Monthly market blueprint

Investment management service

July 2021

mazars

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Foreword

The crystal ball is blurry

Visibility about the future is as low as it has ever been. In recent memory it is difficult to recall a market and economic environment with such low degree of consensus amongst investors and business leaders. Even as vaccination is bringing the world closer to the end of the pandemic, uncertainty is everywhere to be seen. It is evident in inflation scenarios, where experts predict anything from 20's or 70's style hyperinflation to outright deflation. Growth, even for the next few months is equally uncertain. The International Monetary Fund (IMF), the Organization For Economic Cooperation and Development (OECD), the World Bank, the Bank of International Settlements, Central Banks and fiscal watchdogs, all equipped with some of the finest economic minds in the world, are changing their forecasts significantly every few weeks.

Uncertainty is evident is supply chains. The global stocking/unstocking cycle has been disrupted, as economies open up and close down without warning. Complex products, like cars or computers, rely on functional supply chains to produce the thousands of parts needed for assembly. Purchasing managers can't plan, so they order at the last minute. Without planning, costs skyrocket and lead and delivery times are extended to the point of nearly breaking supply chains.

Uncertainty is evident in investments. While headline indices remain at all-time highs, portfolio managers stick with the sure winners, once again growth stocks. Income stocks on the other hand, where investors absolutely need a modicum of certainty about future cash flows, suffer. As the bond market is dismissing all notions of future inflation, its the gold market and style that investors are oscillating between.

George Lagarias
Chief Economist, UK

The pandemic, eighteen months in already, is leaving the world in disarray. The objective for asset allocators, at this point, or any other for that matter, is not to predict the future. It is to prepare for eventualities. We have spent the last few months mapping out growth and inflation scenarios and looking at what these logically mean for risk assets. From a return to before 2008, to growth managed by the state, to stagflation and to the return of 'secular stagnation', we have looked at the past and reasoned about what the future might look like under all of these. While we can't accurately predict where the world will go, we have made sure our portfolios are resilient and prepared. We have evened out our growth and value exposure, focused on managers with a proven ability to create alpha and we have taken few 'bets' only in high conviction and low downside positions, like an overweight on UK equities and an underweight in bonds.

Market performance – in a nutshell

The month in review

Global economic recovery continues and central bank policy diverges

Central banks took centre stage in June with the US Federal Reserve, the Bank of England and the European Central Bank all reiterating that inflation was transitory yet all giving different guidance for the direction of monetary policy. The Fed gave the most hawkish message of the three as its members indicated that rates would be likely to rise in 2023, as opposed to the previous estimate of 2024. The BoE supported the status quo as asset purchases and interest rates were maintained at their current levels. The ECB highlighted that rising yields could derail impact the economic recovery in the Euro Zone and increased asset purchases, while simultaneously raising growth forecasts for this year.

In June, US Treasuries were slightly higher, contrary to traditional wisdom which sees bond yields rise as central banks increase anticipation of interest rate rises. In the UK, Gilts were also slightly higher while in Europe the 10Y German bund moved marginally lower.

The equity markets displayed some volatility around the time the Federal Reserve's more hawkish outlook due to the outsized effect that any reduction of dollar liquidity has on global markets but overall global equities were higher over the month of June.

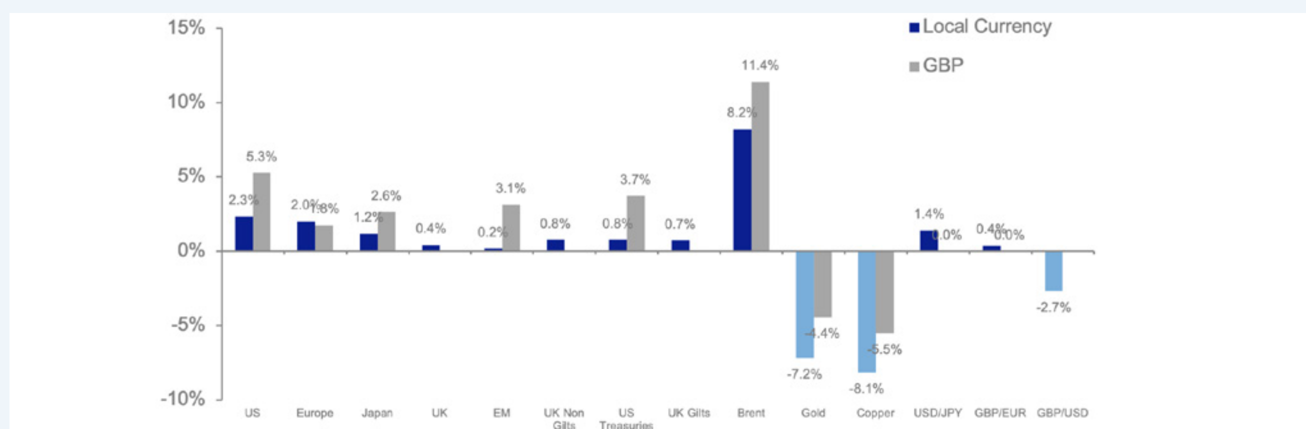
The US equity market rallied the most among developed markets, rising 2.3%. This was mainly driven by the technology sector growing 6.5%, benefitting from the fact that bond yields have not kept up with inflation expectations, pushing real yields lower and flattering future earnings.

Other developed equity markets saw smaller gains. Europe moved up 2%, reflecting the ongoing positive sentiment around the economy as governments loosed lockdown measures. In the UK equity markets moved up 0.4%.

Both GBP & the Euro fell against the US dollar as central bank policy divergence will see higher yields in the US compared to over developed markets.

In the commodity markets gold moved lower on the basis that higher US growth and a stronger dollar reduce the relative attraction of holding the yellow metal. Oil moved up sharply as supply constraints and reduced energy investment since the pandemic began create an imbalance with demand which is set to increase as the global economy reopens.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation

Changes in our Strategic Asset Allocation

Outlook and portfolios

This month marked the end of Q2 and our Investment Committee reconvened to take stock of the global economy and our outlook for markets. Such meetings consist of our Chief Economist, CIO and selected external experts sharing their views and then discussing whether our portfolios were suitably positioned to take advantage of our expectations predictions.

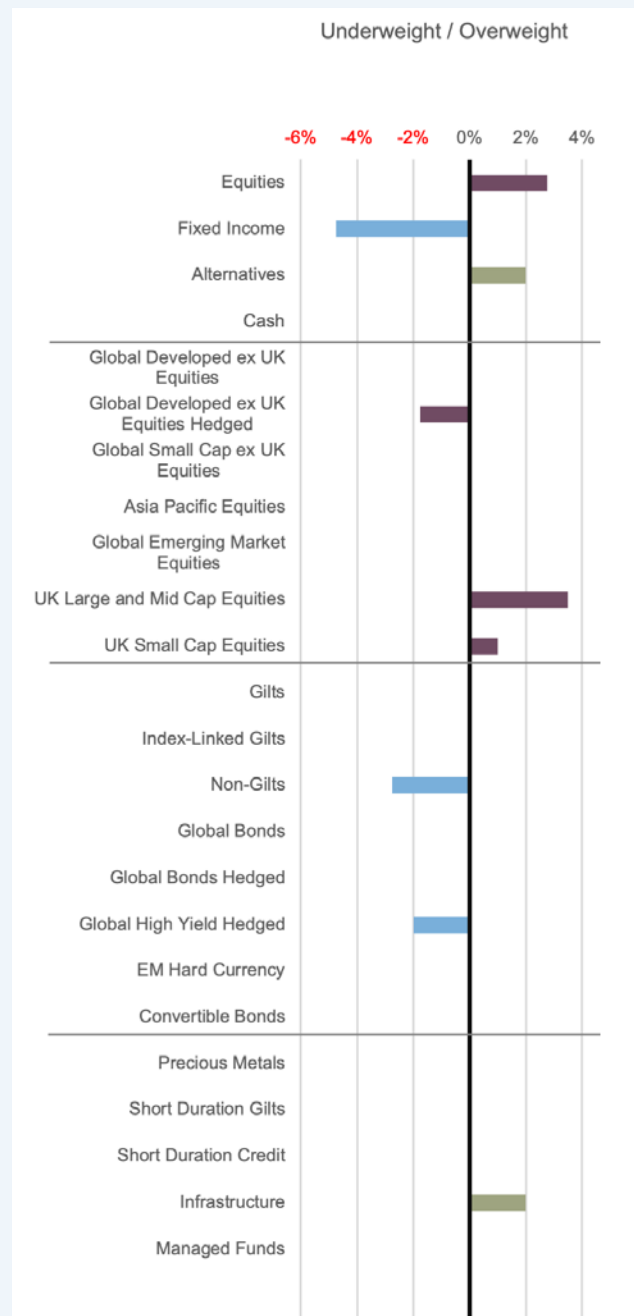
Our fundamental calls/expectations are that equity markets are expensive relative to their historic valuations but bonds even more so. Central banks have an interest in keeping financing costs low despite robust growth leading to inflation concerns, because the levels of government debt in developed economies is so large that it may not be sustainable if servicing costs ballooned.

Given this uneasy equilibrium, we remain underweight bonds and overweight equities and make no changes to our allocation this quarter. We feel that the low yields on fixed income do not justify the potential for capital loss as the market begins to price in higher rates. We also see that while equities could suffer from an untimely withdrawal of stimulus from central banks, they will benefit from economic growth and increasing corporate earnings as the business cycle unfolds.

Within equities we are overweight UK equities across all capitalisations, which are attractive due to their low valuations relative to other geographies and provide exposure to the cyclical recovery of the global economy through the larger weighting to financial and energy companies. The other area where we have a notable overweight is infrastructure, which we believe will benefit from the fiscal stimulus expenditure planned in Europe and the US, as well as the necessary investment over the coming years that will be needed to meet global environmental targets. We are overweight precious metals which should act as a hedge against unexpected economic disappointment and a ballast within portfolios in the case of market volatility.

Some positioning in portfolios is not captured at an asset allocation level but rather at a fund level. At the end of Q1 we added the Dodge and Cox US Stock fund, which, despite the resurgence of growth-oriented equities over the last month, we expect to perform well as value stocks benefit from the cyclical upswing post pandemic.

Mazars balanced portfolio as of 3 July 2021



Risks

The risk of inflation

2021 is 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. Vaccinations and Covid-19 continue to drive economic developments. As countries are exiting 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.

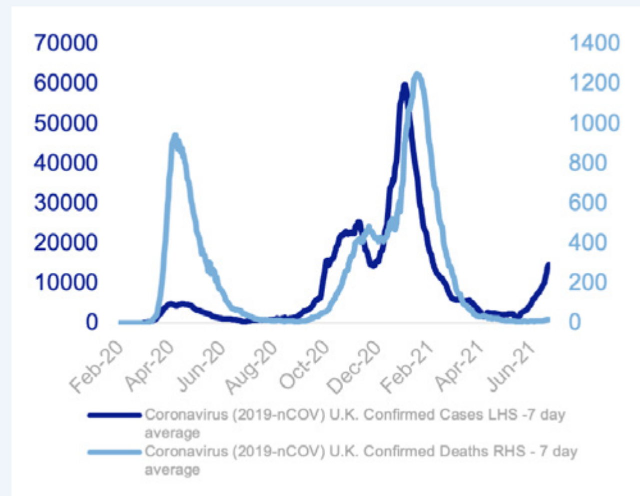
Markets continue to focus on quantitative easing, with investors convinced, for now, that central bank risk suppression is potent enough to weather any economic headwinds. The rate at which monetary and fiscal stimulus will be withdrawn is the main risk for the upcoming economic recovery. Stock prices are near all time highs, but earnings have yet to catch up with expensive valuations and are creating a ceiling against further breakouts. Global bond yields began to climb on inflation fears earlier in the year, however the move proved temporary with the market 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.

We feel that overall risks are more global than local. A resumption of the pandemic with a more aggressive variant may continue to disrupt supply chains, especially those based in emerging markets. At the same time, we don't believe that lockdowns will re-emerge.

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.

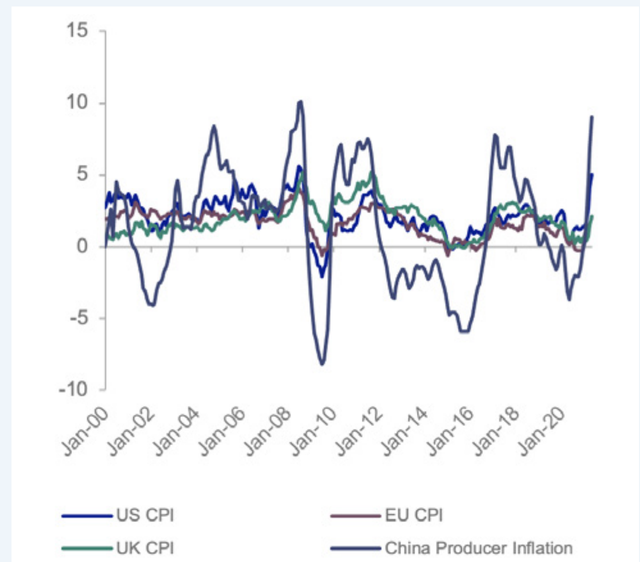
Delta variant is a possible threat to the recovery

UK Covid new cases and deaths



Inflation is rising across the board

Western economies CPI and Chinese PPI inflation



Charts source: Mazars calculations

Macroeconomic backdrop
Global

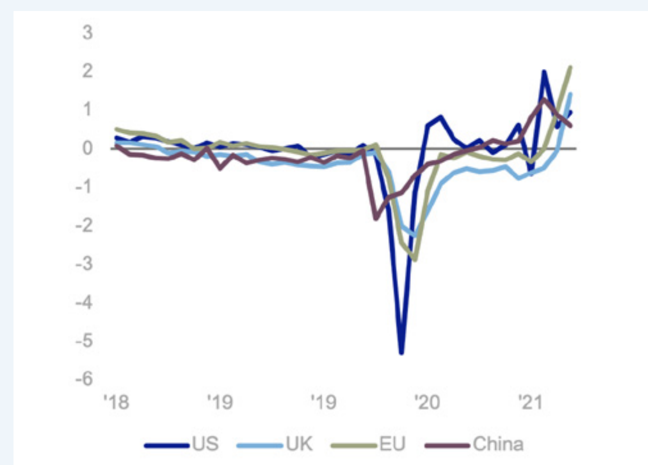
For the period, global stocks rose by 1.5% (4.5% in GBP). The highest performing sectors were IT and Energy while the worst performers were Materials and Financials. Equities were trading at 20.65x times forward earnings, 26% above long term average. Gold fell 7.2% and oil prices rose 10.8%.

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.

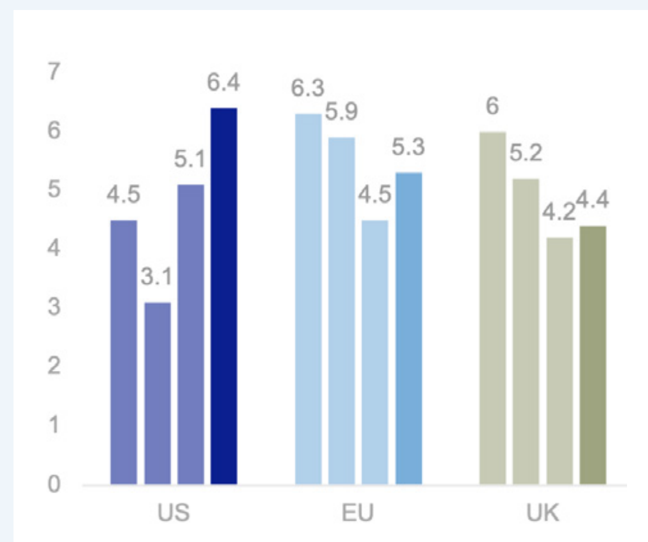
Asia has recovered the most, with the Chinese economy credibly claiming that it's now above pre-2019 aggregate output levels. The US has seen growth forecasts being revised upwards driven by heavy stimulus packages and faster vaccination rates. The UK, which has the second largest percentage of vaccinated 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, continued to pick up in June, 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 sector 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 +0.4% in June. The best performing sectors were healthcare and energy, with the worst performing housebuilders and financials. UK equities are now trading at 13.6x forward earnings, 3% below their long term average.

Despite inflation picking up, the Bank of England appears to be treating inflation as transitory, with the Monetary Policy Committee voting unanimously to keep rates at a historic low of 0.1%. However outgoing chief economist Andy Haldane did dissent on the level of QE, being the only member to vote to reduce levels at the June meeting, arguing that inflation could rise beyond expectations due to rising energy costs and bottlenecks in labour supply.

Cases of Covid have risen significantly, enough that the planned removal of restrictions has been delayed until July. Despite the increased level of cases, the low levels of deaths suggest that a further delay is unlikely, especially given opposition from backbench Conservative MPs to the original delay.

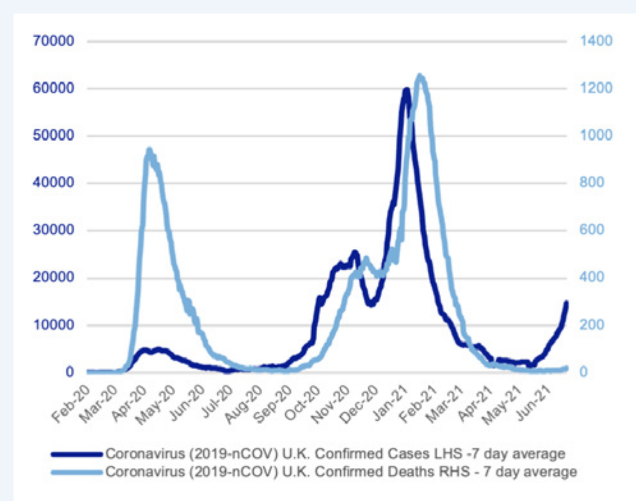
The result is that the UK is likely to see a further leg up in economic activity post July. Measures such as restaurant footfall, consumer confidence and order books already show the economy moving at close to full speed.

Meanwhile the EU has granted a three-month extension to the grace period that allows processed meat to be exported to Northern Ireland from the rest of the UK. 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.

Outlook: With economic activity likely to see a further recovery and valuations cheap compared to global peers, UK equities are looking more attractive than at any point since Brexit. Indeed manager surveys show that holdings in UK equities has increased across the board. However failure to re-open por stay open, along with continued Brexit disruptions, are the major risk for UK markets.

Despite Covid cases rising, deaths remain low

Confirmed cases (lhs) and deaths (rhs)



UK inflation rising

Twelve-month percentage changes

Charts Source: Mazars Calculations

Macroeconomic backdrop

US

For the period, US stocks rose by 2.3% (5.3% in GBP). The highest performing sectors were IT and Energy while the worst performers were Financials and Homebuilding Index. Equities were trading at 22.66x times forward earnings, 30.6% above their long-term average and 9.7% above the MSCI World. 10y bonds fell 12 bps at 1.477%.

Following the 6.4% annualized growth in US GDP in Q1, leading economic indicators point to continued growth in Q2. Markit PMI data, an important indicator of economic conditions, for June signaled the joint-fastest improvement in the health of the US manufacturing sector on record, supported by some of the fastest rates of growth in new orders and production observed to date. The services sector is following suit. Growth has been limited by supply chain disruptions however, with labour shortages reported as suppliers struggle to keep pace with demand, and delivery times lengthen. Employment conditions continued to recover; however, the data is volatile as local restrictions affecting key sectors of the economy persist. As a result of intensifying supply pressures, inflation continued to pick up across the board. Nevertheless, despite stronger employment and inflation data, the Federal Reserve remained relatively relaxed with the current levels of accommodation, despite signaling its intentions to hike interest rates in 2023.

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. At the time of writing the Bill was under negotiation, but the US government has had to make significant compromises to the original number.

US large cap equities trading sideways in the past few months

US large cap equities index, price

The is US expected to rebound faster this year

IMF economic forecast

Charts Source: Markit, J.P. Morgan

Europe

In June many countries in Europe reduced the stringency of their Covid restrictions as economic survey data improved and growth expectations continued to rise. However, a seemingly booming economy drew a different response from the European Central Bank than that which we have seen from the Federal Reserve in the United States.

June saw widespread reduction in Covid restrictions in Europe. Social distancing measures were reduced and even more venues were permitted to operate at increased capacity. The vaccination effort across the continent and the lockdowns endured thus far, as well as the vaccination certificates which are due to be issued from July, will allow the tourist season to go ahead and this is feeding through to the economic survey data that has been released.

PMI data for Europe in June is showing its highest reading since 2006. This optimism is reflected in other survey data too, with consumer confidence, employment & retail surveys all showing a healthy rebound.

Correspondingly, survey data is contributing to more optimistic expectations for economic growth in Europe. When the ECB convened in June, Christine Lagarde informed us that their expectation is for the European economy to growth at 4.6% in 2021 and 4.7% in 2022, both of which are 0.6% higher than their March expectations. However, the optimism stopped short of leading to a reduction in monetary stimulus that the ECB provides.

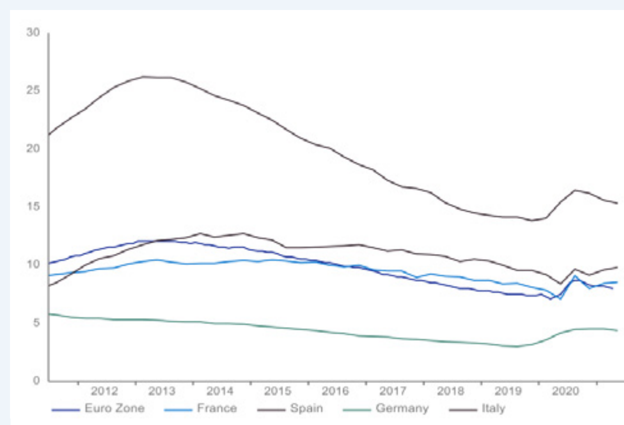
Christine Lagarde warned of the risks to the recovery that can come from higher borrowing costs, signalling that economic growth is not enough on its own and that beneath the surface there are imbalances that still need to be addressed. Although the ECB does not have an explicit employment target, it is the unemployment data from the European Union which reminds us why QE programmes were in place well before Covid. The headline European unemployment rate of 8% masks the difference between its member states where the Spanish unemployment rate is more than triple the German unemployment rate. This disparity marks the ECB's (unstated) goal: to foster growth and moderate inflation without allowing financing costs to worsen the outlook for peripheral states.

Euro area PMIs are at highest level since 2006

Index, 50 = no change

European Unemployment

The headline Euro Zone unemployment rate of 8% hides disparity between member states



Charts Source: Refinitiv Datastream

Japan and emerging markets

Emerging market stocks rose by +0.2% and +3.1% in local terms and Sterling terms respectively. Japanese stocks rose +1.2% and +2.7% in local terms and Sterling terms respectively. The best performing sectors in emerging markets were energy and healthcare while the worst performer was financials.

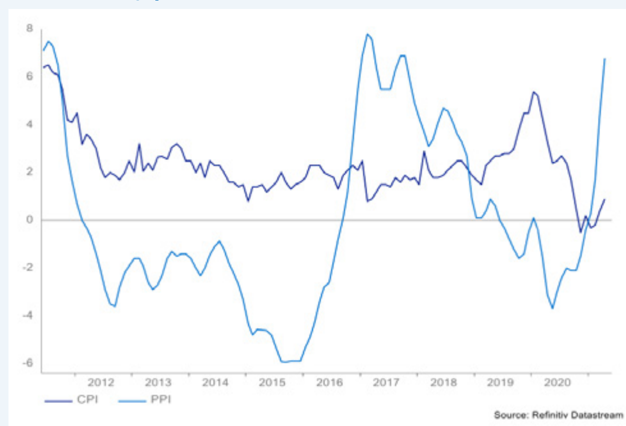
Just as most countries saw inflation tick up, the 'world's factory' – China, saw a sharp increase in its supply side inflation. China's producer prices rose by 9.0% year-on-year(YoY) in May, accelerating from a 6.8% gain previously and above market expectations of 8.5%. While consumer inflation increased to 1.3% during the same period, its something to monitor in the near term. China's retail trade growth slowed to 12.4% YoY in May, from 17.7% in the previous month and below market expectations of 13.6%. The latest figure continued to point to a solid improvement in domestic demand, but also indicated more pressure on the consumption recovery. The official NBS Manufacturing PMI for China edged down to 50.9 in June from 51.0 previously Non-manufacturing PMI for China dropped to a four-month low of 53.5 in June from 55.2 in the previous month, amid an outbreak of Covid-19 in China's major export province of Guangdong.

Industrial production in Japan declined by 5.9% month-over-month in May, worse than market consensus of a 2.4% fall and after a 2.9% gain a month earlier. This was the first drop in industrial output since February, amid a lockdown in some parts of the country following a surge in local coronavirus cases. Automakers in Japan also cut back on production due to the global semiconductor chip shortage. Japan's unemployment rate rose to 3.0% in May, the highest level since December 2020. This compares with 2.8% in the prior month. Most sectors saw lower employment, including manufacturers, logistics, and finance.

Outlook: With Turkey, Brazil and Russia all having recently hiked their interest rates, some EMs face tightening economic conditions that may constrain growth for much of the year. The outlook for EMs still largely depends on how long the pandemic persists and how effective the vaccination drive within those countries proves to be.

China inflation

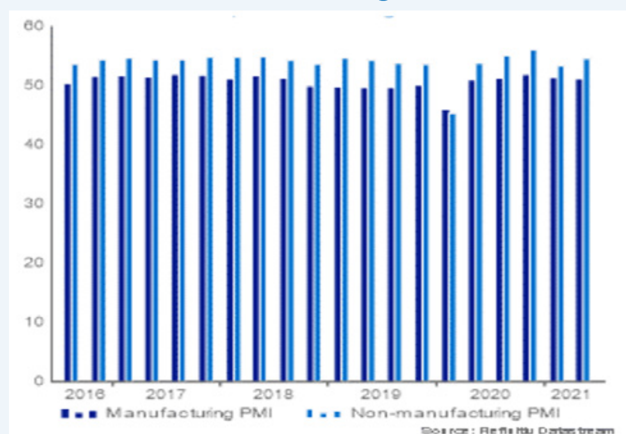
Despite the increase in PPI, there are no CPI inflationary pressures in China



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.

China's post pandemic recovery continues

China NBS PMIs, 50 = 'no change'



China's manufacturing PMI met expectations while the nonmanufacturing PMI came in weaker than expected. Overall, the June PMI readings remained in expansionary territory.

Our themes

Macro theme 1

From Vaccinations to Reopening

As vaccination rates are sufficient and the vaccines have proven effective, Governments are more confident than ever that this is the time to reduce Covid-restrictions. Investors may wish to exercise caution when looking at the next sector to benefit.

The growing number of Covid cases in the UK would have previously prompted lawmakers to issue restrictions on movement of people in order to arrest the spread of the virus. In fact, that is exactly what happened in June when the government delayed so-called Freedom Day in England until 19 July. Contrary to what happened in June, the UK Government is sounding more confident than ever about the reopening of the economy. The UK is not alone in this newfound confidence and it heralds then next stage of the post-Covid recovery for markets.

Anyone watching the recent speeches of Boris Johnson or newly appointed Health Secretary Sajid Javid will have noted a change in the official tone regarding post Covid freedoms. The message is clear: Covid cases will rise but the vaccine is effective so the economy is reopening.

Since the start of May when the rise in Covid cases was on a similar trajectory to those of Autumn 2020 the number of hospitalisations and fatalities has remained low and this means that we are now moving into the phase of living with the Virus.

Looking at the policies in Europe the message is similar as 11 European countries reduced their restrictions on movement in June and from 1 July vaccine passports came into effect. While the measures are being taken more cautiously than in England, Europe is heading in the same way.

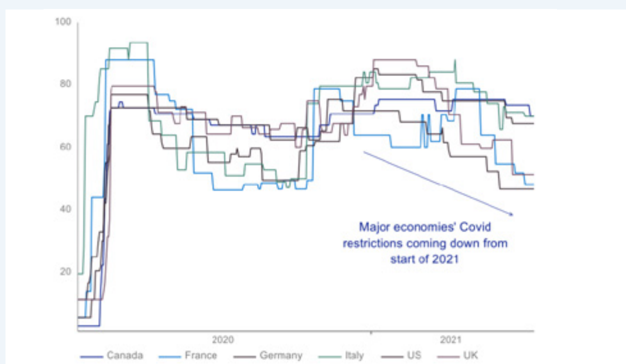
The stockmarket has responded to the economy throughout Covid, albeit helped along by central bank liquidity. Initially the shares that rose the most belonged to companies which benefitted from lockdown, such as stocks of companies which facilitated video conferencing or online grocery shopping. Then the cyclical stocks took the baton as the vaccine discovery and Biden's stimulus pointed to booming economic growth in 2021 and beyond, the car manufacturers and banks rallied.

Now that we enter a more complete reopening of the economy, investors may look to a sector which has yet to recover, such as the travel sector, although that may be little hasty. The travel sector has been one of the worst impacted and for the longest length of time during the Covid pandemic. Company balance sheets have taken a real knock. Assuming that it is the next sector to see recovery one oughts not to overlook the damage inflicted by Covid over the last 18 months.

As we continue to exit the pandemic we take a more measured approach and continue to use a balanced portfolio incorporating value and growth companies to benefit from the post Covid recovery.

Major Nation Covid Stringency

100 = maximum stringency



Europe Travel & Tourism Equities

Values shown are current value as a percentage of pre-pandemic level

Charts Source: Refinitiv Datastream

Macro theme 2

Inflation as a red herring

Global lockdowns stressed supply chains to near breaking point. Despite vaccination progress across the G7 and gradual exits from lockdowns of the world's largest economies, global demand conditions remain erratic. This is causing further strain on damaged supply chains. The pandemic has rolled back globalisation, the key driver of lower prices across the globe for decades. Supply chains are not only more localised, but also unable to cope with the spike in demand from the developed world as G7 nations now simultaneously wake up from the pandemic-induced coma with an appetite to spend. Producers are reporting significant shortages in materials, causing price spikes in most global markets. Frictional unemployment is rising, especially in lower paid jobs, as a lot of skilled and unskilled workers are reluctant to go back to their previous employment. As a result, companies are being forced to pay higher wages and offer permanent jobs to lure workers back, especially in hospitality services.

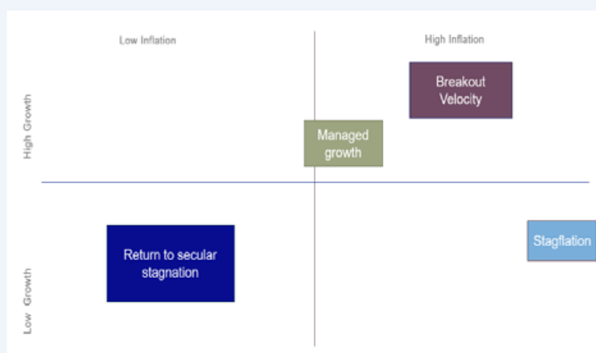
Apart from supply issues, inflation is being driven higher by pent-up demand across the developed world. Companies which had exhausted their inventories didn't stock up, uncertain about the lockdown measures. As stringency conditions ease across the board, the race to re-stock, along with the extra demand, is causing a surge in input prices.

Higher demand for goods and services and lower supply of both plus labour shortages are an explosive cocktail for higher prices, which may look bigger under the magnifying glass of the current news cycle.

For investors used to the Fed running the 'only game in town' however, what matters is not so much the expected impact on corporate margins or the price of goods on the shelves, but what the Federal Open Markets Committee (FOMC) thinks about all of that. For the time being, the American, and arguably the world's, rate setting body considers all these factors transitory.

Supply chain disruptions and frictional unemployment are textbook examples of slack in the economy, which Fed Chair Mr. Powell and co. expect will be resolved in the next few months. The Fed has lived with higher inflation before and it has indicated that it doesn't expect a rate hike until 2023.

Our four basic scenarios on growth and inflation



In 2021, a new US president, Joe Biden, was sworn in. Markets rejoiced in his choice for the Secretary of the Treasury, Janet Yellen, a former Fed Chair and a policy dove. Ms Yellen, fully aware that the Fed could not forever alone shoulder the burden of the economy, came up with a very ambitious plan to proceed with unprecedented fiscal stimulus. The money reserved for investors was now to be redeployed in the real economy.

We immediately recognised this development as a potential paradigm shift. Economists are now thinking how possible, or plausible, it is that the way we have invested in the past decade, may have come to an end. We need to keep in mind four scenarios: a) A return to 'Secular Stagnation', b) A brief 'Stagflation' (stagnation + inflation) interlude, c) A 'Managed Growth' scenario, by which the US government achieves its exact objective and d) a 'Breakout Velocity' scenario that would see a re-empowered consumer and a material pickup in investments in the real economy.

While we can't really yet put accurate probabilities on each scenario, our inflation/growth framework should guide our asset allocation in the next few quarters, depending on the direction of the data.

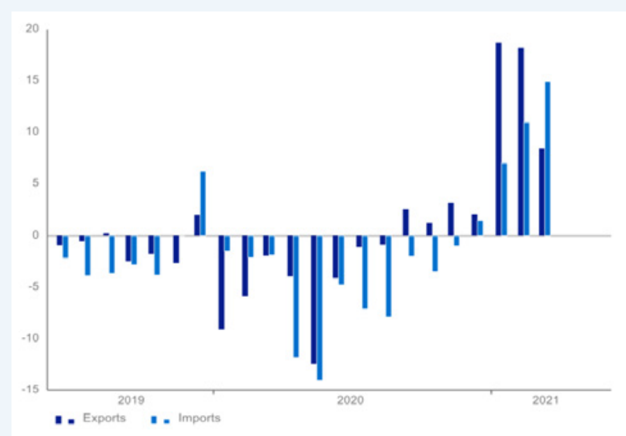
Macro theme 3
Asia's road to recovery

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 stabilization 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.

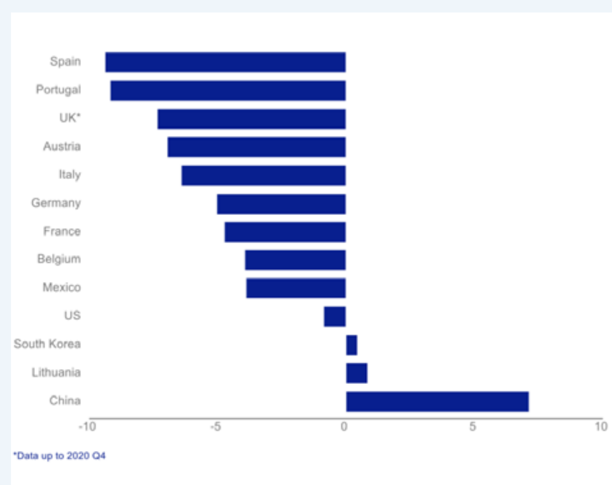
China has experienced one of the fastest economic recoveries in the world from Covid-19, driven mainly by its industrial and manufacturing sectors.

Asia export and import volumes (goods)
Twelve month percentage change



Charts Source: Refinitiv Datastream

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.

Income – In Search of Quality

Despite falling interest rates dividend paying stocks have not benefitted the same way that bonds have. Digging deeper, we can see that not all dividend stocks should be viewed equally by investors, and they should focus on those companies that can restore and increase their dividends.

As the reality of the forthcoming Covid pandemic dawned upon policymakers, developed world central banks acted in concert to reduce interest rates close to zero. Correspondingly, yields on government bonds fell and prices rose. Such a move can be positive for income paying stocks; as income seekers are forced to move up the risk scale to generate regular income they look to equities and this pushes prices. However, that has not really been born out by share prices as since February 2020 income paying stocks have broadly underperformed their respective markets. The reality is nuanced and investors should not expect a full rebound in dividend income, but therein lies the opportunity for investors.

Company dividends are not a contractual obligation, unlike bond interest payments. If corporate strategy or economic circumstances change and management decide that cashflows that had been going to shareholders in the form of dividends would be better used elsewhere then dividends will be reduced or removed altogether. With the unprecedented uncertainty of Covid standing before them many managers took an axe to their dividends, deciding that the money could be better used elsewhere in the business. This caused income paying stock prices to fall more than the broader stockmarket as the relative attraction of holding such stocks decreased.

Now the economy has turned a corner post-pandemic a logical assumption might be that those companies that paid dividends prior to Covid ought to reinstate those dividends. The reality is that dividends have not been reinstated at the same rate as they were reduced during the pandemic and companies are not reinstating them uniformly. Companies which are not confident enough in their outlook may decide that restoring dividends is prudent at this time. Other companies already wanted to cut their dividends before the pandemic but were unsure of how the market would respond so the pandemic gave them the justification they were looking for.

For investors at this point the opportunity lies in companies and sectors which are robust enough to restore and grow those dividends, while excluding the companies whose recovery is uncertain. To play this recovery an active manager should be able to add value, whereas a high-dividend equity index tracker will not discern the wheat from the chaff.

UK High Dividend stocks have lagged the broader index post-pandemic

UK large cap index vs UK high dividend equities

UK corporate dividends are not anticipated to rebound to prior levels

UK Equities 12 Month Dividend Expectations

Charts Source: Refinitiv Datastream

Normalisation of the bond market?

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

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

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

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.

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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.

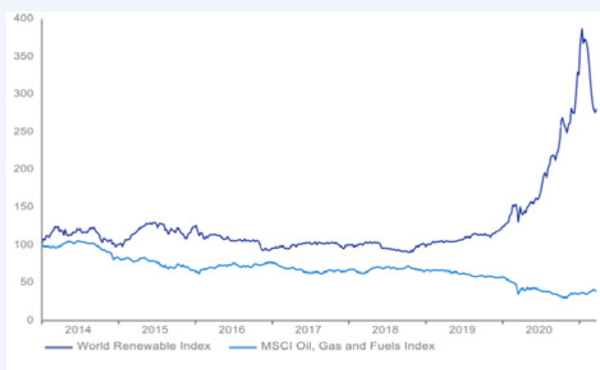
While the focus of ESG investments has largely been on environmental impact and climate change, this year we saw the 'S' in ESG come to the forefront. The social aspect of ESG was not well defined from an investment perspective but Covid-19 has definitely changed that. From early on in the pandemic,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

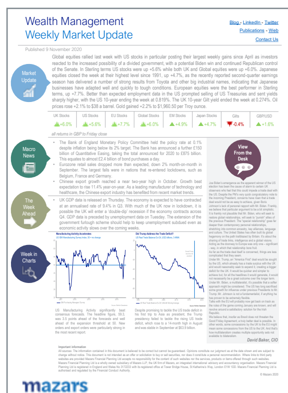
Global renewables vs oil and gas since 2014

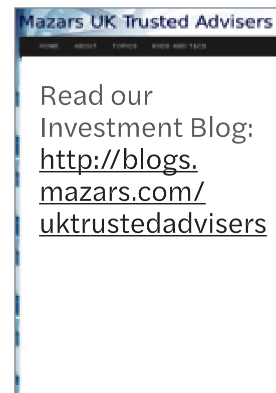


Over the last few years, there has been a dramatic shift in investments into renewable energy vs traditional oil and gas companies.

Source: Refinitiv Datastream

More reading...





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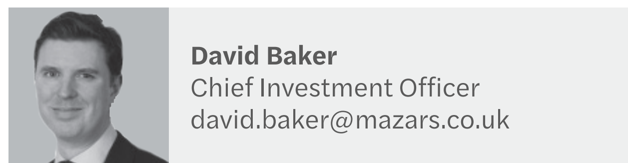

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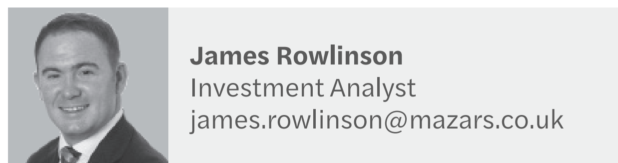

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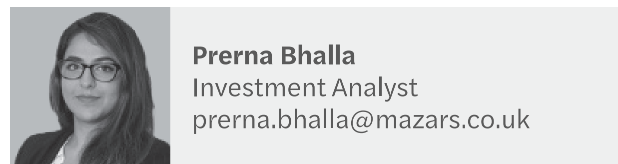

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