Chetwood Investment Management

STRATEGIC INCOME

3RD QUARTER 2021 REVIEW

Introduction and Market Overview

Huge levels of financial support from central banks and subsequent supply constraints as countries emerged from 12-18 months of lockdown and started to consume once more, have finally led to some real inflation. Be it temporary, be it longer lasting, it is the main concern for us as investors, and indeed normal everyday folk. Whilst inflation may have replaced COVID-19 in the headlines, the pandemic is far from over. Global infection rates and deaths have trended down since late August, but numbers remain at high levels and significant gaps in vaccine coverage among high-risk groups mean the US is recording around 2,000 deaths a day as at the end of September, by far the highest rate among advanced economies and around 60% of its peak in January. This is disappointing, as in the UK there can be no doubt that widespread vaccinations appear to be working. COVID cases are on the drop, hospitalisations have not dramatically risen, and most importantly, neither have deaths. The recovery though remains delicate. There was a phrase that was used quite early in the Pandemic; that the virus is "playing a game of cat and mouse with us, and we are not the cat"! This still seems to be the case.

If pressures on the NHS mount the UK will move to the government's "Plan B", deploying a familiar set of tools including mask mandates, vaccine passports and advice to work from home. Case rates can rise very quickly, and to pre-empt the sort of surges in cases and deaths that occurred in April of last year and January of this, the government could need to move rapidly. As the SAGE advisory group said in September, "Early, 'low-cost' interventions may reduce the need for more disruptive measures and avoid an unacceptable level of hospitalisations".

It is prudent to consider this bearish scenario in the short-term. It is also wise to think through the opportunities this may bring. An increase in volatility would likely tilt central banks back in a more accommodative direction, even leading to a delay in the US Federal Reserve's (Fed) tapering if liquidity conditions in markets were to deteriorate.

Changes in consumer behaviour could also help slow the spread of the virus. In the UK the easing of most restrictions has not resulted in a return to pre-pandemic behaviour. Over 40% of people say they are avoiding crowded places and 60% say they wear masks in public places. Many people continue to work from home and consumer spending on services remains suppressed. A sharp rise in cases would probably trigger greater public caution, slowing the spread of infection. In the US, for instance, the spread of the Delta variant has led to a fall in visits to retail and recreation destinations.

Standing back from the current data, what is clear is that the world is having to live with COVID. Early hopes that vaccines, new treatments and restrictions would end the pandemic have been dashed. Even Singapore, with its enviable record during the pandemic, is finding that tight restrictions and high vaccination levels (77% of the population compared to the UK's 66%) do not guarantee success. Case rates in Singapore are at the highest level since the pandemic started and are three times EU levels. At the end of September, Vietnam, another pandemic exemplar, abandoned its zero-COVID strategy in the face of a record drop in quarterly growth. The authorities seem to have concluded that complete suppression of the virus is economically unsustainable.

For now, the balance of informed opinion seems to be that a mix of restrictions, booster shots and changes in behaviour should enable the UK to avoid another full-blown lockdown. Professor Neil Ferguson, whose modelling of the pandemic was influential in the UK entering lockdown last year, said recently that he thought the UK would probably get by without locking down again.

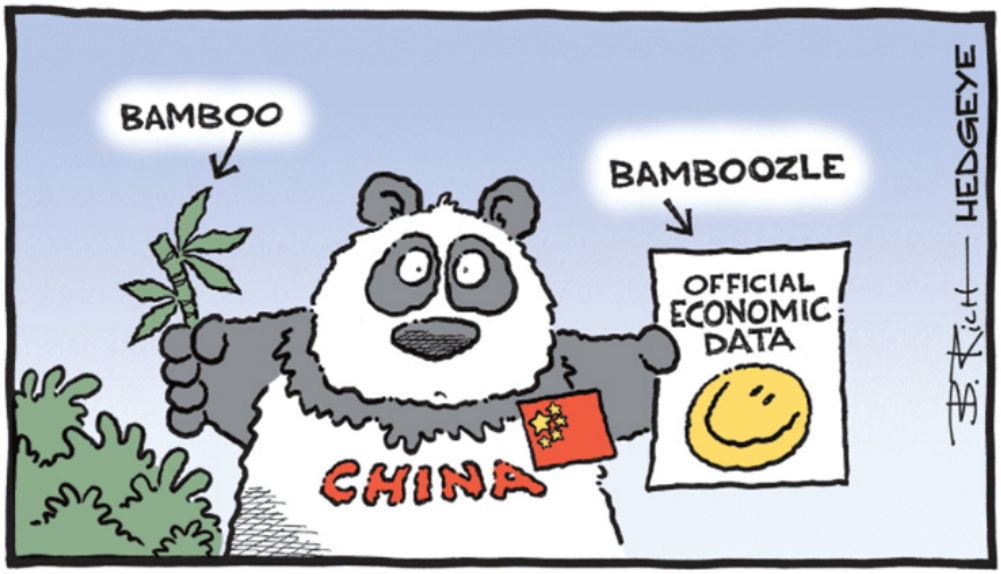
Outside of Europe, which has started to emerge later than China and the US from the massive GDP loss of 2020, the dataflow is pointing to a significantly slower pace of recovery. This was always going to happen once the immediate catch-up effects after the reopening were absorbed.

First, the rebound in food and energy prices, combined with the second-round effects of the global shortage in semi-conductors, has pushed consumer prices significantly higher, dampening purchasing power. This is more pronounced in the US than in Europe, but there as well inflation has accelerated significantly in the last few months, with electricity prices more of a focus for the latter.

Second, in the US, the delta variant has triggered significant pressure again on healthcare capacity, after the vaccination programme decelerated markedly following a strong start. While public authorities still balk at resuming large-scale sanitary measures, it seems that people are "taking matters in their own hands" and consumption on hospitality and recreation is softening. What we found striking when looking at restaurant booking data is that even in cities such as New York where the vaccination take-up has been high, hospitality spending is still markedly down.

Third, the disruption in global value chains is impairing the capacity of the manufacturing sector to meet demand, resulting in "missed output". This is particularly visible in the German car industry where the discrepancy between the order book and production has reached historical highs.

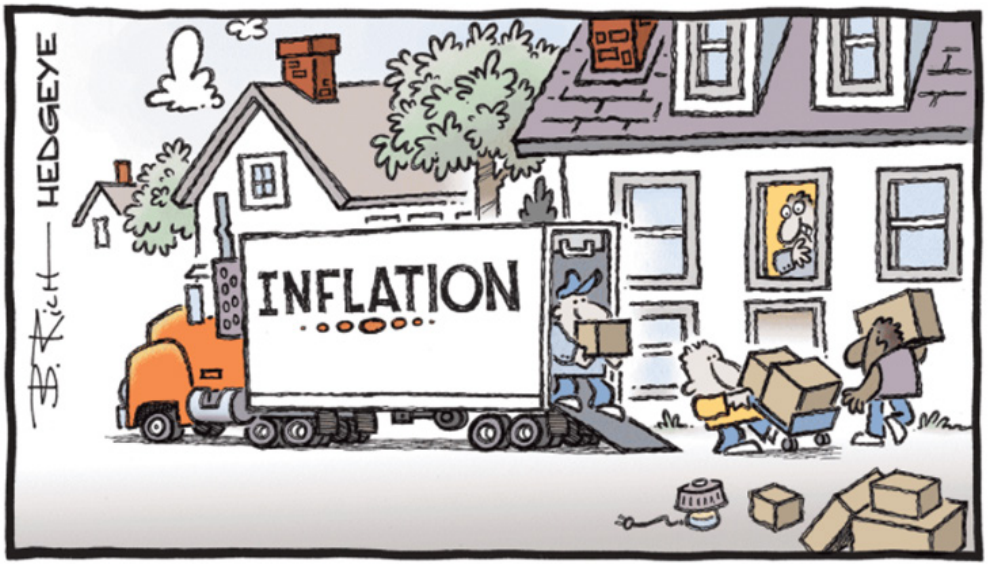
Fourth, the Chinese authorities' decision to opt for a much smaller stimulus than in the West to deal with the pandemic has resulted in a lingering weakness in consumption. Moreover, the regulatory crackdown on real estate is dampening activity in a crucial sector for the Chinese economy (it directly and indirectly contributes to about a quarter of GDP) and is leading to financial stability concerns. Investors are particularly focussed on Evergrande, a large HK-listed property developer, which failed in September to pay an interest payment on some of its bonds, triggering a 30-day grace period ahead of a formal default. The market is waiting to see whether the company can avoid this through government intervention or a rescue from a private buyer. The company has over $300bn in debt and is therefore hugely important in the market although we agree with most investors that in the event of a collapse, this is unlikely to present the same sort of systemic risk we saw when Lehman Brothers failed during the Great Financial Crisis. We have no direct exposure to the Chinese property sector. Furthermore, we reduced our Chinese equity position earlier in the year and are watching the situation closely as it may present an opportunity in due course.



In August, all key macro indicators in China came out below expectations, except for foreign trade. This softer demand in China is already having an impact on the country's main suppliers: German exports to China have taken a hit this summer.

What is reassuring though is that all these issues should prove transitory and/or manageable. The very latest data suggests the Delta variant wave has reached a plateau in the US. While purchasing power is hit, households in advanced countries sit on piles of cash thanks to the savings accumulated last year. While it may take time to sort out the sources of supply disruptions, there are tentative signs that price pressures in some of the hottest sectors – for instance used cars in the US – have started to abate. Finally, the Chinese slowdown is largely self-inflicted and policy driven, hence reversible. Although Beijing seems to be genuinely intent on addressing the speculative aspects of real estate, the risks to social stability – a key goal for the Chinese leadership – from a too brutal correction are significant, and we expect a shift towards accommodation by year-end.

Still, this is putting the market in an awkward position because it had expected to reach the "sunny uplands" of total covid eradication and plain sailing. Central banks are also to some extent wrong-footed. The European Banks confidence in an improved macroeconomic outlook and discussions of upside risks to their inflation forecasts do not come at the best of time. Our baseline is that the recovery is dented, but not reversed, and that the trajectory of prudent monetary policy normalisation has barely moved. Yet, the next weeks and months may be choppy from a market perspective as we understand if high inflation is here to stay.



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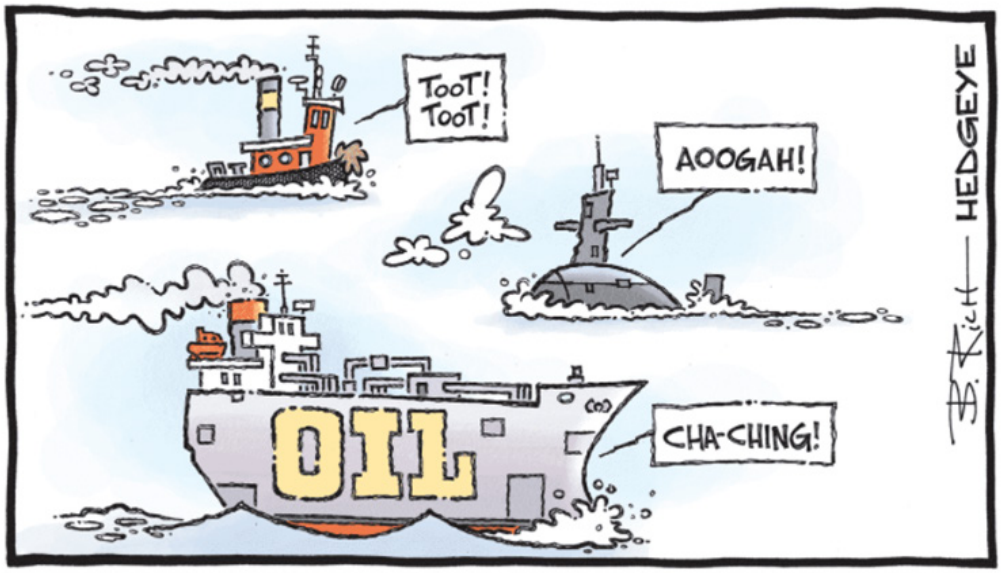
For the last eighteen months we have respected the performance of risky asset classes – credit and equities – in that returns were driven by the combination of huge policy support, scientific progress towards control of the COVID-19 virus and the eventual normalisation of economic activity. Together, those factors have contributed to well above average returns. There have been wobbles as investors became concerned about new variants of the virus, supply side distortions, the jump in inflation and fears of premature monetary tightening. Yet the underlying supports have continued to win out and this has been reflected in very healthy fundamentals for both stocks and corporate bonds.

However, we know markets are not just about fundamentals. As much as we have respected the positive drivers of market performance, we have also paid increasing regard to valuations across a range of asset classes and markets. Valuations have become most stretched in fixed income where both the absolute level of yields and the risk-spreads in the credit markets have continued to trade near to post-global financial crisis lows. There is some merit in the view that quantitative easing has contributed to all financial assets becoming expensive. It is notable that concerns about house prices are evident across several developed economies as well. Liquidity and accumulated savings through the pandemic have impacted on asset prices and created a challenge to investors of where to invest now.

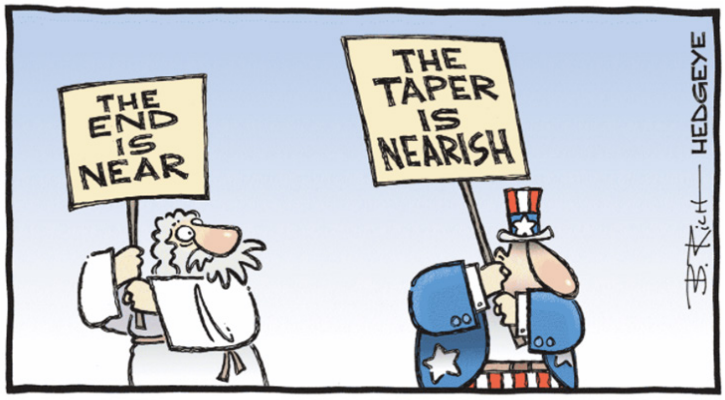
Right now, it seems that investors are showing signs of taking fright, after benefitting from markets that have seen no significant drawdowns for a long time. We note recent bearish predictions from investment banks which appeal to a view held by some market participants that "things just can't keep on going up". Investor sentiment appears to be starting to crumble amid ongoing threats to the recovery from supply side distortions, raging energy prices, issues in the Chinese credit market and dark clouds on the geo-political horizon.



From a macro point of view, we would argue that a lot of the issues that are worrying investors are likely to be resolved through supply-side rebalancing or policy actions. However, that does not mean financial markets will sit and wait for the news to get better. A take-profits mentality is currently evident.

The combination of supportive fiscal policy in Europe and the US and any pushing back to monetary normalisation suggests that the recovery itself is not at a significant risk. A correction in markets in the traditionally volatile September and October period should bring with it a renewed buying opportunity for risk assets as we head into a year which is likely to see lower inflation and the supply side distortions working themselves out. Before then, be prepared for more volatility than we have experienced so far in 2021. On an investment level we have been acutely aware of risks and have been managing our portfolios accordingly. Markets have always taught us that you need some concerns to offer attractive investment opportunities and it is an often-used phrase that "markets like to climb a wall of worry". As bonds have been volatile this year, we have used other assets at our disposal, such as commodities and infrastructure, to diversify portfolios. In other words, we have plenty of tools to harvest opportunities – but managing the risks is always a key area of focus.
For investors the problem is clear – aggressive financial easing by central banks has effectively debased many of the traditionally defensive assets. Meanwhile, there is a dearth of other alternatives; cryptocurrencies offer too many regulatory and ownership hurdles, while gold is potentially attractive, but portfolio position sizes are probably limited due to volatility on the asset class. There are fewer places left to hide as central bank liquidity has now floated most of the boats, however the investment team continue to work hard to build a strong margin of safety in our portfolios and we are confident in our ability to defend, as well as participate in upswings when they come.

We now seem to always live in times of economic policy experimentation. The next few years pose challenges to central banks. The risk of fiscal dominance potentially constrains independence at a time when central bankers know they should be trying to reduce the pace of balance sheet growth (debt) and restore interest rates to "normal" levels – the start of so-called "tapering".



High levels of debt and the existence of what some call "zombie companies" complicate the situation. We have always had the view that, in contrast to a lot of the economics we have learned, the real world is characterised by moving from one disequilibrium to another. The paths between them are unpredictable. That is why markets do what they do, try to allocate capital based on trying to second guess those pathways. The signposts today are either higher inflation, higher interest rates or a continuation of financial repression and fiscal dominance with, as yet, unknown repercussions for financial stability and broader questions of equality. We would argue that there has never been a more sensible time to have professionals running your investment portfolio.

Portfolio Review 3rd Quarter 2021

Strategic Income

During the early part of the quarter, we made a change to the portfolio. The change brought in some portfolio protection, which we felt was sensible given the strong run that equities have enjoyed since the pandemic lows in March of last year, when equities suffered their worst 4-week performance in history. It is remarkable how quickly stock markets have recovered since then, helped of course by the actions of global central banks and governments to support and subsidise workers, businesses, the overall economy and financial markets. This has left parts of the stock market, especially in the US, looking quite richly valued.

We have sold roughly two thirds of the holding of **Vanguard FTSE All World High Dividend Yield ETF**. The fund has a high exposure to US equities and generally to stocks that did well during the so-called "reopening trade". These are stocks that stood to benefit the most from a reopening of the global economy due to the generally successful vaccine rollout. We have made a profit on the position, but we felt this trade had played out for the time being. Corporate earnings and economic growth are currently increasing at a record pace, and we had concerns that a slowing of both later in the year may be the catalyst for weaker performance.

Also, the largest exposure within the Vanguard fund is to the financial sector, which faces a headwind due to the recent flattening of the US bond yield curve (which essentially means that the extra yield available on longer dated bonds is not as great compared to shorter dated bonds) is a negative for US banks as their profits are hit. Banks tend to borrow over the short term (e.g via client deposits) and lend over the longer term (e.g via mortgages).

We used the proceeds from the sale to introduce an exposure to the **iShares $ Treasury Bond 7-10yr ETF**. This fund offers exposure to US Treasury Bonds that have between 7 and 10 years left to maturity, and we intentionally selected an ETF that is not hedged from a currency perspective, so the portfolio will benefit if the US Dollar strengthens against Sterling. Sterling had performed strongly versus the dollar over the previous 18 months or so and was standing at a five year high versus the greenback at the time of the trade. We felt it a useful time to increase US Dollar exposure, and the position has benefitted from the strength of the dollar towards the end of the quarter.

By the quarter-end, 10-year US Treasury Bonds were offering an annual yield of roughly 1.5%, which seems relatively modest, but their real value is during times of equity market weakness, when demand for them typically increases. This can result in strong capital gains. The chart below compares the performance of the iShares $ bond ETF (blue line) with the FTSE 100 Index (red line) since the start of 2007. It is useful to note how well the iShares fund has performed during most periods of weakness for equities (particularly late 2008, and early 2020). This is due to Government Bonds and the US Dollar traditionally being viewed as safe haven assets, which investors flock to during risk-off periods. The iShares ETF gives us exposure to both within one fund.

Our overweight exposure to equities during most of the recovery has helped the performance of the portfolio. We still see plenty of reasons to be positive on the economy and equities. Household net worth has grown the most in history in the past year and the "Wealth Effect" from rising house and equity prices, should feed into the economy. Also, as mentioned earlier, corporate earnings are growing strongly, with a record share of big US companies beating profit expectations within the latest quarterly earnings season. However, we note current sentiment towards equities is at quite elevated levels, with considerable optimism among individual investors about the expected returns from stocks. Generally, this tends be a good time to lighten up on equity exposure. Also, towards the end of the quarter equities (particularly growth stocks) experienced a higher level of volatility than we have become used to recently, with the catalyst appearing to be concerns that inflation may stay stubbornly high for longer than many have predicted. Given all the information we have at hand, we feel a more neutral risk exposure to be appropriate at the current time.