Think-Tank Round Up 2021

I suspect that few of us thought as we wound up our first ever virtual Think Tank a year ago that the pandemic would still be the dominant narrative in markets as we head into the final months of 2021. The ferocity and persistence of the virus has surprised us all and continues to wreak havoc. The delta variant, now the dominant strain globally, has triggered renewed restrictions in many countries, with a consequent impact on growth. Asia, which seemed to have come through the pandemic relatively unscathed, is struggling with a new wave of infections, and globally the daily case count has risen by 80% from the levels of two months ago. With the northern hemisphere winter approaching and the risk of new deadly variants emerging, there are worries that the global recovery could be cut short.

The peak pace of recovery is almost certainly behind us: the base effects of the collapse in activity last year are falling away, the boost from the release of pent-up demand as lockdowns were eased will inevitably fade, and the fiscal impulse will fall as the crisis spending to cushion the effects of the pandemic drops off. Leading indicators of activity levels, especially in services, reflect this fading momentum: they have rolled over and point to slower growth ahead. Forecasts are being duly trimmed.

While the latest wave of the virus will dampen activity, we believe this will be relatively short-lived. The key is the success of the vaccine programme, illustrated by data from the UK, the furthest advanced of the major economies with its vaccine roll-out. As Andrew said, 94% of adults in the UK now have antibodies, either from vaccines or the virus itself. Evidence is unambiguous: the vaccines provide good immunity and dramatically weaken the link between infection and hospitalisation. We can't be certain that the vaccines will work against all mutations, their efficacy fades over time, and they don't appear to prevent transmission, but they have been very effective in dramatically reducing deaths and hospitalisations, and hence pressure on healthcare services. The science community is confident that with adjustments and booster jabs the vaccines will continue to provide high levels of protection from infection.

We therefore view any setback to recovery as temporary: it is delayed, not derailed. We are encouraged by emerging evidence that daily cases globally are flattening out, and by the acceleration of the vaccine roll-out: of the 5.3 billion doses administered globally to date, 1.1 billion have been in the past 28 days. The combination of vaccine rollout and broadening immunity will ultimately keep the virus at bay. We will learn to live with it much as we do with other deadly viruses such as influenza, which the WHO estimates kills up to 650,000 each year, without triggering wholesale lockdowns of economies. The peak of the covid crisis in terms of number of cases might be ahead but its impact on global activity will progressively diminish.

It is important to stress that its impact now falls disproportionately on the developing world, where the vaccine roll-out is much slower than in the developed world and the room for policy support is more limited. It will take time to complete a successful vaccine roll-out across the world and it is inevitable that there will be periods like now where recovery is disrupted, but we have seen that incomes remain strong through lockdowns, and demand bounces back strongly each time. We are well on our way through this crisis and can begin to focus on life after the pandemic and the lessons we have learnt from the past eighteen months.

Among many extraordinary features of the crisis, two stand out from an economic perspective. First, the overnight shock to demand caused by lockdowns was unprecedented in scale and speed, but proved to be short-lived.

Incomes, especially in the developed world, were largely protected by furlough schemes and hand-outs, and household wealth soared as house prices and stock markets not only recovered rapidly from the initial shock, but in many countries moved to all-time highs. The result has been huge releases of pent-up demand each time restrictions are eased, drawing down on excess savings, which in the US for example amount to $2.6 trillion, 12% of GDP. Hence our confidence that the current deceleration in growth will be short-lived; global growth will continue at exceptionally high levels through this year and next, not as rapidly as in the first half of the year, but well above both the historic and expected long term rate.

The second unusual feature is that, unlike normal recessions, which crush mainly the demand side of the economy, in this one the supply side has also been hit hard. Eighteen months on from the onset of the pandemic, we are perhaps now seeing its biggest supply side impact. Supply chains are severely disrupted by labour shortages in many sectors, by port and factory shut-downs and reduced working, resulting in soaring freight rates and difficulties sourcing materials and components. In the recent corporate earnings season the most widely reported concern of management was supply shortages and input costs.

Supply chains will normalise in due course, and supply will respond to the strong demand we are seeing, but it will take time, so shortages and rising costs will be a headwind into next year, with consequences for profit margins. The pressure on input prices and inflation has been all too evident in recent months, with core inflation measures rising to thirty-year highs in the US. Understandably, inflation has been the key concern of investors for much of this year. Will it be transitory as the Fed and other central banks believe, or will it be persistent, which could trigger a sharp reaction from the Fed or a bond market rout.

As the impact of the pandemic fades, the outcome of the inflation question will surely be a key determinant of monetary policy, the durability of the recovery, and, as well as the broad direction of markets, the relative performance of asset classes, sectors and investment styles.

For now, the market buys into the Fed narrative that the rise in inflation will be transitory. Part of the rise is down to the base effects of last year's collapse in inflation, and that will fall away in the months ahead. Forward inflation expectations in the US remain well anchored in the 2.3-2.5% area that prevailed for much of the past decade or more. And wages, a key determinant of the persistence of inflation, show few signs of accelerating to worrying levels. The widely respected Atlanta Fed wage tracker shows wages rising at a 3.7% rate in the US, well within the range of most of the past twenty years. No alarm bells ringing, then, and outside the US, especially in the euro area and Japan, deflation remains a bigger long term concern for policy makers.

It seems to us that the rise in inflation will prove to be transitory and in due course it will begin to move gradually down towards the Fed target of 2%. The huge release of pent-up demand will be satisfied, and supply chains will gradually return to normal, while longer term forces such as demographics, digital disruption and productivity enhancing new technology will restrain price rises, and the high levels of government debt left by the pandemic will be a constraint. But for the first time in many years the risks have shifted from disinflation towards the upside, and some of the after-effects of the pandemic – reconfiguring supply lines, sustained increases in healthcare spending, greater emphasis given to re-distribution, push-back on globalisation – together with the accelerated drive towards a carbon neutral world, introduce additional inflationary risks. We think it is important to build in some protection against this risk in portfolio construction.

In the shorter term, however, the focus is on the Fed. With last year's change of policy target to average inflation of 2% over a cycle, the Fed in effect is prepared to let the economy run hot to ensure the recovery is sustained. On the other hand, it cannot let inflation run out of control as reining it back in again could be highly damaging to the economy and financial markets. Furthermore, the Fed is keen to begin to normalise policy to give it room to respond as and when the next crisis comes along.

It made the initial move in this direction in June, explicitly recognising the risk that inflation could turn out to be higher and more persistent than it expects, and signalling earlier than anticipated rate rises and reduced asset purchases, still running at $120bn per month. The timing and scale of the taper has become a key short term risk factor for investors, fearing a policy error and repeat of 2013's taper tantrum, when bond yields shot up, equity markets fell sharply and the dollar surged in reaction to the Fed's warning of monetary tightening.

We recognise that risk, and markets could be nervous ahead of the Fed's more detailed announcements on its tapering plans in the next few weeks, but we do not expect a sustained fall in markets or the sort of dislocation seen in 2013. This time, the Fed's broad intentions have been well flagged, and as we heard from Powell, Chairman of the Fed, a couple of weeks ago, taper is very likely to be started before the end of the year but there is a bias to caution in withdrawing stimulus. There is no doubt that we are at the turning point in the monetary policy cycle, but there will be no pre-emptive tightening, the Fed will need evidence from the data before making moves, so this will be a slow, cautious shift, a very long road to normality.

It looks like taper without tantrum. Interest rates are likely to be 0.5% or below for at least the next two years and while the Fed will gradually reduce the size of liquidity injections, there is little prospect in this time frame of a withdrawal of liquidity by selling bonds that it owns. By any measure, monetary policy in the US remains highly accommodative. The same is true elsewhere. The European Central Bank and the Bank of Japan are likely to rein in their crisis level asset purchases but there is little realistic prospect of a rise in interest rates for several years ahead.

There is some concern that loose monetary policy could be offset by tightening fiscal policy as governments rein in the huge support programmes brought in during the pandemic and bear down on bloated deficits. There is no doubt that the fiscal impulse will diminish as the pandemic wanes, but a return to post GFC fiscal austerity is not on the agenda. President Biden is calling for a massive spending programme: $1 trillion on infrastructure, and $3.5 trillion on an historic expansion of the social safety net and the environment. If enacted in full his budget proposals would result in fiscal deficits averaging more than $1tn or 5% of GDP each year up to 2030, the highest sustained levels of spending since WWII.

In Europe, the EU's Next Generation recovery plan is moving to implementation, with EUR800bn of grants and loans to be made available, on top of the EU's longer term budget spending plans, bringing total spending to EUR2tn over the next 6 years, the largest stimulus package ever financed in Europe. These are vast sums which will support growth for years ahead.

What lies ahead, then, is a progressively fading impact from the pandemic; growth at abnormally high levels this year and next, the fastest rate of expansion for 50 years; highly accommodative monetary policy; and fiscal policy continuing to underpin demand. Inflation is a greater risk than for some years but should slow as the economy normalises. We see this as a constructive environment for risk assets, and not the conditions for a sustained fall in markets.

Our optimism needs to be tailored by risks and uncertainties. The pandemic could linger for longer if virulent mutations take hold, and delay the recovery. And its impact has been uneven, with some industries, those in the digital world, benefiting, while others continue to suffer scarring, which could be long lasting. Andrew Jones of London Metric explained how, in the property world, sectors such as retail and offices face structural shifts as a result of rapid change in how we work, shop and socialise. Andrew thinks that selectivity is more important than ever in the property world, something I think that applies widely across asset classes.

The enormous debt built up during the pandemic is readily financed at current levels of interest rates and bond yields, but could be a threat to financial stability if (or maybe when) interest rates rise. One lesson from the pandemic is that central banks can and will go much further in loosening policy than we imagined a few years ago. We might well have taken a step closer to direct monetary financing of government debt, with monetary and fiscal policy closely aligned, and the yield curve increasingly controlled by central banks. We share the views of Monica Defend of Amundi, who is expecting a larger role for the authorities in the markets' functioning, with rates lower for longer.

The sheer scale of the debt and the size of central bank balance sheets – they own huge proportions of their government debt, the Fed almost 25%, the ECB over 40% and the Bank of Japan close to half - mean that policy errors would have bigger ramifications than ever. As Monica said, we are entering uncharted waters, a period when policies could become a dominant force in asset class returns.

The extraordinary success of 'big tech' in the pandemic, which accelerated and brought forward growth in the digital world, and gave greater prominence to the reach and power of these companies, has strengthened the resolve of regulators to rein them in. The importance and size of this sector, accounting for more than 25% of the US stock market, means the risk of a regulatory clampdown has been worrying investors. And a risk that is never far off the screen, geopolitics, has reared its head, with the capacity to destabilise markets.

In recent months, these two issues have come together in one place: China. President Xi's abrupt and far-reaching sanctions and regulations on its big tech and internet companies and other parts of the private sector have hammered stock prices. Since the peak in February Alibaba and Tencent are down by 40%, others even more – the private tutoring sector was more or less wiped out with falls of over 90% (and some of these were $100 billion companies earlier this year). The damage inflicted and uncertainty created has pushed the Chinese stock market down by almost 30% from its peak in February, by far the worst performer of the major markets. That comes at a time when those who might have hoped for a thaw in the US-China relationship with the Biden Presidency have been disappointed. While the focus might have shifted from trade to cyber security, intellectual property, human rights, Hong Kong and China's increasingly bold regional aspirations, it is abundantly clear that there is bi-partisan support in the US, and elsewhere, for a tough line.

China's size and importance means these matters have global implications. We do not believe that China is intent on destroying its global leadership ambitions in technology and AI, nor in threatening its thriving private sector, its access to international capital markets and the internationalisation of its currency and asset markets. But the clampdown is a reminder of the pre-eminence of the Chinese Communist Party in all aspects of life in China, and despite decades of liberalising reforms and a remarkably innovative private sector, their model of state capitalism has inherent risks, as we are seeing with the uncompromising actions in Hong Kong and in those parts of China's private sector which pose risks to central control and China's policy priorities.

Those priorities were spelled out by James Morton of Santa Lucia. He explained how China is evolving and changing, with the one constant being the central control of the CCP. Policy priorities have shifted to reform, equality, regulation and climate change, while the economic drivers are shifting from exports, infrastructure and construction to services and domestic consumption. At the same time, China is wrestling with its demographic time-bomb: a fall in the numbers of working age, a low birth rate and an ageing population.

China's reach globally is rapidly expanding, and bumping up increasingly against a liberal West struggling to balance the importance of trade with China against the fears of malevolent interference from an increasingly assertive major power. The clash of ideologies between the world's two largest economies and military powers is set to be the defining issue of our generation. From time-to-time it will unnerve investors, as did the trade war during Trump's presidency. And we need to recognise that the days of extraordinarily high growth rates have gone; China's trend rate of growth will inexorably fall towards those of advanced economies in coming years.

In our view, these issues do not make China uninvestable. But they do mean that the discount applied to Chinese securities should be sufficiently large to recognise the risks. Appropriately valued and sized, carefully selected investments in China offer high growth opportunities in a market whose aggregate growth rate is in decline but which remains huge and vibrant. Periodic sharp sell-offs like this year create longer term buying opportunities.

China is probably one of the few countries to see anything positive from recent events in Afghanistan – the humiliation of the US and its allies opens a void for China to fill. It is difficult to frame what happened in Afghanistan as anything other than disastrous, with untold consequences for its people and the global threat of terrorism. For Biden it has the makings of a Jimmy Carter Iran hostage moment, with his credibility domestically and internationally struggling to recover, a lame duck less than a year into his presidency. Regrettably for America and the rest of us, there is no Ronald Reagan currently in sight to fill the leadership void, re-unite America and restore its international standing.

But never under-estimate the greatest of America's strengths, its ability to renew and rejuvenate. 'Never bet against America' says Warren Buffett. I agree. Although we are currently underweight US stocks relative to benchmark, finding better value and recovery potential in the UK, Japan, and emerging markets, the US still represents by far the biggest single component of our equity portfolios.

It is important to remember that geopolitical issues tend to play out over a long period or, such as Afghanistan today, have no immediate impact on stock markets, their economic impact is negligible. It is unwise to build portfolios primarily around the threats of big geopolitical events or the next pandemic, it could be a long and costly wait in terms of returns foregone.

We believe it is essential to stay with equities through the cycle to generate long term capital growth: they are, as Amundi said, a 'structural must have' in the conditions we face. Although markets have risen sharply from the pandemic lows, large parts of this have come from the performance of big tech. The reflation trade triggered by the vaccine news in November has driven economically sensitive and recovery stocks higher, but as Ian Lance of RWC pointed out, value stocks are still at their greatest discount to world equities for 50 years and greatest ever discount to growth stocks. They should be prime beneficiaries of the economic recovery ahead and have the additional benefit of providing a cheap hedge against inflation. Ian thinks that the repositioning from growth to value has barely started. We share his optimism: the strong growth ahead and extremely accommodative financial conditions underpin a long cycle, and we have added to our value holdings, but we remain true to our approach of blending styles to optimise returns over the long term.

The pandemic has been a vivid reminder of the importance of sticking to a robust, resilient, tried and tested investment philosophy. Our longer-term valuation analysis, looking through the crisis, gave us the confidence to add to equities last year when they were in free fall, and our blending of different equity styles ensured that we captured the massive rally in value stocks as we came through the worst of the pandemic, whilst continuing to participate in the extraordinary performance of growth stocks.

Mark Baribeau of Jennison is one of the foremost managers of growth stocks globally and by explaining the big structural shifts taking place and the opportunities created – he believes the digital transformation is still in the early stages of a long-term trend - he provided a powerful case to support our approach of maintaining exposure to growth stocks despite some very high valuations. The pandemic illustrated yet again the futility in trying to time style shifts, they are usually very sudden and missed by those who were not already positioned. Much better in our view to hold a portfolio of blended styles to capture these moves, rebalancing as and when valuations and relative price movements present opportunities. We will continue to hold growth stocks to participate in those long-term structural trends, alongside value and quality stocks, those companies with high profitability, strong balance sheets and pricing power, resilient companies with defensive characteristics, which are currently offering relatively low valuations.

We also see many opportunities to complement our investments in public markets in the private sector. Richard Watts outlined the extraordinary opportunities available in the world of digital disruption and the advantages of accessing these via Chrysalis, a closed end, liquid vehicle in the crossover area between public and private, our preferred choice to capture these exceptional gains and a meaningful contributor to our growth allocation.

In all cases, we are at the stage of the cycle when careful selection will be vital. Blending styles in this way, actively managed by best-of-breed managers, will we believe continue to deliver market beating returns in the long term whilst constraining volatility.

I emphasise the need for careful selection because after a decade or more of increasing dominance of passive management we see the circumstances for active managers to regain ground. There is a place for passive managers in certain asset classes such as low yielding fixed income, but the environment we are in calls for selectivity and an active approach elsewhere.

More than ever, as Amundi highlighted, it will be crucial to balance the volatility and downside risks of a high equity allocation with diversifying assets. Core to that are US government bonds and gold, assets which over many cycles have demonstrated the ability to preserve capital in times of distressed markets, whatever the trigger might be, and which again proved their worth as the pandemic struck. They continue to play an important defensive role in our portfolios; a vital component of that are inflation protected bonds issued by the US Treasury. These have the safe-haven characteristics of conventional bonds, but because interest and capital are linked to inflation, they offer a highly effective way to protect against inflation risk.

The problem we all face though is that defensive assets either offer no income, such as gold, or are very expensive, and within that I would include all safe haven government bonds. Over $16 trillion of these bonds, 25% of the total, are negative yielding today, and most of the rest offer yields below the rate of inflation. This diminishes their traditional role of providing income and makes the 60/40 equity/bond balanced fund inappropriate. With rates likely to stay low, we increasingly look for alternative sources of income and diversification.

We have introduced you to some of the areas we find appealing in this context, specialist areas of real estate, the burgeoning green energy industry, and opportunities in highly specialised fields now available to investors such as music royalties. These not only meet the increasing need for relatively high and reliable income but in the case of real assets also provide protection against inflation. We don't see these as a substitute for safe haven assets, but they are valuable diversifiers and income generators in an income-starved world. In each case we use structures which provide broad diversification and high levels of liquidity, both of which are core to our approach.

The other big change, or rather acceleration of trend, brought on by the pandemic is the emergence of ESG investing firmly into the mainstream. Companies, asset managers and their advisers cannot afford to ignore the issues, both in their existing capital deployment and in the new opportunities created. Masja Zandbergen from Robeco showed us how rapidly ESG assets have increased, and how they have evolved from sustainability to impact investing, with companies increasingly creating and driving positive outcomes. Some trends can be short lived, but ESG is unstoppable and all those involved in our industry will need to respond. As Andrew mentioned, here at MGIM we have furthered the integration of ESG across our portfolios, and we will soon be launching sustainable global equity and multi-asset funds.

We are optimistic about prospects for markets and expect further gains in what we expect to be a broadly benign environment for the corporate sector. But we need to be realistic about those return expectations. We have had outsized gains over the past year, quite possibly in some areas such as technology bringing forward gains that would otherwise have come over a longer period, and there is ample evidence of extended valuations, some at historic highs. This is especially the case across fixed income markets, and here the risks are asymmetric: if inflation proves to be persistent yields would rise materially whereas the prospects for further falls in yields are limited. It is prudent to keep duration exposure short.

But this is not a time for over-weighting defensive assets. My message is stay invested, we are on our way out of the pandemic, albeit with some bumps on the way. After a strong year for markets, returns are likely to be harder to come by in the months ahead, but with broad diversification around a core of equities, and assets invested with some of the best fund managers from around the world, you will be well positioned to participate in the recovery and growth ahead, in what we believe will be a long and rewarding cycle.

Finally a word of thanks to add to those of Andrew; to the event organisers, my colleagues in South Africa and the UK, and to you, our clients. We are delighted that so many of you joined us for Think Tank, thank you for your support. Without you none of this would be possible and I sincerely hope that we will be seeing many of you next year in London for Think Tank 2022.

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