



BREWIN DOLPHIN

Q3 2021: Quarterly Review

13 October 2021

At the end of the third quarter of the year, Guy Foster, our Chief Strategist, looks back at the events that have shaped the markets over the past three months.

Strong growth in profits provided a boost to company shares during the third quarter of 2021 but anxiety over the future tempered those gains. For most companies the worries surrounded the rise of inflation which has remained higher than policymakers expected. There are winners and losers from higher inflation but it brings with it some concerns. Future profits, for example, might not match those of the past if companies' costs go up but they can't pass on those costs to customers.

“

Some of the supply shortages can be blamed upon companies misjudging en masse about what lockdown would mean in terms of goods demand.

”

Too good to be true?

Prices have been rising for several reasons but most of them stem from the outbreak of the Covid-19 pandemic. The lockdowns which were instigated to control that spread meant the closure of shops which, in turn, was assumed to mean much less demand for goods. In fact, quite the opposite happened. Goods demand moved from the high street to the internet and, confined to their homes, consumers substituted their spending on services for spending on goods.

Where's my stuff?

Some of the supply shortages can therefore be blamed upon companies misjudging en masse about what lockdown would mean in terms of goods demand.

“

'Upstream' oil prices have been rising but towards the end of the quarter oil availability became an even greater problem 'downstream' as a shortage of HGV drivers made it difficult to get petrol to filling stations.

”

Central banks were also surprised by the strength of demand, having reached for their traditional recession-fighting policy tools as lockdowns were imposed. That meant cutting interest rates to boost demand and inflation, both of which were actually in plentiful supply for the economy as a whole.

Aside from misjudging consumer demand, logistics have also played a part. Getting goods from factories has proved to be a deepening challenge. Global long-distance goods transport costs rose as ports became congested (partly through sheer volume) whilst some Chinese ports were temporarily closed to contain Covid-19 outbreaks. Every ship standing idle waiting for a berth to become free for unloading further reduces transport capacity. Passenger flights have been the willing conduits for small, valuable or perishable goods travelling long distances. With fewer passenger flights due to travel restrictions, that capacity has been lost as well.

Fuelling anxiety

Typically, the most volatile form of inflation for consumers and businesses is energy prices, the most volatile

component of which is normally oil. 'Upstream' oil prices have been rising but towards the end of the quarter oil availability became an even greater problem 'downstream' as a shortage of HGV drivers made it difficult to get petrol to filling stations. The world looks forward to a time when fuel price volatility will be a thing of the past due to reduced reliance on fossil fuels. However, that time is not now.

Aside from logistics, the oil market has suffered from the same misjudgement of demand and supply with the expanded Organisation of Petroleum Exporting Countries (OPEC) keen to limit additional energy supply to the market for fear of causing prices to collapse. At the same time, in recent years oil companies have reduced their investment in fossil fuel reserves due to concerns over the long-term demand for this polluting fuel. This has particularly affected OPEC's big rival, the US shale oil industry, which has been slow to respond to rising prices.

In the short term, rising energy costs meant some of the more polluting forms of energy became less expensive than cleaner alternatives. The most obvious example of this is natural gas, the cost of which rocketed during the summer, prompting a gas-to-oil switch. The confluence of additional factors all contributed to the rise. Russia is rebuilding its stockpiles; Norwegian production was lower than normal due to maintenance work. China ended the summer by instructing state-owned companies to secure supplies of energy commodities at any cost, meaning tough competition for European power producers trying to secure cargoes of liquified natural gas (LNG). Northern Europe's great strides in building wind power generation have given a disappointingly low yield due to a lack of wind.

In short, from a supply perspective it seems like anything that can go wrong has gone wrong.

“

At some stage Russian gas reserves will refill; queues at ports will be cleared; air travel will resume; and consumers will prioritise services over goods.

”

Where next?

Oil price inflation often comes in bursts as higher prices prompt more supply, bringing the market back into balance or even over-supply. The same can be said for many of these other inflation categories as well. At some stage Russian gas reserves will refill; queues at ports will be cleared; air travel will resume; and consumers will prioritise services over goods. This can be compounded when consumers need to prioritise their spending on expensive fuel, thereby reducing demand for other goods.

Supply chain managers are wary of what they call the bullwhip effect whereby the cumulative effect of small changes in consumer demand can be amplified as they work their way down the supply chain, causing a market to swing from under-supply to over-supply very rapidly.

In the aftermath of the financial crisis inflation first plunged, then soared, mirroring the swooping performance of oil prices. That experience certainly prepared central banks for the fact that they might find themselves maintaining low interest rates even as reported inflation rates might be quite high. But, as we have seen, the causes of the latest wave of inflation have been much broader than that and the effects will be longer lasting, creating a conundrum for policymakers.

“

Going into 2022 it seems likely that monetary policy will be tightening to some extent.

”

Having seemingly made the mistake of very loose monetary policy whilst demand was booming and inflation soared, should they now reverse course? Should they tighten monetary policy when inflation is likely returning to normal anyway? Might their actions, along with the unpredictable nature of the bullwhip, ultimately cause an undershoot of demand? But if they do nothing and inflation remains above target, could consumers come to expect higher inflation in the future? And would that mean the forfeiture of the decades of work fighting to anchor inflationary expectations among consumers?

Take a hike

The Bank of England seems to have decided to be proactive on this topic. Its comments conditioned the market to expect two interest rate increases in the first half of 2022 alone. Although this will leave interest rates far below the current level of inflation, this policy stance is quite aggressive by comparison with other central banks. Some way behind is America's Federal Reserve. It will slowly reduce its asset purchases (quantitative easing) and may increase interest rates by the end of 2022.

Seemingly in no hurry to meaningfully tighten monetary policy is the European Central Bank, perhaps scarred by two misplaced rate hikes during the recovery from the last global crisis, which needed to be quickly reversed and more. Going into 2022 it seems likely that monetary policy will be tightening to some extent.

China

The one major central bank where there is most room for doubt is the People's Bank of China. That's because China faces the same inflationary challenges as the rest of the world and some other challenges besides. The most obvious of these is President Xi Jinping's regulatory crackdowns. The president has long harboured concerns over the incompatibility of capitalism and China's broader goals. China, for example, wants to raise its dwindling fertility rate which the high cost of private education was impeding. The government therefore announced that the sector will now be run on a not-for-profit basis with devastating effect for the companies operating in that market. Worried about children spending too much time on their screens? The Chinese Communist Party ruled that children may spend only three hours a week playing video games.

Perhaps the most significant restrictions, however, are those being implemented to address the dysfunctional Chinese property sector. Along with education and health, home ownership is one of the three mountains that Xi Jinping believes Chinese society must conquer in order to deliver a prosperous society. Reforming the real estate sector would mean less speculation in housing – houses for living in, not investing in as the president puts it. It would also reduce the accumulation of financial risk in the Chinese economy.

Collateral damage in this latest push is the former second-largest Chinese property developer: a company called Evergrande. Due to its size, leverage and breadth (across real estate development and the backing of

wealth management products) Evergrande is seen as a potentially systemic risk to the financial system. Historically China has been ready to bail out companies that fail to avoid losses to creditors. However, in recent years the mood has shifted towards investors taking responsibility for their own bad decisions. The expectation is that this subtle shift means that investors may pay penance for the lending they offered to Evergrande but that those losses should not be allowed to ripple too far throughout the financial system, and most importantly consumers should be protected from the failure.

So after a remarkable year for stocks that saw vaccinations and profit recoveries vanquishing anxiety from investors' minds, there is a new realisation that the path from here may not be so easy. However, the reason central banks have been so reluctant to tighten policy is because unemployment is still too high. The process of bringing it down means getting people into work, allowing them to spend, and driving growth and profits. Anxiety over inflation has to be seen in that context, and in the context of the diminutive returns which can be made keeping money on deposit.

“

I continue to believe that the American people have a love-hate relationship with inflation. They hate inflation but love everything that causes it.

Former US Treasury secretary William E Simon

”



Guy Foster, Chief Strategist

Guy leads Brewin Dolphin's Investment Solutions team working to align our investment capabilities with the needs of clients. He also provides recommendations on tactical investment strategy to our investment managers and strategic recommendations to the group's Asset Allocation Committee. Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. He frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.

Visit us online at www.brewin.co.uk

www.facebook.com/brewindolphin twitter.com/brewindolphin www.linkedin.com/company/brewin-dolphin

The value of investments, and any income from them, can fall and you may get back less than you invested. Neither simulated nor actual past performance are reliable indicators of future performance. Investment values may increase or decrease as a result of currency fluctuations. Information is provided only as an example and is not a recommendation to pursue a particular strategy.

We or a connected person may have positions in or options on the securities mentioned herein or may buy, sell or offer to make a purchase or sale of such securities from time to time. In addition we reserve the right to act as principal or agent with regard to the sale or purchase of any security mentioned in this document. For further information, please refer to our conflicts policy which is available on request or can be accessed via our website at www.brewin.co.uk.