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Quarterly Investment Update

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New quarter brings new Covid but old inflation

The final quarter of 2021 was one where global equity markets pushed higher once more, with several reaching record high levels around Christmas. Looking back over the entire year, it may well go down in history as the 'buy-the-dip' year. That is to say, it was characterised by investors relentlessly using whatever market weakness that emerged as an opportunity to buy more equities. Central Bank policy came to the fore as a potential source of risk in the fourth quarter. The strength of the global economic recovery does appear to be beyond the grasp of Covid. To achieve this result, both fiscal and monetary policy has been very loose. That is to say, huge spending increases by governments, coupled with very low interest rates from Central Banks, have succeeded in fostering strong economic growth.

Eventually, inflation was going to return to the fray – see chart one below. In the US, UK and the Eurozone inflation is running above levels seen for many economic cycles. It was possible to be patient for a while, but policy will have to respond in 2022. The methods open to Central Banks will be to hike rates, and to soak up some of the excess liquidity that has been created with its various programmes of quantitative easing. It is an open question whether markets will be able to cope with policy shift comfortably. Our best guess is that more volatility could ensue in the time taken to adjust to new policy realities, but that there will be enough opportunities around for investors.

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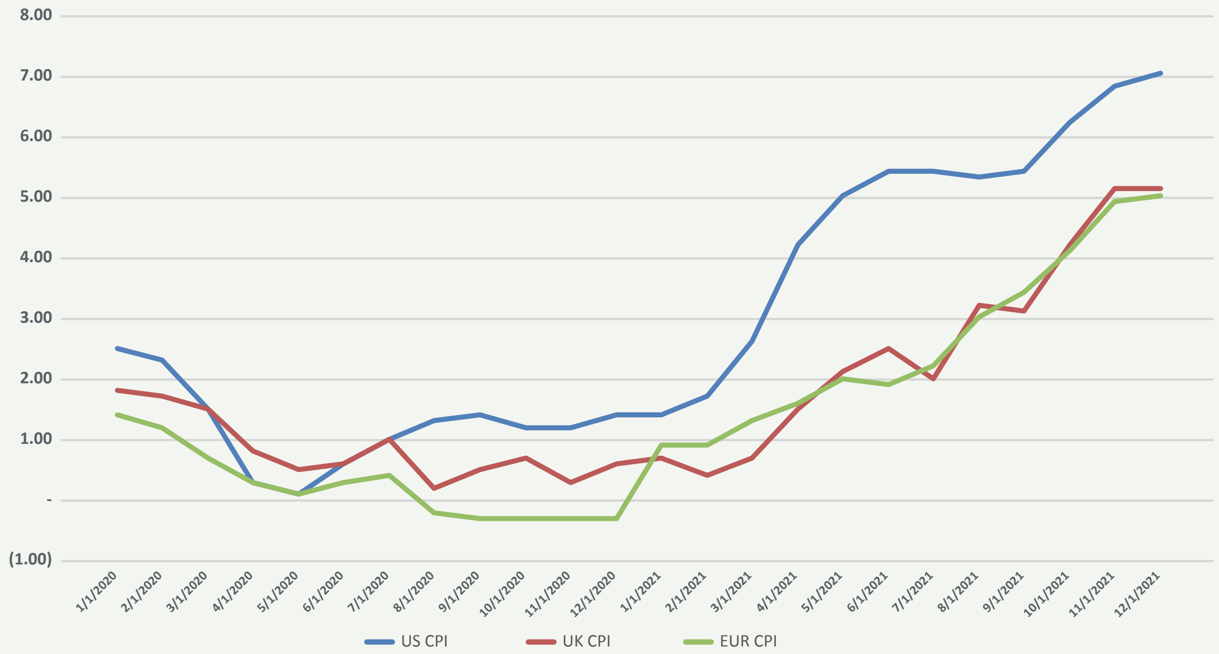
CPI on the rise



Source: Bloomberg

Equity performance in the final quarter was strong across the board, led by the US market with a full 10%. The MSCI World gave 7.7%, but that was mainly thanks to the strong run delivered by the US component. Other markets were more mixed, notably in Asia where the woes of the Chinese property sector remain a concern. In addition, Chinese technology stocks were under very severe pressure.

Apart from the key role that policy makers will play for the immediate future, we can't lose sight of the possible implications of a quick spread of the latest Covid variant. Some countries are again coping with it better than others. The risk is that, as before, the economic impact will be felt in higher prices by closing down supply routes that go into lockdown to prevent spread. The news appears to be that the new strain is not as dangerous as previous ones, and will not impede the slow move from pandemic to endemic.

Market Focus

Global fixed income

In a very marked shift in tone from the US Fed, the term 'transitory' was explicitly dropped from its official narrative. The growing tension commented on last quarter burst out into the open, as inflation numbers in the US and other regions belied the notion of a merely temporary increase in overall prices. In press releases and in its official minutes, the Fed is now making it very clear that it will not hesitate to take action as necessary to halt the rise in inflation.

The change was prompted by a reading of 6.2% for overall consumer prices in October, followed by a jump to 6.8% for November. It could be viewed that temporary price spikes drove previous increases of specific goods, but not after these numbers. It has become clear to the Fed and investors that there is strong recovery going on in the labour market (which will drive up wages), continued price rises in commodity markets, and signs of price increases in housing and rents.

Government bond yields reacted by not rising as much as might have been expected. In fact, the US 10yr yield ended the year at around 1.5%, much the same as the previous quarter. By some measures, this level of yield can be considered too low, as it still leaves real rates (nominal rates less inflation) in negative territory. Such a situation is seldom tenable for very long. It has rightly left the market nervous that bond yields will have to rise further.

Credit markets and government bonds performed roughly in line with each other: down between 1% and 0.7% for the major indices. The exception was the inflation-linked market, which posted a healthy gain of 2% for the quarter as investors looked to increase exposure to this asset class in response to the elevated threat of inflation.

It is worth noting that global credit markets have thus far shrugged off the woes of the Chinese property bond sector. Defaults are occurring in this market quite frequently, and government action and forced restructurings of bonds are becoming more frequent too.

US

The pedestrian performance of Q3 was left behind in Q4, as the S&P500 Index surged by 11.6% from start to finish, touching on some record-high levels on the way. As news broke of the spread of a new strain of Covid-19 (Omicron), investors held their nerve and once more used whatever minor dips emerged to add to holdings. Equally, the change in tone from the Fed did not phase investors, and the market closed the year very close to its high.

UK

While there were gains for UK stocks in the final quarter, the 5.7% (in US Dollar terms) performance posted by the FTSE Index lagged the US market significantly. The UK was unable to avoid the inflationary surge that rolled across the rest of the world, and the Bank of England responded by hiking its base rate by 15 basis points in December. The increase came despite the risk posed to growth by the rapidly spreading Omicron variant. Previous market expectations had been for a rate hike far further into the future.

Europe (excluding UK)

Where the UK and US Central Banks are changing tack to face inflation, the European Central Bank stood firm in its conviction to take no action yet. For the immediate short-term, that stance may be warranted. Underlying economic growth still appears to be more fragile in the European economy, and it has imposed firmer movement restrictions on individuals and businesses to combat the spread of the new variant. For the quarter, European stocks delivered 5.7% in US Dollar terms, matching the UK market but lagging the US.

Japan

The strong momentum displayed by the Japanese equity market in the third quarter dissipated rapidly in Q4. The stock market recorded a loss of 4% for the quarter. Driving the drop was a combination of disappointment with domestic developments, as well as some souring of investment mood towards Asia generally as Chinese markets pulled Asia lower.

Asia ex-Japan

The Chinese market, and the negative headlines it generated, continued to weigh. The Shanghai Composite Index did manage to eke out a small gain (circa 1.7%), but that lagged other major markets by quite a long way. The continued issues facing the property sector pose a very difficult problem for the government to solve. Evergrande was the first property developer to run into trouble, but it is now painfully obvious that the malaise of overleverage plagues the entire sector. More firms have defaulted, and new construction of apartments and houses has stalled in some cities. To add to the challenge, the Chinese economy is showing signs of receding growth at exactly the time that the new Covid strain is causing further tightening of movement curbs and lockdowns.

Other emerging markets

The majority of the emerging universe had a challenging fourth quarter in return terms, as evidenced by the 1.7% drop in the MSCI Emerging Markets Index. There were some exceptions to the rule, but the overall market sentiment turned very pro-US with the US Dollar firming. That usually undermines emerging markets. Furthermore, as noted in previous quarters, the effect of the pandemic has clearly been bigger on the economies of developing countries relative to developed ones. It may be the case that this drag will continue to be felt in asset markets too.

Currency

The US Dollar had another strong quarter. The Global Dollar Index (DXY) was stronger by 1.5%, marking the second consecutive quarter of gains. Among the major currencies, the worst performer against the US Dollar was the Japanese Yen, dropping 3.4% to end the quarter at 115.7 to the Dollar. By contrast, Pound Sterling reversed its recent weakness to end slightly higher at GBP 1.3532, and gaining 0.43% on the US currency over the quarter.

Commodities

The broad trend of rising commodity prices remained largely intact, although the sheer ferocity of gains seen previously in some markets appears to be moderating to an extent. Globally, Central Banks will be watching anxiously for further signs of moderation in the commodity bull run, as it has been a major contributor to the inflation problem now faced by these banks. Precious metals saw modest gains of around 5% for silver and gold, but platinum was stable. Base metals had a mixed spell, with aluminium essentially flat, copper up more than 8% but iron ore down by around 5%. Crucially for the inflation outlook, oil was relatively stable, gaining 3% over the quarter. However, most soft commodities once again saw gains. For example, maize, palm oil, and cattle futures contracts all rose between 5% and 10% over the quarter, driven by a combination of strong demand and some continued difficulties being experienced in global supply chains. These issues continue to add to the cost of shipping goods globally, thereby putting upward pressure on the pricing of goods bought by consumers.

Conclusion

When one considers the risk factors at play in markets in 2021, it is something of a surprise to note that several equity markets came to record highs this year, especially towards the end of December when some Central Banks had already started the pivot from easy policy to tighter policy. The entire year could almost be described as the year of 'buy-the-dip': the idea that whatever setback occurred, it triggered a buying opportunity for investors.

The immediate risk for markets into Q1 would appear to be how resilient equities will be in the face of Central Banks that are now determined to stave off inflation. The factors that have driven prices up are still around, even if they are moderating slightly. As policy tightens, the chances are that bond yields will rise to levels last seen before the pandemic; not just in the US but most likely across major markets.

We also note that geopolitical noise is once more on the rise: on the border between Russia and Ukraine, and Iran. However, if 2021 is anything to go by, there is possibly some resilience still in equities. It may be necessary to be careful and selective, focusing on value stocks over growth. It may also be necessary to be more modest about return expectations in 2022, but opportunities will still be around, as they were in 2021.

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