Strategy & Outlook MARKET UPDATE

July 2021

Global equities marched higher over the course of the month, rising by 4.6% in euro terms to stand +15.9% year to date. The mix within equities was stark though, the rally being driven by technology (+9.3%), with a 7.3% gain for the MSCI Growth Index vs just 1.7% for MSCI Value Index (all figures in euro terms).

There were two main reasons for the dispersion of returns, the primary one being the push-back on inflation narrative that has gripped markets for the last couple of months, falling inflation expectations and a drift lower in bond yields. A secondary factor was the rise of the Covid delta variant, with its associated threat to the more rapid reopening which had been priced into the cyclical sectors of the market. A slightly hawkish twist at the June FOMC meeting, where the median Fed member now expects 2 rate hikes by the end of 2023 (the so-called dot-plot) led to some volatility across asset classes but comments from Chair Powell that investors should take this revised dot-plot "with a big grain of salt" had a calming effect.

Fed Chair Powell reiterated what he has been saying for some time (the inflation blip will be transitory), with similar comments from ECB officials. Indeed, the latest US CPI data implies we are on the balance of probability past peak inflation scares. This has coincided with a shift in Chinese policy which initially cooled credit markets but has now spread to everything from cryptos to commodities, as well as the Chinese currency and local property markets. It is noteworthy that China's credit impulse, which tends to lead industrial metal prices by 6-9 months, peaked some months ago (and is now down y/y), and Chinese money supply growth is decelerating sharply. In addition, the Chinese National Food and Strategic Reserves Administration announced during the month that they will begin to release state stockpiles of metals including copper aluminium and zinc. Commodities globally have been falling on the back of this tightening in China. This has driven inflation expectations lower which in turn reduces the demand for commodities as an inflation hedge causing further weakness in commodities in a reflexive, self-fulfilling cycle. The continued disappointment over each iteration of Biden's Infrastructure plan has also been a factor. Extreme investor positioning and short interest in global bond markets ahead of the so-called "reopening" has probably exacerbated the moves in yields too.

It is clear though that the moment of maximum stimulus (both monetary and fiscal) is in the past. In an unexpected move, the Federal Reserve this month announced plans to begin gradually selling a portfolio of corporate debt purchased through an emergency lending facility launched last year. Although it was a little-used program, and mostly a psychological booster for markets, the Fed is preparing the ground for talk of tapering at least. The spread of the Covid delta variant is adding some confusion to the mix, raising concerns that the vaccination program needs another few weeks to remain ahead of it, leading to potential further delays to reopening which will hopefully be short-lived.

Positioning and Outlook

Concerns about inflation are somewhat understandable, given the huge fiscal and monetary response to the crisis, coupled with the inevitable supply-chain-related bottlenecks as economies reopen. But as tapering of asset purchases approaches (whether than be at year-end or sometime next year), as fiscal policy becomes a headwind to growth not a tailwind, and as supply chain disruptions dissipate inflation should decelerate, driven by the combination of factors above (in the short-term) and the longer-term trend towards automation, productivity and cost reduction that has been accelerated by the pandemic. The implications of the above should be positive but could be profound. With global yields trending lower the relative attraction of equities improves supporting the somewhat elevated spot multiples and confounding the perpetually disaffected equity commentators for at least another few months. We have been expecting the move lower / stabilisation in bond yields to change the leadership in the equity market and while this took longer than we had expected, over the last couple of weeks growth and quality companies have reasserted themselves as the equity leaders. Financials should particularly underperform. With sentiment and positioning in old-favoured sectors such as technology at multi year lows the potential for a sharp summer rally is in place.

We continue to be positioned slightly above the mid-point to growth assets. One nuanced distinction to make though is that is achieved through being overweight equities but being short commodities and European financials in our alternative funds which takes the overall growth asset exposure down towards the mid-point.

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