



Investment commentary

December 2022

Market overview

After a strong recovery in October and November equity markets retreated in December in relatively thin trading. Notwithstanding the rally in the final quarter of the year, 2022 has proved to be an unusually challenging year for both equities and fixed income. Soaring inflation, driven by covid-related supply and demand issues and further fuelled by the energy crisis stemming from the conflict in Ukraine, has compelled central banks to hike rates at a time when global economic growth is falling.

As anticipated, interest rates rose further in December with the US Federal Reserve ('Fed') voting unanimously to raise rates by a further 0.5% and the Bank of England following suit, albeit by a majority rather than unanimous vote of 6-3. The messaging from the US was that further rate hikes would be required with the median 'dot plot' of members' views rising to 5.1% for the end of 2023, and to 4.1% for the end of 2024. We note that current market expectations are for rates to decline slightly quicker than the Fed is suggesting.

Inflation is receding slightly in most key regions as energy prices fall and supply chains ease. Global manufacturing backlogs are falling quite rapidly and delivery times are improving. In the US, the Richmond Manufacturing Index, a key measure of manufacturing activity, indicated the first expansion since April with both prices paid and prices received decreasing. This is all encouraging, albeit not yet sufficient to change the tightening stance of key developed market central banks who are also looking to see more evidence of weaker labour markets before changing policy. In the UK, reported pay increases in the private sector and the expanding list of public sector workers taking industrial action is adding to concerns that wage increases could extend the period of heightened inflation.

On balance, economic data surprised on the upside during December. China's National Health Commission also announced that it would ease covid restrictions as from January 8 and the effect of this on the economy has already been quite dramatic – traveller numbers and the leisure sector appear to be picking up strongly. In addition, China's Ministry of Finance announced a program of fiscal stimulus for 2023, adding to the government's existing pledge to support domestic demand. The rollout of stimulus packages in the eurozone also continues, with Spain announcing a third package of EUR 10bn targeting struggling households.

This stronger economic data and the expectation of recovery in China pushed bond yields higher (and prices down) over the month.

Over the course of 2022 markets have attempted to price in the likely impact of a sharp inflation spike, higher interest rates and recessionary conditions in much of the developed world. The potential prospect of a significant decline in inflation over the next year, greater visibility on the likely peak in rates, and of an economic and earnings growth recovery into 2024 should provide a more favourable backdrop for markets this year.

Strategy positioning

We are maintaining full equity market exposures across strategies – a lot of uncertainty is already priced in by markets and we believe this is not the time to be taking risk off the table, despite the uncertain near-term outlook.

We expect the economic downturn to be relatively short-lived and believe that the risks of exiting and re-entering markets are greater than riding out any potential further adjustment in asset prices. Remaining invested gives investors the chance of fighting inflation by participating in profit and dividend growth.

We are already positioned towards those parts of the world that should prove more resilient to the global slowdown, i.e. Asia and the USA, and which have a more entrepreneurial mindset to trade their way through the current uncertainties and generate superior long-term growth. It is too soon to be increasing exposure to the UK or continental European markets, despite attractive valuations. Commitments to global infrastructure assets and businesses exposed to important environmental and climate change initiatives continue to feature prominently in our asset allocation.

Strong exposure is being maintained to the US dollar; we continue to regard the dollar as the currency of choice, particularly during periods of economic weakness.

We have started to dial up the risk in fixed interest markets, adding targeted exposure to higher quality corporate credit as we believe that yields have become attractive while default risk remains low. Shorter-duration positioning has largely done its job and opportunities are now appearing across the full spectrum of bond markets after significant reactions to higher inflation and tighter policy during 2022.

Further adjustments to existing positioning are possible in the early part of this year and a fundamental increase in exposure could follow if the inflation/interest rate coast continues to clear. Until then, allocations to highly liquid alternative investment funds, exhibiting low levels of volatility, are being maintained – they continue to act as an effective risk management tool and substitute for fixed interest.

Risk warnings

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