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Pride and Prejudice; Terror and Turpitude

Last quarter we spoke about the cold front that moved into markets in September, which undid much of the positive sentiment of the summer. It proved to be a sign, as the season of Autumn was more terror and turpitude than "mists and mellow fruitfulness".

It is hard to avoid a UK-centric piece this quarter, as this was where the attentions of global markets were turned at least for a few critical days in late September. As a calamity played out in UK government bond markets and markets decisively rejected a maverick "mini-budget" and its consequences, leaders stepped down and markets held their breath. The wheels of government ground more quickly for a spell as emergency measures were unleashed to avoid a DB pension fund debacle. Meanwhile central banks globally continued to hike interest rates although conviction wavered.

Employment, Energy and Elections dominated global headlines. While the war in Ukraine intensified in parts, the US saw a Mid-Term election result that was more of an endorsement of the current Biden administration than pundits had been expecting and less of a landslide for Republicans. Brazil saw a shift in power from the right to the left with the election of Luiz Inácio Da Silva "Lula" and in China, Xi Jinping consolidated his power by securing an appointment for a third term (we cover this in more detail in the spotlight section below). The upheaval in geopolitics follows a phase when Covid dominated news headlines. The pent-up geopolitical tensions now unleased have led to terms like the "new world order", "spheres of influence" and "de-globalization". As the war in Ukraine becomes bogged down and new alliances harden, many investors are starting to question what they always assumed about the direction of geo-politics.

In equity markets the same volatility that we have seen all year persisted. We saw a strong month of October followed by gyrations caused by Fed statements and a mixed outlook. Fixed income volatility persisted too as bond yields continued to rise in response to rising base rates.

“Highlights” (or “low lights”) since the last quarterly update:

- **Inflation remains at the front and centre of government and household concerns**, and in September rose to a 40 year high, rising 10.1% (CPI). As levels stay around high single digits or even double digits in Europe and the US, there are nevertheless some signs of it faltering. These are signs that the unemployment rate in the US rose slightly (although is still historically low) while supply shocks seem to have played out and there is evidence that the supply of goods is not still seeing price hikes.
- **Interest rates continued to rise,** with the US Fed raising rates for the sixth time this year (75 bps) in November while the Bank of England raised its rates to 3%, its eighth consecutive rate rise and the largest (75 bps) since 1989. As noted earlier, some central banks are “blinking” in the lights of economic strains and not raising by as much as expected.
- **UK employment figures remain robust,** with unemployment numbers at multi-decade lows and at numbers not seen since 1974. This was partially driven by a lower participation rate, particularly as older workers stayed out of the work force and students choosing not to work.
- **GDP growth in the UK has been flatlining** – falling by 0.6% in September and 1% in August but after growth of only 0.1% in July.
- **The political environment remains fraught,** although the new Conservative government seems less wracked with drama than the previous one and there is clearly a strong desire for stability, from fellow politicians, the general public and market participants.

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Current Macro Snapshot

The UK as a Petri dish (once more?)

The UK became the unfortunate focus of global market attention as an alarming chain of events sparked fears of global contagion, or at least interested onlookers keen to spot the “canary in the coalmine” for other countries. One of the first experiments under the microscope was the maverick “mini-budget” which presented a sharp contrast to the stern and restrictive Bank of England’s tighter monetary policy. Only days after the country wowed the world with the dignified pageantry after the death of Queen Elizabeth II, the Bank of England returned to normal operations and raised rates by 50bps. This was then followed by the promised mini-budget which contained a slew of tax cuts and trickle down economic policies designed to stimulate growth. Unfortunately it only stimulated a loss of confidence in the disconnect between monetary and fiscal policy, and the UK government that had sparked it.

What followed in the next few days was the stuff of legend – UK government bonds collapsed in price sparking sharp increases in yields and a capital flight of the sort more commonly seen in Emerging Markets. The government received a rebuke from the IMF (on September 27) and the currency slumped, even after the Bank of England had raised rates – which is rare. Only the stock market (FTSE 100) remained solid (0.9% year to date) due to the heavy export orientation, which benefits from a weaker Pound.

The next phase of the crisis sparked concerns of systemic risk, which was the fact that a large percentage of UK defined benefit schemes became stuck in the stranglehold of the Gilt market crash. Due to the fact that many of them owned large portfolios of long-dated GILTS to match their liabilities and guard against inflation, and the fact that many of these schemes had applied leverage in levered LDI investments, the swift fall in GILT values led to rapid rises in collateral calls and a liquidity crisis for these pension funds. After a few days of chaos in which the Bank received direct appeals from pension fund staff and consultants alike, it intervened for a limited amount of time to support the GILT market through market purchases.

This crisis was noteworthy for many reasons – first it underscored the dangers of leverage, derivative use and crowding in popular trades, such as LDI (Liability Driven Investing) solutions. Second, it revealed the dangers of “groupthink” and the speed with which “100-year events” can occur and wreak havoc. Third, it was evidence of some of the better lessons learned of 2008 – although that crisis featured financial system fragility and was, in that sense “the last war”, it did teach the importance of swift and concerted action by institutions to prevent the unimaginable. In this case it was hard to imagine a scenario that would lead to the failure of a broad swathe of UK pensioner’s retirement security, but as it seemed to be inevitable, the government institutions worked together to do what it needed to do.

That debacle may well have been the final straw for the government, and within days a replacement administration under Rishi Sunak as Prime Minister was in place. Markets have calmed somewhat since then, perhaps still reeling from the volatility of recent weeks. The Pound gained some ground after the change of administration and as we write has stabilized at around 1.17/1.18 to the USD.

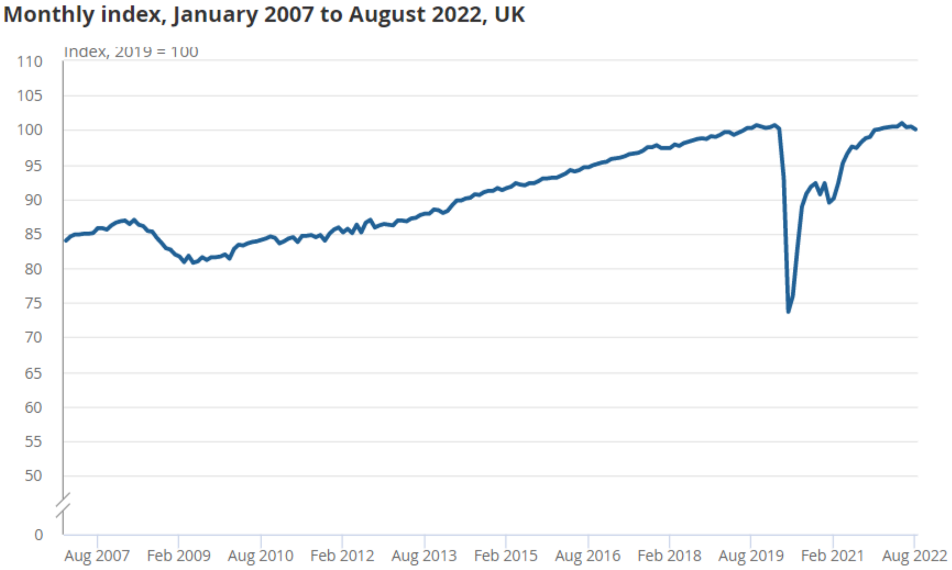
All eyes on the Central Bank Pivot – but sometimes the message is between the lines . . .

Markets were briefly excited at the prospect of a "deceleration" in the pace of central bank rate rises towards the end of October. Canada had started the anticipation, by raising by only 50 bps and not 75 bps in late October (which, notably, led to an instant drop in the Canadian Dollar – a sign that the US dollar is vulnerable to a similar fall whenever the US Fed does eventually slow down) and the Norwegian central bank also came in below expectations. When it came to the US and the UK though, both banks provided a 75 bps raise, although the messaging was starkly different. In the case of the US Fed the raise was its fourth of that magnitude that year, and Chairman Jerome Powell was quick to pour cold water on expectations of a pivot or slowdown.

The Bank of England had slightly different mood music behind its 75 bps hike. It was sober in its assessment of the state of the economy, slowing growth and also the impact that higher mortgage rates would have on the British consumer in particular. There was some suggestion between the lines that rates would not go much higher and also that it was not the market rate expectations "tail" that should wag the Central Bank dog.

This leaves us with decoupling – and, for now, the likelihood that dollar strength will persist, at least until the Fed slows rate rises and decelerates. As can be seen below the dollar/Sterling relationship has been particularly fraught over recent months, which perhaps speaks more than any other visible sign to the extent of the fall in UK fortunes globally.

As can be seen, in the UK GDP is still being supported, but only barely!

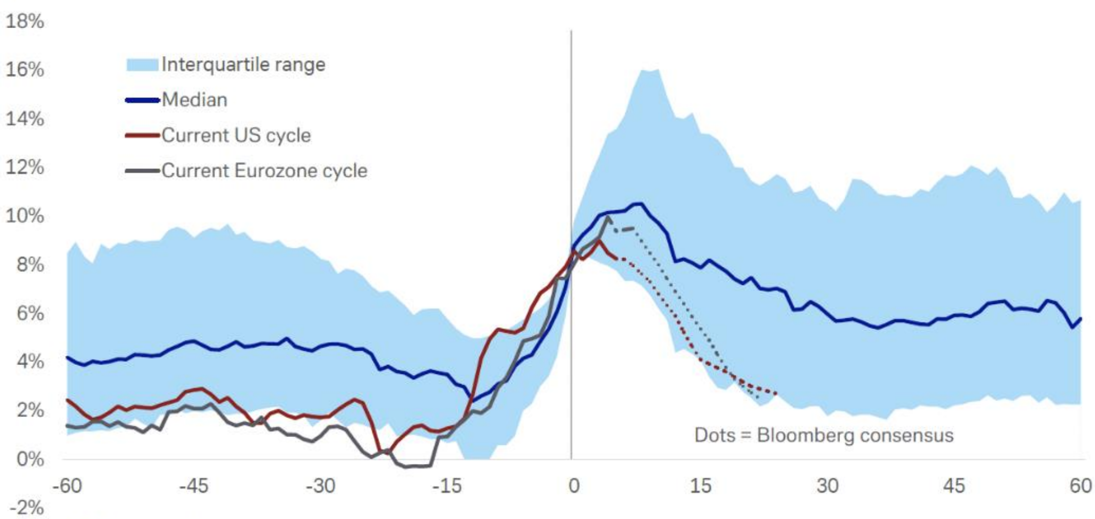


Inflation: Variations on the Theme

Inflation remains high globally, but as we noted before it is sharply divergent by region (say, within Europe and Emerging Markets) and drivers. Popular wisdom would suggest that in the US inflation is largely demand driven, while in Europe and the UK it is driven by imported inflation (due to having weak domestic currencies, especially v. the US dollar) and supply side forces such as higher energy costs.

As this chart suggests, though, there is some evidence that inflation does not hover around this level for very long.

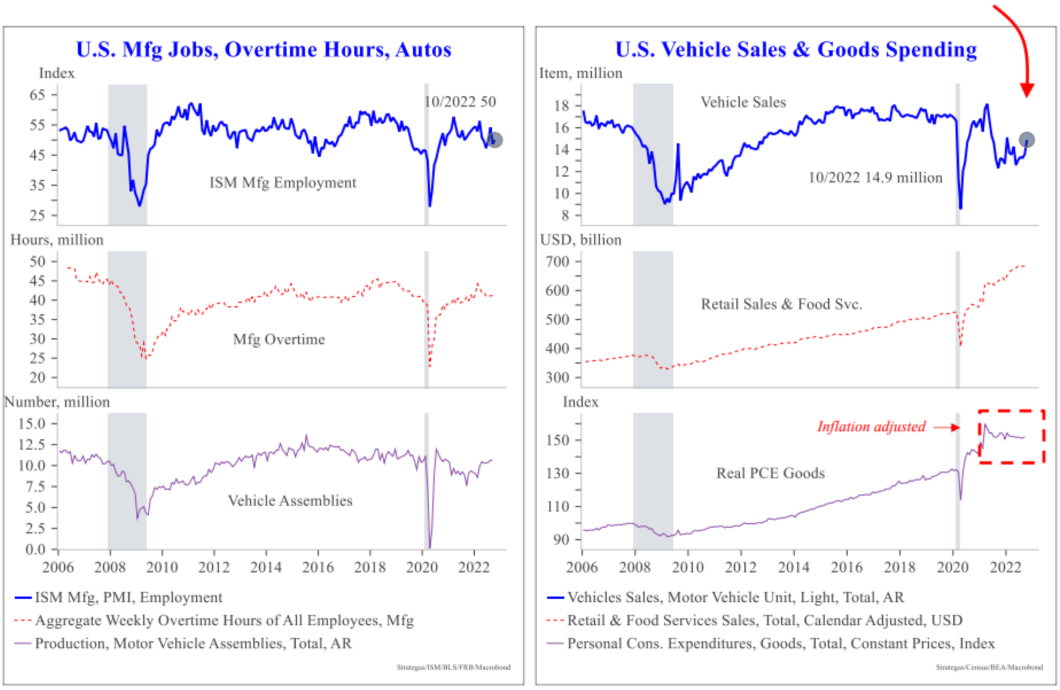
Figure 2: All sample countries from 1920 (318 observations)



Source : GFD, Bloomberg Finance LP, Deutsche Bank

Recent releases have shown some interesting variation under the headline level such as the lower contribution of shipping costs and the general absence of significant supply chain woes. Currently evidence of real price compression in the US housing markets suggests that the higher rates are having their desired effect, while the chart below shows that on an inflation adjusted basis demand is actually flat for certain goods/services. This is notable, as the only power Central Bank tightening can have is to reduce demand, and it seems that may be eventually be achieving "transmission".

RATES UP … STILL WATCHING CYCLICAL DATA: U.S. MFG & AUTOS



Source: Strategas

Geopolitics –Pride and Prejudice

As if the turmoil in the UK were not enough, on the global stage geopolitics continued to be stormy. In Italy a new Prime Minister, Giorgia Meloni, came to power riding a wave of far-right populism, but was quick to denounce "fascism" when she was elected. She seems less inclined to play happy families with her European counterparts though, and did exchange some scathing words with Emanuel Macron on France in one of her first post-election speeches.

In Ukraine, indications of a Ukrainian advance were met with what Zelensky has deemed a wave of energy terrorism – and as the winter approaches both sides seem to be entrenched with tensions rising. The ramifications of this remain important for global energy supplies, and are also a test of fragile global alliances and "spheres of influence" as other potential flashpoints loom.

The single biggest one of these is the consolidation of power in China by Xi Jinping. His ongoing commitment to zero Covid, the elimination of "reformers" within his cabinet and his apparent disregard for some of the economically forward policies of his predecessors has triggered fears of whether China is entering another era – which we might call "post-modernism". This is featured in the Spotlight section on page 9. Finally, ongoing demand for oil supplies has created a laser focus on OPEC and posturing there.

Individual Asset Class Performance.

- Equities
- Fixed income
- Other asset classes

The chart below shows recent performance in our measured equity and fixed income indices (at November 25, 2022)

Equity Index	Year to date (November 25)	1 year
FTSE 100	1.21%	5.12%
S&P 500	-16.6%	-14.17%
Nasdaq	-28.72%	-29.34%
Dax (Europe)	-9.45%	-5.87%
Hang Seng	-26.07%	-27.48%
Shanghai Comp	-15.42%	-13.59%

Equities: A tech rout, and sell-off in China.

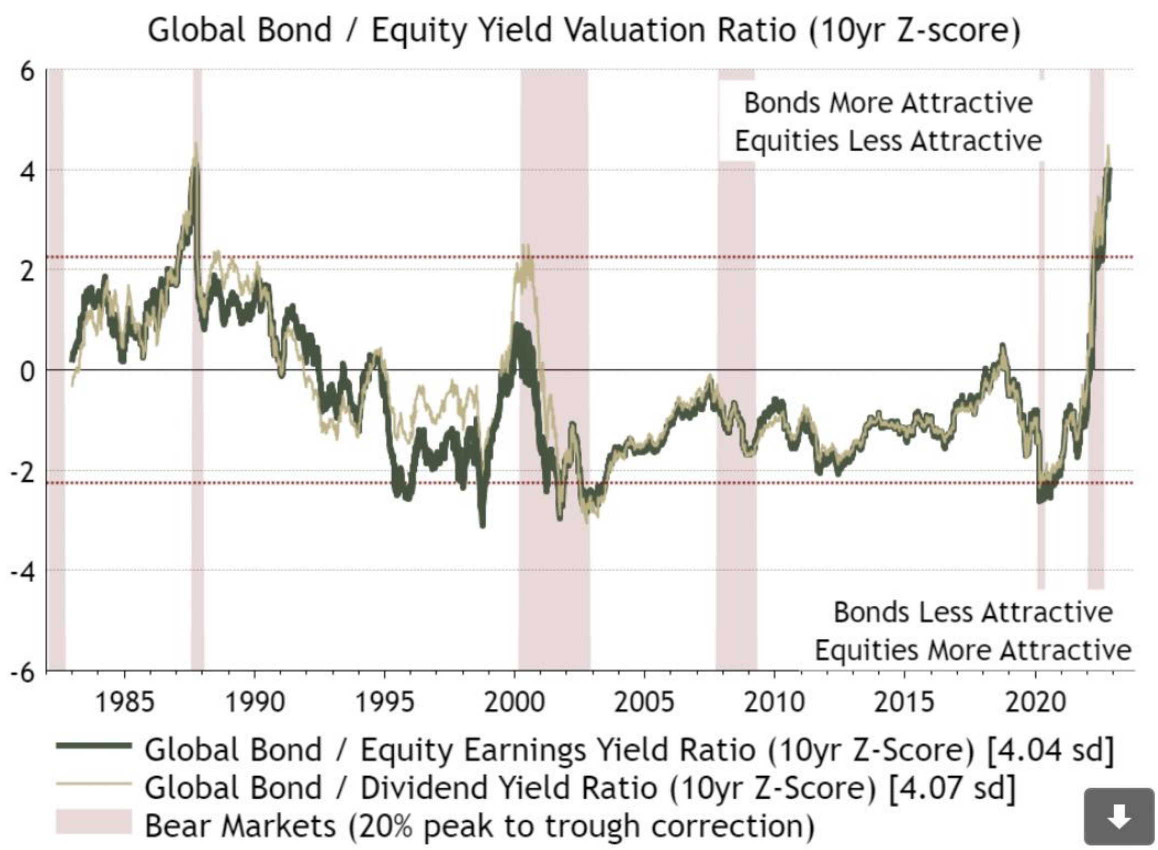
Equity markets remained in varying degrees of negative territory, but there were some subtle changes in fortunes. Europe was slightly stronger over the period as there was some hope that the energy crisis would not be as devastating as previously feared – at least this quarter. The UK saw some slight weakness due to the catastrophic economic fallout, but it was nowhere near as severe in equity markets as it was in the bond market.

Within the US September's weakness was undone in October and overall the stock market continued to experience meaningful intra-day volatility with 85% of the trading days to date in the year seeing moves peak to trough of more than 1%. The tech-heavy Nasdaq displayed more weakness than the broad-based indices, which coincided with announcements of tech retrenchments and lay-offs. All global markets saw a relief rally in early November as the October CPI numbers in the US came in at lower than expected, sparking hopes of a pivot in central bank policy and the beginning of the end of rising rates. Markets immediately rallied sharply, only to be rapped on the knuckles at the weekend for "getting ahead of themselves". That same weekend news broke of an implosion and possible fraud at the digital asset exchange FTX, which led to a widespread crisis of confidence in digital assets, cryptocurrencies and their ilk.

Within emerging markets China saw massive outflows as we discuss later, and this resulted in a challenging environment for Hong Kong too.

Fixed Income: Vicious and Volatile, but starting to look interesting?

Bond markets continued to display unusual volatility with UK government bonds still evidencing weaker demand, selling pressure and higher yields than historically. In the US too government bond yields jumped as investors responded to rising rates and the yield curve remained inverted, pointing to concern about the outlook for the economy. The current state of bond yields means that they are looking quite attractive relative to equity yields as the chart below shows, and with the current yields available bonds alone represent a solid return, which makes a change from the asset allocation assumptions of recent years.



So It can be seen that while, for years, while There (Was) No Alternative to equities (TINA) we are now in a world where TARA (There are Reasonable Alternatives) prevails.

Other asset classes – For Every Action . .

There is an equal and opposite reaction. We have, for some months now, highlighted the risk to private assets if and when valuations are adjusted to reflect the new public market reality. The areas that might be particularly vulnerable to this are venture capital investments (due to the sharp repricing in many tech stocks discussed above) and other areas such as real estate and infrastructure that may have been priced off a much lower risk free rate (and deemed attractive relative to that) or were dependent on cheap borrowing. While some valuations have taken place we have not yet seen this *en masse*, but we will be watching carefully.

Another risk to the area is capital outflows, as investors rethink the percentage of illiquid assets that they wish to have in a portfolio. The recent crisis in UK DB pensions is likely to give rise to a "new normal" in LDI investing of higher collateral levels and lower leverage, which may force these plans to cut back on new allocations and even try to exit existing ones. This is going to have repercussions for all investors, particularly in quarterly real estate funds, where we have already seen a rush for the doors and some gating of redemptions in place. Similarly, it could lead to a wave of secondary private asset volume (although there is no indication of this yet) and overall less demand for assets in private capital.

As noted above, a weaker IPO market and higher levels of borrowing place a strain on private strategies as they hamper exit routes and slow down the pace of cash distributions. Winter may very well actually be coming for these strategies.

Spotlight: China and Emerging Markets

The appointment of Ji Xinping for a third term as leader of China in late October, marked a turning point in his consolidation of power and sparked a further wave of negative market sentiment around China. Some of the rhetoric accompanying his re-appointment was similar to what has previously been seen in China such as his commitment to eliminating inequities between different members of society and a solid focus on growth, but some of it was new, including a renewed emphasis on national security, both in terms of borders, energy supply and public health. This is a justification for any manner of policies – from the zero-Covid policy to which he has recently doubled down to a hardline approach on the claim on Taiwan, to a tough stance on international trade.

Time will tell as to whether this represents a reversal of much of the last two decades in terms of economic growth and development in China, but for now it can be seen that markets have reacted negatively – expressed in massive outflows from China as well as poor stock performance. The chart below shows that the MSCI China has delivered a 0% return in the nearly 30 years since inception, while the chart below that shows a steady reduction in the level of transparency offered into official statistics.

These two factors combine to make the case for investing in China less compelling, and currently the country represents 30% of major Emerging Market Indices, a number which rises to close to 45% when Taiwan and Hong Kong are added. A persistently strong US dollar together with a slowing global economy also are headwinds for this region.

Outlook . . Calling Time

Last quarter we talked about the concept of a "*New New Normal*" – in which investors seem to have quickly adjusted to a reality of inflation in high single digits and in the US markets actually rallied when it looked as if the Fed would introduce merely a 50 bps rate rise in September, as opposed to the 75 bps one that had been expected. This thesis still holds – as we can see in the case of the market response to the Canadian central bank "decelerating" its pace of rate rises. It is an environment where a rate rise of less than 75 bps may be seen as dovish.

The market reaction to the UK "mini-budget" was also instructive. Markets clearly displayed little tolerance for contradictory fiscal and monetary policy and displayed concern re rates of borrowing, and little belief in a "magic money tree". Finally, the lack of a Democrat rout in the US Mid-Terms tells us what is really on voter's minds this season. While inflation is challenging, it was not at a pain-point that would lead to a desire for change. Perhaps this an appreciation of the complexity and challenge of dealing with this problem – it is not something a silver bullet will fix, as, now, six Fed meetings and eight Bank of England meetings have taught us through their rhetoric. When the economy faces such diverse perils that are essentially "challenging needles to thread", there is a preference for stable government, for cooperation and not division and for "grown ups" in the room to handle it.

In coming months we will be watching in particular:

- **A Measure of Winter Cheer.** As we noted last quarter, it is critical to see what the winter brings in terms of energy pricing and consumer sentiment. With mortgage rates in the UK set to rise sharply, this will place extreme stress on certain consumer segments, and the pending more austere fiscal climate will also present challenges. How this translates into retail sales, real estate demand and corporate health will be critical.

- **Tech as a Canary in the Coal Mine?** During the recent layoffs, may tech executives noted with chagrin their recent overly exuberant hiring and growth expectations. It is true that they did contribute to a particularly frothy employment climate. It will be key to see if they have over-steered now, or only scratched the surface, and whether other industries follow suit. With the apparent shortage of labour in some areas and a challenge in hiring, how this all settles with respect to employment will be very interesting to watch.

- **The end of zero-Covid?** As we discussed in the spotlight on China section, there is so much still pending on the direction that Xi Jinping's united front of a government takes with respect to opening up China's economy and relaxing some of the zero-Covid restrictions that are incompatible with that. Visibility as to this, their position on trade and their aspirations with respect to Taiwan will be key to seeing how one of the world's largest economies plays its part in the years ahead.

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November 29, 2022