Mazars Wealth Management investment newsletter

Winter 2022

David Baker
Partner, Chief Investment Officer
david.baker@mazars.co.uk

Foreword

Stock markets posted strong returns during the final quarter of 2021 despite the emergence of the highly transmissible variant Omicron. Global equities returned over +7% in both local terms and when converted back into Sterling (as the Pound remained remarkably steady in foreign exchange markets) with the United States once again the driver of returns posting near +10% for the period. Europe and the UK trailed the US but still returned around +7% and +5% respectively, but emerging markets continued to struggle in the face of extended Covid pressures and fell marginally during the quarter. UK government bonds sold off during December when the Bank of England decided to raise interest rates, but still provided a +2.3% return during the quarter, although this was not sufficient to prevent gilts losing value over the whole of 2021. Gold rallied a little as markets came to terms with the possibility of longer bouts of higher inflation.

In no surprise to anyone, Covid-19 remained at the epicentre of all matters economic, and the emergence of the highly transmissible Omicron variant forced governments and public health officials to reassess the speed at which normal daily life can resume. In highly vaccinated countries such as in western Europe and the US data suggests a much lower level of disease despite enormous spikes in infections, leading to pressures on healthcare systems (and other businesses and public services) being mainly associated with the need for staff to isolate when infected. Hence talk turns to how countries might move towards ‘living with the virus’, with politicians once more in the spotlight as they are forced to decide how to balance health, economic, and social considerations.

The most significant economic by-product of the pandemic is inflation. Lockdowns led to both demand surges for manufactured products and disruption to supply chains, a simple recipe for higher costs in many markets. Though supply side pressures will ease at some point, we should not forget that many lower wage economies where manufacturing takes place remain largely unvaccinated and susceptible to Covid. Talk of ‘transitory’ inflation has gradually disappeared, with fears now turning to the possibility that supply side inflation begets wage inflation as labour markets start to recognise the rising costs of living. Central Bank rhetoric has certainly changed in recent months and now strikes a much more hawkish tone.

The continued buoyancy of equity markets is therefore challenged. Equity prices are still underpinned by the relative unattractiveness of cash and bonds, but with inflation becoming a feature of developed markets and monetary tightening occurring more quickly than expected the question is whether equities can hold their values in the absence of continued quantitative easing and the presence of rising interest rates. It is worth remembering that not all stocks are equal and dispersion of valuations within stock markets is extreme. This fact combined with the possibility of economies reopening more during the year means that active fund managers have an opportunity to outperform the index.

At our January meeting the Investment Committee voted to maintain our neutral position in equities. We continue to hold a balance between value and growth stocks, and favour the UK on a valuation basis. Whilst not our central thesis, we acknowledge the possibility of interest rates rising more quickly than markets currently price in and have therefore reduced the interest rate sensitivity within our bond holdings.

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

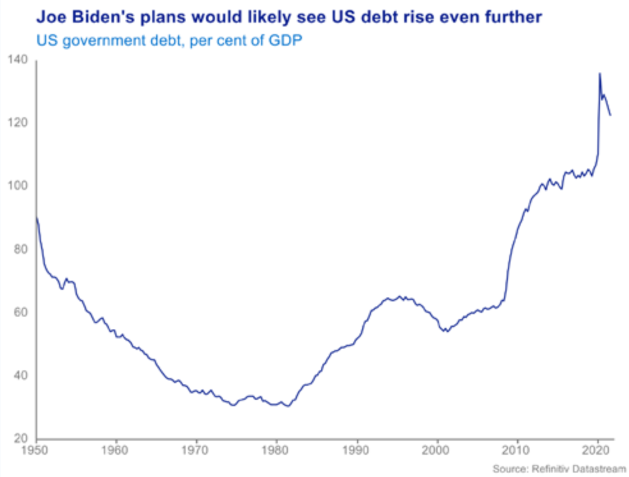
Economies and markets in brief

Inflation

Despite central banks previously projecting that inflationary pressures were likely to be temporary, we go into 2022 on the back of a December 0.15% increase in interest rates in the UK, with the Federal Reserve expected to start hiking by the middle of the year. For now inflation lools like being higher for longer, with markets pricing in a UK average of c.4% over the next five years and nearly 8% next year. Both the BoE and the Fed are expected to raise rates three times next year to dampen the demand factor from further driving prices higher, even though to date inflation has been driven by supply side issues. All these factors make owning bonds, particularly those with longer maturities, a riskier bet as they should exert upward pressue on yields.

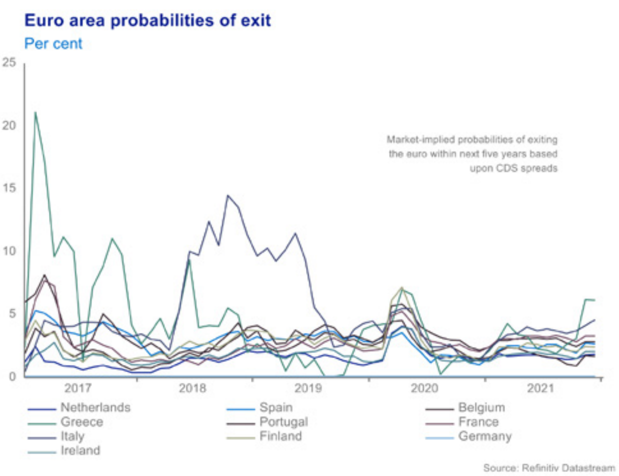
No ‘Build Back Better’

‘Centrist’ Democrat senator Joe Manchin has declared he cannot vote for President Joe Biden’s ‘Build Back Better’ legislation, which would have seen spending of c.$1.7tn to update America’s infrastructure. This figure had already been whittled down significantly from the levels more progressive members of the Democratic party had wanted. However the 50-50 split in the US Senate means that the Democrats cannot afford to lose a single vote, which has given Mr Manchin, who represents the heavily conservative state of West Virginia, significant bargaining power. It is possible a compromise will be made, however for now this is likely to dampen both growth and inflationary pressures in the US economy.



European leadership

Olaf Scholz has replaced Angela Merkel as German chancellor. He will lead a coalition of the centre-left Social Democratic Party (which he leads), the Greens and the Free Democratic Party. The coalition has been dubbed as a ‘traffic light’ coalition due to the parties’ traditional colours. Despite the change in party leadership, the make-up of the coalition means that there is likely to be a great deal of continuity in terms of policy making, something which is positive for equity markets.

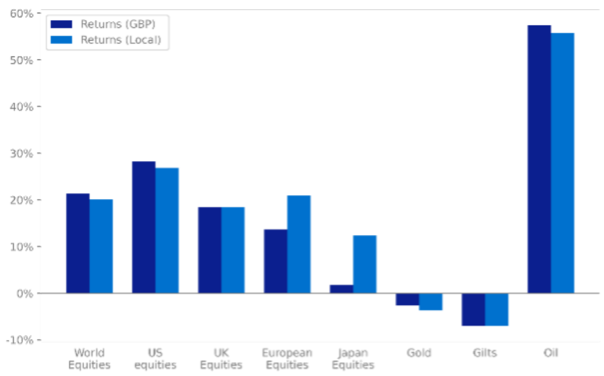


2021: A year of positive asset class returns

2021 saw many equity indices in developed economies reach record highs while posting large returns. Notably, US large cap equities rose +28% in Sterling terms over the year. These returns were however dwarfed by oil, which rose by +57% as demand surged due to lifting of Covid-19 restrictions, and supply was hampered by supply chain issues. Gold had a negative return, perhaps surprisingly as it is considered an inflation hedge, while gilts also performed poorly as yields rose in reaction to hawkish central bank decisions.

A positive year for risk assets

Total return

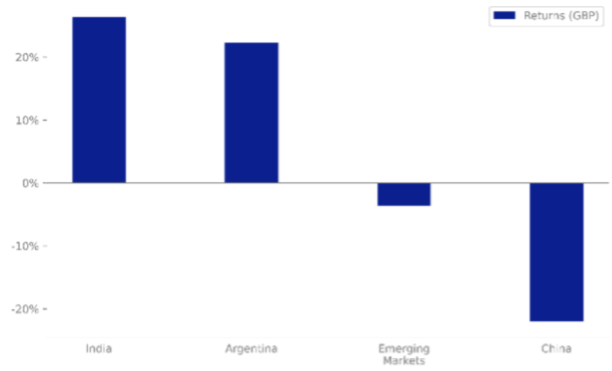


Mixed year for emerging markets

While emerging markets posted losses overall for the year, results varied greatly depending on region. India stood out this year as a particularly strong performer with a yearly return of +26% driven by the technology, basic materials and industrial sectors. India's stock market also benefitted from investors leaving China, where fears of regulatory risks and economic slowdown saw equities fall by -21% over 2021 in Sterling terms. The Argentinian stock market also ranked among the best performing in the world, rising during the year over optimism on talks with the IMF, mid-term elections and provincial debt deals.

India performed well but China was weak

Total return in Sterling



Good year for FAANG Stocks

FAANG stocks generally performed well this year, with Alphabet leading the way with a return of +65%. Amazon was worse off, returning a mere +2.4%, its worst year-on-year increase since 2014, although this time the company was faced which a tough comparison over the previous year where coronavirus restrictions led to a surge in online sales. Apple ended the year as the most valuable public company, and even briefly surpassed $3 trillion in value at one point, making it 65% larger than the total market capitalisation of UK large cap equities.

All but Amazon and Netflix performed well

Total return in US Dollars

Jargon Buster – Filibuster

Historically a filibuster allowed someone opposed to legislation to obstruct the measure by making overly long speeches and running out the clock on the time allocated to passing the legislation. In the United States the filibuster instead means that in the Senate a bill needs 60 votes from the 100 senators in order to be voted on and potentially passed into law. This threshold makes a lot of legislation very difficult to pass since the chamber is generally split close to 50-50 between Democrats and Republicans, meaning that support from the opposition party is needed. There are special budget reconciliation rules that allows some legislation to be passed with a simple majority. Meanwhile some Democrats are talking about changing the Senate rules to remove the filibuster for other types of legislation. In all the presence of the filibuster is making it very difficult for Democrats to pass Joe Biden's 'Build Back Better' legislation and other priorities.

Global asset backed securities – In focus

We are making a change

In order to reduce interest rate risk, we are replacing regular corporate bond exposure with the Morgan Stanley Global Asset Backed Securities fund.

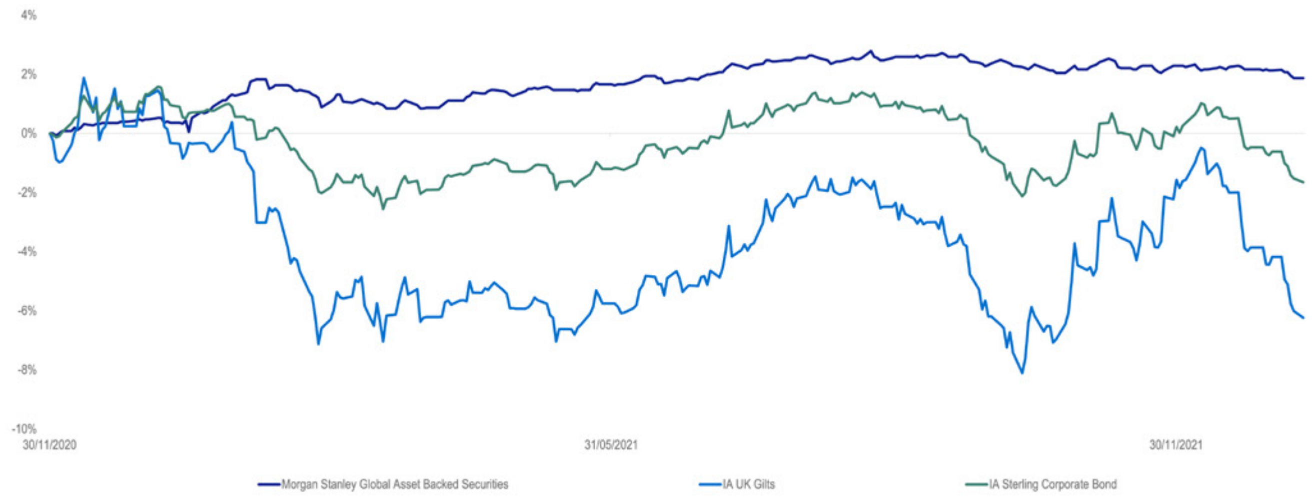
Why the change?

An asset-backed security (ABS) is a type of financial investment that is collateralised by an underlying pool of assets – usually ones that generate cash flow from debt such as loans, leases or credit card balances. The floating rate nature of a lot of the asset backed universe means that, unlike standard bonds, their value is largely unaffected in the event of rising interest rates. Also because of their greater complexity, ABS can be a relatively higher yielding alternative to other debt instruments.

Morgan Stanley Global Asset Backed Securities is run by a well-resourced team that averages 19 years of experience in securitized markets. The fund takes an active and opportunistic approach to investing across a variety of geographies and securitised asset classes.

What is the impact?

Morgan Stanley Global Asset Backed Securities will replace Royal London Corporate Bond in our lower risk regular models (Defensive, Cautious, Income and Balanced) and ASI Ethical Corporate Bond in the equivalent sustainable models.



Source Financial Express Gross Returns in Sterling from 30/11/2020 to 10/01/2022