LWM Consultants Ltd

Quarterly Market Update
– January 2022

"America's present need is not heroics, but healing; not nostrums, but normalcy; not revolution, but restoration; not agitation, but adjustment; not surgery, but serenity; not the dramatic, but the dispassionate; not experiment, but equipoise; not submergence in internationality, but sustainment in triumphant nationality."

— *Warren G Harding*

Compared to 2020, it seemed that 2021 was uneventful!

With Trump leaving the White House, we were introduced to Biden. A fresh start for the US. However as the year progressed so the popularity of Biden dwindled.

It is easy to forget what he has achieved in his 12-months in office. The Build Back Better Act passed the House of Representatives and is expected to pass the Senate, but with a reduced pot of money to spend. The US economy has recovered quicker than many expected and much of this has been credited to Biden. We have also seen the infrastructure bill being approved. These are not small things, but politics are divisive in the US and popularity doesn't last long!

It is not just Biden who is struggling. At the start of the year and with the roll out of the vaccine programme, Boris was riding on a high. As we come to the end of the year, the Boris train is starting to wobble. Not helped by various Christmas parties and indecisions! Maybe Boris will bounce back? The booster vaccination programme has been an amazing success and not enforcing another lockdown may just make people forget his transgressions. Perhaps 2022 will be a better year for him!

The French Presential Election in the Spring should be interesting, with Macron hoping that France taking over the rotating presidency of the European Union will enable him to show his European record and put him ahead of his rivals. Nothing is guaranteed and it will be an interesting election to follow.

We were hoping that 2021 would be the year we moved on from the pandemic. This clearly was not the case. However, we should feel more positive going into 2022. There is a feeling that the virus is becoming weaker, and we should start to be able to move to some form of new normality.

So, coming in to 2022 what are we thinking about. There are four main areas to focus on: higher inflation, COVID variants, monetary policy mis-step and slower growth. We will delve into these in more detail, but briefly:

1. We are not experts on inflation, but it is expected to peak this year and then drop to a more normalised level which is likely to be around 3%
2. COVID variants: there has been some debate as to whether Omicron is the last one. What does seem to be happening is that the variants are getting weaker, but we need to keep an open view on this
3. Monetary policy mis-step: we all saw what happened when the US raised rates too quickly in 2018. There were other factors at play, but we need to remember this
4. All forecasters have reduced growth expectations for 2022 but there still remain opportunities

It is worth touching on a fifth area, and that is navigating the net zero story. Some argue this is a long-term theme and we wouldn't argue with that. But it is happening now and there are massive benefits but also risks. If the transition to net zero is well managed then it should deliver higher growth, and some argue lower inflation. It will also be good for asset returns over the coming years as there is a shift in capital to deliver on the targets.

But there are risks. If there is a disorderly transition where measures are suddenly imposed, this could cause things like energy shortages, and what we saw in 2021 could provide a glimpse of the consequences of this. In a worst-case scenario this could push inflation up and stifle growth.

In summary, politics will be interesting to watch across the US, UK, and Europe, but ultimately economies operate whoever is in power. 2022 could well be the year we move on from the pandemic and watching the strategy of the English government should give us a clue to the future. Expect inflation to peak at some point this year, and if central banks stick to what they have said there shouldn't be a policy mis-step. Growth is likely to lower but equities still seem to be the best place to be. We can choose to ignore the move to net zero, but it has profound implications across every sector and every country, and ultimately how and where we invest. If this is done well then there is higher growth potential, but there are risks.

In terms of what to expect from markets in 2022, do not be surprised if there are market wobbles, but try to focus on the underlying fundamentals which remain positive. There are many opportunities across undervalued parts of the market as well the drive to net-zero. I thought the quote from United States presidential candidate Warren G Harding provided some food for thought. His hope was to restore the United States' pre-war mentality, without the thought of war tainting the minds of the American People. I am sure we all hope for pre-COVID mentality, with perhaps lessons mixed in from the last two years!!

George Ladds

George Ladds, Director, January 2022

Responsible Investing

"Good COP / Bad COP".

The fact that more people are talking about what we need to do has to be positive. In my next monthly update I will explore this further. But I thought it was worth sharing some thoughts we have picked up over the last few months.

Whether we care or not, the reality is that we are in a climate crisis now. If we need evidence we just need to consider extreme heat, droughts, and floods as examples. The jet stream is slowing down because the artic ice cap is melting.

We have lost many decades through inaction and now it is not about the direction of travel but the pace of it. If we carry on then experts believe we are heading to a 2.9-degree world which many say will be catastrophic. The economic system is seen as WILD (wasteful, idle, lopsided, and dirty).

We recently saw a statistic that said that cars sit idle 90% of the time and there is no doubt we must move away from a take, waste model.

But before we get depressed, change is being driven from all quarters. Social disapproval is happening fast; investors want to know what the impact their investments are having on climate change, and they are also demanding investments that don't cause harm. In the UK, although the amount invested in responsible investments is low, the flow of new money is heading towards this, and will grow!

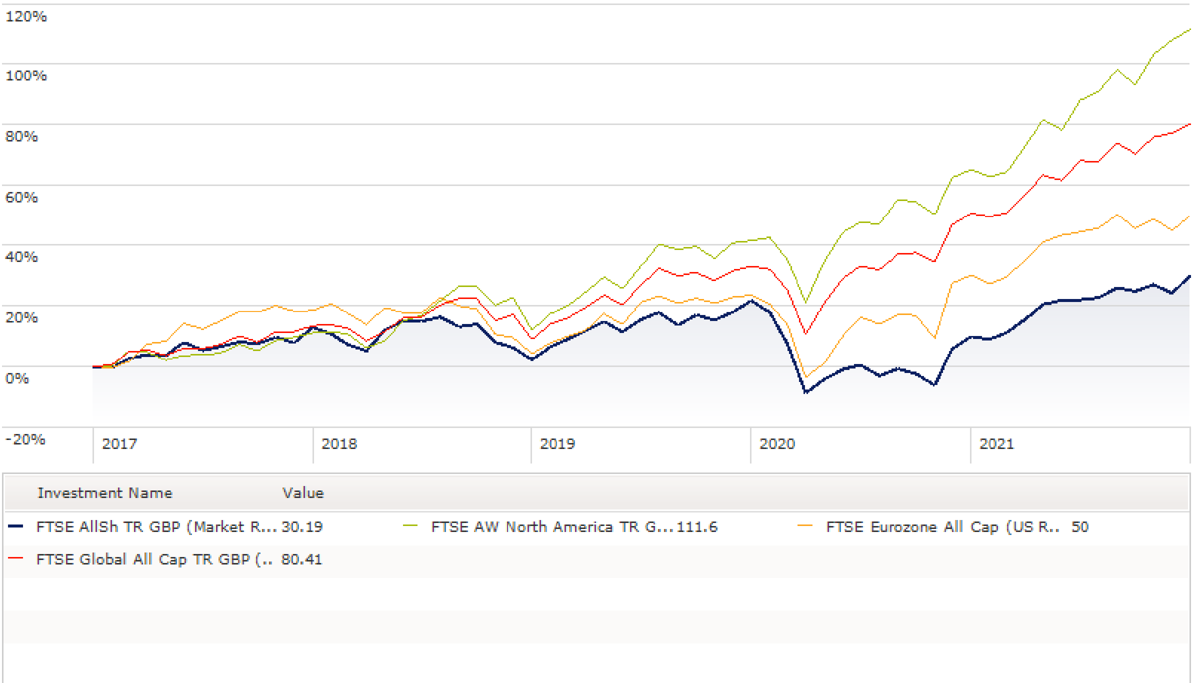
But it is not just about the investor, regulators and authorities are putting pressure on financial institutions to allocate capital responsibly. This is not just about the planet, there is an important social aspect to this too. "Planet" and "people" are themes we need to get used to.

Even if we remain unconvinced it is worth reflecting that change happens very quickly. To cut carbon admissions in half over the next eight years means significant economic change and impacts all asset classes.

In summary, we can't ignore this without directly impacting future investment returns. We already know that despite what many say and think, investing responsibly does not impact investment returns and has potential to provide a better growth profile. Inflation, interest rates, politics etc will always be on our radar but responsible investing is a driving theme now and will be throughout the 20s and beyond.

US, EUROPE & UK

Five year returns 1 January 2017 – 31 December 2021



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When we look back at our report in January 2021, we talked about light at the end of the tunnel and easing of restrictions. It did feel that although there was light in 2021, we are not yet out of the tunnel. However, the news about Omicron seems positive and perhaps 2022 will be the year that we break from the shackles of the pandemic and start to live in a more normalised way.

If we take a step back from the pandemic and consider the economic picture, then perhaps we can see things in a different light. The US has clearly led the recovery and from a market perspective this has been delivered by big "tech". I use tech loosely as many companies would not necessarily be considered tech now. In terms of recovery the US reached pre-pandemic levels of economic activity halfway through 2021. Much of this was driven by retail sales which is around 10% higher than pre-pandemic levels, whereas the service side is down around 2%.

Putting this into perspective it took 4.5 years to achieve the same level after the Global Financial Crisis. We have seen strong returns from the US markets, and this has led many to believe that the markets are "hot", and there is evidence that money is moving out of US markets to cheaper parts of the market. Schroders in a recent update argue that you shouldn't bet against the US as they are the one country with the most reliable recovery.

The UK and Europe are still behind the pre-pandemic limits but are expected to reach these limits during 2022 / 2023. The UK is likely to lag because it has the double whammy of Brexit and the pandemic.

The economic landscape remains robust, and before I delve into this further it is worth touching on inflation. There are lots of “experts” telling us what is going to happen. I tend to follow a simplistic model. It seems to me that inflation is driven by a supply / demand imbalance. If we look at data from the US, the demand for goods exceeds the levels of industrial production. Therefore, if you have that imbalance you get a spike in inflation. As economies move to a more normalised world then inflation in theory should come down. Omicron could delay this and that remains a risk.

In the discussions we have had many suggest that inflation will peak this year and then drop back to a level of around 2 to 3%. There are risks that wage inflation keeps inflation high and this is something to watch. Can we be confident that we are at a turning point? There is data from Schroders that shows that delivery times have peaked and are coming down, so this should help with the imbalance between supply and demand.

If inflation persists this could cause concern. There is already evidence that individuals who don’t have savings are finding earnings not keeping pace with inflation and therefore turning to food banks for help. Even those with savings are finding that earnings are not keeping pace with inflation and therefore turning to this pot of money. So inflation carries many risks but logically if delivery times are coming down then we should see a peak this year and then a move to normalised levels.

Another area to consider is central bank policy. The EU is very different to the US and the UK. The EU is likely to continue some form of QE during this year and they are not expected to raise rates until 2024. This is all very positive for European markets. In the US and the UK there is already tightening on monetary policy and the UK has raised rates, with the UK and US expected to raise rates further during 2022. The UK consumer is also facing higher taxes, higher fuel costs and a cut in subsidies on benefits. Even with rates rising they are only expected to peak at around 2.5% in the UK and US, and 1.5% in the EU.

So inflation and interest rates are things to watch, but perhaps the best measure is in what the economies are doing. Many households have built up strong cash piles. In the US this is 11% of GDP, UK 10%, and Europe 7%. I was staggered to read that US households have seen a rise in net wealth of $27 trillion from the bottom of the market. Putting this into perspective, it took seven years to achieve the same after the Global Financial Crisis.

Although people are spending there remains a pent-up demand, and this will be a key driver in the recovery. As indicated the risks are that wages don’t keep up with inflation and the cash is used to keep people afloat, but if we are right and inflation peaks and drops then this shouldn’t be a cause for concern. There is also evidence that individuals are less sensitive to rising rates (in the US around 5% of mortgages are on floating rates, and in the UK it is 20% which is down from 70% in 2013), we don’t have austerity this time around, and when rates were raised last time we were in the midst of a trade war. Therefore consumer confidence and demand remains positive.

If we turn to the other engine behind economies, businesses, the picture is equally positive. In the US there are 11 million job vacancies and 7 million people out of work. This picture is not that different across the developed world where there are jobs but not the skilled workforce to fill the roles. So we have a tight labour market but jobs are available.

The PMI Data which provide an indication of how businesses feel has peaked but remains strong. Businesses are investing and not only have some had to adapt due to the pandemic, all businesses must adjust to the drive to net zero. This means greater investment. And we have seen businesses adapt quickly and deliver strong earning figures which are expected to continue.

So when you mix-in a strong consumer base with a pent-up demand to spend, and a buoyant corporate sector, you have two elements that are good for the recovery. Some will argue that many Western Economies are moving out of the recovery phase and into the expansion phase. This would certainly make sense in the UK and US with a scaling back of QE and rising rates.

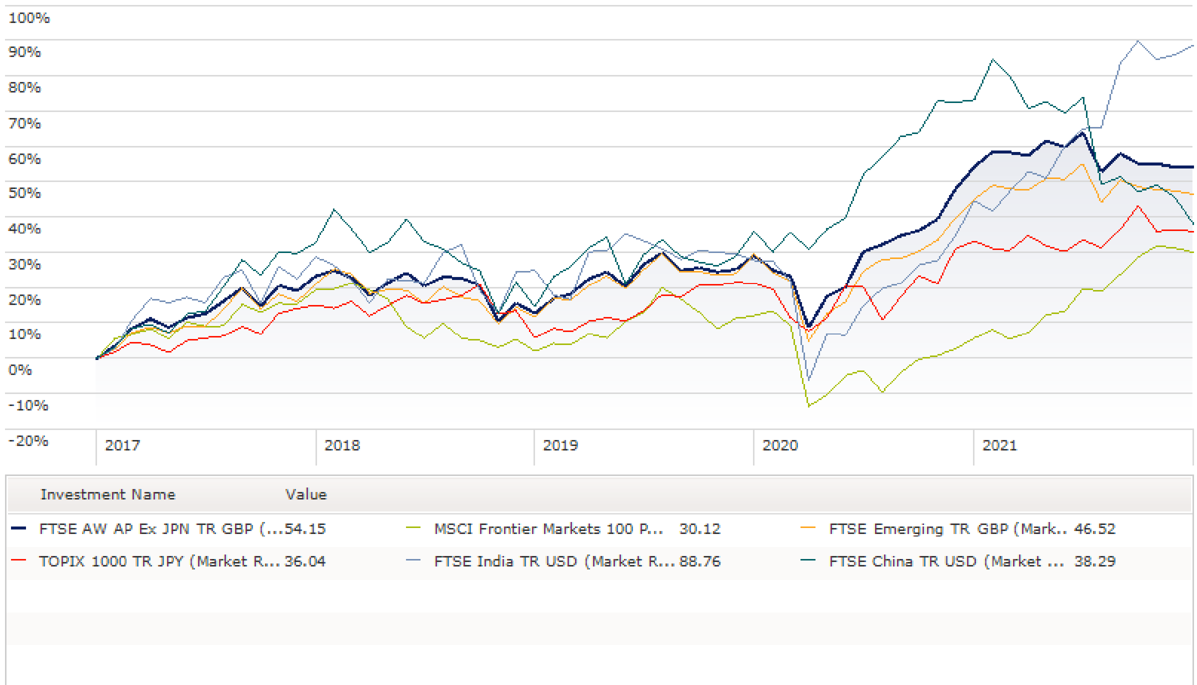
In summary, when we mix this all up the key drivers to any recovery are the consumer and businesses, and both of these are positive. If the data coming out is correct and variants are getting weaker then 2022 could finally be the year we move on, and this is extremely positive. Central banks have been very clear on the direction of travel so there shouldn't be any unforeseen mishaps, but the UK consumer faces higher taxes and higher fuel costs, and this could slow any potential recovery.

If the supply / demand imbalance corrects then we should see inflation peak and come down. That environment should be positive for equities. However if inflation persists for longer that will likely be negative.

Overall, if we weigh up the positives and negatives, we think 2022 has the potential to be a good year for developed markets. Growth is likely to be lower but that should be expected in an expansion environment, but with consumer and company balance sheets in a good place, all of that must be good. In terms of whether we will see double digit returns, the answer is unlikely. But returning to more normalised levels of returns would not be a bad thing because high levels of returns over protracted periods deliver a false sense of optimism.

EMERGING, ASIA AND FRONTIER MARKETS

Five year returns 1 January 2017 – 31 December 2021



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In 2020 China was the talk of the town. How quickly that reversed!! On paper China seems to be a place to avoid. Reform and regulatory change have been front of mind, mixed with concerns over the property sector, zero-covid policy and tensions over Taiwan and South China seas. Then we consider the trade war with the US. China has missed its targets by around 40% on phase 1 of the trade deal. Although Trump is no longer in office the view towards China hasn't really changed.

Having said all of that, we have long argued that although the way China does things isn't perfect, there are often things, they do which I am sure many Western economies would love to do! The reality is that China is a highly innovative country, with many opportunities. Whilst everyone looks at the here and now, they have the potential to miss out on these opportunities. The Government have indicated that they want to return to a period of growth, and we are already seeing a move towards monetary and fiscal policies being loosened. China may not be the US, but as a long-term investment we firmly believe to ignore it would be frivolous!

As a brief whistle stop tour of Emerging Markets, Asia, and Japan, we have to remember these are a diversified group of countries. Vaccine take-up in many Emerging Market countries has been strong, and the expectation is that Frontier Markets will follow during 2022 and 2023.

In the news we can see growing tensions between Russia and the Ukraine. The threat of economic sanctions is a double-edged sword and Russia know that. Europe is dependent on Russia for gas, any disruption could have a significant impact on gas prices across Europe, and this has the potential to delay any recovery in Europe and Globally. So, there is a fine line of standing up against Russian aggression but also not damaging the supply of gas to Europe. Russia has benefited from higher oil and gas prices and has built up a good surplus of cash. However it is suffering from higher inflation and rising rates. A country with money to burn but many risks.

The race to net zero is beneficial to some commodity rich economies like Chile and Peru, and oil will be around for some time as we transition to a greener economy, so countries like Nigeria and Middle Eastern Countries will all benefit.

Turkey sits at the bottom of the equity and bond markets in Emerging Markets. This has been driven by the collapse in the currency. This in turn has spun out of fears of inflation spiralling whilst at the same time the President slashing interest rates. Inflation is likely to go over 30% in 2022! It is worth adding that interest rates are still 14%. In addition, the President imposed a 50% hike in the country's minimum wage another inflationary factor.

The theory is that lower interest rates will alleviate red hot inflation. The problem with this is that it goes against all conventional economic theories. It is a massive gamble if it works, and President Erdrogan is right then he will achieve a high growth environment with low interest rates. As it stands the collapse in the lire would seem to indicate this approach is failing.

Brazil has underperformed in the equity markets, with high inflation choking off any real growth and forcing an acceleration in interest rate hikes. There also remains considerable uncertainty with the election due in October 2022.

India had a good 2021, helped across several areas including exports, and a bounce back in earnings from the trough of 2020. All of this helped deliver a current account surplus.

Japan has been mixed but towards the end of the year started to see a strong recovery in wage growth, strong corporate earnings and global inventory rebuild. Like the US, UK and Europe, there has also been a strong build up of savings.

If we take the longer-term view of Emerging Markets and Asia, there are many positives. The drive to net zero will clearly benefit those countries who are commodity producers helping towards that target. China is an important part of the Emerging Market story and although 2021 showed how volatile it can be, the longer story remains. And it is not just about China – countries like Vietnam, Indonesia, India, Taiwan etc are all important parts of the Asia story.

Longer term, we have always believed that Emerging Markets, Asia, and China must be part of a diversified portfolio. We would never put 100% of our capital in these areas because of the volatility, but will these be the leaders of the future? Of course!

The top-ten economies in 2021 were:

United States
China
Japan
Germany
United Kingdom
France
India
Italy
Brazil
Canada

When you consider the forecasted top ten economies in 2030, the picture is very different:

China
India
United States
Indonesia
Turkey
Brazil
Egypt
Russia
Japan
Germany

This is a move from 4 Emerging Market and Asian economies, to 8 by 2030.

In summary, Emerging Markets and Asia are volatile, but we shouldn't confuse short term volatility with long term opportunities. Whether it is China, India, Indonesia, or any other economy, many are highly innovative and becoming increasingly more important to the global economy. Bringing people into the middle classes provides more spending power and growth opportunities. The drive to net zero is a global challenge and the commodities needed to deliver come from many of these regions. There are arguments that economies like China don't have the money to transition and hence the growth in coal power stations, but often those economies are the ones that are quicker to embrace change.

It has been a volatile period for emerging markets but we remain optimistic for the long term future growth across the different regions and economies.

CASH

<u>Five year returns 1 January 2017 – 31 December 2021</u>

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Cash what is it good for!!!

Fixed income delivered negatively in 2021, and with high inflation this is a negatively yielding asset class. But there are arguments that as a diversified mix of assets there is still a place, particularly if inflation persists and we see negative returns on equities. How "we" allocate to the fixed income pot is clearly changing. We have for many years turned to alternatives. Only in 2021 did other asset allocators start to talk about the need to invest across fixed income, infrastructure, property etc to provide a more diversified base. The point is that fixed income is unlikely to deliver anything special, but as a mix it can provide a safety net within a portfolio.

Cash is a different matter. Holding large sums of cash for long periods of time is likely riskier than investing in equities! If inflation settles at 3% then cash has to deliver more than that to get a positive return. If interest rates settle at 2.5% and saving rates are say 2% (and that would be a fixed term investment of potentially 3 years plus) then we are losing around 1% a year.

However, cash does have a place for short term needs, and can be a useful weapon if as we expect there is increased volatility in the markets. More volatility means there are opportunities to go "shopping". We are not advocates of timing the markets but when markets fail you never know when the bottom is reached but you do know that at some point they will go up. Cash can enable us to take advantage of opportunities like this when they arise.

CONCLUSION

As we conclude this quarter's update, consider 2021, and whatever will happen in 2022, it is important to recognise that the underlying fundamentals remain positive.

Some of the takeaways from this are:

1. COVID-19 – early indications are that the virus is getting weaker and that should in theory open economies. But accept bumps in the road as the UK opens it borders as others are closing them. Also expect unrest as countries like Italy, German and Austria enforce vaccines. But living with COVID could be the talk of 2022 and what this means for how we invest

2. Global growth will slow. This is normal but it remains robust. It does mean that we shouldn't expect double digit returns. Having a diversified portfolio should counter risks but more measured expectations may be needed. It is also worth adding that we have never seen this type of recovery and although we can look to the past, this is different. This is the first recession where in the main people have come out of this better off

3. Inflation is likely to drive market sentiment. Logically this is a supply / demand shock, and we should see a peak and then for it to drop back. But if inflation remains entrenched for longer then this could be negative for markets and potentially bonds. There are some who believe that, for this reason, 2022 could be a negative year for equities and bonds

4. Can markets still go up? There is room for growth and both consumer and corporate balance sheets are strong. But much of the easy money has been made. It means returns will be harder but there are opportunities. With opportunities there are risks and these shouldn't be discounted

5. Don't write off the pent-up demand to spend, Omicron may have delayed this but what happens if we learn to live with COVID and people can spend? The IMF forecasts that the global gross savings ratio will hit an all time high of 28% in 2022

6. Companies are investing to respond to the booming demand and there are jobs. However there is a skill shortage. Corporate earnings are growing and this is positive for markets. Positive earning estimates against the average are up across the US, Europe, China, and UK in 2022, and US, Europe, UK, EM and China in 2023

7. "Tightening" in the UK and US, is coming but what we don't know is whether this stalls the recovery, especially in the UK with rising taxes (NI, council tax etc) alongside rising energy bills

8. ESG / Responsible / Sustainable investing….call it what you want but this is not going away. There will be opportunities as we push towards a net zero world. To ignore would be foolish for any investor but care needs to be taken in selecting the right managers

9. China – don't write off China! This year could be a total reversal of fortunes. China remains a compelling opportunity, they have maintained economic growth, they have responded to demand and so exports are strong, but the common prosperity policy produced several regulatory changes which spooked investors. But fiscal and monetary policy is becoming

more supportive. We shouldn't forget that it is not just about China and there are many opportunities across Emerging Markets and Asia, and EM valuations remain attractive for investors particularly with a 3-to-5-year time horizon

10. Vaccines – we shouldn't forget that two years ago when COVID "appeared" we had no idea that we would have a vaccine. Today we are in a much better place and companies have adapted to a new world. The virus seems to be getting weaker and vaccines seem to be working

In summary, there are many positives and multiple drivers of returns but don't ignore the risks. There is the potential for single digit returns and everything is set to deliver this. But risks over entrenched inflation, stalling growth especially in the UK, and stronger variants could easily place returns into negative territory. So we expect more volatility and returns to be harder to come by, but the potential is there.

Source: Charts have been sourced from Morningstar. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.