Market Commentary

| 30 June 2021 |

Overview

Investors can look back with some satisfaction on the first half of 2021, although the experience of making positive portfolio returns seems to be as unenjoyable as ever, with no end of siren voices calling time on the equity markets' advances. While we doubt that equity markets can continue on their recent trajectory, we continue to believe that the doom-mongers fail to see the full picture, with too narrow a focus on immediate valuations and specific, but relatively contained, pockets of speculative activity. That is not to say that we are complacent, and we can construct scenarios in which risk assets succumb to a correction. However, we remain fully invested, and would, if anything, welcome a setback that gave us an opportunity to put outstanding cash balances to work at more attractive valuations.

The investment landscape remains dominated by a few key features: COVID; the nature, extent and durability of the post-COVID recovery; the outlook for inflation; the response of policymakers; and the desire of some investors to make a fast buck with little acknowledgement of the risks involved. We have covered all these topics in some depth in past monthly commentaries, but the half-year provides an opportunity to mark all our views to the current market situation.

There are a number of subjects that we are happy not to be spending as much time writing about as we have in recent years, especially Brexit and the presidency of Donald Trump - even if the effects of Brexit will only completely reveal themselves in the fullness of time; and we cannot rule out the return of Trump to the White House in 2025. We can look forward to the day when COVID is relegated to the footnotes rather than being front-page material, but, being realistic, that is some time away. However, it is important that our investors understand our approach regarding the pandemic, especially at a time when the more infectious Delta variant is spreading rapidly through a number countries (and even as this is being written, the threat of a new Lambda variant is being reported).

Our underlying view since the vaccine trial data releases in November 2020 has been that science will eventually suppress the virus, but that progress will not be linear. Thus, we have been willing to take on more exposure, on a tactical basis, to sectors and stocks that will be beneficiaries of a resurgence in demand. While much of that return to relative normality has been discounted, we believe that the process is not yet complete. At the same time, though, we see no reason for a wholesale exit from many of the winners of the "stay at/work from home" trade.

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COVID acted as an accelerant to behavioural change with the adoption of a wide swathe of online services, and there is no going back to the status quo ante. And while we don't expect the big platform technology companies and other disruptors to enjoy again the same boost to valuations that they have received in the decade following the financial crisis, it would be dangerous to underestimate their ability to continue to compound high returns. As ever, a judicious balance between the "old" and the "new" is appropriate.

The subject of inflation remains a staple of commentaries, and while we continue to find no market consensus about its future path, we do believe that it will eventually settle at somewhat higher levels, on average, than pre-COVID (although not necessarily because of COVID). There are a number of reasons for this, including the costs of the transition to a more carbon-neutral economy, the establishment of shorter supply chains following recent disruption, higher dependency ratios (that is fewer workers as a percentage of populations), and the avowed intent of governments to spend more money, with post-financial crisis austerity now deemed to have been a mistake. But we fail to see this developing into 1970s-style inflation owing to less organised labour markets, a less labour-intensive economy, the reduced probability of similar oil shocks (in a world that is less carbon energy intensive relative to the size of the economy, even if actual demand for oil is at all-time highs), and the fact that, despite some appearances to the contrary, central banks will not be willing to relinquish their hard-earned reputation for keeping inflation at bay.

However, we can see the risk of what we describe as an "inflation flinch" if the current spike in consumer prices turns out to be rather less transitory that the markets currently expect. This could be the result of more persistent supply chain imbalances as capacity struggles to expand fast enough, especially if that is met by pent-up demand from consumers freed from COVID restrictions. But our current working assumption is that these imbalances will largely correct within a reasonable time frame. Inflation breakeven rates, which infer future inflation rates from the difference in yields between conventional and index-linked bonds, are of the same opinion. We shall continue to watch them closely.

One development that must be mentioned is the subtle but important shift in tone from the US Federal Reserve. At its latest meeting it tacitly acknowledged the risks of inflation expectations becoming unanchored, with the "dot plot" of member voting intentions on interest rate rises compressing the time horizon for tightening. Once the initial fog had cleared, markets were encouraged by this change, judging that it reduces the tail-risk of higher and more persistent future inflation. This was reflected in a fall in bond yields. Even so, the Fed will have to walk a fine line for some time yet between sustaining the recovery and ensuring that there is no overheating.

Finally, reflecting on some of the more speculative pockets of markets, we remain of the opinion that they are relatively small and do not represent a systemic risk to the financial system. Such areas might include cryptocurrencies, Special Purpose Acquisition Companies (SPACs), Non-Fungible Tokens (NFTs), "meme"stocks (such as GameStop) and the activities of highly leveraged entities such as the Archegos fund. They do certainly represent a willingness by some investors to take on high risks (and some of those investors might well not be aware of the risks they are taking) as well as an abundance of capital and liquidity. As is often the case, there are persuasive narratives to be found to support such activity. However, we continue to shun such volatile and illiquid vehicles, especially in the absence of a sufficiently compelling valuation case.

Markets – US

US Equities continue to forge ahead, with the headline S&P 500 Index consistently making new highs. As is the case elsewhere, headline indices fail to capture the whole story. While the S&P 500 rose 14.4% during the first half of the year, the S&P 400 Mid Cap Index put on 16.8%, while the S&P 600 Small Cap Index rose 22.9%, although these relative gains were mostly made in the first quarter. The preference for more “old economy” exposure was also visible in the fact that the tech-heavy NASDAQ Composite Index gained “only” 12.5%. A strong recovery for the oil price in the face of demand recovery, tightening supplies and limited growth in capital expenditure, propelled the Energy sector to the top of the S&P 500 leader board. However, as it started the year with around a 2% market weight, even a 42% rise was insufficient to make an enormous impact on the overall index. Technology remains the big beast. The five largest stocks in the S&P 500 Index (currently Apple, Microsoft, Amazon, Alphabet and Facebook) accounted for 26% of the market capitalisation at their peak last August. By the end of March that weight had fallen to 22.4% (while the index rose 11%) but has subsequently recovered to 24% thanks to the tailwind of lower bond yields. Microsoft joined Apple to become the second US company with a value of more than $2 trillion.

UK

Alongside other markets around the world, UK equities have continued to perform strongly, with notable outperformance from smaller companies. The FTSE Small Cap Index rose 27.4% in the first half of the year, compared with gains of 8.9% for the FTSE 100 and 9.2% for the FTSE 250. Much of this outperformance can be attributed to expectations for the recovery from COVID disruption, with smaller, more domestically focused companies having borne the brunt of the impact, but there has also been an element of relief that a Brexit deal with the EU was reached. The latter factor was also seen as a green light for increased merger and acquisition (M&A) activity, with potential buyers now more confident about the legal and regulatory environment in which they would be operating. In the year to date, UK M&A is running at 2.6x the 2019 pre-COVID level. Much of this is being undertaken by private equity (PE) buyers, who are increasingly attracting more investment from pension funds to add to an already weighty stock of dry powder. Furthermore, PE buyers are in a position to utilise greater financial leverage (or more debt) than publicly quoted companies. While there is an active debate around the long-term benefits of the more financially driven transactions (as opposed to public companies buying other quoted rivals for strategic reasons), it remains difficult for owners to turn down the immediate premium offered by a “bird in the hand”. The outcome of the PE bid approach for supermarket chain Wm. Morrison might provide some pointers as to the willingness of investors to take a longer-term view, and possibly of the government’s tolerance for such transactions. One side-effect of this increased interest in UK corporate assets has been a big rise of portfolio inflows, to the highest levels since 2008, as well as strong Foreign Direct Investment flows. These have helped the pound to gain around 3.5% on a trade-weighted basis in 2021, and 11.6% from its COVID-related trough of March 2020.

Europe

European indices have enjoyed a long-awaited and welcome return to form this year, with the reopening and reflation trades being especially helpful. And after a hesitant start to its vaccine programmes, the region has caught up rapidly. The sectoral performance league table shows that investor preferences have firmly shifted towards more cyclical and short duration companies, with Banks (+25%) leading the way,

followed by Automotive (+24%) and Construction & Materials (+21%). Interestingly, Technology comes next, helped by the dominant weighting of Amsterdam-listed semiconductor equipment manufacturer ASML. Factors including the disbursement of recovery funds by the EU and the still accommodative policy of the European Central Bank should continue to lend support. The volume of political noise will rise again over the summer ahead of German federal elections in September, which will finally see the retirement of Angela Merkel as Chancellor after sixteen years. Earlier fears that the ruling CDU/CSU coalition would be trounced by the Green Party have abated, although it is probable that the Greens will have a greater role than in the past. This is expected to lead to a more relaxed fiscal attitude. Meanwhile regional elections in France in June revealed much reduced support for the parties of the candidates currently viewed as favourites to contest the Presidential run-off in April 2022, with the centre-right Republicans faring best. Given that Presidential elections tend to be more about the individual than the party, it is too early to make firm predictions, but polls suggest that the final round will, as in 2017, feature the incumbent, Emmanuel Macron, and Marine Le Pen, leader of the far right National Rally Party which remains anathema to international investors.

Emerging Markets

The travails of EM continue. With many countries in Asia having initially dealt well with COVID, the spread of new variants has presented new challenges, especially as vaccination programmes have been rolled out more slowly than in most Western developed economies. South America’s woes have been exacerbated by poorgovernance. Russia is the latest country to have to backpedal on its reopening plans, with continuing uncertainty about the efficacy of its domestically developed vaccine, as well as a high level of vaccine hesitancy. As if COVID-related problems were not enough to be dealing with, two other more deliberate negative influences are at play too. First there is the policy tightening being undertaken by the authorities in China. In many ways, this is a laudable effort to rein in speculative excess to ensure longer term financial stability, but it is gradually undermining current growth rates. Second, the recovery in the US dollar that resulted from the Fed’s recent policy shift has tightened financial conditions for EM countries with dollar-based liabilities. Even so, we continue to believe that a repeat of 2013’s taper tantrum, which negatively affected EM more than developed markets, is less probable in this cycle, as the aggregate EM balance sheet is in better shape now, especially in Asia.

Fixed Income

The first half of 2021 has been a distinct “game of two quarters” for sovereign bond investors. Confidence in economic recovery combined with burgeoning fears of higher inflation sent yields sharply higher in the first three months, and capital values correspondingly lower. With very little cushion from the very low yields, total returns were also negative. But bonds have rallied since the beginning of April, when it appears as though investor positioning had become extreme, with hedge funds’ short positions at high levels, and long-only funds shunning longer-duration issues. More surprising, perhaps, was that yields fell further on the day that the US released its consumer price data for May, with the headline index showing gains of 5% year-on-year. But markets do look ahead, and there was a strong belief that this print might mark the high-water mark for this cycle. Yields consolidated at the lower level after the Fed shifted its policy guidance to suggest a more proactive stance towards the threat of future inflation. Yield shifts in other markets were less extreme, but the trends evident in the US were followed across most developed markets. Corporate bonds fared better over the period, with strong economic recovery underpinning the solvency of issuers.

UK Gilts have delivered a total return of 1.7% over the last three months and -6.24% over the last year. Index-Linked Gilts returned 3.47% and -4.4% over the same respective periods. Emerging Market sovereign bonds produced a total return of 4.23% in sterling over the three months to end June (-5.49% over 12m). Global High Yield bonds delivered 2.38% (3.19% over 12m).

Conclusion and Outlook

As markets continue their ascent, it always feels tempting to lock in profits, but history shows that this tends to be a short-sighted approach in the absence of a compelling reason. Furthermore, jumping in and out of markets on a tactical basis needs two separate and equally difficult decisions to be made – when to leave, and when to return. It is one thing to reduce an overweight equity risk position back to neutral, but a much bigger statement to move underweight. Analysis of historical data shows that large and sustained equity market falls tend to be associated with recessions, and (barring any exogenous shocks that are by their nature unforeseeable) none are on the horizon.

The consensus forecast for global GDP growth in 2021 is 6%, followed by 4.5% in 2022. Global corporate profits are expected to rise by 39% this year (up from an estimated 26% in January) and by a further 10% next year – a figure that potentially looks light compared to GDP growth expectations. We must also remember that equity valuations are, to a meaningful extent, a function of the discount rate derived from the yields available on government bonds, corporate bonds and cash. These remain extremely low by historical standards, and although there is some upside risk, our assessment is that central banks will remain very wary about allowing rates to rise too much, if only because of the burden of higher interest payments that would impose upon governments, households and the corporate sector.

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