WAYNE AUSTIN
IFA

A central bankers' Halloween

4 November 2022

This week's topics:

Diverging paths accompanied by seasonally scary messages

October review: Better than expected

The Fed's not for pivoting

Are things looking up for European stock markets?

This week's writers:

Lothar Mentel
Chief Investment Officer

Jim Kean
Chief Economist

Astrid Schilo
Chief Investment Strategist

Isaac Kean
Investment Writer

Hard choices; Christian Adams, 4 November 2022

Diverging paths accompanied by seasonally scary messages

Considering the gloomy news this week from central banks in the US and UK, investors enjoyed a decent enough start to November. Following on from the rebound over the second half of October, it has been welcome news that capital markets no longer seem to overly mind when central banks push through yet another set of jumbo rate rises, accompanied by a continuation of gloomy outlook statements. Whether this is because economic growth has proven resilient or that the messaging raises the prospects that this sequence of steep rate rises is coming to an end is not entirely clear and to be discussed.

In the UK, the 0.75% rate rise announcement from the Bank of England (BoE) came as no surprise but Governor Andrew Bailey delivered a dovish outlook, suggesting interest rates would likely not have to rise as high as markets had anticipated and therefore that mortgage rates can be expected to come down from their current heights. This guidance was enough to send sterling lower, even as prospective UK home buyers will have sighed with (some) relief. It does suggest though, that the Autumn Budget announcement from the UK government (we have to assume the rate setters had sight of its content) will likely see a swing from fiscal easing to some fiscal tightening of at least a magnitude that gave the BoE comfort Downing Street would not undermine their inflation busting efforts by fanning demand.

The messaging from the US Federal Reserve (Fed), two days earlier was the opposite. While the statement similarly seemed to indicate that the intensity of rate rises would likely moderate over the coming months the Fed Chair's press conference conveyed the message that "*the ultimate level of interest rates will be higher than previously expected*". US stock markets reacted to this news with a two-day sell-off, although somewhat counterintuitively resumed their upward movement when job creation numbers for October, on Friday were reported higher than expected. This suggests that the US labour market remains strong and therefore extends the danger of persistent inflation through the self-enforcing dynamics of the wage price spiral.

Before suspecting that markets have lost their fear of higher interest rates all of a sudden, we need to extend our horizon Eastward. Persistent rumours about the nearing of an end to China's zero COVID policy had gotten investors very excited, and led to a 10% rebound in Hong Kong's stock market during the week. This reminded us of the strong market rally that accompanied the post-COVID re-opening phase in Europe and the US in the Spring of last year.

This positive momentum had already spilled over to European markets, further buoyed by better than expected (or less bad) corporate earnings numbers. Meanwhile back in the US, once the gushing profits of the energy sector are subtracted, earnings declines have accelerated. Half-way through this quarter's corporate earnings announcements, it must be acknowledged that the global picture confirms that recent worldwide economic weakness has hit earnings and will continue hitting revenues through the next few months at least. While not great news in terms of that fundamental underpinning of stock markets, this undeniable sign of slowing activity also tells investors the drivers of persistent inflation are abating, and with them the pressure on central banks for more tightening.

This would explain the diverging central bank messaging on either side of the Atlantic. In the US the economy and the jobs market have proved resilient enough to discourage the Fed from easing-off its pressure in the interest rate brake. Meanwhile, across Europe and the UK, household's higher energy and mortgage expenditures are increasingly seen as potentially destroying more discretionary demand than may be necessary to bring inflation back under control. Judging from the BoE statement, concern is also making the rounds that the economic contraction may become so painful it could hamper its ability to keep public support for its actions onside.

The divergence of central bank policy after the extraordinary policy convergence since the beginning of the year, makes forward market assessments ever harder, because it is likely to keep the US dollar on its upward trajectory, or at least stronger for longer. At the same time, the prospect of a return of Chinese consumers to the global demand equation has to be an overall positive, even if oil prices rose in the wake of the good news. We also note the divergence between the US mega cap tech darlings of the pandemic period and the non-tech sectors in the US, with the NASDAQ being the only index to have persistently lost recently.

The coming months are going to be tough for the global economy, as central banks raise rates incrementally and energy prices remain too high. Markets are beginning to spot the tell-tale data points of historic triggers of market sentiment turning point. However, even if these data points cause temporary market sentiment upswings, as long as this weaker growth picture remains accompanied by inflation driven by more than just higher energy costs, we are not out of the proverbial woods.

October review: Better than expected

Asset Class	Index	October	3 Months	YTD	12 months
Equities	FTSE 100 (UK)	3.0	-3.4	-0.8	1.7
	FTSE4Good 50 (UK Ethical Index)	1.8	-6.7	-4.6	-2.5
	MSCI Europe ex-UK	4.3	-2.8	-13.6	-11.7
	S&P 500 (USA)	4.8	-0.5	-3.2	1.7
	NASDAQ (US Technology)	0.8	-6.1	-16.9	-14.9
	MSCI Japan	-0.2	-4.9	-10.8	-10.3
	MSCI All Countries World	2.8	-2.4	-7.2	-4.7
	MSCI Emerging Markets	-6.1	-9.2	-17.0	-17.9
Bonds	FTSE Gilts All Stocks	3.1	-12.4	-22.8	-22.6
	£-Sterling Corporate Bond Index	4.6	-10.5	-20.3	-20.4
	Barclays Global Aggregate Bond Index	-3.7	-4.4	-6.4	-5.7
Commodities	Goldman Sachs Commodity Index	3.5	1.2	52.9	48.5
	Brent Crude Oil Price	5.7	-5.7	40.4	32.0
	LBMA Spot Gold Price	-5.0	-1.6	5.9	8.6
Inflation	UK Consumer Price Index (annual rate)	1.0	1.0	7.6	8.9
Cash rates	SONIA 3-Month	0.3	0.3	0.6	0.6
Property	UK Commercial Property (IA Sector)*	-3.1	-3.3	1.4	4.1

Source: Morningstar Direct as at 31/10/22. * to end of previous month (30/09/22). All returns in GBP.

Global equities rebounded in October, rising 2.8% from the perspective of a sterling-based investor. This came as markets processed mixed third quarter earnings, further monetary tightening, new fiscal support packages and a slowdown in economic activity. Bond market volatility was the big story early in the month, but this calmed down in the last couple of weeks.

In regional terms, UK equities rose 3.0%. This was in large part down to the more positive reaction to new Prime Minister Rishi Sunak's new government, which restored some faith in the UK economy and brought stability to the pound. UK bonds, which had been in freefall after September's "mini-budget", largely recovered the lost ground, although they finished the month still somewhat below the levels seen before the fiscal policy mistake. The implied fall in both short-term and long-term interest rates was a relief not just for Britons, but also for global investors. UK events rarely have a big impact on worldwide markets, but the threatened collapse of pension funds using the liability-driven investment (LDI) model would have bled across the world's financial system. Sunak's perceived stability removed this risk, allowing credit spreads and global equity markets to rally.

US equities rose 4.8% in October. This was despite mixed Q3 corporate earnings announcements,

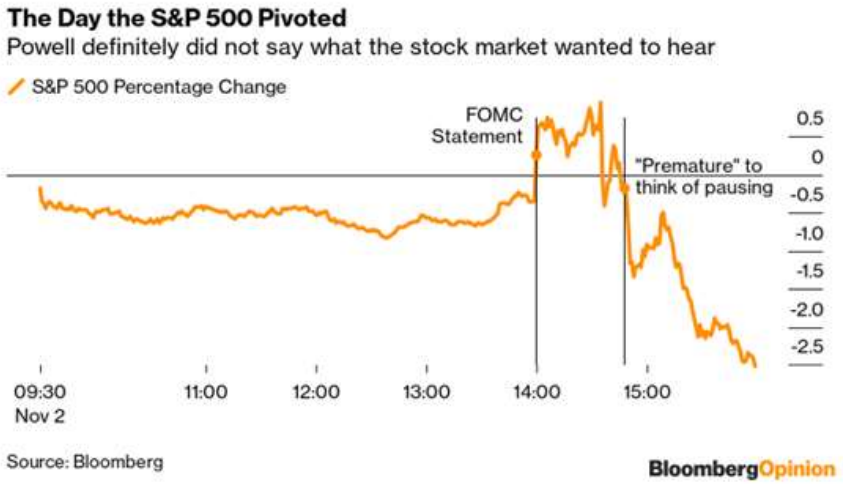
with major technology names reporting a slowdown in global consumer demand, rising costs and subdued growth outlooks. Much of the positive sentiment change beyond the stabilisation in the UK again came from the hope that the US Federal Reserve (Fed) was getting closer to the end of its 2022 interest rate hiking spree. After a strong rally against other major currencies in the last few months, the US dollar pulled back, offering some prospect of an easing in global financial conditions. European equities rose 4.3%, with more optimistic corporate earnings results supporting returns. The European Central Bank (ECB) announced another 75 basis points rate hike, in an attempt to tame elevated inflation. Pressures remain, due to the ongoing energy crisis, but October also saw a fallback in gas prices, which helped the European outlook (see this week's separate article on this topic).

October saw Emerging Markets (EM) lag the major developed equity markets, down 6.1%. China, the biggest contributor to the index (35%), left investors uneasy, after the Communist Party congress yielded a hard-line government and a significant drop in attendees. China's zero-COVID policy is set to continue, despite having significantly slowed economic activity this year. While aspects of state policy appear to be creating more monetary liquidity, consumers remain deeply unsure about their finances, especially given still-volatile property prices. Property companies remain in a very difficult situation and more policy efforts may well be needed to stabilise them.

In commodities, oil prices ended the month up 5.7%. The OPEC+ nations (including Russia) met in early October and promised a larger than expected production cut, which led to an immediate rise in crude oil prices. But, as we noted at the time, the soggy economic outlook continues to be a more important factor than solidarity among oil-producing nations, while several had been struggling to reach the previous oil quotas. The actual fall in production should be milder than headlines suggest. In comparison to many research forecasts, oil prices ended the month well within recent trading ranges.

The Fed's not for pivoting

Another month, another jumbo rate rise in the US. As fully expected, the Fed increased its benchmark funds rate by 0.75% on Wednesday, following an equal hike in September. By the end of the day's trading session, US Treasury yields had risen sharply and equities were down, with the S&P 500 off 2% by the close.



Yet, immediately after the announcement, equities had initially strengthened by more than 1%. The accompanying Fed statement was viewed as carrying a dovish message, suggesting that "ongoing increases …will be appropriate". In addition, past hikes and lags in transmission will be taken into account, an acknowledgement that it takes time before the impacts of tightening spread through the rather complex US economy.

In his press conference afterwards, Fed Chair Jerome Powell undid that optimism by offering his personal guidance in absence of the formal Fed Open Markets Committee (FOMC) forecast guidance (via the 'dots plot', which the Fed doesn't publish for its November meeting). Powell's personal view of potential outcomes appeared quite at odds with the official statement. Here are the bullet points of his comments made at the end of the press conference:

- The window for a soft landing has narrowed
- Inflation has not come down as hoped
- Interest rates had to "go higher"
- Rates will remain "higher for longer"

JPMorgan research sees his stance as likely to tilt the FOMC's balance for the next couple of meetings, keeping the Fed hawkish despite the statement's apparent pivot.

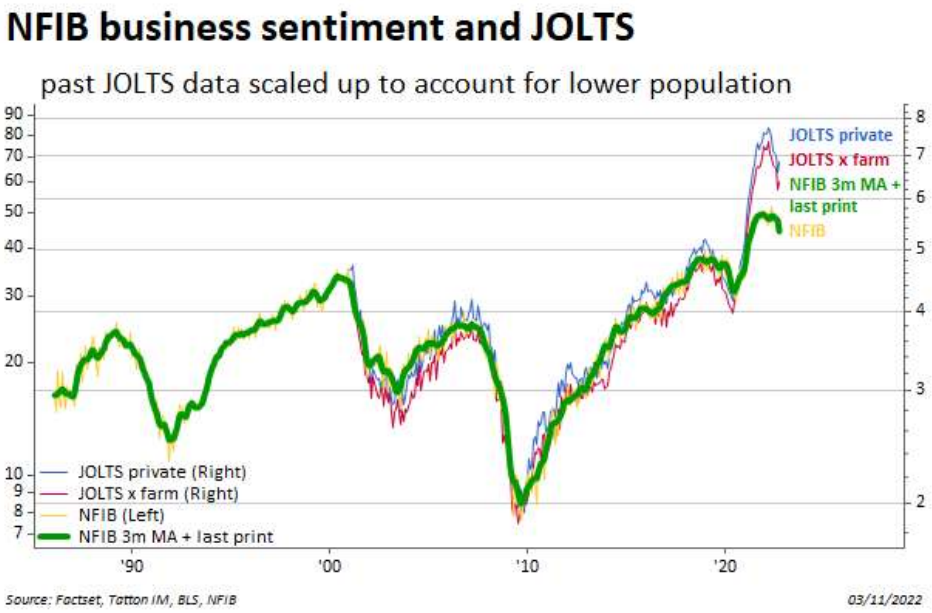
With tight global energy supply and a surprisingly resilient US economy, the rate hike and Powell's continued hawkishness come as no surprise. November marks the fourth 0.75% hike in a row. US interest rates are now between 3.75%-4.0%, having been at zero as recently as March. That is an astounding pace of monetary tightening, the likes of which we have not seen since the Volcker days in the 1980s. At the same time, rates are still well below current year-on-year inflation figures. September's Consumer Price Inflation (CPI) reading came in at 8.2%, meaning the real value, or purchasing power of savings, is still being eroded quickly.

To make matters worse, cost pressures appear to have slowed only a little since the Fed's last meeting. Data released since then have shown broad price increases across goods and services. Moreover, the supply side of labour remains tight – US unemployment is still extremely low and job openings have been increasing again in recent weeks.

While September marked the third consecutive month of falling year-on-year inflation, that trend could well be reversed in October due to rising oil prices Even excluding energy prices, core inflation rates are still expected to continue expanding at a rate of around 6%.

While global supply pressures were the initial catalyst for US inflation, domestic wage rises have taken over as the main driver. The tightness of the jobs market has led to price increases becoming sustained from the domestic supply side, and therefore the labour market is now by far the Fed's main concern. Since the pandemic, US businesses have found it increasingly difficult to source workers. Employees now have greater pricing power when making wage demands – a dynamic that speeds up when consumer inflation expectations are high. The relationship is particularly pronounced for small businesses, which benefitted greatly from the post-COVID rebound in growth, but have also struggled to find employees. This is best shown by comparing business

confidence with job openings, as in the chart below. Generally, these forces go hand in hand. Businesses hire more workers when they are confident about future profits, leading to a tight correlation between sentiment and jobs. But this relationship has come apart in the post-pandemic phase.



Small business sentiment levelled off some time ago, but job openings continued to shoot upwards. This suggests the growth in jobs is not driven by expected growth in profitability, but rather by a perceived shortage of labour. Anecdotal evidence from many American businesses of the difficulty in finding labour reinforces this. Growth has been undeniably strong, but not strong enough to justify the labour tightness we are seeing.

This complicates issues for the Fed. The FOMC has been clear that it wants to see a compression of activity and labour demand, stating that the so-called “full employment” level (the level at which there are enough unemployed labourers to meet ongoing demand without creating inflation) is about 4.5% unemployment. September’s reading came in at 3.5% and, while generally we would expect falling business sentiment to filter through into lower jobs numbers, the breaking of the above relationship suggests things might not be so straightforward. Evidence for this is the juxtaposition of the latest business sentiment surveys pointing to a dreary outlook, while this week’s job openings show a resilient labour market.

However, labour market tightness is not the only domestic factor pushing US prices higher. As the *Financial Times* noted this week, company profit margins have stayed at historically high levels and have been a substantial factor in driving prices higher. This tells us that the global supply crises initially – and the higher cost of labour and energy now – have provided ample cover for producers to increase profits in the name of “passing along costs”. But falling real incomes (as inflation outpaces wage gains) would have compressed spending were it not for the savings built up during the pandemic.

For the Fed, these factors all have the same general solution: restrict activity by inducing a recession, thereby decreasing demand. But achieving that goal while minimising pain will prove difficult. The sustained labour shortage means that the lag between Fed policy and its effect is likely longer. Policymakers might therefore have to push even harder to cool down the economy.

Into September, investors became surer that US inflation seemed to be cooling. As noted before, a large part of this comes from the strength of the dollar, which has decreased US-dollar-denominated import prices. This is, of course, helpful for the Fed in the short term, but it could make the underlying domestic problem worse. Lower cost-push pressures and easier financial conditions (as dollar assets are valued higher than global peers) sustains business and consumer demand. If this filters through into even more demand for workers, wage pressures will continue.

Despite the FOMC's tough talk, bond markets have a pretty rosy view about the future of Fed policy. Most investors currently expect the Fed to raise rates by a smaller 0.5% at the 14 December meeting and a majority now expect the same on 1 February. This will put rates up to 5.0%, the expected peak. In fact, current market expectations are that the Fed will *cut* interest rates as early as next September, having achieved the slowdown and got inflation under control. This is quite the vote of confidence in the Fed's ability, and one it may find difficult to live up to.

The Fed's stated aim of 4.5% unemployment tells a somewhat different story. Historically, each half percentage point increase in US unemployment has been followed by a recession. A full point increase points to a much harder landing than markets envisage – particularly with the labour market proving so stubbornly tight.

Clearly the relationship between sentiment and jobs has come apart in the post-pandemic era. Will this continue? If so, it means substantially tighter labour conditions over the medium or long-term, threatening more inflation whenever the Fed loosens its grip. But if the old relationship resumes, jobs numbers are set for a heavy correction. That would mean a lot of pain for US consumers, pulling down demand by more than the Fed will have planned.

There are no easy solutions here. Over the longer-term, policymakers can take heart in the increased investment in automation, which should drive productivity growth. But in the short and medium-term, the Fed walks a fine line. Markets still think a 'soft landing' is achievable, but as consumers run out of pandemic savings and lose the comforting impression of plentiful job offers, there may be a faster downturn in final demand – or sheer willingness to pay higher prices – than from incremental increases in unemployment alone.

Are things looking up for European stock markets?

Europe has suffered a harsh year. With war raging along its eastern border, the continent struggles with an intense energy supply crisis. Blackouts and rationing plans are on the agenda for this winter, as nations try to wean themselves off Russian oil and gas supplies. The withdrawal symptoms are painful: households and businesses face sharply higher costs, while government

budget deficits widen to provide support. Indeed, Europe is seen as one of the weakest parts of the global economy.

This has led to bad results for European assets. Seen as suffering more than other regions from supply-side disruption, particularly energy of late, corporate credit spreads (the difference between government and corporate bond yields) have widened dramatically, while equity values have substantially underperformed. In common currency terms, Eurozone holdings have been much softer than their US counterparts in 2022. In local currency terms, equity market performance looks slightly better – though both are bad – with the Eurostoxx 50 down 15.6% year-to-date, compared to a 19.6% fall for the S&P 500. As written before, that is only down to the immense strength of the dollar. At the time of writing, one euro buys you less than a dollar, coming down from $1.14 at the start of the year. In sterling terms, that leaves US stocks down only 5.5%, compared to Europe's 13.7% fall.

This broad underperformance hides a great deal of variation though. Some European countries have actually held up well, despite regional pressures. Spain is the most notable of these. Even in sterling terms, Spanish equity has only marginally underperformed the US, losing 6.46% year-to-date. UK equities have also avoided the heavy losses seen elsewhere. Despite the doom and gloom around the British economy, the FTSE 100 is down just 4.2% in sterling terms so far this year.

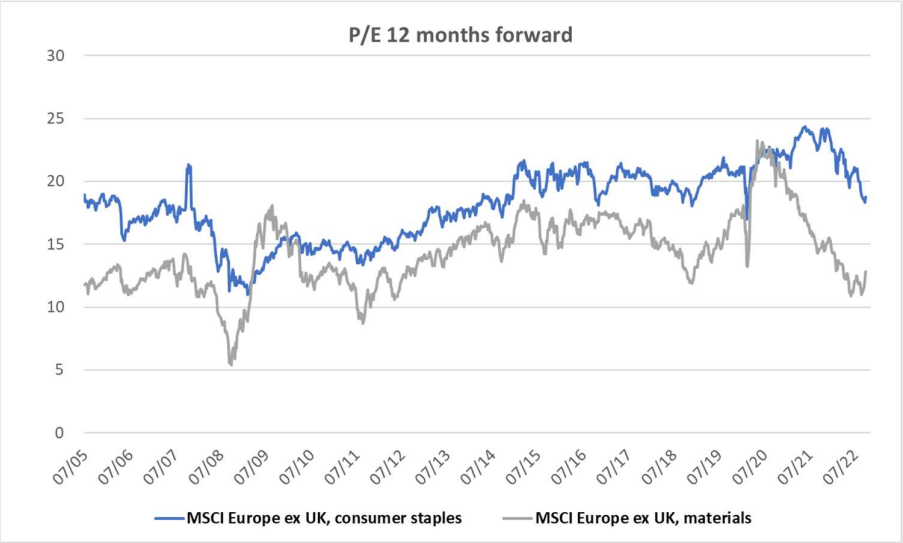
The regional variation is mostly to do with the sectoral makeup of different European markets. The energy supply crisis has been profitable for many energy companies, with increased pricing power leading to some huge windfall earnings. Indeed, record profits have been a topic of intense political debate, pushing governments to enact 'windfall taxes'. This political pressure remains one of the reasons why valuations – in terms of price to earnings ratios – have fallen so sharply in the sector. Despite the good times right now, investors are sceptical about long-term prospects for many energy companies.

Of course, even within the energy sector there are disparate results. Many have struggled, a fact highlighted by the German government's recent nationalisation of Uniper SE, its largest gas importer. On the other hand, utilities providers specialising in renewable energy – such as Spain's Iberdrola – have fared very well. This is down to the way energy is priced on the continent: the last power plant needed to meet overall demand sets the wholesale price, meaning gas costs have a huge impact (even if Spain had introduced a gas price cap) But as renewables are relatively unaffected by gas prices, those companies receive a big earnings boost despite stable input costs.

This pricing mechanism is now also a topic of debate, and there is a strong push from European lawmakers to decouple energy and gas prices. That complicates the longer-term outlook for energy and utilities. Despite soaring prices, Europe's energy sector is still one of the cheapest in valuation terms. Nevertheless, equity markets with a higher proportion of oil and gas companies have performed better – which goes a long way to explaining the UK's returns.

The flipside of this is that energy pressures have substantially decreased in the last couple of months. Gas prices, though still high, have come down from the previous peak. This suggests Europe may be over the worst of its crisis, which is tentatively reflected in recent market moves. European equities seem to have moved beyond peak pessimism.

Investors are still cautious though, reflected in defensive market positioning. The chart below shows the performance of consumer staples (blue line - a defensive sector) versus materials (grey line - which are cyclical and suffer from higher gas prices). The most recent moves show a slight turnaround, but markets are clearly still apprehensive, given the same would be true when comparing healthcare companies with materials.



On the other hand, some traditionally 'defensive' assets have not performed as well. Swiss equities have been weak in local currency terms, despite being regarded as a defensive play. In terms of the country's sectoral makeup, energy is notably absent. Healthcare companies outperformed the other sectors, but were still a drag on overall performance.

Admittedly, Switzerland has been able to claw back some of those losses in sterling terms, due to the strength of the Swiss franc. Like the dollar, investors see the Swiss franc as a safe-haven asset. It has therefore benefitted from the general risk-off mood in global capital markets. The Swiss franc has now moved above parity with the euro, for the first time in the latter's history.

Entrenched pessimism hurts the outlook for Europe. Even with the recent turnaround in commodity prices, investors are not getting too excited about the continent's prospects. One need look no further than the UK to see why. Fresh off the back of bond market chaos, the Bank of England now predicts a lengthy recession with inflation still elevated in the short term. While Britain's performance has diverged significantly from the rest of Europe in recent years, it still serves as a cautionary tale.

Still, as we highlight, things are not all bad. With commodity prices receding, the hope is that spots of outperformance will be backed up by a general turnaround. Markets will take some convincing but, given how expensive US assets have become on a relative basis, there is certainly the potential to pick up some bargains in Europe. This is especially so considering the divergence between different countries and their sectors. Underneath the grim headlines, Europe is as heterogeneous as ever.

Global Equity Markets

Market	Fri 15:25	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7352	+4.3	+304	→	↘
FTSE 250	18336	+2.3	+419	↘	↘
FTSE AS	4009	+4.0	+153	→	↘
FTSE Small	5958	+2.0	+119	↘	↘
CAC	6444	+2.7	+171	↗	↘
DAX	13497	+1.9	+253	↗	↘
Dow	32536	-1.0	-326	↗	↘
S&P 500	3784	-3.0	-118	↘	↘
Nasdaq	10521	-5.2	-582	↘	↘
Nikkei	27200	-0.5	-146	→	↗
MSCI World	2468	-3.6	-93	↘	↘
CSI 300	3767	+6.4	+226	↘	↘
MSCI EM	861	+1.8	+15	↘	↘

Top 5 Gainers

Company	%
Ocado	+35.3
Prudential	+15.0
Rio Tinto	+13.2
Anglo American	+13.1
HSBC Holdings	+11.3

Top 5 Decliners

Company	%
RS GROUP	-9.5
BT	-8.7
Croda International	-4.2
Rentokil Initial	-4.0
Experian	-3.2

Currencies

Pair	last	%1W
USD/GBP	1.132	-2.5
GBP/EUR	0.877	-2.2
USD/EUR	0.993	-0.3
JPY/USD	146.63	+0.7
CNY/USD	7.185	+0.9
Bitcoin/$	21,127	+2.1

Commodities

Cmdty	last	%1W
Oil	98.57	+2.9
Gold	1674.5	+1.8
Silver	20.577	+6.8
Copper	365.9	+6.7
Aluminium	2264.0	-1.0
Soft Cmdties	209.38	+3.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	11.7	9.1	14.3
FTSE 250	3.7	12.8	12.8	16.4
FTSE AS	3.8	12.2	9.3	14.5
FTSE Small x Inv_Tsts	4.0	9.2	9.2	15.5
CAC	3.0	10.6	10.2	15.2
DAX	3.4	11.9	10.8	13.8
Dow	2.1	18.7	17.7	17.1
S&P 500	1.8	18.3	17.0	18.4
Nasdaq	1.0	43.8	24.2	24.5
Nikkei	2.1	30.3	14.7	17.8
MSCI World	2.3	15.3	14.9	17.2
CSI 300	2.4	13.5	12.5	12.8
MSCI EM	3.5	10.0	10.6	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	3.51	+0.03
UK 15-Yr	3.91	+0.11
US 10-Yr	4.11	+0.10
French 10-Yr	2.79	+0.18
German 10-Yr	2.26	+0.15
Japanese 10-Yr	0.26	+0.01

UK Mortgage Rates

Mortgage Rates (LTV c.75%)	04-Nov	05-Oct
Base Rate	3.00	2.25
2-yr Fixed Rate	5.73	4.17
3-yr Fixed Rate	5.66	4.46
5-yr Fixed Rate	5.48	3.96
10-yr Fixed Rate	5.29	4.21
Standard Variable	5.10	5.10

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

Please note:

Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document. The value of your investments can go down as well as up and you may get back less than you originally invested.