MMWealth
Chartered Financial Planners

Keeping you informed matters

Annual Investment Review

January 2022

Chartered Financial Planners

Outlook

Central banks no longer see inflation as “transitory” and begin to tighten fiscal as well as monetary policy response. The Omicron coronavirus variant continues to disrupt lives globally as the vaccination disparity between developed and emerging economies widens.

Central bank policymakers in developed economies have been watching two key indicators closely before deciding on monetary and fiscal policy response as economies recover from the pandemic. The first is inflation, which for some time now has surpassed initial expectations. The second is employment, where a rapid recovery in jobs, coupled with a smaller labour force, has given rise to higher wages.

In particular, recent inflation data from the US with a Consumer Price Index (CPI) reading of 7% will undoubtedly make for uncomfortable reading, piling pressure on the Federal Reserve to begin tightening fiscal response much sooner and apply the brakes much harder to wind down the emergency monetary support provided during the depths of the pandemic recovery.

However, while we agree that the time is right to begin tightening policy in response to inflation, our core view remains that while inflation is here, and higher than long term targets, it will fall after a period of time; more on this later. Similarly, we expect interest rates to go up, but believe they will remain low compared to long term levels.

Not only are the base effects for measuring inflation change starting to fall out of the annual comparisons, but there are growing signs of supply strains easing, with freight rates having peaked, delivery times shortening, and backlogs reducing. This should mean that the most acute price pressures start to fall back in coming months, suggesting a more digestible run of CPI readings are in the offing for future quarters.

"I think the word 'transitory' has different meanings to different people," Fed Chairman Jerome Powell told the US Senate Banking Committee in recent testimony when asked about his persistent use of the word. "To many it carries a sense of short-lived. We tended to use it to mean that it won't leave a permanent mark in the form of higher inflation."

That sounds like an admission of sorts, that perhaps initial inflation expectations were a bit hopeful. "I think it's probably a good time to retire that word and try to explain more clearly what we mean" Powell went on, leaving traders and investors none the wiser to interpret how long this could be once again.

There are a number of factors to consider when forming our core view on the world currently. After the shock Covid-19 recession of 2020, global economic growth bounced back in 2021 and earnings soared ahead of forecasts. Equity returns have been strong, government bond returns have been weak, with corporate credit outperforming government bonds, and metal price increases have boosted commodity returns.

Within this broad outcome however, the divergence of company valuations has been stark, with many of the leaders of the recovery experiencing a reversal of fortunes towards the back end of 2021. We have discussed the disparity between the ‘value’ and ‘growth’ trade in previous commentaries, which is affecting valuations once again. The current share price of these companies is based on an investors’ interpretation of future earnings power and how rising interest rates affect this; that has extended the recent rotation between these stocks.

With expectations for higher inflation, interest rate rises and consequently, rising bond yields, the future earnings potential is considered reduced for many typical ‘growth’ companies, such as the big tech names. Hence those ‘value’ companies that have strong earnings already, but limited growth potential, come back into focus and their valuation improves. It is these rapid valuation changes that tend to dominate or exaggerate short-run returns, and it is the change in earnings power of firms over the long term that is being heavily discounted currently – or ignored even, after such a strong period of performance.

Looking forwards for 2022, there are a number of key themes that we therefore need to consider alongside the primary concern which is the path of inflation and central bank response. Not even considering the potential for geopolitics to upset markets, it is this equity valuation conundrum and the way in which Covid continues to impact the economic recovery that we must position for.

Without any wiser view on inflation than many well respected economists have already provided, we believe inflation should peak in the first half of the year and become more subdued thereafter. There are a number of risks to this view of course, one of which is the change in consumer behaviour that has occurred as a direct result of lockdowns and spending patterns.

Pre-pandemic, the average household spent c65% of income on services and c35% on goods. With less travel, less eating out and more living and playing at home, the dynamic has shifted significantly over a short period of time, with c40% of income now being spent on goods. This upward pressure on the price of goods could continue for longer, particularly with the pent-up spending that could still occur while household savings remain at record high levels.

The next dynamic to consider is the action of central banks. Higher inflation will be addressed through fiscal policy, with markets already pricing in a number of interest rate increases this year in the US and UK. Rates could end the year at the 1% level in each of these markets, but this does remain well below pre-pandemic levels, and indeed, pre-global financial crisis levels in 2008. This is reflective of extremely high debt levels, where bankers need to consider the impact on repayment of interest should rates rise too high, too quickly. The domino effect of debt defaults, leading to companies failing and rising unemployment, could be a potentially catastrophic mix leading to a substantial recession.

The difficulty for companies in this finely balanced environment therefore increases the chance for valuation imbalances through 2022. Without a period of significantly higher levels of capital expenditure, growth is likely to stutter. Covid forces play out as long term structural changes take place alongside rotation between different regions, for example the shift to clean energy; this will lead to volatile returns from equity markets.

In this environment where inflation turns out to be persistently higher leading to concerted central bank interest rate rises, the biggest losers would likely be high growth and high valuation equities and long duration bonds. The expensive US equity market, dominated by a few major tech firms over recent years, could see a reversal of fortunes should the easy liquidity, low rate environment that has been enjoyed over the last decade, disappear.

However, this is not our base case and while we may see lower returns from these areas, they will continue to grow. Structurally high growth firms that disrupt the economic landscape may have demanding valuations currently, but will continue to shape markets in the future. Climate resilient sectors such as tech and healthcare for example, should perform well working with industry to transition from fossil fuels to clean energy. Future pandemics are now more accepted and reversing decades of globalisation and human travel and interaction with lockdowns is not a sustainable solution.

We recognise that the uncertainties are meaningful and myriad, with the scale of drawdowns in some scenarios potentially significant. But the healthy earnings outlook and low yield environment remains and we believe this justifies the valuation of many equity markets. The volatility that is expected will present opportunities for the long term investor to realise solid returns, but we need to appreciate that it won't be at the same sort of level we have seen recently or indeed over the 13 year bull run since the global financial crisis.

From here, above trend growth is still likely and globally we could see momentum pick up as developed economies learn to live and work in a pandemic. Vaccination progress can only contribute to the resilience against new variants and as response becomes less restrictive, the services sectors could become a catalyst for growth again, given the potential to catch up to pre-pandemic levels.

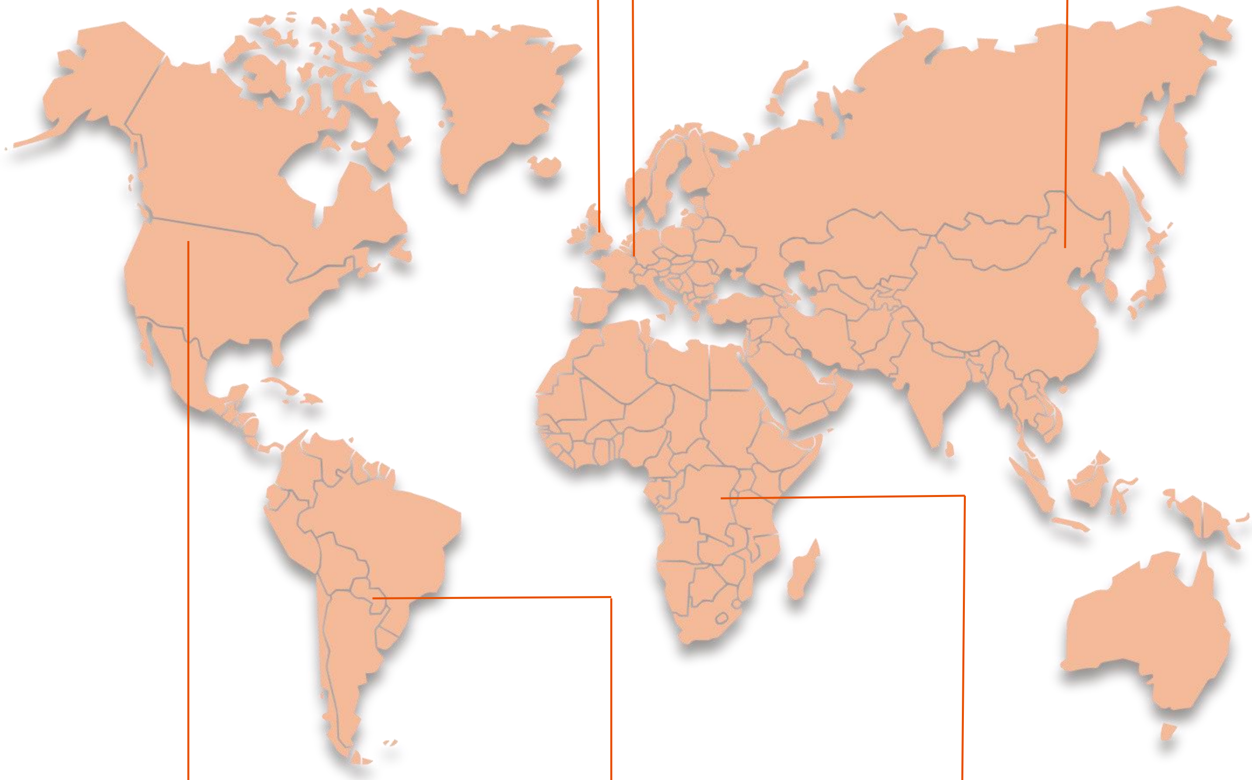
Strong private sector balance sheets should minimise the impact of tighter monetary policy and central banks will remain accommodative while so many competing risks leave us far from any version of pre-pandemic "normal". Investors should be mindful that this is a very different environment to what we have become used to over the last decade, but the outlook remains positive if a balance can be maintained.

Key facts about the world

United Kingdom
- Inflation nears 30 year high, heading for 6% in March/April on surging energy prices with 3-4 rate hikes expected
- Economy finally returns to pre-pandemic size in November
- Valuations remain cheap on 30% discount to US equivalents

Europe
- Renewed surge in Covid sees new restrictions in many countries
- Economic growth outlook weakens with analysts lowering GDP forecasts
- Record high energy prices as inflation hits 4.9% and exceeds ECB's 2% target

Asia
- Japan growth projections raised to 3.2% for 2022 on record extra stimulus budget
- Largest emerging economies, including China, set to slash fiscal deficits in next 18 months, slamming the brakes on inflation



North America
- 3-4 interest rate increases now forecast for 2022
- Another strong year forecast with Conference Board forecast growth of 3.5%

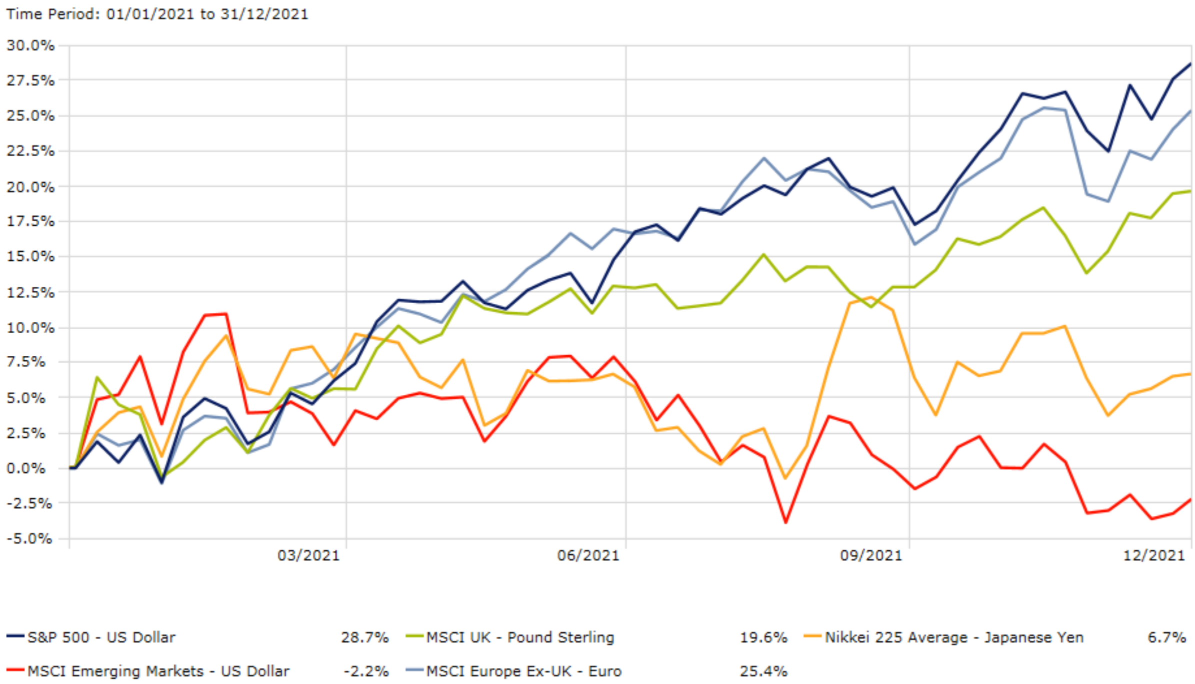
South America
- Latin America likely to have grown faster than expected 6.2% in 2021, over ECLAC* estimates of 5.9%
  Growth to slow to 2.1% in 2022 on weaker global demand and moderating commodity prices which soared in 2021

Africa
- A dearth of immunisation sites, weak communication, Covid denial, syringe shortfalls and Omicron variant complacency slow vaccination rates and recovery

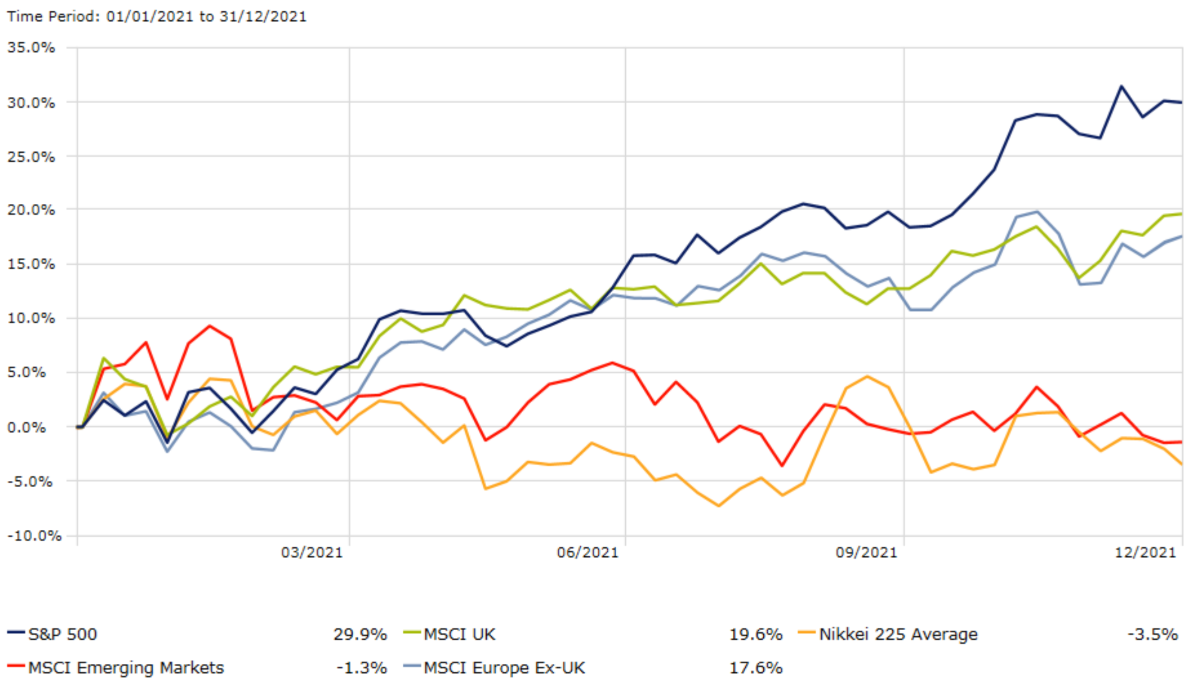
**ECLAC - The United Nations Economic Commission for Latin America and the Caribbean*

2021 in charts

Major market movements in local currency (1 year)



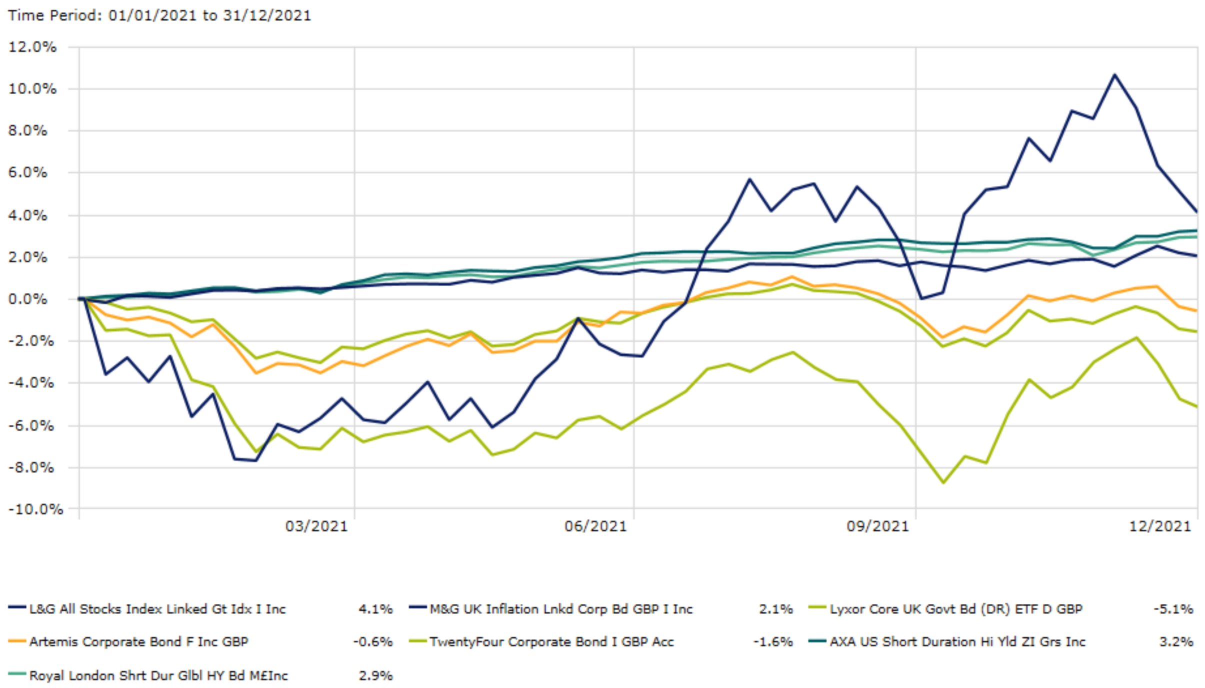
Major market movements for Sterling investors (1 year)



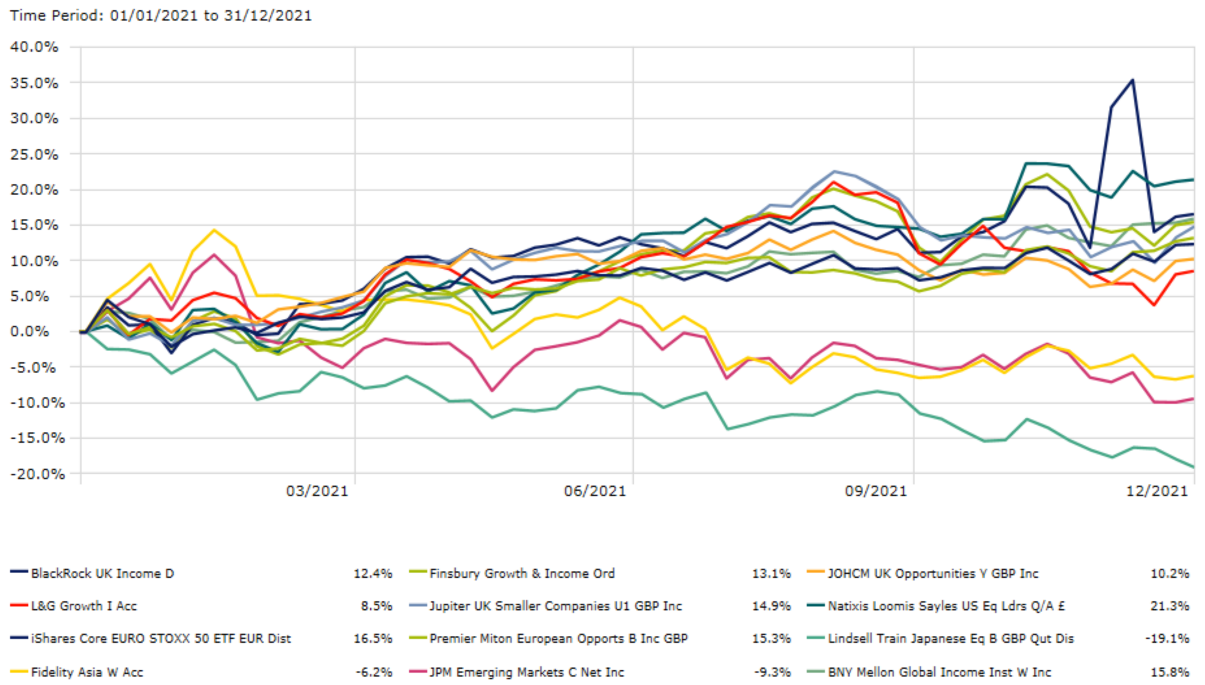
Source: Morningstar Direct

2021 in charts

Model growth returns fixed interest (1 year)



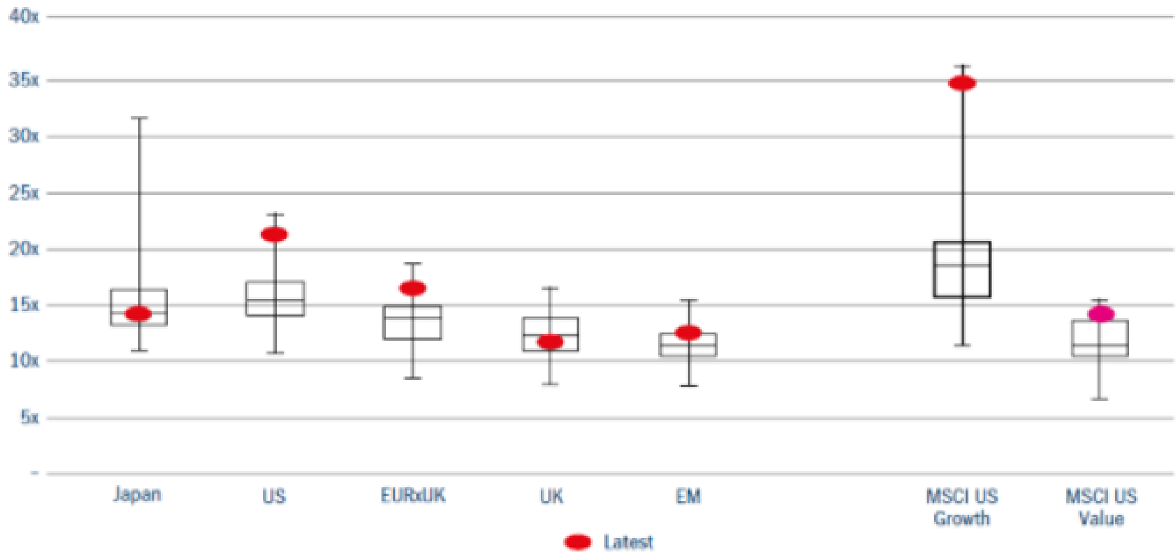
Model growth returns equity (1 year)



Source: Morningstar Direct

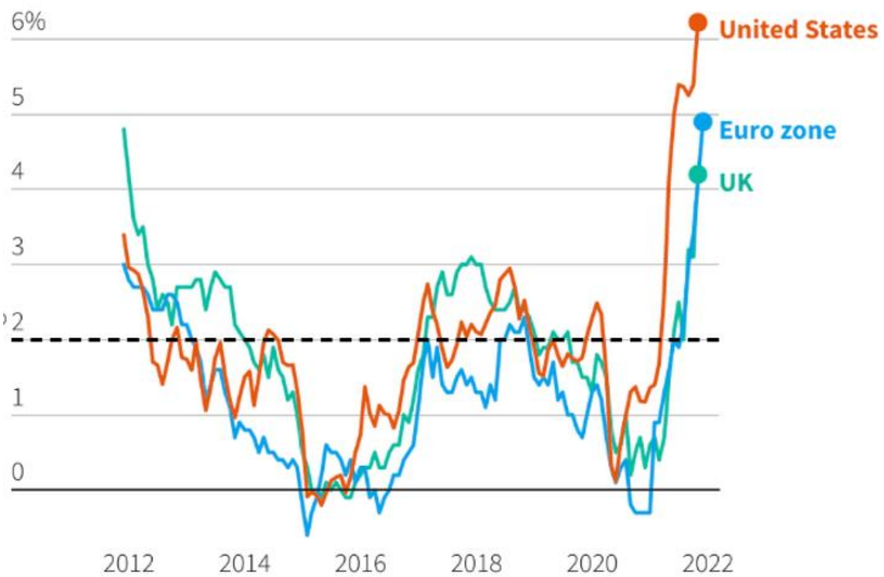
2021 in charts

Equity market valuation divergences



Source: Bloomberg. 30th November 2021 equity market forward PE multiples against 15 year history. Expensive US, relative value still in other core markets.

Inflation overshoots



Source: Refinitiv Datastream. US CPI, UK CPI, Eurozone Harmonized Index of Consumer Prices

2021 performance review

Finding the right balance

- Cautious and Balanced strategies perform in line with expectations
- Quality growth bias in higher risk strategies creates drag on performance in second half
- Return of inflation adds to volatility, more persistent in housing, energy and wages
- Central banks walk market tightrope, balancing appropriate fiscal and monetary policy
- Growth headwinds such as supply constraints and China to subside
- New Covid variants remain a tail risk for markets as vaccinations grind on

A Mixed Bag

With higher inflation, bond markets began to reflect expectations for future interest rate hikes. As such in Q4 we saw solid returns from inflation linked bonds, with the L&G Index Linked Gilts fund +4.57% in line with wider benchmarks. Conversely, the longer duration defensive government bond exposure was more volatile, positive for Q4 but selling off c2.5% in December to leave returns flat at 0.3% for the half. We still see value in our short duration high yield bonds given robust fundamentals and defaults are expected to remain low. Investment Grade corporate credit is well positioned going into the rate rises, with net debt seen as stable and falling going into this hiking cycle.

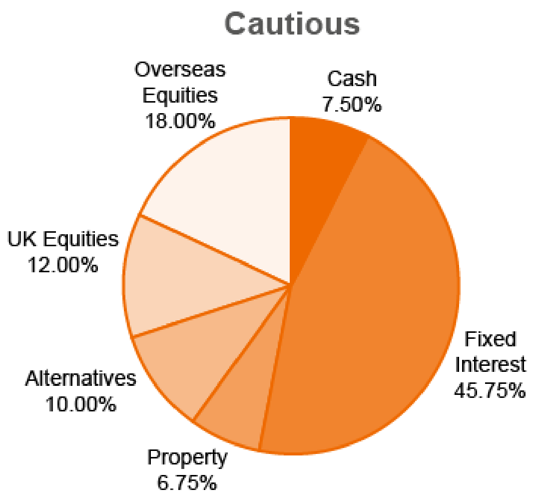
Equity returns have unfortunately been disappointing over the last quarter, continuing the pattern from Q3 with anything 'growth' focused punished as unfavourable factor bias and reopening rotation continued to trump longer term fundamentals. Consequently this had a negative impact given our exposure to quality UK and global growth names, as sector allocation and fund selection both weighed on relative performance. However, while holdings such as the L&G UK Growth Trust may have given a negative return over 3 and 6 months (-2.68% & -0.32%), we shouldn't overlook the positive longer term returns as the best performing UK holding in 2020 and 2019. Similarly, the Loomis Sayles US Equity Leaders fund, a portfolio mainstay and market leader over the long term, has been caught in the rotation – mistakenly in our view – over the last year, returning just 6% in Q4 vs 12% for the US S&P 500 index. Emerging market equity exposure has also suffered within our strategies, as the China slowdown has played out over the second half, but all of these are short term dynamics we believe could unwind very quickly as we move into 2022.

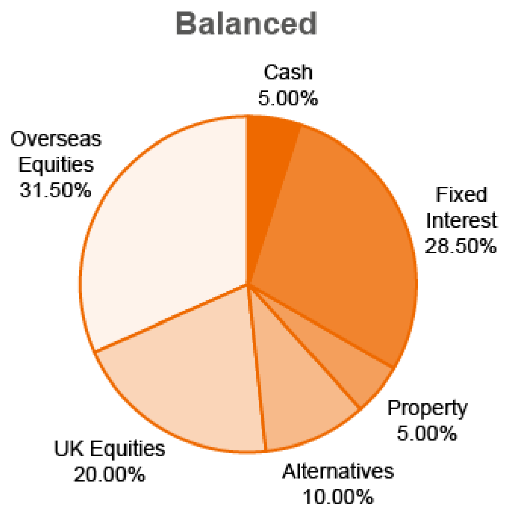
It's easy to focus on short term returns with the availability of so much information, but we don't believe in reacting to lower returns over limited periods unless there has been a fundamental change to the fund or our original investment thesis. As such while we continue to monitor recent underperformance, it is in the context of long term targets. Pleasingly, the sustainable elements of our strategies continued to perform well, as did our alternative holdings, providing uncorrelated risk and returns to wider equity markets.

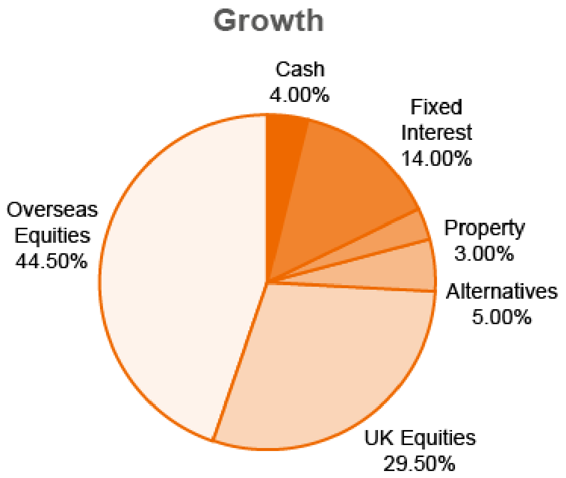
SECTOR	Q4 2021	1 year to 31/12/21	1 year to 31/12/20	1 year to 31/12/19	1 year to 31/12/18	1 year to 31/12/17	5 years (annualised)
IA UK Index Linked Gilts	4.8%	3.9%	11.9%	5.9%	-0.5%	2.2%	4.6%
IA £ Corporate Bond	0.1%	-1.9%	7.9%	9.5%	-2.2%	5.1%	3.6%
IA Property	3.6%	7.4%	-3.8%	-0.8%	2.9%	7.6%	2.6%
IA UK Equity Income	3.2%	18.3%	-10.9%	20.1%	-10.5%	11.5%	4.8%
IA UK Smaller Companies	-1.2%	20.6%	7.0%	25.4%	-11.8%	27.1%	12.7%
IA North America	7.8%	25.3%	16.5%	24.6%	-1.2%	10.5%	14.7%
IA Europe Excluding UK	3.8%	15.6%	10.5%	20.4%	-12.2%	17.4%	9.7%
IA Japan	-4.9%	1.6%	13.9%	17.1%	-11.3%	17.8%	7.2%
IA Asia Pacific Excluding Japan	-0.4%	1.5%	19.9%	15.9%	-9.8%	25.3%	9.8%
IA Global Emerging Markets	-1.6%	-0.1%	13.6%	15.8%	-11.5%	24.5%	7.7%

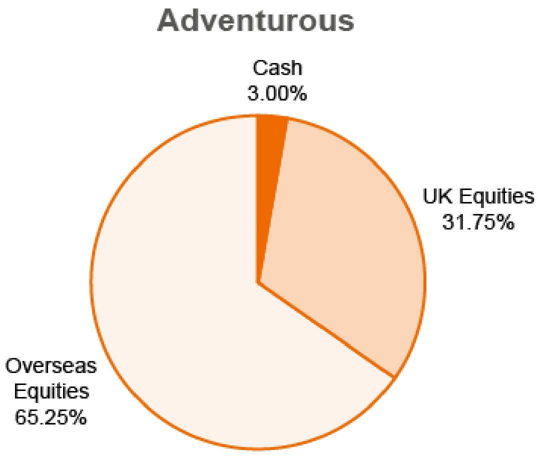
Source: Morningstar Direct

The positioning of our core strategies

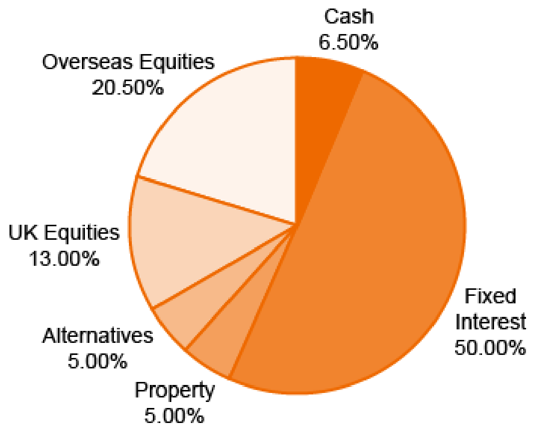




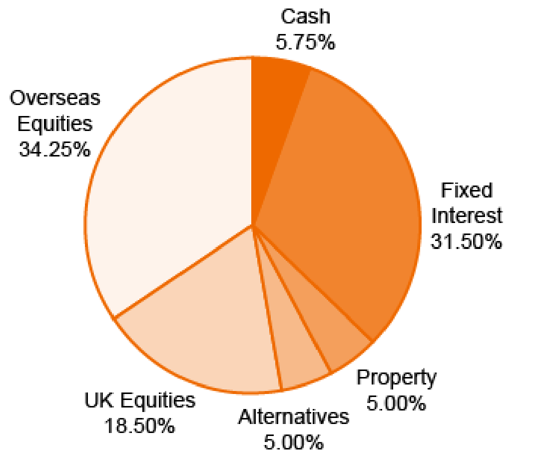




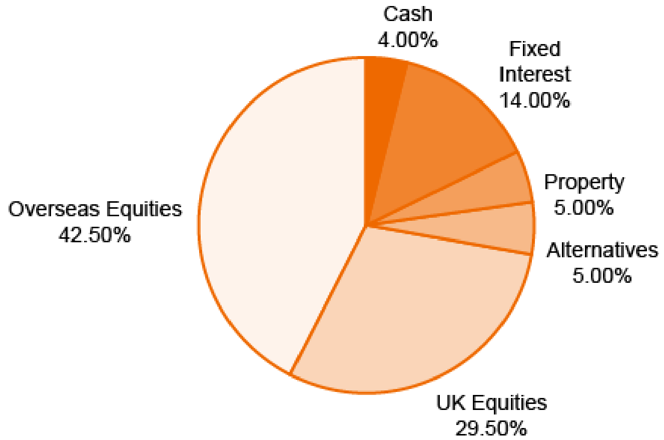
Ethical Cautious



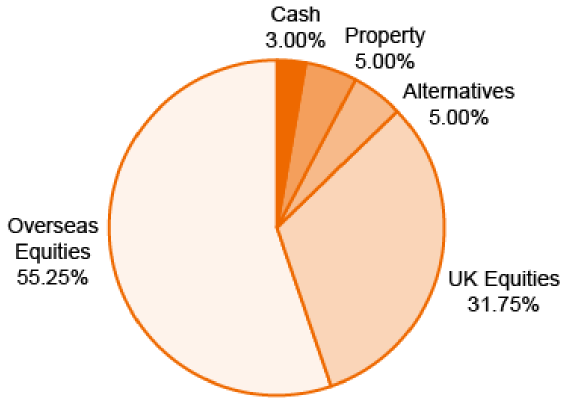
Ethical Balanced



Ethical Growth



Ethical Adventurous



Disclaimer

Opinions constitute our judgment as of this date and are subject to change without warning. The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance is not a reliable indicator of future results and forecasts are not a reliable indicator of future performance. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. The information in this document is not intended as an offer or solicitation to buy or sell securities or any other investment, nor does it constitute a personal recommendation.

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