OUT OF THE ORDINARY

07 January 2022

Market commentary

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The investment markets were shaped consistently by COVID, geopolitics and climate change in 2021.

As has become the fashion entering a New Year, this month's commentary will reflect upon some of the main developments that affected markets in 2021 as well as set out the key issues for the year ahead. In truth, many things have not changed very much over the last 12 months. An ambitious soul attempting to record recent history through the medium of a Bayeux-style tapestry would find very similar threads running its length. These would include the obvious starting point of Covid-19; the interdependent outlooks for inflation and monetary policy; the still-to-be-settled argument about the merits of Growth stocks versus Value; the febrile state of global geopolitics; and no investment discussion these days can afford to omit the climate change debate.

The impact of Covid-19

We shall begin with the subject that, regretfully, continues to dominate the headlines, Covid-19. Our stated position with reference to the virus throughout last year was that medical science would mitigate the worst risks, that the virus would ultimately become endemic and that we would learn to live with it. But we were also pretty sure that any re-opening of economies would be a stop/start affair. It has proven to be thus, with both the Delta and Omicron variants having had their say. The unmitigated good news is that vaccines have reduced the severity of infections, but, with global vaccination rates still running slightly below half of the population, there is still a long way to go, especially in developing economies.

It is also clear that no two countries have the same strategy to manage new outbreaks (make that individual states, or even cities, within the US), with decisions being driven as much by politics as by science. Thus, for now at least, there remains considerable uncertainty about the economic effects. This applies to both the demand and supply sides of the economy. However, the underlying trend remains pointed towards some kind of normalisation, and each new dip in activity tends to be less severe than the last one. Our working hypothesis is that demand will gradually rebalance back towards more service-oriented sectors which require more interpersonal contact. The biggest risk remains a new variant that can not only evade vaccines but also spread fast while delivering a more severe infection. However, virologists and epidemiologists are broadly in agreement that such an outcome has a very low probability, as viruses tend to evolve in such a way as not to maximise all their superpowers.

The effect on inflation

A year ago, investors were almost unanimous in the opinion that inflation indices were going to inflect higher during 2021, if only because the comparative base from 2020 was so low. The consensus view was that inflation would peak during the second quarter before falling away swiftly. The view was spot on with the first part, but woefully underestimated the extent to which inflation would continue to rise as the year progressed. We have commented on several occasions in the past that, even if there has been some agreement on short term shifts in inflation, it has been impossible to find any consensus between economists as to the secular outlook for inflation, with inflationists and deflationists evenly matched. The same still seems to be true, although it does appear that greater support for populist and carbon-reducing policies and the spending that goes with them has raised the average estimate for future inflation to a higher level than it was pre-Covid.

It is also hard to find a consensus as to the causes of the current inflation spike. Some claim it is driven by the supply chain disruption caused by Covid, others that it is purely a monetary phenomenon, with central banks largely to blame. It has also been attributed to fiscal largesse, especially in developed countries where governments handed out large dollops of cash. And there also is the special case of surging wholesale natural gas prices which resulted from a combination of unexpectedly weak renewable energy supplies (for which some blame the weather) meeting insufficient gas inventories (for which some blame a combination of re-opening demand for fuel, lack of long-term investment and, more controversially, the interference of Russian politicians).

As is often the case, rising inflation will have been the result of a mixture of these factors, and we have no ideological adherence to any specific one. Neither do we believe that there is sufficient evidence to support the case for shifting portfolios aggressively towards a stance that would benefit from persistently (much) higher inflation. The message from both consumer inflation expectations and inflation breakeven markets (which derive investors' future inflation expectations from the yield difference between conventional and index-linked government bonds) is that central banks have not lost control of inflation yet. On balance we have concluded that it is wise to incorporate some extra elements of inflation insurance into portfolios.

What might happen to interest rates and other central bank policies?

Which brings us to central banks. The key word in their statements regarding inflation for much of the year was "transitory", but that was finally erased from the US Federal Reserve's vocabulary in November 2021. It, along with the Bank of England and several other central banks around the world, has embarked upon a new cycle of policy tightening, although it is fair to say that financial conditions remain very loose, with real interest rates still in negative territory. Indeed, they are likely to remain there for some time yet. While the Bank of England has started to raise interest rates already (even if only by 0.15% in December), the Fed's plan is first to end its asset purchase programme, which will happen in March 2022. Thereafter, the market expects three quarter-point rate rises over the course of the rest of 2022 and the same again in 2023. It is worth noting at this point that the European Central Bank remains decidedly more dovish in its assessment of the inflation risks, and that the People's Bank of China is gradually easing policy following a tighter period. As for the Bank of Japan, it appears to have lost the instruction manual that explains how to shift policy gears.

How might this affect investment markets?

Liquidity tightening cycles have historically presented headwinds to the performance of financial assets, and it would be irresponsible to dismiss the risk of a similar outcome this time. But if real rates remain subdued and earnings and dividend growth remain robust (even if slower than during the immediate post-pandemic panic recovery), then we are talking about slow progress rather than a sinking ship. Yes, there will be pockets of the market that suffer more, especially those that have benefitted from more speculative activity, and there is likely to be more divergence between sectors, but talk of financial crises and market crashes appears to us to be wide of the mark, even if we are likely to experience more volatility. To extend the seafaring metaphor, the waves will be bigger, but we will still make it to port.

What other risks are investors monitoring?

On the geopolitical front, the main threats are to be found on Russia's border with Ukraine and in the Taiwan Strait, the body of water which separates that country from China. Both are potential areas of conflict which could lead to retaliatory responses (perhaps more economic than military). Given that Russia controls much of the supply of natural gas into Northern Europe and that Taiwan is a key manufacturer of semiconductors (which are already in short supply), the potential for economic disruption is self-evident, alongside the political upheaval. Government bonds, Gold and selective hedge fund strategies can provide some portfolio insurance against the worst outcomes, although, on balance, we continue to believe that it is not in the aggressors' best interests to initiate conflict at this time.

In the United States specifically, we recently observed the first anniversary of two key events: the Democratic victory in both of the Georgia Senate run-off elections which gave the party technical control of the Upper House, and the storming of the Capitol building in Washington DC. Those heady days for Democrats now seem like ancient history, with President Biden's approval rating falling on account of his perceived poor handling of the pandemic and high rates of inflation. The Democrats are on course to lose control of both Houses of Congress in November's mid-term elections and might even fail to pass their Build Back Better stimulus package.

While it might be an exaggeration to suggest that the US Constitution is under threat, the continuing investigations into the Capitol uprising (combined with concerns over new electoral laws being passed in many Republican-controlled states) suggest that US politics will only become more divisive as we head towards the 2024 Presidential election.

Finally, Environmental, Social and Governance (ESG) factors are having a greater influence than ever on investment decisions. While many felt the outcome of the COP26 climate summit in Glasgow was underwhelming in terms of progress towards limiting the rise in global temperature, it is clear that huge amounts of capital are going to be directed towards the mitigation of climate change, from both the public and private sectors. This will present investors with plentiful opportunity. ESG factors are now incorporated much more deeply into our long-term returns and asset allocation process as well as into our sector and stock selection. Indeed, rather than being a special consideration, ESG is rapidly becoming a case of "business as usual".

The performance of key markets

US

US equities showed most other markets a clean pair of heels in 2021, with a large contribution coming from the mega-cap Technology companies. Although comparisons are being made with the Tech Bubble at the turn of the millennium, there are at least two main differences now to suggest that a similar ensuing Tech Bust is not in the offing. First, the leading companies generate immense profits and cash flow; second, the discount rate that drives the net present value of future cash flow is much lower and therefore supports the higher valuations. Of course, there is risk on both fronts, from tighter regulation and higher bond yields respectively, and we are mindful of those risks. We also believe that companies that have minimal or no current profits are at greater risk than the more established ones. Tactically, we see more immediate value in markets that are more exposed to post-Covid economic recovery and whose composition will be rewarded by rising bond yields.

UK

Some believe the UK market has been hampered for many years by its composition, with too much exposure to sectors such as Energy and Mining, and not enough to the racier Technology sector. Despite the resurgence of Energy stocks in 2021, there was still not enough Growth exposure to elevate the index into the echelons of the better performers, although investors continue to console themselves with a higher-than-average dividend yield. Although both companies are constituents of the Consumer Staples sector, it is interesting to note that the drinks company Diageo (+95 index points) and the food manufacturer Unilever (-37) found themselves at opposite ends of the scale in terms of annual points contribution to the FTSE 100 Index. As we enter a cycle of potentially rising interest rates, the Banks sector, while not being the force it was before the financial crisis, should have the capacity to bolster the performance of the index, and to provide a positive relative contribution within it.

Europe

In contrast to Unilever, Europe's largest company Nestlé, another Consumer Staple, fared much better, delivering a return of more than 20% to investors in Sterling terms. The Continental market now offers an attractive balance of risk across the various sectors compared to the US (which is extremely reliant upon Technology) and the UK (which does not have enough). The largest sector weightings are Industrials (15.6%), Healthcare (15.2%), Financials (15.2%), Consumer Discretionary (13.4%), Consumer Staples (10.9%) and Information Technology (10.9%). With plenty of potential for a post-Covid recovery, a central bank that is more reluctant to tighten policy and an increasing willingness in Brussels to sponsor more government spending, the region looks well placed to prosper in the year ahead.

Emerging Markets

We have commented on several occasions in the past that the Emerging Markets label is too broad to capture what can sometimes be a remarkably large difference in relative performance between constituent countries. 2021 was a case in point. Of the higher-profile markets, the clear winner was India (Nifty +26%), which benefitted from a strong rebound in domestic consumption as well as growth in capital expenditure. Despite being an early host to the Delta variant, the population was not badly affected.

China (Shanghai Composite +7%) and Hong Kong (-12%) were the clear laggards. Chinese authorities clamped down aggressively on social media and online financial companies. The travails of Chinese real estate giant Evergrande were also a negative influence, with the whole sector under pressure following government initiatives to contain speculative activity. On a more constructive note, the People's Bank of China has now started to loosen monetary policy, much in contrast to the rest of the world, although overall growth is forecast to remain below trend for at least another year.

Fixed Income

In 2021, global bonds – as defined by the Barclays Global Aggregate Index – delivered their worst nominal return since 1999 (-4.7%). According to analysis by Deutsche Bank, it was the worst return in real terms since 1991 (which is when the index was created). None of this should come as a great surprise given that yields were suppressed in 2020 thanks to the monetary policy response to

Covid-19. Further pressure was piled on by the sharp rise in inflation last year which finally pressured many central banks into tightening policy again. Indeed, it is a surprise that yields did not rise further. This could be accounted for by concerns that increased levels of global debt will make it very difficult for central banks to raise interest rates too far before debt service costs start to weigh on government finances and overall activity. We expect sovereign yields to continue to rise and that returns will be minimal at best. However, sovereign bonds continue to play an important role in portfolios in terms of risk diversification.

UK Gilts have delivered a total return of 2.42% over the last three months and -5.16% over the last year. Index-Linked Gilts returned 4.84% and 3.71% over the same respective periods. Emerging Market sovereign bonds produced a total return of -0.55% in sterling over the three months to end December (-1.42% over 12m). Global High Yield bonds delivered -1.15% (1.92% over 12m).

The outlook for 2022

It is not our habit to make specific forecasts for where equity indices or bond yields will be twelve months from now. Not only would it leave us unnecessarily hostage to fortune, but it would also fail to reflect the dynamic nature of markets. We prefer to focus on longer-term trends, and judge that these will continue to reward a meaningful investment in equities.

Having said that, we are slightly more cautious heading into the New Year as we anticipate running into the headwinds of tighter monetary policy in both the US and the UK (as well as in several other countries). And while we are happy to take bigger positions relative to benchmarks when we have high conviction, one of the lessons of 2021 is that market outcomes will not always comply with received wisdom. For example, had one correctly forecast that the headline Consumer Price Index in the United States would hit 6.8% in November from 1.2% a year earlier, would one also have forecast that the ten-year Treasury yield would only have risen from 0.9% to 1.51%, that expectations for US inflation ten years hence would only have risen from 2% to 2.6%, and that the S&P 500 would have gained 28.7%? Probably not.

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