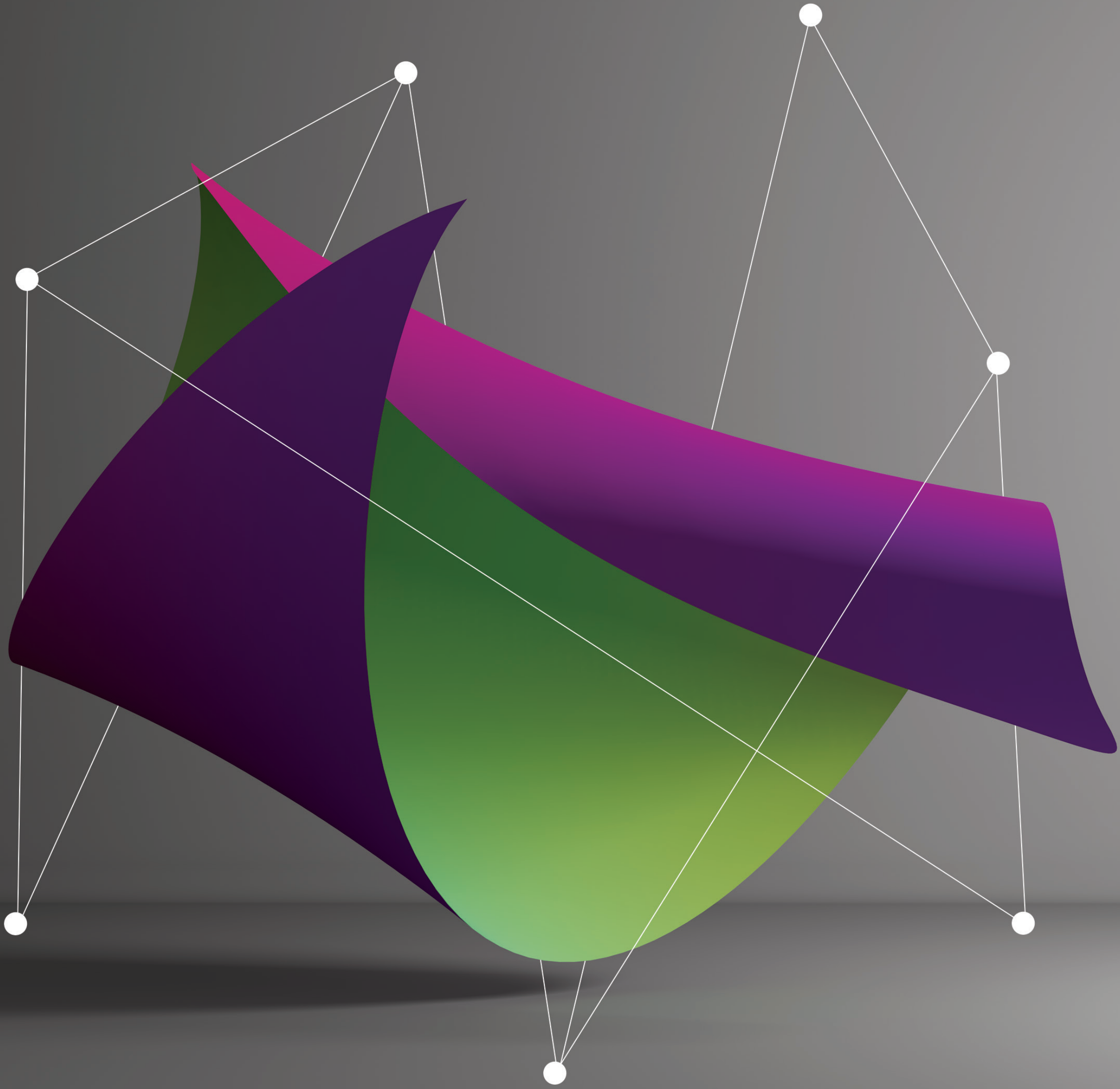
Your investment update

Q3 2022



Succeeding together

7IM

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Visit us at **www.7im.co.uk** to find out more about our latest news and views.

Welcome

Staying the course

When we survey the investment landscape and compare it with the timing of our last publication, it's tempting to say, 'it's déjà vu all over again?'. If anything, the news has deteriorated further over the spring and early summer – economic growth is slowing, inflation has accelerated, the cost-of-living crisis is biting hard, bond yields and interest rates have risen sharply, war in Ukraine continues to rage while Chinese determination to eradicate COVID has derailed one of the world's locomotive economies.

The major difference is that now investment markets have recognised the deluge of worsening news. Stock and bond markets have fallen in lockstep, leaving few hiding places. Plenty to contemplate for sure.

Any one of these developments might cause significant anxiety. Put them all together, and it's easy to see why investors might be extremely uncomfortable and actively considering a more cautious stance. Moving to the sidelines, raising cash and waiting for the storms to pass feels prudent and sensible – but it's almost always the wrong thing to do. What is comfortable is rarely the same as what is profitable in investing. Portfolios sit in cash for too long, inflation erodes their value and opportunities are missed.

One of the major challenges of these episodes is less the events themselves and more their ability to make investors step away from their long-term plans and goals. Serious investors avoid trying to time markets, as David Swensen, the legendary chief of the Yale Endowment Fund, often reminded us. So, what should investors do?

At 7IM, we take investing seriously and have a number of guiding principles that have helped us navigate similar episodes, such as the Great Financial Crisis of 2008 or, more recently, the COVID-19 pandemic. First, avoid responding to your emotions. They will lead you astray for sure. Second, ensure that portfolios are properly diversified.

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Blend traditional asset classes with alternative ones, look for genuine checks and balances, consider sectors and industries and not just countries, look for unloved areas to invest in, consider currencies separately. And finally, have the discipline to rebalance portfolios when market movements move them away from their long-term moorings.

My colleagues expand on some of these themes throughout this publication. Matthew Yeates demonstrates the tangible benefits that a carefully constructed selection of alternatives can bring to the portfolio table. Ahmer Tirmizi tackles the tricky task of how we invest and construct portfolios in times of heightened uncertainty and angst, while Ben Kumar addresses the dreaded 'R' word.

I am acutely conscious that current market conditions can be extremely unsettling for investors. That's entirely normal, and well-rehearsed from challenging times before. Experience tells us to focus on long-term goals, own a sensible spread of assets, monitor developments closely, communicate frequently but, above all, stay the course. That's exactly what we propose to do.

Enjoy reading and let me wish you the very best for the summer months.

MARTYN SURGUY

Chief Investment Officer

Strategy

What's the playbook?

We are approaching a turning point. And it's one most investors aren't prepared for – either in their portfolios, or their mindsets.

The COVID distortions are going to unwind

The story is well known now. While stuck at home with some spare cash, we spent. And we spent big. Because we couldn't go out and spend on services, we spent on goods. In the US, the splurge was so big that around 13 years' worth of spending growth was compressed into just two years.

That kind of growth leaves a mark. Most notably, inflation has risen dramatically. Mostly inflation in those same goods we bought. The common refrain is that this was about clogged up global supply chains. Never have people been more interested in West Coast container traffic or number of ships leaving Shanghai, all culminating in the world's fascination with the *Ever Given* stuck in the Suez in March last year.

But this supply chain story isn't the right one. After all, global manufacturing *boomed*, and China's share of global trade hit all-time *highs*... mostly, supply chains worked fine; it was the surging demand that pushed up inflation.

The employment market also became distorted. The headlines are that wages have risen sharply. But again, look under the surface and the story isn't that simple.

During COVID, the companies that benefitted from lockdowns hired relentlessly in order to meet demand. Workers *flooded* into manufacturing, e-commerce and delivery jobs which left few for any other sector. Take Amazon, who since March 2020, have doubled its workforce. **DOUBLED**.

But what happens when the service sector fully reopens, and goods demand slows? These distortions will unwind. Goods inflation will fall sharply. We are already seeing some retailers report huge levels of inventories – it looks like they thought the boom would last! And some of those workers in 'stay-at-home' winners will trickle to other parts of the job market. This will ease pressure on wages across the economy. Amazon admits that it has gone from *"being **under**staffed... to being **over**staffed"*.

But the transition won't be easy. Central banks are still twitchy. The Russia and Ukraine conflict complicates the inflation outlook. And the manufacturing boom will end as those 13 years of compressed demand growth unwind.

> The headlines are that wages have risen sharply. But again, look under the surface and the story isn't that simple."

Equity markets tend to derive more of their profits from goods producers than from service providers (your local café/bar/restaurant is unlikely to be listed on the stock exchange), so markets will likely come under pressure – as they have already. And where equities go, so does public sentiment.

We expect talk of recession to pick up as a result (which is likely to have real-world impacts, as Ben discusses). But manufacturing *isn't* the economy, either in the UK, the US, or Europe. The other parts of the economy are generally in a good place. Savings are still high, housing is robust and private debt levels remain fairly low.

Put together, the world economy will need to unwind the COVID-driven distortions. The transitions – away from tight global supply chains; from a surge in goods spending; from record high goods prices; from sector-specific labour tightness; and falling manufacturing – have no precedents. We've never had a global pandemic in the modern world. There is *no* playbook for the coming couple of years. >>

AHMER TIRMIZI

Senior Investment Strategist

Strategy
Continued

What to do when there's no playbook

Uncertain macro suggests headline equities and bonds are likely to be uncertain too. Hooked to the latest economic datapoint, the next move will be sideways and volatile. This is a tough environment for a traditional multi-asset portfolio of passive equities and government bonds. But all is not lost. When there is no playbook, we don't fall back on investment *types*, we fall back on our investment *identity*:

Anti-fashion –
Avoid expensive equities

If equities are likely to be drifting sideways, it could be tempting to hold less. But again, we need to look under the surface. First, we need to look beyond what 'worked' over the last decade or so. What has worked tends to also be the most expensive. Headline equities are generally expensive, with US equities leading the way. We swap this exposure out for the cheaper parts of the market, and for companies with robust earnings.

One example is Healthcare stocks which trade cheaper than the market but have the most stable earnings out there. We also look for companies whose fortunes don't rely on the ebbs and flows of the global economy – we have a position in climate change winners that should be able to look through the noise.

Unashamedly conservative –
Look for equity-like returns in credit

If a straightforward passive exposure to equities is likely to do nothing much, it's worth looking elsewhere for returns. Right now, we think that lending to companies and people (credit) is the way to do it.

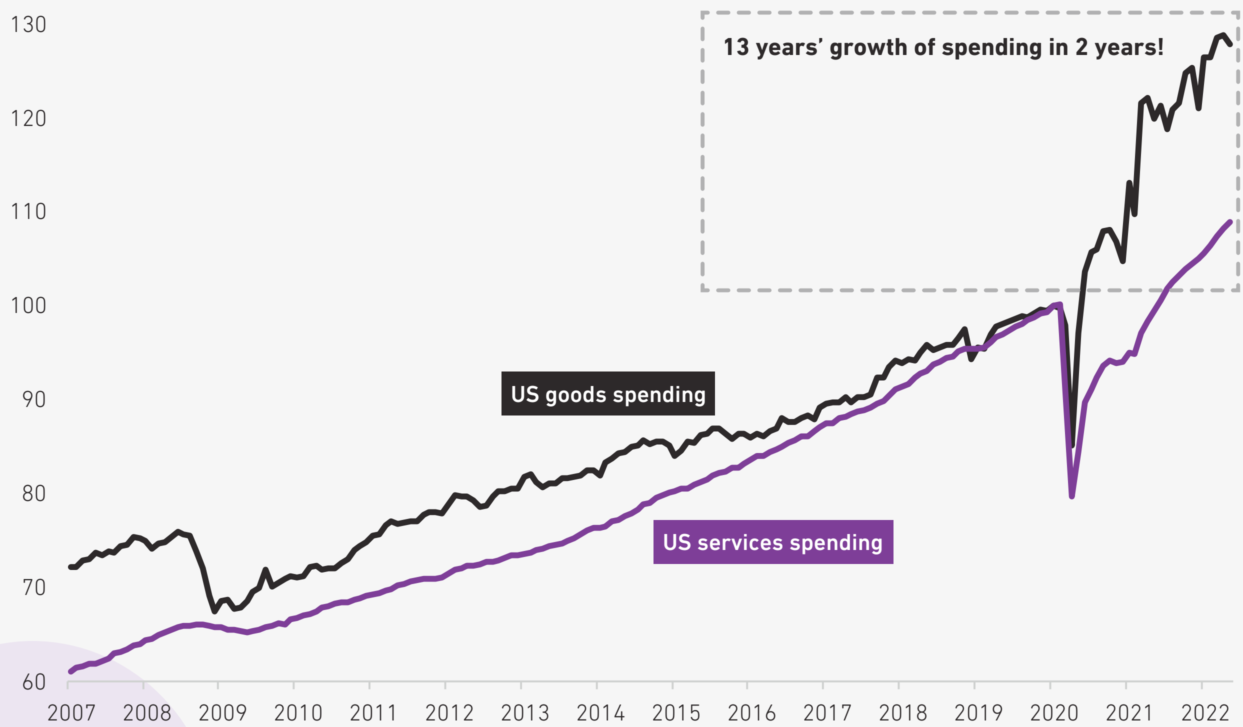
We have exposure to European bank debt and US mortgages, which have higher yields but are safer borrowers than most others. Emerging market debt is another. The Russia crisis has left investors concerned but most countries within the index (Brazil, Thailand, Poland, etc.) have an excellent track record of meeting their debt payments on time. Right now, yields are in the 7–9% range. You will struggle to see many equity markets delivering those kinds of returns over the next couple of years.

Properly Diversified –
Don't rely on traditional bonds to protect portfolios

The role of a multi-asset portfolio is to grow over time (driven by equities) with the smoothest journey possible (helped by bonds). But inflation uncertainty makes it harder for bonds to play that role. Instead, we replace our traditional bonds with a basket of alternatives with the main objective of keeping up when markets rally but protect portfolios when markets get choppy. So far this year, the 7IM alternatives portfolio has generated positive returns, which is not something you can say about most asset classes.

Savings are still high, housing is robust and private debt levels remain fairly low."

Goods demand will need to normalise... (Rebased to January 2020)



Data source: Macrobond

Look back to most economic recessions and you see a familiar pattern. Spending slows, business margins tighten, people lose jobs, spending slows some more, margins get even tighter, and so on. The common feature is that people rein in their spending on goods in a recession but keep spending on critical services.

But with COVID, being stuck at home meant that the COVID recession saw goods spending soar and services spending collapse. The recession was upside down!

The goods spending boom was huge... The upper chart shows US spending on goods and services. We saw around 13 years' worth of growth in goods spending compressed into two years. This led to a manufacturing boom, that needs to unwind.

“The role of a multi-asset portfolio is to grow over time (driven by equities) with the smoothest journey possible (helped by bonds).”

Ahmer Tirmizi, Senior Investment Strategist

Portfolio implementation

An alternative breakfast

The world of investing uses lots of different analogies to convey the benefits of complicated portfolio concepts. Portfolio diversification is often called the '*free lunch*' of investing. And we're told, '*don't put your eggs all in one basket*'. Now, I don't think those phrases are that catchy or relevant in today's world. We don't use baskets anymore, and nothing appears to be free!

So, let me try and update the story for millennials. It's more like: '*avocado, eggs and toast make for a better breakfast than just one of the items alone.*' Hmm. Nearly.

Spreading your investments around sounds like a prudent and obvious thing to do, but in practice it can be tricky. 2022 has been a great reminder of that. We've seen the prices of most kinds of investments, both equities and bonds, falling at the same time.

Traditionally, many investment portfolios have relied on combining equities and bonds to deliver a smoother return. The equities provide the growth, and the bonds give the protection. So, there's a problem when the protection isn't doing its job.

Instead of just relying on bonds to diversify equities, we have long been advocates of using alternative investments to *diversify our diversifiers*. To really stretch my new analogy, we think there are extra toppings that can improve the millennial breakfast even further. For example, we have investments in commodities, in currencies, and in strategies that can benefit from both rises and falls in markets (so-called market-neutral strategies).

Our alternative strategies aren't aiming to deliver the high growth you expect from equities. They're held in portfolios to smooth the journey."

Our alternative strategies aren't aiming to deliver the high growth you expect from equities. They're held in portfolios to smooth the journey. On the whole, they've been successful this year in helping to cushion the falls in portfolios. We use them to make sure you can enjoy your investment breakfast safe in the knowledge that inflationary pressures won't leave you with egg on your face.

What is a bond?

Bond investments are loans. Bonds make money because the companies or governments you lend to are willing to pay you a higher rate of interest than cash.

However, as interest rates rise, existing loan investments are no longer as attractive as the current higher yields on offer. If cash in the bank is paying 1%, you'll need more than that to lend to someone.

It's why the prices of existing bonds fall as interest rates go up.

MATTHEW YEATES

Deputy CIO and Head of Alternatives

Featured topic

Recessions: understanding the story

One hundred years ago, recessions didn't exist.

At least, the term recession – as applied to economic growth – didn't exist. *The Economist* magazine was the first to use the phrase in November 1929; I suspect due to a need to find other ways of writing 'depression'.

I have something I call the '*three P's*' test when it comes to whether something finance-related has gone mainstream. The concept must be used and understood in three key places: in the papers, in parliament, and in the pub. By that standard, 'recession' is firmly embedded in the public dictionary.

Most people broadly understand that it means a decline in broad economic activity – which is essentially the exact definition (see box).

It can be argued that wider appreciation and discussion of the economic environment is a good thing for society.

Surely there's a lot to be said for everyone having an understanding of the bigger picture? If we all know a bit more about the economy, we'll all act in a more informed and appropriate manner, right?

If you've ever read anything I've written before, you'll probably guess that I don't agree. I think of those three P's. The papers. Parliament. The pub. Those aren't the places where sensible, reasoned discussion happens. The media want catchy headlines, politicians want popularity and votes, and the pubgoers want another pint. The economics disappears, and emotions come into play.

The economic environment is created by people, which means it can often be changed by people, in unexpected ways that don't conform to laws or models."

Storytelling

Economists often think about what happens in their field in the same way as physicists do about their field. Concepts like growth, inflation and recessions are talked about in the same way as energy, gravity and light.

But there's a very important difference. Us. Without humans, economics vanishes – whereas energy, gravity and light would still exist even if humanity didn't. The sun still rose for the dinosaurs, even without a coherent theory of monetary policy! >>

The definition of a recession

Many people believe that there's an 'official' or 'technical' definition of recession, something like *two consecutive quarters of falling GDP.*

That's not quite true, although it's a reasonable rule of thumb.

The National Bureau of Economic Research in the US (the authority on recessions) actually defines a recession as *"a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."*

In essence, the economy as a whole is getting worse, rather than better, for a meaningful period of time.

Source: https://www.nber.org/news/business-cycle-dating-committee-announcement-january-7-2008

BEN KUMAR

Senior Investment Strategist

Featured topic
Continued

The economic environment is created by people, which means it can often be changed by people, in unexpected ways that don't conform to laws or models. Robert Shiller, a Nobel prize-winning economist, wrote a book a few years ago called Narrative Economics which examined how economic behaviours are influenced by the stories circulating in society at any given time.

Stories are how asset price bubbles form, on the back of the tale of money being made by everyone else. Stories are how market panics start, with everyone scared because everyone else is scared. Stories are how mobs form, and how protest marches swell in size – and stories are how people become famous (or infamous). They're incredibly powerful, and very difficult to control.

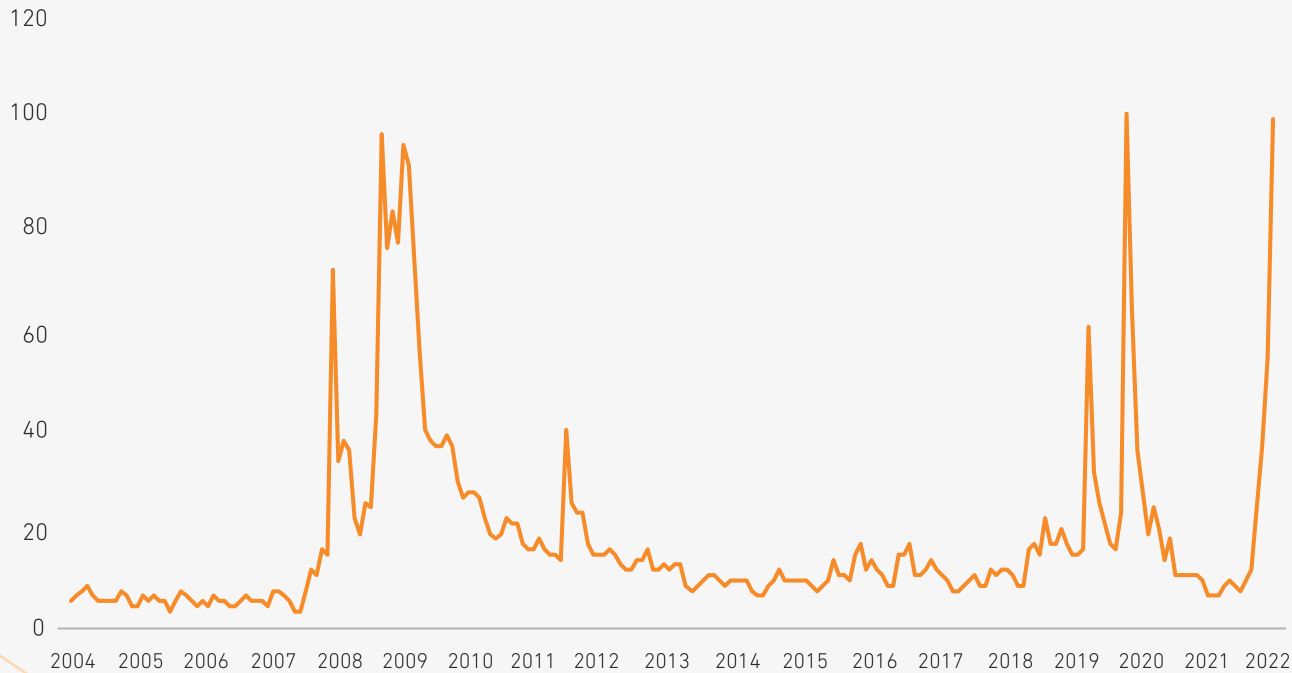
Perception vs. reality

A century ago, The Economist gave a word to the nameless fear of life getting worse; not disastrously so, but enough to feel on a day-to-day basis, and the recession narrative has been waxing and waning in society ever since.

The current narrative is clear. Consumer sentiment surveys around the world are more negative now than in the middle of COVID. CEOs are talking it up in their earnings reports. The Organisation for Economic Co-operation and Development is revising growth forecasts downwards. Google searches for the word are at all-time highs (see chart on page 17). The story is building.

> A drop in inflation, peace in Ukraine, or a series of bold government policies might be enough to stop the story in its tracks."

Google Searches for 'Recession' Worldwide



Data source: Google Trends

All of which is likely to make the next half of 2022 particularly interesting, given that most of the world economy is in good shape – and likely to get better, as Ahmer mentions in his piece.

This is the softer, less scientific part of investing. An economist who's thinking like a physicist might look at the data, and say that the fundamentals suggest a mild recession, or perhaps no recession at all.

But because the fundamentals are human-driven, the story is just as important.

A drop in inflation, peace in Ukraine, or a series of bold government policies might be enough to stop the story in its tracks. Or the narrative could gain so much momentum that it becomes a self-fulfilling prophecy, with fear creating more fear and dragging the economy down.

On the 7IM Investment Management team, we're monitoring both the perception of recession, and the reality of it, acutely aware that both influence each other. We have a recession-risk monitor that tracks both data and sentiment and lets us check the temperature of both. Understanding the emotional story helps us understand the economic one.

Meet the teams

Investment Management Team

Martyn Surguy
Chief Investment Officer

ACA Chartered Accountant, MCSI, CISI Level 4, 35 years of industry experience.

Matthew Yeates
Deputy Chief Investment Officer

BA Economics, CFA, 10 years of industry experience.

Uwe Ketelsen
Head of Portfolio Management

MEcon, CFA, 26 years of industry experience.

Terence Moll
Head of Investment Strategy and ESG

MPhil, PhD. in Economics, 30 years of industry experience.

Duncan Blyth
Senior Investment Manager

BSc Actuarial Mathematics & Statistics, CFA, 24 years of industry experience.

Hugo Brown
Investment Analyst – Alternatives

BEng, 3 years of industry experience.

Christopher Cowell
Senior Quantitative Investment Strategist

MSc, PhD, CFA, 6 years of industry experience.

Fraser Harker
Investment Analyst

MA in Economics & Accounting, CFA, 6 years of industry experience.

Tiziano Hu
Junior Quantative Strategist

MSc in Financial Technology, 1 year of industry experience.

Salim Jaffar
Investment Analyst

BA in Economics, IMC, 1 year of industry experience.

Ben Kumar
Senior Investment Strategist

CFA, MSc Behavioural Economics, 10 years of industry experience.

Tony Lawrence
Senior Investment Manager

CFA and CAIA, 20 years of industry experience.

Stephen Penfold
Senior Investment Manager

BSc in Economics & Computing, 36 years of industry experience.

Camilla Ritchie
Senior Investment Manager

IMC, 32 years of industry experience.

Peter Sleep
Senior Investment Manager

30 years of industry experience.

Ahmer Tirmizi
Senior Investment Strategist

MSc in Economics and Finance, 15 years of industry experience.

Jack Turner
Investment Manager

CFA, 13 years of industry experience.

Risk Team

Joe Cooper
Head of Risk and Portfolio Analytics

CFA / MSc in Applied Economics, 11 years of industry experience.

Alex Mitsialis
Senior Performance and Risk Analyst

MSc / CFA, 6 years of industry experience.

Loic Yegba
Investment Risk Developer

MSc Mechanical Engineering, CFA level 3 candidate

William Wood
Investment Risk and Performance Analyst

BSc in Physics, 4 years of industry experience.

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