Belvest

momentum
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GLOBAL MATTERS
MONTHLY VIEWPOINT

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MARKET REVIEW

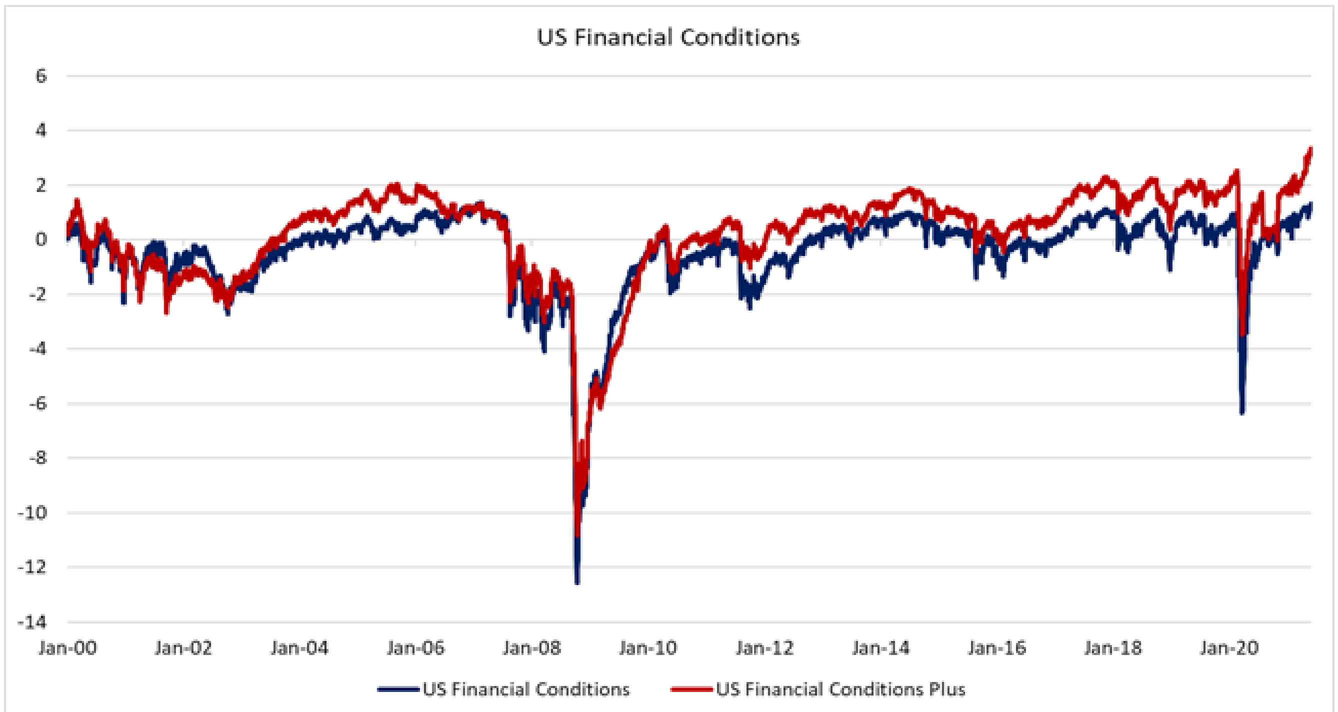
Confidence in economic recovery continued to mount in May, with most data and forward indicators pointing to a period of exceptional growth underway. Confirmation from data releases and empirical evidence that this is being accompanied by a sharp rise in inflation caused some investor nervousness during the month, but dovish signals from the Federal Reserve assuaged those concerns and underpinned a continuation of the reflation trade in markets while, somewhat surprisingly, holding bond yields in check.

The US and global equity market indices again reached new all-time highs during May, with the S&P 500 up 0.7% and MSCI World +1.4%, but markets were led by those thought likely to benefit most from the recovery, with Europe ex UK returning 2.6%, Japan 1.4% and the UK 1.3%, the latter restrained by sterling's strength (all figures in local currency terms). Those sectors with the greatest recovery potential outperformed, MSCI World Banks up 5.9% and MSCI Value +2.7%, while MSCI World Growth stocks fell marginally, -0.3%, and the tech heavy Nasdaq index fell by 1.4%. Emerging markets benefitted from a weaker dollar and rising commodity prices and returned 2.3% over the month. Within that, Asia underperformed, held back by second waves of coronavirus sweeping through several countries, in turn triggering renewed restrictions, and by some evidence of slowing growth in China.

Bond markets were steady, with yields on US Treasuries drifting slightly lower over the month, driven by a fall in real yields as 10 year breakeven inflation moved up to 2.45% at month end from 2.41% at the end of April. US Treasury inflation protected bonds again outperformed, up 1.2%, but the best performance came in emerging market bonds, +1.5%.

With sharply rising demand and signs of supply shortages, industrial metal prices in general continued to strengthen, with copper up 4.4%, but precious metals led the way with the gold price up 7.8%, recovering most of the ground lost earlier in the year.

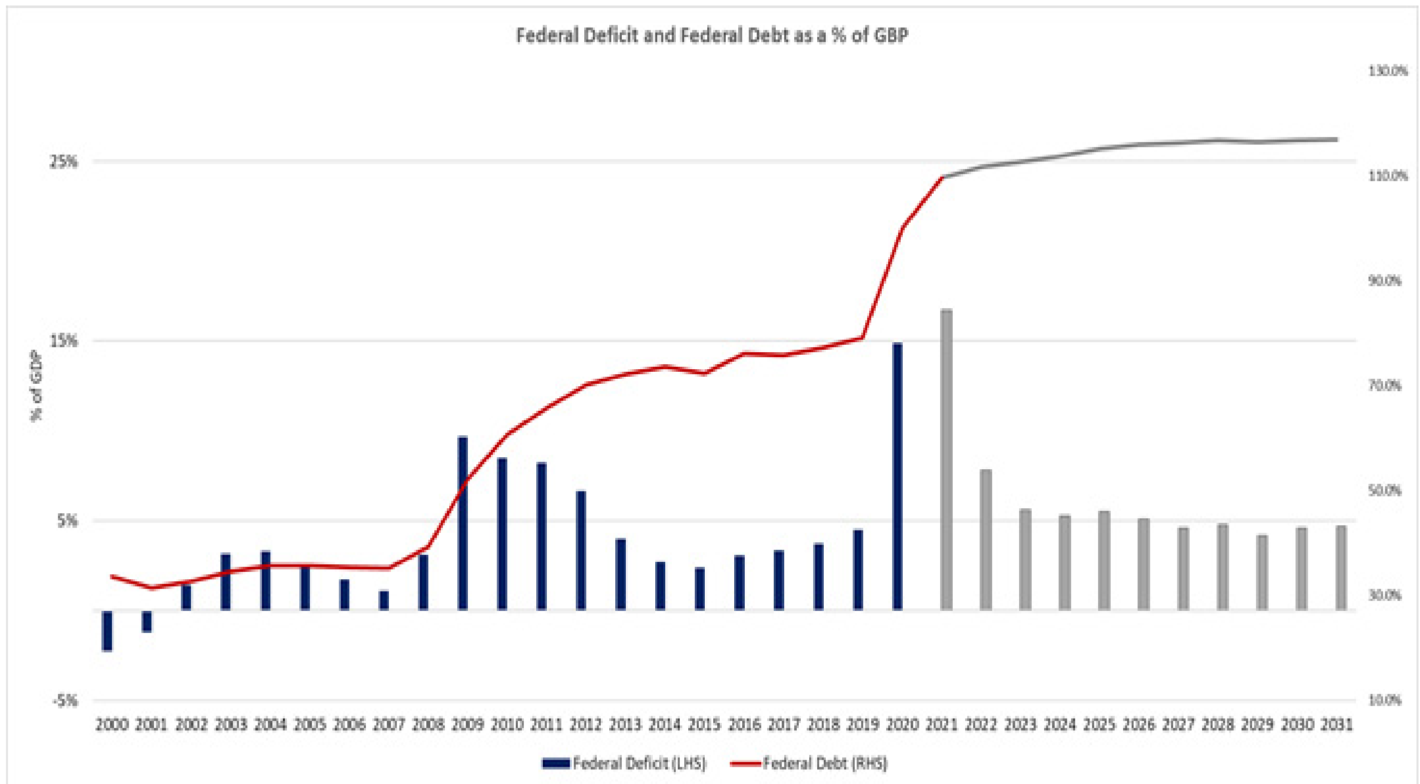
Inflation remains the market's key concern, with all eyes on the US. April inflation numbers came in much higher than expected, with CPI up 0.8% on the month, taking its year-on-year rise to 4.2%, the highest since the financial crisis. Core CPI, which more closely reflects the underlying trend, rose by 0.9% on the month, and 3.0% year-on-year, a level not seen since 1996. Producer prices have risen by 6.2% over the past year, and the Fed's preferred measure of inflation, core personal consumption expenditure, is up 3.1%, the fastest rate since the early 1990s. Inflation expectations moved above 2.5%, their highest for 8 years, and markets wobbled on the news. However, the Fed maintained a steadfastly dovish tone after the figures, insisting that the rise in inflation will be transitory and talking down any suggestions of early policy tightening. The assurances had the desired effect, with inflation fears easing, bond yields falling and equities rising.



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

*The Bloomberg U.S. Financial Conditions index tracks the overall level of financial stress in the U.S. money, bond and equity markets to help assess the availability and cost of credit. The Bloomberg U.S. Financial Conditions Plus index includes indicators of asset-price bubbles including tech share prices and the housing market.

Increased confidence in the global economic recovery has been fuelled by Biden's fiscal spending, building on the pandemic relief programme of $1.9tn already largely distributed, with far-reaching plans to extend the social safety net, support jobs, families, education, healthcare, infrastructure, clean energy and the environment. The broad proposals have been set out in Biden's Federal budget for 2022, an ambitious plan calling for over $6tn of Federal spending, with increases each year thereafter through to 2031. If enacted in full, which seems unlikely given the Democrat's narrow majority in both houses of Congress and the Republican's early resistance to some of the spending and tax raising initiatives, this would result in fiscal deficits over $1tn each year over the next decade, the highest sustained levels of spending since WWII, representing more than 5% of GDP each year on average and increasing Federal debt to 117% of GDP



Source: US Office of Management and Budget, Momentum Global Investment Management

One consequence of the extraordinarily loose fiscal and monetary policies in the US has been an easing of financial conditions to around the lowest levels this century, and reflected in a weaker dollar. On a trade weighted basis the dollar fell by 1.6% in May, taking the decline since its peak this year in late March to 3.7%, returning it to the levels of late 2020. Over the past year the dollar has declined by 9% on a trade weighted basis; over this period the euro is up 10%, sterling 15%, the Swiss franc 7%, the Chinese renminbi 12%, with only the yen of the major currencies down, a fall of 2%. Some emerging market currencies, which suffered sharp falls in early 2020 as the pandemic struck, have enjoyed notable recoveries, with the South African rand up 28% over the past year.

Sterling has been buoyed by the end of Brexit uncertainty, the removal of political uncertainties as the ruling Conservative party has consolidated its electoral advantage over the opposition, and the success of the vaccination programme leading to prospects of a huge economic recovery; the pound has been the best performer of the major currencies this year, up 4% versus the dollar. In contrast the yen has surprised on the downside, down 6% year-to-date, weighed down by weaker than expected growth and a troubling second wave of the virus together with an extremely low vaccination roll-out. Sterling continues to offer reasonable value with the economic recovery in its early stages, while the longer term safe haven characteristics of the yen make its current level relatively attractive. The strength of the renminbi triggered a response from the Peoples Bank of China in May to try to restrain its rise, a delicate balance for the authorities given the continuing frictions between the US and China.

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

We are in the early stages of the global economic recovery and see a wide range of opportunities ahead, especially in those parts of markets which will benefit most from that recovery. Fiscal and monetary policies remain extremely loose and supportive of risk assets. But the picture is clouded with some uncertainty. The virus remains a threat, especially across the developing world, and the race between vaccination roll-out and the spread of virus mutations continues to present challenges. The greatest concern now, however, is the nature of the inflationary surge as recovery progresses; will it be transitory as central banks believe, or will it prove to be persistent? Our central view is that inflation will peak in coming months as base effects fade and pent-up demand is satisfied, but we recognise that the pressures on the supply side are likely to take some time to be resolved, and could underpin an uncomfortably long period of above-target inflation. Given this uncertainty, portfolio diversification is more important than ever, taking advantage of the opportunities in equities while retaining protection against a period of inflation at higher levels than we have experienced through the past 20 years of disinflation.

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2 June 2021

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