IMS Capital

Quarterly Review

Q4 2021

Market Commentary

The OED recently decreed that "vax" was the word of 2021 but from an investment perspective if there was a word that summed up the last year it would probably be “transitory”. The word is defined as describing something that only lasts for a short amount of time, however, that meaning seems somewhat less clear when its used by central bankers to justify above-target rates of inflation. Without a timescale, it is simply too vague; for some, higher inflation for several weeks is transitory, for others it could be months or even years.

In his budget speech at the end of October, Rishi Sunak stated that the main measure of inflation, CPI, would rise to 4% in the new year according to the government’s Office for Budget Responsibility (OBR). The Chancellor was very eager to highlight that the OBR also believe that the UK economy will grow by 6% next year. Perhaps understandably he declined to mention that this forecast also made reference to impact of Brexit which it said would cause a 4% long-term hit to the economy. To put this into context, this is about twice the impact that the Covid pandemic is predicted to have according to the government’s own figures. This means that while UK contends with the same shortages and supply chain issues as every other country, we’re also dealing with a headwind of our own making.

These supply chain issues are a result of the rapid rise in demand caused by the global economy reopening while manufacturing and inventory levels were still very low. The impact has been felt by all of us, whether we’ve been buying a new car, or just trying to fill up our current one. For much of the year, the world's central bankers were convinced that this would be a temporary situation that would be quickly resolved and this was used as the rationale for not altering interest rates which remained stuck at record lows.

Almost immediately after Sunak had sat down, mortgage rates started to tick up and the next day the papers announced the end of the era of ultra-cheap loans. The mortgage companies are now in little doubt that with inflation likely to remain high for longer, central banks will need to tighten policy, i.e. they’ll begin to raise interest rates. The relative timing of expected rate rises is interesting; historically, the US presses the button first before the UK follows. This was the case on the last three occasions that a new raising cycle began in 1986, 1994 and 2015. This time around, however, all eyes on are the Bank of England to make the first move despite the fact that the US recovery started earlier and has been stronger. The reason is that, and despite a small drop in the latest reading, our inflation rate doesn’t seem likely to fall by a meaningful amount any time soon as global supply chain issues continue to be compounded by post-Brexit impacts.

Increasing interest rates imply that bond yields will rise and that is exactly what they have done. This means that their prices have decreased in response which has impacted throughout the fixed income spectrum. Managing portfolios under these conditions will be an important theme as we head to the end of the year, but we must remember that it is a necessary step in the return to a more normal world and that short term reactions like this are part and parcel of investing for the long term.

Performance Update

Contrary to the last quarter, where most sectors continued their upward trajectory, the returns over the last few months were more muted as the pressure of rising inflation began to have a more meaningful impact on some parts of our investment universe. Despite the challenges, all of the portfolios finished in positive territory for the month.

Equity markets were still largely in growth mode with US indices leading the charge on their way through new record highs. Japan equities also performed strongly as a change of Prime Minister gave investors hope that a more business friendly administration would see further improvements to the corporate outlook.

At the other end of the scale, fixed interest assets like bonds and, especially, Gilts struggled in the face of rising expectations for interest rate rises. We have spoken previously about how falling yields had been a boon for bonds as they move in the opposite direction to their value, but more recently whispers about interest rates have grown louder. The major central banks have begun to walk back from their long-held stance that inflation would be transitory and started to talk up the chance of rises at a faster rate than had been indicated. This resulted in significant volatility over the period which naturally had a larger impact on the lower risk models more than those with higher equity allocations.

Portfolio	3 month performance	12 month performance	36 month performance	60 month performance	12 month historical yield %
IMS Defensive Income	0.16%	7.24%	13.69%	19.29%	2.35%
Benchmark	*-0.18%*	*7.17%*	*13.18%*	*16.24%*	*n/a*
IMS High Income	1.46%	16.21%	21.66%	28.92%	2.77%
Benchmark	*1.25%*	*17.11%*	*23.43%*	*30.98%*	*n/a*
IMS Cautious	0.74%	12.80%	18.68%	28.38%	1.75%
Benchmark	*0.72%*	*13.99%*	*18.55%*	*24.06%*	*n/a*
IMS Balanced	1.17%	17.36%	26.08%	38.22%	1.53%
Benchmark	*1.77%*	*20.30%*	*28.48%*	*38.22%*	*n/a*
IMS Growth	1.89%	19.97%	31.57%	46.73%	1.35%
Benchmark	*1.96%*	*20.71%*	*30.09%*	*40.89%*	*n/a*
IMS Ethical	2.18%	20.00%	44.43%	61.28%	1.05%
Benchmark	*1.77%*	*20.30%*	*28.48%*	*38.22%*	*n/a*

All data are to 31/10/2021. Source: Financial Express Analytics

Portfolio Change Summary

This quarter we received the latest update to the long-term strategic models that form the backbone of our portfolios. These are created for us by Morningstar and they are reviewed on an annual basis at which point they reassess the outlook for all of the asset classes under their purview and adjust the weightings as they deem appropriate. As ever, we have overlaid this strategic asset allocation (SAA) with our shorter term tactical view which seeks to take account of factors such as the likelihood of interest rate rises.

One key theme from Morningstar's review was a reduction in the allocation to Emerging Market Debt which they believe has become overpriced. We have incorporated this shift in our portfolios, albeit not to the levels set in the SAA because we value the sector's role as a diversifier with the broader fixed interest universe. On the other side of this trade was a recommendation to increase to the US Equity position following a revaluation of the potential for the sector, specifically in terms of the large technology firms that have been the driver of much of the returns. We were reticent to add much to this end of the market, but have made increases to the sector in the Accumulation models with a focus on smaller caps in the belief that they offer a good pairing for the passive fund we use as the core of our US allocation.

Elsewhere small reductions were made to the Japanese and Emerging Market equity positions, again on the basis of valuations. These alterations should help to lower the overall risk of the portfolios, however, we are mindful of the benefits of holding a diverse range of different equities and have retained meaningful positions where suitable from a risk perspective.

We have also made some small increases to the UK Corporate Bond allocation which may appear a little counterintuitive given the situation with interest rates, however, we are keen to find a balance of different risks across all of our holdings. The SAA talks about adding to Gilts but with inflation predicted to remain elevated into 2022 we have to be cognisant of the impact this will have on total returns.

Tel: +44 2392 239800
Fax: +44 2392 263432
Email: info@imscapital.co.uk

5 Lancer House
Hussar Court
Westside View
Waterlooville
Hampshire
PO7 7SE