May Market Reflection

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Whereas the first quarter of the year was characterised by some big movements in equity markets, and a dreadful start to the year for bondholders, the second quarter so far has been less eventful. One feature has been the consolidation of bond yields, which has helped to alleviate the pressure that was building to reduce equity market valuations. For example, the US 10-year Treasury yield, which sets the discount rate for much of the world's financial assets, fell back from 1.74% to 1.61%. In some respects this could be viewed as surprising, given that the reading for April's US Consumer Price Index came in at a shockingly high 4.2%. However, it is was understood that the comparative data from the prior year is unnaturally weak owing to the onset of COVID. Furthermore, high inflation was largely confined to a small number of categories, with used cars being a notable contributor, as commuters continue to shun public transport and new car sales are held back by a shortage of semiconductor chips. Federal Reserve members, who at some point will be faced with the difficult decision of when to start withdrawing monetary stimulus, continue to view the current inflation spike as "transitory". The move in the UK's 10-year Gilt yield was less pronounced, falling from 0.84% to 0.81%, but, again, a welcome relief following a sharp rise in the first quarter from 0.19%. Here, too, inflation rebounded in April, but to a much more subdued rate of 1.6%. As in the US, the Bank of England's message points to limited pressure to tighten policy until the economy is on a much firmer footing beyond the expected release of pent-up demand once social restrictions are eased. Against this background, equity markets continued to make gains, although less rapidly, supported by an excellent reporting season for first quarter earnings.

- The global economy is set to recover strongly in 2021. Economists are still raising their growth projections, which have now reached 6% (Bloomberg median estimate). There will be some deceleration in 2022, but estimates are still rising, with the forecast now at 4.4%.

- Excess savings are calculated to have been equivalent to around 10% of GDP across developed markets during the pandemic. Evidence of the potential scale of pent-up consumer demand was seen in the UK's retail sales for April, which surged 9.2% from March's level, and 42.4% y/y.

- Governments are also in spending mode, with much support for "levelling up" on the social agenda, as well as for infrastructure and research spending to combat climate change. Companies, too, having been told to tighten their belts last year, are now being encouraged to increase capital expenditure. This will help to unblock various bottlenecks in global supply chains which are at least partially responsible for the recovery in inflation.

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- While COVID remains a key determinant of economic outcomes, and despite a number of case surges around the world, we remain of the opinion that the success of vaccine development leaves the world on a consistent path towards more normal levels of activity, although the odd setback is inevitable, especially concerning new variants.

- Following the strong equity market recovery and valuation re-rating, it would be unreasonable to expect a repeat performance. But risk assets should remain well supported by strong growth and loose financial conditions.

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