September Market Reflection

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COVID has given way to supply chain pressures and risk of monetary policy tightening.

Equity and bond markets remained relatively quiet for much of the summer, consolidating second quarter gains. Investors continued to face several threats. The COVID Delta variant is now dominant in most regions, but the latest wave appears to have peaked, with vaccination programmes crucial in reducing hospitalisations and fatalities. But even if the worst of COVID is behind us, a quite different risk looms – that of monetary policy tightening. Central banks remain eager to withdraw the emergency policy settings that included asset purchases and rock bottom interest rates, if only to accumulate some monetary ammunition for a future downturn. This comes at a time when supply chain disruption is causing all sorts of shortages and price squeezes, with the latest headlines being grabbed by a surge in the price of natural gas. These will have inflationary consequences, but they will also reduce the availability of and demand for certain goods. Thus, the renaissance of the term "stagflation" in the economic lexicon. It will require a skilful balancing act from central bankers to mitigate demand destruction whilst also not allowing inflation expectations to become unanchored. For now, the market largely adheres to the notion that these inflationary pressures will be transitory, although the most recent moves in bond markets, where yields have started to rise again, suggest that some nervousness is creeping in. This also means that within markets there have been greater performance differences between sectors than might be apparent from headline indices, with certain value/cyclical stocks starting to outperform relative to growth stocks. We expect this transition phase from emergency to normality and from turbo-charged recovery to closer to trend growth to be a bumpy one, but with equities still able to make medium-term gains.

- Although global economic growth will end up being very strong in 2021, we have finally begun to see some downgrades to growth expectations. The Delta variant has supressed some of the pent-up demand that was forecast to be the result of excess accumulated savings. Supply chain bottlenecks are reducing supplies of certain goods even where underlying demand remains strong.
- At the global level, the main supply concerns are currently around natural gas, which is a key intermediate fuel as we navigate the transition away from the use of heavy carbon-emitting fuels. The price squeeze has been especially severe in the UK owing to poor generation from renewable energy sources and the structure of the wholesale market.
- Additionally, in the UK, the lagged effects of Brexit combined with lingering COVID effects are exacerbating the supply situation, with a dearth of qualified HGV drivers leading to delivery disruption and closed petrol stations.

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- China's economic slowdown is also a cause of concern. This is largely self-inflicted. Regulatory intervention in several industries has been a feature of the investing landscape this year. Stringent emissions caps, laudable as they might be in a longer-term context, are constraining production in several industrial sectors. But China at least has scope to loosen monetary policy if required.
- The German federal election provided no great surprises and there will be a sense of continuity from whichever coalition is eventually formed. But the Green Party's likely involvement will promote a more climate-friendly agenda.

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