Sailing the ship is easy, navigation is tough

It's been an interesting start to the year. January got off to a good start with further improvements across all our portfolio's, but then came concerns over inflation, bond yields and more recently, what the world's central banks are going to do about it.

BREXIT is now behind us 'or at least the overwhelming news flows concerning it' and we've all now digested the finer details of the most over hyped budget since the Conservatives came into office. There were a number of potential levers the Chancellor could have pulled to reign in some of the much needed tax revenue, but instead, Rishi Sunak and his team preferred to kick the can further down the road.

For many of our clients, the impact of the budget will go largely unnoticed. Overall, UK tax rates remain largely the same, the personal allowance increased marginally from £12,500 to £12,570 with higher rate tax now starting at £50,270 and additional tax remaining at £150,000. ISA allowances stayed static at £20,000 and the capital gains tax allowance remains frozen at £12,300 until 2026. The fact that many of the allowances have not increased means more people will be caught by them. The thinking behind this means they effectively plan to collect more tax in two to three years, once the economy is back on a better footing.

Governments around the world continue to outline their own policies. This week alone, there were rate-setting meetings from the Federal Reserve (US), Bank of England and Bank of Japan. Last week we also heard from the European Central Bank, which set the tone for this week's announcements by promising to accelerate its €1.9trn bond-buying programme over the next few months in order to rein in bond yields which, like those in the rest of the world, are starting to rise on inflation fears.

Europe's bond yields look particularly out of kilter with the reality of its subdued recovery from the pandemic as a relatively unimpressive vaccine roll-out and rising infection rates in places like Italy, Germany and France confirm that the region is far from out of the Covid woods yet.

Almost a year on from the work at home orders that saw us all working out what this new 'Zoom' thing was, we are all still permanently out of office but the light at the end of the tunnel is getting brighter. The return to normality received a massive boost in the US this week as Joe Biden put his signature to a massive $1.9trn stimulus package. Among other things it will put cheques for $1,400 in the post to anyone earning less than $75,000 a year. Much of that money is earmarked for investment in the stock market according to a survey by Deutsche Bank of online brokerage users - 37% on average with a higher percentage for younger investors. With 100 million vaccinations already delivered in America and the proportion of hospital beds assigned to Covid patients falling from 19% to 6% since the beginning of the year, recovery is clearly already underway. An inflationary boom during the rest of the year looks possible and needs to be factored into any further portfolio adjustments.

Already, the number of passengers checking in for flights is running at more than 10 times the level last March even if it is still only half the level of 2019.

Inflation is likely. The only question is whether it is a short-term thing in response to stimulus and the re-opening of the economy or something more entrenched and longer-term because the inflationary genie is let out of the bottle and can't be contained.

It's not a given but now is the time for us to be thinking about ways in which portfolios can be protected from rising prices.

Value-focused shares are one possible solution. Gold, property, commodities, infrastructure and smaller companies are others.

There are plenty of ways to navigate a more inflationary environment as long as prices do not get out of control. What it probably does mean, however, is that the kinds of shares which have benefited so much from a low-rate, low-inflation environment - those high-flying tech stocks – could perform less well as they have in recent months.

Sectors like materials, commodities, consumer goods and industrials, are all areas that may do well as and when the economy picks up speed.

Being caught on the wrong side of this rotation could prove painful but a fantastic opportunity for value and long growth dominance.

In terms of indices, too, the same effect is evident. The FTSE250 index is a classic re-opening trade with lots of financials, industrials and consumer businesses. It is up 5% so far this year having risen by 25% in the last three months of last year after the vaccine announcements in November. Clients have exposure to this index through existing funds, but there could be greater arguments for strengthening these positions further. This is because housebuilders, retailers, restaurants (all the businesses that need people moving around and spending freely) are doing well, and they are all heavily represented in the UK's mid-cap index.

An area of caution could be emerging markets this year. This is because higher yields in the US could be positive for the dollar, and a rising US currency is often unhelpful for emerging markets especially those with a high exposure to dollar-denominated debts. That said, the long-term case for emerging markets remains intact, demographics and a growing middle class are long-term positives. China posted strong industrial production data, the region is benefiting from being first in and first out of the pandemic. As ever the key is balance and diversification and we continue to monitor this carefully.

Here in the UK, inflation looks like less of an issue. For one thing the stimulus is nothing like on the same scale as in the US. The UK economy is clearly suffering from the rupture with Europe at the start of the year, the most recent data for January showed a massive fall in trade in both directions across the English Channel and this is another area that requires close monitoring in the months ahead.

That said, the Bank of England seems to have shifted its thinking away from its recent focus on the possibility of negative interest rates to a much more balanced view. The vaccination roll-out and the phased return to re-opening over the next three months is a positive counter-balance to both Brexit and the Chancellor's much more orthodox fiscal approach than is being experimented with across the Atlantic. Again, we will get more of an insight this week as the Bank of England meets to discuss rates.

So to bring this back to my analogy of 'sailing the ship is easy, navigation is tough', this year is likely to still be a very challenging year for investment fund managers and advisers to navigate through. Closing down the economy was painful but relatively straight forward, supporting individuals and industry at all costs last year was more straightforward than getting things up and running whilst managing risks that appear domestically and internationally.

Like the Monty Python lumberjack, things might not be how they first seem, there are many hidden obstacles under the water this year but the sun is starting to shine with the destination now in sight.

Have a good weekend.

Warmest regards,

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