FlyingColours

Portfolio & Market Update

January 2023

Introduction

Equities had an outstanding start to the year, thanks to the favourable combination of surprisingly low inflation rates, a more accommodative Federal Reserve (Fed), and a robust economic climate.

Markets

Equity and fixed income markets around the world recorded positive returns. In particular, Asian equities performed well in January, as the economy started to reopen. The FTSE 100 and 250 in the UK rose significantly, posting returns of 4.35% and 5.44%, respectively, while UK gilts also saw a positive return of 2.56%. The US and Europe had a strong month, with returns of 3.82% and 6.77%, respectively. Natural resources also continued their upward trend, generating an additional 5.06% return for January.

Macro Environment

Regionally, the macroeconomic situation remains inconsistent. Despite the ongoing conflict in Ukraine, inflation in Europe has moderated from elevated levels. The US economy remains robust, with no clear indications of a downturn. However, the latest forecast from the International Monetary Fund (IMF) suggests that the UK economy is vulnerable to a slowdown.

UK

Consumer sentiment in the UK remains low and the Purchasing Managers Index (PMI) readings continue to indicate a recession, as they remain below the crucial 50 mark. Despite this, the labour market has proven to be robust with an unemployment rate of 3.7%, which has surpassed expectations. The high inflation rate of 10.5% in December was a concern. The Bank of England continued to increase interest rates, but the expected recession is now expected to be less severe than previously predicted.

Europe

Europe continues to grapple with the aftermath of the war in Ukraine and the resultant energy crisis, leading to persistent inflationary pressures on monetary policy. Although inflation has declined from its September peak, it remains stubbornly high and in danger of becoming a long-term issue. The ECB has maintained its gradual pace of rate hikes, but its president warned that interest rates will rise. According to the latest IMF forecast, the Eurozone is expected to avoid a recession in 2023.

US

The US economy showed positive signs, with declining inflation and a robust labour market indicated by the creation of over half a million jobs in January. The Gross Domestic Product (GDP) exceeded expectations with a growth of 2.9%, rebounding from a contraction early last year. Despite these strengths, the economy is sending mixed signals, as the labour market remains strong, but business confidence continues to decline, indicating a potential slowdown. The Fed remains dedicated to lowering inflation, but the probability of a recession has significantly decreased. The Fed is still monitoring the strength of the labour market.

Japan

Japan's economy is steadily improving due to the reopening of the country, and inflation has reached a historical high of 4.0% since 1991. The Bank of Japan surprised markets by announcing a major change to its yield curve control policy, allowing for a greater rise in bond yields.

Asia

In Asia and emerging markets, a rapid return to normality was seen after China relaxed COVID restrictions. The Reserve Bank of Australia raised its policy rate by 25 basis points in December and is widely expected to do another hike in February as it aims to curb inflation. In Latin America, the expected strong recovery after the election of President Lula has not materialized due to ongoing political instability.

Outlook

The main market issue is the re-emergence of inflation after a long hibernation. Our long-term prediction is that we are entering a structurally higher inflationary period as deglobalisation, falling working-age populations and shortages of commodities persist. To a large extent, this is how we positioned our portfolio for this environment and how we managed to generate positive relative returns versus our peers year to date.

Transitioning from a lower predictable inflation rate to a higher and less predictable one will be problematic for asset prices. But it will also create opportunities we can use, as discretionary managers, to help our clients achieve their objectives: maintaining relative wealth in weak markets and taking opportunities as they arise.

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