Market Review

Second quarter 2021

EQUITIES:	Big tech resumes its leads as the reflation trade wobbles
BONDS:	Yields fall back as growth and inflation rates peak
CURRENCIES:	The dollar remains bid, but crypto currencies crash
COMMODITIES:	China clamps down on metals, but oil and gold firm

In the first quarter markets priced in a strong economic recovery. Bond yields spiked, triggering weakness in defensive assets; cyclical “value” equities outperformed. Whilst this proved a temporary headwind for some of our core positions, at the end of March we warned that this unbridled optimism was unlikely to endure.

Fast forward three months and a more subdued macro outlook has emerged with growth and inflation expectations easing. Delayed lockdown re-openings, a softer Chinese economic tone and prospects for watered down US fiscal support have caused long-dated bond yields to fall back (and prices to rise). This, in turn, sparked a rebound in other defensive assets (including gold) and growth equities resumed their lead over their value peers.

As we head towards year-end, Central Banks may intensify their threats to taper QE programs and hike interest rates. This heightens the risk of a short, sharp correction in risk assets. However, with economic momentum waning and indebtedness rising, we believe that any taper tantrum would simply force the authorities to redouble monetary and fiscal support; economies and markets remain (over) dependent on plentiful, cheap cash. As the timing of any fracture is inherently unknowable, we are positioned to benefit from a softer second half GDP narrative and Central Banks rowing back from their recent hawkish pivot. If this comes to pass, it should amplify and extend the solid progress made in client portfolios during the past quarter.

Equities

% change, total return	3 months	12 months
FTSE World Equity index USD	7.7%	40.3%
FTSE World Equity index GBP	7.7%	25.9%

Equity indices continued their run of good form last quarter with the FTSE World benchmark rising nearly 8% in dollar and sterling terms. Beneath the headline return, market leadership switched. The "reflation trade" suffered a setback on concerns that economic growth and inflation are peaking, albeit at elevated levels. This sparked a rebound in growth sectors (particularly the US tech names) as many of the resource and financial stocks paused.

A number of economic indicators point to slower growth in the second half. Many of the key manufacturing surveys have turned lower and consumers have yet to draw aggressively on their covid-induced savings. It is too early to judge how economies will settle once the pandemic restrictions are fully lifted but, for now, consumers and businesses have yet to make up for the lost demand of the lockdown months.

Despite this softer economic outlook, the Federal Reserve's rhetoric has become more hawkish of late. As the market-based inflation forecast for 5 to 10 years hence touched 2.5% pa, the Fed suggested that its first rate hikes will come in 2023, a year earlier than previously forecast. Chairman Powell also confirmed that a debate over moderating the U$120bn monthly QE purchases is underway. A lot of talk but no action.

Given the distant (and inherently changeable) nature of these forecasts, investors shrugged off the Fed's "taper" talk. However, if the inflation data compels the Fed to further truncate the taper timetable, markets are unlikely to remain so sanguine. Indeed, current measures of US equity price volatility suggest that investors have become complacent. The VIX index, a measure of S&P500 expected price volatility (Chart 1), is currently around 15 and drifting back towards its pre-pandemic lows. This suggests that stocks could react quite violently to any shock or unforeseen news.

Chart 1: The falling "fear gauge" indicates rising investor confidence/complacency.

After several months' underperformance, US "big tech" is back at top of the leaderboard with the Nasdaq rebounding by 10% last quarter. A decline in long-dated bond yields has provided support as the lower discount rate makes future profits more valuable. This, in turn, supports current lofty valuations. As importantly, tech fundamentals are still strong; the combined revenues of Alphabet, Amazon, Apple, Facebook and Microsoft rose by more than 40% in the first quarter.

We retain a relatively low exposure to these FAANG stocks, preferring a focused set of structural growth themes. The environment and fintech equity funds fall into the category, as does a mid-May addition to a dedicated Biotech ETF. The latter came days before Biogen's landmark Alzheimer's drug was approved by the US regulator, triggering a broad re-rating of the healthcare sector. The position is already showing a double digit gain.

Whilst unprecedented technological innovation anchors the bull case for these thematic exposures, massive government spending also plays a part. Environmental policies dominated the G7's Cornish gathering last month, whilst President Biden used the April "Earth Day" meeting of world leaders to announce a target reduction in greenhouse gas emissions of 50% by the end of this decade (from 2005 levels). This is nearly double the previous commitment of the Paris Climate Accord and is only remotely achievable if huge amounts of capital are deployed into "green" initiatives over the coming years. We used an early-quarter sell-off in the environment and fintech funds to raise their target weightings to 3% and 5% each in our Balanced and Growth mandates, respectively.

With the Chinese government still evidencing relative fiscal-restraint, President Biden's plans to spend at least U$4trn on various policy initiatives over the coming decade played a vital role in driving cyclical stocks higher in the first quarter. But with focus already shifting towards the vulnerability of Biden's knife-edge Congressional majority at next year's mid-term elections, the Republican's are only allowing watered-down stimulus bills to pass. The Democrat infrastructure bill is likely to be half of the original U$2.4trn proposed and there has been no movement on the U$1.8trn social care package. This less compelling fiscal backdrop has become a headwind for the "reflation trade".

We have used the relative underperformance of value stocks to bolster our cyclical equities allocation. For sterling, euro and Aussie dollar portfolios this was achieved by adding to the economically-sensitive home markets. For US dollar accounts, given the growth-bias of the S&P500, we added a new holding in a dedicated US Value ETF. These additions raise the exposure to industrial, energy and banks sectors, whilst purposefully avoiding the more defensive consumer staples and "innovation" tech plays; we already have direct exposure to these areas. We funded the purchases by booking further profits on some of the sovereign bond holdings.

In the UK, the highly cyclical FTSE All-Share gained 5% last quarter, lagging the Small Cap index that added 8%. This takes its year-to-date gain to 18%. Our exposure to the Tellworth UK Smaller Companies fund, in the GBP Balanced and Growth mandates, remains this year's best performer; the fund rose 25% during the first half.

With a similarly cyclical make-up, European and Japanese indices also trailed last quarter. Most European indices eked out modest gains as growing ECB support (see below) was offset by fears that the highly transmittable "delta" covid-strain could dent tourism, just as the summer holiday season gets underway.

Similarly, Japanese stocks struggled with the Topix and Nikkei indices both registering small losses. Japan's economy is weaker than most with employment, income and private-sector consumption all under pressure due to a vaccination rollout that was, until recently, largely non-existent. The country's inoculation program is now gathering steam and Japanese stocks should outperform if global growth re-accelerates. Whilst the Japanese index remains cheap compared to global peers, we also see our ongoing exposure as an important diversification from our growth-biased equities.

Japan's recent soft patch echoes Asia's broader underperformance this year with many of the region's equity indices lagging developed nation peers. After a sharp recovery from the Q1 2020 lows, a sense that growth is moderating has acted as a drag, as has a slower roll out of vaccinations, leading to worries about recurring waves of infection. China's efforts to rein in domestic stimulus have also dented both sentiment and activity for these proximate countries.

That may be about to change. If the Chinese economy continues to decelerate, the authorities may well loosen the fiscal and monetary purse strings, whilst deploying policy strictures to limit asset bubbles. This would benefit our domestically-focused China A share holdings; notable laggards for the year-to-date after the banner returns of 2020.

Looking at the wider market, the government's regulatory clampdown on the dominant tech firms remains a concern given their heavy index-weighting. In mid-April, soon after Alibaba was hit with a record RMB18bn fine for market abuse, the authorities summoned representatives from the country's 34 largest internet/platform firms and warned them to eradicate any anti-competitive behavior. Such moves and the recent post-IPO travails of Didi (and others) reinforce the message that the Xi government will not accept any threat to its control. The headwinds for Chinese "big tech" look set to endure, reinforcing our bias to the A-shares index; it has a limited exposure to the sector.

Bonds

10-year yield	30.06.2021	31.03.21	31.12.20
US treasury	1.47%	1.74%	0.92%
UK gilt	0.72%	0.85%	0.19%
German bund	-0.21%	-0.29%	-0.57%
Australian treasury	1.53%	1.79%	0.97%

During the June quarter, bond markets recovered from their early year rout with long-dated yields falling (and prices rising). The significance of this happening amidst a period of rapid GDP growth and above-target inflation is not lost on us; US CPI hit 5% in May whilst Q2 US GDP is set to expand at a 9% annualised rate. The rise in bond yields during Q1 priced in the current robust economic reality with markets now adjusting for more moderate progress in the second half of the year.

Chart 2: US CPI hits a 13-year high.

The recent bond market reprieve also highlights how the future path for inflation remains clouded. It could be 2022 before it is clear what the "normal" post-pandemic, global economy looks like; for now, jobs markets and supply chains remain disrupted. Until then, CPI uncertainty could well lead to bond volatility with ramifications for a wide array of asset markets.

The Federal Reserve's flip-flopping reflects this reality. Despite the "looser for longer" policy mantra throughout the past year, the recent spike in CPI prompted Powell and his Fed colleagues to remind markets that rate hikes would be back on the agenda if higher inflation is not “transitory” and/or if the labour market booms. The latter remains a work in progress. Despite adding 0.85mn jobs in June, there are almost 7mn more unemployed Americans than pre-covid. Perversely, hiring is being hampered by generous furlough payments and continued school closures. Both discourage the unemployed to seek jobs just as the economy opens up, leading to pockets of wage inflation. As job support schemes roll off and businesses reopen fully, it will become increasingly clear how many of these job losses are permanent and thus how much spare capacity there is in the labour market. A key factor in the inflation debate.

Although headline inflation has (as expected) spiked due to year-on-year base effects and covid-related supply disruptions, the future trend remains unclear. As Rosenberg Research notes, the vast bulk of the US price pressures stem from a small number of “reopening sectors” like travel and hospitality. If you strip these out, price rises for the majority of the inflation index constituents remains benign. This, in turn, helps explain why the 10yr US treasury yield has fallen back below 1.5%, with the 30yr yield approaching 2%. Having topped up our nominal bond exposure during the Q1 sell-off, our Balanced mandates benefitted from these moves.

Perhaps the most striking feature in debt markets was Greece’s 5yr bond moving to a negative yield. Italy is the last remaining EZ country offering a positive return on similar sovereign issues. Even with the support of ECB bond buying, we struggle to understand why anyone would accept a negative yield from the Greek government; it is return-free risk. That said, EZ QE looks set to continue indefinitely at €80bn/month; a rate that covers the combined sovereign debt issuance of member state for this year and last. It is hard to envisage a material back up in EZ yields, given current circumstances.

Across the channel, the UK economy has proved more resilient than expected. The Bank of England (BoE) has raised its 2021 GDP growth forecast from 5% to 7.25%, whilst maintaining a 0.1% target base rate. Despite growing talk of policy normalisation, action does not seem imminent.

The BoE is also supporting the UK Governments decision to launch “green” bonds. The Treasury will issue £7bn of gilts this year with the proceeds earmarked for government-backed, environmental projects. Demand for the issue is expected to be high, given the success of green bonds in Germany and Italy, and the frenzied investor interest in all things ESG. The 10yr gilt yield finished the quarter 0.13% lower at 0.72%. The index-linked market also firmed, with the 2068 linker adding 8%. At current yields, we continue to avoid straight gilts for mixed asset mandates.

Some of the largest yield declines occurred in Australia. Despite Q1 GDP registering a healthy +2% q/q, policymakers warned that the recovery is likely to moderate. A sluggish vaccination rollout and the geopolitical spat with (a slowing) China are proving to be significant headwinds to external demand. The 10yr AGB yield fell by almost 0.3% to 1.5%.

Finally, the RMB bond exposure, held across Balanced portfolios, continues to make steady progress with returns largely uncorrelated to conditions in Western bond markets. Yields have been drifting lower in response to China’s economic slowdown, which has seen household spending disappoint and construction activity soften in response to another clampdown on property sector lending.

Any growth scare could see the Chinese authorities dial up stimulus before the year-end, but only if the inflation threat remains benign. Whilst producer price inflation is at a 13-year high of 9% due to soft year-on-year comparisons, core CPI remains less than 1%. In the meantime, RMB bond yields look set to fall further (and prices rise) so we lengthened duration by switching into the Gavekal RMB bond fund; it has 2-3 years greater duration than the prior fund holding. We also took the opportunity to lift the currency hedge, as we see further RMB strength as we head into 2022.

Elsewhere in developing nations, we maintain exposure to the emerging market debt and currency funds. After a bumpy start to the year, these rebounded last quarter despite many local central banks starting to hike rates. Investor flows into the asset class remain strong given the positive real yields on offer.

Currencies

Rate versus USD	30.06.2021	31.03.21	31.12.20
GBP	1.383	1.378	1.367
EUR	1.186	1.173	1.222
AUD	0.750	0.760	0.769

Sterling is trading as a “risk on” currency, appreciating when economic optimism is rising and vice versa. A June sell-off saw it finish the quarter flat against the dollar and up 1% year-to-date. It topped out in the low U$1.40s and has struggled to sustain a move beyond. Absent a significant breakdown in the US dollar or an early rise in UK base rates, further progress from sterling seems unlikely.

The Aussie dollar also softened as the reflation trade lost its spark. As noted above, economic momentum is slowing and the conditions the RBA has laid out for rate hikes (centered on wage growth and much lower unemployment) appear some way off. Even Governor Lowe has conceded that policy tightening may not occur until 2024. In the meantime, the country’s QE purchases and formal capping of 3yr yields around 0.25% look set to persist. The Aussie dollar finished the quarter down 1% at U$0.75.

A strong start to the quarter left the euro with a 1% gain against the greenback despite a 3% pullback in June. The latter was triggered by US taper talk and fears that another covid wave is about to hit Europe just as the US economy fully reopens.

Although the burgeoning US twin deficits (budget and trade) and valuation argue for further dollar weakness, its June rally could endure a while longer, particularly if the Fed perseveres with a more hawkish tone. The trade weighted dollar added 3% in June after early year weakness. A firm dollar and talk of less US QE could undermine risk assets in general, so we are watching the greenback closely. It has already broken to the upside against the Japanese Yen, which has fallen 7% this year. Further afield, if the dollar rally continues many EM currencies will likely come under pressure and give back some of their Q2 gains; the Brazilian Real surged by 13% last quarter and is now up almost 5% year-to-date.

The Chinese RMB continues to be supported by relatively tight domestic monetary and fiscal policy, especially compared to America’s profligate measures. US fiscal spending touched 10.5% of 2020 GDP and is on track to represent 11.5% of this year’s output. This has created record peacetime budget deficits that have weighed heavily on the dollar. However, with most emergency pandemic measures set to end this year, fiscal expenditure in the US is estimated to fall to only 2% of 2022’s GDP. This shift has sparked concerns that the US is facing a “fiscal cliff” that should, at the margin, support the dollar and see it rebound against many developed nation currencies. It could also cap further near term RMB strength. That said, we remain constructive on the RMB and many EM currencies over the coming years as any meaningful, near-term dollar strength would likely trigger economic and market unrest that prompts the Fed back into a dovish (dollar bearish) mode.

The 19th May "Black Wednesday" in crypto markets saw falls of 50%+ in many digital currencies and tokens, providing a timely reminder of the nascent, volatile nature of this asset class. After a rampant 12-month crypto bull market, mounting regulatory pushback (particularly in China) and concerns over the environmental impact of Bitcoin "mining" triggered a wave of selling that was amplified by a forced unwind of leveraged positions. The digital asset space and the related software/protocols continue to interest us. Whilst we are exploring ways to capitalise on their huge return potential, recent events prove that meaningful exposure is only relevant for the most risk-tolerant investors.

Commodities

% change	3 months	12 months
Oil (WTI)	25.2%	81.6%
Gold bullion USD	3.7%	-0.6%

The prospect of cooler economic growth has sparked a price correction in many resource markets despite continued supply challenges. Prior winners like lumber were hit particularly hard as prices more than halved from their May peak. Recent evidence suggests that high US property prices are hitting affordability. This is acting as a drag on intentions to buy and build houses and highlights how end demand, not just supply constraints, remains a vital part of the inflation equation.

Chart 3: Lumber prices experience a "timber" moment.

Industrial metals also came under pressure. Over the past year, China has been importing excess quantities of certain resources as a hedge against future dollar strength (which would raise costs in RMB terms) and a disorderly escalation of geopolitical tensions. But with higher commodity prices spurring domestic producer price inflation, the authorities felt it was time to act. Last quarter they announced a clampdown on resource market speculation and released strategic reserves of some commodities. This sparked pronounced weakness in Chinese iron ore, steel and coal prices.

Some resource prices may struggle to revisit their 2021 highs but, for others, talk of a multi-year "super-cycle" appears valid. This is particularly true of copper given its importance to the green energy/electrification theme; it gained another 6% last quarter despite a late period correction.

The gold price had a volatile, but ultimately profitable quarter, gaining almost 4% to U$1,770/oz. Its return would have been much higher were it not for a 7% decline in June, sparked by the Fed's hawkish taper threats. The fundamental outlook for bullion remains exceptionally strong, given global indebtedness and the likelihood that economic growth will disappoint in the second half. As enduring QE and rates suppression become the accepted norm, low real rates should act as the key driver of bullion prices.

As large holders of bullion and the related mining stocks we are also encouraged by the growing interest from the official sector. During the past quarter, the Russian National Wealth fund announced it is dispensing with all US dollar assets and raising its gold exposure to 20%, whilst China has loosened import quotas, triggering a spike in physical gold demand in recent months. We also note that various gold and miner sentiment gauges have fallen to depressed levels that typically presage an imminent rally. The foundations are in place for the precious metals complex to perform strongly in the second half.

Oil shrugged off weakness in other resource markets and gained 25% last quarter, taking the WTI contract to U$73/barrel. The bull market is being driven by demand recovery and the continued supply constraints that stem from the OPEC/Russia 2020 production curbs. At the time of writing, the consortium was attempting to resolve a dispute between the major suppliers (including Saudi Arabia and Russia) who want to raise daily supplies, and the United Arab Emirates, which is holding firm in a bid to secure a higher long-term production quota. Ceteris paribus, this impasse will probably resolve itself, as the cartel can ill-afford a sharp rise in the oil price. Such a move would derail the recovery, sap demand for crude and hasten the adoption of green alternatives. Whilst a dearth of investment in new reserves argues for a relatively firm oil price in the coming years, crude's immediate progress will likely slow from here.

Market Performance

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

	30 Jun 21	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3831	-2.7%	0.3%	11.5%
CHF	1.0810	-2.8%	2.0%	2.4%
AUD	0.7498	-3.1%	-1.3%	8.6%
JPY	111.1100	1.4%	0.4%	2.9%
EUR	1.1858	-3.0%	1.1%	5.6%
BOND YIELDS (10 yr)				
UK	0.72	-0.08	-0.13	0.54
US	1.47	-0.13	-0.27	0.81
Germany	-0.21	-0.02	0.08	0.25
Australia	1.53	-0.18	-0.26	0.66
Japan	0.05	-0.03	-0.04	0.03
EQUITIES				
US. S&P 500 (USD)	4,297.50	2.2%	8.2%	38.6%
UK. FTSE 100 (GBP)	7,037.47	0.2%	4.8%	14.1%
FTSE Europe Ex UK (local)	326.65	2.0%	6.1%	26.9%
Japan. Topix (JPY)	1,943.57	1.1%	-0.5%	24.7%
China. Shanghai Comp (RMB)	3,591.20	-0.7%	4.3%	20.3%
HK. Hang Seng (HKD)	28,827.95	-1.1%	1.6%	18.0%
Australia. All Ords (AUD)	7,584.96	2.4%	8.1%	26.4%
FTSE Asia Pac ex Japan	726.69	-0.6%	3.6%	37.7%
FTSE World (USD)	847.05	1.2%	7.1%	37.6%
FTSE World (GBP)	909.06	4.1%	7.0%	23.1%
COMMODITIES				
Oil (WTI)	73.47	11.1%	25.2%	81.6%
Gold	1770.11	-7.2%	3.7%	-0.6%

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