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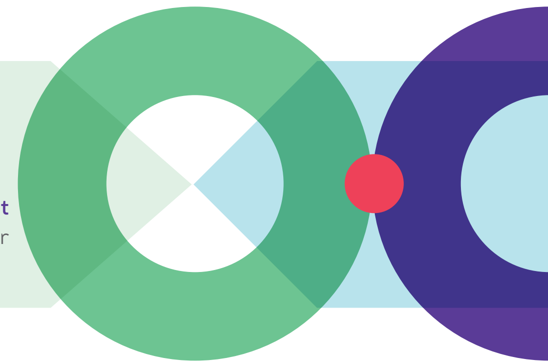

View from Psigma

"Wind of Change"

Tom Becket
Chief Investment Officer

It filled me with both pride and alarm when I realised recently that I have now been writing our "Views" for fifteen years. Thank you to all of you who have read our commentaries and contributed towards the discussion on the global economy and financial markets over that time. It must be said that I now find myself writing opinions and relaying facts that I wouldn't have thought possible only a few years ago. As I reflect on the last eighteen months, it is astonishing how much transformation there has been for all of us as global citizens and investors. In many ways, though, the world changed back in 2008, with the economic destruction wrought on the West by the global financial crisis and the "crossing of the Rubicon" by global central bankers and governments, with their monetary and fiscal largesse. I discussed this with our Chief Executive Officer the other day and we mutually opined that despite our combined near sixty years of investment experience (I'll allow you to guess at the balance of those years between us), there were many occurrences and dynamics in markets today, in no small part down to the financial experiments unleashed in response to the slower post-crisis global growth, that we struggled to understand.

Is it possible that our mental struggles are down to the fact that we have become investment dinosaurs? Maybe it is because the "game" has changed? Or perhaps it is that there are so many short-term distortions created by those hyperactive central bankers and politicians, as well as shifting global trends, that we need to look through the current uncertainty and remain wedded to a longer-term investment philosophy. It could be a combination of all three of those answers and to come to a worthy conclusion, we must address the spheres of geopolitics, politics, monetary policy, inflation and market valuations, which we will do today.

The "turbulent twenties" moniker remains apt

Two years ago, when we outlined our thoughts for the decade ahead, we wrote that it could suitably be named the "Turbulent Twenties". Of course, this view had nothing to do with some prophetic forecast of the COVID pandemic and global governments' handling of the medical crisis that has enveloped the world in the opening innings of this decade, but was instead built around a view that the world was likely to suffer from a continuation of geopolitical, political and social-economic shifts that were rupturing the relatively stable period the world had enjoyed since the end of the Second World War. If anything, beneath the obscuring fog generated by the COVID crisis, the first eighteen months of this decade have hardened this view.

Beijing strengthened by chaos in Afghanistan

Undoubtedly the biggest subject to focus on for us as global citizens is how the world's two super-powers, the US and China, can work together to avoid falling in to the "Thucydides Trap", where conflict arises as two rival countries or states jostle over the sharing and eventual transfer of power from one hegemon to another. This might well be a slow-moving transition and take decades to resolve, but events have accelerated in the last few years, and our sense is that China is emboldened by the lacklustre efforts from the Biden administration, whose foreign policy efforts have been very questionable. In particular, the shambolic scenes in Afghanistan and the further retreat of the US from its post-1945 role as global "policeman" may encourage a view in Beijing that now is an opportune time to strengthen its creeping sphere of influence across their region and through Eurasia, as well as strengthening its ambitions in the South China Sea. We have been of the view that China's claims over Taiwan would likely remain unresolved and that a military conflict was unlikely (unless triggered by a mistake or an overreach), but the probable indirect impact of the chaotic and sadly predictable scenes in Afghanistan is that China will feel much more powerful after the US's miserable retreat. That this is happening when Xi Jinping is about to secure his third term as "Emperor" of China creates further uncertainty and is something we will monitor closely.

Political gridlock in the US

If one indirect result of the events in Afghanistan is an increasingly ambitious China, another is a possible further negative lurch in US politics. Just as commentators and investors were sensing that the Democrats and Republicans could be trusted to work together, in part, on major policy initiatives (such as the messy infrastructure bill currently progressing in Washington DC), those hopes could well have been dashed upon the rocky mountains of Afghanistan. It is likely that the Republicans will sense weakness in the Democrats as an opportunity to gain political momentum into next year's mid-term elections, where we could see control of the chambers of political power in the US swing away from the Democrats. The uproar around recent events in Kabul, as well as a growing unease around underreported rises in consumer prices, could be heavy weights for Democratic candidates to bear into their individual elections next November. Elections are often determined by which political base is angrier, and all confidence and sentiment surveys hint that the Republicans will have a surge in their voter base as we move into next year's elections.

Auf wiedersehen, Frau Merkel

An election that could have a currently understated importance before next year's US midterms is that in Germany next month. The latest polls give a clear indication that the elections will not be clear-cut and will result in discussions over who can form a workable coalition, determined eventually by who is willing to cede their political positioning on various matters in order to govern. Whatever happens, there will be change for the first time since 2005, as Angela Merkel has already decided that her race as Chancellor is run. Irrespective of what one might think of Merkel's policies and philosophies from the last sixteen years, the inescapable fact is that she has been a steadying influence in the turbulent waters of European politics. What happens next will be interesting, with regards to Germany's commitment to a "balanced budget", their commitment to the European project and, most importantly for investors, financially bailing out their neighbours, as they have tacitly done for the last decade. Any new policies and turns could bring fresh opportunities for investors. At least for now, European financial markets and investors have been anaesthetised by the miracle drugs applied by the European Central Bank, who through their exhaustive money printing have created an air of total complacency around the structural political, economic and demographic risks that exist across the Channel; but these could rear their ugly heads once again in a less certain political environment ahead.

Have central bankers destroyed free financial markets?

When I wrote in my introduction about how significantly things had altered in recent times, the relevance was most acute when discussing how central bankers had assumed for themselves the parts of headline-grabbing financial superheroes, in a role where to be unseen and unheard would be a blessed characteristic. Indeed, the creeping influence of central bankers and their ever more grandiose actions have arguably been the greatest change (even if it is missed by most outside the financial world) affecting how the global economy has metamorphosed since 2008. In our eyes, the extraordinarily loose monetary policies, including historically low interest rates and industrial-scale

money printing, have contributed towards a pandemic of wealth inequality, with the richer benefitting from rising asset prices and the poor suffering from rising consumer prices. This has been a major contributor to the unexpected political outcomes of the last decade and will be a factor behind political instability in the coming years.

Central bankers have also created an "everything bubble", with the prices of many financial instruments and nearly all assets rising to unusually high levels. In the financial markets we invest in, we have seen regular records set in the valuations and prices of government bonds, corporate bonds, global equity indices and many corporate shares over the last few years, reflective of the desperation of all investors to move money away from cash accounts and into anything that provides a potential return. This is also why we have seen the price of collectables, artwork, vintage cars and fashionable cryptocurrencies boom, as all of the money created and pumped into the economy by central bankers seeks a home. There is certainly the chance that if, and it remains a big if, central bankers are ever forced to raise interest rates because of growing inflationary pulses and/or because of higher levels of economic growth, then the unanchored valuations of many assets could fall very far. The good news for investors is that alongside the à la mode expensive investments there remain a cohort of cheaper, less trendy opportunities where we continue to focus our attention.

The same again?

Interestingly, over the last few months financial markets have implied that rather than worrying about interest rate rises brought about by inflation and excessive economic growth, we should be dusting off the history books from the last decade and expecting another period of low growth, low inflation and low interest rates. In the short term, economic growth was always going to slow from the rampant growth of the initially reopening economy, and what we are currently seeing in growth trends was to be expected. Certainly, the untimely emergence of the "delta variant" has delayed elements of economic growth, whilst denting consumer and corporate confidence. However, we are still of the view that a combination of pent-up demand, government support and record-low interest rates will encourage economic activity as we head in to 2022. This should mean that certain areas of global financial markets that benefit most from economic growth can offer recovery returns through the next year, benefitting our investment strategies.

What comes after the reopening resurgence is certainly open to debate. Maybe financial markets are right about the medium-term outlook, and we will witness another economic experience like the last decade through the rest of this decade, but this is not our central expectation. We believe that inflation and economic growth outcomes will be less certain than they were in the 2010s, and we envisage a combination of hyperactive governments, reckless central banks, attempts to reduce wealth inequality, the implementation of the "green" agenda and resource scarcity all combining to create volatility in inflation and growth rates. This will present plenty of opportunity for nimble investors in the coming years. The last twelve months have been an abnormal period to adjudge the future for the global economy, but we think that just as the world changed in response to the global financial crisis, there will be significant shifts as we move forwards. At a macroeconomic level, these trends include governments spending ever more money they don't have, increased government involvement across industry (especially in resources and green technology), a balkanisation of global supply chains and a continuation of the dominance of monetary policy, all of which are potentially exciting prospects for investors in a range of different ways.

Conclusion

In answer to my original three questions, there is obviously the potential that our views on global financial markets have become outdated. Indeed, we would admit that we have been forced to adapt some of our short-term investment views and expectations to reflect the fact that central bankers have temporarily changed the game through the liquidity gushes that they continue to direct into markets, resulting in higher asset valuations and lower potential returns. An investor who doesn't behave with humility and employ mental flexibility leaves themselves vulnerable, at least in the short term. However, that doesn't mean that such phenomena and distortions will persist forever.

Hopefully we have outlined today that the decade ahead and the wind of change howling around us provides both risks and opportunities for investors in many different forms, but our core views on investment remain constant to when we first started writing our "Views" all those years ago. We will continue to seek out methods of protecting our clients against inflation, which could prove very necessary in the years ahead. We respect the risks that exist in the geopolitical and political environments, and

stick to our philosophy that balance and downside protection is vital, particularly at a time when others are so complacent. Finally, we stand by the mantra that the only real key to long-term investment success is buying attractively-priced assets; it has become more difficult in a world where value is hard to uncover, but we remain enthused by the prospects of those investments we currently own on our investment clients' behalf.

Tom Becket
Chief Investment Officer

For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providing you with a variety of investment and market commentary.

www.psigma.com/psigma-voice/

Psigma
Investment Management

client.services@psigma.com
businessdevelopment@psigma.com
www.psigma.com

London

11 Strand,
London,
WC2N 5HR

+44 (0)20 3327 5450

Birmingham

4 Temple Row,
Birmingham,
B2 5HG

+44 (0)121 230 1937

Edinburgh

The Capital Building,
12/13 St Andrew Square,
Edinburgh, EH2 2AF

+44 (0)330 094 0090

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