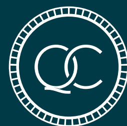

MARKET COMMENTARY - DECEMBER 2021

QUILTER CHEVIOT

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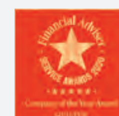


Past performance is no guarantee of future returns.

The arrival of the Omicron variant at the end of last month prompted a sharp but relatively mild setback to risk appetite. Although travel restrictions and other precautionary measures raised fears of another slump in global growth, it is difficult to assess the potential impact of the new variant until more information is available on transmissibility and vaccine efficacy. However, with vaccination rates in many countries - particularly Asian manufacturing hubs - now higher than in the US, the global economy should be less vulnerable than it was a year ago.

Global equities returned nearly 4% in the first half of November and had reached all-time highs before the Omicron news. Despite ending the month marginally down, dollar appreciation produced a positive return for sterling-based investors. While cyclical companies were hardest hit, a strong performance from technology stocks softened the blow and meant the broad US index fell only 0.5%. There were similar modest declines in Asia and emerging markets while Europe and the UK were down just over 2% in local currency terms. After trending higher over the past three months on rising inflation and the prospect of central bank tightening, yields on US and UK 10-year bonds eased to 1.4% and 0.8% respectively. Long-dated and index-linked UK gilts made strong gains which appears a somewhat contradictory reaction to the inflation uptick. Brent Crude fell 15% to $72.

Although supply chain disruptions continue, the evidence so far suggests that global economic activity picked up in Q4 after a soft patch in Q3 for some regions. Early Thanksgiving shopping in the US saw October retail sales surge to 21% above their pre-pandemic level, helped by an improvement in autos and rebounds for online sales and electronics. A similar picture emerges from business activity

and sentiment surveys. While services softened slightly in November, manufacturing picked up and both remain in expansion territory. Jobless claims are declining gradually with over 4 million still at home even after the end of the pandemic benefit payments. Job vacancies continue to far outnumber applicants suggesting that wage pressures may prove less transitory than anticipated. Assuming there is no widespread disruption from Omicron, US Q4 GDP could be as high as 6% versus 2.1% annualised in Q3.

Growth in China has been losing momentum this year. There are some signs of this stabilising - year-on-year industrial output rose 3% in October and retail sales nearly 5% - but new travel restrictions and continuing problems in the property sector indicate that growth could remain subdued for some time. Fixed asset investment has slowed to 6% year-on-year and, with the authorities determined to avoid reflating the property bubble, the economy is unlikely to accelerate while money supply and total social financing remain broadly in line with nominal GDP.

Japan's economy shrank more than expected in Q3 as global supply disruptions impacted car manufacturing and Covid-19 restrictions affected consumer spending. Factory activity, especially auto production, has rebounded and Q4 GDP should see a strong recovery as restrictions ease. As elsewhere, input prices have risen sharply, but Japan does not have the labour shortage experienced in other regions so inflationary pressures are likely to remain muted. The Eurozone has seen a similar acceleration in activity, although new lockdowns have dampened expectations for the services sector. Price pressures are the highest for nearly 20 years with companies reporting some success in passing these on. While the surge in energy costs was the main contributor to CPI rising to 4.9% in November and wage growth is less of an issue than elsewhere, there is pressure on the European Central Bank to reconsider its policy stance with various core inflation measures above 2%.

The UK recovery continues to lag other countries even though there has been the same pattern of sustained growth in business activity, robust consumer spending, an improving jobs market and sharply rising inflation. CPI reached a 10 year high of 4.2% in October and is expected to peak in H1 2022. The key concern is wage inflation despite earnings growth of 4.9% being distorted by temporary factors and compositional effects. Low unemployment and vacancies of around 1.2 million - a third higher than pre-pandemic - indicate a post-Brexit structural shortage. Faced with a potential wage spiral, the Bank of England has hinted that interest rates could soon rise. Bond markets see this as a potential policy error as - if the labour shortage is partly structural - the problem is unlikely to be resolved quickly and higher rates will add to the cost pressures on consumers.

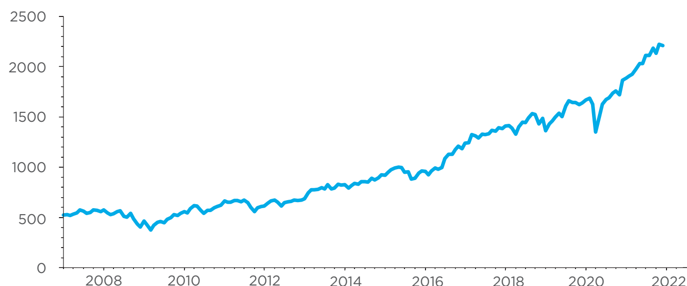
MSCI UK IMI

Source: Refinitiv Datastream 02/12/2021

iBOXX STERLING GILTS

Source: Refinitiv Datastream 02/12/2021

MSCI ALL WORLD £ - TOT Return



Source: Refinitiv Datastream 02/12/2021

The acceleration in growth and sharply rising inflation has emboldened central banks to taper stimulus measures and, in some cases, to start raising interest rates. The Chair of the Federal Reserve has dropped any reference to "transitory" inflation and the ECB is expected to announce plans to unwind its bond purchases. This suggests there is upward pressure on bond yields even without a knee-jerk rate rise which - given high debt levels - is likely to damage growth. The consensus view is that inflation will normalise in 2022 albeit at a slightly higher level than pre-pandemic. However, the last two years have highlighted the vulnerability of the global "just in time" supply chain and companies are expected to respond by diversifying their suppliers. If this is the case, the golden era - from a consumer perspective - of price deflation may be coming to an end.

In the short-term, strong corporate earnings have outweighed warning signs of tighter liquidity and a squeeze on margins from higher costs. Even assuming that the latest Covid-19 mutation has no adverse impact, we expect global GDP growth and corporate profits to revert to trend in 2022. December is often a strong month for financial markets but, after the strong run this year, current valuations leave little scope for disappointment - especially if bond yields edge up and provide an alternative source of return. While we remain positive on equities versus other assets, an element of caution appears warranted.

QUILTER CHEVIOT
Senator House
85 Queen Victoria Street
London EC4V 4AB

Please contact our Marketing Department on +44 (0)20 7150 4000 or email marketing@quiltercheviot.com

quiltercheviot.com

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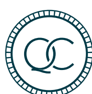

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