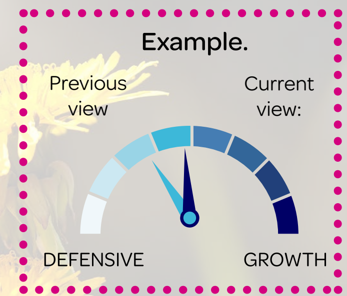
eQ Insight

Market View Q2 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.



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Overview

Summer has begun, and we continue on the road to recovery, with one eye looking over our shoulder.

The recovery continues further as we progress through 2021. Commodities and cyclical equity sectors, like energy, materials and financials have performed very strongly. With more vaccinated people and easing social restrictions, the level of economic activity is growing apace. OpenTable (restaurant) bookings are now running only 20% below 2019 levels (globally), Google's mobility data confirms visitors to retail and recreation venues is back to around 10-20% below 2019 levels. However, our use of public transport is significantly lower, somewhere between 10 – 40% lower for most G10 countries. This is because many of us are working from home, with high variability across countries but with the UK and US still having around 30% fewer visitors to work-places relative to pre-pandemic. So, things are sort of getting back to normal. Time will tell if there will be permanent shifts in service sector jobs as people continue working from home for some of the time and we remain on the look-out for this. Meanwhile, ongoing support from governments and central banks, especially in the USA and notably in the form of low interest rates is spurring orders for capital equipment. This means companies are investing for the future. Growth assets tend to do well in this environment and in particular, company earnings are expected to be strong. This growth boom has some people worried about inflation.

As previously blogged, we agree with the market consensus of a transitory inflation bump, but we think there's a good chance the high level of inflation (notably in the US) could cause some scares. Some suggest it could go over 5% and prove sticky at these high levels for 2-3 quarters! This will test the market's mettle, so the summer could be a little turbulent. In the longer term, we see better balance between inflationary and disinflationary forces, but it is hard to say what level of inflation this will ultimately deliver. Interestingly, climate change is one of the drivers of inflation. Tackling the climate crisis needs us to electrify everything, which requires large amounts of raw materials, notably for wiring and batteries. With global coordination picking up, we could see a surge in demand for these raw materials, creating inflationary effects. At the same time, disincentivising fossil fuels could see these prices rise, which would also be inflationary. Irrespective of this, we observe increased coordination in tackling climate change across both political and corporate spheres. Companies are tuning into their responsibilities as corporate citizens and governments are starting to make some of the difficult decisions that will serve future generations. The scale of the challenge is immense, which means so too are the investment opportunities.

Finally, a cautionary note. Vaccination programmes in the US, UK and Europe have far outpaced the programmes in the rest of the world with first doses in these regions reaching 40 - 60% of their populations. This is partly due to high vaccine orders and effective logistics operations, but also because of lower populations. Less than 15% of the world population lives in these regions, relative to almost 80% that live in Asia and Africa combined. In terms of first vaccine doses, our fight against the coronavirus is only 12% done at a global level. So although life is slowly returning to normal, we will be living with this virus and all its mutations for quite some time.

Growth assets

US

The US economy is re-opening and business sentiment is very strong. While unemployment benefits remain generous, workers are in short supply, but business order books are strong and production is ramping up. Valuations, however, are expensive.

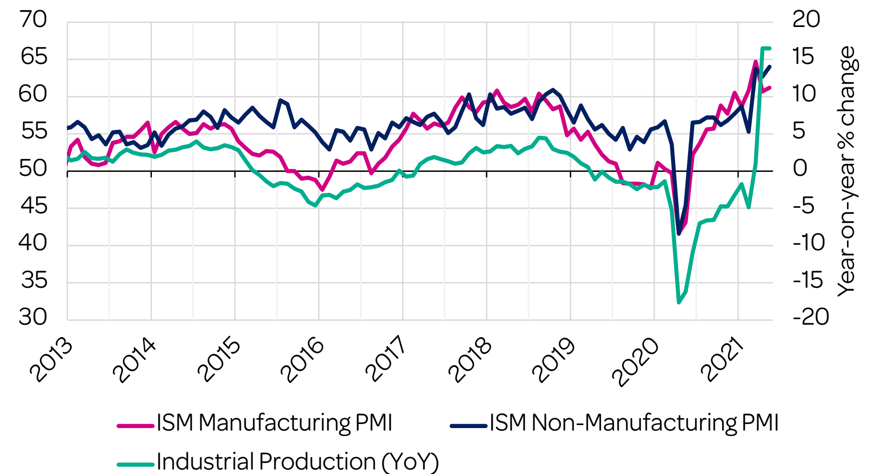
There is always a risk from virus variants, but the highly efficacious vaccines look like they're helping to put the worst of the pandemic behind the US. As expected, this means businesses have started returning to normal and we should see continued growth in activity over the summer.

World trade volumes are also booming with levels currently more than 5% higher than the December 2019 levels, surely making up for depressed volumes over the last year. These volumes should normalise over time, but for the immediate term, this indicates strong demand and will be supportive of growth assets.

One area of concern for us is the labour market where the pace of job gains has slowed dramatically. Part of this could be due to generous unemployment benefits that are set to roll off in September. Until then, it means some people are better off claiming these benefits versus returning to work. But we are starting to see some weakness building in an element of business surveys called the "employment component". Manufacturing businesses are no longer aggressively looking for workers, while services businesses are still looking for new workers, but less aggressively than they were a couple of months ago. The concern is if workers leave it too long to return to work, they may find their job being covered effectively by former colleagues!

Now, this would be a welcome boost to productivity, but it would also mean a lower level of aggregate employment. As such, we think fiscal and monetary conditions are likely to remain loose and support equity market valuations, giving time for fundamental earnings to be rebuilt. That said, given the strength of the economy, the Fed could well start to tighten some of its many loose policies in the months ahead. Unlike a similar episode in 2013, we think this potential is being well telegraphed and is less likely to cause the degree of upset it did back then.

Finally, valuations are expensive given the massive drop in earnings in 2020, which has led us to slightly reduce our weighting. But in aggregate we maintain a neutral view and have continued 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

Easing coronavirus restrictions is creating positive sentiment across manufacturing and services sectors. Valuations are recovering strongly but are still at a discount to the rest of the world.

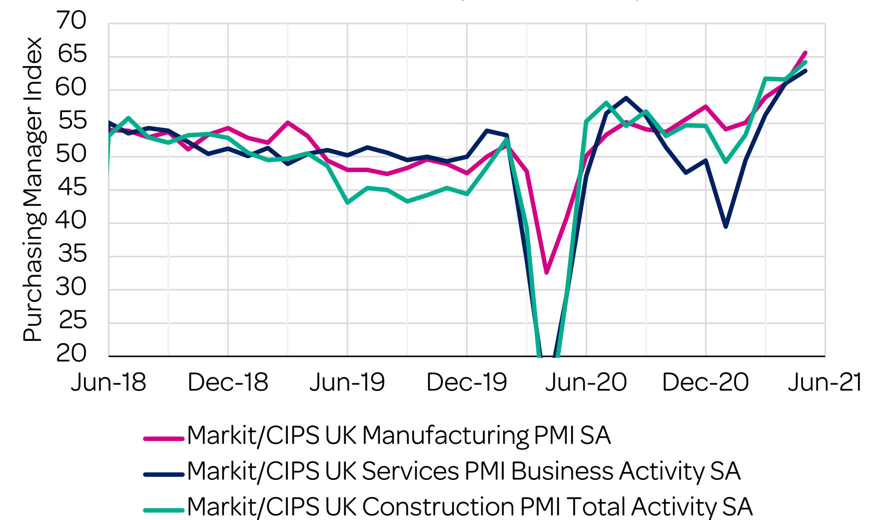
Reopening of the UK economy with more leisure and retail venues back in operation is being reflected in strong business surveys. Given the UK and US are at similar levels of vaccinations, its perhaps no surprise to see these surveys similarly strong in both regions.

Interestingly, after a long period of lacklustre business investment, industrial orders for capital goods are picking up strongly. This could be an indication of a future rise in business investment and be a strong signal that UK companies are finally able to make long term plans with the uncertainty of Brexit behind us.

Similarly to the US, we have concerns about the labour market in the UK. With the furlough scheme extended until September 2021, we are looking for a significant drop in the number of UK unemployment claims over the summer, as we have seen in the US in recent months.

After the initial surge, we think the pace of job creation will slow as companies adapt to the new environment. This could see some low skilled workers left unemployed and in search of alternative vocations.

As we described previously, several UK companies earn a large portion of revenues overseas. The UK equity market is dominated by a number of pro cyclical industries like materials, energy and financials. 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, so we are happy to maintain our small overweight, albeit tempered slightly by valuations having risen off their lows.



Europe

Vaccine delays put Europe a few months behind the US & UK, but business and consumer confidence is returning.

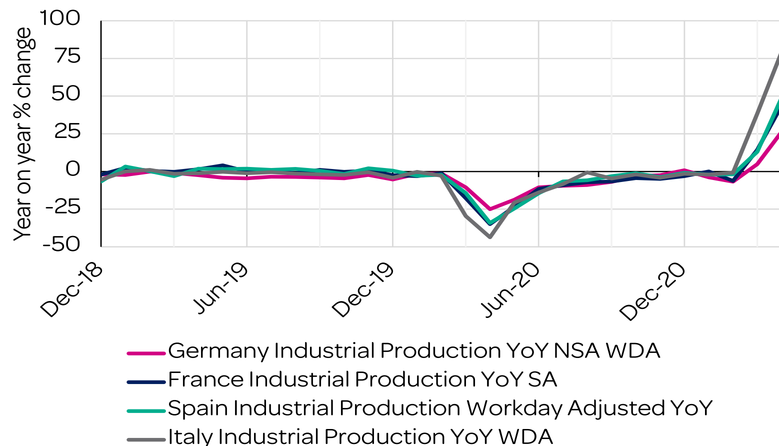
Europe has been much slower than the UK or US in approving vaccines and ramping up inoculations, but it has now picked up the pace and we estimate the continent is running about 2-3 months behind the UK.

We are seeing consumer and business confidence indicators turning up sharply and industrial production is back to pre-pandemic levels across many industry groups while others are fast catching up. In the services sector, expectations of growing demand are leading employment expectations higher also. Consumer confidence is improving fast, albeit still a little below pre-pandemic levels.

Strength in the manufacturing sector may see some headwinds from a softening of growth in China, created by tightening monetary policies, but this should easily be offset by the substantial growth rebound both internally in the EU and from trade with the US & UK.

Equity market valuations are less demanding than the US but not as cheap as the UK, leading us to maintain our overall neutral weight to this region.

European Industrial Production Take Off!!



Japan

Japan is well placed to benefit from the boom in economic activity, especially one that could see companies increase capital investment into high tech machinery.

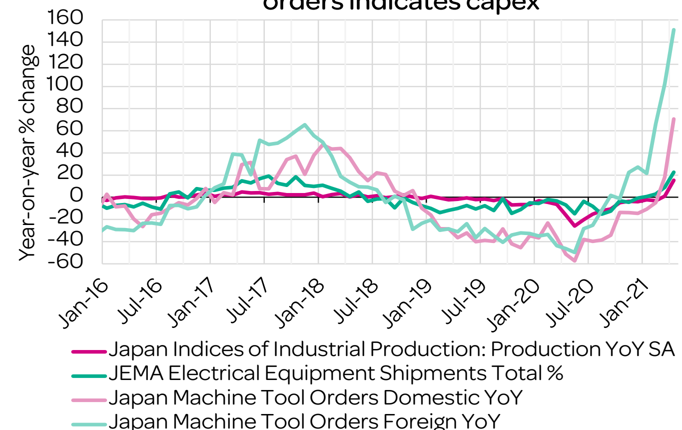
Japanese equities have underperformed in recent months, which doesn't reflect their higher gearing to economic growth, especially when there is a boom in capital expenditure. Japan is home to some of the world's leading robotics and automation companies.

There are several reasons for underperformance. Primarily, a new state of emergency due to rising coronavirus infections was declared in an effort to contain the spread, ahead of the already delayed Olympics. In addition, the country lags behind other major economies in the distribution of vaccines. Finally, the Bank of Japan has been dialling back its asset purchases.

We see many of these things as temporary. In particular, with an accelerating pace of inoculation, we think sentiment in Japan could turn more positive in the months ahead. Coupled with the strong growth in earnings, undemanding expectations for future earnings and the growth in industrial production, Japan looks attractive.

Also considering market valuations relative to other regions, we think there are merits to being slightly overweight.

Japanese industrial recovery led by machinery orders indicates capex



Asia Pacific

China has been a focus point at the latest G7 meeting in the UK, so coordinated opposition from Western allies seems likely. China's focus is shifting toward fostering a stronger domestic consumer economy, which will benefit the rest of Asia through trade ties.

The rapid economic recovery from the pandemic is allowing China to refocus on its long-term strategic interests. This is resulting in policy tightening in the form of greater scrutiny of hitherto lightly regulated industries such as technology, rather than monetary tightening. This should mean broader financial stress is avoided but it also means the market's erstwhile top performers now face headwinds. For example, while internet service companies have enjoyed a light-touch regulatory environment for many years, in the last 6 months they have faced fines and antitrust investigations by the State Administration for Market Regulation. Meanwhile, given China's drive for technological independence, hardware manufacturers are getting more support.

Looking ahead, we could see a different set of companies getting support. Energy and the environment are key focus areas for China, given pledges to cap carbon emissions by 2030 and a resurgence in air pollution. This sets up a rich opportunity for active managers in the region, but tempering this view is the confrontation building between the G7 and China, which we think is merely just beginning. This leaves us only modestly overweight.

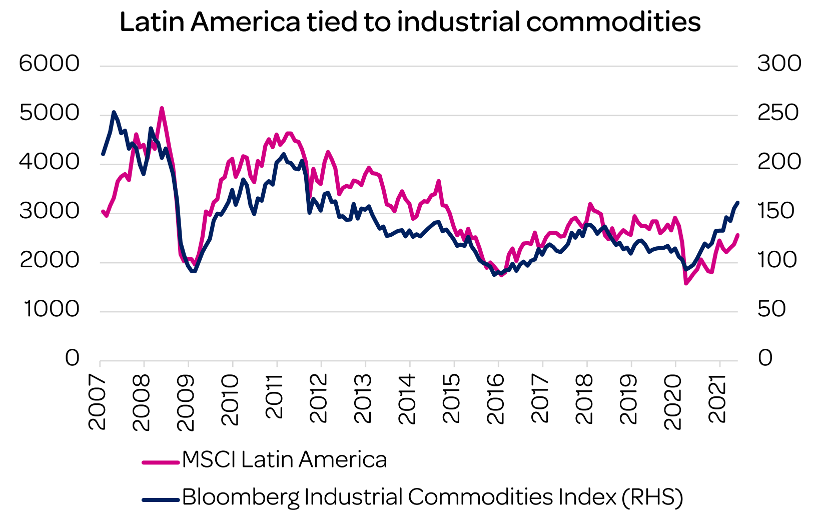
Other emerging markets

The rally in commodities has been a tailwind for Latin America. But headwinds to sentiment come from deteriorating coronavirus case numbers and challenges facing the energy sector.

The pro-cyclical sectors (financials, materials and energy) that make up around two thirds of the market have helped this region perform very strongly since the advent of coronavirus vaccines.

Infrastructure investment is being planned by most major economies around the world. Some of this is to repair existing infrastructure but there are also ever-growing plans for investment in renewables and electrification around the world, all of which will require new raw materials to build them.

We think this exposure to raw materials has good prospects given increased infrastructure investment globally. However, the healthcare crisis, particularly in Brazil, means we are comfortable remaining at neutral and we look for signs of domestic improvement before turning more positive.



Defensive assets

Bonds

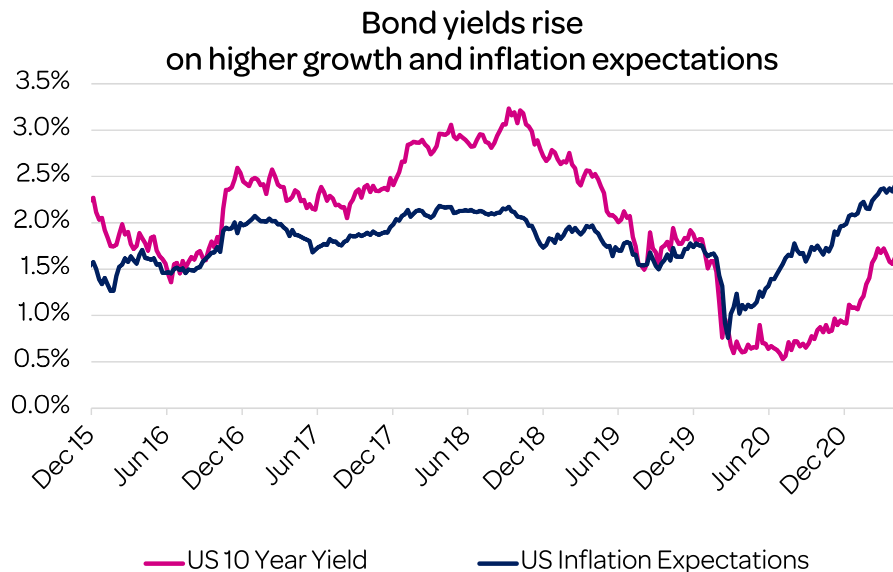
While holding ourselves back from a more overtly bullish outlook, we maintain a neutral exposure to the defensive qualities of bonds.

Government bonds

With a large proportion of the world economy on a reopening path, the outlook for growth is promising. Meanwhile, the surge in economic activity relative to being in lockdown means we are also seeing a surge in inflation, currently around 5% in the US for example.

Our research tells us this high level of inflation could last for a few quarters but should ultimately moderate down to lower levels. However, we think there's a strong chance this lower level will still be higher than anything to which we have been accustomed in the pre-pandemic period. We believe the reason for this change is a better balance between inflationary and disinflationary forces. In particular, it is 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) that we see as a key inflationary factor. Additionally, since some central banks (such as the US Fed) have shifted to an "average inflation target", it means they will be slower to react to higher levels of inflation than before, with the potential consequence of a persistently higher level of inflation.

In recognition of this risk, we have been gradually increasing our exposure to inflation linked bonds that help protect bond investors by paying a real (inflation adjusted) yield and by also favouring short dated bonds that are less susceptible to rising inflation fears and in some cases, they can even benefit if policy interest rates do rise.



Corporate bonds

We have seen little value in corporate bonds for some time, given central banks have flooded this market with cash as well. That said, we do hold shorter dated corporate bonds as a relatively safe store of value that delivers a small yield pick-up. It will be interesting to see how the market reacts to central banks stepping away from emergency asset purchases, possibly over the Autumn. At that point, we could find the asset class more interesting than we do now.

Alternative assets

Property

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.

Forecast returns from commercial property for 2021, with just half the year remaining, are still hugely uncertain with wide forecast ranges across all sub-sectors. For 2022, expectations are stronger, but still widely variable. Over longer horizons of 5 years, property investment professionals still see a wide range of potential outcomes, but largely expect total returns to be positive and driven by income growth.

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 have risen to levels last seen around a decade ago, reflecting the improved outlook for growth. Gold has risen slightly in response. Our positive view on gold is best described as “portfolio insurance”, for an environment where the better balance between inflationary and disinflation forces leads to a prolonged period of higher inflation.

Absolute Return

We maintain our focus on discretionary strategies.

Given the 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 and in particular also if we do enter a higher inflationary period.

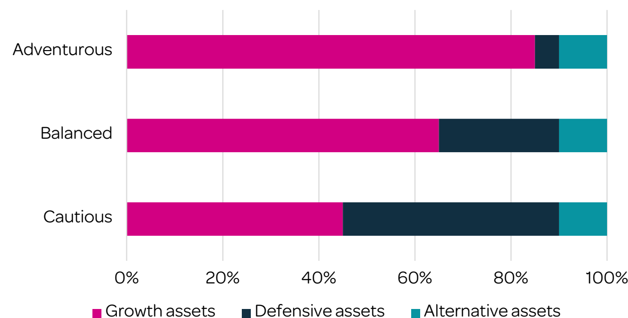
eQ investors

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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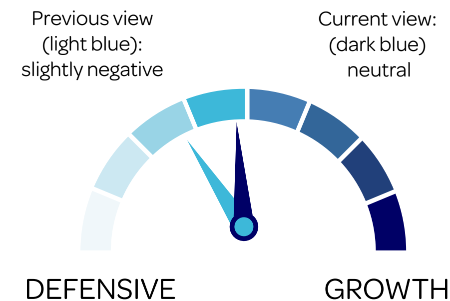

However, our job as your investment manager is to make sure that the risk profile (or overall 'flavour') of your portfolio stays consistent.

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