Brewin
Dolphin

Passive Plus MPS

Quarterly report – Q4 2022
Annual report – 2022

Introduction

Welcome to this expanded edition of our Passive Plus MPS investment review. In this report, we cover information and events that influenced performance, not only in the fourth quarter of 2022, but across the entire year.

2022 was a difficult year for investors. The world was buffeted by economic and geopolitical shocks, which created very challenging conditions for investment. At the beginning of the year, concern was rife about the new more transmissible variant of Covid that was spreading around the world. As concern ebbed over the Omicron variant, fears rose over rising levels of inflation.

Central banks in the US and Europe hiked interest rates during the year in an attempt to rein in inflation, which weighed on bonds and equities. During the last few months of the year, there were signs of easing inflation and investors began to anticipate a peak in interest rates. If this comes to pass, it will remove a major headwind for the stock market, which was reflected in equity and bond market rallies over the fourth quarter.

Autumn saw the UK bond market briefly plunged into chaos, as former chancellor Kwasi Kwarteng's pro-growth mini-budget was met with a violent sell off, causing interest rates on loans and mortgages to soar. Following a brief leadership contest, Rishi Sunak was named UK prime minister. This was welcomed by financial markets, as Sunak is perceived to be fiscally conservative and market savvy.

In China, there were protests against the ruling Chinese Communist Party's zero-Covid policy. This policy was relaxed towards the end of the year, and the final days of the quarter saw people beginning to move about once more. This sets the scene for a year in which China's demand for oil is likely to rise.

Concerns remain about the global economic outlook, but several things have improved. One of the most concerning things about 2022 was the inability of wages to keep pace with inflation, but the US did see wages rising faster than prices in the last few months of the year. In Europe, the biggest anxiety has been over energy and replacing Russian supplies, but the last few months saw sharp declines in gas prices resulting from fortuitous weather, high balances in storage, economising by consumers, and record levels of imports of liquified natural gas.

The falls in stocks and bonds during 2022 were driven by improving valuations rather than collapsing profits. Over the long term, returns for investing at these valuation levels have historically been good. While none of these factors alone is enough to begin a new bull market, they do mark important steps along the path to one.

The big picture in Q4 2022

- After two consecutive negative quarters, the fourth quarter of 2022 saw global equities and bonds deliver a positive return.
- In the US, the Federal Reserve signalled that it would slow the pace of future interest rates rises amid growing evidence that US inflation is on a downward trajectory and the job market may be starting to cool. November's US CPI report showed that inflationary pressures continued to ease.
- On the other side of the Pacific, Chinese equities sold off heavily at the beginning of the quarter following the Chinese Communist Party's national conference. Investors were concerned that president Xi Jinping's move to secure loyalists in the politburo would increase uncertainty around the outlook for corporate profits. The expectation is that policy will be more focused on security and state control rather than the economy.
- Markets rebounded after China moved away from its zero-Covid policy, which had become a headwind for economic activity. In the short term, activity is being held back by people's fears of catching the virus. Chinese economic growth will likely enjoy a surge later in the year, once natural immunity and vaccination protection become established and case numbers subsequently decline. Despite the change in Covid policy and supportive monetary policy from the People's Bank of China, there a number of headwinds for the region and the outlook remains unclear.
- In Europe, the European Central Bank increased its forecast for gross domestic product (GDP) growth in 2022 by 0.3 percentage points to 3.4%. This followed stronger-than-expected services activity over the summer.
- In the UK, inflation touched a 41-year high before showing signs of decline. This led the Bank of England to raise interest rates two times during the quarter. Although the UK economy is being negatively impacted by high energy costs, gas prices are coming down and several measures of future inflation suggest a slowdown in price increases.
- While not experiencing the same level of inflation as the rest of the world, the Bank of Japan was forced to relax its previously ultra-accommodative monetary policy following pressure from financial markets. This resulted in the Japanese yen appreciating against several currencies.

Market overview Q4 2022

- The global equities benchmark advanced +4.0% over the fourth quarter amid signs of easing inflation in the US and Europe and the loosening of pandemic restrictions in China.

- European equities gave the strongest performance, rising by +11.3% on hopes that inflation in the eurozone may have peaked. The UK equities benchmark gained +8.9% after new chancellor Jeremy Hunt reversed the tax cutting measures in his predecessor's mini-budget. Japanese equities advanced +4.8% and Asian equities rose +3.8%, whereas US and emerging market equities lost -0.6% and -1.8%, respectively.

- After experiencing sharp losses in the third quarter, bonds bounced back with a gain of +2.7%. UK corporates were the biggest contributors to growth, surging by +7.2%. Global corporates (+3.3%) and global inflation-linked bonds (+2.7%) also performed strongly.

- Alternative assets recorded a small loss of -0.4%. Global real estate investment trusts (REITs) and absolute return fell -1.4% and -0.3%, respectively, while gold increased by +0.3%.

The value of investments can fall and you may get back less than you invested.

Passive Plus MPS performance

PERFORMANCE												
	Q4	2022 YTD	1yr	2yr	3yr	4yr	5yr	2021	2020	2019	2018	2017
Cautious Portfolio	2.0	-10.8	-10.8	-6.7	-2.8	6.9	3.5	4.5	4.2	10.0	-3.2	6.6
Cautious Higher Equity Portfolio	2.2	-10.5	-10.5	-4.0	-0.7	6.9	3.5	7.2	3.4	10.0	-3.2	6.6
Income Portfolio	2.4	-9.9	-9.9	-2.0	0.5	12.7	7.3	8.7	2.5	12.2	-4.8	8.4
Income Higher Equity Portfolio	2.6	-9.0	-9.0	1.2	3.1	12.7	7.3	11.2	1.9	12.2	-4.8	8.4
Balanced Portfolio	2.8	-8.3	-8.3	4.4	6.9	23.0	17.3	13.8	2.4	15.0	-4.6	9.5
Growth Portfolio	3.3	-7.4	-7.4	8.4	11.0	31.4	23.9	17.1	2.4	18.4	-5.7	11.4
Global Equity Portfolio	3.7	-6.9	-6.9	12.1	13.1	37.7	27.5	20.4	0.9	21.7	-7.4	13.1

All figures shown above are calculated to 31 December 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.

Passive Plus MPS performance highlights Q4 2022

Asset Allocation

What worked and why?

The underweight position in property supported the portfolio over the quarter. The property sector fell over a period when bonds and equities rose.

What didn't work and why?

The underweight position in European equities detracted from performance over the quarter. The region rebounded strongly despite the challenges of inflation and the war in Ukraine. The overweight to absolute return was also problematic over a period when both bonds and equities rose from recent lows.

Fund Selection

What worked and why?

In the MI Select Managers Alternatives fund, the Lumyna Commodity Alpha strategy was a positive contributor as energy prices fell. The L&G FTSE 250 index fund performed well as UK mid-cap stocks rebounded from recent lows.

What didn't work and why?

Schroder Global Cities struggled over a period when the global property sector was weak.

Passive Plus MPS portfolio changes Q4 2022

Asset Allocation

In October, the Asset Allocation Committee increased the allocation to UK government bonds, closing the previous underweight position to take advantage of an entry point provided by the fallout from the mini-budget. The allocation to global inflation-linked bonds was also increased, whereas cash and absolute return were reduced.

In November, the weighting to North America was increased, given the region's exposure to growth stocks and the potential for dollar strength. The weighting to Asia was reduced.

In December, there were no changes to the underlying asset allocation.

Fund Selection

The Ninety One Global Macro Alternatives strategy was launched and included within the MI Select Managers Alternatives fund over October and November. We believe that the addition of this fund will improve the balance of risk and reward.

In October, the BlackRock ICS Short Term Liquidity Fund and MI Select Managers Alternatives were decreased. The Legal & General Global Inflation-Linked Index was increased in place of Vanguard US Government Bond Index.

In November, Fidelity Index US was increased, while Fidelity Asia ex-Japan index was decreased.

In December, Fidelity UK was decreased, while a number of overseas equity funds were increased.

Passive Plus MPS

Annual report – 2022

Passive Plus MPS annual market overview 2022

- A series of economic and geopolitical shocks made 2022 a difficult year for investors. At the start of the year, concern was rife about a new, more transmissible variant of Covid. As concern ebbed over the Omicron variant, fears rose over increasing levels of inflation.

- While most investors and policymakers went into 2022 expecting a return of inflation, few foresaw just how sharply and persistently prices would rise. The US Federal Reserve expected to raise rates by less than 1% by the end of the year, but ended up hiking by more than 4% in what was, arguably, the most aggressive interest rate hiking cycle on record.

- Inflation was more persistent than expected, and therefore interest rates rose by more than expected. This meant bonds were worth less and the growth of company profits was generally outweighed by falling valuations in the equity market.

- In the UK, investors were buffeted by a series of political crises and a mini-budget that was released without the support of the Office for Budget Responsibility's forecasts. The sharp rise in bond yields caused by the mini-budget triggered a vicious circle of rising yields, requiring some leveraged pension schemes to sell assets which, in turn, pushed yields higher. The Bank of England stepped in to end this cycle, but the ultimate task of restoring confidence to the market was left to the government.

- In China, president Xi Jinping secured a third term in office. Shortly after, protests against the government's zero-Covid policy reached a fever pitch. The policy was relaxed and the government transitioned from telling people to avoid spreading the virus at all costs to pressuring them to work whilst infected if symptoms were not too severe. Fear of infection was still a powerful suppressor of economic and social activity, although in the final days of the year it did appear that people were beginning to move about once more.

The value of investments can fall and you may get back less than you invested.

- One bright spot during the year was gold, which rose almost +13% driven largely by weakness in the pound. Cash was mildly positive thanks to interest rate hikes from the Bank of England and other central banks.
- Interest rate hikes and the bungled UK mini-budget proved damaging for bonds. UK gilts and UK corporate bonds fell by around -20% over the year. Global bonds fared little better, with losses in the mid to high teens.
- Most equity regions fell by between -5% and -10%, but the UK equity market proved resilient as demand for energy and raw materials increased following the pandemic reopening and the war in Ukraine.
- The global property REITs benchmark fell by around -15% but absolute return (as measured by the HFRX Absolute Return index hedged to GBP) was up by just under one percentage point.

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Passive Plus MPS performance highlights 2022

Asset Allocation

What worked and why?

Overall, the allocation positioning was beneficial over the year. The underweight to bonds and the overweight to cash and absolute return were positive contributors to performance.

What didn't work and why?

Prior to being closed out in March, an underweight to gold at the beginning of the year was a drag on performance. An underweight to Europe in the second half of the year also detracted from performance.

Fund Selection

What worked and why?

The Lumyna Commodity Alpha strategy, which forms part of the MI Select Managers Alternatives fund, performed well over a period of volatile energy prices.

What didn't work and why?

The L&G UK FTSE 250 Index fund detracted from performance as UK mid-cap stocks underperformed in the difficult market environment.

Passive Plus MPS portfolio changes 2022

Asset Allocation change highlights

Equity and bond markets fell over the first nine months of the year. Against this backdrop, the Asset Allocation Committee reduced exposure to both equities and bonds, and increased exposure to cash and alternatives. As indications rose that central banks were getting closer to the end of their interest rate hiking cycle, the disastrous mini-budget in the UK provided a good entry point for raising exposure to sovereign bonds in October.

Fund change highlights

2022 saw an increase in cash and alternatives, and the introduction of the new MI Select Managers Alternatives fund and the Blackrock Sterling Liquidity fund. The alternatives fund invests in property, commodities and absolute return strategies to give diversification to portfolios via the chosen underlying managers' strategies, whose investment styles complement each other, based on both qualitative and quantitative characteristics. The Ninety One Global Macro Alternatives strategy was launched and included within the MI Select Managers Alternatives fund over October and November. We believe that the addition of this fund will improve the balance of risk and reward.

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, which is a relatively attractive asset class at a time when global growth momentum is slowing but bonds are not rallying. Moreover, the Bank of England base rate continues to move higher.

Bonds

We raised our exposure to government bonds again this month, adding weight to the UK. This decision was underpinned by the UK's relatively high interest rate sensitivity and other factors that we thought would weigh on UK economic growth and limit the upside in UK bond yields. We upgraded global inflation-linked bonds instead of global conventional government bonds because inflation expectations have dropped sharply. Looking ahead, there probably isn't much more downside, with one important reason being that oil prices should remain reasonably strong. If inflation expectations end up moving sideways, that leaves other factors, including index composition, that will determine conventional versus index-linked relative performance. On that front, Japan has a high weight in the global conventional index, but a small weight in the global inflation-linked benchmark. Japan is set to be a global growth bright spot in H1 2023. This, combined with the yen weakness of the past two years, should add to the inflationary pressure that is beginning to emerge in Japan. Against this backdrop, the risk is that Japan continues to tweak its yield curve control policy. If it does, that would push bond prices lower around the world, but the odds seem high that Japanese government bonds would be most susceptible to declines in this scenario. We remain underweight corporate bonds as there is scope for further spread widening if economic growth continues to deteriorate as we expect.

Global Equities

Bond yields are approaching a peak in our view, so how much further the equity market declines from here will come down to how severe the earnings recession is. There is still a pathway for the US economy to avoid a recession, which would be supportive of corporate earnings. But the probability of this scenario unfolding does not seem to be particularly high. That said, for now the US economy is holding up relatively well, and a recession may not begin until the end of this year or early 2024. If the US economy evolves as such, global equity markets may end up trading in a broad range throughout the first half of 2023. While there is no way to know how much earnings per share will ultimately decline at this stage, it's reasonable to believe that a severe decline is unlikely. Importantly, while excesses and imbalances are currently present, the backdrop is not dire.

Alternatives

It is too early to position for a sustained decline in real yields and a drop in the dollar. As such, we retain our neutral position on gold. We also remain underweight property; inflationary pressure is weakening, valuations are unattractive, and real bond yields should remain elevated. 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

Rate hikes are having a more pronounced detrimental impact on growth in the UK than they are in the US, partly because mortgage terms in the UK are much shorter. Higher mortgage rates are pushing UK house prices lower, and that has historically coincided with weaker consumer spending. Relatively weak UK economic growth tends to weigh on UK equity relative performance. Nevertheless, UK equities have outperformed of late (in common currency terms) on the back of both the strong rebound in the pound versus the dollar and the outperformance of the value style-oriented stocks the UK market is heavily weighted in.

US Equities

We retain a modest bias to US equities for several reasons. The first is our outlook for the dollar. If markets slip back into a 'risk-off' environment, which we expect, that should provide the backdrop for a final bout of dollar strength. A strengthening currency generally leads to regional equity outperformance in common currency terms. Second, a cyclical top in sovereign bond yields is probably not far off. Rising bond yields have been good for the relative performance of the global equity value style over the global growth style. If it is correct that bond yields aren't far from a peak, that is good news for the relative performance of growth stocks, which is supportive of the US given that it is heavily overweight the growth style. Third, although an eventual US recession still seems likely, for now the US remains a global economic growth bright spot.

Europe ex-UK Equities

Europe ex UK equities continue to rebound versus the global equity benchmark (in common currency terms). Helping drive this turnaround has been the strength in the euro, which has received a boost thanks to the decline in natural gas prices, increased European Central Bank hawkishness, and the shift to a more risk-on environment. Looking ahead, to believe the pro-cyclical euro will build on this rally will need both global growth momentum and risk assets to be closer to bottoming. We do not believe we are there yet. Without continued upside in European FX, it will be difficult for Europe ex UK to sustain its recent outperformance in common currency terms.

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, which is a structural roadblock to equity market outperformance. More immediately, Japanese equity relative performance (in common currency terms) has been resilient, helped by the drop in the dollar versus the yen. Looking ahead, we do not expect a catalyst to arrive that could spark a sustained period of Japanese equity outperformance. That said, the Japanese economy should benefit from its delayed pandemic reopening in the first half of this year, which is coming 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

With the region heavily oversold, Asia ex Japan equities were primed for a rally. Announcements from the Chinese authorities, such as its 16-point plan to support the property sector and 20-point plan to optimise Covid restrictions (before dropping them completely), helped to catalyse the gains made since late October. In addition, like all regions outside the US, Asia ex Japan has also received a big relative performance boost from the decline in the dollar. In terms of the outlook, as always there are pros and cons. While the list appears balanced, it is probably right to think that there is a cyclical window of opportunity for the region to outperform. Longer term, it is difficult to have a strong view, especially due to the lack of policy visibility.

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. Looking ahead, there are crosscurrents confronting the region. On the one hand, EM ex Asia remains very cheaply valued, and there is scope for the economies in this index to bounce back from the Covid crisis. On the other hand, EM FX should depreciate versus the dollar as global economic growth slows. Against this mixed backdrop, we maintain an exposure slightly below the benchmark.

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