



Investment Views



November 2021

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Global Strategy

The Supply Side Matters Again

For the better part of two decades, analysing demand has been more important than analysing supply. However, times have changed. The predominant problem today is not a lack of spending, but a lack of production.

Previously, investors focused on measures like unemployment rates, wages, consumer and business confidence to gauge the strength of the global economy. This backdrop was termed by some as “the age of oversupply”, an era where goods and services were readily available on demand. While the acute phase of the COVID-19 shock has passed, the effects continue to linger making it a tricky environment for investors, economists and policymakers. Three main reasons help explain how we got to a position where the focus has shifted to the supply side of the economy.

Firstly, the nature of the pandemic meant that many services became unavailable, so consumers diverted spending towards manufactured goods and this hugely increased demand for goods. Think buying home gym equipment rather than renewing a gym membership, or buying a new TV rather than going to a concert.

Secondly, the pandemic hit production as factories were forced to close or at least curtail production due to staff shortages or social distancing measures.

Lastly, the policy response to the COVID-19 crises was very different to the Global Financial Crisis (GFC) response. Back in 2008-2009, worries about moral hazard complicated efforts to provide government support, but the pandemic elicited sympathy as many individuals and businesses were hit by a huge shock that was no fault of their own. As a result, governments in developed economies rolled out a slew of measures to support workers and businesses, which ensured consumers had money in their pockets and could continue to spend.

Initially, sellers were able to dip into their inventories to meet rising demand, but by early this year, inventories had been depleted and shortages began to pop up across much of the global supply chain.

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The US attracted a lot of attention as the third round of stimulus cheques earlier this year were blamed for “doing too much”. But while many focused on the situation in the US, given the comprehensive and timely data, these trends happened all over the world. The good news is that things should start to improve as transportation bottlenecks ease, labour returns to the workforce and vaccines continue to allow the reopening of production facilities.

One of the features of the past two years has been the speed at which things have happened, whether it was the shutdown of the economy, the policy support, the production and roll out of the vaccine or the market rotations in response to these events.

While the supply chain stress story has continued for longer than many expected, based on what has already played out it is conceivable that the story quickly shifts back to one where production catches up and the demand for goods normalises as the service sector recovers. This is the bet that developed market central banks are currently making.

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Fixed Income

Too Far, Too Soon?

The relentless rise in government bond yields that started in September continued into October as the volatility measure for the US bond market, the MOVE Index, surged +24%. Australian government bond yields spiked to levels not seen since 2019. The events in Australia are important, as its central bank failed to step in and defend the self-imposed yield cap of 10 basis points on their 3-year debt. Yields across the world rose sharply as central bankers turned hawkish but once the dust had settled, 48 hours later, the Australian yield stabilised at 0.76% and investors had incurred a capital loss equivalent to 20 years of yield.

While not entirely surprising, this disturbing lesson in monetary policy highlights how quickly sentiment can turn. It has raised the possibility of a monetary policy mistake to its highest level since the Federal Reserve last raised rates in 2018, which they subsequently reversed in short order once cracks started appearing in money markets.

Economic data disappointed across the world in October, with significant weakness seen in emerging markets.

The question is, will history repeat itself? At this stage the Federal Reserve remains one of the more dovish central banks in the world, even with the taper of asset purchases, but with the market now fully pricing in an increase of two 25 basis points to the US base rate by the end of 2022, we are undoubtedly getting closer to that point. In our opinion, four hikes in the UK, five in Canada and seven in New Zealand would be too far, too soon.

Economic data disappointed across the world in October, with significant weakness seen in emerging markets. In the US, the advanced third quarter GDP reading came in at a lower than expected +2% annualised as the Delta variant depressed consumer spending. However, a large bounce back in the fourth quarter is widely expected and likely the reason why risk assets have not responded to the current batch of poor economic data and rise in bond yields across the world. Commodities continued their wild ride with oil rising by another 11% to \$84 per barrel, helping to boost the level of short-term inflation expectations further. While economic data appears to be unexciting using a GDP weighted basket, global activity





is still growing as evidenced by PMI readings, which are comfortably above 50 but the rate of change is slowing therefore the US Q4 GDP bounce back needs to come in on cue.

At the time of writing, the much anticipated upcoming Federal Reserve policy meeting brings with it the expectation that tapering will begin. After the recent more hawkish actions by other central banks, there is a small possibility that the taper will be more aggressive than the market expects. However, we feel the Federal Reserve will bring a sense of calm to markets and keep to the widely expected taper of US\$10bn per month in US Treasuries and US\$5bn in US mortgage backed securities.

Although the taper will have officially begun, the balance sheet will still rise by several hundred billion dollars between now and the expected end date in mid-2022. This leaves risk assets an opportunity to wean themselves off the excess liquidity we have enjoyed since the start of COVID-19. At the same time, on the global fiscal front, governments are also tightening budgets with a US

fiscal cliff looming in 2022 even if the proposed stimulus programs pass. Therefore, financial conditions are about to get tighter and 2022 is promising to be a very different investment backdrop than the one we have experienced over the past 18 months.

During October we digested the much improved valuations in the bond market (with 10-year US Treasuries reaching 1.7%) coupled with still large short positioning, very elevated inflation expectations and slowing growth across the world. This prompted us to increase duration in our US Dollar Bond Funds, leaving us close to benchmark across the USD curve. Our favoured place to gain yield, roll-down and guard against further increases in bond yields, is now the 4-year US Treasury and we have been very active in that space.

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In addition, we remain comfortable holding corporate credit given the low default rates expected over the next 12 months; however, better value can be found in US mortgage-backed securities, which carry an implicit US government guarantee while also providing collateral. Government bond yields outside the US have risen even more sharply due to more hawkish central bank actions and/or commentary.

In multi-currency accounts, we are buyers of short dated Australian, Canadian and UK government bonds as we feel recent moves are overdone. Our currency allocation is currently underweight British Pounds due to declining real yields, overly bullish speculative positioning (caused by very hawkish rate expectations) and increasing negative momentum, with the expectation of huge monetary policy divergences over the coming months. As a result, currency volatility is expected to remain high.

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Equities

The 'Meta' Stage of the Bull Market

Global equity markets rallied 5.1% in October, bouncing back from the end of the third quarter weakness to reach new highs. Developed markets outperformed, led by US stocks which returned 7.0% on strong third quarter earnings as more than 80% of companies beat earnings expectations. Despite the ongoing global supply chain disruptions and elevated inflation, companies have successfully navigated most margin headwinds by relying on pricing power and passing on their higher input costs. For years prior to the pandemic, companies struggled to raise prices in a competitive landscape without damaging demand, but it is now much easier to pass these costs on. Business customers are more likely to be able to pass them on and consumers understand that costs have gone up so there is some inflation in the system.

The IT sector contributed most to earnings, buoyed by market heavyweight Microsoft which returned +18% following growth in cloud computing and machine learning with expectations for continued strong revenue and earnings growth. Microsoft's broad infrastructure and productivity software applications make it a main

beneficiary of the growing digital shift and upgrades to legacy IT footprints. Embracing a hybrid-work environment is expected to aid adoption of Teams, Microsoft's chat-collaboration application, and drive sales of the Microsoft 365 productivity suite.

Microsoft really stood out in a period when other mega-caps struggled. Supply-chain disruptions impacted the likes of Apple, growing regulatory scrutiny and prospects of government intervention impacted Facebook, now rebranded as 'Meta', and decelerating top-line growth hit digital-ad providers following Apple's recent policy changes which require user opt-in for IDFA (Identifier for Advertisers) reducing the effectiveness of individual-user target advertising (Twitter and Snap).

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Other meaningful contributors to October's strong returns include the consumer discretionary sector, which returned +8.0% on a strong rally in autos (Tesla +43.7%, and Ford +20.6%), energy which was up +6.5% on surging commodity prices, and financials which rose +5.8% as multiple banks gained >10% on steepening yield curves.

Meanwhile, the House of Representatives passed the \$1.2T infrastructure bill (\$550B in new spending over five years), which increases US infrastructure and total non-residential construction spend by an average of around 35% and 15% respectively. The bill prioritises 21st century infrastructure needs, such as the electric grid & broadband, and will help catalyse the adoption

of digital/automated construction technology in addition to providing much needed funding to upgrade America's ageing infrastructure. Our thematic exposure to US infrastructure in our US dollar ETF mandates has benefitted as money has flowed into the stocks most likely to benefit from the increased spending.

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