



Investment Report – Q4 2021

“I think it's probably a good time to retire that word and try to explain more clearly what we mean.”
Jerome Powell, Chairman of the Federal Reserve

The final quarter of the year saw a retracement of many of the market trends that had established themselves earlier in the year. In the real economy, the improving picture also took a pause for breath, as some social restrictions were reintroduced to curb the spread of the Omicron variant of Covid-19. Having been on a downwards trend in the first half of 2021, government bond prices rose, particularly in November, as investors sought the safe haven they offer. As the quarter drew to a close, we saw some promising early data indicating that the Omicron variant causes milder illness. Reassured, markets returned to the trends of early 2021 in the final few trading days of the year, with bond prices falling and commodity prices rallying. We examine some of these moves below and identify the structural drivers that we are focused on.

Through most of 2021 and indeed the year before, financial markets traded on assurances from major central banks, including the US Federal Reserve, that inflation would be transitory and that they would continue to implement very stimulative monetary policy. The powerful assumption that yields will remain anchored around zero has fuelled widespread asset price growth in recent years, with global equities delivering double-digit returns for their third year in a row in 2021. However, the monetary policy tailwind stopped blowing for fixed income markets last year, as global bonds delivered their worst annual return since 1999 (-4.7%). We believe that bond markets are telling investors that the backdrop for financial assets is shifting. If this proves to be the case, our actively managed portfolios should materially outperform the returns available from financial markets in aggregate.

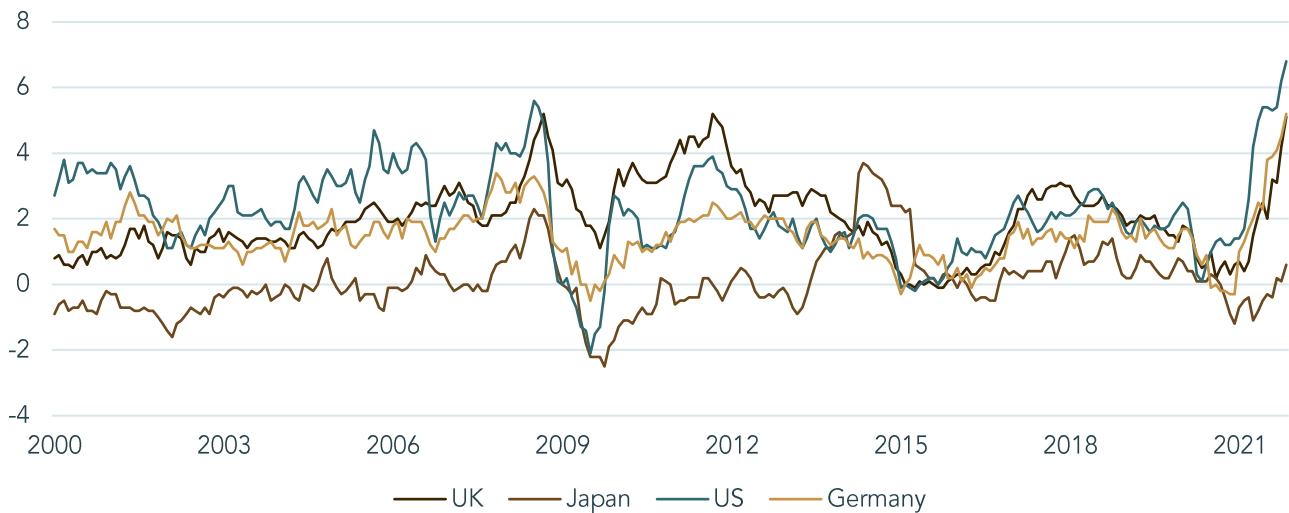
The market patterns of the last three years can be traced back to the global financial crisis of 2008. Since then, markets have been buoyed by large-scale central bank purchases of assets, boosting the prices of the instruments purchased directly in the market (bonds) and virtually all other assets from property to cryptocurrencies. Whilst major central banks' policy will remain accommodative by historical standards in the near term, the US Federal Reserve is expected to completely stop purchasing assets by the end of March and begin selling down these positions. The Federal Reserve is also expected to follow other developed markets such as the UK and Norway in raising interest rates 3 times in 2022. These two pivotal changes are likely to create much wider dispersion of investment returns in the coming years.

The catalyst for these shifts in monetary policy is the emergence of pricing pressure in the global economy: inflation. Across developed markets we saw several eye-catching pieces of inflation data over the course of 2021. The UK's Consumer Prices Index rose by 4.2% in the 12 months to October 2021, a 10-year high and coming hot on the heels of a 3.1% increase in September. In the US, the equivalent measure increased by 6.8% in the 12 months to November, a rate not seen since the early 1980s. Similarly in Europe, inflation across the 19-member eurozone jumped to 4.9% year-on-year in November, the highest rate since 1997. It is true that we have seen significant price increases for many months now, but those recorded in Q4 are more noteworthy given they have less of a base effect than inflation data in April and May of this year. Inflation data in these months were magnified somewhat by the extremely low levels of inflation at the start of the Covid-19 pandemic the year before.

These big price increases cannot be attributed to one single factor. The release of pent-up savings during periods of social restrictions in 2020 and 2021 are partly to blame, with economies experiencing strong consumer and business spending as society re-opened. As a result of monetary stimulus, there has also been a 'wealth effect' encouraging consumer spending, as asset prices, most notably house prices, have been driven higher in recent years causing consumers to feel wealthier. In the face of this strong demand picture, global supply has been slow to respond. A number of industries continue to experience supply chain disruption, which is touted by many as a short-term problem. However, structural factors such as wage growth and inflation in commodity prices, particularly energy and housing, may have a more lasting upwards effect on consumer prices.



Inflation (% year-on-year change in consumer prices)



Source: Bloomberg LLP, 2022

With the Chair of the Federal Reserve having admitted in November that ‘transitory’ was no longer an appropriate word to describe the current inflationary environment, it seems that central bankers have caught up with the market in acknowledging that inflationary pressure is likely to persist without tighter monetary policy. We commented in our letters earlier in 2021 that we felt relatively well prepared for an extended period of higher inflation if we were to enter one. Among the positions we took to reflect this view were an alternative stance towards fixed income, carefully selected equity positions and exposure to commodities, whilst avoiding making concentrated bets on inflation through expensive and volatile instruments such as index-linked gilts or derivatives. We continue to believe that our portfolios will perform well in an environment of higher inflation, with the flexibility to pivot if the situation changes.

As we turn our attention to 2022, we see multiple political narratives that could influence financial markets. After 16 years in power, Angela Merkel has been replaced as Germany’s Chancellor by Olaf Scholz of the Social Democratic Party. Leading a three-way coalition, Scholz will aim to modernise Germany with reformist policies that could prove supportive of the economy. Similarly, Japan’s newly-elected Prime Minister Fumio Kishida is touted as a positive economic force. Investors will watch with interest as these new leaders get their feet under their highly influential tables. Meanwhile, France is bracing itself for an election in April, with incumbent Emmanuel Macron leading in the polls at the time of writing. We expect to see Macron loosening France’s fiscal purse-strings in the run-up to election day, with his projected margin of victory over right-wing rivals Marine Le Pen or Valérie Pécresse by no means unassailable. Pécresse describes herself as “two-thirds Merkel, one-third Thatcher”, so her election would be interesting for European markets.

At the start of the year, it is tempting to have a new resolution or perhaps do something differently. However, the shifting landscape for financial markets, as they adjust to an environment of higher and rising interest rates, is a key component of our existing investment thought process. We therefore retain conviction in our current portfolio of investments, whilst looking for opportunities that these new dynamics may present.

Fred Hervey
Chief Investment Officer