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Market Update

Monthly Round up May 2021

In a somewhat uneventful month, global markets continued to push upwards, albeit marginally. Economic data releases remain reflective of the ongoing bounce in activity, principally in the UK and US, while strengthening vaccine programs in other developed nations are bolstering the global outlook.

Outperformance of value stocks has persisted since the first positive vaccine related announcements in November 2020, with the ensuing economic normalisation and its resultant effect on interest rate and inflation expectations causing a number of sharp sell offs in growth sectors. Despite this late 2020 reversal, the US-based NASDAQ remains the strongest performing major index over one year.

01/06/2020 - 31/05/2021 Data from FE fundinfo2021

Regionally, we are still seeing the effects of Covid-induced lockdowns playing out in market returns. Consumer activity in those areas that are successfully reopening, namely the UK and US, is proving very supportive for growth, while stronger than expected Q1 corporate earnings have boosted confidence in the strength of the global recovery. Despite this, investors are erring on the side of caution when it comes to allocating to the more expensive growth names, leading the technology and consumer discretionary sectors to remain under pressure.

In line with this, the year to date trend towards value and small cap stocks does not appear to be reversing. The MSCI World Large Value index is up 16.01% over the period, while its growth counterpart, the MSCI World Large Growth has gained only 6.86%.

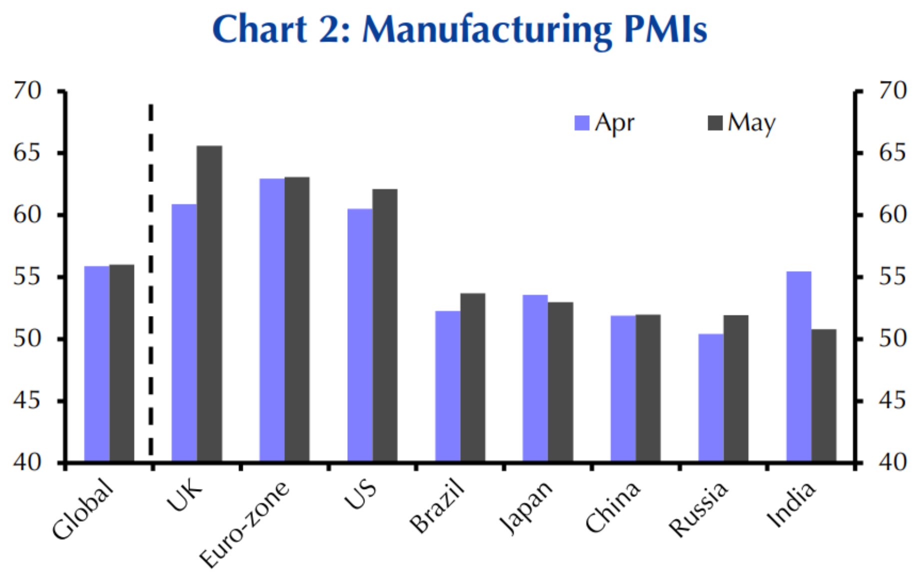
Drastic improvements to vaccine programs, coupled with positive data reports have helped advance growth prospects within the Eurozone, leading to outperformance of the Euro STOXX index versus other major indices through May.

However, lingering restrictions in the region mean consumer demand is still slow, and full normalisation, especially within the service sectors, continues to lag that of the UK and US.

Emerging markets remain a mixed picture. Having sold off through the end of Q1 and into Q2, valuations within Chinese markets are again becoming attractive, while other countries are struggling to make gains as they grapple with the effects of new virus waves.

Growing demand for inflation protection pushed up prices of US TIPS and UK Index Linked Gilts through May, albeit year to date returns on the securities are still negative. Looking at broader fixed income, investment grade credit and conventional government bonds continue to face headwinds as the risk of rising rates weighs on outlook.

Commodity markets have retained their upward trajectory, with the Bloomberg Commodity Index adding a further 2.7% in May, bringing its year to date performance to 18.9% - this makes it the strongest performing broad asset class over the period. With already-surging demand and commodity heavy government infrastructure plans in the pipeline, the sector looks well supported as we move through the remainder of the year.

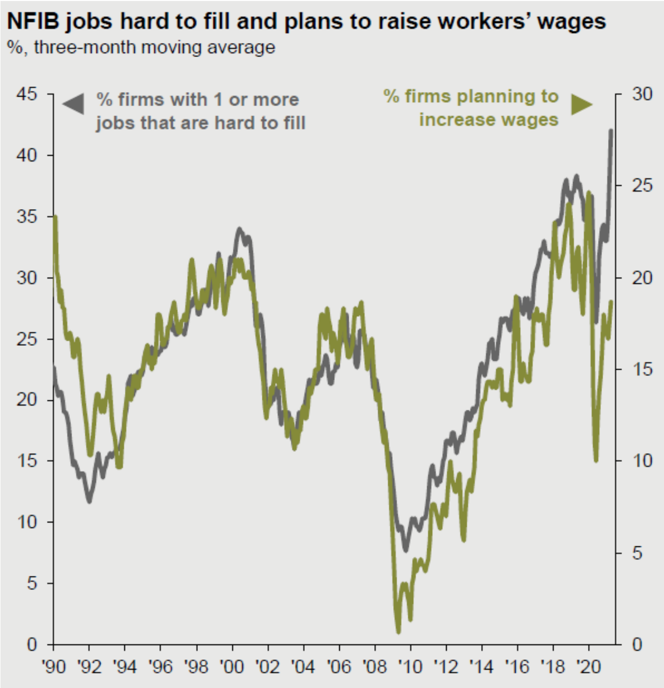


In a similar vein to last month, global manufacturing Purchasing Managers' Indexes (PMIs) indicate industrial production remained strong through May, with the UK seeing a large jump in output. Meanwhile, surging demand is undoubtably putting upward price pressure on production, and commentators are now beginning to note the negative effect it is having. Moreover, while global inventory levels are at record lows it is expected that demand pressures will be further exacerbated as companies look to restock.

As rising goods prices filter through to CPI data, central banks are upholding their narrative that current rising inflation is transitory as opposed to anything more structural, i.e. once supply and demand level out, inflationary pressures will desist. Despite this doing little to reinforce stability in fixed income markets, their assertions are backed by labour markets, which are still experiencing slack and are yet to see material wage growth. Until this occurs, we expect monetary policy to remain accommodative.

For now, our base case is that the rate of change in inflation is likely to level out over the next 12 months. Given how inflation indices are measured (generally on a year-on-year basis) it's important to look ahead to determine what, if anything will be driving prices higher in a year's time. It's possible but unlikely that 'hot' sectors such as energy, commodities and used cars could continue to see surging prices, meaning the gains we see now will wash out in 2022. Further, emergency fiscal programs are set to expire through 2021, removing a buffer for millions of workers that has helped prop up earnings and spending, while the jobs picture in areas such as travel and leisure still remains uncertain.

That said, in the US in particular there is the potential for upside surprises in terms of discretionary wage growth. The chart below shows survey data from the US collected by the National Federation for Independent Businesses (NFIB), which indicates that firms are both struggling to fill jobs and planning to increase wages. Anecdotally, there are many stories of large and small firms having to offer incentives including much-increased basic wages to new staff members, all of which fits with the Biden administration's desire to run the US economy hot, so that tightening labour markets boosts the bargaining power of those working at the bottom:

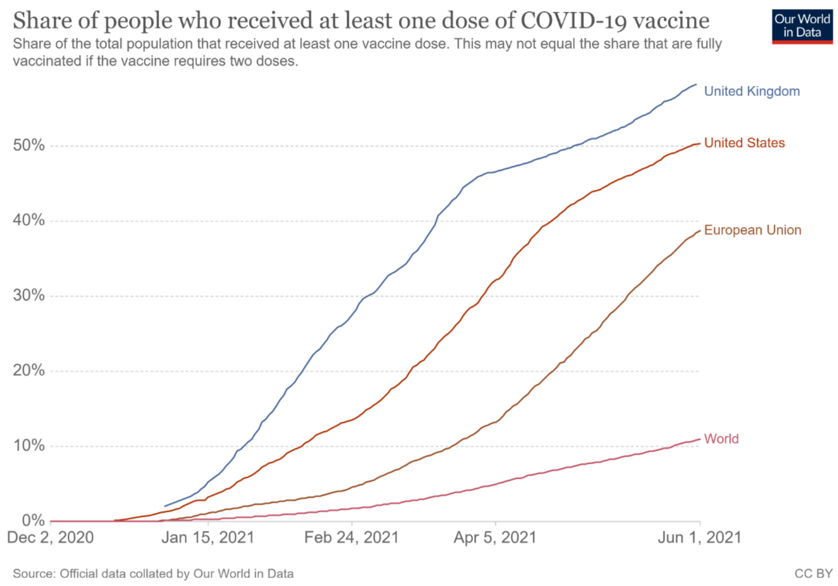


For now, continuing improvements in economic data points coupled with positive real-world vaccine efficacy data are together encouraging for growth moving forwards.

Looking to the virus itself, following the rocky start to its vaccine roll out, President of the European Commission, Ursula von der Leyen has recently stated that the bloc is on target to meet its goal of having vaccinated 70% of adults in July, which would pave the way for much broader reopenings across the region. Despite this and the successful vaccine programs in place across many developed nations, concern remains around new (and yet undiscovered) variants, with governments still treading very cautiously around plans to remove all forms of social distancing and restrictions on activity.

While the UK is potentially set to be one of the first nations to completely remove all restrictions in June, government ministers are now seemingly preparing the public for a delay – this in spite of vaccinations remaining highly effective, and with the vast majority of vulnerable people fully protected. The resumption of Covid restrictions remains a downside risk for us, regardless of our thoughts on their logic, and is something we continue to closely watch.

As May came to a close and UK regulators authorised Janssen's single dose vaccine, data indicated that the UK and US had provided at least one vaccine dose to 58.1% and 50.4% of their populations, respectively, while the global tally has reached just 10.9%. Emerging market nations in particular are struggling for vaccine supplies, even as the Western world looks to start giving jabs to its youngest cohorts at the lowest risk from the virus:



Looking forward, outperformance of risk assets is expected to persist through 2021, with shorter duration assets predicted to outperform while inflation is elevated – in equity this relates to a value bias versus growth, while shorter maturity bonds are preferred versus their long dated counterparts. Regionally, we continue to favour the more undervalued areas, namely the UK, Emerging Markets and Asia, albeit this is subject to volatility as the virus continues to cause disruption. Inflation is set to rise as we move through the remainder of the year, as demand outstrips supply, however the longevity of such inflationary pressures is still unclear. In this environment, portfolios will benefit from holdings in real assets.

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