Fund Management Diary

Meeting held on 13th October 2020

Market Update

Will inflation make a comeback?

- **Although low inflation is likely to be the story over the next couple of years, central banks' asset purchases, along with emergency bank lending programmes, are directly boosting the money supply. The huge amount of policy stimulus could push up inflation further ahead.**
- **Money is ending up in the hands of those most likely to spend it (i.e. firms and households). We expect that firms and households will want to hold higher precautionary cash balances for some time, meaning there is likely to be spare capacity for a while to prevent inflation rising. However, once precautionary saving fades, the extra demand could fuel inflation.**
- **There are risks to higher inflation, particularly in countries where central banks are vulnerable to political pressure and where government debt burdens look unsustainable (in both cases, mainly emerging markets).**

A huge, two-pronged stimulus means broad money growth is accelerating fast

There have been two components to the stimulus response seen so far to the economic fallout of the coronavirus pandemic – the money printing by central banks, and the fiscal stimulus by governments which has redistributed money from financial institutions to firms and households. Central banks' actions, whether through quantitative easing (QE) or the various liquidity programmes, have already hugely boosted the monetary base. Together with the pick-up in bank lending growth, this means that broad money growth has already risen sharply in countries like the United States, United Kingdom and euro-zone.

Some of this rise in the monetary base will quickly be reversed as short-term emergency liquidity measures expire. However, most is unlikely to be reversed soon. In fact, we think that most central banks will expand their quantitative easing programmes further. If we assume that the monetary base grows in line with our forecasts for central banks' asset purchases, then it has much further to rise. By the end of next year, we think that it will end up double its pre-crisis level in the United Kingdom, and not far off that in the United States.

There are two key facts about the recent stimulus that mean it has big inflationary potential. The first is that it has combined both an enormous amount of fiscal stimulus and central bank asset purchases. And the second is the sheer scale of both. The rises in fiscal deficits have generally dwarfed the size of those seen after the global financial crisis. Similarly, central bank asset purchases have generally been on a scale not seen before. Even going back further, it has been rare to see this powerful a stimulus. That is particularly true of past pandemics, which have generally produced little in the way of a policy response.

Money ending up in the right place

The current policy response has effectively amounted to debt monetisation. Crucially, this means not only that the money supply is rising sharply, but that this rise in money will end up in the hands of those most likely to spend it. The financial institutions that have bought bonds from the government and sold bonds to the central bank have essentially just acted as a go-between**.** So the money printed by the central bank has ultimately gone to the households and firms who have been recipients of the fiscal giveaways. Indeed, the magnitudes of the money printing and the fiscal stimulus have generally been very similar so far.

This differs from the policy impact seen during the Global Financial Crisis, when fiscal policy was not being loosened at the same time as QE. QE was accompanied by falling government borrowing in the United States, United Kingdom and Japan, and broadly stable borrowing in the euro-zone. So, although QE still provided a direct boost to the money supply, this money got lost in the financial sector. Accordingly, the only way in which QE was ever going to boost activity and inflation was via the financial sector. Even if such channels did work, the effect was mainly to boost asset, rather than consumer, prices.

Still, the link between money growth and inflation is not automatic. For inflation to arise, faster money growth would need to give a big boost to demand for goods and services and this extra demand would then need to fuel inflation. But uncertainty about the virus means that firms and households will want to hold higher precautionary money balances for some time yet. Moreover, during the crisis, the velocity of circulation (ratio of gross domestic product to broad money) has fallen sharply. We doubt that this will suddenly rebound, even as lockdowns ease. And even if money growth boosts demand, there will be spare capacity in the economy for a while that will prevent inflation rising. We expect aggregate demand to recover more slowly than supply and core inflation to remain subdued by end-2022.

But at some point, uncertainty surrounding the virus will fade and the economy will return to full employment. Then, the risk of a rise in inflation as firms and households seek to reduce their excess money balances will be somewhat higher, especially if they are concentrated in households with a higher propensity to consume. But they might instead use them to repay the emergency credit lines they drew down as a precaution during the crisis and/or repay other debt. In open economies, some of the resulting rise in aggregate demand would just result in more imports being sucked in. Inflation might also be less likely to pick up in countries where there is stability of inflation expectations or weak bargaining power of labour. The coronavirus crisis could also trigger a rise in investment in the digital economy that boosts productivity growth and therefore puts downward pressure on unit labour costs and inflation.

Inflation could be stopped in theory, but there are risks

Any inflationary threat is still years away and low inflation is still likely to be seen in the near-term. Further ahead, though, the picture could be very different. This depends both on the impact of the large amount of money that has been pumped into economies and how policymakers' attitudes towards inflation evolve post-coronavirus.

We think that there are broadly three possible scenarios. The first is that the huge policy stimulus does nothing to inflation, just as the QE after the financial crisis had little impact. Eventually economies just grow into their higher money balances. This may be the case for Japan, where the rise in the money supply has been relatively small and the structural forces bearing down on inflation are very strong. For some other major developed economies, though, the inflationary potential of the recent stimulus seems higher.

If an inflationary threat did emerge, policymakers have the tools to nip inflation in the bud – in theory. They could manage to head it off by tightening policy. Interest rates would therefore probably rise faster in the second half of this decade than financial markets think. Even with financial repression, government bond yields (and yields on other assets) would rise more quickly than most assume. The other scenario is that policymakers allow inflation to rise, whether accidentally or deliberately. In that case, we would be on the brink of a transition to a new – and largely unanticipated – inflationary era.

The risks of inflation are arguably biggest in those countries where governments have the greatest incentive to allow, or encourage, inflation. This includes those whose public sector debt after the crisis will be on an unsustainable path and who view higher inflation as preferable to the other options of austerity or default. For now, this group includes hardly any countries, but it could grow if countries struggle to reduce their debt burden by other means (to include, for example, Brazil and South Africa). It also includes governments that are most likely to continue running deficits even after the crisis, which we think includes the United States and United Kingdom.

Inflation risks are also highest in countries where central banks are most likely to allow higher inflation. This includes those countries where central banks have limited independence and they are vulnerable to political pressure. These are most likely to be emerging markets. India is a good recent example; political pressure from the government culminated in 2018 in the resignation of the Governor of the Reserve Bank of India and the appointment of a government ally. But it also includes countries where monetary policy frameworks might be adapted to permit higher inflation – with the United States again potentially fitting the bill.

Different countries may end up going in different directions. Accordingly, it is possible that later this decade, there could be a period of divergence in inflation rates in the major developed economies not seen since the early 1980s and early 1990s. Whereas a sustained shift to permanently higher deficits seems unlikely within the constraints of the euro-zone, it would be much easier for this to happen in the United States and United Kingdom. In fact, the United States was running significant fiscal deficits even before the coronavirus hit. If we do see the low-inflation era in developed economies draw to a close, it seems most likely to happen first in the United States, and perhaps the United Kingdom.

*This diary has been written in conjunction with Capital Economics.

Strategy

We agree with Capital Economics' assessment that rising inflation expectations will become much more likely due to the sheer scale of stimulus feeding into the economy. Household savings have been forced to increase, and at some stage this excess liquidity will be spent, feeding into the demand side of the inflation equation. This would be particularly painful for long-dated bondholders, who are already paying a premium for a punitive yield, and even the smallest rise in inflation would greatly reduce return prospects.

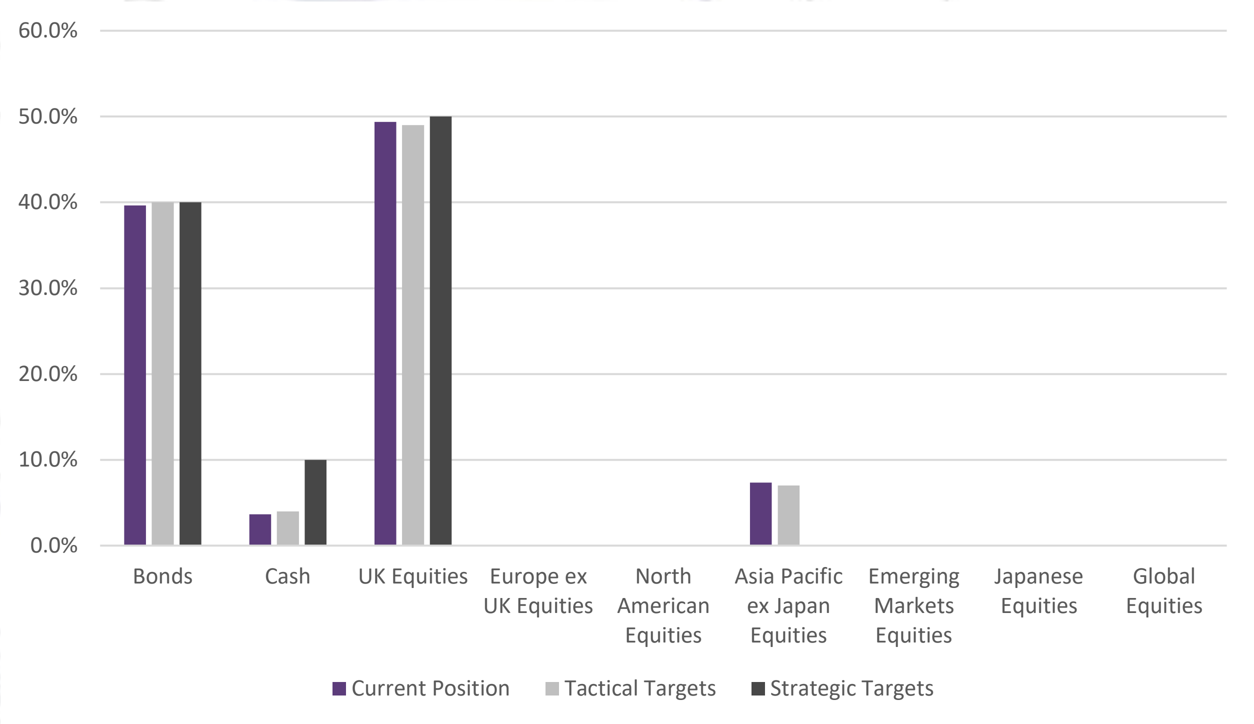
We remain positioned in our bond investments with a bias to short-dated corporate bonds, as these offer an above inflation yield for our investors with much lower credit and duration risk. It is our consensus that the potential of rising inflation, as noted in Capital Economics' assessment, is not adequately reflected in current bond pricing.

Our overweight positioning in equities reflects the much more attractive yield on offer, with FTSE 100 equities yielding over 3% above UK gilts. We maintain our long-held view since the Brexit vote in 2016 that common sense would result in a trade deal in some capacity, and the quiet press and continued dialogue between the UK and EU appears optimistic in this regard. We are also bullish in regard to Asia and emerging markets, particularly those countries who have quashed the virus resurgence via successful contact tracing and local lockdowns and returned to positive economic sentiment and indicators. Our underweight US positioning reflects concern over valuations and the top-heavy constitution of the S&P 500 index.

Fund Comments

The below charts show the current positions of the funds, the tactical (short term) targets, and the strategic (long term) allocations of the funds. We aim to keep the current positions in line with the tactical targets from week to week. The differences between the tactical and strategic weightings reflect the views and convictions of the Margetts Investment Committee.

Providence



Asset Allocation: The above chart, as of 13/10/2020, demonstrates the fund's current asset allocation and tactical targets set by the committee. No changes are being made to the tactical targets or current asset allocation this week.

Fund Selection: Providence was ahead of the IA Mixed Investment 20-60% Shares sector over 1 week.

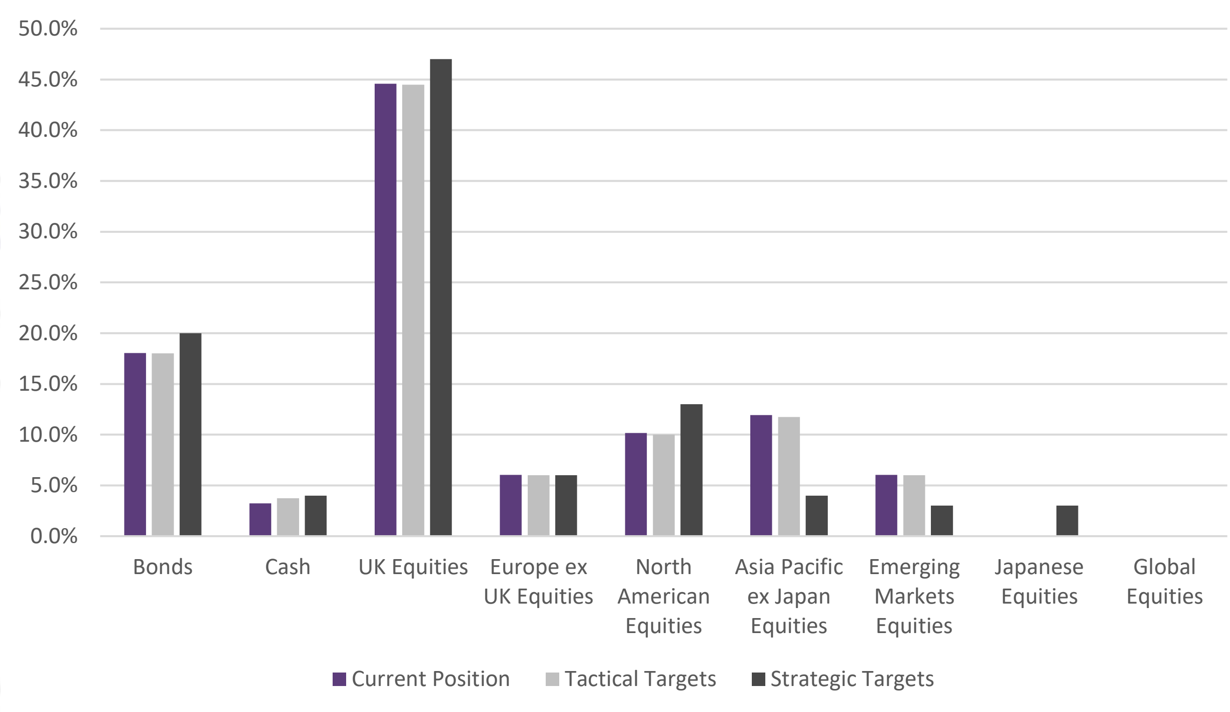
The only Asia Pacific strategy, the L&G Asian Income fund, lagged the IA Asia Pacific ex Japan sector over 1-12 weeks.

All but one of the underlying bond holdings were in line with or ahead of their respective sectors over 1 week, and all were ahead of or in line over 2-12 weeks.

Within the UK, the majority of underlying holdings were ahead of or in line with the IA UK Equity Income sector over 1-12 weeks, with the Aviva UK Listed Equity Income strategy emerging as the strongest performer during this time.

No fund changes are being considered at this time.

Select



Asset Allocation: The above chart, as of 13/10/2020, demonstrates the fund's current asset allocation and tactical targets set by the committee. No changes are being made to the tactical targets or current asset allocation this week.

Fund Selection: Select was ahead of the IA Mixed Investment 40-85% Shares sector by c.1.2 percentage points over 1 week.

The Fidelity Asia and Schroder Asian Income strategies paired well, with the stronger performance of the former offsetting the relatively weaker performance of the latter over 1-12 weeks.

All underlying bond funds were ahead of or in line with their respective sectors over 1-12 weeks.

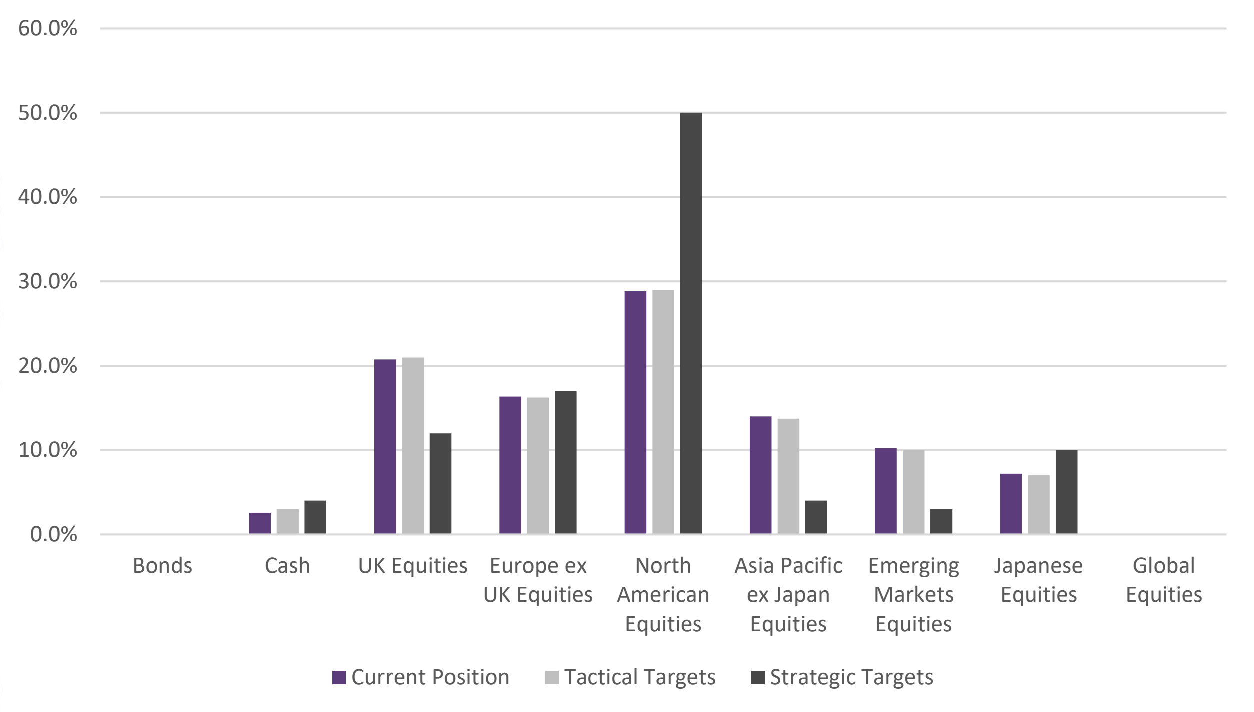
The performance of the UBS Global Emerging Markets strategy was strong, returning ahead of the IA Global Emerging Markets sector over 1-12 weeks, while the Fidelity European holding lagged the IA Europe ex UK sector during this period.

Both underlying US holdings were ahead of or in line with the IA North America sector over 1 week.

While the Jupiter UK Special situations fund proved to be the strongest UK performer over 1 week, the SVM UK Growth strategy had the highest relative returns within the portfolio over 12 weeks, at c.5.5 percentage points ahead of the IA UK All Companies sector.

No fund changes are being considered at this time.

International



Asset Allocation: The above chart, as at 13/10/2020, demonstrates the fund's current asset allocation and tactical targets set by the committee. No changes are being made to the tactical targets or current asset allocation this week.

Fund Selection: International was ahead of the IA Global sector over 1 week.

Within Asia Pacific, the stronger performance of the Baillie Gifford Pacific fund counterbalanced the relatively weaker performance of the L&G Asian Income strategy over 1-12 weeks.

Both underlying holdings within Emerging Markets were in line with or ahead of the IA Global Emerging Markets sector over 1 and 12 weeks.

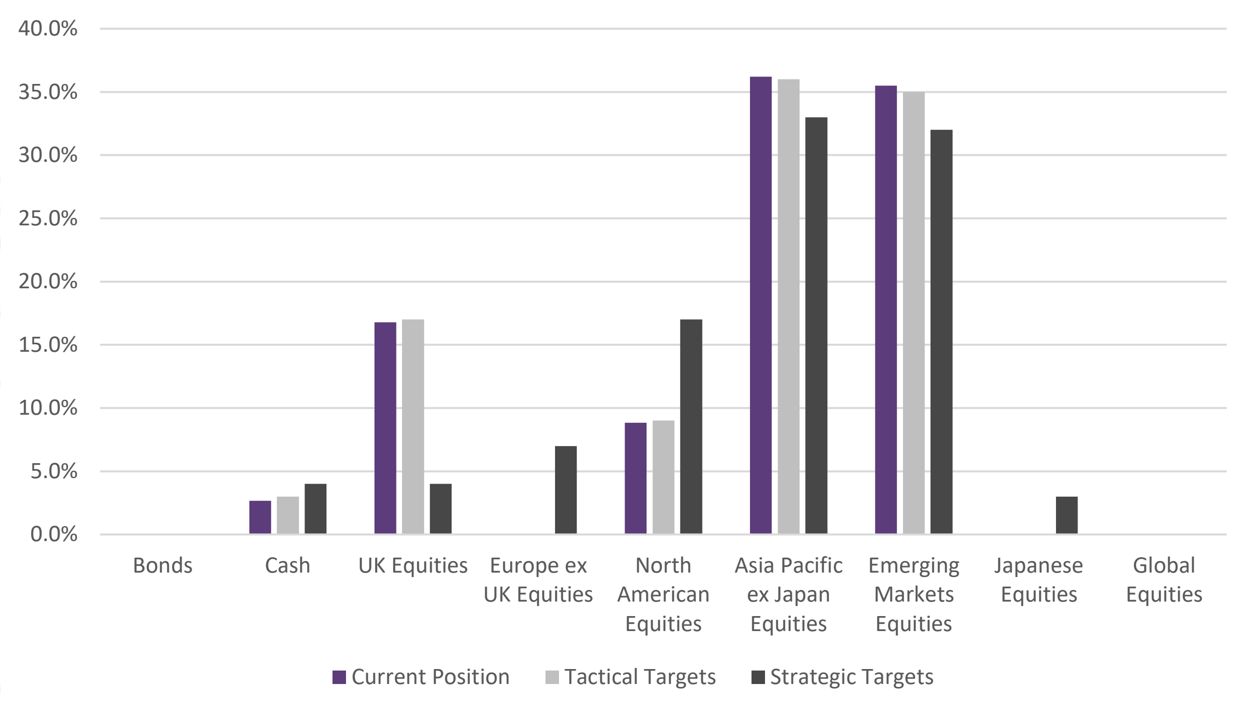
The strongest European performer over 12 weeks remained the Blackrock Continental European strategy, returning c.5.2 percentage points ahead of the IA Europe ex UK sector.

Both underlying Japanese holdings surpassed the IA Japan sector over 1 week and all underlying US holdings were in line with or ahead of the IA North America sector during this period.

The UK mid-cap strategy returned ahead of its large cap peers over 1 week.

No fund changes are being considered at this time.

Venture



Asset Allocation: The above chart, as of 13/10/2020, demonstrates the fund's current asset allocation and tactical targets set by the committee. No changes are being made to the tactical targets or current asset allocation this week.

Fund Selection: Venture's performance was strong, returning ahead of the IA Flexible Investment sector over 1-12 weeks.

Most underlying Asia Pacific funds were in line with or ahead of the IA Asia Pacific ex Japan sector over 1-12 weeks.

All underlying Emerging Markets funds were in line with or ahead of the IA Global Emerging Markets sector over 1-4 weeks. The Threadneedle Global Emerging Markets strategy remained the strongest performer in the portfolio over 12 weeks, at c.6.3 percentage points ahead of the sector.

The underlying US holding was in front of the IA North America sector over 1 week.

As seen within International, UK holdings with a mid-cap bias outperformed larger cap holdings over 1 week.

No fund changes are being considered at this time.

Important Information

Please note that the contents are based on the author's opinion and are not intended as investment advice. This information is aimed at professional advisers and should not be relied upon by any other persons.

Any research is for information only, does not constitute financial advice or necessarily reflect the views of the author and is subject to change.

It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested especially in the early years.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

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