Monthly market blueprint

Investment management service

June 2021

mazars

Contents

Foreword

The Return of Big State

I remember when liberal capitalism failed. The night of Friday 12 September 2008 no one was particularly worried. Barclays would rescue Lehman Brothers, like Bear Stearns was saved before it. On Monday morning we got the news. A Wall Street icon was the first victim of a year-long credit crunch. If one giant can fall, no one is safe. Other dominoes, maybe all of them, were sure to follow. What ensued was the unthinkable: the 'invisible' hand of the markets became an all-too-visible hand of banks asking the state for a bailout. One could almost hear the eerie laments of Milton Friedman (who had died less than two years earlier) and Adam Smith as 'big state' was replacing 'laissez-faire'.

But liberal norms don't allow for very expansive governments. For twelve years, 'big state' meant central banks. The objective was to repair balance sheets, both banking and household. The central bank would print money to give to the banks. Banks used the money to fill the holes - we never really learned how big they were - and curbed lending. Consumers were also warned not to rely too much on cheap bank lending to finance consumption in the future, and set out to fill the holes in their own finances. 'Money printing', essentially given to banks, led to unprecedented asset reflation. US equities, the world's benchmark, grew to more than three times their previous peak, pulling global stocks with them. Bond yields crashed as prices soared and yield curves flattened beyond previous comparison as central banks bought fixed income across the board and on the whole spectrum of maturities. Alpha (getting the securities right) gave way to Beta (timing the market), and analysis was replaced by central bank-watching. The world was in repair mode, growth was sluggish, and investors, flush with cash, were willing to pay extra for growth where they could find it. A year and a half before Lehman, Steve Jobs had introduced the iPhone, and the world would never be the same. Thus, Wall Street Banks were replaced as the most expensive companies by technology. Today, the six largest US firms are tech companies.

Meanwhile, the question: 'can there be a recovery without banks?' was answered. 'Not in the real economy'. Growth and real (ex-inflation) incomes stagnated for twenty years. Inflation itself went missing. Consumers, reeling from the 'Dot Com' Crisis to the 'Global Financial Crisis' became almost too careful with their finances. As did most of their employers, who forewent expansion plans and refrained from wage hikes.

'Recovery' for the financial economy became 'secular stagnation' for the real economy, as the two parted ways. With banks still shackled to Basel III, a restrictive set of lending rules, responsibility for growth reverted to the state. Reeling from the 2008 crisis and mindful of the perils of debt, world leaders happily took a pass on the 'poison chalice' of fiscal expansion which could only come with extended borrowing.

Unexpectedly, it took a pandemic and a semi-retired, ostensibly transitional and nearly octogenarian US president to come up with the boldest plan of government action to tackle lacklustre economic growth, since the days of F. D. Roosevelt and L. B. Johnson. A $4tn infrastructure 'jobs' and education plan on top of a $1.9tn Covid recovery stimulus. A $6tn budget for 2021, which would assume a double digit deficit for the second year running. A plan like that could empower consumers and break the 'secular stagnation mindset'. At any rate, pumping such an amount into the economy would also probably cause inflation. 'Big state' may now become a word for government, not central banks.

Higher inflation, even as a result of the strongest economic impetus, may push investors out of their 12-year comfort zones. Yield curves could steepen (the long end where inflation lives may go up), corporate bond yield spreads may widen and equity risk premiums (what investors get paid to take on risk) may fall if the Fed turns 180 degrees to raise rates and tackle inflation. Alpha would likely replace Beta and 'Value' investing may be resurrected.

At best the result will be a 'breakout velocity' and a new economic and financial paradigm. At worst, a scenario where consumers and businesses don't take Mr. Biden up on his offer and save more than they should, we could see a two-to-three-year bout of 'stagflation' (stagnation plus inflation) and eventual return to the grip of 'secular stagnation'. Gold is already pricing in higher inflation. The bond market much less so.

Pending a few votes in the US Congress, we could be standing at the cusp of significant changes in the way the economy works and money is invested.

George Lagarias
Chief Economist, UK

Market performance – in a nutshell

The month in review

Risk assets buoyed by positive data

The tone of the debate in May can be characterised by reopening post Covid, rebound of the economy and resurgence of inflation. Positive economic data saw risk assets move higher while bond performance was mixed.

In the US, the main thrust of discussion was around the return of inflation driven by Joe Biden's stimulus packages. This was apparently confirmed with core (less food and energy) personal consumption expenditure increasing 3.1%, which is considerably higher than the 2% target rate of the US Federal Reserve (Fed). However, Fed officials reiterated their stance that bottlenecks in supply, which are driving prices higher, will prove temporary. US equities ended the month +0.7% higher in USD terms, although this somewhat masks the volatility that we saw.

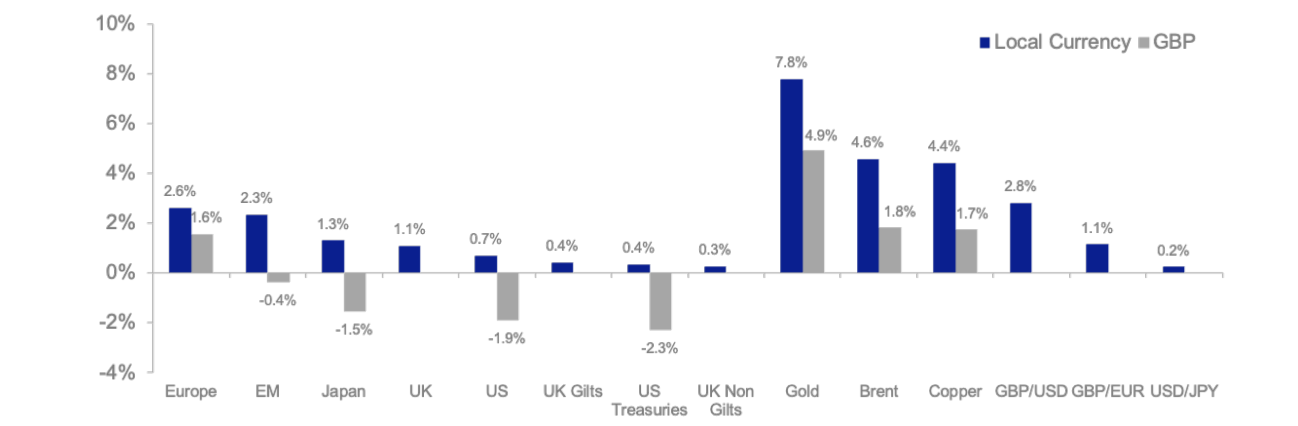
In the UK, May began with the release of Q1 GDP figures showing the economy contracted 1.5% in the first three months of 2021. While on the face of it this is poor, markets are forward-looking and the key data points were the vaccine rollout and the reduced number of Covid mortalities, both of which continue to point towards to the removal of Covid restrictions and the strong rebound of the economy in 2021. UK equities moved up +1.1%.

The economic data to come out of Europe was exceptionally positive in May. From a slow start the vaccine rollout has now picked up pace and various sentiment indicators and surveys show high levels of optimism in the economy as the conversation shifts to removing lockdown measures. European equities ended the month higher by +2.6% in local currency terms. Emerging market and Japanese equity markets moved up in line with their global peers.

Despite the inflation debate, both UK and US 10-year bond prices ended the month slightly higher than they started, while the German 10-year Bund ended the month slightly lower, as the European pandemic asset purchase programme and the support it provides to bonds look less tenable given the expectations for economic recovery.

The talk of inflation sent the gold spot price up +7.8%, while the oil price moved up +4.6%. A strong Pound, up almost +3% against the US Dollar in May, moderated the gains seen in non-GBP assets for Sterling investors.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation

Changes in our Strategic Asset Allocation

Outlook and portfolios

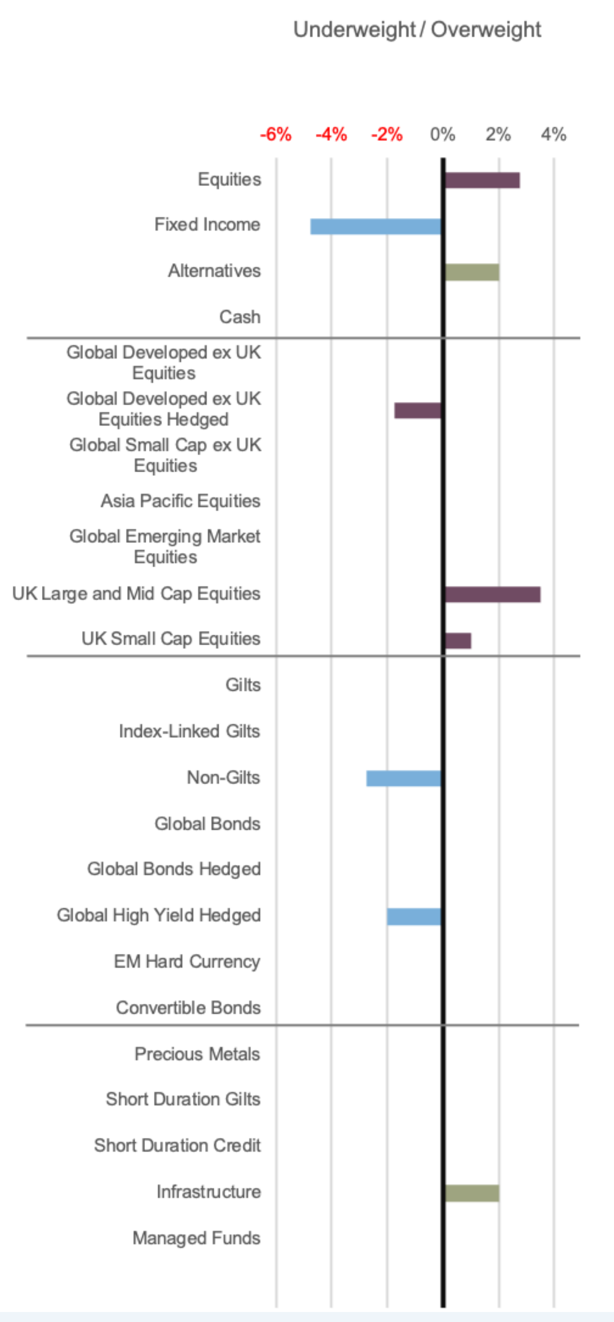
Economic data remains exceptionally volatile. On the one hand, after March we are seeing a fast-paced recovery around the world as vaccination rates improve. On the other, with many parts of the emerging world - where a lot of production takes place – still suffering, imbalances in the global economy are exacerbated by the chaotic and unpredictable nature of local lockdowns. A heavy strain is put on supply chains. Supply constraints combined with pent-up consumer demand are pushing inflation upwards.

Governments are still in spending mode and are considering a departure from the fiscal orthodoxy of the last twelve years. Extensive borrowing which has supported employment and consumption may now be used to push the world out of 'secular stagnation'.

But investors are now worried. Higher long-term demand-side inflation might mean higher rates and quantitative tightening, risking the 'only game in town' for risk assets, central bank accommodation. Central bankers are reassuring for now, as pent-up demand and supply constraints are too temporary to cause a fundamental shift in monetary policy. But a huge amount of cash flooding the real economy could be a game changer for both central bankers and the way money is invested.

In the past few months, we have been moving towards our new Strategic Asset Allocation, while also shifting 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 geographic 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 exposure, we remain close to the benchmark. We maintain a healthy exposure to gold, as the asset class remains uncorrelated with equity markets and tends 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 3 June 2021



Risks
The risk of inflation

2021 is set to be the year of recovery after a period when global economic growth faltered at the swiftest pace since WWII. 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 supply chains 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.

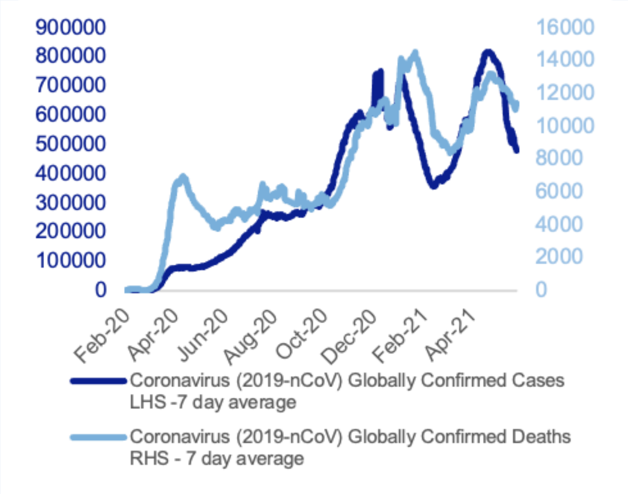
Markets continue to focus on quantitative easing, with investors convinced, for now, that central bank risk suppression is potent enough to weather any economic issues. The rate at which monetary and fiscal stimulus will be withdrawn is the main risk for the upcoming economic recovery. Stock prices are near all time highs, but with earnings still to catch up, expensive valuations are creating a ceiling against further breakouts. Global bond yields began to climb on inflation fears, however the move proved temporary with markets thinking that inflation pressures will recede, as long as fiscal stimulus is withdrawn as well. At any rate the Fed has signaled it will tolerate higher inflation for now.

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 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.

The key risk for investors is an inflation-driven paradigm shift. If stimulus causes higher inflation, central banks will have to rethink a 12-year monetary accommodation regime. Taken further, if growth supports even higher and resilient inflation, central banks will undoubtedly have to adjust. At the time of writing, all key risks are kept in check due to the blanket of liquidity provided by policy makers to markets. We will be vigilant for signs of a significant shift in policy.

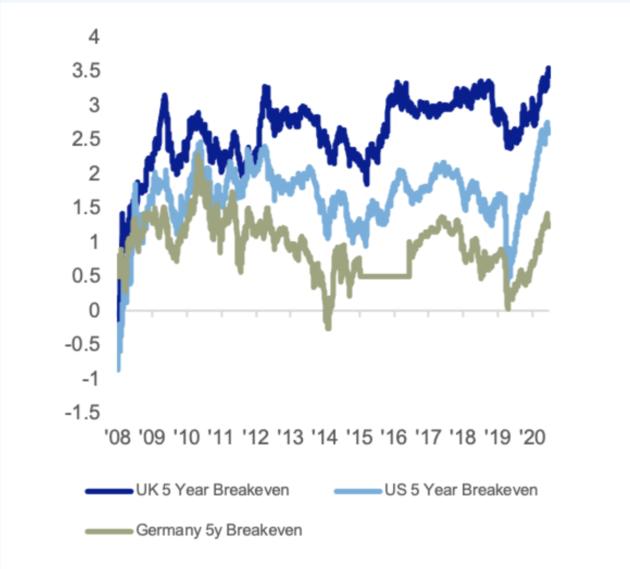
Pandemic levels still high

Covid new cases and deaths



Inflation expectations rise, especially in the US

Five year breakevens



Charts source: Mazars calculations

Macroeconomic backdrop

Global

In May, global stocks rose by +1.4% (+1.2% in GBP). The best performing sectors were energy and financials, while the worst performers were cons. discretionary and IT. Equities were trading at 20.5x times forward earnings, 25.5% above the long-term average. Gold rose +7.8% and oil prices rose +4.6%.

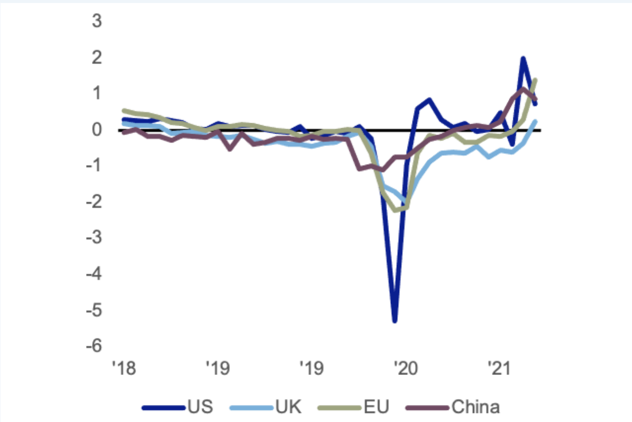
Economic performance has picked up significantly in the past few months, both in terms of services and manufacturing. However, as a result of lack of global coordination, the rebound remains de-synchronized across the board.

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 expanded the least fiscally and negotiated the longest over vaccine contracts, has just entered its more 'explosive' recovery phase. Overall economic performance, both in manufacturing and services, picked up in May, 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 calculating that a rise in prices will only be temporary.

Outlook: Global equities have been trading sideways in the past few months, as earnings begin to catch up to expensive valuations. The effect of supply chain disruptions, global imbalances and lingering problems in the services sectors post-summer 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.

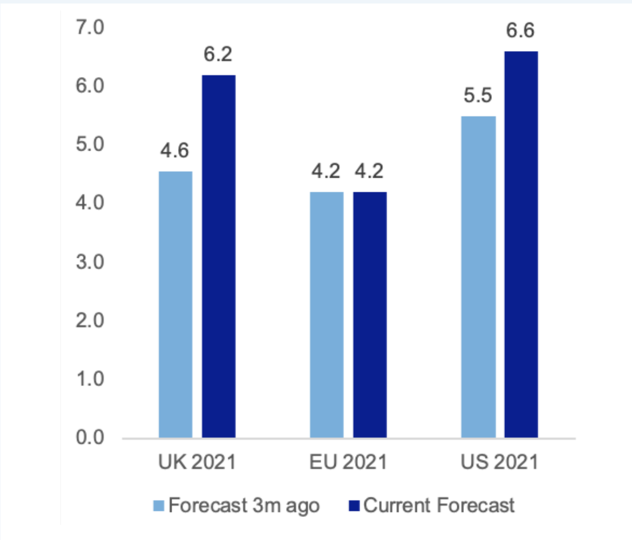
The global economy is rebounding sharply

Z-score of leading indicators



Economic forecasts improve

Bloomberg forecasts from economists



Macroeconomic backdrop
UK

UK equity markets continued their strong start to the year, up +1.1% in May. The best performing sectors were housebuilders and healthcare, with the worst performing telecoms and IT. UK equities are now trading at 14.1x forward earnings, in line with their long-term average.

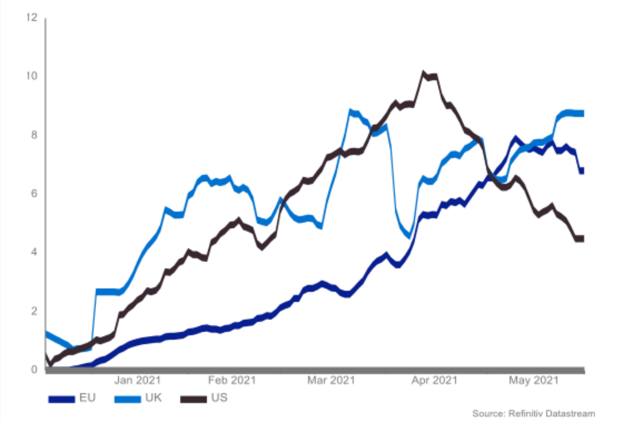
After a strong early start to the month for equity markets, up over +2% in the first week, inflation fears saw UK equities fall off during the second week of the month before trading sideways towards month end. Sterling gained +2.8% vs the US Dollar and +1.1% vs the Euro, and is again near its highs on a trade-weighted basis since the Brexit vote. 10Y yields fell 5bps to 0.795%, a change largely in line with global yields.

The OECD upgraded its forecast for UK growth in 2021 to 7.2% from 5.1%, following a fall of 9.8% in 2020. However the effects of Brexit mean it is forecast to be the G7 country with the largest amount of scarring of around 0.5% of GDP each year. Flash services PMI was largely in line with expectations at 61.8, while manufacturing surprised to the upside at 66.1 for May. These are generally very positive given a reading of 50 represents stability.

On 1 June the UK registered its first day without a Covid death since July 2020, with the vaccine roll-out, with 59% of the population having received their first vaccine, pointing towards the full re-opening of the economy on 21 June. However an uptick in cases following partial re-opening and the new delta variant means the original timeline remains in the balance.

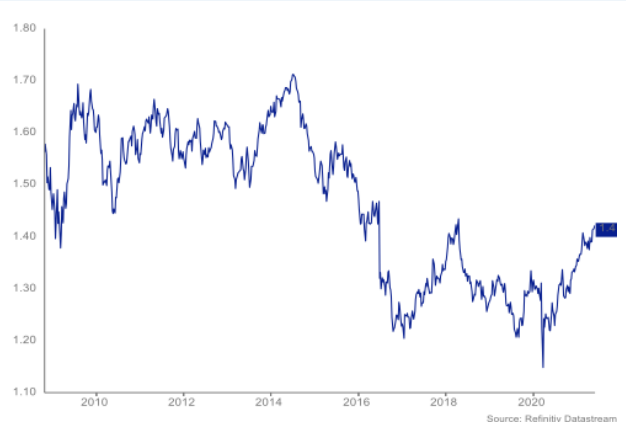
Outlook: The next few weeks appear crucial in the near-medium term outlook for the UK. If the country is able to fully re-open as currently planned, and this does not lead to a significant spike in cases, it would be extremely positive for the UK economy and Sterling.

UK vaccination rates remain high
Per thousand inhabitants, seven-day moving



While vaccination rates have slowed in the US, where hesitancy is high in certain areas, the UK has maintained a high vaccination rate. In fact the rate remains higher than levels in the EU, despite a higher proportion of the population already being vaccinated.

Sterling is again near its highs since the Brexit vote
GBPUSD exchange rate



The positive outlook for the UK economy compared to global peers, on account of its successful vaccine roll-out, has seen significant Sterling strength in th past six months.

US

In May, US stocks rose by +0.7% (-1.9% in GBP). The best performing sectors were energy and materials, while the worst performers were homebuilders and utilities. Equities were trading at 22.6x times forward earnings, 30.5% above the long term average and 10% above global equities. 10Y bond yields fell 3 bps to 1.594%.

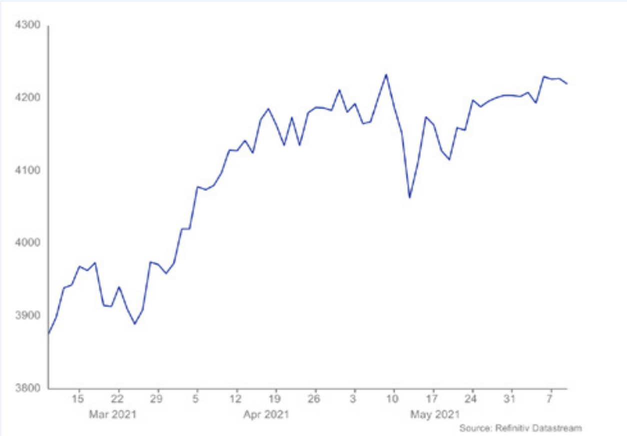
Economic activity in the US continued to improve. The country's output growth during April has been driven by a sharp rise in new business. GDP for Q1 grew an explosive 6.4% (annualised). Manufacturing activity accelerated at the fastest pace in the cycle and continues to constitute a pillar of recovery despite disruptions and challenges in the supply chain. The 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 more quickly.

Outlook: The main factor for economic performance in the next few quarters will be fiscal stimulus, where Joe Biden's proposal to stimulate the economy by an extra $3.4-$4tn could significantly add to inflation, but also spur consumer demand.

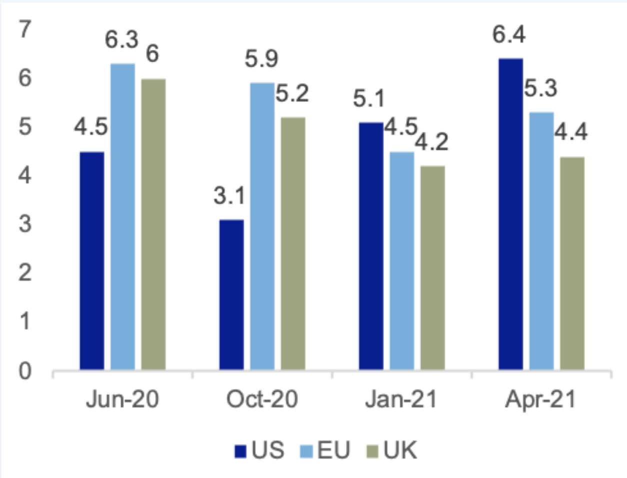
US equities trading sideways in the past few months

Price return



The is US expected to rebound faster this year

IMF economic forecast



Charts Source: Mazars Calculations

Europe

European assets are reflecting the easing of lockdowns. Equities rose by +2.6% in May while the ECB talked yields down on sovereign bonds.

The European vaccination programme has continued apace and this has seen Europe close the gap with other developed markets in terms of the percentage of the people who have received their first dose. This has corresponded with a fall in the number of new Covid cases.

The upshot of the vaccine roll out is lockdowns are being lifted across the continent, which bodes well for continued resumption of economic activity.

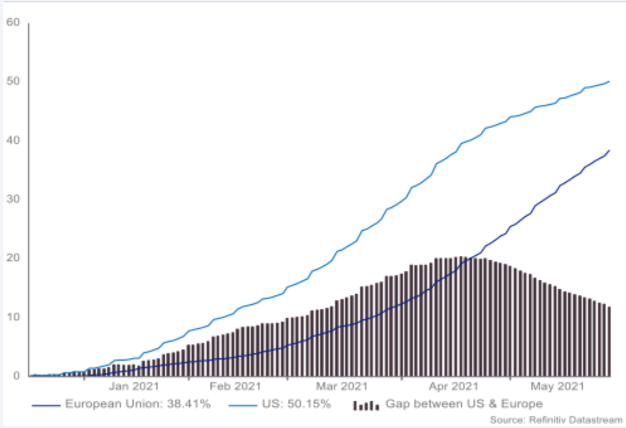
Despite the belated reopening of the European economy relative to the US and the UK, European data has been particularly strong for the month of April, with PMIs, ZEW, Q1 inflation and consumer sentiment all pointing to a positive underlying economy.

Government bond yields were broadly stable this month as the ECB's chief economist played down the risks of inflation in Europe. However, following the slew of positive economic data and the ongoing reopening of the European economy, it is hard for the ECB to justify continuing emergency liquidity measures. The ECB will walk a tightrope between withdrawing the liquidity measures, initiated to cushion the economy during the pandemic which arguably are no longer needed, while keeping a lid on bond yields in order to prevent the increase of funding costs for European corporates and potentially choking off economic growth.

Outlook: The positive economic data should continue given the prospect for further easing of lockdowns in Europe to increase activity, which is supportive for risk assets. Given the potential for tapering from the ECB to come more into focus, there is potential for sovereign bond yields to increase this year. Asset purchases have had the side effect that the spreads of peripheral sovereigns have remained tight, but given the differing outlooks for long-term growth there is potential for those spreads to widen further.

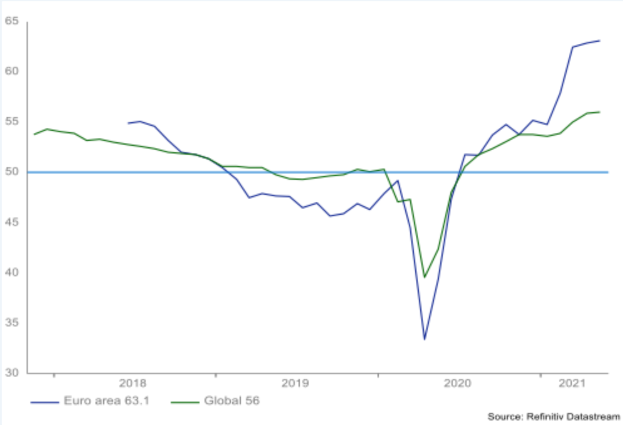
Euro area vaccination efforts are catching up with developed market peers

Percentage of population with at least one dose of Covid vaccine



European survey data points to strong economic recovery

Manufacturing PMI data, euro area charted against the global data



Japan and emerging markets

In May, emerging markets stocks rose by +2.3% in local terms but fell -0.4% in Sterling terms. Japanese stocks rose +1.4% in local terms but fell -1.5% in Sterling terms. The best performing sectors in emerging markets were healthcare and transport while the worst performer was technology.

The Chinese economy saw improvement in domestic demand last month but also witnessed more pressure on the recovery in consumption. Retail sales rose by 17.7% YoY, easing from a 34.2% jump previously, with sales growth eased for all categories including clothing, jewellery and automobiles. China's fixed-asset investment soared 19.9% YoY in the first four months of 2021, beating market expectations. Public investment jumped 18.6% (vs 25.3 percent in January-March) and private investment advanced by 21%(vs 26%). The official NBS Manufacturing PMI fell to 51 in May, compared with market consensus and April's figure of 51.1. This was the lowest reading since February, amid intense inflationary pressure and supply bottlenecks. New orders grew the least in twelve months. Non-Manufacturing PMI rose to 55.2 in May from 54.9 in the prior month. Producer Price Index (PPI) has also been rising in China, which is a major buyer and supplier in global markets.

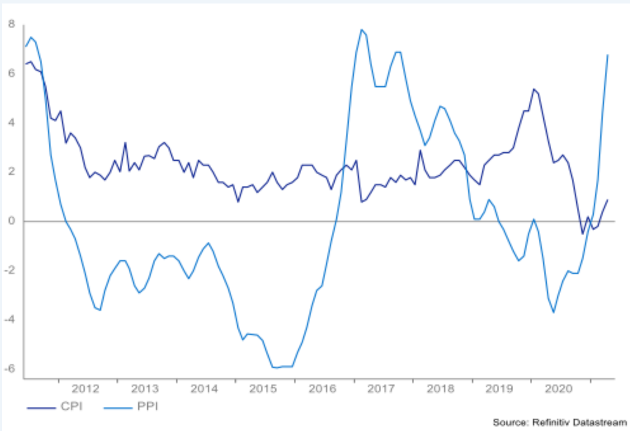
The Japanese economy shrank 1.3% quarter-on-quarter in Q1 2021, compared with market estimates of a 1.2% fall and after a 2.8% growth in the previous period. This was the first contraction since Q2 2020, amid a resurgence of Covid-19 cases and slow vaccine rollouts. Exports from Japan jumped 38% YoY while imports grew by 12.8% YoY to a 27-month high, amid a further recovery in domestic demand.

While India continued to report more than 100,000 Covid-19 cases per day, scientists believe the devastating second wave of infections appears to have peaked. Indian large cap equities also hit an all-time high towards the end of the month.

Outlook: As the global recovery gains traction, emerging market stocks could stay under pressure after their strong rebound last year. The worsening Covid-19 outbreak in India could ripple across emerging markets if Indian officials continue to curtail vaccine exports to prioritize the tragedy unfolding domestically.

China inflation

Despite the increase in PPI, there are no CPI inflationary pressures in China



As we see a rise in inflation, it seems that China has been absorbing much of the PPI inflation and not passing it on to consumers just yet.

Indian rupee and equities

Both equities and the INR remail resilient

India's equity market has proved surprisingly resilient despite more than 100,000 new Covid-19 infections daily. Relatively lax restrictions to curb the virus may have helped, and should mean that the economic impact is more limited than in 2020.

Our themes

Macro theme 1

End of the beginning for Covid-19. The vaccine rollout in the west is certainly encouraging but portfolio managers will be wary of a sting in Covid's tail.

This month we continue our monitoring of the effects of the Covid pandemic on the global economy. Ever-conscious of complacency, we are keeping an eye on the uneven vaccine rollouts in different parts of the world, as well as the potential for political fallout from Covid. While markets are effectively blind to the former at this moment in time, the latter could prove hard to ignore.

As soon as vaccines appeared in November 2020 medical experts warned of the importance of an even vaccine rollout across rich and poor nations, and of the dangers of developed countries hoarding vaccines. Their point was that such action could lead to a situation where in some countries the virus was left to reproduce and potentially mutate into something which the currently available vaccines were not equipped to tackle. To some degree we are seeing such events unfolding at the moment, with the fast-spreading, so-called 'Indian variant' causing increased hospitalisations in the UK. While Public Health England has said that the currently available vaccines are effective against the Indian variant, some scientists have nonetheless called for delaying the further loosening of restrictions in the UK that was planned for the second half of June.

While you can't say that the economic effects of the Indian variant in the UK are significant so far, it is but one variant. There has been news of a variant in Vietnam which is a hybrid of two highly-transmissible Covid strains, the UK (or 'Kent variant', as it was known locally) and Indian variants. This has led to a sharp rise in cases in Vietnam, a country which has previously been notable for the small number of Covid infections experienced. While for UK-based investors it is satisfying watching the fast-paced rollout occurring in our own country, it is the countries that aren't administering the vaccine which we should keep a close eye on.

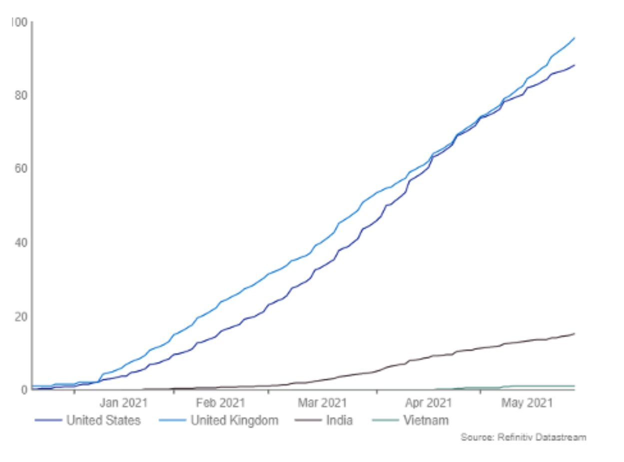
The second area we are looking for risks is the political changes that the Covid crisis could bring about. We should not forget that the largest driver of the global economic recovery, the Biden stimulus plan, is to some degree a product of Covid. Had Donald Trump responded to Covid in a more coherent fashion the US election may have looked completely different last November. This demonstrates that an event with the magnitude of Covid can have far-reaching consequences, and they don't all have to be as benign as a Biden presidency.

In Brazil, the country where the second largest number of deaths from Covid have been recorded after the US, mass protests have erupted over Jair Bolsonaro's handling of the Covid pandemic. His disapproval among the electorate points to political change in 2022. France's Covid record is also damning, with the highest number of cases of any country in the EU. Currently the polls show Macron trailing far-right leader Marine LePen in the polls. Political changes in any major economy can be a risk for investors.

In a year when there is widespread optimism about the economy and developed market equities have already exceeded some analysts expectations for 2021, it is tempting to ignore the risks. Covid is receding thanks to vaccination efforts but investors should ensure that their portfolios are diversified to perform when the market next decides to focus on some of the risks to economic recovery.

Total number of vaccines

Divergence between developed and developing nations' vaccination efforts



It is no coincidence that new variants are appearing in countries which have relatively low vaccination rates. Investors should follow this data as it represents a tail-risk to the reopening of the global economy.

Macro theme 2

Inflation as a red herring

As we head into the summer, and with the US earnings season solidly behind us, equity trading volumes traditionally thin out and risk asset movements become less pronounced.

With inflation expectations higher and gold hitting the $1,900 mark again, markets have now turned to the big question of inflation: Will the inflation figures we are seeing across the world persist and force rates up? After all, higher inflation could have an effect of lowering real wages, forcing companies to compete on margins and thus increasing pressures on labour markets. Inflation tends to lead to a rise in the price of real assets (like precious metals or houses), exacerbating the situation for workers who have already seen real incomes stuck for a decade.

The quick and simple answer is a highly likely ‘no’. The market’s present obsession with inflation stems mostly from the short-term reading of current figures and projecting them into the future.

The current inflation bout is a confluence of obvious transitory factors, such as post-lockdown pent up demand, an imbalanced global economy disrupting supply chains and simple accounting when comparing today with more depressed prices from a year ago. The Fed insists, and we would concur, that this is likely temporary.

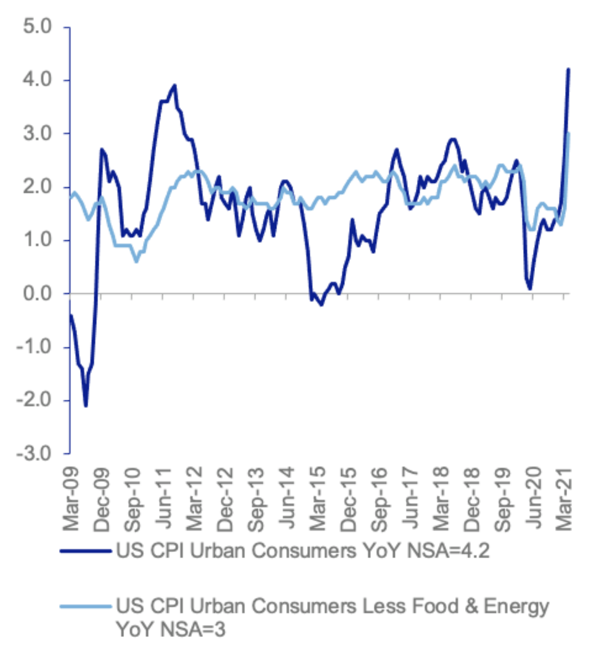
At any rate, investors would be well served to remember that rates are not a panacea against every type of inflation.

Even if the Fed miscalculates the extent of the current inflation bout, how would withdrawing accommodation cool prices? Would higher rates make time go faster and expunge year-on-year effects on the Consumer Price Index basket? Or would they rebalance global economies and supply chains? They could potentially dampen consumer spirits after a more than 14 month internment, but discouraging a sorely needed rebound in growth and reduction in savings after the worst economic year in modern times would go against the Fed’s general growth mandate.

Our view

We believe that the current bout of inflation will likely not be the harbinger of rate hikes because factors are temporary.

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



Charts Source: Mazars Calculations

To see higher rates, the kind that would force the Fed to change tack and threaten to end the present QE-driven paradigm for risk assets, investors would need evidence of persistent demand-driven growth that would threaten to overheat the economy. Considering the last twelve years of secular stagnation, on which the pandemic disruption was added, it would take a very generous fiscal expansion scheme to stimulate that kind of demand.

Enter Mr. Biden’s $6tn budget proposal, which assumes a c.10% deficit on current tax receipt projections (see foreword). Pumping that sort of money into the economy would spur inflation, either for a few years (if consumers remain conservative) or for longer (if consumer ‘animal spirits’ are unleashed).

The real question going forward for investors and businesses is not whether current inflation will force the Fed to hike rates, but whether the new US budget will be enough to break secular stagnation.

Macro theme 3

Asia's road to recovery

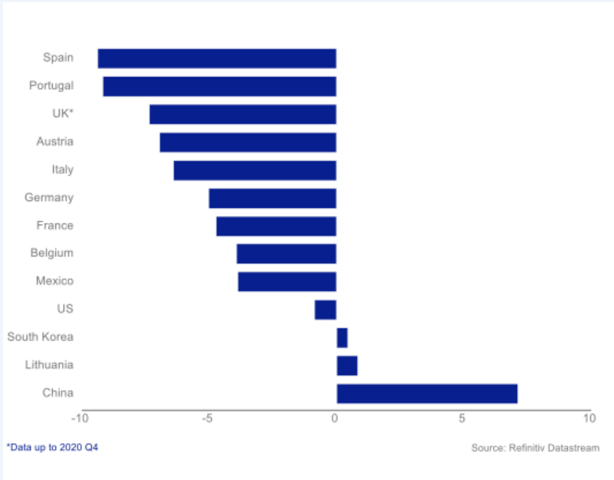
Advanced economies are increasingly looking towards Asia to try and predict what their own recovery will look like. The Asia-Pacific region went into the Covid-19 crisis first and as such, many of its economies are emerging from it first. A major reason for this has certainly been their quick and highly effective response to the pandemic. The early implementation of stringent containment measures proved crucial in flattening the pandemic curve. It ensured that medical systems were not overwhelmed and fatalities were reduced, laying the foundation for the recovery. Meanwhile, the rollback of containment measures only after the stabilisation of outbreaks and establishment of strong testing and tracing regimes, were key in boosting confidence and paving the way for a stronger rebound in economic activity and improved health outcomes.

Extensive monetary and fiscal support – Japan and New Zealand being notable examples – has helped to mitigate the economic effects of containment measures and has facilitated the resumption of activity.

China has experienced one of the fastest economic recoveries in the world from Covid-19, driven mainly by its industrial and manufacturing sectors.

World GDP

Asia's economies are leading the recovery



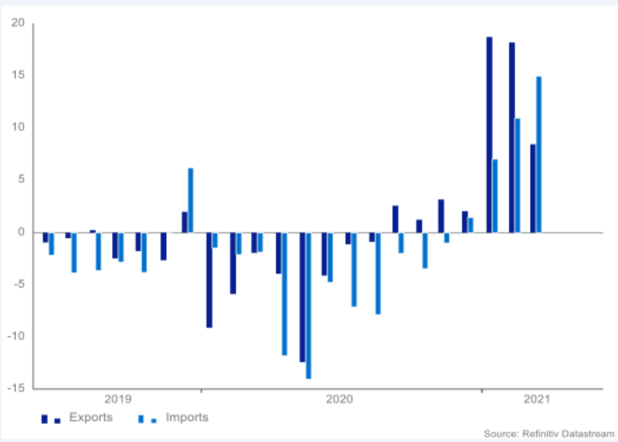
Its economy grew 18.3% in Q1 2021 compared with the same period last year, though the growth rate was boosted by a low base in early 2020.

As consumer demand for both domestic and foreign goods increases, strong trade data out of Asian countries such as South Korea has given further boosts to investor sentiment. The country's exports surged the most in three decades to 45.6% in May 2021, from a year earlier, the fastest growth since 1988, with shipments to the US and China up 63% and 23% respectively. The country's export data is seen as a barometer of global demand, as South Korea is home to leading manufacturers of electronics, automobiles and petrochemicals. Overall, the strong data reflects a gradual recovery in global commerce as business activity picks up in major economies and consumer confidence grows.

As new waves of Covid-19 infections hit economies across parts of Asia, the region's road to recovery may face some near-term headwinds. Though ultimately, we believe that it remains well placed to reward discerning investors willing to take a long-term view.

Asia export and import volumes (goods)

Twelve month percentage change



Checking in on the Value call

We have written about Value and Growth before. Following indices weighted to each style will give an insight into how they are performing relative to one another.

Last month we highlighted that Value stocks' outperformance will be driven by economic fundamentals and inflation expectations as ultimately this points to rebounding corporate earnings accruing to shareholders. For Growth companies, robust economic recovery can have a less positive impact as it can lead to interest rate hikes, which increase the rates used to discount future earnings that support the often high valuation multiples.

For people who are interested in tracking this dynamic, comparing the performance of the following pairs of equity indices will give you an idea of what is happening. The first are US Growth and US Value indices in the United States. The US Growth index consists of Growth companies and approximately 40% of it is constituted by seven well-known technology companies that have epitomised the rally in Growth shares seen over the last few years and particularly since Covid appeared. The US Value index on the other hand is heavily weighted towards financials, industrials and healthcare companies, typical Value sectors. So far this year the US Value index has outperformed the Growth index by 11%, of which 3.5% outperformance was in May.

The second way to follow the Value vs Growth trade is to compare US equities with UK equities. Within US large caps, 37% of companies are either in the technology sector or heavily reliant on technology in the services they offer, such as streaming company Netflix, which formally belongs to the communications services sector, but is reliant on its innovative online platform. UK equities on the other hand are heavily weighted to pharmaceuticals, banks, industrials and energy companies, with no tech sector to speak of. So far this year the relative performance of these indices tells a less compelling story for those expecting Value to outperform as the UK index has underperformed the US by 3%.

We remain positioned for Value to outperform Growth given where we are in the business cycle and hence we watch these relative performances very closely.

The outperformance of Value is certainly visible in the US in 2021

US Value & Growth,YTD, rebased to 100

...however the UK/US pair has not borne out the 'Value trade'

UK and US equities YTD, rebased to 100

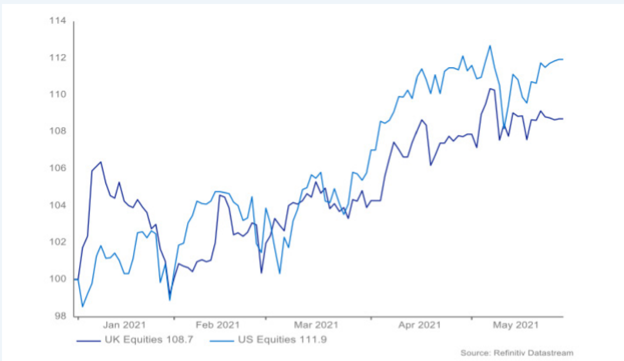


Chart source: Mazars Calculations

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 of interest rates staying lower for longer. As 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 was 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 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.

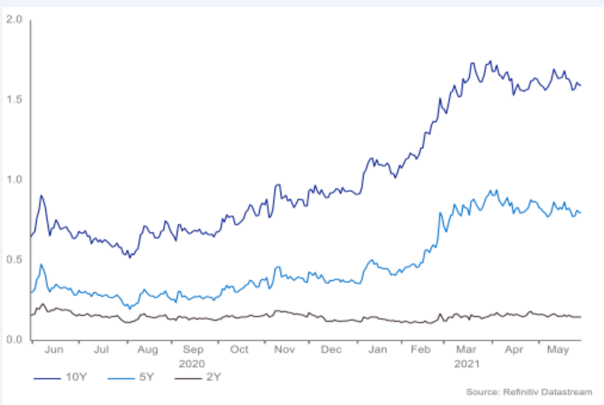
The pandemic is likely to have a similar effect, with global supply chains damaged and the possibility that politicians further prioritise domestic production to combat risks that vital supplies could be hoarded by a trading partner.

Markets had taken notice of rising inflation signs, with yield curves showing nascent signs of normalisation, although yields have fallen from their highs since March. Certainly inflationary pressures appear to be building, particularly in the US. However we have to note that market expectations have historically correlated 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 raise 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.

ESG or ethical investing has now become a trend the investment 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 US large cap firms produced sustainability reports in 2019 and 81% of UK large cap companies have some form of emissions reduction target.

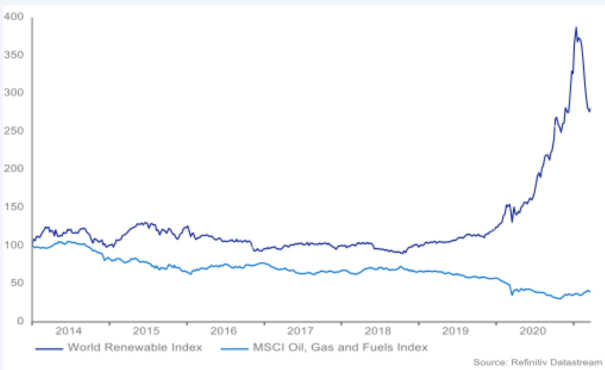
While the focus of ESG investments has largely been on environmental impact and climate change, this year we saw the 'S' in ESG come to the forefront. The social aspect of ESG was not well defined from an investment perspective but Covid-19 has definitely changed that. From early on in the pandemic,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

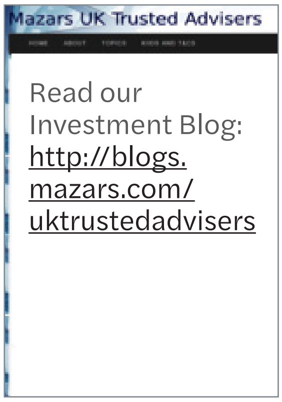
Renewable stocks have significantly outperformed traditional energy stocks

Global renewables vs oil and gas since 2014



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

More reading...



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