FINANCIAL PLANNING WALES

Investment Committee Report

June 2023

Introduction

Over the last month I have continued to watch market conditions and wonder why (certain) stocks markets forge ahead despite an ever-growing list of factors that have historically made them travel in the completely opposite direction. The answer may be provided in two quotes from articles that I have read over the last month, both of which are from bygone times where investors had learned lessons the hard way. Walter Bagehot was an English journalist and businessmen who wrote extensively from the 1850's until his early death at the age of 55 in 1871. During this time, he was editor in chief of The Economist. In Thoughts from the Frontline[1], John Mauldin highlighted Mr Bagehot's view of "John Bull" the average Englishman and how he behaved when interest rates were low.

> *"Whenever money becomes very cheap, experience teaches us to expect that it will be misspent. John Bull, as has been wisely observed, can stand a good deal, but he cannot stand two per cent. The particular form of mania differs in various years; but when the common and tried employments of money yield but a low profit, recourse will be had to new and untried ones, some of which will be unprofitable, and a few of which will be absurd. It is only at the outset of such manias that warning is of the least use—when they attain a certain growth, advice is thrown away. Everybody is seen speculating; and what everyone does must be judicious. Foolish person No. 2 imitates foolish person No. 1."*

Up until recently we have seen interest rates pinned at close to 0% by Central Banks encouraging speculation and unconsidered investment behaviour that has pushed risky assets to new highs and created an atmosphere of FOMO (Fear of Missing Out). We are therefore now at the stage where investor behaviour is entrenched and the belief that the stock market will be heading to the moon regardless of economics, fundamentals, and historical evidence to the contrary. The Felder Report[2] this week reminded me of another famous quote by legendary financier and banker J.P. Morgan.

> *"Nothing undermines your financial judgement as the sight of your neighbour getting rich."*

Whilst I am acutely aware of the negative performance of the last year or so, the risk of chasing temporary gains and drastically altering course is now huge. The evidence telling me risk is high is difficult to ignore and to act differently would be to go against the key tenets of a successful long-term process for investing. However, changing conditions may have provided us with an option….

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[1] A Skip Not A Stop, Thoughts from the Frontline, John Mauldin 16th June 2023
[2] Why Mr Market May Have Its Ass Backwards, The Felder Report 23rd June 2023

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Key Factors to Watch

The indicators that we look at help build a picture of the investment and economic landscape; understanding history is also crucial to identifying the trends and risks that are created.

Economic Conditions

Key indicators continue to suggest that economic conditions are weakening and the risk of recession rising.

Businesses are seeing new orders declining and production is falling, whilst the Purchasing Managers Index (PMI) for manufacturing and servicing are declining. The number of firms entering bankruptcy in the UK are at their highest level since the financial crisis. The inflation that initially allowed firms to increase prices and grow their profits can only be passed on to consumers for so long as there is a limit to what consumers can afford to pay.

Consumer confidence is improving, but from a low that was worse than 2009, and whilst declining energy prices may currently be helping the squeezed consumer, they still face rising costs – particularly from interest rates – that means they are continuing to erode the savings that were built up in the pandemic.

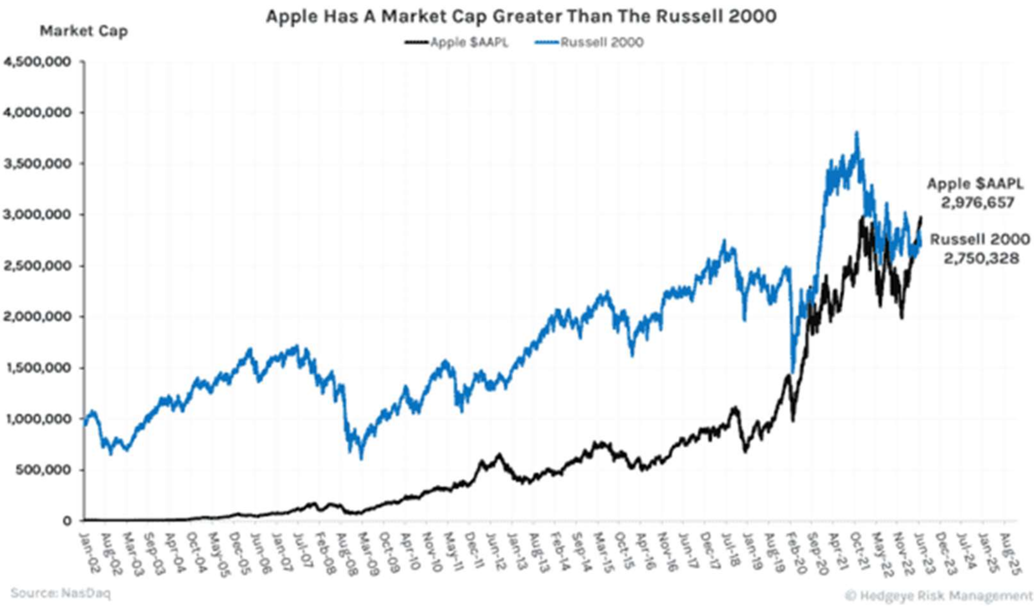
So far unemployment remains at multi-year lows as workforces continue to shrink due to the "baby boom" generation retiring; in the UK this has been accentuated by exit from the EU. This means wage demands continue to rise causing structural inflation that is likely to see interest rates rise further – ***History tells us nothing good happens to risk assets when interest rates rise, but so far little has broken!***

If we look at the global economy this is hardly a picture of health as Commodity prices continue to collapse after a strong run through 2021-2022. The fact that OPEC cut oil production to support prices is a clear indication that demand is weak and a recession possible. At the same time the yield curve (the difference between the yield on 10 year and 2-year Government debt) continues to invert; this has consistently predicted future recession since the 1950's.

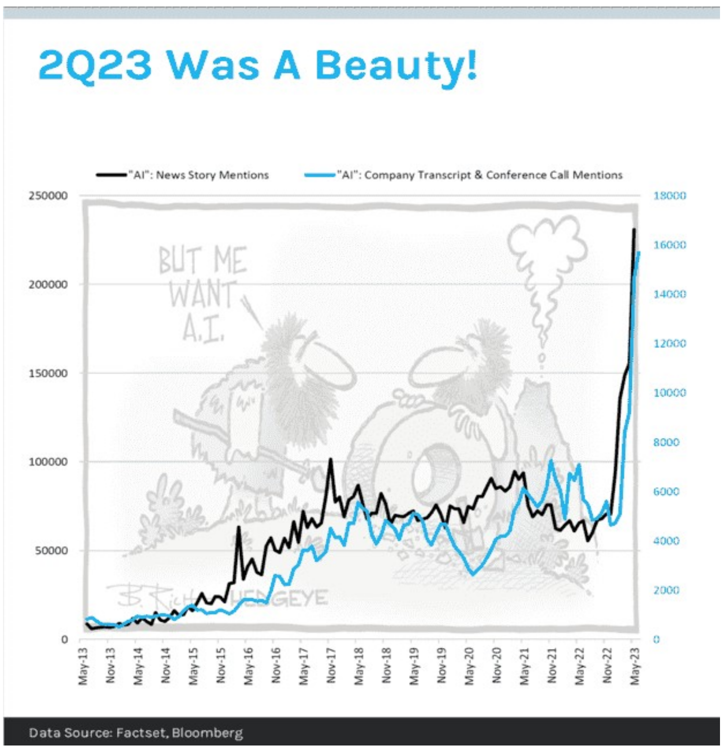
Market Conditions

Looking specifically at the US, as I have mentioned before a small group of seven stocks – Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla – are driving the market to new highs. It seems that much of this is driven by talk of how Artificial Intelligence will bring huge benefits and improvements in productivity and that moving forward this will be the only way to make money!

At the end of June Hedgeye[3] provided two great graphs to demonstrate these points. The graphs below show how the value of Apple as a company is now valued at more than the entire Russell 2000 index (this is made up of 2000 of the largest US Stocks Small Cap Stocks).

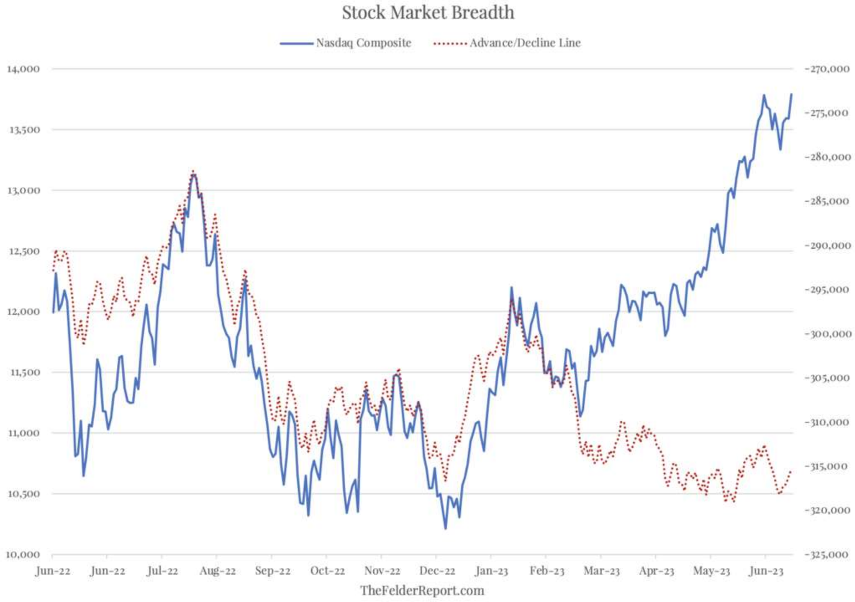


The artificial intelligence narrative is also in overdrive as we see how many times it was mentioned in news stories or firms' earnings calls to investors – perhaps this is the type of thing Mr Bagehot warned John Bull about!



[3] Hedge Early Look – The Next 3-6 Months 29th June 2023 and Disturbing Future 30th June 2023

The result is "narrow" market breadth, and these seven firms are driving entire markets, one misstep by any one of them and this could quickly reverse. This chart from the Felder Report[4] shows how the US Nasdaq Composite index is rising strongly (blue) but the Advance Decline Line (red) is at rock bottom. The Advance Decline line is simply the difference between the number of stocks advancing and the number declining – here we are being told lots are declining yet the stock market is going up?!? This is a dangerous divergence.



Many Global stock markets are currently littered with technical and fundamental indicators that are flashing red, yet everyone seems happy to continue to ignore them.

Possible Outcomes

The famous economist Nouriel Roubini[5] outline four possible outcomes from here due to Central Banks efforts to maintain price growth and financial stability.

1. Soft landing – growth and stability with inflation back to 2% and no recession.

2. Softish landing – growth and stability with inflation back to 2% but with a mild recession.

3. Hard landing – inflation back to 2% but with protracted recession and financial instability.

4. Wimp Out – by trying to slow inflation through raising interest rates Central Banks create severe economic and financial instability, they then "wimp out" on raising rates resulting in an inflation spiral that is persistent.

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[4] Why The Magnificent Seven Are Headed for A Showdown – The Felder Report 30th June 2023
[5] A Mild Global Contraction Is Coming – Nouriel Roubini, Project Syndicate 27th June 2023

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Investment Strategy

The conditions that Mr Bagehot and Mr Morgan refer to are certainly here and we must be careful not to exercise poor judgement simply because results are not currently as we hope; to do that would be to follow the path of the crowd seeking the satisfaction of short-term success. Taking this into account and then being presented with this collection of facts - this is important as they are facts not opinion – it seems hard to make a case for any form of investment! However, these changing market conditions are creating opportunities and I also know the value of pragmatism!

Until recently investing in cash and nominal bonds (such as gilts) was a real "no-no"; with interest rates close to zero and Gilts at record high prices there is little wonder these have subsequently fallen in value by over -15% in the last year (there Index Linked equivalent by -23% over the same period) as interest rates rose. Now we see cash deposits at over 4% and Gilts paying an income of over 5%. Global and UK equities have not had the rapid acceleration of the US and whilst not cheap, they are much less of a risk than their American counterparts. Whilst we have held commodities for some time, benefiting from the rapid growth through 2022 they have given up some of their gains and are back at bargain prices. Gold is unlike other commodities as it is not used in industry, but it is a store of value during inflationary and deflationary periods.

As certain asset prices have normalised – even slightly - this means we can now use them to put together a much more balanced and diversified portfolio with the aim of dealing with any of the four scenarios that Mr Roubini presents. The table below has been adapted from the concept put forward by Bridgewater Capital[6] and details what assets are appropriate for the four main economic scenarios we face.

	Growth	**Inflation**
Rising	Equities Commodities	Index Linked Bonds Commodities Gold
Falling	Nominal Fixed Bonds Index Linked Bonds Gold	Nominal Bonds Equities

We can now obtain three of these asset classes, Nominal Fixed Bonds, Index Linked Bonds and Commodities at low prices, whilst Gold looks primed for some serious future price rises. At the same time, we can add cash at a yield of 4%-5% to provide a cushion against asset price volatility. With a variety of possible outcomes, it seems now is as good a time as any to have a portfolio where an equal split between investments should create some reasonable long run returns without being over exposed to the risks that we face.

[6] The All Weather Strategy Portfolio – Bridgewater Ray Dalio, 2009