Melville Douglas **Focused** Quarterly Commentary

/ Q4 2021

Bernard Drotschie
/ Chief Investment Officer

Karl Holden
/ Head of International Fixed Interest and Currency Strategy

Growth headwinds unnerve investment markets

2021 was a favourable year for risk assets despite some loss of momentum towards the latter part of the year as economic growth concerns resurfaced and the outlook for inflation became far less “transitory”. Several factors including the US Federal Reserve (Fed) bringing forward the end of its quantitative easing (QE) program, is a sign that it wishes to start addressing stickier inflation, and the discovery of the new Omicron variant made investors nervous

Central Banks are recognising that commencing the path to policy normalisation is needed to stabilise inflation and promote a sustained, rather than boom/bust, economic expansion. In other words, excess liquidity (an important driver for risk asset valuations) will gradually be drained from the economy and financial markets in the year ahead, an important development.

The sooner central banks act to lower inflation expectations and rein in excess demand, the lower the chances of a policy mistake (acting too aggressively) as the global economic cycle matures. Yet while this transition in monetary (and fiscal) support plays out, investors should tread carefully. Prices of speculative assets such as cryptocurrencies and high profile but unprofitable businesses have increased hugely from their lows last year, and have no doubt benefited from an environment of growing speculation during a period where the cost of money has effectively become all but free. This will no longer be the case and as investors start to unwind their leveraged positions, the consequences for these asset prices and the potential impact on the rest of the market remains to be seen. As we enter the next phase of the economic cycle, investment returns are expected to moderate as the ‘punchbowl’ of ultra-loose monetary conditions is withdrawn and economic growth momentum moderates back to trend levels.

As we write this end year review none of our early recession indicators are pointing to any stress in financial markets, and as such we remain optimistic that global equities will continue to outperform in the year ahead, albeit with more volatility along the way. Fixed income assets will face significant headwinds as monetary support unwinds, and as such we end 2021 with an overweight position to equities.

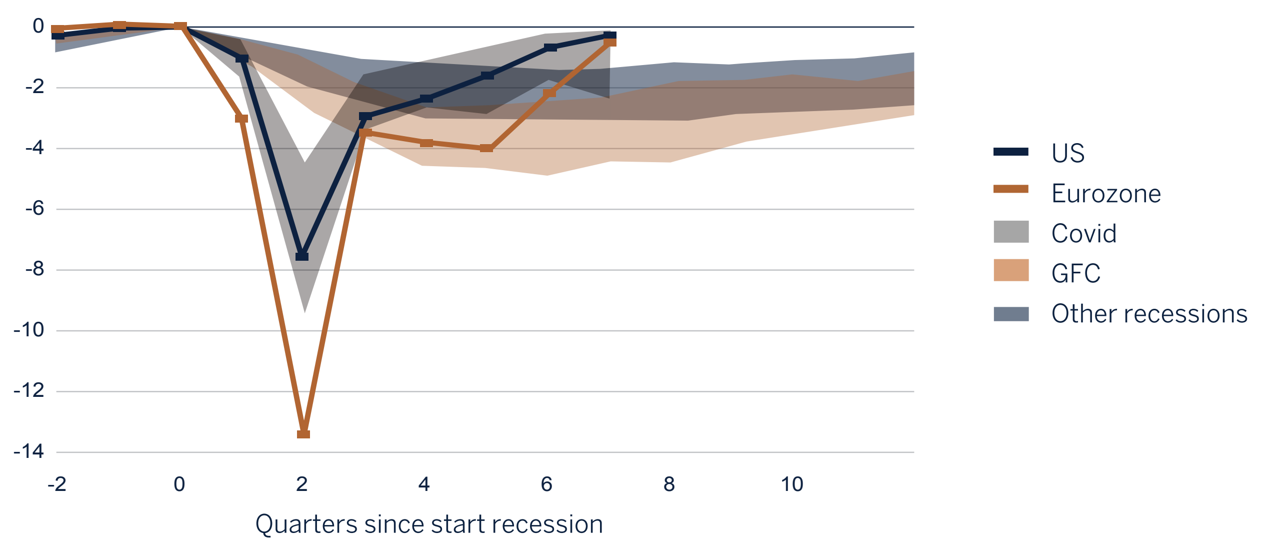
END OF US EXPANSION PHASE INDICATORS	CURRENT VALUE	PRIOR MONTH	TRIGGER POINT	NO RECESSION
US ISM Manufacturing	61.1	60.8	<53	
Inverted yield curve (2-10 year), bps	81	112	<0	
Real rates (Fed Funds - Core CPI)	-4.4%	-3.8%	0%	
US corporate BBB spread vs US Treasury 10 year, bps	128	112	>150	
US unemployment rate	4.2%	4.6%	>6.5%	

Source: Melville Douglas

The outlook for growth remains positive, but headwinds remain

The pace of the global economic recovery has been extraordinary, underpinned by aggressive monetary and fiscal stimulus programs as well as the large-scale rollout of successful inoculation programs in many developed economies. Consumer demand was supported by income transfers and very low interest rates, which also led to an increase in asset prices in real estate and equity markets. Combined, these events have resulted in an improvement in confidence and a sharp increase in the requirement for goods/products, as consumers diverted their spending away from services (travel, hotels, tourism, restaurants, cafes etc.), which unfortunately could not all be met as manufacturing activity struggled to get back to the levels achieved pre-Covid. The services sector has not yet made a full recovery and the current fourth/fifth wave of infections across Europe and other parts of the world will once again hamper the recovery trajectory as governments impose renewed restrictions and households stay/work from home and isolate.

THE TRAJECTORY OF GDP COMPARED TO PREVIOUS RECESSIONS



Source: UBS

The International Monetary Fund (IMF) recently updated their outlook for the global economy. The picture painted is one of optimism given that growth for the year ahead, even after 2021 growth expected to be the strongest in nearly five decades, is forecast to remain well above trend. However, while the fundamental outlook remains favourable, headwinds loom. Supply bottlenecks, higher-for-longer inflation, new variants of COVID-19 and rising interest rates pose downside risk to the pace of economic recovery further out.

OVERVIEW OF THE WORLD ECONOMIC OUTLOOK PROJECTIONS

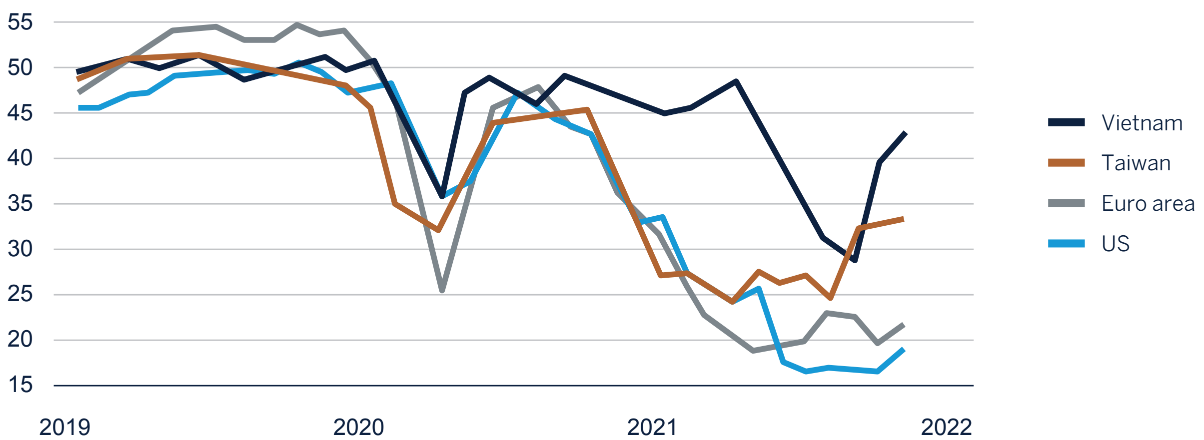
		PROJECTIONS	
Y/Y % CHANGE	2020	2021	2022
World	**-3.1**	**5.9**	**4.9**
Developed Markets	**-4.5**	**5.2**	**4.5**
US	-3.4	6.0	5.2
Euro area	-6.3	5.0	4.3
Japan	-4.6	2.4	3.2
Emerging Markets	**-2.1**	**6.4**	**5.1**
China	2.3	8.0	5.6
Russia	-3.0	4.7	2.9
Brazil	-4.1	5.2	1.5
South Africa	-6.4	5.0	2.2

Source: IMF staff estimates

Supply bottlenecks are slowly but surely easing

Disruption in the supply of goods, due to Covid led manufacturing closures, coupled with strong demand have resulted in a significant pick up in global inflation and a slowdown in industrial production. Furthermore, many companies have indicated that the disruptions are having an impact on their ability to source enough goods whilst input costs have increased significantly. In the near term this will be a headwind to profit margins and earnings growth for companies that cannot pass these costs on via pricing power.

PURCHASING MANAGERS INDEX (PMI), SUPPLIERS' DELIVERY TIMES (HIGHER MEANS SHORTER)



Source: Markit, J.P. Morgan

“

Global central banks will be feverishly hoping that inflationary pressures begin to slow in the coming year

The good news is that some of the leading indicators such as delivery times, inventory accumulation and global shipping costs are pointing to some easing in these supply bottlenecks which is sure to underpin an uptick in manufacturing activity and industrial production (growth). In addition, metal commodity prices and freight costs have been trending lower and auto production in Germany, Japan and the US has accelerated on the back of some renewed supply of semiconductors from Asia. These improvements will assist in cooling elements of inflationary pressures that currently exist and will pave the way to lower inflation as 2022 progresses.

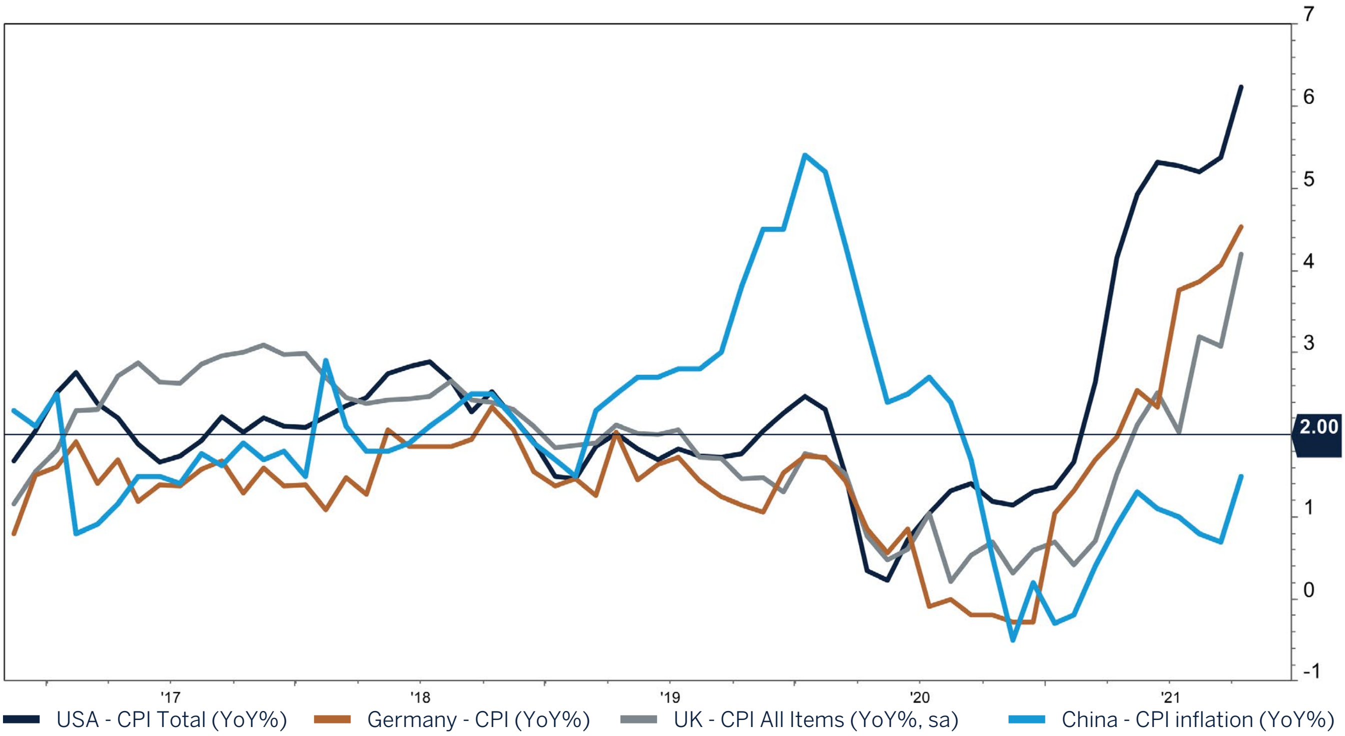
Realistically it is unlikely that supply chain disruptions can be fixed overnight with more pandemic waves looming and will likely continue to be a drag on growth in the year ahead. In the near term, companies will have to adapt and adjust their stock management programs. Certain measures such as double ordering and/or alternating suppliers will be required to offset the supply chain disruption, but this will likely come at a cost to working capital (cashflow) and profit margins. In the long term, should these disruptions persist, it could result in an acceleration of investment and capital expenditure (capex) spend. Reshoring, away from China, of supply chains might become an attractive long-term solution for companies, with greenfield and brownfield investments (manufacturing), accelerating automation, and digitalisation. These changes are sure to provide opportunities for investors and those companies that can adapt fast enough.

Could inflation upset the apple cart?

The US Federal Reserve (Fed) doesn’t always get it right and its recent retirement of the buzzword ‘transitory’ when referencing inflation is a case in point. With US headline inflation recently jumping to its highest level since 1982 there seemed little merit in continuing to spout misleading messages to the market on a subject that clearly has major ramifications for the future pace of monetary tightening. Thus far, the liquidity-fueled ‘rally in everything’ has appeared to (mostly) brush aside concerns of a more hawkish policy response given that economic conditions remain strong, or put another way, inflation hasn’t bitten yet and financial conditions remain ‘very easy’ and accommodative relative to the economic backdrop – but is that all about to change? Global central banks (not just the Fed) will be feverishly hoping that inflationary pressures begin to slow in the coming year as they do not want to ‘fall behind the curve’ i.e. be forced to raise interest rates quickly in an attempt to bring down inflation whilst at the same time creating a headwind for growth. It is difficult to envisage a ‘soft landing’ under this scenario as there would be meaningful negative consequences for asset prices and the global economy with an economic recession almost guaranteed.

Evidence so far is that ‘the return of inflation’ has been seriously underestimated and whilst this clearly has ramifications for central bank credibility, the more pressing and unfortunate by-product is that more vulnerable segments of the population have the most to lose as their already pressured incomes face ongoing strains from sharply higher living costs. Despite mounting evidence, it is still too early to cast an escalation of this more negative outlook in stone. There are tentative signs that some of the key measures in ongoing supply chain issues (commodity related) are easing as consumers continue to rotate away from consumer goods to ‘services’ and China experiences slower growth conditions. In addition, rolling base effects in the underlying inflation components should also provide an element of downforce in 2022. Does this mean inflation is falling back to central bank targets (+/- 2%) next year – certainly not. However, signs of a change in direction would be greatly welcomed by all, including financial markets, as it should indicate a gradual return to more agreeable price conditions, even if that is a story for late 2022 and beyond. Experience tells us that markets can usually stomach shocks in the here and now, provided the future appears more assured and they seem to be holding on to that play for now. COVID-19 aside, inflation and the varying degrees of measures required to combat it remain key to the outlook in the year ahead – we continue to watch these events closely and will act accordingly if, or when, required.

HEADLINE INFLATION



Source: FactSet

Central Banks & Monetary Policy

Since the 2008/09 Global Financial Crisis (GFC) global markets have become accustomed to ultra-easy monetary policy by way of ultra-low interest rates and quantitative easing. It is no secret that low (sometimes negative) risk free rates have been a boon for risk assets and when this ‘cheap money’ environment is challenged, as in late 2018, equity markets vote with their feet until calm is restored via improved economic data or a further loosening in monetary policy. The pandemic has further drained the interest rate armories of developed market central banks and they now face the unenviable challenge of tightening monetary policy whilst attempting to placate markets and maintain the positive and sustainable economic growth trajectory. Memories of 2013’s ‘taper tantrum’ are relatively fresh and the US Federal Reserve (Fed) thought it best to warn about a reduction in quantitative easing (QE) well in advance to avoid any shocks. As a result, their well telegraphed announcement in November confirming a reduction in monthly purchases stirred limited volatility. However, subsequent economic data (predominantly inflation) complicated matters and within a mere six weeks the Fed concluded to accelerate the monthly reduction pace from $15bn to $30bn.

Therefore, US interest rates may rise sooner and potentially quicker than markets had previously anticipated given the reduced timeline for the QE drawdown. Interest rates in the US now look set to be raised in Q2 2022, with three 25bps hikes anticipated for the year. It is too soon to speculate on the ‘terminal’ or ‘neutral rate’ as much hinges on the stickiness of inflation, but currently both the Fed’s ‘dot plot’ and markets alike are speculating a number of around 2.5% (not a coincidence but the same level rates peaked at in 2018/2019). If history is a guide, markets should be able to withstand a rise to this level as long as the pace of interest rate hikes is not aggressive (i.e. behind the curve) and of course, the economic backdrop is resilient enough to withstand tighter policy. There is of course an element of having some faith in the Fed and whilst their ‘transitory’ inflation mishap has dampened credibility, there is little doubt that their immediate policy responses to the GFC and coronavirus pandemic should be applauded and by default, likely reduces the odds of a serious policy error. Ultimately, the trend is towards higher rates globally as inflation is now acknowledged as a clear threat to the economic expansion that needs addressing.

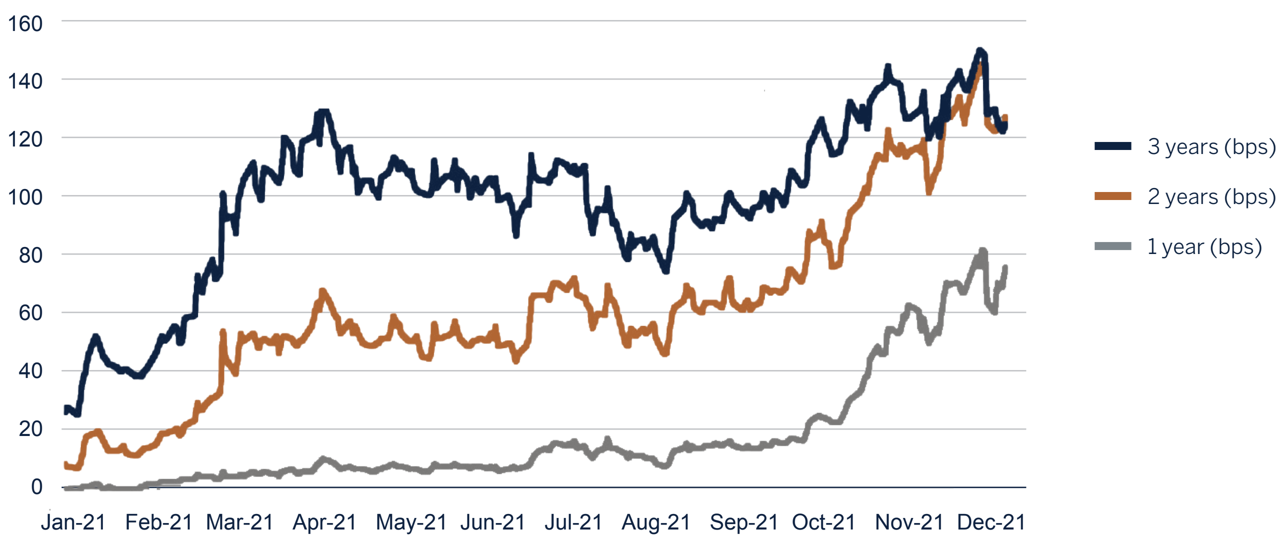
“

it takes on average 3 to 3.5 years from the start of the hiking cycle before a recession occurs

So far, the markets appear to have faith that central banks can engineer a ‘soft landing’ but that appears predicated on current rate hike forecasts and subsequent timelines – a deviation from either (i.e. a surprise) would create uncertainty and asset price volatility. Looking at the quarters ahead, central banks will move at different speeds relative to the strength of their respective economies, levels of inflation and of course, the degrees of impact from ongoing COVID-19 infections, in particular the Omicron variant. Ultimately, in the absence of any unforeseen shocks, indications are that markets can accommodate tighter monetary policy as it unfolds in the year ahead. There remain many pillars of support for growth, perhaps the most obvious is that monetary conditions remain very easy and relative to growth conditions, should remain so even when interest rates begin to rise.

With regards the timing of the next economic downturn, based on data going back over 65 years, it takes on average 3 to 3.5 years from the start of the hiking cycle before a recession occurs, with the shortest being just 11 months. Assuming the first US rate hike is sanctioned in the second quarter, the year ahead should retain a positive growth bias and remain supportive for equity markets.

INCREASE IN FED FUNDS RATE PRICED OVER THE COMING...



Source: BofA Global Research, Bloomberg

Investment Performance

With risk assets benefitting from strong global growth and very robust corporate earnings all our client global equity and multi-asset portfolios enjoyed positive absolute returns during the year. Our asset allocation positioning to remain overweight global equity at the expense of fixed income assets, which struggled, added value. However, on a relative basis USD mandates largely failed to match their benchmarks due to the underperformance of our equity allocation, but we expect the easy gains from lower quality economic recovery/value stocks will subside in the year ahead as investors shift their focus back to long-term secular growth companies with proven business models and pricing power, a backdrop that is more conducive for our style. GBP mandates fared better due to the weakness of Sterling versus the US Dollar and our overweight position to US companies. Our long held defensive underweight and short dated fixed income positioning continued to add relative value for our fixed income and multi asset portfolios.

Asset Classes

Equities	Maximum Overweight
Fixed Income	Maximum Underweight
Cash Plus	Neutral

Asset Allocation

Apart from the risks involved with COVID-19, policy error by monetary authorities remains the key risk for asset prices. During the lockdowns of early 2020, central banks and governments threw in the kitchen sink through huge and expensive bond buying programs and furlough schemes to ensure people made it through a self-imposed recession. A lot of the monetary stimulus found its way into asset markets (such as equities and real estate) as well as the real economy. With world economic growth set to remain above trend and inflation broadening and tracking above target levels, central banks are now looking to withdraw some of the monetary punchbowl.

The fear is that less monetary support equates to lower markets, but this has rarely been the case in the past, except for periods when there was an interest rate "shock" (2006 and 2018) which resulted in a significant slowdown in economic activity. It tends not to be the first-rate hike, but rather the fourth or more, that marks the market top. The same phenomenon was also apparent with the tapering of quantitative easing. When seeking to normalise policy after the Global Financial Crisis (GFC) of 2007-09, the Federal Reserve announced tapering in late 2013 and then started it in early 2014. Although financial markets experienced some volatility around those events, the MSCI All Country World Index was comfortably up over 2013 and 2014 as the economy, and corporate earnings growth, had enough strength to offset the policy change. On balance, we expect the same today and despite some headwinds in the near term, we are comfortable with an overweight position to global equities on better than expected earnings growth, at the expense of low yielding assets such as cash and government bonds. However, as always, we stand ready to make changes to our positioning should threats to our 2022 prediction of ongoing global economic expansion and corporate profit growth materialise more meaningfully.

Bernard Drotschie
/ Chief Investment Officer

MD Global Impact fund - adding positive impact to our client investment solutions

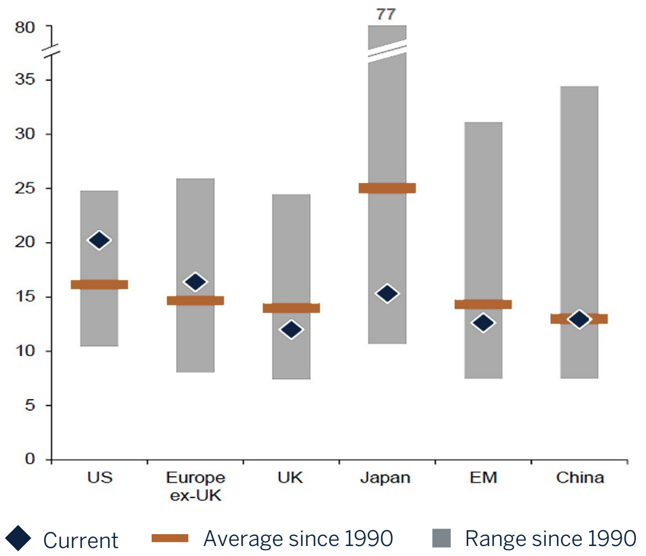
Melville Douglas continues to actively review the role it can play, as responsible investors, in representing our clients' and broader societal interests in driving sustainable change. As such, increasingly we have been incorporating environmental, social and government (ESG) aspects into our longstanding and successful investment process and decision making. We are not alone in this regard and one of the main investment themes emerging over the last few years is the widespread and rapidly growing allocation of capital towards those companies that are driving sustainable positive societal impact and change. We believe this trend will not only continue but, in time, will become the norm. This ever-growing flow of capital directed at companies that are both adopting and driving sustainable change is viewed by us as a potential long-term opportunity to not only achieve superior returns, as we identify future winners, but also as a real and lasting benefit to our societies.

During the first quarter of 2022 we will, where appropriate, be taking advantage of this growing investment opportunity by way of an allocation, either directly or via our MD Global Impact Fund, of up to 10% of our clients' equity exposure to companies that aim to positively change the environment and society whilst still being able to deliver superior long-term returns for their shareholders.

Equities

While it is important to keep an eye on macro-economic developments, it remains equally important to also understand what is already discounted in the valuations of assets. Equity valuations have de-rated sharply on the back of stronger than expected growth (+50%) in earnings during 2021, which has outpaced the increase in share prices - very typical of a strong cyclical recovery. Valuations are reasonable and outside of the US, most markets are now trading below long-term averages, reflecting the path of slower growth, higher inflation and a gradual normalisation in interest rate policy ahead.

GLOBAL FORWARD PRICE-TO-EARNINGS RATIOS
x, multiple



Source:UBS

There can be no doubt that low or negative ‘risk free rates’ have encouraged flows into risk assets and upcoming rate hikes from global central banks will test the resilience of global equity markets. Having said that, much of these concerns are well understood and reflected in consensus forecasts. We expect that volatility will likely increase from current levels and returns from global equities will moderate as interest rates and valuations normalise. Although we continue to expect an element of de-rating in equity valuations this year, we anticipate this to be offset by a combination of positive earnings and dividend growth, which will once again benefit from a normalisation (increase) in dividend pay-out ratios now that balance sheets have been strengthened. We remain overweight equities.

Consumer Discretionary	Overweight
Consumer Staples	Neutral
Energy	Underweight
Financials	Neutral
Healthcare	Overweight
Industrials	Neutral
Information Technology	Neutral
Materials	Neutral
Communications Services	Neutral
Utilities	Neutral
Real Estate	Underweight

Justin Maloney
/ Head: Global Equities

Fixed Income & Currency

The final quarter of the year has been characterised by concerns over the spread of the new coronavirus variant Omicron, but also from rising levels of inflation and the subsequent change in many central bank policies from monetary easing to monetary tightening. In the US, the Federal Reserve (Fed) voted in December to step up the removal of their monthly asset-purchase program from $15bn to $30bn per month and as such, it is now expected to end in March 2022. Also, the revision to the Fed's 'dot plot' now indicates three rate hikes in 2022, three in 2023 and a further two in 2024 taking the rate to just below their long-term neutral rate of 2.5%. Since the November meeting the Fed have become even more concerned over rising inflationary pressures which have proved to be far stickier than they had envisaged earlier in the year. The employment market has recovered well with unemployment falling rapidly to 4.2% and this positive trend is set to continue as job vacancies remain high in key sectors. Economic data remains favourable and next year's growth, whilst slowing should still be above long-term trend levels. US Treasury yields remain expensive and have not fully discounted the more hawkish Fed, and with high inflationary pressures expected to persist in the year ahead we expect yields to continue to grind higher, most notably in the short to medium-dated area of the curve. With yields rising over the year, our defensive strategy has added relative value, however we will be seeking opportunities to increase duration when market conditions allow.

The UK Monetary Policy Committee (MPC) voted 8 – 1 in favour of raising the base rate by 0.15% to 0.25% at its December meeting, taking the market by surprise and being the first major central bank to hike rates since the pandemic began. This is the second month in a row that the rhetoric from MPC Governor Andrew Bailey has been inconsistent with the meeting's outcome. As the UK battles with record high new daily Covid cases from the spread of the new Omicron variant, the MPC has pushed aside the uncertainty over the impact this may have on the ongoing recovery and instead concentrated on targeting "more persistent" inflation which is currently running at 5.1%, the highest level in more than ten years. This initial rise in interest rates coincides with the end of their pandemic-era Quantitative Easing (QE) program which has left the central bank's holdings of government bonds at £875bn, a marked rise from the pre-pandemic £435bn. This initial tightening now leaves the door open for further hikes in 2022, with the market pricing in an 80% chance of a rise in February, with the possibility of a further two 25 basis point moves over the coming year. Looking past Omicron, the path seems set for yields to rise higher in 2022 and therefore our defensive positioning remains in situ, at least in the short-term.

US Investment Grade (IG) credit spreads have widened slightly over the past few weeks as the negative outlook for government bond yields combined with the prospect of higher risk-free rates will have prompted some investors to take profits. We have for some time forecast a neutral outlook for IG markets given the distinct breakdown in correlation between spreads and risk assets generally. Whilst a reasonable pick-up in yield can be achieved through longer-dated lower rated BBB credit, historically tight spreads and expected higher government bond yields have meant we have been reluctant to increase exposure to this area of the market.

The US Dollar has posted its largest annual gain in over 6 years, up 6.37% against a broad basket of currencies (DXY Index). Positive yield and forward-looking interest rate differentials coupled with strong growth and employment dynamics relative to other major developed economies have contributed to the currency's strong performance in 2021. In addition, the recent surge in inflation has prompted the FOMC to provide a roadmap for interest rate hikes over the next three years, while other central banks like the ECB have been more reticent to withdraw stimulus lending further support to the US Dollar. Over the year we have retained the maximum overweight exposure in US Dollar international strategies which has added significant relative value. We continue to support the US Dollar in the period ahead.

G7 Government	Underweight
Index-Linked (US Government)	Underweight
Investment Grade - Supranational	Overweight
Investment Grade - Corporate	Slight Overweight
High Yield - Corporate	Overweight

Simon Bradburry
/ Fixed Income and Currency Strategy

Market Performance / as at 31 December 2021

EQUITIES	DECEMBER	Q4	2021
Global			
FTSE All World TR Net (Sterling)	1.70%	6.07%	19.49%
FTSE All World TR Net (US Dollar)	4.12%	6.55%	18.40%
UK			
FTSE All-Share TR	4.68%	4.20%	18.32%
US			
S&P 500 TR	4.48%	11.03%	28.71%
Europe			
Dow Jones Euro STOXX TR	4.93%	5.81%	22.67%

FIXED INCOME	DECEMBER	Q4	2021
Bloomberg Barclays Series - E UK Govt 1-10 Yr Bond Index	-0.72%	-0.18%	-3.03%
Bloomberg Barclays Series - E US Govt 1-10 Yr Bond Index	-0.26%	-0.57%	-1.72%
JP Morgan Global Government Bond (Sterling)	-2.97%	-1.32%	-5.63%
JP Morgan Global Government Bond (US Dollar)	-0.66%	-0.87%	-6.50%
Iboxx Sterling Corporates Total Return Index	-1.12%	0.34%	-3.19%
Iboxx US Dollar Corporates Total Return Index	-0.03%	0.03%	-0.96%

CURRENCY vs. STERLING	DECEMBER	Q4	2021
US Dollar	-1.96%	-0.50%	0.93%
Euro	-1.34%	-2.12%	-6.05%
Yen	-3.66%	-3.70%	-9.45%

CURRENCY vs. US DOLLAR	DECEMBER	Q4	2021
Euro	0.52%	-1.74%	-6.99%
Yen	-1.73%	-3.20%	-10.27%