Investment Views

November 2021

Coming in hot

As we expected, inflation is coming in hotter than Central Banks forecast. October saw annual rates spike higher, with US consumer prices rising at a rate of 6.2% pa; that's the highest since 1990 and 5% more than the start of the year. The EU and UK saw CPI north of 4% pa; all are set to rise further as we head towards Christmas.

Initially driven by covid disruption, the price data speaks to a wider set of index drivers; energy and shelter costs are adding to goods and services inflation. Indeed, owners' equivalent rent (OER) that we wrote about in September has started to accelerate, rising at a rate of 3.1% pa. As a reminder, the OER measures the cost of shelter in the US and accounts for 25% of the US CPI index. It tends to lag actual home price inflation by 15 months, with the latter currently seeing prices rise by 5% pa (source: M&G).

As we wait longer for supply disruptions and the concomitant inflation to dissipate, long run expectations and behaviour are changing. Measured by 5-year breakeven rates, bond markets in the US and UK are now pricing in 3% and 4% annual inflation over the coming years. That's nearly double the rate at the start of this year and north of the 2% monetary policy targets.

This, in turn, is feeding through to worker compensation. To illustrate, the industrial vehicle manufacturer John Deere has just agreed an inflation busting six year pay award with its 10,000 employees. Workers will receive a 10% pay rise in year one, with a 5% rise in years three and five. As well as an $8,500 deal ratification bonus, they will also receive $3,000 bonuses in years two, four and six. The negotiating leverage of workers has been amplified by shrinking labour force participation. Since the start of the pandemic, the US and UK labour force have shrunk by 4m and 1m respectively (source: FT); it is unclear when or if these "absentees" will return.

As we move through the end of year pay rounds, any signs that inflationary settlements are becoming pervasive will be a key concern. Higher pay can be the conduit through which a transient supply shock morphs into a more worrying wage-price spiral.

All of this has inevitably increased pressure on Central Banks to moderate their emergency policy support, with rates rising in several developing nations like Brazil and Russia. However, the hurdle to a meaningful withdrawal of quantitative easing by the major Central Banks remains high. As the Bank of England Governor noted this month, it is not the Bank's job to fix supply chains. Writing in the Sunday Times, Andrew Bailey observed that "the proximate cause of many of these inflation issues is on the supply side, and monetary policy isn't going to solve these directly...it doesn't get more gas, more computer chips, more lorry drivers."

That said, encouraged by Central Bank guidance, the markets have moved to price in a gradual rise in base rates. The yield on 2-year US Treasuries and UK Gilts have now increased to 0.5% pa, rising more than 0.3% over the last 3 months. Interestingly, the equivalent German bund is little changed, reflecting a widely held belief that the ECB is under less pressure to tighten policy, due to the ongoing 'Japanification' of the Eurozone and the impact of renewed covid-lockdowns.

In the UK and US, as short dated rates have risen, longer dated ones have fallen back; the current yield on 30-year Treasuries and Gilts are lower than the end of September. This suggests that bond investors expect tighter monetary policy to derail growth, leading to one of two outcomes; either the Authorities will tolerate rising unemployment and troubled asset markets or they will perform a policy U-turn, lowering rates and restarting their QE bond purchases. As regular readers will know, the latter scenario underpins our core conviction, that we have entered a protracted period of negative real rates where even modestly higher nominal rates will remain firmly below the rate of inflation.

This conviction is reinforced by softer growth, making it harder for the Authorities to meaningfully withdraw support. Third quarter GDP growth in the US slumped to 2% pa, with EU and Chinese growth falling back to 3.7% and 4.9%, respectively. Projections for 2022 growth are almost universally heading lower, although outright recession remains a minority forecast.

All of this leaves the major Central Banks in a quandary. Whilst the Chinese and EU policy makers may stand pat, given renewed lockdowns and their softer economic and inflation narratives, both the UK and US will probably attempt a degree of monetary tightening over the coming months. Whilst asset markets managed to ignore talk of tapering this year, action now looks inevitable.

As Central Bank liquidity and low rates remain the key prop to over-extended asset markets, this suggests that market volatility could well rise. This is doubly so as many assets are now priced for perfection amid signs of speculative excess. As Nomura notes, the value of US equity call options, that profit from further index gains, are back to a three decade high.

To us this argues for high conviction investing, with a focus on sectors, regions and themes that one will happily add to and own through a market drawdown. It also means that we have to be more patient, as political noise and Central Bank diktat swamp investment fundamentals. Our exposure to bullion and gold miners serves to illustrate. After our preferred Jupiter Gold and Silver Mining fund nearly doubled during 2019 and 2020, it fell back 25% during the first nine months of this year. Talk of transient inflation and an end to QE money printing hurt both gold and the related miners. However, October's resurgent CPI supports our belief in a protracted period of negative real rates, burnishing the attraction of gold and the Jupiter fund; the latter has added over 20% since the end of September, underpinning a decent bounce for all client mandates.

Policy Matrix Summary

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

12-24 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan ESG & Impact funds FinTech & Blockchain	Inflation-linked, Emerging Market, China	Gold, Volatility Strategies
−	Bonds	European US	UK European Japanese High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31 Oct 21	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3682	1.5%	-1.6%	5.7%
CHF	1.0924	1.8%	-1.1%	0.2%
AUD	0.7518	4.0%	2.4%	7.0%
JPY	113.9500	-2.4%	-3.8%	-8.2%
EUR	1.1558	-0.2%	-2.6%	-0.8%
BOND YIELDS (10 yr)				
UK	1.03	0.01	0.47	0.77
US	1.56	0.07	0.33	0.68
Germany	-0.11	0.09	0.36	0.52
Australia	2.09	0.60	0.91	1.26
Japan	0.09	0.03	0.08	0.06
EQUITIES				
US. S&P 500 (USD)	4,605.38	6.9%	4.8%	40.8%
UK. FTSE 100 (GBP)	7,237.57	2.1%	2.9%	29.8%
FTSE Europe Ex UK (local)	1,697.10	4.0%	2.2%	37.8%
Japan. Topix (JPY)	2,001.18	-1.4%	5.3%	26.7%
China. Shanghai Comp (RMB)	3,547.34	-0.6%	4.4%	10.0%
HK. Hang Seng (HKD)	25,377.24	3.3%	-2.2%	5.3%
Australia. All Ords (AUD)	7,639.07	0.1%	-0.3%	24.6%
FTSE Asia Pac ex Japan	1,508.69	3.2%	-1.1%	26.3%
FTSE World (USD)	3,174.73	5.6%	3.4%	38.5%
FTSE World (GBP)	2,321.89	4.0%	5.1%	31.1%
COMMODITIES				
Oil (WTI)	81.78	10.2%	15.5%	107.7%
Gold	1783.38	1.5%	-1.7%	-5.1%

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29 Queen Anne’s Gate, London SW1H 9BU, England
Tel +44 (0) 20 7222 8081, Fax +44 (0) 20 7227 8440, Email UK@bentleyreid.co.uk
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