SARANAC
PARTNERS

Investment Committee Update

November 2021

AT A GLANCE

- Economic growth and corporate earnings were strong in the first half of 2021, which supported a strong equity market rally.
- More recently this supportive background has come under challenge from a slower pace of growth and acceleration in the pace of inflation.
- Our analysis suggests the investment environment will remain positive although some downside tail risks are emerging.
- The latest economic data has surprised to the upside, some supply chain bottlenecks and shortages are easing, shipping rates have started to fall and the Q3 earnings season has been strong.
- The relationship between inflation expectations and real yields seems to have broken down, which is largely down to central bank policy announcements.
- In the event of higher yields and a steeper yield curve, we would expect cyclical and value-related stocks to perform well within equity markets.
- Gold has been a disappointing investment this year but it's one of the few diversifiers that can protect portfolios from the risks of much higher inflation.
- We are not making any changes to our portfolios this month but with the outlook shifting, we're prepared for possible changes in the near term.

At our latest investment committee meeting, the discussion focused on the nature of the global economic cycle into and during 2022. The first part of 2021 was characterised by a surge in economic growth and corporate earnings, which supported a strong equity market rally.

More recently, there have been two major changes to this supportive environment. First, economic growth has slowed, notably in China, but also in the developed world. Second, there has been a marked acceleration in the pace of inflation.

High inflation poses a potential threat to the cycle and many asset prices for various reasons. It increases the potential for earlier interest rate rises than the market expects, squeezes real incomes, and might become more deeply embedded the longer the surge lasts.

Our analysis of the situation suggests the investment environment will remain moderately positive. However, conditions are less positive than they were at the start of 2021, and some downside tail risks are emerging.

MACROECONOMIC OVERVIEW

The current situation remains quite bullish. Growth slowed sharply in Q3 but the latest economic data has surprised to the upside and the picture for Q4 is for a re-acceleration in growth. Some supply chain bottlenecks are showing signs that constraints are easing, semiconductor shortages are less extreme and shipping rates have started to fall.

The Q3 earnings season has shown that most companies have been adept in managing inflationary pressures so far. Profits have exceeded expectations and margins are reaching record highs. Revenue growth has allowed for operating leverage to continue and more than compensate for any cost pressures in the system. Earnings expectations continue to be revised higher into 2022, which is a positive sign.

With strong earnings, reaccelerating growth and early signs of bottlenecks easing, markets are set for a strong move higher since the correction in September. News of a Covid pill that could significantly reduce hospitalisations of those most seriously ill has also been a major boon for the market, in particular for those sectors most sensitive to the reopening of the economy.

FINANCIAL MARKETS

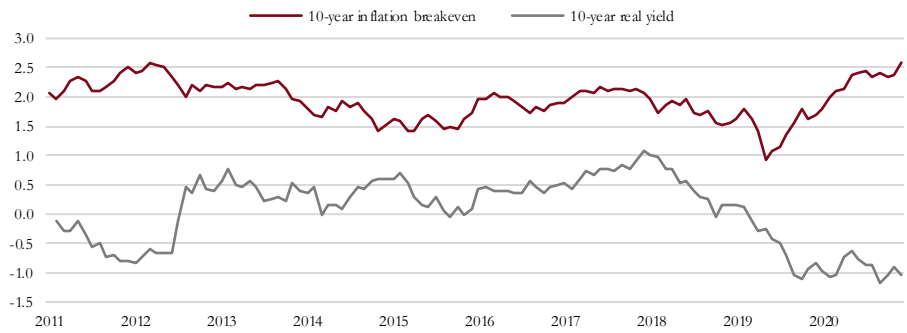
The relationship between inflation expectations and real yields seems to have broken down (figure 1). Inflation expectations in many developed markets are at 10-year highs, yet real yields have fallen to record lows.

Nominal bond yields are lagging inflation expectations, and central bank policy is certainly a possible cause for this disconnect. Forward guidance is targeting a bond yield that is well below current inflation levels, which explains why real yields are so negative. We think that as central banks gradually reverse their extremely accommodative policies, nominal bond yields are likely to rise and real yields will become less negative.

In such an environment, we would expect to see a steepening of the yield curve as longer duration bond yields move higher faster than shorter duration yields.

Figure 1: Inflation and real yields (%)

Inflation expectations have moved to 10-year highs, yet real yields are at record lows as nominal bond yields have yet to respond to the inflation risk. Central bank intervention may have something to do with this. A tightening of monetary conditions may lift real yields.



Source: Saranac Partners.

In such an environment, we would expect to see a steepening of the yield curve as longer duration bond yields move higher faster than shorter duration yields. We are positioned for such an outcome in portfolios with our focus on credit risk and short duration.

In the event of higher yields and a steeper yield curve, we would expect cyclical and value-related stocks to perform well within equity markets. Very high-growth, high-valuation stocks could struggle given their sensitivity to long bond yields.

We have maintained a barbell strategy within our equity allocation for over a year now, balancing our core, high-quality growth stocks with exposure to more cyclical, and cheaper, stocks that we believe will benefit from economic reopening.

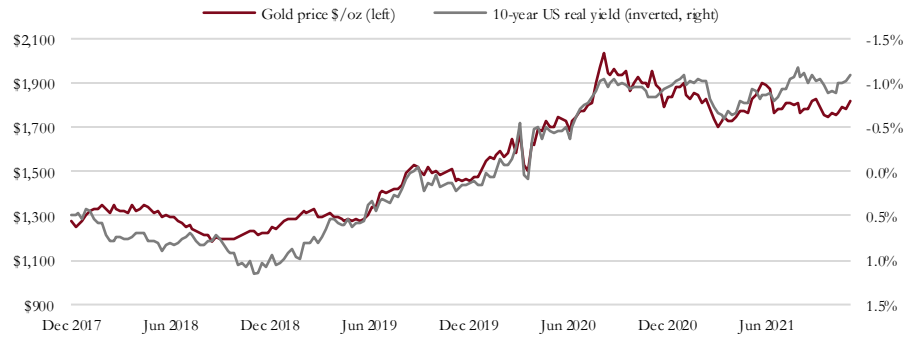
While our growth stocks trade at a valuation premium to the market, the premium is relatively small and we have no exposure to super-charged growth stocks with no earnings and extreme valuations.

A shift to increasing the proportion of cyclical stocks with a valuation discount would make sense in the environment we lay out here. Banks, logistics companies and industrial stocks are candidates for inclusion.

Gold has been a disappointing investment this year, its recent rally notwithstanding. The rise in inflation, higher inflation expectations and deeply negative real yields all failed to ignite a sustained rally (figure 2).

Figure 2: Gold and real yields

Over recent years there has been a tight relationship between the gold price and real yields. The drop in real yields to extremely negative levels this year has failed to elicit a move higher in gold. If real yields move higher, it could spell trouble for the gold price.



Source: Saranac Partners.

We are not making any changes to our portfolios this month. However, the shifts in our outlook, as well as our belief that bond yields should rise and yield curve steepen, prepare us for possible changes in the near term.

In the scenario of higher bond yields and less negative real yields, there is a risk that the gold price drops significantly, as was seen during 2013 as markets prepared for the Fed to taper QE after the financial crisis. We reduced our allocation to gold to 3% at the start of the year and we are debating cutting it from portfolios.

However, in current markets there are increasingly few portfolio diversifiers that protect us from the risks of much higher inflation and the volatility that would create, so we are maintaining the position for now.

INVESTMENT PORTFOLIOS

We are not making any changes to our portfolios this month. However, the shifts in our outlook, as well as our belief that bond yields should rise and yield curve steepen, prepare us for possible changes in the near term.

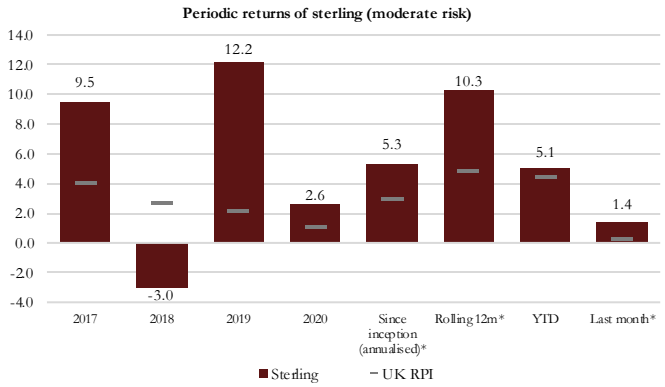
The more immediate challenge relates to fixed income markets and real yields. The environment suggests a very short duration approach to fixed income and a tilt toward more cyclical and value orientated equities.

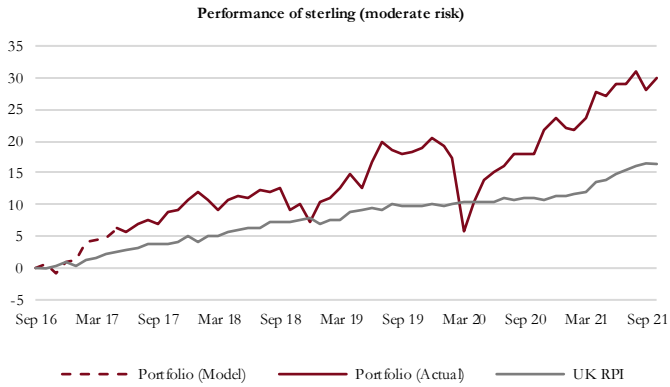
Further out, we are not ignoring the possibility that a squeeze on real incomes from high inflation leads to an unexpected slowing in macro momentum and heightened fears that the cycle is nearing the end. Such a scenario would require a de-risking of portfolios and we want to be alive to this possibility.

Multi-asset strategies

Performance as of 1 November 2021

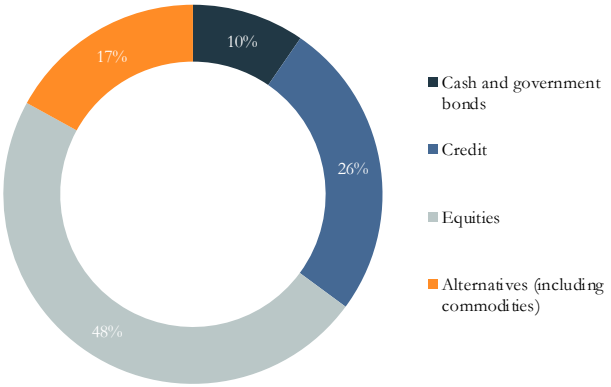
Returns (%)

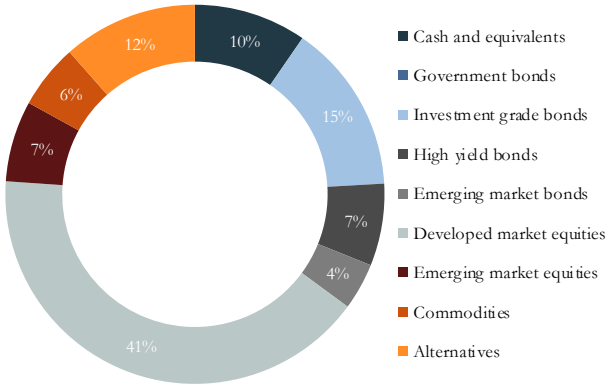




*End October 2021 for Sterling. End October 2021 for RPI (November data not available yet).

Asset allocation (average across all portfolios, %)

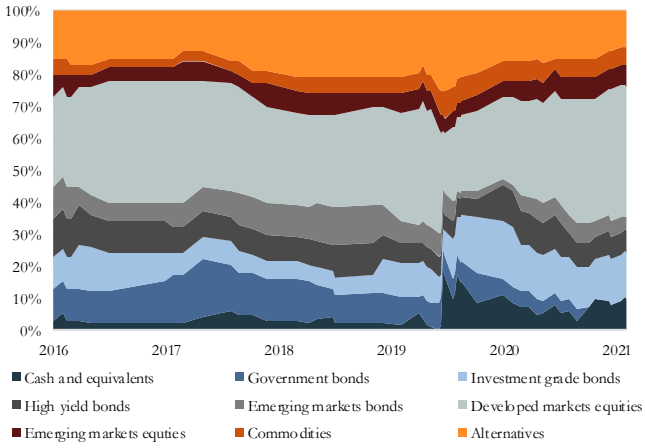




Changes over the past month (%)

	Sterling	Change
Cash and government bonds	**9.6**	**0.5**
Cash and equivalents	9.6	0.5
Government bonds	0.0	0.0
Credit	**25.5**	**-1.0**
Investment grade bonds	14.5	0.0
High yield bonds	7.0	0.0
Emerging market bonds	4.0	-1.0%
Equities	**47.9**	**2.1**
Developed market equities	41.0	1.6
Emerging market equities	6.9	0.5
Alternatives	**17.0**	**-1.5**
Commodities	5.5	0.0
Alternatives	11.5	-1.5

Changes over time (%)

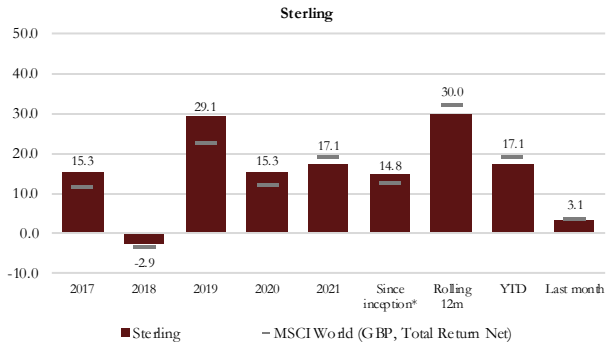


Performance figures from inception (28 September 2016) to end May 2017 are based on model portfolios, simulated from a full record of trading decisions and execution levels are readily available for review. Performance figures from June 2017 onwards are based on an aggregation of actual client portfolios whose mandate most closely follow the Moderate Risk model. Dividends have been included on an accruals basis in both cases. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance.

Equity strategies

Performance as of 1 November 2021

Returns (%)



Euros and US dollar

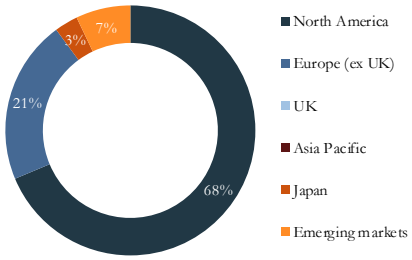
	2017	2018	2019	2020	2021	Since inception*	Rolling 12m	YTD	Last month
Euros	10.9	-4.0	36.7	9.1	24.3	15.1	38.8	24.3	5.0
MSCI World (EUR, Total Return Net)	7.5	-4.1	30.0	6.3	26.3	12.9	41.4	26.3	5.8
US dollar	26.2	-8.6	34.3	19.0	17.5	17.3	37.9	17.5	4.8
MSCI World (USD, Total Return Net)	22.4	-8.7	27.7	15.9	19.4	15.1	40.4	19.4	5.7

*Since inception figures are annualised.

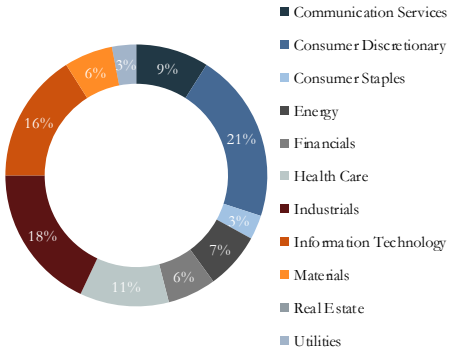
Top 10 holdings (%)

Holding	Weight (%)
MICROSOFT CORP	4.1
UNITEDHEALTH GROUP INC	4.0
ALPHABET INC-CL A	3.9
UNITED RENTALS INC	3.9
LVMH MOET HENNESSY LOUIS VUI	3.7
PIONEER NATURAL RESOURCES CO	3.6
TOTALENERGIES SE	3.4
ADOBE INC	3.3
DISCOVER FINANCIAL SERVICES	3.3
BAYERISCHE MOTOREN WERKE AG	3.2

Regional exposure



Sector exposure

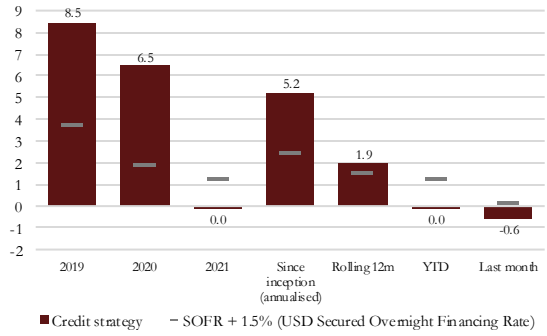


Performance figures from inception (1 January 2017) are based on a model portfolio, simulated from a full record of trading decisions and execution levels are readily available for review. Dividends have been included on an accruals basis. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance. Actual fees paid by the client portfolios excluded. Fees may vary.

Credit strategy

Performance as of 1 November 2021

Returns (%)



	Credit strategy			Benchmark		
	USD	GBP (hedged)	EUR (hedged)	USD	GBP (hedged)	EUR (hedged)
Last month	-0.6	-0.6	-0.6	0.1	0.1	0.1
Rolling 12m	1.9	1.8	1.1	1.5	1.4	0.7
2020	6.5	6.0	5.2	1.9	1.4	0.6
2019	8.5	6.6	5.3	3.7	1.9	0.6
Since inception	15.5	12.8	10.0	7.0	4.5	1.9
Since inception (annualised)	5.2	4.4	3.4	2.4	1.6	0.7

Asset allocation and performance measures

Issuer type	Weight (%)	Yield to maturity (bps)	Modified duration	Composite rating
Core IG allocation	**73.0**	**227**	**4.3**	**BBB**
Developed markets	51.0	216	4.4	BBB
Emerging markets	18.0	259	4.5	BBB+
Asset backed securities	4.0	227	2.2	A+
High yield satellite	**27.0**	**465**	**2.9**	**BB**
Developed markets high yield	12.0	441	1.8	B+
Emerging markets high yield	3.0	410	3.5	B
Corporate hybrids	4.0	444	3.0	BBB-
Financial subordinated	8.0	531	4.4	BB+
Total portfolio	**100.0**	**291**	**4.0**	**BBB-**

Performance figures from inception 31/12/18 are based on an actual client portfolio whose mandate most closely follows the Diversified Credit Strategy. All performance is shown inclusive of fees. Since inception, the portfolio has experienced zero defaults. Your capital is at risk and past performance is not a reliable indicator of future performance.

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