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[INTRODUCTION]
Sam Slator (SS): I'm Sam Slator from FundCalibre and today I've been joined by Juliet Schooling Latter and Darius McDermott, who are going to have a chat with me about what's been happening in the third quarter of this year.

[INTERVIEW]
[0:14]

SS: So, I suppose if we start, there's been a bit of a change in leadership in terms of which funds have been doing well and which haven't, and top of the pops in the last three months has been India. In fact, I think there's something like 19 of the top 20 funds have been investing in Indian equities, what's behind this?

Juliet Schooling Latter (JSL): Yes, I mean, we've been positive on India for quite some time due to various fundamentals such as its, you know, strong demographics. And as we spoke about, the Modi government being strong on reform also being positive for the economy. And one reform was the goods and services tax, and recent data has shown that the goods and services tax collection has risen quite considerably, which shows that that reform is working well. And you know, the economy is in reasonably good health.

Darius McDermott (DM): In fact they're collecting more taxes, is because, you know, they haven't locked down like we have in the West, you know, so their economy is now doing better and that, goods and services tax, is an excellent sort of marker or observation as to that actual improvement in the economy.

[1:30]

SS: And Japanese funds and financials have also done well. Why is that?

DM: So, I think there's two different reasons here. Japanese funds is political. The prime minister Suga, who took over from Abe was initially deemed popular, but his popularity just fell off the side of a cliff. And, when he announced he was going to step down, another more business-friendly leader was going to take over. And I think that's just been a real simple political, you know, political bounce.

JSL: They also, Japan's economy had struggled because of, they had some low levels of vaccination and this sort of prolonged locked down, but you know, their vaccination program has kind of accelerated quite dramatically. And, you know, the Japanese economy's sort of bounced back and don't forget that, you know, Japanese companies have always been sort of frightfully conservative, which has sort of been, markets have sort of thought that's quite negative, because you know, they've held on to, they've had some low levels of debt and strong cash reserves, but obviously that's stood them in quite good stead during the pandemic. And they were able to sort of quite a lot of them were able to maintain dividends.

SS: And financials?

DM: Yeah. Well financials, I think that that's all to do with interest rates, which follows the sort of more stubborn inflation that we're seeing across the globe. When you get inflation, central banks generally, in history, they raise rates. One of the reasons that financials - and when we're talking about financials, I think I'm really talking about the banks - banks have been one of the worst performing sub-sectors of equities for the last decade. So yes, they had to rebuild their balance sheets from a financial crisis. But also when you are a bank, you take deposits and you loan them out and you get something called an interest rate margin. And interest rates being low hasn't helped that margin for like ever, so broadly: cheap valuations, hated sector, but actually potentially some gentle light at the end of the tunnel with respect to rate rises, which are now being openly discussed both in Europe and UK and the US, well maybe not so much Europe, but US and UK rates rate rises are on the horizon. And that is pretty binary benefit to financials and banks in particular.

JSL: But obviously that's had a negative impact on UK gilts and US treasuries, because obviously sort of, you know rising yields has meant that their values have fallen effectively.

DM: Yeah. So when the rate goes up, the yield on those government bonds goes up, but their capital tends to go down. And it's been a disappointing asset class really in the last year, but certainly in the last quarter again.

[4:32]

SS: And perhaps we could talk a little bit more about inflation, you've mentioned it there. I think it started the year with everyone saying it was going to be transitory, but it's still here, we're still talking about it. The narrative seems to be changing that we're going to have higher inflation for longer. Are you in agreement with that? And when would you expect interest rates to rise?

DM: I certainly think inflation looks more stubborn. A majority of commentators or central bank commentary at the beginning of the year was around this transitory inflation. In 2020, oil prices basically went to $10. And when that's up to sort of $50, $60 as it was at the start of the year, that single factor meant we would have inflation, but I think inflation is different in different parts of the world. And Juliet and I were discussing in our investment meeting this morning, some of the issues in the UK, you know, inflation comes from two sides, sort of supply and demand. Whereas in the US actually their economy is really booming post reopening of COVID.

JSL: Yeah. I mean, I think we're in, we're in sort of really unchartered waters, particularly in the UK - the combination of the pandemic and Brexit, you know, has cause both labour and goods shortages. And it's very difficult to see how short term this will be and how long it will take for it to iron itself out. I think, I still believe that it will be ironed out perhaps more quickly than people think. And that central banks are likely to be nervous about raising rates too quickly and too high to, you know, to sort of impact economies that are recovering from the pandemic.

DM: Yeah, I mean central banks saying inflation is transitory is talking up their own book. It's making it easier to not raise rates, but it has become clearer. And the governor of the Bank of England and other members of the MPC have been pointing at a December rate rise. It might not be a big rate rise.

And then people also need to remember where the interest rate from the central bank in the UK is 0.1, I remember going to 0.25 in 2009, because it was the lowest in the 250-year history of the Bank of England. Now it's even lower. So some gentle rate rises, I think as much sends a message as opposed to, you know, interest rates aren't going to 2% this year or next, but might we see them at 1% and the end of next year? Might we have three or four rises, but in small little bits?

So I that's, and as Juliet says, the UK has got, it's not so much demand, it's the supply. There are blockages in the supply chain and that's causing prices to go up. Not just that everybody's demanding more goods, it's actually that there's less of them, hence the demand has gone up. So that's a UK specific issue. And in the US they're talking about early 2022 for the start of rate rises. I think when we talked about this in our meeting this morning, we're actually worried that banks, central banks, might raise rates too much. And then you sort of put too much water on the fire whilst we do need this economic growth post, all the capacity that was lost during the pandemic.

[7:53]

SS: One of the other things making headlines recently has been the fuel shortages. You've mentioned there, the supply chain issues we've got, energy funds did very well in September. Is that linked?

DM: Again, because the words energy is in both of them it's a very easy link to make. The petrol shortages in the UK have seen petrol prices go up. And that was down to supply chain and lack of lorry drivers to physically get it from the refineries to the petrol stations. The problem was then increased by everybody queuing up for petrol, for petrol they actually didn't need in short term. That was a bit of panic buying, which we have seen in the pandemic with a sort of toilet roll. But the price particularly of gas is going up everywhere and has gone up a huge amount. That's not really linked to lack of lorry drivers in the UK, and that it is that gas price and energy rise. I mean, it's not like the price of oil hasn't doubled in the last quarter, but the price of gas has gone up more than double.

JSL: Yeah I mean I think this is obviously a sort of a reopening of economies issue, which it seems amazing that it's taken everyone by surprise really, that there was a sudden surge in demand, but it's been exacerbated by a few other issues, cold weather here in Europe and in Asia earlier in the year didn't help. Also, we have 25% of our energy in the UK comes from wind and we haven't had enough wind here, would you believe it? So there are various factors at play here and which have sent things higher and not aided by the fact that, you know, OPEC doesn't want to boost oil production. Having had, you, you might remember that oil did go actually sort of negative back at the height of the pandemic and now has gone to over $80 dollars a barrel. So I think OPEC is reluctant to sort of produce too much. So, again, I think this is something that will be ironed out, but it's obviously sort of frustrating and very negative for businesses currently.

DM: Yes, and the other big supplier of gas to Europe is Russia and there is also potential political horse trading around that. So all the bits and pieces that Juliet mentioned around that sort of short term demand increases, that this has a number of factors, but I think on energy prices, it's both supply and demand factors hitting at the same time, which we're seeing this huge rise in gas prices, which has linked into the very, very strong performance of energy funds in the quarter.

[10:40]

SS: And the other thing that's been going on in markets has obviously been China and the Chinese government clamping down on various sectors. I think I read recently that there were 30 regulatory interventions in August and another 24 in the first two weeks of September alone. What's going on and should investors be worrying about China right now?

JSL: Well, China, I mean, China, isn't a democracy, which is something that investors can be forgiven for forgetting, given how sort of strongly capitalist their economy has become. And the Chinese government isn't afraid of flexing its muscles. Particularly if it thinks a sector has become too powerful. And that is what it's been doing recently - cracking down on various different sectors. And this obviously makes investors nervous, understandably. And so, you know, they do require sort of extra risk premium to invest there. And we've also seen the large property developer

Evergrande sort of defaulting. So that's leading to problems in the real estate sector which is quite a large part of the Chinese economy.

DM: Yeah. I mean, this there's two issues here in the last quarter. The first was the clamping down on the education sector by the Chinese government. And the one thing the Chinese government are fairly transparent at, is they had said in previous manifestos that they didn't want the private education secretary to be for-profit and then it went for profit and then they stopped it so that they are sort of guilty of doing exactly what they said they were going to.

Jules is absolutely right, it's just not a democracy. And they have the power to do exactly what they say they're going to do and in fairly swift order. Then the second thing is this huge debt, that big property company Evergrande, they have loads of debt held by Chinese institutions, but also foreign institutions. And it's the foreign institutions that they've been refusing to pay their interest on. Property is a huge part of Chinese GDP. And the Chinese government want to keep prices down on Chinese property, so it can be affordable for the masses.

So, it's a very interesting time, but we, in our investments that we make on the funds that we advise to, have never held China directly, but you could see this cascading and you know, some of the Chinese investment trusts might start trading. They're trading at about a 10% discount. I think if that gets to 30, it starts to become a very attractive entry point. It may not get there, but China still as a central bank, has some weapons it can pull, interest rates are not at those record loads that we've been discussing as in Europe and UK and the US. So, they've got some space on rates, but the combination of a overtly strict regime with respect to the education stocks with then this massive property company - it's the second biggest property company in China - not paying it's obligated interest to investors really is sending a really big signal to the markets.

Most of our investors and people who come to the FundCalibre website probably get their India and China exposure via an Asian fund or an emerging markets fund. And there you're really looking for your fund manager to be nimble and, you know, going in and out of those sectors as best. But of all the managers I think we've heard from recently, nobody is writing China off and I think it would be a mistake to write China off.

[14:28]

SS: And just finally, we're sort of heading into the last couple of months of the year. How are you feeling, positive, negative?

DM: Well, this, that's a perfect question for Juliet and I because Juliet’s always positive and I'm not saying always negative but I'm quite cautious at the moment. I think valuations are expensive. I don't want to own bonds with interest rates with inflation is here for a while. Okay. We don't have to say how long and at what rate, but it's here for a while. Inflation means interest rate rises, which are bad for bonds. Not all bonds high yield bonds do have some attractiveness, if I'm getting paid 5% or 6% to hold high yield bonds or high yield bond fund, I'm more comfortable with that.

US equities are as expensive as they've ever been in history. Europe, look at sort of some of the European funds, they've had a really strong 2021. UK has been the laggard market, but I think we can understand why. So, I'm a little bit cautious. I want to have a bit of cash for potentially buying some market corrections, but I'm not talking about going 40/50% in cash because markets have proved me wrong over many, many time periods before and no doubt they will do so again. So yeah, I'm on the slightly cautious side of, the next quarter. Jules, I know you tend to think a bit differently to me on this.

JSL: Well, yes. I'd kind of, I'd like to sound like I've got a different opinion. But I am also a little bit cautious at the moment. I suppose it's difficult when we were looking at, you know, the petrol pumps being closed and everybody talking about Christmas shortages, it's hard to feel positive at the moment. But having said that, companies are doing well. And once we can iron out these energy shortages and so forth, you know, economies should do quite well. And you have to think where do you put your money? Because if you're putting it in the bank, you're not getting anything at the moment.

SS: That was really interesting. Thank you both very much. And if you'd like to find out more about our views, please go to fundcalibre.com and don't forget to subscribe to the Investing on the go podcast.