MARKET BACKDROP
A review of what's happened in markets recently

MARKET OUTLOOK
Looking ahead to the coming months

SPOTLIGHT ON
Tapering

The view
Autumn 2021

architas

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Welcome

to The View – Autumn 2021

The Autumn edition of The View provides a step-by-step guide to how the political and economic environment has driven financial markets, and what this means for your investments.

With any large changes by central banks such as tapering it is inevitable that there could be a degree of volatility. We delve into what tapering is, what led to the 2013 taper tantrum and what could be the impact of tapering this time around.

The term ‘helicopter money’ has been heard many times since the Great Financial Crisis, describing a particular and unorthodox style of monetary policy. Has the experiment ever been tried, and has it ever worked? We hover down and take a closer look.

The Principles for Responsible Investment (PRI) has become increasingly popular with responsible investors across the globe. We find out more about the goals and requirements of the PRI and its signatories.

Jaime Arguello
Chief Investment Officer

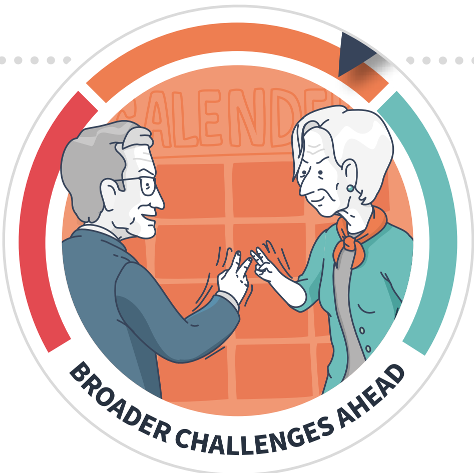
Market BACKDROP

Over the quarter, despite global growth momentum slowing, demand initially remained supported by easy financial conditions and excess savings. That is until September, when markets did a U-turn as a surge in energy prices added to the conviction that the jump in inflation could last longer than previously expected.

Evergrande, also weighed on sentiment as markets witnessed a faltering Chinese economy with worries that it would also dent the world economy.

In the end, global stocks ended down due to losses in September despite hitting record highs earlier.

As lingering worries about slowing global economic growth and higher inflation put the main markets on course for losses all-round. With oil, high yield bonds, the US dollar and US markets the exceptions.



ECONOMIC FACTORS

Taper talk: As major economies bounced back thanks to Covid-19 vaccination campaigns and an easing of lockdown restrictions, the debate about dialling back emergency stimulus began. And despite the Delta variant weighing on growth momentum, multiple developed world central banks started to taper, or at least provide a timetable to normalise policy. With the much-anticipated announcement from the Federal Reserve arriving at the end of the quarter.

China's weakening economy: China's recent regulatory efforts targeted at narrowing gaps in wealth by clamping down on industries stirred markets globally. Regulators targeted industries ranging from steel to education to property, and curbed the outlook for growth in the world's second-largest economy. Fears are starting to grow that Evergrande's problems might be symptomatic of a wider property sector malaise and that the Chinese economy might now be headed for slower and more balanced economic growth.

RISKS

Transitory inflation? Soaring gas prices, staff shortages, a lack of ships and price pressures globally have been picking up faster than anticipated. This challenged the view that inflation will prove transitory. Central bankers are no longer so sure how long transitory pressures will continue as supply bottlenecks continue.

Is Evergrande a systemic risk? Evergrande, one of China's biggest property developers and Asia's biggest junk-bond issuer, is so entangled with China's broader economy that markets worried about the potential for systemic risk as late debt payments could trigger so-called cross-defaults. However, there was a last minute agreement to settle interest payments, temporarily soothing fears of imminent contagion.

FINANCIAL MARKETS

Falling at the last hurdle: Global equity markets ended the quarter in a disorderly fashion as they suffered their first quarterly loss since the pandemic in early 2020. A last-minute sell-off in shares drove major indices lower, capping a tumultuous September. Inflation fears, soaring energy costs and an Asian slowdown fuelled concerns over the strength of the pandemic recovery.

The bond market caught investors off guard. Bond markets were shaken by central bank signals that interest rate rises are drawing closer. After a huge July rally, bond markets tumbled in September, sparking the steepest price declines since the global debt slide at the start of the year. High yield bonds managed to eke out some positive returns whereas corporate bonds and government bonds were generally down.

CONCLUSION

The third quarter was characterised by a growth slowdown, an uptick in Covid cases, and higher inflation. While soaring energy prices threatened to exacerbate a near-term spike in inflation.

However, markets have also shown resilience and remain not too far off their recent highs and demand remains robust. And forward-looking indicators, while off their post-pandemic highs, are pointing toward above trend growth and expansion.

Are we in for a bumpy ride this year? Possibly. Especially if there are any more blows to the world economy, just getting back on its feet. All of this underlines the importance of global diversification.

Market OUTLOOK

As we enter the final stages of 2021, the continued supply shock and outbreaks of the Delta variant of coronavirus have tempered the recovery in global growth. And as the momentum of the global economy slows, surging energy prices and rising inflation have intensified market fears over the prospect of economic stagnation or 'stagflation'.

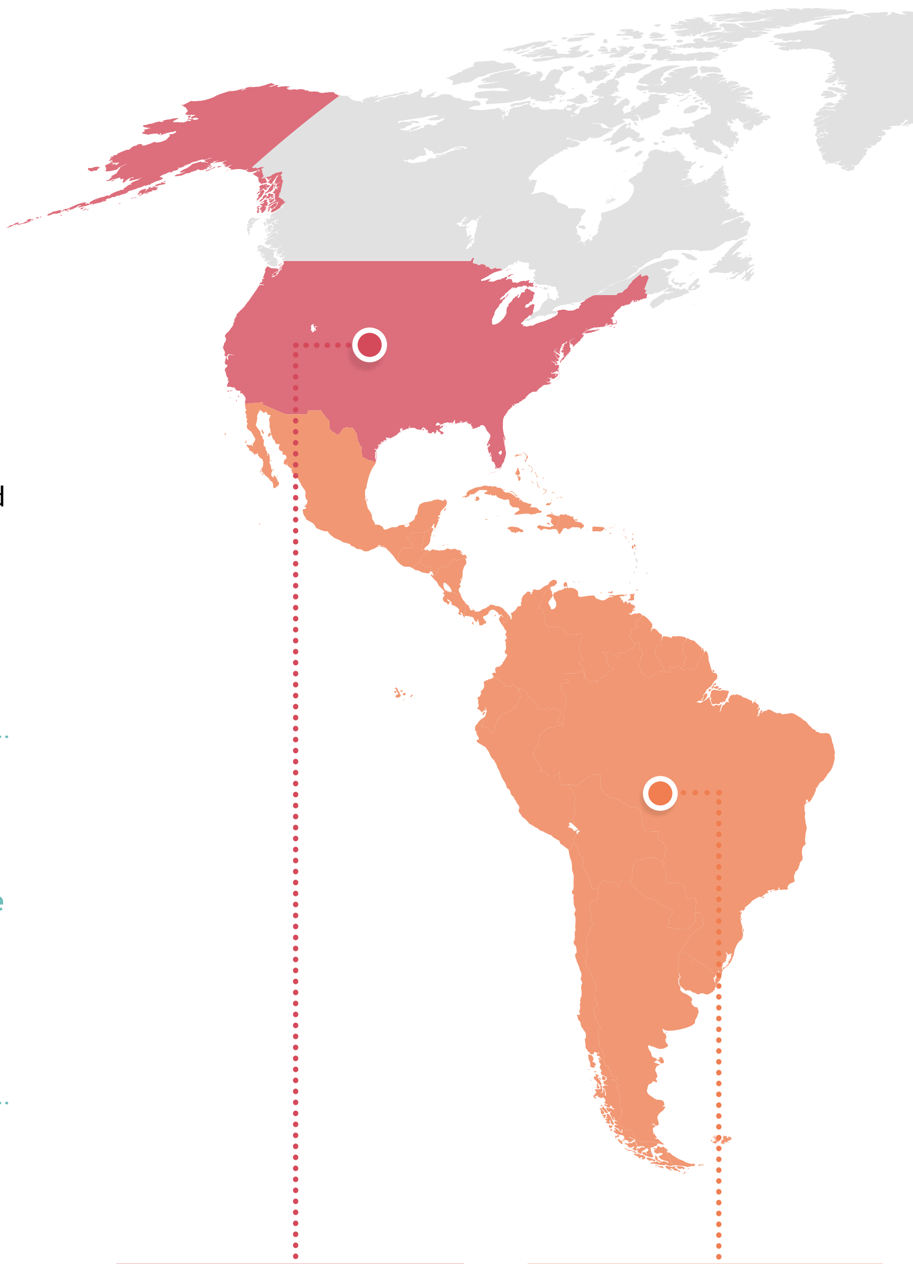
While we are more comfortable with the outlook for some of these key risks, we do note that we are likely past peak growth. The global economy has been in the middle of an extraordinary recovery period, and a moderation of economic growth and consumer optimism should come as no surprise.

We believe that markets remain supported by strong corporate earnings and supportive monetary policy. But debates about the path by which the global economy returns to 'normal' and China's regulatory crackdown also present additional risks.

With this in mind, markets could become increasingly choppy, especially cyclical areas tied to interest rates and economic growth. Investors should not be surprised by ongoing volatility and market rotation; these are a normal part of investing.

KEY

- Positive
- Negative
- Neutral



UNITED STATES

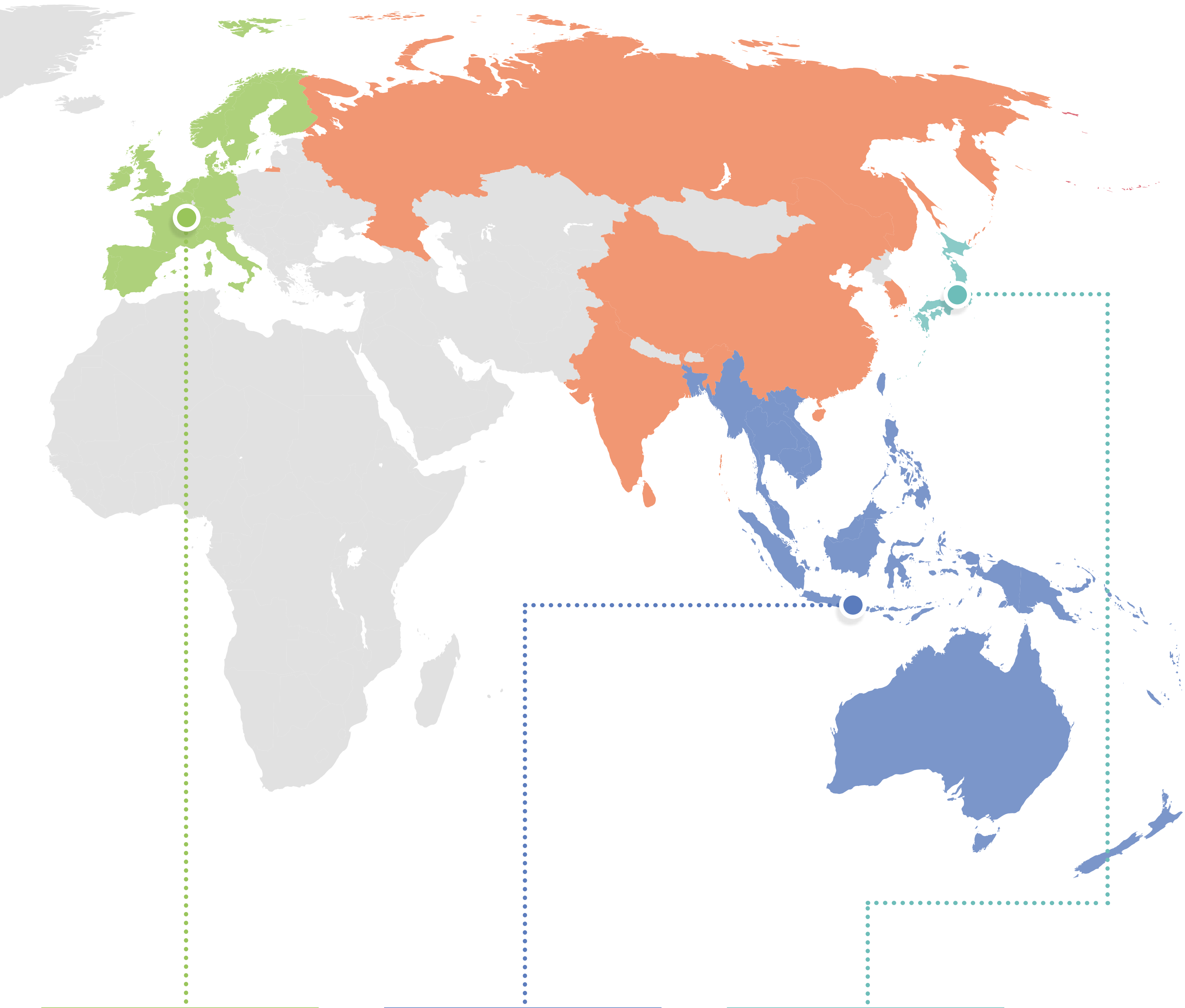
STOCKS (Neutral) BONDS (Negative)

- We have improved our outlook due to strong fundamentals and evidence that the delta variant is fading. Wage inflation is a key risk to this view.
- We remain underweight US bonds because we feel the negative impact of rising rates may be more pronounced in the US.

EMERGING MARKETS

STOCKS (Neutral) BONDS (Positive)

- While the emerging market region looks quite attractive from a valuations perspective, we remain cautious in the near term given the increased political risk.
- We remain cautiously positive about emerging market bonds due to their higher yields than their US counterparts. And any impact from a rise in rates would be less pronounced than in the US.



EUROPE

STOCKS BONDS

- We have become less positive about European stocks. Although we still believe Europe is below its potential output and economic growth will continue to increase in the coming quarters.
- Overall, we remain neutral with a preference for corporate bonds over government bonds as they are better positioned to be protected from rising rates.

ASIA PACIFIC

STOCKS

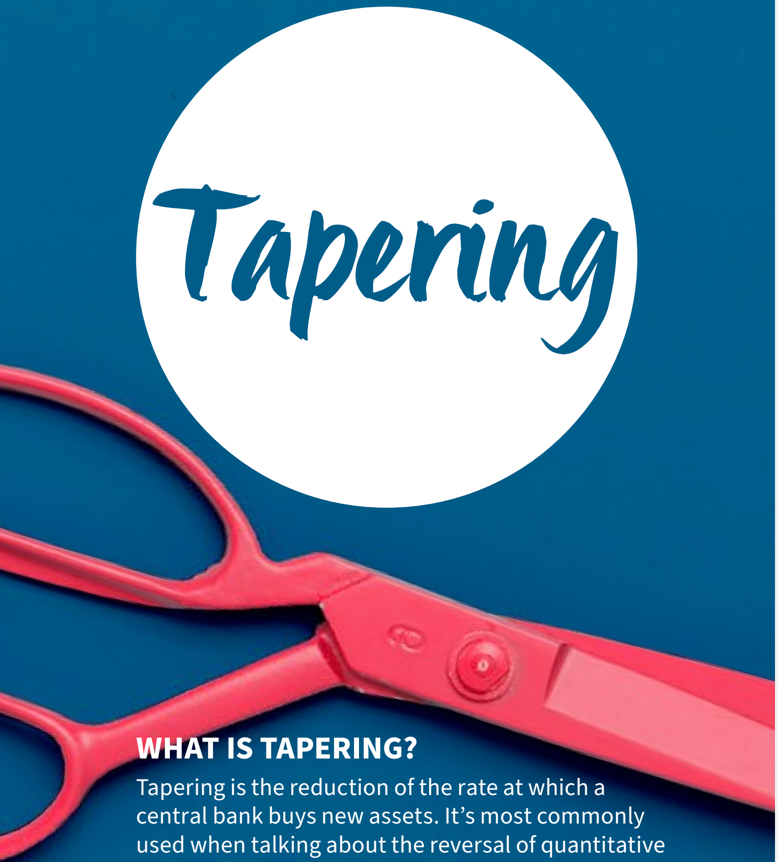
- Global peak growth fears and regulatory tightening in China weighs on Asia-Pacific region. Supply bottlenecks and surging producer prices appear to be capping the upside in much of the manufacturing sector.
- Despite the more cautious near-term outlook, the medium-term outlook for Asia remains positive.

JAPAN

STOCKS

- We are less positive about Japan. Recent Covid-19 restrictions and the delayed economic reopening have dampened consumer sentiment, and it may take time for consumer demand to return with force.
- All eyes now are on the general election. We believe any potential tax increases and the removal of focus on governance would be detrimental.

SPOTLIGHT ON...



WHAT IS TAPERING?

Tapering is the reduction of the rate at which a central bank buys new assets. It's most commonly used when talking about the reversal of quantitative easing (QE) policies. Where central banks print money to buy assets such as government bonds.

The aim – or at least, one of the aims – of QE is to reduce the cost of borrowing across the entire economy. This makes it cheaper for those with debts to pay their interest bills. It should, in theory at least, also make it more appealing for companies to borrow money to invest in expanding their businesses. This in turn should help to boost economic growth.

WHY DO CENTRAL BANKS BUY BONDS?

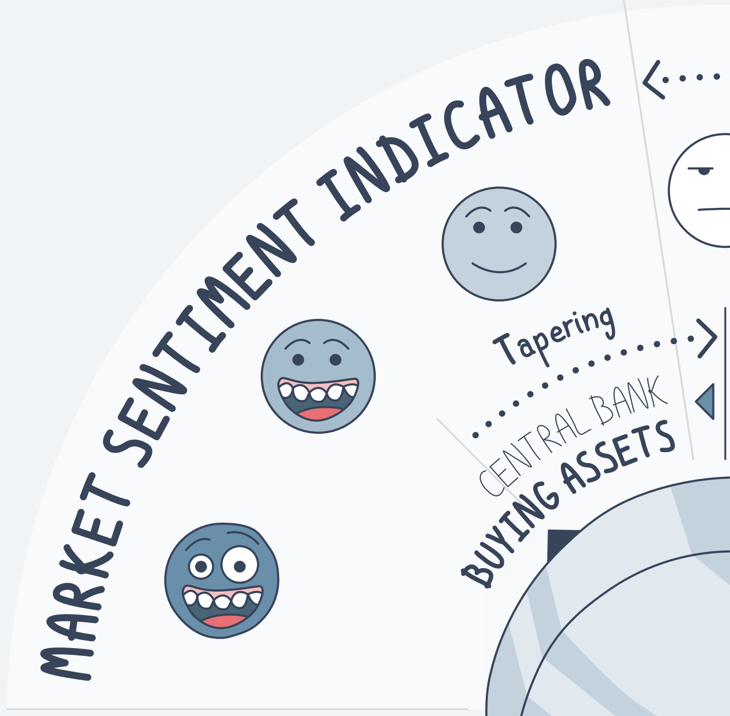
When an economy is in downturn, like it was in 2008-09, or at the start of the pandemic, banks reduce funding such as loans, given an increased risk default as well as an overall reduction in available liquidity. At such times, central banks step in and reduce interest rates and buy bonds to induce liquidity into the economy. Essentially increasing money supply in the economy by swapping out bonds in exchange for cash.

With interest rates at their lowest, banks do not get any interest for the idle funds (and for the extra liquidity) and are therefore induced to give loans to genuine borrowers to enable them to grow their business and uplift the economy.

THE TAPER TANTRUM

The phrase, taper tantrum, refers to the 2013 collective reactionary panic after investors learned that the Federal Reserve was slowly putting the brakes on its quantitative easing programme. At the time, markets feared that less QE would spell lower asset prices and the result was a sharp rise in bond yields.

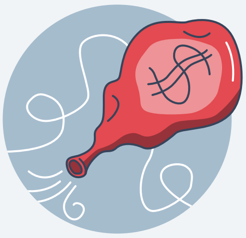
The ensuing period of turbulence became known as the 'taper tantrum'. This resulted in the Federal Reserve taking several months longer than expected to slow down the pace of QE. In the end, the taper tantrum panic was unjustified, as the market continued to recover after the tapering programme began.



TAPERING VS TIGHTENING

Tapering is not to be confused with tightening. When a central bank tapers its quantitative easing programme, it reduces the value of assets that it's buying each month. When a central bank tightens its quantitative easing programme, it will no longer add any assets to its balance sheet and will instead reduce the assets it holds by selling them instead.

WHAT'S THE IMPACT?



Deflation

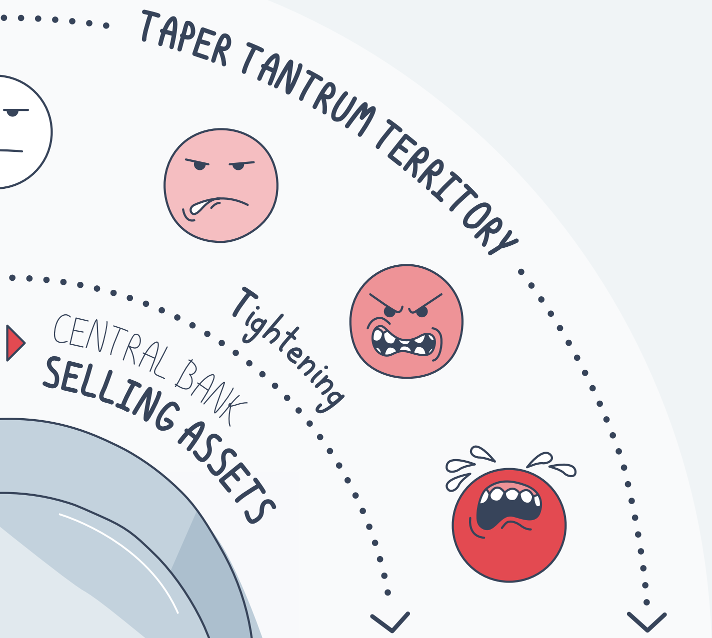
Tapering leads to deflation, pulling money out of the system and making the cost of living more affordable but increases unemployment.

Reducing asset prices

A side-effect of QE has been to drive up asset prices across the board, from bonds to shares to property prices. As a result, investors tend to like it when central banks add more QE but aren't so happy when they reduce it.

Rising interest rates

Bond purchases by central banks have helped keep interest rates low. And tapering of these purchases represents a teeing up of future rate hikes. Meaning that investors will be selling bonds in anticipation of higher rates and less central bank support.



TAPER TANTRUM 2.0

After a string of strong employment and inflation reports, central bank policy makers including the Federal Reserve, the ECB, the BoE and the BoJ are examining the potential for a start to tapering bond purchases as soon as November 2021.

The fear is we might see a repeat of the 'taper tantrum' in 2013. Back then, the decision to taper bond buybacks triggered an increase in long yields of around 100bp in just three months. An equivalent increase now would result in a marked tightening of global monetary policy.

ARCHITAS VIEW

We expect central banks to play a key role in fixed income markets in the coming months. As they cautiously move away from the extraordinary policy easing through bond buybacks that were introduced during the pandemic.

However, we believe that when central banks start tapering it should be viewed as a positive assessment of the economy and consumer confidence. The only sticking point is that communication is key to ensure that markets don't start to panic. Given the scale of the recent bond-buying programme, the Fed will have to be very clear and united in their message, if they want to avoid a bond market reaction similar to what occurred in 2013.

With any large changes by a central bank such as tapering it is inevitable that there could be a degree of volatility, we can expect some capital outflows and consequently some exchange rate volatility. Which is why we always advocate a balanced portfolio.

AN INTRODUCTION TO
PRINCIPLES FOR RESPONSIBLE INVESTMENT

Since its launch in 2006, the Principles for Responsible Investment (PRI) has become increasingly popular with responsible investors across the globe. Here, we find out more about the goals and requirements of the PRI and its signatories.

A BRIEF HISTORY

In 2005, the United Nations invited an international group of institutional investors, alongside experts from the wider investment industry, civil society and intergovernmental organisations to develop the principles. After a year-long process, the PRI was launched at the New York Stock Exchange in April 2006. Today, it boasts more than 4,000 signatories collectively overseeing more than $120 trillion of assets.

THE PRI'S MISSION

The aim of the PRI is to create an efficient, sustainable global financial system that will reward responsible investors and create long-term benefits for the environment and society as a whole. To achieve this, the PRI aims to understand the investment implications of environmental, social and governance (ESG) factors, and encourage its signatories to integrate these factors in their investment processes.

WHAT ARE THE REQUIREMENTS?

Investment companies that want to align their processes with the PRI can apply to become signatories. Before being accepted, they must set out a responsible investing policy outlining their approach to ESG factors. At least 50% of assets under management should be aligned to the policy. Furthermore, senior staff members should be accountable for the implementation of responsible investment.

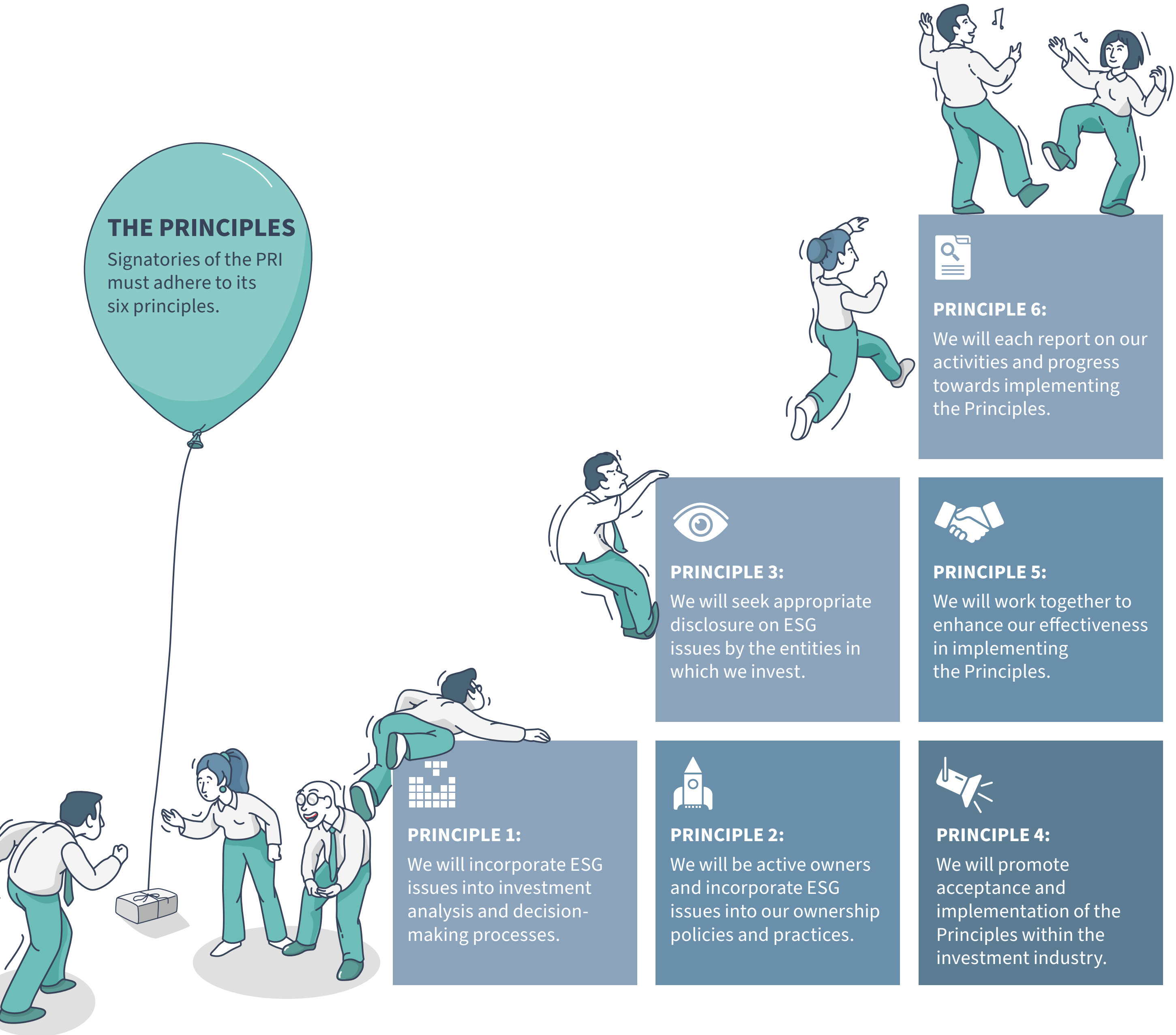
Once accepted, PRI signatories must adhere to its six principles (see the next page). This includes reporting on their progress each year. The PRI has recently updated its reporting requirements and assessment framework to be more challenging, with the aim of driving positive change in the industry.

ARCHITAS IS A PRI SIGNATORY

Architas has been a PRI signatory since 2018. We are continually evolving and improving our investment process to help drive change across our industry. This includes working closely with the underlying managers in our portfolios to make sure they meet our standards and helping them to develop their approach where necessary.

Signatory of:

PRI Principles for Responsible Investment



OUR VIEW

- At Architas we are proud to be PRI signatories, and it is a testament to our commitment to responsible investment
- Our ESG scoring process takes into account whether or not underlying fund managers are PRI signatories
- We believe the PRI is an essential initiative for promoting responsible investment in the wider industry, and society as a whole
- It also helps to improve the credibility of responsible investment and reduce greenwashing, as signatories must report on their progress regularly – ensuring they back up their words with action

Helicopter money

WHAT'S THE BIG STORY?

The term 'helicopter money' has been heard many times since the Great Financial Crisis, describing a particular and unorthodox style of monetary policy. Coined by US economist Milton Friedman in the late 1960s, the term resulted from his exploration of novel ways of jolting an economy out of deflation or falling prices. Has the experiment ever been tried, and has it ever worked? We hover down and take a closer look.

The original reference to helicopter money formed part of a story or parable of a helicopter flying over an American town, dropping $1,000 bills onto the residents, as a gift from the central bank. This event would happen one time only, and no-one was to expect a repeat of the experiment. So what would the lucky recipients do with their windfall? The theory was that they would rush out and spend it, giving a big jolt to demand, creating scarcity of certain items and pushing prices higher. But would that work in practice?

While the physical dropping of paper currency has never actually been tried, there have been monetary experiments with a similar intent. In Japan in 1999, after years of a deflationary cycle, the government issued 'shopping coupons' valued at around $200 each, to families with children and the elderly. This was not a complete success, as it failed to take into account the cautious nature of the population. While the coupons were duly spent, an equivalent sum of money was then saved, bringing little net benefit to the local economy.

The American Families Plan, one of President Biden's stimulus packages, contains an element akin to helicopter money. Not technically speaking of course, as the money came from the US State and not the Federal Reserve. But in the spring of 2021, each adult below a certain earnings threshold received a cheque for $1,400. The clear aim was to kick start consumer spending, held back by the pandemic. But it's thought that a good percentage of these cheques went into financial speculation, fuelling the growth of day-trading websites such as Robinhood.

A more directed approach has recently been confirmed by the government of Northern Ireland. Each adult will receive a voucher for £100 ($137) to be spent on their local high street. Gambling and online shopping are specifically excluded. It's a fairly small amount, but it's closely targeted and could deliver something of a demand boost. Only time will tell if this latest version of helicopter money could finally achieve Mr Friedman's predicted effect.

Why in the news?

It was recently suggested that the helicopter money can help states to come out of the economic chaos created by Covid-19 pandemic. As the ultimate monetary backstop in a severe economic shock, distributing free cash for everyone.

Could it work?

It is certainly an unconventional monetary policy tool. However, it would likely to be a very popular public policy. Printing large sums of money and distributing it to the public, to stimulate the economy during a recession or when interest rates fall to zero. But boosting demand can also provide inflationary effects in the economy. On the next page, we take a look at the pros and cos of helicopter money.

Pros of helicopter money:

- Direct money transfers like this are an immediate and equitable way of boosting private spending when an economy needs it most – without increasing the public and private debt burden.
- With no debt to work off, it could negate the need for policymakers to subject the public to austerity after the crisis has receded.
- In theory, it boosts spending and economic growth more effectively than quantitative easing because it increases the demand for goods and services immediately.
- It doesn't rely on increased borrowing to fuel the economy, which means that it doesn't create more debt and interest rates can remain unchanged.

Cons of helicopter money:

- If the money is given directly to the public, it could spur long-term inflation over time and cause damage to the central bank's financials.
- As more money is printed and supply increases, it could lead to a significant devaluation of the currency on the foreign exchange market.
- It does not involve repayment liability; so it could be argued that it's not a feasible solution to revive the economy and it's harder to drain from the system.
- It requires close coordination between central banks and government, which may undermine bank independence over time to the detriment of ongoing monetary policy.

Conclusion

While it is unlikely that helicopter money drops become normal practice in the foreseeable future, timing is key. As it really depends on when you drop the money more than if you drop the money.

More money during a peak of the economic cycle will make the drop useless, if not damaging, because the money will be worth less when growth slows. But if the drop hits at the right time, you could lessen losses and help ensure a swift economic recovery.

Under certain extreme circumstances such as a sharp drop in demand or exhausted monetary policy, and unwillingness of the legislature to use debt-financed fiscal policies, such programmes may one day be the best available alternative. It would be hasty to rule them out.

Facts & Figures

QUARTERLY DATA

Japanese stocks	US stocks	US corporate bonds	UK stocks	Global high yield bonds	Emerging market bonds
3.9%	0.6%	0.0%	-0.2%	-0.3%	-0.5%
TOPIX Index	S&P 500 Composite Index	Bloomberg Barclays US Corporate Bond Index	FTSE All-Share Index	ICE Bank of America ML Global High Yield Bond Index	JP Morgan Global Emerging Market Bond Index

Global government bonds	European (but not UK) stocks	European corporate bonds	UK corporate bonds	Asian (but not Japanese) stocks	Emerging market stocks
-1.0%	-1.7%	-2.2%	-4.0%	-4.4%	-8.0%
FTSE G7 Index	FTSE All World Developed Europe excluding UK Index	Bloomberg Barclays European Corporate Bond Index	Bloomberg Barclays Sterling Aggregate Bond Index	MSCI Pacific excluding Japan Index	MSCI Emerging Market Index

To highlight the unpredictability of markets, the table below details the performance of global equity and fixed income indices over the past five years (in dollar terms).

This table demonstrates how volatile markets can be, and shows the benefits of diversifying your investment, or in other words, not putting all your eggs in one basket.

Index percentage growth (%)	1 Oct 20 - 30 Sep 21	1 Oct 19 - 30 Sep 20	1 Oct 18 - 30 Sep 19	1 Oct 17 - 30 Sep 18	1 Oct 16 - 30 Sep 17
US stocks	30.0	15.1	4.3	17.9	18.6
European (but not UK) stocks	27.2	5.7	0.4	-0.4	26.6
UK stocks	33.4	-12.5	-3.0	2.9	15.6
Japanese stocks	18.1	4.8	-8.2	7.5	13.9
Asian (but not Japanese) stocks	25.9	-6.0	3.1	4.4	14.6
Emerging market stocks	18.6	10.9	-1.6	-0.4	22.9
Global government bonds	-3.5	6.6	8.9	-1.7	-3.6
Global high yield bonds	9.8	3.9	5.8	1.3	9.9
US corporate bonds	1.7	7.9	13.0	-1.2	2.2
European corporate bonds	0.5	7.8	-0.4	-1.8	5.8
Emerging market bonds	3.9	2.5	10.7	-2.9	4.2
UK corporate bonds	-1.2	8.7	6.7	-2.3	0.5

Past performance is not a guide to future performance. Rebased in US dollar where appropriate, i.e. all index returns are recalculated based on exchange rates to give returns for a dollar investor. Source: Morningstar Direct, September 2021.

Important INFORMATION

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