HYMANS ROBERTSON

Capital Markets Update

Winter 2022

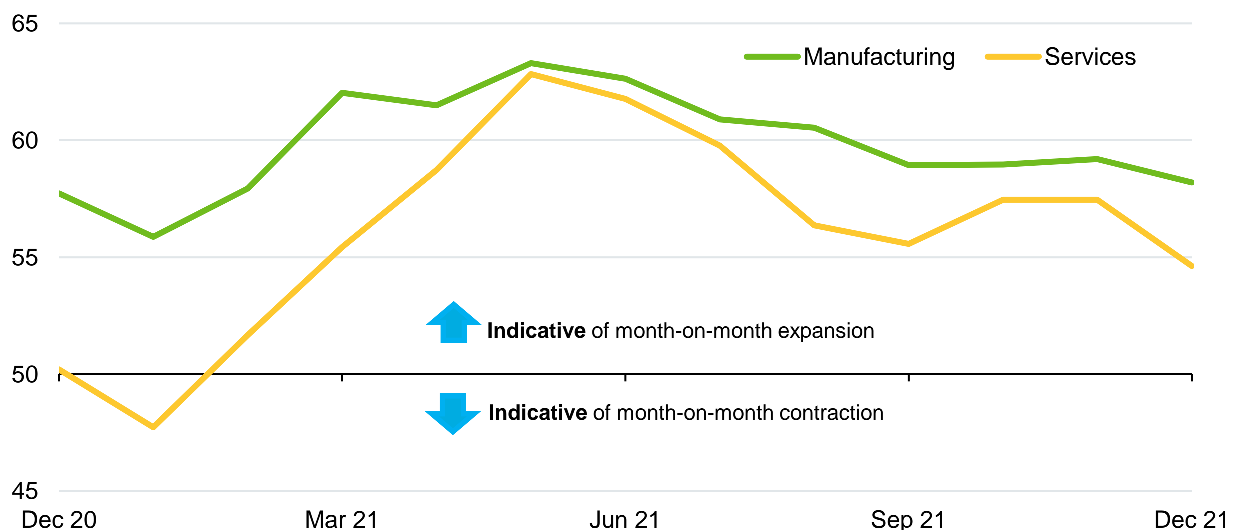
Despite November's sell-off, global equity markets rose in Q4 as evidence suggested that the Omicron variant may not be as virulent as previous strains.

Short-term yields rose as markets priced in a faster pace of interest-rate increases to combat high inflation.

Global themes

The current wave of COVID-19 infections is eclipsing previous peaks and although hospitalisations and deaths are lower, greater transmissibility could still put pressure on healthcare systems. A return of some restrictions on activity, an increase in voluntary social distancing and resulting supply chain disruption, particularly while China continues to pursue a zero-COVID policy, will weigh on growth in Q4 2021 and Q1 2022. On a longer-term view, Omicron's apparent milder symptoms and increasing dominance may accelerate the transition of COVID-19 from pandemic to endemic status, allowing a more permanent normalisation of activity.

Chart 1: Sentiment resilient, particularly in manufacturing[1]



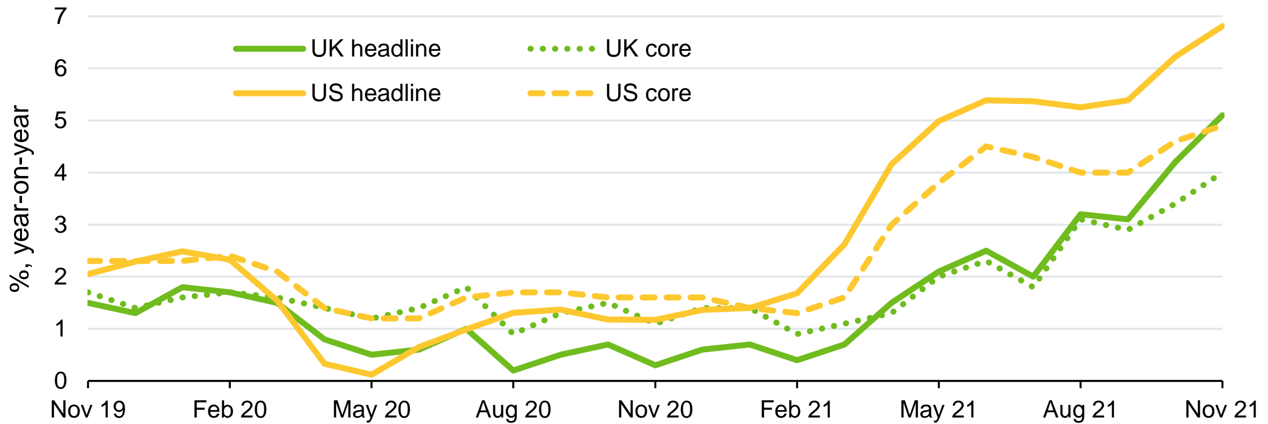
Indeed, current pressure on growth is reflected in December's purchasing managers' indices (Chart 1), which were as low as they have been for almost a year. However, global sentiment is positive, particularly in manufacturing, where output is increasing despite ongoing supply constraints. Backlogs from existing order books plus strong future orders should support manufacturing activity in 2022, while a more permanent re-opening would support the service-sector recovery. Against this backdrop, activity is expected to rebound quickly once cases subside; we still expect above-trend growth in 2022.

Meanwhile, inflation has proved more persistent and pervasive than expected (Chart 2). UK headline CPI inflation is as high as it has been in 10 years, while the US measure is close to 40-year highs. Although tight labour markets, particularly in the US and UK, pose an upside risk, inflation is expected to moderate in 2022. There are tentative signs that supply-chain disruptions are easing, and fiscal policy will be less supportive this year. In addition, central bankers have adopted less

[1] Average of US, UK and eurozone purchasing managers' indices

accommodative stances. The US Federal Reserve expects to raise rates three times this year (interest-rate futures markets expect even more) and is accelerating its reduction of asset purchases. Despite the near-term economic impact of Omicron, the Bank of England made the first of what is expected to be a series of rate hikes in December.

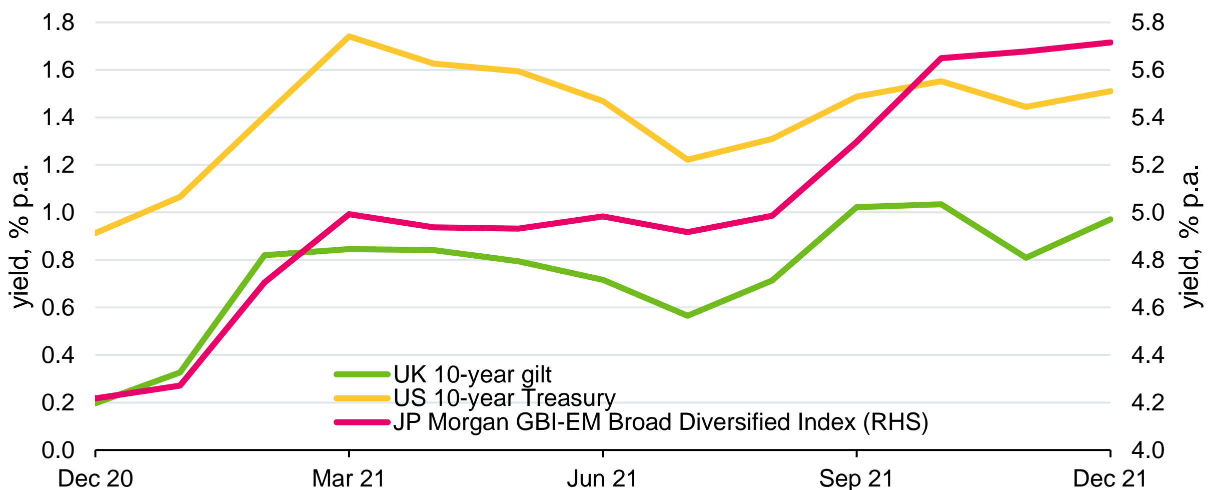
Chart 2: Core inflation is following headline measures higher, indicating broad-based price pressures



Government bonds

The trend in monetary policy is likely to put upwards pressure on long-term bond yields but, if inflation does fall over the course of the year, limiting the need for aggressive monetary policy tightening, the rise in yields is also likely to be limited and gradual. Core sovereign bond yields, particularly at the front-end of the curve, are pricing in a reasonable path of interest-rate rises, but yields are very low in absolute terms and provide little protection against any persistence in inflationary pressures.

Chart 3: EM yields have risen faster and further than developed market yields, even though EM central banks have been more proactive in tackling rising inflation

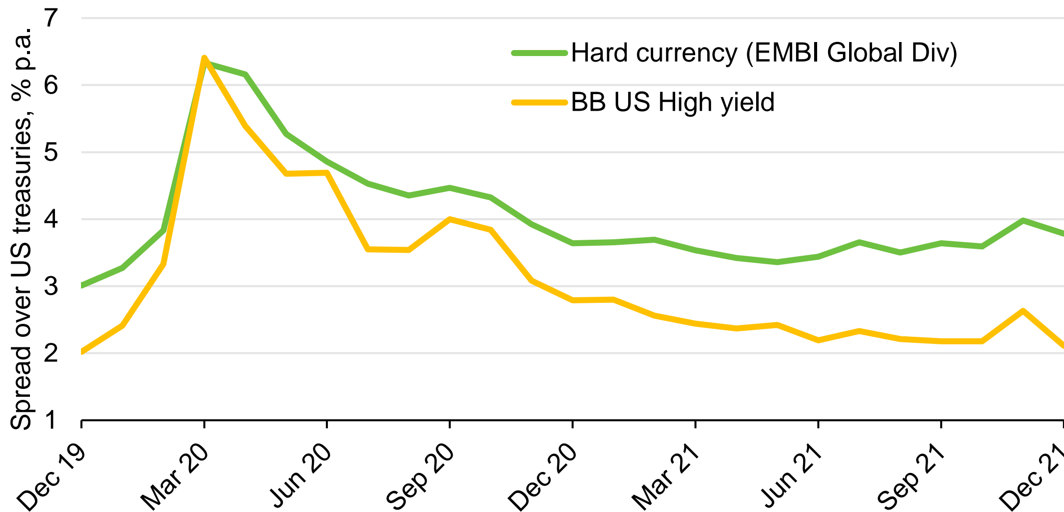


While central banks in the major advanced economies are just starting to reduce monetary accommodation, their emerging-market (EM) counterparts have been raising rates progressively in 2021. EM local-currency yields rose sharply last year (Chart 3) and yield curves are as steep as they have been in 10 years. While a tightening in global financial conditions tends to pose a challenge for EM assets, a reduction in monetary policy accommodation has been well telegraphed and EM central banks have raised interest rates pre-emptively. Meanwhile, emerging-market current accounts have strengthened considerably during the pandemic, though their currencies, in aggregate, still look cheap relative to the dollar by historical comparison.

Credit

2021 was characterised by a recovery in global macroeconomic and corporate fundamentals. Low nominal and real rates spurred investors to reach for yield lower down the credit spectrum. This demand was met by record issuance volumes in speculative-grade credit markets, which enabled borrowers to lower their cost of capital, helping to push defaults well below average levels. Strong corporate balance sheets and positive earnings growth still lend fundamental support but waning central bank support and rising input costs may make for slightly less benign conditions in 2022.

Chart 4: Hard-currency emerging-market debt offers value relative to developed-market corporates

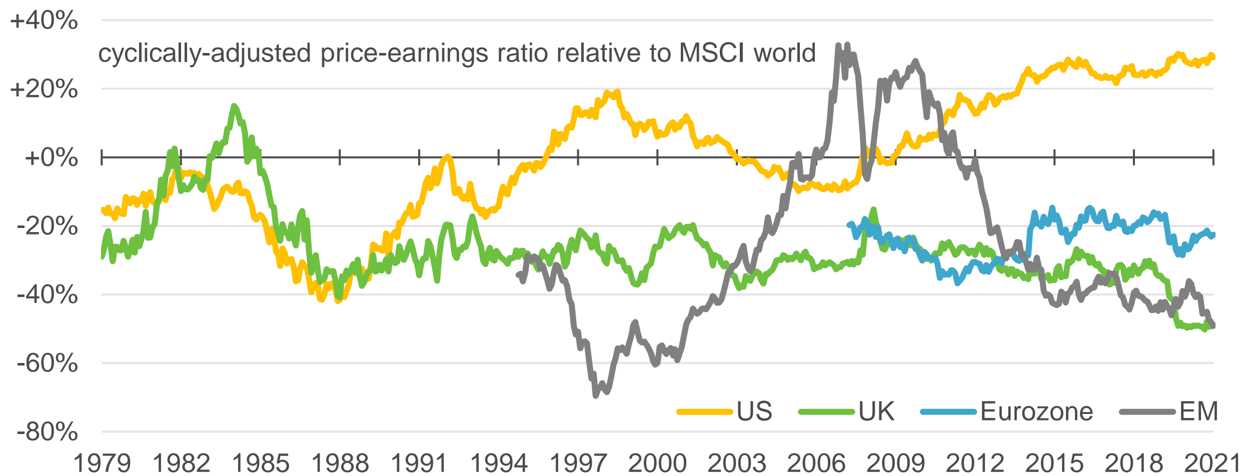


In credit portfolios, we look for some insulation against rising rates. In investment-grade, this may entail a short-duration bias within fixed-interest corporate allocations, investing in floating-rate asset-backed securities, or absolute return bond funds. We prefer speculative-grade credit, given its shorter duration – historically it has performed relatively well in inflationary environments, provided corporate fundamentals remain intact, with interest-rate increases offset by income and low defaults. Though hard-currency emerging-market debt is a slightly longer-duration market, spreads are attractive relative to comparable developed-market corporate credit (Chart 4).

Equities

MSCI World earnings growth is forecast to have risen over 52% in 2021, marking one of the strongest years on record. This would leave earnings approximately 23% above 2019 levels. Although the year-on-year pace will fall dramatically, we still anticipate robust earnings growth in 2022. Even so, high cyclically adjusted equity valuations mean further upside is likely to be more limited. While equity valuations are not particularly challenging relative to very low sovereign bond yields, upwards pressure on longer-term real yields is likely to put the lid on rising valuations. There is notable dispersion in equity valuations by region (Chart 5) and, given its extreme valuation, the US could be most at risk. In addition, as we expect COVID disruption to dissipate as 2022 progresses, more cyclical sectors and markets may benefit as economies fully re-open, particularly those where activity is below pre-pandemic levels. Against this backdrop, non-US equities look poised for a period of catch-up.

Chart 5: There is notable dispersion in equity valuations by region

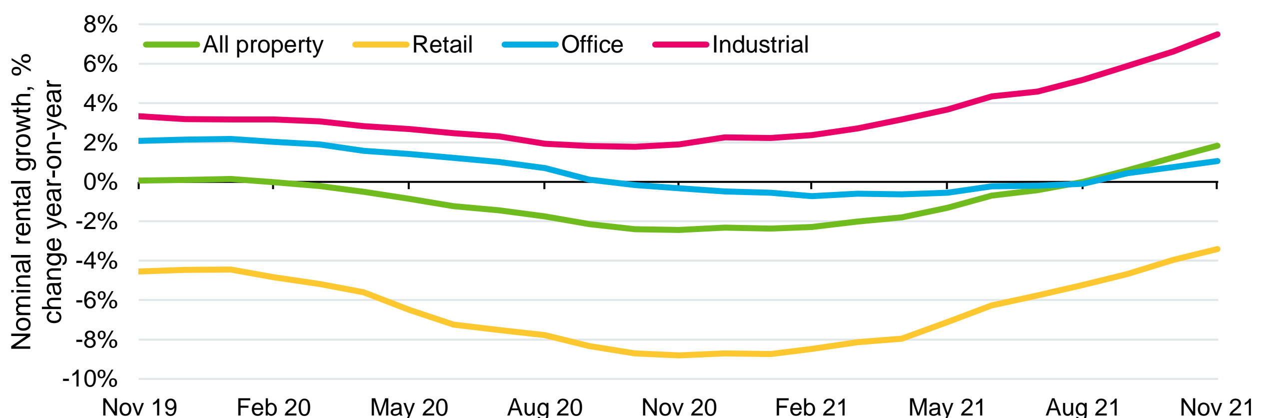


However, we would caution against being heavily underweight the US: valuations are high, but we expect a gradual and limited rise in yields and the secular growth characteristics of the US market have perhaps been enhanced by the pandemic.

Property

UK commercial property rents are growing strongly within the industrial sector, continue to fall, albeit at a declining pace, in the retail sector, and are growing slowly in the office sector (Chart 6). In aggregate, tenant demand is rising while the availability of stock falls, helping to underpin improved rental expectations and allowing landlords to offer fewer inducements to secure tenants. However, rent collection remains lower than normal as rent moratoriums delay payments to landlords. Outside of the traditional core market, the leisure and hotel sub-sectors continue to face near-term disruption stemming from the pandemic.

Chart 6: UK commercial property fundamentals are on an improving trend, but with differing fortunes across sectors



Reversionary (full rental) yields have fallen further in recent months as demand, from both domestic and overseas buyers, remains strong. In a time of inflation uncertainty, we prefer long-lease funds with a high degree of inflation-linked rents. Lower exposure to the retail sector is also supporting demand for long-lease funds, which continue to have queues in place.

Conclusion

The ongoing Omicron wave is likely to weigh on near-term activity, but COVID should ultimately move further into the background in 2022. The consequent economic and earnings growth should lend support to risk assets. Inflation should moderate in the second half of 2022, but tight labour markets and supply disruptions pose an upside risk. Monetary policy will be less supportive in 2022 and, though we expect a modest rise in interest rates, further upside inflation surprises may necessitate a more substantial reduction in monetary support.

Short-term nominal sovereign bond yields already reflect likely rate rises, but long-term yields may still see some upwards pressure. Yields, at all terms, provide scant compensation for current levels of inflation. Strong corporate fundamentals and a short-duration preference support an overweight to speculative-grade versus investment-grade credit. Within investment-grade markets, short-duration fixed interest corporates or floating-rate asset-backed securities are preferred to benchmark investment-grade strategies. Within bond and credit markets, we see relative value in emerging-market debt. EM central banks have pre-emptively tightened monetary policy and sovereign yield curves are steep, while hard-currency credit spreads in emerging-market debt are relatively attractive versus developed-market comparators.

Ongoing earnings growth and our expectation that any rise in yields from low levels will be limited and gradual sees us retain a preference for equity over bonds and credit. However, as investors weigh the impact of waning central bank policy on valuations, and inflation puts upwards pressure on input costs, any increase in volatility may enable cash to be deployed at more attractive entry points.

Nevertheless, investors may want to look for ways to increase cash returns without taking duration risk. This may increase the attraction of short-duration credit and absolute return bond funds as near-cash alternatives.

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