Watson Moore
INDEPENDENT FINANCIAL ADVISERS LIMITED

Monthly Investment Update
August 2020

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Performance Update

Global Stock markets fell for the first time since March. The FTSE 100 and MSCI World fell 4.20%* and 1.32%* respectively. The portfolios held up well and changed between +0.86% and -0.50%.

While the headlines talk about a second wave sweeping through Europe and then the UK, it is looking more likely that we will get clusters of higher infection rates that can be dealt with by employing localised lockdowns. This should mean that the economic recovery is better than initially anticipated a few months ago.

The world's leading scientists and pharmaceutical companies are making headway in the quest to find a vaccine and it is looking likely that a vaccine of some sort will be widely available by 2021. In addition, there has been real progress in the search for drugs to fight the virus and the reduction of the time to receive the results from testing.

Since March, governments and central banks have pumped around $25 trillion dollars into the global economy. The world has never seen such a flood of stimulus. Governments and central banks have learnt the lesson of 2007-08: do not delay.

If progress is made against the virus so that the economy continues to open up, this additional economic stimulus could lead to an unprecedented economic boom. This could be extremely positive for the asset classes that we invest into.

However, if we leave Covid-19 aside, we still have the uncertainty surrounding Brexit and the forthcoming US election which will ensure that markets remain volatile.

The performance of the portfolios over the last month, 3 months and 1 year is shown below:

Portfolio	Performance % 1 month	Performance % 3 months	Performance % 1 year
Foundation	-0.41	3.23	-3.20
Cautious	-0.50	2.42	-5.57
Balanced	-0.03	3.14	-6.74
Adventurous	0.36	4.80	-5.73
Dynamic Equity	0.86	8.04	-0.14
Income Generating	-0.43	2.89	-11.16
Fourth Industrial Revolution	-0.04	16.74	17.67
Retirement Investment Solution 1	-0.04	3.48	-3.44
Retirement Investment Solution 2	0.10	4.13	-3.05
Retirement Investment Solution 3	0.23	4.73	-2.69

Please note that these figures do not include the platform or Watson Moore's fees.*All figures are sourced from Financial Express to 31.07.2020.

Trend Following Signals

The table below shows whether the asset class is either in a positive trend (✓) or a negative trend (x). The portfolios will have more exposure to those asset classes in a positive trend and less (if any) to those in a negative trend. These are the main asset classes we monitor:

Asset Class	Trend Signal		Trend Signal
Global Equity	✓	Emerging Market Equity	✓
UK Equity	x	Commodities	x
Europe ex UK Equity	✓	UK Corporate Bonds	✓
US Equity	✓	UK Corporate Bonds (Short dated)	✓
Japan Equity	x	UK Index Linked Bonds	✓
Pacific Equity	x	Global Bonds	✓
Gold	✓	UK Gilts	✓
Global Property	x	Emerging Market Bonds	✓
Global Infrastructure	x	Overseas Corporate Bonds	✓

Japanese equities moved below its trend line this month.

Cautious, Balanced and Adventurous portfolios

The Adventurous portfolio remains fully invested this month and there were no changes to the momentum part of this portfolio. The Cautious and Balanced portfolios reduced exposure to Japanese equities, as they fell below trend. All three portfolios now have a significant exposure to equities and have benefitted from the recovery. Last month we experienced the first negative month since March.

Dynamic Equity portfolio

The momentum philosophy that forms the core of this portfolio attempts to invest more money in those stock markets that are experiencing the strongest growth (or the lowest losses). There were no changes made and we remain overweight US equities, gold miners, healthcare and technology. Gold miners rose 12.21%, helping the portfolio achieve a positive return despite global stock markets falling. This demonstrates how following a momentum driven investment strategy can reward you.

Foundation portfolio

The portfolio reduced its exposure to Japanese equities. The portfolio is fully invested in bonds which are still growing in value. However, we are fully aware that yields from bonds are at record lows and if the global economy fully recovers, then we expect bonds to start falling. The Foundation portfolio will reduce its exposure to bonds when each sector breaks below trend. However, it will always have some exposure as it is our most diversified portfolio.

Income Generating portfolio

The bond part of the portfolio helped offset some of the losses in equities last month. Despite the portfolio falling for the first time since March, we are pleased that the loss was significantly lower than the FTSE100. We are beginning to see some dividend companies recover and this is helping performance. We expect dividend paying companies to further recover as their level of income is significantly higher than interest rates.

Fourth Industrial Revolution portfolio

We are in the midst of the fourth industrial revolution in which we are seeing an explosion in technological breakthroughs. The portfolio has performed exceptionally well during the recent crash as we have seen the types of companies that the portfolio invests in, benefit from this period. It can be best described as having 5 years of technological advancement within the last 3 months. The outperformance has come from every holding within the portfolio which have all beaten the performance of the msci world index, with the portfolio outperforming by nearly 20%.

Whilst we are delighted with this performance, we have seen some of the worlds biggest companies move significantly higher and these companies are now more liable for a correction or period of underperformance. Therefore, we wanted to diversify away from just the big NASDAQ 'darlings' which we already have exposure to by buying into a fund that gives exposure to smaller companies mainly in the UK but also globally - the Herald Investment Trust. It invests in technology, media and telecommunications sectors and specific companies that are related to cyber security, internet of things, telecoms, semi-conductors, software and internet/media sectors. Whilst there are 303 holdings, which is extremely large and difficult to monitor, the fund manager and team devote all their time to monitoring them. By having that many holdings it helps diversify the fund and gives it the best opportunity to uncover some of the next great companies. We purchased this fund within the portfolio in July.

Retirement Investment Solutions

Global smaller companies and Japanese equities fell below trend so we removed them from the trend following part of these portfolios. The portfolios invest partly in the Dynamic Equity portfolio which helped, as the Retirement Investment Solution 1 was the only portfolio to fall.

Summary of Portfolios

July experienced the first fall in global equity markets since March. We believe that this is just a normal pause in the recovery of global stock markets as most remain above trend. We await a new stimulus package in the US and this appears to be the factor that is currently causing uncertainty in equity markets. The US introduced a massive stimulus package in the initial lockdown, with $1200 given to the majority of adults and $600 a week for millions of unemployed people. It was believed that the new stimulus package would have been agreed before the end of the month, but with the forthcoming US Presidential Election coming up, it looks like there is more political meddling in this package that is delaying it. Once the package is announced it should alleviate the uncertainty.

Since March, governments and central banks have pumped around $25 trillion dollars into the global economy. The world has never seen such a flood of stimulus. Governments and central banks have learnt the lesson of 2007-08: do not delay. The UK, although one of the first to act, now looks like something of a laggard, throwing only (!) 20% of GDP at the recession. In the US and Eurozone, the figure is 44% of GDP. In Japan, it's 60% of GDP.

We believe the authorities did the right thing, given the worst-case scenarios they were presented with. They prevented an economic panic as well as a medical one. However, if it starts to become apparent that the virus is burning out, the stage could well be set for an almost unprecedented economic boom – with governments having abandoned over a decade of austerity-focussed policy. This wave of stimulus is likely to swamp almost everything in its path – in a positive sense!

Asset Class Review

This section will give you an insight into our current thinking and we have included some charts that we believe look interesting.

Gold – new all-time high

In periods of uncertainty, gold tends to do well and we have seen this happen again this time around, with the market continuing to move higher. This is probably due to the fact that expectations for higher future inflation are rising, while interest rates remain low. This is the perfect scenario for gold:

Technology – the leading sector

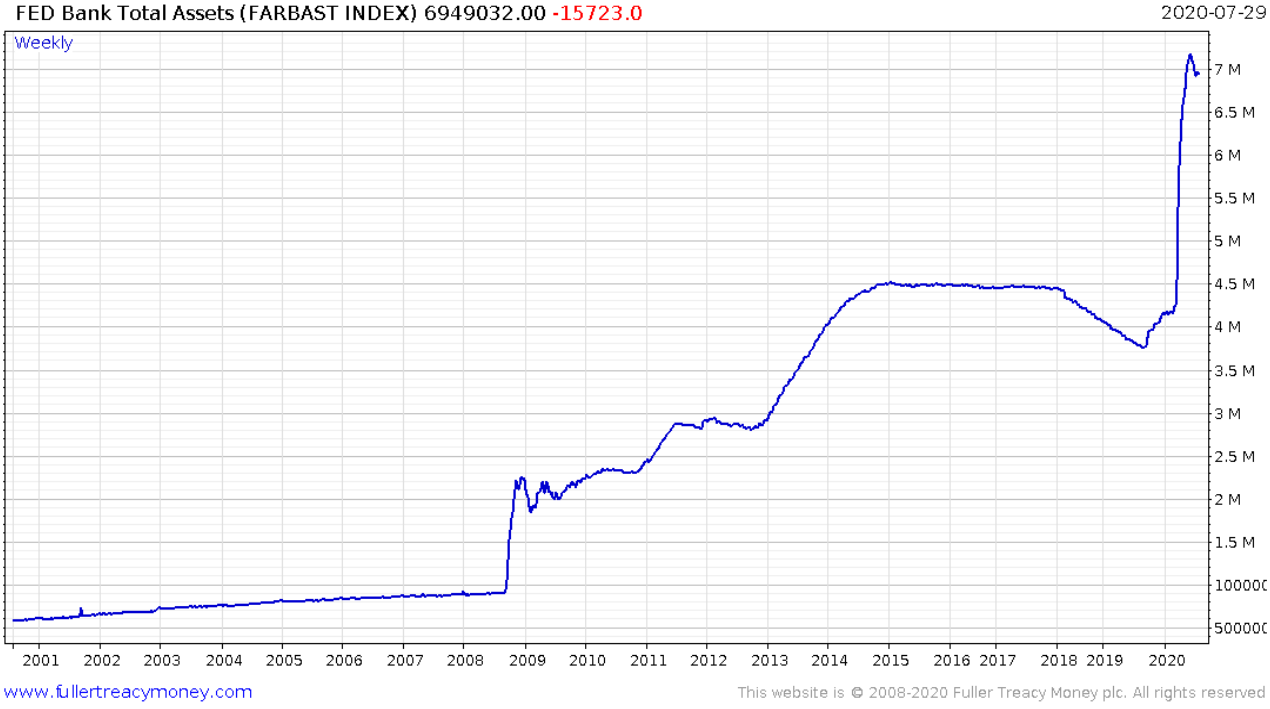
The Nasdaq 100 is a technology orientated index as the biggest constituents are Apple, Microsoft, Amazon, Facebook and Alphabet (Google). You can see how well it has recovered rising by over 50% from the low in March. This sector is benefitting the most from Covid-19:

FTSE100 - recovered somewhat but now falling again

The UK has very few technology firms and this is one of the reasons why the FTSE100 has not recovered the same as other stock markets such as the Nasdaq 100:

Central Banks are printing money like never before

This is perhaps the most important chart currently. FARBAST tracks the aggregate assets and liabilities of banks within the US economy. Essentially the higher it goes, the more money there is. Some of this money finds its way into stock markets and this is perhaps the main reason for the recovery in global stock markets. You can see it jumped up in 2008 during the banking crisis, continued to move higher until 2018 when it began to fall (stock markets also had a bad year in 2018) and then we have seen a surge higher which has coincided with a stock market recovery. Recently we have seen it drop off and this may be what has caused stock markets to fall a bit last month. If more stimulus is added then we should see the next stage higher in global markets - this has led to the saying “don’t fight the FED”:



Inflation is Coming

Every country is engaged in some form of money-printing. Some are running massive government deficits. Some are printing money to buy their own bonds. Some are doing both at the same time. Others are doling out cash to banks to lend and others are just giving money directly to consumers. And then we have governments giving money directly to companies in order to not make people redundant – furlough schemes. Everywhere you look, there are efforts underway to flood economies with liquidity and this is why the FARBAST chart (previous page) has surged higher.

Investors are rightfully worried that just as soon as economic activity picks up, all this money-printing will result in inflation. In fact, the US Federal Reserve has pretty much told us it's not going to raise rates until it has clear evidence of inflation. This has led to the expectation that interest rates will stay lower for longer and is why the yield on 90% of Government Bonds remain below 1%.

We don't have any real data that says inflation is a problem today. In fact, some economic figures still point to deflation. However, it's important to remember that the financial markets are always looking forward. They priced in deflation in February and March. Today, they are looking at next year, and what might happen for government policy and the willingness to throw fiscal and monetary caution to the wind. The chart below effectively predicts what the average inflation rate is going to over the next 10 years in the US. So currently they expect inflation to be on average 1.504% each year over the next 10 years:

As you can see, it hit highs in 2004/05 of nearly 2.8% (during the boom years) and a low of 0.1% during the crash in 2008. We recently experienced a drop to 0.8% before a recovery to 1.5%. Therefore we must conclude that, despite being in the worst recession of our lifetimes, inflation is expected to increase due to the money printing.

How to Protect against Inflation?

Inflation is on the way. That's why gold is rallying (it does well when inflation is above interest rates) and why we own gold and gold miners in the portfolios. Inflation-linked bonds are also another way of protecting as they pay a yield based on the rate of inflation. Finally, companies that have the ability to increase the prices of their products by inflation or higher each year will also do well. We invest in an abundance of these companies. For example, Microsoft has a subscription service in which companies and individuals license their products. If they increase their prices by 10% it is unlikely that they will see subscriptions drop as they have such a great product that people rely on. It is these types of companies that should perform well in an inflationary environment.

Final Comment

We are continually asked about whether we will see another stock market crash shortly. The honest answer is that we (and nobody) knows if this will happen. We have just seen one of the quickest crashes in history, but also a strong recovery. With economic news so gloomy, it just doesn't make sense as to why stock markets are recovering. That is until you start to see how much money has been printed over the last few months. This money is supporting the economy and ultimately pushing up the prices of the assets we own. In addition, there is much more good news coming in the form of how we are fighting the virus in terms of testing and vaccinations, as we have the world's leading scientists and companies working together. While the headlines have been heralding the coming of a second wave, we have not yet seen a second crash appear.

Inflation appears to be the one major consequence of all this money printing and there is a concern that the rate of inflation will increase significantly once we are past the worse of the virus. This can be a good thing for the economy as it reduces the real value of all the debt that has been produced and hopefully increases wages. However, it can also damage our wealth. Therefore the best way to protect against it is to buy gold, inflation linked-bonds and companies that have pricing power. We have an abundance of these assets in our portfolios.

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