Luna Investment Management

2022 Outlook

May You Live In Interesting Times

Introduction

Welcome to the Luna Investment Management 2022 outlook document. The ancient Chinese curse that says "May you live in interesting times" certainly feels appropriate given the last few years. Those interesting times do not look like abating just yet, but there are still reasons to be optimistic. 2021 has been another year of Covid-19 dominating our lives and 2022 looks like it will continue in similar fashion. Despite this backdrop there are reasons to be positive in the new year. In this document we will take a look at the key asset classes, the market backdrop, provide more information on the Investment Philosophy and current views from the Luna Team.

Here are some thoughts on what to expect from this document;

- Inflation in the UK is likely to continue to pick up in the first few months of the year and should then start to fall back slowly.
- Global economic growth is likely to continue to accelerate from the lows of 2020, but to a slower rate than the boom in 2021.
- Central Banks have seen economies recover; the US economy is now bigger than pre-pandemic. Expect more talk (and action) on interest rates.
- Covid will continue to dominate the headlines and market sentiment. The global economy will continue to make progress on the vaccination roll out, but how effective vaccines are against new variants, like Omicron, remains key to the continued easing of restrictions.
- More political developments. Whether that be in the UK, sanctions against other nations and of course a US midterm election at the end of this year, politics will be front and centre in 2022.
- Existing long term trends and themes are well placed to continue; Infrastructure spending will be high, investment in Technology will accelerate so that we protect ourselves and benefit from new functionality.

Global Economic Outlook and the impact on Stock Markets

Global growth was on fire in 2021, with economies bouncing back from the Covid induced lows of 2020. However, the progress on a country-by-country basis has very much been vaccine dependent. The nations that have made the quickest progress on vaccine roll outs have been able to lift restrictions and seen consumers flock back to enjoy themselves and in doing so spend savings which had been built up during the pandemic. This has propelled economic growth higher. On the flip side though, vaccination progress globally has not been as strong as we all would have hoped, and a vast majority of the global economy is still living with some form of restrictions. As vaccine deployment accelerates through 2022, restrictions will continue to be lifted and economic growth will accelerate. The obvious caveat to the above is the progression with the virus and if any variants develop that threaten this.

Closer to home, despite the strong bounce in the UK economy last year, economic growth is forecast to accelerate above a "normal" year in 2022. The OECD has forecast the UK economy will expand by 4.9% in 2022. However, supply chain issues and Covid restrictions cast a shadow over whether this high level of growth for the UK will be achievable.

Overall, we expect this to be a positive backdrop for equity markets with economic growth continuing to accelerate, particularly in those sectors and companies exposed to the economic cycle. However, stock markets have progressed significantly from the lows in 2020 and valuations are not as cheap as they were. Therefore, we do not expect the same levels of returns from equities in 2022 as in the previous 18 months.

Within our equity positioning we like sectors showing high levels of growth and that have demonstrated they are long term winners, such as Technology. We couple this with selective valuation opportunities with companies that can benefit as restrictions are eased.

It is very normal for stock markets to have a 10% 'correction' in a calendar year, this is healthy and means animal spirits do not get too carried away. We are fully expecting this to happen at some point in 2022 whether that be as a function of interest rates changing direction, the ongoing developments with Covid or something left field and unexpected. Importantly though, at this stage we are expecting this to be a short term event meaning we will look to take advantage of any such opportunities that present themselves, and not a more sustained longer term correction.

Interest Rates and Inflation

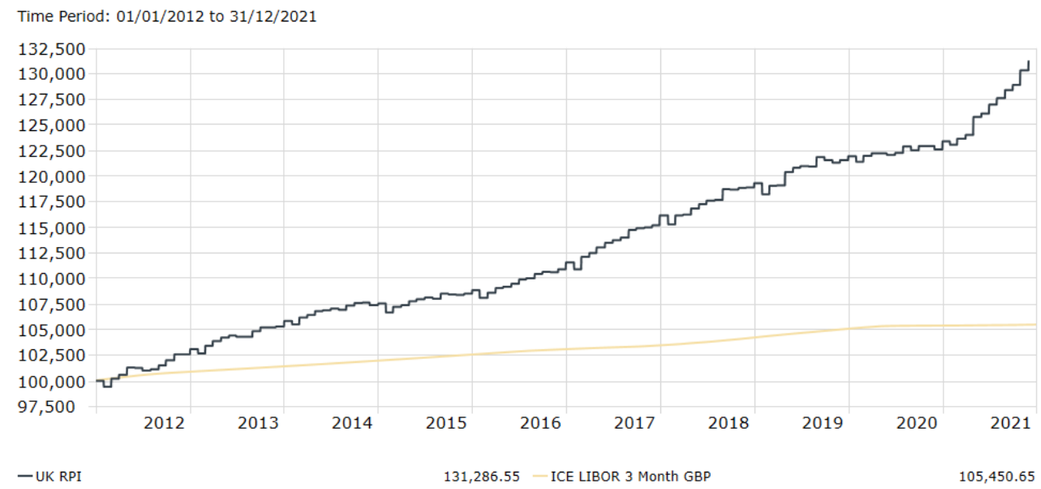
UK interest rates have been close to an all-time low since the beginning of the pandemic. As we moved through 2021 though, the talk of increasing interest rates gained momentum; this was a function of the strength of the economic recovery and also because inflationary pressures have been building. This led to interest rates moving to 0.25% in December. In 2022 it is likely that those factors will continue to be the driving factor with central banks and we may see further rises.

Interest rates have been low for over 10 years now, and this has had a significant impact on all asset classes. We are expecting interest rates, not just in the UK but globally, to start to move higher in 2022. However, let's not over egg this – UK interest rates are likely to peak at around 1% this economic cycle. This is partly because the UK currently has debt levels at a 55 year high as a percentage of GDP, at just over 100%. This means the UK finances are more exposed to an increase in interest rates than they have been. If the official interest rate rose by 1% alongside equivalent rises in the cost of longer-term government debt and the inflation rate, it would add £25bn to the UK's annual bill for debt interest payments.

Inflation levels globally have been creeping higher in 2021. In the UK, Consumer Price Inflation (CPI) was 5.1% in December, well above the Bank of England 2% target, whilst Retail Price Inflation (RPI), which includes the cost of housing, was 7.1%. The Bank of England has said CPI will peak at 6% in April when the energy regulator Ofgem raises a price cap affecting millions of households.

Investors should always remain aware of inflation because it has a significant impact on the real value of individuals wealth – the higher the level of inflation then the greater the risk of capital in low yielding assets, like cash in the bank, being eroded over time.

From a Luna perspective we currently have a low allocation to areas which we see as vulnerable to higher inflation; cash/money market instruments and traditional fixed income markets e.g. government and corporate bonds. This is because the current level of inflation is higher than the interest that can be earned from buying and holding these assets. This means your purchasing power and the value of your wealth is gradually being eroded over time. When investing in these assets for a long period, the compounding impact can be extremely detrimental to your wealth. This is highlighted by the graph opposite – over the last ten years, investing £100,000 then adjusting for Retail Price Inflation would now leave you with £131,286, whereas investing in cash (LIBOR) it has only increased to £105,450. That's a staggering £25,836 difference. This was at a time when inflation has not been roaring ahead in the UK but crucially the reason for this difference is because interest rates have been rooted to lows since the global financial crisis that began in 2008. Looking forward, this gap looks likely to widen further with the difference between inflation and interest rates one of the widest in our lifetime.



Source: Morningstar Direct (01/12/2011 to 31/12/2021)

Opportunities

Not all assets are at risk of higher inflation levels. There are ways to benefit from this environment. For example, "real assets" tend to do well against this backdrop as the real value of the asset increases with higher levels of inflation. When we talk about real assets, think of property, commodities and, to a certain extent, equities.

Those companies with pricing power can pass on higher price levels to their consumers and offset the impact of higher raw material costs. At Luna, we have a bias for quality businesses focusing on companies with earnings growth, high margins and in doing so look for businesses that can deliver returns above inflation.

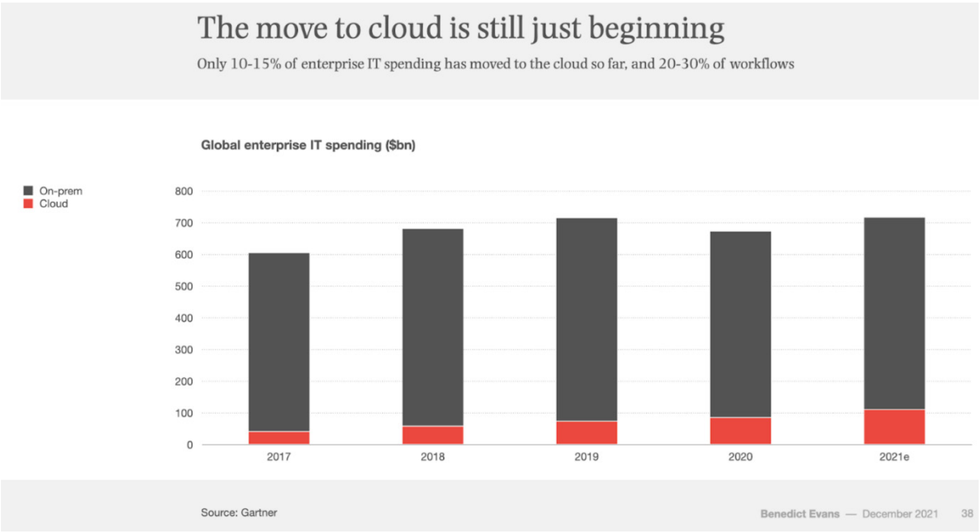
Technology; The Great Enabler

Despite the market's recent focus on reopening and reflation beneficiaries, the structural changes accelerated by the pandemic over the past two years show why thematic investing is relevant for investors who want to benefit from longer term winners. Our portfolios contain dedicated exposure to Cybersecurity, which we believe offers long term growth. We think that the fundamental drivers are well known, relatively steady and are likely to remain strong for some time.

With constant connectivity comes opportunities, especially for business, but also new types of vulnerabilities. Every connection to a network offers an entry point for hackers, requiring security and privacy to be managed (for businesses and individuals). This year has seen a rise in ransomware and cyberattacks – for example, the Colonial Pipeline, a critical part of the US national infrastructure, was attacked resulting in the disruption of gas supplies along the east cost of the US.

These risks have increased the need for security spending, providing firms with a subscription-based income stream along with some pricing power. Given its critical nature, we believe that Cybersecurity is a defensive segment in the technology sector but also with a positive long term growth outlook. Some commentators like to draw comparisons of the current technology sector with the Technology Boom in 2001; the key difference is that the fundamentals for such parts of the technology sector as a whole are very different today. Such businesses have strong balance sheets, attractive margins, are cash generative whilst being supported by long term tailwinds.

Elsewhere, cloud computing has been accelerated by the pandemic and is a key enabler of ongoing digitalisation. The growth in cloud also enables other trends; from the online provision of healthcare services, to data accessibility for remote working, and so on. The chart below indicates the potential that we are relatively early in the move into the Cloud.



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Plan for the future because that's where you are going to spend the rest of your life.

Mark Twain
1835 - 1910

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Final Thoughts

We continue to live in a very different world to that of two or three years ago. Any news on Covid in the short term could impact the way we live our lives and financial markets. Importantly, this is both positively in terms of vaccines and negatively in terms of the impact new variants, like Omicron, can have. Over the last two years, we have collectively demonstrated as individuals and investors that we are adaptable to the changing environment. We do not know how 2022 will progress but this adaptability and resourcefulness will be key.

We see one of the biggest risks continuing to come as a function of 'financial repression'. Inflation is accelerating and the returns from cash and low yielding asset classes means that in "real terms" investors will be going backwards. We believe investors need to have a diversified portfolio that has an allocation to asset classes that can maintain purchasing power, i.e. deliver returns in excessive of inflation. We expect financial repression to be a feature of markets into the future.

Interest rates are likely to continue to move higher in 2022, but they are not returning to the levels seen in past cycles because of the pressure of the debt burden.

We are fully expecting and prepared for periods of volatility. This is very normal and expected at this stage of the market cycle. Stock markets have a tendency to react quickly on the downside during events and it can feel uncomfortable. **What is going on will be short term volatility, but we are long term investors.** Financial objectives are not going to be missed because of what happens in the next few weeks but 5 to 30 years into the future. We should all focus on this time period to meet long term goals and (try to) ignore the short term market noise. It is important not to panic in periods of extreme volatility and disinvest during periods like this because we could be doing so at the worst possible time.

We look forward to working with you over the coming months and years.

The Luna Team

Our team of investment management professionals has over 150 years' combined experience, having managed more than £1bn of client investments. Each member of the team has been specifically recruited to deliver the high level of personal service and bespoke investment solutions that Luna believes clients deserve.

James Carter
Investment Director

James is one of the Founders of Luna and is the lead Investment Director, with responsibility for devising and delivering the Luna investment management proposition.

Ed Maxwell
Investment Director

Ed is an Investment Director at Luna, part of the executive management team and a member of the Investment Committee.

Alex Brandreth
Cheif Investment Officer

Alex is responsible for coordinating the overall investment strategy at Luna. He is also the lead Fund Manager on the Luna Model Portfolio Service.

Barrie Charnley
Senior Investment Manager

Barrie joined Luna as a Senior Investment Manager in June 2020. He works closely alongside the Investment Directors to ensure bespoke solutions are delivered within the wider investment framework.

The Luna Way

Luna is a specialist investment management firm. We exist to nurture the future for our clients and their families by providing tailored, risk-based investment management solutions to help them achieve their long-term financial goals. Luna symbolises new beginnings and the opportunity for positive change and transformation.

Luna offer a truly bespoke service with expert communication and comprehensive administration, underpinned by award-winning technology.

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Luna Investment Management
Level 7, Tower 12
The Avenue North
18-22 Bridge Street
Spinningfields
M3 3BZ

0161 518 3500
enquiries@lunaim.com
Lunaim.com