Rowan Dartington

Vista

ISSUE 13 / SUMMER 2021

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Robert Jukes
CHIEF INVESTMENT OFFICER

Bird on a wire

> “Owning UK assets could be seen as an asset play into stronger Sterling.”

It may not seem like it from the news flow, but the Brexit vote was more than five years ago – still a point of trauma for many, but not for the UK economy it seems. Consensus forecasts for UK growth and trade prospects are just as buoyant, perhaps more so than many European counterparts. Indeed, the UK economy stands tall amongst its developed peers. Honestly, I'm surprised. The City of London hasn't fallen apart and trade with Europe continues, albeit with more friction. There is one glaring difference, however, and that is Sterling. The currency has taken a beating, reflecting the worst of the Brexit possibilities, but unlike forecasts of our nation's prosperity, it has yet to recover. The 'Cable rate', as it is affectionately known in City circles, is roughly 20-25% below what we might call fair value.

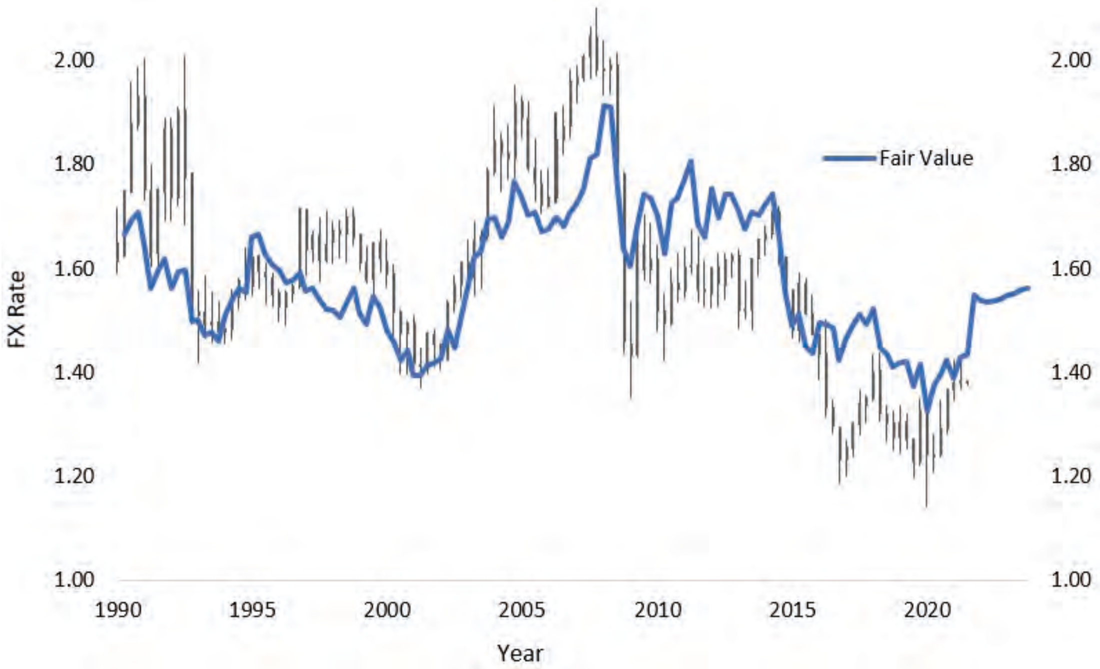
Our fair value model estimates around 20 currency pairs, or cross rates against the US dollar, based on economic fundamentals - an augmented Purchasing Power Parity (PPP) model. The PPP relationship of exchange rate determination works in theory by forcing an equalisation of prices by adjusting the respective exchange rates. The most famous PPP model is the Economist “Big Mac Index” which tracks the relative prices of burgers. In principle the same burger around the world should cost the same and differences should therefore be explained by the exchange rate. Rather than using the relative prices of burgers, our model uses CPI – the national basket of consumer prices. We are also interested to augment the PPP model with indicators that suggest relative competitiveness such as growth, unemployment, and trade. Finally, we have also tried to account for capital flows using interest rates and bond yields.

Estimating all of these factors together over 20 currencies relative to the US dollar produces some relatively intuitive results. The estimated impact of relative GDP and trade surplus drive up the currency relative to the US. The idea being that these are measures of relative economic competitiveness and the exchange rate appreciates to mitigate any misalignment to stop it becoming persistent. Higher interest rates and bond yields also tend to attract more financial capital flows, which will also drive up the value of the currency relative to the US dollar. In the opposite direction, a higher unemployment or inflation rate will drive down the value of the currency.

In the case of the UK, the economy has held up relatively well through Brexit, and is expected to continue growing at a relatively healthy clip with a relatively low unemployment rate. All these economic fundamentals point to a higher 'fair value' of the Cable rate. In the next year or two, we could see the pound rise as much as 20% against the US dollar.

While the UK stock market more closely represents the old economy, such as resources, than the more technologically advanced US equity market, owning UK assets could be seen as an asset play into stronger Sterling. Brexit cut the umbilical cord with Europe and provided the possibility of independent trade deals across the globe. The recent step forward with Australia might prove to be one of these. As Leonard Cohen once sang, “Like a drunk in a midnight choir, I have tried in my way to be free.” Well we may be stumbling into new trade agreements in our bid for freedom, but trade with our old European neighbours, continues; and, more to the point, our economic fundamentals remain sound. Expect a stronger currency to follow.

Chart is Sterling versus the US Dollar and our 'fair value' estimates in blue



Source: Refinitiv, Bloomberg, Rowan Dartington Research, July 2021

The value of an investment may fall as well as rise. You may get back less than the amount invested.

The value of investments may fall as well as rise purely on account of exchange rate fluctuations.

Past performance is not indicative of future performance.

Guy Stephens
TECHNICAL INVESTMENT DIRECTOR

Inflation: Newton's Laws of Motion

Sir Isaac Newton was credited with many things and has inspired many. Perhaps the most famous of his achievements outside of mathematics is simply stating that what goes up must come down, or that every action has an equal and opposite reaction. This applies to mechanics but is also often referred to in a similar way in the investment markets where it is called reverting to the mean or longer-term average.

It is a feature of our times that the media do not report headlines in the same symmetrical way which tends to lead to a distorted picture of negative stories relative to the positive. Rising inflation is now the top investor concern according to surveys and general feedback from market commentators, replacing a resurgence of COVID variants. It is noteworthy that we never heard or read about the benefits of plummeting inflation in the depths of the pandemic. We heard about the oil price future briefly turning negative but nowhere was this reported as a positive because it is a huge cost saving for business.

Hysterical inflationary talk spooked the bond markets in the first quarter of 2021, but they have now calmed down somewhat despite the actual reported inflation numbers exceeding previous pessimistic estimates. This is confusing some who believe there is a nasty shock to come and that the central banks have got it wrong. We have also seen comments from Andrew Bailey, Governor of the Bank of England, where he has publicly rebuked his outgoing Senior Economist, Andrew Haldane, who has speculated that we face dangerous times and that persistent inflation lies ahead. The Governor clearly disagrees and argues that the UK economy is still below its full capacity and still smaller than its pre-COVID size. Many may be inclined to agree, especially as the unlocking process is being hindered by the Delta variant and possibly future variants yet to be discovered.

Uncontrolled inflation requires an excess of rampant demand and inelastic spending regardless of price. These price rises then cause workers to demand higher wages and so you have a spiral. We can all quote examples of builders with two-year backlogs and shortages in materials supplies. However, this is a consequence of increased demand for home improvements whilst we have all been at home with excess savings to deploy, along with a renewed appetite for DIY as normal leisure pursuits have been curtailed. This will wane as we all return to pubs, restaurants, and travel, and with it any thoughts that builders may have of exploiting the demand by raising their prices. Consumers are not stupid, and they know when they are being taken for a ride – excessive prices will lead to curtailed projects for when global supply chains have recovered.

The same goes for staycation prices as UK holidays are the only option for many. A week in an Airbnb property this summer can easily cost £3,000, a ridiculous price but one that some are prepared to pay just to get away. This will be temporary as the green list expands and foreign competition returns. It is a very small part of the economy that didn't exist a few years ago.

> "We will see higher inflation numbers as the economic recovery evolves and the economy unlocks."

This is also true for second-hand car prices and the apparent inability of employers to attract workers. The former has been impacted by the disruption of the global supply chain involving semiconductors; whilst the latter is partly affected by the furlough scheme, in which hospitality employees have saved money they can now spend. They may be considering a summer at leisure, returning to work in the Autumn. Even if these employee shortages lead to wage pressure, this only affects the lowest salaries, many of which are minimum wage. This is less of an issue in the professions and skilled manufacturing industries and so wholesale demands for wage increases, outside of the NHS, are unlikely.

On balance, it is inevitable we will see higher inflation numbers as the economic recovery evolves and the economy unlocks. The rebasing of the numbers year-on-year, the recovery in the oil price and resumption of activity are guaranteed to revert to the mean or adhere to Newton's law of equal and opposite forces. Much of this is reversing the impact of COVID in 2020. Importantly, many workers didn't receive pay rises or bonuses in 2020 and those on furlough suffered a 20% pay cut. It is entirely reasonable to expect some catch-up as the economy recovers; but it should be remembered that as companies also recover, they are now much leaner, which should lead to higher profit margins. That must be positive for equities.

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Tim Cockerill

INVESTMENT DIRECTOR

Complexity and plastic bottles

ESG is changing, or so it seems to me. Only a few years back it was a novel concept, now it's big business and everybody everywhere in the industry is talking about it. I don't think there is a single investment group that does not have ESG embedded into their process and many investment groups have products covering a range of responsible investing options.

Everyone wants to talk ESG, everyone wants to tell you how their process works, how they are different, how they engage and how they are making a difference. If ESG was a political movement the leaders could stand back, view the investment world and see that their mission has been accomplished. Or has it?

Evolution of ESG

As the discussion has evolved it's become ever more evident that nothing is black and white. There is no simple solution to solving environmental and social problems. Once you start to focus on the impact a business has on the environment and society it's possible to drill down to ever-increasing depths – all companies have both positive and negative impacts and the scale of those varies considerably. But as we focus on our impact the more granular we have to become, because each and every action we take as individuals has an impact. Through companies it is multiplied. What's more, the reason we may or may not wish to invest in a company could be driven by increasingly granular concerns.

It's likely in the not-too-distant future the industry will need to engage much more with clients and ask what their environmental, social and governance values and concerns are. Historically this has been done at a high level and going back a few decades it simply centred around exclusions, such as no armaments, tobacco, alcohol etc. We all know the familiar pattern. But in many ways this approach, especially as a singular process, is archaic. I see the adoption of ESG having evolved so quickly that having it embedded into your process in no way confers on the fund an ESG quality. Indeed ESG has now reached the point where it should be in all investment processes as a matter of course, sitting alongside the fundamental analysis that the industry has done for years. Equity analysts look at metrics, p/b, EBITDA, free cash flow and the governance of business. ESG should form an explicit part of that, if a group isn't doing that now they are truly out of step.

But incorporating ESG in this way is no more than common investment sense and this is one area where the industry has moved on because only a few years ago ESG integration set you aside from your peers – this is no longer the case. Indeed, if you wish to claim ESG credentials which are more than simple integrated risk metrics then you need to define the purpose of your fund, the consequences of your process and what you are hoping to achieve.

Looking across the landscape of ESG-mandated funds there are plenty which have set their stall out with a purpose, but the approach and objectives of many funds is similar. That may not be surprising, after all the fund management industry is there to generate financial returns for clients from a universe of stocks and how you define that universe tends to be very similar to your competitors. However, it seems clear that the next stage of evolution is for funds with more clearly defined and specialist mandates. This might well prove to be a big challenge but as investors become more informed about environmental and social issues from an investment perspective the need to become more granular and to articulate your approach will become more pressing.

The plastic bottle paradox

For me an example of this can be found in the bottled water industry. In 2018, 50bn litres of bottled water were sold in the US and it's estimated that the global market for bottled water by 2025 will be $215bn USD[1]. More bottled water is sold than Pepsi, Coke and other fizzy drinks combined[1]. On the one hand we can see this as a big achievement as people seem to be drinking more bottled water than sugary drinks, (a reason to invest perhaps?) however the scientific evidence for any health benefits of bottled water is virtually nil compared with tap water. Add to this the environmental impact of plastic bottles and the nature of the industry becomes clearer.

Bottled water uses 2000x more energy than the equivalent volume of tap water[1]. It takes four litres of water to produce a single litre of purified water and over 10 litres to make the plastic bottle[1]. Then of course there are the issues with the chemicals in the plastic; bisphenol (BPA) is a chemical that has been linked to low-birth-weight babies, cancers and has been banned in numerous countries[1]. Consequently, there has been a switch away from BPA plastic in bottles, although it is by no means complete. And we also know a huge amount of plastic ends up in our oceans. Unfortunately, it seems people like the idea of recycling bottles, after all it seems obvious and there are companies out there using recycled plastics to make clothes, but in the UK only 10% of recycled bottles are made into bottles again[1]. Globally only 1/5 gets recycled[1], so 80% of plastic water bottles end up somewhere else in the environment, often it seems in the seas.

So, with no health benefits and tap water a fraction of the cost, plus the environmental damage caused by the industry, it's hard to see a justification for bottled water. Yet it is a massive industry involving many companies; so as an investor, if I wanted to avoid companies producing bottled water, how would I do this? The point of this example is not to provide an answer, indeed I don't have one, it's to illustrate the complexity that focusing on issues has. This is a path the industry has embarked on, one which I think is very good, but it does mean the industry has to broaden out its thinking considerably. The investment complexity we face with this and many other issues are enormous - nothing is black and white.

Being clear about how a fund invests and how it considers things such as plastic bottles is going to be increasingly important. A common language in the industry is going to be required to enable investors to firstly understand how a fund approaches ESG/sustainability and secondly these issues enabling clients to line-up their own values and concerns with appropriate funds. Much of the approach to-date has focused on the environment as this is more tangible, especially from an investment opportunity point of view. But if companies are to operate with a genuine social licence and genuinely acknowledge their role in society then the industry will have to consider harder to quantify issues that will need to be expressed in client portfolios. An example is gender equality and diversity: neither of these may lead an investment decision; but for clients who wish to invest in companies that lead in these areas there will need to be a means of identifying them and providing analysis back to clients. I can see in time there will be a requirement to provide granular reporting to enable clients to select funds that truly match their own values. And with the regulator likely to drive the advice piece in this direction, probably with a focus on sustainability (SFDR-based), the direction of travel is fairly well established.

In summary, ESG is evolving very quickly and for me it should be part and parcel of what fund managers do irrespective of whether they claim to have a purpose behind their ESG integration or not. At the moment, the industry provides fairly blunt tools for clients to build portfolios seeking to align with their values and concerns – addressing this is going to be a huge challenge, but a challenge that has to be faced.

[1] Tim Spector. Spoon-Fed, 2020

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Donald Maxwell-Scott

TECHNICAL INVESTMENT MANAGER

Inflating the property market

Oscar Wilde once said, “Conversation about the weather is the last refuge of the unimaginative”. While we won’t be as critical towards our fellow compatriots as the acclaimed playwright, we certainly do seem to have a reputation for talking about the very changeable conditions of the British Isles.

However, would Oscar Wilde stand by his original statement today? Or would he decide to replace the weather with our innate obsession with property, their prices, and ‘getting on the property ladder.’

Whether it’s in mainstream media, on social influencing platforms or on TV, there seems to be a continuous flow of noise around the value of property in the UK.

Politicians are also guilty of obsessing about house prices. House prices and inflation are inextricably linked, so if inflation rises, so should the value of your house. As some might be aware, the government has an inflation target which is set at 2% per year[1]. This might not sound like a lot but compounded over many years it can make a significant difference.

According to the Bank of England website, the reason inflation is good is because if it is too low, or negative, people may be put off spending because they expect prices to fall. Consequently, if everybody reduced their spending then companies could fail, which leads to job losses.

While this is partly correct, it can be assumed that the government wants people to feel richer. For those who own property, the easiest way to make them feel richer is to ensure that property prices increase. No government wants people to feel poorer throughout their term – it is a sure-fire way of not winning re-election. This is why inflation plays such an important part in the increase of property prices. As noted on the chart below, property prices have only narrowly outstripped the UK RPI measure of inflation over the last 16 years. The CPI, a more accurate measure of inflation, still shows that the majority of house price growth is down to inflation.

While we celebrate the value of our home going up, when you sell a property you often buy another in the same market, pay for care, or help your children to get on the property ladder. So, even with rising property prices it might not be as beneficial as first thought that your property has increased in value.

As for the younger generation trying to get on the property ladder, higher property prices are certainly not something to celebrate. Arguably, it is a double-edged sword, whereby those who have property get richer and those who don’t get further left behind. It might be surprising to some, but according to Statista[2] the UK has the second highest average price of city residential property in Europe, second only to Monaco.

The COVID pandemic certainly hasn’t helped. According to ONS[3], the average UK house price was £256,000 in March 2021; this is £24,000 higher than in March 2020. While many of us have carried out home improvements over lockdown, it certainly isn’t down to our DIY skills that we have seen this meteoric rise in property values. The largest factor for the rise in property prices is likely to be attributed to the Chancellor, Rishi Sunak, who introduced a stamp duty holiday due to the COVID pandemic. While well intentioned, it seemed to have the knock-on effect of increasing property prices.

There are concerns that if inflation continues rising, the Bank of England will have to raise interest rates to combat this. The current rate of inflation is 2.5%[4], so above the annual target of 2%. However, until there is sufficient evidence of a sustained recovery, the base rate is likely to remain at 0.1%. Nevertheless, at some stage interest rates will need to go up, which may have the knock-on effect on reducing property prices. The theory is that with higher interest rates consumers tend to save because returns from savings are higher. With less disposable income being spent, the economy slows, and inflation decreases.

Perhaps the real area of concern here is that with interest rates remaining so low, and with rising inflation, the ‘real’ return on cash savings remains negative. This means that savers have very little alternative but to invest in property or the stock market. Both areas have proven to be a successful hedge against inflation. Of course, if savers choose to invest in residential property as a buy-to-let landlord then this will only continue to fuel the property market. An alternative to this is to invest in property as part of a well-diversified portfolio. This may protect investors against inflation and against any fall in residential property.

In fact, it could be argued that historic logic no longer applies when using interest rates to combat inflation. Rising interest rates was the first line of defence against inflation. However, given the prolonged period of low interest rates, fewer and fewer people are saving cash and are instead choosing to invest in the stock market or property.

Inflation is currently running at 2.5% so your ‘real’ rate of return for savings accounts is -0.94% against a 1.66% savings rate. This means £10,000 invested today will only have the purchasing power of £9,906 after one year. Given that the highest savings rates lock you in commonly for a period of three to five years then, at the end of your term, while you might have more money, the purchasing power of your original £10,000 will be superior.

As interest rates have been on a steady decline since the 2008 financial crisis, a sudden rise to combat inflation might be too little too late and won’t necessarily have the same effect as it did prior to the financial crisis. More and more people have deserted traditional cash savings and invested in the stock market, either through advice-led services, or through DIY investment platforms. Those who haven’t have chosen property, which in turn has also fuelled property prices. Investing in the stock market doesn’t slow the economy or inflation; if anything, it fuels it, and that should be the real worry. Even the younger generation don’t use cash savings; they choose to use the stock market; or failing that, they choose more speculative investments like crypto currency. Who can blame them for taking higher degrees of risk? This type of investing might be risky, but if successful, then it might be the only way they are able to afford to buy a property.

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[1] Bank of England, July 2021

[2] Statista, July 2021

[3] ONS, March 2021

[4] Bank of England, July 2021

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