



# Investment Views



October 2021

Global Strategy

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Equities

# Global Strategy

## A Bumpy Return to Normality

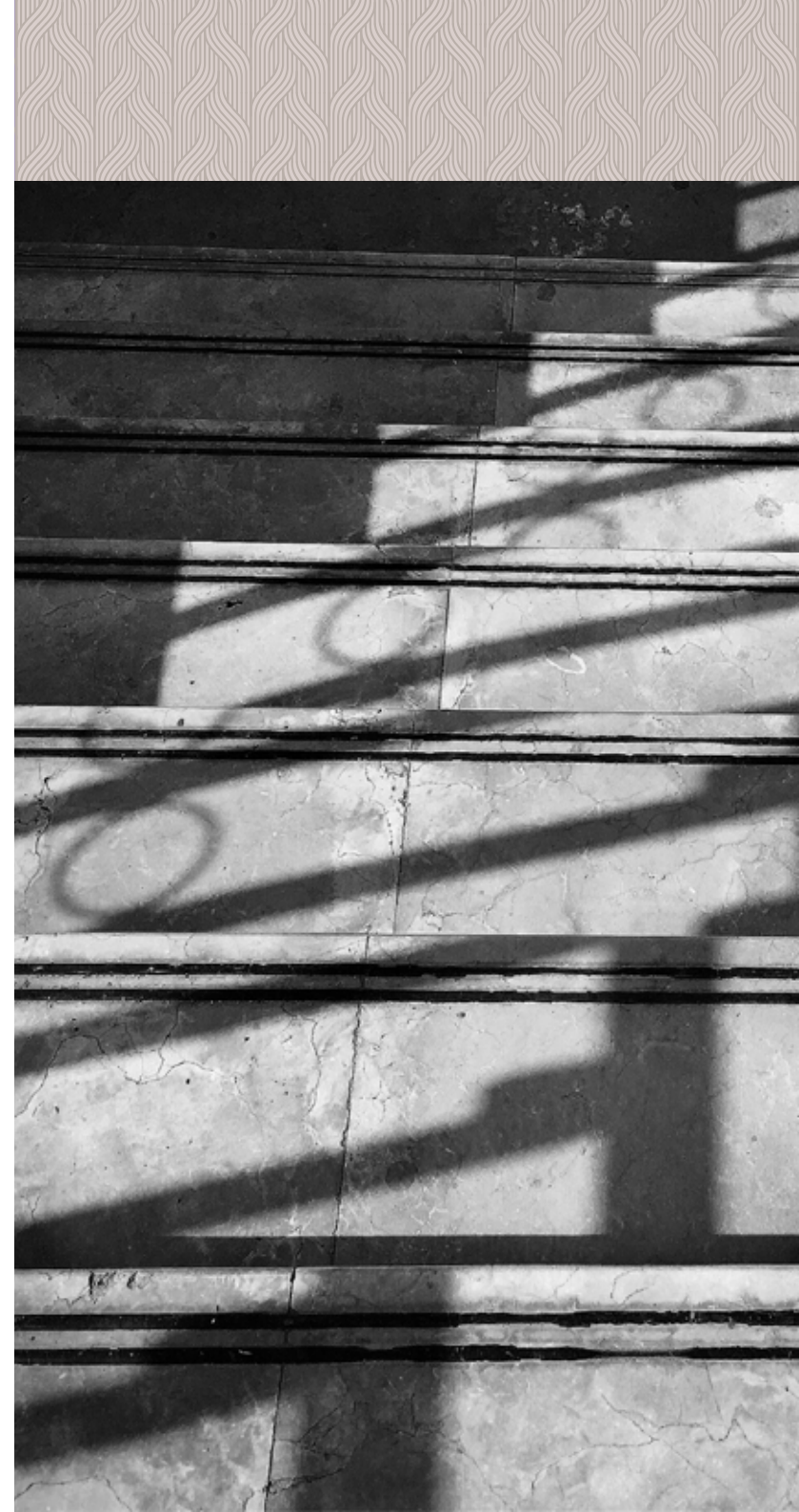
The third quarter started on a strong note for global markets as equities made gains in July and August before giving them back in September to finish the quarter unchanged in US dollar terms. However, over the first nine months of the year, market performance remained strong with the MSCI World returning 13.0% in US dollar terms as all regions gained with the exception of emerging markets, while all sectors saw positive returns with the exception of utilities.

The return to normality has been a bumpy one due to an uneven vaccine rollout across the world, the more transmissible Delta variant and inflationary pressures due to supply chain challenges. The vaccine rollout has picked up pace over the past ten months, with 3.5 billion people, or 45% of the world's population, having received at least one shot. At this point, most people in developed economies who want a vaccine have been able to receive one. While vaccine availability in many emerging markets has been more challenging, the situation is improving rapidly; India is currently vaccinating 7.5 million people per day and Brazil is averaging almost 1.4 million doses each day.

A defining characteristic of this crisis has been the dispersion between different sectors of the economy. People spending more time at home is terrible for restaurants, but demand for e-commerce has boomed. These seismic shifts have caused many challenges for individuals and businesses, but overall the combination of generous government support programmes, technological innovation and market flexibility has meant the global economy has been more resilient than expected.

However, as we move beyond the pandemic, some of the strains are starting to catch up with us. The combination of very low inventory levels, rising input costs and supply chain issues have proved a challenge. The Delta variant has caused particular problems in countries such as Vietnam and Indonesia, which had previously escaped the worst of the pandemic. Factories have struggled to maintain output and have been racing to clear backlogs built up over the past year.

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This has made for a challenging backdrop for investors, as it is the first time in many years that the supply side of the economy has been more important than the demand side. The key question is no longer whether there is demand in the economy, but whether companies can supply the goods and services in a timely manner.

When there is a supply-demand imbalance, price is usually the mechanism that adjusts to bring both sides of the equation closer to balance. Rising prices (inflation) has been a hot topic recently as estimates have been revised substantially higher throughout the year. Back in December last year, the consensus was for U.S. consumer price inflation of 2% through 2021; however, it is now forecast to be 5.2%. Inflation estimates have also been revised higher in the UK and Eurozone, which is proving a challenge for central banks who had previously described inflation associated with re-opening as “transitory”. While it may still prove to be transitory, the breadth has taken many by surprise and the definition of transitory is proving to be longer than expected.

There is still around \$2.5 trillion of excess savings in the U.S., which should support consumption over coming

quarters. However, enhanced unemployment benefits in the U.S. and the furlough scheme in the UK, have both now ended and most of the savings are with wealthier households who have a lower propensity to spend. COVID-19 also remains a risk as cases are stickily high in some countries and consumers are still not 100% confident about going out to dine and for entertainment.

Against a backdrop of disappointing growth on the downside and inflation risks to the upside, there is a risk that fixed income will not provide a traditional safe haven when risk assets, such as equities, are weak. This is something that we are monitoring closely. However, overall we continue to be well diversified with conservatively managed fixed income exposure, together with commodities, gold and hedge funds in appropriate portfolios with alternative assets.

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# Fixed Income

## Storm Clouds are Approaching

Volatility picked up in markets in the third quarter, with some notable divergences across geographies. Canadian, Norwegian, UK and U.S. bond yields rose sharply, whereas Chinese government bond yields fell. The 10-year UK Gilt yield rose above 1.0% for the first time since 2019, while the 10-year U.S. Treasury yield rose back above 1.50%. Economic data releases were broadly weaker than expected, especially in China and Europe, with the latter also seeing a notable uptick in inflation readings.

Commodities continued their wild ride with energy rising sharply and growth proxies (copper, iron ore and silver) all weaker over the quarter. Credit spreads within cash

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bonds remained remarkably stable during the equity market sell-off; although credit default swaps (derivatives) markets, which are traditionally much more liquid and reflective of market sentiment, have seen some spread widening (implying higher borrowing costs).

Over the past quarter, the change of tone from central banks has been dramatic as they have become increasingly mindful that inflation expectations are being anchored too high and asset bubbles could cause instability. Most are planning to, or have started to, tighten monetary policy with the Norwegians being the first to raise their base rate, the Bank of England signaling the same and the Federal Reserve guiding the market for a taper of their balance sheet purchases starting in November and ending sooner than expected around mid-2022. Risk assets will need to digest the complete removal of US\$120bn per month in U.S. Treasury and U.S. mortgage backed security purchases, which have helped to depress government bond yields and also helped keep mortgage rates low.





*...faster than expected interest rate rises could pressure short rates higher and lead to short term mark-to-market losses over the coming year...*

While the tapering of the balance sheet was well telegraphed, markets were caught off guard by the prospect of an interest rate increase in 2022, which was not priced in before the Fed's September meeting. In addition, the Federal Reserve now expects weaker U.S. growth and more inflation in 2021, offset by stronger activity in 2022. More importantly, for fixed income investors, the longer run forecasts for growth and inflation are expected to return to a pre-COVID trend of +1.8% and +2%, effectively capping how high long-term bond yields can rise during this cycle.

Many readers, particularly those based in the Caribbean and the mid-Atlantic, will be familiar with having to weather tropical storms, and the current situation we face within financial markets is no different. Since our previous

quarterly update, economic activity has slowed across all major countries, with the rate of change in China and the U.S. the most pronounced. In addition, natural gas prices have doubled in six months and surged to levels not seen since 2014. We also have the prospect of scaled back U.S. fiscal stimulus and a slowdown in China's property market, which is the largest asset class in the world at 28% of the Chinese economy. Uncertainty and headwinds are clearly elevated but as active managers we remain optimistic. Volatility provides us with an opportunity to produce strong risk adjusted returns.

As we enter the final quarter of the year, fixed income portfolio positioning is generally cautious, with large holdings of U.S. Treasuries across most U.S. dollar accounts, concentrated within the 3-7 year part of the yield curve, where carry and roll down is most attractive. While faster than expected interest rate rises could pressure short rates higher and lead to short term mark-to-market losses over the coming year, the total return captured provides an offset in most of the possible negative scenarios.





Corporate credit is still widely held and we continue to allocate a small amount of capital to U.S. high yield, primarily because we do not expect a recession in the U.S. over the next year, with any spread widening likely to prompt us to increase our allocation. Emerging market debt remains cheap relative to other sectors and provides us with an indirect U.S. dollar hedge through the allocation to local currency bonds.

Duration positioning has been a difficult call recently. Negative momentum in U.S. Treasury yields, over-pessimistic U.S. economic data forecasts, and the prospect of trillions in new bond supply coming to market (without a willing central bank to purchase) needs to be weighed against slowing global activity, a market that is already very short on U.S. Treasuries and energy prices that are likely to constrain consumer spending this holiday season.

Ultimately, we remained neutral for short dated accounts and underweight duration at the long end of the curve, but only marginally given the headwinds we face. As Shakespeare once said 'When clouds are seen wise men put on their cloaks', in this instance a conservatively managed fixed income allocation remains the best cloak for a multi-asset investment portfolio.

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# Equities

## Inflation Starting to Bite

The overall flat return for global equities in the third quarter masked some interesting shifts beneath the headline level. The best performing sector in the U.S. was financials, which returned +2.3% and the weakest was industrials, which fell -4.6%. According to Bloomberg, the gap of 6.9% was the smallest in any quarter since the sector indexes were first calculated in 1989. The prior record was 8.1%, set in the third quarter of 1989. This narrow dispersion was largely a function of a rotation between stocks during the quarter, as market leadership shifted from large cap technology orientated stocks in July and August, to energy, financials and travel & leisure stocks exposed to the re-opening of the economy in September. At a geographical level, the dispersion was much wider, as Japan was the best performing region returning +4.8%, while emerging markets were the weakest, falling -8.1%.

Company earnings continued a very strong run in the second quarter, coming in well ahead of expectations. S&P 500 firms reported year-over-year earnings growth of +86% versus consensus forecast of +61% and margins set a new high of 12.1%. According to Goldman Sachs, these results showed the highest number of earnings and sales “beats” since at least 1998. The quarter was characterised

by not only a large number of beats, but also the impressive magnitude of surprises, with financials, information technology and communication services driving the aggregate surprise. However, as we move into third quarter earnings season, the headwinds are starting to build. Rising input costs, supply chains issues and the end of enhanced unemployed payments or furlough payments, are all making life more difficult for corporates. Against this backdrop, turnover within equity allocations has been relatively low, as things are finely balanced due to the stop-start nature of the recovery.

Emerging market softness was largely due to weakness in Chinese equities, which now make up around one third of the emerging market index and fell -15%. China’s regulatory crackdown, which began with Alibaba last year, has become a lot broader and has now covered a wide range of industry sectors. Digital gaming stocks, such as

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index heavyweight Tencent, came under pressure when an editorial published in state media criticised the social consequences of video games and new regulations limited playing time for children to just three hours per week. Next in the firing line were stocks of education companies, as policymakers forced home-schooling education companies to register for non-profit status. The broader context here is that Chinese policymakers have been cracking down on sectors whose business practices they believe harm China's social fabric; corporate profitability comes very much secondary in China and market valuations have adjusted lower to reflect this.

The regulatory crackdown in China has also had major implications for property developers, the largest and most troubled of which is Evergrande. The real estate sector's problems are structural and this helps explain why Beijing has little interest in bailing out the indebted company. If it were to, every developer would want a handout, so the solution is more likely to be an orderly breakup. However, given the size and role of the property market, it is important that the situation is managed without a loss of confidence by Chinese consumers. China has proved adept at managing their economy through cycles

before, so it is likely that they navigate this period of stress, but the risks are certainly rising given the breadth of the challenges they currently face.

Over the past decade, China has been a very important driver of global growth and the global industrial cycle has followed the ups and downs of the credit and growth cycle in China. The big difference between the COVID-19 recovery and the recovery from the global financial crisis is that developed market governments have provided a huge amount of support to aid the recovery. This has led to a much quicker recovery, but a key question now is can the rest of the world pick up the baton and drive growth going forward? We are inclined to believe that the answer is yes, but the re-opening process has been much more difficult than we had hoped and getting global supply chains back up and running is of paramount importance for earnings and keeping a lid on inflationary pressures.

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