INSIGHT

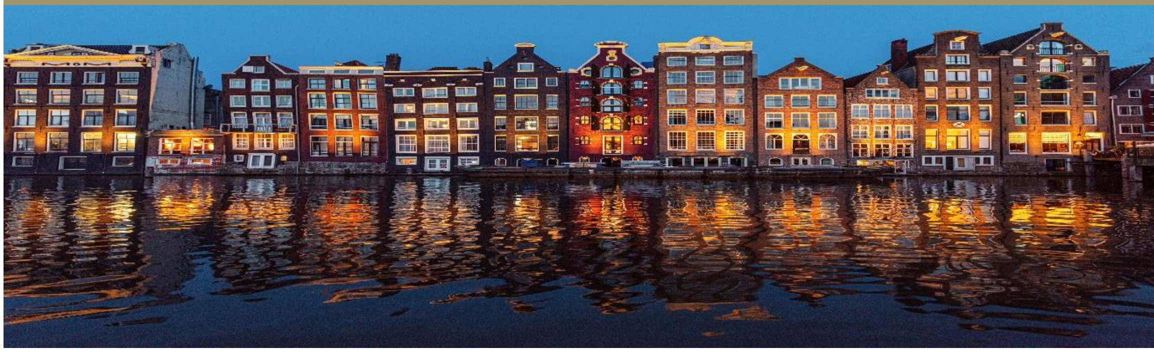
PRIVATE CLIENTS

November 2021 Insights

I want to welcome you to the inaugural issue of our Bi-monthly Investment Newsletter. In this communication, we hope to provide you with a way to keep informed of the latest Economic and Investment Market conditions and how same shape the Investment landscape, going forward. We hope it will assist you in being more informed and inquisitive on such matters leading to better Investment decisions and by extension more acceptable returns on employed Capital.

Norman Barry

In This Issue



November 2021 Market Review

2021 has been a year for the record books. The response by Central Bankers across the world to the Covid pandemic has been a sight to behold.

In the United States for example, following a -10% or -$2 trillion plunge in U.S. GDP in Q2 2020, the Federal Reserve stepped in and printed $4 trillion fresh new dollars out of thin air (in the form of bank reserves) to support their domestic economy. This intervention had the desired effect, and the U.S. economy came roaring back to life, recovering all of the lost growth by Q2 2021. But how sustainable is it for the U.S. Treasury, supported by the Fed, to borrow and spend $4 trillion to boost U.S. GDP by just $2 trillion? And what do officials do now that the money has been spent and the Fed is about to taper its government bond purchases at a time when economic growth is at such a delicate stage?

	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021
U.S. Real GDP	$19.0T	$17.6T	$18.6T	$18.8T	$19.1T	$19.4T	$19.6T
Yr./Yr. % Ch.	*0.6%*	*-9.1%*	*-2.9%*	*-2.3%*	*+0.6%*	*+12.2%*	*+5.4%*

In 2021, inflation also returned, to an uncomfortable degree, a by-product of supply bottlenecks and labour shortages as economies re-opened, and continued monetary stimulus. Producer prices have surged +8% year/year (goods prices +12%, services +6%) in the U.S., while consumer prices are also accelerating. Core CPI recently breached +4% and this excludes food and energy prices, which are skyrocketing too. Crude oil prices, for example, have risen from $49/barrel to $79/barrel in 2021, +61%, while natural gas prices have more than doubled from $2.50/mmBtu to $5.50/mmBtu year-to-date.

Our focus on emerging trends in GDP growth and inflation is an important contributor to our overall investment framework and process. We will provide more detail in future reports, nevertheless, we do need to be cognizant of such underlying conditions.

As we enter the cold season in the Northern Hemisphere, a harsh winter could put renewed pressure on energy markets. We will also be monitoring if Central Banks are losing patience with elevated inflation amid signs that it is bleeding into the price expectations of consumers and businesses.

What should investors do? With current issues still appearing more temporary than structural, the belief exists that markets will continue to move higher. Indeed, small increases in inflation expectations can be positive for markets if it helps to banish fears of deflation. Furthermore, global growth remains robust, supply chain challenges should recede into 2022, and corporate earnings should continue to grow. At the same time, it is important to diversify by region, sector, and asset class to manage current market dynamics. Sectors garnering most attention include Financials, Energy, the Eurozone, and Japan to position for global growth. Among defensive sectors, Healthcare and Consumer Staples are preferred. Investors can further diversify portfolios with alternatives, including Bonds. Particularly Index Linked Bonds which have begun to reflect an improving cycle.

In summary, when economic growth is rising and inflation is either rising or falling (on a sequential basis), risk assets generally tend to perform quite well. However, when GDP growth declines and inflation rises (stagflation) or falls (deflation), markets tend to run into difficulty. Today, we are keenly aware of such an environment and the necessity to maintain both balance and diversification within our approach to Capital appreciation. The conventional wisdom is that the current inflation is to be expected—part and parcel of the fast-and-furious restart of the economy after the unprecedented lockdown—and that price rises are the result of temporary supply–demand dislocations. According to analysts, many of these bubbles will likely prove transitory, disappearing or diminishing in the span of 12 to 18 months. With this framework in mind, let’s take a closer look at Equity and Fixed Income markets to see what opportunities and risks we potentially could face in the months ahead.

Equities

	YTD	1 Year	3 Years	5 Years	10 Years
Global	+21.4%	+29.4%	+16.6%	+13.6%	+14.1%
U.S.	+26.6%	+31.8%	+20.1%	+17.0%	+17.8%
Europe (ex U.K.)	+20.1%	+28.2%	+18.5%	+12.8%	+12.8%
U.K.	+22.4%	+38.1%	+6.5%	+6.0%	+7.3%
Emerging Mkts	+6.7%	+17.8%	+12.2%	+8.8%	+7.6%
Japan	+9.3%	+19.1%	+9.0%	+8.2%	+10.7%

Investors have been well rewarded for taking on equity risk over the last 10 years. Global equities have performed remarkably well, delivering +14.1% per annum over the last decade and all you had to do was hold on during a global pandemic and -40% collapse in the stock market last year! No easy feat I hear you say.

Currently, most economies have regained their pre-crisis GDP within around 18 months of the deepest recession on record. That compares with between 3 and 7 years to return to the prior peak in activity following the global financial crisis (GFC) of 2008. Moreover, forecasters expect economies to return to their pre-COVID trend path of activity by the end of 2022, something that most economies never achieved following the GFC.

Today however, the outlook is more challenging. Global economic growth is hampered on a number of fronts with the migration from Monetary & Fiscal stimulus, with Central Banks flagging the end of extremely accommodative policies. Let's use the U.S. stock market in the next chart as our case study. This chart is a simple price earnings ratio of the S&P 500 where the denominator is the 10-year average inflation-adjusted earnings of the 500 companies in the index.

Today, the S&P 500 P/E ratio is a lofty 38 times and has only been higher in 2 out of the last 151 years, or just 1.3% of the time. Can US equities continue to rally next year? Yes. Even so, there has been a rolling correction within the index as 88% of its constituents have experienced at least a 10% decline from their year-to-date highs. However, with such lofty valuations, alternative Geographical and Sectorial Markets reflect greater potential and value.

Outside the U.S., stock markets offer better value but are not at their cheapest, particularly after the run they've had since the March 2020 lows. The MSCI World (ex US) Index has kept pace with the S&P 500 since January 2020 - both delivering almost +20% returns over that period - and recently made a new all-time high for the first time since 2007. However, drawing equity market implications from such an economic outlook, we note two findings: first, . The focus of growth is now moving toward Europe, where lockdowns ended after those in the US. US growth likely peaked (in quarter-on-quarter terms) in the second quarter of this year but will likely continue to grow well above potential for the balance of this year.

China and Emerging markets in general, which were the first economies to reopen, are furthest along in the recovery and show gently easing growth momentum. Even with a more moderate growth outlook, emerging markets are still expected to lead the global recovery. Growth rates this year are expected to top that of advanced economies, with the exception of the United States, and next year emerging markets growth should even exceed that of the United States. If these forecasts prove to be correct, the recovery will merely have been delayed. Secondly, based on this read-through from economic growth to equity markets, as long as Portfolios remain diversified, being invested should reward Investors over the longer term.

Bonds

	YTD	1 Year	3 Years	5 Years	10 Years
EU Govt +5 Yrs.	-4.1%	-3.7%	+5.5%	+2.4%	+6.0%
EU Govt. +10 Yrs.	-6.2%	-5.7%	+7.7%	+3.2%	+7.9%
EU Corporates	-1.6%	-1.0%	+2.1%	+1.2%	+3.3%
EU Inflation-linked	+6.0%	+8.4%	+5.9%	+3.4%	+3.5%

EU fixed-interest government bonds have delivered negative returns year-to-date as bond markets have begun to discount rising inflation expectations for the first time in years. Certainly, supply bottlenecks, labour shortages and aggressive Central Bank monetary stimulus have created a strong inflationary impulse, which has impacted fixed-interest bonds in recent months. At the same time, inflation-linked bonds, where coupon payments are indexed to inflation over time, have performed quite well this year, providing an excellent investment for more conservative investors during periods of rising inflation.

Will inflation prove transitory this time, or are we at a secular turn higher in inflation and nominal bond yields (and lower in bond prices) following a 20-year bull market? The jury is still out. Despite the recent correction, government bonds remain in a bull market, as the multi-year trend lower in yields has yet to be broken. It is not surprising that bonds are considered a safe haven investment in the current environment. As stated, index linked bonds deserve particular attention, going forward.

Alternatives

	YTD	1 Year	3 Years	5 Years	10 Years
GS Commodities	+52.4%	+74.3%	+8.9%	+10.9%	+1.0%
WTI Crude	+78.8%	+130.8%	+7.7%	+13.2%	+0.6%
Gold	-1.6%	-5.6%	+14.0%	+6.2%	+2.3%
Silver	-6.8%	-0.9%	+19.9%	+4.8%	-1.8%

In a world where traditional asset classes (equities, bonds, property) have already appreciated significantly in value, where can a conservative investor look today to generate an adequate return on capital without taking on too much risk?

Asset classes such as infrastructure, private equity, commodities, precious metals and the newly emerging asset class of blockchain and cryptocurrencies all fall under the 'alternatives' asset class. Each has their own distinct set of advantages and drawbacks. For the majority, the yield curve remains the measuring stick. When discount rates (The discount rate is the interest rate charged to commercial banks and other financial institutions for short-term loans they take from Central Banks) are low, the present value of future cash flows is high, thereby justifying high valuations for most investments.

This rule applies not only to equities, bonds and property, but also to private equity and many infrastructure projects. That tends to leave hedge funds, commodities, precious metals and crypto as the opportunity set. We would also include inflation-linked bonds in the discussion. We plan to analyse each of these alternative investments in greater detail in future reports and welcome your feedback if you feel any particular strategy or asset class justifies our closer examination. The primary rationale for alternatives is their ability to improve the risk/reward relationship for investors – certainly on an appraised basis, but on an economic basis as well. Going forward, the belief exists that returns will be lower than their historic averages – but this is generally true of the public markets as well, particularly fixed income. The diversification benefit will remain and we continue to see more evolution and innovation in the marketplace.

We have laid out the big picture market view in this investment update, which reflects consensus views of a variety of Fund managers, with whom we deal and also their current thoughts on the global equity and fixed income markets. For now, the primary trend of the market remains positive. Against a strong, if slowing, growth backdrop, analysts continue to prefer equities, including those positioned to benefit from global growth such as Financials, Commodity linked sectors, Eurozone and Japanese equities together with Index Linked Bonds. We are not recommending that changes to holdings occur as opinion exists that this transitionary phase may be quite a short-term phenomenon. The upside is that the global economy still has decent ground speed from this year and various strong state policies may add more impulse. Central Banks have so far acted responsibly and have reason to believe that inflation might be transitory. Investors might well find that 2022 turns out to be better than the current challenges seem to suggest.

We have mentioned that inflation-linked bonds are an attractive investment opportunity for conservative investors seeking capital appreciation and inflation protection in today's marketplace. We will revisit this topic in greater detail in a future report. However, as this is our inaugural Newsletter, we will focus on an investment opportunity that has greater potential, for those seeking long-term growth. Specifically, Alternative Energy.

Over the next several decades the energy sector will be an area of profound growth, ingenuity, and change. The global energy transition, aimed at reducing greenhouse gas (GHG) emissions, has created a dynamic market environment with far reaching implications. Shifts in the energy sector to achieve net zero emissions goals will likely drive groundbreaking innovations, impact consumer behaviours, shift the geopolitical landscape, and create numerous potential investment opportunities.

Societal focus on the need to address climate change in recent years has resulted in a growing number of governments, corporations, and other institutions setting net zero GHG emissions targets and promoting other climate-focused initiatives. Increasingly, the question is not whether the world will achieve net zero, but how, when, and at what expense. These developments have driven capital flows into pioneering technologies that have the potential to change daily life.

As the energy transition develops commentators expect that capital flows into alternative energy and clean technology (cleantech) solutions will evolve with some similarities to previous periods of technological innovation and the emergence of new sectors such as ecommerce and biotechnology.

Meanwhile, traditional energy companies will likely have to adapt to a market environment with more limited access to capital as environmental, social, and governance (ESG) initiatives will increasingly determine capital flows. At the same time, traditional energy companies will likely play a major role in achieving a net zero world, owing to decades of experience in research and development and managing capital intensive projects, while also benefiting from improving balance sheets with rising levels of free cash flow available to invest.

For investors, this dynamic environment can offer many varying opportunities. These may include rapidly growing innovative cleantech companies, emerging renewable supermajors, deep value and cash flow generating traditional energy companies, and transition stories of companies shifting from fossil fuels to alternative solutions.

As a result of factors including global efforts to reduce GHG emissions and cleantech costs the potential to take market share while also benefiting from increased global demands for energy, a broad spectrum of alternative energy and cleantech solutions are expected to see significant growth in the coming decades. Indeed, the wide choice of Investment vehicles within this sector have achieved stellar returns, with a continuation of such growth potential for some time to come.

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Insight Private Clients is the trusted advisor to many Individuals, Families and Corporate Entities. Should you wish to explore our service offering it would be our pleasure to discuss your specific requirements and we invite you to make contact with us.

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