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Investment review – End Q3 2021

30 September 2021

The third quarter of 2021 has seen global stockmarkets make further headway. This typically means some very respectable gains have been created in the calendar year as a whole for portfolios with varying risk profiles.

The pace of the global recovery has, however, lost some momentum over the summer months with some economic data releases beginning to soften and typically below levels expected earlier in the year. The US and Chinese economies were among the fastest to return to their pre-pandemic paths or even beyond, so it is perhaps no surprise that they have been the first to drift off track, whereas growth in the eurozone and Japan has yet to peak. The jury is still out on the ultimate shape of the recovery and the timescales involved in returning many economies to pre-pandemic levels of activity, and then surpassing them. But leading economic indicators continue to point towards general expansion rather than contraction in the global economy and this continues to provide a reasonably healthy backdrop for investing.

The different paces and stages of vaccine roll-out, as well as renewed lockdowns in some countries, can generally account for the unevenness of the global economic recovery for much of this year. More recently, it has been the spread of the Delta coronavirus variant that has been the primary culprit for further complicating the course and pace of this recovery.

Encouraging progress on vaccinations

That said, there has been some very encouraging progress on vaccinations over the summer months, particularly in Europe and Japan, which have caught up with, and in some cases leapfrogged, the early progress made by the likes of the UK and USA. Around 45% of the world's population has now received at least one dose of the COVID-19 vaccine; over six billion doses have been administered globally, with the pace picking up to around 25 million per day.

But there is still a long way to go to complete this Herculean vaccination task, particularly in low-income countries, and for COVID-19 to become less of an influence on our lives and economies than it is today. For example, we have the prospect of waning immunity and the need for booster vaccines, and the possibility that other variants of the coronavirus may yet emerge. With winter approaching in a large part of the developed world we are certainly not out of the woods, but there is now some sense that the spotlight is beginning to shift from the urgency of measures and adaptations surrounding the pandemic itself to the road to recovery and what this means for economies and financial markets.

Inflation continues to rise

Renewed outbreaks of the virus have introduced further economic constraints and extended bottlenecks in global supply chains over the summer. This has contributed to the slackening of economic activity of late, but the sharp rise in demand from those economies that have reopened has also pushed up the prices of key commodities, caused a big spike in demand but also contributed to the upward trend in inflation to more meaningful levels than most economic forecasters had been predicting earlier this year.

It is now likely that inflation will move a little higher still: the Bank of England, for example, has recently warned that consumer price inflation could rise above 4% this year, more than double the central bank's target, and that inflation could remain above this level into the second quarter of next year. Whilst we can expect the low base effects from 2020's slump in consumption and short-term supply pressures eventually to fall out of the statistics, it does now seem increasingly likely that some of this near-term inflation will become slightly stickier than originally anticipated.

Labour shortages, for example, have the potential to contribute to higher wage inflation, whilst higher energy and food prices are also a factor in the recent spike in inflation in major economies.

It is worth noting, however, that the US Federal Reserve's preferred inflation measure is Personal Consumption Expenditure ('PCE'), excluding the more volatile food and energy prices that can be impacted by factors such as severe weather and oil supply. PCE inflation is currently also running ahead of target, but not as hot as Consumer Price Inflation ('CPI') and it has also stabilised somewhat over the summer months. This suggests that we may have passed the peak of 'reopening' inflation that can be directly attributed to the pandemic itself.

The prospects for interest rates

Our expectation is that inflation levels in major economies will begin to subside over the coming months and that central banks will generally continue to look through this current period of escalating prices. But the risk of higher inflation becoming more baked in has seemingly grown in recent months and that appears to have brought forward the timetable for the US Federal Reserve ('Fed') in particular to begin unwinding its asset purchases and take the first step towards tapping the interest rate brakes. For the moment, though, the Fed is holding fire due to an assortment of near-term uncertainties as the economic recovery has begun to stutter.

The recent trends of weaker activity, combined with higher inflation and still elevated unemployment levels are complicating the picture not just for the Fed but many of the world's major central banks. Some, including Norway and Brazil, have already become worried about the consequences of holding rates too low and for too long and the possibility of this creating new financial stresses. They have already begun to normalise monetary policy by hiking interest rates. They will not be the last. For now, the key central bank to watch remains the Fed – in its recent statement it has noted that tapering of asset purchases 'may soon be warranted' – markets currently interpret this as meaning sometime later this year. But the first, very modest, hike in US interest rates is still not expected until sometime in 2022. The timetable for a hike in the UK base rate also seems to have been brought forward recently based on underlying wage growth and rising inflation, with markets now pricing in a very small increase in rates during the first quarter of next year. Meanwhile, Europe's delayed recovery is unlikely to cause the European Central Bank to act for a while yet.

Whatever steps central bankers take, their actions are currently expected to be quite modest. However, it is the prospect of a new direction of travel that investors will need to become more alert to over the coming months. So far, both equity and bond markets continue to be reassured somewhat by the messaging from monetary authorities and their ability to perform a more complicated juggling act. Their aim is to sustain the economic recoveries on the one hand and maintain their commitments to monetary and financial stability, against a backdrop of higher inflation and high and rising asset prices, on the other. With an increasing sense that they are sharpening their policy tools, our focus remains on being as well prepared as we can be for this impending change of tack and the eventual end to super-cheap money.

Fundamentally, however, our expectation is that the scaling back of central bank support will be gradual and will generally remain highly accommodative for some while yet. This backdrop should continue to be supportive for risk assets for the remainder of 2021 and, in all likelihood, well into 2022. Although the pace of economic recovery has been tempered by the Delta variant, the prospect of continued stimulus, impressive progress on vaccinations and the wider recovery in corporate profits, which are likely to be aided by increased pricing power, give us confidence to maintain equity exposures at the upper end of the strategic ranges we have in place for clients' portfolios.

Combining equity styles and seeking out longer-term opportunities

'Growth' as an investment style has reasserted itself over the summer months, widening the gap that has opened up in recent years versus more 'value-orientated' companies and sectors. Our preference is to maintain a blend of both styles, avoiding the most expensive areas of 'growth' and the more vulnerable areas of 'value'.

This combination seems to have worked well so far this year, including allocations to funds benefitting from the reinstatement of dividends. But we note that companies generally continue to act with some restraint in terms of how they deploy cash, some taking advantage of ultra-low financing costs to strengthen balance sheets. The full replenishment of company dividends after 2020's drought may therefore still take some time.

Cheap financing is also providing a platform for increased cross-border merger and acquisition ('M&A') activity, particularly in sectors and markets where the coronavirus impact has been greatest and equity valuations are now more attractive. It is not surprising, therefore, to see a surge in opportunistic interest from private equity firms, particularly in distressed UK and continental European businesses.

We are keen to maintain our existing skew towards small- and mid-sized companies, where better longer-term growth opportunities and more attractive valuations, including potential for increased M&A activity, seem to lie. Having recently taken action in Japan to rotate from a 'total return' fund into a more overt growth manager, we are also looking to modify exposure to UK allocations, boosting the commitment to 'growth' themes, 'special situations' and companies with good brand loyalty and pricing power. This activity is all part of a continuous process of ensuring client portfolios remain in sync with the opportunities presented by the unfolding post-pandemic recovery.

Reducing interest rate sensitivity

As things currently stand, the road ahead may contain a few more potholes but it is also fairly well lit and signposted. More care does, however, need to be taken by both the monetary authorities and investors to avoid a stumble. For this reason we are continuing to take action where we see the near-term risk versus reward pay-off looking more out of kilter. If central bank rhetoric does turn more hawkish, then bond markets are likely to be the more vulnerable asset class, so we continue to reduce the sensitivity of any fixed interest exposure to higher interest rates, particularly in the more overvalued areas of corporate debt markets.

Where appropriate, we are increasing commitments to alternative investments. These funds have the ability to neutralise bond or equity market risk, take advantage of cross-market relative value opportunities and produce uncorrelated or negatively correlated returns, thereby reducing overall portfolio risk. They are doing their job in terms of delivering absolute returns but can also act as useful portfolio stabilisers during weaker market periods.

Staying invested

As noted, global stockmarkets have enjoyed a strong run this year. Market volatility has also been exceptionally low, until quite recently – in the US, for example, there have been just four days so far this year when the S&P 500 Index has seen a daily market decline greater than 2%; there has been only one of this magnitude since mid-May and for sterling-based investors this has largely been neutralised by a fall in the pound. The exception to low volatility has been in Asian markets, several of which have been in the crosshairs of the Chinese government's clampdown on internet companies and its campaign to introduce more 'common prosperity' measures, including moves to make housing more affordable and reduce speculation within the property market.

We cannot rule out some form of a market disruption, possibly sparked by resurfacing of concerns surrounding the crackdown on Chinese property developer debt and its potential for contagion within the banking system. An unscheduled move by central banks could equally unsettle market nerves. But any setbacks are expected to be short-lived: medium and longer-term buyers of stockmarket risk never seem too far away as the cash they continue to accumulate increasingly needs a better home to earn some form of return and to combat the vagaries of inflation. Low cash yields, therefore, mean that the TINA (There Is No Alternative) effect still has relevance. There is no perfect inflation hedge, but equities have consistently proven their worth in such periods of elevated inflation. Staying invested, rather than running the risk of mis-timing exit and re-entry points, is therefore likely to prove a better strategy should we encounter any near-term market wobble.

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Remaining active and thinking longer term

Markets' current preoccupation is with the shorter-term influences of the pandemic on economic activity and how and when the huge stimulus will be unwound. But we also feel it is important to maintain some focus on the longer-term picture. This means maintaining our bias towards the USA and Asia, parts of the world that we expect to have fundamentally stronger and more resilient economic growth trajectories in the years ahead. But dominant global franchises, along with businesses at the forefront of a more digitised and environment-friendly world can be found across the breadth of global markets, including in regions with lower levels of general economic activity. We believe our selection of active managers is well placed to uncover and exploit many shorter and longer-term opportunities and themes.

Looking ahead

In all likelihood the ebb and flow of the coronavirus will continue to be the guiding influence on market sentiment and the shape of the recovery over the remainder of this year, and probably well into next. Although governments are increasingly likely to resist reintroducing the scale and type of restrictions imposed during 2020, we cannot yet predict with much certainty how the voluntary actions of individuals or changes in consumer behaviours and working practices will ultimately shape the future economic journey. What does seem more likely, however, is that monetary authorities will continue to err on the side of caution by taking baby steps towards scaling back their policy support. Petrol pumps may be running dry but there is still plenty of stimulus left in the tanks of central banks to keep risk assets on the road.

Risk warnings

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