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Multi-Asset Strategy Quarterly

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Foreword



Jimmy Elliot
Head of Multi-Asset

Welcome to our latest Multi-Asset Strategy Quarterly. In this edition, Philip Saunders looks at how the US Federal Reserve (Fed) may look to respond to the renewed inflationary pressures. Sahil Mahtani discusses a new research paper from the Investment Institute, exploring the true extent of China's technological progress over the past 15 years, and Russell Silberston reviews the policy announcements by the major central banks over the past quarter. Finally, we close with a succinct summary of our higher conviction asset class views, beginning with equities, moving on to fixed income, currency and closing out with commodities.

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Market observations



Philip Saunders
Co-Head of
Multi-Asset Growth

Will rising inflation spoil the party?

After a brief flirtation with deflationary risks, investors' top concern has reverted to inflation as supply shortages have come in the wake of the 'V' shaped recovery. The persistence of supply-demand mismatches has been highly unusual, and we have to go back to the post WW2 recovery to find a precedent. Market inflation sensitivity is hardly surprising given the impact of yet more financialisation within developed economies, which boosts valuations even as it underpins a system more prone to episodic volatility. We believe the most serious risk for markets is regime change; if eventually inflation expectations were to become unanchored, the low interest rate regime would arguably be challenged and central banks would be forced to tighten significantly more than current expectations, with severe consequences for financial asset prices across the board.

The official line has been that the evident price and wage pressures are "transitory", and Fed Chair Powell used his keynote speech at this year's Jackson Hole retreat to articulate why he believes that inflation will subside. In his view inflation is not broad based, some price surges are already abating, base effects from 2020 will wash out, wage pressures are no threat so far and longer-run inflation expectations remain anchored near to the Fed's target level of 2%. Furthermore, many of the structural disinflationary headwinds, such as demographics and technological change, will continue to blow over the medium to longer term. The Fed retains this line even as its own median forecasts for core inflation in 2022 have nudged up from 1.8% last September to 2.3% at the most recent forecast. In other words, "transitory" may last a little longer.

The Fed will be prudent

Some have argued that the Fed no longer cares about inflation and has pivoted towards a focus on its other mandated goal: that of achieving full employment. If the economy runs hot and inflation temporarily overshoots its target, so the argument goes, today's Fed will be a lot more relaxed than it was in past incarnations, forswearing its post Volker tendency to pre-empt rising inflation. This is much too strong a view. For one thing, it conflates time horizons. Supply-demand mismatches while the economy is restarting cannot be extrapolated into a self-reinforcing inflationary spiral underpinned by permanently higher consumer expectations. For another, it conflates the new central bank commitment to tolerate higher inflation with a central bank that cares little about inflation.

In our view, central banks may have pivoted somewhat, but they show no signs of allowing inflation expectations to become unanchored and thus squandering their hard-won legacy of credibility. They will tolerate probably 2.5% inflation on a sustained basis, but anything more will, in our view, be met with a tightening bias. Indeed, recent Fed pronouncements about the timing and speed of the ending of the emergency measures adopted in response to the impact of COVID on markets and economies seem to have surprised in their 'hawkishness'. Finally, while we are not expecting inflation to be quite as low as was the case in the ten years or so after the Global Financial Crisis we think that Powell is right about the strength of offsetting structural factors.

Growth dynamics remain key

All this must upset the conspiracy theorists who believe that central banks are secretly conniving in a plan to get inflation up to levels that would help to inflate away government deficits. Short of a set of circumstances that were to result in central bank independence being severely circumscribed by governments, we believe central banks' 'reaction function', or their response to events, has not changed in any revolutionary way. Far from complacent central bankers marching us to the edge of an inflationary spiral, it would be more correct to say that Western economies will have 'got away' with the printing of money on a vast scale in order to see off two major deflationary collapses.

In the shorter term, the cycle will be determined by growth dynamics. A continuing moderation towards trend growth rates in the key economies would arguably allow excess demand and supply shortages to ease and price pressures to ebb. This is particularly true given that the bar to further increases in inflation numbers is mechanically made difficult by the steep base effects—used car prices will struggle to jump 30% for two years in a row. Furthermore, consumer and business inflation expectations, while currently elevated, are adaptive and notoriously unreliable, they tend to be a reflection of the status quo and the hyped-up news environment rather than providing leading information.

The risk to this view is a reacceleration of growth resulting from widespread herd resistance to COVID, which causes a series of rolling demand shocks that disrupt key sources of supply. This would cause inflation to remain stickier for longer, forcing central banks to raise rates faster and well above current consensus expectations. We remain in the former camp – high prices tend to be the best cure for high prices – and believe supply responses tend to be what gets underestimated, as does the impact of tightening liquidity, the effects of which are already having an impact.

Rather than rising inflation, tightening liquidity is the more likely candidate to spoil the party.

Thematic viewpoint



Sahil Mahtani
Strategist, Multi-Asset

China's tech revolution: unprecedented scale, mixed results

In December 2020, China's Chang'e 5 mission touched down on the moon to collect rock samples. Three weeks later, the lunar module returned to earth carrying a cargo of more than four pounds of samples, the first such mission to be completed in more than forty years, making China the third country after the US and the former Soviet Union to return from the moon. This is remarkable progress, but when assessing China's core mission to achieve independence in key technology-based industries, it helps us ask questions such as: despite some clear success stories, why is China still importing around half of the key components needed to build commercial jetliners?

Further understanding the true extent of China's technological progress was behind our decision to engage Chris Miller, assistant professor of economic history and international history at the Fletcher School of Tufts University, to assess China's progress developing technological independence. This is not just a discussion about China's e-commerce or digital economy, but an independent assessment of China's industrial policy and the government's efforts to develop new technology companies to spur future growth and avoid the middle-income trap that has beset many other nations in their economic development. Beijing is placing billions of dollars of (venture capital) bets that state guidance and government subsidies can produce profitable companies with world-class technology that can continue to lift economic standards.

China's record is mixed, even by its own standards

Chris's research concludes that China's record with flagship government industrial policy programmes, focused on specific sectors through plans like 'Made in China 2025' and its predecessors, is mixed – even when measured on the state's own terms. There's no denying that Beijing has an extraordinary record of generating economic growth over the past four decades. But policies that have produced China's economic growth – its move away from central planning after the 1970s, its embrace of foreign investment and exports, and its massive infrastructure investment – are very different from its attempts to support specific industrial sectors or firms. Therefore, to assess progress over the last 15 years since Beijing launched major subsidy programmes targeting specific sectors and supporting development of cutting-edge technology, we need to define what we mean by industrial policy. Chris draws on the expertise of Barry Naughton, an eminent scholar of China's economy, who defines industrial policy as “any type of selective, targeted government intervention that attempts to alter the sectoral structure of production”.

One of the more intuitive ways to assess China's progress is to look at China's 2006 industrial policy – centred around engineering megaprojects – with comparable categories from 'Made in China 2025', launched in 2015. Chris concludes that only a few of the 2006 megaprojects were phased out, with most added as objectives for 2025, suggesting that targeted sectors have not yet reached the technological frontier. There are certainly exceptions, including the effort to land a spacecraft on the moon and to produce next generation broadband wireless, but in many categories, such as robotic manufacturing, aircraft, advanced pharmaceuticals, and high-end computer chips, China's dependence on foreign components has increased rather than decreased.

One success of note

There is also more than meets the eye when delving into China's success stories, which include its role in consumer electronics production (e.g., iPhones), leadership in digital payments (AliPay and WeChat Pay), high speed rail and TikTok, which has been a major feature of our lockdown lives over the last 18 months. So, what can we deduce from these successes? Firstly, digital payment systems and the likes of TikTok were unplanned and unexpected by the government, and therefore not related to industrial policy. Secondly, China's high-speed rail is less about product innovation and more about the government's ability to build the required infrastructure using technology already in use across Europe and Japan. This suggests that Huawei winning a major share of the market for 5G network equipment is the only major example in which a Chinese firm has won international contracts thanks to technological innovation in a field designated by Beijing as an industrial policy priority. Even then, Huawei, which operates more like a private firm, outperformed ZTE, its state-owned competitor in China.

Looking ahead, Chris's research shines a stark light on China's technological progress and asks the question whether Beijing – through huge subsidies – can achieve independence in its own microchip industry without relying on increasingly less cooperative US technology. It also asks whether China, the largest market for electric vehicles, can assume global leadership in this burgeoning industry where only three Chinese firms make the top 10 in domestic electric vehicle sales and no Chinese brands are in the top 10 for global sales.

Our job at Ninety One is to digest this research, conduct our analysis and consider the implications for investors as China progresses along its path (or not) to technological independence. We have created three scenarios to think through the investment consequences.

- **Scenario one:** against the odds, China's huge investment plan pays off. Western analysts who underestimated China's technological progress on internet-based firms in the early 2000s and 2010s do so again.
- **Scenario two:** successes (like solar equipment) and failures (like semiconductors) forms our base case. Broad-based research and development investments provide some upside to growth through productivity gains in the medium term.

- **Scenario three:** China succeeds in very few areas. Debt piles up and China reverts to a less expansive innovation policy in 2-5 years, weighing on capital and labour productivity.

In determining which scenario might be realised, our analysis of Chris's research has focused on China's shift from horizontal industrial policy innovation to vertical policy innovation. The former seeks to foster economic development without a focus on which particular sectors will grow (infrastructure spending). However, vertical industrial policies target specific sectors and we have seen a decisive shift in this direction since 2006. Chris's research shows unambiguously that the results of these policies have been mixed. However, it is also clear that China is pouring unprecedented sums of money into its effort. If we go back to the aircraft example, while half of the state-owned Comac widebody planes still rely on imported parts – analysts believe that the resources available to Comac are effectively unlimited.

Why is China doing this?

China's motivation is twofold. Relations with the US have remained hostile even with the change of administration in the White House, with the US willing to deny China access to vital technologies. In addition, Beijing believes that in the middle of a technological revolution, there is an opportunity for China to get ahead of other countries in general-purpose technologies.

For a nation established so recently, it is not accidental that the People's Republic of China aims to become a technological superpower by 2050, a year after celebrating its first century. China has demonstrated that it can succeed in technological development despite a lack of historical precedent. The success of the internet names such as Alibaba and Tencent, which are now among the largest in the world, is one of the clearest examples. It is our thesis that despite the mixed record of recent industrial policy, China's general policy apparatus, run by a bureaucratic elite of considerable ability, should not be underestimated.

Policy review



Russell Silberston
Strategist

The Fed heads for the exit

In our last policy review we noted that the “starting pistol has been fired” for the US Federal Reserve (Fed) to pull back on its quantitative easing programme and, over the past quarter, the Federal Open Market Committee has edged further toward the exit door, stating in September “that a moderation in the pace of asset purchases may soon be warranted.” This is pretty explicit guidance, and barring any major economic shock, it will begin to reduce its quantitative easing programme in November, moving at pace, with the taper expected to be completed by June 2022. Our last review also discussed a hawkish shift to “risk management” in the face of persistent inflation and whilst core inflation declined from 4.5% to 4.0% over the quarter, the Committee is clearly nervous and has brought forward its expected interest rate increases, as illustrated by the “dot plot”. Were inflation expectations to accelerate further or cost pressures remain higher for longer, the Committee will be contemplating higher interest rates within the next twelve months. On balance, however, we believe current inflation is transitory and so will ultimately fall back again, allowing the Fed to fulfil its promise of keeping interest rates unchanged until maximum employment has been achieved. One reason why the Committee may be cautious on interest rates is the headwind from fading fiscal relief, as COVID-related support programmes expire. Whilst the Biden administration’s proposed infrastructure bill will provide some offset, its multi-year nature will not be enough to stop a much tighter fiscal stance in the coming year.

China stays cautious

The People’s Bank of China (PBOC) continued its cautious approach, making stability its top priority and ensuring that monetary policy is “flexible, targeted, reasonable and appropriate”. In theory, the PBOC is trying to keep debt-to-GDP stable over the next five to seven years whilst ensuring there is sufficient financial system liquidity to avoid any sudden jolts in the highly indebted property sector. In practice, this means tweaking policy to ensure money goes to favoured sectors, such as manufacturing and rural development, whilst ensuring an orderly deleveraging of the property market. It has released more cash into the system via a cut in bank reserve ratio requirements to allow COVID-related medium-term bank loans to be repaid. The net effect of this is that the PBOC’s balance sheet has actually shrunk modestly this year, in contrast to all other major central banks. Going forward, given the over-riding deleveraging goal, it seems unlikely that there will be a wholesale easing of monetary policy in the face of a slowing economy. Rather, we continue to expect further targeted responses and a slightly easier fiscal stance from that experienced earlier in the year.

Europe faces a tough decision

In the Eurozone, the European Central Bank’s Pandemic Emergency Purchase Programme (PEPP) continued to add a monthly 70 to 80 billion euros of liquidity. However, given this programme is both time and size limited, the pace of purchases will slow in coming months. With headline inflation likely to be at 4% by year end, the Governing Council faces a tough decision. Does it end the programme as planned in March 2022, risking a monetary cliff, or does it roll over some of the purchases into the much smaller and longer-running Asset Purchase Facility? With inflation at twice the target level, there will inevitably be push back from hawkish members, and the risks are that Eurozone financial markets will have to face a sudden and large taper. There will be an additional small negative impulse from fiscal policy, which tightens modestly, although Italy and Spain will benefit from the EU Recovery Plan payments.

Japan goes green

The Bank of Japan introduced a new 10-year green lending programme, offering one-year loans to banks at 0% which they can tap in order to make green loans, sustainability-linked loans with performance targets related to efforts on climate change, also known as fund transition finance. Following a policy review, which sought to ensure policy can remain easy enough whilst mitigating any damaging side effects, growth in the Bank of Japan's balance sheet has slowed to 3.7% this year.

Bank of England faces uncertain speed limit

As highlighted in our last review, the Bank of England unveiled its monetary policy exit strategy. In contrast to most other major central banks, the Bank has decided to start passive quantitative tightening when the base rate reaches just 0.5% and then start actively tightening once it reaches 1%. The framework behind this decision was set out at Jackson Hole in 2020, which, in respect of quantitative easing, can be summarised as 'go big, go fast' but then reduce the stock of holdings once the crisis has passed. With much uncertainty about the UK's economic speed limit, the Bank adopted a tightening bias in August, and markets are now anticipating a series of rate hikes from the end of this year. Whilst there is no doubt that hikes are on the agenda, the economic fog associated with COVID means the Bank is likely to tread cautiously, and whilst we expect the base rate to lift off in February next year, beyond that, it is not clear how much monetary tightening the economy can handle, especially given the ratchet effect of tighter fiscal policy kicking in too.

Summary of high conviction asset class views

Growth Bonds

EM growth and inflation momentum has moderated and is likely to support EM LC. Valuations have continued to improve, in particular real interest rates on both an absolute and relative basis are now scoring very positively whilst roll and carry is close to historical levels, increasing the bar to negative returns. Favour those areas that have nominal and real rate advantages to DM, as well as attractive carry dynamics as these should continue to benefit from deeply negative real interest rates in DM and aggressive central bank policy.

Positive – Mexico, Peru, Colombia, Brazil, Russia, Chile

Negative – No conviction views at present

Sector Equity

Prefer asset light compounders with structural growth underpinning although increasingly wary of high valuations in some areas. Substantial opportunities which benefit from accelerating structural change in cyclical technology, industrial and consumer sectors. Pharmaceutical and Consumer Staples sectors offer an attractive combination of high quality and reasonable valuations.

Positive – Materials, Industrials, Cyclical Tech, Staples, Pharma, Healthcare Tech

Negative – Energy, Telcos & Utilities, Real Estate, Media & Online Retail, Consumer Goods

Defensive Bonds

The outlook is now more mixed for defensive bonds with divergence between markets apparent. A large repricing in inflation premia centred in the US and the dollar bloc has led to a significant repricing in yields which offers steep curve shapes and attractive carry in areas such as Korea and New Zealand. Europe and UK have yet to see the same repricing suggesting there remains room for yields to move higher. Inflation premia is at the point of peaking in the US and should begin to fall as price momentum turns negative in the coming months, supporting a negative view of US breakevens and real yields.

Positive – China, New Zealand, Korea

Negative – Germany, US Breakevens & Real Yields

FX

The Federal Reserve appears to have pivoted and policy is likely to become progressively less easy from here. This comes at a time when the slowdown in the Chinese credit cycle is feeding through into economic data and we have seen growth momentum decline rapidly. Hence there appears to be upside risk to the USD over the next 12m as macro and policy divergence emerge between the US and China while the outlook for the Renminbi looks challenged. Hence CNY has been downgraded to maximum negative and USD upgraded.

Positive – GBP

Negative – CNY, TWD, NZD, SEK, Gold

Credit

Spreads are marginally wider on the month with US HY underperforming due to weakness in CCCs. 2Q21 earnings were strong across the board with US large caps in particular performing strongly. Default rates continue to fall and all asset classes with the exception of US HY saw inflows. Remain neutral on credit asset classes overall with the view of becoming negative once the deterioration in macro dynamics is sufficiently evident to offset the cost of shorting.

Positive – No conviction views at present

Negative – No conviction views at present

Regional Equity

Asia has structural tailwinds however the cyclical outlook looks challenged with relative earning dynamics poor and increasing regulatory incursion. Micro factors remain supportive elsewhere with momentum strong. US benefits from further evidence of resilient capital allocation and the greatest breadth of opportunities. Cyclical growth catchup in Europe ex UK is offset by structural headwinds and expensive valuations.

Positive – US

Negative – Europe ex UK

Commodities

Just when the recovery in commodity prices appeared to be moderating, energy prices moved sharply higher in September, led by natural gas in Asia and Europe. At the same time, US natural gas prices also advanced, putting upward pressure on the whole energy complex with coal and oil prices also moving higher. They have also had knock-on effects for commodities such as nitrogen fertilisers and aluminium which are energy intensive. At the same time, the chronic shortage of power in China has led to factory closures, prompting severe supply chain disruption. The global economy is facing a difficult period as inflation looks set to remain high and growth could slow as high energy prices hit consumer spending and fiscal policy begins to be tightened.

Positive – Fertiliser, Energy, Steel, Aluminium, Gold

Neutral – Iron ore, Copper, Zinc, Nickel

Equity views

We hold a positive view on the **US** equity market, where the underlying strength of the corporate sector has been further demonstrated through another strong earnings season and broad-based upgrades to forecasts. Buy backs have also begun to return, driven by banks that have had restrictions removed. We remain negative on **Europe ex UK** equities, which continue to be weighed down by unresolved structural challenges and high valuations. The composition of the market and export exposure across the European economy also means that the market is highly exposed to the growing risk of a more substantial Chinese growth slowdown later in the year.

On that note, **Chinese** equities have displayed a dramatic divergence between companies most directly impacted by new regulatory measures on internet companies and the property sector and the most cyclical parts of the market, including resources, industrials and banks, which have delivered strong positive returns. A deeper Chinese growth slowdown would be expected to change this trend with the impact falling most heavily on cyclical and asset intensive sectors. **Asia ex. Japan** has been downgraded to neutral given the degree of policy tightening through credit and regulatory channels and reduced valuation support, which offset the positive structural view that the team has towards the region. Emerging markets have also been downgraded relative to developed markets given Asia's large weight within the universe.

At the sector level, we retain our maximum positive view on **cyclical technology** given the strong structural support it is receiving in addition to the expectation that the global manufacturing growth cycle will continue, albeit at a more modest pace. Our thematic research on Chinese industrial policy highlighted the substantial ongoing state-driven investment in building a domestic semiconductor industry, which provides additional support to the positive view on semiconductor equipment in particular. In aggregate, global semiconductor revenues are driven by the global manufacturing cycle and the two have become more closely aligned as semiconductor content increasingly features across consumer and industrial products.

Despite having distinct supply dynamics, the memory cycle is very closely aligned with the broad semiconductor cycle, suggesting that the shared demand dynamic tends to dominate, although price and earnings momentum have been significantly weaker in memory. As long as global manufacturing growth remains positive, we

expect semiconductor earnings to continue to outperform other cyclicals given the secular growth and quality dynamics. Bottom-up evidence continues to point to broad-based strength in end demand across PC, datacentres, networking, smartphone, wireless and analogue. Any concerns about the impending end of the current cycle are based on selective or anecdotal evidence, in our view. Persistent attempts to call the turn ahead of time often leads to missing out on the best periods of returns.

We have upgraded **media & online retail** to negative from maximum negative on the basis of more positive views across a number of smaller components of the sector and a major reset in valuations in the Chinese internet sector given the substantial regulatory change which is underway. Our review of the video gaming and US cable sectors drew positive conclusions on the competitive moats which have been created by the leading companies and in the sustainability of these businesses. Whilst further announcements and uncertainty can remain an overhang on the sector, we believe that valuations of Chinese internet companies have moved to increasingly reflect the heightened regulatory burden. We await greater clarity on the overall regulatory environment before we can take a clearer view on the long-term earnings potential of Chinese internet companies.

We remain positive on the **pharmaceuticals** space and believe recent newsflow on drug pricing demonstrates this topic remains on the political agenda, but incremental changes rather than a sweeping overhaul remain the most likely outcome. Executive and administrative powers are not sufficient to significantly alter the pricing environment; legislation will be required, and we believe measures are likely to be included in the upcoming budget resolution. Given the small Democratic majorities in congress, any workable compromise will have to be acceptable to the most moderate Democrats in both houses. Capping drug costs based on international comparison is unlikely to pass, but additional powers for price negotiation in some Medicare purchases are feasible. With the debate already fierce on numerous other aspects of the bill, appetite for a fight on drug pricing may be limited, with it more politically astute to secure a more modest legislation victory rather than jeopardise the entire programme.

Fixed Income views

The Fed began its discussion around tapering during August with the rhetoric from the committee increasingly pushing towards a shorter time period for tapering in order to give more flexibility around rate hikes. The expectation is for the labour supply to rise in September as the unemployment support measures roll off and people return to work, however, if this turns out not to be the case and the current tightness persists then the Fed may be forced to tighten faster than expected. The shift to a risk management policy setting implies that if the economy is running hotter than expected or inflation remains higher for longer, a hike could come faster than expected. Recent guidance suggests if the core Personal Consumption Expenditures level remains above 3% then that would be a catalyst to hike quicker in order to try and cap the upside to inflation. The most recent MPC meeting saw several members move their rate hike expectations forward and confirm the more accelerated path of tapering. The Fed will now begin to taper its asset purchases in November, taking seven months to complete, allowing it room to hike twice in 2022 if the economy remains strong.

Government bonds: With this in mind, conviction has continued to build over the period that as the Fed moves towards tightening and with inflation fully priced, we should see real interest rates move higher. The team remains neutral on **US** nominal bonds as although inflation has typically been supportive for government bonds, it is offset by the more challenging valuation backdrop for real yields. We have an unchanged negative view on **European** nominal bonds given expensive valuations and accelerating inflation. Clearer evidence that slower Chinese growth is starting to impact Europe would be likely to lead us to revise this view. We continue to hold a positive view on **Chinese** bonds as a result of renewed monetary easing and continued signs of slowing growth momentum. We expect these dynamics to continue as the previous credit tightening continues to feed through into growth, adding a tailwind to lower yields. We also have positive views on **Korea** and **New Zealand** government bonds as these economies are linked into Chinese macro cycle and sensitive to any growth disappointment in China whilst also priced for ongoing tightening cycles and hence offer greater risk premium than the Chinese market.

Emerging market local currency: EM central banks have proactively built in a significant interest rate buffer relative to developed markets (DM), which will prove helpful as the US embarks on a tightening cycle. As long as the external environment holds up, EM local currency markets should be able to weather somewhat faster than expected Fed tightening. The risk scenario for EM likely requires further weakness in Chinese growth and/or a significant drop in

commodity prices alongside US tightening. Current account balances remain very supportive as export demand from DM has been strong and terms of trade very positive. We retain our selective approach, favouring bond markets with a significant number of hikes already priced in; **Russia, Mexico and Czech** are notable standouts.

Emerging market hard currency: IMF SDR allocations have supported balance sheets, particularly in frontier markets but also in some larger economies. Along with better fiscal revenues, this is expected to lead to lower issuance requirements for the rest of the year. We note that a number of distressed sovereigns are also showing improvement (**Argentina, Ecuador, Zambia** and possibly even **Sri Lanka**). The team's preference remains for high yield names where spreads have failed to compress to the same degree as higher rates bonds.

Developed market credit: The overall picture remains one where strong corporate fundamentals and technical factors are offset by expensive valuations. As a result, we have made relatively few changes to credit recently. The default outlook remains very robust, driving strong fundamental support. Our preference remains for **BB or defensive sectors** targeting strong carry names. Technicals remain supportive with inflows across all credit asset classes but loans, in particular, have been strong.

We have thoroughly discussed **Chinese property** names recently given the blow out we have seen following the emergence of Evergrande's challenges. While headwinds to the sector are likely to persist, changes within the developers should mean they have become more attractive from a debt perspective. The regulatory focus on the industry has become much more aggressive which has led to a decent cooling in activity in the property market, which ultimately has led to a crackdown on developers and their sources of funding. Evergrande has been made an example of by the regulator as a developer who hasn't moved towards reaching its 'three red lines' (debt-to-cash, debt-to-assets and debt-to-equity ratios) laid out earlier in the year.

Given its large size in the economy, the team believes it is too big to be allowed to fail but we have seen yields on its debt and other higher beta developers blow out. Higher quality names in the index haven't seen the same stress leading to a large dispersion in the underlying index constituents. Overall, we believe the sector makes sense for a small exposure currently, but if we see a point of greater policy easing in the future then these assets are likely to be the first beneficiaries and a more material position would be warranted.

Currency

Currency views

The **US dollar (USD)** has been upgraded to positive and the **Chinese yuan (CNY)** has been downgraded to maximum negative to reflect the macro and policy divergence between the two major regions. The US is likely to see growth remain robust, supported by excess savings and supply bottlenecks, and the Fed is running the risk of being forced to exit its stimulus policy more quickly than planned in order to catch up with the stronger-than-expected underlying fundamentals.

In China, on the other hand, the tightening in policy we have seen should continue to feed through into growth and ultimately require future policy easing. If we see these dynamics continue to progress and broaden out to also impact economies heavily linked to the Asian growth cycle such as Europe, additional upgrades to the US dollar are likely. This view has been reflected through USD vs. CNY and the **Taiwanese dollar** in the conviction positions and portfolios, with the latter providing a positive carry. Within European currencies, the **Swedish krona** is the preferred short given its high cyclical exposure and highly accommodative policy from the Riksbank.

The **Japanese yen (JPY)** and **euro (EUR)** scores have been maintained at neutral and JPYEUR kept as a hedging position for now, if we see a more material slowdown in growth, we believe it may be necessary to downgrade the EUR vs. the JPY to capture further exposure to a slowing Chinese credit cycle given its likely pass through into European data. We also maintain a neutral view on EMFX, with preference for select high carry EM currencies including the **Russian ruble**, the **Mexican peso** and the **Indonesian rupee**. If further evidence emerges of the US diverging from the rest of the world, this will make further downgrades to EMFX likely. **Gold** has been downgraded to maximum negative to reflect the high conviction view on US real yields rising and USD strength over the coming months.

Commodity views

After the record one-year advance in the Bloomberg Spot Commodity Index through the end of June, commodity price rises slowed in the third quarter. Industrial metals and agriculture rose modestly, while precious metals fell. Energy was the stand-out sub-sector, of course, backing up the second quarter's 24% rally with another 20% return.

With tightness in energy markets being felt globally but particularly in China and Europe, the concern now is what impact this might have on inflation and growth over the coming months. Weather will be an important factor but, with stock levels for LNG and coal looking very low for this time of year and unless there is a very mild winter in the northern hemisphere, prices look likely to remain much above normal levels for at least six months. Whilst oil prices have been relatively slow to rise compared to LNG and coal, they are also at new highs for the year, with Brent above \$80/bbl for only the second time since 2014. OPEC+ has decided not to increase supply by more than the extra 400k bbl/day already signalled, which is not a great surprise; OPEC has historically been much more effective at reducing supply to support prices than it has been at adding supply to moderate price rises.

Growth could overheat, hampering equities

With logistical issues keeping freight rates high, labour shortages in many markets and now higher power costs, consumer prices look set to continue to rise and inflation could well remain higher than forecast. With the Fed looking to begin tapering soon, the odds are shortening that the very strong growth seen in recent months is curtailed faster than expected. The current slowdown in China, exacerbated by power shortages, is a concerning signal for global markets and whilst Europe and the US are unlikely to slow too sharply, central banks could be faced with slowing growth and rising or elevated levels of inflation over coming months. This could increase concerns that equity markets are in for a more challenging period, although it may also signal improved fortunes for the gold price, which has drifted lower recently.

Clearly, we have seen energy related equities react positively to the current squeeze, with gas and coal producers benefiting most in the short term. European oil majors also rallied in the second half of September as oil prices, held back by the threat of lockdowns over the summer, were boosted by the emerging energy squeeze. With cashflows looking very strong going forward and European gas prices adding to earnings at the margin, investors are returning, having been deterred by the uncertainty of COVID outbreaks and concerns over how these companies will transition away from fossil fuels. On this latter point, the Europeans have been much more aggressive in laying out their plans and are beginning to transition at a time they are benefiting from strong cashflows from their existing assets while capital expenditure moderates.

Aluminium looks attractive

However, the current power shortages have boosted a number of aluminium companies in the West as China's power shortages have led provinces to cut this energy intensive production. As China has been a large exporter of aluminium in recent years, these cuts have left Western consumers short. Steel is another commodity where China has cut production hard to lower emissions and conserve power. This has resulted in steep falls for iron ore prices and iron ore producers as China's demand weakens, however steel prices have remained at record highs in the US and Europe. Despite this, whilst aluminium equities continued to rally, steel equities in US and Europe traded sideways in the third quarter, held back by concerns about future growth and new capacity announced in the US, worrying investors about the industry's capital discipline. With annual contracts under negotiation currently with automakers, steel companies are seeking steep rises in contract prices for 2022, which should help underpin cashflows even if order books soften somewhat from the extreme tightness seen this year. With President Biden still looking to get his infrastructure bill approved, any weakness may be temporary in any case.

Commodity

Lumber could be a canary

Agriculture has not been immune to the energy price rises. Nitrogen fertilisers are very energy intensive, with the plant shutdowns in Europe due to high gas prices leading to a sharp advance in the fertilisers and related equities. Potash demand has been boosted, with prices rising to their highest levels in over eight years. Lumber prices may, in fact, be the example we should be looking at for a number of commodities. After futures prices rose sixfold from their 2020 lows to peak above US\$1600 per thousand board feet (mbf) in May this year, they collapsed back to \$450/mbf before settling at around \$600-650/mbf in the past month. Over the past 25 years prices have averaged \$300/mbf in nominal terms and it looks likely that they are resetting to a higher level. Could we see a similar dynamic in steel prices and other commodities? If this occurs, the prospect is very interesting for equities, as lumber shares have held record highs despite the decline in prices. Whilst the equity market can look through temporary extreme moves in commodity prices; we don't see evidence that it is discounting structurally higher prices yet.

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