STONEHAGE FLEMING

7 October 2022

Dear Equity Client

GLOBAL EQUITIES – 3rd Quarter 2022

Equity investors endured another volatile quarter. The MSCI World Index (including Emerging Markets and dividends) decreased by a further -6.8% (in US$ terms, +2.0% in UK£ terms following the weakening currency), bringing the first nine months of the year performance to -25.6% (in US$ terms, -9.6% in UK£ terms)*. This has been the third negative quarter in a row, which occured only twice over the past 35 years (in 2000 and 2008/09) .

Despite the fact that headline US CPI (Consumer Price Index) inflation seemingly has peaked, there are huge uncertainties about its 'stickiness'. This is probably the single most challenging factor in capital markets currently. Investor sentiment therefore experiences huge swings around the release of any important new information in this context.

Most of the original supply chain causes of inflation have receded materially and can soon have strong negative (downwards) cost impacts. These effects reflect clearly in the Supply Chain Pressure, Delivery Time, Container Price and Manufacturers' Cost Indices. Although only slowly, it seems economic supply issues are getting back to normal.

With an interesting anomaly, despite the US economy contracting in the first half of the year (in real terms), it remains strong. Unemployment is currently near a half-century low with another strong jobs report for September, translating into booming wages and spending (switching from durable goods to services, which is twice as large, and five times the size of manufacturing)*. Despite low overall consumer confidence, consumption is growing close to double digits. Despite the negative economic effects of the strong Dollar, US corporate profits continue to grow.

Whilst longer-term inflation expectations have dropped materially since the first quarter to acceptable levels (+2.2%)*, the Federal Reserve's (Fed's) challenge remains the real data over the shorter term. The curse of the employment and economic strength is that inflation is broad based and its declines have been disappointingly small thus far. It became clear with the Fed's September meeting that they are now much more accepting of the risk of causing a recession and will continue on a firmer tightening path until inflation's 'back is broken' convincingly. Along with the cost effects from structural changes from geopolitical issues, this implies higher interest rates for longer than earlier perceived. All said, the risk of a potential Fed-induced recession remains absent of material economic imbalances or systemic threats, with the middle quintile households' cash holdings five** times the pre-Pandemic level. If we do face a US recession, we believe it may be a milder downturn than in most of the previous cases.

Our strategy remains to focus on high quality franchises, steering clear of over-geared operators, cautioning against cyclicality and high valuations and valuing dividend growth potential even more.

We appreciate all your support.

With best wishes.

Gerrit Smit
Partner – Head of Equity Management

** Source : Bloomberg, October 2022*
*** Source : Harvard Business Review, October 2022*

Stonehage Fleming Investment Management Limited
6 St James's Square London SW1Y 4JU United Kingdom
t:+44 20 7087 0000 f:+44 20 7087 0001 e:enquiries@stonehagefleming.com
stonehagefleming.com

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Stonehage Fleming Investment Management Limited
6 St James' Square
London SW1Y 4JU

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