Autumn 2021

market outlook.

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FINANCIAL AWARENESS

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contents.

The UK Economy

Total returns from UK equity markets have been positive over the past quarter and returns were relatively attractive when compared with many other global indices. Valuations remain extremely attractive, which has led to an elevated number of UK companies being bid for, FTSE 100 examples include Entain plc, Meggitt plc and WM Morrison Supermarkets plc.

As a reminder, the UK equity market is dominated by international business and has a weak relationship with its economy. The UK economy is heavily driven by the consumer and in the coming months they will continue to face headwinds from above average inflation (caused by global supply chain bottlenecks), rising energy costs and tightening fiscal policy. Consequently, whilst UK economic growth has been positive and progressing in the right direction, there is still room for it to improve, as UK GDP remains below the pre-pandemic level with a gap wider than many other developed nations.

The UK labour market remains buoyant, unemployment has continued to decline (having peaked in December 2020 at 5.2%) and there are currently a record number of unfilled vacancies. This tight labour market has resulted in exceptionally strong wage growth. However, with the furlough scheme ending in September, there could be a small pickup in unemployment, although it will also help ease labour shortages and moderate wage growth.

In terms of policy in the UK, it was clear in the autumn budget (and build up to it) that fiscal policy is being tightened following a period of unprecedented support. Speculation on the next policy move from the Bank of England has also been rife with inflation running above target. We believe that an increase in UK interest rates would be a policy error, especially given the UK government is also tightening fiscal policy and the UK economy can ill afford both monetary and fiscal tightening as it will further squeeze consumer budgets and reduce discretionary spending.

The Japanese Economy

This past quarter has been politically eventful in Japan. With former Prime Minister Abe's replacement, Yoshihide Suga, stepping down as leader (spawned by some poor policies and a disintegrating approval rating) in September, we saw elections appoint Fumio Kishida as the new Prime Minister. The called election was a step in the right direction, as it saw the Liberal Democratic Party pressured into accelerating its lagging covid policy. Over 70% of Japan's population have now been fully inoculated.

While Kishida has said he is inheriting the policies championed by former Prime Minister Shinzo Abe, known as Abenomics, the new Prime Minister has shown no intention of pushing the Bank of Japan into additional easing to achieve its inflation goal. Abenomics focuses on monetary easing, flexible fiscal policy and reforms to achieve stable growth. With meaningful fiscal reform remaining absent, and with the Bank of Japan's new inflation target set at 0%, with little sign of wage growth, deflation becomes a growing concern once again.

With record levels of monetary stimulus, a continually growing debt pile, and an economy that is far from being self-sustaining, pressing ahead with the summer Olympics saw the beginning of the end for former Prime Minister Suga. For a country that had covid 19 running rampant and little by way of lockdown or vaccination policy prior to the games, we saw countrywide protests against the event. Whilst we also saw major sponsors pull their sponsorship and support, the major financial impact was that the games had to be played largely behind closed doors… a financial drag for a country that should have seen an economic boon from the event.

With an eventful quarter behind us, the outlook for Japan remains one of uncertainty shrouded with volatility. As, whilst valuations further down the market cap spectrum remain some of the most attractive globally, in addition to the potential for domestic level stimulus being a positive for domestically focussed businesses, there remains a number of eclipsing macroeconomic burdens.

The Emerging Markets & Asia Economy

The troubles of Chinese Real Estate giant, Evergrande, have been hard to ignore in the press. However, whilst it is clear that there is a distortion in the Chinese property sector that needs a correction, not all news should be perceived as a negative for markets over the long term. One must remember that the Real Estate sector represents approximately 29% of the Chinese market, of which Evergrande represents 4%. So, whilst Evergrande's debt worries are substantial, its dominance in the market and the building debt pile has been a concern for some time. It should also be remembered, a consolidation in the Real Estate sector has long been talked about! In addition to this, driven by a communist party, policy and support can, and has, been rolled out swiftly… seeing any threat of contagion of the flailing real estate firm largely neutralised. This has included direct funding, the purchasing of Evergrande business interests, and the redirecting of building contracts.

Over the past quarter we have seen some significant regulatory additions introduced by Chinese authorities, seeing companies in the education space, healthcare space and indeed technology space contract over uncertainty. However, given that in the technology space it represents what is tantamount to the introduction of a monopolies commission, this is a huge positive for long term investors that could arguably see a recent market contraction as a buying opportunity. Whilst regulations in the healthcare and education space have been more about equality of the population, the contraction has been non-discriminatory, meaning many names in the space that are not impacted have seen a contraction in valuation… which in turn breeds opportunity for investors!

Off the back of a tough start to the year that saw India's covid infection levels see it make headlines across the world, it must be remembered that India's population is 1.4 billion. As such, in absolute terms the covid infection and mortality rates were horrendous. However, in relative terms, the country was arguably in a better position than the UK. That being said, with Prime Minister Modi pushing through a vaccine support programme, coupled with local regional lockdowns, corporates continued to operate. And, with valuations compressed and support measures rife, we saw an overweight opportunity in the region at the beginning of 2021. However, whilst there is an overwhelmingly strong long term bull case for India, with the market being one of the best performing throughout 2021, it could be thought one should not be criticised for taking profits with valuations looking historically toppy!

Russia has been a key driver to global inflationary pressures in recent months by cutting gas supplies to Europe. As Europe's largest natural gas supplier, this put immense pressure on prices. However, whilst there are price pressures on energy, it appears short term with not only Russia posturing by showing off commodity controls, but also appearing to lever on Europe to utilise the Nord Stream 2 pipeline earlier. Considering all of these factors, it very much appeared that Russia would resume gas supplies… at the end of October we saw Russian President, Vladimir Putin, instruct the refilling of European Silos. Once this resumes, price pressures should subside.

The US Economy

The term 'transitory' has been thrown around a fair few times in recent years, and more recently as a term to describe current inflation levels. As we saw with the pandemic, the impact on markets back in March/April 2020 was indeed transitory (seeing the S&P500 close the year approximately 15% up). Likewise, evidence suggests that despite prevailing worries surrounding current inflation levels, the drivers behind current global inflation measures are shorter term, as with Russia looking to turn gas supplies back on and with covid driven supply chain bottlenecks expected to ease through 2022, inflation is likely to trend towards its target of 2%. This is a view shared by the US Federal Reserve.

In line with history, the US encroaching on its debt ceiling (how much the Federal government can borrow) is nothing new! With the current level of national debt sitting at approximately where the current borrowing cap is set, and the Republicans and Democrats still at odds over who is actually responsible for raising the debt limit, there remains nervousness in the market. Ultimately, neither the Republicans nor Democrats will want to be saddled with the banner of 'the party who caused the economic collapse of the US'! With this in mind, as with previous debt limit frictions, it is likely to be resolved last minute, with the frictions causing valuation opportunities.

Whilst we are yet to see it put to the vote, US President, Joe Biden's, social spending plan looks to all but have the backing of the Democrats. Whilst Biden conceded on 50% of the budget (now $1.75 trillion), the prospect of support and party stability will likely be a boon for markets heading into 2022. As part of the reduced package, areas such as healthcare stand to benefit as, once again, plans for price controls on drugs have been allayed.

With sectors in the value space starting the year (2021) strongly, our belief that this was a temporary phenomenon has since rung true. As, with monetary stimulus still present, and interest rates likely to remain lower for longer, the environment had not changed in favour of value names. As such, the pull back in growth names represented a strong valuation opportunity. The reversion in the market from value to growth has since been aggressive, and as 2021 draws to a close, some of the mega cap growth names are still looking attractive on a valuation basis, despite the S&P floating at an all-time high!

The European Economy

Throughout last quarter's policy meetings of the European Central Bank (ECB), its President, Christine Largarde, remained consistent in two key messages: The first that the ECB would remain adaptive and accommodative, and the second that their firm belief is that current inflation levels are transitory. At the last meeting in October, Lagarde expressed uncertainty as to why markets were pricing in an interest rate rise cycle, and further committed to repeating the message of 'lower for longer' stating rate hikes were "not in line with guidance".

The ECB have reassessed, and will continue to monitor the thesis behind their interpretation of the current inflationary environment. In line with this, they continue to believe inflation is short term, with drivers being the supply chain bottlenecks brought about by covid and the gas supply issues driven primarily by Russia. As such, they are firm in the belief these drivers are short term, and that any alteration to interest rates to ease short term inflationary pressures would derail the long term recovery. They continue to expect inflation to 'run hot', with a view to it trending towards the 2% target through 2022, and in line with this they expect the Pandemic Emergency Purchase Programme to come to an end in 2022.

Much of the inflationary pressures in Europe have been driven by the cut in gas supply by Russia. With Europe heavily dependent on Russia for the majority of its gas, the cut in supply drove up relative demand and consequently prices, as the bloc strove to seek inventory. With the reasons for Russia's move likely driven by commodity price posturing, as well as putting pressure on the utilisation of the new 'Nord Stream 2' project (a new pipeline that will see Europe more dependent on Russia for gas), this appears to be a short lived move. As we expected, Russian president, Vladamir Putin, has since stated they will begin to restock European reserves. As such, it is likely we will see the easing of energy pricing pressures throughout 2022.

The German general election took place in October. With Chancellor Angela Merkel not running as leader for the CDU (Christian Democratic Union) party, an element of uncertainty had already been removed from markets. Whilst the election was more closely run than anticipated, the SPD (Social Democratic Party) collated the most votes, but without the majority, they are still tasked with forming a coalition. However, with only a handful of issues for the SPD to overcome with the Green party and the Free Democrats, it is looking likely that a coalition will be hammered out prior to year-end, adding further stability to the largest economy in the bloc of nations. This, amongst the inflationary distortions highlighted above, introduces an interesting catalyst for valuations and markets in 2022.

Fixed Interest

The story for the year in fixed income markets has been the volatility in government bonds, and that has continued to be the case in the last couple of months. With high inflation prints likely over the coming months, it is possible this volatility continues.

Volatility in government debt has also caused volatility in corporate bonds. Corporate balance sheets are healthy, and the risk of defaults in investment grade credit remains low, however, the strong fundamentals are already reflected in the price of corporate bonds and if there is continued volatility in government debt, this will impact corporate bonds.

Recent moves in government debt means there is quite a lot priced in, in terms of rate hikes in the coming year from central banks like the Bank of England. It remains to be seen whether the UK economy will be strong enough to take these rate hikes, or if indeed the central banks will implement them, with base rates priced in the markets to reach 1% in the second half of next year.

Higher government bond yields do mean fixed income markets aren't as expensive as they have been recently: most UK government debt now yields more than it did prior to the pandemic. However, yields are still low, especially when we consider current levels of inflation. For the sector to become more attractive, further repricing is needed. Pockets of value do remain, however we believe equities are likely to offer better returns in the medium term.

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on **0800 049 2011,** Monday to Friday 9am-5pm or you can email us at **affinity.advise@wealthatwork.co.uk**

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