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Keeping you informed matters

Economic review

April 2023

Outlook

Inflation continues to drive wider market sentiment and the failure of Silicon Valley Bank in the US triggers a new financial crisis. Although not comparable to the Global Financial Crisis in 2008, the balancing act for central banks today is no less hazardous as credit conditions tighten and the risk of recession rises.

Investors started the year expecting interest rates to rise further, as central banks battled to bring inflation under control. They also expected a global economic recession, after seeing patterns in markets that often precede recessions. Professional economists, too, predicted recession, with the Bank of England particularly gloomy as the year began.

Most developed countries had experienced over a decade of 'cheap money' before price inflation started to surge, roughly two years ago. To counter it, central banks have been raising interest rates, slowly at first and then more rapidly. As rates rose, a series of speculative assets - including 'meme' stocks, profitless technology firms and crypto-currencies - crashed in price. Although the speculative mania might have seemed exciting at the time, it's now obvious to just about everyone that these 'assets' had been mis-priced.

Early in the quarter, most measures of economic activity, such as retail sales and employment, proved much stronger than expected. Also, energy prices had been falling, and this raised hopes that the worst might be behind us. Perhaps inflation would fade and there would be no recession after all?

Then, in March, we saw a series of bank failures. Like the speculative assets that had crashed before them, these banking collapses were related to rising interest rates and falling asset prices. However, they were exacerbated by poor risk management: "Silicon Valley Bank's failure is a textbook case of mismanagement," Michael Barr, of the US Federal Reserve, argued a couple of weeks after the bank failed.

Market expectations changed again. Would there be 'contagion' to other banks? Banks would almost certainly become more cautious and tighten their lending standards. This would slow economic activity, helping the central banks in their fight against inflation. At the end of the quarter, asset markets were 'flip-flopping' between fears of financial contagion and hopes for a new cycle of interest rates cuts. 'Uncertainty' and 'sharply changing expectations' probably best sums up the quarter.

To help us think about markets, we consider a variety of possible economic and market scenarios, both positive and negative. The most likely scenario, in our view, is for a mild recession in most developed countries. Corporate earnings in the USA are likely to weaken, and, with valuations (such as the cyclically-adjusted price-to-earnings ratio) still high there, we have allocated less money than usual to the US stock market. We have virtually no exposure to private equity and the speculative stock 'eco-system' which should be hurt by tighter lending standards and constrained access to capital.

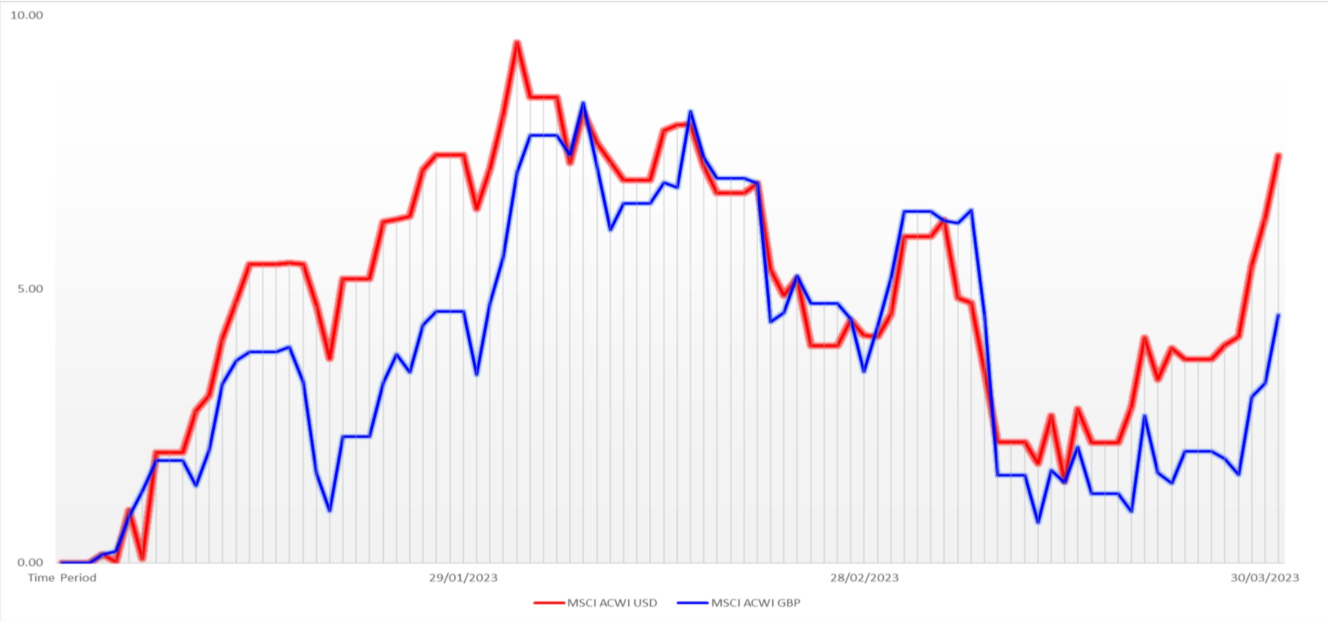
The positive news is that other asset classes already embed cautious expectations. Many shares listed on the UK, Japanese and 'emerging market' stock markets, for example, look like sensibly-priced investments over any reasonable time horizon.

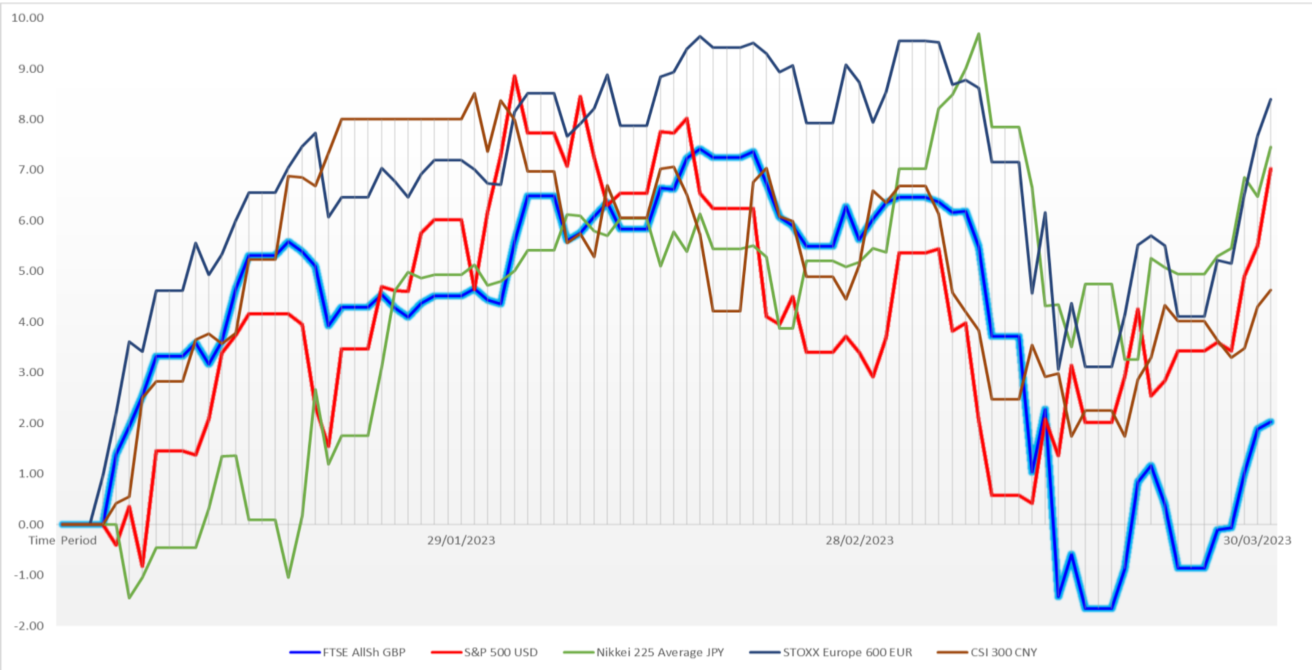
Several other kinds of asset are attractively priced. For example, it is possible to earn a yield of over 6% from owning investment-grade bonds that are due to mature in the next couple of years. These bonds have limited interest rate risk or credit risk. "You can achieve a handsome return in short dated investment grade bonds, whilst keeping capital relatively safe and volatility low" writes Chris Bowie, manager of the TwentyFour Sustainable Short Term Bond income strategy, a fund in which we invest for ethical clients.

Another example would be UK-listed real estate investment trusts. These invest in commercial properties, many of which have already been re-valued downwards to reflect higher interest rates. However, these trusts typically trade at discounts of 20-30% to the new, lowered valuations of the underlying properties, and offer yields of around 6.5% to investors today. These, too, look sensible, as part of a diversified portfolio.

In summary, we are able to build portfolios that reduce risk by being well diversified across asset classes, while offering cash flow yields that we expect to exceed inflation in the year ahead. Ultimately, it is the sustainable cash-flow generation of the underlying assets that creates wealth for investors, and such cash flows are currently available in quite a few markets at attractive prices.

Equity Markets 'Flip-flop' in Q1





Source: Morningstar. (Upper) MSCI All Country World Index (ACWI) in USD and GBP. (Lower) UK, US, Japan, Europe and China major indices in local currency

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Key facts about the world

United Kingdom

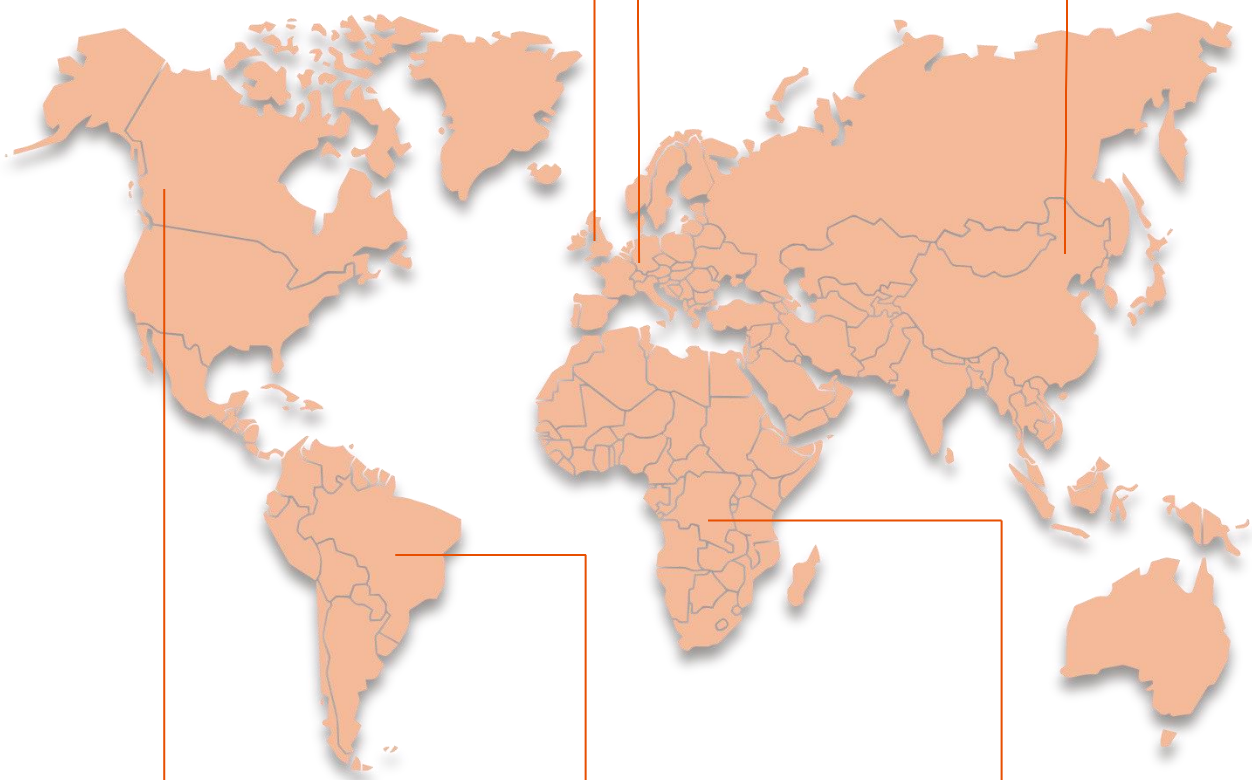
- HSBC buys UK arm of collapsed Silicon Valley Bank (SVB) in the US for symbolic £1.
- BoE raises interest rates from 3.5% to 4.25% in Q1.
- Inflation unexpectedly rises to 10.4% in February. Upbeat budget, including elimination of the £1mn pension lifetime allowance.

Europe

- UK and EU agree post Brexit deal on Northern Ireland.
- Credit Suisse rescued by UBS in $3.25bn emergency takeover.
- ECB raises interest rates from 2.5% to 3% in Q1, despite the banking sector turmoil and as inflation declined to a one-year low in March.

Asia

- China's consumer spending up 3.5% YoY in the first 2 months after declines in previous 3 months.
- Equities recorded a positive Q1, with strong gains in Taiwan, Singapore and South Korea offsetting weaker performances in Hong Kong, India and Malaysia.



North America

- Mini banking crisis begins, as SVB fails, the second largest bank collapse in US history and largest since 2008.
- Interest rates raised from 4.5% to 5% in Q1, with market now pricing cuts before year end.
- US employment in February adds 311,000 jobs, higher than forecast, but unemployment also up to 3.6%.

South America

- Argentina's inflation rate exceeded 100% for the previous year, led by surging food prices after poor weather.
- In New York, Argentina lost a $10+billion lawsuit over its 2012 expropriation of oil firm YPF.
- The IMF is in the midst of a multi-year $44billion bailout package for the Argentine Republic.

Africa

- China finally agrees with the World Bank and IMF on a common approach to debt re-structuring with Ghana and Zambia amongst the first that could see their foreign debt-restructured as a result.
- This should allow for new loans from international agencies, to avert potential economic crises in these countries.

Q1 Performance Review – Unconstrained strategies

Key facts

- The rapid chain of events from the failure of SVB and wider financial contagion risk has altered short term expectations
- Recession risk has increased with credit conditions tightening
- Peak interest rates potentially reached, with markets now suggesting a pivot and cuts by year end
- Diversification in bond and equity allocations essential with significant uncertainty over the next quarter

News travels fast and events move financial markets quickly, but none more so than for fixed income investing and bond prices. Up until March, expectations were for rates to rise until inflation was under control. One financial crisis later and suggestions are that we've now reached peak rates and cuts are coming by year end. In this environment, with credit conditions tightening and uncertainty over inflation, interest rates and the risk of a recession rising, a balanced, lower risk spread in your bonds is sensible.

In Q1 we have seen this rapid shift in expectations drive mark-to-market yields (the yield if bonds are held to maturity) in our investment grade corporate bond funds - the Artemis Corporate Bond Fund (+1.83%) and TwentyFour Corporate Bond Fund (+2.13%) - rise to 6.39% and 5.94% respectively. And of course, with inflation remaining higher and likely for longer than expected, we continue to favour index linked funds currently, with the L&G Index Linked Gilt Index (+4.68%) a core position.

In equities, quality and growth factors have driven returns in the quarter as investors sought safety in the face of renewed recession fears and stickier inflation numbers. We remain underweight in the US, with valuations still rich and not fully pricing in all of the risks we see there. The Loomis Sayles US Equity Leaders fund (+16.45%) enjoyed a strong quarter, and we have used the opportunity to reduce the position in this growth focused strategy, adding a position in the passive XTrackers S&P 500 Equal Weight ETF. By having equal sized positions representing the entire index, it naturally underplays the dominant growth companies and provides increased exposure to smaller, value companies that we have had less exposure to. This brings balance to the US allocation, where last season's performers are unlikely to be the leaders going forwards.

In our UK equity exposure, we have sold the L&G Sustainable UK Equity Fund (+5.84%), where we had concerns over performance and management engagement. Since then, we understand the manager has left the company and as yet, has not been replaced. No other major equity changes have taken place, but we are pleased to see solid performance from our quality growth and defensive funds such as Lindsell Train Global Equity (+4.37%) and Guinness Global Equity (+2.66%). The alternative assets, including Downing Renewables & Infrastructure Trust (+1.07%) and Fortem Progressive Growth (+4.57%) continued to provide lower volatility returns, and despite the falls in underlying asset value of the real estate investment trusts (REITs) and deep discounts, the recovery in rent collections and rising dividend yields reassures us for the next phase of the cycle.

SECTOR	Q1 2023	1 year to 31/03/23	1 year to 31/03/22	1 year to 31/03/21	1 year to 31/03/20	1 year to 31/03/19	5 years (annualised)
IA UK Index Linked Gilts	5.1%	-27.1%	3.8%	-1.0%	5.3%	6.3%	-3.4%
IA £ Corporate Bond	2.2%	-9.4%	-4.4%	9.2%	0.8%	3.0%	-0.4%
IA Property	-0.4%	-10.7%	10.5%	-2.3%	-2.6%	2.3%	-0.8%
IA UK Equity Income	1.9%	-0.3%	10.8%	32.5%	-20.7%	3.6%	3.7%
IA UK Smaller Companies	-3.0%	-17.0%	-3.8%	67.4%	-18.2%	-2.6%	1.3%
IA North America	3.2%	-4.4%	15.9%	42.5%	-3.9%	15.8%	11.9%
IA Europe Excluding UK	8.1%	6.6%	4.4%	39.5%	-9.2%	-1.2%	6.8%
IA Japan	3.2%	0.4%	-4.5%	31.9%	-3.6%	-3.5%	3.3%
IA Asia Pacific Excluding Japan	1.4%	-2.4%	-5.1%	48.5%	-11.3%	3.2%	4.7%
IA Global Emerging Markets	1.8%	-4.4%	-8.7%	47.3%	-15.8%	-1.3%	1.3%

Source: Morningstar, bid-bid pricing. Net income reinvested. Past performance is not a reliable indicator of future results.

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Q1 Performance Review – Ethical strategies

Key facts

- The rapid chain of events from the failure of SVB and wider financial contagion risk has altered short term expectations
- Recession risk has increased with credit conditions tightening
- Peak interest rates potentially reached, with markets now suggesting a pivot and cuts by year end
- Diversification in bond and equity allocations essential with significant uncertainty over the next quarter

While events in the US banking sector, with the failure of SVB and Signature, have bled into the wider financial system, for ethical investors just like the central banks and policymakers, the key factor driving fixed income decisions remains the interaction of rising interest rates and inflation on bond prices.

The correlation in the existing bond fund exposure has been high and more volatile than we prefer, given the reduced opportunity set with our ethical exclusions. However, during the quarter we have introduced a new position in the Vontobel TwentyFour Sustainable Short Term Bond Income fund. This is a high quality, low duration (less than 2 years to maturity of the underlying bonds) fund with an attractive yield (c5.5%) from a specialist fixed income investment house. The manager is a proven navigator of difficult market periods, which we believe is a good combination alongside existing funds and should act to reduce overall volatility, whilst maintaining a sustainable and high level of return.

Within equity allocations, we have seen a much more pleasing period for the UK funds, with continued strength from recent addition Janus Henderson UK Responsible Income (+4.98%) in particular, but also the high quality growth focused abrdn UK Ethical Equity fund (+4.13%) – versus the FTSE All Share index up 3.08%. While our view remains that the UK is heading for a recession given the inflation outlook, we are maintaining our current exposure because we still see from a valuation perspective that it is “cheap” relative to long term levels and against other developed markets. Any shift in sentiment and improvement in outlook could see a period of ‘catch-up’ and swift recovery.

The Janus Henderson Global Sustainable Equity fund (+5.83%) performed well in Q1 as investors sought the security of high quality growth and established technology companies as the increased threat of recession dictated risk appetite. On the flip-side of this trade, the BNY Mellon Sustainable Global Equity Fund (+0.92%), which has been a top performer over the last year, was more subdued as its value bias was out of favour. However, the combination of these styles and the diversification they offer for the uncertain period ahead is still important and we are maintaining positions accordingly. As we approach an inflection point for inflation as interest rate rises begin to bite, keeping a broad balance of assets, by region, industry and style will become increasingly important until the impact can be fully assessed on the long term drivers for ethical, responsible and sustainable investing.

SECTOR	Q1 2023	1 year to 31/03/23	1 year to 31/03/22	1 year to 31/03/21	1 year to 31/03/20	1 year to 31/03/19	5 years (annualised)
Morningstar Global Sustainable	7.6%	-7.4%	5.4%	50.0%	-11.0%	0.6%	5.6%
Morningstar UK ESG Enhanced	7.3%	-3.1%	5.6%	38.9%	-22.2%	-0.3%	2.0%
Morningstar US ESG Enhanced	8.1%	-8.9%	13.7%	59.0%	-6.6%	10.8%	11.2%
Morningstar DM Europe Sust	11.1%	-2.2%	3.2%	49.8%	-10.9%	-0.2%	6.1%
Morningstar EM ESG Enhanced	2.4%	-13.5%	-11.3%	52.9%	-20.6%	-8.5%	-3.2%
Morningstar UK Corp Bond Sust	5.3%	-18.0%	-9.8%	21.0%	-4.3%	-3.0%	-3.6%
Morningstar Gbl Corp Bd Sust	3.5%	-7.5%	-6.3%	10.5%	2.3%	1.3%	-0.2%
Bloomberg MSCI Gbl Green Bd	3.7%	-12.7%	-10.5%	10.4%	0.6%	-2.2%	-3.2%
Morningstar Gbl Renew Energy	5.3%	-3.0%	2.2%	73.9%	-15.4%	3.6%	8.6%

Source: Morningstar, bid-bid pricing. Net income reinvested. Past performance is not a reliable indicator of future results.

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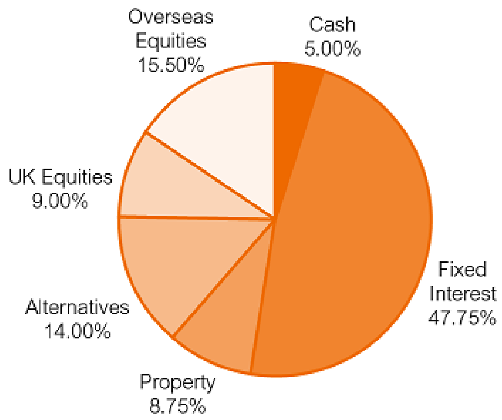
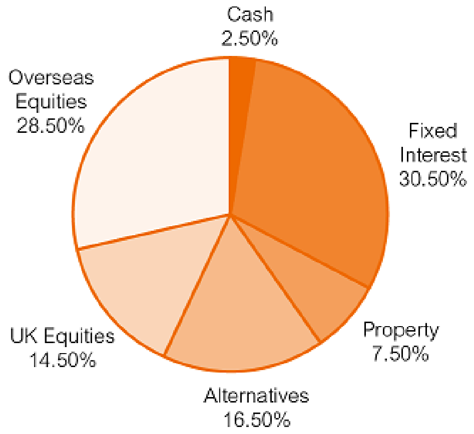
The positioning of our Unconstrained strategies

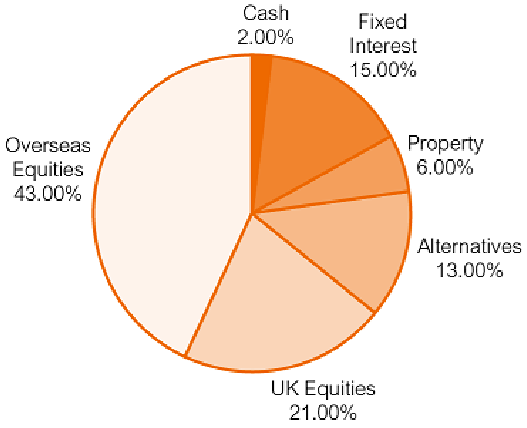
Cautious



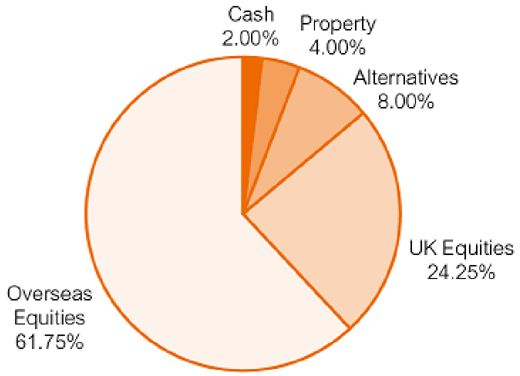
Balanced



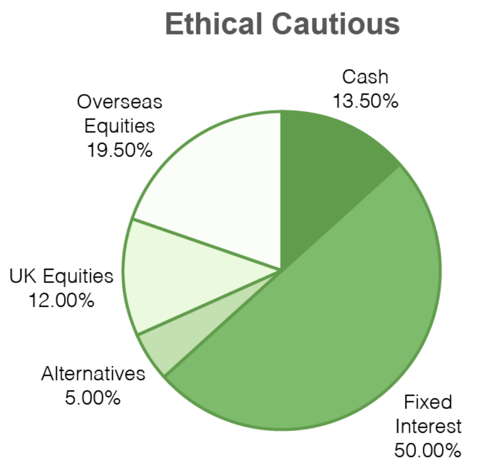
Growth

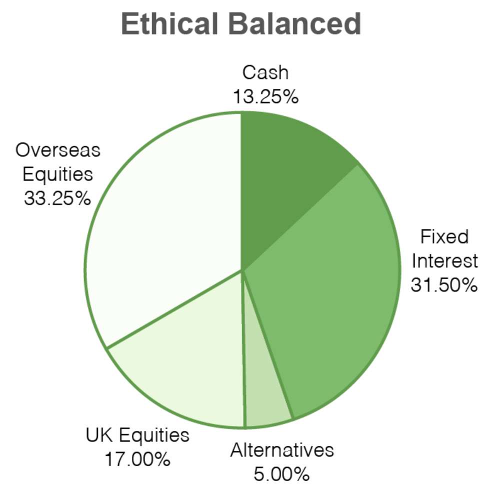


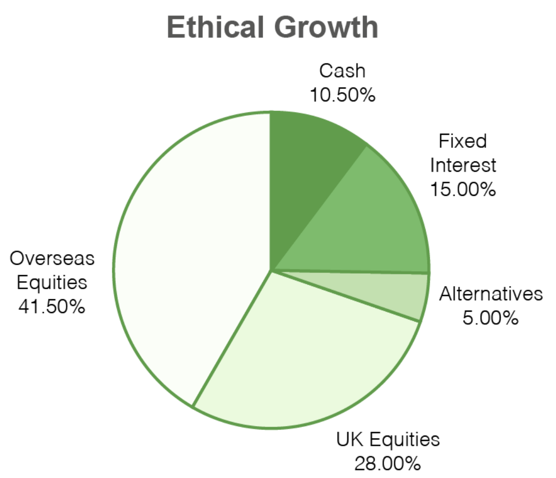
Adventurous

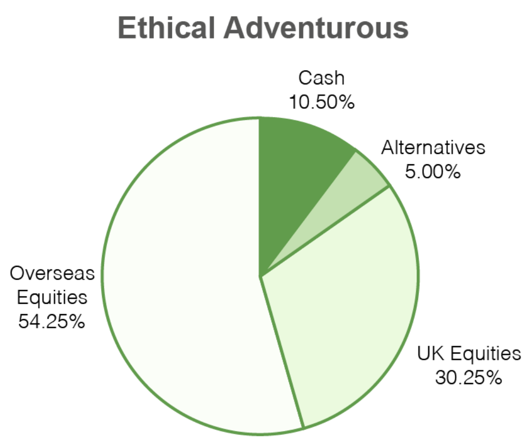


The positioning of our Ethical strategies









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MM Wealth Ltd Wellbrook Court, Girton, Cambridge CB3 0NA 01223 233331 info@mmwealth.co.uk