COURTVILLE PARTNERS

Courtville Partners – Investment Outlook, April 2022

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

- So much for transitory. Inflation is by now deeply embedded; and central banks are behind the curve.
- Stagflation looms, particularly in Europe.
- China is complicated. Chinese equities look interesting, but are not without risk.
- Value has been outperforming growth for the last six months; and we expect this trend to continue for the rest of this year.
- 2022 is likely to remain a volatile year for risk assets. Stay defensive.

Two years have passed since we argued that "it is hard to see how we will now escape a resurgence of inflation"; and, as regular readers know, we have returned often to the nightmare of the reawakened inflation dragon, whose fiery breath is now plain to see. In the interim, we adjusted our portfolios to confront the risks, mainly by boosting exposure to inflation-linked bonds, commodities (including gold) and, more recently, carbon allowances. We never fell for the central banks' party-line that inflationary pressures were "transitory". But now investors have had to face a new exogenous shock; and the one certainty about wars is that they are inflationary. To compound this particular war's impact on price levels, Russia has long supplied Europe with much of its natural gas (and to a lesser extent oil derivatives) – and indeed continues to do so at the rate of about €1bn/day. Moreover, both Russia and Ukraine are huge net suppliers of foodstuffs (including wheat, barley, rapeseed oil, sunflower oil) to world markets, not least in the developing world. Pestilence, War, Famine, Death.

Even if hostilities end soon, the damage to commodity supply chains will not be repaired quickly. So it is hard to see how or why prices (oil, gas, wheat, etc.) might return to the *status quo ante* in the near future. Re-opening German nukes, let alone building new ones; fracking for gas, even assuming the eco-lobby can be overcome; replacing oil and gas with hydrogen; turning fusion into a practical power-generating reality... Each of these options falls somewhere between difficult and almost impossible; and the timescales would be measured in years. It is interesting to note, then, that crude oil futures currently show a smooth "glidepath" down to \$90/barrel by the end of this year, followed by continued and steady decline to \$70-ish by mid-2026. Scope for disappointment? Definitely.

Conventional economic wisdom argues that inflation becomes a serious threat once higher prices are transmitted to wages, resulting in the classic price/wage spiral. Such was the pattern in early 1970s Britain: wage indexation under the Heath government (1970-74) created the transmission mechanism, which was then turbocharged by cost-push inflation from 1973's oil shock. Inflation peaked two years later at 25% p.a., but was still running at 20% or so when Margaret Thatcher came to power in 1979. In a recent interview, Professor Patrick Minford, who was one of Mrs Thatcher's economic *consiglieri*, argued that the Bank of England was unable to bring inflation under control in the mid-1970s because it lacked the one quality required, namely credibility with markets.

Is 2022 a re-run of 1973? Are we in for the most horrific golden anniversary next year? Interestingly, Professor Minford reckons that this time will be different because major central banks *do* enjoy credibility with markets by virtue of three decades of successful inflation-suppression. After a couple of years of listening to "transitory" fairy-tales, we are less sure. On the other hand, we agree wholeheartedly with him that higher interest rates should finally slay the zero-interest-rate zombie that has stalked economies for the last dozen years. Governments must, however, counterbalance tighter money with looser fiscal policy. If not, rate rises will cause economies to slump, triggering more QE/money-printing – and the eventual Japanification of the West. Though not alone, UK fiscal policy is definitely going in the wrong direction.

In the Eurozone a nasty cocktail of rocketing commodity prices and depressed disposable incomes, combined with higher interest rates to force the inflation genie back into the bottle, suggests that the main danger from here is stagflation (i.e. high inflation and low growth à la 1970s). European equities are down 9% so far this year, even after a sizeable bounce. Yet for now the European Central Bank has ruled out further monetary stimulus. Instead, its asset-buying programme will still end early; and interest rates are set to rise in 2Q22. The Bank's view may change, of course, if macroeconomic indicators start flashing red.

Meanwhile the US stock market has so far proved relatively resilient: the broad S&P500 Index is down just 4.5% year-to-date and the technology-heavy NASDAQ is only down 9% after its late-March rally. Within these aggregates, so-called value stocks have continued to do better than growth-oriented stocks. This trend has been visible since 4Q21, i.e. well before war broke out, and represents a logical response by investors to the threat of higher interest rates. Value stocks typically behave as "short-duration" investments – that is, proportionally less of their value (expressed as the net present value of future cash flows) derives from the terminal value, which in turn makes their present value less vulnerable to a higher discount rate. (The opposite applies to growth stocks, of course – aka "long-duration" stocks.)

Our hunch is that value will go on outperforming growth in the US because the Federal Reserve has the necessary leeway to stick to its newly hawkish plans to put up interest rates at regular intervals for the rest of the year. America's near-self-sufficiency in energy immunises its *overall* economy against higher oil prices, while the economics of fracking become viable again (at roughly $100/barrel). Against this background, we have reduced our Model Portfolio's holdings in Europe by 3% and have added a new 4% holding in the iShares US Value ETF (IUVD LN) to beef up exposure to value stocks.

What about China? It's complicated. It really is. Using the standard definition, China's stock market is deep in bear market territory, having fallen 15% this year and a whopping 23% from its March 2021 peak. The two main country-specific causes have been, first, the government's tighter regulation of several sectors of the economy (above all property development and internet companies) and, second, the dogged pursuit of a zero-Covid policy in defiance of all best practice. But the property runes are now looking more encouraging. Sales seem to be recovering; and credit growth is still likely to pick up as the year wears on. We find it harder to be optimistic about Covid in China. The mega-cities of Shenzhen and Shanghai have both been locked down in response to "surges" in Covid cases that by Western standards look like rounding errors. These lockdowns once again threaten global supply chains, not to mention putting further upward pressure on shipping costs. That said, there are indications that Chinese companies – and ports in particular – have learned practical lessons from last year and may well adapt better to Covid restrictions this time.

Other macroeconomic factors weight in China's favour: consumer price inflation is relatively subdued, which should allow the central bank to press on with its plans to reduce interest rates; and the economy's exposure to the global energy price spike is mitigated both by being able to fall back on coal *pro tem* and by the opportunity to buy Russian oil at a discount (even in RMB, not US dollars). In sum, Chinese equities at current levels have quite a few things going for them. But we acknowledge that international investors are likely to remain nervous until they can be sure that Beijing is not going to give material or military aid to Moscow. (Our best guess – and it is no more than that – is that China will not risk isolation from its valuable Western export markets for the sake of an alliance with an unstable Putin, notwithstanding any shared antipathy towards the US.)

One subject that may have cropped up in telephone calls between Messrs Xi and Putin is the Biden Administration's decision to freeze Russia's dollar-denominated foreign reserves. By doing so, the US effectively weaponised the dollar – and may come to regret doing so. What is the point of having reserves if you can't get at them when the proverbial hits the you-know-what? Everyone from governments to oligarchs to Saudi princes will be pondering the implications. China's vested interest is bigger than most by dint of holding more than half its foreign reserves in US treasury bonds, the intrinsic attractions of which are not obvious at real yields of -5%. It is no surprise that the yellow metal is back in favour: gold has risen 6% so far this year.

Staying with the broad theme of re-thinks, war in Ukraine may yet usher in seismic change in European energy policy, above all in Germany. When we added EU Carbon Allowances to the Model Portfolio last quarter, we understood that price volatility might be the companion of non-correlation; and so it has proved. The underlying EUA price began 2022 at €80, quickly rose to €96, collapsed to €60 on the outbreak of war – and now stands at €80 again. When someone like Robert Habeck, co-leader of the Greens and Minister for Economics & Climate Action, says there should be "no taboos" in his country's efforts of wean itself off Russian gas, you know you are living in strange times. For several years at least this will inevitably mean greater reliance than planned on fossil-fuel generation. Other things being equal, this ought to underpin the price of EUAs.

The first quarter of 2022 gave investors another roller-coaster ride. Global equities were down 13% at their nadir, but rallied to finish the period just 5.5% lower. By contrast, the performance of global bonds went from bad to worse as the quarter unfolded; and the Barclays Global Bond Index ended down 6%. Arguably the corollary of bond weakness was the 6% rise in the price of gold. When governments' promises are increasingly debauched, why wouldn't incorruptible assets become more valuable? Perhaps the biggest surprise was the US dollar's strong showing, up 3% over the three months. Flight to quality in time of war? Whatever the reason, it goes against the grain of US money supply that in February was still expanding at 24% year-on-year.

Uncertainty is all around us. Markets feel fragile, probably bonds more so than equities. Most equity markets, though, sit at levels well above the bear market definition of 20% below peak. It seems reasonable to assume that worse may lie ahead, not least because none of the historically observable conditions for ending a bear market apply: central banks are not flooding the system with liquidity (the reverse, in fact); neither oil prices nor US long bond yields have collapsed; and valuations on the whole are not yet compelling. But trying to get the timing right is a fool's errand. So our best advice is to remain invested, maintain a defensive tilt and keep some cash in reserve with which to profit from lower prices.

Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	13	14.7
International Equities	50	46.3
Fixed Income	11	21.3
Alternatives	15	10.1
Commercial Property	2	0.2
Cash	9	7.4
Total	**100**	**100.0**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**13**	**-2**	
UK	VUKE LN	7	-1	0.09
UK	VMID LN	6	-1	0.10
International Equities		**50**	**0**	
US	VUSA LN	14	0	0.07
	XDPG LN	10	0	0.09
	IUVD LN	4	4	0.20
Euro	VERX LN	2	-2	0.12
	EGRG LN	2	-1	0.29
Japan	VJPN LN	5	0	0.19
Asia	VAPX LN	5	-1	0.22
China	IASH LN	4	0	0.40
Emerging Markets ex China	VFEM LN	4	0	0.25
Fixed Income		**11**	**0**	
Government Bonds				
Inflation Linked	INXG LN	4	0	0.25
Inflation Linked	TIP5 LN	2	0	0.10
China	CNYB NA	3	0	0.35
Corporate Bonds				
US	CORP LN	2	0	0.20
Alternatives		**15**	**0**	
Gold	PHAU LN	5	0	0.39
Commodities	BCCU LN	3	0	0.35
Infrastructure	INFR LN	2	0	0.65
Water	IH20 LN	3	0	0.65
Carbon Allowances	CARB LN	2	0	0.35
Commercial Property		**2**	**0**	
Global	IWDP LN	2	0	0.59
Cash	GBP	**9**	**2**	
Total		**100**		**0.20%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2022	-1.8%	-2.6%	0.8%
Since inception(1/1/2015)	82.5%	70.3%	12.2%
CAGR	7.5%	6.6%	0.9%

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