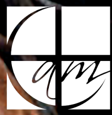

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2023 – The Journey So Far and the Road Ahead

In this article, I wanted to address some of our clients' questions about the year to date and consider the outlook for the next 6 months, so I have:

- **assessed the impact of the tumultuous start to 2023 on markets and the response of those controlling economic policy**
- **given our view of what the key economic indicators suggest might be to come in the next six months and where inflation and interest rates are headed**
- **answered questions about how we are positioning portfolios and when our strategy is likely to change**

Whilst we are cautiously optimistic, the recent deployment of an army of mercenaries in Russia demonstrates that we are currently living in a fast-moving world where the outlook changes rapidly.

What have been the major themes for the first half of 2023?

With our bias towards domestic investment, inflation and interest rates are the pre-eminent concerns. The UK has experienced 13 consecutive rate rises, with the June announcement bringing rates to 5%. The June inflation print was terrible, a forecasted inflation drop failed to materialise with the rate remaining constant from the previous month. The Monetary Policy Committee (MPC) had no choice but to increase interest rates. Rate forecasting is not an exact science, but markets are now looking at the possibility of 6% rates, although our view is that this is on the high side.

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What is our outlook on inflation and rates?

Where will interest rates get to? This is problematic to answer definitively. Interest rate change is the tool, albeit a very blunt instrument, that is used in traditional monetary policy to curb inflation. The central bank makes society poorer through weakening demand, we have less spending power, reducing demand for goods and services, ultimately leading to lower prices (dampening inflation). A valid concern is that inflation remains stubborn, but policy makers keep hitting the rate button and nothing happens. The cause-and-effect lag, leading to the concern that the economy falls off a cliff edge as and when rate rises bite, cannot be ruled out. The media have made uncharitable comments about the Bank of England (BoE), describing its Governor, Andrew Bailey, as being "asleep at the wheel", a view which we share. Rate rises were too long in coming and inflation was already in the system pre-Ukraine's invasion. Announcing a review of the BoE's decision making, or lack thereof, is window dressing at best.

Our current government's economic policy also deserves criticism. We should also ask if the current bout of inflation is 'normal' inflation. It will take economic historians a decade to opine on this but consistent wage growth through strong employment shows no signs of abating. Should we expect an unorthodox monetary response? I am at a loss as to what form this could take. The government have made it clear that there will be no explicit support for mortgage holders. In late June, the government gained agreement from the major banks and the Financial Conduct Authority for banks to offer enhanced terms to alleviate short term stress (a move to interest only and an extension of the mortgage term by way of examples). Forecasting as to the actual rate of inflation in the short term is too tricky. A range of 2.5% to 4%, would appear to be the new normal once the economic dust settles.

Where does that leave us?

The next rate decision is on 3rd August. The next inflation print (19th July) just by its very nature should fall back as big contributors lessen their impact. I am reminded that hope is not a strategy, but I would suspect that August is unlikely to see a pause in rate rises and I would expect guidance. The MPC will only have one further set of jobs and inflation numbers to assess before the early August rate meeting. Its credibility is on the line, and the MPC needs to get in front of the inflation monster. There will be soft pressure from Government to pause, but I do not believe it will be enough to stay their hand. Another 50bps rise is on the cards. I am not as pessimistic as the market as to the terminal rate, but 5.75% is not out of the question.

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The UK Consumer Price Index (CPI) is much higher than other developed countries, why?

As stated, the UK is facing a healthy employment market and, for the first time in over a decade, employees have bargaining power, leading to high wage growth. It is worth noting that the forthcoming winter will see a fall in commodity pricing as the supply constraints of last winter have eased. Forward prices for energy have retreated and suppliers will already be hedging winter purchases. Prices will still be high compared to recent history, but they are not going up so will have no material impact on increasing inflation. Each country or region has a different methodology for its calculation of CPI. In the UK, leisure (holidays, plane tickets etc) accounts for 14%, whereas in the Eurozone it is 8%, and 3% in the US. As a nation we like leisure and are still spending the pent-up demand and savings accumulated in lockdown. There have also been some anomalies (extra bank holidays for example). There is no doubting the consumer remains strong, but this will quickly fade as interest rates rises have the desired impact.

What is happening with portfolios?

Inflation and interest rates are outside of our control, but we actively manage client portfolios to reflect the prevailing environment. At our June Investment Committee meeting, we decided upon reducing risk further within our lowest risk mandate. By its nature, a CPI+2% portfolio is exposed to lower equity risk but, as we believed the outlook to have weakened, it is prudent to reduce this risk. We have maintained equity risk levels for the remainder of our mandates, which are towards the low end of their equity risk exposure.

In our risk reduction moves, assets have been sold across three main categories: equities (largely the UK), alternatives and property. Core fixed income has been the beneficiary of these asset moves. Your investment managers have been active in purchasing UK government debt. By way of an example, buying direct Gilts has tax advantages and avoids us employing an active bond manager or even paying passive fees. One-year Gilts were (in early June) yielding around 4.77%. The last time we saw rates at this level was in late 2008. Our core fixed interest exposure provides diversification, an attractive nominal yield given the low-risk nature of the asset. It also provides 'dry powder' or acts as a source of funds for when, and it is when not if, we become more positive on markets. Selling these gilt holdings will enable us to move quickly to raise risk and give portfolios the potential for greater returns. This policy is common across all the Real Return mandates.

Why does CAM still hold property?

To clarify, our property exposure is for the most part UK commercial exposure. There is no traditional residential property holding, i.e., domestic homes. One would have thought that the UK commercial sector would be unlikely to flourish in the current environment of higher

inflation and rates. So why do we still hold it? There are a few aspects to this. The first is that the property we hold is characterised by its 'trade down' qualities. What do we mean by this? We have taken a very selective approach to what we hold for clients. Exposure is towards those operations that are either not exposed to the economic cycle or are beneficiaries from a weakening outlook. GP surgeries, Aldi, Lidl, and B&M are amongst the tenants of our commercial property exposure.

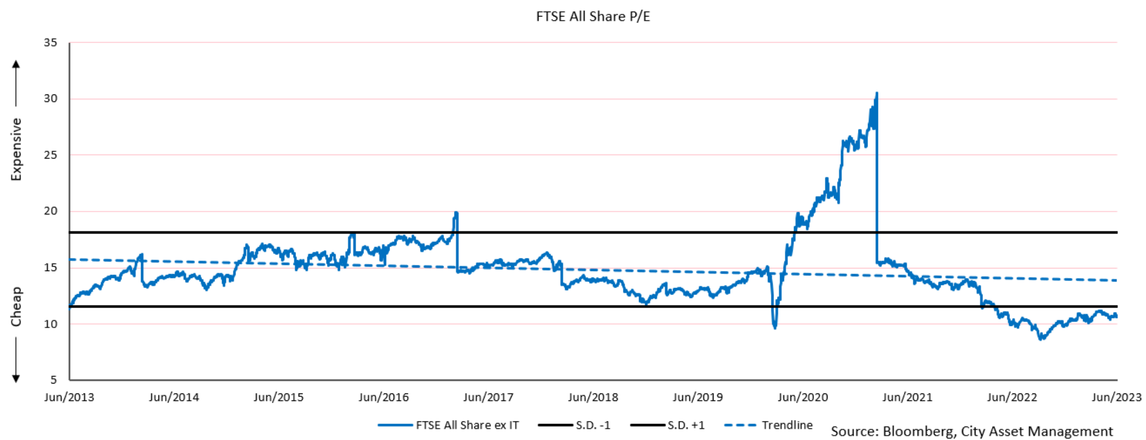
But surely rate rises will affect gearing (borrowing); the point being that most properties have debt and would therefore suffer? That is correct but our holdings have long term fixed debt therefore are not subject to short term changes in rates. Our holdings are made through closed end funds and their share prices are dependent on sentiment, which is weak towards the asset class itself. We believe the holdings we have are deeply undervalued and the pricing reflects a malaise towards the sector. Accordingly, when rationality returns value will be realised. In the meantime, we will continue to 'clip the coupon', i.e., take the dividend, with the view that our holdings are likely to be winners in this environment. Yields (the income earned from the investments) are in the mid to high single digit range. In some cases, the dividend is not only fully covered[1] but growing more than government debt.

How would you view current equity valuations in the UK and beyond?

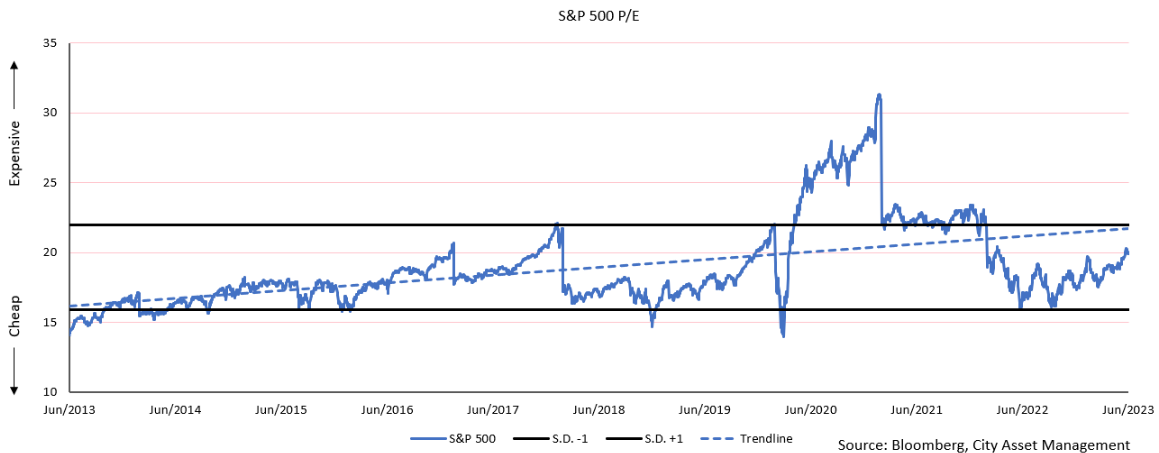
The charts and table below focus upon the Price/Earnings (PE) ratio, which is calculated by dividing the market price per share by the company's earnings per share. The higher the number, the more expensive the share and thus, in aggregate, the market/index where the stock is listed. The PE ratio is a very basic valuation tool, but it gets to the nub of the matter very quickly. As investors we can see if a market is trading cheaply, or expensively, relative to its own history. In some respects, it must be taken with a pinch of salt as there will be sector differences, with some sectors having a greater influence than others, but as a yardstick it has its place. At the risk of getting too technical, Standard Deviation (SD) measures how close a set of values are to their average. This allows us to determine whether the deviation of the current PE, from the average PE is meaningful.

The first table reflects the UK market and indicates that at this point in the economic cycle it is cheap (more than 1 standard deviation below the average), relative to history.

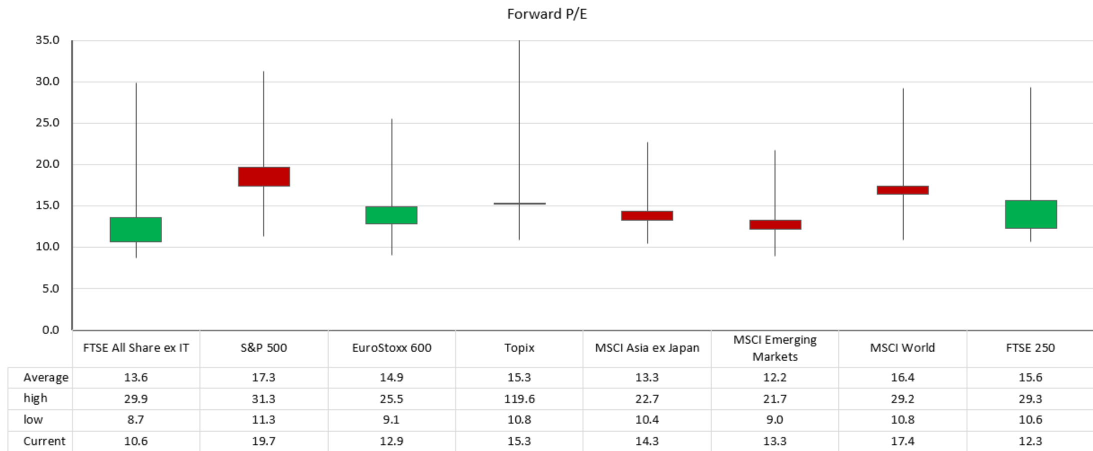
[1] Dividend coverage represents how many times the dividend paid to investors can be covered from the income received by the company.



With respect to the US market, whilst it is not cheap, it is not expensive at present. However, the US, when compared with other equity markets, is considered the most efficient and best performing market. Therefore, historically, it trades at a premium to others.



This table indicates where each of the major markets is within its valuation journey. We have also added the FTSE 250 index, which represents very broadly the UK domestic market. It includes some companies whose operations are abroad, but it provides a rough UK approximation and, again, it represents substantial value at current levels.



	FTSE All Share ex IT	S&P 500	EuroStoxx 600	Topix	MSCI Asia ex Japan	MSCI Emerging Markets	MSCI World	FTSE 250
Average	13.6	17.3	14.9	15.3	13.3	12.2	16.4	15.6
high	29.9	31.3	25.5	119.6	22.7	21.7	29.2	29.3
low	8.7	11.3	9.1	10.8	10.4	9.0	10.8	10.6
Current	10.6	19.7	12.9	15.3	14.3	13.3	17.4	12.3

Source: Bloomberg, City Asset Management

Markets discount future earnings. In other words, they look ahead and pay today what they believe something is worth in a year or so. The market has already discounted a slowdown. So, why not buy more equities now? It's a good question and we debate this regularly within the team. We believe it is too early to buy more equities, as we believe we have yet to finish with the bad news, though when we do make the move it might feel uncomfortable. History tells us that when markets reverse, the early stages of the next bull market tend to be the most profitable, hence we will be keeping skin in the game so we can participate.

What impact will the geopolitical scene have in coming months?

2024 will see elections in the US (Presidential) and the UK (January 2025 is the latest that the General Election can be held). Most politicians usually want to be re-elected but what does the political landscape look like going forward? It is too early to tell who will receive the Republican nomination and President Biden has stated his intention to run for the Democrats again. Until we get closer to the election there is no point in speculating. I am not one to make political statements, it is our role to manage to the prevailing environment. However, in conversations with our fund managers who speak to both front benches, the impression is that in the UK, the shadow front bench see themselves as the government in waiting. In one conversation they were described to me as being more akin to the Labour party of 1997. But whichever party forms the next government, they will inherit an economy in disarray and a government balance sheet in bits. We should note that rising rates not only hurt us the consumer, but also increase the cost of servicing government debt, substantially. If I am to make any prediction, it is that we should not expect any future tax breaks. However, elections are still a way off, so I am not overly concerned at this point.

As I was finishing this note, news of what looked like a coup or civil war emerging in Russia began to arrive. The situation was short lived but had not fully reached its conclusion by my

deadline. Nevertheless, another large step in Russia's journey towards failed statehood has been taken, joining the ever-expanding list of 21st century failed states.

At its most charitable, Russia can only be described as a petrol station for regimes that we in the West would consider having dubious moral compasses. Commodities may again be volatile on the back of these recent events but, as stated earlier, western supply chains have taken the initial shock and have sourced from elsewhere. I cannot predict the end game for Russia, it could take years, or it could be a weekend coup, but the last man standing is unlikely to have a gracious view towards the West.

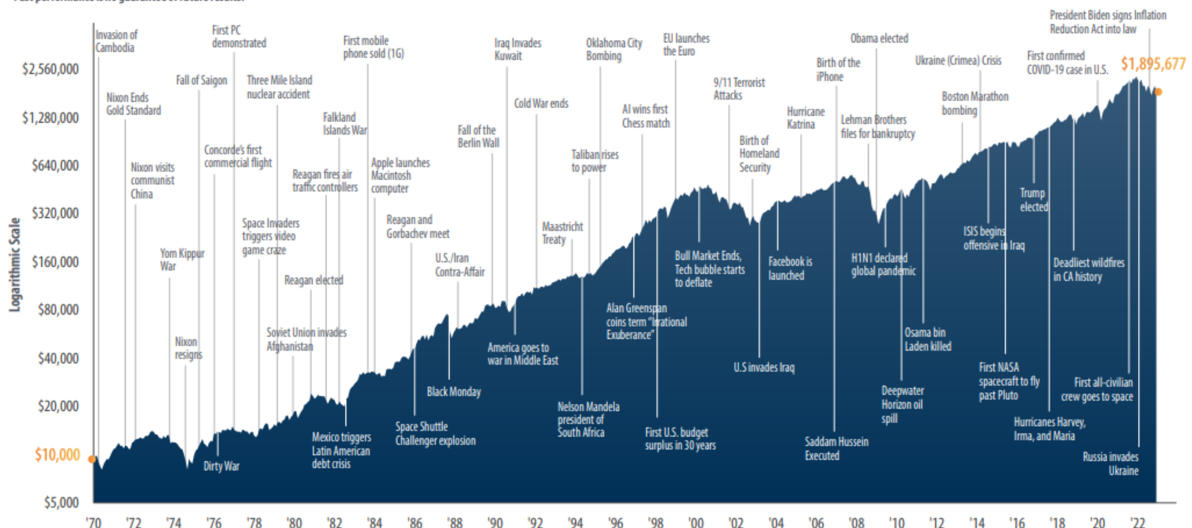
What are your final thoughts on the economic situation?

As the inflation and rising rate environment begins to bite, it is hard not to see a recession on the horizon. To be blunt, that is what the Bank of England is pushing for. The pivot point (when the BoE reverses course) will only transpire when it is obvious that inflation is under control. Given credibility has at least been tarnished, it is plausible that the BoE will want to overshoot on the other side. I think it is likely that a plateau of high rates will be reached only to be replaced with cuts towards the middle of 2024 as economic data weakens substantially. Markets discount future performance today (that is the theory) with valuations looking attractive on a historic basis. Our challenge will be to identify the time when risk should be added; a difficult and uncomfortable decision to make.

This chart shows the growth of $10,000 based on S&P 500 Index performance over the last several decades. We believe looking at the market's overall resiliency through major crises and events helps to gain a fresh perspective on the benefits of investing for the long-term.

THE AVERAGE ANNUAL TOTAL RETURN OF THE S&P 500 INDEX FOR THE PERIOD SHOWN BELOW WAS 10.40%.

Past performance is no guarantee of future results.



Source: Bloomberg, First Trust Advisors L.P., 31/12/1969 - 30/12/2022. This chart is for illustrative purposes only and not indicative of any actual investment. The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. Stocks are not guaranteed and have been more volatile than the other asset classes. These returns were the result of certain market factors and events which may not be repeated in the future.

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Portfolios remain diversified and, at the risk of repeating myself in this note and previous missives, there is substantial unrealised value within our investments. In a recent discussion with a colleague, he reminded me that we must have faith in capital markets as rational thinking will prevail. It is easy to become too pessimistic, however, markets will recover. They always do.

James Calder, Chief Investment Officer, City Asset Management

James joined City Asset Management in 2009 and is our Chief Investment Officer, where he is responsible for managing the investment process and chairing the asset allocation, portfolio construction and fund selection committees. He is also a member of our Executive Committee. He has 25 years' experience, including roles at Gartmore, BestInvest and Baring Asset Management, and specialises in multi-asset real return investing. Throughout his career he has been a key mentor for younger analysts and enjoys watching them progress on to their own successful careers.

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