Economic and Investment Update Conference Call Transcript – 6 October 2021

Presenters

- **Nick Fletcher**, Senior Partner of LWP and Chairman of the Investment Committee;
- **Ian McCafferty**, CBE, former member of the Bank of England's Monetary Policy Committee and member of the LWP Investment Committee; and
- **Stuart Fowler**, Investment Director of LWP.

Nick: Good morning everyone on this beautiful morning, certainly in London anyway. This is the latest in our series of what have become regular quarterly client calls in which we discuss the outlook for the economy and issues pertaining to our investment strategy. This we hope to do over the next forty minutes or so before answering some of the questions that you've kindly submitted, for which many thanks. We aim to finish the call at or before 12 noon.

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Many of you will know my two colleagues on the call this morning, but for newer listeners let me briefly introduce Stuart and Ian. Ian McCafferty is one of the UK's leading economists and from 2012 to 2018 he was a member of the Monetary Policy Committee at the Bank of England. Before that his career spanned the City – the CBI and BP amongst many others. He joined

London Wall Partners as a member of the Investment Committee and senior advisor in the spring of 2019. As well as working with us, he is a visiting professor at King's College London, a member of the government's Senior Salary Review Body and a senior advisor to Oxford Economics. Stuart is the investment director at London Wall Partners, he joined the firm in 2015 following his role as head of Global Equities and Fund Manager Selection at the in-house fund manager of the National Grid Pension Fund. He's been a City stalwart for many years having also worked at HSBC, Morgan Grenfell, AXA and Kleinwort Benson. Good morning to both of you and welcome to the call.

Ian and Stuart: Good morning.

Nick: As ever there's a lot of talk about this morning – Covid-19 continues to cause problems across the globe, and after the early, easy gains in activity in the spring, as many countries emerged from lockdown restrictions, the pace of the revival of activity has slowed over the summer. But we are still undergoing a rapid recovery with the world economy expected to grow by over 5% in both 2021 and 2022, though the speed of that recovery has caused its own problems. The pace of the pick-up in demand combined with the dislocation caused by the lockdowns has led to some serious disruptions in supply chains. Shipping and shipping containers are in the wrong locations to accommodate the recovery in global goods trade, there are shortages of key components and inputs, such as microchips and natural gas, and changes to labour supply and demand wrought by the pandemic have led to labour scarcities and skills shortages in some sectors but heightened unemployment in others. So far, these problems have mostly been considered as temporary which will be quickly resolved as things return to normal. But how far are they likely to affect the outlook for 2022 and what will they mean for

inflation? Both are critical questions for financial markets as they go into the autumn.

So, I'd like to start by asking Ian how he sees the current situation and what, in his view, the next year will look like.

Ian: Let me start with an update on the health aspects of the pandemic as these continue to be a major influence on how the recovery is unfolding across the world. The virus unfortunately is still very much with us. Across the world, positive cases, confirmed through testing are still running at around half a million a day. That is certainly less than the actual number of infections since testing remains very limited in some parts of the world. That half a million is an improvement from the peak of over 800,000 cases a day back in April but the numbers regularly ebb and flow and there's been no fundamental and lasting decline in global infection rates since last November. In part, this is due to the emergence of the Delta variant which is becoming the dominant strain in most parts of the world and which studies show is twice as contagious as previous variants. So, while cases are broadly under control in the US, in Europe and other advanced economies, Sub-Saharan Africa is now in the grip of a third wave, parts of Latin America continue to see high mortality levels and concerns still remain about the situation in parts of South and Southeast Asia.

But offsetting this continued prevalence of the virus is the continued progress in global vaccinations. By late September, 44.5% of the world's population had received at least one dose of a vaccine and that is up from just over 20% in July. So, in the past nine months or so, since the vaccines were first deployed, 6.13 billion doses have been administered around the world and around 25 million are still being delivered every day. So, despite the persistence of the virus itself, fatality and serious illness rates have fallen sharply such that the stringency of anti-Covid restrictions has continued to ease for many economies. But unfortunately, this progress is not evenly

spread across the world. In terms of vaccines, for example, close to 40% of the population in advance economies has been fully vaccinated compared with less than half that number in emerging market economies and a tiny fraction in the lowest income countries.

If we look into 2022, vaccine access will be one of the principle dividing lines between those countries that can look forward to further normalisation of economic activity, and that is essentially all of the advanced economies, and those, primarily in the Third World, that will still contend with prospects of resurgent infections and high Covid death tolls.

So, we're now starting to see greater regional and national diversity in economic performance and that's greater than we did in earlier parts of the pandemic. Prospects for the advanced economies remain promising with the IMF increasing its forecasts for advanced economy growth in 2022 by half a point, compared with its forecast in April. It now expects advanced economies to grow by 5.6% this year and 4.4% next.

But for a number of emerging economies, the appearance of the Delta variant and that slower pace of vaccination mean that the recovery is taking longer to get going. The IMF has revised down its forecasts for emerging economy growth this year but expects some of that shortfall to made be made up with slightly faster growth next year. That slower growth for 2021 is most marked in Asia and that's particularly in India and in the Asian five that are Indonesia, Malaysia, Philippines, Thailand and Vietnam.

So, the pace and extent of the recovery, albeit still rapid, remains unevenly spread across regions. But I have to say that the world economy as a whole is still expected to bounce back strongly from the pandemic and growth rates at 6% this year and just under 5% next year.

Nick: That the IMF is still forecasting a continued strong recovery is encouraging but what about the supply shortages and disruption we keep hearing about? Don't those risk shutting down the recovery almost before it's got started?

Ian: Well, after a period of very rapid growth over the spring and summer, as economies opened for business, more recent data has shown the legacies of the pandemic to the global economy are creating some head winds. The recovery began in the goods sector through a revival in global goods trade and in the manufacturing industry with the service sector somewhat slower to restart. While the demand for manufactured goods is rising rapidly, there are now signs that many producers are having problems with low levels of finished goods inventories and with supply problems for some key raw materials and components. These are slowing the pace of recovery and industrial production around the world, though growth is still expected to continue.

Many of the problems that we are seeing can, I think, be linked to the disruption to the movement of goods and materials when the world abruptly shut down in the spring of 2020. The production of some key raw materials ceased altogether, inventory levels were run down, ships and containers, as you've said Nick, were left in the wrong location and for some sectors these issues have been exacerbated by shortages of specific labour skills, such as HGV driving. These days, local industry works very much on a just-in-time basis. So, shortages or delayed delivery are quickly felt and as a result, the pick-up in production is lagging the recovery and demand, and inventories have run low. Industrial surveys, that is for the US, the Eurozone and the UK, all suggest that firms had the biggest shortfall in their stocks of finished products sitting ready to go relative to their desired levels of stocks than at any point over the past 25 to 30 years.

But at the same time, I don't think we should over-exaggerate these bottlenecks, sitting in the UK in recent days it would be easy to think that they are rife. Unfortunately, for most of us on the call, it does appear that the UK is suffering more than most countries and, in the US, and EU the difficulties are much less acute. But I think the key question for the outlook into 2022 is whether these bottlenecks will prove to be what you might call temporary teething problems or whether they'll be more lasting and more consequential. I think this is obviously a relatively difficult question to answer at this stage. For some products, the most severe bottlenecks are already starting to ease. The surge in US lumber prices to record highs that we saw earlier this year has now been fully reversed in response to rising production and easing demand. In the same way, some disruption caused by Covid related staff absence are easing as vaccination rates have increased. It's also the case that as bottlenecks began to appear, firms probably started to over order on their supplies rather than risk running short and that's added some further pressures over the very short term.

But I have to say, I don't think it's clear that all of the current bottlenecks can be resolved quickly and painlessly. The interdependent nature of our economies means that bottlenecks in one area quickly start to affect production in related sectors. In some sectors, the underlying issues would be resolved only when investment in new supply fully comes on stream. In the semi-conductor industry, for example, such new capacity is unlikely to appear until into next year and the problems in the container shipping industry will probably also require investment in new ships and port infrastructure before things get completely resolved. So, I think some shortages of individual products, and the elevated prices that are the result, are going to be a fact of life for a little time yet, though I don't think they will stop what is still a healthy recovery in global activity.

Nick: But those "elevated prices" you mentioned – aren't they just another way of saying inflation? Is that now the big risk for the outlook, Ian?

Ian: We've already seen some quite marked increases in inflation across the advanced economies. Since the start of the year, inflation has picked up from 1.4% to over 5% in the US from 0.9% to 3.5% in the EU and from 0.9% to 3% in the UK. We are also seeing a sizeable uptick in China, for example, from -0.3% at the start of the year to 1% now. I think those rates are expected to increase further almost everywhere over the course of the next few months.

I think as far as the financial markets are concerned, fears of a serious resumption in inflation becomes the number one issue driving investor sentiment. Now some of the more excitable commentators have raised the spectre of a return to the 1970s, which in my view is still very far-fetched. But the real question, the answer to which will matter a great deal to the economic output for the next few years, is whether what we're seeing is essentially a one-off set of adjustments in relative price levels, as relative prices adjust to the fundamental changes in demand and activity that have been brought about by the pandemic, or whether they are indeed the precursor to a more sustained and more ingrained bout of general inflation.

Now so far, all of the central banks are treating the current rise in inflation as essentially temporary or in their words, they have a jargon for this and they call it, transitory. Their forecasts suggest that after a period of higher inflation into early 2022, it will start to fade back again and will be back in line with their 2% targets by 2023. But I'm not completely sure they're right. I attended a dinner with Andrew Bailey, the governor of the Bank of England, recently and amongst the audience and economists there was a good deal of scepticism, my own as well. After all, the hike in inflation has proved more dramatic and is proving longer lasting than they were forecasting only just a few months ago. Markets and economists alike are starting to ask whether, in the jargon, central banks are "falling behind the curve" – underestimating

the risks of inflation and delaying the necessary adjustment to monetary policy.

But I think whether the Bank of England and the other policy makers are correct with their view, that this is purely a transitory issue, will depend primarily on how people choose to behave and that, as we've seen with the recent petrol crisis in the UK, is a notoriously difficult thing to predict. As long as everyone continues to believe that inflation is purely temporary and acts accordingly, it will fade quickly. Inflation is measured as a year-on-year difference, so unless prices continue to rise continuously, the rate will start to fall back after 12 months. But if people start to believe that inflation is set to remain high after some considerable time – in central bank jargon, that means that inflation expectations start to shift – then they will start to demand higher wages and producers will start pushing up prices that they charge for all of their products. At that point, inflation becomes much more ingrained and the period over which it remains above the central bank's targets would be much more lengthy.

Now if we're thinking of inflation expectations, they can be measured either directly, there are surveys asking people what they think the rate of inflation will be in one, two or five years' time, or they can be measured indirectly, through what happens to wage demands and settlements. At present, neither of those measures is suggesting a big shift in expectations, but I would say from my experience, if inflation stays above 3-4% for any length of time, as is possible next year, expectations could quickly and easily change. So, my own view is that we will see some second-round effects on wages and behaviour so the period of above target inflation would prove more extended than most central bank forecasts currently suggest. But I would emphasise, that is not the same as a return to the high inflation era of 30 years ago.

Two good reasons dictate against that happening. First, I think labour markets are more flexible and trade union power less prominent than was

the case in those days – I was a young economist in the seventies, I remember it well – and that means that wage price spirals are much more difficult to trigger. Secondly, the policy architecture around inflation is very different with independent central banks now under statutory obligations to meet explicit inflation targets. So, if inflation does prove to be more persistent, central banks would have to respond. The real risk is not run-away inflation, but a sharp change of course for monetary policy.

Nick: By that (the sharp change of course of monetary policy), do you mean an increase in interest rates?

Ian: Ultimately yes. But monetary policy is much more complicated than that these days because central banks can also vary monetary conditions through their use of QE. So, if they need to tighten policy to control higher inflation, they could either move rates or adjust the level of QE, or indeed both.

Nick: So how do you see the outlook for monetary policy rates and QE?

Ian: Well, at present, central banks continue to believe that higher inflation will prove temporary – their forecasts indicate that after a period of elevated price rises, inflation starts to fade, and returns to around 2% by 2023. They therefore argue that they can "look through" this current rise and can continue to support the economic recovery by keeping policy relatively unchanged. But if there were to be any sign of a shift in inflation expectations or more general wage inflation, that stance could change quite quickly. So, policy might need to be tightened more aggressively than financial markets are currently expecting. Though market expectations are shifting, I find it extraordinary that using forward money marketing prices as an indicator, for example looking at the UK, markets currently expect UK bank rates still to be under 1% until 2026. I do think that's possibly underestimating how things might move.

So, if it does become clear that inflation is more stubborn and requires more of a policy response, I think the reaction in financial markets could be significant, particularly if they're not well forewarned of any change by poor central bank communication.

Now interestingly, to try and solve this problem and make sure that markets are not taken by surprise, we've had a lot of communication in recent weeks from all of the three major central banks – the US Federal Reserve, the ECB and the Bank of England – about just how they intend to tighten policy and some clues as to when. For example, at this summer's Jackson Hole symposium – that's the annual get together of global central bankers, policy makers, academics, and economists – the Fed chairman, Jerome Powell, gave strong signals of when the Fed is likely to start reducing its monetary stimulus. It expects to make an announcement in November of a reduction in its ongoing programme of QE in December or January. But thereafter, they still believe that rate rises are some way off. The ECB for its part, recently announced a modest reduction in their pandemic emergency QE programme, but they've emphasised that this is not yet the start of a fundamental shift, so they're a little behind the Fed in that regard. But it is now clearly under debate and we're looking to the ECB December meeting for more signals of what's going on in Europe.

Meanwhile, from the Bank of England's point of view, it has announced a new guidance on how and when it intends to tighten. Its current QE round is due to finish in December, and it plans thereafter to use interest rates as its major tool in the tightening process, not adjusting its level of QE asset purchases until after Bank Rate hits 0.5%, and not actively selling gilts that it holds before Bank Rate reaches 1%. This now puts a possible rate rise into play at the December MPC meeting, though most expectations are still that nothing will happen before next year.

So, I think we now have a better idea of how both interest rates and QE will be deployed into the monetary policy tightening cycle and a little uncertainty, still, as to exactly when things might start. But I think the one constant we can say is that whenever it comes, central banks still expect any tightening to be only relatively gradual.

Nick: Yes, inflation has been at the top of our risk list for the London Wall Partners Investment Committee for some time. Perhaps I can bring Stuart in at this point. Stuart, how do you think it might affect investment strategy?

Stuart: I think, should inflation be above current expectations, it seems reasonable to assume we would see higher bond yields and lower bond prices. But I don't think that would provoke us to change our asset allocation for fixed income because we've been saying to clients for quite some years now, that they should have as low a weighting as possible, or as appropriate for their circumstances, in bonds. So higher inflation, lower bonds; we wouldn't need to make any changes. But, I think, probably with higher-than-expected inflation, we could see a sell-off in stock markets. But in the medium to long term, the profit growth, in the companies that the funds we recommend are invested in, should more than offset any decline, especially as the focus on quality companies favoured by our managers means the companies that the funds' hold tend to have good pricing power, high margins and should be able to absorb any rising input costs without a particularly large impact on their profitability.

Nick: Thank you, Stuart. So, inflation is a key economic risk and something we need to key an eye on. But, Ian, what do you see as the other risks to economic outlook?

Ian: Well, we're not yet out of the woods with the pandemic itself. The risks and uncertainties on the health front remain significant, so the recovery into 2022 remains very dependent on widespread vaccine-induced immunity – so

reduced immunity through a natural diminution, if we don't get booster jabs, or through a new vaccine resistant variant of the virus if that were to appear – either of those could set everything back by some time.

Other than the pandemic itself though, I do think that I would focus at the moment on geo-political risks which also look to be more elevated than they have been for some time. Most importantly, and this is a long-term issue, I think we are seeing a change of approach by President Biden, and by the West more generally, towards relations with China. The US now sees China as more of a rival than a partner and believes that its expansionary ambitions have increased under President Xi. This has led to much greater scrutiny of economic co-operation, as well as the heightened military presence that we're now seeing in the South China Sea. As yet, we are not moving back into a cold war or anything like we remember from the seventies and eighties with Russia, but I do think tensions are rising. The issues around Taiwan are not insignificant. From what I hear, the US is operating on intelligence analysis that suggests that China wants to be in a position to at least be militarily able to invade Taiwan by 2027. So, I think these heightened tensions and the military gesturing is unlikely to subside any time soon.

We've also seen some financial instability recently in China through the problems with Evergrande – their biggest property company. While I think those problems of that particular company, Evergrande, are likely to be contained and are not systemic, it does remind us that we don't fully understand all of the financial interdependencies that exist within the Chinese economy. The corporate debt levels in China do remain very high. So, I think more widespread instability in the future does remain a risk.

Nick: Thank you, Ian. We've got a question on China which hopefully we will have time to come to later, as well as some other questions. But we've also had a series of economic analysis from the government here in the UK over the summer. Any thoughts on those?

Ian: Well, I don't often look specifically at UK issues given the international focus of our investment strategy. But given the big fiscal decisions that we've seen over the summer, I think it is worth mentioning as their announcements about taxation and public spending over the summer are not only increasing the tax burden as a percentage of GDP to its highest level since the Second World War for the UK, but also significantly expanding the role of the state by adding social care to the list of those services for which the government is responsible. Together, there have been three recent major tax rises; we have seen a change in direction on corporation tax; the announcement of the national insurance and social care levy, and a freeze in income tax thresholds through to 2026, which is essentially a rise in income tax. Together, they raise about £36 billion a year, that's 1.6 % of national income and Boris Johnson has now directly raised taxes by far more than any Conservative post-war Prime Minister, indeed more than any other post-war Prime Minister, except Harold Wilson. As such, I think we can say that these changes mark the end of the low tax conservatism that has been driving politics in the UK since the 1980s and Mrs Thatcher, and the end of that low tax conservatism will last at least for this parliament and probably for a generation.

But these tax rises cannot, I think, really be blamed on the pandemic. Books have been written about our ageing society for decades, but it's only now that the economic implications are starting to hit home, both in the numbers of elderly and in the ratio of the working to the dependent populations. Both of which are going to increase further over the coming few decades or so. An ageing society almost inevitably means a bigger state. Nearly all governments play a huge role in redistributing income over an individual's lifetime – not only through pensions but also via the need for, and the cost of, health and social care at different stages of life, but the UK stands out in this regard in that the UK internalises a lot more of those costs inside government. We have neither a private health insurance and care system

nor do we leave medical costs to the individual. So, the pressures on the UK government are becoming severe. Until now, these rising costs of health and social care, which have been going up gradually over the last couple of decades, have been met by shrinking other areas of government expenditure. We financed the growth of the welfare state over the second half of the last century without a lasting increase in the tax burden by shrinking the military. Over the past 10 years, the share of public spending covering healthcare has been able to rise only as a result of the austerity imposed upon other services. But after 10 years of such austerity, there is little more that can be easily cut. So, this summer's tax rises reflect less the impact of the pandemic and more the long-term structural pressures on society as we all age. All that the pandemic has done is make these pressures harder to fudge.

So, I firmly believe that this trend to higher taxes and a more activist government, not only in the UK, but also elsewhere, has got a lot further to run, in spite of what some politicians may say.

Nick: Thank you, Ian. Some sobering thoughts, but it would be naïve to think that we could all enjoy a longer and healthier life span without there being some associated costs. All the more reason, of course, for well-considered financial planning for the long term to ensure we can fund our later years. I'd now like to turn to Stuart who will discuss some matters concerning our investment approach and the funds and companies we recommend in our model portfolios – Stuart.

Stuart: Thank you. In our July call, I focused on semi-conductor companies, names such as TSMC and Nvidia, which are held in our model funds. I was aware that some of the names may not have been that familiar so I thought it would be helpful to see how they ranked compared to the largest UK companies, in order to emphasise just how substantial these chip businesses are. But when preparing my notes, I was somewhat crestfallen to be reminded of just how diminished the UK stock market has become in recent years. At the time of

our last call, Unilever, which was then the biggest London listed stock, was just the 59th largest stock in the World Index. As anyone who knows us will be aware, our approach is to recommend global funds in which fund managers concentrate on identifying the strongest businesses and attractive sectors wherever they are listed. We don't recommend funds which focus on one country or a geographic area. We therefore don't tend to focus on the structural performance of individual stock markets, but for a change today, I was going to make some observations on the state of the overall UK stock market – which I'm afraid is a slightly sorry tale – before moving on to describe some of the UK companies held by our model funds, which is far more reassuring and uplifting.

Over the five years to the end of last month, 30 September 2021, the UK stock market has materially lagged the performance of the World Index, with the UK's FTSE All-Share Index total return of 30% comparing unsavourily with the FTSE All World Total Return Index return of 79%. Now over this time frame, the technology sector has been a strong performer and one of the key reasons for the UK's under-performance has been the dearth of IT companies in the UK. The latest figures we've got, show the World Index has a 24% in technology whereas the UK index has just 2% – there just simply aren't any UK equivalents of Microsoft, Apple or ASML. In fact, a fund manager of one of the most successful global funds that we recommend has made the rather feisty observation that the UK stock market largely consists of companies operating in industries from the 19th century – a point they say they have raised with the government in order to try and provoke a bit of a policy response.

But it isn't just historic performance and sector exposure where the UK disappoints perhaps – the number of listed companies has also been shrinking. In August, the FT reported that the number of FTSE All-Share and AIM listed companies had fallen by over 30% since 2007 – from about 1,900 then to about 1,300 today – which is a much sharper decline than we have

seen elsewhere. Many, of course, overseas markets have had a much, much healthier new issue market. But it's also because the UK has seen more than its fair share of corporate takeovers. The UK has traditionally been open to acquisitions by companies at home and abroad as well as private equity and since the pandemic, the pace of corporate activity has picked up a lot. The recent takeovers have included corporate bids for the betting company, Entain, the aerospace company, Meggitt, the potential motor and transport companies, National Express and Stagecoach as well as an indicative approach for EasyJet. The Daily Mail and General Trust appears about to be taken private by its majority shareholder after nearly 90 years of being listed. Private equity buyers have also been busy and temporary power provider, Aggreko, industrial land redeveloper, St Modwen, supermarket chain Morrisons, defence company Ultra Electronics and retirement home builder McCarthy & Stone are amongst a long list of companies which have been taken private recently.

With debt remaining cheap and private equity continuing to raise new funds, I can't see why this won't continue. I think UK investor behaviour may also not be helping much. A letter in the Saturday FT a couple of months ago concerning private equity takeovers, I think is slightly controversial, but it caught my eye, is probably worth consideration again from a public policy standpoint and the letter read as follows (this was published on 10 July this year):

"As chair of a listed company, I see no end to this process (this being private equity takeovers). *Most public company boards are forced by shareholders to keep gearing low, to devote limitless resources to ESG, to maintain gender and race balances on the board, and to operate a rigid executive remuneration policy irrespective of circumstances such as the pandemic. Delivering profits appears to be a lower priority than these. It is no wonder that private equity is able to extract more value, and in the process make the listed board appear Neanderthal."*

I should say that the author's name was withheld when the letter was published.
Fortunately, our recommended fund managers are able to identify a number of strong UK companies for their portfolios and I was going to move on to discuss a few of these. I should probably also highlight that at 12%, the UK's proportion of the company share allocation of our model funds materially exceeds the UK's weighting of 4% in the World Index, which is obviously a fairly significant over-weighting.

Our model funds currently have holdings in the three largest stocks in the UK market which are now AstraZeneca, Unilever and Diageo. I think AstraZeneca appears to be run with boldness and pace which is usually more typical of a US corporation and one of the reasons it is now the biggest UK company is that it has recently issued some new shares to help fund a mere $40 billion acquisition of Alexion, an American business specialising in rare diseases. While AstraZeneca is currently probably best known for its work on the Covid vaccine, which was originally developed by scientists at the University of Oxford, its main investment attraction comes from its portfolio of oncology drugs. They are innovative and targeted on some of the hardest to treat cancers. A strong oncology franchise is always an interesting investment proposition. As a drug which addresses one particular condition, is very often later found to be of use for treating others. We've mentioned Unilever and Diageo on previous calls, but I would briefly note that Unilever's 62% stake in its listed Indian subsidiary, Hindustan Unilever, is worth very nearly 40% of its market value, which bodes pretty well as India recovers from the pandemic and sees a growing number of middle income consumers. Diageo should benefit from continuing investment in its brands that it made during the lockdown.

Our model funds contain a further 14 FTSE 100 stocks, and we should also point out that one of the investment trusts we recommend is itself a FTSE stock. Successful investments in Amazon, Tesla, Illumina, Moderna and other

innovative growth companies has propelled Scottish Mortgage to 27th position in the UK league table. Most of the UK large cap stocks our funds own are familiar names such as National Grid and the London Stock Exchange, whose strong market positions speak for themselves.

There are two I'd like to highlight, not least because they illustrate a feature our managers often seek when looking for investments which is specifically – the opportunity to invest surplus corporate cash flow at attractive rates of return. Whilst some businesses held in our funds have opportunities to invest organically by expanding a product range perhaps or attracting new subscribers or moving to new territories, Halma and Rentokil Initial have a track record of making numerous relatively small corporate acquisitions to strengthen their companies.

Halma is generally not well-known and is actually a member of the FT Lex Column's 'XFT index' which consists of companies which aren't attention grabbing enough to be written about in the FT very often. Hence "ex" or outside the FT. Whenever the Lex Column does choose to write about one of the members of this index, which obviously isn't very often, they tend to update the relative performance of the group and the story tends to remain the same. Companies which don't generate column inches have tended to perform well. Anyway, Halma wouldn't have made money for its shareholders if it didn't have strong fundamentals and its innovative products for the safety, health and environmental markets use their technology in sectors with attractive long-term demographic and regulatory drivers to generate growth. But given Halma's broad geographic and product footprint, it continues to find numerous opportunities for bolt on acquisitions of relatively modest size. Both the number and size of the opportunities is an important element for Halma – as it is for Rentokil Initial – as the experience gained by integrating corporate purchases on a regular basis reduces the risk of each deal, and smaller businesses tend to be less richly priced.

Rentokil Initial is probably better known than Halma, given its strong pest control and hygiene brand, and a couple of decades ago it was also a UK stock market favourite, as the company notched up year after year of 20% earnings growth. Indeed, the chief executive at the time became known as Mr 20%. That era came to an end when the company over-reached itself with ever larger takeover deals in a quest to keep that growth rate going – what the business writer Jim Collins characterises as the relentless pursuit of more. But following a number of years of entrenchment and refocus, the company is seemingly back on track and is now a regular acquirer of readily available smaller businesses in its markets.

The final observation on these two companies – while they may be listed in the UK, their British operations aren't especially meaningful in the context of the whole, with the most recent annual report showing that both Halma and Rentokil Initial coincidentally earned just 16% of their worldwide revenues in the UK. This an illustration of why we usually don't tend to focus on the country of listing for the businesses held in our model funds, because it often doesn't provide any useful insight.

I always like to try find an ESG feature to discuss in the calls to emphasise the focus both we and our recommended fund managers place on the matter, or matters. On this occasion, given the looming climate change COP26 conference in Glasgow in November, I thought I would highlight three smaller UK companies held in one of our model funds which may yet have a big part to play in the moves to decarbonise the world economy. The three stocks are Ceres Power, ITM Power and Ilika. Ceres produces fuel cells, which are likely to play an important role in both the transition to clean power as well as in a hydrogen-based economy. Fuel cells convert either or both natural gas and hydrogen to electricity and heat more efficiently than burning those gases and in being able to use a single or a mix of fuels could be introduced for household heating before conversion to a hydrogen economy is achieved. De-carbonising central heating is likely to be one of the biggest challenges in

cutting CO2 emissions, as electric boilers are unlikely to be a practical option for most properties. However, fuel cells produced by Ceres can work off the existing natural gas supply as well as hydrogen. Given fuel cells are predicted to become more widely used in transport applications, such as buses and trucks as well, the market opportunity for Ceres is substantial.

However, many of the fuel cells already in operation use expensive precious metals to achieve their electrochemical reaction, whereas Ceres uses low-cost steel plates covered with a ceramic coating which can be made with already widely used manufacturing equipment. Ceres Power has strategic relationships with Bosch, which owns 17.5% of the company, and Wi Chi Power of China, which owns 19.5%, and it has other industrial partners in Japan, South Korea and Austria, all of which should accelerate their ability to develop and sell their fuel cells.

The second company, ITM Power, designs and makes hydrogen producing machines using electrolyser technology for splitting water into hydrogen and oxygen, which appears to be better placed to use the fluctuating power arriving from renewable electricity generation compared with other methods. In 2020, ITM established a strategic partnership with the global industrial gas group Linde and it has also got a partnership with the Italian energy infrastructure company Snam, which by-the-by has a top 10 holding in our recommended global infrastructure fund. So ITM has strong support from established industry players.

Finally, Ilika designs and makes solid state batteries which are more compact than existing lithium-ion batteries and which can also be recharged more quickly and operate at a broader range of temperatures. The company's prime focus is currently on the use of their batteries in medical implants but they are also developing products which could yet be of interest for the electric car market.

There hasn't been time today to discuss some of the interesting UK-based life science companies which are held in our model funds, such as Oxford Nanopore, which recently floated in London, but I was concurrently planning to cover the healthcare sector on the next call in early 2022, so I will pick up on those then. So, I think now it's back to Nick.

Nick: Thank you, Stuart. Your knowledge of the businesses in our funds and the industries outside the funds never ceases to amaze me and it's excellent. Thank you so much. I am now going to turn to some of the questions we've received –again many thanks for sending them to us. We are keen to ensure that these calls really meet your needs and the interaction from the e-mail questions and answers, though not quite as rich as face-to-face dialogue, does help.

This is one question we have received from a client – it seems to me that this labour shortage isn't short term and will get a whole lot worse before it gets better and the government doesn't seem prepared to accept the scale of the shortages and the knock on effects. Any views from London Wall?

Ian: I do think there's some truth in what the client says, though I think in terms of the global economy, we should be wary of extrapolating the problems here in the UK onto that wider stage. There are some labour shortages in the EU and in the US but these mostly do seem to be short-term issues as the employment support programmes in those countries have been wound down and as some of the workforce shifts to new sectors. But the problems in the UK do look more structural and may well last longer and this, I think, is because in addition to the pandemic related disruption, we are adapting to new conditions post-Brexit and the end of the free movement of labour. In the last 18 months, some 1.3 million foreign workers have left the UK and under the new immigration rules, many will not be allowed to return. So, the shortages in sectors such as agriculture, hospitality, nursing and haulage are acute and the problems stem not just from the number of foreign workers

leaving the UK. In haulage, for example, the reduction following our exit in what is called permitted cabotage – where a truck delivering to the UK from abroad is allowed to undertake additional domestic deliveries before recrossing the channel – has further reduced domestic capacity in road haulage. So, I think the UK is undergoing a much more fundamental reorganisation of its labour market and this is going to take quite some time, disruption, and higher wages before it's sorted out.

Nick: Thanks Ian. I've got another one for you in a second but let me just come to Stuart if I may. We've got a question from a client and that's the impact of the Chinese Communist Party's crack down on Chinese companies, both in terms of impact on portfolios to date and our future investment in those. Stuart.

Stuart: The Communist Party generally describes this crack down as being a focus on common prosperity. It's almost more of a levelling down than a levelling up approach that they're adopting – companies make a lot of money or indeed individuals that have built up fortunes that way. But we don't think that the focus on common prosperity is going to lead us to make us any changes to portfolios at all. Based on the latest published portfolios that we have access to, just four of our model funds have some very modest holdings in Chinese companies and most of those are healthcare companies where our managers believe they have found companies with differentiated research which should be producing some very interesting new pharmaceutical products in the years ahead. Given that the Communist Party is still keen to encourage such innovation, I think it will be extraordinary if anything adverse happens to those businesses from the government's point of view and we would expect the managers there to continue to hold those investments. The largest underlying Chinese position in our model funds, in fact, is listed – the company is listed in America, but the largest position is a business call Yum China which was spun out of Yum in America and that operates the Kentucky Fried Chicken, Pizza Hut and Taco Bell franchises in China. But I should say

that it's only the 30th largest underlying position in our model funds. I have to say, I don't think those sectors are going to be a particular focus of a government as it's tightening its grip on some elements of the corporate sector.

It is fair to say that one of our model funds does have holdings in the internet giants and has done so for many years and they've been fantastic for successful investments. It's been the internet giants that have been particularly in the eye of the storm of the recent government intervention. However, that manager has been investing in China for a very long time and they've seen waves of regulatory intensity come and go and so we have got every confidence they're going to study the situation calmly and make the right decision as they see fit.

Nick: Good. I didn't want to get too into China at the minute, but, Ian, do you have anything to just add on that?

Ian: Well, just very briefly Nick because I was going to look at China possibly in more detail in our January conference call, I do think that what Stuart talks about with common prosperity is part of quite a big shift in the strategic direction of the Chinese Community Party and of the Chinese economy itself. The current Chinese Communist Party is much more controlling than its predecessors under Deng Xiaoping and I think it is looking much more at equalising what's going on in the economy than it is going for growth. So from that point of view, I think some of these changes are going to be long lasting, but I'll cover those in more detail over the course of the January call.

Nick: Okay. In the meantime, wouldn't inflation be a good thing, and this is a question sent in, for the next ten years to inflate away debt and create higher wages, etc?

Ian: A period of higher inflation when you put it like that, always sounds very seductive, but it only works to inflate away debt if interest rates do not rise in response. In the 1970s, inflation rose sharply but money illusion and financial repression meant that interest rates rose far less. I remember that inflation was 25% and interest rates were only 18%, so they were significantly negative in real terms, and I don't think those sorts of conditions would be repeated. So, what one might gain in terms of inflation reducing in real terms your debt capital, you'd lose in terms of much higher interest payments. So, I think it's a fallacy to believe that somehow you can inflate it away under normal market conditions. On the wages front, standards of living can only rise if the incomes continue to rise faster than inflation. Not only is this not usually possible for everyone, so some groups in society lose out from higher inflation, but unless such wage rises are justified by productivity gains, they are not sustainable. They will simply stimulate yet more inflation and you start to lose out all over again.

Nick: Thank you, Ian. So, let's turn to one on monetary or fiscal tightening to control economies, which is what people used to say there could be – but the higher taxes aren't being referred to that way. Should they be? And won't higher taxes mean people want pay rises?

Ian: Using fiscal policy – that is changes in taxation or government spending to steer the economy through the cycle – is a policy that fell out of fashion in the 1980s and it was largely because it was such a blunt instrument and because it took so long to put into effect. Some of the tax rises that we've seen announced by the UK Chancellor recently don't take effect until 2022 and some in 2023, so it's not as if they can affect the way in which the economy is working now. But for now, in terms of whether fiscal policy is tightening, it is currently being offset by the pace of government spending, so fiscal policy has been stimulatory and will be moving back towards neutral. But by the time we get to 2023, fiscal tightening will become a drag on activity so the Bank of England and what it does with monetary policy will

have to take into account the fact that taxes are a drag on the economy when it is setting interest rates.

Nick: Final question, very briefly, can the UK economy ever realistically prosper and grow without importing foreign labour from the EU or otherwise and doesn't this fly in the face of economic history? We are global investors but given we all live in the UK, most of us anyway. Ian.

Ian: Well ever since the 1950s, the UK economy has relied upon a contribution from foreign workers to drive growth in the economy. This was not only involving direct immigration, this was the case in the 1950s and the 1960s, but also since the 1980s, the use of globalisation and offshoring of production to expand the effective workforce available. So, we've benefited from it that way too. Given the population trends within the UK are going to leave the population of working age almost static over the course of the next decade or so, relative to an ageing population in total, I think growth is going to be somewhat constrained unless we have the addition of foreign workers of some sort to the labour force. Now, of course, if we could radically improve the productivity of our workforce, we could prosper without increasing numbers. But I think improving productivity has been a perennial challenge and in recent years, productivity growth has actually declined rather than advanced and that makes it even more of an uphill task. So, I think there are some real challenges facing us going forward.

Nick: Thank you very much Ian and Stuart, that's all we have time for today. Your contributions are so much appreciated and thank you both very much indeed. Of course, if you have any other questions that you'd like either Stuart or Ian to answer, we'd be delighted to hear from you whether you are listening live or to a recording. So just send an email or call and we'll get back to you. As most of our listeners are aware, our over-arching mission at London Wall Partners is to assist individuals and families to appreciate their capital and by that I mean enjoying the fruits of their labour while also

hopefully growing it and that's by providing sensible advice on the three main disciplines, these being (i) proper financial planning (ii) appropriate allocation and (iii) quality investing. These disciplines are inextricably linked in that the thoughtful goal or planning leads to appropriate asset allocation and good judgment and analysis enables quality investing. A joined-up approach is therefore essential in producing fruitful returns in the context of the economic and investment environment into which Ian and Stuart have been speaking. We're very grateful for the introductions and referrals that we continue to receive from clients, and we would love to meet any of your friends or colleagues who you think may benefit from a confidential discussion with us. Thank you to everyone who dialled into our call this morning and thank you again to Ian and Stuart. We plan to hold our next quarterly call on economic and investment issues in early January – Thursday, 13 January 2022. We will send invitations out in due course and I do hope you'll be able to join us then. In the meantime, enjoy the rest of your day and thank you very much once again.

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