Asset Class Commentary
November 2021

Central banks are moving increasingly closer to raising interest rates as inflation is beginning to look less and less transitory. Despite this, real rates are predicted to remain historically low for the next several years. Currently, US real rates are at -5.3% and UK real rates at -3.0%.

Despite sky-high valuations, US stocks continue to increase in value with the S&P 500 up 27% YTD. These valuations come under threat as October CPI reaches 6.2% and the risk of interest rate rises sooner rather than later increases.

In the UK, although the number of Covid cases is decreasing, UK economic growth faces several hurdles in order to return to pre-pandemic levels. Growth figures reported this month show that the UK economy is still some 2% below its pre-pandemic level.

In the developing world, many emerging economies have already raised their interest rates, and with inflation expected to fall next year this will push the real rates into positive territory, aligning with the higher risk premium attached to investing in emerging economies.

Areas of Focus

- US stocks continue their upward push as firms pass rising input costs onto the consumer.
- Increasing foreign investment in China signals longer-term confidence.
- Investors currently prefer Europe and the US to the UK, as UK growth faces stronger headwinds.
- US Bond yields rise as US inflation tops expectations.
- The COP26 climate summit is aiming to secure global financial commitments to combating the effects of climate change and reducing carbon emissions.

US

Over the past month the S&P 500 and NASDAQ indices have outperformed all other regions and are currently trading at all-time highs. Falling unemployment rates (4.6% last month, previously 4.8%) and an increase in the number of jobs created (531,000 in October, forecasts were for 450,000) provided a helpful tailwind for equity markets.

The news that Pfizer may potentially have a new antiviral drug for treating Covid also spurred markets on. Industries such as airlines, hotels and restaurants bounced on this news.

Wage inflation was up 5% year on year which is an indication that price inflation may not be as transitory as once thought. Increasing wage inflation could see the Feds asset-purchase program be tapered at a faster rate and any rate hikes be brought forward.

US economic growth slowed in the third quarter due to decelerations in consumer spending (largely because of a resurgence in Covid and supply-driven issues). The annualised rate of growth was 2% – below economists' expectations of 2.8% and the slowest rate of growth since the plunge in growth in the second quarter of 2020. Economists expect Q4 growth to bounce back and growth to continue into 2022.

The annualised rate of CPI inflation for September was 5.4%. Inflation data for October showed CPI jumped 6.2%, the fastest increase since 1990. Government bonds sold off and pushed yields up as this was above the 5.8% expected.

Investors were looking for any signs that inflation is nearing its peak, but the latest figures cast doubt that it will be anytime soon. The Fed's latest monetary policy statement showed they still expected inflation to be transitory. The wording differs from their previous statements which assured inflation pressures were transitory. With the latest inflation figures investors are now convinced the Fed will have to raise rates soon, and the tightening of the quantitative easing will have to end this Winter.

For investors increases in inflation and sustained inflation could signal policy rate hikes sooner than expected, reducing many asset values such as growth stocks.

The US is also reopening its borders to fully vaccinated travellers from a variety of countries. This is expected to release pent up demand and tourism related stocks such as airlines are expected to benefit greatly.

Earnings season was very strong in the US. Many companies warned of supply issues impacting their business, but most were able to increase prices (which consumers were willing to pay) and maintain strong profit levels. Around 83% of companies in the S&P 500 reported beating their expectations. Forecasts for the end of the year are high, so to a large degree the current high valuations are justified. Supply issues are expected to subside by the middle of 2022 which will further help companies' profits.

Finally, after much wrangling and negotiating (mostly within his own party) Joe Biden has managed to secure the House of Representatives support for his $1 trillion infrastructure bill.

This bill already contains planned spending and the additional budget of $550 billion will be spent over 8 years, so the short-term impact of the bill on markets has been small. The bill is mainly focused on bridges, roads, rail, but also sets aside funding for new electric vehicle infrastructure and high-speed internet. The social spending bill of $1.75 trillion for healthcare, education and climate change incentives was put on hold.

UK

The Bank of England's decision to not hike interest rates had a positive impact on global bond market. Yields dropped as investors' demand for government bonds increased. Despite this, rising inflation and major bottlenecks in supply are likely to prompt the BoE to increase rates soon – some predict as early as December.

The BoE will only increase rates as long as economic growth continues as they predict it will and the labour market remains tight. Markets predict that the interest rate could reach 1.25% by the end of 2022.

UK economic growth slowed more than expected in the third quarter, even though GDP rose by a monthly rate of 0.6% in September, up from the 0.2% growth in August and above the expected rise of 0.4%.

Although both China and the US have managed to return their economies to pre-pandemic levels, it is difficult to judge as to when the UK has reached this due to differences in the way the Office for National Statistics calculates monthly and quarterly economic data. The quarterly data, which is used by the BoE shows the UKs output is still 2.1% below its pre-pandemic levels. Various issues such as decreases in business investment, Brexit issues and supply chain issues suggest there is uncertainty as to the pace of the economic recovery.

Inflation in September fell slightly to an annualised rate of 3.1%, down from 3.2% in August. This was despite supply chain issues and sharply rising energy costs. The BoE has said it expects inflation to reach 5% early next year and for the rate of increase in after-tax income to not keep pace.

Consumer spending increased in October, with retail sales increasing 1.3% compared with the same month last year. This goes a little way to dispelling fears that rising inflation will dampen consumer spending. With household savings still high there are further opportunities for consumer spending to increase on the run up to Christmas.

While UK stocks have made positive gains in the last 3 months, investors prefer the US and Europe. UK GDP growth has been slower to recover than US and Europe, owing to supply issues, staff shortages and self-isolation requirements. Current headwinds to UK growth are energy price rises, tax rate rises and supply issues brought about by Brexit. The BoE forecasts that UK GDP will return to its pre-pandemic levels in the first quarter in 2022 but there are many uncertainties around this.

UK house prices have risen for the 4 month in a row, as the cost of an average UK house increased by 0.9% in October. This takes the average house price to above £270,000. However, Halifax expects demand to drop off slightly as interest rates rise and the cost of borrowing increases above its historic lows.

Lastly, although it has been widely reported that the UK's tax burden is at its highest since the early 1950s, what has been missed in much of the media conversation is that this also acts as a drag on spending – this may in part be aimed at reducing inflation fears using fiscal policy, rather and easing pressure on the Bank of England to put up interest rates faster than they might otherwise need to.

Japan

Japanese stock markets have seen positive returns over the last month with the Nikkei 225 gaining 4.7%. This short-term performance is positive, but in order to remain competitive in the long-term lots of work needs to be done. Japan needs lots of fiscal stimulus and the Prime Minister's advisers have urged the rapid deployment of an economic stimulus package. This is expected to be announced around 19th November.

The level of consumption in Japan needs to increase as well. At the moment this is not happening. In September household spending fell 1.9% year-on-year as consumers remained cautious around Covid. This has eased slightly from August where spending fell 3.0%. There are indications that the economy shrank in the third quarter, with GDP contracting by 0.8%. As covid restrictions ease consumer spending should hopefully pick up.

While the economy may struggle to grow over the shorter-term, individual company growth can improve and provides opportunities for active investors.

Europe

The ECB looks unlikely to raise interest rates anytime soon, in contrast to its UK and US counterparts. Chief economist at the ECB Philip Lane believes inflation will subside naturally in the Eurozone in 2022.

Eurozone inflation in October reached 4.1%, but the increase in supply and temporary German tax rises should reduce inflation. Analysts believe the ECB will be the slowest to raise its rates as it has spent the last decade struggling to avoid Japanese-style deflation.

Over the YTD and the past month, the Euronext France index and the STOXX Europe 600 have achieved the best returns, second only to the American S&P 500 and the NASDAQ 100. Investors are more confident in the returns coming from Europe then they are with the returns from the UK. The more cyclical stocks in the European market better accommodate the move into more under-valued, recovery-based industries for investors.

Germany is at risk of becoming the slowest growing economy of the Eurozone as a new surge in covid cases could dampen consumer demand. The economy is already suffering due to supply chain issues hitting its industrial sector. The performance of the German DAX 30 index has been below all other indices apart from the Asian indices and this does not look likely to improve in the short-term.

China

Global holdings of Chinese stocks and bonds have jumped by $120 billion in 2021. Investors are investing directly in Chinese markets more and more, rather than through financial instruments. This is due to investors looking for alternative returns as developed market returns may look exhausted and valuations too elevated. This is despite the volatility caused by increased regulatory crackdowns.

Short-term China may be looking volatile, but longer-term prospects are more promising

COP 26

While there are lots of figures being thrown around regarding political spending for climate change, Mark Carney the former BoE governor has claimed $130 trillion of private sector assets have been committed to achieve net-zero carbon emissions. There is much debate about how accurate this figure is and how much capital has been double counted in arriving at the figure.

Under the pledge, institutions will agree to commit to science-based guidelines to reach net-zero emissions by 2050.

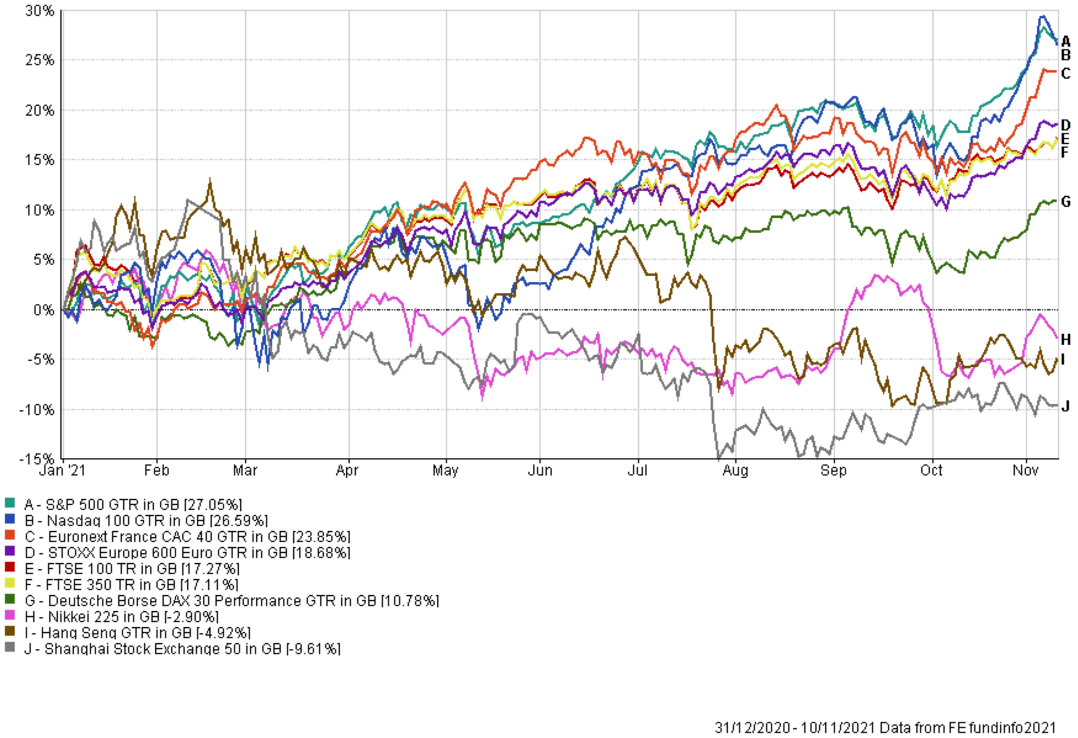
If money is implemented and goals are stuck to, we will see clean capital in areas like technology and new initiatives to such as clean transport and renewable energy.

However, this has been met with much criticism. One critic has said that the $130 trillion is "not a fresh pool of money, and most of it is not allocatable". Some think this could just be greenwashing, and that many financial institutions will fail to meet their goals.

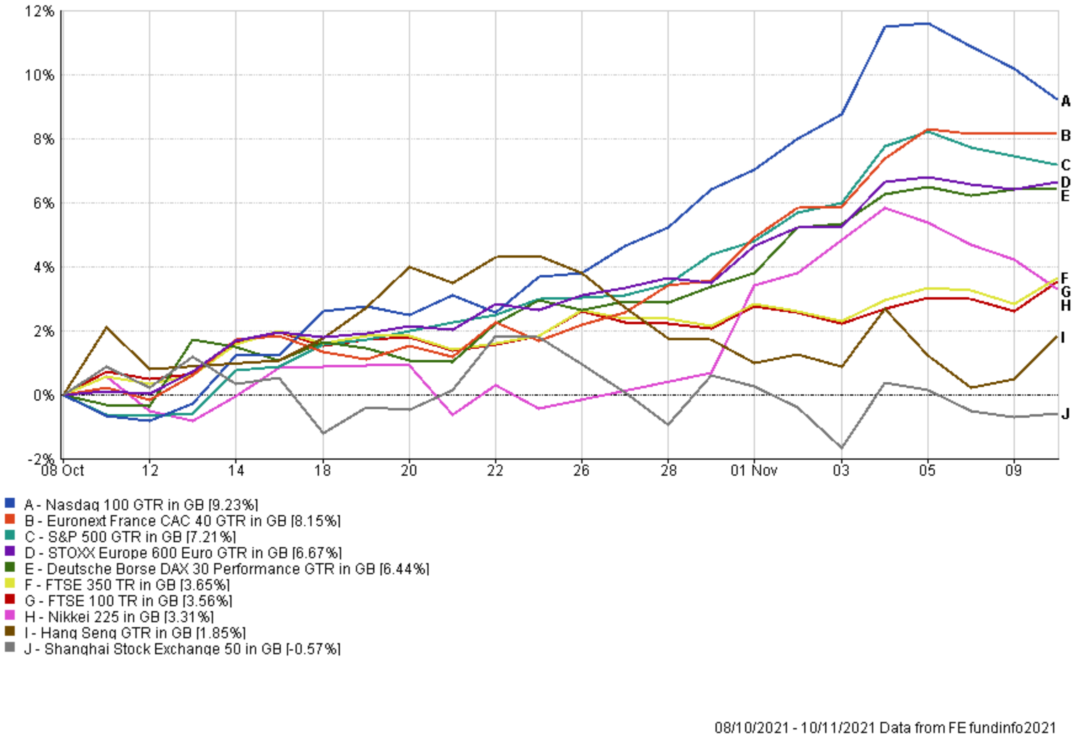
Many institutions that agreed to the pledge do invest in fossil fuels via loans and insurance under-writing and this is still continuing. However, one thing that people do forget is many of these companies that use fossil fuels have the biggest investments in clean energy. Take BP for example. Although they provide fossil fuels, they also invest heavily in electric vehicle infrastructure. They cannot simply stop their current business activities when the clean energy sector and the infrastructure to improve it is not ready for full-scale widespread use.

The pledge will provide huge investment in climate change initiatives as long as the companies follow through on their promises and have the support of governments along the way. Although the $130 trillion will almost certainly never be implemented, a fraction of this would go a long way and provide investment opportunities and infrastructure in clean initiatives.

Robert Dougherty, November 2021.



Major Stock Indices YTD performance



Major Stock indices 1-month performance