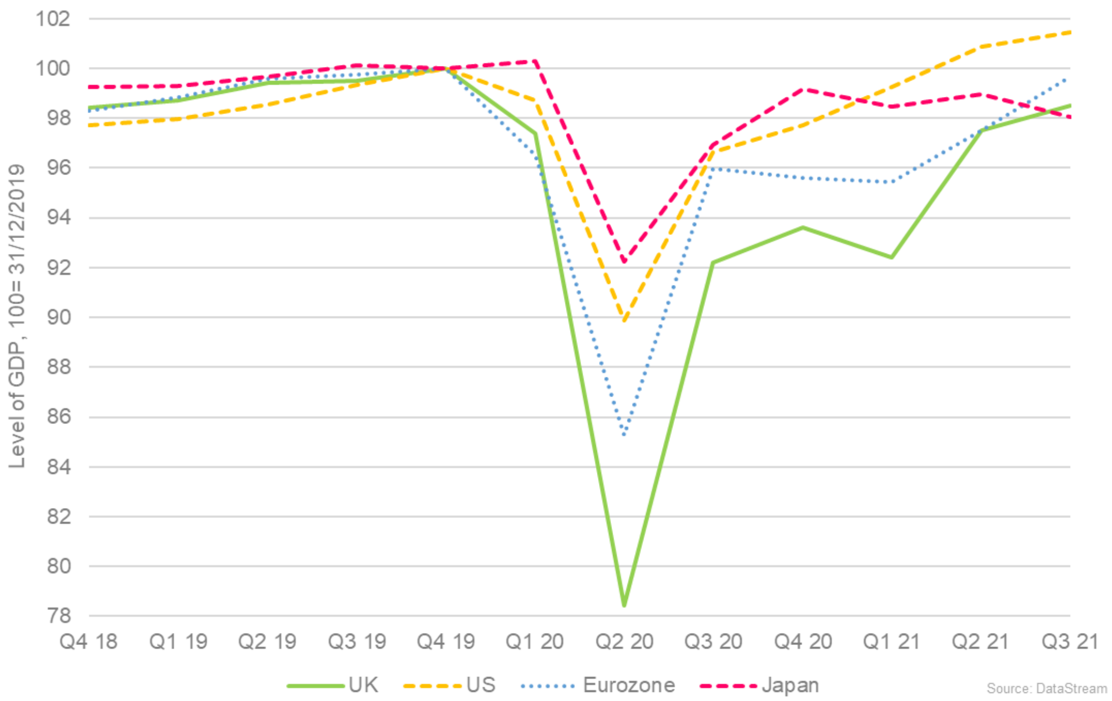
Market commentary Q421

Economic background

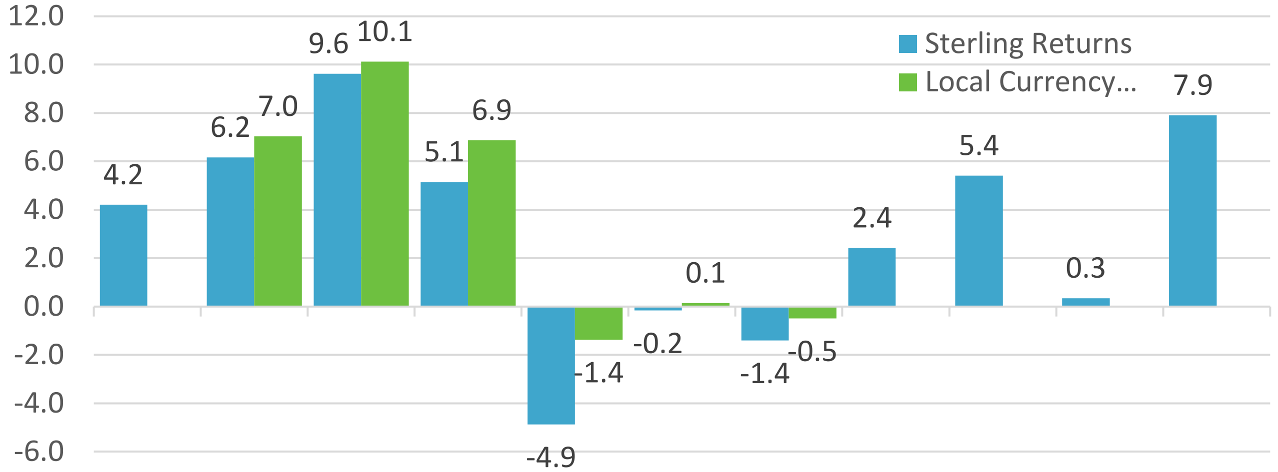
- Strong earnings growth drove global equity markets higher in Q4, despite increased volatility as economic concerns regarding the Omicron COVID variant came to the fore.
- Short-term yields moved higher to price in a faster pace of interest rate rises while longer-term yields were kept in check as investors weighed the impact of policy normalisation on both growth and inflation.
- Corporate bond yield falls in December largely reversed November's increases, leaving credit spreads (i.e. additional return for credit risk) broadly in-line with end-September levels.
- The total return on the UK Monthly Property index was 19.9% over the 12-month period. This was largely driven by the buoyant industrial sector.

Chart: GDP Growth



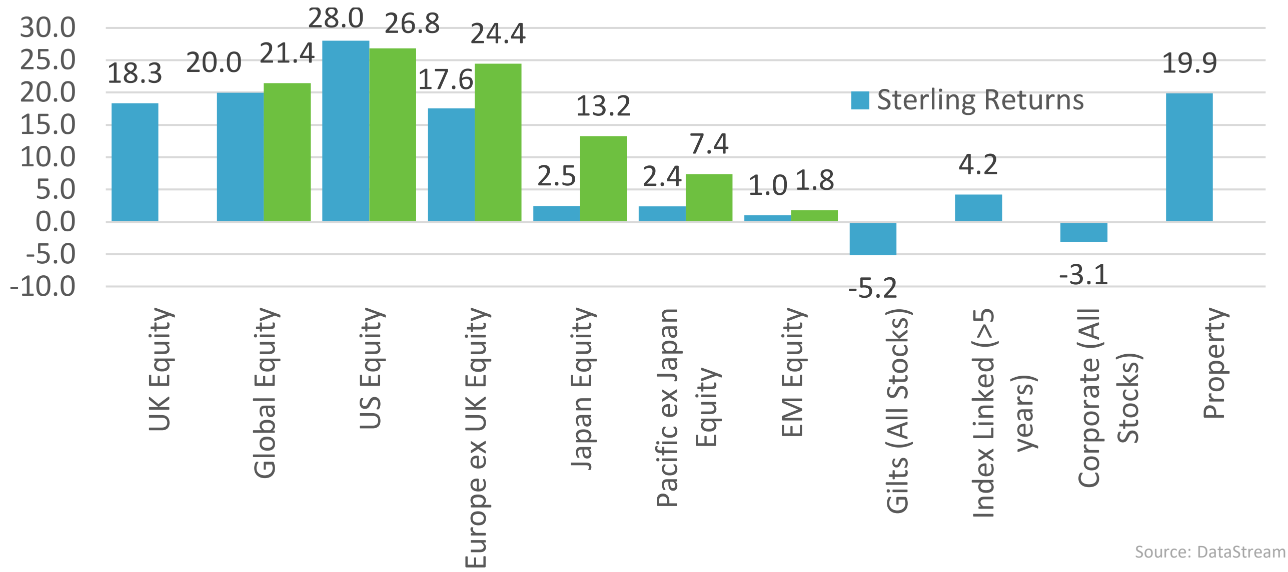
Market returns

Chart: Q4 ‘21



Source: DataStream

Chart: 12 Months



Source: DataStream

Equity markets

Despite falling in November over Omicron variant concerns, global equities produced a total return of 7.0% in Q4, propelled higher by strong earnings growth. Sterling strength reduced returns to unhedged UK investors to 6.2% in sterling terms.

All sectors produced positive returns except telecoms. Outside telecoms, energy and financials were the main underperformers, weighed on by demand expectations and flatter yield curves, respectively. Technology was the notable outperformer, bolstered by strong earnings releases and the prospect of further lockdowns spurring demand for tech.

North America posted double digit returns on the back of tech outperformance. Japan, which reintroduced strict border restrictions shortly after the Omicron variant was made public, is at the bottom of the regional performance rankings over the quarter. Asian and emerging markets also continued their underperformance versus developed markets.

Bond markets

US and UK bond yield curves flattened with short-term yields rising to reflect expectations of further interest rate hikes. Long-term yields remained largely unchanged.

The trend in monetary policy is likely to put upwards pressure on long-term bond yields to rise but, if inflation does fall over the course of the year, limiting the need for aggressive monetary policy tightening, the rise in yields is likely to be limited and gradual.

Core sovereign bond yields, particularly at the front-end of the curve, are pricing in a reasonable path of interest rate rises, but yields are very low in absolute terms and provide little protection against any persistence in current inflationary pressures.

Property

UK commercial property rents are growing strongly within the industrial sector, but more slowly in the office sector. Rents in the retail sector continue to fall, albeit at a slower rate.

In aggregate, tenant demand is rising while the availability of stock falls, helping to underpin improved rental expectations and allowing landlords to offer fewer inducements to secure tenants. However, rent collection remains lower than normal as rent moratoriums delay payments to landlords.

Outside of the traditional core market, the leisure and hotel sub-sectors continue to face near-term disruption stemming from the pandemic.

Reversionary (full rental) yields have fallen further in recent months as demand, from both domestic and overseas buyers, remains strong.

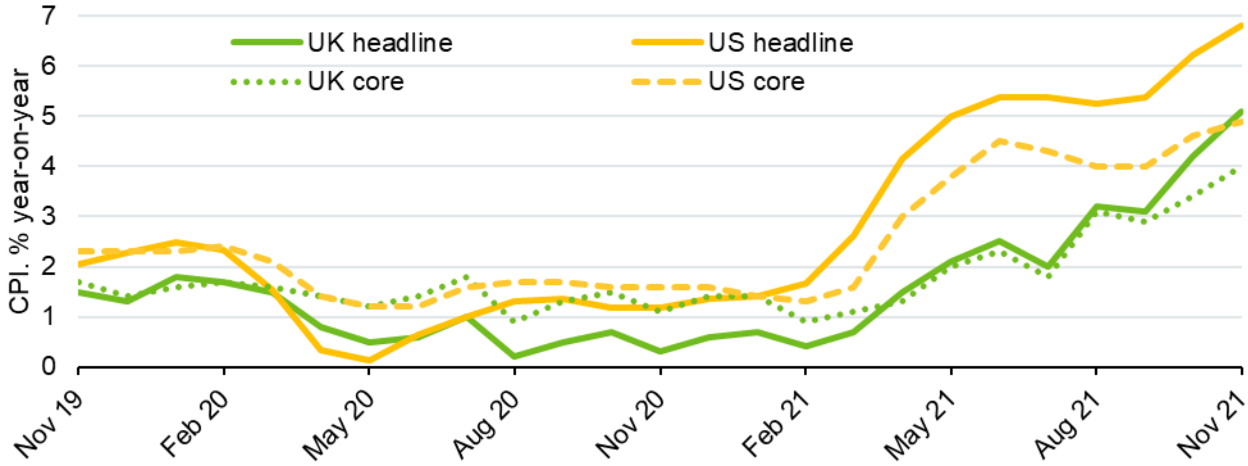
In a time of inflation uncertainty, we prefer long-lease funds with a high degree of inflation-linked rents. Lower exposure to the retail sector is also supporting demand for long-lease funds, which continue to have queues in place.

Subject of interest – Inflation

Inflation is a key factor for the Fund as both the liabilities of the Fund are linked to it and it impacts the prospective return on assets.

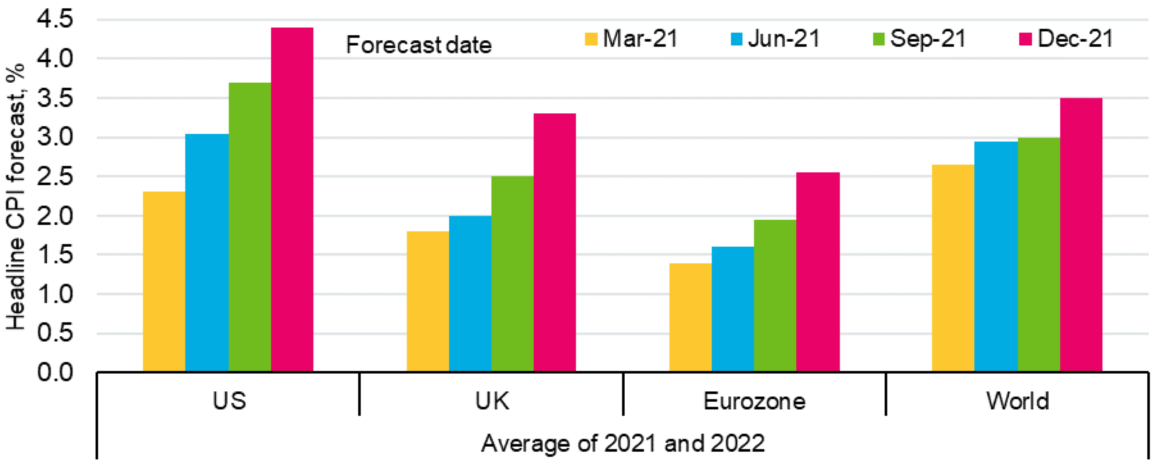
In terms of the recent news stories, while business surveys in the major advanced economies continue to point to a strong expansion in economic activity, measures such as the manufacturing purchasing managers indices are flattered by lengthening supplier delivery times and output is constrained by supply chain disruptions and staff shortages. Supply-side problems are seeing input cost and output price growth running at, or near, record highs. This, alongside a steep rise in energy prices is contributing to inflationary pressures which are proving to be far more stubborn than most forecasters initially expected. Even core inflation, which excludes energy prices as well as food, is exceeding central bank targets in many major advanced economies (Chart 1). Indeed, demand factors are clearly playing a role too, particularly in the US. Strong fiscal stimulus, latent demand from the lock-down period and the shift in demand from services to goods are all demand-pull pressures, which are more appropriately combatted with monetary policy than potentially temporary supply side issues.

Chart 1: Headline and Core CPI have risen strongly across many major advanced economies



Supply and demand imbalances are likely to place ongoing upwards pressure on consumer prices, before moderating gradually in the second half of 2022 and in to 2023. As a result, inflation forecasts, for this year and next, continue to see upwards revisions (Chart 2).

Chart 2: Inflation releases have confounded expectations with forecasts repeatedly revised higher



The labour market will ultimately determine how persistent inflation is.

Most forecasters and central bankers still expect inflationary pressures to prove transitory and are expecting steep declines in year-on-year readings in the second half of 2022 and in to 2023. That some market participants are growing increasingly sceptical of this stance is unsurprising given the extent of upside inflation surprises and the scale of upwards revisions to previous forecasts.

Though forecaster's numbers may have been well off target, their logic is sound. Ultimately, there are three broad causes of recent inflationary pressures:

1. Forgone spending, generous fiscal and monetary support and accumulated savings saw disposable incomes rise rapidly.
2. Supply chains ground to halt as the global economy was shut down and have been strained as economic activity rapidly rebounded; and,
3. Supply chain disruptions have been exacerbated by an unprecedented shift in consumer spending from services to goods, which are more resource-intensive to produce, due to a combination of lockdowns and elevated savings.

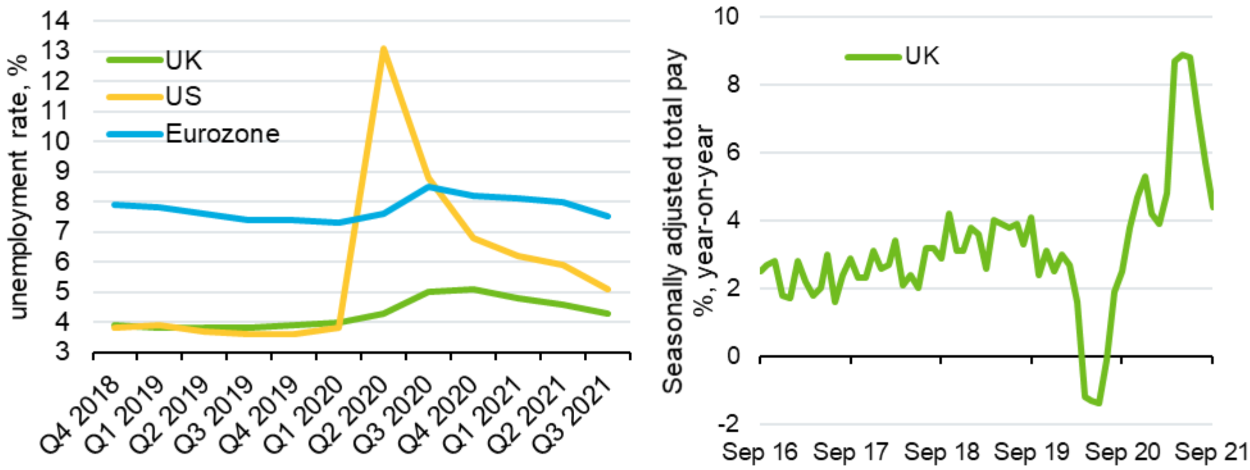
While the near-term risks to inflation remain skewed to the upside, the most intense inflationary pressures should ease in 2022. Base effects and a peak in energy prices should mean the headline numbers necessarily see less upwards pressure. At the same time, the factors described above should reverse as monetary and fiscal policy become less supportive, supply chain disruptions dissipate as production rises to meet demand and spending patterns normalise as consumers rotate back towards services from goods.

Furthermore, the structural forces which have weighed on inflation in the advanced economies will likely re-assert their influence in the coming years: globalisation (although the pace may continue to slow) and technological advance.

In addition, populations in advanced economies will continue to age, and working age proportions decline, which places downwards pressure on inflation by lowering expectations of future growth and increasing the level of savings.

In our opinion, the main route to a persistence in current high inflation would be via labour market tightness and shifting expectations leading to meaningfully higher wage growth. Unemployment has fallen rapidly (Chart 3), business surveys are increasingly highlighting labour shortages, and vacancies and quit rates, which correlate closely to future wage rises, are at all-time highs. However, recent wage data suggests increases are concentrated in lower-income sectors and those most impacted by the pandemic. It is too early to tell how the pandemic will affect longer-term trends in participation and productivity and whether wages and inflation will ease as pandemic disruption fades.

Charts 3 & 4: Unemployment has fallen rapidly but is yet to regain pre-pandemic levels



There are also a number of longer-term trends which may have inflationary consequences. The green transition may increase energy price volatility, and the frequency of price squeezes, as investment in fossil fuels reduces and renewable replacements are scaled-up. The increasing adoption and regulation of carbon prices may lead to broad input cost inflation while specific commodities crucial to the greening of the economy (e.g. copper and lithium), may see acute price rises. Furthermore, political shifts in the major advanced economies and the widespread adoption of ESG investing are seeing social equality move up the agenda – one positive, albeit inflationary, consequence may be the adoption of more generous and widespread minimum wages.

We have also observed mission creep in the mandates of central banks (the Fed officially adopted a new Flexible Average Inflation Targeting framework in August 2020). Not only does this mean central banks are adopting a less pre-emptive stance, they now have greater wiggle room to prioritise full employment and growth over price stability. Indeed, the consequences of raising interest rates, given elevated public and corporate debt levels, may give central banks more reason to emphasise the growth side of their mandates.

We would warn against leaning too heavily on the suggestion that current inflationary pressures are entirely due temporary supply disruptions and base effects – supply is still growing, just not enough to keep up with surging demand. Our central view is that higher inflation will be transitory, partly because supply and the pattern of demand will normalise, but also because central banks will gradually tighten monetary policy to rein in excess demand. However, we acknowledge that upside inflation risks have risen. Even if persistently high inflation is not the base case, current elevated levels of realised inflation, ongoing upwards revisions to forecasts and upside inflation surprises merit discussion.

Asset considerations

In terms of what this means for the assets and strategic approach, we are not proposing immediate change.

Inflation linked gilts that provide a direct hedge of inflation are expensive verses history and therefore do not help with affordability. Although not providing short term 'hedges' to inflation, the significant allocations to 'real' assets within the Fund such as equity, property, and infrastructure are expected to provide long term-inflation linked cashflows and are expected to provide a sensile approach should inflation become more persistent.