



CARTLIDGE MORLAND

INDIVIDUAL WEALTH MANAGEMENT

INVESTMENT COMMENTARY



26 MAY 2022

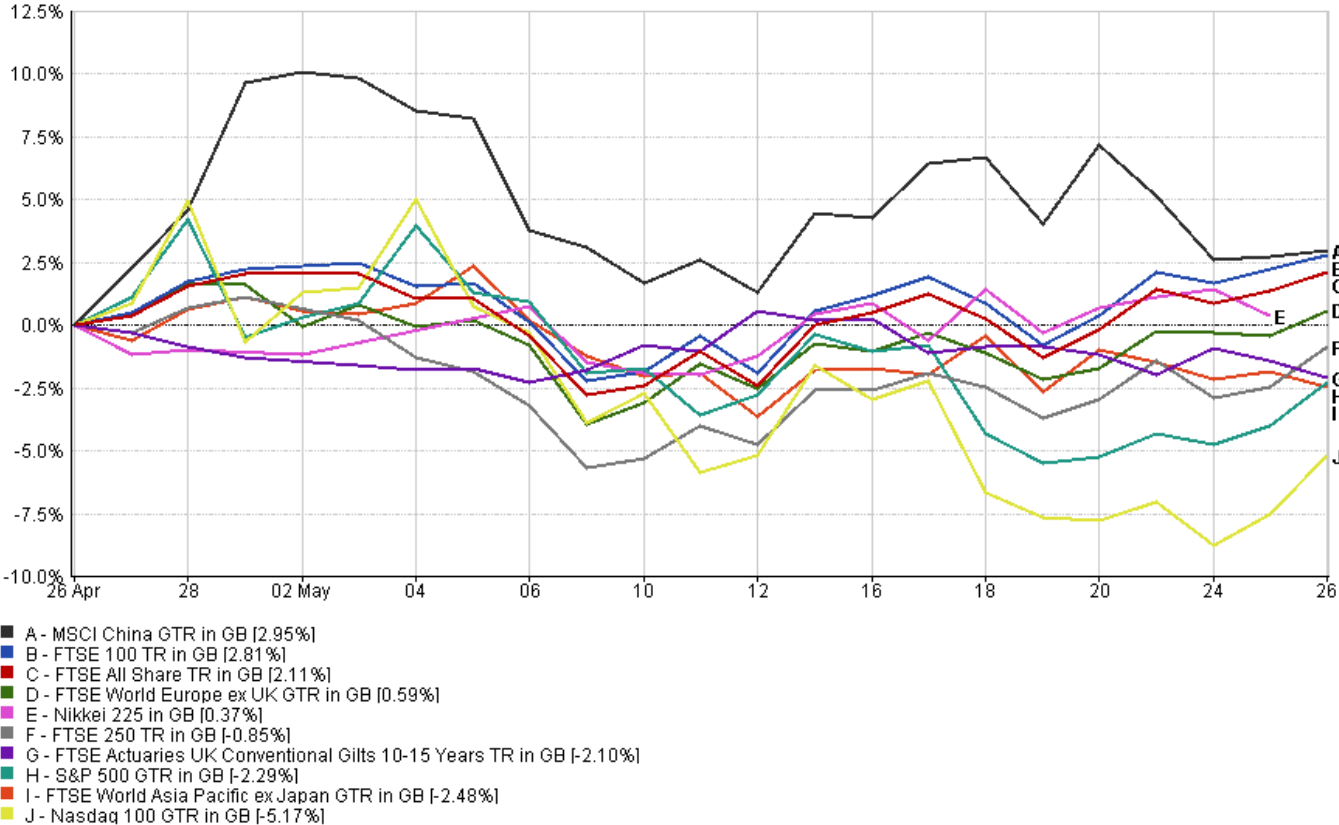


OVERVIEW

Over the past month, markets have remained volatile with concern centred around the extent and speed of US interest rate rises to control above target levels of inflation. Central banks, including the US Federal Reserve and the Bank of England, increased interest rates again following their May 2022 monetary policy committee meetings.

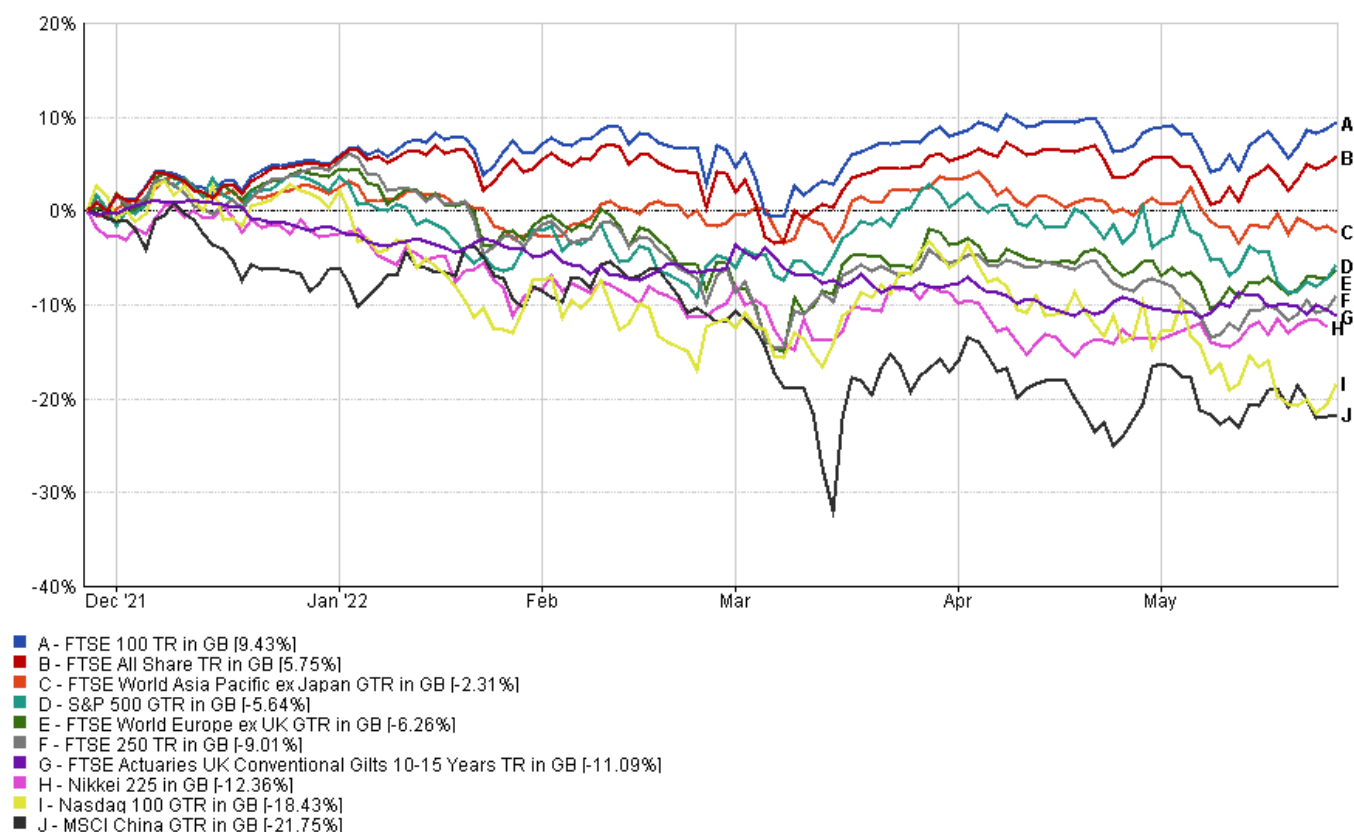
Investors are concerned that weakening economic growth and persistent inflation will lead to stagflation in some developed economies. The war in Ukraine continues to weigh on sentiment as food and energy prices rise further as a result of constraints on the supply of oil, gas and wheat. The Chinese economy is slowing as a result of its zero-Covid policy. However, the Chinese authorities and the central banks have recently announced stimulus measures and Covid restrictions have started to be loosened in some cities. The Chinese equity market has reacted positively over the past month.

INVESTMENT MARKET STERLING RETURNS OVER ONE MONTH



26/04/2022 - 26/05/2022 Data from FE fundinfo2022

INVESTMENT MARKET STERLING RETURNS OVER SIX MONTHS



26/11/2021 - 26/05/2022 Data from FE fundinfo 2022

The possible extent and frequency of interest rate rises in the US has led to heightened market volatility, as the values of companies' future earnings are based on interest rates and any rise impacts negatively on those values. The valuations of growth companies have been impacted, resulting in steep falls in their share prices. Against this backdrop, the US equity market has fallen sharply over the past month. With the consumer price inflation index (CPI) at 8.3% pa in May 2022, the US Federal Reserve (Fed) raised the Fed Rate at its meeting in early May by 0.5% (interest rate range 0.75%-1%) in its efforts to manage the inflation rate back towards its 2% target. Although US inflation fell by 0.2% pa from April, it is anticipated that it will remain far above target and that the Fed will have to continue to raise interest rates over the coming months, with the Fed indicating rises of 0.5% at its next two meetings. The scaling back of the Fed's monetary tightening may be seen if economic growth does slow. US new home sales have fallen around 17% over past month and consumers' discretionary spending has decreased as food and energy prices soar. Employment figures still look healthy with 428000 jobs added in April and the jobs market staying tight. The US dollar has remained strong against a backdrop of rising US interest rates. Such strength boosts dollar assets held in portfolios.

The UK equity market continues to perform relatively well - particularly the FTSE 100 index helped in part by its significant exposure to energy and commodities companies. The majority of the earnings of FTSE 100 index companies are made overseas, so weaker sterling enhances this income further. With CPI running at 9% pa in the UK as a result of steep rises in energy bills, the Bank of England increased Bank Rate by 0.25% to 1.0% at its May meeting. Three of the nine members of the Monetary Policy Committee (MPC) voted for a rise of 0.5%. The concern for the MPC is that quarterly economic growth is slowing and could turn negative later in the year - in March GDP fell by 0.1%. If the country does enter recession (two consecutive quarters of falling economic growth) and inflation is still above target, the Bank of England and the Government will be faced with a period of stagflation to negotiate.

European equity markets still remain weak as the tragic war in Ukraine continues with no end seemingly in sight, inflation soaring and the European Central Bank (ECB) looking set to start to increase interest rates for the first time in six years. As in other developed economies, the inflation rate of the eurozone at 7.4% in April 2022 is far in excess of the ECB's 2% target. The region has been hard hit as it tries wean itself off Russian energy imports. Christine Lagarde, the President of the ECB, has said the eurozone is at a "turning point" on interest rates although stressing that the central bank is not in a rush to raise interest rates or withdraw economic support. However, the ECB is expected to raise its deposit rate of -0.5% in July to help curb above target inflation.



The Japanese equity market has been impacted by the continuing Covid-related restrictions, rising energy costs, lacklustre economic growth and a weakening currency – the yen is at a 20 year low. Investor confidence has improved marginally of late as Japan looks set to start opening its borders to tourists. The Bank of Japan (BoJ) has largely grappled with below target inflation in the past decade and now core consumer inflation (after energy and food price increases are excluded) only exceeded its 2% target in April 2022 for the first time in seven years. The Governor of the BoJ, Haruhiko Kuroda, has maintained his stance that the recent cost-push inflation will be transitory and does not warrant a withdrawal of stimulus. He believes that Japan's slow wage growth and almost deflationary mind-set will keep inflation in check. However, if the yen weakens more, then inflation will increase further as the costs of imported fuel and food rise. If this is the case, the BoJ may then have to consider normalising monetary policy.



The Chinese equity market has begun to recover as social and economic policy changes have started to impact positively on investor sentiment. China's zero-Covid policy has been detrimental for its economy and disrupted global supply chains. Many parts of China, including Beijing and Shanghai, have been subject to stringent Covid containment measures, so weighing on economic activity. Nomura analysts estimated that 26 Chinese cities were under some form of lockdown/restrictions accounting for 208 million people and 20.5% of Chinese economic output. Shanghai is due to loosen its restrictions on 1 June 2022. As a result of the Covid restrictions, the Chinese economy is expected to weaken in the second quarter of 2022. To help support the economy, the government will broaden tax credit rebates, postpone social security payments by smaller employers, as well as cutting loan repayments and rolling out new investment projects. The central bank announced a cut in the five year loan prime rate to 4.45% from 4.6%. This is the main rate underpinning mortgage lending so should help borrowers and the property sector.

Fixed interest assets have performed poorly over the last six months with bond yields rising/ capital values falling as inflation and interest rates increase. The fixed income from a bond becomes less attractive in times of rising interest rates. Gilts, investment grade and high yield bonds have all suffered so impacting severely on the performance of the lower risk proportion of portfolios. Even index linked gilts (linked to inflation) have also fallen in value as short-term real interest rates have been increased by central banks in response to above target inflation so causing a capital loss. The starting coupon payments paid by inflation linked bonds are usually very low, so even if they increase in line with inflation, they form a small proportion of the total return.



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

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OUR VIEW

Over the past six months, portfolio values have been impacted by weakness across all asset classes, except property. However, it is the fall in fixed interest assets and in equity funds with exposure to growth companies - including technology companies - and equity funds investing in Chinese equities that have had the greatest negative impact. Fixed interest and growth funds are particularly affected by interest rate rises in response to inflationary pressures. The composition of the FTSE 100 has held it in good stead with oil and energy companies performing well. We continue to stress the importance of dividends and coupons within a portfolio as this "income" contributes significantly to overall returns when capital returns are under pressure. Equity income funds have performed relatively well with strong underlying dividend growth evident in the UK over the first quarter leading to upgrades. Although on a year on year basis, Q1 2022 dividend figures may look weaker than those in 2021, an exceptional number of special dividends were paid out in 2021 - approximately £6.2 bn. BHP, a historically strong dividend payer, also left the FTSE 100. Stripping out these effects, dividends rose around 12% - with the oil sector increasing pay-outs by about 29%. Dividends are expected to grow by around 15% over 2022.

As we alluded to in our previous bulletin, the rotation out of an ultra-low interest rate/bond yield environment, facilitated by central bank 'quantitative easing' is acutely painful. The latter experiment was unprecedented - meaning the exit strategy from it is unproven. Little wonder there is market uncertainty with the additional background of supply shortages and elevated inflation. It is vital to distinguish macro-economic uncertainties from corporate prospects which in so many cases remain sound. An uncomfortably volatile period is anticipated over the Summer months after which the interest rate/inflation picture should have become clearer. There is a point at which bond yields become attractive and prices stabilise. Company dividend yields can only rise so far too before buyers step in. The difficulty is that the US

OUR VIEW ... Continued

equity market in particular is not viewed as cheap for all that prices are now lower. Just six stocks account for around 25% of the value of the Standard & Poor's 500 Index by capital weighting (as at 1 April 2022) and all have been subject to exceptional share price growth in recent years. Any sign that earnings growth may not justify those prices concerns investors. Our portfolios remain diversified across asset classes and geographic sectors.

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