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The pre-Christmas 'quiz' that not many want to play

As the end of the investing year draws nearer, markets remain on edge, questioning everything that it thought it knew the answers to only very recently. But last week, central bank and government policy, inflation pressures from supply chain issues, and the latest developments from the virus that refuses to be defeated, threatened to leave investors in a state of puzzlement.

Not surprisingly, the new Omicron COVID variant has dominated the news cycle and the financial press. Each time new information (or maybe, at this stage, rumour) hits the headlines, markets move sharply in either direction. However, taking a step back, we suspect these wild gyrations are less to do with the virus news itself, and more a case of the "straw that breaks the camel's back". While not so worrying in itself, the build-up of other risks means the new uncertainty presented by Omicron offers a convenient (and welcome) excuse for investors to crystalise the reasonable returns gained in 2021 so far. After another arduous year, the temptation to close up early, take the money and run is entirely understandable. We include a separate article this week discussing November's capital market returns.

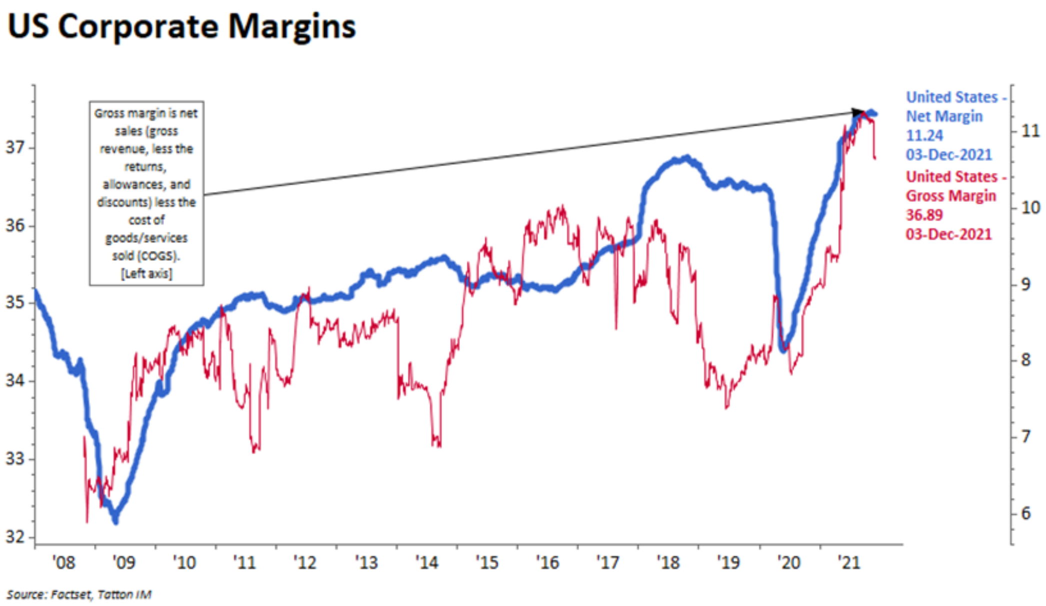
After some weeks of rising concerns about the economic outlook, conditions have started to improve again. While employment indicators have reaccelerated, (notwithstanding a slightly disappointing US figure on Friday), markets are signalling that concerns about the inflation outlook have lessened. Looking at the most recent regional Purchasing Manager Indices (PMIs) which capture the prevailing economic sentiment, JP Morgan research offered a good example of how the ever-changing impact of the various factors mentioned at the beginning are being interpreted:

"Activity data … are constructive. Alongside a reported further improvement in labour markets, country-level retail sales data (including Germany, France, and Spain) align with our call for a 0.2%m/m October spending gain in the region. This increase would leave Euro area retail sales 1.2%ar above the 3Q21 level. A key question, however, concerns the impact of higher energy prices on consumer spending. While natural gas prices have steadied out over November, the sharp gains since this summer are now visible in consumer prices. It is encouraging that consumer confidence remains elevated through November, but rising inflation expectations along with building COVID-19 concerns could pose a challenge to spending growth in the coming months."

Despite expressing concerns about the inflation outlook, they (and we) are of the opinion that supply chain issues may be fading. Since October, ocean container shipping costs from Shanghai to Europe are down by more than 6%, and from Shanghai to US ports by over 20% (source: JP Morgan, WCI). The recent rise in the Baltic Dry freight shipping index is probably driven by an upswing in demand from China – containers are once again returning to China filled with goods, having often gone back empty in recent months. As a result, we do not expect any inflation follow-through from these rising shipping volumes – perhaps the opposite.

Rising worker power as a consequence of labour shortages would be one reason to expect inflation to become sustained rather than remain a temporary phenomenon tied to supply bottlenecks. However, rising wages create a different outcome to supply chain issues. Ultimately, relatively low-paid workers spend a lot more of their earnings than the highly paid and the owners of capital. While there is good reason to expect a wage-price spiral of sorts, ultimately pricing power must mean that the workers benefit, and that real wages rise. That will get spent (especially given household balance sheets have improved during the past two years) so rising real wages translate into rising real economic activity.

Sales volumes should therefore rise but, for businesses, rising input costs from higher labour costs suggests some pressure on margins which have been at historical highs. In the US, gross margins look as though they have started to come back a bit as the chart below shows (red line):



Still, the historical contrast with net margins (blue line) also shows that businesses can usually do a lot to stabilise the final net margin – so it probably will not feed through yet. Meanwhile, a rise in sales will continue to improve overall earnings (Note: the bump up in margins at the end of 2017 was due to Trump's corporate tax cuts).

While the uncertainty caused by the Omicron variant may well disturb the otherwise positive economic backdrop for December and 2022, we note that most investors are not quite so perturbed after the experiences of the past two years. Vaccines are now more straightforward, timely adaptable than we could possibly have hoped this time last year. There is also the possibility that with the Omicron mutation the SARS-Cov2 virus is showing signs of running the course of previous viral pandemics: more infectious but at the same time less dangerous to public health. We shall see.

Elsewhere, the major news item that drove markets from our perspective had to do with the confirmation of Jerome Powell's second term as Chairman of the US Federal Reserve (Fed). Perhaps his reappointment emboldened Powell to speak more forthrightly about inflation than he has in recent months. There is room for different interpretations over what last week's remarks really meant, but most market participants took it to mean that the Fed is very likely to taper bond purchases more aggressively, starting in December. This would mean an earlier than anticipated draining of the 'punchbowl'.

As a result, the market pricing of inflation expectations fell back as short-term yields rose. However, longer-dated nominal treasury bond yields fell, with inflation-adjusted (real) yields rising a little. Our best explanation of this is that investors now believe the Fed has moved into a phase of tightening near-term policy, which means the threat of unconstrained consumer price rises is much less.

However, for markets, it also means less ‘free money’ with which to buy risk assets. In that sense, Powell’s words are a double-edged sword. So, while risks for elevated equity valuations from rising yields – on the back of rising inflation expectations – have reduced, the cheap ‘fuel’ for economic activity is also less plentiful. The coincidence of the arrival of a new variant may further hamper activity in the short term is unfortunate. However, even in light of this double whammy, markets only sold off lightly. This indicates the narrative of a sustained economic upswing into 2022 remains firmly embedded in medium-term investment outlooks.

November 2021: capital market returns review

Asset Class	Index	November	YTD	12 months	5-yr rolling annualised
Equities	FTSE 100 (UK)	-2.2	13.1	16.8	4.8
	FTSE4Good 50 (UK Ethical Index)	-2.6	7.7	10.5	1.4
	MSCI Europe ex-UK	-1.7	12.3	14.6	10.0
	S&P 500 (USA)	2.9	27.3	29.1	16.6
	NASDAQ (US Technology)	4.0	25.3	29.4	25.1
	Nikkei 225 (Japan)	1.1	3.1	4.9	8.2
	MSCI All Countries World	1.1	17.8	20.4	14.0
	MSCI Emerging Markets	-0.6	-1.2	3.6	9.5
Bonds	FTSE Gilts All Stocks	3.0	-2.6	-1.0	3.3
	£-Sterling Corporate Bond Index	1.0	-2.1	-0.4	4.4
	Barclays Global Aggregate Bond Index	3.3	-1.4	-2.4	2.1
Commodities	Goldman Sachs Commodity Index	-7.6	34.8	39.5	2.2
	Brent Crude Oil Price	-14.3	38.1	45.9	6.0
	LBMA Spot Gold Price	3.7	-2.4	1.7	8.6
Inflation	UK Consumer Price Index (annual rate)*	1.4	4.1	4.4	-
Cash rates	Libor 3 month GBP	0.0	0.1	0.1	0.5
Property	UK Commercial Property (IA Sector)*	1.2	4.7	4.6	2.4

Source: Morningstar Direct as at 30/11/21. * to end of previous month (31/10/21). All returns in GBP.

November ended with markets dominated by rising COVID infections and hospitalisations in parts of Europe as well as the emergence of the new Omicron variant. Having risen much higher during the month, developed market equities ended the month up only 1.1% - thanks to positive return contributions from the US and Japan.

An alarming rise in COVID hospitalisations has so far been limited to parts of Northern Europe but has resulted in increased restrictions coming into force in several countries. The UK, which remains ahead of the European Union in terms of vaccinating – and offering booster shots to its population - has so far opted for less strict infection prevention measures.

It is still unclear whether Omicron will reduce the effectiveness of existing vaccines, and this is the critical issue to monitor over the coming weeks. Even if vaccines are less effective against this variant, drug companies seem confident newer vaccines could be available in a matter of months. So in terms of market response to Omicron, we are much further down the line than when vaccines were not available at all.

November also saw the UN Climate Change Conference (COP26) held in Glasgow, where global leaders met to discuss ways to limit global warming to less than 1.5°C. Although the announcements fell short of expectations, climate change was one area where the US and China agreed to work together, which is significant progress in itself.

The weeks in November before the COVID crunch, produced encouraging economic news, with the key indicator of JPMorgan's Global Composite Purchasing Managers Index (PMI) increasing 1.2 points in October and generally better than expected predictions for most countries.

In regional terms, US equities were the strongest performers. The main market climbed 2.9% (4% for the US technology sector), although US Federal Reserve (Fed) Chair Jay Powell's reappointment for a four-year term along with the Federal Open Market Committee meeting later in the month gave markets further reason to expect tighter monetary policy in December, on the back of prospects of slowing progress in the labour market and growing supply chain disruptions. The European Central Bank (ECB) followed the Fed's earlier stance in indicating that a change to its own bond purchasing programme would take place sometime in the future, but was at pains to reassure markets that those changes were still some way off.

The UK equity market ended the month with a 2.2% decline, while Europe equities dropped 1.7%. However, in stark contrast to the rest of Europe the lower impact of the latest COVID-19 wave increased UK consumer confidence. Elsewhere in Europe, Germany unveiled its new government: a three-way coalition between the Social Democratic Party, the Green Party and the Free Democratic Party which began in positive fashion by announcing ambitious climate targets.

Emerging Market equities fell 0.6%. Indications of policy easing from the People's Bank of China was interpreted as a positive signal for the region, and helped to counterbalance losses driven by other markets. Oil prices also closed the month in the red, falling 14.3% as rising COVID cases raised concerns over potential disruption to demand.

We still expect monetary policy to tighten gradually into 2022, but all comments from central banks appear to show a gradual normalisation process with monetary and fiscal policies staying accommodative. For the rest of 2021, the risk – but also the opportunity – remains centred on Omicron. We should know by the end of the year whether the COVID variant will disrupt what would otherwise be a positive economic outlook for the new year.

Powell turns into Scrooge – with unfortunately timing

The financial commentariat loves a good change of narrative. That is what they got from Fed Chair Jay Powell's speech on Tuesday, when he appeared to reverse two years of monetary policy thinking in a single afternoon. Powell had spent much of this year preparing financial markets for a slight reduction in asset purchases, reassuring them that zero interest rates were not going anywhere and proclaiming that inflation was merely "transitory". But now that US inflation has hit its highest level in 30 years, there is no more Mr Nice Guy. The Fed Chair told US Congress that bond-buying could be tapered quicker than expected to combat rising prices and that the central bank should retire the "t" word when describing inflation. It was his most hawkish-sounding speech since the start of the pandemic, and it gave news outlets a juicy narrative shift: after months of mollycoddling, Powell the disciplinarian is here.

Except that is not quite what the Fed Chair said. On transitory inflation, Powell told Congress that "It's probably a good time to retire that word and try to explain more clearly what we mean". The need for clarity comes from markets' tendency to interpret transitory as meaning 'no big deal' – implying the central bank can simply ignore it. That was never the case and highlighting this misinterpretation does not necessarily mean that policymakers' outlook has changed significantly. Similarly, while the bond market response implied that investors expect interest rate rises to come sooner, Powell made no such assertion.

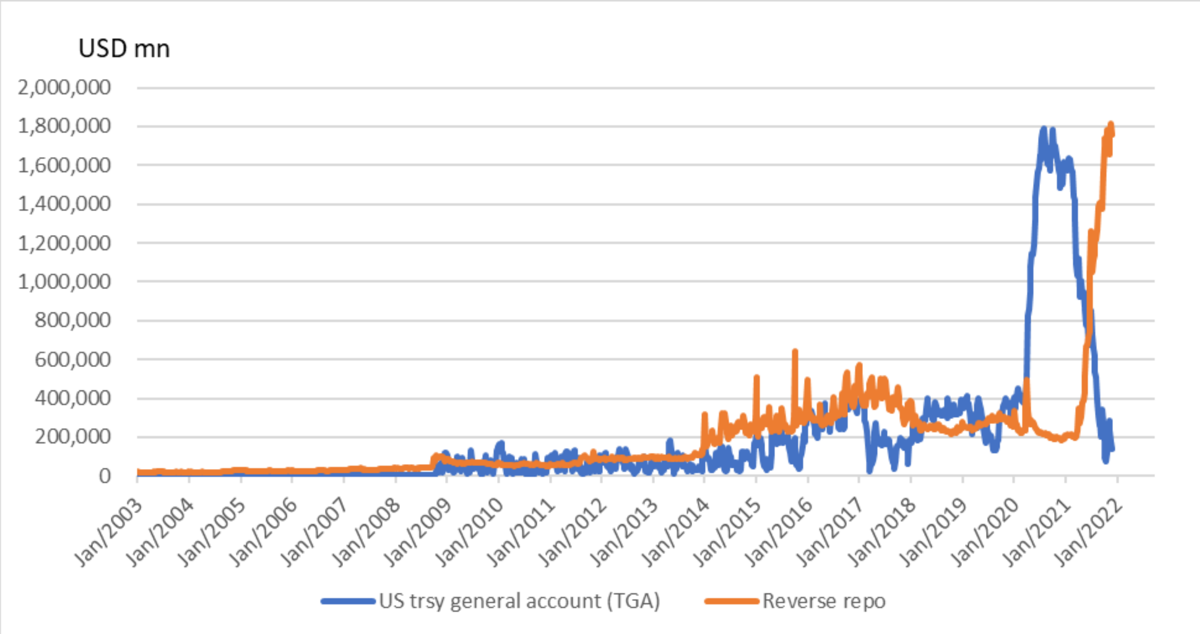
Nevertheless, capital markets interpreted Powell's comments as decidedly hawkish. Markets brought forward their expectations on Fed rate hikes – as the rise in yields on short term government bonds informs us – while longer-term bond yields fell, indicating slower growth expectations down the line. The latter may also have been prompted by fears over the Omicron variant and its potentially negative effect on the global economy. According to Powell, the Omicron risk is not yet "baked into" the Fed's projections – leaving room for easier monetary policy if needed. But the end result is a flattening of the US yield curve (the difference between long and short-term yields) and the threat of tightening financial conditions.

For markets, one of the biggest concerns is that these moves could cause overall liquidity to dry up as we head into an already difficult winter. A tighter Fed means less money around, while an Omicron-induced economic slowdown increases risks and drives up financing costs. All of this coming at the end of the year – when trading volumes are usually smaller – is a worry. Could we see a year-end liquidity shortage?

It helps to think about the different sources of liquidity here: **First,** the liquidity provided by policymakers – in the form of central bank purchases or government stimulus. **Second,** liquidity that comes from financial market trading – from the volume of willing buyers and sellers. And **third,** the liquidity generated by the underlying economy – such as banks or growth in activity.

On the first point, a quicker-than-expected tapering from the Fed would clearly lower overall liquidity injections. Powell suggested tapering could be wrapped up a few months earlier than planned – a clear change of policy signalling whichever way you look at it. But we should note that this is what many have been suggesting for a while. Indeed, some economists have implied that the Fed has been too cautious in its approach and undermined its credibility as a guard against inflation.

Arguably, the Fed has been supplying too much liquidity, if moves in money markets are anything to go by. The chart below shows the Fed's injections into reverse repo markets (a form of interbank lending that the central bank uses to inject liquidity) against the Treasury General Account (the US government's checking account).



Source: Factset, Tatton IM

As we have written before, the mismatch essentially means that the money the Fed injects is not finding its way into the market – due to saturation – and simply ends up back with the Fed as excess liquidity. If the Fed does not mop up liquidity with reverse repos and leaves it in the market, this can create serious problems, as it drives down the returns of short-term money market funds to zero or negative – causing funds to flow out and money markets to seize up. Earlier in the year, the Fed tried to solve this problem by raising repo rates in money markets – a recognition that they had flooded the financial system with more liquidity than it could handle, or indeed was required.

That effect is a sign that some form of monetary tightening is needed. On the positive side, it also means that injecting fewer dollars into the system should not have a substantial effect on overall market liquidity. That is, the market has enough cash to withstand some tapering.

Importantly, tapering of this kind is a very different question to rate rises. The system might have more than enough liquidity, but that does not mean rates should go up. On his part, Powell has been keen to emphasise that tapering should not be seen as an indication of imminent rate rises. Markets have not quite bought that message, but the points above suggest he is right, and that the Fed still has the ability to fine-tune rate rises.

The second kind of liquidity – provided by the market – is a slightly different story. Corporate credit spreads have been widening recently, suggesting markets are feeling nervous. This will make financing harder to come by and could have a big impact on broader assets if nerves persist. Unfortunately, there is not much central bankers can do about this problem. The Fed has been pushing cash into the system, but there is little they can do about where it ends up.

The third is a distribution problem, driven by investors' relative confidence in companies. Fortunately, the problem is not yet too dramatic, but it is one the Fed – and ourselves – will have to keep a close eye on. In an extreme situation, the Fed can always decide to intervene in a specific market to maintain proper functioning, but we are not close to such a situation currently. In the short-term, it could mean lower liquidity just as problems pop up elsewhere in the economy – exacerbating volatility.

Over the longer-term, though, the Fed might rightfully feel it had to tighten things. There was too much liquidity in the system, and some had to be drained out; the timing was just a little unfortunate as it is overlayed with the Omicron variant. From here, much depends on the economic news-flow and the fate of Joe Biden's fiscal plans. As we go into the year-end, we suspect that will become the bigger narrative.

Turkey: the poster child for EM risks

Turkey is at "war". That was President Recep Tayyin Erdogan's assessment last month, comparing the nation's current struggles to its fight against occupiers nearly a century ago. Exactly who or what Turkey is fighting against is unclear – this war is not a physical one but an economic one, against a vast array of foreign "opportunists", "doomsayers" and "global financial acrobats". But Erdogan's government will fight with fervour, nonetheless. According to Erdogan: "With the help of God and the support of our people, we will emerge victorious from this war of economic independence".

Judging from capital market moves, the opening battle is not going very well. The Turkish lira has lost around 25% of its value against the US dollar in the last couple of weeks. Year-to-date, the decline is approaching 50% and shows little sign of slowing. For currency traders, things are as bad or worse than the crisis of 2018. Meanwhile, inflation continues to soar – with prices rising 20% year-on-year in October. In a country that relies heavily on foreign imports, many economists worry Turkey is entering into a dangerous spiral of hyperinflation.

We wrote recently that currency values usually reflect the market's relative confidence in an economy. The strange thing about the lira's current nosedive, though, is that Turkey's economy looks in good shape compared to recent history. Turkey has run a current account deficit (exports minus imports) for a long time, but September saw a second consecutive month of surplus. This was prompted by a massive recovery and exports and tourism, which helped to push growth to 7% in the third quarter of this year.

Currency markets' lack of faith in the lira stems less from the economic backdrop than Erdogan himself. Turkey's long slide toward authoritarianism has been well-documented in the western press, and Erdogan's strong-arm tactics have often been at odds with investor preference for stability. But the biggest concerns have come from his unorthodox economic views.

Textbook monetary policy says that raising interest rates is the best way to combat inflation – by encouraging more saving and less short-term spending. Erdogan takes a very different view. He believes that, for emerging markets like Turkey that have large dollar-denominated debts and current account deficits, interest rate hikes increase inflation pressures. Therefore, he has repeatedly pushed for interest rate cuts to combat rising prices – a belief he triumphantly reiterated last week as he praised the central bank's recent rate cut.

We should point out that Erdogan's beliefs are not as outlandish as they might at first seem. There is a great deal of academic debate around the effects of monetary policy and how it may differ between economies. But asking whether there is any truth in Erdogan's theories misses the point. Markets do not like straying from orthodoxy at the best of times, but what they hate above all else is erratic and unpredictable policy.

That is exactly what Erdogan has delivered throughout his presidency. When he took office in 2014, $1 could buy you just over 2 Turkish lira. At the time of writing, it will buy you more than 13. Not all of that slide can be attributed to one man, of course, but no one doubts Erdogan has played a big part. The current bout of chaos began in March, when he fired respected technocrat Naci Agbal from his role as central bank governor and replaced him with loyalist figure Sahap Kavcioglu.

Agbal was the third Turkish central bank chief to lose his job in two years. If anyone still believed Turkey's central bank was independent from the government (as is official policy), actions this year have dispelled those notions. Last week, monetary policymakers returned to a contentious policy of selling foreign exchange reserves to influence currency markets – to which Erdogan gave his blessing.

The situation was compounded by the resignation of finance minister Lutfi Elvan on Wednesday – who was replaced by another Erdogan loyalist. Whatever one thinks about the merits of these decisions, they point to erratic policymaking at the highest level. In the view of capital markets, Erdogan runs his economy like an impatient football club owner – hiring or firing staff whenever results go against him.

Erdogan's combative style is a red flag, not just for Turkey, but for emerging markets (EM) more generally. On the face of it, 2021 should have been a good year for EM assets – with global growth recovering strongly and various commodities seeing strong gains. But some EM currencies have performed badly, against a backdrop of expected monetary tightening in the US. This has led to global capital flowing out of developing countries at a time when they need it most. EMs with high debt have struggled recently, and are at risk should global sentiment takes another downturn.

Erdogan's strong-man politics are an extreme example of an EM scare story. But interventionism and delicate politics are a common feature in EMs, from Russia to Brazil and even China. Most developing countries also have far less access to vaccines and are therefore seen as more susceptible to COVID outbreaks and the resulting slowdown in economic activity. Meanwhile, international bodies like the International Monetary Fund (IMF) have suggested that EM countries are much less able to take on debt as developed countries have done – limiting the space to spend their way out of crises. With this backdrop, it does not take much to dampen investor sentiment. A currency crisis and erratic policy in one country can therefore have a big knock-on effect for financing elsewhere.

The standard route out of these problems would be to resort to the IMF or World Bank. But Turkey's experience shows how this can still be difficult. Erdogan has ruled out resorting to external funding that would tie the country to foreign diktats (something the IMF has been criticised for many times down the years). In any case, the IMF would be unlikely to help Turkey without its government returning to something like economic orthodoxy – making any compromise nigh-on impossible.

There are other avenues Erdogan might pursue – such as a funding agreement with Russia – which may prove more lenient. That has its own difficulties, given past flare-ups between the two nations. Ultimately, external currency problems will persist as long as Erdogan wages his war. If he is seen to be losing it – as the recent hit to living standards suggests – his own position could come under pressure.

Global Equity Markets

Market	Fri 15:49	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7017	-0.5	-35	↘	↗
FTSE 250	22926	-2.9	-683	↘	↗
FTSE AS	4023	-1.0	-39	↘	↗
FTSE Small	7410	-1.7	-127	↘	↗
CAC	6505	-2.0	-133	↘	↗
DAX	15136	-2.6	-396	↘	↗
Dow	33920	-2.5	-878	↘	↗
S&P 500	4293	-3.6	-162	↘	↗
Nasdaq	14397	-4.3	-650	↘	↗
Nikkei	28771	-4.9	-1478	↗	↗
MSCI World	3007	-3.1	-97	↘	↗
CSI 300	4866	+0.3	+13	↘	→
MSCI EM	1253	-0.9	-12	↘	→

Top 5 Gainers / Top 5 Decliners

Company	%	Company	%
Royal Dutch Shell	+7.4	Renishaw	-12.6
Royal Dutch Shell	+7.4	AVEVA	-10.4
Rolls-Royce	+7.2	Admiral	-8.6
Glencore	+6.1	Halma	-7.8
BP	+5.4	Spirax-Sarco	-7.7

Currencies / Commodities

Pair	last	%1W	Cmdty	last	%1W
USD/GBP	1.354	-1.0	Oil	78.08	-0.0
GBP/EUR	0.857	+0.1	Gold	1758.7	+0.5
USD/EUR	1.16	-1.0	Silver	22.47	+0.2
JPY/USD	110.95	-0.2	Copper	416.9	-2.8
CNY/USD	6.44	+0.2	Aluminium	2858.5	-3.1
Bitcoin/$	47,131	+8.0	Soft Cmdties	228.7	+1.3

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.1	15.3	12.3	14.2
FTSE 250	2.4	15.5	24.0	16.0
FTSE AS	3.8	15.2	13.3	14.4
FTSE Small x Inv_Tsts	2.0	12.9	18.8	15.5
CAC	2.3	20.8	15.6	15.0
DAX	2.2	15.2	14.9	13.5
Dow	1.8	19.0	18.4	16.5
S&P 500	1.4	24.3	21.3	17.6
Nasdaq	0.7	29.4	31.8	23.0
Nikkei	1.5	15.4	17.2	17.7
MSCI World	1.7	21.2	19.4	16.6
CSI 300	1.9	16.0	15.1	12.5
MSCI EM	2.4	13.8	13.2	12.6

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.00	+0.08
UK 15-Yr	1.23	+0.10
US 10-Yr	1.48	+0.03
French 10-Yr	0.12	+0.01
German 10-Yr	-0.23	-0.00
Japanese 10-Yr	0.06	+0.00

UK Mortgage Rates

Mortgage Rates	Sep	Aug
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.23	1.28
3-yr Fixed Rate	1.41	1.48
5-yr Fixed Rate	1.40	1.45
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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Data used within the Personal Finance Compass is sourced from Bloomberg 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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