Watson Moore
INDEPENDENT FINANCIAL ADVISERS LIMITED

Monthly Investment Update

July 2023

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Performance Update

June proved to be a good month for global stock markets, with the S&P500, FTSE 100 and Euro Stoxx rising 3.93%, 1.40% and 3.62% respectively. Bonds and gold suffered losses though. This caused our portfolios to rise between 0.12% and 1.00%. The outlier was the Income Generating portfolio which fell 0.19% as it has a higher exposure to assets that are more affected by interest rate rises.

UK inflation surprised to the upside for the fourth month in a row as it remained at 8.7%, well above the expected 8.4%. The Bank of England raised interest rates by 0.5%, bringing the rate to 5.0%. The expectation is that they will continue to raise rates to 6.25%. Economists now fear that this will push the UK economy into recession. By contrast, headline inflation is down to 4.0% in the US and the Fed has paused its increases in interest rates. We are beginning to experience many of the most important commodity prices fall year on year and therefore inflation in the UK should start to significantly fall over the next few months.

Higher-than-expected inflation figures caused bond yields to rise and bond prices to fall. UK Gilts and Corporate Bonds fell by 0.87% and 1.52% respectively. Overseas bonds also fell, and gold suffered a 5.04% drop.

Rising mortgage rates are now hitting the UK housing market with asking prices for homes falling in June for the first time in six years (albeit Rightmove said the drop was only by £82!). The Nationwide said prices in the year to May had dropped by 3.4%. As mortgage holders begin to see the expiration of their fixed-rate deals, expect there to be more stress in the housing market over the next year. Oxford Economics is expecting a 12% fall in UK house prices.

Apple became the first company with a market value of over $3 trillion, the latest sign of big technology's seemingly unstoppable dominance in equity markets. This helped push up the value of most equity markets, with the tech-laden Nasdaq racing higher and approaching the Covid peak. Japan's Nikkei is also moving closer to its all-time high last seen in 1989. By contrast the UK's FTSE 250 remains in a strong downward trend.

The war in Ukraine may be approaching its end, although we have no idea exactly what is going on in Russia.

The performance of the portfolios over the last 1 month, 6 months and 1 year are shown below:

Portfolio	Performance % 1 month	Performance % 6 months	Performance % 1 year
Foundation	0.12	0.52	0.40
Cautious	0.37	2.23	2.79
Balanced	0.46	1.88	2.59
Adventurous	1.03	0.93	2.24
Dynamic Equity	1.00	-0.67	5.00
Income Generating	-0.19	0.21	3.04
Fourth Industrial Revolution	0.57	11.47	14.53
Retirement Investment Solution 1	0.41	0.60	0.65
Retirement Investment Solution 2	0.50	0.36	1.22
Retirement Investment Solution 3	0.59	0.13	1.74

Please note that these figures do not include the platform or Watson Moore's fees.*All figures are sourced from Financial Express to 30.06.2023.

Trend Following Signals

The table below shows whether the asset class is in a positive trend (✓) or a negative trend (x). A positive trend is when the market is above the average price over the previous 200 days. 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	x
UK Equity	✓	Commodities	x
Europe ex UK Equity	✓	UK Corporate Bonds	x
US Equity	✓	UK Corporate Bonds (Short dated)	x
Japan Equity	✓	UK Index-Linked Bonds	x
Pacific Equity	x	Global Bonds	✓
Gold	x	UK Gilts	x
Global Property	x	Emerging Market Bonds	x
Global Infrastructure	x	Overseas Corporate Bonds	x

Most bond markets remain below trend, but global equity markets are slowly beginning to move above trend.

Cautious, Balanced and Adventurous portfolios

We are in a period of much uncertainty and stock markets are fluctuating between being above and below trend. Exposure to bigger UK companies was increased, but exposure to smaller UK companies was decreased. Gold exposure was cut in the Cautious and Balanced portfolios, whilst exposure to bonds remains minimal.

Dynamic Equity portfolio

There is much volatility in global equity markets, and we are seeing changes in the momentum of different stock markets, leading to more portfolio changes. This month saw the exposure to World markets increase, whilst Japan smaller companies were reduced.

Foundation portfolio

The Foundation portfolio is our lowest-risk portfolio that will increase and decrease exposure to different asset classes depending on the underlying trend of each asset class. As many asset classes have been below trend over the last year, we have seen that this portfolio has had higher than usual amounts in cash. This has led to the portfolio being relatively stable, especially when we compare the portfolio (blue line) to lower-risk UK Government bonds (red line) over the last year:

Income Generating portfolio

As interest rates increased in the UK more than expected, we experienced a loss of 0.19% for the portfolio. This is because investors value the income generated from companies and bonds less as interest rates rise. For example, the holding in the VT Gravis UK Infrastructure fund fell 5.18%. The fund relies on safe predictable income from infrastructure investments e.g. toll roads and property. The fund is now producing an income of 5.15% which is very attractive. The overall portfolio current yield is 3.16% which is again attractive. Hopefully, we will start to see interest rates come down and the portfolio should benefit significantly.

Fourth Industrial Revolution portfolio

The portfolio has risen 14.55% over the last year and 0.66% last month. Despite the rise last month, 5 of the 9 underlying holdings fell. The holding in the L&G Battery Value-Chain fund grew by 6.86% which helped ensure the portfolio continued its good run of positive returns.

Retirement Investment Solutions

The Solutions invest in three of our portfolios, the Foundation, Dynamic Equity and Multi-Asset Trend Following. The Dynamic Equity portfolio will always invest in equities, whilst the other two are very diversified, increasing and decreasing exposure to asset classes depending on whether they are above or below trend. Exposure to equities rose a little over the month, and exposure to bonds remains relatively low. Having a low exposure to bonds has helped the Solutions over the last year.

Summary of Portfolios

Britain's economy is still smaller than before the Covid-19 pandemic and the latest poor economic news, with higher inflation, has pushed up interest rates to 5% with expectations of them now hitting as high as 6.25%. The Bank of England's forecasting abilities are now under intense scrutiny, and it has agreed to an external review of its forecasting processes. The UK appears to be suffering from a combination of European energy problems and US-style tightness in its labour markets exacerbated by Brexit. This has seen wages rise by over 7% in the last year. From a simplistic point of view, it does appear that all the money that was printed during Covid (furlough, bounce-back loans, eat out to help out) went on for too long and was not drained out of the economy quickly enough. We are now paying the price.

Whilst the news in the UK remains bleak, we are experiencing some good news elsewhere. US inflation is falling as the price of many commodities is now falling year on year. While US interest rates are expected to go up in the future, they have paused the rate rises for now, which has boosted stock markets, especially those with a high weighting to technology. Japan's stock market is racing higher, and we have begun to see other markets such as India and Brazil show encouraging signs that they too could advance much higher.

Finally, we might just be seeing the end of the war in Ukraine as questions have been raised about Putin's control over his warlords and generals. Prigozhin's march towards Moscow was a complete surprise, but Russia's most successful warlord heading towards Belarus with thousands of his hardened fighters is a cause for concern. Russia had already sent thousands of troops to Belarus and stationed nuclear missiles there. This could be a Trojan horse type of action against Ukraine rather than retirement for Prigozhin.

Asset Class Review

This section will give you an insight into our current thinking. This month we look at how some of the major commodities have been falling and thus why we should start to see lower inflation numbers in the UK.

Oil – down over 30% in 12 months

Global inflation has fallen significantly but remains sticky in the UK. The price of oil is down 30% and is one of the main reasons that we have seen inflation moderate globally. Oil spiked to $120 last year, demonstrating how the global economy has been able to wean itself off Russian energy. This is great news for our wealth.

Copper – down 23% from its high

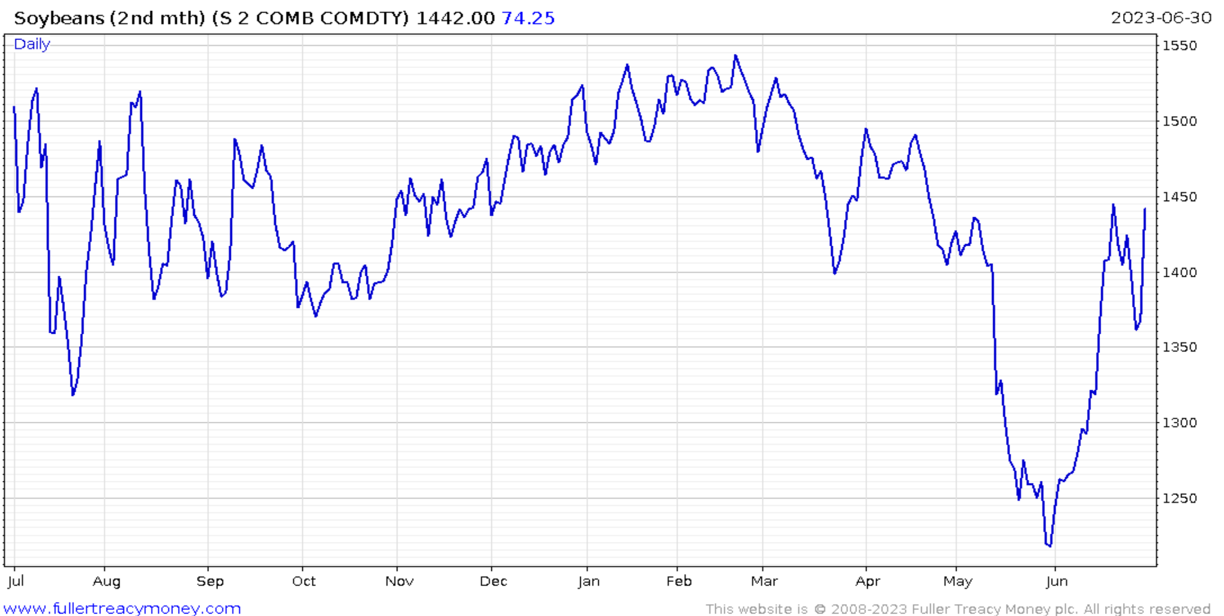
Because of its widespread application in most sectors of the economy, copper is widely thought of as the second most important commodity to that of oil. The price is significantly off its high and since early 2023 we have seen it fall. This has and will contribute to lower inflation rates.

Corn - down 21%

Corn is one of the most important agricultural commodities as it forms a major part of diets globally. The price has fallen over 20% during the last year. The price had hit over 800 during the initial stages of the Ukraine invasion and over the last few weeks, we have experienced a dramatic fall. If this continues, then expect food prices to stop going up and overall inflation to fall back significantly.

Soybeans- down 4.5%

Soybeans are down 4.5% over the last year, despite rising significantly last month. The price had hit 1700 in 2022 so should be helping inflation return to a much lower over the next few months. The crop is extremely important in South America and China and is an important source of feed for animals.



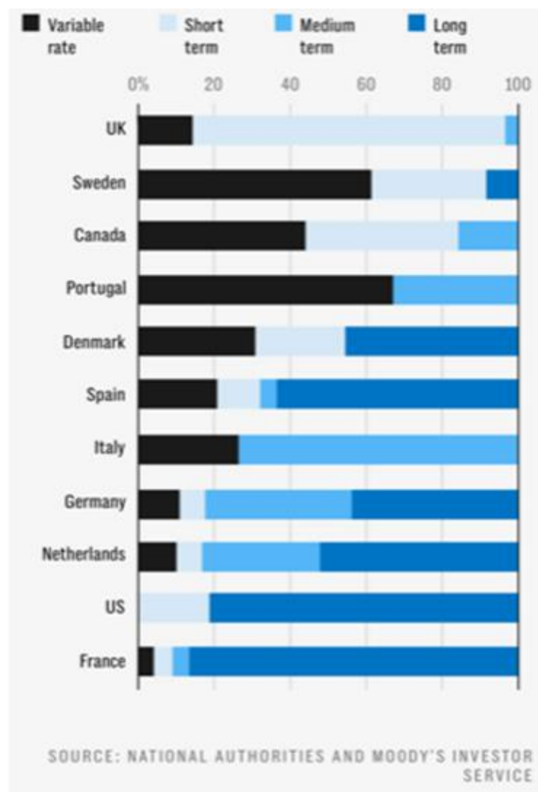
In Summary

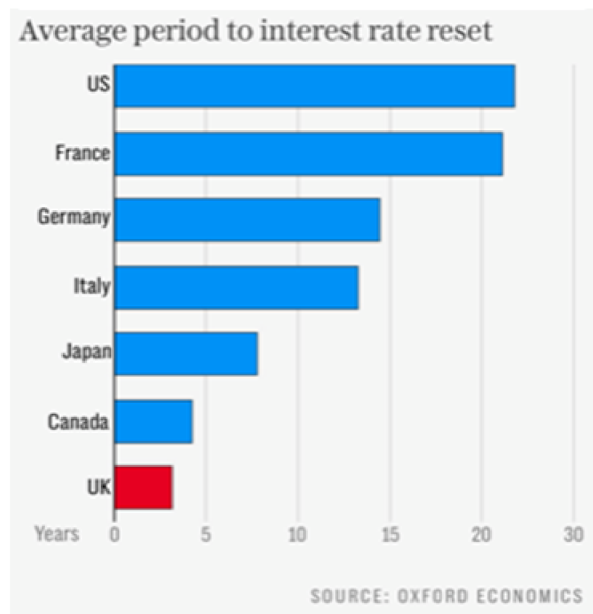
The rate of inflation is falling globally, and it is easy to see why. Inflation is simply a measure of how prices have changed over the last year, and many of the main commodities have been falling in price over the last 12 months. It can't be long until inflation in the UK starts to fall rapidly but it is currently proving much sticker than expected.

Has the Bank of England gone too far?

The Bank of England raised interest rates to 5% last month after inflation came in at 8.7% in the year to May. This was above the Bank's expectations for a fall to 8.4%. More concerning is that underlying inflation, which strips out more volatile movements in food and energy, climbed to 7.1% from 6.8%, the highest rate in 31 years. By contrast, the post-Covid inflation scare appears to be easing in the rest of the world. The US has seen consumer price inflation drop to 4% in May (down from 4.9%) and thus paused their interest rate rises. The Eurozone saw inflation fall to 6.1% in May from 7.0% the previous month. The ECB deposit interest rate is still rising but is now at 3.5%. So why is the UK different, what is going to happen and how will this affect our investments?

Unfortunately, we have no special insight into what the Bank of England is doing but there must be something that they are seeing that we can't, as it looks to us that they are raising interest rates too quickly and far too high. The expectation is that interest rates will now rise to 6.25% and perhaps even as high as 6.5%. The pictures below have both been copied from the Daily Telegraph and are worth looking at and considering:





The reason why the Bank of England raises interest rates is to control inflation by taking money out of the economy via the increased cost of servicing our mortgages and debt. If more of your money goes into paying off the mortgage that means there will be less demand for goods and services and therefore companies cannot push up prices. The chart on the left-hand side shows that the UK has few mortgages that are linked to the variable rate but has the most amount on short-term fixes. Mortgages in the UK have tended to be sold as either 2- or 5-year fixes and these rates are beginning to come to an end and thus need refinancing. The chart on the right-hand side shows the average term until a mortgage is due to be put onto a new deal and this reinforces the idea that the UK is just about to see the pain of the recent interest rate increases. We have the shortest time period of all the 7 countries. Therefore, it is safe to say that the recent increases in interest rates have not yet hit the UK economy. By contrast, the US has extremely long-term fixed-rate mortgages (30 years) and thus increases in interest rates do not affect ongoing mortgage payments, yet inflation there is falling quickly. Common sense therefore dictates that the effect of rising interest rates has not yet helped to bring down inflation in the UK but will do over the next 18 months. Perhaps the Bank of England has raised rates too much and this will now inevitably cause a recession.

UK Inflation

We have already looked at the charts of some of the major commodities and seen the price of them falling significantly. This is the reason why inflation in the US has fallen substantially. So why hasn't inflation in the UK fallen by a similar amount?

We don't have the answer to this but common sense dictates that the only difference between the UK and every other country has been Brexit. We believe that there are three possible reasons why inflation in the UK is higher due to Brexit:

- Brexit caused supply chain issues which meant that there are fewer goods available and thus companies can charge higher prices. For example, we have seen shortages of some goods in the supermarket and thus price competition is less than previously.
- Labour shortages in the UK caused by Brexit have meant that wages have increased significantly over the last year (the Office for National Statistics says pay has increased by 7.2% over the last year). Employers are still hiring and there are still 1 million job vacancies on offer and employers are struggling to fill them. This has meant that those in employment have had more money to spend but have yet to see higher mortgage rates. Thus, there is more money chasing goods and the price of them can go up.
- Companies are in fact profiteering and have seen an opportunity in the UK to raise profit margins. We have a buoyant economy, an abundance of money pumped in during Covid and high wage increases, so why wouldn't they try and make more profits now?

What will happen next?

With many people coming off fixed rates in the next year, we could have a Bank of England-induced recession which will almost certainly put a brake on inflation. In addition, the price of many key raw materials have also stopped rising and are indeed falling so this could mean inflation falls quite quickly and then there may be more concerns about deflation and a clamour to cut interest rates. We could easily see that the Bank of England raises rates too high after a period of having them too low. Perhaps what might happen can be summed up by Gordon Brown's speech to the CBI on November 18, 2003:

"Remember the old days, what was called the British problem: stop-go, boom-bust, unstable cycles…Britain the country usually first in, worst hit and last out of any world downturn; invariably hit by an inflation problem that prevented interest rates falling when they needed to come down; and usually then by wage inflation that could not be afforded and prevented you making long term investment."

How will this affect our investments?

We must remember that what happens specifically in the UK is largely irrelevant as the global economy (especially the US economy) is much more important. If the UK has a similar "British problem" to what Gordon Brown describes then we can expect sterling to fall and the value of our overseas investments to go up correspondingly.

Global companies have also been able to protect their profit margins as they have been able to increase their prices at a time when inflation has been high, but now that the cost of raw materials appears to be falling, they should be able to maintain their profits. This makes them relatively attractive.
In addition, UK Government bonds are looking quite attractively priced and if we do get a bust, interest rates will fall, and UK bonds should produce some significant returns.

Final Comment

The UK appears to be on a different economic cycle to the rest of the world and the "boom and boost" cycle described by Gordon Brown, could once again be seen. It does appear that the Bank of England has been "behind the curve" and loose monetary policy has gone on for too long. However, falls in the prices of most commodities must surely help going forward and do not be surprised if we see much lower inflation numbers and calls to cut interest rates by the end of the year.

Globally we are seeing some much better economic numbers feed through, and this has helped increase the value of our wealth in June.

Watson Moore Independent Financial Advisers Limited
54 Station Road
Upminster
Essex
RM14 2TU

Tel: 01708 250624

Email: chrismoore@watsonmooreifa.com

www.watsonmooreifa.com

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