Investment Views

June 2021

Keeping it Real

The first quarter delivered mixed economic news. Whilst China and the US enjoyed annualised GDP growth of 18% and 6% respectively, the likes of the UK, EU and Japan all contracted. Looking ahead, as lockdowns fall away and generous fiscal and monetary support endures, growth is set to broaden out. Global real GDP will hit a new high during the second quarter with the world economy forecast to expand by more than 5% this year (source: IHS Markit).

As the covid clouds clear, the debate grows about the scale and duration of emergency policies. On the fiscal front, Governments remain committed to aggressive reflation given an uneven recovery and elevated unemployment. As political dogma meets economic necessity, left-leaning incumbents feel empowered to test the limits of debt-fuelled expenditure. Indeed at the end of May, President Biden announced his budget for the year ending September 2022. It included \$6trn of spending and various tax increases, most notably a 7% hike in corporation tax to 28%. The net effect is a forecast budget deficit of \$1.84trn. That's twice the pre-pandemic level and about 8% of GDP. Even Larry Summers, a Democrat economist who served the Clinton administration, questioned the prudence of such unfunded outlays.

Given this fiscal profligacy, if the global recovery persists and inflation continues to tick higher, bond yields and base rates should rise. At 1.6%, a US 10-year Treasury currently yields 2.6% less than inflation. Parity or a modestly positive real yield are the historic norm. As we have often noted, we do not feel this will be allowed to happen, even if over-heating economies argue for it. Given the epic scale of global indebtedness, a sustained rise in the cost of debt servicing would rapidly choke activity, plunging the world into a painful recession. With US government debt now exceeding 130% of GDP (source: St Louis Fed), activity is hyper-sensitive to the cost and availability of capital.

As such, if the current rise in inflation persists, we expect the US Federal Reserve to intervene to cap yields and corporate bond spreads. For now, their resolve has not been tested as bonds have flat lined since a sharp first quarter sell-off. This suggests that many agree with the Fed's premise that the rise in consumer price inflation (CPI) is transient. Whilst US CPI rose to 4.2% in April and is set to push higher during the summer, the Fed sees it falling back to 2.4% by year end.

Even if the Fed is proved correct, we see this sanguine view being severely tested by the unfolding data, as the gap between covid-disrupted supply and resurgent demand continues to feed inflation. Furthermore, as net Treasury issuance rises to finance the Biden deficit, a dearth of overseas buyers could amplify any upward pressure on yields. Foreigners have been net sellers of US Treasuries since May last year, at a rate of $20bn per month. As the US Congressional Budget Office expects Federal debt to increase by $2.3trn this year, the Fed may need to step in as the buyer of last resort (source: CrossBorderCapital).

Finally, as the flood of stimulus cheques and QE money continues to leak into asset markets, talk of bubbles abound. Whilst the various Fed Governors are starting to "talk about talking about tapering QE", we suspect this is an attempt to discourage leverage and asset speculation rather than a genuine move towards stimulus withdrawal. In stock markets, the S&P 500 now stands at an all-time high from both an index level and valuation perspective whilst the cost of a US single family home rose by a record 13% in the year to March.

Given all of the above, we may see renewed weakness in global bond indices as investors demand higher yields; this will challenge the Fed to act (alongside other Central Banks). How high can the cost of capital go before activity in the real economy is threatened? Given the Fed's renewed focus on full employment, our guess is "not very" and that Chairman Powell will initiate some form of yield curve control, using the Fed's balance sheet to cap both yields and spreads.

The hurdle to such overt intervention is necessarily high and would probably follow a period of rising rate angst and equity market volatility. The Authorities would also be mindful that by supressing both nominal and real yields, they risk further inflating asset bubbles. As a result, yield curve control would probably be accompanied by a raft of macro-prudential policies that seek to limit leverage in the financial system.

This outlook is not predicated on a firm view of future inflation. Either we are seeing the start of a secular rise in inflation or the economy and prices will roll over, forcing the Authorities to redouble their reflationary efforts. The direction of travel seems set; it is only a matter of timing. Whilst we suspect the current rise in CPI may last longer than many anticipate, the debate will rage until the impact of last year's weak prices has washed through (the so-called 'base effects'). Things will become clearer as we head into the autumn. In the meantime, we are monitoring whether workers forsake generous furlough benefits to return to work and whether they have the confidence to spend their material lockdown savings. Both elements will inform the evolving supply/demand imbalance.

Client portfolios reflect our conviction that, over the coming 12-18 months, nominal rates will remain depressed with inflation-adjusted "real" rates falling back through cycle lows. We are agnostic as to whether this comes to pass via yield curve control, falling nominal yields or rising inflation (or a mix thereof). In taking this view, we expect heightened volatility as these uncertainties are resolved against a backdrop of richly valued asset markets.

Policy Matrix Summary

The matrix below is a summary of our current outlook for the various equity, bond and commodity markets that we monitor. We have changed the time frame from 6-12 months to 12-24 months, to better reflect our investment horizon. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

6-12 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan Value ESG & Impact funds FinTech & Blockchain	Inflation-linked, Emerging Market, China	Gold, Volatility Strategies
–	Bonds	European US	UK European Japanese High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31- May 21	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.4212	2.8%	2.0%	15.1%
CHF	1.1125	1.6%	1.1%	7.0%
AUD	0.7734	0.2%	0.4%	16.0%
JPY	109.5800	0.2%	2.8%	1.6%
EUR	1.2227	1.7%	1.3%	10.1%
BOND YIELDS (10 yr)				
UK	0.79	-0.05	-0.02	0.61
US	1.60	-0.03	0.19	0.94
Germany	-0.19	0.02	0.07	0.26
Australia	1.71	-0.04	-0.21	0.83
Japan	0.08	-0.01	-0.08	0.08
EQUITIES				
US. S&P 500 (USD)	4,204.11	0.5%	10.3%	38.1%
UK. FTSE 100 (GBP)	7,022.61	0.8%	8.3%	15.6%
FTSE Europe Ex UK (local)	320.27	2.3%	10.4%	28.7%
Japan. Topix (JPY)	1,922.98	1.3%	3.1%	23.0%
China. Shanghai Comp (RMB)	3,615.48	4.9%	3.0%	26.8%
HK. Hang Seng (HKD)	29,151.80	1.5%	0.6%	27.0%
Australia. All Ords (AUD)	7,406.66	1.6%	6.7%	26.1%
FTSE Asia Pac ex Japan	731.28	1.3%	2.1%	49.2%
FTSE World (USD)	837.08	1.3%	9.1%	39.7%
FTSE World (GBP)	873.04	-1.3%	7.3%	21.5%
COMMODITIES				
Oil (WTI)	66.32	4.5%	10.3%	71.4%
Gold	1906.87	7.8%	10.0%	10.2%

Disclaimer/Regulation

How to subscribe to Investment Views

If you would like to receive a free copy of Investment Views by email at the start each month, please contact us at UK@bentleyreid.co.uk. We publish a digital and audio version. Alternatively, Investment Views is available on the Bentley Reid App or via our website (www.BentleyReid.com); go to the Investment Views section. This also houses our quarterly market commentaries and in-depth investment interviews.

Instructions for downloading the Bentley Reid App on Apple devices:

The App can be downloaded onto Android and Apple devices.

1. Scan or click the QR code or search for 'Bentley Reid' in the relevant App Store. For Apple devices the search must take place in the 'iPhone Apps' section, which sits at the top of the screen, regardless of the device being used. If you search in the 'iPad Apps' section no results will appear.

2. Install the app and click 'Open'.

3. Once the app is installed, to ensure you receive a pop up notification that new publications have been posted, go to the general 'Settings' section on your device and then choose 'Notifications'. Scroll down on the right hand side and select Bentley Reid. In the 'Notification Center' section choose 'On,' the type of 'Alert Style' you would like and then return to the main screen.

Contacts and Regulation

Published and distributed in UK by **Bentley Reid & Co (UK) Limited**
29 Queen Anne's Gate, London SW1H 9BU, England
Tel +44 (0) 20 7222 8081, Fax +44 (0) 20 7227 8440, Email UK@bentleyreid.co.uk
Authorized and regulated by the Financial Conduct Authority, registered office 29 Queen Anne's Gate, London SW1H 9BU. Registered Number 07602886

Published and distributed outside the UK by **Bentley Reid & Co Limited**
24 Floor Diamond Exchange Building, 8-10 Duddell Street, Central, Hong Kong
Tel +852 2810 1233, Fax +852 2810 0849, Email HK@bentleyreid.com
Licensed by the Securities and Futures Commission in Hong Kong

The content of this document is for information purposes only. The authors believe that, at the time of publication, the views expressed and opinions given are correct but cannot guarantee this and readers intending to take action based upon the content of this document should first consult with the professional who advises them on their financial affairs. Neither the publisher nor any of its subsidiaries or connected parties accepts responsibility of any direct or indirect or consequential loss suffered by a reader or any related person as a result of any action taken, or not taken in reliance upon the content of this document.