Banking on a Downturn

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Simon Gergel
Portfolio Manager

Viewpoint on the Bank of England's latest rate rise.

Companies are selected for the portfolio because we view the prices their shares trade at as being cheap relative to their intrinsic value.

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This is a marketing communication. Please refer to the Key Information Document (KID) before making any final investment decisions.

What Happened?

On August 4th, the Bank of England (BoE) raised interest rates by 50 basis points (0.5%) bringing the official rate to 1.75%. While this was the biggest hike since 1995, such a move was widely expected by economists and market participants, and continues a monetary policy tightening cycle which is slightly less aggressive than that being pursued by the US Federal Reserve.
Perhaps more significantly though, the BoE announced forward-looking expectations for inflation and the broader economy that were resoundingly gloomier than expected. Under the Bank's revised estimates, CPI (consumer price index) inflation is expected to rise further and peak at just over 13% in the fourth quarter of 2022. What's more the bank expects this to remain high, at 9.5% in the third quarter of 2023, before falling swiftly to a normalised 2% level the following year.
A substantial part of this sustained inflationary pressure is projected to be from energy costs. Annual household fuel bills are expected to rise by around 75% in October when the price cap is reset (previously at the BoE's May meeting, the increase was only expected to be 40%).
At the same time, the Bank now predicts the UK will enter a recession from Q4 2022 with GDP (gross domestic product) declining every subsequent quarter to 2023 Q4, only subsequently stabilising in 2024.

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What Are We Doing?

In terms of our investment approach, we consider ourselves to be 'macro aware' rather than 'macro driven', analysing the potential impact of macro-economic and geo-political factors on our portfolio companies, but not selecting or removing holdings purely on that basis. Companies are selected for the portfolio because we view the prices their shares trade at as

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being cheap relative to their intrinsic value, either on a normalised free cash flow basis or – where appropriate – their net asset value. However, the prospect of a prolonged stagflationary environment (persistent high inflation combined with high unemployment and stagnant demand in a country's economy) is likely to have a greater than usual impact on equity markets. In this context, our considerations turn to the following:

1) In a lower growth environment, where rising corporate earnings are likely to play a diminished role in driving equity returns, mispriced assets remain a valuable source of alpha generation (excess return over the market)
2) The BoE's own cautious tone about the reliability of its forecast is in stark contrast to valuations already evident in the market. Many companies, particularly with exposure that has traditionally or even incorrectly been viewed as cyclical, already trade at distressed valuations. For companies where a downturn in earnings is far from certain, and accompanied by robust balance sheets as well as a strong long term growth picture, then we see fertile ground for contrarian and opportunistic stock picking
3) In an inflationary environment, a company's cash flows are eroded when the business is unable to pass higher input costs on to its customers. Assessing the resilience of these cash flows, however, is a key part of our fundamental analysis. In this respect, portfolio holdings should be better insulated either through their pricing power, or their controlling position within the value chain. Pricing power may, for example, be secured by virtue of occupying a strong position within a niche or, alternatively, controlling the supply of resources which are increasing in price (such as oil & gas and copper) where these costs can be passed on directly, leading to a proportional rise in margins relative to a relatively fixed cost base.

All data from **https://www.bankofengland.co.uk/monetary-policy-report/2022/august-2022**

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