COURTVILLE PARTNERS

Courtville Partners – Investment Outlook, July 2022

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

- Things will probably get worse before they get better – but investors should hold their nerve, which means staying invested.
- Russia has retaliated by weaponising energy, which makes for an especially bleak outlook for Europe.
- We have further reduced equity weightings in Europe & the UK and increased the US. We are still overweight Asian equities.
- Central banks are at last taking action to tame inflation; but they may find it harder than they (or investors) hope.
- As protection against recession risk, we have increased our exposure to fixed income for the first time in years (though we remain underweight). We have also increased cash.

Are we nearly there yet? This has been a miserable year so far for investors, who have seen global equities and bonds tumble 20% and 14%, respectively. Is the end of this bear market in sight? The past is famously not a guide to the future; but, with that caveat, history suggests there may be some way to go until stock markets in particular get their mojo back. Wall Street's 15 bear markets since 1926 (i.e. peak-to-trough falls of at least 20%) saw median declines of 34% over an average period of 17 months. So far in this cycle the broad S&P 500 index has shed 20% – and has taken only six months to do so. For now, the usual heralds of a stock market turnaround – aggressive interest rate cuts, collapsing energy prices, a tumbling US dollar or bargain-basement value – are all notable by their absence.

The snag, of course, is that no one – and certainly neither of us – can predict the future returns from markets. Devoid of this superpower, investors serve their own best interests by taking as long a view as they can of risk assets, uncomfortable as it may be during periods of economic and geopolitical mayhem. Asset prices will eventually correct; and the ownership of claims on real assets (aka equities) offers the best route to long-term growth in wealth. This is especially true now that our longstanding warnings on inflation have been borne out.

We identified the threat of much higher inflation over two years ago. A dozen years of ultra-easy money was always likely to end this way. But the harebrained global groupthink that put whole economies into suspended animation in March 2020 sealed the deal. The world's supply-chain was thrown off its axis, where it remains; and governments redoubled their money-printing addiction. Back then, not many foresaw that a conflict that had been smouldering in Eastern Ukraine since 2014 would reignite and in the process turbocharge those pre-existing inflationary pressures, above all via energy prices. And this is where it gets serious for asset allocation because, as independent research house Gavekal regularly reminds us, at a basic level economies are simply energy transformed – and 84% of the world's primary energy comes from hydrocarbons.

Vast swathes of the world are more or less self-sufficient in energy, including North and South America, much of Africa and the Middle East. Many Asian economies are not, but neither do they share the Western "narrative" on Ukraine, let alone support sanctions against Russia. Wearing self-interest as a badge of pride, China and India have seen an opportunity to buy discounted Russian oil – and are even being allowed to pay in their own currency, not US dollars. What about Europe, the continental poster child of Net Zero? The EU's pledge to cut carbon emissions by 55% by 2030 wilfully ignores the technological impossibilities. As an economic and social policy, it amounts to slow-motion suicide. But Europe's renunciation of Russian oil and (in due course) gas

inflicts self-harm that is distressingly immediate. From the narrow perspective of the Russian government, the decision to weaponise energy was a logical response to the US government's weaponisation of the dollar (when it froze Russia's dollar-denominated foreign exchange reserves). Yet the economic consequences of this geopolitical tit-for-tat are marginal for resource-rich America. For Europe, by contrast, they are life-changing.

What choices will European leaders have once winter sets it? There are probably three, none of them good: ration energy – or impose "climate lockdowns" – or reach a humiliating deal with Russia. Of the three, political leaders may see locking up their citizens once again as the least bad option. And that is the true measure of how desperate the situation is.

As if this wasn't enough, the Eurozone once again faces the threat of a full-blown euro crisis. With inflation roaring away, the European Central Bank might *like* to raise interest rates in textbook fashion, but knows that to do so risks bankrupting Italy, among other countries. Yet if it doesn't put up rates, the single currency may simply fall apart. When Mario Draghi said 10 years ago that the ECB would do "whatever it takes" to preserve the euro, he wasn't prepared to admit publicly that what it would take – in the end – would be Germans paying for Mediterranean Europe's pensions, i.e. unadulterated fiscal union. But that is what it has always meant. It is merely ironic that Draghi in his current role as Italian PM finds himself the beneficiary of his own 2012 promise – as if he had run round to appear in the panoramic political photograph at both ends.

In asset allocation terms, the result of all this is to make Europe almost uninvestible; and we have reduced further our already underweight position in the region. More broadly, however, Europe's agony is evidence of a growing separation between developed markets (DMs) and emerging markets (EMs) – a separation already traced by the outperformance of EM over DM assets at this time of the cycle. Such underperformance has been surprising, but is not an accident. DMs have started to display the sort of quixotic policy behaviour usually associated with EMs (e.g. the *de facto* confiscation of Russian citizens' assets). For a quarter of a century DM governments have relied on recycled EM savings to fund their current account deficits. But moving the property-rights goalposts, for example, is bound to make EM-based investors think twice about owning DM assets – whether that is governments recycling US dollar savings into US treasury bonds or oligarchs buying houses in Mayfair.

And the timing is not good for DMs. Even before lockdowns, levels of government debt were in some cases already nudging post-War highs and are now heading into the stratosphere. Meanwhile, most of the oil and gas needed to power DM economies still sits in EM territory. And if solar, wind and batteries look like the answer (leaving aside inconvenient back-up generation costs), bear in mind that China is home to a large proportion of the world's rare earths. How about nuclear instead? Half the world's uranium enrichment is done by Russia's Rosatom (which is why you are unlikely to hear Western politicians proposing sanctions on the Russian nuclear industry). In sum, swapping oil for electricity may exchange one geopolitical dependency for another.

The ECB may be skewered on the horns of its rate-setting dilemma. But other central bankers are showing more appetite for the fight against inflation, starting with the US Federal Reserve. Last month's 0.75% hike to 1.75% was unexpectedly aggressive. Indeed, the Fed's aggression is now stoking fears of an imminent US recession. Liquidity is certainly drying up: money supply growth has plunged from 18% YoY in April to a little over 2% over the last quarter. In fact, the weakness of US markets can be seen as the almost mechanical effect of the Fed turning off the money tap (or cutting down the magic money tree if you prefer). Perhaps the Fed reckons it is in a race to raise rates as much as it can in the time remaining (before recession arrives) so that it then has enough room to *cut* rates once the economy needs baling out. Whether that is the case or not, the

Fed's apparent determination to impress its inflation-fighting credentials on investors ("to get ahead of the curve," in market slang) persuades us to add a little to our US equity exposure.

Widening interest rate differentials have fuelled a stunning 10% appreciation of the dollar against its basket so far this year. Can it last? In the short term, it is hard to see either the euro or sterling bouncing back. Sterling may be re-testing its post-Brexit lows; but multiple factors keep us gloomy on its prospects (yawning trade & current account deficits, structurally higher inflation, poor productivity growth, weak government – and so on). The yen is trickier. Investors are itching to call time on the Bank of Japan's artificial control of government bond yields, a side-effect of which has been a 20% fall in the value of the yen against the dollar in nine months. We have no idea whether the BoJ will finally crack and raise rates. If it does, foreign investors will make money on the currency; and if it doesn't Japan Inc. will still benefit from a heavily undervalued currency.

Faced with a bewildering array of threats and uncertainty, how should investors conduct themselves?

- First of all – and we cannot say it often enough – staying invested (within tactical reason) is crucial to extracting the benefits of compounding and thus generating decent long-run returns. The corollary of this is that attempting to time markets is at best guesswork and at worst damages the compounding engine.
- Second, the steep rise in bond yields, albeit from the lowest of bases, makes certain types of fixed rate bonds worth buying – which is not something we have said for many years. Within our Model Portfolio, we have taken profits in inflation-linked bonds (both dollar & sterling) and have extended the duration of what remains. In their place, we have added some medium-term fixed rate US treasuries and UK gilts.
- Third, owning commodities has paid dividends so far this year. But their near-term merits are waning as interest rate hikes threaten to usher in recession; and we have trimmed our exposure for now.
- Fourth – and on a more strategic note – the DM/EM split that we referred to above is a reminder that *in the long term* investors should be prepared to skew their portfolios away from Europe and towards Asia, where they stand a better chance of finding growth, low (or at least lower) government debt levels and sound(er) monetary policy.
- Fifth – and somewhat counterintuitively – when the world last faced an inflation firestorm in the 1970s, cash proved to be one of the most defensive assets, but only if handled with care. In practice, that meant investing cash balances in a variety of short-term instruments – and holding cash, if possible, in the "hard" currencies of countries with structurally low inflation. In other words, we don't expect the dollar's strength to last. The consequences of severe fiscal incontinence and a record current account deficit will make themselves felt on the US currency sooner or later.

Whether born of conviction or wishful thinking, a fashion has recently emerged to call the top for inflation. We aren't tempted to join in yet. We would point to at least two reasons. First, many economies, including the US, are experiencing acute labour shortages, which in turn are helping to propel wages higher. Second, China is reopening. Once its economy is running at full steam again, the demand for raw materials, including oil, will give another shove to prices worldwide. One obvious, but important, caveat: a ceasefire in Ukraine has the potential to bring about a material change in the inflation weather. For the time being, however, we think it would be premature to put too much investment faith in the Fed getting ahead of the curve (to use the slang). In fact, the Fed may take longer than investors think to put the inflation genie back in the lamp. With economic growth weakening, the US therefore risks a period of stagflation, i.e. a nasty combination of rising prices and stagnant or even contracting GDP.

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Asset Classes	Courtville Partners Asset Allocation (%)	FTSE PI Balanced Index (%)
UK Equities	12	14.7
International Equities	49	46.3
Fixed Income	13	21.3
Alternatives	13	10.1
Commercial Property	1	0.2
Cash	12	7.4
Total	**100**	**100.0**

Courtville Partners Model Portfolio	ETF	Weight (%)	Changes this quarter	Weighted OMC (%)
UK Equities		**12**	**-1**	
UK	VUKE LN	8	1	0.09
UK	VMID LN	4	-2	0.10
International Equities		**49**	**-1**	
US	VUSA LN	16	2	0.07
	XDPG LN	11	1	0.09
	IUVD LN	3	-1	0.20
Euro	VERX LN	1	-1	0.12
	EGRG LN	2	0	0.29
Japan	VJPN LN	4	-1	0.19
Asia	VAPX LN	4	-1	0.22
China	IASH LN	4	0	0.40
Emerging Markets ex China	VFEM LN	4	0	0.25
Fixed Income		**13**	**2**	
Government Bonds				
Inflation Linked	INXG LN	2	-2	0.25
Inflation Linked	TIP5 LN	0	-2	0.10
Inflation Linked	IDTP LN	2	2	0.07
UK	IGLT LN	2	2	0.07
US	IDTM LN	5	5	0.17
China	CNYB NA	2	-1	0.35
Corporate Bonds				
US	CORP LN	0	-2	0.20
Alternatives		**13**	**-2**	
Gold	PHAU LN	5	0	0.39
Commodities	BCCU LN	1	-2	0.35
Commodities	NRGW LN	1	1	0.30
Infrastructure	INFR LN	2	0	0.65
Water	IH20 LN	2	-1	0.65
Carbon Allowances	CARB LN	2	0	0.35
Commercial Property		**1**	**-1**	
Global	IWDP LN	1	-1	0.59
Cash	GBP	**12**	**3**	
Total		**100**		**0.18%**

Courtville Partners	Model Portfolio	FTSE PI Balanced Index	Relative performance
2022	-7.3%	-7.7%	0.4%
Since inception(1/1/2015)	72.8%	60.6%	12.2%
CAGR	6.6%	5.8%	0.8%

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