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Keeping you informed matters

Annual Investment Review

January 2023

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Outlook

Forget everything you know from the last 20 years, as the return of inflation, rising interest rates, war in Europe, trade wars, an inward looking China and a planet lurching towards ecological disaster present a new regime for investors. But with change comes opportunity.

Bloomberg writer John Authers summed it up well: for investors “2022 has been an unmitigated disaster. Stocks and bonds have tanked together. There’s been nowhere to hide.”

For the past twenty or so years, the prices of shares and government bonds tended to move in opposite directions, at least in the short-term. This meant that a mix of shares and government bonds created a simple, diversified portfolio. But last year, they started to move together. When both fell, investors around the world suffered badly. It’s happened only a couple of times before in the past century - rare enough to make this the big investing story of 2022.

And it wasn’t just shares and bonds that fell. After a recent global boom, house prices have started falling in North America, China, Britain, New Zealand and elsewhere. And speculative crypto-currencies, such as Bitcoin, collapsed - by an average of around 70% - after one of the most incredible booms in financial history.

Asset prices usually move when expectations for the future change. So, what in fact did change in the past year? The main change in expectations came just before the start of the year, when US Federal Reserve boss Jay Powell declared that the bout of US inflation should no longer be considered “transitory”. Up to that point, many had believed the Fed’s earlier proclamations and expected inflation would fade away without too much intervention. Now, everyone knew that there was an inflation problem and that interest rates were going to rise.

Russia’s invasion of Ukraine in February was another piece of news that changed expectations. As well as being shocking, war means a greater mobilisation of resources by governments, and that means more borrowing and spending. War is inherently inflationary, and this war exacerbated an existing inflation problem. Energy prices in Europe soared, leading not only to price inflation, but a bigger risk of recession in major energy importing countries such as Germany, Japan and many others.

In China, decision-making that appeared increasingly arbitrary led to a series of surprises, including strict controls on technology platforms, tutoring and (video) gaming. The intensification of China’s Covid-Zero policy (until December, at least) caused discontent and led to challenges for global manufacturing suppliers, raising the price of many goods. And although little reported, China’s property bubble has burst, with risks for financial stability.

The mostly inflationary forces above resulted in higher prices almost everywhere, with essentials such as food and energy in particular now priced far higher than a year ago. Rising prices for essentials affects lower income countries and individuals disproportionately, and social and/or industrial unrest could be seen around the world, from South Korea to Sri Lanka, the UK to the USA.

A lot more than this happened in the past year - we haven’t even mentioned the strength of the US Dollar or the ‘flash crash’ in UK assets caused by the Truss/ Kwarteng mini-budget in September - but there isn’t enough space to cover all of it. Some investors might choose to ignore this news-stream and stick with a long-term investing plan. There’s some merit in this path. Other investors, though, might ask “What is likely to happen next, and how should I invest in anticipation of it?”

Outlook

Most economic and earnings forecasts fail, so we don’t aim to make precise forecasts for these. Instead, we build ‘scenarios’ as a framework for thinking about the future. We use current information and long-term 'baseline' asset returns to create our scenarios, and adjust them as new information comes along.

Most of our scenarios involve a near-global recession in the short-term. Some countries appear to be in recession already, although the US might just avoid one, due to its energy surplus.

A global recession sounds like a poor outlook for investors. Spending would cool, company earnings would likely fall, and unemployment would rise. But remember that it is changes in expectations that drive asset returns. Almost every economist (and journalist for that matter!) expects a recession. And on stock markets, large stocks have been out-performing small; and defensive stocks out-performing cyclicals, suggesting that investors too expect economies to be weak. Thus, it's clear that a slow-down or recession on its own would do little to change expectations.

Examining stock market history reveals that shares typically start to rise during a recession, several months before its end. Presumably, this is because they start anticipating the next stage of the cycle by then. As economies cool, inflation is likely to abate and central banks should start cutting policy interest rates. So, with economies already weak and recession widely expected, there is little reason to sell shares out of fear of economic weakness – it should be reflected in share prices already. Looking around the world, it's clear that economic weakness is very much reflected in UK, Japanese and emerging market shares. It's probably reflected in Continental European shares, but only partially discounted in the USA, where expectations are for inflation to abate by the summer and for company earnings to remain strong (this latter feels like a risky assumption). China looks too difficult to assess and come up with any meaningful conclusion.

Government bonds would probably 'enjoy' a recession. Corporate bonds would behave somewhere between government bonds and company shares.

In the UK, real estate investment trusts (REITs) trade on big discounts to their net asset values (some fell to 50% discounts following the Truss/Kwarteng mini-budget) indicating strong expectations for commercial property prices to fall. Property prices are indeed falling as interest rates rise, but these discounts look to be overdone. We used cash to add to REITs in the late autumn, there was an opportunity as the discounts were deeper than we felt was reasonable and it seemed sensible in terms of the price of REITs compared to the expected cash flows from these funds. There may be similar opportunities in the year ahead to invest in depressed emerging market funds and UK smaller/mid cap company funds.

There is the possibility of a medium-term 'capital expenditure' boom. The reasons for this are the need to invest globally for an energy transition, and the building out of new supply chains in light of the developing 'cold war' and lack of trust amongst China, USA, Russia and Europe. A capex boom would favour industrial, capital goods and commodity stocks, plus some energy firms. A rotation of sorts has already started in stock and bond markets, with companies involved in 'physical' goods now favoured over those in virtual or intangible fields. This rotation could last for quite some time, given such a long period of distaste (and low starting valuations) for 'physically-oriented' firms, such as industrial and basic material companies. The rotation could also favour certain countries, rich in manufacturing and energy resources.

Summary

2022 was a terrible year for most investors, as expectations changed for the worse. However, expectations are now set low and although 'bad' economic scenarios might occur, many of these appear to be 'priced in'. Perhaps the biggest market risk is if US company earnings disappoint, and US shares fall again. In most other stock markets, poor earnings are already expected, with the UK amongst the cheapest markets relative to others, and its own history. China looks too difficult to predict.

Most bonds look more sensibly priced, now that yields have moved up sharply from the tiny yields on offer a year ago.

It's important not to be scared out of investing by gloomy expectations that everyone else shares. Investing should be about changes in expectations, and that's a much more subtle endeavour. Today, asset prices are lower, expectations are lower and, in some places such as UK REITs, expectations look unrealistically low. 2023 will likely be noisy, but there should be some exceptional opportunities along the way to invest in depressed assets that offer solid returns.

Key facts about the world

United Kingdom

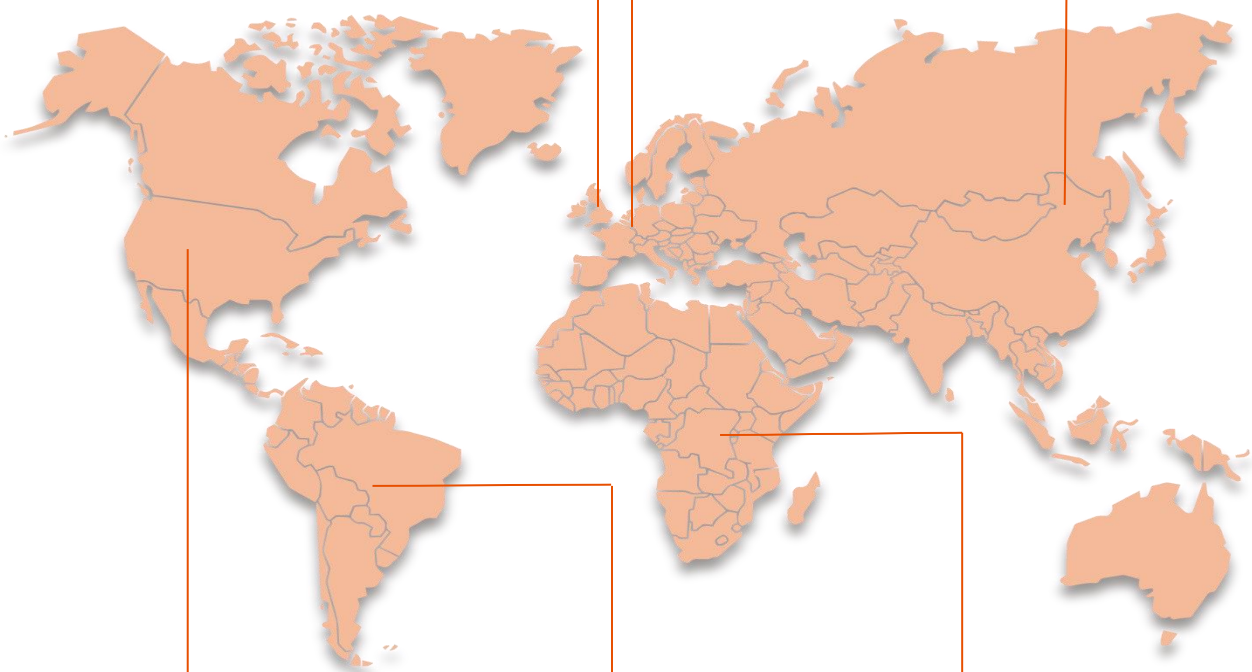
- Reforms to EU financial rules, relaxing ring-fencing, as well as introducing a mandate for UK financial regulators to focus on economic growth.
- £165mn coal mine, first for 30 years, given go ahead. Could be damaging to the UK's reputation as a global climate leader.
- Inflation hit 41 year high, rising to 11.1% in October, before declining to 10.5% in December.

Europe

- European embargo and $60 price cap set by G7 on Russian Crude oil.
- Germany completed construction of its first LNG import terminal, reducing its dependency on Russia.
- EU annual inflation was 10.1% in November, down from 10.6% in October.

Asia

- Shock reversal from Xi Jinping and the CCP on Covid restrictions, as it shifts away from zero-Covid policy.
- India's stock market hit all-time highs, up 7% this year, as outflows from China into India increase.
- Yen up from 32-year low, after Japanese government supported the currency with $64bn package, as well as in anticipation of easing of interest rate increases.



North America

- Federal Reserve warns US unemployment could hit 5% in 2023, up from current 3.7%.
- USD fallen from 20 year highs, inflation fears ease, and slowdown in interest rate rises expected.
- US mid-terms: Republicans won the House with 221 seats, whilst Democrats won majority in Senate by 51-49 margin.

South America

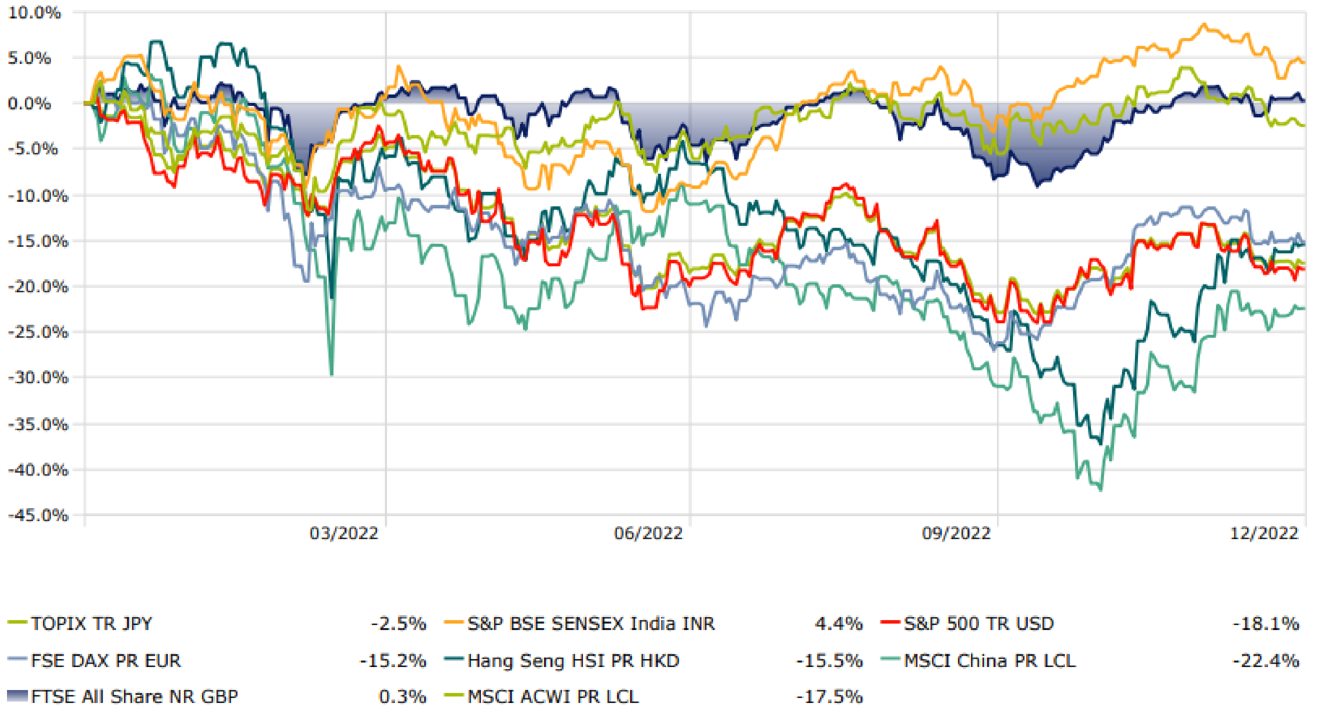
- Lula won the Brazilian election, as he seeks to raise country's mandated spending cap by $28bn.
- Brazilian lithium mine to be opened in 2023 with claims it has mineral reserves of 34mn to 55mn tonnes across its sites.
- EU trade deal with Chile, allowing EU countries easier access to Chile's lithium and copper reserves, important in the move towards renewable energy and away from Russian.

Africa

- Ghana begins talks with IMF over $3bn loan as it experiences a financial crisis. Its currency has fallen more than 50% against USD in 2022, as well as inflation hitting 40% and interest rates reaching 24.5%.
- COP27 climate conference held in Egypt, in which it was agreed $4 - 6tn a year needs to be invested in renewable energy until 2030, in order to reach net-zero emissions by 2050.

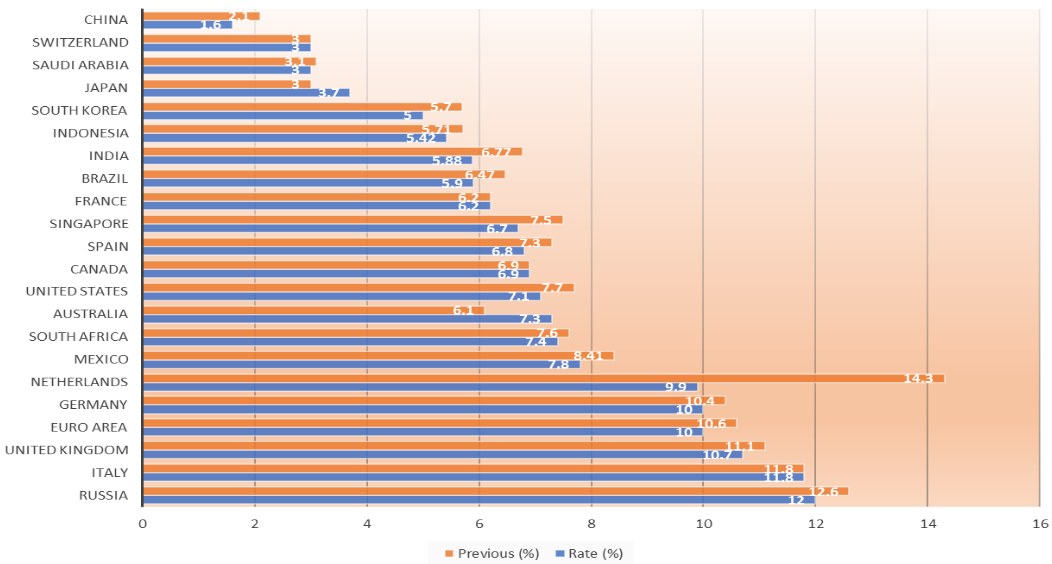
2022 in charts

Major market movements in local currency (1 year)



Source: Morningstar Direct, index list: UK (FTSE All Share), Japan (Topix), S&P BSE Sensex (India), S&P 500 (US), FSE DAX (Germany), Hang Seng HSI (Hong Kong), MSCI China and MSCI ACWI (All Country World Index GBP)

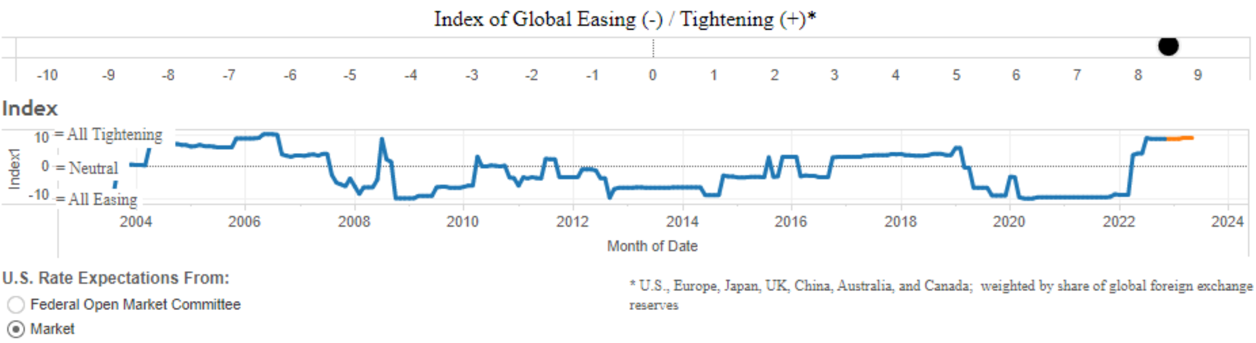
G20 Inflation Rates – latest reading versus previous month rate (Nov v Oct)



Source: OECD Economic Outlook Library. Argentina (88%/83%), Turkey (84.39%/85.51%) outliers removed

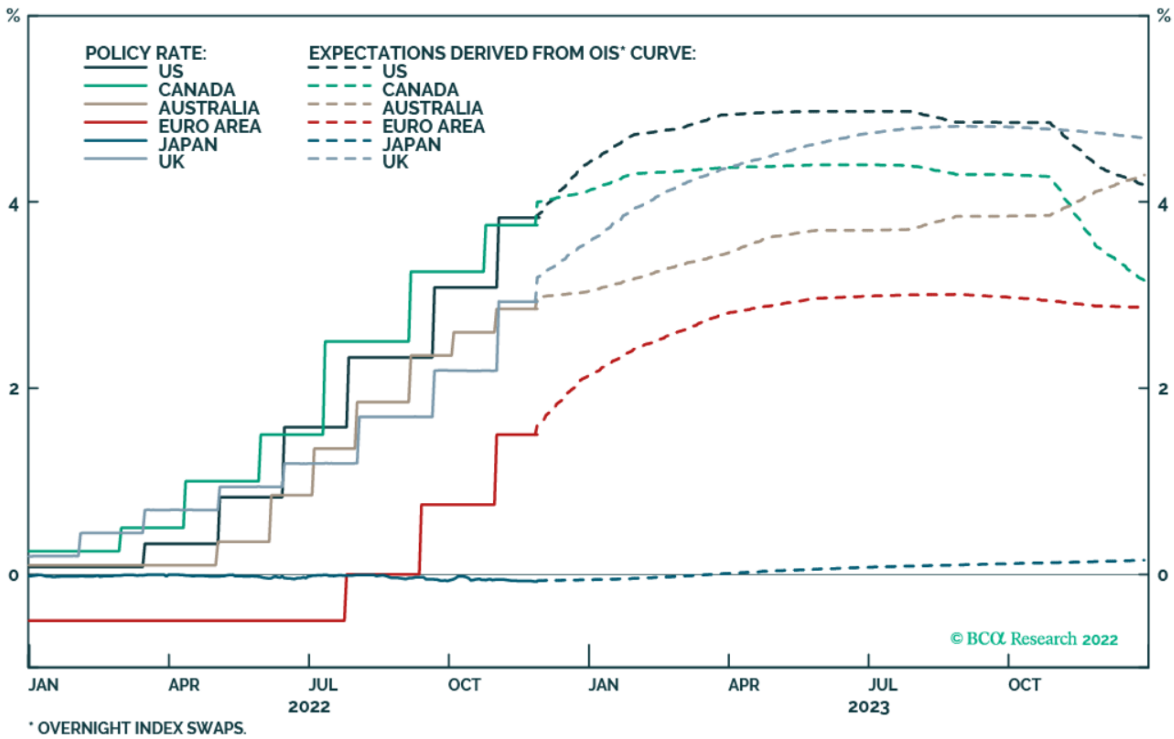
2022 in charts

Central banks tighten monetary policy after a decade of ‘loose money’



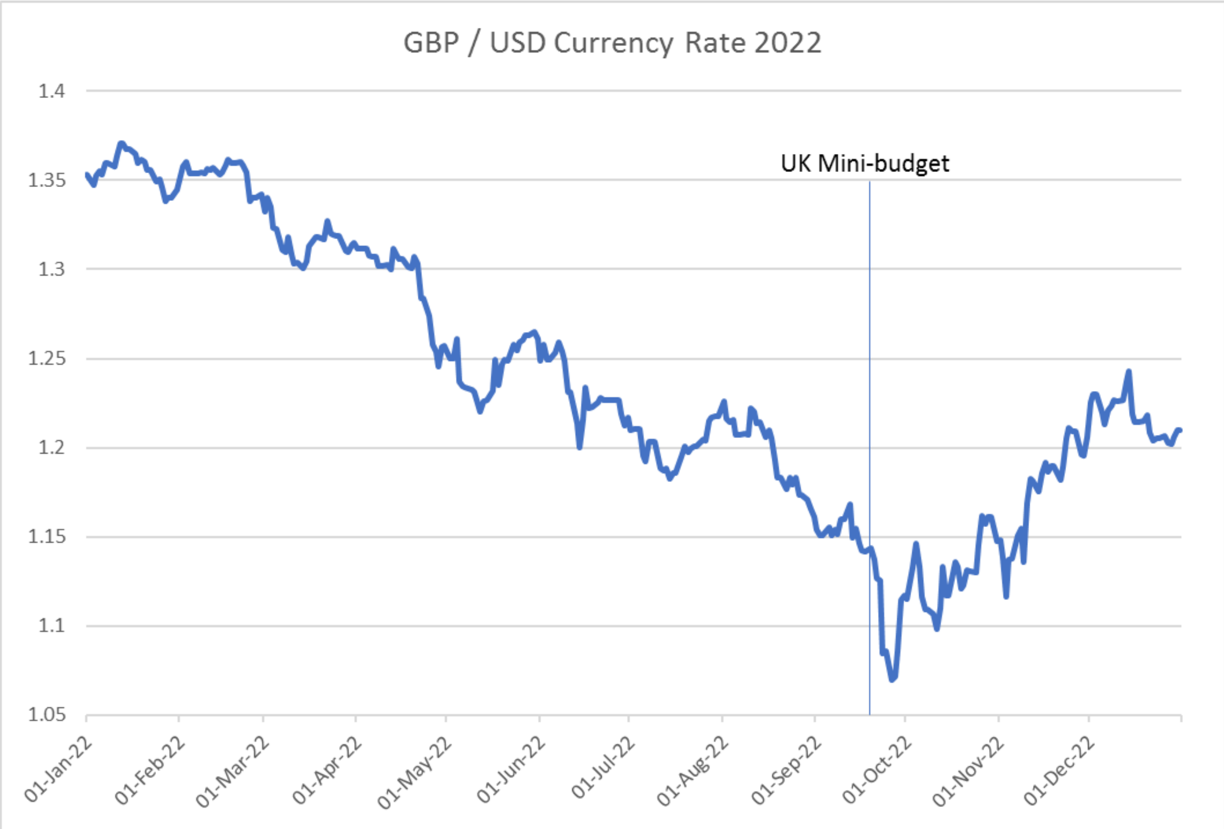
Source: Council on Foreign Regulations (CFR). CFR Global Monetary Policy Tracker

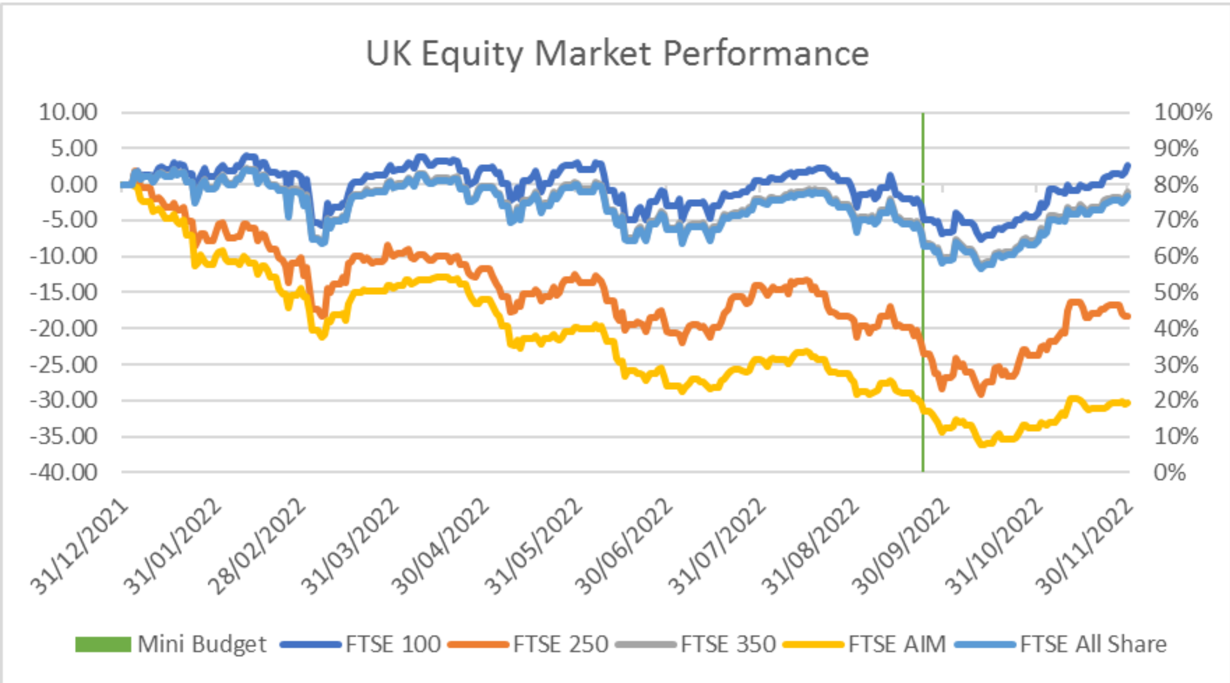
Inflation more than just ‘transitory’, with market expectations for interest rate rises now suggesting a peak later in 2023



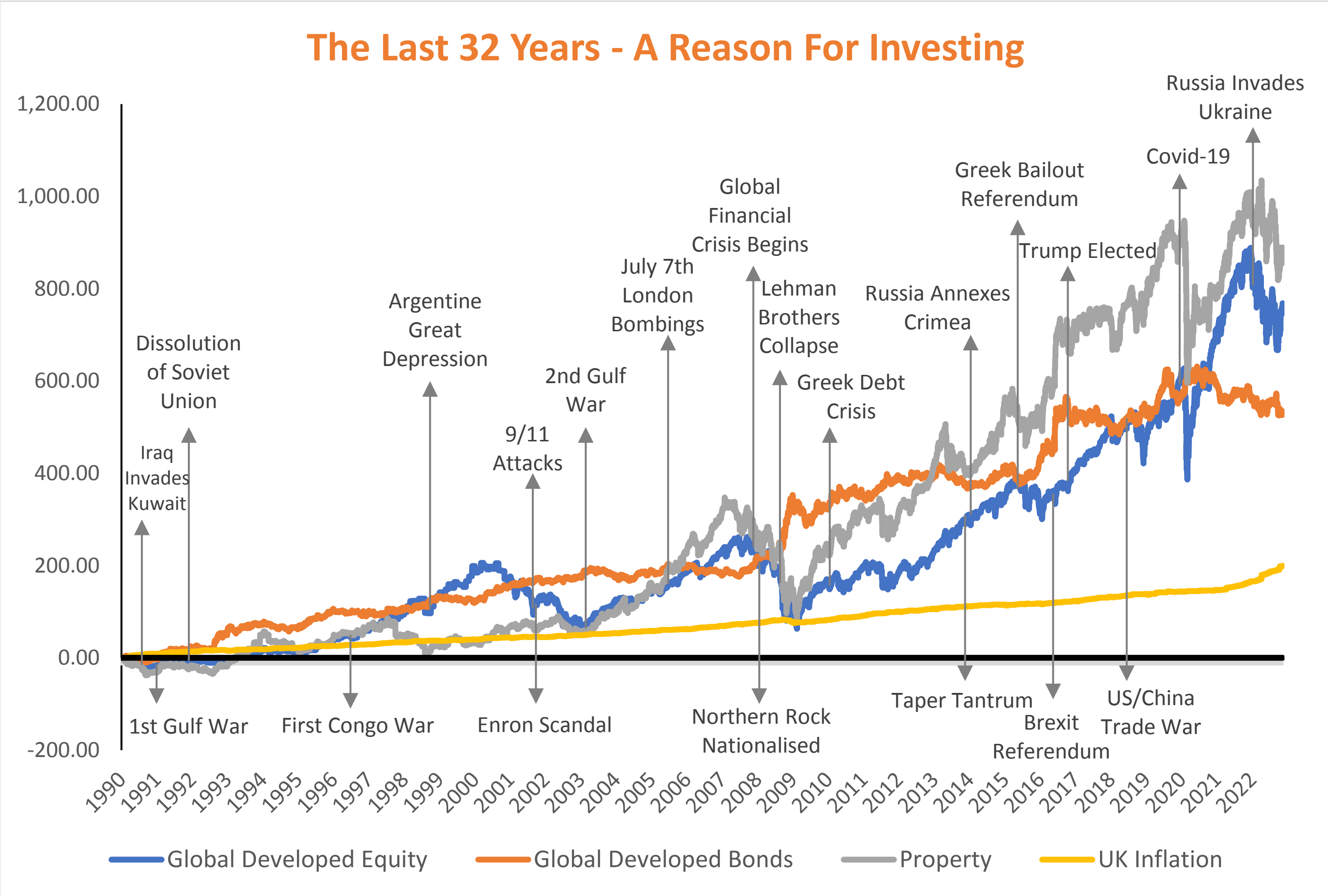
Source: BCA Research

Truss / Kwarteng mini-budget in September creates UK asset 'flash-crash'





Source: MMW Investment Team, Morningstar Direct. Sterling/US Dollar FX (Top), Core UK Indices (Bottom), decline and recovery post September mini-budget and end of Truss leadership



Source: MMW Investment Team, Morningstar Direct. Indices used: Global Developed Equity = MSCI World Net Revenue LCL, Global Developed Bonds = Bloomberg Global Aggregate Total Return USD, Property = S&P Global Property Total Return USD, UK Inflation = UK RPI

Short term events compel short term thinking and can impact the potential for long term portfolio gains. Market volatility is a fact of investing and not a bad thing in and of itself: for the patient, long term investor, it allows the opportunity to buy at lower prices.

It is inevitable that the value of investments will go up and down, the question is whether this volatility will influence you enough to make you over-react. Trying to "time" the market can increase the chances that you'll sell low, only to buy high when you reinvest later after prices recover/rise.

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2022 performance review - Unconstrained

- Global recession likely in next 12 months, but not yet fully priced into equity markets
- US Federal Reserve to err on side of caution towards inflation, even if growth slows, until confident core personal consumption expenditure (PCE) inflation on track for 2%
- US Recession likely to be mild, average length 10 months with stock low 4 months before end – suggests buying opportunity in second half of 2023
- For now, underweight equities, neutral government bonds, corporate credit and overweight inflation linked bonds
- Preference for alternative assets including low volatility strategies, real estate investment trusts and commodities
- Emerging markets ex-China could perform well after decade of low returns as dollar falls from recent highs

Respite in Q4

2022 has been a notoriously bad year for government bonds globally, as central banks embarked upon (or continued) interest rate hiking cycles to fight rocketing levels of inflation. However, we believe this reset in bonds has offered an attractive opportunity for topping up government, inflation linked and investment grade corporate bonds, where we see attractive potential returns in this new interest rate environment.

Equities have faced a similarly volatile year, but finally showed some resilience in Q4 on a combination of easing politics in the UK and US (post-new leadership and mid-terms), China's decision to roll back Covid Zero policy, and what was initially a mild run of weather into December dampening demand for fuel. However, natural gas prices still trade at twice the price from the start of the year and nearly 3.5x their pre-Covid levels. We also remain sceptical on China – even if the Covid policy U-turn allows some recovery in the market, it is unlikely to be back to pre-Covid growth levels soon (if ever), making it one of the least attractive emerging markets for the level of risk implied through increased government intervention and a possible property crash.

Our top performing positions have been Downing Renewables & Infrastructure (+14.67%), Prusik Asian Equity Income (+10.82% since Feb) and BNY Mellon Sustainable Global Equity (+5.11%), highlighting the importance of the sustainable, income and value themes. We are also pleased to see new addition BlackRock Natural Resources +5.13%, performing well since introduced. Unfortunately, weakness in the UK small cap market and a corporate restructure saw the Jupiter UK Smaller Companies Fund sold after lagging its benchmark. Following a disappointing review with the manager, we switched exposure to existing UK holding River & Mercantile UK Recovery (-5.59%) and the introduction of the Montanaro Income Fund (+14.0% since added in October).

Given the current tricky environment, we continue to recommend a well-diversified, balanced approach, with an underweight on equities and preference for some bonds, REIT's and alternatives. However, we do not want to overstay our welcome in the bearish camp, and would look for a buying opportunity for risk assets sometime in mid-2023.

SECTOR	3 months	1 year to 31/12/22	1 year to 31/12/21	1 year to 31/12/20	1 year to 31/12/19	1 year to 31/12/18	5 years (annualised)
IA Japan	3.6%	-8.4%	1.6%	13.9%	17.1%	-11.3%	1.9%
IA Asia Pacific Excluding Japan	3.8%	-6.8%	1.5%	19.9%	15.9%	-9.8%	3.5%
IA Global Emerging Markets	1.8%	-12.3%	-0.4%	13.6%	15.8%	-11.5%	0.3%
IA North America	-0.7%	-10.1%	25.3%	16.5%	24.6%	-1.2%	10.1%
IA UK Smaller Companies	8.6%	-25.6%	20.6%	7.0%	25.4%	-11.8%	1.2%
IA UK Index Linked Gilts	-1.6%	-35.3%	3.9%	11.9%	5.9%	-0.5%	-4.5%
IA Property	-9.1%	-7.8%	7.4%	-3.8%	-0.8%	2.9%	-0.6%
IA UK Equity Income	10.6%	-2.2%	18.3%	-10.9%	20.1%	-10.5%	2.1%
IA £ Corporate Bond	5.7%	-16.3%	-1.9%	7.9%	9.5%	-2.2%	-1.1%
IA Europe Excluding UK	12.6%	-8.9%	15.6%	10.5%	20.4%	-12.2%	4.2%

Source: Morningstar, bid-bid pricing, net income

2022 performance review – Ethical strategies

- Long-term ESG themes were reinforced by the Covid-19 crisis and Ukraine war in 2022
- A decelerating economy in 2023 with high inflation should favour ESG with a best-in-class approach
- Key focus on energy transition (post-crisis), food security and infrastructure (energy and geopolitical re-shoring trend)
- Social themes may be back in focus, as the deteriorating labour market and ongoing high inflation will call for more attention towards social well-being
- "Bonds are back" is also an investor theme as we enter 2023 with a focus on high-quality credit
- Equities will offer entry points during the year, but favour developed US and Europe quality/value/dividend tilt where possible

ESG / Ethical trends reinforced

Ethical investors have faced a particularly challenging year. They have been unable to benefit from the few areas that have consistently performed well, especially from market leaders such as fossil fuel/energy companies. However, the broader reset in equity and bond markets that has been felt so keenly in ethical corners, now offers a much more attractive outlook for an investment approach that has weathered numerous setbacks throughout the year. From an uninspiring COP27 after the progress and hopes raised in Glasgow a year earlier, to governments turning to environmentally harmful fossil fuels to address a short term energy crisis. Hopes are that the majority of the negative news flow is now priced into these assets which should continue to benefit from the long term structural shifts taking place in the way we live and invest.

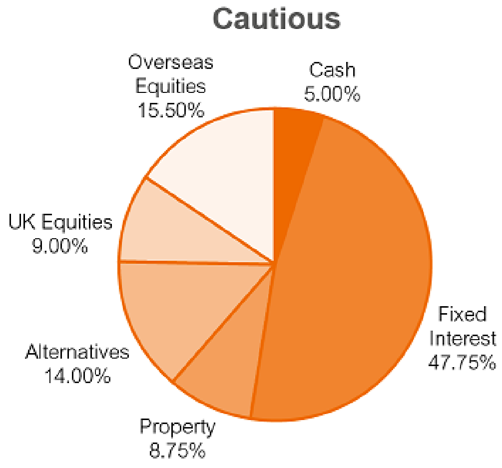
Within our own strategies, we faced an additional setback from former favourite Home REIT, which faced a short seller attack from Viceroy Research, with a list of allegations about the practices of the specialist social housing provider. While the Board of Home REIT denied claims that it had invested in assets not consistent with its socially responsible investment approach, we felt the full defence and subsequent actions taken by the investment manager, still left question marks regarding their governance standards (the G in ESG). We therefore made the difficult decision to exit the position. Although the government continues to guarantee the cash flows which could eventually aid a recovery in share price, for now, the holding no longer meets our strict ethical inclusion criteria.

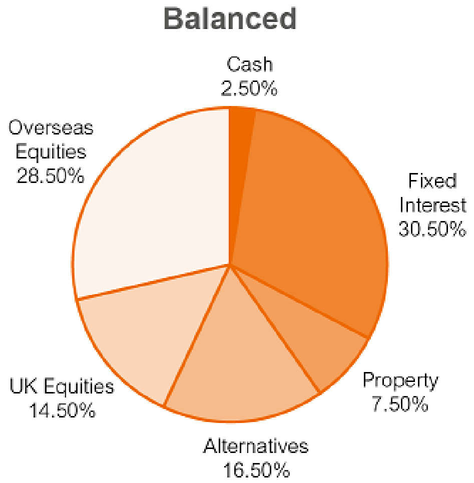
Elsewhere within strategies, new entrant at the start of the year, Edentree Global Impact Bond Fund (-13.49%) has continued to show lower volatility than wider bond markets, even its IA £ Corporate Bond equivalent (-15.36%) which is unconstrained. The Downing Renewables & Infrastructure position (+14.68%) has been a very bright spot in performance, highlighting the importance of focusing on real assets, particularly in the clean energy/energy transition space. In equity, the new Janus Henderson UK Responsible fund has shown resilience, down -3.3% since added in May. All equity positions have enjoyed some respite into year-end as geopolitical, Covid and inflation issues show early signs of easing, but we remain cautious into the start of 2023.

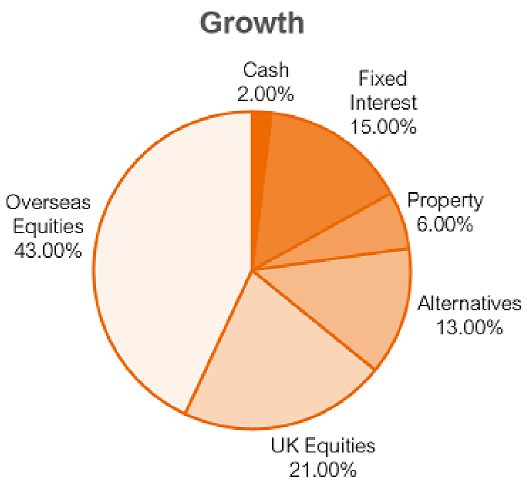
SECTOR	3 months	1 year to 31/12/22	1 year to 31/12/21	1 year to 31/12/20	1 year to 31/12/19	1 year to 31/12/18	5 years (annualised)
Morningstar Global	11.3%	-20%	18.6%	13.8%	24.6%	-10.5%	3.8%
Morningstar UK ESG	17.9%	-14.5%	17.9%	-8.9%	25.0%	-13.3%	-0.1%
Morningstar US ESG	7.2%	-21.1%	28.6%	20.6%	32.6%	-3.1%	9.5%
Morningstar DM Europe	18.0%	-21.3%	19.2%	12.5%	27.7%	-11.2%	3.7%
Morningstar EM ESG	8.7%	-21.0%	-3.5%	12.1%	16.0%	-15.7%	-3.5%
Morningstar UK Corp Bond	15.6%	-29.6%	-4.3%	12.4%	15.3%	-7.4%	-4.1%
Morningstar Global Corp	5.7%	-17.3%	-3.5%	11.1%	11.0%	-3.2%	-1.0%
Bloomberg MSCI Global	6.3%	-22.7%	-7.8%	12.7%	6.4%	-3.4%	-3.8%
Morningstar Global	12.2%	-12.2%	11.0%	27.6%	25.2%	-8.5%	7.3%
MSCI ACWI NR USD	9.8%	-18.4%	18.5%	16.3%	26.6%	-9.4%	5.2%

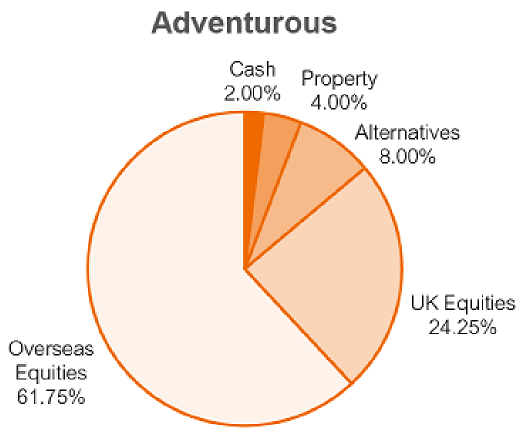
Source: Morningstar, bid-bid pricing, net income

The positioning of our Unconstrained strategies

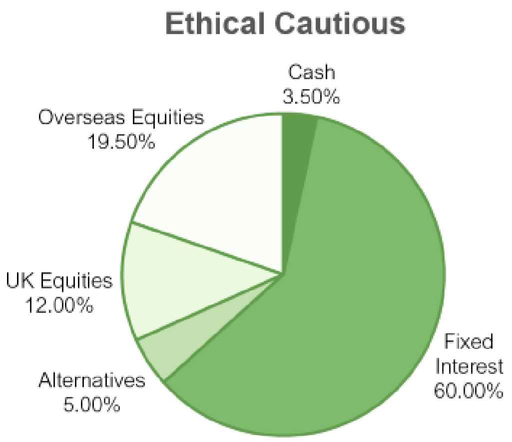


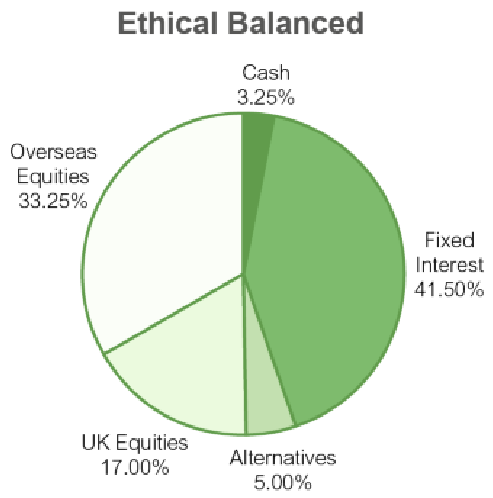


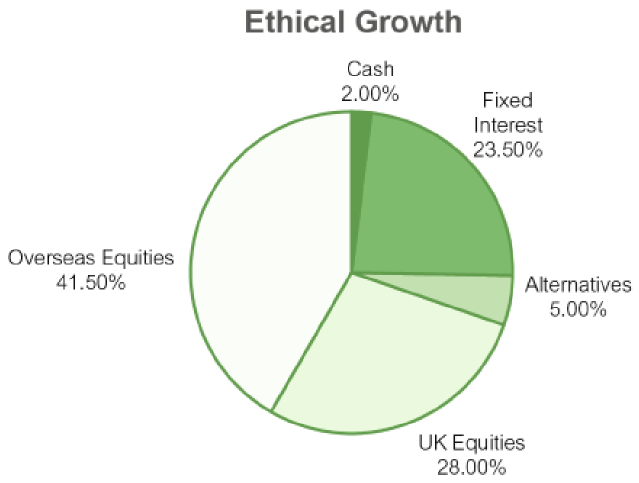


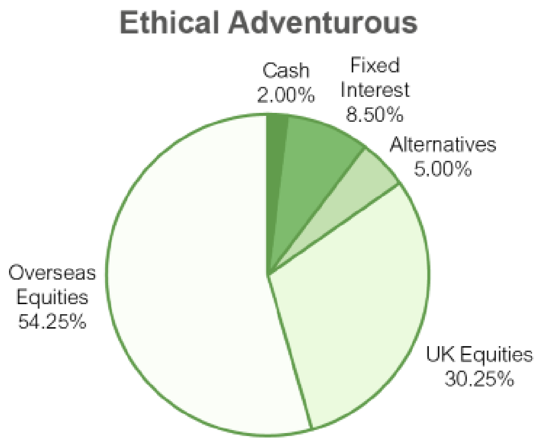


The positioning of our Ethical strategies









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