CAMBRIDGE
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Have we passed the peak of supply disruption?

Last week we noted that October had picked up for investors where September had left off, namely equities slowly climbing down from the heights gained over the summer. As petrol availability returned even to London's suburbs and temperatures outside rose again, so it seemed did global stock markets. Despite broader UK news flow still very much on the gloomy side, stock markets around the world turned positive for October, and drove diversified investment portfolios back above where they had started the month.

This begs the question: are we already past the point of peak supply chain disruption, or have market participants spotted other developments on the horizon that make them more comfortable with what looks like being a largely disappointing end to the year? On the first point, it is a possibility, but not a certainty, and with UK retail trade representatives whipping up fears over no toys for Christmas, there is clearly a chance that the UK at least will work itself into another period of panic buying.

The more important points in our view, however, are around China, and the first Q3 corporate earnings reports coming out of the US. Regarding China, there have been persistent fears that its political leadership was failing to grasp the seriousness of the threat on domestic financial stability from property developer Evergrande going under, and a wider slowing of the economy because of increasingly frequent power cuts. On both issues we saw the type of decisive action in the past week that investors have come to expect from Chinese policymakers over the past decade.

First, the electricity price cap was removed for all heavy industrial users, like aluminium smelters and steel mills, which is expected to ease the China-specific energy crisis at the expense of those heavy industries. This is seen as a much lower price to the economy overall than the damage sudden power cuts inflict on all businesses. Second, Beijing delivered a very decisive acknowledgment of the risk arising from the financial troubles of Evergrande, while at the same time stating that the situation was "controllable" and contagion "unlikely to spread". Following the heavy sell-off in the Chinese sub-investment grade bond market last Monday, this could become the 'do-whatever-it-takes' moment for this testing episode in the Chinese financial sector. We discuss China's likely contribution to global growth in a separate article this week.

On the side of corporate earnings, some very strong results reminded investors that gradually rising yields are indeed quite beneficial to some sectors, even if they tend to affect overall equity valuations negatively. While corporate earnings reports are by their very nature a look into the 'rear view mirror' of economic development, the growth in earnings nevertheless cheered up investors, and contributed to the partial shift in sentiment to the positive. To be frank, the issues and concerns of the past weeks around a slowing of the economy on the back of the supply chain constraints have not suddenly disappeared, but it does seem that more market participants are coming around to accepting that, while the next few months are likely to bear earnings disappointments, the overall cycle remains on track for more expansion through 2022.

That does not mean to say it will be plain sailing in markets from here to the end of the year. Of course, short-term sell-offs on specific bad news (like unwelcome central bank statements) remain a distinct possibility. In terms of general market sentiment though, it does feel as if a page has been turned and markets are once again looking further ahead, with a degree of optimism.

The state of the global economy

By most measures, economic growth has been disappointing over the last few months. Economists started the year with high expectations for the post-pandemic recovery to become a sustained expansion – optimistic that vaccines and rebounding confidence would spur activity. The hope was that COVID conditions would normalise while monetary and fiscal policy remained supportive, leading to a virtuous growth cycle with higher wages, credit growth and global demand well into 2022. Quite a few economists were even worried demand could prove too strong and cause rapid and damaging inflation. And even though most would have expected a slowdown in the second half of this year, a few factors did not quite turn out as expected in the summer and autumn months.

Inflation expectations came true, in a sense. Prices for many goods have picked up substantially across the developed world – led by a sharp uptick in the cost of energy. But the latest spikes have been driven more by heavy supply constraints than rejuvenated demand. Oil and gas prices have risen substantially on the back of tighter supply, while labour shortages in delivery have exacerbated the problem and caused knock-on effects for a host of other goods.

To be clear, inflation itself is not always a bad thing. Much of the excitement investors felt in January was driven by the so-called 'great reflation' trade, when optimism and policy support was expected to drag the developed world out of the sluggish decade leading up to the pandemic. Price rises can be a spur of real (inflation-adjusted) growth. But that tends to come from higher disposable incomes and more confident consumers – while sudden price spikes can have the opposite effect.

Britain is a case in point. The Bank of England (BoE) now expects inflation to hit 4% or more by the end of the year. And while some of this comes from sharp wage increases in understaffed industries (like much-needed lorry drivers, who have reportedly seen wages rise as much as 15% this year) most people's incomes have not risen nearly as much. The BoE reports that typical pay settlements are around 2-3% higher than a year ago. With prices rising and taxes set to increase, the average Briton has seen their real income fall.

Similar trends can be seen in the US and Europe. Global supply shortages have pushed up prices but without a comparable increase in short-term growth prospects, meaning many consumers and businesses will see themselves as worse-off – putting a dampener on demand. These fears have been heightened by media talk of 1970s style 'stagflation', where prices continue to rise despite low growth. If that came true, it would mean an end to the post-pandemic growth cycle before it properly began.

Fortunately, we do not expect that to happen, as slowdowns driven by supply issues – as long as they remain temporary - have proven much less difficult to remedy than demand shortages. Given the focus had as usual been on demand, the economy hit an unexpected air pocket over the summer, but it is still in flight. The slower-than-anticipated unwind of supply constraints and concerns over the Delta variant mean the rough patch will likely spill over into the fourth quarter. However, these problems are unlikely to persist into the medium term, given global production resources for goods are merely 'out of kilter' following the abrupt restart, but still have the same capacity as before the pandemic (when oversupply tended to be the economic worry point). This is not withstanding the longer-term structural change we can see in the 'green transition' of global capital allocation leading to continued elevated prices for much needed input materials of 'old' but still very much needed manufacturing sectors (for instance metals and minerals – we wrote previously about this).

In terms of COVID, the UK's recent experience has shown variant-driven outbreaks in highly vaccinated populations are not a systemic threat, while vaccine rollouts have lessened the need for lockdowns even in developing countries. Those two points together mean supply issues should clear up soon enough – just as the UK-EU vaccine spat did after vaccine suppliers increased production.

To put it bluntly, the current problems are somewhat old news for investors, even though they may persist a bit longer. For the cycle as a whole, underlying fundamentals remain strong. Household balance sheets are in good shape, supported by surplus savings built up during lockdowns, which will help households to absorb temporary price rises in energy and food. On the business side, companies reliant on high yield corporate (junk) bonds in the US, which can always be a bit of a soft spot, have pushed their debt maturity into the future, meaning they are less vulnerable to rising interest rates. The three major developed market central banks – the US Federal Reserve (Fed), European Central Bank (ECB) and Bank of Japan (BoJ) are unlikely to raise interest rates into the current cost inflation shock, even if some of the Fed's representatives have sounded a bit more nervous about the persistence of inflation. The underlying reasoning being that tighter policy would drive down demand but do little to counter supply constraint-driven price pressures. And of course, a lot of focus is on so-called 'second round' effects. Here, the debate hinges on whether there is sufficient evidence that higher commodity prices are persistently driving up wages across sectors, without at the same time triggering productivity, increasing business investment.

Fiscal policy will tighten everywhere when compared to the extraordinary COVID stimulus boost, but the US and Europe have both put forward substantial infrastructure support packages. They are not always a 'given' in a normal cycle, and hence should be viewed as an incremental positive, especially in comparison to the aftermath of the global financial crisis, when many governments did the exact opposite by very quickly switching to fiscal austerity. Interest rates are low, and the combination of a demand surplus and undersupply provide a double incentive for productive investment – all the ingredients for a cyclical pick-up in growth.

Admittedly, some of the positivity from January seems overly optimistic now. There was hope that consumer savings built up over the pandemic would become a significant, if not worrying source of demand and growth once confidence improved. That now looks less uncertain, as on the one hand the demand is not being met by sufficient supply, and on the other, many individuals have dropped out of the labour market altogether – especially in the US – and so will be more eager to maintain their savings. The lower labour participation rate could push up wages over the medium-term, but we are still waiting on labour market tightness to feed through into increased consumer confidence/consumption and business investment.

In the meantime, spiking global inflation makes things difficult for emerging markets (EMs). EM central banks do not have the luxury of waiting out the inflationary storm like their DM counterparts. Many have had to tighten monetary policy this year, choking off growth while their economies are still reeling from Delta outbreaks. A loosening of global supply problems will be crucial for EM prospects, alleviating cost pressures and allowing policymakers to ease conditions. If global activity improves and the Fed maintains its loose monetary stance, we should also see downward pressure on the US dollar – a factor that almost always benefits EMs.

The elephant in the room throughout all of this is China. The world's second-largest economy has been one of its main sources of incremental growth for over a decade, and many expected this to continue after the pandemic. But the recent troubles in the property market – and extensive interventions from the Chinese government – have put that in doubt. Evergrande, one of China's biggest property developers, is teetering on the edge of a collapse, which could put serious pressure on domestic Chinese growth, even if it does not pose a systemic risk to global financial markets, as some had been quick to suggest.

We still do not expect a so-called 'Lehman moment' ahead for Evergrande and China, but the response of the Communist Party had initially not been encouraging. President Xi Jinping appears eager to use the current crisis as a means of driving forward his agenda – on everything from systemic deleveraging, re-enforcing the *caveat emptor* (buyer beware) principle among Chinese property punters to making housing more affordable under his drive towards common prosperity. Not all of this is a negative for China's long-term growth prospects, but enough of it is. What's more, the short-term damage this policy drive could do to confidence and investment are a threat to the fragile global growth cycle.

Ultimately, we should expect Beijing to avoid excessive contagion where they can, given only high growth rates are conducive with Xi's overarching aim of creating a more evenly prosperous society in China. But Chinese policy is another hurdle the world will have to overcome if strong growth is to return (hence the very positive market reaction last week to the decisive policy action mentioned in this week's top article). Like the other risks, it does not detract from the underlying strong fundamentals – although perhaps this area has the potential to make a bigger impact on next year's growth outlook than the supply chain issues currently keeping observers of the western world occupied.

Q3 corporate earnings: rays of hope or shadows of doubt?

Colder winds and autumn leaves are not all that October brings. For investors, the end of summer marks another quarter done and a season of corporate earnings results ahead. Companies began announcing profits last week, amid a notable cooldown in global economic activity. Analyst expectations are nevertheless reasonable for most companies. Growth may have slowed unexpectedly over the last three months, but earnings-per-share (EPS) has been solid.

EPS for the S&P 500 is predicted to have grown 27% year-on-year in July to September, while the STOXX 600 – Europe's benchmark equity index – is on course for 59.7% growth for the whole of 2021 (figures are not directly comparable). Overall, 2021 expectations for Europe have been revised up 8.5% since the start of the third quarter. But most of this has stemmed from strong summer momentum, while growth upgrades have slowed recently.

As usual, there is only so much information investors can gain from corporate results. Earnings are inherently backward-looking, and in recent years have become susceptible to 'tweaking' from analysts (particularly in the US). Companies often deliberately guide analysts with lower (they would say prudent) earnings expectations, only to later deliver a positive surprise with the intention of boosting their share prices.

More important, therefore, are the outlook statements and guidance on future earnings that accompany the results. These give a more up-to-date picture of corporate health. This is particularly important now, as the biggest challenges to the global economy – heavy supply constraints, rising prices and a dampening of growth – have arisen very recently. Most countries are expecting a difficult winter ahead, with COVID numbers all but certain to increase. This will have an impact on consumer behaviour – even if vaccination rates remove the need for lockdowns.

The impacts on demand are difficult for businesses to predict (see our separate global outlook article above for a more detailed discussion) and many certainly got it wrong during last year's lockdown, when companies cancelled orders for input goods like computer chips. Outlook statements can give a good idea of how companies are coping with supply constraints and cost pressures. On this front, businesses overall are managing quite well. Profit margins for 2021 in Europe have been revised upwards, making a change from years of downgrades. This improvement comes despite input costs rising faster than consumer prices.

That might seem contradictory, but analysts at Goldman Sachs put it down to three factors: (1) companies with high operational gearing (those whose fixed costs are a large proportion of overall costs) do well during economic recoveries as growth offsets cost pressures; (2) businesses often have a greater ability to pass costs on when supply pressures build rapidly; and (3) high excess savings among consumers from last year give companies an even greater ability to pass costs down. These factors bode well for businesses as we head into an uncertain end to the year. Costs are rising fast, but pricing power is high while background financing conditions are supportive.

Speaking of which, financial companies fared very well over Q3. Morgan Stanley saw its investment bank revenues increase 67% year-on-year, while Citigroup and JPMorgan had similar returns for their investment banking fees. Low interest rates and disappointing demand for loans have hurt financial companies (a factor that has been particularly pronounced in Europe for years), but Citi and Morgan Stanley benefitted from a surge in deal-making over the summer, even if this is not Citi's core business, while trading revenues were healthy as well. Another positive was that Bank of America's EPS was up a stellar 67% year-on-year, and comments by CEO Brian Moynihan pointed to an improvement in deposit and loan momentum, which tends to be more closely related to the economy than deal and trading revenues.

Those positive results are in line with the cyclical rotation that excited investors earlier this year. Rebounding growth bolsters credit demand and puts upward pressure on yields – benefitting banks, which have a high sensitivity to global growth. Recent fears over the Delta variant and weakening global demand (in the face of spiralling cost pressures) have put the cyclical positivity in doubt. But as we discuss in the article above this week, we see these problems as a bump along the recovery road, rather than an end to it.

Positivity around financials supports this view. Banks perform better when the yield curve (the difference in yield between long-term and short-term government bonds) steepens, as they can take deposits at the short end and lend at the long end. That tends to happen further through an economic cycle, when the recovery has matured, and growth has settled into a more stable pattern.

Also supporting this is the performance of energy companies and – to a lesser extent – material companies (here high raw material costs can be a challenge). Fuel shortages have been well-publicised, but wider commodity prices have also risen. Some commodities are benefitting from structural shifts to do with the world's green transition. But we can certainly see a strong cyclical boost to demand and economic activity too.

This stands in contrast to the negativity around growth prospects that we have seen in consumer-related news recently, but it is mostly in line with our own expectations. Recent problems may hurt short-term consumer demand or, in many cases, frustrated consumers unable to get hold of the goods they seek, but the underlying fundamentals point to solid growth ahead. Positive earnings reports and outlook statements will help to convince investors of this.

Global Equity Markets

Market	Fri 16:02	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7226	+1.8	+131	→	⬀
FTSE 250	22980	+2.0	+444	↘	⬀
FTSE AS	4120	+1.8	+74	→	⬀
FTSE Small	7431	+0.6	+44	⬂	↗
CAC	6733	+2.6	+173	→	↗
DAX	15569	+2.4	+363	→	↗
Dow	35191	+1.3	+445	→	↗
S&P 500	4466	+1.7	+74	→	↗
Nasdaq	14903	+2.2	+324	→	↗
Nikkei	29069	+3.6	+1020	↗	→
MSCI World	3085	+1.3	+41	→	↗
CSI 300	4932	+0.0	+2	→	⬂
MSCI EM	1267	+0.8	+10	→	⬂

Top 5 Gainers

Company	%
Antofagasta	+10.9
Ocado	+10.5
Glencore	+9.5
Anglo American	+8.6
Barratt Devts	+8.2

Top 5 Decliners

Company	%
Pearson	-17.7
BT	-4.3
Informa	-3.7
Tesco	-3.0
Prudential	-2.9

Currencies

Pair	last	%1W
USD/GBP	1.376	+1.1
GBP/EUR	0.843	+0.8
USD/EUR	1.16	+0.3
JPY/USD	114.13	-1.7
CNY/USD	6.43	+0.2
Bitcoin/$	59,851	+8.0

Commodities

Cmdty	last	%1W
Oil	84.69	+2.8
Gold	1772.9	+0.9
Silver	23.35	+3.0
Copper	473.0	+10.6
Aluminium	3117.0	+5.8
Soft Cmdties	230.3	-0.7

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.0	15.7	12.6	14.2
FTSE 250	2.4	15.5	19.6	16.0
FTSE AS	3.7	15.5	13.4	14.4
FTSE Small x Inv_Tsts	2.0	12.8	16.5	15.5
CAC	2.2	21.5	16.1	15.0
DAX	2.1	15.7	15.1	13.5
Dow	1.8	19.6	18.8	16.5
S&P 500	1.3	25.1	21.9	17.7
Nasdaq	0.6	29.4	32.9	23.1
Nikkei	1.5	15.7	17.9	17.7
MSCI World	1.7	21.7	19.8	16.7
CSI 300	1.8	16.2	15.4	12.5
MSCI EM	2.4	13.9	13.3	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.09	-0.07
UK 15-Yr	1.28	-0.09
US 10-Yr	1.56	-0.05
French 10-Yr	0.17	-0.03
German 10-Yr	-0.18	-0.03
Japanese 10-Yr	0.08	-0.00

UK Mortgage Rates

Mortgage Rates	Oct	Sep
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.20	1.23
3-yr Fixed Rate	1.20	1.37
5-yr Fixed Rate	1.29	1.37
10-yr Fixed Rate	2.59	2.59
Standard Variable	3.61	3.61

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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18th October 2021

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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