



CARTLIDGE MORLAND

INDIVIDUAL WEALTH MANAGEMENT

INVESTMENT COMMENTARY



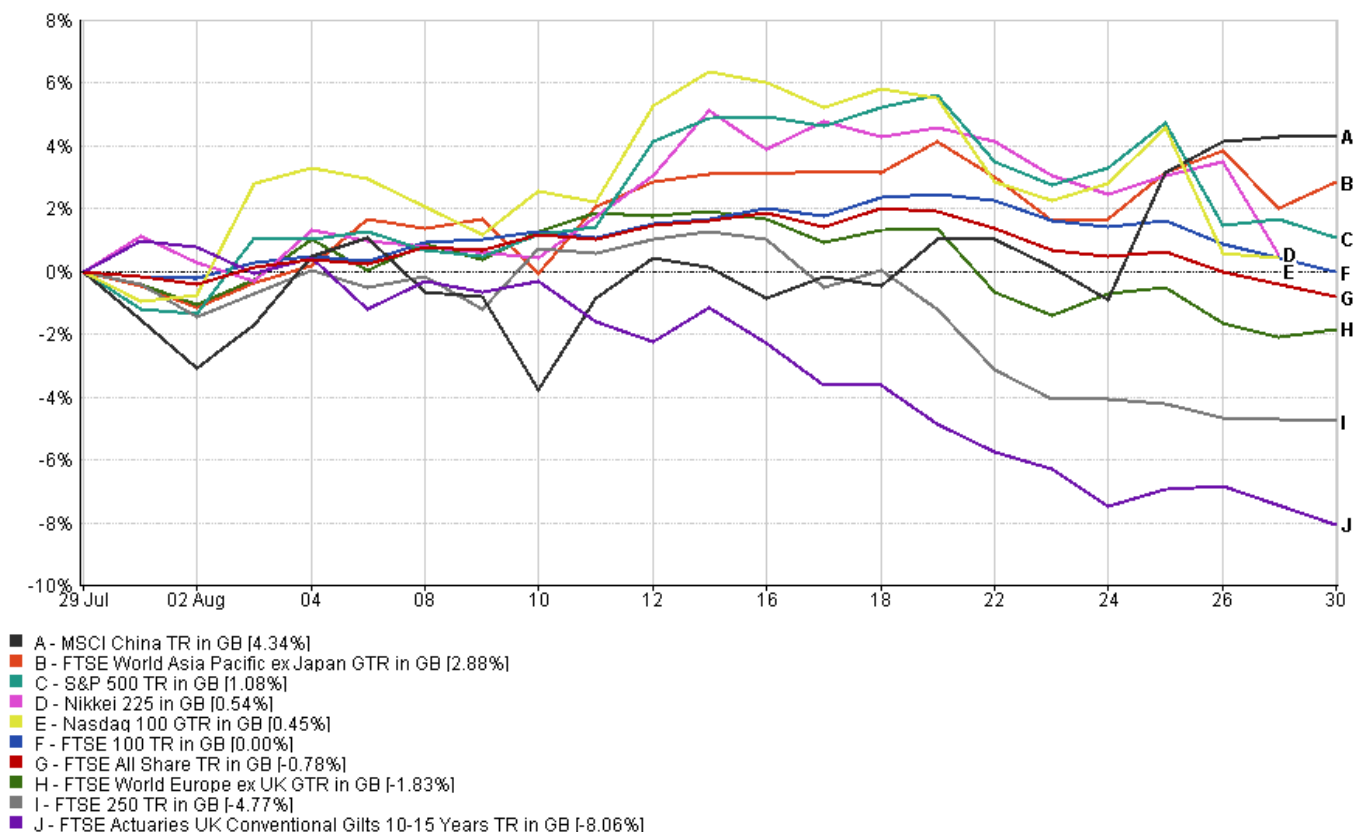
30 AUGUST 2022

OVERVIEW

Since the middle of July 2022, investment markets have been seeking direction from central bank actions and rhetoric as to the speed of monetary tightening. Until very recently, investors were a little more optimistic about the prospect for less aggressive monetary policy due to economic data indicating that global economic growth was slowing. The view

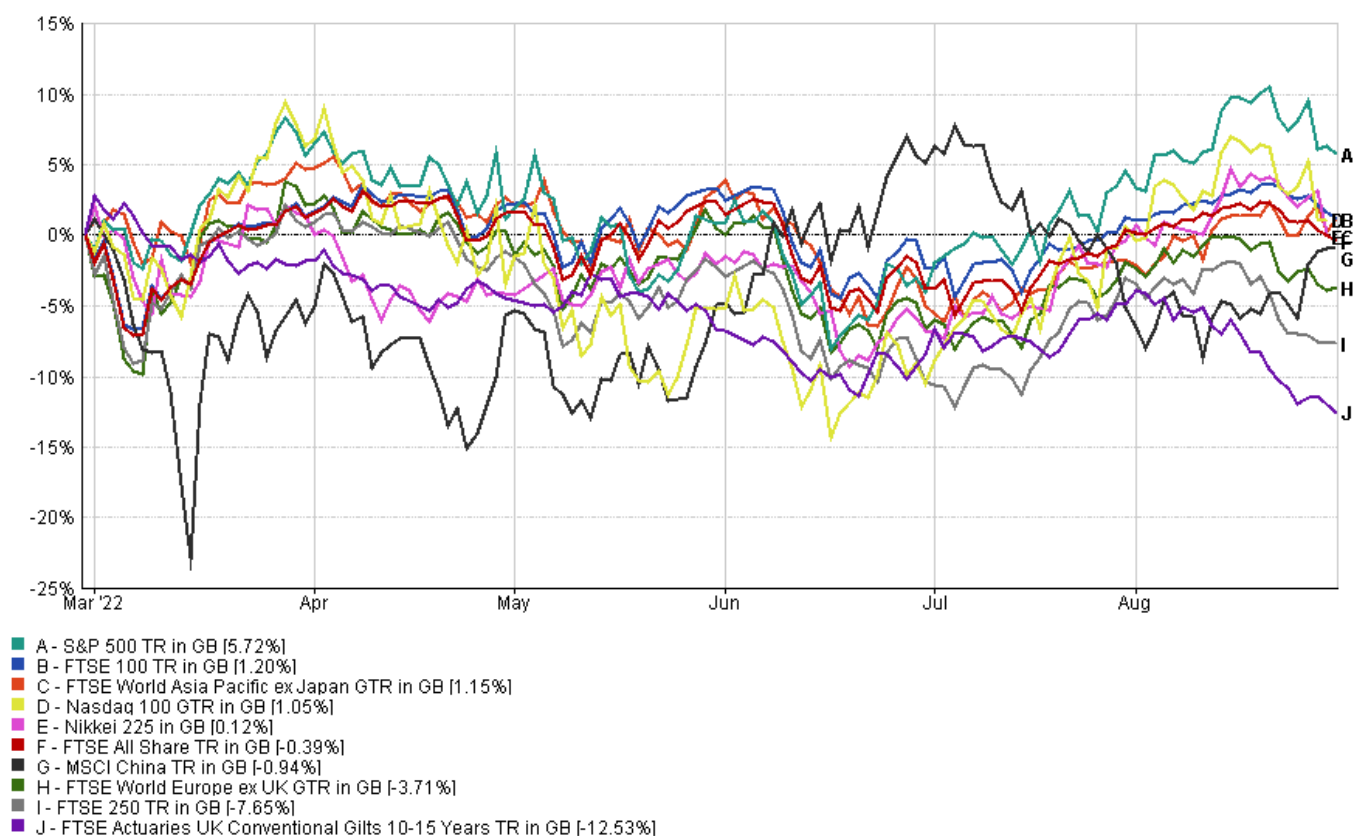
was that central banks would not want to stifle economic growth further with rapidly rising interest rates. However, Jay Powell, the Chair of the US Federal Reserve (Fed), put paid to that hope in his speech at the Jackson Hole symposium last week. He confirmed the Fed's commitment to ensuring that inflation would not become entrenched and that the Fed "must keep at it until the job is done". Traders are expecting the Fed to raise interest rates to between 3.75% and 4.0% in the first half of 2023 as a result. This is higher than the 3.50% 'terminal rate' assessment only weeks ago. The US equity market fell 3% on the back of Jay Powell's speech.

INVESTMENT MARKET STERLING RETURNS OVER ONE MONTH



29/07/2022 - 30/08/2022 Data from FE fundinfo2022

INVESTMENT MARKET STERLING TOTAL RETURNS OVER SIX MONTHS



28/02/2022 - 30/08/2022 Data from FE fundinfo 2022

A weakening global economy has weighed on investor sentiment. Recent economic activity indicators point to contraction in the manufacturing sectors in the US, Europe, the UK and Japan. Service sector activity also appears to be slowing. Strong inflationary pressures have seen demand moderate with labour and supply shortages also having an impact. However, there does seem to be some tentative signs that the rate of inflation is slowing. There is also concern that the Chinese economy will continue to be negatively impacted by weakness in its housing market as well as by the Chinese strict zero Covid policy. The Chinese manufacturing sector has contracted over the last two months. China has taken action to support its economy by cutting its five and one year lending prime rates to reduce the costs of new mortgages and corporate loans. The State Council (China's Cabinet) has also added \$44bn in credit support. These stimulative measures have seen sentiment towards the Chinese equity market improve very recently. However, the State Council stated that China would avoid "resorting to massive stimulus or comprising longer-term interests".

Central banks are expected to continue to raise interest rates aggressively as they try to combat persistently high inflation rates. The Fed is expected to raise rates again in September having increased the Federal Funds Rate by 0.75% to a range of 2.25-2.50% in July. The rise is expected to be at least 0.5%. The Bank of England (BoE) is also expected to follow suit at its forthcoming meeting after a 0.5% rise in early August taking Bank Rate to 1.75%. The European Central Bank (ECB) raised its deposit rate by 0.5% in July taking the rate to 0%. The expectation is for a further 0.5% rise in September. The Bank of Japan is on a different trajectory. It left its short-term policy interest rate at -0.1% in July. It maintained its long-term yield target and asset purchase programme with a view to achieving its inflation target of 2%.

Central banks are walking a tightrope of controlling inflation through higher interest rates whilst trying to slow economies without sending them into recession. Rocketing energy prices are likely to impact heavily on consumer and corporate balance sheets and therefore on demand over the coming months. Despite tight labour markets, both the UK and the eurozone could both be tipped into recession as a result. The US has still to feel the impact of the Fed's monetary tightening. Although the economy has been contracting over the first half of 2022, the National Bureau of Economic Research (NBER) has not certified a recession, as it uses a wide range of indicators including employment statistics. The unemployment rate is at 3.5% - the lowest level since 1969 - and consumer spending has held up to date.

The US dollar has continued to strengthen over the last three months as the outlook for interest rates and economic growth vary greatly in the world's largest economies. The Fed's message that it will continue to raise interest rates lent the dollar further support. The energy crisis in Europe, made worse by Russia's war in Ukraine, has led to increased negative sentiment towards the euro and sterling as the European and UK economies could be pushed into recession as a result. The strong dollar has helped the performance of the US equity funds held in our portfolios. Equally the weak pound has supported the return of the FTSE 100 index, as over half of the earnings made by the 100 largest UK companies are generated overseas - a considerable portion of them in US dollars.



In the face of high inflation, rising interest rates and slowing demand, it is important to have portfolio exposure to companies/sectors which are more resilient to economic changes. Companies which produce consumer staples, healthcare providers and food retailers are good examples. Companies with strong balance sheets and those with a history of a reliable income distribution should prove to be robust. Companies with substantial overseas earnings should perform better against a backdrop of weaker sterling. Our portfolios provide significant exposure to equity income funds which typically would invest in these types of companies. Good active managers will also position their portfolios accordingly using thorough research to identify financially strong companies, the share prices of which are offering value in the longer term.

Fixed interest funds have lost value over the year as inflation and rising interest rates affect the attractiveness of the fixed income they pay. The potential for rising default rates in corporate bond markets also increases as the economies weaken. We continue to hold fixed interest funds, although their negative correlation to equities has been tested recently as inflation has hurt both asset classes. Nevertheless, fixed interest assets are not as volatile as equities so should provide some protection when equity markets fall. Fixed interest assets also provide income streams and more recently those income streams have improved as capital values have fallen. These rising yields will eventually become attractive to large institutional funds seeking income, such as pension funds. Higher demand for income could then see prices begin to recover.



The CM Investment Commentary is compiled by Angela Cooper, Managing Director of Cartledge 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

Equity markets are likely to remain volatile over the remainder of 2022 as the major central banks continue to tighten monetary policy to control inflation. The ongoing war in Ukraine and the 'weaponisation' of gas supplies by Russia is likely to see energy prices rise further, so exacerbating inflation levels. We continue to run diversified portfolios for longer term capital growth and income where required. In the shorter term, we have positioned portfolios to generate higher levels of income which are important components of total return. As we have said during market downturns in the past, it is important to stay invested – so that portfolios can benefit from improving market sentiment which may result in equity markets moving quickly.

UK fixed income has been a major headache this year – one we knew would come eventually – as quantitative easing ceased and the Bank of England sought to manage interest rates upwards. Although we have sought to reduce UK fixed income exposures through diversification into international bonds and more recently, infrastructure it is difficult to find asset classes other than bonds that are non-correlated to equities and which will (typically) rally in response to equity market falls. As a shorter term strategic holding, cash is looking more attractive owing to higher interest rates being obtainable. Diversification into international bonds brings additional exchange rate risks – and currency movements can be very sudden. What is clear is that at 2.0% pa + even gilts are beginning to offer acceptable yields in the context of the Bank of England's target for inflation.

The signposts for interest rates and inflation should become clearer over the next few months but the shorter term picture is an unpleasant one. Supply chain pressures are not easing as quickly as markets anticipated, inflation in US/UK/Europe seems likely to hit higher levels than expected and whilst interest rates will peak at levels well below pre-credit crunch norms, they will hit higher levels than the peak 2.50% pa/3.50% pa expected for UK/US respectively, until recently.

The developed economies of the US/UK/eurozone all seem likely to experience **mild** recession next year cushioned only by relatively high levels of employment. A contracting economy is not good for companies and their share prices, although the latter have perhaps already fallen far further than a 'mild' recession would

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OUR VIEW ... Continued

appear to justify. Companies with highly leveraged balance sheets will suffer disproportionately, as the cost of finance increases as its availability shrinks.

The UK money supply is no longer expanding, it is now stable and will probably switch to reverse. This is a positive signal for inflation as it strongly suggests the rate will begin to fall for all it will rise further first. Energy prices are much higher than they were a year ago presenting major challenges for both business and domestic consumers. The effect of this rise is deflationary for the economy although it adds to the consumer price indices owing to the manner in which they are constructed. The money sucked from consumers' pockets by energy costs should limit the extent and duration of higher interest rates as demand for other goods and services will fall as a result. Supply pressures are likely to ease during the course of 2023 as the countries continue to adjust their energy policies without reliance on Russia.

Of the developed economies, Japan stands out as the one place where inflation remains below target and interest rates seem unlikely to rise. Japan's trade nowadays tends to be in deficit and its exports are only half the value of Germany's. The much higher costs associated with imported energy may worsen the trade deficit. However, if inflation and pay settlements indeed remain at very low levels – with a deliberately depressed Yen – then Japanese exports may become ultra-competitively priced. The substantial overseas earnings of Japanese companies will also translate into more Yen potentially boosting share prices. On a long-term view we continue to favour Japanese equities.

Market volatility may continue for longer yet without definite direction as markets await signs that inflation is indeed being curbed and that energy supplies can be improved leading to price falls. Therefore, we cannot predict strong performance from any asset class in the shorter term, merely that sentiment will improve as the outlook for the global economy normalises. Presently, the global economy is experiencing trauma and uncertainty which are reflected in sentiment in financial markets.



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