Watson French
INDEPENDENT FINANCIAL PLANNING
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Asset Class Commentary
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As economies edge closer to reopening, there are undoubtedly more positives to look forward to.

At the same time, many investors are taking a cautious approach as the "unknown unknowns" of future coronavirus variants are holding back confidence. Further lockdown restrictions are an ever-present risk, as we are seeing all over the world.

The G7 summit in Carbis Bay was closely watched and although plans for a minimum rate of Corporation Tax were advanced, many investors are not yet pricing in any effect on share price valuations; the likelihood of a minimum company tax rate being implemented in the short to medium term is low.

Inflation in the UK, US and Europe has now risen above central banks' targets, but investors are content that this increase is transitory and is in fact a key dynamic in economic growth.
Interest rates in the key economies are still not projected to rise until at least 2023 and bond yields have taken this into account, shrugging off the recent high inflation statistics without too much damage to prices.

One theme from the G7 meeting will almost certainly be a key feature in planning for long term investment growth – returns within almost all asset classes will be affected by governments' climate change goals, providing good potential investment opportunities.

Areas of Focus

- UK equities are still looking attractive and under-valued relative to overseas equities.
- Bonds and fixed interest investments will be underweight in most portfolios compared with equities, but there is the potential for high-yield bonds to produce reasonable returns.
- Cyclical stocks are an attractive prospect as economies come closer to fully reopening.
- Rising house price inflation is an important factor for both individuals and governments.
- Asian equity is looking promising over the long-term due to increasing incomes and growing GDP.

UK

UK inflation reached 2.1% in May, above the Bank of England's 2% target. This is partly due to increases in the cost of travel compared to last year. Also, clothing stores last year sold items at discounts to reduce excess stock, resulting in lower prices.

Interest rates have nonetheless been kept on hold, as was expected.

The departing chief economist for the BoE, Andy Haldane, warns that rising inflation threatens to overheat the economy. Currently, the continued supply of money into the economy is supporting share prices, but this is likely only short-term, especially as the BoE's bond-buying program is scaled back and monetary policy is tightened in the future.
If inflation does rise out of control it will necessitate a sudden and more significant rate rise, which will severely impact stock prices and bond yields. Although possible, at the present time this scenario looks unlikely.

The threat of the Delta variant spreading in the UK still looms and is a reminder that the road to recovery is not straight. Delays to the easing of restrictions is always a risk.

UK shares are still attractive due to the uncertainty over Brexit being removed. Relative to most other major overseas markets UK shares remain under-valued.

Sometimes viewed as a sign of investor confidence (or over confidence!) the number of Initial Public Offerings (stock market flotations) on UK markets is been at its highest level for over a decade, as companies look to take advantage of the huge investor demand and increased cash flows.

North America

After a quick start in vaccine rollouts, the pace has started to stall due to vaccine hesitancy. The US will most likely not be able to meet their July goal of vaccinating 70% of the population.

President Biden's infrastructure plan has hit even more roadblocks in the last month as Republicans opposed the size of the plan, the way the money will be spent and how the money for the plan will be raised. However, a deal has been presented to President Biden which he has accepted.

The original planned amount was for $2.3 trillion to be spent on infrastructure such as roads, bridges, climate change and elderly care. The new figure is $1.2 trillion. There are many stocks that will still benefit from this such as materials, construction and any growth stocks that will benefit from structural changes.

The US Federal reserve has said they will still not raise interest rates or reduce their bond buying program but have talked about tightening monetary policy, even though inflation has now risen above 5%.

This again is likely only transitory as the pent-up demand from lockdowns is released. The Fed wants to make sure the job market is fully recovered, and so short-term high inflation will be accepted for the time being.

The consensus among Fed committee members has changed since their last meeting in March and the consensus is for two rate hikes in 2023, a year earlier than previously thought.

Not much has changed with US equities as many of the points above had already been priced in by investors. If the consensus does change again and rate rises are brought forward then this will reduce stock values, especially on growth stocks (whose future cashflows will be discounted at a higher rate, making them less valuable). However, stocks such as financials and under-priced value stocks will benefit from this.

Also, as rates rise and savings accounts become more attractive, cash outflows from equity may increase as returns in less risky investments increase.

Europe

The vaccine program in Europe is catching up with its UK and US counterparts and the stock market performance gap is narrowing.

This is evidenced by the STOXX Europe and Euronext France being among of the top performing indices in the last month. Q1 earnings season has passed in Europe and the strong earnings of many companies is one reason for the strong recent performance.
It is therefore no surprise that inflows to European equities are at their highest level in three years.

The European Central Bank (ECB) has kept the interest rate at historical low levels to keep financing conditions favourable while the economic recovery progresses. Christine Lagarde, President of the ECB, has reminded investors that Europe's recovery is behind that of the UK and the US and so comparisons are difficult. Any increase in the -0.5% deposit rate would be most likely in mid-2023.

Asia

Many Asian countries have managed to effectively contain the virus outbreak and so are further ahead in their economic restarts than other countries.

Chinese equity has underperformed all the other major indices in the last month, with a negative return. Despite the outlook for the economy being positive, this slump can be attributed to a few factors. The tightening of monetary policy, the government crackdown on big tech companies and other major economies looking to work together to counteract China's economic dominance.

Despite this, the long-term outlook for Chinese equities is still positive as rising incomes in the country and an increasing population provide huge scope for increased consumption and economic growth.

Japanese stock markets have performed poorly in the last three months as surges in the number of Covid cases has led to further lockdowns. Although the number of cases in the country as a whole is on a downward trend, the number of cases in the capital has risen With the Olympics still set to go ahead there is a risk that emergency measures could be reintroduced.

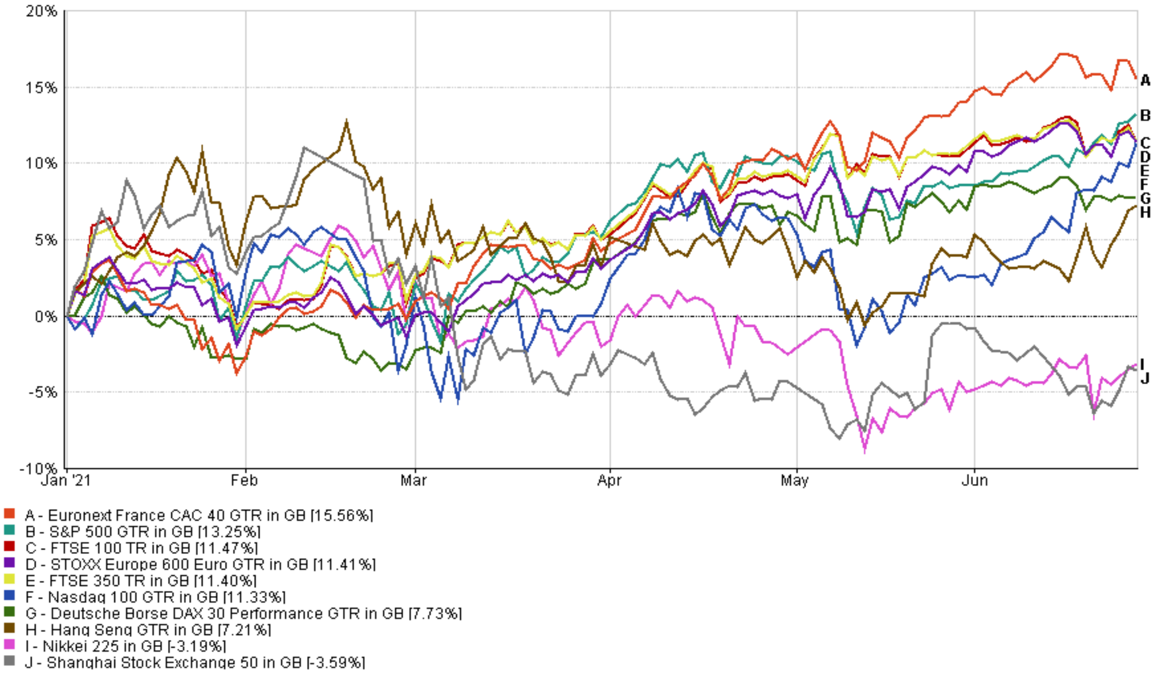
Japanese equities are also expected to miss out on many of the beneficial effects of a renewed US-China trading relationship.

In other emerging Asian countries such as Thailand, Indonesia and Malaysia, rising Covid cases and new lockdown measures are a cause for concern.

One of Australia's most populated cities, Sydney, has had to go into lockdown due to the Delta strain of the virus causing a cluster of new cases. The Australian government have already said their economic growth and population growth will be lower over the next 40 years due to Covid. This is a particular concern as Australia's growing population has been a key driver of their economic growth.

The increase in Covid cases in all of these regions will have short-term implications for the equity markets there; the scale of the long-term impacts will depend on how long it takes to bring Covid under control.

Chart showing the YTD performance of major stock indices.



31/12/2020 - 28/06/2021 Data from FE fundinfo2021

Bonds and Fixed Interest

Rising bond yields can hurt equity valuations. However, if bond yields are rising because growth expectations are rising then valuations do not have to decline.
Put another way – if profits rise more than the decline in valuations due to bond yields, then stock prices can rise.
Rising inflation has left bond markets relatively unscathed. Yields have risen from last year to March but have since fallen as prices have risen. This is due to investors believing that the present high inflation is only short-term and transitory. High yield bonds are still looking more attractive as spreads have tightened.

However, an increasing number of analysts expect monetary policy to tighten more quickly than the wider market currently anticipates.

Looking at the US 10-year Treasury yield, in mid-March it was at its highest of 1.732% when fears of runaway inflation were biggest. As of 28th June the yield is 1.487%, which demonstrates that investors are less concerned with short-term inflation and rate rises.
Asian fixed income is looking more attractive relative to other regions as many of the countries as further ahead in their economic restarts.

The outlook on inflation-linked bonds is neutral as high inflation rates have now been priced in and any further big increases look unlikely.

As central banks contemplate tightening monetary policy, it can be hard to find a reason to include bonds in a portfolio, although most investors continue to hold global fixed income investments to provide a degree of income protection.

Property

House prices globally have skyrocketed over the past year, with the biggest year-on-year increase coming from Sweden at over 15%. In the US house prices have risen by an average of around 13%, and in the 12% in the UK.

In the UK, tax breaks and ultra-loose monetary policy have been a big factor causing double-digit house price inflation.

The risk here is that prices could rise into bubble territory which would eventually burst and have an immediate impact on household wealth. Another risk is that the inequality between wealth classes and generations widens, making it harder for people to get onto the housing ladder.

The number of renters in arrears in the UK was £360 million which has built up over the pandemic and is a concern for any investor renting out properties. As house prices continue to increase and so does the cost of renting, this could develop into a more serious problem as the lowest-earning household's income is stretched further and the amount of rent in arrears increases.

With demand for houses high and supply perennially too low, there are good opportunities for construction and materials companies, who will benefit from efforts to increase the overall housing stock.

Real estate investments have a low correlation with equity markets and as their income streams are often linked to inflation, they are often considered a good hedge against inflation risk. The downside is the liquidity risk – property investments can be slow and costly to sell when access to capital is needed.

Commodities

Commodity prices have continued their upward surge as economies recover and the demand for materials increases. This has helped to push inflation higher and has brought interest rates hikes into the spotlight.

Since the US Federal Reserve's last meeting, the consensus on the timing of an interest rate hike has changed from 2024 to 2023. Commodity prices consequently experienced their largest weekly drop since the pandemic began.

For other commodities such as oil and base metals, their prices are likely to be supported in the medium-term due to a range of issues, such as the shortage in metal supplies, rising temperatures and water shortages.

A particular area of note is with the surge in clean energy objectives. For example, the increase in the number of electric vehicles has prompted an increase in Lithium, Nickel and Copper to build the batteries for these cars. Demand for these materials is expected to increase and supply is not expected to be able to keep up, which will drive prices higher.
Precious metals like gold and silver have all failed to increase in line with the reflationary trades. Only if inflation looks set to become more persistent will precious metal prices rise further (these assets are often a haven in times of high inflation).

Oil prices are now at their highest level since 2014 and analysts think the rally still has further to go. This is mostly due to vaccination roll outs, economic recoveries and higher demand from increased travel.

Oil producing nations are gradually increasing the output of barrels to support the current prices. However, in the long-term the phasing out of fossil fuels may mean there will be supply-side shocks in this commodity.

Robert Dougherty, July 2021.