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January déjà vu

Although 2021 did not close with another ‘Santa rally’, December – and the year as a whole – generated some pleasing returns for diversified investment portfolios. Compared to 2020 (another strong year in performance terms), equity investors fared considerably better than bond investors. Overall, and across asset classes, investors have experienced a notably better pandemic than so many other aspects of society, and we cover last year’s returns in detail in the next article.

So far, 2022 has kicked off very much where 2021 ended, with central bank policy decisions – and bond market reactions – causing volatility in equity markets. However, compared to this time last year, which was marked by a second national lockdown in the UK, and the storming of the US Congress by a violent mob of Trump supporters, last week looked comparatively dull.

Despite COVID infection rates being near double what they were a year ago, and the economic outlook looking far less clear cut or positive, central banks are indicating they are more worried about an overheating economy (causing inflation) than a renewed stalling of activity levels. As with last year, this friction is having a profound impact on bond yields, which in turn is continuing to affect valuation metrics in equity markets. As a result, the higher market volatility of last week continues to be predicated on the juxtaposition between balancing short-term versus medium-term risks.

By way of example, in August 2018 Apple had a market capitalisation of $1 trillion. But it has undoubtedly been one of the great winners in the pandemic period. Being stuck at home, consumers have spent their money on personal tech, both hardware and software. It broke the $2 trillion market barrier in September 2020, and last Tuesday, it hit a market capitalisation of $3 trillion (it was back down to $2.8 trillion by Thursday).

Apple’s revenues and margins shot up just when one thought it could no longer achieve the sort of profit growth of 20 years ago. Nonetheless, compared to then the company is now so large, so dominant and cash generative, that it has become a defensive stock in nature, even when renewed pandemic restrictions limit economic activity elsewhere. At the same time, Apple has almost no long-term debt, which makes its shares now behave less like a tech stock and more like a high-grade bond proxy. Thus, when long-term rates move up, Apple’s share price comes under pressure.

That is exactly what happened last Tuesday evening. The minutes for the December meeting of the Federal Open Markets Committee (FOMC) were released, and the committee’s hawkishness was unmistakeable. Even before this, yields in almost all major markets had been moving higher in the last days of the year. However, they moved sharply higher and closed the week with yields having risen by about 0.25% in the US, Germany and the UK.

So, the interest rate sensitivity of the US ‘mega-caps’, a decided boon for most of the pandemic period, has bitten hard. The beneficiaries have been financials, especially banks. Moreover, European banks have this time kept pace with US bank share price performance, aided by the fact that European yields have risen almost as much as US yields. The growth outlook for Europe appears as strong as the US over the next two years, with fiscal stimulus more certain and valuation upside decidedly larger.

Inflation concerns have been at the forefront of market concerns. In the US, the FOMC minutes have made it more so. The US labour market report released on Friday (7th January) failed to alleviate concerns, despite job creation being less than expected. This was because average hourly wages rose 4.7% year-on-year and, even worse, were revised higher to 5.1% for December. Interestingly, the story is one of people working less rather than overall pay rising. It was expected that more people would join the jobs market but the 'participation rate' (people in work or actively seeking work, relative to the adult population) remained at the low level of 61.9%. Meanwhile, the number of hours worked in the week fell.

In a sense, in inflation terms, this is potentially good news for the rest of this year. Many of the incentives for people to be inactive are decreasing. The failure of the Democrat Party to get its second stimulus bill through has meant child tax credits have ceased as of this month. It may be unpleasant for many, but it will probably result in an increase in the active workforce.

In Europe and the UK, there is some pressure on wages, but inflation pressure is coming more from energy price rises. We cover this aspect in more detail below. Again, we think inflation pressure will decline as we head into the spring, with natural gas prices likely to head lower. Oil prices should stabilise.

The European growth outlook should help the euro to regain some ground against the US dollar (and perhaps sterling will benefit, to a lesser extent). The European Central Bank (ECB) is not sounding anywhere near as hawkish as the Fed, which normally is a recipe for US dollar strength. However, and perhaps remarkably so, that was not the case last week. Indeed, the euro has strengthened slightly.

Elsewhere, China has been a source of growth concern through the latter part of 2021, after the authorities' deliberate action to compress the major property developers through tightening of lending standards. However, policy action went into reverse last week, with both the central bank acting to ease conditions, and the government pressing the banks to provide funding to developers. It has been notable as well that the renminbi has remained very stable through the year. While it is unlikely to rise sharply against the US dollar, a stronger domestic economy would also reduce the likelihood of a renminbi fall – so a slight improvement in outlook here, after an otherwise not great start to the year in China.

That the US dollar did not strengthen markedly last week is good news (see above). We think this indicates a more broad-based global growth picture than was the case in the second half of 2021, one which is not reliant on the US consumer. We are optimistic that demand will be well-based outside of the US, while the Fed is unlikely to be more hawkish than is now discounted by the market. Investors will benefit from more synchronised strength, as earnings of 2021's laggards should catch up, provided the Fed (through US dollar strength) does not tighten financial conditions too rapidly. We expect the COVID wave caused by the omicron variant will reduce the urge to do so, as inflationary pressures should subside from lower consumer activity levels, while the supply side continues to gradually normalise.

However, we sound a note of caution. In the end, it is not just about the actions the Fed takes, but also what markets anticipate, which is what we saw unfolding last week. Markets will continue to worry about the Fed's apparent zeal not only to stop buying more bonds, but probably to become a seller. Therefore, we expect every word uttered by a Fed official will be dissected for evidence of when 'quantitative tightening' (QT) will begin. The Fed may move uncomfortably quickly if inflation refuses to decline. Equally, the market may over-anticipate how swiftly the Fed does tighten. Should liquidity tighten rapidly, either by means of central bank policy or by the mere anticipation thereof by nervous markets, then the equity bears will have an outing.

December 2021: capital market returns review

Asset Class	Index	December	2021	2020	5-yr rolling annualised
Equities	FTSE 100 (UK)	4.8	18.4	-10.2	4.7
	FTSE4Good 50 (UK Ethical Index)	4.9	13.0	-13.2	1.3
	MSCI Europe ex-UK	3.9	16.7	8.8	9.8
	S&P 500 (USA)	2.1	29.9	14.5	16.3
	NASDAQ (US Technology)	-1.6	23.3	40.9	25.0
	Nikkei 225 (Japan)	-0.5	2.6	11.4	8.2
	MSCI All Countries World	1.6	19.6	13.0	14.4
	MSCI Emerging Markets	-0.5	-1.6	15.0	9.9
Bonds	FTSE Gilts All Stocks	-2.6	-5.2	7.9	2.4
	£-Sterling Corporate Bond Index	-1.1	-3.2	8.4	3.7
	Barclays Global Aggregate Bond Index	-2.5	-3.8	6.3	1.5
Commodities	Goldman Sachs Commodity Index	5.1	41.6	-26.0	2.8
	Brent Crude Oil Price	9.7	51.5	-23.9	6.5
	LBMA Spot Gold Price	-1.1	-2.9	20.8	9.4
Inflation	UK Consumer Price Index (annual rate)*	0.7	-	5.5	-
Cash rates	Libor 3 month GBP	0.0	0.0	0.5	0.5
Property	UK Commercial Property (IA Sector)*	1.1	7.0	1.8	2.5

Source: Morningstar Direct as at 31/12/21. * to end of previous month (30/11/21). All returns in GBP.

Christmas did not quite bring the hoped-for ‘Santa Rally’, but investors still received many happy returns in December. Equity markets wobbled during the month, but overall global equities climbed 1.6% in sterling terms. This capped off a strong quarter (and year) in stock markets, with the MSCI World index rising 19.6% in 2021. It means that, despite the well-known COVID scares and supply chain problems of the last 12 months, investors have fared well during the pandemic.

For 2021 overall, the US once again outshone its peers, with the S&P 500 returning 21.2% compared to 18.4% for the UK and 16.7% for Europe. Much like in 2020, investors flocked to the US tech sector, which ended the year 30% up. In December itself, though, this outperformance was reversed. The S&P returned a decent 2.1% on the month, but the tech-heavy Nasdaq fell 1.6%. By contrast, the UK and Europe climbed 4.4% and 3.9% respectively. This was despite soaring COVID cases in both regions – and the introduction of new restrictions in the latter.

When looking at the quarterly picture, the US was dominant. This was driven by the continued rise in profitability of US American companies and positive investor flows into equities. That said, the fourth quarter was kind to most regions, except for Japan (-4.4%) or emerging markets (-1.8%), the only equity markets to end Q4 in the red. Emerging markets had a particularly hard year, with MSCI EM the only major equity benchmark to post negative returns for 2021.

December's equity performance was comfortably outdone by returns in commodity markets. The Goldman Sachs Commodity Index rose 5.1%, while Brent Crude oil prices soared 9.7%. This capped a stellar 41.6% return for commodities over the year. Much of this was driven by oil prices – which shot up 51.6% – as well as industrial metals. Well-documented problems of supply chains (as seen in the UK's September fuel crisis) while an easing of restrictions across many regions led to a strong recovery in demand.

Industrial metals – particularly those used in newer technologies and infrastructure – also found support. This specific price pressure appears to be structural, driven by the rapid green transition across developed economies. Gold prices, by contrast, fared much less well; it returned -1.1% in December, and -2.9% for 2021 overall.

December's reversal of fortunes for equity markets had much to do with central bank action. The Bank of England surprised investors by becoming the first major central bank to raise interest rates since the start of the pandemic (straight after surprising investors by *not* doing so in November). Meanwhile, the US Federal Reserve (Fed) pivoted to a hawkish outlook for monetary policy. In its December meeting, it announced a faster reduction of bond purchases starting in January, and that it expected to raise interest rates three times in 2022.

The minutes from that meeting were only released last week – and showed a decidedly more hawkish Federal Open Market Committee (FOMC) than many expected (we cover this in a separate article below). Following the Fed's announcement, the European Central Bank (ECB) announced a similar reduction in its bond-buying programme over the first few months of 2022.

These actions pushed up bond yields and led to the volatility in equity markets. All in all, December 2021 marked the turning point in global central bank policy – from emergency support to the post-pandemic normal. The rapid spread of the omicron variant across the world could still complicate this picture, particularly in the short term. But so far, central bankers seem determined to push through to the next stage of the transition.

Should that play out, the heady returns of the last two years could be difficult to replicate. Tightening central bank policy means less liquid markets. In the best-case scenario, monetary support would be replaced by economic optimism spurring business investment, as the world transitions out of the pandemic. But even in that case, lower liquidity levels and higher yields can create pockets of volatility. Going forward, we could see more bumpy months like December – even if they end in the green.

Fed hawks soar to their peak

Perhaps words really can speak louder than actions. That was the experience of capital markets last week, after the minutes of the FOMC's December meeting emerged. The meeting itself brought a significant pivot in Fed policy: policymakers announced a faster reduction of its bond purchases (QE) and three interest rate rises in 2022. Markets reacted well at the time, with equities climbing higher into the end of the year. Now that investors know what was said at last month's meeting, though, things are markedly different. The minutes showed everyone how hawkish the Fed really is, and it sent a chill through markets: The S&P 500 fell 2% last Wednesday, while the technology-heavy Nasdaq fell 3.3%, its worst day since last February.

The worry is an old one. Emergency central bank support kept the economy and financial system afloat through turbulent times, and its withdrawal could mean the party is over. According to the minutes, committee members think the Fed may need to raise rates “sooner or at a faster pace” than previously thought, and officials are fully on board with reducing the bank’s bond purchases “relatively soon” after rates start rising.

It is a significant change of tack from the Fed. Policymakers spent most of 2021 assuring markets that policy would shift slowly, and that spiking inflation was only transitory. But as supply problems persisted and prices continued to soar, many worried the Fed was behind the curve on inflation. As we wrote last month, changes to the bank’s ‘dots plot’ (which graphs where policymakers expect rates to be over the next few years) actually brought the Fed more in line with market expectations on inflation and interest rates.

In that respect, the Fed’s policy shift is nothing new. What has spooked investors, though is the bank’s zeal for fighting inflation. In November, one of the Fed’s preferred inflation indices (private consumption expenditure (PCE) inflation) jumped to 5.7% year-on-year (core PCE at 4.7% year-on-year), its highest level in four decades. In the minutes released last week, Fed Chair Jay Powell made it clear this is beyond what policymakers will tolerate. The Fed’s average inflation target has been “more than met”, while several members thought employment levels were sufficient to tighten policy. Some even suggested rates could rise before the US reaches full employment – a move Powell ruled out when announcing the current policy framework in 2020.

US Personal Consumption Inflation (ex food & energy)
Fed's favoured measure

Source: Bloomberg, Tatton IM, BLS: G632

This is a clear signal that the era of market handholding is over. But the question that markets are struggling with is what comes next. Here, it helps to think about the two major parts of Fed policy individually: first interest rates, and second the bank’s balance sheet.

On rates, the Fed’s plan is uncontroversial. As we mentioned, December’s dots plot brought officials’ expected rate path in line with market expectations – itself a reaction to stronger growth and inflation expectations (before omicron fears set in at least). It is clear policymakers feel they need to tighten more quickly to combat inflation. But tightening *faster* does not necessarily mean tightening *harder*. Inflation pressures will subside eventually, and the longer-term path for rates will be determined by what the Fed considers the ‘neutral’ price of money to be.

Books have been written about what this should be, without a firm answer. But judging from bond markets, investors have concluded that the Fed is reducing its longer-term looseness. We suspect markets are misguided in this conclusion – and, in any case, there is not much evidence for a tighter longer-term stance. Governments built large debt piles throughout the pandemic, and sustaining these over the long-term will be difficult if long-term real interest rates are much above zero. As such, we think there is not much room for interest rates to go higher over the long-term – even if rapid tightening is needed now. Another way to look at the situation is that it may be too early to come to a firm judgement on what the structural set-up of future inflation and growth will look like. Will secular stagnation considerations – a low growth and inflation environment –genuinely be a thing of the past?

The balance sheet problem is different. The Fed has always maintained its huge stock of bonds would need to be sold back into the market eventually; we just did not know when. That policymakers want to not only stop purchases but sell its assets so soon is a surprise – one that markets clearly do not appreciate. If the central bank aggressively reduces its balance sheet while markets and the economy are still in transition, it could lead to a rapid and damaging shortage of liquidity. That would be a big policy mistake, and we suspect it is the main reason markets were so worried last week.

Hopefully it will not come to that, however. We have written many times in the last few months about the Fed's excess liquidity problem – how its quantitative easing programme pushed so much money into the financial system it threatened to overwhelm money market funds. The Fed has had to extract some of this liquidity back through its money market operations. The current drive for balance sheet reduction might be a reaction to this problem, rather than a signal of full-scale quantitative tightening. It may prove a challenge for the Fed to manage this process, and for now its balance sheet reduction process has not been communicated as a 'technical tweak' but more as a removal of previous liquidity accommodation.

Hence, the debate is unnerving for investors – and we should not underestimate how the looming threat of a liquidity crunch could affect markets. Of course, it need not be as dramatic as a genuine liquidity crunch. The Fed has underlined that its (new) standing repo money market facility means ad-hoc liquidity is more easily available than in the previous quantitative tightening (QT) period in 2017/2018. Nevertheless, all things being equal, less liquidity reduces the pro-risk impetus in asset markets. In this sense, the monetary element needs counterweighing from a flamboyant real economy.

With the release of December's minutes, the Fed has left a bombshell in capital markets – one that could cause a further sell-off and tightening of financial conditions. Powell and co will no doubt be wary of this, and we may well hear more soothing comments from them in the coming months.

More dovish tones would not necessarily be inconsistent with the Fed's message either. The December meeting was held before the omicron variant became the world's main pandemic concern – and we still do not know how it will affect future growth prospects. If conditions worsen in the short-term and/or inflationary pressures recede, it is very unlikely the Fed will tighten as aggressively as it suggested a month ago. It all depends on data over the next few months, but the Fed's hawkish talk may well have reached its peak.

More energy crisis in the pipeline?

Nowhere has the current inflation shock been as clear as in energy prices. UK households are facing a 50% rise or more in gas and electricity prices once caps are raised in April – which is expected to push overall price inflation to 6.8%. Similar price scares emerged across Europe last year, after supply threatened to leave large sections of the continent without power. Oil prices, meanwhile, soared by more than 50% in 2021, continuing the rally from the lows of March 2020. Rising energy costs have also increase inflation across the board – exacerbating supply constraints and pushing inflation to its highest level in decades. As such, the outlook for energy prices is essential to any inflation expectations in the short term.

For oil, the rally has continued into this year. Brent crude prices currently sit at nearly $82 per barrel, after climbing another 1% on Thursday. Yet again, the reasons are on the supply side – with traders concerned about further outages and unrest. Libyan oil producers just recorded an output of 729,000 barrels per day (bpd), significantly down from a high of 1.3 million last year, due to maintenance problems. Meanwhile, the uprising in Kazakhstan (an OPEC+ member) has sparked fears that the country's 1.8 million bpd output could be hit.

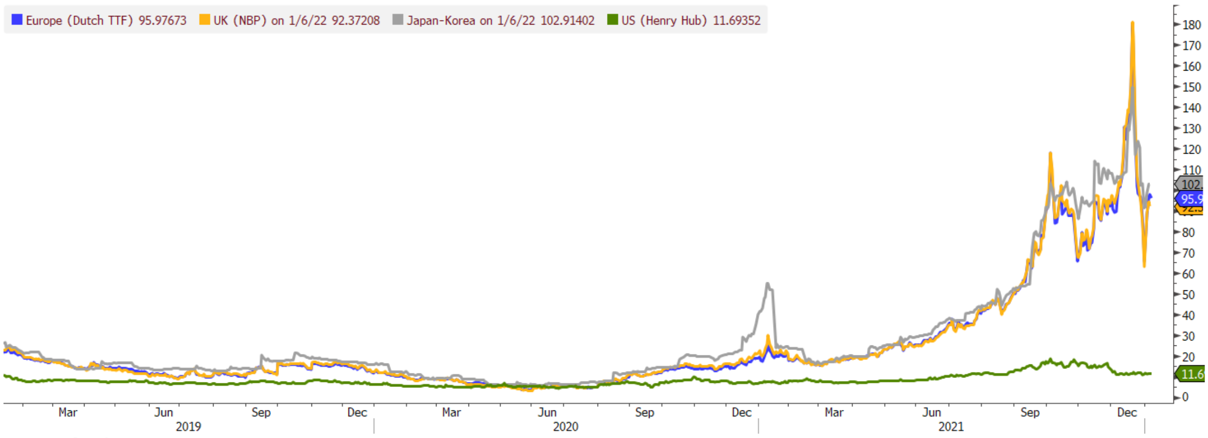
There are no indications of that happening yet, but riots in the former Kazakh capital Almaty and the presence of Russian troops was enough to frighten traders. This comes after energy markets were already disappointed by output figures from major oil producers. According to Price Futures Group's Phil Flynn: "OPEC production, while it did increase, disappointed the market – it is not going to be enough to keep up with demand,"

Oil's continued rally has been enough to make analysts wheel out the infamous $100 per barrel figure once more. These bullish forecasts hinge on two key factors: a healthy recovery in global growth and oil demand, and a lagged production growth – caused by underinvestment by both US shale producers and OPEC+ members.

Both sides of this story are contentious. Oil demand is likely to pick up through this year, but omicron scares and the global transition away from fossil fuels both call in to question whether demand will be enough to overwhelm supplies. In terms of production, it is hard to see how OPEC+ members could keep output low should prices stay as high as they are.

Oil bulls would point out that producers may be unable to scale fast enough to meet demand, but the fact remains that OPEC members, led by Saudi Arabia, have ample spare production capacity. Those countries have already promised to increase output, and at $80 per barrel, there is a big incentive to produce more oil. This applies to US shale producers too, who could add more than 1.1 million bpd this year according to the International Energy Agency.

Global Gas Prices
Next month delivery, all priced in €/MWh

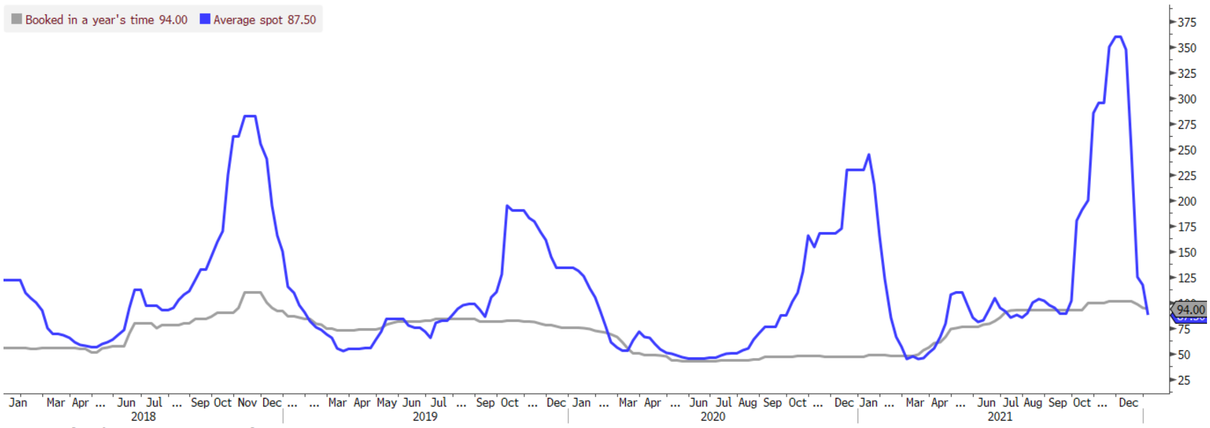


Source: Bloomberg, Tatton IM, ICE: G629

Natural gas is a slightly different story. Gas problems have arisen from supply chain disruptions in Europe and Asia rather than curbs on output – exemplified by lower gas prices in the US. Stockpiles have been low in parts of Europe since the beginning of autumn, causing prices to surge. Europe, especially Germany, is reliant on Russian gas and Ukraine has become a major issue. European politicians have already clashed with Russian President Putin over his readiness to shut down the pipeline to Europe which crosses Ukraine. The use of commodity supply as a political weapon was deemed unthinkable up until 2019 (even the Crimea annexation did not prompt such a move in 2014), and things may still worsen in the event of a cold winter on the continent. Meanwhile, events in Kazakhstan may present another problem – though the latter looks less likely as western nations have little to gain by standing in Putin's way.

The good news is that gas inflows to western Europe are already picking up. LNG tankers have begun to arrive in numbers at Rotterdam, and indications are that stocks are already expected to be back to at least last year's level in a couple of weeks. That is evidenced by the sharp retreat in LNG tanker rates from the December record highs.

LNG tanker rates
Current and in one year's time, $'000 per day



Source: Bloomberg, Tatton IM, Fearnley Secs: G633

In the US, there is enough production capacity for drillers to take advantage of sky-high prices. Moreover, only a freezing cold winter in Europe could cause enough demand to send prices sustainably higher than they are now. Supply problems proved surprisingly persistent last year, but they were always likely to filter through once producers had enough incentive to increase output.

Current energy prices provide that incentive. Now in the middle of winter, energy demand – particularly for gas – is strong. But this mismatch in Europe and Asia is likely to dissipate as the weeks and months roll by. If production is still intact, that will inevitably lead to lower prices.

Unfortunately, we suspect this will not be soon enough to lower short-term perceptions of inflation. Energy bills are one of the most visible signs of inflation, and as they bump up in the coming months, consumers and households are likely to increase their inflation expectations. It is unclear what effect this will have on spending, but it could lead to inflation expectations becoming ingrained. Ultimately, the question for policymakers is how this affects the labour market. If rising costs push workers to demand higher wages, it will lead to more inflation down the line. The jury is still out on how this will pan out, but central bankers and governments will need to watch labour market developments closely.

Global Equity Markets

Market	Fri 15:24	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7468	+0.9	+65	⬀	↗
FTSE 250	23344	-0.8	-195	→	⬀
FTSE AS	4241	+0.6	+24	⬀	↗
FTSE Small	7424	-0.1	-8	→	↗
CAC	7205	+0.7	+52	→	↗
DAX	15917	+0.2	+32	→	⬀
Dow	36193	-0.4	-146	→	↗
S&P 500	4689	-1.6	-77	→	↗
Nasdaq	15016	-4.0	-629	↘	↗
Nikkei	28479	-1.5	-428	↘	→
MSCI World	3185	-1.5	-47	→	↗
CSI 300	4822	-2.0	-99	↘	⬂
MSCI EM	1217	-1.2	-15	↘	⬂

Top 5 Gainers

Company	%
Int'l Consol Air	+12.4
Lloyds Bank	+9.4
Stan Chartered	+8.8
NatWest	+8.7
Barclays	+8.4

Top 5 Decliners

Company	%
AVEVA	-10.2
Scot Mtge Inv Trust	-9.3
Polymetal International	-8.4
Just Eat Takeaway.com N	-8.2
RELX	-7.7

Currencies

Pair	last	%1W
USD/GBP	1.357	+0.3
GBP/EUR	0.836	+0.6
USD/EUR	1.13	-0.2
JPY/USD	115.69	-0.5
CNY/USD	6.38	-0.3
Bitcoin/$	41,597	-11.5

Commodities

Cmdty	last	%1W
Oil	81.96	+5.4
Gold	1790.6	-2.1
Silver	22.12	-5.1
Copper	437.4	-2.0
Aluminium	2921.5	+3.9
Soft Cmdties	227.7	-1.8

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.8	15.6	12.3	14.3
FTSE 250	2.5	15.3	16.6	16.2
FTSE AS	3.6	15.5	12.8	14.5
FTSE Small x Inv_Tsts	2.2	11.5	13.7	15.7
CAC	2.1	20.6	15.3	15.1
DAX	2.1	14.8	14.3	13.7
Dow	1.7	18.8	19.1	16.7
S&P 500	1.3	24.8	21.3	17.9
Nasdaq	0.6	28.3	30.5	23.5
Nikkei	1.7	15.5	17.1	17.8
MSCI World	1.7	21.1	19.3	16.9
CSI 300	1.7	16.5	14.3	12.6
MSCI EM	2.4	12.4	11.7	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.16	+0.19
UK 15-Yr	1.32	+0.18
US 10-Yr	1.77	+0.26
French 10-Yr	0.28	+0.08
German 10-Yr	-0.05	+0.13
Japanese 10-Yr	0.14	+0.07

UK Mortgage Rates

Mortgage Rates	Dec	Nov
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.52	1.35
3-yr Fixed Rate	1.52	1.26
5-yr Fixed Rate	1.52	1.35
10-yr Fixed Rate	2.55	2.56
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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CAMBRIDGE
INVESTMENTS LIMITED

10th January 2022

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet 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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