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Courtville Partners – Investment Outlook, January 2022

Summary of the key points in this quarter's Investment Outlook

- Inflation came roaring back in 2021, much as we predicted; but stock markets continued to reward investors with handsome returns, just as they did the year before.
- A new cycle of higher interest rates has begun. It is not yet clear whether central banks will act decisively to tame inflation – or instead will remain behind the curve.
- Barring recession, energy prices may still be a one-way (upwards) bet thanks to the collapse in oil and gas companies' capital spending and governments' zero-carbon *hara-kiri*.
- Investors may want to consider investing in carbon allowances, based on both supply-and-demand and low correlation to other assets.
- The longer the easy money party goes on, the worse the eventual hangover will be.

When Covid-19 first appeared almost two years ago, established wisdom had it that pandemics tend not to initiate trends, but rather to turbocharge trends that are already in place. Zoom, WFH and mRNA technology all pre-date Covid. Financial markets are no exception. Governments spending money like sailors on shore leave, ultra-loose interest rate policies, the uninvestibility of most bonds, even the cult of ESG: all of these were in evidence two years ago, but have been amplified and accelerated in the interim.

That is not to say that markets have been predictable – or even that they would have been predictable if certain key facts had been known in advance. The US – still the world's largest economy – entered 2021 with inflation apparently subdued, its stock market highly valued, especially the tech-related mega-capitalisation stocks, and treasury long bond yields near all-time lows. Since then, however, something that we *did* predict has been borne out in spades, namely the return of inflation. It has soared to levels unknown to this generation. And its effect on markets? Well, the S&P500 shot up 28% in 2021, propelled by the same mega-cap stocks; bond yields have barely moved; and the US dollar has risen 6% against the DXY basket-of-six (currencies). Who'd have thought that US equities and the dollar would continue to beat all other asset classes? We didn't – which is why our Model Portfolio retained its tilt away from the US (and Europe) and towards Asia throughout last year. Although we got this wrong, we were redeemed somewhat by our overarching preference for equities over bonds: global equities rose 18% in 2021, bettering even their 2020 performance, while global bonds actually fell 5%. This equity/bond divergence underpinned our Model Portfolio's 13% return for the year, 1.5% ahead of its benchmark. The Portfolio has now returned 85% since inception in 2015, 10% ahead of the same benchmark.

Where to from here? The inflation elephant-in-the-room has grown to such a size (US November CPI +6.8% YoY) that even the Federal Reserve's favourite epithet, "transitory", has proved to be, well, transitory. The tension between runaway prices and zero interest rate policy has been laid bare. How will the Fed respond? We see at least three plausible outcomes. First, high inflation persists, but so does loose monetary policy – or at least the Fed remains behind the curve. This would be bad news for bonds; and, within equities, it ought to favour value over growth. The second option: central banks and governments in the West tighten monetary and fiscal policy, respectively, in an effort to slay the inflation dragon. This would probably bring about steep falls in most asset classes, but especially in growth-oriented equities (including those US mega-cap stocks). A third scenario (and least likely in our view) sees inflationary pressures dissipate – perhaps partly in response to the Π, Ρ or Σ variants-of-concern.

In this case, the US market's long-duration, mega-cap growth stocks – and even bonds – should continue to do quite well.

We subscribe to the first of these scenarios: persistent inflation, accompanied by a lack of moral courage among central bankers and governments to tackle it with conviction. Investors expect three official interest rate hikes in the US this year, in accordance with the Fed's signals. We think the reality could well be less aggressive, not least because of lingering Covid fall-out. If we are right, our preference for equities over bonds and, within equities, for the Asia-Pacific region over the growth-heavy US will be undimmed. To back up this view, we would point to early signs that China's monetary policy is likely to get looser this year, following an extended period of rigour. The central bank recently cut bank reserve requirements by 0.5%; and the smoke signals from the recent Central Economic Work Conference (the annual Politburo meeting to set policy for the financial and banking sectors) were for a more relaxed attitude to credit growth in 2022. There is also a decent chance that Asian countries will abandon their deleterious zero-Covid policies now that everyone on the planet (outside Davos) accepts that the virus is now endemic.

Having said this, we confess to a nagging worry that central banks may feel forced to tighten the interest rate ratchet at some point and, in so doing, trigger a sell-off across financial markets. Indeed, the Bank of England has already put up official rates, albeit by just 0.15%. The fear that other central banks may follow suit is one reason why we continue to over-allocate in our Model Portfolio to both cash and alternative investments (gold above all).

The nagging nature of our worry stems from a belief that higher inflation is the result of some powerful secular forces – and two in particular: labour costs and energy costs. Economic orthodoxy dictates that for inflation to become persistent rising prices for goods and services must feed through into rising wage demands. There is plenty of evidence at all levels of the labour markets that this "crossover" is taking place. For example, hourly wages are growing at nearly 5% p.a. in the US and at almost 4% p.a. in the UK. But it is in the energy landscape that we see potentially the most deep-seated and stubborn drivers of inflation.

Energy price inflation is facing a classic double-whammy. On the one hand, the oil and gas industry's capital expenditure (especially on exploration) has collapsed and, in the face of a merciless green agenda, is very unlikely to recover. On the other hand, most of the Western world has committed itself to meeting zero-carbon targets within timeframes that are at odds with power generation technology, either current or imminent. To make matters worse, some countries are committing energy self-harm by closing down large swathes of their nuclear fleets. Germany shut three of its remaining nukes in December, depriving itself of 4.2GW of zero-carbon baseload electricity (roughly 2% of all its generating capacity). All three plants were relatively youthful, dating from the mid-1980s, and could easily have last another 20 years or more. The country's last three remaining nukes will be closed this year. It would be wrong to blame Olaf Scholz because it was Angela Merkel who took these decisions in the wake of Fukushima in 2011. At the same time it would be fantastical to think that Germany's new "traffic-light" coalition government would overrule the closure plan. The Greens have always been anti-nuclear (as well as anti-fossil fuels). Over the border in France the government is hamstrung by the Green Growth Act (2015), which legally enshrines a reduction in nuclear capacity to 50% of total generation by 2025. (In 2020 France's nukes produced 71% of the country's electricity.)

And did somebody mention Russia? The geopolitical brinkmanship over Ukraine – set against mysterious interruptions in Gazprom's supply of gas to Western Europe – has been the immediate cause of the recent vertiginous rises in gas prices. Just before Christmas benchmark

Dutch TTF gas futures contract hit all-time highs, equivalent to eight times the price a year earlier. LNG deliveries to Europe – mostly from the happy frackers of the US – have since taken the edge off prices. But any relief may be temporary. Gas storage levels across Europe are well below historic averages. Even the UK is not immune. If President Macron faces a choice between, say, keeping the lights on in France or honouring contracts to deliver electricity via the cross-Channel inter-connectors, which way will he jump?

Another piece of the West's energy puzzle lies far away in China. As recent research from Gavekal has reminded us, the great disinflationary boom of the last 30 years was literally fuelled by a huge rise in coal consumption in China (where coal still accounts for almost two-thirds of electricity generation). Put another way, the degradation of China's environment has been part of the price for the West's economic growth. If (or rather when) China becomes serious about cutting its carbon emissions, the effect will be to remove this source of global disinflation (at the very least). More probably it will stoke underlying inflationary forces across the world. In any case, China is no longer interested in meeting every economic slowdown with excess capital spending. As we discussed last time, the supply of labour in China is in secular decline. The government's priorities now lie elsewhere – and include weaning the rest of Asia off the US dollar and maintaining a relatively strong currency (two sides of the same coin). All of this is likely to prove inflationary at the margin for the rest of the world.

In sum, we see the world's march toward uncosted zero-carbon targets as distinctly inflationary. In a more constructive vein, we also think that investors can profit from this long-term trend by buying into the large and liquid market for carbon emission allowances. Far and away the most developed such market is in Europe, where EUAs (European Union Allowances) came into being in the wake of the 1997 Kyoto protocol. In effect, the EU caps the amount of CO^2 that can be emitted by companies covered by the scheme (that together account for about half of EU GDP). A fixed number of EUAs is issued annually, but declines each year. Under the existing (Phase 4) regime, EUA issuance reduces by 2.2% p.a. But the EU's latest "Fit For 55" plan, which aims to cut carbon emissions by 55% by 2030, will double the rate of shrinkage to 4.4% p.a. – and it will also bring new carbon-emitting industries into the net, such as agriculture. National legislatures have yet to approve the plan; but, assuming they do, the measures will take effect next year.

In sum, the EU's system creates a structural imbalance between the supply and demand for EUAs. Too good to be true as an investment? The most obvious risk lies in the reliance on EU regulation – which, like all regulation, is prey to political whims. Still, investors can form their own view on how likely the EU is to back down from its longstanding carbon-reduction strategy. As it is, the market price of EUAs shows low correlation (20-30%) with equities and no correlation at all with bonds. We see them as a potentially useful asset for investors who want to hedge inflation risk, but who already own as much gold as they feel comfortable with. EUAs also come with the added – and underplayed – attraction of hedging out carbon emissions from a regular investment portfolio: each EUA acquired by a financial investor is one less available to industrial buyers. We have added an initial 2% position in EUAs to the Model Portfolio.

Inflation and its associates are not the only risks confronting investors in 2022. Far from it. Nevertheless, surveys of investors' attitudes in late 2021 suggest that the consensus remains robustly optimistic, even while acknowledging that a new cycle of monetary tightening has probably begun. Equities are still heavily favoured over bonds, although there seems to be no agreement on which regions' equities offer the best prospects. Almost no one foresees recession in 2022. Given the scope for policy mistakes by central banks (and the political clowns who rule over us), this is a bit of a surprise.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	15	16.7
International Equities	50	47.0
Fixed Income	11	20.4
Alternatives	15	9.7
Commercial Property	2	0.3
Cash	7	5.9
Total	**100**	**100**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**15**	**0**	
UK	VUKE LN	8	0	0.09
UK	VMID LN	7	0	0.10
International Equities		**50**	**-1**	
US	VUSA LN	14	0	0.07
	XDPG LN	10	0	0.09
Euro	VERX LN	4	0	0.12
	EGRG LN	3	0	0.29
Japan	VJPN LN	5	0	0.19
Asia	VAPX LN	6	0	0.22
China	IASH LN	4	0	0.40
Emerging Markets ex China	VFEM LN	4	-1	0.25
Fixed Income		**11**	**0**	
Government Bonds				
Inflation Linked	INXG LN	4	0	0.25
Inflation Linked	TIP5 LN	2	0	0.1
China	CNYB NA	3	0	0.35
Corporate Bonds				
US	CORP LN	2	0	0.20
Alternatives		**15**	**1**	
Gold	PHAU LN	5	0	0.39
Commodities	BCCU LN	3	0	0.35
Infrastructure	INFR LN	2	-1	0.65
Water	IH20 LN	3	0	0.65
Carbon Allowances	CARB LN	2	2	0.35
Commercial Property		**2**	**0**	
Global	IWDP LN	2	0	0.59
Cash	GBP	**7**	**0**	
Total		100		**0.20%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2021	12.9%	11.4%	1.5%
Since inception(1/1/2015)	84.6%	74.0%	10.6%
CAGR	8.0%	7.2%	0.8%

The value of your investments can fall as well as rise, and you may not get back all the money you invested.