QUARTER 3, 2021

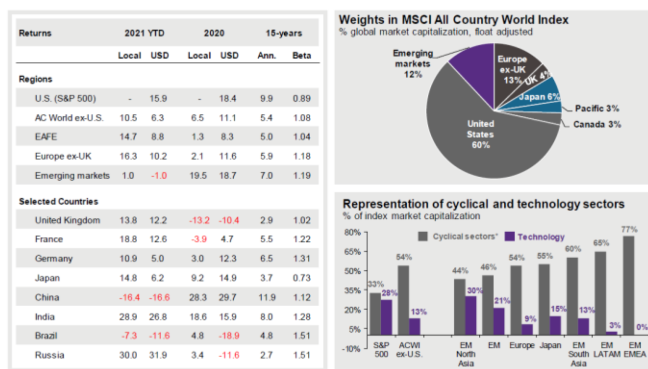
PPM
WEALTH

Global Markets & Economy Update

Markets have continued to outperform and move higher than pre-Covid levels, while the pace of the economic recovery in Q3 has continued to be strong. Market normalisation continues but regionally the recovery has been uneven. Covid cases increase as economies reopen, but mortality rates fall supporting the view that more lockdowns are unlikely which should allow some activity to continue to improve.

Bloomberg Global Stock Market Cap - As of 10/10/2021 (Source: Bloomberg)

Global equity markets (Source: JPMorgan; FactSet, Fed, MSCI, S&P) – As of Sep 30, 2021



Returns	2021 YTD		2020		15-years	
	Local	USD	Local	USD	Ann.	Beta
Regions						
U.S. (S&P 500)	-	15.9	-	18.4	9.9	0.89
AC World ex-U.S.	10.5	6.3	6.5	11.1	5.4	1.08
EAFE	14.7	8.8	1.3	8.3	5.0	1.04
Europe ex-UK	16.3	10.2	2.1	11.6	5.9	1.18
Emerging markets	1.0	-1.0	19.5	18.7	7.0	1.19
Selected Countries						
United Kingdom	13.8	12.2	-13.2	-10.4	2.9	1.02
France	18.8	12.6	-3.9	4.7	5.5	1.22
Germany	10.9	5.0	3.0	12.3	6.5	1.31
Japan	14.8	6.2	9.2	14.9	3.7	0.73
China	-16.4	-16.6	28.3	29.7	11.9	1.12
India	28.9	26.8	18.6	15.9	8.0	1.28
Brazil	-7.3	-11.6	4.8	-18.9	4.8	1.51
Russia	30.0	31.9	3.4	-11.6	2.7	1.51

During this recovery there has been some evidence of market stress; namely the move in commodities, China tech, supply chain constraints and inflation.

Supply chain issues have become more common and somewhat cloud the positive economic rebound: power shortages in China have continued to limit production, the UK is still struggling with truck drivers due to Brexit, and German ports have seen significant backlogs of goods. These constraints have lifted freight and labour costs while mobility restrictions are all having a significant knock-on effect.

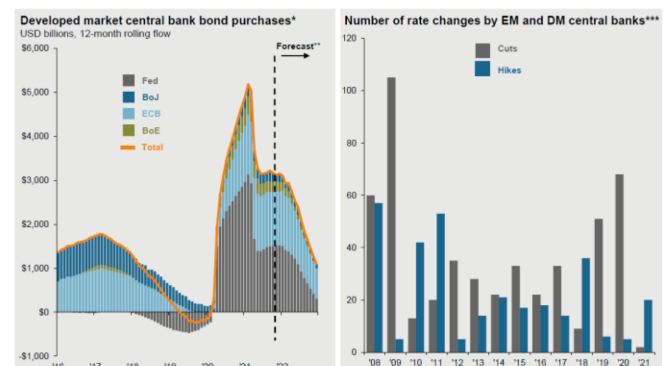
Supply-chain bottlenecks have become a hot topic of investor calls this year (Source: Bloomberg)

Even so, economies have recovered rapidly, with continual monetary and fiscal support leading to a swift recovery in economic demand. With some regions showing some manufacturing weakness throughout 2021, the speed of recovery in demand throughout this year has been strong. Once we see production accelerate and recovery across inventory levels (to match demand) in manufacturing, commodity, and retail, it should alleviate the upward pressure on prices.

Shortage of labour is also adding some pressure to supply chains (with vacancy numbers increasing), but we anticipate that once furlough and other employment support schemes are withdrawn then the unemployment numbers should start to trend back lower (if not, then wage pressure will increase further). This brings the inflation narrative into focus and has been at the forefront of investors thinking during Q3.

This point is of particular importance as the mandate of global central banks is to support price stability and provide full employment – so if they view inflation to indeed be temporary then they will not be in a rush to remove policy support. The rate outlook has changed towards the end of Q3 – the market is now pricing in Fed tapering before year end. The BoE is likely to hike rates later this year and end asset purchases while the ECB should end the Pandemic Emergency Purchase Programme (PEPP) in Q1 2022 and extend the Asset Purchase Programme (APP). The difficulty faced by central banks will be not to remove accommodative policy too quickly as virus cases increase and could inhibit the recovery. According to the World Health Organisation (WHO) the delta variant now accounts for over 80% of new infections, meaning that as more effective vaccines are implemented, assuming the death rate stays benign and decreases, then populations can look to return to normal quicker.

Global monetary policy (Source: JPMorgan, CBs; FactSet; Bloomberg)



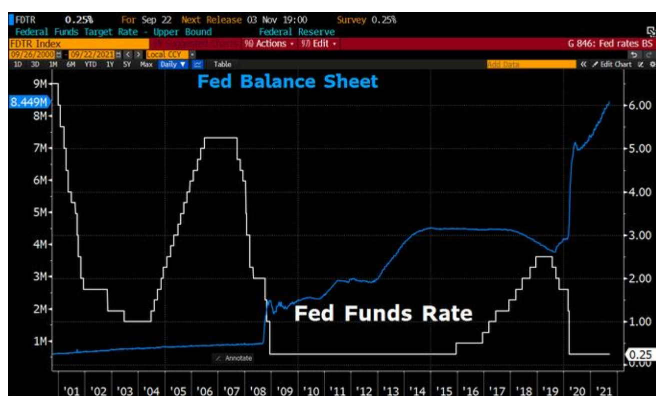
Q4 focus areas will revolve around some key themes namely inflation, virus cases and policy action from central banks. Once data and earnings normalise then we can focus on the strength of this recovery once policy accommodation is slowly removed. Q3 was strong but towards the end of September the market weakened due to a decline in risk appetite led by:

- Hawkish Fed
- US infrastructure plans facing delays
- Slow debt ceiling discussions
- Power outages
- Evergrande fall out and China slowdown

US

US equities delivered a positive return over the quarter with financials and utilities performing best and industrials and materials lagging. The Fed stated in September that tapering of QE will be announced at the November meeting and will finish by mid-2022. The median rate expectation for 2023 moved up to three hikes from two in June, with three additional hikes in 2024 and Fed officials were evenly split 9-9 on a rate hike in 2022. The shift comes in the context of a downward revision of real GDP growth estimates (from 7% to 5.9% for 2021) and a rise in inflation (from 3.4% to 4.2% in 2021).

Fed Balance Sheet & Fed Funds Rate – 26/09/2000 – 22/09/2021 (Source: Bloomberg; Fed)



Despite these uncertainties, investors have been actively moving money into US equities and the S&P 500 closed to record highs 54 times in 2021. Q3 has been a bumpy quarter, but Q4 historically tends to be a good period for the market.

Towards the end of Q3, the Nasdaq fell to the lowest level since June as rising bond yields served to drive mega-cap tech names lower. According to Bloomberg, the NYSE FANG+ Index is priced at about 27.6x estimated earnings for the coming year versus 20.2x for the S&P 500 index. That's the narrowest premium since December 2018, when markets slumped because of U.S.-China trade war, hawkish Fed and falling earning expectations.

Nasdaq & US 10-year yields – 30/03/2021 – 04/10/2021 (Source: Bloomberg)

Europe

The European equity market was flat in Q3 with energy and technology shares being the top performers. Consumer discretionary was the weakest sector amid signs that China could aim for greater wealth distribution, which could hit demand.

Like in other regions, investors have been concerned about inflation due to supply chain disruptions and spikes in energy prices.

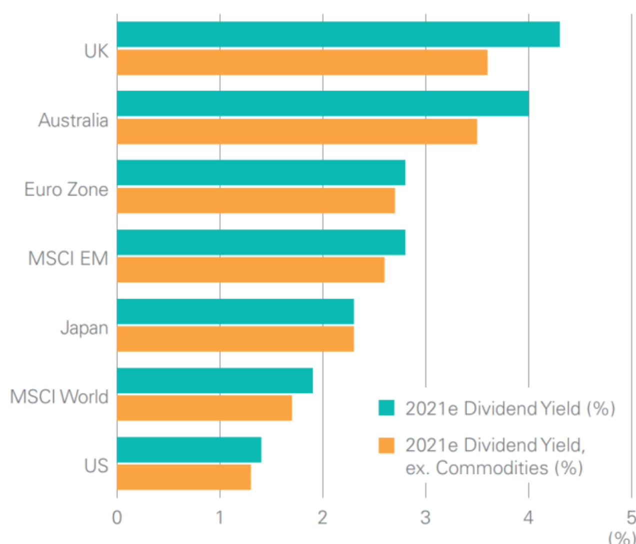
The ECB has continued to change its APP with monthly purchases down from €80bn to around €60-70bn. The ECB continues to be acutely aware that during this recovery phase the easing of purchases is still accommodative enough to buy future excess debt.

The region provides upside on the back of a strong economic recovery, driven by new highs in the DAX, moving from a low of 8900 in 2020 to a print of nearly 16,000 in Q3.

UK

UK equities rose over the third quarter with energy stocks outperforming and consumer staples delivering polarised returns with lowly valued grocery retailers performing best. The UK market is currently trading at the lowest forward P/E level against global peers in the last two decades with a 4% dividend yield which is the highest across developed markets.

Dividend yields across markets – As of 06/09/2021 (Source: Lazard, JPM, MSCI)

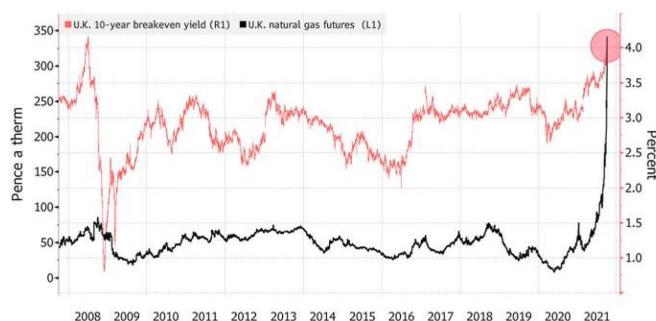


More M&A activity has continued during the quarter with FTSE 100 names such as Meggitt, Morrisons, Entain and Avast all being subject to takeovers. In the mid-cap space, Sanne and Apex have had substantial premium buyouts with plenty more expected. With share prices starting to recover and the opportunity for easy financing, activist interest has also increased (e.g., GlaxoSmithKline and SSE). Overall, takeover

activity is near a 14-year high, rates are likely to rise by year end and the earnings cycle should provide like-for-like upgrades in Q4. The FTSE 250 has hit a new high and we do see scope for the FTSE 100 to move higher - hence why we continue to favour the region.

UK inflation expectations hit 13-year high and 10-year breakeven rate tops 4% supporting a more hawkish tone of the Bank of England (BoE). Again, these pressures are primarily due to supply bottlenecks and UK gas prices rises.

Inflationary woes: UK 10-year breakeven rate, natural gas prices soar in tandem (Source: Bloomberg)



Japan

Japanese stocks performed strongly in Q3 despite the increased number of Covid cases in the country and the resignation of Prime Minister Suga. The market reaction to his stepping down was positive as Suga was blamed for mismanaging the pandemic crisis and the government's policy. Mr Kishida was ultimately elected as Liberal Democratic Party (LDP) leader becoming Japan's 100th prime minister. We don't anticipate any significant changes in the direction of monetary or fiscal policy, but we should see a stronger position in the vaccination programme and long-term policy should favour national and economic security, digitalisation, and green initiatives.

General election should be held in mid-November and, historically, Japanese equities tend to perform strongly in pre-election periods. We view the region as being one to continue to outperform into the end of the year.

Strict lockdown measures have prevented the Japanese economy from achieving a full rebound. Flash estimates for services PMI have started to improve but remain below 50, evidencing that the slow vaccine rollout has had a detrimental effect on activity improving. However, recent numbers have been encouraging with Japan's Q2 earnings results exceeding consensus expectations. As infection rates ease off, we should see a more robust economic turnaround.

Emerging Markets (EM) & Asia ex Japan

In general, EM equities have lagged in Q3 due to the after effect of the virus and the slower vaccine rollout, but the major catalyst was the Evergrande news in China. Even before this there was some government pressure on tech companies to take more account of data security and market concentration concerns. Within this space also was the immediate restrictions placed on gaming and education sectors, which led to a quick aggressive sell off in domestic and global markets as investors tried to quantify the impact of these quick policy changes for corporates. The message from China was it was being implemented to protect mental health and rebalance inequality. The Evergrande situation stemmed from a policy to prevent excessive risk taking in the property sector. In turn this forced real estate developers into higher financing costs affecting those with weaker balance sheets.

On a macro level, this gives some elevated risks to the outlook for the Chinese economy as the cost of financing increased and dropped demand for real estate at a time when the Delta variant was already impacting domestic demand. Given that this sector represents nearly 27% of GDP, it shows why the reaction was severe and moved into other global regions and commodities.

China real GDP growth slowed to 4.9% YoY in Q3, from 7.9% in Q2. On a quarterly basis, growth slowed to 0.2% QoQ from 1.3% QoQ in Q2, highlighting lost momentum as supply chain disruptions, Evergrande, energy price moves and regulatory crackdown being the main catalysts.

China GDP YoY – 31/03/1992 – 30/09/2021 (Source: Bloomberg)

Economic data in China pointed towards a slowdown in Q3 primarily due to supply chain bottleneck and zero-tolerance policy on Covid (school closures, workplace closures, and travel bans), which has weighed on activity. This also led to a significant easing of retail sales (slowest growth since August 2020) and the fallout from the Evergrande situation.

Recently, the PBoC has injected a huge amount of liquidity measures into the economy to prevent any contagion effects from the Evergrande news. The outlook for China does remain delicate, but we know from history that when weakness emerges then the subsequent monetary and fiscal policy response has been sufficient to support growth metrics. We are witnessing a shift back to political power where domestic corporates – especially those operating as effective monopolies or duopolies are being brought to task. Going forward the focus is on realigning party policy and actions with a programme of prosperity for all.

Fixed Income

US and European government yields ended up flat in Q3 amid a hawkish shift from central banks and rising inflation concerns.

The US 10-year Treasury yield finished slightly higher at 1.49% after continuing inflationary pressures and increasingly hawkish Fed. The UK underperformed, with the 10-year yield increasing to 1.02% after signals of a hawkish shift by the BoE. In Europe, where the economy continued at a strong pace, the German 10-year yield was negative at -0.19% while Italy's 10-year yield finished at 0.86%.

The more speculative high yield (HY) fixed income made positive returns, while investment grade (IG) segment ended flat. European IG outperformed government bonds, while the US market was in line with Treasuries.

EM government bond yields rose, but EM corporate bonds delivered small positive returns.

We continued to reduce our fixed income exposure with proceeds being reinvested into our preferred physical infrastructure holdings.

Inflation

During Q3 markets struggled to interpret inflationary expectations. Initially it was deemed the shift in yields was the reason for equity weakness but then the narrative changed to point towards a slowdown in growth. The expectation for inflation is primarily driven by the trajectory of the economic recovery and the ability of monetary and fiscal policy to manage a balance between a desirable level of inflation and the risk of an overheated economy and the Fed being deemed to be behind the curve.

Inflation expectations – 12/10/2013 – 15/10/2021 (Source: Bloomberg)

US 2-10-year yield curve – 25/03/2015 – 13/10/2021 (Source: Bloomberg)

Commodities

Commodities were the best performing asset class in Q3.

Bloomberg Commodity Spot Index – 01/01/1900 – 04/10/2021 (Source: Bloomberg)

Global commodities (Source: JPMorgan; Bloomberg; CME) – As of Sep 30, 2021

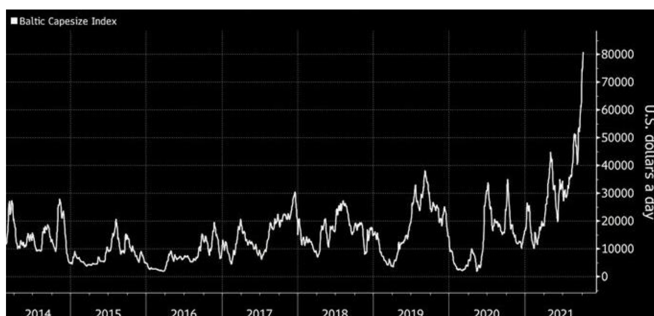
Energy was the outperforming segment, led by a sharp rise in US natural gas prices. Chinese macro data softening has not prevented oil and gas staging a dramatic recovery in pure price terms and easing Covid cases and the slow rise in mobility have given cyclical commodities a tailwind. Oil demand from India, the US and China can be attributed to the large price swing to the upside and should maintain demand into 2022. We envisage some rising oil supply next year from some Iranian barrels coming back on the market and from the US and OPEC+ (Saudi Arabia and Russia).

WTI & Brent Oil – 19/03/2001 – 11/10/2021 (Source: Bloomberg)

Aluminium outperformed on China's decarbonisation-inspired supply curbs while some other base metals have continued to drop after weak Chinese data and Evergrande contagion risk. Precious metals underperformed on rising yields and a stronger US Dollar, and we expect this trend to continue in the midst of Fed tapering.

Overall, in the last quarter we have seen robust demand for commodities and global shipping constraints, and we expect this to continue.

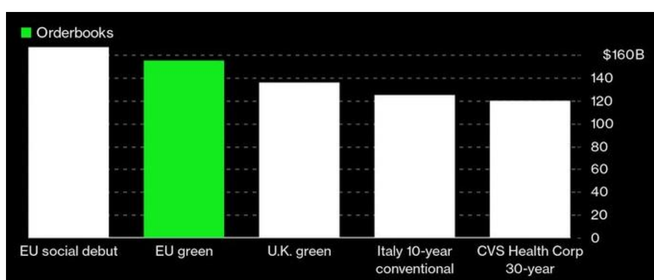
Commodity shippers are earning the most in years – Baltic Capesize Index (Source: Bloomberg; Baltic Exchange)



ESG

Demand for ESG investments has continued to gain momentum in Q3 as more investors are willingly embracing the importance of ESG exposure within portfolios and global initiatives (infrastructure package in the US, China changes and tax breaks) have widened the net. This secular trend pushed corporates to transform the way they craft strategy, drive performance, and report results.

EU green debut is among the largest-ever debt orderbooks (Source: Bloomberg)



Despite the positive momentum, we look closely at the risks involved in the ESG world like sector concentration, lower portfolio diversification, and the tactic of greenwashing which companies use to appear more sustainable than they actually are.

Investment Outlook

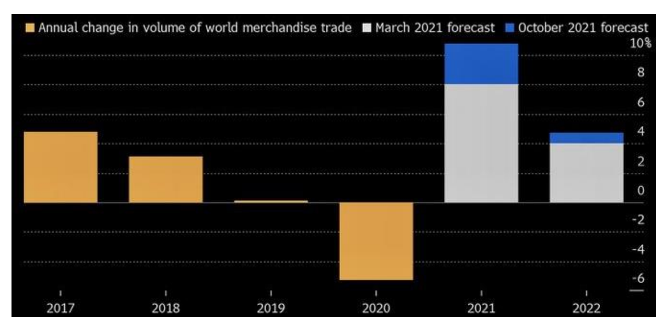
Q4 will most likely start with caution, given recent hawkish central banks' rhetoric, some weakness in global growth prints and elevated idiosyncratic risks. Investors have already seen weaker macro data, higher inflation and arguably a peak in earnings growth during Q3 - all of which we do not think will be repeated in Q4 as historically post Q3 the market has a strong finish into the year end.

The effect of the pandemic and supply chain bottlenecks are now impacting supply and demand leading to imbalances in services and commodities. We are yet to see if the supply chain disruptions and rising costs will impact profits and to what extent corporates can pass on higher costs to the consumer - both questions that should be answered in the coming earnings numbers.

In the next set of earnings, we should also get some clarity on the impact of rising bond yields and rising cyclical commodity prices. The Fed have signalled tapering will occur in November and finish by mid-2022 while the ECB should provide clarity on the specific details of the APP once the PEPP ends in March 2022.

WTO raised its projection for global trade growth in 2021 and 2022 to 10.8% and 4.7%, respectively, citing the resurgence of economic activity in the first half of 2021. Should the 2021 forecast be met, it would mark the biggest year-over-year jump since 2010.

WTO expects trade to rebound 10.8% in 2021 and 4.7% in 2022 (Source: Bloomberg; WTO)



In general terms, we continue to tactically adjust our global asset allocation within risk graded portfolios, taking advantage of secular themes and market price anomalies. Greater market participation from computerised trading, algorithms, and retail investors, exacerbates volatility, but it also creates opportunity – this environment enables us to take a holistic view on the market and capitalise by using our experience in such circumstances whilst simultaneously, managing risk exposure.

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