September 2022 Rebalance

General Overview

Asset/Region	Current Stance	Previous Stance
US Equities	Neutral View	Neutral View
UK Equities	Cautious	Neutral/Cautious
European Equities	Cautious	Selective Approach
ROW Equities	Neutral View	Neutral View
Fixed Income	Neutral View	Neutral View
Property	Selective Approach	Selective Approach
Infrastructure	Positive View	Positive View

The annual Jackson Hole symposium outlined how aggressive Central Banks were willing to get in tightening monetary policy to bring inflation back towards respective targets. Many have come in for plenty of criticism for their relaxed approach up until now, although monetary tools have limited power to tame inflation brought about by certain supply issues.

There were some signs during this reporting period that supply chain issues had eased, but this was not widespread and earnings have continued to be impacted by higher energy, wages and staff shortages. Last month's US Purchasing Managers Index was lower with shortages of materials one of the contributing factors.

Near term the inflation rate will drop particularly as the base effect kicks in, but also factors such as the weaker oil price and lower shipping rates will feed through. The medium-term inflation outlook suggests prices could remain more elevated after years of lacklustre pressure in the post financial crisis world. Near shoring or the reversing of some of the globalisation trends witnessed during the last few decades will be inflationary, as will the continued transition to a lower carbon society.

The energy crisis remains one of the biggest threats at the moment, particularly in the UK and Europe, and we struggle to see an end in sight with regards to the Ukraine conflict. It has led to a greater focus on energy security which in the short term has meant dirtier fuels such as coal will be with us for longer.

Recessionary fears have continued to grow, with tighter monetary conditions and a cost-of-living crisis impacting most. However, the labour market remains rather resilient, so whilst it's expected that unemployment will rise and assist in cooling consumption, it's predicted that any downturn would be more shallow than previous events.

We have taken a more cautious approach at the latest rebalance given the continued and accelerated tightening in monetary conditions. We have reduced exposure to some of the small and mid-cap funds where the cash flows are longer duration and susceptible to downgrades given the rise in the discount rate.

Given the rising inflation expectations in the UK, we have partly reversed our previous move and reduced exposure to longer dated gilts in favour of shorter duration or money market funds. Hindsight is a wonderful thing but it seems that we were slightly premature with this call given the accelerated hawkish rhetoric in recent weeks.

US

Despite a decline in July's headline inflation figure, there has been an accelerated hawkish stance from the Federal Reserve who are keen to control inflation.

The labour market has remained resilient, which is proving to be a major headache for a number of central banks. Secondary inflation effects are feeding through, with wage increases being introduced to combat the rise in everyday items, with a number of companies worried about staff shortages or turnover. Nonetheless we expect the labour market to soften which was confirmed by a PWC survey which showed 50% of businesses polled said they expect their workforce to be smaller in the year ahead.

We recently heard from a number of US retailers who have been cutting prices to get rid of excess inventory in the more discretionary items as consumers change their spending habits. Some lower end stores had fared better than expected as wealthy people 'traded down' in the face of higher costs.

PMIs saw a downward surprise, where the composite index fell by over 2.5 points to 45.0, with the reading for Services dropping to 44.1 from 47.3, its lowest reading since May 2020. Firms were 'struggling with demand conditions' thanks to (among other things), shortages of materials and higher interest rates.

The feed through of higher rates takes some time to work through the system, but it would appear at first glance that it's beginning to take effect.

Earlier in August the Inflation Reduction Act was signed by President Biden, which is the country's largest package introduced to combat climate change. The $370 billion package is aimed at accelerating their net-zero plans and this buoyed a number of green energy stocks.

The US dollar has been well supported, a reflection of the worsening situation in Europe and the UK whose currencies have broken to multi year lows, meaning allocating into USD at the moment is becoming increasingly difficult. A reduction in our overall equity exposure did mean US equity exposure has declined at the rebalance.

UK

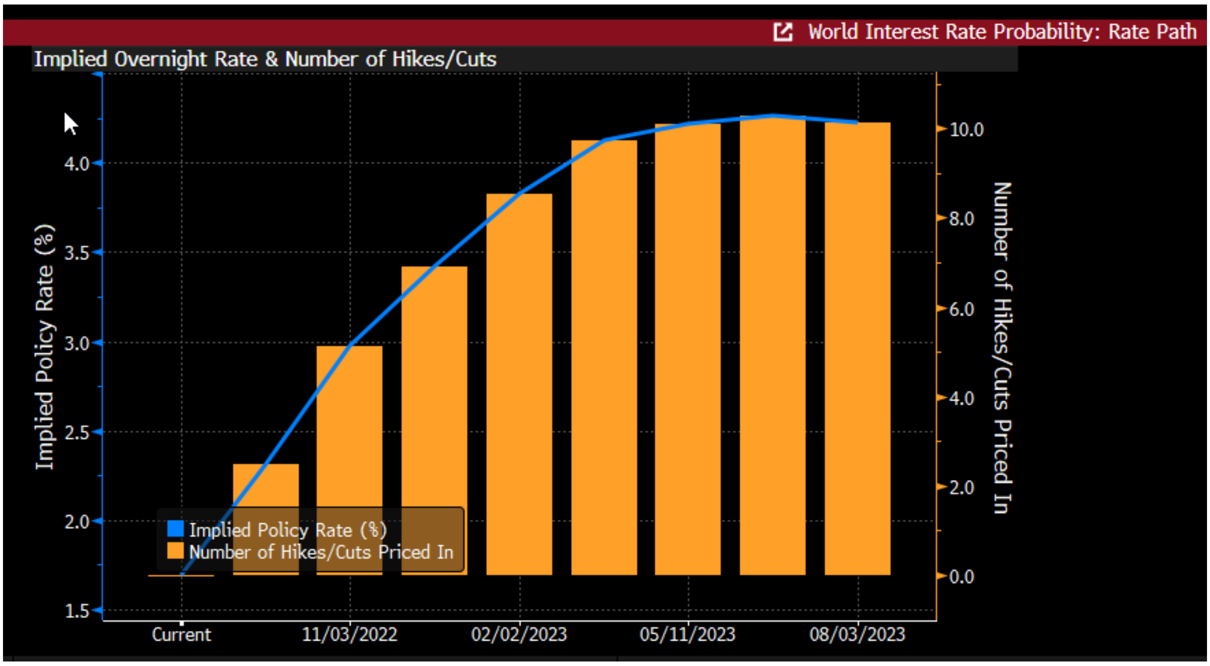
The Truss and Sunak battle has been ugly at times and highlighted the rifts amongst Tory members, which has seen the Labour Party take a healthy lead in the polls. An emergency budget, as touted by Liz Truss, where taxes would likely be cut could add to inflationary pressures and see interest rates rise further than is currently being priced in.

The cost-of-living crisis is weighing on the UK's outlook, with UK energy bills to rise further still, despite an 80% rise in October. The latest prediction is that a typical bill could hit over £5000 a year by next year, with some now expecting UK inflation to hit over 20% in Q1 next year.

The UK is experiencing a "summer of discontent", with obvious similarities with the Winter of Discontent in the 1970's which was similarly characterised by strikes from workers demanding pay in the face of high inflation.

The UK's PMI data was weak, highlighting falling demand, shortage of labour and materials disrupting production. Manufacturing saw the slowest activity in 27 months, whilst Services (although still in expansion territory), grew at the lowest pace in 18 months.

As a result of the above and tightening monetary conditions, a UK recession is likely. There has been an acceleration in the interest rate expectations, and with Liz Truss likely to loosen the purse strings, the BoE will react by more aggressively tightening monetary policy. Although where interest rates peak is still an unknown. As per the below, the market is pricing in rates peaking at around 4% by June 2023, which we feel is a tough ask given the economic outlook.



Source: Bloomberg

Our largely UK based infrastructure holdings (owners and operators of renewable assets) have held up during this year's volatility. Benefiting from the inflation linkage in many of the long-term power supply contracts they have, whilst those that have more exposure to the spot power price (such as Greencoat wind), have benefited from the rise in the electricity price. There is growing talk to widen the windfall tax, so we remain wary of this potential political issue. At the rebalance, we trimmed some of the infrastructure holdings as a result.

Europe

Europe's struggle with energy and the uncertainty with the war in Ukraine means the continent is heading for or already in a recession.

We have seen a continued decline in PMIs, a trend that started in mid-2021 following the post covid lockdown bounce back. More recently, the composite PMI for the Eurozone came in at 49.2 from a previous 49.9.

Nordstream and Gas from Russia is still massively impacting markets, as seen by the recent swings in European gas prices hitting fresh highs with a single day jump of 20%, highlighting the volatility.

Some industrial management teams in Germany have been talking about factory closures this Winter, posing risks for both domestic but also global supply chains given it's the world's third largest industrial exporter. One US bank has mentioned moving work away from Frankfurt to combat any potential energy blackouts.

On top of this, climate change is having a detrimental impact too. The Rhine River reached a critical level that meant, for a period, it was not economically viable to take barges down the river. Whilst the situation has improved, this may cause further supply issues which comes on top of the potential shutdowns driven by energy shortages.

Trading in European bonds is proving harder as the ECB withdraws as one of the more important buyers, creating with it thin liquidity and increased volatility.

Our exposure to European companies would have largely declined given our reduction in equity, particularly our decision to cut some of our small and mid-cap exposure.

Asia/RoW

Tensions between the United States and China have recently flared following the visit to Taiwan by House Speaker Nancy Pelosi. Any further escalation would weigh on sentiment at a time when growth and supply lines are under pressure.

Chinese lockdowns and major concerns over the real estate sector have weighed on the country's growth, and this was largely reflected in the latest corporate earnings, from Caterpillar to luxury goods and retail brands liked Burberry and Adidas. Portfolio exposure to China is extremely limited given the concerns with the regime and the treatment of minorities. We continue to gain exposure through economic activity rather than country of listing.

Elsewhere, India is still expected to be the fastest growing major economy over the next year or two, although the headline growth figures projected are flattered by the weak output numbers in the prior years as a result of the loss of output from covid. Nonetheless, the government has a mandate to operate and the latest numbers suggest they will become the third largest economy by the end of this decade.

The Indian composite PMI remains steady, with Manufacturing up to 56.4 and Services at 55.5 albeit lower than previous. India will continue to benefit from the 'make in India' push as they seek to gain private investment to modernise and advance production. India is also expected to benefit from Chinese lockdowns, with recent news from Apple regarding the iPhone production potentially signalling a changing of the times to come.

Japan’s economy has moved back into life following a number of pandemic induced precautions, although they have lagged behind many other developed nations. They haven’t seen the inflationary pressures witnessed elsewhere, although it has been moving higher and wages aren’t keeping pace. Policy remains ultra-accommodative and unlikely to change given the fact that growth will be impacted if there is a wider global slowdown.

Any changes to Asia and RoW allocation were as a result of trimming global funds who had some allocation to the region, however this was a negligible change.

Please contact us for specific model portfolio changes.