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A Half Of Two Quarters

Although the individual components of financial markets should pay little heed to the ends of months, quarters or even years, these moments in the calendar still offer a useful opportunity for people who write about markets to make some observations. I have just published our Monthly Commentary, which provides a retrospective of the first half of the year, and as I was compiling it, it became even more clear that there were some distinct differences between the first three months and the second.

Just looking at the FTSE 100 Index, it was notable that three of the top-ten index points contributors in the first quarter, namely Prudential, Barclays and HSBC, were in the top-ten detractors in the second quarter. That’s quite a big reversal. Because all those companies’ fortunes are tied closely to the fortunes of the bond market, the finger of suspicion immediately pointed to bonds, and with some justification. The UK ten-year Gilt yield was just 0.19% at the start of the year, and by the end of March it had reached 0.84%. Given that the base rate remained anchored close to zero, that delivered a steepening of the yield curve, which, all other things being equal, tends to be beneficial to the profitability of banks and insurance companies. As I have mentioned on several occasions in the past, with so much investment money now being run on the strength of quantitative models that rely on the historical correlations between certain types of financial asset, a lot of the flows into banks and insurance companies arrived without much intervention from human fund managers.

However, the Gilt yield has drifted back since then, falling to 0.71% at the end of June. The moves in the US Treasury market, which is the real driver of global asset markets, were more extreme. The yield on the ten-year Treasury Bond ended 2020 at 0.92%, jumped to 1.74% at the end of March (and peaked on March 30th), before falling back to 1.46%. If we look at how this affected the US equity market at the sector level, we can observe there, too, the contrast between the two quarters. In the first quarter the market was led up by Energy, Financials, Industrials and Materials, with Information Technology (IT), and Consumer Staples propping up the table. Fast forward to the second quarter, and IT was back at the top of the charts,

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followed by Real Estate and Communications Services (home of Alphabet and Facebook – essentially viewed as "tech" stocks too). At least the previous leaders still made positive returns while underperforming, testament to the huge amount of liquidity that is still being attracted to equities.

The notable relative losers in both quarters were Consumer Staples and Utilities, owing to the fact, dare I say, that they are deemed to be too dull for investors currently. They have neither the virtue of supernormal long-term growth and returns potential, nor immediate exposure to the reopening trade.

Perhaps even more important than the influence of nominal bonds yields is the role of real bond yields - the difference between the nominal yield and inflation expectations. Historically, investors might have expected the ten-year Treasury bond to yield 3% or so more than expected inflation, enabling them to lock in a safe real return without taking much risk. The real yield turned decisively negative following the financial crisis, owing to a combination of low actual growth, low expected growth and central bank intervention to suppress yields. It popped back into positive territory when the Federal Reserve started to tighten policy (and reduce asset purchases) in 2013, and remained relatively steady until 2019, when growth fears emerged again, and the Fed intervened once more. It's worth remembering that real yields were falling even before the COVID pandemic, as talk of "secular stagnation" persisted, but COVID turbo-charged the move further into negative territory, with the nadir being -1.08% in August 2020, and again at a similar level in February 2021. The subsequent squeeze up to a real yield of -0.58% in March took some of the steam out of equities in aggregate, but favoured cyclical and value stocks exposed to the economic recovery (what we prefer to describe as "short duration" stocks), very much at the expense of the big growth companies ("long duration"). The real yield was -0.63% at the beginning of April, falling to -0.86% at the end of June. Hence one reason for the latest IT rally, helped along by an excellent trading performance.

What has happened most recently? The biggest shift has been in the Fed's messaging, revealed at its last meeting a couple of weeks ago. In acknowledging the risk of higher future inflation, and bringing forward the timeline for tightening policy, it somewhat counterintuitively pushed bond yields even lower. That doesn't normally happen when the Fed talks about raising rates sooner rather than later, but this time the difference is that investors now believe that there is less risk of the Fed losing control of inflation and "getting behind the curve". One can see evidence for this in the inflation breakeven rates which represent the difference between yields on nominal bonds and those on inflation-protected bonds. The two-year breakeven rate has fallen back from a May peak of 2.95% to a current 2.68%. There have been similar moves down right along the curve.

The key observation here is that relative performance within the equity market is being driven primarily by real bond yields, and they, in turn, are being driven by a combination of central bank behaviour and inflation expectations. Given that the majority of investors (at least according to investment bank surveys) seem to believe that bond yields are going to be higher by year end and that the current inflation spike is deemed to be transitory, that would suggest that real yields are going to rise again at some point. If that's correct, it does not necessarily mean that equity markets are headed for a big fall, but it is more probable that the short duration stocks and sectors will perform better on a relative basis than they did in the second quarter. But an awful lot still depends on COVID developments, the pace of economic reopening, and the speed of rebalancing in global supply chains.

Following on from last week's comments about the COVID Delta variant and the race to vaccinate, I note that infection rates in Spain are up 100% on a 7-day rolling average basis from the previous week, although from a pretty low base, admittedly. Spain's current vaccination rates of 56% (of the whole population) having had one dose and 39.5% two doses are remarkably similar to the UK's rates of 58% and 37% respectively when the Delta variant really started to make its presence felt here at the beginning of June. Developments in Spain

will be watched closely, as it could be the next big test case for the breaking of the link between overall infection rates and the levels of severe infections, hospitalisations and deaths.

I usually travel to Spain around this time of year for a long weekend of golf, but this year's trip is delayed until the end of September (fingers crossed for that). One feature of the journey down is that the plane is always half full of hen parties and stag dos. It appears that more of them are staying on these shores this year, because walking in the Liverpool Street/Shoreditch area of London on Saturday afternoon required a lot of hen and stag dodging (not to mention the football fans). At least everyone was looking bright and perky at tea-time. Things were a bit messier driving through the same area at 11pm on the way home from dinner. Spain's loss…

And the final word on COVID this week comes from the US, where, over the weekend, a Washington Post/ABC News poll showed that more than a quarter of people in the country are unlikely to get a COVID-19 shot, with 20% saying they definitely won't and 9% saying they probably won't. Interestingly, this poll news came out just as Dr Fauci, the President's chief medical advisor, told the country that 99.2% of recent COVID deaths in the US were in the unvaccinated population. You can lead a horse to water, but you can't make it have a vaccine.

Last week's Economic Highlights

FTSE 100 Weekly Winners

Hikma Pharmaceuticals Plc	5.1%
Informa Plc	5.0%
Pershing Square Holdings Ltd Public Class USD Accum.Shs	4.2%
AVEVA Group plc	4.2%
Compass Group PLC	3.5%
Melrose Industries PLC	3.5%
JD Sports Fashion Plc	3.4%

FTSE 100 Weekly Losers

Burberry Group plc	-8.9%
London Stock Exchange Group plc	-4.7%
BT Group plc	-4.5%
Prudential plc	-4.0%
International Consolidated Airlines Group SA	-3.9%
Rolls-Royce Holdings plc	-3.7%
Admiral Group plc	-3.3%

FTSE 100 Index, Past 12 months

Source: Factset

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