Newsletter - Third Quarter 2022

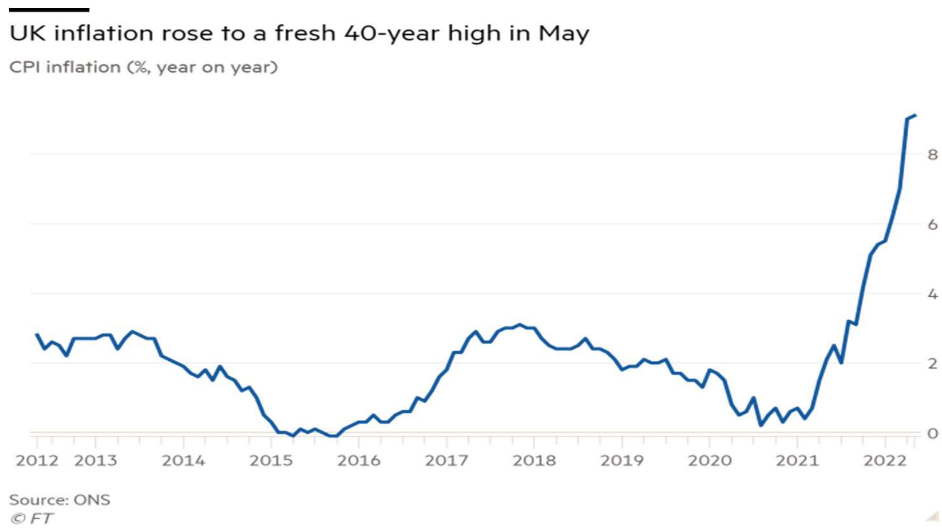
RUNNING UP THAT HILL

Trying to find a tune that befits this backdrop may have been easy but, given Kate Bush has hit the top of the charts with *Running up that Hill,* 37 years after its initial release, I'm a sucker for the eighties so it was an easy decision. As an economics student in that decade, I recall the inflation rate was 3.85% back in 1985, tame by today's standards...

Kate Bush

ASSET ALLOCATION MUSINGS

There's not much to feel optimistic about this quarter. The headlines are full of doom and gloom, from the ongoing conflict in Ukraine, rising interest rates care of UK inflation at a 40-year high, supply disruptions adding to the cost-of-living crisis, extreme weather conditions in Europe and beyond, travel disruptions in the UK and for those looking for a holiday overseas; the list appears endless. Maybe the new look newsletter is all that is needed to brighten one's day!



LAYING IT ON THE LINE

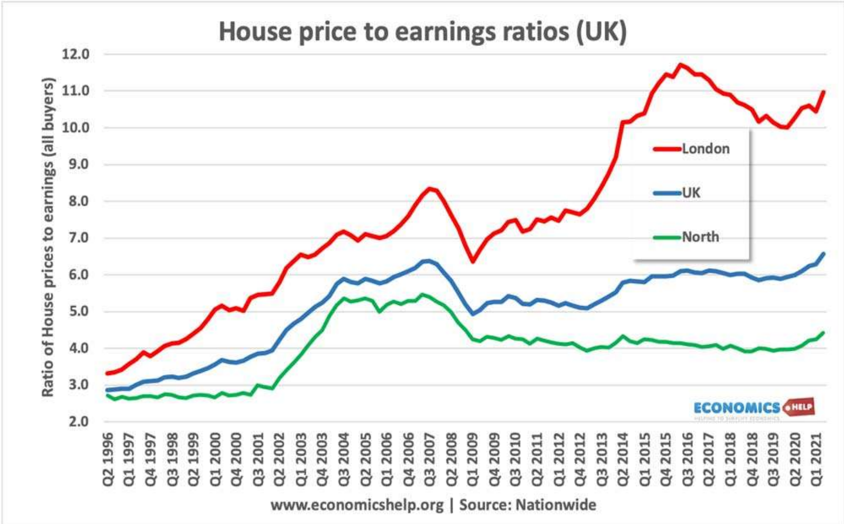
Unlike the mid-1980s, when the Thatcher government had just won a landslide general election (care of a victory in the Falklands War), had outmaneuvered Arthur Scargill and the privatisation of major industries was just taking off, the current landscape couldn't look more different. But hang on, isn't Top Gun topping the movie releases, Kate Bush the music charts and we're back in a Cold War with Russia? A few news snippets from the world of finance and economics are worthy of a second look to frame our own cautionary mood:

"It's the economy stupid" – a famous piece of advice given to Bill Clinton in his successful run for the White House. George Bush was perceived as out of touch with the needs of ordinary Americans and Clinton's team adopted this as their election mantra. Sound familiar? It certainly does to us...

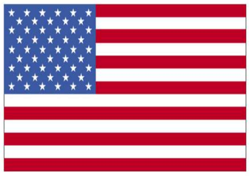
HERE'S OUR TWO PENNIES WORTH ON THE NEAR-TERM OUTLOOK

Firstly, inflation remains the only story in town. However the prognosis for a return to the government's 2.5% inflation target looks wildly optimistic. Labour market shortages will push wages up over the coming 12 months or so. Wage inflation is the Bank of England's main bete noire, as the ratcheting impact may bring about an unwelcome return to the 1970s double digit inflation backdrop. Asking employers to hold back will fashion a new wave of strikes. Rising costs are hard to pass on to the end consumer for most corporates, meaning corporate profit cycles will diminish, possibly leading to cost cutting measures.

Secondly, rising interest rates has hit all areas of the economy. However, there has been little impact on the general housing market to date. If the mantra that the US leads and others follow, news that the US 30-year mortgage rate hitting 6.40% should have economists revisiting their projections on the health of the property market. For too long, homeowners have become accustomed to negligible borrowing rates. Is this about to change? The affordability ratio (incomes relative to house prices) in the UK has never looked so bad. This may be a welcome relief to those that have been unable to get a foot on the housing ladder at least.



Thirdly, the transition from fossil fuels to zero carbon emission energy sources has been problematic. Hydrocarbon operators were mandated to stop investing in fossil fuels and expend all their energies on renewables. They were omitted from dialogue during climate conferences as the green agenda took centre stage. A lack of new investment into the oil and gas sectors over the last few years has contributed to production capacity shortfalls. Should the airline industry recover to previous peak demand and China ends it's zero Covid stance, then the demand-supply imbalance will worsen further leading to likely higher petrol pump prices. This at a time when utility costs will surge higher in the next quarter.



Finally, in our humble opinion, geo-politics looks a mess. Midterm elections in the UK and US reveal the level of disquiet on main street. Throw in the Ukraine conflict and it looks as if we got ourselves a new Cold War, with the world split into two camps, with Russia and China on one side and the West and its allies on the other.

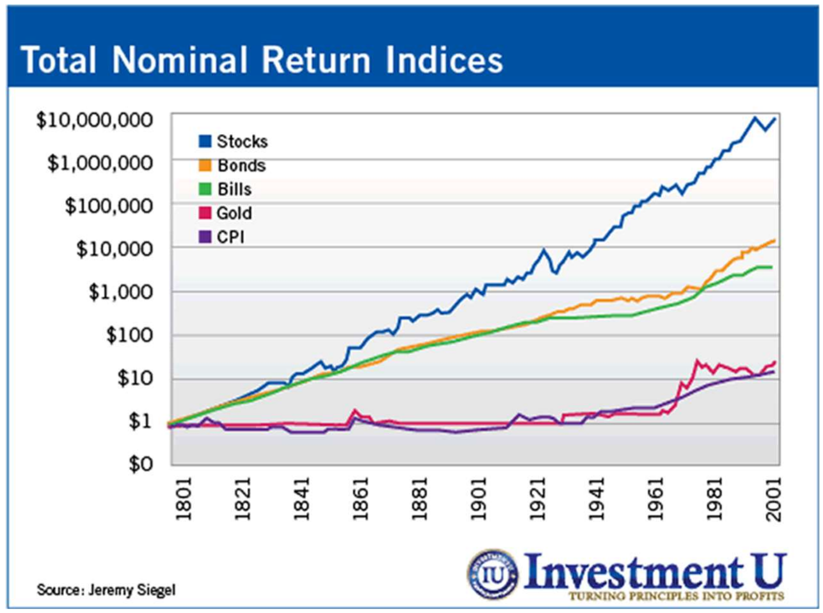
IF YOU LIKE WHAT WE DO…

As some of you will know, Warner Matthews Ltd is a business that has thrived on word of mouth. It was set up over 30 years ago by Jonathan and has remained faithful to its Cheltenham roots. Referrals are our bedrock, there is little we do in the way of marketing, relying more on trust and reputation to spur our growth. With this in mind, if you like what we do, feel free to recommend our services to family, friends and work colleagues.

LOOK TO THE LONG TERM IN TIMES OF TROUBLE

It's easy to get bogged down in the negativity. Indeed, a lot of psychological study has been devoted to this - humans have stronger reactions to negative news compared to positive news, which may explain a lot about the way news is conveyed.

With this in mind, it's important as asset allocators not to get too bearish when things look bad and equally not too bullish when things look good. In the words of Warren Buffet, "be bullish when others are fearful and bearish when others are greedy". So perhaps it's worth reminding ourselves why equities have been long favoured as the asset class of choice.



Often regarded as the "sliver of hope between assets and liabilities", the case for investing in equities is pretty simple and straightforward: in the long run, equities outperform bonds and cash, therefore maximizing your exposure to stocks will improve your returns. Time horizons are key however, as the simple mantra is backed by data going back 200 years, not a time frame most investors can get comfortable with.

An equity is a share in the ownership of a company. Shareholders have only residual rights to what is left in a company after all other stakeholder's claims have been satisfied. So obviously riskier than bond holders. However, in return for this lowly position in the company's pecking order, the returns for equity holders are in theory uncapped, unlike other stakeholders.

Unsurprisingly, not all equities and equity markets perform well. There is an element of survivorship. Additionally, a large part of an equity return comes in the form of dividends. So, the power of compounding is critical and it's why Warren Buffet acknowledged it as being a pillar for him to build his fortune. There is much to admire with Warren's dedication to managing money, most importantly we subscribe to his ethos of buying great companies at fair prices and holding them forever.

Equities are a riskier asset and should be more volatile. Being cognisant of your appetite for risk and therefore being comfortable with those risks should in theory lead to higher returns over the long term. So, although we are cautious in our assessment of the near-term direction of markets, we keep these investment thoughts close to the front of our minds.