



CARTLIDGE MORLAND

INDIVIDUAL WEALTH MANAGEMENT

INVESTMENT COMMENTARY



29 SEPTEMBER 2022



OVERVIEW

The past week has seen tumultuous moves in the UK gilt market and in sterling as investors reacted negatively to the UK government's mini-budget, intended to boost growth above its recent trend in an economy which is teetering on the brink of recession. Tax cuts together with the cancellation of tax and national insurance rises had been flagged before the event. When considered as a whole alongside the previously announced energy price cap, markets took fright at the extent of the new government borrowing requirement, just when the Bank of England had increased interest rates and announced that it would be selling some of its stock of gilts back into the market. The Chancellor said that his 2.5% pa growth target would be supported by tax cuts and reforms to the supply side of the economy – including infrastructure projects, new investment zones and more private sector investment. Measures to increase participation in the labour market were also announced. Markets are worried that the government plans are not sufficiently funded and that growth may not be forthcoming – there was no Office of Budget Responsibility (OBR) forecasts to support the spending plans. Sterling fell and gilt yields soared on the prospect of the rise in gilt issuance and worries that fiscal easing will add to the economy's inflation woes as demand could increase. If inflation remains high then the Bank of England would have to raise rates even higher. Pension funds also faced pressure to sell bonds to maintain solvency as additional cash was required to meet margin calls. Strategies to provide inflation and interest rate risk protections were impacted by falling gilt prices. Consequently, the Bank of England (BoE) stepped into the bond market, postponing its decision to sell part of its gilt portfolio and started buying longer term gilts to stabilise the market. Yields fell as a result of these 'temporary and targeted purchases'.

The US dollar has strengthened considerably over the year due to aggressive monetary tightening by the US Federal Reserve (Fed) to combat above target inflation. At its most recent meeting, the Fed Rate was increased by 0.75% to a range of 3% to 3.25% pa attracting investors to buy the world's reserve currency. Although the US economy is contracting in common with other global economies, it is not as affected by the soaring energy prices experienced elsewhere, due to the impact of the Russian invasion of Ukraine on supply. Sterling has fallen around 20% against the US dollar over the year with around 4% of that fall occurring over the past week. The Yen has fallen around 20% over the year as Japan continues with its loose monetary policy. Japan stepped in to protect the Yen last week, by selling US dollars. The Chinese renminbi has also fallen around 12% against the US dollar as the authorities continue with monetary easing to support its slowing economy. The euro has also fallen around 15% against the US dollar over the year as the region faces energy shortages and the European Central Bank has been slower to raise interest rates.

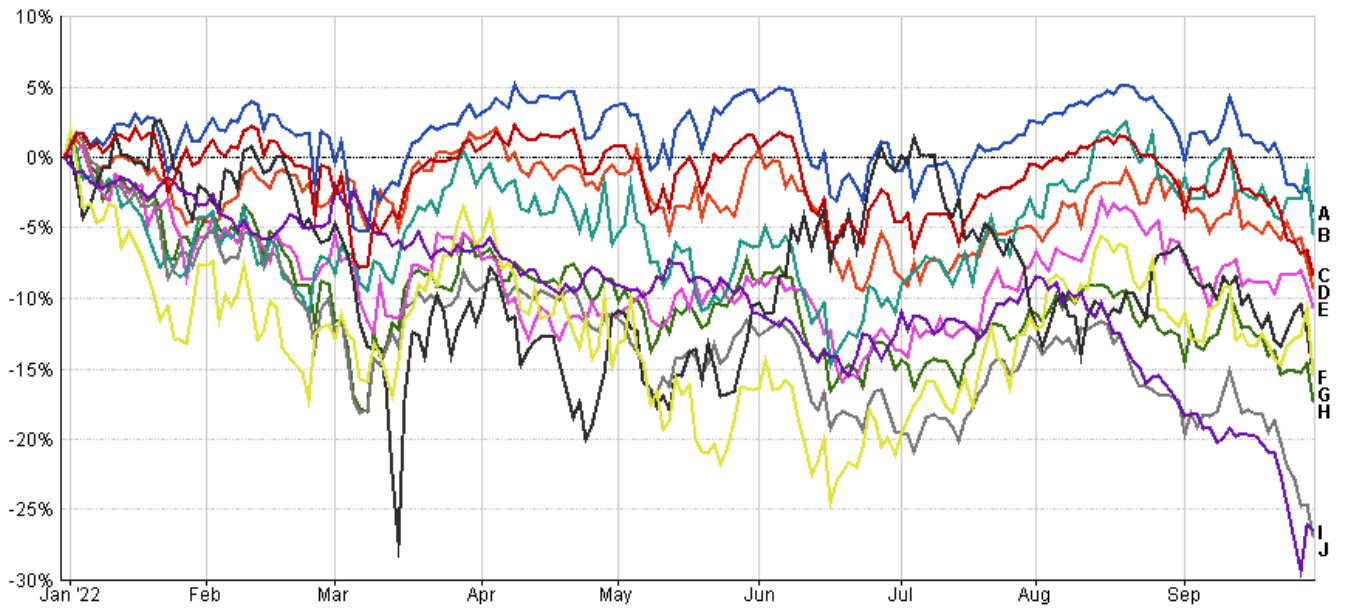


The Fed looks set to do whatever it takes to crush inflation as the 3% rise in the Fed Rate this year illustrates. Currently, the market expects the Fed rate to peak at 4.6% next year. A global recession is on its way with developed economies already slowing considerably/contracting. The question is whether the Fed will over-tighten as it appears that the rate of inflation is slowing – oil and gas prices have fallen as have those of other commodities. Supply chain pressures are easing as Covid-related restrictions disappear around the world and shipping rates are falling. Housing markets around the world are weakening. The cost of living rises could see people returning to the workforce. A recession in itself will also lead to a decline in inflation, but if the Fed (and other central banks) overtighten that recession could be deeper and longer. Inflation rates are measured on a year-on-year basis so inflation increases should moderate over 2023 following the sharp rises over 2022. The energy caps which many countries have introduced should also bring downward pressure on inflation.

So where does this leave investment portfolios?

The strong dollar has impacted markedly on portfolio performance. Our US equity funds, which are unhedged, have performed well in sterling terms over the year but in local terms (US dollar), the US equity market has been one of the weakest markets. The US mega-tech companies, which comprise a large proportion of the S&P 500 index, performed strongly over the Covid period and ultra-low interest rates also led to very high valuations. As interest rates have increased and demand has fallen for their products/services and inflation impacts, their values have fallen. The charts below show investment market returns in local currency terms and in sterling terms which underlines how the strength of the dollar has affected returns.

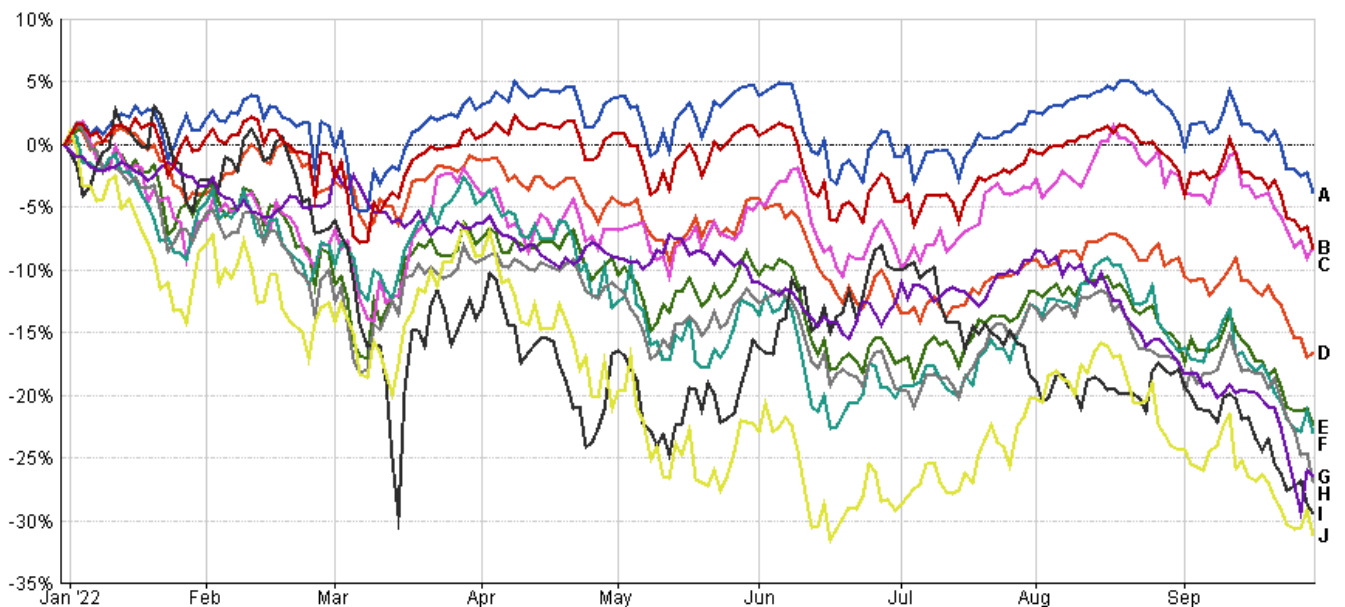
YEAR TO DATE INVESTMENT MARKET TOTAL RETURNS IN STERLING



- A - FTSE 100 TR in GB [-3.84%]
- B - S&P 500 TR in GB [-5.46%]
- C - FTSE All Share TR in GB [-8.32%]
- D - FTSE World Asia Pacific ex Japan GTR in GB [-9.40%]
- E - Nikkei 225 in GB [-10.61%]
- F - MSCI China TR in GB [-15.44%]
- G - Nasdaq 100 GTR in GB [-15.50%]
- H - FTSE World Europe ex UK GTR in GB [-17.36%]
- I - FTSE Actuaries UK Conventional Gilts 10-15 Years TR in GB [-26.46%]
- J - FTSE 250 TR in GB [-26.93%]

31/12/2021 - 29/09/2022 Data from FE fundinfo2022

YEAR TO DATE INVESTMENT MARKET TOTAL RETURNS IN LOCAL CURRENCY

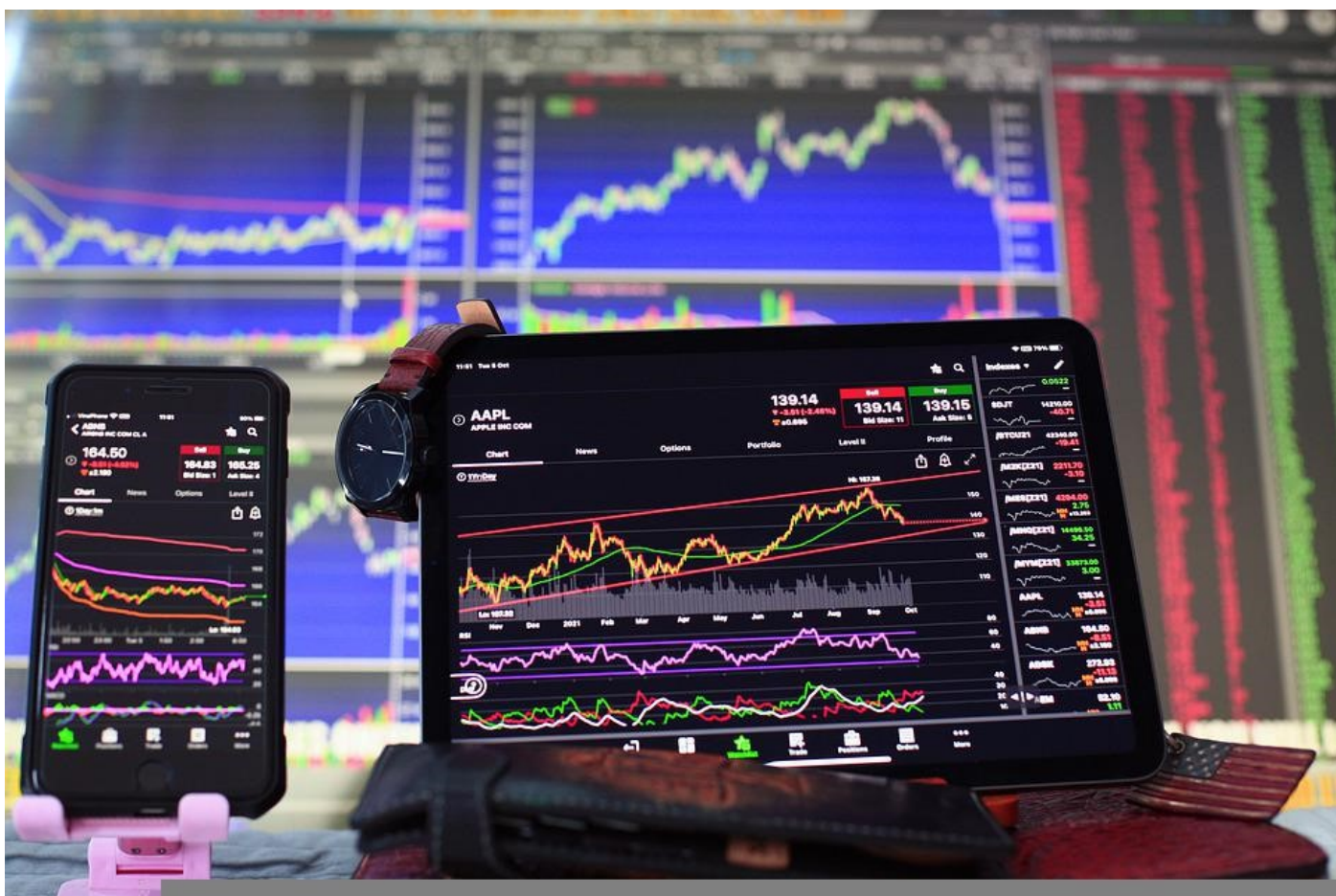


- A - FTSE 100 TR in GB [-3.84%]
- B - Nikkei 225 in JP [-8.23%]
- C - FTSE All Share TR in GB [-8.32%]
- D - FTSE World Asia Pacific ex Japan GTR [-16.56%]
- E - FTSE World Europe ex UK GTR [-22.42%]
- F - S&P 500 TR in US [-22.98%]
- G - FTSE Actuaries UK Conventional Gilts 10-15 Years TR in GB [-26.46%]
- H - FTSE 250 TR in GB [-26.93%]
- I - MSCI China TR [-29.42%]
- J - Nasdaq 100 GTR in US [-31.16%]

31/12/2021 - 29/09/2022 Data from FE fundinfo2022

Fixed interest funds and growth funds have experienced considerable falls this year against a background of rising inflation and steep rises in interest rates by the central banks, as they battle to curb inflation. Over the past few years, we have reduced our exposure to UK fixed interest using global bond funds, commercial property funds and protected funds to diversify exposure at the lower risk end of our portfolios. We have also increased holdings in good quality, income-producing equity funds to enhance the income generation in the portfolios, which is an important component of total returns over time. These income funds also tend to invest in larger companies deriving earnings overseas. In the case of UK equity income funds, the exposure to larger companies with the majority of their earnings made overseas has been supportive, especially whilst sterling has weakened. This impact is seen in the returns shown in the graph above with the FTSE 100 index out-performing other markets in local currency terms. Furthermore, the UK equity indices comprise fewer growth companies whilst having significant exposure to energy, commodities and financials which have performed relatively well since the beginning of the year. Similarly across Europe, large multi-national companies will be benefiting from overseas earnings given the weakness in the euro.

Our diversified portfolios are managed for the longer term investing in a range of complementary good quality funds, bearing in mind the macro economic outlook and client objectives and risk profile. We invest across equities, fixed interest, commercial property, infrastructure and cash as appropriate.





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

The US has been blessed by its exceptionally dynamic and ambitious technology sector together with its unbridled determination to be self-sufficient in energy. Conversely Europe has made itself dependent on Russian gas, now weaponised against it as so many predicted.

Following Russia's invasion of Ukraine, we predicted a sharp rise in the US dollar owing to its defensive status as the world's reserve currency, the fact that the US is a net oil and gas exporter and also because the US Federal Reserve (Fed) appeared most likely to raise interest rates aggressively.

Only co-operation amongst the developed world's central banks has permitted apparently unlimited quantitative easing and more than a decade of ultra-low interest rates. The Fed has broken free on 'America First' principles, citing the need above all to curb a runaway US economy and associated inflation.

The European Central Bank (ECB), the BoE and the Bank of Japan (BoJ), which are custodians of the world's junior reserve currencies, are now drowning in the Fed's wake – the danger to them being that such a rise in the dollar will add to their input costs and in the case of EU/UK to already serious domestic inflationary pressures.

These woeful conditions will persist until the Fed is at last convinced that it has done enough to combat inflation. In the meantime, larger rises in EU/UK interest rates than were anticipated two/three months ago seem highly likely. Fighting inflation is now deemed more important than supporting growth.

Here lies the obvious contradiction with the loose fiscal policy now being pursued by the UK government, led by Liz Truss. The financial markets are truly astounded by it as are so many Conservative MPs. It would seem international confidence in the UK government's stewardship of the economy has plummeted, adding to sterling's woes and leading to further falls in the gilts market. Those with memories of the late 1970s might fear a Kwarteng cap-in-hand visit to the International Monetary Fund (IMF).

The government is right to pursue policies intended to drive UK economic growth higher – but doing so really does raise questions whilst the Bank of England is attempting the very opposite. Perhaps the Kwarteng case is that his fiscal measures will have little or no effect



OUR VIEW ... Continued

until after 6 April next year, by which time he expects inflation to be under control and trending downwards. If this is Mr Kwarteng's view (and to us it seems his only credible explanation) he still needs to explain it and support it by justification, to regain the confidence of the markets.

It is important to remember that the UK's problems are common to the EU and to many other nations of the world. The currency issue is a tale of US dollar strength rather than sterling weakness – for all that sterling's woes have been exacerbated recently.

More positively, weaker sterling will feed the profits of the FTSE 100 companies, which derive 70% of their earnings from overseas – much of them in US dollars. The FTSE 100 index has been relatively stable this year – dividend yields remain high and a strong US dollar means overseas earnings translate into more pounds. In this sense, present conditions are ideal for the FTSE 100 companies and for European and Japanese multi-nationals with strong US dollar earnings too.

It is important to remember that the converse will be the case for US multi-nationals, as their overseas earnings will translate into fewer dollars, putting profits under pressure. US companies with strong domestic focus will probably fare better amidst current conditions.

As Asia Pacific and Emerging Markets countries/companies tend to borrow heavily in US dollars, often over the shorter term, they are likely to experience considerable pain. However, their exports will be priced far more competitively for US dollar buyers.

The fixed interest market globally is severely undermined by a combination of exceptionally high inflation and rising interest rates – to levels which still remain uncertain. The only good news is that much of the damage has already been done by now and with US Treasury/gilt yields nudging 4% pa and above, the asset class is looking more attractive. Buyers other than the Bank of England will be back – once it is clear at what levels inflation and interest rates will peak.

Living through periods of exceptional disruption and uncertainty is part of being an investor – but these words will provide little comfort to those absorbing significant paper portfolio losses. Pulling money out during such times is rarely profitable because one merely embeds



OUR VIEW ... Continued

losses that have already occurred and denies oneself the benefits of recovery when it comes – which it always does. Indeed, by the time one feels such inclination any further risk of losses is usually slight whilst that of losing the benefit of recovery is highly elevated.

Markets will only turn for the better once the rates of interest needed to curb inflation become clear – most importantly in the US. We are not at that point yet, although we suspect it is not far away. In the meantime, it is safe to assume further interest rate rises although many of the effects of these are already priced into assets.

The UK is a large and resilient economy so it is unlikely the government can ‘crash’ it (Keir Starmer’s phrase) no matter how badly it manages it. There are inbuilt adjustment mechanisms in free markets and the government needs to convince markets to at least allow it the benefit of the doubt or it will be forced to change its policies. Potentially, the government has the right policies – introduced at the wrong time.

If you have any queries

please do not hesitate to contact

your Cartlidge Morland consultant.



83-85 Mansell Street London E1 8AN
t: +44 (0)20 7709 5560
e: enquiries@cartlidgemorland.com
www.cartlidgemorland.com

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