Market Commentary

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Overview

Equity markets chalked up another positive month in April to build upon the gains made in the first quarter of the year. One might think that this would be a cause for widespread celebration, but it remains difficult for many investors to shake off a sense of impending doom, especially as the “Sell in May” mantra is more widely heard. We have written in the past about the seasonal tendency of equity markets to offer less good returns in the summer months, and there are plenty of plausible reasons. These range from the timing of company results and dividend payments to the reduction in market liquidity as a result of summer holidays in the northern hemisphere – even if the idea of well-heeled stockbrokers and fund managers retiring to the news vacuum of their country estates is something of an anachronism in these days of near-permanent connectivity.

Luckily, and with immaculate timing, the ever-resourceful market historians at Deutsche Bank have published work addressing this particular canard. Citing data going back to 1928 for the S&P 500 Index in the United States, they find that, on average, the index experiences its first major reversal of the year in May, but that it has regained those losses by early July. And these being average data, that reversal is around 2%, which is hardly sufficient justification for a wholesale exit from equity portfolios.

Given that those ninety-three years of data show that the annual return has been around 11%, one could inadvertently get side-tracked into a bigger debate about whether or not one should even bother trying to time markets. Indeed, our central view is that investors are best served by “time in” the market, rather than “timing” the market, but rather like a batsman who is trying to maximise his score from his time at the crease, we also acknowledge that there are times to be on the offensive, and times to be more defensive. On the other side of the Atlantic, baseball metaphors are more appropriate. There, the patient investor will say that she is waiting for the “fat pitch” – a delivery that is just begging to be hit out of the ground.

Before we get bogged down in too many sporting metaphors, where are we now? After all, risk assets embracing equities, credit and commodities have experienced a sensational recovery following the losses experienced during the early months of the COVID crisis. It would certainly be unrealistic, unreasonable even, to expect them to continue rising at such a pace. Analysis of previous economic cycles suggests that the “recovery” phase delivers the fastest and steepest gains. In this period the greatest part of the return is accrued from re-rating, with earnings lagging behind. It is when investors are anticipating better times ahead. That describes much of the past twelve months, especially the period following the positive vaccine trial news in November. Recovery tends to be followed by the “growth” phase, in which corporate earnings catch up with expectations.

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Valuations tend to drift lower now, but, overall, markets can still move higher, even if at a slower pace. Historically, this period has been longer than the recovery phase. That would appear to be where we are now. Progress will be more pedestrian, rather as it feels to be driving in a 30 mph zone after leaving the motorway – but it will be progress nevertheless. Although there will be the odd speed bump to negotiate.

We have written at length in previous commentaries about the main forces behind the recovery in markets, with monetary and fiscal policy to the fore. Although we do not anticipate an abrupt withdrawal of support on either front, it will be difficult for either central banks or finance ministers to be as incrementally generous as they have been in the past year. Thus what are known as the monetary and fiscal impulses will begin to flatten out. Again, this tends to be associated with periods of lower, but not necessarily negative, returns.

The outlook for inflation continues to be at the centre of the investment debate, especially as it will have a strong bearing on future monetary policy. As a reminder, central banks, with the US Federal Reserve to the fore, are currently in a mood to welcome a bit more inflation if it is a symptom of the higher levels of economic growth required to deliver full employment. Indeed, after a decade or more of failing to achieve average inflation close to its preferred 2% target, the Fed is now planning to let inflation "run hot" for a period to make up for previous shortfalls. The challenge will be in judging when "hot" is at risk of turning to "scalding". Well anchored inflation expectations have been one of the main foundations of a golden period for financial assets. Allowing expectations to become unmoored would threaten that equilibrium. In the short term, it is widely expected that measures of consumer price inflation will spike up owing to weak comparative readings in 2020. Re-emergence from lockdowns will also boost demand in a world where supply chains remain disrupted and labour shortages are already being reported in, for example, the hospitality trade. Key central bankers currently consider this expected jump in reported inflation to be "transitory", although we will probably have to wait several months to be sure.

Meanwhile there is an increasingly vocal segment of economists, strategists and investors who believe that we are on the cusp of a commodities "supercycle", which will be driven by a combination of resurgent demand, especially for investment in the green economy, and constrained supply. This narrative cannot be ignored. The Democratic Party in the United States is leading the charge in the battle against climate change, and has proposed to spend trillions of dollars over the next decade on that front. Meanwhile, resource companies have found virtue in greater capital discipline since the last commodity bust in 2015, and very little new supply is in the pipeline. With a helping hand from a La Niña weather event which has propelled certain food prices higher, the Bloomberg Commodities Index has risen 52% since its COVID trough in 2020. While that might sound unrepeatable, it still leaves the index some 60% below its last cyclical peak in 2008. We feel that there is, for now, insufficient evidence for us to subscribe to the supercycle theory, or to make it a key component of portfolio construction, but there is no doubt that there are grounds for some inflation hedges to be introduced, and also to be acutely aware of the domino effects that might flow through corporate margins and consumer prices.

We will conclude this section with our current opinion on the COVID crisis. Our central view remains that the scientific community has delivered us the tools to contain COVID, although we also acknowledge that the virus is now endemic and that we will be managing it for the duration of what can be considered any reasonable investment cycle. Insufficient vaccine supplies, challenging distribution logistics and unwillingness to be vaccinated are the key impediments to faster containment. And then there are the

variants. These, perhaps, represent the greatest risk, especially if they evolve in such a way as to make current vaccines redundant, although in this respect, too, it seems that new vaccines can be quickly developed. Therefore we currently expect a gradual re-opening of the global economy rather than a "big bang", and are aware of the risk that the return to previously normal social conditions is unlikely to follow a straight path.

Markets – US

April witnessed a subtle change in the fortunes of the various elements of the equity market, with the NASDAQ Index, which is comprised generally of faster-growth companies, especially in the Technology sector, making something of a comeback. Until mid-March the Russell 2000 Index of smaller companies had been by far the strongest performer, eclipsing the S&P 500 Index. This was a function of the expected greater leverage to the re-opening of the economy, as well as a lower exposure to "long duration" businesses whose valuation was put under pressure by higher bond yields. While the Russell 2000 remains ahead for the year, the relative performance gap has closed substantially. Those long duration companies were certainly helped by lower bond yields after Easter, but not to be ignored was the phenomenal first quarter reporting period, when market leaders Apple, Microsoft, Alphabet, Facebook and Amazon all surpassed expectations. In fact, of the 252 constituents of the S&P 500 to report earnings to the end of April, 86% have beaten consensus forecasts, delivering overall earnings growth of 57% - some 25% higher than expected.

UK

A similar relative performance can be seen in the UK, with the FTSE Small Cap Index delivering a total return of 15.5% so far this year to the end of April, versus 9.3% for the FTSE 100. The post-March rotation in favour of longer duration stocks was not so evident in the UK indices given the continuing paucity of Technology companies. This relative shortfall is something that the London Stock Exchange is trying to rectify by persuading new innovative companies to list in London. The first big name to arrive was home delivery pioneer Deliveroo, and that has been something of a disaster, given that the shares trade around 31% below the offer price. More successful was the listing of Darktrace, a company involved in cyber security. The shares trade at a 32% premium to the offer price. While the Technology sector still accounts for just 1% of the current market capitalisation, we look forward to being offered a wider choice of opportunities in the years ahead, although all new arrivals will have to be judged on their merits and valuations.

Europe

Europe continues to grapple with the latest COVID wave, but its equity market (as represented by the Euro Stoxx 50 Index) continues to hover close to the top of the leader board in terms of year-to-date performance. The fact that this is happening despite the euro zone falling back into recession during the first quarter once again demonstrates the forward-looking nature of financial markets. The latest round of Purchasing Manager Indices generally pointed towards a more optimistic view of the future as well. We continue to view European equities as favourably exposed to the gradual re-opening of the global economy. Politics are a potential banana skin, with elections due in both Germany and France in the next twelve months. But at least there is limited risk of any prospective results leading to a break-up of the European Union.

Emerging Markets

We return to the subject of the composition of the Emerging Market index with more detail. In 2008, Energy and Materials accounted for 37% of the index. Now they comprise just 13%. The degree of heavy, capital-intensive cyclicality within EM indices is nothing like it was. On the other hand, companies classified as Technology and Consumer Discretionary now make up 51% of the index, versus 26% in 2008. This means that the index is much more vulnerable to higher bond yields than it was in the past. Indeed, historically, higher bond yields might have been seen as a benefit. The dominance of China is also a factor, along with its politics. A less lenient attitude towards technology entrepreneurs has been followed by the threat of tighter restrictions on the financial arms of thirteen key companies. While in the long run we are willing to take at face value the promise that this will ensure more sustainable growth and less risk of a “boom and bust” cycle, the move reduces more immediate growth prospects and creates uncertainty around levels of profitability. On the geopolitical front, China’s incursions into Taiwanese airspace continue to be unsettling. While escalation into a full-on war, with the United States entering to defend Taiwan, remains a low probability event, it would certainly be highly impactful, and in a very negative way, especially as Taiwan is a key global producer of semiconductor chips, which are already in short supply.

Fixed Income

Bond markets enjoyed a period of stability in April, having been under pressure for most of the first quarter. The yield on the key US 10-year bond fell from 1.74% to 1.63% during the month. Hardly a bull market, perhaps, but remember that in the first quarter the yield had risen from 0.92% in response to rising inflation expectations. Not only were investors anticipating a re-opening of economies, but Joe Biden also added some fuel to the fire by introducing a further $4 trillion investment plan hot on the heels of his $1.9 trillion COVID stimulus package. We have not witnessed such fiscal largesse since at least the “Great Society” of Lyndon Johnson, or even the “New Deal” of Franklin D. Roosevelt. Given that economic growth forecasts continue to rise along with those inflation expectations, many commentators have been at something of a loss to account for the latest dip in yields. One reason cited is that US pension funds’ solvency has been greatly improved by the equity market rally. Consequently, managers are shifting equity holdings into long-term bonds to de-risk the liabilities. That is prudent. Continued central bank purchases are also a consideration. Just as probable is the fact that Treasuries were heavily oversold, and were due a break. In the UK, the 10-year Gilt yield was effectively unchanged at 0.84%, while Germany’s Bund saw its yield rise from -0.29% to -0.20%. It remains difficult to see much value in government bond markets, although they continue to offer an insurance policy against any sort of economic setback.

UK Gilts have delivered a total return of -5.14% over the last three months and -7.79% over the last year. Index-Linked Gilts returned -2.52% and -1.97% over the same respective periods. Emerging Market sovereign bonds produced a total return of -2.95% in sterling over the three months to end April (+2.79% over 12m). Global High Yield bonds delivered +0.27% (+10.96% over 12m).

Conclusion and Outlook

There are any number of reasons cited for why equity markets are (over)due a reversal. Headline price/earnings ratios are often the key witness for the prosecution (especially when it comes to Technology companies), although further cross-examination is required on behalf of the defence. We believe that full consideration is still not given to the high margins that many of these companies enjoy, nor their ability to operate with limited amounts of invested capital. The cash flow that this generates, with just a modicum of growth built into expectations, delivers high net present values, especially when interest rates are so low. Therefore the key to the sustainability of such valuations is to preserve the margins and not to see interest rates and bond yields rising too far or too fast. Warning shots were fired earlier in the year, in the form of regulatory sabre-rattling and the rise in bond yields. As we saw then, though, much of the slack was taken up by more cyclical companies that benefit from higher rates (and the reasons why they are rising). Thus we believe that internal market rotation is a greater threat to relative performance than an outright collapse.

Even so, investors should be most surprised if there are never any shocks at all. BCA Research calculates that the probability of there being no market shock in any 10-year period is a meagre 4%. There is a 60% probability of there being between two and four. There is a non-negligible 12% chance of there being more than five! This is not meant to scare anyone. Only to say that setbacks, when they do arrive, should be no more surprising than the regular arrival of the seasons, the exact timing of which, in these days of climate change, is also increasingly difficult to pin down. Excess returns are generated by taking risk, especially when interest rates and bond yields are as low as they are. The entry fee is exposure to higher volatility of capital values. But, for those with any reasonable investment horizon, “time in” the market will remain crucial to generating acceptable returns.

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