HYMANS ROBERTSON
INVESTMENT SERVICES

Hymans Robertson Investment Services (HRIS)

Weathering the storm of 2022

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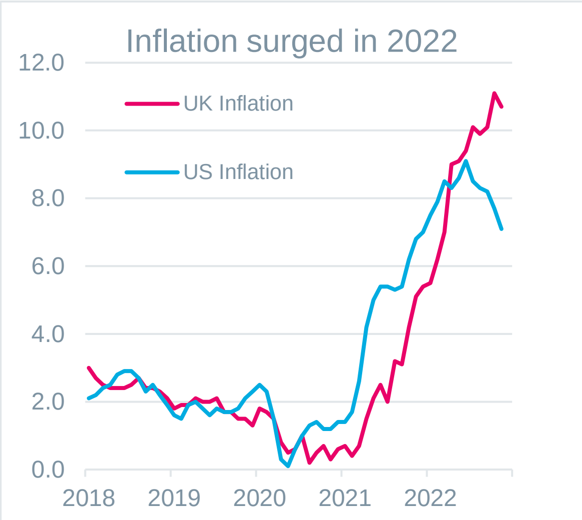
With the exception of the Global Financial Crisis in 2008, 2022 is set to be the worst year for markets this century:

- High and persistent inflation led to one of the fastest periods of rate rises for decades hurting almost all asset classes.
- There were few hiding places, with cash and certain equity sectors, like oil & gas, being the few areas of the market to generate positive returns.
- Volatility increased, causing periods of market stress as seen after the mini-budget.

But the night is always darkest before the dawn and, although a challenging economic environment remains, forward looking returns on a range of asset classes have increased which creates opportunities for investors. As part of a two-piece series, we shall first look back at the events that drove markets in 2022 before discussing what investors should look ahead to in 2023.

Inflation is back

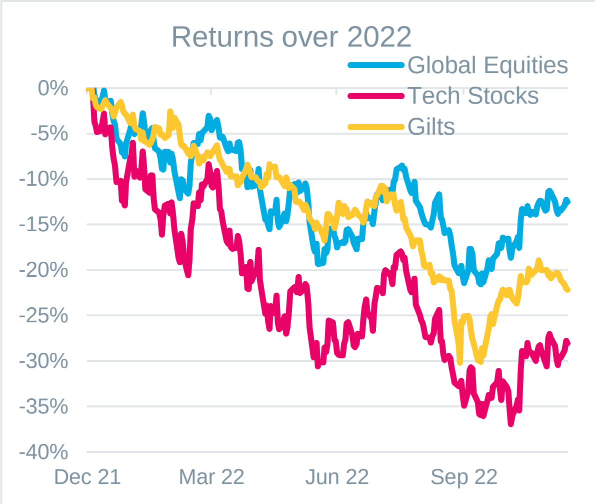
The end of 2021 marked almost perfectly the peak in the market cycle. Back then, the US central bank, the Federal Reserve ("Fed"), was still contemplating the start of a mild series of interest rates rises. Fed members, at the time, expected rates to reach just 0.9% by the end of 2022. Yet as we come to the end of the year, the Fed's target interest rate sits at 4.5%. In 2021, a 0.5% rate hike at a single meeting looked like the Fed was slamming its foot on the economic brakes, but after four consecutive 0.75% hikes in 2022, markets reacted to a half-point increase this December with (almost) joy. Other central banks around the world, including the Bank of England ("BoE"), have taken similar actions, leading to one of the most dramatic shifts in financial conditions that markets have seen in decades. The motive for this considerable change in central bank policy was of course surging inflation. Appearing initially as a consequence of the pandemic's effects on global supply chains, this was exacerbated by the war in Ukraine driving up energy prices and tight labour markets pushing up labour costs.



Source: ONS, US Bureau of Labor Statistics

Challenging year for assets

The effect this has had on asset markets everywhere has been staggering. Since the start of the year, global equity markets fell 17% by the end of October. Technology stocks, one of the main drivers of equity market returns in the preceding years, fell 33% to October. The earnings growth that tech companies offer many years into the future are no longer as valuable to investors who now favour companies that can promise cash flows today. Speculative areas of the market, such as cryptocurrencies, have collapsed in value. An asset that yields nothing is worth far less when everything else yields something. One of the few sanctuaries for investors was in energy stocks, boosted by the elevated oil & gas prices. These stocks are up in value by over 40% to the end of November.



Source: Datastream

However, the real pain to many investors has been with fixed-income. Bonds are meant to dampen volatility in portfolios by historically being negatively correlated to equities – when investors are too scared to hold equities, they buy bonds, boosting prices. But because the origins of this sell-off came from rising inflation and higher interest rates this has affected bond prices heavily. UK government bonds, or gilts, bottomed out in late September when they were 30% down from the start of the year – comparable to the losses seen in some of the riskier sectors of the equity market. Bond portfolios focused on shorter-dated bonds would have held up better owing to their lower sensitivity to interest rates.

Currency markets have also seen outsized moves over the year. The strength of the dollar was so relentless, a symptom of the aggressive Fed rate hikes, that by the end of summer it had reached parity with the euro. Although a weak pound might sound negative, from a UK investor's perspective it has helped to offset some of the losses sustained on overseas assets as those assets are worth once translated back to sterling.

The fastest rate tightening cycle in decades has led to other crises in markets. In late September, the government's mini-budget sent the gilt market into near free-fall. Although the mini-budget was the trigger, the preceding rise in interest rates, volatility and the BoE's retrenchment from the gilt market set the conditions in place for such a crisis to occur (the BoE was forced to re-enter the gilt market with another bond buying programme in order to stop the selling). The volatility in gilt markets was so high during this period that yields on these bonds were moving by over 1% in a matter of hours – in 2018 the BoE described this level of movement over a month-long period as a 1 in 1,000 event.

This year reiterated our belief that diversification between asset classes alone is not sufficient but diversification within asset classes is also necessary. For example HRIS holds an explicit allocation to infrastructure within our equity allocation, which benefited from the rise in energy prices, as well as short-duration and floating rate bonds in the fixed-income portfolio, which partially insulated portfolios from the rise in yields.

Light at the end of the tunnel?

This year will be remembered by investors as the end of the era of cheap money, but investors should remember that the previous decade or so was the exception, not the rule. Although the transition to the new (or old) regime has been painful for some, the forward outlook for asset returns looks much rosier. Investors can now receive just under 4% p.a. for lending to the US government at almost no risk. This is in stark contrast to the past decade where investors were having to take evermore risk in order to generate any return, infamously summarised by the acronym TINA – There Is No Alternative (to investing in stocks). The fight against inflation is not over however, and economic growth looks precarious.

Nevertheless, markets have historically acted as lead indicators of macroeconomics and therefore we would expect to start seeing signs of markets recovering well before the worst of the economic news is fully out of the system.

Next month we will look ahead to 2023 to try and identify where the opportunities may lie and where caution should be prioritised.

Jack Richards, CFA
Investment Manager

Risk warning

The value of your investments and the income from them may go down as well as up and neither is guaranteed. Investors could get back less than they invested. Past performance is not a reliable indicator of future results. Changes in exchange rates may have an adverse effect on the value of an investment. Changes in interest rates may also impact the value of fixed income investments. The value of your investment may be impacted if the issuers of underlying fixed income holdings default, or market perceptions of their credit risk change. There are additional risks associated with investments in emerging or developing markets. The information in this document does not constitute advice, nor a recommendation, and investment decisions should not be made on the basis of it. The material provided should not be released or otherwise disclosed to any third party without prior consent from HRIS.