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INDEPENDENT FINANCIAL PLANNING
& INVESTMENT MANAGEMENT

Asset Class Commentary
October 2021

Last month the spread of Covid variants was at the forefront of investors' minds. This month tighter monetary policy is pushing its way forward. Many investors thought inflation would only be transitory, a view which is being challenged globally as the demand for commodities and services soars, while supply is unable to keep pace.

Despite this, central banks are all advocating the view that the high inflation we are presently experiencing is only transitory. It may be that only a proportion of inflation is transitory – but the question then becomes, how much?

Meanwhile, rising commodity prices are impacting both consumers and businesses alike. In the UK multiple energy companies have collapsed due to the rising cost of wholesale natural gas (usually smaller suppliers which have not hedged their prices). This is likely to load at least some additional costs onto consumers as the winter progresses.

Government bond yields have also been rising globally, with US 10-year treasury yields at their highest point since June at 1.52%.

Stock markets have retreated in recent weeks and the shift from growth to value stocks is again evident in some places, although this effect is not universal.

The low interest rate environment and strong performance of equities in recent years has pushed valuations to high levels. Expectations of future returns are generally low and a big factor in determining the level of returns will be the strength of earnings growth.

If interest rates do rise, inflation in commodities will persist and tighter monetary policy may be ineffective at the present time.

The issue of the US Government raising the debt ceiling is a present concern. If the debt ceiling is not raised the US treasury will be unable to make good on its liabilities. While the prospect of a US default remains unlikely, the political posturing and last-minute negotiations can make investors nervous and markets volatile.

Points of Interest

- Property returns have improved as lockdown restrictions ease and more workers return to the office.
- The short-term outlook for Japanese equities has improved, but long-term hurdles are still present.
- Global government bonds have performed poorly due to rising yields.
- Emerging market equities have performed poorly, with China dragging the region down.
- UK growth momentum has slowed, but equities are still attractively valued.
- Earnings seasons will be closely watched as higher input costs put pressure on profit margins.

Inflation

The general view is that the present spike in inflation is related to the speed at which economies have bounced back from the pandemic – recoveries have been so rapid and widespread that existing supply chains are simply struggling to cope. This leads demand to outstrip supply, pushing prices higher.

In Europe and the US, natural gas prices have risen by more than 350% and 120% respectively this year. In the UK, a shortage of HGV drivers caused widespread panic as consumers all rushed to the fill their cars with fuel in the fear that supplies will run out.

The global shortage in semi-conductors is causing issues in a multitude of industries. Car manufacturers are cutting their productions, limiting supply, and pushing prices higher. The semi-conductor manufacturers themselves are facing higher input costs as the price of commodities in the production of the chips are increasing.

Global food prices are on the increase. Data from the UN Food and Agriculture Organisation shows food prices rose 30% in August year-on-year. This is due to a number of factors. The price of agricultural crops has increased, but also pandemic pressures such as the disruption in logistics are pushing the prices up. This is not too much of an issue for developed markets, but in emerging markets food and produce makes up a bigger proportion of the inflation basket. This could push central banks to tighten monetary policy more quickly.

The transition to a green economy is causing inflation in a lot of areas. There are many rules' that governments have imposed to create greener economies and they are having adverse effects on industries such as shipping and mining.

As the cost of goods rises, inevitably wage inflation also increases. However, the picture is mixed across different regions. Certainly, in the US investors are watching carefully for any news about wages as this will be the main focus for the Fed in whether interest rates are increased.

UK

The UK government ended the furlough scheme with an estimated 1 million employees reliant on the scheme. Whether these employees can fill the gaps in the labour market will be key in the BoE decision on interest rates. Consumer spending has been stronger in the UK, and this was reflected in a revised estimate for GDP growth for Q2 from 4.8% to 5.5%.

Over the past month both the FTSE 100 and FTSE 350 have experienced negative returns of -2.55% and -3.48% respectively. This is mainly due to a drop in global equities due to rising yields and the fear of monetary policy being tightened sooner than expected.

UK Gilt yields have risen to the highest point in over a year at 1.07%.

Growth is expected to continue but at a slower pace as political and economic uncertainties loom. Inflation is also expected to jump as the base costs of goods rises. The question is whether this will be transitory or longer-term, with expectations being the former.

US

One of the key points regarding US equities is the Democrats proposal to raise the debt ceiling. If this is agreed with the Republicans, then the US Treasury will not have the funds needed to service its debt.

This would have widespread implications for many asset classes as a key basis for their valuation is based on the risk-free rate, which is often a US treasury yield.

A temporary agreement to raise the ceiling until December has been reached, but this is only a short-term solution to a longer-term problem. Government shutdowns will have negative effects on the US economy and markets.

Many investors are eyeing a sooner-than-expected increase in interest rates. This has caused the value of the US dollar to appreciate and the value of growth stocks to drop. If the rates are increased too early, this will have a damaging effect on both stocks and the wider economy itself.

Jobs reports are a key factor in determining the level of monetary support and these are being watched closely by investors. If the latest figures are near the Fed's expectations, we will most likely see an announcement at their meeting in November to taper the bond buying program (effectively beginning to withdraw supportive monetary stimulus.

The performance of US growth stocks has suffered in recent months. The tech-heavy NASDAQ 100 has dropped 3.5% in the last month, while the S&P 500 has dropped 1.53%. This does represent a slight recovery over the month – at one point, the NASDAQ had been as low as -5.8% down.

Once again this highlights the high level of volatility in the market at the moment.

Japan

The appointment of a new leader for the ruling Liberal Democrat Party in Fumio Kishida has boosted Japanese equity returns in the short-term. He is most likely to be elected Prime Minister and this has boosted investor optimism for short-term fiscal and monetary stability.

The short-term outlook for Japanese equities is looking brighter. The demand for Japanese exports has been high which has boosted corporate earnings and is expected to continue to do so.

On the other hand, consumer sentiment in the country has been dampened due to restrictions and lockdowns. Despite 60% of the population having received one dose of the Covid vaccination, while 50% are now fully vaccinated, the sentiment has not increased. The slow implementation of a vaccination program, a lacklustre economic reopening and covid restrictions such as bars closing early are to blame for this.

The supply bottlenecks that are being experienced globally and shortage of materials may prompt some much-needed inflation into the country, as low levels and deflation has hampered the country's growth for some time.

The long-term outlook for the region is still not clear. Changes in the business culture and a need for inflation will likely persist, particularly against the potential headwind of the new Prime Minister's conservative approach to fiscal policy.

Europe

European equities had a strong second earnings quarter which analysts had forecast at a 152.6% jump in profit, mainly due to a post-pandemic rebound. That is expected to slow-down for the third quarter to a 45.6% growth in profit.

Inflation is expected to be pushed higher due to soaring energy costs. Recently European markets have been pulled down over losses to the tech sectors. These outweighed the gains made in the auto sector. Sectors such as consumer discretionary and industrials are facing supply disruptions and rising input costs which will further hurt their profit margins.

Emerging Markets

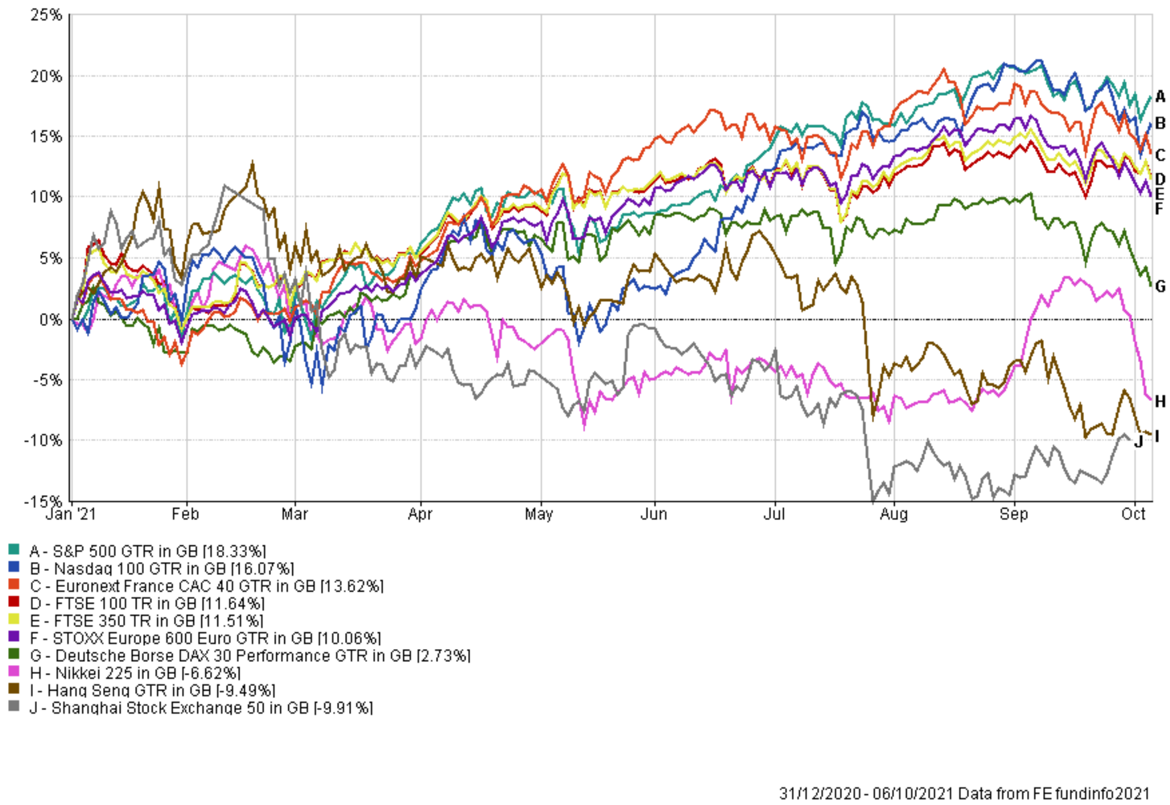
The Chinese markets have been dealt many blows in the past week due to regulatory crackdowns, covid outbreaks and more recently issues in the property sector. Some investors are seeing a buying opportunity as stocks have dropped to low valuations.

Lots of investors' minds are clouded by the risks of more regulation crackdowns. It is hard to see past this as to whether there are long-term positives. One key short-term issue is to see how the government will deal with the issue of the cash-strapped China Evergrande Group.

Some investor views of China have become more negative as a result of how the offshore holders of the Evergrande debt have been treated. Some have said they have received no communication from the company, while the onshore holders have (and have even received a partial payment).

There is a very wide range of forecasts and possible results from the Emerging Markets sector. The broader indices have been pulled down by China's poor performance in recent months. Europe, Middle East & Africa (EMEA) have posted positive returns, while Asia and Latin America have both seen negative returns in 2021. As always, it reinforces the lesson of diversifying as widely as possible.

Rising commodity prices does bode well for Latin American economic growth, while outbreaks in various Asian countries has pulled the economic growth estimate for them down.



Graph showing YTD performance of major stock indices

Fixed Income

Investors are once again pouring money into inflation protected securities, while government, investment grade and high yield bonds have experienced outflows. This is due to the high inflation levels and mostly negative real yields on these assets.

While bond yields in government securities have risen, the real yield is still negative.

Property

Property companies and funds have seen improved earnings as workers return to the office in greater numbers.

UK house prices have hit another all time high. According to data from Halifax, house prices rose by 1.7% in September, bring the year-on-year rate of house-price inflation to 7.4%.

The stamp duty holiday has ended in England which had spurred on buyers to close deals in September. However, the lack of residential properties has been a factor in the rising property prices which is likely to continue into next year.

Robert Dougherty, October 2021.