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INVESTMENT MANAGEMENT

EPIM Brunel

Quarterly report – Q3 2021

POWERED BY

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Introduction

Welcome to the EPIM Brunel investment review. In this report we will be covering information and events that influenced performance during the third quarter of 2021.

Global equities rose at a more modest pace in the third quarter of 2021, as investors weighed up strong corporate profits against higher inflation and slower economic growth.

Much of the rise in inflation was driven by greater-than-expected demand for goods, which wasn't matched by a corresponding increase in supply. Rather, several business surveys revealed that global supply chain bottlenecks constrained output, leading to concerns that the recovery from the pandemic would be slower than anticipated. Supply constraints were particularly evident in the oil market, driving energy prices to record highs.

Against this backdrop, central banks began to adopt a more hawkish tone as the quarter progressed. The Bank of England indicated there could be two interest rate hikes in the first half of 2022, while the Federal Reserve said it would slowly reduce its pace of asset purchasing and may increase interest rates by the end of 2022.

Events in China also weighed on investor sentiment. The government's regulatory crackdown hurt the education and technology sectors, power outages resulted in lower factory production, and the Evergrande crisis sparked fears of global financial chaos.

Global equities continue to face several headwinds going into the final quarter of 2021, but with ongoing fiscal support and an encouraging outlook for corporate profit growth, a healthy equity overweight continues to be justified.

Market overview Q3 2021

- The strong global economic growth that we saw earlier this year cooled in the third quarter, yet ongoing fiscal support is likely to support growth going forwards.
- The Covid-19 vaccination drive gathered pace, and figures show vaccines are helping to prevent severe illness. Vaccine mandates are becoming more common throughout the world.
- China's regulatory crackdown in July caused a selloff in Chinese technology stocks and other sectors such as healthcare, insurance and real estate. The Chinese Communist Party is putting greater emphasis on its social goals, reducing monopoly power, and maintaining control, which is hurting Chinese large cap corporate growth prospects.
- Bond yields rose as central banks turned more hawkish and inflation proved to be stickier than expected.
- The Bank of England conditioned the market to expect two interest rate increases in the first half of 2022. Although this will leave interest rates far below the current level of inflation, this policy stance is quite aggressive compared with US Federal Reserve, which will slowly reduce its asset purchases and may increase interest rates by the end of 2022.
- Interest rate discussions have been helpful for cyclical value stocks relative to growth names.
- After the massive rally of the past 18 months, the Evergrande crisis, high inflation, a hawkish central bank tilt and plateauing global growth momentum have provided nervous equity investors with an excuse to take profits.
- While these headwinds are important, they probably do not amount to insurmountable roadblocks to the equity bull market. Corrections like the one we are in the midst of are healthy components of a bull market.

The big picture in Q3

- Global equities put in a more modest performance in the third quarter, rising by 1.6% as investors weighed up positive yet slowing economic growth against supply chain disruptions and rising inflation.
- UK equities gained more than 2%, ahead of overseas equities which rose 1.3%.
- Within overseas equities, Japanese equities outperformed with a gain of 7.0%, whereas Asia ex-Japan equities fell by 5.4% amid China's regulatory crackdown. US equities rose by 2.5%, with a rise in Treasury yields weighing on technology stocks.
- In Fixed Interest, Bonds were relatively flat, with corporates outperforming sovereigns. Inflation-linked bonds gained 2.0% whereas higher-duration UK bonds slipped 1.4%.
- Cyclical value stocks outperformed growth stocks as central banks signalled interest rate hikes could come sooner than expected.
- After falling at the start of the quarter, the ten-year US Treasury yield finished up one basis point to 1.49%, while the ten-year UK Gilt yield rose from 0.72% to 1.02% as central banks adopted a more hawkish stance.
- Property returned around 2%, Gold was up 1.5% and Absolute Return declined 0.6%.
- Commodities rose as increased demand in the wholesale gas market resulted in a surge in energy prices.

The value of investments can fall and you may get back less than you invested.

EPIM Brunel performance

EPIM BRUNEL PERFORMANCE												
	Q3	2021 YTD	1yr	2yr	3yr	4yr	5yr	2020	2019	2018	2017	2016
Cautious Portfolio	-0.35	1.77	6.76	8.48	16.02	20.31	24.51	6.72	11.24	-2.70	5.87	9.81
Income Portfolio	-0.16	4.27	11.39	12.45	19.65	25.73	33.28	6.82	14.51	-4.20	8.08	12.28
Balanced Portfolio	-0.05	7.57	16.92	18.09	25.07	33.43	45.85	7.84	16.58	-3.92	8.84	15.42
Growth Portfolio	0.22	9.98	21.56	24.14	30.34	43.27	61.49	10.30	18.39	-4.00	11.77	16.71
Global Equity Portfolio	0.41	11.92	25.91	26.98	33.60	48.63	68.99	10.00	22.13	-4.85	12.46	17.87

All figures shown above are calculated to 30 September 2021.

Performance Calculation: All income is reinvested. Performance is shown inclusive of underlying fund charges but gross of EPIM Brunel's investment management charge. Deduction of this charge will have the result of reducing the illustrated performance.

EPIM Brunel performance highlights Q3 2021

Asset Allocation

What worked and why?

Being overweight to Japanese and US equities was a positive contributor to performance over the quarter.

What didn't work and why?

Overweight positions in Asia ex-Japan equities and Absolute Return were a drag to performance.

Fund Selection

What worked and why?

Schroder Global Cities Real Estate and the more defensive Newton Asian Income strategy outperformed over the quarter.

What didn't work and why?

The growth oriented strategies of Baillie Gifford Japanese, Baillie Gifford American and Fidelity Asia underperformed over the quarter. BlackRock Gold & General was also a drag on performance.

EPIM Brunel Portfolio changes Q3 2021

Asset Allocation

There were no changes to strategic asset allocation this quarter.

On a tactical basis, we increased our US equity overweight position to be in line with our other preferred regional overweights. This reflects the defensive nature of the dollar and the sectorial composition of the market as we appear to be close to the peak in global growth momentum. We reduced our Gold allocation by 0.5% given the scope for real yields to rise, whereas our Absolute Return allocation was increased by the same amount. The change was not reflected in lower risk categories, where the underweight position in Gold was already reflected.

Fund Selection

Artemis US Select was introduced into the MI Select North American Fund in July. The inclusion of this strategy, run by Cormac Weldon, offers a complementary growth approach which helps to balance out other strategies within the fund.

Within the higher risk models, BlackRock European Dynamic was introduced and Threadneedle European Select was removed. The HSBC European Index was also reduced in favour of BlackRock European Dynamic.

BlackRock Gold & General Fund was removed from the Global Equity model.

Following strong recent performance in Hermes Asia, we took the opportunity to rotate into another of our preferred investments for the region, Invesco Asian.

EPIM Brunel performance against benchmarks

- The Cautious model underperformed the IA Mixed Investment 0-35% Shares benchmark last quarter by 0.5% and fell by 0.4% in absolute terms.
- The Income model underperformed the IA Mixed Investment 20-60% Shares benchmark by 1% and fell by 0.2% in absolute terms.
- The Balanced model underperformed the IA Mixed Investment 40-85% Shares benchmark by 1.3% and was broadly flat in absolute terms.
- The Growth model underperformed the IA Flexible Investment benchmark by 1% but rose by 0.3% in absolute terms.
- The Global Equity model underperformed the IA OE Global benchmark by 1.3% but rose by 0.5% in absolute terms.

Investment outlook

Cash

We recommend retaining a small cash overweight. We want to have liquidity on hand so we can opportunistically add to positions in other asset classes in the event of corrections.

Bonds

Safe haven bond yields have been rising for the better part of the past two months. This has been driven by central banks turning more hawkish, mostly due to the fact that inflation is proving to be stickier than assumed. A key question is how central banks, particularly the Federal Reserve, will react to this inflation. The Fed has a 2% inflation target, but it changed its framework last summer in a way that encourages an overshoot of this target following periods when inflation has missed on the downside (as it has in recent years). The Fed hasn't specified how long its look back window is, and how long (or how big) an overshoot it wants to engineer. But the level of the inflation index it targets is now above what is implied by 2% per year over the past five years. In response, last month the Fed raised its interest rate projections despite downgrading its expectations on growth. If we get decent economic growth over the next couple quarters, which seems likely, it is probable that the Fed will raise its rate projections further. This should see bond yields continue to edge higher.

Global Equities

Valuations are high, investor sentiment is bullish, margins may be approaching a peak, global growth momentum is rolling over, and financial conditions are as good as they get. Structurally, globalisation, taxes and regulation are growing headwinds. Against this backdrop, there is the potential for bond yields to rise further on the back of inflation proving less transient than the consensus expects. Nevertheless, a healthy equity overweight continues to be justified. The base case outlook for the global economy is reasonably solid, which should see corporate profits rise at a solid pace. In addition, the recent market correction flushed out the weak long positions, and dragged previously very optimistic equity sentiment lower. Moreover, an inflation problem that spells an end to the bull market is only a risk, rather than a base case.

Alternatives

We remain underweight gold. Real bond yields, the main macro driver of gold, probably have scope to rise a bit further. A rise in real yields, at a time when investors are increasingly looking to crypto as a hedge on the debasement of fiat money, makes gold vulnerable. We retain our underweight in property, which is made up of developed world REITs. If the global equity market rises, as we expect, REITs would likely keep going up as well and provide a superior return over cash, bonds, and other alternatives. However, because our property benchmark is comprised of listed stocks, we evaluate developed world REITs against the broad global equity market. If bond yields continue to edge higher, as we expect, REITs would struggle versus the broad equity market.

UK Equities

Even with the weaker pound, UK equity relative performance in common currency terms has come alive recently on the back of the rebound in the global value versus growth trade. The UK equity market is relatively heavily weighted in financials, energy, and materials. The latter has lagged, but energy and financials have strongly outperformed at the global level, bolstering UK relative performance. There's probably a bit more scope for value-oriented sectors to outperform. But questions remain about the durability of this trade. We advise a continued modest overweight.

US Equities

The rise in Treasury yields has weighed on the relative performance of long duration US tech + FANG. Nevertheless, the US has held up relatively well recently. Offsetting the weakness in tech has been the strong dollar, which has supported the common currency relative performance of the US. The dollar tends to behave as a defensive currency and therefore often performs well during risk-off phases. On this front, there has been a close inverse link between the dollar and the global equity market lately. Our view is that this is a healthy pullback in risk appetite that is unlikely to morph into something more pronounced. Against that backdrop, it would be surprising to see the dollar make continued strong gains. It would be unusual to see the US outperform as bond yields edge higher and the dollar flattens out. That said, the experience of the last decade would suggest there is probably not much room for underperformance either, as the US is heavily weighted in companies with attractive long-term growth prospects. A continued healthy overweight in US equities continues to make sense.

Europe ex-UK Equities

The German election took place in September. As expected, and as is always the case in Germany, no single party won enough seats to govern alone. The parties have now begun exploratory talks to see if a coalition can be formed. Whatever coalition Germany ends up with will have some impact on the economy and markets, but it's not likely to be a gamechanger. Europe ex-UK has underperformed recently in common currency terms, with much of the weakness linked to a weaker euro exchange rate. The euro tends to positively correlate with investor risk appetite, so the recent increase in risk aversion has had a negative impact. The Fed turning incrementally more hawkish, at a time when the European Central Bank has not, has also weighed on the single currency. Currently, the outlook for the euro looks reasonably balanced. Importantly, sentiment has swung from bullish to neutral. It is hard to get excited about Europe ex-UK, but there doesn't seem to be a compelling reason to adopt a more negative stance after this recent underperformance. We retain a modest overweight.

Japan

Japanese equities should benefit from the fact that the state of emergency, which has held back areas representing around 75% of Japan's economy, ended on 30 September. Meanwhile, there is some hope that the new prime minister, Fumio Kishida, will be able to steer policy in a way that allows the economy to grow at a slightly more respectable pace than it has in recent decades. That said, the longer-term challenges facing Japan remain intact. Much of what determines Japan's longer-term growth will be out of Kishida's control, as so much of it is driven by demographics. Japan's population has been in decline for a decade. With the birth rate collapsing, there is no sign of that changing anytime soon. The implication is that beyond a reopening linked growth spurt, there is probably not much reason to get excited about economic growth prospects in Japan. That's important for the Japanese equity market because despite being known for having lots of multinational companies, it is still a relatively domestically exposed equity index. The bottom line is that we believe it makes sense to have some modest exposure to Japanese equities. But given the continued structural economic challenges, we wouldn't expect much in the way of sustained equity market outperformance from Japan.

Asia ex-Japan Equities

After a brutal six months, Asia ex-Japan equities are trying to bottom out in relative performance terms. The pivot in August came at a time when the largely anti-business Chinese regulation announcements were continuing to roll in. This raises the question whether most of the bad news is priced in. On this front, the 12-month forward P/E of MSCI China is trading at a 28% discount to the global market, which is bigger than its historical average discount of 18%. While this is certainly a more attractive multiple than Chinese equities were trading on earlier this year, it's not clear that it is low enough given the new regulatory reality that will likely weigh on Chinese corporate profit margins. Nevertheless, the dominant market emotion toward China right now is fear. Against this backdrop, it doesn't appear to be a great time to be either adding or cutting positions. We maintain a modest overweight.

Emerging markets ex-Asia

We believe there is likely some additional upside in the oil price. Meanwhile, emerging markets ex-Asia economies have scope to expand relatively strongly in the months ahead as the nations that make up this index catch up on the vaccination front. These views underpin our desire to maintain a modest overweight to this commodity-sensitive region.

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