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PRIVATE & CONFIDENTIAL

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General Economic Overview – Quarter 2 2021

The second quarter of the year proved to be positive overall for risk assets but the path to the final return numbers was not always clear as we moved through the quarter. As we noted in the previous two quarterly bulletins, the sentiment of investors was a very strong influence on market movements and inflation was again one of more prevalent themes. As we saw in Q1 the debate centres around which inflation force will be dominant in the global economy – the structural disinflationary forces of disruption, debt, and demographics, or the cyclical expansion forces.

The continued relaxation of monetary policy by most central banks in the developed economies, combined with fiscal policy, has tipped the balance for the moment towards inflation being seen as a transitory phenomenon that will fade once we have come through the initial expansionary phase, following the relaxation of Covid-19 lockdowns in many western economies. The latest data on the spread of coronavirus from the delta variant is not encouraging as infection rates are rising in those countries currently exposed to it, but hospitalisations and deaths remain low which is more positive news.

Inflation has been a key feature of market movements and has influenced the debate around which style of investing will be dominant during 2021. Value investors certainly did well in the first months of the year, but this trend has weakened noticeably in the last quarter. Growth and quality factors have dominated returns with April and June the strongest months for these styles. This more recent period has seen markets slow after the activity of the first months of the year, with the Vix index falling to a pandemic low of 15.7 points on Friday 11thJune 2021. This is seen as a reaction to the Federal Reserve's 'wait and see' policy, where they are prepared to sit out a spell of higher inflation before potentially withdrawing or reducing monetary support. There is a fear that complacency may be setting in, highlighting the potential of greater downside risk from news flow than is usual. The Fed has managed to convince investors that inflation will be transitory even after US CPI reached 5% in the 12 months to the end of May following a 4.2% increase in April. Other signals reinforced the inflationary fears as businesses continue to reopen after the pandemic lockdowns. In the UK the IHS Markit/Cips interim composite purchasing managers index was 61.7 in June, down slightly on May, but matching some of the highest readings since the survey began. Not all data is positive however, as concerns over labour shortages and higher wage costs saw optimism fall to its lowest level in five months. Investors are treading water at the moment waiting for the signals that will perhaps allow them to act in a more positive way, hence the reason that markets have range-traded in recent weeks.

One of the strongest areas to invest in this year has been commodities - indeed oil has seen a significant bounce back with Brent Crude up 20.76% over the quarter compared to global equites averaging around 7%. Other commodities also fared strongly including copper and iron ore reflecting the uptick in global demand.

Global economic growth has seen significant improvement over the first half of the year. In March the IMF upgraded its world outlook to 6% in 2021 falling to 4.4% in 2022 based on fiscal support in the larger economies and the vaccine roll out. This rate of growth has certainly stimulated the inflation debate and whether this is transitory remains to be seen but overall, the recovery phase is underway as markets are backing companies that have struggled during the pandemic, although more recent data has dampened this progress with yields falling, surprising many investors.

We still believe we can look forward more positively to the next twelve months, but Covid-19 and its various mutations will result in bumps along the road.

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Equity Markets

As we are at the mid-point of the year it makes sense to look at what has happened so far and what the next few challenges might be. Equity markets have run well this year so far but have reached a point where the direction over the next few months is more difficult to predict. Markets have stabilised around certain values and have been range bound for several weeks around the quarter end. There are some obvious reasons for this – the prospect of less monetary and fiscal support, and the potential of higher taxes in the future on corporations in the US and around the globe. This puts a potential brake on expectations of growth and has been reflected in the pricing in markets. Much of the uncertainty is based around future inflation which, if greater and longer lasting than expected, will create a bumpy ride for many equity markets. This makes assessing where we are in the cycle and where to invest a more complicated task.

So far this year, value stocks have benefitted from their sensitivity to the improving economy, but their lead has been reducing since April as a reduction in bond market yields signalled doubts about the strength of US growth, and there was also a period of consolidation after significant gains. The debate continues as to whether fiscal stimulus plus a period of post-pandemic spending will result in stronger growth and push wages and prices higher as labour and goods are in shorter supply. Value is still cheap compared to growth and may prevail, but some investors and strategists are looking more to quality companies with strong dividends as these are more attractive after the recent value rally has stalled. Views on inflation will certainly direct sentiment but at the moment it appears that the Fed are convincing investors that it is under control. Growth stocks outperformed in the second quarter thanks to strong returns in April and June as inflation fears subsided.

As we enter the summer period there are no obvious signals emerging that are driving market direction, and this may continue as western markets move into the holiday period. This should not detract from the fact that this quarter, and this year overall, we have seen strong returns for UK investors. The UK market has been one of the strongest equity markets across the globe with smaller company returns strongest of all.

UK

In the last review we noted how rapidly the economy had shrunk during the pandemic and, although there is some way to go to reach the pre-pandemic trajectory, the recovery in certain areas has been almost as rapid. According to the ONS, headline GDP figures were 8.7% lower in Q1 than in the same period in 2020, illustrating the effect of further lockdowns, but Q2 figures should show a significant improvement. For many areas of the economy, such as the service sectors, the effects of the pandemic were severe, and the recent lifting of restrictions has begun a return to normality. Government support such as the furlough scheme has helped to shelter the sector, but this will gradually be reduced through to September leaving businesses to rely on trade once again.

There are some positive trends and the ONS survey in February–April indicated that the unemployment rate dipped to 4.7% from 4.8% in the previous rolling quarter, with weekly estimates showing the rate fell markedly to a little over 4.0% towards the end of April. Experimental data for May showed that employment rose by close to 200,000 from April, with the accommodation and food services sector seeing particularly sharp gains. The housing market has had a major boost over the last 12 months because of the stamp duty holiday, pushing house prices up by over 9.5% in the 12 months to the end of May (Halifax House Price Index).

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The UK stock market has attracted more flows this year with its value bias in areas like energy and industrials and this has resulted in strong performance over the year to date. This quarter has been weaker, and it dropped back relative to US and European markets which led the way. The UK still has some issues to resolve on Brexit and with its global trading partners, but these issues are not as influential as they once were.

US

The US market has once again topped the returns list for equity markets this quarter for sterling investors. Market data has been positive but concerns over high valuations and a focus away from the large technology companies was a drag on returns in the previous two quarters. There has been some strong recovery in growth areas in June as the Fed has managed to convince the market that inflation fears are transitory, dropping yields back from what was an upward trajectory. Some sectors have maintained recovery, such as financials and energy stocks, and the oil price has recovered substantially. The strong economic growth prospects aligned to the expansive fiscal policies of the Biden administration have helped to drive this reaction in the stock market. The fiscal intervention was supported by both parties in its initial phase, but the second instalment had to be tempered by those holding the balance of power in the Senate. The effect of fiscal policy will start to fade towards the end of 2021 unless another package can be constructed. In line with this, US growth looks likely to beat forecasts on the upside with Q2 expectations close to 9% and over 6% for the year as a whole. Some are more optimistic, Deloitte's believe that it's beginning to look as though the US has not only avoided the 'scarring' that many economists feared at the beginning of the pandemic, but that the pandemic has also accelerated technological change, meaning that productivity growth, and GDP, are likely to remain above pre-pandemic levels. Business finances are healthy. Most recessions in the past had financial causes, and businesses (especially financial businesses) had to take time to rebuild their balance sheets. The current recession, by contrast, was met with firm government action that bolstered the financial system and most businesses' balance sheets. That leaves businesses ready, willing, and able to spend once they get the signal that they can do so safely. Households — particularly higher-income households — are sitting on a large pile of savings (about US$2.8 trillion) and the reopening of the consumer service sector is likely to result in a burst of pent-up spending as people return to restaurants, theatres, sports events, and travel.

Like most western economies there are risks including inflation, international relations, the debt burden and of course Covid-19 setbacks.

This quarter has seen investors return to growth and quality areas as the inflationary threat has reduced but the stock market is taking a breather compared to the technology led momentum we saw over 2020.

Europe

In previous quarters, Europe has been a laggard as far as economic recovery is concerned as they have been slow to roll out their vaccination programmes which has affected the return to broader economic growth. This quarter has seen definite improvements, as vaccines have been distributed and rolled out more effectively which has led investors to start rebuilding positions in European companies, seeing it as an area of value. Like many economies, the Eurozone has had the spectre of inflation, although perhaps it has been less of a threat than in other western economies as they have generally lagged the upturn. The ECB has continued to promote a dovish tone with support for bond markets still in place and no sign of tapering at this point.

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In the stock market, this recovery of confidence has meant that European stocks have been neck and neck with their US rivals in 2021 – the broadest measure of European markets has raced ahead by 15% in euro terms since the end of last year. As with other markets, European shares have benefitted in sectors that are considered to be sensitive to economic fluctuations, such as banks and energy companies which have gained favour as countries have lifted lockdowns. Gains have been broad in consumer discretionary, technology, energy, industrial, financial, and basic materials, and many of the old industry stocks have benefitted from this turnaround including auto maker Porsche and glassmaker Saint-Gobain.

The ECB has supported the bond market and has indicated a willingness to continue this alongside a loose monetary policy with negative rates persisting in some countries. The EU recovery budget is also seen as a strong statement of fiscal support and will come into force in the autumn of 2021. The European commission has also hinted at relaxed fiscal rules continuing.

Asia & Emerging Markets

Asian markets have performed well over 2021 although recent data from China has dampened growth expectations. Industrial production expanded 8.8% year-on-year in May (in April it was +9.8% yoy). May's figure was the worst reading since December 2020 and was below market expectations, with activity potentially weighed-on by surging input prices and port disruptions in Guangdong province. Other areas such as credit have also seen tightening led by the party's wish to curb speculative lending, particularly on property. Credit growth in 2021 is likely to be notably slower than in 2020 as the PBOC unwinds Covid-19 relief measures and seeks to limit financial risks, particularly in the property sector. Over 2021 as a whole, growth should be robust. Exports will benefit from fiscal stimulus abroad and the lifting of global restrictions, while consumer spending will gain steam as the labour market improves. That said, further domestic Covid-19 outbreaks, tense relations with the West and elevated corporate debt levels – particularly in the property sector – pose risks. Focus Economics expect GDP to expand 8.7% in 2021, which is up 0.1% from last month's estimate.

China remains the country globally that has recovered the best from the pandemic and even last year it grew by over 2% with growth of 8% plus expected this year. China also delivered a record growth rate for the first quarter with output leaping 18.3% in the first three months of the year compared to 2020, the fastest rate since records began in the early 1990's, however on a quarter-by-quarter basis growth was a more subdued 0.6%. Growth has been driven by industrial production and booming exports, although retail sales also saw a strong recovery in March.

The country has now successfully navigated its way through two crises, the GFC and Covid-19, and has emerged stronger on the world stage from each of these. The whole Asian region is arguably the manufacturer for the world benefitting from a global recovery led by manufacturing with Western consumers diverting service sector spending towards manufactured goods. Throughout Asia the domestic consumption story will be a secular growth driver for many years, aided by under penetration of most consumer services and, outside of China itself, positive demographics. Within Asia the pace of growth and maturity of economic development varies by country presenting diverse and different opportunities even within the one region. India, whilst hard hit by its second coronavirus wave, has seen the stock market look through the country's difficulties, with investors focussed on long-term potential with the belief that the second wave, whilst a human tragedy, will only have transitory economic impact. The reform programme continues and, after the self-inflicted hit of demonetisation and the teething problems of a new nationwide goods and services tax which replaced the old and wasteful state systems for collecting revenue, the country should start to deliver on its long-term potential over the next 5 years.

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In this recovery, the emerging world, with the exception of North Asia, has lagged developed economies due to poor vaccine roll out caused by unaffordability or incompetence and in some cases a mixture of both. A survey produced by Global Economic Prospects suggests 94% of high-income countries will regain pre-recession GDP per capita within two years, whilst in the developing world this will only be 40%. Whilst it has often been argued that emerging countries have stronger fiscal positions than many in the developed world, the low level of government revenue from taxation has meant their ability to respond with fiscal stimulus has been limited. In many developing countries government revenues are dependent on oil prices which, whilst recovering this year, suffered a large hit in 2020. The developed world has also been able to implement quantitative easing. It is estimated that fiscal support averaged 17% in high income countries against 5% in emerging and developing countries and some emerging world countries have even seen an increase in their borrowing costs in contrast to Western nations. In other regions, the Central Bank of Indonesia kept rates unchanged at an all-time low in June, while the central banks of the Philippines and Thailand will hold meetings later this month. Going forward, regional rates should remain highly accommodative this year in order to support the recovery in their respective economies amid ongoing uncertainty.

Global growth rates in advanced economies are now above those in the emerging world as a whole. Outside of China, India and some parts of developing Asia, large parts of the emerging world have stagnated economically as the commodity super cycle ended and corruption and poor economic management took its toll. Within the emerging world, the chief drivers of recovery have been countries with a strong manufacturing base especially China, whilst Latin America and the EMEA region including Russia have lagged.

Japan

As the Olympics nears its summer start, there is still a level of scepticism in the Japanese population about running the games with the current Covid-19 situation. Japan has been slower than many western populations to take up the vaccine due to a cultural cautiousness about vaccines – the government are working hard to overcome these prejudices, but it will take time. That said there has been more positive news as yen-denominated merchandise exports soared 49.6% annually in May, on the back of April's 38% jump. May's reading marked the strongest increase in over 30 years.

There remain supply chain disruptions, such as in the car industry, but there is optimism that overall the external outlook is strong as robust Chinese demand, a buoyant manufacturing sector, and US President Joe Biden's fiscal plans will all provide support. At its meeting in June, the Bank of Japan (BoJ) left all its monetary policy parameters unchanged, as was widely expected by market analysts. The policy decisions came amid muted price pressures and an ongoing but fragile recovery. The Bank described the economy as still being in a 'severe situation' due to the effects of the Covid-19 pandemic and with a third state of emergency likely having restrained economic activity from April to June, the BoJ felt that it had grounds to take a wait-and-see approach. There were some small inflationary moves in May as core consumer prices — which exclude fresh food — increased 0.1% in annual terms, contrasting with April's 0.1% year-on-year drop in prices. May's figure was the highest inflation rate since March 2020 and bucked the previous trend of nine consecutive months of falling prices. Nevertheless, the annual average variation of core consumer prices was unchanged at 0.4%. Compared to other markets around the world, this year has been poor for the Japanese stock investor as a growth biased index has struggled against the rising tide of infections and lockdowns. This should ease further into 2021 and 2022 as the vaccine rollout improves and fiscal expansion begins to have an effect.

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Japan continues to have significant structural issues, the most significant being a declining population, but with a high debt to GDP ratio and national debt at over 200% of GDP there are other headwinds to stimulating the economy.

Fixed Interest

The first phase of the second quarter was characterised by the threat posed by inflation and the likelihood of central banks having to change course and increase interest rates at a faster pace than initially thought. This led to yields rising in anticipation of a more hawkish tone from the Fed, which was helped by comments from Janet Yellen about the government supporting main street rather than Wall Street. As it turned out, by the latter part of the quarter the Fed had managed to convince investors that the inflationary threat was transitory and whilst inflation would rise it would fall back again as the economy began to normalise. They were more hawkish later in June about rate rises coming in 2023, ahead of the previous schedule, with the dot plots (these are where Federal Open Market Committee members place dots on the dot plot denoting their projections for future interest rates in subsequent years and in the longer run) also reflecting this change in stance. Surprisingly this didn't seem to affect investors' concerns on future inflation pressure and has meant that we have been in relative calm for several weeks as investors come to terms with the acceptance of stable rates for the time being. Naturally there are risks with this so termed complacency, the largest of which is a sustained period of price increases that disrupt consumer spending which in turn continues to push up inflation rather than normalising.

This calm has meant that, although yields have fallen back, the majority of the return available has been in carry (coupon) and naturally investors have looked to the areas of greatest potential or highest yield. Higher yield markets and emerging market debt have been in favour, but even here spreads are still tight and offer limited gains in capital terms. The investment grade and government bond assets have less to offer and yield little in western markets, once again forcing some investors to seek riskier assets. Central banks have continued to back loose monetary policy with bond buying programmes to support market stability and it is expected that the Fed will initiate a gradual tapering of its asset purchases late this year or early next year. In order that another taper tantrum can be avoided this move is likely to be signalled well in advance and accompanied by reassurances that rate hikes are not on the horizon until well after the end of tapering.

Most investors in fixed interest recognise that the market lacks obvious direction at the moment with the ongoing pandemic and mounting inflationary pressures resulting in an uncertain future for the global economy. Consensus suggests that consumer price inflation – both headline and, to a lesser extent, core – will be on a bumpy path this year across countries and this may lead to gyrations in longer-term inflation expectations and what PIMCO described as a potential 'inflation head fake' in bond markets.

Bond markets remain difficult to judge in terms of value with yields stable but likely to fluctuate. For most they remain a hedge for risk assets whose value in a portfolio should not be underestimated.

Property

This is slow moving asset class, which is reflected in any valuation changes that take place. Quarter 2 did see improvements in the confidence of investors in property as economies opened up again, but certain sectors remain challenged such as traditional retail and leisure. Funds that operate in the direct property sector have been opening to the retail market, but several smaller funds have also chosen to

close with Aviva and Aegon being the latest to make this decision. The FCA are continuing to consider the feedback from the industry on how to approach illiquid asset classes and this may decide the fate of the small number of other funds in the direct property retail sector.

There is no doubt that many of the changes in the commercial property sector created by the coronavirus crisis are still in place – some of them will be temporary and some longer term due to structural changes in the economic environment. This has of course affected different areas of the market in different ways. The recovery in retail looks to be a long one with possible change of usage or multi use coming to the fore. Rental income data has been stronger than expected overall but in certain sectors very poor – the obvious casualties of the lockdowns are the retail and leisure sectors. Structural changes such as working from home may well be temporary, but a variety of institutions have already started to flex their traditional working arrangements after seeing significant increases in productivity.

Some sectors have seen signs of a pick-up, but these will take time to come through as other structural changes take place. Investors are likely to remain focused on core, well-located retail space with secure and long-term income streams, underpinned by high-quality tenants. The office occupational market remains subdued, with limited leasing activity reflecting delayed occupier decision-making although this has begun to show signs of improvement. This partly reflects the normal reaction of companies to economic weakness, but also the pandemic's impact on working from home.

This quarter has seen a reversal in some of the trends we reported the last quarter as the value momentum has subsided and growth has reasserted itself – possibly only on a temporary basis – generally as a reflection of sentiment around yields and rate increases. The market will remain sensitive to interest rates, but the lowering of yields has, for the time being, reduced that threat to the sector.

As we noted in the previous review, the position for many investors in direct property is probably now as much about liquidity, access, and timeframe requirements as it is about the diversification that direct property can provide. With FCA changes soon to be published this may become more difficult to manage for those with a shorter-term investment horizon as access to funds could be more restrictive. Direct property can offer low correlations to other asset classes so should not be ignored but clearly practicalities need to be factored into any investment decision.

Summary

2020 demonstrated how difficult short-term forecasting can be and, despite the consensus view of a strengthening economic recovery and continued stimulative monetary policy, markets in 2021 have seen some of the strongest levels of style rotation in the post crisis period illustrating how easy it is for investors to be whipsawed and suffer relative underperformance. This market volatility is not readily apparent at the index level and perhaps a lesson to take from this is the necessity of taking a longer-term view in today's world as few investors would be able to successfully anticipate these moves and rotate portfolios in a pre-emptive rather than reactive manner.

Markets have continued to front run the global economic recovery and have been prepared to look through second or third waves of Covid-19 lockdowns due to the belief that vaccine efficacy will result in eventual economic recovery. This is especially true of the developed versus the emerging world where, with the exception of North Asia, growth rates are now below those of advanced economies. Markets continue to focus on the prospects for recovery in the second half of this year and into 2022 and beyond, encouraged by the step change in economic policy making, combining fiscal support with monetary stimulus. The world is undoubtedly seeing the most dramatic policy shift that has occurred in

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the last 30-40 years with, for example, US President Biden increasing the government's share of GDP from 20% to 25%, higher therefore than its pre-pandemic level. With the adoption of Keynesian policies there is a belief in a trickle up rather than trickle down response. Markets have even been unperturbed by potential shifts in taxation and by US standards the Biden administration is advocating a significant re-distribution of wealth from companies and high earners to those with the greatest propensity to spend. Developed country governments and central banks now all favour higher wages for the lower paid. There has been a sea change in attitudes to fiscal policy away from the belief that government debt levels matter, which ushered in a period of austerity post the Financial Crisis. Whilst a full adoption of modern monetary theory (MMT) has not yet fully accepted, central banks have altered their thinking towards outcome-based policies rather than being outlook focused, which is very different to what has occurred in the past 30 years.

Markets have remained relatively relaxed after a period of turbulence in February and March, due to the belief that inflationary pressures will be transitory and there are clearly strong arguments both in favour and against this view. For inflationary pressures to persist it will be necessary for wages to increase in line with price rises as this would result in seemingly one-off increases in prices to cascade through the system, and permanently raise inflationary expectations. This remains the chief threat to financial market stability today. Unfortunately, as much of current economic policy can be best described as experimental, the precise outcomes must have a significantly lower level of certainty than the continuation of more tried and tested macroeconomic policies.

Forecasting has always been uncertain, and the distinct events of the past two quarters, when the driver of equity market outperformance has arguably been movements in government bond yields, suggest the most prudent course for investors is to adopt a balanced approach to portfolio construction. Historically, investors would expect value orientated strategies to perform well when economic growth was accelerating, and whilst this proved true in the latter two months of 2020 and the first quarter of 2021, it cannot explain the underperformance of value in the second quarter of this year. Value has underperformed even as economic growth rates and forecasts of economic profitability have improved.

This interim market volatility suggests that, for most investors, extreme style views could be costly and the chances of successfully exploiting style rotations in a portfolio unlikely. To date in 2021 economic fundamentals have improved, and even in areas such as South Asia where coronavirus numbers have remained persistently high, valuation opportunities and the more favourable demographics suggest exposure to the consumer story for long term investors will arguably be profitable. Whilst market valuations remain above long-term averages, a combination of a lasting economic recovery, and historically low interest rates gives support to equities, especially when no other asset classes offer strong long-term value. Whilst many professional investors like to argue that future returns will depend on stock picking, this has not been the case so far in 2021 where the chief driver of returns has been the ongoing battle between structural disinflationary pressures and a cyclical upturn in the inflation rate. The growth versus value debate will continue to depend on whether the era of secular stagnation highlighted by Laurence Summers (Economist) has ended or not. Overall, equity markets seem likely to be supported by the continued economic recovery and pro-growth measures, but market leadership is likely to continue to rotate in a volatile manner.

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