Beckford · James

chartered financial planners

Portfolio Review *January 2022*

After a strong performance in 2021, it has been an exceptionally challenging start to the year for equity markets. The continued rise in inflation, concerns around central bank tightening and escalating tensions between Russia and Ukraine rocked markets in January and led to a sharp increase in volatility. There were very few places to hide, with equity markets down across the board, although our domestic FTSE 100 Index just about managed to keep its head above water. The rallying of oil and gas prices and higher US Treasury yields saw energy and financial stocks significantly outperform the rest of the market, which contributed to the largest monthly outperformance of value versus growth in more than 20 years.

So, it has indeed been a turbulent start to the year. The US Federal Reserve (Fed) set the tone for markets in the first week of the month following the release of the minutes from their December policy meeting in which they acknowledged for the first time that inflation is "well above" their 2% target, having dispensed with the term transitory late last year. The Fed pointed to a strengthening economy, tight labour market conditions and persistently higher inflation to suggest that the economy no longer needs sustained high levels of monetary policy support and that it intends to start raising interest rates in March. Whilst this comes as no surprise to investors, the tone of the Fed's statement was taken as increasingly hawkish which spooked investors who worried the Fed may have to tighten more aggressively to combat surging inflation. That uncertainty sent volatility soaring and triggered three consecutive weeks of stock market declines to kick off the new year.

Why does the stock market care about rising rates? The reasons are broadly twofold: firstly, central banks walk a tightrope between raising rates just enough to get a lid on inflation without risking a slowdown in economic growth if rates are raised too quickly and secondly, rising rates makes the prospect of investments like bonds more attractive relative to stocks. When interest rates rise, banks and lenders tend to raise their borrowing costs too which means mortgages, credit cards and other loans become more expensive, reducing consumer spending and demand. Businesses also pay more to finance their operations. Broadly, this dampens the outlook for company profits in certain sectors and reduces investor enthusiasm for buying their stocks.

While the prospect of interest rate rises on the other side of the Atlantic has unnerved investors, in the UK the interest rate hiking cycle is already underway. At the time of writing, the Bank of England has just announced a second rate increase taking rates to 0.50%. Inflation in the UK rose 0.50% in the month to December, taking the year-on-year headline rate to 5.4%, the highest level since 1992. The prospect for inflation to rise above 7% in the first half of the year is now a realistic probability with the impending rise in energy prices, although it is still expected to fall back later in the year, just not quite so transitory as we were originally led to believe. This is undoubtedly leading to challenging conditions for UK consumers and undermining consumer confidence as the emergence of a cost of living crisis grows.

Volatility, which has been conspicuously absent from markets over the last year or so, returned with a vengeance in January. The Cboe Volatility Index, the market's so-called "fear gauge", hit a 52-week high following the Fed's statement and although it has since fallen back, remains at elevated levels. January's large swings in equity markets caught investors off guard. Even with all the supply chain issues and covid variants over the last year, markets have been very resilient because companies delivered a steady

stream of healthy earnings reports which drove markets higher. Investors have become accustomed to steady, consistent gains which makes the current bumpy ride feel all the more uncomfortable. It is important to remember that volatility is a normal feature of markets and it does present investors and fund managers with buying opportunities. What's more is that markets have gone up by double digits for three years in a row now, which is not sustainable, and January's sell off could be the market adjusting itself to more realistic valuations based on future outlooks.

The sharp rise in bond yields that took place in January due to the changing interest rate landscape caused a significant rotation in equity investment styles. Investors rotated out of the "stay at home" stocks, where revenue growth of the pandemic years is unlikely to be repeated going forward. Growth orientated stocks in general saw widespread indiscriminate selling, with some of 2021's key winners becoming 2022's biggest losers so far. Technology shares were some of the hardest hit, with some very sharp movements at individual stock level, as investors feared higher rates would expose their lofty valuations and higher financing costs will see them come under pressure in the coming quarters. In contrast, value stocks and those that typically benefit from rising interest rates, such as banking stocks, were among the more resilient areas of the market while energy stocks also performed well. However, despite the underperformance of growth versus value for the month, growth stocks still trade at a large premium to value stocks, particularly compared to pre-pandemic levels.

The UK market's strong value credentials, with our high weighting of banking and oil & gas stocks, saw our home benchmarks outperform other developed market indices. The FTSE 100 returned 1.33% while the broader FTSE All Share delivered marginally negative returns (down -0.33%) dragged into the red by small-cap stocks. In stark contrast to this were the US indices, where the dominance of technology stocks that drove markets to record highs last year bore the brunt of the selling and led the S&P 500 to experience its worst January since the depths of the Global Financial Crisis in 2009 and its worst month since the onset of the pandemic. Stocks in Europe were not immune to January's selling whilst the tensions in eastern Europe also had knock on consequences, most notably the ramifications for energy supply and the impact this may have on the region's economic growth if the situation escalates further.

Markets in Japan, which also have a high weighting towards technology names, suffered falls in line with other global markets. A rise in Covid-19 cases also weighed on sentiment as lockdown measures were extended in certain prefectures while Japan's borders remain closed to foreign travellers until at least the end of February. Emerging Markets suffered further falls, dragged down by China where data showed a continued slowdown in economic growth, however energy rich markets such as Latin America, Saudi Arabia, Qatar and UAE benefitted Emerging Market indices which on the whole fared better than their developed market counterparts.

Energy and Commodities were the only bright sparks during the month. Oil prices continued their rally with Brent crude reaching $90 a barrel for the first time since October 2014, driven by falling inventory in the US and rising political tensions with Russia. With bond yields rising, global bond markets fell 2% last month, although still outperformed equities. Corporate bonds underperformed government bonds as credit spreads widened. Negative returns across bond markets serve as a reminder that in times of heightened inflationary risks bonds provide less protection to portfolios than in times of recessionary risk.

Despite a challenging and painful month for investors, the picture is not all bad. The global economic recovery should continue to expand so long as central banks aren't forced to raise rates too quickly

or aggressively. Companies too are in pretty good shape and those that can continue to deliver that all important earnings growth should see their share prices rewarded. In fact, the last week of the month saw companies start to report their earnings for Q4 2021 which saw the biggest two-day rally since 2020 and some of the months worst performers ended with major advances. Of course, we know markets don’t move in a straight line and volatility is likely to persist in the near term at least, but the fundamentals remain supportive for equities.

Portfolios

After the turbulent start to the year with negative returns across almost all asset classes, the Beckford James portfolios declined over the course of the month. The Income portfolio held up best, delivering a total return of -0.45% which was well ahead of its composite benchmark return. The Growth portfolios declined, ranging from -2.43% for Growth 3 to -4.80% for Growth 10. The Ethical portfolio was the worst performing portfolio, falling by 7.90% for the month.

In terms of the underlying fund constituents of the portfolios, in the Growth portfolios the Natixis H2O Multi Returns delivered an impressive positive return whilst the direct UK listed property funds, Threadneedle and L&G, also delivered positive returns and demonstrated their diversifying credentials while equity markets were falling. Unfortunately, these were offset by some weakness in some of the ex-UK funds we hold, such as the Baillie Gifford Japanese Smaller Companies Fund and Jupiter European. Meanwhile funds with a particular growth bias and high degree of exposure to the technology sector came under pressure such as the Goldman Sachs Global Millennials Fund.

In the Income portfolio there were some strong performances from some equity income funds, particularly those which have a high degree of exposure to value or cyclical type stocks such as GAM UK Equity Income, Schroder Global Equity Income and JOHCM UK Equity Income. This was offset to some degree by weakness in our European holding, BlackRock Continental European Income, suffering partly due to the spill over of Russia-Ukrainian tensions and the Chelverton UK Equity Income Fund which has more of a quality growth style.

The Ethical portfolio came under particular pressure last month, with all except one fund in the portfolio delivering negative total returns. The Edentree Responsible & Sustainable European Equity Fund produced a very modest positive return thanks to its value investment style. However, all other funds in the portfolio fell, largely due to the more growth orientated nature of their investment styles and a lack of exposure to energy and financials which were the only bright spot in an otherwise dismal month for investors.

Although negative returns are of course disappointing and the magnitude of the fall in returns over a short period is understandably worrying, it is important to remain focused on the medium to longer term outlook and view returns in this wider context. Despite the falls in January, all portfolios have delivered positive returns over the course of the last 12 months and are higher than they were at the onset of the pandemic. We are constantly reviewing the investment funds in your portfolio to ensure they remain appropriate and will be shortly recommending some changes to the Ethical and Growth portfolios.