4 SHIRES
ASSET MANAGEMENT

Investment Commentary

Winter 2020

Expert Asset Management

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Introduction

Welcome to the 4 Shires Investment Commentary for the Winter of 2020.

In this edition we look at the global economic outlook as we potentially exit pandemic restrictions. Financial markets tend to rally ahead of events, and the fourth quarter of last year and the beginning of this year show exactly that.

We look at the implications of a new US administration as well as a changing of the leaders in European capitals, notably Germany and Italy. We also look at China and Japan, the Far Eastern powerhouse economies, and how their economies look in the light of recent changes to the economic outlook.

In our Markets and investment section we look at the importance of the US government bond yields for global investors and the effect of inflation on pension incomes, as well as the outlook for the U.S. dollar and for sterling.

We hope that you enjoy reading this latest Investment Commentary.

Jeremy Le Sueur
Managing Director

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Research & Events in 2021

We look forward to keeping you in touch with the world of investment and how it affects you throughout the coming year.

February
Winter 2020 Investment Commentary & Webinar

March
Budget Review Report
Wealth Matters, our bi-monthly financial advice periodical

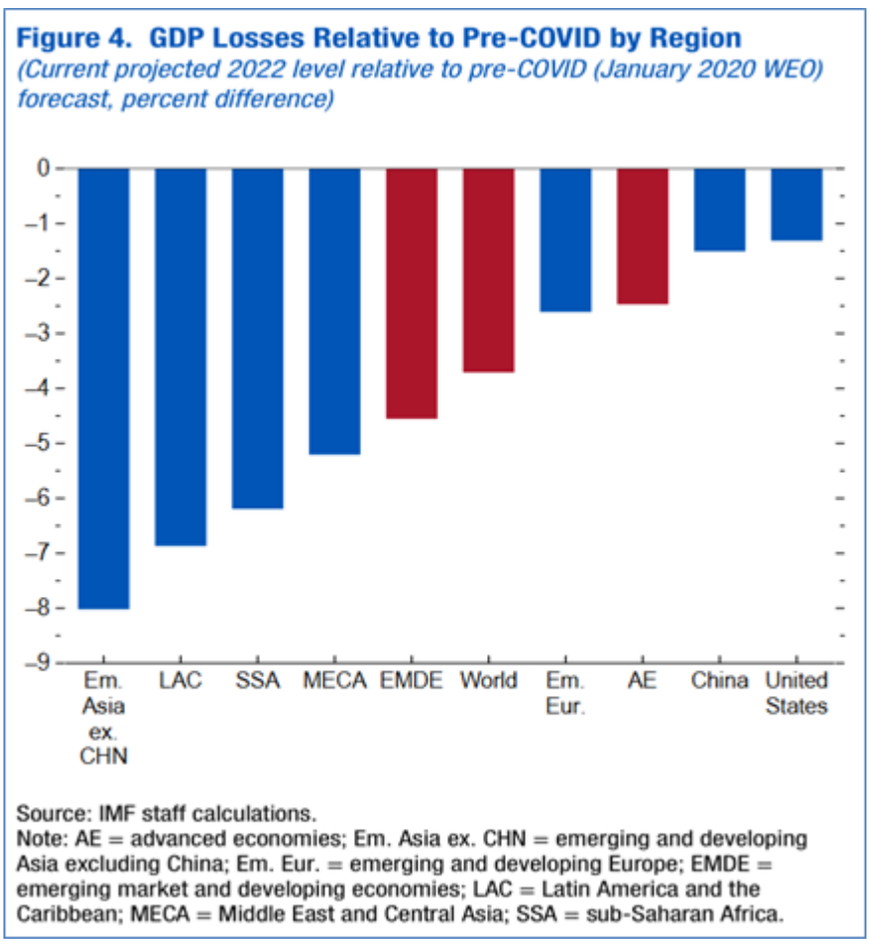
April
Financial planning webinar

May
Spring 2021 Investment Commentary & Webinar
Wealth Matters, our bi-monthly financial advice periodical

June
Investment Seminar & Garden party
St James's Square, London

Global Outlook

The global Covid pandemic caused GDP to fall in all major economies. The graph below shows the estimated drop in GDP in 2022 compared to pre-Covid forecasts for these economies:



(Source: IMF)

The graph indicates the scale of the retracing required for the economies to recover from the effects of the pandemic, with the U.S. and China being the least affected and Latin America and frontier markets being the most affected.

The IMF is less optimistic than other forecasts, notably those of accountancy firm PWC whose data shows a notable global economic recovery from 2021 onwards (see Graph overleaf).

(Source: PWC/4 Shires)

The rollout of vaccinations to key workers and the older members of society in 2021 gives the forecasters reason to be optimistic. However the scale of the rollout required and the volumes needed to reach the vulnerable members of society will no doubt put a break on economic growth in 2021.

The new Biden administration is on the cusp of launching a massive stimulus package for the U.S. Britain's March budget will no doubt involve expenditure far in excess of taxation revenue in order to kickstart the economy back to life. Both packages will focus on infrastructure, although the Congress will approve direct cash grants to citizens around the $1,400 per person level.

We also believe that people will get back to normal life as quickly as they possibly can.

The 'Roaring 20s' (1920s) came just after World War I and the Spanish flu pandemic. The buoyant expenditure by consumers in this period led to an economic boom.

Could the 2020s repeat this experience a hundred years later? People have been saving money (so long as they remained employed) during lockdown, and our suspicion is that they will reverse the trends of the past 12 months (home improvements, internet shopping, no travel or leisure expenditure) and spend lavishly on leisure, travel, visiting shops and generally reuniting themselves with their families and peers.

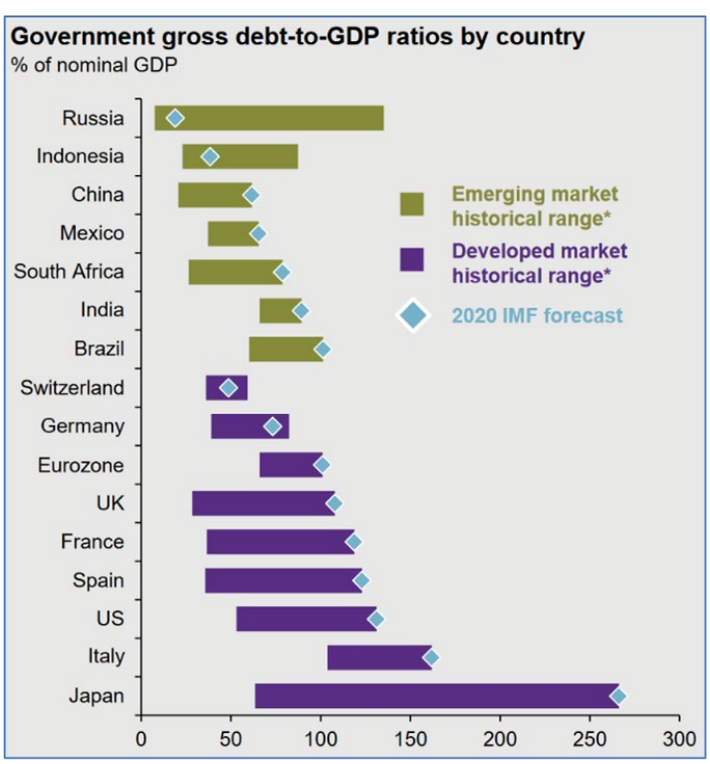
Despite this, the world's economies face several major structural changes alongside the Covid pandemic crisis. The first is the climate emergency which is being directly addressed by the U.S. and the EU in their budgetary expenditure.

The structural challenges of the internet closing down the shopping malls and high streets around the world (the UK is possibly the worst affected) have been accelerated due to Covid causing a rapid move to online from physical retail. These retail workers will need to find employment and governments will need to replace lost taxation income, or at least try to grow the economy to replace it.

Our view is that the scale of the problem is so large that governments around the world will continue to stimulate economies alongside expansionist monetary policies (quantitative easing) until the greens shoots of recovery are well established.

This will be a powerful background for asset classes around the world. But it will be important to be positioned to benefit from these trends. For infrastructure, we view commodities as attractive (see our articles elsewhere in the report on this subject). Most travel and leisure stocks will see a large rebound in activity in the second half of 2021, so long as they survived this lockdown. There are more examples, and we are doing a lot of work on identifying those companies with good balance sheets who will benefit from a cyclical upswing in activity.

All of this stimulation will cause a build up of government debt, particularly in the developed world. The advanced economies will see debt to GDP surge over 100%. The chart below shows debt levels of major economies and also the historic range of their debt.

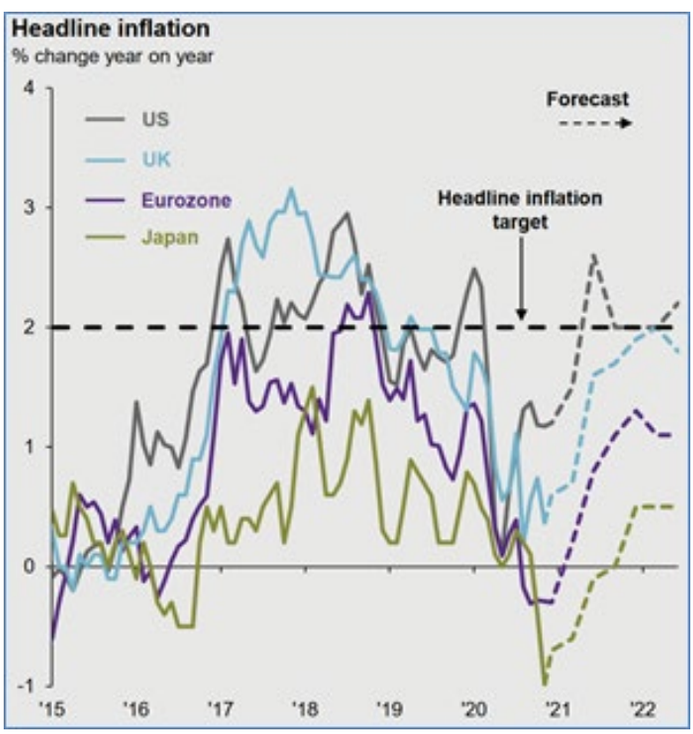


(Source: JP Morgan)

What is clear is that most countries are pushing at the top end of their historic debt ranges. However, emerging markets have more ability to increase debt to aid recovery, and their debt to GDP levels are nearer 60%, consistently lower than developed markets due to the tendency to have currency crises in these economies.

The graph below shows the effect that this economic stimulation will have on the inflation outlook; an expected pick up in inflation over the coming two years in the major economies.

This is significant for two reasons. The first is that with the rise in debt levels, both private and governmental, comes the risk of deflation. Inflation expectations are showing that this is not expected. Indeed, five years from now, expectations of inflation are higher still. The second reason is that economic activity levels are below their trend output level, meaning that they are performing below capacity. Governments can stimulate economies with no risk of a sharp pick up in inflation for several years to come.



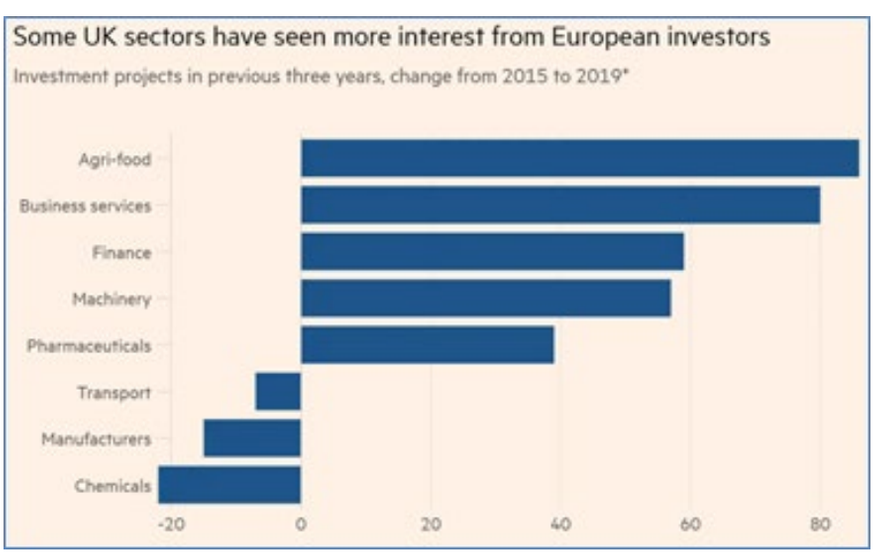
(Source: JP Morgan)

Against this background of stimulation and benign inflation we believe corporate profits can recover from the pandemic crisis, corporate debt can be repaid and stock markets can remain healthy in the medium to long term.

Brexit Update – Outlook for Britain

Since our last commentary the terms of a Brexit trade deal were announced. What has been described as a 'thin' deal covered trade in goods but not in services. Whilst we have a 'free trade' agreement, this is nothing like being a member of the single market. We still have no deal on access for services to the UK, which is our largest trade area with the EU. There was also no deal on financial services. It is likely that Britain will be in negotiations with the EU for many years to come both to refine the existing deal and to open up new areas of trade, i.e. in services. The trade outlook remains difficult due to the lack of an agreement with the US as well as an incomplete EU trade picture. The Road Haulier's Association (RHA) has said that exports to the EU are down 68% in January in comparison to January last year. A similary percentage of lorries that had come from the EU are leaving empty for the return journey. This is blamed on hold-ups at the ports and UK exporters not currently sending goods overseas.

But the news is not all bad, with EY's UK Chief Economist, Mark Gregory, saying "Brexit is a process not an event and the winners and losers will only become clear over time." Certain industrial sectors have become more attractive since the 1st January, such as food manufacturing. It is likely that finance and automotive will see a net decline in investment, the latter due to problems with just-in-time deliveries resulting from trade friction. The chart below shows investment in the UK into different sectors between 2015 and 2019.

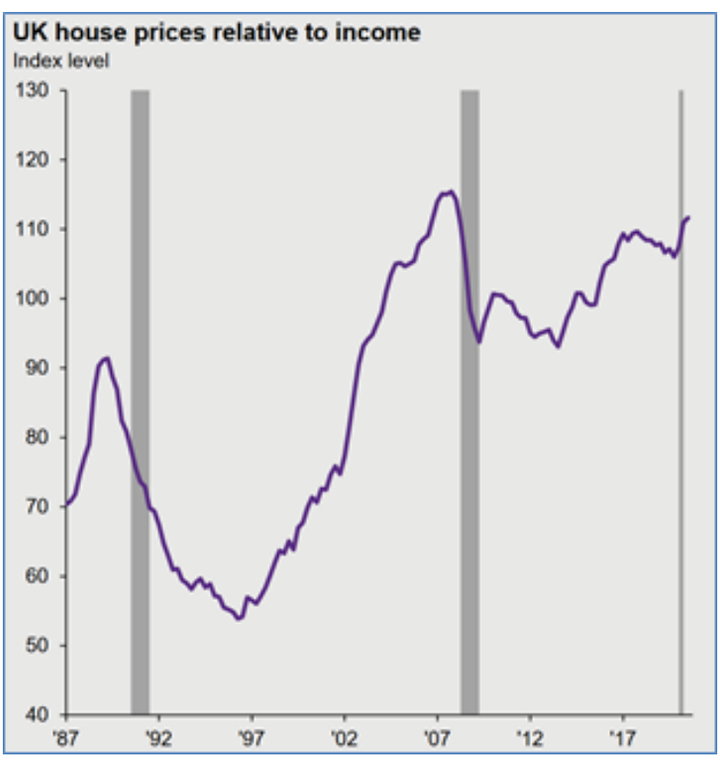


(Source: EY/FT)

The recent national lockdown has frozen the economy, with the Government's Christmas visiting rules rebounding ferociously in the New Year with a Covid case surge. Many businesses are not just struggling with lower demand due to Covid, but trade friction with the EU is causing supply difficulties in several parts of the economy. Banks are also wary of lending more to already indebted companies.

Not all areas of the economy are suffering, particularly internet and delivery businesses, but many areas are being boosted by direct government intervention (e.g. the housing market that is benefiting from a stamp duty holiday and the help-to-buy program).

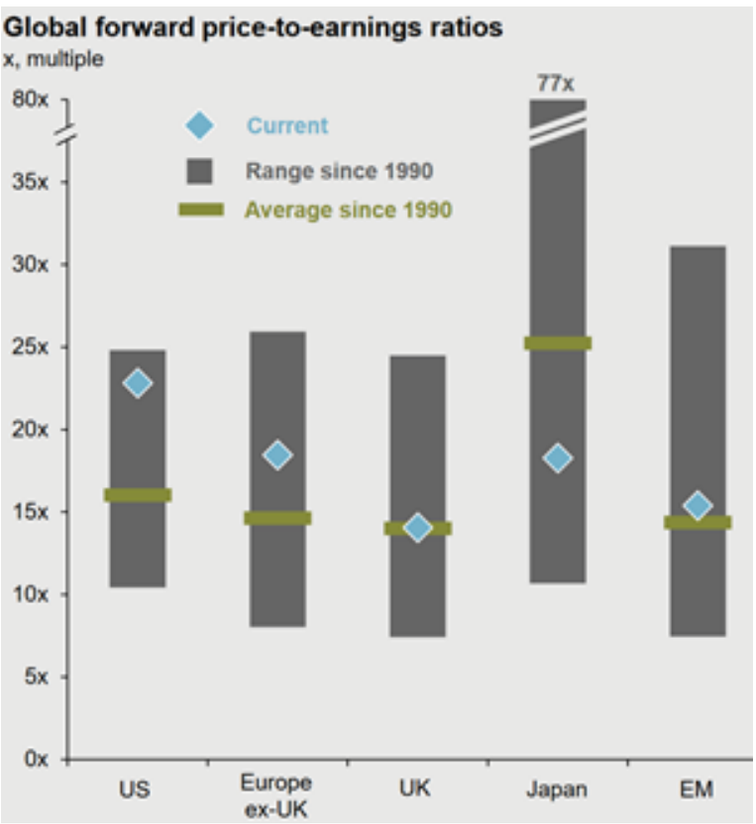
The chart below shows the affordability of UK housing has reached a peak and, without continuing Government tax breaks, it could correct as it has in previous cycles as it did in the early 90s and also during the financial crisis.

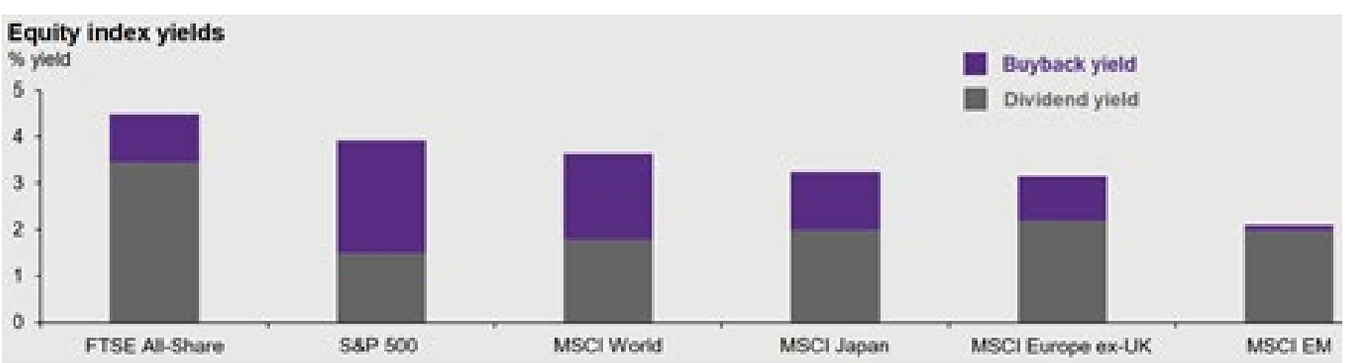


(Source: JP Morgan)

Despite what must seem a slightly depressing outlook for Britain on the trade front, we are optimistic about domestic consumption and government investment in the coming months. Banks are holding plenty of capital and many of the recent loans are guaranteed by the government. To hedge some of the exposure to the cyclical sectors we continue to like some of the large, UK listed, global companies, notably in the commodities sector.

The valuations on the UK stock market look attractive relative to other investment markets, both on a p/e ratio and also having the highest prospective dividend yield relative to other markets. There have been questions raised about the sustainability of those yields, but many companies have already reduced their dividends in the light of the cyclical downturn, so we view the current levels as an improvement on previously unsustainable payouts.

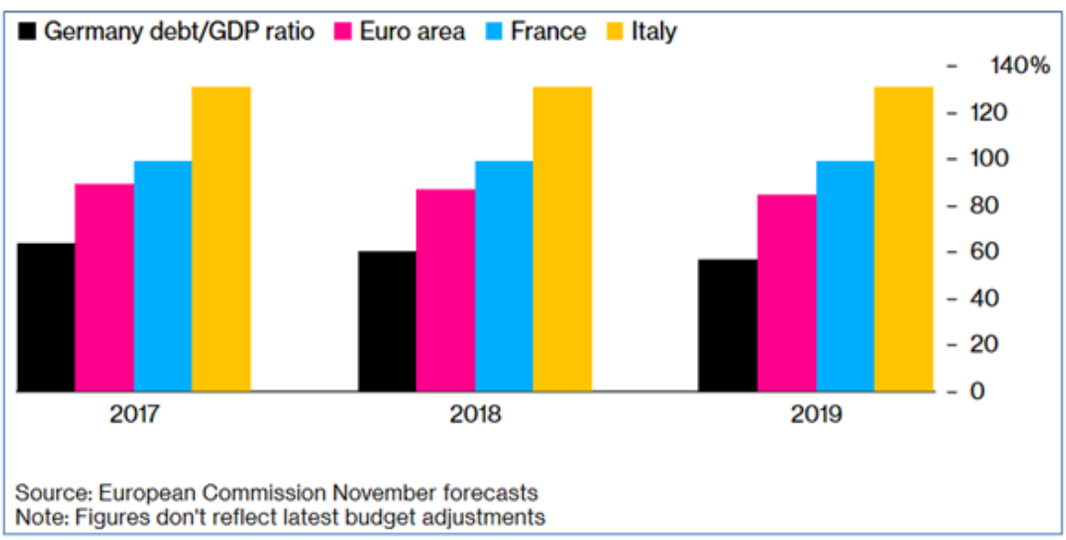




(Source: JP Morgan)

European Politics - Changing of the Guard

The black zero or "Schwarze Null" policy is the much-loved symbol of austerity in Germany, which refers to a balanced budget with no new Government spending. Germany has always been a nation of savers, saving about 10% of their disposable income, twice as much as the average American or European. There is a national obsession with their personal preoccupation with saving. The architect of the black zero policy was Wolfgang Schauble, Angela Merkel's Finance Minister between 2009 and 2017, who introduced it to bolster the economy in the aftermath of the Eurozone debt crisis. It has been government policy for nearly a decade and Chancellor Merkel has been instrumental in this direction.

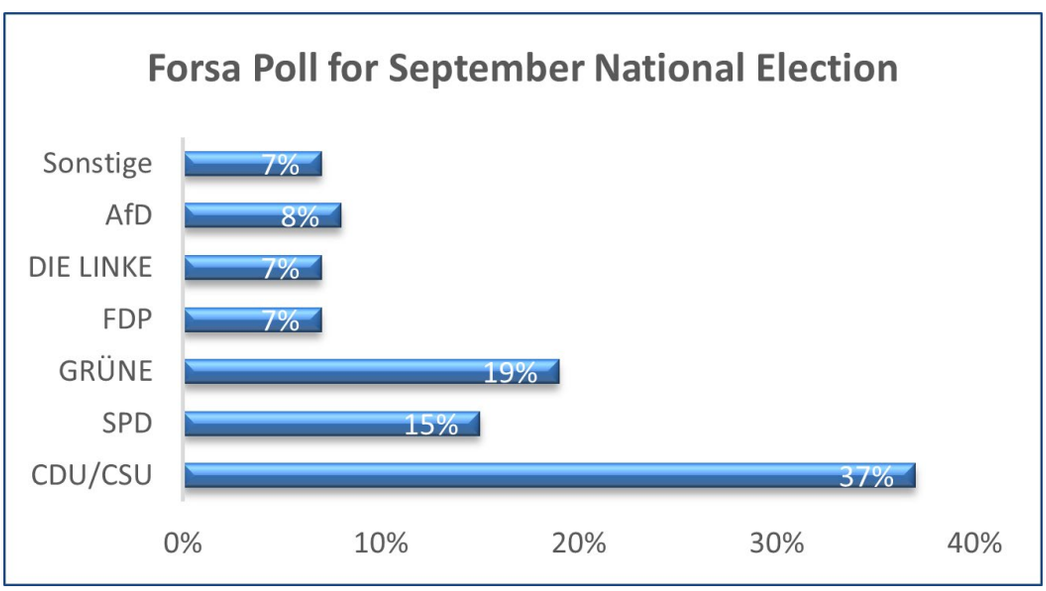


However, despite its popularity, the lack of fiscal spending has come under public pressure both domestically and externally in recent years. Before the pandemic, European leaders had criticised Germany's reluctance to spend since it impedes the economic output of the euro bloc. French President Emmanuel Macron said that Germany's penchant for balancing budgets always occurs "at the expense of others". More importantly, Germany's low growth in recent years has drawn criticism over its lack of new spending. According to the Federal Statistics Office, Germany's growth fell 0.6% in 2019, down from 1.5% in 2018. In November 2019, German trade unions and businesses formed an unlikely alliance and called for a EUR450bn fiscal spending package but it was rejected by Angela Merkel who believed in debt reduction during good economic times to save for future crisis.

Merkel's stance changed dramatically when the pandemic struck in early 2020. She swiftly implemented a fiscal response including the €500bn Economic Stabilization Fund (14% of GDP), €860bn of guarantees (25% of GDP), and hardship funds for SMEs and the self-employed (2.4% of GDP). To enable these support measures, the federal government passed two supplementary budgets in 2020, one for €156bn (4.9% of GDP) in March and another in June, which topped this up to €219bn (6.3% of GDP).

The big question that now faces Germany and the EU is whether this drastic switch in fiscal policy is temporary, only to support the the post- pandemic recovery, or if there will be a longer term shift in fiscal policy.

Germany's National Election on 26 September will likely provide some answer to this question. Following Angela Merkel's annoucement to step down as Chancellor in October 2018, her party Christian Democratic Party (CDU) elected a new leader in January Armin Laschet, a centrist. Laschet is seen as a continuity candidate following Merkel's pragmatic approach who can unite the ruling CDU's broad church of members, from conservatives and pro-business members of the party to environmentalists. As Laschet will need to decide with Markus Söder, the leader of the CDU's Bavarian sister party called the Christian Social Union (CSU), who will be the CDU-CSU's joint candidate for chancellor, the CDU/CSU camp will likely have to form a government with a centre-left party, possibly the Greens. This will further dilute the more fiscally conservative instincts in the CDU/CSU camp.



(Source: https://www.wahlrecht.de/umfragen/forsa.htm)

A coalition with a centre-left party is unlikely to support any austerity under Chancellor Merkel as Chancellor. In addition, Armin Laschet, the newly elected CDU leader, has previously criticised Merkel that Germany should have been "more responsive to Mr Macron's call for action in Europe". In 2011 he attracted attention for speaking out in favour of a closer fiscal union, including an open debate on joint borrowing through Eurobonds.

As Germany's general election could bring a new stance in fiscal policy, Italy is also showing signs of change. Mario Draghi, who was credited with successfully taming the Euro debt crisis in 2012, has been appointed Prime Minister of Italy. His bold decision to initiate quantitative easing and fight off currency speculators upset some countries at the time, particularly Germany.

However, his appoinment as the new leader of Italy has raised speculations that he might be a neo-Keynesian with a willingness to intervene and spend to shore up growth. Draghi has previously argued that the EU funds, if used for growth-boosting investments, could be the key to reviving Italy's economy and making its debts sustainable. "We have the extraordinary European resources at our disposal. We have the opportunity to do a lot for our country," he said.

As we watch closely the changing of the guard in Germany and its new government's fiscal policy regime, the combination of the Draghi-led Italy and a general election planned in France in 2022 will support political incentives for a more relaxed fiscal management for the bloc, including potential growth not seen since the Euro crisis.

U.S. - New Democrat Administration

With Joe Biden now established in the White House, and both houses of Congress under the control of the Democrats, the first 100 days will set the pace of what the administration wants to achieve. The appointment of the key members of government is likely to go smoothly given the control of the Senate.

Already Joe Biden has used executive orders to overturn many of Donald Trump's own executive orders, in line with his manifesto pledges. The U.S. has:

- Rejoined the Paris Climate accord
- Stopped separating migrant families at the borders
- Restored collective bargaining for workers
- Allowed transgender people in the military
- Stopped the US withdrawal from the World Health Organisation (WHO)
- Cancelled the Keystone pipeline project
- Halted the border wall construction by ending the 'National Emergency'

The list goes on to further rescindments of Trump's executive orders. But the likely path of the new administration is to use Congress to pass laws, preferably with consensus with Republicans.

Why the administration will work with the Republicans, particularly in the Senate, is due to its one vote majority in that house, via the casting vote of vice president Kamala Harris. This is so narrow a margin of victory that conservative Democrat senators will be likely to play hardball to gain benefits for their districts, and moderate Republicans will also seek to garner similar benefits for theirs. This process, or 'pork barrel' politics, sees these benefits tagged onto the end of bills, often that have nothing to do with the main bill. Maintaining discipline amongst Democrat senators is likely to be difficult as they position themselves for garnering financial benefits for their districts.

However, despite the return of pork barrel politics, the Biden administration is likely to achieve a lot of its goals in the first 100 days. The main aims of the new administration are:

- A $1.9trillion stimulus bill, with $1,400 per citizen in stimulus cheques. Larry Summers, treasury secretary under President Bill Clinton and senior economic adviser to President Barrack Obama, has said this is excessive, saying congress will have spent 15% of GDP on similar programs (including President Trump's) without any increase in public investment. Summers has said this expenditure is potentially inflationary.

- A $2trillion bill to address the climate emergency in order to reduce the US's emissions and reduce the impact on the climate.

- Measures to deal with the covid pandemic.

- Raising of the minimum wage to $15 per hour. This will be difficult to achieve without Republican support which is almost certain to be witheld.

- Criminal justice and police reform.

- Ending the war in Yemen.

- Continue to invest in US infrastructure.

It is too early to tell how well the programme will go down or how effective it will be. However, the Democrat Administration shows it means business and a flurry of early legislation is likely, lest the Congressional elections in two years' time remove their majority in one or both houses.

Next time Donald Trump won't be inciting his followers to violence and destruction, so elections will most likely be a close call.

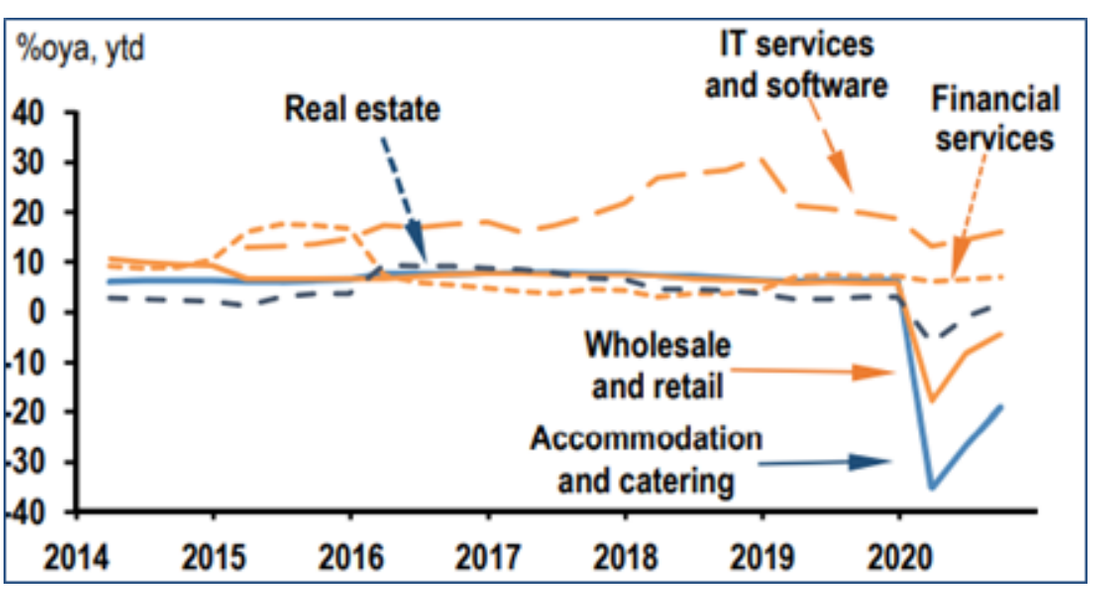
Asia over the Long Term - China in 2021

Despite being at the epicentre of the global public health crisis at the beginning of last year, China's economy outperformed the rest of the world in 2020. Effective epidemic control measures meant that China was able to end its lockdown in March, initially reducing restrictions on factories followed by ending controls on the movement of people. Combined with significant fiscal and monetary stimulus targeted at the corporate sector and public investment, the Chinese government steered a strong V-shape recovery with full year 2020 GDP growth expected to be 2%, according to the World Bank

This economic recovery was primarily driven by surprisingly strong exports, public investment especially in infrastructure spending and housing investment. Consumer spending and the service sector, on the other hand, lagged, reflecting China's characteristically top-down policy driven approach in its crisis management framework.

This central government driven approach successfully pulled China out of the recession after the Global Financial Crisis in 2008. However, this support measure driven by public spending also led to the imbalance of its recovery. Consumer spending, especially by the low and middle income households, who are typically employed by the hardest hit industries such as tourism, entertainment, and restaurants, remains weak. In contrast, consumption by the high-income groups was far more resilient. Supported by easier credit conditions, they have contributed to the strong recovery in auto and property sales. The graph below illustrates the sluggish recovery of the retail, accommodation, and catering sectors through 2020, most of which are still substantially below 2019 levels.

Breakdown of Chinese Sectors

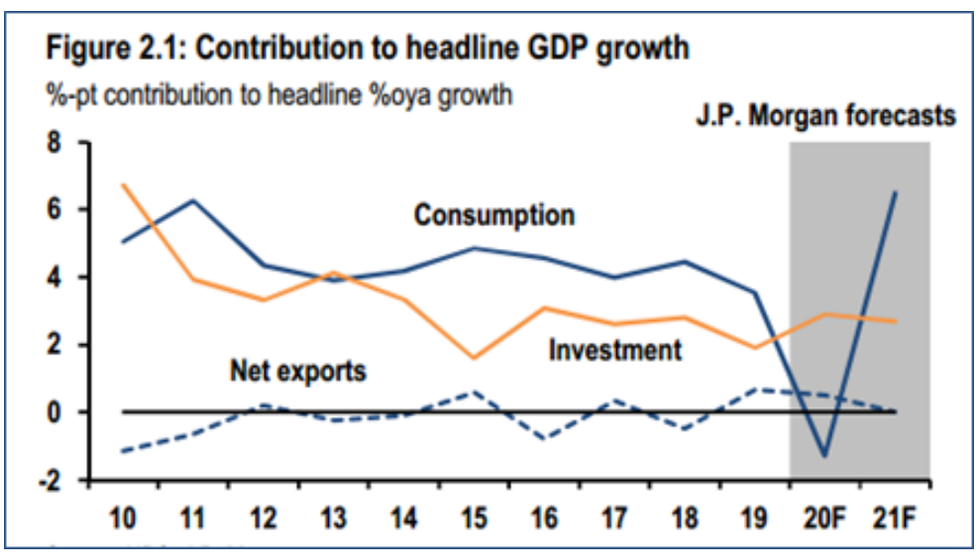


(Source: JPMorgan)

Looking into 2021, it is expected that Chinese government will unwind some of the 2020 stimulus including a reduction in publicly funded infrastructure projects. As private consumption is positioned by President Xi Jingping to be the driver of China's long term growth, and as economic activity normalises, we expect domestic consumption to be the primary driver for China's economy this year, and investment to shift from infrastructure and real estate to manufacturing.

The chart below shows domestic consumption's contribution to China's GDP growth over the last 10 years. It has contributed more than two thirds of the growth in the world's second largest economy. Investment bank JPMorgan forecast a strong recovery in domestic consumption in 2021. The Q4 2020 data is supportive of this view, with improving sales in retail, beverages, cosmetics, and jewellery.

Chinese GDP Contribution



(Source: JPMorgan)

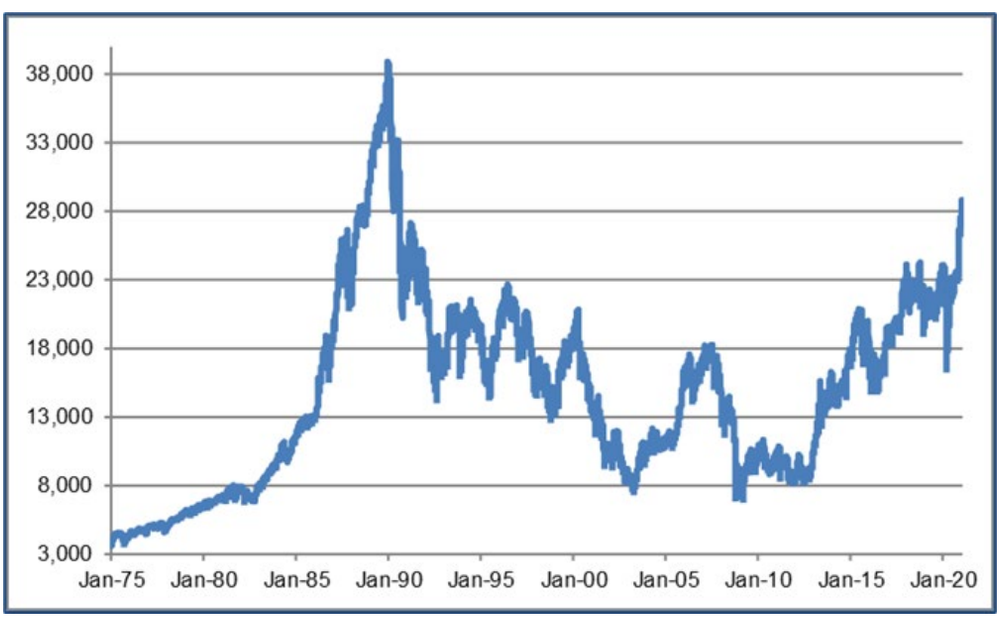
Our overweight stance in Asia and China is well placed to benefit from normalising domestic demand driven economic growth. For our clients' income portfolios, we hold Henderson Far East Income Ltd (HFEL), which has 35% of the portfolio invested in China and holds companies that will benefit from the growing middle class in Asia. JPMorgan Asia Growth & Income Plc (JAGI) gives our clients exposure to some of the fastest growing companies in Asia such as Tencent and Alibaba, China's largest online retailer, with over 50% of the fund invested in China and Hong Kong. JAGI has returned 40% over the last 12 months.

Over the next couple of months, we will be awaiting details of China's new 5-year plan, a policy blueprint to guide China's political and economic development over the next five years towards 2025. We will look for clues as to how President Xi plans to double China's GDP by 2035.

Asia over the long term - Can Japan exit deflation?

Leading up to 1989, Japan experienced a steep increase in asset prices driven by strong growth, rising leverage, and a belief that Corporate Japan was set to overtake the US enterprises and dominate the world. That was the time Japan was Number 1. The Nikkei Index produced a compound annual return of 16%, appreciating ten folds over the 15 years leading up to the burst of the asset bubble at the beginning of 1990. Property prices were also inflated and it was estimated that the housing bubble in Japan then was twice that experienced by the U.S. through the 2000s. At peak level, Tokyo's land value alone was bigger than the whole of America. The stock market bubble and subsequent burst is shown in the graph below.

Japan's Nikkei Index (January 1985 – January 2021)



(Source: macrotrends.com)

The following 32 years were a prolonged economic malaise, trapped in a deflationary spiral with low growth. Over the period, the Nikkei index and housing prices fell 67% and 47% respectively from the peak, and Japan's financial institutions were brought to their knees drained by substantial bad loans.

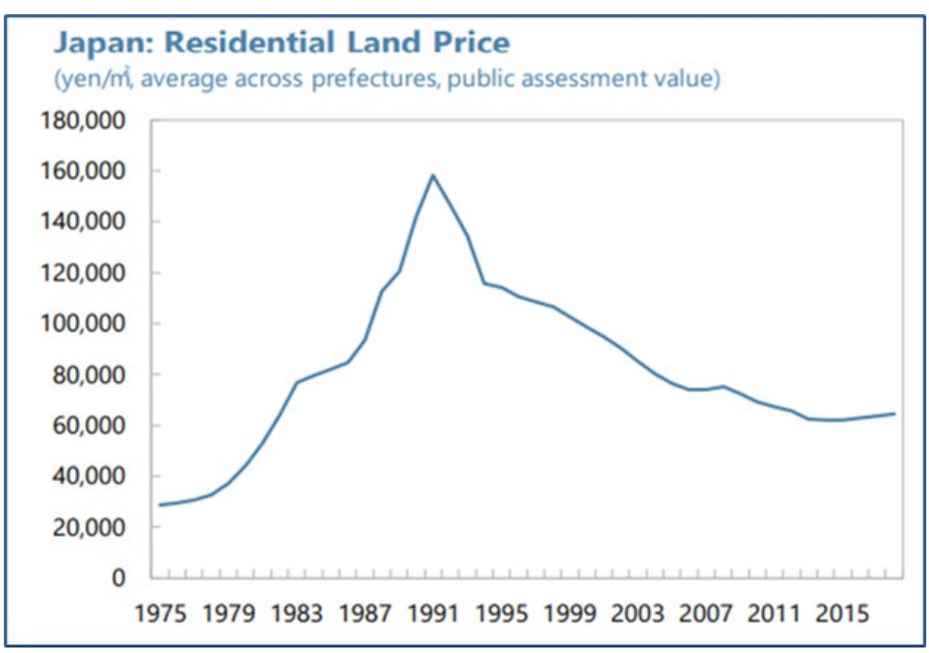
Despite repeated attempts by the government to rescue the economy by pumping public capital into the system, the country was unable to recover and the Nikkei Index hit its lowest level since 1980 at 7,054 following the Global Financial Crisis in 2009.

Determined to fight deflation, Shinzo Abe, following his land slide victory at the general election in 2013, launched Abenomics promoting aggressive monetary easing with fiscal expansion, an unprecedented fiscal and monetary policy combination in the post-World War II Japan.

The Bank of Japan (BoJ), under Governor Kuroda, undertook experimental quantitative and qualitative easing (QQE) including purchase of risk assets such as equity Exchange Traded Funds (ETFs) and corporate bonds with the aim to force liquidity into the banking system and inflate asset prices.

After eight years of QQE experiment, we are starting to see signs that Japan is getting out of its deflation malaise. Although these policies have so far failed in reaching the BoJ's 2% inflation target, they have collectively reflated the economy. The Nikkei index has quadrupled from its low during the GFC, house prices have appreciated, and land value has stabilised (shown in the graph below).

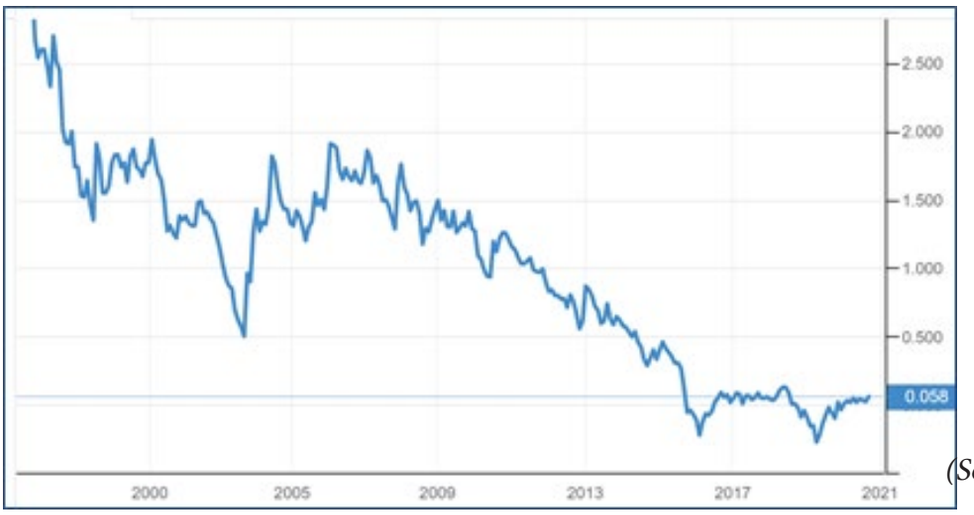
Average Land Price in Japan 1975-2020



(Source: Ministry of Land, Infrastructure, Transport and Tourism)

Perhaps more interestingly, Japan's 10-year government bond yield has stayed above 0% for most of last year despite the economic challenges globally due to the pandemic a sshown in the graph overleaf. This is a contrast to Germany's 10-year bund which stayed at -0.4% level.

Japan 10-year Government Bond Yield



(Source: 4 Shires)

Besides the reflation narrative, corproate Japan is becoming more investor friendly with many of them exercising share buyback and dividend increases to manage their capital more efficiently. Typically, many Japanese companies, often risk averse due to their deflation experience over the past decades, have been hoarding substantial amount of cash on their balance sheets.

With the end of deflation and the potential return of inflation, Japanese management, under mounting pressure from activist investors, are finally understanding the need for efficient capital management either by returning unused cash to shareholders or investing for future growth. Either way, this is a very positive start for investors looking to invest in Japan.

Into 2021, Abe's successor Yoshihide Suga, who is expected to call a snap election this autumn, will likely continue to promote "Abenomics", policies to reflate the economy through its three arrows of monetary easing, fiscal expansion, and structural reforms.

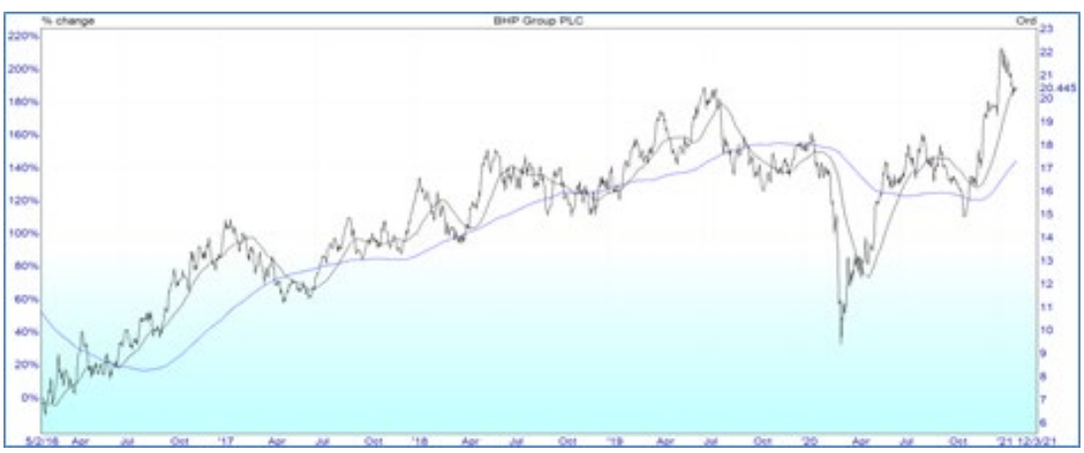
As the domestic economy will be stimulated by the postponed Tokyo Olympics and Paralympics scheduled to be held in July, anticipation is high that Japan will exit deflation and the Nikkei could return to its peak over 30 years ago.

Portfolio Activity & Investments

The past quarter has been relatively quiet for trading in the portfolios. We have reduced our exposure to some defensive funds, such as Finsbury Growth and Income, while continuing to invest in the RWC UK Equity income fund to gain exposure to more cyclical sectors of the UK economy.

In this section we will look at the following stocks and markets: BHP, Rio Tinto, BlackRock Gold and General, David S Smith and Vodafone. (Share graphs source: Alpha Terminal).

BHP



BHP is the world's largest mining company, formed in Australia from the original Broken Hill Proprietary company, founded in 1885. It mines iron ore, copper, nickel and coal as well as extracting oil and gas. It shares, with Rio Tinto, significant iron ore assets in the Pilbara region of north western Australia. These iron ore mines are the heart of the earning power of BHP, with the cost of extraction at about $13 per tonne. The current price of iron ore is circa $150 per tonne. BHP and Rio Tinto share joint ownership of the railway that takes the iron ore from the Pilbara to Port Hedland.

It owns the largest copper mine in the world, La Escondida in Chile, estimated to produce 1m tonnes of copper in FY 2021. Its other copper mines are in Latin America apart from the Australian Olympic Dam mine which it acquired when it bought Western Mining Corporation (WMC) in 2005. Olympic Dam is the largest Uranium resource ever discovered and the 4th largest copper resource in the world.

BHP has energy generation assets in the form of thermal and coking coal in Australia and it shares the vast Cerrejon open cast coal mine equally with Anglo American and Glencore. Its also produces nearly 100,000 barrels a day of oil and gas equivalent.

The prodigious cash flow of BHP is what attracts us to being investors. With a free cash flow yield of nearly 20%, buoyant commodity prices and relatively little debt, we are confident that the dividend yield of circa 6.6% is well covered by earnings and still allows for debt reduction.

The company has good financial discipline and has excellent disclosure in its accounts. The negative aspect to the stock stems from its continuing exposure to hydrocarbon extraction, but we believe the firm will start to dispose of its operations in the coming few years. The stock trades on circa 10.1x June 2021 earnings which hardly does justice to this undervalued giant.

Rio Tinto

The commodities company Rio Tinto, which we have held for some time, is exposed to fewer minerals than BHP, focusing on Iron Ore, Copper and Aluminium. It also finally exited the coal business in 2018.

There have been two concerns at Rio Tinto. The first was the deliberate destruction of a 35,000 year old Aboriginal historical site in the Pilbara to access iron ore reserves which cost the previous CEO his job. The second is the problems they have had and are continuing to have with the Mongolian government over the Oyu Tolgoi Copper/Gold mine in Outer Mongolia.

Despite these problems, the business has been well managed, and, like BHP, the business produces prodigious cash flow and dividends. Debt is so low at Rio Tinto that we believe there is a high chance of a continuing special dividend for shareholders and/or a major share buyback which ought to push the shares higher.

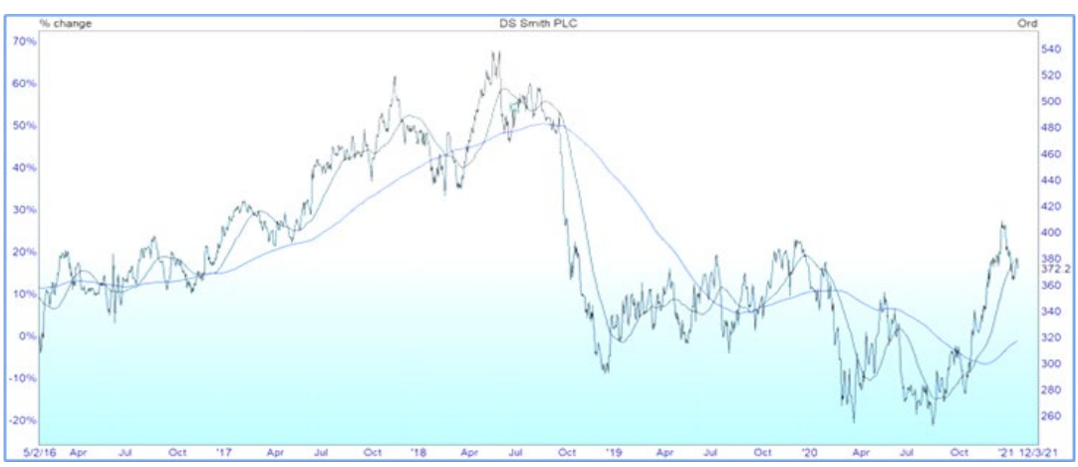
The stock trades on circa 10.4x December 2020 earnings with a 6.2% estimate yield.

BlackRock Gold and General

We invested in the fund in mid-2020 and benefited from a dramatic rise in the gold price and the price of the fund. However the gold price went into rapid reverse in the Autumn of last year and the price of the fund's units has fallen from a peak of $17 to $12.78. We took the decision to exit our position after a rally in the price at circa $13.70 per unit.

Gold benefits when money has no interest rate and is viewed historically as a hedge against devaluation of currencies. However, expectations of a normal cyclical recovery in the world economy. As U.S. long term interest rates rose, the attractiveness of gold declined as did its price.

David S Smith



Paper and packaging group David Smith operates in three main markets – the UK, the EU and North America. It has grown via acquisition, notably of Linpac in the UK in 2011, the purchase of Swedish liner board business from SCA and Europac in 2018 in Spain. The main driver of the business is sustainable packaging and we were attracted to the operations of the company for its ethical benefits, i.e. removing plastics from packaging and replacing them with cardboard. We were also attracted by the depressed share price.

David S Smith had a difficult time in 2019 and 2020 when the share price fell from its high of over 500p per share to a low of 260p. We bought the shares at circa 280p a share and recently exited the position at 365p following a sharp rally in the share price. The stock trades on 15.2x April 2021 estimated earnings with a 3.4% yield covered twice by earnings.

Vodafone

The UK listed mobile phone company, Vodafone, has been an unattractive investment in recent years, and the shares have been in decline following a major investment programme that produced negligible earnings growth and rising debt levels. However recent events have seen us buy into the company following several key factors that underpin the low valuation at current levels.

The first is the upcoming sale of its Vantage Towers mobile phone mast business. This is currently expected to be floated on a very high valuation because it is highly attractive to infrastructure funds that are flush with cash available for investment and because comparator companies are trading on high multiples of profits. This could raise as much as £3bn for Vodafone which can be used to reduce its borrowings.

The second factor is the likely recovery of earnings in 2021 and 2022 as populations start to move around more as the Covid pandemic subsides. The stock trades on 16.8x March 2022 estimated earnings and it should yield 6% in that year. We believe the dividend is covered by free cash flow after spectrum purchases.

This free cash flow is also rising, with Numis securities forecasting cash cover of the dividend rising from 1.1x in FY 2021 to 2x by FY 2024.

Markets & Investment Outlook

In this section we look at U.S. bond yield volatility and the outlook for the U.S. dollar and sterling.

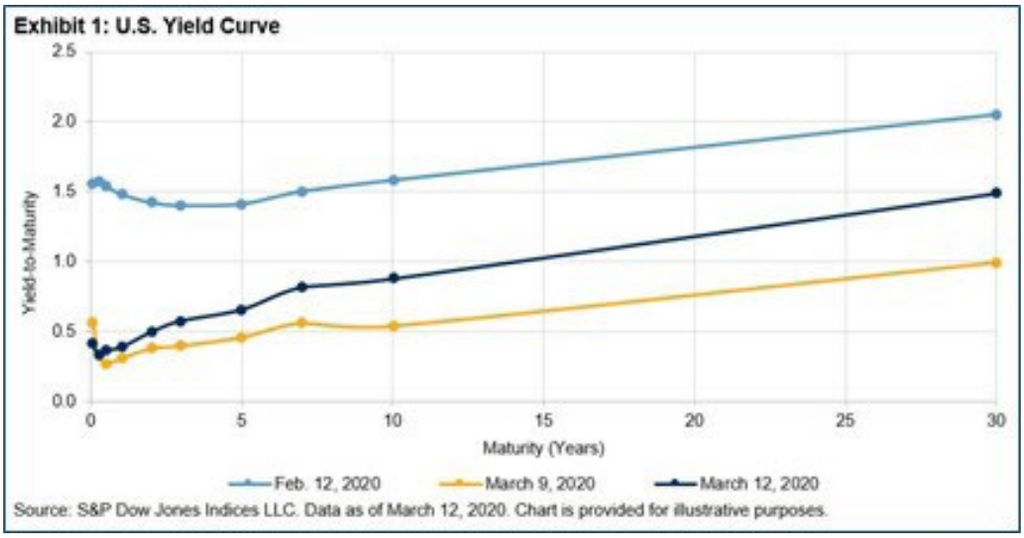
US Yield Volatility and Why it Matters

If you invest in equities, you should watch the bond market. If you invest in property, you should watch the bond market. If you invest in bonds or bond ETFs, you should definitely watch the bond market. The bond market is a good indicator of inflation and economic expectations, both of which directly affects the stock market and the property market and, well, really any financial asset. The yield curve simply shows the yields on the same bonds with varying maturities. The US Treasury yield curve represents the U.S. government bonds issued by the Treasury with different yields to maturity. U.S. bonds are considered one of the safest investments because the U.S. is extremely unlikely to default as it would just print money if it was not able to pay back the loan. The US bond market is the largest government bond market in the world.

The price of the bond and the yield run inversely to each other. When the price of the bond goes up, the yield of the bond falls as the coupon received is fixed. A bond yield is calculated by dividing the coupon with the bond price. When market sentiment is optimistic and the economy is in an expansionary phase, investors tend to possess higher risk appetite and invest in riskier assets for higher returns. They will sell the safe assets such as government bonds and buy riskier assets such as equities. This leads to lower bond prices and higher bond yields. Vice versa, when there is fear in the market, investors will put their money into the safest assets such as the US Treasuries and push up the bond prices while depressing the yields.

So how does the yield on government bonds affect you as an investor and, in turn, the economy? Government bond yields are, among many things, used to base lending rates by banks and financial institutions as well as the discount rates to value financial assets such as equities and properties, called the risk free rate. If bond yields rise, interest rates on consumer and business loans will go up. Higher interest rates increase the borrowing costs for the purchase of property, leading to weaker demand.

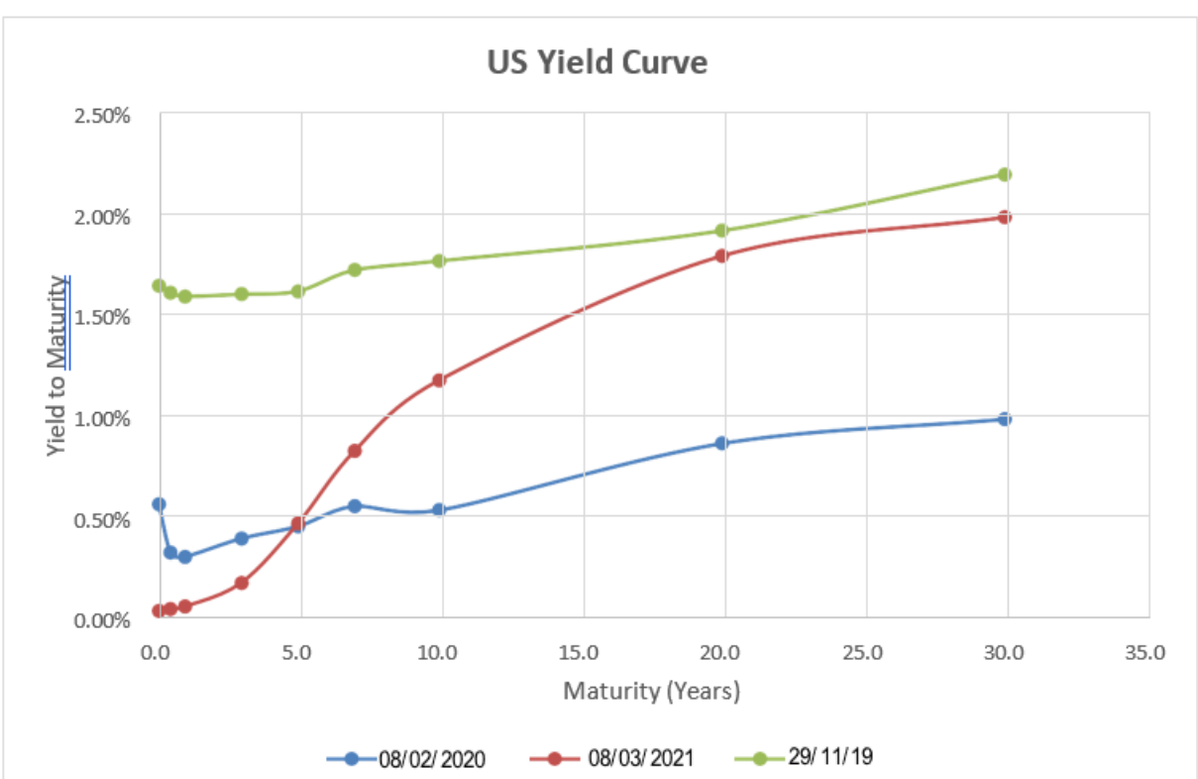
When the pandemic struck in early 2020, government bond prices across the world skyrocketed with yields collapsing. On 25th February, 10-year U.S. Treasury yield hit a record low of 1.33% but two weeks later on March 9th, the height of the pandemic, it fell to as low as 0.54%. Investors were so terrified of the outlook brought about by the pandemic that they rushed to the safest asset, government bonds.



(Source: S&P/Dow Jones)

The chart above shows how the yield curve changed when the pandemic started. In February yields were high as shown by the light blue line. However, as the pandemic chaos hit, yields of all maturities dropped across the board as investors rushed to safety. What is truly remarkable is on March 9th (yellow line), the one-month bond yield was 0.57% and the 10-year bond yield was 0.54%. This is what is known as an inverted yield curve where yields on short-term bonds are higher than those on longer-term bonds. This occurs when investors lose confidence in the stability of the economy in the short term like the next several months or years.

The chart below shows the different yield curves between now and late 2019.



(Source: 4 Shires)

The green line is a more standard yield curve where short-term yields are over 1.50% and yields increase with maturity. The blue line is when the pandemic struck discussed above and the 10-year yield dropped to an all-time low of 0.54% as the curve inverted whereby the 1-month yield higher than the 10-year yield. The red line is the present day and shows how the curve has steepened dramatically and where yields increase sharply with maturity.

This represents market expectations for a brighter economic outlook. However, another reason behind this steepening is the expectation of the return of inflation as the US government implements aggressive fiscal stimulus which has pumped trillions of dollars into the economy and flooded the market with low-cost money.

The rise in yield, which reflects a decline in price of US government debt, comes as the Biden administration lobbies lawmakers in Congress to pass a sprawling $1.9tn stimulus package. The injection would follow a $900bn package passed late last year and a $3tn scheme at the start of the pandemic. Economists have repeatedly revised up their growth forecasts for this year considering this enormous government support, and the additional funds are likely to push estimates even higher.

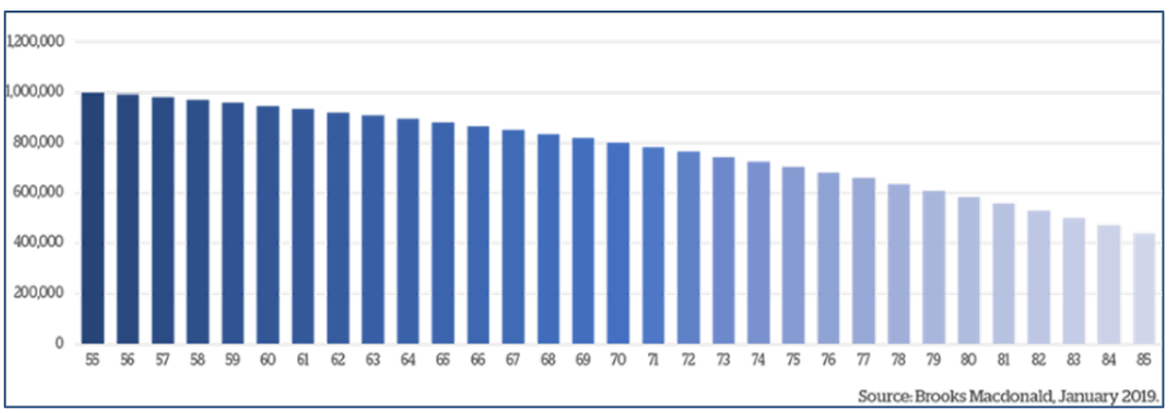
US investment bank Morgan Stanley expects the US economy to expand 6.5% in 2021. Combined with the unprecedented monetary easing launched during the crisis by the Federal Reserve, some market participants believe another aid programme will prompt a more sustained rise in inflation — something the US central bank has struggled to achieve over the past decade. The curve or the red line shows that market is expecting inflation to rise sharply, demonstrated by the largest difference between the 30-year bond and shorter-dated bonds not seen since 2015. Absolute inflation expectations remain low (2% in 30 years' time), although that has doubled over the past year.

So why does this matter to investors? Typically, if inflation goes up over time, the target returns for one's investment must increase at least in line with inflation to achieve a positive real return (i.e. after inflation). This is particularly important when investors are taking a stream of income including the level of income required in the future and the portfolio returns necessary to sustain it. The total return must account for the anticipated level of inflation in the future. This is because inflation erodes the value of assets and income over time.

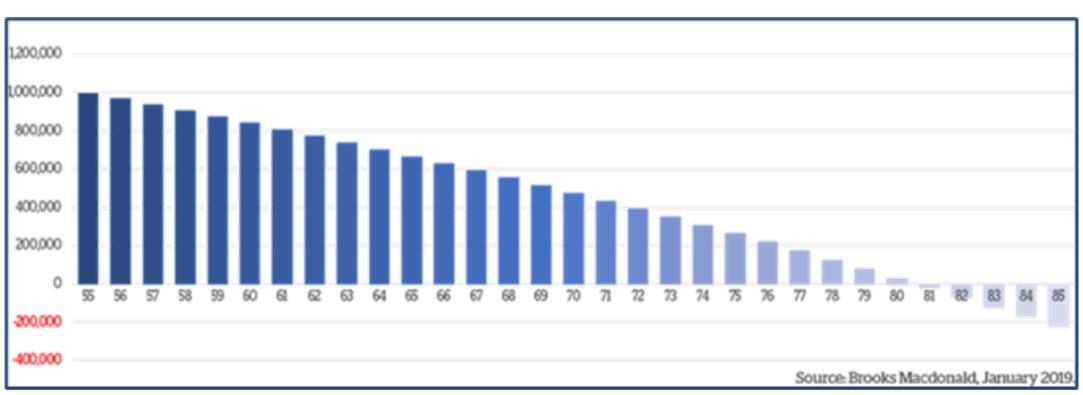
Inflation is an even more important consideration for investors in retirement, given that income is being withdrawn from the portfolio and there is a shorter investment period for future capital growth.

This is illustrated by the two charts below, which show the difference in inflation impact upon a portfolio (where income is being drawn down). The first chart shows the impact of draw down £50,000 p/a assuming inflation is 0% and assets growing at 4% p/a. The second chart shows the same drawdown trend but assuming inflation at 2% (i.e. the income will rise at 2% vs. the previous year to maintain equivalent purchasing power) . As shown, inflation erodes the value of the portfolio completely by the age of 81. Higher inflation rates could do more damage to that income.

Withdrawing £50,000 with no inflation from age 55, with 4% asset growth to age 85



Withdrawing £50,000, rising at 2% inflation, from age 55, with 4% asset growth to age 85



To summarise, the US yield curve is a good indicator of how market participants view where the economy is heading. At this moment, investors are expecting a sharp recovery in economic growth, supported by stimulus packages and low interest rates for the foreseeable future, and a rise in inflation. Therefore, it is important that investors are well aware of the yield curve and how it predicts future inflation because it could be detrimental to a portfolio's return.

Outlook for the U.S. Dollar

The US. Dollar Index (DXY), a measure of the value of the dollar against a basket of global currencies including the pound, the euro and the yen, has resumed its decline as financial markets embrace post Covid economic recovery, depreciating by nearly 10% since last May. After hitting a 12-year high after Donald Trump won the Presidential election in November 2016, the dollar index has been trapped in a narrow range of 90 and 100, unable to break out.

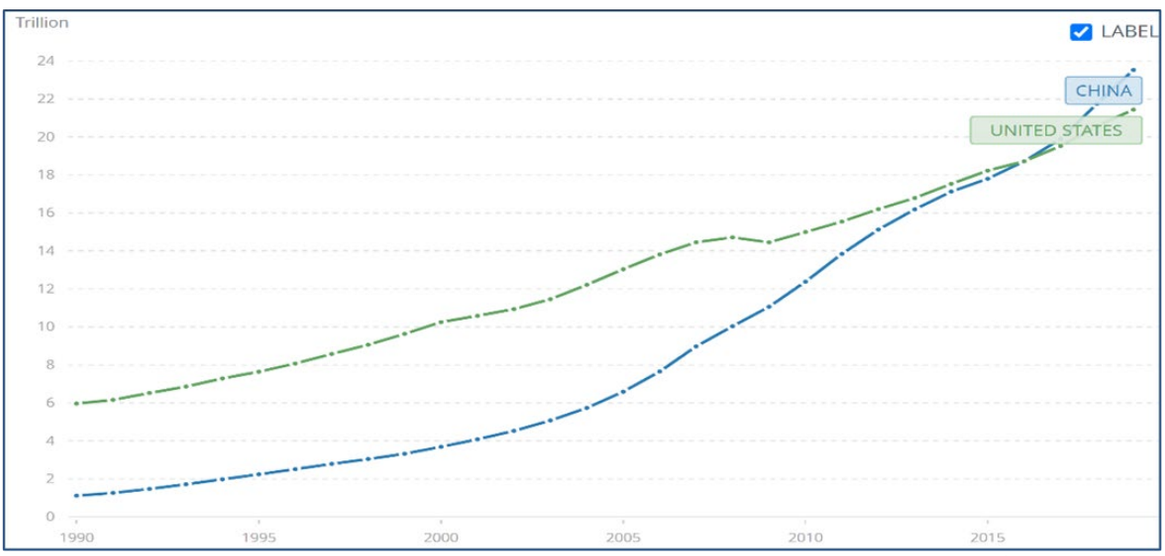
With aggressive monetary easing and fiscal stimulus under the new Biden Administration, questions arose about whether the dollar would start a new downward cycle as it did in the early 2000s and the question of its sustainability as the world's reserve currency.

According to the International Monetary Fund (IMF), 61% of all foreign bank reserves are denominated in dollars as well as 40% of the world's debt. This is largely due to the size of the U.S economy and the dominance of the U.S in global trade as the largest consumer market in the world. Despite large current account deficit, mounting government debt, and aggressive money easing, U.S. Treasuries remain the world's safest asset.

The chart below shows the long term trend of the dollar since the early 1970s which illustrates how over the past four decades the Dollar has been gradually declining. Although there have been peaks and troughs following the global economic cycles and capital flows and ebbs, it has been unable to reach the previous peak but forming a lower bottom each time.

If a currency symbolises the strength and dominance of an economy, this chart is indicating a potential shift in the world's economic dominance away from the US.

According to the World Bank, China's economy has already caught up with the U.S. at $23.5 trillion compared to the US' $21.4 trillion if we use the purchasing power parity (PPP) instead of the current currency exchange rate (see below). The PPP, the so-called Big Mac Index, adjusts currencies based on what basket of goods they could buy in those countries rather than currency exchange rates. It also adjusts for the difference in cost of living between countries.



(Source: World Bank)

As export driven economies and with very high saving rates at home, China and Japan constantly run very high current account surpluses which lead them to hold large amounts of US Treasuries in their central bank reserves. With a combined $2.2 trillion of US Treasury holdings, the currently second and third largest economies are unlikely to dispose of their holdings anytime soon as sharp appreciation of their own currencies against the dollar induced by the sale of the US Treasuries will weaken their global competitiveness and reduce their exports.

While it is unlikely that we will see a sharp decline in the dollar in the very near future, for the reasons above, the weakening dominance of the US economy is likely to cause a structural decline in the importance of the dollar over the long term. This could lead to a new currency to take the lead to become the world's reserve currency. In the short term, the weaker U.S. dollar induces risk appetite and supports riskier assets such as emerging market currencies and equities as well as commodities.

Outlook for Sterling

The UK Sterling Pound has been volatile in the last few years since the EU Exit referendum in 2016 when it fell to 1.20 against the dollar. However, after hitting the low in March during the pandemic, it has recovered strongly by 15% to 1.39 at the time of writing. The finalisation of the Brexit deal has lifted some of the uncertainty around the country in the short term and sterling produced a relief rally, outperforming the Dollar and the Euro as shown in the graph overleaf.

(Source: Yahoo.com)

Despite the strong recovery, the long term prospects for the pound remains uncertain due to the economy's structural challenge of slow productivity growth. Although the Brexit trade deal guarantees that goods such as food, clothes, white goods and machines will continue to trade without tariffs, there are caveats likely to undermine the Brexit transition and pose threats to trades between the UK and the Continent.

The lack of an agreement with the EU for the service sector, especially the financial service sector, UK's largest export generator, is already hurting the long term prospects of one of the UK's most competitive sectors and is causing businesses to restrain from long term strategic planning and investment.

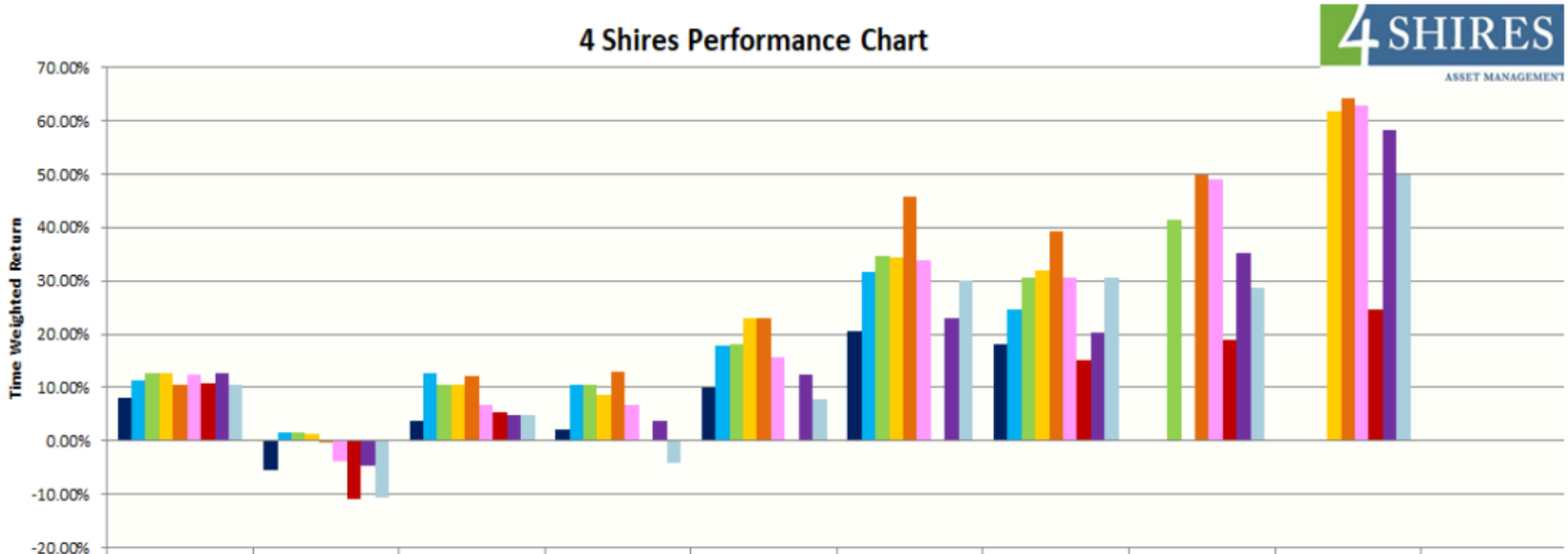
Being the biggest single market UK exports, any disruption in trade with the EU will pose a substantial impact to the UK's economy and potential fragile recovery from the pandemic. In addition, as the UK becomes an independent trading nation outside all major trading blocs, there is an incentive to use a weaker currency to regain its competitiveness and promote exports.

Investment Outlook

Investment markets are continuing to rally as a result of economic stimulus, accommodative central banks and light at the end of the Covid tunnel due to the newly developed vaccines. We expect this rally to continue as the cyclical recovery takes hold.

JLS/DIS/HAH 18/2/21

Investment Performance - To 5th February 2021



	6 months	1 year	2 years	3 years	4 years	5 years	6 years	7 years	8 years
Risk A	8.00%	-5.53%	3.80%	2.21%	9.90%	20.46%	18.15%		
Risk B	11.21%	1.64%	12.82%	10.60%	17.85%	31.61%	24.55%		
Risk D	12.81%	1.58%	10.49%	10.50%	18.17%	34.76%	30.59%	41.56%	
Risk E	12.68%	1.25%	10.49%	8.65%	22.99%	34.38%	31.92%		61.64%
Risk F	10.59%	-0.02%	12.15%	13.00%	22.99%	45.73%	39.29%	49.93%	64.18%
Risk G	12.36%	-3.85%	6.84%	6.82%	15.69%	33.90%	30.62%	48.92%	62.75%
Risk H	10.76%	-10.94%	5.50%				15.01%	19.05%	24.66%
Risk I	12.68%	-4.57%	4.83%	3.75%	12.51%	23.02%	20.42%	35.17%	58.25%
UK IMI	10.51%	-10.74%	4.97%	-4.19%	7.89%	29.92%	30.52%	28.57%	49.88%

Notes: Performance is measured to 05/02/2021. 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.

(Source: 4 Shires)

Important Compliance Information

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

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.

Research & Events in 2021

We look forward to keeping you in touch with the world of investment and how it affects you throughout the coming year.

February
Winter 2020 Investment Commentary & Webinar

March
Budget Review Report
Wealth Matters, our bi-monthly financial advice periodical

April
Financial planning webinar

May
Spring 2021 Investment Commentary & Webinar
Wealth Matters, our bi-monthly financial advice periodical

June
Investment Seminar & Garden party
St James's Square, London

Shires House
School Lane
Gillingham
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