

Market commentary

October 2021

Overview

The global economy contracted by -3.5% in 2020 due to Covid-19, which was the first time since the -0.4% decline experienced in the Great Financial Crisis of 2009. The intervening years have seen global economic growth at around 3.0% per annum, which puts into perspective the robust recovery that the world economy has experienced in 2021 with a growth rate of 5.9%. However, the initial acceleration stage of the recovery following the re-opening of the world economy is likely over and we are in a new phase where supply constraints are having a major impact. The strength of the rebound has caught firms by surprise and supply chains are stretched, with the consequence that inflation has picked up. The increasing spread of the delta variant is being blamed for the slowdown and is becoming more of a drag on activity, particularly in Asia. Order levels are very high but backlogs and delivery times for goods and services are at record levels, particularly in semi-conductor, computer chips, which has resulted in steep price increases as buyers chase scarce supplies.

Production is also being constrained by a lack of labour. This may sound surprising at a time when unemployment rates are well above average but economies such as the UK for example, have depended on the flow of labour from overseas and have been particularly hard hit with work visas down by more than a third. More generally, worker shortages have been attributed to a reluctance to increase social contact, difficulty in making childcare arrangements and for some US workers, enhanced unemployment benefits relative to in-work benefits. In the US, there are 4.2 million fewer people engaged in active work compared to the pre-pandemic levels of February 2020. Recent analysis from the Dallas Federal Reserve suggests that around 2.6 million people will have retired because of the pandemic. These factors together, account for much of the increase in US inflation, which is now expected to be 3.8% this year, but should drift down next year as the recovery progresses. The future path of inflation beyond next year remains very uncertain.

The latest minutes from the US Federal Open Market Committee (FOMC) noted that; “provided that the economy was to evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year”. The US Federal Reserve intervened in the bond markets in March 2020, on an unprecedented scale to avert economic collapse, predominantly by buying treasury bonds in the open market, which has continued at a rate of \$120 billion per month since June 2020. This was a measure designed to support the corporate bond markets, providing a pathway for companies to borrow money, whilst keeping interest rates artificially low. The Federal Reserve’s holdings of bonds increased from \$4 trillion in 2019 to an eye watering \$8 trillion within an 18 month period, providing huge liquidity at a time when the financial system needed it most.

However, investors now fully expect that the world’s largest central banks will always come to their rescue at the first signs of a financial crisis. Consequently, there is mounting evidence of ever-increasing financial speculation as the price of financial securities has become totally detached from the accounting fundamentals and economic reality. Speculation is most evident in the crypto currency market with potential life changing fortunes made and lost within months. There is a large body of academic studies demonstrating that retail investors are also becoming highly emboldened by their recent successes in poster child stocks like Tesla and by highly co-ordinated trading on vulnerable stocks, through their membership of social media investment groups.

The US Federal Reserve is likely to reduce the level of financial intervention towards the end of the year by a paltry \$10 billion to \$110 billion per month, through a process known as ‘tapering’. This is mild tinkering given the sheer scale of the broader programme and is likely to have minimal impact.

Previous announcements of 'tapering' in 2013 caused interest rates to rise and the US equity market to fall but a 2013 study by the Federal Reserve's economists stated that it was the size of the balance sheet or the value of the holdings of the bonds that was more important than the pace of bond purchases in keeping interest rates low. Unfortunately, as complicated as all this sounds, the pace at which external financial support is withdrawn is the key academic debate of our time for the stability of financial markets. It is fair to say that retail investors and many professional investors alike have become largely complacent to the sheer scale of financial stimulus, which is artificially inflating their investment returns and no central banker wants to be written into history, as the person who spoiled the party.

UK equities

The FTSE All-Share Index (a measure of the top 641 companies in the UK) produced a total return of +4.4% in the period under review (6th April 2021 to 5th October 2021) and has risen +10.3% from the beginning of the year. It has now breached its previous, pre-covid high of mid-January 2020, recovering all the covid induced declines. However, the UK equity market continues to be a stubborn laggard, when compared against the steep recovery from the March 2020 low by their US, European, China and emerging market counterparts.

After three difficult trading years, there are new signs of life in Rolls Royce, as they were selected by the US Air Force to provide power plants for the Boeing B-52 Stratofortress. Rolls Royce noted that it had been providing jet engines to the US Air Force for more than 70 years. The deal is worth a potential \$2.6 billion and may be the first steps to a tentative change in fortunes for the company. In other defence news, the board of Meggitt Plc agreed to a £6.3 billion takeover by Parker Hannifin Corp, virtually doubling the share price overnight but the UK government has ordered a probe into the deal, on the grounds of national security. Due to many of the well-known issues surrounding the UK equity market over the last 5 years, some of our international companies are looking very cheap to overseas bidders and could be ripe for further takeover activity.

Associated British Foods warned that sales at its largest business unit Primark, are set to fall in 2021 as they were hit by the 'pingdemic', in the first half of the year. Large numbers of staff and would-be customers were forced to stay at home for 10 days of isolation, as the NHS covid-19 app became overwhelmed with rising cases. The future still looks bright for the group as restrictions ease, as they will return to rolling out further stores in line with their pre-covid expansion plans.

The oil price has moved sharply from just under \$50 a barrel at the beginning of the year to \$80 at the time of writing, driving strong performance in BP and Royal Dutch Shell. Royal Dutch cuts its dividend for the first time in over 80 years in 2019 and is trying to build the dividend back up, although it remains at 50% below its previous highs.

The rate of inflation in the UK, measured by the Consumers Price Index (CPI) is expected to rise to around 4% by the end of 2021, driven largely by rising energy prices. Consumer spending is likely to remain strong over the next year or two, as households will run down their savings accumulated during the lockdown. Rises in commodity prices and increase in shipping costs have pushed goods prices up globally, so this is not simply a UK-centric problem. Unless oil and gas prices keep on rising, then the effects of inflation should be transitory, with inflation peaking in 2022 and falling back towards the Bank of England's central target of 2% by 2024. House price inflation has picked up sharply since the middle of 2020 with prices rising across the board by about 10%. A desire for space as more workers prefer to work from home or live outside city centres is partly to explain this phenomenon, alongside the temporary freeze in property transaction taxes. It is also likely that a proportion of money saved during Covid, has also found its way into the housing market.

Trade with the EU remains subdued as new trading arrangements are coming into force. The latest export data suggest that there has been a recovery of sorts, with an increase in demand from the EU for UK goods following a sticky beginning in the months after we left. However, the levels are still materially lower than the peak in 2019, by about 18%, and UK businesses are now sourcing more of their goods outside of the EU.

International equities

The S&P 500 Index, used as a broad measure of the total investment return achieved by the largest 500 publicly quoted companies in the US, rose by +7.4% in the full period under review. The US market looks outrageously expensive from a historical perspective and relative to other advanced markets, but that sentence could have been written at any time over the last 3-4 years. Moderna Inc. was the stand-out performer, as the share price rose by +148% in 6 months, although for context, it has risen a staggering 22 times since 2018. It is a biotechnology company pioneering RNA therapeutics and vaccines, helping hundreds of millions of people around the world with the Covid-19 vaccine. They were recently granted Priority Review to the Biologistics License Application for the 'Moderna COVID-19' vaccine, by the US Food and Drug Administration. They are currently working on a vaccine for children aged 6-12, which is already showing positive early results. The company made \$60 million of sales in 2019 and this will increase to an incredible \$20 billion of sales by the end of this year. 10% of its volume sales have been made in low-income countries and this is likely to rise significantly in 2022.

The US economy is expected to grow by 5.8% this year, driven by pent up demand from the lockdown, but this will likely fade back down next year to growth of 3.7%, as conditions normalise. Core inflation in the US should remain relatively high at 2.5% as the global supply bottlenecks will take time to ease. The Consumer Price Index hit 4.2% in April, its highest level since 2008. The recovery in business growth has largely been due to the re-opening of the service sector and has therefore favoured advanced economies over the emerging markets. This is in contrast with the last financial crisis when massive stimulus from China, led the way for the emerging economies. Inflation will remain high enough to prompt the US Federal reserve to raise interest rates at some point next year.

In Europe, governments have made good progress in vaccinating their populations. Economic growth in the Eurozone should hit 5.1% by the end of the year, due to the removal of covid restrictions over the summer helping european stocks to move up +3.7%. The limited return of international tourism is also going to be very helpful for the rest of the year. Eurozone inflation is high due to high wholesale energy, food, alcohol, and tobacco prices, exacerbated by a weakening Euro against the Dollar. The European Central Bank is very cautious to not raise interest rates too early as they are still running their 'Pandemic Emergency Purchase Programme (PEPP)', designed to support the commercial lending markets by purchasing bonds in the open market.

The Chinese stock market has fallen by approximately -20% from the beginning of the year, following a crackdown by the Chines Communist Party. In recent decades, China has seen huge economic success, but the party remains committed to 'common prosperity'. The main thrust has been broad based regulation to handle inequality, poor labour practices in the gig economy and restrictions on foreign shareholders. Tensions between the US and China have exacerbated the situation as China wants to move towards a self-sufficient economy. Education is highly competitive in China, and it is very competitive to get into top universities, which can define your life chances. This has led to strong demand for private tutoring and therefore, a crackdown by the government on some of the educational profiteering. Chinese technology companies have also fallen by about 40% due to further regulatory uncertainty driven mainly by the tensions between the state's objectives and the private sector's implementation. It could take some time before international investors become confident again and they will need to see evidence of regulatory stability before investor flows pick up.

One of China's top three property developers, Evergrande, reported that it was struggling with crippling debts and would have to sell property to remain solvent. The headlines stated that it would miss two interest repayments and default on its commitments to some investment products and would need financial restructuring. The property sector contributes 15% of China's economic growth and is therefore systematically important to the economy and there were concerns that contagion would spread into the banking system and beyond. Fears have been alleviated in the short-term, but it could be an early indicator of some of the excesses in Chinese borrowing reaching their limits. Economic growth in China is under pressure and likely to decelerate to 5.9% in 2022, after a decade of growth above 6%.

Fixed interest securities

The ten-year UK Gilt yield is 0.9%, which is the estimated annualised return an investor should expect to receive over ten years and remains below the current rate of inflation. The equivalent US 10-year Treasury bond yield is 1.6%. US and UK government bonds are considered low risk but offer poor nominal investment returns over ten years. The main risk to investing in these assets is inflation, eroding the real purchasing power of capital over time. The withdrawal of financial stimulus through the tapering process, by the central banks of the US, UK, Europe and Japan will likely provide a catalyst for higher interest rates and sovereign bonds and corporate bonds will perform very poorly in this scenario. The US corporate bond market is particularly vulnerable to a change in market sentiment, given that valuations are extremely expensive and there is no margin of error at current prices.

Commercial property

The performance of the broad based MSCI Liquid Real Estate Index was +9.2%, during the period under review, confirming the gradual improvement in sentiment towards the sector. That said, the retail sector remains under pressure, although evidence suggests that tenants are the least negative they have been since 2017. Office and retail landlords continue to raise the value of inducement packages to attract new tenants, whilst the industrial sector is recovering strongly. Prime industrial rents are envisaged to pick-up by roughly 6% over the coming year, office rents by 1% and retail rents are more downbeat and expected to fall by -4%.

Analysts have focussed attention on three growth areas, colloquially known as “beds, sheds and meds”. For clarity, these refer to student accommodation, logistics, parcel and storage warehouses, primary health care properties and aged care homes. We can also add data centres to that list. These areas of the market are expected to post strong capital gains in the year ahead. A London based surveyor had an interesting observation to make about the office sector. “In the last two weeks there has been a noticeable increase in office occupation by staff in Central London. This is partly because some organisations have required staff to return to the office, including businesses in the property sector. As someone put it to me, but with important implications, last Thursday, offices in London were one third full but the pubs after work were 100% full. The point being that those coming back to work want to take part in the social aspect of an office.” Another surveyor made a comment that we hear frequently from fund managers; “...questions are predicated on how investors view impending ‘game changer’ issues such as office fit outs and climate change. For investors willing to invest properly to create the highest quality product, they should find their capital well invested for the long term but, those seeking to ignore these issues and create basic fit outs or ignore net zero carbon, face more risk as they will become redundant.”

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Indices performance statistics are for the period 6th April 2021 to 5th October 2021, total return with income reinvested. Returns are stated in local currency terms unless explicitly stated otherwise.

Source of statistics: PIMFA, Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times.

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