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Keeping you informed matters

Economic review

July 2022

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Outlook

Regime change: economic, geo-political and environmental. The perfect storm as the tailwinds of the last decade transition to headwinds, challenging long term growth expectations as Covid, inflation and the war in Ukraine become entrenched.

At the start of the year, we envisaged a number of key themes that would direct markets over the course of 2022, from the changing inflation outlook and central bank policy divergence, to geo-politics and company valuation imbalances. Never though, would we have anticipated quite the combination of events that have created the perfect storm for investors as we have over the last 6 months.

The pandemic of course, continues to disrupt markets globally, whether directly or indirectly. Spiralling rates of infection in most developed economies regardless of the success or otherwise of their vaccination efforts, have left companies with unusually high levels of absentees. Dominating emerging market headlines has been China's rigid zero-Covid policy and rolling lockdowns as infection rates rise and fall, which have continued to cause supply chain disruption globally.

The simple knock-on effect of Covid and the disruption to manufacturing and services it creates has been inflation. After decades of low and falling inflation in a world where more goods were produced than could ever be consumed, the sudden change in dynamic of supply and demand has been significant. Persistent supply chain issues have made the production of a whole raft of goods and services suboptimal, while demand has been driven by the enormous pools of cash sitting in consumers' bank accounts as a result of fiscal stimulus driving savings ratios to record levels.

So the first regime change has been the transition to accepting a higher inflation and rising interest rate environment. Central banks' initial response has been slow, but perhaps after decades of low inflation and declining or negative interest rates, they could be forgiven. However, their contribution to this artificial backdrop has been years of ultra-loose monetary policy and quantitative easing in response to every crisis, which has led to huge fiscal expansion and a world built on debt. Perhaps then, they should have known better and acted sooner.

The war in Ukraine has then been a rude awakening for the world order and continues to impact global trade, logistics and prices. Exacerbating the inflationary backdrop, the war has exposed the West's dependence on Russian energy and Ukrainian wheat exports as the breadbasket of Europe. Also, where Covid had seen countries and industry begin the process of onshoring manufacturing, turning the tide on decades of globalisation, the further fragmentation of supply chains can only lead to faster deglobalisation. This will be no doubt be exemplified by the rise of nationalism and populism, just when the opposite is needed.

In the short term, we expect old economy industries such as oil and gas, mining and defence to see renewed investor interest as the West seeks to decouple from Russia. However, longer term this is unsustainable and will feed into the final pillar of regime change which is the need to combat environmental degradation. Fire and flood, drought and famine, war and population migration all lead to rising cost pressures.

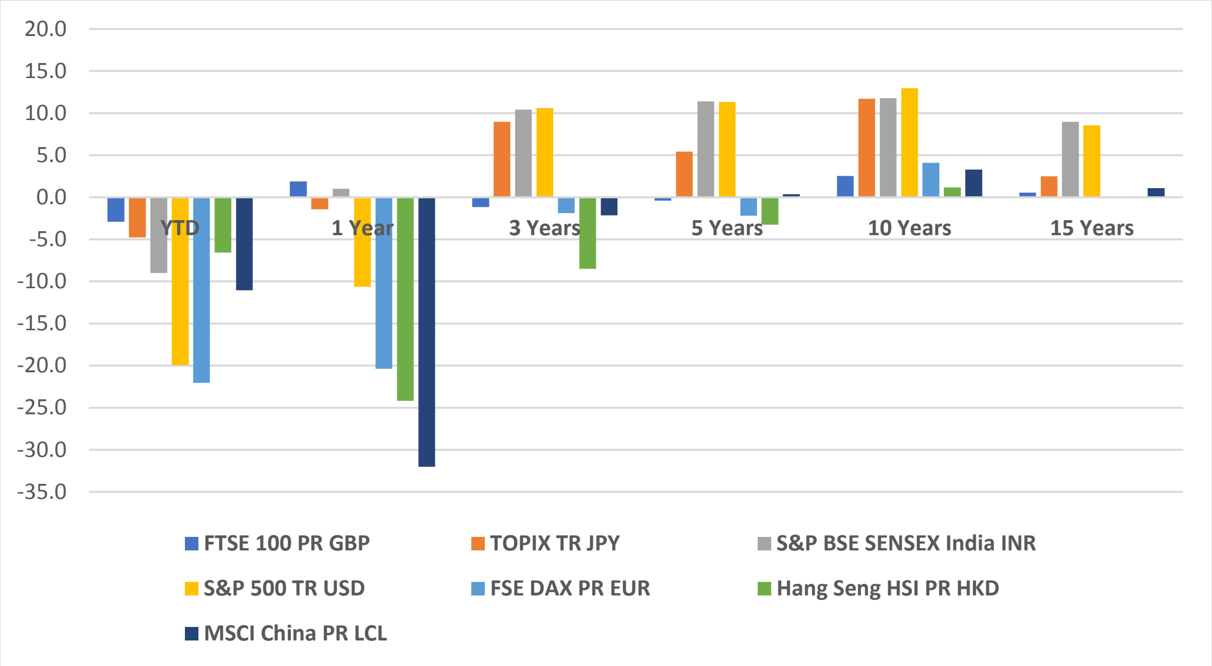
Without doubt, every political leader of any background now faces increasing calls to ensure not just energy security, through green and renewable sources, but also food and water security. The cost of living crisis is a global phenomenon that central bank action will have little impact on. Unless these core energy and food cost issues can be addressed, it is likely to lead to an extended period – years not months – of inflation spikes as supply chains shift and demand increases in line with population expansion.

For now, the key to progress in markets is the immediate direction of inflation. This will not be consistent across all economies, with the US for example, likely to have seen peak inflation where they are more energy self-sufficient and not as beholden to the rapidly rising food prices seen in Europe. Whilst not suggesting we are at the lowest ebb for markets and confidence, there are encouraging signs that the main drivers of inflation are easing. Most commodities have seen substantial price declines, with oil down 10% in a day at the start of Q3 and down 17% in the last month. Other core products have also fallen, with aluminium down 12%, copper and nickel down 20% and most notably, wheat down 27.5% over the last month.

This should be positive for markets and may provide some stability, given wheat futures have given up all their gains since Russia's invasion of Ukraine. This also suggests, that not just for central bank action, aggregated demand has already started to slow, but now is not the time to be brave, rather to ensure our defence is solid.

Charts of Interest

Major Index Returns: Short Term Pain Affecting Long Term Numbers



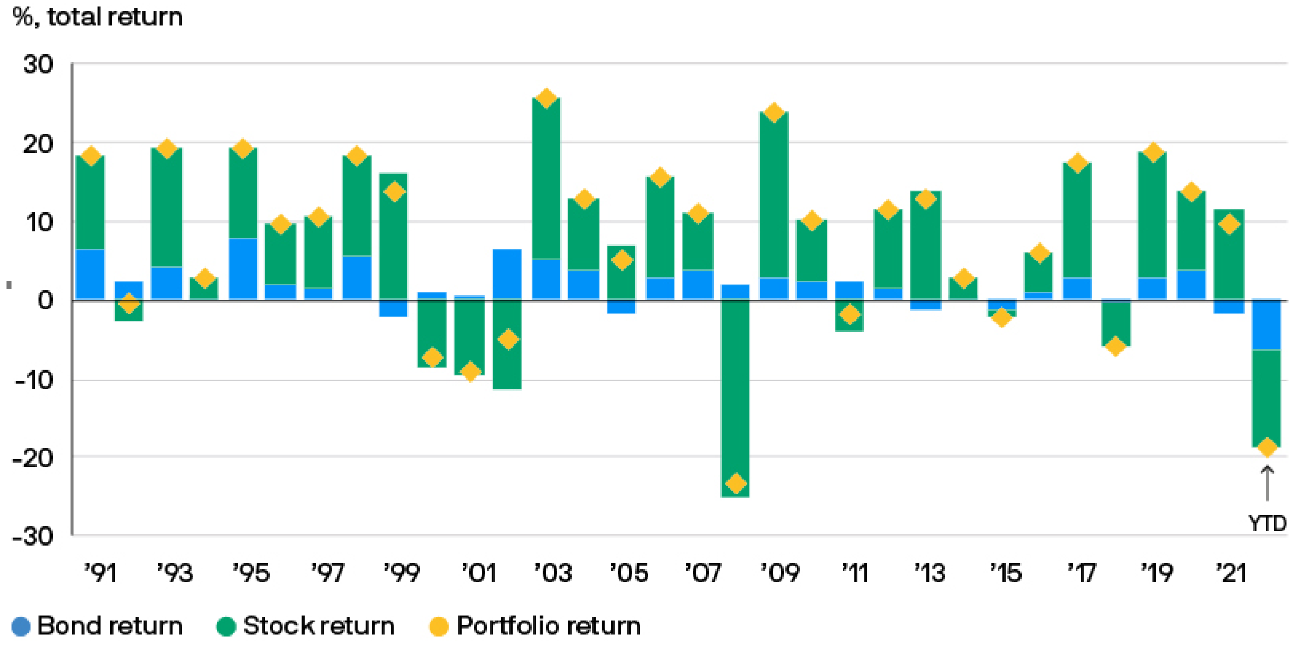
Source: Morningstar, MM Wealth Investment Team. Local currency market returns in %, 2022 reverses Covid recovery.

Major Index Returns (in local currency): Downside Capture

Country	Index	Q2	H1
UK	FTSE 100	-9	-9
Japan	Topix	-9	-16
India	Sensex	-15	-16
US	S&P 500	-20	-24
Germany	Dax	-14	-24
Hong Kong	Hang Seng	-14	-26
China	MSCI China	-16	-32
Russia	MOEX	-21	-46

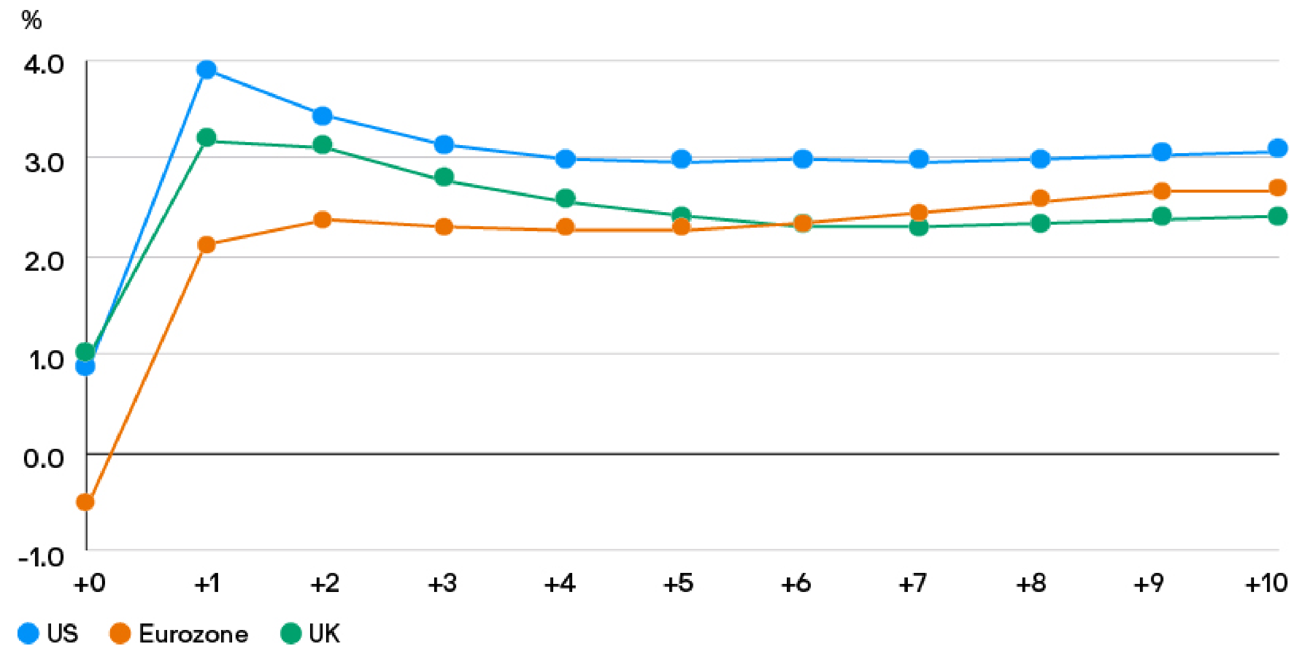
Source: Morningstar Direct, MM Wealth Investment Team. Peak-to-trough downside in 2022.

Traditional investing (60:40 portfolios) on track for worst year since the financial crash



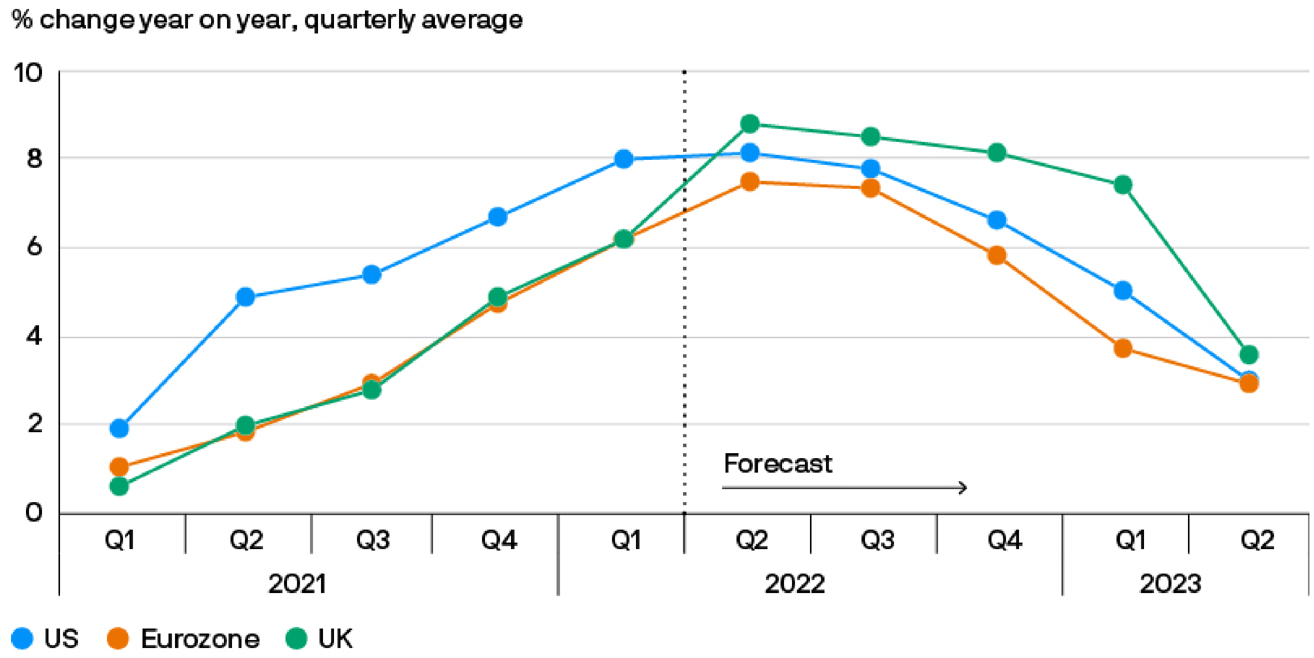
Source: Bloomberg Barclays, MSCI, Refinitiv DataStream, JP Morgan Asset Management. Annual returns in a 60:40 stock-bond portfolio.

Markets are pricing a sharp rise in interest rates (over 10 year term)



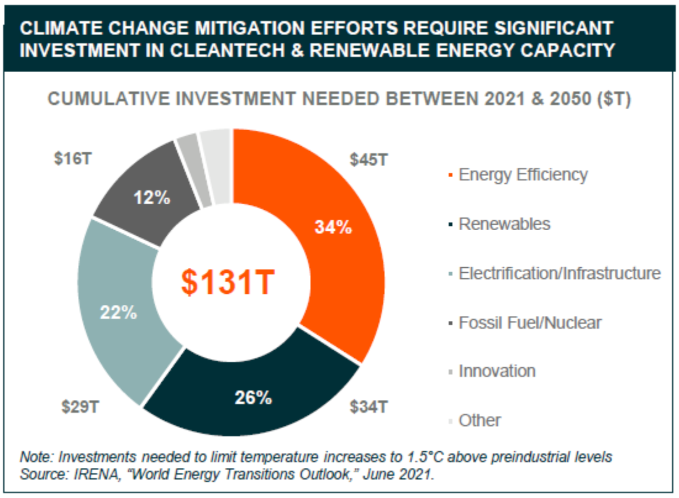
Source: Bloomberg, JP Morgan Asset Management. Market expectations for central bank policy rates.

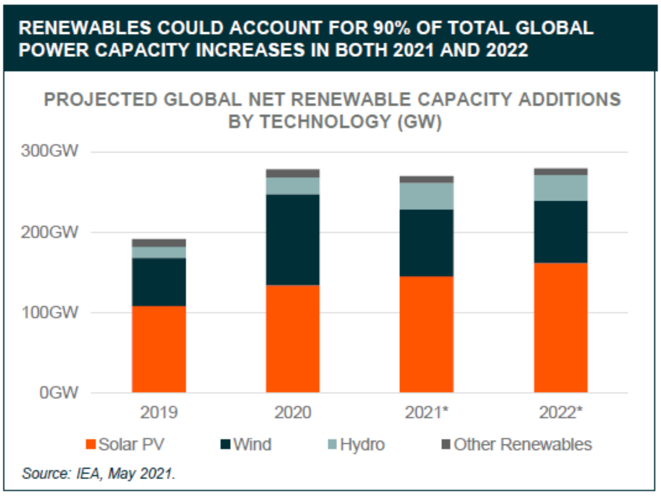
Inflation is expected to peak in second or third quarter of 2022



Source: Bloomberg, BLS, Eurostat, ONS, JP Morgan Asset Management. Median of economists' forecasts for headline CPI (consumer price index).

The need for investment in green energy grows





Key facts about the world

United Kingdom

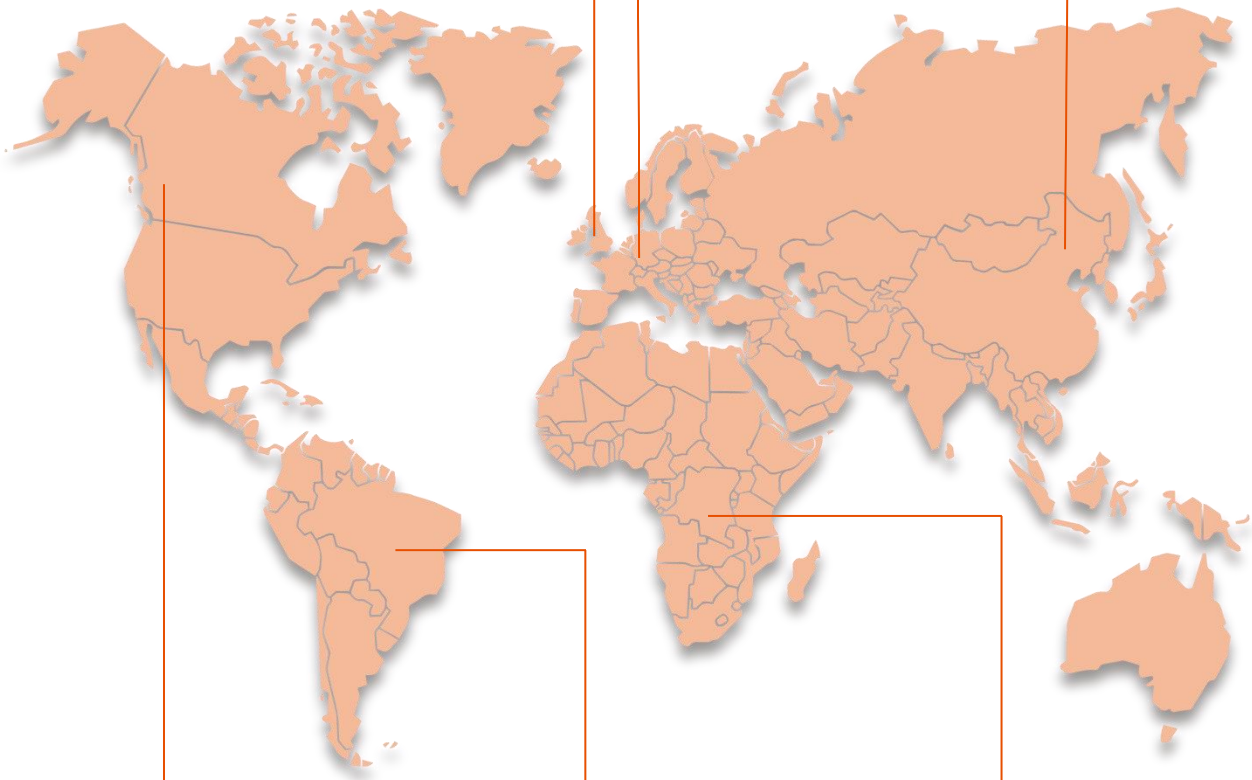
- Bank of England increased its official rate with a combination of hikes to take the bank rate to 1.25%.
- Ex-chancellor Rishi Sunak unveiled additional measures to help households facing higher energy bills.

Europe

- Consumer confidence has collapsed due to falling wages and higher energy prices – natural gas up 300% YTD.
- Euro area growth slowing down even faster than the US.
- ECB poised to lift interest rates with further hikes this year.

Asia

- Russia is now the second largest oil exporter to India since the turn of the year.
- The Japanese Yen weakened against the USD, breaching the 130 level for the first time in 20 years.



North America

- Slowdown in housing – 30-year mortgage rates risen to 5.8% from 3.0% at the start of 2022.
- Personal Consumption Expenditure (PCE) inflation, the Federal Reserve’s preferred price gauge, was unchanged at 6.3% YoY in May.
- Consumer staples and utilities were the most resilient sectors across the quarter.

South America

- Weakened industrial metal prices contributed to Columbia, Peru and Brazil being amongst the weakest markets in the region.
- However, Columbia is set to be Latin America’s fastest-growing major economy this year, following a strong recovery from the pandemic.

Africa

- Despite port shutdowns and protests, Libya oil output is holding up at around 700,000 barrels a day.
- Annual investment of $25bn would deliver universal energy access in Africa by the end of the decade. 43% of the population currently lack access to electricity.

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Q2 Performance Review

Key facts

- Equities and bonds remain highly correlated
- Alternative assets such as infrastructure property and structured products continue to offset this risk
- 'Value' continues to make up ground on 'Growth', although the rotation has slowed
- Dividends and income become more important with investors seeking payment for their patience
- Inflation will continue to dictate market direction over the coming months

Another challenging quarter for all asset types and most regions, including those that we would normally consider more defensive, such as bonds. The core inflation linked holding in L&G All Stocks Index Linked fund suffered its worst quarter for returns, down -19.75%. When assessing why, given inflation is so high, it's important to remember that the price performance of these bonds looks at future inflation expectations. So they perform well when inflation is expected to rise, but badly when it actually does, and to the degree we have seen lately, it is no surprise it has unwound the last couple of years' performance in just a few months. However, is it now suggesting expectations are for inflation to fall? The price would suggest so.

Elsewhere, the property exposure has provided broadly neutral returns compared to declining equity and bond prices, with BMO Commercial Property just clinging onto positive figures, including income. We have used this relative strength to begin reducing UK specific exposure, introducing a globally diversified property fund, with the long-term goal of providing ongoing inflation hedging and reducing the idiosyncratic risk.

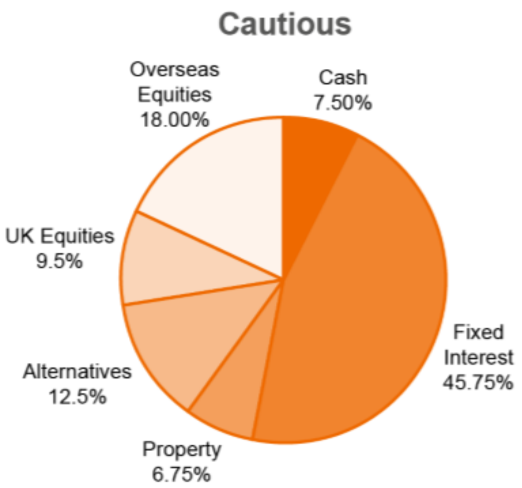
In our equity allocations, we have also made tactical moves to reduce the UK element in favour of more globally diversified holdings. Pleasingly, the 'value' and income holdings added recently have held up well, with Blackrock UK Income +0.29% and River & Mercantile UK Recovery -7.25%, both ahead of their respective benchmarks. Similarly, where we have increased exposure to Asia with the Prusik Asian Equity Income fund, the manager has achieved positive returns of +10.6% over Q2 against a very tough backdrop.

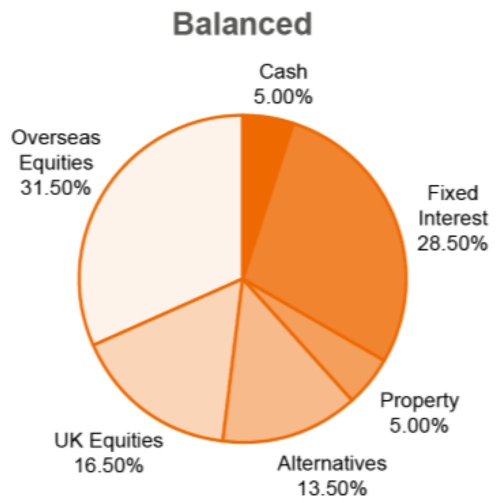
For our strategies more broadly, 'challenging' is a generous description of the difficulties we, as many other investors have, experienced in Q2. The start of the year saw many of the dynamics from the previous decade reverse quickly, with those strategies that had performed well, facing a very rapid devaluation as investors flocked to more traditional sectors such as oil and gas, mining, defence and financials. This is understandable given the factors dictating short term returns, but we remain focused on achieving our long-term objectives without rushing to buy what we consider to be in long term structural decline. Patience is not inaction.

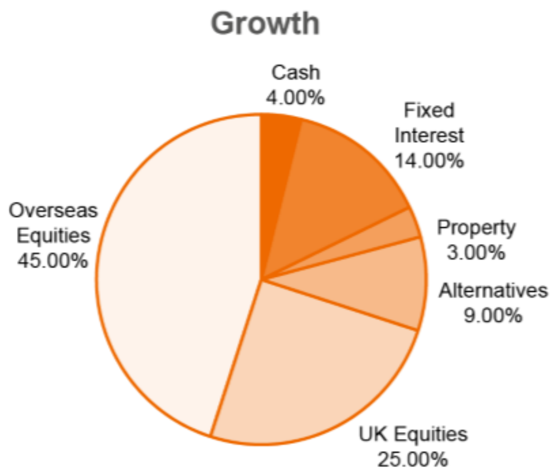
SECTOR	Q2 2022	1 year to 30/06/22	1 year to 30/06/21	1 year to 30/06/20	1 year to 30/06/19	1 year to 30/06/18	5 years (annualised)
IA OE UK Index Linked Gilts	-20.0%	-20.2%	-4.3%	11.2%	9.0%	1.9%	-1.2%
IA OE £ Corporate Bond	-7.6%	-13.1%	3.5%	5.7%	5.6%	0.7%	0.2%
IA OE Property	2.2%	11.1%	1.1%	-4.3%	0.8%	6.5%	2.9%
IA OE UK Equity Income	-5.7%	-0.5%	25.4%	-13.7%	-2.5%	6.2%	2.2%
IA OE UK Smaller Companies	-13.2%	-22.7%	50.8%	-6.4%	-6.2%	16.9%	3.7%
IA OE North America	-10.3%	-3.7%	27.3%	8.5%	11.4%	12.5%	10.8%
IA OE Europe Excluding UK	-10.2%	-12.5%	23.8%	1.0%	3.3%	3.3%	3.1%
IA OE Japan	-8.1%	-11.8%	13.1%	7.9%	-3.4%	10.7%	2.9%
IA OE Asia Pacific Excluding Japan	-3.2%	-10.8%	26.9%	2.7%	4.3%	7.4%	5.4%
IA OE Global Emerging Markets	-5.2%	-17.3%	28.3%	-3.3%	6.1%	4.1%	2.5%

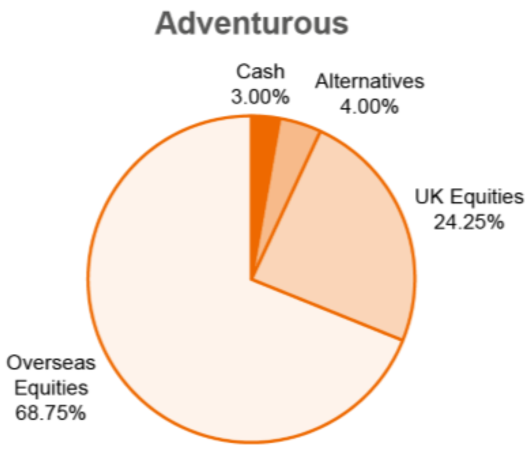
Source: Morningstar, bid-bid pricing. Net income reinvested. Past performance is not a reliable indicator of future results.

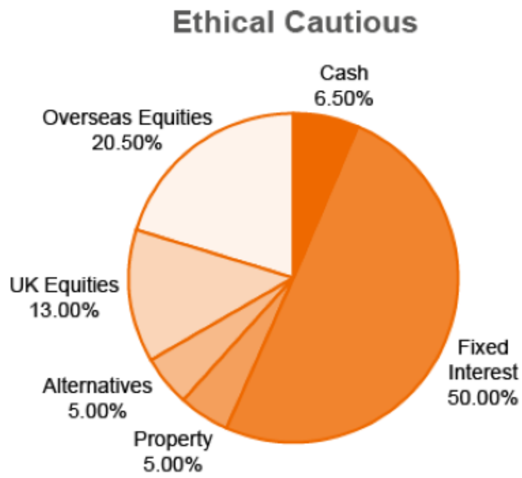
The positioning of our strategies

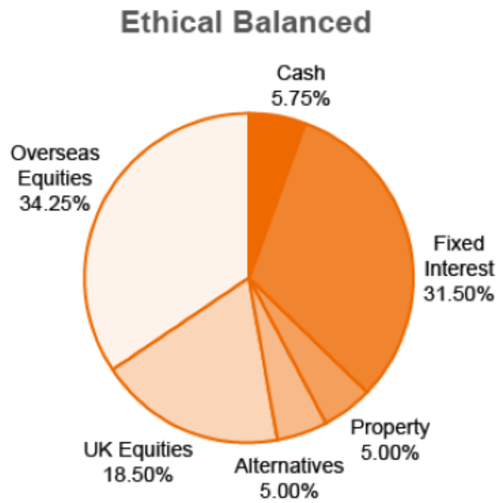


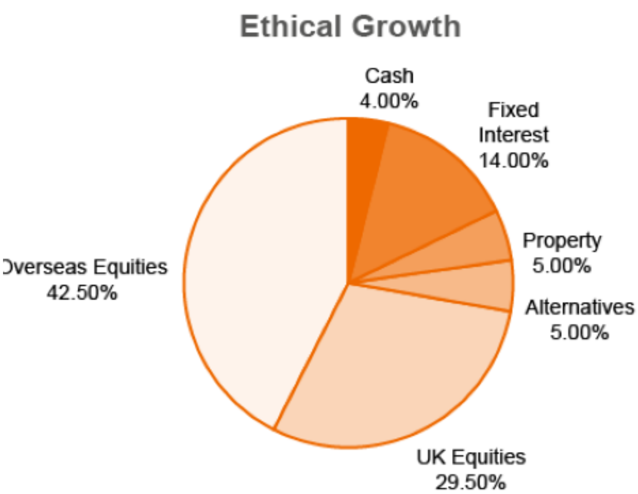







Ethical Cautious
Cash
6.50%
Overseas Equities
20.50%
UK Equities
13.00%
Alternatives
5.00%
Property
5.00%
Fixed
Interest
50.00%


Ethical Balanced
Cash
5.75%
Overseas
Equities
34.25%
Fixed
Interest
31.50%
Property
5.00%
Alternatives
5.00%
UK Equities
18.50%


Ethical Growth
Cash
4.00%
Fixed
Interest
14.00%
Property
5.00%
Alternatives
5.00%
UK Equities
29.50%
Overseas Equities
42.50%


Ethical Adventurous
Cash
3.00%
Property
5.00%
Alternatives
5.00%
UK Equities
31.75%
Overseas
Equities
55.25%

Disclaimer

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