UK Mid Cap strategy

Central banks remain steadfast in their view that inflation will be temporary

- Signs that some supply and inflationary pressures have peaked in some areas
- "Value" stocks outperformed "growth" in September
- We initiated a position in Smart Metering Systems and Oxford Nanopore (IPO)

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What's happening?

With economic growth slowing and inflation rising, newspaper headlines are shouting 'stagflation!'. The debate about inflation and its persistency will continue over the coming weeks and potentially months, with consumer confidence at risk if supply tightness is not relieved soon. Over the month, the UK benefitted from its structural biases as oil and gas and resource companies outperformed the wider market. This dynamic was reflected in the 'style' performance metrics, with 'value' stocks outperforming 'growth'. Overall, equities fell over the month as the prospects of tightening monetary policy and inflationary pressures were digested.

Portfolio positioning and performance

Over the month, the strategy reduced by less than the UK mid cap market Index (FTSE 250 Ex Investment Trusts). Stock selection and sector allocation were both positive for the month. The underweight position in the real estate sector was positive, whereas the underweight in utilities and overweight in technology detracted. Detractors from a stock perspective included boohoo (an online fashion retailer), TI Fluid Systems (which develops, manufactures and supplies automotive fluid storage, carrying and delivery systems) and Auction Technology Group (provides marketplaces and a proprietary auction platform for curated auctions).

Positive stock performances of note included Serica (a gas & oil business), Darktrace (a cybersecurity company) and Dunelm (a home furnishing and furniture retailer). Darktrace released an update on their first quarter which was met positively by the market. The positive quarter led to the company revising their revenue guidance upward slightly. Dunelm saw its share price rise in September after the company upgraded their full year earnings expectations again. They also announced a special dividend.

We used share price volatility to add to core holdings and make reductions. New positions were taken in Smart Metering Systems (part of a fund raising) and Oxford Nanopore (part of its IPO). Oxford Nanopore develops technologies for molecular detection and analysis. These technologies are used in, but not limited to, DNA sequencing, diagnostics, drug development, and defence applications. Positions closed included Made.com, TP ICAP and IWG Group.

Outlook

Macroeconomic events arising from the rate of economic recovery are likely to drive capital flows over the short term. Inflationary pressures, both short and longer term, the incidence of COVID infections (globally), together with the commensurate rate of economic growth are likely to influence investor sentiment and allocation of capital. Central banks remain steadfast in their view that inflation will be a temporary phenomenon and monetary policy remains accommodative, although moderate monetary tightening seems increasingly likely. Supply chain tightness is distorting several markets and we will continue to monitor both the severity and duration of this.

Company management teams are not seeing enough evidence yet to declare that price rises are over, however there are signs that perhaps some of the tightness in supply and inflationary pressures have peaked in some areas. For example, lumber and Iron Ore prices are down over 50% from their peak in May 2021 and the oil price is in backwardation, suggesting that future prices will be lower than current prices. At the aggregate level, the UK Input Price Index peaked in June 2021 and the US Index peaked in August 2021. In addition, furlough support for 1.5 million adults in the UK will cease at the end of September, adding to the pool of labour.

Longer term, the more secular forces of both inflation and deflation will continue to battle for aggregate supremacy. ESG investment will remain inflationary, China is unlikely to export deflation going forwards to the same extent as it has historically and both demographics and technological innovation will continue to exert powerful deflationary pressures.

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