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Quarterly Investment Update

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Less growth and more inflation tests the Central Banks

In aggregate, the third quarter of the year delivered less global growth and more inflation than many had expected. Economists' growth forecasts drifted lower for much of the quarter as Covid lockdowns lingered and supply lines were compromised. Hence, even if demand was there, the ability to deliver products promptly was not necessarily possible.

While economists can point to a series of one-offs lifting the inflation rate, the longer these 'one-offs' continue, the greater the risk that workers will demand higher wages as compensation for the loss of real income. The more wage inflation we see, the greater the chance the market will price a more substantial inflation risk. As we have often said, you don't necessarily have to believe that inflation will stay at the 4-5% level; rather that some central banks will hit their medium-term inflation target of around 2%.

In the immediate aftermath of the spate of Covid restrictions imposed around the globe, it became clear that supply chains were being stretched.

Initially, the response from investors was to pay little heed, assuming that things would return to normal in due course. However, such a presumption is now starting to look dangerous; many countries face energy supply shortages, labour shortages, and severe spikes in the cost of transporting goods around the world. Several factors drive the supply chain troubles, including longer-lasting pandemic movement restrictions than initially factored in, especially in Asian countries. It seems as though, for the rest of the year at least, these problems are here to stay.

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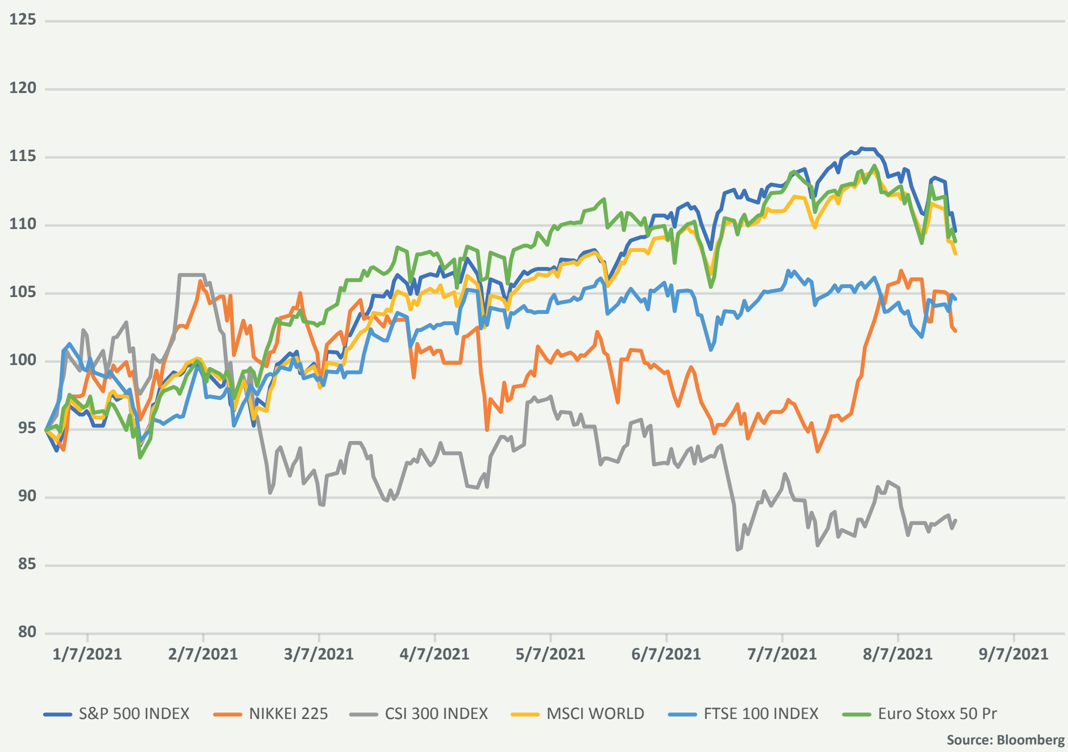
China has been the laggard



The quarter was marked by the Chinese government's drive for 'common prosperity'. From afar, it does appear to be a crackdown on technology stocks, but it started in the online education sector and has also rippled out into gambling and online gaming. Global investors are still digesting the implications for China as an investment destination, but in the short-term, a blow to confidence has been noticeable. Indeed, we've seen that Chinese stocks were under pressure for the entire quarter, struggling to keep up with other Asian markets or globally. The effect on the Shanghai 300 Index is clear to see in Chart 1. The question now facing investors is whether to keep faith in the long-term growth story of the Chinese economy or to instead take a more cautious approach.

In the third quarter, equity performance was harder to come by than in the first half of the year. The global MSCI World Index was flat in total return terms for the quarter. Reversing its fate as the laggard in Q2, Japan led the way with a gain of 4.6% in Q3. Europe was down 1.9%, and the China-heavy Asia region declined 9.3% in the quarter.

Market Focus

Global fixed income

The noted shift in tone from the Fed, marking its aforementioned stance towards hiking interest rates as early as 2022, made quite a difference to bond markets towards the end of the quarter. We've seen that yields on government bonds ended close to where they started. However, this belies the fact that the final week saw a sudden shift in pricing. In the US, for example, the 10Y yield drifted to 1.53% briefly from 1.3%, before settling in at 1.5% at the close - the lowest level seen in the period was 1.17%.

Much the same pattern was observed in the other G7 markets, where some nervousness is beginning to take hold over the path of monetary policy. At some point, the ‘longer’ in ‘lower for longer’ will come to an end. Inflation-linked bonds performed better than nominal bonds, delivering 1.8% in total return compared to a loss of -1.1% for Treasury bonds.

Credit markets, on the other hand, delivered positive returns for the most part. While the Global Aggregate Index was 0.9% lower, the high-grade component was flat, while US high-yield bonds returned 0.9%. The performance of credit in other markets was less impressive, once again dragged down by adverse developments in China. The ongoing saga of the potential collapse of a major property developer has forced spreads on Chinese high-yields bonds to even wider levels than seen in April 2020. As such, further market stress is expected before the government hopefully finds a way to mitigate the worst of the damage that could ensue in a disorderly bankruptcy. Despite this, other emerging markets were not too badly hit by fall-out from China. However, a stronger US Dollar has been a drag on EM debt performance this quarter, especially for local currency bonds. The overall return for this asset class comes in at c. 1.0% for the quarter.

US

US equities managed to eke out a positive return for the quarter despite the index falling 4.8% in September the largest monthly fall since March 2020. The market was knocked by the indications of future Fed tightening, the budgetary negotiations in Washington and higher inflation hitting corporate margins. Despite the challenges, the mood of the market was to rebound off critical supports as ‘buy the dip investors’ re-emerged.

UK

The UK equity market held up relatively well in the third quarter despite a number of headwinds. Growth disappointed despite the UK government’s brave decision to unwind many of the Covid restrictions on movement and activity. One aspect that worries the market is the ongoing inflationary pressures that appear to be pressuring the Bank of England to raise rates as early as the first quarter of 2022. The market remains relatively good value and with reasonable dividend support.

Europe (excluding UK)

After a strong start to the quarter the performance of the European market rather petered out as the reopening of the economy became choppy and a sharp rise in gas prices took hold. Investors are currently fretting about the impact of higher gas prices on inflation and the possibility that a lack of energy could cause a disruption to industrial production should the region suffer a very cold snap over winter. The market however offers more sensitivity to a cyclical recovery built on a marked acceleration of growth as the global economy reopens. While the US market’s performance is built on tech stocks, a swing to cyclical and value stocks would undoubtedly benefit Europe.

Japan

Japanese equities were a standout winner in the third quarter, even though the market sold off somewhat in the final week on China concerns. The corporate sector has seen ongoing good news with upgrades to consensus corporate profit forecasts, a reopening of the economy and political change holding out the prospect of an expansionary government budget by year end.

Asia ex-Japan

The dampening impact of Covid on smaller countries such as Indonesia and Malaysia and China's particularly poor performance all held Asia ex-Japan back in the quarter. The index fell 9% unwinding all of the modest recovery seen in the previous quarter. Indian equities were the standout positive performer, returning over 12%. The economy has recovered well from its Covid-induced lows and now looks to benefit from China's problems. The equity market has also been buoyed by a series IPOs. As an example, OYO created in 2012 by an 18-year old drop out is due to raise $1bn in a capital raise. The company is a budget hotel booking platform. Emerging market equity portfolio managers have swung behind Indian equities to use the cash generated from sales of Chinese shares.

Other emerging markets

Emerging markets were down heavily for the quarter, largely due to the marked weakness in the Chinese market that fell 18%. What is becoming clear is that China's loss is another market's gain. India equities were up strongly based on a good recovery from the challenges of Covid and an investor belief that India could gain significant market share from China in both manufacturing and service sectors in the future.

Currency

The US Dollar was strong throughout the quarter, with the Global Dollar Index (DXY) ending up by 1.76%. The effect of higher bond yields was clearly supportive, as was the generally more risk-off tone in equity markets. Against some of the other major currencies, the US Dollar was higher too; rising 2.1% against GBP and 2.3% against the Euro. Against the JPY it rose a more modest 0.22%, perhaps a reflection of stronger flows into Japanese equity over the quarter.

Commodities

Commodity prices varied much more in the third quarter compared to the second. Precious metals were lower across the board. We saw that gold, for example, dropped 1.1%, whereas silver (-14.8%) and platinum (-11%) saw considerably sharper declines. In base metals, iron ore saw a sharp fall of 29.7%, and copper also posted a decline (3.8%). On the positive side, however, there were gains for aluminium (13.9%) and jet fuel (11.4%). In contrast, oil prices were volatile, falling initially before rallying into the end of the quarter to end more or less flat.

The trend of rising prices in soft and agricultural commodities remained largely intact. Large increases were registered in cotton, palm oil, maize, and coffee. All of these rose between 12% and 30%, showing that surging consumer demand and supply chain troubles continue to have an upward effect on prices.

Conclusion

For now, the ‘buy on the dip’ mentality holds in equity markets. Partly, this is to do with easy policy from the central banks, but is also tied up with the belief in markets that, ‘what has been going up, will keep going up’.

The foreboding sense about the next wave of Covid variants, Delta in particular, has thus far found no grounds, as the developed world continues to vaccinate populations, even with top-up shots being administered in several countries. Where growth concern was previously focused on movement restrictions, it is now more crucial to unplug supply bottlenecks quickly. Apart from being an inflationary force, it will also be a temporary growth drag.

The final quarter of the year may shape up to be quite a test for central banks, especially the US Fed and the Bank of England - both facing possible (further) increases in inflation. In the US, the Fed will begin to reduce stimulus to the financial market in this coming quarter, and the Bank of England is starting to signal its discomfort with price increases. Supply constraints seem to be more serious in the UK, with energy shortages compounding the other issues also faced by Europe and the US.

In equities, it is to be expected that the sectors that have pricing power and resilience to interest rate rises will come to the fore. Commodity plays, apart from energy, have not come out well as input cost pressures offset the benefit of higher factory gate prices.

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