JOHNSTON CARMICHAEL WEALTH

Market Update

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SQUARE MILE INVESTMENT SERVICES

Summary

We are sanguine about prospects for economic growth in 2022 but rather less sanguine about the outlook for inflation, which risks becoming entrenched through wage increases. The response of central banks to the inflation threat is of crucial importance and the risk of policy error is, in our opinion, the biggest risk to financial markets in 2022. Central banks are walking a tightrope.

Although government bond yields rose in 2021 inflation rates rose by considerably more so bond yields are now very negative in real terms. The outlook for bond markets in 2022 is therefore immensely challenging and our return expectations are modest. As before, and where our mandates allow, we continue to favour flexible bond funds which can cherry-pick the best opportunities as they arise.

Even after their double-digit gains in 2021, equity markets remain our most favoured asset class. We expect corporate profits to grow further in 2022 but our enthusiasm is tempered by lofty valuations which provide little protection and are also vulnerable to rising bond yields. We believe that we hold a prudent level of equity risk in the portfolios we manage and it would almost certainly require a substantial fall in stock markets for us to consider adding to exposure.

OUTLOOK FOR BOND MARKETS VERY CHALLENGING

Macro Highlights

In the absence of any big surprises in the fourth quarter, it is likely that the UK economy grew by between 6% and 7% in 2021. If the final number exceeds 1973's figure of 6.5% it will be the biggest annual expansion since 1941 (8.7%). This exceptional growth can be attributed not only to the explosive release of pent-up demand as coronavirus vaccines allowed the economy to re-open but also to the fiscal largesse of the government and the continuing monetary largesse of the Bank of England. Before we all get too carried away, however, it should be remembered that the UK economy shrank by 9.4% in 2020 and at the end of September 2021 was still 1.5% smaller in real terms than it was at the end of 2019.

Whilst the economic contraction in 2020 may have been bigger and the subsequent rebound stronger, the UK's overall economic performance since the pandemic struck has not been materially different to that seen in many other developed countries. The economies of both Germany and Japan were also 1-2% smaller in real terms at the end of September than they were at the end of 2019. Indeed, the only developed nation economy which was larger is the US which has grown by 1.4% in real terms. Given that the fiscal boost in the US in response to the pandemic has been much larger (as a % of GDP) this is not surprising.

Gloomy predictions that the end of the government's furlough scheme in September would cause the unemployment rate to rise from 5% to nearer 7% have not been realised. Instead, the rate has continued to decline and at 4.2% (for the three months to the end of October) is at its lowest level since June 2020 and only 0.4% above its pre-pandemic record low of 3.8%. The latest unemployment rate in the US also stands at 4.2%, which compares with a peak of 14.8% in April 2020 and pre-pandemic low of 3.5%. In both countries there are record job vacancies and there is clearly very strong upward pressure on wages. This might seem at odds with unemployment rates still being above their pre-pandemic levels. In the UK, part of the explanation is a consequence of Brexit which has exposed the country's previous dependence on foreign workers in a variety of sectors such as lorry drivers and restaurant staff. The main reason, though, is shrinking workforces. Notwithstanding the well-established demographic trend of ageing populations, millions of workers worldwide have also chosen to withdraw from the jobs market because they can afford to take early retirement funded by gains from soaring financial markets over the last few years or because they are making a lifestyle choice in the wake of the pandemic.

The growth and unemployment statistics seem almost trivial, however, when compared with the big story of 2021 which was the resurgence in inflation. At the end of December last year, the UK's year-on-year inflation rate (as represented by the Consumer Prices Index) stood at just 0.6%. In November this year it was 5.1%, its highest level in more than 10 years. The 'old' Retail Prices Index, which also captures an element of house prices as it includes mortgage interest payments (and so some would argue that it is a better measure of the cost of living) reached 7.1%. With the energy 'price cap' set to rise substantially in the Spring, the rate of inflation is almost certainly set to climb further in the months ahead to its highest level since March 1992. Again, soaring inflation is not just a problem in the UK. In the US, the inflation rate reached 6.8% in November and in Germany, where the control of inflation is a national obsession, it has reached 5.2%. We remain confident that some of the causes of the global inflation spike, such as supply chain bottlenecks and year-on-year increases in energy and commodity costs, will ease during 2022. However, there is clearly evidence and the risks are growing that inflation becomes embedded in wages, leading to a self-perpetuating wage price spiral. It remains our best guess that inflation rates will decline from current elevated levels but remain stubbornly above the 2% figure that central bankers are targeting.

Notwithstanding the risk of dangerous new variants of COVID-19 and the squeeze on consumers through rising inflation and higher taxes, we remain fairly sanguine about the prospects for economic growth in 2022. It will not be as high as in 2021 but will be maintained by government spending and the continuing recovery from the pandemic. The big concern for 2022 is inflation, whether it becomes entrenched in wage increases and, perhaps most importantly for financial markets, what response it draws from central banks. They have clearly been wary and reluctant to withdraw the monetary stimulus which has propelled bond and stock markets for more than a decade. The US Federal Reserve blinked first, deciding in November to begin to scale back its bond purchases (quantitative easing) and in December the Bank of England raised its Bank Rate from 0.1% to 0.25%. However, interest rates and bond yields remain very negative, and unsustainably so. In our opinion, the biggest risk to financial markets in 2022 is therefore policy error by central banks. Do nothing or too little and the inflation genie, the scourge of the 1970s, may well and truly escape its bottle. However, excessive tightening of monetary policy could turn an economic slowdown into full-blown recession and also expose the very high levels of debt that now characterise the financial system. Central banks are walking a tightrope.

Bonds

Often regarded as boring and safe when compared with equity markets, government bond markets provided a rollercoaster ride for investors in 2021, at times defying economic data and leaving some of the brightest investment minds bamboozled and licking their wounds. History will record that broad indices representing the performance of the UK conventional gilt market finished 2021 down by just over 5% from where they had begun the year. Global government bonds (in local currency terms) were also down by approximately 2.5%. A large part of the reason why gilts fell by more is because the maturity profile of debt issued by the UK government is much longer dated than most other governments. This means that the gilt market as a whole is more sensitive to changes in bond yields. When the yield of a bond rises, its price falls.

At the beginning of 2021, 10-year gilt yields stood at just 0.2%, not far above the historic lows of 0.1% seen during the summer of 2020. For investors who remember that 10-year gilt yields typically averaged 5% in the decade before 2008's Financial Crisis, such a yield would have seemed preposterously low. However, it was possibly justifiable given the scale of the UK's economic contraction in 2020, that the inflation rate stood at just 0.6% and the Bank of England's bond buying programme was in full flow. Unsurprisingly, as the vaccine rollout allowed the economy to re-open and the first signs of recovery and an uptick in inflation appeared, gilt yields began to rise, reaching 0.9% in May. During the summer, gilt yields drifted lower as the Bank of England joined the chorus of central banks in declaring that the rise in inflation was 'transitory.' As those reassurances increasingly began to ring hollow yields rose again to reach 1.2% in October, a six-fold increase since the start of the year. At this point, investors in the broad gilt market were nursing losses of almost 9% year-to-date.

It was in the final ten weeks of 2021, however, that many investors found themselves wrongfooted and struggling to make sense of what they were seeing. Inflation is the nemesis of bond markets because it erodes the value in real terms of both interest payments and the capital that is repaid when a bond matures. However, even as the UK inflation rate began to soar, rising from 3.1% in September to 4.2% in October to 5.1% in November (all reported in the following month), gilt yields tumbled again by 0.5% to just 0.7% in the space of just over three weeks. Certainly the Bank of England's unexpected decision not to raise interest rates in November contributed to the rally in the gilt market but the magnitude of the decline in yields seems excessive and nonsensical. A degree of sanity was restored in the last two weeks of 2021 as yields rose again to just under 1%. However, the latest inflation rate of 5.1% means that investors in gilts are receiving a very negative rate of return in real terms. It is the same story in the US. Although 10-year Treasury yields increased from 0.9% to 1.5% in 2021, the rate of inflation rose from 1.4% to 6.2% so yields in real terms are also very negative.

The end of 2021 saw the Bank of England finish its latest tranche of bond purchases (taking its cumulative total to £895bn) and the US Federal Reserve announced in December that it too will cease to be a net buyer of bonds after March this year. Against this combined backdrop, we expect bond yields to trend higher in 2022. Accordingly, in the portfolios we manage we will maintain the ('short duration') bias to shorter maturity bonds which are less sensitive to higher bond yields. Indeed, with credit spreads (the additional yield that investors require to take on the risk of lending to companies instead of governments) close to levels last seen before the Financial Crisis, our expectations of returns from investments in bonds in 2022 are modest. They should, however, continue to confer the quality of overall risk reduction in portfolios. Where our investment management mandates allow, we continue to favour strategic and tactical bond funds whose own very flexible mandates allow their managers to cherry-pick the very best opportunities as they arise across the wide spectrum of bond markets.

CENTRAL BANK POLICY ERROR THE BIGGEST RISK

Equities

The economic, monetary and corporate backdrops could not have been more benign for investors in equity markets in 2021. The rollout of vaccines allowed economies to reopen, releasing a flood of pent-up demand which has overwhelmed parts of the supply chain spectrum, ranging from semiconductors to energy. The price of shipping a standard 40ft container from Shanghai to Rotterdam increased approximately sixfold in 2021. Notwithstanding the bonanza this has been for shipping companies, many other companies have been able to protect their profit margins by raising prices and their profits have surged. Companies' earnings per share for the third quarter of 2021 were more than 40% higher than a year ago in both the US and Europe. Despite the economic bounce-back, both fiscal and monetary stimuli have remained in full flow, Chancellor Rishi Sunak choosing to increase spending by £150bn in his October Budget. Meanwhile, central banks kept interest rates and bond yields at levels which became increasingly negative, and therefore unattractive, in real terms as inflation rose. This left equities as the only major asset class in which investors could hope to achieve a positive real return.

Unsurprisingly, it was therefore a barnstorming year for most equity markets. The UK stock market had its best month of the year in December (+4.7%) and was up by more than 18% (including dividends) in 2021, more than erasing 2020's decline of 10%. Some European stock indices were up by even more in local currency terms (the main index for French stocks rose by 32%), although gains were partially eroded by the weakness of the euro against the pound. Once again, however, the leading major market was the US which was up by 28% in dollar terms and 29% in sterling terms. Much has been written about how more than a third of the US stock market's gain can be attributed to just five stocks (Apple, Microsoft, Alphabet/Google, Tesla and Nvidia). However, of the main index's 500 constituents just Nvidia made the top twenty, the list being headed by two oil and gas production companies and vaccine maker Moderna. The contributions of the other four owed as much to their sizes, and hence weightings in the indices, as it did to their stock performance. Not every stock market yielded bumper returns. The weakness of the yen meant that the Japanese stock market, up a respectable 12% in local currency terms, returned less than 2% in sterling terms. Bottom of the pile by a long way, however, was China which fell by more than 20%. During 2021 investor confidence was undermined as the Chinese authorities staged a wave of clampdowns on some of the country's most successful companies. At the same time, the world's most indebted company, property developer Evergrande, continues to teeter on the edge of collapse.

Booming economies and rising bond yields should have been a boon to cyclically sensitive 'value' stocks and a handicap to interest rate-sensitive 'growth' stocks respectively in 2021. Earlier in the year, when the recovery was at its strongest, value stocks were well ahead of growth stocks but by the end of the year the gap had largely evaporated and there was little to choose between the two styles. Perhaps more interesting has been the divergence in share price performance of big and smaller companies. The marked outperformance of big companies in the UK in the fourth quarter of last year is probably explained by the heavy weightings of banks, oil companies and miners, as well as the international bias, of the former. Like value stocks, smaller companies have historically been favoured when economies are strong. However, in the US the index comprised of the country's largest 1000 companies outperformed the index of the next 2000 by more than 10% in 2021. Our best explanation of this is the sensitivity of smaller companies to the cost of borrowing (not least because approximately one third of the 2000 companies are unprofitable and are therefore dependent on raising capital) and also 2021's seemingly unstoppable march of big technology companies.

Looking ahead, the outlook for economic growth and therefore for corporate profits is generally favourable, albeit the bar is now much higher and growth in profits in 2022 will therefore be markedly lower than in 2021. Our biggest concern is valuations, which remain extremely high on any historical basis. However, with interest rates and bond yields so low in real terms (and likely to remain so) it is entirely possible that high valuations may persist. We are also alert to the degree of speculation and lack of investment discipline now prevalent within stock markets. This particularly applies to the US and cash-voracious companies which have little prospect of ever making a profit. Whilst we acknowledge that equities will continue to benefit from the unattractiveness of other mainstream asset classes, we will stay disciplined and will not chase the bandwagon. We believe that we hold a prudent level of equity risk in the portfolios we manage and it would almost certainly require a substantial fall in stock markets for us to consider adding to exposure.

Currencies

The rollercoaster ride in bond markets and soaring stock markets relegated currency markets to a distant third place in terms of interest to investors in 2021. In the fourth quarter of the year, the pound appreciated by 0.5% against the US dollar, by just over 2% against the euro and by almost 4% against the Japanese yen. Over the whole of 2021, the dollar emerged victorious, just, appreciating by about 1% against the pound. However, the pound was up by over 6% against the euro and by more than 10% against the yen. The strength of the pound and the dollar against the other major currencies reflects expectations, already partly realised, that the Bank of England and the US Federal Reserve will tighten monetary policy before the European Central Bank and the Bank of Japan.

Exposure to foreign currencies in the portfolios we manage is provided by investments in international equity markets and, opportunistically, in strategic and tactical bond funds.

Alternative Investments

One of the main drivers of the price of gold historically has been the trend in real interest rates, i.e. bond yields minus inflation. Thus, gold usually performs best when inflation is rising or bond yields are falling. The price of gold did indeed increase in the fourth quarter of 2021, but we would have expected it to rise by much more than 4% as inflation rates soared. Astonishingly, the price of gold was down by 4% in dollar terms and by 3% in sterling terms over the whole of 2021. Of course, the behaviour of bond markets was similarly muted and suggests that investors are, for now at least, not overly concerned about inflation. It is also possible that gold now has a rival as the ultimate hedge against inflation in bitcoin and other cryptocurrencies.

From start to finish in 2021 bitcoin appreciated by 60%. The exceptional volatility that has come to characterise the cryptocurrency was once again evident during the year. Bitcoin appreciated by 120% between January and the middle of April, then fell by 53% (July), then appreciated again by 130% (taking its year-to-date gain to just under 140% in November) before falling by 33% in the final seven weeks of the year. The polarisation of opinion unsurprisingly continues unabated, with legendary JP Morgan CEO declaring bitcoin to be worthless and analysts at Goldman Sachs recently writing that its price could double to US$100,000 if it continues to take market share from gold as a store of value. Bitcoin's price swings are fun to watch but we continue to regard all cryptocurrencies as speculative investments which are wholly unsuitable for use in the portfolios we manage.

The outlook for retail funds which invest in physical property remains in limbo with the FCA continuing to delay its decision on how to resolve the blatant liquidity mismatch between funds' underlying investments and the daily dealing offered to investors. Notwithstanding the analytical challenges of trying to predict the permanence of the shifts to Working From Home and online shopping and what this means for property values and rents, the practical uncertainties due to the FCA's continuing deliberations mean that we will remain on the sidelines.

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