



Investment Views



June 2021

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Global Strategy

Time for a recovery in Europe

2021 consensus economic growth forecasts for the US and the UK have increased from 3.9% to 6.6% and 5.3% to 6.2% respectively, while for the Eurozone there has been a slight downgrade from 4.6% to 4.2%. This divergence reflects the rapid pace of vaccine rollouts in the US and UK compared to Europe, together with more supportive economic policies. Expectations in the US jumped in February and March, as the \$1.9 trillion American Rescue Plan Act of 2021 passed, whereas the UK benefitted from increased mobility with the reopening of the economy.

As we entered April, the vaccine rollout in Europe started to pick up speed and this was reflected in currency markets as the euro recovered after a weak first quarter. Although growth projections for Europe have not changed, underlying economic data remains robust, with sentiment reaching a three-year high bolstered by gains in the services and retail sectors as economies reopen and reap the benefits of pent-up spending.

In China, recovery from the pandemic crisis has reached the point where authorities are intentionally slowing the economy down to grapple with strong commodity

prices, Renminbi appreciation and various speculative bubbles. In the US, economic activity essentially took a breather in May with payrolls, business and consumer sentiment, durable goods orders, existing and new home sales all weaker than expectations. However, the vast majority of these data releases are at extremely elevated levels, reflecting the strong rebound the US economy has experienced since March last year.

There are also some large distortions that make reading the underlying health of the US economy difficult at present. The Biden administration's additional US\$300 per week in unemployment benefits has affected the supply of workers willing to be employed, leading to labour shortages across the US; it is currently more rewarding financially for some workers to stay home until the benefits expire in September.

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Against this backdrop, the baton passes to Europe to continue the global recovery. Europe is moving rapidly to save the summer tourist season with mobility surging in France, Greece and other countries. Vaccination rates remain relatively high and warmer weather is setting in meaning Europe looks set to enjoy an economic boost over the coming months.

While the outlook for international travel remains uncertain, the manufacturing sector has provided significant support over recent months and, with inventories being drawn down, this should continue to provide a solid foundation for the ongoing recovery.

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Unlike in the US, there is little evidence of labour shortages in the Eurozone. In April, the number of those unemployed fell by 134,000, pushing the jobless rate down to 8.0%. The unemployment rate declined in France and Germany but edged up in Spain and continued on a rising trend in Italy. However, since then, timelier data shows the number of job openings has risen in all of the four major Eurozone economies, with Italy experiencing particularly strong growth. We have recently increased our exposure to the Eurozone in appropriate equity mandates and reduced our Japanese equity exposure, as the country continues to face challenges from the pandemic and has more muted recovery prospects.

Fixed Income

Taper talk builds

Financial markets worked themselves into a frenzy in May, having been spooked by the recent price gain data, as concern mounted over elevated US inflation data. As a result, the US dollar weakened considerably, helping to boost already elevated commodity prices, with gold - the traditional inflation hedge- rising to \$1,907 per ounce. With speculation mounting that the US economy may be overheating, the debate on a reduction in the Federal Reserve's balance sheet, which has now reached US\$7.9 trillion, gained traction. However, the bond market continues to send a message of stagflation, as 10-year US Treasuries remain anchored at 1.59%. Given the uncertainties surrounding the durability of the US recovery, the "fiscal cliff" in 2022 and risk of a surging US dollar (as the Bank of Canada experienced), which would in turn tighten financial conditions, a case could be made to maintain current policy; the risk being several large inflation prints could change the narrative very quickly.

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As economies reopen rapidly, supply chains are struggling to cope. This, along with speculative activity, is leading to surges in some commodities such as corn (up 27% year-to-date), lumber (up 50%) and WTI crude oil (up 36%). The US also recorded an increase of 10% in used vehicle prices in April alone. Taken together, the US year-over-year Consumer Price Index (CPI), or broad inflation reading, was up 4.2%, the highest reading since 2008, while "core" CPI also came in 3% higher. However, we expect this number to normalise towards the end of this year, possibly after some additional bumper readings in June and July as consumers spend their savings and workers return to the labour force later this year.

Developed countries continue to reopen and normalise as vaccinations have largely broken the link between case numbers and fatalities. In the UK there have been some worrying signs that the Indian, or Delta variant, could lead to another major wave, delaying any further reopening of the economy. However, cases have been confined to the younger segments of the population who are currently unvaccinated but are about to receive their first doses in the coming weeks. In the Southern Hemisphere, where temperatures are falling and vaccination rates remain low, Australia, Japan, Singapore, Taiwan and Vietnam are all





re-imposing mobility restrictions as hard border closures are failing to contain case numbers. This poses a risk for semiconductor supply chains and has ramifications for a wide range of industries.

Portfolio positioning took a defensive tilt in May as we exited the majority of our US Treasury Inflation Protected Securities. This may seem counterintuitive given the current news coverage surrounding inflation pressures building in the economy. However, while we do expect elevated US CPI readings throughout 2021, the cost of inflation protection has reached very expensive levels. The market is overwhelmingly convinced that inflation is here to stay, so we have been inclined to capitalise gains on our positions, which were added at extremely distressed levels during the aftermath of the market meltdown in March 2020. We would prefer to capture any further acceleration in inflation expectations via other asset classes such as equities and commodities.

We still find the five-year part of the US Treasury curve attractive given its low duration risk, carry (0.8% as of the end of May) and roll down characteristics. We have moved to overweight versus our benchmarks in our US dollar bond funds. In addition, with global central banks becoming ever so slightly hawkish over the past few months and expensive valuations (credit spreads are back to their pre COVID-19 lows), we feel no need to stretch for risk at this point in the cycle and feel comfortable running high cash levels if maturities come due. Given the current distortions in economic data, we are going to exercise caution as we approach the traditionally illiquid summer and wait for clarity.

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Equities

Another strong month for cyclicals

Global equities climbed for the fourth consecutive month in May, returning 1.4% in US dollar terms, taking performance over the first five months of the year to a very healthy 11.4%. Cyclical sectors, such as energy, financials and materials performed well and benefitted from the ongoing economic recovery. On a regional basis, Europe outperformed as the equity markets are more exposed to the cyclical sectors compared to the technology heavy index in the US. The euro also appreciated as the vaccine rollout picked up pace, which helped boost returns for international investors.

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. The rise of COVID-19 variants has delayed the recovery in global travel, which is a negative for Europe given the importance of tourism in many of the southern countries. Performance has been mixed in the industries most exposed to travel, but the strength of manufacturing, particularly the auto sector, has been more than sufficient to offset the slower recovery.

Within the energy sector, the main story has been the recent decision by The Organization of the Petroleum Exporting Countries and allies (OPEC+) to return 2.1 million barrels per day of supply to the market in anticipation of a rise in demand as the world continues to reopen.

The oil price has rebounded strongly this year as OPEC+ has been returning supply to the market and continues to balance expectations of a recovery in demand against troublesome COVID-19 case growth in emerging markets and a possible increase in Iranian supply. Oil prices have extended their rally and have now gained more than 40% this year, which leaves energy the best performing sector so far this year.

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Another interesting story in the energy sector has been the struggle between the management at Exxon Mobil and the activist hedge fund Engine No. 1, which managed to seat three of its nominees on Exxon's board despite owning just 0.02% of the stock. Engine No. 1 claimed that Exxon needed a "more disciplined capital allocation strategy, improved long-term strategic planning, more shareholder-aligned management compensation, and a board of directors with the skills, experience, and independence to make these goals a reality".

This argument persuaded other shareholders, such as passive managers like BlackRock and a number of pension funds, that the board needed independent voices with the skills to manage the energy transformation. This marks a pivotal moment for the shift that is happening in both sustainable investing and the energy transition; both are important trends that we continue to cover.

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Tel +(441) 299 3817
www.butterfieldgroup.com/Investments

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Tel +(345) 949 7055
www.butterfieldgroup.com

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Tel +44 (0)1481 711521 Fax +44 (0)1481 714533
www.butterfieldgroup.com

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