Monthly market blueprint
Investment management service

May 2021

mazars

Contents

Foreword
A fiscal game changer

April saw a de-escalation of bond yields and a further rise in stock market prices across the board. Risk assets began to gear up for the acute phase of the economic rebound, as vaccinations progress in most G7 countries, especially the UK and the US.

Data, even from Q1, suggest that the developed world is racing back to normality. US GDP for the first few months of the year rose 6.4% on an annualized basis. While the initial footprint of US earnings (up 45.8% year-on-year after 60% of large caps have reported) is impressive. The sluggish response of markets to corporate results allows earnings to catch up to exuberant valuations.

Currently there are three big themes we think all investors should be watching:

The first thing investors must watch is the course of the pandemic globally. Despite the positive narrative and high vaccination rates in the US and the UK, investors should be attuned to persistently low vaccination rates in Europe and globally. News about renewed lockdowns in Germany and France, and a very sharp spike in India, have already drawn the attention of investors, even if markets don't reflect that. Supply chains are again under threat. Wounded by last year's experience, when markets initially failed to react to the Wuhan news and dropped sharply after the first death in Italy, the investment world will likely remain particularly sensitive to the geography of the pandemic news flow. The latest variant to trouble health officials, the so-called 'Indian' B.1.617 variant, has drawn some market concern. Portfolio managers worried about new variants, coupled with 'lockdown fatigue' in the developed world and low vaccine availability in many emerging markets, may understand that while valuations anticipate a normalisation of earnings, the fight against the pandemic is far from over. This also means that risk assets will remain correlated to stimulus availability, both on the monetary and the fiscal front.

The second thing investors should watch is multilateralism. Normally this falls into the more academic geopolitical sphere. However, the cost of the unraveling of the global world order in the years after the 2008 financial crisis has been steep. Trade wars, lack of policy coordination on issues such as the environment and central bank operations, and as of late a lack of a centralized response to the pandemic. These 'opportunity' costs are not immediately visible, but they could amount to trillions of Dollars.

The pandemic has done more damage to international relations than the entirety of the previous decade. Countries now frequently close borders and engage in vaccine nationalism. In a world that has enjoyed the benefits of globalization for years, de-globalization could have significant consequences, especially in respect to the free movement of capital.

The third thing investors must watch is the impact of fiscal stimulation, especially in the US. In the last week of the month the Federal Reserve disappointed markets by stating it would not increase quantitative easing. Janet Yellen, formerly a Fed Chair herself, then contradicted her successor by saying that rates could be forced to rise to prevent the economy from overheating. It was the first such public statement from a government official in years, suggesting that rates would be driven not by the Fed's esoteric monetary deliberations but rather by economic policy.

Investment managers, trained in Pavlovian fashion to respond to cues from the Fed as the purveyor of the 'only game in town', might be slow to embrace the potential for such a change, especially from an administration considered a 'caretaker'. There might not be appetite to consider that, after more than a decade of monetary focus, fiscal policy is the 'new game in town'. The new US government is increasingly viewing the pandemic as an opportunity to break 'secular stagnation' and it has been increasingly taking steps towards expanding its reach. If that is the case, companies should prepare to welcome back more confident and emboldened consumers in the near future. The Fed will have to work overtime to try and balance a huge debt pile, an incredibly expanded balance sheet, and 'good', demand-driven inflation. In this scenario, current valuations would be neither expensive nor cheap. They would be rendered irrelevant.

George Lagarias
Chief Economist, UK

Market performance – in a nutshell
The month in review

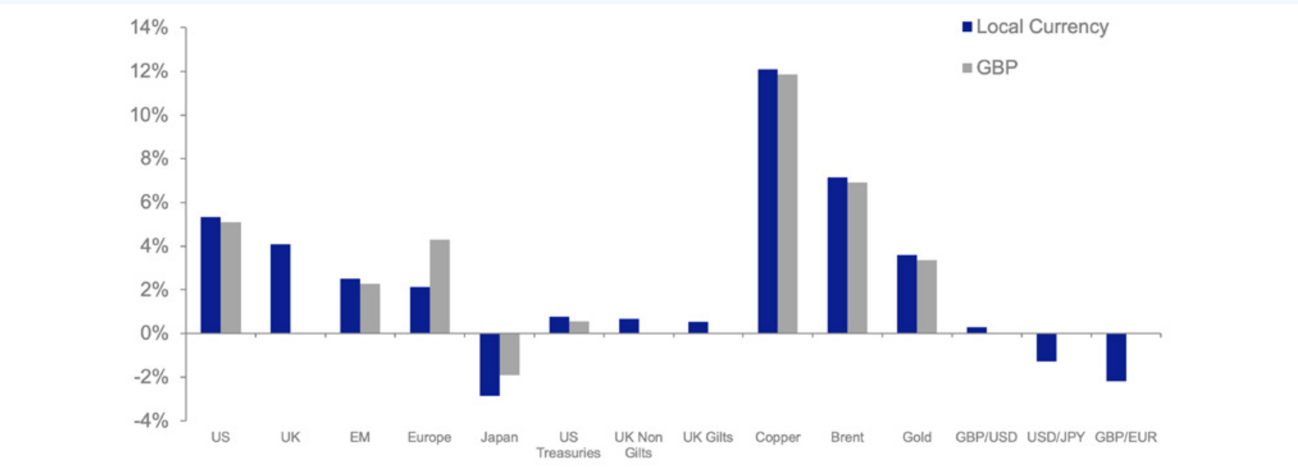
Developed markets beginning the road to recovery

April saw strong economic data show evidence of some resilience in major developed nations. Vaccine sentiment continues to be strong, the UK and the US are clear leaders among major nations, and although off to a slow start, Europe is beginning to increase the rate of vaccinations. In equity markets 'growth' stocks typically outperformed, and this helped the US to once again show market leadership last month.

UK equities rose +4.1% in April, although the more domestically focused small and medium size indices fared even better. The UK is beginning to benefit from its vaccination campaign and has seen no discernible rise in cases even as lockdown has been eased. US equities returned +5.1% in Sterling terms. The US vaccination campaign sped up in early April and the President has lined up trillions more in fiscal stimulus following the passing of his first major fiscal package in March. European equities gained +4.3% in Sterling terms. Emerging market equities grew +2.3% in Sterling terms. China continues to grow moderately, and consensus economic forecasts expect domestic consumption to be a key driver of GDP in the region. However, the deterioration of the situation in India provides clear evidence of the health and economic risks countries in the region face, India is increasing its government lockdown measures and is likely to see a contraction of GDP in Q2 2021.

Inflation continues to be a hot topic in the market news cycle. In the US, inflation data released in April showed inflation had been higher than anticipated in March, up 0.6% month-on-month. Labour market data shows accelerating job growth in March, and forecasts for job growth released next month are being revised upwards. There is less focus on inflation in Europe, where Lagarde has stated inflation will probably be 1.5% in 2021. Investors will be looking to address to what extent inflation is short-lived, with central banks only likely to act in the face of steep and long-lasting inflationary effects. In bond markets, yields stopped their rally, the US 10-year fell -11.5 basis points to 1.63%. UK yields were nearly unchanged, down -0.2 basis points to 0.84%. Gold rose +3.4% in Sterling terms, although remains firmly in negative territory year-to-date. Oil has continued its bullish start to the year as investors bet on a stronger recovery. Oil rose +6.9% in April.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation
Changes in our strategic asset allocation

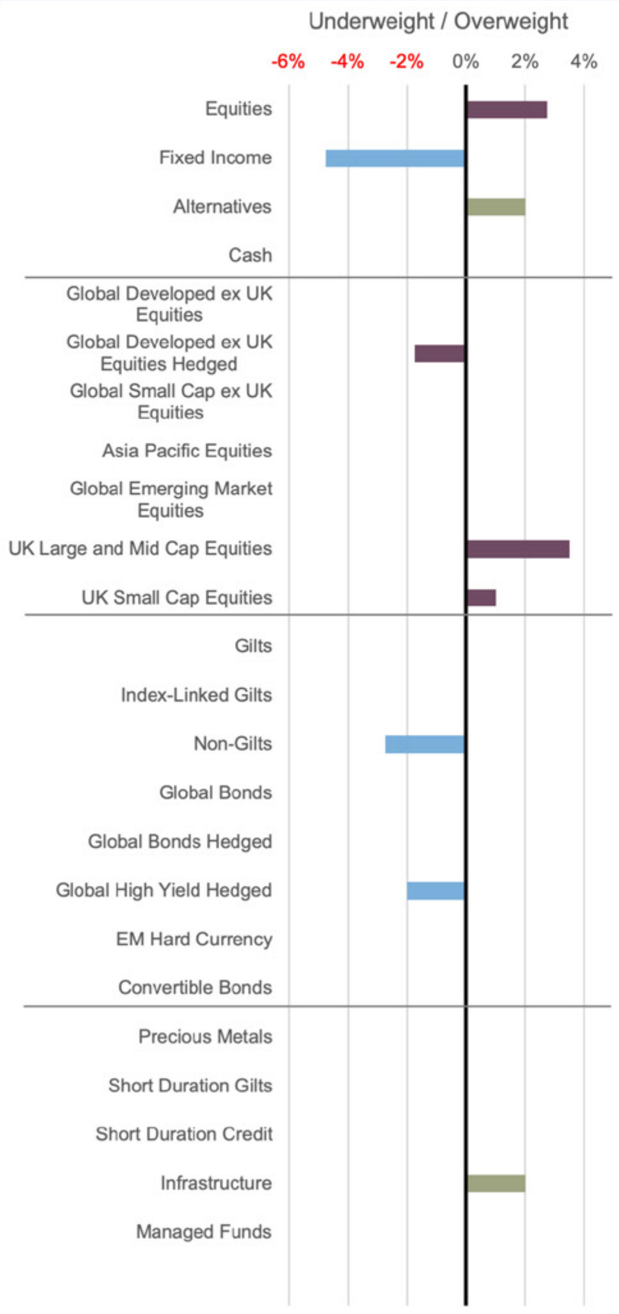
Outlook and portfolios

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. Despite notable progress in vaccination amongst G7 countries and the lifting of some restrictions, imbalances in the global economy are exacerbated by the chaotic and unpredictable nature of lockdowns continue to put a heavy strain on supply chains, forcing higher output gaps.
The second quarter marks the acute phase of the rebound. For April, overall conditions improved despite a drag from supply chain disruptions and rising prices globally.

Central bank support has greatly contributed to the continuation of the financial cycle. Governments are still in spending mode and have not focused on the rising debt just yet, as extensive borrowing has supported employment and consumption. Recent plans unveiled by President Biden and Secretary Yellen suggest that the US's push for fiscal expansion and income redistribution is strategic in nature and may not end as the pandemic subsides. The rate of stimulus retraction 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 were 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 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. 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 May 2021



Risks
Avoiding policy mistakes will be key

2021 is projected to be a year of exit from lockdowns and recovery. This comes after a period when global economic growth faltered at the swiftest pace since WWII, but overall asset prices 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 a pickup of the pandemic in the emerging world.

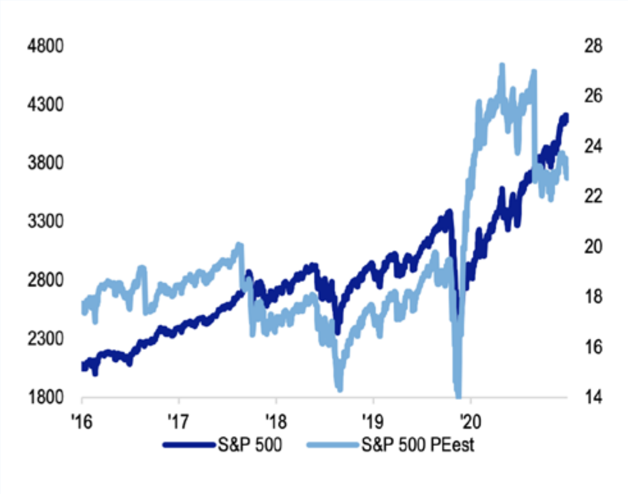
Markets continue to focus on quantitative easing, with investors convinced, for now, that central bank risk suppression is potent enough to weather any economic issue. The rate at which monetary and fiscal stimulus will be withdrawn is the key risk to the upcoming economic recovery. Stock prices are near all time highs, with earnings still to catch up expensive valuations are creating a ceiling against further breakouts. Global bond yields have begun to climb, on inflation fears, however we feel the move is temporary so long as fiscal stimulus is withdrawn. At any rate, the Fed has signaled it will tolerate higher inflation for now. Many companies find themselves with weaker balance sheets. An 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.

In the US, risks have been falling, after the return of a more multilateral-oriented government. In the UK, a weak economy is further threatened by adjustment issues surrounding a 'hard Brexit' deal and recovery will largely depend on stimulus. 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.

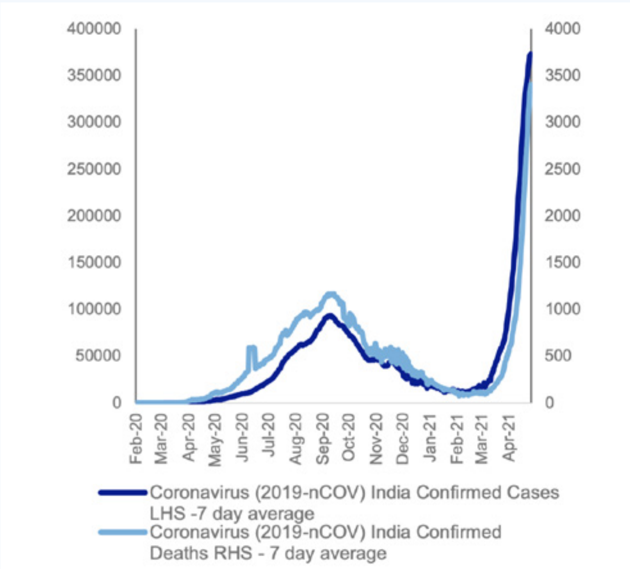
Valuations are still elevated

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



India's Covid-19 surge is causing concerns

Covid-19, India, new cases and new deaths



Charts Source: Mazars Calculations

Macroeconomic backdrop
Global

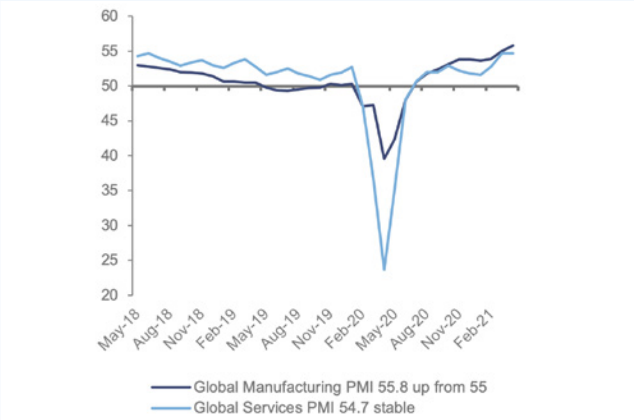
For the period, global stocks rose by +4.7% (+4.4% in Sterling terms). The highest performing sectors were telecoms and IT while the worst performers were energy and industrials. Equities were trading at 20.79x forward earnings, 27.8% above long-term average. Gold rose +3.4% and oil prices rose +7.1% in Sterling terms.

Economic performance has picked up significantly in the past few months, both in terms of services and manufacturing. However, as a result of lack of global coordination, the rebound remains de-synchronized.

Asia has recovered the most, with the Chinese economy credibly claiming to be 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 of developed nations is on the road to reopening after having experienced one of the biggest strains on its economy. Meanwhile, the EU, which negotiated the longest over vaccine contracts, is now experiencing the economic repercussions of this strategy, with the services sector, and thus tourist dependent economies, being the hardest hist. Overall economic performance released in April, both in manufacturing and services, showed an uptick in March, with Eurozone countries exhibiting a relatively strong growth in manufacturing activity. Nevertheless, supply chains remain strained. Inflation, at least in the short-run, may well be coming back. Central banks remain accommodative 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, possibly more so than that of a major policy mistake. The effect of supply chain disruptions and lingering problems in the services sector are still issues economists and investors will have to contend with. 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 near all-time highs
(MSCI World)



Inflation expectations picking up
Market-implied 5y inflation expectations

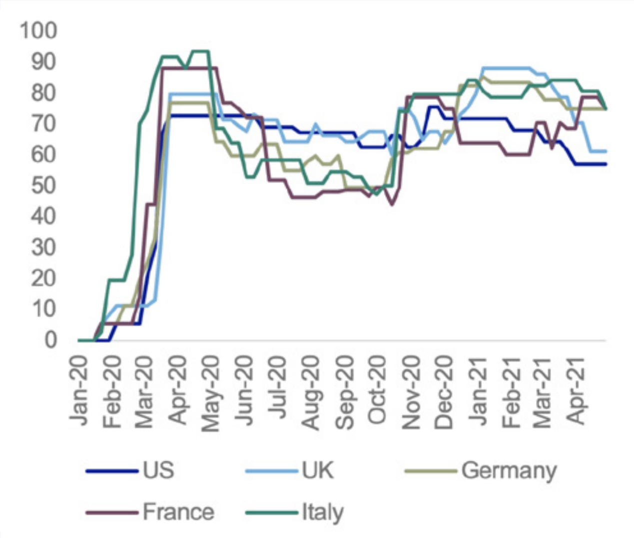


Chart source: Mazars Calculations, Markit

UK

UK equity markets continued their strong start to the year, up +4.1% in Sterling terms. The FTSE 100, an index of the largest UK listed companies, rose above the 7000 level before falling back just below before month-end.

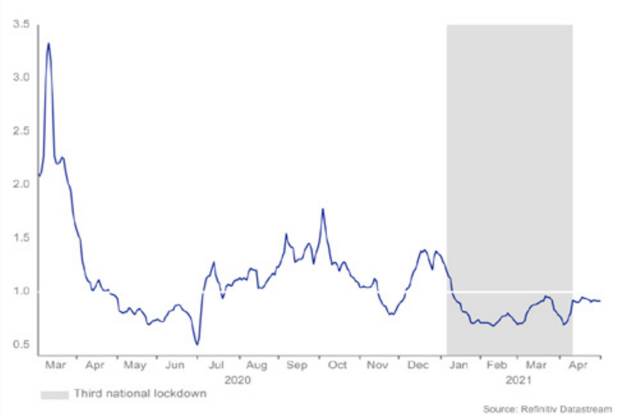
As the national lockdown ended, April saw an acceleration in the rate of growth of the UK economy. A relatively weak Sterling supported UK equities with the European vaccination campaign helping the Euro to climb against Sterling, Sterling was down -2.2% on the month against the Euro. This effect was seen most greatly in the more domestically focused mid-cap index the FTSE 250 which reached record highs in April. Large caps also fared well rising +4.1% in April. IT was the best performing sector, although there was no clear bias towards cyclical or non-cyclical sectors. Despite a rising oil price in March, the energy sector continued to act as a headwind for UK equities, with the energy sector the worst performer in April. UK stocks are trading at 13.76x forward earnings, following further earnings upgrades in April, however the discount to the MSCI World narrowed to 24. The UK 10-year yield was almost unchanged, falling -0.2 bps to 0.84%.

Purchasing Manager Index surveys continued to show an acceleration in April. UK Manufacturing PMI reached a near-record high, and total new orders rose for the third straight month. The flash Services PMI showed services at 60.1, the highest reading since before the Brexit referendum. Firms have begun hiring at the fastest rate for over three and a half years. One notable disappointment in the UK economy has been the more modest rate of export growth relative to other major developed nations, linked to Brexit related supply chain difficulties and this has lead to further input and output price growth. In terms of the vaccination campaign the focus shifted during April to second doses, with over 10 million second doses being administered during April.

Outlook: The UK looks to be successfully containing the pandemic. The economy is reopening and there is no evidence of an uptick in infections. Whilst some increase is expected in summer, the country appears able to sustainably reopen throughout May and June.

UK Covid-19 R rate

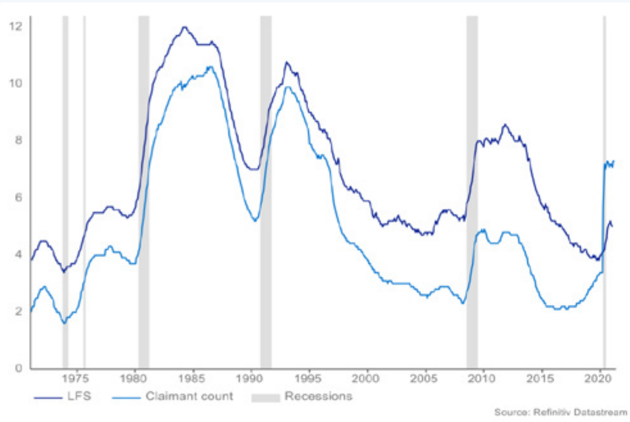
Reproduction rate



Despite coming out of a third national lockdown, the UK Covid-19 reproduction rate has stabilised below the crucial ‘1’ level. This means that on average someone with the illness infects less than one other, which leads to an exponential fall in the number of cases over time.

UK unemployment rate

Percent of labour force



UK unemployment rate fell by more than anticipated, the Government furlough scheme continues to depress the ‘true’ unemployment rate which is likely to peak later this year or early in 2022.

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 output growth during April has been driven by a sharp rise in new business. GDP for Q1 grew at a very strong pace, 6.4% on an annualised basis. Manufacturing activity continued to constitute a pillar of recovery despite disruptions and challenges in the supply chain. The 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.

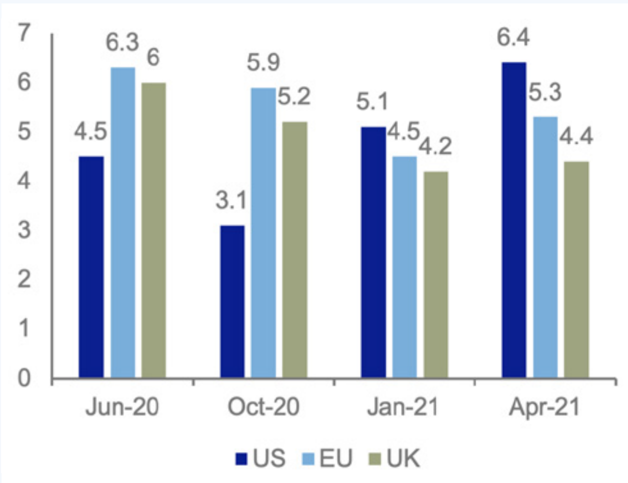
Outlook: The main factor for economic performance in the next few quarters will be the rate of vaccinations, which will determine the pace at which the economy will reopen. The United States currently have the second highest vaccination rate within the G7, second only to the UK.

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 $4tn infrastructure and welfare project down the line.

A very important aspect of economic performance, prices, has seen modest increases. Forward-looking data from Markit 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 new record levels
S&P 500 index, price

The US rebound
(Bloomberg economic forecasts)



Charts Source: Mazars Calculations

Macroeconomic backdrop
Europe

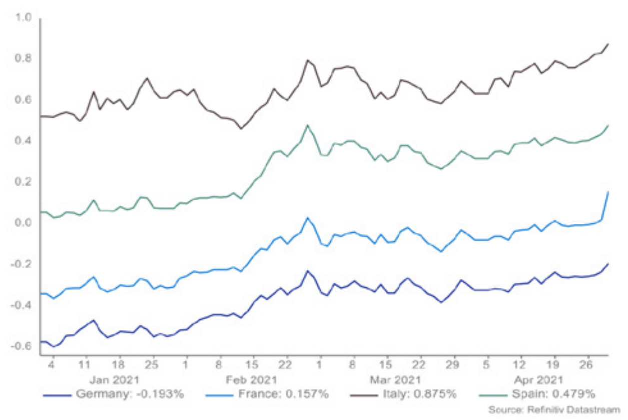
In April European stocks rose by +2.1% (+4.3% in Sterling terms). The best performing sectors were retail and materials while the worst performers were energy and autos. Equities were trading at 17.8x forward earnings, 23% above their long-term average.

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 but has raised the rate of vaccination over the last month. As of the end of April, approximately 23% of the EU's population has received at least one dose of the vaccine, while most countries still have lockdown restrictions in place that are planned to be gradually lifted soon. The economy continues to recover along a dual-speed path where manufacturing is at much higher pace than services. The Purchasing Managers Index (PMI) for the manufacturing sector has hit a record high while the services sector has shown signs of growth after 8 months of contraction according to flash estimates.

Consumer confidence has risen to levels above its long-term average while the European Sentiment Indicator is well above pre-pandemic levels, and its long-term average, as well. Euro area retail sales have recently increased too, boosted by strong online spending however still unable to fully compensate for the closure of physical retail stores. Monetary policy will remain strongly accommodative in line with an expansionary fiscal policy. The European Central Bank (ECB) vowed to keep the pace of its asset purchasing programme unchanged, highlighting its determination to keep borrowing costs low. The EU Recovery Fund will be implemented according to plan as the German Federal Constitutional Court (GFCC) has rejected requests for an injunction against Germany's approval.

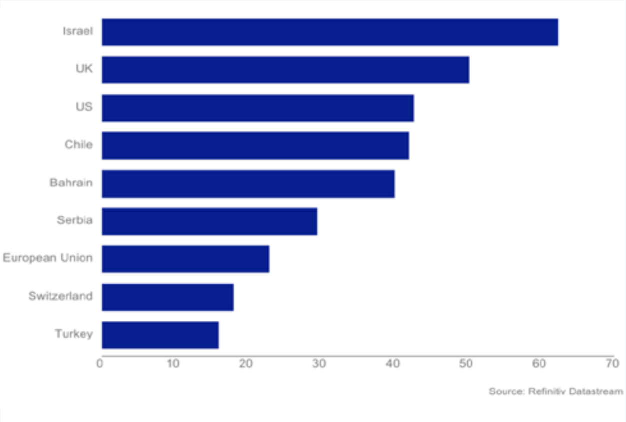
Outlook: The main factor for economic performance in the next months remains the pace of the rollout of the vaccines. Additionally the rate of ECB's asset purchasing programme will be decisive for market sentiment, in particular equities. Another aspect worth monitoring is the extent to which supply chain disruptions will continue to affect the European manufacturing sector through higher input prices and severe delays in the delivery of parts.

Euro area 10-year government bond yields
(Per cent)



10-year government bond yields have remained fairly stable over the last month

EU is lagging the race to rollout the vaccine
(Per cent of population vaccinated with at least one dose, 29/04/2021)



Macroeconomic backdrop

Japan and emerging markets

For the period, emerging markets stocks rose by +2.5% and +2.3% in local and Sterling terms respectively. Japanese stocks fell -2.9% and -1.9% in local and Sterling terms respectively. The best performing sectors in emerging markets were healthcare and retail while the worst performers were utilities and technology.

The Chinese economy grew 18.3% year-on-year in Q1 2021. This was the strongest pace of expansion since the series began in 1992, boosted by strengthening domestic and global demand, strict virus containment measures, and continued fiscal and monetary support. On a quarterly basis, the economy expanded just +0.6%, well below expectations. Exports and imports soared +30.6% and +38.1% respectively due to higher commodity prices and improving domestic demand. Retail sales rose +34.2% year-on-year in March, the largest annual increase since January 1995. It is important to note that most annualised number look inflated due to the significant drop witnessed in March 2020. The official NBS Manufacturing PMI fell to 51.1 in April from 51.9 previously and missing market expectations of 51.7.

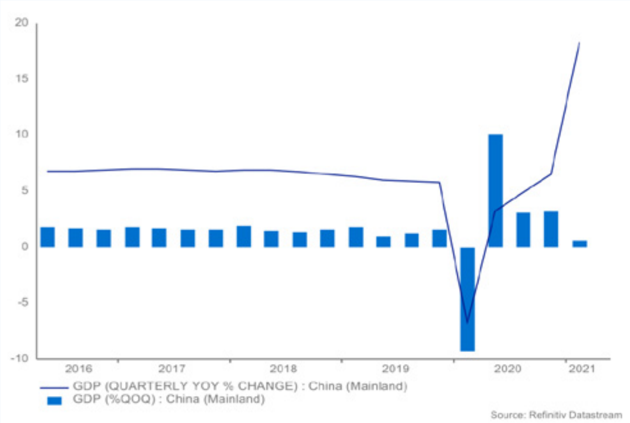
According to the OECD, Japan's economy is expected to expand 2.7% in 2021, up 0.4% from December forecasts. Exports from Japan jumped +16.1% YoY in March, beating market consensus of an +11.6% growth and after a -4.5% fall in February. This was the steepest growth in outbound shipments since November 2017, amid fresh indication global trade recovery. Manufacturing PMIs rose to 53.6 in April from 52.7 in March.

The surge of the highly infectious Indian variant of the coronavirus has swamped hospitals and depleted supplies of oxygen, while sufferers have died in ambulances and car parks. India's Covid-19 cases toped 20 million, with 3.45 million active cases, India is recording more than 400,000 new infections a day, while deaths have risen to 222,408, health ministry data showed.

Outlook: As the global recovery gains traction, emerging market stocks could stay under pressure after their strong rebound last year. The worsening outbreak in India could ripple across emerging markets if Indian officials continue to curtail vaccine exports to prioritise the tragedy unfolding domestically.

China GDP growth

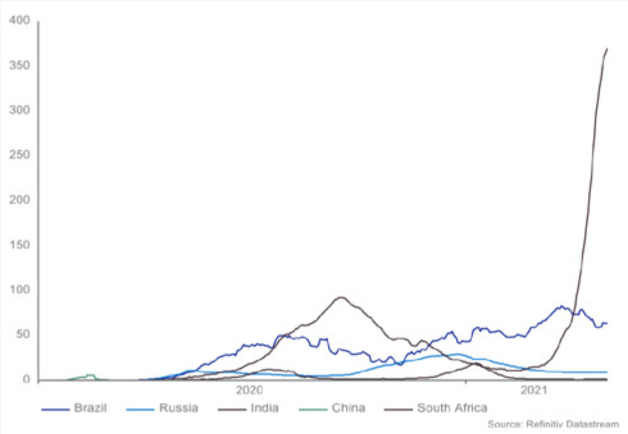
China's economy continues its strong recovery



The high growth rate was anticipated because in the same period last year China's economy contracted for the first time in decades as the country went into lockdown.

BRICS Covid-19 new daily cases

Per million inhabitants, 7-day moving averages



The Covid outbreak in India is potentially devastating for the country's economy but it could also foreshadow risks for other countries that are still struggling with vaccinations.

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.

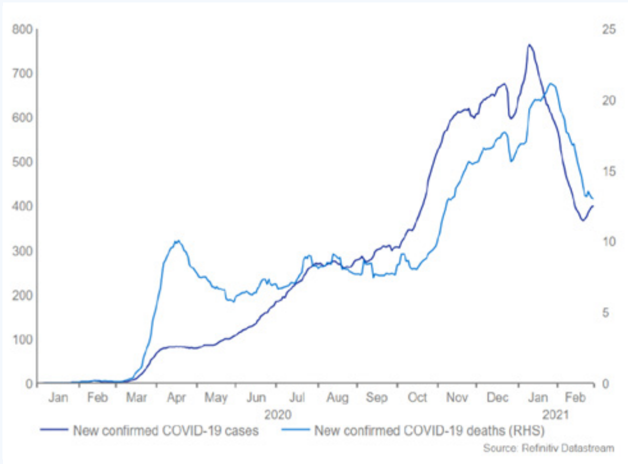
Although the prospects of an economic recovery look positive, the damage done so far makes it a challenging one. In its January World Economic Outlook Update, the IMF projected global economic growth at 5.5% this year and 4.2% in 2022. However, a report by the World Bank notes that losses relative to 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.

As developed countries like the UK and US are rushing to vaccinate their populations, emerging countries in India are battling a fresh wave of Covid-19. India became the world's second nation, after the United States, to pass the grim 20 million milestone for infections. It took the South Asian country just over four months to add 10 million cases, versus more than 10 months for its first 10 million. Daily new infections and deaths are mounting with alarming speed in India with no end in sight to the crisis.

The Covid outbreak in India is potentially devastating for the country's economy but it could also foreshadow risks for other countries that are still struggling with vaccinations. Uneven vaccine distribution was one of the top concerns among policy makers gathered for the International Monetary Fund's annual spring meeting earlier this month. If Indian officials continue to curtail vaccine exports to prioritize the tragedy unfolding at home, it could potentially threaten the global recovery.

Global Covid-19 new cases
New cases of Covid-19 are growing exponentially



Despite vaccinations in major developed countries, new Covid-19 cases are growing at a faster rate in emerging countries. According to the WHO, the trajectory of the pandemic is now 'growing exponentially' at more than 4.4 million new Covid-19 cases.

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 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 (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, a 68% correlation, with only 47% R2 (a measure of fit). Which is why the focuses 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.

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 $4tn US infrastructure spending bill, we see an increasing likelihood of a scenario where central governments continue

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

US inflatoin / Implied inflation vs reality = correlation 5%

US inflatoin / Implied inflation vs 2 months ahead = correlation 68%

Charts Source: Mazars Calculations

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.

Macro theme 3

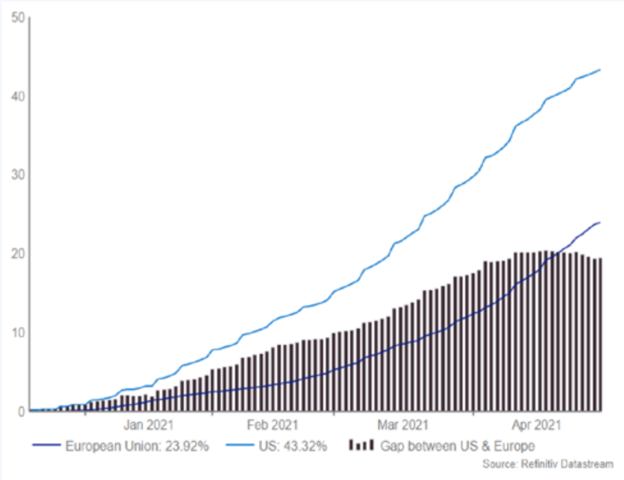
How the European vaccine rollout may determine Europe's future

The European vaccination campaign stumbled out of the starting blocks. In strong contrast to the swiftness of the US and UK campaigns, the EU's efforts were mired by slow supply and vaccine hesitancy. However, in recent weeks there has been a breakthrough. With vaccine deals beginning to reach the bloc, there is a growing sense of optimism especially in relation to the larger nations and the key tourist destinations.

Michel Barnier, the EU's chief Brexit negotiator admitted there were 'lessons to be learned' regarding the delays involved in the vaccination campaign. These centred on the bloc's inability to take risk relative to the British and the Americans, he said, 'we don't know how to do that yet'. The delay in sorting vaccines was partly attributed by Barnier to the need to work as a bloc of 27, instead of one country. Highlighting differences between the US and the EU in what constitutes an optimal trading area. Early in the pandemic the UK declined to join the EU vaccination programme, and there was criticism that the government was putting politics ahead of practicalities. However it became increasingly clear that the EU spent too long using its collective purchasing power to enable the lowest possible price, at the expense of a swifter rollout. This, combined with perhaps an overly prudent approach to pausing vaccinations to investigate potential blood-clot related risks has delayed the EU's programme relative to peers.

After slow start European vaccines pick up

Percent of population with at least one dose



Consequences and risks

The slow rollout of the vaccine has been the cause of significant consternation in the EU, and a point of attack from governments who would put limits to the reach of Brussels. The pandemic only exacerbated anger at the decision making process within the EU. That anger is now translated in political repercussions.

In France, Mr. Macron's popularity has waned and the 2022 presidential election is set to become a standoff between the incumbent and the National Front. The result could define Europe going forward.

Anger is nowhere as visible, however, as it is in Berlin. Angela Merkel's near 20-year rule is coming to an end, and with it the popularity of the governing CDU party. Polls suggest a strong probability that the 'Green' party, led by the charismatic Annalena Baerbock could top the race. It's position in the spectrum could give it a wide range of possible coalition partners. Even if it loses, however, it could still become a strong junior member in a coalition with the CDU, currently led by Armin Laschet. A political sea change in Germany after September is a high probability event, as it often happens when a long-time leader leaves the scene. The furore surrounding the handling of vaccination and the economic repercussions of the pandemic will probably play a large part in how the stage is set in the aftermath of the pandemic.

A strong and united Europe could follow the US and the UK in an effort towards a Keynesian regeneration of economic impetus and redistribution of wealth. A divided Europe, hampered by strict deficit rules, decision making around national interests and a less empowered central bank, could pay a very steep economic price after the Covid-19 pandemic is over.

Equity spotlight

Has the rotation into value stalled?

Successful vaccines, the passing of the US election and an increasing belief in strong global growth in 2021 spurred global equity markets and risk assets higher towards the end of 2020 and in the first few months of 2021. Over this period, value stocks reversed the trend of the past few years, outperforming stocks with higher growth expectations. However recent performance for value stocks has been less impressive, raising the question of whether the long-awaited rotation into value was a mere blip as opposed to a longer-term trend.

So what is the reason for the stall in momentum for cheaper stocks? It seems that markets may have become slightly overly optimistic about the prospect for the re-opening of economies globally. Despite good new on vaccinations in the UK and the US, most of the rest of the world is seeing stubbornly high Covid numbers. Some areas, in particular India, are sadly seeing a surge in infections and deaths and markets appear to be taking heed. If economies aren't able to open up as expected, many of the more economically sensitive sectors will have to wait longer for their earnings to normalise.

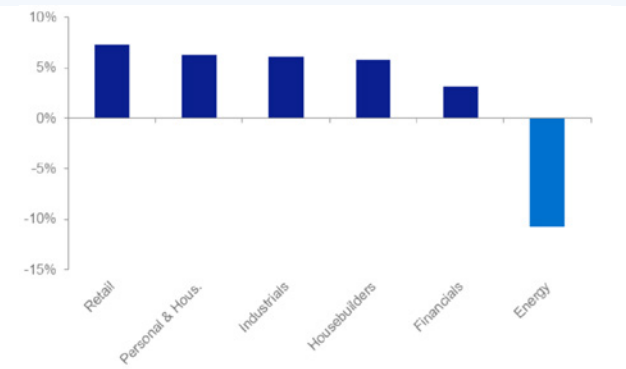
This issue will inevitably have differing effects by sector and region. For example, the UK looks set to largely re-open its domestic economy; a boon to the struggling hospitality sector which has suffered significantly during the pandemic. However with Covid levels still high overseas, airlines are unlikely to see earning rebound so soon.

An interesting conundrum is inflation. There has been a certain amount of justification for high valuations for growth stocks due to low yields, which reduces the rate at which future earnings are discounted in valuation models. Yields spiked significantly at the start of the year, anticipating a steady rise in inflation as economies re-open. This was another reason for value outperformance over the period, as these stocks' valuations are less reliant on future earnings growth. In fact certain sectors, often commodity focused, generally benefit from rising inflation which increases the prices of their products. However yields have fallen from their highs, suggesting markets have adjusted inflation expectations lower. But empirical evidence, such as mentions of inflation on earnings calls, points to rising inflation, certainly in the short to medium term.

Overall evidence suggests markets need more good news in order to re-ignite value stocks, although UK sectors with a greater domestic focus should continue to benefit from the re-opening here.

Performance since mid-March has been mixed for value sectors

UK sector equity returns in GBP



Treasury yields have fallen from recent highs

Rising yields had stoked inflation fears

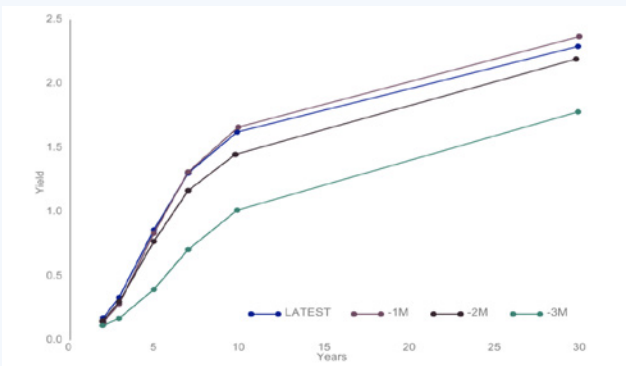


Chart source: Mazars Calculations

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 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.

Treasury yields have fallen from recent highs

US 10Y, 5Y and 2Y yields

Source: Refinitiv Datastream

Equity spotlight
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.

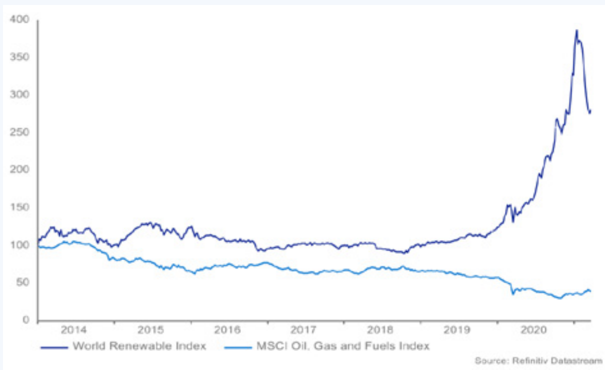
While the focus of ESG investments has largely been on environmental impact and climate change, this year we saw the 'S' in ESG come to the forefront. The social aspect of ESG was not well defined from an investment perspective but Covid-19 has definitely changed that. From early on in the pandemic,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

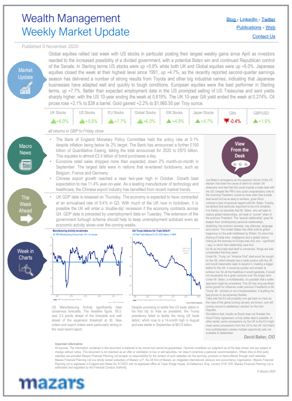
Renewable stocks have significantly outperformed traditional energy stocks

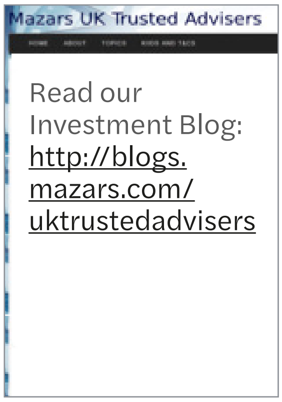
Global renewables vs oil and gas since 2014



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

More reading...





Weekly Market Update **Investment newsletter** **Quarterly outlook** **Investment blog**

Investment team

David Baker
Chief Investment Officer
david.baker@mazars.co.uk

James Rowlinson
Investment Analyst
james.rowlinson@mazars.co.uk

George Lagarias
Chief Economist
george.lagarias@mazars.co.uk

Prerna Bhalla
Investment Analyst
prerna.bhalla@mazars.co.uk

Patrick McKenna
Investment Analyst
patrick.mckenna@mazars.co.uk

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.

Contacts

David Baker, Chief Investment Officer
T: +44 (0)7580 999 021
E: david.baker@mazars.co.uk

George Lagarias, Chief Economist
T: +44 (0)20 7063 4721
E: george.lagarias@mazars.co.uk

Mazars is an internationally integrated partnership, specialising in audit, accountancy, advisory, tax and legal services*. Operating in over 90 countries and territories around the world, we draw on the expertise of 42,000 professionals – 24,400 in Mazars' integrated partnership and 16,000 via the Mazars North America Alliance – to assist clients of all sizes at every stage in their development.

*where permitted under applicable country laws

Mazars Wealth Management is a trading name of Mazars Financial Planning Ltd. Mazars Financial Planning Ltd is a wholly owned subsidiary of Mazars LLP, the UK firm of Mazars, an integrated international advisory and accountancy organisation. Mazars Financial Planning Ltd is registered in England and Wales No 3172233 with its registered office at Tower Bridge House, St Katharine's Way, London E1W 1DD. Mazars Financial Planning Ltd is authorised and regulated by the Financial Conduct Authority.

www.mazars.co.uk

mazars