Investment Review

Q3 2021

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1. Summary

The past quarter resulted in increasingly divergent performance from investment markets as concerns over the path of inflation, interest rates and company earnings potential came to light.

Year to date most markets have shown positive returns with the exception of fixed interest investments, which have seen yields rise and values fall.

• UK consumer price inflation grew +3.2% in August.

• Yields on fixed interest investments rose given the increasing prospect of higher interest rates.

• Japanese shares led world markets higher ahead of a general election.

• Weaker Chinese shares negatively impacted Asia and Emerging Markets.

• United Nations pivotal 26th Climate Conference (COP26) to be held in Glasgow next month.

The International Monetary Fund (IMF) downgraded global economic growth modestly this month to 5.9% in 2021 and 4.9% in 2022, resulting from a weakening in advanced economies due to supply disruptions[1].

The outlook for markets remains tied to the extent that central banks will act to contain growing inflation pressure or if the pressure starts to fade next year as global trade re-balances.

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- The information is provided in good faith and is believed to be accurate, but as some data is provided by third parties this can not be guaranteed.
- Past returns should not be seen as predictors of future returns.

[1] 'World Economic Outlook', IMF: October 2021.

2. Market Performance (Year to Date)

Asset Class	Index	Q3 2021	Year to Date
Japanese Shares	TSE Topix	7.2%	7.3%
UK Commercial Property	FE UK Property Proxy	3.1%	7.9%
North America Shares	S&P 500	2.9%	17.1%
UK Shares	FTSE All Share	2.2%	13.6%
World Shares	FTSE World ex UK	2.0%	14.2%
Gold	S&P GSCI Gold Spot	1.4%	-6.7%
European Shares	Euro STOXX 50	0.0%	11.3%
Corporate Bonds	Bloomberg Sterling Aggregate Corporate	-1.0%	-3.8%
UK Gilts	Bloomberg Sterling Gilts	-1.9%	-7.6%
Emerging Market Shares	MSCI Emerging Markets	-5.8%	0.1%
Asia Pacific Shares	MSCI AC Asia Pacific ex Japan	-6.2%	-0.8%

Performance Data: FE Analytics in GBP to 30/9/2021

UK Shares

The UK economy continues its recovery, albeit modest, but July estimates of GDP remain 2.1% below pre-pandemic levels in February 2020. Unsurprisingly, the arts, entertainment and recreation sector saw the strongest monthly growth up 9% following the easing of lockdown, providing some respite to a battered industry. The government furlough scheme has come to an end and data will have to be watched carefully to see how employers act and whether workers that find themselves unemployed can transition to other sectors.

UK shares returned +2.2% over the quarter and +13.6% year to date helped significantly by the weighting of energy companies as oil and gas prices moved higher.

Global Shares

Japan outperformed all major markets this quarter rising +7.2%, which represents the region's entire gains for the year. This is attributed to much improved progress in vaccination rates, with over half of the population now 'double jabbed'. Further, there is a pending change of leadership, expectation for extra economic stimulus and also the country's focus on exports drove higher economic activity as global demand returned.

Asia (excluding Japan) and Emerging Markets have had a difficult time overall as the large weighting within the indices towards China impacted negatively, which we discuss later. The Asia Pacific region is now negative on the year -0.8%, having been one of the strongest markets during the darkest days of the pandemic.

2. Market Performance (Year to Date) cont.

Fixed Interest

It has been a difficult period for fixed interest investments, with UK gilts and corporate bonds continuing the sell-off that began in Q1, which is linked to fears of rising inflation. The UK 10-year gilt yield rose from just below 0.5% in August to over 1% in September. In the US, the 10-year treasury note increased from around 1.1% to 1.5%. The direction of travel is certainly higher, though if inflation moderates next year yields would be expected to lose momentum.

Investors should recognise they have achieved capital growth from fixed interest investments beyond what might normally be expected from this asset class, which is primarily used to provide an income stream and diversification from risk assets.

Property

Data from the ONS showed residential house price growth slowed year on year in July +8%, down from +13.1% in June. London continues to be the region with lowest growth +2.2%[2] . Much of the tailwind to growth has disappeared now the stamp duty holiday has ended with HMRC data showing 73,740 transactions in July -62.8% compared to June's 198,420.

[2] House Price Index, ONS: July 2021.

3. Higher Taxes Ahead

The much-anticipated NHS and social care funding announcement arrived this quarter, with a 2.5% increase in National Insurance (split 50/50 between employer and employee) and a 1.25% increase on the dividend income tax rate over the £2,000 allowance aiming to raise an extra £12bn.

The tax rises will begin in April 2022 and take the dividend rate to 8.75% for basic, 33.75% for higher and 39.95% for additional rate taxpayers, which clearly increases the benefit of utilising available tax efficient savings wrappers (ISA, pension, bonds).

FPC economic consultant John Calverley at Tricio Investment Advisers highlights that the changes to social care, including the introduction of an £86,000 lifetime cap, is expected to help only 1 in 7 people who spend more than this in their lifetimes, with the average cap being reached at about 3 years and 4 months in a care home. The rise in National Insurance to fund social care breaks a conservative manifesto pledge and may be seen as unfair because the burden is largely being met by working people, including many on low incomes. Savers are however being asked to share the burden with the dividend tax rise.

From an economic perspective, it may be that an increase in tax discourages business hiring, whilst taking away from the disposable income available to individuals therefore lowering aggregate demand but this is seen to be only marginal. In the end there is an acceptance that the NHS is underfunded, social care costs have the potential to impact everyone and the pandemic aftermath needs paying for so this tax change seems fairly palatable.

4. Inflation Running Hot

Most people are no longer just reading about the threat of inflation but are now feeling the effects of it on their daily lives. The consumer price index (CPI) inflation measure in August rose at an annual growth rate of 3.2%, which is an increase from 2.0% in July and the largest ever recorded monthly jump since the statistic began in 1997[3].

The pandemic led to a sharp imbalance of demand and supply as workers continued to receive an income during lockdown either from shifting to working from home or receiving government furlough payments. With limited opportunity to spend it has resulted in a savings glut and these savings are now being released.

Soaring demand for goods rather than services (you are unlikely to make up for the haircuts or hotel stays you missed) is being met with a global shortage of commodities and labour to produce what is needed. This is leading to higher prices across the board with a knock-on effect throughout supply chains. The forces of demand and supply are a delicate balance as it only takes two motivated (and potentially desperate) buyers to move the needle in any market if there are no sellers.

Added to this imbalance, which is arguably temporary, is the more structural inflation we are seeing as we move away from globalisation and also the start of the transition to a net zero economy. On the latter point, the present increase in natural gas prices (UK prices more than tripled over the quarter[4]) shows the disruption potential of a move towards renewable energy given that capacity remains constrained, even when the wind is blowing. Individuals and businesses across the UK are feeling the impact of rising energy costs, which trickles through to the cost of goods sold.

The Economist writes that 'Governments will therefore have to plan carefully to cope with the higher energy costs and slower growth that will result from eliminating emissions. Pretending that decarbonisation will result in a miraculous economic boom is bound to lead to disappointment'[5]. Energy needs continue to grow, but investment is not up to speed, so we can expect sustained upward pressure on energy prices going forward as economies continue to expand.

In the UK the Bank of England has the role of controlling inflation in the economy and more specifically a legal remit to both:

1) maintain price stability (at an annual rate of 2%);

2) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment (updated recently to also incorporate the transition to a net zero economy)[6].

[3] Consumer Price Inflation, ONS: August 2021.

[4] 'Record gas prices hit bonds as investors fear wider damage', Financial Times: 5th October 2021

[5] 'The shortage economy', The Economist: October 9-15 2021.

[6] Remit from the monetary policy committee (MPC) letter, HM Treasury: March 3 2021.

The bank has insisted that current inflation pressure is 'transitory' and will pass through naturally, though having not had a period of sustained inflation for many years there is a sense the bank may be feeling pressure to act by raising interest rates. However, their focus is inflation over the medium term, which requires looking through any immediate pressure.

The bank's Governor Andrew Bailey's 'Hard yards' speech in September at the Society of Professional Economists highlighted that whilst the COVID recovery had been rapid, it was as yet incomplete, as the UK economy had not regained its pre-pandemic growth level. He said that "…monetary policy (interest rates) will not increase the supply of semi-conductor chips, not increase the amount of wind, and nor will it produce more HGV drivers. Moreover, tightening monetary policy could make things worse in this situation by putting more downward pressure on a weakening recovery of the economy"[7].

Our view is that inflation will continue to rise over the winter but will naturally be controlled as the economy becomes more balanced in 2022. The bank however will likely raise interest rates to send a message that it is not sitting on its hands and that monetary policy is starting to normalise. It will be very hesitant to restrain an economy that is clearly disrupted and which needs to attract significant investment to transition to a net zero economy in the years ahead.

For investors what does this all mean? Bank base rates will rise but the market is always ahead and as noted in our performance section bond yields have responded. This has the effect of lowering the value of existing fixed interest investments (new investments become more attractive with higher yields) but also impacts the method for valuing future company earnings meaning lower present values.

The biggest risk to investors should interest rate expectations continue to rise could be in those companies that have the highest market valuations relative to earnings, as investors price in an 'interest risk premium'. That said, shares still remain attractive given the backdrop of enormous government stimulus, particularly from the US, and the prospect of earnings growth as the world economy continues to recover.

[7] Andrew Bailey Guest Speaker Society of Professional Economists, Bank of England: October 27 2021.

5. A Tamer Chinese Dragon

Global investors have spent the past few months focusing upon China as the main cause of market concern. Perhaps the most highlighted issue is the challenge within China's property sector, with Evergrande (China's second largest developer) missing interest payments on outstanding debt. The private company is entwined within the financial system and because of a slowdown of home sales due to the pandemic and its high debt the company is facing serious financial strain, which could reverberate throughout the economy[8].

So far, the government seems reluctant to bail out the group, instead looking to mitigate the impact of any difficulties regionally. Steps have also been taken in Beijing to constrain mortgage lending and borrowing by property developers, which will have an inevitable impact on overall economic growth as the sector contributes more than a quarter of economic output[9].

This harder line follows on from an earlier regulatory crackdown on domestic technology companies, which is a sector that has grown significantly in recent years. For example, Alibaba, one of the better-known Chinese tech companies, hosts twice as much e-commerce activity as Amazon. There have been over 50 regulatory actions across the sector covering anti-trust abuses to data violations, as the government cracks down on powerful enterprises. This has weighed on the share prices of these influential companies[10].

A further problem facing the economy has been a significant energy shortage as the government imposed strict output limits on coal-fired power stations (more than half of overall power generation) due to environmental concerns, which has led to factories closing. This has had the impact of constraining production at a time when global demand for goods is rising, fuelling overall price inflation across the world. Longer term forecasts for Chinese growth remains higher than for most large economies but there is little doubt previous levels will be unmatched as global trade tensions and regulatory intervention changes the economic structure of the country.

[8] 'What is China Evergrande, and why is its crisis worrying markets?', Wall Street Journal: October 8 2021.

[9] 'Chinese economy', Financial Times: October 18 2021.

[10] 'Xi Jinping's assault on tech will change China's trajectory', The Economist: August 14 2021.

6. Looking Forward

The investment landscape feels like it is entering a transitionary phase after a decade of rock bottom interest rates and low inflation. That is not to spook investors, because markets always have cycles, but to merely guide that 'real' returns (after inflation) may not mirror what has been experienced over recent years, which has been extraordinary for both defensive and growth assets.

Do not be surprised if interest rates do change direction in this coming quarter and markets are already expecting that outcome but a sudden surge higher is unlikely. Even in a rising interest rate environment companies can make progress and grow earnings so it is not the death knell for the bull market in shares, though volatility may grow. Investors do also have to consider the risk of not being invested given the increasing impact of inflation. Long term investors should not be too concerned about an increase in market volatility if it does come about because it is the 'cost' that must be paid to receive a higher return on capital.

The United Nations 26th Conference of the Parties (COP26) on climate change is held in Glasgow next month and having been delayed by a year represents the first five-year cycle since the 2015 Paris agreement in which countries will update their plans to reduce emissions. The movement towards a net zero economy seems to be motoring along but in reality, we are at the start of a long and disruptive economic journey.

The Environmental, Social and Governance (ESG) factors in company analysis are percolating throughout all industries and it is a genie that is not going back into the bottle. There is significant interest right now in how the asset management industry can consistently identify, measure and reward companies seen to be operating responsibly and sustainably but soon enough there will be no other acceptable way to do business. We will be discussing our approach further with clients at the time of their review.

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