Watson French
INDEPENDENT FINANCIAL PLANNING
& INVESTMENT MANAGEMENT

Asset Class Commentary
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With economies starting to re-open and recover, and Covid vaccination programs in full swing, investors are becoming increasingly focussed on inflation. Central Banks in the US and UK are telling investors the base rates will not rise until around 2023, but many investors are sceptical about this and are testing the banks by pushing treasury and gilt yields higher. Value stocks that have been under-valued and in low demand are now in high demand, and a big sell-off of growth stocks is promising longer-term underperformance relative to their value counterparts.

The UK is finally looking more attractive to investors as much of the Brexit uncertainty wanes. In the US, President Biden has big plans for infrastructure spending in the United States to increase its global competitiveness but faces considerable pressure from Republicans in Congress.

Searching for a return from fixed-income investments is proving difficult, while returns in crypto-assets are swinging wildly from positive to negative. At times like these diversification is key, but returns are definitely out there to be found.
Naturally, if you have any questions or would like to discuss your portfolio in more detail please do not hesitate to contact us.

Areas of Focus

- UK equity is looking more attractive as the risk premium attached due to the uncertainty over Brexit is removed.
- There are early indications of a shift to value stocks, although there are many growth industries that will benefit from structural changes.
- Government bonds and investment grade bonds have performed poorly, whereas high yield bonds are more attractive. This is likely to hold true as yields rise.
- Property is expected to lag other asset classes.
- Most commodities have performed well and are expected continue to do so for the next few years. This is especially true for metals which have seen big prices rises in response to increased demand for materials.
- Japanese markets are lower as the country is experiencing a surge in Covid cases, as well as concerns that Japan will not benefit from any US-China trade deal as much as other countries in the region.

- Emerging Markets' performance varies by region but is expected to perform well if the US dollar weakens and yields hold steady.

Interest Rates

The Bank of England base rate still remains at 0.1% and market consensus is presently for any rise in interest rates to be at least 2-3 years away.
This will mean continued low real returns on cash deposits for the foreseeable future, particularly as inflation picks up.

Equity
Value vs Growth

Value stocks are expected to outperform growth stocks, although it is worth noting that not all value stocks will outperform as many of them face structural challenges. Some growth stocks are set to benefit from structural changes and investment, so selectivity is key.
With economic recoveries progressing (in the UK and USA), economic growth and inflation are picking up and this is making value stocks more attractive.
There are some early indications that although interest rates rises are not on the immediate horizon, investors have already shifted towards value stocks.
Research from Vanguard suggests that value stocks likely to outperform for the next 10 years, with returns being in the range of 5% to 13% higher than that of growth stocks over this time period.
The only scenario in which growth stocks could outperform is if economic recoveries stall or reverse and inflation and corporate earnings do not increase. This view is a generally supported across the market – many growth stocks are considered overvalued as well, so profit taking and the consequent over-selling of these stocks is something to look out for.
The following table compares value and growth fund performance over recent time periods.

ETF	5 Day	1 Month	YTD
Vanguard Growth	1.08%	9.65%	10.93%
Vanguard Value	1.91%	3.43%	16.50%

(taken from https://personal.vanguard.com/pdf/ISGVVG_042021_A4_ONLINE.pdf)

Industries

Cyclical industries are still the most likely to benefit from the economic recoveries.
Green energy is also at the forefront of Government plans to rebuild economies in many countries. President Biden has called on other governments to make it a priority and part of his infrastructure plan is to inject $350 Billion into clean energy.
This is a long-term view as there are lots of barriers and opposition to green energy which will make its effective implementation difficult. Biden's $2 trillion infrastructure plan could see many other industries benefit, such as construction and basic materials, but again this plan needs to pass through Congress and Republicans will attempt to reduce the budget.

Semiconductor equipment manufacturers could also be set for long-term gains due to processor chip shortages and increasing demand.

UK

Lockdown restrictions are easing and the vaccine rollout is progressing swiftly and efficiently, making the UK look more promising for investors.
Any increases in economic growth and inflation are likely to be only transitory (the same as for other geographic regions). The UK market is overweight cyclical and financial stocks, which could make it a more attractive investment if market expectations for a global economic recovery are realised.
This is tempered by the fact that Brexit continues to pose issues for for banks and other financial stocks, as well as manufacturing and exporters. Lots of EU equity trading has moved from London to Amsterdam and the European Central Bank is pressuring banks to move their activities and staff to the EU.
Continued easing of restrictions and economic recovery, coupled with increasing certainty over Brexit will help to stabilise the pound and in turn small- and mid-cap stocks may offer better returns than large-cap stocks. A strong US dollar will also hurt large-cap stocks as many of the constituents of the FTSE 100 have strong overseas operations and book many of their profits in US dollars.
However, it must be noted that if new variants of the Covid virus cause further lockdowns then small- and mid-cap stocks are likely to underperform. As always, holding a diversified portfolio is essential.

North America

The vaccine roll out has also progressed quickly in the US and economic recovery looks positive with services reopening. President Biden has announced plans for infrastructure and tax rises, but there is uncertainty about how much will actually be delivered given the need for approval by Congress. Although the Democrats have a small majority there has been division in the party about the planned spending, and there is firm opposition from the Republicans.
North American equities have provided strong returns for some time. The NASDAQ is heavily weighted in growth stocks, and this could see underperformance as demand for value stocks increases (as mentioned earlier).
On the other hand, if planned infrastructure spending is successful then select growth stocks may benefit from structural changes.
Furthermore, part of Biden's fiscal plan is to increase the top marginal rate of tax to 39.6%, which will increase the capital gains tax investors pay on investment gains. This has the potential to hurt growth stocks – if the plans look likely to pass Congress, then investors may well decide sell some of their holdings to crystallise gains at a lower tax rate.
President Biden also wants to raise the corporate tax rate from 21% to 28%, which would further hurt US stocks as their after-tax earnings would decrease. Although the intention is for the additional tax to fund the infrastructure plan, many business leaders in the US believe it will hurt business and offset any positives.

Europe

The vaccine rollout has been slow and disjointed across the bloc, with some countries progressing better than others. There has been disagreement in the supply of medical supplies and vaccines, and now a disagreement in the Covid vaccination certificates that would allow people to travel between countries.

As Europe faces a third wave of infections and vaccination numbers are low, allowing people to travel between countries and tourism to reopen could lead to a surge in infections and continued economic and social restrictions.

Europe's big energy firms have profited from rises in oil prices, driving profits back to pre-covid levels. It has been earnings season in Europe but investors have been more focused on economic recovery. As in the UK, cyclical stocks have seen increasing demand with financials and car manufacturers leading the way.

Asia

Asian stocks are under pressure as the number of Covid cases ticks upwards. Malaysia and Thailand are both examples. However, Thailand's stock market has stood its ground as investors have bought into sectors which are out of favour.

Japan

A resurgence in Covid cases and a slow vaccination rollout has meant Japanese equity markets have been among of the worst performers in recent weeks.

Domestic consumption has been hit which has led to underperformance in transportation and restaurant stocks (to name a few). Previously investors had high hopes for Japanese recovery, so this set back has made Japan a less attractive investment proposition.

China

China had a strong economic recovery in January-March, but some analysts are sceptical as to whether this can be taken at face value.

This is due to the governments crack down on big tech companies, ensuring they comply with the strict regulations. Also, in April China's factory activity slowed due to a bottleneck in supply, a softer demand and a rise in production costs. Analysts expect the demand to pick up as the US economy continues to recover.

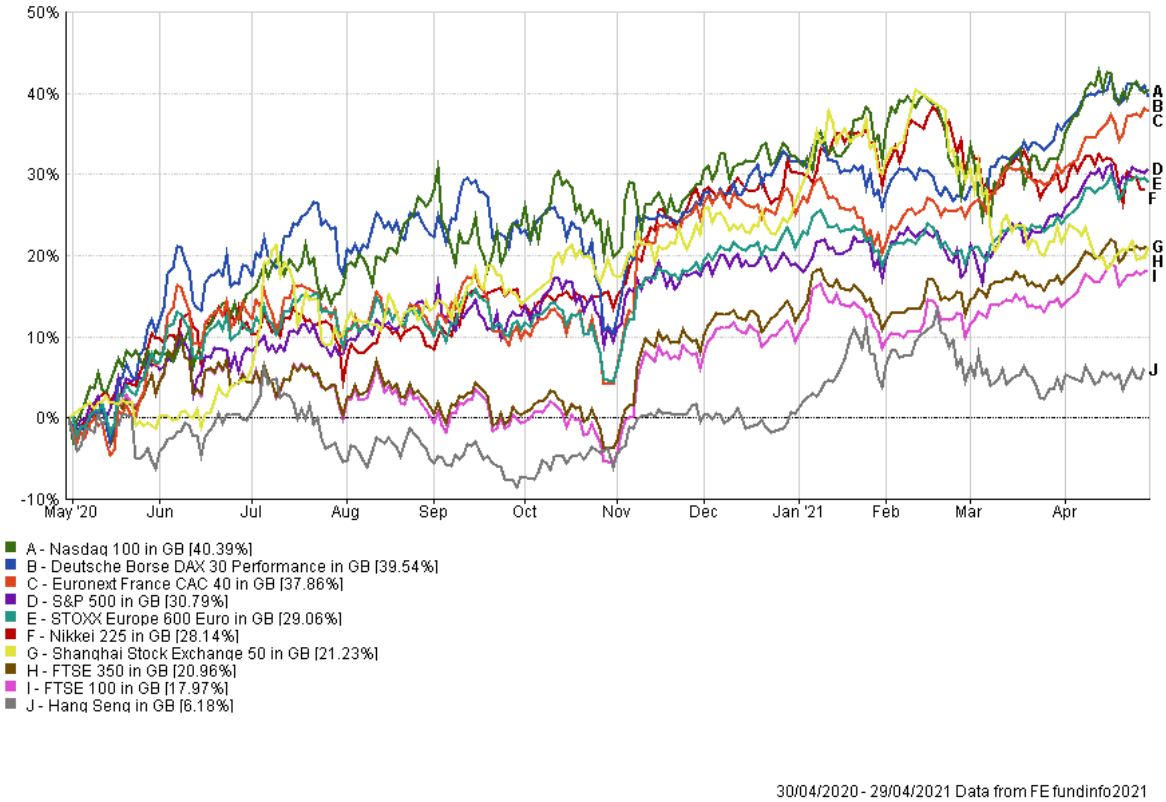
Emerging Markets

The outlook varies across countries but generally vaccine rollouts point to broad economic recoveries. A weakening US dollar would further help equity returns in emerging markets as well. However, higher sustained inflation levels leading to an increase in interest rates in the US would damage the prospects for emerging market equities.

A notable struggling market at present is in India. With a surge in Covid cases hurting the economy, stock markets are much lower. Even if infections are controlled, economic recovery will be delayed and behind other markets. Taiwan and Latin America have also seen recent dips due to the struggle to contain Covid cases.

Emerging markets are expected to have higher vaccination rates after developed countries, so this is something to look out for. Any further disruptions and outbreaks will weaken the equity markets in what is usually a more volatile asset class.

Charts showing the performance of major stock indices over one year.



Fixed Income

In the UK the Bank of England maintained the rate of its bond buying program. This should help to prevent yields from rising much higher. However, if inflation rises more quickly than the market expects, this will push yields higher as fixed income investments become less attractive.

On the other hand, if inflation does not rise as much as forecasted or if investors view it as a temporary spike, then yields should stabilise and fixed income will be back in favour.

Corporate bond markets will benefit from increased global optimism, but there will be little in the way of returns from price appreciation.

In the US bond yields have again risen and investors expect yields to top their March highs, despite the Fed continuing its bond buying efforts with no signals of it relaxing any time soon. The general trend for US government bond yields is upwards, although there have been some recent dips.

Some analysts believe the Fed will struggle to contain yields in the coming months as the economic recovery continues. At the current time the Fed plans to keep interest rates close to zero until 2024, but a common measure of expected future interest rates, the Eurodollar Futures index, points to an increase in early 2023.

In the summer this approach from the Fed could be tested, especially if expectations for stronger economic reports on jobs and industrial activity are realised. In these circumstances the Fed will find it harder to justify continued loose monetary policy.
One opinion is that European markets will bear the brunt of the next market sell-off, as they weathered the last sell-off relatively well.
Among Emerging Markets, the best returns are presently coming from high-yield bonds, with government and investment grade bonds showing negative returns.

Commodities

Most commodity prices exceed that of their pre-pandemic levels. This is due to increased global recovery and government stimulus.
Oil prices have seen a fast recovery, buoyed partly by OPEC agreeing higher-than-expected production cuts. Although oil demand is 5% lower than its 2019 level, demand should return as economies reopen and tourism picks up (among other industries). Metals have also seen big price rises as actual and expected demand for materials increases. This is partly due to advancements in technologies and a general shift to using non-fossil fuels.

Property

The consensus is for commercial real estate to lag behind other asset classes. If inflation does pick up to high levels property prices are likely to rise, but continued Covid restrictions in many countries mean that some retail and leisure properties have not yet re-opened.

Cryptocurrencies

Cryptocurrencies have been very volatile and subject to large swings in value, both up and down.
Bitcoin has generally been on an upward trend as large institutions, both financial and non-financial, have taken a greater interest in it. For example, the price rose sharply following Tesla’s announcement that it bought a large amount of Bitcoin to hold on its balance sheet as short-term marketable securities and that they will accept Bitcoin as payment for their cars. This reversed just as sharply when Tesla’s Elon Musk suspended the ability to pay by Bitcoin in response to concerns about Bitcoin’s environmental impact. Many critics believe Bitcoin and similar cryptocurrencies are a speculative “bubble” with no intrinsic value. Those with a more positive view of Bitcoin say that it is different, and that price movements are now driven by demand.
Since the start of January Bitcoin’s price has grown by 85%, and companies that are operating in the digital sector are attracting a lot of investment. An example of this is Coinbase, which recently listed on the NASDAQ at a value above many traditional businesses that have been around for a lot longer.
Bitcoin is very volatile and although it does provide an alternative asset class for investors, opinions remain sharply divided.

Robert Dougherty, May 2021