CityAsset
MANAGEMENT PLC

Sustainable Valuation Commentary

October 2023

Executive Summary

The Bank of England (BoE) agreed to hold rates at 5.25% at the most recent Monetary Policy Committee meeting, which was a surprise for many. While the economic data is changing and we are starting to see the impacts of recent rate rises, inflation still has a way to fall before it hits the BoE's 2% target.

So where does this leave us? We continue our thoughts that the UK will enter recession as a by-product of restrictive monetary policy. It seems likely that we'll see interest rates remain around current levels for the next six months or so, it is a similar situation across the Atlantic in the US.

We remain positive towards short-dated government debt, but the next move for us will be to consider what we do in the upcoming stage in the cycle, and how (and when) we reposition our sustainable portfolios once we are in a lower rate environment.

Our recent letters have been dominated by inflation and Central Banks' effort to curb this through interest rate rises. We have remarked that forecasted interest rate levels are changing very rapidly; in fact, in June, we wrote "Where do UK rates get to? The market is now pricing in a rate of more than 6%. Only a month ago, this looked unrealistic." Expectations topped out at 6.5% only to be, thankfully, halted; weaker than expected UK data led to a surprising hold on rates by the BoE at the September rate setting meeting. In the days prior to the September rate meeting, data surprised on the downside. A much-expected rise in inflation, due largely to forecourt petrol rises, morphed into a small fall in inflation because other inputs dropped substantially. The latest Gross Domestic Product (GDP) figure, a measure of economic growth, fell prior to the meeting. The latest Purchasing Manager Index (PMI), a measure of prevailing trends within industry and services, was released post the rate meeting, but the BoE would have had sight of these figures, which were also feeble. This data led to the BoE deciding to keep rates on hold at 5.25%, although voting was split and the Governor, Andrew Bailey, had to use his casting vote.

What can we read into this? The first message is that, at this point in the economic cycle and with unusual circumstances prevailing, forecasting is challenged. However, some assumptions can be made. The UK is either close to or at peak rates. Another rise should not be ruled out but only if inflation restarts its upwards climb with a vengeance or if wage inflation proves much stickier. The consensus is that higher for longer is now considered the most likely environment. Do we agree? In part, it is doubtful that rates will come down as quickly as they went up. However, as recessionary fears become reality, the BoE will be forced to act. The market is predicting that the first rate cuts will be towards the middle of 2024, but we expect the move to be earlier than this.

Looking further afield, consensus predicts a ‘soft landing’ for the US economy. This is important as the US is still the dominant economy globally, although we do not underestimate China’s influence. This is a knife edge in terms of the US central bank, the Fed, being able to deliver a soft landing. Let us not forget that this outcome is just marginally better than a recession and, to many, it will feel just like a recession. So why are we less negative here? The US economy continues to confound with better-than-expected data. But, very recently, a selloff in the bond market is reflecting a change in the mood music; again, higher rates for longer are now being priced in. We are observing the exuberance from a small number of highly influential US stocks starting to wane. However, one can never rule out the US market; it remains the most efficient and prestigious of all the global markets.

China is experiencing a problem set all its own; woes within its property sector have severely dented sentiment. Some high-profile Chinese property companies are in, or close to, debt default, highlighting the pitfalls of carrying large levels of debt. Additionally, the Chinese government appear unwilling to bail these companies out, given their view that residential property is for accommodation not speculation. Re-shoring and changes in US policy with respect to semi-conductor imports (limiting China’s access) is squeezing the outlook and, of course, sentiment. China will continue to play a substantial role within the global economy but, in comparison with the last decade, forecasted growth is much more muted. It remains possible that China begins to re-export deflation to the rest of the world to protect domestic jobs, but the playing field has changed.

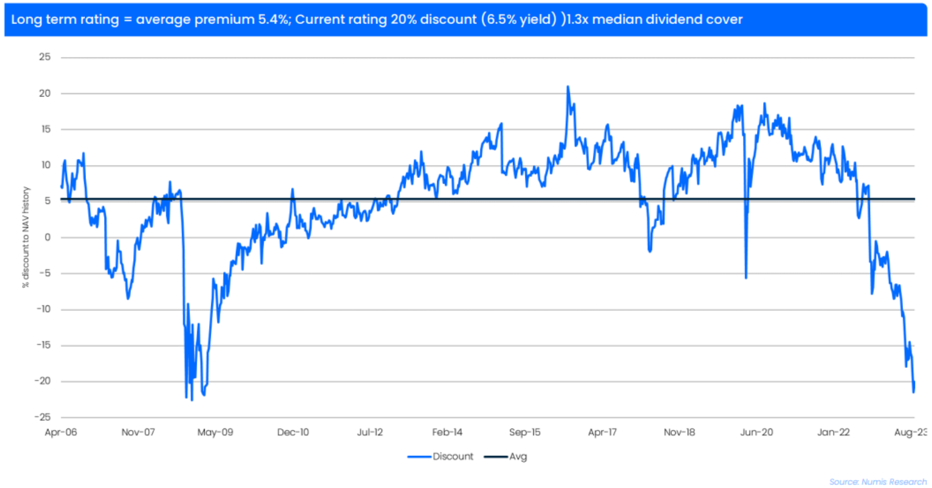
European data continues the negative theme, with their latest PMIs confirming the weak trend. Even Germany, once the stalwart, looks fragile. The German reliance on China is hurting and, of course, its strong industrial base is facing the headwinds of a global slowdown. Our exposure to Europe is minimal and, to be blunt, our overall equity weights have not moved materially in some time.

We split our bond exposure between what we call ‘core fixed interest’ and ‘specialist fixed interest’. In the past, we have discussed that the former provides a degree of ballast within portfolios and given recent increases in interest rates, it has proven attractive. We believe that core fixed interest will remain attractive for the short term at least but, as the outlook for interest rate changes, we will look to move this bucket towards those fixed income assets with longer duration. For example, government bonds that are longer dated and will benefit from a rate fall. The specialist fixed interest sector continues to provide an attractive risk versus return payoff, with a substantial part of the return coming from what is known as the ‘coupon’ or yield; in most cases these are high single digits.

We are also still positive on the alternative income sector and have written about this extensively (you can read the previous commentaries here). We will not revisit this topic for long, but we want to confirm our view that selling holdings in the alternatives sector where latent value has not yet been unlocked would be capitulation. The chart below shows the discounts/premium for the listed infrastructure going back to April 2006. One can see the last time discounts were this wide was during the Global Financial Crisis of 2008 and, of course, these assets rallied post that environment. Whilst many companies in this sector continue to trade at a discount, good dividend cover and attractive yields reaffirm my view that there is good value to be found here.

By this point in the letter, we would usually have mentioned several issues dominating the sustainable investing landscape. It is telling that it has taken us this far before mentioning the subject – but also not wholly surprising. There are times where sustainable investing issues are at the fore. The way companies and governments are managing issues such as the energy transition and wider societal impact seem to be one of the most important parts of an investment case. However, at other times this is not the case, and it certainly feels like we are in one of those moments. Over the last 18 months, companies benefitting from strong sustainability themes have been out of favour. A large part of this is that when the economic environment becomes more challenging our focus becomes much shorter and we focus on the here and now. We can see this with our government rolling back targets for electric vehicles and improving the energy efficiency of our housing stock. However, it is not just limited to these shores. A more dominant fossil fuel industry is taking shape in

Few prolonged periods of wide discounts



the US, as shown by the acquisition of shale gas producer Pioneer Resources by Exxon. We can see China, India, and even Germany making use of cheaper energy from burning coal. At these moments, it can be a headwind for sustainable investing which by definition is long-term.

On top of this, we still have the very real geopolitical issues that shift focus to the short-term again. Following on from the Russia/Ukraine conflict beginning last year we are now confronted with news of the terrible events in Israel and Gaza. I am sure that like us, you are all shocked and saddened by the incidents that have occurred and the current environment in the region. Market moves pale into insignificance with any loss of life. But there will be implications. Whilst neither Gaza nor Israel are oil producers, this has had implications for the oil price. The price of crude rose by around 5% over fears as to how the Saudis and the Russians will respond. The overall implications of the attack are too early to tell at this point. Israel and her allies will ask questions as to which nation states were involved and, of course, the Israeli response is likely to be extensive. Peace in the Middle East looks as unlikely as at any other point in recent history. Some form of inflationary impact (oil price rises) is likely and global stability has weakened further. If the Russians are perceived to have a hand in this, Syria becomes a larger problem – it is already assumed that Iran is involved. The Saudis are now caught between two opposing forces. We would not expect substantive market falls if the conflict is contained, but if one of the larger traditional foes of Israel enters the fray then markets could react.

It is easy then to get carried away, as much of the market will have, and become fearful and take decisions which could be damaging to your future wealth. We have heard many stories of investors capitulating and selling their long-term investments at times like these. They do this to move to savings accounts or short-term investments which are safer and feel more comforting in the short-term, but do not have the ability to grow wealth above inflation over the long-term. The same dynamic happening in market sentiment regarding the sustainable investments we make on your behalf. This results in many assets trading at multi-year low valuations which are key to the long-term future of our society and have significant opportunities for growth ahead of them. This is where thinking sustainably can help. As investors we can think long-term and back the investments which stand to benefit when businesses run more sustainably and see growth from areas such as renewable energy, the circular economy and creating products using less of the earth's finite resources.

In summary, we remain confident that our sustainable portfolios are heavy with latent value and that patience is key. Our internal discussion is moving towards how we reposition sustainable portfolios to take advantage of buying assets that will do comparatively well in challenged markets and those that typically do well once we have reached peak fear in the markets. In the short-term this equates to long duration assets (those that benefit when interest rates fall) and in the medium-term a move towards assets with higher returns that do well in a recovery.

As always if you have any questions, please get in touch with your usual CAM contact.

Louis Tambe

Head of Managed Portfolio Service

As Head of our Managed Portfolio Service, Louis is responsible for investment research, fund selection and asset allocation, mainly focused on equity and alternative asset classes. He is motivated by the opportunity to protect and grow the hard-earned capital of City Asset Management's clients and has recently been a key part in designing CAM's sustainable investing service. Before joining CAM, Louis was a Fund Analyst at FE Investments where he covered equity and alternative strategies and he has Chartered Alternative Investment Analyst status.

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