Five Diamond rating awarded on Alpha Beta's Core portfolio range.*

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