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Introduction

In this investment report, we consider what has been going on in financial markets recently and discuss our outlook for the year ahead. We also take a closer look at European Equities, which have been disproportionately affected by the war in Ukraine, and discuss a fund that we recommend to our model portfolios, JP Morgan Japan.

Recent market conditions

The first quarter of 2022 was unusually tough for investors. Bond and equity markets were both knocked in January by central banks becoming increasingly concerned about inflation and starting to signal a faster pace of interest rate rises and stimulus withdrawal than they had, last year, guided markets to expect. This proved particularly painful for US equities and the technology sector specifically. Investment strategies that had performed well in recent years by investing in the fastest growing companies in the world, regardless of valuations, fell sharply at the beginning of 2022. Meanwhile, value-focused strategies, investing in unfashionable sectors like energy, mining and financials, and the UK stock market generally, performed well.

Russia's invasion of Ukraine in late-February provided a further shock to financial markets, with equity investors suffering greater losses until markets troughed in the second week of March. However, while equity markets then staged a rebound, bond markets continued to retreat as central bankers, particularly at the US Federal Reserve, signalled faster and faster paces of interest rate rises.

Economic and Market Outlook

As we came into 2022, we expected to see global economic growth decelerate as central banks raised interest rates to fight inflation, governments tightened fiscal policies and growth in households' real disposable income slowed due to inflation. The war in Ukraine and central banks becoming even more concerned about inflation have increased the likelihood that we see more than a typical economic slowdown this year, and potentially recessions in the eurozone, UK and even the US over the next 18 months.

The big questions are whether inflation remains very high or starts to come down over the remainder of 2022, and whether central banks, in particular the US Federal Reserve, will indeed raise interest rates as rapidly as they have been signalling over recent weeks.

If inflation surprises the world by slowing sharply over the summer, then central banks may feel less pressure to raise interest rates aggressively. This would tell us that we need not be overly concerned about economic recession and that equity allocations could be maintained or even raised. If, however, inflation stays elevated and central banks show no signs of concern about the economic impact of tighter financial conditions, we would become warier and would act to protect portfolios from a likely recession. We envisage that a defensive stance within portfolios would be warranted until at least early-2023.

Our current thinking is that inflation will soon begin to cool as the pain being felt by consumers from the recent inflation surge erodes confidence and in turn discretionary spending, alongside supply constraints from 2021 easing.

One of the challenges to this view comes from the rises in commodity prices because of the war in Ukraine and sanctions on Russia. Although we think that many commodity prices may stay at historically high levels for a long time, in order to have the same impact on inflation next year, they need to rise a lot further. Unless supplies are disrupted in other countries, we do not expect this to happen, and so inflation rates should naturally slow down.

Another risk to inflation is that governments provide large scale financial support to businesses and households to offset price rises. This could keep demand high and therefore put additional upward pressure on inflation. Also, we could see lending accelerate as people and companies borrow to bring forward consumption to lock in today's prices. This could also push inflation up.

However, we are reassured on two fronts. Firstly, governments' generosity appears to be waning after two years of pandemic support measures and, secondly, surveys of banks' loan officers to gauge demand for credit are not indicating excessive appetite to borrow amongst their customers. Banks, if anything, are becoming increasingly cautious on lending, and growth rates for broad measures of money supply are slowing to levels seen during the pre-pandemic period. Such a backdrop has not normally been associated with rampant inflation.

Our view on inflation, therefore, is that it is less worrying than it might appear today. If correct, then the risk of a severe recession over the next 18 months is low, but we would not completely rule it out. From an investment perspective, this tells us to maintain equity allocations in portfolios but increase the focus on the strongest companies that have both pricing power during inflationary times and defensive characteristics that help them to ride out challenging economic environments.

We are also inclined to add more ballast to portfolios via funds that can position defensively in periods of economic stress. We also favour bond funds that have recently been buying government bonds as their prices have fallen on concerns about inflation and interest rate rises. The yields on many government bonds are at their highest levels since 2018, and, while below current rates of inflation, we believe that they now stand a reasonable chance of making positive returns over the next year, particularly if we do see a sharper economic slowdown.

What should investors be looking out for over the coming months? Our answer, unhelpfully, is volatility. However, a well-diversified portfolio should be able to ride this out, particularly if the investor has a long time horizon. Also, volatility may present investors with attractive opportunities to add to holdings in risk assets, though our assumption right now is that it may be better to wait until next spring before raising equity allocations significantly, especially in more economically-sensitive regions and sectors. We are, as ever, thinking about the best ways to protect and grow our clients' wealth. If we believe changes are warranted, either to increase weightings to defensive funds or to invest for future asset growth, we will be in touch.

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European Equities – style allocations in times of uncertainty

European equities have endured a multitude of market shocks over the last six months. Rising bond yields through December and January put pressure on longer duration quality-growth equities, an area we are underweight versus peers, but have generally dominated positioning and performance post the Global Financial Crisis. The resulting sell-off over January was extreme by historical standards. The Omicron variant added to investor anxiety as European economies fell into varying degrees of lockdown over Christmas and January. Finally, the Russian invasion of Ukraine in late February helped to ignite a global sell-off in risk assets as the threat of war in Europe became a reality, sentiment indices fell, commodities spiked and the likelihood of stagflation rose.

Major European ex UK equity indices bottomed on 8th March down between 17-19% year to date; however, growth indices were down more, around 21%, with some growth-orientated funds falling over 25%. Despite these headwinds our European model has made a robust relative start to 2022 (Fig. 1) being down only 5% over the first quarter and outperforming its peer group. Outperforming in down markets is a highly reliable way of compounding longer term returns. For completeness, Figure 2 below shows the 5 year returns of our European model versus the peer group.

Figure 1: 1 year performance of Saunderson House European Wealth Management Balanced Model vs the IA European ex UK peer group

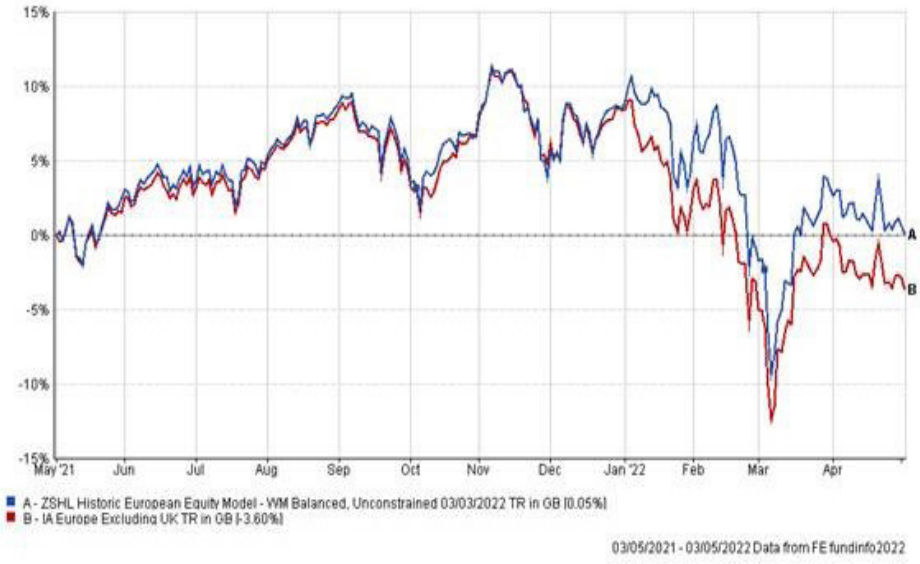

Figure 2: 5 year performance of Saunderson House European Wealth Management Balanced Model vs the IA European ex UK peer group

We believed it likely a recovery in economic data following the Omicron variant would support a reopening trade in more cyclical, value and economically-sensitive parts of the market. Bond yields over 2021 were, compared to history, too low versus elevated GDP growth, with inflation breakeven rates high versus history as inflation built; combined, these pushed real yields ever lower. It therefore seemed logical that nominal yields would have to rise in time. Taken together we decided to increase our exposure to value equities over the fourth quarter 2021, by increasing funds with large allocations to Banks, Autos, Resources and Energy stocks, with a view to benefiting from a value rotation over H1 2022 as real yields normalised.

A disconnect existed in the market between value/growth performance and bond yields when compared to the historical relationship. As mean reversion investors we wanted to take advantage of this disconnect as yields moved higher off the back of persistently higher inflation by increasing our value exposure.

Post the Ukraine invasion we decided to marginally reduce the value bias and recycled profits into quality-growth stocks which had suffered heavily over January and February. This resulted in a more style neutral European model. As of early April, this had paid off with quality-growth funds outperforming over March. However, we are cognisant to the risks of overweighting to the growth style, when what looks to be an aggressive rate hiking cycle, has just begun.

Looking forward, we recognise the conflict in Ukraine is highly likely to reduce European GDP growth and will certainly increase European inflation, as we have already seen from the March 2022 CPI print of 7.5%, a historical high. Typically, kneejerk selling of equities on the advent of war has proven to be the wrong decision; equities tend to rally post the event. For this reason, in addition to wanting to better assess the situation, we did not sell down our overall exposure to European equities and subsequently the market has rallied over March with Europe ex UK indices finishing the month in positive territory and growth equities outperforming.

As of today, the outlook in aggregate for European equities is more clouded, compared to before President Putin's invasion of Ukraine. However, there are still a number of reasons to be bullish, not least starting valuations with European equities now trading at their largest discount to US equities on a Price-Earnings (PE) basis since 1987. Predicting Putin's next move is virtually impossible, with the future outlook tied to his decision making, however we strongly believe that holding equities on a low starting valuation is the best margin of safety that we can provide to clients. On a PE basis, European equity markets have de-rated from 17x to 14x - near levels last seen at the onset of the Coronavirus pandemic, to us this feels overdone. We believe that a better exit opportunity will present itself in the near future should we wish to reduce European equity exposure.

Looking forward, we await more economic data on the impact of the Ukraine war on European economies. If Russian gas imports become subject to sanctions then we should expect a recession across Europe and likely energy rationing for consumers and businesses. That in turn depends on how Putin escalates from here. The March macroeconomic data, a first cut at the impact of war, showed sentiment falling but other data points outperforming; however more time is needed to determine the full impact of the war on economic activity. Provided Russian gas imports remain uninterrupted, Europe may just be able to avoid a full recession. Currently only Russian coal is due to be banned from August 2022 and the European Commission is actively working on a deal to phase out Russian oil by the end of 2022. However, some countries are at greater risk of an economic slowdown, having a greater reliance on Russian energy imports, countries such as Germany, which may already be in a technical recession of two consecutive quarters of declining GDP output following a fall in the fourth quarter of 2021.

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Fund to Watch: JP Morgan Japan

The JP Morgan Japan fund aims to provide capital growth over the long term by investing in the shares of Japanese companies. The fund has been managed by Nicholas Weindling since October 2012 and follows a disciplined investment process by investing in companies that he believes can deliver strong and sustainable earnings growth, which benefit from strong competitive advantages.

After a decade of strong outperformance, the fund has underperformed the main benchmark since December 2021. This was due to a significant style reversal in the market which favoured value stocks at the expense of growth ones. Previous growth winners have largely sold off on concerns over rising global interest rates due to higher levels of inflation.

However, there are few indications of any material changes in the fundamental strengths of the vast majority of stocks that the fund invests in. What has changed is the valuation that investors are willing to assign to these long-duration, growth businesses as a result of the current macro-economic challenges. We've seen this behaviour in the past, in the second half of 2016, and most recently in the last quarter of 2020, when investors became concerned over rising interest rates.

Whilst we are seeing increased volatility in the performance of the fund, looking at the largest detractors from recent performance, we note that there are almost no stocks that have underperformed due to negative changes in their fundamentals or the business environment of these companies. As a result, Weindling has made very few changes to the fund.

The fund remains exposed to innovative and fast-growing companies in Japan, which the fund manager believes are able to deliver high excess returns. The themes that they invest in, such as e-commerce (which still accounts for less than 10% of total retail sales in Japan), cashless payments (where there is increased adoption amongst Japanese consumers), digitalisation and increased automation are just some of the trends that are at an early stage in Japan compared to the rest of the world. All of these trends are expected to continue, regardless of the macro-economic backdrop. Even if higher inflation were to take hold, the fund manager believes their companies have a strong enough pricing power to cope in such an environment.

The fund's holdings continue to benefit from leading market positions, have strong balance sheets, with low debt, high cash levels, and high profitability. In addition, the expected earnings growth of the fund remains above that of the broader market.

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