Monthly market blueprint

Investment management service

February 2022

mazars

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Foreword

She is tossed in the waves, but does not sink

A hawkish Fed has sent volatility spiking, marking one of the most memorable weeks in forty years. On average, for the past five days the S&P 500's gap between the day's highs and the day's lows hit 3.4%. Since 1982, only 2% of all five-day periods have been more volatile.

The most important thing for investors, right off the gate, is that "third standard deviation" events are not tradeable. These are high frequency markets turbo charged by high-powered computers and no amount of analysis, technical or fundamental, has the slightest predictive value. It will, in hindsight, but not now. Gurus will fall and others will emerge after this, but right now forecasters are mostly shooting in the dark. We are in uncharted waters. Consumers are always pricing in more inflation than actual, core goods inflation. The fact that real inflation numbers have caught up with expectations, shows how much momentum prices have right now.

Surveys suggest that consumer are more afraid of the Fed than trust it.

To be certain, after last week, markets are pricing in five rate hikes until the year's end. Still, if the Fed was serious about beating inflation with rate hikes, it would be so far behind the curve that it would take a significant escalation of hawkishness to even begin making a difference in inflation expectations. But it isn't. Record global debt loads simply don't allow for 10% rates. Neither do traders who have learned to rely on the Fed increasing the supply of money every time they felt insecure in the past decade. They would drive the S&P down three thousand points before allowing for money to cost that much.

The Fed is trying to keep wage growth down, by being hawkish enough to lower consumer inflation expectations. Fast-rising consumer inflation expectations suggest that half-measures fool no one. The Fed could either support markets or fight inflation. It chose to do both, which means it chose to do neither.

In other words, the worst has happened: We have runaway inflation, and the Fed is out of ammo. So inflation will have to work itself out. Either underlying demand remains sluggish and eventually we retreat to inflation commensurate to "secular stagnation", plus some "Green Inflation", or we inflation momentum takes a life of its own, like it did in the 70s.

Volatility will have to work itself out too. Currently we are experiencing sharp market gyrations, as investors take profit from popular pricey stocks and wait to see what happens next.

"Fluctuat nec mergitur". Parisians said of their in the 19th century. "She is tossed by the waves, but does not sink". We don't think this sort of turbulence forebodes the end of capitalism. We believe, instead, that we are experiencing the long-awaited return of non-Fed-driven markets, where supply and demand were not dictated by one indicator, but many. The waters will be turbulent. Some will find themselves overboard, most likely due to lack of liquidity (ironically). Some will jump ship and wait, only to buy again when the bulk of good news has been priced in. Not losing is not the same as winning, however. Inflation is a well documented phenomenon, and some assets, like equities or real assets tend to win out. Those investors who believe that the boat won't sink and trust that the money they pay to their asset managers are well spent, may well experience a lot (more) volatility, but they will, probably, have the most prosperous journey.

George Lagarias
Chief Economist, UK

Market performance – in a nutshell

The month in review

In January, markets have been digesting the Federal Reserve's hawkish position and moved lower.

Asset prices fell broadly in January as investors considered the effect of tighter monetary policy. Global equities ended the month -5.2% lower. Bonds prices fell as their relative attraction is diminished in a world of higher interest rates.

US equities fared worst among developed regions as the outsized technology sector came under pressure. Higher interest rates detract from technology companies and other high growth sectors as their future earnings are reduced when discounted with higher interest rates.

European equities performed poorly and fell -4.8% in January, the IT sector was the biggest detractor from the index, for similar reasons to the US.

The UK was an anomaly among global equities in January as the only index to rise, +1.1%. The index's large weight to energy companies was a boon, as the oil price rise with escalated geopolitical tensions in Ukraine. Another of the UK's largest components, financials, also benefited as it became clear that the Bank of England will raise rates faster than previously anticipated.

Japanese equities were in line with global equities and fell -4.8%.

Emerging market equities were lower but only by -1.2%.

Among the 10-year government bonds of major economies the UK's bond fell the most as the yield moved from 0.97% to 1.30%. With the Bank of England sending the signal that combating inflation expectations was a priority, and having already raised rates in December, there may be more conviction around the UK's central bank following through with rate rises compared to other major central banks.

US Government bond yields rose +27bps to 1.78% as the Fed maintained its hawkish stance in regards to righter monetary conditions.

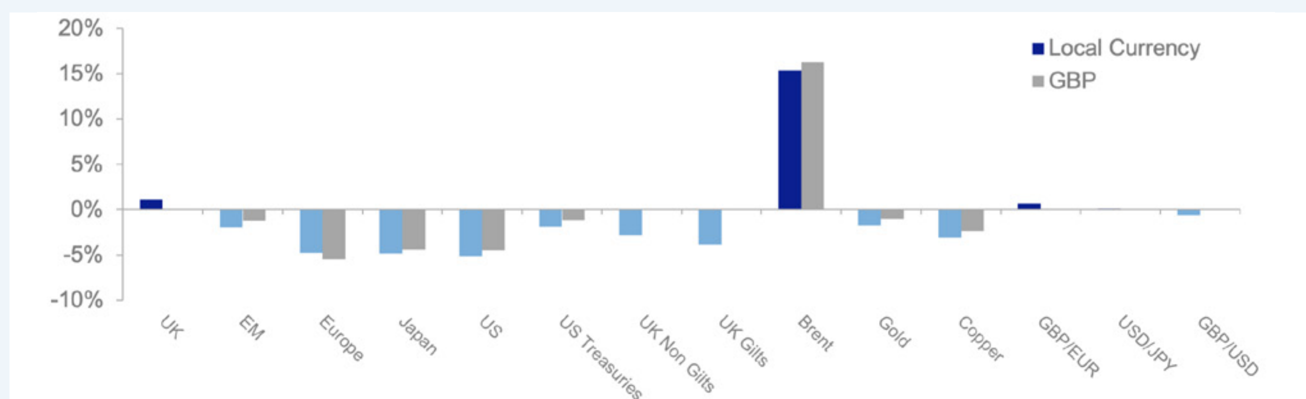
In Europe, the German 10 year ended January in positive territory for the first time in 3 years, with yields rising +19bps to 0.01%.

The oil price was up very sharply with Brent crude oil rising +15%, predominately on Ukraine tensions and any risk that may cause to supply.

Gold held steady, falling -1% in January. Providing diversification benefits to risk assets.

Sterling was weak against the US dollar, falling -0.6% yet strong against the Euro, rising +0.7%.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation

Changes in our Strategic Asset Allocation

Outlook and portfolios

In January our Investment committee voted to keep our asset allocation unchanged. Despite mounting risks we maintain a neutral position in equities and an underweight position in fixed income.

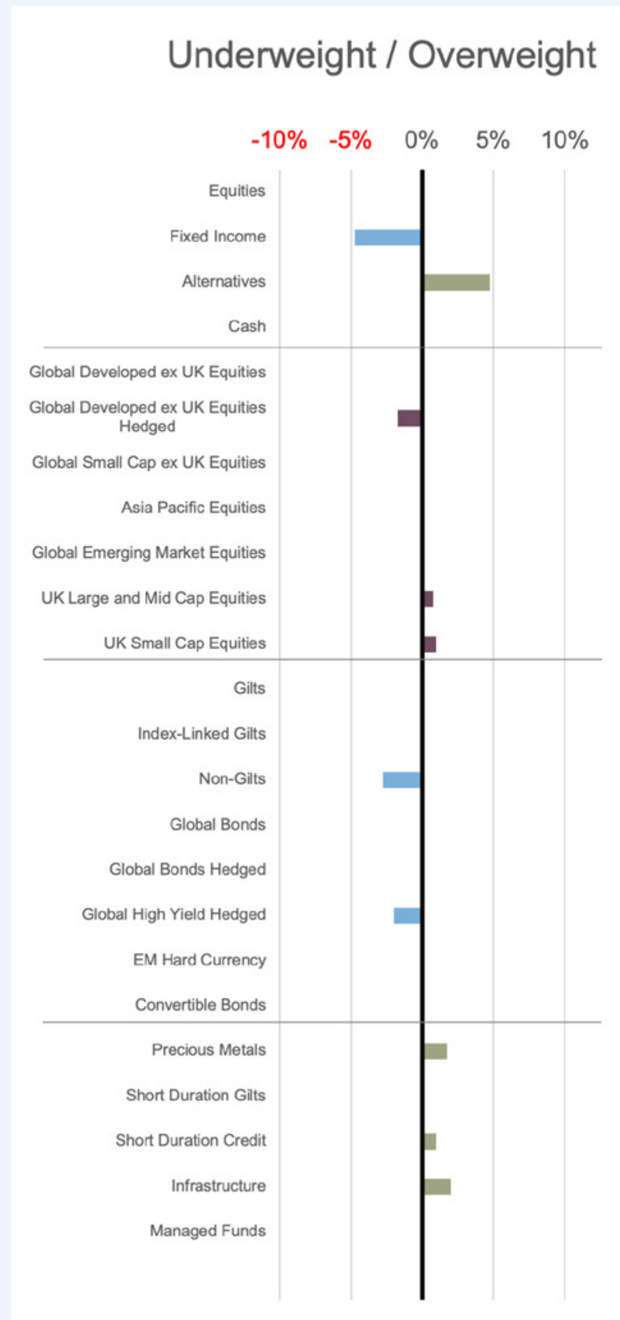
The biggest risk in our view comes from central bank tightening. Less QE and higher interest rates slow liquidity growth in the financial system and create tighter economic conditions. This leads to financial markets which are less forgiving when negative news inevitably arises, whether it is economic data or pandemic-related. This is the main reason we reduced our equity overweight in October and why we maintain that position.

It is also worth noting that within our equity portion we are tilted away from international equities towards UK equities, albeit marginally. We expect our allocation to US value companies to drive outperformance as some of the more expensive areas of the US market come under scrutiny.

Central bank tightening and inflation lead us to remain underweight bonds in portfolios. As central banks move closer to raising interest rates, as has already happened in the UK, the relative attraction of bonds is diminished. We maintain an underweight position and have taken further steps to reduce duration (sensitivity to rising interest rates) within our more conservative portfolios.

At a fund level, this quarter we have introduced Morgan Stanley Global Asset Backed Securities to Defensive, Cautious, Balanced and Income portfolios to reduce duration. To reduce concentration in any single fund we have spread our Japan equity exposure across an index tracker to sit alongside Lindell Train Japanese Equity and we have reduced our allocation to Foresight Global Real Infrastructure fund and added M&G Global Listed Infrastructure.

Mazars balanced portfolio as of 3 February 2022



Risks

The Omicron is receding but inflation is running away

2021 was 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 got back to normal. It is a year of great uncertainty and a wide variety of outcomes. Volatility in the beginning of the year is at record highs. At best, it will be a year when developed markets learn to live with the virus. Its' course will depend, by and large, on the Omicron variant, a highly transmissible but lower mortality string of Covid-19 with the dynamic end the pandemic.

Risks from the pandemic seem to abate, however we can't rule out the emergence of a new variable which, along with lockdown fatigue, could significantly stress economies and consumers.

At the current juncture, our top area of concern is the potential of runaway inflation and the Fed's inability to fight a war on two fronts (price pressures and market volatility). Slower growth could mean a stagflationary environment, to last 1-3 years.

Given low bond returns, investment arsenals is primarily confined to equities and certain liquid alternatives.

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

Geopolitical risks are on the rise. We would focus on Ukraine, US politics, the French election and possibly Taiwan. While any of these has the potential to turn into an explosive matter, risks are parabolic and thus difficult to price in at the current juncture

Upside risks, however, also exist and are not priced in. If Omicron proves to be the last of variants and doesn't mutate significantly, then the world could be faced with a 'sudden return to normality' within the next 3-6 months. This would overall be good, and de-escalate price pressures, but it could put further stresses of supply chains.

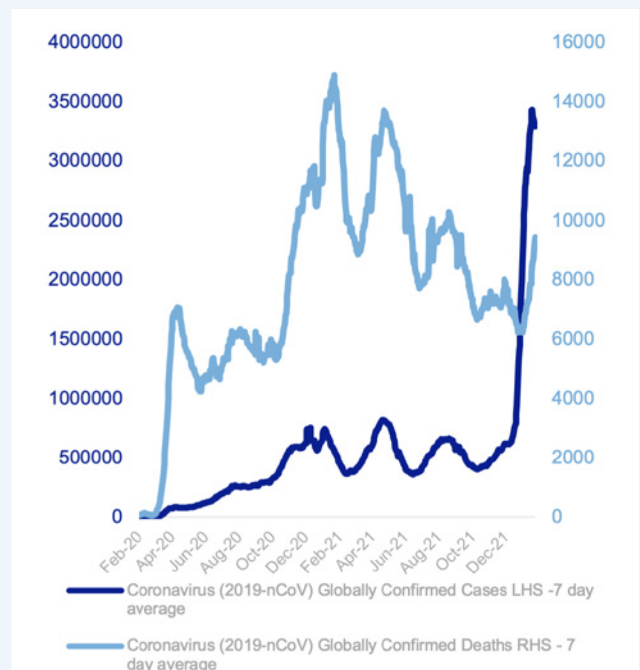
At the time of writing, residual liquidity and pandemic optimism (as opposed to 'fresh liquidity' and 'normality') are holding the economy and markets together. However, both the real and the financial world are expected to experience further volatility throughout the year.

Rate expectations drive volatility

S&P 500 daily volatility (High/Low), US Market Implied Rate Expectations (%)

Covid cases soared, but fewer people died

Global Covid cases and deaths



Charts source: Johns Hopkins, Mazars Calculations

Macroeconomic backdrop
Global

It has been one of the worst starts to the year for risk assets in general, as inflation momentum has knocked the US central bank out of its previous focus on market stability. As a result of the Fed's retraction of Quantitative Easing, global equities, especially US equities which have been led by a narrow selection primarily of tech stocks, and bonds have seen significant retrenchment.

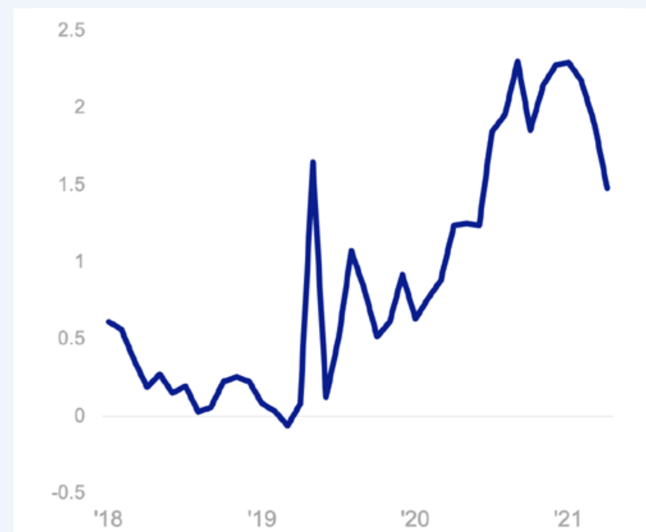
Global stocks fell by 5.3% (4.6% in GBP). The highest performing sectors were Energy and Financials while the worst performers were IT and Cons. Discretionary. Equities were trading at 18.37x times forward earnings, 8.9% above long-term average. Gold fell 1.8% and oil prices rose 14.5%.

The global economy continues to expand above its pre-pandemic rate. However, performance remains divergent between regions, subject to lockdown rules. Manufacturing and services continue to expand at a satisfactory pace. While global supply chain pressures remain, producers are reporting easier shipping and delivery conditions than in the past months. The services sector is expanding at a satisfactory pace, however it remains vulnerable to lockdown policies. Retail sales across the board are satisfactory, but the post-pandemic pent-up demand phase has passed.

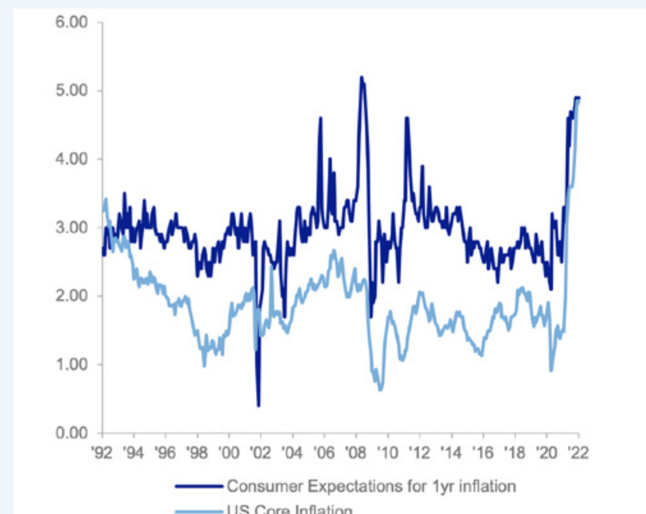
Meanwhile, supply-side pressures are now mutating into demand-side, as persistently higher prices have fed into wage demands. Employment conditions are improving, however labour participation rates have yet to return to pre-pandemic levels, putting further pressures on wages. This has raised flags with the US Fed which has now changed tack and is pursuing a more aggressive rate policy to stem inflation. However, US consumers remain unconvinced that the Fed will be successful in this endeavour. This creates a conundrum for the Fed which has abandoned volatility suppression policies but it has failed to see its inflation strategy bare fruit yet.

Outlook: From an asset allocator perspective, especially in the US, 2022 marked one of the worst starts to the year. However, financial performance remains as disperse as economic. UK stocks and "value assets" which had not experienced significant inflows in the past few years have materially outperformed the US. Over the long term, we remain positive. However, we expect more volatility over the shorter term, as markets adjust to a new post-QE regime.

Supply chain pressures are reduced
Z-score of eight key supply indicators



Consumers aren't convinced that the Fed's strategy will work
US University of Michigan cons. survey, US core inflation



Charts Source: Mazars Calculations

Macroeconomic backdrop

UK

UK Equities have been mixed over that 2 months. Large cap equities have held up well while medium and smaller companies have not. The political undulations have created noise but not had noticeable impact.

Global equities have been roiled in 2022 as concerns have grown about persistent inflation giving rise to interest rate hikes. Large-cap UK equities have been resilient in the face of this but mid-cap equities have not fared so well. However, as Covid restrictions are lifted, mid-cap equities may still benefit.

The UK's large-cap index has eked out a small gain year to date, faring better than other major equity indices. To a large degree, this is because the energy and basic materials sectors have benefited from commodity price increases, rather than by any particular virtue on the part of UK PLC's management.

The UK's mid-cap index has however been weak in 2022. Downgrades to UK economic expectations have arisen just as the Bank of England has committed to tackling inflation by raising interest rates. This has contributed to concerns about the cost of living dampening consumer demand which will hurt the earnings of the mid-cap companies, which are seen as more sensitive to the domestic economy than their large-cap peers.

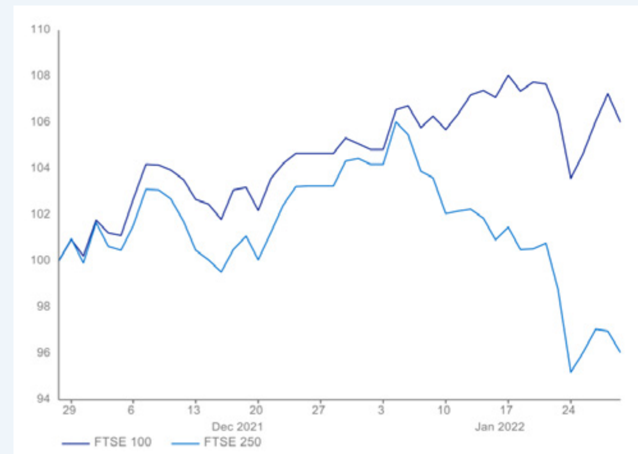
Outlook: Elevated inflation, along with the tension in Eastern Europe, could sustain commodity prices which would be supportive for the energy sector and large-cap UK equities.

For UK mid and smaller companies, the outlook is more nuanced. On the one hand, the UK consumer is in a solid financial position, armed with the savings they have accumulated during the pandemic, as Covid restrictions have been lifted. However, the potential for elevated energy bills and overall consumer prices is likely to eat into consumption.

While turmoil within Boris Johnson's Conservative party has occupied the news, this is not necessarily market-relevant as it appears unlikely to alter the overall political direction or government spending plans.

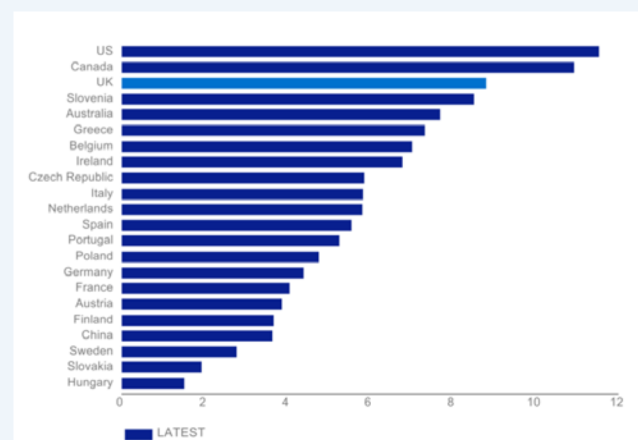
Large-cap UK Equities have held up while mid-cap companies have fallen

Equity performance for December and January



Accumulated savings still gives cause for optimism for UK consumer activity

Savings accumulated since 2019 as a percentage of GDP



Charts Source: Refinitiv Datastream

US

For the month of January, US stocks fell by 5.2% (4.5% in GBP). The highest performing sectors were Energy and Financials while the worst performers were Consumer Discretionary and IT. Equities were trading at 20.43x times forward earnings, 14% above their long-term average and 11.2% above the MSCI World. 10y bonds rose 27 bps at 1.777%.

The US economy finished 2021 on a high note, reporting a 6.9% GDP growthin Q4 2021. However, this growth mostly reflected a record surge in inventory investment by private businesses, which contributed 4.9%. Meanwhile, other signs point to a slowing rate of growth in the months to come, as the effects of the Omicron variant on the economy start to show in the data. In December, retail sales, consumer spending, nonfarm payrolls and existing home sales - all fell more than expected. Manufacturing growth also slowed in December amid high increases in prices for raw materials, energy and wages.

In the new year, initial jobless claims were higher than in December, while early data has shown that manufacturing growth has continued to slow, while business activity expanded only marginally.

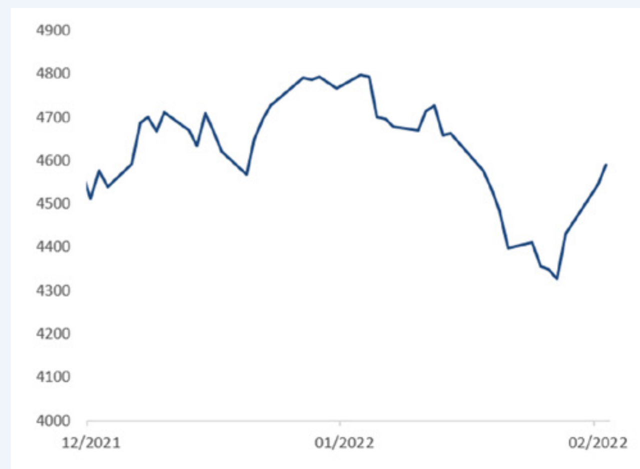
January's narratives were dominated however by the US Fed, and its hawkish stance towards inflation, which rose to a level of 7% for Q4 2021. Markets have started to price in as many as seven interest rate hikes. Although some have been bracing for a half point hike in March, the idea has yet to have been backed by members of the rate-setting committee - even the more hawkish ones.

The prospect of the end to quantitative easing sent markets into a sell-off, with stocks falling almost 10% from their peak, and the US 10 year bond yield rising to as much as 1.9% during the month. Markets rebounded strongly towards the end of the period however, recovering almost half of its losses, as stronger than expected earnings helped improve investor sentiment.

Outlook: Despite the worst start to the year, we remain cautiously optimistic about the region as residual liquidity remains plentiful, and pandemic risks appear to be decreasing. We think an outlier risk could be geopolitical, as further escalation between the US, Russia and China could have unforeseen effects on markets.

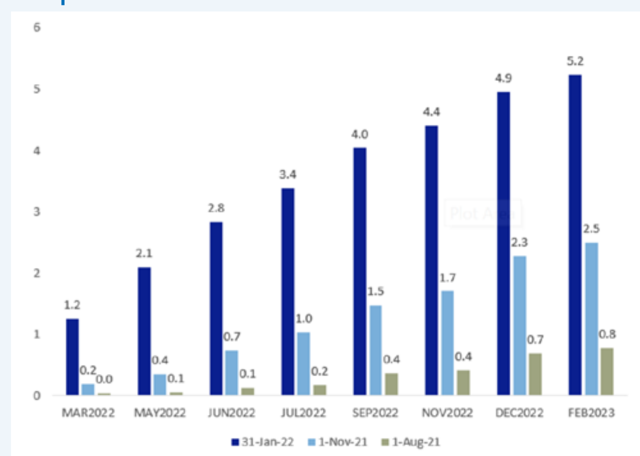
US Stocks fell sharply, but rebounded partially

US Stocks



The Fed changed is turning more hawkish, exponentially

Market Implied Rate Hike Expectations, 1 hike = 25bps



Charts Source: Mazars Calculations

Europe

In January, European stocks fell by 5.5%. The highest performing sectors were Energy and Financials, while the worst performers were Industrials and IT. Equities were trading at 15.56x times forward earnings, in line with the long term average, and 15% below the MSCI World. 10y Bunds rose 19 bps at 0.011%.

2022 has started with a positive outlook for the Eurozone manufacturing sector according to Markit PMI data. The Eurozone Manufacturing PMI rose to 58.7 in January as the rate of output and new orders accelerated. However, supply chain issues remain a problem across Europe and continue to delay the rebalancing of demand from goods to services.

In January, cases of coronavirus sky rocketed across Europe, with France recording in excess of 500,000 infections per day at the peak of their infection curve. Nevertheless, many European countries have begun unwinding the numerous restrictions on mobility put in place in Q4 2021 to control the spread of the virus. Encouragingly, there are signs that infection rates may be slowing, as countries including Italy and Spain continue to report a falling number of cases.

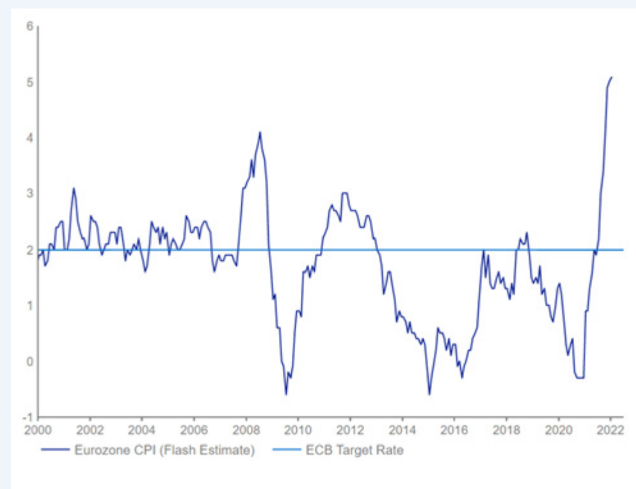
Consumer prices continued to rise in January, as Eurozone CPI flash estimates recorded a record 5.1% year on year increase, well above the 2% inflation target set by the ECB. Whilst concerning, there are indications that the rising inflation rates may be starting to ease across some European economies. German CPI fell slightly from its record high of 5.3% in December to 4.9% in January.

Nevertheless, the persistence of these high levels of inflation are likely to only further increase pressure for the ECB to reduce their monetary stimulus. The ECB have previously been firm on their stance on combating inflation: ECB President Christine Lagarde publicly dismissed calls to raise interest rates in January. But as high energy prices, rising food prices and supply chain issues continue across much of Europe, it will be necessary for the ECB to consider tapering asset purchases at a faster rate.

Outlook: Markets are currently fixated on any news regarding inflation in European economies. As such, any perseverance of supply chain issues is likely to weigh on the outlook. Any alterations of the ECB's stance on inflation will also be decisive for market sentiment.

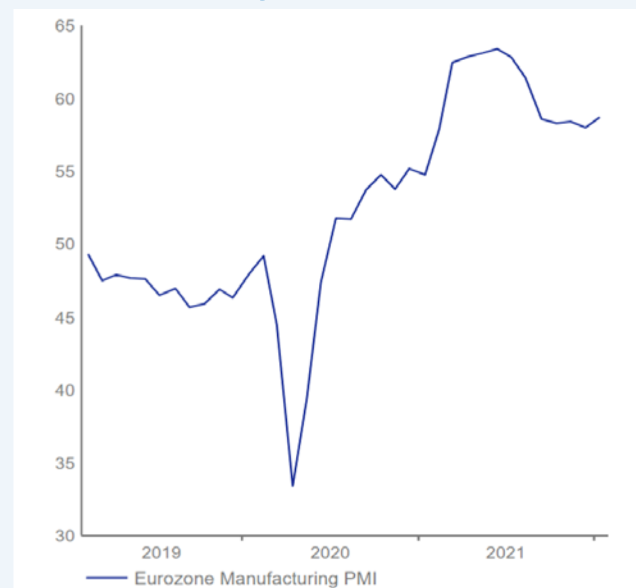
Eurozone inflation continues to climb

Eurozone CPI, year on year change, per cent



Eurozone Manufacturing PMI

(Index, 50 = no change)



Charts Source: Refinitiv Datastream

Japan and emerging markets

In January, emerging market stocks fell -1.9% and -1.2% in local and Sterling terms respectively. Japanese stocks fell -4.8% and -4.4% in local and Sterling terms respectively. The best performing sectors were Financials and Energy while the worst performers were Healthcare and IT.

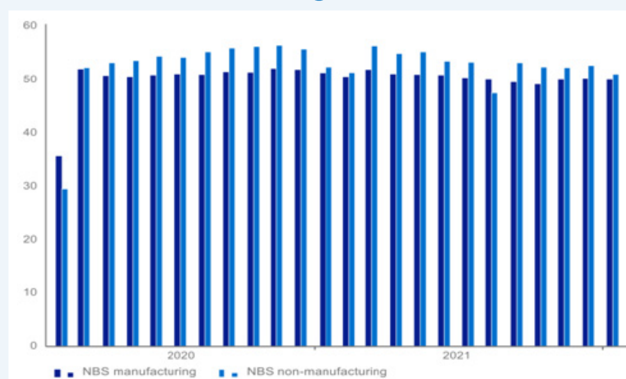
The Chinese economy expanded 4% YoY in Q4 2021, easing from a 4.9% growth in the previous period but exceeding market consensus of 3.6%. It was the slowest pace of expansion since Q2 2020, amid multiple headwinds including a property downturn, supply chain issues, and Covid-19 outbreaks. China's regulatory 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.

Japan has expanded its quasi-emergency measures in an effort to bring the latest outbreak of Covid-19 under control. The Bank of Japan left its key short-term interest rate unchanged at -0.1% during its January meeting, by an 8-1 vote, as widely expected. The BoJ stressed that it will maintain its ultra-loose monetary policy even as its global counterparts seek to exit from crisis-mode policies. The Jibun Bank Japan Manufacturing PMI was higher to 55.4 in January from 54.3 previously. This was the strongest growth in factory activity since February 2014, amid surging vaccinations and despite pressure from a persistent chip shortage. Services PMIs plunged to 46.6 in January 52.1 in the previous month. The latest reading marked the first contraction in services activity in four months amid mounting fears about the Omicron strain as new infections surged to a record high on the back of a reintroduction of curbs in the country.

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

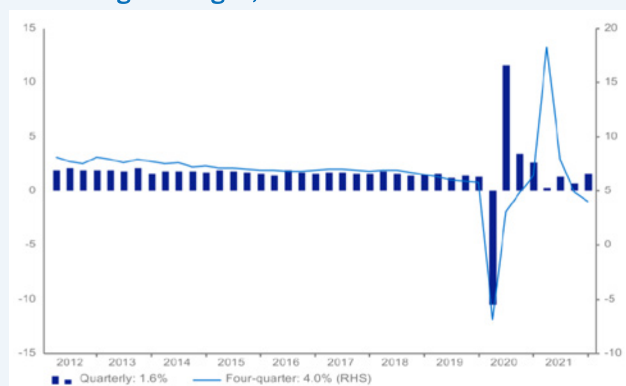
China PMIs, 50 = no change



The official NBS Manufacturing PMI for China was at 50.1 in January, down from 50.3 a month earlier. The latest reading reflected uncertainties brought by sporadic Covid-19 outbreaks. Non-Manufacturing PMIs also declined to a five-month low of 51.1 in January from 52.7 in the prior month.

China GDP growth slows to 4.0% in Q4 amid COVID, property woes

Percentage changes, both axes



China's gross domestic product growth slowed to 4.0% on the year in the fourth quarter of 2021, delivering a full-year result of 8.1%, as a Covid-19 resurgence and a real estate downturn combined to restrain economic momentum.

Charts Source: Refinitiv Datastream

Our themes

Macro theme 1

Central banks learn their inflation limits

US Core Personal Consumption Expenditure, the Fed's favourite gauge of inflation, hit 4.9% in December, the highest level since 1991. It rose more than three percentage points in a year.

The pace at which inflation climbed, has been the steepest since the 1970s. In the UK, Brexit could also add to inflationary pressures temporarily, until businesses have become efficient in keeping costs under control. The rate of change is the key to understand the Fed's and, subsequently the market reaction. Following the transition into monetarism, as well as geopolitical oil shocks, the 70's featured significant inflation volatility. Modern, independent central banking was supposed to have provided the answer. Globalisation, which featured a persistent reduction in prices was also a key component of controlling inflation.

In the past twenty years central banks were fighting with deflation much more so than inflation. Until a year ago, inflation was an academic question. This is a market where very few decision makers even remember what an inflationary environment looks like. It is natural that it took time to recognize it, as it is natural that we are reactive versus proactive.

Inflation happened quickly, the Fed reacted accordingly and markets, still conditioned from the previous free-money paradigm are volatile. One thing that is made apparent is that as the Fed tries to transition from one paradigm to the other, it is not in control, at least for now.

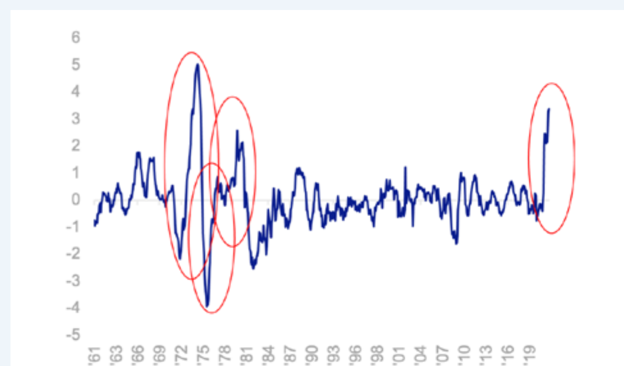
With inflation running this hot, are we facing the prospect of "runaway inflation", a condition which would probably require more than five 25bps rate hikes priced in today?

We can't say for sure. We feel, however, that the central scenario is that if inflation comes down, it will do so on its own. Year-on-Year calculations should be made easier after January 2022. Supply chain issues are already being addressed. Less lockdowns and a faster virus pass-through rate, along with more employers now offering hybrid working, could send people back to work and increase labour supply enough to reign in wage pressures.

If residual market liquidity proves enough until such time as inflation is tamed (actively or passively), investors could see volatility receding as fast as it rose.

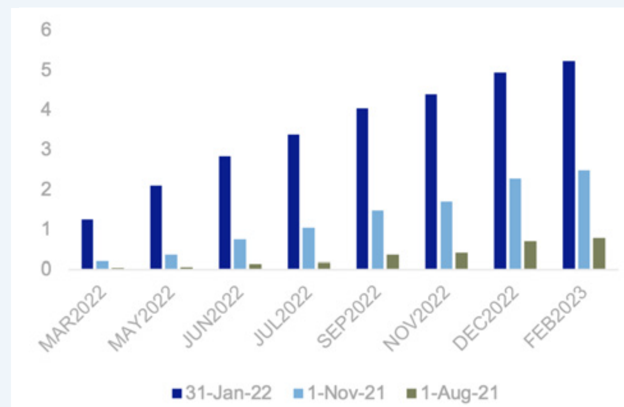
Inflation hasn't climbed this fast since the 1970's

Core PCE, YoY, headline numeric change from previous 12 months



The Fed is turning more hawkish, exponentially

Market Implied Rate Hike Expectations, 1 hike = 25bps



Charts Source: Refinitiv Datastream

Even if supply pressures abate, can we be certain that inflation won't continue to rise like in the 70s? No. But in this particular case, it could be due to immense fiscal easing and Green transition, a process of creative destruction. Both of these conditions could be inflationary, but also growth-positive, which means that real growth could offset price rises.

Macro theme 2

Ukraine – Words speak louder than actions

Various heads of state have increasingly talked up the likelihood of a Russian invasion of Ukraine. Investors would be wise to remember that the outcome is hard to predict and the impact on asset prices is likely to be restricted to specific sectors.

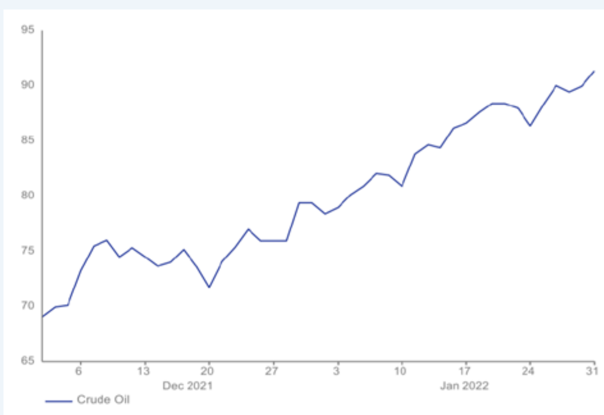
As tensions have risen between the West and Russia and the news has increasingly broadcast the potential for war, markets have started paying attention. However, the reality is that the impact to markets is likely to remain limited to those sectors and geographies that are more economically sensitive to the region and the economic sanctions that may be placed on Russia.

The most obviously affected sector is energy. Any reduction of Russian commodity exports, either voluntary or imposed, will push energy prices higher. To a degree, markets are already discounting this and hence Brent Crude rose 32% in the two months from the beginning of December to the end of January.

Russian equity investments have also come under pressure. The market has already discounted worsening business conditions and, at their lowest point in January, Russian equities were 18% lower than they were at the beginning of December.

Commodity prices have been driven up

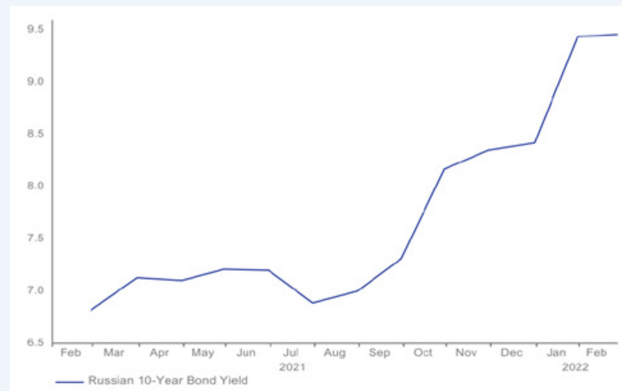
Brent Crude price, 2 months



Charts Source: Refinitiv Datastream

Russian bond yields have risen as tension has escalated

Russian 10-Year government bond yield



Charts Source: Refinitiv Datastream

Russian government bonds are another area showing signs of stress. As perceived creditworthiness worsens, the yield on Russian 10-year debt in Roubles has risen 2% in as many months, to 9.4%.

While these moves are significant and no doubt alarming for those who are in possession of the assets, they are still only pockets of the global market for investable assets. Developed market stocks and bonds are much less subject to economic fallout as Russia accounts for only 1.3% of global GDP.

The ECB has sounded out European banks that may have business exposure to Russia through loan books and banking operations. However, the impact to those bank profits is likely to be less than 10% of forecast profits.

For our portfolios, we do not believe that adjusting them based on the likelihood of military activity in Ukraine is the correct course of action. Foremost, this is a binary outcome that very few could reliably predict and we would not consider ourselves as having any advantage compared to other observers.

Also, our diversified mix of equities and bonds, mainly from developed markets, are unlikely to be significantly impacted by the conflict or its repercussions over the medium term.

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 real estate woes weaken property investments

China investment in real estate development

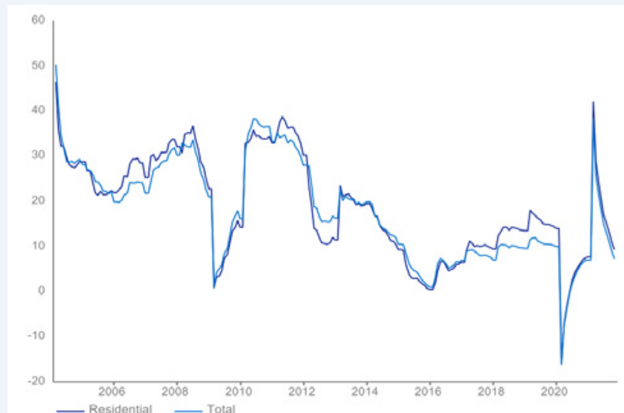


Chart Source: Refinitiv Datastream

China signals easing due to property sector downturn

China reserve requirement ratios, %

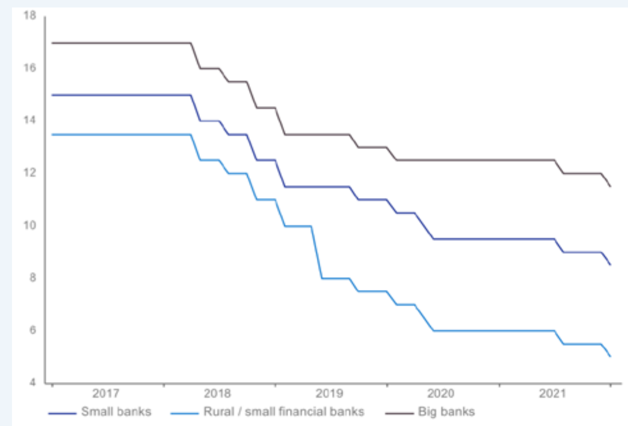


Chart Source: Refinitiv Datastream

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.

In November last year, the PBOC cut the reserve requirement ratio for most banks by 0.5%. A move that unleashed 1.2 trillion Yuan ($188 billion) for business and household loans. It further slashed its key lending rates for corporate and household loans for a second straight month at its January meeting as policymakers sought to cushion a slowdown in economic recovery due to multiple headwinds.

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 rate cuts sends a signal that policy will turn more accommodative.

Equity spotlight
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.

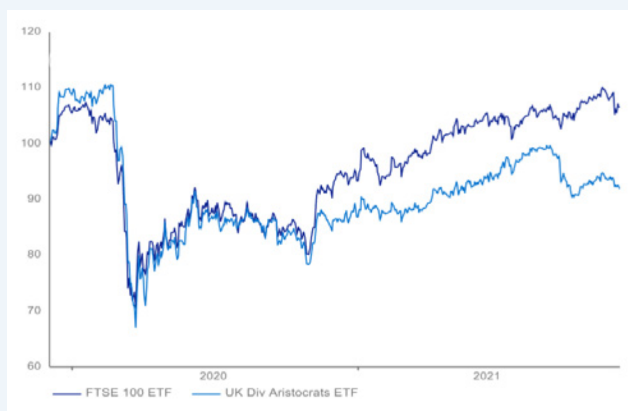
We continue to look at company dividends and here we discuss what people should expect from dividend yields, as well as other forms of capital return, and how these can impact share prices.

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.

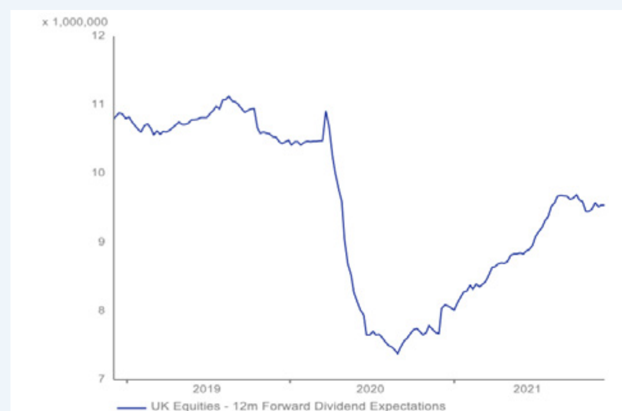
The upshot of this is that some dividend cuts which occurred during the pandemic are unlikely to be fully reversed in the near future. While in many cases dividends have been reinstated and increased in 2021 companies will enjoy the flexibility that paying out less to shareholders gives them: it leaves 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

Fixed income in the time of Quantitative Tightening

It's not always the case that fixed income inventors pay too much attention to equity markets – there is a general view that equity markets instead follow the wise lead of bond markets. However recent volatility in both equity and bond markets requires close attention.

Markets are pricing in five US rate hikes by the end of 2022 to counter higher than desired inflation, which would take interest rates there to 1.5%. Meanwhile bond purchases are scheduled to end in March. In the previous tightening cycle the Fed kept the balance sheets steady for three years and started reducing its balance sheet when rates reached 1.25%. However with inflation now more of a concern, this time the switch could come more quickly

The relative attraction of each asset class affects flows, so with several rate rises all but certain, central banks expected to soon be a net seller of bonds, and equities looking far more attractive than they have for some time, surely the prospects for bond returns is bleak?

Clearly that would be too simple. First of all yields have already risen in anticipation of rate rises and a certain amount of inflation. If inflation moderates (quite possible given high base effects) or interest rate rises don't come at the speed previously expected, yields could well fall back and deliver strong positive returns to bond investors.

While this currently feels unlikely, it has pretty much been the pattern of the post-GFC world. In 2018 there were market commentators predicting that finally we had lift off, and that US 10Y yields would reach 5%. Instead they topped out at around 3.2% as the Federal Reserve blinked in the face of rising market volatility.

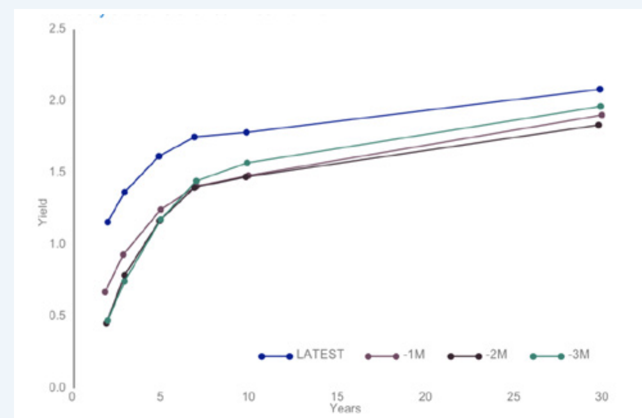
Yields have consistently failed to take off as expected

10Y yields, per cent

Source: Refinitiv Datastream

US Yields have risen but likely have further to go

US yield curve over the last three months



Source: Refinitiv Datastream

A further factor is that, despite the sell-off this year, the recent equity bull market has seen pension funds in both the US and UK move close to being fully funded. At this point they will be looking to de-risk. So while the Fed could soon be withdrawing their support for bonds, pension funds could be adding theirs.

On balance we believe there is sufficient capital risk for bonds that an underweight to interest rate risk and the asset class as a whole is warranted. The size of the Fed balance sheet is enormous and yields have risen even before this has started to be addressed. However we would not be surprised if some combination of slowing inflation, more dovish central banks or even oversold bond markets make re-entry into bonds more attractive sooner rather than later.

The function of gold

Although gold surged during the pandemic, it has remained relatively stable since mid-2020. Since the start of the year, gold has outperformed stocks and bonds for a relatively low level of volatility. Gold saw large returns over the first half of 2020, rising to over 30% above its pre-pandemic level at one point.

During the pandemic, investors saw gold as a safe haven in a year of much financial turmoil and looming inflation. Since then however, gold has slipped from its pandemic-era peak, settling at levels around $1800 USD.

Gold is not necessarily a good hedge against inflation: it can be a good trade if one is able to anticipate inflation before it happens, but may not be as profitable if one buys and holds after the fact. Instead, investors should consider gold as a part of a wider long-term portfolio, to protect some of their assets against unexpected changes in the inflation expectations of others.

Within this context, we believe that gold plays an important role in our portfolios and accordingly, we remain overweight. Following the surge in the price of gold at the height of the pandemic, it has traded within a relatively narrower range around $1,800. Since the start of the year, gold has fallen by 1%, avoiding the sharp downturns seen in global stocks and global bonds, which fell by 4.4% and 2% respectively.

Gold has been relatively stable since the height of the pandemic

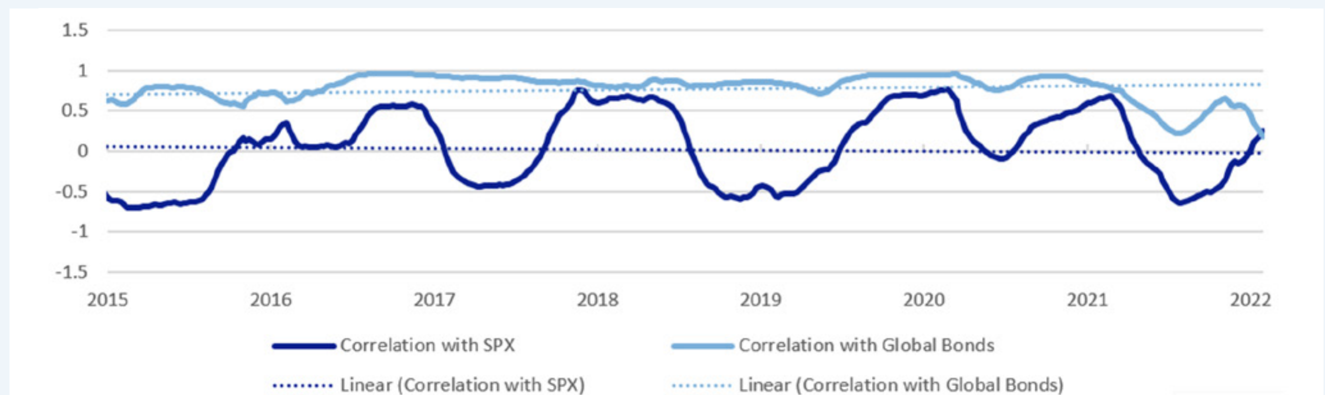
Gold price in USD

Source: Refinitiv Datastream

Thus, gold has outperformed stocks and bonds for a lower volatility. Perhaps just as importantly, gold acts as an essential source of diversification, being an asset class which currently has a low correlation with stocks and bonds.

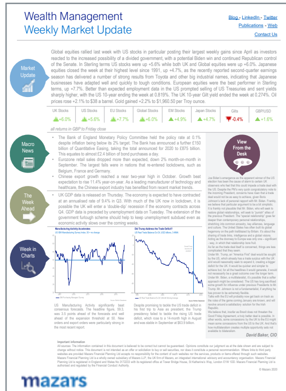
Gold currently has a low correlation with global stocks and bonds

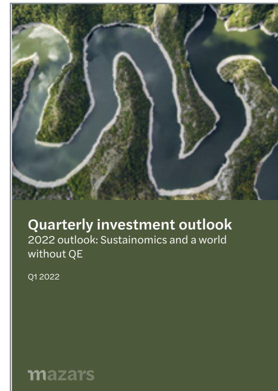
Correlation between gold and global stocks and bonds over time

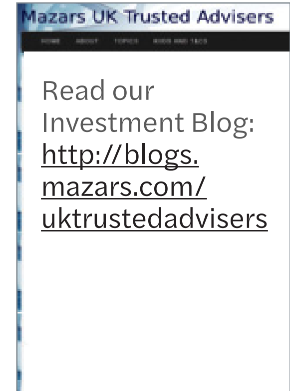


Charts Source: Mazars Calculations

More reading...







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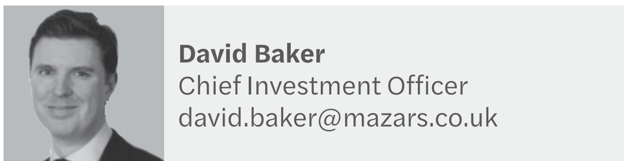

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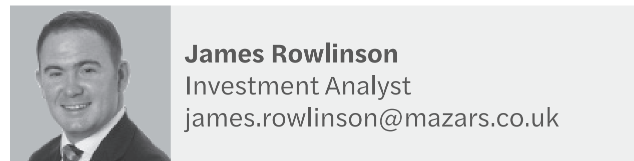

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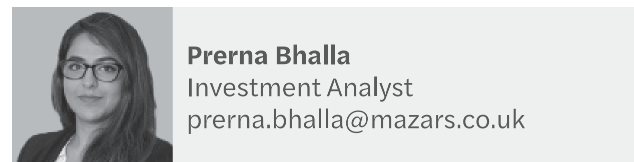

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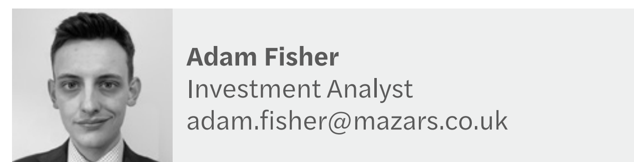

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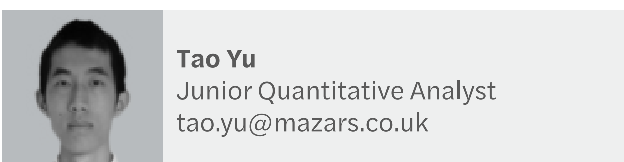

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Chart Sources: Bloomberg. The information contained in this document is believed to be correct but cannot be guaranteed. Opinions constitute our judgment as at the date shown and are subject to change without notice. This document is not intended as 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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