LONGLEY
ASSET MANAGEMENT

3Q 2021 Commentary

Financial markets performed well during the first two months of the third quarter, then suffered some volatility during the final month. Towards the end of September, the leading US equity index, the S&P 500, fell just over 5% from the peak it hit at the beginning of the month. The volatility was due to uncertainty surrounding potential negative effects on economic activity from the delta variant of the coronavirus, the shortages of various components required in manufacturing and technology sectors, various geo-political worries, and concerns around the timing and pace of the removal of the stimulus provided by the Federal Reserve (Fed) at the start of the pandemic last year.

The concerns further afield included negative news from China, first turning private tutoring companies into non-profit organisations (which worried investors who thought similar action could extend to other sectors), and imposing tighter regulations on the technology sector. Fears also surrounded the potential default of the world's most heavily-indebted Chinese conglomerate, Evergrande, which has a primary source of business from real estate and property management. Evergrande's shares have fallen around 70% year to date, and are currently suspended as the company organises fire sales of certain parts of the business in order to shore up its balance sheet. Additionally, there are concerns that other smaller Chinese property companies may also have financial difficulties. This highly-leveraged, debt-driven sector has played a major role in the country's strong economic growth in recent decades, but is now experiencing strict constraints from Beijing.

Although the pandemic's grip on economic and social activity is abating, there are concerns about an increase of local variants of the virus, especially as the northern hemisphere enters the winter months. The vaccine rollouts within most developed countries are proceeding well, but developing countries are likely to require a lot of support with their own vaccination programmes. The recent news of new antiviral drugs cutting hospitalisations is very welcome, and should be positive in easing strains on healthcare provision.

The Fed continues to signal to investors that the US economic recovery is progressing well and that it has plans to taper its bond-buying program. In its most recent communication, the Fed referred to US unemployment making substantial further progress. Fed Chairman Jerome Powell eased concerns regarding the Evergrande situation, stating that it should not be viewed as a preview of what could happen with other corporations around the world, and that the company's distress does not appear to pose a risk to major US or Chinese banks.

The Fed has admitted that the inflationary pressures are continuing for longer than expected, but still refers to this as 'transitory'. There is no change to previous communications, suggesting that the Fed expects a couple of interest rate rises by the end of 2023. It is encouraging that consumers have accumulated very healthy savings balances and, together with restored corporate balance sheets, it appears that inflationary increases can be absorbed.

Inflation pressures have been stoked from commodity prices which have risen strongly since the beginning of the year. European energy prices have recently soared, partly due to increased demand but also due to the benign late summer/early autumn weather, when there has been insufficient wind for the offshore wind farms to generate electricity. The global shortage of truck drivers has exacerbated the situation. OPEC and other oil producers have recently resisted pressure to accelerate production and thereby ease the situation with increased supply: these countries are still recovering from the effects of the extremely low oil price at the beginning of 2020, and they are clearly now keen to recoup some benefits from the higher prices. With increased economic demand and controlled production limits, we would expect to see a steady rise in oil prices.

COP26, the international climate summit, will take place in Scotland in early November, and so we expect the global discussion around climate change and green energy, especially after such recent extreme weather patterns experienced around the world, to be a major focus for the final quarter of the year.

Developed market equities were broadly flat over the quarter, but they are still sitting on strong gains for the year to date. Chinese equities struggled and have dragged down emerging market equities over the quarter, despite some markets, such as India, continuing to perform well.

Despite all the concerns we have highlighted, equities held up over the quarter, and investors clearly believe that recession risk remains low. Regions such as Europe and the UK remain attractive from a valuation perspective and, in light of a recent surge in global capital expenditure, we think it is sensible for client portfolios to maintain good exposure to both domestic and international equities.

The IMF (International Monetary Fund) is forecasting global economic growth of 6% in 2021 and, with expectations for good third-quarter earnings and sales growth as well as steady dividend growth, this should all be supportive to equities. There of course remains the possibility for bouts of volatility in financial markets, and we remain vigilant – though historically the upcoming season has often been a positive period for markets.

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