Smith & Williamson

Investment outlook

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

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Investment outlook

No time for stagflation in the UK

Given the recent surge seen in global energy prices, concerns are growing over stagflation – an economic environment characterised by low growth and high inflation. Historically, the last time developed countries experienced stagflation was in the period 1973 to 1982. After inflation trended up in the early 1970s, a tipping point came with the first oil shock in October 1973 when the crude oil price surged after OPEC embargoed oil. This was in response to the Western nations supporting Israel during the Yom Kippur War. By the time the OPEC embargo ended in March 1974, oil prices had risen 300%, while inflation accelerated to double-digit rates with weakening output growth.[1] A second oil shock occurred in 1979 with the fall of Shah in Iran and caused more oil supply uncertainty that ensured stagflation lingered into the early 1980s.

Essentially, stagflation occurs because inflation pushes prices up faster than wages and profits, forcing consumers and businesses to cut back on expenditure. This “demand destruction” becomes counter cyclical to growth. Investors can then become cautious on how much they pay for equities. For example, US stocks performed particularly poorly during the 1973-1982 stagflation period, losing -1.5% after inflation at an average annualised rate, compared to 3.2% gains for the UK equity market.[2]

Fast forward to today and strong GDP growth expectations means that firms are expected to pass on some costs to consumers without materially affecting demand, so the trade-off between growth and inflation is still favourable for fundamental company earnings - the underlying driver of stocks. Last month the IMF updated its projections to forecast UK 2022 real GDP (a rough indicator of revenue growth) to expand by 5.0% and CPI inflation of 2.0%. This is a long way from 1.4% real GDP growth and 13.9% annual inflation averaged by the UK during 1973-1982.[3]

Moreover, there is little evidence that company profit margins are being eroded by rising input costs (raw materials and wages). The UK MSCI forward profit margin (as a % of sales) has continued to trend upwards since troughing in June 2020 to reach 10.5% currently, its highest ratio in 14 years.[4]

Despite these broadly supportive drivers of company profits, a risk for UK stocks is that a supply squeeze leads to lower growth, as high energy prices could force manufacturing to cut production to save costs. For instance, rising natural gas prices have already interrupted production of fertilisers and, ironically, carbon dioxide, a key input in the meat packing industry. While petrol shortages seem past their worst, broader supply chain disruptions continue. In October, the CBI’s Distributive Trade Survey of the retail sector showed that the ratio of stocks-to-sales fell to its lowest level since records began in 1985.

The good news is that timely macro data shows that the UK economy is weathering the supply squeeze well. Job vacancies are at a record high and this is leading to rising aggregate UK employment and higher wage growth. On balance, we expect income from employment and a lower household savings rate to support consumption over the coming months.

Risk of cop out at COP26

The UK is hosting COP26 (shorthand for the UN’s climate summit) in early November. The summit is widely seen as an opportunity for major countries to propose policies and pledges to reach net zero emissions by 2050. Investors will be looking for progress at COP26, but there are significant future headwinds that need to be addressed.

First, nations are struggling to find a consensus on how to deliver on countering climate change. In the run up to the meeting, Bloomberg reported that G20 officials failed to reach agreement on lowering coal subsidies and methane emissions. Moreover, though China has committed to carbon neutrality, it is still not clear how it plans to do this particularly when there is no agreed price for carbon globally. China’s commitment is essential, as its greenhouse gas emissions exceed the rest of the developed nations combined.[5]

Second, the global economy is currently reliant on fossil fuel for around 84% of its primary energy needs, while solar panels and wind turbines offer only intermittent sources of energy.[6] Governments’ emission targets and investors put global energy companies under pressure to scale back fossil fuel exploration and production. There is a risk to economic growth should investment in renewable energy sources be unable to meet the world’s growing energy demand.

The journey to net zero needs to follow a route which is both environmentally and economically sustainable. In recent years, disinvestment from fossil fuels has become synonymous with the rise of investors considering sustainable factors in their portfolios. However, oil companies have a role to play in increasing renewable capacity. It is the huge complex energy projects involving renewables including offshore wind platforms, hydrogen, carbon capture & storage and the balance sheets that makes integrated oil companies potentially ‘system positive’ companies. Provided there is cooperation between fossil fuel producers, governments around the world and the renewable energy sector, COP26 could end up being a milestone in the path to reduced carbon emissions. Stakes and expectations have never been higher, but neither has global resolve.

Sources:

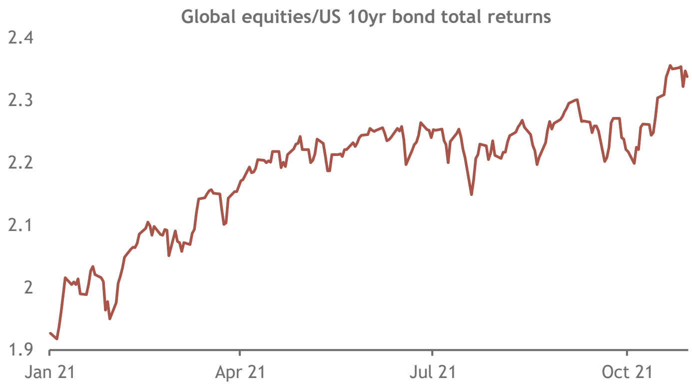
[1,2,3,4] Refinitiv/Smith and Williamson, data as at 29 October 2021

[5] CNBC “China’s greenhouse gas emissions exceed those of U.S. and developed countries combines”, data as at 6 May 2021

[6] Our World in Data, data as at 2019

Equities

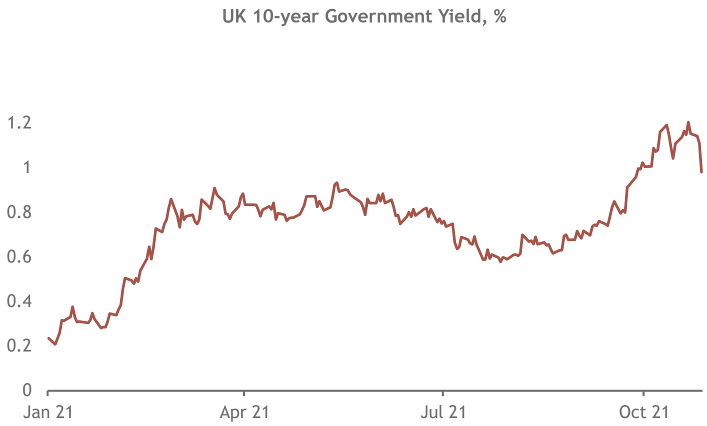
The beginning of the year saw confidence in the equity market rise as vaccination rates increased and economies began to reopen. Markets then cooled into the end of summer as concerns over peaking growth and signs of inflation drove investors to take a more cautious stance. In the past month, inflationary fears and the accompanying growing expectations of interest rate hikes pushed down bond prices. Accompanied by a rally in stock markets, the outperformance of equities over bonds was more marked in the past month. If growth remains steady and interest rate rises occur we expect this trend to continue.



Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 November 2021

Fixed Income

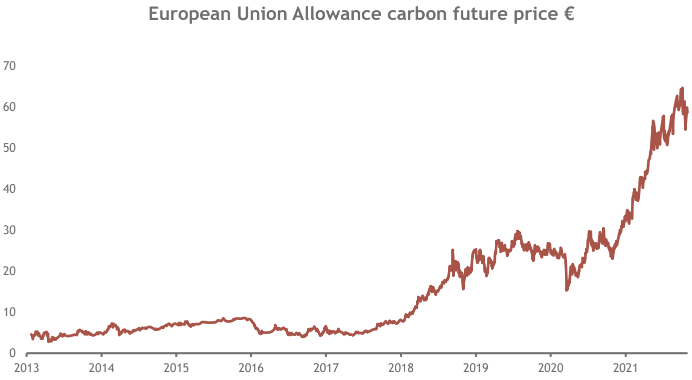
In the UK since the beginning of the year the 10-year gilt yield has been rising (bond yields move inversely to price). However, this became even more pronounced since the start of September, when gilt yields started to move higher, ultimately up nearly 50bps to touch 1.2% in October. This jump in yields was driven by inflationary fears and consequent higher possibilities of interest rate hikes. UK CPI (Consumer Price Index) inflation surpassed 3% annualised in August and is forecast to reach 4% by the end of the year. Some Bank of England policy makers including Governor Andrew Bailey made more hawkish comments, and clarified that they may need to act if inflation continues to increase. Money-market derived interest rate rise expectations have been brought forward compared to a month ago, pushing gilt yields higher.



Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 November 2021

Commodities and FX

As world leaders address climate concerns at the COP26 summit in Glasgow, market pricing of carbon could play a part in reducing emissions. The market for carbon credits remains young but has matured in recent years. The EU Emission Trading Scheme is the largest and most mature emissions market in the world and EUAs (European Union emission Allowances) are the focus for investment products in this area. The EU ETS began in 2005 and has recently entered its 4th phase of development. The credibility and impact of the scheme have increased considerably along with the price. From all-time lows in 2013, the system was reviewed, introducing measures to limit supply and increase industries under coverage. This, along with credits being recognised as a financial instrument in 2018, have helped to drive futures prices up nearly 80% year-to-date. Such growth could continue as the EU conducts its Phase 4 review, likely incorporating more ambitious emission targets.



Refinitiv/ Smith & Williamson Investment Management LLP, data as at 1 November 2021

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	3.4	4.9	30.0	81.5
MSCI UK	2.3	4.2	35.6	23.9
MSCI UK Broad	1.8	3.5	35.9	27.7
MSCI USA	5.2	6.4	35.2	115.8
MSCI Europe ex UK	3.0	2.1	33.2	61.7
MSCI Japan	-4.9	3.9	13.4	35.2
MSCI Pacific ex Japan	1.5	1.6	23.3	37.1
MSCI Emerging Markets	-0.6	1.0	10.7	42.1
Bonds				
iBoxx GBP Gilts	2.4	-2.3	-4.2	13.8
iBoxx USD Treasuries	1.0	2.6	-7.5	7.8
iBoxx GBP Corporate	0.4	-2.0	0.5	21.1
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	7.4	10.4	124.8	77.2
Gold ($/ounce)	0.9	-2.6	-5.5	39.5
GBP/USD	1.7	-1.4	6.0	12.3
GBP/EUR	1.8	1.0	6.7	6.4
EUR/USD	-0.1	-2.4	-0.7	5.6
USD/JPY	2.2	3.9	9.1	8.5

Market commentary

Equities rebounded from prior falls over the month leaving global equities to end the month up 3.4%. US equities reached a new all-time high, up 23% year-to-date. Similar trends were seen in the EU and UK, but with slightly lower overall growth. This comes as strong Q3 corporate earnings quelled some fears of the impact of high inflation as profit margins continue to increase. Emerging markets began to recover as regulatory changes in China slow. In the fixed income market, core sovereign bonds weakened as the possibility of higher interest rates comes to the fore. In the US the 10-year government falling back somewhat, and in the UK the 10-year gilt yield moved up to 1.2% but ended the month back at 1%.

Key macro data	Latest	2021 Consensus forecast	Spot rates	31-Oct	Yields (%)	31-Oct
UK GDP (YoY%)	23.6	7.00	GBP/USD	1.37	MSCI UK	3.632
UK CPI Inflation (YoY%)	3.1	2.30	GBP/Euro	1.18	MSCI UK broad	3.314
Bank of England Base	0.10	0.20	Euro/USD	1.16	10 Year Gilt	1.03

All values and charts as at 31 October 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

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