Investing for a world of change

Multi-Asset Strategy Quarterly

October 2022

Foreword

Jimmy Elliot
Head of Multi-Asset

Welcome to our latest Multi-Asset Strategy Quarterly. In this edition, Iain Cunningham reflects on how the three concerns the team anticipated heading into 2022 have evolved. We present a comprehensive review on China's approach to climate change which has progressed significantly over the last decade, before reviewing the policy announcements by the major central banks over the past quarter. Finally, we close with a succinct summary of our higher conviction asset class views, beginning with equities, moving on to fixed income, currency and closing out with commodities.

Contents

General risks. The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth. Past performance is not a reliable indicator of future results. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations. Investment objectives and performance targets are subject to change and may not necessarily be achieved, losses may be made. Environmental, social or governance related risk events or factors, if they occur, could cause a negative impact on the value of investments.

Specific risks. Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income. **Emerging market (inc. China):** These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. **Commodity-related investment:** Commodity prices can be extremely volatile and significant losses may be made. **Default:** There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. **Equity investment:** The value of equities (e.g. shares) and equity-related investments may vary according to company profits and future prospects as well as more general market factors. In the event of a company default (e.g. insolvency), the owners of their equity rank last in terms of any financial payment from that company.

Assessing the year so far

Iain Cunningham
Co-head of Multi-Asset Growth

Michael Spinks
Co-head of Multi-Asset Growth

The environment for risk assets has remained challenging through the third quarter and investors hoping for a US Federal Reserve (Fed) 'pivot' through the summer were left disappointed after the Fed Chair's annual speech at Jackson Hole. Jerome Powell made it clear that inflation fighting was priority number one and warned that businesses and consumers could feel pain in the coming year, adding that history has been unkind to Fed Chairs that have backed off before finishing the job and regaining price stability. This reduced the likelihood of a 'pivot' anytime soon. Developed market equities and bonds sold off heavily, finishing lower on the quarter, post a strong rally through July and August. Emerging markets and China struggled over the same period due to a combination of USD strength, the ongoing zero-COVID policy in China and concerns that policy stimulus is not yet sufficient to offset these headwinds.

Our three main concerns

We came into this year highlighting three main concerns for asset markets and the global economy: slowing growth in China as a function of material prior tightening, developed market central banks, particularly the Fed, being substantially behind the curve on inflation, and extended valuations across asset classes. As a result, our portfolios were broadly positioned underweight equity, underweight fixed income, and long US dollar versus Asian and European currency positions, as we sought to benefit from macro policy divergence between the Fed and other major central banks.

We continue to believe that it makes sense to countercyclically allocate capital into Chinese and Hong Kong risk assets, with a medium-term horizon. Policy dynamics are at the opposite end of the spectrum versus early 2021, with credit being expanded, incremental support for the real estate market emerging and a more constructive policy attitude towards regulation. We continue to use volatility to accumulate positions supported by our longer-term thematic road-map as a result.

The Fed moves ahead of the curve

In terms of the Fed being behind the curve, we believe it is becoming likely that it is moving ahead of the curve as its policy path in the next six months should be sufficiently tight to slow the US economy down, in the process probably leading to recession. Evidence is emerging across leading indicators, monetary aggregates, and corporate profit announcements that growth is slowing, but the effect of most of this year's tightening will likely be felt in the first half of 2023 due to policy lags. Quantitative tightening is now also beginning to pick up pace, presenting a direct headwind to asset prices. In addition, the Fed is focused on backward looking economic releases such as unemployment and inflation. Together these increase the risk of a period where growth and earnings are weakening, potentially sharply, while Fed policy remains tight or continues to tighten.

Figure 1: US 10 year treasury vs. breakeven yields

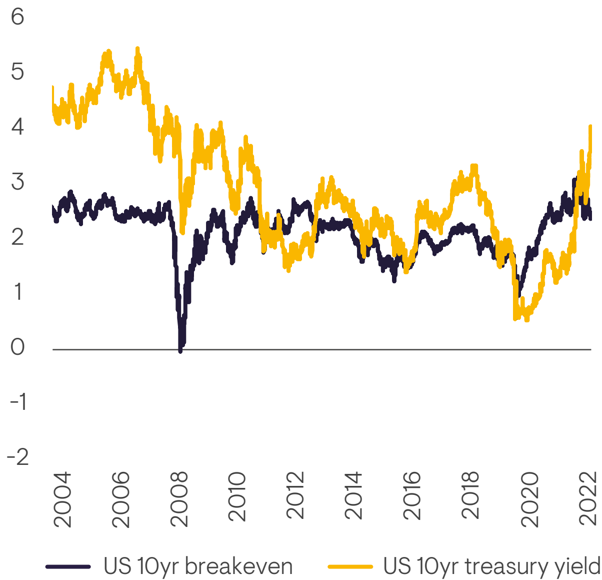
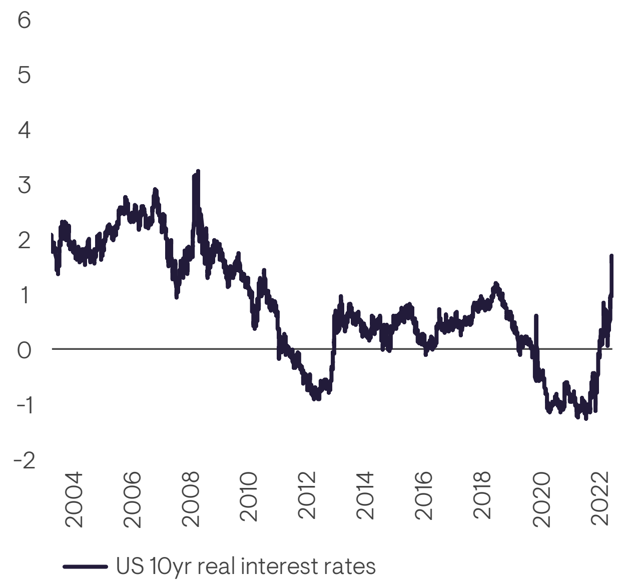


Figure 2: US 10 year real yields

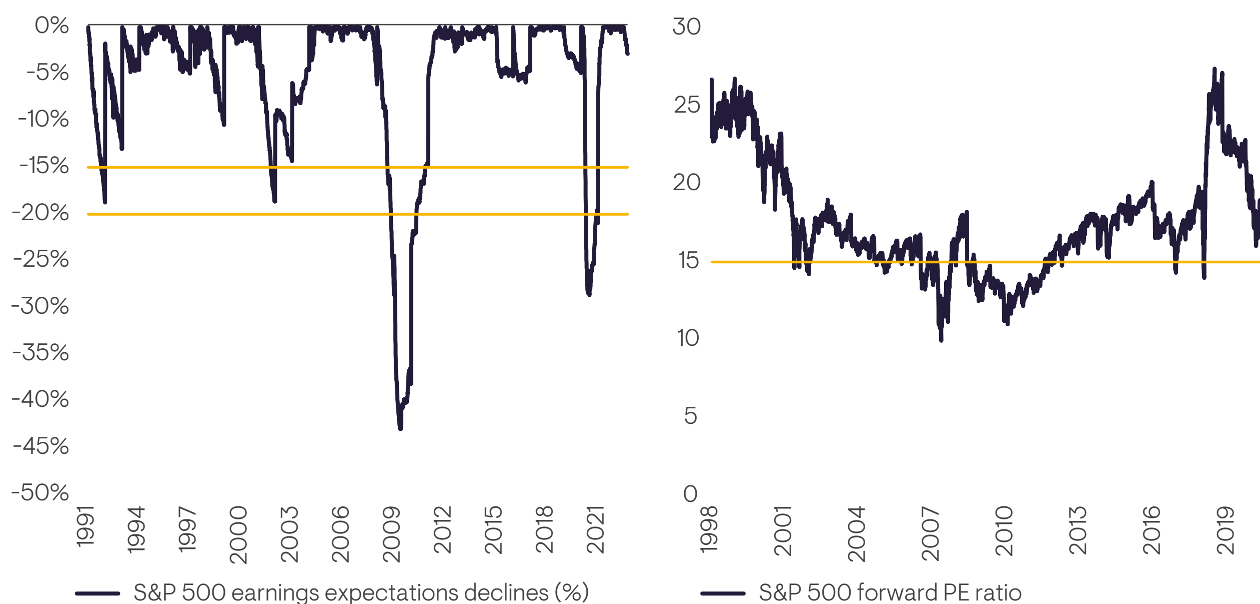


Source: Bloomberg, September 2022.

Where to find value

On valuations, there is a lot of value, coupled with policy support, in select Asian equity markets. In US equities, we would characterise this year's sell-off so far as a valuation reset, with the market moving from being overvalued to more reasonably valued, based on current earnings. This has been driven by rising discount rates. Further downside from here will likely be driven by earnings downgrades in our view, and we remain cautious on developed market equities, remaining notably underweight equities as a result.

Figure 3: US equities: further derating required under central scenario



Source: S&P 500, September 2022.

In fixed income, we would note that real yields in several developed market government bonds are the highest they have been in over a decade, while recession risk is rising. We have added exposure here, particularly in the government bonds of developed economies with household leverage and housing market imbalances, where higher rates appear to be beginning to weigh. Defensive duration exposure is now in line with typical (or neutral) allocations as a result.

Figure 4: Household debt to disposable income ratios

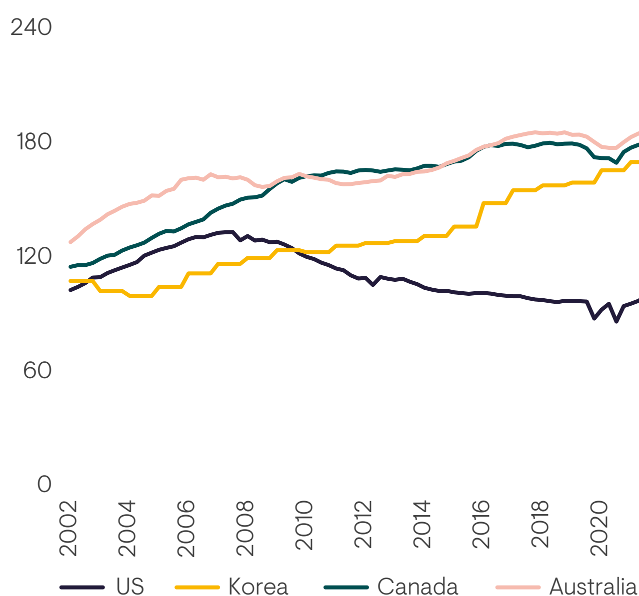
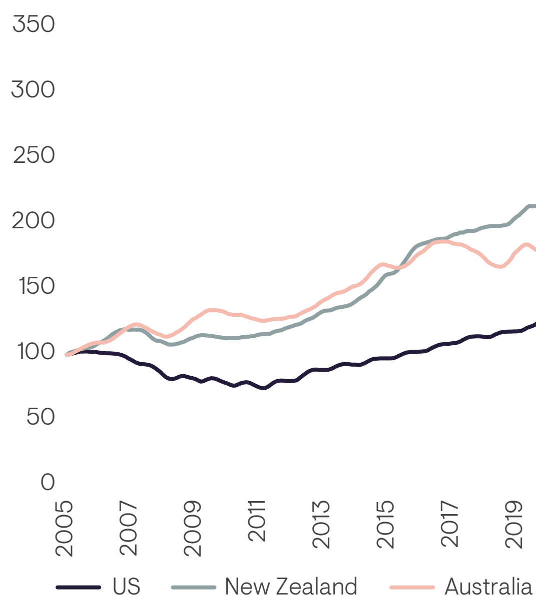


Figure 5: House price indices



Source: Bloomberg, September 2022.

The paradox of China's climate policy

China's approach to climate change has evolved significantly over the last decade, yet there remains a deep paradox at its heart. On the one hand, the country remains by far the world's largest emitter of greenhouse gases and biggest developer of coal-fired power stations; on the other, it signed the Paris Agreement in 2021, pledged that CO_2 emissions would peak before 2030 and declared carbon neutrality would be achieved before 2060.

What China does is important. The planet's ability to limit global warming to below the 2°C limit included in the 2015 Paris climate accord hinges on China's commitment and ability to cut its emissions. Understanding how the Chinese Communist Party reconciles this seemingly contradictory position on emissions reduction was behind Ninety One's decision to commission research from Eyck Freymann, Postdoctoral Research Fellow at Columbia-Harvard China & the World Program, who is writing a book on Chinese environmental policy. The following serves as a summary of his detailed analysis.

Coal-powered growth

China's 30-years of exponential economic growth has been powered by a plethora of coal-fired power stations, billowing pollutants into the atmosphere. Despite their appetite for coal-fired power, Chinese leaders have never denied the conclusions of climate science, but in line with other developing economies they argue that there should be no obligation to commit to targets that hinder economic development. After all, the West did not make such sacrifices.

That said, trade-offs are necessary. The country is vulnerable to climate change. Much of coastal China, including industrial centres like Shanghai in the east and Shenzhen to the south, not to mention countless nuclear power plants and shipping infrastructure could be below sea level at least once per decade by 2050; furthermore, arable land is low lying and susceptible to flooding, making food security a concern.

Ecological civilisation

Beijing introduced climate change policies as far back as 2004, but it was public discontent with high levels of pollution that forced a rethink on the 'growth at all costs' development model. Elected to the presidency in 2012, Xi soon elevated the concept of 'ecological civilization' to the centre of party doctrine. This espouses an eco-socialist utopian vision in which mankind and nature share the earth in harmony.

Yet China's brand of environmentalism is not primarily about conservation. Rather, China's leadership saw that economic and geopolitical opportunities could be created by responding to climate change effectively. Implementation of the concept has been through a system of state targets, quotas, and five-year plans to drive its policy goals and measure its officials, with varying success.

Mixed results

China has endured growing pains for its brand of environmental policy. For instance, of the estimated 70.5 billion trees planted in China as part of its `sponge city' initiative to green cities and reduce rainwater run-off, just 5% remain due to poor soil conditions. Recognition of this has spurred a shift in how China is pursuing this environmental target. The targets are typically imposed by the top and then operationalised by local authorities. Results are mixed but this experimental approach has also led to notable successes.
By 2019 China was the largest producer, exporter and installer of solar panels, wind turbines, batteries, and electric vehicles worldwide, with more installed wind and solar capacity than any other country, in part due to strong incentives from central and local authorities.

In fact, state support for domestic wind and solar industries has been so successful in creating businesses at scale that other countries are worrying about the impact on their own renewable energy sectors. The EU for instance has imposed taxes on some Chinese green products under its carbon border adjustment mechanism (CBAM), which targets imports of carbon-intensive products. China, with an economy 60% dependent on coal (compared to the EU's 14%), is heavily exposed to such a tax. However, it is also true that Europe needs China's capital equipment to decarbonise given the context of the war in Ukraine. That tug of war that characterises engagement with China – between the need for China's products and fear of undermining one's own industrial base – is likely to be a persistent dynamic.

Coal and green energy in parallel

Unfortunately, despite many carbon-friendly initiatives, there are few signs that China plans to phase out coal anytime soon. Why, given the hype around ecological civilization, is this so? Freymann provides reasons for this contradiction. Among them is the entrenched power of the coal industry, as well as China's concept of what some China-watchers have called `fragmented authoritarianism'. This is the interaction between coherent, but overly deterministic, central government guidance and the messy implementation and unintended consequences of this at the local level, as we saw with the trees.

Last is China's drive for self-sufficiency, which has been accelerated by the souring of its relations with the US.

Reducing its dependence on imported oil and the US is a priority, as was reinforced by the 20th party congress. It is apparent that China's attitudes and policies towards energy and climate have evolved over the last decade.

The CCP has a strategy to minimise the costs and risks of climate change at home, while believing it can maximise the geopolitical and economic benefits on the global stage.

However, progress towards its 2030 and 2060 emissions targets will be conditional on the economic and geopolitical context remaining favourable to rapid decarbonisation.

Russell Silberston
Strategist

Aggressive action to control inflation

Our last policy review was titled ‘Credibility under threat’ and detailed how, with inflation far above target, most major central banks were fighting to keep their integrity intact.

The Fed leads the way

The US Federal Reserve (Fed) was at the vanguard of this battle, raising the target range for the benchmark Federal Funds Rate by 2.25% in just three months to get monetary policy to a level where it can slow economic growth and help subdue inflation. The most recent set of forecasts sees a further 1% to 1.25% rise in interest rates this year, leaving official interest rates at 4.4%, a level last seen before the Global Financial Crisis. However, with neutral policy – the theoretical level of rates that is neither restrictive or expansionary – standing at just 2.5% monetary policy is tight, and economic growth is likely to slow sharply, with unemployment rising. As Chair Powell stated at his most recent press conference: “we have to get inflation behind us. I wish there were a painless way to do that, there isn’t.” Markets can’t say they weren’t warned.

The Fed has done a great job of communicating its intentions for those willing to read the speeches, but its Federal Open Market Committee (FOMC) will face a challenge when it decides to keep interest rates unchanged and assess the cumulative effects of this historically large tightening. At that point, which is likely to be in Q1 2023, there is a danger that expectations run away as markets look for the so-called Fed pivot and contemplate a turn in the rate cycle. To avoid this, communication will continue to argue that a long period of steady and restrictive monetary policy is necessary as ‘history shows we must be resolute if we are to completely uproot inflation[1].’ Of course, it might be that inflation doesn’t fall back and policy must become more restrictive. But if, as is widely expected, inflation does indeed begin to fall back in the face of demand destruction, then interest rates will peak at some stage over the coming six months. What’s not clear is how long rates will need to stay there before the Fed sounds the inflation all clear.

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1. Staying Purposeful and Resolute in the Battle against Inflation, Raphael Bostic, President and Chief Executive Officer, Federal Reserve Bank of Atlanta.

Rate tightening to continue in Europe

The European Central Bank (ECB), which was still executing quantitative easing at the beginning of July, has re-discovered its Germanic hawkish roots and escaped negative interest rates quickly by hiking official interest rates by 0.5% in July and another 0.75% in September. With inflation standing at 10%, further increases are inevitable as the ECB rushes towards a more neutral policy setting. In a recent speech, Christine Lagarde, President of the ECB set out two elements of this journey: the destination and pace of increases. The former is a function of how well inflation expectations are anchored and how quickly growth reacts to tighter policy. If, for example, expectations drift away from target, then the bank will take rates into restrictive territory. The latter is all about signalling its intention to fulfil its mandate. Given the level of prevailing inflation, it is safe to assume that further large increases are likely in the months ahead. The Governing Council, however, is still refusing to discuss where neutral monetary policy is, making the likely end point of the ECB's rate cycle difficult to divine and the probability of a policy mistake higher.

Tough choices for the BoE

The Bank of England had, to put it mildly, a turbulent quarter with the worst growth and inflation outlook of all major economies, and the Monetary Policy Committee (MPC) was attempting to balance the trade-offs inherent in its forecasts. This meant it was hiking interest rates at a less aggressive pace than its peers, and despite being the first to increase official rates and shrink its balance sheet, the MPC has now been overtaken by recent fiscal events. The UK administration, having announced a large round of unfunded fiscal easing without the oversight of the Office for Budget Responsibility and in the face of double-digit inflation, unleashed an historically large sell off in the government bond market which compelled the Bank to step in to stabilise matters. But with fiscal policy easing, the Bank has been left with no choice other than to become more hawkish on interest rates, with its Chief Economist stating that it is "hard to avoid the conclusion that the fiscal easing announced last week will prompt a significant and necessary monetary response in November." With markets pricing in a cumulative increase in Bank Rate of over 2% by year end and a peak in the cycle close to 6%, the UK faces a turbulent time ahead.

Disinflation is the chief concern of the BoJ

In complete contrast, the Bank of Japan sees the current inflation spike as an opportunity to finally re-anchor expectations and put the dis-inflation mindset behind it. The key to achieving this is to welcome second round effects from high headline inflation, something the rest of the world is trying to avoid. In practice, this means encouraging wages to rise at a level that is compatible with 2% inflation, something that has not been achieved despite headline inflation being well above target. Until the Bank is comfortable that it is seeing this 'virtuous circle' it will continue with its aggressive monetary policy stance, despite the weakness of the yen and the outlying position this places it in.

PBoC biased towards easing

The People's Bank of China is fighting a different battle, as continued COVID restrictions and a weak housing market place significant headwinds on private consumption. As such, the Bank maintains a monetary policy easing bias, reducing the benchmark interest rate used as the basis for mortgage pricing by 15bps and encouraging banks to lend to favoured sectors such as infrastructure, industrial upgrading, and green development. The renminbi fell over 5% against a resurgent US dollar in Q3, causing the PBoC to try to guide it stronger and set tighter restrictions on those banks selling it. However, its FX reserves remain stable, suggesting any intervention is verbal at best. There are signs that the piecemeal nature of China's policy easing is beginning to gain some traction, but with growth so slow, expectations so subdued, and inflation stable, it seems far too soon for the PBoC to change its monetary stance yet.

Summary of high conviction asset class views

Growth Bonds

The EM macro score remains negative, while our quality scores continue to move negative reflecting higher inflation, which has eroded institutional strength scores, as well as a deterioration in fiscal scores. Valuations remain attractive across the board, in particular real interest rates on a relative basis. We are neutral the asset class but favour those areas that have nominal and real rate advantages to DM, as well as attractive carry dynamics as these should continue to benefit from yield advantages to DM.

Positive – Mexico, Peru, Colombia, Brazil, Chile, South Africa, Poland

Negative – Peripheral spreads

Defensive Bonds

The outlook is now more mixed for defensive bonds with real interest rates having risen sharply, and implied inflation above realised historical levels. This is true across developed markets, with inflation premium recovering in Europe to catch up with the recovery already seen in the US. The US curve has repriced aggressively and with growth momentum showing signs of moderation we have upgraded nominal yields back to neutral. Other areas such as the $ Bloc and South Korea which have repriced significantly above medium-term fair value remain attractive considering the structural challenges.

Positive – New Zealand, Canada, Australia, South Korea

Negative – Implied inflation to fall, real rates to rise

FX

The outlook for major currency blocs has become more uncertain. While macro and policy divergence between the US and China should continue in the short term, this has largely been priced by exchange rate markets and we remain neutral on all major Bloc FX. We have downgraded $ Bloc given signs that the large structural imbalances within the household leverage and housing markets are beginning to correct. These should act as headwinds to growth and central bank tightening vs. the US.

Positive – No comments

Negative – CAD, NZD, AUD, Gold

Credit

BB-rated credit instruments are looking expensive after a strong, technically-driven and up-in-quality rally. US IG notably lagged the rally. EU HY, which has underperformed this year, is now flat to the US. Recent Q2 results and management guidance is better than hoped although commentary remains cautious and sector-specific warning signs exist. There has been a shift in spending from Consumer Discretionary to Staples, however some discretionary areas remain robust. Inflows continue in to HY and to a lesser extent IG. While the macro backdrop looks challenged for credit spreads, valuations have improved, and we have moderated our maximum negative view.

Positive – Asian HY

Negative – US/EU high yield

Regional Equity

The Asian region has structural tailwinds and is beginning to see earning dynamics trough as regulatory incursion lessens and macro policy becomes more supportive. By contrast, the need to keep policy tight to lower inflation constrains the growth outlook for the US, where valuations are elevated, as well as for Europe ex UK and UK which face additional structural headwinds.

Positive – Asia ex Japan

Negative – US, Europe ex UK, UK

Sector Equity

Asset heavy: we are cautious on cyclical sectors that are exposed to consumer goods demand and the manufacturing cycle.

Asset Light: the best opportunities lie in areas that benefit from accelerating structural change in the technology and healthcare sectors. The valuations most at risk are those the highest growth areas as real discount rates rise.

Stable Return: higher quality defensive sectors are attractive given the growth outlook, but this is offset by relatively stretched valuations and margin pressures.

Positive – Pharmaceuticals, Healthcare Tech

Negative – Industrials, Consumer Goods, Software, Media and Online Retail, Telcos and Utilities

Equity views

We have not changed our regional views over the past quarter. This means that we remain maximum negative on US and European equities, negative UK, neutral Japan, and positive Asia excluding Japan.

Tight monetary and liquidity policy remains the focus in the **US**, and we believe the full impact of this policy has yet to fully play out across markets, with the full economic impact of the tightening, which has already taken place, only likely to become visible over the next few quarters. And while equities have derated, we are not convinced that markets have adjusted to a much weaker growth outlook - the US large cap market, for instance, remains expensive. Similarly in the **UK**, we view valuations as having returned to a neutral level only, despite substantial downside risks, not helped by tensions between fiscal and monetary settings and an unsettling lack of policy clarity. Some market watchers had hoped for a soft landing, driven by strong services demand and low unemployment, and supported by slowing rates of inflation. This is not our base case, and we believe a manufacturing-led global recession is the most likely outcome. This has negative implications for developed markets in general, and Europe in particular, given its exposure to the sector.

We remain positive on **Asia ex-Japan** and prefer emerging markets to developed given our view that Asia is emerging out of a tightening cycle towards easing, and regulatory headwinds in **China** are starting to abate, with attractive valuations in absolute and relative terms. At the sector level, we remain cautious on cyclical sectors with the highest exposure to consumer goods demand and the manufacturing cycle, with key negative views on **Industrials** and **Consumer Goods**. The richest opportunity set is found across areas which benefit from accelerating structural change in technology and healthcare sectors although we have become increasingly selective and expect to rebuild exposure as long-term opportunities arise. Higher quality defensive sectors are attractive given the growth outlook, but this is offset by relatively stretched valuations and margin pressures.

We downgraded **Consumer Goods**, to maximum negative, from negative last quarter, fully reinstating a long held negative view on the sector as cyclical challenges intensify for even those sub industries which have been relatively immune to the ongoing real income squeeze and inventory management challenges. In particular, we have moderated our positive view on home improvement retail where structural factors remain supportive, but the combination of a sharp housing slowdown and historic demand pull forward are starting to weigh on growth.

Following a strong rebound in August, we also trimmed our view on **Cyclical Technology** to positive from maximum positive. We maintain a positive overall view on the sector because of a strong structural growth outlook. The increased capital intensity and technological complexity of semiconductor manufacturing create powerful barriers to entry, and a more concentrated industry structure and wider competitive moats are resulting in higher and less cyclical industry profitability. Nevertheless, in the near term we acknowledge the stretched valuations and incremental signs of cyclical weakening in end demand across different technology verticals.

Overall, we believe equities will face continued pressure as earnings expectations – which remain at all-time highs – adjust to a cyclical weakening in demand alongside a substantial inventory challenge.

Fixed Income views

As detailed in the policy review, it is increasingly clear that, despite the odd dovish comment, the Fed has not held back when it comes to managing inflation. The lessons of the 1970s - its stop-start approach to interest rate hiking led to an unprecedented period of stagflation – have been learned. Thus, we expect to see rate hikes continuing through 2022. This is likely to bring US interest rates to 4.4% this year. Thereafter the Fed may opt to pause to assess the impact of its tight monetary policy. We do not, however, anticipate policy loosening any time soon, as the central bank is expected to keep policy tight to counter inflation.

On the other side of the globe, the Bank of Japan is following its own path. It is keeping monetary policy ultra-loose to support a fragile economic recovery and is the outlier among a host of central banks raising interest rates to combat soaring inflation. The risk is that the Japanese economy overheats in the process.

Government bonds: This quarter has not brought much relief to the bond market, but as the year progresses, we are beginning to identify selected opportunities and have added some long positions on government bonds. We have also upgraded Chinese government bonds to neutral from negative. We were negative after we had expected policy easing to be focused through credit, however, over the quarter the Chinese central bank chose to cut rates, opening up the potential for an easing cycle, leading us to upgrade Chinese fixed income. Whether we choose to downgrade Chinese fixed income again will depend on China's economic recovery as that country moves out of lockdowns and pursues more accommodative regulatory and fiscal policies.

Emerging market local currency: This quarter has seen a continuation of the perfect storm that has buffeted emerging markets all year. As the Fed continues to raise rates to levels last seen ahead of the financial crisis, safe-haven yields have begun to look more attractive than their riskier EM counterparts, prompting capital flight and plunging currencies. This is even though many EM central banks began to hike rates in 2021 – well before the Fed. Thus, we have not changed our view and remain negative on growth, and neutral on the outlook for inflation.

Emerging market hard currency: US dollar strength, high commodity prices, higher US rates, quantitative tightening are making it significantly more challenging for emerging markets to roll over their maturing debt, or to fund their budget deficits. Thus, we are seeing ratings downgrades in countries facing short-term external financing issues, like Turkey and Ghana. But there are some bright spots such as emerging market economies that export energy and have benefited from the increase in prices. A key catalyst for a more positive outlook may be driven by China easing back on its zero-COVID policy which will have positive knock-on effects for the global economy.

Credit: We continue to hold a cautious view on credit. The combination of policy tightening, and persistently high inflation sets the negative backdrop for credit which has become increasingly sensitive to the macro environment.

More recently credit issuance has stalled at multi-year lows, rather than presenting a compelling supply/demand rebalance, this instead reflects the inability of the market to absorb new bonds.

While spreads have moved wider to reflect some of the downside risks, they remain below the levels at which a meaningful default cycle has been priced and as Q4 progresses the market will have to contend with an increased pace of quantitative tightening from the Fed.

Currency views

The outlook for major currencies has become more uncertain over the quarter. While macro and policy divergence is expected to continue between the US and China in the short term, this has largely been priced by exchange rates. As a result, we have neutralised our major region currency views after being positive on USD and negative on CNH for much of the last 12 months.

We have downgraded **$ Bloc (CAD, AUD & NZD)** currencies to maximum given an expectation of future policy divergence due to structural imbalances within their underlying economies. While US households experienced a period of deleveraging post the GFC, these economies have continued to see debt piles build and housing markets become ever more inflated. This creates headwinds to growth and inflation and constrains the ability of domestic central banks to maintain high interest rates, ultimately creating a divergence with the US, where imbalances are less extended. Hence, these currencies should underperform the US dollar.

Within the Euro Bloc we closed positions in **short GBP and long NOK.** While the UK economy continues to face challenges the Bank of England has become more hawkish in its outlook for policy, adding uncertainty to the direction of the pound. Additionally, given weakening global growth momentum and its implications for oil demand and prices, the outlook for NOK has also become less clear.

Commodity views

Energy shortages unresolved as Northern Hemisphere winter approaches

The worst fears around Nord Stream 1 were realised when the gas pipeline between Russia and Western Europe was shut down for maintenance in late August and has not re-opened since. According to Russia, the pipeline requires critical parts which cannot be obtained unless sanctions are lifted. European nations and the European Commission are trying to co-ordinate a reduction in gas consumption over the coming winter. The details and implementation of this are not clear and we expect the market to do most of the work via higher prices that will destroy or postpone demand. Signs of this were seen during Q3 already when smelters, chemical and fertiliser plants were shut down.

Crude oil saw signs of weaker demand during the quarter, which was linked to the affordability of petrol and diesel in the US and elsewhere. Refining capacity was arguably a bottleneck for oil prices which could have pushed even higher. More recently, OPEC announced a production cut based on its view of a weakening demand outlook: while the mathematics of the cut are debatable given the uncertainty around existing production levels, the signal from OPEC that it will defend prices is unmistakable. When we put this all together we continue to have a broadly constructive view on oil and natural gas prices.

Metals in perfect storm of weaker demand and a stronger dollar

We expected cost support to stem the price decline in certain metals such as aluminium, but this did not happen during the quarter. While shutdowns of various European smelters were announced during Q2 and Q3, other global producers were helped by a weaker local currency. China is the key demand driver for most base metals and there property sector weakness has continued to weigh on sentiment. Infrastructure projects are more important for the likes of copper, but activity has also been disrupted by the zero-COVID policy.

Anecdotally, metals demand remains fairly healthy in the US, but Europe saw a deterioration as the economic outlook for 2023 worsened and supply chain de-stocking widened. We were encouraged by greater supplier discipline in the steel sector compared to previous cycles. However, this has not been enough to halt the price decline in western markets. Depending on stimulus measures, China could lead a broader metals recovery early next year, but we must see an improvement in the fundamental data to change our cautious view.

Agriculture supply remains constrained

Small crops get smaller, and we expect continued downgrades of the US and European summer crops currently being harvested. Dry and hot conditions in late July and August limited the yield potential for corn, soy and spring wheat. Farmers are reporting harvest data and while some regions such as the southwestern Corn Belt in the US experienced good growing conditions, the overall picture is of further declines in corn and soy estimates. Thus, we expect elevated prices to continue, with record levels potentially tested again (e.g., US$8 per bushel for corn). A lot will depend on the pace of Ukrainian exports and their ability to continue shipping after c.7m metric tons have been moved to international markets already.

Overall, we see strong demand for inputs again next year as farmers follow the market's price signals and attempt to increase output by higher planted area and full application of seed, crop protection and fertiliser products. The gold price fell during the quarter, ending below US$1,700/oz. Despite the challenging environment, expectations for aggressive action by the Federal Reserve, together with continued US dollar strength, diminished the precious metal's lustre.

The oil price fell by 22% during the quarter, however this decline may be bottoming out as Chinese demand showed signs of rebounding and U.S. sales of strategic reserves end.

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Investment Team

There is no assurance that the persons referenced herein will continue to be involved with investing for this Fund, or that other persons not identified herein will become involved with investing assets for the Manager or assets of the Fund at any time without notice. References to specific and periodic team meetings are not guaranteed to be held or fully attended due to reasonable priority driven circumstances and holidays.

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CS_433 10/22