October 4th, 2021

All for Nothing

- **Both equities and bonds end almost flat for the third quarter**
- **EM equities the standout; China down 18%, India up 12%**
- **Equities need some better news, and a potentially significant reduction in COVID restrictions would help**
- **Japanese equities still have a lot of potential**
- **Energy prices have further upside**

Although there was much noise in the markets over the past quarter, when you net everything out, most of the broad indices ended the quarter virtually where they started. Global equities returned zero, and the global aggregate bond index was down 0.3%, while gold fell a modest 0.7%. The most significant deviation from zero was the Chinese equity market, which fell 18.2% as a resetting of the government's industrial policy overwhelmed the equity market.

Table 1: Third-Quarter Returns by Asset Class

S&P500 (TR $)	0.6%	Global Aggregate Index	-0.2%
Japan (TR $)	4.6%	UST 7-10yr	-0.4%
UK FTSE all share	2.2%	US High Yield	0.9%
Europe ex UK (TR $)	-1.9%	EM Bonds	-0.5%
Asia ex Japan (TR $)	-9.3%	Negative Yielding Bonds	-2.1%
MSCI World (TR $)	0.0%	Inflation-Linked Bonds	4.5%
China (TR $)	-18.2%	Brent ($ bbl)	0.6%
India (TR $)	12.7%	Trade-Weighted Dollar	1.9%
MSCI EM (TR $)	-8.1%	Gold	-0.7%

TR: Total Return
Source: Bloomberg

We believe the global economy currently finds itself in a much trickier spot than where it started the quarter. Economic data continued to surprise the analysts to the downside during the quarter. Inflation, though characterised as transitory initially, continues to be of concern, and economists can no longer so easily classify it as transitory. International supply lines are compromised through shortages of ships, shortages of workers, shortages of semiconductors and now a critical shortage of energy. The news out of China has led many economists to cut third-quarter GDP growth to below zero. Although the market expects the authorities there to react by providing a stimulus to the economy for the balance of the year, the loss of one of the key engines to global growth does not bode well for global economic health.

While economists can point to a series of one-offs lifting the inflation rate, the longer these 'one-offs' continue, the greater the risk that workers will demand higher wages as compensation for the loss of real income. The more wage inflation we see, the greater the chance that the market will price a more substantial risk of inflation persisting. As we have often said, you don't have to believe that inflation will stay at the 4-5% level; rather, there is a materially higher risk that some central banks will hit their medium-term inflation target of around 2%.

Global equities have corrected 4.5% from their mid-September peak; it's not a disaster, but the fall has damaged investors' confidence. From unprecedented investor exuberance, we have come to a stage where investors have turned net sellers of equity mutual funds. That said, there is no sense, at least for the moment, of a more severe sell-off in equities. However, there are many headwinds such as tighter monetary policy, more limited fiscal support and more mixed changes to corporate profit forecasts. Also, it shouldn't be forgotten that a good measure of the markets' rise was heavily reliant on the tech sector that received a re-rating from lower bond yields. We expect the next 12 months to witness materially higher long-term interest rates, which will challenge the high valuation placed on tech leaders.

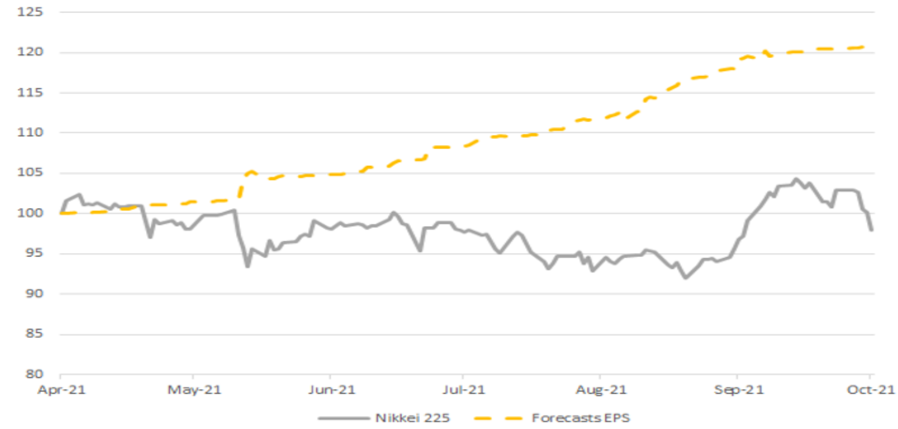
The US 10-year government bond yield is remarkably close to where it started the quarter. But there are reasons to be more worried about higher yields in the future. The critical change for the quarter was the signal from the Fed in the last meeting that they were prepared to start tapering their bond purchases and that a first rate rise was on the cards for next year. The Bank of England looks likely to raise interest rates as early as the first quarter of 2022. This week we expect the New Zealand central bank to follow the Norwegian central bank and raise rates. Emerging markets have already started raising rates, although Turkey and China are likely to go against the trend and remain biased to ease.

It's not just the central bankers who are becoming less supportive of growth. Governments are becoming increasingly mindful of the legacy of debt left by the COVID crisis. The UK is on a path to tightening and the US is struggling to build a sufficient consensus around the infrastructure bill, even as politicians toy with the consequences of hitting the debt ceiling. The Japanese government is expected to be more supported with a new spending budget scheduled before the end of the year now that a new LDP leader and PM has been appointed.

We move into the fourth quarter with many headwinds, but maybe there is hope that the world can finally get out of the grips of COVID. As Nassim Taleb of Black Swan fame remarked, COVID was never the Black Swan. A pandemic was forecast for some years by infectious disease experts. The Black Swan was the reaction of policymakers. Finally, it seems that more and more politicians are on a path of taking their countries back to normal. Australia is set to re-open its border for the first time in 18 months. The UK has in the past week taken more countries off its red list. This past week Japan fully dropped the COVID state of emergency for the first time in six months.

We expect Japanese equities to build on their third-quarter solid performance. The recent setback (equities are down 6% from their mid-September highs) provides a buying opportunity. The equity market has the benefit of the ongoing easy economic policy and persistent upgrades to corporate profits forecasts. Since April 1st, consensus forecasts for corporate profits have risen close to 20%; however, the market is down 2%.

Chart 1: Japanese equities have yet to factor in upgrades to corporate profit forecasts
Data rebased to April 2021 = 100



Source: Bloomberg

We see little let-up in the strength of energy prices. Gas inventories are low in many parts of the world, and there seems little on the horizon to relieve the situation bar a remarkably mild winter, particularly in Europe. With gas prices at such highs, coal and oil substitution looks likely. Oil prices are likely to hit $90 bbl before OPEC considers any remarkable change of strategy. Many of the OPEC countries will be happy to enjoy the premium prices while they last. Again, to complicate matters further, OPEC plus is unlikely to push for higher production. Mineral-rich emerging markets, including Russia, should do well, with a recovery in Brazil and further solid performance from the UAE and Saudi Arabia expected.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)