Embracing Uncertainty

Global Matters Weekly

15 November 2021

– **Lorenzo La Posta**

The only certain thing in financial markets is uncertainty. And if you can't avoid it, you'd better embrace it.

Today, uncertainty takes many forms. It revolves around inflation, supply chains, energy prices, interest rates, wages, growth and more. Is the current bout of inflation more than transitory, or will inflation indicators turn down towards the widely used 2% target any time soon? When will disruptions to global trade end? Will labour shortages and raw material supplies come back to normal? Is there such a thing as 'normal' anymore, or are we heading towards a 'new normal'? Is the recent surge in oil and natural gas prices going to hurt economies more or have we seen the worst? Are we going to survive winter without emptying out our wallets? How is all that affecting global growth? How much longer than expected (or hoped) will it take for economies to get back to full speed, given all these problems? How will central banks react to all these conditions? Are interest rates about to be increased rapidly and inexorably?

To this long (and not comprehensive) list of uncertainties, there are many possible answers and even more news headlines, thought pieces and opinions available out there. A lot of that is probably confusing noise. We do worry about all these questions but are conscious that it's important to distil the most significant and impactful information out of all that confusion.

In our scenario modelling and stress-testing, we highlight a few possible scenarios that we may encounter in the coming months and put down some assumptions on what interest rates, earnings growth, equity valuations etc would look like in each of these. Different combinations of inflation and growth dynamics determine very different market conditions and while we have a view on what scenario is more likely than others, we do not put all our eggs in one basket. It's important to account for the tail risks, for those events that are less likely but far more dangerous than others. Currently we see stagflation as the main tail risk: rising inflation and slowing economic growth would be the most damaging scenario for most asset classes. With rising interest rates on top of that, in this low probability scenario we would expect to see equities and government bonds lose ground. However, even in such a grim scenario, opportunities would appear;, commodities (and their producers) could do well, regions like the UK and Japan would arguably fare better than the US, floating rate bonds would be well suited and inflation-linked bonds would probably outperform nominal treasuries.

The only certain thing in financial markets is uncertainty. And if you can't avoid it, you'd better embrace it.

We are outcome-based investors, in that our focus when building portfolios is providing our clients with the most efficient way to achieve their objective. We worry about two things: maximising the probability of achieving the desired outcome and providing a palatable journey towards it. Key to both things is having a diversified portfolio. No matter what economic environment you are in, diversification remains the best way to decrease overall risk (it is the only free lunch after all). We own commodities, floating rate and inflation-linked bonds for the stagflation scenario; emerging market equites, or real estate for a high growth, high inflation world; government bonds for a stagnation scenario, with little growth and decreasing inflation; and developed market equities and convertible bonds for another round of the 'goldilocks' scenario. Alternative assets, such as hedge funds, are useful across most scenarios as their uncorrelated nature means they can generate good returns across all environments, no matter what growth, rates and inflation levels prevail, so we do have a strategic allocation to those across all risk profiles.

Ultimately, we believe that investing is not too different from sailing a boat. To get to your destination, you need a good, solid vessel and a reliable crew sailing it. You need to point in the right direction, but also be able to change course as obstacles come and winds change. The vessel here is the strategic asset allocation, that must be risk-efficient, diversified and tailored to the desired outcome. The crew needs to take care of the tactical asset allocation, which is often a three-step process. Step one: understand what the possibilities and probabilities are. Step two: understand what the consequences of those events would be on the various asset classes. Step three: tilt the portfolio accordingly.

If today the world seems more uncertain than usual, with all that's happened over the past 18 months, we think sticking to a diligent and proven investment process is the best way to manage the risks that lie ahead.

NDL

momentum

Global Matters Weekly

15 November 2021

The Marketplace

- Global equities fell -0.2% last week.
- Brent crude fell -0.7% last week to $82.17 a barrel.
- Gold fell -0.7% to $1864.9 per ounce.
- US consumer inflation spiked to 6.2%, the highest since November 1990 and above the 5.8% forecast.

Market Focus

US

- US equities fell -0.3% last week, with basic resources and homebuilders outperforming, whilst consumer ddiscretionary and oil/ gas sectors underperformed.
- Weekly jobless claims came in at 267k, higher than the 265k forecast and down from 271k last week.
- U.S. Core CPI for October came in at 0.6%, better than the 0.4% forecast and 0.2% in September.
- US 5 year breakevens surged to a record high of 3.03%. The 2–10-year yield spread collapsed to as low as 96bps, as shorter-term rates rose.

UK

- UK equities rallied 0.7% last week.
- COP26 succeeded in getting 197 countries to agree on new rules on limiting greenhouse gas emissions. Still, last-minute objections from India and China stymied a commitment to end coal use and fossil fuel subsidies. Countries instead agreed to “phase down” rather than “phase out” coal. Australia’s PM insists the coal industry in Australia will continue for decades despite this COP deal.
- UK Q3 GDP quarter-on-quarter came in at 1.3%, down on the 1.5% forecast.

Europe

- European equities rallied 0.7% last week, with basic resources and media outperforming, while travel and oil/ gas sectors declined.
- There is a greater risk of an accidental war breaking out between the West and Russia than at any time since the Cold War, with many of the traditional diplomatic tools no longer available, Britain’s most senior military officer said. Russia said they would not tolerate NATO creeping armed forces into Ukraine.
- On Friday, Holland enters a 3-week lockdown, and Austria will lockdown unvaccinated citizens as Covid cases spike.

Asia/Rest of The World

- UK equities rallied 1.0% last week
- The Bank of England maintained their benchmark interest rate at 0.1% and Q.E. program with a vote of 7-2. However, BoE Governor Bailey said that the interest rate would have to rise in the coming months to meet targets
- The UK October Manufacturing PMI came in at 57.8, higher than 57.7 forecast.

Global Matters Weekly

15 November 2021

Asset Class/Region	Currency	Currency returns			
		Week ending 12 Nov. 2021	Month to date	YTD 2021	12 months
Developed Market Equities					
United States	USD	-0.3%	1.7%	25.7%	33.7%
United Kingdom	GBP	0.7%	1.8%	18.4%	20.6%
Continental Europe	EUR	0.7%	2.9%	24.6%	29.5%
Japan	JPY	0.0%	2.0%	15.3%	20.7%
Asia Pacific (ex Japan)	USD	1.4%	1.1%	0.7%	9.4%
Australia	AUD	0.0%	1.9%	16.9%	20.2%
Global	USD	-0.2%	1.6%	21.3%	30.3%
Emerging markets equities					
Emerging Europe	USD	-4.0%	-3.2%	23.8%	40.8%
Emerging Asia	USD	2.2%	1.7%	-1.3%	7.5%
Emerging Latin America	USD	1.9%	4.3%	-6.8%	10.8%
BRICs	USD	2.6%	1.9%	-3.5%	2.3%
China	USD	3.5%	1.2%	-13.0%	-10.8%
MENA countries	USD	1.5%	2.6%	34.1%	38.5%
South Africa	USD	-1.0%	1.4%	5.4%	13.4%
India	USD	1.8%	3.3%	28.6%	44.7%
Global emerging markets	USD	1.7%	1.7%	1.4%	11.0%
Bonds					
US Treasuries	USD	-0.7%	-0.1%	-2.9%	-2.7%
US Treasuries (inflation protected)	USD	0.7%	1.6%	6.3%	8.6%
US Corporate (investment grade)	USD	-1.0%	-0.1%	-1.1%	0.9%
US High Yield	USD	-0.3%	0.4%	4.7%	8.1%
UK Gilts	GBP	-0.9%	0.8%	-4.8%	-2.3%
UK Corporate (investment grade)	GBP	-0.7%	0.7%	-2.5%	1.0%
Euro Government Bonds	EUR	-0.3%	1.3%	-2.4%	-1.9%
Euro Corporate (investment grade)	EUR	-0.2%	0.8%	-0.3%	0.3%
Euro High Yield	EUR	0.0%	0.4%	3.5%	5.8%
Japanese Government	JPY	-0.1%	0.1%	-0.1%	0.0%
Australian Government	AUD	0.0%	1.2%	-4.2%	-4.4%
Global Government Bonds	USD	-0.9%	-0.1%	-6.1%	-3.9%
Global Bonds	USD	-0.9%	-0.2%	-4.9%	-2.7%
Global Convertible Bonds	USD	-0.3%	0.6%	0.8%	8.3%
Emerging Market Bonds	USD	-0.6%	0.3%	-4.1%	-2.2%

Source: Bloomberg. Past performance is not indicative of future returns

Global Matters Weekly

15 November 2021

Asset Class/Region	Currency	Currency returns			
		Week ending 12 Nov. 2021	Month to date	YTD 2021	12 months
Property					
US Property Securities	USD	0.0%	1.7%	33.8%	39.1%
Australian Property Securities	AUD	-1.8%	2.4%	14.8%	13.4%
Asia Property Securities	USD	1.3%	0.4%	2.4%	1.7%
Global Property Securities	USD	0.0%	1.3%	19.8%	25.2%
Currencies					
Euro	USD	-0.9%	-0.8%	-6.3%	-3.0%
UK Pound Sterling	USD	-0.5%	-1.8%	-1.7%	2.3%
Japanese Yen	USD	-0.5%	0.2%	-9.3%	-7.6%
Australian Dollar	USD	-0.9%	-2.4%	-4.7%	1.2%
South African Rand	USD	-1.6%	-0.2%	-4.3%	1.9%
Swiss Franc	USD	-1.0%	-0.4%	-3.9%	-0.6%
Chinese Yuan	USD	0.3%	0.4%	2.3%	3.7%
Commodities & Alternatives					
Commodities	USD	0.9%	0.0%	43.6%	57.9%
Agricultural Commodities	USD	2.9%	2.1%	31.9%	43.9%
Oil	USD	-0.7%	-2.6%	58.6%	88.8%
Gold	USD	2.6%	4.6%	-1.6%	-0.7%
Hedge funds	USD	-0.1%	0.2%	4.9%	8.5%

Source: Bloomberg. Past performance is not indicative of future returns

Important notes