



Investment Report – Q2 2021

“We find ourselves in a situation here where we’re on the roof, and there is no risk-free path. We’ve got to jump.” Federal Reserve Chairman Jerome Powell, 2013, on tapering discussions.

The second quarter of 2021 saw some consolidation of many of the themes that had begun to emerge in Q1. Economic data gave investors reason to believe that a recovery was truly underway in the real economy, which provided continued support for many of the holdings in our portfolios. This fresh data brought a renewed focus on the actions of the Federal Reserve, with market movements in June driven largely by news from the US central bank. We reference some of the quarter’s key data points below, before highlighting two events occurring later in the year which we expect to prove significant for investment returns.

Recent monthly data have provided some hard evidence of an economic recovery. Perhaps most notably, the US Core CPI Inflation Index (excluding the volatile food and energy components) rose nearly 1% in April, the largest monthly gain since 1982. The US labour market also produced some healthy figures later in the quarter, with 850,000 jobs added in June, comfortably ahead of the 720,000 forecasted by economists. In the EU, the latest available data show that unemployment fell by 382,000 in May, with European manufacturers stating in a widely followed industry survey that they were taking on new employees at the highest rate for two decades.

Whilst these figures are encouraging, the size of the numbers is to some extent less relevant, particularly given the extensive government support and social restrictions which remain in place across the world. What is more important is that the direction of travel in the economic data coming out of several major economies is clearly positive. This should prove supportive for assets that are likely to benefit from an improving economic outlook, such as the cyclical equities to which we have exposure.

Policymakers made efforts to catch up with the consensus in financial markets over the last three months. The most notable capitulation on this front was the Federal Reserve’s revision of its economic projections in June, with both growth and inflation forecasts for 2021 adjusted upwards. Whilst the Fed kept interest rates at their current historically low range of 0-0.25% at the June meeting, committee members acknowledged that rate hikes may be required in 2023, having previously guided the market that the central bank’s first interest rate hike would come in 2024. Indeed, some Fed officials have said on record in recent weeks that they could not rule out a rate hike as early as 2022 if certain conditions are met. In the UK, the Bank of England’s outgoing Chief Economist Andy Haldane warned of the rising threat of a rapid increase in prices. Haldane went on to say that he expects inflation to be nearly 4% by the year-end, double the bank’s target inflation rate.

With the world’s most influential central bank plotting a path towards higher interest rates and other key central banks looking to follow suit, a higher interest rate environment over the medium term should be expected. Against a backdrop of rising interest rates, we maintain our view that conventional fixed income securities are an unattractive asset class, with holders of government bonds likely to suffer capital losses over the medium term. Until the interest rate outlook improves, we are comfortable avoiding these securities in our portfolios.

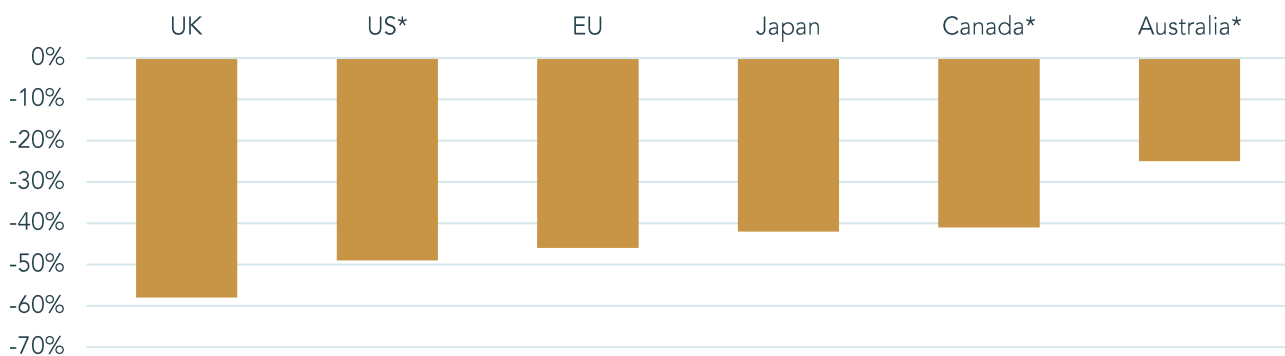
With markets increasingly fixated on the Federal Reserve, the Jackson Hole Economic Symposium in August will be closely watched by investors. Market participants are expecting Fed Chairman Jerome Powell to unveil the US central bank’s plan for tapering its bond purchases at the meeting. As a reminder, the Federal Reserve stepped into bond markets last year to provide liquidity and prevent the cost of borrowing from rising at a time when the global economy was vulnerable. The Fed’s support is ongoing, with \$80bn in US Treasury securities and \$40bn of mortgage-backed securities currently purchased each month by the bank.

At some point, this bond-buying scheme will have to end. The last time the Federal Reserve announced its intention to stop buying bonds was the so-called ‘Taper Tantrum’ of 2013, which saw a jump in US Treasury yields and a 5% drop in the US equity market. We note that the drawdown in equity markets at the time was concentrated in expensive growth stocks, with cheaper value equities delivering a positive return as yields rose. We believe the withdrawal of support from the Federal Reserve is better telegraphed today than it was before the 2013 Taper Tantrum. Perhaps financial markets are recalling Jerome Powell’s words in 2013 when the bank found itself in a similar situation. We anticipate an understandable level of market uncertainty leading up to the event.



Away from monetary policy, we see fiscal policy as a potential source of significant returns for certain asset classes. In this context, the UN Climate Change Conference (COP26) due to be held in Glasgow this Autumn may attract more attention from investors than prior events. The summit brings together delegates from UN member states with the aim of accelerating action towards the goals of the Paris Agreement and the UN Framework Convention on Climate Change. Environmental policy has moved to the centre of the political stage this year, with large economies making ambitious commitments to reducing greenhouse gas emissions. The chart below illustrates the size of the voluntary emissions reductions that several key economies have committed to. Both the extent of the cuts and the number of nations making these commitments is likely to result in profound economic trends. Notably, the UK's pledge to reduce its emissions by at least 58% compared to 2010 levels by 2030 is among the most ambitious in the world.

2030 greenhouse gas reduction targets vs. 2010 levels



Source: Rhodium Group, UNFCCC
*Upper end of NDC presented as a range.

Among the opportunities created by the raft of recent climate commitments is the structural demand increase that is forecast for various commodities including copper, nickel, lithium and uranium. Taking copper as an example, the CEO of Glencore, one of the world's largest mining companies, said the price of copper must rise 50% in order to encourage enough new supply to meet the projected demand from the 'global green revolution'. He went on to say that most of the world's more accessible deposits have already been mined and that a price of \$15,000 was required to encourage investment into these more difficult projects. The copper price at the end of June was \$9,374. Similar constraints exist in other metal markets, prompting some economists and commentators to forecast a commodity 'super-cycle' over the next decade. Whether the green revolution proves to be super-cyclical or just cyclical, we believe the outlook for many commodities is attractive, particularly those that have suffered years of under-investment. The returns available in the equities of companies that mine these commodities is likely to be even greater than the returns of the commodities themselves.

The growing evidence of inflation emerging in recent economic data only strengthens the investment case for commodities, with many natural resources having proven themselves to be good investments during times of rising inflation expectations. Gold is possibly the best-known asset that has attracted investors with its inflation-protection properties. Historically, gold has tended to perform best during highly inflationary periods, demonstrating an ability to store value over the long term. Additionally, the asset class generally performs well during times of stress in financial markets as investors flock to gold for its perceived 'safe haven' status. These characteristics underpin our conviction in our holding of gold within portfolios.

Going into the second half of the year, we are confident in our investment positioning. Whilst we anticipate financial markets to be more unsettled in the coming months, particularly ahead of central bank announcements, we feel constructive on the medium-term outlook for the global economy. In this context, we have a good level of exposure to assets that should perform well in what we see as an improving economic environment.

Fred Hervey
Chief Investment Officer