February Market Reflection

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February saw an escalation in the wrestling match between the bond market and the equity market. The constructive view is that widely distributed Covid vaccines will allow a broad re-opening of economies through the summer months, leading to a resurgence in activity, notably in the service sectors. The more cautious view is that such a surge will result in sharply higher levels of inflation owing to excess demand meeting supply shortages. It is almost inevitable that inflation readings will jump beyond central bankers' preferred 2% level in the second quarter thanks to the very low base from the previous year, when the world was experiencing the first wave of lockdowns. However, there remains much debate about the persistence of any such spike in prices. Indeed, the chairman of the US Federal Reserve expects it to be "transient". Even if that does turn out to be the case, so-called "bond vigilantes" could test investors' resolve first. Indeed, that was the narrative driving markets through the last few days of February, with bond yields rising sharply. While this did not completely undermine equity markets, the full picture was not visible in headline indices. Under the surface there was an acceleration of the rotation away from high-growth "long-duration" equities towards the sort of "short-duration" shares that will benefit from the vaccine-led recovery. In some ways, it was welcome to see some of the froth being blown off markets. There has been increasing evidence of speculative retail activity, especially in the US, but also in certain Asian markets, including China and South Korea. This has been evident in the demand for shares in newly-listed companies, the majority of which are loss-making, the interest in cryptocurrencies and "Non-Fungible Tokens", and the proliferation of Special Purpose Acquisition Companies.

- The global economy is set to recover strongly in 2021. Economists are persistently raising their growth projections, which currently stand at 5.4% (Bloomberg consensus).

- Households, in aggregate, across a range of developed economies have accumulated excess savings equivalent to around 10% of normal annual consumption during the pandemic. A good portion of this expected to be unleashed as economies re-open.

- This will lead to a period of synchronised global growth surpassing even that of the recovery from the financial crisis. It should persist into 2022, especially as governments currently appear reluctant to reimpose austerity measures.

- Indeed in the US the new Biden administration is intent on enacting further bills to increase government spending. For example, $3 trillion is earmarked for carbon-reducing infrastructure projects over the next decade.

- Accumulated debts also mean that central banks will be less willing to raise interest rates as soon as they might have done in past cycles. There is a widespread belief that they will move to dampen any big rise in bond yields to keep government debt servicing manageable.

- This all speaks to a world of persistently low returns from lower risk assets such as cash and government bonds. Therefore investors will remain compelled to have greater exposure to more volatile assets classes such as equities and corporate bonds. While this situation is far from optimal, it suggests that longer term investors should remain committed to full equity weightings in balanced portfolios.

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