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# **Near the end of Tightening**

Since our last update, the bear market rally seen in the summer months has fizzled out, as global central banks continued to signal they will increase interest rates to reduce inflation, even if it is at the expense of economic growth, employment, and potentially, corporate profits.

As a result, increased levels of pessimism and a lack of confidence have crept into the minds of market participants and investment clients alike, with the question "how long will this last" being increasingly asked.

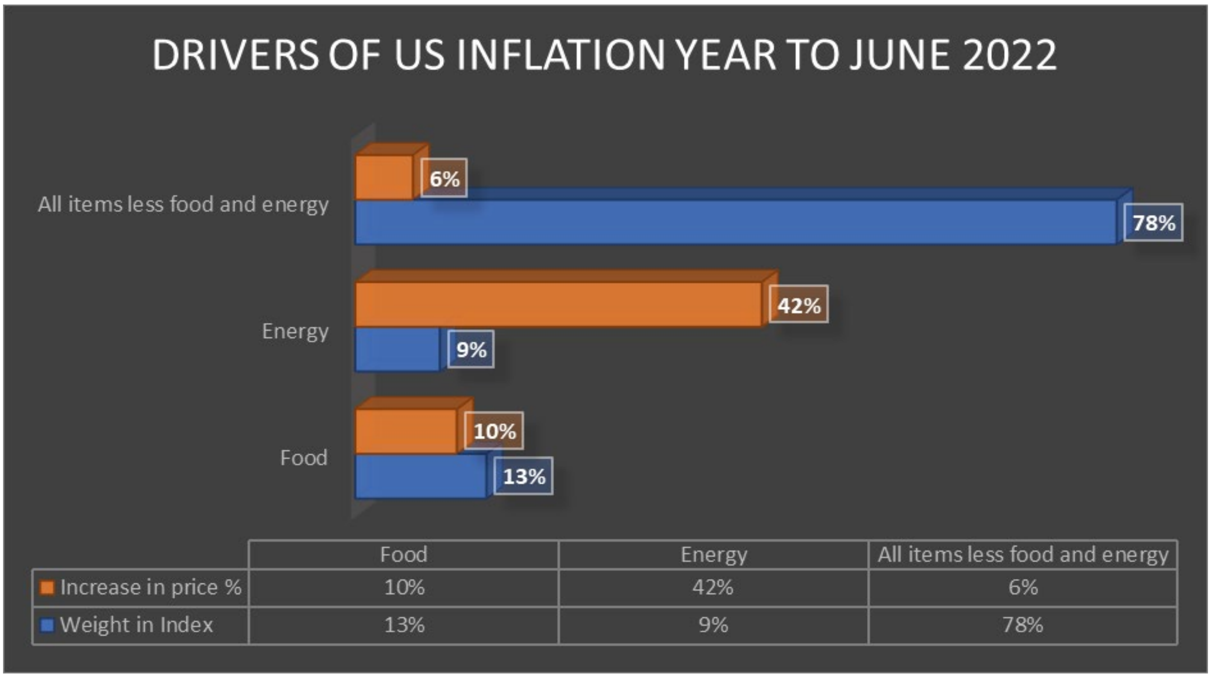
Using history as a guide, the U.S and global markets have suffered declines in the past, with the Wall Street crash in 1929 that started the Great Depression being the most notable. The oil supply crisis plus the unpegging of the U.S. dollar from the Gold Standard and the consequent recession caused a severe market downturn in 1973; the 'Dotcom Bubble' in the year 2000 saw a severe downturn; the Great Financial Crisis of around 2008 to 2011 was precipitated by the subprime mortgage crisis in 2008; and more recently of course we have had the Covid-19 and lockdowns-induced setback to the global economy. All of the above have led to market downturns of varying degrees of severity, however measured in terms of time elapsed from peak markets to troughs, none of these falls in fact lasted for very long.

As of December 2021 according to Ned Davis Research, S&P 500 Index declines of 20% or more (defined as a bear market) between 1929 and 2021, on average lasted for 289 days, which is roughly 9.6 months, with the average fall recorded being some 35.62%. *Note that on the basis of the same research, this time span is significantly shorter than the average length of a bull market, which is defined as stock prices rising typically by at least 20% over a two-month or longer span, with high investor confidence and strong economic growth.*

The current bear market in the U.S. S&P 500 Index was confirmed on June 13th 2022, but the market began its slide from all-time highs seen in late 2021, on 3rd January 2022. Taking this date as the start of the current bear market, and crudely considering the average bear market as lasting 289 days, implies that the current downturn could or would end around 19th October 2022.

Obviously, this is too simplistic an approach to take in trying to define when the current market downturn may end, but as the central banks' response to thwarting underlying inflation has been the main culprit behind depressed markets, from an inflation and economic viewpoint, we should ask where are we now as regards inflation and interest rates?

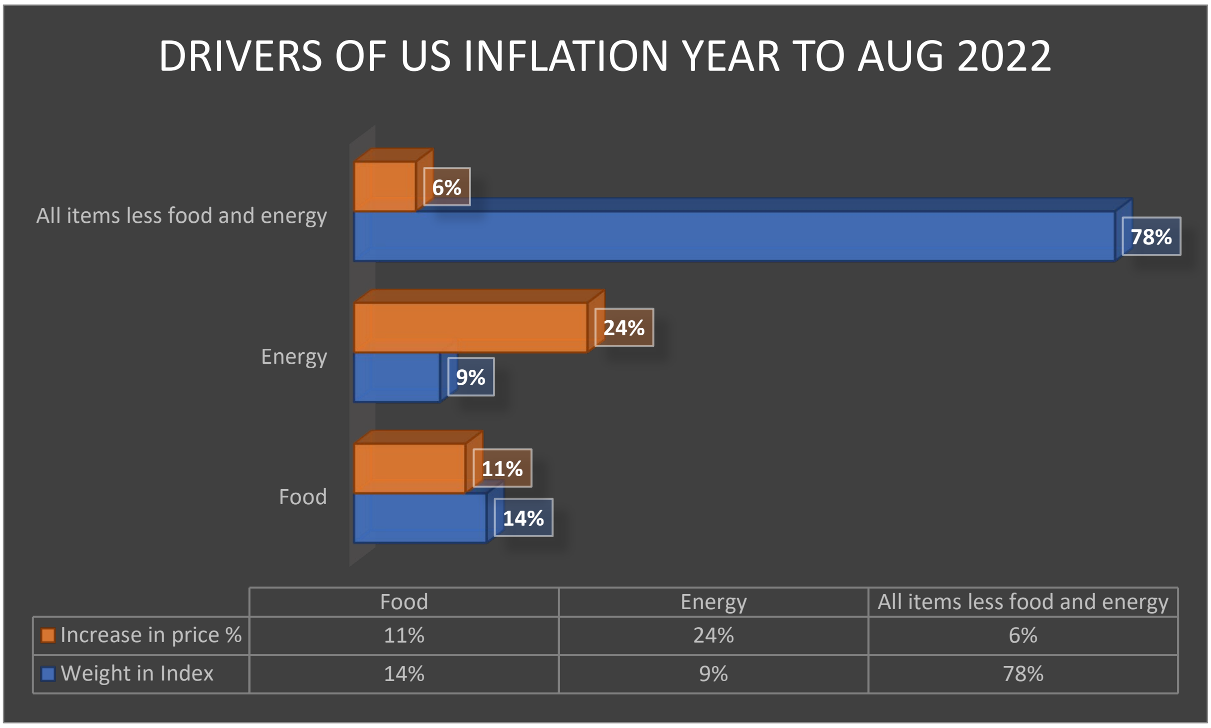
In our last letter we defined the main drivers of inflation in the United States as follows:




| | Food | Energy | All items less food and energy |
|---|---|---|---|
| Increase in price % | 10% | 42% | 6% |
| Weight in Index | 13% | 9% | 78% |

Source: US Bureau of Labor Statistics/MPL

The increase in energy prices was clearly a major driver of inflation year-on-year at this point.




| | Food | Energy | All items less food and energy |
|---|---|---|---|
| Increase in price % | 11% | 24% | 6% |
| Weight in Index | 14% | 9% | 78% |

Source: US Bureau of Labor Statistics/MPL

By August, whilst there was a marginal increase year-on-year in prices of food, there had been a significant fall in energy prices year-on-year from +42% down to +24%, which has culminated overall in the unadjusted percentage annualised increase change in US CPI inflation falling from 9.10% to 8.26% in the three months between June and August. We hope that this is a positive trend which will continue.

The above numbers are lagging indicators, which focus on past events effectively, and whilst the fall in the energy inflation component has helped, supply-lead inflation remains sticky with leading indicators such as the Purchasing Managers Indices (PMI), which look at corporate spending intentions, providing us with a more up to date picture of the US economy.

The US Manufacturing PMI survey for September registered 50.9 (50.0 is the dividing line between growth and contraction), indicating that the US economy expanded for the 28th month in a row after the last contraction in April and May 2020, but at the lowest rate since the pandemic recovery began.

Panellist companies in the PMI survey noted four straight months of softening New Orders rates, with companies adjusting to potential future lower demand by managing head counts through hiring freezes. But the absence of any large-scale layoffs being announced to date, implies continuing corporate confidence in near-term demand for their products, and in their medium-term employee head counts. For many companies the supply chain remains constrained on necessary or critical items for production of finished goods, with staffing on the production side also often remaining in short supply, whilst overall demand for finished products remains strong - with obvious consequences for inflation.

Readings on manufacturing inputs - defined as supplier deliveries, inventories, prices and imports - have all accommodated some growth. Inventories have increased as companies manage total supply chain inventory and move from a 'just in time' to a 'just in case' basis of production. The Manufacturing Prices Index, which measures input or cost of production prices manufacturers have to bear, decreased overall for a sixth straight month and is near to contraction territory below 50, which in part is a feed-through from the decrease in energy prices mentioned above.

In the US's Services PMI survey for September, companies echoed similar sentiments, survey respondents noting that "there have been improvements regarding supply chain efficiency, operating capacity, and materials availability; however, performance remains less than ideal. Employment continued to improve despite the restricted labour market."

The latest 'Non-Farm Payrolls' jobs Report in the U.S. showed that payroll growth has slowed, from a rise of 315,000 reported in August, to the 263,000 reported for September. Whilst September's jobs report was the weakest monthly read since April 2021, it is still strong in comparison to the pre-pandemic average.

Source: Bureau of Labor Statistics, Morningstar. Seasonally adjusted. Data as of September 2022.

Taking the above factors into consideration, we are beginning to see early signs of year-on-year price rises easing, and supply chains and inventories improving. At the same time, jobs growth remains solidly positive and demand in the manufacturing and services sectors remains reasonably robust.

This all feeds into the expectation that the US Federal Reserve may deliver at least one more aggressive interest rate hike of 75 basis points (0.75%) in early November, which will inevitably stoke further fears of a full-blown recession in the U.S.

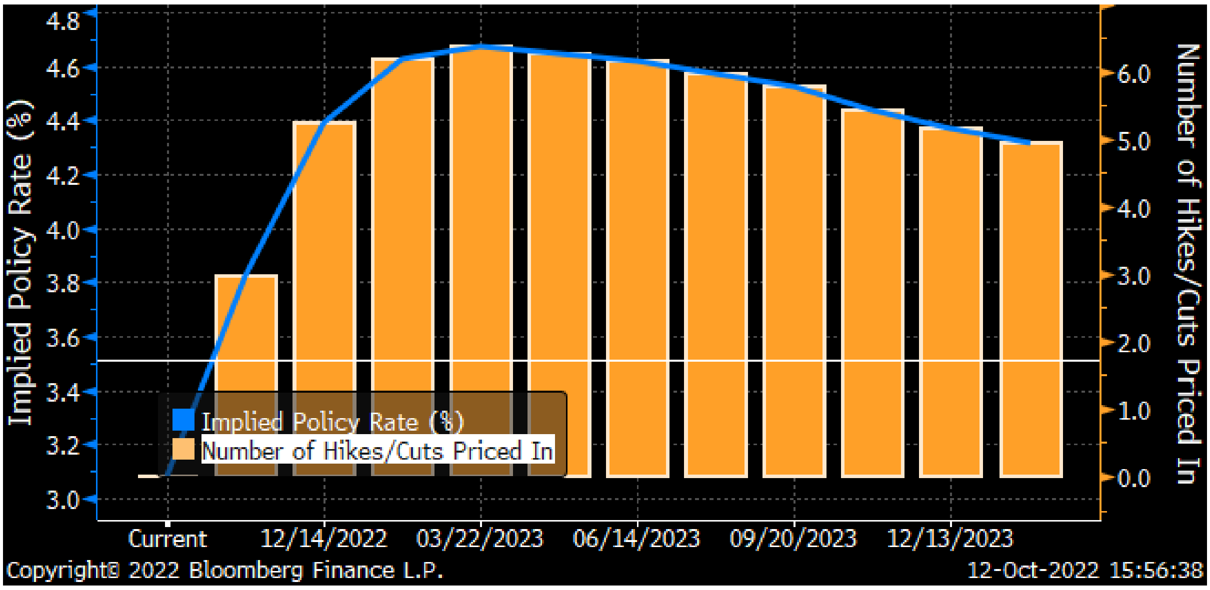
Such a hike would take the Federal Funds Rate target to 3.75% to 4.00%, which is up dramatically from the start of the year, when the Fed Funds rate was at zero to 0.25%. For the December Federal Reserve meeting, the market now sees a circa 70% chance of an additional 0.50 percentage point increase, which would bring the rate to its probably maximum level of around 4.50%.

Morningstar chief economist Preston Caldwell recently stated: "In the face of ongoing high inflation, only steep job losses would impel the Fed to slam the brakes on rate hikes," and based on the information noted above, there is no evidence of this so far.

With the macro-economic and central bank position discussed as above, we can finally point to the interest rate futures market, so as to give an indication of where we are now, in respect of expected interest rate rises going forward and ultimately the central bank fight against inflation.

The following chart shows the implied overnight interest rate and number of hikes/cuts which are currently priced into the futures markets in the United States:

**U.S Implied Overnight Interest Rate and Number of Hikes/Cuts Priced In**

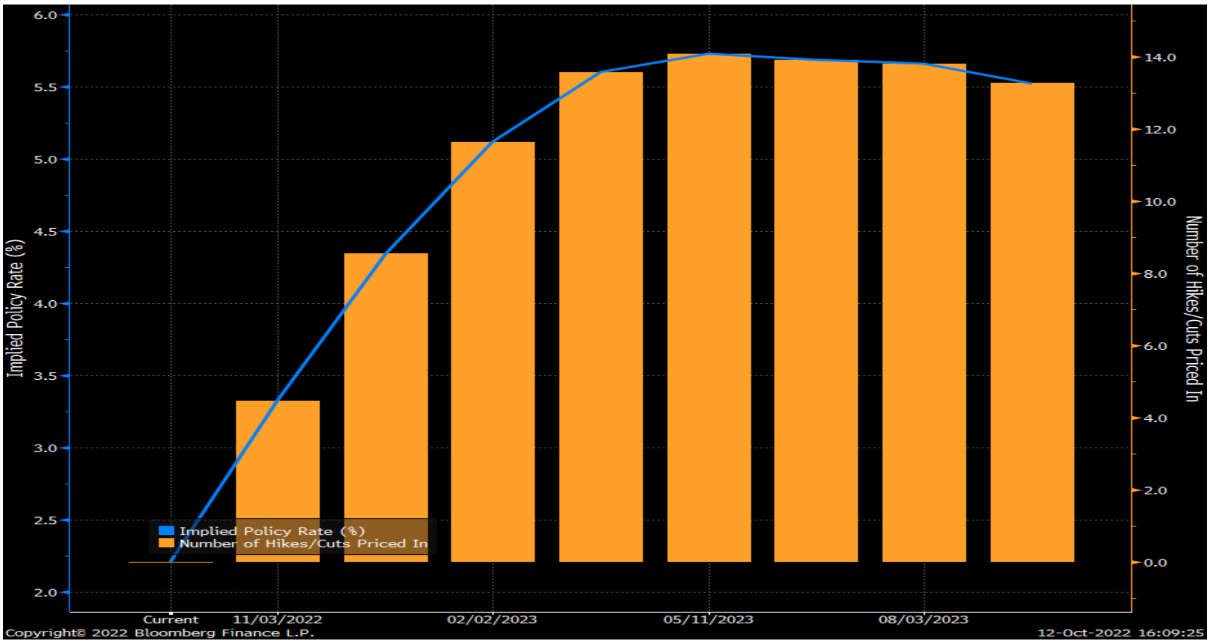



Source: Bloomberg

At present the target rate is 3.25% with current pricing suggesting that the interest rate cycle in the U.S. will peak at circa 4.50% - 4.75% by late March 2023.

We see a similar picture here in the U.K with the base rate currently at 2.25%, while the implied price in bond markets has the base rate between 5.50% - 5.75% by Mid May 2023.

**U.K Implied Overnight Interest Rate and Number of Hikes/Cuts Priced In**



The reasoning behind and basis for this update focusing on events and metrics in the United States, is primarily because what happens there will impact global financial markets. According to The World Bank and Credit Suisse, the estimated market capitalisation of every publicly-listed company in the world combined, is approximately $94 trillion. Some 59.9% of this value is held in the U.S. stock markets alone, so what happens in the US affects everywhere else effectively, and this is what makes the Greenback the world's reserve currency. Japan is next in line, with a global market share of 6.2%. The UK is third at 3.9%, followed by China at 3.6%, and France fifth at 2.8%.

If the above indicators are correct, then we are potentially less than six months away from the end of the Federal Reserve rate tightening cycle. As financial markets are forward-pricing mechanisms, typically looking ahead and discounting by some 6-8 months, we should be close to this prospect of peaking and then flattening rates being already fully priced in to market values.

This implies that by late March this tightening cycle will have tamed current levels of inflation, although we may have to contend with a higher level of ongoing future inflation of say 3%, rather than an original target of 2%. If this is the case, and a deep recession in the U.S. is averted, we posit that this will result in a favourable environment for financial markets.

**Current portfolio changes**

In late September we had hoped to begin the process of deploying the high cash weighting currently held across client portfolios. We have waited a while longer however, as the recent financial disruptions caused by the new government front bench here in the UK, plus further hawkish commentary from the US Federal Reserve, have led to a further increase in market volatility as market participants returned to their desks after the summer break to find these various factors affecting the outlook.

This has however put us into a position where we are now able to redeploy a portion of this cash weighting into the markets at more attractive levels, and indeed into areas of financial markets which have been substantially altered.

<u>Cash deposits</u>

After 15 or so years, we are delighted to be able once again to access on behalf of our clients, short-dated cash deposits at interest rates only previously available to institutional investors, this via the MPL cash management service.

Whilst we will be writing shortly to all clients in respect of the initiation of this service, we will in the immediate sense be using one-month cash deposits at banks such as Barclays, for a portion of the cash weighting which we are yet to deploy back to investment markets.

Recent conversations with clients have revealed that little interest is payable upon cash deposits held individually with retail banks, despite the sharp increase in the UK base rate over the past seven months.

In one instance an interest rate of 0.50% per annum up to a sum of £25,000 (0.30% per annum on more than £25,000) is being paid on cash deposits by one retail bank.

This contrasts with the gross 1-month interest rate of 2.30% pro-rata offered by Barclays Bank (0.19% gross interest per month), which MPL is now able to access for clients. This obviously is a significant uplift upon interest rates currently available to retail investors, and in the example given above, is over seven times the retail rate offered on sums under £25,000.

Income Producing Assets

Volatility and concertedly upward movements in bond yields of late have impacted all manner of income producing assets (including the cash deposits mentioned above), as valuations of these assets have adjusted downward to reflect the sharp increase in bond yields.

We will shortly be increasing our weightings of assets in areas such as UK Commercial Property, Infrastructure, Global equity income funds, and Technology, where prices are now keener.

In the case of the UK Commercial Property Trust, owing to recent events the pricing of this stock is now at a 52.31% discount to the underlying net asset value of the properties within this fund, which in our view represents an extreme undervaluation and offers compelling value. This is particularly the case when a dividend yield of 4.84% is factored into the equation.

Given the drawdown in equity valuations, investment now into the equity income area will give our client portfolios the option of being paid a good rate of income whilst we wait for global financial markets to recover in capital terms.

If we are indeed nearing the peak of the rate tightening cycle, Technology is being viewed as one of those areas which will lead any rebound in valuations should this prove to be the case. We are also considering several other promising sectors in this regard.

With Kind Regards

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