Q2 2023: Why UK equities' underperformance is unjustified and how the consumer remains in good shape

Quarterly Performance	Personal Account	FTSE All Share TR
Q1 17	0%	0%
Q2 17	-8%	1%
Q3 17	-5%	2%
Q4 17	-1%	5%
Q1 18	9%	-7%
Q2 18	19%	9%
Q3 18	-16%	-1%
Q4 18	-30%	-10%
Q1 19	45%	9%
Q2 19	39%	3%
Q3 19	0%	1%
Q4 19	8%	4%
Q1 20	-43%	-25%
Q2 20	42%	10%
Q3 20	-3%	-3%
Q4 20	76%	13%
Q1 21	32%	5%
Q2 21	-3%	6%
Q3 21	5%	2%
Q4 21	1%	4%
Q1 22	37%	1%
Q2 22	-3%	-6%
Q3 22	17%	-3%
Q4 22	20%	9%
Q1 23	0%	3%
Q2 23	-13%	0%

Annual Performance	Personal Account	FTSE All Share TR
2017	-9%	9%
2018	-31%	-9%
2019	113%	19%
2020	52%	-10%
2021	37%	18%
2022	99%	0%
H1 2023	-13%	3%

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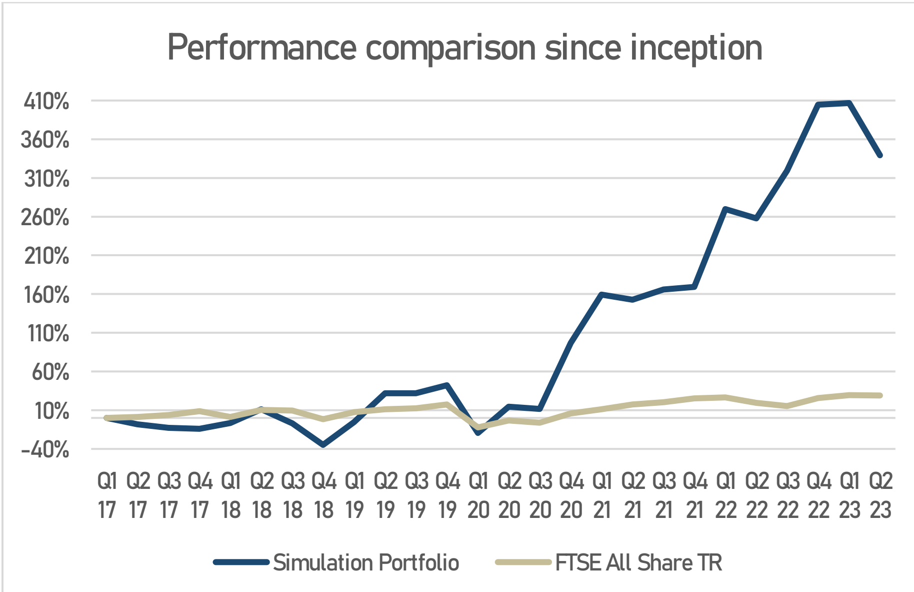
Overall Performance	Personal Account	FTSE All Share TR
CAGR	25.6%	4.0%
2017-23 Return	339%	29%



10th July2023

Dear fellow investor,

Since the SVB crisis, the UK equity market has had a lackluster performance, especially when compared to international indices, such as the S&P 500 or DAX Index. The reason for the underperformance likely lies in higher interest rate expectations in the UK in recent months, which in turn is the result of higher inflation than expected. However, UK inflation was also the latest to rise due to the way households are charged for energy. The UK's energy regulator has put a standard energy tariff for households in place that is extremely protective and forward looking, making the utilities hedge the households' energy demand around 8 months in advance for a period of 6 months. Utility costs for households have made up a share of between 20% and 33% of the UK CPI in the last two years, and therefore play a key role in the level of inflation. The tariff has been changed at the height of the energy crisis to ensure prices are coming down faster by making the utilities hedge the households' energy demand 5 months in advance for a period of 3 months. Hence, inflation is coming down slower in the UK than in Germany and the US.

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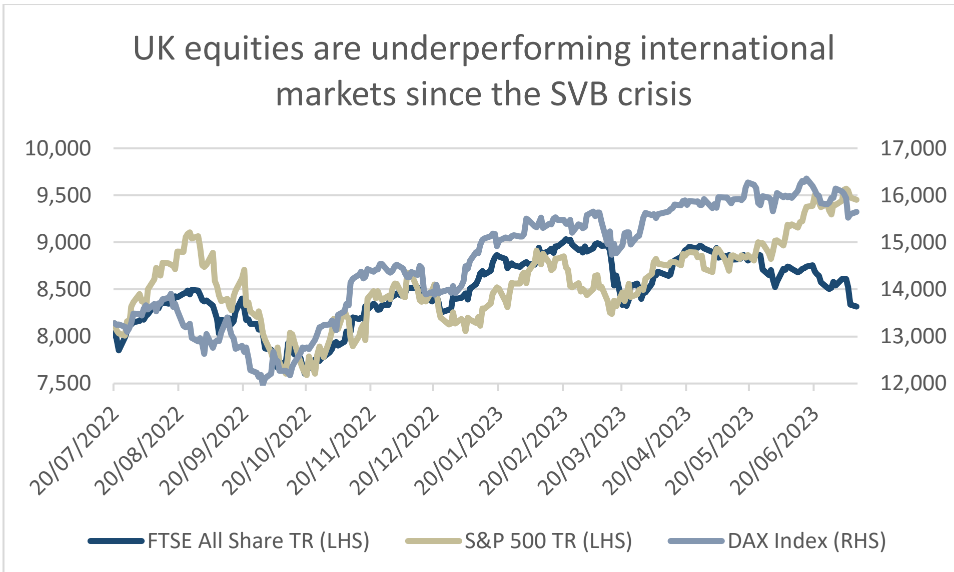
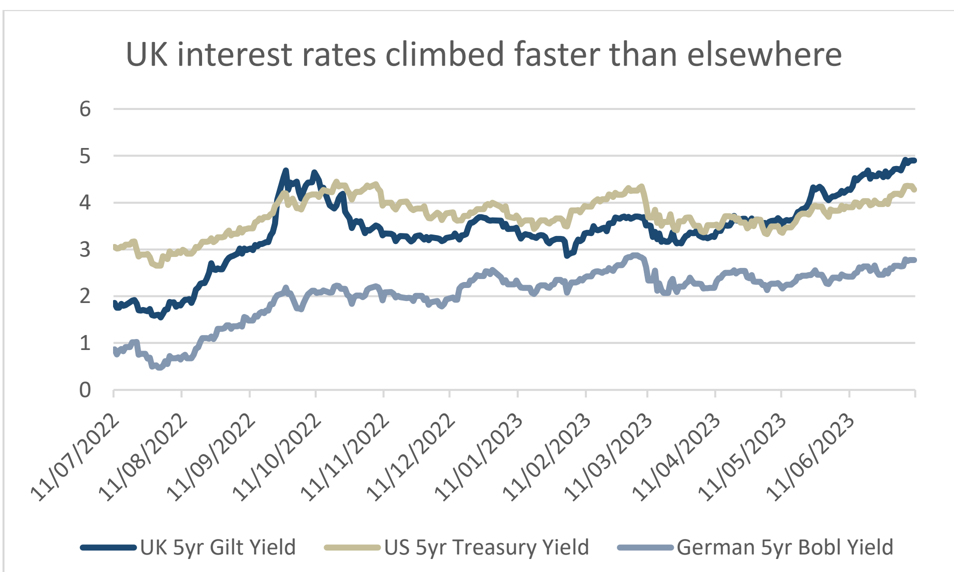
Nonetheless, rate markets are overestimating the impact of this, as the next resetting of energy costs will come in July and will be reflected in the July CPI report that is being published in mid-August. This makes me extremely optimistic about the UK markets and an ideal opportunity to go bargain hunting.



Source: Investing.com



Source: Investing.com

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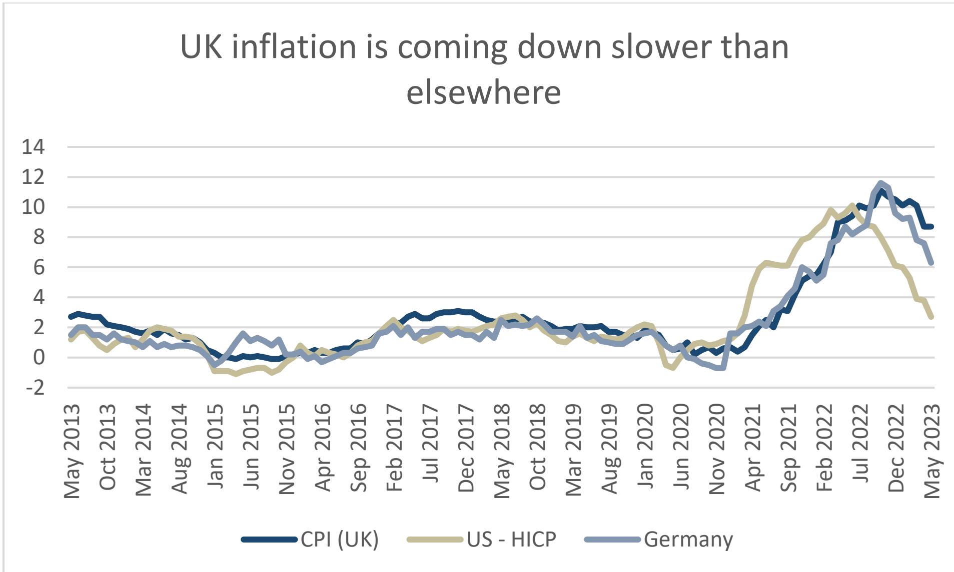
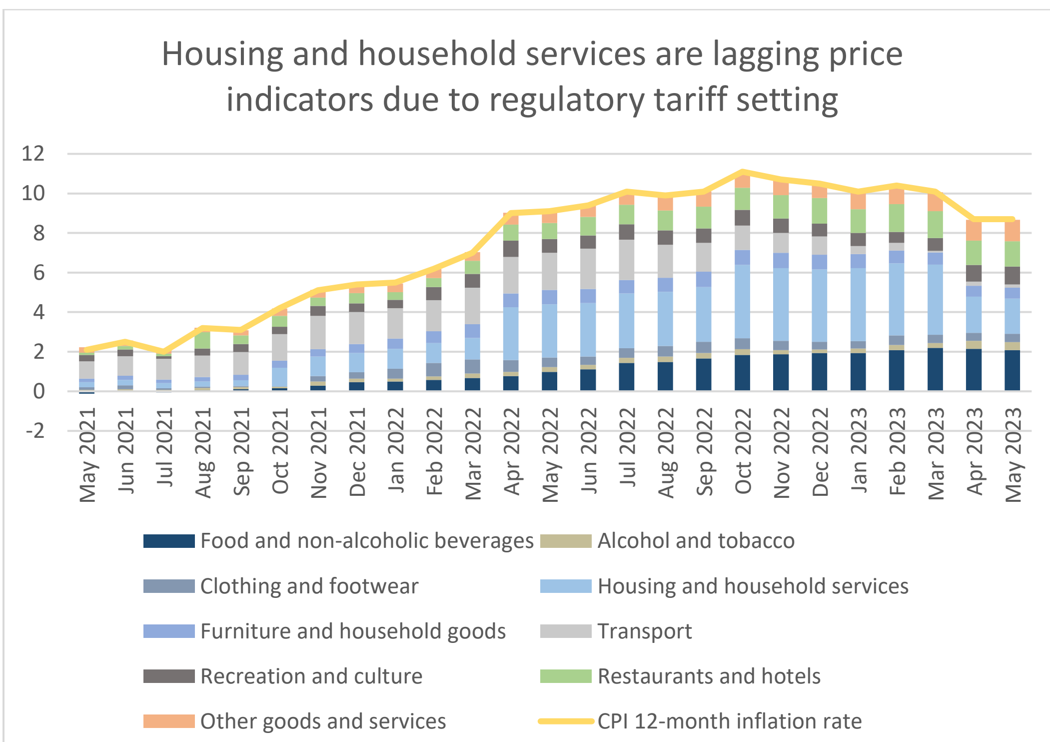


Source: Office for National Statistics



Source: Office for National Statistics

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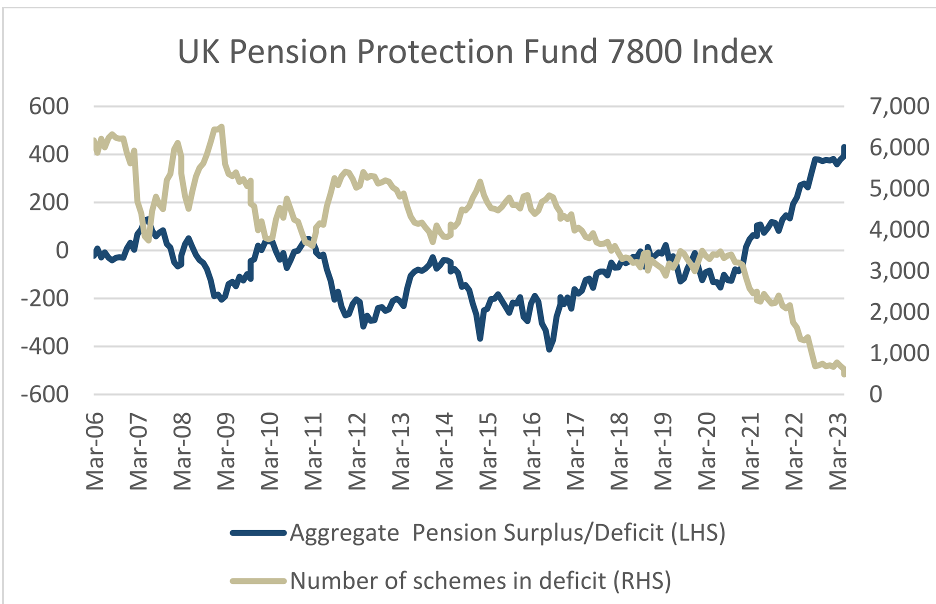
Higher interest rates = lower pension liabilities

In fact, for many companies in the UK the higher interest rate expectations are a blessing, not a curse. This is due to more than 5,000 corporations with legacy defined pension funds, which mostly now trade with a healthy surplus as the discount rates have moved higher, while inflation expectations remain anchored and mortality rates are stable. The Pension Protection Fund, which would step in if corporations are unable to service their pension deficits, monitors these pensions and by end of May 2023 have estimated a £430.9bn surplus of UK pensions with only 486 out of 5,131 pension schemes in deficit. This is a huge relief for many corporations that pay millions of £ into their pensions annually, representing a drag on free cash flow. These pension schemes have now the unique opportunity to either hedge their future pension payments or receive a buyout from an insurance company that will manage their pensions altogether. It is a golden opportunity to remove a key obstacle that justified lower UK equity valuations compared to elsewhere.



Source: Pension Protection Fund

The strong consumer (!?)

All over the news you read how the consumer is suffering from high inflation. I disagree. Yes, inflation has been high and outpacing wage hikes, however, when you compare to pre-pandemic times, median pay is

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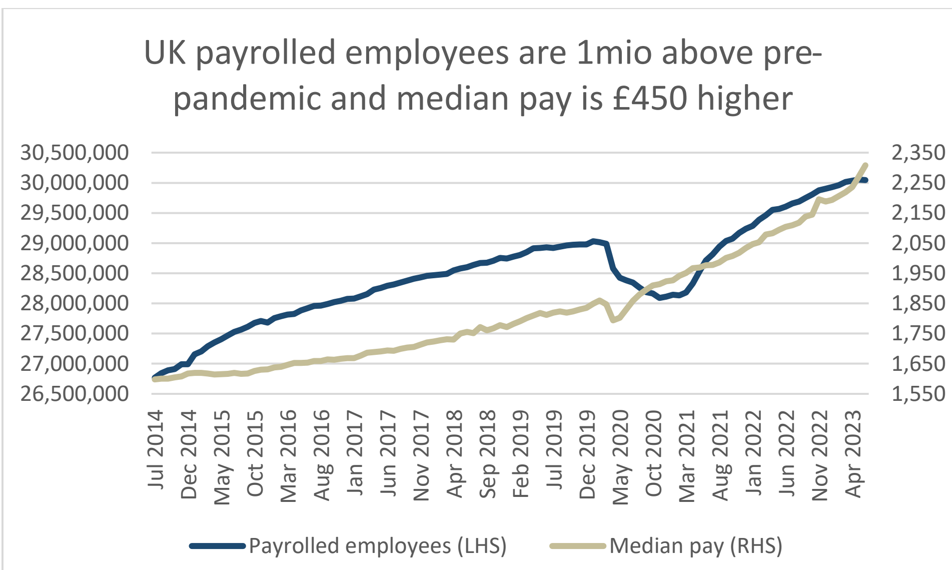
over 24% higher at around £2,300 per month and payrolled employees are 1mio higher than pre-pandemic times. In fact, so far the consumer appears extremely strong. In addition, the pay rises gained through strike action often start backdated, and hence give employees a large sum “upfront” straight into their pockets[1]. My view is that rate hikes by central banks purely help FX rates, and hence imports. Nonetheless, when the primary driver of inflation becomes owner occupiers’ costs, i.e. mortgage rates & household energy prices, and with energy prices coming down, higher interest rates could actually inflame inflation instead of cooling it down. The downturn in the manufacturing sector is mostly related to the lockdown cycle – and so is the strength of the service sector. We are going back to 2019 behaviour, but with leverage due to not being able to travel and go out for the last two years. And while all this seems so obvious, central banks continue their hawkish narrative – all because they have been wrong about inflation in 2021. When humans make mistakes, they always try to correct these mistakes from happening again, often by going to the other extreme, in this case central banks have been staying too hawkish. As output prices have descending very quickly in recent months, expect CPI inflation to follow through with a 3-month lag, however, which will lead to a repricing of UK interest rates – lower from where they are now.



Source: Office for National Statistics

[1] https://www.unitetheunion.org/what-we-do/unite-in-your-sector/

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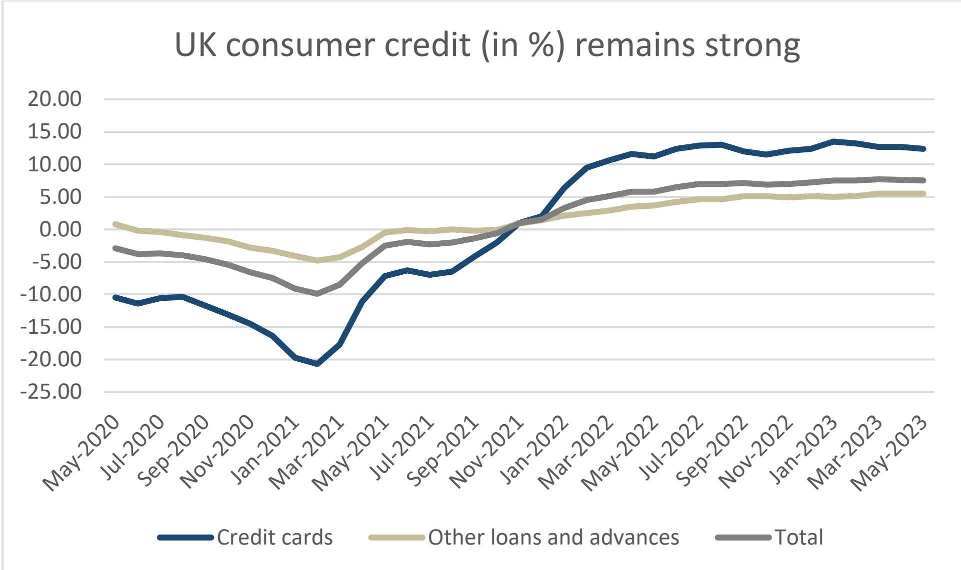
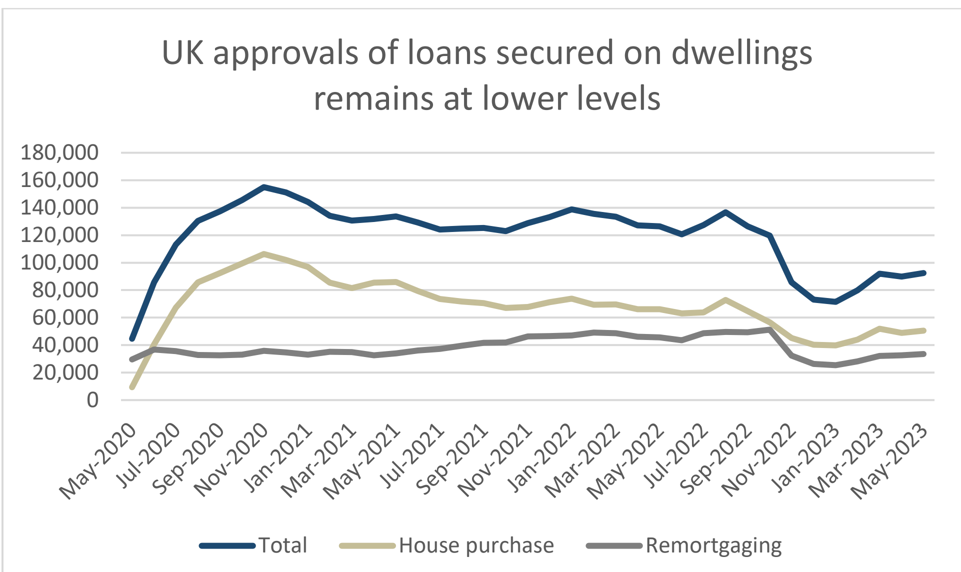


Source: Bank of England



Source: Bank of England

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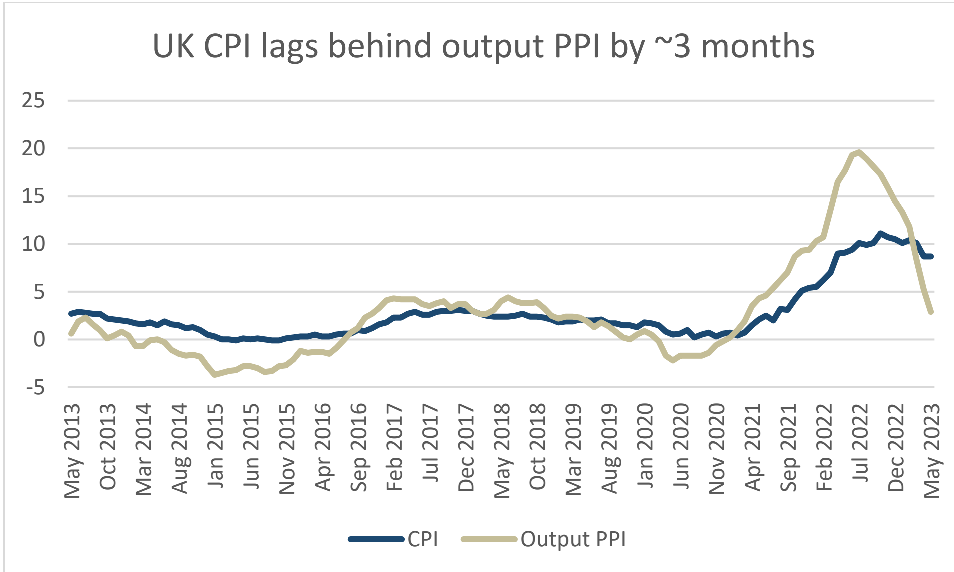


Source: Office for National Statistics

Performance

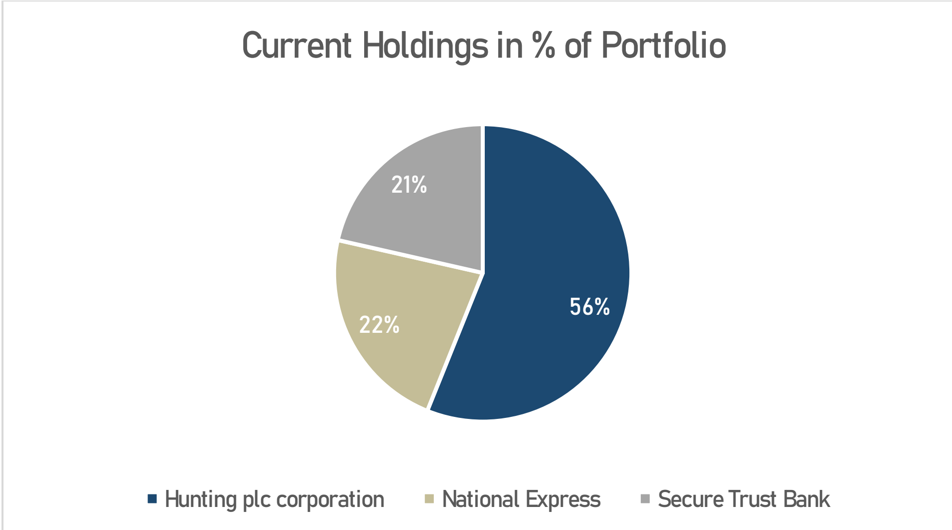
The 2nd quarter has been an extremely difficult one for our portfolio, down -13%, mostly due to the rise in UK interest rates compared to other countries elsewhere and how algorithms have sold certain UK listed companies with this background. In addition, Baillie Gifford axed their British Smaller Companies fund amid poor performance[2] and the demise of Crispin Odey also led to selling pressure in certain UK listed companies. By now, mid-July, I believe we have passed this point and this is reflected in the very strong performance of the portfolio in recent days.

<u>Current Holdings</u>

Company	Average Purchase Price	Current Market Price	% change
Hunting plc corporation	2.33	1.99	-14%
National Express	1.20	0.97	-19%
Secure Trust Bank	6.29	6.20	-1%

As of 30th June 2023

[2] https://citywire.com/wealth-manager/news/baillie-gifford-axes-british-smaller-companies-fund/a2421427



Outlook

Uncertainties remain high in so many ways. The globalization we have experienced over the last 20 years seem to have come to a halt and could reverse. The last time this happened was in the 1920s, after World War I and a pandemic caused shifts in geopolitics that were hard to reverse. The strong movements towards the left have followed a movement towards the far right, and this could repeat itself this time again. In the short to medium term, however, the biggest movement will likely be a de-coupling of China, and our portfolio is largely positioned to be unaffected by this (although the degree to which this is happening could have repercussions everywhere). Apart from the automotive industry, there is not much new investment going into China, and there will be a focus on localized supply chains. In the very near term, the consumer remains strong, and the lag between knowing that inflation has come down and pay rises should benefit the economy and consumer strength. This is why the portfolio is positioned towards consumer sensitive industries, in which there was the most value to be found as well.

Sincerely,

David Herrmann

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