PORTFOLIO POSITIONING UPDATE JUNE 2021

16 June 2021

momentum
global investment management

Performance

The Balanced Fund added 1.2% in May, ahead of its benchmark return of 1.1%. The Growth Fund returned 0.6%, lagging its benchmark of 1.4%. The unusually wide difference in returns between the two funds was due to a) the strong performance of the property component of the Balanced Fund, which returned 2.7%, well ahead of the broad global equity market of 1.6%, and which is not held in the Growth Fund; and b) the larger absolute weighting to growth and quality managers in the Growth Fund in a month when these styles underperformed the broad equity market significantly.

Inflation

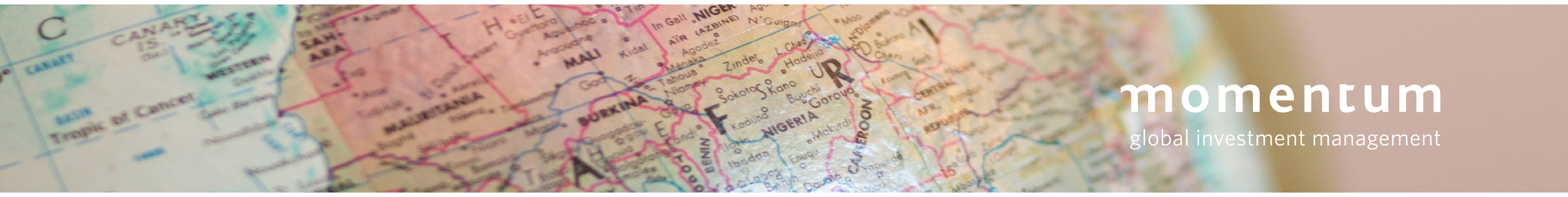
Extraordinary though it might seem after the shock of the pandemic-induced global recession, the spectre of inflation has become the dominant discourse and biggest risk factor in markets. The base effects of a period of negative inflation last year are falling away, and this alone is resulting in higher inflation. But other forces are at work. Recovery is on the way and it will be like no other in pace and scale. Activity levels plunged last year, and supply chains were disrupted. But swift and enormous policy action protected households and businesses, which have built up substantial excess savings. These savings are now feeding into the economy as pent-up demand is released.

There are material implications as we enter the recovery phase. The disruption to supply chains will take time to return to normal: increasing capacity is not an overnight task. As the surge of pent-up demand meets restricted supply, the result is higher prices. In recent weeks this has become the most widely reported concern of businesses and there is ample evidence of supply shortages in key areas such as semi-conductors and raw materials. The stand-out feature of markets in recent weeks has been the surge in commodity prices, taking the rises over the past 12 months to 60-70%, more in some cases. In the latest purchasing managers' survey in the US, the prices paid component was at its highest for 13 years with inflation of prices across most supply lines, and businesses citing difficulties in attracting and retaining labour.

At the same time, liquidity is abundant; central bank asset purchases, most importantly by the US Federal Reserve, are feeding through to money supply, in contrast to the financial crisis when banks were crippled and unable or unwilling to lend. Now the banks are in good shape, balance sheets are strong, and they are supporting the recovery. Money supply, which reflects the amount of liquidity in the economy, is expanding in the US by over 25%, its fastest rate in decades; this has often been a lead indicator of inflation ahead. Furthermore, the Fed sees the rise in inflation as transitory and is intent on keeping its foot on the pedal; its recent policy change to average inflation targeting over a cycle means that it can keep policy loose for an extended period of inflation above 2% as it has been running below that level for several years. In other words, it is prepared to allow the economy to run hot.

On top of this, the US President is intent on pursuing a fiscal spending programme on an extraordinary scale, one of the biggest in US history. While emergency covid-related support will fade, it will be replaced by massive social and infrastructure spending, with fiscal deficits projected to run at levels only previously seen in war times, and potentially pouring fuel on the recovery underway.

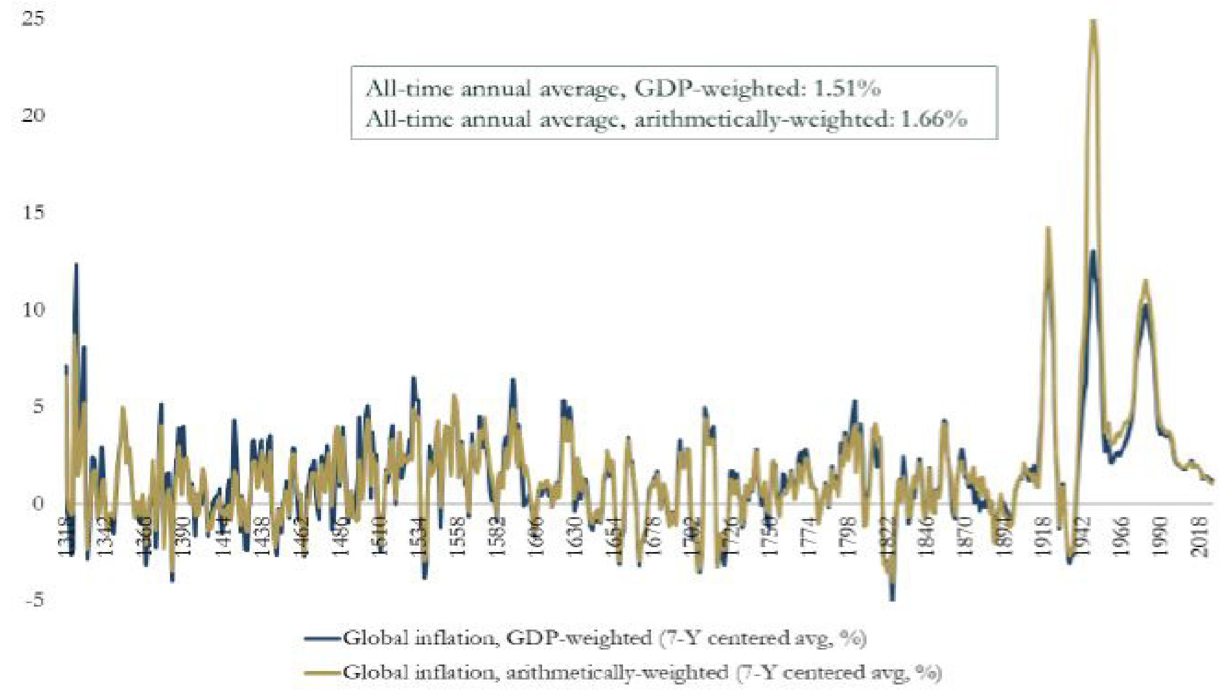
Recent inflation data from around the world has surprised on the upside; in the US the CPI rose by 5.0% year-on-year in May while core CPI, which strips out more volatile components such as food and energy, rose by 3.8% year-on-year, the highest for 29 years. If the rise in inflation proves to be persistent rather than transitory, it would have big implications for monetary policy; it will largely determine the durability of the recovery and the performance of financial markets. It could signal an early end to the Fed's ultra-loose policy stance and



trigger a market sell off with a rise in bond yields and fall in risk assets. The yield on US Treasuries is in effect the world's discount rate; a rise in that discount rate would have global ramifications, not least in emerging markets, potentially undermining all risk assets but especially long duration assets such as longer dated government bonds and highly valued sectors of stock markets.

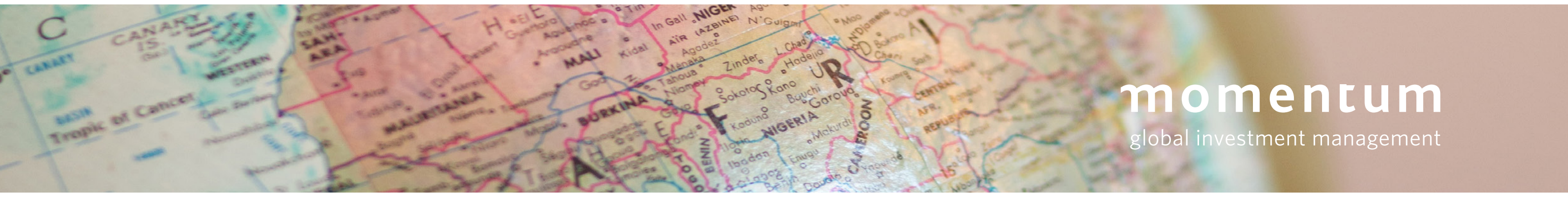
The outcome is by no means certain. Once the pent-up demand has been satisfied, spending and growth could settle back, while output could rapidly respond to the surge in demand and keep prices in check. The pace of recovery in China, the world's second largest economy, is already showing signs of slowing as policymakers tighten policy to rein in excessive debt levels, and this could have a disinflationary impact globally. Longer term constraints, including demographics, digital disruption and competition, and new technology such as AI, could bear down on inflation. But after years of low inflation it would be complacent to assume that the trend will continue. Globalisation, which has held down inflation over the past two decades, could well have peaked, governments are giving greater emphasis to re-distribution and regulation, and reconfiguring of supply chains to prioritise security of supply could all push up costs.

It is invariably worthwhile to put today's issues into a longer-term perspective: history can tell us much about what the future might hold. The Bank of England recently produced a paper on real interest rates and showed global inflation over the past 800 years.



Source: Bank of England staff working paper no. 845, January 2020

The data covers essentially the UK and a handful of European countries together with the US in more recent centuries, and shows average inflation of 1.5%, with long periods of negative and/or very low inflation. However, the past century has been characterised by three dramatic spikes in inflation, the first two triggered by world wars and the third by massive monetary and fiscal expansion followed by an oil and commodities boom. While a return to 1970s style inflation seems inconceivable, current circumstances could cause inflation to be sustained well above 2% for a long enough period to trigger considerable anxiety among investors and the Fed. We will therefore be scrutinising developments carefully, paying particular attention to inflation expectations and the extent to which higher prices feed through to rising wages.



Outlook

Our base case continues to be that the current spike in inflation is transitory and remains manageable over the long term. However, for the first time in many years, the balance of risks has changed, shifting away from disinflation towards the upside. As the data from the Bank of England shows, political and economic events can cause inflation to diverge substantially from its long term trend. With the uncertainty of the outcome and the risks ahead we are constantly challenging our assumptions and we believe that portfolio diversification is more important than ever, balancing assets which offer protection against inflation with more defensive assets which would perform well in a lower inflation environment. Both funds continue to hold precious metals, defensive currencies such as the yen, cash and equity put options, while largely eschewing long dated bonds.

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