Elmwood's market review – a walk through 2021

2021 marked a strong performance for global stock markets, which were bolstered by strong corporate earnings as economies began to re-open from lockdowns. Markets showed their resilience against a backdrop of rising inflation and continued disruption brought about by the COVID-19 pandemic.

The year began with a sense of optimism; however, it was quite clear from the start that the year ahead would be defined by the COVID-19 pandemic and how policy makers would respond in dealing with it. There was some exuberance in markets during the first quarter, as investors celebrated the successful vaccine programmes in both the UK and US.

Developed market equities: UK, US, Europe and Japan performed well over the quarter, whilst China and Asia Pacific fell into the red. China was the only major economy to record economic growth for 2020[1], however 2021 proved a difficult year as supply chain disruptions stifled demand from its trading partners.

On 20th January, Joe Biden was sworn in as the 46th president of the United States and the Democrats now had control of both the House of Representatives and the Senate[2], the latter previously under the control of Donald Trump's Republicans. This was seen as a positive for the year ahead, because Biden would have a better shot at passing through policies – the first of which being a $1.9t trillion American Rescue Plan, passed in March, aimed to provide critical aid to workers and business still dealing with the effects of the pandemic.[3]

Whilst markets performed well, there was some turbulence across asset classes as fixed income bonds experienced some volatility to the downside – rising inflationary concerns nudged investors to favour equities, causing bond yields to rise.

Since the start of the pandemic, Technology shares have performed exceptionally well – partly due to robust business models, but also due to increased demand for their goods and services as consumers worked from home and/or self-isolated. February, however, marked a sharp sell-off in Technology shares[4], as investors expected economies to begin re-opening and policy makers hinting at interest rate hikes. Technology shares are often negatively correlated to interest rates due to the way in which they are valued, so when interest rates go up, the value of Tech shares normally fall, to reflect this 'revaluation'. Some Tech companies have also borrowed and thus taken on high levels of debt to drive further growth and undertake share buy-backs – therefore, rising rates will drive up the servicing costs of this debt.

Government bonds also struggled during the first quarter due to rising inflationary pressures, leading to the anticipation of rising interest rates.

By the Spring, Europe had begun to turn around its hampered vaccine programme and started to catch up with the UK and US. Emerging economies were still struggling with inoculating their populations as access to vaccines proved difficult. A strong US dollar also created a headwind for Emerging Markets,[5] due to having debt exposure to the global reserve currency. Emerging Markets service their US dollar debt by selling their local currency, this means they must sell more of their local currency when the US Dollar rises – which normally impacts their performance.

During the second quarter of 2021 inflationary concerns took centre stage, and the rest of the year was consumed by this debate on whether increased levels of inflation across the world was going to be 'transitory', or more persistent.[6] The argument for being in the transitory camp was that rising costs would be temporary as the world re-opened following lockdowns – prices would taper back to pre-pandemic levels. Whilst in the persistent camp being that supply chain bottle necks and continued disruption would persist, due to the emergence of the various variants spreading rapidly.

Throughout 2020, the so-called growth companies outperformed their value counterparts – this seemed to switch around during the first three months of 2021 which saw value outperform growth. The market waited with abated breath to see if this trend would continue – Indeed, growth shares have outperformed value for many years, but reversion to the mean is potentially overdue. By the end of the quarter, it was clear that growth was back in favour and looked as though investors sought these growth companies to some extent, as a haven.

Growth shares, which is dominated by the big Technology companies gave a boost to stock markets at the beginning of the second quarter, with strong corporate earnings showing further demand for their goods and services during the pandemic. Industrials and financials also reported strong earnings.

Most major stock markets performed well throughout the second quarter to the mid-year point – US and Europe were leading the way with the UK and Asia Pacific providing good returns to investors. Japan turned red and China continued to disappoint. There was correlation in markets between those countries most affected by the pandemic, a theme we expected at the beginning of the year.

Fixed income bonds produced a modest but positive return over the second quarter – this contrasted with the first three months of the year, which saw bonds underperform. Yields across US, UK, Japanese and German bonds fell as investors agreed with the central bank narrative that rising inflationary pressures would be transitory. Worried about reversing much of the recovery since the onset of the pandemic, central banks were signalling that they would hold interest rates at their extremely low levels, even in the face of rising household costs.

By the third quarter of 2021, there was some positive news coming out from the US with their economy officially recovering to pre-pandemic levels.[7] However, there were several themes playing out and being debated due to their idiosyncratic effects on the future performance of financial markets. This gave rise to a term not seen or really spoken about since the 1970's – stagflation. Otherwise known as recession-inflation, is a situation in which the inflation rate is high, the economic growth rate slows, and unemployment remains high. It's rather paradoxical in nature, because it's a tricky set of circumstances for policy makers to navigate out from: if they raise interest rates to counter inflation, they risk derailing the recovery, however if they do nothing, they risk losing control of inflation. Damned if you do, damned if you don't.

Continued supply chain disruptions were persisting throughout the year and could partly be explained by China's zero-Covid policy.[8] A zero-Covid policy certainly increased the chance of sudden disruptions caused by testing or new lockdowns and brought about much uncertainly. Markets do not like uncertainty, and this began to by priced into valuations by September.

At the September rate meeting, the US Federal Reserve (Fed) indicated that they could begin raising the fed funds rate by as early as 2022 and that they may begin tapering their bond buying programme (known as quantitative easing) sooner rather than later.[9] The Bank of England (BoE) on the other hand, indicated that their benchmark rate was likely to increase sooner – something that played out with a rate increase at the end of the year. The BoE raised their benchmark rate from a record low of 0.10% to 0.25% on 16th December 2021,[10] causing UK Government bond yields to rise.

Stock markets across developed economies were negative or moved sideways during September, erasing gains from the previous two months. Japan however providing strong returns throughout the whole of the third quarter. China affected the whole of Asia Pacific and Emerging Markets due to a multitude of factors. The demise and possible default of China's once largest property developer – Evergrande, gave rise to concern about the systemic risk to China's real estate sector.[11] China also embarked on a major regulatory crackdown across the education, technology and gaming sector – wiping billions from companies' market values. When investment in the Tech sector moves away from China, the Emerging Market of India is seen as a beneficiary.[12] An outright contraction in China's manufacturing sector in

September cemented the already known supply chain bottle necks and rising costs of raw materials.

By the fourth quarter markets were showing their resilience against a backdrop of increasing Delta cases and rising inflation. UK inflation surprised investors in November, soaring to 5.1%, up from 4.1% in October.[13] The other side of the pond saw US inflation print at 6.8%,[14] its highest point since 1982, as reported by the Bureau of Labor Statistics. Despite this, the global recovery continued, even if momentum had weakened. In its October outlook, the International Monetary Fund (IMF) projected the global economy to grow by 5.9% in 2021 and 4.9% in 2022.[15]

November marked the 26th UN Climate Change Conference. COP26 took place in Scotland, which saw world leaders come together and agree on policies to accelerate the transition to a net-zero carbon economy. This resulted in the newly established Glasgow Financial Alliance for Net Zero of $130 trillion of private capital to accelerate this transition. This is expected to shape markets and drive new areas of growth in the coming years.[16]

Developed market shares performed well during the last three months of the year, despite the emergence of the new COVID-19 variant Omicron and the prospect of central banks raising interest rates sooner than expected. Some parts of Europe introduced new restrictions to curb the spread of Omicron and an energy crisis in natural gas emerged – causing its price to spike higher – something that is expected to continue into 2022.

2021 will be remembered as a stand-out year across western developed market equities – which returned above average returns during a precarious economic climate.

US equities rose during the final quarter of the year – helped by a 'Santa rally'. The S&P500 returned 26.9% and the Dow Jones gaining 18.7% in 2021, while the Nasdaq gained 21.4%. In fact, the S&P500 notched 70 all-time highs during 2021, which hasn't been achieved since 1995.[17]

The UK's FTSE 100 had its best year since 2016, finishing the year up by 14.3%. Europe's Stoxx 600 recorded a 22.4% jump for 2021, its second-best yearly performance in over a decade. Japan's Nikkei 225 finished the year up 4.9%, whilst the MSCI's Emerging Markets index recorded a 2.54% drop over the year, weighed down by continued supply chain disruptions with economies still struggling to recover from the pandemic. India on the other hand, was amongst the best performing Emerging Markets in 2021, with the NSE Nifty 50 index closing out the year up 24% - helped by China's clamp down in the Tech sector.

US domestic bonds lost 1.9% last year with long term Treasuries losing 5.0%. Bonds around the world had a somewhat lacklustre year – inflation, once again, being the primary driver.

Outlook for 2022

Whilst developed markets have been extremely resilient to many risk factors throughout the course of 2021, there is an expectation that 2022 will see increased levels of volatility and further economic headwinds. Central banks have begun removing some accommodation (QE) and are sailing on a policy course to higher interest rates to counter recent spikes in inflation, which is now being seen as less 'transitory'. Corrections in markets are a normal and healthy mechanism which serve as a catalyst to move on from.

The pandemic is by no means over, however markets and economies have had plenty time to adjust to the 'new normal' and are better placed to tackle future challenges, when they arrive.

We remain cautiously optimistic for the years ahead and remember that investing is for the long term, which means staying away from short term noise.

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[3]The Guardian, $1.9tn American Rescue Plan Passed, 10/3/21

[4]CNBC, Rate driven sell-off is hitting Tech Stocks hardest, 5/3/21

[5]CNBC, Strength in USD, harder for EM to service US debt, 1/12/21

[6]Reuters, What if transitory is not so transitory after all, 16/7/21

[7]The Guardian, US Economy Returns to Pre-Pandemic Level, 29/7/21

[8]CNBC, China's zero-Covid policy, 13/8/21

[9]Reuters, Fed Bond buying taper coming soon, rate hike next year, 22/9/21

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[16]Law Society, COP26, 3/11/21

[17]Forbes, Stock market year in review, 3/1/2021

Important Information