Quarterly Portfolio Update: 30 September 2022

Paradigm Market Update……………………………………

James Mirams
Director and Head of Investments

In The Thick of It

The September 2022 quarter started with a general market rally and some promise of recovery, however, it was sharply reversed following the speech of Jerome Powell's (US Federal Reserve Bank Chairman) at the Jackson Hole Symposium. Powell indicated aggressive action to tame inflation and followed through with an increase to US interest rates by another 0.75%. This year's cumulative rate increase in the US from 0.25% at the start of the year to now 3.25% is the most aggressive since 1994. In equities the index of Australia's top 200 companies (ASX 200) ended the quarter + 0.39% and the top 500 companies in the US (the S&P500) ended down -3.43%.

The S&P500 has now fallen 25% for the calendar year. The Nasdaq, an index of the largest technology and e-commerce companies in the world, the top 5 being Apple, Microsoft, Amazon, Tesla and Alphabet (Google) has fallen 33% for the calendar year. Whilst global economic challenges and geopolitical events have conspired to undermine confidence this year, and whilst risks still exist, global equites are now looking relatively attractive on their fundamentals for long term investors who are willing to accept the volatility inherent in that asset class.

Encouraging Signs of Lower Inflation

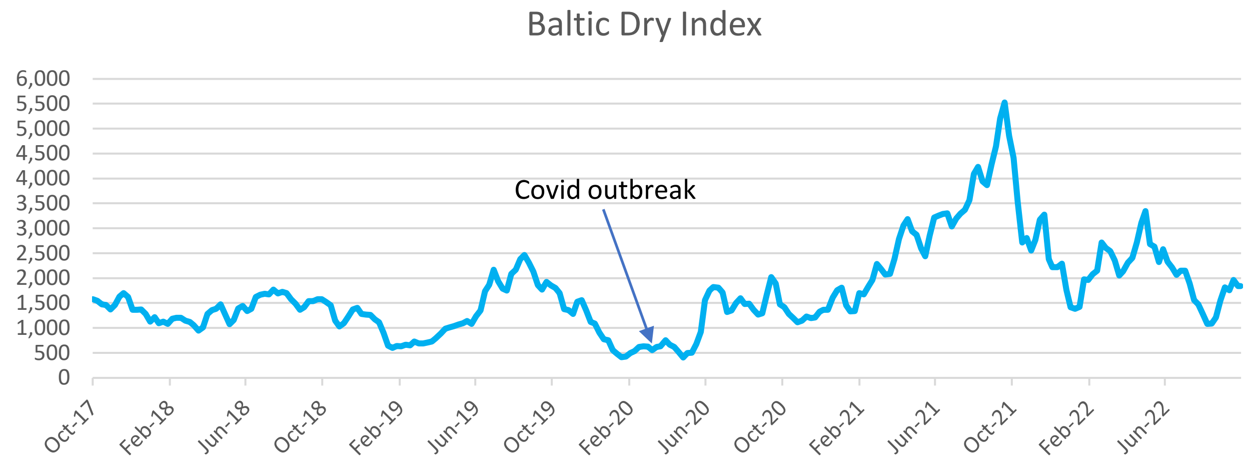
Media and market news has focused on inflation. The resultant fear over the impact on interest rates has destroyed confidence. Looking at recent trends US inflation has fallen every month since June from 9.1% to now 8.2% in September. This is a positive sign although inflation must fall much further to appease central bankers. In Australia, the RBA has not been as aggressive as the Federal Reserve, and slowed the monthly interest rates raises in October to only 0.25% vs 0.50% in the previous few months.

Local food prices may see some relief as Ukraine grain export quantities have recently risen back to pre-war levels and further talks with the UN are in order to allow more agricultural commodities to be exported to the rest of the world. Below shows how a spike in the price index of agricultural commodities when the war in Ukraine broke out and a return to average levels.

S&P GSCI Agriculture Index

Paradigm Market Update...

Every-day consumers may see some price stability as supply of goods should increase as a result of easing/reduction of shipping delays, backlog, port congestion and container shortage, from the height of the pandemic. The Baltic Dry Index (a measure of shipping cost) has also dropped to pre-pandemic levels which contributes to lower transport costs and end prices.



China is facing a significant economic slowdown from the pursuit of a zero-covid policy and the bursting of the decade long real estate bubble. President Xi Jinping is being sworn for a third term which means there is no need for zero-covid to be used as internal campaigning or propaganda. Retail consumers may catch a further break as if China do relax the zero-covid policy, factories will come back online and exports will rise thus increasing supply and putting downward pressure on consumer prices. Xi may have no choice but to open up or face complete economic collapse.

On the flip side, energy prices might remain high as gas supply to Europe has been crippled due to leaks found in Nord Stream 1 pipelines. These pipelines feed natural gas from Russia to the rest of Europe are closed indefinitely. It is estimated that it will take at least 6 months to repair and parts of Europe will suffer a harsh winter due to limited gas supplies.

All in all, with many of the uncertainties and fears priced into markets, we can be cautiously optimistic although short term risks still lurk.

The Way Out

History would suggest it takes more than just corrective monetary policy via interest rate rises and quantitative tightening (selling government bonds held by central banks) to quell inflation. Government fiscal policy in the form of reducing government spending and raising taxes may also be necessary. Economies around the world may have to slow into a recession and the unemployment rate will rise to as a consequence. Central banks will want to see some cooling of private sector spending as well. A mild global recession is more than less likely, although economists and markets have already priced in this possibility.

In these circumstances, portfolio diversity remains an important factor. With weakness in share markets, whilst portfolio volatility and negativity can be concerning in the short term, history tells us that long term investing, and not trying to pick peaks and troughs, provides long term rewards. Companies that have robust balance sheets, long term growth prospects and competitive advantages are preferred in such circumstances, and will be a focus.

Paradigm Market Update...

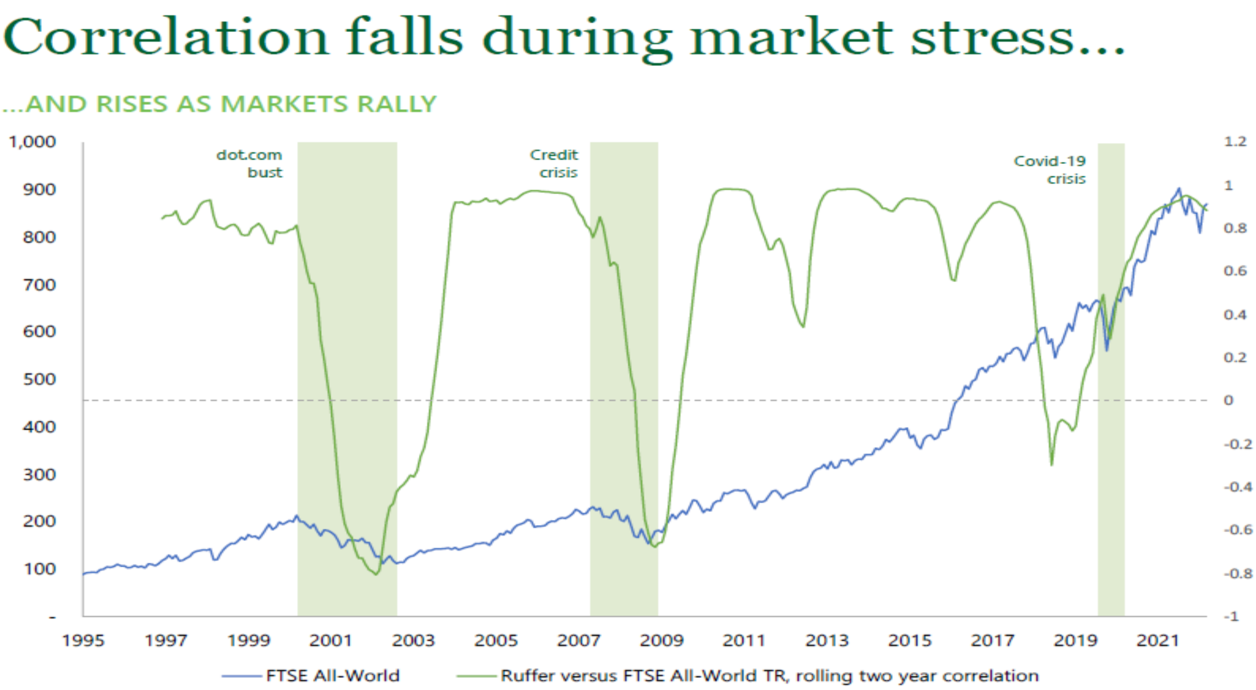
Manager in focus – LF Ruffer Total Return Fund

Global financial markets have suffered greatly in 2022 (the S&P 500 is down 25% this calendar year) and it is very hard to find fund managers that are in the black in this environment. One of Paradigm's alternative managers, Ruffer, has consistently outperformed throughout times of uncertainty and this year is no different. For the quarter they have returned +4.03% and +5.61% calendar year-to-date.

Ruffer's main philosophy is to protect capital by investing in a well diversified portfolio with protection against adverse market conditions. They have used the same single focused strategy that has consistently delivered positive returns in a 12-month period for the last 27 years.

The ability to deliver this is based on the virtue of its holdings, so it will perform differently within a number of market conditions. The relationship or correlation of the Ruffer fund, against a well diversified general index of stocks changes drastically during times of crisis. Correlation is measured between -1 meaning a perfectly opposite relationship and +1 meaning a perfectly consistent or matching relationship. On the graph below, the level of correlation is on the right of the chart. The green shaded sections shows periods of economic or financial crisis.

Notice how the correlation falls close to -1 in times of distress which indicates Ruffer does the complete opposite to what the index and general market is doing. During normal times they go back closer to one.



This is done through a number of means. Firstly, the Ruffer portfolio can invest in a diverse range of financial products, which can include currencies, commodities and inflation linked bonds to name a few.