KINGSWOOD

PROTECT AND GROW YOUR WEALTH

Q4 | 2021

INVESTMENT OUTLOOK

SUMMARY

- Supply bottlenecks are proving significantly worse than expected and now look set to continue well into next year.
- Global growth has slowed and the surge in inflation is proving more protracted than anticipated.
- Stagflation fears should prove overblown. Growth should remain quite strong and inflation fall back somewhat.
- Interest rates should start rising, over coming months in the UK and late next year in the US.
- Government bond yields should continue to head higher while corporate bond spreads remain around cyclical lows.
- Prospective returns for fixed income remain poor and significantly lower than for equities.
- The economic recovery continues to drive strong gains in corporate earnings and equities still have further upside.
- Within equities, we remain positive on the UK and Asia and a variety of specific themes, including climate change.

ECONOMIC AND MARKET OUTLOOK

The big development over the last few months has been that the supply-side bottlenecks facing the global economy, as it rebounds from its Covid-related collapse, are proving much worse than expected.

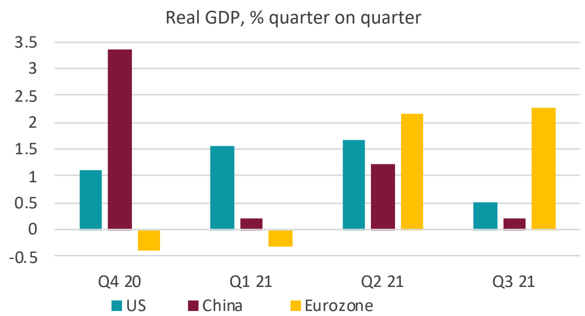
Rather than just lasting for a few months, the bottlenecks now look likely to continue well into next year. They are also turning out to be much more widespread than anticipated. For example, the shortage of semi-conductor chips has been most visible in its impact on new car production but it is also limiting output in many other areas. Bottlenecks in shipping have also been causing widespread disruption and energy shortages have recently only exacerbated the maelstrom.

The problems have not been confined to goods. Labour markets are also showing signs of stress with vacancies in the US and UK at record levels and firms finding it very hard to fill positions. People have not returned to the labour force as quickly as expected and those that have come back do not necessarily have the appropriate skills.

The big question now is how large and enduring an impact these bottlenecks will have on growth and inflation. Growth slowed considerably in the third quarter in the US and China, although not the Eurozone. This slowdown was a result both of bottlenecks and the lingering impact of Covid. Vaccination rates have picked up substantially in laggards such as the Eurozone and hospitalisation rates are down sharply. Nonetheless, the spread of the Delta variant is still, to varying degrees, imposing a drag on activity.

Bottlenecks are expected to ease next year as spending is re-oriented away from goods, where there has already been a sharp rebound, to services which are still relatively depressed. This, along with restocking by companies and some spending of the excess household savings built up during the pandemic, should offset the impact of waning fiscal support. We expect growth to be relatively strong in 2022 even though it is set to slow significantly through the course of the year.

Growth slowed sharply in Q3 in US & China but not Eurozone



Source: Refinitiv

Inflation has picked up sharply, particularly in the US where the headline and core rates are now running at 5.3% and 3.4% respectively. Inflation is significantly lower in the Eurozone and UK but will head higher over coming months and looks set to hit 5% in the UK in the spring.

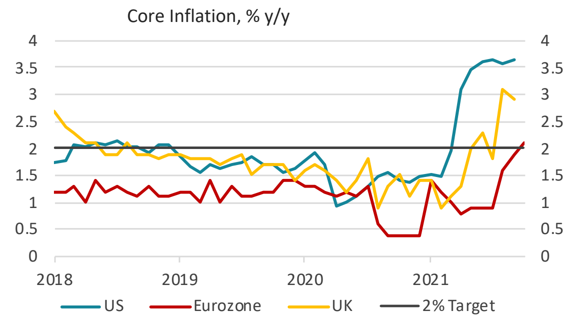
Much of the rise so far has been concentrated in particular areas such as used car prices. However, upward pressure has started to broaden out beyond these outliers as companies push cost increases onto consumers in the form of higher prices. Commodity prices have also risen to a 10-year high and are adding to the inflationary cocktail. Finally, wage growth is now picking up, increasing the danger of a wage-price spiral.

The risks of a sizeable inflation overshoot have clearly risen. Even so, our base case remains that inflation slows next year as shortages of both goods and workers lessen. Those areas where prices have risen most should see some of these increases unwound over the next twelve months.

All the same, we see inflation returning only to 2.5-3%, still rather higher than seen in the years running up to the Pandemic. Central bankers have until recently been adamant that the surge in inflation is only transitory. However, they have begun to change their tune and no longer see it falling back quite as quickly as they had earlier anticipated.

This in turn has prompted the monetary authorities to become rather more hawkish and bring forward their tightening plans. The Bank of England should raise rates over coming months and the market expects rates to be up at 1% by the end of next year. As for the US, the Fed is now starting to scale back or 'taper' its bond purchases. In addition, rates look set to rise a bit sooner and faster than before, with the first hike likely to occur late next year.

Inflation pressures have picked up substantially



Source: Refinitiv

Now central banks are beginning to withdraw the emergency support put in place during the pandemic, the policy environment is becoming less supportive for equity markets. Fears of stagflation, the nasty combination of low or no growth and high inflation, have also surfaced and equities witnessed their first 5% decline in a year.

However, the correction proved short-lived and the upward trajectory has resumed subsequently. As has been true all year, corporate earnings are a key factor driving equities higher, with results in the current reporting season once again beating expectations.

Earnings growth has slowed from the very high levels of late but should still be a strong 35% or so in the US in the third quarter. Companies generally seem to have pricing power, limiting any hit to profit margins from cost pressures.

We expect earnings to drive further gains in markets over the coming year as valuations look broadly sustainable, assuming no dramatic rise in bond yields. The global forward price-earnings (P/E) ratio is looking less stretched and is down to around 18x from a high of 20-21x last year.

Equities should also benefit from further inflows from investors. There remains a good deal of cash on the side-lines with no obvious alternative destination other than stocks which look considerably better placed than bonds in an environment of rising rates.

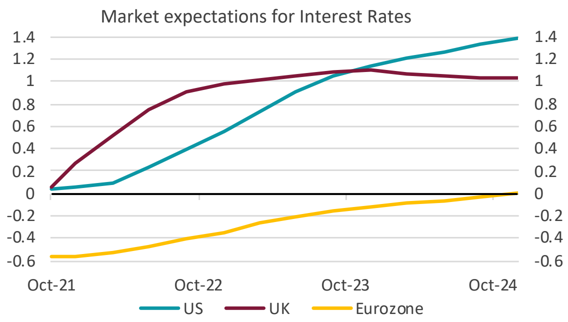
Even if inflation proves rather worse than expected, equities should still fare relatively well because of companies' improved pricing power. Only if central banks were then to slam on the brakes, triggering a recession, would they suffer badly.

While we believe equities should see further gains, we are also of the view that they could be quite volatile and their upside is not that great. All the same, they still look set to outperform bonds comfortably.

Bond yields have resumed their upward trend since July as inflation worries have worsened and central banks turned more hawkish. The rise has been largest in the UK with 10-year gilt yields at one point hitting 1.2%, their highest level since spring 2019 and up from a summer low of 0.5%. However, 10-year US Treasury yields have also increased from 1.2% to 1.6%.

We expect government bond yields to continue to head higher as inflation worries persist and rates start to move up. That said, the pace of increase should be considerably slower than in the last few months. Much of the shift in expectations regarding policy tightening should now be behind us. The unexpected fall in bond yields in the second quarter is also a good reminder that even if bonds are now in a secular bear market, there can be sizeable counter-trend rallies.

UK raising rates sooner and faster than elsewhere



Source: Refinitiv

With yields still very low and set to continue trending slowly higher, prospects for conventional government bonds remain poor leading to negative returns over the coming year. Inflation-protected bonds should fare somewhat better but while they provide protection against rising inflation expectations, they are vulnerable to any rise in real rates, that is after adjusting for inflation.

Corporate bonds should also perform rather better but returns are still expected to be no higher than 1-1.5% or so. The yield pick-up over government bonds remains close to historical lows at 1.0-1.2% and has no room to compress any further.

POSTIONING

We retain a constructive pro-equity stance. Our allocation to risky assets generally, and equities more specifically, is a little higher than we would expect to have over the long term. This still seems appropriate given our view that equities should outperform bonds appreciably on a risk-adjusted basis, even if their upside potential is no longer that great.

UK equities remain one of our favoured areas and in recent months have performed broadly in line with the rest of the world. Near term, they do face some headwinds from the early rise in rates and heightened stagflation worries. Longer term, however, they should benefit from their cheapness, with the P/E ratio now over 30% lower for the UK than the rest of the world. If as we believe, the rotation away from 'growth' into 'value' stocks has further to run, the UK should be a prime beneficiary.

Within our UK exposure, we retain a tilt to small and mid-cap companies. They have recently given back some of their sharp outperformance over the past year but their pro-cyclical bias means they still have some scope to outperform on the back of the economic rebound.

We also continue to favour Asia and emerging markets due to their relatively strong long-term growth prospects and cheap valuations. China has of late been the dominant driver of performance of these regions and has performed in line recently, having underperformed earlier in the year as a result of the regulatory crackdown. The latter, however, should be largely behind us as the government will be keen to avoid triggering a further slowdown in growth, with 2022 an important political year for the Communist Party.

Indeed, the authorities should do their best to contain the fall-out from the demise of Evergrande, China's largest property developer. We believe the longer-term attractions of China remain intact with its vast domestic equity market a fertile hunting ground for stock pickers.

By contrast, we remain cautious on US equities, which have recently seen a renewed bout of outperformance. Valuations are the main concern, with the US P/E ratio now just under 45% higher than elsewhere. This premium is considerably higher than seen in the past, other than very briefly last year.

The US should also suffer from any renewed move towards value stocks. In addition, tax and regulatory risk is rather higher than elsewhere. The authorities are intent on trying to rein in the tech giants and President Biden is planning to raise corporation taxes as a means of funding his Build Back Better spending plan.

We are broadly neutral on Europe. On the positive side, the vaccine roll-out has caught up the UK and US and policy looks set to remain more expansionary than elsewhere. The EU recovery fund is now starting to be spent and the ECB is unlikely to raise rates before 2023. Against that, equity valuations are not especially cheap and the underlying structural defects of the eurozone remain a longer-term concern.

We also have no strong view on Japan. The resignation of Prime Minister Yoshihide Suga led to a burst of outperformance. But this was then reversed as hopes of major change faded with the appointment of Fumio Kishida as his successor. Improving corporate governance and relatively cheap valuations remain supportive, but the economic recovery in Japan is significantly weaker than elsewhere.

Thematic investing remains a strong feature in our client portfolios. We have had holdings in technology and artificial intelligence for many years and plan to retain them. Valuations are on the high side but the results of the tech titans this year have confirmed the enduring strength of their growth models which should prove resilient to a rather harsher regulatory backdrop.

Climate change is another major growth area we are keen on. The COP26 summit means the attention of governments, companies and investors is now even more focused on this issue. We also have an allocation to healthcare. Ageing populations and rapid biotech innovation are attractions, as are cheap valuations.

Infrastructure is another theme we favour as it offers enhanced inflation protection and should do relatively well in this new higher-inflation environment. Finally, we have an allocation to frontier markets which has performed very well recently on the back of strong earnings growth and cheap valuations.

We retain a sizeable underweight to fixed income as prospective returns continue to look very limited. The majority of our exposure is to developed market corporate bonds of relatively short maturity, although we do have a modest holding of emerging market bonds where yields are more attractive.

We have only a relatively small exposure to conventional government bonds given they look set to deliver negative returns. However, we do have an allocation to inflation-linked bonds in the medium-to-lower risk portfolios to increase their protection against higher inflation.

Alternatives, which aim to provide moderate returns regardless of the moves in bonds or equities, also **continue to look attractive** given the poor outlook for fixed income. Finally, we have an **allocation to gold** where possible. The price has been fluctuating around $1800/oz, but continuing inflation concerns should push it higher in the medium term. It should also be a source of protection if there were a major sell-off.

MARKET VIEWS

	PREVIOUS VIEW	CHANGE	CURRENT VIEW	
ASSET CLASS				
Cash	●	-	●	Unattractive with interest rates so low
Fixed Income	●●	-	●●	Yields to reverse recent decline and return prospects are poor
Equities	●	-	●	Strong global economic rebound means equities still have some further upside
Liquid Alternatives	●●	-	●●	Considerably more attractive source of return and capital protection than government bonds
Commodities	●	-	●	Gold should offer protection against rising inflation and risk of another major sell-off
Property	●●	⇧	●	Illiquidity is a major problem and retail and office property face significant headwinds
FIXED INCOME				
Government Bonds	●●	-	●●	Strong growth and higher inflation to drive yields higher and outlook is for zero/negative returns
Inflation-linked Bonds	●	-	●	Valuations are expensive but offer protection against pick-up in inflation
Corporate Bonds	●	-	●	Spreads over government bonds are very low and prospective returns limited
EQUITIES				
REGIONS				
UK	●	-	●	Relative valuations are very cheap and should benefit from renewed rotation from growth into value
US	●	-	●	Valuations are very high and should suffer from renewed rotation to cheaper more cyclical markets
Europe	●	-	●	Growth outlook has improved following speed up of vaccine roll-out but market not especially cheap
Japan	●	-	●	Economic rebound has disappointed but market's cheapness remains an attraction
Asia/Emerging Markets	●	-	●	Strong long term growth prospects and cheap valuations but regulatory crackdown a drag on China
THEMES				
Infrastructure	●	-	●	Offers enhanced inflation protection and a beneficiary of increased government spending
Technology & AI	●	-	●	Strong growth prospects but headwinds from value rotation and tougher tax/regulatory backdrop
Healthcare	●	-	●	Ageing populations and biotech innovation are positives as are cheap valuations
Frontier Markets	●	-	●	Very cheap valuations are attractive as is structural reform and good demographics
Climate Change	●●	-	●●	Major focus for governments, companies and investors and has strong growth prospects
Small & Mid Cap Stocks	●	-	●	Cyclical bias means well placed to benefit from strong economic rebound

Our view reflects our assessment of the relative attractiveness of each asset class after taking into acccount its riskiness

Change = change in view over the last quarter

● = POSITIVE ● = NEGATIVE ● = NEUTRAL

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