Quarterly review

for the three months to 30 September 2021

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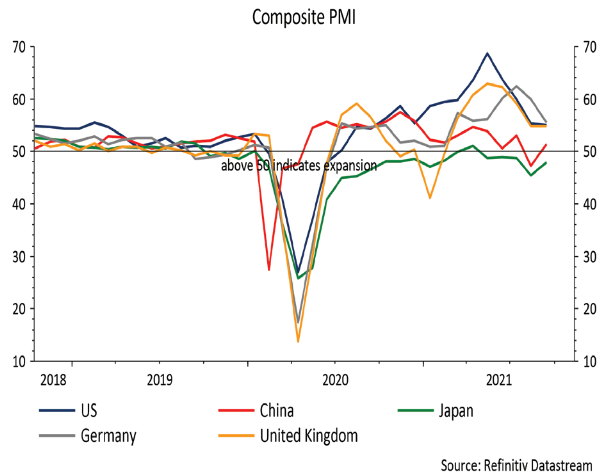
Global equities and bonds fell 0.95% and 0.88% respectively in local currencies over the quarter but rose 1.48% and 1.55% in sterling because of currency movements. Inflation data proved stronger than expected and central bankers turned more hawkish.

Equities in Asia excluding Japan and emerging markets lagged, falling 7.00% and 5.71% respectively in sterling. Chinese equities fared even worse, down 16.12% in sterling because of political interference in quoted companies and signs of slowing economic growth. Indian equities bucked the trend, however, up 15.47% in sterling as the economy recovered from impact of the Covid-19 delta variant and the reforms of Narendra Modi, the prime minister, improved the ease of doing business.

In July, in its latest "common prosperity" edict, Beijing banned companies teaching the school curriculum from making profits, raising capital or going public, leading to falls for education technology stocks. China's economic transformation, started by Deng Xiaoping, has entered a new, more interventionist phase under Xi Jinping. Prior examples of interference include Ant Group's cancelled flotation in 2020 and the removal of the ride-hailing company, Didi Chuxing, from Chinese app stores in July. The increased political risk of investing in Chinese companies may result in lower valuations for Chinese stocks.

In a similar vein, in early October, Beijing declined to intervene to prevent the private property developer, Evergrande, from defaulting on bond payments. The lesson in "moral hazard" meted out to Evergrande investors contrasted with the earlier bailout of the state-owned China Huarong Asset Management, deemed systemically important and thus too big to fail.

Investors also fear an economic growth slowdown. In September, at 51.7, China's purchasing managers' index (PMI), a leading indicator, stood above 50, the level that demarcates expanding and contracting economies, and implied growth was on the horizon. As the chart opposite shows, however, the leading indicators for China and other major economies including the US are below post-pandemic highs, signalling growth may slow or, in the case of Japan, fall.



Slowing growth in China and elsewhere may result partly from supply constraints. In 2020, China, the world's largest coal importer, banned imports from Australia, the largest exporter, allegedly in retaliation over Australian calls for a global inquiry into the Covid-19 pandemic. The local coal price rose and shortages led to shutdowns and blackouts in some cities. In a separate development, China has curbed steel production in line with ambitious decarbonisation plans. Supply shortages and commodity price increases contributed to Chinese producer price inflation of 9.5% in August.

The US embargo on trade in key technologies with China may accelerate China's progress towards self-sufficiency in "strategic emerging industries" such as electric vehicles, artificial intelligence, robotics and 5G mobile networks. Semiconductors are essential in many of these industries and supply shortages have led the US and China to increase domestic semiconductor capacity. Taiwan Semiconductor is, therefore, building capacity simultaneously in Arizona and Nanjing. Chinese economic development may, in the past, have been disinflationary as low-paid Chinese workers joined the global workforce, reducing manufacturing costs. Sino-US trade tensions and Covid-19 disruption have, however, promoted a move away from "just-in-time" supply towards greater resilience for businesses through the development of domestic suppliers, potentially leading to inflation as cost increases are passed on to consumers.

Quarterly review (continued)

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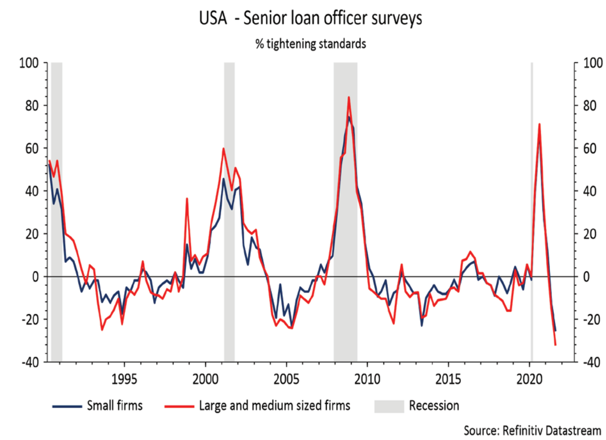
Higher energy prices fuelled global inflation. The oil price rose 6.23% in sterling over the quarter as demand outstripped supply in a synchronised global recovery while the major producers of OPEC+ maintained discipline, only gradually increasing supply. In August, US headline inflation rose to 5.3% but core inflation excluding food and energy also rose as the personal consumption expenditures (PCE) index, the Federal Reserve's chosen measure for prices, showed a 3.6% rise in August against the official average target of 2%. In September, the Fed's policymaking Federal Open Markets Committee indicated that the tapering of asset purchases might soon commence, with the first interest rate rise likely in 2022, not 2023. The Fed's forecast for 2021 economic growth fell from 7% in June to 5.9% in September but inflation forecasts rose for 2022 and 2023 to 2.3% and 2.2% respectively, up from the previous 2.1% forecast for both years.

UK consumer inflation was 3.2% in August, prompting an exchange of letters between the Bank of England governor, Andrew Bailey, and the chancellor, Rishi Sunak. Bailey said the case had strengthened for tightening policy sooner than anticipated at the time of September's monetary policy committee meeting. The Bank forecast inflation would reach 4% later in 2021. Bailey expected supply shortages to ease but was concerned labour shortages might persist despite the end of the furlough scheme. Third-quarter job vacancies reached a 1.1 million high.

Eurozone energy costs rose as the bloc's dependence on Russian gas was laid bare once more. Eurozone inflation rose to 3.4%, with German consumer price rises thought to have risen to 4.1% in September.

UK government and sterling investment-grade corporate bonds fell 1.92% and 1.03% respectively over the quarter but sterling high-yield bonds bucked the trend, rising 1.03%. For strategies with high allocations to bonds , Brompton invested in shorter-dated and inflation-linked bond investments because they may provide some capital protection should inflation prove higher and more persistent than central bankers expect.

Equities may, however, perform well in an environment of moderate inflation. The Fed and the European Central Bank have recently moved from fixed inflation rate targets of 2% to average 2% targets, implying inflation may exceed 2% for some time before monetary policies tighten significantly. As the Fed's loan officer surveys in the chart below show, monetary policy tightening is one of the few reliable indicators that a recession, indicated by the grey-shaded bars, may be coming. Although Brompton's investment team will monitor this data closely should interest rates rise, current lending conditions are ultra-loose compared to history.



Higher US interest rate and inflation expectations may, however, fuel a rise in the dollar and capital outflows from emerging markets. For this reason and the rising political risk from China, Brompton's investment team prefers developed to emerging market equities overall and investments with high weightings in companies with pricing power and thus more able to pass on rising costs to customers through higher prices.

Important information

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