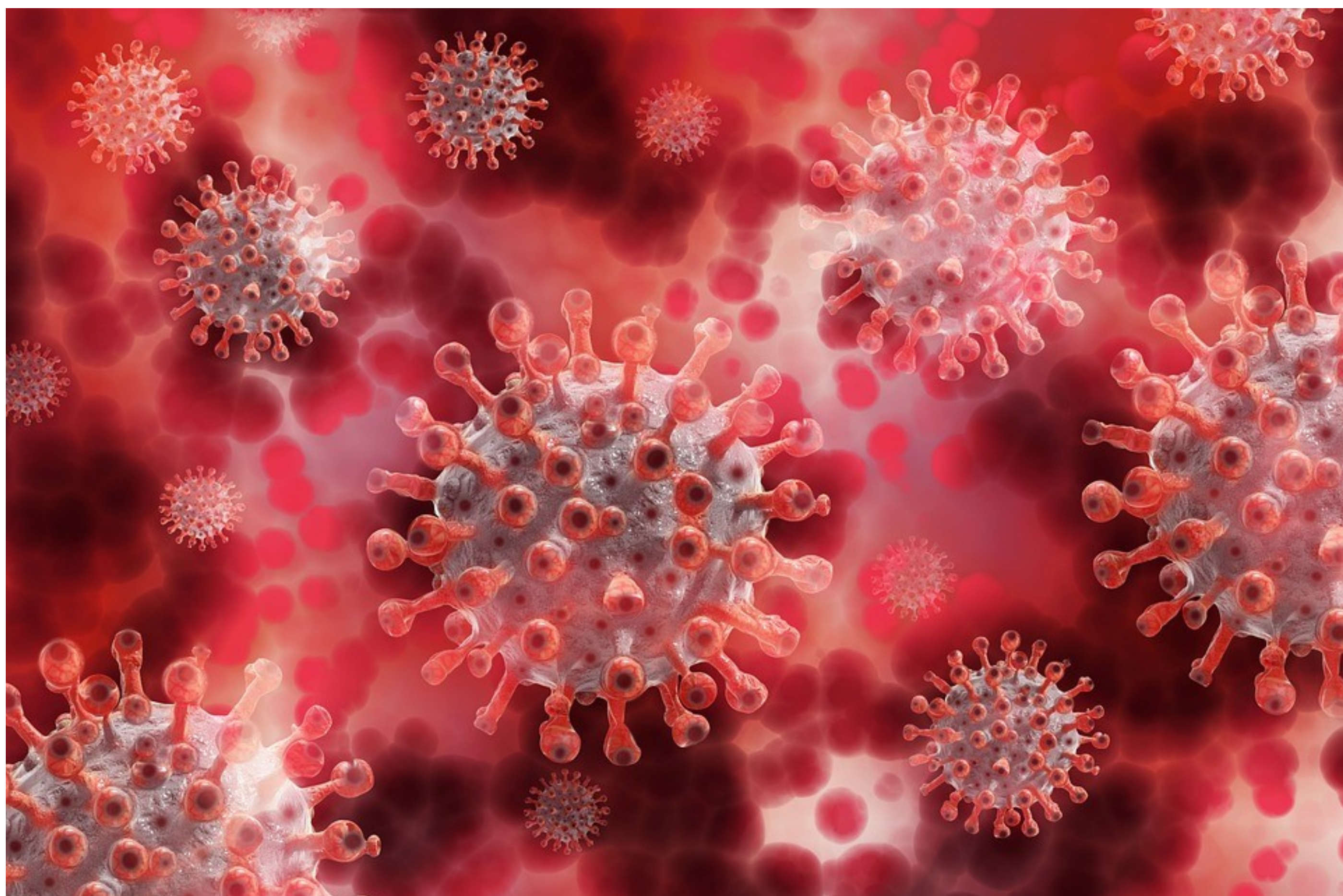
CARTLIDGE MORLAND

INDIVIDUAL WEALTH MANAGEMENT

INVESTMENT COMMENTARY

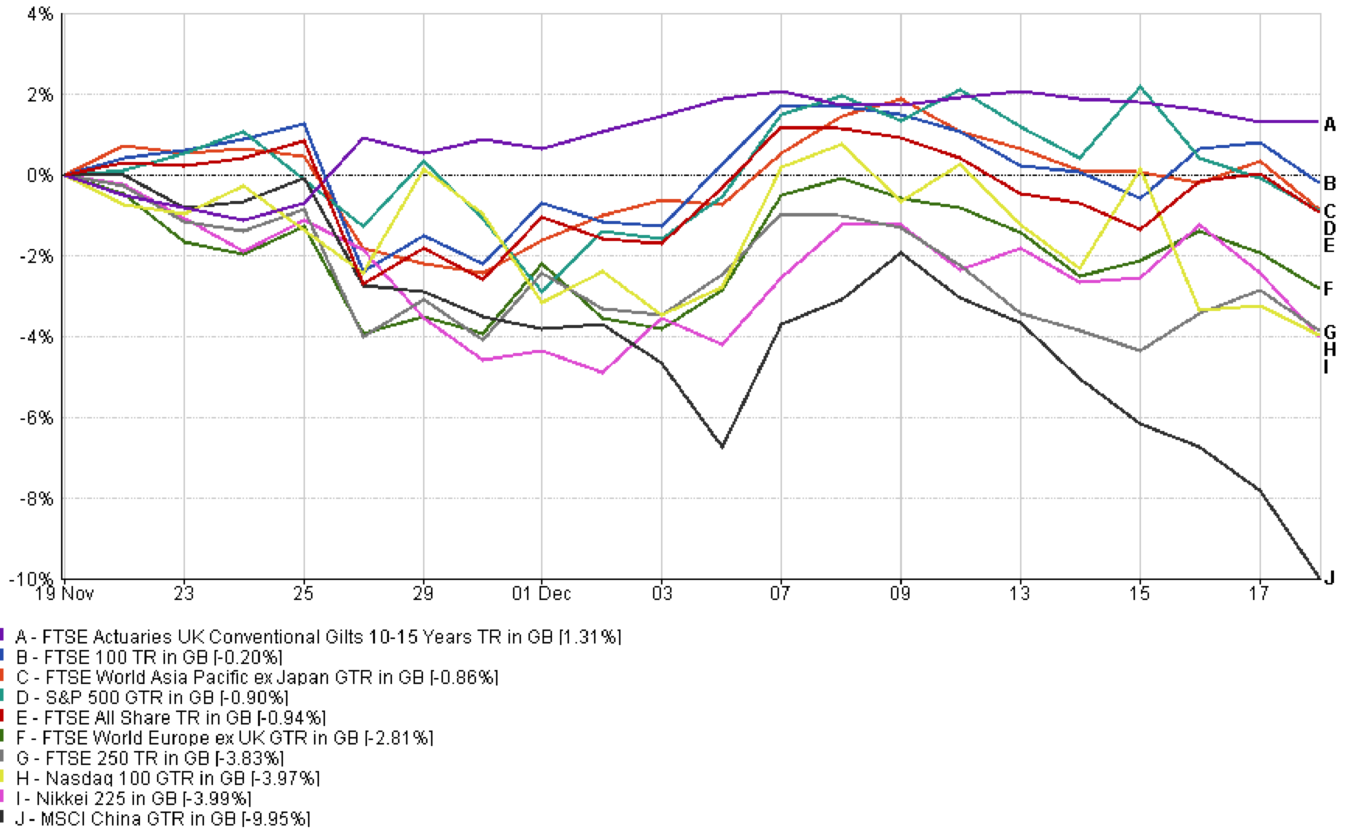
20 DECEMBER 2021



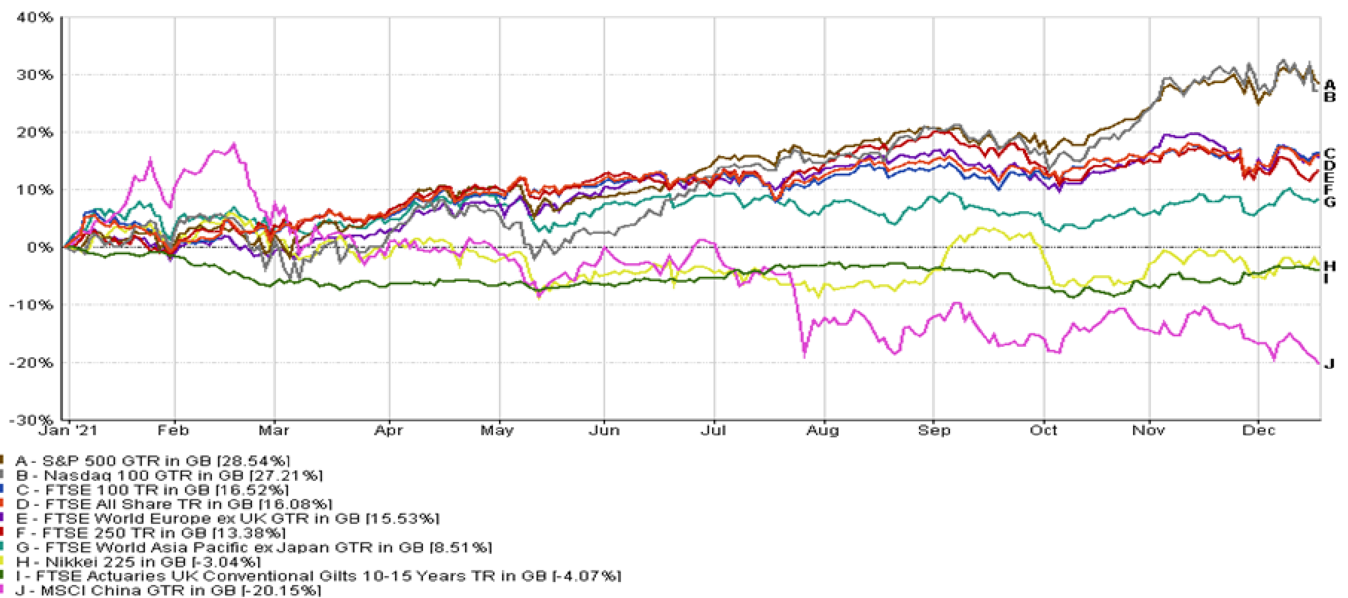
OVERVIEW

Over the past month, investors have become increasingly concerned about prospects for the global economy as the new Covid-19 variant, Omicron, spreads rapidly around the world and the monetary policy of the major central banks is set on a tightening course to control inflation. In a recent 'commentary' we observed that the major central banks must act in concert – not least to prevent significant disparities in interest rates influencing capital flows and destabilising currencies. The Bank of England's scope to raise interest rates is limited, without similar appetite at other central banks. As investors have sought safer assets due to worries over the impact of renewed virus-related restrictions on economies and equity markets, 'safe haven' investments such as government bonds and the Japanese yen have benefited. However, rising inflation and increasing interest rates are not good for bond markets as the real value of bond returns are eroded; indeed UK gilts did sell off to some extent following the Bank of England's surprise move last week in increasing interest rates. However, despite the recent volatility, many equity markets have made outstanding returns in sterling terms over 2021 with China and Japan notable exceptions.

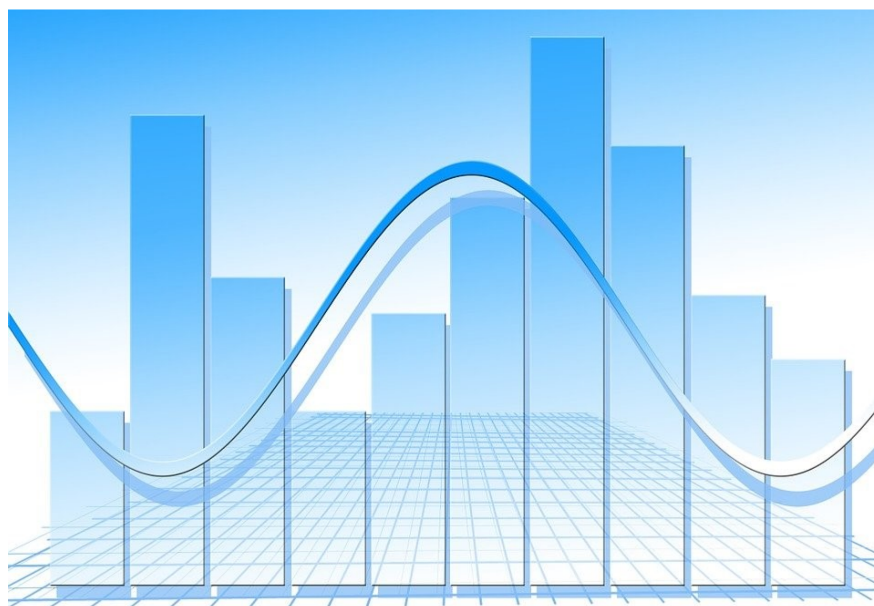
ONE MONTH INVESTMENT MARKET STERLING RETURNS



YEAR TO DATE INVESTMENT MARKET STERLING RETURNS



As we observed only last month, the Covid-19 pandemic always had the potential to strike back with a new variant as the virus mutates to circumvent naturally and vaccine acquired immunity. Whilst 'Omicron' is highly contagious, its severity has yet to be scientifically established. Nevertheless, governments across Europe (the current epicentre) have reintroduced restrictions to protect health services from being overwhelmed. The travel, leisure and hospitality sectors have all been impacted once again. However, the duration of these restrictions will depend on better understanding of the latest variant and the success of booster vaccination programmes. We know from past experience that economies are now better placed to cope with restrictions and when they are lifted that economies should bounce back.



Inflation continues to rise across the world as global demand is exceeding the manufacturing capacity for goods and provision of services. The US consumer price index (CPI) rose to 6.8% pa in November - the fastest annual pace since 1982. UK CPI increased to 5.1% pa and eurozone CPI to 4.9% pa in November. Against this backdrop, the US Federal Reserve (Fed), the Bank of England (BoE) and the European Central Bank (ECB) changed their stances in combatting inflation at their December meetings which took place last week. The central banks are now increasingly worried that inflation will be more persistent than expected and believe that action is now required. The ECB and Fed announced that they would scale back their asset purchase programmes more quickly whilst the BoE raised Bank Rate to 0.25% from 0.1%. The BoE justified its surprise decision by pointing to the prospect of companies planning for wage and price increases. Other central banks, including those of Norway, Russia and Chile, pushed rates higher. The Bank of Japan, which is more focused on deflation, confirmed that it would be tapering its emergency economic support programme by cutting back its corporate debt purchases to pre-pandemic levels. The central banks' decisions appear to have been made without giving priority to the spread of Omicron due to uncertainty about its impact currently. The Fed is set to end its asset purchase programme in March 2022 with interest rates expected to rise three times during the year – perhaps the first rise as early as March. Jay Powell, Chair of the Fed, indicated that the Fed's more hawkish view was due the strength of the US economy – with growth in 2021 around 5.5% and predicted to be in the region of 4.0% in 2022. The state of the US labour market has improved rapidly so the Fed's objective of full employment is in sight. Its other aim is to maintain stable prices so action is needed to control inflation. The ECB still appears on a slightly different tack, as its members felt that there were fewer signs of rapid wage increases in the region and are expecting Eurozone inflation to fall below its target of around 2.0% pa within the next two to three years.

Bond markets are indicating that interest rates will increase in 2022 and beyond but they will not climb to relatively high levels. In the US, the bond market is predicting the Fed will raise its main rate to 1.6% although the Fed itself is expecting its longer policy rate to reach 2.5%. The BoE expects Bank Rate to reach 1% in 2023 but fall back to around 0.7% in 2025. However, with lower household indebtedness and less fiscal austerity to put the brakes on demand, it may be that bond markets are under-estimating the extent of monetary tightening required to control inflation.

Equity markets fell after the December meetings of the major central banks. With the Fed tapering its highly supportive asset purchase programme sooner than expected, the markets fear that the first interest rate hike will come earlier than predicted. The prices of technology stocks fell as their future values are based on potential longer term growth. The value of their future earnings falls as interest rates rise. The share prices of energy companies and consumer discretionary companies also fell as global growth could slow if Omicron-related restrictions are prolonged and demand falls. One uncertainty was removed for investors - the US avoided defaulting on its debt as Congress eventually agreed to raise the debt ceiling just ahead of the 15 December deadline. The Chinese equity market has continued to be negatively affected by the problems in its property sector, despite the Chinese authorities trying to reassure the market that "quality" property companies would be supported following some companies, including the massive Evergrande, defaulting on their debts. China has lowered a key benchmark lending rate for domestic banks to alleviate slowing economic activity, resulting from concerns arising from the property sector problems as well as the impact of the Covid-19 pandemic and weaker consumer activity.

The CM Investment Commentary is compiled by Angela Cooper, Managing Director of Cartlidge Morland's Investment Services team.

Angela runs the firms' investment management propositions, with over 30 years' experience in investment research working for investment companies, leading UK national IFAs and wealth managers. Angela graduated from the London School of Economics and is a Chartered Insurance

We take this opportunity to wish all clients a very Merry Christmas and our best wishes for 2022.

CHRISTMAS CLOSING

Our offices close at 2.00 pm on Friday 24 December 2021 and reopen at 9.30 am on Tuesday 4 January 2022.

OUR VIEW

In past Investment Commentaries, we have been cognisant of the fact that the pandemic could take unexpected twists as new variants develop. We have continued to maintain exposure to lower risk assets appropriate to risk parameters although longer term we believe that equities will deliver superior returns as the pandemic subsides/we learn to live with coronavirus. We have trimmed our UK equity exposure as the UK equity market now comprises a smaller part of global indices in the face of the US equity market becoming more dominant. Whilst we remain overweight to the UK equity market and sterling for UK resident/Sterling orientated clients, we continue to increase exposure to international equities. Although the US equity market has reached record highs, there is a disparity within the market itself. Some of the mega tech stocks – Apple, Microsoft, Nvidia, Tesla and Alphabet - have accounted for more than half of the S&P's returns since April according to Goldman Sachs. Whilst index tracking funds capture these returns – and typically around 50% of our client US equity exposure is to tracker funds - it is important to maintain holdings in well-regarded stock-picking funds which invest in high quality companies offering good value. We have been adding exposure to actively managed and where appropriate smaller companies funds in portfolios with this objective in mind.

Perhaps the most significant questions for domestic investors in 2022 are:

(a) whether the UK equity market will make inroads into its valuation gap against comparative markets

(b) whether bond markets dip meaningfully in response to a climate of elevated inflation/rising interest rates

(c) whether US investors' focus shifts to some degree from tech/social media towards other opportunities – against an economic background promising strong growth in most business sectors

(d) will the world learn to live normally alongside COVID 19 and future viruses?

Investors inhabit a world which is evolving at an ever faster pace. Investment portfolios and indeed the services Cartlidge Morland provides continue to evolve both in anticipation and response to the changing investment environment.