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OUT OF THE ORDINARY

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# Market commentary

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## Overview

Despite fears that August would subject investors to an upset, with many predicting that thin market liquidity during the peak holiday season presented a considerable risk, equity markets have continued to make progress, building on already decent gains made earlier in the year. Indeed, global indices, notably the MSCI All-Countries World Index, made no fewer than seven new all-time highs during the month (punctuated by a short-lived 2% setback in the middle). Bond markets were also much calmer than they had been for a while, with both sovereign and corporate yields remaining in relatively narrow ranges. An observer from Mars might well conclude from this that all is well on planet Earth, but a closer inspection of the headlines reveals plenty of things to worry about, and the autumn appears to offer the prospect for ongoing heated debate about the sustainability of returns.

As has been the case for some time, the key drivers to sentiment remain COVID developments and the outlook for monetary policy. The former continues to have a considerable bearing on economic activity and short-term inflation outcomes, although the consensus opinion is that vaccination programmes will eventually allow life to return to something close to normal. Meanwhile central banks are sowing the seeds for the next policy tightening cycle, although are generally reluctant to apply much fertiliser yet. We will delve deeper into these subjects in a moment.

The headlines over the summer have been dominated by events in Afghanistan, with the United States and its allies announcing the withdrawal of troops from the country. This has led to the Taliban effectively taking control, negating almost two decades of attempts to establish a regime more friendly to Western interests. However, it is fair to say that these events and their undoubtedly tragic consequences for many have had a minimal impact on financial markets. Such is the way of things. Afghanistan is neither a major consumer of goods, services and commodities nor a source of key supplies – although some reports have suggested that it is rich in deposits of rare earths which are important components of many hi-tech products. The political fallout from these developments might not be felt until over a year from now if they have a bearing on the outcome of the US mid-term elections in November 2022. The betting site PredictIt currently has the Republicans as strong favourites to regain control of the House of Representatives as well as being marginal favourites to win the Senate. A split Congress would stop President Biden's policy momentum in its tracks, and so we can only assume that he will spend the next twelve months trying to push through as much of his agenda as possible.

Returning to COVID, the main development in recent months has been the increased prevalence of the Delta variant, which is proving to be, if not the most virulent, then certainly the most transmissible variant so far. Even countries with high vaccination rates have struggled (and generally failed) to contain its spread, although, thankfully, the vaccines have reduced the incidence of hospitalisations and fatalities. It is notable that countries such as Germany and Vietnam, both of which fared relatively well in the early waves of COVID, have been much more badly affected this time. Both countries feature heavily in global manufacturing supply chains, and it is here that the economic effects of the virus have been most impactful, with many companies reporting shortages of materials and products. This phenomenon has also been evident in purchasing manager surveys, with record gaps appearing between actual demand and available inventory. The situation is exacerbated by an ongoing shortage of shipping containers which, given the lead times for new capacity, is not expected to be alleviated soon. In the

UK, specifically, a lack of Heavy Goods Vehicle drivers is widely cited as a major constraint. All of this is leading to price rises for a number of goods, which is reflected in rising inflation readings almost everywhere.

The main questions exercising both the economics community and central bankers are whether the current bout of higher inflation will prove to be transitory and whether it will feed through to demands for higher wages. Inflation breakeven rates, derived from the prices of conventional and index-linked bonds, suggest transitory, although settling at a higher level than pre-COVID, but much is still up for debate. However, what the latest disruption has achieved is to halt the steady rise we had been seeing in economic growth forecasts. Indeed, we have seen some downgrading of growth expectations on both sides of the Atlantic in recent weeks. Corporate earnings forecasts have been more robust so far, supported by what was an exceptionally strong second quarter earnings season. More detail on the outlook for regional central bank policy will be provided in the country sections.

Last in this section, but by no means least, climate change remains an important topic for investors. This was underlined by the latest report from the United Nations' Intergovernmental Panel on Climate Change (IPCC). While, in our opinion, the report did not provide much new information to those well versed in the subject, its tone was distinctly gloomier than previously, conveying a need for stronger and more immediate action. It certainly set the stage for the forthcoming COP26 gathering in Glasgow. We continue to take the threat of climate change extremely seriously in our analysis as part of our initiative to integrate even more fully environmental, social and governance (ESG) factors into the investment process. This extends from asset allocation to the evaluation of individual stocks. It is impossible to overemphasise the challenges that lie ahead. While it is widely recognised that behavioural change is necessary and inevitable, this will, in all probability, only be achieved by policy-led enforcement and economic incentives (a yet-to-be-determined mix of carrot and stick). There are likely to be nasty surprises as well as attractive new opportunities for investment.

## Markets – US

Although the Jackson Hole symposium provides a stage for central bankers from all around the world to discuss policy initiatives, the spotlight always tends to fall on the chair of the US Federal Reserve (Fed), and this year's edition was no exception. The run up to the event was punctuated with regular opinions being delivered by any

number of Fed members, who, between them, evolved a sort of "good cop/bad cop" routine. One would assert that the path was set for policy tightening and some sort of tapering of asset purchases, only to be followed by another reassuring that nothing would happen prematurely. When Jay Powell finally delivered his speech in Wyoming, it was, perhaps inevitably, something of a damp squib, but sufficiently dovish to give equities a booster shot with which to end the month. The Fed remains very much in the camp that believes current inflation pressures to be transitory, although there was a tacit admission that we will only know for certain in retrospect. In terms of policy developments, Powell made it clear that the conditions for reducing asset purchases and for raising interest rates were quite separate. On the former, the requirement of increasing inflation and reducing high unemployment had been largely met, and it is now widely expected that tapering could be announced as soon as September's Fed meeting, with asset purchase reductions beginning in December and running down to zero by the third quarter of 2022. However, for interest rates to rise we will need to see much more progress towards full employment as well as evidence that inflation can remain close to the Fed's 2% target sustainably. Investec Bank's economics team envisages no US interest rate rise until the first quarter of 2023.

## UK

The Bank of England's Monetary Policy Committee (MPC) refreshed its policy for the sequencing of monetary tightening at August's meeting. The MPC considers the policy rate to be its primary policy tool, and, consequently, a rise in the base rate will be the first shot to be fired once conditions are deemed to be suitable – even if it has not been made explicit exactly what those conditions might be. Investec Economics expects there to be a sufficiently robust and sustainable recovery in place to forecast that an initial 0.15% rise to 0.25% will be announced in May 2022. This will be followed in December 2022 by a further rise of 0.25% to 0.5%. The MPC stated that once the base rate reaches 0.5% it will only then begin to run down the purchases of gilts made under its Quantitative Easing programme by not reinvesting maturing issues. Outright sales of gilts will not be made until the base rate reaches 1%, a destination that we do not see being reached before early 2024. None of this looks particularly onerous for investors and constitutes only the most gradual approach to reducing liquidity.

## Europe

The minutes of July's European Central Bank (ECB) meeting suggested a similarly cautious approach to monetary tightening. On current expectations, the ECB will be the last major central bank – with the possible exception of the Bank of Japan - to begin tightening policy. Investec Bank sees nothing happening on the interest rate front on the Continent before December 2023. Even so, the "flash" Consumer Price Index for the euro zone in August showed inflation of 3%, a level not seen in close to a decade. This prompted the traditionally more hawkish leader of Germany's Bundesbank to comment that "we shouldn't disregard the risk to too-fast inflation". It is worth recalling, though, that the ECB prematurely (and misguidedly) raised its deposit rate following the financial crisis, thus helping to precipitate the euro zone crisis. One feels it will be extremely wary of repeating such a mistake. For the record, the ECB posted three conditions for raising rates: inflation should be expected to meet the target (2%) well before the end of the projection horizon; price rises should be expected to remain durably at target through to the end of the horizon; and current inflation should be on a convergent path to target. These appear to be designed to avoid premature tightening in response to a shock that may only be temporary.

Of course, all this commentary on monetary policy is highly dependent upon "events", and, as we have seen in recent years, the best laid plans of central bankers can go awry. Remember, for example, the infamous "Powell Pivot" of January 2019 when the Fed had to reverse its policy tightening in the face of a severe market tantrum. And that was before we had to cope with COVID. But it represents the best view currently available, and markets are taking their cue from that for now.

## Emerging Markets

This month we return to the subject of regulatory intervention by the Chinese Communist Party. In the words of one commentator, it has reminded investors what the middle C in CCP stands for. The latest sector to fall foul of the government's new approach is gaming, with minors being restricted to just three hours a week of online play. While this would seem to be a move to improve both the mental health and eyesight of younger people, previous interventions into the internet, fintech and private tutoring industries were more in keeping with what has latterly been described as China's "Common Prosperity Plan". This plan, which aims to set policy goals out as far as 2049 (a luxury generally not afforded to democratically

elected governments!), encompasses mixed ownership in the corporate sector (that is a combination of state control and private capital), reforms to the tax code which will involve some redistribution of income, the establishment of property rights and initiatives to reduce the wealth disparity between urban and rural households. In a nutshell, it seeks to bolster the position of the broader middle class at the expense of wealthier segments of society. While that might sound like classical western socialist policy, the accompaniment of greater censorship of the media and public discourse is a more sinister element. While there are obvious losers from this policy shift, their share prices have already taken a beating. By the same token, there are other companies which will stand to benefit from more income being put into the hands of aspirational middle-class consumers. Even so, we would prefer to have more clarity over the CCP's ultimate goals before committing strongly to the region again.

## Fixed Income

Following two very distinct periods of performance in the first seven months of the year, with a sharp rise in bond yields globally being followed by an almost equally impressive drop, bond traders appear to have followed everyone else to the beach in August. The threat of future monetary policy tightening was not great enough to cause alarm, and was, in any event, offset by the disruptive influence of the Delta variant. Meanwhile, inflation prints tended not to be materially worse than in previous months. In the corporate arena, strong profits underpinned the case for owning credit, while the outlook for corporate defaults remains extremely benign. Most importantly, the threat of a re-run of 2013's "taper tantrum" appears to have been avoided, mainly thanks to the exhaustive guidance provided by central banks. The greatest threat to the current equilibrium remains persistently high inflation combined with rising wage demands (and settlements) which would then feed through to higher long-term inflation expectations. A test of central banks' resolve to allow inflation to "run hot" for a longer period would potentially create a much more volatile environment.
UK Gilts have delivered a total return of 2.67% over the last three months and -1.88% over the last year. Index-Linked Gilts returned 6.48% and 6.01% over the same respective periods. Emerging Market sovereign bonds produced a total return of 5.46% in sterling over the three months to end August (0.28% over 12m). Global High Yield bonds delivered 3.91% (6.42% over 12m).

## Conclusion and Outlook

As we move into the final third of the year, our message remains very much as it has been so far this year: while it is hard to argue that equities or bonds are particularly cheap, there is no compelling reason to head for the exit either. We are on a recovery path which we always suspected would be bumpy and there have certainly been some
testing moments. But staying fully invested has been rewarding. As outlined above, monetary policy continues to be accommodative, and it is our opinion that central banks will err towards allowing too much growth and inflation rather than too little. We acknowledge that this policy brings its own potential longer-term problems, ranging from social inequality to the risk of overheating, but we are of the opinion that we must always play the cards that we are dealt rather than the ones we wish we had been dealt. There are far too many investors who spend too much time trying to tell policymakers what to do (which is generally a futile endeavour) rather than acting on the policies themselves.

We have commented on several occasions in the past that the greatest dangers to investment portfolios arise during periods of increasingly restrictive liquidity conditions and rapidly falling growth expectations. While we have certainly passed the points of both peak liquidity provision (in terms of central bank balance sheet expansion) and peak recovery (in terms of year-on-year growth in economic output and corporate profits), the fact that both are still positive suggests a period of less generous portfolio returns rather than a severe setback.

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