Monthly Commentary

February 2022

Market update and portfolio positioning

In the first couple of months of the year, the story behind equity moves has been all about high inflation and rising interest rates. We have seen significant shifts in stance from the Federal Reserve (Fed) and the European Central Bank (ECB), and a rate rise from the Bank of England (BoE). Furthermore, rising tensions between Russia and Ukraine have added to market tensions.

With inflation having risen in the UK, the BoE decided to raise rates by 0.25% to 0.5% early in February. While this hike was expected and fully priced-in, investors were caught off guard that four of the nine members on the Monetary Policy Committee (MPC) wanted to increase rates by an even larger 0.5%. The MPC also committed to fully unwind the £20bn corporate bond purchase program by the end of 2023. This revelation drove markets to expect increases in base rates at a faster pace, with rates now expected to breach 1% in May, rather than June. The rise in prices (particularly energy costs), in addition to potentially higher interest rates to come, may constrain consumer spending. As a result, whilst we still expect the BoE to raise rates several times this year, we do not expect it to mark the start of a multi-year hiking cycle. The latest Consumer Price Index (CPI) of 7.5% in the US was the highest in over 40 years, and was higher than expected, leading to a sell-off in both bonds and equities. One of the more hawkish members of the Fed expressed a preference for raising rates at a faster pace than anticipated. Chair Powell too has remained steadfast, displaying little concern about recent market volatility, and suggesting that hiking at a faster pace could not be ruled out. The market is now pricing in a 1.5% rise in rates this year, with lift-off taking place at the March meeting. The Fed has also been discussing reducing its balance sheet later this year, a process referred to as 'Quantitative Tightening'. As financial conditions will be tightening over the course of the year, we are cognisant of the heightened level of economic and geopolitical uncertainty. With the potential for higher energy costs to weigh on consumption, we have decided to moderate our view on US equities.

The ECB surprised investors by opening the door to a rate hike later this year. This marks a significant shift from its announced tapering plans as proposed in December. Inflation was expected to peak at the end of last year, but it continued to climb in January driving a reassessment of the ECB's base case scenario, which now sees inflation risk tilted to the upside. This unexpected turn has driven a wider gap between funding costs across Eurozone nations, with Southern European nations coming under some pressure. As Germany's 10-year government bond yields turned positive for the first time since 2019, this compounded upward pressure in both gilt and treasury market yields.

With central banks turning at a time when Russia is posturing around the Ukrainian border, this may push energy costs higher whilst adding inflationary pressures and uncertainty in equity markets. Whilst one cannot second guess the outcome of this crisis, we continue to believe investing in high-quality compounders continues to be the right approach when faced with uncertainty. The results season has demonstrated that the dispersion of returns has remained high and, in many cases, what has proven important is what companies do can be as important as the macroeconomic situation.

LGT Vestra Model Portfolios

In the Model Portfolios, we have implemented changes so the portfolios may be more robust in the face of heightened volatility. The introduction of the Ruffer Diversified Return and the trimming of the Fundsmith positions are indicative of this. Despite these changes, we remain confident in the overall composition of the portfolios and are not deviating from our preference of owning quality businesses with profitability, unique business models and high levels of cash generation. Top 10 holding, Diageo, is a great example as this is a business who's share price has fallen 10% YTD despite reporting a spectacular 24% growth in earnings and 20% growth in net sales[1]. This is exactly the type of business that may be affected by inflation in the short-term as the share price is re-rated, but over the long-term possesses the pricing power to pass on costs to consumers and post consistently strong earnings.

[1] Factset

Over the last few years, we have cut some of our larger positions, particularly in the global equity space in order to diversify fund manager risk. We've decided to continue this theme, switching 2% from Fundsmith in to the Evenlode Global Income fund, a position that we initially added in September 2020. Whilst the Evenlode fund has a similar quality bias to Fundsmith, its investment process is much more valuation focused. This leads to a portfolio that is similar in terms of sector exposure but has a very different regional allocation; higher UK and Europe, lower US. The underlying portfolio features companies with asset light business models and strong economic moats that are able to grow the dividend in real terms over the long-term. So whilst the fund has income within the name and will deliver a yield of 2-3%, the approach is about balancing income today with opportunity for growth.

As mentioned in the update above, uncertainty is high and we expect volatility to remain elevated. Therefore, we have decided to reduce exposure to the high beta Morgan Stanley US fund. We have removed the position in the lower risk portfolios and tapered it slightly in our Balanced portfolio. Whilst volatility levels for all portfolios have trended upwards over the last few years, we must be particularly aware of breaching our stated risk bands in the lower risk portfolios and therefore, felt it was no longer prudent to hold such a high Beta fund in these portfolios. Whilst recent performance has been disappointing, it is important to remember that this is a position that we've taken profits on multiple times since its inclusion as the position grew in size due to strong performance. We have temporarily allocated the holding in to the passive L&G US Index until we see an opportunity to deploy the capital elsewhere.

Model Portfolio Service (MPS) performance and volatility as at 31 January 2022

	Target*			Five year annualised	
	Volatility %	Return % pa	Maximum Loss %	Volatility %	Return %
Defensive	2 to 4.75	3 to 4.5	-5.0	4.30	3.86
Cautious	4 to 7	4.5 to 6	-9.1	5.45	4.65
Balanced	5 to 9	5.2 to 7.5	-13.5	7.86	5.72
Growth	8 to 13	6 to 8	-19.0	9.78	6.47
Adventurous	10 to 16	7 to 10	-25.0	11.54	7.50
Strategic Income	Annual target income of 3.5%				

* **Where targets are given, these are for indication purposes only; the actual figures achieved could be more or less than the ranges given.** Quarterly figures are net of underlying fund costs but gross of all other charges. Other charges include the LGT Vestra discretionary management fee, the platform custody charge, all adviser charges and where applicable any transaction costs (e.g. trading charges).

Key market data (as at 31/01/22)

Asset class	Level	1m %	3m %	6m %	1y %	3y %	5y %	YTD %
Equity indices (total return) *								
FTSE All-Share (GBP)	4192	-0.3	2.0	5.6	18.9	21.7	30.2	-0.3
S&P 500 (USD)	4516	-5.2	-1.6	3.4	23.3	75.9	117.2	-5.2
Euro Stoxx 50 (EUR)	4175	-2.8	-1.6	2.6	22.2	41.0	45.4	-2.8
Nikkei 225 (JPY)	27002	-6.2	-6.4	-0.2	-0.8	37.6	56.0	-6.2
MSCI World (USD)	3059	-5.3	-3.4	0.3	16.5	58.4	86.3	-5.3
MSCI AC Asia Pacific ex Japan (USD)	605	-4.0	-6.4	-6.6	-9.9	26.8	51.6	-4.0
MSCI Emerging Markets (USD)	1208	-1.9	-4.1	-4.6	-7.2	23.2	49.0	-1.9
10 year bond yields **								
UK	1.30	0.3	0.3	0.7	1.0	0.1	-0.1	0.3
US	1.78	0.3	0.2	0.6	0.7	-0.9	-0.7	0.3
Germany	0.01	0.2	0.1	0.5	0.5	-0.1	-0.4	0.2
Japan	0.18	0.1	0.1	0.2	0.1	0.2	0.1	0.1
Commodities (USD)								
Gold	1797	-1.8	0.8	-0.9	-2.7	36.0	48.4	-1.8
Oil	91	17.3	8.1	19.5	63.2	47.4	63.8	17.3
Currency								
GBP-USD	1.34	-0.6	-1.7	-3.3	-1.9	2.6	6.9	-0.6
GBP-EUR	1.20	0.7	1.1	2.2	6.1	4.5	2.8	0.7
EUR-USD	1.12	-1.2	-2.8	-5.3	-7.4	-1.9	4.0	-1.2
USD-JPY	115.11	0.0	1.0	4.9	10.0	5.7	2.0	0.0

Sources: Bloomberg, ICE, London Stock Exchange, MSCI, Standard & Poor's, Stoxx Tokyo Stock Exchange
* Performance is given on total return indices, but the levels are for the main indices.
** Displayed as absolute changes in yields, rather than percentages.

MPS positioning as at 11 January 2022 (%)*

	Defensive	Cautious	Balanced	Growth	Adventurous	Strategic Income
Fixed Income	**41**	**35**	**21**	**17**	**5**	**32**
AXA US Short Duration High Yield Bond	8	6	3	4		7
Jupiter Strategic Bond	8	7	6	5		7
M&G Strategic Corporate Bond						6
Muzinich Global Tactical Credit	4	4	3	3		4
Vanguard US Govt Bond Index	7	6	3			
Neuberger EM Debt Blend				5	5	5
Muzinich EM Short Duration	3	3				3
Allianz Strategic Bond	5	5	4			
Vanguard Global Short Term Bond Index	6	4	2			
UK Equities	**8**	**11**	**17**	**17**	**17**	**15**
Merian UK Smaller			3	5	7	
Threadneedle UK Equity Income	3	4	5	4	4	4
Marlborough Multi Cap Income						3
Schroder Income Maximiser						4
RWC Enhanced Income						4
CF Lindsell Train UK Equity	3	3	4	4	4	
Liontrust Special Situations	2	4	5	4	2	
International Equities	**18**	**30**	**47**	**61**	**76**	**51**
North America	*7*	*8*	*14*	*14*	*19*	*8*
Schroder US Equity Income Maximiser						8
Morgan Stanley US Advantage			3	5	5	
T Rowe US Smaller Companies			5	5	6	
AB US Sustainable	3	4	4	4	4	
M&G North America Value					4	
L&G US	4	4	2			
Asia Pacific & Emerging Markets	*2*	*6*	*10*	*16*	*19*	*9*
Baillie Gifford Japanese Smaller Companies				3	6	
Schroder Asian Total Return	2	2	3	4	5	
Schroder Asian Income Maximiser						7
Stewart Investors Asia Pacific Leaders		4	4	3	2	2
Morgan Stanley Asia Opportunity			3	3	3	
Impax Asian Environmental				3	3	
Global	*9*	*16*	*23*	*31*	*38*	*34*
Fundsmith	2	5	6	6	6	*5*
Morgan Stanley Global Brands Hedged			5	5		
Morgan Stanley Global Brands Equity Income						5
Brown Advisory Global Leaders	2	3	3	4	4	
Fidelity Global Dividend	3	4	4	5	6	
Fidelity Global Dividend Hedged						8
Lindsell Train Global Equity						4
Evenlode Global Income	2	4	5	4	5	6
BG Global Discovery					2	
Polar Capital Global Insurance Fund				3	4	
L&G Tech					5	
Lazard Global Listed Infrastructure				4	4	6
RobeccoSAM Smart Materials					2	
Alternatives	**22**	**20**	**12**	**3**	**0**	**0**
Absolute Return	*22*	*20*	*12*	*3*	*0*	*0*
BlackRock Global Event Driven	3	2	3			

Henderson Absolute Return	5	5	2			
Troy Trojan	6	5	4	3		
CG Absolute Return	4	4				
Ruffer Diversified Return	4	4	3			
Cash / Liquidity Funds	**11**	**4**	**3**	**2**	**2**	**2**
BlackRock Cash	9	2	1			
Cash	2	2	2	2	2	2

*This date reflects the most recent asset allocation for the Model Portfolios.

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The market views herein are drawn from the minutes of the LGT Vestra LLP Investment Committee which meets on a monthly basis.