4 SHIRES
ASSET MANAGEMENT

Investment Commentary

Spring 2021

Expert Asset Management
Investments | Pensions | Financial Planning

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4 SHIRES
ASSET MANAGEMENT

Introduction

Welcome to the 4 Shires investment commentary for the Spring of 2021.

The recent excitement in the world economy following the development, approval and roll-out of Covid 19 vaccines continues to shape the path out of the pandemic.

In this edition we review our central economic thesis for markets and review the state of the world economy as we begin to exit the Covid pandemic. We look at the impact of higher corporate tax rates, the British budget and Tesla's imaginary profits amongst other articles.

In the markets section we look at how oil stocks have not kept up with the oil price, how bond markets have moved with higher inflation expectations and special purpose acquisition vehicles (SPACs).

If there are any subjects raised in the quarterly you would like to discuss, or with regards to you own finances, please do get in touch.

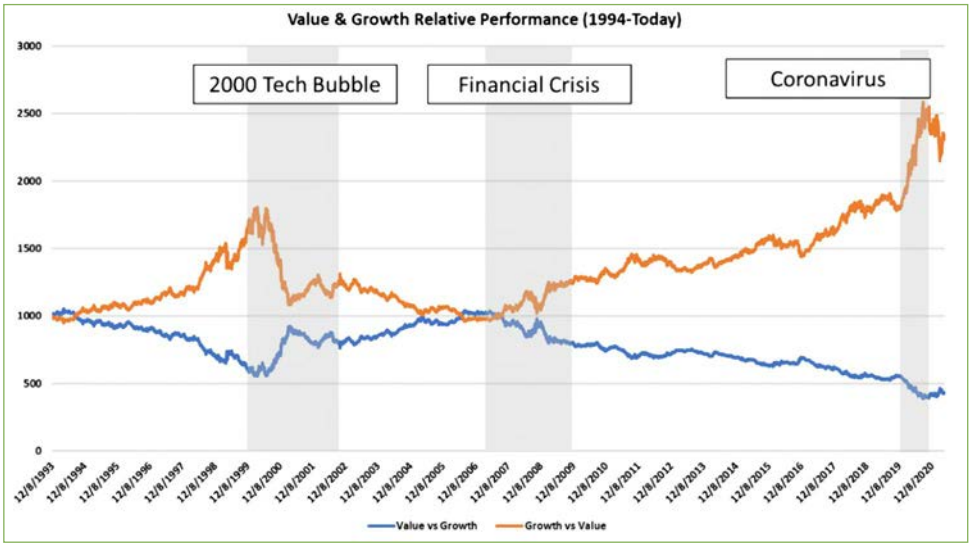
Central economic thesis

Value to outperform growth

Value stocks and growth stocks can behave extremely differently depending on the economic cycle and typically have very opposite characteristics. Value companies generally have low price-to-book values, high dividend yields and a low price-to-earnings ratio. They tend to look cheap because investors have fallen out of love with them which has consequently led to a depressed share price. Typically, they trade at a lower price than the intrinsic value of the company's assets or their prospective earnings. Growth stocks are the exact opposite. They have a high price-to-earnings ratio and a low dividend yield. Investors expect these companies to continue to grow their earnings and the share price will generally be a lot higher than the actual value of their assets. Value sectors currently consist of financials, industrials and energy companies whilst growth stocks will mostly be technology, media, new economy or consumer goods companies.

The chart below shows the performance of value stocks vs. growth stocks over the last 30 years. The first segment shows the bursting of the late 1990s technology bubble. Prior to this period, growth stocks had substantially outperformed value stocks, but when that bubble ultimately burst, growth stocks then severely underperformed. Heading into the Financial Crisis, value stocks (led by financials) were outperforming, and then have underperformed ever since. The last highlighted section shows growth stocks again outperforming to a high degree (which is shown by the orange line from 2007 onwards). The last ten years have seen an incredible divergence between the performance of value and growth.

During the last ten years we have seen historically low inflation, low interest rates and unprecedented monetary stimulus. This is often the reason given as to why growth stocks



(Source: Canterbury Investment Management)

have performed so strongly during this period. This is emphasised by the fact that the U.S. markets, which are currently dominated by growth stocks, has significantly outperformed Europe and Japan which have a lot more of a value make up. In a low interest rate, low inflation world, growth stocks tend to perform better while value stocks tend to do better when inflation and interest rates are higher. This means investors are forced to discount the future earnings of growth companies more. In turn, this reduces today's value of those future earnings, causing the price of growth stocks to fall.

The reason we believe value stocks will outperform is because they are cheaper than growth stocks, economic recovery will show a recovery in profits and we expect inflation to rise which should help value to outperform growth. The unprecedented fiscal and monetary stimulus injected into the global economy by central banks and governments has led to an oversupply of money into the economy. As we can see by the rise in 10-year U.S. Treasury yield, it is expected that inflation is coming, which will inevitably lead to a rise in interest rates. In the last 6 months we have seen value stocks outperform growth and we expect this to continue to happen as inflation rises and subsequently interest rates.

Bond markets & other assetes

In this environment we believe that bonds will underperform due to the impact of inflation on the income received from bonds. Bond prices have an inverse relationship to interest rates and inflation. When interest rates and inflation fall, bond prices rise, and now that these indicators are set to rise, we would expect bond prices to fall, as they have been doing since Q4 2020.

Commodity supercycle

In the last few months commodity prices have surged showing increasing demand and tight supply. We have seen copper and iron ore hit all-time highs whilst oil is up 25% since the start of the year. The term "supercyle" is reserved for the very largest fluctuations, when commodity demand is strong and sustained, supply is tight and prices rise above their long term trend for a lengthy period. The industrialisation of the United States at the end of the 19th century and the post-war re-industrialisation of Europe and Japan in the late 1950s are two such examples. More recently, the rapid economic growth of BRIC countries, most notably China, sent demand for commodities, and with it prices, soaring in the early years of the millennium.

However, the global financial crisis, together with slower than expected Chinese consumption lead to a significant fall in commodity prices over the last decade. After languishing in a bear market for the past ten years, 2020 saw commodities find favour with investors once again. In 2021 commodity prices have continued to rally hard as global infrastructure spending has led to vast demand. At the same time, a weakening U.S. dollar, combined with the widespread fiscal stimulus, has stoked concerns of growing inflation, against which commodities have historically been used as a hedge.

Demand is only part of the story. Having learned the lessons from the last cycle, there has been a lack of new mine supply, and this is causing a tight market for commodities that is allowing prices to rise. It takes between 5 and 10 years to build a new mine from discovery, and this indicates that tight supply will be a feature for the coming decade.

According to commodity analysts at J.P. Morgan: "The past decade was marked by low growth and low inflation. Bonds and secular growth stocks were in a bull market, while commodities and cyclical stocks performed poorly. We believe that the tide on yields and inflation is turning." The new commodity upswing, and in particular the oil up-cycle, has started. Mostly, it will be the story of "post-pandemic recovery, ultra-loose monetary and fiscal policies, weak U.S. dollar, stronger inflation, and unintended consequences of environmental policies and their friction with physical constraints related to energy consumption and production".

Furthermore, the impact of the green industrial revolution, with countries across the globe vowing to spend big to meet their climate targets is likely to raise demand for commodities. China, the largest energy producer and consumer in the world, recently committed to become carbon neutral by 2060. Beyond China, the U.S. Biden administration has set a new $2-trillion green deal, while the European Union has pledged to reduce greenhouse gas emissions by at least 55 per cent up to 2030, compared with 1990 levels. This sustainable push will push demand higher for commodities, in particular copper and iron ore. Analysts at Goldman Sachs believe this transition has the potential to create $1 trillion to $2 trillion a year in infrastructure investment, surpassing oil and gas drilling for the first time.

We at 4 Shires believe this to be just the start of commodity supercyle that could last for years. With the incredible increase in infrastructure spending as a result of the pandemic and a push for green sustainability combined with a weaker dollar and higher inflation, this is likely to push commodity prices higher and likely to result in significant increases in profit for big commodity and mining companies.

U.S. economic surge

President Joe Biden has hit the ground running, and, with an echo to Franklin Delano Roosevelt (FDR) in his first 100 days, he has been busy with significant legislation to correct President Trump's legacy, driving America's economic and social policy with a snowstorm of dollars.

The economic effect of such a large stimulus to the economy has been a surging labour market. The chart below shows the U.S. unemployment rate over the past 20 years and the collapse in

(Source: U.S. Bureau of Labor Statistics)

unemployment due to Coronavirus, followed by a market recovery with unemployment dropping from nearly 15% to 6% since summer 2020. This drop in unemployment has come with a tight labour market.

The infrastructure investment, carbon change plans and other stimulus measures are driving the economic recovery. U.S. GDP grew at an annualised 6.4% rate in the 1st quarter. Warren Buffett has described the economic rebound as 'red hot', saying "we're seeing very substantial inflation. It's very interesting. We're raising prices. People are raising prices to us and it's being accepted."

U.S. GDP quarterly growth chart

Currently, Fed Chairman Jay Powell says this inflationary surge will run out of steam. However, most of the stimulus money has yet to be spent in the U.S. With Joe Biden's cash yet to be spent, and with a tight labour market and buoyant expenditure, the potential for inflationary surprises cannot be discounted. What can't be denied is that U.S. economic growth is good for the world economy

Higher corporate taxes

This surging economic growth and its associated government stimulus packages will need to be paid for at some point. Countries are looking at increasing corporate tax rates, notably in the U.S. and the U.K. President Joe Biden has proposed an increase in corporate taxes from 21% to 28%. In addition, he wants to remove the carried interest from private equity that has shielded so many gains from the Internal Revenue Service (IRS). In the U.K., Chancellor Rishi Sunak recently announced that corporation tax from April 2023 would rise from 19% to 25%, whilst at the same time preserving a lower rate of tax for businesses that make less than £250,000 of profits per year.

Janet Yellen, U.S. Treasury Secretary, has also proposed that developed economies have a minimum corporate tax rate of 21%, up from 10.5%, creating a more level playing field. This would mean jurisdictions such as Ireland and the Netherlands could no longer have tax rates that reduced taxation income for governments. These loopholes are widely used by multinationals.

The impact of higher tax rates are higher valuations in the stock market for companies as a result of lower net profits for shareholders, i.e. lowering earnings per share. Lower net profits could also mean lower dividends or reduced dividend growth. As with all government policies, there is always someone paying more to fund the inexorable rise in government expenditure. However, companies have had tax rates reduced in many mature countries, and this race to compete for corporate residency has probably come to an end. This time shareholders will find that they are the ones paying the government via the companies in which they invest.

The question as to whether this increase in tax could cause a market correction is not yet certain. Valuations are high, but recent quarterly earnings have beaten analysts estimates to varying degrees. In the first quarter, over 80% of U.S. corporate earnings have so far beaten consensus estimates and elsewhere in the world this has been repeated to a lesser extent. As such the cyclical recovery is supporting valuations. However the tax rises will at some point put a brake on earnings. In the U.K. that won't be until the second half of 2023.

U.K. Budget

Chancellor of the exchequer, Rishi Sunak, has revealed a budget that has balanced the needs to spend now to stimulate the economy and also rein in the deficit growth in later years through stealth tax rises and the rise in corporation tax.

Companies

Hospitality industries have had significant support during the crisis, and that support will be continuing into 2023. VAT for the hospitality sector will remain at 5% until 30th September 2021 and then increase to 12.5% until 30th March 2022. Business rates for hospitality companies will be cut by 2/3rds from July 2021 until June 2023. These measures ought to be sufficient to power results in the sector as consumers are very keen to eat out and drink. Indeed, there are concerns that there may be a beer shortage in coming months as the pubs reopen, and a staff shortage is also a possibility post Brexit.

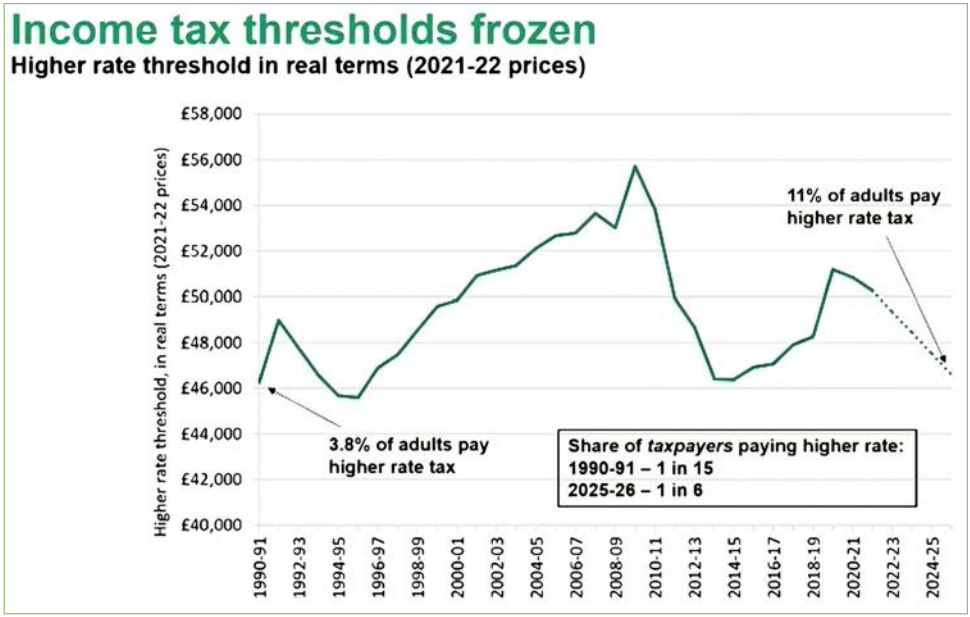
The furlough scheme has been extended until September 2021 for up to 80% of salaries. The question is whether all those people who were on furlough will be rehired.

As mentioned above, corporates will be paying 25% corporation tax from April 2023 onwards. To help offset that effect there will be enlarged capital investment allowances. These will potentially allow companies tax relief at 25p in each £1 on plant and equipment. This will be a help to any companies considering purchasing new capital equipment (it does not apply to second hand).

Personal

There is little good news for citizens in the budget bar the extension of stamp duty and the government underwriting of 95% loan to value (LTV) first time buyer mortgages of up to £600,000. The stamp duty holiday for houses up to £500,000 will end on 30th June 2021, changing then to only houses below £250,000 being exempt until September 30th 2021, at which point the stamp duty holiday will end.

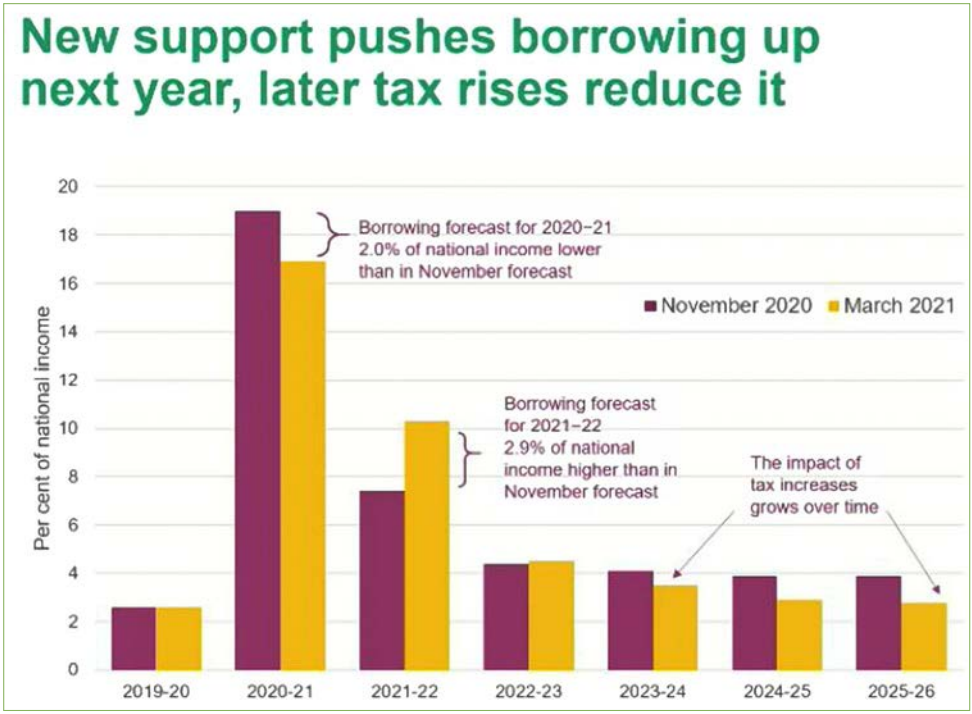
Personal tax allowances will be frozen until 2026, and this will be where the government will increase its tax take as inflation means that more of people's earnings will end up in the Treasury. This method was used extensively by Gordon Brown during the 2000s. The chart below shows this reduction in allowance in real terms (i.e. after inflation) reducing the effective high rate threshold to under £47,000 by 2025.



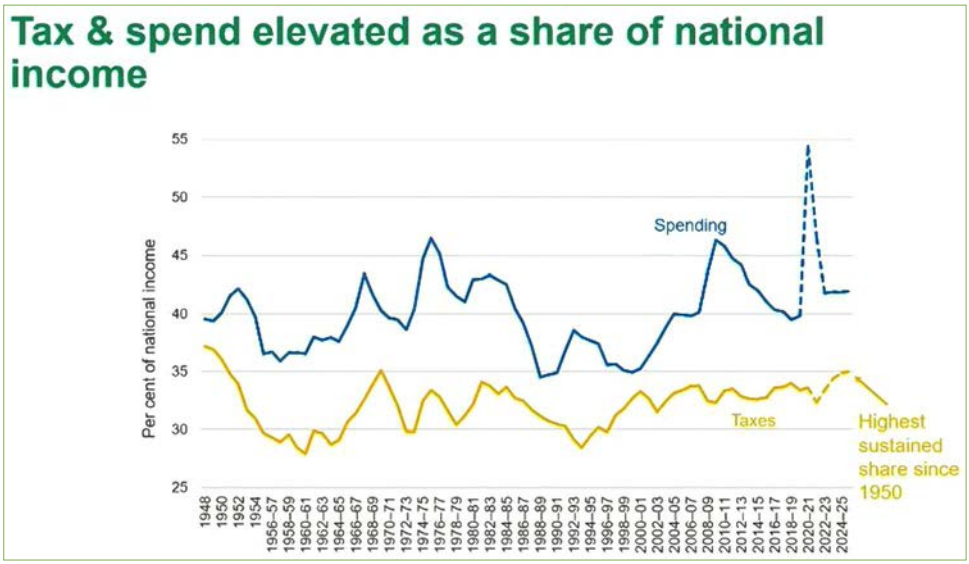
(Graphs Source: Institue of Fiscal Studies)

The pension lifetime allowance (LTA) will also be frozen until 2026 at £1,073,100 until 2026. This will affect those with large pensions and those that hover around the LTA. If this affects you, please do get in touch so that we can discuss if there is anything you could do for mitigation.

Government will also be looking to cut costs, and the chart above from the Institute of Fiscal Studies shows the effect of the budget on government expenditure and the deficit up until the end of the 2025/26 tax year:



The net effect of these tax rises is for government tax take as a percentage of national income to peak in 2024/25 at the highest rate since the late 1960s:



Covid Update

As the British economy begins to come to life as the latest Covid lockdown is wound down and infection rates are below the critical R=1 level, it is worth remembering that this is not the case elsewhere in the world. However the light at the end of the tunnel for the world is getting brighter as vaccination programmes around the world are gaining speed and reaching larger percentages of populations.

Sadly, Brazil and India are showing the problem that exists when governments are in denial of the realities of the virus' ability to spread at near exponential speed. The graph above from the FT shows the surge in India caused by the government allowing vast general election rallies. This has caused a health emergency in India and an oxygen and hospital bed shortage. Brazil has only recently looked like death rates are peaking. Both countries have also suffered from the new variants spreading in their respective countries. The good news in other countries has come from the roll out of the mass immunissation programmes (at the time of writing the U.K. is starting to vaccinate 40-45 year olds). Israel is the first country to have vaccinated all of the population it considered to be at risk. The situation in the U.S. is clearly improving, albeit both France and the U.S. at present are seeing deaths plateau rather than drop.

Smaller, developing countries are not shown on these charts, and there is a chronic shortage of vaccine doses in those locations. The advent of summer may reduce infection spread, but a third wave is possible given new Covid variants. However it is likely that the world has seen the last of the national lockdowns, and that when they end, normality can reassert itself, albeit a new normal of more distance working and other effects.

Russian sanctions, oil and self-sufficiency

The recent build up of Russian troops, and subsequent withdrawal, from the Ukrainian border showed Vladimir Putin cannot be ignored. Putin wrested a promise of a U.S./Russia summit from the military escalation, no doubt with the hope of reducing the quantity and effect of sanctions on the Russian economy.

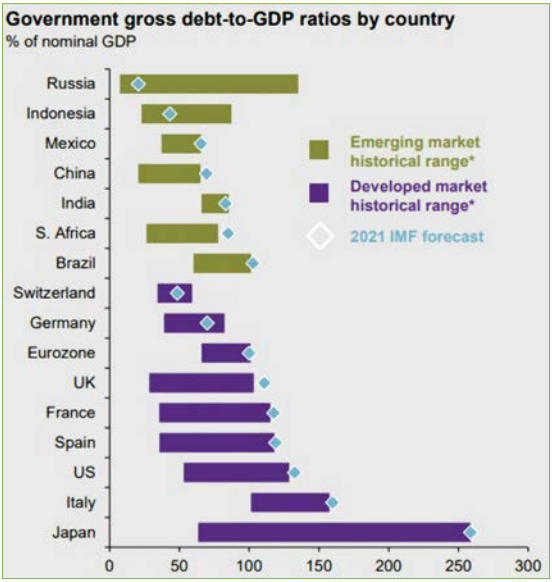
Russian sanctions were imposed after the invasion and annexation of Crimea, part of the Ukraine. The Russo-Ukraine war that followed also caused sanctions. The second set of sanctions came after the attempted murder of Sergei Skripal and the final set of sanctions came as a result of the interference in the U.S. 2016 presidential elections (although they actually came into effect after the Skripal sanctions).

The primary target of the sanctions were individuals close to the centre of power, preventing access to international businesses and freezing of overseas assets. But these sanctions now cover 5 of the largest banks, shipbuilding, semiconductors, defence systems and gas turbine engines.

The effect of these sanctions were slightly damaging, but nowhere near as destructive to the Russian economy as the fall in the price of oil over the last 7 years, as seen in the chart below. Russia had to do something about the oil price collapse, and a year ago the OPEC+ group that includes Russia, agreed to a 9.7m barrel a day cut in production as the effects of the Covid lockdowns on fuel consumption became apparent. This was the largest production cut since the bgenning of OPEC. The current oil price rally will last as long OPEC+'s production quota discipline and Iran's embargo remains.

Russia has already reduced its exposure to the Western financial system, increased its grain production and sought to expand links with markets outside of the U.S. sphere of influence. Grain has become a more important export earner than defence, and domestic food is 80% sourced from within Russia, versus 60% in 2014. In 2018 the Russian government announced plans to invest $51bn to boost food exports by 70% (to $45bn) by 2024.

(Chart source: dailyfx.com)



(Chart source: JP Morgan)

Jack Ma, Alibaba and China

Alibaba, one of China's preeminent internet corporate giants, has just been fined $2.8bn by the Chinese government for monopolistic practices across its busineses. Alibaba, in some ways China's Amazon, also has a significant financial services business, Ant Financial, which was about to float on the stock market in late 2020. When Jack Ma, Alibaba's chairman and founder, poured scorn on the banking regulators of China, he disappeared from public view and Ant Financial's float was pulled by those selfsame financial regulators.

This growing self sufficiency has also extended to the financial sphere. There was a drop in the rouble as a result of the sanctions, but more noticeably when the oil price plunged in 2020. But the Russian government had been running surpluses until the Covid pandemic, and even now its debt to GDP is only 22%, the lowest amongst developed and emerging countries. The chart above also shows the range of previous debt levels. Russia also has the world's 4th highest foreign currency reserves at just under $600bn.

What is clear is that despite a damaging set of sanctions and a far more damaging drop in oil prices, Russia, a country in conflict with the West, has managed to significantly shore up its economic position. The recent oil price recovery will strengthen the country further, and possibly embolden its leadership.

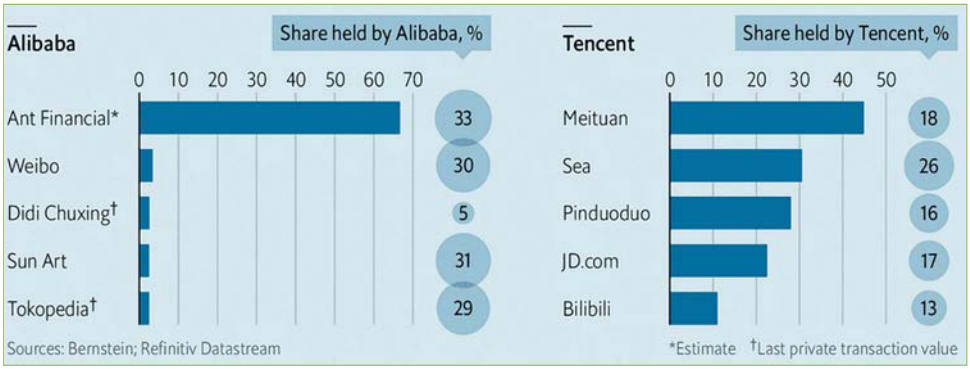
What seemed an inexorable rise in the value of Chinese internet companies was stopped overnight. The chart below shows the initial drop in values (in $trn) from the time of Jack Ma's disappearance, a subsequent rally and then a recent fall.

(Charts source: Economis/Bloomberg)

Since the aborted flotation, the authorities have forced Ant to become a financial holding company, undermining its lucrative, asset-light business model of matching depositors with lenders. Further restrictions also mean that there is wall between the data held by Alibaba and Ant Financial, which reduces the ability of the companies to data mine their own customer bases for new business and cross-selling opportunities.

But it was not just Alibaba in the sights of the Chinese government. Ten Cent (owner of the WeChat social network), Pinduoduo (online grocer) and Meituan (food delivery) were also targeted. President Xi Xinping publicly criticised the groups despite years of corporate cooperation with state regulators on surveillance of China's citizens. In addition, Alibaba and Ten Cent own shareholdings in many other large internet companies:

Value of top 5 holdings in internet companies held by Alibaba and Ten Cent



Interestingly, foreign companies still have large shareholdings in both Alibaba and Ten Cent. Softbank of Japan owns 24.9% in Alibaba and Napster, via its listed subsidiary Prosus, owns 28.9% of Ten Cent.

China was clearly worried about the growing power of the internet giants and have publicly clipped their wings. Property rights have little or no protection when it comes to the Chinese government. Foreign shareholders also need to be careful (Alibaba's primary listing is New York) when investing in companies that may face further restrictions.

Tesla & imaginary car profits

The most desirable electric cars in the world come from Tesla. It has ramped up production, producing 500,000 cars last year, and is on track to produce over 600,000 cars in 2021 after the opening of its new Shanghai factory.

Given the car brand's popularity and scale of production you might be surprised to know that Tesla makes no money whatsoever from making cars.

In the first quarter profit release out at the end of April, the company stated that it had made $438m of net profits. However $101m of that profit came from selling 10% of the company's bitcoin holdings that Elon Musk bought with such publicity in 2020. He has even redefined his finance director as 'Master of Coin' at Tesla. The chart below shows the company's exposure and profits from bitcoin.

(Source: Refinitiv © FT)

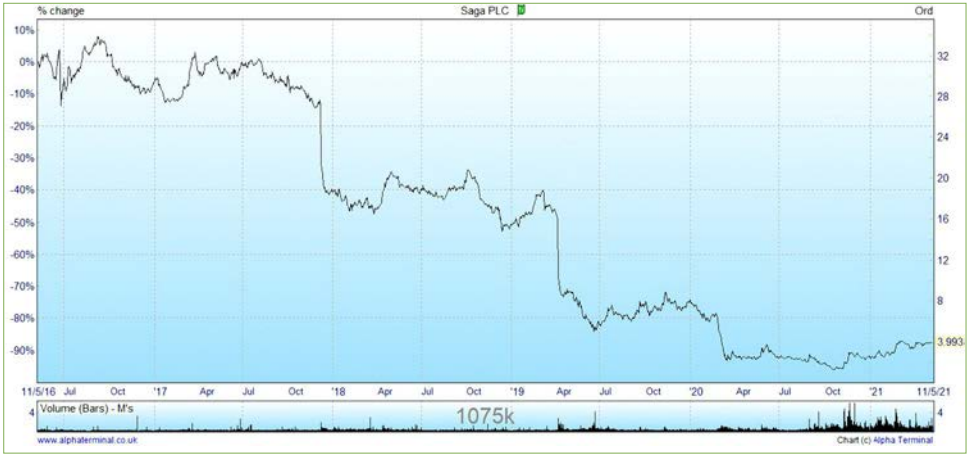
(Graphs source: FT)

Even more productive has been the profits from selling carbon credits, producing over $400m of profits with an 80%+ profit margin. These carbon credits are sold to other car companies that are not yet compliant with emissions rules and need to buy the credits to offset their more polluting car ranges.

But Tesla is facing more competition, and price cuts by competitors have reduced average selling prices. It is still not clear at what point the company can make money from selling cars. At the moment, Tesla remains a financial profit manufacturer.

Portfolio Activity & Investments

The start of 2021 has seen a repositioning of portfolios more in line with economic recovery. We have reduced technology weightings globally (**Scottish Mortgage**) and in Asia (**JP Morgan Asia Growth and Income**). We continue to find value opportunities in the U.K. and believe Europe offers interesting recovery opportunities. We continue to like **Henderson Eurotrust**, where a circa 10% discount to NAV has developed, and we have taken a new position in **Montanaro European Smaller Companies** investment trust. This quarter we are looking at some of the interesting stocks we have been researching including insurance and travel business **SAGA**, pension administrator **Curtis Banks**, inhaled pharmaceutical business **Vectura** and speciality chemical business **Synthomer**.



(Graphs source: Alpha Terminal)

SAGA

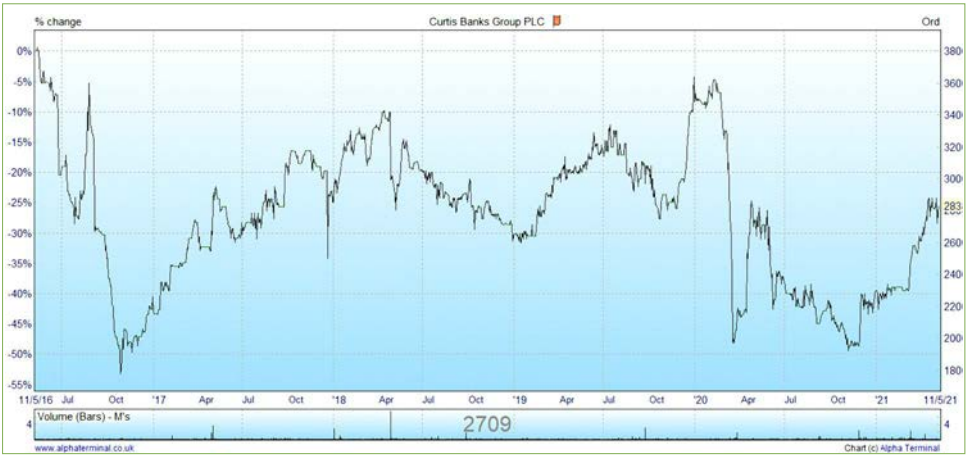
Saga is a company focused on the older members (50+) of society. It was founded by Sidney de Haan in 1951, then run by his son Roger until it was bought by private equity in 2004 and quoted on the London Stock exchange in 2014.

It has two main businesses; insurance and travel. The former insures cars and homes, partly on its own books and partly as a broker. This is the core of the business, making £134m (pre central costs) last financial year.

The travel business organises tours and cruises. The latter involves their own ships, both for river and ocean cruises. The recent construction and launch of their own cruise ships, the Spirit of Adventure and the Spirit of Discovery, came at the time when Covid started. The huge debt required to purchase the ships meant that Saga shares collapsed from over £32 a share in 2017 to under £1.50 in 2020.

The business has refinanced following a £100m cash injection from Roger De Haan, who now owns 26.3% of the business. The banks that financed the cruise ships have allowed covenant waivers, i.e. not forcing the company to repay its debt now but deferred to when there is revenue coming into the business. The debt on the cruise ships is significant, and any slowdown in the business would probably require a further fund raising from shareholders. Current bookings look strong.

The business is highly leveraged to a return of profitability in the cruise business, in addition to the steady (but improving) insurance business. Numis securities are currently forecasting earnings of 12.6p to January 2022, 58.8p to January 2023 and 64.4p to January 2024, or a p/e ratio of 6.7x Jan 2023 earnings falling to 6.1x Jan 2024. However, there will be minimal cash flow left in the business to pay dividends until the cruise ship debt diminishes or a debt reorganisation takes place. We are optimistic on the recovery of the cruise business, but it won't be plain sailing from here due to the variability of profits as a result of the huge debt pile. Shareholders should take comfort from the return of Roger DeHaan.



Curtis Banks

Curtis Banks is a pension administration business that provides the wrapper for self-invested personal pensions (SIPPs). Their customers are some of the largest wealth management firms in the U.K.. The business has grown both by acquisition and organic growth. They recently purchased two companies, an IT provider and a SIPP administration business, that offer considerable merger benefits.

The company trades on 15.3x December 2021 earnings falling to 14.6x 2022 earnings, with dividend yields of 3.6% and 3.9% respectively. We purchased the shares for our AIM portfolio clients as we believe there is considerable upside in the shares if they deliver the benefits outlined in their business strategy.

Vectura

Vectura is a world leading inhaled drug and drug delivery business. It is the product of several companies including ML Labs, Skyepharma and Vectura. It can be described as a contract design and manufacturing operation (CDMO) in that it partners with drug companies in the inhaled therapeutic space (e.g. asthma inhalers) to develop a delivery mechanism that works with the chemical that the patient needs. It receives income in the form of royalties and product sales.

It has worked with major pharmaceutical companies, particularly Novartis of Switzerland and Bayer of Germany. An exciting development recently has been the relationship with Hikma (U.K. listed) to develop a generic, or off-patent, version of Advair, GSK's asthma drug. GSK has also had to pay Vectura circa $200m to settle a patent infringement case. This will fund a 19p, or 16% special dividend. After this payment the shares will consolidate, meaning fewer shares in issue, but the same level of profits which ought to enhance earnings per share.

The stock trades on 23.8x December 2021 earnings falling to 16.3x December 2022 earnings, although these valuations may fall post the share consolidation.

Synthomer

Synthomer is a speciality chemicals business that has been benefitting from Covid related sales of its latex (rubber) based chemicals, that are used in the manufacture of surgical gloves. It has other speciality chemicals businesses and purchased Omnova in April 2020. This new acquisition has proved to be very successful, and the super normal profits from selling latex chemicals can be reinvested in further bolt-on corporate acquisitions.

The company will benefit from the economic activity and yet remains on a relatively low p/e rating of 8.7x December 2021 earnings and 11.2x 2022 earnings, yielding circa 3.4% prospectively. This valuation doesn't take into account the potential to reinvest the latex profits into other areas of the business, or the potential for a special dividend for shareholders.

4 Shires
Client Events 2021

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

May

Spring 2021 Investment Commentary
Spring 2021 Investment Commentary webinar
Wealth Matters, our bi-monthly financial advice periodical

August

Summer 2021 Investment Commentary
Summer 2021 Investment Commentary webinar
Wealth Matters, our bi-monthly financial advice periodical

September

Investment seminar and garden party, St James's square

October

Financial Planning Seminar

November

Wine tasting

Markets & Investment Outlook

In this section we look at oil stocks and how they haven't moved as much as the oil price, the bond market moves and one of the main drivers of the U.S. bull market, special purpose acquisition vehicles (SPACs).

Why are oil stocks not keeping up with the oil price?

Crude oil prices have made a surging recovery since they briefly turned negative in April of last year. The upturn has coincided with the partial reopening of the global economy, but also from a weakening dollar and OPEC+ production cuts. The West Texas Intermediary (WTI) spot price is currently $64.50 per barrel, not far below its 5 year high of $76 dollars per barrel.

What has been noticeable is the strong recovery in the crude oil price, which has not been matched with a renaissance in the share price of major oil producers. The chart below displays the WTI price and Royal Dutch Shell share performance since July 2019. Crude oil has exceeded its pre-pandemic price level, whereas Royal Dutch Shell shares are more than 50% lower than in 2019. This is the case among most oil majors worldwide.

(Chart source: 4 Shires)

The growing popularity of environmental, social, and governance (ESG) centred investing has also weighed on oil producer's share price. ESG funds in the U.K. enjoyed record inflows in 2020, bringing in over £8.8bn. ESG focused strategies now account for more than £38.4bn in assets under management in the U.K. alone. Even funds not targeted at ethical investing are turning their backs on investments deemed damaging to the environment. Most fund manager presentations we attend spend a significant amount of time covering their ESG screening criteria.

As one would expect, the oil companies have responded. Examples of a change in their

approach include BP's target to achieve net-zero carbon status by 2050, and the CEO of Royal Dutch Shell no longer describing the company as an oil and gas company but instead an energy transition company. Although some have applauded the efforts, the issue is that renewable energy projects require significant investment upfront, and take longer to payback the initial outlay compared to fossil fuel investments. Green infrastructure investments are on average 1.5 to 3 times more capital and labour intensive than hydrocarbon investments. Although, green investments may be solid long-term investments, they are at the expense of today's cashflows. It is probable that oil majors' dividends and share buybacks will have to be curtailed to allow for large green infrastructure spending.

Therefore, despite a surging oil price, the shares of oil majors could be under pressure for some time. It will be interesting to monitor how they reinvent themselves over the next 20 to 30 years.

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Bond market moves

In the last 3 months the U.S. 10-year Treasury yield has continued to rise. From the lows of August 2020 when the yield was 0.51%, the yield has risen to 1.64% as of 11th May 2021. As discussed in our last Investment Commentary, the yield curve is a key measure of inflationary expectations. The reason why the yield curve is deemed a measure of inflation is because as yields increase with maturity investors need a higher rate of return to compensate them for holding an investment longer and potentially suffering inflation risk.

Inflation is currently the single biggest factor that could affect the economic recovery. The central banks and governments admit inflation is coming, but are convinced it will abate after the current spike. The most common global measure of inflationary prices is the Consumer Price Index (CPI). The CPI measures a basket of goods within the economy and compares their prices month on month. Recently the U.K. CPI rose to 0.7% in April from 0.4% in March. In China, the CPI rose 0.4% month on month. This is a clear sign that inflation has returned and at some point the central banks of the world will have to start reacting to it by changing their monetary policy. The bond market is important because it gives investors the indication of where interest rates are expected to be at in the future.

The chart above shows the 10-year U.S. Treasury yield curve over the last year. From August to March the yield rose as inflationary expectations, and thus potential interest rate increases, rose. Over the last two months the yield has been in a range between 1.7% and 1.55% as investors continue to monitor the global inflation outlook. However, these are the same yields for the U.S. 10 year Treasury at the start of the pandemic in 2020, and inflationary indicators are higher and more intense than a year ago.

Inflation continues to remain the biggest concern for the U.S. economic recovery as fears the Federal Reserve may be forced to raise interest rates sooner than telegraphed keep high-growth, large-cap technology stocks under pressure. Specifically, economists are worried about shortages on the supply side of the U.S. economy: A lack of commodities, labour and other inputs to produce all the goods and services demanded by other businesses and American consumers. The Labour Department's April jobs report released on 7th May relieved investors of their Fed fears with a far weaker than expected 266,000 payrolls added. The kneejerk reaction on Wall Street assumed that the economy added far fewer jobs because employers did not want to hire workers in the numbers expected. However, inflation fears later crept in as more traders began to see the low payrolls number as a supply-side issue. In other words: working-age Americans did not want to return to the labour force. In theory, that could force employers to entice would-be workers with higher wages and eat into corporate profits.

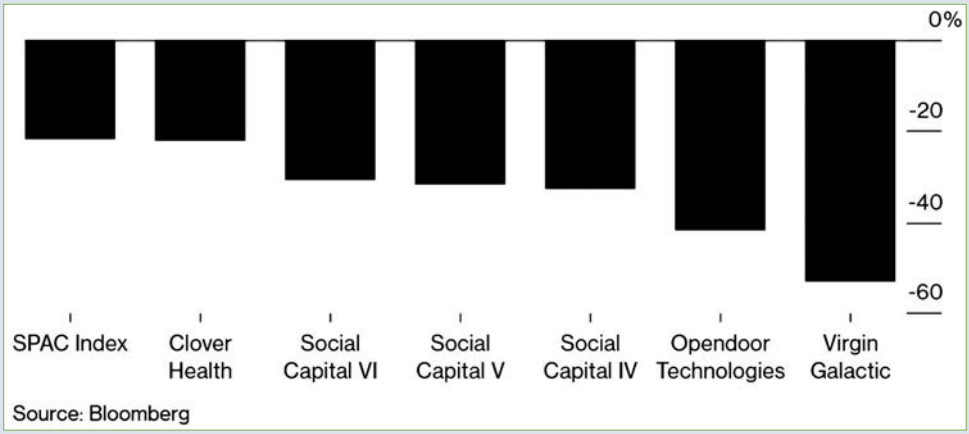
"If supply disruptions persist and demand remains firm, the Fed might need to tighten monetary policy faster than expected," Evercore ISI strategist Dennis DeBusschere wrote. "That theory seems to be driving market volatility higher and technology stocks lower. In the coming months we will continue to monitor the bond yields and position the portfolios accordingly in order to benefit from the inflationary trade by investing in cyclical stocks which will experience more downward pressure as long as yields continue to rise."

Special purpose acquisition vehicles (SPACs)

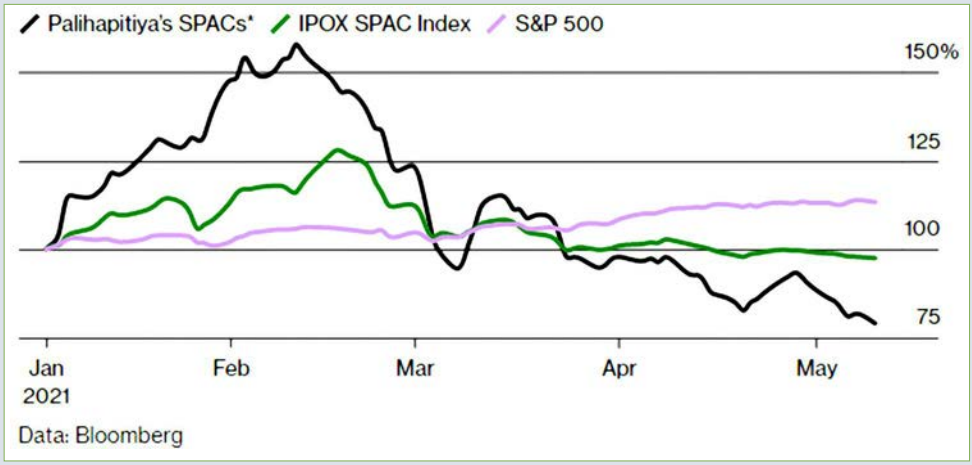
The U.S. stock market has been focused on shell companies called SPACs. These are listed on the stock market, raising large sums of money with the express purpose of buying private companies that do not have to go through the expensive and timely due diligence of listing. In 2020 $82bn was raised for these shell acquisition companies, in what has become known as the 'blank cheque boom'.

There are certain rules about what a SPAC can do. These shell companies have to buy a company with a minimum of 80% of the cash raised in the SPAC. Until then the funds are held in an escrow account. The management of the SPAC are usually specialists in a certain sector and/or investment bankers. There have been some people who crop up on multiple SPACs, for example Chamath Palihapitiya who was behind the acquisition of Virgin Galactic from Richard Branson at the end of 2019. He ended up with 11% of Virgin Galactic, and has subsequently sold over $300m of shares in the company since flotation, and every time he has reiterated his commitment to the business.

He was also behind a range of other shell companies. However, between February 13th and April 17th 2021 the value of the SPACs that Palihapitiya sponsored has plunged as confidence in the SPAC process has waned. The chart below from Bloomberg shows this collapse (in the case of Virgin Galactic by over 50%):



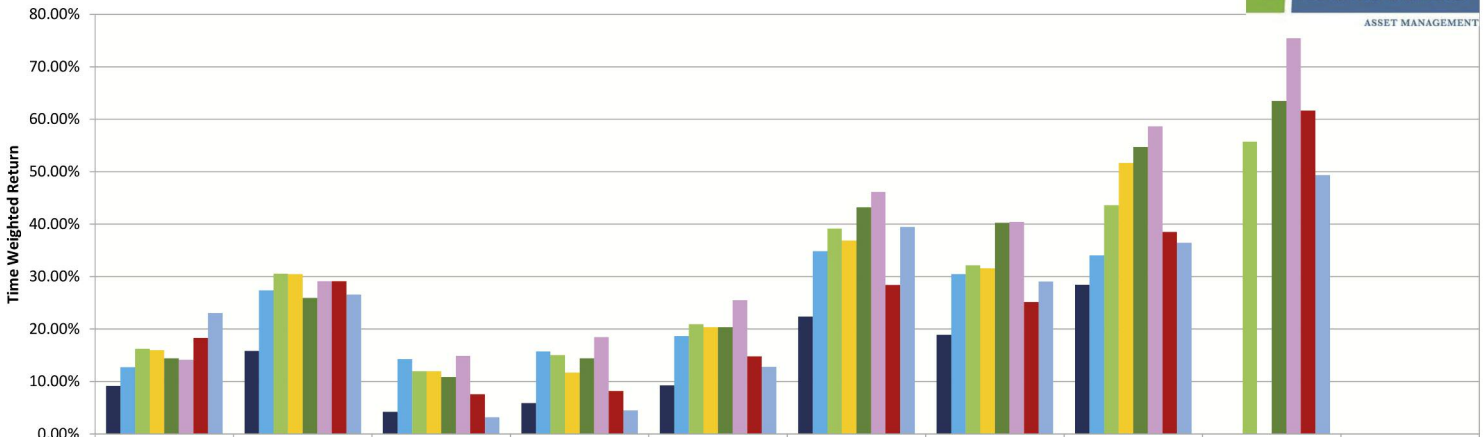
But Palihapitiya's SPACs have done worse than the market:



SPACs are classic signs that the bull market in shares is over extended. In the initial deals, some good companies were able to come to market via this method and at attractive valuations. But as time went on, more 'operators' of these investment vehicles came into the process, as they could see by introducing a company via the SPAC they could end up with a significant stake in the company. The quality of new companies began to fall, and eventually the hype faded, shown by the precipitous fall in Palihapitiya's stable of SPACs.

Investment Outlook

Stock markets may well pause the current rally over the traditionally calm summer months, but we expect the rally to continue later in the year as the outlook for the world economy becomes clearer. We believe commodity prices are likely to remain reasonably firm without new mine supply during the current infrastructure boom. Stocks that benefit from increasing inflation should do well, and we remain on the lookout for new investments where the market has yet to perceive the earnings recovery.



	6 months	1 year	2 years	3 years	4 years	5 years	6 years	7 years	8 years
Risk A	9.18%	15.80%	4.19%	5.90%	9.26%	22.37%	18.91%	28.42%	
Risk B	12.75%	27.38%	14.26%	15.71%	18.66%	34.85%	30.45%	34.04%	
Risk D	16.23%	30.54%	11.96%	15.06%	20.90%	39.13%	32.13%	43.62%	55.73%
Risk E	15.94%	30.49%	11.96%	11.66%	20.34%	36.85%	31.59%	51.65%	
Risk F	14.40%	25.96%	10.84%	14.44%	20.34%	43.18%	40.25%	54.71%	63.46%
Risk G	14.11%	29.14%	14.92%	18.44%	25.48%	46.13%	40.46%	58.66%	75.44%
Risk I	18.32%	29.09%	7.60%	8.19%	14.81%	28.38%	25.18%	38.53%	61.67%
UK IMI	23.06%	26.57%	3.17%	4.46%	12.78%	39.46%	29.07%	36.45%	49.35%

4 Shires investment performance

Graph to 5th May 2021 (*source: 4 Shires*) showing the average performance of all of the portfolios on each risk scale.

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

Important

Compliance Section

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.

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