ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

Market Commentary

December 2022

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Monthly returns and summary

Index	Portfolio Benchmark Risk Level	31/12/2022	1 Month	3 Months	1 Year	3 Years	5 Years
ARC Cautious	Low Risk	192.93	-1.5%	+1.5%	-8.0%	-0.1%	+4.0%
ARC Balanced	Medium Risk	236.74	-2.1%	+1.9%	-9.4%	+1.7%	+7.9%
ARC Steady Growth	Medium High Risk	281.73	-2.5%	+2.4%	-10.5%	+3.2%	+12.0%
ARC Equity Risk	High Risk	328.91	-2.6%	+3.1%	-11.3%	+5.4%	+16.3%

Source: ARC. NB: Price returns only, excluding dividends. Figures based on ARC estimates.

Index	Region / Asset Class	31/12/2022	1 Month	3 Months	1 Year	3 Years	5 Years
UK 100	UK	7451.74	-1.6%	8.1%	0.9%	-1.2%	-3.1%
UK All Share	UK	4075.13	-1.6%	8.3%	-3.2%	-2.9%	-3.5%
Dow Jones Ind Avg	US	33147.25	-4.2%	15.4%	-8.8%	16.1%	34.1%
S&P 500 Index	US	3839.50	-5.9%	7.1%	-19.4%	18.8%	43.6%
Nikkei 225	Japan	26094.50	-6.7%	0.6%	-9.4%	10.3%	14.6%
MSCI Europe Ex UK	Europe	167.01	-3.4%	10.0%	-14.5%	4.5%	12.9%
MSCI Asia Ex Japan	Asia	619.23	-0.4%	11.0%	-21.5%	-10.0%	-13.2%
MSCI Emg Mkts (£)	Emg Mkts	603.60	-2.4%	1.8%	-10.0%	1.5%	4.8%
MSCI World Index (£)	Global	2602.69	-4.3%	9.4%	-19.5%	10.4%	23.7%
UK Conventional	Gilts	3018.10	-4.1%	1.7%	-23.8%	-21.8%	-15.9%
UK Index-linked	Gilts	4000.23	-5.1%	-6.0%	-33.6%	-23.2%	-18.5%
AES Property Index	Property	112.66	-2.3%	-14.9%	-14.3%	-13.9%	-14.8%
FTSE All-Share Real Estate Investment Trust Index	Property	2034.72	-0.9%	3.4%	-34.1%	-32.5%	-28.9%
WTI Crude ($/Barrel)	Oil	80.26	-0.4%	1.0%	6.7%	31.4%	32.8%
Gold Spot $/Oz	Commodities	1824.02	3.1%	9.8%	-0.3%	20.2%	40.0%
£1 = US$	Currencies	1.2083	0.2%	8.2%	-10.7%	-8.9%	-10.6%
£1 = €	Currencies	1.1295	-2.5%	-0.8%	-5.0%	-4.5%	0.3%
£1 = Yen	Currencies	158.47	-4.8%	-1.9%	1.7%	10.0%	4.1%

Source: Bloomberg. NB: Price returns only, excluding dividends

Index	Region / Asset Class	31/12/2022	1 Month	3 Months	1 Year	3 Years	5 Years
FTSE All-Share Investment Companies Index	Diversified	11,591.86	-1.4%	3.5%	-18.7%	3.1%	14.8%
Latest Weighted Average Discount	-13.8%						
Previous Month Weighted Average Discount	-11.3%						
12 Month Weighted Average Discount	-5.7%						

Source: Bloomberg. NB: Price returns only, excluding dividends

General Comments

In the same way we are bound to our ancestors and those who made us, financial markets today are a function of what has preceded them. Conditions in 2022 followed a period of unprecedented loose monetary policy established in the aftermath the global financial crisis of 2008/09. The unwinding of this, with the most aggressive monetary tightening in more than 40 years, hit valuations of most asset classes in most jurisdictions.

This meant December ultimately brought an end to a poor year for many investors. Multi-asset portfolios were once again negative as both bonds and equities lost value. Investment companies followed this sentiment and closed the year at a significant discount to their asset values on average.

In brighter news, the FTSE 100 was one of the best performing markets in the world last year, with the above positive return and a total return (including dividends) of 4.6%. Its modestly negative December return led the index to finish the year at 7451.74.

Commodities were another area that did offer some degree of shelter in the year. One example that has shone recently has been gold, which returned 3.1% this month. As gold is priced and traded in US dollars, this recent performance has been helped by the relative strength of most major currencies against this counterpart of late.

Index-linked gilts closed out a weak year with a return of -5.1% in the month. Over the course of 2022, these securities modestly underperformed the high-growth Nasdaq equity index (when considering both returns in their respective currencies). Intuitively, the high levels of price rises would be beneficial to securities whose returns are indexed to inflation. However, given that these are typically long-dated securities, the duration of these assets means that they are very sensitive to interest rate rises, which we saw plenty of in 2022.

In fact, it is worth pointing out at this stage that the effective Federal Funds Rate (the base interest rate in the US) was 0.08% at this time last year. When reading the below comments on interest rates, it might be worth remembering this and considering just how far and how quickly things changed in 2022.

UK Commentary

Strike action was a key story in the UK, as there was a walkout of some form on every day in December. Numbers from the ONS highlight that UK pay growth for the private sector grew at an annualised rate of 6.9% between August and October, compared to just 2.7% for the public sector. With inflation in double digits, significant real terms pay cuts are happening across the board. This means that strike action may continue unless the government steps up its negotiation efforts, which it seems reluctant to do.

The Bank of England's Monetary Policy Committee (MPC) was split on interest rates at the latest meeting. Members ultimately voted 6-3 in favour of the widely predicted 0.5% rate increase to 3.5%. However, two participants wanted to keep rates where they were and one wanted a larger 0.75% increase. While it obviously seems quite ridiculous to be arguing against increasing rates with inflation so far above their 2.0% target, the members pointed to softening economic conditions as a reason against tightening financial conditions.

To highlight some such data, UK CPI inflation for November was reported to be 10.7%, down from the 41-year high of 11.1% seen in October and below the 10.9% expected by economists. Meanwhile, British retail sales fell unexpectedly in November, down -0.3% compared to an expected 0.4% increase. While inflation falling is a positive sign, consumer confidence falling is not. However, inflation is still well above target, so the majority of the MPC still seem keen to act by increasing interest rates. Opinions are mixed and economic data is also varied. The next meeting in February, which will be accompanied with a monetary policy report, will make interesting reading.

In other news, Microsoft took a 4% stake in the London Stock Exchange as part of a 10-year strategic partnership. Both companies seemingly see value in the enhanced data and analytics capabilities available with a tie-up. This could also act as a reminder of the UK market's reasonable valuation and that there are globally significant companies listed here.

North America Commentary

The Federal Reserve raised its benchmark policy rate by 0.5% in December to a range of 4.25 to 4.5%. This represented a slowdown in the rate of increases from the previous 0.75% increments. Most predictions now seem to place base rates rising to around 5.1% in 2023 and then falling back to 4.1% in 2024 and 3.1% in 2025.

As we highlighted in previous commentaries, US inflation appears to have peaked, so this slower rate of monetary tightening makes some sense. We had further positive inflation news this month as CPI came in at 7.1% year-on-year, below the expected 7.3%.

However, markets remained volatile in December with investors trying to second-guess future monetary policy based upon various data releases. We are in an unusual situation where positive economic data releases (such as lower than expected jobless claims) negatively affect stock prices. Investors fear upbeat data may cause The Fed to raise rates further, while weak data may point towards more easy monetary policy, which could benefit equity prices.

Briefly, while it is worth mentioning what is potentially one of the largest frauds in history in the form of FTX, there is little for us to comment on as we continue to stay away from the crypto space.

Europe Commentary

The ECB and the Swiss National Bank took the same action as The Fed and The Bank of England in raising base interest rates by 0.5%. Deposit rates now sit at 2.0%, remaining quite a bit below developed market peers such as the UK and US.

The EU approved Germany’s nationalisation of two major gas companies; Uniper and SEFE. Meanwhile, Spain announced a €10bn package to ease inflation costs. These are just two examples of how Europe is still grappling with its own cost-of-living crisis. However, European natural gas prices recently fell back to levels last recorded before Russia’s invasion of Ukraine in February. This will be very welcome news for many on the continent, and indeed elsewhere. It is also a reminder of how fortunes are currently tied quite closely to energy prices.

Asia Pacific Commentary

The re-opening of China’s economy (and society) was arguably the major story of December. They have ended mass COVID testing and have announced various other restrictions are being lifted. Commentators who pointed out that they were likely to do this after the CCP’s national congress have been vindicated.

China is also reportedly planning a $143bn semiconductor package, as the “chip war” with the United States escalates with Japan and the Netherlands joining in with the US sanctions.

Japan had a significant impact on markets this month as their central bank relaxed their yield curve control policy, allowing the yield on their 10-year government debt to fluctuate by plus or minus 0.5%, rather than the previous 0.25%. It kept overnight interest rates at minus 0.1% and remains the only country in the world pursuing this ultra-loose monetary policy and with negative yielding debt.

New Zealand officially banned future generations from buying tobacco with a new law, which is one of the strictest in the world, determining that nobody born in 2009 or later will ever be able to legally purchase tobacco products.

Emerging Market Commentary

According to Bloomberg, Argentina's world cup victory will only modestly boost their economy. However, November's month-on-month inflation of 4.9% was the lowest since February. The IMF therefore agreed that macroeconomic conditions in the country are improving as it agreed to release a further $6bn following their third Extended Fund Facility review.

Elsewhere, Ukrainian president Volodymyr Zelenskyy left Ukraine for the first time since it was invaded in February as he visited the US to meet Joe Biden and give a speech to congress. He took with him a flag signed by the liberators of the city of Bahkmut, the site of latest victory for Ukrainian soldiers. Zelenskyy pleaded for further aid and one nation that responded soon after was the Netherlands, who pledged another €2.5bn.

Charts of the month – Retail Sales Volumes vs Values

This excellent chart from the FT encapsulates the impact of inflation. It shows that in Great Britain people are spending more to buy less. As mentioned above in the UK commentary section, people have received some pay rises, so are able to spend more. However, as these have been less than inflation their purchasing power is lower.

The timing of the divergence of the two lines is also worth noting. Beginning in mid-2021, it is certainly not the case that inflation was caused solely by Russia invading Ukraine and is an issue that began before 2022.

The implications of this for equity markets are mixed. Ultimately though, it is a reminder that even in times of elevated inflation quality businesses will still be able to attract customers to purchase their products, despite elevated prices.

Investment Profile – Gore Street Energy Storage Fund

Gore Street Energy Storage Fund is an investment company listed on the London Stock Exchange. They offer investors exposure to a portfolio of industrial scale battery storage assets, connected to power grids in developed markets across developed markets globally.

In brief, these batteries are connected to grids with the intention of helping to balance the supply and demand of electricity at any given time. They help prevent surges when there is a glut of electricity being produced and less demand, while also helping offer additional energy capacity when there is an excess of demand over supply. Therefore, in the age of ever-increasing reliance on renewable energy, which is typically intermittent by nature, these are vital assets for economies' key infrastructure.

While there are many intricacies of this somewhat nascent market, and therefore many different ways these assets can be used to make money, Gore Street's recent results showed that 96% of their revenues came from the most straight forward of those; grid balancing. Simply put, this means the batteries being partially charged and connected to the grid, ready to either supply the grid with additional power or absorb any excess, whichever is required.

In the UK, this means National Grid pay operators such as Gore Street for this service and there are similar agreements in other geographies as well. In fact, the Nuclear Industry Association compiled National Grid's data to show they paid out £3.2bn for grid balancing services between January and October this year, an increase of 20% over last year's figure for the same period.

Gore Street has returned 46.3% since its 2018 launch in total return terms, much of which has come from dividends. The fund currently yields 6.3%.

Investment Team's thoughts

2022 was truly a year for the history books. Many unprecedented events took place, and this year will certainly look an outlier among many data sets for decades to come. We have little doubt there will be many charts we look at in coming years with huge swings in 2022 which we will need to remember to put various asterisks against in our analysis.

One of the more significant impacts of 2022 might well be that it was the year that TINA died. TINA standing for "There Is No Alternative" in reference to investors being forced to invest in equities, as roughly fourteen years of low and falling interest rates and quantitative easing drove yields on bonds and other assets (such as property) lower to the point of them no longer offering attractive returns.

Perhaps in hindsight 2022 will not appear as remarkable as it looks now. It may well prove that the real outliers were the years of unprecedented monetary policy across the globe which led to such a situation where negative real interest rates were common place. It might not be unreasonable to suggest 2022 was, in fact, an unwinding of irrationality and a return to a more "normal" long-term trend.

Given our style of investing, we welcome this change. We struggled to comprehend the degree to which investors piled into shares in many unprofitable companies. We also found ourselves struggling to understand at times just how little return was on offer from bond markets. For a long period of time following the 2008/09 financial crisis, excessive risk taking from investors was rewarded over and above a focus on quality and valuation.

We hope that events of 2022 ultimately represent a broader trend of rationality returning to financial markets and believe that, as investors who care deeply about the quality of the assets we invest in and the valuation which we pay to do so, this will benefit our style moving forward.