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PRIVATE & CONFIDENTIAL

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General Economic Overview – Quarter 3 2021

As we enter the last quarter of the year, we can see that whilst certain themes have continued throughout the year, the interpretation of the timelines around them has changed. The dominant theme has been the threat of inflation following the recovery after the coronavirus outbreak in 2020. Whilst most of the central bank rhetoric through Q2 and the summer has been about the transitory nature of inflation, the current more persistent high levels have seen the language gradually change to something more hawkish in nature. Concerns around the global supply chains have risen as demand for goods and services has increased, and manufacturers and distributors are unable to support this increase. Other concerns include the Chinese economy which has seen investors rattled by the increasing intervention by the CCP in areas of e-commerce and property that have led to curbs on entrepreneurial activity.

Has the time now arrived for the brakes to be applied to the era of cheap money? This is a question that was posed around the taper tantrum in 2018 but appears to have more validity this time. The timeline for the normalisation of policy has certainly shortened in recent months as various central banks have issued more hawkish statements, the most prominent of which has been the Federal Reserve in the US. In recent weeks we have seen the Norwegian bank raise rates by 0.25%, the first advanced economy to raise rates since the pandemic began. Four emerging economy central banks also raised rates in the last week in September. In some ways this is a good sign as it suggests the global economy is now stronger than expected, but this then threatens other metrics such as inflation, and the fear is that this will lead to financial instability. There are different issues affecting the way in which central banks can react to coming out of the crisis, which have changed the shorter-term outlook for inflation and rate rises. The disruption of normal patterns of consumption during the pandemic are difficult to ignore – shipping costs have risen almost five-fold with an equally unusual increase in raw material and food prices. With supply bottle necks and outbreaks of Covid-19 disrupting the smooth flow of goods, prices have risen. A world of stubborn price rises and unpredictable bumps in the recovery is difficult for central banks to deal with – they prefer more linear increases in data so they can deliver a gradual policy of normalisation. The tapering of asset purchases by central banks is the first element of the move to the normalisation of policy and it has now been given a timeline by the Fed, with other central banks also looking more closely. There is likely to be a more aggressive line on interest rate increases by the Fed, with a possible rise in 2022 and others will follow suit – the Bank of England has voiced concerns about rising prices and lack of slack in the labour market. In economies where food and energy account for a larger share of spending, such as emerging markets, the reaction is more immediate with the outlook in Argentina, Brazil, Mexico, Russia, and Turkey becoming troubling. Brazil recently raised rates by 1% to 6.25%. The ground has shifted in recent months and the bias amongst central banks has moved towards a tightening of policy.

Elsewhere the fears over a more interventionist policy by the Party in China has led to greater political uncertainty in the region and in its relations with the west. The slogan of 'common prosperity' is not new and has been flagged for some time by Xi Jinping's government which has stressed the need to address inequality in the economy. The Party needs to be popular to retain support and bringing more emphasis on socialist policies is seen as a way of doing this. Education, property, and technology are all areas where they believe intervention is needed. Issues such as the problems with the property company Evergrande have not helped investors' confidence over China during the quarter.

Broadly speaking, equity markets have remained buoyant despite the uncertainty indicated in the previous paragraphs, and the economic outlook has remained positive with upgrades from the OECD indicating continued, albeit slowing, improvement.

Equity Markets

It is often noted that equity markets tread water during the summer months as there is less trading activity with many investors taking summer breaks, and this was the case this year. Quarter 3 was flat compared to the previous quarter as a number of issues have dented the confidence shown in the first half of the year. The Japanese market has led returns (in local currency), and the US once again performed strongly. Emerging markets and Asia have been weak as the aftereffects of the Chinese crackdown on certain sectors of their economy hit investor confidence. Markets had a wobble right at the end of the quarter following comments from the Fed and ex Fed chairpersons which heightened the likelihood of rate rises earlier than anticipated. A fall close to 3% in late September was the largest for some time.

The current and continuing growth expectations suggest that areas of value should lead markets in the next upward phase, but levels of uncertainty can still push investors back towards quality growth holdings and this has been the dominant theme in the third quarter. Many managers still believe that equities offer the best opportunities looking forward, as fixed income and cash offer very little reward for what is an increasing risk should interest rates rise. Structural changes during the pandemic have benefitted certain sectors although the level of earnings growth in these areas is felt to be past its peak as we enter a new economic period. The US market is seen by many as overvalued with the UK and Europe offering better opportunities.

UK

The UK has faced the challenge of Brexit alongside that of the pandemic, and some of the supply side shortages that have been seen recently in food and fuel are probably due to a combination of both effects coming together. There continued to be positive news however as growth and GDP improved, reaching close to pre-pandemic levels at the end of Q2. Many economists and managers believe we are still in the recovery phase with the US the only developed economy ahead of its pre pandemic levels. The UK is still some 4.5% behind but on an improving trend. This tells us that there is potentially more value in the UK economy (and Europe) which is positive for investors. If the re-opening trade regains some momentum in future months, then this could be beneficial for the UK stock market. The re-opening trade, which lifts long-term interest rates and favours cyclical and value stocks over technology and growth stocks, worked well for several months following the vaccine announcement last November. The UK market has a stronger value bias and the cyclical stocks that comprise the value factor are reporting stronger earnings upgrades than technology-heavy growth stocks, and the value factor is cheap compared to the growth factor. This could lead to better returns from the UK market than the US for example. There are some risks however and supply bottlenecks and labour shortages have triggered a sharp rise in underlying inflation and created concerns that the Bank of England (BoE) may start rate hikes in the first half of 2022. Not many managers subscribe to this outcome however as it is felt that as more labour comes back into the market these issues will be resolved. The rapid post-pandemic outbreak growth rate has slowed down and it will need careful economic management to remove monetary support whilst maintaining what is a fragile growth trajectory.

US

The US economy is the global leader and is the barometer of global consumption. It is not surprising that other economies and markets take their lead from what happens in the US and what is commented on by the central bank. This quarter the Fed has changed position slightly and become more hawkish after data has indicated strong economic growth and higher and more persistent inflation. For companies however the easiest gains appear in the rear-view mirror at the end of the third quarter as the recovery phase of the business cycle matures. This is most visible for corporate earnings, where S&P 500® Index earnings-per-share already sit 20% above their previous cyclical high. The stock market has benefitted from this, powering ahead of other markets in 2021, up until the end of September, when a short setback occurred. The Fed looks poised to start tapering its asset purchases around the end of 2021. The timing of the first-rate hike will then hinge on what happens to inflation next year. Most observers believe that inflation will drop back in 2022 allowing the Fed more time to execute rate hikes although much will depend on wage inflation which is creeping up and, should the pool of labour be used up quicker than expected, then the Fed may need to act more quickly than expected. There are other important factors to take account of in the assessment of the US – they are currently in a negotiation period for the debt ceiling to be increased, any failure of agreement can lead to a shutdown of the federal infrastructure which would be a big negative. There are also discussions about further fiscal stimulus, but this comes with potentially higher taxes to fund the moves. Higher corporate taxes could lead to a setback in future growth and earnings in the economy. Conflict with China on a political level continues and investors need to be mindful of pinch points such as the treatment of Taiwan and Singapore as well as further trade disputes which can all undermine global economic growth.

Europe

The outlook for Europe has continued to be more positive as vaccination rates are high, and the euro area has more catch-up potential than other major economies, particularly the United States. The euro area is also set to receive more fiscal support than other regions, with the European Union's pandemic recovery fund only just starting to disburse stimulus, which will provide significant support in southern Europe. The second quarter saw signs of recovery with the lifting of restrictions in the region amid expansionary fiscal and monetary policies, bolstered household spending and investment activity. Available indicators suggest the recovery has carried over into the third quarter, albeit at a softer pace. A healthy rebound in industrial production in July, upbeat business sentiment in July-August and strong manufacturing PMI readings throughout the quarter hint at expanding private sector activity. The economy should expand robustly this year and next, as accumulated savings, EU recovery funds and expansionary fiscal and monetary policies fuel domestic activity, while easing restrictions boost foreign demand. However, pandemic-related and political uncertainty, weaker fiscal metrics in the Mediterranean countries and banks' troubled assets pose downside risks. The economy is expected to expand 4.8% in 2021 and in 2022 GDP is seen increasing 4.4% according to Focus Economics.

The ECB has continued to support the bond market and has indicated a willingness to continue this alongside a loose monetary policy with negative rates persisting in some countries. Overall, investors see Europe as an area where valuations have not yet reached the heightened levels of the US and therefore offer greater potential.

Asia & Emerging Markets

Asia ex Japan equities including emerging market countries recorded a sharply negative return in the third quarter, largely driven by a significant sell off in China. This was partly due to concerns over the ability of property group Evergrande to service its debts. The Evergrande situation sparked global investor concerns over a potential spill over risks. A lot of comment has been made about the indebted Chinese property developer and investors need to remember the Chinese financial system is completely different from the west. Whilst foreign and institutional holders of Evergrande corporate debt are at high risk, the authorities in China have historically made good wealth management products sold to retail investors and have also pledged to complete properties where purchasers have paid a deposit.

The chances of wider contagion or systemic risk is minimal, and it remains a priority of the Party to take the froth out of the housing market and discourage speculation.

The Chinese government has become more socialist and interventionist in recent years. It is focused on consumer rights, employees' rights, whether parents have too high burdens, whether students have too high burdens, whether kids are playing too many (internet) games, whether property prices are too high, whether pharmaceutical drugs (especially generics) are too expensive, and whether banks are making too much money. This is a risk the market awoke too rather belatedly this year. Xi is a populist politician and this is now being seen.

The regulatory environment in China has turned less stable and China has been increasingly become more socialist under President Xi with stronger State control. The government under Xi is very different from that in the post-Deng period when there was a collective approach amongst the Politburo Standing Committee (PBSC) with a consensus on economic and social policy sought. President Xi and the Party have been focused on the 'Three Mountains' that make life difficult for people. These are the costs of property, healthcare, and education. Xi has commented that property is for living in, not for investing in, and around three months ago made comments about the excessive cost of education. The Chinese Census results were delayed and showed a population either down or only seeing a small increase in size and the Party is very concerned about a shrinking population and so have moved to a 3-child policy. Unfortunately, the cost of education has counted against couples having larger families. It can be argued the regulatory cycle was not unexpected or unannounced having been clearly flagged last October/November when the ANT IPO was pulled at the last minute. The education sector was one where rising costs were leading to even greater levels of inequality in the country. Successful investment in China needs to be focused on companies which solve China's issues and problems rather than compounding them. Avoiding social unrest is at the core of policy decisions in China. At this stage, the internet giants Tencent and Alibaba have both seen significant price corrections and have in effect become consumer companies, so growth rates will be slower than delivered previously, although still strong compared to the market average.

Within the rest of Asia the uncertainty regarding regulation in China and the objectives of the Party for private enterprises have seen India benefit as a safe haven in the region. India delivered a strong gain, with sentiment boosted in part by the recent stream of initial public offerings. It is viewed as a country in the region with a strong rule of law as regards investor' rights. The country's reform programme seems to have gathered pace and Covid-19, whilst a humanitarian tragedy, has not made lasting economic damage. The Indian market has a number of well-managed business and underpenetrated consumer sectors including banking, so should enjoy a long runway of growth.

Brazil was the weakest market in the MSCI EM index as above-target inflation continued to rise and the central bank responded with further interest rate hikes. Meanwhile Q2 GDP growth disappointed, developments in China weighed on industrial metals prices, and political rhetoric picked up ahead of next year's presidential election. South Korea also posted a double-digit fall amid falling prices of dynamic random access memory chips (DRAM) and concerns over the impact of power issues in China on production and supply chains. Weaker industrial metals prices also weighed on performance of net exporter markets Peru and Chile.

By contrast, net energy exporters in general outperformed, most notably Colombia, Russia, Kuwait, Saudi Arabia, Qatar and the UAE.

Japan

Japan has seen the strongest stock market returns this quarter as markets reacted well to the decision of Prime Minister Yoshihide Suga to not seek re-election as leader of the Liberal Democratic Party. This probably masks several factors that still concern investors about the economy overall. The composite PMI fell in July and August as conditions soured amid a surge in Covid-19 cases through the summer months and the extension of the state of emergency in several prefectures until the end of September has likely further suppressed activity. The Olympics were expected to provide a significant boost to the economy but although seen as a sporting success, they were not a financial one due to the lockdown. The bank of Japan kept rates on hold at -0.1% at its September meeting and continued to not set an upper limit on the amount of Japanese government bonds (JGBs) it will purchase to cap the 10-year JGB yield at around 0.00%. Core consumer price inflation remains stubbornly low and was flat in August after a negative July. The economy is projected to rebound this year, and growth is set to accelerate marginally in 2022. An uptick in private consumption on the back of pent-up consumer demand, combined with higher capital spending, should outweigh a slowdown in fiscal stimulus however the ongoing pandemic and its impact on supply chains remains a key determinant of the outlook.

Fixed Interest

Inflation remains the biggest threat to bond markets as we move into the last quarter of the year, and its impact on interest rates is especially important at a time when financial assets have re-rated upwards, and a lack of visibility on inflation is a major factor behind the sharp style rotations seen this year. Central bank actions in preventing a Covid-19 depression by flooding the financial markets with money has driven significant gains in asset prices and, whilst not by intention, has widened the inequality gap. This year has seen bond yields gyrate quite violently over short periods of time without any huge change to the immediate macro fundamentals. The jump in yields over the last week in September, for example, coincided with a period where economic growth estimates were pared back slightly, although admittedly inflationary expectations had become a little more entrenched. The final week of September saw government bond yields react to what have been slightly more hawkish signals from the major central banks, combined with gas shortages, a rally in the oil price, and increased costs of fuel. This resulted in US Treasury yields reaching their highest level in three months and rising above 1.50% for 10-year Treasuries and UK Gilts yielding over 1%. Consumer price inflation in the States has now topped 5% for three consecutive months and the Bank of England expects UK inflation to exceed 4% well into next year. Investor positioning had become progressively more bullish on the outlook for government bonds, but this has fallen back in more recent weeks. The most recently released minutes of the US Federal Reserve meeting were, perhaps surprisingly, taken by market participants in the first few days as being dovish, when in fact there was a small shift in tightening expectations with a majority of Fed members now expecting the first rate rise in 2022 and a further three in 2023. Comments by the Bank of England also refer to heightened inflationary pressures and it seems expectations for a UK rate rise have now been brought forward to the November to end March period.

All of this suggests a weaker future for capital values in fixed interest assets as we move into 2022 but it has ramifications for other asset classes as well. The acceleration in the bond market selloff, which had seen yields creep up since early August also resulted in heightened volatility in equities, or in layman's terms a sharp pullback, with the rise in yields centred across the middle and long end.

There are areas of value where the coupons still provide a reasonable return such as in emerging market debt and areas of high yield. These assets carry more risk and would not constitute the weighting in defensive assets traditionally needed in balanced portfolios.

Property

The fact that this is a slow-moving sector has been positive in terms of removing the levels of volatility we have seen in other asset classes. Last quarter we noted the improvement in the direction of UK commercial property, and this has continued in the third quarter. UK commercial property trends remain intact, with strong demand for industrials and out-of-town retail recovering. Capital growth has been underpinned by strong investor sentiment leading to further yield tightening across the favoured sectors, however rental growth has been limited to the industrial sector. There has also been some concerns caused by global events such as the problems raised by Evergrande, the world's most heavily indebted property group. Whilst this might appear to be a China problem, the potential contagion across other regions has caused further concerns. The London property market has benefitted from the interest of Chinese developers since the financial crisis but the recent regulatory crackdown in China has dampened this enthusiasm.

Although generally we have seen positive returns from the asset class, there are differences between the sectors, as might be expected following the pandemic. In the industrial sector, intense demand from online retail, coupled with low availability of good quality stock, continue to fuel the positive outlook for warehouses. The office sector has seen confidence grow and is expected to see cyclical recovery, albeit structural trends may temper this somewhat – home working and flexible employment has changed the way in which offices will be used. Economic factors are looking favourable to support a bounce-back in 'bricks and mortar' retailing. Retail warehouses are leading the recovery and supermarkets continue to deliver attractive returns. Meanwhile, the rest of the retail sector is still facing headwinds, with city centres suffering from low footfall and spending levels. The easing of Covid-19 restrictions and a return to the office in the second half of the year are expected to lead to improvements in the performance of select shopping centres and tourist focused high streets. The recovery in retail looks to be a long one with possible change of usage or multi use coming to the fore. Rental income data has been stronger than expected overall but in certain sectors very poor – the obvious casualties of the lockdowns are the travel and leisure sectors.

Investors are likely to remain focused on core, well-located retail space with secure and long-term income streams, underpinned by high-quality tenants. This partly reflects the normal reaction of companies to economic weakness, but also the pandemic's impact on working from home.

The position for many investors in direct property is probably now as much about liquidity, access, and timeframe requirements as it is about the diversification that direct property can provide. With FCA changes soon to be published, this may become more difficult to manage for those with a shorter-term investment horizon as access to funds could be more restrictive. Direct property can still offer low correlations to other asset classes so should not be ignored but clearly practicalities need to be factored into any investment decision.

The REIT market has prospered as equity markets have advanced and several property funds in this sector have seen returns improve strongly since the global recovery started. The same areas of the market have performed well – industrials, and warehousing with the addition of some residential developments.

Summary

The third quarter started very much where the second quarter left off, with markets performing strongly encouraged by the belief that the goldilocks economy, especially in the United States, would continue. Early economic data during the quarter, including unemployment numbers, suggested a slowdown in the breakneck pace of the recovery seen in Q1 which encouraged investors to believe that central bank policies would remain firmly supportive of markets, whilst governments continued with their pledge of providing fiscal support during the early stages of the recovery. The first two months of Q3 showed an outperformance of the growth investment style over value, although there was some more mixed performance amongst technology stocks outside of the sector's mega caps. This changed in the latter days of September when central bank comments and sentiment saw markets retreat on the fear of earlier interest rate rises, with inflation staying higher than the transitory nature levels it has reached in the re-opening of economies.

To date in 2021, equity market performance has been driven far more by macro considerations in the form of expectations about future levels of inflation, short term interest rates, and bond yields than stock picking, with extreme and sometimes violent rotations between the value and growth investment styles. This has meant that at certain times, however good a stock picker is, they have not been able to defy the shorter-term headwinds. Globally over the last 18 months, central banks and governments have provided unprecedented support both monetary and fiscal to economies and financial markets. This stimulus resulted in confidence in the prospects for a strong economic rebound and also strong asset prices and more recently a fear of rising inflation. Towards the end of September, we saw government bond yields rise on more hawkish statements combined with oil price rises and rising fuel costs. US Treasury yields reached their highest level in three months with consumer price inflation in rising above 5% for three consecutive months. The UK central bank also expects the higher inflation we are seeing being stickier than anticipated earlier in the year.

Investor positioning had become progressively more bullish on the outlook for government bonds. In the short term the raised interest rate expectations have hurt growth stocks, reinforcing how rotational markets have been in 2021.

The style rotation in equities, which had been driven by bond markets, shows how difficult short term macro forecasting for markets actually is. Longer term secular trends or themes have been, and will probably continue to be, an important influence on how an investor should shape their portfolio. For investors today, the question of whether higher inflation is permanent or transitory is perhaps the most important factor influencing portfolio construction. If you view the answer as being important but not knowable with certainty, constructing a portfolio which can avoid extreme outcomes may be the most prudent course of action.

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