QUARTERLY MARKET OVERVIEW – OCTOBER 2021

"I am a lead pencil – the ordinary pencil familiar to all boys and girls and adults who can read and write" –
I, Pencil, My Family Tree as told to Leonard E Read

It is perhaps worth remembering that what happened in 2020 was a once in a lifetime event. The recession was man made, created rightly or wrongly by fear. It seems unlikely we will go back into lockdown and therefore economies will naturally start to open and life will return to some form of normality.

However, there are many uncertainties. Trillions of dollars were pumped into global economies to keep them functioning. As the furlough scheme comes to an end in the UK. it is estimated that the cost was around £70 billion and at its peak it supported 8.9 million people.

The press is keen to spread fear about the upcoming winter months, rising fuel prices, food shortages, no presents for Christmas etc. This is where FOMO (fear of missing out) comes into play. If we see shortages in fuel, we feel we need to get some, if we worry we won't get a turkey, we rush to buy one. Sounds familiar? Who can forget toilet roll being more valuable than gold at one-point last year!!

I recently read a brilliant short paper called "I, Pencil, My Family Tree", I cannot fully do justice to it so would recommend a read. But basically, it explains that a pencil is not just a pencil. It starts with a tree, the tree needs to be harvested, transported, taken to a mill and then a pencil factory. All the way through the process you have people involved, equipment etc. And then you have the graphite and that must be mined and shipped to the factory. It is a very profound piece, and to me it highlights that nothing is ordinary.

As we look at the global supply chain, factories ran down inventories during the pandemic, empty shipping containers were left in the wrong parts of the world and so forth. If you have a short sharp recession, and then demand goes from zero to full throttle it means that supply cannot keep up with demand.

Take some examples: for those hoping to go abroad on holiday in the summer, trying to find somewhere in the UK at short notice was almost impossible, and where you could you were faced with 40% plus increased costs. If you run a campervan business, you are riding a wave of demand. If you want a new car there are bottle necks which means second-hand car prices, especially in the US, are over inflated.

As with everything, to get goods moving you need trucks. Some truck drivers were being paid less than someone working in a supermarket, with more unsociable hours. COVID made many reflect on whether they wanted to continue to do this. Also some drivers returned to their home countries. So as demand grows you do not have enough supply of drivers. You also cannot get new drivers quickly as there is a long waiting list for tests. So, drivers are then offered more and that might attract people back into the industry.

The point is that COVID might be over but there are wider ramifications. We have written a piece on inflation and perhaps it goes a little against what we said last quarter, but inflation will be higher in the short term due to the increased demand. How it settles over the longer term remains to be seen but most agree we should expect higher inflation than the previous ten years.

If we go back to the pencil analogy, if one part of the chain is damaged it slows the process, and if demand remains high then it causes problems. All of this supply / demand angst will flush through the system, but it does mean in the short term there will be bumps in the road.

We still believe long term equities are the place to be but there will be more volatility and the journey will not always be smooth. It is worth reflecting September was the worst month for equities since October 2020 and this was driven by concerns over a China slowdown, the energy crisis in Europe and China and the US debt ceiling. I would also add that as a month September tends to be weak. I am not sure what the theory is behind this, but looking back over history this seems to be the case.

In summary, we are continuing to re-open and strive towards some form of normality. If we turn to the humble pencil, it is worth remembering that it is complex beast with many moving parts. This well reflects the world we are in. An enforced shut down has temporarily damaged supply chains and so demand cannot be met. In time this will settle, we just have to ride it through. Although we do not know the eventual outcome of this experiment, we remain positive on the long-term outlook for equities.

George Ladds

George Ladds, Director, October 2021

SUSTAINABILITY

In our next monthly update, we hope to share more thoughts on sustainable investing and why it is so important. This is very timely, with the UK hosting the 26th UN Climate Change Conference of the Parties (COP26) in Glasgow on 31 October – 12 November 2021.

COVID has been a massive re-set for global economies and provides the opportunity to tackle climate change in a way we have never seen before. In Europe we have the European Recovery Plan, China has announced its plans as has the UK. In fact around 70% of the world economy is now covered by net zero targets.

It is not just about clean energy or the shift to electric vehicles, but also about how we develop cleaner cities. We know that storms, floods, and wildfires are intensifying and the impact that has on people and livelihoods. With this in mind, the conference is looking to focus on four areas:

- Secure global net zero by mid-century and keep 1.5 degrees within reach
- Adapt to protect communities and natural habitats
- Mobilise finance
- Work together to deliver

Even if we claim not to care, the fact is that this is where all the effort and money is going. Businesses that are transitioning or delivering solutions are likely to be the winners over the next decade and more.

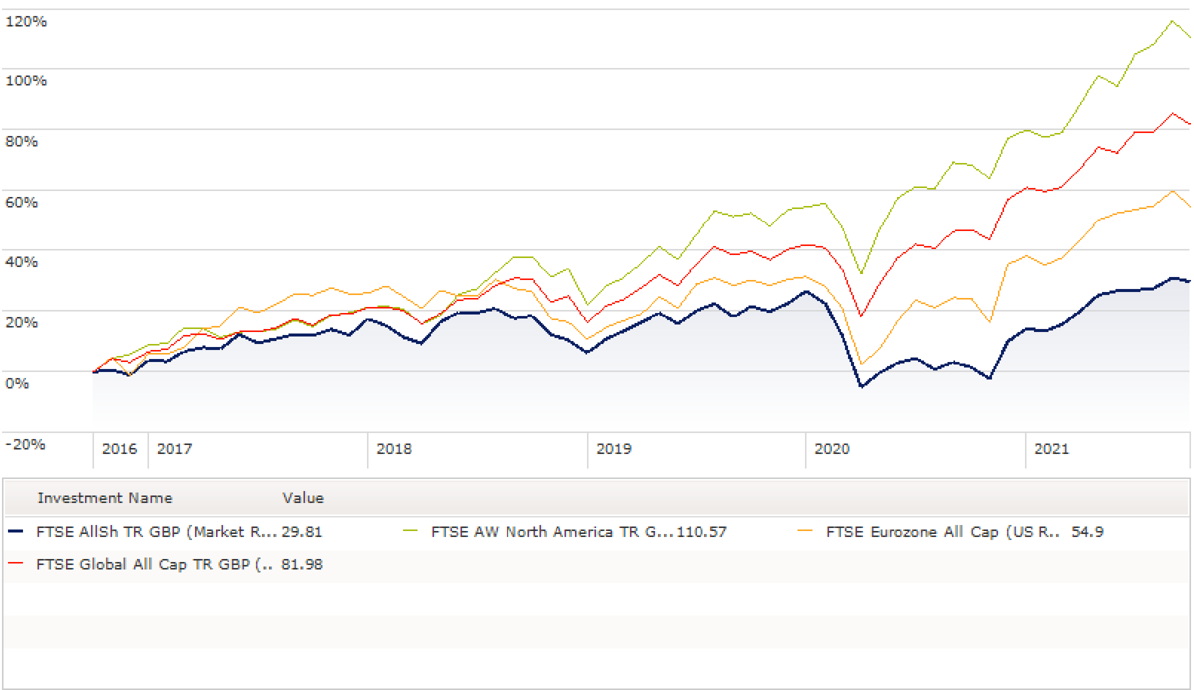
To bring this to life, we were discussing Shell with two fund managers, and they politely explained how we did not understand the business. It is complicated, and on paper they are not investing in renewables. However, they are disinvesting from their oil exposure and stepping back from refineries. The focus for the business with a 30-to-40-year horizon is natural gas, hydrogen and carbon capture:- all elements needed in the switch to a cleaner a world. This means at some point people's views will change and this will become a more accepted company.

Another company is Befesa. Recycling is a growing source of value for investors as a circular approach to natural resources displaces our traditionally linear model. Befesa is focused on the industrial recycling of hazardous waste generated in steel and aluminium manufacturing. Befesa's process diverts toxic material entering landfill, and its end products can be used in place of virgin ingredients in cement, ceramics, and insulation.

In summary, COP26 really brings to the forefront what we need to do as a world to make change happen. As investors, the opportunity is vast. There are many profitable companies doing great things, and some of these we may never have heard of. At the same time, we may be dismissive of established businesses but these too have a significant part to play.

US, EUROPE & UK

Five year returns 1 October 2016 – 30 September 2021



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Although the PMI (purchasing managers index) remains strong there has been a deceleration in growth. The US PMI dropped from 61.1 to 60.5 in September, the lowest for five months, and the services index dropped to a fourteen-month low. The Eurozone PMI dropped from 61.4 to 58.7 a seven-month low, with services at a four-month low. In the UK the PMI dropped from 60.3 to 56.3 a seven-month low, services were also at a seven-month low.

Across the globe this reflects peaking demand, supply chain delays and labour shortages. All of this will push up prices in goods and services as demand outpaces supply. So what does this mean for recovery across the US, UK and Eurozone?

US

Biden is still trying to get his $3.5 trillion super package approved. It seems likely if this is agreed it will be watered down. However, the focus has shifted in October to the debt ceiling; the markets are unlikely to like the game of chicken as the two parties battle to be seen to be the one who gets a resolve.

To understand the importance of the $3.5 trillion super package, it is worth reflecting that COVID came on the back of a decade of recovery from the global financial crisis, and although the labour market and employment has recovered to pre-crisis levels, there is some debate on the health of the economy.

Concerns over deteriorating infrastructure, wage stagnation, rising income inequality, elevated pension, and medical costs, as well as large current account and government budget deficits are just some of the challenges that the government faces. The super package is all part of that drive to address some of these issues. Politics are a game and does any politician really have an incentive to hand this to Biden? Probably not, and that is why there is a general feeling that the result will not be as good as promised.

This will likely rumble on for some time to come, but if we look at the here and now the economic fundamentals for the US look good. Household and business balance sheets are still in good shape and consumers have cash to spend. Production output is strong and GDP remains robust. But a boom in retail which is up 17.5% compared to February 2020 is not sustainable.

So there is a post-COVID boom but is this sustainable? One short term concern in the US is the slowdown in the vaccination programme. Some argue this doesn't matter due to herd immunity. However, the Centers for Disease Control and Prevention (CDC) states that only 60% of the US population is fully vaccinated. This could make the economy fragile if there is a spike in cases which creates shortages in ICU beds, closed schools and people avoiding shopping and entertainment venues.

The US is treading a tightrope. On the one hand there are positive signals from consumers and businesses, and if Biden can somehow drive through his super package, then things look positive. On the flip side, COVID hasn't gone and the reluctance of many to be vaccinated could cause problems in the winter and slow the recovery. The debt ceiling talks will likely cause market volatility, and whether Biden gets what he wants is yet to be seen.

The fed is also a crucial part of the story, and they must get things right. It looks likely that QE will slow, and indications are that the first-rate rises will come in 2022 with 2 or 3 in 2023. As it stands in the short term, even with challenges, we remain positive for the US.

UK

The UK remains fascinating and feels a bit like marmite! (You love it or you hate it!)

Since 2016, we have been ignored by the outside world. Weak governments, uncertainty over Brexit and COVID all conspired against the UK.

The vaccine programme may be to Boris what the Falklands was to Thatcher. Whatever our thoughts about him he seems popular, especially in the labour heartlands. Even if he is alienating some of his traditional voters, these are more likely to go to the Lib Dems rather than Labour. Rumours of an election next year seem unlikely, but you can see why with this momentum he would want to gain an even bigger majority.

Furlough has now come to an end with 1 million people still on the scheme and at a cost of around £70 billion. Without this the outcome would likely have been very different, with a deep recession with thousands of businesses shut and millions of people out of work. Effectively this was a job retention scheme, and it is very hard to argue against. There are jobs out there and the government has announced a £500 million jobs and training drive focused on those people coming off furlough.

The UK has attracted around £60 billion of private equity bids this year and therefore there is a feeling that investors are starting to see value and opportunities within the UK market. As the UK economies climbs out of a recession, the journey is not going to be easy. The same concerns that apply globally on supply chains, rising natural gas and oil prices, and lack of workers in certain key sectors, have the potential to slow the recovery.

We have seen the economy bounce back strongly as restrictions have been lifted and this has filtered through to household spending and investment activity. But consumer confidence has dropped back. This is driven by inflation and the rise in the price of essentials items like gas and oil. To drive an economy you need consumers to spend. If consumers are worried about the future, then this could dampen any potential economic recovery over the long term.

So, in the short term, the signals remain positive but there are clouds which have the potential to slow any recovery.

Eurozone

The OECD believe the Eurozone will recover more quickly than previously assumed, with strong policy support and progress in vaccination campaigns rebooting economic activity.

In Germany there was no outright winner in the election, meaning there remains some uncertainty as to which party or parties will lead going forward. Perhaps a re-boot in German politics is needed and certainly businesses would like a three-party coalition.

In the Eurozone the income support schemes are also coming to an end, and like the UK there are shortages of staff in key areas of the economy. It is worth reflecting that in Germany there is a shortage of truck drivers of around 60,000, and this is expected to increase by 15,000 per annum as drivers retire. So it is not just a problem faced by the UK.

As of the first quarter of 2021, the eurozone's active workforce remained 2.6m below pre-pandemic levels. In Germany there is an aging population which may explain some of this. In Spain and France certain taxes and poor training create barriers to work, and of course although no longer part of the EU, the UK choked off inflows of migrant workers.

So the shortage of staff is a global issue and will need to be tackled, but how is the million-dollar question!

The worry with shortages of staff and inflation is wage inflation.

In Germany workers at motorhome makers Carthago went on strike over pay, and unions are demanding pay rises in the banking and public sectors. In the Hesse region retailers and mail order companies agreed a 3% pay rise this year. How this feeds into other Eurozone economies will be interesting to watch.

Europe is not immune to the rising gas prices, which have more than quadrupled in Europe this year, contributing to a sharp increase in wholesale electricity prices and disrupting sectors that rely on gas by-products, such as fertiliser makers and food packaging.

Like the US and the UK, the data is positive, and the European recovery plan is an important part of Europe coming out of the lockdown. The challenge is global with inflation and workforce shortages creating wage inflation, and then whether that slows any recovery.

In summary, in the US, although the manufacturing and service data has dropped back, it remains relatively strong and the economic data remains positive. There are risks long term and this highlights the importance of Biden's $3 trillion package. In the short term the slowdown in the vaccine programme does place fragility into the system and demonstrates how the virus is still out there and should not be ignored!

The UK has bounced back strongly over the last few months as the success of the vaccination programme has enabled the economy to open. Supply constraints and rising prices, especially in oil and gas, have dampened consumer confidence and this has the potential to slow the recovery.

Turning to the Eurozone, the data from the OECD is positive and although the economic data has dropped back slightly, this is still positive. Going back to our pencil analogy, the impact of rising gas prices impacts all parts of the global economy, and this is already disrupting other parts of the economy. With the shortages in workers, rising inflation and demands for higher wages, all of these could have the potential to slow any recovery.

Having said all of this it is important to remember that Governments will be spending, particularly in areas which could reduce our carbon footprint, and therefore although in the short term there might be worries about inflation, economic slowdowns etc, in the long term it is worth considering what the potential long-term investments into economies will look like and how this impacts growth moving forward.

EMERGING, ASIA AND FRONTIER MARKETS

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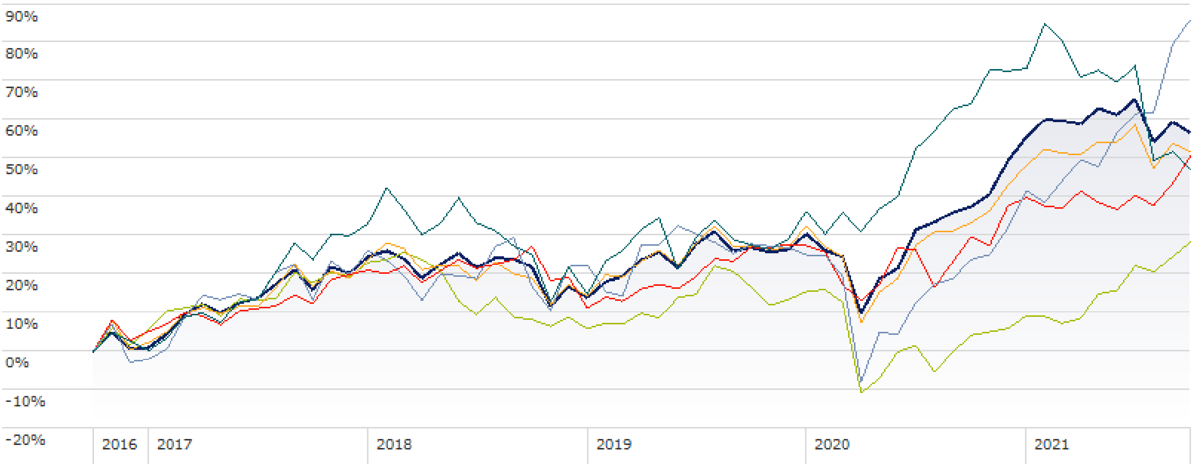

Investment Name	Value				
FTSE AW AP Ex JPN TR GBP (...	56.61	MSCI Frontier Markets PR US...	28.21	FTSE Emerging TR GBP (Mark..	51.83
TOPIX 1000 TR JPY (Market R...	50.5	FTSE India TR USD (Market R...	85.95	FTSE China TR USD (Market ...	47.23

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We have always been advocates of emerging markets but we know the journey is not always smooth. We have written a piece on China recently and it is important to note the three mountains – education, health, and housing – are all part of ensuring equality rather than inequality.

The focus on Evergrande highlights more inequality. It is estimated that the empty properties could house 90 million people and that many are held as speculative investments. The Government have said that housing is for living in and not for speculation. But property represents a large share of GDP, so the Government need to tread carefully, and although we might not see a bail out of Evergrande we might see some form of restructuring.

China is not immune to the energy crisis. The growing demand for power hungry factories has pushed up coal prices, and as power companies can't raise rates they have slowed operations, forcing output to slow. Over 10 semiconductor related facilities have announced temporary closures which could lead to a shortage of smartphones and other goods over the coming months.

A slow down in China does matter because it is an integral part of the global economy, so it is something to watch.

India is changing with the vaccination programme gathering pace and with over 860 million doses administered to date. The $1.2 bn agricultural infrastructure fund and focus on “Made in India” is driving growth and there has been a 45% increase in new businesses registrations since 2019.

Emerging markets remain a fascinating landscape. Although debt has risen because of COVID, debt to gross domestic product (GDP) in emerging economies is much lower than developed economies. Away from China, many economies have lower household and corporate debt as well.

Where we may feel certain parts of the US equity market are over inflated, emerging market equities hold attractive valuations, trading at discounts to developed markets, have developed strong growth potential and lower levels of debt. Eastern Europe and Latin America trade at even lower levels.

Latin America is rich in natural resources and will likely benefit from the recovery post pandemic. Brazil, Argentina, and Chile supply the world with lithium, a key component of electric vehicle production. Chile and Peru are global leaders in the supply of cooper. Russia supplies nickel, aluminium and of course, oil.

Emerging market companies are doing well, especially commodity orientated and technology orientated companies (in particular the semiconductor industry).

In the short term there are risks with COVID and more infectious variants. We have seen what happened in India and the slower vaccination programs have the potential to slow recovery across regions.

In Japan, Yoshihide Suga stood down as Prime Minister and has been replaced by Fumio Kishida. He will likely take the party into the General Election in November where they currently have a healthy lead. Although the economy is recovering from COVID, due to consumer demand, it is still fragile in terms of supply constraints and re-emergence of the virus.

In summary, China does matter and a slowdown in the property market, and energy prices reducing production does have an impact on the global economy. However, we still believe much of this is short term and longer term the outlook for Emerging markets is positive, especially for those commodity producers directly linked into the drive to net zero.

CASH

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We know that interest rates will not go up fast any time soon. I was looking at easy access accounts and some of the best rates were 0.65%. A fixed rate 3-year plan will pay 1.8% p.a. Inflation rose to 3% in August. This means that inflation is further eroding the value of capital. If we assume inflation ends up between 3% and 4% then the picture looks fairly bleak for long term holders of cash.

The table below shows the value of cash over 10 years, assuming inflation of 1.5% after any interest (we have assumed gross inflation of 3.3% and an interest rate of 1.8%).

Cash	Impact of inflation
£50,000	£43,083.36
£100,000	£86,166.72
£250,000	£215,416.81

CONCLUSION

In the short term we are seeing the bounce back coming through into economic data, and although there has been a slight deceleration, this remains positive. There are factors that are unnerving markets, including supply / demand issues, gas prices, China, and the US debt crisis.

In terms of oil and gas it is worth reflecting that oil is hovering around $80 a barrel, the highest level since 2014. Natural gas has gone up five times the level of this time last year, and coal prices are up 100% since September 2020. Lower supplies of gas from Russia to Europe has not helped, as well as storage shortfalls and supply problems.

And then we add into the mix the general supply / demand issue. Coming out of lockdown there is pent up demand but not enough supply. When will the semiconductor supply chain correct? COVID lockdown was a once in a lifetime event, economies shut down, factories ran down supplies, containers ended up in the wrong part of the world. When you open economies, people want to go out and spend, and therefore we should not be that surprised by what has happened.

We still believe there is the potential for a super cycle and for the 20s to be a good place for investors. However, we also think that there will be more volatility and bumps in the road. If we consider the Government's spending on the drive to net zero, that must be positive for economies. There also has to be a natural recovery over time and lower interest rates are extremely positive. But inflation means that things will not be as cheap as in the past and this could force higher wages and therefore wage inflation.

Source: Charts have been sourced from Morningstar. Any reference to a fund or share is not a recommendation to buy or sell that asset. Past performance is no guide to future performance and investments can fall as well as rise.

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