Market Commentary

| 31st March 2021 |

Overview

The first quarter of 2021 delivered modest, but respectable, returns to balanced portfolio investors. However, as we have observed in the past, and, indeed, suspected might happen this year, what appears to be serene progress on the surface conceals several very strong, swirling undercurrents. Some of these relative movements are the result of developments on the Covid front; others of the unfolding of both fiscal and monetary policy measures. And the New Year also brought with it two tectonic shifts on the political front: Donald Trump is no longer the President of the United States; and the United Kingdom has now formally exited the European Union's.

As Covid continues to dominate almost all of the news, we shall begin with a review of the current situation and also with an assessment of how it affects our investments. We have never believed that the path through the pandemic would be smooth, citing "rolling lockdowns" in response to new waves of infection as a particular threat. That has very much been the case in the UK and Europe.

At home, we are just now embarking upon a gradual exit from a period of restrictions that have been in place for almost all of the year so far. On the Continent, healthcare systems are under renewed pressure and governments are imposing more stringent measures as more infectious variants of the original SARS CoV-2 virus become established. Europe's situation is compounded by what has so far been a disappointing start to the vaccine rollout. India and certain countries in South America are also experiencing a new surge in cases. The United States, on the other hand, appears to have weathered the winter reasonably well, bolstered by the fact that incoming President Biden has overseen the delivery of 100 million vaccinations well inside his original target of within a hundred days of moving into the White House. Meanwhile China's economy is alone in having surpassed its pre-Covid levels of activity.

One thing, though, has become very clear during the successive waves of lockdowns and other restrictions, and that is that policy support and modified behaviour on the part of both consumers and the corporate sector have

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combined to ensure that the negative effects on overall activity have been successively less pronounced. That is far from saying that the impacts have been negligible, but Covid no longer possesses the shock factor that it had a year ago. Another key reason for this is the progress that has been made by the scientific and medical communities in terms of both vaccinations and treatment. It was clear from the moment that the results of the first vaccine trials were announced that investors would be willing, indeed enthusiastic, to "look through" current disruptions towards the return to a more normally functioning society and economy. Really, it was only the timescale that was in question.

To all intents and purposes we, too, are looking beyond the current pandemic. However, the after-effects of some of the policy responses that Covid has elicited will resonate for some time yet. Not least amongst these is the shift in attitudes towards fiscal policy. Whereas, following the financial crisis, treasury ministers across the world were encouraged to tighten their belts, now there is increased tolerance of government deficits. They provide a financial bridge for both households and companies during the pandemic, and are also viewed as a means to prolong a sustainable post-Covid recovery. Moreover, this new attitude is finding favour with voters, as they perceive the return of a policy tool that can help to rebalance the societal inequalities that have built up in recent decades.

The standard bearer for such radical change is the United States, a role that was cemented in early January when the Democrats prevailed in both Senate run-off races in the state of Georgia. This handed them effective control of the Upper House to go alongside their majority in the House of Representatives, and within weeks the new administration was able to push a $1.9 trillion stimulus package through Congress. Before the ink was dry on that bill, the new President, evidently a man in a hurry, proposed a further $2.25 trillion investment package aimed at rebuilding the country's infrastructure, with an added emphasis on environmentally-friendly commitments. Spending on healthcare and education was also included as part of the "levelling up" promise.

The reaction of investors has been generally positive. The combination of medical progress on the Covid front and huge spending packages has been a boon for more economically sensitive sectors and companies, which have taken the lead role in guiding equity indices higher, and even to new peaks in some cases. The other side of this coin has been a weak performance by government bonds. The initial rise in yields was regarded positively as the world's economy stepped back from a deflationary cliff edge. More recently, worries have accumulated that higher yields will tighten financial conditions and imperil the recovery.

Higher bond yields have also dampened the valuations of high-flying shares, predominantly in the Technology sector, that were the previous market leaders. This remains one of the key undercurrents that we mentioned at the beginning of the commentary. "Carpe Diem" is the cry from value investors, whose style is back in vogue. In fact, they believe that a value, or short duration, bias will be in the ascendant for years to come. While we are willing to concede that they have the upper hand for now, it is by no means a foregone conclusion that the current state of affairs will persist. The debate about the inflationary consequences of current policies remains heated. The Federal Reserve has openly endorsed a policy of letting the economy "run hot" until it has returned to full employment and society has achieved a reasonable degree of rebalancing. Other central banks are hinting at adopting a similar attitude. That would support higher growth and inflation and, consequently, a victory for the value camp, especially if bond yields climb yet higher in response.

But there is an equally vocal camp that considers the burden of debt to be a persistent drag on growth and also believes that the continuing force of technological innovation will restrain inflation in the longer term. In the short term, though, it is almost inevitable that inflation indices will spike higher, initially thanks to very weak comparative data from the second quarter of 2020, and then as pent-up consumer demand in the service economy meets potential supply chain bottlenecks. Although the experience is far from uniform across the economy, the average household in the major developed economies has accumulated extra savings calculated to be equivalent to around a tenth of normal annual consumption. At least a good portion of this is widely expected to be unleashed once restrictions are eased.

It's what happens after that which is harder to pin down. A "Roaring Twenties" narrative is alluring, although, perhaps, misleading. The 1920s featured the General Strike of 1926, after all. On balance, though, we do believe that the shift in policy preferences has increased the probability of a more inflationary (or at least less deflationary) outcome in the years ahead, not least because it remains, in many respects, the least painful way to shrink outstanding debts and deficits in real terms, especially if interest rates remain anchored at such historically low levels.

Overall, equity markets appear resilient, supported by policy, by economic momentum, and by liquidity. The relatively benign market reaction to, for example, the GameStop saga early in the year and, more recently, the demise of Archegos Capital and the blockage of the Suez Canal, are testament to that resilience.

Markets

US

The S&P 500 has continued to make progress in 2021, with the index +5.8% in the first quarter. However, there has been a wide dispersion in performance between the various subsectors, and the market's strength has not this year been a function of the leadership of a very narrow cohort of mega-cap growth companies. The best-performing broad sectors were Energy (+29.3%), Financials (+15.4%) and Industrials (+8.6%). Bringing up the rear were Healthcare (+1.9%), Information Technology (+1.7%) and Consumer Staples (+0.5%). The ranking of the latter category is intriguing, especially as this sector tends normally to be a happy hunting ground for us when it comes to investing in strong companies that have the ability to compound positive returns over their cost of capital for many years. For much of the period of the market's recovery it has been deemed, by the marginal investor at least, to be too boring to own. It doesn't have the hyper-growth allure of disruptive technology; neither does it have the immediate attractions of post-pandemic recovery. This lack of kerb appeal has represented something of a headwind to relative performance, but we remain of the opinion that the sector's positive qualities will be recognised again in the longer term.

UK

A preference shift towards more cyclically exposed sectors should, perhaps, have provided a bigger boost to the FTSE 100 Index, as investors had long bemoaned the lack of IT exposure. However, Unilever's move to a single listing on the London Stock Exchange means that the afore-mentioned Consumer Staples sector is now the largest in the UK. Even so, rallies in Energy, Miners and Banks have all been beneficial. The arrival of a major innovator/disruptor, in the form of Deliveroo, onto the market at the end of March was meant to herald the beginning of a new surge of such listings. However, the share price immediately dropped by more than a quarter from its issue price. The risk now is that London will be viewed as an unwelcome trading venue

for such businesses, following a widespread rejection of the offer by a number of leading British investment institutions. Aggregate performance was much stronger below the headline cap large index. The FTSE Small Cap Index rose 15.9% in the first quarter. Over the last six months it is up a startling 50.8%. This is owing to its components' far greater gearing to the re-opening of the UK economy.

Europe

It's hard to believe that twelve months ago Germany was being hailed as the model by which to manage the worst of the spread of Covid infections. Now it is experiencing a third wave of the virus and imposing strict restrictions on social activities. A harsh reminder that we have to continue to treat the virus with respect. Germany's disarray also extends to its domestic politics, with September's elections destined to introduce us to a new Chancellor for the first time since before the financial crisis – Angela Merkel was elected in 2005. It also seems probable that the country will shift further towards the left in its political preference, and Merkel's Christian Democratic Union Party may well have to cede power. The Green Party is bound to have a big say in the formation of any new coalition, and that will only magnify the influence of environmental campaigners. It is also likely to encourage a further loosening of the fiscal purse strings, amplifying the trends of increased government spending discussed earlier.

Emerging Markets

The Emerging Market index has recently failed to show the leadership that might have been expected during a recovery period for the global economy. There are a number of reasons for this. First, we must return to the composition of the index. Whereas in the past it was dominated by banks and resource companies, now the largest exposures are to technology-related sectors. These have been impacted not only be the derating associated with higher bond yields, but also by a tightening regulatory regime in China, especially vis-à-vis companies run by dominant, charismatic individuals. A period of dollar resurgence has also weighed on EM (because it raises the cost of servicing dollar liabilities and also tends to slow the flow of new capital into EM). Finally, Chinese authorities are vocally discouraging more speculative activities in both the financial and real estate markets, and are gently tightening policy as well. Even so, they appear to have little motivation to slow the whole economy, and so we expect the current headwinds to lead to a period of consolidation rather than a major setback.

Fixed Income

A brief perusal of the bond yield shifts in three major developed economies gives a handy snapshot of how investors have interpreted their relative speed of recovery this year, as well as the outlook for inflation and interest rates. Leading the pack is the United States, where the yield on the 10-Year Treasury has risen 82 basis points to 1.74% this year. Given that many forecasters can see the potential for around 7% real GDP growth in 2021 (or an astonishing 10% in nominal terms), maybe we should be grateful that the rise has been so well contained. This is a result of current estimates by the Federal Reserve that it will keep interest rates unchanged until 2024, as well as continuing asset purchases. Of course, the yield level also betrays the fact that such a rapid pace of growth is considered unsustainable. Meanwhile in the UK, a 63 basis point rise leaves the 10-Year Gilt yield at 0.83%, and although the threat of a negative base rate has faded, here, too, there is no sign of a rate rise in the foreseeable future. The Bank of England remains an active buyer of Gilts. Germany's 10-Year Bund yield of -0.3% (+28 bps) reflects the European Central Bank's negative interest rate policy as well as the market's expectations that trend growth will remain weak and inflation will be difficult to rekindle. Investors also continue to pay

a premium for Germany's perceived fiscal rectitude, although it will be interesting to see how well that survives a possible change in government. Government bonds certainly offer somewhat better value than they did last summer, and some of the asymmetry in terms of potential future yield movements has been reduced. Even so, it remains difficult to argue that they are cheap given that real yields remain negative.

UK Gilts have delivered a total return of -7.24% over the last three months and -5.54% over the last year. Index-Linked Gilts returned -6.46% and +1.79% over the same respective periods. Emerging Market sovereign bonds produced a total return of -6.48% in sterling over the three months to end March (+0.94% over 12m). Global High Yield bonds delivered -0.8% (+12.64% over 12m).

Conclusion and Outlook

In military circles, it helps to know what one's objective is when embarking on a campaign, rather than just turning up for a random fight. Once the objective is defined, a strategy can be put in place. But there will always be unplanned events that require a responsive action, and those fall into the realm of tactical decisions. Long-term investing requires similar discipline. Clients' objectives are different. Some want to maximise their gains to build wealth, while others are more inclined to preserve what they have already accumulated. Yet others will need income upon which to live. Once the objective has been identified, a portfolio is built in line with a predefined Strategic Asset Allocation (SAA) benchmark, which will also take into account volatility and the risk of capital loss. The icing on the cake, as it were, is delivered by a combination of Tactical Asset Allocation and stock selection, by which we strive to deliver returns better than the SAA benchmark. Long-term performance records illustrate that we have been successful in this objective. However, periods when market returns are being driven by companies that might not meet our quality thresholds can be more challenging. Yes, tactically, one can always lower the barriers to entry to some degree, but that is difficult, if not foolhardy, across a whole portfolio. This is when it becomes more important than ever to remain focused on the longer term objective, and to continue to deliver returns that we believe to be sustainable over longer economic, market and investment cycles. Should more fundamental shifts occur - if, for example, persistently higher inflation were to become embedded - which required a realignment of the assets within the SAA benchmarks, we would make those decisions accordingly.

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