

Capital Markets Update

Autumn 2021

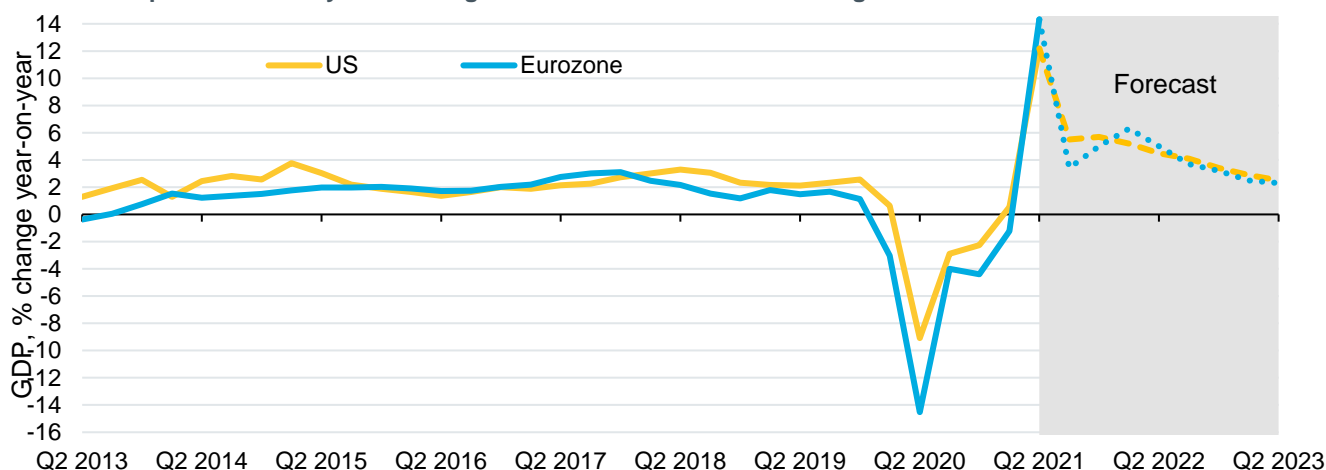
Unexpectedly high inflation in the third quarter meant that investors brought forward their expectations of interest-rate rises. The UK gilt market was as weak as it has been since spring 2019.

Global equities gave up earlier gains as strong earnings growth was largely offset by easing economic momentum and the prospect of fading monetary support.

Global themes

Growth has been slowing as the positive impact of economies re-opening late last year fades. Global composite purchasing managers' indices (PMI) fell for the fourth consecutive month in September, after a high in May, with a particularly sharp fall in services PMIs. Consumer sentiment surveys have also weakened in recent months. Manufacturing PMIs remain at a level indicative of expansion, with the new orders component still very strong, but global industrial production has been lacklustre in the first half of 2021, highlighting supply chain and transportation issues. Nevertheless, the pace of growth in the major advanced economies is forecast to be strong over the next couple of years (Chart 1), but longer-term forecasts envisage a decline to the pace of growth we saw before the pandemic.

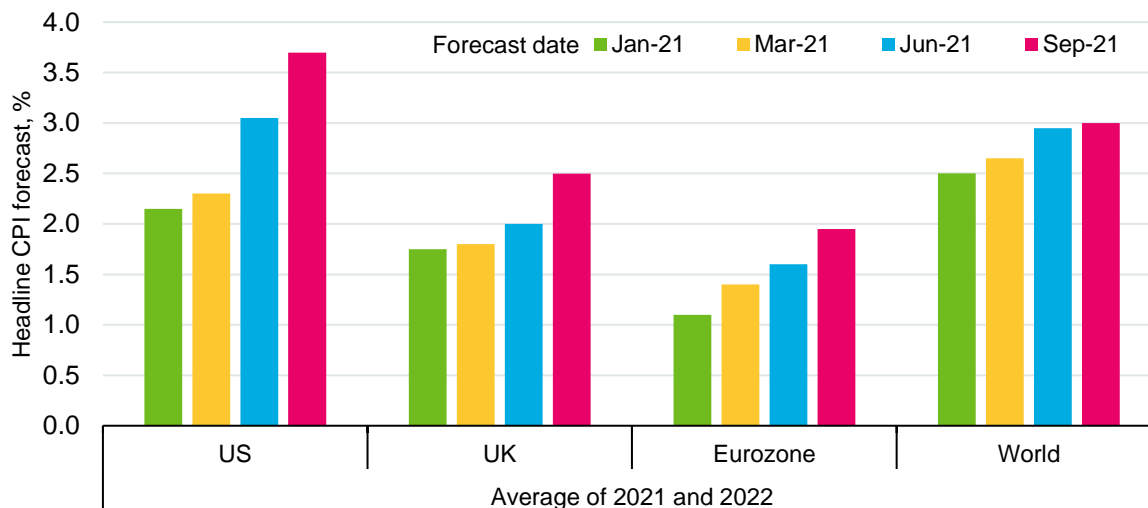
Chart 1: The pace of recovery eases but growth is forecast to remain strong for a while



It is perhaps easier to identify downside risks to this view. Most commentators assume the spread of the Delta variant will hinder but not derail recovery in the major advanced economies, as rising vaccination rates reduce the likelihood of stringent restrictions. However, new strains or outbreaks of coronavirus in those countries that have lower vaccination rates or adopt zero-tolerance approaches to the spread of infection, are a risk to both global demand and supply. Supply shortages and transport-related bottlenecks are extreme, and many of these issues appear to be deteriorating, highlighting the risk that disruptions are not as transient as forecasters have assumed. A more specific short-term risk is that significant retrenchment in China's financial system in the wake of disruption in the real estate sector, a key engine of economic growth, further slows the rate of global growth.

Inflation continues to exceed expectations, and this year’s upward revision of forecasts has been extended (Chart 2). Most forecasters still think that current inflationary pressures will fade, but some have started to question just how temporary current price pressures are. In the UK, where both headline and core CPI inflation rose above 3% in August, anecdotal evidence of labour shortages abounds, vacancies are at all-time highs, payrolls have returned to pre-pandemic levels and the trend in underlying wage growth is increasingly positive.

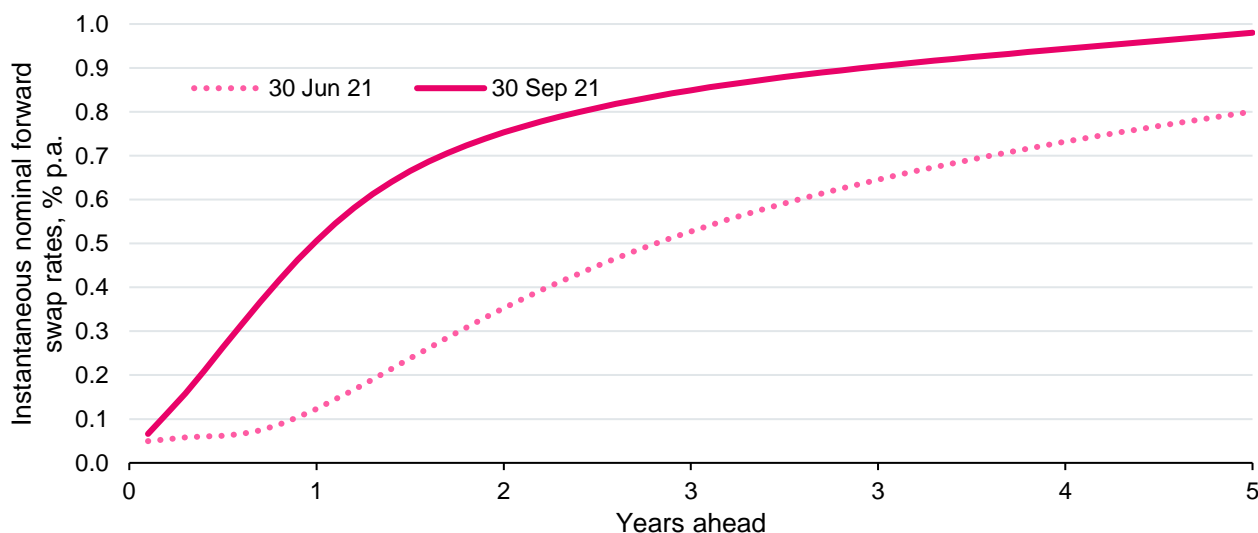
Chart 2: Inflation releases have confounded expectations with forecasts repeatedly revised higher



Government bonds

A combination of strong growth and high inflation, even if it is temporary, has resulted in indications from central banks that rates will rise a little faster than previously thought and markets have adjusted accordingly (Chart 3). The pace at which markets now imply interest rates will rise over the next few years does not feel unreasonable. Although the risks still seem skewed to an even faster pace – which would be bad for bond markets – we do not think the shorter end of the gilt market is particularly expensive. But ongoing hedging demand means that longer-dated gilt yields imply that interest rates will fall from a not-very-high level after 12 years. That does feel expensive for those who do not need to hedge.

Chart 3: Bond markets expect rates to rise more quickly than previously

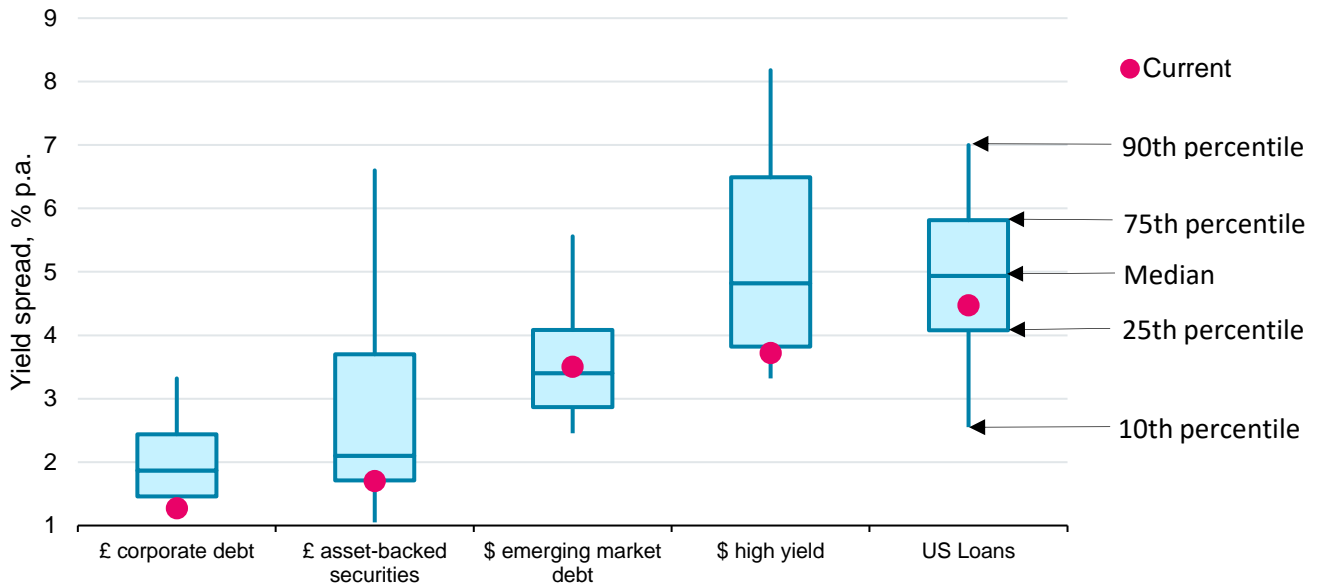


Implied inflation, measured as the difference between conventional and index-linked gilt yields, varies greatly by term but looks high across all terms. Our neutral expectation for annual RPI growth would be 3% p.a. until 2030 (albeit it’s a little higher in the immediate future) and 2% p.a. thereafter once RPI and CPI have been aligned. Against that background, we see inflation pricing at terms between 10 and 30 years as being the most expensive.

Credit

Strengthening corporate finances provide a strong fundamental backdrop for credit markets: defaults and leverage levels are falling, interest coverage is rising, and liquidity is plentiful. As a result, upgrades to credit ratings increasingly outweigh downgrades. Strong investment demand has absorbed a record pace of issuance in speculative-grade markets, allowing companies to refinance and extend debt maturities.

Chart 4: Credit spreads are generally in the lowest quartile of their long-term history¹

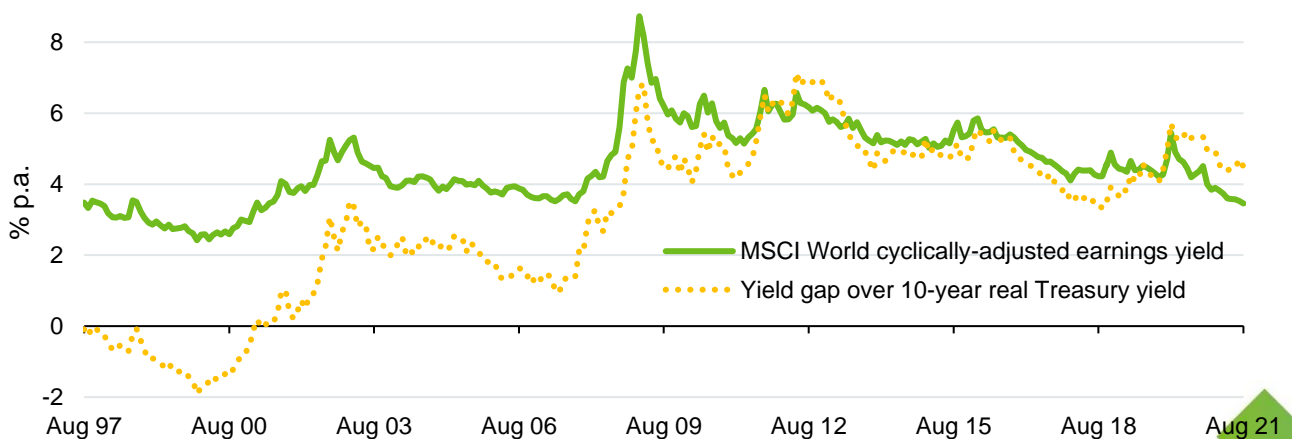


Despite this fundamental and technical support, we think caution is warranted. Credit spreads are generally within the tightest quartile of their longer-term history (Chart 4) and a larger-than-expected slowdown in growth or tightening of financial conditions could see fundamental credit metrics deteriorate. It is becoming increasingly difficult to identify attractive opportunities in credit markets – certainly in absolute terms, but increasingly also relative to risk-free alternatives. Within investment-grade markets, we favour asset-backed securities over corporate bonds, while loans and hard-currency emerging market debt look less stretched than high-yield bonds.

Equities

Global equities gave up earlier gains in September as markets weighed the prospect of easing economic momentum and fading monetary support. The stellar earnings recovery shows little sign of flagging so far, but traditional valuation metrics are stretched versus history, leaving little scope for disappointment.

Chart 5: Equities look expensive...except in the context of very low real yields



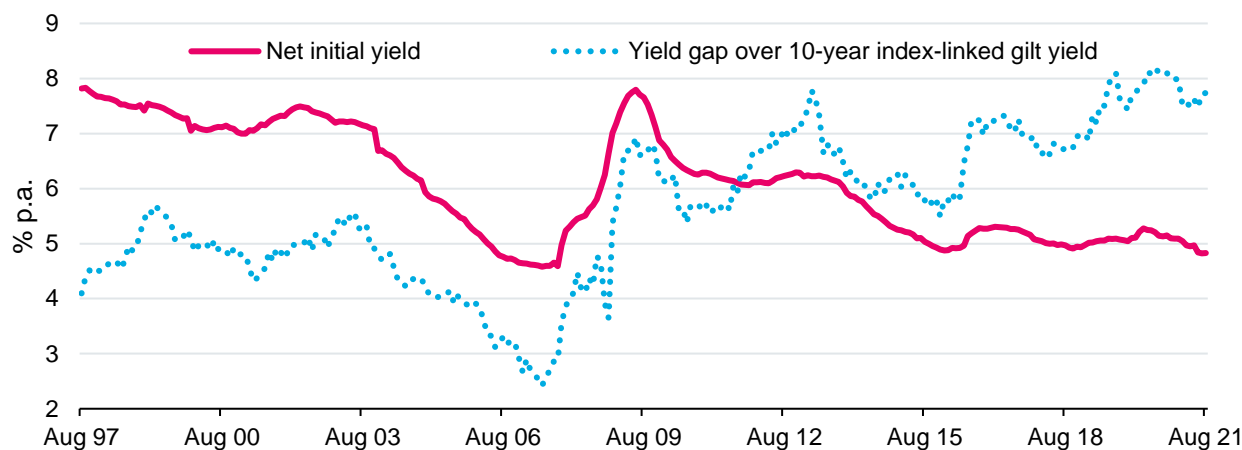
¹ £ corporate debt = ICE BofA ML BBB Sterling Corporate Index; £ asset-backed securities = JPMorgan UK 5-year BBB RMBS weekly spreads; \$EMD JPM EMBI GD yield less 10-year US treasury yield; \$ high yield = ICE BofA ML BB US High Yield Index; US Loans = Credit Suisse Leveraged Loan Index

Perhaps the only lens through which global equity valuations do not look bloated is that of real yields. Chart 5 shows the global equity earnings yield, based on the average inflation-adjusted earnings of the previous 10 years, and the gap between this earnings yield and the 10-year real US treasury yield. On this basis, equities look no more or less expensive than post-crisis averages. However, this may simply be comparing one expensive asset class with another. Even a moderate rise in real yields, to levels seen as recently as 2019, would considerably narrow the risk premium on offer. While we acknowledge the relative value argument, it is the absolute level of valuations, and the risks around the assumptions which justify them, which prevents us from forming a more positive view.

Property

Capital values in the UK industrial and retail commercial property sectors have continued to edge higher in recent months; values in the office sector have changed little. Over the last 12-month period, only the buoyant industrial sector has seen a rise in capital values.

Chart 6: Net initial yields look low versus history



Property fundamentals have continued to improve in recent months, with tenant demand increasing for the first time since 2017 in Q2, according to the RICS quarterly UK commercial property survey. Nominal annual rental growth across property sectors, in aggregate, has been increasing since February, but has still not caught up with the rising pace of inflation. However, initial (current income) and reversionary (full rental) yields remain very low versus history (Chart 6). As with equities, property yields also look far more reasonable in the context of very low government bond yields, but the high absolute level of valuations set against a tentative fundamental improvement gives us cause for caution.

Conclusion

Economic momentum may have eased, but the global economy is forecast to grow at a healthy pace. Concerns about coronavirus have diminished, but supply-side risks and China's economic slowdown have intensified.

Though central banks are adopting a slightly less accommodative stance, financial conditions are easy and negative real yields are expected to persist for some time. However, even a moderate rise in real yields could pose a challenge, with an obvious potential trigger being interest rate increases in response to persistence in current inflationary pressures.

The risk of a faster pace of rate rises leaves us cautious on bond markets in general. In both investment- and speculative-grade credit markets, we have a fundamental preference for floating versus fixed-rate assets. In addition, investment-grade asset-backed securities continue to offer a reasonable spread pick-up versus similarly rated corporate credit, as do loans and private credit versus fixed-rate speculative-grade bonds. Equity and property valuations reflect a lot of good news and valuations lean heavily on low bond yields. However, positive earnings momentum and relative value still lend short-term support to equities, which we prefer to property – where any improvement in fundamentals is more tentative – and bonds. Given the absolute level of valuations across most asset classes, we still advocate holding elevated levels of cash.

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