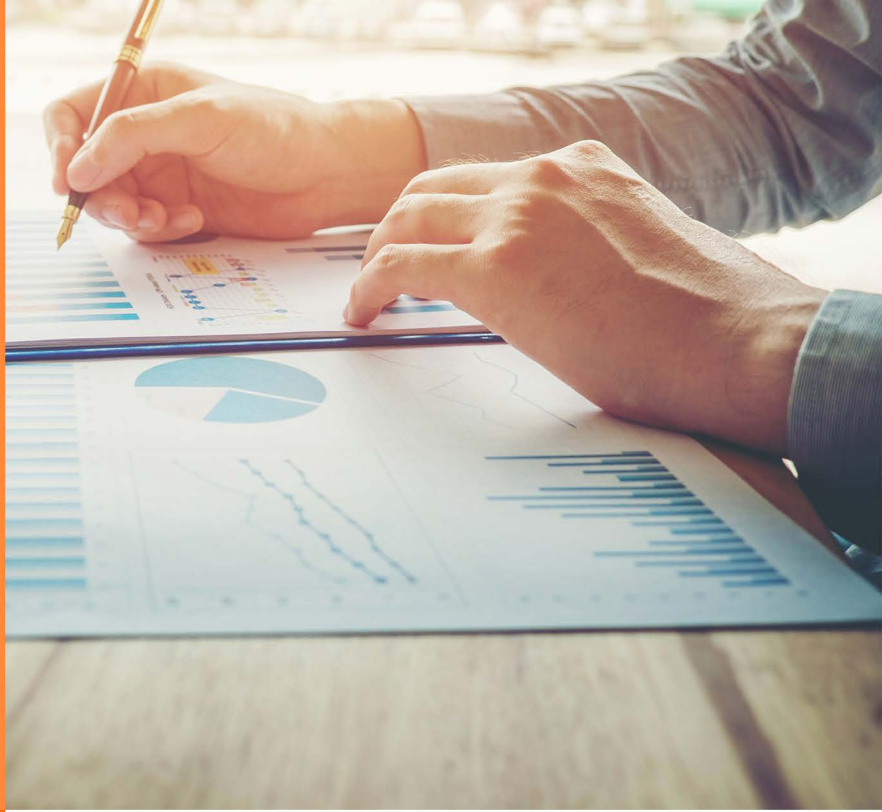
Investment Review

Q2 2022



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Contents

1. Summary

- Q2 was very challenging for investors, no matter their portfolio risk positioning.
- Inflation continued to accelerate but headline numbers expected to fall sharply.
- Global equities fall across the board but remain the best long-term inflation hedge.
- Strong returns from commodities, but it does not make up for poor returns over many years.

Investors have experienced portfolio drawdowns over a short period during the first half of 2022. This may naturally have caused unease, especially for the more cautious and/or inexperienced of investors, who may not have been through such turbulence before.

The increased volatility reflects the sudden change in the economic landscape, and a reversal of the factors that have driven asset prices higher over a number of years i.e. monetary expansion and low inflation. Most central banks are now in an upward interest rate cycle with further increases due before the year end as they play catch-up in tackling inflation pressures.

Global growth is slowing and this will likely result in economic recession in many regions, but the hopes are that any downturn will be short and release pressures that might otherwise cause greater damage later.

There has been some respite recently as Q3 has begun more positively, but it is not out of the question that lower values may be seen during the remainder of the year. Investing is a longer-term game and providing investors are diversified and importantly treat market falls as just a temporary loss of value, the volatility experienced should be accepted in return for higher returns going forward.

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- This investment commentary review contains information and opinion on current economic and political positions and does not constitute advice.
- The information is provided in good faith and is believed to be accurate, but as some data is provided by third parties this can not be guaranteed.
- Past returns should not be seen as predictors of future returns.

2. Market Performance (Year to Date)

Asset Class	Index	Q2 2022	Year to Date
Commodities	S&P GSCI Commodities	10.6%	51.5%
Hedge Funds	HFRX Global Hedge Fund	4.4%	5.9%
UK Commercial Property	FE UK Property Proxy	1.2%	5.5%
Gold	S&P GSCI Gold Spot	0.2%	9.8%
Asia Pacific Shares	MSCI AC Asia Pacific ex Japan	-3.0%	-5.9%
Emerging Market Shares	MSCI Emerging Markets	-4.0%	-8.1%
UK Shares	FTSE All Share	-5.0%	-4.6%
Japanese Shares	TSE Topix	-6.7%	-10.2%
UK Gilts	Bloomberg Sterling Gilts	-7.8%	-14.8%
Corporate Bonds	Bloomberg Sterling Aggregate Corporate	-8.0%	-14.2%
European Shares	Euro STOXX 50	-8.2%	-15.9%
North America Shares	S&P 500	-9.2%	-10.9%
World Shares	FTSE World ex UK	-9.3%	-11.3%

Performance Data: FE Analytics in GBP to 30/6/2022

UK Shares

The FTSE All Share was one of the few market indices to have remained in positive territory in Q1, but it succumbed in Q2 to the weight of economic concerns and the index is now -4.6% for the year. Despite heavyweight energy companies like BP and Shell delivering record quarterly profits, share prices sold off mid-way through Q2 as commodity prices fell from peak levels.

Global Shares

Asia and Emerging Markets put in a better relative performance this quarter as dominant China seemingly relaxed its zero-Covid policy and announced stimulus measures to support the economy[1]. The Eurozone remains the country with the weakest economic sentiment given its reliance on Russian oil and gas, with high prices having a large impact on both households and businesses. Steps are being taken to reduce consumption ahead of the high demand winter period, with guidance issued from the International Energy Agency (IEA) for a more strategic plan to reduce reliance on Russia[2], which will come with time delay and high costs of investment.

Fixed Interest

Both government and corporate bond prices continued to come under pressure as central banks surprised the market with their aggressiveness in tackling inflation, albeit considered a little late. The Bank of England (BoE) raised rates from 0.1% to 1.25% this year and is forecast to rise above 2%, including a 0.5% increase in August. The US Federal Reserve operates interest rates in a range, moving from 0-0.25% at the start of the year to the current 2.25-2.5% and is forecast to move even higher.

[1] Reuters, "China announces detailed stimulus measures to support virus-hit economy", 31 May 2022.

[2] International Energy Agency, "10-Point Plan to Reduce the European Union's Reliance on Russian Natural Gas", March.2022.

2. Market Performance (Year to Date) cont.

However, the market decided during the month that whilst short term rates might well be heading north, the consequence would be economic weakness, which in turn would require central banks to begin lowering rates again! We feel it likely that fixed interest investments will stabilise at current levels, perhaps even rise over the coming months as rate expectations are tempered.

Alternatives

Commodities have been one of the only asset classes to provide a positive return in 2022. Whilst the headline figure +51% shown above appears spectacular, it is interesting to note that investors have only earned a total return of 7% over 10 years due to a steep fall in prices back in 2014. The asset class is very cyclical with the below table showing prices of some of the major components of the S&P GSCI Commodities Index during 2022, to demonstrate just how high volatility has been:

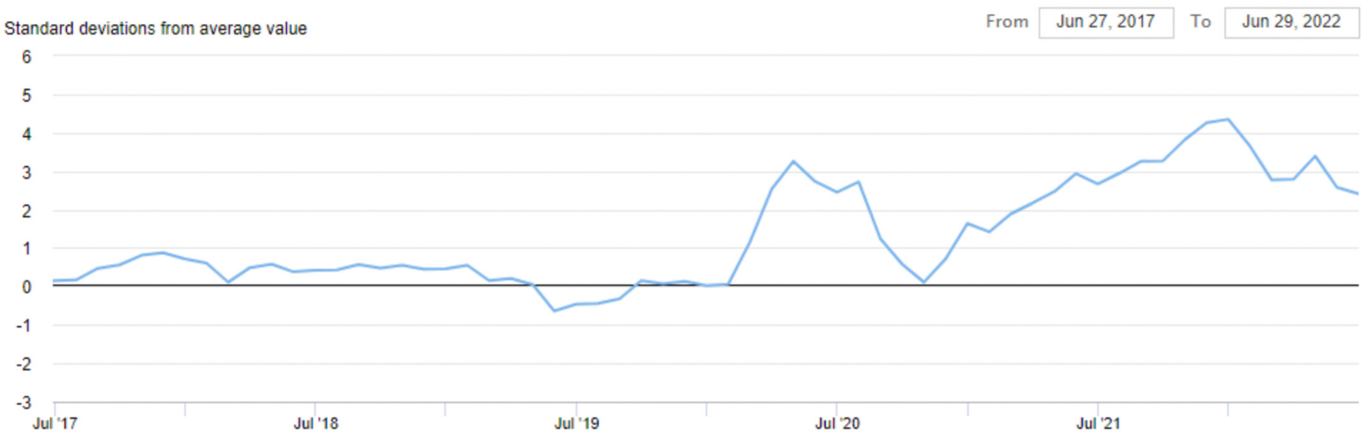
Commodity	Price				
	January 1	Peak	To Peak	June 30th	Peak to June 30th
Brent Crude Oil	$672	$1073 (March 8th)	+59%	$927	-8%
* Natural Gas	$178	$436 (June 6th)	+144%	$253	-41%
Copper	$239	$265 (March 7th)	+10%	$202	-23%
Aluminium	$178	$246 (March 4th)	+38%	$155	-36%
Wheat	$514	$878 (March 7th)	+70%	$599	-31%
Corn	$571	$755 (April 18th)	+32%	$635	-15%

*At the time of writing the price of natural gas has again risen to over $400 (MMBtu) due to Russian supply restrictions.

3. Soaring Inflation…Yesterday's Story?

Clearly the issue front and centre has been that of soaring inflation, with consumer price indices (CPI) rising by +9.1% in the US in July and +9.4% in the UK in June year on year, the highest levels in 40 years. The BoE has continuously raised its forecast for CPI with commentary following the bank's June meeting suggesting a peak of over 11% in October, which reflects the anticipated rise in the Ofgem energy price cap, before it steadily falls back down to target of 2%[3].

One of the main sources of inflationary pressure has been the supply side shock from Covid, with a lack of available goods driving prices higher. The New York Federal Reserve publishes a supply chain index that aims to capture global transportation data as well as supply chain related indicators from Purchasing Managers Indices (PMI) and the five-year chart is shown below. Whilst still elevated, pressures are falling and this has been attributed to a large decline in Chinese goods delivery times in recent months.



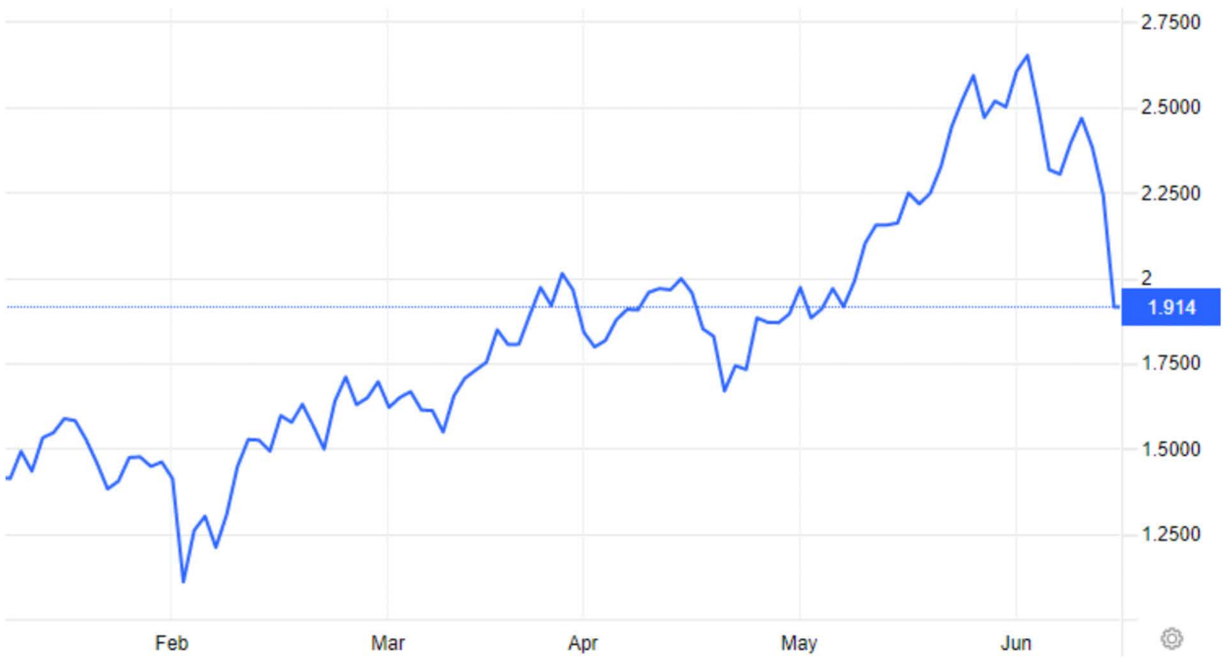
Source: New York Federal Reserve

This pressure release is welcomed and should feed through into falling headline rates, but the bigger question is whether the current bout of cost-push inflation is not just because of supply chains (as well as war), but has more of a structural footing. The result of de-globalisation, labour shortages from Brexit and people leaving the workforce following Covid and changing demographics with retirees becoming spenders rather than savers, are all thought to have inflationary effects. These factors may cause a permanent change to inflation dynamics going forward.

[3] Bank of England, "Monetary Policy Summary", June 2022.

3. Soaring Inflation...Yesterday's Story? cont.

However, markets never seem to dwell too long on an economic story, adjusting prices accordingly before moving on to the next item on the agenda, which is that of recession. The below chart shows the 10-year UK gilt yield rising throughout the year, peaking at over 2.6% in June before falling sharply to 1.9% by the quarter end. This indicates the market believes the economy is set to slow and interest rates will have to adjust lower to offer support, rather than there be rampant future inflation for which yields would need to be higher to compensate investors. Expect headline inflation numbers to come off the boil and become yesterday's news as the market shifts focus.

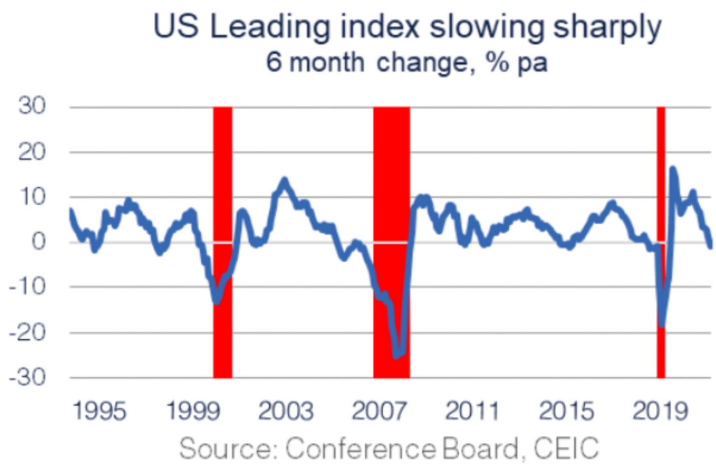


Source: Trading Economics

4. Economic Slowdown Ahead...

The global economy has entered a slowdown phase, with recession increasingly likely. According to the International Monetary Fund (IMF) world growth is forecast to fall from +6.1% in 2021 to +3.2% in 2022, which is a further -0.4% downward revision from April estimates[4].

The IMF points to reduced household purchasing power and tighter monetary policy as the drivers, in particular highlighting North America. Our economic consultants Tricio have also demonstrated this slowing growth through the US Conference Board's Leading Economic index that is shown below. This offers a window into the business cycle, which has now turned negative, and suggests that many economic indicators have slowed significantly and a recession is potentially upon us (red columns indicate previous recessions).



A recession is not yet a guarantee, but it is looking probable, and there is evidence at a corporate level that consumer demand has weakened. In North America consumer bellwether stocks such as Wal-Mart and Target have issued profit warnings suggesting buyer behaviour is changing, and in the UK, listed companies profit warning have risen 66% in the first 6 months year on year, with over half coming from consumer facing sectors[5]. It is pretty clear the consumer is hurting at the moment.

One of the key questions for investors is what will interest rates do if we are in, or enter a recession? We think it unlikely that rates will fall back to the exceptional lows we have seen over the past couple of years and therefore fixed interest capital values have probably already peaked. It needs to be remembered that central banks have officially ended their Quantitative Easing (QE) policies, meaning they are no longer in the market buying fixed interest assets and keeping yields artificially low, so that era is likely behind us.

But, interest rates may well have to reverse course at some point and it seems unfeasible they can rise much higher than they have already. It will be an easier decision if and when inflation is tamed. The paradox in financial markets is that whilst economic recession may be on the cards, the potential reaction of lowering interest rates (or at least lowered market expectations) can result in support to asset valuations. Furthermore, if a recession does happen there is the potential for it to be short given that corporations and household savings are in a better financial position than previous recessionary periods.

[4] IMF, "World economic outlook update", July 2022.

[5] EY, "profit warnings issued by UK listed companies increased by 66% in H1 year on year, with over half citing rising costs", 18 July 2022.

5. Looking Forward

It is appreciated this review is not filled with great positivity, but there is no skirting around the fact that the global economy is suffering considerable uncertainty presently. We suggested in our Q1 review that volatility would most likely persist throughout the year, which was probably a fairly easy call at the time given the prevailing background. We have seen market prices in Q2 adjust lower across the board, but moving through the rest of the year we could well see divergence of performance and winners and losers.

Fixed interest investments should stabilise from this point, perhaps even gaining in value as interest rate expectations fall. If recession does hit then the higher quality part of the market should hold up better than high yield given the additional credit risk. Share values on the other hand could see some further weakness and drift lower as forward company earnings forecasts are adjusted down to reflect the weaker economy[6].

We do not amend our asset allocation because of volatility, though we do take note of significant shifts in the economic landscape and what impact that may have on medium term portfolio returns. We are not ignoring the current inflationary environment, but we seek more evidence that a structural change has taken place. It should not be forgotten that evidence suggests that global equities provide the best opportunity for returns above inflation, with the probability of doing so increasing with the length of time invested.

Liquidity as ever is key for having the confidence to take no action and stick to your plan and if circumstances allow, investors should consider taking advantage of the lower cost of financial assets now available, notwithstanding assets could well become cheaper still, suggesting a phasing approach to new investment is worth considering.

[6] Renzi-Ricci, G. Vanguard, "Multi-asset investing when inflation is high", July 2022.

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years".

Invest With Confidence

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We do that by providing the financial planning and investment advice you need to secure your future.

We recognise that investors with similar risk profiles may have very different objectives, tax positions and personal circumstances so we adopt a bespoke approach in each case. There are no 'off the shelf' solutions.

We focus on choosing the right blend of assets, managing risk, and minimising tax and costs. Our investment philosophy is founded on a number of key principles which have served our clients well for more than 30 years:

- Differentiate savings from investment
- Understand and manage risk
- Get the "investment recipe" right
- Avoid market timing
- Fear inflation
- Manage tax and costs
- Process is paramount

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