COMMENTARY

1st January to 31st March, 2021

The reflation trade is on (for now at least)! Growing expectations of increased inflationary pressures from a global economic recovery fuelled by fiscal / monetary stimulus and the rollout of Covid vaccines dominated the movements of and sentiment within financial markets during the quarter. Sharply rising sovereign debt yields saw bond markets suffer drawdowns that were every bit as severe as those in recent memory, while a surge in demand for value and cyclical names provided fresh impetus to equities and commodities. A resurgent Dollar vied with Sterling for line honours on the foreign exchanges.

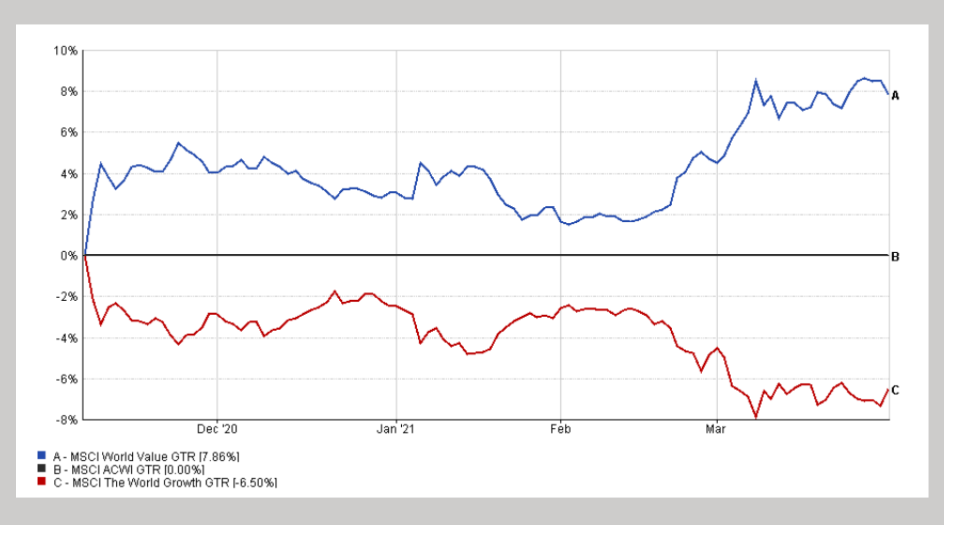
EQUITIES

Equity Market Indices

Index	Q1-2021	2020
MSCI World ($)	+4.52%	+14.06%
MSCI World (€)	+8.75%	+4.77%
MSCI World (£)	+3.39%	+10.82%
MSCI World (local ccy)	+5.74%	+11.67%
S&P 500 ($)	+5.77%	+16.26%
FTSE UK All Share (£)	+4.29%	-12.46%
MSCI Europe ex-UK (€)	+7.32%	-0.06%
Japan Topix (¥)	+8.27%	+4.84%
MSCI Asia ex-Japan ($)	+2.45%	+22.47%
MSCI Emerging Markets ($)	+1.95%	+15.84%
MSCI Emerging Markets (€)	+6.07%	+6.41%
MSCI Emerging Markets (£)	+0.85%	+12.55%

The shift in leadership that began with the announcement of the first Covid vaccine in November was the dominant feature of the period under review, with the rotation gaining additional momentum after Democrat victories in run-off elections for two seats in the US Senate paved the way for further large-scale stimulus in the form of both fiscal packages ("helicopter money") and major infrastructure spending. As a result, economically sensitive sectors – energy, financials and industrials – outperformed the previous winners, most notably "stay at home" technology and consumer names, by a wide margin (as shown in the chart overleaf). Despite significant differences in the speed and volume of vaccine programmes at a regional and country level there was little variation in the returns from developed markets. This seemingly anomalous outcome can be explained largely by the sectoral make-up of those markets in areas whose pandemic response has been less effective than elsewhere. In Europe, for example, the greater proportion of industrials and financials has offset the immediate effects of renewed lockdown measures resulting from rising infection rates (ditto Japan). By contrast, emerging markets, for whom a stronger Dollar and rising interest rates are perceived as headwinds, lagged the global trend.

MSCI World Growth & Value Indices (relative)



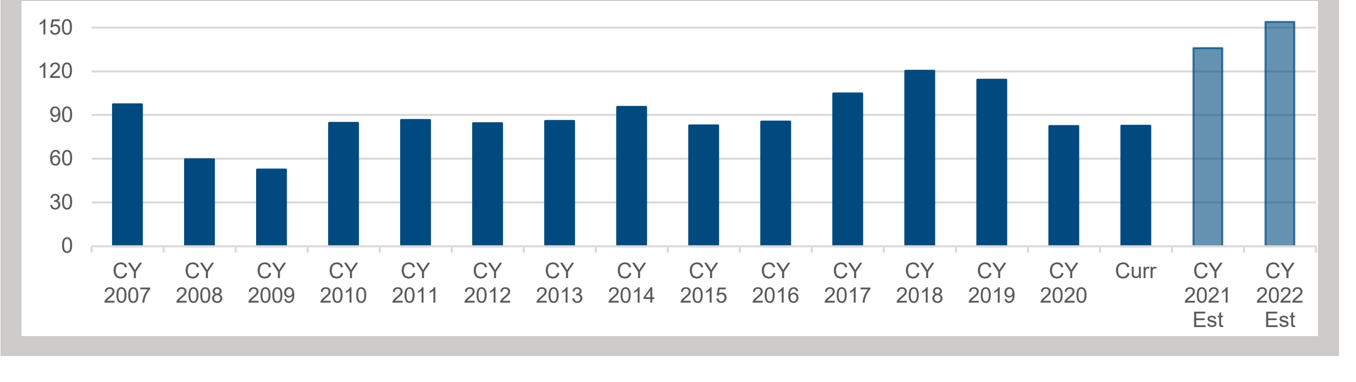
Source: FE Analytics

The multi-speed nature of the economic rebound was evident from data released during the quarter. Whereas US Purchasing Manager Indices (PMIs) pointed to healthy increases in both manufacturing and services with the latest (March) prints of 58.6 and 59.8, the corresponding figures for the EU of 57.9 / 45.7 suggested a mixed picture (a score of 50 is the threshold between expansion and contraction), as did the respective Q4 GDP reports of +4.3% and -0.7%. In China, meanwhile, which is the only major nation whose economy did not shrink in 2020, PMIs of 50.6 and 51.4 and GDP growth of 6.5% represent a normalised level of activity.

Although travails within the bond space grabbed most of the headlines during the quarter (see below), the equity world was not without its own dramas. In late January, a coordinated “short squeeze” campaign by retail investors using an on-line trading platform to ramp up the price of a small number of unloved US stocks inflicted heavy losses on a small number of hedge funds, sent volatility indicators up sharply and caused disruption across the wider market. More recently, the collapse of a family office with a highly leveraged and concentrated portfolio triggered the forced selling of large stakes in (predominantly Chinese) technology stocks by several (n.b. competing) US, European and Japanese investments banks at large losses. Worryingly, the swap arrangements through which the positions had been held meant that they were exempt from reporting and the banks in question unaware of each other’s exposure. While the damage inflicted has (happily) been temporary and relatively contained, both incidents have highlighted markets’ vulnerability to left field events and raised questions over regulatory standards in equal measure.

On a more positive note, corporate earnings have continued to recover from their mid 2020 lows, with the 13% increase in the final quarter of last year, putting the MSCI World Index on a trailing price / earnings multiple of 29 times. Although this and other historic valuation metrics remain towards the top end of historic ranges, current consensus estimates suggest that, with profits for the coming year expected to surpass 2018’s record levels by a meaningful margin, that falls to a much more palatable 20 times on a forward-looking basis. Notwithstanding the huge positive developments in relation to the global pandemic response and much improved outlook, uncertainty over such factors as the pace of vaccination programmes, their effectiveness on new virus variants, the direction of bond yields, prospective corporate tax increases, we would suggest that the margin for error in such forecasts warrants a degree of caution. As such, we remain comfortable with the current level of exposure within portfolios and the mix of managers and investment styles that our roster of preferred managers delivers.

MSCI World Index Aggregate Earnings (USD)

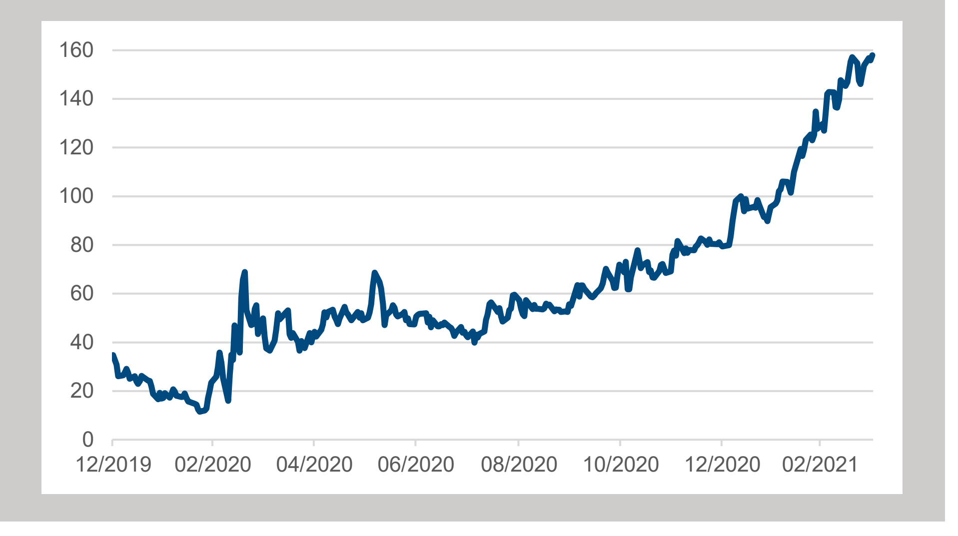


BONDS

With the success of vaccine programmes in the US and UK providing the template for a swifter return to economic and social normality than had been previously anticipated (by bond markets at least), concerns over the potential inflationary implications of the Biden administration's multi-trillion stimulus packages came to the fore. As expectations over the likely timing of the shift towards a tighter monetary policy shortened, a continued dovish tone from the Federal Reserve added to investors' disquiet.

The result was one of the worst quarters for sovereign debt markets in recent decades, which saw benchmark indices for US, German and UK government bonds down -4.25%, -2.44% and -7.43% respectively, as yields climbed and maturity curves steepened at a rapid rate throughout the period. Though optically modest by (extreme) equity standards, these were HUGE numbers within a bond context: in the case of the US and UK markets, for example, the 30-year "on the run" Treasury and Gilt issues fell 16% in price terms – equivalent in both cases to ten years of coupon payments and in terms of index (not yield) movements compares with the notorious bear markets of 1994 and 2013. Indeed, applying the same multiple of "earnings" to equity markets would have seen the MSCI World Index down 29% for the quarter.

10 year vs 2 year US Treasury Yield Spread (%)



Though the drawdowns they experienced were no less exceptional by historic standards, investors in corporate bonds fared marginally better than those in the sovereign space thanks to the additional yield available across the credit spectrum. Having said that the period under review was notable for being the first in which credit spreads for investment grade paper did not improve since Q1 of last year – in fact, they widened by one or two basis points, as indeed, did those for the emerging market sovereigns. High Yield bonds, on the other hand, delivered positive returns, as the combination of narrower spreads, higher coupons and shorter duration offset the effects of movements in yield curves.

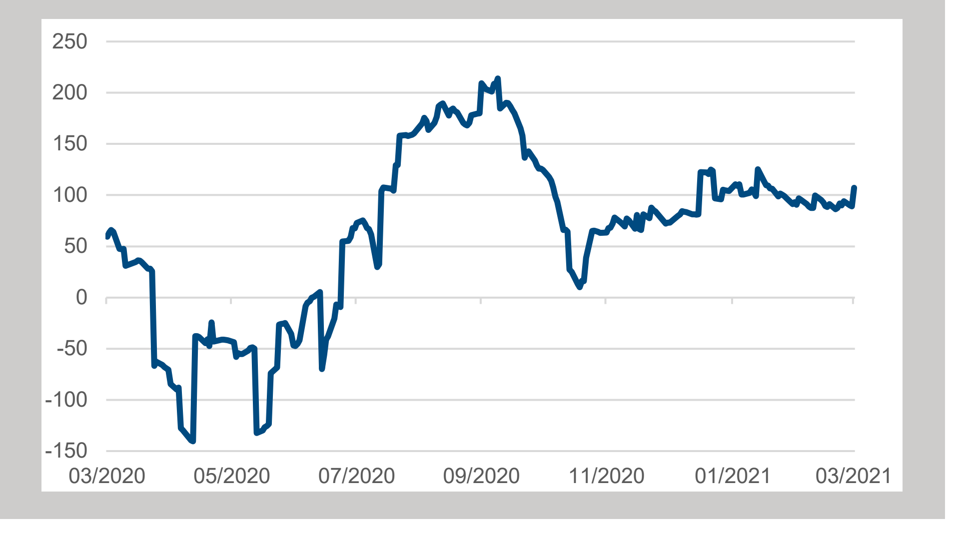
After the severe battering delivered by (most) markets over the last quarter, the big question facing bond investors is: what next? Using past episodes as a guideline this latest rate scare bears strong comparison with those of 21 and 8 years ago, in terms of their magnitude and the time frame over which they took place. In both cases strong reversals followed, as what were first perceived as structural changes in the interest rate environment were downgraded to shorter term, cyclical shifts. With annualised inflation figures destined to rise meaningfully over the coming months due to the base effects from the collapse in activity (and energy prices) last year, it may be some while before we can expect to have a clearer idea. Indeed, while the potential inflationary effects of the combination of loose policy in a recovery scenario are not in dispute, we are also reminded that the powerful deflationary impact of demographics and technological innovation remain very much in place. Importantly, comments from, and the positioning of, the strategic bond fund managers that form the core of our fixed income allocations suggest that a repeat of the aforementioned (temporary) shifts in the markets' inflationary mindset is the most likely outcome.

CURRENCIES

Economic data and vaccine delivery were the key determinants of relative performance on the foreign exchanges, with the DXY US Dollar (trade-weighted) Spot Index recording its first quarterly gain since the corresponding period last year. Among the 17 major currencies listed by Bloomberg, only the Canadian Dollar (+1.55%), Pound Sterling (+1.09%) and Norwegian Krone (+0.71%) made advances in USD terms. At the other end of the spectrum, the Brazilian Real (-7.72%), Japanese Yen (-6.61%) and Swiss Franc (-6.04%) ceded most ground.

After dragging its heels for the best part of five years since the EU referendum, the Pound's renaissance continued. Rather than its outright economic performance, it was the resilience in UK data against the backdrop of re-imposed lockdown restrictions that underpinned Sterling's relative strength – it was the only major (G7+) nation whose Economic Surprise Index went up over the period. With some 59% of the UK's population having received at least one dose at the time of writing, only Israel, the United Arab Emirates, Chile and Bhutan have achieved faster vaccine delivery according to Oxford University figures; at 55% the US is close behind, while the EU, at 21%, China at 12% and Japan at 1% (!) have a long way to go by comparison. In spite of the positive outlook, with the technical picture somewhat clouded and opinions divided as to its prospects, forecasting the Pound's direction (or for that matter that of any currency) is nevertheless as difficult as it has ever been.

Citi UK Economic Surprise Index



COMMODITIES

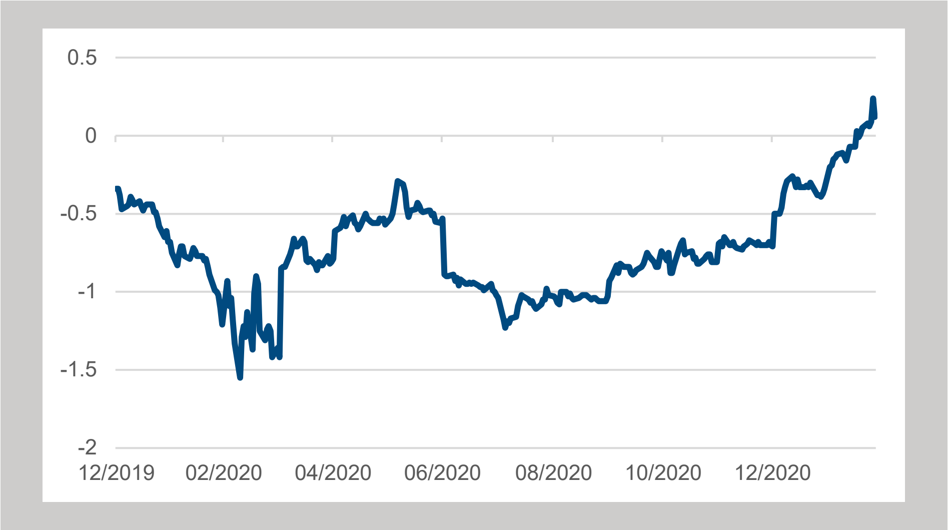
Movements in broad benchmark indices reflected the strong demand throughout the commodity space, with price movements across the various complexes very much in keeping with the prevailing reflationary narrative. The Refinitiv CRB Index was up 10.23% and the Rogers Ex-Energy Index +5.43% in USD terms.

Oil prices extended their steady climb for much of the period; the "front month" futures contract for West Texas Intermediate moved from an opening mark of $48.52 per barrel to a 23-month high of $66.09 in early March on its way to a quarter-on-quarter gain of 21.93%, while the corresponding Brent contract was up 25.55%.

Base metals – invariably seen as an important indicator of economic activity and future prospects were also buoyant, with the rise in price of Copper (+13.54%) and Aluminium (+11.75%) reflecting stronger physical demand as well as increased speculative investment interest.

Precious metals, meanwhile, were among the notable laggards, with the sharp rise in real government bond yields (as shown in the chart overleaf) and, to a lesser extent, the stronger Dollar, representing brisk headwinds. The Gold bullion spot price declined steadily over the first two months of the quarter, hitting a nine-month low of $1,681 per troy ounce before closing at $1,729 for a loss of 8.74% in USD terms. In keeping with the comment above, we have maintained the gold positions across our portfolio models, based on the current view that global inflationary pressures are more likely to be transitory than a long-term structural influence.

US 10 year Treasury Real Yield (%)



Source of all data, unless otherwise stated: Bloomberg

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