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GLOBAL MATTERS
MONTHLY VIEWPOINT

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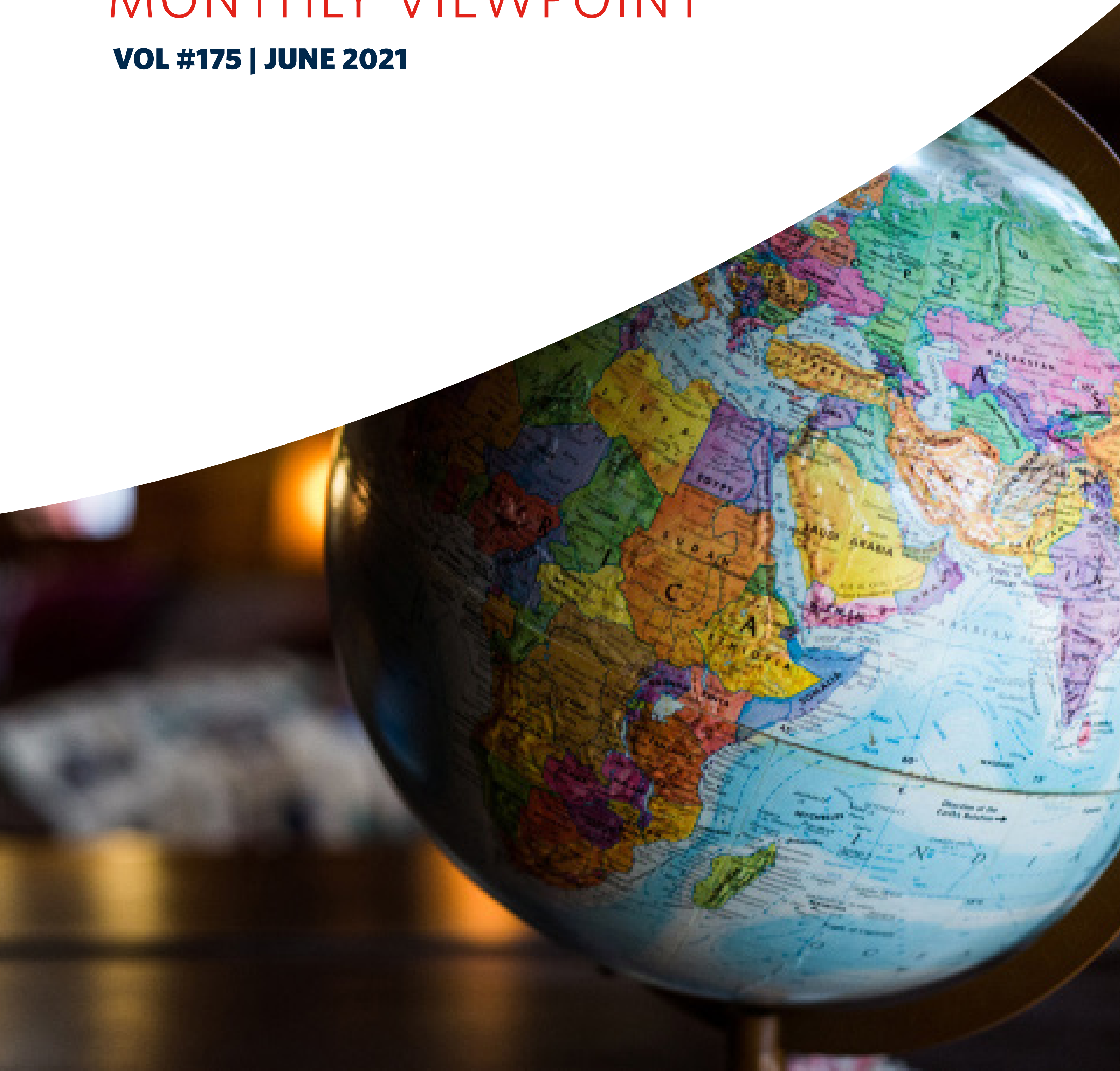

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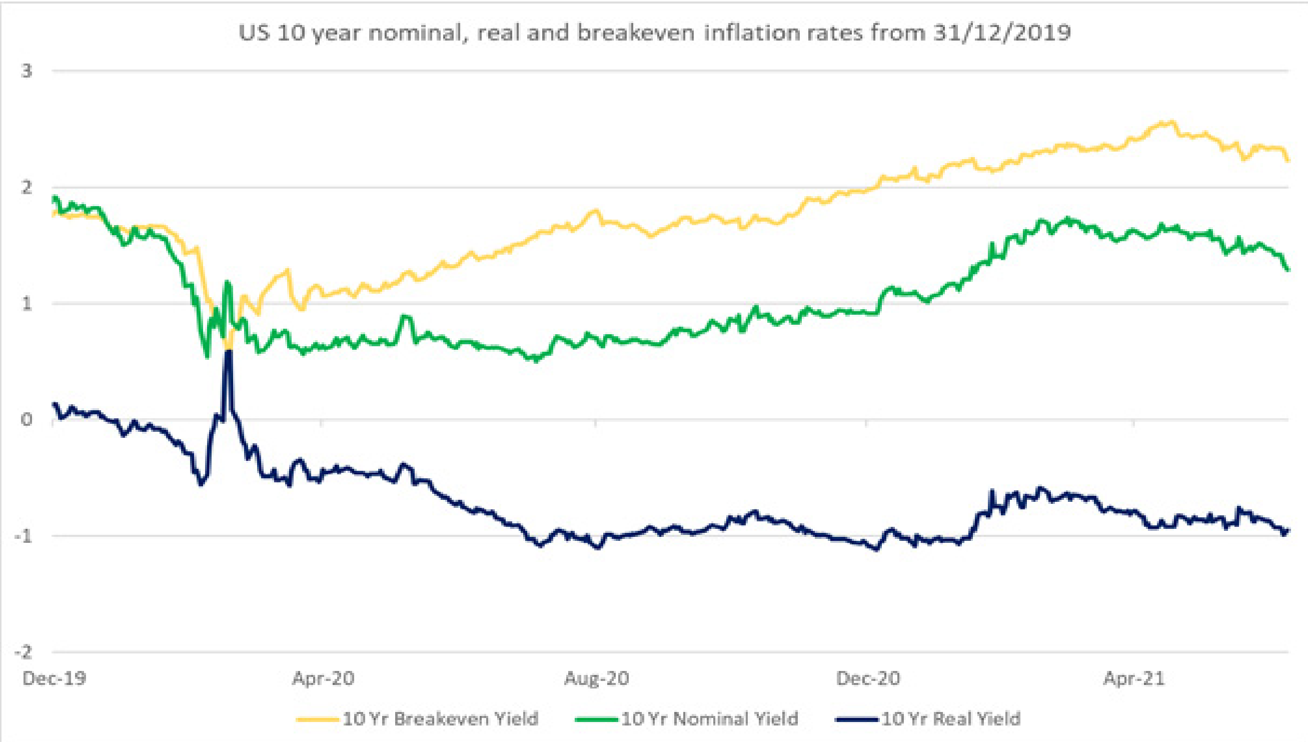
MARKET REVIEW

The global recovery continued to build momentum during the second quarter, driven by developed markets, where vaccine rollout is proving to be decisive in lifting pandemic restrictions. Forecasts for growth this year and next were revised up materially: the IMF is now forecasting global GDP to expand by 6% in 2021, up from its previous forecast of 5.2%; the OECD raised its growth expectation to 5.8% from 4.2%, the Federal Reserve upped its 2021 forecast for US growth to 7% (6 months earlier it was predicting 4.2%), while the ECB is now expecting growth in the Euro Area of 4.6% in 2021, compared with its March forecast of 4%. At the same time, inflation has been much higher than earlier expectations: CPI reached 5% in the US in May, while the Fed's preferred measure of inflation, core Personal Consumption Expenditure, reached 3.4%, its highest for almost three decades and well above the Fed's 2% target. Yet despite this extraordinary reflationary environment, government bond yields fell sharply over the quarter, with the yield on 10-year US Treasuries down from 1.74% at the end of March to 1.46% by the end of June. Notably, almost the entire drop in yields was a result of falling real yields, which ended the quarter at -0.87%; 10 year inflation expectations peaked at 2.56% in mid-May but by the end of June had returned to 2.34%, little changed from levels at the end of March, and still within the range of the last decade.



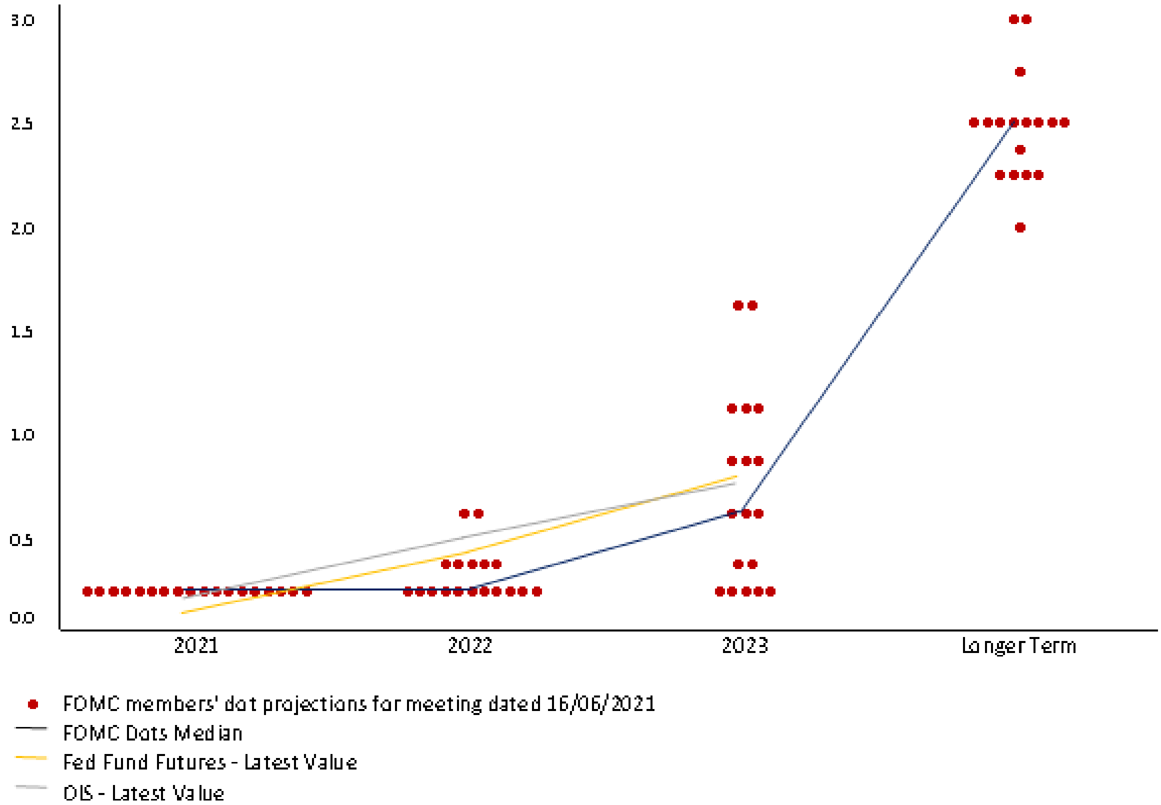
Source: Bloomberg Finance L.P, Momentum Global Investment Management

The combination of strong growth, feeding through to big increases in corporate earnings, and falling bond yields underpinned risk assets. Global equities returned 7.7% in Q2, led by the US, up 8.4%, corporate credit and high yield bonds returned 3.5% and 2.7% respectively, and commodities were up 15%, with sharp increases in oil, metals and agricultural areas.
Growth is being driven by the release of pent-up demand as covid restrictions are eased and consumers begin to draw down on their huge excess savings built up over the past 18 months, estimated to amount to $2.6tn, 12% of GDP, in the US. The reality is that the vast majority of people across the developed world have been largely protected from the extraordinary recession of 2020, both in terms of income and wealth, with many stock markets at all-time highs and house prices, the cornerstone of household assets, up sharply - in the case of the US by 15% over the past year.

The policy response has been on a scale never seen before in peace time. The huge fiscal spending packages to support people and businesses through the pandemic will fade as economies emerge from the recession but it is clear that there will be no return to fiscal austerity. President Biden’s spending plans, on top of his $1.9tn pandemic relief programme, call for over $6tn of spending in infrastructure, healthcare, education, clean energy and the environment, while extending the social safety net and supporting jobs. If enacted in full, it would result in annual fiscal deficits averaging more than $1tn, 5% of GDP, over the next decade, the highest sustained levels of spending since WWII. The EU’s Next Generation recovery plan is also moving to implementation, with EU bonds now being issued to finance EUR750bn of grants and loans to support regions most affected by the pandemic. On top of this, central banks have persisted with extraordinarily loose monetary policy, underpinning vast amounts of liquidity and the easiest financial conditions of the past 20 years.

The challenge for policy makers now, however, is that the surge in demand underway is being met with supply constraints, in part a consequence of the disruption to supply chains resulting from the pandemic. The ensuing inflation is far exceeding expectations and is much more than simply the base effect of very low inflation during last year’s collapse in activity levels. To date, central banks have been resolute in their belief that the inflation surge will be transitory and have stuck to their ultra-loose policies, but in its latest policy review meeting the Fed has wavered, Chairman Powell recognising that ‘inflation could turn out to be higher and more persistent than we expect’. The Fed brought forward expectations for a reduction in its QE programme, with current asset purchases of $120bn per month likely to be reduced in coming months, and for interest rate rises. The Fed ‘dot plot’, which shows where each governor thinks interest rates will be at future dates, now indicates two rate rises of 0.25% each before the end of 2023, while previously no rate rises were expected before 2024. But it is noticeable that the ‘dot plot’ has a very wide range of predicted outcomes for 2023, reflecting a great deal of uncertainty around the way both growth and inflation will play out in these unprecedented times

Fed's Dot Plot



Source: Bloomberg Finance L.P, Momentum Global Investment Management

This more hawkish tilt by the Fed in June signalled the beginnings of a monetary policy tightening cycle and triggered an immediate, but very short lived, alarm in markets. The subsequent comments from Fed governors, reaffirming their view that the inflation rise will be temporary, and the reality that the tightening will be very slow and gradual, with interest rates no more than 0.5% or thereabouts for at least the next 18 months, helped to push down yields on longer dated bonds and supported equity markets. This will be a very long cycle, the Fed will not tighten policy pre-emptively, it and other central banks continue to err on the side of caution with respect to the state of the economic recovery, and policy is likely to remain supportive for a considerable time ahead.

Source: Bloomberg Finance L.P, Momentum Global Investment Management

The pace of recovery and ensuing inflation have become the dominant narrative in markets in recent months. Will the rise in inflation be transitory as central banks believe, or will it be persistent, which could trigger an unwelcome early tightening in policy? And will the pace of recovery be sustained, or will it fade if covid variants spread rapidly and trigger renewed restrictions?

Covid concerns resurfaced in June as the delta variant spread rapidly across the world to become the dominant form of the virus. In the UK, where the vaccine rollout is well ahead of other major countries, evidence suggests that the vaccines provide good immunity and dramatically weaken the link between infection and hospitalisation. But this is not preventing a surge in cases, and makes those countries where the vaccine rollout is much slower vulnerable to a setback to full reopening of their economies. It is casting doubt over the sustainability of recovery and has been a factor in pushing bond yields lower and undermining the recovery trade - value stocks have underperformed growth stocks in recent weeks, following their surge of outperformance after the initial news of the vaccine success in November last year.

Source: Bloomberg Finance L.P, Momentum Global Investment Management

While clearly a concern, we view any setback to recovery as temporary: it is delayed and slowed but not reversed, and the combination of vaccine rollout and broadening immunity will ultimately keep the virus at bay. We will learn to live with it much as we do with other deadly viruses such as influenza: the WHO estimates that seasonal flu kills up to 650,000 each year. The peak of the covid crisis in terms of number of cases might still be ahead but the height of its impact on global activity levels has passed.

We therefore remain broadly constructive about risk assets. This will be a long cycle, with growth at exceptionally high rates in 2021 and 2022, underpinned by continuing loose monetary and fiscal policies – below the crisis levels of support but remaining at historically very high levels. We remain alert, however, to the risks ahead. The uncertainty around the extent of virus mutations remains a concern, as does potential long-term scarring. The huge public debt overhang arising from the pandemic is a longer term drag on growth and could become a more urgent problem if bond yields rise meaningfully. The US-China relationship is problematic, as is China's increasingly strident approach towards Hong Kong and Taiwan, and the clampdown on its digital giants, at a time when growth in China is slowing. Most importantly, if the rise in inflation becomes persistent, markets, having performed well over the past year and with stretched valuations in some areas, could be vulnerable, with a jump in bond yields and a sharp sell-off in risk assets. The risks around inflation and policy moves are likely to remain at the forefront of investor concerns.

After a strong quarter and half year for markets, returns are likely to be harder to come by in the months ahead. Recovery is being discounted, at least in part. Nearly all safe haven bonds offer negative real returns and in the absence of deflation are deeply unattractive, even more so if inflation takes hold. The uncertainty and risks surrounding this exceptional economic cycle point to periods of volatility ahead. However, the risks should be kept in perspective. Inflation expectations remain reasonably well anchored. Financial conditions are very easy, and liquidity is abundant. Short term setbacks are likely but the conditions for a sustained fall in risk assets are not currently evident. Further progress in equity markets and other risk assets is therefore likely.

We will stay invested to participate in the recovery but believe that it is vital to keep broadly diversified, blending defensive assets with a range of equity styles and specialist income producing areas. This is likely to be a long market cycle and we believe that patience and true diversification will be well rewarded in the year ahead.

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