QUARTERLY INVESTMENT LETTER

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

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Executive Summary

The past three months has seen the market cycle transition from a strong 'relief rally', which started at the end of March 2020, to a more typical 'mid-cycle' phase. Global equities declined by c. 1% in US Dollar terms[1], marking the first quarterly decline since Q1 2020.

The concept of 'peak growth' has dominated market sentiment with earnings and economic growth rates declining from high levels. Meanwhile, inflation fears continue to linger as higher commodity prices and disrupted supply chains feed through. The threat of persistent 'stagflation', when weak economic growth combines with high inflation, has pushed bond yields higher and rattled investors' nerves.

Without doubt, the outlook has become more balanced compared to earlier this year. This is common in the second year of a post-crisis recovery. However, we retain a constructive view towards equities, particularly when compared to traditional fixed income investments. A strong consumer market, continued policy support and an improving covid-19 situation underpin a resilient global economy, which we expect to support further earnings growth in 2022.

Depleting availability in global supply chains and further energy shortages pose a key threat in the coming months, with inventory levels in key markets significantly lower than normal. Much of what we are seeing today reflects the uneven path out of the pandemic. Demand and supply dynamics have been disrupted across industries for more than 18 months, but we see good reason to expect a gradual normalisation. We consider what is driving the inflation fears, the likelihood of its persistence over time, and what the market is currently anticipating from core inflation readings.

Our global multi-asset strategy includes dedicated allocations in Asia and broader emerging markets, which we increased earlier this year. The region has been at the centre of a number of investor concerns, particularly in China where regulatory reform has raised uncertainties about shareholder treatment in certain industries. The property market has also revealed its fragility as one of China's largest property developers, Evergrande, warned of a high risk of default. We retain the increasingly contrarian view that the Asian market has considerable growth potential over the long term.

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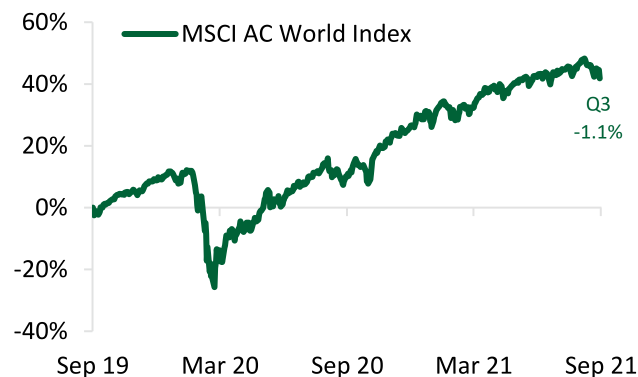
[1] Source: Bloomberg.

Introduction

The past three months has seen the market cycle transition from a strong 'relief rally', which started at the end of March 2020, to a more typical 'mid-cycle' phase. From an investor's perspective this means equities are more likely to suffer bumps in the road, as further gains are more dependent on earnings growth than market valuations. The concept of 'peak growth' has dominated market sentiment with earnings and economic growth rates declining from high levels. Meanwhile, inflation fears continue to linger as higher commodity prices and disrupted supply chains feed through. The threat of persistent 'stagflation', when weak economic growth combines with high inflation, has pushed bond yields higher and rattled investors' nerves. For the first time since the first quarter of 2020, global equities declined in US Dollar terms (see chart 1).

CHART 1: Global equities are up 11.1% in 2021



Source: Bloomberg, total returns in USD, September 2021

The outlook has become more balanced compared to earlier this year. This is common in the second year of a post-crisis recovery. However, we retain a constructive view towards equities, particularly when compared to traditional fixed income. To expand on this view, we cover three key topics this quarter. Firstly, the state of the global recovery in economic activity. Secondly, supply chain disruption and lingering inflation fears. We consider what is driving inflation fears, the likelihood of its persistence over time, and what the market is currently anticipating from core inflation readings. Thirdly, we review events in Asia that have fed negative sentiment and consider China's investability looking forward.

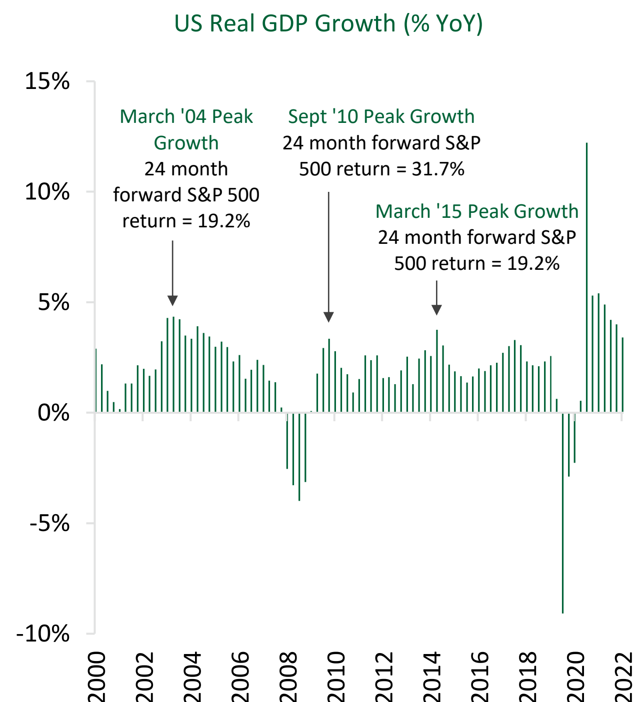
The state of the recovery – what follows 'peak growth'?

The dominant narrative that has driven market sentiment in recent months has been the concept of 'peak growth'.

> Having fallen sharply in the first half of 2020, year-over-year growth in economic activity and corporate earnings was impressively high in the second quarter of this year.

This is no surprise, with such rates of growth comparing an improving economic picture this year with widespread lockdowns in 2020. It is also no surprise to see such rates of growth decline over time. A similar dynamic played out during the post-2008 recovery. Looking at the past two decades, we can see growth rates peaking on three previous occasions following a crisis or slowdown. The interesting observation, however, is market returns following this point have historically been strong, as highlighted in chart 2.

CHART 2: US GDP growth over time



Source: Bloomberg, total returns in US Dollar. Real GDP growth beyond Q2 2021 are Bloomberg consensus estimates.

In the five years that preceded the pandemic, average Real GDP growth in the US was in the 2-2.5% range per year[4]. Recent IMF projections suggest that a 6% rate of growth in 2021 will decline to 5.2% in 2022[2] – slower growth, but still considerably higher than 'trend growth'. A number of economies, particularly in Asia, are expected to accelerate into year-end having suffered a deeper slowdown during the summer.

> Fears that slower growth means weak growth, or even recession, are premature at this stage.

Concerns around slowing growth have centred around three main issues; the pandemic, the reduction in stimulus measures (both fiscal and monetary), and inflation.

The lingering threat of Covid-19

Whilst significant progress has been made, a more deadly or transmissible Covid-19 variant could re-energise the spread of the virus. Such a scenario is likely to lead to increased restrictions or lockdowns, if the efficacy of current vaccines cannot maintain current low levels of hospitalisations. For most advanced economies, this risk is relatively low, with high vaccine coverage. Currently, 58% of the population in advanced economies have been fully vaccinated. However the global picture is very uneven. Approximately 36% of emerging economies and just 5% in low-income developing nations are fully vaccinated against Covid-19[2]. As such, future mutations remain a key risk.

Despite the uncertainty, there are reasons to be optimistic. Firstly, at a global level, the worst of the delta variant wave is hopefully behind us, with c. 650,000 new daily cases in mid-August falling to c. 400,000 today. Secondly, we are yet to see evidence that vaccine efficacy against severe illness is compromised from recent variants. For countries such as the UK where vaccine coverage now covers >80% of the adult population, recent infection waves have not resulted in significant hospitalisation. A recent study in medical journal The Lancet analysed the efficacy of the Pfizer vaccine against the delta variant after six months, and found that "*vaccine effectiveness against hospital admissions for infections with the delta variant for all ages was high overall (93%) up to 6 months*[3]". Thirdly, the vaccine disparity is expected to improve significantly over the coming months. India, the epicentre of the pandemic during the spring, has seen daily cases fall from c. 400,000 at the peak of the crisis to c. 18,000 today, and is now vaccinating c. 5-6million people per day[4].

The pandemic is still with us and remains the primary risk for the recovery and portfolio returns, but we see good reasons to expect further progress towards normality to be made.

Dialling down the stimulus

During the early phase of the pandemic we witnessed fiscal and monetary policy shift into expansionary territory at an unprecedented pace. For many advanced economies, interest rates have remained near zero and government budget deficits have expanded further. Now, as economic impact of the pandemic recedes, some fiscal support measures are expiring. In addition, central banks are starting to guide the markets towards higher interest rates. Norway became the first developed nation to raise rates late in September, while the Federal Reserve and the Bank of England are both due to reduce asset purchases later this year.

Where fiscal policy is concerned, the significant level of government spending will also start to decline. The IMF estimates that the aggregate budget deficit of the G7 will shrink from 6.9% of GDP this year to 4.9% in 2022[5].

With fiscal and monetary policy getting tighter, is this a warning sign for the recovery? An important consideration is the level of stimulus, not just the change from the prior period. In this case, the Federal Reserve will still be engaged in quantitative easing into 2022, albeit at a slowing pace, and is unlikely to raise rates for at least another 12 months. Even then it will take time and further rate hikes before policy

[2] Source : IMF World Economic Outlook, October 2021.
[3] Source: Tartof, SY et al. "Effectiveness of mRNA BNT162b2 COVID-19 vaccine up to 6 months in a large integrated health system in the USA: a retrospective cohort study", The Lancet, 4 October 2021.
[4] Source: Bloomberg, October 2021.
[5] Source: IMF Fiscal Monitor, October 2021. Cyclically-adjusted primary budget balance of G7 nations.

enters restrictive territory and slows the economy. Also, a reduction in fiscal stimulus does not represent a major headwind. The level of government spending in the coming years is still expected to exceed pre-pandemic levels, and this is before sizable infrastructure spending passes in the US. In addition, it is reducing against a backdrop of a healthy consumer market, with high levels of accumulated savings and pent up demand. Goldman Sachs estimate that such savings will lift GDP growth in the US by 1% in 2022[6].

Inflation – where has it come from and where does it go?

The threat of runaway inflation continues to test investors' nerves and dominate headlines.

> The first question to answer is where the inflation has come from. Is it broad based and likely to be a sustained trend, or a shorter term dynamic from specific areas?

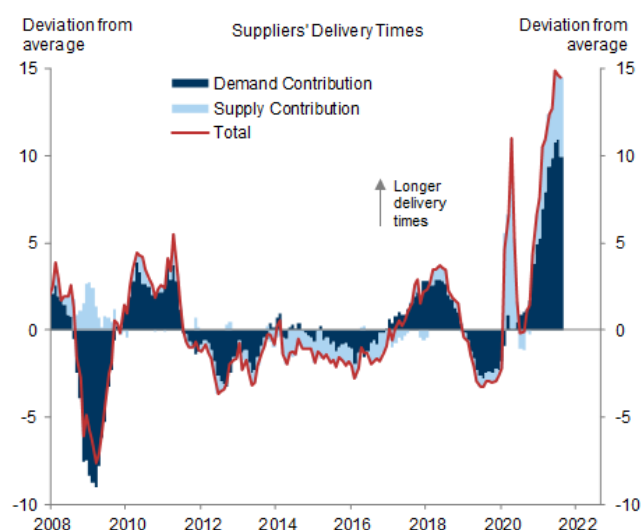
The breakdown of US CPI inflation is quite revealing, showing that the annual percent change in energy commodities, which represents just 4% of the inflation basket, is almost 42% (see chart 3[7]). For the 58% component of non-energy service inflation, the annual change is 2.9%. For the most part, inflation remains in a comfortable range.

CHART 3: US CPI Inflation Breakdown

Expenditure	12 month % change	Relative importance
All items	5.4	100.0
Food at home	4.5	7.7
Food away from home	4.7	6.2
Energy commodities	41.7	4.0
Energy services	8.5	3.2
Other commodities	7.3	20.7
Services less energy services	2.9	58.1

The rise in inflation has clearly been heavily driven by commodity prices, as demand acceleration has outstripped supply across markets and industries. Could this demand and supply mis-match persist over the long term? It is important to recognise that much of what we are seeing today reflects the uneven path out of the pandemic. Goods demand recovered very rapidly after the onset of the pandemic, driven by a combination of low borrowing costs, accumulated savings, increased demand for home improvements and collapsing spending on services. The demand side of the equation has been the key driver in creating bottlenecks (see chart 4). However, supply disruption has exacerbated matters, with Covid-19 restrictions slowing production, reducing labour availability and closing ports in some cases. As a result, soaring freight transport prices are inevitably feeding into input costs and consumer prices further down the line. Goldman Sachs estimate that approximately 2/3rds of the increase in suppliers delivery times in the manufacturing sector is down to increased demand[8].

CHART 4: Global Manufacturing PMI Breakdown*



*Purchase power parity weighted average of US, Euro area, UK, Japan, China and India

The extent of the demand / supply imbalance has exceeded recent history, but it is not unprecedented. History suggests that normalisation over time will follow.

If our assumptions about the Covid-19 situation are correct, and we continue to see fewer restrictions and more vaccination coverage, consumer demand will gradually shift away from goods towards services.

[6] Source: GS Global Research, "The Boost From Pent-Up Savings", October 2021.
[7] Source: US Bureau of Labor Statistics, September 2021.
[8] Source: GS Global Research, "Supply Chains, Global Growth, and Inflation", September 2021.

It makes sense that spending on big-ticket items in 2020 and 2021 will not repeat in the near term, and demand for entertainment and tourism is likely to improve from depressed levels. In turn, logistical issues in the supply chain should be worked through and price inflation will moderate. It may well be 2022 before the disruption is firmly behind us, but longer term persistence is unlikely.

It will not surprise us to see inflation remain stubbornly high over the coming months, but we do not yet see evidence of the kind of runaway inflation that was so damaging in the 1970s. Market pricing is informative for this analysis, where 10 year expected inflation currently sits at 2.5%[9]. This is a similar level to the early 2000s, and represents quite a meaningful increase from the 1.5% to 2% range of the prior decade.

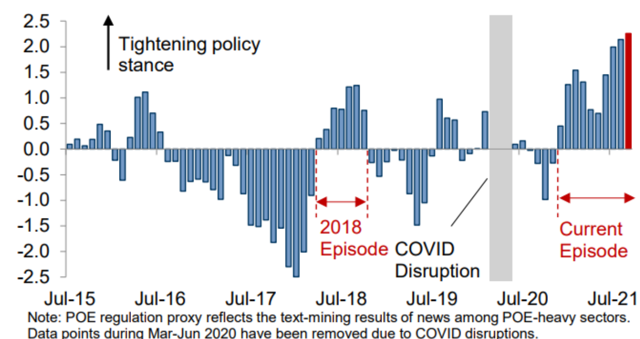
> We suspect the market has priced long term inflation risks fairly well – a higher range than before, when 'deflation risks' dominated, but well within the comfort zone.

Unforeseen events could change this expectation, and we keep such signals under close review.

The Chinese market – is it still investable?

Sentiment towards the Asian equity market reversed sharply this year, following a strong post-lockdown recovery in 2020. Economic growth stalled in the first half of the year, as reimposed Covid-19 restrictions combined with rising inflation – higher agricultural commodity prices a key factor. In addition, the Chinese authorities announced a series of regulatory measures that aimed to clampdown on undesirable private sector practices. Chart 5 below from Goldman Sach's Asia Strategy team serves as a useful illustration, which uses reports of regulatory changes across privately owned businesses as a proxy for a shifting stance[10]. This is all in the context of President Xi Jingping's "common prosperity" agenda, focusing on equitable and sustainable growth. Internet platforms, private education and real estate have all suffered tighter regulations, with Chinese equities losing c. $1trillion of market value since February.

CHART 5: Chinese Regulatory Reform



Note: POE regulation proxy reflects the text-mining results of news among POE-heavy sectors. Data points during Mar-Jun 2020 have been removed due to COVID disruptions.

An important consideration is whether the authorities have launched a broad attack on the private sector that should deter investors. Should investors turn their back on the region? The detail suggests this is not the case, but rather they are targeting specific behaviours and industry practices that are not aligned with sustainable growth goals. From a global perspective, the tightening of tech sector regulation is not inconsistent with measures coming through in Europe and the US. However China has taken a more heavy-handed approach to enforcement, which has shaken investor sentiment.

Some industries are likely to face further scrutiny and tighter measures, for example real estate, where the authorities are keen to control the kind of speculative demand that has created 'ghost towns'. The government announced measures to curtail leverage in the property sector in late 2020, which in turn has led to one of China's largest property developers – Evergrande – announcing difficulties meeting debt repayments and staying afloat. The risks of a 'Lehman moment' from their debt crisis appears low, with little foreign exposure and the authorities almost total control over the financial system. With the economy having cooled and the next 5 year Party Congress being held next year, it seems likely that the authorities will manage an orderly wind down of the developer and stabilise broader investor confidence.

[9] Source: US 10 year breakeven rates, Bloomberg, Sept 2021.

[10] Source: GS Global Research, "Top of Mind – Is China Investable?", September 2021

From an investor's perspective, the elevated sentiment towards Chinese equities has completely reversed, and valuations have shifted down. In some cases, this is justified by a tighter regulatory framework in which they operate. For those stocks that are facing core areas of growth, such as digitised infrastructure, clean energy, AI, cloud computing, medtech, domestic consumer brands, and others, there remains a breadth of opportunity. Importantly, we are deploying capital with specialist active managers in the region who have navigated the recent headwinds well, tilted their portfolios towards sectors viewed in a favourable light, and stand well placed to capitalise on such opportunities.

Summary

The global economy has slowed, but retains momentum that we believe is sustainable. More volatility in the coming months will not come as a surprise, as a number of these headwinds linger. However, the combination of a resilient consumer, contained inflationary pressures and attractive opportunities across global markets supports our constructive view. Our portfolios continue to hold short duration credit (over traditional government bonds), lean into equity markets across styles and regions, and diversify prudently through insurance-linked bonds, gold and long / short equity. As always, our underlying managers and headline positioning is kept under close review, as market dynamics evolve.

Stonehage Fleming Investment Management
Investment Committee
September 2021

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