Monthly market blueprint

Investment management service

December 2021

mazars

Contents

Foreword 1
Market performance 2
Asset allocation 3
Risks ahead 4

Macroeconomic backdrop

Global macroeconomic backdrop 5
UK macroeconomic backdrop 6
US macroeconomic backdrop 7
Europe macroeconomic backdrop 8
Japan and emerging market macroeconomic backdrop 9

Themes

Macro theme 1: Containing Covid 11
Macro theme 2: Central banks learn their inflation limits 12
Macro theme 3: China's property sector woes 13

Spotlight

Equity spotlight: Income – what next for income investors? 14
Fixed Income spotlight: Where now for volatile bond yields? 15
Equity spotlight: COP26 - a recap and what it means for investors 16

Foreword

It's not inflation that will 'transition'. It's everything else.

The Omicron variant was not much of a surprise. We have already seen many mutations of Covid-19. But a hawkish Fed? We haven't experienced one since 2018. As the potential of a new outbreak emerges, Fed Chair Jay Powell surprised markets by insisting that the US central bank would accelerate asset purchase tapering in December. Instead of customarily intoning the 'Fed Put', as per usual in times of crisis, Mr. Powell added fuel to the fire, causing unusual, for December, equity volatility.

The unspoken truth amongst policymakers is that supply chain optimisation, not central bank policies, kept prices in check. In other words, their basic mandate, inflation, has long been out of their control. Because it was going down, not up, no one bothered. Central bankers, instead, focused on maintaining financial stability by increasing banking oversight and flooding financial systems with cash.

Let us not lose sight, then, of what central banks have evolved into by pretending they can still adhere to their inflation mandate. They transitioned their institution from 'stewards of inflation' to 'risk enablers' for financial markets. Central bankers should have learned that they have no control over prices, after a decade of 'Japanisation' of their economies, where they tried, and repeatedly failed to bring inflation up to 2%. Their attempts to lift the long part of the yield curve (to make money lending profitable again) and inflate away some of their countries' soaring post-GFC debt simply did not work.

So why are they even trying? We think the answer is surprisingly simple: politics. To misquote Mr Friedman, 'Inflation is everywhere and anywhere a political problem'. Inflation is a very visible 'tax' on consumer incomes. This causes incumbent governments to become unpopular, as Mr Biden recently found out. Elected leaders are ready to shoulder the political cost of taxes they impose, usually on a specific and targeted segment of the population. But inflation may wreak havoc across the board and seriously disrupt political planning.

This puts the onus on central banks to demonstrate that they can control inflation and that their sole job is not to prop up asset prices. Likely, central bankers aren't blind to the limits of their powers. Still, they are responding to inflation with more hawkishness to reassure both the public and their political superiors that they are in control.

As for inflation? If interest rates aren't the way to control it, we may have to learn to live with it, perhaps for a few years. Central banks will have to decide whether they are willing to let the mid and long-end yield of the curve adjust (which means 3-5 year rates over 3-4%) or face a permanent reality where the sole purpose of bonds as an asset class is capital appreciation because of institutional demand.

Our base-case scenario remains that a sharp market downturn should reaffirm the 'Fed put', the promise that the world's de facto central bank will unequivocally add to asset purchases whenever risk levels rise beyond comfort.

However, we now find that the probability of a cyclical or even secular hawkish shift of central bankers is not infinitesimal anymore. It is an observable and quantifiable scenario. As investors, we should at the very least be prepared and positioned for more market volatility and different patterns for assert returns as we are entering what is promising to be another exciting year.

George Lagarias
Chief Economist, UK

Market performance – in a nutshell

The month in review

Omicron sparked a retreat in risk assets which saw equity markets end the month in the red.

Most of November's market movements were undone by the emergence of the Omicron variant of Covid-19 from South Africa in the last week of the month. The result was a sharp sell-off in risk assets and a reallocation into investment grade bonds.

The most widely telegraphed moves took place in the equity markets as shares fell sharply on the last trading day of the month. The US equity market ended the month down -0.7%, having given up some of the gains that led to new all-time highs earlier in November. European equities were down -2.4% in November, more sensitive to the effects of Covid and the responding to the willingness of governments to impose lockdowns to control the spread of the virus.

In the UK equities moved broadly in line with European peers, falling -2.2% in November. The biggest driver of this fall was investors selling shares of companies in the most economically sensitive sectors, energy and financials.

Emerging market equities fell -4.1% due a combination of being exposed to a fall in global economic activity as well as the potential complications arising from having administered fewer vaccinations than Developed Market countries. Japanese equities fell almost as much as EM equities, -3.6%, as Emerging Asian nations make up 4 of 5 Japan's biggest export markets, meaning their economic pain will also be felt in Japan.

Concern about the spread of the Omicron variant dwarfed the concerns about central banks and their moves to tighten monetary policy in response to rapidly rising inflation.

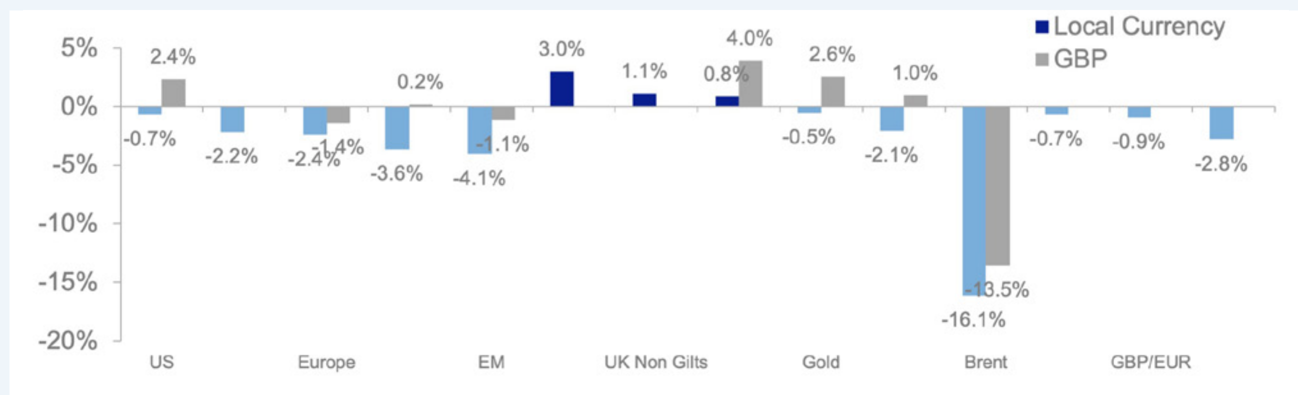
The Bank of England was widely expected to raise interest rates at the start of November but instead stood pat, which sent gilt prices higher and yields lower. The 10-year UK Treasury yield fell from 1.03% to 0.81% in November.

The movement in all major bond yields was linked to expectations that the economic impact of the Omicron variant will cause central banks to slow or halt plans to tighten monetary policy.

The asset that saw the biggest fall due to Omicron was oil, which fell -16.1% on fears about virus' spread impacting economic activity and oil demand.

GBP fell -1.3% against the US dollar and -0.9% against the Euro, flattering returns of investments denominated in euros and US dollars for UK investors.

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 a 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.

We reduced our UK equity position to achieve a smaller position overall in equities. We still feel the UK's cheap valuation relative to developed world peers makes them attractive to hold and would make them relatively resilient if a risk-off mood were to take hold among investors.

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

Mazars balanced portfolio as of 3 December 2021

Risks

Inflation, meet Omicron. Omicron, say hello to inflation.

2021 is the year of recovery after a period when global economic growth faltered at the swiftest pace since WWII. 2022, however, is not expected to be the year when things get back to normal. It is a year of great uncertainty and a wide variety of outcomes. At best, it will be a year that we take another step towards normality. It may well be a year when operations managers and CEOs decide to make adjustments towards a less-mobile future. Its' course will depend, by and large, on the Omicron variant, a highly transmissible string of Covid-19 with the dynamic to either end the pandemic or set the recovery back. Additionally, investors have to contend with inflation threatening to throw fixed income real returns deep into negative territory, hawkish central banks and nearly broken supply chains, not to say anything about the Chinese economic transition.

Given low bond returns, investment arsenals are primarily confined to expensive and diverse set of equities.

From an economics perspective, the Chinese slowdown is putting more pressure on supply chains which are already near breaking point, 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. Until two months ago, generalised lockdowns were not in the picture. The Omicron variant, or a subsequent one, could potentially change that.

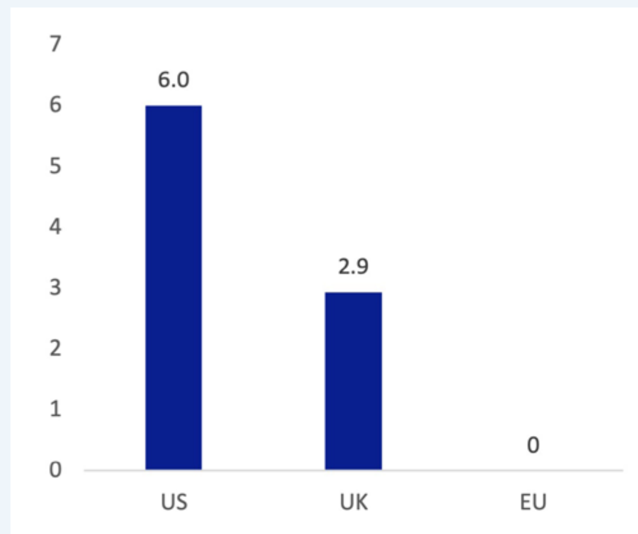
The key risk for investors is an inflation-driven paradigm shift. If stimulus causes higher inflation, central banks may have to rethink a 12-year monetary accommodation regime. Slower growth could mean a stagflationary environment, to last 1-3 years.

Upside risks, however, also exist. The potential of a highly transmissible, non-vaccine resistant but low impact variant, could effectively end the worst aspects of the pandemic. While this may be welcome from a consumer standpoint, the effects on supply chains are unknown.

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.

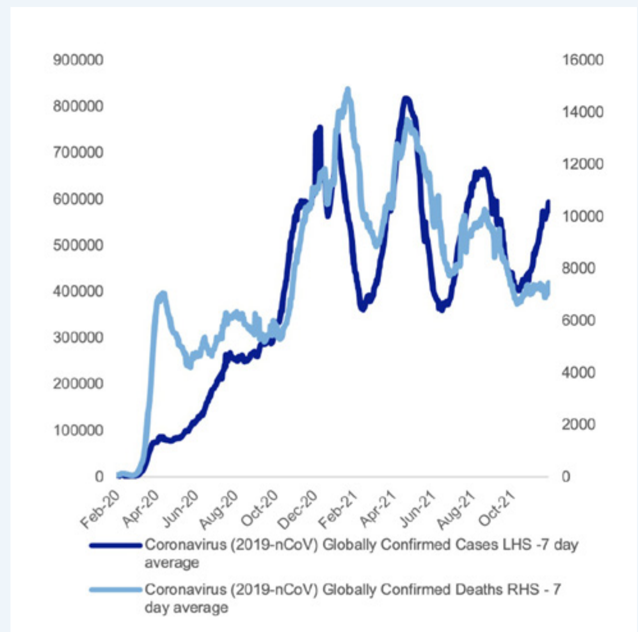
More hawkish central banks

Rate hike expectations



Covid-19 is on the rise again?

Global Covid cases and deaths



Charts source: Johns Hopkins, Mazars Calculations

Macroeconomic backdrop

Global

For the period, global stocks fell by 2.2% (0.8% in GBP). The highest performing sectors were IT and Cons. Discretionary while the worst performers were Energy and Financials. Equities were trading at 19.5x times forward earnings, 16.4% above long term average. Gold fell 0.5% and oil prices fell 20.8%.

Economic performance has picked up significantly in the past few months, both in terms of services and manufacturing. While the global economy remains well into expansionary territory, momentum is stalling as the Omicron variant continues to advance and supply constraints may already be impacting demand.

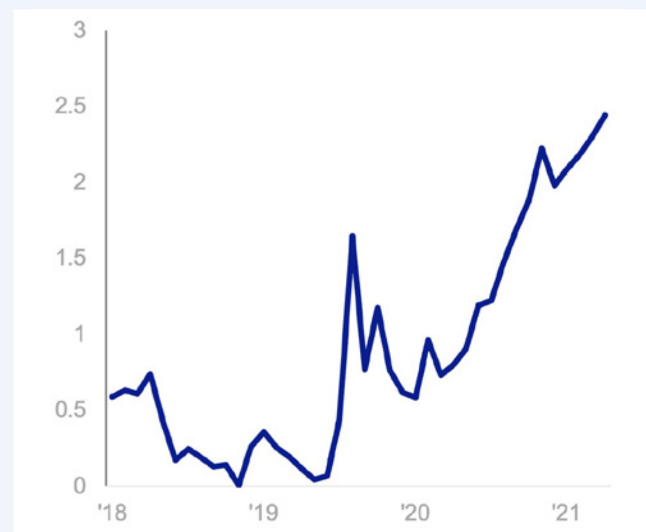
Supply chain issues continue to plague the global economy, with transport rates and delivery times at all-time highs. Manufacturing demand has shown signs of abating due to weaker international demand, but capacity remains very tight, as backlogs continue to increase. In the services sector, which accounts 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. 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.

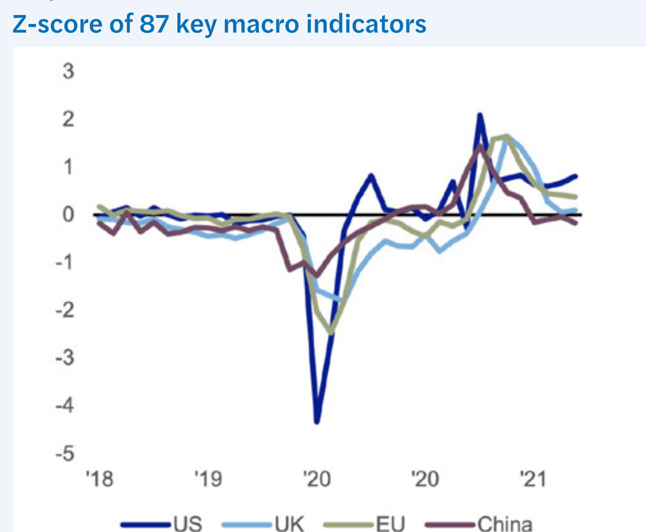
Supply chain pressures are getting worse

Z-score of eight key supply indicators



Still, the global economy is well into expansion territory

Z-score of 87 key macro indicators



Charts Source: Mazars Calculations

Macroeconomic backdrop

UK

The UK has been roiled along with other developed markets since the Omicron variant was discovered. While valuations ought to be supportive, the weighting to economically sensitive sectors has hit the market.

Towards the end of November, the Omicron variant caused consternation among investors as fears that the new variant of Covid 19 would lead to shuttering of the global economy to prevent the spread of the virus.

The cheap valuations of the UK have been highlighted as giving potential for capital growth as valuations converge with global peers. Equally, were markets to suffer a setback, it was expected that the UK would remain insulated to a degree, due to its lower valuations. This has not been the case as UK equities markets underperformed the US in the last week of November as the Omicron variant came to light.

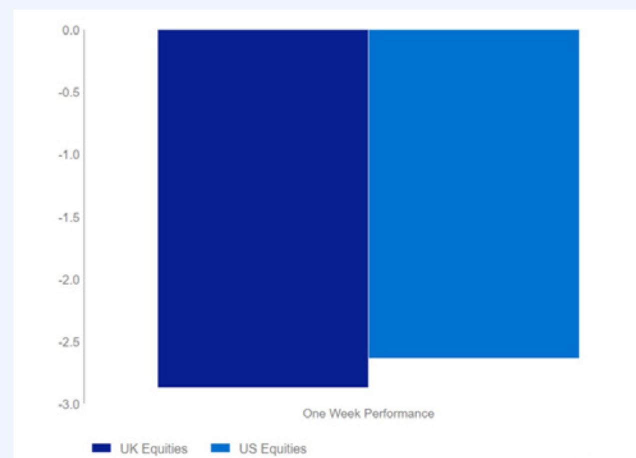
Here the constituents of the index are relevant. If Covid flares up, the UK market is exposed to any slowdown in economic activity as some of the largest constituents are cyclical sectors like energy and financials. Oil and gas and financials together account for approximately one-third of UK equities.

This nuance demonstrates that a simple metric such as price/earnings ratio in isolation is unlikely to hold predictive power. The broader context must always be taken into account. Fortunately, we reduced our UK exposure at the beginning of Q4 as we reduced risk in our portfolios.

Outlook: The recent dynamic seen in the markets may lead investors to question the benefit of investing in lower valued companies does not completely contradict the arguments that had been put forth as to why UK equities were attractive relative to global peers that trade at higher valuations. As Covid recedes we see less drag on the economy as we see fewer lockdowns. This should reduce the downside risks to the UK market.

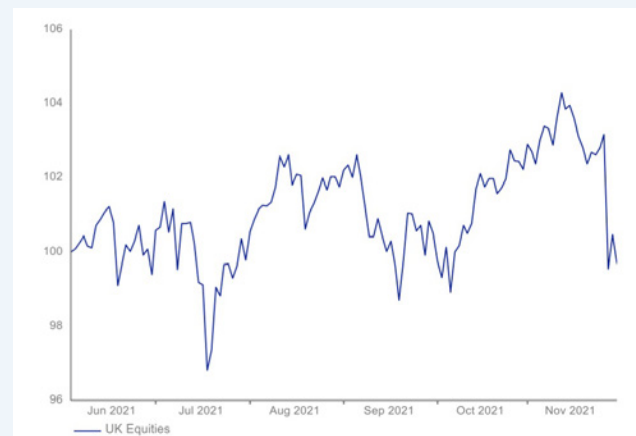
UK Equities have not outperformed the US during the latest bout of volatility

Equity performance for the last week of November



The latest bout of volatility leaves UK Equities unchanged over 6 months

UK Equities 6-month price performance



Charts Source: Refinitiv Datastream

Macroeconomic backdrop
US

For the period, US stocks fell by 0.7% (2.4% in GBP). The highest performing sectors were Homebuilding Index and IT while the worst performers were Telecoms and Energy. Equities were trading at 21.83x times forward earnings, 22.9% above long-term average and 12% above the MSCI World. 10y bonds fell 11 bps at 1.444%.

Economic conditions in the US remain firmly in expansion territory, with the region outperforming other developed markets. Having said that, momentum, especially in manufacturing, is gradually losing steam, despite strong new orders, as capacity and inventories remain challenged, supply delays are near-record and businesses are struggling with high costs, supplier and labour shortages. In the services sector, backlogs continued to rise fast, while a resurgence of Covid-19 weighed on new order growth. Consumer spending increased at a moderate pace and employment conditions improved, despite a November disappointment in payroll numbers. Still, childcare, retirements and Covid-19 continue to weigh on employment availability and push wages up.

Supply side pressures continue to have a significant impact on prices, with core consumption expenditure recording a 4.1% rise, the highest figure since 1991.

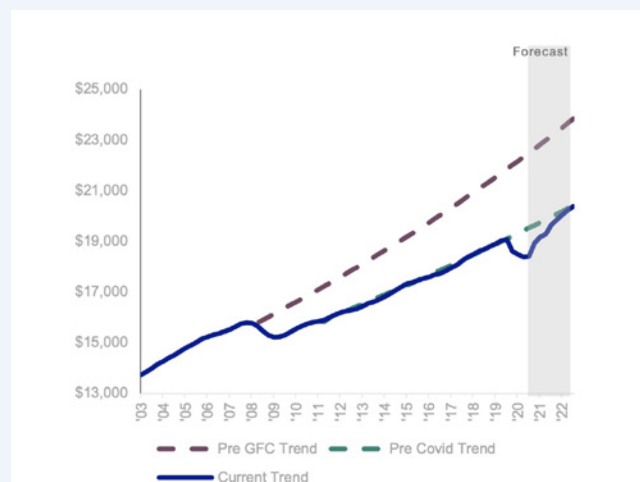
As a result of inflationary pressures, the Federal Reserve, whose Chairman, Jay Powell, was re-nominated to hold his post, adopted a more hawkish stance, especially in tapering asset purchases, causing some market volatility in early December.

Equities, led by a narrow band of eight tech-related stocks, remain very expensive by historical standards and relative to their global peers. However, a string of strong corporate earnings in the last few quarters has served justification for current valuations. Meanwhile, bond yields remain low, despite the hawkish Fed and rising inflation, suggesting that bond markets have yet to price in significant changes in the way the central bank intervenes with markets.

Outlook: We remain positive on the region, both economically and in terms of risk assets. The US economy leads the global recovery and it's market is still favoured amongst investors. Having said that, most of the good news are already priced in, while a resurgence of the pandemic is probably not. Thus, we remain equal-weight for the region.

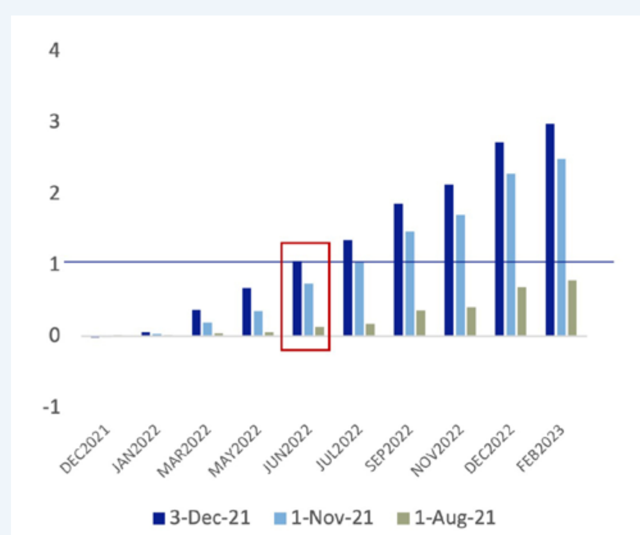
US Set to return to trend growth by the end of 2022

Z-score of leading indicators



First rate hike priced in from June 2022

Rate expectations, implied by futures



Charts Source: Mazars Calculations

Macroeconomic backdrop

Europe

In November, European stocks fell by 1.4%. The highest performing sectors were Telecoms and Utilities, while the worst performers were Energy and Financials. Equities were trading at 16.65x times forward earnings, 7.8% above long term average, and 39% below the MSCI World. 10y Bunds fell 24 bps at -0.349%.

The Eurozone manufacturing sector stabilised in November according to Markit PMI data, moving from 58.3 in October to 58.4 in November after several consecutive months of slowdown. The services PMI also rose, reaching a level of 55.9, compared to the October value of 54.6, indicating an increasing rate of expansion. Supply chains remain under extreme stress despite strong demand, as shortages of inputs restrict production growth.

Inflation rates in Eurozone countries rose to record levels this month, as inflation was reported at 4.9%, above the 4.5% predicted by economists and the highest since the creation of the Euro. German inflation was also reported at 6%, the highest since 1992.

These figures undoubtedly put pressure on the ECB, which sets a target inflation rate at 2%, to reduce their monetary stimulus. Key officials in the ECB have stated that the central bank is serious about ending pandemic bond-buying, but that flexibility may be maintained, allowing for purchases to restart if necessary.

November also saw a powerful resurgence of coronavirus cases in Europe, leading many countries to reimpose public health restrictions. The situation was exacerbated by the emergence of the Omicron variant, which has been detected in most European countries, and has recorded rapidly increasing case numbers across the continent.

After two months of intense negotiations, the make-up of the German government has become clear. Olaf Scholz is set to succeed Angela Merkel as the Chancellor of Germany after her 16-year tenure. Scholz's centre-left Social Democratic Party will form a coalition with the Greens and the Free Democrats.

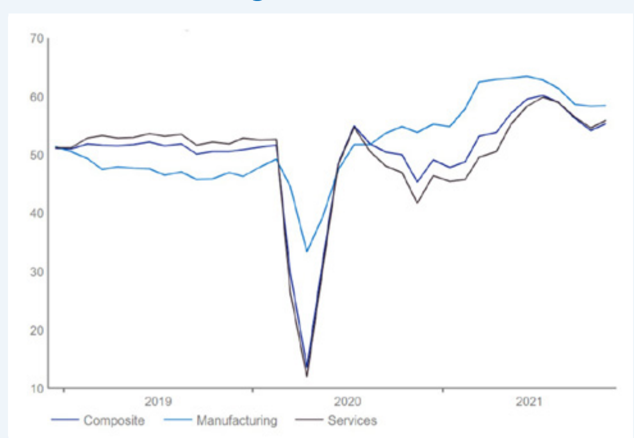
Outlook: The main factors for economic performance in the next months are the impact of rising Covid-19 cases on supply chains and government policy. The ECB's stance on inflation will be decisive for market sentiment.

Eurozone inflation at highest level since launch of the euro

Euro area inflation rate

Euro area PMIs

(Index, 50 = no change)



Charts Source: Refinitiv Datastream

Japan and emerging markets

In November, emerging market stocks fell -4.1% and -1.1% in local and Sterling terms respectively. Japanese stocks fell -3.6% in local terms but rose 0.2% in Sterling terms. The best performing sectors in emerging markets were energy and transportation while the worst performers were healthcare and technology.

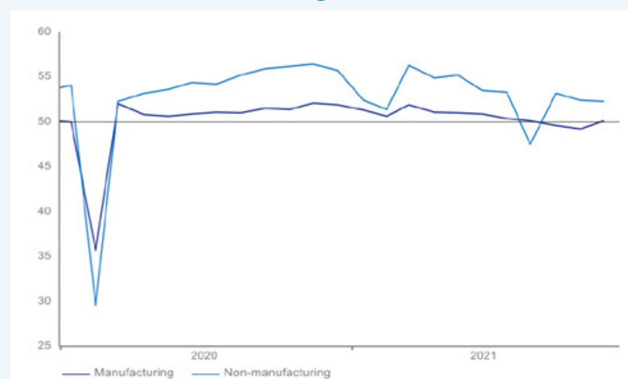
China's regulatory crackdown in sectors such as technology, property, gaming and education has caused significant market volatility over the recent past. The property sector in particular is facing a liquidity crisis of sorts as multiple developers across the country have signalled the possibility of defaulting on their debt. The property sector makes up a significant chunk of the country's GDP and policy intervention to save it is likely. China's producer price inflation surged by 13.5% YoY in October 2021, following September's figure of a 10.7% rise. This was the tenth straight month of increase in factory gate prices and the strongest growth since 1995, amid a jump in cost of raw materials and widening power shortage. The NBS manufacturing PMI rose to 50.1 in November from 49.2 in October. The Caixin/Markit Services PMI fell to 52.1 in November from 53.8 in October, indicating a slowdown in service sector activity.

The Japanese economy shrank 0.8% QoQ in Q3 2021, compared with market expectations of a 0.2% fall and after a 0.4% growth in Q2, amid a resurgence of Covid-19 cases and persistent global supply chain disruptions. On an annualized basis, the GDP contracted 3.0% in the third quarter. The Manufacturing PMI of Japan was 54.5 in November, following a reading of 53.2 a month earlier. This was the tenth straight month of expansion in factory activity and the strongest pace since January 2018, lifted by soaring vaccinations and easing lockdown restrictions. Both output and new orders grew to the quickest pace in seven months, while new export orders growth hit a five-month high.

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.

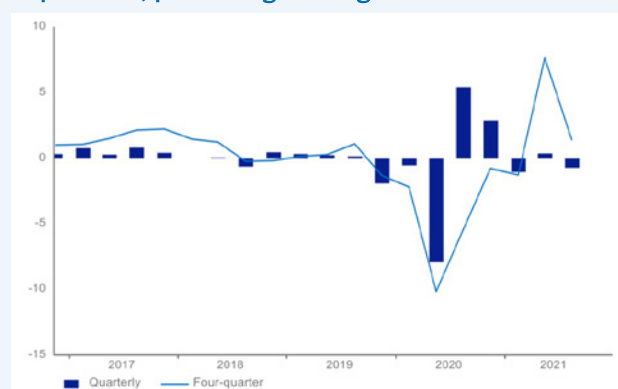
China's economic recovery remains fragile

China PMIs, 50 = no change



Japan's economy shrinks faster than expected in Q3

Japan GDP, percentage changes



Charts Source: Refinitiv Datastream

Our themes

Containing Covid

The contrasting approaches to lockdowns of Europe and the UK

The UK and Europe have taken different approaches to Covid restrictions since the beginning of 2021. The UK has appeared more reluctant to impose restrictions on its citizens while European leaders have preferred to err on the side of caution to contain infections. The UK's vaccination effort has been the biggest factor explaining this difference and now that the Omicron variant has arrived, the divergent paths of the UK and Europe could continue.

There has been a tendency to characterise the UK's approach to imposing lockdowns as more laid back, preferring to prioritise the economy and a "return to normal". This reputation may have stuck after the British government was slow to enact restrictions when the virus first appeared in March 2020. In 2021 the UK has continued along a more lax path and imposed fewer days of lockdowns than some European countries. Even before Omicron emerged, some European countries were again imposing restrictions and even mandatory vaccinations. Vaccinations are the key to lifting restrictions.

The reason the UK has been able to impose fewer restrictions in 2021 is that the vaccination programme moved at a much more rapid pace than in Europe, thanks to effective procurement by the British government and the effective distribution network of the NHS.

Now we face a new threat in the form of Omicron. Initial findings show that the latest variant of the virus spreads more rapidly than previous variants and that its mutations may make it less susceptible to being suppressed by the vaccine.

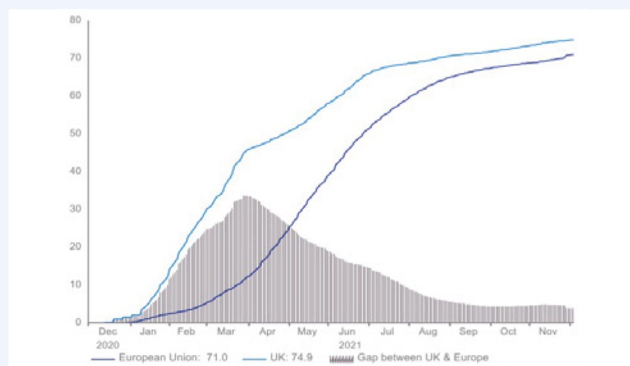
There have been competing theories about how effective the existing vaccines will be against this latest variant. While it is not fully tested, it appears that vaccines still protect against extreme illness which should limit the need for hospitalisations. Hospitalisations are still a key data point for policymakers in deciding to impose lockdowns and so vaccinated populations will continue to reduce the need for such restrictions.

Looking at the number of booster vaccinations, the number of vaccinations given in Europe is far behind that in the UK. This indicates that the UK may continue to avoid the severity of lockdowns we are seeing in Europe.

European stock markets fell more than the UK when the Omicron variant was uncovered. This is at least partially a reflection of concerns about the European economy being closed down to control the spread of the virus. The UK's advanced vaccination efforts again lead us to believe that the UK will be protected from the harshest forms of lockdown, which justifies our relative overweight position in UK equities.

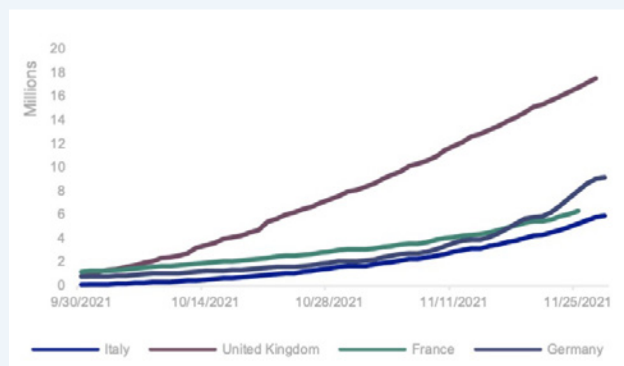
Vaccinations in 2021

First doses administered



Booster vaccines

Number administered



Charts Source: Refinitiv Datastream

Macro theme 2

Central banks learn their inflation limits

Operations managers are approaching the point where they have to overhaul global supply chains and adapt them for a world with much less business travel, labour mobility and in-person services, including sales. Such a transition will inevitably disrupt the global supply chain system, super-optimised and calibrated for a way of life that may not be available anymore. As with any change process, it can't be expected to go entirely smoothly. Add to this picture the price pressures from China's transition into a more consumer-centric model, and supply inflation may be here to stay for some time.

On the face of it, then, it might sound wise and even timely that the Fed decided to drop 'transitory' from its vocabulary.

True wisdom, however, does not come from optimising predictions, especially after the event. As any person over a certain age knows, it comes from accepting what one can't control.

The last twenty years saw a persistent drop in prices, as a result of globalisation. The unspoken truth amongst policymakers is that supply chain optimisation, not central bank policies, kept prices in check. In other words, their basic mandate, inflation, has long been out of their control.

So far, price rises have been focused on a small part of the economy, namely energy and used car prices (as manufacturers struggle to deliver new vehicles due to microchip shortages). Gasoline and heating prices went up for some consumers (many are still on fixed or capped heating bill rates), but overall prices in the supermarkets remained under control. This has begun to change. Food inflation in the US is now 5.6% per annum. In the UK it remains controllable, 1.3% and so in the EU, 2.3%. But it has been on the rise.

This puts the onus on central banks to demonstrate that they can control inflation and that their sole job is not to prop up asset prices. Likely, central bankers aren't blind to the limits of their powers. Still, they are responding to inflation with more hawkishness to reassure both the public and their political superiors that they are in control.

It's not just the US. Or the UK, where the newly installed Bank of England leadership has shown indecision regarding interest rates.

Our four basic scenarios on growth and inflation

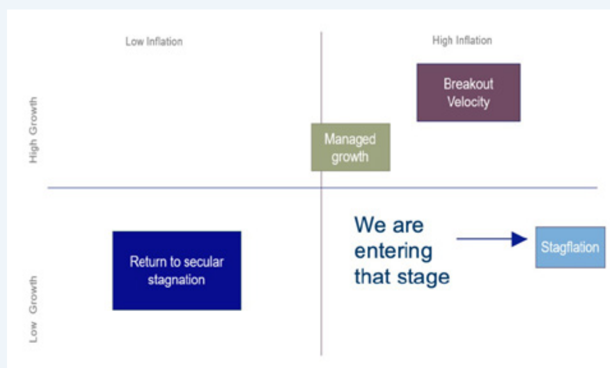


Chart Source: Mazars Calculations

Some countries, like Germany, are more sensitive to inflation than others. German CPI at 6% is now at the 95% percentile (top 5%) since the country's post-reconstruction in the 1950s. German consumers are already disgruntled over negative bank rates for over five years and ignoring inflation is politically prohibitive, especially for a fragile and diverse new coalition government.

If interest rates aren't the way to control inflation, we may have to learn to live with it, perhaps for a few years. Central banks will have to decide whether they are willing to let the mid and long-end yield of the curve adjust (which means 3-5 year rates over 3-4%) or face a permanent reality where the sole purpose of bonds as an asset class is capital appreciation because of institutional demand.

Our base-case scenario remains that a sharp market downturn should reaffirm the 'Fed put', the promise that the world's de facto central bank will unequivocally add to asset purchases whenever risk levels rise beyond comfort.

However, we now find that the probability of a cyclical or even secular hawkish shift of central bankers is not infinitesimal anymore. It is an observable and quantifiable scenario. As investors, we should at the very least be prepared and positioned for more market volatility and different patterns for assert returns as we are entering what is promising to be another exciting year.

Read more on our Blog: It's not inflation that will transition, it's everything else

Macro theme 3

China's property sector woes

China's Evergrande Group has rapidly become Beijing's biggest corporate threat as it wrestles with debts of more than $300 billion as a result of years of aggressive expansion. But that was just the tip of the iceberg. The total combined debt of China's major property developers is now estimated at more than $5 trillion. To make matters worse, 20 of the top 30 property firms by sales have breached at least one of three debt limits set by the Chinese government to rein in real estate speculation, meaning they're unsustainable.

With property being a key driver of economic growth – contributing about 29% to China's GDP – any major real estate crash could threaten the entire Chinese economy. Its important to note that China has about 65 million empty homes, which is equivalent to the total number of households in France and the United Kingdom combined, due to a massive building boom and rampant speculation.

Betting on sustained growth, a large proportion of China's population has money tied up in residential property. According to China's central bank, 93.6% of urban households owned homes last year, one of the highest rates in the world. The real estate market has continued to expand because investors, developers and home buyers have generally believed that the sector is too crucial to the economy for the government to allow any significant correction.

While new-home sales dropped 32% last month as the Evergrande scandal unnerved investors, huge differences in the way the Chinese real estate market operates could limit the impact of any bubble bursting. One reason for that is that typically a Chinese buyer will only take a 60% bank loan to buy a property. Down payments are therefore 40%, compared to just 3-6% in the US, 5-15% in the UK, and 20% in Germany. So, even if property prices drop 20-30% and there is a rise in defaults, the banking sector can manage.

China signals easing due to property sector downturn

China reserve requirement ratios, %

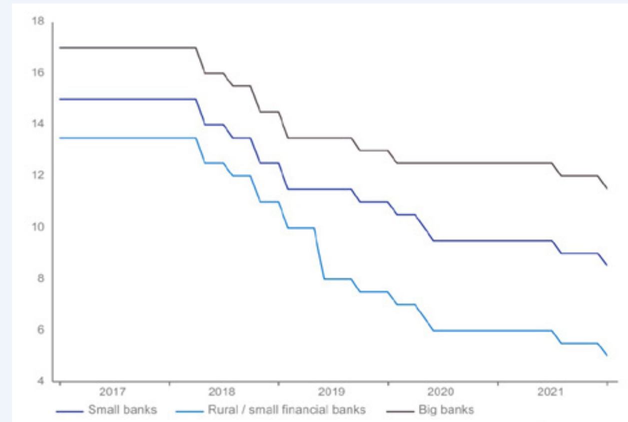


Chart Source: Refinitiv Datastream

That's not to say that some of China's biggest property developers won't go under. In recent weeks, Evergrande and others have struggled to offload assets to help repay their debts. Any collapse of a company like Evergrande — which employs more than 200,000 people and indirectly sustains 3 million jobs — is likely to be carefully managed by Beijing to limit the fallout to the wider economy.

Just this week, China's central bank cut the reserve requirement ratio for most banks by 0.5%. A move that will unleash 1.2 trillion yuan ($188 billion) for business and household loans. Beijing has been very cautious about intervening in China's economic recovery during the pandemic. It hasn't cut the country's benchmark lending rate since early 2020, and has refrained from flooding the economy with stimulus. But China has faced a slew of challenges to growth in 2021, including a power shortage, shipping delays and a crisis in real estate. The central bank's ratio cut sends a signal that policy will turn more accommodative on the property sector.

China real estate woes weaken property investments

China investment in real estate development

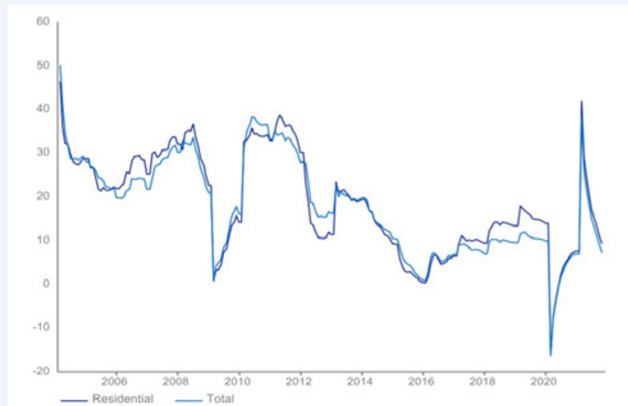


Chart Source: Refinitiv Datastream

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 here we discuss what people should expect from dividend yields, as well as other forms of capital return, and how these can impact share prices.

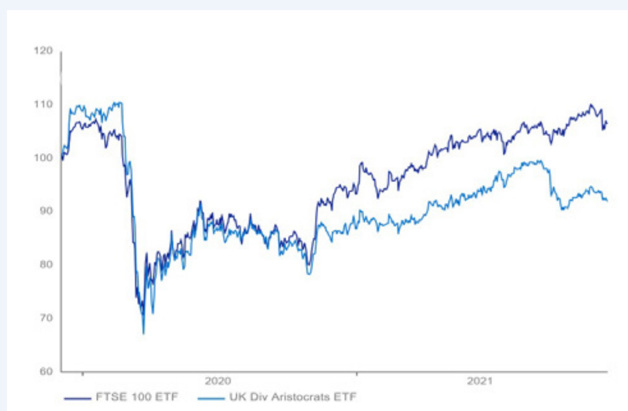
In the midst of the Covid crisis, facing an uncertain future, companies cut their dividends to shore up their balance sheets. Sometimes this was to avoid insolvency, sometimes it was prudent given the extreme uncertainty of the time. Now were are coming out of the pandemic and economic activity is normalising 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 some 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 lead 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

Where now for volatile bond yields?

Government bond yields have been extremely volatile recently as conflicting economic news makes interest rate policy more difficult to predict. Bond yields had been slowly rising across the board, a result of hawkish central bank comments and rising inflation expectations.

In the UK there had been expectations of a rate rise in early November which didn't materialize. In theory a rate rise could come in December, although it is expected to come in the new year

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 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.

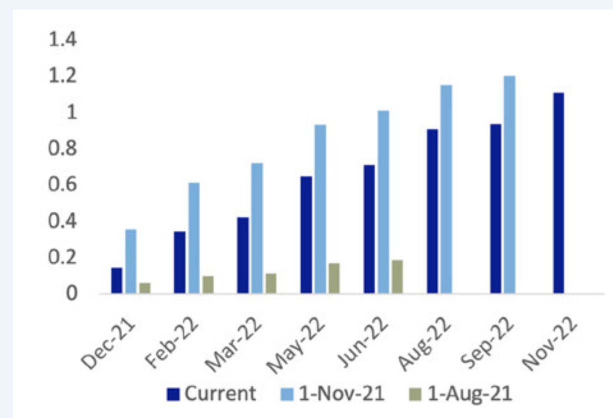
However, the emergence of the Omicron variant of Covid-19 has caused a sharp reversal in the upward trend, and has seen a significant increase in volatility as market participants try to work out how much this is likely to affect central banks' thinking.

This uncertainty comes because central banks have - often conflicting - concerns about maintaining low unemployment while keeping inflation muted.

With Omicron quite likely to force governments into stricter measures in the coming months, this is likely to curtail economic activity. As such it would seem natural that central banks would delay any planned rate hikes to avoid choking off economies at their most vulnerable. In fact in a 'normal' interest rate environment we could perhaps expect rate cuts, but with rates at rock bottom this is highly unlikely. However there is a question of whether central banks can delay acting on inflation, which has proven more persistent than had been initially hoped.

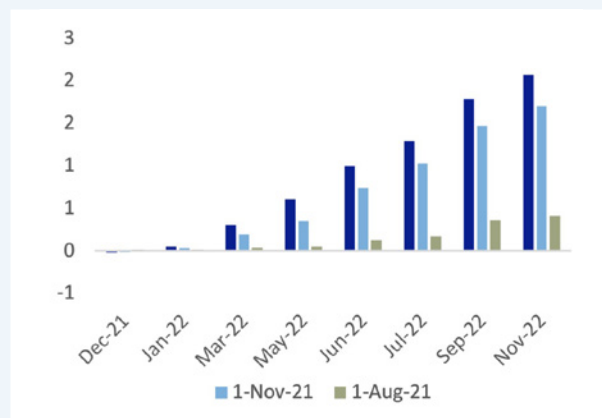
Our view is that the recent fall in yields makes interest rate risk even less attractive, with most of the bad news likely priced in. As such we are likely to remain underweight interest rate risk over the medium term.

UK rate expectations have risen and then fallen



Source: Refinitiv Datastream

While US rate expectations have continued to rise



Source: Refinitiv Datastream

COP26 - a recap and what it means for investors

The latest United Nations climate summit, or COP26, officially concluded on 14 November, ending two long weeks of negotiations in Glasgow, among almost 200 countries.

Scientists and experts have long agreed that it's crucial for levels of warming to stay below the pivotal threshold of 1.5 degrees Celsius above pre-industrial levels, a vital objective of the Paris Agreement (2015) and the point at which the risk of deadly climate disasters surges. The world is currently 1.1 degrees Celsius above pre-industrial levels.

COP26 produced the Glasgow Climate Pact, the first-ever global climate deal to explicitly plan to reduce coal, the worst fossil fuel for greenhouse gases. The pact acknowledges that commitments made by countries so far to cut emissions are nowhere near enough. To solve this, it asks governments to strengthen those targets by the end of next year, rather than every five years, as previously required.

During the conference, some countries did make positive strides in this direction. More than 100 countries agreed to slash their methane emissions by 30%, relative to output in 2020 - and that matters because methane is an incredibly potent greenhouse gas. Another 100-plus nations - holding more than 85% of the world's forests - pledged to halt deforestation and land degradation by 2030.

The United States and China surprised onlookers when they agreed to curb emissions and limit warming over the next decade. The two countries jointly are the world's biggest greenhouse gas emitters, accounting for an estimated 40% of global annual carbon output. China is the world's top emitter, exceeding all developed countries' emissions combined, while the United States is second.

According to the Climate Action Tracker, existing national policies would see the world on track to heat up by 2.4 degrees Celsius by 2100. In acknowledgement of this, countries have agreed to return next year with greater cuts and new targets, accelerating, in theory, their efforts to bend the curve. In acknowledgement of this, countries have agreed to return next year with greater cuts and new targets, accelerating, in theory, their efforts to bend the curve.

Ultimately, COP26 saw nations make some brave promises. In the absence of clear government policies to drive change, the key breakthrough was the agreement to ensure the financial system will deploy capital in a manner consistent with climate objectives. The Glasgow Financial Alliance for Net Zero, an initiative tabled by Mark Carney, saw over 450 financial institutions commit more than USD 130 trillion of private capital to support the net zero transition. Yet governments will still have a key role to play here: a combination of policy incentives and clearer guidance on future regulation will be necessary to enable the financial sector to effectively put its capital to work.

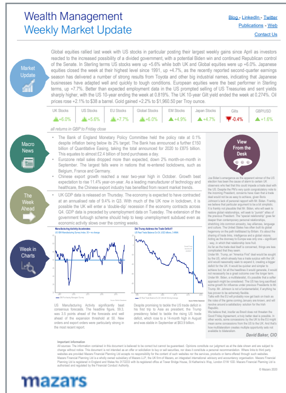
Investors will need to pay more attention to the climate risks in their portfolio. The potential for macroeconomic disruption, not just in carbon-intensive industries but extending across the economy, will increasingly need to be factored in by long-term investors. Physical climate risks will also require careful consideration.

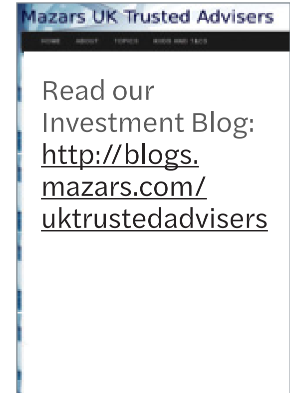
Renewable stocks have significantly outperformed traditional energy stocks

Global renewables vs oil and gas since 2014

Source: Refinitiv Datastream

More reading...





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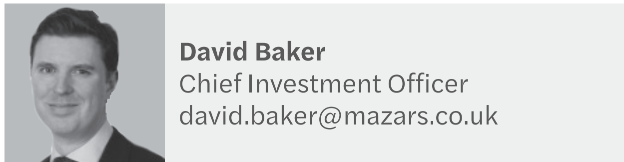

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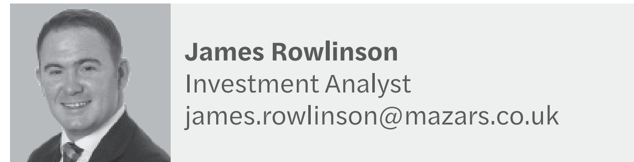

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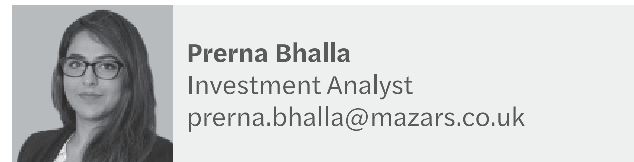

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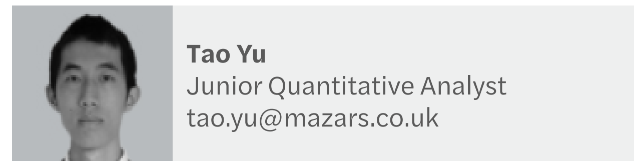

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Chart Sources: Bloomberg. The information contained in this document is believed to be correct but cannot be guaranteed. Opinions constitute our judgment as at the date shown and are subject to change without notice. This document is not intended as an offer or solicitation to buy or sell securities, nor does it constitute a personal recommendation. Where links to third party websites are provided Mazars Financial Planning Ltd accepts no responsibility for the content of such websites nor the services, products or items offered through such websites.

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