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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. Darius McDermott and Juliet Schooling Latter return to discuss the major issues impacting markets during the first half of 2022, and tackle the question: is inflation here to stay?

[INTERVIEW]

Sam Slator (SS): I'm Sam Slator from FundCalibre and today I've been joined by Juliet Schooling Latter and Darius McDermott, to have a chat about the first six months of the year really, we're at the halfway point. It's not been the best of years so far. Stock markets have continued to fall, and the US is now in a bear market. So, perhaps we could start with that. Can we explain to listeners perhaps what a bear market is and how long we think this one might last?

Juliet Schooling Latter (JSL): So, bear markets are defined by a drop in investment prices. So generally, when a market index declines by more than 20% from its recent high. So, it's usually caused by negative investor sentiment due to declining economic prospects. So, when investors see a shrinking economy, they expect corporate profits to decline, and they sell stocks - hence sort of pushing the market lower. And so it can often be an indicator of an economy moving into recession.

Darius McDermott (DM): You're absolutely right I was just going to say that. Stock markets do often signal recessions. Not that they're necessarily cthe ause of a recession. That's not the case, but you often find that markets move in advance of recessions or slower economic climate. And you've absolutely nailed the definition of a bear market, it's a fall of 20% or more.

I suppose the other observation is maybe they had over, they'd gone up too much. They had risen too high. Particularly, one might argue, in the US. So, if you remove the COVID blip where we had that most violent set-off and really fast recovery, if you can erase that from your mind, we've broadly been in a bull market for the best part of, you know, 13 years. So, in the old adage, what goes up must come down. It doesn't have to come all the way down, but, you know, when markets have had good returns for many years, it's just unrealistic to not expect them to have periods of difficulty. And certainly, to my mind, the US had been the strongest performing market and hence was most ripe for that bit of a sell off.

JSL: On the plus side, bear markets tend to not last as long as bull markets, but it's really a sort of how long is a piece of string really? It can be, you know, they can be sort of shorter term or longer term, you know, lasting for a few weeks, months or, you know, possibly over a year. You know, it really just depends upon the economic picture.

DM: Yeah, I mean, if you think of the most recent market falls where we had that violent sell-off in COVID from sort of mid-February to the end of March where it fell 30% in six weeks, but then recovered super fast. We had the Great Financial Crisis in 2008, which was a very scary six months, really from the summer, but markets bottomed there in March of 2009. And unfortunately, I'm old enough to remember the tech sell-off as well, where actually it began to fall in 2000 and the market sort of halved over a three-year period. So that one was a bit more painful with respect market reactions. But, as you say Juliet, hopefully we'll have something shorter and sharper is the hope.

SS: There's some, I think there's almost 60 different sectors that investment funds fit into, and of all of those, there's only three that are in positive territory this year, which are commodities, Latin America and UK direct property. But the first two, commodities and Latin America, they've lost some of their gains that they made in the first quarter. Latin America, for example, was up about 25% and is now only up 6%. Commodities were up 16% and are now only up 8%. So why aren't they continuing to do so well?

JSL: Well the move to electric vehicles for instance means that some commodities are in greater demand which, coupled with lack of investment in recent years, led to prices going up and Latin America is home to many of these commodities. And so it's benefited from this increased demand. However, commodities suppliers are some of the most cyclical businesses in the market. And so they're heavily influenced by global demand. So the recent threat of sort of slowing global growth and you know, potential recession, has been negative for them in the shorter term. Hence the pullback.

DM: Yeah, I think on our last quarterly review, when we discussed this, everything Juliet said is absolutely spot on. Commodities were up and there's a big correlation between commodities and Latin America. Since then, we've all been waiting for inflation to stop going up. And that doesn't mean it has to go down, but we've been waiting for inflation to stop going up and it hasn't stopped going up. And this has led to central banks having much more aggressive rate hiking sentiment, and that's actually spooked to all parts of the market.

So, you're quite right, Sam, in your question, there were very few areas that were actually in positive territory, but the last quarter does feel to have been even more negative with respect to markets and sentiment because of increasing rate rises to try and put a lid on inflation. And, so far, it's not working.

SS: And sort of conversely with that, China, which has had a real stinker for the past, I don’t know, 12 to 18 months, it was down 12% when we spoke last time, but it's now only down 6%, so that market's actually gone back up. Do we think that China's finally bottomed?

DM: I mean, sometimes you just get a bounce, and I looked at this the other day, maybe the news is getting less bad in China. And the other thing is, whereas nearly every other central bank globally is putting interest rates up, China actually put interest rates down a little bit. So that is a positive stimulus rather than what the rest of the world is trying to do, which is to take stimulus away by putting rates up. So we've all got less money to spend on consumption, to try and curb that inflation.

So it is possible they’re in a slightly different cycle. That said, if we end up with a global recession, China's a big producer of goods, they will suffer as well. But that seems to me the logical answer to why it's had a bit of a bounce. That also, maybe it got a slightly oversold. China has still… are still having lockdowns and there has been a bounce off of that end of April or sorry end of March low.

JSL: I think this is one of the problems with China. You know, they're still attempting to deploy this zero tolerance policy towards COVID, which I don't think anyone believes is sustainable. So, it's very difficult to call at the moment with these sort of potential lockdowns a continued threat. It's obviously having quite a big impact on growth there. So, it's very difficult to say whether the market's bottomed or not, I think.

DM: And the funds in which we advise on, we have discussed having a direct China holding. We clearly have some China exposure via Asian and emerging market funds. And we would've looked rather clever if we'd pulled the trigger in the very last week of March when it bottomed, but we've not yet got to a place where there's enough visibility for us to add a direct China holding. That said, on relative valuation, it is one of the cheaper markets.

SS: And one of the worst performing areas so far has been the technology sector, which is perhaps not so much of a surprise. But when I looked at the figures, UK index-linked gilts are down 24%. Now, I thought these were the bonds that are actually supposed to do okay in an inflationary environment. So, am I wrong with that?

DM: Well, it's fascinating really, isn't it? Sometimes there is more than one factor in play. But, like you, I would've expected to see that asset class up this year. Inflation is up, these bonds have their yield and their coupon at maturity linked to inflation plus whatever it might be 1% or 2%. But the other factor at play is what in the fixed income world we call duration. But you and I might talk about the sensitivity to interest rates.

So, very basically, the longer the duration on my bond, the more I lose when rates go up. And it is a bit of a well, it's a fact, that a lot of index linked bonds in the UK have very long duration. Ie they have 10, 20, 30 years to maturity. And whilst this isn't an exact equation, if you've got a duration of 20 [years] on a bond and interest rates go up by one full percent, your capital is going to go down by 20%.

And it's that expectation that not only- the rates have gone up 1% this year in the UK - there've been quarter point rises for the fifth consecutive month. But actually, the expectation is that they're going to continue to go up. And then those longer duration bonds with maybe 20 or 30 years have actually sold-off because of it. You have to remember where index link bonds have come from. I mean they were giving you a negative real rate 18 months ago. So you're now getting a positive real rate, but when yields go up, prices go down, and that's been a more important factor to total return than the inflation linking.

SS: And on inflation. We might as well talk about that a bit more. It's the big subject of the year. I saw report today that it was looking back to the 1970s and the fact that we had really high inflation then, I mean, interest rates then went sort of up to 10%, 15%, 19% at one point. And it was because they kept trying to get inflation down. They managed it a bit, but then it came back again. Do we think inflation's here to stay in that way for some time?

JSL: Well that's the tricky question, isn't it? And it's what's making markets nervous at the moment. You know, obviously its energy costs rocketing, you know, it doesn't just affect those of us filling up our cars, but, you know, its input cost into businesses, it's squeezing profit margins. So, it's making it harder for businesses to plan and invest.

I mean the governor of the Bank of England has warned that inflation will hit Britain harder than any other major economy. And he expects the UK economy to deteriorate more quickly and severely than other nations, which is rather depressing.

You know, in May it sort of reached 9.1%. But the Bank of England now anticipates it's going to sort of top 11% in October. So, I'd hope that we'd like to see it start to sort of decline early next year. There's evidence that consumers are already cutting back, you know inflation makes us all prioritise our spending. So that's our best guess.

DM: Yeah. I mean, the other factor to consider, which is a secondary factor is our currency. If I want to buy a barrel of oil and it's a dollar and my pound goes down against a dollar actually that barrel of oil has stayed at the same price, but it's become more expensive to me in sterling terms. We’ve had weak currency, particularly against a dollar, in the last six months. And you're almost, that's called importing inflation because of the currency. So that is having that extra detrimental effect maybe on the UK.

For me, the day to clap and cheer and whoop and holler is when it actually stops going up. That will be the first pause for breath. Do I think inflation is going to go back to 2% in the next 12 months? Most definitely not, but if it goes from 12% or 11% to 6% or 5%, I think that's probably a much more manageable world. Fingers crossed, touch wood, I hope that's where we get to. If it stays at those elevated levels for a prolonged period of time, then I think it could look quite challenging out there as central banks can't raise rates to curb that inflation.

I mean, it does look a bit like the seventies, there was an oil price surge, tick, people going on strike because they need more wages, tick, and high inflation. Maybe a differentiator is the massive debt, both on a personal and government level. And if you think just about the UK government alone, and I'm sure this figure's going up by the month, but the UK government had to borrow about 400 billion pounds to pay for the COVID black hole. We've all got mortgages where we've been used to paying 1% fixed for five years, but as they roll over, we won't find interest rates at 1% they've going to be 3% and 4%. So, there is only so much tolerance to that debt mountain at both government and personal level.

So, I sort of very much hope, to me the day, the month, that inflation stops going up will be the first point to breathe. And then we can start hopefully rolling over in 2023 to a less frightening level.

SS: Interest rates are going to go up, I mean, you've mentioned 3%, 4% there. If inflation's still 6% in 12 months' time, presumably it could be even higher, but is that just going to push us into recession? Can we afford to get that high on interest rates?

DM: Well, I don't think companies or governments or individuals can afford to pay 4%, 5% interest rates on one's debt whether that's credit card debt or mortgage or whatever it might be. So, I do think interest rates historically, would've been higher than inflation. So, if inflation was 10% rates would've been 12% back in the seventies or whatever it might be, certainly. So I think there's that natural cooling down of demand because people can afford to consume less. And then central banks trying to, and I think, I don't think there's any great secret. I think that the US Fed - the people who set the rates in the US - they want US to go into recession, to stop, to fight the inflation problem. But clearly, they'd like it to be a short sharp recession, you know, a couple of negative GDP quarters, then back off to the races, we shall see.

I'm not an economist. But it does look that the next six months, from an economic point of view, are going to be more challenging. Whether stock markets have already led the way and come down that 20% we touched on earlier, that's led us into a bear market in a States particularly, is that, or is that not enough? Is that the market looking forward going yes, recession's coming or markets continue to be volatile? My guess would be that we should expect more volatility certainly in the rest of 2022, and potentially into the first half of 2023.

JSL: Yeah. I mean, in the UK, you know, the Bank of England thinks the economy contracted in the second quarter this year and the technical definition of a recession being when an economy contracts over two consecutive quarters. So, you know, we could actually already be in recession, only time will tell, really. But yes, it's looking likely, I would say.

SS: So, the billion- dollar question, I suppose, how do you invest through this kind of period then?

DM: Well, I think maybe the simplest is to share some of the views on the funds that we advise on. Juliet, did you want to jump in?

JSL: Well, I was just going to say it's, you know, it's good not to be sort of frightened by falling markets because obviously it can, you know, pay dividends as it were to invest as markets fall. You know, if you can afford to sort of drip feed into markets. It's always a difficult call as to where to go, you know, instinctively, you want to say you want to be defensive. But it's always about valuations and markets, as we've said, have come off quite a lot year to date and growth stocks in particular have been hurt. You know it's impossible to predict the bottom. But as I say, if you're drip-feeding money in as markets go down you know, that's going to pay off over the long term.

DM: Yeah. All I would add is it's always a good time to remind ourselves of our investment horizons. If I had a pot of money that I wanted tomorrow, I think I'd be going into cash. But if I have a pot of money, I want in 10 years, who knows which way markets will go? Juliet's absolutely right, buying the dips, whether either on a monthly saving, or just waiting for markets to go up and systematically adding in.

With a respect to what we are doing in the funds, we have been fairly cautiously positioned or been getting a bit more cautious, building up a bit more cash, which we hope to deploy into maybe some of that future volatility that I mentioned previously, but who knows? We could be on the bottom of the market today and I could be totally wrong and having 5% cash or thereabouts would be a drag. And I suppose it's quite a nice balance. Juliet is always a bit more bullish than me. I'm always a bit more cautious and, you know, between us, we sort of manage to get there, but I don't think holding a little bit of cash at the moment is a bad thing.

I still do or invest my ISA and my wife's ISA on a monthly basis. When markets fall, every time my money goes in, I get more units for the same price. So, there's people far cleverer than me can't time markets. So I don't try, I try not to do it.

JSL: And I think it's also worth adding… perhaps obvious. But you know, when the economic picture is quite opacitic as it is at the moment, you know, when we've got these, you know, exogenous shocks to it, you know, diversification is, I think, key, don't put all your money into one sector or region, spread it about a bit.

SS: That's great, thank you very much - as always very informative. If you would like to more about our views, please go to fundcalibre.com and please don't forget to subscribe to the Investing on the go podcast.