INVESTMENT OUTLOOK NOV 2021

GLOBAL RECOVERY ROBUST DESPITE MODERATION

While Covid-19 cases have been in decline in many areas, Europe is currently seeing rising infection rates with pockets of tighter government restrictions. This has led some consumers to report a more cautious outlook. However, consumer spending has largely stayed above pre-pandemic levels and the recovery remains on track with an encouraging absolute rate of growth still evident. Despite the recent rise in the infection rate, it has not been accompanied by a significantly higher death rate, which has been crucial. This reflects the success of the vaccination programs across much of the developed world. This progress has allowed many governments to avoid drastically tighter restrictions even as cases rose, assuming they had a sufficient vaccination rate to allow a suitable level of comfort. However, there are still concerns about returning to prior lockdown restrictions.

The Federal Reserve(Fed) and Bank of England(BoE) have begun discussing an end to super-easy monetary policy. Markets now expect the Fed and BoE to gradually lift interest rates in the coming year to address concerns that recent inflationary pressures may influence longer-term expectations. However, our expectation is still that Central Banks will continue to prioritize sustaining the recovery. A key driver of higher prices has been the impact of supply-chain friction on global shipping routes, as a result of the Covid-19 pandemic. This has also seen manufacturing activity slow, albeit from high levels. Recruitment difficulties have also driven production delays, which saw knock-on effects on both activity and prices. This has been somewhat offset by a service sector that's received a healthy boost since reopening but, businesses have been hindered by increasing competition for employees, particularly given the strong levels of government support for workers that has only just begun to ease.

Looking ahead, markets will pay attention to any further changes in China's education and technology sectors' regulatory environment. This recently drove price volatility in a sector that is anticipated to help underpin sustainable growth. How the US administration approaches its international relationships following the Afghanistan crisis, especially regarding China and Russia, will set the tone for global trade relations. We look for the global economy to show strong growth in 2021 and 2022, as policy makers remain committed to promoting the economic recovery. Ultimately, it is likely policy makers will prioritise growth and tolerate an inflationary overshot, if necessary, to return unemployment to pre-covid levels.

SHARES OVER BONDS FOR THE LONG-TERM

Investors seem comfortable looking through near-term economic volatility, as the world continues its readjustment post-lockdown. Policy support, corporate innovation, and most importantly, the vaccine roll-out all supported strong share price growth, which has been driven by strong earnings growth from business and consumer spending. As with the Global Financial Crisis, both bond and share prices were supported by central bank Quantitative Easing (QE) programs (where central banks purchase financial assets to increase the money supply to support the economy). This recovery has one significant difference – massive fiscal easing (unemployment assistance programs) which has been financed by increased government debt issuance (bond sales).

Global bond yields had fallen dramatically (meaning bond prices have gone up) since the start of the pandemic due to risk aversion and global central bank rate cuts. But as the economic outlook improved and deflationary concerns eased, bond yields recovered. This is one reason for our short-duration bias, which sees less impact from rising rates. We remain cautious on the outlook for bonds due to the potential for higher inflation in the medium-term, both from pent-up demand but also from the aftereffects of significant monetary and fiscal stimulus. However, bonds will likely provide protection in the event that the economic outlook worsens. We retain broad global property exposure, as post-Covid we expect the sector, outside the retail sector's well-known difficulties, to recover.

TOP RISKS

New covid-19 variants are vaccine resistant.
Stock markets remain highly sensitive to rates of infection. A continued successful and evidently efficient vaccine roll out is key to support further gains.

Greater Central Bank policy uncertainty
Many Central Banks have revised their outlook for interest rates, at least rhetorically. Whether this translates into action is unclear.

Record stimulus boosts economies and inflation.
Pent up demand and historic stimulus may see a persistent 1970s style inflation shock.

Further China regulations
Tighter regulation of a wide range of sectors from tech to teaching in H1-2021 could spread further.

Rising political turmoil
Global political unrest has not disappeared. US and China trade relations remain a risk.

Post-Brexit UK
The UK's evolving trade relationships still weigh on investor sentiment.

Higher unemployment
Most governments took steps to cushion businesses and employees from the pandemic. The withdrawal of this support in the face of economic changes, particularly in the service sector, remain a risk.

INVESTMENT TYPE	OUTLOOK	RATIONALE
SHARES		
UK	+	International investor sentiment towards the UK has improved, spurred on by a successful vaccine roll out and economic reopening. But UK shares still face lingering negativity driven by Brexit. This is surprising given UK shares have a heavy weighting to overseas earnings, at around 70% for FTSE-100 and around 50% for FTSE-250. UK shares remain both comparatively and historically cheap, despite the UK government and Bank of England providing significant policy support to help offset the negative economic impact of the pandemic. Policy support's hasty withdrawal remains a key risk.
US	+	US policy makers have delivered a comparatively stronger fiscal and monetary response than expected, supporting the economic growth outlook. This is particularly likely to benefit firms with the greatest US market exposure, such as small and medium-sized businesses. This contrasts with the prior decade where much of US share prices gains were driven by the tech sector, which remains cash rich. There are some near-term inflation risks, but the Federal Reserve appears comfortable with these and will not become entrenched. The possibility remains that other markets, given their lower valuations, will finally play catch-up.
Europe ex UK	=	The European Central Bank (ECB) continues to provide significant monetary support. However, the region's fiscal responses differ significantly. The region is heavily exposed to the global trade cycle which should accelerate in 2021-22. Lockdown has been particularly economically challenging for Europe, with generally longer and more severe lockdowns in place compared to other regions. This has been somewhat offset by more generous government schemes that support consumer spending. Longer-term, a key risk remains that US-China trade tensions could widen to include Europe.
Japan	=	In recent months, Japan has continued its aggressive vaccine roll-out. This boosted optimism with a backdrop of strong government fiscal support and a significant level of government bond purchases by the Bank of Japan (BoJ). Despite some political uncertainty, October's elections saw New Prime Minister Kishida secure a lower parliamentary chamber majority. He has pledged to focus on broader economic improvement. Uncertainty surrounding the global economy, which would likely see the Japanese Yen strengthen and in turn deliver a double punch to Japanese exporters, is a risk worth being alert to.
Emerging Markets	+	Heightened concerns surrounding China's regulatory action in the education and technology sectors in the past few months have driven a difficult period for Emerging Market shares. EM markets have also seen a slower vaccine roll-out but this is well known and therefore offers a potential for catch up. While current valuations are above historical averages, the region remains well positioned to benefit from the continued upswing we anticipate with the expected normalisation of economic activity. A sharp rise in global interest rates is an ever-present risk, however we see little probability of this in the near-term.
Asia Pacific ex Japan	+	This region continues to see vastly divergent success in dealing with Covid-19's human and economic impact. Owing to the region's dependence on global trade, the economic rebound of key trading partners is vital. Vaccine rollouts have also accelerated but there is still some room for further improvement. We expect these drivers to promote a healthy recovery, with the vaccine roll-out providing a significant opportunity for catch up. The prior China regulatory changes are the prime near-term concern.
FIXED INCOME		
Government bonds		
UK	=	UK government bonds (gilts) benefited from both continued Brexit uncertainty and significant monetary policy easing. The cycle appears to have turned but we do not expect the Bank of England policy rate to rise as much as the market forecasts in the medium-term. This provided an opportunity to increase our duration levels, although longer-term our bias remains toward short duration.
US	=	Investors had become more concerned about a pre-emptive tightening from the Federal Reserve given inflationary worries. This has seen rate expectations rise recently. However, Fed officials have made it clear that a persistent inflation shock would be a concern, but a one-off boost from normalisation is something they would expect to be looked through when considering policy changes. Significant changes appear unlikely, but are always a risk.
Europe ex UK	-	We believe Eurozone government bonds are overvalued given their continued distortion by Quantitative Easing. ECB QE is likely to cap yields, although continued political event risk (French and German elections ahead) and budgetary concerns may see them move higher intermittently. Concern surrounds the long-term debt sustainability of the periphery compared to the core.
Japan	-	Japanese bonds offer little income and remain severely distorted due to the BoJ's "Yield Curve Control" program. While the BoJ might alter this program, there's little expectation for significant medium-term change.
Emerging Markets	=	EM government bonds offer a strong yield premium compared to Developed Markets, coming at the cost of higher volatility. Similarly, their currencies appear undervalued, offering an additional supportive factor. Comparisons of the current situation with the 1998 EM crash are overdone, with external debt, Foreign Exchange reserves, and overall fiscal prudence significantly firmer.
Corporate Credit		
UK	=	The BoE's expanded bond buying program will likely provide continued support for corporate credit, at the cost of distorting the market further. We are reluctant to increase our position as spreads are historically tight, reflecting renewed optimism about the outlook and a high demand for yield pick-up.
US	=	Continued economic optimism coupled with central bank purchases have driven spreads to historically narrow levels. But yields available are still firmly above government bonds. As with other regions, we prefer Investment Grade over High Yield, given that the additional risk/reward premium on offer is unconvincing.
Europe ex UK	-	The ECB's newly expanded bond buying program has stretched this market further. These bonds are uncompelling, particularly compared to shares.
Japan	-	Like Japanese government bonds, Japanese corporate bond prices have been distorted by QE. We prefer share exposure, especially while Abenomics continues.
Alternatives & Thematics		
Environmental	+	Companies focused on reducing their environmental impact often have a competitive advantage due to greater resource efficiency, leading to lower costs. They may also experience lower downside risks due to more robust corporate governance, and this can support greater diversification benefits.
Global Real Estate	=	Covid-19 placed real estate under pressure, we see this strain as being resolved post-Covid. The retail sector's woes are well documented, but a sectorally and regionally diverse portfolio remains fundamentally appealing given constrained supply and low-interest rates which also provide a buffer.