



Wealth  
Management US

VALUES WORTH SHARING

# Quarterly report

Q3 2022 market review







**Joseph Höger, detail from “View of Lake Gmunden near Ebensee”, 1836**

Landscape painter Josef Höger was closely connected with the Princely House of Liechtenstein through the numerous commissions he received from the family. As a result, an incredible body of his work in watercolour has been preserved in the collections. In his paintings, Höger documented the family's assets. He also frequently accompanied Prince Alois II von Liechtenstein on his travels, and therefore assumed a very special status. He captured the countries and landscapes through which they travelled, sometimes with astonishingly quick and fresh sketches, but sometimes also in large, detailed presentation drawings that demonstrate the full extent of his skill. Höger's views of Salzkammergut play an important role here. In his work, the artist painted cities such as Bad Ischl, Gmunden and Hallstatt, as well as the surrounding landscapes in which everyday life in the region is always depicted.

© LIECHTENSTEIN. The Princely Collections, Vaduz–Vienna

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## A look inside the Princely Collections

For more than 400 years, the Princes of Liechtenstein have been passionate art collectors. The Princely Collections include key works of European art stretching over five centuries and are now among the world's major private art collections. The notion of promoting fine arts for the general good enjoyed its greatest popularity during the Baroque period. The House of Liechtenstein has pursued this ideal consistently down the generations. We

make deliberate use of the works of art in the Princely Collections to accompany what we do. For us, they embody those values that form the basis for a successful partnership with our clients: a long-term focus, skill and reliability.

**[www.liechtensteincollections.at](http://www.liechtensteincollections.at)**

# Q3 2022 summary

It has been a turbulent time for investment portfolios, dominated by the impact of actual and expected interest rate rises as central banks continue to fight inflation. Equity markets dipped in June, but generally rallied as the quarterly results season progressed. By August, the S&P 500 was 17%<sup>1</sup> up from the June low. However, the optimism was short lived as central banks on both sides of the Atlantic made it clear they were prepared to raise rates aggressively to counter the surge in inflation. Equity markets fell back and by the end of the quarter the S&P 500 reached a new low for the year.

## At a glance

- Inflation remains high, with real wages under pressure.
- Central banks remain on a tightening path.
- The US dollar has strengthened against most other currencies.
- Bond markets have priced in higher rates.
- Equity markets have seen a sizeable correction this year, and whilst we expect volatility to remain high, the underlying valuations of equities with quality earnings should play out in the long run.

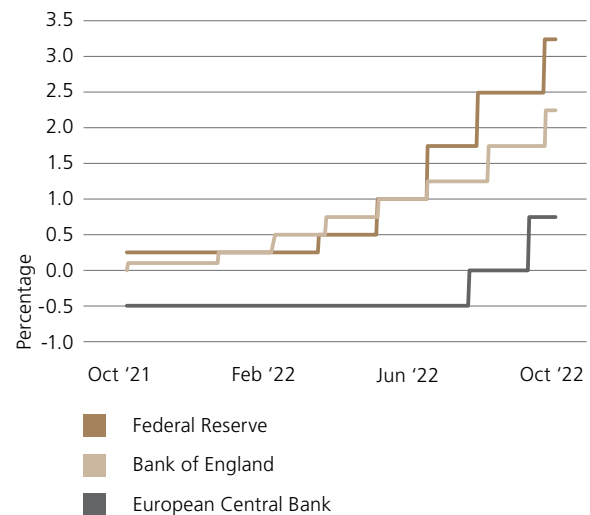
# Macro summary

The US Federal Reserve (Fed) has now raised interest rates by 3% over the last six months and is expected to make further tightening moves at the remaining meetings this year. They are also reducing their balance sheet, reversing the quantitative easing put in place during the pandemic. The pace of tightening elsewhere has been more modest. The Bank of England (BoE), who moved earlier than the Fed, has only raised rates by 2.15% since its first move in December last year. The European Central Bank (ECB) has been slower to act, and only started to raise rates in July by 0.5%, accelerating the tightening further in August with a 0.75% move. In the Far East, Japan has stubbornly held back from rate rises and China, with a continuation of lockdown policies, has moved to ease rather than tighten. The increased interest differential between the US and the rest of the world, combined with the economic woes in Europe and the war in Ukraine, has seen the dollar strengthen against most other currencies.



Central banks have been on a tightening path, with the Federal Reserve, Bank of England and European Central Bank all raising rates since the end of 2021.

Central Bank Policy Rates



Source: Bloomberg, LGT Wealth Management

In the UK, newly appointed Prime Minister, Liz Truss, and her Chancellor, Kwasi Kwarteng, delivered a 'mini budget' in an effort to boost the economy. However, this was seen as boosting inflation at a time when the BoE is raising rates to fight inflation. Borrowing to cut taxes was not favourably received by markets and triggered a sharp sell-off in both sterling and gilts. Pension funds have been encouraged since 1997 to hedge their

liabilities using fixed income strategies. In recent years, pension funds have taken leveraged exposure to fixed income to match the interest rate risk. As interest rates rose, there were collateral calls on pension funds and the sell-off became exaggerated. As the bond price falls became precipitous, the BoE had to step in to support the market by buying gilts. This provided some stability and some of the losses were reversed.

The war in Ukraine continues and, with Ukraine taking back territory, Putin is getting more aggressive by further reducing supplies of gas to Europe. Many countries in Europe have been building gas reserves for the winter and regulating to cut demand, however, it still looks as if this winter could be particularly difficult. As fears of a global recession grow, the oil price has been declining which may ease some inflationary fears. However, historic price rises are still feeding through, and in the Eurozone inflation has topped 10%. The cost-of-living crisis is leading to higher wage demands which if met will continue to push prices higher.

Overall, it has been a difficult quarter for both equities and bonds. The markets have priced in considerable further tightening and a challenging economic backdrop. Curiously as we enter the final quarter, weaker economic data may be taken positively by both bond and equity markets, as this could see less monetary tightening than the market fears. We will have to watch wage settlements closely, but with the oil price down by over 30% from the high earlier this year, some of the inflationary pressures may ease as we move into the new year.

Reassuringly, government bond yields have already priced in considerable further tightening and corporate spreads now reflect the heightened credit risk. As ever, we recommend a selective approach to equity markets, favouring companies which have strong pricing power and robust balance sheets. Our investment process seeks to capture companies with resilient business models, that are well-placed to generate returns over the long term. This does not mean the portfolios will not participate in market declines, but we remain of the view that our investment philosophy and the holdings in our portfolios will recover.

“Reassuringly, government bond yields have already priced in considerable further tightening and corporate spreads now reflect the heightened credit risk.”

Jonathan Marriott, Chief Investment Officer

# Fixed income

Over the last few decades, the role of central banks in developed market economies was seen to be one of supporting demand when economic shocks hit. This so-called “put” generally provided a floor on risk assets. With the dynamic between economic data and central bank response functions being well understood, this was further complemented by their forward guidance. Investors have been trying to find the point when central banks “blink” and soften their tone this year, but this exercise over the course of the summer period proved less than successful.



While the Fed continued its hiking cycle, delivering the second 0.75% increase in July, investors took the comments from the Fed that rates are now closer to what they deem neutral, as a dovish pivot. This led to a further recovery following the resilient overall earnings season. Expectations in the US were building that inflation had peaked in June and given the drop in broader commodity prices, it was thought that this process

would continue. This resulted in the view that the Fed could slow the pace of tightening. However, shortly after the July meeting, several Fed members came out and pushed back against these expectations. This came to a head at the annual Jackson Hole symposium in August. Chair Powell provided a short and powerful speech saying that their job is far from over and invoked the experience of Paul Volcker, who raised interest rates sharply during the 1980's to quell inflation. This hawkish rhetoric was not only supported by strong labour data showing robust wage growth, but also stickier core price pressures. As such, the Fed opted for a third increase of 0.75% taking the target rate to 3.25%. Furthermore, the median expectations for rates implied a further 1.25% of increases between now and the end of the year. The costs of enacting such a tight monetary policy stance should not be underestimated. The Fed is becoming more open about a potential hard landing not only becoming the more likely scenario, but ultimately being required to cool the labour market and bring the economy back in balance. Thirty-year mortgage rates have shot up to 6.7%, the highest since 2007. This is having a material impact on the US housing market and house building, but also across the wider manufacturing sector. Whether the Fed can proceed along its prescribed path, and tolerate the economic damage, will be something that investors will watch closely.

On this side of the Atlantic, it is the recently announced fiscal policy of the new UK government that has dominated the discussion on the potential course for interest rates. The ‘mini budget’ raised concerns of enormous additional borrowing on top of the extremely expensive policy to freeze utility

bills. This unleashed a crisis of confidence in the gilt market, exacerbated by leveraged positions held by pension funds. The BoE had to intervene and committed to buying bonds to stabilise the market. This came only a few days before they were due to commence their program of gilt sales, which has been postponed until the end of October. Given the fiscal intervention, the BoE may have to adopt a more aggressive hiking path, with the futures markets already pricing in a 1% increase at their next meeting. This in turn has roiled the mortgage market, which has seen short term fixed rates rise sharply.

“On this side of the Atlantic, it is the recently announced fiscal policy of the new UK government that has dominated the discussion on the potential course for interest rates.”

Jeremy Sterngold, Head of Fixed Income

Across the channel, the ECB decided to follow the Fed with a 0.75% increase in September. This time Christine Lagarde struck a hawkish tone in the press conference stressing that inflation has been rising consistently every month. These words have proved pertinent as the September reading for the Euro Area inflation rate came out at 10%, considerably higher than 9.1% recorded in August. The increase was in large driven by spiralling costs of energy as volatility around gas supplies and storage dominated over the past few months. In an attempt

to reduce prices, Germany has announced a €200bn fund to be used for setting an energy price cap. The ECB is expected to continue on its hiking path with another 0.75% increase in October and 0.5% in December. On top of this, there is a potential start of quantitative tightening (QT) which was alluded to during September’s press conference. This would result in three major central banks embarking on QT only a few months after the final asset purchases have been completed under their respective quantitative easing (QE) programmes.

Investors continue to assess how far central banks are willing to push their economies in order to fight inflation. With few exceptions, we have so far seen broad based central bank hawkishness globally. Perhaps the first signs of change are now emerging with the Reserve Bank of Australia (RBA) deciding to increase interest rates by “only” 0.25% against the 0.5% that was expected. The economic situation is slightly different in Australia where inflation and wage growth, while high, is weaker than in other developed markets. Households there are also highly sensitive to interest rates given record indebtedness and a significant proportion of mortgages on variable rates. It remains to be seen whether the caution from RBA is just an anomaly, or the first sign of change in the global path of hawkishness.

# Equities

### International Equities

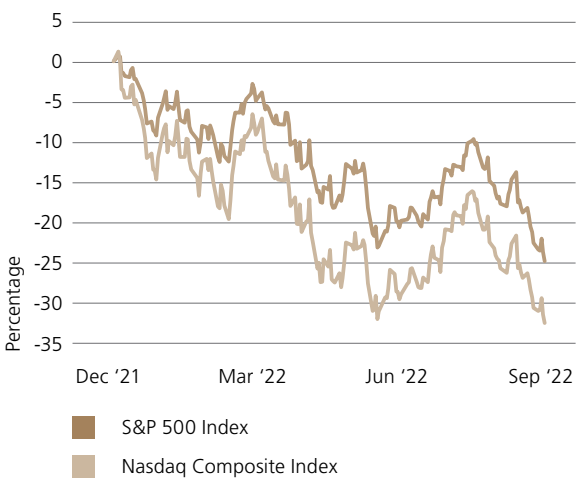
Even after the large declines across all global indices in Q2 2022, the vast majority managed to fall once again in Q3, after the July rally was swamped by falls in the following two months.

Concerns over inflation, growth and interest rates meant that it was the ‘macro’ and not the ‘micro’ that once more drove investor sentiment.

In the US, both the S&P 500 and the tech-heavy Nasdaq Composite index fell 5% over the quarter. The broad base of the decline is demonstrated by the highly economically sensitive financials sector falling approximately 5% and the normally defensive utilities sector falling roughly 9% in the US. The energy sector managed to eke out a gain during the quarter despite oil prices falling by nearly a quarter.

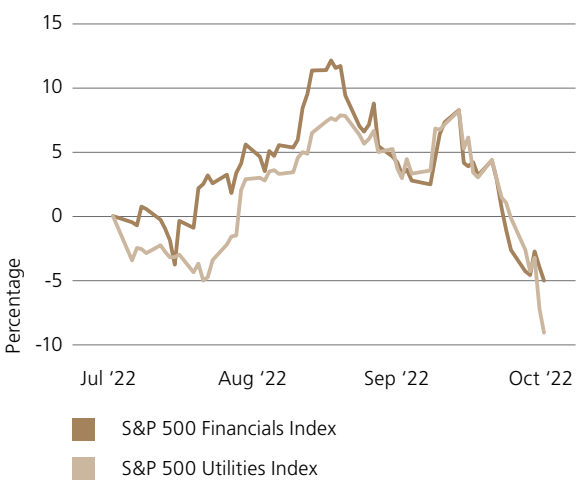


YTD performance of S&P 500 and Nasdaq indices



Source: Bloomberg, LGT Wealth Management

US S&P financials and S&P utilities performance over Q3



Source: Bloomberg, LGT Wealth Management



The very strong dollar, and concerns over global growth, had a chilling effect on emerging markets, with the MSCI Emerging markets index falling 12%. China shows no sign of abandoning its zero Covid strategy, so localised lockdowns continued over the period, helping the Shanghai and Shenzhen indices to shed a tenth of their value.

Painful as the current shakeout is, ultimately performance of operating businesses will drive share prices. This is why we believe it is quality companies that will fare best, as pricing power means they are not squeezed by inflation, and sound capital management means they are not pinched by rising interest rates. We are laser focused on the state of businesses and looking for others that have the right kind of characteristics but are being thrown out with the bathwater.

“This is why we believe it is quality companies that will fare best, as pricing power means they are not squeezed by inflation, and sound capital management means they are not pinched rising interest rates.”

Russell Harrop, Head of International Equities

### UK Equities

In the three months to 30 September 2022, the UK's FT All-Share index declined by just over 6%.<sup>2</sup> This was driven by global growth/recession concerns (with over 70% of the all-important FTSE 100 earnings derived from overseas markets<sup>3</sup>), fuel bill worries, and fears over what might follow on from the appointment of a new Prime Minister. The period in question was also marked by a sharp decline in the value of the Pound, with further falls seen immediately after the new Chancellor's 'mini-budget' in the final week of September. Currency moves of this nature will often result in investor enthusiasm for companies with large overseas earnings, and a rotation out of more domestically orientated stocks. The impact of this rotation was certainly seen during the quarter, with share price weakness seen in UK-listed retailers, banks, utilities, and house builders. Sentiment towards related stocks like Next, Marks & Spencer, Natwest Bank, Pennon, and Persimmon, was also impacted by investor concerns about higher UK living costs, a squeeze on incomes, and a resulting drop in UK household spending power. After the 'mini-budget', when the yield on UK long gilts was pushed higher by fears over the unfunded nature of tax cuts, these concerns were supplemented by worries over the spiralling cost of mortgages. As a result, there was a fresh wave of selling in UK-listed house builders at the very end of the period.

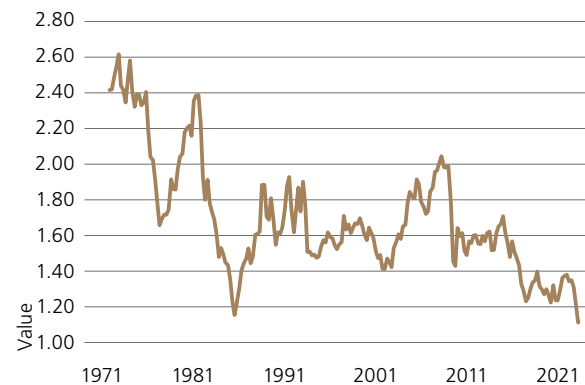
As most readers are probably aware, there is an inverse relationship between gilt yields and gilt prices. Therein, the spike in yields after Kwasi Kwarteng's 'mini-budget' resulted in some equally sharp falls in the prices of UK 30-year bonds. As recent headlines have suggested, various pension funds with derivative exposure to this end of the yield curve were subsequently hit by large collateral calls. In the last few days of September, related concerns over the implications for UK-listed insurance companies resulted in a slump in the share prices of groups like Phoenix, Aviva, and Legal & General.



The fall in the pound during the period did result in support for large overseas earners like Sage, the accounting software Company; the drinks giant Diageo (owner of brands as diverse as Baileys, Tanqueray Gin, and Johnnie Walker whisky), and RELX, the media group that used to be called Reed Elsevier. It also added to the oil and gas price-driven enthusiasm for BP and Shell, but

with certain sectors overshadowed by global recession fears, the impact of the sell-off in the pound proved to be reasonably limited. We suggested in our last quarterly missive that businesses located in other global markets should be naturally interested in the acquisition opportunities afforded by the combination of share price falls and currency weakness. There was no related surge in takeover activity over the course of the Summer, but we remain of the view that investors should be alert to the possibility that lowly-rated UK sector leaders will be subject to predatory interest. We are likely to return to this subject in our next quarterly update.

#### The pound has fallen to historic lows against the US dollar



Source: Bloomberg, LGT Wealth Management

# Key market data

## Key market data (as at 30 September 2022)

Asset class	Level	1m %	3m %	6m %	1y %	3y %	5y %	YTD %
<b>Equity indices (total return) *</b>								
FTSE All-Share (GBP)	3763	-6.88	-4.99	-11.62	-7.00	-4.44	-8.97	-10.56
S&P 500 (USD)	3586	-11.84	-8.05	-20.11	-18.35	22.04	40.58	-24.77
Euro Stoxx 50 (EUR)	3318	-7.05	-5.37	-14.00	-18.54	-5.03	-7.80	-22.80
Nikkei 225 (JPY)	25937	-5.44	-2.09	-3.54	-6.29	21.34	25.36	-9.91
MSCI World (USD)	2379	-10.37	-6.83	-17.26	-16.10	21.77	38.66	-21.56
MSCI AC Asia Pacific ex Japan (USD)	453	-8.12	-9.51	-14.48	-20.40	4.79	6.17	-19.40
MSCI Emerging Markets (USD)	876	-7.73	-8.57	-14.71	-21.63	5.05	4.63	-20.46
<b>10 year bond yields **</b>								
UK	4.14	1.38	1.83	2.49	3.19	3.68	2.76	3.17
US	3.80	0.69	0.82	1.44	2.27	2.12	1.49	-1.49
Germany	2.13	0.60	0.75	1.47	2.32	2.71	1.65	2.31
Japan	0.24	0.02	0.02	0.03	0.18	0.47	0.18	0.18
<b>Commodities (USD)</b>								
Gold	1662.40	-3.53	-7.85	-14.02	-5.29	13.42	29.72	-9.03
Oil	88.90	-10.51	-25.78	-23.09	14.25	45.76	56.54	15.1
<b>Currency</b>								
GBP-USD	1.12	-3.62	-7.18	-14.19	-18.14	-9.11	-15.55	-17.58
GBP-EUR	1.14	-1.20	-3.60	-4.75	-3.29	2.18	1.86	-4.33
EUR-USD	0.98	-2.45	-3.71	-9.90	-15.36	-11.05	-17.09	-13.85
USD-JPY	144.74	1.61	6.38	16.35	29.19	34.09	29.21	25.70

Source: Bloomberg, ICE, London Stock Exchange, MSCI, Standard & Poor's, Stoxx Tokyo Stock Exchange

\* Performance is given on total return indices, but the levels are for the main indices.

\*\* Displayed as absolute changes in yields, rather than percentages.



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