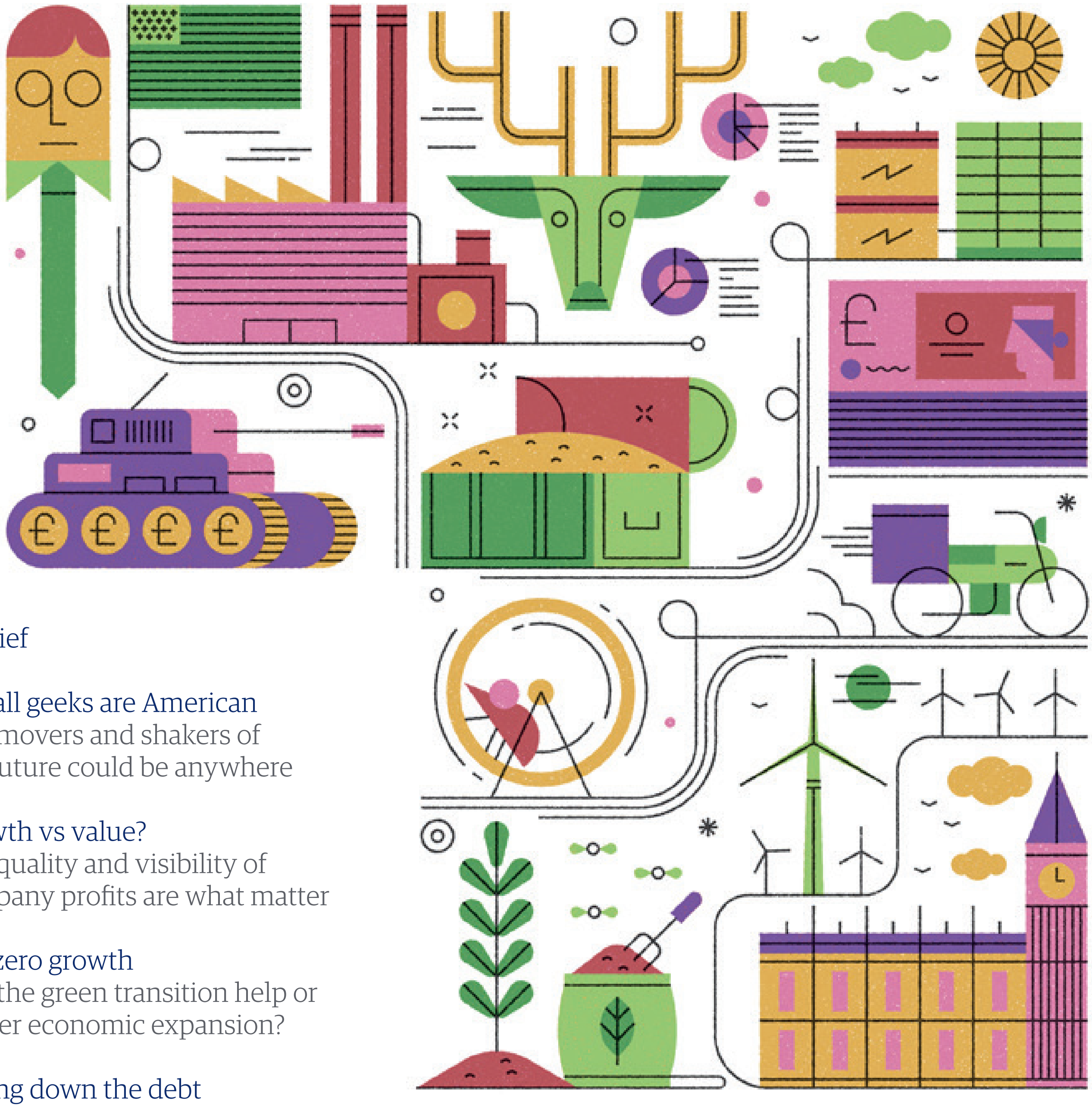
Investment*Insights*

Issue 31 – First quarter 2022

Looking for the stag in stagflation

Although consumer prices have been rising rapidly, they're likely to fall back this year and the risks of entering a period of stagnant growth remain remote



In brief

Rathbones
Look forward

Foreword


The final quarter of 2021 proved to be an eventful one for the global economy, with surging inflation and ongoing concerns about supply shortages. Yet markets performed relatively well over the period despite the new Omicron strain adding to the uncertainty. As we look ahead to 2022, economic indicators suggest the post-COVID recovery should continue, and so too should earnings growth.

Our lead article looks at the buzzword of the moment – stagflation. As investors' fears of the potential stagnation of output coupled with rising inflation ebbed and flowed, equity and bond markets experienced some volatiliy. What will this uncertainty mean for the year ahead?

On page 5, we look at the domination of the markets by US-based tech firms, as we ask if all the geeks are American. Where should we look to for the next wave of tech innovation (and investment opportunity) – and is it necessarily going to come from across the pond?

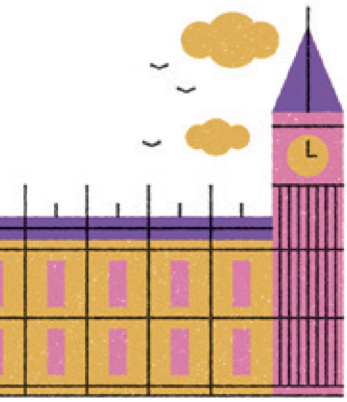
After the initial wave of selling amid the first lockdowns in March 2020, global equity markets have been on a more or less upward path, but leadership has shifted from one style to another. But rather than focus on styles, such as 'growth' versus 'value', we explain why we think the best approach is to look for companies with quality and durability of earnings growth, whatever style category they might fit into.

On page 8, we explore whether the transition toward a world of net-zero carbon emissions will boost overall economic output or hinder it. There is hope that it could have a net positive effect, but governments and business need to start taking action now to avoid a more disruptive transition.

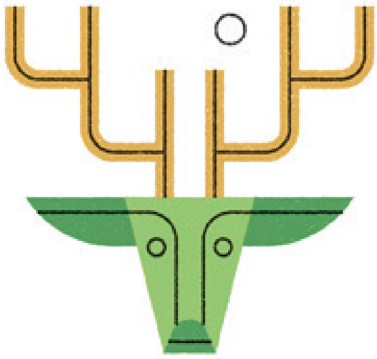
Lastly, on page 9, we focus on the UK's large 'credit card' bill, as pandemic related borrowing starts to come due. Having borrowed more in the 2020/21 fiscal year than at any time since records began in 1946, more of this debt will have to be absorbed by the market if the Bank of England starts to wind down its purchases of gilts this year. That's one of a number of factors that make us cautious about UK gilts.

We hope you and your family remain healthy and safe. We also hope the new year will bring more of a return to normal, including the chance to meet and collaborate once again. In the meantime, we will continue monitoring how the investment environment is evolving as the world reopens and we start to see what the 'new normal' looks like. Please visit rathbones.com to find out more about our latest views.

Liz Savage and Ed Smith
Co-chief investment officers



Inflation is high but the pace of economic growth isn't stagnating



Global equity and bond markets had a bumpy end to 2021 as investors began to fear the worst of both worlds – stagnating output and persistently rising inflation, that nasty combination called stagflation. While we do think inflation will begin to fall back from the spring, there is considerable uncertainty around its outlook. However, fears of stagnating growth look overdone.

We see encouraging signs for equity investors in purchasing managers indices (PMIs) of global business activity and other leading economic indicators. In general, they remain strong and consistent with continued momentum in company earnings growth. These indicators are moderating from their extreme highs as economies initially roared back to life from pandemic-related shutdowns. But we are a long way from stagnating growth, much less a contraction.

As the post-COVID recovery enters its next phase of expansion, we think business investment is likely to be a driving force. Both in the US and worldwide there is evidence of a strong pick-up in business capital spending (capex) plans. As well as preventing stagnation, this factor is also likely to ease inflationary pressures.

More and better tools lead to enhanced productivity growth; better productivity puts downward pressure on unit labour costs; and unit labour costs tend to correlate with core inflation (figure 1). Minutes from the latest meeting by the US Federal Reserve (Fed) have also noted anecdotal evidence of the increased use of automation by many businesses in the face of ongoing labour market shortages.

Equity investors can also appeal to history for some level of comfort. Profit margins nearly always expand during periods of economic growth (with sales going up by more than costs). In addition, since the turn of the last century, profit growth has only failed to beat inflation during the great depression of the 1930s and in 1910.

Looking for the right signal

The yield curve has started to flatten again (financial market shorthand for a narrowing difference between the yields on longer versus shorter-dated US Treasury bonds) and some investors are citing this as a reason to be negative. That's because it's seen as signalling rate rises in the short term and slowing growth further down the line. However, a flattening yield curve is not on its own cause for alarm.

The relationship between yield curves and the business cycle – or GDP growth or stock market returns, for that matter – is not linear. After the yield curve flattened over the summer, an argument was floated along the following lines –the yield curve is flattening, it may invert next. While an inverted curve (when longer-dated yields fall below short-dated yields) tends to be associated with impending recession (figure 2, overleaf), that doesn't mean that a flattening but still upwardly sloping yield curve denotes a sub-par environment that should cause investors concern.

Since the relationship is not a linear one, many analysts (including us) transform the signal sent by the yield curve into a probability of recession using what we call a non-linear model. Even in September, after a summer of flattening, the yield curve still suggested a 0% chance of recession according to this model.

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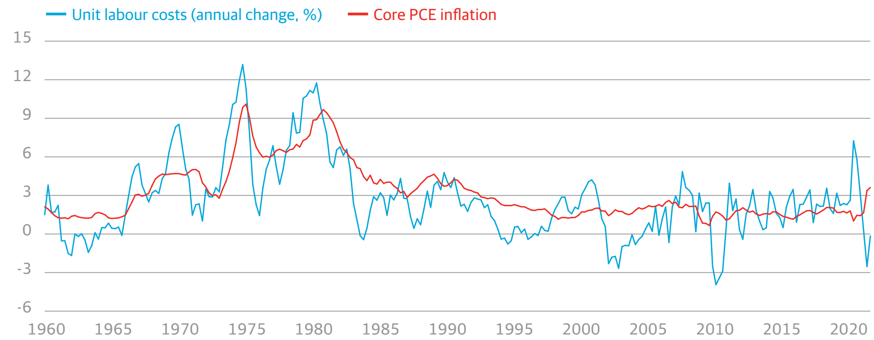
Figure 1: Unit labour costs and inflation

Wage inflation tends to correlate with core inflation, represented here by the Fed's favoured Personal Consumption Expenditure (PCE) measure..



Source: Refinitiv, Rathbones.

Past performance is not a reliable indicator of future performance.

In fact, because yield curves start to flatten mid-cycle, a recent study in the Journal of Investment Management (JoIM) found that flattening is actually associated with a more stable growth environment – that's good news for investors, not bad.

Another crucial lesson to heed is that the window between inversion and recession tends to be long, 14 to 15 months on average, and has been getting longer with time. This makes it harder for investors to use the yield curve as a signal, as equity markets only lead recessions by three to six months. Selling equities as soon as the curve inverts could cause you to miss out on rising stock prices for rather a long time, let alone selling them when the curve starts to flatten.

Regaining some balance

The big worry for 2022 is the potential trade-off between growth and inflation, for a corollary of 2021's growth bonanza has been steeply rising prices, as we've noted in this quarter's *Investment Update*.* US inflation has reached a three-decade high – UK inflation is likely to do the same in the spring – and there is an unusually wide fan of possible outcomes from here for investors to be alert to.

Overall, excess inflation is primarily about the unusual composition of spending. Consumer goods inflation rose in line with spending on goods. Demand here has fallen sharply, and it is difficult to see how consumer goods inflation could stay elevated for too long without the demand.

High inflation in consumer goods is unlikely to fully pass over to high inflation in services as spending normalises. Our base case is for global inflation to fade meaningfully from the spring, but to remain elevated until at least 2023. Much depends, however, on a resumption of normal spending patterns, which could be stalled by Omicron.

Central bankers have been clear that there is little they can do to stem the unique causes of today's inflation, but that they are more mindful to tighten policy as output and employment are strong. Rising rates would ordinarily be a headwind to valuations, but markets are already pricing for a substantial number of rate hikes in the US, UK and Europe. Both the Bank of England and the Fed made surprisingly hawkish changes to policy in December and bond and equity markets were unperturbed.

Keeping an eye on earnings

Still, our relative optimism shouldn't lead us to be complacent about the many challenges facing investors in the year ahead – after the blistering gains in equity markets coming out of the worst of the pandemic, it's likely to be a difficult year by comparison. One major challenge will be to work out where the next leg of growth is going to come from, while also navigating the supply chain and labour market disruptions and government debt burdens that the pandemic is leaving in its wake.

We would be cautious about having any significant bias toward a particular style, especially highly valued 'growth' companies or 'cyclical' shares that are more sensitive to broader economic conditions. Both of these could come under pressure if bond yields resume their rise or the economy stutters. There has been relatively little differentiation between these and other investment styles this year, which is typical in the middle of the economic cycle when the initial spurt of growth has peaked.

In the article 'The quality and visibility of company profits are what matter' on page 6, we explore more about why we think a 'bottom-up' focus on companies with persistent momentum in generating good-quality, growing profits makes sense, irrespective of styles. Strong earnings momentum can be found in both value and growth, cyclicality and defensiveness, and these more 'top-down' macro factors are likely to be a less relevant source of differentiation.

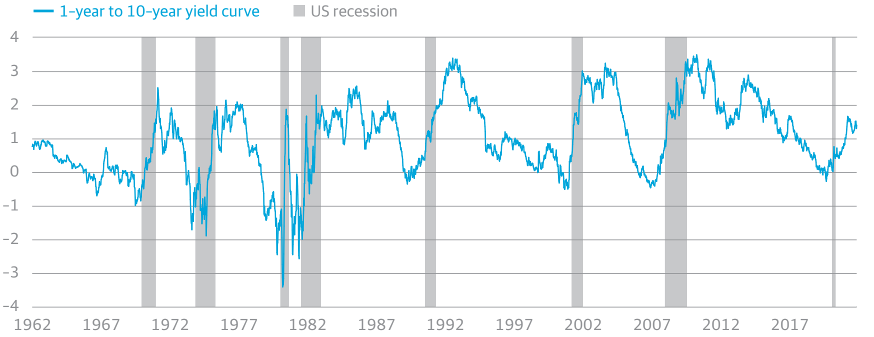
In the US and other major markets, average earnings continued their streak of comfortably beating expectations in the latest quarterly results, though guidance on future earnings was more cautious than expected. Supply chain disruptions and labour supply shortages could also continue to weigh on profit margins and need to be watched carefully on a case-by-case basis. Still, though caution in the face of uncertainty is warranted, the bar for earnings expectations in 2022 may now be set sufficiently low to limit the risk of disappointment.

* www.rathbones.com/knowledge-and-insight/quarterly-investment-update-surprisingly-stellar-2021-and-unusually-uncertain

Our relative optimism shouldn't lead us to be complacent about the many challenges facing investors in the year ahead.

Figure 2: The yield curve and recessions

While an inverted curve tends to be associated with impending recession, that doesn't mean a flattening but still upwardly sloping yield curve is a reason for investors to be concerned.



Note: The difference between 10-year and one-year US Treasury yields is used here to represent the yield curve
Source: Refinitiv, Rathbones.

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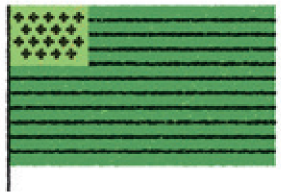
The movers and shakers of the future could be anywhere



We often get asked if US equities are in a bubble. Bubbles are characterised by the separation of asset prices from their fundamental value. The outperformance of US equities – and particularly America's technology giants – has been driven as much by their earnings growth as by their valuation. Unlike the tech stocks at the turn of the millennium, these companies generate billions of dollars of earnings growth, even though they also spend billions on research and development and other intangible items, which accounting rules don't allow them to 'capitalise' (effectively spread out over a number of years) and instead get subtracted from earnings immediately. Our research suggests that adjusting earnings and book value for what we call "knowledge capital" and "organizational capital" makes their valuation multiples look far less lofty.

Much of the difference in the valuation of these American companies and more averagely valued ones in the global index can also be explained by interest rates. American tech companies' earnings are expected to grow at a higher rate for longer than the average business. That means more of today's price is determined by future earnings, and so it's more sensitive to the discount rate used to translate tomorrow's earnings into today's money. As interest rates have fallen, American tech valuations have risen. None of these things suggest a separation of prices from reality.

That said, as new technologies come to the fore we must ask, are all the geeks American, and do they all work for the US tech giants? Of course, the US tech sector is and will remain a big driver of innovation and overall earnings growth, but future investment opportunities could be spread more widely.

A competitive advantage

As we explore in our lead article, investors have been wrestling with the implications of post-pandemic reopening in terms of inflation, monetary policy and stock market leadership. For long-term investors like Rathbones, it makes sense to focus on those companies that can benefit from their durable competitive advantages.

Research by investment bank Goldman Sachs suggests opportunities for investing in these future "innovators, disruptors, enablers and adapters" can be found across virtually all sectors, including retail, healthcare and other more traditional industries.

With the world's focus turning to a green transition, this could have the effect of amplifying innovation and disruption in industries like energy, utilities, industrials and transportation. Companies already using technological innovation to help drive the green transition can be found across a wide spectrum of industries and geographies, from small hidden gems to large established brands.

Goldman's research suggests the split is fairly even across North America, Europe and Asia. That compares with a much greater US concentration of about 60% in the current makeup of the MSCI World Index, for example (figure 3). Another case for having an active investment approach, rather than passively tracking an index.

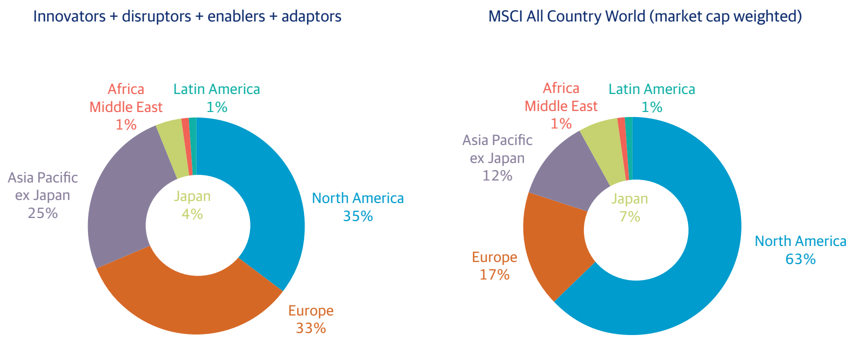
More winners to choose from

A repeated question in recent years – which has been amplified by the pandemic – is whether investors are at greater risk of relative loss if they don't pick the winners. This has tended to be shorthand for that elite club of US tech giants. What the question boils down to for investors is whether the largest earners are increasing their share of total earnings – or what we might call winner takes all. Research we conducted in 2019 showed that, while the share of the largest earners was indeed large, it hadn't changed much over the past 30 years. If anything, that share had been decreasing in more recent years.

While we're not claiming to have found the winners of the next 10, 20 years or more, we believe there is good reason to think there will be plenty of opportunities across many and varied sectors, and in lots of different places. That's good news for active global investors like ourselves – as well as for our clients.

Figure 3: Geographical breakdown of headquarters location

Research suggests tomorrow's winners can be found across virtually all sectors, including retail, healthcare and other more traditional industries.



Source: Goldman Sachs.

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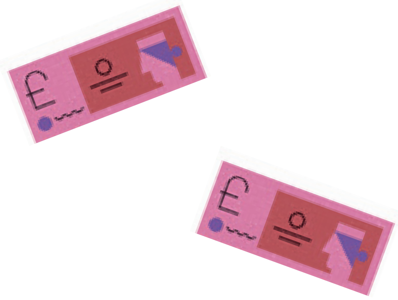


The quality and visibility of company profits are what matter

Global equity markets have been on an upward path more or less since their precipitous drop in March 2020, when the world first went into lockdown. Over the course of this nearly two-year advance, leadership has passed from one investment style to another. But rather than choosing broad styles like growth or value, we believe a more company-specific focus on the quality and durability of profits will continue to be the best guide for finding long-term returns as the world moves on towards a post-COVID normality.

The market's recovery was initially driven by the swift reaction of Western governments to lockdowns, limiting the potential for them to cause permanent structural increases in unemployment and losses to economic productivity.

The investment styles of 'defensive growth' and 'quality' initially led the recovery in 2020 as investors shifted towards beneficiaries of COVID-driven changes. They include consumer staples that were favourably exposed to increased consumption as people spent more time at home (such as packaged food and dishwasher tablets) and technology companies which facilitated and benefited from an acceleration in e-commerce and in remote working and networking (defensive growth). Companies with recurring and predictable revenue streams (quality), affording them earnings resilience, were favoured over so-called cyclical companies whose demand was more sensitive to economic conditions.

The unique conditions of the COVID downturn, in which lockdowns restricted mobility and caused entire purchasing channels such as restaurants and high street stores to be shut down for extended periods of time, led to weakness in businesses reliant on footfall, which would have held up much better in more conventional downturns. Conversely, some sectors that tend to be cyclical in more 'normal' circumstances, such as semiconductors, proved to be far more resilient as they benefited from a surge in investment in the computers and remote hosting of cloud software applications that facilitated remote working.

Following the November 2020 announcement of effective vaccines, market leadership shifted to the sectors and stocks that had underperformed through the initial pandemic crisis and would benefit from a normalisation of economic activity (figure 4). Companies that become known as 'recovery' stocks were found in both traditional value areas (which typically trade at lower valuations), such as energy and banks and so called 'cyclical' companies that are more geared to economic recovery, such as travel and leisure, which had suffered from COVID-related closures and weakened demand.

Persistent performance

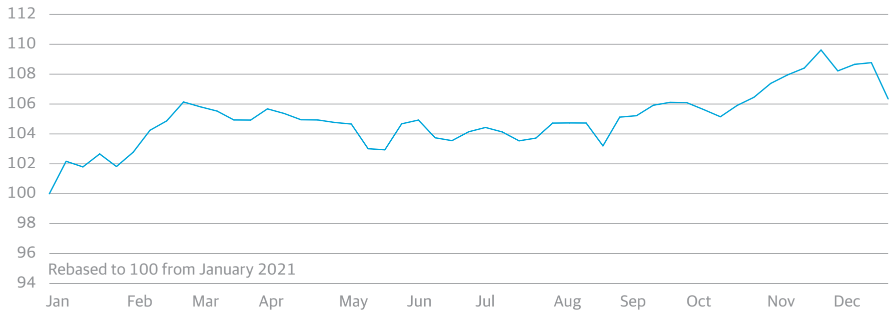
The outperformance of these recovery stocks persisted until February 2021 and the emergence of the Delta variant, when concerns about the pace of recovery temporarily reasserted themselves. Since March 2021, there has been relatively little differentiation between value and growth investment styles, or between cyclicality and defensiveness. Earnings momentum and revisions to earnings forecasts have been the key determinant of stock performance. This is not surprising, as it is what tends to happen in the middle of an economic cycle, after the initial spurt of growth at the start of the recovery.

The rebound in economic activity has been so robust that it has created bottlenecks in the supply of various economic inputs, from labour to commodities and freight services, which since the second quarter of the year have caused heightened inflation concerns for business owners and policy makers alike. This has created a volatile and uncertain environment for profit margins and corporate earnings, which has only been exacerbated by the emergence of the Omicron variant.

Further uncertainty surrounds the pace and timing of monetary tightening as authorities respond to inflationary pressures proving less transitory than had been initially expected. Rising short-term bond yields (figure 5) are typically not conducive to segments of the market with higher or more defensive growth rates. As more of their price today is determined by future earnings (compared with the average company), they are more sensitive to these short-term yields, which provide the discount rate that is used to translate tomorrow's

Figure 4: Global performance of cyclical relative to defensive sectors

Cyclical sectors have given back some of their earlier outperformance as style leadership has shifted over the course of 2021.



Source: Refinitiv, Rathbones.

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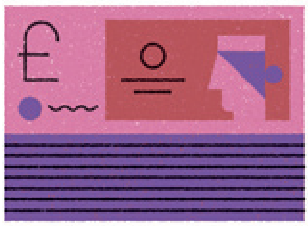

earnings into today's money. Yet some of the leaders in these sectors have thrived and indeed re-rated in what is turning out to be a productive environment for stock selection.

One example is software giant Microsoft, which reported 22% sales growth in the third quarter of 2021 driven in particular by Azure and cloud services as well as the ongoing rollout of subscription services such as Office 365 and Dynamics 365. Another is spirits company Diageo, which was initially hit by the COVID-driven closure of bars, but swiftly used its market leading data analytics and agile business model to pivot its marketing and distribution towards at-home drinking occasions. Of course, this past outperformance may not be repeated as the recovery moves into its next phase and beyond, but it highlights the need to look to company specifics rather simply focus on particular styles.

Recovery from the lows

Many 'COVID victims' have enjoyed a recovery from depressed levels of profitability and share price, but others such as travel-related stocks have continued to languish as full reopening and normalisation have been delayed. The value sector of mining has also seen more muted performance because of its reliance on demand for iron ore from Chinese construction and infrastructure development. After surging in 2020, the curtailment of these activities and the travails of the Chinese property development sector have led to a collapse in iron ore prices in recent months.

Many of the stocks that enjoyed outperformance in 2021 benefit from structural tailwinds which have persisted throughout the last two years almost irrespective of COVID (and often accelerated by it). These include the increased penetration of cloud-based software and services, the inexorable rise of e-commerce (along with digital media, online gaming, online food delivery and other aspects of online consumption), growing automation and digitalisation of industry and increasing electrification of energy systems and transport.

Electrification is part of a wider structural trend of investment in sustainability and transition towards a more renewable-energy-based system. The ever-increasing importance of this transition to 'net zero' carbon emissions was evidenced by government and corporate commitments around November's COP26 climate change conference in Glasgow. (You can read about the investment implications of COP26 in our post-COP *InvestmentUpdate** and about the global economic impact in our article 'Will the green transition help or hinder economic expansion?' on page 8.)

A key factor for success in 2021, given the sharp rise of inflationary pressures, has been inflation sensitivity (how flexible companies can be in finding lower cost inputs, and/or how well they can pass on higher costs to customers), which is generally a function of strong competitive advantage and differentiation, high switching costs and relatively sticky customer demand.

The low-hanging fruit of recovery has been reaped and performance will likely continue to be driven less by any particular investment style than by picking the stocks with the best earnings momentum – underpinned by structural growth drivers and a strong business model that is resilient to inflation. As the initial recovery comes off the boil and enters its next phase of normalisation, a balanced approach seems warranted, including exposure to companies in both the growth and value camps (you can read more about our views on the economic outlook in our lead article on page 3). Whatever the style, emphasising these company-specific qualities seems to us to be the best method for generating future returns.

* www.rathbones.com/knowledge-and-insight/investment-update-cop26-good-cop-or-bad-cop

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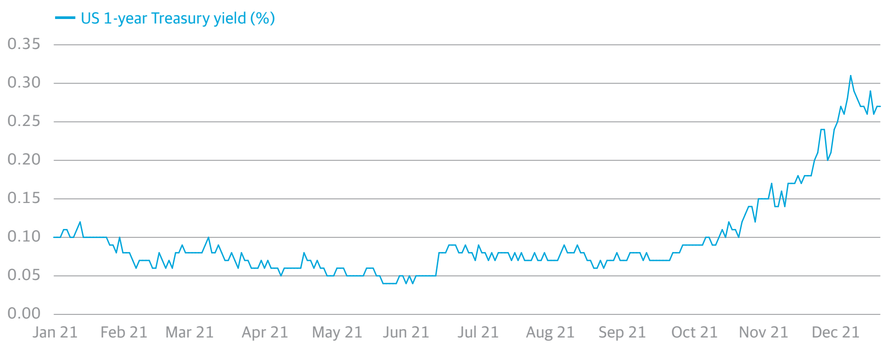
Figure 5: Short-term US Treasury yields are on the rise

Rising short-term bond yields are not typically conducive to segments of the stock market with higher or more defensive growth rates.



Source: Refinitiv, Rathbones.

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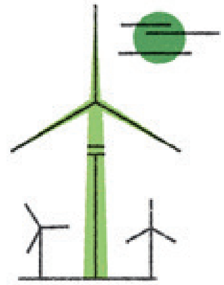


Will the green transition help or hinder economic expansion?

A key question for investors over the first half of this century, and one for which there is a lot of diverging opinion out there, is whether the move toward 'net zero' carbon emissions will help or hurt economic growth. Though the recent COP26 global climate summit in Glasgow had its disappointments, we remain hopeful that governments and businesses will avoid a negative impact from this transition by taking sufficient action sooner rather than later.

A recent report from the International Energy Agency (IEA) concluded that annual investment in the energy industry will need to rise from $2 trillion today to $5 trillion by 2030 if we are to transition to a net zero world. But you can't simply add that extra $3 trillion per year to annual GDP and say 'happy days, more growth'.

That would be to ignore the question of where that $5 trillion dollars is coming from. Capital doesn't grow on trees. It's most likely to come from capital that otherwise would've been invested elsewhere. In which case, will this net-zero transition lead to less innovation, less productivity growth than if this capital wasn't diverted from elsewhere? That's a really crucial question.

An optimistic outlook

We are optimistic for a couple of reasons. First, some of this investment is likely to be in public infrastructure, which encourages lots of job creation and investment and raises productivity. The second reason is that the fall in the cost of clean energy technology has exceeded even the most optimistic expectations from 10 to 20 years ago. There is some interesting evidence that the change in the cost of climate-change fighting technology assumed by many of the models used to determine the economic impact is too slow.

If you assume the cost of these technologies falls at a pace similar to what we have seen in many other technologies in the last 50 years, you might find that the transition actually boosts growth. Including the first industrial revolution we have had five great waves of productivity growth: energy revolutions have been involved in four of them. So why can't we have another industrial revolution powered by cheaper green energy?

That's the optimistic view. Economists at the Bank of England (BoE) and the Network for Greening the Financial System (NGFS) suggest the transition to net zero is likely to reduce GDP by 2050, but only by 1 percentage point. So only a little less growth than if we do nothing. A recent review of the academic literature showed an inconclusive split between studies that suggest it would help, hinder or make no difference to economic growth.

Worth the cost

Our base case is a small negative impact on growth by 2050, but we are optimists. Eliminating the huge negatives from not combating climate change, which don't show up in GDP figures but do actually impact our wellbeing, is probably worth that cost (figure 6).

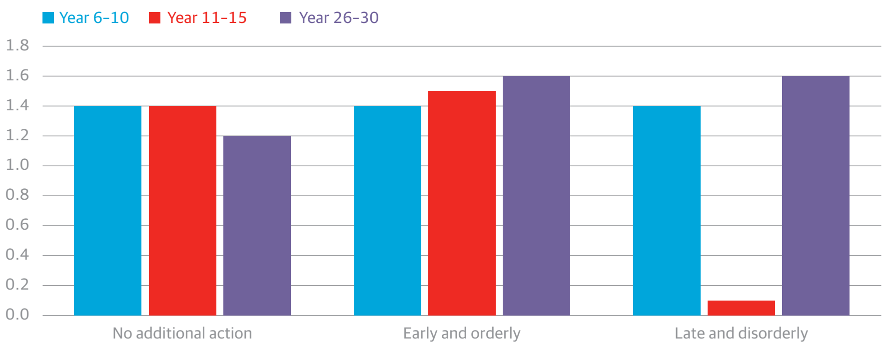
Policymakers need to take action now, however. That's the best way to prevent the economic costs outweighing the benefits over time. Economies and businesses can evolve and adapt to well signalled and spread-out changes, but a more sudden imposition of policy – for example in 2028 or 2029 – could entail huge transition risks. And it isn't just about policymakers. We urge higher carbon businesses we speak with to adopt robust decarbonisation policies today, to decrease that risk of a more sudden, financially disruptive policy being imposed by governments further down the line. Those same economists at the BoE/NGFS expect GDP in 2050 to be 5 percentage points lower if we delay the transition by 10 years.

You can hear more on the net-zero transition from our co-chief investment officer Ed Smith, stewardship director Matt Crossman and Kate Elliot, head of ethical, sustainable and impact research at Rathbone Greenbank Investments in this video* of our November COP26 webinar. We'll also be communicating in greater depth on this crucial question of economic impact over the coming months – so stay tuned by visiting rathbones.com or speaking to your investment manager.

* www.rathbones.com/knowledge-and-insight/cop26-what-investors-need-know

Figure 6: Expected average UK annual GDP growth (%)

Early and orderly action to combat climate change would be expected to produce better future growth than doing nothing or starting too late.



Source: Network for Greening the Financial System, Rathbones.

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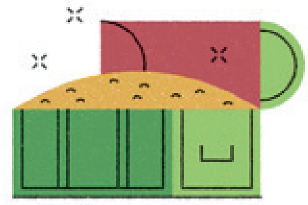
Beware the growing pile of gilts as the UK's credit card bill comes due



To pay for its economic response to the coronavirus pandemic, the UK government borrowed more in the fiscal year 2020/21 than at any time since records began in 1946. It's not as though this episode has escaped the notice of bond investors – plenty has been written about the increase in government borrowing during the health crisis. So you would be forgiven for wondering why UK government bonds (gilts) haven't taken a hit.

A host of factors can influence the price of government bonds. However, all else being equal, a large increase in the supply of something would be expected to put downward pressure on its price (the same number of pounds spread out over an increased amount of gilts).

When analysing government bonds, we look at net supply. This figure is supply less redemptions on the assumption that bondholders would reinvest the capital received from those redemptions, thus absorbing an equivalent amount of new supply. However, we also need to consider the impact of quantitative easing (QE), or gilts purchased by the BoE, which don't have to be absorbed by the market (figure 7).

Under pressure

Once we look at net supply excluding QE (net supply less QE purchases undertaken in the year, a more 'true' reflection of net supply in our view), the lack of pressure on gilt prices from the pickup in supply makes more sense. In total the BoE announced £450 billion of additional QE in 2020 (£440 billion of which related to gilts, the final £10 billion relating to corporate bonds).

Not all of this was undertaken in fiscal year 20/21, the final purchases were being made in December. Excluding QE, the net new supply of gilts looks far less alarming. Net issuance of £388 billion becomes just under £66 billion, while for fiscal year 21/22 the net supply excluding QE is expected to be just over £21 billion.

Looking ahead to the 2022/23 fiscal year, Barclays estimates just under £73 billion of net gilt issuance. But this doesn't take into consideration the potential for the BoE to stop reinvesting the proceeds from its gilt holdings as they mature, which its Monetary Policy Committee (MPC) has indicated will happen when it has increased its base rate (its official lending rate) from 0.25% to 0.5%. Market-based rate expectations at the time of writing suggest this will happen in May. That would result in another effective £9 billion of net supply (from redemptions that are not reinvested). That would take us to net supply (ex-QE) of around £82 billion, the highest level for a number of years.

Rate expectations

One of the reasons we disagreed with market expectations for the base rate to reach 0.5% in February is because £25 billion of BoE gilt holdings are maturing in March. According to the MPC's guidance, this would therefore be added to the net supply of gilts rather than be reinvested. Still, net supply for the first three months of 2022, in other words the last quarter of fiscal year 21/22, will be negative and that means there won't be any supply pressure on gilts in the near term.

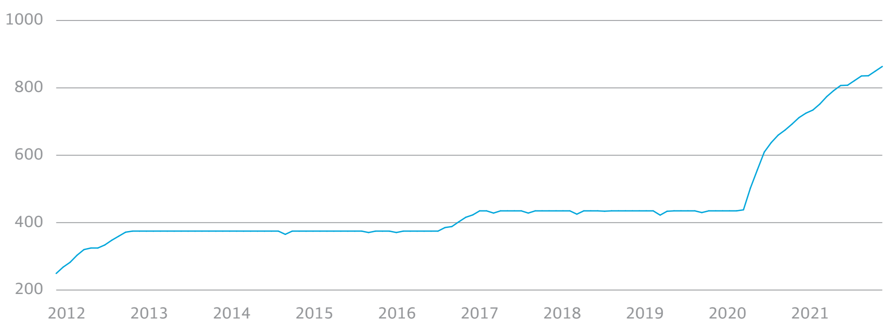
The fall in gilt yields (meaning prices increased) that followed the autumn Budget, when estimates for gilt supply for this fiscal year were lowered significantly, shows that net supply can affect gilt prices. The potential for that supply to increase significantly going into the next fiscal year is one of a number of factors that make us wary of having too much exposure to longer-dated gilts, given their greater sensitivity than shorter-dated gilts to any rise in yields from their current low levels.

As we approach 2023, we expect a growing focus on the BoE's plans to stop reinvesting the proceeds from gilt redemptions as some larger holdings within its QE programme reach maturity.

One of the reasons we disagreed with market expectations for the base rate to reach 0.5% in February is because £25 billion of Bank of England gilt holdings are maturing in March.

Figure 7: Bank of England gilt purchases (£ billions)

The central bank's substantial quantitative easing programme has distorted the price of government bonds and is likely to continue to exert its influence.



Source: Bloomberg.

Past performance is not a reliable indicator of future performance.

Financial markets

High inflation and uncertainty about central bank policies raised concerns about the economic recovery. Rising COVID infections and the new Omicron variant were another cause for concern, and social restrictions came back in December. However, leading economic indicators pointed to a continuation of strong growth as the world economy enters the next phase of recovery from the pandemic.

Despite ongoing concerns, global equities performed well at the start of the period and finished the year with decent gains. In October, US stocks had a record month, with the S&P 500 surging by 6.9%, its biggest monthly gain for 2021. The FTSE 100 also rose to a near 20-month high in October, recovering all losses since the pandemic began. However, at the end of November the discovery of the new Omicron variant and what it could mean for the potential return of lockdowns unsettled markets.

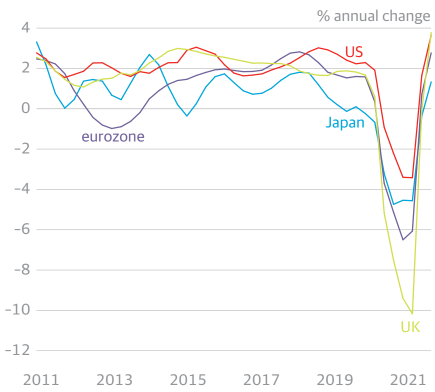
Central banks change course

US Federal Reserve (Fed) Chairman Jerome Powell also spooked markets when he said it was time to drop the word "transitory" from the Fed's statements on inflation, though markets regained their poise into the end of December. While the tone from the Fed has changed, Powell still expects inflation to fall closer to the central bank's 2% target over the course of 2022.

Government debt rallied over the prospect of widespread COVID-19 lockdowns as investors turned to assets traditionally seen as carrying lower risk. Gold prices also rose as investors looked for a safe haven amid increasing uncertainty and high inflation.

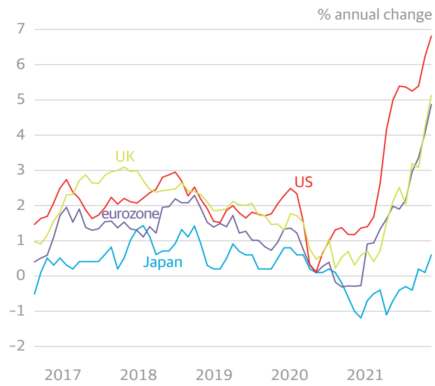
It was another rollercoaster quarter for energy markets, with the price of Brent crude hitting $84 a barrel in October before falling back down. European natural gas prices also soared to fresh records due to worsening supply from Russia, depleted reserves and high demand from Asia.

GDP growth



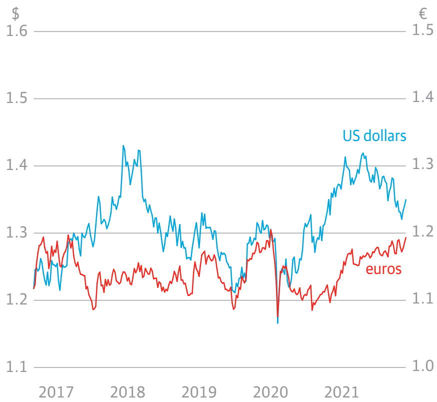
Source: Factset and Rathbones.

Inflation



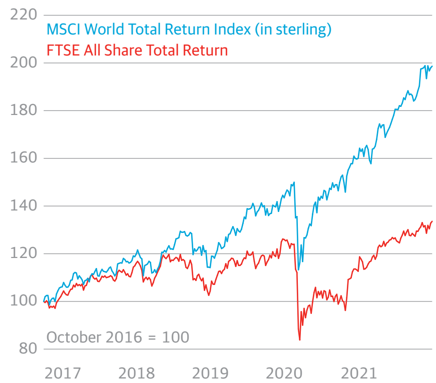
Source: Factset and Rathbones.

Sterling



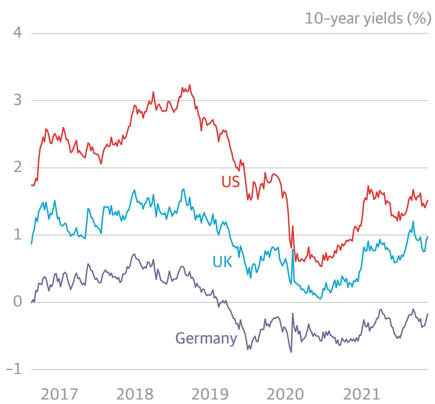
Source: Factset and Rathbones.

Equities



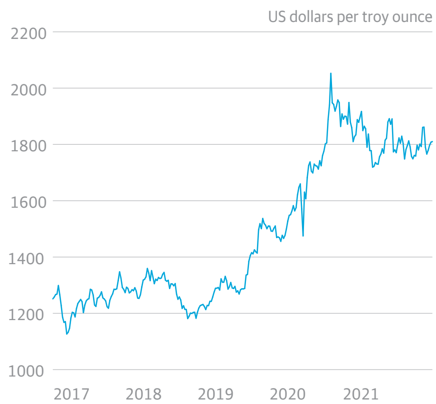
Source: Factset and Rathbones.

Government bonds



Source: Factset and Rathbones.

Gold



Source: Factset and Rathbones.

Past performance is not a reliable indicator of future performance.

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