



Economic & Political Roundup

Monthly roundup | Investment companies | August 2022

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A collation of recent insights on markets and economies taken from the comments made by chairs and investment managers of investment companies – have a read and make your own minds up. Please remember that nothing in this note is designed to encourage you to buy or sell any of the companies mentioned.

Roundup

The threat of recession seems more and more likely as rising inflation, supply chain woes, oil price volatility (as a result of the ongoing war in Ukraine) and of course the pandemic, remain key macroeconomic challenges. Two 0.75% US interest rate rises in quick succession, and a higher-than-expected increase in European interest rates, appear to have convinced investors that inflation will eventually be tamed; bond yields plummeted. UK equity markets enjoyed an upturn, although a contributing factor may well have been the announcement of Prime Minister Boris Johnson's resignation. Meanwhile, the month saw other major global events including the assassination of former Japan prime minister Shinzo Abe, wildfires across Europe as a result of record-breaking heatwaves while the World Health Organisation declared monkeypox a global health emergency.

Recession on its way?

Global

Brunner's chair discusses the 'silver lining' for bottom-up investors.

Paul Niven, manager of F&C, shares fears of a recession to hit developed economies later this year and into 2023.

Despite a 'bleak' backdrop, the chair of Herald is reassured by signs of bubbles deflating – especially in the US.

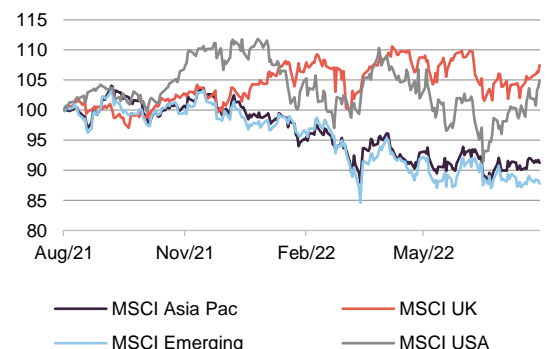
The managers of Scottish American say the world economy still faces a great deal of uncertainty.

Exchange rate	31/07/22	Change on month %
GBP / USD	1.22	(0.1)
USD / EUR	0.98	2.6
USD / JPY	133.27	(1.8)
USD / CHF	0.95	(0.3)
USD / CNY	6.74	0.7

Source: Bloomberg, Marten & Co

MSCI Indices rebased to 100

Time period 01/08/2021 to 31/07/2022



Source: Bloomberg, Marten & Co

Indicator	31/07/22	Change on month %
Oil (Brent)	110.01	(4.2)
Gold	1765.94	(2.3)
US Tsy 10 yr yield	2.65	(12.1)
UK Gilt 10 yr yield	1.86	(16.4)
Bund 10 yr yield	0.81	(38.9)

Source: Bloomberg, Marten & Co



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Analysts

Jayna Rana

jr@martendandco.com

James Carthew

jc@martenandco.com

Matthew Read

mr@martenandco.com

Richard Williams

rw@martendandco.com



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Global Investors

July's highlights

UK

Over time, cash-generative franchises with duration will find ways to adapt to inflation.

The managers of Aberforth Split Level income list four macroeconomic challenges that they believe are increasing the risk of recession later this year.

John Dodd and Kartik Kumar of Artemis Alpha say that over time, cash-generative franchises with duration will find ways to adapt to inflation.

Miton UK Microcap's chair highlights the benefits of investing in microcap companies in the face of current macro concerns.

The managers of Oryx International Growth think that the global economic picture has arguably rarely looked more uncertain.

SVM UK Emerging's manager says there are signs that the UK economy is adapting to the disruption in supplies, creating opportunity for new onshore suppliers to replace risky ones overseas.

Sell-side forecasts look too high

Richard Davidson, chair of Aberforth Smaller Companies says he is perplexed that government bond markets are not more concerned about inflation.

BlackRock Throgmorton's Dan Whitestone believes a valid market concern is that sell-side forecasts look too high.

The managers of Law Debenture think that in a year's time, as the large jump in energy costs work their way out, inflation will likely retreat.

Flexible investment

The JPMorgan Global Core Real Assets team share their outlooks for real estate, infrastructure and transport.

Nick Greenwood and Charlotte Cuthbertson, managers of MIGO Opportunities say they expect that there could be more volatility to come as the global economic headwinds put pressure on markets.

More volatility to come as global economic headwinds put pressure on markets.

Technology & media

Tim Levene of Augmentum Fintech says the volume of venture capital raised over the last two years leaves significant "dry powder" commitments across Europe.

Polar Capital Technology's manager thinks we are facing a more uncertain macroeconomic backdrop than at any stage since the pandemic.

Other

We have also included comments on **Asia Pacific** from abrdn New Dawn; **Japan** from Atlantis Japan Growth; **India** from Aberdeen New India; **China** from abrdn China; **Russia** from JPMorgan Russian; **private equity** from Seed Innovations; **debt** from Henderson Diversified Income and TwentyFour Income; **financials** from Polar Capital Global Financials; **growth capital** from Schroder British Opportunities; **infrastructure** from Sequoia Economic Infrastructure Income;

renewable energy infrastructure from Gore Street Energy Storage, Greencoat UK Wind and Harmony Energy Income; **biotechnology & healthcare** from Bellevue Healthcare; **royalties** from Hipgnosis Songs; **environmental** from Jupiter Green; **leasing** from Doric Nimrod Air Three and Doric Nimrod Air Two and **property** from SEGRO, Hammerson, Primary Health Properties and Unite Group.

Global

(compare global funds [here](#), [here](#) and [here](#))

Carolán Dobson, chair of Brunner - 13 July

During the past two years the dominant opening theme for the company's annual and interim reporting was, unsurprisingly, the effects of the COVID pandemic. Whilst things have started to move on, the world still seems to be grappling with the tail end of this modern global pandemic.

Nor have we been so fortunate as to have been offered the respite of a return to what we had all become accustomed to calling normality. The human cost aside, the unsettling effects of the pandemic and associated lockdowns on economies, monetary systems and markets have pushed us into a new world order where inflation is rampant, supply chain issues persist and central bank intervention is finally coming to bear, exerting downward pressure on growth. Unfortunately, inflation is not simply a number to be quoted in financial reports and news articles - it is a real-world factor that is felt by most, but ultimately has the biggest effect on those on lower incomes.

As this scenario began to take grip, shortly after our reporting of the company's 2021 financial year, we also stood aghast with much of the rest of the world as we witnessed the horror of war returning to Europe when Russian forces invaded Ukraine in March. To witness such an act in Europe unfolding in front of us in the 21st century seems unfathomable. As with any event that is a humanitarian crisis, our thoughts are firmly with those either directly affected or with connections to those that are.

Wars tend to cause inflationary impacts and that is what we have witnessed in Europe, particularly with the impact of Russian energy supply to large parts of the continent. This exacerbated an already growing issue.

Closer to home in the UK, we have witnessed ongoing political turmoil - whilst not on the scale of some world events, it has nonetheless had an ongoing unsettling effect on the UK market.

From an investment perspective the period was dominated by a somewhat indiscriminate purge of the highest rated growth stocks from the past several years. Whilst our investment manager believes the de-rating was necessary for some stocks (in particular what the team describe as "spec-tech", where valuations had become more about chasing the next 'shiny new thing'), many quality businesses who are still operating successfully have also seen their ratings plummet as the market indiscriminately punished all growth stocks.

This brought an end to a strong run for equity markets, where huge gains were made, but often concentrated to a handful of companies and predicated on sectors like technology that were already causing a paradigm shift in the world but that were further highlighted during the unusual circumstances of global lockdowns.

The net winners over the period have been so-called value stocks, for many years unloved by investors. This was spurred on latterly by many of these companies being in 'old-world' industries such as fossil fuels, that have benefited from the turmoil and surging commodity prices as a result of the Russia/Ukraine conflict.

Despite the gravity of these factors, as we have described before - most recently during COVID, there have been pockets of opportunity for investors who were able and/or willing to look through the near-term volatility towards the longer term. Please

do take time to read the investment manager's report on pages 8 to 13 where they look at the backdrop to the period in more detail, but also describe what they have done as stockpickers to make the most of the situation.

Outlook

Inflation continues to push higher with interest rates increasing as central banks react to the unfolding scenario. The backdrop is hastening the onset of an economic slowdown. This is all putting pressure on the ratings of high growth stocks in particular as their future cash flows are less attractive under those conditions than the current cash flows of value stocks.

It would also be remiss to assume we are completely clear from any more impacts from COVID - certainly when considering a global stage. New headlines continue to suggest that the virus is far from fully controlled, however across the globe most governments seem more focused on living with the disease on the back of widespread vaccination programmes rather than continuing to pursue harsh lockdown tactics.

One silver-lining for investors who can keep their nerve and look beyond any 'paper loss' is that markets have been acting rather indiscriminately. For investors who invest 'top-down' (trying to predict a macro-economic or stockmarket direction or outcome and then finding stocks that fit that) it can be hard to find a way forward in such market conditions. For a 'bottom-up' investor however who looks purely at the business and financial fundamentals of individual companies and how they should individually provide a return - constructing a portfolio of such companies from the ground up, the indiscriminate punishment of stocks means opportunities will start to arise where the shares of a sound company have been oversold on 'macro' concerns. Brunner's investment manager remains primarily focused on the fortunes of individual companies. They still look at driving trends and positive and negative macro-economic factors and their potential impact on companies and industries, but the core investment philosophy remains to find great companies that can perform well despite any backdrop.

In terms of how companies are coping with inflation, thus far most companies have been able to pass on inflationary cost pressures to customers as demand remains. However, looking to the future, if demand starts to weaken, as the factors noted above start to bite, companies will find it harder to pass on cost inflation, putting pressure on profitability and earnings. This is also an environment where the differences between business models will become more apparent. Those that have genuine pricing power and which are selling essential products that customers have to buy should be able to navigate this environment best.

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Paul Niven, manager of F&C - 25 July

It has been a difficult period for financial markets so far in 2022 with a substantial rise in market interest rates, reflecting concerns over the outlook for inflation, a widening in credit spreads, due to concerns over an economic slowdown and increased risk of corporate defaults, and sharp falls in equity markets.

Inflation and growth concerns, exacerbated by the conflict in Ukraine, were key themes over the first half of the year. Inflation continued to accelerate across many different regions, reaching the highest levels seen in the US for 40 years. With the exception of Japan, most major developed market central banks have now begun increasing interest rates or indicated their intention to do so. This pivot from central banks has led to a marked rotation away from highly rated growth stocks towards

the value segments of the market. Despite the steps taken so far, pressure remains to curb persistent inflation. Indeed, inflation has proven less transient than many initially thought, as markets continue to price in further monetary tightening and are now increasingly contemplating a recession in the US and other developed market economies.

Currency markets also saw significant volatility. Sterling fell sharply against the US dollar, from 1.35 to 1.22, while the yen declined to a greater than twenty-year low against the US dollar, driven by ongoing loose monetary policy against a backdrop of rising global interest rates.

The current backdrop is challenging for the global economy and for financial markets. Investors are increasingly concerned that recession will hit major developed economies later this year and into 2023 as central bankers increase interest rates and rein in excess liquidity. In addition, inflation is proving more problematic than many had originally envisaged, raising questions over the level that interest rates will reach and how deep the growth downturn will be.

Having seen a substantial reduction in valuations in equities, led by more expensive parts of the market, and a significant change in expectations over interest rates, there is likely to be greater investor focus on margins, cashflows and overall corporate earnings in the coming months. Here, consensus still seems reasonably optimistic. This presents some further near-term risk to equity markets. Nonetheless, and despite a period which is likely to continue to see further volatility in returns, opportunities are emerging. Valuations have corrected and are more attractive for long-term investors. While margins are at risk, equities will provide some hedge to inflation as corporates pass on price rises to consumers.

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Tom Black, chair of Herald - 21 July

Share prices have fallen in all regions and across all sub-sectors within the targeted telecommunications, multimedia and technology sector. Rising energy prices, labour shortages, inflation and therefore interest rate rises are now well established. Looking ahead, it appears that the UK and North America may be better placed to cope with the gas shortage exacerbated by the Ukrainian war than Germany and other European countries with no indigenous supplies. The UK is also less exposed to trade with Russia, and capital goods exports to China. However consumer spending will inevitably be squeezed globally by inflation and rising interest rates, and some companies will suffer from reduced demand and an inability to pass price rises through to customers. We therefore expect profits growth to slow and some downgrades to forecasts, albeit we are endeavouring to minimise exposure to the most vulnerable consumer-facing companies. However, there will also be some bright spots and the US and UK will benefit from an already evident upturn in demand for defence equipment, which stimulates demand across a broad technology supply chain.

The economic and political background is bleak. The Ukrainian war is a damaging headwind for Europe in particular. The UK faces public sector pay awards which the country can ill afford. We face a potential hard landing in the US, with New York and San Francisco seemingly much more damaged by Covid than London. The longer-term impacts of Covid are manifest with a significant resistance from staff to return to the office in the US, and China's zero tolerance approach is causing serious economic harm.

In spite of all the bad news, we are reassured to see some evident bubbles deflating: cryptocurrencies, SPACs (special purchase acquisition vehicles) and overpriced IPOs especially in the US. More fundamentally, metal prices are declining sharply which should help inflation, albeit oil and gas are still a problem. The labour market has been tight in the technology sector for several years, leading to excessive pay and share-based payments. We have expressed concern about this for some time, and feel a downturn was overdue. We note the lay-offs and hiring freezes in California as the crazy fashion for revenue growth at any cost seems to be ending. Too many investors strayed into late-stage venture funding which made capital raising too easy; but as this money disappears, cash flow will inevitably become the priority concern. There will be companies that fail, while others will be desperate for cash. There was a good buying opportunity in 2008-9, when funding was scarce in the financial crisis. We believe the coming period may present us with similar opportunities.

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Managers of Scottish American - 28 July

The world economy still faces a great deal of uncertainty. Russia's invasion of Ukraine has triggered a large and sudden increase in energy and food prices. Combined with persistent supply chain issues and a still elevated demand in developed markets, this has led inflation to accelerate further and hit levels not seen for a very long time. With persistent, and accelerating inflation, Central Banks around the world have moved into tightening mode and raised interest rates faster than investors expected just a few months ago.

Leading the charge is the US Federal Reserve, which raised its benchmark rate by 75bp in June and hinted at further increases later this year. This was the largest increase in interest rates since 1994 and further evidence of a new era in Central Banking. The credibility of Central Banks, so essential to keep inflation expectations in check, is at stake.

In turn, investors have started to anticipate a sharp slowdown in economic growth, if not a recession, in the coming months. This is not a supportive background for financial markets in general, and both global equity and bond markets fell in the period.

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UK

(compare UK funds [here](#), [here](#), [here](#) and [here](#))

Managers of Aberforth Split Level Income - 28 July

The negative shift within stockmarkets was due to a confluence of macro-economic challenges, several of which have been in evidence for some time.

- The newest challenge was Russia's invasion of Ukraine. Beyond the suffering of the Ukrainian people, the immediate impact was to raise risk aversion as financial markets contemplated a war in Europe involving a nuclear power. The economic effects stem from Ukraine's industrial and agricultural importance, which intensifies pre-existing supply chains constraints and inflationary pressures. Over the longer term, the war and the unintended consequences of the sanctions deployed against Russia may accentuate pre-existing geopolitical tensions between the world's major economic regions.

This threatens to undermine the benefits of globalisation, which has been a disinflationary force over recent decades.

- The oil price has rebounded sharply from its mid pandemic low point. Recovering demand has been mainly responsible, but the supply-side has also been influential as a result of years of under-investment in hydrocarbon exploration. The supply pressures have been exacerbated by the Ukrainian war, as Russian energy sales to Europe are brought into question. The consequent jump in oil and gas prices has severely aggravated the cost-of-living pressures that are being felt in the UK and elsewhere. Ultimately, high energy prices are an effective tax on economic activity and complicate the decision-making of central banks as they raise interest rates to address inflation. A longer term consequence of the war is likely to be a reprioritisation of energy security. Notwithstanding arbitrary windfall taxes on oil companies, this may involve renewed investment in hydrocarbon exploration to ease the transition to alternative energy sources.
- COVID is still with us. While widespread and efficient vaccine campaigns have allowed western economies to live with the virus, that is not the case in China. Important manufacturing centres, such as Shanghai, were subject to strict lockdowns through much of the first half of calendar 2022. This has again worsened the supply chain difficulties and inflationary pressures that have plagued economies since demand started to recover in calendar 2021.
- Inflation has proved considerably more persistent than most had expected. Caught out, central banks are now using their most aggressive rhetoric in decades. Their words, though, have not yet translated into meaningful action: interest rates are now rising in the UK, US and EU, but they remain deeply negative in real inflation-adjusted terms. The same is true for government bond yields, despite them more than doubling over the twelve months to 30 June 2022 to 2.2% in the UK and 3.0% in the US. Perhaps bond markets are confident that the presently severe inflationary pressures will abate or that the relatively high levels of debt in western economies will require smaller interest rates rises to affect activity. However, the effect of wage settlements on inflation rates is yet to be determined. Moreover, the historical record for central banks' commitment to dealing with inflation is mixed, especially when they are under political pressure to achieve the so-called "soft landing" for the economy.

The combination of these challenges has been to increase the risk of a recession later this year or in early 2023. Since most companies within the NSCI (XIC) and the portfolio are sensitive to the economic cycle, the impact of a potential recession on corporate profitability explains much of the pronounced weakness in share prices experienced in the first half of calendar 2022.

Stockmarkets have also had to contend with pressure on the valuation ratios ascribed to company profits. The war, tightening monetary policy and rising bond yields have served to shorten investment horizons. In other words, investors are now less comfortable to ascribe high valuation ratios to profits or, in the case of loss-making companies, to their sales. The valuation stretch within equity markets – that is, the gap between the highest and the lowest PE ratios – has contracted markedly. This has particularly penalised the share prices of companies that previously enjoyed higher PE ratios, typically the growth stocks, and other long duration assets with little near term cash flow. Consequently, the value style has enjoyed a period of good relative performance. This valuation effect has been of benefit to ASLIT and, by mitigating the corporate profitability effect previously described, has helped mitigate the decline experienced by the NSCI (XIC).

Outlook & Conclusion

From the top-down perspective, the challenges to equity valuations are clear. The war in Ukraine rumbles on and helps keep the oil price high. In turn, this adds to the inflationary pressure that emerged from the economic dislocation of the pandemic, and increases the cost of living, which threatens to tip economies into recession. Were that not enough, we must trust the judgement of central banks, which have been slow to respond thus far and now seem to be making up for lost time with their aggressive rhetoric. The gap between near double digit rates of inflation and low single digit government bond yields implies that the central banks are in control, but history would underline the risk of a less benign outcome. The chances of the “soft landing” appear slim.

Even deep into the second half of ASLIT's financial year, these challenges contrasted with composure on the part of companies. There were some disappointing updates, notably from consumer-oriented businesses towards the end of the period, but in general trading has been better than might be expected, given macro-economic concerns, and a year of profit progress in calendar 2022 still seems likely. The disparity between the top-down and the bottom-up viewpoints is likely one of timing. In the current “phoney war” phase, profit estimates have not yet moved in a meaningful way – companies' order books are generally full, the demand recovery from the pandemic still has momentum, and price pressures are being passed on. From the perspective of company boards, little else matters and there is no incentive to risk letting customers down.

However, the actual fullness of order books is moot. In times of inflation and compromised supply chains, a degree of over-ordering on the part of customers would not be surprising. Moreover, it is plausible that, in the initial stages of an inflationary shock that many still see as transitory, it has been relatively straightforward to pass through price increases. This may prove trickier on subsequent occasions, particularly when demand begins to ebb. Overall, therefore, it would seem prudent to expect that some of the top-down gloom catches up with companies through the second half of calendar 2022, perhaps indeed to precipitate a recession in 2023.

Clearly, the stockmarket has already judged that this is the likely outcome. However, the duration and depth of an economic downturn are far from certain. There are mitigating factors at play, including the scope for governments to offset the worst of the pressures on the cost of living. Additionally, private sector balance sheets have emerged from the pandemic in good shape and employment rates are relatively high, which should help the gap between the rates of wage growth and inflation close in 2023. A final consideration is that the current macro-economic challenges might ease. A resolution to the war in Ukraine would bring down energy costs. China's restrictive policies may be relaxed after November's Communist Party congress. Central banks' actions may not prove as hawkish as their words, particularly if these words themselves – so-called jawboning – succeed in cooling activity.

Nevertheless, a recession is what the stockmarket currently expects. It would be bad for profits earned by relatively cyclical value stocks and by companies in general. However, share prices will also be influenced by the valuation that investors ascribe to corporate profits. Valuations in turn will continue to be affected by inflation and monetary policy. Uncertainty about these factors should hinder the ability of growth stocks to return to the very high valuations that they enjoyed as recently as six months ago. Numerous growth stocks are also having to contend with pressure on their own profitability or, for the loss-makers, their forecast path to profitability.

Whether provoked by general economic conditions or by company-specific issues, redundancies and cost cutting programmes are not a good look for glamorous growth companies aspiring to high valuation multiples. The stockmarket is less inclined to give the benefit of the doubt as its focus shifts to companies' near term profits and cash flows. In the tussle between value and growth styles, this backdrop is suggestive of a better outlook for the value style or, at least, a more level playing field than has been the case in recent years.

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John Dodd and Kartik Kumar, managers of Artemis Alpha - 7 July

Unexpected inflation is a negative for all financial assets. But unlike bonds, whose coupons are fixed, equities offer the potential of growing earnings in nominal and real terms.

In the short-term the likely impact of inflation can be to damage nominal earnings growth due to an impact on margins that is hard to respond to. But over time, cash-generative franchises with duration find ways to adapt.

Our view is that we remain in a peculiar macroeconomic environment impacted by a war and a virus. For this reason, we are reluctant to make drastic changes, as one of the key lessons of the last few years must be how difficult it is to distinguish between temporary changes and permanent trends in such an environment.

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Ashe Windham, chair of Miton UK Microcap - 19 July

The investment outlook looks pretty bleak with inflation approaching double digits, rising interest rates (admittedly from multi-century lows), stalling growth, fears of recession and the worst conflict raging in Europe since 1945 with the possibility of further escalation. At the time of writing, one might almost be pleasantly surprised at how resilient markets have been. You might well be forgiven for thinking one would be unusual to even contemplate investing in a portfolio of microcaps. However, there are a useful number of factors which might make such a thought compelling.

First, ever since MIFID II was sprung on the market at the start of 2018, there has been a steady withdrawal of investment analysts covering microcaps and small companies generally. Typically, microcaps only have one analyst covering them and that individual is usually from the sponsoring house, whose opinions are often regarded as little more than a marketing ploy.

Secondly, your Investment Manager currently deploys a FTSE 100 put well out of the money, which will help bring much sought after liquidity to the portfolio if the FTSE falls to 6,200 by December 2022. This, coupled with the long lived and dedicated facility to borrow £5m from a leading UK bank, gives the Investment Manager the ability to get hold of funds when stocks are trading at distressed valuations and thus is able to take advantage of such conditions.

Some may think that microcaps are companies of little consequence but many of them are world leaders in their fields and astute leadership can enhance their already dominant positions with sensible infill acquisitions and canny investment. MTI Wireless, an investment made soon after the Trust's launch, subsequently rising to become one of the largest holdings, is a good example. It is currently being actively engaged by many of the largest 5G equipment manufactures because its 5G aerals have patented commercial advantages over others. It is a fact that well-

chosen microcaps can, and often do, rise by multiples of their original price, and this then brings them into the sights of investment managers who, until this point have eschewed the smallest companies, leading to yet further share price appreciation. Over the life of the Trust there have been numerous stocks that have risen many multiples from their entry cost. Within the portfolio at present there are 63 stocks that are standing above entry cost, of which 14 have at least doubled since purchase, seven that have tripled, and five that have quadrupled, one of which has risen even further. 'Elephants don't gallop' is an old Stock Exchange maxim, but microcaps can fly!

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Managers of Oryx International Growth - 8 July

The current market faces several challenges. The war in Ukraine has created a socio-political European conflict not seen since World War II. Global supply chain issues, rising inflation and interest rates have all contributed to declines in every sector outside of financials and mining/oil and gas related companies. Additionally, mutual funds are facing heavy redemptions from investors, creating forced sellers in the market that further damage share prices.

At the year end March 2022, the global economic picture has arguably rarely looked more uncertain. The positives of the world gradually moving on from Covid-19 were undone as global supply chains struggle, inflation soars, interest rates increase and worst of all, Russia breaking its global ties by invading Ukraine.

Multiple 'Black Swan' events have rocked global equities markets and particular damage has been inflicted on growth and technology companies that have traded at historically high multiples.

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Manager of SVM UK Emerging - 22 July

Over the 12 months there were a number of challenges to the UK stockmarket; the Russian Ukraine war, inflation and the possibility of recession. These developments squeezed supply of energy, food and key industrial commodities at the same time as high consumer demand came at the end of the pandemic. Investor interest was very narrowly focused - on oil, banks and resources while most other sectors lagged. The fund strategy is focused on growth in medium sized and smaller companies, with low exposure to cyclical sectors such as commodities. There are signs that the UK economy is adapting to the disruption in supplies, creating opportunity for new onshore suppliers replacing risky ones overseas. The world is now much better placed to manage changes to supply chains and build up resilience. In time, disinflationary forces could reassert.

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Richard Davidson, chair of Aberforth Smaller Companies - 26 July

We are confronted by an unholy combination of war in Ukraine, potential famine stemming from the conflict and lingering pestilence in China. High rates of inflation are proving much more persistent than many had expected. It is widely believed that rising interest rates and high energy prices will tip economies into recession within the next twelve months. The outlook is all the murkier for a political situation in which leaders lurch reactively from one issue to the next apparently without strategy and in which national agendas increasingly impede international cooperation.

For financial markets, these issues cast doubt on the comfortable assumptions of recent decades, when the disinflationary tide allowed central banks to resort to ever looser monetary policy in order to offset economic threats. So, echoing my words in the annual report six months ago, I remain perplexed that government bond markets are not more concerned. Certainly, yields have risen sharply, but they remain well below present rates of inflation. The reaction of equity markets is more understandable – the recession fear has precipitated the 20.2% fall for the NSCI (XIC) this calendar year. And within equity markets, the investment styles are behaving in a manner that one might expect in an environment of high inflation and rising rates, with value out-performing.

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Dan Whitestone, manager of Blackrock Throgmorton - 20 July

Volatility has been a key feature of equity markets during the first half of the financial year, with concerns around inflation, monetary tightening, the humanitarian and geo-political ramifications of Russia's invasion of Ukraine and COVID-19 all driving large scale market moves. For the most part, the strongest sectors have been the energy-related sectors and those deemed most defensive as investors continue to grapple with the fear of an economic slowdown. Within the UK equity market, the effect of this can be seen in the gap between the performance year-to-date of the FTSE 100 (make up is over 50% in resources, staples and healthcare) and the FTSE 250, which now has the largest dispersion on record, and we think gives some measure of the extremes of positioning caused by current events. The period has also been characterised by a marked stock market rotation from growth to value, negatively impacting the Company's positioning as companies with strong growth prospects and solid financial foundations have retraced in recent months as investors question the appropriate valuation for long duration assets in a rising interest rate environment.

A valid market concern is that sell-side forecasts look too high, certainly true in some cases (but not all), with the result that share prices have certainly moved. We believe many companies are already pricing in very bearish scenarios and we continue to believe in their ability to achieve double-digit growth over many years. Some names are now trading on free cash flow yields of 4-5% and as such represent significant value for us. It would seem many of the management teams agree, judging by the size of share buy-back programmes that have been commenced in recent weeks, and, as we have articulated before, we own many companies where a sizeable percentage of their market cap is in net cash. Furthermore, at a time of increased economic uncertainty, we think differentiated companies with strong pricing power and enviable market positions and long-term prospects for earnings growth are more valuable than ever.

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James Henderson and Laura Foll, managers of Law Debenture - 29 July

The economic backdrop is highly unusual. Interest rates are going up to combat inflation, while recession is widely predicted for later this year. The economy had, in 2021, staged a partial recovery from the pandemic but it was uneven. Shortages of labour and supply bottlenecks were evident in many areas but recessionary conditions continued in others. Then the first quarter of this year saw war break out in Europe, with Russia invading Ukraine. Whilst we are witnessing the impact now, with the expansion of NATO, Germany substantially increasing military spend and food shortages stoking inflation, the consequences will be experienced for years.

The current uncertainties have dominated investor thinking, leading to steep valuation declines that were largely concentrated in the most cyclical areas of the market.

Dividend growth has been coming through at the upper end of our expectations, corporate balance sheets are conservatively positioned to weather an economic slowdown and company outlook statements, while acknowledging the uncertainties ahead, are broadly positive. The substantial de-rating we have seen in much of the UK equity market in the first half of this year may, to a large extent, already reflect the current economic uncertainties. For these reasons we have been net buyers of UK equities in the first half of the year, concentrating purchases in the areas that have seen the steepest valuation falls.

Outlook

Inflation and interest rates will rise further in the short term but there are signs that the supply bottlenecks are easing. In a year's time, as the large jump in energy costs work their way out, inflation will likely retreat. Once this is clearly seen, the upward trend in interest rates will cease. Company operating performances may come to be seen as surprisingly robust given the backdrop. Portfolio valuations are low on any historic perspective. These are the ingredients for a share price recovery and is the reason we are a net buyer of UK equities for the portfolio. We continue to see opportunities across a wide range of companies, buying stocks on weak days in a diversified list of well-run companies that have strong management and low valuations.

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Asia Pacific

(compare Asia Pacific funds [here](#), [here](#) and [here](#))

Donald Workman, chair of abrdn New Dawn - 7 July

It was a challenging year, as Asia experienced a resurgence of infections from more transmissible Covid-19 strains, amid the pandemic that is now into its third year. In contrast to many Western countries, which moved towards living with Covid-19 and re-opened their economies, mobility curbs and lockdowns remained a feature across Asia. In China, for instance, the government's "zero-Covid" policy led to severe lockdowns in major cities including Shanghai following a spike in infection rates. Some officials have talked about providing support for the economy and promised that GDP growth targets would be met. However, few concrete measures have been announced so far. Pandemic related disruption continues to impinge on global supply chains. With global demand starting to recover, commodity prices were already rising when the Russian invasion of Ukraine in February added to the pressure. Evident growing inflation risks led major central banks to shift their policy stance, with the US Federal Reserve leading the way in interest rate increases.

In such times, perspective matters. Over the past year, economic growth and corporate earnings have been resilient in important markets such as India. Other countries in the region, including Singapore, Malaysia and Vietnam, are re-opening gradually. As vaccination rates have steadily risen, up to around 70% in India for example, governments are increasingly viewing the disease as endemic. That is bringing an end to many restrictions and puts the region on a path back to normality, as people are once again able to travel across borders. That should provide an

economic boost this year as sectors which have been heavily affected by lockdowns, such as tourism, begin to revive.

The Russian invasion of Ukraine caused more volatility, especially in commodity prices, but Asia has few trade or banking links with Ukraine, so the direct economic effects of the war have been limited so far. However, the indirect impact of inflation and slowing global growth are being felt. Saying that, inflation levels in the region remain relatively benign so while central banks in many developed countries have already raised interest rates, the same has not yet happened widely across Asia.

Another challenge for investors was an increase in regulatory risk in China as the central government laid out plans to increase rules and supervision in several sectors, most notably for technology companies. In anticipation of this and taking into account the potential impact of the zero-Covid measures, the Investment Manager reduced exposure to the sectors most affected, which helped mitigate the portfolio's decline.

Fears about rising interest rates have led some investors to move away from growth stocks and towards a more value-orientated strategy. However, the Investment Manager remains focused on quality and seeking out companies with sound fundamentals. The benefits of an active investment approach are clear when there is increased market volatility. It can throw up opportunities as well as enable investors to sidestep parts of the market that are most exposed to risks and uncertainties.

Outlook

While Covid-19 may be receding in most places, other concerns have emerged in the form of the slowdown in global economic growth and the rise in both inflation and interest rates. Problems with supply chains and logistics also remain, but these should ease in the second half of 2022. On a more positive note, there is room for monetary and fiscal policy to support growth in Asia, and the Chinese government has already indicated a willingness to take further measures. Some of the regulatory changes could even help growth by shifting more power away from the giant technology groups and into the hands of consumers. There are clear signs of economic resilience in the region as demonstrated by the markets in India and the Philippines, which remain on course to deliver double-digit earnings growth in 2022.

Amidst all of this it is important for investors not to lose sight of the long-term benefits and opportunities of investing in the region - the fundamental drivers of growing internal demand from consumers, driven by economic development and the rise of the middle classes. These factors fuel a wide range of activities, from infrastructure development to solar panel production to the development of batteries for electric vehicles and online payment services.

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Japan

(compare Japan funds [here](#) and [here](#))

Noel Lamb of Atlantis Japan Growth - 6 July

The Japanese market, like many of the developed markets, saw a persistent rotation between growth and cyclical companies over the past 12 months. This came as investors sought to account for the geopolitical tensions, rising inflation and the

subsequent impact on the interest rate cycle that helped drive a re-rating of growth companies.

Uncertainty over the outcome and timing of the war in Ukraine will continue to weigh on sentiment in global markets, particularly as to how the impact on inflation and economic growth of disrupted global supply chains will play out for corporate earnings. Japan's economic outlook has remained more resilient than many of the developed economies and it is encouraging to see positive growth forecasts being released by corporates for the next Fiscal Year. Ongoing corporate governance reforms are also creating more value for minority shareholders. These factors support the valuation argument for Japan with relatively attractive PER, PBR and yield comparables particularly as our Investment Adviser ekes out those overlooked growth opportunities. Key focuses of attention will be on how the upcoming July Upper House elections will impact stimulus policies and the pressure on the Bank of Japan to respond to inflationary pressures, currently reflected in widening interest rate differentials and a twenty year low for the yen versus US dollar. Yen weakness has been a challenge for some Japanese companies but is also helping to boost corporate earnings for others. It is not just the exporters who have benefited, since cost inflation has helped many companies to increase product prices in a way that they were unable to do before.

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India

(compare India funds [here](#))

Kristy Fong and James Thom, managers of Aberdeen New India - 1 July

It was a Year of two halves for Indian equities. Over the first six months, Indian equities displayed remarkable resilience despite a massive surge in Covid-19 cases due to the emergence of the Delta variant. The outbreak slowed the momentum of the country's economic recovery and dampened consumer sentiment severely, but the Indian government resisted another countrywide lockdown such as the one in 2020. Instead, it implemented targeted mobility restrictions, which helped to cushion the impact of the second wave. In this environment, the Indian stock market outpaced most of its emerging and developed market peers, building on the steep rally in 2020. Steady corporate earnings further supported sentiment as companies adapted to the resurgence of Covid-19 cases.

A noteworthy event subsequent to the end of the Year was the announcement of a merger of HDFC Bank with HDFC through a share swap. The merged bank will be more than twice the size of India's next largest private bank, creating a financial giant in one of Asia's fastest-growing countries. This transformational event comes at a time when their share prices have lagged the market despite the companies delivering consistent results. The merger is earnings, book value and capital accretive, and has minimal integration risks.

Market conditions globally have become more volatile this year. India is not immune to the turmoil. Policymakers have the unenviable task of managing commodity-led inflation without compromising the country's economic recovery from the Covid-19 crisis. The Reserve Bank of India revised its initial dovish stance after the end of the Year and, in May, raised its policy repo rate by 40 basis points to 4.4%. Rising commodity prices and higher interest rates may hinder earnings growth momentum,

which could lead to market wobbles, given that Indian equities are trading at a premium.

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China

(compare China funds [here](#))

Nicholas Yeo and Elizabeth Kwik, managers of abrdn China - 6 July

Chinese stock markets endured a volatile six months. The Shanghai Composite and Shenzhen Component share indices both hit 21-month lows in mid-March before clawing back some ground following supportive policy rhetoric from the government.

Investors were buffeted on many fronts, both domestically and globally. A flare-up of Covid-19 cases in December, albeit amounting to a relatively low number of reported infections versus outbreaks in Western societies, saw lockdowns imposed first in Xi'an followed by the major cities of Shanghai and Shenzhen, as the Chinese government stuck to its 'zero-Covid-19' policy. Lockdowns since March have disrupted industrial production and pushed out hopes of China's reopening further, which has added to investor caution. Ongoing anxiety over regulation crackdowns added to negative market sentiment, as did fears that the US may delist Chinese companies listed in New York if they fail to provide audit documents.

In January, we witnessed a general rotation from growth to value stocks with more expensive and higher growth sectors such as healthcare and information technology seeing the largest pullbacks, while value-concentrated sectors such as real estate and financials were relatively resilient. Amidst the economic slowdown, the government set an increasingly easing tone on both monetary and fiscal policies, cutting the reserve requirement ratio and loan prime rate.

Towards the end of February, and with preliminary full year results generally in-line or above expectations, growth stocks recovered from earlier sell-offs at the expense of value names.

March was another volatile month, with a number of macroeconomic factors and events adding to market fears and jitters. The 5.5% GDP growth target that was announced at the National People's Congress early in the month was met with scepticism by investors as the real estate sector, the largest contributor to GDP growth, remained under pressure. Omicron cases of Covid-19 started rising in a number of provinces including Shanghai and Shenzhen, leading to city-wide lockdowns, causing temporary disruptions to economic activity and global supply chains.

The Russian invasion of Ukraine further increased turbulence in global financial markets including commodities, with oil prices hitting multi-year highs before receding slightly. Speculation over China's relationship with Russia raised concerns relating to possible secondary sanctions which also led to a sell-off in the market.

Furthermore, US regulators commenced a de-listing process for Chinese ADRs that fail to satisfy the regulator's audit requirements by 2024. The news triggered a large sell-off in Chinese ADRs which spread to the overall market. Our view is that the extent of this sell off was surprising as this was not a new or unexpected development, but was consistent with the way in which the market has reacted to bad news since the start of 2022.

Chinese stock markets remained under significant pressure in April as the effects of Covid-19 lockdowns continued to weigh on investor sentiment and economic activity. The Shanghai and Shenzhen markets edged steadily lower over the first three weeks before selling off heavily. They then recovered some ground at the month-end amid supportive announcements from the Chinese central bank, which vowed to support liquidity levels, alongside promising support for the development of technology platform companies, which have been the target of a regulatory crackdown in recent months.

While there was some easing of Covid-19-related restrictions in Shanghai amid signs of falling case numbers towards the end of April, an outbreak of cases in Beijing stoked fears of a Shanghai-style lockdown in the capital. As a result, the Caixin China Manufacturing PMI, an index of the prevailing direction of economic trends in the manufacturing and service sectors, hit a 25-month low at the start of the month. This was below consensus expectations and new orders fell by the most since the first wave of the pandemic. In the services sector, the Caixin China Services PMI fell from 50.2 in February to 42.0.

On a brighter note, Chinese exports recorded 14.7% year-on-year growth, which eclipsed forecasts, but was obviously based on depressed comparatives. Industrial production grew 5% year-on-year to March, which also surpassed expectations. The Chinese economy grew 4.8% year-on-year in the first quarter of 2022, beating forecasts of a 4.4% expansion.

In contrast to Western economies, Chinese monetary policy is expected to remain loose, given the country's currently slowing economy. In addition, China is not facing as much inflationary pressure as other economies.

Outlook

While the economic outlook for the remainder of the year looks challenging amidst Covid-19 outbreaks and a weak property market, incrementally we have started to see more supportive comments from central government. Vice Premier Liu He, President Xi Jinping's closest economic adviser, stated that the Chinese government would introduce policies that will be "favourable to the markets" and will "boost the economy" and we have witnessed a gradual easing since the end of 2021. To this end the People's Bank of China has lowered banks' reserve requirement ratio and loan prime rates several times over the period. Furthermore, despite market volatility, the company volatility, the company results season in March and April proved that the market is still focused on fundamentals and it was reassuring that the high quality companies in the portfolio, whose results exceeded expectations, saw improvements in their share prices. We remain cautiously optimistic on the outlook for 2022, as the stimulus starts to work through the system. We also believe that Covid-19 measures are likely to be gradually less stringent and the long-term policy support for our five themes (aspiration, digitalization, going green, health and wealth) remains compelling.

We continue to focus on quality companies with strong balance sheets that are not reliant on debt financing and particularly to those companies with robust franchises. We expect these companies to be able to grasp opportunities not available to heavily leveraged competitors and, in the case of those with competitive advantage, to be in a better position to pass on inflationary cost pressures, and continue to generate positive cash flows from their operations.

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Country specialist

(compare country specialist funds [here](#))

Eric Sanderson, chair of JPMorgan Russian - 28 July

If current levels of public concern in much of the West about the humanitarian crisis unfolding in Ukraine continues, many Western governments will be under pressure to permanently and significantly reduce their reliance on Russian energy supplies. This, together with the continuing exclusion of Russia from Western financial systems may destabilise and isolate Russia to such an extent that holding investments in the country becomes prohibited and/or unviable.

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Flexible investment

(compare flexible investment funds [here](#))

Managers of JPMorgan Global Core Real Assets - 4 July

Real estate outlook

Pandemic-related impacts are now becoming visible. For example, the shift to hybrid home-and-office working patterns means that the link between aggregate market vacancy and the availability of grade A rental space has been weakened. In some markets, we expect to see high vacancy rates associated with surprisingly robust rental growth - and in these instances, maintaining a focus on quality is essential.

We expect that many asset owners with high quality assets will have the flexibility to increase rents at or above the inflation rate in real estate sectors characterised by moderate supply and robust fundamentals. Conversely, sectors with high vacancy rates and excess supply pipelines (or even negative demand patterns) may see revenues fall below the inflation rate. This sector dispersion is at an all-time high and therefore we feel that a quality portfolio of assets, which is well positioned, should see above trend returns in 2022 and beyond.

We also see opportunity in the real estate mezzanine debt space, particularly in the US. The mezzanine market no longer reflects the pre-global financial crisis marketplace where leverage was high and capital structures were complex. Senior lenders continue to be conservative, allowing for subordinated loans to play a crucial role in bridging the financing gap required whilst offering an attractive risk adjusted investment opportunity, with a healthy income orientated return and downside protection in the form of substantial levels of subordinated equity. Many of the loans are also floating rate allowing for protection from rising rates.

Core real estate can offer some inflation protection, on both an implicit and explicit basis. The positive correlation is in many cases through the explicit protection built into leases whereby lease rates are increased automatically every year or reviewed and adjusted in line with an inflation benchmark. This helps the income stream retain its real value. There is however some regional variation of how leases are structured to protect against inflation. Capital values may also benefit in a more explicit way if replacement values increase and thereby support capital values. There is no historical evidence that higher inflation hurts return, even when inflation leads to central bank rates hikes as we are currently seeing.

Infrastructure outlook

We expect core infrastructure assets to continue to serve as a lower risk, more forecastable source of diversification and steady income (mostly from cash distributions) through their regulated frameworks, often correlated to inflation, government concessions; and long-term contractual revenues with investment grade counterparties.

Looking at both the regulatory and inflationary environment, utilities and renewables will likely be areas we focus on. Regulated utilities typically exist within regulatory frameworks that allow for relatively explicit inflation protection via passing through costs and expenses to customers. Furthermore, given the long-term nature of ownership and the capital required to backup resiliency and decarbonisation plans, there are relatively few operators who can successfully invest in this space.

Renewables will continue to be an area of opportunity. The conflict in Ukraine has put energy independence at the heart of European political agendas and the acceleration towards renewables is key to this. Many governments have now pledged and/or increased their commitments to transitioning to a lower carbon world. For investors such as ourselves, when making long-term investments in communities' essential services, sustainability is the top priority. Investors have an obligation to a broad set of stakeholders to be a positive force in the current energy transition.

Core infrastructure investments can offer a considerable degree of inflation protection. Explicit inflation protection is the simplest to quantify and occurs when regulatory frameworks, concession agreements, and long-term contracts automatically adjust using inflation-indexing mechanisms, allowing underlying price increases to be passed on to customers and counterparties. An example of this would be for a contracted power generation company, such as a producer of renewable energy where inflation indexing in energy contracts results in higher prices achieved as the price for power increases, providing upside. Implicit inflation protection exists for many infrastructure assets, even when there is no direct linkage through contracts and regulation. These assets are often well-positioned to pass on rising costs, maybe due to monopolistic positions making it feasible to pass through higher costs, thereby protecting revenue streams while costs rise.

Transport outlook

Backlogs and disruption in global supply chains, exacerbated by continued lockdowns in China, are likely to be positive for market sentiment given their beneficial impact on profits. Furthermore, we see ongoing growth in e-commerce continuing and strong consumer demands. Inflation does, however, pose some risk to this demand if consumers are required to focus more on essential spending.

In aviation, we expect domestic passenger volumes to continue improving, although questions remain about long-term trends in international and business travel. Amid concerns created by new variants of the coronavirus and dynamic border control requirements, the recovery time for international aviation remains uncertain. The market share vacated by 70-plus airline bankruptcies is being filled by fewer, larger, more stable and well-capitalised companies.

Supporting the ongoing energy transition from fossil fuels to renewables is one of the biggest opportunities we see. Transport assets can support this transition to a less carbon intensive future by increasing energy-efficiency and actively supporting certain industries. Demand for LNG is also now likely to accelerate as the UK and Europe reduce dependency on Russian hydrocarbons and look to alternative

sources - with new sources of LNG likely to be key; we therefore expect LNG carriers to be in high demand.

When it comes to inflation, transportation, as an asset class, probably has the least explicit protection for investors as contract prices are often fixed throughout their life. That said, over the long-term lease rates have been correlated to inflation when they come for renewal and asset values are also well correlated owing to replacement values going up when inflation is high. As such, we see transportation as having the ability to provide some inflation protection over the medium to long term.

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Nick Greenwood and Charlotte Cuthbertson, managers of MIGO Opportunities - 25 July

The vast monetary and fiscal stimulus unleashed by the central banks in response to the pandemic is steadily being withdrawn. This is taking an inevitable toll on asset values. We believe that rate rises will slow the economy much quicker than in past cycles because the amount of debt within the financial system is much higher. We are likely, therefore, to experience a shorter but more brutal correction than many commentators are predicting. The majority of the liquidity-fuelled gains we enjoyed post Covid-19 have already been lost and market participants are already bearish. It is difficult to recall the last time we heard a bullish commentary. It is likely that we have already experienced the bulk of the bear phase but with scope for some gut wrenching falls before the cycle is completed. That said, early stage growth stocks still feel like a bubble where some air still needs to escape.

Turbulent markets throw up opportunities and with some historically wide discounts in the closed-ended sector there are plenty of trusts that we believe have the potential for a dramatic rerating. We do expect that there could be more volatility to come as the global economic headwinds put pressure on markets but at the time of writing we have seen most stocks fall in unison. The wheat has yet to be sorted from the chaff. Once the difficulties from inflation and rising interest rates start properly feeding through into company results, we may see a divergence between those with stronger underlying portfolios and we are constantly monitoring where these potential pitfalls could be. One of the advantages of the closed-ended world is the variety of asset classes available to us which means we have more opportunities to choose from. There will always be sectors that are hot, where investors have already priced in the good news, and those under the cosh where fears are reflected in the price. We discussed earlier in the report how we sold out of the booming shipping industry and recycled the money into friendless biotechnology. Challenging conditions often create the foundations of the next bull run and we are ideally positioned to exploit pricing inefficiencies with our closed-ended structure which allows us to be patient whilst waiting for investments to mature.

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Private equity

(compare private equity funds [here](#))

Ed McDermott, CEO of Seed Innovations - 21 July

The current inflation shock, combined with geopolitical concerns and central banks raising rates, have impacted investor sentiment, with investors looking particularly

at growth stocks valuations more sceptically and some moving away from their riskiest positions, particularly in the technology market. This in turn has impacted valuations across many small cap sectors and which we expect may take some further time to recover.

Although we believe the cannabis industry continues to offer opportunities for growth, we have had to deal with sectoral derating in recent periods, with share prices of cannabis listed companies seemingly not finding bottom over the last 12 months. However, we are not sector buyers; we are very selective pickers of the operators that we think will win.

Patient numbers are growing globally, and we are seeing this in particular in the areas we are invested. In Australia, the number of patients has been growing dramatically over the last 2 years). In Germany, the market has also been growing steadily with public reimbursements showing double-digit growth year-over-year since the law changed in 2017, including in 2021.

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Debt

(compare debt funds [here](#), [here](#) and [here](#))

John Pattullo, Jenna Barnard and Nicholas Ware, managers of Henderson Diversified Income - 15 July

In the last 6 monthly report we said that we felt equities were euphoric, credit spreads were reassuringly expensive and volatility was suppressed. We expected a tougher regime going forwards and we have certainly got one! When running a geared Company investing in fixed interest whose primary objective is the consistent generation of a reasonable income stream without permanent capital destruction, throughout the economic cycle, the start of a rising interest rate period and end of a recovery is always going to be challenging. The skill is to avoid defaults and invest in quality resilient businesses which are sustainable in the true meaning of the word. Shareholders will be aware of our sensible income approach which focuses on large, modern day digital businesses at the lower end of investment grade, BBB and the top end of high yield, BB whilst avoiding the heavy cyclicals, analogues, small caps and structural losers. The NAV has fallen but we feel is more temporarily impaired rather than permanently lost. In this period we have underperformed the benchmark. In hindsight we had too little loans which in a relative sense performed very well, and too little lower quality high yield whilst having too much better quality, but more interest rate sensitive BBB investment grade bonds. The issue with loans is because they float over short-term interest rates they did not yield enough to justify a material part of the Company's portfolio. In addition, secured loans have financed more of the marginal and arguably lower quality issuance this cycle, compared to high yield bonds. The average quality (and credit rating) of loans has deteriorated over recent years, whereas the opposite is true for high yield bonds. We expect this deviation in quality of issuance to become apparent in time. This is the first year of using the indicative benchmark and we suggest it should be used over the long-term for sensible appraisal. In addition, and somewhat ironically, the better quality bonds, generally being longer duration performed worse than the lower quality single B and CCC bonds. In this rather bizarre period the heavily cyclicals and of course energy were the relative outperformers! So what has happened?

Sovereign bonds have sold off very aggressively due to the Federal Reserve, amongst other Central Banks having a 'volte-face' regarding inflation not being transitory. The panic that inflation may become entrenched has led to an extraordinarily aggressive and late change in monetary policy reaction function. Bond markets on both sides of the Atlantic are currently pricing in an extraordinary number of rate hikes. This panic was compounded by the exceptionally tight labour markets experienced post pandemic and many workers (particularly those of 50+ years) have chosen not to re-participate in the labour markets (the great resignation). The Ukraine war has of course heightened and extended the inflation scare via the exceptionally high oil price. The Fed was already behind the curve and saw a shrinking window of opportunity to raise rates very quickly into an already slowing economy - they were still buying Treasury and mortgage bonds in March! It is important to highlight that during this period most of the capital loss was experienced in 2022 and was due not to credit spreads widening but due to the aggressive sell off in the underlying sovereign bond (which is an important part of a corporate bond). It is only really in the period post year end that the credit spreads have widened aggressively and the worse credits have underperformed, but this is a story for next year's review.

Policy makers and companies are struggling to assess the new normal of activity post pandemic so this environment was always going to be volatile with massive swings in all economic data. Recent profits warnings from some of America's biggest retailers emphasise how many companies have over-earned, over stocked and over hired on an unsustainable basis. We are now faced with super high energy costs, a strong dollar, a very flat yield curve and slowing growth in money supply - all the ingredients necessary for a recession. We feel a hard landing is almost certain in the UK and Europe, with a less severe downturn expected in America. The bulk of the assets remain in American/global businesses. We are all grappling with the consequences of the war-like response of monetary and fiscal stimulus to boost the economies. Unfortunately, we are now in the tough medicine period - we expect the economic cycles to be shorter and more sine wave than prior periods - the COVID echo could last for some time.

The outlook looks remarkably uncertain and challenging. We remain focused on securing a realistic and reliable dividend stream for our shareholders. The net asset value will remain volatile as the economic downturn progresses. This will no doubt present some opportunities and threats for shareholders.

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Managers of TwentyFour Income - 12 July

Markets performed strongly during the opening phase of the reporting period, with strong economic data and asset returns evident. Market participants closely followed central bank developments, but policymakers remained eager to support the economic rebound from the Covid-pandemic. After a first quarter characterised by robust primary issuance levels in the ABS markets, April proved quieter with only around €2.7bn of new supply. Meanwhile, the secondary market tone remained constructive over the month. In the UK, spreads ground tighter across all classes of ABS as demand outstripped supply once again. Primary ABS issuance remained a little subdued at the start of May, but several new deals were announced as the month progressed. Secondary issuance also remained quiet, helping spreads to retrace from the slight weakness observed in UK RMBS during Q1.

June brought a resurgence in the pace of primary market ABS issuance and meant the total supply for the first six months of 2021 hit €52bn, just below the post-2008

record observed during the first half of 2018. This elevated pace of primary ABS market issuance largely continued as the markets traversed summer and continued through Q3 2021, with year-to-date primary supply hitting €81bn by the end of September. However, that robust headline value belies several nuances; for example, issuance of CLOs and CMBS dominated during September, which placed pressure on spreads. In contrast, after several months of sustained issuance, the European ABS market saw very few primary deals in August due to the market's expected summer holiday. However, September brought a resurgence in primary market issuance, with €13bn of bonds placed, led by RMBS and CLOs. Meanwhile, secondary market spreads reflected the weakness affecting broader credit markets, with spreads faltering slightly by the end of September. Conversely, secondary CLO trading activity accelerated during September following a very subdued August.

This activity occurred against a backdrop of seemingly disconnected central bank policy, US Treasury yields and economic fundamentals. US Treasury yields did widen from July to September, with the 10-year yield widening by 22bp during Q3 2021 to 1.49%. This largely stemmed from the Fed signalling at its September meeting that it could begin to taper its bond purchases as early as November. Likewise, the Federal Open Market Committee (FOMC) raised its inflation forecast for 2021. During October credit markets began to falter as the volatility in the rates markets weakened investor sentiment. In addition, the combination of hawkish central bank rhetoric, renewed COVID-19 potency and evidence of durable inflation also negatively affected broader markets. By November, the Federal Reserve Bank (the "Fed") officially announced it would begin tapering at a pace of \$15bn per month in line with market expectations, while commenting that the US economy might require a faster pace of tapering. Meanwhile, the Monetary Policy Committee ("MPC") of the Bank of England ("BoE") unexpectedly left UK interest rates unchanged in November, before hiking by 15bp in December citing evidence of increasingly tight UK labour markets. The Fed adopted a more hawkish stance in December by announcing it would double the pace of tapering to US\$30bn a month, meaning US quantitative easing would end in March 2022.

Despite wider market fluctuations, primary European ABS market activity was high as 2021 approached its close, with around €15bn of primary issuance in October, including €5bn of CLO issuance. Sustained issuance from various asset sectors and geographies across Europe represented the overall trend during the final few months of 2021. The UK market dominated primary issuance, with highlights including the refinancing of the mezzanine notes from a large UK RMBS deal. Overall, despite elevated activity levels, activity faltered during the final weeks of December. At the same time, with market confidence already returning due to strong demand for ABS, spreads retraced some of the weaknesses experienced by the markets during the autumn months. However, spreads did not reach the tight levels experienced in early September.

The initial weeks of 2022 were difficult for markets as Fed minutes underscored the central bank's increasingly hawkish pivot, and tensions flared between Russia and Ukraine. US inflation rose to 7% in January, while the European Central Bank ("ECB") and the BoE also indicated inflation would require tighter policy.

Despite the weakness exhibited in the broader credit markets, the primary ABS market enjoyed a solid start to 2022, perhaps due to the relatively quiet end to 2021 and overall increasing demand for floating rate bonds. Placed supply in January reached just under €5bn, of which UK RMBS accounted for €3.8bn. Secondary trading was muted for most of the month, although it picked up after the market absorbed the first wave of transactions. The pace of issuance in the primary ABS market understandably faltered in February, given that Russia seemed increasingly

likely to invade Ukraine and finally did so on 24 February 2022. That said, the market did see several transactions priced successfully.

Secondary selling in RMBS and ABS markets remained relatively contained, despite some widening, until mid-March. As the end of Q1 approached, improved sentiment pervaded the market, as did an increase in secondary risk appetite from trading desks. CLO primary issuance fell 40% month-on-month during March, while secondary CLO activity was busiest in AAAs and experienced some retracement; secondary AAAs tightened by 8-10bp and sub-investment grade by 25bp.

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Financials

(compare financials funds [here](#))

**Nick Brind, John Yakas and George Barrow, managers of Polar Capital
Global Financials - 1 July**

Markets

While markets initially rallied in December 2021 (despite concerns around the Omicron variant and growth expectations), the remainder of the period covered by this report was a brutal one for financial markets with 2022 so far proving to be one of the worst ever for both equity and bond markets.

In January, the steep rise in bond yields led initially to a sharp rally in stocks tagged as value and a decline in growth stocks, albeit against a background of falling equity markets. The Financials sector is primarily a value sector, due to low valuation metrics, and therefore, in the main, benefited. However, there are a number of companies within the Financials sector that are deemed growth and consequently trade at high valuations, and these fell sharply.

Against this backdrop, US bank stocks rose sharply before suffering from profit taking. This was despite earnings beating expectations due to stronger loan growth and lower provisioning, partially offset by higher costs. JP Morgan's guidance for increased costs seemed to spook investors, albeit driven primarily by a \$3.5bn increase in its technology spend to \$15bn for 2022 and weighed on sentiment for the sector, although most banks reiterated unchanged cost guidance.

Nevertheless, in February equity markets took a further fall as the shocking events of Russia's invasion of Ukraine unfolded and a stronger than anticipated international response understandably overshadowed other news., European financials, which had rallied to levels not seen since 2007, were very weak, given the proximity to the war and exposure some banks have to Russia. While European banks have reduced exposure to Russia since the Crimean crisis in 2014 and now have limited direct exposure, selling was fairly indiscriminate across the sector.

As a consequence of sanctions put in place by the US, UK, European and other governments, impacting sentiment as well as the war having a significant impact on commodity prices, the US 2-10 year yield curve inverted in March. However, equity markets bounced sharply to a level above where they had been trading prior to Russia's invasion of Ukraine. This proved short-lived as increasingly hawkish commentary from central banks saw financial markets roll-over again and fall sharply in April, although there was some recovery in May.

Despite Europe's proximity to the war and the greater impact from the rise in energy prices, European financials outperformed US financials over this period. Asian

financials also proved to be relatively robust even though China's zero-COVID policy impacted growth in the region. Earnings remained resilient and banks in the region saw the benefit of relaxation in COVID restrictions while commodity exporting countries such as Australia benefited from strength in its currency on top of good share price performance.

Banks and, to a lesser extent, insurance companies, drove the initial strong performance of the sector up until the outbreak of war. But with concerns mounting around the deterioration in the outlook for growth, bank shares started to underperform while insurance companies held up well due to their more defensive characteristics. In addition, this sub-sector benefited from the continued rise in insurance premium rates, as well as a \$12bn bid for Alleghany, a US property and casualty insurance company, by Berkshire Hathaway, which lifted share prices.

Diversified financials, where we are underweight the benchmark, covers a broad spectrum of companies from stock exchanges, asset managers and investment banks to information service companies. The subsector performed poorly due to high valuation multiples coming under pressure as well as a number of negative earnings revisions. In particular, asset managers, which had performed extremely well over the last couple of years on the back of rising equity markets and a pick-up in fund flows, suffered some of the sharpest share price falls.

FinTech companies were also extremely weak over the period, primarily due to very high valuations coming under significant pressure and disappointment around earnings, while regulatory concerns impacted the Buy Now Pay Later sector. This also reflected broader weakness in the technology sector, with unprofitable companies the worst affected.

S&P and MSCI, which compile many US and global indices, include FinTech companies within the technology sector, not the financial sector, so any investments in this area are currently off-benchmark and effectively result in us having an overweight position. However, they have announced that they will be moving certain payment companies, notably PayPal Holdings, Visa and MasterCard to the financial sector from the technology sector in 2023. This technical event that could lead to various investors rebalancing their portfolio which may impact these share prices.

Outlook

The performance of equity markets and the sector over the short to medium term will most likely be decided by the outlook for inflation and how central banks react to it. Will their response result in a recession, and if so, how deep will it be? What will its impact be on unemployment and businesses and to what extent will governments provide fiscal stimulus to mitigate the effects?

Inflation has exceeded expectations, fuelled in part by commodity prices. Commodities have continued to rise, exacerbated by the war in Ukraine but also due to persistent supply chain issues with lockdowns in China and staff shortages. If commodity price rises are not tempered by demand or supply responses or if inflation becomes more broad-based and feeds into wage demands, central banks will be forced to respond.

The argument that inflation will subside relatively quickly in 2023 is severalfold. Recent sharp rises in commodity prices are unlikely to continue at the rate they have, supply chain issues are being resolved as economies continue to open up, and rising food and energy prices as well as interest rates rises and withdrawal of liquidity by central banks should quickly dampen demand.

However, if inflation results in higher interest rates, this is a positive for the sector as it leads to wider net interest margins and therefore higher profitability for banks and higher investment income for insurance and life assurance companies. Higher inflation should also mean that loan growth is stronger as businesses have to borrow more money to cover the increased costs of their working capital or capital expenditure. Equally, it should lead to higher insurance premiums to cover the increased cost to repair insured risks.

Higher interest rates are a positive driver of earnings revisions and should underpin the sector going forward. But if inflation continues to prove more durable than current forecasts, we would see this as bad news for financial markets and for the sector. Central banks would have to raise interest rates significantly and potentially hold them at a higher level for longer. Equity markets would likely derate further and, while bank shares outperformed wider equity markets during the 1970s (arguably the most relevant period for comparison), they would not be immune to concerns around the impact on economic growth.

In this vein, the inversion of the US 2-10 year yield curve is a concern as it has been a reasonable predictor of recessions over the last 30 years with a lead time of around 18 months. However, prior to that it had given a number of false signals. Historical data also shows that equity markets on average continue to rise for some time after it inverts, nullifying some of its predictive power. Furthermore, the US 3 month-10 year yield curve has been a much better predictor of recessions. By contrast, it has steepened markedly this year, suggesting that the next recession, when there is one, will be much further out than markets fear.

Nevertheless, the fall in bank and other cyclical stocks reflects the market concern that there will be a recession at some point over the next year. Consequently, the expectation is that banks will have to increase their provisions for potential loan losses, as the outlook for growth worsens, a scenario which is yet to be reflected in analyst forecasts. This view is supported by very weak consumer confidence surveys, as well as anecdotal evidence that lower income households are struggling with rising inflation, which would explain the sharp jump in credit card balances despite strong employment data.

However, so far this is at odds with what banks are seeing from customers. Bank of America highlighted in its first quarter earnings call that average customer deposits were significantly higher than they were pre-pandemic. For example, those Bank of America customers who had between \$1,000 and \$2,000 in their bank accounts in 2019 today have an average cleared balance of \$7,400 and even higher for those with higher balances pre-pandemic.

Other banks have given similarly upbeat prognoses both on their retail and corporate customers who are also holding much higher levels of cash than they did two years ago. For example, Jamie Dimon, CEO and Chairman of JP Morgan, stated at their investor day, "Credit looks really good. We've never seen it this good," before being quoted a few weeks later saying, "You know, I said there's storm clouds but I'm going to change it...it's a hurricane."

Against this conflicting background, banks remain in rude health with strong levels of capital and liquidity, good profitability and a conservative risk appetite where more risk has shifted to capital markets and private credit over the last 10 years. Property & casualty insurers have also benefited from strong rises in insurance premia ahead of claims cost inflation over recent years and are much less economically sensitive due to claims being driven by weather and accident driven events.

While banks and insurance companies remain firmly in the value camp, diversified financials and FinTech companies which can be generalised as growth stocks, have seen a significant derating in their shares and consequently are looking much more attractive. Furthermore, many of these generate very high returns on capital, have extremely durable franchises and long-term structural tailwinds.

Looking forward as to how the sector will perform with these two competing drivers, it is instructive to look at how the sector has performed in the past. Taking data on US banks, which is the largest component of the Trust's portfolio, their relative performance has been highly correlated to US 10-year government bonds since the global financial crisis i.e. banks have outperformed when bond yields have risen, reflecting market expectations for higher growth and/or inflation, and vice versa.

However, in the past few months this relationship has significantly broken down. The only time there was any serious divergence in the past 12 years was at the end of 2018, but on that brief occasion the relative underperformance of bank shares was a better leading indicator than the bond market, as the Federal Reserve had to rein back on raising interest rates and bond yields consequently fell. This time is different.

Going back to before the global financial crisis, the relationship between the relative performance of US bank stocks and bond yields broke down significantly on three occasions namely in 1994, 1999 and 2007. While in 2007 history speaks for itself, on the two other occasions banks went on to significantly outperform over the following three years. In 1995, despite a sharp increase in interest rates in the preceding year, there was a soft landing, while in 2000 it led to the bursting of the TMT bubble and the outperformance of value stocks.

An alternative view is to look at the performance of US banks around recessions. Autonomous, a research firm, calculated pre-pandemic that in the 12 preceding recessions in the US bank stocks had underperformed in the year prior to the recession in eight of the 12 occasions, going on to outperform in the year that a recession started. This makes logical sense as investors sell cyclical companies such as banks in a lead up to a recession and shift their assets into more defensive companies, shifting back once there is greater clarity on the outlook and central banks start to cut interest rates to soften an economic downturn.

In summary, while we remain very constructive on the outlook for the sector and the prospects of the companies in which we are invested, market perceptions have recently deteriorated markedly. It is likely we will have a much clearer view over the next six months. Even though share prices already factor in lower earnings, a sustained recovery is only possible when the outlook improves or if earnings continue to surprise in their resilience and the market gives credit for the improved longer-term profitability outlook. Until such time we will remain patient about taking on risk.

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Growth capital

(compare growth capital funds [here](#))

Managers of Schroder British Opportunities - 14 July

The period was a game of two halves, especially for small and mid-cap areas of the market. UK public equities in aggregate rose over the last six months of 2021,

punctuated by bouts of volatility driven by COVID-19 news. UK large, mid and small cap equity (FTSE 100, 250 and Smaller Companies respectively) indices posted positive returns. However, while UK equities overall were resilient in Q1 2022 as investors began to price in the additional inflationary shock of Russia's invasion of Ukraine, this resilience was driven by large cap oil, mining, healthcare and banking companies. Meanwhile, UK small and mid-cap stocks performed poorly; they were negatively impacted as consumer-focused sectors and a number of economically sensitive areas of the market underperformed. Companies offering high future growth potential lagged as the prospect of rising interest rates continued to heavily influence the investor mindset in favour of nearer-term returns. Given the portfolio's focus on investing in companies with strong long-term growth prospects, this was a challenging period.

In private markets, the second half of 2021 saw continued high levels of activity taking total deal volumes and deal numbers to record levels for the year in the UK. This reflected confidence returning to the market following a disrupted 2020. The final quarter of 2021, however, saw several headwinds emerge which caused a slight cooling in sentiment. The Omicron variant of Covid-19, combined with ongoing issues around supply chains, and the emergence of inflation, led to the reassessment of transactions. However, deals continued to complete as demand remained high. Despite the correction in public equity markets which started in the first quarter of 2022, private markets, particularly at the growth and buyout stage where the Company is most focused, remained buoyant as transactions negotiated over the preceding 3-9 months continued to come to fruition. The first signs of the downturn approaching were most evident in the valuations of venture-stage businesses in the technology sector, which saw steep mark-to-market corrections. Throughout this period of irrational exuberance, which resulted in more capital chasing after transactions, we continued to remain particularly cautious, maintaining our price discipline, and no new private investments were made during the period.

Outlook

The recent downturn in tech stocks precipitated by rising inflation and interest rates, as well as the ongoing war in Ukraine, has principally impacted the venture capital and pre-IPO landscape, where valuation multiples have significantly contracted, putting them at a funding risk in the current environment. In contrast, our portfolio focusses its private investments on the later 'growth capital' and 'buyout' areas of the private equity landscape, where valuations have contracted but the delta has been relatively more resilient. Whilst we recognise that private equity valuations may continue to converge towards that of the public markets, we believe that the business models of our investments, and their end market fundamentals, differentiate our portfolio. This was evidenced during the period, where the aggregate of our private asset portfolio was revalued upwards - a function of growth in the underlying businesses offsetting the compression in the valuation multiples applied to them.

A change in the business cycle represents an opportunity for leading companies to consolidate their advantage by acquiring smaller players at attractive valuations. We have seen a number of the private companies in our portfolio complete acquisitions, and we expect this trend to continue.

We expect to see more attractive public and private investment opportunities emerging and will look for factors such as pricing power, business transformation potential and robust technological enablement.

We see the pace of the current quantitative tightening cycle as the greatest risk to equity markets for the rest of 2022, whilst inflation will continue to weigh on consumer confidence and impact the demand outlook.

While 'growth' as an investment style may be challenged in the current environment, falling valuations for many businesses are removed from their underlying positive fundamentals.

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Infrastructure

(compare infrastructure funds [here](#) and [here](#))

Robert Jennings, chair of Sequoia Economic Infrastructure Income - 11 July

We are taking full account of the risks - and opportunities - that higher inflation may present. In general, a moderate amount of inflation is helpful for the credit quality of the companies that we lend to. This is because in many cases these companies are able to increase their revenues more or less in line with inflation, while their debts remain the same in nominal terms. In other words, inflation reduces the real amount of leverage that our borrowers have. There, however, is a risk, currently exacerbated by high energy prices and the ongoing consequences of Russia's invasion of Ukraine, that central banks decide to address inflation aggressively, reducing growth in the economy or even triggering a recession and a period of stagflation.

While we do not welcome recessionary pressures in any of the countries where we hold investments, the resilience of our borrowers to recession is one of the most important factors that our Investment Adviser evaluates in its loan assessment processes. We are also mindful that interest rates are increasing and are likely to continue to do so.

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Renewable energy infrastructure

(compare renewable energy infrastructure funds [here](#))

Gore Street Energy Storage - 26 July

The market backdrop wherein the company operates, shows a growing shift toward low carbon energy generation, which represents strong fundamental drivers for energy storage deployment. The UK and Irish Governments are committed to achieving carbon neutrality by 2050, as well as the US. Germany has set on a path of accelerated clean-energy expansion, bringing forward its goal of 100 per cent. renewable power to 2035. This provides a tailwind for the deployment of battery energy storage systems and has led to rapid growth within the sector.

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Shonaid Jemmett-Page, chair of Greencoat UK Wind - 28 July

There are currently over 27GW of operating UK wind farms (14GW onshore plus 13GW offshore). In monetary terms, the secondary market for operating UK wind farms is over £90 billion. The Group currently has a market share of approximately

5 per cent. As at 30 June 2022, the average age of the portfolio was 7 years (versus 5 years at listing in March 2013).

Driven by recent security of supply and cost concerns, as well as by net zero climate objectives, the UK is now targeting 50GW of offshore wind by 2030, supported by the CFD regime. New build onshore wind and solar are also expected to contribute, both on a subsidy free basis and supported by the CFD regime. Over 10GW of total capacity was awarded in CFD Allocation Round 4, announced on 7 July 2022.

Power prices during the period were well above budget, primarily reflecting high gas prices driven by the recovery in global demand, supply chain constraints and the war in Ukraine. The average N2EX Day Ahead auction price was £176.05/MWh (H1 2021: £68.45/MWh). Forward power prices over the period 2022-2025 remain high. High power prices drove strong cash generation in H1 2022 and the Group should continue to benefit from strong cash generation over the next few years through its balanced exposure to power prices.

Short term power prices have been modelled on an appropriately conservative basis, reflecting high volatility and market uncertainty. In the medium term, various market design options are being considered by BEIS with a view to accommodating a higher proportion of renewable generation and storage.

In general, the outlook is very encouraging, with proven operational and financial performance from the existing portfolio, combined with a healthy pipeline of attractive further investment opportunities.

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Norman Crighton, chair of Harmony Energy Income - 7 July

BESS projects in Great Britain have continued to enjoy strong revenues from a mixture of Ancillary Services and wholesale markets, and National Grid ESO has introduced a number of new services providing additional opportunities to projects.

The most successful BESS projects are those which demonstrate revenue agility - i.e. the ability to participate in and switch between multiple revenue streams, identifying the most valuable at any point in time.

The conflict in Ukraine has led to a significant increase in near-term gas pricing and independent forecasts project that this will not stabilise until 2026. This is likely to support continued high average wholesale electricity prices as well as price volatility: two factors which create revenue opportunities for battery projects. Wholesale electricity price volatility was already projected to increase as a result of the "net-zero" driven shift to intermittent renewables as a primary source of electricity generation. In the Investment Adviser's opinion, this shift to renewables could now accelerate as energy security becomes a greater Government priority, and policies are developed to reduce reliance on Russian gas imports.

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Biotechnology & healthcare

(compare biotechnology & healthcare funds [here](#))

Manager of Bellevue Healthcare - 7 July

Macro environment

Let us begin with some positives. The COVID-19 pandemic is no longer the predominant macro-economic driver of economies, markets and societal behaviour; the pandemic is firmly in the rear-view mirror. However, society continues to wrestle with the supply-side shock and consequential inflation that a rapid recovery in demand has unleashed, especially as the Chinese government clings to unworkable COVID policies that impact the supply side. These negative forces are further compounded by the unprovoked invasion of one of the most economically under-appreciated countries in Europe.

Whilst these travails cast a long shadow over the 'return to normal', we should not ignore the progress: all-cause mortality is back to pre-pandemic norms and most Western countries have returned to full employment. Both of these outcomes seemed unimaginable in the spring of 2020, as we watched the COVID crisis unfolding in Italy. China aside, the re-imposition of lockdowns seems a remote risk and all of this is due to the appliance of bio-science.

With the positives out of the way, we can consider the current situation and outlook. Over the six months to 31 May 2022, the MSCI World Total Return Index declined 4.6% in sterling terms (-9.3% in dollars). There are many cogent reasons why broad equity gauges have fallen: economic and geo-political uncertainty makes future demand harder to predict.

Furthermore, rapidly rising inflation also weighs on demand and potentially erodes corporate profit margins as input costs rise and they may not be able to pass all of this through to consumers in the form of higher prices. In this scenario, it is understandable and rational investors would want to pay a lower price for a share of those future profits than previously.

To the logician (or finance student lectured by our Chairman), a share price encapsulates the net present value of an enterprise's future cashflows adjusted for liabilities; many a tome has extolled the wondrous wisdom of markets and crowds as a value discovery tool. Such comments hold up over long periods of time, during which the participants have the opportunity to assimilate large amounts of data.

Humans though are not dispassionate calculating machines. Amidst fast changing macro conditions, markets become insensible, and liquidity dries up. Price 'discovery' can become a race to the bottom as flighty investors withdraw capital and hedge funds pile on the pressure. This can exacerbate share price movements at the company-specific level far beyond what is implied by any changes to the long-term revenue and profit outlook.

Indeed, we can see this made manifest in the huge intra-sector moves over the period-in-review, belied by the relatively modest change in the dollar value of the Index as a whole: Energy up 44%, Retail -58%, Automotive -25%, Consumer Durables -24% and both Software and Semiconductors -23%. Correlates to economic growth and consumer spending are out, input costs are all the rage.

Any attempt at a quantitative analysis of such moves presumes the starting point for share prices was rational; let us not forget that the MSCI World Index made an all-time high in early January 2022 as Russia began its war against Ukraine. What

we are seeing is in an inculcation of uncertainty being discounted in the form of structurally lower return assumptions allied to a long-overdue correction of irrationally high ratings for some technology and media related companies that gained halo status during the pandemic. For companies whose end customers are either the consumer or linked to consumption patterns, all of this makes sense.

Healthcare performance review

If consumer affordability and consequential demand reduction, allied to rising energy and input prices (predominantly raw materials, labour and manufacturing equipment) is ultimately what bedevils the market, then one would expect defensive (i.e. non-cyclical, non-discretionary) sectors with high gross margins (which indicates lower profit margin sensitivity to price inputs) to outperform during this period and, broadly speaking, this is what we have seen for healthcare; the total return of the MSCI World Healthcare Index was +4.5% in the six months to May 2022 (-0.6% in dollars), outperforming the wider market by 9.1%.

Within the broader healthcare sector, the sub-sector performance dispersion reflects the broad 'risk aversion' theme, with the best performers being Distributors (+42%), Managed Care (+22%) and Diversified Therapeutics (predominantly Large/Mega-Cap Pharma, +17%). Distributors have arguably the lowest revenue cyclicalities of any of the sub-sectors and have also benefitted from resolving long-standing opioid litigation overhangs.

Managed Care's performance partly reflects a slower-than-feared normalisation of elective procedure volumes (abetted by the Omicron wave around the New Year) but also its general earnings dependability. There can be some late-cycle earnings slowdown if there are signs of weakening employment trends, but this is not a factor in the US market at the moment. Large-Cap pharma revenue streams are both highly diversified and highly predictable and it is these perceived virtues that investors currently flock to. The fundamentals for the industry around pricing and poor R&D productivity remain as intractable as ever.

On the other side, it was Dental, the most discretionary area, that capped the underperformers (-65%), followed by highly-rated Healthcare Technology (-39%) and Diagnostics (-30%). The Dental sub-sector's biggest virtues are also its biggest vice. Everyone has teeth and almost everyone's teeth come out wonky. We all know too well that, as much as one might try to avoid it, eventually we all end up in the dentist's chair for some treatment or other. However, oral health is rarely a matter of life and death and the work can be finished to varying degrees of visual perfection. One can readily trade down to cheaper treatments and it is this concern that has driven negative investor sentiment.

Healthcare Technology is somewhat discretionary in nature; you do not need to upgrade to a clever pump or continuous glucose monitoring system if you do not wish to. These are very much premium products in the current marketplace. Like Dental, the ratings of these companies got pretty silly in the latter part of the 2021 and a correction was overdue.

Diagnostics is a harder one to rationalise. Coming into 2021, there were some pockets of over-valuation driven by COVID-related excitement about the wider industry, but many of the most egregious over-valuations seemed to have normalised by late 2021. What has followed since has been rather indiscriminate and less obviously fundamental to our minds. It is undeniable that the shift toward 'point of care' diagnostics is an inevitable and necessary part of the ongoing care paradigm transformation and genetics-based molecular diagnostics are an

increasingly essential part of population health and preventative healthcare programmes.

Our final observation on the healthcare sector performance would be the continued influence of the 'size factor'; namely small and mid-sized companies have materially underperformed their large and mega-cap brethren. This is partly a function of generalists seeking havens in defensives. In such scenarios, large liquid names are preferred and this helps to drive the dispersion in performance between the two groups.

One could also make arguments for companies in need of short-term equity funding struggling more in a falling market and also for more highly rated stocks to fall further as implied discount rates rise (since a premium rating is the manifestation of a lower implied discount rate or higher terminal growth rate, or both), having a premium rating or needing cash are not directly linked to company size. The key point to our minds is that whilst we are experiencing a divergence in share price behaviour, we are not seeing a commensurate divergence in operating performance; the fundamentals do not support the pattern.

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Technology & media

(compare technology & media funds [here](#))

Tim Levene, CEO of Augmentum Fintech - 4 July

Despite a backdrop of continued economic uncertainty fuelled by the current geopolitical and macroeconomic challenges, the financial services industry continues to go through a major digital transformation. The industry has seen record levels of investment over the past 12 months, and it is important to distinguish between the opportunity that is still ahead of us alongside the ongoing and much welcomed moderation in fintech valuation multiples both in the private and public markets.

Markets are understandably volatile, and the tech sector has perhaps been the hardest hit. Many high profile public fintech businesses have been hit hard. Market volatility has foiled many IPO plans and many of the SPACs (special purpose acquisition companies) that were crowding the headlines in 2021. We have also seen a contraction in the digital asset (crypto) sector. This shake-out has shone a light on some of the obstacles and shortfalls the sector still needs to overcome as it becomes more mainstream, but this doesn't diminish the fundamental disruptive potential of blockchain technologies.

But uncertain times drive increasing innovation, and activity continues unabated in high potential earlier stage fintech companies. With significant volumes of "dry powder" (fund commitments raised over the last couple of years and not yet deployed) in the European venture market, and a finite number of high quality companies, valuations at the early stage remain relatively cushioned from broader public market uncertainty. Maintaining price discipline and delivering advantaged deal access therefore remain critical to the work that we do in securing long-term returns for our shareholders.

Outlook

We have evolved in just six short months from a risk on market that had developed over a number of years to a risk off environment.

The volume of venture capital raised over the last two years leaves significant “dry powder” commitments across Europe, with estimates suggesting more than two and a half years of capital in place at deployment rates matching the last two years. Such volume of capital seeking a finite number of quality investments is likely to serve to continue to maintain momentum for the fintech sector. In addition there has consistently been a trend, particularly in fintech, for companies to stay private for longer, something that the external market conditions is likely to reinforce.

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Ben Rogoff, manager of Polar Capital Technology - 20 July

Market review

An unexpected monetary volte-face by policymakers amid persistently high inflation weighed on equity markets and valuations during the year. However, losses were more than offset by pronounced US dollar strength which gained more than 12% on a trade-weighted basis and more than 9% against the British Pound (GBP). As a result, the MSCI All Country World Index over the year to 30 April 2022 gained 4.3% in sterling terms, aided by a strong first half characterised by economic reopening, upward earnings revisions, and rampant M&A.

The strength of the US dollar mirrored sharply higher US interest rate expectations following the revelation in November that the Fed no longer believed inflationary pressures were 'transitory'. Energy prices likely played a part in driving this Fed Pivot as oil and commodity prices rose 79% and 54% respectively during the year. Higher risk-free rates (10-year US Treasury yields increased from 1.6% to 2.9%) resulted in a much more challenging fiscal second half with negative headline returns failing to capture the magnitude of the correction experienced by the average stock. While the US, as measured by the S&P 500 Index gained 10.2% in sterling terms (and 0.2% in local terms), drawdowns were significantly greater elsewhere including Europe (Eurostoxx 600 +2.3%), Japan (Nikkei 225 -12.0%) and Asia ex-Japan (MSCI Asia ex-Japan -12.9%) (all returns in sterling terms, unless otherwise stated). Weakest performance was reserved for Chinese stocks (MSCI China -29.8%) where a deluge of regulatory changes and market unfriendly developments took their toll on investor sentiment and lockdowns in Shanghai towards period end reflected the challenge posed by the omicron variant to China's zero-COVID policy.

Small-cap indices meaningfully underperformed during the year, with the Russell 2000 (small cap) declining 9.6% while the Russell 1000 (large-cap) advanced by +6.2% (both in sterling terms). Breadth also continued to deteriorate with just c.25% of NYSE stocks trading above their 200-day average at year-end, compared to 58% a year earlier.

The first half of the year saw markets grind higher amid economic reopening, positive earnings revisions, and record equity inflows. This was possible due to worldwide vaccination programmes that succeeded in breaking the link between COVID-19 infections and deaths. Economic recovery was most evident in consumption trends and in labour market strength, the US unemployment rate falling below 5% by September before returning to pre-COVID levels by year end. The recovery trajectory was complicated by waning fiscal stimulus and labour shortages, exacerbated by the combination of limited improvement in the labour participation rate and early retirement (aka the 'Great Resignation'). However, the most significant headwind was commodity shortages and soaring energy prices with oil surpassing \$80/barrel in November for the first time since 2014, while US producer prices rose 8.3% y/y in August, the largest year-on-year increase on

record. The combination of shortages and a surfeit of freshly printed liquidity saw CPI increase 5% y/y in May - the fastest growth in consumer prices since August 2008. This led to the June FOMC 'dot plot' implying two rate hikes in 2023, up from zero in March, and, in October, the Fed signalled that it could begin scaling back asset purchases in November. However, equity markets were able to shrug off these negative developments largely due to the Fed maintaining its earlier 'transitory' stance and persistently negative real rates supporting equity multiples.

The emergence of the highly mutated Omicron variant in November was an inauspicious start to what proved a very challenging fiscal second half. In the same month, recently re-nominated Fed Chair Jerome Powell performed a remarkable pivot regarding inflation, declaring "it's probably a good time to retire that word transitory". While the milder variant of COVID likely contributed to a "more hawkish variant of the Fed", it was November's CPI print (+6.5% y/y) - the highest reading since 1982 - that likely forced Powell's hand. Hawkish monetary developments dominated the balance of the year, with the Fed first moving to double the pace of tapering in December. An inflation shock morphed into a rates shock as the release of FOMC minutes in January raised the spectre of rate hikes and quantitative tightening (QT) "sooner or at a faster pace than participants had earlier anticipated".

The first US rate hike since 2018 was also delivered in March, three months after the UK became the first G7 economy to raise interest rates since the pandemic began. By the end of April, markets had priced in Fed Funds at 250bps having anticipated zero rate hikes little more than a year earlier, and 10-year US Treasury yields had backed up to 2.9%, almost doubling during the first four months of 2022. The persistence of inflationary pressures saw other central banks adopt more hawkish positions too, forcing rates higher.

Long-duration stocks felt the full force of this monetary about-turn with the earlier tremor in weaker, more speculative names turning into a full risk-off episode across high growth and long duration names. This was particularly true within small caps where growth stocks trailed value by more than 20% during the year.

In addition to the human tragedy associated with the invasion of Ukraine, the conflict added untimely upside pressure to inflation and downside risk to global growth forecasts. Reflecting the elevated risk of so-called 'policy error' (the Fed tightening against this most uncertain of backdrops) the two-year versus 10-year Treasury yield spread briefly inverted during March, something often seen as a precursor to a recession.

Technology review

Calendar year 2021 proved a strong recovery year with worldwide IT spending +9% y/y as compared to earlier estimates of +6%. Upside to 2021 forecasts saw the technology sector deliver revenue and earnings growth of 15.7% and 28.9% y/y respectively, well ahead of estimates this time last year of 10.1% and 17.5%. As a result, technology revenue growth ended up only narrowly behind the market (16.5%) although earnings trailed significantly as the market delivered 47.5% growth. This was unsurprising given more difficult comparisons and less incremental leverage in the technology sector. Despite better-than-expected IT spending, technology stocks trailed the broader market during the fiscal year, the Dow Jones World Technology Index declining 1% in sterling terms (total return) due to fading pandemic tailwinds, tough comparisons and extreme factor rotation following the shift in Fed policy. However, and even more extreme than in the broader market, returns were dominated by US stocks which increased 6.6% while non-US technology stocks (as measured by the W2TEC index) fell 22% during the year. Small caps also significantly underperformed, the Russell 2000 (small) technology

index declining 10.1% while large-caps (as measured by the Russell 1000 technology index) advanced 6.9%, both in sterling terms. Moreover, US relative strength was driven by an even narrower group of megacap stocks that continued to deliver strong growth against a less uniformly positive backdrop while also enjoying strong ESG-related equity inflows. At year end, just 19% of NASDAQ stocks were trading above their 200-day moving average. Higher multiple, long duration stocks saw very significant multiple compression down from their November highs, as the most expensive quintile of the US technology sector fell -47% while the least expensive (value) quintile only declined -8% through our fiscal year end.

At the sector level, strongest performance was enjoyed by the semiconductor sector as demand remained strong amid chip shortages despite concerns about double-ordering and the durability of the cycle. Strong capex growth (+20% y/y) at the hyperscale public cloud companies led to continued strength in cloud data centre capex. While most of the automotive industry struggled with the global chip shortages, Tesla enjoyed a stellar period delivering a record number of vehicles and record margins in Q3 and Q4 against a supportive backdrop for electric vehicles.

Value-oriented sectors such as networking (aided by datacentre strength) and hardware also performed well. Software stocks trailed, with average returns significantly worse than headlines due to Microsoft, as the sector suffered material multiple compression amid higher rate expectations. This trend accelerated into calendar year 2022, which saw software EV/NTM (Enterprise Value / Next Twelve Months) sales multiples compress by 42% by the end of April to an average of 8x. Private Equity buyers stepped in to take advantage of the weakness.

Weakest performance was reserved for Internet stocks (and other 'work from home' beneficiaries) which struggled with reopening, difficult comparisons, changes to user tracking, supply chain travails and (towards period end) consumer spending concerns. While the sector struggled (particularly in China, where a series of regulatory crackdowns weighed heavily) the average stock suffered far more than headlines suggest. Softer ecommerce trends and the impact of waning fiscal stimulus checks put pressure on the ecommerce and payments space.

Public cloud results remained very solid as the three major public cloud operators reached a collective annual revenue run rate of c.\$140bn, up +41% y/y. Many of the bellwether WFH and lockdown beneficiaries more than reversed out earlier gains as companies broke below pre-COVID levels despite strong growth in their revenues and user bases in the intervening period. The most speculative areas of the market saw the largest drawdowns. The GS Non-Profitable Tech Index returned -47% and the ARK Innovation ETF delivered -57% during the year as investor enthusiasm for 'TAM' (Total Addressable Market) stories abated in the context of more persistent inflation and a higher rate outlook.

Market outlook

With the worst of the pandemic apparently behind us, investors could be forgiven for thinking that recovery might have been more straightforward. Instead, we are faced with a more uncertain macroeconomic backdrop than at any stage since the pandemic and - given the loss of policymaker support - arguably since the Great Financial Crisis (GFC). As recently as January, the IMF was forecasting global growth of 4.4% and 3.8% in 2022 and 2023 respectively - a deceleration from an estimated 6.1% in 2021 - reflecting higher interest rates, slower US growth and troubles in China. However, the invasion of Ukraine in late February has seen growth forecasts contract further while resultant soaring food and energy prices have led to inflation expectations of 5.7% in advanced economies and 8.7% in

emerging markets this year, significantly ahead of earlier forecasts. Beyond the tragic humanitarian consequences of the war, the conflict has also highlighted Europe's reliance on Russian energy with the EU receiving nearly 40% of its gas and more than a quarter of its oil from Russia. With the war ongoing (and with systemic risk thus far avoided), higher commodity and energy prices will be the primary mechanism for how the conflict affects the global economy. While Russia only explains c.1.6% of global GDP, it is the world's largest exporter of natural gas (c.20% global share) and the second largest exporter of crude oil. Russia is also the largest exporter of wheat (c.20% share) and supplies c.10% of the world's copper and aluminium and 40% of palladium. Consumer spending is being challenged by higher energy costs with UK families said to face the biggest real income squeeze in nearly 50 years. In the US, a gallon of gas recently exceeded \$5 - the first time ever - with negative implications for disposable incomes and consumer confidence which recently fell to a decade low.

Sharply higher energy prices also pose a new and substantial risk to an inflationary backdrop that had already become problematic. As previously discussed, inflation has soared almost everywhere with annual CPI growth rates in the US and Europe at multi-decade highs. Originally understood as a supply shock due to COVID-related disruption, the past year has seen higher prices become more pervasive and less transitory. As previously mentioned, US CPI reached +6.5% in November, while in the same month, Eurozone inflation came in at +4.9% y/y, way ahead of the ECB's earlier forecast of +1.5% for 4Q21. Tight labour markets have also led to wage inflation, with unit labour costs +6.3% y/y in 3Q21, the biggest increase since 1982. As a result, the narrative has shifted to inflation as a demand problem caused by stimulus, excess savings, and pent-up demand which, when paired with more inelastic supply, has created a "perfect storm of higher prices".

Since the start of the pandemic, highly accommodative fiscal and monetary policy designed to prevent financial collapse has 'flooded the economy and financial markets' with unprecedented liquidity. Between February 2020 and November 2021, M2 rose \$6trn to \$21.4trn - equivalent to almost a year's worth of nominal GDP, a record. Excess liquidity was recently estimated at c.\$3trn while fiscal support packages have seen government deficits balloon. In the US, the federal budget deficit reached c.\$2.8trn, almost three times the 2019 level. The Fed's balance sheet has expanded by almost \$5trn too, reaching a record \$8.7trn by the end of the calendar year. While the Fed may have "greatly miscalculated" the inflationary impact of earlier stimulus, they could not have known the pandemic would result in a labour supply issue. Just two years ago the pandemic was said to have "triggered one of the worst jobs crises since the Great Depression". Instead, and despite the US economy being 1.4% larger than it was pre-pandemic, there are still 3.6 million fewer people in jobs and nearly 1.9 job openings per job seeker. This is largely the result of the 3m additional 'early retirees' equivalent to c.2% of the US workforce (aka the 'Great Retirement'), another pandemic-related twist which has accelerated the labour market recovery timeline. As a result, wages are rising, with the National Federation for Independent Businesses (NFIB) recently reporting a record net 48% of small businesses increasing worker compensation. Despite this, labour force participation remains subdued at 62.3% (as compared to c.63% pre-pandemic) leading to massive employee churn (aka the 'Great Resignation'). Labour shortages may persist which will put further upward pressure on wages and could presage a self-reinforcing wage-price spiral unless productivity growth improves significantly.

As such, a US tightening cycle was necessary to prevent inflation becoming more embedded in the labour market. While the Fed may appear behind the curve,

inflation expectations appear to remain relatively well anchored. The Fed will want to keep it that way; to fail to have pivoted after the November data "would have risked Powell's rhetoric degenerating into self-parody". Since then, rate hikes have begun with further increases anticipated this year and next. The decision by the ECB in early March to accelerate tapering despite events in Ukraine highlighted the fact that central banks will (and should) always prioritise credibility over policy error risk. As such, we expect Powell to "do whatever it takes" to becalm inflation but do not anticipate a Volcker re-run given the very different backdrop with one notable exception - soaring energy prices. Regardless, it is difficult to see how central banks can come to the rescue of markets with interest rates near zero. Moreover, reducing inflation has become an increasingly important political focus, and a more important consideration than bailing out equity investors. At some point concerns about reflexivity will resurface but there is no obligation for the Fed to act and, in any case, we know it failed twice to stop selloffs of as much as 50% in the bear markets that ended in 2002 and 2009.

Until recently, our base case was slowing growth rather than stagflation or recession. However, we have to acknowledge the increasing risks posed to this relatively sanguine view by tighter monetary conditions, war, and soaring energy costs. For now, we are encouraged by earnings expectations that have remained relatively robust with growth in earnings and revenues this year forecast at 7.7% and 11.5% respectively. While these forecasts may prove stale and subject to downward revision, it is worth recalling that while GDP is measured in real terms, earnings estimates are nominal. As such, inflation currently represents a greater risk to multiples than to corporate earnings. Of course, much depends on the durability of cycle-high corporate profit margins given an increasing number of cost pressures. We continue to keep a close eye on the direction of operating earnings given its strongly positive (0.94) correlation with the S&P 500.

Following the recent market correction, valuations look less problematic today with the S&P 500 trading at c.15.8x forward earnings as compared to last year when we noted they were "somewhat extended" at c.23x. As a result, US stocks now trade below both five-year (18.6x) and ten-year (16.9x) averages. However, this year we are forced to consider valuations against a very different inflation backdrop. That said, we are somewhat willing to look through current elevated inflation because longerterm expectations remain well anchored and because the Fed is alive to inflationary risk. Equity valuations should also be somewhat supported by a paucity of alternatives. Compared to bonds, the Fed Model suggests stocks are c.50% undervalued compared to Treasuries, and c.20% undervalued versus investment-grade credit. Cash continues to look unattractive with negative real returns guaranteed in most major markets, although elevated levels of equity market volatility have added to its relative lustre.

Upside risk could manifest via the cessation of hostilities in Ukraine - unlikely in the very near term but possible in time. While a return to the prior equilibrium enjoyed between Russia and the West appears impossible, an end to hostilities could significantly ameliorate current market uncertainty, becalm energy prices, and meaningfully reduce the risk of escalation. Structural inflation fears may also be overdone with many of the imbalances that existed prior to the invasion of Ukraine appearing pandemic-related: pent-up demand boosted by household savings bloated during COVID, supply-chain challenges frustrated by uneven vaccine availability and draconian approaches to COVID containment, particularly in China. Heightened labour market churn also appears to be somewhat pandemic related with the pursuit of more flexible work and/or relocation important reasons for changing jobs. Reopened borders and easier international travel may also

ameliorate labour shortages in lowerpaid work where wage growth has been strongest. This malalignment of demand and supply is reminiscent of the post-war period when the end of price controls saw CPI leap from 1.7% in February 1946 to a peak at 19.7% in March 1947, before plunging to zero in 1949. The cause of this volatility was a combination of pent-up demand, as soldiers were demobilised, and plunging industrial production, as factories retooled from armaments to consumer goods. Two years later, production rebounded dramatically, helping to bring inflation down. A similar experience also occurred during the Korean War. Both of these episodes revealed that inflation can rise and fall very quickly without inflation expectations being permanently altered. Fed Chair Powell may have been alluding to this possibility when he stated that "appropriate monetary policy in this environment requires a recognition that the economy evolves in unexpected ways".

Other positive impulses include the so-called 'CFO put' with S&P companies sitting on \$2.4trn in cash and other liquid assets. Leverage at public companies (as measured by net debt/EBITDA) is back at 2014 lows which should support capital spending, higher dividends and stock repurchases. It should also fuel greater M&A activity with private equity additionally said to have c.\$2.3trn of 'dry powder' cash reserves. During 2022, we have seen private equity spend more than \$34bn acquiring three software vendors. A return of strategic M&A may also prove supportive too, with \$95bn of gross transaction value announced in the videogaming industry alone this year. We also see many of the conditions necessary for a rally falling into place: the IPO market is essentially shut, and investor sentiment is at post-1992 lows (a recent AAI survey of US retail investors revealed that just 15% of investors are bullish). Small caps have underperformed considerably from highs and new issues have been smashed as the GS Recent Liquid IPO Index has halved from November highs, both of which have typically been preconditions of previous rallies

Market risks

While COVID remains a wildcard, war, inflation, and recession represent the most significant interconnected risks this year. In terms of COVID, we continue to believe the worst of the pandemic is behind us thanks to vaccine rollouts that have broken the link between cases and mortality, as well as the link between cases and behavioural adjustments. Put differently, most people appear to have concluded that the health risks associated with COVID are no longer significant enough for them to change their behaviour. As long as Omicron remains the dominant strain, our base case is a continuation of the transition from pandemic to endemic disease. The main risk to this is a significantly different new variant that changes the trajectory of the virus. In addition, current lockdowns in China - where omicron is challenging the efficacy of local vaccines and the zero-COVID policy - are a pertinent reminder that COVID is likely to continue disrupting life and supply chains for the foreseeable future. We also cannot know how the Ukraine conflict will evolve. At the same time, China will be watching closely given its One-China Principle is similar to Putin's desire to rebuild a Greater Russia. There is also a real (if small) risk of escalation (evidenced by potential NATO enlargement) - a chilling prospect given Russia controls the world's biggest nuclear arsenal and has been unafraid to sanction the use of chemical weapons in Syria.

The conflict also poses additional risks to the prevailing investment backdrop. History says we should expect higher inflation: as the saying goes, "war is inflationary; peace is deflationary". Put differently, the pursuit of both "guns and butter" comes at an inflationary cost. In the US, inflation spiked during the War of 1812, the American Civil War, WWI, and WWII through the end of the Cold War. We might also do well to consider the implications of permanently higher defence

spending and the potential for a new arms race. If so, this may coalesce around hypersonic weapons which reduce the effectiveness of existing ballistic missile defence systems. With the potential to derail the theory of deterrence based on mutually assured destruction (MAD), higher defence budgets look inevitable. Germany has already announced an immediate €100bn budget to modernise its army and an ambition to exceed a target of 2% of GDP in defence spending (from c.1.5% today). This pivot is significant, as was the recent decision by some ESG funds to allow defence stocks within their investment remits. During the Cold War, the US spent around 7% of GDP on defence which détente saw fall to c2.8% today. The war in Ukraine has drawn a line under that peace dividend with US defence spending already forecast to rise towards 3.5-4% over the coming years.

War in Ukraine has also highlighted Europe's dependence on Russian oil and gas, particularly in Germany where 65% of gas comes from Russia. Naturally, this has brought energy security to the fore and Europe's urgent need to reduce this vulnerability. While this should accelerate the clean energy transition, the reality is that it takes a lot of alternative energy to replace gas. The invasion has so shaken Germany that its economic minister from the Green Party is reviewing the possibility of keeping both coal and nuclear plants online to reduce dependence on Russian energy. We are excited about the opportunity to participate in another wave of environmental technology spending, but the climate transition also represents another "slow-moving negative supply shock" because it embeds the cost of carbon emissions in production prices. It is also another reminder we may already be past peak globalisation. This process arguably began with Brexit and Trump's tariff wars but stepped up a gear with COVID when the world's interdependence was tested. Vaccine nationalism was a particularly difficult moment, while post-pandemic challenges have further highlighted the risk associated with global supply chains built on hyperspecialisation and finely-tuned just-in-time (JIT) inventory management. The risks to US equities from a decline in globalisation are not insignificant: Bank of America estimates that globalisation has driven more than half of all margin expansion due to lower COGS on exports, taxes, and labour.

More significantly, the risk is that peak globalisation is part of broader inflation regime shift. In recent years we have seen a wave of populism presage significant minimum wage increases and social unrest, while a number of COVID policy responses in the developed world (such as massive transfer payments indirectly financed by central banks) represent a "generational shift in fiscal policy". The demand for more flexible work post-pandemic is also perhaps symptomatic of a recalibrated relationship between labour and capital that could persist. Taken together, these factors represent a significant challenge to the disinflationary era that has been in place since the early 1980s. Finally, we might highlight the long-term risk posed to the dollar-based system following the freezing of Russian US dollar reserves, described as "the weaponization of money". While a paucity of alternatives suggests limited immediate risk to the dollar's reserve currency status, so-called 'de-dollarisation' could become a key theme in an "increasingly multi-polar and potentially more contentious world".

Technology outlook

Earnings outlook

After increasing 9% in 2021, worldwide IT spending is expected to reach \$4.4trn this calendar year representing an increase of 4.0%, in current dollar terms. However, this forecast has already been revised lower from +5% forecast in January reflecting deepening geopolitical and macroeconomic risks. For 2022, the technology sector is expected to deliver revenue and earnings growth of 11.2%/12% while the S&P

500 is forecast to grow at 9.8%/10.3% respectively. These forecasts do not look unreasonable, particularly after a solid Q1 results seasons that at the time of writing has seen the sector deliver 11.7% y/y revenue growth. However, guidance has been more mixed than usual, likely reflecting inflation, supply chain challenges, USD strength and the impact of the conflict in Ukraine. These headwinds come at a tricky time for the technology sector's net profit margins which are elevated at c.25% as compared to the five-year average of 21.8%. Sustained US Dollar strength could challenge revenue estimates given the sector's international exposure of 59% (the highest of any sector) vs. 41% for the market.

Valuation

Having made a new cycle high of 28x ahead of the Fed Pivot in November 2021, technology valuations have been in retreat. Today, the forward P/E of the technology sector is c.19 - considerably less than this time last year (26x), below the five-year average (21.7x) but still ahead of the ten-year (18.2x) average. In addition, technology remains the best-capitalised US sector and the only one with net cash. The sector's relative rating has also contracted from post-2004 highs of 1.4x registered in late 2021. Today, technology stocks trade at 1.1x the market PE multiple, towards the middle of its post-dotcom bubble range of 0.9-1.4x and a far cry from levels seen during the dotcom bubble, when the sector traded at more than twice the market multiple. However, as we have long argued, aggregate valuations continue to be diluted by 'cheap' incumbents such as HP and Intel (and now arguably Meta / Facebook) that trade on P/E's of between 7-13x.

Last year, we highlighted how the technology story had hardly gone unnoticed, evidenced by next-generation valuations that had expanded to cycle highs, revisiting levels not seen since the late 1990s. While this group of stocks boasted unusual growth profiles, we cautioned that elevated valuations also reflected several late-cycle features - elevated retail participation, SPAC issuance, concentrated portfolios and 'classic late-cycle exuberance' that had coalesced around long-term 'total addressable market' (TAM) investing. Since then, those pockets of exuberance have been truly burst including ARK (a proxy for TAM investing) which peaked in February 2021 - a full nine months before our own benchmark made its highs- and has subsequently suffered peak-to-trough decline of c.77%. SPACs have fallen by c.50%. At time of writing, valuations across the SaaS space have more than halved across all growth groups. While we have been nervous about high-growth valuations, our own base case did not envisage a derating that would be as deep or dramatic as it is currently proving; what began as an overdue valuation reset has gathered momentum of its own as investors have begun to question the durability of growth and even the validity of some companies' non-GAAP profitability given high (and persistent) levels of share-based compensation. While macroeconomics and the Fed pivot have played a significant part in this, it has been the reversing fortunes of the working from home (WFH) and other pandemic beneficiaries that began this process.

Conclusions

As one of the largest beneficiaries of the pandemic, reopening was always going to generate crosscurrents for the technology sector. E-commerce normalisation has led to significant retracements within the internet and payment subsectors which are likely to take time to recapture. However, we are confident that secular tailwinds will reassert themselves, supported by favourable demographics. Software spending growth remains robust as companies digitally transform, automate workflows, gain insight from AI, secure themselves from cyberattacks and apply technology to drive productivity gains. Gartner believe software spending will increase 9.6% this year;

IDC size digital transformation as a \$10trn opportunity through 2025. And then there's a myriad of other secular themes within technology to get excited about - AI, cybersecurity, electric vehicles (EVs), healthcare and clean energy to name a few, as well as optionality associated with autonomous vehicles, the metaverse and blockchain/ distributed computing. With macroeconomics currently dominating equity markets and near-term volatility high, it is easy to forget how good the long-term technology story is.

Long-term returns ultimately reflect economic value added, even if market disruptions and cyclical impulses can overwhelm the powerful underlying drivers of longer-term technological progress in the short term. If the past year has shown anything, it is the enormous risk associated with hubristic and Panglossian investment approaches: TAM, growth at any price, disregard for liquidity, and high conviction trumping risk management as the basis for portfolio construction. None of these things, however, alter the underlying criticality of technology (via its contribution to total factor productivity) to future economic growth, especially as the other two inputs to growth (capital and labour) may contribute less as they become relatively scarcer. As the OECD puts it (quoting Krugman): "Productivity isn't everything, but in the long run it is almost everything." Technology is the handmaiden to productivity improvement, and so long as the sector can continue to help the economy become more productive and create economic value, we expect value to continue to accrue to equity holders in the most impactful companies enabling this change.

While valuations have now corrected back to mediumterm averages, they are still susceptible to further downside given increased volatility, the growing influence of energy prices and real rates on equity markets as well as heightened recession risk. The current drawdown (c.21%) is already consistent with the average nonrecessionary bear market (-18% over eight months). However, the average recessionary bear market has seen the market fall by c.33% over 17 months, suggesting the current correction may only be c. two-thirds complete in the event of a recession. That said, technology valuations have meaningfully corrected such that next generation software stocks now trade broadly in line with incumbents on a forward EV/sales basis. The last time this happened was 2015/2016 when the market was also significantly concerned about a hard landing, suggesting that technology stocks have begun to meaningfully price in recession risk. As such, we have begun to rebuild our exposure to higher-growth stocks while maintaining a modest amount of Nasdaq put protection and cash to help ameliorate the impact of further market weakness while ensuring the portfolio remains highly liquid.

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Royalties

(compare royalties funds [here](#))

Merck Mercuriadis, founder of Hipgnosis Songs - 14 July

In 2021/2022, the music industry has gone from strength to strength. We have seen a continued acceleration of the adoption of paid for Streaming. Global Streaming revenue growth rates of 24.3% in 2021 exceeded all expectations (IFPI). This led Goldman Sachs to further increase their forecast Streaming revenue growth rates to 12% per annum for the rest of the decade in their updated 2022 gold standard Music In The Air report. There are now 523 million users of paid music subscription

services globally and the market is well on its way towards 2 billion in the coming decade.

Technological innovation has also continued to create new ways of consuming and monetising music. Emerging technologies such as TikTok, Roblox, Social Media and Peloton not only have provided additional revenue streams to copyright owners such as Hipgnosis, but have also created a platform where we can introduce great hit songs from the past to new generations of listeners.

Music Performance income recovered strongly from the impact of various global COVID-19 lockdowns in 2021. Live music venues are full, and booked into 2024, whilst bars, pubs and restaurants have reopened and are playing music again. As a result, industry experts are expecting a near complete recovery in Performance income in 2022.

During COVID-19, Hipgnosis' resilience against the challenging market proved the reliability of our income. In the second half of our fiscal year 2021/2022, as most global restrictions have eased and market growth has returned, we have now also shown that our acquisition strategy and disruptive Song Management approach leaves us well positioned to outperform. Our strategy to acquire only the most successful and culturally important Songs, including 67 of the 271 Songs that have been played over 1 billion times on Spotify, has delivered like-for-like Streaming growth of 19% in the second half of our fiscal year alone.

Despite the current challenging macro-economic environment, with expectations of high inflation and a squeeze on consumer spending, having built an incomparable portfolio of iconic songs that yield uncorrelated income we go into 2022/2023 extremely confident of our growth prospects. Great songs are not just entertainment; they are the soundtrack of our lives and people turn to them for comfort and escape equally in times of hardship as they celebrate with them in times of prosperity. As a result, music revenues have been historically uncorrelated to economic conditions, and we strongly believe that Streaming growth will continue uninterrupted over the coming years. Streaming remains the cheapest form of entertainment, provides one of the highest quality offerings of all entertainment subscription services, and has low penetration rates with significant room for growth in both the developed markets as well as emerging markets. This view is shared by the leading voices in our industry including Goldman Sachs, who are forecasting 9% annual global music revenue growth through to 2030.

Finally, in a period when both global recorded music and music publishing grew at the fastest rate in history, it's important to emphasise that for the first time ever almost all consumption of Music is now paid consumption.

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Environmental

(compare environmental funds [here](#))

Jon Wallace, manager of Jupiter Green - 18 July

Market review

The period began with the rollout of vaccines across the world, in a race to outpace the spread of the Delta variant and, later, the Omicron variant.

In the US, Joe Biden secured senate approval for a \$1trn infrastructure package, but political compromises mean this was a slimmed down version of the original

proposal, and ongoing concerns amongst his Democrat colleagues mean that he struggled to get the bill successfully through Congress. This marked the beginning of a trend, as the Biden administration's initial plans for a progressive policy agenda on many issues - not least climate change - have not fared well upon contact with the political reality in Washington. As a result, ambitions have been scaled back quite significantly over the course of the last year.

The theme of frustrated ambitions continued with the COP26 Climate Conference in Glasgow, which delivered a series of small steps, but lacked the overall ambition and urgency needed to place the globe on a trajectory capable of limiting climate change to 1.5 degrees. Among the areas of progress were China-US commitments on climate change cooperation and agreements on "phasing down" of coal, curbing methane emission and halting deforestation.

In the early months of 2022, the market became preoccupied with continued rises in inflation, and increasingly hawkish language from major Central Banks, most significantly the US Federal Reserve, which raised interest rates in March and guided the market to expect several more incremental rises over the rest of the year.

The pressures on inflation were intensified by Russia's invasion of Ukraine which, in addition to exacting a horrific humanitarian toll, disrupted global supplies of energy as well as agricultural and industrial commodities. The profits of fossil fuel companies surged alongside oil and gas prices, although the conflict highlighted the paramount importance of affordable, secure energy and greater efficiency of its use.

Outlook

Recent months, as noted above, have seen an increase in market volatility and a rotation away from the sort of long-duration structural growth trends of which Environmental Solutions companies are typically a part. What is more, in the near term it has become more challenging for environmental solutions businesses to have visibility on nearer-term factors such as supply chain disruption and cost inflation and their overall earnings impact.

Crucially, though, the long-term growth picture for these companies is arguably stronger than ever, as the gathering momentum around efforts to mitigate climate change, as well as renewed focus on issues surrounding biodiversity and natural capital, provide traction for companies that can address multiple environmental challenges. Our conviction remains that companies focussed on providing solutions across these challenges can provide superior returns over the medium and longterm.

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Leasing

(compare leasing funds [here](#))

Charles Wilkinson, chair of Doric Nimrod Air Three and Geoffrey Hall, chair of Doric Nimrod Air Two - 29 July

Despite the war in Ukraine and COVID-19 related travel restrictions in China, global air travel has resumed its strong recovery trend through April 2022, according to IATA. The recovery has been driven by a continuing rebound in international travel, as previously travel-restricted Asian countries have new flexible conditions that allow more foreign travellers to come in. However, inflation, high jet fuel prices and low consumer confidence are points of concern for the coming months, according

to IATA. International bookings still show a high willingness to travel abroad, and this trend is expected to last throughout this summer. Although the relation between rising inflation and increase in cost of travel is not straightforward, it is expected to have an impact on passenger decisions sooner or later.

In late February 2022 Emirates' President, Sir Tim Clark, provided useful insight into the airline's fleet operating considerations. Following the retirement of Emirates' first five A380s, Clark noted: "Cutting up the A380 fleet stops there, after these five are retired, all the other aircraft remain. In fact, where we started to drop some, I just decided to bring them back into the program." With a looming aircraft shortage in Emirates' fleet in 2024/25, Clark wants to extend aircraft lives: "Life extension will affect about 120 aircraft, 80 of them A380s... The exact numbers haven't been fixed, it's a movable feast. Their life will be extended by six to ten years each." Clark reiterated this stance in late June, commenting Emirates would be: "retaining all the A380s now, probably until the mid-30s, 118 of those." In its annual report Emirates noted that the high seat factor on the A380 continues to demonstrate the customer preference for the aircraft with the airline embarking on a major two-year retrofit programme from November 2022, to equip 120 existing 777 and A380 aircraft with their latest Premium Economy cabin class, as well as refreshed interiors, at a cost of over USD 1 billion. Clark also seems sceptical about the delivery timelines of the new aircraft types the airline has ordered with Airbus and Boeing, stressing that the planes need to be "in the shape that the contract requires."

Emirates results for the year to 31 March 2022 reported a 91% year-on-year increase in revenue and a much-improved loss of USD 1.1 billion (FY2021: USD 5.5 billion loss) with the target to return to profitability in the current financial year. Emirates ended the financial year with a cash balance of USD 5.7 billion after receiving a further capital injection of USD 954 million from their ultimate shareholder, the Government of Dubai. Whilst Emirates do not have a formal credit rating, they have previously issued unsecured USD bonds with maturities in 2023, 2025 and 2028. As at 22 July 2022 these instruments are trading at approximately 99.9, 99.4 and 98.5 cents respectively, equivalent to USD running yields in the range of roughly 3.9 to 4.6%.

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Property

(compare UK property funds [here](#), [here](#), [here](#), and [here](#))

David Sleath, chief executive of SEGRO – 28 July

Occupier demand for warehouse space is strong, broad and deep and continues to be driven by long-term structural tailwinds particularly in those urban markets where our space is used to provide a wide range of often essential goods and services to consumers and businesses. We are mindful that the coming months will be impacted by heightened macroeconomic risk but, against this backdrop, our portfolio offers considerable inflation protection: almost half of our rents are index-linked and the majority of the remaining leases are exposed to UK upwards-only rent reviews, where we have significant reversionary potential and continue to see strong demand led market rental growth.

Our sizeable, mostly pre-let, current development programme and well-located land bank provide us with both significant potential to grow our rent roll, and optionality due to the short construction periods of our assets. We will continue to be led by

customer demand as we make decisions regarding the execution of future projects. The long-standing and strong relationship between our development teams and key construction partners is helping us to de-risk our pipeline by securing materials on a timely basis, whilst the tight occupier supply-demand situation has meant that we have been able to offset increased building costs with higher rents, which is in turn helping to drive further rental growth from our £20 billion portfolio. We will continue to take a disciplined approach to allocating capital to development and investment activity, ensuring that our portfolio should continue to outperform, and expect to invest at least £700 million on development capex in 2022.

Finally, in recent years we have significantly strengthened our balance sheet alongside our property portfolio. We benefit from low leverage and one of the longest debt maturities in the sector with no significant refinancing requirements in SEGRO before 2026. We have demonstrated again this year that we have access to diverse sources of debt finance. 94 per cent of our debt is either fixed rate or capped so we are well protected against interest rate rises and have plenty of capacity to continue to invest capital in the profitable opportunities available to us.

These factors combined mean that we are heading into the second half of the year with confidence in the outlook for our business. Whilst we remain watchful of the world around us and will respond accordingly to any changes in market conditions, we intend to continue to deliver the much-needed modern, sustainable warehouse space in the right locations to enable our customers to make their businesses fit for the future, and at the same time ensure that we continue to create value for all of our stakeholders.

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Rita-Rose Gagné, chief executive of Hammerson - 28 July

Physical retail is a critical part of the omnichannel fulfilment and brand experience for our occupiers and to the consumer. Our strategy is focused on best-in-class city centre destinations which play a central role for our occupiers and the communities in which we operate, and which can continue to grow and thrive.

Notwithstanding the macroeconomic events unfolding at the beginning of the year and the ensuing economic and political turbulence, the recovery in footfall, sales, collections, and leasing at our destinations has strengthened year-on-year.

Footfall recovered steadily through the period with Q2 stronger than Q1, with the latter slightly dampened by the impact of the omicron variant on consumer appetite. Having started the year with footfall at around 77% of 2019 levels, June levels were around 90% of 2019 for the Group as a whole. Certain core destinations have continued to exhibit footfall at or above 2019 levels.

We continued to see resilient sales, with customers spending with confidence. As with footfall, Q2 showed an improving trend over Q1. For the half, sales were 2% over 2019 levels in the UK, 3% in Ireland, and around 5% below in France, although we saw sales 2% above 2019 levels in France in Q2 ahead of the key summer sales period. Strong categories included leisure, sports & outdoors, men's fashion, jewellery, food & beverage and services.

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Steven Owen, chairman of Primary Health Properties – 27 July

PHP's mission is to support the NHS, HSE and other healthcare providers, by being a leading investor in modern, primary care premises. Never has this been more

important as the NHS seeks to work through the backlog of procedures created by the COVID-19 pandemic and the Government delivers its Levelling Up agenda. In the longer term, the ageing demographic of western populations means that health services will also be called upon to address more ongoing, complex, chronic co-morbidities. PHP stands ready to play its part in delivering the real estate infrastructure required to meet this need in the community.

We will continue to actively engage with government bodies, the NHS, HSE in Ireland and other key stakeholders to establish, enact (where we can), support and help alleviate increased pressures and burdens currently being placed on healthcare networks.

In July 2021, the UK Government published a draft Health and Social Care Bill setting out a number of reforms in order to implement the commitments of the NHS England Long Term Plan. This included the introduction of regional Integrated Care Boards and Partnerships tasked with co-ordinating NHS partners with local government services and budgets, such as social care and mental health, in a geographic area, for the first time; the idea being that services are then pushed to the most efficient, cost-effective part of the system (whether primary care, hospital or care home) for the best patient outcomes. We welcome these reforms and are hopeful they will lead to better outcomes for patients and to further development opportunities in primary care in the medium to long-term.

Despite the recent and rapid interest rate increases we have not seen any change in investor sentiment in our sector and the UK and Irish investment markets for primary healthcare property, with its strong fundamental characteristics and government-backed income, continues to be robust. However, we do not expect any further significant yield compression in the second half of the year as the market digests the outlook for longer-dated interest rates.

We believe that our activities benefit not only our shareholders but also our wider stakeholders, including our occupiers, patients, the NHS and HSE, suppliers, lenders and the wider communities in both the UK and Ireland.

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Richard Smith, chief executive of Unite Group – 27 July

We are anticipating strong student numbers for the 2022/23 academic year, with UCAS data showing a 7% increase in the number of applicants as at the 30 June deadline compared to pre-pandemic levels in 2019/20. A record 44.1% of UK 18-year-olds have applied to university this year, reflecting growing awareness of the opportunities and life experience it provides. Applications from non-EU students are up 9%, including notable growth from China and India, which has helped to substantially offset the expected decline in EU applications (-18%) as a result of Brexit.

We expect the share of international students to increase to around 35% of total reservations for 2022/23, up from 30% for 2021/22, with particularly strong growth from India (5% of direct-let reservations), but still modestly below the pre-pandemic level of 40%. This reflects a return to face-to-face teaching by universities and fewer travel restrictions than experienced over the past two years.

We are confident of a strong sales performance for the 2022/23 academic year, reflecting the depth of student demand, reduced disruption from grade inflation and fewer travel restrictions for international students. This underpins our guidance for 97% occupancy and rental growth of 3.5-4.0% for 2022/23.

Our business model has inflationary protection through annual repricing of our income and cost hedging but, like others, we are not immune from the impact of rising costs and interest rates. We will seek to offset higher operating costs through our pricing, while ensuring we continue to offer value-for-money accommodation to students.

The outlook for the business remains strong, reflecting growing student demand, our alignment and partnership with the strongest universities and the capabilities of our best-in-class operating platform. We are well positioned to benefit from the strength of HE, which has historically become more attractive during economic downturns.

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**123a Kings Road, London SW3 4PL
0203 691 9430**

www.QuotedData.com

Registered in England & Wales number 07981621,
2nd Floor Heathmans House,
19 Heathmans Road, London SW6 4TJ

Edward Marten (em@martenandco.com)

David McFadyen (dm@martenandco.com)

Nick Potts (np@martenandco.com)

Colin Edge (ce@martenandco.com)

INVESTMENT COMPANY RESEARCH:

Jayna Rana (jr@martenandco.com)

Matthew Read (mr@martenandco.com)

James Carthew (jc@martenandco.com)

Richard Williams (rw@martenandco.com)