



# LWM Consultants Ltd

**Quarterly Market Update  
– October 2022**



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*“It is during our darkest moments that  
we must focus to see the light.”*

*— Aristotle Onassis*

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It is very easy to be consumed by the negative headlines, and just question when and how does it end? There are many challenges that are testing markets, whether it is the direction of interest rates, inflation, the conflict in the Ukraine, recession etc.

In all of this it is hard to focus on the facts. I recently read a brilliant piece called “the illusion of knowledge”. Shortly after that I had a meeting with a fund manager, and it perfectly illustrated the point of the article.

If we focus on the UK, there are many economists who will tell you how the future looks:

1. Interest rates 6% plus
2. Inflation persistently high
3. Short or long recession (depending on who you read)
4. Drop in house prices

In the US I hear that Donald Trump could be the next President in 2024, and there are rumours that Liz Truss won't last 12 months and Boris Johnson could come back.

Economists and journalists are paid to form an opinion. If an economist was right every single time, they would not be an economist, but they would be very wealthy! No-one monitors how often an economist is correct, but an economist will remind you when they are correct (they forget to remind you when they are wrong!).

The reality is that no-one really know and through all of this we must navigate the waters that are the markets.

In the conversation I had with the fund manager, they provided a different perspective to what we were reading in relation to the government's economic policy. They were not forming an opinion of whether it was right or wrong, it was about observations. I haven't been able to verify some of the points made but they do paint a different picture:

1. Liz Truss has been telling everyone for the last three months that she would cut taxes and help people with their energy bills. In the mini-budget this is what she did, but without any figures. It shouldn't have been a surprise because everyone knew it was coming
2. The Bank of England must take some responsibility for the turmoil. They knew the mini-budget was coming, they would have known that there would have been tax cuts, and yet they only raised interest rates by 0.5%
3. The UK must compete with the EU on tax to attract investment, (effectively a Singapore-on-Thames!) In terms of the tax cuts:
  - a. Reversing corporate tax rises make sense especially as we are coming into a recession
  - b. The cost of removing the 45% tax band is immaterial. In fact, when the top rate of tax was last reduced the tax in take at this level went up
  - c. The 1% reduction in basic rate tax is probably the most controversial as it does little to help the poorest. Raising the nil rate band and the 40% band is probably a better way but the cost of doing this is relatively small

The issue is that the way it was presented was poor, the ill-informed media stirred up a storm, the Bank of England are also very much to blame, and the markets reacted as if it was a surprise when clearly it wasn't.

The media frenzy focused on the collapse of sterling and not the strength of the dollar. The yen had fallen more than sterling this year, but this seemed to slip out of the reporting.

The point in all of this is that we must focus on the facts, and from that we can get some view of the future.

Taking this further, what happens if the experts are wrong?

Could interest rates hover around 3.5 to 4% in the US, and 4% in the UK?

Could inflation in the UK come down to 4 / 5% and the US 3 / 4%?

What happens if we have a short recession?

And we can go on. Just the smallest change in data will change market sentiment.

In summary, we think that the next few years will be more volatile. We expect interest rates and inflation to be higher than they have been for a few years. In terms of a recession, this is likely to happen, but how bad it will be no-one knows. One observation we would make is that in Bristol last weekend there was a job fair. If employers were worried they wouldn't be employing people. Sometimes looking at what's around us paints a different picture.

*George Ladds*

George Ladds, Director, October 2022

## Responsible Investing



I recently read an interesting article about how decarbonisation is too expensive. I have also seen articles which claim the events in the Ukraine will slow the drive to decarbonisation. This seems to ignore the trillions of dollars that have been pledged globally.

As we wrote last time, we need our existing resources to achieve the perfect world and so there will always be arguments from both sides. What we need to find is a middle ground.

What we know.

1. Government investment – governments will offer assistance to companies who are developing technologies within this sector. As this technology gains momentum it creates a tipping point where the dominant technology gives way to the new one.

The article we read argues that over time, as the cost of a solar panel or wind turbine comes down, so does the production of a unit of electricity. This cannot be done through mature means of energy such as coal.

2. Subsidies – offshore wind produces electricity at about a quarter of the current price charged to consumers in the UK – a price set by the wholesale cost of gas. So although subsidies might have been needed at the start they are no longer needed.
3. Jobs – it is estimated that 3 million jobs will be lost in mining, power plant construction and other sectors. On the other side, it is estimated that 12 million new ones will be created across transport, renewable power generation and energy efficiency

When we consider what governments have committed to it is staggering:

USA - \$2 trillion climate focused infrastructure plan

UK – plan to power all UK homes with wind by 2030

China – 2060 net zero target

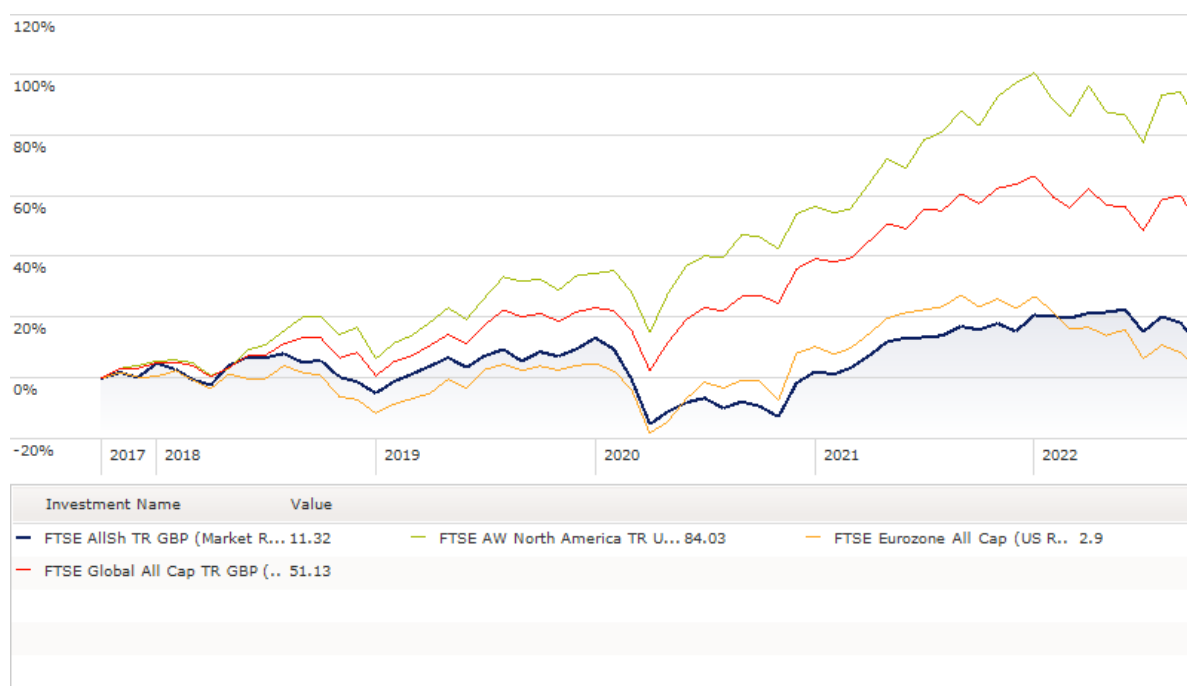
Japan – carbon neutral by 2050, 50% renewable electricity by 2030

EU – green house gas emissions cut by more than 55% in 2030, climate neutral by 2050. EU Green Deal €750bn

In summary, the spend within this area will be inflationary, but as we get to the tipping point from old to new this will naturally bring costs down. We can already see a whole new sector of jobs being created and therefore, although some jobs will be lost, it is likely more will be created. In terms of investing, this is a theme that is multi decade and there are many profitable companies operating in this area. But equally we haven't got to that tipping point and so change will take time to come.

## US, EUROPE & UK

Five year returns 1 October 2017 – 30 September 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.

When it comes to “predicting the future”, it assumes that we can model the behaviour of millions of different inputs. In reality we cannot do this. We have a whole industry that claims to know what will happen based on what has happened in the past. We believe that you can see patterns, you can understand facts and that logic sometimes prevails, but this guarantees nothing.

Let’s start with the bonkers! The US election is in 2024. The two mooted front runners for the Republicans are Donald Trump and Ron DeSantis, both being investigated but could one of these end up as President? And before we consider how crazy this looks, there are two rumours flying around in the UK. Firstly there are already plots afoot to oust Liz Truss, and depending on what you believe the replacement could be Boris Johnson. Labour in theory just need to cruise at this point and they should win the next election, but as we know this doesn’t always pan out.

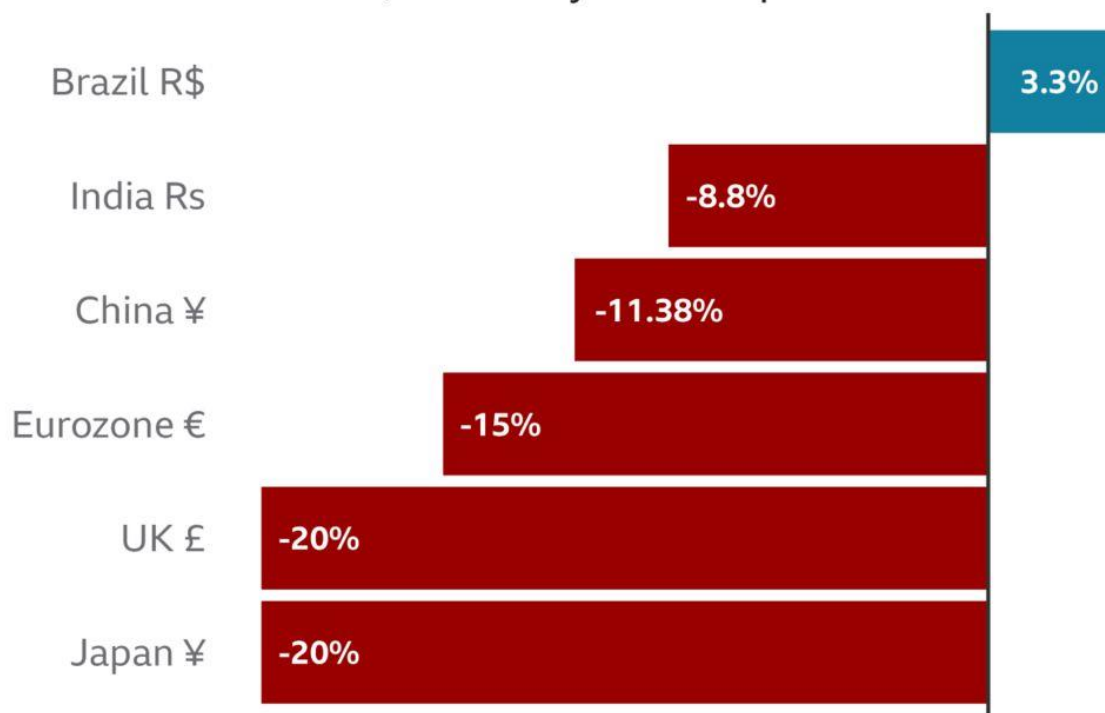
In Italy Draghi was seen as a reformist from outside of the country, but internally he was painted as one of the financial elite. The collapse of the Government led to a far-right government in power. Constructing a coalition will not be easy and how long Meloni stays in power will be interesting to see. There have been 69 governments since 1945 so the track record is not great.

Political instability is something we need to accept, and it leads us to what the economic outlook might be.

We have talked about the collapse of sterling, but it is more about the strength of the dollar. The table shows how some selected currencies have performed against the dollar this year up to 27 September:

## Many currencies have fallen against the US dollar this year

Selected currencies, 1 January to 27 September 2022



Source: Bloomberg

BBC

This creates a global problem as goods imported from the States are more expensive, including oil which is priced in US dollars. But in times like a global recession the US dollar is seen as a haven and therefore we expect this to remain relatively strong.

We have talked about market and economic assumptions. The feeling was that the Fed would cut interest rates in 2023. In August the Fed stated they would fight inflation rather than support growth. This took off the table any potential drop-in interest rates, and a rate of around 4.5% is estimated. By doing this the Fed could force the US into a recession and then a global recession.

It is difficult to guess how any recession will look. Consumer confidence has dropped to its lowest level for 50 years and the US has seen two consecutive negative quarters of economic growth. On the flip side, the labour market remains strong and average wage increases are around 4% p.a.

The housing market is under strain but pressure on households is different to the UK where around 95% of the mortgages are on fixed long-term rates (these are normally 30-year mortgages), and subprime mortgages are only around 2.3%.



Turning to politics, the mid-term elections are in November and this could shift the balance of power. These elections are important as a unified government has allowed Biden to pass important legislation such as the Climate-Focused Inflation Reduction Act. A republican victory would likely stall further legislative change. It increases the risk of a political crisis over the increasing debt ceiling and make active fiscal policy in response to both near term inflation pressure and medium-term recession risk almost impossible to deliver.

In summary, the picture for the US is mixed. Uncertainty with politics could lead to a bad outcome, and it seems unlikely a recession can be avoided. However, the strength of the labour market could mean this is a short sharp recession rather than a deep one.

The UK is challenged across many areas. Households face many pressures although rising fuel costs have been capped. Unlike the US, many mortgages are fixed for shorter periods and so as the terms come to an end, so costs are going up significantly. We could end up in a scenario like the 90s where house prices fall and / or stagnate. Fixed rates are high now and predictions are that interest rates will peak at 6% plus. No-one knows for certain if that is the case but the fear for households is very much there.

Without placing any opinion on the government, we can understand the challenge they face. We are effectively now competing with the EU and therefore the best way to compete is through lower tax. The phrase "Singapore-on-Thames" is being banded around. It is probably more akin to what Ireland did. The danger as we saw with Ireland is the return to boom and bust.

With that in mind, we can understand more as to why corporate tax rises were scrapped, and why the proposal was to reduce the highest rate of tax. More investment, in theory, benefits everyone. The theory of capitalism is such that you need entrepreneurs because if successful they employ people who pay taxes. Making the UK an attractive tax environment makes it more attractive to invest in.

However, there is a growing feeling that just cutting personal income tax or even corporate profit tax has little effect on economic growth.

This quote from Michael Roberts states, *"what matters for growth is increased productivity of labour and that depends on increased investment in technology. That in turn under capitalism depends on rising profits and profitability. If they are falling or low, then even large adjustments in income tax will have limited effect compared to changes in overall profitability. And remember the bulk of tax revenues no longer comes from personal or corporate taxes, but from sales or value-added taxes, customs duties, social security deductions and so-called stealth taxes."*

The other side of the argument is that cuts to taxes at the top rate only benefit the rich who will use legitimate tax schemes to shield their earnings, and therefore the gulf between rich and poor becomes greater. Equalising the national insurance and lower rate tax bands was a means of benefiting the poorer in society and raising those bands is potentially better than dropping basic rate by 1%. The issue all comes back to making the UK attractive and the headline figures are key. As we have seen, if this is not presented in the right way then it is for nothing.

Who is to blame for the fiasco? Ultimately, everyone knew tax cuts were coming. The Government must take blame for the poor presentation, the Bank of England increased rates by just 0.5% the day before and they must also take blame for what happened, and the media ignorance created panic. This combination caused the chaos within markets which is now impacting mortgage and loan rates.



Somehow the Government needs to restore its credibility and backtracking is not going to do that. There are already rumours of plots to remove Liz Truss. Could Boris return? Labour could in theory do nothing and win the next election, not because they offer anything different but because there is no alternative!

The markets are pricing in interest rates rising to 5.75%. Some feel they could go above 6%. Consumer confidence is low and the PMI business survey dropped into contractual territory. On the flipside, as we have evidenced the labour market remains strong and wage growth is around 5.5%.

In summary, the UK is challenged. On one hand the burden of tax has come down for households but on the other hand increased energy bills and mortgage payments places extreme pressures on individuals. How the government creates growth is yet to be seen.

Turning to the EU and Europe. We know they are in the thick of it with such reliance on Russia for gas supplies. The main thing to remember is that Russia has played its main card by switching off the supply. It is important to note that the EU has met its target to fill 85% of its storage capacity which should take some of the pressure off over the winter.

In addition, there are three proposals they are looking at:

1. EU wide electricity savings with a broad target of 10% for general consumption
2. EU level uniform cap on energy prices
3. Tax on the revenues of fossil fuel producers

It doesn't mean it won't be difficult and there is the potential for rationing which could impact industries such as chemicals, basic materials, cement and concrete, and mining and quarrying.

Interest rates are rising and expected to peak around 3.5%. Similar to the UK the PMI business survey is in contractual territory. Industrial production dropped sharply in July and consumer confidence is at an all time low.

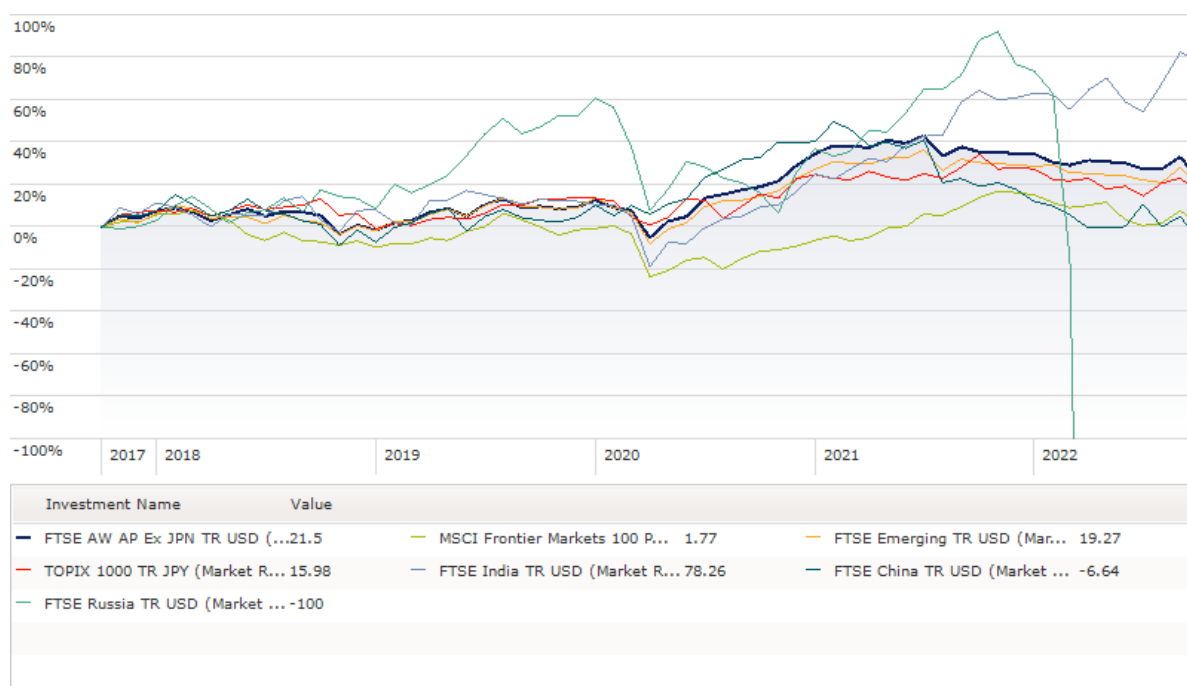
As we know, politics ebb and flow within Europe. All eyes have been on Italy. What seemed like a populist government headed by Draghi was bringing in reform and investment. However, the government collapsed, and Draghi was painted as part of the financial elite. The Brothers of Italy stayed out of the coalition and they used this to their advantage. On the basis that there have been nearly 70 governments since 1945 it is questionable how long Meloni can stay in power. But having a far-right party in power has worried many.

In summary, the EU and Europe have been challenged this year because of its overreliance on Russia to supply gas. This will change but not immediately, and this winter could be challenging for the EU and Europe.

As an overall summary, the developed economies face many challenges and the real focus is when we get a global recession and how long that lasts. The employment data in the US and UK remains strong and it could be that this is a short recession rather than a prolonged one. Markets have priced in so much bad news that even the slightest shift in data could change the direction of markets.

## EMERGING, ASIA AND FRONTIER MARKETS

Five year returns 1 October 2017 – 30 September 2022



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The main thing to watch is China's 20<sup>th</sup> Party Congress. There are many concerns around China; the economy remains fragile, especially with the focus on the real estate market. Many see China as akin to Japan, seeing decades of stagnation and the zero covid policy has subdued domestic demand. On the flipside inflation remains relatively low due to cheap oil imports and interest rates are falling, and so they have more levers to pull in terms of stimulating the economy.

So what might we see from the congress? President Xi will be re-elected as China's leader. It is difficult to know the direction of the next five years but the pillar of everything President Xi does centres around "Common Prosperity". He has vowed to tackle corruption amongst the party elite, raise education, employment and income opportunities for the average person, reform health and social security systems, and improve the environment.

We have therefore seen an evolution within China and often this has been done without much thought to shareholders, even if the reforms have been positive. It is important to understand that China is probably the only global economy; to place full sanctions on China would be extremely bad for the world economy. So there will always be a balance at play.

There will always be tensions with Taiwan, but our view remains that these won't escalate because ultimately anything that destroys "Common Prosperity" has the potential to destroy the communist party. There be tensions with the US because China is a threat to them. In terms of Russia, we can already see that not everything is what it seems. Again China must balance that relationship, but they are not fully supportive.

We have indicated that to transition to a greener world we need old style commodities – copper, oil, gold, lithium, nickel, silver etc. The economies benefiting from this are Brazil, Mexico, Chile, Peru, Columbia, and Argentina.

But EM economies are sensitive to a strengthening dollar, rising inflation and a global recession. Economies to watch are Sri Lanka, Zambia, Pakistan, El Salvador, Ghana, Egypt, Tunisia, and Lebanon.

As Russia comes out of the EM index so the focus falls on Brazil as it takes more of the index. Brazil is experiencing its best run of growth for a decade and output is above the pre-virus level. Policymakers have pushed through fiscal stimulus ahead of the elections in October.

However, it is likely any stimulus will be unwound after the election and this could slow growth. Growth will also be impacted by any global recession and a drop in commodity prices.

There are many challenges for emerging markets, and the war in the Ukraine has pushed up food and energy prices. In many economies this makes up around 50% of the consumer basket which curtails consumer spending. Food shortages also impact the poorest people. Central banks and governments must somehow soften the impact of this, and not all countries have that ability. The danger for some countries is ever present in terms of policy mistakes, and it can also spill into unrest within economies.

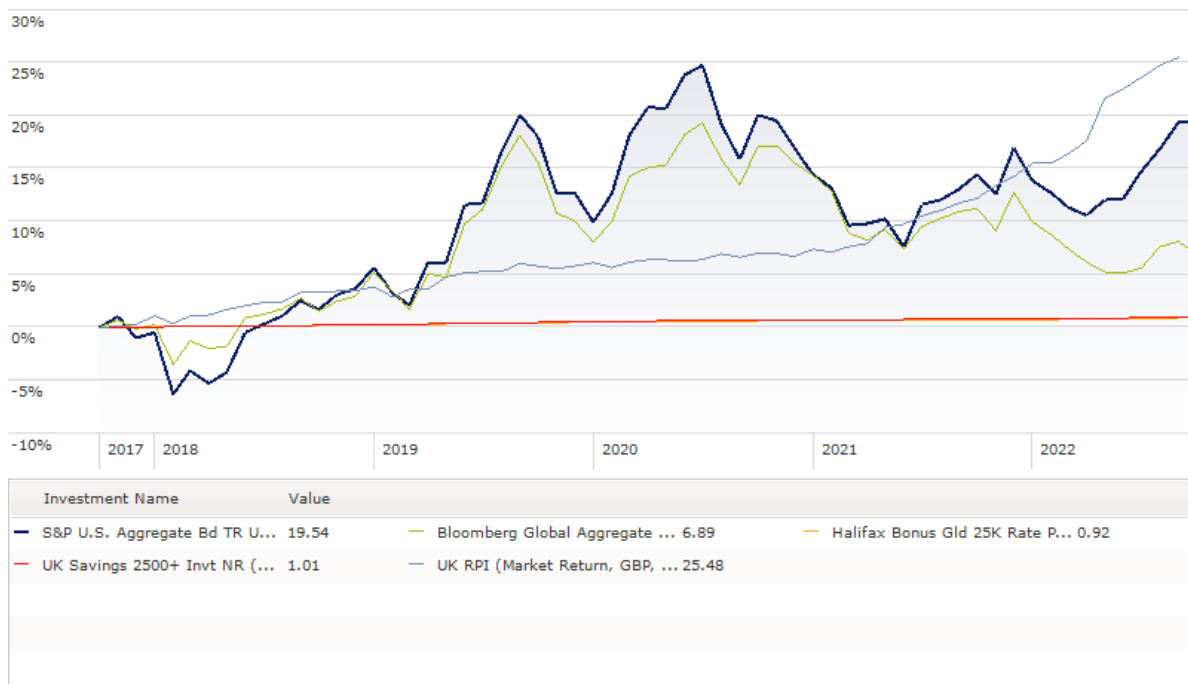
However, it is important to reflect that three-thirds of the world's population is in emerging markets and therefore the impact of change, both positive and negative, is felt globally. We have said before that valuations remain cheap and the opportunities abound. This will always be a long-term story but it will never be smooth.

One region to consider is Japan. With the tragedy over the assassination of Abe it is important to reflect on his legacy. The current Prime Minister, Fumio Kishida, has continued with the reforms, delivering better corporate governance within Japanese companies. Unlike many other global economies, inflation remains relatively low in Japan and there is political stability and a clear path to reform. Japan has been slow to open following COVID, but this is starting to change and this will benefit the economy.

In summary, as with the developed world there are challenges. Some economies will have greater struggles and the risk for policy error is high. But things are changing India has overtaken the UK as the world's fifth largest economy. It is worth following the policies announced in China and the election currently happening in Brazil. How Russia responds to the advances by the Ukraine will be one to watch, but the feeling remains this could be a long-drawn-out conflict.

## CASH

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Cash has come back into play as a “haven”. As interest rates rise, in theory the interest on cash should reflect this.

The challenge with any “investment” is inflation and whether interest on cash can exceed inflation. If it doesn’t then over time the real value will erode.

After years of being negative on cash, holders of cash should get some return which they haven’t seen for 10 plus years.

## CONCLUSION

This year continues to be challenging, and certainly keeps us on our toes.

In the past we have considered where many think interest rates and inflation may end up. It is worth reflecting on the paper from Howard Marks, "The Illusion of Knowledge". We can look to the past which may provide some indication of the future, but there are many different variables to consider.

What we know is that there is a great deal of uncertainty and central banks have indicated that to tackle inflation they will raise interest rates. Markets are pricing in where they think interest rates will land. There is a school of thought that these are too high and therefore the actual rates will be lower.

Inflation will come down but we have spoken in the past about the push / pull of inflation. Technology drives down inflation but spending on the drive to a net zero world will be inflationary. So how the two combine is unknown. Inflation will be higher than we have seen over the last decade.

As we have always said, it is about what the world may look like in two-years' time that is important. Could inflation be around 4%, and interest rates around the same level or less?

The focus really is how the recession will look. We know the UK and Europe have different challenges. In the UK employment remains robust and therefore the ability to come through this is stronger, but mortgage rate costs alongside fuel costs could stifle growth. The US is probably in a stronger place to come out of the recession quicker.

In terms of emerging markets, the combination of increased costs of fuel, food and a stronger dollar will hamper growth in the short term, and pressure turns to how central banks respond to this. It will be interesting to watch the policies coming from China.

We do see Japan as a ray of light in this difficult world, with low inflation and stability within politics and policies.

In summary, there are many challenges facing us this year but if we look outwards then some of these factors will reduce. The market finds it hard to digest good news but if there is persistent positivity, this will feed through. Many high-quality companies are now trading at significant discounts and the opportunities are abundant. There are many who claim to know what will happen next, and many hedge fund managers have made a lot of money but ultimately they are betting on an outcome that they don't always get right!

*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.*

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