eQ Insight

MarketView Q1 2021

This document presents a summary of our investment views. It explains our latest thinking on world markets and the most recent decisions we have made about what to buy and sell within your portfolio.

Please note that our views may change at any time.

Overview

The rosier medium-to-long term outlook we described in our last update has continued to play out.

The optimism from the end of 2020 has continued into 2021 as healthcare systems around the world ramp up inoculations. Over last few months we have seen pro-cyclical sectors (like financials, materials and energy) outperform defensive sectors (like consumer staples and healthcare). Typically, small companies also do well during economic recoveries and this time is no different with them outperforming large companies over the last several months.

We share this optimism. In the absence of any disappointments with the vaccine or from mutations of the virus, we can see economies gradually opening up through the spring and into the summer. The return of local hospitality industries will certainly feel like life returning to normal.

We also have a powerful combination of accommodative monetary policy with loose fiscal policy (government spending). Longer term, this combination could become inflationary, but in the short-term elevated equity market valuations are supported and we are afforded time for stronger growth in underlying fundamentals to develop.

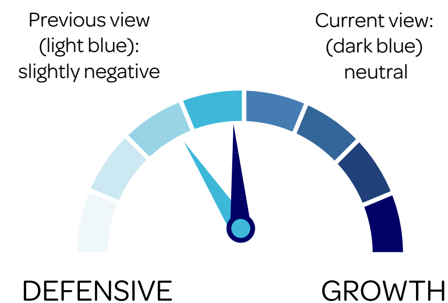
Of course, there are also risks. We think there could be ongoing restrictions (corridors, quarantines) to international travel for some time since each country is at such different stages of their inoculation programmes. We also maintain the view that some of our behaviours have been changed for the long term.

Additionally, there is the risk that we need to contend with some longer-term challenges of labour reallocation as sectors such as services begin to open and adapt. The hope is the extraordinary support packages implemented in the early stages of the pandemic could mean many companies can rehire staff and restart operations quickly.

With markets having come a long way since November when vaccines were first announced, they could be susceptible to a pull-back if anything threatens to derail the healthcare recovery but on balance, we think there are merits to a small increase in growth asset exposure. Within growth assets, we also reduce exposure to defensive sectors in favour of more sensitive sectors like industrials and increase in exposure to medium and small sized companies that will continue to benefit from the strengthening economic environment.

The views outlined in this document will influence how we manage your portfolio. For example, we may decide to increase your exposure to one region at the expense of another.

The dials give an indication of whether we are positive or negative on each asset class:



Growth assets

US

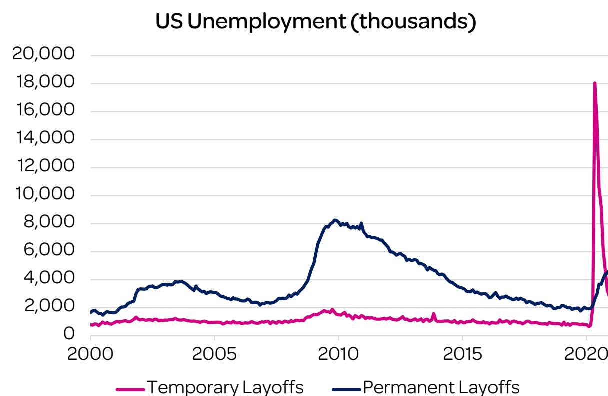
Positive sentiment given a new US administration and highly efficacious coronavirus vaccines is compounded by supportive monetary and fiscal policy.

The US has experienced three waves of rising coronavirus infections and with the help of highly efficacious vaccines and better central coordination, new case numbers and the number of COVID patients in hospitals are both declining quickly.

This hopefully means the worst of the healthcare crisis is behind us and businesses can start returning to normal over the summer. The most promising element of recent business surveys is the so called "employment component" which indicates companies across the manufacturing and services sectors intend to increase hiring.

Hiring intentions need to remain firmly positive for a long time to work through the massive volume of people that are currently unemployed. The number of people temporarily unemployed is falling at a slower pace than a couple of months ago. With permanently unemployed people at higher levels than during the 2002 recession, there is a very high number of people to get back into the workforce. This will take some time. And this gives us confidence that fiscal and monetary conditions are likely to remain loose and support equity market valuations, giving time for fundamental earnings to be rebuilt.

We maintain a neutral view, but have begun to shift investments away from the relative safety of large quality companies and towards medium and small companies that will benefit if the recovery continues.



UK

Brexit is done and Britain is now free to forge an independent path. But, first things first: we need to get our domestic economy back up and running before planning global conquests.

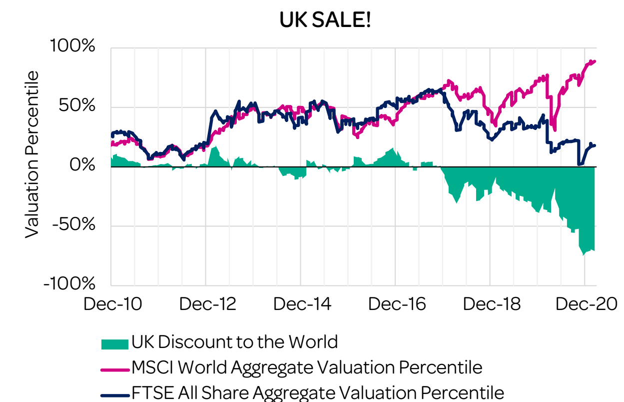
The UK faces all the same challenges as the rest of the world with getting the coronavirus under control. But despite suffering with some of the highest numbers of cases in the world, the UK is now a leading example when it comes to vaccinating citizens.

Unlike the rest of the world, the UK has the additional challenge of making a success of Brexit. It's too soon to draw sweeping conclusions, but in the near term we think removal of Brexit uncertainty is a boost for UK assets.

The good thing about a number of UK companies is they have a large portion of revenues earned overseas and so have little to do with the UK economy! The UK equity market is dominated by a number of pro cyclical industries like materials, energy and financials.

Now, these have been struggling industries for over a decade and we don't see any secular change here. However on a cyclical basis, economic recoveries usually favour pro cyclical industries and given recent Brexit uncertainty these companies are also cheap relative to their international peers.

We upgrade the UK accordingly.



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Europe

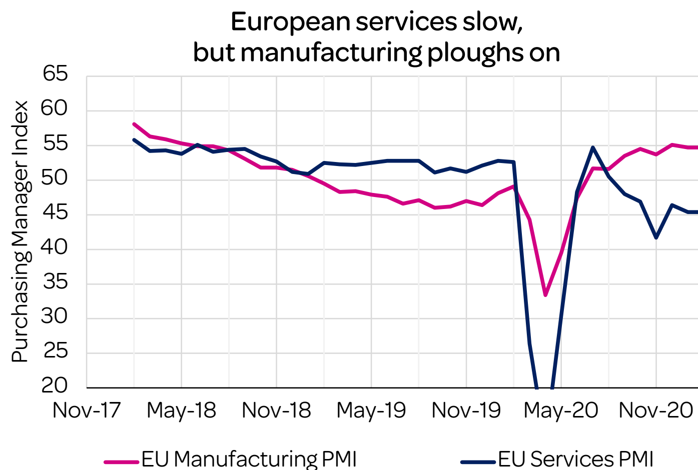
The second wave of coronavirus infections in Europe has not hit growth as badly as it did in the first wave of the pandemic. Virus control measures have been more targeted, allowing a large part of the economy to function close to normal.

Europe has been much slower than the UK or US in approving vaccines and ramping up inoculations. Consequently, its services sector is suffering with the latest social restrictions, but Europe is doing better at keeping its manufacturing sector open and thereby benefiting from the slow increase in global trade volumes and the economic recovery being enjoyed in China. This is especially true in the German manufacturing powerhouse, but activity in most European countries looks similar.

European equities are more heavily geared towards industrial and manufacturing activity than they are to discretionary consumer spending. So, while vaccination programmes are ramping up, and while the economic recovery continues apace in Asia, European equity markets should be ok.

However, there is still some weakness with the European consumer, being driven by concerns about unemployment. This could develop into a greater headwind for the region, suppressing local demand.

Overall, for now we maintain a neutral view for the region.



Japan

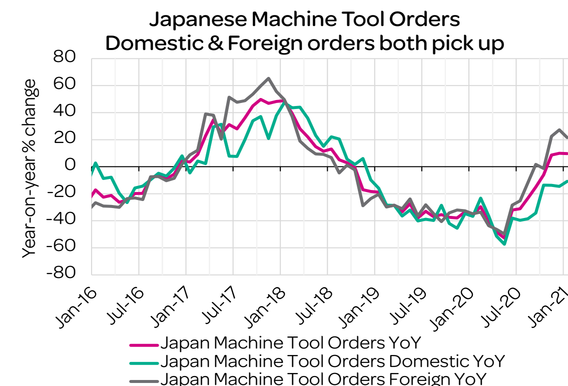
Japanese equities are highly geared to global manufacturing activity with its market dominated by industrial companies making machinery and cars, and many technology companies involved in robotics & automation.

While Japanese equities have performed well over recent months, they have not outperformed in a way that reflects this higher gearing to economic growth. Part of the reason could be the market doesn't cover Japan in as much detail as some its other Asian neighbours. It could also be due to an expectation that currency weakness is needed to boost the value of foreign earnings to create outperformance.

We previously said we thought companies will seek to increase the level of automation in their production lines and that support for this is found in Japanese machine tool orders. This continues to be borne out with a continued increase in the measure. We could see growing strength in the global economic recovery if we see an increase in machinery orders flowing through into broader intentions of capital expenditure by companies.

The key risk, as with other regions, is potential labour market weakness that feeds into a weak consumer demand environment upsetting corporate confidence.

Considering Japan's market valuations relative to other regions, we think there are merits to being slightly overweight but we hold back on a more bullish stance in the short term.



Asia Pacific

It is likely that China will face more coordinated opposition from Western allies. China's growth strategy is pivoting toward rural development, infrastructure spending and fostering a stronger domestic consumer economy.

With the Biden administration in place in the US, we have seen a dramatic change in tone with respect to China. While there is no doubt both will continue to clash over China's economic rise, the tone has shifted to a more coordinated approach between Western allies. This should mean less frequent rifts in the geopolitical landscape, but could lead to a more meaningful structural shift in the long term.

China has been growing its importance in global manufacturing for 20 years, so its dominance in existing supply chains will be near impossible to break. Focus is shifting to supply chains specifically related to industries of the future in an effort to reduce China's dominance and ensure "national security" among Western allies.

In recognition of this growing united front, China is pushing forward with a "levelling up" strategy of its own where significant investment is planned in its rural economy to improve agriculture and self sufficiency. This extends the "dual circulation" strategy which aims to support its established manufacturing & export industries but also to nurture the development of its internal consumer market.

In the short term, flare-ups of coronavirus are forcing ongoing social restrictions and holding back more buoyant consumer retail activity. The potential for long term outperformance remains strong, but we temper our enthusiasm in the short term.

Other emerging markets

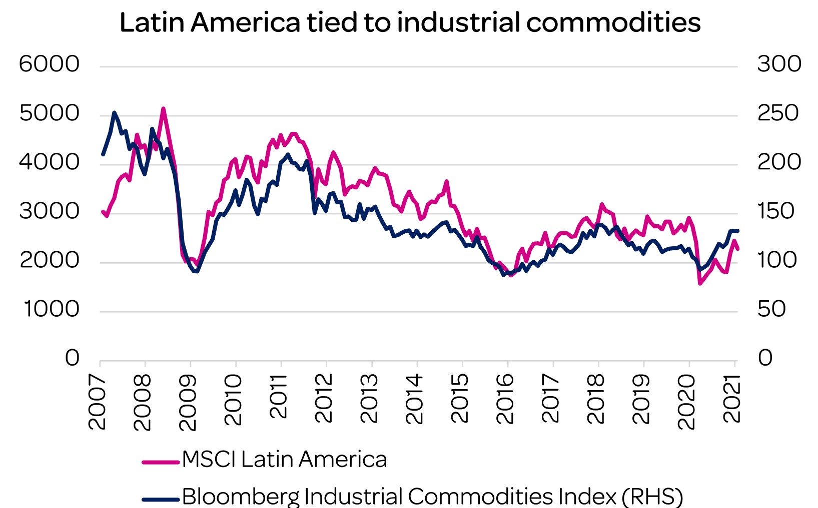
With a bias toward cyclical sectors like commodities, the Latin American equity market is looking a lot more attractive than previously. A weaker US dollar would also be supportive.

There is a stark difference between the domestic economies across Latin America and its equity markets which are dominated by a handful of very large commodities companies and the financial sector.

Domestic economies are suffering much the same as western counterparts but with a much slower and disjointed vaccine rollout, the prospect of a broad-based recovery (in sectors like tourism) still seems beyond the horizon.

In the interim, it is exposure to raw materials in Latin American equity markets that has driven their recent strength. We think there are good prospects for increased infrastructure investment, but we think the nature of infrastructure spending could focus on environmental & technological infrastructure upgrades which are often significantly cheaper (and involve different commodities) than building new roads and bridges.

We have returned to neutral and look for signs of improvement in domestic economies.



Defensive assets

Bonds

While holding ourselves back from a more overtly bullish outlook, we maintain a neutral exposure to the defensive qualities of bonds.

Government bonds

The combination of government spending (loose fiscal policy) and central banks setting low interest rates while also buying large volumes of government debt (loose monetary policy) is a potent combination. It has helped to avert the worst possible outcome from the effects of the global coronavirus economic shutdown.

With the success of the vaccine rollout in developed markets, we are expecting economies to reopen gradually over the coming weeks and months.

Meanwhile, so far, central bank governors sound comfortable in maintaining low interest rates for a long time to come. So with yet higher government spending planned by the US government under President Biden, inflation expectations have started to rise. And this means bond prices are under pressure.

People have worried about inflation at various times over the last few decades, but it has remained low and stable. We think the conditions this time mean it has a higher chance of materialising.

Importantly, few people today have experience investing in a higher inflation environment, which compounds the potential for this phenomenon to become a major risk factor. This is because inflation is bad for bonds and if it gets too high, it can be bad for equities too.

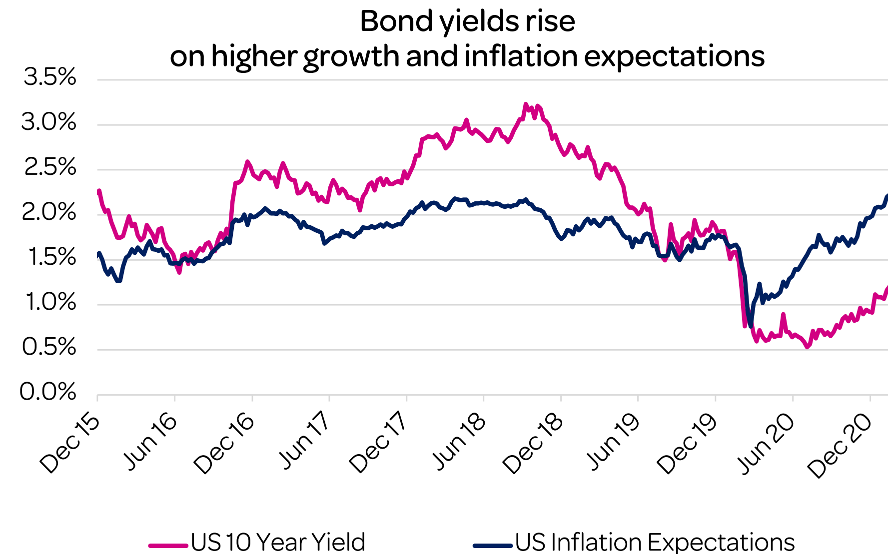
Consequently, we have been gradually increasing our exposure to inflation linked bonds that help protect bond investors by paying a real (inflation adjusted) yield.

That said, we also favour a high dose of short dated bonds that are less susceptible to rising inflation fears and in some cases, they can even benefit if interest rates do rise.

Corporate bonds

Central banks have flooded the corporate bond market with cash as well, making most corporate bonds expensive and offering very little upside opportunity.

Given these bonds are also sensitive to rising interest rates and inflation expectations, our preference is to own shorter dated bonds.



Alternative assets

Property

Our view on other asset classes is more constructive than property and so we maintain a low exposure.

Forecast returns from commercial property are highly uncertain in the near term and given this, we have very little exposure in our portfolios. Over a slightly longer horizon of 5 years, property investment professionals still see a wide range of potential outcomes within sectors, but largely expect total returns to be positive and driven by income growth.

As economies reopen and we can get a better picture of economic scarring, offices and retail could prove to be attractive and commercial property could once again offer a compelling alternative to low yielding bonds.

Commodities

We have limited exposure to commodities, favouring precious metals over industrial commodities.

As discussed earlier, with the fiscal purse strings having been loosened and with greater potential for infrastructure spending, there is the possibility for even higher industrial commodity prices. This improvement in our view would best be expressed through commodity sensitive companies rather than direct commodity holdings.

With precious metals, we know that gold has a negative relationship with real yields, i.e. gold rises when real yields fall. For real yields to fall, interest rates need to fall faster than inflation or rise slower than inflation.

Interest rates are highly unlikely to be rising in the near term and inflation expectations are certainly rising with the improved outlook for growth. Despite these expectations being reflected in a variety of markets, gold prices are pretty much unchanged relative to November 2020 when news of the first vaccine hit the wires.

Absolute Return

We maintain our focus on discretionary strategies.

Despite the positive market sentiment, given the sheer scale and breadth of intervention from governments and central banks, our preference continues to be for discretionary strategies that can wade through the highly abnormal environment.

As such, we continue to avoid systematic strategies with the one exception of trend following which we think should soon return to form as global uncertainty levels fall.

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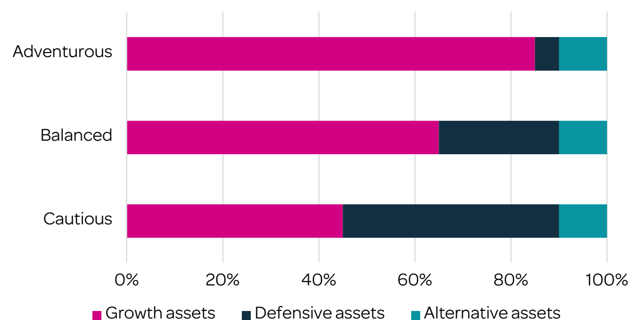
How does this relate to my portfolio?

Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world these ingredients fall into three broad categories: **growth assets** (used to build capital), **defensive assets** (used to preserve capital) and **alternative assets** (that sit somewhere in between).

The overall 'flavour' of a portfolio is determined by its **risk profile.** Broadly speaking, more cautious investors will have more defensive assets in their portfolios, while more adventurous investors will have more growth assets.

Here is what three typical portfolios might look like:



Growth assets consist mainly of **equities** (shares in public companies). We invest in equities regionally, based on the size and relevance of different markets to UK investors. Growth assets also include other riskier investments such as **high yield bonds.** Defensive assets consist of other types of **bonds.** Alternative assets include **property, commodities** (raw materials) as well as more complex financial instruments such as **hedge funds.**

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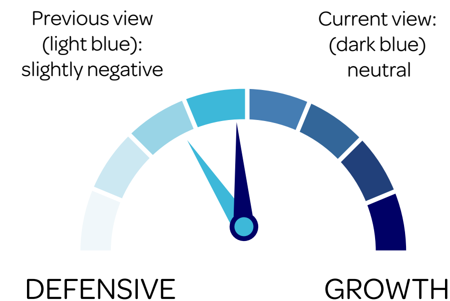

However, our job as your investment manager is to make sure that the risk profile (or overall 'flavour') of your portfolio stays consistent.

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Please remember that past performance is not a guide to future returns. The value of investments and income derived from them can fall as well as rise, and you may get back less than you originally invested.