2022: THE ANNUS HORRIBLIS FOR LOW RISK INVESTORS AND PENSION FUNDS?

The recent sterling/gilt crisis has received much coverage in the press but throughout this reportage much hysteria and nonsense has been presented as fact. Yet despite all the noise it is striking how little attention has been paid to how rising gilt (UK Govt Debt) yields, and hence falling prices, are impacting ordinary investors, particularly "low risk" mandates.

Historically government bonds have been the reliable backbone of low-risk investments and they either directly, or indirectly, impact the construction of such portfolios. Yet **as interest rates and bond yields have risen so gilts have fallen, frequently by as much as 30%-40%**, and this is contributing to falls of 10%-20% in some low-risk portfolios, wiping out years of steady gains. Our analysis also suggests that some of the cautious funds that have weathered this crisis better have a surprisingly high weight in equities, so should stock markets drop further (very probable at the moment) then the investment industry may face some awkward questions.

In reality we have long regarded government bonds not as a safe haven but an opportunistic trade on interest rate expectations, so current events do not surprise. **We have often pointed out the intrinsically high risk of the low-rate environment** where, for instance, if a 1% income is accepted then an instrument priced at £1 need only pay out 1p to investors. If a 2% income is later required then for that 1p to reach 2% the instrument halves in value, for 4% it quarters, and so on. Reality is naturally more complex, but government bonds are linked to base rates and with the UK going from 0.1% to 2.25% within a year this explains, in part, why falls of 40% have been seen.

Cutting through the hysteria while the UK government has been incompetent they are not alone in folly, and rising UK interest rates are part of a much bigger global story that, as per our currency observations on page three, follows US monetary policy. In (a deeply misguided, if conventional) response to inflation **the US has taken the Fed funds (base) rate to 3.25% in the fastest rate rise cycle in history**, helping to drive the dollar up. This has forced others to respond to protect their currencies and try and stabilise the inflationary impact of dollar priced commodities (oil, gas, grains, metals etc. all price in USD) with the UK steadily lifting rates from 0.1% to 2.25% since late last year. Looking at the attached chart (showing US, UK, and Italian 10 Year bonds) we can see how yields have moved closely, following both interest rates and market sentiment, but is the clear recent acceleration in UK rates justified? Despite our issues many UK metrics are less bad then either the US or the Eurozone (and much better than Italy's), but government policy missteps created a great trading opportunity for investment banks to latch on to. Then **alarming systemic issues in the UK pension** fund industry exploded into view and attention has shifted to the use of **Liability Driven Investment (LDI)** portfolios by large institutions. These financial-derivative based structures were designed to improve pension returns in the low-yield environment that has rapidly evaporated and it is becoming clear that some pension managers have geared-up their exposures using flawed risk models. This has alarming echoes of the infamous CDO market that brought down Lehman Brothers. While the risks may not be so elevated, or systemic, it turns out that these structures are used globally, which is a real concern in volatile markets.

With interest rates still rising, despite the clear signs of economic stress, we may look back on current events as an opening salvo in a much larger, more dramatic saga.

John Paul Thornber
Investment Manager

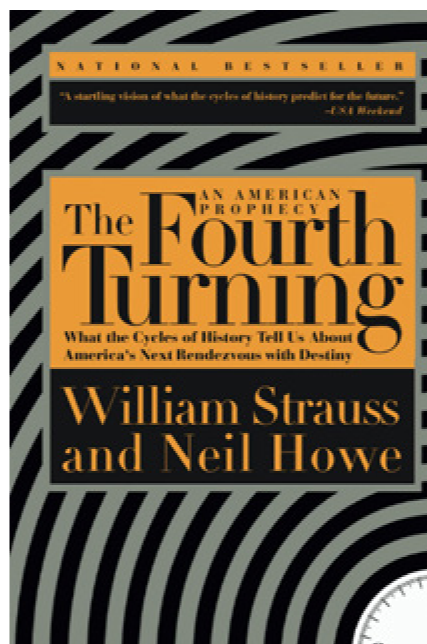
United Kingdom Government Bond 10Y. Source: Koyfin, Andrews Gwynne

THE CRESCENDO OF THE 4TH TURNING?

Mark Smith
Partner

After ushering in a new Prime Minister and Monarch it is worth remembering a quote from one of our most venerated statesmen, Winston Churchill, who said "The longer you can look back, the farther you can look forward".

His wisdom is correct, of course and by looking back in history we can often find examples of events which seem to rhyme with those of today, the revolutions in society, the challenges of new technologies, unexpected conflict, pandemics, or inevitable booms and busts in financial markets. There is a cyclicality to some of these events, often caused by us humans not learning from the past, always convinced that, somehow, this time is different.



The Fourth Turning

These cycles have intrigued a variety of thinkers over time and one theory we think worth sharing is the "generational cycle", devised by Strauss & Howe in the 1990's after their research into the characteristics of different generations (they were largely responsible for the popularisation of the notion of the "boomer" or "millennial" generations). In summary, within a typical human lifetime of say 80 years are four separate "turnings" or "seasons" as each new generation evolves. Within a few centuries history of both the UK and the US as the dominant world powers, they have traced the seasonal rhythm of changes in politics, economics and social outlooks stimulated by newer generations challenging the old.

There are some who deride the simplicity of the authors theories, which are sweeping, but their work does provide very convincing perspectives of human history not taught in typical textbooks, and certainly not those used by investment managers. As they predicted (in 1997) that America would fall into the 4th turning, one of 'crisis' (or Winter) in the latter 2000's reaching a crescendo in the 2020's, reading their work today, you may well conclude that their timing was not far off!

The Great Financial Crisis of 2008 had begun to unfold in 2007, unrecognised by most, caused by excess debt and the financialization of the real economy (particularly housing) and financial markets which blew into a bubble, whose bursting caused financial ruin for many in society. But this was the early Winter Storm as the massive bailouts saved those who fuelled the crisis at the expense of the rest of society who has born the weight of the ever-higher debts. Since then, governments have stimulated markets many times, propping up asset prices, supporting the wealthier, while impoverishing many of the younger generation who cannot afford a house, or pushing income-needy investors into buying riskier overvalued assets.

During these years we have seen continual 'can-kicking' as imbalances in trade, wealth and social equality widened, environmental damage accelerated, and systems were abused by those in power, uncomfortably reminding us that the last generation Winter was seen in the 1930's/40's. Now with the disruption to supply chains formed first by COVID and now a growing energy crisis, worsened with Putin's invasion of Ukraine, inflation has jumped to levels not seen for two generations, while emerging economies see social unrest, food shortages and extreme weather events. Inequality is at extremes in too many societies, politics often becoming extremist or a laughingstock, while the very real "hybrid wars" being waged by major powers risk escalation. It is a period of huge stress as political and economic models break down. Perhaps this is all a coincidence, nothing to do with a vague theory (that just happens to have been correct), but it certainly provides some weight to our investment approach.

Currently it is difficult to see through the uncomfortable environment, to picture the new beginning, but after the Winter, after the 4th turning, comes the Spring, the fresh 1st turning heralding another change in society and hopefully (and usually) in a more positive direction.

"The longer you can look back, the farther you can look forward"

Winston Churchill

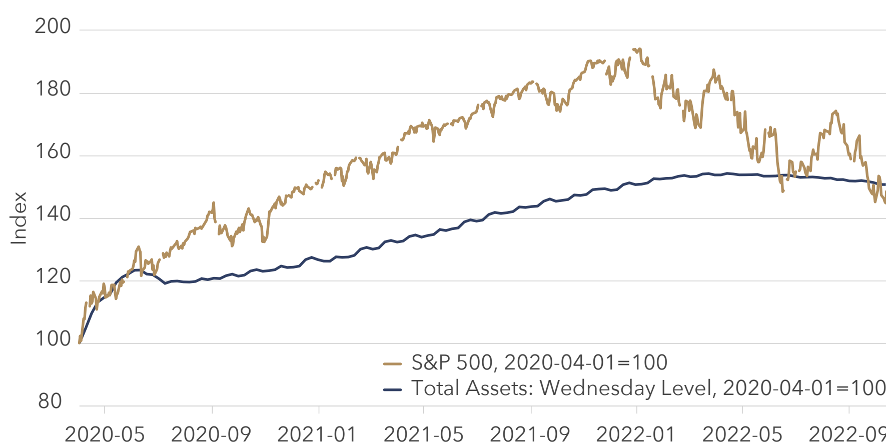
CENTRAL BANK TRIGGERS MARKET FALL

David Scott
Investment Manager

In December 2021, Jerome Powell, the Chairman of the US Federal Reserve (the Fed), hinted that they would potentially have to slow down and ultimately reverse their asset purchasing known as Quantitative Easing. This reversal, known as Quantitative Tightening, finally began in June 2022.

The chart below shows the Fed's assets (blue line) vs the S&P 500 index (gold line), both rebased to 100 on 1st April 2020. You can see the initial ballooning of the Fed's assets post covid and then from July 2020 a steady rise, plateauing in early 2022, but now turning over. The rise of the S&P 500 is clear in the stimulative period post covid, but it is striking to see that the peak of the stock market was December 2021, when Powell spoke, and it has subsequently fallen by around 24% since (so is technically in a Bear market).

Just as we highlighted in our Spring edition, the chart shows how connected stock markets and central bank policy remain. With the potential for further balance sheet tightening, in conjunction with increasing interest rates, there could be further pain for the US stock market. The big question is whether the Fed will pivot to save a falling market while its fight with inflation continues?



Source: Board of Governors; S&P DJ, fred.stlouisfed.org

THE USD ECONOMIC HEADWIND

It was not only UK stocks and bonds that came under pressure in late September but our currency (GBP) as well, falling against the US Dollar (USD). This brought the usual UK naysayers out of the woodwork describing it as another sign of our permanent decline, yet in reality it is not so much the pound falling but the USD rising against almost all major currencies.

The chart shows how over the last eighteen months the USD has risen against **GBP (in gold)** by around 21%, historically dramatic, yet clearly very closely aligned to the 21% gain against the Euro (grey). Both of these move's pale into insignificance against the **blue line**, which demonstrates vividly how the USD has soared 36% against the **Japanese Yen** over the same period.

From the Norwegian Krona (25%) to the Korean Won (27%) currency charts have a universal look as the direction of travel for the USD, the currency of global trade, has been one way as the US Federal Reserve has hiked interest rates, trying (and failing) to control US inflation, while actually stoking inflation, and recession everywhere else. With the US policy unlikely to change until something breaks, the USD solidifies its new **'dollar wrecking-ball'** title as it spreads chaos and hardship, not just to the UK, but to the global economy.

Mark Smith, Partner

Source: Koyfin, Andrews Gwynne

BEWARE OF THE 60% INCOME TAX BRACKET

Every individual taxpayer has a personal annual allowance of £12570 (22-23 tax year) on which no income tax is payable, but that allowance is restricted by £1 for every £2 of income you receive over £100,000 until the personal allowance disappears entirely as income exceeds £125,140.

The effect is the same as a 60% tax rate applied to any income in the range £100,000 to £125,140, some stealth tax that!

As with all tax issues it's never that simple, but if you're heading for that income bracket all might not be lost, it may be possible to reduce your income for tax purposes. One method is by making gift aid charity donations. Another is by ensuring you have maximised your pension contributions in the current year, which in effect increases your personal allowance tax exemption bracket within an income tax calculation.

An extension of the pension route is that you may also be able to mop up any unused pension contribution annual allowances, as it is allowable to carry forward unused allowance from the three previous tax years.

Some careful research and calculations will need conducting, but if you feel you need any help with this area of financial planning, please get in touch.

We manage our clients pension funds in-house along our independent, multi-asset investment, non-industry benchmark, portfolio approach. This has helped better protect the value of our clients pension pots in this turbulent year. If you'd like any information on our investment approach please get in touch with one of the team.

Douglas Croft
Partner

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