Fund Managers Report
Third Quarter

Crossroads

The road so far

As we enter the last quarter of 2021, the world is approaching the second anniversary of the pandemic. From a period of economic recovery in late 2019, what followed was an unimaginable sequence of global events that are still playing out today in society, the global economy and the global ecosystem.

The human toll of what has happened has been immense. Millions of lives have been lost and many more affected, not only directly by the virus but also through lockdowns and the social and economic consequences of what has happened.

The UK, as well as other developed nations, responded with various forms of lockdowns alongside unprecedented monetary and fiscal stimulus to mitigate the economic impact of a global pandemic. To enable this, a great deal of government and government backed debt has been taken on, with central banks' balance sheets expanding to levels that far exceed that of the 2008 financial crisis. These actions have certainly prevented a serious and dangerous economic depression.

Since the depth of the crisis in 2020, access to vaccines, particularly in countries such as the UK, has paved the way towards a normalisation back to pre-pandemic life. Many other parts of the world have been less fortunate and are still struggling with the virus and its social and economic consequences.

In response, global capital markets have reacted. Equity markets, which were falling sharply in the first half of 2020, have recovered strongly. Some twenty months on, many global equity market indices are much higher (depending upon their constituent stocks).

Initially, technology focussed companies excelled during lockdown as digitalisation accelerated; on top of this, more future focussed companies also benefitted. This included many significant impact investments, whilst the older cyclical companies (such as oil, tourism, airlines, etc.) suffered as the global economy slowed.

In 2021, global equity markets continued to rise as cyclical investments caught up with the growth investments, and the governments and central banks continued with their aggressive stimulus. Global markets found themselves in the classic "Goldilocks scenario" with a growing economy and cheap and abundant money.

The Junction is approaching

As in the story of Goldilocks, the three bears do eventually arrive. This time in the form of inflation, supply constraints and the post-Covid world. However, unlike in the story, fleeing the scene is not a viable option; global markets, businesses and society are going to have to address how they adapt to these changes.

Traditionally, inflation is regarded as the consequence of too much money chasing too few goods and services. During the financial crisis of 2008 we saw a sharp rise in the quantity of money which, as explained by the Fischer equation, was not accompanied by inflation due to a collapse in the velocity of money.

Advance to 2021 and a parallel outcome has not been observed; this time around the velocity of money has not collapsed, with the more recent perpetrator of rising inflation levels being predominantly cost-push pressures. Measures to mitigate the spread of the pandemic have made doing business more expensive, and the faster than expected recovery has led to some key shortages. Chip shortages have impacted many key industrial sectors, a global shortage of truck drivers and containers has hit logistics, and more recent gas shortages have impacted a number of core sectors across Europe.

The rise in inflation itself has not come as a surprise given the unprecedented monetary stimulus; index-linked investments were already pricing this in, and they look expensive. At the start of 2021, the debate was focussed on whether the uptick in inflation would be transitory or more entrenched; the consensus tended towards a more short-term trend. Since then, the pre-mentioned shortages in some key areas have adjusted that transitory picture slightly. The previously super-efficient, just-in-time global supply chains are unlikely to return in the same capacity; they will be replaced by more resilient and local supply chains, but with an obvious cost premium for closer to home operations. Whilst this will be a social and environmental positive, it will not happen overnight, and inflation remains a short-term risk which may persist longer than expected.

Supply chain constraints are now featuring in company reports, and we will not be surprised if there is a subsequent impact on earnings for a number of companies in October and November. This is a truly global issue as business models are challenged and pushed to redesign. Whilst this might lend itself as more positive for some and negative for others, we suspect it to become a homogenous feature of reports and outlooks.

Although we use the term “post-covid world” we’re not expecting an eradication of the virus, but rather anticipating a world that has adapted. There are two things we forecast to impact markets. The first is around expectations; the reflation trade that depends on higher levels of mobility and consumption is looking vulnerable, in the first instance to any new variants, but also to longer term trend changes. This will continue to be a swing factor over the next year; although, expectations for the recovery are already high. There’s still a large degree of uncertainty surrounding how the world of work will look and people will behave in a year’s time.

The second impact is around the political fallout of shortages, as well as European elections and tensions in Asia. The gas crisis is already straining relations within the EU; alongside this, the recent German elections, and next year’s French presidential elections, are reminding us of how divided society is. From an environmental perspective, COP26 should provide an opportunity for faster action, but may also disappoint. We expect a great deal of noise in the next quarter.

The Market Outlook

The fact that equity market returns have been much more subdued in the last quarter after six strong quarters, accurately reflects the current position as well as underlying uncertainties. Fiscal support will need to end in almost all countries; the UK has finished its furlough programme and announced higher employment taxes, and the US budget is being hotly debated. Of far more concern to the markets are changes in monetary policy, both in terms of ending quantitative easing as well as rising interest rates. In the UK and the US, comments are now being made by Central Banks to manage expectations, with markets listening intently. Fixed income assets have already declined in expectation of tighter monetary policy in the quarters ahead.

There is increasing tension between impatience (as perceived bubbles begin to build) and caution not to act too fast and create another downturn. Sometime this quarter this will need to be addressed, especially with the Evergrande debt crisis in China proving a timely reminder about the consequences of delaying action on asset bubbles.

We therefore see both opportunities and risks in the fourth quarter. The main risk might be a decline in all asset classes: the worst-case scenario being an expected tighter monetary policy driving down fixed income, coupled with peak growth and lower profit expectations driving down equities.

We have been running fixed income at a lower level for some time, and have been more exposed to lower risk Floating Rate Notes which do not carry the interest risk. We've utilised the recent weakness in fixed income to add to some high coupon paper for income and risk purposes. However, we continue prefer fixed income paper that cannot be accessed through equities, such as IFFim (immunisation bond), Network Rail or the Co-operative.

We perceive a slight possibility of an interest rate rise in the UK, as well as an end to QE, in the next quarter; if so, we expect it would be well-received as a start towards normality as long as it is clearly flagged.

Our property exposure has been focussed on quality rental homes, social housing, medical property and homeless housing. During the quarter we cut our exposure to medical property on valuation grounds, and added exposure to homeless housing. In social housing, there has been an issue with an investment (but which we do not hold) that has impacted the whole sector. The need for quality housing in the UK remains paramount, and although this sector is interest rate sensitive, we feel it has been priced in adequately.

This quarter has proved mixed for renewable energy infrastructure. The summer was not great for either wind or solar, especially in the UK and Europe, but we have seen wind improve in recent weeks. Battery storage and AD continue to do well. We see these assets as a reliable defensive investment for the coming quarter.

In terms of equities, much will depend on the specific sector and how recovery continues. At the moment, there are a few perceived bubbles developing and expectations remain high; we remain particularly vigilant heading into the quarterly and second half earnings season. Higher input costs may impact margins, but could be offset by higher demand or prices. This has been reflected in the underperformance of key impact sectors (such as renewable energy) amongst declining expectations.

Whilst this is a tough period with a lot of potential hurdles, many of the dangers are out in the open. It will therefore be a process of navigating through the shortages, inflation and uncertainty. The need for better infrastructure, more digital healthcare, renewable energy, clean mobility, good housing, sustainable finance and food remains strong.

Disclaimer