Smith & Williamson

Investment outlook

A monthly round-up of global markets and trends
March 2021

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COVID-19

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Investment outlook

Reflation continues to drive the equity rally

Following the global peak of new coronavirus cases in January, equities continued to rally from their March 2020 lows. So far this year, the MSCI All Country equity index total return (including dividends) is up 3.5% in local currency terms, as optimism grows on a global economic recovery[1].

By geography, emerging markets' equities (particularly Asia) have led the way, registering a 7.8% year-to-date gain, with UK stocks lagging their global peers slightly on 3.7%[2]. Arguably, UK stocks may have been held back due to uncertainty from trade friction in a post-Brexit world and an out-break of COVID-19 mutations. However, with a third of the population already having received their first dose, there are signs that the vaccine is beginning to immunise some of the most vulnerable parts of society against the pandemic. In a survey taken over the 28 days to 1 February, the UK Office for National Statistics reports that 41% of those aged over 80-plus tested positive for coronavirus antibodies in England[3]. Now that PM Boris Johnson has laid out a road map to open-up the UK economy, the probability that the economy and company earnings can rebound in 2021 after sharp declines in 2020 has increased. This creates an opportunity for domestically-orientated UK stocks to outperform in the coming months.

The rally in stocks has also broadened to other financial indicators that reflect strengthening economic activity (i.e. reflation). For instance, since the March equity low last year there have been sharp price rises in commodities (raw materials), including copper (104.5%), aluminium (93%), corn (71.8%) and crude oil (146.5%)[4]. Some of the underlying drivers for a sustainable upturn in commodities are falling into place. These include moving towards the end of lockdowns, fiscal infrastructure plans and an improvement in US-China trade relations under the Biden administration.

Environmental policies have given an added boost for commodities. A secular demand shift towards electric vehicles is creating strong demand for copper, which is now trading at a 10-year high. For instance, a battery-powered electric car typically uses around four times as much copper in its weight than a petrol or diesel equivalent. Additionally, with the US re-joining the Paris climate accord and the cancellation of the Keystone XL pipeline in America, capital investment in fossil fuels faces material headwinds. A subsequent tightening in energy supply is likely to put upward pressure on crude oil prices and backstop the reflation trade.

Looking forward, we see a favourable backdrop of support for reflation beneficiaries, such as; i) equities over bonds; ii) energy, materials and industrials in the value sector over high-growth technology, at least in the near term; and iii) non-US equities like emerging markets and the UK.

Implications and risks from rapid money supply growth

Global attention has been focused on the coronavirus vaccine, Brexit and a new president in the US. The growth in money supply in the US was never likely to attract headlines, but it is also important to the global economy.

US broad M2 money supply increased by 27.5% in January 2021 from a year ago[5]. This measure includes bank current accounts, savings accounts (household and corporate) and the monetary base (i.e. the Federal Reserve's balance sheet). To put this in context, it is the fastest growth rate in 150 years and even surpasses that seen in the 1940s when the US was ramping up war production. The reasons for this expansion are clear: the fiscal and monetary policies pursued by the US government has boosted citizens' bank accounts as well as bank lending and has led to a multiplier effect of more money flowing through the financial system which in turn should drive-up economic growth.

However, greater money flows into the financial system also comes with risks. Recently, retail traders have taken advantage of easy access to money and low rates to leverage up their investments. Excluding what investors hold as cash and profits from previous trades, US net margin debt stands at a record $333bn[6]. By borrowing money at the "margin", this can lead to significant market dislocation, where equity prices move far away from their underlying future earnings potential – see Market Highlights opposite on GameStop.

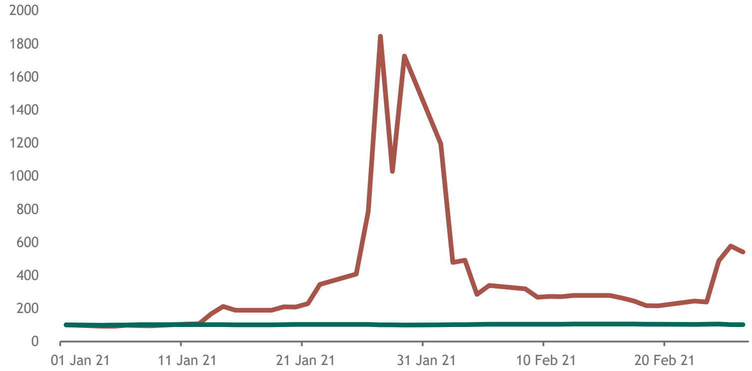
Moreover, traditional valuation metrics like the Price-to-Earnings ratio (PE) have also been inflated by an expansion in central bank balance sheets and money supply. While there can be little doubt that such valuation metrics are at historically elevated levels for equity markets, notably in the US, this should be considered in the context of historically low (unattractive) bond yields. Valuation metrics are also often poor market timing tools; they can become more stretched over long periods leading overly cautious investors to miss out. Considering that the consensus of analysts forecast strong global Earnings Per Share growth of nearly 29% for 2021 and a further 15% in 2022, valuation multiples can continue to expand to even higher levels to capture the positive company earnings backdrop and supportive money supply growth[7].

[1,2,4,5,7] Refinitiv Datastream, data as at 26 February 2021
[3] ONS coronavirus COVID-19 antibody data for the UK, data as at 21 February 2021
[6] FINRA Margin Statistics, data as at 1 February 2021

Equities

Last month, investors were reminded of idiosyncratic risk as so-called "meme" stocks hit the headlines. The share price of GameStop, a US physical video game retailer which had been in long-term decline, rose 23 times over 11 days in January. Traders used social media to organise coordinating buying of the shares knowing that some hedge funds were positioned for a fall in the stock price. As the share price rose, hedge funds were forced to reduce their losing positions by purchasing GameStop shares at higher and higher prices in what was a classic "short-squeeze". After peaking, the price of GameStop fell 85% over the following 5 days. This shows that money flows can have a great impact on individual share prices, causing them to become far removed from underlying fundamental values.

GameStop & S&P 500 total return performance (rebased to 100)

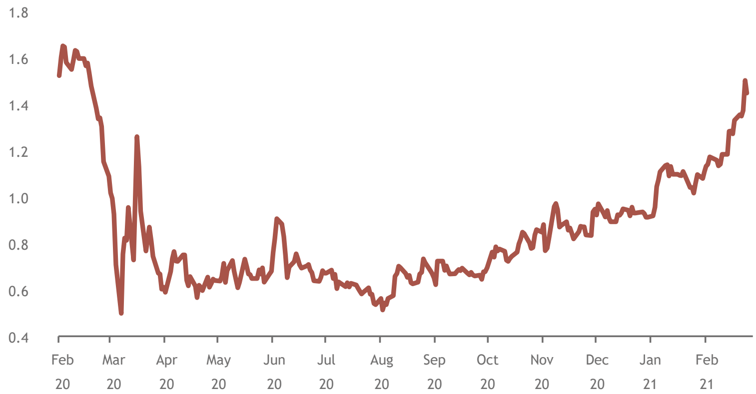


Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 March 2021

Fixed interest

The increase in developed market bond yields have been quite fast of late. This reflects improving optimism over the economic outlook thanks to the biggest global vaccine roll-out in history, as well as rising inflation expectations on the back of more stimulus by central banks and governments. 10-year bond yields in US, Germany and UK rose by 37, 51, 26 bps respectively in February. In particular, the benchmark 10-year US bond yield is now 1.45%, at its highest since February 2020. The rise in bond yields has had a negative impact on growth equities especially the tech sector, as investors discount future earnings at higher rates

US 10-year government bond yield

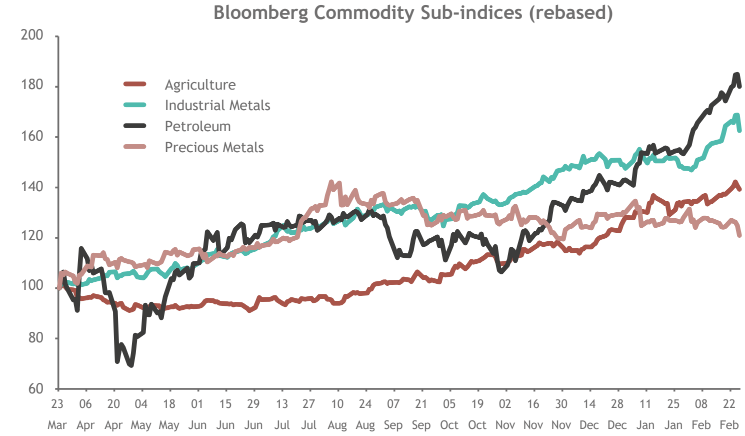


Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 March 2021

FX and commodities

Commodities have staged a great recovery over the last year. The petroleum sector (crude oil, heating oil, unleaded petrol) has been the standout performer, propelled by a spot crude oil which has more than tripled from its lows of less than $20/barrel. Industrial metals (aluminium, copper, nickel and zinc) have also rebounded strongly, up over 60% from their low point. Precious metals (gold and silver) were strong initially, given their safe-haven status, but traded sideways as the recovery gained strength. While these broad-based gains in the commodity complex are reflective of increasing levels of optimism in the global recovery, they will likely also be a catalyst for higher levels of future consumer price inflation.

Bloomberg Commodity Sub-indices (rebased)



Source: Bloomberg/Smith & Williamson Investment Management LLP, data as at 26 February 2021

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	0.5	1.9	19.6	99.1
MSCI UK	1.8	4.1	-0.2	26.1
MSCI UK Broad	2.2	5.1	1.7	29.8
S&P 500	0.9	0.9	20.0	116.9
MSCI Europe ex UK	0.3	0.1	13.9	69.1
MSCI Japan	-0.3	0.0	17.7	73.0
MSCI Pacific ex Japan	1.1	4.2	11.2	75.2
MSCI Emerging Markets	-1.0	6.5	24.7	106.3
Bonds				
iBoxx GBP Gilts	-5.8	-5.9	-4.3	16.2
iBoxx USD Treasuries	-4.0	-7.8	-9.2	13.0
iBoxx GBP Corporate	-3.2	-2.6	2.0	32.9
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	18.1	38.5	30.8	81.4
Gold ($/ounce)	-7.0	-2.7	8.9	40.1
GBP/USD	1.8	4.7	9.5	0.3
GBP/EUR	1.9	3.2	-0.9	-10.2
EUR/USD	-0.1	1.5	10.5	11.7
USD/JPY	1.8	2.2	-1.2	-5.6

Glossary of terms

Bonds – The relationship between price and yield. Yield is the return you get on a bond. When the price of a bond changes prior to maturity due to supply and demand pressures, so does its yield. When the price of a bond goes up due to demand, the yield goes down to compensate. This is so the bond's fixed rate of return (coupon) remains relatively constant – and vice versa. A bond's price and its yield are inversely related. A key factor which influences a bond is the prevailing interest rate. When interest rates rise, the prices of bonds fall, thereby raising yields. This is because the older bonds are sold in order to buy new higher yielding bonds.

Equities – A stock or any other security representing an ownership interest.

Fed – Federal Reserve Bank.

FX – Foreign Exchange.

GDP – Gross Domestic Product.

GFC – The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

IMF – International Monetary Fund

Monetary policy – Actions of a central bank or other agencies that determine the size and rate of growth of the money supply which will affect interest rates.

V Shaped Recovery – Real GDP growth trajectory.

Key macro data	Latest	2021 Consensus forecast	Spot rates	28-Feb	Yields (%)	28-Feb
UK GDP (YoY%)	-7.8	4.60	GBP/USD	1.40	MSCI UK	3.37
UK CPI Inflation (YoY%)	0.7	1.50	GBP/EUR	1.15	MSCI UK broad	1.99
Bank of England Base	0.10	0.10	EUR/USD	1.21	10 Year Gilt	0.86

All values and charts as at 28 February 2021. Total returns in sterling.
Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.
Source: Thomson Reuters Datastream and Bloomberg

Important information

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