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Investment review – End Q2 2021

30 June 2021

It is pleasing to reach the mid-point of the year without too much drama in financial markets. This has been achieved despite growing evidence of a strong economic recovery and seemingly being slightly closer to a potentially more nervous time when the current extensive stimulus measures might need to be scaled back.

Investment returns in the second quarter have generally been better than the first, and so we go into the second half of 2021 with some decent year-to-date returns under our belts, particularly when seen in the context of still non-existent returns from cash deposits.

An ever-changing and improving environment

The drivers behind market returns have certainly altered during the course of the COVID-19 pandemic. For much of last year it was largely a one-way investment street for a relatively narrow range of 'growth' companies: those seen as offering some protection from weakening economic activity, falling inflation, low interest rates or being direct beneficiaries of lockdowns.

Since the rollout of vaccines last November and for much of 2021, including the early part of the past quarter, the market leadership has rotated to those 'value' businesses more in tune with a reflating economic cycle. Most recently, however, 'growth' has reasserted itself once more as the dominant investment style, helped by the calm tone from central banks and muted reaction in bond markets to inflationary spikes. Although markets have, so far, navigated the changing environment quite well and all has appeared quite calm on the surface, there has still been plenty going on below deck to keep markets', and our, minds in focus and the investment ship sailing in the right direction.

The substantial support given by governments and central banks, and now backed up by the successful rollout of vaccines and easing of restrictions, has certainly begun to shape a strong rebound in global economic activity in recent months. Leading economic indicators in both the manufacturing and services sectors actually suggest that the recovery may come a little sooner than originally anticipated for those economies where vaccine deployment has been particularly successful; but for many, including the UK, attaining pre-pandemic levels of activity could still be delayed until mid-2022 or beyond. Thereafter, the stronger rates of economic activity are still expected to emanate from the Asia-Pacific region and the USA, and that is where the emphasis of our stockmarket exposure remains, including to themes connected with combating climate change and the necessary infrastructure investment that surrounds it.

The inflation conundrum

A sharp rise in inflation, particularly in the US, has accompanied the fast-improving economic outlook and been the dominant influence on financial market behaviour recently. Although stockmarkets have continued to make some further headway overall during the second quarter of the year, rotations in terms of fancied sectors and oscillations between 'growth' and 'value' styles have kept investors on their toes. So too has increased jostling in bond markets, with their reactions to rising inflation, at times, appearing rather counterintuitive; time will tell, but perhaps this is an indication that the fear of rising inflation and moderately higher interest rates had largely been priced in since the start of the year.

The overriding calming influence on markets has come via the steadying hands and words of the US Federal Reserve's ('Fed') top officials and other developed world central bankers. They have reminded market participants that there is currently no intention to make pre-emptive moves on removing stimulus; they will remain patient and tolerant of what they see as temporarily higher, COVID-sensitive, inflation in particular. There are some solid arguments to support central banks' beliefs on transient inflation.

In the US healthcare sector, for instance, they (and we) can be fairly certain that payments made to hospitals and physicians under Medicare, the US national health insurance programme, which currently include a 20% COVID 'add-on', will revert to near normal levels once the public health emergency ends. In an entirely different area, the severe supply-chain bottlenecks in the autos sector, including a global semi-conductor chip shortage for key technology components, has created unusually high near-term demand (and inflated prices) for used, rather than new, vehicles. Both healthcare services and used vehicles are large components of US consumer price indices, so watching the price movements in these sectors over the coming months is likely to give markets a better clue as to whether they are right to continue giving central banks the benefit of the doubt, as they are currently.

The Fed's guidance on when we are likely to see a rise in interest rates has been brought forward slightly in recent weeks, but even this slight change in rhetoric has so far had a muted effect within bond markets, perhaps a sign that investors were already one step ahead and knew what was coming. Markets dislike surprises but so far they appear to be gradually coming to terms with what seems like the inevitable next step, that of the unwinding of the stimulus that has kept the world economy ticking over during the pandemic.

The current expectation is that the Fed will not blink when faced with an ever-increasing array of near-term data surges that might ordinarily suggest some action should be taken. It has set out a clear roadmap of the conditions that need to be met before interest rates are raised, including giving itself more manoeuvrability in the form of average inflation targeting. It is also easy to forget amongst all the inflation talk that attaining something close to full employment is the second condition that the Fed has said needs to be satisfied before it alters its policy course. The current US unemployment rate, at 5.8%, is still a fair degree higher than the pre-pandemic level of around 3.5%. Over seven million more Americans are out of work now compared with prior to the pandemic.

There are clear risks to having a complacent view on the near-term inflationary forces, which in some sectors could have greater permanence than initially thought. For example, where businesses can successfully pass on rising input costs to consumers they will do so, but once the supply bottlenecks and post-COVID demand imbalances iron themselves out, it is possible that those businesses will be slow to normalise their pricing – it is hard to see some of the embattled companies in the travel, entertainment and hospitality sectors, for example, being overly generous with their pricing models when current COVID-restricted consumers return in force.

So, some care needs to be exercised in being overly wedded to a view that the current inflationary forces will be completely transitory. We do expect the current surge in inflation to subside later this year and into next, and also for central banks to continue to act with restraint, but that does not necessarily mean financial markets will continue to take the possibility of an earlier shift in policy in their stride. Our recent actions to reduce the sensitivity to rises in interest rates within clients' fixed interest exposure is a nod to the risk that the apparent trust financial markets currently place in the Fed's (and other central banks') messaging may begin to wane. Our move also acknowledges that some of the current 'transitory' inflation could become more permanently embedded. So too does our recent redistribution of US stockmarket exposure away from some of the more expensive technology heavyweights into less expensive parts of the US market that offer better value and scope for growth, particularly lower down the market capitalisation scale.

Active stockmarket exposure remains key

Within clients' stockmarket allocations we feel we have good exposures to a range of factors and styles that cover both a recovering economic cycle and longer-term growth trends. We have also built good coverage across the market cap spectrum. Active managers, by definition, naturally shy away from hugging market indices so have a healthy skew towards mid- and small-cap stocks where future large-cap growth stories are typically incubated. Looking further to the future, when stimulus packages eventually burn out and the economic recovery becomes less impressive, we are likely to see much more of a return to investment fundamentals where strong balance sheets, corporate cashflows and low debt are perhaps given greater priority than they have been for some time.

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Active managers are also well positioned to make the transition to more defensive or 'consumer staple' type stocks if necessary, and indeed in some cases are already thinking ahead to a more mature, non-cyclical, phase of economic recovery and are repositioning accordingly. We, too, are keeping a close eye on market influences and are prepared to make further adaptations to our stance if necessary.

Positive signs for income

Income-focused funds have also been enjoying a renaissance of late, aided by the actual or expected reinstatement of company dividends – capital flows into global higher dividend funds have exceeded $1 billion a week recently, a sign of confidence in what was an unloved investment area during 2020.

Some care is needed here too – whilst it may be encouraging to see companies beginning to reward shareholders again, these payouts must have some durability and be reflective of a sustainable level of underlying profits. Some companies have used the period of dividend famine to reset their dividend policies and priorities, which we see as a healthy step. Furthermore, we are encouraged when we hear from underlying managers that they would rather invest in a low or moderate dividend-yielding business that has the capacity to grow its payout over time based on growing profits, than a company that stretches itself too much and has nothing left in the tank to either strengthen its defences or reinvest for long-term growth.

A supportive backdrop for risk assets

Despite the near-term inflation spikes and risks of slightly sooner-than-expected policy change, we can still expect substantial monetary and fiscal stimulus to remain in place for the foreseeable future. This backdrop should act as a fundamental underpin for markets and allow the relative attraction of, and reward from, risk assets versus cash to be maintained. But the recovery road still contains plenty of potholes and we could therefore see a more skittish ride for markets over the second half of 2021 than we have seen for a while, especially since inflation and economic data are likely to be picked over with a fine-tooth comb.

This does not mean opportunities to generate attractive investment returns will evaporate. On the contrary, the recent market oscillation between growth and value stocks, where some crowded trades have appeared, is perhaps healthy in that it signifies some investor fatigue for investment in the extreme ends of the market where the low-hanging fruit has been picked. It suggests that market participants are starting to become less polarised, broadening their horizons and turning their attention to the somewhat unforgotten 'quality' found in the market middle ground where greater earnings visibility and resilience to a range of economic conditions can often be found. Seeing some greater breadth to investor mindsets, with improved discernment around investment fundamentals, will be no bad thing as it should allow markets to continue their upward journey as we come through the other side of this extraordinary pandemic.

Risk warnings

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