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Investment review – End Q4 2021

30 December 2021

We close out the year with some very respectable investment returns under our belts. Global stockmarkets have responded well to an improved economic backdrop and some impressive progress has been made on tackling the coronavirus pandemic compared to 12 months ago – from a standing start at this time last year, almost 60% of the world's population has now received at least one dose of a vaccine.

Notwithstanding the emergence of the Delta variant of the virus in the summer and now the imposition of renewed restrictions connected with the surge in the Omicron variant, economies around the world have generally begun to re-open as the year has unfolded. This has, however, brought fresh challenges, including a surge in demand for goods, many of which either do not exist or are in the wrong place due to labour shortages and supply chain bottlenecks. Energy supply problems have exacerbated issues and contributed to a surge in inflation. It may feel like two steps forward and one step backwards, but as the year has progressed the general vaccination, booster jab and medical treatment picture has been improving day by day, giving more confidence to financial markets. The world's population and economy are becoming more accustomed to living with this deadly virus and governments, in theory at least, are now better informed in terms of the most appropriate actions they need to take. The immediate pressures on the world's health services may yet to be alleviated, but it does generally feel as though we are making some headway.

It is fair to say, however, that we – and that includes the world's population and financial markets – go into the year end and the beginning of 2022 with a partially occluded line of sight, not knowing yet how this latest variant will unfold and impact people's lives, livelihoods and freedoms, or its impact on economic activity in different regions of the globe. But as this year-end overview will go on to outline, we remain quite positive about the investment backdrop and prospects for the year ahead and are hopeful that we can build on the attractive returns delivered for clients during 2021.

Economic recovery in progress

From an economic growth perspective, the global economy is generally in post-pandemic recovery phase and some strong rates of growth are still anticipated in 2022, subject to the impact on activity from the unfolding Omicron situation. As things currently stand, global GDP growth is likely to revert to pre-pandemic levels sometime in 2023, although this is expected to be propped up by the stronger recoveries emanating from Asia and the developing world, where several countries have already recouped the lost ground. Several of these economies coped well with the early stages of the pandemic and seem well placed to maintain their general advantage in growth terms versus many advanced economies, perhaps with the exception of the US, which is still expected to deliver the strongest growth amongst advanced nations. In the UK, for example, the Office for Budget Responsibility currently predicts the economy will slow to 2.1% in 2023 and average a rather paltry 1.5% between 2024 and 2026.

Inflation outlook still unclear

The overall picture on inflation has definitely altered in recent months. US consumer prices are currently 6.8% higher than at this time last year, the sharpest rate of increase in almost 40 years. In the UK, inflation is rising at 5.1%, a 30-year high, whilst in the eurozone the latest reading of 4.9% is the highest since records began in 1997. These are not just uncomfortable times for consumers, but central banks too as inflation shoots above their 2% targets.

Inflation is now tracking much higher than originally anticipated principally due to the sharp rebound in demand during 2021, which has coincided with severe bottlenecks in supply chains, labour shortages and a big rise in energy prices, all of which have contributed to squeezing prices higher.

Inflation is most acute in manufactured goods rather than the less inflation-sensitive services sectors, where price increases generally have been much more stable. One example of the hiatus in the manufactured goods sector can be seen within the auto industry and its reliance on semiconductors. At the onset of the pandemic, sales of semiconductors collapsed globally as one of the big users, car manufacturers, cancelled orders. But this shortfall was soon offset by a surge in demand for computers, monitors and gaming equipment as the world's population quickly adapted their working, learning and entertainment arrangements to the home environment. Once the recovery took hold, with consumers starting to spend their lockdown savings, the production of semiconductors was insufficient to meet the sudden surge in demand from the car industry, which by now had been consigned to the back of the queue for chips and other automotive components. In the US, the knock-on effect has been huge: a near 50% increase in the price of second-hand vehicles in the past year.*

Looking ahead, though, it is entirely possible that inflation will retreat just as quickly as it has risen, particularly if the current pandemic health situation turns the corner reasonably quickly, demand stabilises, labour availability improves and general shortages, including within energy markets, allow the current constraints to ease. A lot clearly still hinges on the impact of the Omicron variant, so it may be a while yet before we see an unambiguous downturn in inflation. However, some signals are already turning amber: crude oil and natural gas prices have already begun to moderate and the cost of shipping raw materials has fallen; German car production has been rising in recent months; furthermore, the huge progress on vaccinations, where around 35 million doses are now administered globally every day, suggests that conditions for labour force participation will soon look brighter. These are factors that should help with some 'levelling up' of the current inflationary forces, allowing consumption to rotate away from goods and back towards the less inflation-sensitive services sectors.

Central banks remain patient

Subject to the severity and reach of this latest virus variant, current supply and demand imbalances are expected to subside during the second half of 2022. Although inflation is now less likely to return entirely to its pre-pandemic level, we, in line with most forecasters, do still think it will settle within a range that continues to allow central banks to remain patient and make only very small adjustments to monetary policy. After living for years with sub-par inflation, the US Federal Reserve ('Fed') and other central banks are actually now seeing the inflation they had been seeking. Current, higher inflation may be greater than policymakers would ideally like, but it should help average out those leaner years when it was running below trend, giving them some latitude in terms of their responses, including allowing them to act with some restraint. The monetary authorities will not want to kill off this inflation as soon as it has arrived, particularly if a large element does indeed turn out to be quite transitory or COVID-specific, as it currently seems.

Small moves in interest rates for now

As noted, the Omicron variant does of course complicate the inflation and interest rate picture and potentially increases the risk of policy error. But a longer-sighted view of inflation currently points to it retreating within a more manageable range by the end of 2022, suggesting that authorities will tap the monetary brakes very modestly over the course of the coming year. So far, central banks' reactions have been quite measured. The Bank of England's Monetary Policy Committee has already dipped its toe in the water, raising interest rates by a small margin to 0.25%. The increase, from just 0.1%, is unlikely to make any difference to savers and will have only a modest initial impact on borrowers, particularly with around three quarters of mortgagors being on fixed rate deals. So, this recent small move by the UK rate-setters – likely to be followed next by the Fed in the first half of 2022 – is largely symbolic.

**Source: Manheim Used Vehicle Value Index, Dec 2021.*

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But it does signify intent to address inflation and that we have, hopefully, come a long way since lifelines were thrown out at the start of the pandemic to support the world's economy. The bigger issues for those who have overstretched themselves may, of course, not materialise until they come to re-finance their borrowing, particularly if interest rates have been raised further than expected and lenders decide it is time to raise the bar on lending criteria and seek to widen their profit margins.

Looking ahead at our positioning

So how does this backdrop inform us about the likely market behaviour and influence our portfolio positioning for 2022? There is clearly some near-term uncertainty revolving around the latest wave of the pandemic, and whilst this may cause some delay to the full global recovery it is unlikely to derail it unless the world's scientists have completely miscalculated its impact on what is now a significantly vaccinated population, or governments over-react. In all likelihood, the backdrop we have will remain supportive for risk assets such as stockmarket investments in the coming year.

Defensive assets

But real, inflation-adjusted rates of return from cash deposits and many parts of fixed interest markets are expected to remain under water unless policymakers hit the brakes very hard or current inflation disappears in a flash. Although the anticipated measured responses from policymakers might suggest a relatively benign backdrop for fixed interest investments, we are mindful that conditions for traditionally lower risk asset classes like bonds could remain quite choppy and vulnerable to any unscheduled central bank actions or misinterpretation of their rhetoric as they begin the delicate task of unwinding the current stimulus. We believe that the adjustments we have made to fixed interest positioning during the pandemic have prepared portfolios well for the conditions ahead: any exposure we do have is focused on inflation-linked bonds and with strategic managers who can pivot quickly, particularly if the coast clears a little, to take advantage of changing conditions.

Our government bond exposure remains minimal, but there could come a time in 2022 when the policy outlook and inflation trajectory is a little clearer than it is today and it becomes safer to add more risk again within bond markets. For now, depending on portfolio risk appetites, we have diverted more capital into alternative, 'market neutral' investment funds. These can exploit relative value opportunities in both bond and equity markets, acting as good portfolio stabilisers and can offer genuine risk diversification benefits and alternative sources of return, particularly when more traditional defensive assets, such as conventional fixed interest investments, are not in vogue.

Fully invested, but wary of extremes in market valuation

General bouts of higher market volatility have appeared in recent months and this pattern could continue during 2022, but with periods of weakness snapped up quickly by nimble investors as they have been this year. Despite the likelihood of small upward moves in interest rates, returns from cash are unlikely to be attractive, especially whilst inflation remains high. We therefore expect to remain fairly fully invested and are comfortable with maintaining stockmarket exposures at the upper end of our strategic ranges, a position we have held – and which has worked well – since vaccines were first unveiled in November 2020. The recovery in corporate profitability is expected to moderate after a strong rebound in 2021, but still within an acceptable range that supports current market valuations.

We are, however, mindful that the pandemic has accentuated skews in investor preferences and behaviour: some very high growth companies now have a lot to do to justify their heady valuations; equally, many ostensibly cheap businesses may struggle to release their true value over an acceptable investment time horizon. Therefore, we expect the breadth of market interest to widen and the gulf between the market poles of 'growth' and 'value' to begin to close during 2022 as investors start to re-focus on investment fundamentals.

Our preference is to continue with a disposition more in the middle ground, with low exposure to the market extremes yet with good diversification across sectors and market capitalisations. Investing with active managers, who have strong investment disciplines and can adapt to what is still quite a complicated market scene, is likely to prove a more fruitful strategy going forward than following the herd, particularly into very expensive corners of the market. To illustrate the point, at one point during 2021 electric vehicle (EV) maker Tesla's market capitalisation was greater than the next ten largest carmakers combined, despite many of these competitors having already built strong EV capabilities themselves. Tesla has been one of the US stockmarket's darlings since early 2020, but seeing its share price fall by over 20% recently from its November peak is perhaps a sign that some investors are finally coming to their senses.

Higher US exposure has paid off

Our broad geographic equity allocations, with a bias to the US and Asia, remain unchanged. Our decision to increase the exposure to the US stockmarket in 2020, at the expense of the UK, has continued to be of benefit to investment returns during 2021 – at the time of writing, the gap between each country's broad market index return, in local currency terms, has grown by a further 10% this year as the appetite for the US market's more vibrant growth sectors has generally continued unabated. The US dollar has also appreciated against the pound on the back of the US economy's relative strength and an anticipated larger upward shift in interest rates. This has boosted returns for sterling-based investors in the US stockmarket and is a tailwind we expect will remain during 2022.

Asia's long-term opportunity

In Asian markets we have avoided some of the more troublesome issues caused by the Chinese government's regulatory clampdowns during 2021. These have impacted a range of sectors including education, property, internet/e-commerce and gaming. China dominates most Asia-Pacific stockmarket indices, so it has paid to have an active rather than passive approach to investment in the region, allowing some good returns still to be made. Many solid long term economic growth drivers remain intact for countries within the region, including China as it pushes its 'common prosperity' initiative. We are confident that our range of active managers, who have their ears very close to the ground, are well placed to identify leaders in innovation, change and operational excellence, giving clients exposure to a diverse range of established and developing themes within the region – some aided by policy tailwinds – including local brands, technology, wellbeing and 'green' initiatives.

Even economies that have less appealing economic growth trajectories offer investment opportunities for active managers. The commitments we have retained in the UK and Europe, for example, give exposure to 'growth' and 'special situations' further down the market capitalisation scale as well as companies with good brand loyalty and pricing power. Dominant global franchises can be found in all corners of the world, along with businesses at the forefront of a more digitised and environment-friendly world. The pandemic has shaken up traditional asset allocation frameworks and so our stockmarket exposures today are much more international in nature than they perhaps were a few years ago. As the global economy and its population works through this virus crisis, we feel that our range of active managers are in the best possible place to uncover and exploit these shorter- and longer-term global opportunities and themes, wherever stocks happen to be listed.

The reinstatement of corporate dividend payments has been welcomed during 2021 and is expected to continue during the coming year. Dividends help provide an additional dimension of return as well as a mild safety blanket in times of market stress. But for income-seeking investors, including those planning their retirement strategies, our stance also focuses on 'total return', where more growth-orientated investments are used if natural income sources of return are poor, or the investment case is unattractive.

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Risks versus opportunities

The pandemic is still likely to impact our lives, occupy the media headlines, dictate the shape of the global economy and influence the reactions from policymakers and governments during 2022. So, it is understandable to think that there could be more risks to the downside for financial markets than the upside.

But, as ever, investment is a constant balancing act that weighs up both risks with the opportunities. On the opposite side of the investment scales are a number of positives that should continue to be supportive for investment in risk assets: the substantial progress on vaccinations and more advanced treatments to tackle the disease should increasingly soften the impact and restrictions of any further virus outbreaks; the monetary policy framework is only expected to see very modest change over the coming year as several inflationary forces weaken; and there are large swathes of global stockmarkets that remain attractively valued, offering growth opportunities within a range of sectors and underlying themes – these are likely to continue to benefit from the societal, environmental and technological adaptations that are expected to continue way beyond the duration of this pandemic.

We are quite sanguine about the year ahead and see no need to batten down the hatches, but equally remain prepared, alongside our suite of active managers, to change course, if necessary, to keep the risks and opportunities in good balance.

Risk warnings

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