Gibraltar Asset Management Stock Market Commentary

'Inflation, inflation, inflation'

GIBRALTAR ASSET MANAGEMENT LIMITED

STOCKBROKERS & INVESTMENT MANAGERS

A new month, a new quarter, good riddance to the old. It's been rough of late, with all asset classes falling hard and fast. There are many market conditions that investors need to evaluate: inflation, interest rates, dollar strength, global monetary policies, geopolitics, bond-yield inversions, rising volatility, and corporate earnings. Still, central banks have been clear: the focus needs to be on inflation, inflation, and inflation. That suggests investors are being forced to prioritise how the overall economy is holding up against steady and large interest-rate hikes. The Fed believes that its harsh medicine will work, but not instantaneously. It expects inflation to grow in the US by 5.4% in 2022, 2.8% in 2023, and 2.3% in 2024, finally reaching its target of 2.0% in 2025. So much for transitory but at least 2023 is looking much brighter.

by Mark Maloney, Managing Director, Gibraltar Asset Management Limited

Market Outlook

Our allocation to the stock market moves to overweight. A bad year for stocks as of midyear turned worse in the third quarter. Given the false-hope surge in July, the FTSE 100 declined 3.8% in Q3. Whilst it did better than the ugly 4.6% collapse in the second quarter, it is still an uncomfortable market to be invested in.

Yet, the stock market is fundamentally more attractive now that what it was in January. Yes, the outlook for higher interest rates challenges the market outlook in the intermediate term. However, the light is darkest before the dawn and central banks are surely closer to the end than the beginning of their rate cycle.

Investors continue to confront stubbornly high inflation and an unsettling geopolitical situation that now includes North Korean ballistic missiles flying over Japan. On the upside, the economy is holding up; fully employed consumers are continuing to spend with their rising wages; and corporate earnings continue to move higher, preventing valuations from becoming overstretched. In the commercial and industrial economy, the usual markers of a sinking economy - business loan defaults and missed mortgage payments - are largely absent.

On the geopolitical front, surprising successes by the Ukrainian armed forces suggest that the war in Eastern Europe could be settled (or even won) sooner than anticipated. That has given a psychological boost to stock markets worldwide. Markets are also steadying as investors (and consumers and business people) adapt to the higher interest-rate environment. They are learning to live with inflation, predicated on the assumption that annual growth in prices has begun to moderate.

As stock markets test their year-to-date bear-market lows and teeter on another major breakdown, we are starting to see some signs that at least a short-term bounce is near. Major indices are trading at oversold levels, "triple bottoms" have been formed and there is a sense of capitulation in the air.

Can the market fall another 10%? Absolutely. But there is no bell that rings when the stock market has hit the bottom. To be within 10% of it is good enough for investors investing for the long term. Seasonally, we are now in the strongest half of the year. And the fourth quarter is historically the best-performing quarter for stocks. Sentiment is weak. Gloom among investors runs deep, and few are counting on a bounce-back quarter. A bottom in sentiment is one of the necessary ingredients for a recovery rally into year-end.

Recommended Investment

iShares Core S&P 500 ETF

"I recommend the S&P 500 index fund and have for a long, long time" billionaire investor Warren Buffett said at Berkshire Hathaway's 2021 annual shareholders meeting. And indeed, over the long term, this index of major US companies has proven remarkably resilient. Despite wars, pandemics, recessions and numerous other challenges since its inception in its current form in 1957, the average annualised return on the S&P 500 is 11.88% (to Y/E 2021). Though numerically just a small portion of the more than 4,200 publicly listed companies based in the United States, S&P 500 companies represent about 80% of total US market capitalisation. Thus, the index is widely regarded as a "proxy" for the broader US equity market.

Some of the underlying qualities that make the S&P 500 such an important benchmark include:

i-Quality - S&P 500 companies are often considered the most representative of the key industries in the economy, and they tend to be large-caps with relatively higher quality and stable businesses.

ii-Access to secular growth - the US is a global innovation juggernaut, the most dynamic economy on earth and home to world-leading technology firms, many of which are included in the S&P 500. Legendary investor Warren Buffett once said that most people need only put their into an 'American business' and let it grow.

iii-Real returns - the S&P 500 over the long term has historically provided real returns - or the amount earned after accounting for inflation - as companies have become more productive and able to pass on higher costs to consumers. Even during the Great Inflation decade from 1971 to 1980, consumer prices rose by a cumulative 117%, but the S&P 500's total return was higher at 125%.

iv-A foundation for consistent earnings - because of the stringent requirements for inclusion in the S&P 500 Index, the companies have generally kept up with long-term structural changes in the economy, technology and consumer preferences, which contributes to a rise in corporate earnings - the foundation for long term equity gains. To be selected for inclusion in the index, companies must have at least $14.6 billion in market capitalisation, have positive earnings in the most recent quarter and year and meet a host of other standards. The list is continually updated by the Index Committee as companies expand or decline, and this regular refresh may help to explain the index's historical resilience in the face of market pressures.

v-Durability during and after recessions - considering the last four recessions, the S&P 500 tended to perform better on average in terms of price return, both during and 12 months after the start of the recession, compared with global peers and commodities.

vi-Ongoing reinvention - creative destruction, or the process of constant reinvention as emerging companies become eligible for inclusion and others drop off, has transformed the S&P 500 over time. In 1969, industrials represented a third of the index. Today, only 72 firms are industrials, while technology companies have risen from 16 to 76.

Of course, investors should not focus solely on the S&P 500. Stocks of smaller, promising companies as well as domestic and other international equities can offer important potential growth opportunities for investors, while bonds and alternative assets are essential for diversification. However, it is a core holding for most 'balanced' and 'capital growth' portfolios.

We recommend the iShares Core S&P 500 ETF, a low-cost tracker fund that captures the performance of the index through physical replication. It trades on the LSE in sterling (CSP1.L), is income accumulating and has a Total Expense Ratio ("TER") of just 0.07%. For those investors who are bullish on the pound, there is a sterling-hedged version (GSPX.L) that distributes its income and has a TER of just 0.1%.

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