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OUT OF THE ORDINARY

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Market commentary

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Overview

A couple of months ago we highlighted that seasonality is a factor taken into account by investors and that the months of September and October have tended on average to produce poor returns. We also noted that averages are just that and not necessarily predictive of future outcomes. Thus, we recommended remaining fully invested in risk assets even if, with Halloween looming, there might be the odd bump in the night. Although equities experienced a five percent correction during the period, it did not develop into anything more pernicious, and we exited October with many equity indices standing at all-time highs. Sadly, the UK market was not among them, and, owing largely to its historical and current composition, still has some ground to make up. Even so, it too has participated in the continuing rally.

November, December and January have tended to deliver much better returns historically, with pre-Christmas gains dubbed a “Santa Claus rally” and the new money that often enters the market in January, adding to those gains. However, given what we have experienced in the last couple of years, it would be typical of the investing gods to turn those odds against us.

Indeed, and not just in defiance of those long-term averages, we do believe that a bit more caution is called for in the short term. And yes, we are also aware of another old saying that a “bull market climbs a wall of worry”. But there comes a point at which the evidence we are weighing begins to tip the scales more decisively in one direction.

Investment factors to consider

The two overriding factors for investors to take into account currently remain the path of inflation and central banks’ reaction to it. We have written in some depth in past commentaries about the factors that are behind the current rise in consumer prices. To begin with, it was clear many months in advance that we would experience a sharp rise in spring of this year owing to the collapse in average prices a year earlier during the initial COVID lockdown. That was expected to be a short-lived statistical quirk, and central bank chiefs adopted the term “transitory” to emphasise that they would not react to it in the traditional manner by tightening monetary policy. This was a well-intentioned move to provide forward guidance as to the supportive nature of policy as we recovered from the COVID-related recession.

So far, so straightforward. However, an extraordinary combination of new factors has conspired to keep inflation indices elevated for a much longer period. These include supply chain disruption in both sea-borne container shipping and land-based freight transportation at a time of increased demand for goods; labour shortages, which are largely COVID-related, but exacerbated in the UK by Brexit; and a huge squeeze higher in energy prices which stems to some degree from the transition to more sustainable sources of power, but which has been amplified by meteorological phenomena (which might in turn have been the result of climate change). Prices for many food crops have also risen substantially, too, again owing to either droughts, floods or freezing. The Financial Times’ proprietary Breakfast Indicator, which tracks the prices of coffee, milk, oats, wheat and orange juice futures, has risen by around 50% this year, for example.

The outlook for inflation

It is still not abundantly clear whether this is the beginning of a more persistent period of elevated inflation, but central banks are increasingly unwilling to take any chances. They are particularly concerned that expectations of higher future inflation will become more ingrained, and that this will lead to calls for higher wages to compensate which would lead to a classic wage/price spiral. Consequently, markets are now expecting the Bank of England's Monetary Policy Committee to raise the base rate at November's meeting and the US Federal Reserve to start reducing its asset purchases (both of which might have occurred by the time you are reading this). In many ways these are welcome moves because they signal the end of the emergency period embracing the pandemic, but they also constitute a tightening of liquidity conditions which begins to soften the strong tailwind that has propelled financial assets higher.

Markets

US

US equity markets have continued to make new highs, with the S&P 500 index achieving that feat on sixty occasions during the first ten months of the year. The latest bout of strength can be attributed largely to another strong corporate reporting season. With around half of the results in, sales are running 2% ahead of analysts' consensus forecasts, while earnings are some 12% ahead. The overall rate of earnings growth for the quarter is 34% versus the third quarter of 2020. One feature of the reports is the sustainability of, and indeed increase in, profit margins. There remain some questions about whether this can persist in the light of supply chain squeezes and a tight labour market, and it also appears that companies are prioritising the shipment of higher margin goods where possible. But it is also the case that incremental margins for many of the country's most profitable businesses, especially platform technology companies, are multiples of their existing margins. That is to say that adding an extra dollar of revenue does not require the addition of very much cost. There is no particular reason why that trend cannot persist for a while yet if current consumption patterns continue.

UK

October's Budget and accompanying Autumn Statement about the country's finances were not exactly a prelude to imminent Guy Fawkes' Night fireworks, but nevertheless contained some interesting sparklers. Although he chose not to spend his windfall immediately, Chancellor Rishi Sunak was able to convey the message from the Office of Budget Responsibility (OBR) that this year's fiscal deficit will be substantially lower than previously forecast – although at £183bn it will still be large by any historical standards. Not only did the OBR conclude that recovery from the pandemic had been stronger than expected, but also that "scarring" to the economy will be less damaging than originally estimated. This all plays nicely into the hands of the government when it comes to the electoral cycle, though, with the Chancellor potentially having something up his sleeve to give away in future. The OBR also calculated that the government's annual interest bill will peak at £36bn, which is testament to the low level of interest rates and bond yields. Five years ago, the projection was £40bn even though the overall debt burden was substantially lower. Of course, this means that rising interest rates could leave the Chancellor with less room for manoeuvre, a point also subsequently made by the OBR. With public spending's contribution to the economy now at levels not seen since the 1970s it is clear that there has been a shift in the political landscape, with far greater focus on the "levelling up" agenda. Savings vehicles such as pensions and ISAs continue to be made less valuable thanks to a lack of index-linking to contributions and, in the case of the former, the Lifetime Allowance cap. At least there was no move to bring Capital Gains Tax rates into line with Income Tax rates, although one feels that this threat will be enduring.

Europe

Last month we addressed the political situation following the German Federal elections. A month later, the proposed coalition between the Social Democrats, Free Democrats and Green Party has yet to reach agreement over the bulk of its policies, although there is a self-imposed Christmas deadline to reach a settlement. Just to add to the uncertainty, the Bundesbank's long-standing and hawkish president, Jens Weidmann, has also decided to retire, paving the way for a potentially more dovish successor. That might well suit a government that leans towards more progressive policies.

The corporate sector across Europe, though, continues to brush off any concerns about governance in its most important economic constituent. As in the US, earnings growth is strong, increasing at 44% year-on-year, although the positive surprises are not as

impressive, at 1.5% and 8% respectively for sales and earnings. We have our eye on next May's French presidential election as the next big political pressure point. The last edition in 2017 created much concern about the potential for a disruptive nationalist winner, namely Marine Le Pen of the National Rally Party. Her share of the potential vote is currently being undermined by Eric Zemmour, an outspoken right-wing political journalist. He doesn't have a party and has yet to declare his candidacy – but the same was true of Emmanuel Macron not long before he became president.

Japan

We rarely write about Japan in these commentaries, but in our current recommended Tactical Asset Allocation it has a similar weighting in portfolios to both Europe (ex-UK) and Emerging Markets. Often its performance appears to hover between the two regions. Like Europe, its economy has a large export component and the country generates a healthy current account surplus. In recent years both have struggled to generate meaningful domestic growth or inflation. But Japan's geographical location also makes it more beholden to the economic performance of its neighbours, notably China. Earlier this year the government's ham-fisted approach to COVID and its slow vaccine rollout pushed Japan's equity markets to the bottom of the class, but it has caught up quickly, which has helped shares to recover. Much of the blame for the debacle was placed at the door of the relatively new Prime Minister, Yoshihide Suga. He stepped down from leading the Liberal Democratic Party in September, with former foreign minister Fumio Kishida taking his place. Kishida called a snap parliamentary election, which resulted in a surprisingly large LDP majority in the lower house. His next move is expected to be the announcement of a stimulus package for the economy. While the Japanese equity market has been something of a value trap in the past, improving returns and a positive trend in the realm of corporate governance are encouraging factors. And in a world where central banks are generally shifting towards tighter monetary policy, the Bank of Japan is deemed to be pretty much at the end of the queue. Indeed, a little bit more inflation might put Japan in the "sweet spot" for equity performance just as other countries are potentially entering the danger zone.

Emerging Markets

We have often commented in the past that the Emerging Markets (EM) label is poor one, as the divergence of performance between different countries is often very large, although this does offer active investors the opportunity to beat the benchmark. For example,

in the year to date, one might find the -2% capital return (all figures for returns in sterling) of the MSCI EM Index to be extremely disappointing. But the range of returns is huge. The index is dominated by China, where MSCI's China Index has lost 15.6%. And if you want an example of how relative returns can be distorted depending upon one's benchmark, the CSI 300 Index is down a rather less dramatic 5.2%. Much of this underperformance versus global indices is the result of the regulatory crackdown on leading technology and social media companies, as we have discussed in recent commentaries. The range of performance across other EM indices is wide. While Taiwan is +16.9%, South Korea is -2.9%. India's Nifty 50 has managed an impressive 25.2% gain despite a nasty case of COVID earlier in the year. Russia's gains are more than 30%, which makes one question how far investors should take their governance concerns at the expense of investment returns. Within Latin America, the two largest economies, Brazil and Mexico, have seen their markets diverge, with Brazil losing 19% and Mexico gaining 12.5%. Much of the blame for Brazil's travails must be laid upon President Bolsanaro, and he might soon be facing his own day of reckoning in court. Out of such political dislocations tend to rise opportunities, which is why we advocate an active approach to investing in Emerging Markets.

Fixed Income

Bond markets continue to confound those who try to trade them. Just as 10-year benchmark yields in many countries looked as though they were entering a more persistent uptrend (with consequent falls in capital values) on account of rising concerns about inflation, they rallied again as soon as expectations started to rise about central banks ending asset purchases and raising interest rates sooner and more aggressively than thought. If carried out, these actions might reduce the probability of higher inflation becoming more entrenched. There is even the possibility that policy could be tightened too aggressively, leading to an unwelcome slowdown. UK Gilts received an extra boost from the glad tidings from the OBR mentioned above, which will lead to lower supply from the Treasury than expected. Meanwhile at the short end of the yield curve, two-year yields shot up in both Australia and Canada when their respective central banks accelerated their policy-tightening plans. While neither is considered to be a bellwether market, the ructions were sufficient to remind investors that the transition to more normal monetary policy settings has the capacity to upset markets. We continue to find minimal value in government bond markets other than to provide portfolio insurance in the event of the sort of economic shock that by its nature will be almost impossible to predict.

UK Gilts have delivered a total return of -2.43% over the last three

months and -4.31% over the last year. Index-Linked Gilts returned 0.63% and 3.94% over the same respective periods. Emerging Market sovereign bonds produced a total return of 0.09% in sterling over the three months to end October (-2.61% over 12m). Global High Yield bonds delivered 0.62% (2.66% over 12m).

Conclusion and Outlook

We have been aware for some time that the confluence of factors that has been so supportive for financial assets would begin to become less powerful at some point and we have been content to ride the wave for as long as possible. But with monetary policy tightening now a reality and evidence accruing that we have passed the peak of positive earnings revisions and growth, it is time to be more circumspect. That does not preclude further gains for risk assets, but our current view is that markets are more vulnerable to a larger correction. It is the asymmetry between potential risk and reward that we are managing.

In the longer run we still believe that a healthy exposure to equities will remain the optimal way in which in which to defend wealth against inflation. We also believe that once monetary policy begins to normalise it will increase the opportunities for active managers to outperform relative to passive indexers. There is no end of challenges to surmount, but successful investment has always been about rising to those challenges and taking advantage of the dislocations that they often produce in market pricing. Perhaps the biggest challenge for all of us today, both personally and professionally, is climate change, and this commentary is being written as world leaders gather in Glasgow for the COP26 Climate Change Conference. We intend to dedicate December's Monthly Commentary to a broader discussion of the subject.

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