QUARTERLY INVESTMENT UPDATE

Q3
22

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Introduction

Year-to-date losses for stock and bond markets accelerated in the third quarter, with the MSCI World index finishing Q3 down by 6.6% in dollar terms while September followed its typical seasonal pattern as the worst month of the year in terms of equity market performance. This was mostly driven by further signs of slowing growth, and inflation readings exceeding analysts' expectations, which has of course forced Central banks to remain hawkish for the time being. Equity market declines were accompanied by losses on government bonds as yields rose dramatically, with Germany's benchmark 10yr yield increasing by 89 basis points over the quarter and periphery bond spreads widening. The US 10yr yield similarly increased by 94bp over the same period. These moves have caused global government bond funds to fall by roughly 5% over the third quarter. Notwithstanding all of the above, what happened over the course of July and early August in equity markets also gave us a taste of just how quickly investors can and will react once inflation, in particular, begins to fade.

Higher inflation has implications for global growth, which is decelerating to a more sustainable level of expansion. While recession risks have risen, risks are still moderate across a suite of indicators. Europe is more vulnerable at present, but if a recession does occur in the US we would expect it to be shallow given the strength of the private sector and today's lack of structural imbalances. With this macroeconomic backdrop, we still believe there are potential opportunities within markets.

As we head into the final three-month period of 2022 there are events and sets of economic data that can be positive for markets. We see the potential for still-robust earnings to support equity prices, for inflation to continue to wane – especially in the United States, energy issues in Europe turning out to be less severe than were feared, and for the Chinese economy to fully re-open and move on from here. Equally, there may be other factors this quarter that will not help markets; US and European recessions could occur and be deeper than expected, earnings results may disappoint across the board, or the Russia-Ukraine crisis could potentially worsen.

We understand that bear markets can be daunting for many investors. We would like to point out to clients that after what has been a difficult 2022 so far across most asset classes, much of the bad news is likely already reflected in prices, leading us on to a potential recovery during the fourth quarter and into 2023. While the final bottom may not be in just yet for equities, longer-term buying opportunities at current prices are presenting themselves to us in a variety of sectors and will likely continue to do so over the coming weeks and months. At Seaspray we carry out our own thorough, team-based research to help us find what we believe to be the best investment opportunities. Our main aim is to meet the needs of our clients. Whatever their priorities – from income and growth to sustainable investing - our experience in these areas allow us to target a wide range of outcomes in this regard.

	1 Month	3 Month	YTD	1 Year
Equity Indices				
S&P 500	-4.0%	-2.0%	-21.3%	-14.0%
DAX	-2.6%	-2.0%	-21.1%	-16.3%
EuroStoxx 50	-1.4%	-0.2%	-19.7%	-13.9%
ISEQ	-5.4%	3.4%	-22.3%	-22.1%
FTSE	-3.6%	-2.5%	-4.7%	0.6%
Nikkei 225	-1.8%	3.7%	-5.8%	-1.5%
Multi-Asset Funds				
Aviva Multi-Asset ESG 3	-3.4%	-2.9%	-11.8%	-10.0%
Irish Life MAPS 3	-2.9%	-1.2%	-9.9%	-6.6%
New Ireland iFunds 3	-2.3%	-1.2%	-6.4%	-4.9%
New Ireland PRIME 3	-2.7%	-1.4%	-7.8%	-4.9%
Zurich Prisma 3	-2.8%	-1.9%	-8.9%	-6.7%
Aviva Multi-Asset ESG 4	-4.1%	-2.0%	-12.5%	-9.3%
Irish Life MAPS 4	-3.4%	-1.0%	-10.4%	-5.5%
New Ireland iFunds 4	-3.1%	-0.8%	-7.5%	-4.3%
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Irish Life MAPS 5	-4.1%	-1.4%	-12.5%	-7.0%
New Ireland iFunds 5	-3.9%	-0.3%	-8.1%	-3.1%
New Ireland PRIME 5	-3.9%	-0.3%	-10.3%	-3.4%
Zurich Prisma 5	-6.3%	-2.9%	-17.9%	-11.9%
Currencies				
EUR/USD	-0.3%	-5.3%	-13.1%	-14.6%
EUR/GBP	1.7%	1.5%	4.1%	2.7%
GBP/USD	-1.9%	-6.7%	-16.5%	-16.8%
USD/JPY	1.2%	6.6%	25.6%	29.7%
Fixed Income				
US 10yr	0.54	0.95	2.25	2.23
German 10yr	0.45	0.83	2.20	2.21
Irish 10yr	0.33	0.72	2.31	2.36
UK 10yr	1.10	1.99	3.07	2.95
Commodities				
Gold	0.6%	-2.6%	-6.1%	-2.5%
Brent Crude Oil	-0.3%	-18.6%	18.9%	14.1%

Source: Seaspray, October 2022.

Global Economy

It is becoming more likely that Europe may experience a recession at some stage over the next few quarters, given the combination of energy price hikes, core inflationary pressures and increasing rates. Governments will be eager to ease the pain on households and businesses and may even try take a leaf out of the Covid-supports playbook. In fact, we have already seen plans emerge for significant fiscal spending in the UK. The scenario we find ourselves in at present is a very different one to the Covid pandemic though, and therefore should be treated differently. Higher energy prices are generally a necessary factor for reducing demand, while levels of inflation and interest rates are also very different at present. Today's unique situation requires a very different targeted response to the problem, and has left central bankers with a difficult balancing act of taming inflation without destroying economic growth.

Europe faces the obvious challenges the war in Ukraine puts on its economy, in particular as it relates to higher-for-longer energy and food prices. It has also faced a drag on its exports to China, given zero-Covid lockdowns and weaker Chinese consumer demand and growth. Furthermore, a weak euro is adding to Euro area inflation, as it costs more to import goods that are dollar denominated, i.e. many commodities.

The US is already experiencing a technical recession, after we recently saw its 'Final GDP' figure for Q2 showing a 0.6% contraction (in annualized terms). This followed the -1.6% registered in the first quarter, with two consecutive negative quarters signifying a recession, at least by definition. We believe that in reality, the US economy is actually nowhere near a recession at present. Not only has the nation's labour market remained tight recently with unemployment at just 3.7%, but the negative quarters of GDP seen this year can also be partly explained by the significant role played by supply-chain disruptions. Unfinished products that remain sitting at shipping docks are excluded from GDP figures until they become classed as inventories. Indeed, inventories rose by almost $84 billion during Q2 in the US, followed a colossal $188.5 billion increase in Q1. Economists estimate that this shaved about 1.83 percentage points from GDP in the region.

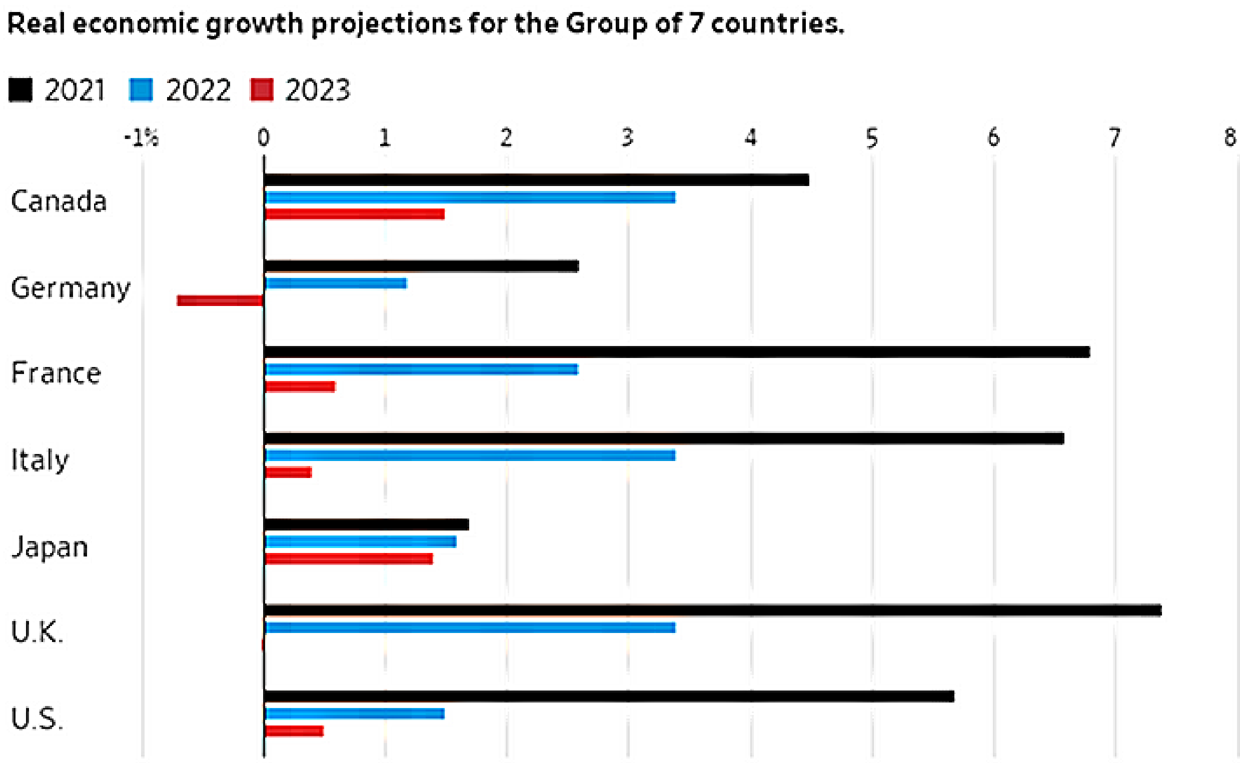
Looking ahead, a legitimate recession could still be on the cards for the United States, as it likely is for Europe. However, given the strength of the labour market, and in corporate balance sheets and earnings, the scale of savings and evidence that inflation is falling, it is likely to be mild. The difference is that the US would be experiencing a recession brought on by tight financial conditions and a Federal Reserve who could be relentless in their fight against inflation. This compares to Europe, where the Ukraine war is weighing on economic activity both directly and indirectly, by negatively impacting trade flows, and by reducing real incomes through higher inflation. The ECB will ultimately have to tighten less than the Fed to slay inflation, so the risk of a central bank-induced recession is larger in the US than in Europe. But Europe's energy crisis is nonetheless something that we need to keep a close eye on as investors during Q4.

Labour markets in the Euro area look less overheated than in the US, which has led to a weaker wage-price spiral. While concerns exist about the inflation impacts of high natural gas prices, it could be argued that energy price caps enacted by many European governments to shield households from higher energy bills should ease inflationary pressures. Although someone will ultimately have to pay the price for this, we are not overly worried about the fiscal consequences of these short-term policies. That said, while the ECB hiking cycle is likely to prove shallower than the Fed's, economists see higher recession risk in the Euro area and UK than in the US.

We would like to take this opportunity to point out that recessions are a normal part of the economic cycle and are to be expected every 5-7 years on average. Naturally, the possibility of a recession on the horizon can be quite concerning for clients. Most people hear the word recession and they automatically think of their most recent experience of one, which outside of Covid (which was a unique once-in-a-century pandemic event) was the Global Financial Crisis (GFC). In fact, the GFC could also be described as very unique since it was accompanied by a systemic banking crisis, and as a result was very sharp and very painful in many ways. The reality is, we do not have to have a recession like that this time around. Last month we saw senior Fed official Thomas Barkin being interviewed by the Financial Times, in which he stated that "the word recession does not have to mean a calamitous decline in activity", but rather can mean a slowdown. He added that "the word recession can mean a rebalancing to get the economy back to normal".

The latest assessment from the Organisation for Economic Co-operation and Development (OECD) in September saw a significant deterioration in the global outlook when compared to its previous set of forecasts in June. Global growth is now expected to slow from 3% in 2022 to 2.25% in 2023, well below the pace foreseen prior to the war. In 2023, the OECD is estimating that real global incomes could be around $2.8 trillion lower than what was expected one year ago, which is a significant economic shock. Annual GDP growth is projected to fall relatively sharply to 0.5% in the US next year, and just 0.25% in the euro area, with risks of output declines in several European economies during the winter months.

While technical recessions are definitely possible next year in the key Eurozone and US regions, the OECD is importantly still predicting real GDP growth for both regions when we look at 2023 as a whole. Growth in China is projected to drop to 3.2%, due to its repeated Covid shutdowns and significant property market weakness, but policy support is expected to help growth recover somewhat next year.



Source: Wall Street Journal, OECD

The United Kingdom's economy has become a hot topic of discussion over the past couple of weeks – since the announcement of the region's new so-called 'mini budget'. Sterling and UK government bonds saw fairly extreme volatility in the days following the release, as investors began to panic about the irresponsible and unsustainable nature of new UK Prime Minister Liz Truss and Chancellor Kwasi Kwarteng's massive fiscal package. Indeed, it is set to be the largest package of tax cuts the UK has seen for 50 years. We think the International Monetary Fund (IMF) best summed it up in the days following the announcement when they said: "Given the elevated inflation pressures in many countries, including the UK, we do not recommend large and untargeted fiscal packages at this juncture, as it is important that fiscal policy does not work at cross purposes to monetary policy".

We saw politicians and economists in the UK, and beyond, almost immediately speak out against this fiscal package. Many of these were from within the PM's own Conservative Party, ultimately leading to the reversal of part of budget. The cut to the top rate of income tax will be abandoned, sealing the first big U-turn of this new government. This decision came after an opinion poll gave Britain's opposing Labour Party an historic 33-point lead over the Conservatives, and is likely to place both Truss and Kwarteng under massive political pressure, after only about one month in power.

It is worth noting that the UK's economy has gone from being the strongest performing G7 economy before the 2016 Brexit vote to now the weakest. It had a very turbulent Covid crisis, seeing a GDP contraction of 11% in 2020 vs the -6.2% experienced in the Eurozone and -2.8% in the United States. The UK is also now having a relatively poor energy and cost-of-living crisis, with the region's performance weaker than elsewhere. The UK's GDP in the second quarter of this year was still below its pre-Covid levels, whereas in the Eurozone activity was 2% stronger, and in the US it was above pre-Covid by 3.5%. The UK's departure from the European Union has led to a significant blow to trade with the rest of Europe. The OECD is projecting that the region will run a budget deficit of 5.3% of GDP and a balance of payments deficit of 7.2% of GDP for 2022.

In their fight to combat high inflation, major central banks around the globe have embarked on aggressive tightening paths that seem all but guaranteed to continue in the near-term, especially given the hotter-than-expected CPI reports we have seen recently from the Eurozone and US. In the States, a heated debate has emerged about whether the Fed have the ability to rebalance an overheated labour market – a key requirement to tame inflation – without a sharp rise in unemployment. In the Euro area, the ECB is stuck in a difficult situation as the region remains in the throes of an energy crisis that is both weighing on growth and contributing to high inflation. How much more tightening will be required to reduce inflation significantly, whether that will spark a recession, and what that means for markets, will be the key questions over the fourth quarter and beyond.

Global Economy, contd.....

Headline inflation rates have risen to very high levels in many countries. They stand at circa 10% y/y in the Eurozone and UK, and have reduced to 8.3% in the US. The BOE is projecting that the UK rate will rise to around 11% in the autumn. There is a risk of a spill over into higher wage inflation, which would make it more difficult to get consumer price inflation (CPI) rates back down to their 2% target anytime soon. Indeed, a shortage of workers is already putting upward pressure on wages. The unemployment rate fell to 3.6% in the US earlier this year (currently 3.7%) and a record low of 6.6% in the Eurozone. With price pressures becoming more broad-based, inflation is now expected to remain elevated next year. The IMF sees world CPI averaging at 8.3% this year and a still high 5.7% in 2023, even with a fall back in commodity prices. Growth is weakening, making central banks task more difficult, but it is quite clear that they are committed to bringing inflation back under control. Price stability is their clear policy priority.

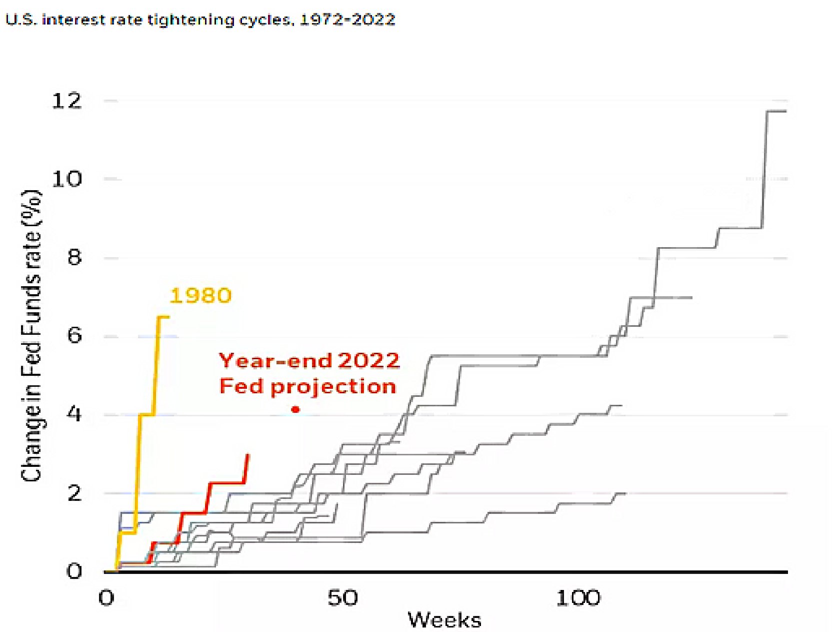
We expect inflation in the UK to continue to rise across the winter months. However, it is less clear for the Eurozone, as the effects of the war in Ukraine, tighter monetary policy, and energy price fluctuations to be key inputs to those inflation rates. In the US, while August Core inflation (excludes energy and food) figures did tick up slightly, they are still below the levels that we saw earlier in the year. Importantly, it now does appear that the high in US inflation is behind us and markets took confidence from this. While the Fed has gone to great lengths to dissuade the market that the battle with inflation is over, it remains a very positive development that at least the direction is likely to be downwards from here.

Monetary Policy

Federal Reserve

US equities and bonds both sold off while yield curves further inverted after the Federal Reserve's monetary policy release last month. This was the central bank's sixth release of this kind this year, with two more remaining on November 2nd and December 14th. As was mostly expected by the market, the bank decided to raise interest rates in the region by 75 basis points and also signalled that borrowing costs would remain high for some time. This leaves US rates at a range of between 3.00 – 3.25%, with markets currently pricing in for a 50bp increase next month and another 50bp before the end of the year. During his post-meeting press conference, Fed Chair Jerome Powell remarked that "we are focused on getting inflation back down to 2%. We cannot fail to do that", while noting that a failure to reduce inflation significantly would be the most painful thing for the American people. It is without a doubt that inflation is the Fed's overarching focus at present, and will be over the coming months and quarters.

In terms of the central bank's updated economic projections, it is now forecasting for headline inflation in the United States to come in at an average of 5.4% this year, with a core reading (excludes food and energy price changes) of 4.5%. Policymakers then estimate that inflation will fall to 2.8% in 2023 with a core figure of 3.1%, while also projecting for 2.3% in 2024 and 2% the following year. The Fed expects its policy rate to rise to circa 4.4% by the end of the year, before hitting a high of 4.6% in 2023, with no rate cuts predicted for next year. They also stated they expect the US economy to grow by just 0.2% in 2022, and by 1.2% next year. Unemployment is forecast to increase from the current 3.7% to 3.8% by December, and to 4.4% at some stage next year.



Source: BlackRock Investment Institute, Refinitiv Datastream

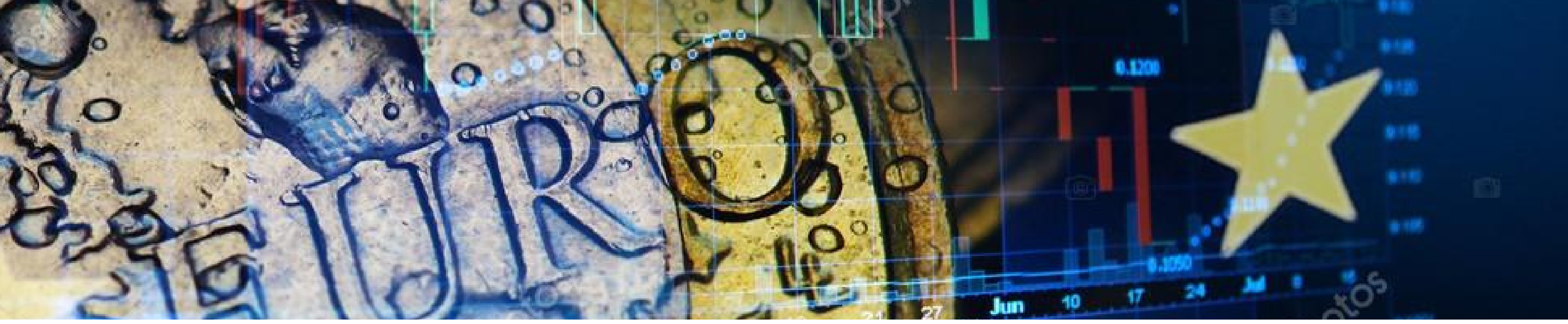
It is worth pointing out that the US Federal Reserve is currently on its fastest rate hiking cycle since the early 1980s, as can be seen above. Despite encouraging signs that US inflation may have already peaked, the Fed remains committed to raising rates and even recently talked down any suggestion of a big dovish pivot in the coming months. Several voting members of the Fed's monetary policy committee have expressed this view, but it was Chair Jerome Powell's comments at the annual Jackson Hole symposium in August, and the Fed's own release in September, which were both taken as the strongest signal by investors.

Monetary Policy

European Central Bank

The ECB in September opted to hike each of its three key rates by 75 basis points, in what was a unanimous decision by officials. The bank's 'Main Refinancing Operations' rate has now been increased to 1.25%, the 'Marginal Lending Facility' rate to 1.50%, and the 'Deposit Facility' to 0.75%. This decision followed the 50bp move made by the ECB back in July, with their next meeting due to take place on October 27th. Market participants paid close attention to the comments made by the ECB that they were front-loading with these interest rate hikes – meaning that the central bank is looking to do most of the heavy lifting as early as possible, leaving some room to ease off the tightening in the future. Further hikes are to be expected at upcoming meetings, as the bank is forced into prioritising inflation even as the Eurozone economy likely heads for a winter recession.

In terms of its updated economic projections, the ECB is now expecting inflation to come in at 8.1% this year (vs June forecast for 6.8%), and 5.5% next year (vs 3.5% previous forecast). 2.3% is now forecast for 2024. In terms of growth, the ECB sees the region expanding by 3.1% this year, followed by 0.9% in 2023. This year's growth estimates were lifted slightly, while next years were sharply cut.



European Central Bank, contd..

Interestingly, ECB President Christine Lagarde did disclose projections for a potential "adverse scenario", which can be seen below. This would involve a total shutdown of Russian gas supply and subsequent policies to ration energy. In this scenario we should expect a recession to occur early next year, with a 0.9% contraction.

	Baseline forecast				Adverse scenario			
	Jun 22		Sep 22		Jun 22		Sep 22	
	2022	2023	2022	2023	2022	2023	2022	2023
GDP	2.8	2.1	3.1	0.9	1.3	-1.7	2.8	-0.9
Inflation	6.8	3.5	8.1	5.5	8	6.4	8.4	6.9

Source: Goodbody

The ECB guided that it expects over the next several meetings to raise interest rates further to "dampen demand and guard against the risk of a persistent upward shift in inflation expectations". In her press conference, Lagarde stated that "several" is "probably more than two including this one but it is probably also going to be less than five". The ECB also continued to emphasise that its future policy decisions will be data dependent and follow a meeting-by-meeting approach. However, the President provided no indication as to where the ECB sees the 'terminal rate'. She stated that the ECB is still far away from the rate it hopes will help bring inflation back to its 2% target.

Monetary Policy

Bank of England

The Bank of England's September monetary policy meeting saw it hike rates by 50 basis points yet again, bringing its main interest rate up to 2.25%. This means that monetary policy has now been tightened for a seventh consecutive meeting in the UK, the most recent two of these being 50bp and the rest 25bp. These were the United Kingdom's first 50bps hikes since 1995.

The bank's Monetary Policy Committee (MPC) noted that the labour market is still tight and domestic cost and price pressures remain elevated. Headline and regular pay growth has also continued to advance and outpace expectations. It also observed that the recently announced 'Energy Price Guarantee' cap means that household spending is likely to be less weak than envisaged previously.

The last economic outlook from the BoE was published following its August meeting. In terms of the baseline, which assumes global energy prices follow futures contracts prices until end year and remain unchanged thereafter, the bank projected for GDP growth of 3.5% in 2022. However, the MPC now believes the economy will contract by 0.1% in Q3 rather than expand by 0.4% as projected in August. This would imply a technical recession in the UK, given that GDP also fell by 0.1% in Q2. The BOE looked for GDP contractions of 1.5% in 2023 and a more modest 0.25% in 2024, in its baseline scenario.

Meanwhile on the inflation front, the August forecast was for the CPI rate to reach a high of just over 13% by Q4 of this year, largely on the back of further big jumps in household energy bills. However, since then, gas prices have fallen back while the Government price cap should limit the average household energy bill to £2,500 per annum. As a result, the bank indicated last month that it now anticipates the CPI rate will peak at just under 11% in October.

Last week we saw the BOE take emergency actions when it unleashed a £65 million bond-buying programme. The aim is clear – bring some stability back to debt markets in the UK after when was an episode of extreme volatility following Truss and Kwarteng's announced tax cuts and enormous borrowing. The bank warned of a "material risk to UK financial stability" from the recent turmoil we have seen in its bond markets.

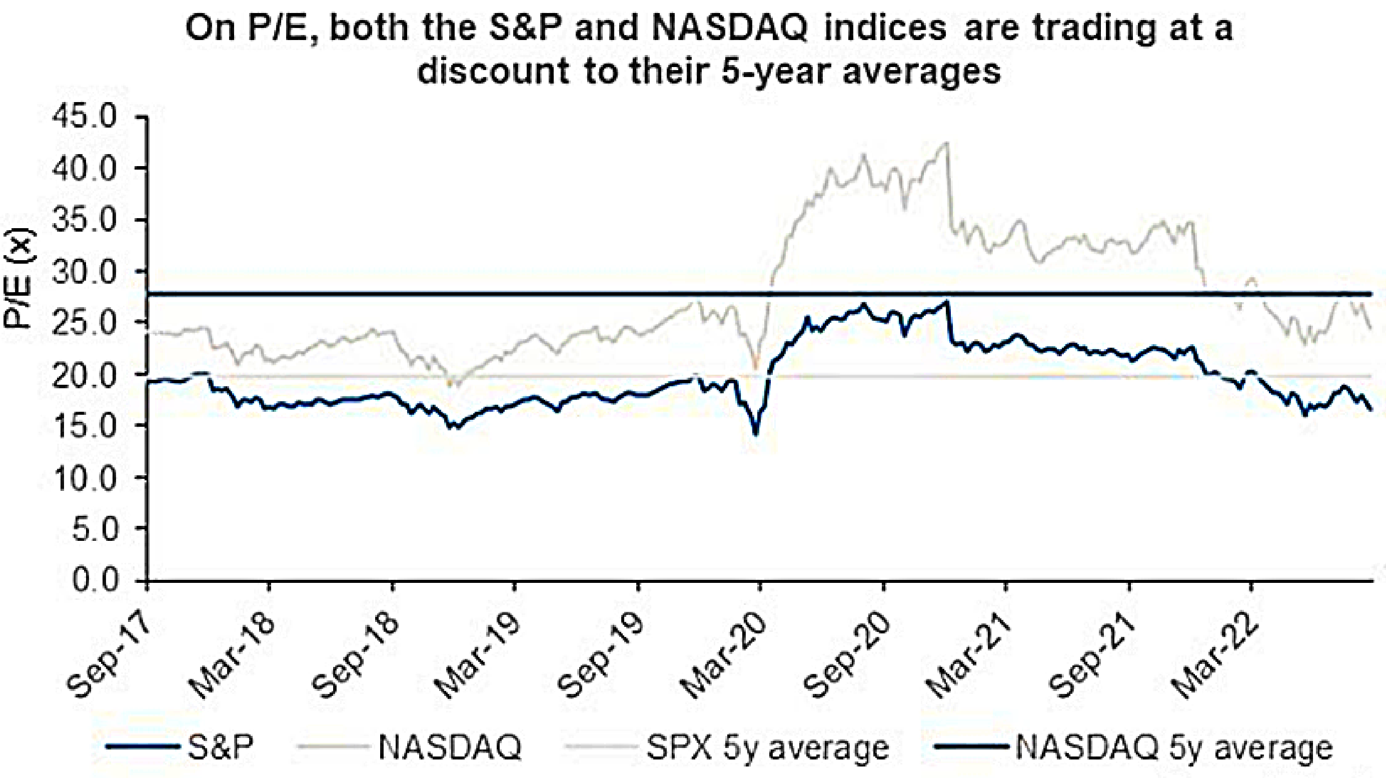
The BOE chose to suspend its programme of selling gilts – which had been part of an effort to get inflation under control – and has instead moved to buy long-dated bonds at a rate of up to £5b per day for the next few weeks. Importantly, the BOE stressed that it is not seeking to lower long term government borrowing costs, but merely to buy time to prevent a situation in which heightened volatility causes pension funds to be forced into selling gilts in order to meet demands for cash from their creditors.

Markets

Equities

We continue to prefer equities as an asset class, as well as certain commodities, although their relative appeal versus bonds has slightly diminished recently as bond yields have rallied sharply. At present, we are neutral developed market equities, due in part to an increased risk of central banks overtightening policy and also a deteriorating global growth backdrop. Central banks now seem to be almost exclusively focused on taming inflation, with risks emerging that policymakers may not fully acknowledge or care for the high costs that tight policy will bring to growth and jobs. Should we see the likes of the Fed and ECB overtighten, and then subsequently make a dovish pivot at some stage next year, we would look to move back towards an overweight positioning in equities.

While investors around the world are beginning to show concerns around the drawdowns they have seen year-to-date with regard to their equity exposure, we would like to remind our clients that stock markets have already fallen a long way this year and may not be far from the ultimate bottom. Looking at the S&P 500 for example: since 1929, the index's average bear market decline stands at 33.5%, with a median of 33.2%. At the deepest point of last week's sell-off, the index was down 25.5% from its peak. It is also important at this point in time to highlight that while corporate earnings have been slowing somewhat, they are still positive. This, added to this year's stock market pullback, leaves market multiples looking attractive relative to their start of the year levels.

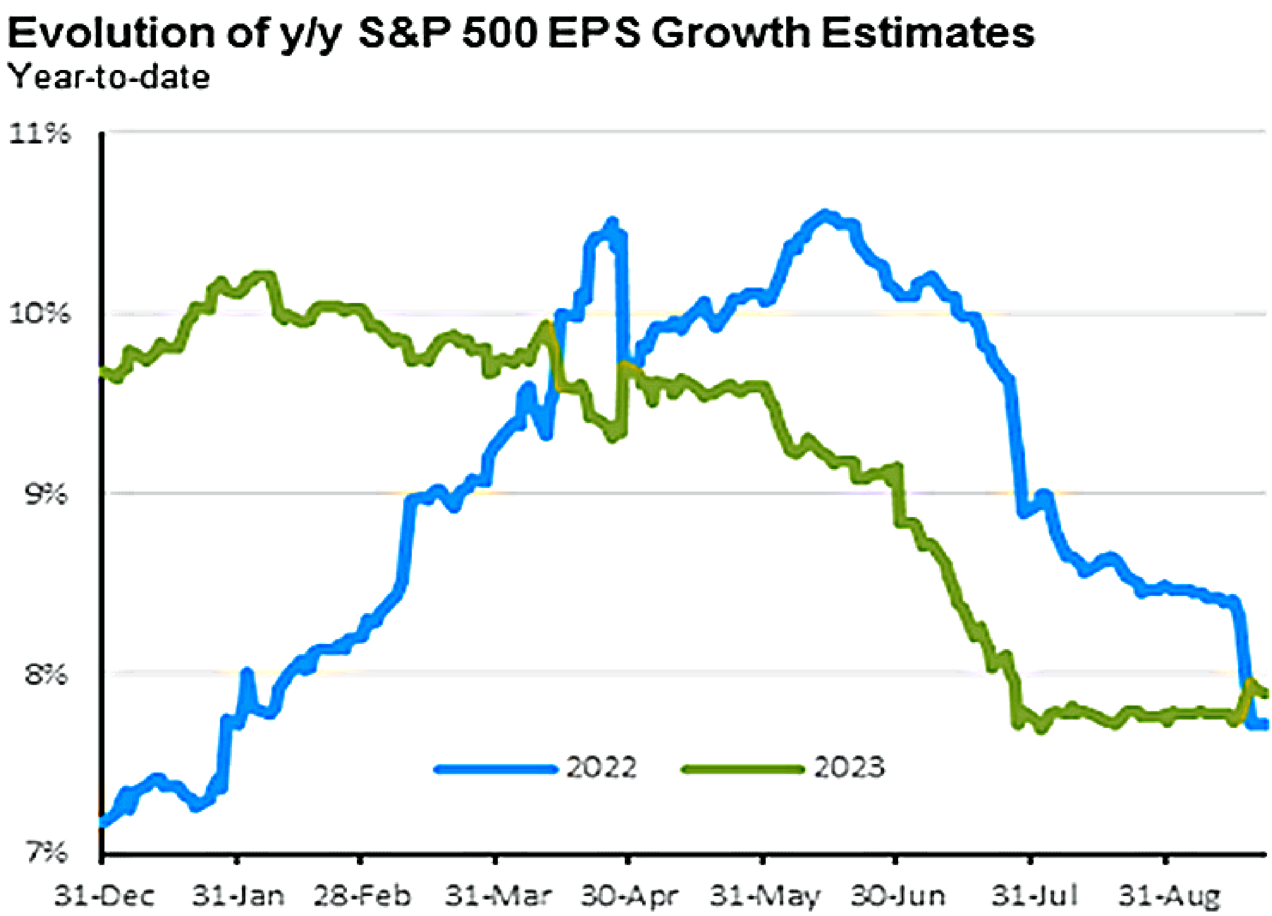


Source: Bloomberg, Cantor Fitzgerald

Equities, contd.....

Inflation results over the coming months, in our opinion, will continue to be a key influence for stock markets. Investors on all time-frames will be closely watching to see if inflation around the world can come down fast enough to prevent central banks from pushing financial conditions too far during this tightening cycle. Growth is clearly slowing given the dramatic rate hikes we have recently seen and the scale of quantitative tightening in developed regions. Commodities will without a doubt play an important role going forward – if the asset class in general continues its recent move lower, or even stabilises around these prices, it will reduce margin pressure on companies and cost-of-living pressure on consumers. This, in turn, would take pressure off central banks to be hawkish and should reduce bond market volatility (which reduces rate pressure on equity markets).

Concerns regarding a slowing global economy and rising costs have clearly increased as the months have gone on this year. However, as you can see on the below chart, S&P 500 earnings forecasts have remained relatively robust. Importantly, analysts are still expecting 8% year-over-year earnings growth next year (green line).



Source: JP Morgan Asset Management

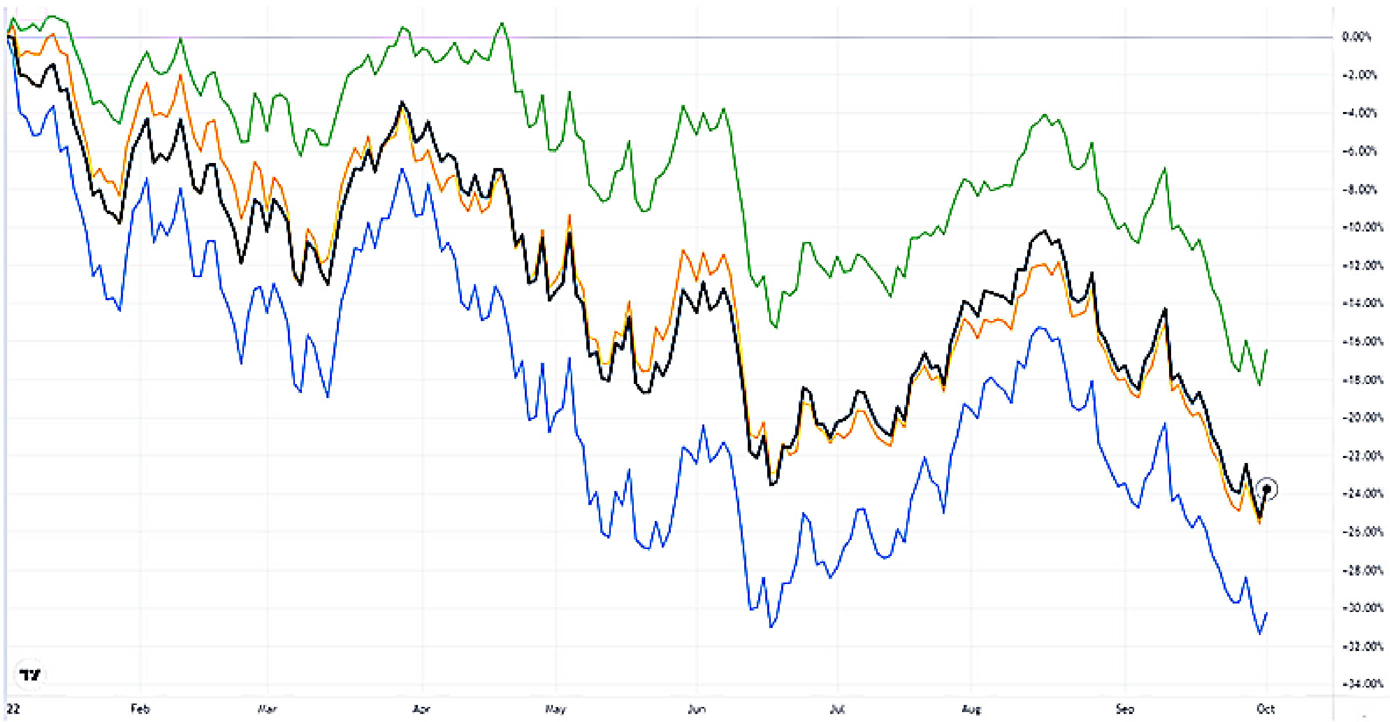
Equities, contd.....

The S&P 500's drawdown this year can be explained by declining P/E ratios, as earnings expectations themselves have proven relatively robust, despite increasing recession as of late. While wage and input costs have risen rapidly this year, earnings expectations have only seen small declines since January. This relatively mild reaction to recession fears highlights the perceived ability of large companies to pass on higher costs to their customers, in our view.

Further downgrades to 2023 earnings may come to fruition and could act as a slight headwind to equities, however history tells us that markets will recover before the downgrade's trough. History also tells us that high-quality companies are better placed to navigate a slowing global economy. In light of this, we continue to favour the quality equity factor, mostly due to the ongoing uncertainties markets are facing as we head into Q4. We believe companies with strong balance sheets and high earnings visibility should outperform in an environment of elevated macro uncertainty and mounting profit margin pressure.

Equities, contd.....

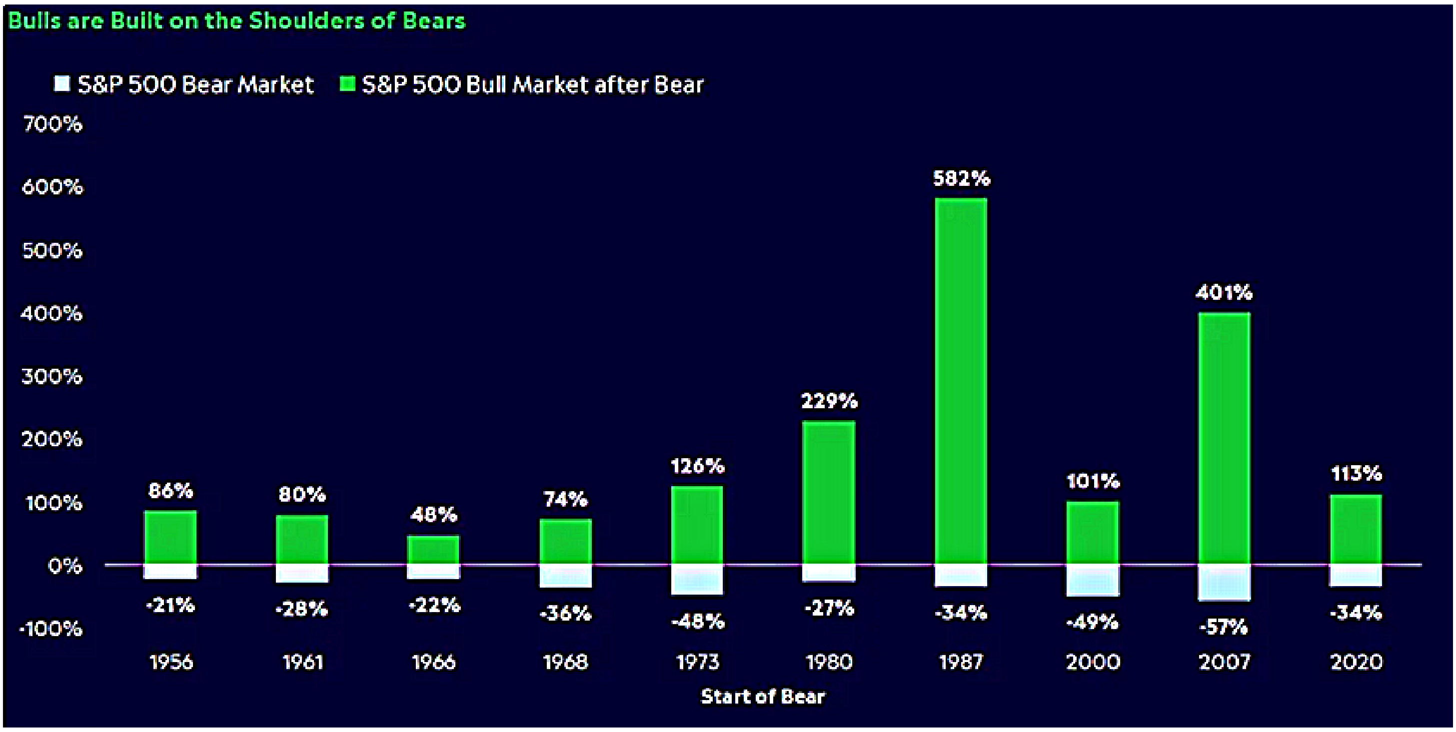
It must also be said that the value equity factor will likely continue to outperform for as long as we continue to see elevated inflation, or at least for as long as developed regions' CPI readings continue to come in ahead of what analysts are forecasting each month. At a minimum, higher inflation and higher interest rates suggest a slowing of earnings growth in the future and that is the key cause for the contraction that we have seen in the valuation spread between growth and value stocks over the past year or so. Should we see persistent inflation over the next while, the valuation spread between the two would have further room to shrink. In that scenario, whether stocks go up or down, value would be the outperformer. Below we can see the YTD performances of the S&P 500 index (in **black**), along with the S&P 500 Value (**green**), Quality (**orange**), and Growth (**blue**) indices.



Source: Seaspray, October 2022.

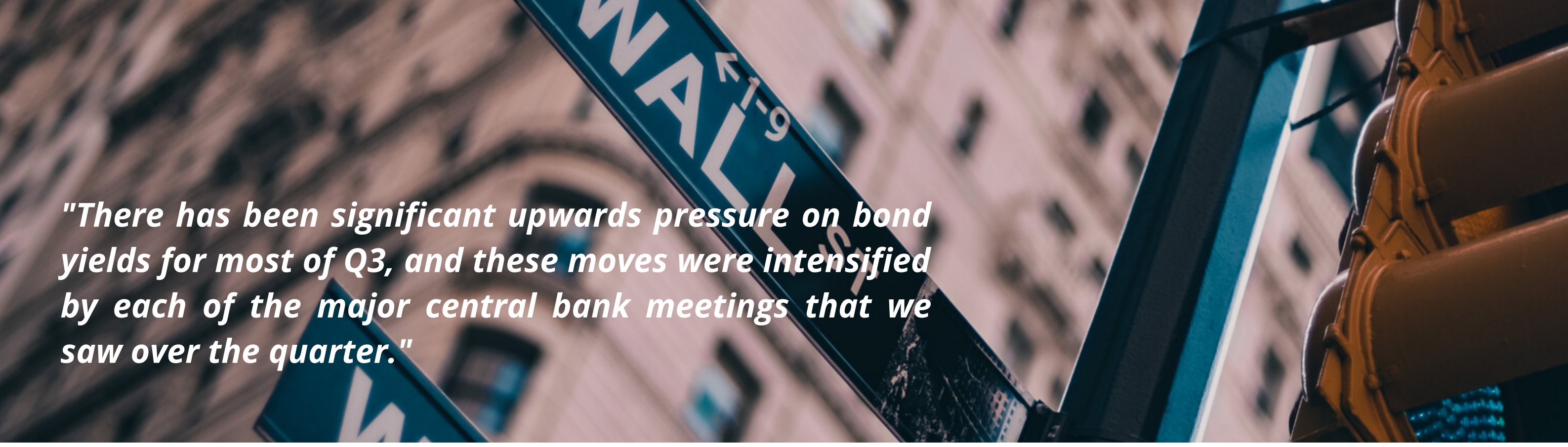
Equities, contd.....

Although we have seen a volatile year so far across all major equity markets, it is vital during times like these to remember that we are long-term investors and fully accept that it is effectively impossible to time the market perfectly. Broadly speaking, we would advise clients to maintain their normal allocation to stocks and to not be shy about continuing to buy at your normal intervals. That way, you will be purchasing at low prices, and your newly-purchased assets should be worth substantially more as underlying longer-term market trends ultimately prevail as the years go on. Part of our research involves studying historical trends, so that we can build a credible and realistic picture of what to expect going forward in markets. In light of this, the below graph highlights that markets (in this case the S&P 500) have always come back stronger after experiencing bear markets.



Source: eToro, Bloomberg

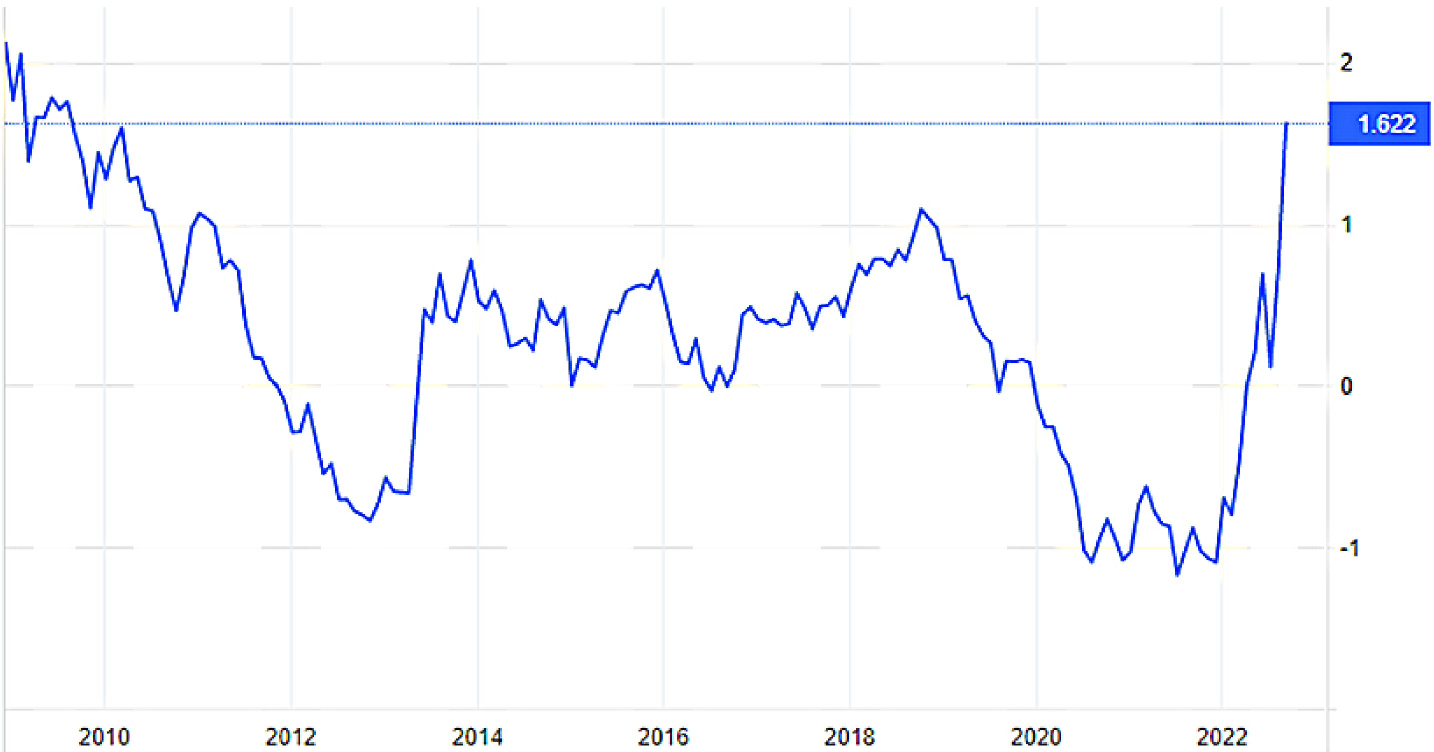
We understand that equity bear markets can be uncomfortable for clients, and while they are normally relatively short-lived, they can often feel like the longest part of the investment cycle. Remember, that as some investors exit the market during a bear market or during a recession, others enter. Every transaction at every price involves two participants – a seller and a buyer. As Warren Buffet simply put it: "The stock market is a device which transfers money from the impatient to the patient".



Bonds

There has been significant upwards pressure on bond yields for most of Q3, and these moves were intensified by each of the major central bank meetings that we saw over the quarter. US Treasury yields ratcheted higher with the 2-year recently breaching 4.3% for the first time since 2007. Yields on the benchmark US 10-year last week saw their highest level in over 12 years, when they traded through 4.0%. Elsewhere, 10-year UK Gilt yields have surged by an astonishing 94bps over the last two weeks, hitting a high of 4.5% before pulling back slightly after the Bank of England was forced to step in and bring some composure to markets. Meanwhile, equivalent German bund yields have added 20bps over the same period to move to nearly 2.1%.

US real yields, the returns investors can expect to earn from US government bonds after accounting for inflation, have now soared to the highest level since 2009 (as can be seen below). These are becoming somewhat appealing again to investors since they made their recent return to positive territory. The yield on 10-year Treasury inflation-protected securities last week reached 1.6% and is up from roughly -1.0% at the start of the year, as traders bet the Federal Reserve will continue to aggressively raise interest rates and keep them elevated for years to come.



Source: Seaspray, October 2022.

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Real yields are calculated using 'breakeven inflation rates', which represent the average annual rate of inflation expected over the next 10 years, in the case of the above example. These instruments are closely followed on Wall Street and by policymakers at the Fed, offering a gauge of borrowing costs for companies and households as well as a scale to judge the relative value of any number of investments. Those real yields fell deeply into negative territory at the height of the pandemic as the Fed cut interest rates to stimulate the economy, sending investors racing into stocks and other risky assets in search of returns. That has reversed as the central bank has rapidly tightened policy this year.

At Seaspray, we prefer inflation-linked bonds to nominal. Despite their sharp re-rating higher over recent months, we still see the potential for nominal yields to increase further as we move through the fourth quarter. Any significant move higher in yields would represent a valuation drag on expected returns for clients, and therefore we remain modestly underweight for now. However, with real yields in developed regions now positive for the first time in years, we are beginning to turn our attention slowly towards the bond market. This is something we have been watching closely, and will certainly be reporting on in upcoming investment updates.

It is important to note that we have reduced UK gilts to significantly underweight following the UK government's recent fiscal splurge, which we believe raises serious questions about the region's fiscal credibility. In addition, the Bank of England will clearly need to keep hiking rates in order to rein in what are serious price pressures in the region. This will only serve to worsen the UK bond sell-off. Instead, we are focusing on the Eurozone and the United States with regard to our bond exposure at present. Particularly in the Eurozone, we believe that at times over the last couple of months, market pricing of rate hikes has been too hawkish, and yields may have overextended themselves to some degree.

We continue to prefer shorter-maturity bonds, as we see investors demanding higher compensation for holding longer-dated government bonds amid what will likely still be an inflationary environment over the coming years. From these levels, we also expect to see steepening yield curves over the next few quarters and potentially years, which would leave shorter-term bonds relatively better off.

This quarter, we are shifting from underweight corporate debt to neutral. We prefer investment grade credit as yields better compensate for default risk, in our view. Plus, traditionally, high quality credit will weather a potential recession better than stocks. We continue to monitor this situation, but do acknowledge the risk that central banks keep tightening at their current pace, which could cause some credit quality deterioration on the horizon. This further bolsters our view that short-duration is more attractive.

US Dollar

The US Dollar index, which measures the greenback against a basket of six other major currencies, has recently traded a 20-year high of 114.00 and is undoubtedly adding to inflation pressures in other countries as most commodity prices are set in USD. Not only are other countries facing the inflation pain of higher commodity prices, but the strength of the Dollar is adding to that pain. It is tempting to think that the Dollar is overbought at current levels, but we may not see a meaningful turnaround in the trend as quickly as one thinks.

In times of uncertainty, the US dollar tends to be sought after as a safe haven. But when it is also the currency where interest rates are rising faster that serves to turbo charge demand, where money can of course earn more. Breaching parity with the euro during August and then again last month were significant milestones, and we may yet see further gains in the short-medium run, even if it looks overvalued at this stage. For euro-based investors, with significant portions of their funds holdings US assets, this has had a significantly positive impact so far this year.

The strong Dollar has also been causing issues this year for emerging economies, many of whom have significant amounts of dollar-denominated debt. The World Bank has recently warned that aggressive rate rises in the US, while necessary to quell inflation, could also risk sending the global economy into a recession next year, which would leave the world's poorest countries at risk of a collapse. The World Bank drew comparisons from the early 1980s, when the jump in global rates and the ensuing downturn in global trade sparked the Latin American debt crisis and a wave of defaults in sub-Saharan Africa.

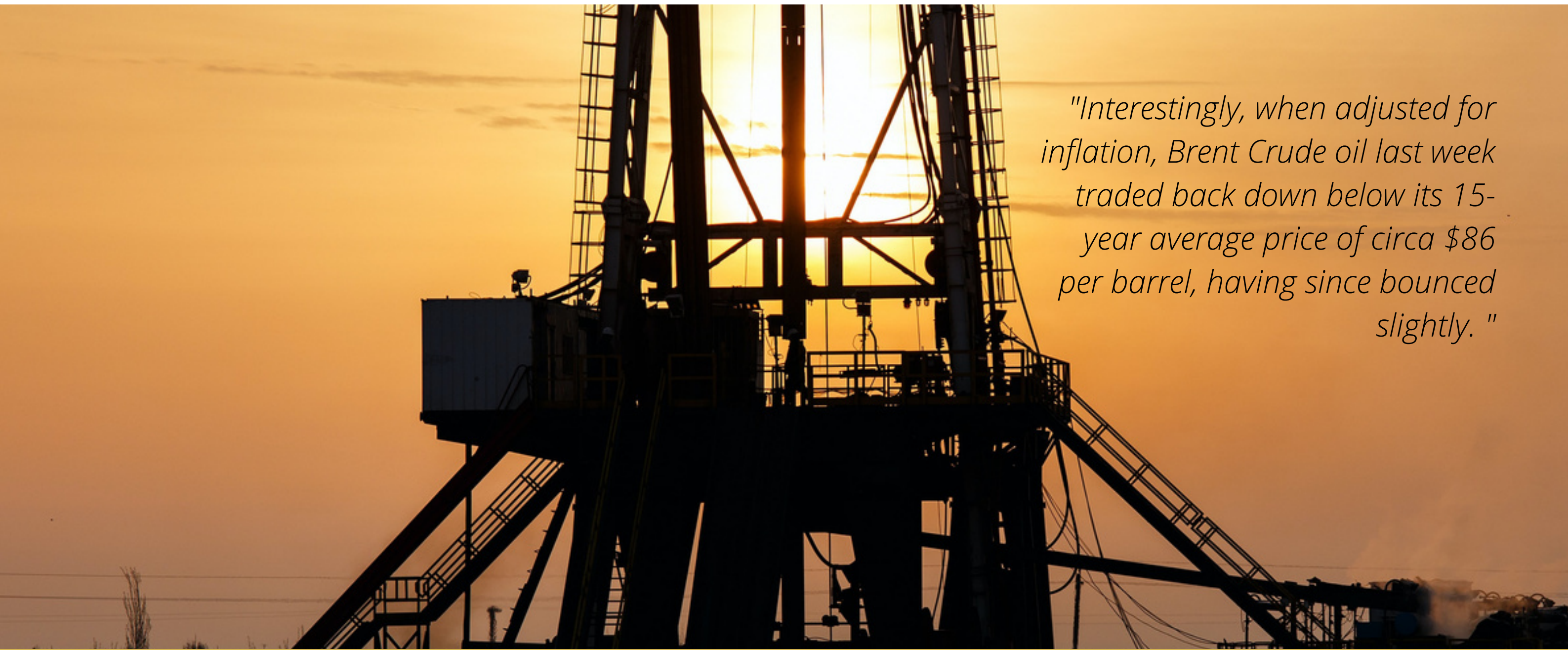
Energy

Recently, we have seen tell-tale signs in oil markets that overly tight supply is now waning. Spot prices are falling, forward curves have flattened, physical differentials have reduced, and refining margins have weakened. A growth slowdown in all main economic blocs has led to weaker oil demand for some months now, and this is now visible in oil specific data. China, as the world's largest oil importer, has been a particularly important contributor to this.

Interestingly, when adjusted for inflation, Brent Crude oil last week traded back down below its 15-year average price of circa $86 per barrel, having since bounced slightly. In this context, the current price is not particularly high. Also, the Brent futures curve has in fact flattened to such an extent that current time spreads have historically corresponded with much higher inventories expressed in days of demand. What this means is that the market structure is already discounting significant inventory increases, and/or a large demand decline.

On the supply side, uncertainty continues after OPEC+ this week cut production by 2 million barrels a day in an effort to support oil prices, and from Russia, once the EU embargo kicks in later this year for crude oil and early next year for other oil products. The EU still imports around 3.5 million barrels of oil per day from Russia, redirecting such a large volume of oil to other buyers and then redirecting other oil back to Europe is possible over time, but probably not without significant disruption for an extended period.

European natural gas futures continue to fall as we enter October, in what is an encouraging move in terms of this month and next month's CPI inflation readings for the region. Natural gas has dropped below €160 MWh for the first time since late July, after Russia's Gazprom said gas flows to Italy are resuming after the weekend's suspension of flows. European natural gas prices are now roughly 50% below the record levels seen in March and August, as concerns about shortages eased on milder weather and full stockpiles.



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