4 SHIRES
ASSET MANAGEMENT

Investment Commentary

Winter 2023

Expert Asset Management
Investments | Pensions | Financial Planning

Commentary contents

Compliance & Regulations

Themes

Financial Planning

Markets & Investing

Important - Compliance Section

In this section of the commentary, we would like to remind our clients and prospective clients of the following regulatory topics:

Consumer Duty – Client Consultation

The Financial Conduct Authority (FCA) has launched a major new regulatory initiative called 'Consumer Duty'. This aims to ensure that customers of financial services companies:

- Have products and services that meet their requirements and they perform as expected
- Understand the products and services they purchase, that they are appropriate and that customer vulnerability is considered
- Have products and services that offer fair value
- Receive good customer service and support

To this end we will be getting in touch with clients with a short questionnaire to better understand their perception of 4 Shires and how we deliver on the services that we provide to clients.

We appreciate that such surveys often arrive for people to fill in, but it will help us to improve our service to you and to respond constructively to feedback that we receive.

Risk Disclaimer

The value of investments and the income you get from them may fall as well as rise, and there is no certainty that you will get back the amount of your original investment. You should also be aware that past performance may not be a reliable guide to future performance. This document is not intended as investment advice.

Any security mentioned in this commentary is for information purposes only and is not a recommendation to buy. 4 Shires, its clients and its staff may own some of the investments that we mention in this report.

4 Shires Asset Management

Tel: 01747 824600

Email: info@4-shires.com

4 Shires Asset Management Limited is authorised and regulated by the Financial Conduct Authority (FR3N number 557959). Company number 7657527

www.4-shires.com

Introduction

Welcome to the 4 Shires investment commentary for the Winter of 2023.

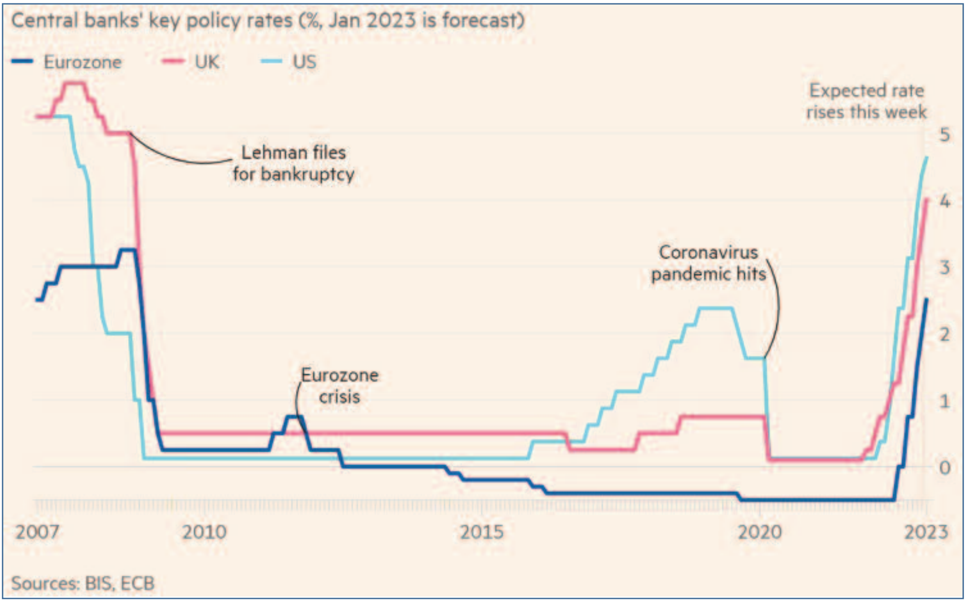
This winter has seen volatile markets and rising interest rates. Our articles in this edition look at whether it is right to buy into stocks to benefit from cyclical recovery. We also review the outlook for defense spending in the light of the Ukraine war. Improving China/US relations are very important to form a basis for a good economy and we examine whether they are on the right path.

We have also added a new section on Financial Planning, looking at interesting current issues in the market. We review the advantages and disadvantages of having drawdown versus buying annuities and the changes to pensions from the budget in the new tax year.

In the markets section we review recent UK company results as well as looking at two recent purchases, Workspace and Coats. We also look at the recent market turbulence and US bank crisis, effect of the mild winter and the recent all-time high on the FTSE 100 index.

Is it time to buy into cyclical recovery?

The January and February rally in stock markets has come to an end with the failures of SVB bank, the 16th largest bank in the US and of Credit Suisse, the second largest private bank in Switzerland. This has led market expectations of the cost of money, i.e. interest rates, to start to come down. However, inflation still remains in developed economies from tight labour markets, making it harder for central banks to bring down interest rates in the short term. In this article we look at whether it is the right time for investors to take a more optimistic view of the world economy given the lower cost of capital for businesses.

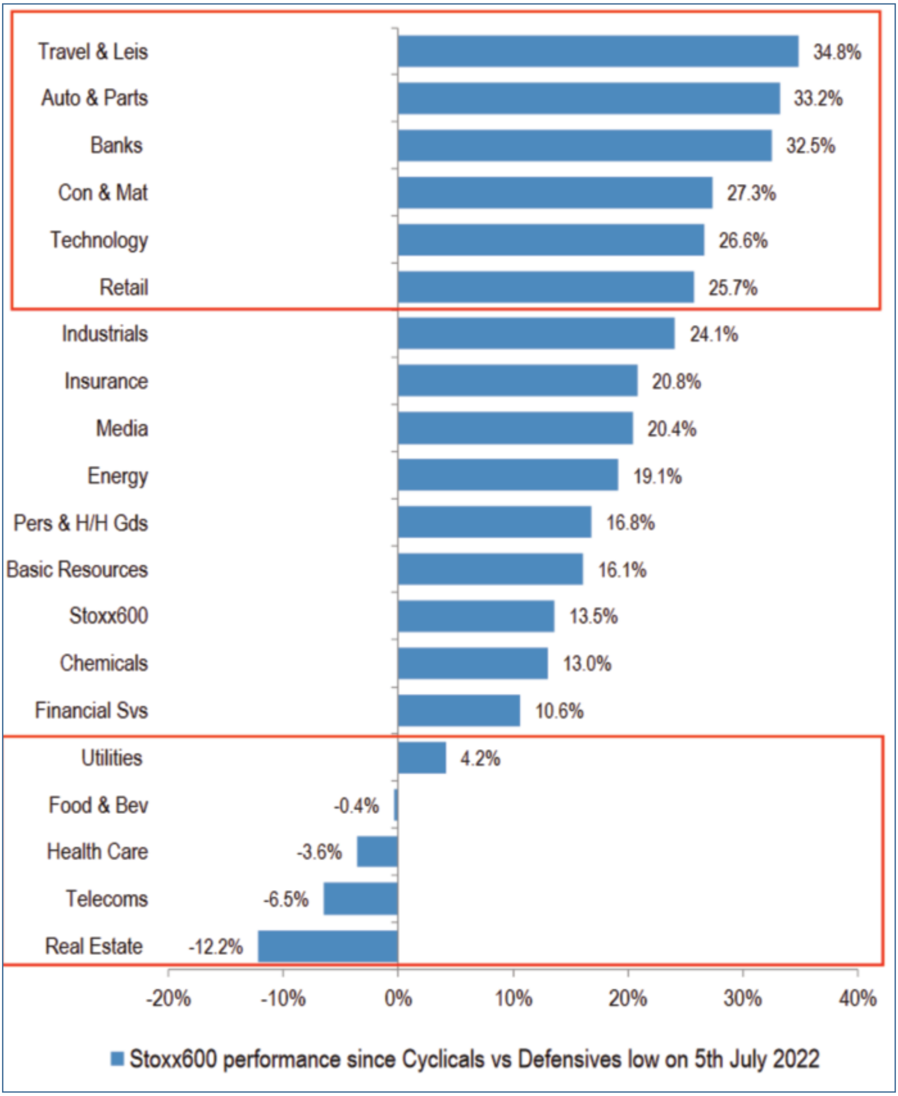


(Graph source: *Financial Times*)

The recent tightening of interest rates only began to accelerate in the middle of 2022, with real interest rates remaining negative (i.e. after inflation, interest rates were negative) for the whole of 2022. These negative interest rates meant central banks were only modestly slowing economies. Wage inflation and new hires, particularly for more lower income jobs, surged in 2022. In January 2023, over 500,000 new jobs were created in the US economy, causing the Fed chairman, Jay Powell, in his recent testimony to the US Congress, to indicate rates may need to be higher for longer to bring the economy back to balance.

Developed economies are currently unwilling to increase the supply of labour via increased migration, so labour markets are likely to remain tight in 2023. This situation is likely to continue throughout 2023 as companies will be unkeen to lose staff.

Economic growth remains in positive territory, and, from the lows of 2022, cyclical sectors in Europe have outperformed defensive sectors:



(Graph Source: JP Morgann/Datastream)

We view this rally in cyclial stocks to be premature given that we have yet to experience the recession. The recent bank failures have highlighted where we are in the economic cycle, as such companies tend to collapse at the beginning of the recession.

Why do we believe that the recession will come and a 'soft economic landing' be avoided? The main reasons are as follows:

- Continuing high valuations in equity markets
- Residential property prices have just started to fall and remain expensive
- Consumer incomes are under pressure from inflation and debt costs
- Unemployment is very low and job losses have yet to occur

Against this rising wall of bad news in the world economy, inflation has yet to come down sufficiently to allow interest rates to fall. If interest rates were to fall, it is plausible to expect inflation to surge again, as it did in the 1970s. In that decade the oil shock and subsequent inflation were not taken seriously enough, which led to stagnation with inflation, or stagflation. Monetarism, led by Milton Friedman, became the philosophy which doubted the approach of governments and central banks' ability to curtail inflation. Eventually, monetarism prevailed and interest rates surged at the beginning of the 1980s, leading to a deep recession. Thereafter, the fiscal stimulus of the Reagan presidency set the economy back on a growth path.

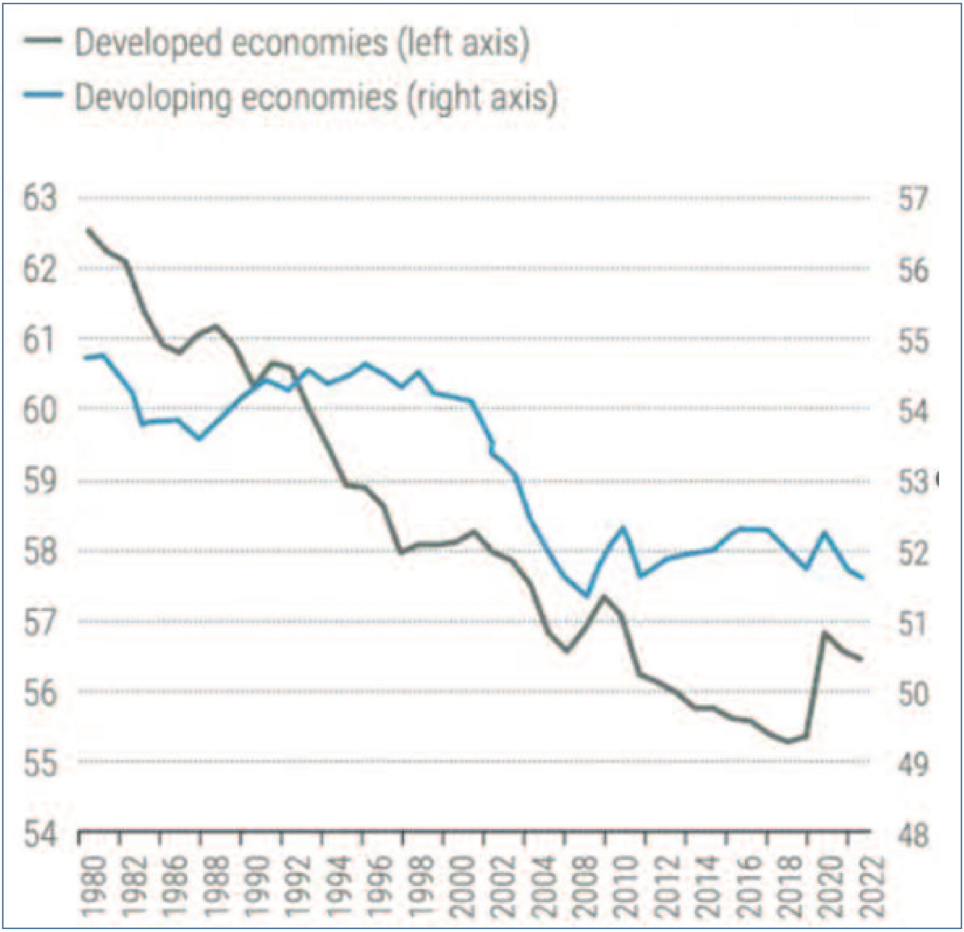
So, for the moment, we believe that the economy will need to have a recession before it is worth re-entering more cyclical stocks. We currently prefer to hold higher yielding shares in companies that have good market shares, high margins and, to an extent, predictable earnings.

Labour Markets

Labour markets are tight at the moment, i.e. there has been a shortage of labour and companies have, until recently, had a lot of unfilled positions. Anti-immigrant policies have exacerbated this situation. In this article we look at the tensions that are evident in the labour market and whether a more assertive labour movement could make gains in real wealth after a decade of falling real incomes.

In the post lockdown era, we find ourselves in an inflationary environment where central banks across the world are engaging in tighter monetary policy. There are substantial price increases not only in the basket of goods we typically buy but also in salaries. It is worth taking a closer look at this relationship by considering 'Labour Share'. It is calculated as the ratio of the sum of compensation of employees and mixed income to GDP. Against the long-term decline, in 2020, there was a pronounced increase in the aggregate labour share as you can see from the graph below:

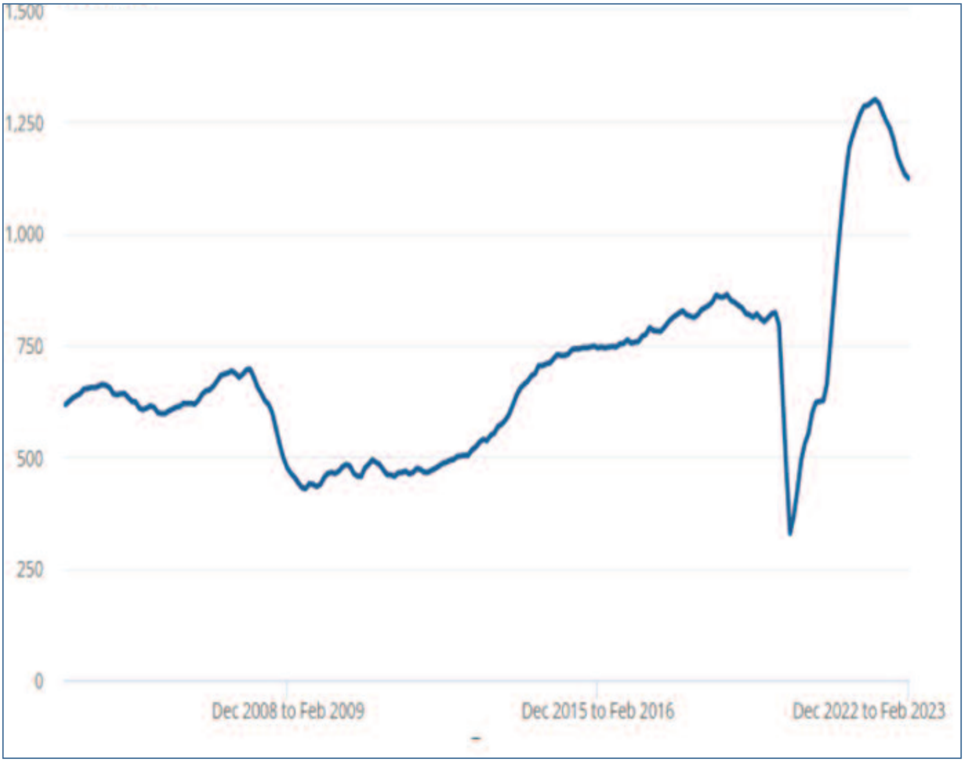
Labour Share as a % of GDP (1980 – 2022)



(Source : United Nations Global Policy Model database)

What happened was that firms continued to pay their workers during lockdown, aided by the government, even as productivity dropped. Since reaching a peak in 2020 the developed world labour share has fallen by 2.3 percentage points. One might observe from the graph that in recent data, the battle seems to have shifted in favour of capital. Yet in Britain, wage growth is at a substantial 5% per year, a significant figure for a developed economy. Indeed, corporations seem not to be able to offset higher costs in the form of higher prices, exhibiting their lack of pricing power. Looking closer at the national accounts, it can be estimated that the average profit per unit of goods and services sold is at pre-pandemic levels. This means that that labour seems to have regained the upper hand against capital because the labour costs have risen by at least 3%. This phenomenon is also reflected in the number of job vacancies in the UK, depicted in the graph below:.

UK job vacancies 2000 to 2023 (thousands of jobs)



(Source : Office of National Statistics)

However, the chart shows that when recessions strike, such as in the global financial crisis between 2007 and 2009 as well as the Covid shock in early 2020, job vacancies fall quickly. With rising interest rates, we expect job vacancies to fall.

Despite expectations of falling vacancies from here, recent wage rises have gained momentum in the US and UK, but salaries still have not kept up with the rate of inflation. For the first time since International Labour Organisation (ILO) records began, global wages have seen real term declines. Labour's share of global income has also declined, by the ILO's calculations, as productivity growth outstripped wage growth by the biggest margin since 1999. A decade of minimal wage growth in UK before COVID-19 is set to be followed by the sharpest fall in living standards for households in six decades, while central bankers face the prospects of inflation spiralling out of control. And all this is going underway while the labour market is stubbornly tight.

In the 1970s, when severe inflation swept the economy, the labour market was able to attain big enough wage rises to preserve their living standards. Real wages rose by 2.9 per cent on average per year throughout the decade.

Today, the labour market of a domestic economy operates within a greater network of deeper globalization, while the internet and automation continue to re-define the modern worker. The golden age of workers unions is long gone and it has been well documented how their power has been depleted over the decades. Specifically, trade union membership has been halved on average across OECD countries since 1985. Collective agreements that covered national, industry or firm level have decreased by a third. Those that included inflation-linked pay settlements rose from about 25 per cent in the 1960s to 60 per cent in the late 1970s. By the 1990s the number had dropped to a mere 20 per cent. Within the European Union, only about 3 per cent of private sector employees have their salaries indexed to inflation.

As workers face the challenge of higher inflation there is evidence of a renaissance of union activity in both UK and US. Indeed, in the US, the self-proclaimed 'most pro-union president' was elected. The labour movement has made progress in areas and in sectors where they usually did not find success. Memberships have seen radical increases in firms like Starbucks. But even as grassroots efforts to unionise an Amazon warehouse occurred last year in New York, the pathway ahead is not very clear. The labour movement leaders have found it hard to replicate their success beyond what they have achieved locally. Furthermore, the US president did not confirm his pro-union reputation with his actions, as he called on Congress to intervene and block a railroad strike last November. In the UK, there were some pay compromises and agreements for truck drivers, nurses and train operators, but widespread strikes are still an on-going concern. These settlements look likely to keep inflation elevated in the UK. In the US, there has been considerable upward pressure on lower-skilled job wages, and US wage growth is currently running at over 7%, implying inflation will be harder to tame and require higher interest rates for longer.

US 1 year Wage Growth

(Source: Trading Economics/US Bureau of Economic Analysis)

Could the trend be turning, whereby labour captures more of the shares of output (GDP)? Is it enough to change the balance of power in the future or is this a fleeting moment of labour having the upper hand? At the moment it is not clear whether the recent gains for labour are transient or the beginning of a more significant trend.

Defense - Huge investment needed to supply Ukraine & NATO

The ongoing war in Ukraine has been a great boon to defense manufacturers worldwide as countries re-arm, particularly in Europe, but also a continuation of the growth in defense spending in Asia, where an expansive China has caused friction and concern. This demand is putting pressure on supply chains everywhere.

Despite the generosity of the US and its allies in NATO, it is clear that NATO has been carrying very low levels of ammunition inventories. For example, the highly effective and accurate, ground-to-ground HIMARS missile system given to Ukraine by the US, doesn't have enough stock of vehicles and equipment to fulfil the gift of further systems. Although promised, these new HIMARS will not arrive for another 2 years. The same goes for the Javelin anti-tank missile, where a complicated supply chain involving parts from over forty factories means it is very difficult to ramp up production.

The much needed land systems, such as the German Leopard II tank, are also taking a long time to reach Ukraine. Spain has resisted, having earlier promised, the transfer of large numbers of Leopard II tanks. NATO is also restocking its own stores first before sending further munitions and equipment to Ukraine. An example of this is the rebuilding of inventories of the NLAW anti-tank weapon for the British Army after so many were shipped to Ukraine in the early days of the war.

Money for armament factory expansions have to come from governments as demand can evaporate overnight when wars end, so there are very few companies who would take such a risk with £10millions or evern £100millions of investment. No such factory expansions have taken place to date. However, the European Union is working to put in place a plan to supply Ukraine with ammunition with large new contracts for European defense companies.

Unfortunately, the real bottleneck is that lack of nitro-glycerine, gunpowder, TNT and other explosive chemicals that are needed to make munitions. The EU programme to make more munitions for Ukraine will have to create the factories and buy the feed stock to ensure the raw materials needed to create such explosives are present to prevent idle workers and machines. The sums required for an effective ammunition policy are not known, but are probably in the tens of billions of Euros. So far the pledges of money to the problem imply Ukraine will suffer ammunition shortages for a long time to come.

China-US relations

The United States and China thought they had a narrow window to improve relations. It may now have closed. At the beginning of the year, China and the US were tiptoeing toward something akin to a diplomatic cease-fire. President Biden's envoy was due in Beijing to craft a possible framework for high-level government-to-government dialogues and the stabilisation of ties after years of bitterness.

Then, a suspected Chinese surveillance balloon was detected crossing North America, casting a new shadow over relations. The fence-mending trip was postponed and relations between the two powers have plunged further into a spiral of recrimination and tension.

Chinese President Xi Jinping, who just one month earlier had been preparing to welcome Secretary of State Antony Blinken on a visit to Beijing cancelled over the balloon, warned this week that the United States is pursuing the "containment, encirclement and suppression of China." For years, Mr. Xi has sounded ever-darker in his assessments of international relations, though until this week he usually avoided criticizing the U.S. by name.

This situation has been exacerbated as Beijing has drawn closer to Moscow, including during its war on Ukraine, and stepped-up military provocations against Taiwan, while last summer cutting off more of the few channels for U.S. dialogue that had existed, including military-to-military exchanges. The US has responded by initiating the return of a US military base in the Philippines just after the election of President Bongbong Marcos. This base is building a ring of steel close to Taiwan in case of a Chinese invasion. The ring includes American bases on Okinawa in Japan, in South Korea and now the Philippines.

The United States has also warned of new sanctions as it publicly presses China on intelligence purported to show that Beijing is considering military aid to Russia to help its war in Ukraine. Avril Haines, the US director of national intelligence, told Senate that Xi's speech was "the most public and direct criticism that we've seen from him to date." Haines said that Chinese policymakers increasingly believe they can only advance Xi's vision of a powerful China "at the expense of US power and influence." The summit between Russia and China showed the Chinese remain circumspect about publickly backing the invasion and providing military assistance to the Russian war effort.

The breadth of discord in U.S.-China ties, however, shows the difficulties in reducing tensions. The Biden administration has continued Trump-era trade tariffs, sharpened controls on exports of advanced semiconductors, rallied allies and sought to persuade other countries to counter China's growing diplomatic and economic influence around the world.

Japanese new central bank president

Japan has appointed in April a new central bank governor to replace the long term incumbent, Haruhiko Kuroda. He will be replaced by a university economist, 71 year old Kazuo Ukda. While this news is seemingly a reshuffle of septagenarian public officials, there may also need to be a change in the ultra-low interest rate policy that has been in place for nearly two decades. The leadership transition marks a historical end to Kuroda's decade-long monetary experiment that sought to shock the public out of a deflationary mindset. The new governor may eventually chart a course away from the "yield-curve control" policy but investors probably should not expect a radical change in Japan's monetary policy overnight.

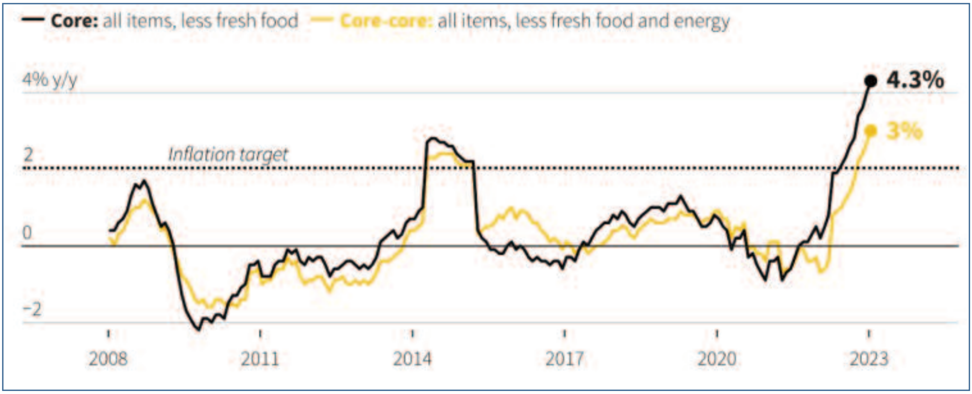
The chart below shows that rates over the past 25 years have not risen above 1%, have been 0% for most of the time and even went negative from 2016 onwards. The reason for this ultra-low policy was Japan seemed to be in the grips of powerful deflationary forces.

Japanese interest rates (1998 to 2023)

(Source: Trading Ecnonomics/Bank of Japan)

However, the inflation picture, as with the rest of the rest of the world, has changed. The chart below shows Japanese inflation over the past 15 years, showing a clear trend of inflation moving from deflation to inflation:

Japanese inflation (2008 to 2023)



(Source: Trading Ecnonomics/Bank of Japan)

Mr. Ueda is difficult to pigeonhole as simply a hawk or a dove. With inflation exceeding the BOJ's 2% target, Ueda faces the delicate task of normalising its prolonged ultra-easy policy that has drawn increasing public criticism for distorting market function and crushing bank margins.

A quick reversal of Japan's ultraloose monetary policy stance—including its negative interest-rate regime—seems unlikely. In an opinion piece in the Nikkei newspaper last year, Mr. Ueda argued against raising rates too early as it could hurt the economy and would undermine the long-term goal of bringing Japan out of deflation.

In his article, Mr. Ueda said inflation is temporary and driven by external factors such as high energy prices. Inflation data in the coming months will show whether he is right. Japan's inflation, excluding fresh food, hit 4% in December, much higher than the BOJ's 2% target.

But the BOJ's yield-curve control policy, which keeps 10-year government-bond yields in a narrow range around zero, might be a different story. In the same piece, Mr. Ueda said the policy is not suitable for fine-tuning and is prone to attack by speculators, which is exactly what is happening.

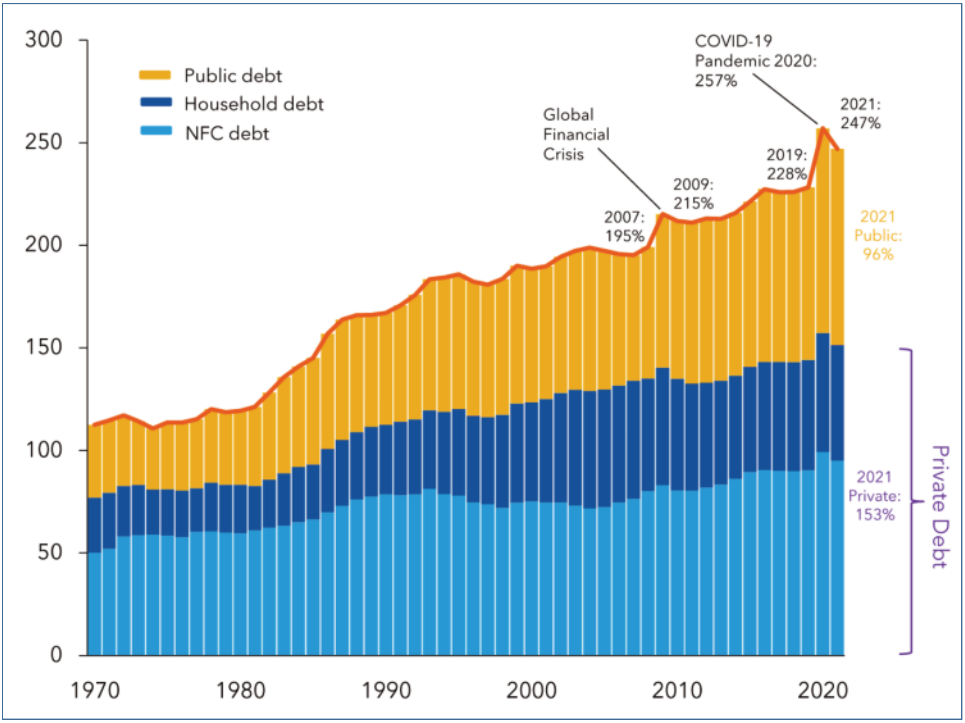
The central bank raised the effective cap on 10-year bond yields to 0.5% from 0.25% in December to try to fix the artificial kink in the yield curve. That decision itself signals the possibility of further tweaks, which has invited speculators to push bond yields across all tenors higher. That in turn forced the BOJ to make record bond purchases in January—of several different tenors, not just the 10-year—further distorting the functioning of the market. Abolishing the policy might not be in the cards in the near term, but eventually a more meaningful adjustment is likely.

As a rare outsider poised to take the reins of the BOJ, Mr. Ueda may eventually find it easier to shift course. But investors shouldn't expect change to come too quickly.

National indebtedness and rising tax

Global debt has been rising and the following two charts show this clearly. The first one is from the IMF and shows the three main types of debt and how it has risen:

Global public and private debt 1970 to 2021

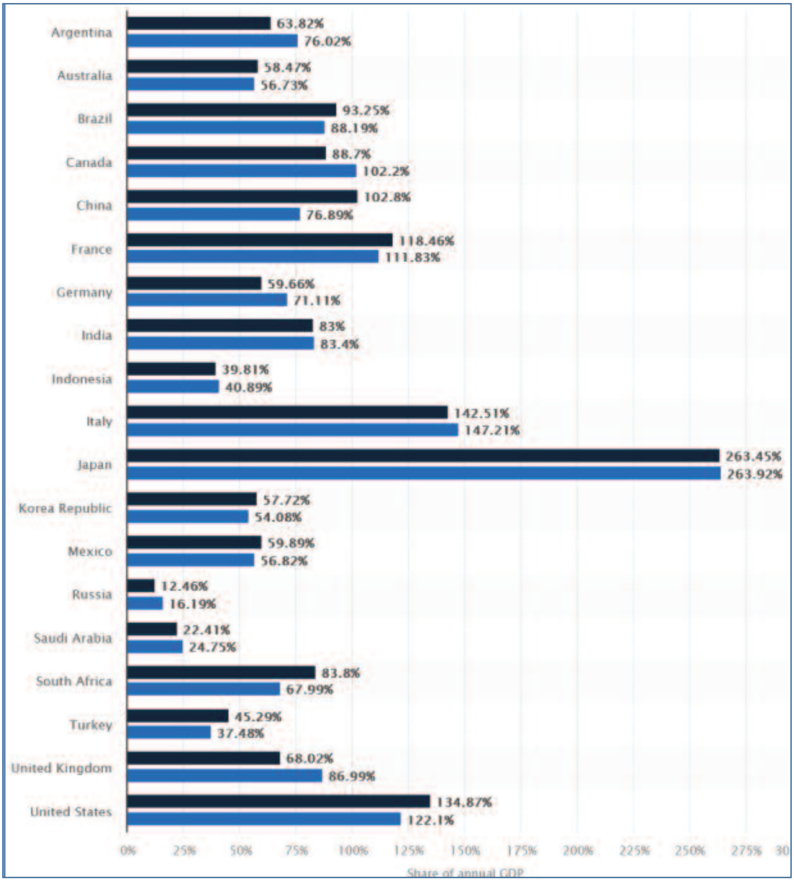


(Chart source: IMF)

You can see clearly that the response to the 1980s deep recession was a big increase in government expenditure, notably in the US under President Reagan. Household debt surged in the 1980s and 1990s, but from 2000 onwards has remained at a similar percentage of GDP. The largest growth in debt has come in national debt, incurred by governments that have abandoned fiscal restraint to stimulate economies and, partially, to bail out the financial system that has seen considearble strain since the financial crisis.

The chart below shows the expected change in debt to GDP in economies between 2022 and 2027.

Government Debt to GDP in 2022 and with 2027 estimates (in black)



(Source: Statista)

With such high levels of debt, and the projected drop in debt levels in some major economies such as Canada, UK and Germany, the room for Keynesian economic stimulation looks limited. The US, France and China all seem to be set for higher debt levels. Japan and India are prpojected to have no rise in debt levels over the coming 4 years, which seems unlikely given the rise in debt service costs

One of the reasons that debt levels in certain economies could come down is due to inflation partially evaporating away some of the liabilities of governments. Whatever does happen over the coming few years, the ability to stimulate economies will be constrained which could lead to more difficult times ahead if higher interest rates persist to restrain inflation.

4 Shires

Annual Investment Seminar & Garden Party

22nd June 2023

Army and Navy Club, 36 Pall Mall

Please join us for our annual
investment seminar followed by
a relaxing evening in St James's Square.

Contact James Morgan on 01747 824600 or email him
james.morgan@4-shires.com
to let us know if you would like to attend

Financial Planning

In this section we are looking at two topics of interest from the pension world. The first looks at whether annuities have become interesting relative to income drawdown. The second looks at changes to pension saving limits announced in the chancellor's March budget.

Drawdown vs Annuities

The recent rise in annuity rates as a result of higher interest rates made us revisit whether it makes sense to take income drawdown or annuities with your pension pot in retirement.

First of all, what is an annuity and what is income drawdown?

When you purchase an annuity you essentially buy a guaranteed income. Your provider will look at your health and lifestyle, make assumptions about your life expectancy, and offer you a fixed, regular income in exchange for your pension pot. With a lifetime annuity this income continues for your whole life. If you opt for a fixed term annuity you will get more money on a monthly basis, but only for a set number of years. You can also include different 'add-ons' such as indexing and spousal pensions. Annuities can be based on a single life or joint life basis.

There are various types of annuities, including enhanced annuities. An enhanced annuity is a lifetime annuity that takes into consideration important information about your health and lifestyle. Depending on your health conditions, you could qualify for up to 75% more annuity income than through a standard conventional annuity. The more ill you are, the higher the annuity income.

Income drawdown is when you take an income from your invested SIPP (or SSAS). You can specify the income that you take, and it normally makes sense to keep the income taken close to that which is generated to avoid exhausting the capital too soon. It is currently possible to take an income of up to 4% after our investment management fees without selling investments to finance the income.

There are advantages and disadvantages of both approaches.

Annuities

Advantages

- You know exactly where you stand, with a fixed regular income every month, regardless of how long you live
- You have the flexibility to add protection against inflation or to purchase a joint annuity, giving security to a remaining partner when one dies
- You can purchase a guarantee period so that your annuity will continue to be paid out for a set period of time if you die within the guarantee period

- You have the security of knowing your pot is never going to run out
- If you live longer than your life expectancy, you could earn more from the annuity than if you had taken an income drawdown option

Disadvantages

- Annuities can be very complex and expensive due to the mortality and other expenses incurred on setting them up
- If you die earlier than normal life expectancy with a standard annuity, the benefits cease and there is no death benefit payable
- The more options added to a basic annuity, the lower the yield tends to be
- You can never change your options or payments
- Most importantly, inflation can erode the value of the income from an annuity and reduce its purchasing power

Income Drawdown

Advantages

- You can take up to 25% tax-free cash, and leave the balance of the pension to grow tax free instead of locking in annuity rates
- You can vary the amount of income you receive at anytime.
- Your nominated beneficiary can inherit your whole pension tax free if you die before 75 up to the lifetime allowance. After 75, it can be inherited subject to tax at your marginal rate on withdrawal
- The income over time from the portfolio should rise as time goes by, giving a measure of inflation protection

Disadvantages

- Stock markets can go up and down, affecting your capital sum
- Income can vary, usually during a recession, when companies the pension is invested in reduce payouts if profits fall
- Taking out more money than the pension produces can accelerate the end of the pension quicker than expected
- Poor investment performance can denude your wealth
- Investment management fees can reduce returns over time

I found an old edition of FT on Saturday's Money section from August 2021, just over a year and a half ago, to see how much has changed in annuity rates since then. The table below shows the change that has occurred:

Annuity Rates 15/3/23 vs 11/8/21 (£100,000 invested to get income p/a)

	22/03/2023	11/08/2021	Difference	% increase
Age 55 - Single Life	5,701	3,911	1,790	45.8%
Age 60 - Single Life	6,147	4,333	1,814	41.9%
Age 65 - Single life	6,734	5,044	1,690	33.5%
Male 60 / Wife 57 - Joint Life	5,718	3,956	1,762	44.5%
Male 65 / Wife 62 - Joint Life	6,181	4,430	1,751	39.5%
Average change			**1,761**	**41.0%**

(Source: Financial Times/JLT)

N.B. Joint life - spouse benefit of 50% of annual sum on 1st death

The increase in annuity rates is considerable over less than two years, driven higher by higher interest rates as well as a small reduction in life expectancy. But it is worth bearing in mind that UK inflation is high at over 10%, so an annuity's purchasing power is worth 10% less over the past year.

So, which of the two routes would we recommend to clients? As always, it depends on the client's circumstances. For smaller clients, an annuity may bring an element of certainty, although its benefit is eroded over time. For wealthier clients, the ability to leave your capital sum to your heirs, generation after generation, is extremely valuable and is a core part of inheritance tax planning. The flexibility of taking payments as you need them can be beneficial, subject to not wasting away your savings too fast. You can also take a mixture of annuity and income drawdown.

Please call us to discuss your pension retirement options and we can go through your specific circumstances and requirements and tailor a personal solution for your retirement.

Pension changes in the budget

There are two main changes to the pension announced by Chancellor Jeremy Hunt in March. The first is the abolition of the lifetime allowance and the second are a set of changes to the Money Purchase Annual Allowance (MPAA). We apologise for the jargon of the pension's world.

The main changes are:

- You can make gross annual contributions, the Annual Allowance, up to £60,000 into your pension from April 6th onwards. This depends on having sufficient PAYE earnings in this year.
- From April 6th, 2023, if you earn more than £260,000, your annual allowance

will gradually reduce by £1 for every £2 of 'adjusted income' above £260,000.

For example, if your adjusted income was £280,000 your annual allowance would be reduced to £50,000.

This 'tapering' stops at £360,000, so everyone will retain an allowance of at least £10,000. Last tax year this was £4,000.

- You can invest as much as you like over the AA but will not be able to claim tax relief. However, this will be subject to a tax charge depending on the individual's taxable income and the amount of their pension savings that are in excess of the annual allowance. However, this still can be an advantage for Inheritance Tax (IHT) planning.

- The Lifetime Allowance (LTA), which limits the amount of tax-free pension savings before a tax charge comes into effect, has been abolished from 6th April 2023. In the last tax year (2022/2023) it was £1,073,100.

- However, tax free cash on an 'unprotected' pension remains 25% of the previous lifetime allowance, or £268,275.

- If you have 'protected' your maximum pension LTA, which could be from £1.25m to £1.8m, your tax-free cash is 25% of the protected amount.

- If you have retired and are in possession of a pension income, you were allowed last year to put £4,000 gross more into your pension. From now on you can put £10,000 gross into your pension each year. This is called the money purchase annual allowance (MPAA).

How these changes affect you will be different depending on your personal circumstance. If you have a pension pot over £1m and are still working, you should definitely get in touch to see how these changes will affect you.

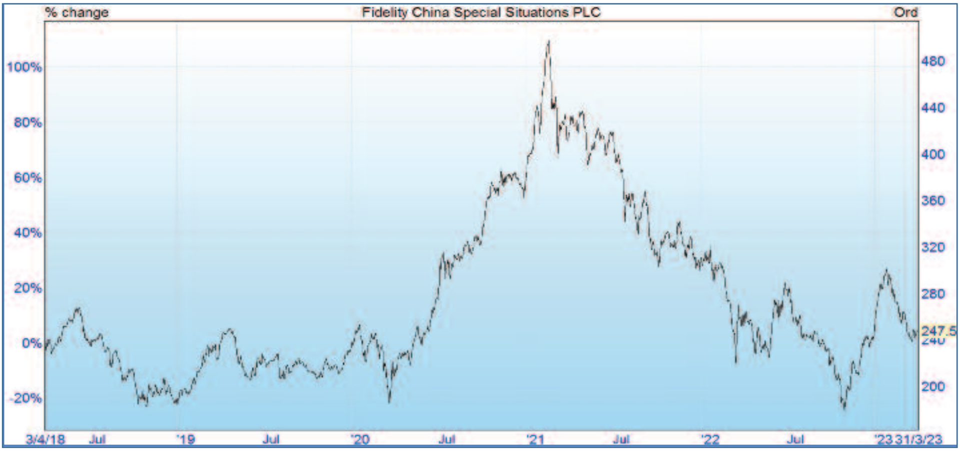
Finally, it is important to bear in mind that the Labour Party, were they to get into power, have committed to removing these changes, so it is important to get in touch with us to discuss these changes as they may not last for long.

Portfolio Activity & Investments

In this section we are looking at some of the recent investments we have made and also review some of the full year results of companies that have recently reported.

We look at **Fidelity China Special Situations**, an investment trust that we have owned in the past and whose manager has a good track record of investing in good companies in China and Hong Kong. We also invested in a London office property business that specialises in easy-in, easy-out leases for small and medium size enterprises (SMEs), **Workspace**. Despite the downturn in commercial property the low valuation and alternative uses for the properties attracted us. **Coats**, the world's number 1 textile yarn business, was purchased. Finally, we review some of the recently reported 2022 full year results.

Fidelity China Special Situations



(Graphs source: Alpha Terminal)

We purchased Fidelity China Special Situations in January following the news that China was finally ending its zero-covid lockdowns. The objective of the trust is to achieve long-term capital growth from an actively managed portfolio made up primarily of securities issued by companies listed in China and Chinese companies listed elsewhere.

Now that the lockdowns in China have ended, there is likely to be a big rebound in consuming spending within China. FCSS has a weighting toward the consumer sectors with over 50% allocated to consumer discretionary and consumer services.

Portfolio manager, Dale Nicholls, looks for opportunities among small and medium-sized companies, where fewer investors leave greater scope for mispricing. However, the Trust has a flexible approach and may invest in larger companies if they fit his criteria.

The trust is the UK's only £1bn plus China-focused investment trust. It has been the best performing Chinese closed-end trust over the last year and YTD. We are happy to hold for the long-term.

Workspace

Workspace is a real estate investment trusts (REIT) that rents out offices in London on flexible leases to SMEs. The business was created from the offices owned by the Greater London Council, GLC, and has been very successful at renovating and letting out the space to the large numbers of SMEs in the capital.

The shares have fallen over the past 4 years. The recent acquisition of McKay securities has caused the shares to have a relatively high level of debt as disposals from the logistics part of McKay was not possible due to weak market conditions. However, we bought the shares on a 50% discount to their net asset value, and feel that the company has always been able to release value from their properties via conversion to residential and clever conversions. The stock is expected to yield 5.7% this year to March, and 6% next year.

Coats

Coats has two main businesses. It is the world's largest yarns manufacturer for stitching clothes together. It also has a functional textiles business in footwear, and has recently been buying businesses in this area, where margins are higher than in their core business. They recently purchased Texon and Rhenoflex which have not stretched the balance sheet, leaving the business modestly geared at 1.4 Net Debt to EBITDA.

The company recently released full year results with profits up 19%. The stock trades on 10.4x earnings with a 2.9% yield to December 2023, and 8.4x earnings the following year. We see scope for upgrades once the recently purchased businesses are bedded in and producing in line with expectations.

Results season update

We have been generally satisfied with the recent results reported by the companies that we invest in. Whilst UK the economy is experiencing problems, the stock market has a lot of global businesses that offer attractive valuations relative to other markets and give good risk diversification for clients. We have written a short paragraph on a few of these stocks below:

HSBC – The second largest bank by the size of assets produced good results and the shares responded. Profit before tax rose 13.4% and earnings per share (EPS) rose 21%. The dividend per share rose by 28%, covered more than two times by profits. The cost to income ratio, a key measure of bank efficiency, fell to 64.4% from 69.3%. The bank is a big beneficiary of rising US interest rates, and this effect should continue in 2023. There is likely to be a U$0.21

special dividend in 2023 from the sale of HSBC Canada.

Shell – The integrated oil major recently moved its primary listing to the UK. Profits surged on the back of the energy prices rising after the invasion of Ukraine. The company produced $68bn of cash flow from operating activities, up from $45bn in the prior year. Profits more than doubled to $42.9 from $20.6bn, and earnings per shares rose to £4.72 and the dividend per share was £0.86. The company bought back 9.8% of the share capital at a cost of $18.4bn. The company continues to prefer share buybacks over dividends and remains cautious of dividend growth after having to cut its dividend in 2020 when the oil prices went negative.

BAe Systems – A solid set of results from BAe saw earnings rise 6.7% to 59.2p, but these were overshadowed by the huge rise in the order book from £35.5bn to £48.9bn, a rise of 37.7%. This increase in order book will underpin earnings for the coming decade and should, over time, lead to a step change in earnings. Interestingly, hardly any of the orders relate to Ukraine, with a large order from Saudi Arabia being a feature. The stock has looked good value in comparison to US defense companies, and its joint ventures in Europe in land systems (tanks and armoured personnel carriers) should benefit the company.

British American Tobacco – Solid annual results have not pushed the shares up as investors would like to see sizeable buybacks, while the company is focused on reducing its total debt. Earnings per share were up 12.9% from 329p to 371.4p and dividends rose a modest 1% to 217.8p, albeit the dividend yield is high at over 7.6% based on the current share price (circa £28.40) as at 7/4/23. The biggest news is that BATS' next generation products (vaping and heated tobacco) are on target to reach break-even one year earlier than expected and have seen market share gains vs. the competition. The stock trades on 7.6x historic earnings.

Rio Tinto – The iron price came down from the heady heights of summer 2021 and fell from a peak of $210 per tonne to $80 per tonne in Autumn last year, but have since rallied to the current $120 level today. The company was affected by the fall in price, but still produced 625p of earnings and a dividend of 407p, valuing the company on 8.5x historic earnings with 7.7% yield (based on a £53 share price).

Markets & Investment Outlook

In this section we look the recent market turbulence, including the US and Swiss bank crisis. We examine the effects of the mild winter on asset prices. Finally, we look at the outlook for markets for the remainder of 2023.

Market Turbulence and the US / Swiss bank crises

The recent failure of several banks in the United States as well as Credit Suisse in Switzerland has caused ripples of concern to emanate across financial markets. What caused these banks to fail is not one common reason, but several, unconnected reasons leading to a crisis of confidence in their viability.

Silicon Valley Bank (SVB) grew rapidly on the deposits from technology companies that had raised huge sums from investors as well as being a bank where technology companies felt at home. The growth in deposits meant the bank had to lend the money out to other investors to get a return in order to pay their depositors. They invested the money in long dated bonds, with low interest rates. When inflation started to surge, so did bank deposit rates. Because the depositors were mostly from companies, they weren't covered by the Federal Deposit Insurance Corporation (FDIC) limit of $250,000, so their $millions looked for a higher interest rates. SVB had to sell the bonds which had fallen about 20% due to rising Fed Funds interest rates. This caused them to be short of capital. When the bank went to raise money from investors by issuing new shares, there was no interest in chipping in to save a bank that still had a severe liquidity problem, i.e. it didn't have the money to pay depositors their money. A bank run ensued, and on 12th March, SVB bank was shut down.

The same weekend, Signature bank, which had similar problems and was also heavily involved in Crypto currency monies, was shut down. The bank had suffered severely since FTX and Binance, amongst other Cryptocurrency exchanges, were suffering their widely broadcast problems.

But more worrying was the announcement that the FDIC believed that US banks had $620bn of unrealized losses on their bond portfolios, or circa 5% of total bank capital in the US. These losses will, of course, vary with the change in the price of long-dated bonds, which, in turn, will fall if long-term interest rates rise. However, these losses are substantial, and what the market doesn't yet know is where they are concentrated. Like SVB, when depositors remove funds from banks with weak balance sheets, there may be further collapses.

The credit Suisse collapse has its origins in the investment bank, where several major losses had hit the capital of the bank. These losses came from Credit Suisse's backing of Greensill Capital, a non-conventional lender involved with ex-prime minister, David Cameron. The bank also facilitated the leveraged trades of Bill Huang's Archegos Capital. Both these caused combined losses of over $1bn. Indeed, there were serious questions about risk control within the bank.

In 2022 the bank raised CHF4bn in new equity from existing shareholders and Saudi National Bank, who bought nearly 10% of the bank. This was supposed to restore confidence in Credit Suisse. However, within a few months the bank failed and had to be propped up by the Swiss National Bank until it was merged with UBS in a transaction with questionable characteristics that will have long lasting implications.

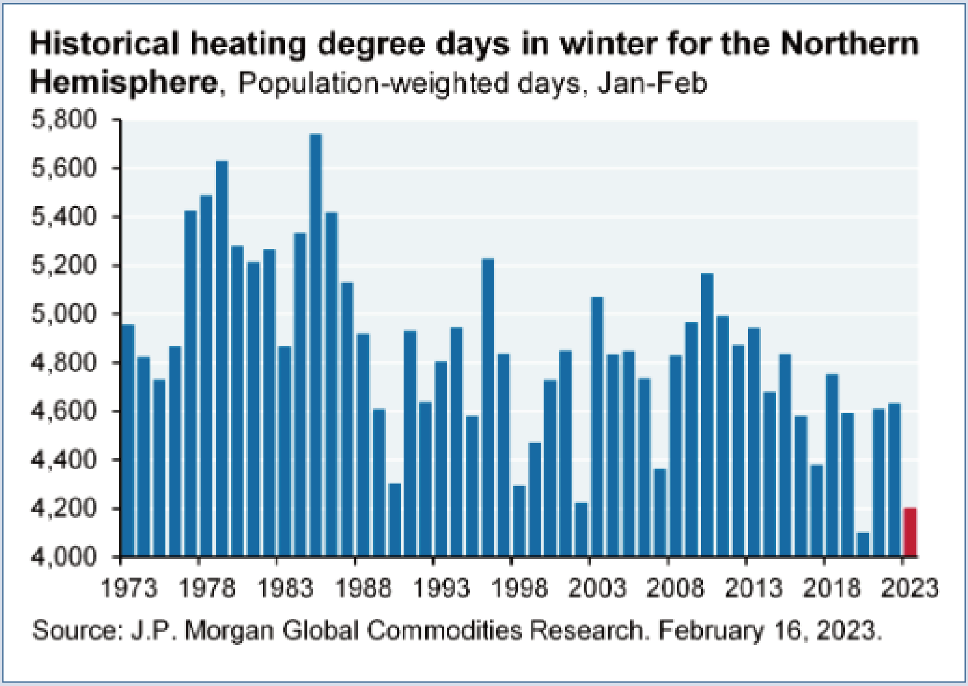
Bank capital after the financial crisis included contingent capital, or 'co-co' bonds, that paid a very high rate of interest, but would convert to equity when the bank breached a low level of core capital. When Credit Suisse went under, this capital was wiped out, yet the equity, or share capital, was preserved, when it should be the other way round. This change in the order of winding up was done so that Credit Suisse could quickly be acquired by UBS via Credit Suisse shareholders voting on the deal. Already, there are lawsuits launched to contest this.

So how long will the market turbulence last? The sudden shock increase in interest rates in 2022 and 2023 caught many investors the wrong way around, particularly long term capital providers such as banks and final salary pension schemes. With higher interest rates will come more bankruptcies from over-leveraged companies, many of which are in the private equity sphere. Many of the lenders to private equity companies are banks. This could in turn put more pressure on capital ratios. In the UK, banks have strong balance sheets, but elsewhere this is less clear. The US has experienced red hot capital markets for the last decade. It is here that we expect further signs of stress. It looks like turbulence is here to stay.

Effects of the mild winter on asset prices

Markets got off to a blistering start in January 2023, a reminder just how quickly the mood can change in this uncertain investing environment. A more optimistic outlook for Europe – which averted an energy crisis thanks to a mild winter – and the reopening of the Chinese economy added to fervour.

The warm Northern Hemisphere winter has coincided with a flurry of positive economic surprises in the US, Europe and Japan. The US list of positives includes retail sales, manufacturing output, a rebound in the PMI services index, and jobless claims back at low levels. A large rise in energy prices has historically been a reliable predictor of recession but unseasonably warm weather, particularly in Europe, in recent months resulted in gas prices falling back to pre Ukraine war levels.



While the fall in gas prices will eventually cause prices to rebound in the short term, gas storage remains close to full, and a gas shortage this winter is now unlikely. This positive development, together with the normalisation of supply chains, has boosted business confidence. However, before getting overly enthusiastic, remember that energy prices are highly volatile and recent developments cannot be extrapolated to the entire year and we still expect an increase in the second half of the year when China starts to accelerate and Europe prepares for next winter. Britain is particularly vulnerable to any rise in prices or consumption as it has very little storage capacity, so consumers should get ready for such an environment.

In the short term, UK and eurozone activity will continue to be resilient as a result of lower gas prices, normalising supply chains, and full order books. However, in the medium term, global economic weakness and the effects of monetary policy will likely result in a recession. Indeed, sticky core consumer price index (CPI) inflation, alongside resilient real activity, will support the ECB's strong commitment to further monetary tightening. This will likely reinforce recessionary dynamics later in the year.

Investment Outlook

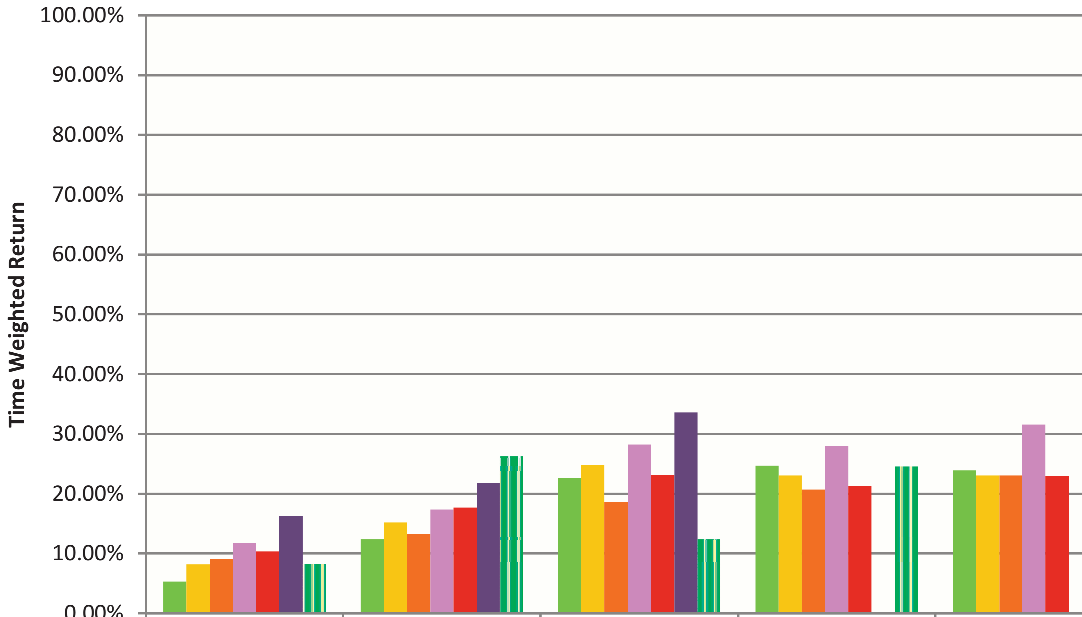
The recent volatility in bond markets has upended many forecasts. Economists are divided over the next move in interest rates, whether they remain higher for longer, or will be reduced as economies slow. The former seems likely for the US, whereas Europe is already seeing inflation begin to fall back. The UK is likely to see higher rates for longer as they are simply not high enough relative to the current rate of inflation.

These elevated interest rates will eventually slow developed economies and a recession is highly likely. However, inflation is likely to continue for some time to come as economic power shifts from capital to labour. This will bring down returns for companies in the short term as they adjust to higher costs and lower revenues. However, we see opportunities in companies with high margins and defensive business models. We also believe some economies will reduce rates sooner from already elevated levels, particularly in emerging markets.

Investors should stay invested in these times, for when the economies turn back to growth, you need to be invested to gain from the rapid surge in prices from the markets' nadir.

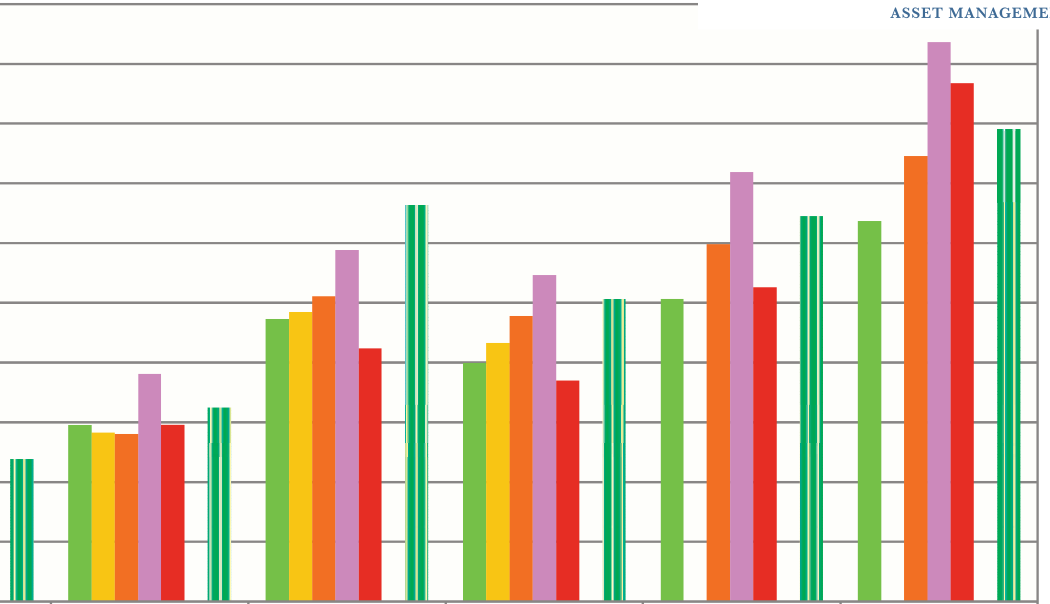
JLS/HAH/JHM/SKW – 7/4/23

4 Shires investment performance



	1 year	2 years	3 years	4 years	5 years
Risk D	5.33%	12.37%	22.58%	24.69%	23.94%
Risk E	8.22%	15.16%	24.80%	23.06%	23.09%
Risk F	9.10%	13.23%	18.63%	20.75%	23.09%
Risk G	11.73%	17.35%	28.22%	27.95%	31.58%
Risk I	10.36%	17.65%	23.12%	21.27%	22.94%
Risk S	16.34%	21.80%	33.62%		
UK IMI	8.28%	26.29%	12.33%	24.60%	23.87%

Graph to 5th October 2017 *(source: 4 Shires)* showing the average performance of all of the portfolios on each risk scale.



6 years	7 years	8 years	9 years	10 years
29.51%	47.33%	39.92%	50.66%	63.77%
28.32%	48.45%	43.29%		
28.02%	51.10%	47.85%	59.76%	74.60%
38.13%	58.88%	54.66%	71.87%	93.62%
29.62%	42.33%	37.00%	52.58%	86.75%
32.45%	66.37%	50.64%	64.50%	79.10%

Notes: Performance is measured to 05/03/2023. All 4 Shires performance figures are net of management fees, VAT, stamp duty and commissions. Total return measures include dividends and income received. Time weighted return measures consider deposits and withdrawals to/from the portfolio. The performance for each risk scale includes every portfolio in that risk scale at that time.

Disclaimer: The value of investments and the income you get from them may fall as well as rise, and there is no certainty that you will get back the amount of your original investment. You should also be aware that past performance may not be a reliable guide to future performance.

4 SHIRES
ASSET MANAGEMENT

4 Shires Asset Management
01747 824600
info@4-shires.com
www.4-shires.com