Mazars Wealth Management investment newsletter

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Foreword

Developed markets' continued vaccine rollouts and a corresponding easing of lockdown measures buoyed equity markets during the second quarter despite already starting the period at elevated levels. Global stock markets rose by over +6% in Sterling terms and whilst the US was again the best performing region, European and UK stocks were not far behind. The outlier in developed markets was Japan whose vaccine programme lags well behind that of western markets, while emerging markets were also below average for similar reasons. Gold rallied strongly during the quarter before selling off to end up +2.4%, and Gilts posted a positive +1.2% return as yields remained stubbornly low as a consensus of any inflation being 'transitory' seems to have been reached (for now) in markets.

For some time now we have commented that markets were pricing in expectations of lockdown measures being eased, and some sort of return to normality bringing about better fortunes for corporate earnings. We are now seeing that hypothesis play out in part as a very strong earnings season went some of the way to justifying stock market valuations. That said, markets remain expensive by historical standards and will rely on the continued reopening of economies being unaffected by unwelcome virus developments even with the now familiar backdrop of very accommodative monetary policy. Dispersion in fortunes between geographies and sectors remains a pronounced feature of equity markets, with the US remaining the most expensive market by virtue of its weighting to technology firms, and we expect active managers to be able to add value in this environment. By contrast to the US, the UK market continues to look markedly inexpensive as analysts' expectations for better earnings in financials and industrials go unrewarded, and investors remaining seemingly undrawn to dividend paying stocks.

Lockdown measures in the largest economies are easing, workers are returning to jobs, and though in some areas the Delta variant is leading to an increase in Covid cases, vaccine rollouts mean that this wave of infections is proving less deadly. Vaccine supplies though remain a challenge for large parts of the world meaning that the now familiar economic problems will remain in those countries. While the situation is undoubtedly improving and swiftly so, we concur with the Bank of International Settlements' view that we will see a "strong but uneven recovery".

The possibility of higher levels of inflation, and how long these might persist, are the main questions vexing markets at present. For over a decade extraordinarily accommodative monetary policy has kept financial assets high whilst not fuelling inflation in the real world. That economies have not fallen apart during the pandemic is due to quick governmental action, but at a heavy price in terms of fiscal deficits. The US at least looks likely to continue to spend beyond its income, and with the cost of borrowing presently so low others might be tempted to follow. Such fiscal expansion, cash saved by households during lockdowns, remaining pressures on supply chains, and the growing urgency to tackle climate change are all potential sources of inflation.

At our June meeting the Investment Committee voted to make no changes to our portfolios. We continue to feel that the bond market offers little value and thus maintain our overweight to equities and infrastructure assets. We continue to hold a balance between value and growth stocks, and favour the UK on a valuation basis.

I hope you find this newsletter interesting and relevant to you, and I would very much welcome any feedback you may have. Please do feel free to get in touch with your thoughts either by phone on: **020 7063 4259**, or by email on: **david.baker@mazars.co.uk**.

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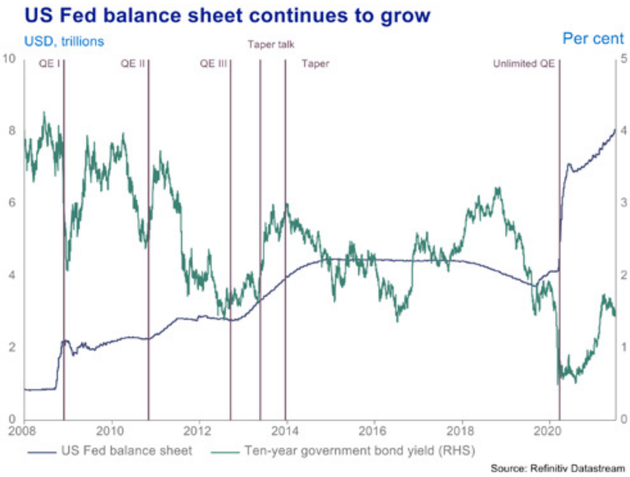
Economies and markets in brief

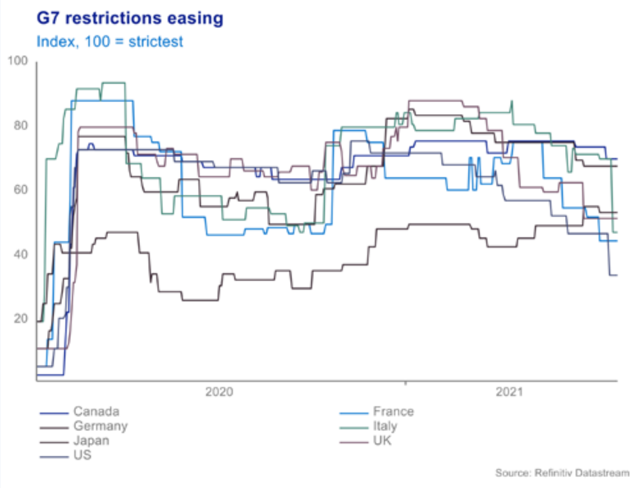
Where now for interest rates?

Most data points suggest inflation is rising and the US Federal Reserve has surprised markets with suggestions that there could be two rate hikes in 2023. There has also been talk of tapering of the Fed's bloated balances sheet. Are we on the cusp of a significant monetary tightening cycle? We think not, for several reasons. The inflation we are seeing is largely the result of damaged supply chains and price recovery following the crisis – two areas interest rates have little effect on. The Fed has made it quite clear they think inflation is likely to be transitory, and we are inclined to agree. Given debt/GDP levels, the world simply can't afford significantly higher interest rates, so in all likelihood no long-term inflation spike equals no significant rate rise.



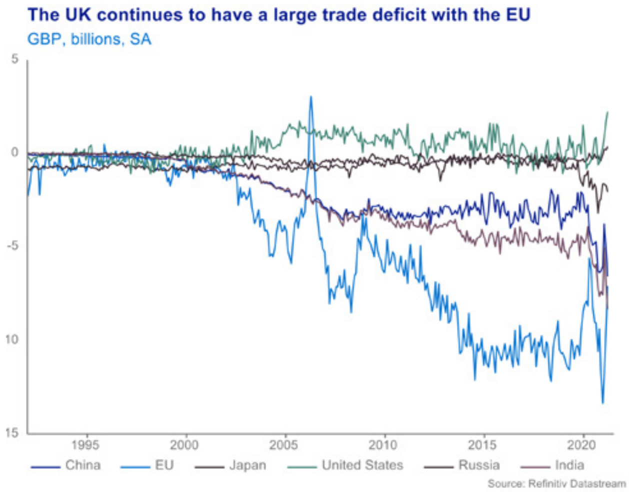
Lockdown measures easing

With lockdown restrictions easing, measures such as retail and hospitality footfall are on the rise. This brings with it the obvious risk of further waves, however is a much needed life-line for these struggling sectors. In the G7, all countries apart from Japan and perhaps Canada have eased restrictions since the start of the year, on the back of vaccine programmes that have been largely successful. With its lower level of original restrictions and need to control virus levels before the start of the Olympics this summer, Japan has recently been moving to tighten restrictions.



No UK/EU trade war?

The EU has granted the UK a three-month extension to the grace period that allows processed meat to be exported to Northern Ireland from the rest of the UK. Northern Ireland still follows EU customs union and single market rules, unlike the rest of the UK, in order to avoid a hard border with the Republic of Ireland. This extension is likely to ease tensions, as the UK had previously threatened to flout the ban and unilaterally trigger Article 16, which would suspend the Northern Ireland Protocol and potentially see a trade war break out. However as with all things Brexit, a solution either needs to be found, or another cliff-edge moment will occur when the grace period ends in three months.

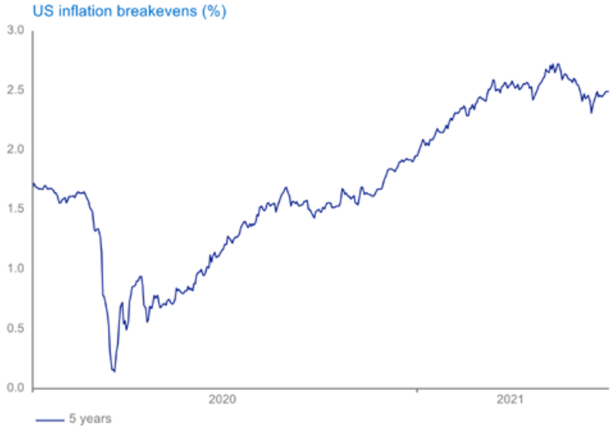


Are inflation concerns overblown?

Fiscal and monetary policy changes in response to the pandemic have been significant, with unprecedented stimulus programs and an extended era of quantitative easing. As the Covid-19 vaccine rollout gathers pace, many market participants are expecting the economy will soon reopen fully, giving rise to robust demand when supply chains are still facing significant pandemic-related shortages, driving heightened inflation expectations. The US five-year breakeven inflation rate, which implies what market participants expect inflation to be in the next five years, has skyrocketed over the past year, surging from its low of 0.14% in March 2020 to 2.5% in June 2021.

Inflation expectations climbing

US inflation breakevens (%)

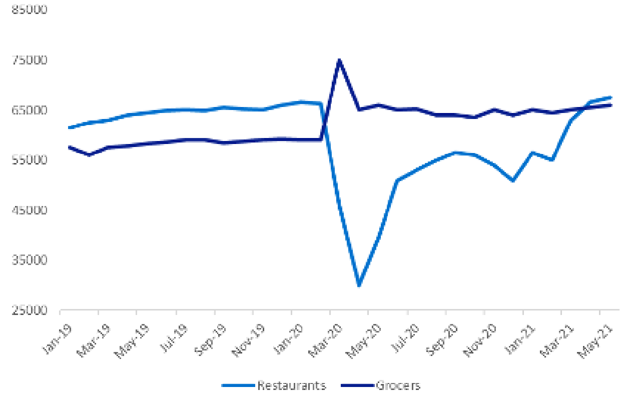


Source: Refinitiv Datastream

As people begin to live their post-Covid lives, we can see major changes in the post-lockdown economy. To illustrate the point, restaurant sales have eclipsed grocery sales for the first time since March of last year. Less spending on goods and more spending on services could bring better balance to the off-kilter economy. The surge in demand for physical products last year caused supply chains to become more tangled, sending consumer prices higher. Along with alleviating pressure on supply chains, more services spending means people are finally enjoying experiences they couldn't during the lockdown, like vacations and live music.

Consumers have returned to spending at restaurants

Restaurant vs grocery sales



Investors have fretted about the inability of central banks to foster any inflation over the past decade, as weak inflation is a sign of a weak economy. A little bit of inflation might just be a good thing, as it's a sign the economy is growing at a healthy pace. So why are investors so worried about inflation now? Investors in financial assets such as stocks and particularly bonds have to consider the cost of inflation because it erodes the buying power of returns on investments. If you make 2% on an investment, but inflation is also 2%, your real return is zero. The other reason is that higher inflation usually brings higher interest rates in response. Since the 1980s, interest rates have been on a long-term decline, which has helped foster economic growth, along with stock and bond prices.

For now the Fed has indicated it believes any inflation is likely to be transitory, which should mean they don't need to aggressively tighten monetary policy through increased rates or reducing the amount of assets that they have built up through quantitative easing. The main danger for markets is if the Fed is wrong and acts too late, allowing prices to rise significantly for a long period. It would then have to act even more aggressively, even though record debt levels mean the world can't really afford much higher interest rates. Although we currently subscribe to the Fed's view, we will be closely monitoring conditions for signs that this view is wrong.

Jargon Buster – Tapering

Tapering is the process by which the US Federal Reserve has at times reduced the amount of assets its holds, which currently stands at just under $8tn. This is generally achieved by not re-investing the proceeds of bonds that mature, although a more aggressive approach is to outright sell positions. The build up of assets has had the effect of reducing yields globally, and thus funding costs for firms that issue public debt. As such tapering should allow yields to revert to higher, more natural levels, which should have a dampening effect on economic activity.

US Equities

US equities are the largest component of global equities by some way, accounting for over half of the value of global stock markets. To put that in context, the next largest country is Japan which is 7.5% of global stock markets. This underlines the importance of US equities when constructing portfolios that broadly track the growth of the global economy.

The US market is not only large by value, but it is also diverse and comprises many sectors. We invest in US equities by holding a combination of different funds in our portfolios, in order to tailor our exposure to how we think the economy will behave.

Why are specialised funds useful now?

The economic recovery after the pandemic has not only been robust but we have seen a marked difference from the economic environment that prevailed in the years leading up to the pandemic. This has led to different sectors of the US stock market performing better than those that performed well previously. We have written in various publications about the environment being right for sectors such as banks or energy to do better than the technology sector. We believe that to capture this new dynamic it is sensible to invest in a fund which specialises in this area.

How have we captured this?

We have purchased Dodge and Cox US Stock, which sits alongside Artemis US Select in our portfolios. Whereas the Artemis fund has a broad mandate to invest in companies that they expect to appreciate in value, Dodge and Cox employs a very rigorous approach in selecting companies which it believes to be undervalued by the market. This leads it to have large positions in those sectors which should perform well as the US economy rebounds, specifically financials (banks) and energy.

Despite some funds performing very well over the long term...

Source: Refinitiv Datastream

...post pandemic different funds are better placed for the robust recovery

Source: Refinitiv Datastream

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