Watson Moore
INDEPENDENT FINANCIAL ADVISERS LIMITED

Monthly Investment Update
October 2022

Contents:

Performance Update

Global stock markets fell significantly over the month, with the FTSE100, Euro Stoxx and S&P500 losing 5.16%, 6.21% and 7.83% respectively. The performance of our portfolios ranged between -1.98% and -6.15%.

The pound hit a record low of $1.033 last month as investors reacted to Kawasi's "growth plan" for the UK economy. The mini-budget included a much larger package of tax cuts than had been expected, raising further concerns over the size of government borrowing. This is turn put further downward pressure on the pound.

Several mortgage lenders pulled mortgage deals from the market amid speculation that the Bank of England would be forced to hike interest rates aggressively and forecasters say that they will now hit 6%. Fear gripped the mortgage market as the BBC highlighted one mortgage deal at 10.5% for a first-time buyer. The major lenders do not appear to be anywhere near this level, showing how fear from the media can cause panic and negatively affect economies, often disproportionately.

Gilts fell significantly, before the Bank of England stepped in with a short-term purchasing programme in order to stabilise the market. We hold very little bonds in our portfolios so have been relatively unaffected by these falls and volatility. Inflation-linked gilts ended 13.54% down for the month, though were down over 30% at one stage. This level of volatility is unprecedented.

The Bank of England intervened to support the domestic pension system during the last week of September and will likely continue to do so until mid October. Several pension schemes required £100 million in additional capital each, whilst others were looking at closing. The Bank had no choice but to wade in and provide stability. The ramifications of this move raised more questions than answers.

The good news is that the UK economy is still growing as the Office for National Statistics (ONS) revised upwards its estimates for GDP growth between April and June from a contraction of 0.1% to an expansion of 0.2%. Perhaps knowing this would have made the Bank of England increase rates by more than 0.5% and thus avoid sterling falling.

The performance of the portfolios over the last 1 month, 6 months and 1 year are shown below:

Portfolio	Performance % 1 month	Performance % 6 months	Performance % 1 year
Foundation	-3.24	-5.17	-3.82
Cautious	-1.98	-2.99	-2.46
Balanced	-2.43	-3.89	-2.91
Adventurous	-3.05	-5.27	-5.00
Dynamic Equity	-4.18	-7.59	-5.01
Income Generating	-6.15	-9.24	-6.87
Fourth Industrial Revolution	-5.44	-9.24	-16.92
Retirement Investment Solution 1	-3.10	-5.34	-4.60
Retirement Investment Solution 2	-3.27	-5.75	-4.77
Retirement Investment Solution 3	-3.43	-6.11	-4.93

Please note that these figures do not include the platform or Watson Moore's fees.*All figures are sourced from Financial Express to 30.09.2022.

Trend Following Signals

The table below shows whether the asset class is in a positive trend (✓) or a negative trend (x). A positive trend is when the market is above the average price over the previous 200 days. The portfolios will have more exposure to those asset classes in a positive trend and less (if any) to those in a negative trend. These are the main asset classes we monitor:

Asset Class	Trend Signal		Trend Signal
Global Equity	x	Emerging Market Equity	x
UK Equity	x	Commodities	✓
Europe ex UK Equity	x	UK Corporate Bonds	x
US Equity	x	UK Corporate Bonds (Short dated)	x
Japan Equity	x	UK Index-Linked Bonds	x
Pacific Equity	x	Global Bonds	x
Gold	✓	UK Gilts	x
Global Property	x	Emerging Market Bonds	x
Global Infrastructure	x	Overseas Corporate Bonds	✓

All major equity markets are now below trend as well as most bond markets.

Cautious, Balanced and Adventurous portfolios

The portfolios significantly increased their weighting to cash as 5 different equity markets moved below trend. This is in addition to the existing high cash position as a result of most bond markets being below trend.

Dynamic Equity portfolio

It was a difficult month for all equity markets but the change we made last month by buying Indian equities (down 2.62% in September) and selling global property equities (down 9.11%) shows how a momentum investment philosophy can help to achieve better performance over the long term. US equites remain high up the momentum scale, and we continue to have a relatively high weighting to them. No changes were made this month.

Foundation portfolio

The Foundation portfolio fell 3.24% during the month as bond funds were again hit hard. The portfolio will always have some exposure to most asset classes as the Foundation portfolio is our most diversified portfolio and reduces exposure to each asset class when the asset class is below trend. Currently only one bond asset class is above trend, and this has full exposure whereas the other ones have half the maximum exposure.

Income Generating portfolio

This portfolio was our worst performing portfolio in September as interest rates continued to rise globally. This means the income generated from dividends and bonds is less attractive relative to cash returns. The US appears to be raising rates the quickest and is the most determined to fight inflation. They raised interest rates by 0.75% last month and are expected to raise rates by a similar amount next time. The UK raised rates by 0.5% but the Bank of England is now under pressure to increase them by 0.75% with some economists calling for a 1% rise.

The current yield on the FTSE100 is now 4.12% which is significantly higher than in 2021 in which the yield fell to just 2.72% as companies drastically cut or suspended their dividends to protect cashflow amid economic uncertainty. The yield on 10-year UK Government bonds now stand at 3.90%, up from 1.12% at the beginning of the year. Despite some weak performance over the last few months, the yields available from most asset classes now appear to be attractive.

Fourth Industrial Revolution portfolio

This portfolio remains extremely volatile. From mid-June to mid-August, the portfolio rose over 22% but since that high it has fallen back by over 10%. The portfolio is up 63.13% over the last 5 years, despite the volatility.

Retirement Investment Solutions

The Solutions increased cash levels as five major equity markets moved below trend. They are defensively positioned with very little invested in bonds and the equity exposure has just reduced.

Summary of Portfolios

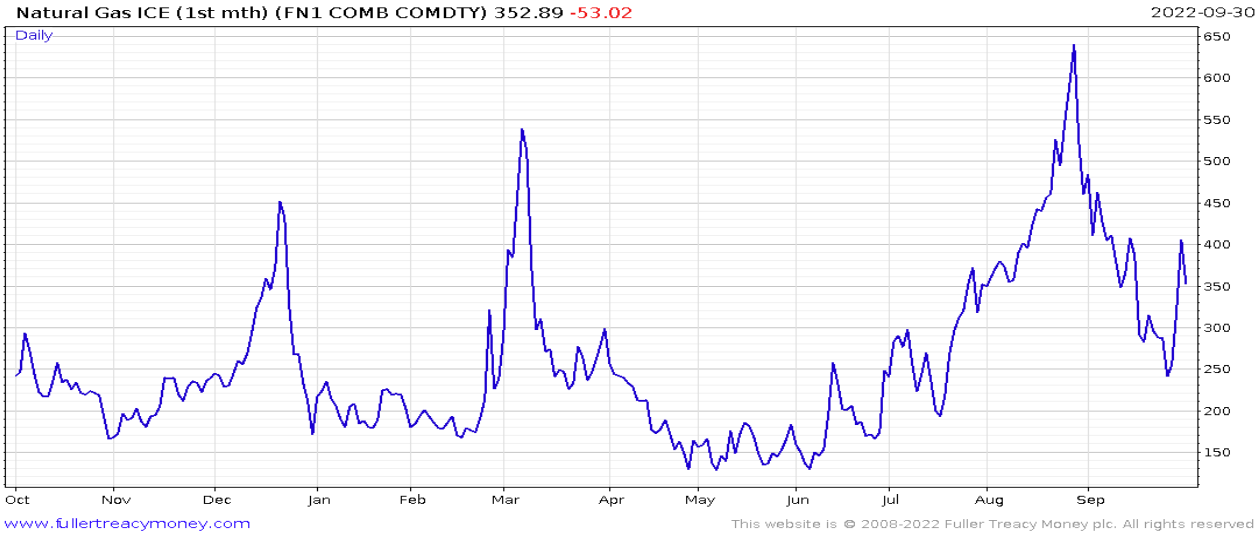
We remain in a very volatile period in which both equities and bonds have fallen significantly. UK bonds suffered large falls that are unprecedented in recent times and September will go down as the month that the UK pension industry (not personal pensions) nearly collapsed. However, economic growth remains positive, employment high and there are signs that inflation is turning lower. The US economy in particular is strong, and this acts as a tailwind for the rest of the global economy. For a recovery in global equities and bonds to occur, we do need to see inflation turn lower consistently as this will signal an end to the interest rate hike cycle. In addition, and in line with the bad news is good news theme, lower than expected growth (and even a recession) may also help our investments as this will naturally curb inflation.

Asset Class Review

This section will give you an insight into our current thinking. This month we look at the most important charts affecting our wealth.

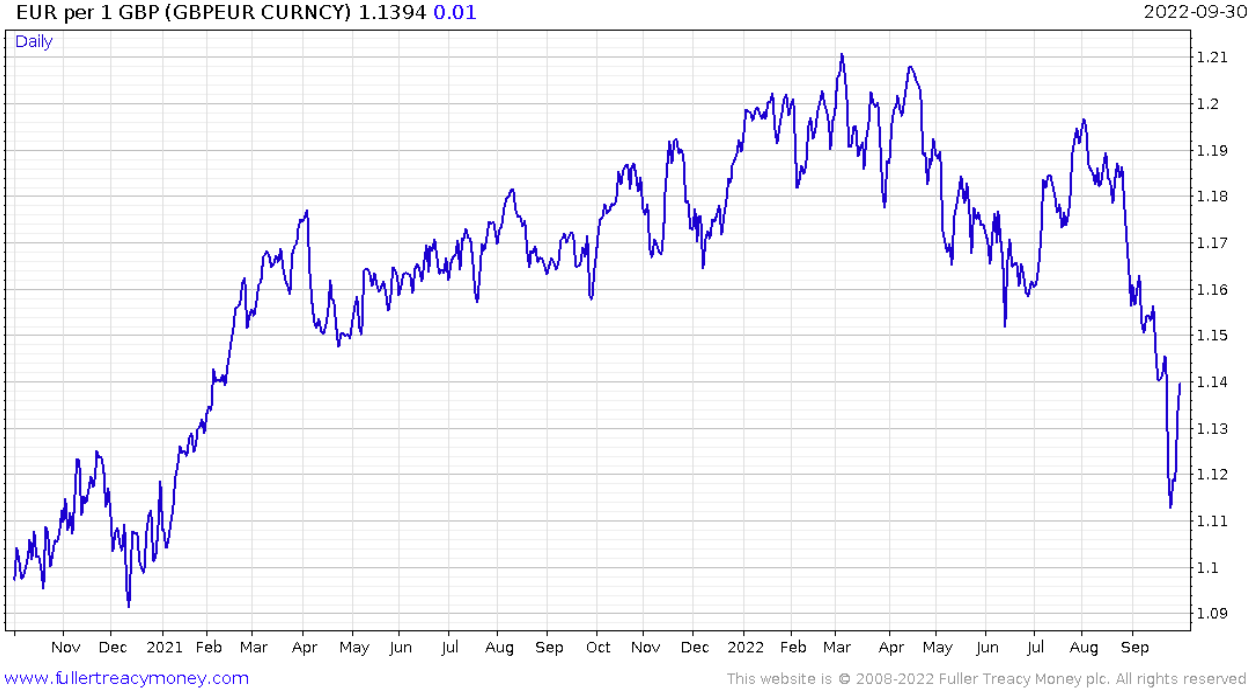
UK Gas–Russia's biggest weapon

The chart below shows the spot price that the UK has to pay for natural gas, and you can see how it fell recently until Russia (allegedly) blew up the Nord Stream gas pipes. The price has subsequently started to fall again. Putin is trying to break the resolve of Europe by trying to raise the price of heating as winter kicks in. Governments are reacting by implementing energy price caps with significant increases in government borrowing, though if the price of gas falls the cost of this will reduce. However, if the price of gas spikes again, borrowing across Europe will rise significantly and this could bring economies to their knees, cause deep recessions and governments to be changed. Putin believes that he can break the resolve of Europe through the economy and thus win his war.



Sterling takes another leg lower

The US (3.25%) is raising interest rates much quicker than the UK (2.25%). This has led to the fall in sterling as well as just about every other currency against the US dollar. Sterling falling helps protect our portfolios somewhat, with many investment holdings based in dollars. Whilst sterling fell to $1.03, it has subsequently recovered to $1.11. However, against the Euro, sterling is still higher than what it was a year ago. Paris Disneyland looks more appealing than Disneyland Florida!



UK Gilt yields-the chart that nearly broke UK final salary pension schemes

The chart below shows the yield that you can receive from investing in UK government bonds. The rate of increase is the problem as this caused major final salary pension schemes to struggle to keep up their "hedges" and many lost a small fortune and were close to going bankrupt. Only intervention from the Bank of England saved them by reducing the yield on gilts to below 4%. It is the rate of increase and not the actual level that was the problem as the move from 1% to 2.5% was in an orderly fashion but the move from 3.5% to 5% was rapid.

Stock markets still trending downwards

The S&P500 is the world's most followed stock market, and the pattern is very similar to many other stock markets. You can see how since 2022 each recovery high has been lower than the previous high and each new low is below the previous low including the recent September low. This signals we are still in a down trend.

In Summary

Asset classes are experiencing some of their most volatile price moves ever. We remain in a downward trend for both equites and bonds, but the falls in sterling have assisted our portfolios as well as having a minimal amount invested in bonds. The price of gas is now an extremely important chart to look at as a falling price will improve the UK's finances as well as reduce inflation.

Trussonomics

The mini-budget nearly caused the meltdown of the UK pension system. The political headlines have been terrible, and labour now have a 33-point lead as voters now feel that the Conservatives are mismanaging our economy. However, what is really going on and is it as bad as the media are portraying?

The Background

Central banks globally are raising rates in order to combat inflation. The US is raising rates much quicker and appear more determined than the UK to bring inflation down and this has led to sterling (and just about every other currency) falling significantly against the dollar. The Bank of England is also about to start taking money out of the economy to help combat inflation. This is the opposite of Quantitative Easing and is known as Quantitative Tightening.

The mini-budget announced the expected energy price cap but surprised everyone with tax cuts (income tax, national insurance, stamp duty) of about £45 billion. So, we have the Government putting more money into the economy whilst the Bank of England is trying to take money out of the economy.

What then happened?

After the surprise tax cuts more government bonds will need to be issued to pay for them and this increase in supply caused an increase in gilt yields (prices fall inversely as yields go up). But that was just the start. Defined benefit pension schemes (final salary pensions) guarantee to pay retirees an income and invest their money in two parts. The first part seeks to grow the money and therefore generally invests in equities. The other part "hedges" the liabilities by buying long-dated government bonds which have predictable income streams, and in turn helps pay pensioners income. The problem for pension funds is that as interest rates go up, the value of bonds fall, and if inflation moves higher then they have to pay higher incomes to pensioners. In order to reduce their risk, pension funds try and hedge out the impact of changing interest rates and inflation. They do this with a liability-driven investment strategy (LDI). However, you are trying to hedge out up to 100% of your liabilities, but with less than 50% of your assets as you are also invested in equities. What this means is that you have to put down a deposit (collateral) to pay for your "leveraged" hedge. This is the perfect solution for pension schemes as the LDI will ensure that the assets of the pension fund and the deficit in the scheme won't change as interest rates and inflation rise or fall. Perfect!

However, as gilt yields rose quickly after the mini-budget, each pension scheme had to put down a slightly bigger deposit and thus was forced to sell their assets (generally gilts) to provide this liquidity. These additional sales pushed the price of gilts down further and we ended up in a spiral in which the value of gilts were crashing. However, it takes time to sell an asset and get the money as cash. Pension funds did not have a solvency issue (i.e. they have enough assets), they just didn't have enough liquidity to pay for the hedges and encountered a short-term problem. This forced the Bank of England to buy gilts which effectively puts money back into the economy and was against their intention of Quantitative Tightening. Still with us?!

What happens now?

The Bank of England's gilt purchases have calmed the market so that is good news. We are likely to find out which pension funds made money out of the recent events and which ones lost money. This will be down to timing as some schemes will have been in and out of the market due to lack of liquidity. Hopefully, the losses won't be large enough to cause significant problems. We may also see other countries experience similar episodes.

Rishi Sunak and Liz Truss both want to cut taxes, but the difference was that Rishi wanted to cut them at a later date, which probably meant after the recession that we are likely to experience. This is because reducing tax rates at a time when tax revenue reduces during a recession is probably not the sensible thing to do. Unless there is a "growth" strategy that ensures tax revenues will go up even though tax rates go down. Liz Truss therefore needs to detail her growth strategy as soon as possible and it now needs to be significant. In addition, the timing of cutting taxes for the "rich" by reducing the 45% rate to 40% rate was a political mistake and she is under pressure to delay this decision (now done). Possibly this was the tipping point for the whole crisis. **The good news is that this has not affected our wealth as we have very little invested in bonds and sterling falling helps with our overseas investments.**

Final Comment

What happened in September was unprecedented and trying to summarise it is almost an impossible task. We almost experienced the crash of final salary pension schemes in the UK that would have made the Mirror pension scandal look tiny and would have decimated the income of millions. However, the Bank of England provided a solution to the problem and no doubt there will be an inquest to provide measures to ensure that this will never happen again. The media seem to pin it all on reducing the higher rate of tax from 45% to 40% but this seems a bit simplistic - the cost of this policy was forecast to be at most £2 billion or less than 5% of the total budget costs.

Sterling fell significantly and bond prices have acted in the most volatile way in our lifetimes. It is easy to be very pessimistic, but it won't take much to change sentiment. Falling gas prices and inflation would no doubt reduce the pressure on interest rates from rising and, with a recession likely to be only mild in nature, this could be the point in which we start to experience some volatile positive returns.

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