Market Review

First quarter 2021

EQUITIES:	The growth-to-value rotation continues as markets rally
BONDS:	Yields rise sharply as vaccines boost recovery optimism
CURRENCIES:	The dollar rebounds; sterling and the aussie hold recent gains
COMMODITIES:	Bullion slides as crude and industrial metals drive higher

Financial markets are now anticipating that stronger economic growth and inflation will last beyond the “mini-boom” that seems inevitable as lockdown restrictions ease. This recovery or reflation trade, which is being fuelled by the vaccine rollout and unprecedented US fiscal stimulus, has had a stark and varied impact on asset prices. The most notable feature is the surge in bond yields with longer-dated government debt experiencing one of its worst sell-offs in 40 years. Other low rate beneficiaries, like precious metals and growth equities, have also struggled, whilst the more cyclical value stocks have rallied strongly. The FTSE All-World index gained 4% in £ terms over the quarter, whilst most government bond indices fell by at least 4-5%.

Some of our core positions benefit from falling inflation-adjusted (real) yields, so the recent rates backup has been a headwind, particularly for the bond and gold exposures. Conversely, the value/recovery equities that we have added to over the past 6 months, particularly via the UK and Japan equity allocations, have produced strong gains.

Whilst we agree with the forecast for a near term economic revival, since November last, markets have moved to price this in. However, we question the more extravagant predictions, given the headwinds of massive debt burdens, labour market slack and long-run disinflationary forces. We expect forward-looking growth and inflation estimates to ease as we head towards 2022, which could take the wind out of the reflation trade. This would likely foster even more monetary and fiscal support, renewing the decline in real yields as inflation exceeds nominal yields. Whilst the timing and path to this reality are uncertain, we expect this trend to dominate for several years and have positioned our client portfolios to profit from it.

Equities

% change, total return	3 months	12 months
FTSE World Equity index USD	4.8%	55.4%
FTSE World Equity index GBP	3.7%	39.6%

Many indices are back trading around all-time highs just a year after COVID-19 triggered a 30-40% market crash. The speed of the rebound is unprecedented, but beneath the headline moves a significant rotation in market leadership has emerged. Last year's high-flying tech stocks and other "stay-at-home" beneficiaries have sold off sharply in recent months, as recovery hopes have pushed bond yields higher. Conversely, financial, energy and small cap listings have all outperformed as part of a broader value stock renaissance.

The new US administration evidently understands that fiscal support is key to driving growth and inflation expectations higher. President Biden, in the job for just two months, has already delivered U$1.9trn worth of debt-funded handouts and is now shifting his focus to a U$3trn infrastructure bill. The President is benefiting from the Democrats winning both seats in January's Georgia Senate run-off, which gave the party an effective majority of 51 seats in the 100 seat upper House. However, with Republicans support for the latest stimulus absent, Biden is relying on a loophole called "reconciliation" to force through his spending policies. This procedural technicality enables policies to pass on a simple majority, rather than the usual 60 votes.

The fiscal largesse has resulted in a sharp increase in inflation expectations. In the US, 10yr breakeven rates (a market forecast of inflation over the next decade) have more than doubled over the past year to 2.4%p.a.; they look set to rise further. The speed of the move has been the catalyst for the violent sell-off in bond markets.

Whilst rising yields are not unusual at this stage of a cycle, rapid changes can destabilize economic activity and are often a precursor to significant market volatility. The impact on growth/momentum equities has already been profound with higher rates (or discount factors) reducing the present value of future earnings. In turn, this undermines the valuation premium that many attach to these high-growth stocks.

The racier "innovation" stocks (including the poster-child, Tesla) have been hard hit with many experiencing 30-40% pullbacks intra-quarter. The performance of the ARK Innovation ETF, focused on high growth tech names, serves to illustrate (chart 1). We are generally staying clear of these more speculative names, but have used the recent weakness in blockchain technology stocks to introduce a dedicated ETF exposure. We view this as a "picks and shovels" way of playing the boom in the digital economy and the transformative adoption of blockchain technology across many industries.

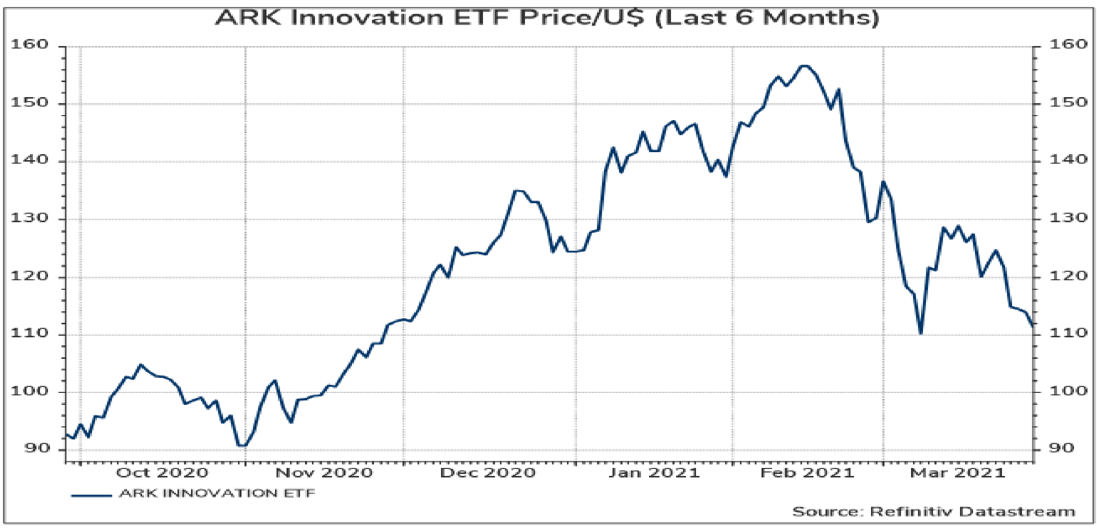

Chart 1: Many US tech stocks have tumbled since mid-February.

Hedge funds have been in the press for all the wrong reasons since the start of the year. In a bizarre development an army of amateur day traders used social media chat forums to collectively bid up the price of stocks they knew were heavily shorted by hedge funds. Typically, retail investor flows are too modest to trigger market dislocations but that wasn't the case in early January. The price of Gamestop, a troubled US computer games retailer, spiked almost 2,000% in a matter of days, as a coordinated wave of retail buying forced hedge funds to close out their bets against this small, illiquid stock (a so-called "short squeeze"). Several funds had losses running into the hundreds of millions of dollars.

The saga is a contemporary equivalent of the "Occupy Wall St" protests that followed the banking crisis, as disenfranchised parts of society corral to voice their frustration. It will make many speculators more reluctant to short stocks, removing a key component of price discovery in markets, particularly in the small cap space.

The cyclical nature of UK and Japanese indices has made them a main beneficiary of the reflation trade. Our allocation to both has been an important source of returns for all equity-based mandates since last November's "Pfizer Monday", when the first successful vaccine trials were announced.

The FTSE 100 ground higher during the quarter to produce a 5% gain. The recent rally has recouped some of the 11% loss in 2020, leaving a flat total return over the past 2 years. As we noted last time, the FTSE 100's hefty exposure to the likes of banks, energy and mining stocks gives it a high correlation to the business cycle; rising when growth/inflation expectations are accelerating and vice versa. We added to UK large-cap stocks at the beginning of the year.

The same cyclical narrative is broadly true for most European bourses, which enjoyed a solid quarter despite a shambolic vaccine roll-out and rising infection rates. The reflation rotation has attracted record investor inflows since last November. We are not inclined to chase European stocks higher, particularly as the stocks showing strong momentum screen poorly for indebtedness and profitability (or lack thereof).

Back in the UK, the mid and small-cap stocks produced another strong quarter with the FTSE Small Cap index gaining 10%. Compared to EU peers, we view this sector as a high-quality value opportunity. Even after the run-up they remain on the cheap side of fair value and the sector is benefitting from a lot of overseas M&A interest; the FTSE250 is on track for a record year of takeover deals. We will add to our existing actively-managed mid & small cap funds once the current overbought conditions dissipate.

Japanese stocks continue to trade strongly with the Topix adding 9% over the quarter. Our preferred active fund (Man GLG Japan Core Alpha) rose 27% as its value bias was finally rewarded. Bank stocks were notable outperformers, benefiting from stronger growth and a steeper Japanese yield curve. Along with our UK positions, this remains our preferred way of playing the recovery story.

In its long-awaited policy review the Bank of Japan reaffirmed its commitment to yield-curve control, anchoring the 10yr JGB yield around 0%, but it did make an important change to its equity purchase program. Just a few months after surpassing the Government pension fund as the largest owner of Japanese stocks, the Central Bank announced it would no longer purchase Nikkei-based ETFs. Instead it will focus exclusively on buying Topix trackers after periods of market weakness (rather than routinely as is currently the case). This benefits our Topix ETF holdings; a complement to the Man GLG fund.

Chinese stocks were one of last year's best performers, with our A share ETF rising 42% (in dollar terms). They have struggled since the turn of the year (off 4%), with a number of growth stocks losing ground to their value counterparts. The tech, healthcare and liquor names have been particularly weak although with many trading at more than 100x P/E, some form of consolidation was inevitable. Mainland weakness contrasts to a strong start for most Hong Kong indices. At one stage the Hang Seng was up over 14%, but finished the quarter 4% higher.

The dominant Chinese tech names could remain under pressure as we head into the summer. The US regulators are accelerating the delisting of Chinese ADRs from American exchanges and the Beijing authorities are intensifying their regulatory clampdown on the likes of Alibaba and Tencent. Despite these omnipresent political risks we still like Chinese equities, particularly the domestically focused A-share market; we added to positions on weakness.

Bonds

10-year yield	31.03.2021	31.12.20	31.03.20
US treasury	1.74%	0.92%	0.67%
UK gilt	0.85%	0.19%	0.36%
German bund	-0.29%	-0.57%	-0.47%
Australian treasury	1.79%	1.01%	0.76%

Bond markets have just witnessed one of the worst declines in 40 years with emerging inflation fears and a glut of new issuance triggering a sell-off that rivaled the 1994 downturn and 2013's "taper tantrum".

This tantrum occurred without any credible "taper" threat as the Federal Reserve, and most other Central Banks, have clearly stated that base rates will remain anchored at or near current levels for 2-3 years. They also stressed there is a high bar for removing any of the unconventional support like QE and yield curve control. This did not stop markets from pricing in earlier rate hikes; at one stage, US money markets were forecasting a Fed hike as early as 2022.

Most of the action occurred at the longer end of the yield curve with issues maturing beyond 5 years witnessing the sharpest price declines; the 20yr+ US Treasury ETF fell 14% over the quarter (chart 2).

Chart 2: Long-dated USTs have now given back all their 2020 gains.

Inflation rates are set to rise. US headline CPI was 1.7% pa in February, but will rise to at least 3% by the summer as current prices compare to depressed levels a year ago; a base effect that will boost CPI for 3-4 months. Compounding this technical aspect, stimulus cheques and lighter lockdowns will boost aggregate demand whilst supply chain disruption is driving up raw material and transport costs. The annual increase in energy prices will also boost the CPI. We are approaching the 1-year anniversary of oil temporarily trading at -$38/barrel. It is currently priced closer to U$60/barrel.

The Fed believes these are passing pressures, likely lasting a few months before general price rises roll over later this year. This is what has happened during several reflation episodes since the 2008/09 crisis. Given the huge amount of economic slack created by the pandemic, a similar outcome is distinctly possible. We are though alert to the risk that rampant fiscal support may drive inflation and bond yields much higher. If we are in the foothills of a multi-year period of 3-4%+ sustained inflation, bond markets remain significantly over-valued.

However, we doubt that the major Central Banks will stand back and allow nominal yields to rise to levels that derail the economic recovery; if they did, the scale of global indebtedness risks triggering a depression-like outcome. Indeed, the Reserve Bank of Australia (RBA), Bank of Japan (BOJ) and the European Central Bank (ECB) have all doubled down on QE and yield control policies in recent weeks. We firmly believe the Fed will follow suit, but US yields may have to be a little higher to catalyse action.

The RBA's decision to expand its QE program came as a surprise given that Australia has been amongst the best performing economies of late. Quarterly GDP has expanded by more than 3% over two consecutive quarters for the first time in decades, yet the authorities still felt compelled to act as the 10 year AGB yield touched 1.9%. It fell back to 1.7% by end quarter.

It was less surprising to see the ECB intervene given Europe's troubled vaccination rollout. Strikingly its pledge to increase its weekly QE purchases, from the current €12bn pace, came whilst most sovereign yields were still trading well below 0%. Despite rising 0.3%, the 10yr German Bund yield finished the quarter at -0.3%.

UK Gilts joined the rout with a successful vaccine program encouraging economic optimism. The Bank of England (BoE) reinforced sentiment by forecasting a "rapid, vaccine-fueled recovery" in the second half. However, at the same time, it ordered commercial banks to prepare for the possibility of negative base rates; a timely reminder that the medium term outlook for inflation and growth remains cloudy.

The 10yr gilt yields quadrupled to 0.9% with Chancellor Sunak's "spend now, tax later" budget adding to the upward pressure on yields. He plans to fund near-term covid support with a delayed increase in corporation tax (from 19% now to 25% in April 2023) and a future freeze of income tax allowances. Whilst fiscally-prudent, one wonders if the UK economy will be strong enough to stomach such moves.

The emerging market debt complex was also under pressure. Brazil, Russia and Turkey all raised rates by more than expected to counter rising domestic inflation and capital flight. Despite their quality bias, our holdings in dedicated EM debt funds were not immune, giving back much of last years' gains. We continue to hold and may well add, given their attractive 4-5% pa yields on offer.

On a more positive note, Chinese government bonds have proven relatively immune with the 10yr yield little changed at 3%. Given the debt-funded spending sprees taking place elsewhere, fixed income investors have been reassured by the Chinese government's pledge to deliver a fiscal deficit of only 3-4% (compared to a 15-20% range in the US and UK). Foreign flows into Chinese bonds hit a record level for a second consecutive month in February, benefitting our holding in a CGB debt fund. The price was unchanged over the quarter.

Currencies

Rate versus USD	31.03.2021	31.12.20	31.03.20
GBP	1.378	1.367	1.242
EUR	1.173	1.222	1.1031
AUD	0.760	0.769	0.613

After a year of almost uninterrupted losses, the US dollar caught a bid, with the trade weighted dollar adding 4%. Conversely, some of the emerging market currencies had a tough quarter. The Turkish lira sank by 10% as President Erdogan sacked his Central Bank chief for hiking base rates by 2% in March. Tighter monetary policy seems warranted by Turkey's 15%+ inflation rate, but a higher cost of borrowing is anathema to the populist President who believes it breeds higher, not lower, prices.

Political risks were also to the fore in Brazil where ex-President Lula looks set to make a comeback after his corruption convictions were quashed. His approval ratings remain high in a country that seems to lurch from one crisis to the next; sadly its health system appears on the brink of collapse as a result of the government's covid denial. The Brazilian real fell 8%.

So far there has been limited contagion to other EM currencies. Significantly, the renminbi was little changed against the dollar. The Chinese currency is becoming an increasingly important driver of EM debt and currencies now that most global benchmark providers are formally including RMB bonds in their EM indices.

On the continent, last year's impressive euro rally ran out of steam with the single currency falling by 4% over the quarter. Whilst a period of consolidation seemed overdue, the relative strength of the US economy also argued for a reappraisal; several southern and mid-west US states are easing lockdown restrictions just as Europe braces for a nasty-looking 3rd wave. Politics has also been a factor in the euro's recent weakness with yet another change in Italy's government (this time because of fallout over how the country should spend a €200bn grant from the EZ covid recovery fund). However, the appointment of Mario Draghi, ex-ECB head, as Prime Minister has soothed market nerves.

The Aussie dollar was one of the few major currencies to hold its own against the greenback last quarter as rising commodity prices and robust resource exports to China offset the dovish RBA. Similarly, the pound managed to grind out a modest gain against the greenback, finishing 1% higher at U$1.38. Intra-month, it briefly traded above U$1.40, buoyed by overseas interest in UK assets. The first post-Brexit update showed January exports to the EU falling by 41% y/y. Whilst the figure was distorted by the UK lockdown, there is little doubt that Brexit has disrupted the pattern of trade between the two neighbours. The scale of this disruption (net of the impact of covid) will only be clear after a year or two.

Moving away from traditional fiat money, we continue to explore the rapidly changing world of digital currencies, which gained further traction last quarter as an influx of institutional investment pushed the market cap of Bitcoin (the pre-eminent cryptocurrency) above U$1trn. It took just 12 years to reach that milestone, half the time it took Amazon to become a U$1trn company. Despite their outsized return potential, cryptocurrencies remain a speculative offering and for a host of reasons (mainly regulatory) we cannot invest in them directly for client portfolios.

However, we believe digital currencies (and the related digital infrastructure) are here to stay and the development of central bank digital currencies, most notably in China, could become one of the most disruptive, impactful macroeconomic events of this decade. We will delve into this area in more detail in future publications but we are increasingly attracted to the opportunities in the digital economy. To achieve exposure, we are gradually building positions in a dedicated Fintech equities fund and a Blockchain technology ETF (as per the equities sections, above).

Commodities

% change	3 months	12 months
Oil (WTI)	22.0%	188.9%
Gold bullion USD	-10.0%	8.3%

Economic recovery and rising inflation expectations had a varied impact on the commodity sector; cyclical resources like oil and industrial metals have flourished, whilst precious metals have sagged. The agri complex has drifted sideways after a strong 2020.

Whilst it's hard to quantify exactly how much of the recent increase in industrial metals demand is borne of a "real" economic rebound, it is safe to say that financial speculation and strategic Chinese stock-piling have amplified gains. The copper price added another 16% last quarter, with Chinese demand particularly evident. Regardless, the recent rally has left copper less than 15% off its all-time high; a period of consolidation is surely due.

Gold's correction from a record U$2,064/oz last August continues; it declined by 10% last quarter to U$1,707/oz. Compared to prior bull markets, both the scale and duration of the pullback are perfectly normal. The gold price continues to track the real yield on the US 10yr treasury. Chart 3 shows the inverse of the gold price (orange line) set against the real yield on the 10 year treasury (blue line, left hand axis). The latter has risen from a trough of -1.2% last August to -0.4%, dragging the bullion price lower (a rising orange line); so far this year, nominal bond yields have risen more than inflation expectations.

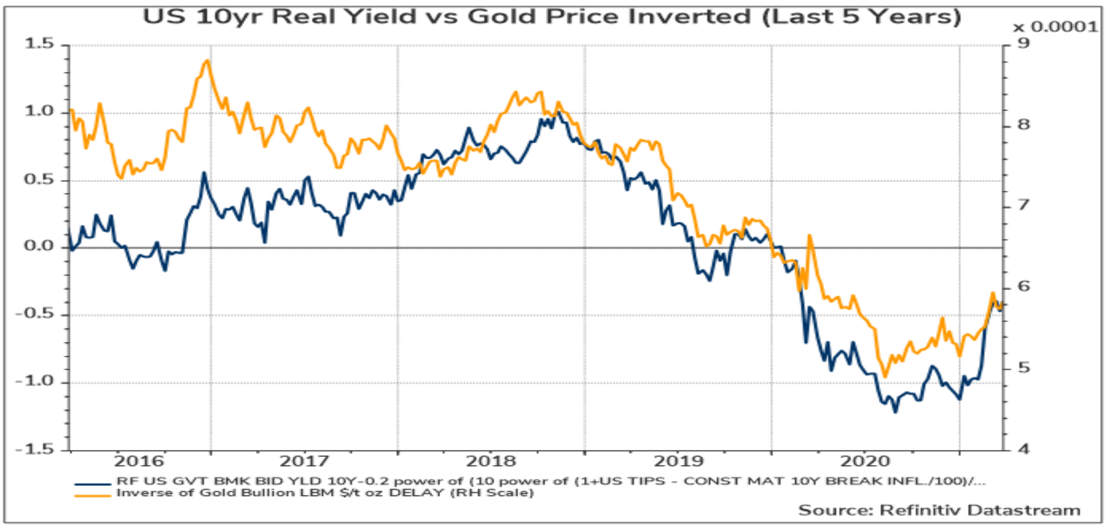

Chart 3: US 10yr real yields remain almost perfectly inversely correlated to the gold price; falling real yields equate to a stronger gold price (and vice versa).

Sentiment and speculation in the precious metals complex has also collapsed with a growing number of people suggesting investors are switching to Bitcoin as their preferred store of value. This may be true at the margin, but we doubt it is happening in large enough size to have a dramatic impact on the gold price.

We draw comfort from gold's continued tight relationship with real yields as we believe the latter will soon resume their downward trend. This is the only politically-feasible way for the authorities to deal with their crippling debts; negative real yields effectively inflate away the nominal liabilities. We do not believe that we have seen the low in real yields for this cycle; indeed, they troughed around -5% post WW2 when similar policies were employed. We expect both our bullion and gold mining exposures to repay our patience.

The oil price surged by 22% last quarter to U$60/barrel, despite a firmer dollar. Whilst post-lockdown optimism has boosted demand forecasts, the supply-side remains key. The OPEC/Russia cabal surprisingly opted to maintain production cuts with Saudi Arabia holding back up to 1 million barrels per day of potential supply. Supply concerns were briefly amplified by a drone attack on a Saudi Arabian oil terminal, the world's largest, although the damage was relatively limited.

Looking forward, the supply situation may improve with the Baker Hughes rig count, a proxy for US shale oil production, rebounding strongly and Iranian oil exports to China starting to flow. Although the latter breach US sanctions, they divert some Chinese demand away from the "formal" market; technically a negative development for official oil prices, although not yet a material one.

All-in-all, whilst post covid reopening argues for a firm demand backdrop, ample variable supply should stop a runaway crude bull market.

Market Performance

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

	31 March 21	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3783	-1.1%	0.8%	11.0%
CHF	1.0595	-3.7%	-6.2%	1.8%
AUD	0.7598	-1.4%	-1.2%	23.9%
JPY	110.7200	3.9%	7.2%	3.0%
EUR	1.1730	-2.9%	-4.0%	6.3%
BOND YIELDS (10 yr)				
UK	0.84	0.03	0.65	0.49
US	1.74	0.34	0.83	1.07
Germany	-0.29	-0.03	0.28	0.18
Australia	1.79	-0.13	0.82	1.02
Japan	0.09	-0.07	0.07	0.08
EQUITIES				
US. S&P 500 (USD)	3,972.89	4.2%	5.8%	53.7%
UK. FTSE 100 (GBP)	6,713.63	3.6%	3.9%	18.4%
FTSE Europe Ex UK (local)	307.90	6.1%	7.2%	36.7%
Japan. Topix (JPY)	1,954.00	4.8%	8.3%	39.3%
China. Shanghai Comp (RMB)	3,441.91	-1.9%	-0.9%	25.1%
HK. Hang Seng (HKD)	28,378.35	-2.1%	4.2%	20.2%
Australia. All Ords (AUD)	7,016.99	1.1%	2.4%	37.3%
FTSE Asia Pac ex Japan	701.56	-2.1%	2.7%	57.4%
FTSE World (USD)	790.85	3.1%	4.5%	52.6%
FTSE World (GBP)	849.82	4.4%	3.6%	37.2%
COMMODITIES				
Oil (WTI)	59.16	-3.4%	21.5%	64.8%
Gold	1707.71	-1.5%	-10.0%	8.3%

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