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Keeping you informed matters

Economic review

October 2022

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Outlook

Winter is coming. For investors already grappling with the inflation phenomena, trying to interpret the impact of war, geopolitics and mini-budgets on asset prices is leaving many fearful for the cooler months ahead. But will central bank policymakers kill or cure with their interest rate remedy?

Price inflation has dominated business headlines for over a year now. It first came to general attention when demand for many items surged relative to their supply as Covid lockdowns lifted. A well-known example was high demand for new cars being unmet by supply, such that second hand car prices surged. More recently, and especially after Russia invaded Ukraine, energy prices in many parts of the world have soared, with gas prices in Europe being the stand-out example.

At first, many market analysts thought such inflation would be 'transitory' - a simple post-Covid effect that would fade - but as inflation filtered through to most goods and services and inflation thus gathered pace, central bankers in the USA told us it was time to retire the word 'transitory' with respect to inflation. This was in November last year. Today, price rises have been seen not only in energy but in products and services that rely on energy inputs, whether it be transportation or food that requires fertilizers. Higher wage claims (and the strikes sometimes needed to secure those pay rises) are a growing phenomenon in many countries. This leads to two very important questions for investors: what does inflation mean for asset prices? And, is inflation a phenomenon that will last for a few years only, or are we now in an 'era of higher inflation'?

Below is a stylized view of what inflation means for asset prices. In summary, commodity prices benefit from inflation, bonds suffer under inflation, and equities are most highly rated when inflation is low and controlled - the environment we inhabited a few years ago. Equities generally 'de-rate' (become cheaper) when there is either price deflation or meaningful inflation, probably on account of the costs and business risks associated with these scenarios.

As inflation has taken off globally, it should be no surprise that bonds have recently softened on fears of a global recession. Commodities did well at first, but have recently softened on fears of a global recession. For equity and bond investors, at least, it is very important that inflation is controlled, quickly and enduringly.

How enduring is the inflation we are seeing? Here are three thoughts:

First, the political response to inflation today seems itself to be inflationary over the medium-term. Around the world, governments seem instinctively keen to borrow money to subsidize energy prices for consumers, write off student loans etc. Price subsidies

Source: Long-short Consulting Limited. Asset prices and inflation.

can reduce headline inflation in the short-term, but where government borrowing is used to pay for those subsidies, the policy is inflationary over the medium-term. The markets seem to understand this, and are integrating this insight into assets prices quite quickly, through sharply higher bond yields (falling bond prices). This has been one of the worst years for global bond investors in recorded history. So, we believe that the politicians' actions are inflationary, but the market believes this too, and so we have no investing 'edge' through this insight.

A second, interesting, perspective comes from Ben Hunt (creator of Epsilon Theory, a past professor of political science, and a successful investor), who studies the role of 'narratives' in shaping markets. He argues that, due to extremely high inequality in the USA and other countries, most of the money lies with a small cohort of people. Policy interest rates must rise, not just to a level that changes the behaviour of the average person, but to a higher level that changes the behaviour of the richest in society. In his view, the skewed distribution of wealth and income means that the impact of interest rate policy is "non-linear". The final resting point for policy interest rates will likely be higher than most expect… and the rise in rates will hurt many people along the way. This is not a generally perceived perspective, but if correct, it suggests that policy interest rates will go higher and maybe stay higher for longer than expected.

Our third thought concerns war. If you ask, "Are we at war?", most folk would probably say "No, of course not!" However, if you think more deeply about this question, it's clear that we are currently in a broadening trade war. This exists not just between Russia and western / Anglo Saxon countries, but also between China and the USA, along with many of its allies. Gradually over the past few years, new restrictions have extended these trade wars. We are also in a worsening 'cold war,' where trust between the great powers has collapsed and seems unlikely to return any time soon. Furthermore, we are also participating in a 'hot war' in Ukraine. In short, we are (partially, at least) at war. War means greater government 'resource mobilisation' and control of the economy. This means more government borrowing and spending than would normally be seen during peacetime. This is inherently inflationary.

How do asset prices behave during a war? There is no simple, recurrent pattern for war and asset prices. In general, though:

- Commodity prices rise, where not supressed by government
- Gold holds its value
- Bonds suffer
- Equity and currency returns vary wildly, depending on the initial position, anticipation of the conflict, and how the war develops.

Taken together, the second and third observation above suggest greater price inflation (over the medium-term) than the market expects. This insight might be worth acting upon. Unanticipated inflation means higher than expected interest rates. This suggests investing in less interest–rate sensitive assets at the margin, including:

- Short-dated bonds over longer-dated bonds (this is already playing out very rapidly in markets!)

- 'Value' over 'growth' equities. With growth stocks, most profits arise further in the future and this tends to make them more interest-rate sensitive than value stocks, where cash flows are more immediate. Growth stocks out-performed value stocks for around a decade after the Global Financial Crisis of 2007-2009, as interest-rates fell towards zero in many countries. Then, after the announcement of Covid-19 vaccinations in November 2020, both value and growth stocks did well. However, since Nov 2021, when the Fed (US central bank) told us that this inflation was not transitory, value stocks have beaten growth stocks handsomely. This should continue under the outlook described above.

- Some exposure to commodities. Note that, at the time of writing, fear of a global recession is acting against commodity prices, so there are at least two powerful forces at work here.

Over the past year, we have been adjusting client portfolios gradually to hold more value stocks than before, compared to growth stocks. We have also reduced exposure to long-dated bonds, which are more interest-rate sensitive. Further, we've added to commodity stocks. Together, these moves have been sensible, and when we consider the outlook described above, we expect to do more of this in the months to come.

Key facts about the world

United Kingdom

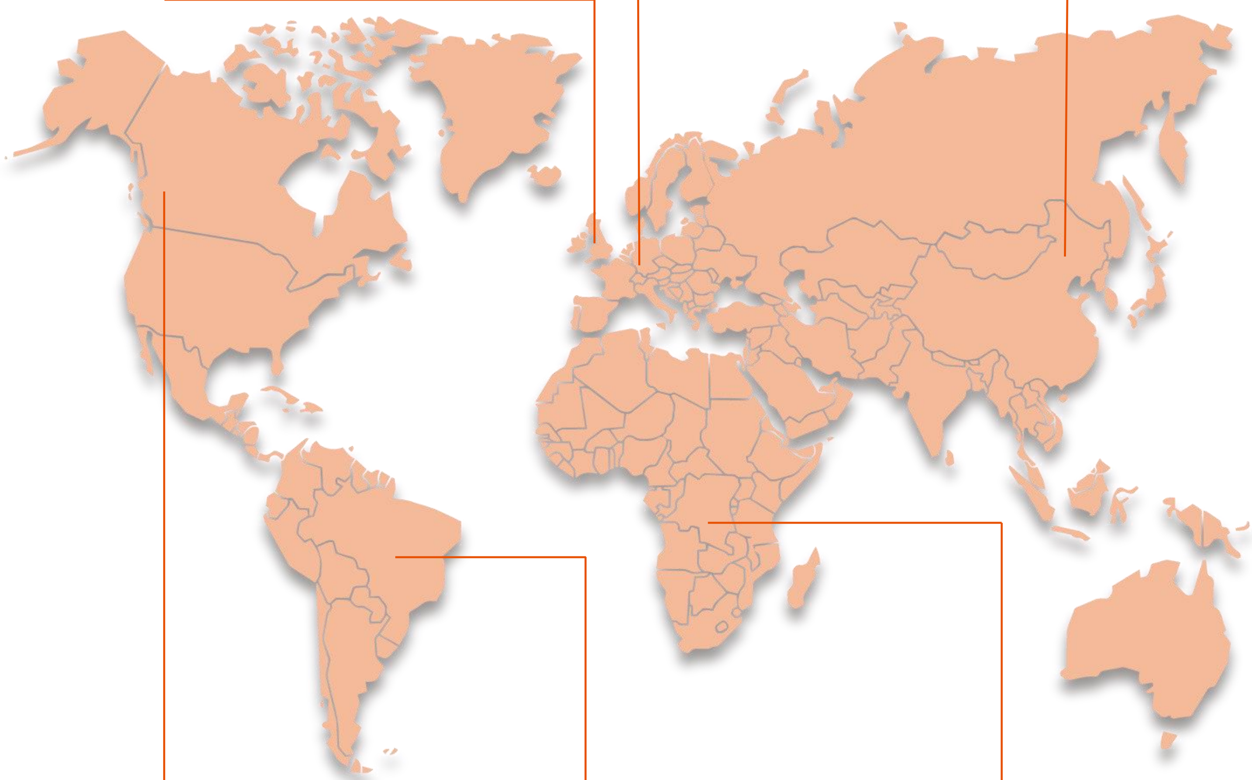
- Unprecedented £150 billion intervention leads to an energy price cap, typically of £2,500.
- UK CPI rose 9.9% Year on Year for August, 0.3% ahead of economic forecast.
- Sterling recovered the record low losses against the USD, following the mini budget.

Europe

- Eurozone inflation hit 10%.
- New phase of Ukraine war – Russia losing territory. Annexation of 4 key regions could lead to further escalation.
- Germany announced €200 billion energy support package, causing a divide in the EU over the energy crisis.

Asia

- Japan has spent $20 billion in an attempt to support falling Yen.
- Renminbi has fallen to lowest level since 2008. Main contributors - zero covid policy and property market collapse with housing prices falling c75% in Chinese cities.



North America

- Federal Reserve has backed a fourth consecutive 0.75% rate hike in November.
- Strong USD, with the Dollar index (Dixie) at near 20 year highs.
- US job vacancies plunged more than 1M in the sign of a cooling economy, hitting the labour market.

South America

- Ecuador agrees $1.4 billion debt restructuring with China.
- Paraguay urges Taiwan to invest $1 billion to reinforce the strategic alliance between the two countries.

Africa

- Turbulent global inflation rates will mean by Year End, up to 30M Africans will not be able to afford liquified petroleum gas.
- Nigeria's oil output has hit a 32 year low, due to theft pushing down daily crude production to 1M barrels.

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Q3 Performance Review – Unconstrained strategies

Key facts

- Bonds battle in face of higher inflation and interest rate expectations (and mini-budgets)
- Preference remains for short dated bonds over more rate sensitive long dated
- The 'value' vs 'growth' rotation slows and return dispersion closes
- Maintaining a balance in size and style bias as well as geographically is sensible
- Portfolio diversifiers such as infrastructure, renewables, precious metals and commodities remains a focus

The bruising year for bonds continued with further weakness in UK government bonds compounded by a mini-budget that failed to reassure investors. Long dated bonds – those that mature in over 10 years – are particularly sensitive to interest rate moves and after signs of stability in July, the L&G All Stocks Index Linked Gov't bond fund fell at the end of September, down -11% for the quarter. This volatility has however been offset somewhat by bonds at the opposite end of the spectrum, with the AXA US (+1%) and Royal London (+0.8%) short duration funds (<2 years to maturity on average), where returns were at least flat for the period. The preference remains for bonds with shorter maturities, although the insurance aspect of the longer dated government bonds remains the worst case scenario backstop, albeit with expectations for better performance from this point as inflation and interest rate expectations become more realistic.

In the UK equity element of strategies, the return dispersion between the 'growth' and 'value' strategies has reduced following the rapid and substantial rotation out of 'growth' investments into 'value' that was a feature of the first half of the year. Defensive strategies such as BlackRock UK Income (-3.13%) and growth strategies such as the L&G FW Sustainable UK Equity fund (-1.76%) both outperformed their relative benchmarks as fundamentals reasserted themselves and investors began to look for quality, over the rush for anything just seen as cheap. However, one area that remains a concern is UK smaller companies, which are deeply out of favour as the picture has worsened for corporate UK following the recent mini-budget which has confused the outlook. This is an area already reduced across our risk strategies over the last 6 months, although at current valuation is now very attractive for recovery potential in the coming months. The Jupiter UK Smaller Companies fund therefore remains under review.

A similar story has unfolded in the global equity ideas, where positive returns have been seen from long term growth plays such as Loomis Sayles US Equity Leaders (+7.24%) and defensive quality fund, Lindsell Train Japanese Equity (+5.55%), both ahead of expectations. Unfortunately, strength in the US dollar has continued to hamper emerging market returns, but reassuringly the JPM Emerging Markets fund (-2.33%) managed to show much lower volatility over the quarter than it had been able to sustain earlier in the year.

Where we have invested in assets other than traditional equity or bonds, new investments such as the Jupiter Gold & Silver fund (+0.91%) and Downing Renewables & Infrastructure Trust (+1.09%) continue to perform well. Extending our alternatives exposure we have also established a position in the BlackRock Natural Resources fund which we believe blends well with existing holdings to provide a differentiated source of portfolio returns.

SECTOR	Q3 2022	1 year to 30/09/22	1 year to 30/09/21	1 year to 30/09/20	1 year to 30/09/19	1 year to 30/09/18	5 years (annualised)
IA OE UK Index Linked Gilts	-13.7%	-32.4%	-0.7%	1.3%	19.1%	1.3%	-3.9%
IA OE £ Corporate Bond	-9.3%	-20.8%	1.2%	4.3%	9.0%	0.1%	-1.8%
IA OE Property	-3.5%	5.0%	3.4%	-4.3%	-0.4%	5.8%	1.8%
IA OE UK Equity Income	-6.1%	-8.7%	32.6%	-17.4%	-0.1%	3.5%	0.7%
IA OE UK Smaller Companies	-9.3%	-32.4%	48.7%	0.0%	-7.1%	10.5%	0.6%
IA OE North America	4.1%	-2.3%	25.3%	9.3%	7.4%	19.7%	11.4%
IA OE Europe Excluding UK	-2.5%	-16.0%	22.4%	3.2%	2.2%	1.9%	2.0%
IA OE Japan	2.3%	-15.8%	16.5%	5.7%	-1.2%	12.6%	2.9%
IA OE Asia Pacific Excluding Japan	-4.1%	-10.5%	15.4%	8.1%	5.8%	3.7%	4.1%
IA OE Global Emerging Markets	-2.6%	-15.4%	17.3%	1.7%	6.4%	-1.4%	1.1%

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

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Q3 Performance Review - Ethical strategies

Key facts

- Bonds battle in face of higher inflation and interest rate expectations (and the recent mini-budget)
- UK equity struggles in face of inflationary and political onslaught, although yields remain attractive – paid to wait
- Maintaining a balance in size and style bias as well as geographically is sensible
- Portfolio diversifiers such as infrastructure, renewable energy and impact investing, remains a long term focus

Recent addition to ethical strategies, Edentree Global Impact Bond fund (-3.69%), has begun to differentiate in terms of performance and volatility within the fixed interest allocations, while core funds such as Aegon Ethical Corporate Bond which is down 10.57% and Rathbone Ethical Bond (-9.57%) reflect the broad impact of a mini-budget splurge that led to collapse in gilts as well as wider corporate bond markets. However, after this latest setback and yielding as high as 7%, we believe they may offer a decent, inflation-beating opportunity going forwards, and we retain our balance of fixed interest funds in the lower risk strategies.

UK equity selections have continued to battle under the current inflationary environment, and with perceived poor political leadership destabilising the outlook further, the natural bias towards smaller, growth focused funds from the ethical universe has meant greater sensitivity to rising interest rates. However, we have moved to increase the defensive income element during the period with the addition of the Janus Henderson UK Responsible Income fund, which we believe blends well with existing positions.

In the global equity element of strategies, the wider range of potential investments and styles has seen pleasing positive returns from more 'value' and income focused ideas such as BNY Mellon Sustainable Global Equity (+0.66%), Jupiter Ecology (+6.83%) and Regnan Global Equity Impact Solutions (+3.38%). While September saw the reversal of gains made at the start of the quarter, the recovery potential from the range of funds held, where a significant de-rating has taken place over the course of the year, was reassuring.

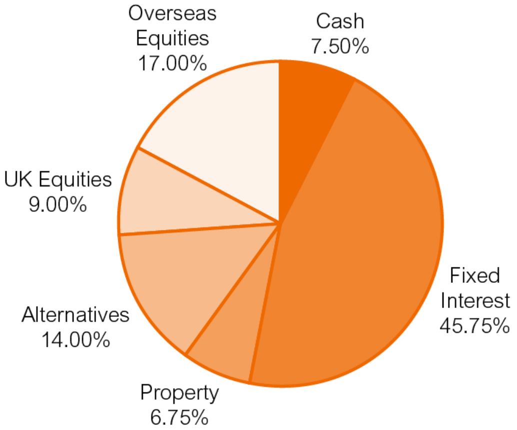
The alternative investments including Downing Renewables & Infrastructure (+1.09%), performed very well during the quarter, although the recent closure of a number of well established, large UK property funds, combined with the mini-budget fallout and the temporary collapse of the mortgage market left Home REIT (-19.14%) exposed to investors looking to reduce their property exposure wherever they could. However, given the unique proposition from Home REIT, investing in specialist property to support the homeless, with government backing, we believe this short term impact can quickly be reversed.

SECTOR	Q3 2022	1 year to 30/09/22	1 year to 30/09/21	1 year to 30/09/20	1 year to 30/09/19	1 year to 30/09/18	5 years (annualised)
Morningstar Global Sustainable	-7.9%	-22.8%	23.9%	10.1%	0.9%	7.0%	2.6%
Morningstar UK ESG Enhanced	-12.5%	-23.4%	32.0%	-13.9%	-1.8%	3.7%	-2.4%
Morningstar US ESG Enhanced	-5.2%	-18.2%	30.1%	16.7%	5.8%	18.9%	9.3%
Morningstar DM Europe Sust	-10.7%	-28.6%	27.4%	7.5%	3.0%	2.6%	0.7%
Morningstar EM ESG Enhanced	-11.1%	-27.9%	15.6%	5.4%	-2.3%	-3.8%	-3.7%
Morningstar UK Corp Bond Sust	-20.3%	-38.3%	3.8%	9.6%	5.4%	-2.6%	-6.4%
Morningstar Global Corp Bond Sust	-7.0%	-22.1%	0.9%	8.5%	8.6%	-1.4%	-1.8%
Morningstar Global Renewable Energy	-8.1%	-20.5%	38.1%	10.9%	6.1%	1.3%	5.5%

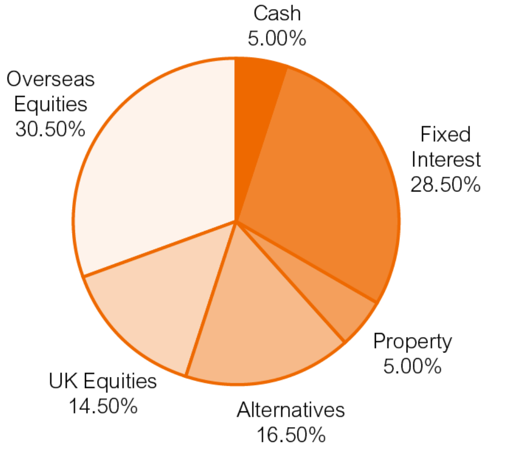
Source: Morningstar, bid-bid pricing. Net income reinvested. Past performance is not a reliable indicator of future results.

The positioning of our Unconstrained strategies

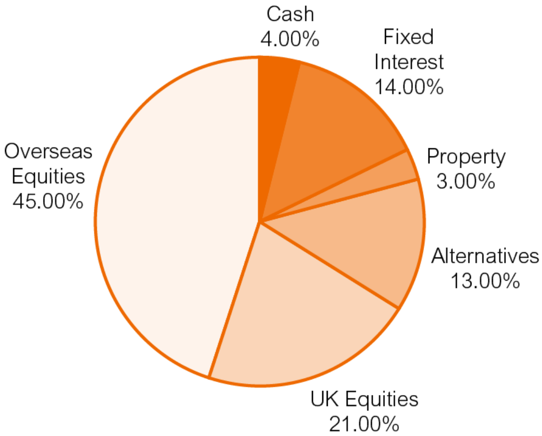
Cautious



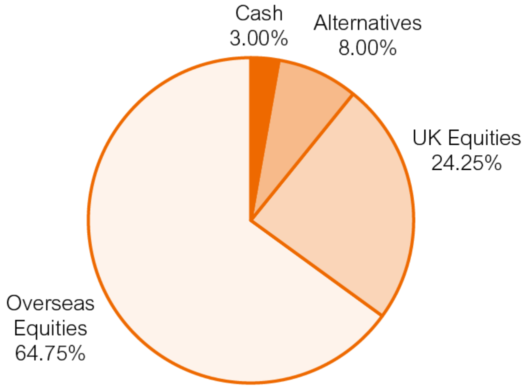
Balanced



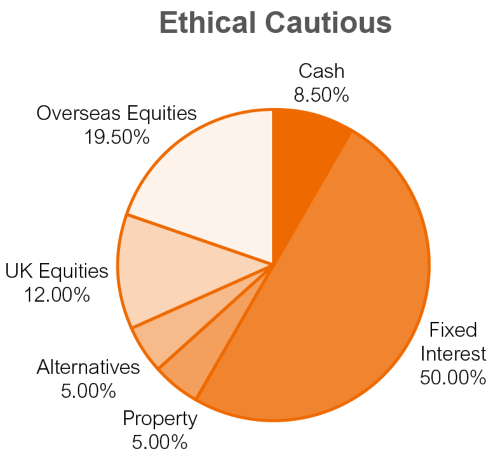
Growth

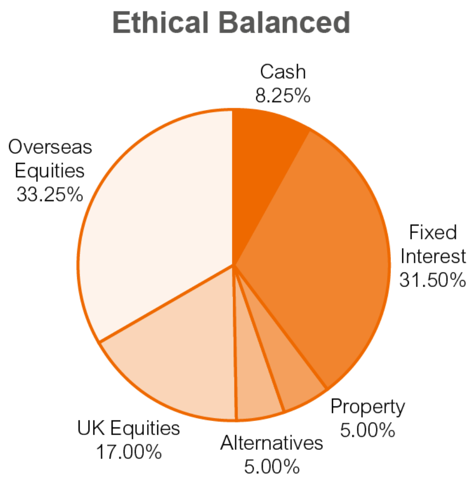


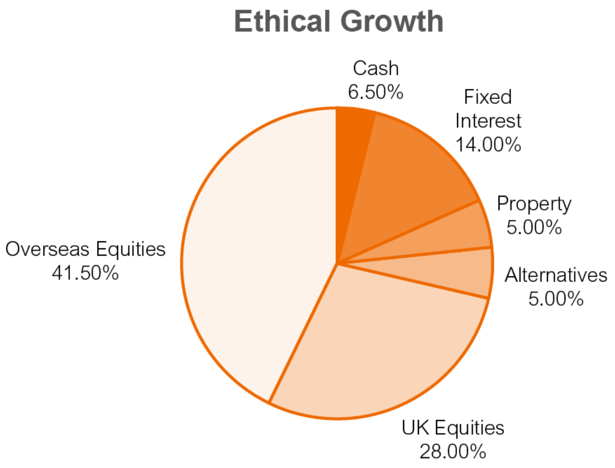
Adventurous

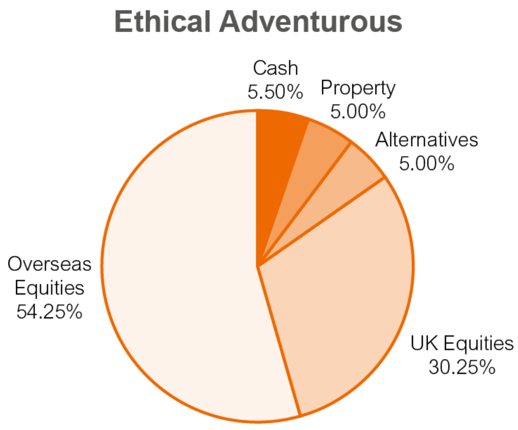


The positioning of our Ethical strategies









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