Market Commentary

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Overview

The headline market trends that characterised the second quarter of 2021 extended through July. Equity markets continued to accrue gains, with longer duration growth stocks to the fore. The main driver of this performance was the ongoing fall in yields of sovereign bonds, a development that continues to have many market participants scratching their heads. Does the bond market see a much weaker economic environment ahead, or are lower yields more a result of temporary technical flows and some short-term insurance being taken out against the risk that the COVID Delta variant will lead to more restrictions on activity being imposed around the world? It certainly appears that, more than ever, judging the direction of the next move in bond yields will be crucial in determining investment performance over the rest of this year.

Along with COVID, the main topics of debate remain the outlook for both inflation and monetary policy, which are, naturally, very closely related. Although headline inflation indices continue to surpass expectations and to make new highs for this cycle, the majority opinion reflected in fund manager surveys is that this is a fleeting phenomenon and the result of low comparative numbers from 2020 combining with temporary COVID-induced disruptions to supply chains and labour markets. Central bank chiefs are in broad agreement, describing such inflationary pressures as “transitory”. Inflation fears, as reflected in breakeven rates (derived from the relative yield of nominal and inflation-linked bonds), peaked as long ago as May.

As for central bank policy, it is an open secret that monetary conditions will be tightened at some point, although the exact pace and timing remains something of a mystery. It is fairly clear that, in most cases, the sequence will begin with a reduction (and eventual cessation) of asset purchases. If markets can bear that, then gradual interest rate rises will be the next stage. Interest rate futures and swap markets suggest that the US Federal Reserve (the Fed) will begin to raise rates no earlier than the second half of 2022, while the European Central Bank (ECB) will not achieve lift-off until at least 2025. The Bank of England, as is often the case, will be somewhere in between. However, the process of raising rates is expected to be extremely gradual, with the very high levels of government debts accrued during the pandemic imposing a much lower ceiling on rates than might have been the case historically.

Indeed, it remains difficult to see interest rates surpassing inflation rates for the foreseeable future. This form of “financial repression” might be helpful in reducing the overall debt burden relative to the size of the economy, but will continue to leave savers needing to take some investment risk in order to generate income and to preserve their wealth in real terms, as has been the case for much of the period following the financial crisis.

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A strong current source of support for equity markets is corporate profitability, with results for the second quarter of 2021 handily beating expectations, as is covered in more detail in the country sections to follow. Overall earnings growth for the constituents of the MSCI All-Countries World Index is forecast to be around 40% for the year as a whole. It is worth pointing out that this will leave earnings some 25% higher than the previous peak at the end of 2019, following a double-digit fall in 2020. This surge in aggregate profitability goes a long way towards justifying the strong performance of equity markets that we have witnessed in the past year or so, and is, surprisingly, not widely reported.

The valuation that markets ascribe to those profits is also key to the levels of equity indices, and this is where the debate often becomes more heated in investment circles. There is no shortage of commentators prepared to assert that equity markets (notably the US equity market) are in bubble territory, but we continue to find these assertions misleading, not to say ill-informed. The composition of many equity markets today is greatly changed from the past when indices were dominated by much more capital-intensive businesses. Today's market leaders tend to derive their wealth from intellectual rather than physical property and do not have to carry large amounts of inventory. Thus, their returns on invested capital can be far greater, as can the ensuing cash flows. One of the key jobs of our Research analysts is to judge the sustainability of those returns. Assuming that they have some persistence, the use of discounted cash flow or divided discount models delivers net present values that can translate into near-term price/earnings ratios that appear eye-wateringly high compared to past averages, which is one reason, at least, why there is such a difference of opinion between the bulls and the bears.

Of course, such valuation methodologies are highly subservient to the discount rate, which is primarily a function of the US ten-year Treasury yield, which circles us back to the bond market. The first quarter of the year saw bond yields rising sharply as investors (correctly) anticipated the forthcoming spike in inflation and also looked forward to the normalisation of economic activity as COVID vaccine distribution ramped up. US President Biden's promise of government-funded spending programmes was the icing on the reflationary cake. Those first three months were characterised by a strong performance for stocks and sectors that might variously be labelled as value, cyclical or short duration. Once bond yields topped out at the end of March, and especially once inflation fears peaked in May, the rotation reversed, with growth/defensive/long duration stocks in the ascendant.

This is where we bring COVID back into the equation. The answer to one particular question in Deutsche Bank's July fund manager survey betrays the shift in sentiment that has occurred in the past couple of months. The survey asked what life in participants' countries would be like by the end of the year. In May, 50% answered "very close to normality", but by July this number had fallen to 31%. Meanwhile the response to "approaching normality but with some daily life/economic restrictions in place" rose from 41% to 56%. Finally, and quite probably on account of the Delta variant, the percentage of respondents ticking the box for "heavily restricted following a fresh wave of COVID-19 cases" jumped from a negligible 3% to a more meaningful 12%. The timeline for a return to post-COVID normality has undoubtedly been extended, but the good news, in many respects, is that will also have been reflected in share prices.

Much now depends upon the next twists in the COVID narrative – and the virus still has the capacity to surprise us. For example, in the UK it appeared in mid-July that case numbers were set to soar to new highs, but, instead, they have fallen back dramatically. High vaccine prevalence will have been a key factor, although there are also reports suggesting that individuals are not coming into contact with as

many people as they used to, which is reducing the spread of the virus relative to modelled expectations. That sounds like good news, but the fear persists that a fuller return to work after the summer holidays combined with schools and universities resuming normal service could trigger yet another new wave of infections. Meanwhile, in other parts of the world that are not so well vaccinated, the Delta variant is of greater concern, with more restrictions being imposed.

We continue to believe that we are on a path back to normality, but that it will remain a bumpy one. Thus our central view is that the economic recovery will be durable, even if we are currently enduring a softer patch, and that the reflationary trade will reassert itself in the months to come, leading to a rise in bond yields and market leadership reverting to more cyclical sectors. Even if we are mistaken in that belief, though, the underlying quality bias in our stock selection should ensure that any damage to performance will be limited.

Markets – US

US Equities ended July within a whisker of their all-time highs. With almost 300 constituents of the S&P 500 Index having reported their second quarter results by the end of the month, there is little doubt that corporate America is in rude health. Even accounting for the usual downward manipulation of expectations that occurs before the results season, this one has been surprisingly strong, with 88.5% of companies beating consensus earnings forecasts and by an average of 16.7% (IBES data sourced from Refinitiv). It is not rare for analysts to underestimate the power of operational leverage in both directions but, to be fair to them, the current circumstances remain out of the ordinary. The biggest winner relative to expectations has been the Consumer Discretionary sector (with a 29.7% surprise factor), which speaks to the re-opening of the economy. Second in the league is Financials (24.7%), mainly thanks to further provision releases by banks. However, what is also notable is that even these positive “surprises” have been pretty well discounted, with limited further impetus to share prices, while “misses” have been more severely punished.

UK

Although only around 60 members of the FTSE 350 Index (ex-Investment Trusts) have reported so far, the big guns were out early, accounting for half of the market capitalisation. Maybe UK companies are more transparent with their guidance because the average “surprise” is only 4.1%. However, some of the more positive news has come in the form of free cash flow generation, which has allowed bigger dividend payments and increased share buybacks. Two sectors have been at the forefront of this trend, namely Energy and Mining. Both industries are surfing a wave of strong underlying commodity prices and have continued to be very disciplined in terms of their capital expenditure. Unfortunately, neither sector ranks especially highly in Sustainability terms, presenting something of a moral dilemma for many investors. It also means that although the UK market overall looks relatively attractive on free cash flow metrics, its composition means it might continue to struggle to fulfill its promise. More positively, at least on a short-term view of returns, UK companies continue to attract bids, with Meggitt, the aerospace engineer, the latest to fall prey. Both corporate and private equity buyers remain keen acquirers of UK plc, which still seems to be carrying a residual political risk discount.

Europe

Rounding off the analysis of the second quarter results season, we note that with around half of the constituents of the Euro STOXX 600 Index having reported, the Continent is faring a little better, with a 9.3% positive earnings surprise. As might be expected at this time, it is cyclical companies that have led the way. Whereas the first few positive surprises were greeted with share price advances, market expectations now appear to have caught up with reality. Further support for European indices will come from the ECB’s decision to allow banks to start paying dividends again. This move was further justified by the results of the latest balance sheet stress tests. Overall earnings are expected to rise by more than 50% this year, and then by around 10% in 2022 as the post-pandemic recovery flattens out. We remain of the opinion that European equities are a good vehicle to play the reflation trade.

Emerging Markets

In this section we will focus on a risk very specific to EM, which is regulation in China. We have written before about interventions in the financial and real estate sectors and believed these to be justified in the name of preserving financial stability with an eye to longer-term sustainable growth. However, the latest crackdown on the private education and tutoring industry came as a bolt from the blue, with billions wiped off related companies’ equity valuations after the government decreed that the sector should no longer be allowed to make profits. The justification for this move is that it will lower the cost of bringing up a child, and therefore encourage families to have more children, something that is deemed to be a priority in the face of declining birth rates and an overall population that will be shrinking soon if current trends persist. The government has the luxury of being able to make such sweeping changes because it is not beholden to the ballot box, but such licence also has the potential to increase the volatility of investment instruments. We tend to believe that China acts in its own best interests for the long term, and sometimes this can mean that international investors become collateral damage. The latest developments mean that investors will demand a higher risk premium until the dust settles.

Fixed Income

A significant conundrum has arisen in government bond markets once again. Why has there been such a significant reduction in global bond yields in the face of strong economic growth and very high inflation prints, notably in the US? At least some of this is down to the Federal Reserve’s change of stance regarding the timing of policy tightening at June’s meeting, when it brought forward the horizon. This move reduced the market’s fears of inflation expectations becoming unanchored, and lowered yields at the longer end of the duration curve. Subsequently, though, the Fed has been keen to point out that it will not act prematurely either, which has brought shorter duration yields lower too. It is also apparent that investors, in aggregate, became too bearish earlier in the year, and that extreme positions needed to be reversed. At the same time, pension funds enjoying the benefits of strong equity markets have been switching into bonds to match their long-term liabilities, thus reducing their solvency risks. Throw in a touch of deceleration in growth expectations, and the riddle is solved, although it remains hard to argue

that government bonds offer great value today, other than in an extremely negative economic scenario, which is not envisaged currently within our investment horizon. Our expectation is that yields will track higher again as the year progresses.

UK Gilts have delivered a total return of 3.96% over the last three months and -4.12% over the last year. Index-Linked Gilts returned 8.9% and 0.53% over the same respective periods. Emerging Market sovereign bonds produced a total return of 2.21% in sterling over the three months to end July (-3.65% over 12m). Global High Yield bonds delivered 0.6% (3.4% over 12m).

Conclusion and Outlook

The uncertainties of COVID developments combined with the planned exit from extreme monetary policies continue to make this an investment environment in which it would be imprudent to make heroic bets on market direction, and we continue to hold equity weightings close to strategic asset allocation benchmarks. While we cannot rule out a more meaningful correction at some point – indeed, by some measures one is already overdue – a more enduring market fall appears improbable in the face of such strong corporate earnings growth and our opinion that no economic recession is visible on the radar within our eighteen-month strategic investment horizon. Even if interest rates and bond yields move higher, they will remain very low by historical standards, and we continue to believe that policymakers are more fearful of a loss of economic momentum than a period of higher inflation.

Having said that, there is widespread talk of "peak growth", which is hard to deny. But the bounce from the COVID trough has been unprecedented in its speed and scale, and it would be unreasonable to expect the recovery in activity and profits to continue at the same pace. However, it does mean that, in all probability, market returns will be shallower from here, and investors will have to display more patience.

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