Managed Portfolio Service

Quarterly report – Q3 2022

Introduction

Welcome to the RBC Brewin Dolphin Managed Portfolio Service (MPS) investment review. In this report we will be covering information and events that influenced performance during the third quarter of 2022.

Equities and bonds were highly volatile in the third quarter as high inflation led to interest rate hikes by central banks around the world.

In the US, the S&P 500 registered its third consecutive quarter of declines for the first time since 2009. Signs of slowing economic growth led to hopes of interest rate cuts in 2023, but these were quashed when the Federal Reserve reaffirmed its commitment to fighting inflation at the Jackson Hole summit in August.

UK chancellor Kwasi Kwarteng's mini-budget sparked widespread market turmoil towards the end of the quarter. The raft of tax-cutting measures raised concerns about a surge in UK government borrowing and more aggressive interest rate hikes. The pound hit a record level against the dollar, yields on ten-year gilts surged and mortgage lenders pulled deals from the market. The Bank of England subsequently launched a temporary bond-buying programme in an attempt to restore orderly market conditions.

The ongoing energy crisis and rising inflation weighed on shares in the eurozone. The annual rate of inflation hit a record 10% in September, with price rises in Germany reaching a 71-year high of 10.9%. The downturn in business activity deepened and European Central Bank president Christine Lagarde warned the eurozone's economic outlook was darkening.

The quarter also saw geopolitical tensions escalate – both between Russia and Ukraine, and China and Taiwan – which added to the overall risk-off sentiment.

Long-term investors may take some comfort from the fact that a lot of the bad news is already priced in to valuations. Inflation should begin to drop significantly and there probably isn't much room for central banks to increase rates by much more than markets expect. While the outlook remains uncertain, this probably isn't the time to become more bearish.

The big picture in Q3 2022

- Financial assets continued their downward trajectory in the third quarter of 2022. High inflation and a tight labour market in both the UK and US resulted in central banks continuing to raise interest rates. The Bank of England (BoE) implemented two interest rate hikes of 0.5 percentage points each, the European Central Bank enacted its biggest single rate hike in its history, and the US Federal Reserve made its third-consecutive 0.75 percentage point increase. This resulted in continued stress in bond markets.
- In the latter part of the quarter, UK sovereign bonds sold off heavily after the newly elected prime minister Liz Truss proposed new fiscal measures. The mini-budget contained a package of tax cuts, including lowering the basic rate of income tax, corporation tax, national insurance contributions and stamp duty, which raised concerns about a dramatic increase in the nation's debt burden. The ensuing volatility in the UK government bond market saw the BoE intervene with a commitment to purchase bonds for a limited time. Sterling touched a multi-decade low against the US dollar, before recouping its losses following the BoE's intervention.
- One of the spill-over effects of high and volatile interest rates in the UK has been in the mortgage market, where selected providers have withdrawn a number of products. Generally, the higher cost of borrowing has led to a slowdown in the number of mortgage inquiries. House prices are showing signs of stalling after a period of record highs.
- Europe is preparing itself for a difficult winter. In September, the Nord Stream pipelines that transport gas from Russia to Europe were sabotaged in a move which nobody has claimed credit for, but which seems most likely to be a Russian act. European countries have filled gas storage facilities and implemented measures to reduce consumption.
- Sentiment towards the equity market continues to be very poor. But even though the basic macroeconomic concerns continue to operate as stock market headwinds, current valuations and improved long-term return expectations militate against being too pessimistic.

Market overview Q3 2022

- Equities slipped by -0.3% over the third quarter, according to the RBC Brewin Dolphin benchmark, as central banks reaffirmed their commitment to fighting inflation.
- The UK was among the worst performing equity regions, declining by -3.4% as fears of an imminent recession grew. In contrast, the emerging market equities benchmark outperformed with a gain of +7.2% (in GBP terms) on the prospect of Brazilian president Jair Bolsonaro's term coming to an end. North America equities gained +3.3% in GBP terms, with returns boosted by the strong US dollar, while Japan equities rose +0.93%.
- Bonds tumbled -7.7% following the mini-budget induced sell-off and interest rate increases by several of the world's major central banks. The biggest negative contributors were gilts (-12.8%), UK corporates (-12.5%) and global inflation-linked bonds (-6.5%).
- The ten-year US Treasury yield rose to 3.83% following the Federal Reserve's fifth interest rate hike in the year so far.
- Alternative assets recorded a small gain of +0.4%. Gold and absolute return increased by 2.1% and 1.6%, respectively, while global real estate investment trusts (REITs) fell by -3.9%.

MPS performance

MPS PERFORMANCE (%)												
	Q3	2022 YTD	1yr	2yr	3yr	4yr	5yr	2021	2020	2019	2018	2017
Cautious Portfolio	-3.6	-12.7	-11.6	-5.1	-3.6	3.2	7.0	3.7	6.7	11.2	-2.7	5.9
Cautious Higher Equity Portfolio	-3.2	-12.9	-11.1	-3.1	-1.8	4.6	8.6	5.5	6.6	11.2	-2.7	5.9
Income Portfolio	-2.7	-12.5	-10.7	-0.2	0.8	7.2	12.7	6.8	6.8	14.5	-4.2	8.1
Income Higher Equity Portfolio	-2.2	-12.1	-10.0	2.4	3.1	9.4	15.0	8.4	6.9	14.5	-4.2	8.1
Balanced Portfolio	-1.7	-12.5	-10.2	5.2	6.2	12.5	20.0	10.6	7.8	16.6	-3.9	8.8
Growth Portfolio	-0.5	-12.5	-10.0	9.8	12.1	17.7	29.4	13.5	10.3	18.4	-4.0	11.8
Global Equity Portfolio	0.4	-12.4	-9.6	14.3	15.3	21.3	34.9	16.0	10.0	22.1	-4.8	12.8

All figures shown above are calculated to 30 September 2022.

Performance Calculation: All income is reinvested. Performance is shown inclusive of underlying fund charges but gross of RBC Brewin Dolphin's investment management charge. Deduction of this charge will have the result of reducing the illustrated performance. Neither simulated nor actual past performance are reliable indicators of future performance.

MPS performance highlights Q3 2022

Asset Allocation

What worked and why?

Being underweight bonds helped the portfolio. As central banks hiked interest rates and the UK government introduced its mini-budget, bonds lost value. Being overweight absolute return was helpful over the period.

We cut equity exposure at the right time in August, to become underweight before the sell-off in late August and September. The overweight to cash and the underweight to bonds were also positive contributors to performance.

What didn't work and why?

The underweight to emerging market equities detracted slightly from relative performance. Most equity regions fell but emerging markets (excluding China) rose.

Fund Selection

What worked and why?

Among equities, the stock market rally which started in mid-June resulted in Baillie Gifford American being a significant positive contributor to performance. Among bonds, Colchester Global Bond and Allianz Strategic Bond also performed well.

What didn't work and why?

Muzinich Global Tactical Credit and Schroder Global Cities were a drag on performance.

MPS portfolio changes Q3 2022

Asset Allocation

In July, the Asset Allocation Committee agreed to have a neutral position on equities, by reducing the weight of UK and European equities by 0.5% each and increasing cash by 1%.

In August, the committee voted for a further reduction to the equity weight, moving to an underweight position, while increasing the weighting to absolute return. In September, no changes were made, as the overall underweight to both equities and bonds, and the overweight to cash and absolute return, were considered appropriate.

Fund Selection

In July, the Schroder European Recovery fund was introduced in the active Balanced, Growth and Global Equity models. The fund has a value tilt which should help to balance the exposure within the region.

MI Select Manager fund weights

MISM FUND WEIGHTS AS AT 30/09/2022		
MISM Fund	**Mandate**	**Weight (%)**
MI Select Managers Bond Instl Inc	Robeco Global Credits	29
	PIMCO UK Corporate Bond	23
	Insight UK Government Bond	16
	Colchester Global Bond	19
	Allianz Strategic bond	4
	DWS US TIPS 10yr+	9
MI Select Managers NA Equity Instl Inc	JPM US Equity Income	33
	Baillie Gifford American	10
	BNY Mellon US Equity Income	27
	Artemis US Select	30
MI Select Managers UK Eq Inc Instl Inc	Ninety One UK Equity Income	34
	Man GLG UK Equity Income	33
	Threadneedle UK Equity Income	33
MI Select Managers UK Equity Instl Inc	JPM UK Equity Core	31
	RWC UK Equity Income	29
	Lindsell Train UK Equity	26
	Jupiter UK Mid & Large Cap Crossover	7
	Teviot UK Smaller Companies	7
MI Select Managers Alternatives Fund	Schroder Global Cities	11
	Muzinich and Co	23
	Commodities and other alternatives	40
	Absolute Return Funds	16
	NN Investment Partners	10

The value of investments, and any income from them, can fall and you may get back less than you invested. Neither simulated nor actual past performance are reliable indicators of future performance. Investment values may increase or decrease as a result of currency fluctuations. Information is provided only as an example and is not a recommendation to pursue a particular strategy.

Asset Allocation Committee investment outlook

These views are implemented across our portfolios but there may be deviations where asset classes or suitable investments are unavailable or excluded.

Cash

We remain overweight cash. Cash is a relatively attractive asset class at a time when global growth momentum is slowing and bond yields are rising. Moreover, the Bank of England (BoE) base rate continues to move higher.

Bonds

We increased our allocation to gilts in October. However, we only increased gilts to neutral, as we believe it is too early to expect a sustained rally. One reason is that the peak in yields typically happens much closer to the point when the BoE stops hiking rates. Historically, the furthest the gilt yield peaked ahead of the last BoE hike of the cycle was five months. Currently, the market is pricing in BoE rate hikes until next June. Even if the BoE finishes its hiking cycle a few months earlier than traders expect, it would be unusual for gilts to start a sustainable rally so far ahead of that. Another reason is that there is a lot of gilt supply coming to the market that the private sector will need to absorb. This is due to the government ramping up net issuance to pay for both the energy bailout and tax cuts at a time when the BoE is shrinking its balance sheet. On that point, the recent market ructions only caused the BoE to delay its programme of active sales – those will now begin at the end of this month. We remain underweight corporate bonds as there is scope for further spread widening if economic growth continues to deteriorate, as we expect.

Global Equities

We remain underweight global equities, largely because of our view that we are on the cusp of a meaningful slowdown in global economic growth that will see the US economy suffer a recession at some point next year. Historically, the S&P 500 reaches a bottom a median of four-and-a-half months before the associated recession ends. Importantly, if we exclude the dot-com and Covid bear markets, which were atypical, the range around which the S&P bottoms ahead of a recession ending has been tight at between three and six months. There is no reason to think that won't hold again this cycle. Given a US recession has not even started, it is probably too early to think that global equities have hit a bottom.

Alternatives

We hold a neutral position in gold. The potential for real bond yields to rise further (a headwind for gold) is offset by the potential for a further decline in sterling. We remain underweight property. Real bond yields are rising, inflationary pressures in the US are close to peaking and valuations are unattractive. Finally, we are overweight absolute return. This is a relatively attractive asset class at a time when the risk/reward backdrop for equities and bonds is not great.

UK Equities

Interest rate hikes will likely impact growth in the UK faster than in the US, partly because mortgage terms in the UK are much shorter. Rising UK mortgage rates should put a dampener on UK house prices, and that historically has coincided with weaker consumer spending. Relatively weak UK economic growth tends to weigh on the relative performance of UK equities. That said, if global bond yields continue rising, that should help to offset a weak UK economy. Within equities, rising bond yields tend to boost to the relative performance of the global value style versus its growth style counterpart. The UK equity market is very value style exposed.

US Equities

The relatively richly valued US market is particularly vulnerable to rising interest rates and bond yields. That said, a slowing in global economic momentum is a performance tailwind for the US, given that its sector composition and currency are both relatively defensive. Against this mixed backdrop, we maintain modest exposure to US equities.

Europe ex-UK Equities

On the one hand, Europe ex UK stocks are cheap and unloved. In addition, tech/digital stocks, which Europe has very little of, are vulnerable to further underperformance if bond yields keep moving higher. That said, most other non-US markets are out of favour, and there probably isn't massive upside from where bond yields are now. Meanwhile, it is probably too early to bet on a sustainable rally in the euro. If European FX continues to slide, that has negative implications for relative performance in common currency terms. At a time when the key macro drivers of Europe ex UK equity relative performance look set to move in competing directions, and given the uncertainty around the natural gas backdrop in Europe heading into the winter, we believe it is prudent to stay modestly negatively positioned.

Japan

Given Japan's plunging population and birth rate, Japanese equities are confronting major demographic headwinds. This acts as a strong disincentive for Japanese businesses to invest and is a structural roadblock to equity market outperformance. More immediately, Japanese equity relative performance in common currency terms has been hindered by the very weak yen. Looking ahead, we do not expect a catalyst to arrive that could spark a meaningful turnaround in Japanese equity relative performance. That said, Japanese equities are relatively defensive in the current environment of tightening monetary policy in the Western world. Meanwhile, the Japanese economy should benefit from its delayed pandemic re-opening in the next few quarters, which should come at a time when US/European economic growth is slowing. Against this backdrop, the relative performance outlook is balanced in our view.

Asia ex-Japan Equities

The Chinese economy is facing strong headwinds and it is right to be cautious on the outlook. But there are several reasons to believe it makes sense to take a contrarian stance and position for Asia ex Japan outperformance on a 12 to 18-month view. Valuations are undemanding, China should begin to ease up on its zero-Covid policy, there is very little inflation, and there has been a shift on the part of the Chinese authorities to stimulate the economy and impose regulation in a more market friendly way. Importantly, Asia ex Japan equity correlation with the global equity market is fairly low. If US and European markets remain weak, the region stands to hold up relatively well.

Emerging markets ex-Asia

Brazil, Saudi Arabia, South Africa, Mexico and the United Arab Emirates are the countries with the highest market cap weightings in EM ex Asia, making it a very commodity exposed index. The Brazilian presidential election was held recently and with no candidate getting 50% of the vote, it is heading to a second round later this month. Odds are good that Lula wins, but Brazil's strong performance under his previous leadership (from 2003 to 2010) is unlikely to repeat, as commodity prices are unlikely to rise like they did back then. Lacklustre commodity prices are a relative performance roadblock for this region. That is somewhat offset by the fact that valuation multiples are very undemanding.

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