Monthly market blueprint

Investment management service

March 2021

mazars

Contents

Foreword

Inflation is not-yet-the problem

Late in 2020 equity markets climbed on the anticipation of vaccinations and are now consolidating at higher levels. They are now trading sideways, patiently waiting for economies to open and earnings to catch up to heightened valuations. In the first two months of the year, equities have gained a healthy 2.6% (though less than 1% in GBP terms). Nevertheless, for all the excitement about vaccines and the impending reopening of the global economy, investors understand the exceptional equity performance since last year and, in fact, risk asset performance in the past twelve, is primarily owed to the ability of central banks to absorb risk. Central banks have been, and continue to be, the "only game in town". The cornerstone of their ultra-accommodative policy has been the absence of inflation, which would compel them to adhere to their mandate and tighten money supply in the real economy, to the detriment of the financial economy.

In February, and early March, we are seeing a challenge to this main cycle-long thesis that central banks will continue to encourage risk taking in markets. Market inflation expectations (implied by the differential between simple government bonds and their inflation-linked counterparts) have been steadily climbing. Real-time data suggest a pick-up in inflation in the next few months. This is due to higher input costs, a result of broken supply chains, plus an expected jump in consumption as economies reopen. In other words, inflation pressures are on both the demand and the supply side, and that is no accounting for the unavoidable timing effect, as we begin to compare against the beginning of the lockdown at the same time last year. Inflation is mainly showing up on the longer end of yield curves. Thus, long maturity bonds have begun to climb, exacerbating fears that central banks have lost control of the yield curves, and thus their ability to dictate market prices.

We believe that these inflation pressures are transitory and that at current high valuations, it is natural for investors to exaggerate fears and take some risk off the table. And, if we have learned anything in the past few years, is not to fight central banks. Currently, monetary policy makers have signaled that they are willing to tolerate higher inflation insofar as it transitory. Their concerns lie more towards any tepid growth, new Covid variants and the possibility of an early retraction of fiscal accommodation which could hamstring the recovery.

Risks exist that inflation might peak higher than expected or overstay its welcome, but impending unemployment pressures, once fiscal stimulus dissipates, are enough to remove those worries for now.

We have no reason to believe that our underlying assumptions about markets have been changed by the exogenous event of the pandemic. However, we feel that once the pandemic has passed, countries and the banking system must address the decade-old disconnect between the real and the financial economy. Simply put, central banks can make sure there's little downside risk to the financial economy but can't do the same for the real economy. Yet, their primary mandates (inflation, unemployment, growth) are very much real-economy concerns. What is sorely needed is innovation. A decade ago, bold central bankers on both sides of the Atlantic utilised largely untested financial tools, including quantitative easing. Political authorities, cognisant of the amount of responsibility and awesome power that wrests on the shoulders of central bankers, especially due to their own reluctance to expand fiscally, gradually replaced economists with figures more political, more able to compromise. As a result, central bankers are not surprising governments anymore (no more impromptu 'whatever it takes' speeches) but are also not daring enough to adjust policy tools to address secular stagnation, flat yield curves and growth challenges in a post-pandemic world. The strongest possible catalyst for a breakout in risk assets from their current levels and the return of trust in the real economy, would be signs of daring new policy ideas from central banks.

George Lagarias
Chief Economist, UK

Market performance – in a nutshell
The month in review

Rising Covid-19 cases and volatility dampens equity markets

Equity market performance was linked to vaccination programme success in February. The most advanced countries in terms of vaccinating their populations enjoyed the strongest gains in equity markets.

UK equities were up +1.6% in February, the best performing major equity market in Sterling terms last month. Investors increased their demand for Sterling, which led to an appreciation against both the US Dollar and Euro by +1.9% and +3.2% respectively. The UK markets benefited from a steepening yield curve and rising oil prices, which are themselves indicators of improved economic growth outlook. A steeper yield curve and higher oil price benefits the profitability of the UK's two most overweight equity market sectors, Financials and Energy.

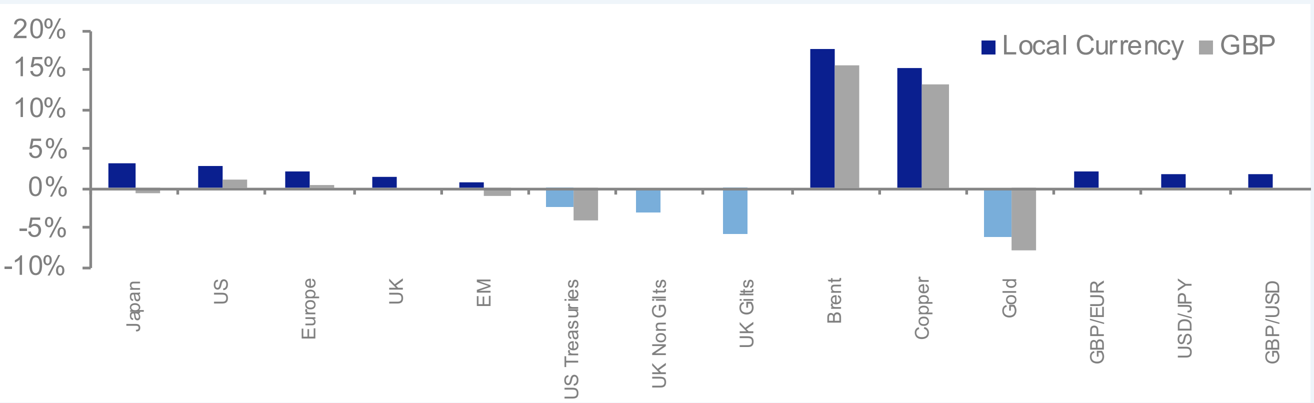
US equities were the next best performer in Sterling terms in February up +1.0%. US equities have been supported by plans for massive fiscal expansion with the Biden administration pushing through close to $1.9 trillion. This has helped push inflation back to the forefront of market discussions and has seen markets price in higher inflation expectations, seen in the steepening US yield curve.

European equity markets performed reasonably well, up +2.2% in local currency terms. However, after currency effects this meant European equities were unchanged in Sterling terms in February.

Elsewhere, economic data showed a slowdown in Chinese growth, with PMI and inflation data suggesting weakening demand from the World's marginal buyer.

In bond markets, the UK 10-year was up +49.3 basis points to 0.82% whilst the US-10 year rose by +33.9 basis points to 1.41%, its highest level since the beginning of the pandemic. Gold fell -7.8% during February as markets become more bullish on the real economy. Oil rose +15.8% to $62 a barrel as investors increasingly price in a recovery of demand.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation
Changes in our strategic asset allocation

Outlook and portfolios

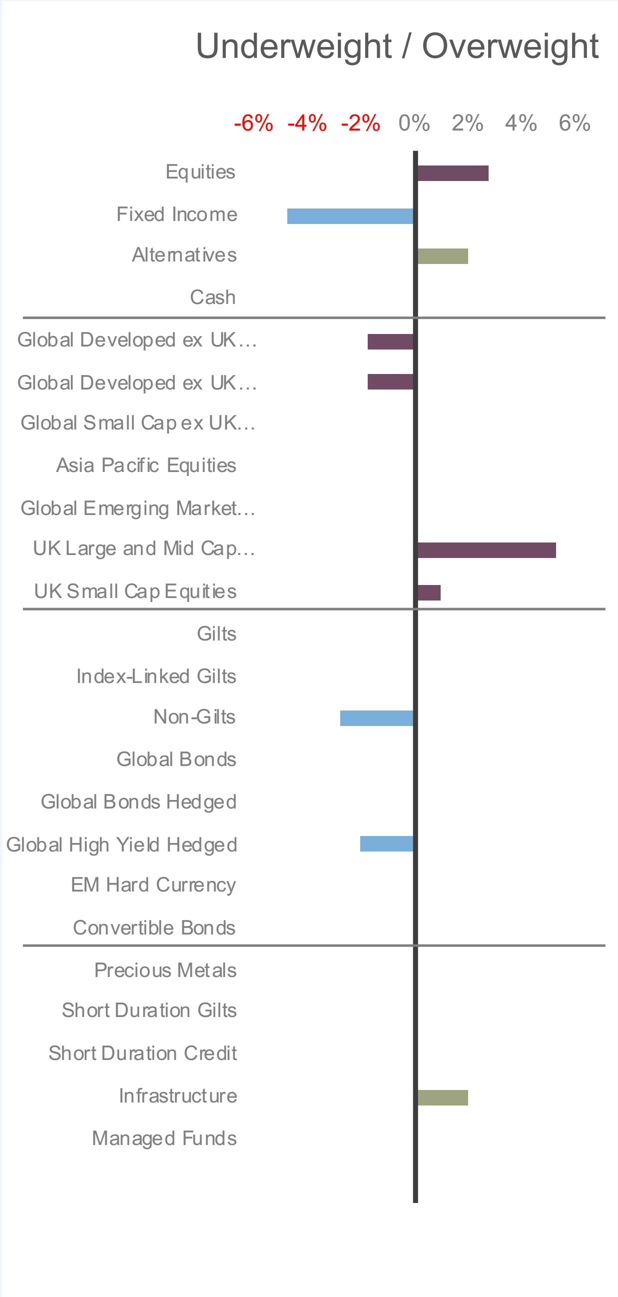
The 11-year global economic expansion cycle has come to an end, the result of a rare "Black Swan" event, a global pandemic. Economic data remains exceptionally volatile. Imbalances in the global economy are exacerbated by the chaotic and unpredictable nature of lockdowns and travel restrictions have heavily strained supply chains, causing a global container shortage crisis.

Central bank support has greatly contributed to the continuation of the financial cycle, even as the economic cycle broke down. Meanwhile, extensive borrowing has supported employment and consumption. The rate of retracting stimulus will be of great importance for businesses when they plan for the recovery, especially in the more month-to-month cash-flow-sensitive services sector.

Following a re-evaluation of our long-term asset return and volatility assumptions, the Mazars investment committee has decided to proceed with a number of strategic changes in our portfolios. We reduced home equity bias significantly and reduced the levels of government debt to reflect our conviction of low yields persisting over the longer term. Conversely, we increased international exposure through global equity ETFs, which both reduce the cost of maintenance and have asset classes available to cater for our need to hedge to Sterling. We also increased weight in less traditional areas of fixed income such as emerging market debt and convertible bonds.

We remain slightly overweight equities and risk, in the belief that even a central bank-guided market can still deliver returns. In terms of geographical allocation, we haven't made large deviations from the new benchmark, and rely more on our fund selection to create alpha. Our underweight in fixed income continues as a result of structurally low yields. In terms of Sterling, we keep close to the benchmark. We maintain a healthy exposure to gold, as the asset class remains uncorrelated with equity markets and would tend to gain in times of aggressive monetary accommodation. We zeroed out the asset class in our portfolios, mostly due to liquidity concerns. In terms of alternatives, we maintain exposure to infrastructure, which we believe might be a beneficiary of increased fiscal spending in the next few years.

Mazars balanced portfolio as of 28 February 2021



Risks ahead
Avoiding policy mistakes will be key

Global economic growth faltered at the swiftest pace since WWII, but overall asset prices have kept climbing as policy makers actively sought to avoid market panics. Over the short-term, Covid-19 has had a significant impact on both economic fundamentals and market sentiment, while adding to de-globalisation pressures. The development of vaccines is good news, but logistical and production issues, as well as mutations which can become more menacing as the pandemic persists are still cause for concern

Nevertheless, despite Covid-19 being the primary driver of economic performance, markets' focus has been primarily fixed on quantitative easing, with investors convinced, for now, that central bank risk suppression will is potent enough to weather the economic storm. The rate at which monetary and fiscal stimulus will be withdrawn is the main risk for the upcoming economic recovery.

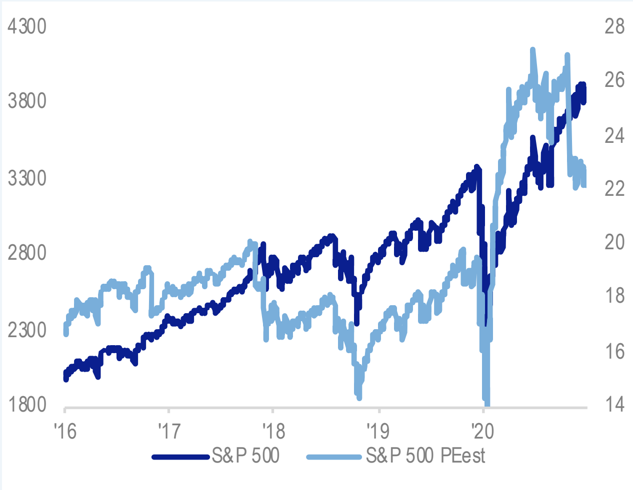
Stock prices are near all time highs, but with earnings yet to catch up. Expensive valuations are creating a ceiling against further breakouts. Meanwhile, global bond yields have begun to climb, on inflation fears, however we feel the move is temporary and inflation pressures will recede. At any rate, the Fed has signaled it will tolerate higher inflation for now. However, many companies find themselves with weaker balance sheets. If there is an inability to raise new debt or refinance old debts, especially in the face of a sudden stoppage of operational cash flows, we could see devastating consequences, especially for smaller/mid-caps and companies teetering at the edge of the investment grade spectrum.

In the US, risks have been somewhat reduced, after the return of a more multilateral-oriented government following the last election. In the UK, a weak economy is further threatened by adjustment issues surrounding a 'Hard Brexit' deal. In China, growth conditions have been restored, and stimulus is slowly being withdrawn. In Europe some of the risks were mitigated, as countries have coalesced to mutualise some of the debt raised to fight the virus. However, problems in vaccine rollout and the dissolution of the Italian government are still red flags for investors.

We feel that short-term systemic risks are being reduced but that longer term risks are building up, especially in the form of high indebtedness.
Debt, the bill countries will have to pay for supporting their economies, will certainly be at the heart of the next debate.

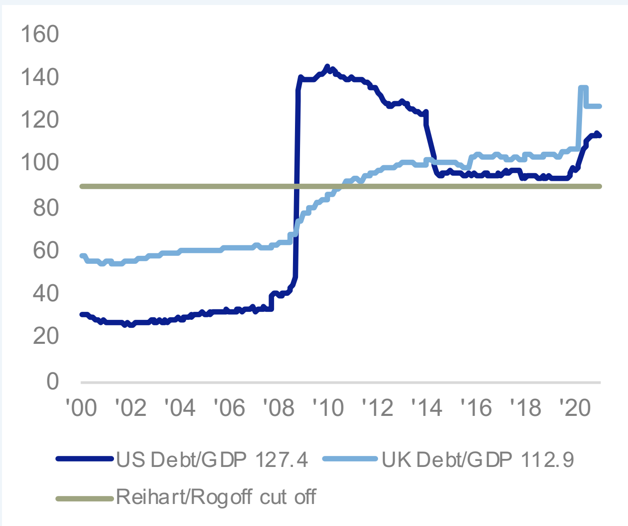
Valuations are still elevated

(S&P 500 and forward P/E ratio)



Debt has risen to levels above 100% of GDP

(Debt/GDP %)



Charts Source: Mazars Calculations

Macroeconomic backdrop
Global

For the period, global stocks rose by +2.6% (+0.8% in Sterling terms). The highest performing sectors were Energy and Financials while the worst performers were Utilities and Healthcare. Equities were trading at 20.66x times forward earnings, 28% above long-term average. Gold fell 6.1% and oil prices rose 17.8%.

As a result of lack of global coordination, economic performance remains de-synchronized across the board to the point where a uniform economic commentary is becoming very hard to articulate.

Asia has recovered the most, with the Chinese economy credibly claiming that it's now above pre-2019 aggregate output levels. The US, which never locked down on a national basis is following a decisively different strategy, through heavy borrowing and spending to support businesses and focus on vaccine development. The UK, which borrowed less, has arguably seen the biggest strain on its economy, a product of an extremely heavy Covid-19 toll and hard Brexit. Meanwhile, the EU, who negotiated the longest over vaccine contracts, is now experiencing the economic repercussions of this strategy, as wave after wave and mutation after mutation ravage its economy. Overall economic performance, both in manufacturing and services, picked up in February, as key G7 countries are now seeing a recession from the pandemic, after having reached critical levels in vaccination. Nevertheless, supply chains remain strained and inflation, at least for the shorter term, is coming back. Central banks remain accommodative however, calculating that a rise in prices will only be temporary.

Outlook: Lockdown-associated uncertainties may persist well into Q2 2021, a period after which there's a consensus estimate that economic conditions should start to improve materially. However, operational risks in vaccination rollouts and possible impactful mutations still create a litany of downside risks for the global economy, much more so than the possibility of a major policy mistake. Portfolio managers can, by and large, rely on central banks and governments to support risk assets, but should still be on the lookout for risks which might demand more aggressive policy approaches, or even transcend the ability of policy makers to deal with them.

Global stocks are at all-time highs
MSCI World, gross total return

Inflation expectations picking up
Market-implied 5y inflation expectations

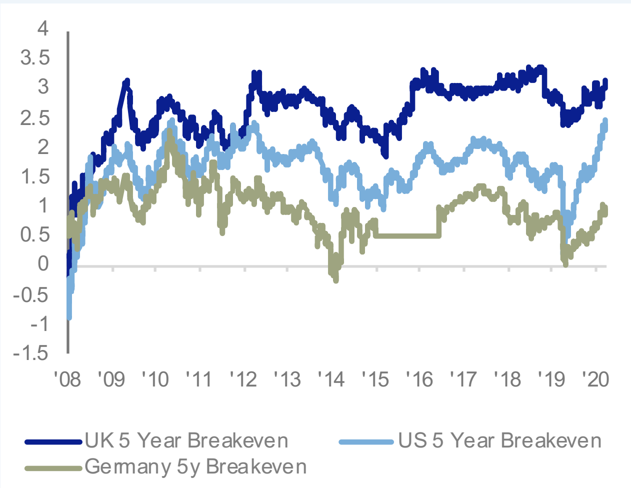


Chart source: Mazars Calculations, Markit

Macroeconomic backdrop
UK

UK equity markets provided the best returns to investors in Sterling terms during February, up +1.6% for the month. Investor sentiment turned increasingly bullish on the relative attractiveness of the UK to other regions, helping Sterling to appreciate against trading partners. As a result the more domestically focused small and mid cap indices outperformed large-cap peers.

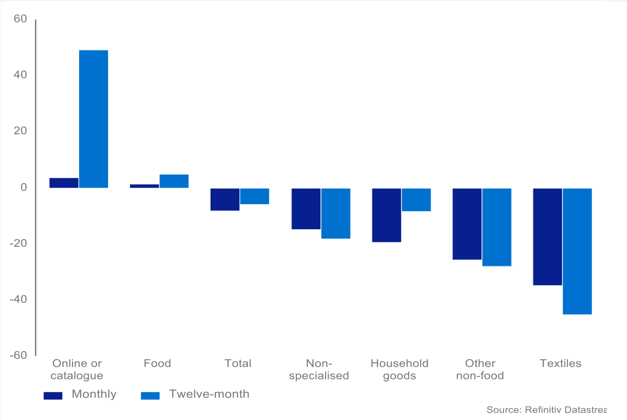
The UK markets benefited from a steepening yield curve and rising oil prices, which are themselves indicators of improved economic growth outlook. A steeper yield curve and higher oil price benefits the profitability of the UK's two most overweight equity market sectors, Financials and Energy. However, many sectors ended the month negative due in part to the late-month sell-off. Healthcare was the worst performing sector in February. UK stocks are trading at 14.65x forward earnings at a discount of 29% to the MSCI World, representing the greatest discount to the MSCI World on a valuation basis of the major equity markets. The UK 10-year yield rose +49.3 bps, driven in part by the improving economic outlook.

The economic situation has reached a crossroads between the dire current economic situation, and the increasingly rosy outlook. Retail sales fell by more than expected showed data released in February, down 8.2% twice the expected fall. However consumer confidence improved, from admittedly low levels. This combined with improving PMI data begins to suggest the UK may be entering a recovery phase whereby although economic data may be in contraction territory it is improving month-on-month. Business confidence in PMI surveys about the economic situation over the next year reached a seven-year high. Meanwhile unemployment rose slightly, although more timely indicators such as PAYE earnings data suggests a slight increase in jobs for the second consecutive month.

Outlook: The UK now appears to be one of the favourites for economic recovery in 2021. It should be noted that some of this is merely a catch-up effect from the dire economic and health consequences over the last twelve months. However, the vaccination success provides the UK with an opportunity to begin to open up again, crucial to the economic outlook is whether consumers begin to spend the savings households have built during the pandemic.

Online sales the key area of growth in retail

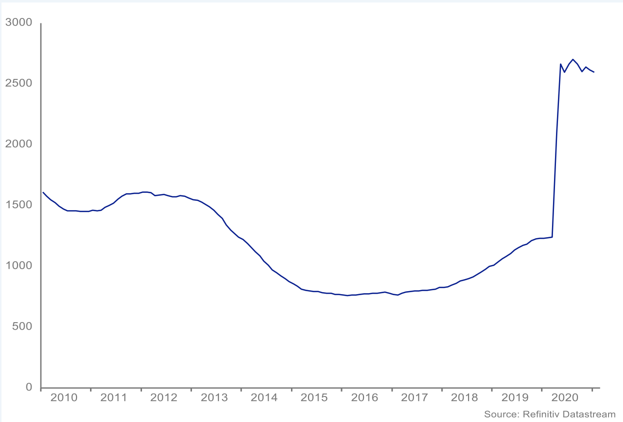
Percentage changes, by type, January 2021



Retail sales fell by more than anticipated at the latest reading. Online retail sales growth has been a key change since the start of the pandemic, far exceeding its rate of growth pre-pandemic as consumers are prevented from shopping on the high street.

Claimant count falls more than expected

People, thousands



Despite the unemployment rate ticking 0.1% higher, the claimant count fell 20,000 in the latest reading. Far exceeding expectations of a 35,000 rise.

Macroeconomic backdrop
US

For the period, US stocks rose by +2.8% (+1% in Sterling terms). The highest performing sectors were Energy and Financials while the worst performers were Healthcare and Cons. Staples. Equities were trading at 22.22x times forward earnings, 30.4% above long-term average and 7.6% above the MSCI World. 10y bonds rose 34 bps at 1.4%.

Economic activity in the US continued to improve at a modest pace, as the country weighed carefully the cost of avoiding national lockdowns against public health concerns. The country's leadership in online shopping has also helped balance the effect of localised retail lockdowns. Manufacturing activity continued to constitute a pillar of recovery despite disruptions and challenges in the supply chain. Residential real estate activity remained strong with house supply tightening significantly. Employment conditions continued to recover; however, the data is volatile as local restrictions affecting key sectors of the economy persist.

Throughout the crisis, the central bank has provided ample liquidity and several fiscal packages have been signed to contain the economic fallout and help restart the economy quicker.

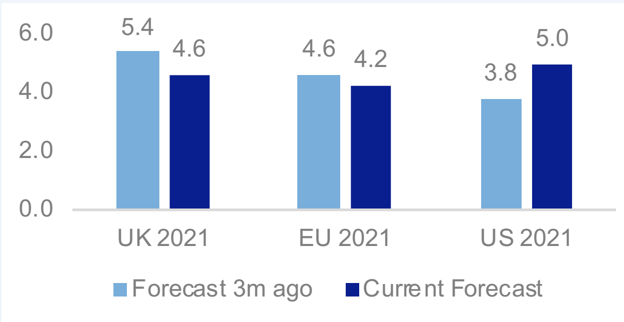
Outlook: The main factor for economic performance in the next few quarters will be the rate of lockdowns, with vaccination rates determining the possibility of further disruption in economic activity. The United States have the second highest vaccination rate within the G7 (23/100), second only to the UK (31/100).

The other factor will be the rate of stimulus withdrawal. However, currently stimulus is being expanded, with an extra $1tn to $1.9tn being negotiated in Congress.

A very important aspect of economic performance, prices, has seen modest increases. Forward-looking data from Markit PMI suggest that, due to the continued resurgence of input costs, we could see a material yet temporary pick up in inflation going forward.

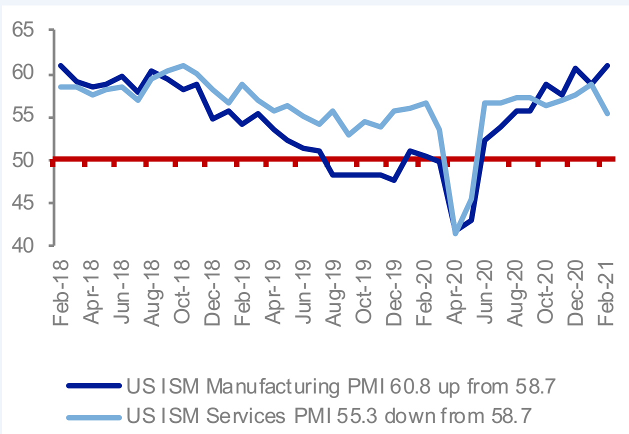
US economic forecasts for 2021 improved

(Bloomberg economic forecasts)



Economic activity is till expanding rapidly

ISM manufacturing PMI, prices paid, >50 = expansion



Charts Source: Mazars Calculations

Macroeconomic backdrop
Europe

In February European stocks rose by +2.2% (0.0% in Sterling terms). The best performing sectors were Financials and Materials while the worst performers were Utilities and Healthcare. Equities were trading at 18.08x times forward earnings, 21% above their long-term average.

Europe is facing several issues which could delay its recovery from the pandemic. The EU has a long road ahead to implement its coronavirus vaccination program due to supply shortages coupled with structural deficiencies. As of the end of February, only 6.4% of the EU's population has received a vaccine. In addition, restrictions to ease the spread of the virus will not be lifted very soon due to recent local rises in infections(e.g. Paris, Lombardy region).

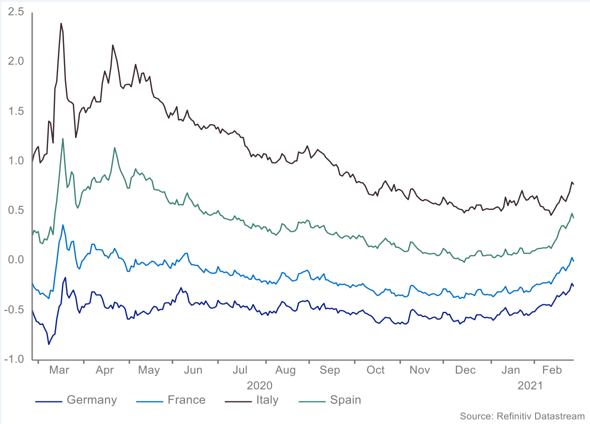
Euro area annual inflation was 0.9% in January 2021, up from -0.3% in December 2020. Inflation, together with future inflation expectations, has risen, largely driven by short term factors (e.g. VAT tax cut in Germany) and supply-linked base effects. Investors have started pricing the inflation risk premium more heavily thus driving long term government yields higher during the last few weeks.

Fourth-quarter GDP growth rate for Germany was revised upwards to +0.3% from an initial estimate of +0.1%. Despite weak household final consumption the German economic growth was driven by strong fixed capital formation in the construction sector coupled with increased foreign trade. Meanwhile confidence in the eurozone area improved with the Economic Sentiment Indicator rising to its highest level since March 2020.

Mario Draghi, former head of the ECB, has become Italy's new prime minister after receiving parliamentary majority. Mr. Draghi was invited to form a government of national unity following the collapse of Giuseppe Conte's coalition.

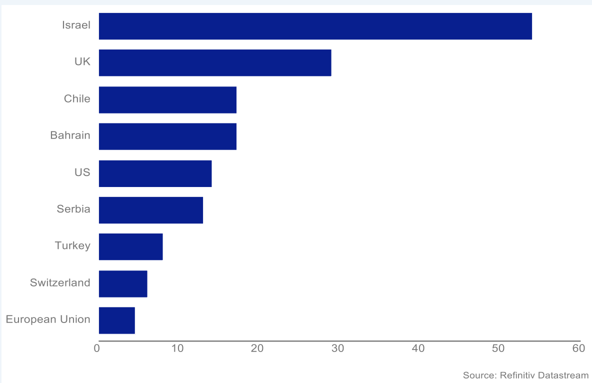
Outlook: The main factor for economic performance in the next months will be the pace of the rollout of the vaccine. This will determine the timeline of easing restrictions within the euro area. In addition, inflation spikes (even though characterised as temporary by the ECB) will determine the extent to which real yields will rise further. Finally, the EU is expected to benefit from the release of the European stimulus package from the end of Q2.

Rising government Bond Yields
10Y Bond Yield, Percent



Long-term bond yields have been rising both in the core and periphery of Europe amid high future inflation expectations.

EU is lagging the race to rollout the vaccine
Per cent of population vaccinated with at least one dose, 26/02/2020



The EU has distance to cover faring far behind the top of the race to rollout the vaccine.

Macroeconomic backdrop

Japan and emerging markets

For the period, Emerging Markets stocks rose by +0.8% in local terms but fell -1.0% GBP terms. Japanese stocks rose +3.1% in local terms but fell -0.5% in GBP terms. The best performing sectors were Utilities and Transportation in Emerging Markets while the worst performers were Technology and Healthcare.

China's economic recovery slowed in February as factories shut during the Lunar New Year holidays and virus restrictions dampened what's usually a busy travel season. The official NBS manufacturing PMI fell to a nine-month low of 50.6 in February from 51.3 in January as export orders plunged. The NBS services sector PMI declined to 51.4 in February, down from 52.4 in the previous month. The official loan prime rate—a reference rate for new renminbi loans—was unchanged for the 10th straight month. February marked the second month of net liquidity withdrawal by China's central bank, something not seen since March 2019, possibly signalling an inflection point for monetary policy.

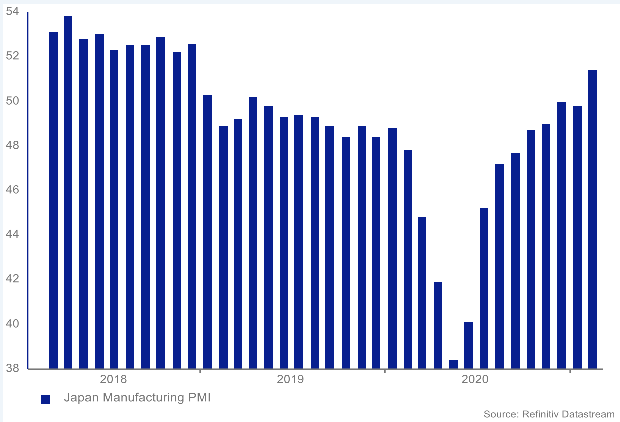
Japan's GDP grew at an annualized rate of 12.7% in Q4 2020, lower than market consensus of a 9.5% expansion and following a revised 22.7% growth in the previous period. Japan Manufacturing PMI was 51.4 in February, up from 49.8 a month earlier, marking the first month of expansion in factory activity since April 2019. The service sector PMI declined to 45.8 in February, from 46.1 in January, as businesses struggled to mitigate the impact from emergency measures taken to curb the spread of coronavirus in Tokyo and nine other prefectures.

Other Emerging Markets like India and Korea also saw a pick up in manufacturing and trade activity. Manufacturing PMI in Korea rose to 53.2, the highest since February 2011. India's GDP grew +0.4% YoY in Q4 2020, recovering from -7.3% drop in Q3 2020.

Outlook: Despite a bumpy ride in 2020, emerging markets have demonstrated their resilience picking up steam in Q4 2020 thanks to Covid-19 vaccine breakthroughs and the US election outcome. We expect that emerging markets economies will benefit further as the vaccine distribution begins.

Japan manufacturing PMI

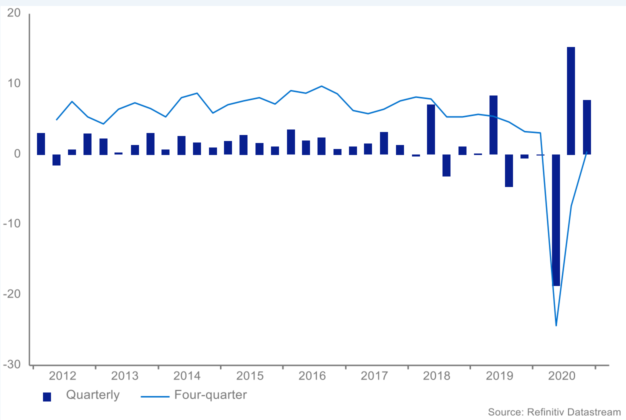
Pent-up demand lifts manufacturing revival



Manufacturing activity in Japan expanded at the fastest pace in over two years suggesting export-reliant economies are benefiting from robust global trade.

India GDP growth

India's economy returned to growth in Q4 2020



India's economy witnessed its first expansion in three quarters as the government opened economic activities in phases from June after a coronavirus lockdown in late-March.

Our themes

Macro theme 1

End of the beginning for Covid-19

As of Q4 2020, the annual GDP growth rate of the UK stood at -7.8%. China was the only major economy to experience a positive GDP growth rate, of +6.5%, during that same period.

While there is no way to exactly evaluate what the economic damage from the pandemic will be, there is widespread agreement among economists that it has, and will continue to have, severe negative impacts on the global economy. Last year, early estimates predicated that, should the virus become a global pandemic, most major economies will lose at least -2.4% of the value their GDP over 2020. As actual GDP data for 2020 is reported out of the world's seven largest economies, the United Kingdom was the most negatively affected by the pandemic. As of Q4 2020, the annual GDP growth rate of the UK stood at -7.8%. China was the only major economy to experience a positive GDP growth rate, of +6.5%, during that same period. Governments around the world are acting decisively to protect their businesses and people from the economic disruption caused by Covid-19.

Although the prospects of an economic recovery look positive, the damage done so far makes it a challenging one. In its January World Economic Outlook Update, the IMF projected global economic growth at 5.5% this year and 4.2% in 2022. However, a report by the World Bank notes that losses relative to pre-pandemic expectations are large and likely to prove permanent, partly due to the damage done to investment and human capital. Other contributing factors include the combination of pre-existing economic weaknesses before the pandemic with increased fragilities, such as rising debt.

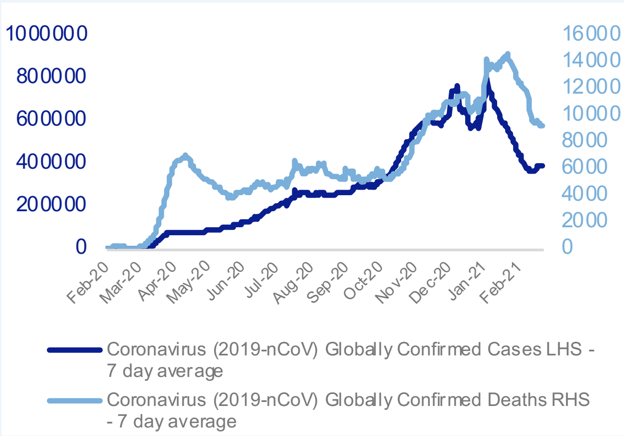
Global stocks had their best month since 1988, propelled by a series of Covid-19 vaccine breakthroughs in November 2020. The rally reflected investors' growing eagerness to buy into risky assets, encouraged by progress in the development of Covid-19 vaccines at pharmaceutical groups Pfizer-BioNTech, Moderna and AstraZeneca. Investors moved out of tech stocks into sectors that they expect to benefit most from a quicker end to the health and economic crisis. The gains came despite a surge in coronavirus infections and fresh lockdowns across the globe that pose a threat to the economic recovery achieved in recent months.

Now that several vaccines have been developed and won regulatory approval in record time, the aim is to vaccinate as much of the adult population as possible, as quickly as possible. According to Our World in Data, at least 268 million doses of Covid-19 vaccines have been administered around the world already. Vaccine rollouts in advanced economies are largely outpacing those in emerging and developing economies — even in countries with similar death rates. Raising concerns of inequality that sees the young of rich nations vaccinated before elder people in poorer nations. The lasting impact of this health inequality could materially impact economic outcomes.

As vaccination efforts accelerate, daily new cases and mortalities are falling. This should allow economies to recover gradually as normality returns and consumers are finally free to unleash their pent-up savings.

Global Covid-19 cases/deaths

New cases and deaths have plummeted worldwide



The situation has vastly improved, and vaccine roll-outs across the world are a huge step forward. But the WHO has also pointed out that the world is far from done with the pandemic.

Macro theme 2

Inflation as a red herring

Heightened inflation expectations led a simultaneous retrenchment of stock and bond indices. In February and early March, markets experienced a situation similar to the infamous 2013 ‘Taper Tantrum’, a violent bond and stock market reaction to the Fed’s plan of tapering Quantitative Easing. In a world where risk is actively suppressed by central bank policy, assets become more correlated, and inflation is the only realistic inhibitor to the kind of unfettered accommodation that has driven risk asset performance for a decade.

Will inflation end the ‘central bank era’ for financial markets?

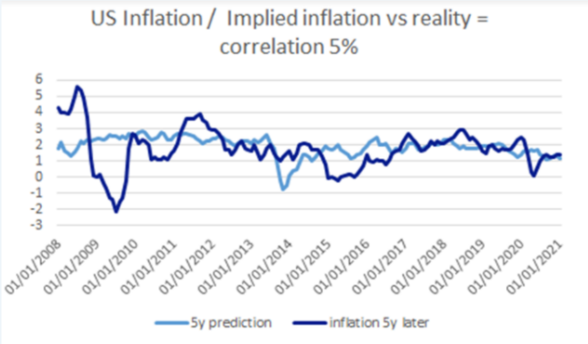
First, we must note that long term market expectations are not a reliable predictor of long-term inflation, as they correlate more with inflation in the next two months than with consumer prices in the next five years.

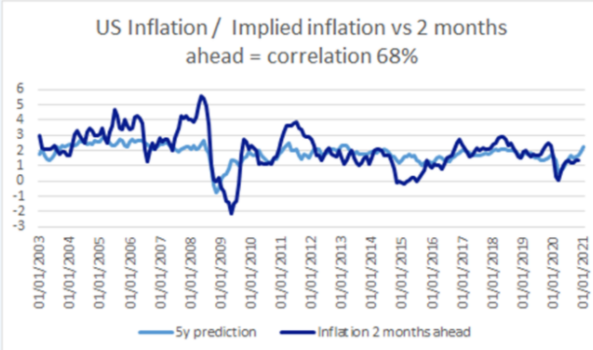
The market is using the 5y breakevens (nominal bond yield less inflation-linked bond yields) or similar measure to figure out what future inflation is priced in. As one would expect, the “market expectations” for inflation as a measure of inflation in the next 5 years are only 5% correlated.

The breakevens, or any other such measure, should primarily be seen from a “second derivative” perspective. It’s a measure of what the rest of the market is thinking, and possibly how bond traders will react. In macroeconomic terms, market expectations at best have a medium correlation with inflation in the next 2 months (68% correlation, with only 47% R2, a relatively low reading as a measure of goodness-of-fit). Which is why the Fed is more likely to dismiss those expectations and focus on the real data, especially their favourite, Core Personal Consumption Expenditure. The longer this number stays above 2.5% (currently 1.5%), the more pressure on the Fed to change policy.

Second, central banks have signaled that they are willing to tolerate higher short-term inflation, currently exacerbated by the effect of year-on-year calculations, a global supply chain crunch and demand boosted by the expected end of lockdowns and fiscal stimulus.

5-year inflation expectations more telling of 2-month prices





Charts Source: Mazars Calculations

Our view

We continue to listen to what central banks are saying and presently subscribe to their views. The year-on-year effect will pass, global supply chains will eventually repair themselves and demand will probably flatten out after the initial post-lockdown boost and the withdrawal of fiscal stimulus. In fact, governments are getting ready to end Covid-era fiscal easing for fear of an increased debt burden. Ahead of the UK Budget announcement on the 3rd of March, the government has signalled that it is as anxious to fund businesses that have suffered from the Covid-19 crisis, as it is to reign in fiscal spending and avoid deficits it may find difficult to tackle. Investors would do well to remember that this environment, where additionally unemployment could well remain elevated vis-à-vis pre-crisis levels, is hardly conducive towards long-term inflation. With risks in fact mostly on the deflationary side and the need to manage global debt levels, we expect the big central banks to remain active in steering risk assets for the foreseeable future.

Macro theme 3
Sterling strength

February saw Sterling rise +1.9% against the Dollar, and by +3.2% against the Euro despite a sell-off on the last trading day of the month as global markets were impacted by the fallout from bond markets.

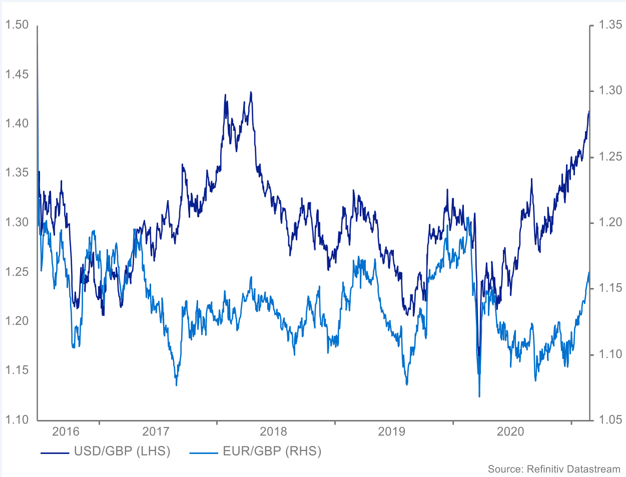
Sterling is trading close to its post referendum highs against both the Dollar and the Euro, this warrants a closer inspection of some of the forces driving Sterling.

Against the Dollar it is as much a story of Sterling strength as Dollar weakness. The chart shows that Sterling has been rising against the dollar for some time now. A combination of less demand for the 'safe haven' currency, as a result of an improved global economic outlook and a slowdown in global trade flows have weighed on the Dollar's performance in recent months. Further, the scale of fiscal and monetary expansion in the US far exceeds that of other developed nations which has put more downward pressure on the Dollar.

However, Sterling has begun to appreciate against most other trading partners indicating signs of a resurgence in the popularity of the currency. Sterling weakness in 2020 has become one of its main strengths. As one of the most affected nations globally in both health and economic outcomes, there has been a significant fall in potential output. The UK suffered the worst fall in GDP in over 300 years. This provides opportunity for 'catch-up' when economies open up again.

The UK's capacity to reopen sooner may be better than that of other nations. It has achieved one of the most effective mass vaccination programmes of any nation globally, and is the clear leader of the G7 nations. By the end of February over 20,000,000 people had received at least one vaccine dose, and the number of second doses approaches 1,000,000. Vaccination rates are about half as many daily in Germany, and a third in France. The UK's remarkably successful campaign combined with falling infections allowed Boris Johnson to outline plans for a gradual reopening of the economy, culminating in a potential 'freedom day' on June 21.

Sterling rise against key trading partners
GBP against EUR and USD since Brexit



The improved outlook for the UK economy was observed in bond markets. Bond yields on UK government bonds had the greatest month-on-month change in nearly five years. Rising yields are indicative of improved growth outlooks for economies and this increased income on investment in Gilts raises their attractiveness to investors seeking income. This puts upward pressure on the exchange rate and helps contribute to the rally in Sterling observed.

Another key contribution to Sterling's rise In February came at the start of the month as Bank of England comments on commercial banks needing to be ready for negative rates in six months were taken to indicate negative rates are less likely to be implemented in the short-term, something markets had priced in. With a return to economic growth expected in the second half of this year, it raises the possibility negative rates won't be need at all.

The focus for Sterling now turns to the Budget in early March, to see how the government will provide an economic roadmap to coincide with their route out of lockdown. When lockdowns end the brutal reality of months closed down, and Brexit complications will weigh heavy on British businesses and may present some downside risk to both the economy and the currency through to year-end.

Equity spotlight

Is the market a bubble?

The race for gradual reopening of the global economy is about to begin as the UK and the US are close to reaching significant milestones in Covid-19 vaccination rates. From that perspective, markets have every reason to feel positive, with stocks near all-time highs and record equity inflows.

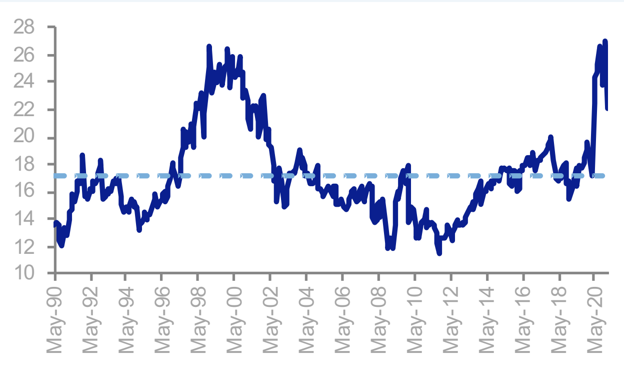
The US earnings season further boosted equity returns, with US large caps increasing their earnings by 3.4% in Q4 2020, against a 9% drop expected by markets, as companies managed to weather Congress's tardiness in handing out stimulus cheques. A further reason -or perhaps sign- of buoyancy is the capitulation in the bond markets. The recent rise in yields and steepening of the yield curve are a confluence of economic optimism and rising inflation expectations.

Despite all the usual flags, however, we can't treat this as a run-of-the-mill bull market. For one, we are already in the bubble-building stage. We see circumstantial evidence of bubbles building, whether it is in the US automotive industry, US microcaps, cryptocurrencies or other company-specific evidence, with the whole of the S&P 500 trading significantly above historical levels. Additionally, we believe that exceptional fiscal stimulus will be withdrawn as soon as it is practicable, lest countries see their public finances derailed after a year of nearly-unprecedented borrowing. This could have a significant impact in the corporate bottom line going forward.

The most important factor that keeps us on our toes, however, is that we know that market performance is still driven by exceptional monetary stimulus. Accommodation will most probably remain elevated for the year, but 2021 will challenge the iron resolve of central bankers, as inflation figures are expected to materially climb. While we believe that this inflation will probably be transitory, a result of supply chain pressures, stimulus and mere year-on-year consumer price comparison (against the horrid Q2 2020), we need to remain vigilant in case it overshoots or overextends its welcome, causing central bankers to question a 12-year market-friendly policy which has often been dubbed as 'the only game in town' for portfolio managers.

Valuations are expensive

Trailing P/E S&P 500



But not as expensive if we consider stimulus

Trailing P/E ratio S&P 500 deflated by M2 money supply

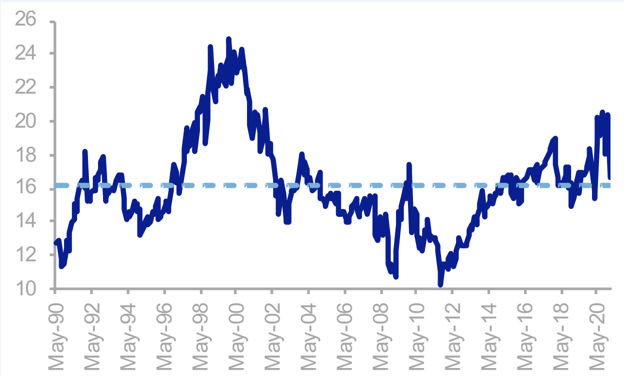


Chart source: Mazars Calculations

Fixed income spotlight
Normalisation of the bond market?

Heightened inflation expectations towards the end of February saw a simultaneous retrenchment of stock and bond indices. The situation vaguely resembles the infamous 2013 'Taper Tantrum', a violent bond and stock market reaction to the Fed's plan of tapering Quantitative Easing.

Historically government bonds and equities have had a negative correlation, with government bonds rising (and yields falling) in times of economic stress, a period when equities have generally fared poorly as earnings are depressed. However in the recent years of Quantitative Easing this relationship has increasingly broken down as markets have become addicted to central bank stimulus. We have often seen the somewhat ludicrous situation where weak economic releases have seen equities rally in expectation of greater stimulus (they also benefit from lower borrowing costs and a reduced discounting rate), with bonds also rallying on expectations interest rates staying lower for longer. A such policy makers have been reluctant to raise interest rates/cut back on stimulus for fear of upsetting both equity and bond markets.

So far policy makers have been able to get away with maintaining low interest rates and continuing stimulus through Quantitative Easing (QE) due to the absence of inflation. In fact central banks have often been trying to stoke inflation, with several economies experiencing deflation. The global pandemic may have ended this luxury.

Prior to the Global Financial Crisis, yields were significantly higher and the difference between short-term and long-term yields were invariably higher than they are today. Ultra-low interest rates have suppressed short-term yields, while QE has reduced yields of all maturities as central banks have become a buyer of their own debt, artificially reducing the supply/increasing the demand and so pushing up prices. A normalisation of yields would see the long end of yield curves rise, possibly significantly. The direction of short-term yields is less certain as they are more dependant on the direction of interest rates.

The world was already inching away from peak-globalisation before the pandemic, enacting inflationary policies (think Brexit and "America First") which encourage more expensive domestic production over cheaper overseas production.

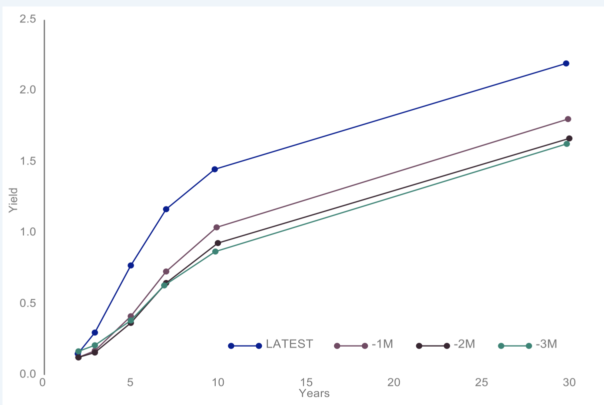
The pandemic is likely to have a similar effect, with global supply chains damaged and the possibility that politicians further prioritise domestic production to combat risks that vital supplies could be hoarded by a trading partner (think of the supply of PPE and even vaccines).

Markets have taken notice of rising inflation signs, with yield curves showing nascent signs of normalisation. However we have to note that market expectations have not historically proven to be a reliable predictor of long term inflation, as they correlate more with inflation in the next two months than with consumer prices in the next five years.

Perhaps the best argument against yields rising is that governments, with Debt-to-GDP levels at all time highs, can't afford for them to rise as it would increase their interest burden when issuing new debt. However in the unlikely event of inflation rising significantly for a prolonged period, policy makers will likely be forced to rise interest rates and so short-term yields. What is in question is whether they would be able to, or even want to, continue to depress yields, particularly longer-term yields, through continued QE.

Yields have risen and yield curves steepened in the past three months

NUS yield curve



Source: Refinitiv Datastream

ESG investing

While the trend of Environmental, Social and Governance (ESG) investing, has been gaining momentum for years, this year the pace of green change has been rapidly accelerated as a by-product of the pandemic.

While the trend of Environmental, Social and Governance (ESG) investing, has been gaining momentum for years, this year the pace of green change has been rapidly accelerated as a by-product of the pandemic.

ESG or ethical investing has now become a trend the investments industry can't afford to ignore. The pandemic has fuelled investor demand. Figures from Morningstar show flows into European ESG funds have reached an all-time high, attracting €52.6bn during the third quarter of 2020, helping grow overall assets across ESG funds to a record €882bn.

Opportunities for sustainable investment used to be scarce, but today it is hard to find a business that does not have an ESG policy. For example, 90% of companies in the S&P 500 index produced sustainability reports in 2019 and 81% of the FTSE 100 companies have some form of emissions reduction target.

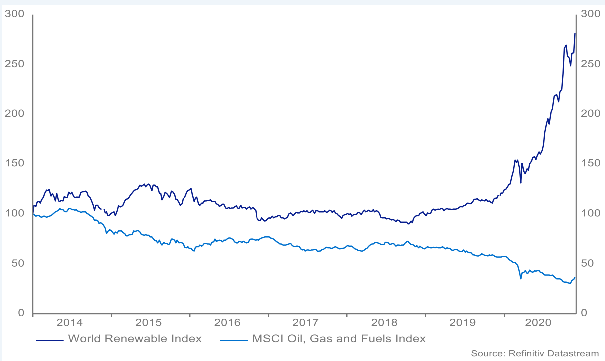
While the focus of ESG investments has largely been on environmental impact and climate change, this year we saw the 'S' in ESG come to the forefront. The social aspect of ESG was not well defined from an investment perspective but Covid-19 has definitely changed that. From early on in the pandemic, major shareholders urged company bosses to make timely payments to employees and suppliers during global lockdowns, even at the risk of losing dividend payments. Even social movements such as Black Lives Matter pushed companies to do more on racial injustice and called for greater disclosure of their staff's racial mix. Most companies will now be expected to not only disclose data on gender diversity but also racial and ethnic diversity.

As the focus on ESG investments increases, we can also see a shift in policy makers worldwide. In Europe, the EU taxonomy, which came into force this year, established an EU-wide classification system or 'framework' intended to provide investors with a common language to identify to what degree investment activities can be considered environmentally sustainable.

In the UK, chancellor Rishi Sunak announced the launch of Britain's first ever "green gilt" and also pledged that Britain will be the first G20 country to make large companies report their climate change exposures by 2025. China, the world's biggest producer of greenhouse gases, has said it will cut its carbon dioxide emissions to nearly zero by 2060. The US is also expected to re-join the Paris climate accord under Joe Biden, who has also called for a transition in America from fossil fuels to renewable energy.

Renewable stocks have significantly outperformed traditional energy stocks

Global renewables vs oil and gas since 2014



Over the last few years, there is a dramatic shift in investments into renewable energy vs. traditional oil and gas companies.

More reading...

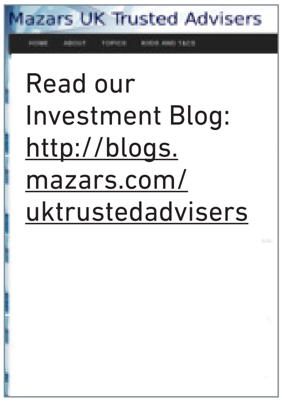


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Chart Sources: Bloomberg. The information contained in this document is believed to be correct but cannot be guaranteed. Opinions constitute our judgment as at the date shown and are subject to change without notice. This document is not intended as an offer or solicitation to buy or sell securities, nor does it constitute a personal recommendation. Where links to third party websites are provided Mazars Financial Planning Ltd accepts no responsibility for the content of such websites nor the services, products or items offered through such websites.

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