Watson French
INDEPENDENT FINANCIAL PLANNING
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Asset Class Commentary
December 2021

Initially, the emergence of the Omicron variant spooked investors and caused markets to fall. Investors have since put less weight on the risk of the new variant causing significant disruption to the global economic recovery, albeit with a large degree of uncertainty.

Interest rate rises are becoming more likely as "transitory" is no longer the word central bankers use to describe the high inflation rates. Slowly, over the course of the year, officials have changed their stance on how long high inflation could last, with many officials now taking a more hawkish stance.

A common global theme for this month's update is that small and medium-sized companies are expected to outperform large cap stocks.

Areas of focus

- The debate over how much emphasis investors should place on rising inflation continues
- UK equities trade at a 40% discount to global peers, and although there is much promise, political risks still deter large capital inflows.
- High US valuations could be tested as Fed officials take a more hawkish tone.
- China could prove to be a good long-term investment with many companies standing to benefit from regulation reforms.
- India is a popular addition to investors' portfolios with a barrage of IPO listings, especially in the tech industry.
- Europe could become a market leader in green tech.
- Europe risks inflation becoming entrenched and interest rate rises brought forward.

UK

Recent research by Morgan Stanley shows that UK equities trade at a 40% discount to their global peers.

UK equity valuations are still depressed due to the political and economic risks lingering over Brexit. Many overseas private equity firms are taking advantage of this and are buying large stakes in comparatively "cheap" UK companies. A good example of this is the acquisition of Morrisons by US-based private equity firm Clayton, Dubilier & Rice.

According to official statistics, the total value of foreign companies buying UK companies was £27.7 billion in Q2 2021. This is significantly higher than the value of £2.8 billion in Q2 2020. Clearly, private equity firms see some undervaluation or potential for good returns in UK companies.

The risks surrounding Brexit are still present and we are seeing this in different areas. The US is putting off a trade deal with the UK which would lift tariffs on steel and Aluminium over post-Brexit trading rules in Northern Ireland. You only have to glance at the news to see issues with France over fishing licences, as just one example. All of these factors are holding back the UK economy and UK businesses from operating as efficiently as possible, as the costs of doing business increase.

Another perceived problem with UK equity (which is really an old myth) is that typically lots of UK stocks are value companies in sectors such as banking and oil and are valued for their dividends. Investors at the moment prefer new economy stocks such as technology and healthcare.

There are several reasons for cautious optimism with regard to UK equities, however.

Firstly, in the past most technology companies commonly look to list in the US rather than the UK. There are changes to the listing rules in the pipeline which could attract future listings to the UK. This would involve companies who have dual share structures being able to list on the FTSE indices such as the FTSE 250, where currently they cannot list.

Lots of companies in the UK also have chances to reinvent themselves. For example, BP and Shell both have a big hand in renewable energy and reducing global emissions.

Although many companies cut their dividends during the 2020 period due to the pandemic, most of these companies have now reinstated their dividends and their share prices are close if not past their pre-pandemic levels.

With investors expecting interest rates to rise in the UK in the coming months (possibly in December), this should benefit some stocks such as financial institutions. That said, most FTSE 100 companies actually book their profits in US dollars and convert back to pounds sterling, so rising interest rates could cause the pound to strengthen against the dollar and make it more expensive for companies to exchange their profits back to sterling. This would reduce their appeal.

If inflation does persist into 2022, the winning companies will be those that are able to pass rising costs onto consumers (those with real pricing power). Companies in more specialist sectors such as veterinary products will be better able to pass the rising costs on. The energy price rises are more likely to stick which will hurt some consumers more than others.

Although the UK has been positive with its vaccine roll-out, perceptions over the Brexit issues it continues to face will take time to change. Large investors have been wary of investing in the UK, and while the US indices push higher this caution will most likely continue.

The charts above show the relative underperformance of the UK over a 1 and 5-year period.

US

The NASDAQ and the S&P 500 have both outperformed most other markets and have consistently outperformed the MSCI World index over the short and longer term. Many investors believe that US tech companies are now over-valued, and it is difficult to judge whether this is true. When looking at the average price-earnings ratio of the NASDAQ 100, we see that at the start of 2019 it was 20.34 – it has since risen to 37.69 as of 30/06/2021. We do see though that from its high at the start of 2021 of 39.46, this figure has dropped. The forward 12 months estimate is expected to be somewhere around 30.

The reason for this projected drop is likely to be the strong earnings that lots of US companies have reported over the past few earnings seasons. Although the P/E ratio is still high compared to historical standards, if firms are able to pass on rising costs to the consumer this should drop slightly as firms profits continue to increase as expected.

That being said, due to the high valuations, new and highly valued growth companies are being punished severely if they miss their earnings targets. As an example, when DocuSign revealed their revenue estimates were $20 million below company guidance the stock dropped by 32% in pre-market trading, wiping $15 billion off the company's value. This just serves to demonstrate how little tolerance investors have for missed targets, as well as the high volatility of the US tech market.

Small and mid-cap companies are expected to benefit more than large cap companies in the next few years as there is a wider choice of smaller firms in growth opportunity industries. Although profits have been rising, in order to continue this upward trend companies will need to ensure they have high revenue growth, while being able to pass any cost inflation onto the consumer. Supply bottlenecks are expected to subside around the middle of next year, although this is dependent both on minimal disruption due to Covid and increased infrastructure to cope with higher demand (e.g. semiconductor supply).

A more persistent issue will be wage inflation as job markets remain tight due to the low supply of skilled and unskilled labour.

Furthermore, President Biden's infrastructure plans will help to support higher valuations, with capital going to sectors such as high-speed internet and renewable energy.

Compared to other regions such as Europe and the UK, average price-earnings ratios in the US have been much higher. This may not necessarily mean that the US is overvalued, however – arguably, both the UK and Europe are undervalued.

The Chair of the Federal Reserve Jay Powell recently made comments suggesting that monetary policy could start to tighten, with rate rises bought forward to combat rising inflation before it becomes entrenched.

The Fed started its asset purchase tapering a few weeks ago and is expected to end its bond buying altogether in June at its current pace. This is a change of narrative for the Fed, which has previously adopted a cautious approach. Markets are currently pricing in three rate rises next year, with the earliest coming as soon as May. The term "transitory" has been abandoned here too. Treasury yields increased after this news and markets dropped slightly.

The latest figures also show that the US unemployment rate fell to 4.2%, its lowest since the start of the pandemic. However, the number of jobs created stood at 210,000, far below economists' predictions of 550,000 for October. Markets sold off modestly at this news, indicating a belief that the Fed will continue with its course.

Europe

Although Covid infection rates in Europe have soared and some countries have increased lockdown measures, these are not expected to be long-lasting.

More concerning is inflation in the bloc becoming entrenched. There is a difficult balancing act between rising rates to tame inflation, and letting inflation continue to avoid choking off economic recovery. European governments have high debt levels and for countries like Italy, increasing interest rates could cause the cost of servicing these debts could become unsustainable.

Tapering of the central banks bond buying programs are expected to commence early 2022, but at the moment rate rises are some way off (in direct comparison to the US and UK).

Investment in Europe does look promising. Europe has many market-leading companies in green technology which are poised to do well against the long-term backdrop of increased climate awareness. Not every company in the green sector will do as well as others, however. Wind turbine manufacturers are facing higher input costs and poor execution on orders. Stock selection will be important here to differentiate the winners from the losers.

Other industries of note in the European area are life science companies which are experiencing high capital inflows. Technology companies such as semiconductor manufacturers are expanding their capacity to take account of a growing market. Capital goods manufacturers, banks, and financial stocks are also poised to do well.

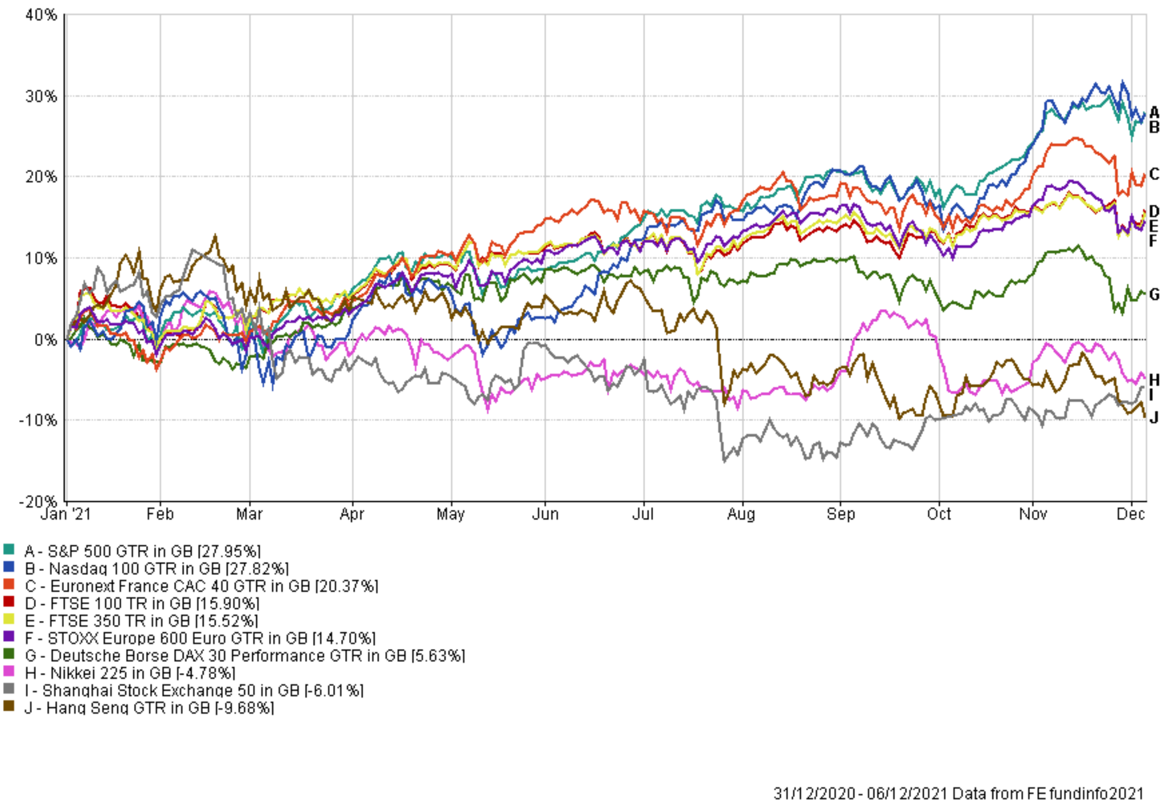
One area of concern is consumer facing stocks, such as restaurants, which could be squeezed by wage inflation and returns to more restrictive lockdowns.

Emerging Markets

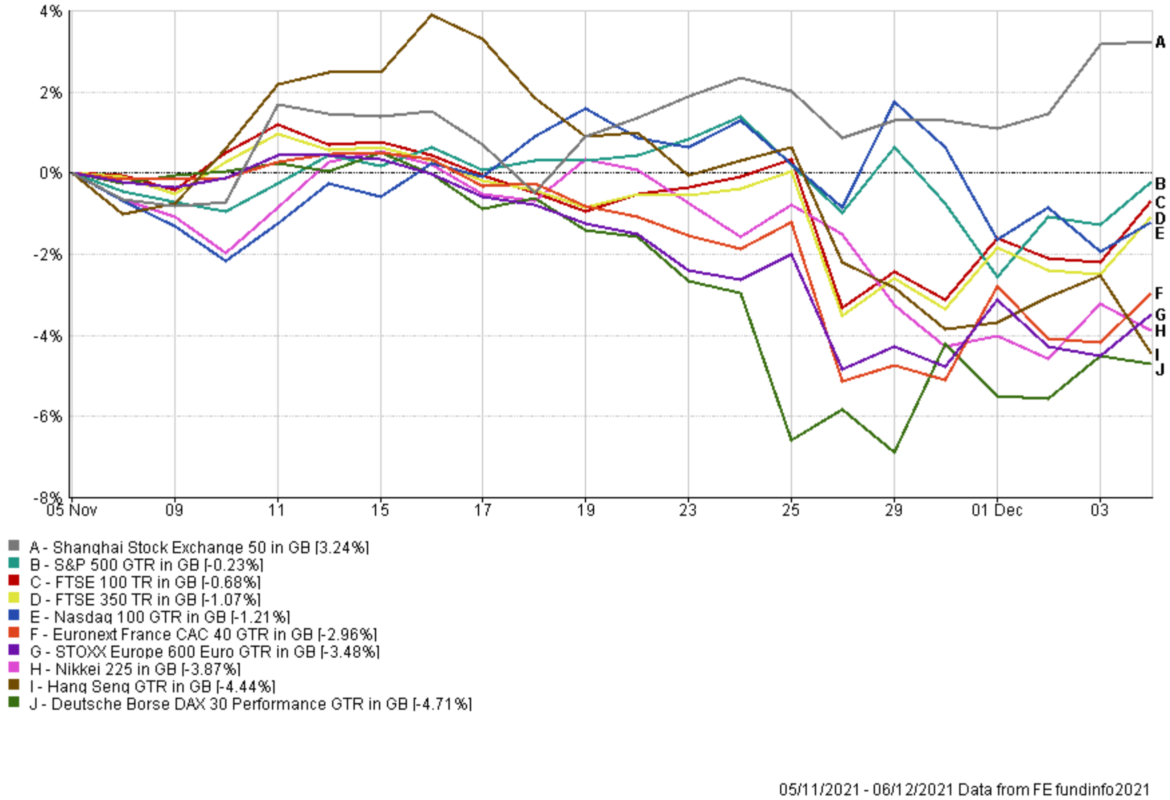
Further regulatory reforms in China are making many stocks in the region unattractive. However, these reforms could be set to benefit smaller companies. The recent drops in Chinese equities could signal a could buying opportunity, but there remain considerable risks to investing in this region, especially if government officials interfere in markets too much and the emergence of a planned state becomes another unwelcome development, albeit not a surprise.

Many investors are preferring to invest in Indian stocks rather than Chinese stocks due to uncertainty over the regulatory reforms in China. Although many stocks have sky high valuations in India, investors are still confident the region can deliver good returns, mainly in the tech industry.

There is also a long pipeline of new IPOs that investors are looking forward to.



Major Stock Indices YTD performance



Major Stock Indices 1-month performance

Robert Dougherty, December 2021.

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