Mazars Wealth Management investment newsletter

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Foreword

Much as we had expected at the start of the summer, equity markets in the developed world traded pretty much sideways for the past three months as corporate earnings rose to justify somewhat the high stock market valuations. Returns for global equities in local currency terms were around 0.7% for the quarter, though UK based investors returned over 2.5% thanks to a sell off in Sterling (mainly against the US Dollar) late in September. Japan was an outlier as a change in prime minister drove sentiment and returns of over 7% in local terms.

Covid-19 factors continue to dominate global economics, either directly in those parts of the world where vaccination programmes are yet to reach the majority of at risk populations, or via the legacy effects of global lockdowns in those economies which have largely now reopened. Pictures of container ships queued outside ports worldwide give a visual insight into the dislocations in global supply chains, while the cost of transporting goods has increased substantially. Frictions also exist in labour markets as countries attempt a return to normality and find transitioning from emergency fiscal support measures to regular employment conditions a challenge. Job openings might be as high as the unemployment rates, but a seamless matching of people to jobs is unlikely particularly in the service sector. Psychological factors are also at play as the pandemic has caused many in the workforce to rethink their work and life priorities. Climatic effects have stoked energy prices, adding to concerns that inflation pressures may be 'transitory' for a longer period than first expected.

There are brighter points in the economy. Corporate earnings have improved above market expectations despite GDP numbers not yet recovering to Q4 2019 levels in many parts of the world. While Purchasing Manager Indices (seen to be one of the better leading indicators or future economic growth) are falling, they remain firmly in expansionary territory and the rate of decline is not dramatic. It is reasonable to assume that consumer demand will remain buoyant as the unemployment rate falls and those households which stored cash during the pandemic are freed up to resume consumption in the service sector. Similarly, corporate cash levels are at very high levels, a factor which usually indicates an increase in capital expenditure to come.

Thus markets are confused and jumpy. The link between extraordinary monetary policy (principally Quantitative Easing (QE)) and stock market growth is undeniable, so we revert to a position where good economic news is bad for markets, and bad news is good due to the impact on the probable path for QE and interest rates. The complicating factor now is that much of the bad economic news is inflationary in nature, testing central bankers' resolve to allow price rises to run unopposed for a period of time. Indeed, the US Federal Reserve has become more hawkish in recent weeks, a position mirrored in the UK if not yet in Europe. Add in issues such as the US debt ceiling, a change in leadership in Germany, and waning equity momentum, and we find reasons to exercise caution even though the economy may be in 'mid-cycle'.

At our September meeting the Investment Committee voted to reduce any overweight equity positions within our portfolios to neutral. We acknowledge that bond markets continue to look unattractive on a real return basis (after inflation) and therefore allocate the proceeds of equity sales to gold and short dated corporate bonds. We continue to hold a balance between value and growth stocks, and favour the UK on a valuation basis.

I hope you find this newsletter interesting and relevant to you, and I would very much welcome any feedback you may have. Please do feel free to get in touch with your thoughts either by phone on: **020 7063 4259**, or by email on: **david.baker@mazars.co.uk**.

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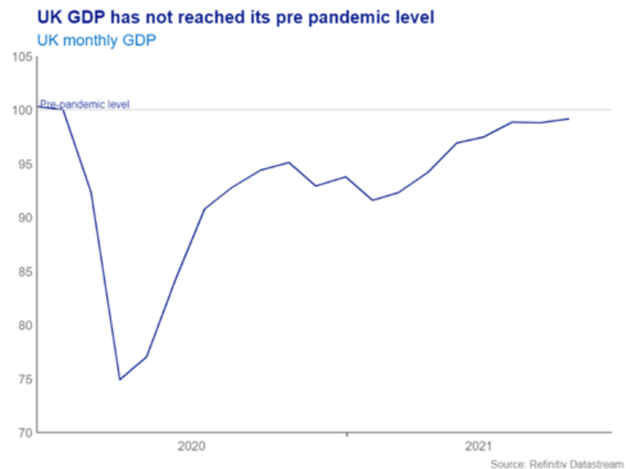
Economies and markets in brief

A whiff of stagflation

The UK's combination of flat economic growth in July and rising inflation has led the current situation to be described as having a whiff of stagflation. The post pandemic UK is reminiscent of the 1970s when rising commodity prices and loose monetary policy led to runaway inflation. However there are some marked differences between the UK now and then: in the 1970s labour markets were more organised and less competitive while offshoring was not possible in the same way it is in the 21st Century, all of which gave workers more pricing power. The post pandemic dysfunction in global supply chains has led to price rises but a repeat of the 1970s is not a foregone conclusion at this point.

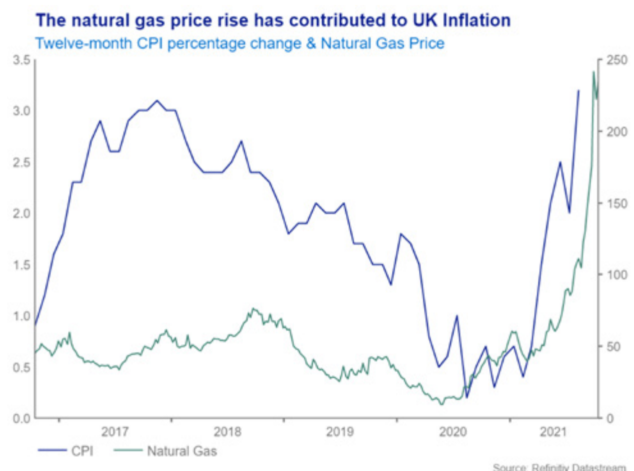


Travel restrictions

September saw further lessening of restrictive measures for people returning to the UK from abroad. This positive news will be welcomed by travel companies who, following a dire 18 months, are eager that travellers face as few barriers as possible. Investors may also look at the travel sector in the hope of snapping up a bargain in the form of an airline company or cruise operator but would be wise to exercise caution. If the government feels the need to bring in restrictions again to curb the spread of Covid then international travel is less painful than restricting some other sectors and such a move may bring some of those airline stocks down to earth again.

UK inflation and gas prices

Observers following the inflation debate will be aware that the UK's August CPI print came in at 3.2% bolstering the case for those that argue inflation is returning to the UK. However, a large part of this inflation reading was due to utility prices as wholesale gas prices have reached extreme levels and forced the UK utilities regulator to raise the price cap by 12% from 1 October. It is likely there will be a similar rise in prices next April but as this will be from a higher base it will have a smaller effect on inflation overall.



UK labour market post Covid-19

The Covid-19 furlough scheme officially comes to an end on September 30 and the labour market continues to recover. In the three months to July, the UK unemployment rate fell and hit a new low of 4.6%, while the employment rate rose to 75.2%. Similarly, according to the latest report from the Office of National Statistics (ONS) the number of payroll employees rose by 182,000 to 28.9 million in July.

UK unemployment rate fell the lowest level since August 2020, adding to signs of labour market recovery

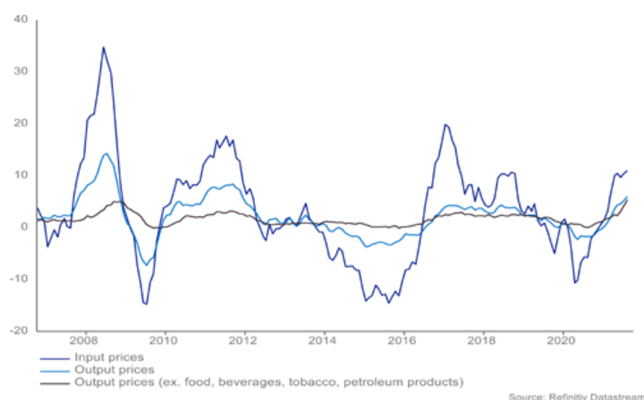
UK unemployment rate

Although this seems like positive news, the labour market is far from being close to fully healed due to labour supply issues, as worker shortages in some professions make it very hard to fill vacancies. The focus has recently been on the shortage of lorry drivers, which is partly due to Brexit and Britons leaving the industry. Coupled with other existing supply chain issues this shortage has severely impacted the supplies of restaurants and supermarkets amongst other businesses. McDonalds for example blames the weak labour supply for its milkshake shortage in the UK.

In addition, sectors affected by the shortage of workers face both wage and price inflation. For example, British supermarkets have been promising lorry drivers significant pay increases in order to fill in the large number of current vacancies. Thus, a reason why we are seeing wage growth this year is because some wages were falling last year due to the lockdown restrictions.

British producer price data shows more persistent price pressures in the pipeline

UK producer prices



What's even more important to take into account is the most recent inactivity rate. Approximately 490,000 workers have left the labour market since the fourth quarter of 2019, making it harder to fill the record number of 1 million vacancies.

Firms are worried that the worker shortages coupled with the rising wages and input prices in certain sectors could create further inflationary pressures. In order to mitigate part of the problem, industry bodies have proposed the introduction of temporary visas for drivers from the EU to cover for shortages.

The labour market is recovering, but there are still issues to be monitored. If the labour supply cannot meet the demand for workers, this could result in inflationary pressures or even hamper potential future growth.

Jargon Buster – NFT

A non-fungible token (NFT) is a unique and non-interchangeable unit of data stored on a digital ledger (blockchain). In economics, a fungible asset is something with units that can be readily interchanged - like money. For example, you can swap a £100 note for two £50 notes and it will have the same value. However, if something is non-fungible, this is impossible - it means it has unique properties so it can't be interchanged with something else. It could be a painting such as the Mona Lisa, which is one of a kind. You can take a photo of the painting or buy a print but there will only ever be one original painting. NFTs are one-of-a-kind' assets in the digital world that can be bought and sold like any other assets, which have no tangible form of their own. The digital tokens can be thought of as certificates of ownership for virtual or physical assets.

US Small Cap stocks – In focus

We are making a change

Previously we used Schroder US Smaller Companies to take exposure in US small capitalisation stocks. Now we are changing to Granahan US SMID Select Fund.

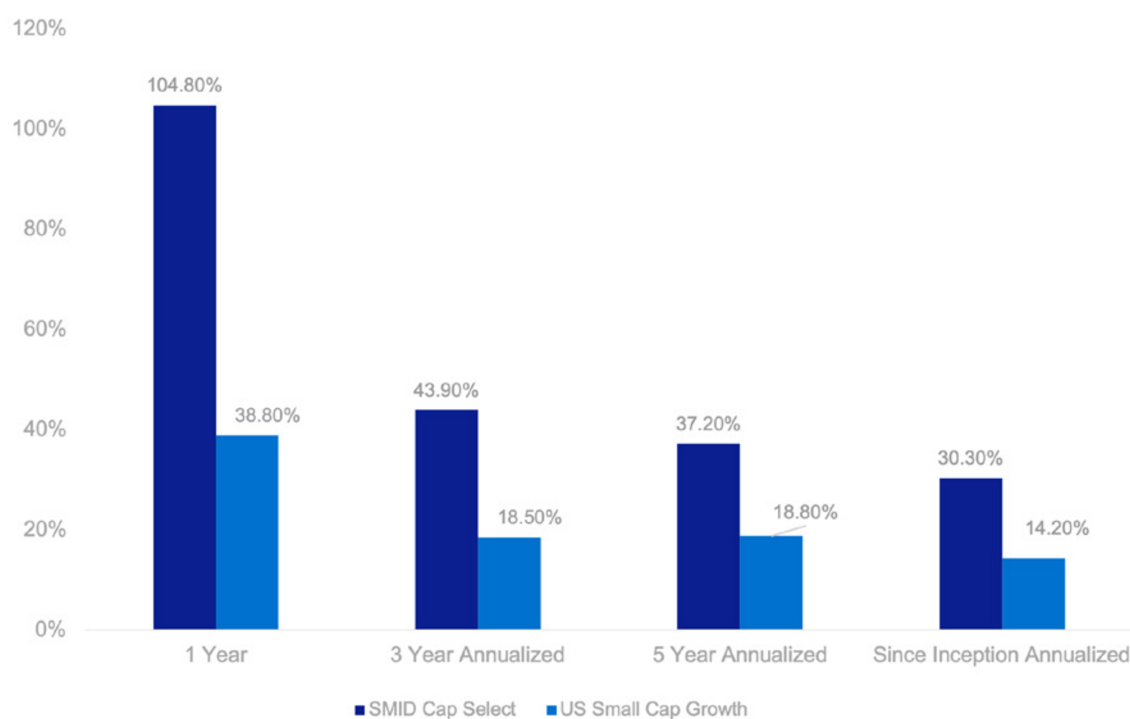
Why the change?

Granahan US SMID Select is a fundamental, bottom-up small/smid cap growth equity fund. The fund has had a strong outperformance over the last five years relative to its benchmark as well as peers. We believe that Granahan's relatively concentrated portfolio coupled with its highly experienced investment team will continue to produce strong returns for our clients over the long term. The fund is run by David Rose who is supported by a team of fund managers and analysts that have an average experience of more than 30 years.

We have held the Schroder US Smaller Companies fund for around five years and although returns on an absolute basis have been steady, it has underperformed peers in the space. The fund went through a change of management earlier in the year and we feel now is an opportune time to make a change.

What is the impact?

Our exposure to US Small Cap stocks is still relatively small and this change will impact Balanced and Capital Growth portfolios.



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