July 2022

Handelsbanken
Wealth & Asset Management

Strategy Update

Take a closer look at the landscape for financial markets, and what this means for our investment strategies

Key takeaways

Financial markets have been unsettled by commodity price rises and central bank policy changes

Economic growth will be impacted, but this is both predictable and intentional, as policymakers attempt to take some heat out of the economy

Data signals suggest that inflation could be reaching its peak, despite the inflationary shock provided by commodity markets

New areas of potential long-term value could be emerging amid the volatility, particularly in areas like government and corporate debt

We have not made any significant changes to the mix of asset types held within our strategies, but have made adjustments to create efficiencies and make room for new ideas

Financial markets are in the midst of digesting two very different events. The first is a commodity price shock, as the prices of raw materials (from food to oil) have spiked higher. The second is an update to central bank policies – effectively a regime change – as interest rates are raised and the ultra-accommodative policies of the past few years are removed. Financial markets are working out what these changes will mean for economic growth and for business earnings in the future. In turn, this has created the indigestion issues experienced across asset prices, and within our own investment strategies.

History strongly indicates that, while it can take time for markets to process change at this level, these periods of turbulence are typically temporary. Importantly, this change was required, and an ultimate slowdown in global economic growth is the intended outcome of central bank actions – not a cause for panic. It's also worth noting that change often brings with it opportunity, and the current weakness in financial markets is revealing the potential for long-term value in certain areas.

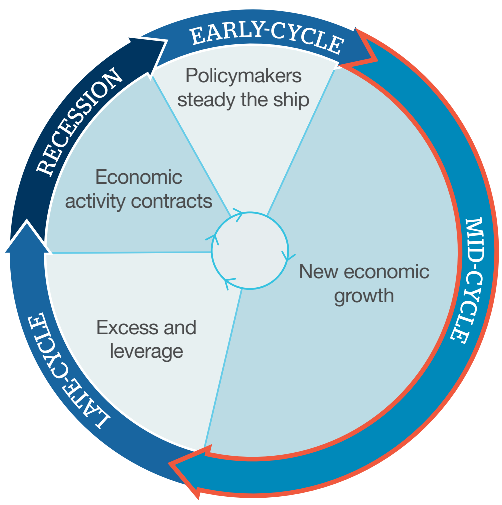
Understanding where we are, and where we're going

We continue to think a lot about how best to identify our current position in the economic cycle (sometimes referred to as the 'business cycle'). There are four phases in the economic cycle, and we believe we are presently in the 'mid-cycle' phase. The next phase – 'late-cycle' – is characterised by excess, and the use of borrowed money as finance. This leads into a recessionary period (before the cycle begins anew), so it's important that we remain watchful for change.

Working out which phase we are in today – and how soon the next phase will arrive – is not an exact science, but it does matter hugely to our decision making process. This is because it helps to determine the level of risk (and the types of risk) we take on within our investment strategies in search of financial reward.

Is the economy still in the 'mid-cycle' phase?

The global economic cycle, sometimes termed the 'global business cycle'



Source: Handelsbanken Wealth & Asset Management

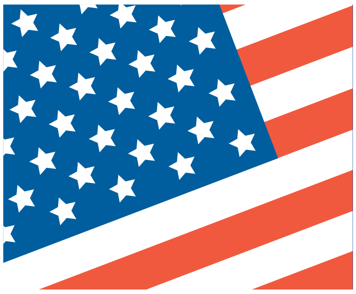
Reading the tea leaves through global economic data

As we seek to understand our position in a changeable economic landscape, we can look to data signals to guide us.

We are global investors, so we assess all economic indicators at a global level. However, as the world's most powerful economy, the US makes a helpful case study. The US economy is driven heavily by consumers, and US consumer confidence is currently falling dramatically due to very high inflation expectations. The large savings buffers built up by US households during the extremes of the COVID-19 pandemic have been all but eroded, while the cost of borrowing is rising as interest rates increase (though it's worth remembering that this cost is rising from an extremely low level following many years of ultra-low rates).

Does this mean we're in the 'late-cycle' phase? We don't think so – not yet. For one thing, we think inflation is likely peaking in the US, with prices beginning to step back in a range of areas from commodities (e.g. copper, natural gas and oil) to microchips and shipping costs. If inflation begins to ease off, this takes significant pressure off the all-important US consumer. (Bear in mind too that financial markets are also factoring in a lower inflation environment ahead for the UK and Germany.)

Another important area to watch is the US employment market. At the moment, US employment is very high, which is out of keeping with a late-cycle phase. Indeed, for the US central bank, it is too high. The Fed has a 'dual mandate', meaning that its role is to manage both inflation and unemployment levels, and it doesn't want unemployment to spike too high. However, it does want to take some of the heat out of the employment market to ease pricing pressures by slowing down economic activity. Achieving this probably requires further restrictive policies (more interest rate hikes) from the Fed, but once policymakers see concerted signs that inflation is falling back, the Fed's policies are likely to become less aggressive.



US unemployment
3.6%

US inflation 9.1%
(Consumer Price Index)

Source: Bureau of Labor Statistics

Under the bonnet in our investment strategies

While it's important not to overly rely on history as a guide, we would note that periods of turbulence in financial markets have historically set the foundations for attractive future returns for long-term investors. We are already seeing new areas of potential value emerging in government and corporate debt, which have been a relatively uninteresting area of markets for some time.

While we have not made any significant recent changes to the mix of major asset types in which our strategies invest (i.e. bonds, shares and non-traditional/'alternative' assets), we have been making adjustments to our existing positions, either to make space for new holdings or to bring fresh efficiencies to our investments.

Improving the tax efficiency of our UK government bond holdings

We recently switched into longer-dated UK government debt in an effort to improve our investment strategies' tax efficiency.

In practice, this has meant switching over to bonds paying lower coupons (often referred to as the 'interest' on a bond), but trading at less than their face value. These bonds have a higher anticipated overall return (if held until their maturity date).

'Gains' on the capital invested in these bonds are typically tax-free for investors, as tax is only paid on the regular coupon payments.

Looking for opportunities in unloved stock market areas

With investors preoccupied by their fears over economic slowdown, they could be undervaluing key areas of the stock market.

For example, the shares of smaller US businesses have fallen out of favour, with the recent underperformance of small and mid-sized US company shares consistent with significantly lower economic activity than is currently being reported.

In essence, these shares appear to be priced for severe (and imminent) recession, which we think is unlikely. As a result, we believe they represent the prospect of attractive future returns.

Investing in the world's natural capital

A number of our Sustainable investment strategies have begun a new position in a biodiversity fund, which identifies companies adopting innovative approaches to protecting and restoring the planet's natural wealth.

Our position in this fund offers something new and different to our sustainable strategies, and represents an under-researched and under-exposed area of high impact and importance, with the potential for compelling long-term financial gains.

Important information

Registered Head Office: No.1 Kingsway, London, WC2B 6AN. Registered in England No: 4132340. www.wealthandasset.handelsbanken.co.uk
Telephone: 020 7045 2600