Market Review

Third quarter 2021

EQUITIES:	Slowing growth and stimulus withdrawal keep stocks in check
BONDS:	A late quarter sell-off as Central Banks turn hawkish
CURRENCIES:	The dollar firms on the Fed's tapering and rate hike plans
COMMODITIES:	Energy prices surge as supply bottlenecks intensify

Markets lost momentum over the summer. During September Central Banks, including the US Federal Reserve and Bank of England, surprised investors with a more hawkish narrative. In both cases, officials brought forward their projections for future interest rate rises and the tapering of QE asset purchases. A resultant strong US dollar and higher nominal bond yields acted as a headwind to equities, bonds and gold.

Compounding market nerves, President Xi's regulatory clampdown led to pronounced weakness in Chinese equity and credit markets. Private tuition and technology companies were particularly hard hit. In the debt markets, property company China Evergrande became the first victim of the country's new "three red-lines" policy that seeks to clampdown on excessive debt. Fears of contagion led to a sharp sell-off in Asian high yield bonds, with spreads soaring.

Natural resource prices continued to move higher. Oil prices have risen 55% this year (WTI crude) whilst natural gas prices have more than doubled. In the UK, several smaller energy suppliers went bust after they failed to hedge supply costs, whilst a lack of HGV truck drivers aggravated an (already disrupted) supply chain. Queues at the petrol pumps were the most visible consequence but shortages are also evident in food supplies and all manner of industrial inputs. Similar travails are evident globally.

Equities

% change, total return	3 months	12 months
FTSE World Equity index USD	-0.4%	29.3%
FTSE World Equity index GBP	2.1%	24.0%

The FTSE World index finished the quarter down in USD terms. September saw global markets sell off as bond yields spiked on more hawkish central bank rhetoric. The S&P 500 was flat for the quarter as a whole, but fell by 5% in September to break a seven-month winning streak. Other US equity benchmarks performed less well, with the Russell 2000 small cap index falling 5% during Q3.

President Xi's regulatory clampdown led to pronounced weakness in Chinese and Asian stock markets; the Hang Seng index fell by 15%. The most striking example was the private tuition sector. Leading stocks like TAL Education and New Orient have plummeted by 90%+ since the February Lunar New Year (chart 1), when President Xi called the tutoring sector "a chronic disease that is very difficult to cure". Tuition companies are being forced to become "not-for-profit" and no new operational licences will be granted.

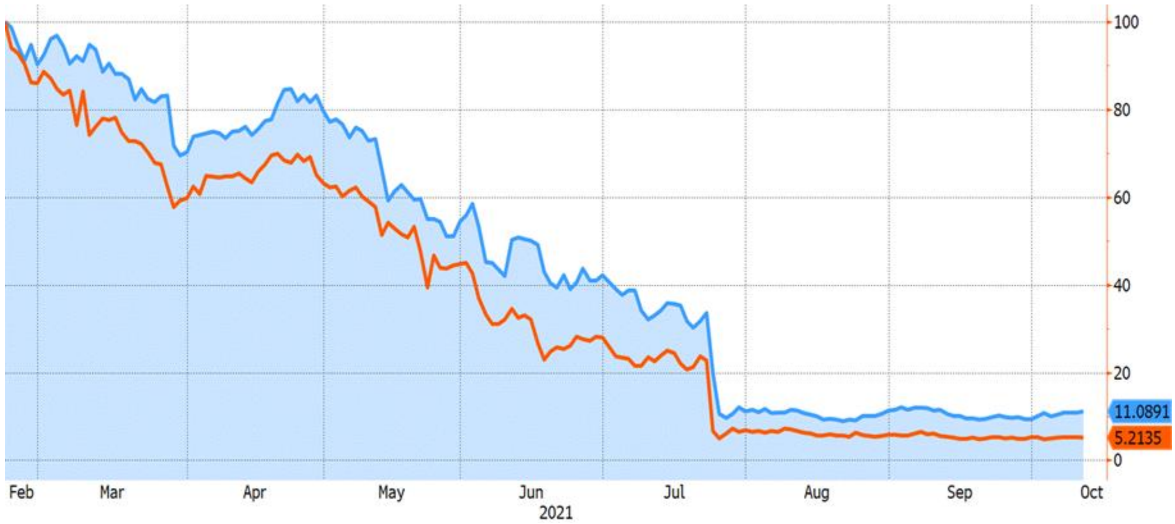

Chart 1: New Orient / TAL Education % change share price (since 19th Feb)

Other areas under the regulatory spotlight include internet stocks, property developers and digital gaming. Hong Kong listed H shares performed poorly in this environment, largely due to continued weakness in the share price of the technology giants.

US listed Chinese ADRs remain particularly vulnerable given rising US/China tensions and recent Senate legislation regarding stricter audit requirements. However, our favoured position in onshore listed China A shares fared better. The Shanghai Composite fell by just 1% in Q3; it is a more diversified index with a broader sector exposure and fewer dominant single stock names. We took advantage of the recent volatility to switch half our passive A share tracker holdings into a proven active manager who has a better chance of navigating the political uncertainty.

The Japanese market was one of the strongest performing global markets over the quarter; the Topix index gained 5%. On 4th October, Fumio Kishida was appointed Prime Minister, replacing the outgoing Suga. He immediately called a snap-election for the end of the month, vowing to bolster fiscal and monetary support to fight the pandemic. The prior administration presided over the worst Japanese equity underperformance in a decade as investors focused on its mishandling of the Covid crisis. In contrast to its spendthrift Western peers, the Suga government spent only 60% of its $725bn Covid rescue budget. Another contrast is Japanese inflation that continues to miss to the downside. With CPI at -0.4% pa, monetary policy will remain ultra-loose for the foreseeable future. Japan remains one of the cheapest and most cash rich equity markets.

The UK also remains a relatively cheap market. The iShares FTSE 100 ETF held in GBP mandates currently trades on a 12x forward price-to-earnings ratio and a 4.2% dividend yield (source:

Bloomberg). As we have previously highlighted, the UK market has struggled due to factors including Brexit and Covid disruption. Talks of petrol and food shortages, in addition to soaring gas prices, have uncomfortable echoes of the 1970s.

Whilst many stock market investors continue to shun the UK, private equity (PE) interest in UK assets remains robust, attracted by cheap valuations and a depressed sterling. This year has seen U$64bn of PE bids for UK companies with supermarket Morrisons currently the subject of a £10bn bidding war. The FTSE All Share gained 1% this quarter, whilst the mid cap FTSE 250 index added 3%.

Bonds

10-year yield	30.09.2021	30.06.2021	31.03.21
US treasury	1.49%	1.47%	1.74%
UK gilt	1.02%	0.72%	0.85%
German bund	-0.20%	-0.21%	-0.29%
Australian treasury	1.49%	1.53%	1.79%

Bond markets rallied during the early part of the quarter, before selling off into the close; many fixed income benchmarks now show significant losses for the year-to-date. The US Federal Reserve surprised markets with a more hawkish narrative at its September Open Market Committee meeting. Spooked by rising inflation, the Chairman suggested an end to QE bond purchases by mid-2022 with rates rising thereafter. The Bloomberg US Treasury index was flat in Q3 but is down 3% since the start of the year. Our preferred inflation-linked treasuries performed better, adding 2% in Q3.

In laying out his revised forecast, the Fed Chairman said a “decent” jobs report would be a key hurdle to begin winding down its U$120bn monthly asset purchase program. However, both August and September employment reports disappointed, adding 366,000 and 194,000 jobs respectively; well below consensus expectations of 500,000. The rate of unemployment declined for the third straight month, falling to 4.8% from 5.2%, but there are still five million more Americans out of work than at the start of the pandemic. At 61.5%, the employment participation rate is still 2% lower than January 2020. The Fed faces a tricky dilemma on whether to taper in November, or reconsider.

The UK bond market came under pressure, as soaring oil and gas prices stoked inflation fears. Having started the quarter at 0.7%, the yield on a ten-year Gilt dropped as low as 0.5%, before selling off sharply in September to finish at 1% (chart 2). Bank of England Governor, Andrew Bailey, spooked markets when he said he was “concerned about inflation”, whilst fellow MPC member Michael Saunders told the Sunday Telegraph that expectations of earlier rate hikes were appropriate. Futures are now pricing in the first rate rise (from 0.1% to 0.25%) before the year-end. The FTSE UK All Stocks Gilts index lost 2% this quarter and has tumbled 7% year-to-date.

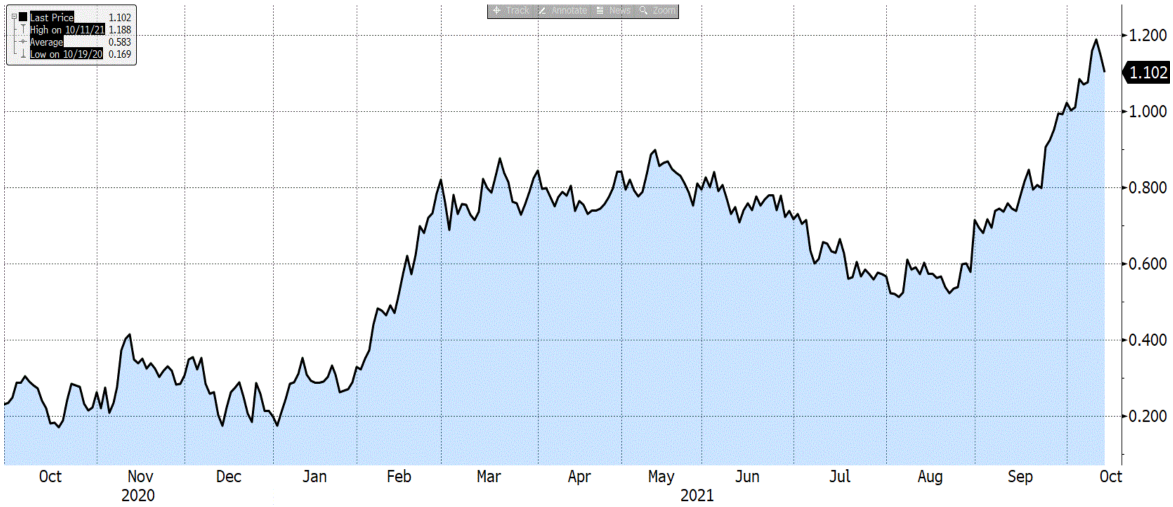

Chart 2: UK Gilt 10 year yield (Sept 2020 to Oct 2021)

Sustainable or "ESG" linked bonds continue to attract huge investor demand. During the quarter, the UK raised £10bn from its first "green" gilt. According to the FT, this 12 year issue was ten times oversubscribed. The bond trades slightly inside the yield of a normal gilt; the "greenium" premium. It is the largest sovereign "green" bond to date, encouraging further issuance later this year. Proceeds from the bond must be spent in line with a formal green framework, which includes projects linked to renewable energy, flood defence and carbon capture.

UK inflation-linked bonds outperformed, up 2% over the quarter, with rising inflation expectations weighing on real yields. 10yr break-even inflation rates have risen to 4% pa, their highest level since 2008. The latest UK CPI print was 3.2% with external factors such as a global shortage of computer chips and building materials reinforcing the energy price effect. On the continent, the German rate of inflation hit 4.1%; the highest level in 29 years.

China Evergrande became the first victim of China's new "three red-lines" policy, aimed at curbing excessive leverage in the real estate market. The Shenzhen property developer is struggling to sustain its debt fueled business model. Its share price has fallen 90% and is now suspended whilst the company's 2025 bonds are trading at 20 cents in the dollar. The question for investors is whether this becomes China's "Lehman Brother's" moment or will the authorities act to prevent a rolling debt crisis? We believe the latter is the most likely, should the need arise.

That said, Evergrande bondholders look set for a wipe out. They are subordinate to a long line of Chinese consumers who await completion of their properties and the many suppliers involved in an estimated 7,000 outstanding home-building projects. Evergrande has RMB240bn of debt due over the coming year and has already started to dispose of assets in a desperate attempt to fund its liabilities.

With Chinese companies such dominant debt issuers, contagion has reached other Asian credit markets. The Bank of America Asian High Yield spread has nearly doubled to 12% in recent months (chart 3); conversely our holdings in RMB sovereign bonds have proved a safe-haven, gaining 5% in GBP terms over the quarter.

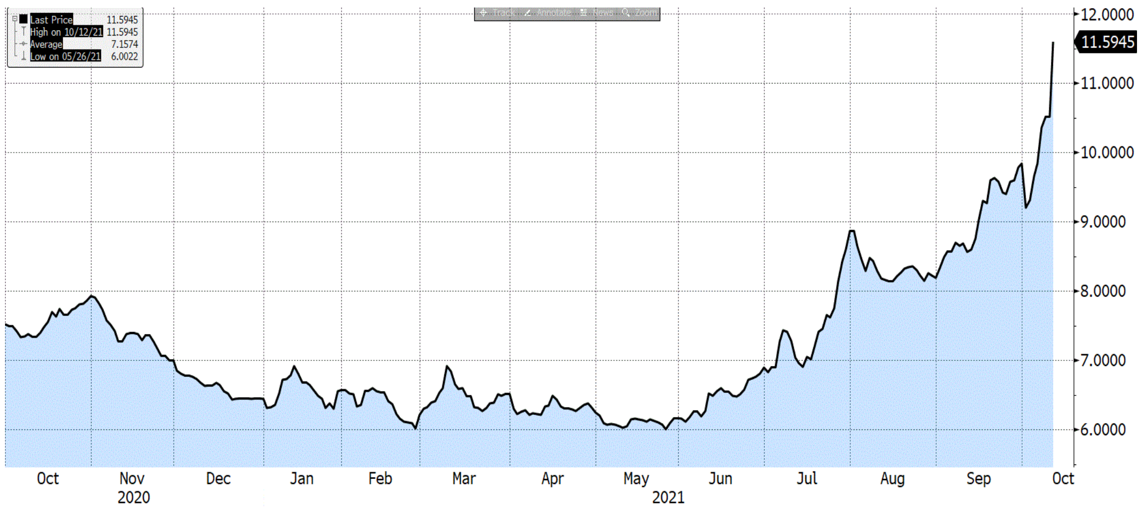

Chart 3: Asia High Yield Spreads (Sept 2020 to Oct 2021)

Currencies

Rate versus USD	30.09.2021	30.06.2021	31.03.21
GBP	1.347	1.383	1.378
EUR	1.158	1.186	1.173
AUD	0.723	0.750	0.760

With the Fed turning more hawkish than many of its peers, the trade-weighted US dollar added 2% during the quarter. It rose against most currencies, with the Chinese RMB a notable exception. A strong dollar tends to tighten global liquidity, as many loans and commodities are dollar priced; it is thus a headwind for risk assets.

The pound lost 3% against the dollar despite the UK economy growing by a faster than expected 5.5% (annualised) in Q2. Other major currencies such as the euro and Australian dollar also softened against the greenback, falling 2% and 4% respectively.

Political uncertainty in Germany did not help the euro. The centre-left Social Democrats (SPD) claimed victory in the General Election with 206 seats, narrowly ahead of outgoing Chancellor Angela Merkel's CDU/CSU party with 196 seats. SPD leader Olaf Scholz is now in talks with potential coalition partners such as the Greens (118) and pro-business Free Democratic Party (FDP). Mr Scholz will hope that a new government is in place by the time Germany takes over leadership of the G7 next January.

Emerging market currencies remain weak, with the Brazilian real and Mexican peso falling 9% and 3%, respectively. Commodity exporter nations fared better, with the Russian rouble benefiting from higher fossil fuel prices; it gained 1% this quarter and is up 7% over the past twelve months. In contrast to other emerging markets, the Chinese RMB was a picture of stability with a flat return over the quarter. The same was true of the Japanese Yen, which often benefits during 'risk-off' periods.

Cryptocurrencies enjoyed a strong rebound in Q3, following their precipitous May sell-off. Bitcoin gained 26%, finishing the quarter above U$43,000. Ethereum, the second largest cryptocurrency by market cap, fared even better with a 33% advance. The nascent asset class largely shrugged off headlines about China banning cryptocurrencies (a known threat), partly thanks to a more constructive tone from US officials. Fed Chair Powell has said he does not intend to ban cryptocurrencies, but warned that stablecoins need greater regulatory oversight, given their connection to the traditional financial system.

Commodities

% change	3 months	12 months
Oil (WTI)	5.8%	74.4%
Gold bullion USD	-0.7%	-6.8%

US oil prices continued their recent strong run on the back of the post-pandemic economic rebound and tight supplies; OPEC continues to ignore calls to increase production. US WTI oil finished the quarter at U$75/barrel, the highest level since 2014. US energy secretary, Jennifer Graham, suggested the government may release inventory from its strategic petroleum reserve to help calm surging petrol pump prices.

Whilst oil prices were strong, price action in the natural gas market has been even more dramatic; futures prices skyrocketed 60% in Q3 (chart 4) and have more than doubled since the start of the year. Russia's President Putin is playing hardball with Europe, as he pushes for the approval of the Nord Stream 2 pipeline to Germany; it will deliver Russian gas to EU markets. The IEA's executive director told the FT that Russia could raise exports by roughly 15% should they so wish, rebalancing energy markets. In the UK, several smaller energy suppliers went bust after they failed to hedge their supply costs. The energy price cap in the UK means they cannot pass on rising costs to consumers

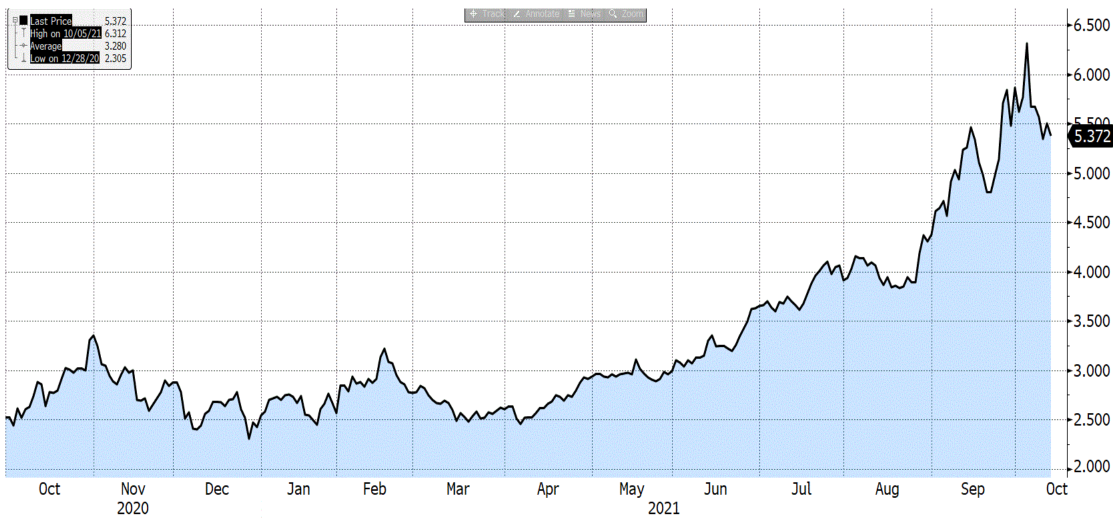

Chart 4: Natural gas prices skyrocketing (Sept 2020 to Oct 2021)

The gold price traded sideways for much of the quarter, falling by 1% to U$1,757. The market remains pre-occupied with the threat of rising rates – both nominal and real – as the Central Banks share a more hawkish outlook. We believe the long-term fundamental outlook for bullion remains exceptionally strong as high debt levels make it almost impossible for rates to rise meaningfully without triggering an economic and/or market crisis; this would force the authorities back into a policy easing mode. Gold tends to flourish when the stimulus taps are wide open and real rates are falling.

Interestingly, Gold ETF holders continue to liquidate their holdings whereas Central Banks remain large net buyers.

Silver prices fell 15% over the quarter, from U$26 to U$22; a 12-month low. Lower industrial demand (mainly autos, electric vehicles and solar) has been driven by the global chip shortage; silver is unlikely to recover until gold rediscovers its shine and industrial demand recovers. Despite recent weakness, we take encouragement from the fact that financial speculators are the most bearish in a year; this is often a contrarian indicator.

Industrial metals were more of a mixed bag with copper falling 4% and aluminium rising 13%. China's recent clampdown on financial speculation and its economic slowdown continue to weigh on some resource markets; iron ore prices have fallen by over 40% in recent months.

Market Performance

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

	30 September 21	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3474	-2.0%	-2.6%	4.3%
CHF	1.0735	-1.7%	-0.7%	-1.1%
AUD	0.7227	-1.2%	-3.6%	0.9%
JPY	111.2900	1.2%	0.2%	5.5%
EUR	1.1580	-1.9%	-2.3%	-1.2%
BOND YIELDS (10 yr)				
UK	1.02	0.31	0.31	0.79
US	1.49	0.18	0.02	0.80
Germany	-0.20	0.19	0.01	0.32
Australia	1.49	0.34	-0.04	0.70
Japan	0.07	0.05	0.01	0.06
EQUITIES				
US. S&P 500 (USD)	4,307.54	-4.8%	0.2%	28.1%
UK. FTSE 100 (GBP)	7,086.42	-0.5%	0.7%	20.8%
FTSE Europe Ex UK (local)	328.94	-3.5%	0.7%	26.7%
Japan. Topix (JPY)	2,030.16	3.5%	4.5%	24.9%
China. Shanghai Comp (RMB)	3,568.17	0.7%	-0.6%	10.9%
HK. Hang Seng (HKD)	24,575.64	-5.0%	-14.8%	4.8%
Australia. All Ords (AUD)	7,629.74	-2.5%	0.6%	27.0%
FTSE Asia Pac ex Japan	665.28	-4.1%	-8.5%	16.2%
FTSE World (USD)	839.17	-4.4%	-0.9%	26.9%
FTSE World (GBP)	922.71	-2.4%	1.5%	21.7%
COMMODITIES				
Oil (WTI)	75.03	9.9%	5.8%	74.4%
Gold	1756.95	-3.1%	-0.7%	-6.8%

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