MONTHLY MARKET Commentary

Albemarle STREET PARTNERS

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Data, drama, and a return to orthodoxy:

After a six-week period of political turmoil, back pedalling and sudden resignations, UK Government finances have returned to a sounder footing. 10-year gilt yields (below) have stabilised, even as the Bank of England pushes through its sharpest interest rate increase in 33 years.

10-year gilt yield:

Source: Bloomberg - 02/11/2022

The UK's bank rate was hiked by 75 basis points to 3% in November. The Central Bank forecasts inflation to hit a 40-year high of 11% during the current quarter. At the same time, Andrew Bailey, the bank's Governor, warned that Britain has already entered a recession that could last two years. He expects a lower peak in interest rates than current market expectations, given a weaker outlook for the UK economy.

The US Central Bank raised interest rates by 75 basis points in a widely expected move. Fed Chair Jerome Powell signalled that rates could peak higher even as he hinted at a slower pace of increases later this year. The US job market remains extremely tight, which could make it harder for the Fed to cool the economy and tame inflation.

Improving portfolio outcomes:

The on-going turmoil in financial markets and the global economy has been extenuated by the aggressive response of policy makers. While an end to policy tightening may be a few months away, we are in the final third of this process and it is important to maintain a well-diversified, risk aware portfolio in assets that can recover when inflation starts to fall.

While bond markets have hurt client portfolios this year, it is important to recognise the opportunity this has created. Having weathered these losses, a well-diversified portfolio of bonds and large cap equities can now expect to enjoy a period of higher-than-average returns.

We are embracing returns in areas of the market that will expose portfolios to the limited downside while allowing portfolios to recover when inflation rolls over.

We have allocated a larger section of our client's portfolios to Government bonds and high-quality corporate bonds. These assets have seen a meaningful increase in their yields and over time have been resilient sources of return, particularly during economic contractions.

The return of the 60/40 portfolio:

We have sourced our allocations to these areas from multi-asset holdings and a slight reduction in equity exposure.

The challenging market backdrop has caused many to seek solace in high-cost alternative strategies that have a chequered track record of protecting on the downside and provide limited upside participation.

We believe that the rise in bond yields has created a sound footing for traditional, low-cost investment approaches and we have embraced this change whole heartedly.

The ghost of recessions past:

Finally, as we wait for the impending recession to bring down inflation, it is important to recognise the areas of greatest downside risk within portfolios.

Recessions can be long drawn-out affairs, that can severely damage client outcomes. Small cap equities, emerging markets and value tilted strategies can suffer severe drawdowns during recessionary periods.

We have therefore removed small cap tilted portfolio holdings in most client portfolios. High risk portfolios will retain some small cap exposure, as a greater tolerance for risk reduces the need to mitigate against higher volatility.

These allocations have been re-invested in large-cap index like holdings, which helps maintain upside exposure in portfolios whilst limiting the exposure to outsized declines.

Conclusion:

Our approach throughout 2022 has been to reduce sources of unintended risk within portfolios, in preparation for a period of higher volatility and economic challenges. Our portfolios, by and large, have performed in-line with their industry benchmarks in 2022, but shown greater upside participation when markets have recovered.

Our investment approach is data driven, forward looking, and focused on the long-term. This allows us to look through the here and now and focus on opportunities as they become available. We are excited by the opportunity set we see ahead of us.

We closely monitor market-based signals such as breadth, factor performance and risk sentiment and stand ready to take advantage of the discounts on offer when asset prices start to recover. Expected returns for a wide range of assets have improved significantly as inflation and recession risks are simultaneously being priced into a variety of asset classes. It is important to have a disciplined approach when navigating periods of uncertainty as the final leg of a sell-off is often the most painful.