Swallow
Financial Planning

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Investment Update March 2022

It is unusual for us to put out an update on investments so soon after our December issue. We like to think of the funds we manage as long term holds and therefore an investment update is only required every 6 to 12 months. 2022 has however been extraordinary in several respects so we wanted to pass on how this change of circumstances has affected our ongoing investment views.

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OVERVIEW OF THE UKRAINE WAR

It is noticeable that world stock markets and governments seem little affected by the destruction caused in Aleppo and Syria but when that same destruction comes to Europe we are in “high dudgeon”.

At its worst the current conflict will lead to a nuclear war in which event savings will be of little consequence.

There is a much bigger chance that Russia will annexe Ukraine. Hopefully (but by no means certain) the West will then take the threat of Russian expansionism seriously. In the short term this will lead to:

Commodities

Russia’s economy is completely dependent upon its commodity exports.

Russia generates 11 million barrels of oil every day and uses 3, so 8 million gallons are exported. ½ goes to Europe (that’s 1/3rd of the European gas supply) the rest goes to China. China gets 1/3rd of its gas from Russia.

Sanctions will severely affect Russia however if the volume of oil and gas it exports to Europe decreases it can probably sell more to China. A reduction in the supply of oil and gas will lead to higher prices which will be exactly what Russia is hoping for since higher prices mean their limited reserves will last longer.

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INFLATION

Predicted Rates Of Inflation

Estimates vary however LGIM were of the view that energy cost rises due to the war will lead to higher inflation. By August expect inflation of 7.5% in the USA and 8% in the UK. Inflation should start to drop out in September. Inflation of 5% and more is likely to continue into 2023 and the longer term trend is around 2.75%.

There are two drivers of inflation at present

Commodity Prices

I am sure many clients have seen the tripling of the electricity rate over the last 3 months. The general view is that rates may double again before the year is out.

The drive for climate change has led to massive under investment in traditional fossil fuel extraction which is needed to maintain the current fossil fuel provision until non-fossil fuel alternatives are available.

Unless there is a grown-up debate about the necessity of maintaining fuel supplies commodity prices will continue to rise leading to millions in fuel poverty.

Labour Costs

Labour costs are main driver for inflation. At present the unemployment rate is very low so a lack of supply for labour will lead to higher wage demands. Employers have little option but to acquiesce or automate and they are doing both.

Interest Rates

It is expected that interest rates will rise rapidly in the coming months in an effort to curb wage inflation. The dampener on the magnitude and speed of the rate rises will be the effect of commodity price rises.

THE ECONOMIC CYCLE

No we don't believe the economic cycle has gone away. If the inflation scenario we have outlined pans out then the central banks have to increase interest rates to take the heat out of the economy. Increasing interest rates will reduce the available cash to spend which will lead to recession. How bad that recession will be again depends on many factors.

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ESG

A sign of the current fuel crisis is that Nuclear power is no longer the pariah of the Green parties. Nuclear power is now acceptable for many SRI fund choices as it offers a less bad alternative to fossil fuels.

COVID

The Omicron mutation has perhaps led us all into a false sense of security. Myself and many family and friends have had it with little effect. Understandably we can only cope with so much at any one time and Ukraine has pushed the Covid issue to the side-lines. Nonetheless it remains an ever present threat until the vaccinations are embedded in a like manner to the flu jab.

ASSET ALLOCATION

Bonds

We continue our zero bond allocation where we can, or else recommend short-dated bonds where cautious investors wish to diversify from cash.

Cash

We are now heavy cash on all of our recommendations (despite the recent equity falls). Transact offer term deposit bonds where we need cash in platform wrappers.

UK

The UK market (big companies at least) has had a great run compared with the remainder of the world in recent weeks. The larger market (FTSE 100) is also packed with commodity companies and banks both of which perform better than growth stock in a recession. We have increased our allocation to the UK.

Developed World

The US market used to be around 50% of world market cap. Most global x UK funds now have it as over 60%. We are reducing our exposure to the US market in favour of Asia, Europe and the UK. This isn’t however easy as most of the tech companies are US based.

Property

Residential

LGIM confirmed that they have started to build residential property in the UK as an investment for its pension funds. Many clients have an excess of residential property in their portfolios both the main residence and rented property. The problem with bricks and mortar property funds is liquidity. In much the same way as their commercial counterparts, bricks and mortar residential property funds are very illiquid in times of price falls. We are however looking at this sector in more detail and may add a collective fund if we see a suitable candidate.

Commercial

Commercial property had a great 2021. As is often the case the fall in values overshot and was corrected. At a recent lecture from Hannah Critchlow she pointed out the need for physical contact in both a personal and corporate capacity. Whilst office space has a significant drop in demand the mood has reverted somewhat to the principle that physically working together can improve productivity and wellbeing.

Whilst many suggest the prices have perhaps overshot, the yields on commercial property are much higher than residential property and in a difficult market the volatility of commercial property is low. We have therefore increased our commercial property exposure where appropriate to do so.

Henderson

The Henderson suspension we think is because they have sold the fund to a private investor. To safeguard the sale price prior to completion they need to suspend trading. When the sale is concluded clients will receive the cash for re-investment. We switched from Henderson to L&G in our January template revision. The L&G fund is still reporting excellent returns in a difficult market.

FACTORS IN FAVOUR

Clients will know that we invest in a number of factor funds to try and improve the performance of our portfolios. The following are some of the most popular at this time.

Value Stock

Value stock is shares which have an inherent value which is high in relation to their stock market price. The current market should favour Value over growth. We have increased our exposure to Value stock.

Minimum Volatility

Minimum volatility stock are a means of reducing the volatility of our portfolios. This index invests mainly in large US household names such as Nestle, Johnson and Johnson and Pepsi. These companies tend to provide stable returns in all environments.

If, as we suspect, inflation continues to rise we know that quality companies can increase their prices and retain their client base. We will monitor just how successful the fund has been in reducing volatility.

Clean Energy

This has the bonus of ticking both SRI and investment boxes. The current crisis is bound to increase the demand for alternates to fossil fuels.

Infrastructure

Again this often includes significant elements of Wind and Power construction plus the yield is often attractive.

Automation

The wage demands will fuel the capital expenditure to create more Automation and Robotics.

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REGIONS OF INTEREST

Far East & Emerging Markets

We continue our bias to Far East and emerging market funds. Emerging markets had a torrid time during Covid but they are showing signs of early recovery and we expect them to do well out of a normalisation post Covid.

THE FUTURE IS IN THE EAST

"I think one of the biggest risks to civilization is the low birth rate and the rapidly declining birth rate," (Elon Musk).

There are 4.7 billion people Asia. Each ***month*** 1 million Indian students come onto the labour market. In the West, birth rates are nowhere near sufficient to maintain the population. Europe, China, Japan and the USA are all getting older. This population collapse will reduce demand save for areas such as healthcare and support.

MARKET OUTLOOK

Our Job is to invest our clients' capital for the long term. When one has the ability to pass assets down the generations, long term can mean 20+ years. Whilst on the one hand increasing liquidity will reduce the short term downside risk of savings, the increase in inflation (and some of us can remember the inflation of the 70's when it rose to 26% p.a. in 1975.) will hugely favour things that are revalued by inflation such as shares and property.

The changes outlined within this note are an attempt to provide the best returns we can from within our asset-backed portfolios however the return will still be broadly that of the market in the short term.