CAVENDISH
FAMILY OFFICE

Market Report
Soft Landing or Slump?

30th September 2022

In our last quarterly Market Report, we reflected back on a very busy first 6 months, and from an economic perspective, the flow of information and decision making has not taken a breath over the summer!

The story of the first half of 2022 was one of "stagflation," with fears that the Federal Reserve (the Fed) will need to hike rates faster and further to contain inflation, driving bond yields higher, and equities lower. Sadly, not much has changed.

We also posed a question in what story will drive the market over the second half of the year: "Stagflation," "reflation," "soft landing," or "slump"? And how will markets react? As there is now a trend of data available, and also as the Fed has signalled its intention, we have a better view of what's in store for the future than previously. There are mixed views, but "soft landing" is chosen by the optimists and "slump" (read recession) for the pessimists. The events of the last week of September have probably swung most now towards recession, albeit a "growth" one.

A growth recession is defined as a prolonged period of meagre growth and rising unemployment. The pain is sharper and lasts longer than that of a soft landing, but a growth recession doesn't pull the entire economy into contraction the way a proper recession would. It looks like a recession, and feels like a recession, but it isn't a recession — at least not officially.

Our core observation though remains constant. Macro fundamentals are changing and therefore the leadership of portfolios will change with them. Investors should avoid investing using the rear-view mirror at times when the economic, and therefore profit fundamentals, are changing.

More Pain?

In an ideal world, the Fed has already vanquished pandemic-era inflation while keeping unemployment at historic lows and avoiding a recession. Hopes for such an outcome are all but entirely dashed, and the Fed has switched to plan B.

The central bank's message at its annual conference in Jackson Hole, Wyoming, this year was a simple and stark one. In remarks on 26 August, that lasted less than 10 minutes, Jerome Powell, the Fed's

chair, warned that cooling inflation would "bring some pain" to Americans through layoffs, weaker pay growth, and higher borrowing costs." He said that while the side effects are "unfortunate," a failure to slow price growth and normalize the economy "would mean far greater pain."

The speech laid to rest the idea that the US can enjoy a so-called soft landing, in which the Fed can bring inflation back to its 2% target without driving up unemployment. The central bank has been raising interest rates at the fastest pace since the 1980s (see table below) in an attempt to ease Americans' demand and slow inflation. Powell clarified in the speech that additional rate hikes are on the way, further eroding optimism for a soft landing. We have had a third consecutive 0.75% increase on 21st September with further hikes expected before the end of the year.

In its place is the likelihood of a "growth recession," which describes a period of slow economic growth and higher unemployment. It's not quite stagflation, as that scenario requires high inflation in addition to those two conditions. But it's a brute-force way to stamp out inflation, and Powell's remarks signal it's what the Fed is turning to after more than a year of faster-than-usual price growth.

The economies of the mid-1980s and mid-1990s offer some clues about what growth recessions look like. The former followed a historic inflation spell that required the Fed, then chaired by Paul Volcker, to raise interest rates to record highs. While that worked to cool price growth, the economy expanded at a below-trend pace. The unemployment rate didn't surge, but it lingered at elevated levels for several years before resuming its downward trend.

The economic expansion of the mid-'90s was similar, featuring easing inflation, below-average growth, and stubbornly high unemployment. The economic expansions that came after both growth recessions were healthy but still included some scarring from the few years prior.

The strong US Dollar ($)

The most important currency in the world is on a roll. The dollar has climbed by around 22% over the past year against a basket of global currencies and is at its highest level in 20 years. One euro is now worth less than a dollar, and other pretenders to the dollar's throne as the world's reserve currency, such as the yen, yuan or even crypto, have slumped (Sterling is not far behind either!) Even as America has used its financial clout to squeeze Russia, others have rushed to the dollar-based financial system as a safe haven. This cyclical strength of the dollar dominates the global financial landscape.

The dollar's run reflects several forces. Even as Europe and China face a downturn, America's economy is proving remarkably resilient, with job growth and profits still strong. Inflation is high and the Federal Reserve is raising rates faster and higher than other big central banks. Energy crises are terms-of-trade shocks that favour energy exporters and punish the currencies of importers. Thanks to the shale revolution America became a net energy exporter in 2019 for the first time since 1952. None of these dynamics looks likely to abate soon.

For America a strong dollar has some advantages. It will help bring down inflation, even if it might pose some longer-term competitiveness problems. For much of the world, though, it is bad news. The greenback remains pre-eminent in trade invoicing and cross-border debt. As a result, as the Fed raises rates and capital shifts to America, the finances of emerging markets get squeezed.

Will the dollar weaken? According to the Economist there are 3 conditions that need to be met first.

- Global growth gap has to narrow – so prospects out of America to improve
- Rapid reduction in price and wage pressures in America – allows the Fed to ease off the monetary brake
- Good news on global energy supplies

None of these conditions seems likely to be met soon. Until they are, the dollar will stay strong, and also aided of course by weaker currencies and economies, in the UK, EU and Japan.

How have the markets performed during the last quarter?

We have selected 3 more key indices this quarter, to add to the original, as a representation of the markets rather than a substitute for the whole market as they are probably the most recognisable for our clients.

	1 January	31 March	30 June	30 September	Change since January (%)
S&P 500	4,797	4,530	3,785	3,585	-25.3%
Dow Jones	36,585	34,678	30,775	28,726	-21.5%
Nasdaq	15,833	14,442	11,029	10,576	-33.2%
FTSE 100	7,505	7,516	7,169	6,894	-8.1%
Global Bonds	243	230	211	196	-19.3%
UK Bonds	255	235	213	182	-28.6%
Energy Index	31	46	49	46	+48.4%

NB: Figures rounded up to the nearest whole number.

As a result of the Fed's aggressively hawkish statements, and other recently published data, which

Cavendish Family Office (London) Ltd Registered in England No. 11213617
Registered Office at 1st Floor, 3 Sharrow Lane, Sheffield S11 8AE
VAT Number - 327 7076 88

came out far above expectations, investor sentiment has deteriorated, and equity markets have retreated to their mid-June lows while US Treasury and UK Gilt yields have surged to levels not seen since before the 2008 global financial crisis. Markets are pricing more aggressive rate hikes and a higher terminal rate for a longer period.

Interest Rates

All the major central banks now have a mandate to ensure that interest rates rise and fall to ensure that inflation is stable, which in most instances is 2% per annum, the "goldilocks" scenario where the underlying economy is neither "too hot nor too cold."

	1 January	31 March	30 June	30 September	Highest prediction
US (Fed)	0.20%	0.50%	1.75%	3.25%	4.75%
UK (BoE)	0.25%	0.75%	1.25%	2.25%	4.25%
Europe (ECB)	0.00%	0.00%	0.00%	1.25%	2.25%
Japan (BoJ)	-0.10%	-0.10%	-0.10%	-0.10%	-0.10%

NB: The figures in the final column are an amalgam from several different sources, so are more akin to a trend rather than a prediction. They are for the full cycle rather than a fixed period.

Although the headline and core inflation measures remain stubbornly elevated, there are advanced signs that inflation is peaking while demand and economic growth are softening, including falling commodity prices, high inventory levels, improving global supply chains slowing global growth, and a less inflationary balance between labour demand and supply.

However, the fact that inflation is peaking does not mean that it will fall rapidly, as mentioned by Chair Powell. Fed policymakers have indicated that moving aggressively now allows for flexibility to shift course later as needed.

We therefore expect the central bank to be data-dependent and ultimately react to the disinflationary forces that we expect to gradually emerge. This should provide support for equity and credit markets.

However, in the short-term, markets are increasingly pricing a "hard landing" scenario, driven by the hawkish Fed and higher interest rate expectations, where excessive monetary tightening by the Fed would lead to a US and global recession, and their focus is on the timing, magnitude, and duration of a potential recession. Markets therefore will continue to be driven by inflation and growth data in the near-term.

What asset classes should we consider?

Stock markets were rattled in the second week of September with worse than expected inflation data. The S&P 500 for example fell 4.8%, delivering its worst weekly performance since June, and reversing its early-September gains. It was a similar story in the third week of September with the increase in interest rate announcements from the Fed and the Bank of England (and indeed the Truss Government tax cuts in the UK).

The risk-off mood in markets has left some investors seeking refuge in cash. Fund managers increased average cash balances to 6.1% in September, according to a survey by BofA Global Research. Retreating to the side-lines, especially given the drag on cash from high inflation, and the challenge of timing a return to markets without missing out on rebounds, is a difficult task.

So far in 2022, "Value" has outperformed "Growth" by 15%, a trend we predicted in Q4 2021. Historically, "Value" has done better than "Growth" in periods when inflation has been above central bank targets. While we do expect that the Fed will ultimately prevail in its effort to control inflation, price increases will remain above the central bank's 2% goal for some time (they may even prefer a slightly higher rate for a period). We also favour sectors that are less vulnerable to recession risks, such as consumer staples and healthcare. Both sectors have outperformed the broader market by around 8% this year.

Investors should avoid the temptation to retreat to the side-lines. Instead, position portfolios to perform well in a variety of potential scenarios.

The key part of markets over the last few months is that they priced in a smooth landing over the summer, but inflation has proved to be persistent. As a result, the Fed is getting aggressive just when the front end of the economy is slowing rapidly. Hence, we are more likely to have a recession than previously thought.

The Markets got it wrong over the summer. They are now going to have to deal with the earnings hit that comes with the slowdown. The first 6 months of the year was about change in interest rates and its impact on the discounted cashflow models that happens there (the key factor is the risk-free rate of return, the 10-year US treasury yield, as this declines as valuations go up, and when it goes up, equities tend to fall. There are other factors of course but that is effectively what has been going on for 40 years. The decline in interest rates has increased the value of assets). Now it is about the extent of earnings' declines (although we are aware that inflation can actually keep earnings nominally higher).

If we take the recent earnings report from FedEx, a kind of proxy for corporate profits, the world is slowing down and inflation which probably has peaked now, seems rampant.

Cavendish Family Office (London) Ltd Registered in England No. 11213617
Registered Office at 1st Floor, 3 Sharrow Lane, Sheffield S11 8AE
VAT Number - 327 7076 88

CAVENDISH
FAMILY OFFICE

In talking to our selection of investment managers they seem to think that the best place to invest over the next 6 months will be quality bonds that are offering decent yields at last (not vs inflation) and assign firepower into risk assets as current entry levels are attractive.

They key directive though seems to be a transitioning from worrying about inflation to worrying about a recession over the next 12 months. During this period, we can expect more volatility to portfolios as the markets react and find their levels in the current environment.

Mark Estcourt
CEO