ROCQ CAPITAL

Third Quarter 2021

It was an eventful summer in the markets with some significant global developments and moves within asset classes, particularly in September. The US withdrawal from Afghanistan captured attention in August, with the evacuation of military bases in rapid fashion causing chaos and leading to some upsetting scenes amid the return to power of the Taliban. This had a negligible impact on financial markets, but reinforces the view that the geopolitical balance in the Middle East and elsewhere is shifting, perhaps with a more prominent role for Russia and China overseas as the US draws back.

Domestically, China had a challenging quarter. The government acted to clamp down on a number of sectors as it made strides in its push for "common prosperity", which is a key goal of President Xi. Mobile gaming and the private tuition sector had new regulations introduced while e-commerce companies were also targeted. Areas that may have negative social impacts, or that collect large volumes of data, seem to be the focus. This introduces a level of uncertainty into Chinese investments, and is a reminder that the business climate there can be quite different to that fostered by western governments.

In addition, the problems of Evergrande, a large property developer, came to a head in September after being flagged for some time, supporting Ernest Hemingway's notion that there are two ways to go bankrupt – "gradually, then suddenly." The government will be closely watched in its handling of the fallout given how interconnected Evergrande is with banks, retail financial products and prominent political interests. The Chinese economic model has been strongly supported by the property market over recent decades, with huge amounts of lending, construction and demand for raw materials providing the foundation for much activity. While the economy has broadened significantly in recent years with the growth of e-commerce, hospitality, travel and healthcare, it is reasonable to expect a slowdown of growth in the quarters ahead.

Elsewhere, economic growth looks set to remain strong with companies and individuals in the US and Europe in good health on aggregate. Evidence amongst large firms suggests buoyant operating margins and high cash balances with which to invest or make acquisitions, while households have built up higher cash buffers and are supported by record low interest rates. The main constraint on activity, whether at a company or individual level, appears to be supply issues. There has been no shortage of examples of long lead times for materials, accompanied by steep prices increases. This is a global phenomenon, and there seems little sight of it easing over the next few months. The UK's recent problems with fuel supplies – exacerbated by labour shortages in the wake of Brexit – and gas prices have been a stark example.

This backdrop is undoubtedly inflationary, and previous expectations of merely a 'transitory' period of sharper price rises look less likely as time goes by. Inflation has risen to 3.2% in the UK, with the Bank of England expecting it to breach 4% before falling back, while it has reached 5.3% in the US with narrower 'core' measures also moving higher (such as the PCE Core Deflator at 3.6%).

Concerns about inflation prompted a sell-off in most assets in September. Cyclical or lower-valued sectors were the exception, doing relatively well towards the end of the quarter with energy particularly strong given a significant run-up in the oil price (Brent Crude ended September around $80 per barrel, compared to $40 a year before). As a whole, however, September was a bruising period with equity and bond indices both suffering

after a period of solid gains during July and August. For the quarter as whole, returns in local currency were close to zero across the leading major equity indices such as S&P 500 +0.2%, FTSE 100 +0.7%, Eurostoxx 50 -0.4% and MSCI World -0.4%. Weakness in China drove the MSCI Emerging Markets Index to a loss of 8.8% during Q3, making it a clear underperformer. UK government bonds fell by 1.8% during the quarter after posting a 3.7% drop in September alone, and the Global Aggregate measure of bonds worldwide also declined by 0.9% during Q3. The low fixed coupons on offer from most fixed income investments are less attractive at higher inflation rates, so for the quarter as a whole they did not provide the diversification benefits they usually have over the past decade or so.

Outlook

We have reached this point in the commentary without mentioning Covid-19. The outlook on this front looks brighter than three months ago. The successful vaccination roll-out in most developed countries and greater social mixing without a spike in hospitalisations gives confidence that the Delta variant can be managed, though it may still present challenges during the winter. This provides an additional boost to economic activity, which looks strong in most regions and industries.

Supply constraints and their impact on inflation are a concern, even if longer term demographic and technological trends remain disinflationary. Higher wages in lower-paid industries may be good for long-term growth, but labour mismatches in the short term and the difficulty of procuring goods in a timely manner look highly likely to put continued upward pressure on prices. It seems reasonable to expect the current disruption to continue for some time, and to prompt further de-globalisation as supply chains are brought closer to home, or even in-house for large firms that are able to acquire upstream or downstream businesses to give their operations more security. Amongst asset classes, equities have historically provided the best protection against inflation and our equity investments are largely targeted to funds holding companies that have pricing power so that cost pressures can be passed on without too much impact on margins. These companies are also often in a strong financial position to expand where necessary via acquisitions, given their cash flow generation is typically robust.

As mentioned in previous quarterly commentaries, we expect volatility in fixed income markets to remain relatively high so are most comfortable in shorter duration holdings or, via Alternatives, in strategies that are able to quickly and efficiently move duration around in the case of significant moves in sovereign yields. This is particularly the case given that leading central banks have started to shift to slightly more hawkish stances, with interest rate rises and the gradual removal of monthly asset purchases (QE) on the cards for next year. The US Federal Reserve and the Bank of England both made steps in this direction during September. Given the overhang of debt at a corporate and household level they will want to move slowly and probably to a lower terminal point than was reached in previous cycles. It is unlikely that developed economies could withstand rates back in the 4-5% range that was common before the financial crisis.