Q2 2022 Overview – Countrywide Assured plc Balanced Managed Pension / Life Investing Fund

This report is provided by our Fund Manager Schroders and covers the portfolio activity on our main investing funds the Countrywide Balanced Managed Pension/Life Investing Funds, together with their short-term economic outlook. The report describes the current economic background and Schroders' perspective of this and how it impacts their management of the Countrywide Balanced Managed Pension/Life Investing Fund. It also covers all individual asset class sectors (UK & Global Equities; fixed interest; Property and cash).

Your policy will be invested in a specific customer fund of your choice which has its own fund objectives (see fund list and specific fund objectives) www.countrywideassured.co.uk/fund-centre/understanding-my-funds/fund-objectives/. All customer managed funds are invested in the Countrywide Balanced Managed Pension/Life Investing Funds, to a greater or lesser extent depending on the nature of the fund objective. If you're invested in an individual asset class sector fund, although no specific commentary is provided for these funds, the report does cover individual markets and other asset classes, which is consistent with the fund managers reasoning.

Portfolio Activity

Our quantitative models which assess where we are in the economic cycle (to which there are four stages – recovery, expansion, slowdown and recession) have started to shift into the "slowdown" phase, when earnings expectations are disappointed. This is typically the most challenging phase of the cycle for equities and so the fund remained underweight. Much of our activity within equities was centred on our cautious stance in both Europe and the US, along with the introduction of an opportunistic position in China. Starting with Europe, on the back of the hawkish stance by the European Central Bank, the exposure to European equities was reduced. With the US market particularly vulnerable to the withdrawal of liquidity, the underweight US equities position was maintained. A relative value UK versus US equities position was added to the fund in April. Given the geopolitical headwinds, we expected UK equities to outperform as the FTSE 100 index is tilted more towards defensive and commodity stocks (overweight consumer staples and energy). The scenario played out as expected with UK equities outperforming and so the position was closed in May in order to book profits. Recognising that growth risks have increased, the overweight global energy equities position was closed in May as higher prices have started to dampen demand in the energy sector. One area where we have become more positive on is China, which is starting to emerge from stringent lockdown conditions, and the likelihood of looser monetary policy presents us with a relative opportunity. The exposure to Chinese equities was therefore increased towards the end of the quarter.

Turning to fixed income assets, the fund started the period with an underweight bonds position. However, as the quarter progressed, we recognised that bond yields had moved a long way (as yields rise, prices fall) and so the underweight US treasuries position was closed at a profit. An overweight Australian versus German and US government bonds position was added to the fund. Whilst the market expected more rate hikes from the Reserve Bank of Australia (RBA), inflation appeared to be less problematic in Australia. However, following the RBA's decision to increase interest rates by 50 basis points, the position was closed.

In currencies, the overweight US dollar versus pound sterling position was closed in April and an overweight euro versus pound sterling position was added to the fund. We expected the monetary policy divergence between the Bank of England and European Central Bank to reach a maximum and to subsequently retreat from the levels seen. This scenario played out as expected following the fall in the pound sterling and so the position was closed in May in order to book profits. Towards the end of the quarter, an overweight New Zealand dollar (NZD) versus Australian dollar (AUD) position was added. The relative weakness in the NZD appears to be overpronounced as the resurgence of economic activity in New Zealand has been at a faster pace compared to Australia.

Outlook

We wrote in our previous report of an increasingly stagflationary environment (slowing economic growth and rising inflation) and our base case has now moved further in that direction. We have revised our forecasts for global GDP growth downwards, and global inflation upwards, for both 2022 and 2023. As stagflationary fears grow, markets are caught in the cross currents of concerns about interest rate increases on the one hand and worries about recessionary risks on the other. For now, central bankers' priority is not to support markets, but to quell inflation through higher rates; however, in terms of portfolio positioning we are increasingly focused on the growth side of the equation. Our cyclical models are pointing to a shift into the "slowdown" phase which is typically the most challenging phase of the cycle for equities. In our view, equity valuations do not yet adequately reflect uncertainty about corporate earnings as growth slows.

The peak in global inflation is probably not far away and already in the rear-view mirror for some economies such as the US. However, there are concerns that while headline rates of inflation may soon begin to decline, they will do so relatively slowly for at least three reasons. First, the continued zero-Covid policy in China means that supply chain bottlenecks are likely to persist for some time. A second reason why inflation may be slow to subside is commodity prices. Energy prices have stabilised since the initial shock to markets following the invasion of Ukraine by Russia – but they remain high and upside risks remain. However, it is perhaps food prices that are the greatest threat as the huge price shock in the fertiliser market means there is a risk that higher costs persist. A third concern for the inflation outlook comes from the services sector, which is only just revving up as fading concerns about Covid have seen demand start to rebalance back from the consumption of manufactured goods. Considering all of these risks, we have revised up our forecast for global inflation this year to 6.4%, from 4.8% previously. And while we continue to expect inflation to decline next year, it will probably do so more slowly and we have revised up our forecast to 3.6% in 2023 from 2.8% previously.

Upward revisions to our expectations for inflation are accompanied by downward revisions to our projections for global GDP growth. We now expect global GDP growth of just 2.7% this year and next, down from 3.8% and 3.0% respectively. Activity has so far been robust as consumers have shown willingness to absorb higher prices, in part as they have run down the savings accumulated during the initial phase of the Covid pandemic. Buoyant labour markets and a corresponding pick-up in wage growth have also bolstered activity. These factors should remain supportive for a while longer; however, cracks have begun to appear on the demand side of the global economy.

All of this makes for a very difficult environment for policymakers. Faced with broad price pressures, central bankers have set out their stalls to tackle inflation, and higher interest rates are the only real tool at their disposal. Accordingly, so long as inflation pressures remain a concern, central bankers will raise interest rates and deliver hawkish forward guidance in a bid to cool activity. Tighter monetary policy will cause the cracks in demand that are already appearing to widen further in the months ahead. As a result, the mood music amongst central bankers may change later in the year once inflation has convincingly rolled over and attention turns back to growth. That may ultimately mean that interest rates will not rise as far as is generally expected. However, they are fairly blunt tools and any shift in policy may come too late to engineer a soft landing and the risks of recession are clearly rising.

With a backdrop of higher inflation and increasingly hawkish central banks, we maintain our negative view on global equities. Concerns for economic growth are having a clear knock-on effect on sentiment where markets struggle for near term direction. While valuations in many regions have fallen, they are not overly attractive given the headwinds for the global economy. The one area we can find reason to be positive is China. In recent months, its zero-Covid policy saw major cities, manufacturing hubs and ports suffer from periodic lockdowns. The various, yet tentative, re-openings should ease some of the supply bottlenecks in the region. Recently, comments from high-ranking authorities as to the need to 'support' technology companies have also given some optimism that the regulatory crackdown is lessening.

On the other hand, we have upgraded our view on government bonds to neutral over the quarter. With the jump in yields in recent months, the US 10-year looks fairly priced based on our models, although real yields still look too low. With inflation continuing to accelerate while growth expectations are falling, it is too early for central banks to start thinking about a reversal in monetary policy, meaning that we need to see higher yields levels to compensate us for the potential volatility. As it is for equities, the "slowdown" phase, is historically a challenging environment for credit assets. However, valuations have improved recently meaning some of this negative sentiment appears priced in, leaving us neutral.

In summary, while the stagflationary environment has intensified since our previous report we think that there is still a fair chance of a 'muddling-through scenario', where global inflation is to peak at some point later this year, providing the Federal Reserve opportunities to step back from the current hawkish stance. However, the risk of a recession is clearly rising and valuations do not yet fully reflect this so we maintain a cautious, diversified stance. Nonetheless, our dynamic approach to asset allocation means we are well placed to seize opportunities as the growth picture darkens in the next few months - history has taught us the best valuation opportunities tend to emerge in recessions.

Important Information

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