

Market Review and Outlook.

3rd Quarter 2023

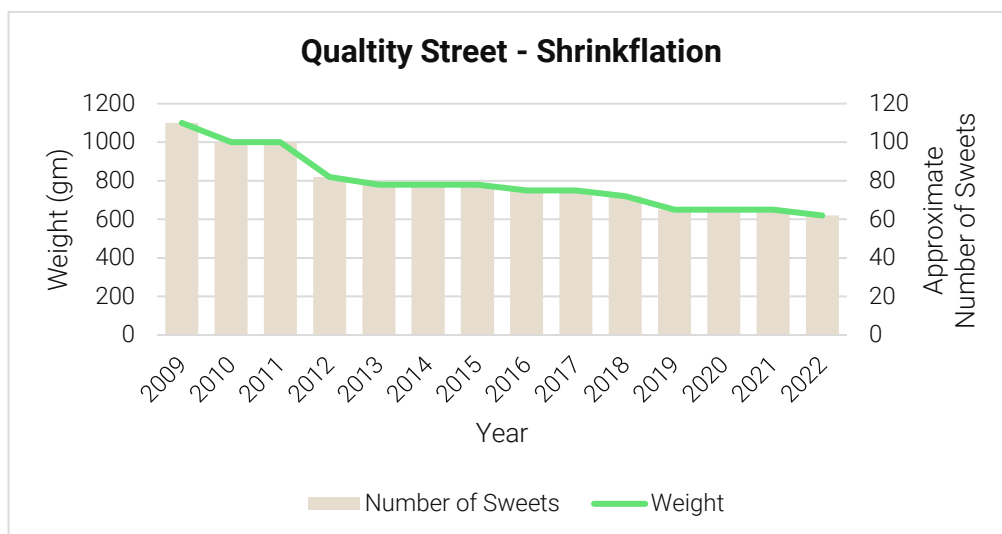
Economic Outlook and Market Commentary – September 2023

Shrinkflation for Halloween

With Halloween just around the corner, when trick-or-treaters will be knocking on doors in the hope of being given handfuls of sweets, it is timely to consider the all too familiar 'shrinkflation' phenomenon.

Over the last 2 years we've experienced high inflation and some consumers have been reluctant to pay more for goods so the retailer has shrunk the item and is charging us the same price; shrinkflation.

This is aptly shown in the Quality Street chart below, which shows that the tin (now tub) has roughly 45% less sweets in it compared to 2009!



Source: News Group Newspapers (2022)

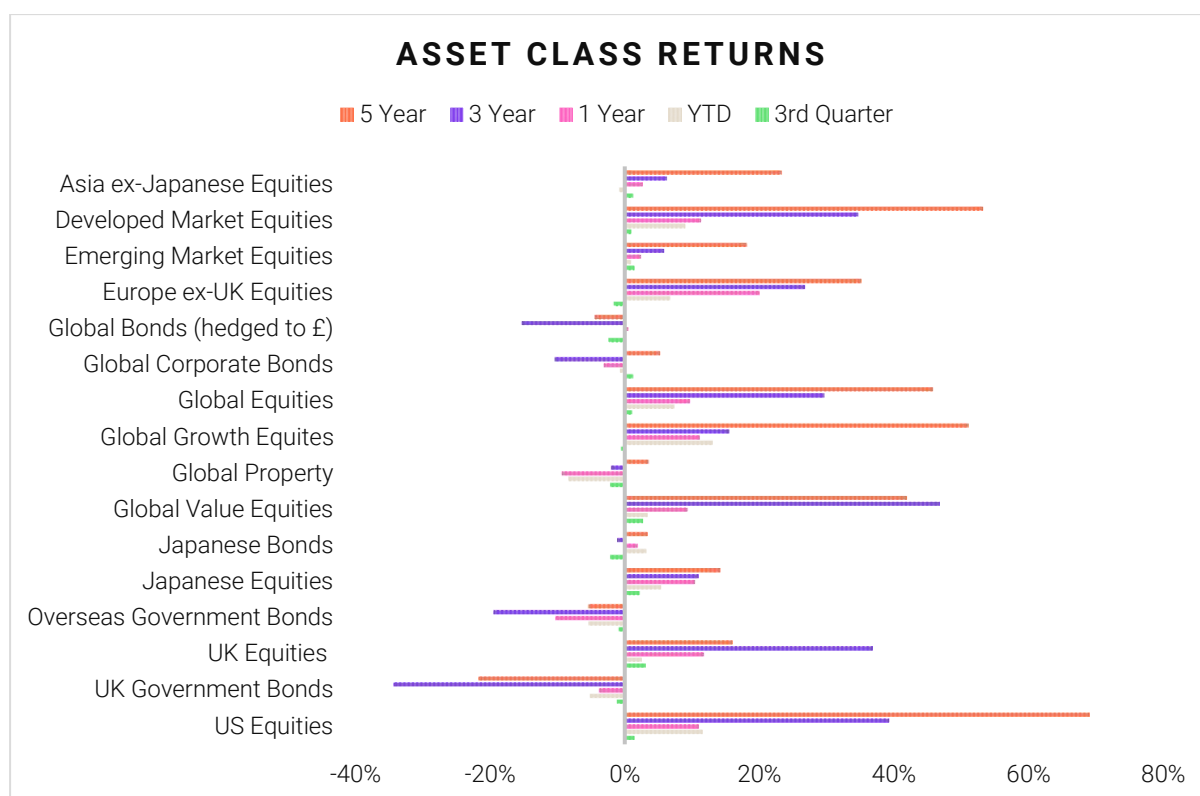
It provides a very visual representation of the impacts of inflation. One silver lining may be an improvement in our waistlines and overall health if we eat fewer sweets.

Central banks also, in a roundabout way, want us to eat less sweets by making it more expensive to borrow money. This means there's less cash circulating in the economy to buy all those sweet treats, which helps keep sweet prices from increasing.

Understanding the impact of inflation is part of financial planning and that is why that it is essential to hold investment portfolio that have the potential to delivering long-term returns that can outpace inflation and have an appropriate planning strategy to manage the shorter term volatility that these assets can possess.

Investment Asset Class Returns

After a robust rally in equity markets during the first half of the year, the third quarter delivered more modest returns. Global equity markets were mildly positive as a whole, while individual regional returns were more mixed, with some delivering negative returns over the quarter. Bond markets, unsurprisingly, given the economic conditions continued to struggle. Commodities performed well, as oil prices surged.



Source: Timeline (2023)¹

Equities

Global equities delivered a modest return of 1.12% for the quarter, which, while falling short of the strong returns achieved in the first two quarters, culminated in a pleasing year-to-date return of 7.36% as of the end of September.

After significant gains in the first half of the year, technology stocks were more muted over the quarter, as investors grew increasingly concerned about persistent inflation and higher interest rates. The Nasdaq achieved a return of 37.18% from the start of the year to its peak

¹ Proxies. Asia ex-Japanese Equities: Morningstar Asia Pacific ex-Japan Large-Mid Cap GR GBP; Developed Market Equities: Morningstar Developed Markets Target Market Exposure GR GBP; Emerging Market Equities: Morningstar Emerging Markets Target Market Exposure GR GBP; Europe ex-UK Equities: Vanguard Emerging Markets Stock Index Acc GBP in GB; Global Bonds: Vanguard Global Bond Index Hedged Acc GBP in GB; Global Corporate Bonds (hedged £): Vanguard Global Bond Index Hedged Acc GBP in GB; Global Equities: Morningstar Global Markets GR GBP; Global Growth Equities: Morningstar Global Growth Target Market Exposure GR GBP; Global Property: Morningstar Global Real Estate GR GBP; Global Value Equities: Morningstar Global Value Target Market Exposure GR GBP; Japanese Bonds: Morningstar Japan Treasury Bond TR GBP Hedged; Japanese Equities: Morningstar Japan GR GBP; Overseas Government Bonds: iShares Overseas Government Bond Index (UK) D Acc in GB; UK Equities: Morningstar UK GR GBP; UK Government Bonds: Vanguard UK Government Bond Index Acc GBP in GB; US Equities: Morningstar US Target Market Exposure TR GBP. Performance periods: 3rd Quarter: 30/06/2023 -- 30/09/2023, Year: 30/09/2022 - 30/09/2023; 3 Year: 30/09/2018 - 30/09/2022, 5 Year: 30/09/2016 - 30/09/2022; 7 Year: 30/09/2014 - 30/09/2022.

this year and has since dropped by 9%. The S&P 500 Information Technology Index experienced a similar rise and fall.

The exceptional returns earlier in the year had been driven in part by the Artificial Intelligence boom, particularly among the "Magnificent Seven"² group of large-cap technology stocks.

In Europe, despite equity returns being up 6.78% September, returns were down 1.58% over the quarter. This was due to growing concerns about the potential effects of sustained higher rates on economic growth, as well as the ongoing property crisis in China.

At home, UK equities marked a notable improvement over the quarter, with a gain of 3.10.% compared to the -0.42% decline in the previous quarter. The UK market, owing to its substantial exposure to the energy sector, reaped the rewards of a remarkable 30% surge in oil stocks over the past three months.

The fall in the value of the pound was also positive news for many firms in the FTSE 100, which generate approximately 75% of their sales from overseas. The pound's value has dropped -6.87% from its peak in mid-July, when a pound was worth \$1.31, finishing the quarter at \$1.22, which should make UK goods more competitive. As the quarter drew to a close, upward revisions to the UK's economic growth figures since the pandemic's onset, the unexpected softening of inflation, combined with a pause in interest rate hikes, provided a significant boost to market sentiment.

The difference in performance of developed and emerging market equities was narrow over the quarter with returns of 1.03% and 1.44% respectively.

Despite downgraded economic growth forecasts for 2023 and 2024 in most countries, emerging market nations are expected to exhibit resilience. Projections from the OECD suggest that India, China, and Indonesia will achieve growth rates of 6%, 5.2%, and 5%, respectively, in 2024, in contrast to the 1.5% forecasted for the G20 advanced economies.

Bonds (Fixed Income)

It was another challenging quarter for fixed income. Bond prices are inversely related to interest rates; when interest rates rise, bond prices typically fall. In addition, fixed-coupon bonds not linked to inflation face added price pressure as their real coupon value declines.

Global corporate bonds performance better than global government bonds this quarter; global corporate bonds rose 1.26%, while global government bonds, UK government bonds, and overseas government bonds posted negative third quarter returns of -2.34%, - 1.08%, and - 1.1%, respectively.

² Amazon, Alphabet, Apple, Meta Platforms, Microsoft, Nvidia and Tesla.

Portfolio Performance

Our investment philosophy is focused on building portfolios that take a globally diversified market-cap approach, so the performance of our portfolios delivers more consistent returns and less deviation relative to their investable markets. This helps clients build long-term wealth and provides the building blocks to real financial planning.

Tracker portfolio performance

Our Tracker 100 model returned 0.98% over the quarter, continuing the positive growth seen in the first two quarters. Our Tracker 60 model (60% equities), was up 0.31%



Source: Timeline (2023)

Classic portfolio performance

Our Classic 100 model, with its factor tilts, was up 1.34%, and the Classic 60 model was up 0.75%



Source: Timeline (2023)

Dimensional Core portfolio performance

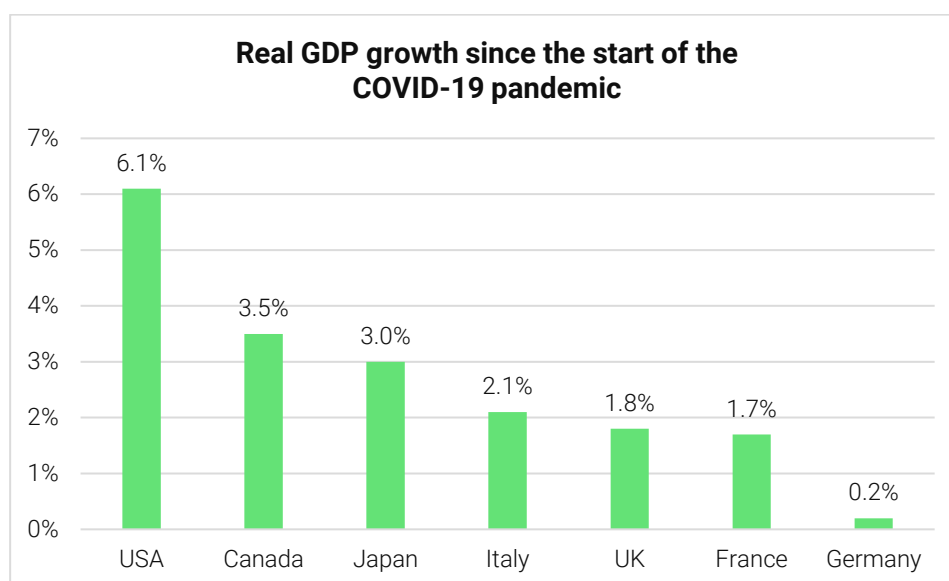
Our Dimensional Core 100 model, with its factor tilts, was up 1.65%, and the Dimensional Core 60 model was up 1.30% over the quarter.

Economic Outlook

Growth

As the quarter drew to a close, there was some positive news for the UK, with the Office of National Statistics (ONS) publishing revised economic growth estimates. The data indicated that the UK economy has grown 1.8% since the start of the pandemic, not contracted by 0.2%, as previously thought. The revised figures mean that the UK's growth exceeds that of France, with 1.7% and Germany's at 0.2%.³

However, compared to many of the other G7 nations, the UK is still somewhat behind in terms of growth. In addition, leading economists from Capital Economics, the EY Item Club and PWC, were quick to point out the challenges still faced by the UK economy. These include high interest rates and frozen tax brackets, that will reduce consumers' spending power. The Organisation for Economic Co-operation and Development (OECD) forecasts economic growth in the UK of 0.3% in 2023 and 0.8% in 2024.⁴



Source: Office of National Statistics (ONS), Organization for Economic Co-operation and Development (OECD) and Italian National Institute of Statistics (ISTAT) (2023)

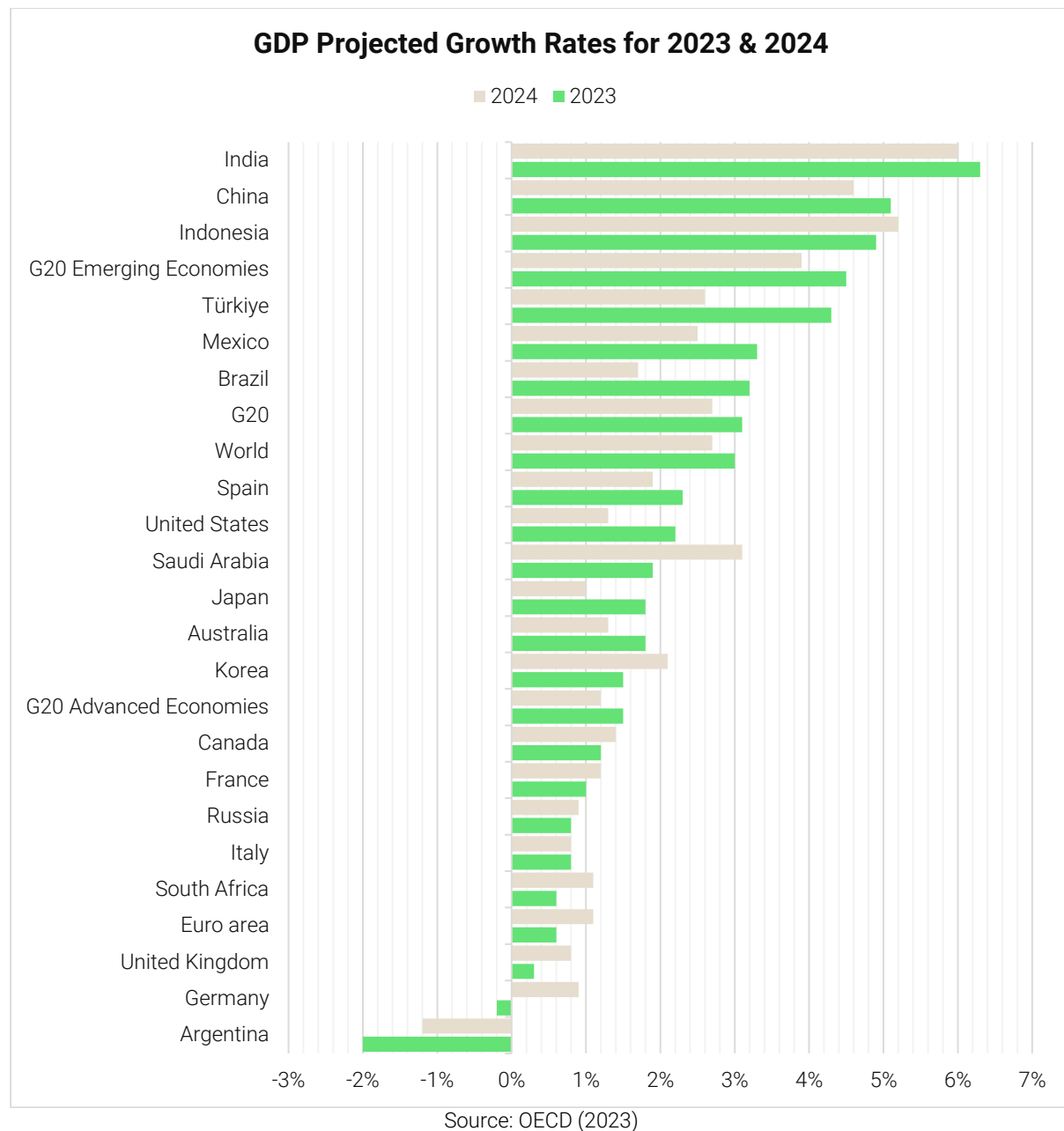
The global figures for economic growth for 2023 and 2024 are somewhat better than the UK, projected as 3% and 2.7% respectively. In fact, the world economy has been more resilient in 2023, than the original forecast of 2.7% growth made by the OECD in 2022. However, the current forecast of growth for 2024 is down from the original forecast of 2.9% also made in 2022.

The 2024 growth forecast downgrade stems from two key factors: the impact of tight monetary policy and a less robust-than-anticipated recovery in China. Notably, despite the subdued expectations for China's recovery, a significant portion of global growth in the 2023-2024 period is anticipated to come from Asian economies, underscoring their important role in the global economy.

³ Office for National Statistics (ONS) (2023).

⁴ Organization for Economic Co-operation and Development (OECD) (2023).

There are continuing risks, and the pessimists are already predicting recession. Inflation may persist longer than expected, with potential for additional disruptions in energy and food markets. A more pronounced economic slowdown in China could exert a more pronounced drag on global growth. Furthermore, public debt remains elevated in numerous countries.

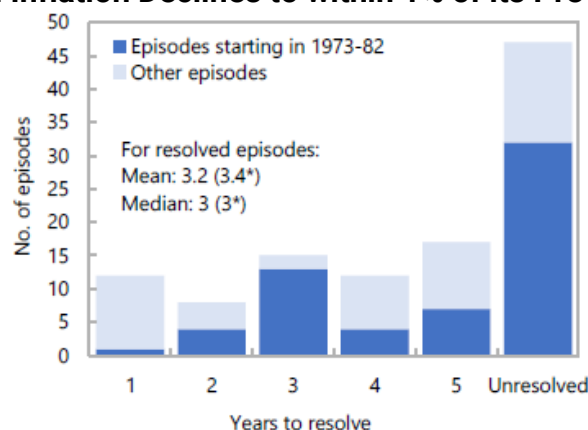


The Endless Journey

Inflation has been a persistent headwind for investors since mid-2021. Regrettably, in the intervening years, it has felt that almost no quarterly commentary was complete without a discussion on either the reasons why inflation was rising so quickly or why central banks seemed to be so ineffective at bringing it under control. But are we being too hard on central banks by expecting a quick fix when an inflation shock occurs?

Recent research by the International Monetary Fund (IMF), suggests, yes. After reviewing 111 inflation shock episodes in 56 countries since the 1970s, including over 60 episodes linked to the 1973-79 oil crisis, the authors found that only 60% of the episodes were brought back to within 1% of pre-shock inflation levels within 5 years. Even then, it took on average 3 years to resolve.⁵

Years until Inflation Declines to within 1% of its Pre-Shock Rate



Source: International Monetary Fund (IMF) (2023)
(*Episodes starting in 1973–82).

Given that we are currently 2 years into the current inflation shock, and many countries continue to see inflation rates not seen for decades, investors undoubtedly will be concerned that it may be years until inflation returns to pre-shock levels. The IMF did however find a number of factors that influenced how successful policy makers were in combating an inflation shock. In relation to the current shock, two factors seem the most important.

Firstly, success rates were lower, and resolution times longer for inflation triggered by terms-of-trades shocks during the 1973-79 oil crisis. As the recent shock was exacerbated by an increase in energy prices, caused by the war in Ukraine, this could make fighting current inflation more difficult.

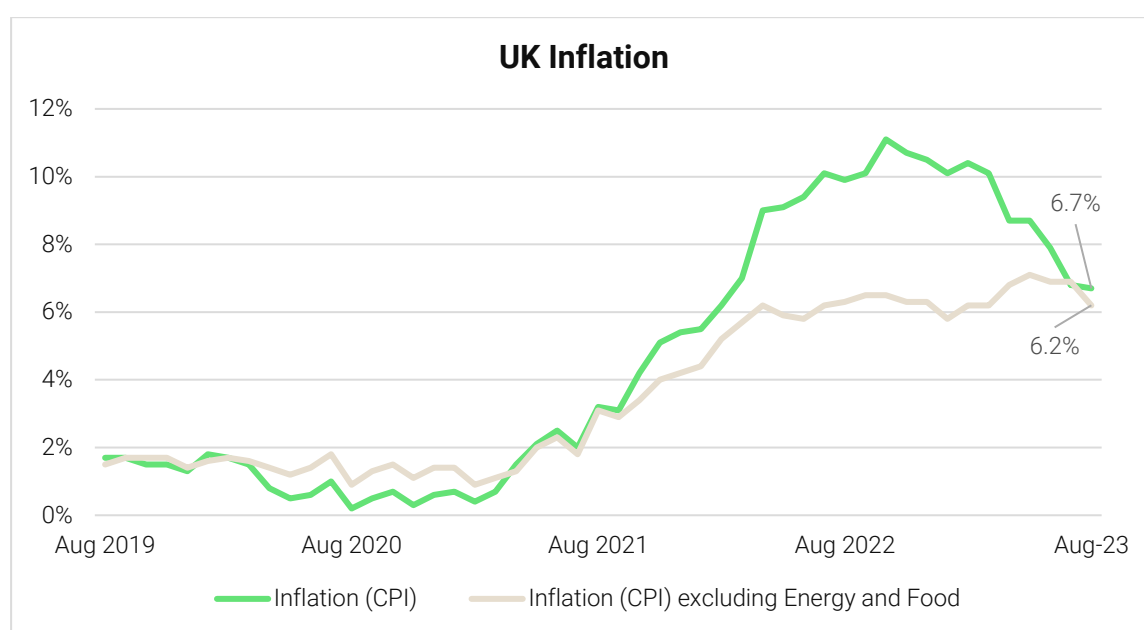
Secondly, consistency is crucial. To successfully combat inflation, tight fiscal and monetary policy must not only be implemented but also maintained for extended periods of time. Policy loosening at the first signs of weakening inflation needs to be avoided as this trend often reverses. Investors should take comfort in the fact that governments and central banks have reacted robustly to the current inflation shock, and continue to do so, voicing their intention to maintain tight policy measures for the foreseeable future.

Recently released data appears to show that inflation is starting to wane. In Europe, inflation in the Eurozone rose by 4.3% in September, the slowest pace since October 2021, dropping from 5.2% in August. Core inflation, which excludes energy and food and is seen by most

⁵ International Monetary Fund (IMF) (2023).

economists as a better gauge of the underlying trend, fell from 5.3% to 4.5%, the biggest drop since 2020. It wasn't all good news however, while energy prices declined by 4.7% in September, food inflation remained at 8.8%.⁶ In addition, the European Central Bank (ECB) recently revised inflation forecasts upward for both 2023 to 5.6% and 2024 to 3.2%, driven by the belief that energy prices will continue to rise.⁷

In the UK inflation fell by 0.1% to 6.7% in August. This was the third consecutive monthly drop and took economists by surprise, given surging global energy costs. Brent crude oil increased in price by 28%⁸ over the quarter, as Saudi Arabia and Russia announced their intention to maintain output cuts for the remainder of the year. Indeed, fuel prices were the largest upward contributor to inflation in the UK, but this was offset by slower increases in food and a drop in the cost of hotel rooms. The Bank of England (BoE) believes by the end of the year, inflation should fall to 5%, continue to fall throughout 2024, and reach the 2% target in the first half of 2025.⁹



Source: Office of National Statistics (ONS) (2023)

UK core inflation was also down 0.7%, to 6.2% in August, again, coming as a surprise to economists who had forecasted a far smaller decrease. Importantly, the decrease in core inflation was driven by a slowdown in services inflation, a key measure that reflects firms' labour costs. This is encouraging, as inflationary periods can lead to a wage-price spiral. As workers demand higher wages to keep up with rising prices, businesses may respond by increasing prices for their products or services to cover the higher labour costs. This creates a feedback loop where wage increases drive price increases and vice versa. This can result in hyperinflation if left unchecked, severely eroding the purchasing power of money, and destabilising the economy.

Across the pond there was yet more positive inflation news. While inflation did increase to 3.5% in September, up from 3.4% in August, it was the slowest increase since September 2021. Core inflation, although growing 3.9%, was down 4.1% from the previous month. The Federal Reserve (Fed) expects inflation to drop to 3.3% by the end of 2023, to 2.5% next year and to 2.2% by the end of 2025. It will take until 2026 to get inflation back to its 2% target.

⁶ Eurostat (2023).

⁷ European Central Bank (ECB) 2023.

⁸ Reuters (2023).

⁹ Bank of England (BoE) (2023).

Although the BoE, ECB, and Fed are still far from their 2% target inflation rate, its clear real progress has been made. Inflation peaked in the UK and Eurozone last October, at 11.1% and 10.6% respectively. In the US, inflation peaked a few months earlier at 9.1% in June 2022. But fighting inflation comes at a cost, that of increased interest rates.

Will They, Won't They?

Investors may hope that following the recent good news on inflation, central banks would cut interest rates. This, thankfully, seems unlikely. In the past, central banks have made the mistake of acting too swiftly, lowering interest rates at the first signs of declining inflation, only to see inflation subsequently rebound. This caused central banks to lose credibility. It seems central banks have learned from the past and are applying policy consistency in their approach to tackling inflation, which the IMF noted as essential to successfully tackling inflation. In the main, central banks remain hawkish on inflation and do not rule out further interest rate increases despite the recent weakening of inflation.

In August, UK interest rates were held at a 15 year high of 5.25% after 14 consecutive increases. Andrew Bailey, Governor of the BoE warned against "*complacency*" and "*premature celebration*" explaining "we've got a long way to go to bring inflation down to the Bank's 2% target".¹⁰

On the continent, Christine Lagarde, the head of the ECB said interest rates will stay high enough to restrict business activity for "*as long as necessary*"¹¹. The interest rate in the Eurozone is now at its highest since the Euro was established in 1999, after 10 consecutive increases, at 4%.

In the US, the Fed left rates unchanged at a 22-year high of 5.5%. Since March 2022, the Fed has raised rates 11 times, only holding them steady on two occasions, including September's pause. The Fed's Chairman, Jerome Powell, has made it clear that he believes inflation is still too high and: "*We are prepared to raise rates further if appropriate, and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective*"¹².

The trade-off is of course, economic impact of higher rates, central banks would like to mitigate inflation without causing a recession and increasing unemployment. This ideal scenario has been coined the "*soft landing*". However, central banks have made it clear that avoiding a recession is not their primary concern.

Andrew Bailey remarked in June that: "*We are not desiring a recession, but we will do what is necessary to bring inflation down*"¹³. Jerome Powell takes a similar position, and acknowledged last year that rising interest rates does bring "*some pain*"¹⁴ in the form of job losses and weaker economic growth. Economists seem optimistic that further increases in interest rates, although expected will be limited.

¹⁰ British Broadcasting Corporation (BBC) (2023).

¹¹ European Central Bank (ECB) (2023a).

¹² Federal Reserve (Fed) (2023).

¹³ Sky News (2023).

¹⁴ Federal Reserve (Fed) (2022).

Taming The Property Dragon

The UK and China have something in common when it comes to their property markets. Both are experiencing the effects of basic economics - a mismatch between supply and demand. In the UK, supply is too low to meet demand, the result has been skyrocketing prices and rents. It's estimated that the UK needs an additional 4.3 million¹⁵ homes to alleviate the crisis.

In China the opposite is true. Years of debt-fuelled overbuilding has resulted in an estimated 65-85 million¹⁶ homes and apartments standing empty, putting downward pressure on prices and spooking the property market. The scale of the oversupply is simply mindboggling. It's estimated that filling all the vacant properties would require more people than currently live in China - that's over 1.4 billion¹⁷ people!

Property has been a key driver of Chinese economic growth since the 1980s, when the country first started to open its economy and adopt capitalism. However, it was not until 1998, that China's property boom truly started, when the government removed the restriction on the private sale of property. This coincided with a rapid period of urbanisation, as people moved from the countryside, looking for better opportunities. This created strong demand for new property.

As the market boomed, and with limited access to traditional financial markets, the emerging middle class invested in property, believing it to be a safe investment. Developers were encouraged to build by local and regional authorities, as the sale of public land bolstered their budgets. Central government was equally supportive, recognising the significant contribution of the property sector to the high levels of economic growth China experienced throughout the 2000s and 2010s.

The major problem underlying the Chinese property boom, was that it was being funded by vast sums of debt. Developers, desperate to finance construction projects, increasingly sold homes off plan and borrowed from foreign investors. Annual sales of dollar-denominated offshore bonds surged from \$675 million in 2009 to \$64.7 billion in 2020.¹⁸ Investors in turn borrowed to buy the properties.

In 2020 the boom in prices reached such levels that housing was becoming unaffordable in many cities. The government responded, introducing new rules in August 2020 based on the principle that "property is to be lived in, not to be speculated on"¹⁹. The rules imposed annual borrowing limits on developers and introduced more stringent lending criteria. The new rules coincided with the start of the pandemic, which resulted in lockdowns in China and falling demand for property.

Consequently, many developers found it challenging to comply with the new requirements. Notably, Evergrande, at the time, the second largest property developer, missed a deadline to repay interest on approximately \$1.2 billion of international loans in December 2021, leading credit rating agencies to declare it in default.²⁰ Fears of a global crash resulting from the default did not materialise; however, it did rattle markets, leading foreign investors to seek reduced exposure to the Chinese property market.

¹⁵ Centre for Cities (2023).

¹⁶ Fortune (2023). ()

¹⁷ Business Insider (2023).

¹⁸ Bloomberg (2023).

¹⁹ Jin (2023).

²⁰ British Broadcasting Corporation (BBC) (2023a).

The Chinese property market remained sluggish in the intervening years, as it dealt with the fallout from the default of Evergrande and others. Now, there are renewed signs that the crisis is deepening once more. In August, Country Garden, which until last year was China's biggest property developer and was considered financially sound, missed two coupon payments totalling \$22.5 million and announced it faced a debt restructuring.²¹ Unsurprisingly, this caused its shares to plunge in value.

Evergrande also made the news again in August, as it filed for bankruptcy protection in the US, to allow it time to reach a deal with creditors.²² In the final days of the quarter, Evergrande was again back in the headlines, as police detained current and former executives and trading of the company's shares was suspended.²³ This has put in jeopardy a massive government supervised debt restructuring plan, which was due to be finalised in the coming weeks, designed to prevent the firm collapsing under its \$300 billion of liabilities.

Evergrande's collapse could have wide ranging impacts in China. Investors that had purchased properties off plan from the developer, risk losing their money as projects are never started, or finished. Suppliers could see invoices go unpaid and be forced into bankruptcy themselves. Banks and other lenders may be forced to lend less, resulting in a "credit crunch". In such a scenario, businesses may face difficulties in securing loans at favourable rates to fund their expansion, which can impede overall economic growth.

Some analysts believe, because of the potential impact on the Chinese economy from Evergrande's collapse, the government will step in and rescue the beleaguered firm. The problem for the government, is that although Evergrande and Country Garden grab the headlines, there are hundreds, if not thousands of development companies that are in similar situations. That said, some of the firms may indeed be "too big to fail", especially as the property sector contributes to approximately 25% of GDP growth.

Investors have naturally drawn comparisons to the US sub-prime housing market collapse, which led to the 2008-09 global financial crisis. However, there are differences between the scenarios that reduce the prospects of a financial crisis and its spread within and beyond China.

The financial sector in China is dominated by 20 large, government owned banks, which are well capitalised and regulated. Smaller banks, that have run into problems because of exposure to property, according to various media sources, are being quietly bailed out by local government.²⁴ Leverage, which is often the cause of financial crises, is comparatively lower in China than it was in the US before the 2008 collapse. In the US, where NINJA (no income, no job, no assets) no-money-down loans were commonplace; however, the use of leverage by homebuyers in China has been low. In fact, until recently, a 30-50% downpayment in cash was required to purchase a home.²⁵ The lack of excessive leverage could be a major mitigating factor when it comes to financial contagion from China's real estate downturn. Finally, global markets have already priced in losses stemming from the crisis in the property market.

It's also noteworthy that the Chinese property market carries a relatively low weight in emerging markets, accounting for just 1.02% in the FTSE All-World Emerging index and 0.91% in the MSCI Emerging Markets index.

²¹ Reuters (2023a).

²² New York Times (2023).

²³ The Guardian (2023).

²⁴ Nikkei Asia (2023).

²⁵ Bloomberg (2023a).

Don't Panic

Faltering growth, never ending inflation, high interest rates, a shaky Chinese property market? That's just what investors have contended with in 2023. If we look back even a few more years, and remind ourselves of the pandemic, the start of the war in Ukraine, and Trussonomics in the UK, it seems like we never get a break! Against such a continuing backdrop of headwinds, it's understandable that some investors consider withdrawing entirely from the markets and waiting for a more favourable environment before reinvesting.

However, the poor long-term performance of active investors who try and time-the-market should be evidence enough that this can be a risky strategy and rarely successful.

Recent research, conducted by the team at Timeline and soon to be published, underscores the significance of staying invested and provides quantifiable insights into the adverse effects of missing out on the most lucrative trading days. Drawing from data spanning from 1915 to 2022, their findings reveal that an investor who missed just five of the best trading days within a 20-year timeframe would witness a decline in returns of around 2% per year.

Final Thoughts

As we approach the end of 2023, investors continue to grapple with numerous challenges and persistent uncertainty. This may not come as a surprise to most, considering the events of recent years, and it's understandable if some have grown weary. However, as history has shown, investors are typically rewarded for their willingness to bear market risk over the long term rather than the short term. To borrow a phrase from Lance Corporal Jones from the classic comedy "Dad's Army," we'd like to remind investors, "Don't Panic."

There are reasons for investors to be optimistic. Inflation, although still elevated compared to recent history, appears to have started to ease. Central banks have responded by temporarily halting interest rate rises. Importantly, they have maintained their credibility by clearly stating that rate cuts are unlikely for some time, and further increases will be implemented if necessary. This approach provides central banks with a solid foundation for tackling inflation. Despite the potential for recessions stemming from ongoing tight monetary policies, the global economic growth outlook remains resilient at 3% for the current year. While next year's forecasts have witnessed downgrades, there is still an expectation that the world economy will attain a growth rate of 2.7%. Emerging markets are expected to play a role in driving some of this growth, even if the Chinese economy faces challenges due to its delicate property market.

Investing presents inherent challenges, and it's crucial for investors to understand that positive returns are not consistently guaranteed; instead, they should expect short term fluctuations and volatility in their investments against the backdrop of long-term growth. However, by coupling our diverse investment portfolios with strategic financial planning that is tailored to each client, clients have the best chance of achieving their long-term financial objectives.

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