



# Investment Views



July 2021

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# Global Strategy

## The Recovery Continues

Global equities continued their strong run in the second quarter, returning 7.7% in US dollar terms for a fifth consecutive quarterly gain. Bond yields stabilised following the rise in yields seen in the first quarter, so bond returns were also positive while prices of gold, oil and base metals also rose.

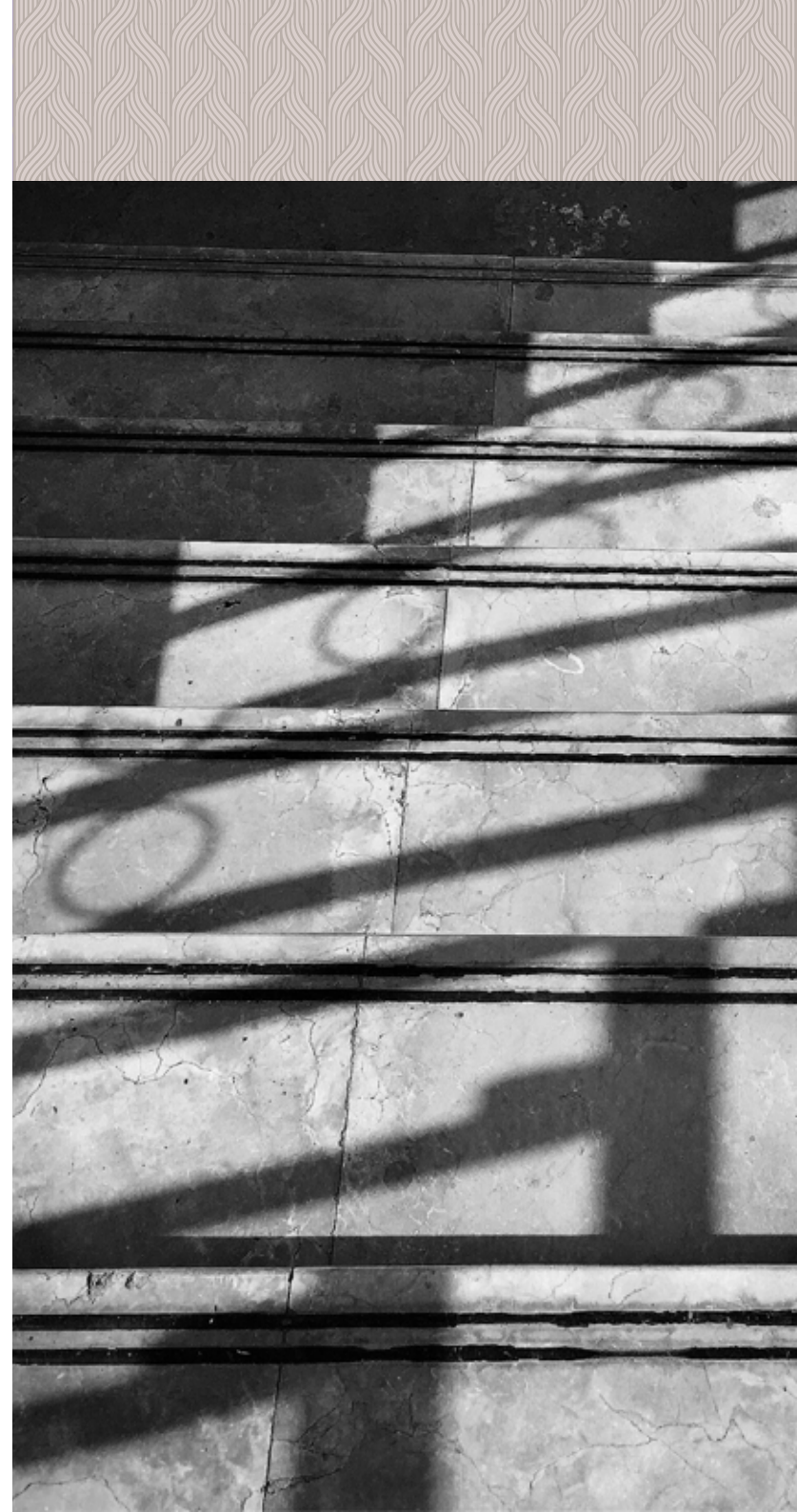
A number of factors combine to explain this period of strong broad-based returns on financial assets. Since the beginning of the year, consensus 2021 economic growth forecasts for the US economy have increased from 3.9% to 6.6%, while inflation estimates have also increased from 2% to 3.5%. In sum, the vaccine rollout, the reopening of the economy and the substantial US\$1.9 trillion American Rescue Plan have proven to be a powerful and positive mix for the US economy.

The picture outside of the US has been more muted, as COVID-19 variants outpaced vaccine rollouts in a number of countries and economic policy support has been less generous. The ongoing pandemic has caused some industries exposed to travel and leisure to lag in

the recovery, but the broad market has remained resilient, with vaccines providing a path out of the current situation.

Over the past few months one of the most hotly debated topics has been inflation. The combination of a low base for comparison, economies reopening and bottlenecks in global supply chains have led to US core inflation reaching 3.8% in May, the highest reading since 1992. A handful of sectors most directly affected by the pandemic have been the driver, including used vehicles (up 7.3% over the month), car rentals (up 12.1%) and airfares (up 7.0%). However, anecdotal evidence from company management across a range of sectors suggests that inflationary pressures are more broad-based.

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Until recently, the message from the Federal Reserve (the Fed) was that inflation was entirely transitory. While we have seen many commodity prices rise substantially and inflation breakevens in the bond market climb higher, investors have largely agreed with the Fed's assessment. In the latest Merrill Lynch Fund Manager Survey, 72% of respondents believed that the elevated inflation readings would indeed be transitory. A 30-year US treasury yield of 2.28% as at the end of May hardly suggested the market was concerned that inflation might be on the verge of heading out of control.

The post-Global Financial Crisis economy has been characterised by low growth and inflation, however the policy stimulus and economic recovery from the pandemic have raised hopes that we could escape this uninspiring backdrop, often described as secular stagnation. Inflation is a politically charged topic, often provoking strong views on both sides of the debate. Curiously, former Treasury Secretary Larry Summers,

who was previously vocal on the risks of stagnation, has recently argued that the "primary risk to the US economy is overheating – and inflation".

While inflation is likely to remain firm as we head into next year, the peak inflation fear has likely passed and the rate of economic growth is peaking. Given the nature of the recovery from the pandemic, it is inevitable that the rate of change will slow. The real question is whether the recovery continues through next year. With a US infrastructure package highly likely to pass later this year and the vaccine rollout supporting the reopening of Europe and emerging markets, probability suggests the focus will shift from inflation scare to the longevity of this growth cycle.

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# Fixed Income

## The Central Bankers' Dilemma

Bond markets performed well in the second quarter, but markets witnessed some volatile moves following the Fed's June meeting which suggested that interest rates would rise earlier than previously expected. The inflation backdrop has clearly spooked the Federal Reserve and 39% of Federal Open Market Committee (FOMC) members now see a hike in 2022, 72% see at least one hike in 2023 and 61% see two hikes or more by the end of 2023. The yield curve flattened, the dollar rose, many assets exposed to the reflation trade sold off and investors were left questioning the recently announced Flexible Average Inflation Targeting framework.

Fundamentally, the market was reminded that inflation is still important to the Fed and interest rates are unlikely to remain at zero forever. There was also a technical aspect to the market moves as positioning in 'reflationary' assets had become crowded. This hawkish messaging, designed to combat rising inflation expectations at a time when US growth is showing signs of slowing and the US approaches a large fiscal cliff in 2022, highlights the dilemma policy makers find themselves in. It raised the prospect of a policy mistake (providing a bid to 10 year US Treasury

yields which fell to 1.47%). However, with the balance sheet still growing by US\$120bn per month, including US\$40bn being injected (via mortgage backed security purchases) into the US housing market, arguably, house prices need no further support having risen by 14.6% year-over-year, the fastest level on record.

During the second quarter, economic data was mixed. Europe remained robust with sentiment reaching a three-year high as economies started reopening and reaped the benefits of pent up spending, but China continued to slow as the authorities grappled with a surging Renminbi, spiraling commodity prices and various speculative bubbles. Japan's data largely disappointed as manufacturing activity and industrial production slowed sharply and virus worries resurfaced.

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Although economic activity in the US has remained at an elevated level, the rate of change has slowed considerably and most recent data has disappointed expectations; business and consumer sentiment, durable goods orders, existing and new home sales are all weaker. However, the vast majority of these data releases are at extremely buoyant levels reflecting the strong rebound the US economy has experienced since March 2020.

In addition, supply chains continue to struggle to cope with a rapidly reopening economy. Together with speculative activity, this is leading to surges in some commodities prices with investors looking to hedge inflation risks, generating a feedback loop spurring further price gains. Combined with pent up demand from lockdown weary consumers, the US Consumer Price

Index (CPI), which is a broad measure of inflation, increased 5% year-over-year in June, the highest reading since 2008. Core CPI also rose by 3.8%, although, we expect this number to normalise towards the end of this year, possibly after some additional bumper readings in the third quarter, as consumers spend their savings and workers are forced to return to the labour force once generous unemployment benefits expire.

We had expected that midway through 2021 COVID-19 would be over in the developed world and that while there would be pockets of outbreaks, mostly in unvaccinated areas and outside the West, the crisis would largely have passed. The more transmissible Delta or Indian variant has given us pause for thought. Currently the UK is experiencing a wave in cases which has led to the delay of the final reopening stage, but hospitalisations and fatalities remain very low, providing evidence that the rapid vaccination program (with 49% of the population fully vaccinated) is working. The UK is a test case for the rest of the world and the vaccines seem to have delivered so far, which leaves us with a very positive longer term outlook.





However, in the short-term, mainland Europe, Cyprus and Ireland are of particular concern. The tourist season in full swing and with lower vaccinate rates their economies could be very exposed, followed closely by the largely unvaccinated southern US states. Given the economic damage, pandemic fatigue and the wave like nature of the virus, renewed lockdowns are not our base case and any market volatility should be used as an opportunity to add risk.

Looking ahead to the second half of the year we expect US growth to slow and inflation to fall back, as massive fiscal stimulus is reined in and labour supply in the employment market returns to normal. We remain bullish but cautious on risk assets given the above trend growth potential, global vaccine rollout and lack of a major catalyst for a risk reversal. Given the bullish macro and liquidity backdrop, we continue to hold corporate credit, as well as small positions in emerging market and high yield debt. However, valuations are expensive and as a result we haven't been a significant buyer of risk for most of the second quarter, preferring curve trades such as a long position at the five-year mark of the US Treasury curve.

Prior to the June Federal Reserve meeting, we also reduced our US inflation protection further. We believe that valuations now almost fully discount the current surge in US inflation; this call was vindicated as the policy committee all but abandoned their recently announced policy of allowing the economy to run 'hot' and appeared concerned by recent inflation readings. US portfolio duration was maintained at neutral for short dated accounts, as a 0.89% yield on five-year US Treasuries compensates us for an accelerated upwards move in US base rates. For longer duration US dollar accounts, we maintain an underweight duration, but the Delta variant, slowdown in Chinese and US economic growth and summer seasonality could lead to a short-term decline in yields and a stronger US dollar in the near term.

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# Equities

## Strong Gains but Cyclical Stocks Pause

Over the second quarter, equity markets generated positive returns in all regions except Japan and across all sectors except utilities. Since Pfizer released the positive news of a COVID-19 vaccine in the second week of November, markets moved higher led by cyclical stocks and those more exposed to the economic recovery. This was in contrast to the period between March last year and November, when markets were largely driven by more defensive growth sectors such as the large technology companies. This dynamic continued through the end of May, but then lagged in June as market leadership returned to the technology sector and the wider “FAAMNG” (Facebook, Apple, Amazon, Microsoft, Netflix, And Google) complex.

Outside of utilities, there was relatively narrow dispersion between the various global sectors. The shift in leadership during the quarter from cyclical stocks to defensive growth stocks can partly be attributed to the macro environment and partly due to company specific factors. Company earnings have been incredibly strong this year and consensus estimates for the S&P 500 have risen from \$164 to \$191. This is a huge upward revision based on historical

figures and overall earnings are now expected to be 36% higher than last year. While cyclicals have seen very strong earnings growth as the global economy has recovered, the large technology companies have demonstrated remarkable resilience through the pandemic and an ability to continue to post solid numbers this year too.

The performance of value versus growth reflected the gyrations in US Treasury yields. From the start of the year through mid-May, investor enthusiasm for value was pronounced, with the Russell 1000 Value benchmark surging 15% versus just 2% for the Russell 1000 Growth index. But a significant reversal occurred during the last six weeks of the quarter, concurrent with the decline in Treasury yields. The Russell 1000 Value index returned 2% while the Russell 1000 Growth rebounded by 12%.

*Europe has had many false dawns since the depths of the Eurozone crisis in 2012, but the region remains home to many high-quality businesses, especially in the consumer sectors.*





As discussed above, inflation has been a topic of debate over recent months and a cyclical recovery with an associated inflationary impulse is generally good for cyclical and value stocks; financials benefitting from rising bond yields and materials companies benefitting from rising commodity prices. One explanation for this shift is that positioning in 'reflationary' assets had become too crowded. As vaccines have been rolled out around the world, there has been a growing consensus on recovery.

Such positioning can be akin to a lot of people on one side of a boat; a wave can throw people off balance and anyone leaning too far off the side runs the risk of going overboard. Our investment process never involves leaning too far off the side of the boat, but the hedge fund industry can be prone to such risks due to their use of leverage; these moves can then have a self-fulfilling aspect in markets. Our bias at this point is that this is more of a mid-cycle pause in the recovery trade, but this is something we are keeping under constant review.

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An interesting feature of the first half of 2021 has been the record inflows into equity markets. According to Bank of America, almost \$600 billion flowed into global equity funds. If that pace continues to the end of the year, it would surpass total inflows from the last two decades. The S&P 500 currently trades at a forward price-to-earnings (P/E) multiple of 22.3x which is in the 94th percentile, so equities continue to be expensive versus history. However, low bond yields, strength in corporate credit markets and a recovering global economy against a backdrop of continually supportive Central banks, keeps us fully invested in equities and rebalancing exposure where we deem it appropriate.





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