Monthly market blueprint

Investment management service

October 2021

mazars

Contents

Foreword

Can the Fed be the answer to everything?

Seen from a bird's eye view, the Fed has turned more hawkish in preparation to taper asset purchases. As a result, markets are now more prone to respond with volatility to rising risks, of which there's no shortage: From soaring natural gas prices to impaired supply chains threatening consumers and businesses; from a new status quo underpinning the European common currency, to political obstacles for Mr Biden's game-changing -proposed- stimulus.

Corporate earnings might have beat expectations and helped valuations down in the past three quarters, but projections going into the last part of the year augur stagnation. Meanwhile, governments are scrambling to pull back Covid-era employment measures and contemplate taxation increases, while the pandemic itself just entered its most dangerous season of the year.

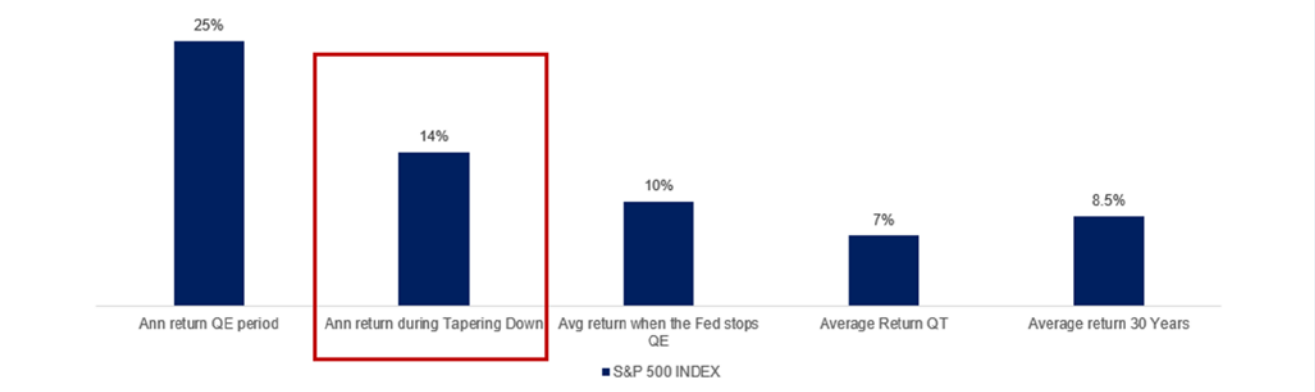
And let us of course not forget Asset Tapering itself. The Fed has signalled it will be gradually reducing the amount of money it funnels into the markets. While still above non-QE returns, tapering has traditionally seen reduced the return for equities.

However, fact remains that for all the dangers out there, both pullbacks did not evolve into full-blown corrections and didn't last for more than a couple of days. This just confirms that there's a lot of liquidity looking for returns, and with bonds yielding negative real returns (yield minus inflation), equities are still the preferred asset for allocators.

Acknowledging the risk buld-up and the fact that we are entering a period when equity returns might wind down, weighed against the overall willingness to 'buy the dips', our investment committee reduced our equity exposure from 'slight overweight' to 'equal weight'. As long as the Fed is still purchasing assets, it makes little sense to be underweight equities. But we can take some profits off the table and put them into safer assets (like gold and short-term bonds) to protect against the probability that any of those risks might trigger a wider correction.

Performance tends to drop during last stages of QE

Annualised return S&P 500, net



Charts Source: Mazars Calculations

George Lagarias
Chief Economist, UK

Market performance – in a nutshell

The month in review

Headwinds to growth and rising interest rate expectations send stocks and bonds into retreat in September.

September was a month when the markets moved their focus to the risks to the global economic recovery. Equity markets moved lower across almost all sectors and geographies and government bond yields ended the month higher.

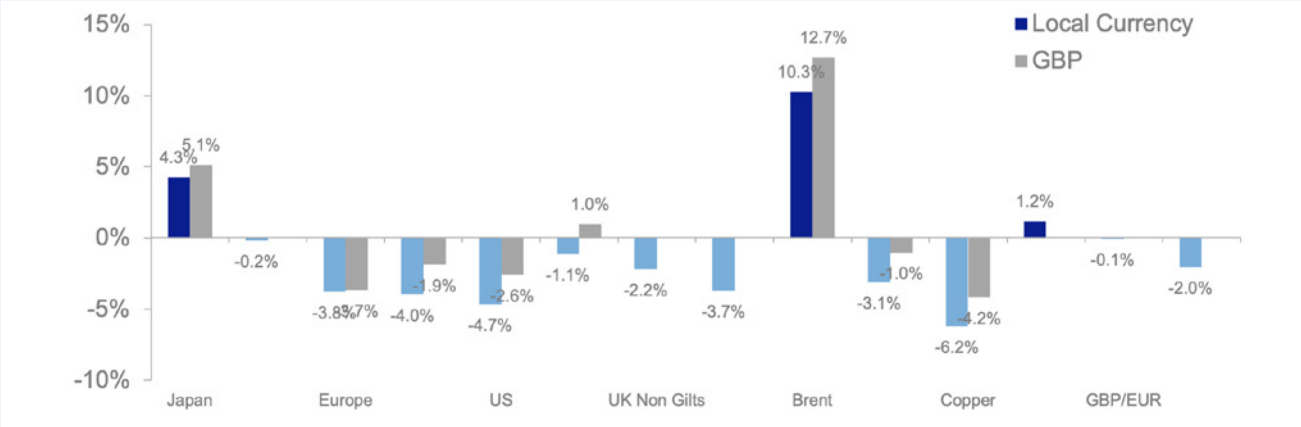
The prospect of central banks tightening monetary policy became more real this month as both the Bank of England and Federal Reserve indicated that 2022 would see interest rate rises. Interest rate rises are most keenly felt in government bond prices as their attraction relative compared to short term interest rates falls, which leads to lower prices. The UK 10 year gilt yield moved 30bps higher and ended the month above 1%, which marks a post pandemic high. US 10 year Treasury yields moved from 1.35 to 1.49% and German 10 year bund yields rose to -0.2%. While these levels are low relative to long term average levels the increases will increase the cost of finance across the respective economies.

Equity markets showed more volatility than investors have been used to lately. In part that is in response to higher bond yields; higher financing costs can eat into profit margins and weigh on consumer activity. Another drag on equities was the continued signs that supply chain disruption is weighing on economic activity. The beneficiary of the post-Covid disruption was the energy sector which benefitted from strong oil and gas prices as demand outstrips supply for these commodities.

The UK large cap index was down -0.2%, much less than other developed markets, due to its large weight in energy and financials, with the former sector benefitting from increased commodity prices and the latter benefitting from the prospects of higher interest rates from the Bank of England. Other global markets broadly fared worse as the US and Europe ended the month 4.7% and 3.8% lower respectively. Emerging markets moved lower in sympathy with developed markets, finishing September 4% lower. The one bright spot was Japanese equities which moved 4.4% higher as the prime minister's resignation was taken as a signal that more central bank support may be forthcoming. All movements are in local currency.

GBP moved lower against developed market peers as the UK's higher inflation and headwinds to growth sparked talk of stagflation. This took the edge off the fall in GBP investors' foreign currency investments in September.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation

Changes in our Strategic Asset Allocation

Outlook and portfolios

The mood in the market has changed and with it we adjust our outlook and asset allocation.

In Q3 of this year the sentiment was optimistic as Europe and the UK lifted Covid restrictions and consumption patterns began resembling the period pre pandemic. With this came economic growth upgrades and expectations for rising corporate profitability. The supply chain issues and price rises were present but not a concern while monetary conditions were loose and consumers were finding their feet.

Now the market's attention has been caught by concerns that damaged supply chains will lead to inflation and central banks appear not to be as tolerant of inflation as they once advertised so this has brought about fears of interest rate rises.

Markets have broadly held up but have come off highs and we are seeing a few more "2% down days" than we were.

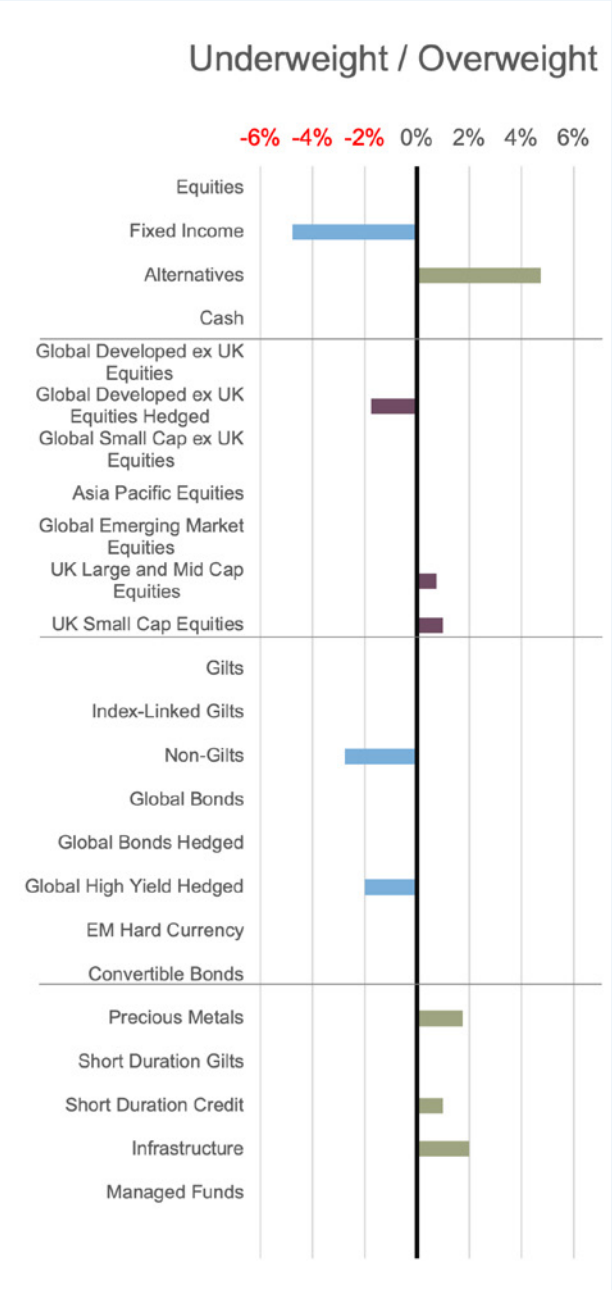
Our investment committee took the view that risks are mounting and with less central bank support, be it less asset purchases or, eventually, lower interest rates, the markets are not going to be as forgiving as they have been to disappointing data should it materialise.

Having been overweight equities going into the end of Q3 we are now neutral. This doesn't mean we are calling the end of the business cycle, nor do we see recession on the horizon, but we believe that following the market rising so robustly there is potential for it to lose a bit of momentum.

The biggest change we made was to the UK equities allocation, which we were overweight because they were undervalued but have now moved to a neutral position. They are still undervalued but that will not completely insulate them from volatility in other markets which are not as attractively valued.

We have also changed two funds in the portfolio where our fund selection team felt management changes could lead to underperformance. We have added new corporate bond and US smaller companies funds to the portfolios which show a lot of promise.

Mazars balanced portfolio as of 3 October 2021



Risks

The risk of inflation

2021 is the year of recovery after a period when global economic growth faltered at the swiftest pace since WWII. Overall asset prices have kept climbing as policy makers actively sought to avoid market panics. As countries exited lockdowns, the key determinants of economic activity on the demand side will be repercussions of the Delta variant and the extent of stimulus and its impact on inflation. Economic decoupling and pressures on the supply chain will be the key focus on the supply side. There are two key risks for markets right now: the possibility of the return of long-term inflation and a pickup of the pandemic especially in the emerging world.

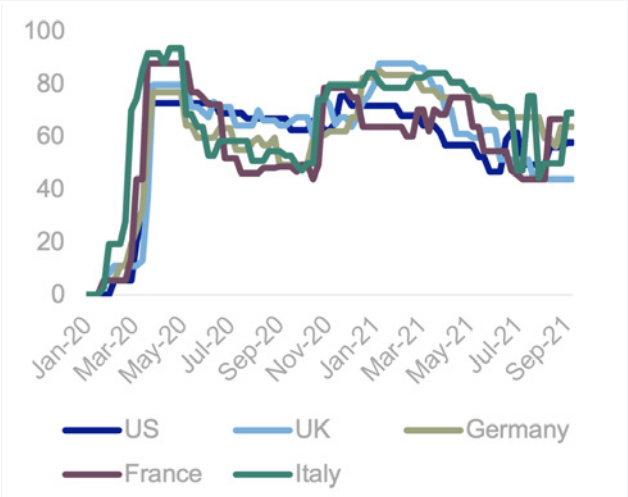
Markets continue to focus on quantitative easing, with investors convinced, for now, that central bank risk suppression is potent enough to weather any economic headwinds. The rate at which monetary and fiscal stimulus will be withdrawn is the main risk for the upcoming economic recovery. Stock prices are near or at all time highs, but earnings have yet to catch up to expensive valuations and are creating a ceiling against further breakouts. Global bond yields began to climb on inflation fears earlier in the year, however the move proved temporary with the market thinking that inflation pressures will recede, as long as fiscal stimulus is withdrawn as well. At any rate the Fed has signaled it will tolerate higher inflation for now.

We feel that overall risks are more global than local. A resumption of the pandemic with a more aggressive variant may continue to disrupt supply chains, especially those based in the emerging markets. While we don't believe that lockdowns will re-emerge

The key risk for investors is an inflation-driven paradigm shift. If stimulus causes higher inflation, central banks will have to rethink a 12-year monetary accommodation regime. Taken further, if growth supports even higher and resilient inflation central banks will undoubtedly have to adjust. At the time of writing, all key risks are kept in check due to the blanket of liquidity provided by policy makers to markets. We will be vigilant for signs of a significant shift in policy.

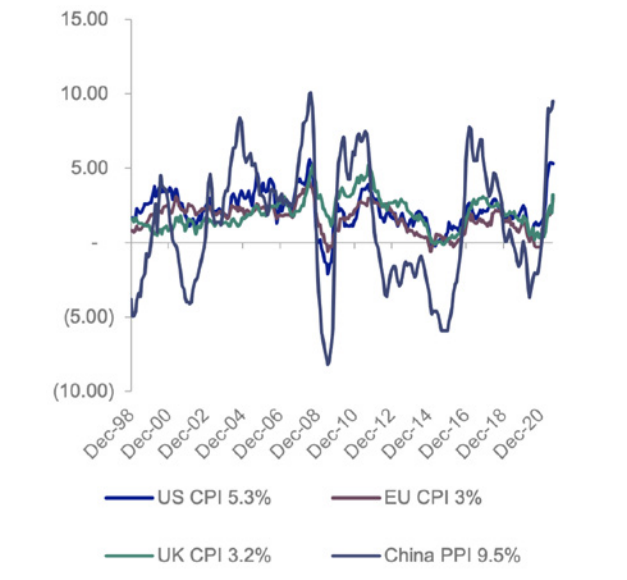
Delta variant is a possible threat to the recovery

Global stringency conditions remain elevated



Inflation is rising across the board

Western economies CPI and Chinese PPI inflation



Charts source: Mazars calculations

Macroeconomic backdrop
Global

For the period, global stocks fell by 4.2% (2.1% in GBP). The highest performing sectors were Energy and Financials while the worst performers were Materials and Utilities. Equities were trading at 19.43x times forward earnings, 16.9% above long term average. Gold fell 3.1% and oil prices rose 9.5%.

Global economic momentum has stalled, and the acute phase of the recovery is nearly over. Meanwhile, the Delta variant continues to advance, exacerbating supply constraints which may already be impacting demand. However, current indicators suggest that overall, the global economy is expanding at a healthy pace and, while slowing, the rate of deceleration is lower than anticipated. Developed markets are outperforming developing economies, as they are the primary beneficiaries of vaccination. Employment levels across developed markets are satisfactory, with a lot of companies reporting difficulties in finding skilled workers.

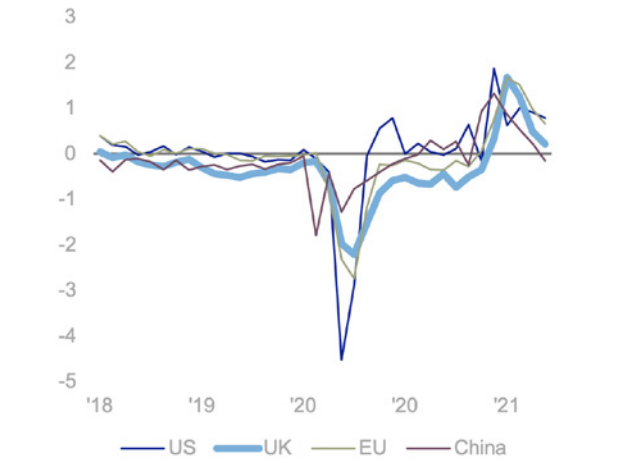
The key feature across the board is persisting supply chain disruptions causing supply shortages for goods and services. This is pushing transportation prices up significantly. According to Clarkson's, a UK-based shipping broker, costs to transfer goods from China to the US have risen by 350% and to Northern Europe by a whooping 890% in the last year. Waiting times in ports have almost tripled since before the pandemic. As a result, inflation has been climbing across the board.

Still, central banks have opted for patience. Data for western economies suggest that most of them have reached high vaccination levels. While child-care issues keep part of the workforce still away from the office –or work altogether- policy makers are confident that a large part will return to employment soon, filling the skill pool and reducing wage pressures on inflation. As a result, they are overall maintaining a dovish stance and continue to increase the levels of asset purchases. The Fed has, of course, signaled that it will taper asset purchases and increase interest rates within the next two years, but markets remain optimistic.

Outlook: Global corporate earnings have beaten expectations, and valuations are slowly reverting to mean. Nevertheless, we remain optimistic and believe that another eight months of almost assured QE should help risk assets across the board.

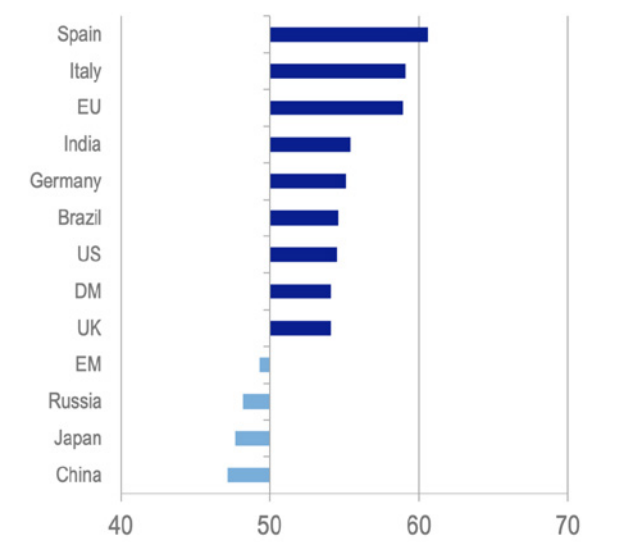
The acute phase of the recovery may be over

Z-score of leading indicators



Still, the global economy is well into expansion territory

Composite PMIs, September



Charts Source: Mazars Calculations

Macroeconomic backdrop

UK

UK equity markets continued their strong start to the year, up +0.4% in September. The best performing sectors were healthcare and energy, with the worst performing housebuilders and financials. UK equities are now trading at 13.6x forward earnings, below their long term average.

The UK's cheap valuations have been well covered in this publication and had led to us holding an overweight position in UK equities in our portfolios. The UK's valuations remain cheap but risks to economic growth in the UK lead us to pare back our positioning.

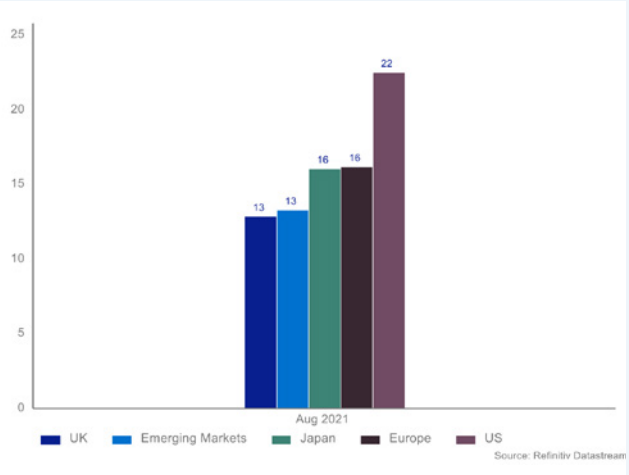
The UK's valuations are objectively cheap when compared to international equity markets. The most commonly cited metric is price earnings ratio, where the UK sits at a 18% discount to European shares and 40% discount to US shares. Our detailed analysis went further to incorporate return on assets and return on equity and confirmed the UK's equity market offers better value than international peers. However, cheap valuations are not a panacea to skittish markets and risks mounting in the UK and the rest of the world can even impact undervalued markets.

Covid-related disruption in the UK economy is manifesting itself in different ways, from shortfalls in goods and labour to elevated commodity prices. The risk is that as that feeds through to lower consumer sentiment ,that profit expectations will fall and volatility will return to equity markets which have been eerily calm over the last 18 months.

Outlook: Our stance on the UK relative to other equity markets has not changed in that we still see it is undervalued. Nonetheless, inflation expectations and moderating growth expectations leave it open to a correction downwards, particularly the mid and small cap segments of the market which have been enjoying the fruits of a reopening economy this summer.

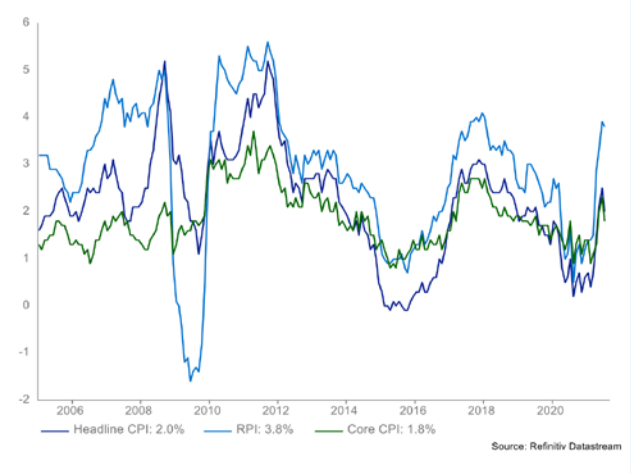
Global equity valuations

UK discount to global peers



UK inflation rising

Twelve-month percentage changes



Charts Source: Refinitiv Datastream

Macroeconomic backdrop
US

For the period, US stocks fell by 4.7% (2.6% in GBP). The highest performing sectors were Energy and Financials while the worst performers were Materials and Telecoms. Equities were trading at 21.33x times forward earnings, 21.1% above long term average and 9.8% above the MSCI World. 10y bonds rose 18 bps at 1.487%.

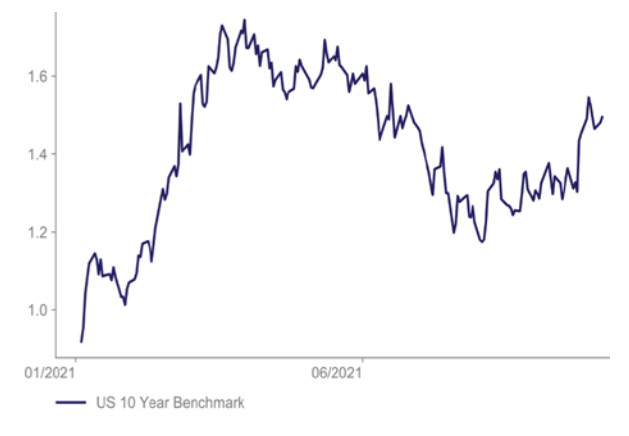
The economic situation in the US has continued to improve as PMI data signalled positive developments in operating conditions. Despite the PMI rising markedly, this improvement was the slowest in five months, and was still accompanied by severe material and labour shortages. The US Services Flash PMI dropped a point in September, suggesting a reliable but more gradual rise in business across the business sector. Consumer confidence surveys showed a continuation of a recent trend of decreases as the Delta variant weakened consumer optimism; a high level of confidence compared to historical levels was maintained but has fallen considerably from its peak earlier in this year.

Data released in September showed that new home sales fell by two percent during August, suggesting a possible cool down of price inflation. On the other hand, new home sales have risen, though still short of the level in August 2020.

The most recent data shows unemployment at 5.2%, a pandemic low, and following a consistent trend of downward movement. However, non-farm payroll data at the end of August showed a smaller increase than had been projected. Contrary to expectations, this did not lead to a more dovish Federal reserve. Instead, it was signalled that tapering may come sooner than some might have expected. An important question is how the Federal Reserve will react to the Non-Farm Payrolls report which will be released on the 8th of October, the last such report before Federal reserve policymakers gather in November.

Inflation data from August suggested a possible cooling down of consumer prices, as US CPI eased from its 13 year high of 5.4% year-on-year down to 5.3%. Furthermore, prices were only up 0.3% over those in July 2021, markedly lower than month-on-month increases during the past year. If this trend prevails, it may come to confirm the Federal Reserve's view that inflation is a transitory phenomenon.

US 10 Year Benchmark



US manufacturing PMI

Charts Source: Mazars Calculations

Macroeconomic backdrop
Europe

In September, European stocks fell by -3.8% (-3.7% in GBP). The best performing sectors were Energy and Financials while the worst performers were Utilities and Materials. Equities were trading at 17.07x times forward earnings, 11% above their long-term average.

The European economy is still growing fast but at a slower pace as indicators point towards momentum fading. The Eurozone manufacturing PMI in August stood at 58.7, down from 61.4 in August, while the services PMI fell to 56.4. Manufacturers continue to face significant supply chain disruptions as delivery times continue to lengthen considerably while inflationary pressures persist.

According to flash data the inflation rate in September is expected to rise to 3.4%, up from 3.0% in August and higher than the 2% ECB target. Energy prices are estimated to be the rate's main driving force, expecting a 17.4% increase year-on-year while core inflation stood at 1.9%, 0.3% higher than the previous month.

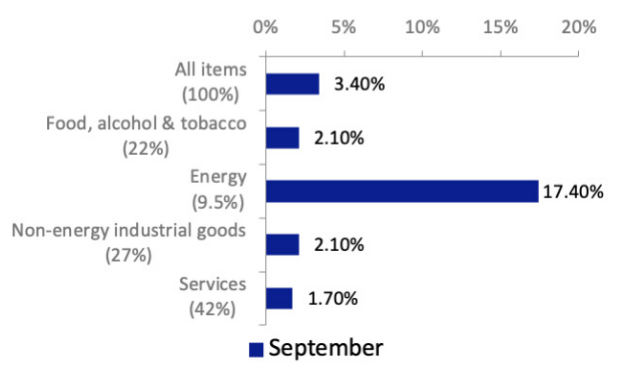
GDP in Q2 grew by 2.2% relative to Q1 and by 14.3% on a year-on-year on basis. Household consumption was the main driver of growth given the ease of lockdown restrictions earlier during the quarter. Consumer confidence remains at high levels relative to historical standards despite the fear of inflationary pressures. Moreover, sentiment is still high across most industries despite the supply chain issues.

Earlier during the month, the ECB decided to slow the pace of its PEPP purchases for the next three months. However, monetary policy remains modestly accommodative as the central bank is recalibrating its pace rather than planning to remove the purchasing programme.

Germany's centre-left Social Democrats (SPD) have claimed victory in the federal elections; however there is little clarity about which coalition will lead the next government.

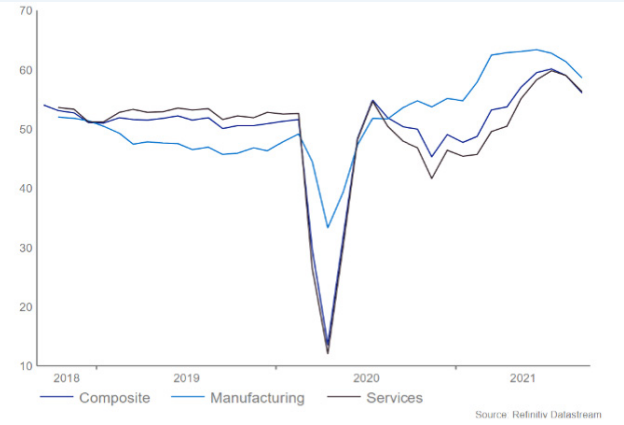
Outlook: The main factor for economic performance in the next months is the impact of supply chain disruptions on European manufacturers. Additionally the ECB's stance on inflation will be decisive for market sentiment, in particular equities. Germany's new leading coalition could also impact sentiment depending on how "euro-friendly" it will be.

Flash: Euro area inflation rate in August
(Per cent)



Energy is estimated to be the inflation rate's main driving force, expecting a 17.4% increase year-on-year while, core inflation stood at 1.9%, 0.3% higher than August.

Euro area PMIs
(Index, 50 = no change)



The Eurozone manufacturing PMI in August stood at 58.6, down from 61.4 in August.

Charts Source: Mazars Calculations

Japan and emerging markets

Emerging market stocks fell by -4.0% and -1.9% in local terms and Sterling terms respectively. Japanese stocks rose +4.4% and +5.2% in local terms and Sterling terms respectively. The best performing sectors in emerging markets were healthcare and utilities while the worst performers were communications and technology.

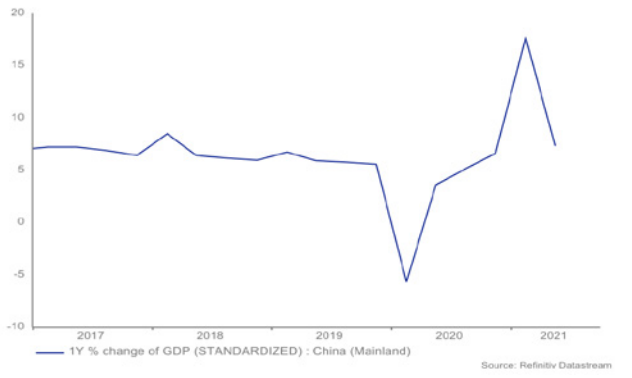
Economic data out of China, for the last couple of months, has been weak. Fresh outbreaks of the delta variant led to strict closures of cities and ports, resulting in a drop in economic activity. China's retail trade rose by 2.5% year-on-year, easing sharply from an 8.5% gain in the previous month and missing market expectations of 11.5%. China's annual inflation rate unexpectedly was at 0.8%, compared with market consensus of 1%. The official NBS Manufacturing PMI unexpectedly fell to 49.6 in September from 50.1 a month earlier. This was the first contraction in factory activity since February 2020, with output, new orders and export sales all declining amid the Delta variant of Covid-19 outbreaks, higher material cost, production bottlenecks, and more recently, electricity rationing. Non-manufacturing PMI for China jumped to 53.2 in September from an 18-month low of 47.5 in the prior month. Services confidence strengthened from August's seven-month low.

Manufacturing activity in Japan slowed down, with the manufacturing PMI reading of 51.2 vs 52.7 a month earlier. This was the weakest growth in factory activity since a contraction in January, as pandemic restrictions and heightened supply chain disruption dampened activity in the sector. Meantime, employment grew at the strongest rate since April 2019, as backlogs of work increased in many months. The consumer confidence index in Japan was up to 37.8 in September. It was the strongest reading since February 2020.

Outlook: Some EMs face tightening economic conditions that may constrain growth for much of the year. The outlook for EMs still largely depends on how long the pandemic persists and how effective the vaccination drive within those countries proves to be.

China GDP

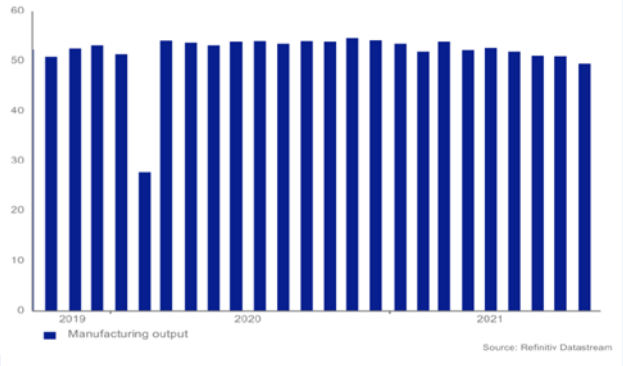
The Chinese economy slowed sharply from record growth



China enjoyed a rapid post-pandemic recovery, but its economic ascent is in question. Evidence suggests that this is a situation China's policymakers are all too aware of, as signalled by the absence of a growth target in the 14th Five-Year Plan for 2021-25 and the setting of a readily achievable growth target for this year.

China PMIs

Manufacturing activity showed further signs of weakness



Data over the past several months have shown the extent of the slowing in Chinese economic momentum.

Charts Source: Refinitiv Datastream

Our themes

Macro theme 1

Labour market post Covid-19

The UK labour market seems to be recovering as hundreds of thousands prepare to leave the furlough scheme. The path towards healing will not be smooth as the pandemic and Brexit pose structural challenges to the labour force.

The Covid-19 furlough scheme is coming to an end in September 30 and the labour market continues to recover. The UK unemployment rate fell by 0.2% hitting a new low of 4.7% for the months of April to June. 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.

The number of vacancies during May to June hit a record high of 953,000. 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 in the 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 to name among others.

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.

That is partly reflected in the positive annual growth rate of employee pay for the 3-month period of April and June reported by the ONS but that should be interpreted with care. Recall that this is an annual growth rate, which means that we are comparing the current weekly wages with depressed weekly wages in 2020. Thus, a reason why we are seeing wage growth this year is because some wages were falling last year due to the lockdown restrictions.

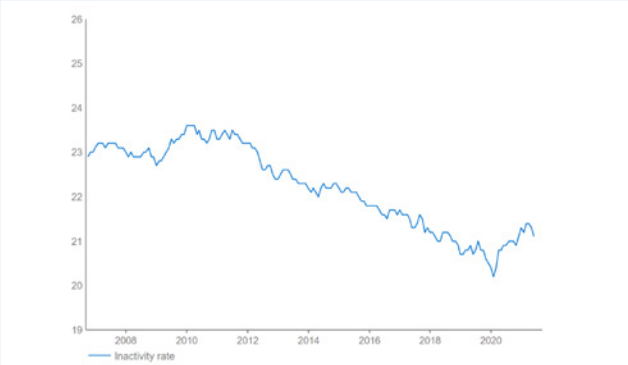
What's even more important is the most recent inactivity rate for the second quarter of the year. The rate was estimated at 21.1%, approximately 490,000 workers have left the labour market since the fourth quarter of 2019. That constitutes an alarm for the labour market making it harder to fill the record 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 to introduce temporary visas for drivers from the EU to cover for shortages. However, the government rejected this solution and instead proposed to train new drivers, which would take longer to fill the job openings.

The labour market is recovering indeed, 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.

UK unemployment rate
(Per cent)

UK inactivity rate
(Per cent)



Charts Source: Refinitiv Datastream

Macro theme 2

Why this inflation will not cause interest rates to go up

Global supply chain arrythmia after a protracted pandemic is a key feature shaping the global economy. After the initial rebound, global growth is now slowing again, even as the pandemic continues to grip countries with low vaccination rates, where most supply chains begin. The labour force is also struggling to cope, as school program disruptions persist, keeping many parents away from employment or forced to work from home.

The challenges for British people are exacerbated due to Brexit complications. Waiting times in ports are increasing further because increased paperwork. Imports through the Irish sea are becoming contentious. Where in other countries labour participation rates have dropped, in the UK the situation is made worse by the mass exodus of European skilled workers. As a result, and despite adequate inventories, British people are experiencing gasoline shortages due to lack of drivers. Similar pressures can be seen across hospitality, retail and construction, where at least the pool of workers is large enough to keep those industries afloat. Overall, shortages of skilled labour pushes wages higher. Housing prices rising 5% to 15% per annum, put further angst on consumers. All of these factors are further exacerbating inflation which has reached 3% per annum, a level not seen for nearly a decade and with no signs of abating.

Energy price pressures, especially, are only getting worse. In the past few weeks, three energy providers have gone bust, causing problems for at least a million consumers. The factors leading to this situation are aptly described as a perfect storm, the first part of which relates to the rising cost of wholesale gas: Europe's gas stocks were depleted after a long winter last year, Russia has been supplying the market with less gas, Asia has been taking up more of the gas available and supply from the North Sea is diminished while maintenance is performed that had been delayed due to the pandemic. These factors are not specific to the UK but led to an increase in gas prices which has affected all European countries.

In the UK rising gas prices have been felt particularly hard. The UK is more reliant on the spot market for gas supply than other gas-importing nations because it has significantly less gas storage capacity.

Natural gas prices pushing higher

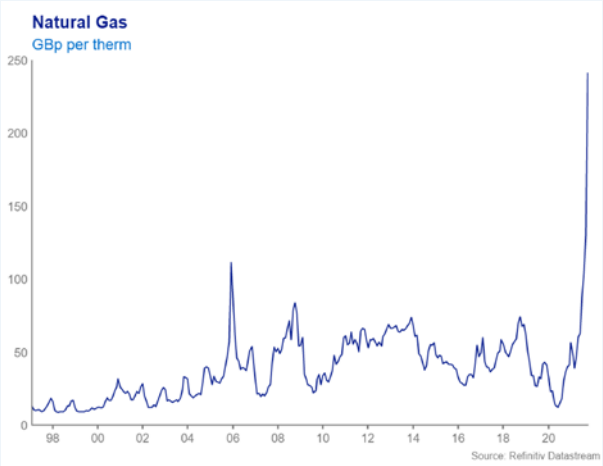


Chart Source: Mazars Calculations

Also, the UK's renewable sources of energy have recently delivered less than would be expected normally due to lower levels of wind and nuclear energy production suffering outages. As a result, UK suppliers have bought more gas at the market rate than they have historically and more than other gas-importing countries have had to.

The first place that energy prices can impact the wider economy is consumer demand, particularly among low-income households.

The second issue is the effect of energy prices on inflation and the decisions of the Bank of England's Monetary Policy Committee (MPC).

The drag of rising prices, including rising energy prices, and potential interest rate rises by the MPC on economic growth mean that investors need to consider whether the 7% economic growth forecast by the IMF for the UK in 2021 is achievable or overoptimistic. We are aware that domestically focused UK mid-cap companies have rallied 15% in 2021 and 40% over 12 months reflecting the economic rebound. An important question is whether there is too much optimism in the post-pandemic recovery given that the elevated pace of growth post pandemic must moderate at some point and should we therefore reduce our allocation to the UK.

Read more on our Blog: The UK's energy market and its broader implications

Macro theme 3

China in the age of slower growth and regulatory crackdown

In the minds of investors China has long been synonymous with the rise of the middle class as the country moves from an export led economy to one reliant on consumption. However, more recently China has attracted attention for more negative reasons, including slowing economic growth and

a government crackdown on certain businesses' activities. As investors we have to decide whether the long term appeals of investment in China are diminished or whether what we are seeing now is simply growing pains that must be endured.

China's ability to still post 2.3% economic growth in 2020 when the global economy fell -3.2% was taken by some to be further proof of the inevitable "rise of China" which saw its middle class swell from 80m in 2002 to 200m people in 2020 and will see the size of its economy overtake the US in this decade.

However, Chinese economic growth is showing signs of slowing as credit growth within the economy appears to be falling and PMI survey data points to contracting economic activity. On top of that, the reopening of western economies means that those consumers who have been spending money on goods while lockdowns were in place will now be able to spend money on services, which have not been available during the pandemic. This tilt away from goods is likely to negatively impact China's exports.

China Economic Surprise Index

Negative territory

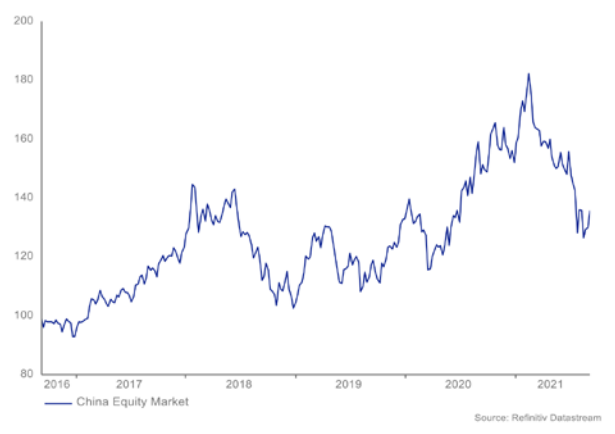


Chart Source: Mazars Calculations

China equities

25% lower than 2021 high

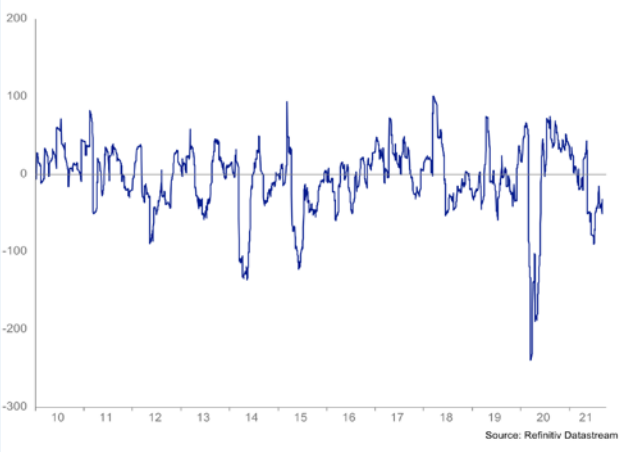


Chart Source: Mazars Calculations

In the news China's economic slowdown has been covered less than the government crackdown on certain industries, such as technology companies or education providers. This is seen as a Chinese government which is hostile to the interests of private investors in favour of creating a more cohesive society which has spooked investors.

Investors allocating capital must weigh up the long term appeal of China with the near term headwinds. The headlines are alarming and the troubles seem significant but the Chinese equity market has already fallen approximately 25% from its recent high leading some to think that the bad news is already discounted by the market. Our diversified portfolios will always contain some allocation to China and we are among those weighing up the current economic situation while we consider our allocation.

Income – What next for income investors

Dividends are likely to grow as companies become more confident about their revenues post Covid. However, many companies will be reluctant to return to previous levels of dividend yields, instead preferring to only gradually lift their dividends.

We continue to look at company dividends and this month we discuss what people should expect from dividend yields, as well as other forms of capital return, and how these can impact share prices.

In the midst of the Covid crisis, facing an uncertain future, companies cut their dividends to shore up their balance sheets. Sometimes this was to avoid insolvency, sometimes it was prudent given the extreme uncertainty of the time. Now were are coming out of the pandemic and economic activity is normalising one may expect that in aggregate dividends could return to their prior levels, however this is unlikely to be the case for some time yet as companies enjoy the leeway that not having to payout all their spare cash to shareholders gives them.

The upshot of this is that dividend cuts which occurred during the pandemic are unlikely to be fully reversed in the near future. While in many cases dividends have been reinstated and increased in 2021 companies will enjoy the flexibility that paying out less to shareholders gives them: it leaves more money to pay down debt or invest for growth. In the future dividends will likely increase but in some cases will not reach previous levels for many years, or capital return will come via more flexible means such as buybacks, where there is less expectation for it to repeat and grow each year.

For income investors there must be some acceptance that in an era of conservative dividend payouts and low bond yields income levels are reduced. However there are always opportunities somewhere and at this point it makes sense to look towards companies that have high free cash flow yields as these will be likely to return cash to shareholders in some form, such as a dividend or a share buyback. In fact, one does not have to only be interested in income to place such a trade as announcements of higher dividends usually leads to an upward rerating in price thereby also satisfying investors who look for overall capital growth.

UK High Dividend stocks have lagged the broader index post-pandemic

UK large cap index vs UK high dividend equities

UK corporate dividends are not anticipated to rebound to prior levels

UK Equities 12 Month Dividend Expectations

Charts Source: Refinitiv Datastream

Fixed income spotlight

Yields pushing higher on a more hawkish Fed and a looming debt ceiling fight

Bond yields have been slowly rising across the board, a result of a more hawkish Fed and concerns over the Debt Ceiling in the US. The global benchmark, the US 10-year Treasury bond, crossed the 1.5% threshold. The move, while noticeable, is not yet significant. High Yield indices are still yielding below inflation in many places around the world and corporate spreads are tight.

The rate decision by the FOMC, the Fed's rate-setting body, suggested that asset purchases might be tapered as early as November and end by mid-next year.

The debt ceiling is a legal limit beyond which the US government can't borrow. Traditionally, Republican and Democratic politicians have a fight every few years, with the party in the minority claiming that fiscal expenditures are too high and demanding 'something to be done about it'.

the way this is usually resolved is that both parties let the debt ceiling expire, then let the Treasury use its available cash to avoid a possible default and the 'real negotiations' begin. As the Democrats are preparing to spend nearly $3.5tn in the budget, Republican leadership will require to have a say on where some of that money goes and if possible, it will try to limit that spending, ahead of the congressional mid-term elections next fall.

In the modern era, there has always been some sort of last-minute deal, and we fully expect that on this occasion this will be the case too. However, the political climate is as acrimonious as it has ever been, and we can't rule out the possibility of an accident.

What would happen in the case the debt ceiling is not raised and the Treasury runs out of cash? The US government would have to prioritise payments. For example it could stop paying tax refunds, unemployment benefits, stall some national security payments or furlough Federal workers.

In this scenario, markets would naturally be concerned. We would expect the US Dollar to take a hit, long end interest rates (10year plus) to rise sharply and equities to correct significantly. A default, or near-default, could have significant repercussions for the bond markets, especially as bonds are very expensive and have a long way to fall. Conversely, gold and commodities could rally.

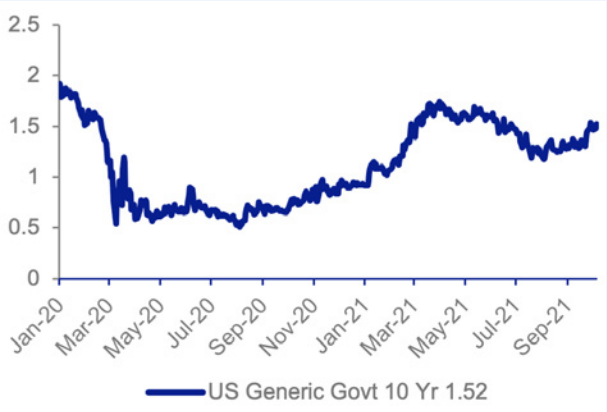
We believe that while bond yields could climb further, especially as the Fed has adopted a relatively more hawkish stance, the factors driving them up don't necessarily have a lot of steam.

Despite the beginning of tapering, there's no assurance that the Fed will end the process by mid-June 2022 or that it will manage to hike interest rates thereafter. Looking at 85 non-zero rate forecasts by the US central bank, only one has managed to accurately predict interest rates over one year ahead. There's ample evidence that hawkishness could be reversed, something that portfolio managers are painfully aware of.

Meanwhile, scintillating as the Debt Ceiling fight may be, we consider the probability of a wanton US default very low. Even if it did happen, in terms of portfolios there's very little we can do in advance. The only way to prepare for a systemic event is to reduce risk to zero. But the event doesn't happen (by far the larger probability), portfolio performance could suffer for years.

In that occasion we would also hold an emergency investment committee and decide whether the central banks can make sure markets stay afloat (in which case we could even increase risk) or whether the financial system just crashed (in which case we would significantly reduce risk).

US Yields pushing higher



Source: Refinitiv Datastream

ESG investing

While the trend of Environmental, Social and Governance (ESG) investing, has been gaining momentum for years, this year the pace of green change has been rapidly accelerated as a by-product of the pandemic.

While the trend of Environmental, Social and Governance (ESG) investing, has been gaining momentum for years, this year the pace of green change has been rapidly accelerated as a by-product of the pandemic.

ESG or sustainable investing has now become a movement the investment industry can't afford to ignore. The pandemic has fuelled investor demand. Figures from Morningstar show that the global sustainable fund universe attracted USD 139.2 billion in net inflows in the second quarter of 2021.

Opportunities for sustainable investment used to be scarce, but today it is hard to find a business that does not have an ESG policy. For example, 90% of companies in index of America's largest companies produced sustainability reports in 2019 and 81% of the leading UK companies have some form of emissions reduction target.

As the focus on ESG investments increases, we can also see a shift in policy makers worldwide.

In Europe, the EU taxonomy, which came into force this year, established an EU-wide classification system or 'framework' intended to provide investors with a common language to identify to what degree investment activities can be considered environmentally sustainable.

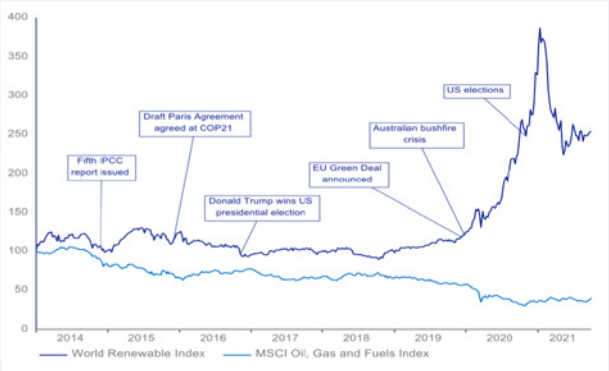
In the UK, chancellor Rishi Sunak announced the launch of Britain's first ever "green gilt", the proceeds from which will fund spending on clean transportation, energy efficiency, renewable energy and more. Demand for the UK government's sale of green gilts was 10 times oversubscribed as investors to place orders for GBP101.4 billion worth of the 12-year gilts.

As tackling climate risks is becoming a global challenge, regulation is inevitable. A flurry of work has already been issued by various bodies, all of which could have implications globally. The

International Financial Reporting Standards' plans for a Sustainability Standards Board continue to evolve, in anticipation of further announcements ahead of the UN Climate Change Conference of the Parties 2021, or COP26. The Task Force on Climate-Related Financial Disclosures consulted on enhancements to its climate-reporting framework, which continues to gain wider adoption. Going forward, companies should expect renewed questions from investors and regulators on how they are using the information available from the regulators to plan for and adapt to these changes.

Renewable stocks have significantly outperformed traditional energy stocks

Global renewables vs oil and gas since 2014



Over the last few years, there has been a dramatic shift in investments into renewable energy vs traditional oil and gas companies.

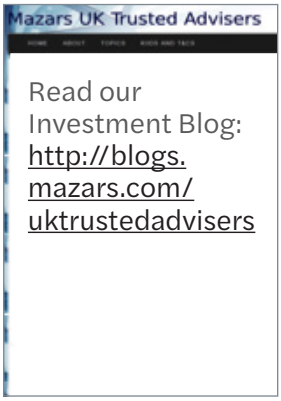
Source: Refinitiv Datastream

More reading...

Weekly Market Update

Investment newsletter

Quarterly outlook



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