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The Winds of Change

As summer came to an end news flow became dominated by energy prices, supply chain shortages, and the anticipation of the UN Conference of the Parties (COP26) in Glasgow that started in late October. Inflation remained at elevated levels, but if the Bank of England's forecast is to be believed, the worst is yet to come. Interest rates are still at historic lows, although economic activity remained strong as Covid outbreaks were not initially followed by renewed lockdowns or restrictions. This looked set to change maybe with the labelling of the South African coronavirus strain as a "variant of concern" and with a surge of cases in European countries. Geopolitically, all eyes were on COP 26 in Glasgow, which saw a flurry of multi-lateral commitments to ending deforestation, methane reduction and green finance. The holdouts were obvious as China, Russia and India sat on the sidelines while the focus on "energy security", by China in particular, underscored the tensions between the desire to decarbonize and the thirst for electrical power.

As the end to the year nears, there is still a stubborn resilience in developed markets and another year of disappointment for emerging markets in the books. With performance flat to negative in those markets for 2021, and the spectre of regulatory "whiplash" from China as well as a stark disparity in vaccination rates compared to developed nations, all international diversification is not created equal. Meanwhile dollar strength continued while Sterling weakened as expectations for a rate rise were recently dashed.

Highlights:

- **Low interest rates and naggingly high inflation combined to create confident expectations of an upwards move by the Bank of England at their early November meeting – these expectations missed the mark however, and Sterling fell as UK rates were maintained at their historic lows of 0.1%.**

- **Supply chain issues and labour shortages continued to plague manufacturing and high energy prices remain a strain on input costs. Reports of factory closures, particularly fertilizer manufacturers as well as energy companies in distress underscored the high dependence on energy and indeed globally, blackouts as in China, emphasized the importance of "energy security" around the world.**
- **As Covid's impact continues to muddy the post-Brexit economy, an ongoing fishing row and labour shortages were reminders of the complex implications of the move which are still "work in progress".**
- **The regulatory interference in China has continued to cast a pall over Chinese stocks, as well as the ripple effects of the Evergrande default, one of the world's largest property developers.**
- **COP26 garnered a huge amount of media attention, and those countries who sat out (China, India and Russia) attracted as much attention as it served as a reminder of the inherent conflict in many of the conference's goals – especially with developing economies still committed to coal-fired production.**

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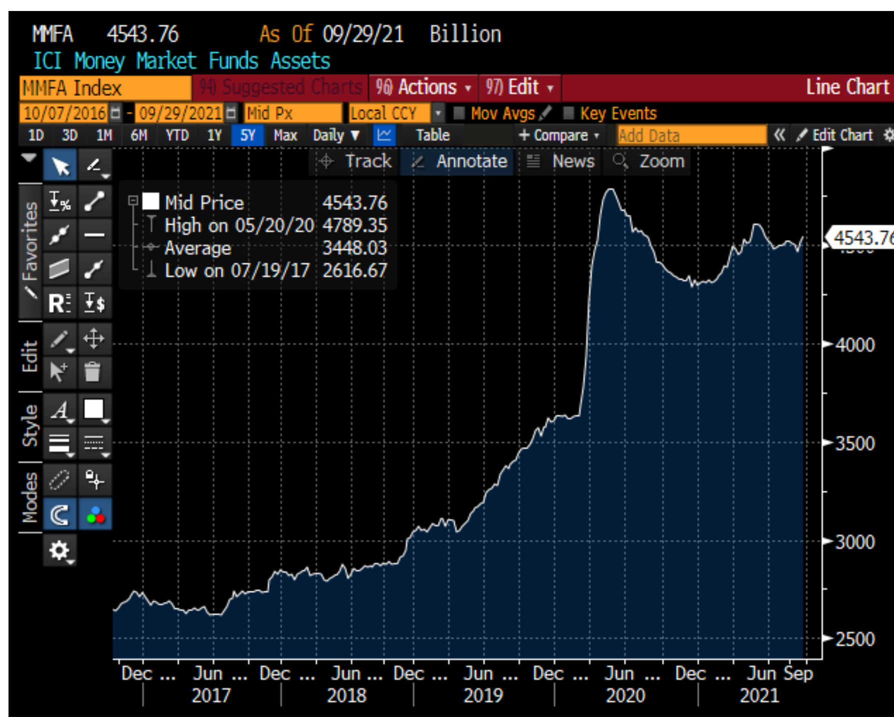
Current Macro Snapshot

Market strength continues

The message is little changed from last quarter in terms of market performance – while September was a negative end to the third quarter for most markets, October saw a renewed enthusiasm, and strong company earnings as well as a smattering of hype from COP26 underpinned markets. Facebook's fortunes took a dip down, but they took control of the narrative in late October by announcing a name change – to "Meta". November saw a sharp downturn on the day after Thanksgiving – as Black Friday turned into a sea of red. The spectre of renewed travel restrictions – in this case with flights limited from southern African countries sent the Dow Jones tumbling by over two percent and US indices had their worst trading day in 2021.

Markets remain broadly strong though, and as to the question of whether the current equity market strength can last, it is useful to point to the amount of "dry powder" or cash still sitting on the sidelines. The chart below, which shows the volume in money market funds (figures only available for the US), is a useful barometer of that. While off its record, the chart shows that levels of cash are still extremely high relative to historical levels. This may explain why equity market weakness has been so short-lived – as cash is redeployed to "buy on weakness".



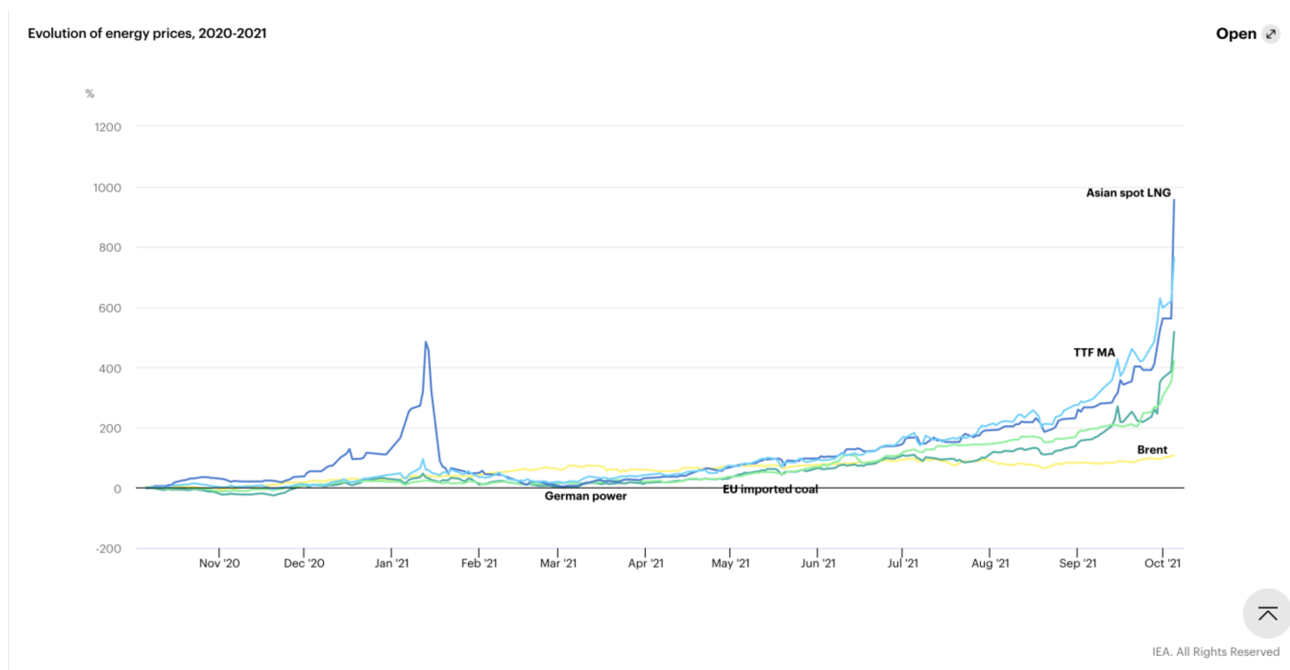
Dollar Strength also Persists

A strong dollar will have shored up internationally diversified portfolios and a weaker Sterling did not dent the fortunes of the FTSE to a great degree. The dollar has remained strong this year (see chart below).

Inflation – A Calm Before the Storm?

Last quarter we mentioned that the strength of Sterling in recent months had dulled the impact of "imported" inflation, but the recent reversal in Sterling will have re-introduced the potential for that. The Bank of England itself even admitted that inflation was likely to get worse before it gets better and conceded that the "cost push" nature of it would render their ability to control inflation through monetary policy essentially moot. Currently the Bank is forecasting levels to hit 5% in 2022, which might, in relative terms represent a higher rate than the recently reported US level of 5.4% due to the higher base level – i.e. the US rate is still compared to the relatively low level of activity in 2020, but the levels in 2022 will be compared to 2021, when economic activity had already increased.

The global nature of recent rises in energy prices is starkly evident in the chart below.



Brexit Update:

The aftermath of Brexit discussions continued to feature tense negotiations around Northern Ireland's future, as EU and British delegations were deep in discussions as to how free flow of trade between Britain and Northern Ireland could continue. Customs controls and health checks on animal and plant products exist as part of the trade deal, through which Northern Ireland remains in the single market for goods.

The effect of these disruptions has been felt for some time in Northern Ireland but the chance of Britain triggering Article 16, which would allow them to take unilateral "safeguard measures" to suspend part of the deal based on "serious economic, societal or environmental difficulties". The dispute regarding post-Brexit fishing rights was also still brewing, while uncertainty and strains on the supply chain continue to impact businesses on both sides of the channel.

Individual Asset Class Performance.

- Equities
- Fixed income
- Other asset classes

Equities: Records still being broken

In the UK November has been a negative month so far, although year to date performance is a deent 9%, which is still lagging other developed markets and its neighbouring European markets too, which soared to highs of their own driven by oil and pharmaceutical companies.

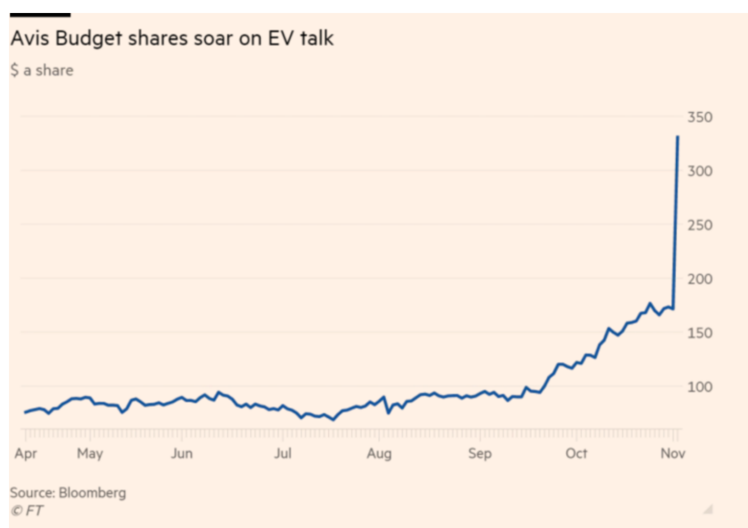
In the US, markets continued be strong with the S&P, the DJIA and the Nasdaq all reaching new highs earlier in the month of November. The S&P is showing 22% year to date return, and but is now flat for the past monthly time period. The recent boost came from a strong October jobs report, which beat expectations and showed that the pace of hiring had picked up as fears about the delta variant faded. The vaccine manufacturers saw diverging fortunes with Pfizer boosted by the pending rollout of the jab to the 5-11 year old cohort as well as the announcement of its experimental treatment (a pill). Moderna on the other hand saw an extended multi-day slump as it cited shipping delays as likely to slow the rollout of its vaccine.

An interesting twist in markets was the extraordinary boost that certain newsflow, particularly around the expected policy changes relating to green energy, had on individual results. Tesla saw its valuation pass $1 trillion as there was simply the announcement (subsequently contested by Elon Musk) that Hertz had simply ***ordered*** 100,000 EVs.

Hyperdrive

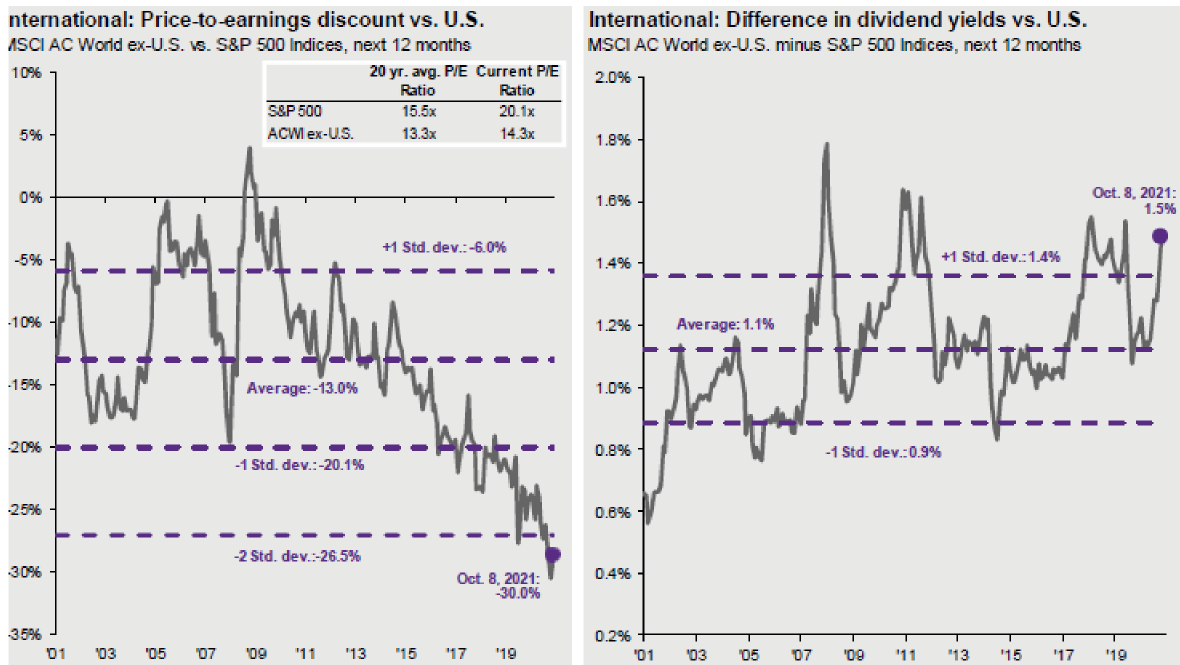
Hertz Order for 100,000 EVs Sends Tesla Value to $1 Trillion

It is worth remembering that Hertz only emerged from bankruptcy 4 months ago following its own Covid-related travails, and that a demand shortage has never been the constraint in EV sales – rather component parts and the supply chain. Just this past week we saw a similar move in the price of Avis, another rental company, when it mentioned also ***building*** an EV flight its stock soared 2x. No contract was announced.



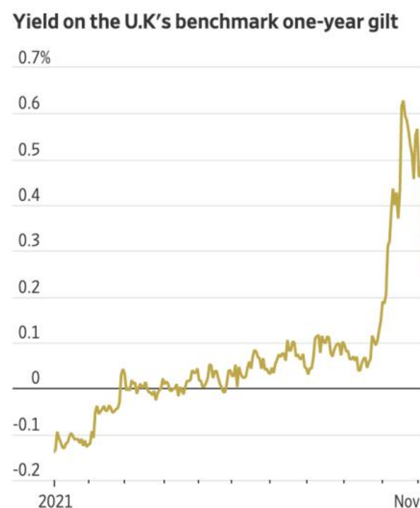
Emerging Markets continue to lag, with the exception of the Indian market (Sensex is up 20% year to date), Singapore (+11% ytd) and Japan (+5%). The shock of the distress of Evergrande (with over $300 bn in debt – including $20 bn in international bonds), had ongoing aftershocks as other developers faltered – such as Fantasia, China Properties Group and Modern Land.

The disparity between non-US markets and US is shown in the charts below. Non-US markets are trading at lower valuations and higher dividend yields than US markets, suggesting better value at this juncture. But the US offers appeal of "safety", a defensive currency and the irrepressible engine of growth.

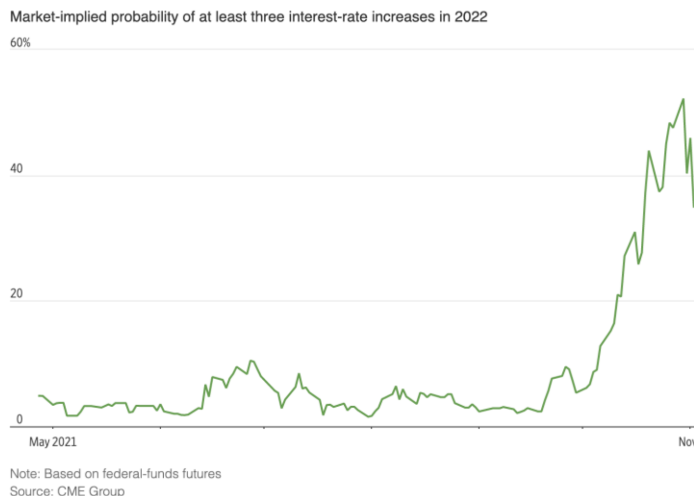


Fixed Income/Credit: an expectation of a rate hike misses the mark

Fixed income has had disappointing returns year to date, but demand for the asset class remains high despite low "real" yields – or yields after inflation – many of which are now negative. The mounting focus on inflation has led to increased expectations of rate rises, but these missed the mark this quarter, and Gilts saw their biggest daily drop in yields since the 2009 crisis, while the Pound lost 1.4% against the dollar in a single day, its biggest one day fall in more than a year.



As the chart below shows, the mood music is moving in terms of rate expectations in the US too, but if the UK experience is anything to by, there is a strong likelihood that Central Banks may lose their nerve.



Other asset classes

While oil prices remained strong, as did natural gas, and this drove the rising awareness of energy price inflation.

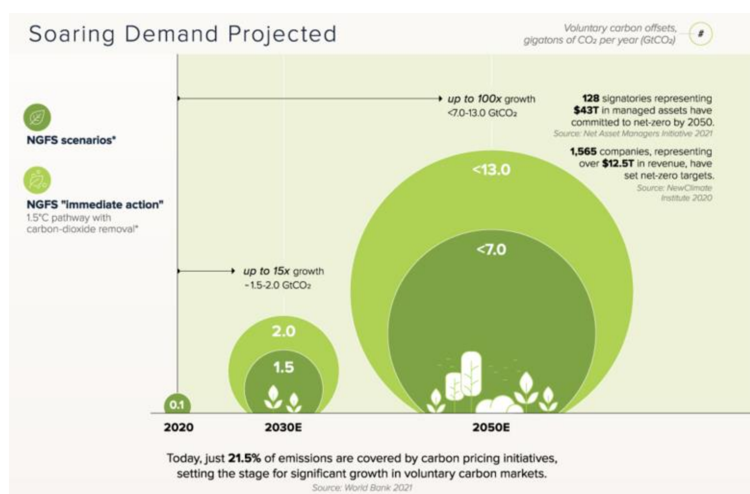
Lumber prices have come down somewhat – per the chart below – due to an easing in supply chain tightness. A reminder that what comes up *can* come down.

Spotlight: The Road from Glasgow

Meanwhile the climate was distinctly chilly in geopolitical circles as climate change policy was discussed at Glasgow and COP26. Attending nations used the opportunity to call out Russia and China for remaining holdouts on key multi-lateral pledges. One of the first such pledge was a pledge to end deforestation within the next decade, with more than $19 billion of public and private capital committed to the plan. The US joined with European nations in planning to cut methane emissions by 30% by 2030, and an announcement was made about an International Sustainability Standards Board (ISSB)– to have a global presence and receive support from regional financial institutions. These standards are expected to represent internationally consistent, high-quality, and reliable baseline standards for disclosure of sustainability-related information on enterprise value creation.

The pressure on companies to demonstrate “green credentials” was highlighted by Larry Fink of Blackrock as an arbitrage opportunity that would spur sales of polluting subsidiaries into less transparent private subsidiaries. His statement was notable in that it highlighted the disparity between developed and developing countries in their readiness to meet decarbonization standards and cited the fact that Blackrock had raised close to $700 m for a climate-focused infrastructure fund focused on developing countries. He also floated a “re-imagining” of the role of institutions such as the World Bank and the IMF, but also acknowledged the challenges in weaning energy-hungry countries off hydrocarbons. In this connection the Asia Development Bank plans to aid decommissioning of coal-powered plants in Indonesia and the Philippines and South Africa was promised $8.5 bn from the US, the UK and the EU to do the same. Meanwhile after recent blackouts China is building more coal-powered plants, although it has conceded that they will have cleaner technology.

Gestures such as this illustrate the importance of energy security, particularly in a highly digitized world, and underscore the challenges that all of the energy transition work is continuing to face. What is abundantly clear, though, is the extent of resources that will be committed to this cause on a global scale and the pressure on corporations to comply. It would seem to be unwise to take our eyes off this space. The chart below shows how meaningfully the demand for carbon credits is expected to grow in the coming decades.



* NGFS = Network for Greening the Financial System

Outlook

Last quarter we forecasted a climate of VUCA - volatility, uncertainty, complexity, and ambiguity and the conflict at the centre of COP26 illustrates why this complexity and nuance is important to understand. Inequality and the disparity of progress between developed and developing countries is at the heart of the conflict and has been seen to arrest the recovery from Covid as well as the race to address climate change. Bridging this gap will be an essential piece of the puzzle in the years ahead. In coming months we will be watching in particular:

- **Supply Chains – How bad is the crisis really, and are there any pressure valves that can be released in order to address the problem?** The coming Christmas shopping season will test supply chains and it may be that large providers who integrate their own supply chains flourish while other less integrated and smaller providers struggle. Energy prices will reach their maximum during the cold season and there may be "valves" that can be opened to relieve price pressure there too. If not, it could indeed place a catastrophic dent in consumer and company budgets.

- **Corporate Earnings and Next Steps.** The past earnings season may be viewed as a lagging indicator, based on the summer surge in travel and spending. As some of that subsides and

Covid savings are spent down, it will be interesting to see how the busy retail season fares and what impact that has on end of year earnings.

- **The Road from Glasgow.** As the fanfare in Glasgow subsides, watching what policies translate into action will be interesting. Will the deforestation pledge and the increased push to Net Zero lead to more forestry developments, more pressure on companies to comply and more incentives for sustainable and renewable energy? What will methane reduction mean in practice? How will corporations adapt – will they engage in the "arbitrage" forecast by Larry Fink – of shedding their polluting assets and thus improving their credentials? Or will the change be at the root of their business models, and will they build their own offsets, instead of paying away to get credit?

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November 26, 2021