BOWMORE

ASSET MANAGEMENT

Q3 MARKET OVERVIEW

October 2022

GLOBAL MARKETS

Despite a positive start to the quarter with a strong relief rally in July, equity and bond markets fell through the end of August and September to register a third successive negative quarter for investors. As inflation remained high across developed markets, central banks continued to tighten monetary policy, with the Federal Reserve (Fed), Bank of England (BoE) and European Central Bank (ECB) all hiking rates.

Global equities fell 6.6% in US dollar terms over the quarter, with investors pricing in the ongoing expectation of higher interest rates for longer. Emerging markets broadly underperformed their developed counterparts. The prospect of higher rates weighed heavily on fixed interest assets, with global bonds falling 7.3% as tighter policy continued to be favoured over support for growth.

Source: Refinitiv

OUR STANCE

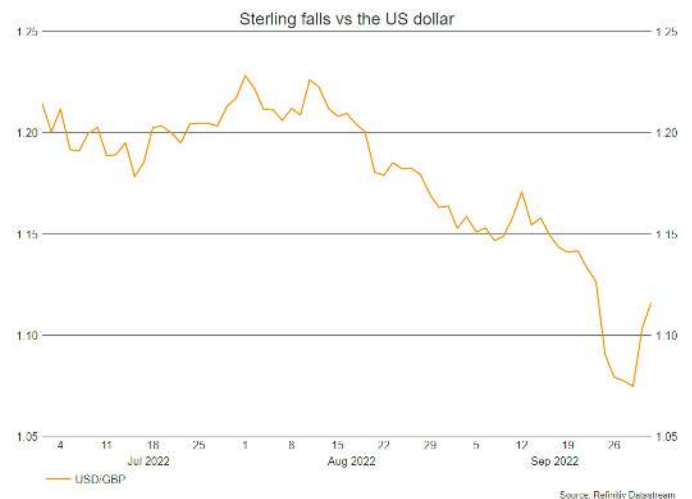
Negative	Neutral	Positive

Our outlook on global markets remains neutral. Though we have seen asset prices fall this year, at times steeply, equity and particularly fixed interest markets are presenting opportunities for investors. With valuations coming down on overinflated equities and credit spreads widening, fund managers will have an opportunity to leverage attractive price points. What remains to be seen is when a global recession hits and how deep this may be, but the medium to long term view offers positivity for patient investors.

UK

UK equities fell 4.1% over the quarter as small and mid-sized companies led the sell off, down 9.0% over the same period. UK value, an area of the market that has this year protected on the downside considerably, fell further than growth stocks in Q3, falling 5.2% and 1.6% respectively. The BoE raised rates twice over the quarter, moving up to 2.25% with a unanimous vote to increase another 0.50% in September, the largest rise since 1995. Inflation remains high, but appears to have stabilised around the 10% level, at least for now.

Ongoing sterling weakness vs the US dollar was exacerbated in September as Liz Truss won the conservative leadership contest, becoming prime minister and bringing in a swathe of fiscal stimulus, which was largely condemned by commentators and markets.



Source: Refinitiv

Sterling fell to a low of 1.068 against the US dollar, a level not seen since the 1980s, before recovery as U-turns were made on policy. This was enhanced by the Fed's clear intentions to stick with higher interest rates, boosting support for the green back. The rising cost of living in the UK has continued to weigh heavily on expectations for the consumer, with domestically focussed sectors suffering most as the prospect of recession looms. Despite ongoing concerns, GDP remains strong, coming in at 4.4% for the second quarter of 2022 (YoY) and continuing to avoid technical recession with positive quarterly growth rates persisting for now.

OUR STANCE

Negative	Neutral	Positive

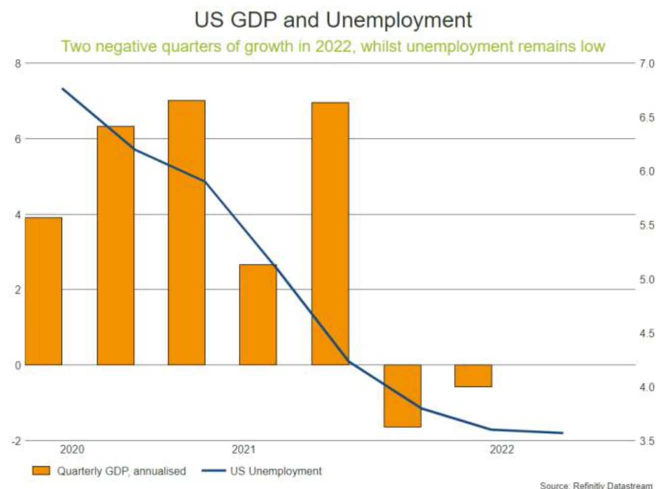
We remain neutral on our UK view. As our domestic market, we hold a meaningful allocation without being overly bullish on UK equities. Further rate hikes are anticipated by the BoE (1-2% in the next four months) and short-term expectations for the health of the economy are modest. However, growth remains steady and with new PM Rishi Sunak offering a stable approach to fiscal policy, a more robust pound will provide support for domestic importers and consumers.

US

Equities fell in the US for the third consecutive quarter, with the broad index down 5.1%. As in the UK, the more traditional value sectors bore the brunt of drawdowns with US value stocks falling 6.4%.

Though we saw improved sentiment in July, as investors started to toy with the idea that the Fed may pivot towards cutting rates in 2023, this was promptly reversed when it committed to its aggressive plan for tightening policy at the Jackson Hole summit in August. US interest rates climbed 1.00% over the quarter, moving up to 3.25%, whilst inflation continued to come off its June high of 9.1%, falling to 8.2% year-on-year (YoY) in September.

Despite GDP data pointing towards a technical recession, with two negative quarters for growth, the US economy appears to remain in respectable health. Unemployment sits close to pre-Covid lows, with non-farm payrolls showing more jobs than expected being added throughout the quarter.



Source: Refinitiv

OUR STANCE

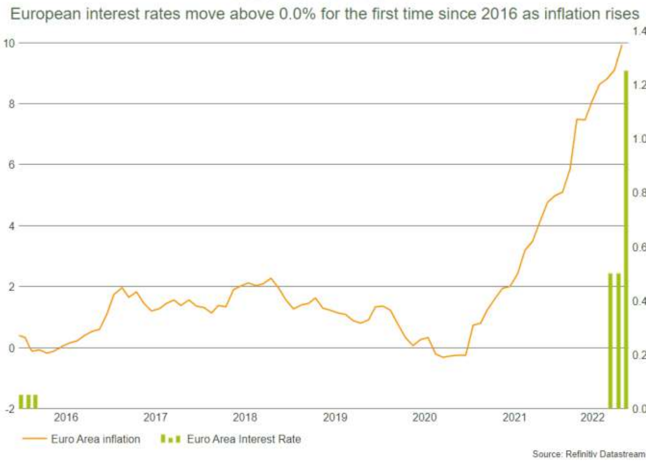
Negative	Neutral	Positive

We are cautiously holding our US equity exposure in the short term, with consideration to hedge some of the currency risk that has been priced in by a strong dollar. With the US economy seemingly robust, all eyes will be on how far the Fed will go with rate rises. When global sentiment turns more positive, we will see sectors of the US market come back strongly.

EUROPE

The broad European equity index fell 4.1% over the third quarter, leading some its global peers despite ongoing concerns around proximity to the Russia/Ukraine conflict and the possible impact of over-reliance on Russian energy on economic growth. Value stocks underperformed growth stocks by 2.5%, falling 6.1% over the period, and small and mid-sized companies shed 7.3%.

In contrast to the UK and US, inflation in the Eurozone continues to push higher, reaching 9.9% (YoY) in the last month. The ECB therefore began raising interest rates as expected in July and again by 1.0% in September, ending the quarter at 1.25% after years of zero-rate policy.



Source: Refinitiv

Energy dependence continues to be a concern for investors in the Euro Area, and in July the Nord Stream 1 pipeline, which carries gas from Russia into Europe, was shut for maintenance and was shut down again by Russia in September. With the winter approaching these risk events highlight possible strains in supply.

OUR STANCE

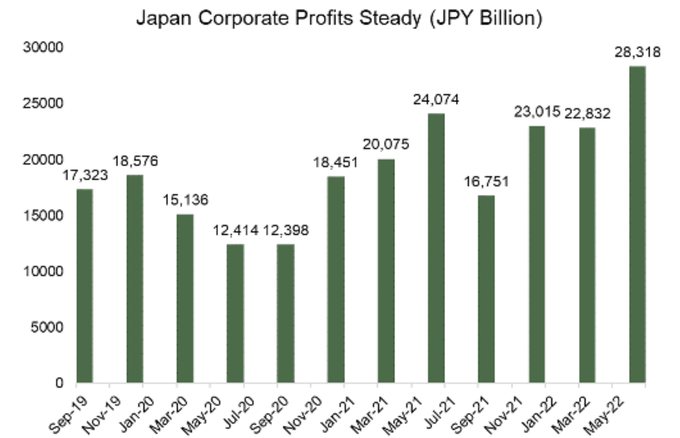
Negative	Neutral	Positive

Geopolitical tensions in Eastern Europe and persistent concerns around energy pricing and supply moving into Winter leaves the industrial landscape in limbo and output over the short to medium term is uncertain. We have reduced our allocation to broad European equities and a higher short term cash balance has helped dampen downside in portfolios.

JAPAN

Japanese equity markets fell a relatively modest 2.5% over Q3 2022, when compared to developed peers. At the beginning of the quarter the country was rocked by the assassination and untimely death of popular former prime minister Shinzo Abe. Once again, value stocks led the downward trend, falling 4.0% over the period, though small and mid-sized companies remained resilient, with the broad index relatively flat (-0.5%).

Unlike many of its developed peers, the Bank of Japan (BoJ) has retained its stance to monetary policy, keeping rates low and maintaining its yield curve control programme. With policy so accommodative, the yen weakened considerably against a strong US dollar, falling to 144 by the end of the quarter, the lowest since 1998, and because of this excessive move the BoJ intervened to support the yen toward the end of September. Despite a much weaker yen increasing the cost of imports, growth in Japan appears to be steady, with second quarter GDP growth coming in at 0.9% and corporate profits beating expectations.



Source: Trading Economics

At present the BoJ has managed to keep policy looser, as inflation has not been as rampant in the region. It has started to creep up this year, and reached 3.0% YoY in August and September, but clearly has some way to go before it compares to other developed economies.

OUR STANCE

Negative	Neutral	**Positive**

The relative valuations of Japanese companies versus their global peers are extremely attractive within certain segments of the market. Whilst Japan has not been completely immune to inflationary woes, it sources its energy from alternative regions, such as the Middle East, and is not as exposed to many of the challenges faced by Europe and the UK. A weak yen also provides an opportunity for foreign investors to benefit when the currency moves back into a more sensible trading range.

ASIA AND EMERGING

Emerging markets underperformed their developed peers through the last quarter, the broad index fell 12.5% in US dollar terms. Chinese equities lead the way in this regard, off 23.1% on fears of a global slow down, and with their zero-Covid policy the prospect of further lockdowns fanned the flames of concern. Despite this, August saw factory activity expand in China.

Indian equities were a standout performer in Q3, finishing the period up 9.5%, though a strong US dollar and higher US rates pegged back returns in late September. India has been well placed this year following a strong vaccine roll

out and recovery from Covid, with business-friendly policy supporting a cyclical rotation in the economy.

Source: Refinitiv

As investors mulled their asset allocation options, flows moved away from riskier assets. Taiwan (-10.4%), South Korea (-9.0%), Hong Kong (-21.2%) and the Philippines (-8.2%) sold off, though pockets of support were found for Brazil (+7.7%), Indonesia (+10.0%) and Thailand (+2.6%). Turkey, where inflation is running at more than 80% and the central bank has been cutting rates, was up 28.9% over the period.

OUR STANCE

Negative	Neutral	Positive

The Chinese markets have been challenging for our portfolios, though by reducing some of our exposure earlier in the year we were able to provide a more diverse allocation to Asia. Alongside our India-specific holding we have seen strong relative performance from this sector. Although China is sensitive to global growth and demand, if we see a lower oil price and a weaker dollar, Asia/Emerging assets will benefit and we hold a neutral to positive stance to the broader sector.

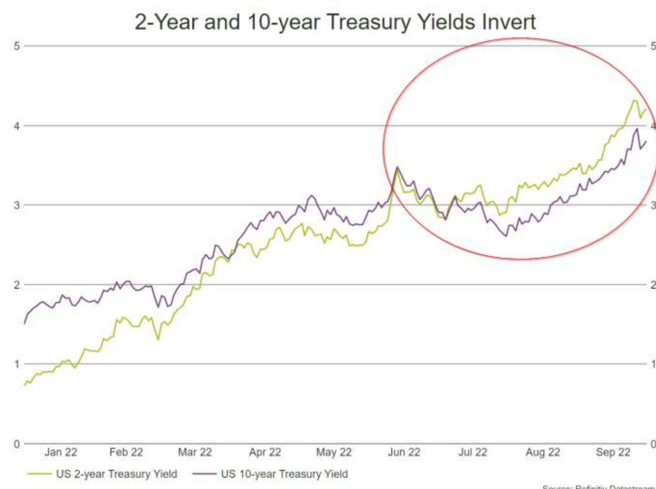
FIXED INTEREST

Government bonds

As developed central banks have been hiking rates this year, the yields on fixed interest securities have moved higher as the prices of bond instruments have fallen. With the third quarter of 2022 bringing renewed promises from bankers to push on with tighter policy to curb inflation, higher yields were inevitable.

The US 10-year treasury finished the quarter yielding 3.83%, having started out at 2.97% and briefly approached 4.00%. The 2-year treasury yield finished at 4.21%, higher than that of the 10-year, indicating an inverted yield curve.

By this measure, the yield curve inverted at the beginning of the quarter and is often seen as a precursor to a recession, though the timing of said recession can be difficult to predict.



Source: Refinitiv

UK gilts also fell over the quarter, with the 10-year gilt yielding 4.09% by quarter end vs 2.07% at the start. September's mini-budget announcement saw gilt yields balloon out at the end of the month, with the BoE having to step in, to calm bond markets and provide liquidity as pension funds were forced to sell assets. 10-year German bunds finished the period with a 2.11% yield, up from 1.22%.

Credit and high yield

Credit spreads broadly widened over the quarter (the premium paid on corporate debt over government debt of a similar maturity rose). Investment grade bonds fell 7.3%* over the quarter, though global high yield bonds fell less, despite the risk premium paid within this sector, falling 5.5%*. Many parts of the high yield market have been punished by the risk of recession being priced in, perhaps unfairly in the eyes of some commentators, who see value in those oversold segments.

Global convertible bonds protected relatively well for investors in both bonds and equities, registering a 2.5%* drawdown for the period. Global index-linked bonds fell 6.3%*, with almost all of this loss in September.

*US dollar returns

OUR STANCE

Negative	Neutral	Positive

With high inflation and interest rates rising more aggressively, fixed interest assets have had a torrid year. Our negative view remains for now, as allocating aggressively in this space could prove

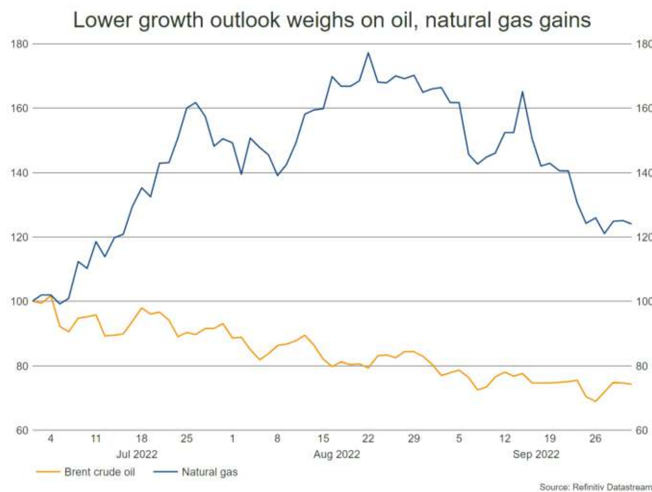
painful in the short term. We therefore favour low duration funds but rising yields and wider credit spreads are offering better value.

ALTERNATIVES

Commodities

With the expectation of a global slow down and/or recession, commodity prices have receded of late, indicating the market anticipation of lower demand and production. Lower prices have aided some stabilisation in inflation numbers for now.

The broad commodity index fell 4.8% over the three months to the end of September, led by lower energy and metals prices. Brent oil fell 23.4% over the period, offsetting higher natural gas prices, which rose 24.7%. Gold, platinum and silver all registered negative returns, falling 8.2%, 6.2% and 3.9% respectively. Industrial metals also fell with zinc down 3.0%, nickel down 7.1% and tin down 20.5%.



Source: Refinitiv

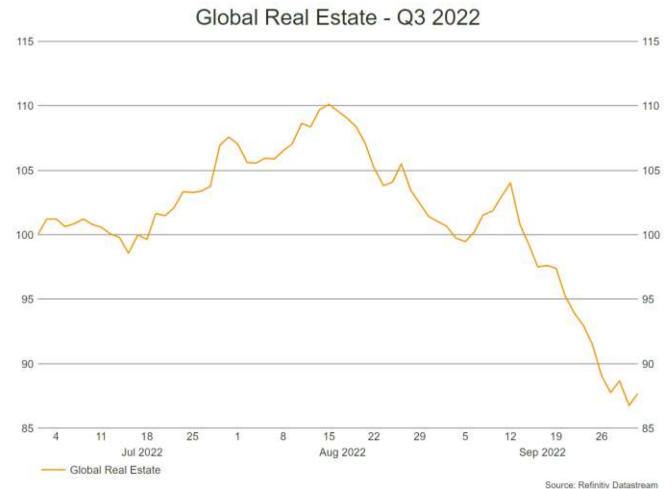
OUR STANCE

Negative	**Neutral**	Positive

We shifted our stance from positive to neutral for commodities last quarter as the expectation of slowing growth and recession had increased. This has been played out in lower commodity prices in Q3. There will come a time to reallocate commodity assets, and we are conscious the inflationary commodity cycle will not last forever.

Property

As interest rates have risen sharply this year, mortgage rates in the UK have also spiked, causing concern for the housing market. Despite this, property prices remained relatively robust. This said, global real estate funds fell over the quarter, with the global REIT index declining 11.5%. In the UK, property funds came under enhanced pressure towards the end of September as the mini budget raised concern for liquidity within open-ended products.



Source: Refinitiv

OUR STANCE

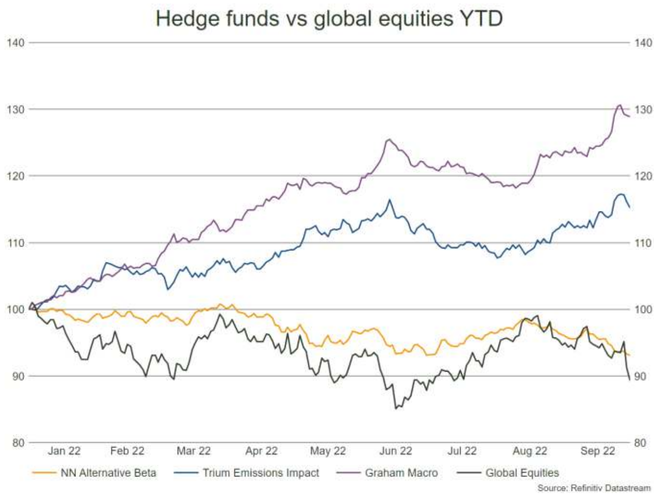
Negative	**Neutral**	Positive

Our stance on the property sector is deteriorating, as higher rates and volatility in the bond markets has caused liquidity concerns as assets have been withdrawn by investors. Although we retain our allocation for now, we are mindful of short-term strains within the market. Property prices are linked to the economy and will come under pressure if recessionary pressures build further. That said, long leases and stable tenants can provide an attractive yield for portfolios at a time when asset prices are falling.

Structured products and hedge funds

Structured product allocation performance fell in the third quarter, posting an average drawdown of 5.2%. As investment markets fall and yields move higher the opportunity for future allocation within this space becomes more compelling, with the market offering higher yields at more attractive levels.

Hedge funds continued to outperform most other asset classes in Q3, registering a 2.3% return for portfolios. Within the sector it continues to be managed futures, commodity and market neutral strategies that have added most value, with equity long/short, multi-asset and credit coming under pressure.



Source: Refinitiv

OUR STANCE

Negative	Neutral	Positive

We remain positive on structured products and hedge funds. The volatile nature of short-term markets has allowed these segments to exploit opportunities and provide protection in a diversified portfolio for investors. We feel that volatility will remain elevated in the short to medium term and so retain our stance to these assets.

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