FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 1 2022

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	-	Central banks face challenges balancing the need to tighten as inflation spikes, with the desire to keep their funding costs low. In the US, the demands to rebuild the TGA makes this more difficult. The potential for policy error leads us to reduce here, but keep inflation linked exposure
Investment Grade Bond	N	Company fundamentals are strong and while spreads over government bonds are tight, leaving little margin for error, but this is still balanced by the scarcity of income producing assets. We expect our managers to search for yield and balance the credit risk to reduce potential volatility
High Yield Bond	N	Stay neutral. 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. We value the Interest rate spread in current environment
Emerging Market Bonds	N	The risk of US tapering remains a headwind to the performance of EM local bonds. While the sector is at risk in the event of too much tightening, the yield available balances the risk at a time when income is scarce and valuations suggest we are paid to take the risk
UK Equity	N	We reduce exposure as UK has serious headwinds, needing to tighten fiscal policy at a time when the recovery may be stalling. We take profits in small and mid cap areas where performance since March 2020 has been stellar preferring foreign earnings and international exposure now
Developed Market Equity	+ +	US stocks still favoured maintaining our exposure across style strategies and lower down the capitalisation scale for better value. Asia faces headwinds due to China slowdown. Europe still undervalued relatively but needs growth to recover and ECB to remain accommodative to prosper
Emerging Market Equity	N	Although valuations are lower, vaccination rates remain compared to developed markets, so economic recoveries are more 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 remain under pressure in the short term. The continuing post COVID stabilisation and recovery are supportive as rental values recover. When international investors return, they will drive down yields.
Absolute Return	+ +	Our view on future market dynamics 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	+	We increase our cash weighting as market uncertainties and the future outlook for inflation, interest rate rises, tapering and market valuations may cause volatility, interrupting the market's one way journey. Cash gives balance and some optionality in the event of further market volatility

Please Note: The views expressed are those of the Investment Strategy Committee. They should not be taken as a personal recommendation to invest or refrain from investing.
Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements.

LOOKING BACK…

In the final quarter of 2021 equities continued to rally **(FTSE World +7.41%)**, as strong earnings growth drove markets higher. For the third year running we saw strong positive returns, albeit with some considerable intra-year volatility making the ride quite uncomfortable at times for equity investors. The Omicron variant reared its head in late November and a significant spike in equity market volatility followed, but markets recovered in December as data suggested a lower risk of severe disease. Corporate strength and the prospect of earnings growth in 2022 drove returns, despite rising hospitalisation rates in several countries. Over the year the World index rose +21.56% reflecting an improving view of COVID's effect on the global economy. In bond markets, fears of central bank policy normalisation leading to weaker growth led to a flattening of the US yield curve. Government bonds outperformed corporate bonds.

US equities rose strongly again in Q4 **(S&P 500 +10.65%)** despite a weaker November, due to rapidly rising cases of the Omicron variant and the speed of the Federal Reserve's asset tapering. Theses worries reduced through December as data indicated a stable economy with robust corporate earnings and Omicron fears subsided. Despite a slower Q3 the economy remains on track to record its best performance since 1984, with GDP rising 2.3% (annualised) and unemployment falling to 4.2%, the lowest since pre-COVID times. Tech stocks were among the best performers, with chipmakers especially strong. Real estate was buoyant amid expectations that e-commerce will drive further demand for industrial warehousing. Energy and financials were more muted over the quarter. Over 2021 the S&P 500 rose +26.89%.

UK equities rose **(FTSE All Share +3.67%)**. More economically sensitive areas of the market (banks and value stocks) suffered sharp falls in November due to Omicron but recouped the losses as fears subsided. However, others that are linked to travel or re-opening (travel, leisure, oil and gas) didn't bounce as much and ended the quarter lower. Some defensive names outperformed, including some internationally diversified consumer staples groups. Fears of a Chinese zero tolerance approach to Omicron affected sentiment towards other globally exposed large cap companies which underperformed over the quarter, despite reduced concern regarding increased regulatory oversight in China. Some domestically focussed areas were particularly volatile. Travel and leisure companies fluctuated with Omicron news, and UK consumer facing sectors such as retailers and housebuilders yo-yoed in line with expectations around the timing of a rise in UK base rates, which came in December. Supply chain disruptions for retailers led to some high-profile profit warnings, despite strong demand. For the year FTSE All Share was +14.55%.

Eurozone shares made healthy gains **(FTSE Europe ex UK +6.62%)** as strong corporate profits and economic resilience triumphed over worries about Omicron with equity markets supported by data indicating a lower risk of severe illness. Conversely, rising COVID infections hit services leading to a reduction in positive sentiment as shown by the Purchasing Managers Index (PMI) which fell for the first time in nine months. Some countries introduced restrictions on sectors such as travel and hospitality in order to try and reduce the spread of the new variant. Utilities, IT, Technology hardware and semiconductor stocks performed particularly well. The important luxury goods sector also performed very strongly, recovering from the summer sell-off. Volatile gas prices contributed to higher inflation, which reached 4.9% in November, compared to -0.3% a year earlier. The European Central Bank said it would scale back bond purchases but ruled out interest rate rises in 2022. In December, Olaf Scholz of the Social Democrats (SPD) finally succeeded Angela Merkel as chancellor, forming a coalition government with the Greens and Free Democrats (FDP). Over the year FTSE Europe ex UK rose +21.56%.

Despite regaining some ground in December, the Japanese market fell over the quarter **(TOPIX -1.86%)** exacerbated by a weaker Yen. Japan held a general election in October, and despite concerns about the popularity of Kishida's leadership the LDP lost only 15 seats and retained a solid majority. This allowed a shift in political focus to a substantial fiscal stimulus package, including direct cash handouts to households in an effort to kick-start a consumption recovery. In December, industrial production rebounded very strongly, as auto output began to recover from the global semiconductor shortage. The increasingly positive outlook was clouded by Omicron concerns, despite overall infection rates remaining remarkably low. The short-term weakness in December was driven by the Fed's tapering talk, despite evidence of a pick-up in corporate inflation expectations and current inflation moving into positive territory. There seems little chance of Japan experiencing a short-term inflation spike as seen elsewhere. For 2021 TOPIX rose +10.40%.

Asia ex Japan equities fell slightly **(FTSE Asia Pacific ex Japan -0.77%)** after a broad market sell-off following the emergence of the Omicron variant which investors feared could derail the global economic recovery. China was the worst-performing market, with share prices sharply lower as investors feared new lockdown restrictions following the rapid spread of Omicron. Share prices in Singapore also ended the fourth quarter down for similar reasons along with concerns the city-state's government might have to scale back some recently relaxed curbs on activity. India and South Korea also fell, but the declines were more modest. Taiwan and Indonesia were the only two index markets to achieve gains in excess of 5%. In Taiwan, positive economic data and a rise in exports boosted investor confidence, with chipmakers performing well. FTSE Asia Pacific ex Japan fell -0.67% over the year.

Emerging Markets underperformed the developed markets (**FTSE Emerging -0.91%)** with US dollar strength a headwind along with numerous notable political events. Turkey was the weakest index constituent, with extreme currency volatility leading to a weak Lira. The central bank lowered its policy rate by 4% to 14%, despite above-target inflation which reached 21.3% year-on-year in November. President Erdogan announced an unorthodox scheme to compensate savers for lira weakness and reduce the use of US dollars. Chile lagged as leftist Gabriel Boric was elected president. Brazil continued to hike rates in response to spiralling inflation, rising by 3% during the quarter, with concerns over the fiscal outlook. Russia suffered due to increasing geopolitical tensions with the West and a build-up of Russian troops on its border with Ukraine. FTSE Emerging fell -0.78% in 2021.

Bond markets oscillated over the quarter due to persistent elevated inflation, the hawkish shift in central bank policy shifts and the emergence of Omicron. Despite the volatility, 10-year government yields ended the quarter largely unchanged, having fallen for most of the quarter before reversing in late December as sentiment improved **(FTSE WorldBIG Domestic Sovereign +0.02%)**. Yield curves flattened, with shorter-dated bonds hit as central banks turned more hawkish, but markets seemed more confident of the long-term outlook for rates. Talk from the US Federal Reserve turned increasingly hawkish in November suggesting tapering could be accelerated, which then happened in December. Inflation is no longer referred to as "transitory". The US 10-year Treasury yield moved from 1.49% to 1.51%, having reached 1.7% in October (inflation and expectations of policy tightening) then 1.36% in early-December (Omicron). The UK 10-year yield fell from 1.02% to 0.97%, dropping sharply in early November as the

Bank of England surprised by not increasing interest rates and reversed in December when the MPC changed their minds and yields rose with the bank base rate, mostly at the short end. 2-year yields sold-off, from 0.41% to 0.68%. Elsewhere the pattern was similar as rates moved with sentiment, hawkish rhetoric and Omicron. Germany's 10-year moved from -0.17% to -0.19%, having fallen below -0.40% in December. Italy 10-year increased from 0.86% to 1.18%. Eurozone inflation rose to the highest level since 2008 and to a near 30-year high in Germany. In 2021 FTSE WorldBIG Domestic Sovereign fell -2.57%.

Corporate bonds lagged government bonds. In investment grade **(Bloomberg Global Aggregate Corporates -0.46%)** the US market saw modestly positive total returns, but Europe weakened. Further down the credit scale **(Bloomberg Global High Yield -0.71%)** US high yield was the standout performer, with positive returns and narrowing spreads, but other areas struggled. In emerging markets **(JPM GBI-EM Global Composite-0.61%)** local currency bond yields rose, particularly where central banks continued to raise interest rates amid elevated levels of inflation. Central and eastern Europe underperformed. EM hard currency bonds declined, with high yield significantly weaker, though investment grade sovereign bonds saw positive returns. Over 2021 High Yield outperformed (Bloomberg Global High Yield +0.99%) corporates (Bloomberg Global Aggregate Corporates -2.89%) and EM bonds (JPM GBI-EM Global Composite-3.73%).

Commodities fell in the fourth quarter **(Bloomberg Commodity -1.56%)** with a sharp decline in the price of natural gas. The industrial metals component was the best-performing segment in the quarter as the global economic recovery gathered pace. There were strong gains in the prices of zinc, nickel, lead and copper. The agriculture component also achieved a positive return in the quarter, with robust gains recorded for coffee, cotton, corn and Kansas Wheat. Precious metals also gained in the quarter, with modest price gains for silver and gold. The energy component saw a sharp fall in the price of natural gas with modestly higher prices for unleaded gasoline, crude oil and Brent crude. The index rose 27.11% over the year.

UK Property continued its recovery **(FE Property Proxy +5.26%)** as economic prospects continued to improve and investors started to think that the end of the worst of COVID was a real possibility. Prospects for warehousing and transport infrastructure related property is in focus as the use of online retail continues to rise. In 2021 the index rose +13.6%.

Sterling strengthened against major currencies over the quarter - **EUR (+2.51%), USD (+0.26%)** and **JPY (+3.44%),** reducing the returns from many unhedged foreign assets. Over the course of 2021 GBP weakened against the **USD (-1.15%)**, but strengthened against others **EUR (+6.48%)** and **JPY (+9.23%),**

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

LOOKING FORWARD…

"It is possible to have too much of a good thing" **– Aesop**

As we get back into the work habit after a welcome break, not only do we look back at 2021, but also look forward to consider potential threats, opportunities and actions that might shape 2022. It is over 13 years since the Great Financial Crisis and we have got used to the financial conditions that are the gift of that event, so much so that many cannot remember a time when things were different. Developments over 2021 and noises from the last Federal Reserve meeting of the year have led us to wonder whether 2022 might see a change in approach.

Since the mid 80s policymakers have tried to control currency volatility and manipulate exchange rates through the Plaza and Louvre Accords, the ERM, the Eurozone and finally the Shanghai Accord. While often initially successful, this type of intervention leads to unintended consequences. Our ISC economist, Andrew Hunt feels that these accords, and the rise of forward guidance in central banking created a world where: "The US set liquidity, China determined growth, and Europe accepted the consequences".

It also gave us surging asset prices, rising moral hazard and leverage, and occasional market crashes and rewarded investors that "didn't fight the Fed", no matter what the traditional market fundamentals or metrics may have been telling us.

Post the Great Financial Crisis, added to this has been the heady mix of ultra-low interest rates and the almost boundless liquidity of the QE era in a low inflation environment. It seems like Central banks have spent 30 years targeting financial conditions not monetary conditions, in fear of the balance sheet recession, where high levels of private sector debt cause individuals or companies to focus on saving by paying down debt rather than spending or investing, causing economic growth to slow or decline.

This has worked because, even in times of stress, they have managed to sustain (nominal and real) income growth, but importantly they have been unconcerned about CPI inflation. So unconcerned that we saw the Fed change its stated sensitivity to inflation, possibly at the worst possible time. Asset prices are targeted, and markets have been their favoured children, and those children have run amok.

The wealth of individuals and the growth of economies is so tied into asset prices that policymakers cannot afford a nominal slowdown, especially in a time when inflation has returned with a vengeance. In the USA, the sum of new borrowings plus interest costs is already compounding faster than GDP, creating fiscal policy headwinds and the prospect of slowing income growth that they cannot afford.

Central banks will not tighten if they can avoid doing so, preferring to wait until they know that they are through the fiscal tightening danger, and that CPI inflation is a real threat. In the near term, we do expect somewhat weaker growth, and an easing in global trade price inflation, which will allow the Fed to hold off raising rates in early 2022. But, once clear of the fiscal tightening, we expect inflation to come back strongly and are concerned the central banks will need to play catch up thereafter.

There was a great deal of debate and discussion during the December 2021 FOMC meeting, but two things stood out. Firstly, it was agreed to conduct monetary policy by allowing members to "assess the incoming data" before making decisions. The Fed is still committed to forward guidance, but markets are going to have to become more aware of risks and data trends since the Fed can no longer be relied upon to tell them exactly what is about to happen. This could become a factor for markets through 2022. In 2020-21 it paid to invest according to what Powell said would happen, now the Fed is data dependent and implicitly offering less forward guidance. If Central banks become less predictable this could impact the amount of market leverage and be reflected in more financial market volatility.

The second stand-out comment was that financial conditions had tightened since the previous meeting which is an interesting statement. While short term rates had indeed increased, the dollar appreciated slightly, and equity prices had stagnated, monetary growth in quantity terms had been very strong, private sector credit growth rates had accelerated sharply, and long-term yields had in fact declined slightly. The statement confirmed to us what we have long believed - that the Fed focuses on short term rates credit spreads, equity market trends, and the USD when considering monetary policy. Since the changes to personnel in the Yellen era, the Fed lacks the contacts and the staff to be able to analyse

monetary quantities. If you are looking for confirmation of this, you need to look no further than September 2019 when the Fed was blindsided by the repo rate spike and was forced to flood the market with short term liquidity (see Q4 2019 commentary). This is a concern, as liquidity has been such an important driver of markets for so many years. Evidence that the Fed is not really in touch with liquidity conditions, despite how much their actions contribute to it, suggests that as they pivot into Quantitative Tightening (QT) we may be in for a bumpy ride.

One question that has been doing the rounds for some time now is whether we are in a financial bubble, but there will always be justification for even the most extreme valuations, until there aren't. But perhaps there is guidance from a different angle – looking at investor confidence and behaviours rather than arguing about market prices. in 2021 we saw retail investors' rushing into "meme stocks" thanks to social media sites like Reddit and online trading platforms like Robinhood, more because of social media than any insight on company success or valuation. Other popular trends included trading in non-fungible tokens (NFTs), SPACs, and numerous cryptocurrencies. Increasingly, investors wanted things that were different from the norm and frankly, difficult to explain. However, whether or not something makes sense or has any utility seems secondary to its relative price compared to a point in the past driven by a clear under current of that most seductive of investor biases, FOMO – the fear of missing out. Some of the valuations of these esoteric things whilst worrying, are particularly informative in terms of judging investor confidence. Having been through numerous market cycles over the years, we have seen that as valuations in traditional markets become stretched even experienced investors can get drawn into investing in assets or schemes that are sold because of low correlation or alternative sources of return. There seems to be a clear message in terms of investor confidence (or overconfidence) that can be drawn from what investors are buying at different stages of the market cycle.

When confidence is low, investors crave certainty. They buy bonds, gold or shares in the safest companies with tangible assets, strong earnings and cash flow. On the other side of the coin, at peaks in confidence, they care little for certainty and at the moment what is most expensive is also extremely abstract and esoteric and speaks to the zeitgeist of anti- mainstream, anti-government, pro-digital — almost the antithesis of what the crowd flocked toward in the very depths of the GFC. We've come a long way from the flight to safety and certainty at the bottom of the 2008 financial crisis, when many investors looked no further than under their mattresses to safeguard their cash and gold. There seems a massive reduction in the scrutiny of what many investors are buying made easier by financial deregulation and the lowering of disclosure requirements enabling more companies to go public giving less information. It is clear that many investors are now committing significant amounts of money to the most esoteric and abstract opportunities in history with little due diligence and understanding of what they are actually buying. Does this extreme investor behaviour mean a peak of investor sentiment?

SPACs, or special purpose acquisition companies, which raise funds and then look for a business to buy, seem to be losing their lustre and some of the value of many of these companies are down sharply – with shares in electric vehicle maker Lordstown Motors falling more than 90 per cent from their peak. There seems to be a reduction in the extremes of interest in cryptocurrencies, reflected in lower prices after last years peaks - time will tell if this continues. History warns that the end of a period of extreme investor confidence does not end well for those arriving last to the party. Investors pivot to more traditional and predictable investments, and scrutiny intensifies on recent crowd favourites often showing that these emperors have no clothes. We saw these behaviours when the dotcom bubble burst and in 2008 financial crisis, and if 2021 was the peak of yet another bubble in investor confidence we will see them again. The beginning and the end of market cycles can be seen in prices, but also importantly in the very extremes of investor confidence and behaviour. At these extremes, the behaviour of markets is at its most animalistic and human greed and fear are the sole drivers of market prices.

We are on the cusp of the withdrawal of "the largest ever fiscal stimulus" in many economies, an event that does make forecasting difficult for everyone. In the near term, we suspect that the Central Banks are t likely to be conflicted over what message they wish to convey, balancing data dependence with forward guidance. There are uncertainties over the outlook for China's economy and central banks found out in 2016 and 2018 how difficult it was to judge China's true economic impact on the Rest of the World.

We suspect that the Banks will acknowledge that global growth is slowing, with DELTA & OMICRON providing convenient scapegoats. There will therefore be some desire within the Banks to "hold the line" on there being no rate hikes for the foreseeable future, at least while they await more information. We suspect that they will not want the short end of the curves to sell off any further. But we are witnessing the fastest rates of inflation for a generation and central banks must acknowledge this or face the prospect of a sell off at the long end of the curve, raising governments' funding costs and placing pressure on equity market valuations – the 2007 sell off in T Bonds was the catalyst for what became the GFC. The FOMC may consider accelerated tapering but needs to consider the effect QT had on the repo market in 2019 and ensure liquidity to protect short term rates.

The Eurozone economy is much weaker than the US and inflation probably more transitory so we expect that the ECB will be rather more guarded in what it says and does, while the Bank of England faces a tough task with a positive output gap around 4-5% of GDP and more fiscal tightening needed.

On the COVID front, the ability of the OMICRON variant to outcompete others – leading to it representing 96% of gene sequenced positive tests as of 5th January – makes us wonder whether it marks the beginning of the end of the pandemic. If this is the case, the markets would view this very positively and we could expect a strong response certainly in the short term. However, there are longer term and possibly more important issues bubbling under the surface and any market response may be a last hurrah until central banks can solve the Gordian Knot of inflation, tapering and sustaining global growth.

In response, we have reduced our tactical allocation to government bonds but maintain our exposures to inflation linked issues reflecting our longer term inflation view. We feel that the UK has significant headwinds, and we reduce to a neutral position reallocating to Developed market equity due to greater growth prospects and anticipating a weaker Sterling. At the same time, we are taking profits from our small and mid cap UK exposures which are more domestically focussed. Our absolute return holdings are key at this point in time as we prepare for volatility and are concerned about traditional assets (bonds) ability to balance our portfolios.

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