Punter Southall Wealth

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Your Questions Answered

KEY QUESTIONS FOR INVESTORS

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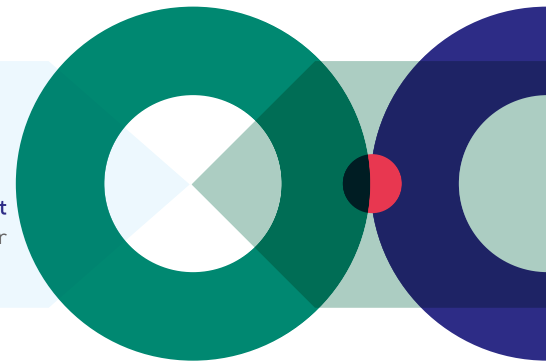

Investors could be excused for being utterly perplexed by what has happened in financial markets over the last 18 months. I'm sure that if anyone had possessed a crystal ball that had depicted clearly that the world would soon be enveloped in a medical crisis and that the global economy would be about to suffer its weakest period since the end of the Second World War, then the natural inclination would have been to sell most of their investments and retreat to the sidelines. In hindsight, that would have been a painful mistake. The powerful performance from most assets of the last year would have been missed, and given the rise in valuations and prices, that Nostradamus would now be scrambling to find a re-entry point into those investments that they had sold. It has been as confusing and contradictory a period in financial markets as we have ever known. For those who hoped that 2021 would provide definitive answers, I'm afraid there is disappointment.

To try and help our clients plot a path through the years ahead, we have been holding regular client events to discuss the key macroeconomic factors and answer any questions that the audience might have. Having enjoyed a record number of questions at our latest webinar, we thought it would be useful to reproduce some of the most commonly asked questions, as well as outline again our key conclusions on the outlook for the ongoing medical situation, the global economy and financial markets.

When will the economy fully recover from COVID-19?

The basic facts are that the global economy is about to go through a period of relative boom, certainly by comparison to the woes of 2020. A combination of unprecedented government and central bank stimulus mixed with pent-up consumer demand should create a potent cocktail for economic activity that will lead to very strong growth over the next year or so. We are expecting the global economy to make up all the lost ground to COVID early next year, with various parts of the world recovering at different speeds. By way of analogy, we liken the global economy to a four-engine jumbo jet. Right now, the first engine in the US is firing on all cylinders; the Chinese engine fired up again first and is steadily chugging away; Europe and the UK are just starting to accelerate, while parts of the emerging world are spluttering. As we move into the second half of the year, assuming the vaccination programmes persist and no virus variants affect the vaccinated populations, all four economic engines should be operating nicely and the jumbo should be flying high, even if there is the occasional patch of turbulence.

Does the economy no longer matter to financial markets?

In our view, financial markets have already priced in a very positive economic tomorrow and one can certainly put together a cogent argument that markets have moved "too far, too quickly", thereby outpacing the economic reality. The improvement we have seen in financial markets is down to two factors. Firstly, the support from the government and central banks, including unprecedented levels of asset purchases and record low interest rates, has encouraged (forced) investors to take more risk. Whilst we would argue that the authorities' actions have been the preeminent driver of asset prices in the last year, one cannot totally ignore the fact that the economic future looks relatively bright and there should be a period of strong growth for the world ahead. How strong economic output will ultimately be will depend on how quickly consumer confidence can fully recover, and upon how committed governments are to chucking around money that they don't have. If this money is spent wisely, something that has been sadly all too rare in previous bursts of fiscal spending, then we could see markets and economic activity both benefit in the coming years. What we would then expect to see in such a scenario is that economic fundamentals will once again become the primary driver of financial market performance, whilst central bank activism hopefully takes a back seat.

How concerned are we by inflation?

We are always concerned by inflation. Benchmarking a portfolio against any sort of asset index can be irrelevant to clients when what really matters is whether one can continue to spend in the future like one can now, hopefully with some growth in wealth as well.

However, the last decade was a period of low inflation, as disinflationary pressures persisted from the "Great Recession" of 2008, while greying demographics, growing debt piles and China's exported goods price deflation kept global inflation rates at historically low levels.

Whilst stultifying demographics and constraining debt piles are set to stay with us (and deteriorate further), we do sense that there is greater inflation uncertainty ahead by comparison to what we experienced during the previous decade. Beyond the short-term factors of supply-chain bottlenecks, which will be fixed as the economy reopens, and pent-up demand, as consumers go out and spend their COVID savings (admittedly where they are able to), there are big shifts in the global economy. The first is a growing lack of trust on a global scale; this will lead to an onshoring of the global production of vital goods. In addition, the cheap labour pool in China and certain other parts of the world will not provide the suppressing effect upon global wages that we saw in the last decade. We also note that we are seeing soaring commodity prices, as the of consistent underinvestment in resource exploration starts to bite as demand rises in an improving economy.

However, the major shift has been the complete termination of any form of mental or physical restraints on government spending. It could well be that governments persist with their splurges long into the future, for a variety of excuses, and that this creates a demand shock, which drives up prices as supply is overwhelmed.

Our central case is that short-term inflation rates will continue to rise through the summer, before cooling off towards the end of the year and into 2022. But the issue over inflation is not a short-term cyclical concern; rather, the issue is whether the structural forces have switched, and if one of the nasty side-effects of the fiscal and monetary responses to global economic inequality, "climate change" and the COVID pandemic will be inflation. We could certainly see inflation rates of 4-5% at points this decade, considerably higher than the 1-3% that was the consistent experience of the 2010s.

Should I be worried by the rise of China?

There has been much to be impressed by in China's rise over the last few decades. The speed and the scale of China's re-emergence into the global economy has been nothing short of extraordinary. China now contributes a very large share of overall global economic growth. China's economy and its government's approach to spending also increasingly leads the global economic cycle, in our view. The fact, therefore, that China's government is starting to apply the brakes on China's credit growth, their own response to the COVID crisis, should catch our attention, and we might need to reassess our optimistic view for economic growth a year out from

from now. Currently we expect the Chinese consumer to power a positive economic experience from China in the coming years, as reflected in our portfolio positioning, but we must continue to focus on this increasingly important influence on the global economy.

Discussions around China do not just centre around economic potential. Napoleon once said, "Let China sleep for when she wakes, she will rule the world". 200 years later and it would appear that China wants to prove him right. China's sphere of political and military dominance, as well as its sprawling economic might, is spreading, and this is leading to friction with other leading nations, not least the US. Countries in Asia, but also across Europe and Africa, are starting to feel China's growing power. Domestic and international situations are undoubtedly fuelling a creeping unease about China's intentions. As investors, we cannot ignore these fears, but we must recognise that shaping a portfolio deliberately to avoid potential geopolitical concerns would have been a losing strategy throughout history. Will China's developing dominance of regional affairs and extending influence contribute towards political, economic and financial market volatility in the coming years? Undoubtedly, is our view. Should that mean we entirely avoid investing in China's consumer growth story? We believe that would be a mistake.

A question for investors: How should I position my investment portfolio for the decade ahead?

We have long expected the 2020s to be the "Turbulent Twenties". We felt that the pressures of high debt loads, greying demographics and the most pronounced levels of financial inequality in history would lead to volatile economic, political and financial market outcomes. We also continue to believe that we will experience higher levels of inflation uncertainty ahead. Because of this view, we continue to stress the importance of balance and diversification in any investment strategy. Nobody can say with any certainty what lies ahead. But we can say where there is value in a world of expensive assets.

The good news is that there are several attractive growth themes that we can embrace for our clients (this only applies where we are directly managing client assets ourselves in-house). Chief amongst these themes are the energy revolution and medical development, both of which should benefit materially from future economic trends. Governments and companies appear to be moving quickly down the path of renewable energy, from which there is no return, while COVID will inspire an acceleration in the golden age of medical technology, which should bring rich rewards to investors.

We would also urge all investors to be global in their approach. Right now, we do see good relative value in UK equities, but some of the best opportunities that we can pinpoint are in the Far East, with both Asian consumption and Japanese corporate change acting as two of the structural long-term investment themes within our portfolios. The former is a tale of sustainable long-term growth, while the latter is a case of realising value from inefficient Japanese companies, who are being forced to reassess how they manage their assets after three decades of lacklustre performance.

A key differentiator for our investment strategies is the way that we address fixed income investing. The paucity of future returns and concerns over rising interest rates are probably the key hindrances to prospective returns and the major reason why many investors are simply giving up on bonds. In our view, there are a range of exciting and enticing opportunities still available across global fixed income markets, such as asset-backed securities, specific corporate credits and emerging market debt, with potential returns of 3-6% per annum still viable over the next five years.

It would still be very easy to throw one's hands in the air and declare that investing is too hard. As tempting as that might be, it would likely be just as wrong as it was a year ago. We would reiterate a message of "don't give up, but do think differently". We believe that such a mantra can lead to success, regardless of what the world throws at investors. As the experience of the last 18 months has shown, that could be anything!

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