FINANCIAL PLANNING WALES

Investment Committee Report

February 2023

Introduction

We know that last year was our worst performance in over fifteen years. However, we take some comfort from the fact that history tells us when we take decisions to realign portfolios (often a bit early) we then come back strongly in the subsequent years.

Whilst we appreciate this can be of little comfort to investors, particularly when it happens at points when major financial decisions need to be made, it is important to remember that periods of negative performance are impossible to avoid. Our strategy is focused on looking at the economic, fundamental, and technical information available and making the best decisions we can to deal with what we think this data is telling us may be around the corner.

In doing this we frequently remain "out of sync" with equity markets such as the FTSE-100 in particular; this can make us appear somewhat contrarian, and this is an approach that requires patience and the strength to think differently to the crowd. As Howard Marks of Oaktree Capital pointed out in his recent memo Ditto[1]

> *"Thus…successful contrarianism requires the ability to stick with losing positions that, as David Swensen has written, 'frequently appear, downright imprudent in the eyes of conventional wisdom.' If you can't stand living the embarrassment of being unconventional and wrong, contrarianism may not be for you. Rather than trying to do the difficult opposite of what the crowd is doing, you might have to settle for merely refusing to join in its errors. That would be a good thing. But even that is not easy."*

We would probably put ourselves in the category of avoiding the errors of the crowd as we know that there will be times when we can safely join in the irrational exuberance of the broader market we can benefit from some great returns.

Key Factors to Watch

At present inflation is dominating the investment landscape; making the right call on the path of inflation us crucial to ensuring we are invested appropriately. Inflation is complex and driven by many factors, but Hedgeye[2] simplifies this - The Pareto Principle states

[1] Ditto, Howard Marks, Oaktree Capital 07/01/2023

[2] The Vital Few, Hedgeye, 10/02/2023

that 80% of consequences come from 20% of causes – the key to gauging the direction of inflation is by watching unemployment.

This seems a sensible approach as while unemployment remains at or near multi-year lows, employees can demand higher wages. This is an issue for many developed countries and Bridgewater Capital[3] also highlighted how in Europe the situation is being compounded by a structural energy problem.

It seems likely that inflation will remain high whilst unemployment remains low; the level of inflation could also change rapidly if we see continued volatility in energy prices. Higher inflation means that Central Banks are unlikely to reverse their policy of higher interest rates until inflation starts to fall consistently and/or unemployment increases to an unacceptable level.

Consumers are also continuing to feel the pinch as rising expenditure starts to exceed income, credit card balances are increasing and savings levels decreasing. At some point consumers will have to reign in discretionary spending as they cannot finance this from credit or the savings that they built up during lockdowns for ever.

There is a school of thought that Central Banks, and the US Federal Reserve in particular, intend to break the back of a inflation by forcing a recession that already seems highly probably. Longview Economics[4] US recession warning scoreboard certainly seems to add reliable historic evidence that a recession is imminent.

Table 1: Recession warning scoreboard (key categories of indicator)

		1990	2000-01	2007-08	2012	2015	2023
		Category of indicator signalling recession? (Y/N)					
1	Corporate sector health	Y	Y	Y	N	Y	N
2	Liquidity indicator	Y	Y	Y	N	N	Y
3	Credit conditions	Y	Y	Y	N	N	Y
4	Financial conditions	Y	Y	Y	N	N	N
5	Housing	Y	N	Y	N	N	Y
6	Household net wealth	N	Y	Y	N	N	Y
7	Manufacturing	Y	Y	Y	N	N	Y
8	Conference Board LEI	Y	Y	Y	N	N	Y
9	Oil price	Y	Y	Y	N	N	Y*
10	Michigan sentiment	Y	N	Y	N	N	Y

Source: *Longview Economics*
*Move higher in oil cost as a share of GDP from 2020 to 2022.

If a recession is imminent then it does lead to the question as to why the stock market continues upwards in most regions? It seems

[3] Europe's Stubborn Inflation Problem, Bridgewater Capital, 24/01/2023
[4] Longview Economics Recession Warning Scored Board, The Felder Report, 17/02/2023

likely this continues to be a case of FOMO (Fear of Missing Out) as investors see recent declines as an opportunity. The reality is very different as stock markets historically don't hit their bottom until 7-8 months into a recession.

Investment Strategy

We remain out of sync with equity markets as whilst we retain a proportion of capital in areas that we feel would be relatively resilient in a recession we are not over committed. Taking part in bear market rallies that whilst strong have consistently ended badly should not interest us.

The US S&P500 index is repeating its 1973, 2000 and 2007 bear market patterns and key firms that make up large swathes of the index are now reporting negative earnings. We follow the US closely as its hegemonic role in the global economy effects all other markets.

An opportunity exists for nominal fixed interest bonds such as US Treasuries and UK Gilts if the Central Banks have to cut interest rates to deal with a recession – we are not their yet but it is something that we feel we will be recommending at some point this year.

The prospect of recession, lower interest rates and a number of technical indicators continues to make a bullish case for Gold; a fact supported by the fact Central Banks have been buying Gold at the fastest rate since 1967 (as reported in the Financial Times) as they try to diversify away from the US Dollar.

Longer term commodities should perform well given their long-term undervaluation, but history tells us this trip could be volatile if a recession bites. Whilst this is in not a complete volte face from our recent annual report reducing holdings in the short-term to protect value seems prudent to us.

Our outlook means that we will remain cautious for now and run the risk of looking foolish for a bit longer, or until the evidence leads us to another conclusion.