Investment outlook

A monthly round-up of global markets and trends
September 2021

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Investment outlook

"Nixon Shock" remembered 50 years on

The 15 August 2021 marked the 50-year anniversary of President Nixon taking the US off the "Gold Standard" - a monetary system whereby foreign central banks and governments could exchange their US dollar cash holdings into gold. By breaking the link with gold, commonly known as the "Nixon Shock", the US could expand its money supply without being constrained by how much bullion was held in reserves. Essentially, this move to a pure fiat money-based regime made it easier to issue more debt to finance growth. President Nixon would not have known it at the time, but that momentous event enabled the US authorities to swiftly deliver unprecedented fiscal and monetary stimulus to support the economy during the pandemic nearly 50 years later. This has led to a very different business cycle from the past in two key ways.

First, the pandemic-led recession was brief. The National Bureau of Economic Research, the arbiter of timing business cycles, recently reported that the downturn lasted just two months (between March and April 2020), the shortest US recession from data that goes back to 1854. To put that in context, the previous recession that started during the Global Financial Crisis (GFC) in 2008 lasted 18 months.

Second, the nature of the crisis was more akin to a natural disaster, rather than a 'normal' recession that was driven by Fed tightening and/or over-leverage that takes time to unwind. By opening up the economy from lockdowns, stimulus-boosted output growth recovered quickly: US real GDP grew 12.2% from a year ago in the second quarter, the fastest growth rate for over 70 years at least[1].

Given the success of the vaccine rollout in the developed world, it appears that the impact on the broad global economy from this short, sharp recession has not led to persistent macro weakness. On the contrary, there has been a strong recovery in investment, limited bankruptcies/stress in credit markets and no significant rise in long-term unemployment. As such, the IMF left its latest July 2021 global GDP growth projection unchanged at 6.0% from its forecast in April, though revised up its 2022 estimate to 4.9% from 4.4%.

The fiat currency regime has shown that policy makers have the flexibility to smooth financial stress by flooding the monetary system with liquidity using Quantitative Easing (QE or central bank asset purchases). For markets, this policy support, and the relief that there has not been structural economic damage, has lifted global stocks. The US S&P 500 equity benchmark index has now doubled from its low point in March 2020 in what is the quickest bull market doubling from a trough since World War II.[2]

Nursing a stimulus hangover in 2022

The downside from an unprecedented $10tn expansion in G4 central bank assets since the pandemic began is that financial markets have become increasingly addicted to the wave of liquidity flows it creates. Goldman Sachs, an investment bank, estimates that 2021 net inflows into global equity mutual funds and Exchange Traded Funds are currently running higher than the previous 25 years combined![3] A key uncertainty is how markets will behave when central banks begin to taper their asset purchases. There are growing expectations that the Fed will taper its QE programme in the latest July FOMC minutes, potentially at the start of 2022.

Moreover, ample liquidity pumped into the financial system by central banks is leading to potentially speculative froth in house prices globally. According to data covering 25 major country residential markets compiled by the Dallas Fed, first quarter real house prices rose 6% from a year ago, the biggest increase from 45 years of data, and have now exceeded their previous peak of 5.5% in the second quarter of 2005. The risk for the global economy is that residential prices collapse from elevated levels and this leads to a downturn in global growth, like the housing bust during the GFC.

Another hangover for markets is the drag on growth from lapsing fiscal stimulus, such as expiring emergency enhanced unemployment benefits and business loans and grants. Notwithstanding additional spending from the expected US infrastructure and social agenda bills to be spent over several years, Congress is not set to offer more pandemic relief to the economy. Under current law, less money will be spent by the government in 2022 compared to the large amounts of stimulus in 2020 and 2021. The non-profit Brookings Institution estimates that fiscal spending will be a drag of 2.3% on real GDP growth by the end of 2022 and needs to be offset by increased private demand.

For now, equity investors may be complacent about some of the future market risks, and valuations have been bid up. The global price to earnings ratio is trading on 18.3x, at the high end of its historical range, and is up from a pre-pandemic peak of 17.0x[4]. On balance though, given the relative visibility of the economic recovery and a Fed that is willing to be patient to remove policy accommodation, equities still have room to rally. However, as the day approaches for the Fed to taper, it would be reasonable to expect more market volatility to price in rising macro risks in 2022.

[1,2,4] Refinitv/Smith & Williamson, data as at 1 September 2021
[3] Data Driven Investor, "Money is flowing into stocks at record-breaking pace", data as at 16 August 2021

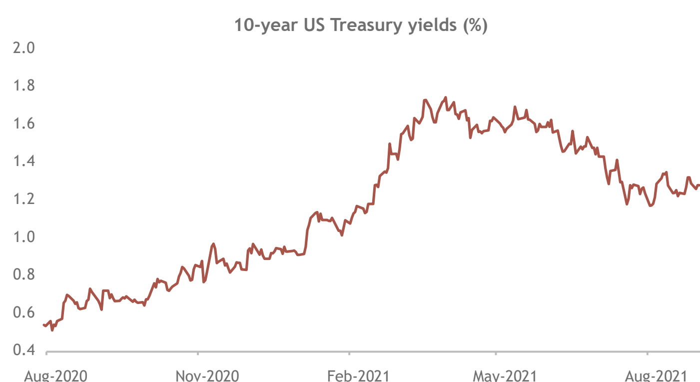
Equities

In the wake of the global financial crisis, the Federal Reserve introduced quantitative easing in order to stimulate the economy. The central bank expanded its balance sheet by purchasing Treasury securities and mortgage-backed securities. Since the pandemic hit, the Fed has purchased close to an additional $4tn of assets. This unconventional monetary policy tool has been a key support to the equity markets, enabling the S&P 500 to rally and reach its 50th all time high close this year, on the 24 August.

Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 September 2021

Fixed income

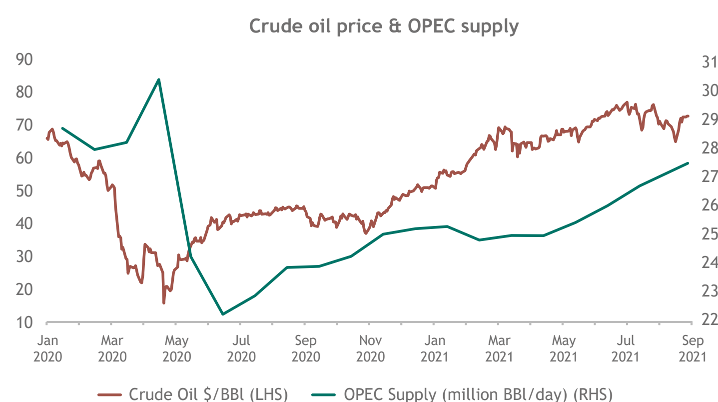
The focus of bonds investors in recent weeks has been when the Fed will taper its asset purchases, currently at $120bn/month ($80bn of US treasuries and $40bn of mortgage-backed securities). At the annual Jackson Hole symposium last week, Fed Chair Powell said that "substantial progress" on its inflation objective has been met, and there has been "clear progress" towards maximum employment. He and some other policy makers may think that it could be appropriate to scale back purchases this year, although the spreading of the COVID-19 delta variant remains a key risk. On the back of these developments, US 10-year Treasury yields moved up 0.1% to 1.3% in August.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 September 2021

FX and commodities

The oil price has responded strongly to rising economic growth expectations as markets have recovered from the pandemic shock, with the price of Brent Crude more than tripling from its April 2020 lows of around $20/bbl to around $70/bbl now. However, during August, the oil price suffered a setback (along with other areas of the commodity complex), as investors became concerned that the rapid spread of the COVID-19 delta variant would impact economic growth. Following their biggest week's loss in more than 9 months, oil prices bounced as the dollar weakened, leaving Brent within 5.5% of its July high. Energy investors' focus will now be on the Organization of the Petroleum Exporting Countries meeting on 1 September to see how they will assess and respond to the changing demand situation.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 September 2021

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	3.6	8.1	25.7	90.4
MSCI UK	1.9	2.6	23.8	24.5
MSCI UK Broad	2.5	3.2	26.6	29.6
MSCI USA	4.0	11.9	28.3	122.1
MSCI Europe ex UK	2.7	6.2	27.0	71.7
MSCI Japan	4.1	4.8	17.1	49.8
MSCI Pacific ex Japan	1.7	0.9	19.5	48.0
MSCI Emerging Markets	3.7	-0.8	18.2	58.9
Bonds				
iBoxx GBP Gilts	-0.8	2.8	-1.8	8.2
iBoxx USD Treasuries	0.9	5.4	-4.9	8.0
iBoxx GBP Corporate	-0.1	2.2	3.1	17.3
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-4.5	4.8	61.8	55.8
Gold ($/ounce)	-0.9	-5.2	-8.2	38.1
GBP/USD	-1.0	-3.2	2.8	5.1
GBP/EUR	-0.6	0.3	4.1	-0.9
EUR/USD	-0.5	-3.5	-1.3	6.0
USD/JPY	0.1	0.4	3.6	6.2

Market commentary

Global equity markets ended August on a high, having risen 3.6% (GBP, total return) over the course of the month, despite optimism being dampened by the spread of the delta variant of Covid-19. Notwithstanding rising Covid cases, the US outperformed its peers, returning 4%, with emerging markets following closely, increasing 3.7%. The UK was the regional laggard returning 1.9% over the month as Covid cases remain high and growth sectors outperformed their value orientated counterparts. Bond yields broadly increased over the month as inflation remains high and central bankers began to strike a more hawkish tone. In the UK the 10-year gilt yield moved up 13bps whilst the US 10-year treasury yield rose 4bps. Investors remain in buoyant mood as we approach the Autumn, supported by the re-opening of economies as countries attempt to return to a post-COVID normality.

Key macro data	Latest	2021 Consensus forecast	Spot rates	31-Aug	Yields (%)	31-Aug
UK GDP (YoY%)	22.2	6.90	GBP/USD	1.38	MSCI UK	3.68
UK CPI Inflation (YoY%)	2.0	2.10	GBP/Euro	1.17	MSCI UK broad	3.30
Bank of England Base	0.10	0.10	Euro/USD	1.18	10 Year Gilt	0.72

All values and charts as at 31 August 2021. Total returns in sterling.
Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.
Source: Thomson Reuters Datastream and Bloomberg

Important information

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

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