



CARTLIDGE MORLAND

INDIVIDUAL WEALTH MANAGEMENT

INVESTMENT COMMENTARY



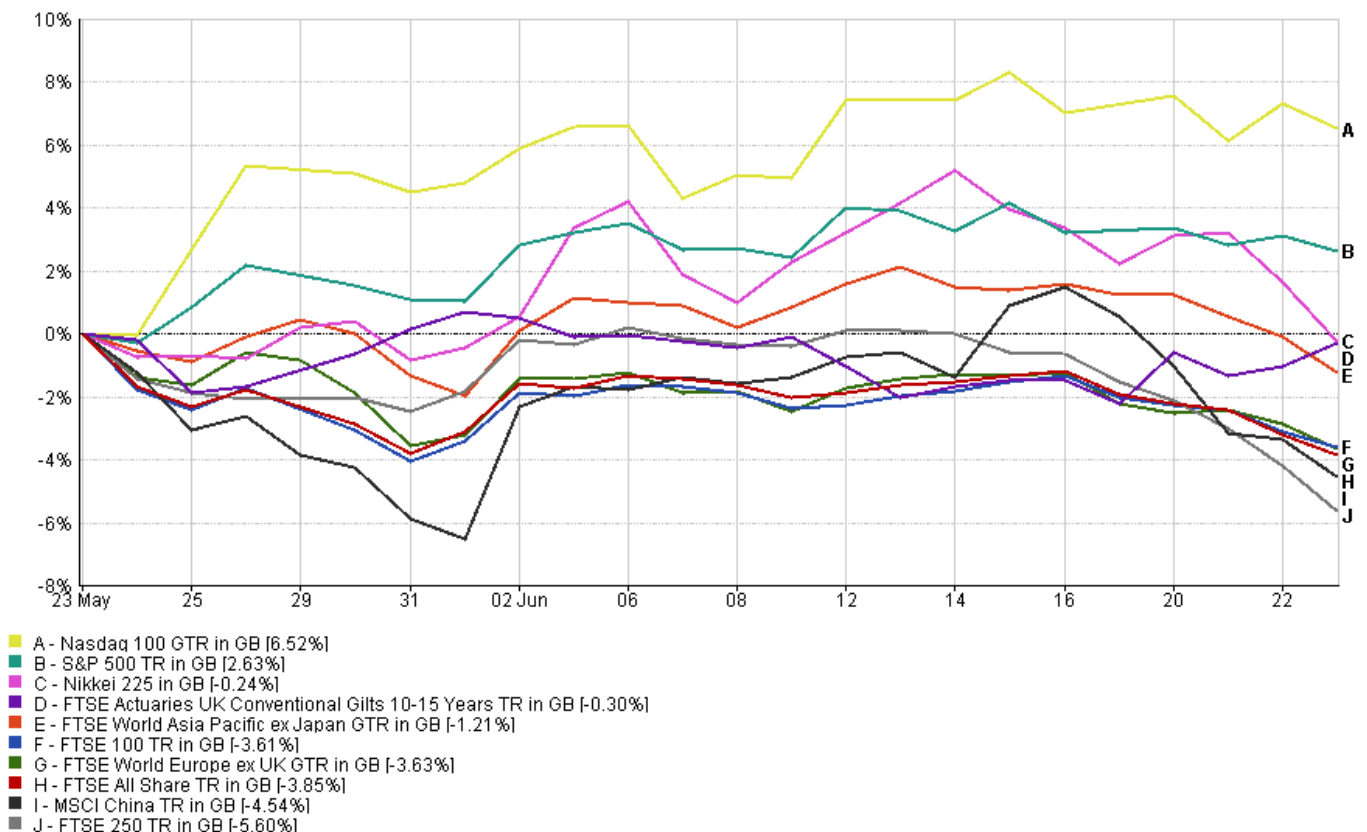
23 JUNE 2023



OVERVIEW

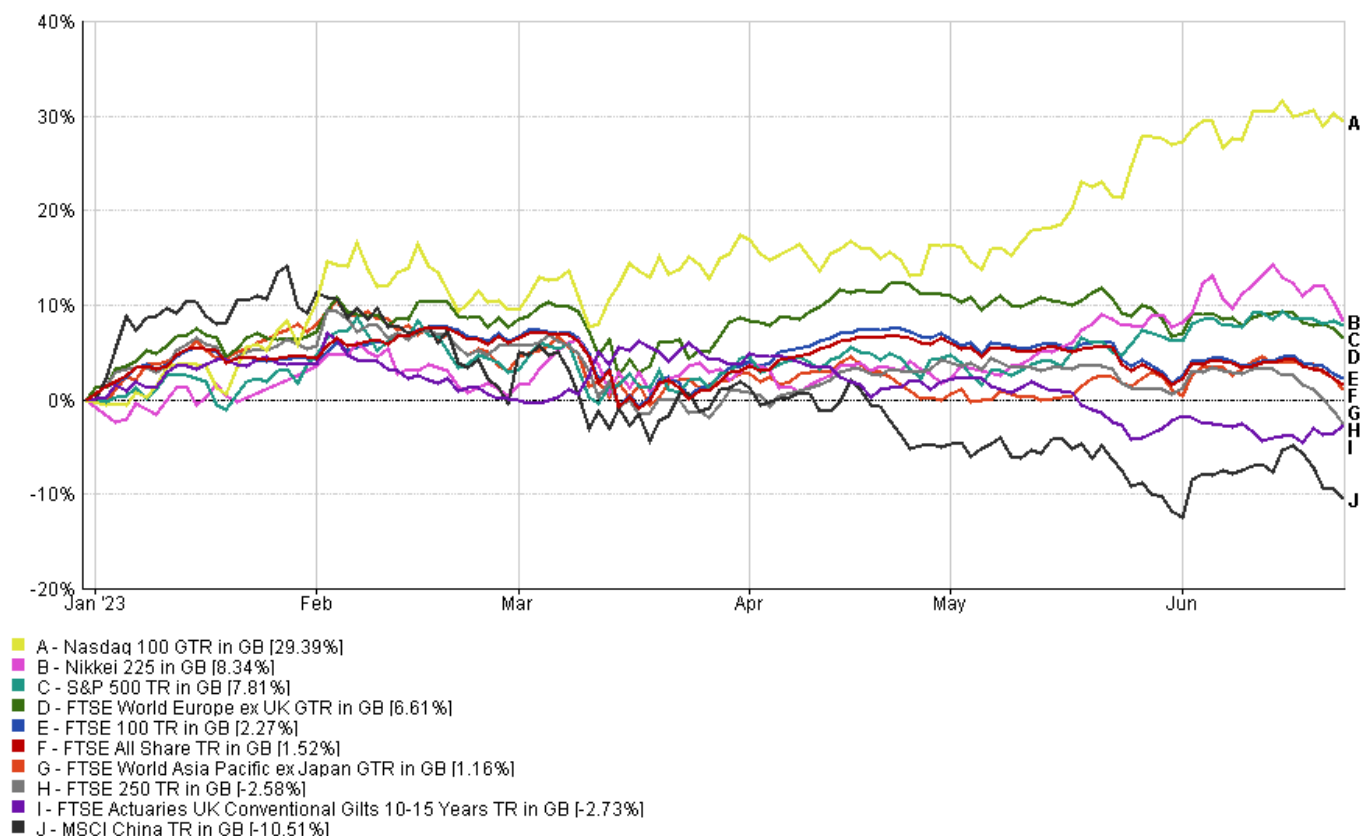
Investment markets continue to be driven largely by macro-economic news and data. Above target levels of inflation, particularly in developed economies, continue to challenge central banks' monetary committees. If monetary policy is tightened too much, then deep recessions may result, but too little and inflation remains rampant in economies. As markets try to anticipate the likely trajectories of inflation and interest rates, equity and fixed interest rate markets have responded.

ONE MONTH INVESTMENT MARKETS STERLING TOTAL RETURNS



23/05/2023 - 23/06/2023 Data from FE fundinfo2023

YEAR TO DATE INVESTMENT MARKETS STERLING TOTAL RETURNS



30/12/2022 - 23/06/2023 Data from FE fundinfo 2023

At its June meeting, the US Federal Reserve (Fed) paused its interest rate hiking cycle, having increased the Federal Funds Rate by over 5% since the beginning of this cycle in March 2022. The Fed left the rate at 5.00%-5.25%. The Chair of the Fed, Jerome Powell, indicated that this was a “skip” rather than a “pause” and that further rises are still on the cards, with another 0.25% rise expected in July. The Fed is targeted with maintaining price stability and full employment. It appears that US inflation is easing, reaching a level of 4.00% in May (from 4.90% in April) driven by falling energy prices. Core inflation, which excludes energy and food, also fell to 5.30% from 5.50% in April.

The European Central Bank (ECB) increased its key interest rate to 3.50% from 3.25% - its highest level in 22 years. The ECB is expected to raise rates again at its July meeting by 0.25%. Whilst acknowledging that inflation is falling, the ECB expects it to remain “too high for too long” predicting that core inflation will increase to 5.10% for 2023 from 4.60% now. Wage increases are driving this elevated level of inflation.

The Bank of England (BoE) somewhat unexpectedly increased Bank Rate by 0.50% to 5.00% (0.25% had been anticipated). Andrew Bailey, the Governor of the BoE, said the central bank would do “whatever is necessary” to bring inflation down. The series of interest rates rises implemented since the end of 2021 have not yet had their full impact due to the preponderance of fixed rate mortgages. Inflation as measured by the Consumer Price Index (CPI) remained at 8.70% pa in May, which was 0.30% higher than predicted. Core inflation rose to 7.10% pa from 6.80% pa in April. The strong labour market has added to inflationary pressures but it now appears that more people are returning to work as high inflation impacts on finances. The BoE does expect inflation to fall significantly during the rest of the year more closely reflecting the decrease in energy prices, falling producer output and food inflation. However, a tight labour market and continuing resilience in demand were the main reasons for this latest hike in interest rates.



As mentioned in previous commentaries, the Japanese economy differs from other developed peers in that it had been battling deflation for decades. Although inflation is now stronger than expected, the Bank of Japan (BoJ) has maintained its relatively loose monetary policy. It expects inflation to slow later this year whilst “nimble responding to developments in economic activity and prices as well as financial conditions”.

By increasing interest rates, central banks are aiming to slow demand, as higher interest payments will mean that there is less to spend elsewhere in the economy. Consequently, economic growth is likely to slow and possibly contract over two quarters (a technical recession). US growth has been slowing over the last two quarters and is expected to slow further into 2024. Economic growth in the eurozone shrank by -0.10% in the last quarter of 2022 and first quarter of 2023 therefore entered a technical recession. It seems strange that the ECB is continuing to raise rates against this background but although the headline eurozone inflation rate is 6.1%, there are significant differences in inflation levels between member countries. The ECB is trying to ensure that inflation falls across the whole eurozone. In the UK, GDP increased by 0.1% in the first quarter of 2023. April saw the economy grow by 0.20% in the month as car sales increased and more was spent in pubs and bars. Economic growth is expected to remain weak through 2023 but currently predicted not to enter recession although the recent hike in interest rates may weigh heavily on the economy later in the year. Japan saw economic growth of 0.70% in the first quarter of 2023 supported by strong growth in the services sector and the reopening of the economy following Covid lockdowns.

After the initial rebound of the Chinese economy as it came out of pandemic-related lockdowns, growth has slowed, as demand globally and domestically weakened. Geopolitical tensions have also increased. Investors had expected some sort of stimulus to support the economy which materialised in the central bank’s reduction in its medium term lending rate



Investment markets are reacting to the likelihood that the interest rate cycle is nearing its peak. In the aftermath of the Fed's decision not to change the Fed Rate, the US equity market rallied. The valuations of growth companies have been strengthening on the prospect of lower interest rates on which the values of their future earnings are based. The performance of the tech heavy NASDAQ reflects this improvement as well as the support for artificial intelligence (AI) related stocks. European equity markets fell following the ECB's increase in interest rates. Similarly the UK equity market fell on the back of the BoE's latest interest rate rise as more interest rates rises are expected in the face of above target inflation. The values of smaller and medium sized companies have been affected as the UK consumer, to which these companies typically have high exposure, is likely to be negatively impacted by stubbornly high inflation and rising interest rates. Sterling has also strengthened as interest rates have risen. As many of the UK's largest companies make the majority of their earnings overseas a strong pound has a negative impact on the value of these earnings, so weighing on their performance. Even UK mid-caps generate around 50% of their earnings from overseas.



The Japanese equity market has made a strong return over 2023 and still remains attractively valued. There are a number of factors which have supported this performance. The re-opening of the economy after the pandemic supported economic growth as domestic demand recovered. Core inflation is now running at around 4.00% pa and wages are finally increasing. Tourism has recovered significantly with visitor numbers 15 times greater than in April 2022. Japan is also benefiting from increased investment with some movement of manufacturing away from China and from making equipment required for the manufacture of AI-related chips. The weaker yen has also been supportive of its exporting industries. There has also been progress made on corporate governance reform with more emphasis on improving shareholder returns.

UK fixed interest assets have been negatively affected by above target inflation and rising interest rates. Until economic data confirms that inflation is on a rapid downward path, weakness will remain in the market. This could take some time but it appears that the BoE has restored some credibility with its latest interest rate increase as demand and inflation should slow as a result.



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

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OUR VIEW

Given the gloom afflicting the global investment community, it is difficult to accept that over the 12 months to 23 June 2023 that, in local currency terms, the FTSE 100 Index is up 10.43% and the FTSE World Europe ex UK index 19.14% higher. In the US, the S&P 500 Index has managed 15.95% whilst the Japanese Nikkei 225 index has risen 25.26%. These returns reflect strong recovery from a depressed period 12 months ago and in the case of certain markets, strong dividend flows too. However, whilst losses have been recovered to some degree, the gilts market (FTSE Actuaries UK Conventional Gilts 10-15 Years) is still down 14.56% over the same period and corporate bonds (IA Sterling Corporate Bond Sector Average) fell 4.57% - the price of normalised bond yields and higher interest rates. (Source FE Analytics)

The current calendar year has largely been witness to continued progress, the exceptions being gilts and Chinese equities whilst the recovery in UK mid-caps has stalled. The US mega-tech companies have benefitted from resurgence in their share prices as investors anticipate the top of the interest rate hiking cycle and prospects of developments in AI. Avoiding increased exposure to the 'mega-tech' band wagon is hard to resist because shorter term it flatters portfolios with instant gains and the long 'bull run' in this area has placed other investments in the shade. We are satisfied with the exposures we currently hold in the sector against a background in which experts are fervently stating that Apple Corporation, for example, does not justify the £3trn valuation placed on it. It is not so many years since the same analysts asserted Apple was not worth \$1trn, as its share price headed ever upwards. The mega-techs account for most of the gains in the S&P 500 Index this calendar year. Index tracking investment strategies play a significant part in this performance as the higher the percentage of US market capitalisation which is accounted for by these US mega-tech stocks, the more of them the 'passive' or 'tracking' funds have to buy. Whilst the bubble is inflating few wish to risk 'crying wolf' - but when it bursts, investors will wish they had taken account of fundamentals, instead of placing reliance on 'chain letter' style momentum. Index tracking or 'passive' funds certainly have their place in portfolios and we use them - but they are just one tool in the box which should be used in conjunction with other investment strategies.



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OUR VIEW ... Continued

The direction of investment markets in the short term is difficult to anticipate as inflation levels and monetary policy responses are driving sentiment. Our portfolios are managed for longer term returns and we maintain fully diversified portfolios investing in an appropriate mix of active and passive funds investing in equities, fixed interest, property and cash. We have taken opportunities to invest in asset classes buying on weakness including high quality fixed interest funds and Japanese equity funds in recent times.

A major change in conditions for private investors is the relatively high yields currently available from bonds combined with reasonable capital stability. We are now including strategic allocation to cash/money market funds in the lower risk area of our portfolios as we can obtain reasonable yields there too.

Overall, neither investment managers nor their clients should be too readily seduced by yields, save as a means of securing a comparatively fixed income. In cash terms, such yields are presently being consumed by elevated rates of inflation which only 'real' assets, such as equities and the income from them, are likely to withstand over the longer term. However, a blend of equities including some with decent yields when combined with bonds on current yields, can make a major contribution to portfolio income needs. Equities will improve in value over time but markets need to see that the central banks have inflation under control, so that the more recent increases in interest rates may be reversed. At policy level, the central banks have no appetite for return to the 'crisis' interest rates which applied during the pandemic and in the aftermath of the Great Financial Crisis. In the absence of further serious crisis, a return of interest rates to 2.00% pa or less seems unlikely.

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