Bulletin

KMG CHARTERED FINANCIAL PLANNERS
SERIOUS ABOUT WEALTH

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Politicians, bankers, stagflation and how we see the world going forward

By **Patrick McIntosh**
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To clarify, stagflation is likely to mean a period where prices increase more rapidly than investment returns and in the case of cash on deposit this is likely to be a very wide margin. However, we hope your investment portfolio will outperform cash and we also hope it will keep reasonable pace with inflation.

In considering the most appropriate investment strategy to cope with stagflation it is important to understand some key players in the global game of economic evolution. We must not lose sight of the reality that in the long run the global economy will continue to expand, and notwithstanding some enormous local ghastly human hardship and tragedy, the outcome of the current challenges are likely to be positive. Even in recession profits are still made and investment returns achieved; it's just a case of making sure that we have a reasonable exposure to the most likely investments which will support humanity through a very challenging period.

In moving some of the portfolio to cash in January ahead of the Ukraine crisis and then beginning to deploy that cash towards value stocks that benefit in recession as human consumption concentrates on the absolute essentials of life, so therefore we have performed relatively well against many major fund managers and global indices. But we readily accept that we are behind the UK market in the short term even though we continue to outperform the market over three years and beyond.

So, how do we view the next 18 months?

In the matter of politicians, we are being dominated by autocratic leaders in Russia, China and even to some extent in Europe - especially in Turkey and Hungary. India too has moved in the same direction and if Trump was still in power America would be a much more complicated place.

Here are some key dilemmas for global autocratic leaders in addition, of course, to the fact that they don't live forever. They have to face many very challenging problems, and as George Orwell observed in the book 1984: "Who controls the past controls the future: who controls the present controls the past."

Autocratic leaders would not survive if they were not able to sell an unreliable narrative to a significant and gullible population of poorly educated and less well-off individuals, so in America 30%-40% of the population believe in the Trump Theory of Life. In Russia, as I experienced when cycling from one end of the country to the other in 2019, huge swathes of the population absolutely believe in everything and anything Putin does, says and advises them to do.

In Turkey we see the same as we do in Hungary and India. The only thing that liberal open democracies can do is to play a waiting game whilst slowly and necessarily unfrocking their masks of delusional idealism.

One of the problems Putin has, whether he likes it or not, is that the birth rate is deteriorating even more rapidly through the Covid crisis, and the Ukraine war on top of this is another massive brain drain. You may recall my observations when I came back from Russia that part of the dilemma for Russia has been the massive brain drain that has occurred since the Revolution through the First and Second World wars, Stalin and the subsequent desperate management of the USSR until it finally collapsed.

What Putin did not anticipate was the resilience of Ukraine, the fact that his armed services were not nearly as strong as he thought nor that he would now be suffering from massive cyber war attacks which in turn are leading to challenges across his entire industrial base.

In looking at China, Xi has many of the same problems; one of which seems to have passed him by, which is a lack of microchip development and an enormous reliance upon Western technology to support his industry and development. China simply hasn't got the knowledge and sophistication in chip technology it needs.

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World going forward continued...

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China also has enormous problems with population distortion because of the one child policy and the autocratic way in which they are trying to control Covid as a consequence of poor vaccine management and rollout. These in turn are leading to significant population challenges, especially in Shanghai, and one has to wonder how long it may be before there is a significant change in policy.

What is also striking in China is the dilemma they are now faced with regarding Taiwan. It now becomes much more challenging for China to carry through the threat of integrating the two countries without unbelievable hardship. The dilemma, of course, is that the main prize for the Chinese is that the Taiwanese have the jewel in the crown as the world's leading chip manufacturer.

Europe is likely to benefit from the vast migration of population from Ukraine in helping to offset some of the birth-rate decline, and is also likely to benefit from better qualified people paying taxes and thus expanding the European economy at the expense of both Ukraine and Russia. I don't think Putin has thought this through at all.

Profit And Loss

It is important to remember one basic human flaw in many of us which is that we will happily sell a small profit, but will hang on to any amount of loss in the hope that it can only get better; of course it rarely does. The discipline of getting out when things are going wrong is unbelievably difficult for humans to accept. The observation that the short-term pain when an investment goes wrong can become a long-term strategic investment is pretty much where Putin has got himself stuck in Ukraine. The more rational humans in Russia have got to find a face-saving way of resolving the problem, and that's not going to happen any time soon!

So, our conclusion at this time is that the longer the population migration goes on the more likely it is that the population will stay where it's migrated and benefit Europe despite the costs, and the faster will be the decarbonisation of the global economy.

If politicians and bankers can keep a reasonable grip on fiscal and monetary policy, then we will probably get used to the idea of higher inflation and slowly rising interest rates.

Energy prices will stabilise but won't come down, wages will increase to meet the cost of living but over time and in the meantime we will all spend less and hope for better times to come.

Yes, there is going to be massive food poverty, energy poverty and probably some significant social dislocation.

The problem the bankers have is that almost all their economic models are based upon theories that were devised before the evolution of mass data, and therefore they are managing human psychology from a primitive and out of date set of ill-defined economic theories. We all have to go along with these theories, as do the politicians, until eventually human behaviour will overwhelm the theories and a new orthodox of evolution will occur.

As we have commented in the past, change happens more and more rapidly and we believe that this current change, which will be seismic, is likely to pass through the system relatively quickly ie in the next 18 months. If we hold on to our principles and thematic strategies, we believe we will come out of this on the right side of positive and in a very strong position to benefit from a changed global economic, environmental and societal position.

Finally, there is much positive evidence of the following:

Onshoring (the return of industry to its home country both here and across the world) is happening because transportation costs have risen, border controls have become frustrating and technology is enabling more to be done locally at a reasonable price.

The great resignation particularly in the 50 to 60 year old age bracket continues a-pace. This is a great loss to the global economy and in particular in the UK, but as we adapt to mechanisation and computerisation so too will the global economy move again in a positive direction.

The world will automatically start to waste less food as it becomes scarce and unaffordable. The same is true of energy.

Higher prices automatically drive human ingenuity. When the price is right alternative transport for example by electric vehicle or food grown at home, and manufacturing locally rather than at distance become justifiable. In turn wages increase because the profit margins and prices can justify employing people at a reasonable wage rather than slave labour in underdeveloped markets; this in turn drives underdeveloped markets to support themselves and improve their homegrown economies - which ultimately benefit the whole world.

We will be adjusting the portfolio yet again in recognition of these themes and to build upon the strategy which we think will ultimately prove rewarding for us all, even if there are some depressing periods of negative performance in the short term.

Where next?

By **Nick Matthews**
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If Patrick has outlined the macro-level considerations and thoughts on how KMG is looking forward and the themes and trends that we believe we will see ahead, not in the weeks or even months but over the years, then here we are looking to keep you all equally well informed about how this plays out in terms of how we invest your money.

We are at a crunch point, with the immediate pressure from inflation being the predominant worry this year; inflation that comes from what is happening due to the war, the widespread closure of factories and transport in China, energy and food prices right through to higher wages. Inflation is the issue of the moment and although we look to the future and see benefits from high levels of investment, efficiency, less waste and so on that will provide future benefits, clearly we cannot ignore the present either.

It looks as though inflation will persist through the year and into 2023, stagflation perhaps, and higher interest rates to counter it and so over the current period we have been reallocating money to three main areas that are better able to cope:

1. Defensive, income generating companies – in a World where growth in the price of shares is likely to be lower than we have seen over the past 10 years or so, companies that can continue to throw out regular and sustainable income become more attractive.

2. Lower priced, more traditional companies – if the past decade has been the environment for high flying tech stocks, with enormous growth in the likes of Amazon, Tesla and Google, the collapse in the price of Netflix and Peloton has shown that they are just as vulnerable when conditions change. Again, it makes the more boring, consumer-led stocks more attractive and stable. So, we have been moving in that direction as well.

3. Real assets – and I include commodities and investment in infrastructure within this remit as well as bricks and mortar. If we are to see higher inflation for some time then assets that have income linked to inflation or that will typically benefit (as we are seeing with oil, gas, metals and so forth) are relatively more attractive than companies where profits need ongoing consumer spending to thrive.

As a result we have and continue to shift the focus towards these ideas, but overall we maintain our broadly diversified approach rather than betting heavily in one direction or the other. We maintain direction in the themes we have spoken about over recent years, including energy transition, healthcare and so on.

On the other side, as we look for a degree of stability

in an environment where leading markets are between 15-20% down from the close of last year (and the Chinese market closer to 50%), we are generally keeping the level of cash in the portfolio higher than would typically be our intention, whether to take advantage of opportunities in the future or to make sure that you have funds available should you need them without having to sell assets when times are tough.

Finally, we continue to be less than impressed with the opportunity fixed income or bonds offer. Why would someone want an income yield of less than 1% or 2% when the inflation rate is almost double digit? Therefore, although a modicum remain, we are keeping these to a minimum until opportunities present themselves again, when they have reached equilibrium and perhaps that will be sooner than many think. Markets, and this applies to the wider market not just fixed income, are based upon future speculation and with that comes wild swings in sentiment of both optimism and fear. The pendulum has swung quite dramatically already for obvious reasons and will take time to reset, just as it has many times before.

We will continue to meet as an investment team and to decide on any changes to be made, and we will continue to send out these reports to keep you up to date on how the strategy is evolving and what we might expect ahead. As always, if you have any questions then please do let us know.

New Terms of Business now available on our website!

Please see the resources section

Where did everybody go?

By **Jenna Duffett**
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As Patrick touched on in his article, we have seen following COVID the great resignation where those in their 50's and 60's decided that the time had come to retire early and simply not return to work. Some having had their careers fold during the pandemic or simply due to health decided that quality of life was far more important.

Some changed careers and chose not to return to their old roles and some having held several part time jobs opted for having just one.

This is now having a huge impact on us all as the lack of people in the workforce impacts all sections of hospitality and services such as call centres. You may have noticed when you are out socialising that there is an obvious shortage of waiting staff in restaurants and service is much slower because of this. Equally when you need to call a service provider such as a utility company, there is now by default at least a 20-30 minute wait before a human answers the phone!

Will this change? It is very unlikely in the short term as we now see more job vacancies than people to fill them. We will all have to accept longer wait times as we go about our daily lives. For us at KMG this is a great frustration as providers do not have the staff to address any queries we need to raise from time to time. We hope to continue to deliver excellent service, but do bear with us as at times we are delayed by others!

Trust registrations - REMINDER

All Trusts to be registered with HMRC by 1st September 2022

KMG's seminars are back!

Wednesday 28th September 2022

From 11am at Denbies in Dorking