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INDEPENDENT FINANCIAL PLANNING
& INVESTMENT MANAGEMENT

Asset Class Commentary
September 2021

Investor sentiment is being sapped as the number of Covid cases worldwide rises. Global growth momentum is starting to fade, evidenced by economic data from major economies.

A lower than expected US jobs growth report put doubt into investors' minds as to when the Fed would taper its bond buying and this spurred US indices on to record highs. High inflation in Europe also raises the question as to when the ECB will taper its own quantitative easing (QE) program. Continued investigations in China are increasing the political risk in the country, and it is unclear whether long-term investment will pay off. Elsewhere in Asia, the announcement that the current Prime Minister of Japan will step down at the end of his term has been met with a positive reaction by investors, but whether this will translate into long-term outperformance remains to be seen.

Areas of Focus

- Short-term growth in Japanese markets has improved.
- UK post-lockdown economic growth has slowed, while Mergers & Acquisitions (M&A) activity in the country has picked up.
- Global dividends have recovered well and are set to continue this recovery.
- The S&P 500 is expected to end the year somewhere around its current level
- Gold has been spurred on by the prospect of potential delays to the tapering of US QE.
- US 10-year bond yield forecasts for the years end have been revised downwards.

Japan

The Prime Minister of Japan has announced his resignation. This news was met by an increase in the Nikkei stock index of nearly 4%, rising to its highest level since mid-April.

Prime Minister Suga was not well liked due to his handling of the pandemic. His departure removes a source of concern for Japanese stock markets. This brings about the question as to whether Japanese markets will now outperform in the long-term or whether it is only a short-term boost.

The Japanese market has had many false starts in the past and underperformance when compared with the MSCI All-World index has been evident over a long-time. From 2008 Japanese equities lost an annualised rate of 4.8% compared to global equities.

Deflation has plagued the Japanese economy and a declining natural change in lives (births – deaths) has worsened the economic situation. Looser immigration policies have led to an inflow of foreign residents which will help to boost consumption somewhat.

Looking at the EV/EBIDTA (Enterprise value/Earning before interest depreciation tax amortisation) shows that although the Japanese markets have recouped much of their EPS (earnings per share) and are nearly at record highs again, the MSCI Japan index is valued at 9.1x EV/EBITDA compared to 15x for the MSCI World Index. This is a big discount of 40%, highlighting the pessimistic view investors have towards Japanese equities.

Much of the wealth and power in Japan is concentrated between several huge conglomerates, and so Japan has lost out on many growing industries such as cyber-security to regions like the US. The ROE (return on equity) of Japanese companies is currently around 9%, and since 1995 has averaged 5.2%. This is below the cost of equity and is one reason for the poor performance relative to other regions. NASDAQ companies currently have a ROE of 26.9%, and 17.2% for S&P 500 companies. Investors want a higher ROE and invest in US growth companies where they can get this, resulting in a lower demand for Japanese markets.

Long-lasting performance will require a much-improved ROE. This can only come from improved business culture and a redistribution of innovation and wealth from the biggest conglomerates. The candidates to become the new prime minister will have different policy priorities, but investors are not too concerned in the short-term as the main focus will be for them to control the pandemic and normalise the economy. Only after this can investors get a clearer idea of how the economy will be run in the long-term.

Economic conditions have been worsening as the newest wave of covid infections disrupts factory activity resulting in a slowdown in growth. The private services sector also shrank at its fastest pace since May 2020 as business activity has declined for a nineteenth consecutive month. Household spending in the country increased less than expected in July as Covid hindered consumer activity.

Future prospects for this sector have been greatly dampened and any change in outlook is not looking bright until Japan control the Corona virus and vaccinates a higher percentage of its population.

Japan has made progress with 58% of the population having received one dose of the vaccine, but there is still a long way to go.

China

China is aiming to achieve “common prosperity”, narrowing the wealth gap between the rich and the poor. This will be achieved by means such as taxation and income redistribution. There are concerns as to whether this will derail the private sector by decreasing consumption growth, limiting the reliance on exports and investment.

The private sector has been a vital source of growth for the Chinese economy. Provided the policies are implemented carefully, this will be a long-term driver of Chinese growth, providing lower-income households with the means to boost domestic consumption.

Investors are still concerned over regulatory crackdowns. Recently many ride-hailing firms have been called to appear in front of regulatory committees and investors are left wondering what will be next.

The government has imposed restrictions on the amount of time children can spend playing video games and boy bands have been banned. The above points highlight how much political risk there is

for any investment in China. How much of an impact this will have on the video game industry (worth $40 billion in China) remains to be seen.

Input shortages and low inventories caused by government restrictions via port and factory closures will lead to production cuts and delivery delays.

Technology stocks, which have seen big drops recently due to government actions, have regained some of their lost ground as the government announced stimulus support of a predicted $45 billion to aid its struggling economy.

UK

Economic growth has again slowed as businesses struggle to deal with staff and material shortages. The high inflationary pressures have eased slightly, but all of this points to a slowdown in post-lockdown growth momentum.

Inflation in July fell to 2%, giving the BoE a bit more room with their monetary policy. The drop from the previous annual rate in June of 2.5% was larger than analysts had expected. Although wage inflation was on the rise, interest rates are still not expected to be increased anytime soon. Clothing prices decreased due to the summer sales while the cost of second-hand cars increased as the shortage of new cars is still an issue for consumers.

There is still an expectation that inflation will rise for the rest of the year, but this all depends on the recovery of the UK and no further steps backwards into new lockdown measures.

The rise in National Insurance Contributions and dividend tax rates of 1.25% will weigh on workers. The rise will leave less money in consumers' pockets and consumer spending will fall, affecting business profits and economic growth.

Europe

Inflation in the eurozone has been estimated at 3% this week, higher than the 2.2% previously seen in July. This increase in inflation has put more pressure on the ECB to potentially reduce its bond buying program. This is seen by looking at the German 10-year bond yields (a common benchmark for debt in the euro area), which rose to -0.37% on the announcement. When bond yields rise prices drop as investors sell the bonds in anticipation of rate rises.

German industrial output has increased by 1%, higher than expectations. This is most likely not a sign of an easing in the supply bottleneck. In June the output dropped by 1% so this is merely a reversal of the previous fall. The economy is approaching full recovery but supply-chain issues such as semiconductor shortages will leave GDP below its pre-pandemic level until at least Q4 2021. The supply chain bottleneck will most likely not be fully resolved until 2022. A rise in industrial orders suggest companies are expecting the supply shortages to ease in the coming months.

US

The NASDAQ and S&P 500 have continued to reach new highs due to a solid corporate earnings season and continued reliance on central bank monetary stimulus.

The most recent jobs report for the US showed a smaller increase in the number of jobs than analysts expected. Wages did however increase, and this was enough to steepen the yield curve and send longer-dated security yields higher.

Analysts still believe the Fed will signal its intent to taper its bond buying program but believe it will happen in December not November.

The high valuations of the American indexes will be called into question when the Fed does taper it asset purchases. The S&P 500 is currently at 4539 and a Reuters poll shows that analysts expect it to end 2021 at 4500 points, slightly below where it currently is.

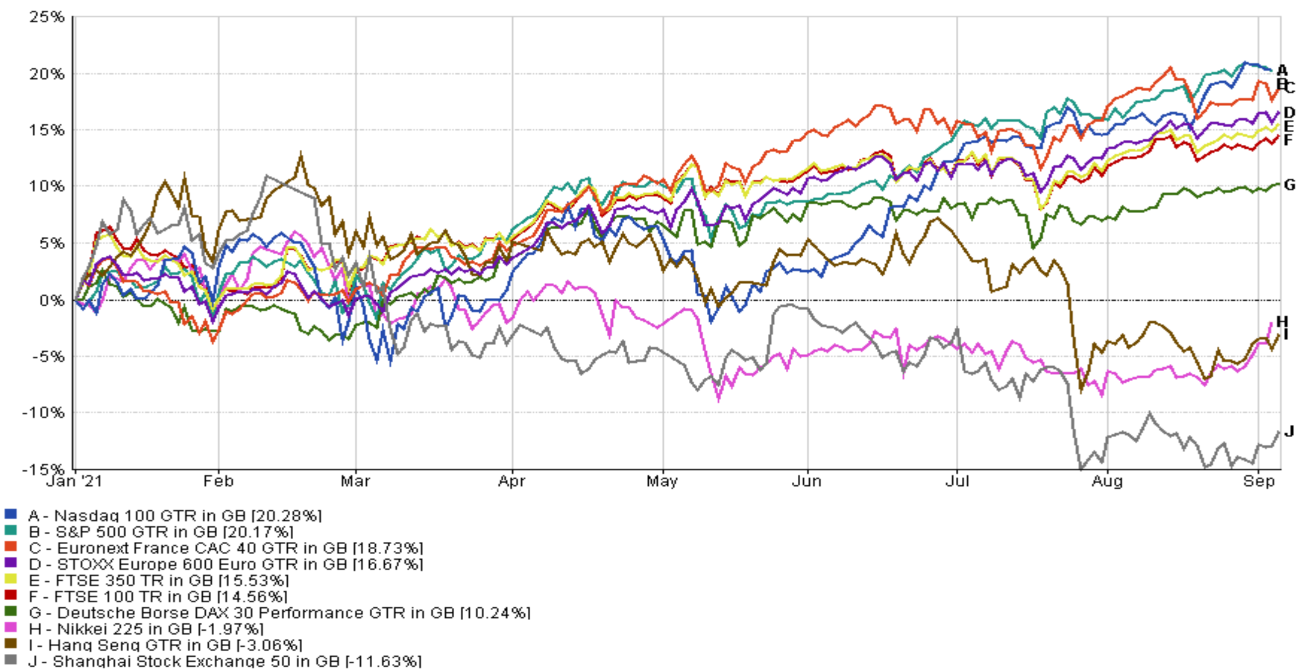

Chart showing YTD return of major stock indicies

Ethical Investing

With governments focusing on tackling climate change and implementing sustainable sources of living, and the number of extreme weather events increasing in their frequency, much of the world has shifted their thoughts to living sustainably.

The rise in popularity of ethical investing has been matched by the inflow of new money into the sustainable investing sector. In 2020, the net inflow of funds into European sustainable funds was EUR 233 billion, nearly double the figure in 2019. (Morningstar)

The number of new European sustainable funds launched in 2020 was 505, and many existing funds have been repurposed with a ESG mandate. (Morningstar)

There are a wide variety of sustainable funds. Some have a broad ESG mandate, and some have specific themes by which they choose the stocks in their funds. When most people think of ESG funds at the moment they focus mainly on the environmental aspect.

Ethical funds are not just about environmental changes, and it is important not to forget this. For example, there are several funds that focus on gender equality (social aspects of ESG).

Of the 505 new European funds, the bulk of them had a broad ESG mandate. 13% of the new funds had an environmental focus, and of this 13%, 66% were looking specifically at climate change. Although the achievement of global environmental and sustainable goals is a long way off, the methods and policies for achieving these goals is not and therefore it is wise to consider this now. The technology and healthcare sectors are most likely to benefit from a transition to a green economy as the structural changes will provide further growth opportunities. If we look at Tesla for example, the shift to electric vehicles will only further improve the demand for their products. Energy and utility stocks are at the other end of the ESG spectrum and are expected to lag in performance.

One big risk is with the adoption of new methods for producing energy. At the moment there are several different options including green hydrogen, wind power and electric heat pumps to name a few. Which method will eventually be the most cost effective and provide sufficient economies of scale is unknown and there is no indication which will be take the highest market share. This results in a relatively high degree of investment risk.

Developed economies are expected to benefit more from the move to climate change due to the larger weight in tech and healthcare in their benchmark indices.

Income/Value

Dividends slumped last year as businesses struggled. Global dividends are expected to rise to $1.39 trillion this year, up from previous estimates by 2.2% to reflect a stronger than expected recovery in company earnings and payouts. This would leave dividends 3% below their pre-pandemic high.
In 2020 financial institutions had restrictions placed on their payouts. This has since been lifted and global dividend recovery is expected to be strong.

Increases in commodity prices have boosted mining company prospects. Industrials and consumer discretionary are also showings signs of a strong comeback.

Fixed Interest

The value of Chinese government bonds being held by global investors has risen to an all-time high.

The pace of the increase in these holdings has slowed due to the yield premium (the spread between the US 10-year and Chinese 10-year government bond) narrowing. The reason behind this is the anticipation that the Chinese government will provide extra monetary support. Chinese government bonds have been popular due to their stable interest rate and lower correlation with equity markets.

Analysts have lowered their expectations for where the US 10-year treasury yield will end the year. Originally many thought the yield would top 2%, but forecasts have been revised downwards to 1.8%, up from its current level of 1.37%. How much of an effect his will have on the equity market rally remains to be seen.

Commodities

The prospect of a delayed start to the US Fed's quantitative easing program helped to push the price of gold upwards.

Despite the US wanting oil production to increase at a faster rate, OPEC have decided to continue their plans to supply an increase 400,000 barrels a day until mid-2022. This will help to mitigate risks of a drop in demand as the Covid virus spreads further. Investors are positive that the risks of a drop in demand in oil due to Covid are not overly high, and this has been supported by a drop crude oil inventories.

Robert Dougherty, September 2021.

This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.