FPWM
TAILORED FINANCIAL SOLUTIONS

Investment Strategy Committee Tactical Asset Allocation Views & Commentary

Tactical positions relate to the strategic allocations for our five risk rated portfolio benchmarks which power our investment process. They are expressed as in the key below.

- - Strong Underweight	- Underweight	N Neutral	+ Overweight	+ + Strong Overweight

Please contact us if you require further information.

ASSET CLASS	TACTICAL POSITION	COMMENTARY
Global Government Bond	N	The strength of economic momentum has diminished whilst the peak in liquidity appears to be behind us. This will be a key headwind going forward but expect markets to look through the near-term inflation and don't expect any significant moves here. T Bond issuance high in short term
Investment Grade Bond	N	Significant Central bank and government support has benefitted this market along with improving fundamentals. Spreads over government bonds are at long term lows, leaving little margin for error, but this is still balanced by the scarcity of income producing assets. Credit quality is important.
High Yield Bond	N	We stay neutral despite valuations widening. Fundamentals continue to improve, and we expect this to persist, with relatively low default projections. European fundamentals improving with low default rates and marginally wider credit spreads relative to US high yield credits
Emerging Market Bonds	N	The risk of US tapering remains a headwind to the performance of EM local bonds. The Latin America region has improved given the stronger growth outlook helped by the roll-out of vaccinations and the spill over effects from US fiscal stimulus. Prefer higher quality EM corporate credit now
UK Equity	+	We still feel there is scope for the performance of UK equities to catch up to peers. Accommodative monetary policy and the success of the UK vaccination programme are real positives, supply problems a negative. We maintain value tilt alongside our quality growth exposures for long term.
Developed Market Equity	+	US stocks still favoured with a tilt towards value strategies and lower down the capitalisation scale for better value. Asia faces headwinds due to China slowdown. Europe may catch up as vaccination programmes are a success reducing COVID rates, growth recovers and ECB accommodative
Emerging Market Equity	N	Although valuations are attractive, vaccination rates remain low in many markets, suggesting their economic recoveries will be uncertain. The China effect on surrounding markets could well be a headwind for EM in the short term. There are opportunities for good stock pickers here after falls
Commodities	N	We expect moderate gains as global economic activity slows. Demand remains good but prices are driven as much by supply side issues which can be both positive and negative. Gold should be strong if inflation concerns remain a market focus as it is a good hedge against price increases
UK Commercial Property	N	Industrial, warehousing and logistics favoured, with portfolio balance key. Retail and offices likely to be under pressure in the short term. The post COVID stabilisation and reflationary suggests a recovery, as rental values bottom out and international investors return and drive down yields.
Absolute Return	+ +	The current market dynamics continue to place focus on this basket to provide diversification, reduce portfolio volatility and provide downside protection. We stay with a combination of market neutral and macro strategies to help diversify risk exposure, despite challenging sector dynamics
Cash	N	No significant change to cash weighting as the recent market uncertainties and the future outlook for inflation, interest rate rises, tapering and market valuations cause volatility, interrupting the market's one way journey. Cash gives some optionality in the event of further market volatility

LOOKING BACK…

Global equity markets were broadly flat **(FTSE World -0.53%)** in Q3 as declines in September wiped out gains over the quarter. However, this still leaves developed market equities sitting on strong gains for the year to date. Emerging market equities underperformed amid a sell-off in China. Global sovereign bond yields were little changed in the quarter. Global equity styles all fell, but Value suffered the worst, down -1.78% over the quarter as sentiment faded. The US Federal Reserve said it would soon slow the pace of asset purchases. Commodities gained with natural gas prices seeing a sharp spike.

US equities ended Q3 having barely moved **(S&P 500 -0.29%)** despite strong earnings and a dovish Federal Reserve providing momentum through August. September showed a reversal in direction as growth and inflation concerns weighed on the market to quarter end. In September the Fed announced that tapering of quantitative easing would be announced at the November meeting and would finish by mid-2022. Fed funds rate projections showed a faster rate hiking schedule than in June, moving to three hikes from two, with three additional increases in 2024. Fed officials were split 9-9 on a rate hike in 2022 in the light of revised real GDP growth for 2021 (5.9% from 7% at the last meeting) and rising inflation. The Fed sees inflation at 4.2%, above its previous estimate of 3.4%, and GDP for 2022 and 2023 at 3.8% and 2.5%, respectively. September's sell-off hit almost all sectors as financials and utilities outperformed and industrials and materials struggled. Energy bucked the trend as supply constraints drove prices higher.

Eurozone equities were flat **(FTSE World Europe ex UK -0.39%)**. The quarter had started well with a positive Q2 earnings season and ongoing economic recovery from the pandemic. Most large eurozone countries have fully vaccinated around 75% of their population, enabling many restrictions on travel and other activities to be lifted. Energy and IT sector were the strongest performers, with semiconductor-related stocks seeing a robust advance. Consumer discretionary stocks suffered as luxury goods companies came under pressure due to concerns China's issues could hit demand. Later in the quarter, concern rose over inflation due to supply chain bottlenecks and rising energy prices. Annual inflation was estimated at 3.4% in September, up from 3.0% in August and 2.2% in July. The European Central Bank said that it would tolerate any moderate and transitory overshoot of its 2.0% inflation target. Germany held a general election which saw the Social Democrats (SPD) take the largest share of the votes. Coalition talks are now under way over the formation of a new government.

UK equities ended Q3 flat **(FTSE All Share - 0.09%)** but the dispersion between the best and worst-performing stocks was quite marked. Energy was strong on the back of a recovery in crude oil prices. In consumer staples the highly valued consumer goods companies were outperformed by grocery retailers who have been less favoured. Merger & Acquisition (M&A) was prominent, including a counteroffer for Wm Morrison Supermarkets, a proposal from US sports betting group DraftKings to acquire Entain, and a bid for aerospace and defence equipment supplier Meggitt. The M&A activity helped the positive return from the consumer discretionary and industrial sectors, which also benefitted from the easing of transatlantic travel restrictions. Despite the September pull-back, Small and mid-cap equities performed very well over the quarter, partly due to M&A. The Bank of England turned more hawkish as a response to inflationary pressures which surprised markets. Supply bottlenecks were recognised as constraining output, and gas and fuel shortages made negative headlines as the quarter ended.

The Japanese equity market bucked the trend rising strongly in September **(TOPIX +4.69%)**. Public opposition towards the government's approach to COVID meant the approval rate for the government fell until Prime Minister Suga announced he would resign with Mr Kishida becoming Japan's 100th prime minister. Mr Kishida is seen as a safe choice to guide Japan with little likelihood of any change in the direction of monetary or fiscal policy. The general election could be held by mid-November, to benefit from a stronger position in the vaccination programme. Q2 Corporate results were good and order trends and capital expenditure plans continue to look strong, but sentiment was impacted in August by the announcement of production cuts from Toyota due to the global shortage of semiconductors.

Asia ex Japan equities fell sharply **(FTSE Asia Pacific ex Japan -6.79%)** driven by a significant sell off in China with concerns over the ability of property group Evergrande to service its debts, leading global investors to worry over potential contagion risks. Market concerns over inflation and the outlook for interest rates also weighed on confidence during the quarter. China was the worst-performing index market, with sentiment towards the country also weakened by the government's regulatory crackdown affecting the education and technology sectors, power outages and the rationing of energy hurting production of key commodities. The market was concerned that downside risks in China have significantly increased against a backdrop of slowing economic activity and recent regulatory policies that might affect growth. Hong Kong and South Korea followed China sharply lower, as market jitters spilled out into the wider region. India was the best-performing index market during the quarter and achieved a strongly positive performance as accommodative monetary policy and the easing of Covid-19 restrictions boosted investor sentiment, with India now on track to deliver at least one dose to 70% of its population by November.

Emerging markets declined sharply **(FTSE Emerging -6.33%)** influenced by China, concern over continued supply chain disruptions, and worries over higher food and energy prices. Regulatory actions in China were the initial trigger for market weakness, compounded by some Covid-19 restrictions, supply chain disruption and concerns about systemic financial system risks stemming from the potential collapse of Evergrande. Brazil was the weakest market as Q2 GDP growth was weak, inflation continued to rise above expectations and the central bank responded with further interest rate hikes. South Korea also posted a double-digit fall amid falling prices of DRAM, and concerns over the impact of power issues in China on production and supply chains. By contrast, net energy exporters in general outperformed, most notably Colombia, Russia, Kuwait, Saudi Arabia, Qatar and the UAE.

US and European government yields were flat for the quarter **(FTSE World BIG Domestic Sovereign - 0.10%)** the initial decline reversed in September due to a hawkish shift from central banks and continuing inflationary pressure. US 10-year Treasury yield finished at 1.49%, despite falling early in the quarter and giving up gains as the market's focus turned to rising inflation and the prospect of the withdrawal of monetary policy support moving back to similar levels seen at the beginning of the quarter. The UK underperformed with the 10-year yield increased from 0.72% to 1.02% on increased expectations for monetary policy tightening. There was a marked hawkish shift at the Bank of England, with a suggestion that rate rises might be warranted before the end of the year. Recent economic indicators came out worse than expected, and consumer price inflation rose to 3.2% in August, the highest since 2012. German 10-year yield was one basis point (bps) lower at -0.19%. Italy's 10-year yield finished 4bps higher at 0.86%. Economic activity continued at a robust pace, the region benefiting from the release of pent-up demand, having come out of lockdown later. August Eurozone inflation hit a decade high of 3.4%.

In corporate bonds, high yield (Bloomberg High Yield -0.45%) and investment grade credit (Bloomberg Global Aggregate Corporate -0.72%) slipped marginally in price terms. European investment grade outperformed government bonds, while the US market was broadly in line with the treasury market. Emerging market government bond yields rose, particularly in September, EM corporate bonds made a small positive return, but Emerging market currencies broadly fell against the US dollar leading to a fall in the index **(JPM GBI-EM Global Composite -1.27%)**.

Commodities **(Bloomberg Commodity +6.42%)** were strongly positive, driven by sharply higher energy prices caused by increased demand in the wholesale gas market. Prices of gas oil and heating oil also rose and unleaded gasoline also gained strongly as consumers moved towards normal consumption after the Covid-19 crisis. Industrial metals component was modestly higher, as aluminium rose balancing declines for lead, copper and nickel. Precious metals declined with Gold falling and silver sharply lower. The livestock and agricultural components of the index also declined.

UK Commercial Property **(FE Property Proxy +2.91%)** continued its recovery after the lows seen in 2020, benefitting from the UK economic recovery.

In currencies Sterling weakened against all major currencies, other than the Euro **(EUR -0.13%). JPY (+2.39%)** and **USD (+2.27%)** were the major movers with GBP weakness enhancing the majority of returns from unhedged foreign investments.

Please Note: All quoted returns are on a price basis in local currency terms.

LOOKING FORWARD…

"*Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output. It is made by or stopped by the central bank" – **Milton Friedman***

It is interesting to note that the US equity indices have ended Q3 pretty much where they started despite the fact that the US monetary base (currency in circulation and reserve balances at the Federal Reserve) is $900 billion larger than it was in June, and our economist's weekly measure of M2 (a wider measure that includes public and commercial deposits and money market funds) has grown by around $1,600 billion over the same time. These rates of monetary growth are massive, being similar to a year's worth of the QE1 or QE2 monetary stimulus in only a few weeks. Yet this massive injection of liquidity seems only to have succeeded in holding asset prices up, rather than boosting them further – a change from the post GFC norm in markets fuelled by liquidity and low interest rates. The question we are asking ourselves, is whether the lack of reaction to the monetary inflation tells us something about the underlying health of the equity markets.

One reason that the markets may be running out of steam is that the inflation of the monetary base, and therefore financial market liquidity, may well decline over the fourth quarter. At the risk of going over old ground and rehashing a theme we have visited many times in the last few commentaries, it is worth looking at the different contributors to the manipulation of the monetary base, which has fuelled markets for so long.

The Fed has been using three main tools in its monetary policy -, purchasing and holding securities (Quantitative Easing or QE); the Government's Treasury General Account Cash balances (TGA); and finally Reverse Repo Activities (RRP).

The RRP helps with very short-term liquidity and also to prevent short term interest rates going negative. The Fed sells bonds to the banks so that they have somewhere to park their cash other than the short-term money markets which would likely push rates down below the Fed's target. It seems the banks view their repo loans to the Fed as equivalent to cash reserves. The funds are effectively instantly available, they pay a small amount of interest, and the transactions are insured by the ultimate insurer, the Federal Reserve. The RRP are liquid monetary liabilities of the central bank and therefore part of the monetary base.

Turning to purchasing and holding securities, or QE… When the Fed buys a bond from somewhere, it gives that entity cash or credits its bank account, creating a monetary liability at the central bank and expanding the monetary base.

The impact of TGA is a little more complicated.

If the government runs a budget deficit that is funded from the TGA, or redeems bonds using TGA funds, there is a net transfer from the public sector to the private sector and the monetary base and money supply are inflated. The recipients of the government money will tend to save some of it allowing the injected funds to flow into the financial sector, and (absent matching bond issuance) this money stays in the financial sector, meaning that a drawdown in the TGA is inflationary for the money base and usually beneficial for institutional liquidity. On the other side of this equation, if the government wants to run a budget surplus, or simply replenish the TGA if it has reached the legal limits, it issues more bonds to non-bank institutions or individuals and effectively takes money from the private sector. The government then deposits the surplus at the NY Federal Reserve, which locks it away in an electronic vault. Since money has left the private sector and is now owned by the public sector who has locked it away, the funds leave the money supply/monetary base and therefore if the TGA is rising then the monetary system is contracting, as we saw in mid-2020 and also more obviously in 2018.

There has been a massive drawdown in the TGA since March representing the bulk of the growth in the monetary base over the last six months, creating more money than the much higher profile QE programme.

We now know that the debt ceiling will be raised, with the result that the drawdown in the TGA will stop or perhaps even reverse as they will have to issue bonds given how low the government's cash balances will likely be by the end of October. This will mean the removal of the main monetary stimulus from the previous quarter creating a headwind or at worst even feeling like monetary tightening.

At the same time as the TGA effect is waning, the FOMC has signalled the potential for tightening via some degree of tapering of monetary stimulus from QE .Our view is that ultimately Governor Powell will not have to do very much if anything, as with the debt ceiling raised, and the drawdown in the TGA likely to reverse, we can expect the rate of growth in the monetary base to slow to virtually nothing, effectively doing the job of tapering. The monetary cliff that this implies may well be spooking equities but could be good news for the dollar and broadly neutral for bonds.

It might seem outlandish to consider, but taking into account Governor Powell's continuing preference for inflating the monetary base, perhaps the Fed won't taper? If liquidity and growth slow too rapidly, they may feel the need to again raise its QE. A few weeks ago, amid talks of definite tapering this was definitely not on the table but we would not put it past the Fed to panic and ease fiscal policy in the latter part of 2022, just as they did with QE2 in 2010. In this event the USD would be weak, but equities might benefit in the short term. The likelihood of this is low, but certainly not zero anymore....

As investor confidence wanes and companies face faltering consumer demand and higher business costs, this may create an uncomfortable margin squeeze that threatens corporate profits. Broadly speaking profits vary positively with corporate investment, the budget deficit, and the current account balance. They also vary negatively with the household savings rate. Over recent months, as economies opened post COVID it was expected that consumers would spend all of their lockdown savings, but the household savings rate has not fallen to the levels expected, remaining above its 2019 levels and leading us to consider the possibility of a profit forecast miss. When this is added to a $30bn deterioration in the trade balance on a quarterly basis, a significantly reducing quarterly budget deficit and a slowing down in durable goods orders we should prepare for profit misses and disappointments. We feel the evidence is growing that post-COVID supply side issues, inflation and waning consumer spending is leading to a cooling in economic growth.

The previous quarter saw a significant sell off in Chinese equity markets reflecting concerns over the ability of China's second largest property group, Evergrande, to service its debts, leading global investors to worry over potential contagion risks. While clearly for Evergrande bondholders defaulting is an issue, we feel it is more importantly a symptom of the wider malaise that is affecting the Chinese economy.

In China, monetary conditions are tight, and the country is facing a credit crunch because its banks are running out of funding, therefore Beijing has had to prioritise key areas of the economy. Evergrande shows us that the Property sector has been the casualty, but it is a huge part of the economy, at around 15% and a larger contributor to GDP than in any other leading economy. With falling property prices and low construction spending there will be a direct effect on Chinese growth, which will slow as a consequence.

Further, if we are correct that China's corporate sector is facing credit constraints, then it will have to shift its model from output maximization to profit maximization, with the result that export prices may well end up higher even as demand slows. This would be a strange world in which both supply and demand are slowing. What we know is that world trade growth will likely be lower as a result, but the outlook for prices is less certain and we suspect more volatile. It seems that the Goldilocks era of strong growth and falling world trade prices is likely behind us. This too may be weighing on equities.

Markets are also concerned about inflation. Previously, the consistent narrative was that inflation was transitory and markets looked through the rises in CPI, now that narrative is changing.

The yield on the equity market is now lower than the rate of inflation, an historically rare event which was previously seen during the Oil and Supply Side Shocks of the 1970s. However, equity yields are still high relative to bond yields, which the market uses to justify high equity prices. It is therefore unlikely that we see any sustained weakness in equity prices unless bond prices fall.

The outlook for inflation is very important for financial markets as well as households, and we are mindful that high inflation might lead to weaker bond prices, and even to the Fed finally being deflected from its policy of maintaining loose financial conditions, which could derail equity markets. Consequently, the inflation debate and the response to it by Central Banks and Government is perhaps the most important issue to face markets in some time, closely followed by China's Boom-Bust.

Our concern is not the current position, but rather the potential for policy error to create higher inflation in late 2022, 2023 and beyond. As detailed previously, we believe that the world is entering an unwelcome downturn, which risks scaring Biden, Boris and other leaders into further monetised fiscal stimulus and a repeat of the narrative of the 1970s, the last major supply side shock.

The supply side disruptions during the 1973 Oil Embargo/Conflict in the Middle East relieved Western companies of a significant chunk of their margins, and Western households a significant part of their real incomes. The oil shock raised the consumer price index in the near term, but it also hit growth, to which policymakers reacted by printing more money (does this remind you of anything?). But, printing more money did not mean that the factories that were closed because of power cuts and energy shortages could produce more, or that people could buy more, it just meant that the price of what you could still buy just went up.

The supply side disruptions caused by COVID-19 and other factors may well be acting in the same way. Shipowners, gas producers and some chip suppliers are highly profitable at the moment, and just as the quadrupling of the oil price in 1973 resulted in a massive transfer of wealth from consumers to a relatively small number of oil production site owners, the spike in Natural Gas and other prices is transferring real incomes from the many to the few. In the case of some goods, we can simply choose to delay our consumption and wait until supply is available, which may be part of the explanation for the signs of a loss of momentum amongst Western consumers.

Real incomes are being squeezed by the rise in prices that is occurring in some of the things that we have to buy, and it may be that people are not spending so freely as they are worried about rising taxes and more inflation. Rising energy prices are usually stagflationary in the near term, and detrimental to growth and we suspect that many of the other things that have been affected by the economic consequences of COVID-19 will have a similar effect. Data suggests that trade volumes are lagging spending in the US and this drop in imports relative to sales reflects the impact of COVID-19 on product availability and the transport system - supply side shocks are bad for output and realised growth.

There was a rally in bonds during the mid-1970s, as bond markets looked through the oil price inflation of 1973 to the recession of 1974, a behaviour repeated during the 1990 Gulf War mini energy price shock, which also contributed to a global slowdown. It would seem that bond markets have a long track record of not reacting to supply-side driven inflation shocks, most likely because they usually result in a recession quite quickly afterwards.

But these are not ordinary times, and we are concerned that policy actions by governments in the near future could prove highly toxic to asset prices. Governments and central banks have got into the habit of tinkering to maintain asset prices and this tinkering is not always welcome.

The current bout of inflation is largely the result of the fact that the global supply potential contracted over the pandemic and governments put money in the hands of private individuals who emerged wanting to spend it, chasing scarce supply. Supply issues continued longer than was anticipated, and inflation followed suit. However, we feel that the momentum in the inflation data should dissipate of its own accord so long as nominal wage and monetary growth rates remain controlled. With global monetary growth slowing and household nominal incomes in the USA expected to decline in 2022 compared to the 2021 levels (which were inflated by stimulus cheques), the current global inflation scare should run out of steam early next year. It is a feature of the makeup of the CPI indices that property related data takes a while to show and inflation may well have peaked but not yet show in the index.

Our view is that central banks therefore need to do very little in this environment except perhaps to slowly taper their bond purchases

If central banks overreact and were to tighten more aggressively in response to the current levels of inflation and its more persistent nature, then they could easily cause a slowdown and excessive tightening could by definition risk creating deflation – a much more concerning situation to deal with.

Conversely, if governments were to react to the coming economic slowdown by once again easing in the cavalier way in which they did in 2020, then they would create a new and probably more dangerous potential for inflation that would in all likelihood be highly damaging to markets.

Perhaps governments and central banks should stop attempting to do so much and instead concentrate on fostering stable monetary conditions? Perhaps they could let the private sector get on with their business without all the policy and price instability that their constant tinkering creates. Perish the thought that we might someday get back to a time when market fundamentals actually mattered rather than government and central bank "puts".

Our central views in the near term are for small potential increases in short term bond yields and for (as in the 70s) the market to see through the current inflation meaning long term yields remain fairly stable, absent high levels of Treasury bond issuance and tightening liquidity which may place a small amount of pressure on yields in the very near term.

Equities face some headwinds in the near term, including a margin squeeze, economic slowdown and weaker liquidity environment but, providing that bond markets do not weaken, we are not expecting any significant moves in the next few months.

As a result, we have sat on our hands and other than small style and capitalisation changes in certain areas, we are happy with our asset allocations. We are sanguine, but far from overconfident, mindful that the potential for policy error still remains and the Fed is at a key inflection point driven by more persistent and higher inflation than they had predicted. Hopefully, they too will sit on their hands for a while……

Milton Friedman's comment at the start of this commentary is very much on point in the current scenario and it is with the Central Banks in terms of how to deal (or not to deal) with the inflation that they are in part responsible for at this time. It is a test of Governor Powell's understanding of the current dynamics as well as his attachment to policies that may need to be reassessed because of the peculiar situation that COVID and the reaction to it has left us. It is a mistake that is often made to presume that action is always a positive, but sometimes when you have considered all the options, making an active decision to do nothing is actually the best "action" to take.