Santander Asset Management

50 years creating value

State of Play

9 December 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. As well as spending time with loved ones, the festive period generally sees many investors, professional or amateur, peer into their crystal ball in an attempt to anticipate what the following year may hold. State of Play explores some of the themes that may impact investment markets next year.

Global economic recovery to continue

The reaction by governments to the emergence of COVID-19 was to restrict most of our daily activity and switch the pause button on the economy in the hope of reducing the impact of COVID-19 on both lives and the economy. What followed in the UK was the worst economic recession in over 300 years. Following the stock market rout, financial policymakers reacted like never before with swift and decisive action in reducing interest rates to near zero, printing trillions of pounds in new money and ensuring financial markets had stability and, importantly, liquidity. Job support schemes and financial loans were introduced and helped to protect against mass unemployment and business failures, providing the necessary time for scientists to team up with drugs companies to develop new vaccines.

The roll-out of double injections, and now boosters, has supported economies to re-open and with it investment markets have continued to drive higher. So, will economic growth continue into 2022? Given the continuing financial support and favourable monetary environment the consensus across the investment management profession is that economic growth will remain

strong in 2022, albeit not as strong as this year's extraordinary bounce back. Regardless of the ongoing supply side issues and shortage of raw materials, continuing consumer demand will likely drive growth forward next year despite consumer confidence taking a knock in the wake of the Omicron variant discovery. Clearly the scientific analysis of the new strain will be key to whether this is temporary or develops into something which could slow the economic momentum.

Certainly, recent Omicron impacts notwithstanding, current economic activity levels and mobility continue to improve and only experience lags in countries where immunisation is incomplete. The effectiveness of vaccines has been key in this recovery, which began in manufacturing and then transferred to the services sector, including travel, tourism, and hospitality. This recovery has been extraordinarily supported by policies which accelerated economic growth but appear now to be unnecessary. Strong household spending, inventory restocking and growth in capital spending should support economic activity globally next year.

Inflation to play a leading role

Elevated rates of rising prices have played a significant part in investment markets in the second half of 2021. A combination of pent-up demand, dislocation in supply chains and a shortage of raw materials has seen inflation spike to the highest in 10 years in the UK and the highest in 30 years in the US. Initially, central banks claimed that this would be temporary but changed their tune as prices rose faster than their forecasts had suggested. All central banks acknowledge that they underestimated the breakdown in the world's supply chains, especially in the shipping industry. Vast numbers of containers scattered around the world, caused by China being in lockdowns and reopening at different times to developed markets, has seen a sharp rise in transportation and distribution costs, leading to a shortage of goods being delivered to meet demand. Unusual weather in both China and Europe has seen energy prices soar with most commodity prices elevated to above pre-pandemic levels. In addition to all of the 'cost-push' factors like shortage of raw materials, in certain sectors there is also an acute lack of people to fill vacancies prompting high wage settlements and higher contracts being offered. This has also seen pressure on the cost of goods and services as companies raise their prices to help meet the cost of bigger pay packages to attract new recruits.

The Bank of England said a couple of weeks ago that they now anticipate inflation to average 4% for most of 2022, and 3% in 2023. They are not expecting inflation to fall to their target level of 2% until the end of 2023. In the US the rate is even higher, but importantly policymakers appear to be willing to tolerate higher inflation to protect the ongoing recovery. The Federal Reserve has started to switch off the financial support and with inflation elevated, both here in the UK and elsewhere in the world, a gradual

rise in interest rates is expected. The crucial unknowns are when rises will happen, by how much and how often?

At this point the world's biggest central banks mainly share the same view, having not raised rates since the crisis started, but high inflation levels and their tolerance to above target levels will be different depending on the country and region. This may lead to a divergence of rate rises, shifting bond yields, changing currency dynamics and may result in economies growing at different speeds. Importantly, economies are unlikely to go back to the 1970s and most experts agree the world is not heading into stagflation. However, we can all expect inflation to be significantly higher than in the recent past, affecting interest rate rises, bond yields, and share price valuations. For savers the combination of much higher inflation and low interest rates for longer represents a significant threat to the ongoing value of their wealth. One to watch closely in 2022.

Learn more

You can learn more about stagflation in this previous edition of **State of Play**.

Growing influence of sustainability

Assets in dedicated sustainable investing strategies are one of the highest growth segments of the wealth management industry. This demand looks poised to accelerate – being driven by societal and demographic changes, increased regulation and government focus, and greater investment conviction. To achieve the goals of the Paris Climate Agreement and restrict further increases in global average temperatures to well below 2°C, human society needs to reach net-zero emissions of long-lived greenhouse gases by mid-century. This great transformation will only be possible if we globally embrace new non-polluting technologies.

Whilst additional progress was made at the United Nations summit in Glasgow in November, there is much work to be done. Policymakers and governments can lead this change with dynamic decisions encouraging us to adapt to a new way of living but without the influence of private companies and importantly private investment, the ambitious goals are unlikely to be met in the timescales required to avoid disastrous long-term consequences. The investment management profession has made great strides in support of these goals by starting to factor in the way companies plan and change their behaviours to a more sustainable future. If companies are unwilling to make the necessary changes over time investors will likely vote with their feet and may move their investments elsewhere. The role of the financial sector in this transition is crucial, channelling the money from investors to the companies performing a successful sustainable transition and to the economies most committed to it. Environmental social governance (ESG) transitioning is one of the leading themes not only for next year, but probably for the next decade.

Investment markets

The recovery in financial markets has been even more remarkable than the economic recovery and it is difficult to find a financial asset that has not far exceeded pre-pandemic price levels. In some cases, such as commodities or shares, the revaluation has been truly spectacular, benefiting from both the favourable interest rate environment and the strength of the economic rebound. Economies and investors are looking beyond the recovery and questioning the sustainability of the cycle and the variables that are experiencing the greatest degree of uncertainty. How will the key themes and the financial environment potentially affect asset classes?

Fixed income assets

One of the consequences of the outbreak of COVID-19 is the financial response from central banks to lower rates to all-time lows. When investors hold bond assets, often as a diversifier for a multi-asset portfolio, they seek an asset class that will behave differently to shares. In times of financial stress or uncertainty, like we saw in the first few weeks of the crisis, bond assets delivered this diversification as bond yields plummeted increasing the value of the bonds helping to protect portfolios against some of the stock market sell-off.

However, with rates at record lows and inflation rates elevated for longer, the pressure on central banks to respond eventually to the inflation threat places bond assets under increasing pressure as yields start to rise in response. We have seen this at times in the latter half of this year, but the expectation is this has only just begun. Eventually, when central banks do raise rates and importantly their language becomes more hawkish (their desire to tackle inflation grows), then bond yields will likely grind higher reducing the value of bonds themselves, hurting portfolio values.

As State of Play has explained in previous updates, bond assets struggle when inflation remains higher than bank targets, especially if it is sustained. The problem for investors is once inflation is factored in, the ‘real’ return on bond assets is negative unless you are willing to invest in higher risk debt which carries much higher volatility. One thing is very likely, multi-asset portfolios may not provide the total returns investors have become used to in recent times as bonds remain under pressure from raising yields and high inflation therefore making the job of portfolio managers much harder.

Shares

The spectacular rise of share prices since the sell-off in the first quarter of 2020 has made many investors nervous about share valuations and whether these can be sustained next year. It is important to remind ourselves that investors always face a trade-off between risk and return, and this has always been the dilemma and will remain so. In part, this is one of the

reasons for continued rise in share prices. Investors facing the threat of much higher inflation than we have seen for many years embrace more risk to overcome this threat. With bond assets offering very little real return over the next few years, many have moved some or all of their investments into shares, driving valuations in many cases to record levels.

The record-breaking financial support offered by banks with loose monetary policy and governments backing employers and employees with furlough schemes, have enabled company earnings to grow substantially. Whilst this support will be gradually removed and loose monetary policy will tighten, this does not necessarily mean that earnings will fall sharply. The growth of earnings may slow but with continued pent-up demand, perhaps the driver of earnings will shift from policy support to more organic growth. If inflation does remain elevated for longer, share prices may come under pressure as investors revalue their share price, especially when inflation is factored into a high starting point as we are at currently. So, it may mean much more volatility as markets become sensitive to important inflation data trying to predict how central banks respond and how investment markets will likely react.

The last two years have been extraordinary by anybody's standards and this horrible virus is not yet defeated. However, there remains lots of optimism for next year albeit mixed with plenty of uncertainty. For the average retail investor, it remains vital that they regularly review their portfolio ensuring that their investments are aligned to a combination of their individual long-term goals and risk appetite. Maintaining a diversified portfolio matched to these factors will provide more probability of achieving those goals.

Find out more!

Click **here** to read our latest A Month in the Markets, where our Head of Multi-Asset Solutions, Stefano Amato, looks at how key themes impacted markets in November.

Note: Data as at 7 December 2021.

Important Information

This material is for information only and does not constitute an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services.

Opinions expressed within this document, if any, are current opinions as of the date stated and do not constitute investment or any other advice; the views are subject to change and do not necessarily reflect the views of Santander Asset Management as a whole or any part thereof.

Issued by Santander Asset Management UK Limited (Company Registration No. SC106669) is registered in Scotland at 287 St Vincent Street, Glasgow G2 5NB, United Kingdom. Authorised and regulated by the Financial Conduct Authority (FCA). FCA registered number 122491. You can check this on the Financial Services Register by visiting the FCA's website www.fca.org.uk/register.

Santander and the flame logo are registered trademarks. santanderassetmanagement.co.uk.