Morningstar October update, from our Portfolio Specialist Natalie Tysoe.

Economic & Market Round-up (October)

- Overall, the final quarter of 2022 has started positively for equities markets, except for Emerging Markets and Asia ex-Japan. The Chinese stock market struggled on the back of continued lockdowns impacting economic growth, especially the services industry, as well as government changes following the reappointment of President Xi for a historic third term.

- Broadly, bond markets fell as most governments continue to tackle inflation by raising interest rates, although UK government bonds rallied following the almost complete reversal of the recent budget by the new Chancellor, Jeremy Hunt, and the appointment of Prime Minister, Rishi Sunak and his likely more measured approach.

The continued hike: interest rates were pushed up by central banks in Europe (up 0.75% to 1.5% on 27th October), the US (up 0.75% to 4% on 2nd November) and the UK (up 0.75% to 3% on 3rd November). The actual interest rate increases are broadly expected by markets and therefore priced in even before they are officially announced. Instead, markets react to the comments that come with the move from the central bank. Andrew Bailey of the Bank of England caused the pound to fall when he said markets had likely priced in rates going too high, a bit of good news for people having to renew their mortgage, but a very different message to the US.

The great Fed pivot…not quite yet: the market is on tenterhooks every time the US central bank (Fed) chair Jerome Powell speaks as they try to gauge when the Fed will start to slow down or even reverse interest rates. Last week (November) we got more of a glimpse into the Fed's thinking, and the markets did not like it. The gist of the message was that we may see a slowdown in the rise of interest rates, but the rate may go higher than is currently expected as the fight against inflation rages on. Equity markets fell on the back of these comments given the increased likelihood of a recession as the Fed intentionally attempts to slow down the economy.

China weakness: since the beginning of 2021 to end October, the Chinese stock market has fallen around 50% in both local currency and sterling terms (MSCI China). The continuation of lockdowns, the ongoing property crisis, and the increased regulation of technology companies have all shaken markets and caused extreme pessimism. More recently, volatility has come from the reappointment of President Xi and changes in the leadership team, prompting uncertainty of economic decision-making and geopolitical risk persistence, and the apparent shift from globalisation to an internal demand-driven economy. Nevertheless, we continue to think Chinese valuations are compelling and we will continue to focus on the fundamentals of Chinese companies, apply enough margin of safety in valuation assumptions, and ensure portfolio sizing continues to take account for the high level of fundamental risk.

Performance

The Morningstar Multi–Asset Funds have performed relatively well this year (to end October), with the MA40 fund ranking 26th percentile in the IA Mixed 20-60% Shares peer group and MA60 and MA80 ranking 13th and 10th percentile in the IA Mixed 40-85% Shares peer group. Since inception (30/11/2020) the funds have returned -4.36%, 2.64% and 8.77% (MA40, MA60 and MA80).

The Morningstar Managed Portfolios across our Governed and Passive ranges all outperformed the relevant ARC benchmark, as well as the Moderately Cautious to Adventurous Active portfolios this month (October). Our Passive, Active and Governed portfolio ranges from Moderate to Adventurous have outperformed the relevant ARC benchmark year-to-date, as well as our Moderate Income portfolio, Adventurous ESG portfolio and our flexible and 500 Real Return portfolios. Over the longer term, medium through to higher risk profiles have tended outperformed the relevant ARC benchmark as our equity positions have been broadly beneficially to performance versus a recent difficult and unusual period for bonds.

Outlook

We've had a whole load of bad news this year with inflation in many countries at levels we've not seen since the 1970's, interest rate increases slowing economies and recessionary risks very much present. Accordingly, financial markets have priced in a lot of doom and gloom and despite the outlook remaining challenging, October was a lot more positive for equities, perhaps signalling markets had overdone the pricing in of bad news. Nevertheless, the October rally may not be here to stay as many economies are unlikely to stave off a recession; how deep and for how long that potential recession is remains unknown.

The important thing to remember is that we invest based on long-term, research-driven analysis, and trying to time the market is unlikely to yield good results. In this environment diversification is your friend, and we balance our best ideas from a valuation perspective with the current temperature of the market, enabling our robust portfolios to perform well across the different scenarios we face, and ultimately helping clients achieve their financial goals.

Chart of the month

Bond markets have sold off aggressively this year, primarily driven by rising interest rates with October being the 13th straight negative month of performance. Although unsettling for investors, particular for those in lower risk profiles, bonds markets are now offering much better value.

The chart below looks at five areas of the US bond market from government bonds (Treasuries) to high yield (higher risk, company issued debt). As can be seen, the average return available across these bonds now is much greater than the average return since 2009, thereby providing an attractive entry point.

We have recently increased our exposure to UK government and corporate bonds given the attractive price and yield, as well as the point that there is an increased perceived risk with investment in UK bonds, which we don't believe is warranted.