CARTLIDGE MORLAND
INDIVIDUAL WEALTH MANAGEMENT

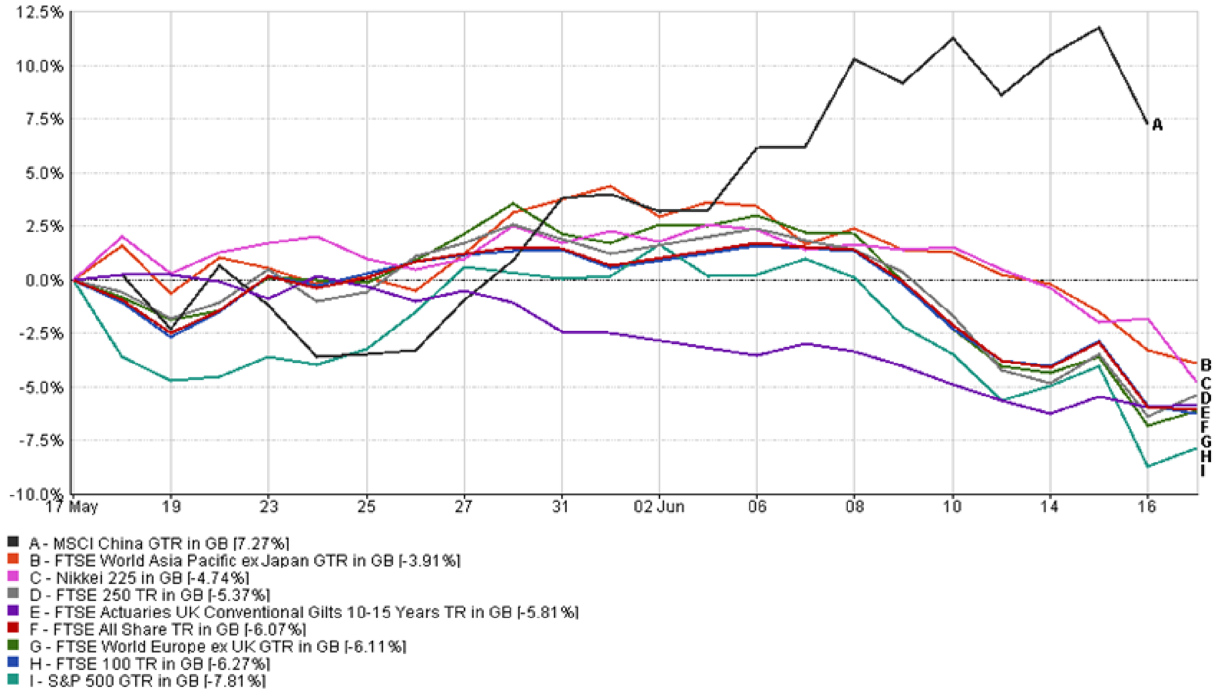
INVESTMENT COMMENTARY

17 JUNE 2022

OVERVIEW

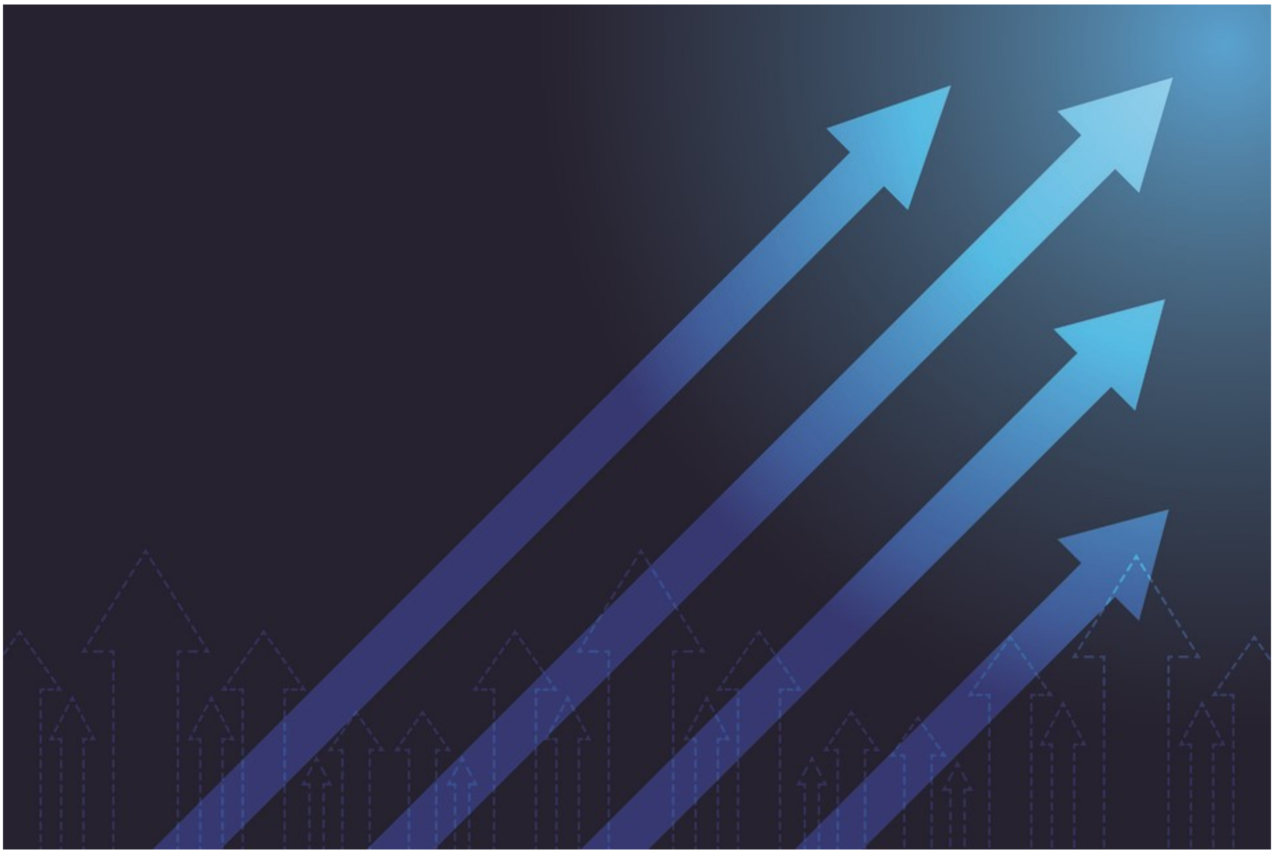
We anticipated an "uncomfortably volatile" period for investment markets over the Summer as inflation levels in the major developed economies have continued to rise, stoked by rising energy and food prices as well as supply chain constraints. In response, the major central banks have tightened monetary policy with interest rates rising and asset purchase programmes ceasing. Equity and fixed interest markets have reacted negatively to persistently high levels of inflation and more rapid and aggressive monetary tightening than expected. Global economic growth expectations have been revised down and investors fear a bout of stagflation – rising interest rates and low economic growth.

INVESTMENT MARKET STERLING RETURNS OVER ONE MONTH



17/05/2022 - 17/06/2022 Data from FE fundinfo2022

In the face of US inflation rising to a rate of 8.6% pa – the highest level since December 1981, the US Federal Reserve (Fed) raised its main interest rate by 0.75% pa at its recent meeting to a range of 1.50-1.75% pa. The Fed had signalled to expect increases of 0.50% pa at its June and July meetings but it is likely that another 0.75% pa increase will be announced in July and perhaps smaller increases until the end of the year with more to follow in 2023. Jay Powell, Chair of the Fed, commented the he did not expect adjustments at such levels to become common. It is now anticipated that US interest rates will reach 3.4% pa by the end of 2022. In tandem with the rate rises, the Fed is scaling back its $9trn balance sheet, as a result of starting to unwind its asset purchase programme. Against this backdrop of more severe monetary tightening, US economic growth is expected to slow to 1.7% pa by the end of the year and to remain at a similar level in 2023. The previous estimate had been for growth of around 2% pa. The US unemployment rate is 3.6% and is expected to climb to around 4.1% in 2024 as the economy slows.



In a similar vein although less aggressive in its action, the Bank of England (BoE) raised Bank Rate by 0.25% to 1.25% - the fifth consecutive increase as inflation reached a 40 year high of 9% pa. In April 2022. the BoE expects inflation to rise to 11% pa by October 2022. The economy contracted in April 2022 by 0.3% following a decline in March of 0.1%. The labour market remains tight with unemployment at 3.8% and pay deals averaging around 5%. There are presently more vacancies than unemployed people to fill them. A high employment rate matched by higher wages for the lowest paid (leading to greater productivity and smaller payments in tax credits and other benefits) should arguably encourage investment in plant and machinery to reduce labour requirements, whilst increasing national productivity. Unfortunately, with inflation at present levels and without the requisite level of capital investment, there a dangers of an inflationary spiral, fuelled by wage increases. The surge in business investment the Chancellor has sought to encourage is yet to materialise. Hence the BoE's present pre-occupation in discouraging employers from making high wages/salary settlements.

The European Central Bank (ECB) announced that in addition to the planned 0.25% pa interest rate increase in July 2022, it is likely than a further 0.5% interest rate rise will be made in September to fight inflation, which has soared to 8.1% pa. If the rise proceeds, it will be the first time in ten years that European interest rates have risen above zero. The ECB also said that it "anticipated that a gradual but sustained path of further increases in interest rates will be appropriate". In addition, the ECB announced the cessation of its remaining €20bn pm bond purchases although it would continue to reinvest the proceeds of the maturing bonds in its €1.7 trn bond portfolio. The bond yields of Italy and Spain shot up following the ECB meeting with fears of repeats of the 2012 and 2014 debt crises as their sovereign borrowing costs increased sharply. To counter these developing concerns, the ECB held an emergency meeting to hasten plans to lessen the widening gap between the borrowing costs of economically strong countries such as Germany and weaker ones like Spain and Italy.

The Japanese yen has continued to weaken as the Bank of Japan (BoJ) has continued with its ultra-loose monetary policy whilst its counterparts elsewhere in the world have started to tighten policy. The BoJ has kept overnight interest rates at -0.1% and has maintained it daily purchases of 10 year bonds at a yield of 0.25%. The Japanese government has called for more stability but has not yet intervened to stop the currency's decline. The BoJ believes that the underlying demand in the economy is too weak to withstand tighter monetary policy. Investor sentiment towards the Japanese equity market remains negative as there are fears that the weaker yen will have a wider impact on the economy with cheaper exports not compensating sufficiently for higher priced imports.

The Chinese economy has been adversely affected by President Xi Jinping's zero Covid policy. Retail sales have declined over the last three months as lockdowns and mass testing persist. Even after reopening from lockdowns which had been supportive of equity markets very recently, parts of Shanghai and Beijing have undergone mass Covid testing once again. Industrial output recovered to some extent in May as factories reopened following Covid-related closures in April. CPI for May 2022 was 2.1% pa – the lockdowns may have dampened demand whilst a key task for the government is to ensure domestic provision of grain and energy as lack of supply could fuel inflation.

The gloomy outlook for the global economy has weighed on equity markets, as the probability of a global recession has increased against a backdrop of above target inflation and interest rate increases. It seems that earnings are likely to reduce as costs rise and demand falls. The prices of growth stocks have fallen as increasing interest rates lead to future earnings being less highly valued. In the fixed interest arena, monetary tightening is likely to lead to real yields being driven up which makes equities comparatively less attractive. Yields on longer term bonds will also rise (capital values fall) as investors are compensated more for taking on interest-rate risks over the term of the bond.

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 Practitioner.

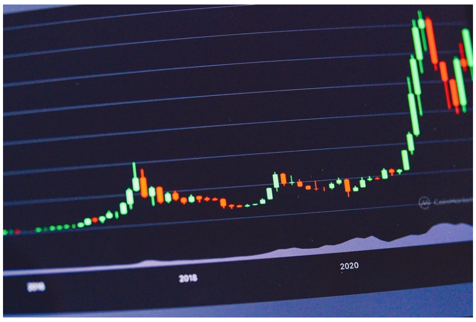
OUR VIEW

Our investment commentaries during the lockdown period flagged our expectation of elevated inflation as lockdowns eased. We referred specifically to likely misaligned forces of 'supply and demand', citing the difficulties in immediately reinstating supply chains in response to the predictable sudden surge in demand. Airline capacity – an example we cited at the time – is just one facet replicated across the global economy. We also pointed to the inevitable surge in the money supply as a result of the surge in 'quantitative easing' during the pandemic and the ease with which cash flowed to businesses and consumers. The factors described are classic, stimulatory ingredients of inflation - but add hot labour markets and sanctions against one of the world's critical suppliers of oil and gas and a surge in inflationary pressures is unavoidable. The war in the Ukraine and the fuel it has added to the inflationary fire was not predictable.

As an investor – the obvious question is what did we do about it given the predictions we made before such circumstances arose. In fact we explained the action we had taken and why in our January 2021 Investment Commentary:

> *"We continue to maintain diversified portfolios, but have re-balanced where appropriate, by taking from growth orientated equity funds, especially US equity funds which have benefitted from their technology and consumer discretionary exposures."*

Taking profits, at least in part, whilst available is a tough discipline to acquire and for many, it comes only after bitter experience and pain. The classic dilemma is whether to hold on irrespective of perceived 'value', in the expectation that sheer 'momentum' will continue to drive gains, or to sell in part or as a whole, to consolidate and preserve gains. The more cautious approach is often costly in terms of shorter term returns but will contribute to reduced portfolio volatility and to more stable returns over time. 'Momentum' will cease abruptly at some stage and when it does, the price of the most over-valued assets will plunge – often for some considerable time. Knee-jerk selling in the doldrums will serve only to embed losses and to deny recovery. No investor nor investment manager will get 'timing' right through judgement very often, so perception of value and acting in response to it is vital, without disregarding the benefits of 'momentum' and taking advantage to some degree.



OUR VIEW .... Continued

Recently, the 'momentum' in markets has been downwards as equity prices have fallen in response to bleaker expectations for global economic growth caused by global inflationary pressures and the fear of the extent to which interest rates will need to increase to combat it. Market sentiment switched from a 'risk-on' to a 'risk off' environment abruptly as US inflation surged and the Federal Reserve revealed a hawkish stance, which the Bank of England and the European Central Bank have little choice but to follow especially given similar problems in their own economies.

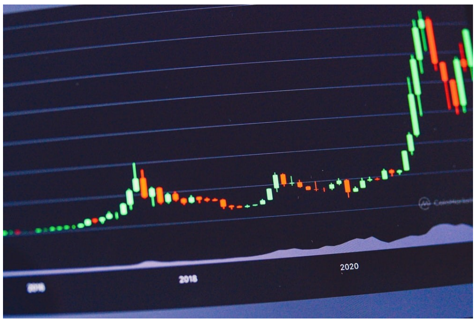
In the bond markets, the 'rotation' to higher interest rates and bond yields will remain painful with bonds offering equity investors a far less reliable insurance policy until capital values have stabilised at lower levels to allow sufficient yield. Provided inflation is brought under control, the floor is probably approaching in the US, with prices needing to fall further in the UK/European sovereign bond markets.

Fundamentally, it is important to remember that a major recession – traditionally the worst enemy of global equity markets - is not predicted in the near term. As we have said previously, with full employment and strong consumer/industrial/commercial demand for goods and services, even mild recession appears relatively unlikely. There is of course a danger of high inflation becoming embedded and of 'stagflation'. History has demonstrated that neither cash nor bonds will offer any succour in that environment and only 'real' assets such as land and the diverse range of underlying assets and income streams represented by equities will provide any protection. For this reason we are allowing the proportion of our portfolios held in bonds to reduce naturally and to allow the equity portion to increase.

Our expectation remains a turbulent summer for financial markets, with clear direction perhaps only becoming apparent in the early autumn. The central bankers are mindful of their responsibility to encourage sustainable global economic growth and not to apply the brakes too sharply during a period of rapid escalation in energy prices over which they have no control.

It is vitally important that investment portfolios are held for the longer term through market cycles and shocks. As we have advised during various financial crises in the past, it is impossible to time markets. Investor sentiment can turn quickly and consequently markets can move sharply and some of the best gains can be missed if not

OUR VIEW .... Continued



invested in markets. Who would have guessed that 9 March 2009 would be the date on which markets turned more optimistic in the aftermath of the Great Financial Crisis, or that 24 March 2020 would see markets start to recover after the Covid pandemic shock?

When investment markets have fallen sharply, attractive investment opportunities present themselves. Shares of good quality companies offer better value and fund managers then have the chance to build new positions in carefully researched companies at lower prices or top up their favoured existing holdings in their portfolios.

INVESTMENT MARKET STERLING RETURNS OVER FIFTHEEN YEARS

15/06/2007 - 17/06/2022 Data from FE fundinfo2022

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