LWM Consultants Ltd

Quarterly Market Update – April 2022

"The individual investor should act consistently as an investor and not as a speculator"

— Benjamin Graham, author of The Intelligent Investor

It is fair to say that in January our focus was on inflation and central bank policies. We expected market wobbles, but we remained cautiously optimistic for 2022. For someone fascinated by history, and growing up in Germany during the seventies, the events unfolding in Ukraine didn't ring alarm bells. In fact to some extent you could understand why Russia felt threatened, but logic told you it would make no sense for them to invade.

Perhaps Putin believed, as tanks rolled into the Ukraine, the people would welcome him with open arms, and like Crimea the West would protest but do nothing. Certainly many people we speak to say that the invasion was not expected, nor were the level of sanctions imposed on Russia. What is now unfolding is tragic for both Ukrainian and Russian people, and when the conflict ends will take many years to repair and build any form of trust.

We often feel detached from regional conflicts because they are in places in other parts of the world, and often they are not reported. This is very different because it is so close to home. It is therefore hard to write a market update when this is happening.

Anyone who tells you what is definitely going to happen is only guessing, which to some extent is true of all economic forecasting. We applied logic and logic does not seem to apply. However, there does seem to be a shift in action, and one thing we have always said from the start is how does Putin save face? Our view is neutrality, and Donbas regions may be the route he pushes for. Whether Ukraine accept this is another matter. It does feel that we are moving to some form of peace, but this could be weeks away.

So with this in mind, how do we navigate what was already starting to be a challenging year? The US stock market endured the worst January since the global financial crisis, and there was the biggest swing to "value" stocks for 15 years. This was driven by a variety of factors, including COVID variants, inflation, growth, geo-political tensions, and central bank policy. Markets hate uncertainty and there was an abundance of it in January.

Sitting here and reviewing what we said in January, and comparing it with what we think now, what are our thoughts for the next nine months?

1. We are cautiously optimistic that there will be some form of resolve in Ukraine. Our feeling is that this will centre around neutrality and Donbas
2. The implications of the war have hit oil, gas, and other commodities so we believe that inflation will continue to get higher before peaking towards the end of the year, and then it will start to fall, but it could be that it is remains at a higher level than we thought this year. So some are suggesting around 5%
3. Central bank policy is now starting to differ. The US seem set to raise rates possibly faster than many expected, whereas the UK seem to be taking a more steady and measured approach. The UK is expected to be around 1.25% by the end of the year and the US perhaps as high as 3.0%
4. There is talk of a recession and Europe is at the forefront of this. This could have implications for the French elections
5. Consumers across the Western world are facing higher prices, but place into the mix that the job market is robust, especially in the US and UK, and that consumers have savings. Also, companies are still investing and there is an increase in mergers and acquisitions. There is uncertainty what this all means because these are positive fundamentals in an uncertain environment. A squeeze on incomes will start to feed through over the coming months and the thing to watch is whether this could impact both consumers and companies despite these fundamentals
6. There is considerable misunderstanding about China in terms of its relationship with Russia, Taiwan, and its global ambitions. This means Chinese shares are now very cheap

What does this all mean? It is likely there will be more of a focus on quality companies at the right value. So good fund managers are key. There are pockets of the market that are cheap, including emerging markets, Europe and the UK. It is also important to understand that in the short-term conflicts damage markets, but in the medium to long term markets tend to see through this. Good quality companies are cheap, and we are starting to see this turn. Some wise investors say that the best time to invest is when people are most fearful and this seems true today. At some points markets will rally hard, we just don't know when.

Navigating markets moving forward will be more volatile and expected returns lower. But even with higher inflation and interest rates there are opportunities. Some believe the value rally will now last for most of 2022, but ultimately fundamentals will come to play on quality companies that have pricing power and low levels of debt because they will be best placed to navigate this period.

In summary, our thoughts are very much with the families of both Ukrainians and Russians caught up in this terrible conflict. We, like many, hope for a resolution as quickly as possible. In terms of investing, it has shifted things, especially inflation, which we expect to peak and come down but be at a higher level than we first anticipated. Equity markets really remain the only place for long term investments but expect more volatility and lower returns. Do not be surprised if areas like emerging markets, Europe and UK outperform the US in the long term as this is where much of the value currently lies.

George Ladds
George Ladds, Director, April 2022

Responsible Investing

One of the questions we had was whether ESG means green? It made me think long and hard!

ESG is the new buzz word. It stands for enviromental, social and governance. I googled ESG and it seems it can be a little confusing. One of the first things that came up was green investing made easy. Further down my search I came up with an explanation of applying non financial factors as part of the investment process to identify material risks and growth opportunities.

There is no doubt that responsible investing is high on the agenda but we need to be careful that we understand what it means. Over the last 2 years I have come to the realisation that ESG is just a quality overlay.

We look for fund managers who invest in good quality business. As part of that analysis we would expect them to filter to understand risks and growth opportunities. They may not have called this ESG in the past but that is what they had been doing. Now of course they have to report what they are doing, which is a little different.

ESG, importantly, doesn't necesssarily exclude, so the term green is misleading and every manager has their own criteria. Take an example of a UK fund we invest in. They invest in good quality companies. They have holdings in two tobacco companies. Their view is that these are good, well-managed businesses that are generating cash and have the ability to grow their share price over the long-term.

In fact if we dived deeper into our mainstream holdings we might find fossil fuels, arms etc. We might not agree with what they do but the fund managers believe these to be good businesses.

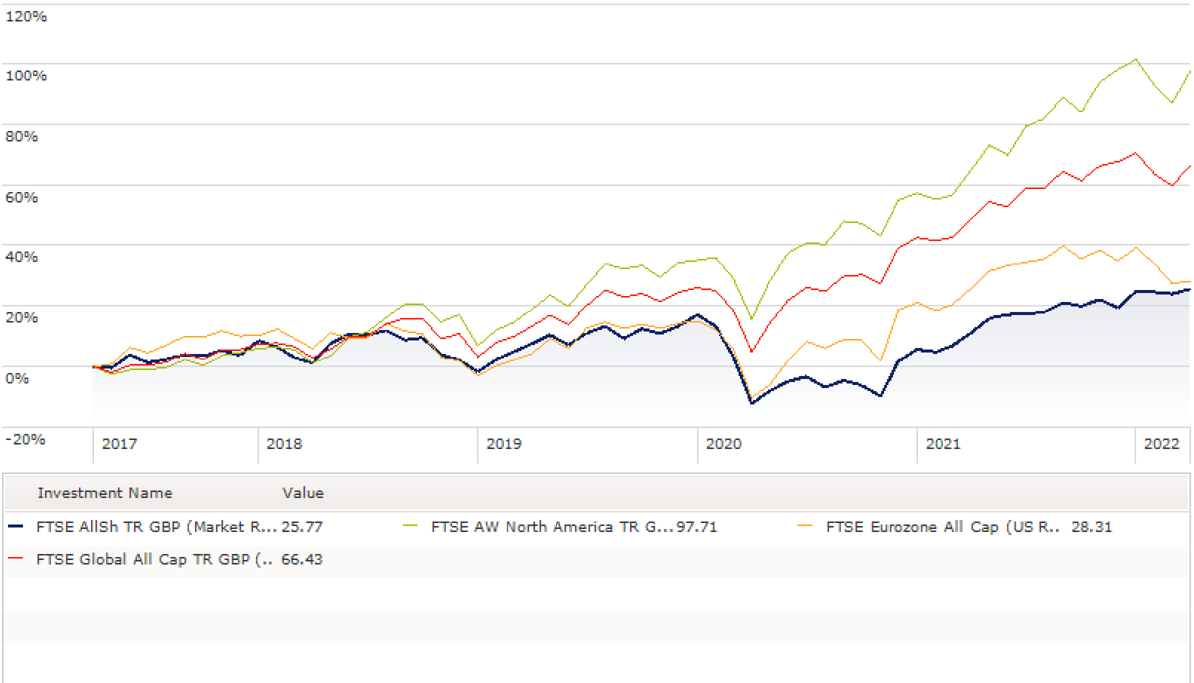
If we go one step further, I was speaking to a fund manager recently and they are moving their fund to what is classed as an Article 8 Fund (financial services are great at producing confusing terminology!). To gain this status they have to exclude things or have very minimal exposure. In applying and going through the process they have had to sell two holdings, one of which was a steel producer. The fund will have an ESG overlay but also exclusions and so you would not expect to see things like fossil fuels, arms etc.

So to summarise, almost all the funds in our mainstream portfolio have a quality filter (and this can be called ESG). However, the majority of funds do not have exclusions which means a quality company can include one that invests arms, tobacco, gambling, pornography, fossil fuels etc. The manager using the filter will make that assessment. This is responsible investing at a basic level.

If investors want to do something positive for the planet and for society by excluding certain areas, then that is the next step which perhaps we should call ESG plus! Either way we shouldn't get too hung up on terminology. We like quality managers, the question is more about whether we want exclusions or not and that is an individuals own choice.

US, EUROPE & UK

Five year returns 1 April 2017 – 31 March 2022



Special note to graph: *You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.*

On the face of it the fundamentals across US, Europe and UK are relatively positive. In the UK and US, you have pretty robust labour markets, and we should not discount the levels of savings that people have accumulated over the last couple of years. People want to spend. Companies are also investing, and mergers and acquisitions are expected to hit record levels in 2022.

As we came into this year we expected inflation to peak and then drop away as we saw oil prices come down. The level of inflation was expected to be around 3%. Now it is expected to be around 5%. That places a massive pressure on consumers.

Consumers, especially in the UK and Europe, are struggling with increased oil and gas prices and it is hard to see how and when these will come down. Higher prices and a strong labour market might not be positive for markets. If workers demand higher wages this is inflationary.

It is also worth reflecting that COVID and Ukraine has united Europe in a way we have never seen. Firstly the European recovery plan is the largest stimulus seen and will see e2.018 trillion invested to help rebuild a post-COVID-19 Europe. It covers modernisation via research and innovation (Horizon Europe), fair climate and digital transitions (Just Transition Fund and Digital Europe Programme) and preparedness, recovery and resilience (Recovery and Resilience Facility, rescEU and a new health programme, EU4Health).

Additionally, it pays attention to:

- Modernising traditional policies such as cohesion and the common agricultural policy, to maximise their contribution to the Union's priorities
- Fighting climate change with 30% of the EU funds, the highest share ever of the European budget
- Biodiversity protection and gender equality

But remember, investing in the green economy is inflationary.

With Ukraine we have seen Germany announce they will spend 2% of GDP on defence spending. This is massive and we will likely see others follow. Again, is this inflationary.

Europe is dependent on Russia for oil and gas, especially Germany, and so we are starting to see rationing. This is again inflationary. But it has forced these economies to look globally and although it will take time, the dependence on Russia will decline and this makes Europe more global in its outlook.

It feels that Europe could fall into a recession because of rising inflation and the supply shock but we think there are many factors that are different this time around. Europe has a massive spending package which is being drip fed over many years, more money being spent on defence is again positive and the drive to green energy may in the short term slow, but the longer-term trajectory remains.

Also many European companies are global, and compared to similar businesses in the US, these are trading at significant discounts. We believe that in the short-term Europe could fall into a recession but over the long term it has the potential to outperform the US markets.

The UK remains interesting. In terms of taxes, it is interesting that most people have forgotten that these were increased to pay for the NHS. The UK has strong employment figures, high levels of savings but consumers are faced with higher taxes, higher food costs and higher fuel costs.

The UK exports 53% of its goods to Europe and Centra Asia. The biggest export markets are US (15.70%), Germany (9.90%), France (6.70%), Netherlands (6.49%) and China (6.44%). Russia is 0.72%. In terms of imports, again Russia is relatively small, with the main reliance on Germany, US, China, Netherlands, and France. A recession in Europe is likely to hurt the UK and like Europe we are not global with our trade partners, mainly being focused in Europe and the US.

But the Ukraine has breathed life into Boris Johnson and this seems to be his moment, and what he is good at. We don’t believe people should write off the UK. It is cheap, especially in the small and mid-cap space it has some amazing global and innovative companies. The UK is not the FTSE100!

Deloitte carried out a survey of 85 CFOs from 60 listed companies in the UK. This identified that major British companies plan a surge investment over the coming years due to strong demand and a response to climate change. Areas of focus are likely to be around digital technology, productivity and workforce skills. This is on the back of an expected growth in demand, both in the UK and from abroad.

Like Europe we wonder whether the UK could outperform the US over the next ten years. And don’t forget, like Europe, the UK is committed to the green revolution.

The US seems to be less likely to be hit by what is happening in Europe. It is energy self-sufficient. 60% of its exports are to Latin America & Caribbean, North America, and Canada. It has strong employment, and consumers seem to have plenty of money. Rising inflation and the central banks move to rise rates quickly may be negative for the economy.

It is also interesting that Biden's dreams of Build Back Better have faltered and are now about Building a Better America. This was his flagship policy which would have seen over a trillion dollars invested in infrastructure and reduction of the effects of climate change, and spending on welfare and social services. Whether anything comes out of this now will be interesting to see.

The clock is ticking as the mid term elections are in November and it is expected that the republicans will take control of one of the houses, meaning that it will be almost impossible for Biden's dream to come to fruition. This infrastructure spend would have been significant for the US.

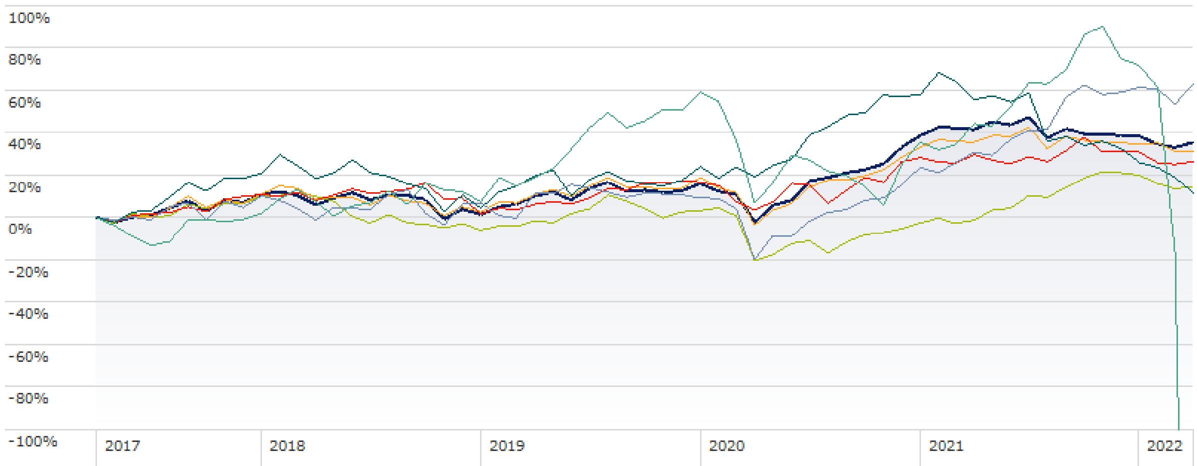
Tech has dominated the last ten years and the US has been at the forefront of this. Can these companies repeat the same over the next ten years? We question this. We could see a sideways movement.

The point is that the fundamentals in the US are good but unlike other economies, the investments from COVID are already spent and it is unlikely they will invest in infrastructure in the same way as Europe, Asia and the UK. Rising rates and inflation will take a toll, and we think the US market could run out of steam whilst others take the batten. We still think there are returns to be had from the US but investors should not discount Europe and the UK as it could be these regions, alongside Emerging Markets, which are the better performers.

In summary, in the short term the US is less impacted by what is happening in Europe and mainland Europe are at the forefront of what is happening. But long-term, Europe has pulled together in a way we have never seen, and this is translating into greater investment across infrastructure and defence. Equally UK companies are investing and positive for the future and the UK is committed to the green revolution. The US short term remains robust but failure to sign the flagship policy longer term has to be negative for the US. It still has world leading businesses but logically these cannot grow at the same rate and so we think there could be a shift. We have already said in this update, invest when others are fearful. People invest in the US because of what it has achieved and the assumption is it will continue. Europe and the UK offers lower valuations and plenty of opportunities.

EMERGING, ASIA AND FRONTIER MARKETS

Five year returns 1 April 2017 – 31 March 2022



Investment Name	Value				
FTSE AW AP Ex JPN TR GBP (...	35.54	MSCI Frontier Markets 100 P...	14.74	FTSE Emerging TR GBP (Mark..	31.18
TOPIX 1000 TR JPY (Market R...	26.42	FTSE India TR USD (Market R...	62.82	FTSE China TR USD (Market ...	11.91
FTSE Russia TR USD (Market ...	-100				

Special note to graph: *You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.*

It is important to understand why the press could be wrong about China. There is an assumption that China is like Russia and that Russia is a major trading partner. Firstly, one of the key arguments is the importance of Russia as a trading partner. According to the World Integrate Trade Solution the top five export partners are USA (16.75%), Hong Kong (China) (11.19%), Japan (5.73%), Korea (4.44%) and Vietnam (3.92%). In fact, Russia comes in at 13 at around 1.98%.

If we then breakdown to regions, East Asia and Pacific accounts for 38.41% of exports, North America 18.23%, and other areas (South Asia, Middle East & North Africa, Latin America and Caribbean, and Sub-Saharan Africa) 19.38%. Europe and Central Asia (which includes Russia) is 21.67%.

This tells us that China is a player in the global market. If we consider Russia then 63.51% of exports are to Europe and Central Asia, and 22.25% East Asia and Pacific. In terms of the main countries Russia exports to, these are China (13.43%), Netherlands (10.50%), Germany (6.57%), Belarus (4.96%) and Turkey (4.96%). The make up is very different.

The second point to understand is common prosperity. Over the last 20 years China has lifted over 800 million people out of poverty. The theme of common prosperity goes across everything they do. Where Russia is more insular, to achieve its goals China trades globally and anything that disrupts that destroys everything they have achieved.

So lets take three specific arguments as to why China is going down the route of Russia. The first one is that it will side with Russia. This makes little sense on the basis that the trade they do with Russia is small. They must tread a careful balance because they do import raw materials but to achieve common prosperity, they need the global economy more than they do Russia. There is an argument that China will purchase excess oil and gas, but how will they import this without the infrastructure! They have agreed a gas deal, but it will take many years to build the pipelines needed.

Secondly, China will invade Taiwan. My understanding, and please correct me if I am wrong, is that there are seven points to invade Taiwan. All of these are heavily protected and the only way to attack is by sea. It is highly unlikely an invasion would work. More importantly China imports around 80% of the semiconductors and materials, and this is important to make their economy work. They want to be self-sufficient but they are not there yet. Of this, Taiwan is around 30%, and Korea 20%. An invasion would switch that off immediately.

Thirdly, the Chinese economy is slowing and the zero COVID policy is damaging for supply chains. The Chinese economy is around 1.5 billion people. If Shanghai goes into lockdown that's around 25 million people. When Shenzhen went into lockdown for seven days there was evidence that factories and offices started almost immediately after lockdown. There is no evidence to suggest that this approach is impacting supply chains. China is protecting the health of its citizens, and this seems to be working for them. Also, they are targeting growth of around 5% this year, and many claim they can't achieve this. That might be true but fiscal stimulus has increased by 16% this year and interest rates are coming down.

The point in all of this is to consider the facts: China is not Russia. China has sold-off because many do not understand the differences and we think that offers opportunities.

Turning to the current crisis, there are areas to consider; oil prices are likely to remain elevated, there were already rising gas prices, and this will continue, Russia is a major producer of several base metals (aluminium, titanium, palladium, and nickel) and Russia and Ukraine are major produces of agricultural commodities (Wheat, maize, barley and rapeseed).

Navigating Emerging Markets is going to be harder. Higher food and energy prices will impact many countries. 40% of Ukraine's wheat goes to the Middle East or Africa. Even if the war stopped today exports will be damaged this year and probably for the next few years.

Egypt imports 80% of its wheat from Russia and Ukraine. It is also a popular holiday destination from these regions. Turkey is another area which is struggling with inflation at around 50%. Lebanon is experiencing one of the most devasting economic crisis in more than a century and gets more than half of its wheat from Ukraine.

I had never heard of palladium before but Russia exports around 40% of this and it is used in automotive exhaust systems, mobile phones and even dental fillings.

The points to consider are importers of oil and other commodities like wheat will struggle, but exporters of commodities like oil, copper, iron ore, corn, wheat, and metals will likely do well from this.

Looking at the data we started with, we can identify those countries more likely to suffer. Asian economies are probably less vulnerable compared to some African and Middle East economies. Equally some Latin America commodity producers will do well due to increased demand. When the conflict ends it is likely that Russia will no longer be part of the MSCI World Index, and this may increase the weighting to countries like Brazil.

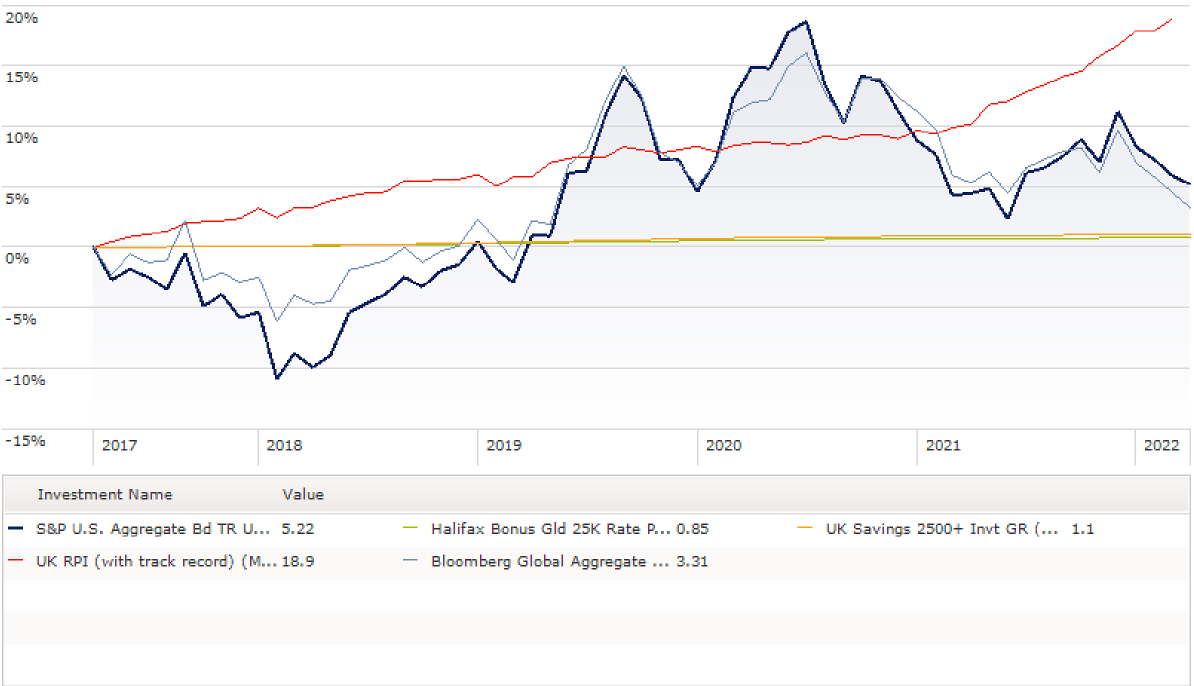
It is also just worth adding that rising inflation puts pressure on balance sheets and could place pressure on unpopular governments, especially where there are weak social safety nets and few job opportunities.

What does this all mean for emerging markets? We think parts of emerging markets have been unfairly punished by the markets and are now offering opportunities. China is one of those regions. It is also clear that Asian economies are also offering opportunities, as do commodity rich economies in Latin America. Even with a quick resolve it will take time to rebuild supply chains and it will take longer for many economies to trust Russia again.

In summary, if investors are looking for value, then emerging markets are offering this in abundance. Careful navigation is needed because there are regions that will suffer, but due to cheap valuations this is a part of the global economy which, we believe, offers investors the opportunity for good long-term returns. The journey will not be smooth, and the press will be negative for some time to come. It really comes back to the best time to invest is when people are most fearful. We are now at that stage with emerging markets, and we think investors will be positively surprised in the coming years.

CASH

<u>Five year returns 1 April 2017 – 31 March 2022</u>



Special note to graph: *You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.*

So central banks in the US are talking about 7 rate increases this year and the UK around 4. In the UK we are now expecting rates to land at around 1.25% by the end of the year, and inflation settle at 5%. Even if a financial institution offers a rate of 1.25%, the net effect after inflation is negative.

Cash, for short terms needs is really important but holding cash with the hope that interest rates will return to 5% is perhaps wishful thinking.

It seems that although rates will go up it is very unlikely we will see them rise to the levels we have seen in the past.

CONCLUSION

If you have travelled this far, I hope this update has given you some food for thought. We may not be 100% right but perhaps it will spark debate. Some key take outs from all of this:

1. We are cautiously optimistic for a resolve in the Ukraine. But the impact, which is not just the human impact, ripples globally. There are implications across commodities which will likely keep inflation at an inflated level. It could drive some economies, especially in Europe, into recession and in emerging markets there will be winners and losers

2. The underlying fundamentals are actually pretty solid, with the UK and US showing strong employment data and significant savings levels. We don't know what the squeeze on income will do to this and how this will feed into the economic growth moving forward but it may be different to what economists expect

3. In the short term it seems that Europe will fall into recession, but with the recovery plan this will generate spending across many parts of Europe which should stimulate growth, but could also be inflationary. The US on the other hand is likely to squander the opportunity it had with Biden's Build Back America, either unlikely to see the light of day or if it does in a very diluted form. We think Europe could outperform the US over the next ten years

4. French and US elections are things to watch this year. A recession in France might not be good for Macron, and it seems that Biden won't have the full house he has had since he came to power

5. Do not believe everything we read about China; this misunderstanding opens opportunities. They have a delicate line to balance but unlike Russia they are a global player and to disrupt that undoes everything they have achieved

6. We have seen the biggest rotation to value stocks in 15 years, and this may continue for the rest of this year. But in an environment of high rates and inflation, quality companies which can produce cash and have pricing power will be the likely winners

7. The best time to invest is when others are fearful. The markets are volatile and choppy. The journey is not comfortable but often at the points of greatest fear they produce the greatest opportunities. Many parts of the markets are cheap (UK, Europe and parts of Emerging Markets). When markets rally they tend to rally fast. Now may be the time to be selectively taking advantage of the opportunities.

8. The last decade was all about US tech. It is unlikely these companies can deliver the same levels of return. It doesn't mean they will fall in value but they may move sideways or grow at a lower rate. Perhaps Europe, UK and Emerging Markets may be the surprising winners over the next decade

In summary, going back to where we started, this year has been all about the tragedy in the Ukraine and how this impacts so many people. We are so often detached from localised conflicts because they are not close to hand, this is different. It feels wrong to focus on the economics but in doing this we are mindful of what is happening. This year will not be easy for markets but there are good underlying fundamentals, and we think longer term the opportunities are there in the right places.

General disclaimer: The data has been sourced from external sources (the charts for example are from Morningstar) and although we have looked to ensure this is as accurate as possible, we are not responsible for data they supply.

The view on markets is written in a personal capacity and reflects the view of the author, it does not necessarily reflect the views of LWM Consultants. Individuals wishing to buy any product or service because of this update must seek advice or carry out their own research before making any decision. The author will not be held liable for decisions made because of this paper (particularly where no advice has been sought).

Please also note past performance is no guide to future performance and investments can fall as well as rise.