WEALTH MANAGEMENT
MPL Wealth Management Limited
45 Doughty Street London WC1N 2LR
Tel: 020 7831 4711
Fax: 020 7831 3137
enquiries@mplltd.co.uk
www.mplwealthmanagement.co.uk

**The Discount Factor**

In our last letter we explained in some detail the current stance of the US Federal Reserve (The Fed) in respect of hiking interest rates to tackle stubbornly high inflation. Indeed, on July 26th it telegraphed a further 25-basis point rate hike to bring base rate to 5.25%, with most Fed policymakers anticipating possibly one more hike after that, to bring US rates to a likely peak of 5.75%. The Bank of England meanwhile has also raised rates a further 0.25% on August 3rd with perhaps two more 25 basis point increases anticipated to occur in September and November, which would bring UK base rate to 5.75% if the September and November increases actually take place.

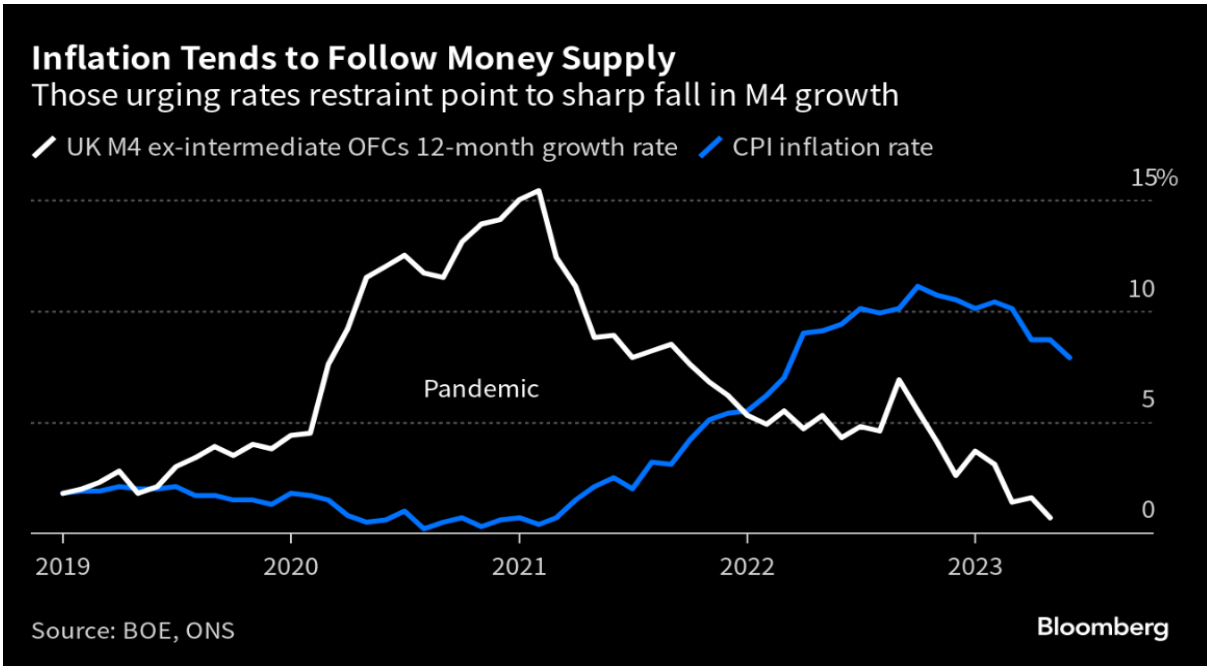
We continue to believe that we are now very near to the top of the current interest hike cycle in the US and the UK, for the following reasons:

A very well-flagged and anticipated recession in the US is forecast in some quarters to occur in the fourth quarter this year. In short, certain unique factors which have kept the US economy resilient in the current economic cycle, such as excess household savings accumulated during the covid lockdown period, are now on the wane as those savings are spent down, for instance. Some commentators estimate that excess savings for the poorer half of the US population are already depleted, while rapidly rising debt-servicing costs will generate financial stress for some households.

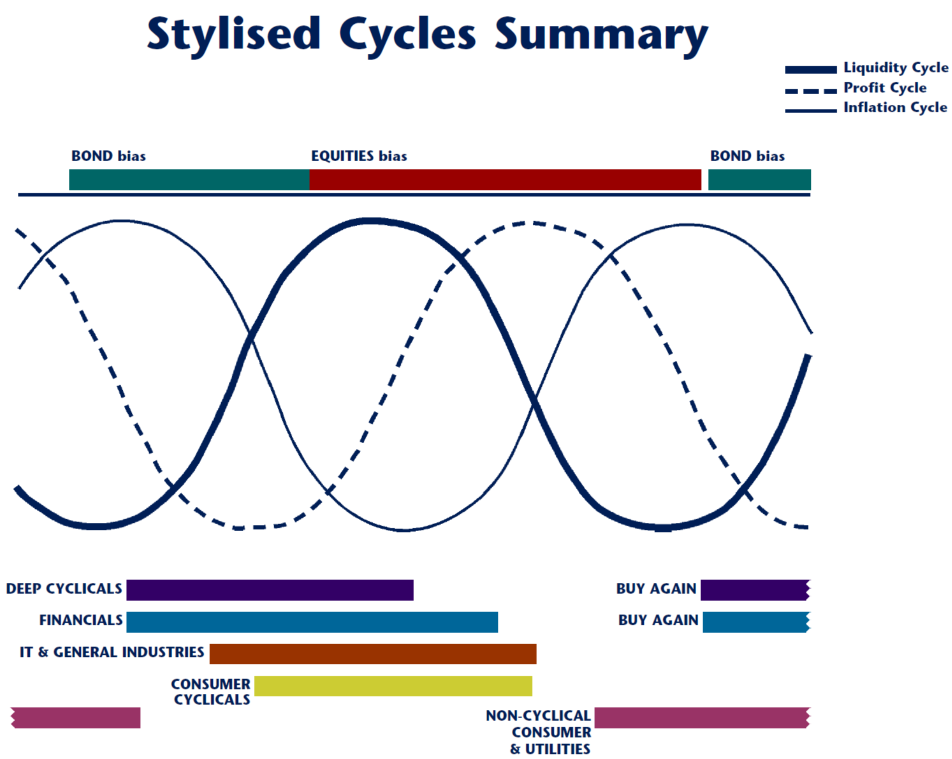
Here in the UK, whilst consumer price inflation dropped to 7.9% in June from 8.7% in July, (a far bigger decline than markets had expected), that inflation rate is still around four times the Bank of England Monetary Policy Committee's 2% target, and double the rate in the United States. The fall has been driven more by short-term moves in energy prices, rather than longer-term pressures such as wage growth and housing costs.

However, the fall has nevertheless prompted market participants to price in a maximum UK base rate of 5.75%, reduced from a former expectation of a top rate of 6.0% or higher. Former Bank of England Governor Mervyn King has warned recently that the BOE risks making a "big mistake" if it continues to hike. He pointed out that key money supply indicators are suggesting that inflation is headed for a rapid drop.

The following chart depicts UK M4 - a broad measure of money supply, that is money in the wider economy - set against the Consumer Price Inflation (CPI) rate, and clearly indicates that money supply is already falling fast as rates tighten and money becomes more expensive and hence scarcer. The CPI rate, which will normally follow the M4 rate with a time lag of perhaps a few months, has already started turning down, indicating that the Bank of England now needs to exercise caution as regards any further rate increases.




We are now circa 17 months into the global interest rate hiking cycle. Economists estimate that it takes about two years for rate hikes to be fully felt on the ground, which chimes with the following Stylised Cycles Summary illustrating the relationship between liquidity, profits and inflation.

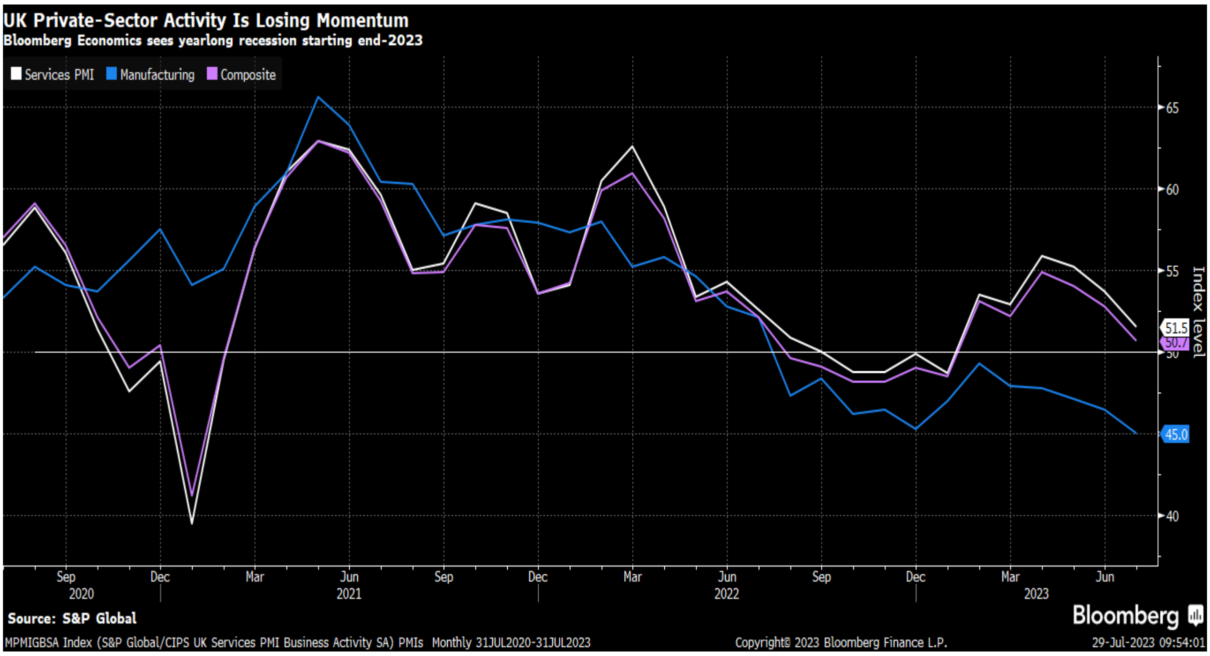



Source: David Stewart - Blackrock

Liquidity leads profits, which in turn leads inflation in this stylised business cycle. The Liquidity cycle is driven by the existing trend in interest rates, especially in short-term rates.

The Liquidity Cycle - We are now at the tail end of the phase during which central banks have increased interest rates at the onset of rising inflation - on the chart that is at the bottom of the thick black line.

The Profit Cycle – Profits lag the change in interest rates by approximately 15 months. UK Treasury advisers have recently cited a survey by S&P Global Market Intelligence showing that British companies reported their slowest growth in six months in July, as the latest evidence indicated that elevated interest rates were beginning to take their toll, in turn indicating that the interest rate cycle is nearing its end.




Inflation – According to consensus, the inflation cycle lags liquidity by about 30 months on average. In a simplistic sense, the strong liquidity growth that the global economy witnessed prior to and during the initial stage of the COVID pandemic around two and a half years ago, led to a strong upturn in profits which in turn led to higher levels of corporate investment and also job growth, all of which started to eliminate slack in supply chains, and hence started to create shortages. These shortages, along with the emergence of increased pricing power in the corporate sector, flagged the arrival of the inflation cycle, which was the cue for policy interest rates to start rising in March 2022, causing the current bear market.

How does all this relate to portfolios today?

This is explained by the mechanism by which the majority of assets within a multi asset portfolio are valued: in basic terms, by using a 10-year bond yielding 10% per annum as an example:

If you purchased this bond for £10,000, and the 10 future annual interest payments (of £1,000 per year) were to be paid to you in a lump sum at the maturity of the bond 10 years from now; along with the initial investment of £10,000, you would be in receipt of £20,000.

The investor will want to know what the future income stream totalling £10,000 (£1,000 per annum x 10) payable ten years from now, is worth today, what is called 'Net Present Value.'

In 10 years' time, the investor will not be able to purchase the same basket of items for this sum of money that can bought today, because in the main positive rates of inflation will diminish the purchasing power of £10,000 over this 10-year period. So, we have to use a mechanism which discounts the total value of these future revenue streams back to a present-day value.

Typically, government bond yields are used to do this, and these yields are heavily influenced by interest rate expectations, which in turn are heavily influenced by inflation rates, which erode the future value of moneys. In short, if interest rate expectations rise, bond yields rise, and hence the number used to discount these future income streams increases. You are therefore discounting by a larger number, which results in a smaller value.

Again, in simplistic terms, the opposite is true if interest rates are reduced, or at least if there is an expectation that they will be. And this is what we are waiting for.

In terms of future strategy, deep cyclical and economically sensitive sectors such as commercial property should begin to outperform once we have an expectation of a pivot in interest rates. We have already gone overweight in this sector, as we felt that the pullback seen in recent times was significantly over-done in this area, especially within the higher quality areas of the sector.

## **Portfolio Changes**

Our overweight in the technology sector, which is now super-cyclical in nature, has performed well in the main, partly due to the current fervour surrounding the Artificial Intelligence (AI) area of the overall technology markets, which is driving this entire sector forward in valuation terms at present.

Having undertaken extensive research in bond markets, we will shortly be introducing some strategic bond funds into client portfolios, as this will give them a slightly more aggressive and more global exposure to the bond markets, as opposed to a mainly UK-focused stance within this asset class. This will essentially be to take advantage of market opportunities as the interest rate cycle turns.

Not only are we able to invest at attractive yields globally in this and other asset classes at present, but with the advent of lower interest rates over the next two years at the minimum, total returns will no doubt be driven by capital gains, with valuations set to be driven up by the lower discount factors that we expect to see come into place in the markets.

In the meantime, and whilst we wait for these anticipated events to unfold, we are looking for our client portfolios to be benefitting from some fairly attractive market yields on the intended bond positions.

With Kind Regards


Mark Kitson
INVESTMENT DIRECTOR

Simon Weighell
SENIOR INVESTMENT MANAGER

Richard Dawes
INVESTMENT MANAGER