DART CAPITAL

Market Commentary

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October was a positive month for portfolios, with equities and corporate bonds making the most significant contribution to performance. The month saw promising progress made in European energy storage, with most countries having filled much of their storage ahead of schedule. Across portfolios we have used the indiscriminate sell-off in the bond market to add further to our highest conviction positions in this area – most notably investment grade UK corporate bonds – where valuations had fallen to particularly compelling levels. Against a backdrop of tighter monetary policy, we take comfort from the strong profitability and balance sheets of our underlying equity holdings, which we believe will be key in capturing the eventual rebound in equity markets.

Interest rates

The path of interest rates is largely dependent on how long the current period of elevated inflation lasts for, which itself is largely dependent on the speed with which labour and property markets slow, and the level of commodity prices. Whilst the latter two factors have shown clear signs of cooling over recent months, labour markets have remained resilient, with wage inflation having become more embedded as wage settlements have responded to the higher cost of living and tightness across the labour market. This is particularly relevant across lower paid roles where willingness to work at the prevailing wage has declined over recent years.

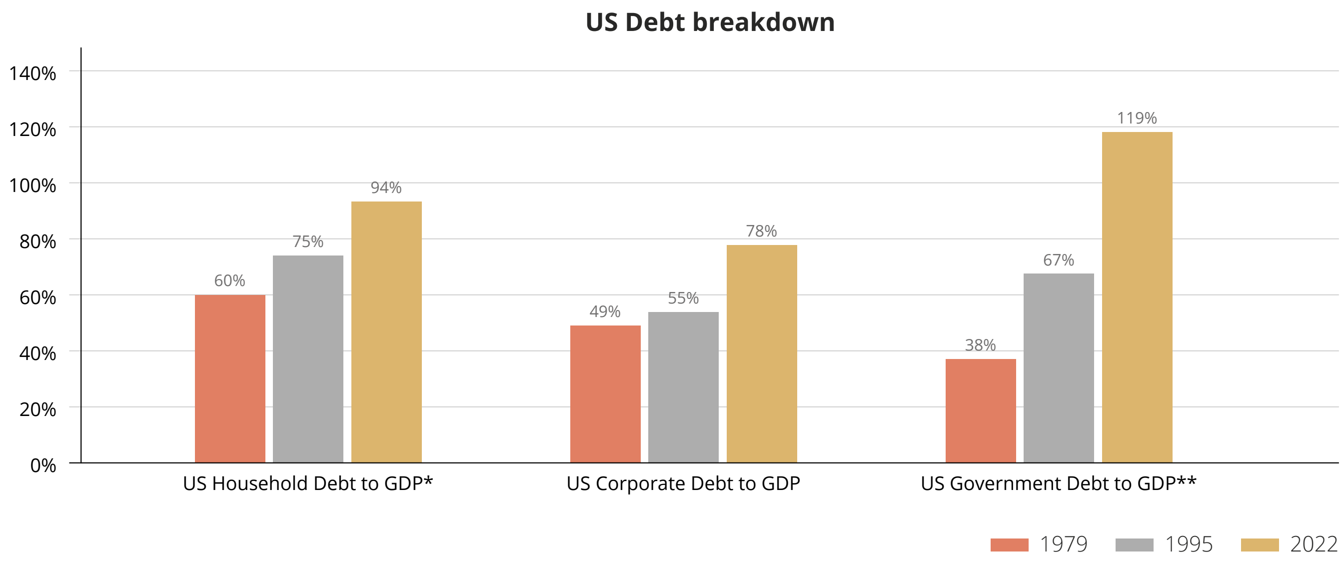
Following the recent Central Bank meetings, the market expects US and UK base rates to peak at around 5% and 4.5% respectively by early next year, and we see this as broadly fair pricing given stickiness of inflation outlined above and the desire of Central Banks to keeping consumer inflation expectations well anchored. Notably, there is plenty of room for interest rates to eventually decline once the outlook for growth and inflation has weakened as we expect it to by the second half of next year.

Although US and UK interest rates have now risen to 4% and 3% respectively in their November meetings (the details of which are discussed further below), the impact on the economy is yet to be felt. Based on historical evidence, the lag on rate hikes is believed to be between around 9 months as the impact of the increases feeds through to the real economy, other than the particularly interest rate sensitive housing sector where the lag is far shorter.

Thus, most of the current economic data is still reflective of last year's 0% interest rates and very supportive fiscal policy, particularly in the US where government stimulus cheques to households helped households build up a significant buffer of savings. Furthermore, equity & property market valuations – which are impactful on household sentiment – have declined significantly from their peak at the beginning of this year, and this is also yet to be fully reflected in household spending.

One factor which affects our long-term view on interest rates is debt levels, which are at far more elevated levels in this monetary tightening cycle than they were in periods such as the 1970s, or 2000s. In particular, with debt to GDP of around 300%, western economies are susceptible to interest rates remaining at elevated levels for a sustained period of time, with households, governments and corporates having to eventually refinance their debt loads at far higher interest rates than they became accustomed to over the prior decade. This surge in interest costs will act as a significant drag on real-GDP growth, and encourage Central Banks to keep real (after-inflation) interest rates at lower levels than they would if their economies were less heavily indebted.

Debt levels have increased significantly across the US economy



Source: federalreserve.gov

*US household debt to GDP including mortgage debt
** Includes state and local government debt

Based on the above, we expect both the Bank of England and the US Federal Reserve to pause rate hikes once the labour market has shown signs of significant weakness and inflation is seen to be on a sustainably declining path, with this point likely to be reached by the middle of next year. Notably, we expect markets to continue to react positively to each piece of economic data which indicates that the economy is weakening, and with valuations on most equity markets down to low levels, we believe the outlook for market returns is more optimistic than might be indicated by the popular press.

UK

It was another eventful month in UK politics, with Liz Truss eventually resigning as Prime Minister, and replaced by former Chancellor Rishi Sunak. Sunak, and new Chancellor, Jeremy Hunt, have committed to withdrawing the stimulus measures of the previous administration, and this has helped provide support for both the Pound and domestic asset prices. The fiscal update, having been set rather ominously on Halloween - 31st October - has been delayed to the 17th November, in order to provide the new leadership time to assess the best course of action.

The Bank of England (BoE) are stuck in a challenging position, given the squeeze on household incomes from higher energy prices (which will be worsened by higher rates), and elevated inflation, which would be exacerbated by a weaker currency should the BoE decide to slow the pace of interest rate hikes. Notably, we see the Bank of England softening their policy stance as soon as the inflation backdrop allows it, given the impact higher interest rates have on the property sector which forms a large component of household wealth and source of employment.

UK inflation was 10.1% in the 12 months to the end of September according to ONS figures released over the month, which was slightly above economist expectations, whilst the unemployment rate declined modestly to 3.5%. UK corporate bonds, to which we have been adding to significantly over recent months, had a strong month, gaining 4.8%, as did Gilts, with the yield on the 10-year Gilt declining 56 basis points to end the month at 3.53%. UK equities enjoyed a positive month, with MSCI UK All-Cap gaining 2.8% over the month in capital return terms.

US

The inflation figures released over the month remained elevated, driven this time by the shelter component (which captures housing and owner equivalent rents) and food prices. The former is still being boosted by the exceptional surge in property prices over the past two years which is still filtering through to the rent component of the index, whilst the latter continues to see upward pressure in part due to the Russia-Ukraine conflict which has pushed up the price of many agricultural commodities.

The backward-looking data from the labour market has remained relatively strong so far, although we are starting to see a sharp divergence between the strength in lower paid roles, where strong consumer demand for services – many of which were unavailable during the COVID restrictions of 2020 and 2021 – has remained buoyant, and more interest rate sensitive – usually higher paid – sectors such as technology and real estate which are seeing a sharp slowdown. There have been signs that weakening raw material prices – many of which are down over 30% from their peak – is finally feeding through to manufacturers, with a sharp fall in the manufacturer's prices paid in data released at the end of the month. Forward looking indicators for the property market have also started to weaken markedly, with mortgage rates – which are now c.7% - leading to a sharp fall in prospective property transactions and prices, particularly in those regions which saw property prices rise significantly over the prior two years.

Earnings season has been generally mixed, with most of the largest technology companies beating lowered expectations, but most reported slowing profit growth amidst rising costs and cut their outlooks for next quarter's revenues and profits. The S&P 500 gained 8% over the month in US Dollar terms, although this was lowered for UK investors owing to the 3% weakening of the US Dollar against the Pound over the period.

Europe

French and German GDP growth both came in above economist expectations, with the former benefitting from lower energy prices than most of their fellow European states. Eurozone inflation came in above expectations again, with the Consumer Price Index increasing 10.2% in the 12 months to the end of September. European governments have made significant progress in filling their energy storage, which has been further helped by the spell of warmer than usual weather that Europe have been experiencing over recent weeks. MSCI Europe ex-UK ended the month up 7.1% in local currency terms.

China

China's party congress disappointed many investors, with President Xi's re-appointment for a third term, and selection of an inner circle of loyalists seemingly dashing hopes of an imminent end to the zero-COVID policy. China's equity markets struggled on the back of the news, with renewed selling particularly across technology stocks. MSCI China H ended the month down 10.9% in local currency terms.

November's Monetary Policy meetings

US Federal Reserve

On the 2nd November, the US Federal Reserve's monetary policy committee (known as the FOMC) announced a 75 basis points increase in the Federal (Fed) funds rate, which brought the rate up to 4%. The statement accompanying the decision indicated that the committee will likely slow their pace of rate hikes over coming months, whilst the Committee are aware of the significant size of the monetary tightening over the last six months, and the inevitable lag in seeing the impact the policy changes are having on the underlying economy.

However, of greater concern to the equity market was the comments following the meeting by the Chairman of the Federal Reserve, Jerome Powell, in which he struck a far more wary tone with respect to inflation. Most notably, Powell indicated that the FOMC now expect the terminal level of interest rates to be above their previous expectation of 4.6%, with this level now expected to be around 5%. Powell further noted that the Committee are more worried about under-tightening than over-tightening, as they believe the former would be easier to correct than the entrenched inflation which could result from a premature ending of interest rate hikes. Having rallied over prior trading days, the S&P 500 ended the day down 2.5% in response to the decision. Such hawkish messaging here is likely due to the Fed's commitment to keeping inflation expectations anchored, and avoiding a sharp rally in the equity market which could reinforce inflationary forces.

Bank of England

In their meeting a day after the Federal Reserve, the Bank's Monetary Policy Committee (MPC) agreed a 75-basis point increase in the base rate, which brought it up to 3%. Notably, two members of the Committee dissented from the decision, with one member each voting for an increase of only 25 basis points and 50 basis points respectively. Per the meeting minutes, "the majority of the Committee judged that, should the economy evolve broadly in line with the latest Monetary Policy Report projections, further increases in Bank Rate might be required for a sustainable return of inflation to target, albeit to a peak lower than priced into financial markets". On the prospects for the economy, the MPC were less optimistic than their American counterparts, with the Committee forecasting an imminent recession which could last up to two years, with the base rate likely to peak at a lower rate than the 4.75% the market had been pricing in given the significant impact of rate hikes.