November 2022 | Investment update

Omnis Managed Funds Investment manager reports

For the 12-month period ending 30 September 2022

We explain how the global economy and financial markets have evolved over the past 12 months, with individual comments about fund performance from the managers responsible for each strategy.

View from the Omnis investment team

Robert Jeffree
Chief Investment Officer
at Omnis Investments

Over the past 12 months, we have navigated an ever-changing macroeconomic and market environment. Following a pickup in economic growth in Spring 2021 as Covid-19 vaccines paved the way for economic reopening, we saw inflation pick up sharply, initially due to a backlog of supply chain disruptions, and from Q1 2022, due to the ongoing war in Ukraine driving energy and food prices higher. Over the review period the Bank of England and the US Federal Reserve began raising interest rates to combat inflation.

Just prior to the review period, in September 2021, financial markets were rocked by the news that Chinese property developer Evergrande would likely default on its interest payments to bond holders. The S&P 500 dropped more than 4% over the month, the worst drop in over a year. The UK's economic rebound continued on its slowdown trajectory, with attention turned to the effects of Brexit on the economy. Such was the volatile backdrop to markets and economies as we entered the period under review.

Volatility in markets continued in October 2021 as a global shortage of natural gas supplies impacted on energy and fuel price across the world. Despite this volatility, markets enjoyed some of their best days since July 2021. October also saw the Bank of England warning that the global rise in inflation could slow the UK's economic recovery.

Markets rallied for most of November despite inflation remaining high and the economic recovery slowing down, but still in expansion. However, this market trend was short-lived as towards the end of the month, Omicron, a new variant of the coronavirus spooked markets across the world.

The Omicron variant caused markets to experience a period of volatility, which lasted well into December. Despite this, most global equity markets ended 2021 with solid gains. The UK's inflation rate surged prompting the Bank of England to raise interest rates and the US Federal Reserve (Fed) decided to accelerate the tapering of its bond-buying programme sooner than expected.

Markets reversed in 2022 due to concerns that the Fed would increase interest rates more aggressively to control inflation in 2022 and investors began to worry that such an aggressive interest rate hike cycle could choke global growth.

On 24 February 2022, Russia initiated an invasion of Ukraine. A wholesale Russian invasion of Ukraine takes us back to a world we thought we had left behind decades ago. From a social and political perspective, the impact will be huge. From an investment perspective, sentiment was rocked causing an increase in volatility that has persisted for much of this year. The resulting rise in energy prices, has proved to become yet another headwind for economic growth around the world.

Omnis
INVESTMENTS

Stock markets were volatile in March, as oil and gas prices continued to soar with Brent crude at one point reaching $139 a barrel. The International Monetary Fund (IMF) and World Bank warned that increasing commodity prices are likely to fuel inflation for some time. Concerns that the world economy could suffer a period of stagflation – surging consumer prices combined with weak economic growth – also became more prevalent.

April brought further economic effects from the war in Ukraine, as rising inflation prompted the IMF to cut its forecast for global economic growth for the rest of 2022 and 2023. US and European stock markets fluctuated during the month as investor concerns once again revolved around central banks and their measures to tame rising inflation by increasing interest rates.

Markets continued to be unsettled in May amid fears of an economic downturn and potential recessions. There was a continuation of energy and food supply issues caused in part by the war in Ukraine and supply chain disruption in China, which was and is still mired in zero-Covid policies. Recession fears also affected financial markets, with rising inflation and supply chain problems driving up the cost of living and putting pressure on company profits. In May, the Fed raised its benchmark interest rate by 0.5% points for the first time since 2000 and revealed plans to shrink its $9 trillion balance sheet in an effort to tackle high inflation.

At its June meeting, the Fed announced the largest hike in interest rates since 1994, raising the rate by 0.75 percentage points to 1.5%. Stock markets in the run-up to the Fed's decision fell in June, as concerns mounted over the likely rise in rates in a more aggressive move to tackle surging inflation.

In July, markets however rallied as investors looked to balance their assessment of the risk of a global slowdown with the prospect that central banks might scale back their plans for interest rate rises. A strong US employment report for June and strong consumer spending eased recession fears slightly. But US inflation figures for June came in higher than expected at 9.1%, putting a further focus on the Fed, which raised interest rates by a further 0.75 percentage points, the second such hike in as many months. There was some positive news in the UK, as figures showed economic growth of 0.5% for the economy in May after two consecutive months of contraction. The news followed a Bank of England financial stability report stating that global economic conditions had worsened due to rising inflation. The inflation rate in the Euro area rose to 8.6% in June, prompting the European Central Bank to raise interest rates for the first time since 2011, taking it from a negative rate of -0.5% to zero. The European Commission also cut its growth expectations and increased its inflation forecast for the region.

The market rally continued into August, with investors contemplating the next moves from major central banks in their efforts to tame inflation, but at the same time spare their economies severe knock-on effects. Investors reacted positively to a strong jobs report from the US. The news also strengthened speculation that the Fed could slow the pace of interest rate rises. However, markets dipped towards the end of August in the wake of central bankers warning investors to prepare for a more sustained period of rate rises. The Bank of England raised interest rates in August by 0.5 percentage points, taking the rate to 1.75%. It had been the biggest rate rise in 27 years, and the Bank said it hoped these rate rises would help combat rising inflation, which it believed would remain at double digits for the remainder of the year. Britain's GDP contracted in the second quarter by 0.1%.

September started with a jolt for gas prices in Europe, which rose by over a third in the wholesale markets after Russia abruptly announced it would be suspending supplies through the Nord Stream 1 pipeline. The World Bank issued a warning during the month that a global recession may be getting closer as central banks continue to fight rising inflation by raising interest rates. Liz Truss became the new Prime Minister of the UK and announced a relief package of £150 billion in an effort to help UK households deal with the rising energy costs coming this winter. Chancellor of the Exchequer Kwasi Kwarteng announced an emergency fiscal statement that focused on boosting the UK's economy. In response, the pound plunged to its weakest level against the dollar for decades due to the uncertainty surrounding the UK's economic outlook following the government's new fiscal plans. In an unusual step, The Bank of England stepped in to announce that it would start buying long-dated government bonds to calm markets and protect pension funds. The pound did however recover within a week of the fiscal statement, even before the Chancellor U-turned on one of the tax cuts announced.

What has perhaps characterised this year was the lack of diversification that bonds have provided in this equity market sell-off. During the period, global equities (as defined by MSCI All Countries World Index) fell 17.7% and UK gilts (as defined by ICE BofA UK Gilt Index) had fallen 26.0%.* In the past 69 years, there have only been nine calendar years where stocks and bonds had fallen simultaneously. Higher and more persistent inflation, because of the war in Ukraine, has led to central banks having to raise interest rates. Expectations for higher interest rates has led to bond yields rising (and bond prices to fall). This unusual environment in which central banks are raising interest rates into an already slowing economic environment has made equity market investors concerned about the additional economic damage that these higher rates may cause.

Whilst recognising the challenging market conditions over the last 12 months, we note the disappointing relative performance of the Multi-Manager and Managed Fund ranges. The short-term performance of The Managed range of funds broadly reflects the marked, relative under-performance of growth stocks over the period. The potential for a rotation of investment styles over the funds' recommended holding period of five years is expected and we believe that the position will improve over time. The relative under-performance of the Multi-Manager range reflects, to a large extent, the disappointing fund selection by the Investment Manager.

*Source: FE fundinfo

Investment outlook

It has become clear that global growth has peaked and whilst inflation remains elevated, we believe that we are at or approaching peak inflation levels, which will take the pressure off central banks to continue raising interest rates aggressively. We believe interest rates will continue rising but the pace of rate hikes will begin to slow down from here. Any dispersion in approaches between global central banks will continue to have an impact on currencies. The market is expecting interest rates in the US to peak above those in the UK for example, which has led to USD strength this year.

The political landscape will also continue to influence markets. Political instability in the UK had caused market turmoil towards the end of the reporting period and the subsequent appointment of Rishi Sunak as Prime Minister (after the review period had ended) and his approach to fiscal discipline appears to have calmed markets down, though it is yet unknown what the impact of his fiscal policies will have on an already slowing economy. In the US, midterm elections will be in focus, and in China, the government's strict zero-covid policies will come under pressure, as the country's economic growth continues to falter.

We have experienced significant market volatility this year and we expect volatility to continue over the short term. We believe many earnings forecasts have failed to fully account for the worsening economic outlook, and that equity markets could have further to fall. Despite the poor performance from government bonds this year, we believe that at current yields we can expect bonds to deliver protection for diversified portfolios as we navigate a global recession over the next 12 to 24 months.

Of course, whilst we are likely to experience more challenging periods in the short term, it is important to separate out the economic environment from investment opportunities. Our funds are actively managed by our specialist investment managers who continue to search for investment opportunities regardless of the more challenging economic environment. As we look further ahead, whilst we have become more cautious on the global outlook, our managers continue to find interesting investment opportunities.

Views from Threadneedle Asset Management

Investment manager of the Omnis Managed Adventurous Fund

Global markets had a turbulent 12 months. Initially, optimism prevailed and corporate profits rebounded as the global economy recovered from the pandemic. Covid-19, Omicron variant, threatened to derail the comeback, though it quickly became clear that the contagious new variant was relatively mild and less vaccine-resistant than initially feared. Booming consumer demand and supply chain problems drove inflation higher and caused central banks to withdraw the financial help that had boosted flagging economies during Covid.

Inflation accelerated after Russia invaded Ukraine in late February, which caused commodity prices to spike, energy bills to soar and prompted central bankers in several major markets to raise interest rates sharply. Consumer sentiment deteriorated and investors were left to mull the possibility of a global recession. China's zero-Covid policy hit domestic demand and exacerbated disruption in global manufacturing and supply chains, while economic data in the US and Europe suggested that economic growth was slowing.

In terms of activity, we initially trimmed the US equity allocation following the market's strong performance in 2021. Although the country is home to many long-term secular growth opportunities that do not exist in other regions, we felt that higher interest rates are likely to pressure the elevated valuations in the US market's sizeable growth-oriented sectors in the short term. Later in the period, we reduced our equities exposure more broadly, given the more uncertain economic backdrop. In September, our Asset Allocation Strategy Group (AASG) downgraded equities from 'in favour to neutral; we are more cautious about the outlook for the asset class in the near term due to growth and monetary policy headwinds.

We lowered the holdings in UK and Europe ex-UK equities, thereby moving from a modest overweight in the latter at the start of the period to a modest underweight. Expectations for corporate earnings seem unrealistic and we believe that Europe is at risk of a more severe recession than other regions owing to its structural dependence on Russian energy imports. In the UK, there are uncertainties about the country's fiscal position and the potential impact of more aggressive interest-rate hikes on growth.

On the flip side, we increased exposure to emerging market (EM) equities, although relative market movements in the period meant that the portfolio's weighting dropped modestly. We are encouraged by signs that domestic demand has continued to recover after the pandemic. Furthermore, high energy and commodity prices are likely to prove beneficial for many major resource-dependent EM economies.

Elsewhere, we continue to favour Japanese equities (even though we trimmed our position here as a result of the aforementioned reduction in the overall equities exposure). Earnings growth prospects for Japanese corporates still appear attractive and valuations are favourable. Additionally, the direct economic impact of Russia's invasion is minimal for Japan, as Russian imports are in the low single digits as a percentage of total Japanese imports. Therefore, the Japanese economy is less likely to be impacted by cost inflation from the spike in oil and other commodity prices relative to economies in Europe, where energy policy is more dependent on Russia. Over the longer term, we believe a variety of structural reforms – ranging from labour to corporate governance – is likely to transform corporate Japan in the next decade, supporting a step change in profitability and returns on capital in particular.

Views from Threadneedle Asset Management

Investment manager of the Omnis Managed Balanced Fund

Global markets had a turbulent twelve months. Initially, optimism prevailed, and corporate profits rebounded as the global economy recovered from the pandemic. Covid-19, Omicron variant threatened to derail the recovery, though it quickly became clear that the contagious new variant was relatively mild and less vaccine-resistant than initially feared. Booming consumer demand and supply chain problems drove inflation higher and caused central banks to withdraw the financial help that had boosted flagging economies during Covid.

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In fixed income, we reduced our high-yield exposure. The AASG downgraded the outlook for the asset class to neutral in the second quarter, in response to a worsening global growth outlook and a period of outperformance versus investment-grade credit.

We increased exposure to UK government bonds. In July, government bonds were upgraded from dislike to neutral on the asset allocation grid. We believe that bond yields (which move inversely to price) have now peaked, as we are around the high point in inflation and note the improved hedge that current increased yields offer, should a more pronounced 'flight to safety' materialise. As such, we no longer wish to actively underinvest in government bonds.

Views from Threadneedle Asset Management

Investment manager of the Omnis Managed Cautious Fund

Global markets had a turbulent 12 months. Initially, optimism prevailed, and corporate profits rebounded as the global economy recovered from the pandemic. Covid-19, Omicron variant, threatened to derail the recovery, though it quickly became clear that the contagious new variant was relatively mild and less vaccine-resistant than initially feared. Booming consumer demand and supply chain problems drove inflation higher and caused central banks to withdraw the financial help that had boosted flagging economies during Covid.

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We lowered the holdings in UK and Europe ex-UK equities. Expectations for corporate earnings seem unrealistic and we believe that Europe is at risk of a more severe recession than other regions, owing to its structural dependence on Russian energy imports.

We continue to favour Japanese equities (even though we trimmed our position here as a result of the aforementioned reduction in the overall equities exposure). Earnings growth prospects for Japanese corporates still appear attractive and valuations are favourable. Additionally, the direct economic impact of Russia's invasion of Ukraine is minimal for Japan, as Russian imports are in the low single digits as a percentage of total Japanese imports. Therefore, the Japanese economy is less likely to be impacted by cost inflation from the spike in oil and other commodity prices relative to economies in Europe, where energy policy is more dependent on Russia. Over the longer term, we believe a variety of structural reforms – ranging from labour to corporate governance – are likely to transform corporate Japan in the next decade, supporting a step change in profitability and returns on capital in particular.

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Views from PineBridge Investments Europe (sub-delegated to PineBridge Investments)

Investment manager of the Omnis Multi-Manager Adventurous Fund

PineBridge INVESTMENTS

The Fund was positioned constructively throughout 2021 as the global economies were reopening from Covid-19 lockdowns. The bullish view was based on the expectation that a strong consumer, robust corporate investment, and government policies would support markets. Towards the end of 2021, concerns around long-lasting inflation, tighter monetary policy, an energy crisis, and supply chain bottlenecks were at the forefront. This led to a reduction in equities in favour of traditional safe assets like government bonds in the Fund.

In the US market, we took note of the risk that stickier inflation on the back of more solid demand coupled with a Covid-19 supply shock could result in a wage-price spiral. The Team's expected response given these conditions was accelerated tightening by the Federal Reserve (the Fed). While the Fund held a modest underweight to stocks in the first quarter of 2022, we continued to reduce equity exposure as evidence grew that the Fed would hike rates more aggressively for longer. Outside of the US, the UK and Eurozone's ongoing energy crisis, rapid interest rate increases and deteriorating economic growth outlook created a challenging environment for stocks and bonds.

The Fund saw a positive impact from asset allocation over the period. In Q4 2021 the Fund benefited from selection within equities as an underweight to emerging markets equity in favour of UK was additive to relative performance. Equities in China, specifically, were one of the worst performers in the broader EM market as investors feared new lockdown restrictions would emerge because of the Covid-19 Omicron variant news. In Q1 2022 the Fund benefited from an underweight in UK bonds as the Bank of England raised rates multiple times in the quarter citing geopolitical risks exacerbating already high inflation expectations. In Q2 2022 the Fund benefited from defensive positioning. The period proved challenging for managers as nearly all major liquid asset indices sold off sharply. Markets continued their downward trajectory, pricing in a combination of slowing growth and tightening financial conditions. Shifting towards cash and cash equivalents in favour of stocks and bonds was additive to performance. In Q3 2022 volatility once again dominated equity markets. The overall market was weighed down by several factors including hawkish central banks, upside surprises to inflation, the Russia-Ukraine War and the anticipation of an energy crisis during winter in Europe. Once again underweights to equities in favour of cash was a top contributor to performance as traditional safe assets like global bonds and UK bonds experienced comparable levels of drawdown.

Despite the positive impact from asset allocation over the period, the Fund underperformed the benchmark due to negative contribution from manager selection. Active managers, particularly in equities, struggled in early 2022. A pronounced value/growth style reversal proved challenging for many security-selection approaches that had been top performers over previous quarters. UK equity managers had the most difficult time as the benchmark index features significant exposure to energy and mining-related companies. These commodity-related stocks were boosted by rising energy prices on the back of the Russia/Ukraine conflict. Geopolitical risks are difficult to anticipate and challenging to position for. In this environment the benchmark index proved difficult to beat over the first half of 2022. While manager selection detracted for the period, the Fund experienced a bounce back in Q3 2022 as managers were rewarded with 'growth' outperforming 'value' in the quarter after underperforming by 20.7% over the previous nine months.

Views from PineBridge Investments Europe (sub-delegated to PineBridge Investments)

Investment manager of the Omnis Multi-Manager Balanced Fund

PineBridge INVESTMENTS

The Fund was positioned constructively throughout 2021 as the global economies reopening from Covid-19 lockdowns. The bullish view was based on the expectation that a strong consumer, robust corporate investment, and government policies would support markets. Toward the end of 2021, concerns around long-lasting inflation, tighter monetary policy, an energy crisis, and supply chain bottlenecks were at the forefront. This led to a reduction in equities in favour of traditional safe assets like government bonds in the Fund.

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Views from PineBridge Investments Europe (sub-delegated to PineBridge Investments)

Investment manager of the Omnis Multi-Manager Cautious Fund

The Fund was positioned constructively throughout 2021 as global economies were reopening from Covid-19 lockdowns. The bullish view was based on the expectation that a strong consumer, robust corporate investment, and government policies would support markets. Toward the end of 2021, concerns around long-lasting inflation, tighter monetary policy, an energy crisis, and supply chain bottlenecks were at the forefront. This led to a reduction in equities in favour of traditional safe assets like government bonds in the Fund.

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Views from PineBridge Investments Europe (sub-delegated to PineBridge Investments)

Investment manager of the Omnis Multi-Manager Distribution Fund

PineBridge INVESTMENTS

The Fund was positioned constructively throughout 2021 as the global economies were reopening from Covid-19 lockdowns. The bullish view was based on the expectation that a strong consumer, robust corporate investment, and government policies would support markets. Toward the end of 2021, concerns around long-lasting inflation, tighter monetary policy, an energy crisis, and supply chain bottlenecks were at the forefront. This led to a reduction in equities in favour of traditional safe assets like government bonds in the Fund.

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The Fund saw a positive impact from asset allocation over the period. In Q4 2021 the Fund benefited from selection within equities as an underweight to Emerging Markets (EM) in favour of UK was additive to relative performance. Equities in China, specifically, were one of the worst performers in the broader EM market as investors feared new lockdown restrictions would emerge because of the Covid-19 Omicron variant news. In Q1 2022 the Fund benefited from investments in 'alternatives' (largely income oriented) funds which were boosted by a continued recovery from Covid-19, value enhancement initiatives across their respective portfolios, strong asset pricing in core geographies, and higher than anticipated inflation. These funds demonstrated less sensitivity to rising rates as the value oriented, high dividend paying nature of the funds led to more resilience in the growth sell-off. In Q2 2022 the Fund benefited from its defensive positioning. The period proved challenging for long-only managers as nearly all major asset class indices sold off sharply. Markets continued their downward trajectory, pricing in a combination of slowing growth and tightening financial conditions. Positioning in high-income generating alternative funds helped performance as the withdrawal of central bank liquidity has been a headwind for most traditional financial assets. In Q3 2022 volatility once again dominated equity markets. The overall market was weighed down by a number of factors including hawkish central banks, upside surprises to inflation, the Russia-Ukraine War and the expected winter energy crisis in Europe. Once again underweight positions to equities and bonds in favour of alternative funds were top contributors to performance as traditional safe assets like global bonds and UK bonds experienced comparable levels of drawdown to equities.

The Fund outperformed the benchmark due primarily to asset allocation as manager selection was a detractor over the one-year period.

Views from BNY Mellon Investment Management EMEA (sub-delegated to Newton Investment Management)

Investment manager of the Omnis Multi-Asset Income Fund

BNY MELLON
INVESTMENT MANAGEMENT

Over the last 12 months, the Fund has benefited from having limited exposure to bonds and from holding a number of alternative assets, particularly renewable-energy assets. With inflation rising sharply in the UK and the US, central banks have been under pressure to bring inflation back under control leading to material rises in interest rates and bond yields (resulting in falling bond prices). The Fund saw strong performance from its renewable-energy assets and while the bond holdings were a negative contributor to performance, the negative impact was mitigated by both the Fund's lower weighting to bonds overall and its emphasis on short-duration bonds. However, there have been relatively few hiding places amid the bond-market turmoil and the pace of interest-rate rises has had an impact even on the performance of short-duration bonds. Surprisingly, high-yield bonds have been less affected than higher-rated investment grade and government bonds due to the lower duration of the asset class.

Turning to equities, exposure to energy, consumer staples and basic materials has helped offset some of the negative returns from longer-duration and higher-growth companies in the technology sector.

Having previously highlighted our concern on the energy transition becoming better understood and likely supply-side constraints, events appear to be playing out as we anticipated, with capex (capital expenditure) discipline now frequently discussed on company earnings calls and the OPEC + oil group agreeing to reduce the supply of oil to support prices. The under-investment in new supply continues and is resulting in a higher oil price and a tailwind for the Fund's holdings in energy companies, which were reinstated post the Covid-19 pandemic on the basis that the ESG (environmental, social and governance) concerns had become more prevalent in investor and management discussions, leading to real change in the industry and these were being properly priced into valuations by investors.

Higher oil and gas prices also benefited the Fund's holdings in renewables, as power prices rose to reflect the higher input prices for power, which is typically set by the price of gas. After the invasion of Ukraine, power prices rose even more dramatically and governments in Europe stepped in to prevent the dislocation between the cost of power generation and the price which renewables achieve in the power market, leading to a retracement of much of the gains that had been made. Nevertheless, the performance of many of the Fund's renewable-energy holdings has been noteworthy in a twelve-month period where diversification has been hard to find. Furthermore, we continue to believe they are well positioned for the future.

With concerns over defence heightened following Russia's invasion of Ukraine, the Fund's holdings in defence companies, including BAE Systems, performed strongly as investors re-appraised the necessity of spending on defence to protect borders. While defence stocks have historically been shunned by investors on ethical grounds, some investors are reconsidering and weighing the potential social good of helping to defend freedom and values, while rightly remaining cynical about exporting weapons to non-liberal democracies.

After a period marked by a significant tailwind for the semiconductor sector, supply chain concerns have finally eased. Clearly, there has been over-ordering in many sectors as companies looked to secure supply, leading to high inventory levels at a time when consumer spending has come under pressure. Retailers and consumer-discretionary companies have underperformed, as investors have 'priced in' the likelihood of a recession, as consumers retrench under pressure from rising household bills, particularly in the UK and Europe where power prices have rocketed. Looking ahead, after an inventory correction, and a continued bleak outlook for the consumer, it is possible that retailers are under order to keep their inventories in check, which means prices and inflation could stay higher than expected, increasing pressure on central banks to keep raising interest rates.

From a thematic standpoint, the Fund continues to benefit from the strong structural growth of electric vehicles with strong performance from holdings in lithium mining company Albemarle as strong demand for batteries fed into lithium prices, which more than doubled over the review period.

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