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Portfolio and Market Review

4th Quarter 2022

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Economic Outlook & Market Commentary – January 2023

As we begin 2023, it is essential to take stock of the economic and investment landscape. 2022 was marked by difficulties and challenges on multiple fronts. Inflation and high interest rates made their first appearance since the great financial crisis. The conflict in Ukraine weighed heavily on global relations and economic stability.

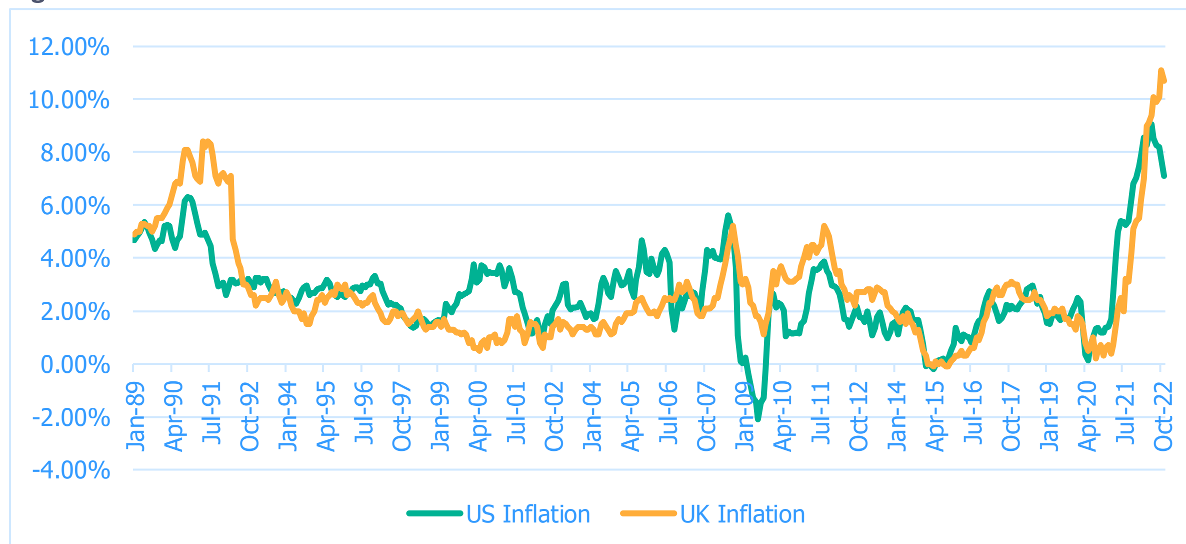
These and other factors have created a complex and dynamic environment for investors and businesses alike. However, despite these challenges, there are also numerous opportunities to be found for those willing to navigate these uncertain waters. This update will delve into the key trends and factors shaping the economic and investment landscape and provide insights and analysis on how best to position yourself for long-term success.

Economic outlook:

Inflation is coming down, but it may be sticky…

Inflation expectations have been a key focus in recent months. While we saw a peak of 11.1% in October in the UK, followed by a slight decrease to 10.7% in November[1], it is still too early to say that we have definitely reached a turning point. However, if we look at the US market as a leading indicator, there may be cause for optimism. As depicted in the chart below, US inflation reached a peak of approximately 9% in June but has since declined to the vicinity of 7%[2]. This trend could potentially signal a turning point in inflation levels globally.

Figure 1: US vs UK Inflation



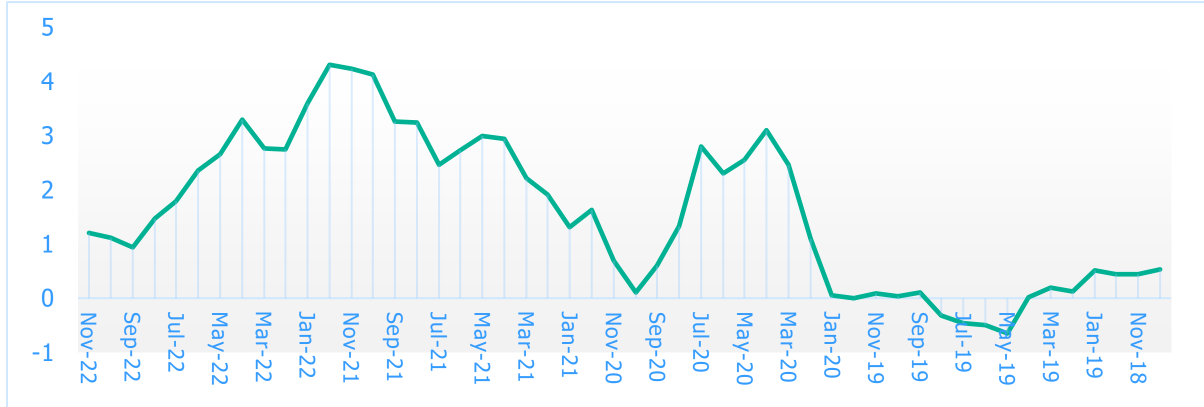
Office for National Statistics (2022), RI (2022)

The recent decline in inflation levels can be attributed to various factors. One key factor is the easing of supply chain constraints, which can be measured using the Global Supply Chain Pressure Index (GSCPI) developed by the Federal Reserve Bank of New York. As figure 2 below demonstrates, we have seen a significant reduction in supply chain pressures towards the end of 2022.

[1] Office for National Statistics (2022)
[2] RI (2022)

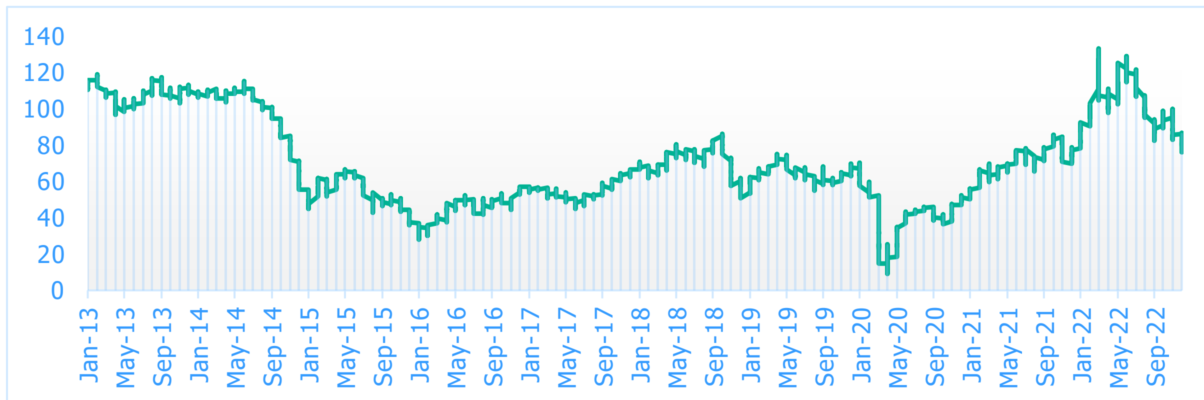
A second factor can be attributed to the decline in the price of certain goods, particularly commodities such as Brent crude oil, which is currently trading on par with where it was 12 months ago. While prices remain elevated, we will soon approach a period where the base rate of Brent crude oil reaches a high of $133 per barrel. These developments signal a positive shift in global inflation levels.

Figure 2: Global Supply Chain Pressure Index



(Federal Bank of New York, 2023)

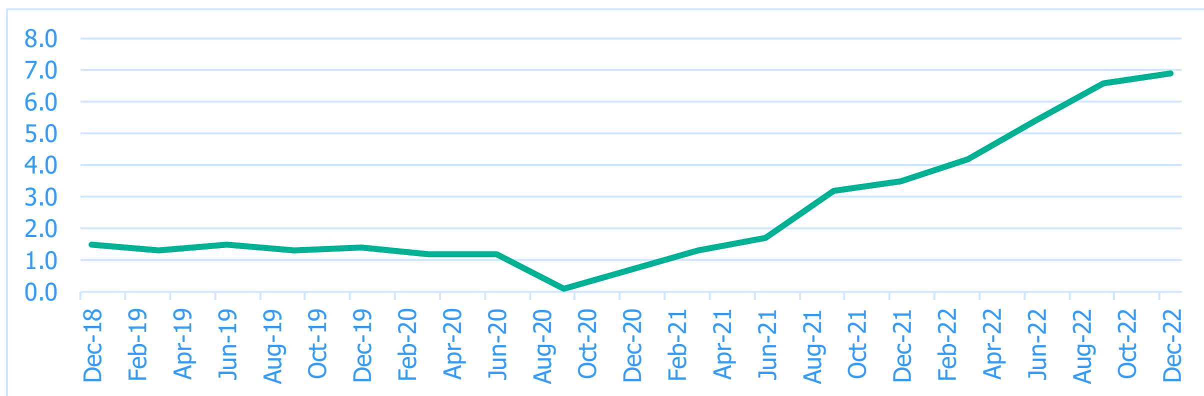
Figure 3: Brent Crude Price



(MacroTrends, 2023)

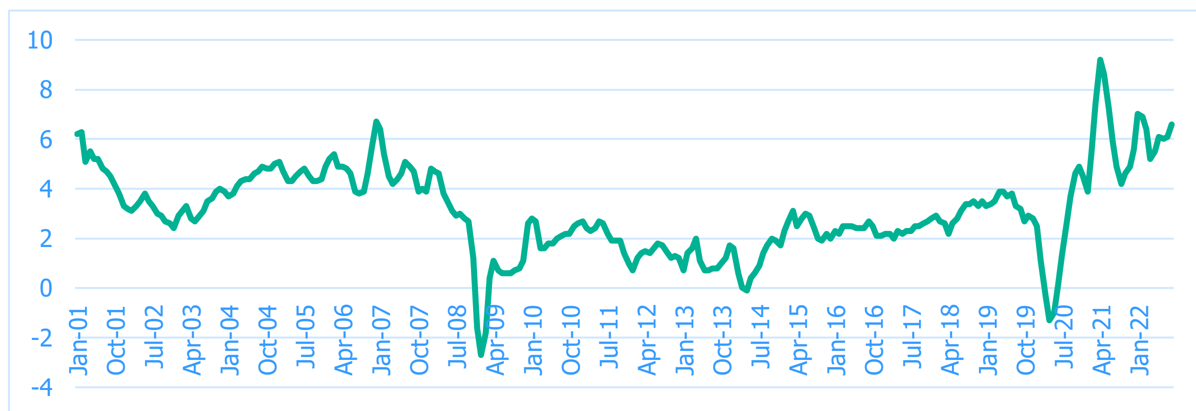
That said, we should be careful of being too optimistic. While inflation may be turning, there is still a risk that it will not decline to the target level of 2% anytime soon. One reason for this is that service prices are still climbing. As illustrated below, in figure 3, The Service Price Index (an index that measures the price change for a range of services) is currently at 7%. Also, wages are rising more rapidly, as illustrated in Figure 5. These two contributors to inflation tend to be stickier than inflation on goods and could contribute to persistently high inflation.

Figure 4: Service Price Index (SPPI)



(Office for National Statistics, 2023)

Figure 5: UK Wage growth



Office for National Statistics, 2023)

Overall, the economic outlook for inflation expectations remains uncertain. While there are positive signs that prices may stabilise, there are also risks that could lead to a sustained period of high inflation and no economic growth, more commonly known as stagflation.

Interest rates and (maybe) a looming recession…

The Bank of England increased interest rates yet again by 50 basis points in December to 3.5%[3]. According to market expectations, there may be a further increase of 50 basis points in February, followed by 25 basis point increases in March and May, bringing the terminal rate to 4.5% before the Monetary Policy Committee may decide to pause their hawkish behaviour.

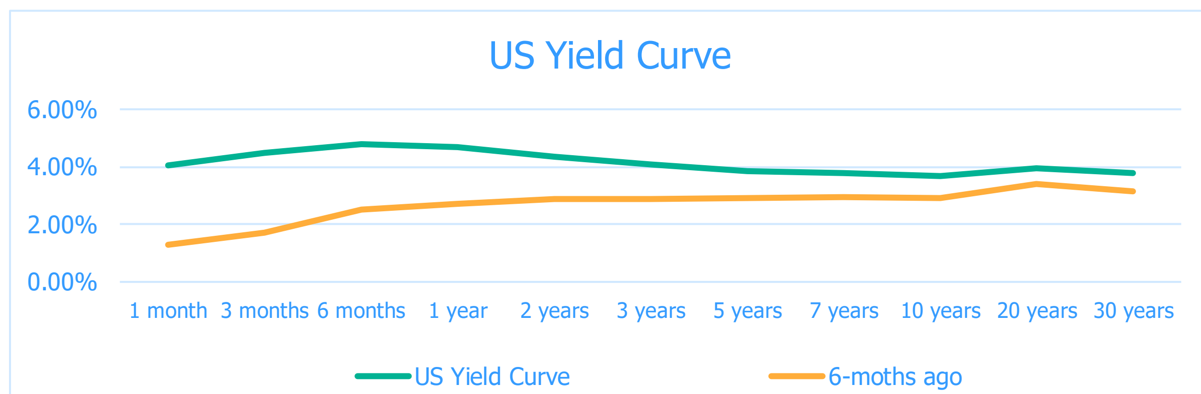
This market outlook is supported by the Bank of England, which has indicated that "additional increases in the Bank Rate may be necessary in order to sustainably return inflation to target levels." It is expected that the Bank of England will pause its interest rate hikes by the middle of 2023. However, it is not anticipated that there will be any decrease in rates until 2024. The Bank of England plans to maintain elevated rates to prevent inflation from remaining at elevated levels. These expectations are consistent across all global central banks.

[3] (Bank of England, 2022)

As interest rates have risen, mortgage rates have also increased, reaching a high of 6.4%[4] in December. This increase in rates has put significant pressure on both individuals and corporations, which could ultimately impact the real GDP growth rate of the economy. Given these factors, is it reasonable to expect a recession in 2023?

Well, the answer to this question does not seem black and white at this stage. One way to potentially predict a recession is to examine the shape of the yield curve. It is commonly believed that an inverted yield curve, where long-term interest rates are lower than short-term interest rates, may indicate an imminent recession. The current yield curve in the US has been inverted for over 190 days[5], which could suggest that a recession is approaching. The following chart shows the current shape of the US yield curve compared to its shape six months ago.

Figure 6: US Yield Curve



(World Government Bonds, 2023)

Do inverted yield curves really predict recessions?

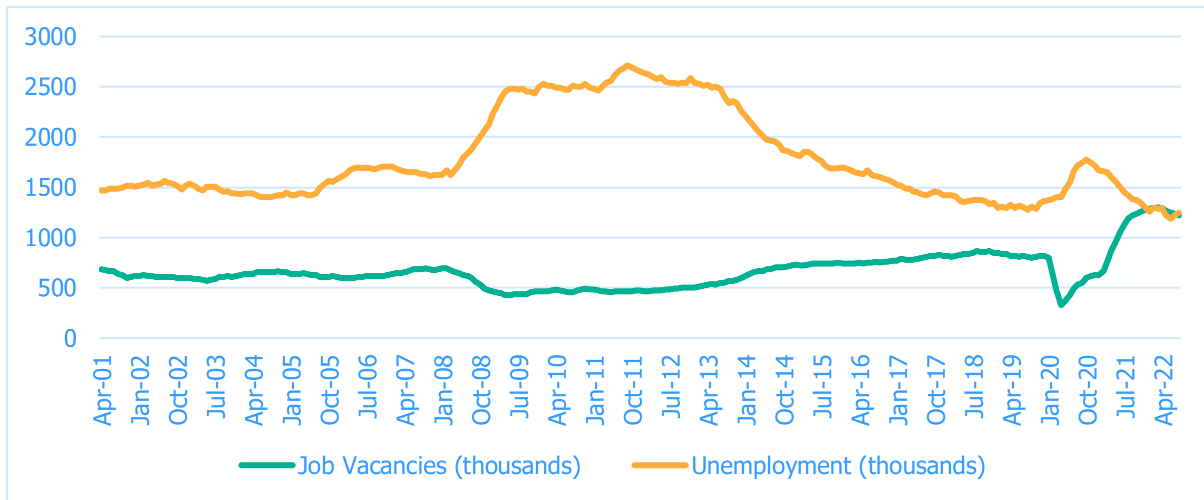
An inverted yield curve can signify a recession because it suggests that investors expect interest rates to fall in the future, which can indicate economic weakness. When this happens, investors may move their money from long-term investments to short-term ones to take advantage of the expected drop-in interest rates. This shift in investment can contribute to a slowing economy and possibly lead to a recession. However, it's important to note that an inverted yield curve is not a sure sign of a recession and there have been cases where an inverted yield curve did not result in a recession. Additionally, not all recessions have been preceded by an inverted yield curve. It's just one factor to consider when looking at the risk of a recession.

With the above said, there is still uncertainty about the possibility and depth of a potential recession, despite specific indicators, such as an inverted yield curve. The fact that job vacancies in the UK remain high and unemployment rates are still low may suggest that the economy has yet to reach a point of significant weakness. There are currently an equal number of job vacancies as there are unemployed individuals in the UK (figure 7). During a recession, unemployment rates typically tend to rise as companies begin to lay off workers and job vacancies decrease as hiring slows. The fact that these trends have yet to emerge may be a positive sign for the economy. However, it is worth noting that there have been several reports of planned mass layoffs globally, including Amazon's recent

[4] (Tradingeconomics, 2023)
[5] (World Government Bonds, 2023), Spread measured by the 10yr-2yr US spread.

announcement to cut 18,000 jobs[6], which would undoubtedly impact the job market and the economy's overall health.

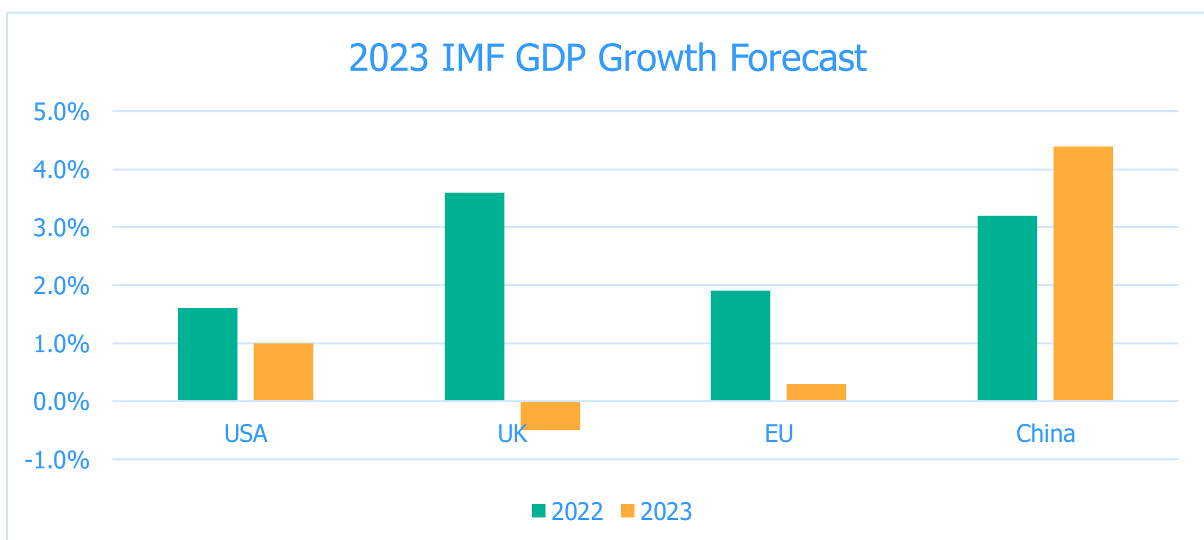
Figure 7: UK Job vacancies vs UK Unemployment



(Office for National Statistics, 2023)

Overall, the IMF's GDP growth forecast for the major economic players suggests a mixed outlook for the coming year. While the USA and China are expected to see modest growth, the UK and EU are expected to experience zero or negative real economic growth due to the war in Ukraine and the ongoing energy supply constraints. It is important to note that these forecasts are subject to change and could be impacted by various economic and political factors. That said, it is clear that the global economy is facing a challenging environment and it will be necessary for policymakers to carefully monitor these trends and take appropriate measures to support growth and stability.

Figure 8: 2023 Economic Growth Forecast



(International Monetary Fund, 2023)

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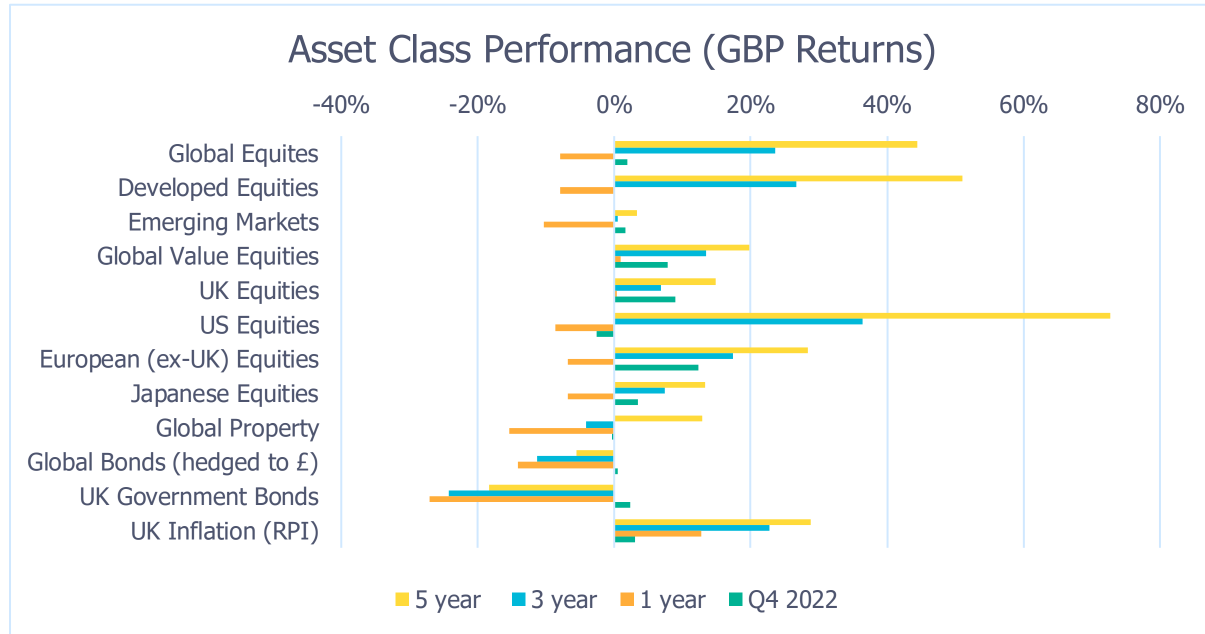
[6] (Reuters, 2023)

Asset Class Returns

Last year was one of the worst years in history for the financial markets, with almost all asset classes ending the year in negative territory.

Figure 9: Asset Class Returns



(Timeline, 2023)[7]

Equities

Global equities saw a return of -7.88% over the past year, with developed equities realising a negative return of -7.97%. Emerging markets struggled particularly, with a return of -10.3%. However, UK equities broke the trend with a positive return of 0.33%.

Despite these challenging conditions, the final quarter of 2022 brought some good news for investors. Global equities saw a more upbeat performance, with a return of 1.89%. This was driven by strong returns in emerging markets (1.66%) and UK equities (8.91%), as well as impressive returns in EU equities (12.37%).

Value stocks have been relatively stable compared to global equities from a factor-based perspective. Over the past year, value stocks saw a return of 0.99%, with a return of 7.82% in the final quarter of 2022. Large-cap growth stocks had a challenging time in 2022 as global investors turned their backs on overpriced big tech companies and turned towards companies with better valuations. The size and profitability (quality) risk factors, which are prominent alongside the value premium in our evidence-based (Classic) investment philosophy, were not able to keep up with the performance of value stocks over the past year, however, they did manage to maintain a low level of volatility and outperformed the global equity markets in general, as can be seen in figure 10 below.

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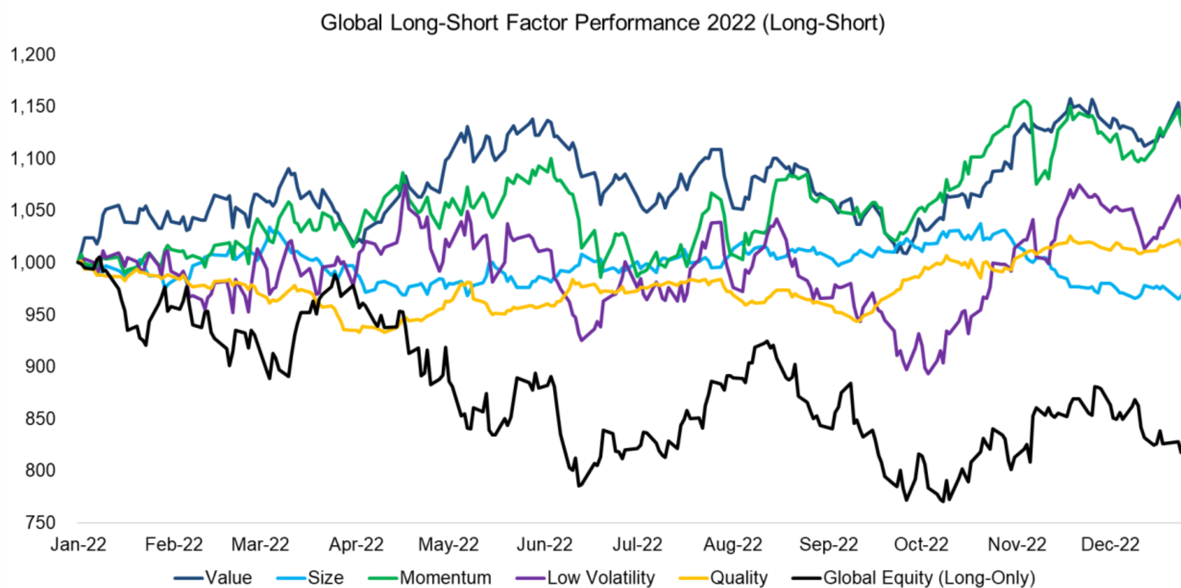
[7] Developed Equities: iShares Developed World Index; Emerging Markets: Vanguard Emerging Markets Stock Index; Global Bonds (hedged to £): Vanguard Global Bond Index Hedged; Global Equities: iShares MSCI ACWI UCITS ETF; Global Property: iShares Global Property Securities Equity Index; Global Value Equities: iShares Edge MSCI World Value Factor UCITS ETF; UK Equities: Vanguard FTSE U.K. All Share Index Unit Trust; UK Government Bonds: Vanguard UK Government Bond Index; UK Inflation (RPI): Index: UK Retail Price Index; . Performance periods: 1 Year: 01/01/2022 - 31/12/2022; 3 Year: 05/01/2020 - 05/01/2023, 5 Year: 05/01/2018 - 05/01/2023; 7 Year: 05/01/2016 - 05/01/2023.

Figure 10: Factor performance



Source: (Finominal, 2023)

Property

Global property was one of the worst-performing asset classes of 2022 due to aggressive rises in interest rates worldwide. Property ended the year with a negative return of -15.34%, with a sideways move in the final quarter of 2022.

Fixed Income

Fixed income has been a hot topic for most of 2022, as this 'safe haven' asset class was one of the most volatile asset classes of the year. The underperformance in fixed income was driven by unexpected inflation, which sparked all central banks around the globe to engage in aggressive monetary tightening by raising interest rates to fight off the threat of inflation. The level of interest rates directly influences the performance of fixed-income assets. As rates are expected to rise, the value of fixed-income securities declines.

Global fixed Income ended the year with a negative return of -14.06%. UK government bonds (GBP hedged) fared even worse, with a year-end return of -27.02%. However, the last quarter of 2022 saw fixed-income assets staging a fightback attempt, with global bonds seeing a return of 0.59% and UK government bonds (GBP hedged) recovering 2.37%.

While 2022 was a challenging year for investors, the final quarter of 2022 provided some encouraging signs for a recovery. It remains to be seen whether these trends will continue. However, with the heightened recession risk, the war in Ukraine, and the possibility of sticky inflation, it is too soon to predict whether a turnaround point has finally arrived.

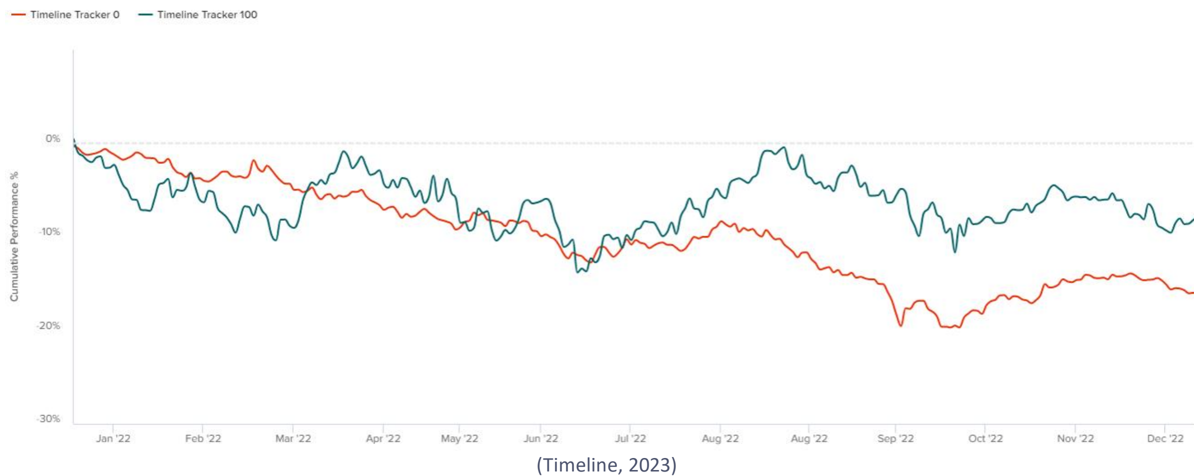
Portfolio Performance

In the previous quarterly commentary, we stated that the great thing about following a globally diversified market-cap approach to investing is that you always have relative predictability of what will happen in your portfolio relative to the general market. Therefore, it should be no surprise that the performance of our portfolios has been struggling throughout 2022. However, we experienced strong rebounds in the final quarter of 2022.

Timeline Tracker

As seen in the chart below, both the equity and fixed income portions of the Timeline Tracker portfolio have been in negative territory over the last twelve months. Timeline 100, our equity position in the Tracker model, has returned -7.90% over the first three quarters of 2022, whereas Tracker 0, our fixed income position in the Tracker model, has returned a negative performance of 16.05% over the same period.

Figure 11: Timeline Tracker performance

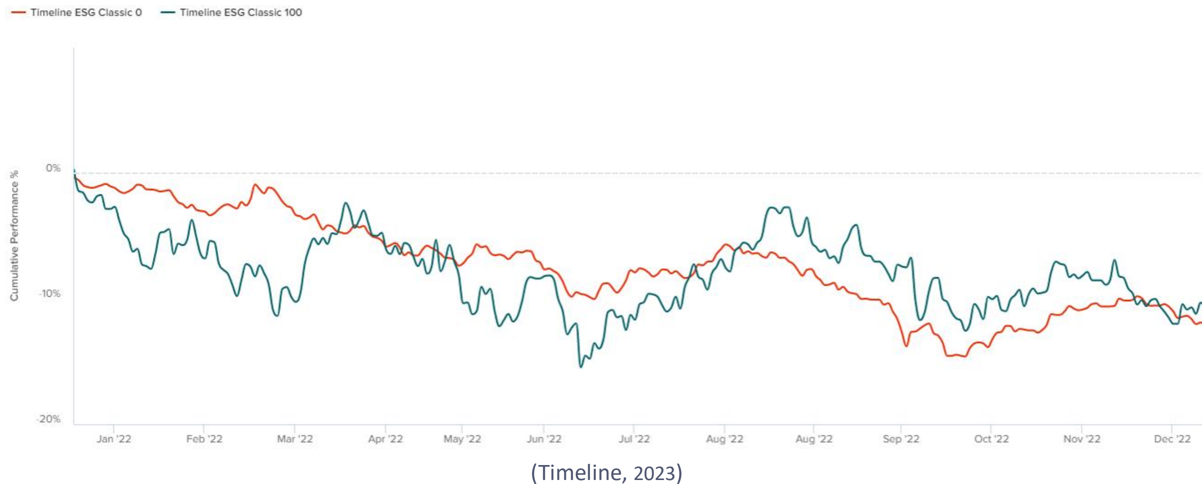


(Timeline, 2023)

Timeline Classic

The performance of Timeline Classic has outperformed the general market, as measured by Timeline Tracker, on both the fixed-income and equity portion of the model range. Our Classic 100, the equity portion of our Classic model, has returned -5.49% for the year. This outperformance can be attributed to the value risk premium that made a comeback in 2022. The Timeline Classic 0, the fixed income portion of our Classic model, has performed better than its Tracker counterpart, with a performance of -11.74% for the year. The outperformance of Classic 0 compared to Tracker 0 can be attributed to a shorter duration.

Figure 12: Timeline Classic performance

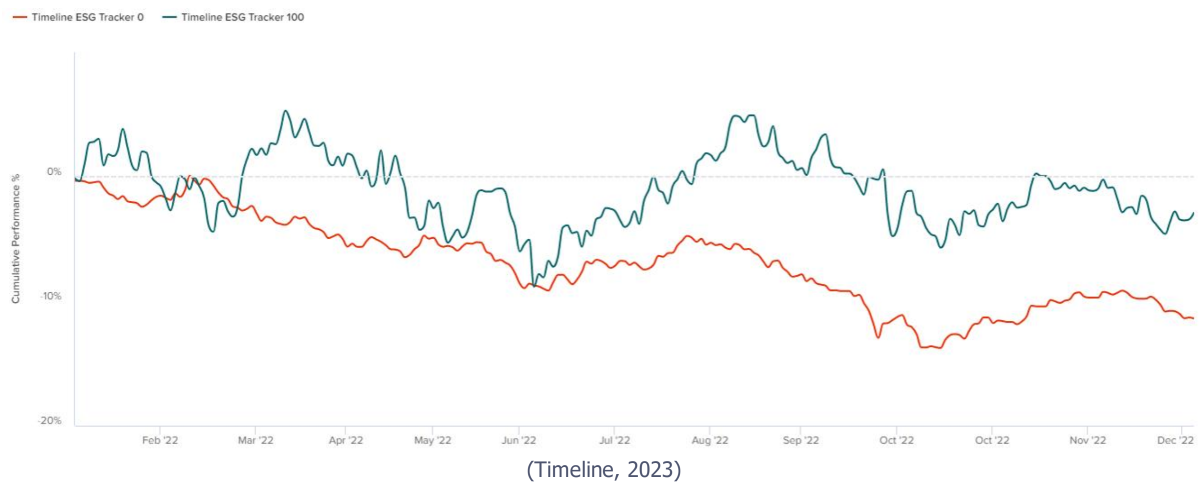


(Timeline, 2023)

Timeline ESG Tracker

Timeline ESG Tracker 100 returned -10.23% for the year end. Compared to our Tracker and Classic portfolio, this underperformance in equity was primarily driven by active ESG risks. The ESG overlay in the portfolio underweights energy and commodity stocks which were the best-performing sectors in 2022. The Timeline ESG 0 portfolio, the fixed income portion of our ESG model, had a negative return of 12.25% for the year end. This fixed income performance was in line with Timeline Classic, which has a similar average duration.

Figure 13: Timeline ESG Tracker performance



(Timeline, 2023)

Timeline ESG Classic

Timeline ESG Classic 100 returned -10.73% for the year end. Compared to our Tracker and Classic portfolio, this underperformance in equity was driven by being underweight in energy and commodity stocks due to the ESG overlay in the portfolio. Timeline ESG 0 portfolio, the fixed income portion of our ESG model, had a negative return of -11.97% for the year end. This fixed income performance was in line with Timeline Classic, which has a similar average duration.

Figure 14: Timeline ESG Classic performance

(Timeline, 2023)

For individual performance charts and data of each portfolio, please visit the performance tab in your Control Centre. You can also compare our portfolios' efficient frontier against the 'masters of the universe' in the Control Centre. When doing so, you will note that all Timeline portfolios are performing highly efficiently against their peers and prove that a disciplined long-term investment strategy will always deliver rewards at the end of the day.

Regulatory Update - 10% Drop

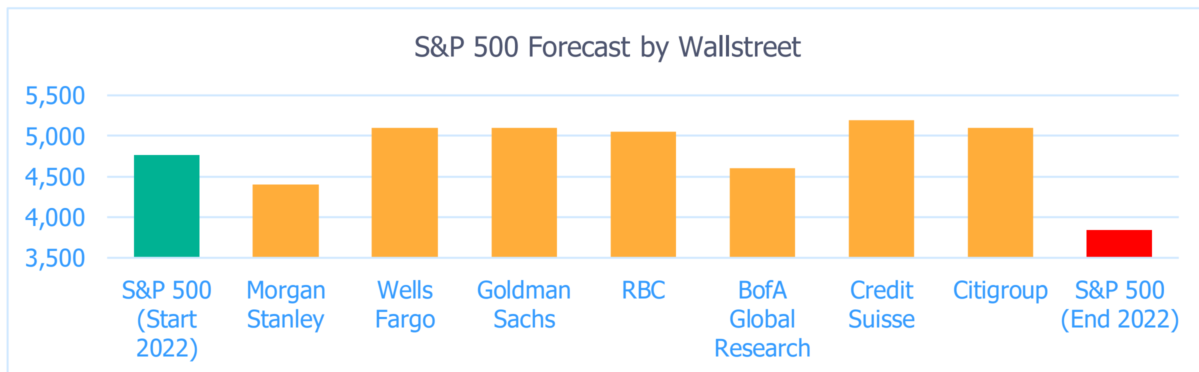
The UK is set to scrap the MiFID II legislation that required firms to inform investors when their portfolios fell by 10% or more. The rule, which came in with MiFID II in January 2018, required wealth and advice firms to report a 10% drop in portfolios to clients within 24 hours. It has been considered that whilst the intention of the requirement was to ensure that consumers were kept informed of the performance of their portfolios and whether they were exposed to any increased risks. In reality, however, the outcome of the rule had the potential to cause concern and panic and, in some instances, could lead to consumers crystallising short-term losses in instances of markets rebalancing themselves after periods of gains. The 10% requirement is currently suspended and is likely to be completely removed in the coming twelve months.

Closing Comments

It would be an understatement to say that the past year has been difficult for investors, with all major asset classes ending the year in negative territory. The one thing that 2022 has made sure to remind us of is that inflation can be a formidable enemy in any investment portfolio. This reminds me of the famous quote by President Ronald Reagan: “Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man.”

When trying to steer your investment portfolio through the current market environment, it is worth noting that even the most seasoned professionals on Wall Street could not predict the past year’s events. Figure 13 below shows how the most prominent names on Wall Street were utterly wrong in their predictions of where the US stock market, as measured by the S&P500, would end up by the end of 2022.

Figure 15: 2022 US equities Forecast



(Reuters, 2021)

The above outcome should not be shocking to us, as this trend has been ongoing forever. We, therefore, maintain that it is crucial to stay focused on the long term and not get too caught up in short-term market fluctuations. We have overcome the first three quarters of 2022, and the final quarter has given us renewed hope for the future. As we look ahead to the new year, it's important to remember that there may still be inherent risks in the market. But by maintaining a diversified, long-term investment approach, we will weather any storms that may come our way.

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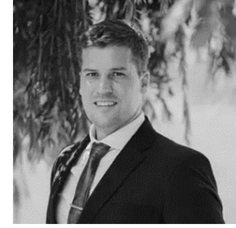

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