



Investment Views



September 2021

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Global Strategy

Building Back Better

There have been a number of occasions where policymakers or economic commentators have compared the response to the pandemic as akin to a war effort. Over the past 18 months we have written extensively about the swiftness and scale of the economic policy response and just how effective it has been at limiting the long-term economic damage. While the pandemic still rages in many parts of the world, for the majority of developed market countries the focus has now turned from the short-term response to the long-term structural policy questions.

President Biden ran on a campaign platform promising to “Build Back Better”; a broad-based and ambitious agenda covering infrastructure, housing, education, economic fairness and health care. The plan had three pillars: the American Rescue Plan, which detailed a COVID-19 relief package; the American Jobs Plan, which provided a proposal to rebuild America’s infrastructure and create jobs; and the American Families Plan, which highlighted an approach to invest in areas related to childcare and education. The American Jobs Plan was the short-term focus, getting businesses and households through the pandemic, and this passed in March of this year. Attention

has now turned to the other initiatives, some of which are politically contentious and gaining the necessary votes is proving to be a challenge.

The plan to rebuild infrastructure is the least controversial, as there is widespread agreement that it is in need of extensive modernisation. This has come into sharper focus over recent years given the increasing number of extreme weather events including wild fires, flooding and even frosts in Texas. In August, 19 Republicans joined all 50 Democrats in the Senate to pass a bipartisan infrastructure package which includes \$550 billion in new funding for transportation, broadband and utilities. While the size of the bill falls short of the initial proposal, the bipartisan nature of the agreement is important and will lead to significant new investments in America’s infrastructure.

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From here it gets more contentious and partisan. A recent budget resolution allows Democrats to approve a further \$3.5 trillion spending plan later this year without Republican votes. The Democrats control all three branches of government in the US but the balance of power is very finely balanced. A small number of centrist senators wield significant power given the slim majority in the Senate. One of those senators, Joe Manchin, recently penned an opinion piece in the Wall Street Journal titled “Why I Won’t Support Spending Another \$3.5 Trillion”.

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Inflation has been a hot topic of debate this year, as the combination of economic re-opening and supply chain issues has caused inflationary pressures in a wide range of items from semiconductors, agriculture, construction materials and labour costs. The inflation backdrop is one of Manchin’s primary concerns: “Congress should hit a strategic pause on the budget reconciliation legislation. A pause is warranted because it will provide more clarity on the trajectory of the pandemic, and it will allow us to determine whether inflation is transitory or not”.

Few expected that the full \$3.5 trillion package was ever realistic, with Wall Street estimates currently closer to \$2.0-\$2.5 trillion (with the separate \$550bn infrastructure package taking the total to \$2.5-\$3 trillion). The plan covers areas relating to the rebuilding of infrastructure that couldn’t previously get passed on a bipartisan deal, such as clean energy, together with elements of the American Families Plan.





The plan has also been referred to as “human infrastructure” and includes a host of expenditures aimed at supporting broad economic participation such as extending the expansion of the child tax credit, improving child care options, together with free community college education. The details continue to be debated but there will need to be tax increases to partly offset the cost of these new programmes.

Like Biden, President Franklin Roosevelt entered office in a time of economic and political crisis. Roosevelt’s New Deal helped the US economy escape from the ravages of the Great Depression, while also fundamentally shifting the relationship between Americans and the federal government. Biden’s bold Build Back Better plan has

echoes of the 1930’s New Deal programmes, but the finely balanced political situation means it remains to be seen how much of the legislation will actually get passed. While it’s not the New Deal, it’s highly likely that there will be a deal later this year which will support the recovery and provide a broader base for continued growth.

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Fixed Income

The Countdown to Taper

During August, uncertainty increased as fading vaccine efficacy in Israel and new COVID-19 restrictions in Australia, Japan and New Zealand showed that, although the worst is likely behind us, the lurking Delta variant remains a problem for most of the world and this reinforced global growth concerns.

Economic data has disappointed in China, Europe and the US over the past few weeks and this contributed to declines in commodities and inflation expectations. However, US Treasuries appear to have already factored in a third quarter growth slowdown, as 10-year yields rose to 1.31% and other major bond markets remained flat, apart from the UK where there was discussion on a balance sheet taper, which saw long yields rise by 15 basis points.

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Federal Reserve Chair Jerome Powell reaffirmed the 2021 taper intention at Jackson Hole, but importantly reassured markets that there is no urgency to raise base rates, which helped risk assets make new highs. We expect the Federal Reserve to signal that tapering of their US Treasury and US Mortgage Backed Securities purchases will begin this year, but there is some uncertainty as whether this means November or December. Either way, quantitative easing will likely end by the middle of 2022 and risk assets will have to digest a huge reduction in liquidity as global demand wanes.

In addition, other major central banks also reassessed their asset tapering plans while still maintaining accommodative policy overall. The Reserve Bank of Australia (RBA) stuck to their September taper plan, the Bank of England (BoE) and European Central Bank (ECB) signaled a willingness to taper and the Norges Bank flagged that their first rate hike may come as soon as this year. Differentiation across countries is notable and could deepen further in coming months.





Looking ahead we have several potential catalysts which could trigger a spike in volatility. Economic data in the US is likely to settle over the coming months as COVID-19 supply disruptions fade and the labour market is supplied with millions of people losing generous pandemic unemployment benefits. As a result, good or bad, we will finally start to see the true state of the US economy. Furthermore, negotiations over the US debt ceiling will collide with the Biden administration's next fiscal stimulus—at the same time as economic growth is cooling and the Federal Reserve tightens monetary policy.

There was little transaction activity across portfolios in August, as government bond yields were mostly range bound and positioning remained appropriate given the current economic outlook. As we enter September, we continue to turn our focus to the 3 year part of the US Treasury curve as a place to generate total return via carry and roll down.

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Although, some indicators are signaling that adding some duration at this point may be appropriate given the bond market's large short positioning and potential for risk assets to negatively react to the Federal Reserve taper and global growth slowdown; so we maintain our previous positions in the 5-7 year bonds for now. In our multi-currency portfolios we prefer the Japanese Yen and US dollar over the Swiss Franc (due to the elevated level of Swiss longs and negative terms of trade balance) in our risk-off bucket. The Australian dollar, which could be poised for a rally once Delta cases subside, and the Euro, where buying momentum is building and where risk premiums are low versus historical average, are our most favoured risk-on overweight.



Equities

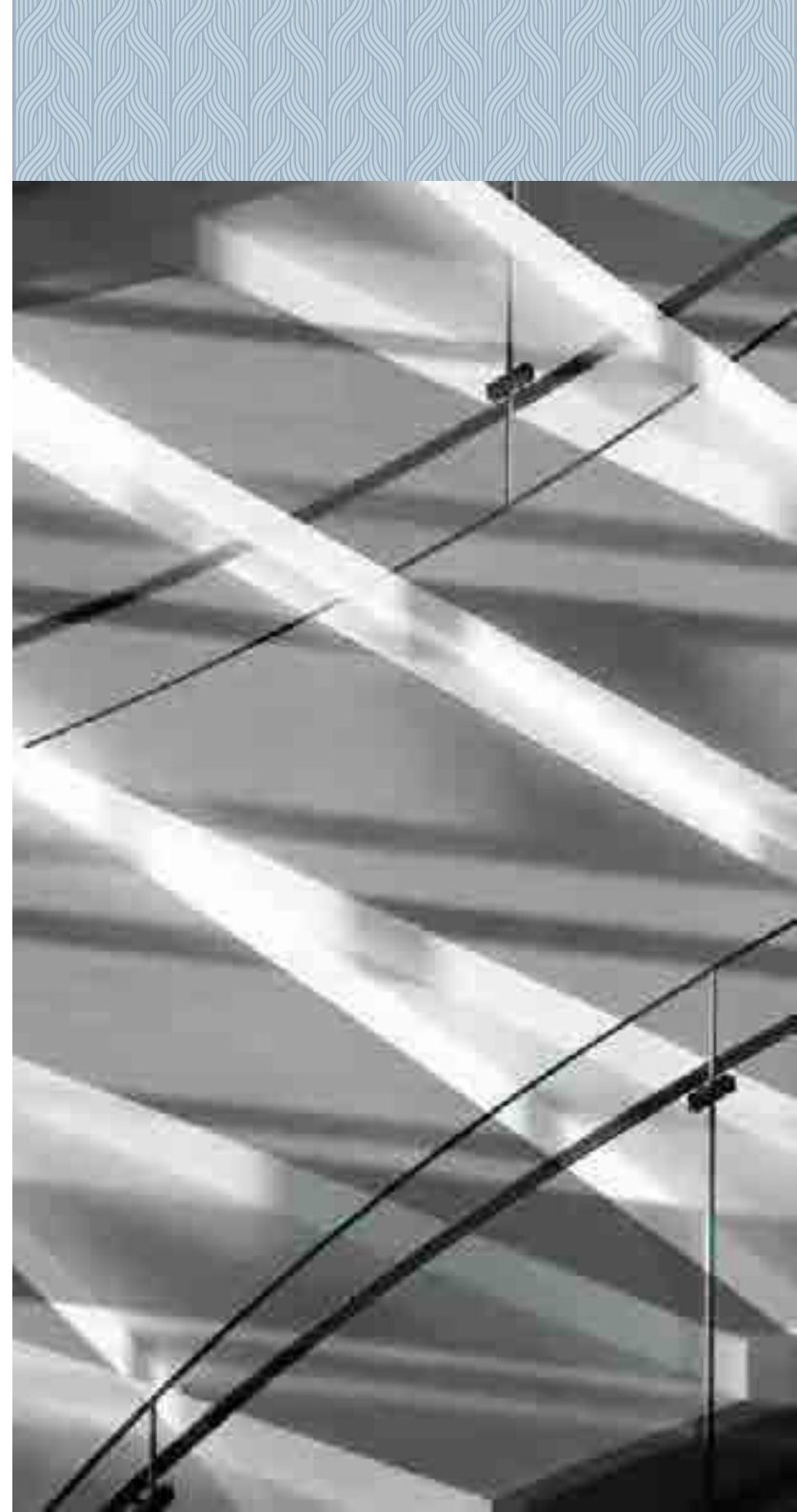
China's Loss is India's Gain

August was another positive month for global equities, with the MSCI World index returning +2.5% in US dollar terms. This was the seventh consecutive positive month and took the year-to-date return to an impressive +17.9%. The market strength can be explained by a few primary factors. Firstly, company earnings have been incredibly strong as the recovery has progressed and pent-up demand has been unleashed. Secondly, the rotations under the surface of the overall market index have supported the headline level.

More simply, at any given time, either “defensive” growth stocks (e.g. technology) have been doing well or more cyclical stocks (e.g. financials) have been doing well. To get a meaningful correction, both groups need to fall at the same time and that has not happened for many months. Central banks have been very cautious in the manner in which they dial back their support programmes, but the tapering of asset purchases is on the agenda as we head into the last quarter of the year. As discussed above, this could be what finally injects a little more volatility into financial markets.

Aside from cyclical stocks versus defensive stocks, a key theme this year has been the regulatory clampdown in China and the stress this has caused in the Chinese equity markets. The term “emerging market” has become increasingly obsolete and the lines between developed markets and emerging markets have become increasingly blurred. For example MSCI classifies South Korea as an emerging market, but FTSE classifies it as developed. China is a particularly tricky case, as it still has many attributes of an emerging market (for example GDP per capita and financial market governance), but as the world's second largest economy, its scale and importance for global growth is significant and suggests a developed market framework is more appropriate.

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Chinese equities now equate to just over a third of the MSCI Emerging Markets index, so an argument can be made to separate China out from the rest of the emerging markets and consider it separately. Many investors have been doing this for years, or at least separating different regions, such as Asia from Latin America. However, the latest regulatory crackdown in China has given this idea a new impetus.

Other emerging markets have seen fund inflows redirected from China, and India has been a notable beneficiary. Given China's scale, there are challenges for other countries to absorb the fund flows as their markets do not have the same depth and liquidity, with India being the market of choice for many investors. India's equity market has been one of the top gainers globally this year, driven by financials, utilities, industrials and consumer discretionary stocks; however, valuation multiples have been pushed higher and the premium over Chinese equities now look stretched versus history. The theme of differentiation within emerging markets will continue to be an important driver of relative returns.



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