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Investment review – End Q1 2021

31 March 2021

It is pleasing to be writing with a more upbeat tone than at this time last year when the coronavirus pandemic was just unfolding.

A year ago there was some hope that a recovery would come, but we were staring into an alphabet soup of potential recovery shapes and timelines, all of which seemed entirely plausible. Financial markets had already started to bounce off their lows as a big rotation out of distressed sectors and into perceived beneficiaries began, but there was still a huge amount of uncertainty about what lay ahead.

We have come a long way since then, thanks to the substantial support given by governments and central banks and of course the prospect, and now rollout, of vaccines. This has facilitated a significant recovery in a wide number of asset classes. The first quarter of 2021 has seen markets take more of a breather with some heightened volatility, notably in bond markets, but the rolling 12-month returns since the nadir of last March are substantial, perhaps highlighting the importance of staying invested through difficult times, provided one can afford, or has the stomach, to do so. We do still have several unanswered questions about the shape and scale of the ultimate recovery in different parts of the world, but nevertheless it is certainly a more encouraging backdrop and outlook to the one we faced in the spring of last year.

Growth vs value – having a blended approach

'Growth' stocks, which generally dictated the direction of markets for the majority of 2020 have taken more of a back seat since the rollout of vaccines began, with so-called 'value' and 're-opening' stocks showing a better period of performance more recently. This recovery has also extended to more income-biased investments where the expected reinstatement of dividends has renewed their appeal. It is good to see some narrowing of the big gap that has developed between 'growth' and somewhat cheaper 'value' stocks, but there is still a long way to go.

Some care is also needed from an investment perspective: for many businesses in the 'value' camp it will be a huge relief to turn on the lights and welcome customers through their doors again. But many may face the harsh reality that the landscape will have changed for their business models, and if they did not have the foresight or were unable, to adapt as the pandemic unfolded they are likely to see erosion in any competitive edge they may have had previously.

In recent months market sentiment has swung back more in favour of the unloved sectors and stocks most impacted by the coronavirus in anticipation of the recovery in earnings that will come soon. But as we have noted previously, for many of the hardest hit businesses in sectors such as leisure, hospitality and travel it is likely to be an incomplete recovery. Therefore, the durability of this near-term market rotation does need watching carefully.

We are resisting the temptation to overly tilt portfolios towards the 'value' or recovery parts of markets, as there will be plenty of apparently 'cheap' stocks that are likely to remain permanently impaired and cheap – so-called 'value traps' – as we emerge from the pandemic. Having a blended approach seems the more prudent approach at present.

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No uniform recovery

At the end of 2020 hope had turned to reality regarding the possibilities of economies opening up, yet despite significant progress in vaccinations in countries like the UK and US, there are still many parts of the world, most notably in continental Europe, that are lagging behind. Some economies may be better prepared and further along the curve than others in terms of moving towards re-opening, but as the weeks of continued lockdowns (and in some cases renewed lockdowns), phased relaxations and paces of vaccine rollouts grind on, the picture for 2021 has perhaps become a little less clear than markets had been expecting going into the year end. The idea that the world economy is going to see a uniform recovery is therefore quite difficult to see. This suggests, then, that one still needs to be quite selective about where one allocates risk capital.

Inflation – where next?

Markets do have a tendency to look further ahead and attention has now begun to turn to the next phase of the recovery, with a debate rumbling within the media and markets themselves, in recent weeks relating to the future inflation trajectory and the implications for financial assets.

Inflation noise has been dialled up particularly now that the economic recovery seems much more tangible The passing of the US's $1.9tn fiscal stimulus package has also set tongues wagging that the $1,400 cheques about to land in many US consumers' laps will stoke the embers of an inflationary fire that has lain dormant for some time. Bond markets have been particularly unsettled of late, becoming more fearful that higher inflation will erode the value of bondholders' fixed income payments. Bond yields have risen quite markedly since the start of the year, most notably in the US, with the worry that the US Federal Reserve ('Fed') will soon need to pull the monetary policy trigger by withdrawing its accommodative stance and signal a rise in interest rates.

We said at the end of last year that inflation could be the one thing to watch and impact market sentiment during 2021, and this has certainly been the case of late. However, it is somewhat freshening to learn that several economic forecasters and external managers we speak with are questioning whether the re-opening of economies will cause the fundamental upward shift in inflation that some forecasters are suggesting. We tend to agree with the healthy scepticism and more measured reaction from those closer to the coal face. Yes, inflation is on an upward path in the US, but the Fed has also said it will adopt what it calls 'average inflation targeting' to take account of the sub-trend inflation witnessed during the pandemic. So, even if inflation does nudge above the Fed's 2% target, which is likely this year, we believe it will then retreat to levels that require no near-term intervention.

An important consideration in reaching this view is differentiating between the type of inflation that is sensitive to the re-opening of the economy – such as the higher prices charged for hotel accommodation and air travel as demand returns, or the increased prices charged for goods that are in short supply – and the more insensitive inflation that has been largely unaffected by the pandemic. We expect the former to increase, but the demand spikes and supply shortages should soon settle down once the pandemic impact itself fades. This should mean that the type of inflation isolated to the pandemic alone will be temporary.

It also means that more attention should really be focused on what is happening to consumer prices in those sectors of the economy where the pandemic has had little or no influence. This area of inflation currently shows a very stable trend and is what the Fed is more likely to focus on when it considers its next move.

A further reason to question the recent upward moves in bond yields emanates from central banks themselves. Their rhetoric has been unflinching, promising to do whatever it takes to help economies through to the other side of the pandemic, and some distance beyond it, even if inflation does tick higher in the short term. As one regional governor put it recently, the Fed is expected to show 'resolute patience' in waiting to meet its employment and inflation goals before removing its support for an economy that still has many wounds to heal.

Jabs mean jobs

US unemployment, the other key metric that will determine the future of monetary policy, is also being closely monitored. More vaccine jabs should mean more jobs, but the headline rate is still above 6% and therefore has some way to fall before it comes within the Fed's range of 'full employment' that we came close to before COVID-19 struck.

We also know that the Fed is very determined to play its part in tackling some of the inequalities within in the labour market – it knows there is currently very little ability for large sections of US society to absorb any rise in interest rates without accentuating the current divisions between the 'haves' and the 'have-nots'.

Inflation risks not widespread

The current primary focus is on the prospects for US inflation, yet in other parts of the world inflation risks do not appear to be too evident – for some countries the consumer and business backdrop is just not at a stage that could withstand higher interest rates.

In the UK, for example, the employment data is likely to deteriorate further before it improves as furlough schemes are withdrawn over the summer. Furthermore, and despite its independence, the Bank of England will also be very well aware that it will not be long before the Chancellor's recent Budget measures to increase corporation tax and restrict personal tax allowances begin to create additional headwinds for economic growth. If anything, there may be a case for interest rates to go even lower, possibly into negative territory like in Europe, in an effort to nudge the economy out of its mire. The latest annual inflation print in the UK showed an unexpected fall to just 0.4%, the same as in Japan; in Europe consumer prices are stable at less than 1% year-on-year. Although some recovery from these low readings is expected as this and next year unfold, current forecasts do not suggest any meaningful shift above the respective central banks' inflation targets that would in turn cause them to raise interest rates any time soon.

Even if a strongly recovering US economy does appear ready for a small tap on the monetary brakes, the Fed will also be cognisant of the fact that any action it takes will not operate in a vacuum – the US economy is one piece of a much bigger global jigsaw and the Fed knows that by signalling a tightening of US policy it could prompt knee-jerk monetary policy reactions and have adverse economic and financial market repercussions in parts of the world that are not yet ready for change.

Our approach to fixed interest

There is therefore a heavy weight of responsibility on the Fed's shoulders. Markets and the media will undoubtedly be quite twitchy over the coming months as we gain a clearer picture of the scale of the global economic recovery and its potential to set the inflationary hare running.

Our current opinion is that central banks will stay true to their word and that bond markets have been a little hasty in their recent reaction to what might lie ahead. As a result, we are maintaining our diversified approach to fixed interest investments where exposure is not only skewed towards corporate debt and inflation-linked bonds, but also to strategic bond managers who can pivot their portfolios very quickly to minimise risks or take advantage of mispriced opportunities.

We currently believe we are still some way off needing to fret about permanently higher inflation and tighter policy that would spell more serious trouble requiring a quick change of tack. But we are prepared to alter that view, and our fundamental allocation to bond markets if necessary, as and when more reliable data become available. In the meantime, the current low inflation and monetary backdrop continues to paint a relatively benign picture for a range of risk assets generally. This presently means holding low levels of cash and maintaining stock market exposures at the upper end of their strategic ranges.

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Feet in both camps

Over the course of this year investors will perhaps need to more careful that they do not pay too much for longer-term growth that may take longer to emerge than anticipated or, as noted, get sucked in to some of the 'value traps' that often appear after a recession. We have seen both extremes in vogue over the past 12 months, but going forward it will be healthier for the market's general composure if we see a broader opportunity set acknowledged – a polarised strategy, skewed towards the extremes of either 'growth' or 'value', risks neglecting a large middle ground that is still worth exploring, particularly by the active manager.

For this reason, we are keeping our feet firmly in both camps, having stock market allocations to both longer-term growth drivers and shorter-term recovery plays, whilst also having diverse exposure to a combination of large-, medium- and small-sized companies. Overlain is our bias, which we accentuated last year, towards those parts of the world that we expect to have fundamentally stronger economic growth trajectories in the years ahead i.e. the USA and countries within the Asia-Pacific region. Our positioning extends to investments that should benefit from the global commitment towards decarbonisation, electrification and renewable energy, including the necessary infrastructure spending that surrounds these themes.

Encouraging signs but uncertainty still remains

Although many countries still have some considerable way to go just to return to pre-pandemic levels of economic output, the predictions for growth in 2021 and 2022 now look more encouraging and also more reliable, assuming vaccination programmes do not stall or the virus itself does not return in a form that causes another wave of lengthy lockdowns later this year.

It is becoming clear that all of us, and financial markets, are going to have to learn to live with a certain level of general uncertainty for some time to come. This is likely to produce more frequent bouts of market volatility that may test our nerves. But we are also likely to have the continued steady hands of central banks on the global monetary policy tiller: we believe they will stick to their words by looking beyond any short-term inflationary squalls, maintaining an appropriate level of stimulus and cutting troubled economies some slack to help them return to their pre-pandemic courses.

Risk warnings

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