Monthly market blueprint

Investment management service

April 2021

mazars

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Foreword
Inflation is not-yet-the problem

Global economic divergence has caused a surge in input prices evident in various Purchase Manager Index reports as well as producer price indices. In early February markets began to price in the probability of higher inflation. The long end of the yield curves (where inflation lives) rose, while the short end (affected more by interest rates) remained at the same levels.

However, at this point we have to say that rising inflation expectations are mostly a US phenomenon. This is due to the fact that the US is projected to vastly outspend the rest of the world in terms of fiscal easing. While there may be technical factors behind the rise in market 'expectations' (the difference in yield between an inflation-linked and its simple equivalent bond), like increased demand by the Fed for inflation protected securities, there's also solid economic reasoning. The narrative goes: authorities are willing to risk an overheating the economy, rather than risk a post-pandemic slump which could further hurt already sluggish economic growth.

The US's projected $3tn infrastructure project was the piece of news that launched the 'inflation trade'. The US central bank was quick to endorse those hopes, changing its framework to target 'average' inflation and reiterating that it would tolerate a modicum of higher inflation over a short period of time, especially if this improved growth conditions and helped it achieve its other mandate, full employment.

As a result, US 10y bond yields rose by almost a full percentage to 1.71% at the time of writing since November, and the market quickly saw the biggest yield curve steepening in the past five years. In the past two weeks bonds moved in a small sideways. Evidence shows that the market still hasn't seen massive influx of capital.

We believe that at this range bonds are still too expensive versus equities to make a difference within the context of a diversified portfolio. The MSCI World's Dividend Yield is at 2% and the MSCI World's Earnings Yield (earnings/price) is at 3%.

George Lagarias
Chief Economist, UK

Currently, fund managers have very low allocations towards cash, which means that for bond yields to see inflows, it would have to be between the 2% and 3% range. Thus, above 2% they start becoming interesting and near 3% they would start to become attractive and offer pension funds and other income-seeking vehicle a good risk-free yield.

Various manager surveys also corroborate those levels. We feel, however, that the global appetite for yield is so large that demand would soon bring yields down again. Also, we should note that credit spreads (the difference between a sovereign and a similar maturity corporate bond) are persistently low, which means that corporate exposure offers only slightly better returns than sovereign.

Thus, our view on the matter is simple and in line with consensus: we feel that lack of free cash and unattractive valuations versus equities could allow the bond selloff to continue for a little while. After all, there are still $14tn worth of global bonds still in negative yield territory.

However, much of the market also believes that inflation will eventually underwhelm, which is why the selloff seems to have paused at current levels.

We would not add to our allocation at the current yield levels and would consider expanding our bond holdings only if the US 10-year yield found itself sustainable within the 2%-3% range.

Market performance – in a nutshell

The month in review

Equity markets looked past Covid-19 outcomes in March as markets including Europe and Japan, which are lagging behind the vaccination campaigns in the US and UK, performed strongly. With the passing of a large infrastructure bill in the US, both fiscal and monetary policy continue to be extremely accommodative for markets.

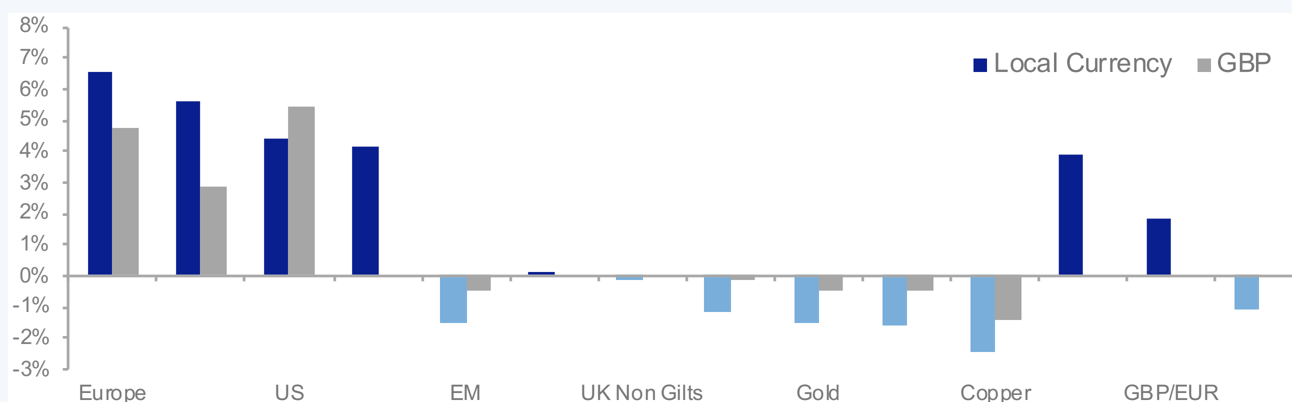
All major developed economy equity markets were positive in March. In February, the vaccination leaders (the United Kingdom and United States) led equity market performance, however in March both Europe and Japan performed at least as well as other markets despite their slower vaccination campaigns.

UK equities rose +4.2% in March, benefitting from the value rally. Value stocks have significantly outperformed growth stocks in 2021, after one of the widest performance gaps ever in 2020 when value underperformed growth by over 30%. US equities returned +5.5% in Sterling terms as Biden's stimulus plans passed through congress leading to elevated earnings growth expectations. European equities gained +4.7% in Sterling terms but were the best performers in local currency terms up +6.6%. European stocks have benefited from the opening up of global trade, although the raising Covid-19 cases towards the end of the month begin to increase downside risk in the outlook for the region.

Emerging market equities were the worst performing region, falling -0.5% in Sterling terms and the only region to fall during March. This movement was largely driven by a fall in China equities, ceding some of their gains from the positive start to the year.

US inflation expectations rose sharply in March, on fears that as the economy opens up the widespread monetary and fiscal stimulus could become inflationary. This rise in inflation expectations coincided with the labour market heating up. Just under one million jobs were added to US payrolls in March, a significant beat of the 616,000 expected. In bond market, yields continued to rise, the US 10-year rose +33.6 basis points to 1.74%, with a notable steepening in the yield curve. UK and German yields moved more modestly, up +2.5 basis points and down -3.2 basis points respectively. Despite a sharp rise at the beginning of the month oil fell back slightly from its February highs, down -2.8% to $60 a barrel. Gold continued its downward trend, falling -0.5%.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation
Changes in our strategic asset allocation

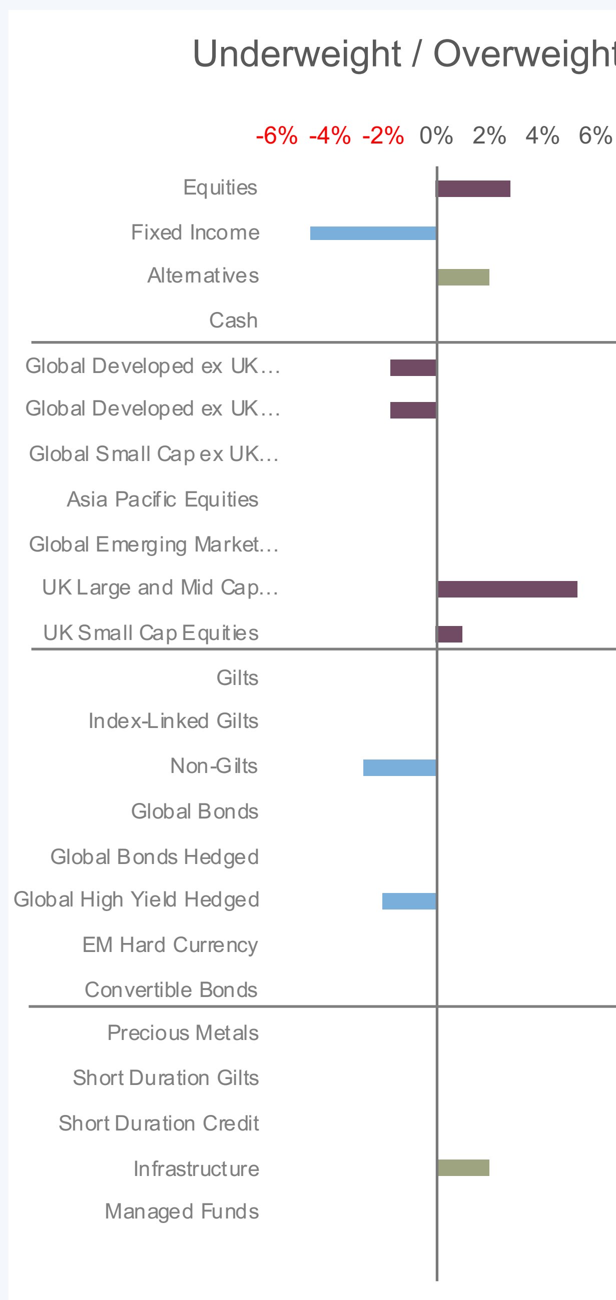
Outlook and portfolios

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 and have heavily strained supply chains, forcing higher output gaps. For March, overall conditions improved and activity continued to pick up, despite a drag from supply chain disruptions and rising input and output prices globally.

Central bank support has greatly contributed to the continuation of the financial cycle, even as the economic cycle broke down. Governments are still in spending mode and have not focused on the rising debt issue just yet, as 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.

The investment committee decided to make no headline asset allocation changes, as we saw little value in adding to our bond positions at current valuations. The changes made this quarter will in line with moving towards our new Strategic Asset Allocation, while we also intend to shift some weight towards value to better balance our value-growth exposure. 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. 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 6 April 2021



Risks
Avoiding policy mistakes will be key

2021 is projected to be a year of exit from lockdowns and recovery after a period when 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. Vaccination and Covid-19 continue to drive economic developments. After countries have exited lockdowns, the key determinant of economic activity on the demand side will be the extent of fiscal stimulus and its impact on inflation. Economic decoupling and pressures on the supply chain will be the key focus on the supply side. There are two key risks for markets right now: the possibility of the return of long-term inflation and unexpected hurdles in vaccination in G7 countries.

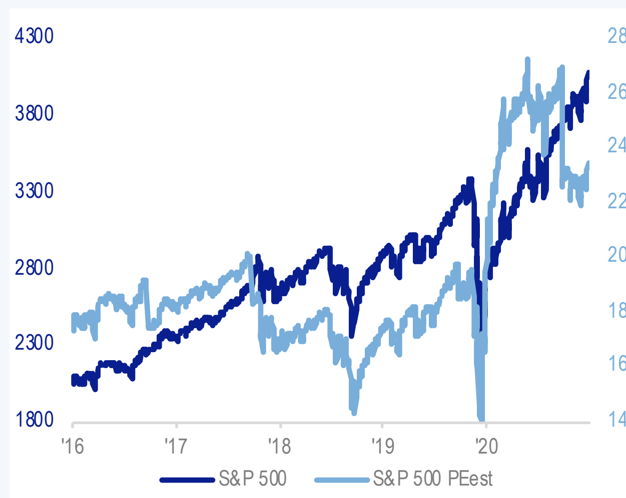
Markets continue to focus on quantitative easing, with investors convinced, for now, that central bank risk suppression will is potent enough to weather any economic issues. The rate at which monetary and fiscal stimulus will be withdrawn is the main risk for the upcoming economic recovery. Stock prices are near all time highs, bur, with earnings still to catch up, expensive valuations are creating a ceiling against further breakouts. Global bond yields have began 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. Many companies find themselves with weaker balance sheets. Possible inability to raise new debt or refinance old debts, especially in the face of a sudden stoppage of operational cash flows, could have devastating consequences, especially for smaller/mid-caps and companies teetering at the edge of the investment grade spectrum.

In the US, risks have been 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 debt raised to fight the virus. However, problems in vaccine rollout persist.

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.

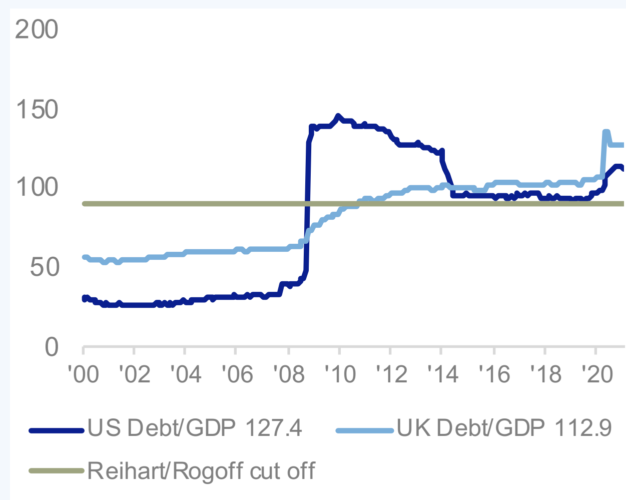
Valuations are still elevated

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

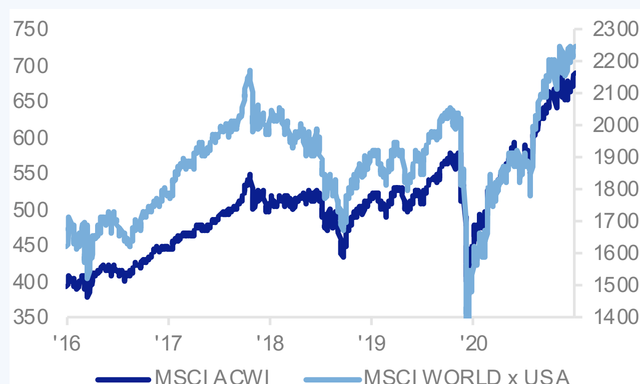
For the period, global stocks rose by 3.3% (4.4% in Sterling terms). The highest performing sectors were Utilities and Consumer Staples while the worst performers were IT and Telecoms. Equities were trading at 21.2x times forward earnings, 30.8% above long-term average. Gold fell 1.5% and oil prices fell 3.8%.

As a result of lack of global coordination, economic performance remains desynchronised 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, has seen growth forecasts being revised upwards driven by heavy stimulus packages and faster vaccination rates. The UK, which has the second largest percentage of vaccinated population globally is on the road to reopening after having experienced the biggest strain on its economy. Meanwhile, the EU, which took most fiscal the least and 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 with the services sector being the hardest hist. Overall economic performance, both in manufacturing and services, picked up in March, with Eurozone countries exhibiting a relatively strong growth in manufacturing activity. Nevertheless, supply chains remain strained and inflation, at least for the shorter term, may well be 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



Growth projections for 2021 have been raised
IMF world economic outlook

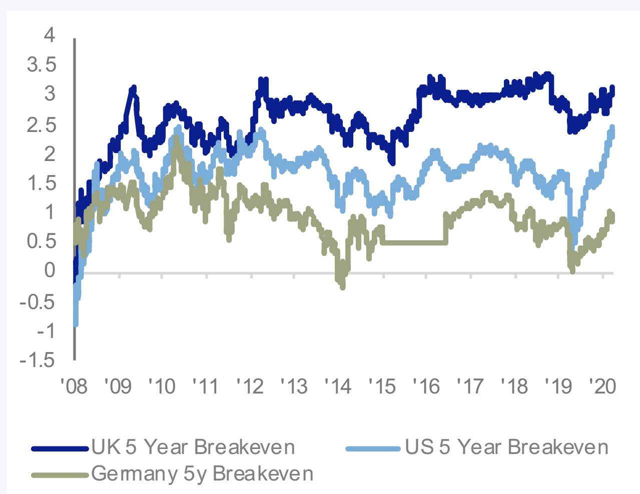


Chart source: Mazars calculations, Markit

Macroeconomic backdrop
UK

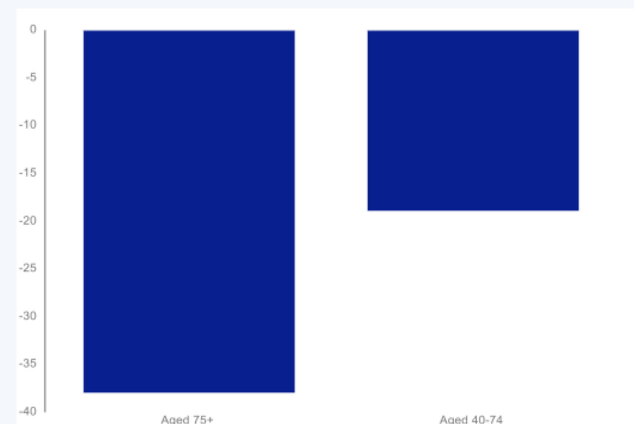
UK equity markets were strongly positive in March, rising +4.2%. This takes year-to-date returns up to +5.0%, joint with US equities for the best returns in Sterling terms. UK equities have started to slip relative to other major equity markets, but the rising value of Sterling has moderated overseas returns for British investors.

The ongoing success of the UK vaccine rollout is beginning to have a clear effect not just on health outcomes, but economic outcome also. UK consumer confidence rose by the greatest amount in nearly a decade, to the highest level since the beginning of the pandemic, as consumers begin to look towards the easing of lockdowns in April and beyond. Cyclical sectors fared best in March, with telecoms the best performing sector. As the oil price fell in March, the energy sector shifted from a tailwind for UK equities into a headwind, with the energy sector the worst performer in March. UK stocks are trading at 14.40x forward earnings, following earnings upgrades in March, however the discount to the MSCI World, widened slightly to 32% representing the greatest discount to the MSCI World on a valuation basis of the major equity markets. The UK 10-year yield was almost unchanged, rising +2.5 bps to 0.85%.

The Chancellor's budget highlighted the scale of the crisis so far. Projected borrowing is to hit the highest level since the second world war. As part of the new budget, there is an increased focus on bringing spending forward and then raising taxes in the near future. The Government will rise to its most significant role in GDP in almost fifty years. At last year's budget £55bn of spending was forecast, economic forecasters are now expecting close to £350bn. Final GDP data for 2020 showed some room for optimism despite the bleak headlines. GDP grew slightly ahead of expectations in Q4, up 1.3% however this means GDP fell by 9.8% in 2020, the worst fall in over three centuries.

Outlook: The vaccination campaign has been a success so far, but supply chain disruptions and vaccine nationalism present increased downside risk to the UK outlook. In spite of this, the UK is one of the first-movers in terms of vaccine distribution and looks set to benefit from an earlier reopening than peer economies.

Decline in Covid-19 deaths
Percentage changes, by age, January to February



The decline in Covid-19 deaths has been most pronounced in the eldest age groups, evidence of the success of vaccinations. This trend was not observed coming out of previous lockdowns, and so is fairly strong evidence of the efficacy of the vaccination campaign.

UK consumer confidence picks up
Balance

UK consumer confidence rose in March, since the pandemic the gap between personal finance and general conditions has widened, with much of the government support targeted at the individual level.

Macroeconomic backdrop
US

For the period, US stocks rose by 4.4% (5.5% in Sterling terms). The highest performing sectors were Homebuilding Index and Utilities while the worst performers were Energy and Telecoms. Equities were trading at 23.42x times forward earnings, 36.7% above long term average and 10.4% above the MSCI World. 10y bonds rose 34 bps at 1.74%.

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 output growth during March has been driven by a sharp rise in new business, that is particularly concentrated in the Financials and Technology sectors. Manufacturing activity continued to constitute a pillar of recovery despite disruptions and challenges in the supply chain. US Services sector exhibited a substantial increase in business activity as well, reflecting rising client demand. 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 vaccinations, which will determine the pace at which the economy will reopen. The United States have the second highest vaccination rate within the G7 (29/100), second only to the UK (46/100).

The other factor will be the rate of stimulus withdrawal. However, currently stimulus is being expanded, with an extra $1.9tn being approved by the Congress and a possible $3tn infrastructure project down the line.

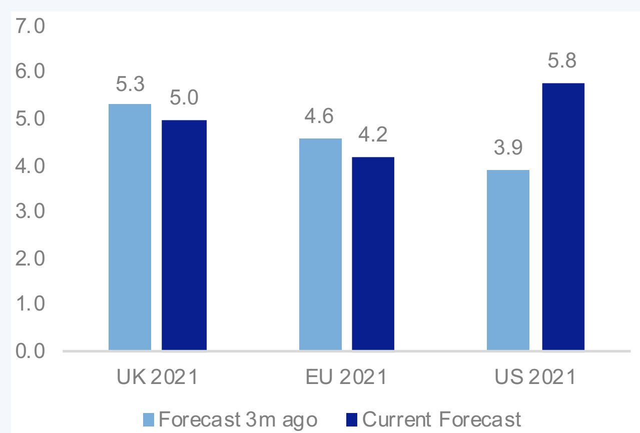
A very important aspect of economic performance, prices, has seen modest increases. Forward-looking data from Markit PMI suggest that, due to the continued resurgence of input costs, we could see a material–yet temporary-pick up in inflation going forward.

S&P 500 rising to record levels

S&P 500 Price Index

The US expected to rebound faster this year

Bloomberg economic forecasts



Charts Source: Mazars Calculations

Macroeconomic backdrop
Europe

In March European stocks rose by +6.8% (+2.9% in Sterling terms). The best performing sectors were automotive and telecommunication services while the worst performers were energy and materials. Equities were trading at 18.94x times forward earnings, 27% above their long-term average.

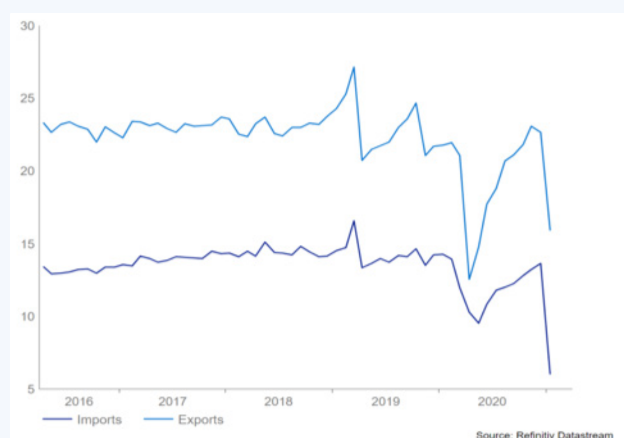
Europe is still facing several issues which could hamper its recovery from the pandemic. The EU has been relatively slow in implementing its coronavirus vaccination program due to supply shortages coupled with structural deficiencies. As of the end of March, approximately 11.8% of the EU's population has received a vaccine. In addition, restrictions to ease the spread of the virus are still in place due to a faster than anticipated spread of the British variant of the coronavirus.

Euro area annual inflation rose to 1.3% in March, up from 0.9% in February, according to a flash estimate. Future inflation expectations have also been trending upward, partly influencing the rising long term government bond yields observed earlier during March. Rising yields reversed as the European Central Bank (ECB) was quick to intervene by pledging to accelerate the pace of its bond buying programme.

The economy continues to recover along a dual-speed path where manufacturing is recovering at much higher pace than services. Eurozone Purchasing Managers Index (PMI) data for March beat expectations, with the Composite PMI index standing at an 8-month high of 52.5. Manufacturing PMI hit a 24-year high of 62.4 while Services PMI continued to contract but at the slowest rate over the last seven months, equalling 48.8.

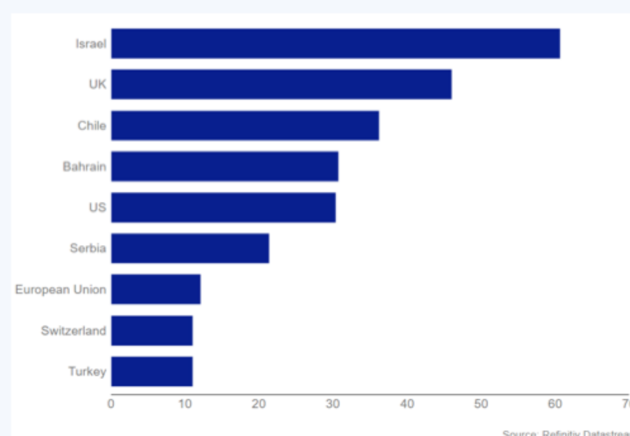
Outlook: tThe main factor for economic performance in the next months remains the pace of the rollout of the vaccines. This will determine the ease with which restrictions will be lifted across European countries. Monetary policy is expected to remain accommodative by the ECB, aligned with expansive fiscal policy's implemented through the release of the recovery fund.

Euro area trading activity with the UK
Billion euros



Exports to the UK fell by -31.9% m/m while imports from the UK fell by -57.5%.

EU is lagging the race to rollout the vaccine
Percent of population vaccinated with at least one dose, 31 March 2021



The EU has some distance to go to keep pace or catch-up with leaders of the mass vaccination campaigns.

Macroeconomic backdrop

Japan and emerging markets

For the period, emerging markets stocks fell by -1.3% in local terms but rose 0.3% in Sterling terms. Japanese stocks rose +2.9% in local terms and +5.7% in Sterling terms. The best performing sectors were utilities and industrials in emerging markets while the worst performers were technology and healthcare.

From a macroeconomic perspective, China had stellar data releases this past month. There were two major factors at play. Firstly, most of the data released grouped together numbers for January and February. Secondly, most YoY number look inflated due to the significant drop we witnessed in March 2020. The official NBS Manufacturing PMI for China rose to 51.9 in March from 50.6 in February, beating market consensus of 51.0. This was the highest reading since December 2020, as factories resumed their production after being closed for the Lunar New Year holiday. The services PMI rose to a four-month high of 56.3 in March 2021 from 51.4 previously. China's retail trade, industrial production and fixed-asset investment surged by +33.8%, and +35.1% +35% YoY in January-February 2021 respectively, as consumption accelerated sharply from last year's massive slump.

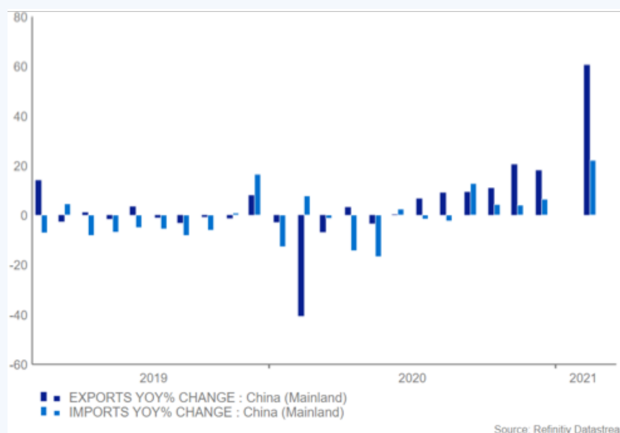
In Japan, the recent lifting of the state of emergency in the Tokyo region provided some optimism, but news of the return of coronavirus lockdowns in Europe dented hopes of a broad economic reopening. Japan's Diet approved a record JPY 106.61 trillion (USD 976 billion) budget for the 2021 fiscal year to help mitigate the fallout from the coronavirus pandemic as well as rising social security and defence costs. Manufacturing PMIs in Japan rose to rose to 52.7 in March from 51.4 in February.

Policymakers in Brazil, Russia and Turkey raised interest rates, while central banks in South Africa and Mexico hinted at less dovish monetary policy. In most cases, each central bank cited rising bond yields in developed countries, elevated inflation and pressure on their respective currencies as rationale to lift policy rates.

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.

China exports

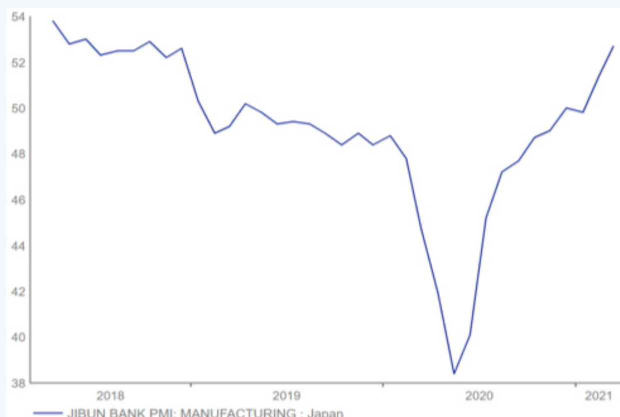
Strong exports and imports signal a recovery



China's strong export and import growth YTD in February means not only recovery in China but also a recovery in some major export markets.

Japan manufacturing PMI

Further expansion in manufacturing in March



Japan's manufacturing PMI was 52.7 in March higher than 51.4 in February. This was the second straight month of growth in factory activity and the steepest pace since October 2018, as a recovery in the economy from the Covid-19 pandemic gained traction.

Our themes

Macro theme 1

End of the beginning for Covid-19

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.

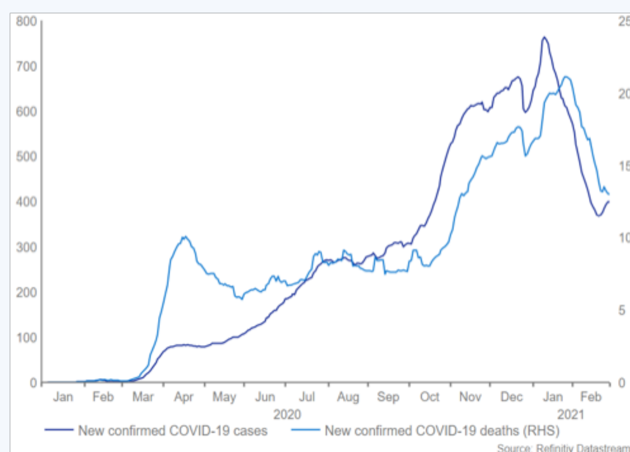
Global stocks had their best month since 1988, propelled by a series of Covid-19 vaccine breakthroughs in November 2020. The rally reflected investors' growing eagerness to buy into risky assets, encouraged by progress in the development of Covid-19 vaccines at pharmaceutical groups Pfizer-BioNTech, 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
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 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 have to 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 (normal bond yield less inflation-linked bond yield) or some very 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.

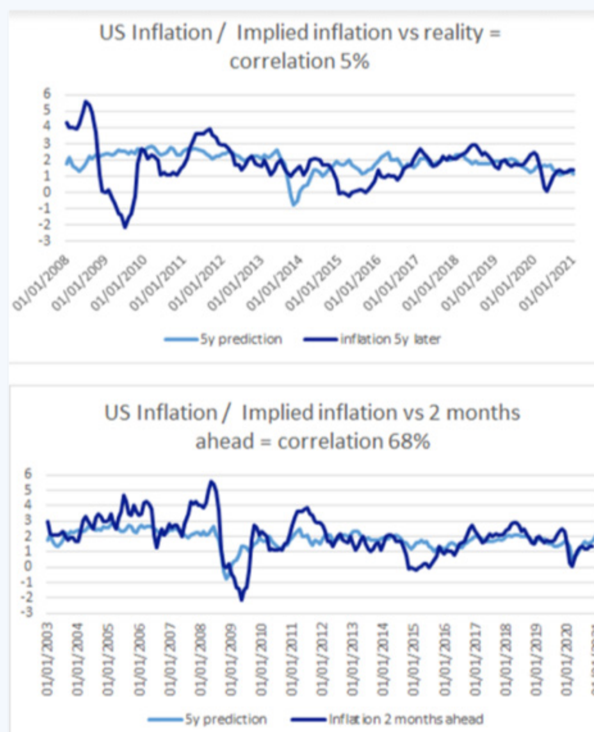
The ‘breakevens’, or any other such measure should primarily be seen from a ‘second derivative’ perspective. It’s a measure of what the rest of the market is thinking, and possibly how bond traders will react. In macroeconomic terms, market expectations at best have a medium correlation with inflation in the next 2 months (68% correlation, only 47% R2). 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 more 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.

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. However, following the generous UK budget and plans for a massive $3tn US infrastructure spending bill, we are forced to consider a scenario where central governments continue fiscal expansion until they either break the ‘secular stagnation’ mindset, or long-term inflation stages a comeback. In this environment we would expect to see a significant re-rating of risk assets. However, the experience of the last 30 years with central banks leaves hope that, even in such a scenario, we would pivot towards a new and improved financial paradigm with volatility actively minimised by policy makers, who would seek to foster a quick rebound for stocks and bonds.

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



Charts Source: Mazars Calculations

Macro theme 3
Sterling strength

March saw Sterling rise +1.8% against the Euro, and fall by -1.1% against the US Dollar on the back of the Dollar's change in fortunes from its strong start to the year. Sterling is up +5.1% and +0.8% against the Euro and the Dollar respectively this year.

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. March saw a reversal of these trends as stronger than anticipated US labour market data led to rising yields which increased demand for the currency.

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. 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

Bond yields on UK government bonds had the greatest month-on-month change in nearly five years in February . 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 has been the Bank of England comments on commercial banks needing to be ready for negative rates in six months. These 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.

A high spending budget in March has helped support optimism for one of Europe's worst affected economies. Despite losing ground against the Dollar, Sterling continues to strengthen against the Euro. Sterling is trading above both its 50-day and 200-day moving averages, an indicator of a strong continued upward trend against the currency.

Equity spotlight

Will the rotation into value continue?

Successful vaccines, the passing of the US election and an increasing belief in strong global growth in 2021 have all come together to spur global equity markets and risk assets higher over the past few months. After a decade of fast-growing technology companies dominating the markets, a strong economic recovery could cause a major shift.

Value stocks – or cheaper shares such as banks and energy firms – have handsomely outperformed fast-growing stocks such as the big tech names in 2021 so far. Stocks such as Bank of America and Exxon are beating the likes of Tesla and Amazon.

US Federal Reserve Chairman Jerome Powell suggested that the central bank would let inflation run hotter if it helped achieve full and inclusive employment. Recent concerns about inflation have driven bond yields higher. This month yields on the benchmark US 10-year treasury climbed to 1.75% — the highest since January 2020, while the 30-year treasury yield jumped to 2.5% for the first time since August 2019. Higher inflation, after all, often comes with an uptick in economic growth, which should benefit value stocks that are economically sensitive – like those of banks and energy companies – more than those that aren't, like tech. That's reflected in share price moves this year too: US energy and banks stocks have outperformed tech stocks by 33% and 16% respectively.

So can the rotation sustain itself beyond 2021? While it remains to be seen how long value leadership will last, many of the drivers that led investors to flock to growth stocks have reversed and now favour value stocks. The jury is still out on whether we will see a generalised correction in stock markets, and there would have to be the prospect of interest rate rises or other monetary tightening before that occurs. We believe that even if a rotation takes place there will be winners and losers among both growth and value shares – they will not all go up, and all go down. For instance, over the past year, people have made themself even more familiar with digitalisation by shopping online and working from home. Therefore, technology shares and other growth companies could continue to serve investors well even in a post-Covid world.

Banks and energy stocks gain on recovery hopes, outperforming tech

Equity returns in USD, rebased to 100

Treasury yields soar as markets digest economic recovery prospects

Increasing yields spark inflation fears

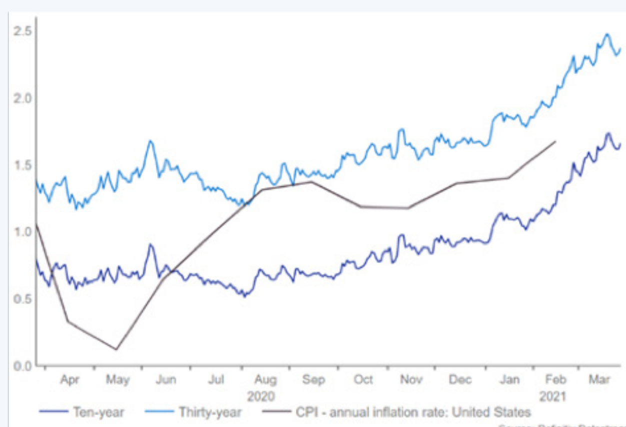


Chart source: Mazars Calculations

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 resembled 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.

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. 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.

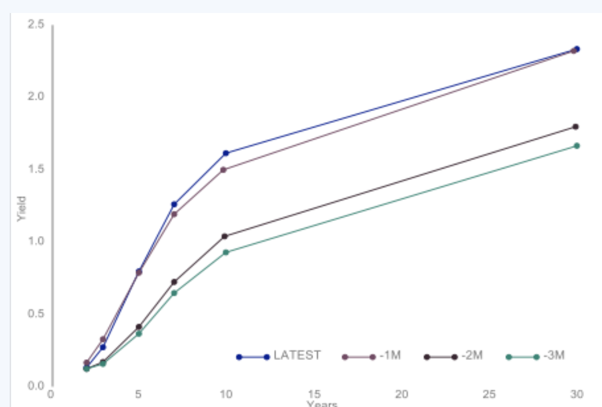
The pandemic is likely to have a similar effect, with global supply chains damaged and the possibility that politicians further prioritise domestic production to combat risks that vital supplies could be hoarded by a trading partner (think of the supply of PPE and even vaccines).

Markets had 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. Also the trend hasn't continued into March as inflation signals haven't materialised.

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 paceof 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.

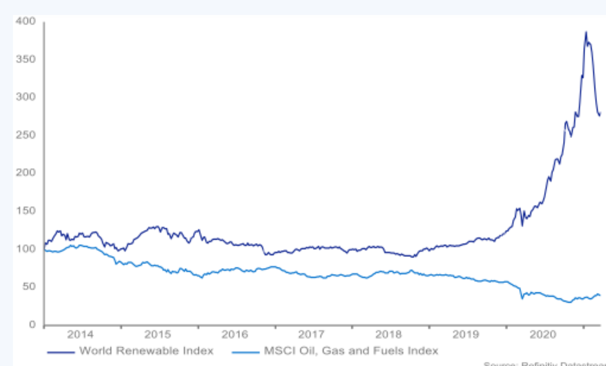
While the focus of ESG investments has largely been on environmental impact and climate change, this year we saw the 'S' in ESG come to the forefront. The social aspect of ESG was not well defined from an investment perspective but Covid-19 has definitely changed that. From early on in the pandemic, 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.

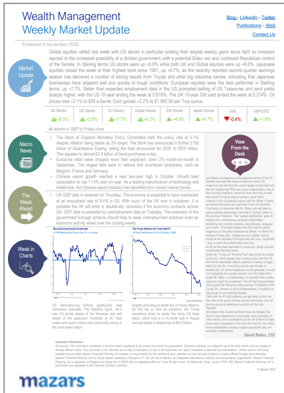
Renewable stocks have significantly outperformed traditional energy stocks

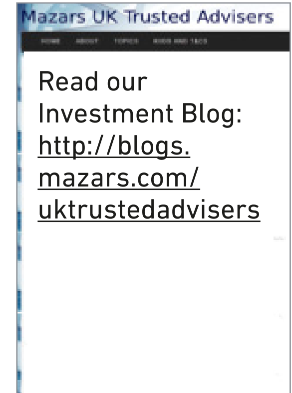
Global renewables vs oil and gas since 2014



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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