



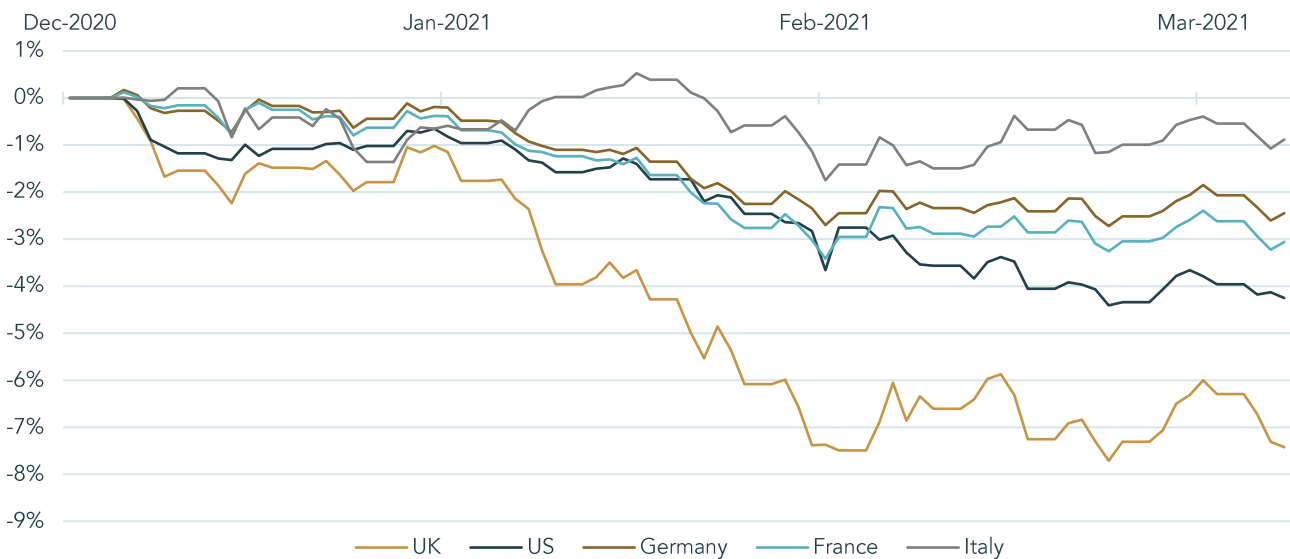
Investment Report – Q1 2021

"I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." James Carville, political adviser to President Bill Clinton

Many of the trends that established themselves towards the end of 2020 carried their momentum into this quarter, providing continued support for the tactical positioning in our client portfolios. The narrative of early 2021 was one of improving outlook for the global economy and rising bond yields, the latter being costly for holders of conventional fixed income. Given we currently have an alternative approach to investing in this asset class, we take this opportunity to dig deeper into the recent drivers of debt markets and to explain their implications for portfolio construction.

The first quarter of this year was the worst in decades for conventional fixed income securities, presenting a considerable headwind for traditional portfolio models. Yields on benchmark fixed income securities rose sharply, with the market value of these bonds declining as a result. The losses across major fixed income indices are illustrated on the chart below, with UK government bonds performing particularly poorly over the quarter. The UK government bonds index returned -7% in Q1, as a generally difficult environment for fixed income coincided with the emergence of the UK as one of the global leaders in the roll-out of vaccinations. This encouraged domestic investors to sell more defensive securities such as bonds.

Developed Market Government Bond Indices Returns: Q1 2021



Source: Total Return Indices, Bloomberg LLP, 2021

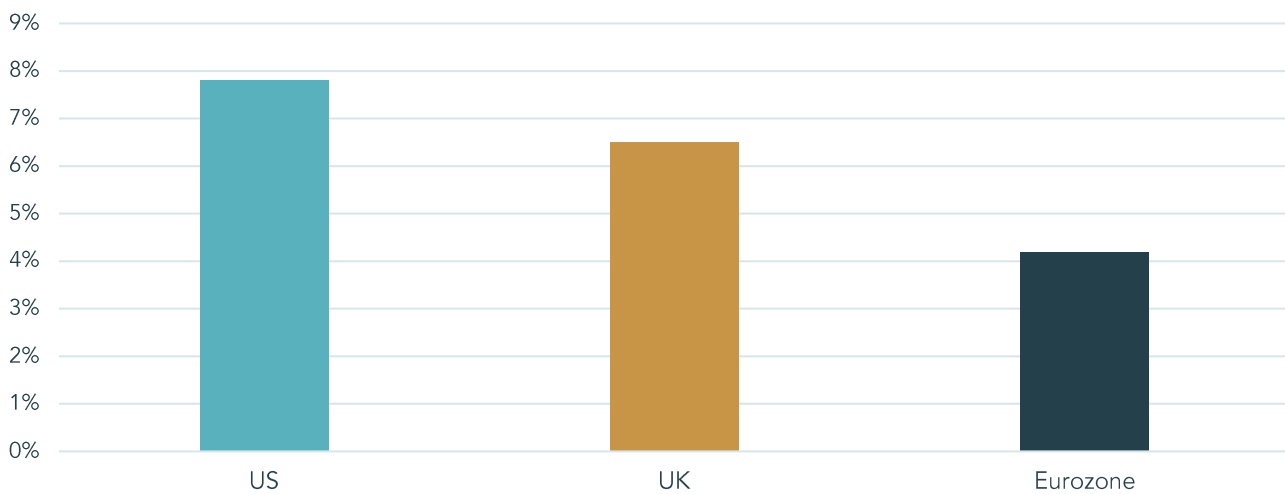
A number of factors have driven yields higher, but we crudely separate these into two buckets: debt issuance and inflation. Firstly, the existing and proposed fiscal stimulus across the developed world will need to be funded by the issuance of more government debt. Flooding the market with a fresh supply of bonds will push yields higher, as a relatively fixed pool of buyers demands a higher yield to justify continued purchases. The chart above shows that US Treasuries struggled in this respect, as the debt markets priced in President Biden's \$1.9tn fiscal support package as well as his planned \$2tn infrastructure bill.

Secondly, investors are becoming increasingly wary of inflation as the global economy recovers from the pandemic. Inflation will erode the value of fixed income securities such as government bonds, as the real value of a bond's coupon payments and the final capital repayment are diminished. One potential source of inflationary pressure is the support which global governments have provided to their economies, including the furlough scheme in the UK and stimulus cheques in the US. Importantly, and by contrast to monetary policy, these payments are being made directly to workers, meaning that the cash is likely to be spent in the real economy.



Moreover, whilst many workers have sadly lost jobs to the pandemic, others have continued to earn the same monthly salary without the usual outlets for their expenditure. In fact, wage growth in the US is tracking at c.6% on a trailing three-month view, so salaries are going up in many cases. The result is an elevated level of consumer savings today which we expect will be released once lockdown measures across the world are eased. The extent of the consumer savings surplus is illustrated in the chart below. Surplus savings are defined as the amount of savings in excess of the average savings level in 2018 and 2019, expressed as a percentage of a given economy's gross domestic product (GDP). In the UK, these excess savings account for a staggering £130bn or 6.5% of the UK economy. The figure in the US is even more remarkable, with consumers sitting on excess savings that account for nearly 8% of the country's economy.

2020 Excess Household Savings as % of Nominal GDP



Source: J.P. Morgan Asset Management, Bloomberg LLP, 2021

Alongside this supportive consumer outlook, we saw record levels of monetary liquidity pumped into developed markets last year, including bond buying programmes and interest rate cuts from central banks in Europe, the UK and the US. This liquidity initially found its way into financial assets, driving equity markets higher and creating artificially high demand for fixed income. Going forward, we expect this freshly printed cash to find its way into the real economy via consumer and corporate spending, pushing up the prices of goods.

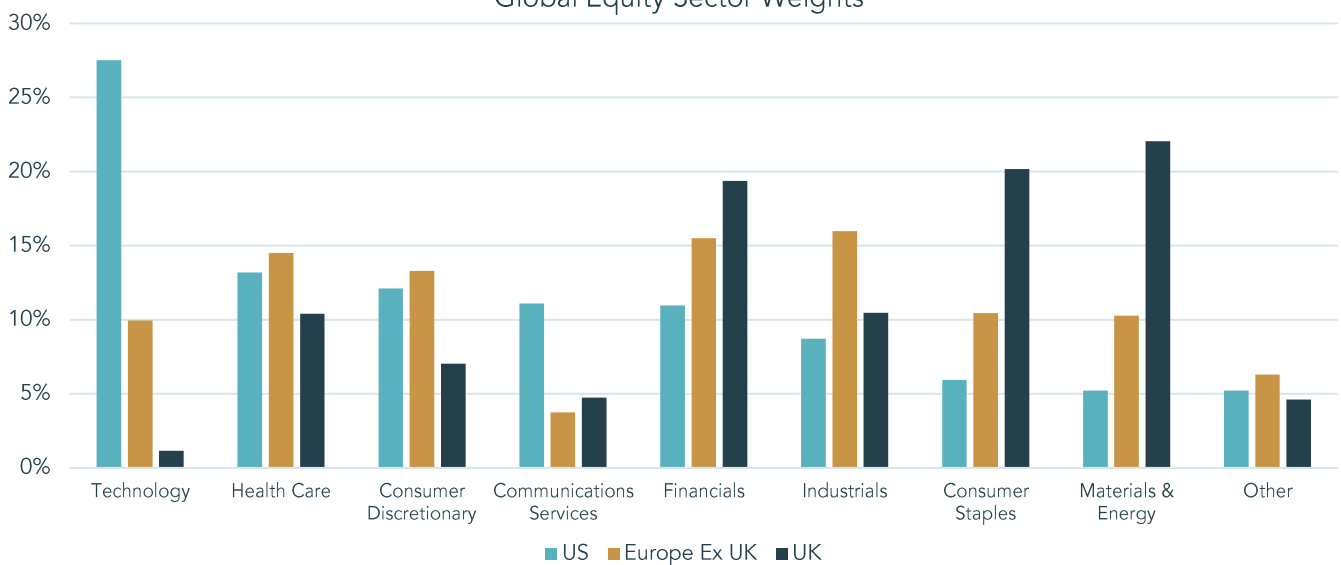
All told, the demand side of the inflation equation looks strong, but prices could see upwards pressure from the supply side too. The outlook for many key commodities is rapidly improving, as years of under-investment in capital expenditure at a company level coincides with an uptick in economic activity across the world. With mining companies operating with limited spare capacity, we have seen gains in cyclical commodities such as copper and oil as markets anticipate a supply-demand mismatch. This is likely to make certain goods more expensive to manufacture and we would expect to see some of this increased production cost passed onto consumers through higher prices. Whilst we acknowledge several factors that could delay or mitigate these inflationary pressures, for example a slow economic recovery due to vaccination delays, we feel the weight of evidence suggests that inflation risk should be taken seriously in today's portfolio construction process.

The recent guidance from central banks has also changed considerably. Monetary policy, particularly that of the Federal Reserve, is allowing for higher inflation expectations. This implicitly imposes a floor on bond yields, reducing the scope for government bonds to provide a positive return in times of market stress. We believe that this stance from central banks, combined with the inflation risks outlined above, challenges the notion that government bonds can provide a safe harbour during times of equity market volatility. With this in mind, we continue to prefer unconventional fixed income positions which offer a superior return profile in current market conditions. It appears that professional investors are increasingly coming round to this idea. In a recent survey of 1,500 institutional investors, 60% of respondents were reducing their allocation to conventional fixed income or employing a more active strategy in anticipation of higher volatility in the asset class.



The picture in fixed income markets is important for all our client portfolios because it has a significant impact on equities too. Whilst rising yields make borrowing more expensive for all companies, inflation has a divergent effect on different equity market sectors. Asset-backed industries such as Industrials and Real Estate have traditionally been beneficiaries of an inflationary environment, as asset prices are pushed higher. In contrast, asset-light sectors such as technology and consumer staples have typically fared worse in these economic conditions. This is especially true for high-growth names as inflation erodes the real value of the future earnings of these companies, causing their current value to decline in a similar way to a government bond. We note that the US equity market has a significant allocation to companies of this type, particularly within the technology sector which accounts for 27% of the US market.

Global Equity Sector Weights



Source: msci.com, 2021

It can be seen on the chart above that European and UK equity markets offer higher exposure to sectors such as Materials, Industrials and Financials. Broadly speaking, these markets should benefit more directly from an economic recovery and a reflationary environment. One specific example that captures our views on inflation and rising yields is the current allocation we have to European banks in our client portfolios. Bank equities have traditionally performed well in a rising-yield environment, as a wider profit margin is created between the interest they can charge on their loans and the money they borrow to make these loans. Additionally, banking equities are trading at cheap valuations, providing additional scope for relative outperformance of these equities against other sectors.

As our routines slowly creep back to some form of normality, we see plenty of opportunities in the current market environment as the global economy recuperates from the hardship of last year. We are encouraged by the fact that, at the time of writing, more than 710 million vaccine doses have been administered worldwide, equal to 9.2 doses for every 100 people. Our domestic picture is even more encouraging, with 56 out of every 100 people having received a vaccine dose in the UK. Whilst the social and healthcare outlook rightly remains uncertain for the time being, the economic implications of these statistics provide much to be positive about.

Fred Hervey
Chief Investment Officer