SQUARE MILE
INVESTMENT SERVICES

thomascarroll
WEALTH MANAGEMENT

Market Update

October 2021

Summary

It is too early to judge if inflation is transitory or entrenched but this is the economic measure with the greatest power to determine the course of financial markets over the next year.

Return expectations for government and high-quality corporate bonds are modest at best. Lower quality bonds are richly priced and, in our judgement, offer inadequate compensation for the risk of default. We favour bond funds with flexible mandates which can cherry-pick the best opportunities across the wide spectrum of bond markets.

Equities remain our most favoured asset class. However, our enthusiasm is tempered by lofty valuations, the squeeze on corporate profit margins from higher wage, energy and raw material costs and higher tax rates. It would require a significant fall in stock markets for us to consider increasing exposure.

Macro Highlights

Rising inflation has dominated financial headlines and been at the forefront of investors' concerns over the last few months. Although dipping slightly in August, the annual inflation rate in the US has been above 5% for the last four months, a far cry from the 1.4% at which it began the year. In the UK, the Consumer Prices Index surged from 2.0% in July to 3.2% in the twelve months to August, its biggest monthly jump since records began in 1979. The Bank of England now expects the rate to top 4% by the end of the year. Meanwhile, the Retail Prices Index (remember that?) which includes mortgage interest payments and is still used as the basis, inter alia, for final salary pension payments, train tickets and interest on student loans, jumped from 3.8% in July to 4.8% in the twelve months to August.

Inflation = transitory or entrenched?

The burning question is whether the rise in inflation is 'transitory', as central banks largely continue to insist and reassure, or is becoming more entrenched and structural. The truth is that it remains too early to judge. The distortions wrought by the pandemic are still working their way through year-on-year statistics and will continue to do so for some months to come. In the UK, for example, the jump in August 2021's inflation rate was partly due to August 2020's 50% discount on restaurant food under the government's Eat Out to Help Out scheme which has now dropped out of the calculation. The deflationary forces of technology, ageing populations (who spend less) and indebtedness remain and we would also expect the supply bottlenecks, which have been a feature and problem of the economic bounce-back, to ease. However, the vast sums now being spent on infrastructure (including decarbonisation), as well as social programmes such as President Biden's US$2trn American Families Plan and the UK government's 'levelling up' schemes, are contributing to upward pressure on both wages and raw materials. In the UK, the situation is being exacerbated by the withdrawal of European workers as a result of both the pandemic and Brexit. Incidentally, the well-publicised challenges being presented by skyrocketing gas prices and the shortage of lorry drivers are not peculiar to the UK but are global and a consequence of perfect storms of supply, demand, Covid, climate and politics. Taking all these factors into account, our best guess is that inflation will fall from today's elevated levels but, in the US and particularly in the UK, could easily settle higher than the 2% level that central bankers are targeting.

The last three months have seen some reductions to forecasts of still very strong economic growth in 2021. This is most likely because the pent-up demand which was suddenly released as pandemic restrictions were relaxed earlier in the year has peaked. It may also be because of the prospect of higher taxes, both corporate and personal. In the UK, national insurance rates and taxes on dividends are increasing by 1.25% from next April to provide funding for the NHS and social care. In the US, the Federal Reserve has revised down its forecast of economic growth in 2021 from 7% to 5.9%, citing the impact on businesses of the new delta variant of the coronavirus. Unsurprisingly, unemployment rates have also continued to fall, albeit not fast enough to prevent wages from rising due to skillset shortages. In the US, the unemployment rate fell to 5.2% in August, which compares with a figure of just 3.5% immediately before the pandemic took hold. Similarly, the unemployment rate in the UK has continued to drift lower (the latest figure for the three months to the end of July is 4.6%) but it is expected to rise by about 1% over the next few months following the ending of the government's furlough scheme.

As much as the statistics measuring growth and unemployment corroborate the continuing recovery from the pandemic, it is the inflation numbers that we will continue to monitor most closely and which are likely to have the greatest influence on the actions of central banks and hence the future course of financial markets.

Bonds

Government bonds may widely be regarded as dull investments but they provided a rollercoaster ride for investors in the third quarter of the year. The price of a conventional bond is very sensitive to the rate of inflation because the regular interest payments and repayment of capital at maturity are fixed sums. If inflation is rising, the price of a bond tends to fall because the value of those payments in real terms is being eroded. When the price of a bond falls, its yield rises.

Even as inflation continued to climb, however, bond yields fell quite sharply in July as investors continued to accept central bank assurances that inflation would prove transitory and that the big rise in bond yields earlier in 2021 had therefore been overdone. Thus, between the end of June and early August, the 10-year gilt yield fell from 0.72% to 0.51% and US Treasury 10-year bond yields declined from 1.47% to 1.17%. Bond investors were happy. Whilst the messaging has not changed, however, central bankers have clearly become more jittery about inflation over the last few months and the timings of expected increases in interest rates and the scaling back of bond purchases under quantitative easing programmes have been brought forward. Investors now expect the first rise in interest rates in the UK to be early in 2022, with some even expecting an increase before the end of this year. In the US, the Federal Reserve is preparing investors for a reduction in its bond buying as early as November. In addition, and as in the UK, the timing of interest rate increases is also creeping forward with the US central bank's committee members now forecasting one interest rate rise in 2022, three in 2023 and a further three in 2024. The partial undermining of the messaging and the prospect of monetary policy being tightened earlier than had previously been expected caused bond yields to rise sharply (and prices to fall) in September. In the US, 10-year Treasury bond yields have finished the quarter close to where they began it. In the UK, the gains that investors enjoyed in July were overwhelmed by losses in August and September.

Although we expect further bouts of volatility, it seems probable that government bond yields will grind higher over the medium term as monetary stimulus is slowly withdrawn and investors demand rates of return that are higher than inflation. Interest payments may be sufficient to offset capital losses as yields rise but return expectations for government bonds are modest. Credit spreads (the additional yield that investors require to take on the risk of lending to companies instead of governments) are at the lowest levels since 2008's financial crisis. Return expectations for high quality corporate bonds may be higher than for government bonds but not by much. We continue to question if the optically attractive yields of many lower quality corporate bonds are sufficient compensation for the risk of default. At the time of writing, Chinese property developer Evergrande has a dollar-denominated bond outstanding and due for repayment in just six months time that appears to offer investors an annualised return of more than 700%. Caveat emptor.

Where and as much as our own investment management mandates allow, we prefer to allocate to strategic and tactical bonds funds. Due to their own very flexible mandates, such funds are nimble and can cherry-pick the very best opportunities as they arise across the wide spectrum of bond markets.

Equities

The last quarter provided a reminder that the decline in bond yields and interest rates to negligible levels has been one of the main driving forces of this extraordinary bull market which began in 2009. For much of the quarter, stock markets in most countries continued their ascents, the UK stock market advancing by another 4% by early September to take its year-to-date gain to more than 15% (including dividends). However, sharply higher bond yields in September clipped the wings of soaring shares, causing many stock markets to give back a large part of the gains they had recorded in the previous two months. Most stock markets still finished the quarter with gains but these were modest in comparison with recent previous quarters. The UK market recorded a gain of 2.2% (including dividends) and is now up by 'just' 13.6% since the beginning of the year. Returns from overseas markets benefited from the weakness of sterling. Unsurprisingly, the pattern in broad stock markets was also evident in the fortunes of 'growth' and 'value' stocks. Growth stocks are valued according to their expected profits and cash flows extending into the distant future, which are discounted back to a 'present value' using current bond yields. Lower bond yields therefore make growth stocks more attractive to investors and vice versa. In early September, growth stocks were 4% ahead of value stocks during the quarter but by the end of the month this gap had shrunk to less than 1% as bond yields spiked. In portfolios which are invested in actively managed funds we continue to maintain a close balance between growth and value factors.

The best performer amongst major international stock markets in the last quarter was Japan, its benchmark index rising by 6% in local currency and by 8% in sterling terms. Japan had been a notable laggard amongst developed nations in vaccination rates and this had impacted its economy and stock market earlier in the year. It is now catching up. In addition, investor sentiment has been boosted by an Olympic Games that was much more successful than many dared hope. At the other end of the spectrum, it was a turbulent quarter for Chinese stocks, with indices reflecting the performance of the country's largest companies down by 17%. The share prices of perhaps China's two most well-known companies, Alibaba and Tencent, fell by 36% and 21% respectively. The Chinese authorities seem to be engaging in regulatory whack-a-mole across a variety of business sectors, including fintech, private tutoring and video games ("spiritual opium"). We suspect that this is born out of determination to prevent individual companies becoming too powerful, as they arguably are in the US, and also serves as a reminder of the power of the Chinese Communist Party. Meanwhile, the spectre of property developer Evergrande looms large. With a stock market value down 90% to US$5bn and US$300bn of debts, default and a carefully managed restructuring to prevent contagion is surely just a matter of time. China has much too big an economy and stock market for us to ignore. However, given the market's idiosyncrasies and complexities we choose to invest through specialist emerging market funds whose managers can vary exposure as they see fit.

Equities = wings clipped by rising bond yields

With cash yielding nothing and bond yields still very low (and probably heading higher), equities remain the only asset class in which investors can hope to maintain or grow their capital in real terms, albeit with greater risk to that capital. For at least the next quarter or two, stock markets should continue to be supported by strong economic growth and the impressive bounce-back in corporate profits. Past precedent also suggests that stock markets can take moderate inflation and gently rising bond yields in their stride. However, there are challenges on the horizon. First, higher wages and rising costs for raw materials are putting pressure on corporate profit margins. Second, corporate tax rates are going up. Third, as the worst ravages of the pandemic pass further into the past, year-on-year growth in corporate profits will be harder to achieve and will slow markedly. Most of important of all, though, is the risk that inflation remains stubbornly high, forcing central banks to raise interest rates faster and by more than investors currently expect. Notwithstanding that such action could ultimately lead to a recession, this would undermine valuations which are lofty and in which there is little or no margin of safety. For these reasons, we would probably only consider increasing the exposure to equities within portfolios if there were to be a substantial sell-off in stock markets.

Currencies

From news headlines you would have thought that the value of the pound had plummeted against other major currencies in September and over the quarter as the UK's economic recovery was threatened by the dearth of lorry drivers, the scarcity of petrol and spiralling energy costs. The pound did indeed depreciate by just over 2% against the US dollar during the quarter but its value against the euro was virtually unchanged. The main feature in currency markets over the period was therefore the strength of the dollar and this can be attributed to signals from the US Federal Reserve that it could begin to taper its bond buying in November and that the timetable for interest rate rises is shortening.

The strength of the dollar in the latest quarter means that it has now usurped the pound as the strongest major currency year-to-date. Nevertheless, the pound is still up 4% against the euro and by just over 6% against the yen since the start of the year. Exposure to foreign currencies in the portfolios we manage is provided by investments in international equity markets and, opportunistically, in strategic and tactical bond funds.

Alternative Investments

Historically, one of the main drivers of the price of gold has been the trend in real interest rates, which is bond yields minus inflation. Thus, the price of gold tends to rise when bond yields are falling or inflation is rising. During the early weeks of the quarter, the gold price rose as bond yields fell but this reversed in September and the price of gold in dollar terms ended the quarter almost exactly where it had begun it. After gains of 19% in 2019 and 24% in 2020, gold is down by 7% in dollar terms and 6% in sterling terms so far in 2021. Unsurprisingly, where it goes from here probably depends mainly on what happens to inflation and the narrow range in which gold has traded in the last few months is symptomatic of the uncertainty.

The polarisation of opinion about bitcoin and the accompanying volatility in its price continues unabated. During the quarter, payments giant PayPal joined the ranks of companies allowing customers to trade in bitcoin whilst the Chinese central bank effectively banned the cryptocurrency. In dollar terms, bitcoin appreciated by 27% over the three-month period but its performance during the quarter ranged from a loss of 13% to a gain of 49%. Year-to-date bitcoin has appreciated 49% but at the end of September its price was still more than 30% below the peak recorded in April. Unsurprisingly, we continue to regard bitcoin and other cryptocurrencies as highly speculative investments which are wholly unsuitable for use in the portfolios we manage.

With many workers finally returning to their offices and city centres after an eighteen-month hiatus, the outlook for office and retail space is almost certainly better than it was six months ago, although it will for some time remain difficult to judge and quantify the scarring caused by the shifts to WFH (Working From Home) and online shopping. In terms of the investibility of property funds in the portfolios we manage, however, a matter that is even more important is the FCA's long-delayed but now impending decision on how to resolve the liquidity mismatch between funds' underlying investments and the daily dealing offered to investors. The two most sensible solutions are to require investors to give 90 or even 180 days notice of redemptions or to move to closed-end structures, but neither will please both asset managers and investors.

SQUARE MILE
INVESTMENT SERVICES

Important Information