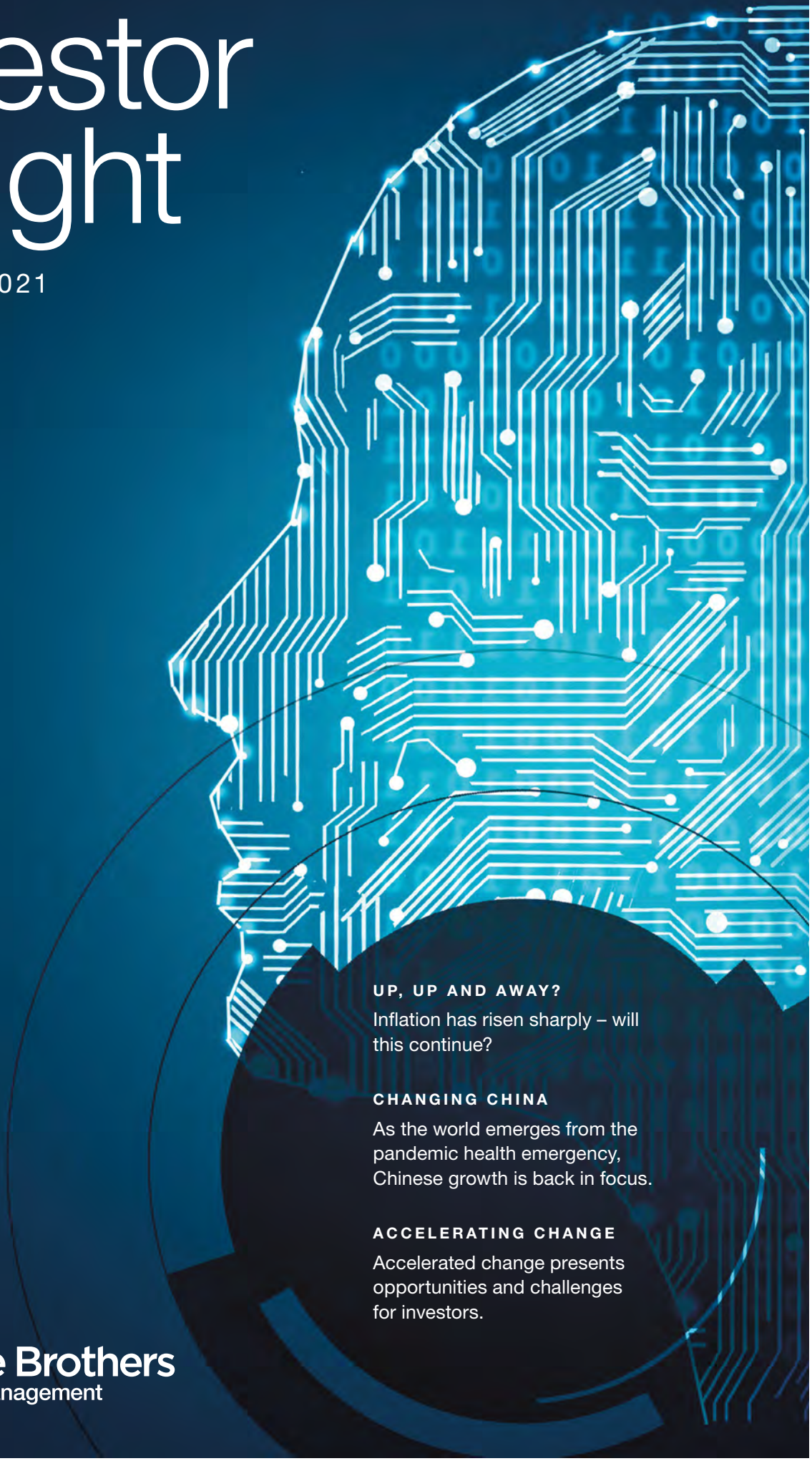
# Investor Insight

AUTUMN 2021



**UP, UP AND AWAY?**

Inflation has risen sharply – will this continue?

**CHANGING CHINA**

As the world emerges from the pandemic health emergency, Chinese growth is back in focus.

**ACCELERATING CHANGE**

Accelerated change presents opportunities and challenges for investors.

Close Brothers
Asset Management

# Introduction

As we enter the final quarter of 2021, economic conditions have recovered significantly. Industry surveys point to economic expansion in both developed and emerging economies, and countries with successful vaccine rollouts so far have been able to withdraw social restrictions without hospitals being overwhelmed. If this continues, we expect to see strong growth for the rest of 2021.

The last eighteen months have been dominated by health policy, the efficacy of which has been the main constraint on a country's economy. This remains a powerful driver of economic activity but, as social restrictions ease, it is time to consider some broader themes which could have a powerful impact on markets.

Firstly, we consider the impact of higher inflation on the economy, monetary policy and asset prices. We also look at the impact of tighter regulation on growth in China and beyond. Lastly, we explore a number of themes which have accelerated in recent years, and which present both opportunities and challenges for investors.

## UP, UP AND AWAY?

### Inflation has risen sharply – will this continue?

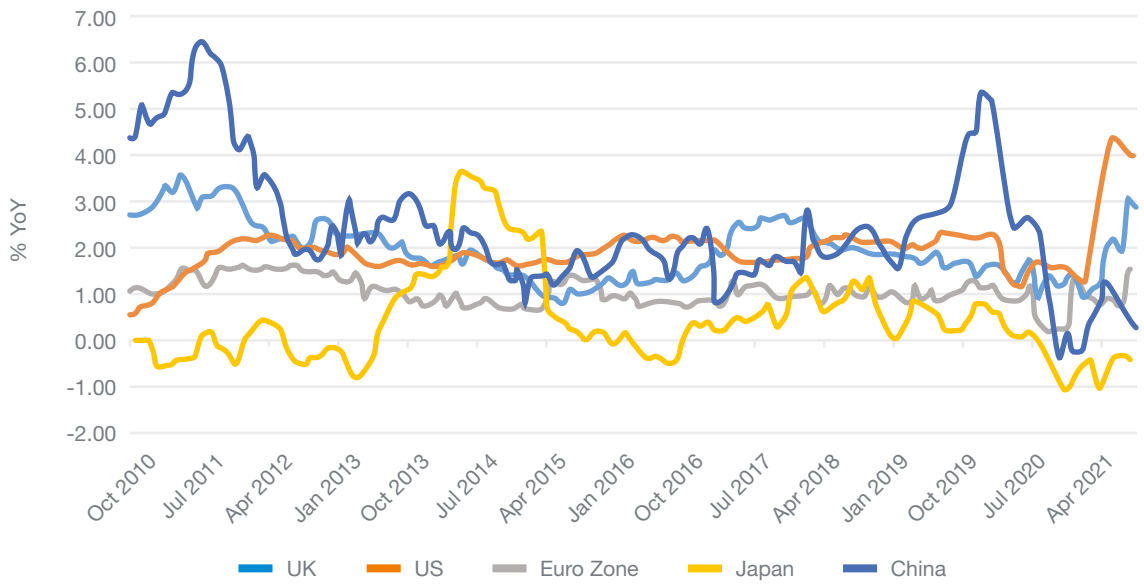
Inflation has surged over the course of 2021: the US consumer price index saw an annual increase of 5.4% June and July saw the highest readings since the 1980s. The UK has also seen a rise, with further increases likely ahead. Given the prevailing trend of low inflation prior to the pandemic, what has caused these surges? (Fig.1)

The first cause of these higher inflation readings is the "anniversary effect"– prices were weak in 2020 because the pandemic weighed on demand. This makes it easy for prices to be higher today.

Secondly, the economic recovery in many parts of the world has been vigorous, aided by fiscal measures that supported, and even boosted, consumption spending.

Thirdly, the recovery in the supply side of the economy has been slower causing supply and demand imbalances that have pushed prices up across a number of areas of the economy. In the UK, we have seen this illustrated in dramatic fashion. In energy, low supply of gas in the European market has pushed up prices, sending a number of energy providers under, and necessitating the energy regulator Ofgem to raise the price cap on energy. A shortage of hauliers has also forced up driver wages and

Figure 1: Change in Consumer Price Indices, % YoY




Source: Datastream

goods costs, while the global shortage of semiconductors has disrupted the auto market, pushing up the cost of used cars and other important sectors. (Fig.2)

How long should we expect this inflationary surge to last, and will central bankers respond? Some of the factors pushing up inflation will fade in time, and even kick into reverse. This includes the anniversary effect, as well as the fiscal stimulus boost to spending. Moreover, many goods are "price elastic", meaning that consumers purchase less of them when prices are high.

Other factors may be more persistent – global semiconductor supply shows signs of normalising but it will take time for the impact of gas prices to feed through the UK economy, because of the structure of the energy cap. Likewise, it may take time for UK firms to recruit and train enough hauliers.

While monetary policy tools can be used to respond to surges in inflation, they are ill-equipped to remedy these sorts of shortages; central bankers prefer to leave it to the market to resolve these imbalances. However, central bankers are vigilant of inflation, especially persistent, self-reinforcing changes in prices that threaten price stability.

For this reason, UK central bankers are closely monitoring the labour market, where vacancies are high and unemployment is low, leading to high wage growth. These higher wage costs must be either absorbed by employers, thereby hurting profits, or passed onto customers, pushing up prices.

While the end of the furlough scheme will have released extra workers into the UK labour market, the Bank of England expects no rise in unemployment at the end of the scheme, and stands ready to tighten monetary policy in order to head off inflationary risks. Even if the Monetary Policy Committee does not decide to raise interest rates, the current Q.E. programme ends in December, effectively tightening conditions.

Looking beyond the UK, the post-pandemic supply adjustment is a common theme across economies. Shortages and higher costs are beginning to weigh on business activity in some regions. As in the UK, central bankers are alert to the risk posed by inflation and in time are likely to tighten monetary policy. The pace and degree of tightening is expected to be modest, but this is likely to have a cooling effect on both the real economy and financial markets, with bond prices, and therefore equity valuations facing pressure.

## CHANGING CHINA

China has been a powerful driver of global growth for several decades now and, as the world emerges from the pandemic health emergency, Chinese growth is back in focus.

China is the world's second largest economy, and has sustained high growth rates consistently in recent years. Because it makes up such a large share of global growth, the global economy is sensitive to changes in Chinese growth and policies that may impact it.

Historically, weaker growth in import-intensive sectors has translated to declines in economic expectations elsewhere in the world. We saw this in 2015, when the European recovery was undermined by Chinese officials tightening regulation around the real estate sector, a policy which was swiftly reversed.

**Figure 2: Change in UK Second Hand Car Prices, % YoY**


Source: Datastream

### Quality over quantity

While Chinese officials continue to target high growth rates, the emphasis of China's economic policy is changing. In recent years officials have been seeking to balance high growth with economic reform. This includes diversifying away from the industrial sector, increasing regulation, and developing high-tech industries. Growth is likely to be somewhat lower as a result.

However, economic shocks, such as the China-US trade war and the pandemic, disrupted some of these reforms while policy makers supported growth. Now, reform is back in focus for China's leaders, especially regulation.

### Regulation, regulation, regulation

Policy makers are strengthening regulation to promote data security, market competition, social equality and financial stability. Financial regulation has long had the highly-leveraged real estate sector in its sights, a key source of risk to the financial system.

In 2020 regulators introduced rules to control debt levels in real estate businesses, which precipitated a crisis in China's second largest and most indebted property firm, Evergrande, earlier this year. Policy makers are sticking to their tough stance, refusing to bail the company out, to discourage businesses from taking on high debt levels. However, they are acting to limit any contagion risks within the financial system, and supporting the real estate sector, which indirectly drives as much as a quarter of the economy.

### Common prosperity

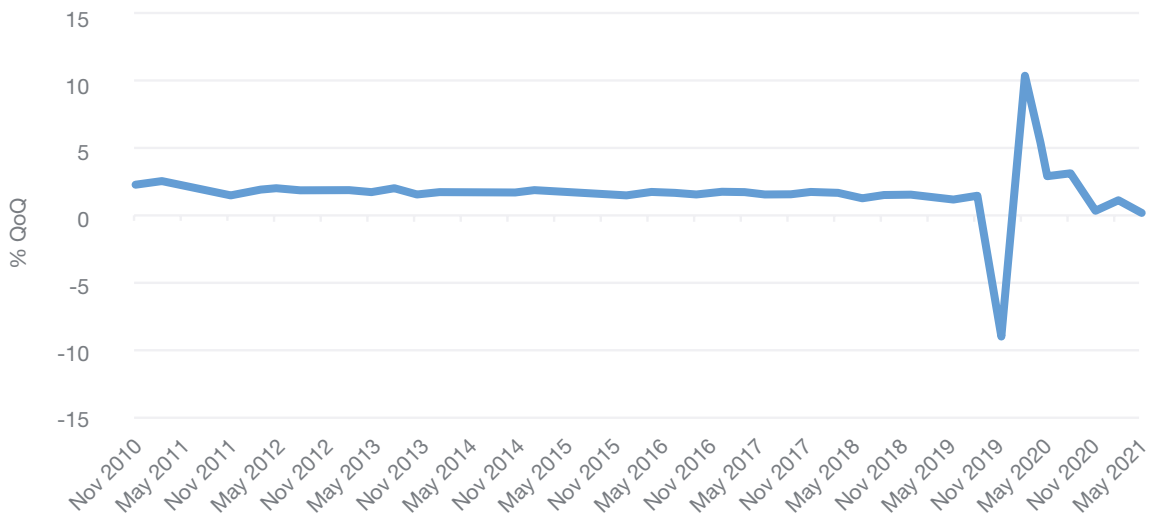
China has also embarked on a new five year economic plan, with a focus on technological self-sufficiency, internationalisation, and a greener economy. Having declared victory in the fight against poverty in China, policy makers are also seeking to achieve "common prosperity". This objective has made investors nervous, as it is unclear how far policy makers intend to take regulations to achieve greater social equality. Moreover, a number of high profile businesses were sanctioned by officials, calling into question China's support for private enterprise.

While Beijing has reiterated its commitment to private business, developing social services will be a costly business in coming years, and tax reforms are likely. The government is also likely to continue to intervene in essential sectors such as healthcare and education, providing an additional source of policy risk.

### Global consequences

China is moving away from delivering "growth at any cost" towards quality growth in strategic areas, with a greater emphasis on long-overdue regulation. The structure of China's economy is likely to change as a result, with a knock-on effect on the rest of the world. In the near term, controlled growth in the real estate sector may translate to weaker demand for industrial goods. Longer term, less state intervention for ailing businesses may diminish the perceived attractiveness of some Chinese investments, though greater financial regulation may strengthen the financial system.

Figure 3: Change in China GDP, % QoQ




Source: Datastream

## ACCELERATING CHANGE

The last few years have seen some significant changes, which present opportunities and challenges for investors. Some of these developments have likely been accelerated by the pandemic, while others have happened in parallel.

### Cryptocurrencies

Cryptocurrencies, such as Bitcoin, have been an area of increasing interest for investors in recent years, thanks to a number of unique properties:

**INDEPENDENCE:** Cryptocurrencies are currently not issued by a government and often their supply is fixed. This means supply is not impacted by monetary or fiscal policy.

**SECURITY:** Cryptocurrency transactions are secured through computational work within a "trustless system". Instead of relying on bank institutions or central authorities, the system's security relies on blockchain technology.

**PRIVACY:** Transaction and personal information is encrypted such that buyers and sellers can remain anonymous.

**EFFICIENCY:** Cryptocurrency transactions have the potential to increase efficiency of payment systems because all transactions are settled via consensus checking and automatically logged, requiring fewer intermediaries in the transaction process.

The pandemic emphasised the value of some of these features. Widespread use of fiscal and monetary stimulus caused inflation concerns, and some investors sought cryptocurrencies as a source of inflation protection. Independence from financial institutions was also attractive at a time when it was unclear how much disruption the pandemic might cause.

Cryptocurrencies becoming more mainstream has emboldened policy makers to integrate them into the financial system. In September, El Salvador made Bitcoin official legal tender, alongside the US dollar, seeking to lower the transaction costs of remittances from overseas Salvadorans, which equate to 20% of GDP. However, the growing popularity of cryptocurrencies also presents a challenge for financial authorities.

Firstly, cryptocurrency still largely sits outside the remits of existing regulation, making it hard for regulators to oversee financial stability risks. Secondly, should cryptocurrencies become a serious competitor to national currencies, this would have profound effects on the monetary system and the way central banks work.

With this in mind, it is unsurprising that many central banks are exploring the idea of their own digital currencies, and central bank digital currencies are likely to pose an increasingly powerful challenge to cryptocurrencies in coming years.

### Medical science

The pandemic has been a powerful catalyst for advances in medical research, most notably in the development of mRNA vaccines.

Rather than injecting a weakened virus into our bodies, mRNA vaccines teach the body to make a protein that triggers an immune response, to defend against the viral infection. This vaccine technology potentially has both improved efficacy and safety over the legacy vaccine technologies, alongside greater adaptability to protect against many other diseases.

Significant advances have also been made in the field of gene therapy, used to treat genetic diseases, which can be life threatening with few treatment options. Research into gene therapy has been ongoing for decades, but the recent success of a medication for Spinal Muscular Atrophy demonstrates that gene mutations can be treated, opening the door to treatments for other genetic diseases.

These developments are good news for global health and create some exciting investment opportunities, as these medicines have shown to be safe, efficacious and importantly cost effective to society.

### Climate change

Climate change poses a systemic risk to our investments across sectors but innovative technology and systems present means to manage climate risks and make for interesting investment opportunities.

This year we have seen an accelerated focus on climate from all sectors, as well as governments. There has been a rise in net zero greenhouse gas (GHG) emission commitments made by corporates and financial institutions, and US President Biden's first executive order addressed climate change. In the UK, an ambitious target of cutting emissions by 78% by 2035 relative to 1990 levels would bring the UK more than three-quarters of the way to net zero emissions by 2050.

A net zero world will be hard won. When the pandemic caused the global economy to shut down in 2020, global GHG emissions only decreased by around 6%. Limiting global warming to 1.5 degrees, as set out in the Paris Agreement, will require a 6% decline every year until 2050.

The 2021 United Nations Climate Change Conference, or COP26, will take place in November and is an opportunity for world leaders to accelerate the transition to a decarbonised world. We hope to see accelerated progress in three key areas.

**ENHANCED NATIONAL CONTRIBUTIONS:** Countries could target more ambitious reductions in greenhouse gas emissions.

**GREEN CLIMATE FUND:** An estimated, US$100bn is needed to assist developing countries in adaptation and mitigation practices to counter climate change.

**GLOBAL CARBON MARKET:** Leaders need to agree on the structure of a global carbon market, with international trade between countries.

## INVESTMENT IMPLICATIONS

Today, three policy levers are supporting global growth. Effective health policies have delivered vaccines to the world's major economies, allowing economic activity to restart and consumption behaviour to resume. While global vaccination rates are low, meaning that the pandemic will continue to disrupt the global economy for some time, the fact that vaccines have prevented hospitals from being overwhelmed is crucial.

Fiscal policies have provided a lifeline to households, with the bulk of government spending going to income support measures. While these measures have largely ended, they have boosted household savings. While fiscal packages will continue to support segments of the economy in Europe and the US, overall, we expect fiscal policy to become less supportive in the coming year and this may be less supportive of growth.

Monetary policy, which was eased at the start of the pandemic, broadly remains accommodative, though we have seen central banks beginning to tighten, or talk about tightening, monetary policy in response to the recovery in growth and inflation. Unless the health situation derails the recovery, we would expect to see tighter monetary conditions across the world's main economies. This is also likely to weigh on growth and inflation, though monetary policy will do little to ease supply side constrains in the wake of the pandemic and some of these trends may persist.

The dynamics that would support a more sustained change in the inflationary environment are not well understood but we are vigilant of signs that the period of low inflation that persisted since at least the financial crisis may be at an end.

Higher inflation is a reason to be cautious on bonds. The prospect of higher interest rates causes bond yields to rise, and therefore bond prices to fall, weighing on fixed income performance. This can also undermine the valuations of equities, because interest rates are used to value the future earnings of companies. Companies in growth sectors have been more sensitive to these movements, as a higher proportion of the value of such companies is due to high growth expectations in the future. However, equities also have exposure to the real economy, and earnings expectations should receive a boost from expectations of sound economic growth.

At the same time, we continue to believe that a number of structural changes are in play within the global economy, and that businesses exposed to these themes can make attractive investments. Moments of market turbulence, when stocks in these often richly valued sectors are repriced lower, may present buying opportunities.

# Conclusion

The impact of the pandemic continues to be felt globally. While effective health policy has allowed the demand side of the economy to recover in many of the world's major markets, the supply side of the economy remains constrained globally. Slower Chinese growth, tighter fiscal policy and some monetary tightening may contribute to weaker demand but supply side constraints may be longer lasting.

We are also monitoring changes to the global economy that have accelerated during the pandemic. Technological and policy advancements provide investment opportunities as well as disruption risks.
While higher inflation readings and the spectre of monetary tightening are likely to continue to weigh on bonds, we continue to like equities with long-term structural growth advantages at reasonable valuations.

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