

# QUARTERLY INVESTMENT REVIEW

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Some sombre clouds have darkened the global economic outlook. The energy crisis is making headline news daily, and creating considerable political trouble. China's economy continues to suffer due to their zero Covid policy and the weakening of its real estate market. Inflation is running at levels in the West not seen for decades. Then at the end of the quarter a radical and poorly communicated budget statement in the UK led to an alarming collapse in sterling and UK gilts. So, it is not surprising that the markets have been under pressure. Equities had seen the worst first half to the year since 1962. By the end of the third quarter the World Index was down 26%, and the Nasdaq was down 32%. Technology having been far and away the best performing sector in the last decade, meant that a lot of money was crowded there, so it has suffered even more than the general index. The bond market has performed even worse, with some analysis showing 2022 being the worse year for bonds since 1788 and 1865. It is an environment that begs a lot of questions that are not easy to answer. How will the war in Ukraine progress? Can European solidarity with Ukraine survive a cold winter? How in control of its real estate sector is China, remembering that Chinese real estate is now the largest financial asset in the world? What happens if Central Banks run out of room to raise rates due to their national debt situation, but inflation remains high? Put another way how would Central Banks respond to an inflationary depression? That could be caused by continued high prices of food and energy, and disrupted supply chains.

Many of these uncertainties come down to inflation and the cost of living. Some price rises are due to the lingering after effects of Covid with shortages in critical components, such as semi-conductors, exacerbated by China's lockdown. Russia's invasion of Ukraine represents a completely different scale of disruption. Europe's reliance on Russian gas, for example, represents a colossal strategic mistake. How can European economies thrive when they undergo a five to ten-fold increase in electricity prices? Energy bills have skyrocketed, putting huge stress on consumers and businesses. It has also highlighted the plight of the general consumer who has experienced hardship for some time. An interesting chart in the Financial Times after the death of Queen Elizabeth in September showed the evolution of real wages in the UK during her reign. From 1952 to 2008 real wages followed a trend of growing 2.6% per year, since then they have flatlined. Soaring energy and food bills have made life impossible for many people. Energy bills have been widely discussed, but, as an illustration of food inflation over the past year, feed costs have risen 83% and fertiliser costs are up 179%. As a result, demands for higher wages are being heard everywhere and strikes have returned. While unions are weaker than they were, social media has become an equally powerful force at pressuring governments. It is becoming a political necessity for governments to encourage wage growth. Strangely this suits Central Banks in some ways, because sovereign debt levels have become so vast that the only realistic way to reduce them is through inflation. 5% plus levels of inflation with negative real rates for several years erode the levels of debt. The loss is paid by the saver whose purchasing power diminishes steadily. Bond prices have reacted to this but they are still priced on the basis that inflation will eventually settle at 3%.

If inflation continues at a higher rate they face further falls. Equities have more flexibility given businesses' ability to raise prices and reduce costs. However, managements today have little experience of handling inflation, which can ravage profitability. It's hard to stop costs rising and hard to pass costs on. Profits can be crushed as a result. Moreover, while PE ratios sit at approximately the average of the last twenty years in the high teens, in the high inflation 1970's they fell to single digits. Earnings have benefited from record low interest rates, globalisation holding costs down, record low taxes, and suppressed wages. All of these trends are reversing making the E in the PE vulnerable. This looks particularly true in Europe where indices are dominated by old economy businesses, which are energy intensive, so those rising costs further undermine earnings. Europe is suffering from running the energy transition too fast, given that renewable energy is not ready to replace fossil fuels. The global system is still configured for a fossil fuel economy so when oil and gas prices increase GDP growth suffers. China's growth is also a concern. In the last thirty years China has never reported such low growth. The export sector remains impressive with its deep pool of skilled educated labour, excellent infrastructure and logistics. However, the domestic economy is struggling with too much bureaucracy, high debt, adverse demographics, and a buckling real estate market. This is another drag on world growth.

What should investors do? Cash is far from being a safe haven with elevated inflation. Bonds remain highly valued by historical standards and face significant inflationary pressures which if they come through will lead to another heavy sell off. Even if inflation fades, concerns over the unfunded rise in debt levels by western governments may mean investors demand a higher return on Sovereign bonds, as the UK example in late September showed. If bond yields go higher that will put pressure on equity valuations, and any company that shows weakness will be de-rated sharply. However, there are opportunities. The commodity sector is performing strongly thanks to higher commodity prices. This is partly due to the Russia/Ukraine shock, but is sustainable because the transition to renewable energy is commodity intensive. There is a shortage of supply in the critical energy-transition materials due to environmental restrictions which will also support prices. Many investors are under-weight these sectors and if they increase their exposure there could be a significant upward move. While the large components of the indices are highly rated, many smaller companies show good value. This is true across the globe but particularly in Europe, Asia and Japan. Japan is a good market to hide in. It has low inflation, low leverage and has seen a significant change in profitability over the last decade. The yen is also cheap, so one can buy a cheap market in a cheap currency. An increasing number of Asean and Hong Kong stocks also look cheap with high yields and low PEs. Asean is expected to grow faster than China in the next ten years, its population is greater than that of Latin America, it has a GDP greater than India, and its currencies are backed by reserves well in excess of one trillion dollars.

If inflation does prove stickier than currently anticipated then most investors are positioned poorly. The popular 60% in stocks and 40% in bonds type portfolio looks especially exposed to inflation, given that most of the equity exposure is in growth stocks. The next decade may see a rebalancing to neglected areas such as Japan, Asean, and value stocks. Such a process is likely to be protracted. Global growth is ragged and there is little conviction anywhere. Active management with careful stockpicking will be critical; focusing on companies with strong franchises and cashflows which can take market share, and avoiding highly rated and highly indebted ones. Finally, the US dollar has been extraordinarily strong and looks overvalued. If and when it does fall that should be positive for equity markets outside the US. The euro and sterling have well-advertised problems, but the yen and the Asean currencies look good value.

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