Monthly market blueprint

Investment management service

November 2021

mazars

Contents

Foreword

From Pandemic-nomics to Sustain-omics: The Return of Big State

What do the British budget and COP 26 have in common? The -possibly inevitable- return of 'Big State'.

The 1980s ushered in an era of lower taxes and reliance on consumers to fuel growth. The Covid-19 pandemic, twelve years after the global financial crisis, followed by at least a decade of 'Sustainability Economics' may put a tombstone on Ronald Reagan's chapter of liberalism for western economies.

When this pandemic started and governments stepped in to save companies hit by lockdowns, we argued that the future would see an augmented role of the state in western liberal economies. Our commentary focused on the government's role in directing industry towards desirable goals. This made sense. The non-financial corporate sector has the heftiest debt load except governments themselves and could not be given a blank check with public money

The British budget revealed another dimension of state intervention. Fiscal spending fueled by higher taxes. The fact that this comes from a Conservative party may look surprising, but it demonstrates how pragmatism and need can easily trample and possibly redefine ideology. And this could be just the beginning. While this is a pandemic-related budget, we have every reason to believe that the coming era of 'Sustain-omics" may well feature even more consumer dis-empowerment.

During the last crisis, twelve years ago, governments avoided fiscal interventions and instead let central banks and quantitative easing do the heavy lifting. As a result, the financial economy grew exponentially while the high street economy stagnated. And where the latter grew, it did so in the direction of tech products. Consequently, the eight first companies in the S&P 500 belong to the tech sector and account for more than a quarter of the world's leading equity index. Clearly, what little growth western economies experienced, was neither equitable nor in any way balanced. Classical economics assumes that aggregate consumer spending will always lead to the wisest economic decisions. But decades of rapid growth have led to the depletion of natural resources to the point where the human species is adversely terraforming its own home. As debt piles up for future generations and the air becomes thicker, the prevailing thinking amongst political leaders is that too much is at stake to let consumer randomness decide the next steps of economic development.

As we enter the era of 'sustainable' economics, we will have to come to terms with a considerably bigger state and, at least for a decade, possibly higher inflation. Post-pandemic pressing realities may be just the start. In the next few years, the western consumer may not nearly be as empowered as in the previous decades, if the world economy is to be set on a more sustainable path.

George Lagarias
Chief Economist, UK

Market performance – in a nutshell

The month in review

October was a surprisingly good month for risk assets

During a month when the risks of tighter monetary policy were combined with lower economic growth caused by supply chain issues, risk assets enjoyed a buoyant month while the selloff in bonds was only moderate.

As they have all year, US equities led the charge in October rising 7%. As Q3 earnings season kicked off it showed that another round of earnings ahead of expectations was possible which led the S&P 500 to a new record high. This is despite supply side disruption and hurricane Ida leading to Q3 GDP coming in below expectations at 2% growth vs Q3 2020.

Europe also enjoyed a strong start to earnings season which led to strong equity market returns of 4.8%. This was despite well-documented shortages in semi-conductors restricting industrial activity, most notably car production in Germany.

The UK's equity market performance was more muted than other major markets at +2.2% but nonetheless impressive. The UK was buoyed by the performance of financials which appeared to move up on the prospect of interest rates moving higher.

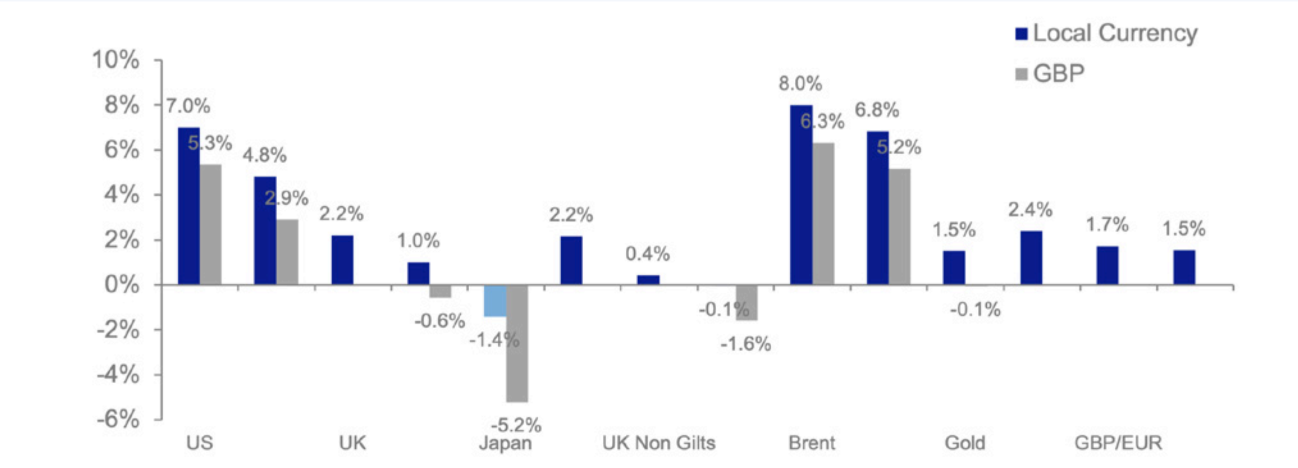
While equities seemed to move up in spite of the economy, bonds seemed be more reflective of the reality. 10-year government bond yields from the US and the UK both moved higher but not by as much as their 2-year bonds. This amounts to a flattening of the yield curve and acknowledges the fact that tighter monetary policy is effectively a brake on economic growth and inflationary pressures.

The oil price moved up +11.4% but despite this sharp move it was the natural gas price that really grabbed headlines. Reduced supply from Russia and pandemic-related demand anomalies have seen the gas price rise dramatically in October which has put pressure on consumers in Europe and the UK.

The gold price moved up 1.5% in USD terms which was modest compared to the move in risk assets seen in October.

The British pound strengthened against the dollar and Euro by 1.5% and 1.7% respectively, boosted by the UK looking likely to be the first major economy to lift interest rates post-pandemic.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation
Changes in our Strategic Asset Allocation

Outlook and portfolios

At the end of Q3 our investment committee highlighted that risks are mounting and with less central bank support, be it fewer asset purchases or, eventually, higher interest rates, the markets are not going to be as forgiving as they have been to disappointing economic data should it materialise.

At this point disappointing data could come from a number of directions. On the one hand supply chain disruption is still preventing goods reaching their end markets which is particularly hampering economic activity in regions that rely on industrial production, such as Germany. On the other hand Covid is still preventing consumption from reaching its potential, visible in UK household savings levels which have not reduced to pre-pandemic levels.

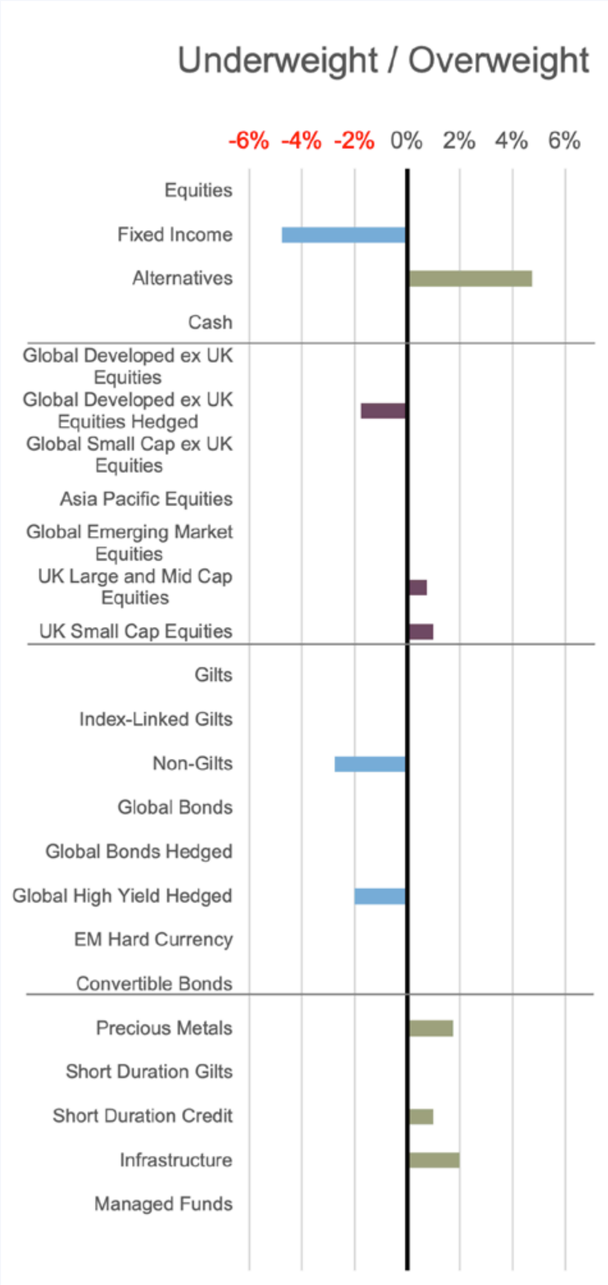
The combination of less central bank support and the potential for economic data to disappoint led us to move from an overweight equity position to one which is in line with our benchmark.

In the bond portion of our portfolios we remain underweight, as we continue to feel that bonds do not adequately compensate for the higher yields fewer central bank asset purchases and will likely bring about.

We have increased our allocation to gold, which is a hedge against volatility in the market. We also added to our short duration credit which will not be as sensitive to interest rate rises but offers lower returns than longer dated fixed income.

Since our Investment Committee convened at the beginning of October the markets have been benign and equities have risen. Much of this is driven by Q3 earnings numbers from the US which have beaten expectations, although not as much as they did in any other quarter since the pandemic. This slowing of earnings growth has vindicated our caution and we remain happy with the allocation as it stands.

Mazars balanced portfolio as of 3 November 2021



Risks
Inflation is still the key risk

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 exit 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: policy responses in the light of rising inflation, and a pickup of the pandemic especially in the emerging world.

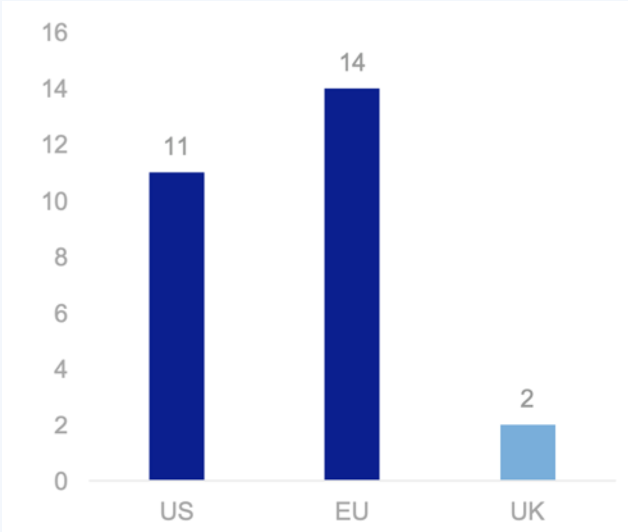
Markets continue to focus on quantitative easing. The rate at which monetary and fiscal stimulus will be withdrawn is the main risk for the upcoming economic recovery. Stock prices are near or at all time highs. Global bond yields began to climb on inflation fears earlier in the year.

From an economics perspective, the Chinese slowdown is putting more pressure on supply chains and it is bound to reverberate on western economies.

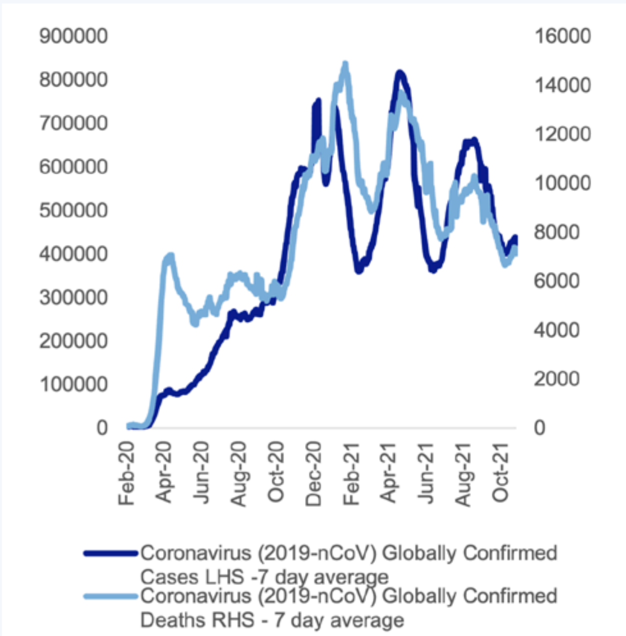
We feel that overall risks are more global than local. A resumption of the pandemic with a more aggressive variant may continue to disrupt supply chains, especially those based in the emerging markets. While we don't believe that lockdowns will re-emerge

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. Slower growth could mean a stagflationary environment, to last 1-3 years. If, conversely, growth supports even higher and resilient inflation, central banks will undoubtedly have to adjust their model. 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.

More hawkish central banks
Rate hike expectations



Covid-19 is on the rise again?
Global Covid cases and deaths



Charts source: Mazars calculations

Global

For the period, global stocks rose by 5.7% (4% in GBP). The highest performing sectors were Cons. Discretionary and Energy while the worst performers were Telecoms and Cons. Staples. Equities were trading at 20.18x times forward earnings, 21% above long term average. Gold rose 1.5% and oil prices rose 11.4%.

Economic performance has picked up significantly in the past few months, both in terms of services and manufacturing. Momentum however, has stalled as the Delta variant continues to advance and supply constraints may already be impacting demand.

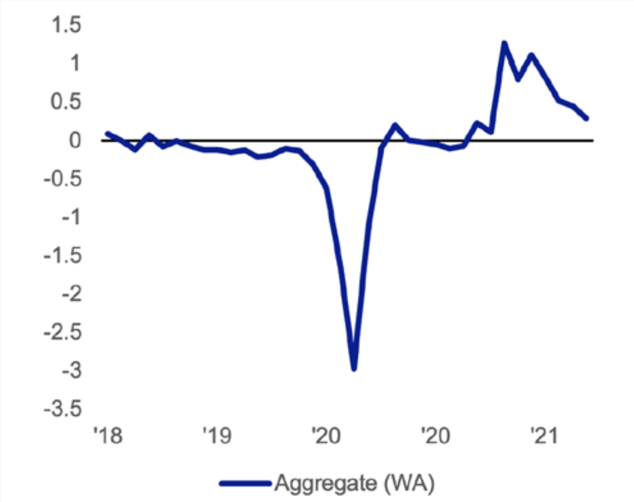
Supply chain issues continue to plague the global economy, with transport rates and delivery times at all-time highs, Manufacturing demand has shown signs of abating due to weaker international demand, but capacity remains very tight, as backlogs continue to increase. In the services sector, which accounts for a larger part of the economy, things are more diverse, with the US experiencing a sharp upturn and Europe slowing its expansion. Retail sales across the board are satisfactory, but the post-pandemic pent-up demand phase has passed. As a result of supply pressures, inflation is climbing at all levels. Employment conditions also remain tight, as developed markets have experienced lower participation rates (i.e. people have left the workforce altogether) and skill shortages persist, pushing wages higher. Inflationary pressures are having a positive effect on real estate prices, especially residential.

Central banks, previously impervious to inflation fears, are now slightly more hawkish, setting a path towards rate hikes. Meanwhile, fiscal policy remains accommodative in much of the developed world, bar the UK where the budget was tighter.

Outlook: Global equities have been trading upwards in the past few months, while earnings begin to catch up to expensive valuations and central banks have remained by and large dovish. The effect of supply chain disruptions, global imbalances and lingering problems in the services sectors post-summer are still issues economists and investors will have to content with. Portfolio managers can rely on central banks and governments to support risk assets, but should still be on the lookout for risks which might demand more aggressive policy approaches, or even transcend the ability of policy makers to deal with them.

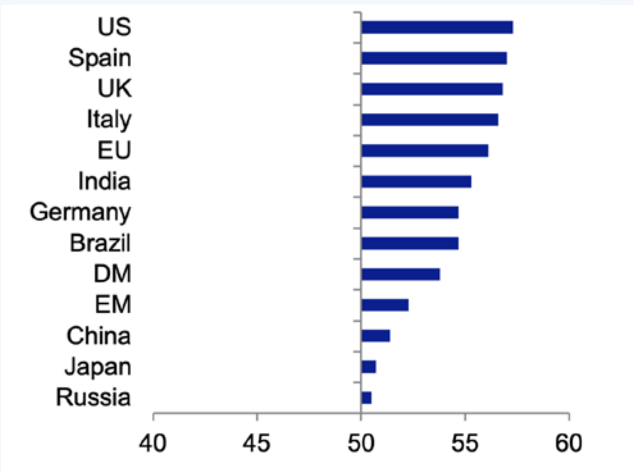
The acute phase of the recovery may be over

Z-score of leading indicators



Still, the global economy is well into expansion territory

Composite PMIs, September



Charts Source: Mazars Calculations

The UK's large allocation to energy and financials has not led to outperformance against the US, which has a larger allocation to growth sectors

UK equities grew 2.2% in October and two sectors which saw some of the biggest moves over the month were the energy and financial sectors, both value sectors. However, the larger weighting to value companies in the UK and the lower stock valuations has not led the UK to outperform its global peers.

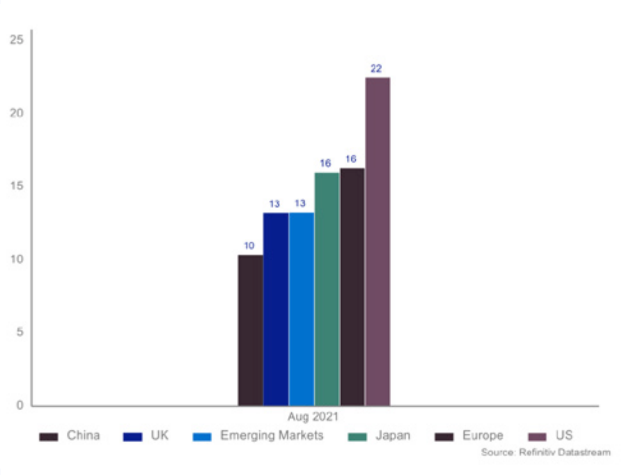
The price of energy has been a hot topic in the UK over recent months, particularly as it affected household bills and led to some suppliers filing for bankruptcy. Large energy companies have particularly benefitted from the rise in the oil price and traded strongly over the month but this moderated to just 2% by the end of the month.

In October financial companies were beneficiaries as expectations grew for the Bank of England to became the first major central bank to raise interest rates post pandemic as higher interest rates tend to allow for greater profits. The financial sector equities rose by over 8% during the month.

Unfortunately, the outperformance of value companies in the UK has translated into the UK outperforming its global peers in October or in 2021 so far as European and US equities have both fared better. While the attractive valuations of UK companies is undeniable the potential for growth of the US and notably its technology companies has proven to be more of a draw to investors than the UK's attractive valuations.

Outlook: The UK's relatively cheap valuations still deserve attention. On a long term basis valuation is a good determinant of future performance as both undervalued and overvalued companies revert to mean and therefore we continue to look favourably on UK equities.

Global equity valuations
UK discount to global peers



UK & US Equities
Year to date changes

Charts Source: Refinitiv Datastream

US

For the period, US stocks rose by 7% (5.3% in GBP). The highest performing sectors were Consumer Discr. and Energy while the worst performers were Cons. Staples and Utilities. Equities were trading at 22.35x times forward earnings, 26.4% above long term average and 10.8% above the MSCI World. 10y bonds rose 6 bps at 1.552%.

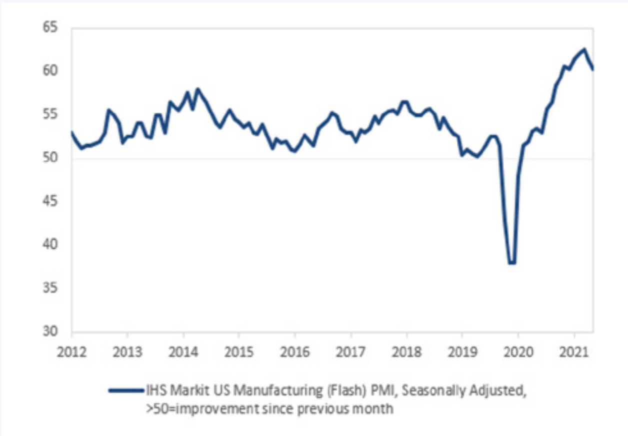
US stocks rallied to new highs this month, fuelled by a robust earnings season in which 82% of reporting companies in the S&P 500 beat Wall Street's profit expectations. Economic conditions in the US continued to improve, although at a decreasing rate, with the Bureau of Economic Analysis reporting the lowest rate of GDP growth of the pandemic recovery period in the third quarter of 2021.

Significant upturns in areas such as manufacturing were in many cases held back by supply chain disruptions, labour shortages and uncertainty over the Delta variant. In the Federal Reserve's report on economic conditions known as the 'Beige Book', it was noted that consumer spending, trucking and freight, and residential real estate showed moderate growth in most districts, while loans, agriculture and energy conditions were mixed or steady, and auto sales widely decreased.

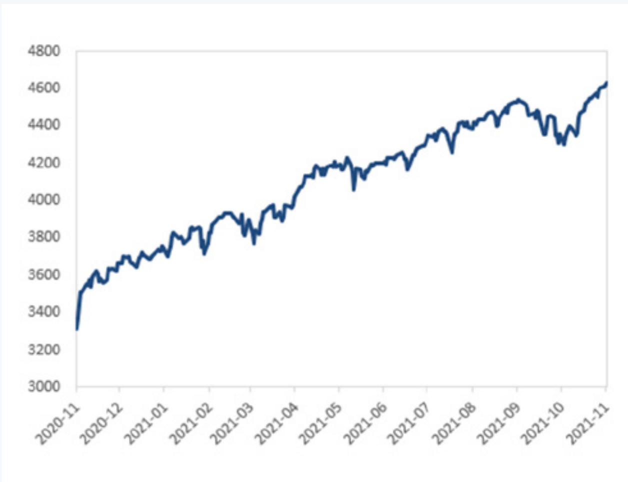
Employment data disappointed this month, with the increase in non-farm payrolls falling short of expectations and being the smallest gain of the year thus far. Labour shortages were reported across the board, as high turnovers forced many retail, hospitality and manufacturing firms to cut hours, decrease production, or increase wages. This news comes as the final report on employment before the Federal Reserve's meeting on November 2nd, however it is nonetheless still widely expected that the Federal Reserve will announce the tapering of its bond purchase program by the middle of 2022.

Outlook: The main factor for economic performance in the next few quarters will be fiscal stimulus, where Joe Biden's proposal to stimulate the economy could significantly add to inflation, but also spur consumer demand. At the time of writing the Bill was under negotiation, but a compromise appears near. Meanwhile, we remain positive on US risk assets on the back of strong earnings and the potency of its leading tech sector.

US manufacturing PMI



S&P500 all time high



Charts Source: Mazars Calculations

Europe

In October, European stocks were up by +4.8% (+2.9% in GBP). The best performing sectors were Utilities and IT while the worst performers were Retail and Telecommunications. Equities were trading at 17.63x times forward earnings, 15% above their long-term average.

The European economy is still growing but at a slower pace as indicators point towards momentum fading. The Eurozone manufacturing PMI in October stood at 58.3, down from 58.6 in September, while the services PMI fell to 54.7. 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 October is expected to rise to 4.1%, up from 3.4% in September and modestly higher than the 2% ECB target. Energy prices are estimated to be the rate's main driving force, expecting a 23.5% increase year-on-year while core inflation stood at 2.1%, 0.2% higher than the previous month.

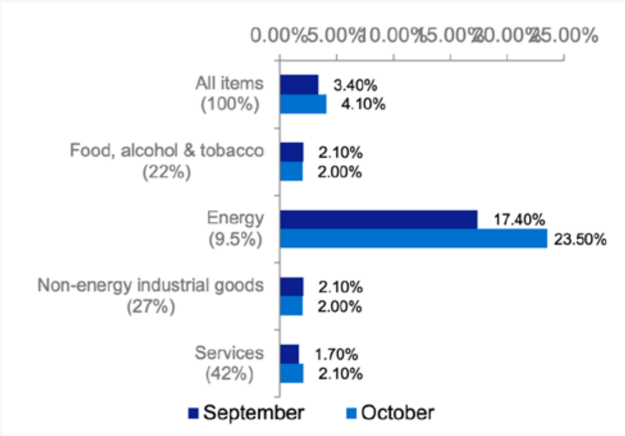
GDP in Q3 grew by 2.2% relative to Q2 and by 3.7% on a year-on-year on basis. France and Italy GDP grew at higher rate than expected while Germany and Spain recorded a slower than expected growth rate. Europe is now closing the output gap with USA and China with GDP standing at 0.5% below the pre pandemic level.

Chistine Lagard, president of the ECB continues to support the idea that inflation will fade next year with the likelihood of a rate rise before the end of 2022 remaining very low. Markets are not aligned with that as they are currently pricing in a rate rise 0.1% by Q3 next year. The Pandemic Emergency Purchase Programme (PEPP) will continue but at a slower pace going forward.

Outlook: The main factor for economic performance in the next months is the impact of supply chain disruptions on European manufacturers. Growth forecasts have been revised downwards largely due to supply bottlenecks and rising input prices hampering manufacturing output. Additionally the ECB's stance on inflation will be decisive for market sentiment, in particular equities. The ECB has been one of the most relaxed banks with regards to inflation and is worth monitoring going forward.

Euro area inflation rate

(Per cent)



Energy is estimated to be the inflation rate's main driving force, expecting a 23.5% increase year-on-year while, core inflation stood at 2.1%, 0.2% higher than August.

Euro area PMIs

(Index, 50 = no change)

The Eurozone manufacturing PMI in October stood at 58.3, down from 58.6 in September.

Charts Source: Mazars Calculations

Japan and emerging markets

In October, emerging market stocks rose +1.0% in local terms but fell -0.6% in Sterling terms. Japanese stocks fell -1.4% and -5.2% in local terms and Sterling terms respectively. The best performing sectors in emerging markets were energy and materials while the worst performers were healthcare and utilities

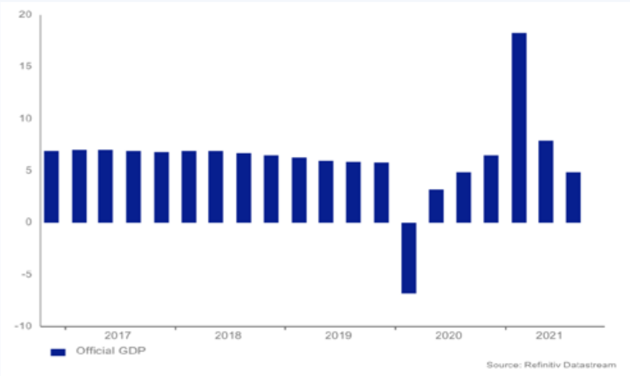
China's GDP expanded 4.9% in Q3 2021, slowing from previous quarters amid rising economic challenges including a power crunch and the global supply chain bottleneck. The growth was slightly lower than market expectations of 5%. The regions supply side inflation (PPI), increased by 10.7% YoY in September, this was the ninth straight month of increase in factory prices, amid surging cost of raw materials. Despite pressures on factories from power shortages, exports jumped 28.1% YoY to an all-time high in September, beating market expectations of 21%, amid solid global demand. Imports also rose 17.6% YoY to a record high of USD 239.0 billion. The official NBS Manufacturing PMI for China unexpectedly fell to 49.2 in October from 49.6 previously and missing market expectations of 49.7. This was the second straight month of contraction in factory activity.

Japan's ruling conservative party, the LDP, won the general election and announced the regions new prime minister, Fumio Kishida. The newly elected PM signalled that he would pursue defence policies aimed at deterring China, address climate change and accelerate recovery from the pandemic. The Bank of Japan left its interest rate unchanged at -0.1% during the October meeting, as expected. In a quarterly outlook report, the central bank slashed its projected rates of the GDP for the current FY to 3.4% from earlier forecasts of 3.8%, citing sluggish consumption and a slowdown in exports and output as supply disruptions persisted

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's economic growth slows amid power crunch, supply bottleneck

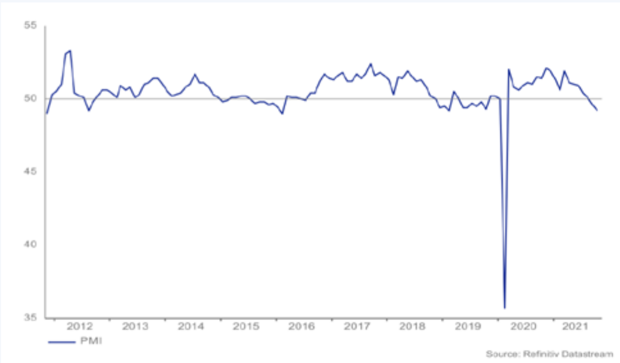
China GDP growth (YoY)



China's economic slowdown came amid a lower base effect from last year, but also amid a range of economic challenges that China is facing now, such as the power crunch and supply chain issues.

Manufacturing activity showed further signs of weakness

China NBS manufacturing PMI



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
The UK Budget

The Chancellor's budget was more generous than anticipated. Helped along by the OBR's upgrade of the UK economy, Rishi Sunak was able to spend more, to save more and to keep something in the tank for the 2023 election.

Going into this budget investors had cause for concern; against a backdrop of the Bank of England looking increasingly likely to raise rates in November it appeared that the UK Treasury may be about to fiscally tighten. However, they need not have worried as the Chancellor's October budget was more generous than anticipated. Helped along by the OBR's upgrade of the UK economy, Rishi Sunak was able to spend more, to save more and to keep something in the tank for the 2023 election.

The OBR revised up its expectation for UK economic growth in 2021 to +6.5% from +4%, lifting UK government tax receipts and allowing the Chancellor of the Exchequer to issue policies to satisfy calls for more spending and less government debt.

On the spending side, the government will spend significantly more on health and social care spending, as well as targeted spending that sits within the governments "levelling up" agenda. Changes to the way that universal credit is awarded to make it more generous were also set out to tackle concerns about the cost of living.

Regarding government debt, the improved OBR forecasts mean that borrowing is forecast to be £30bn lower than previously estimated from 2021/22 to 2025/26.

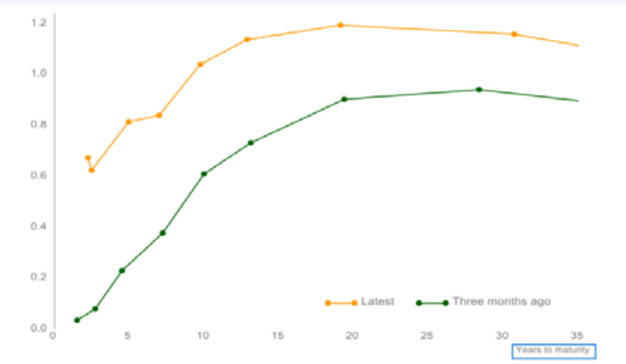
It should be noted that there wasn't much discussion about tax rises but it was not long ago that increases in national insurance and dividends were announced. This allowed for a message of unalloyed good news on the day despite the significant.

The magnitude of the OBR's improved forecast means that despite the giveaways and lower government borrowing Rishi Sunak still has more room for further giveaways leading up to next national election in 2023.

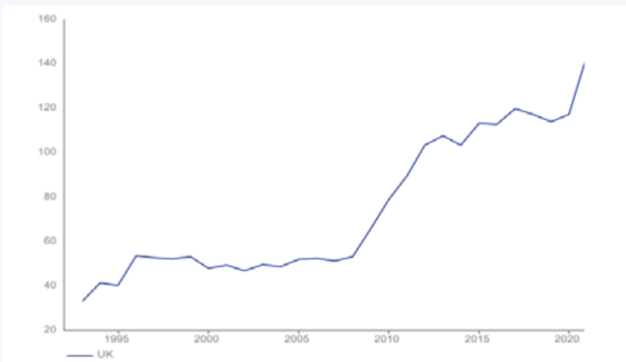
Investors can breathe a sign of relief as ahead of the budget it was expected that the chancellor would be reigning in spending at the same time as the Bank of England raised interest rates. The simultaneous tightening of fiscal and monetary policy was seen my many as too aggressive in an economy which is still suffering from pandemic-related supply side anomalies.

The market response to the budget was fairly muted but the curve of UK treasury bonds has flattened as the expectations of the rate hike in November grew.

UK treasury yield curve
3 month change



UK government debt
Percentage of GDP



Charts Source: Refinitiv Datastream

Macro theme 2
Inflation 1.0 and 2.0

Milton Friedman famously said that ‘inflation is always and everywhere a monetary phenomenon’. The idea is that inflation is really caused by demand in excess of supply. Extra demand is a result of more money in the economy than necessary. If one, the theory goes, only discourages consumption, by raising interest rates for example, then demand –and inflation- go away.

His thinking is probably not appropriate for the era we live in.

Inflation 1.0 Supply inflation

Global lockdowns stressed supply chains to near breaking point. Despite vaccination progress across the G7 and gradual exits from lockdowns of the world’s largest economies, global supply conditions remain erratic and demand precarious. This is causing further strain on damaged supply chains. The pandemic has rolled back globalisation, the key driver of lower prices across the world for decades. Supply chains are not only more localised, but also unable to cope with the spike in demand from the developed world as G7 nations simultaneously woke up from the pandemic-induced coma with an appetite to spend. Producers are reporting significant shortages in materials, causing price spikes in most global markets. As a result, companies are being forced to pay higher wages and offer permanent jobs to lure workers back, especially in hospitality services.

Apart from supply issues, inflation is being driven higher by pent-up demand across the developed world. Companies which had exhausted their inventories didn’t stock up, uncertain about the lockdown measures. As stringency conditions ease across the board, the race to re-stock, along with the extra demand, is causing a surge in input prices.

Higher demand for goods and services and lower supply of both plus labour shortages are an explosive cocktail for higher prices, which may look bigger under the magnifying glass of the current news cycle.

Mr Friedman, the great economic guru, whose thinking continues to underpin most policy makers in the post-Gold standard era, could not have envisaged either a situation where excess money did not mean excess demand, or where inflation was the result of an unprecedented disruption of supply chains.

Our four basic scenarios on growth and inflation

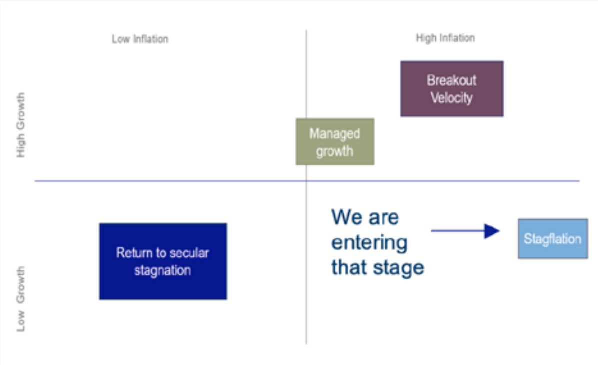


Chart Source: Mazars Calculations

Central banks know this, and that’s why they are mostly patient with supply-side inflation and higher wages in an environment where a lot of workers have dropped out from the labour force. However, they have also staked their territory in case interest rate hikes are warranted.

Inflation 2.0 Longer term inflation

The combination of fiscal stimulus, de-globalization and the Chinese transition into a more consumer economy could change the trajectory of inflation. Consumer credit will not solely drive prices higher in this scenario, and thus interest rate hikes alone might not be an effective tool to combat higher prices. Central banks will have to think up novel ways of tightening excess demand while avoiding damage to consumer confidence. As this path has not yet been set out, we would expect that a second bout of inflation would be longer lasting and could lead to a radical redesign of policy responses.

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

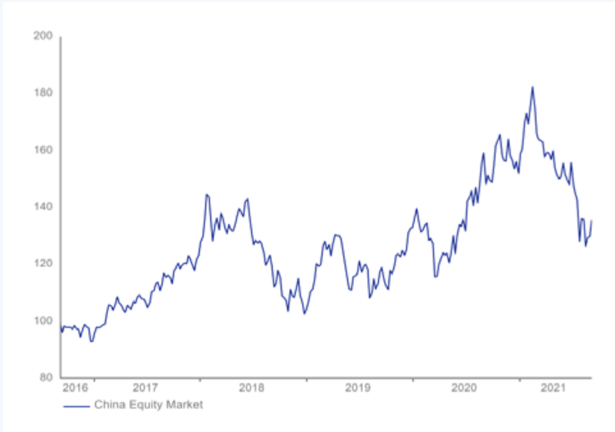


Chart Source: Refinitiv Datastream

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.

China equities

25% lower than 2021 high

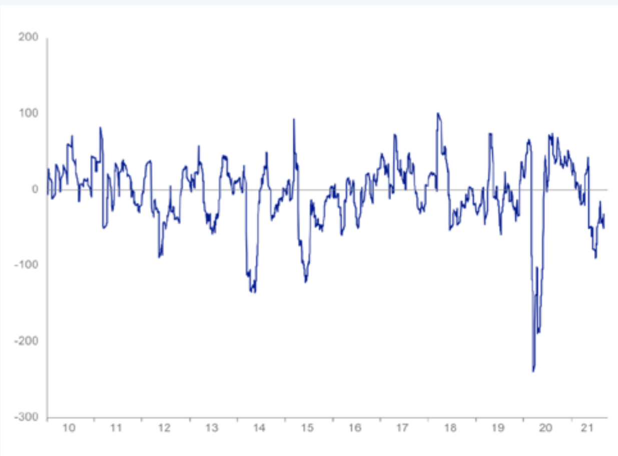


Chart Source: Refinitiv Datastream

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 as central banks appear ready to start rate hikes

Bond yields have been slowly rising across the board, a result of hawkish central bank comments, rising inflation expectations and concerns over the Debt Ceiling in the US.

In the US and Germany yields remain below the highs reached in March, however in the UK, where expectations are for a rate rise in November, 10-year Gilt yields are at the highest level since early 2019.

Although a decision on raising rates appears further off in the US, the FOMC, the Fed's rate-setting body, has suggested that asset purchases might be tapered as early as November and end by mid-next year.

Meanwhile in Germany inflation concerns appear to have captured the public's attention. Germany's top selling newspaper Bild has designated the President of the European Central Bank, Christine Lagarde, 'Madam Inflation'. We don't expect the ECB to base interest rate policy on sensationalist headlines, however it highlights pressures on the ECB to start raising interest rates.

The Debt Ceiling is a legal limit beyond which the US government can't borrow. The issue is a long-standing game of political cat and mouse between parties in the US. There was a reprieve at the start of October as Republicans agreed to a delay on the issue until December, at which point senate Democrats may have to raise the limit through a messy and time-consuming process known as reconciliation.

Usually 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. However, Republicans are keen for Democrats to produce a borrowing figure which they can then campaign against them on in the mid-terms next year. Democrats would not need to do this through traditional negotiations, which is why Republicans are likely to deny any votes and force the use of reconciliation. Given the political climate is as acrimonious as it has ever been, we can't rule out the possibility of a failure to raise the Debt Ceiling.

At this point 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.

Yields rising in all developed markets

10Y yields, per cent

Source: Refinitiv Datastream

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

Right now, 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. Scintillating as the Debt Ceiling fight may be, we consider the probability of a wanton US default very low.

Further, despite the talk of tapering, there's no assurance that the Fed will end quantitative easing 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.

ESG investing – looking ahead

The global response to Covid-19 has not held back the rapid evolution of the sustainable finance policy landscape. These policy shifts are set to change the way capital is channelled, and will be critical as we consider what our economic recovery may look like.

The 26th United Nations Climate Change Conference of the Parties (COP26) is set to take place in Glasgow, with nations gearing up to discuss the progress made since the 2015 Paris Agreement and what steps should be taken next. COP26 will be the most important global event yet for addressing the issue of climate change – especially given how far behind countries are in meeting the agreed target of limiting global warming to 1.5°C.

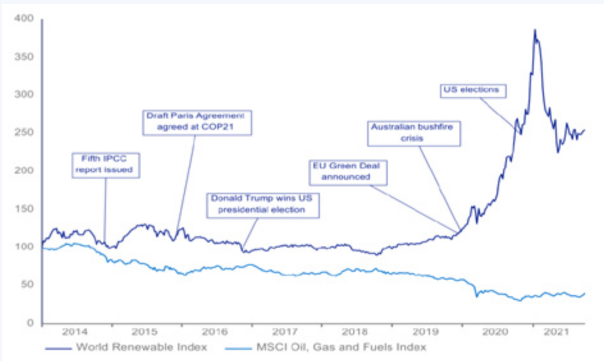
Policy decisions and targets made during COP26 can have a significant impact on certain sectors and change investors perspectives. For example, the UK has set some of the strictest carbon-reduction goals in the world. It has committed to cutting greenhouse-gas emissions by 68%, compared to 1990 levels, by 2030 – the fastest rate of any major economy. It plans to slash emissions by 78% by 2035 and reach net zero by 2050. To help achieve this, it has banned the sale of new petrol and diesel cars and vans from 2030, and hybrids by 2035. Given the likely growth of EVs, several manufacturers have already committed to ending pure-ICE sales before 2030. Bentley recently announced that it would sell only electric cars from 2030, while Volvo is committed to only offering electric or plug-in hybrid models from 2025.

Additionally, the Sustainable Finance Action Plan (SFAP) is a major policy objective by the European Union which aims to promote sustainable investment across Europe. It was first laid out by the European Commission in March 2018 and led to the creation of the Sustainable Development Goals. A core tenet of the EU SFAP is the Sustainable Finance Disclosure Regulation (SFDR), which will classify investment funds according to their sustainability credentials for the first time. SFDR sets out a number of actions aimed at 'greening' the finance industry. It aims to make the sustainability profile of funds more comparable and better understood by end-investors, using pre-defined metrics for the ESG characteristics used in the investment process.

Greenwashing continues to be a major concern for ESG investors and regulators alike, due to which we are seeing an increase in disclosure related regulation being passed. In Europe, the EU Taxonomy – a framework for classifying environmentally-sustainable economic activities, comes into effect in 2022. On a global level, the Financial Stability Board created the Task Force on Climate-related Financial Disclosures (TCFD) to improve and increase reporting of climate-related financial information by public companies and other organizations. The TCFDs are important for businesses to improve their own understanding of their long-term climate-related risks and opportunities. Further, they matter because of the growing pressure on companies from governments, consumers and investors to respond to climate change. More governments will shift from recommending the TCFDs as guidance to enacting laws and policies to embed the recommendations into mandatory legislation and regulation. In the UK, the FCA is set to publish its own TCFD report next year.

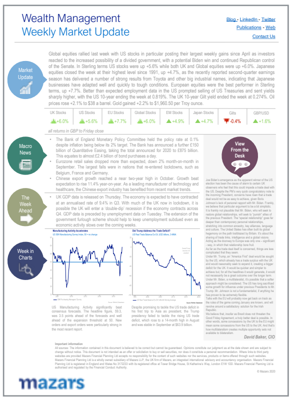
Renewable stocks have significantly outperformed traditional energy stocks

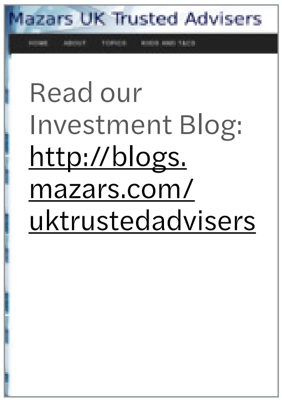
Global renewables vs oil and gas since 2014



Source: Refinitiv Datastream

More reading...





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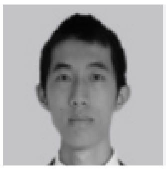

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