Smith & Williamson

Investment outlook

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

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Investment outlook

Seizing an opportunity in equities after the Ides of March

The Ides of March were an ominous warning from the soothsayer to Julius Caesar in William Shakespeare's classic play of the same name. The Ides were certainly in force last year when the economy and financial system fell into turmoil as the COVID-19 pandemic spread around the globe and governments imposed unprecedented lockdowns. Fast forward to today and there are some concerns that equities appear vulnerable once again due to another source of risk - a rising US interest rate environment. US Treasury yields of 10-year maturity have risen from a trough of 0.6% to 1.7% today[1]. Warren Buffet, the American investor and CEO of Berkshire Hathaway, has described interest rates as having a gravitational effect on valuations. When interest rates are high, they can exert a big pull downwards on valuations, but when they are nothing, as they are now, valuations can be almost infinite. Even so, we believe there are probably three reasons to believe that any potential equity market vulnerability should be transitory.

First, US interest rates are still too low to cause a sharp economic slowdown. For instance, mortgage debt servicing costs (interest and principal) are at a historically low level of 4% of US take-home pay, suggesting favourable affordability to owning a home[2]. Furthermore, household aggregate net worth has recovered from rising equity and house prices to stand at a record 7.5 times disposable income[3]. While not equitable, this wealth provides an additional source of funds for consumers (~70% of GDP) to spend when rates are rising[4].

Second, the economic recovery should mitigate some risk related to an increase in the cost of borrowing. Growth remains supported by highly accommodative policy. The US has already legislated a new $1.9trn fiscal stimulus, with more to come from the Biden administration's infrastructure and healthcare plan currently being discussed in Congress. Given the extent of the upcoming fiscal stimulus, the OECD recently revised up its 2021 US real GDP growth target to 6.5% from its 3.3% forecast in December, which if realised would be the strongest rate since 1984[5].

Third, Treasury yields tend to rise when growth expectations are rising which is good for equities. Looking back to 1990, there have been eight episodes of a sharp rise in US 10-year yields (defined as at least a 1% increase)[6]. Global equities gained in all those periods, with MSCI All-Country World Index rallying the most during June 2003 – June 2007 (+83.4%), as yields rose 2.1% points[7].

In summary, this tug of war between stronger growth on one hand and higher rates on the other can be expected to be a source of market volatility. However, provided the rise in yields doesn't occur too quickly and reflects a return to growth, it is still a conducive backdrop to favour equities over bonds. We see specific opportunities in value-focused recovery themes as economies are opened-up again. These include non-US markets, like emerging markets (and particularly in Asia) and the UK.

A market risk is that a booming global economy absorbs excess capacity left over from the pandemic more quickly than central bankers anticipate. That could potentially lead to overheating, where higher inflation erodes real incomes and hinders output growth. It would also show that the Fed is behind the curve on interest rates and possibly lead to a broader market decline.

US dollar appreciation is another potential risk to our positive stance on equities, since it is an implicit form of monetary tightening for non-US equities, and particularly for emerging markets. Rising US yields this year have halted the downward US dollar trajectory which has been in place since March 2020. Nevertheless, sizeable US debts and deficits are likely to remain a drag on the dollar for some time to come and there is a growing reluctance of overseas investors to own Treasuries. Moreover, as a counter-cyclical currency, the dollar tends to depreciate as risk appetite increases with stronger, broadening output growth.

UK budget - Spend now, tax later!

Given that much of the content was flagged to the press already, the only real surprise in UK Chancellor Rishi Sunak's second budget in March was that tax increases would be postponed until 2023. Essentially, the chancellor went against his political rhetoric at the virtual Tory party conference last autumn to balance the books after the pandemic.

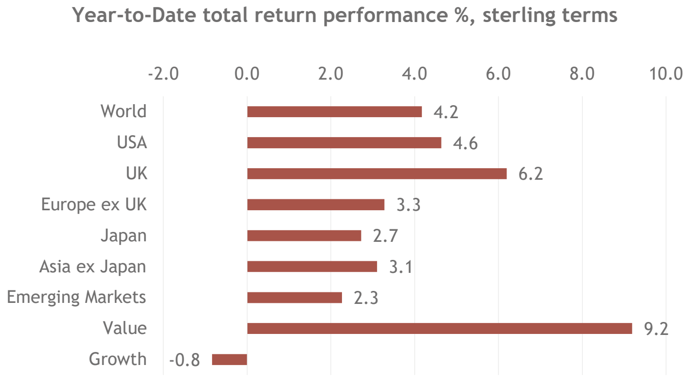
With the UK economy still constrained by lockdowns, more money is to be found to support growth. Some prominent government measures to support consumption include extending the residential stamp duty holiday threshold of the first £500k to end June and the furlough scheme for workers till the end of September. Business investment is also likely to be brought forward and boost growth thanks to a capital allowance that is 10 times as generous as it was in 2009[8]. Given this fiscal largesse, the OBR projects GDP growth of 7.3% in 2022 and for the economy to return to pre-COVID-19 levels by the middle of next year, 6 months earlier than its projections in November[9].

In short, the chancellor chose to ensure that near-term economic support would be maintained, while ensuring the long-term sustainability of government finances. We expect this growth-friendly policy mix (at home and abroad) to be seen as a tailwind for UK equities and should offset concerns over the impact of sterling appreciation as a risk for owning UK stocks with a large proportion of international earnings.

[1-7] Refinitiv Datastream, data as at 31 March 2021
[8] HSBC, Tough questions on World Maths Day, data as at 3 March 2021
[9] Office for Budget Responsibility, data as at 31 March 2021

Equities

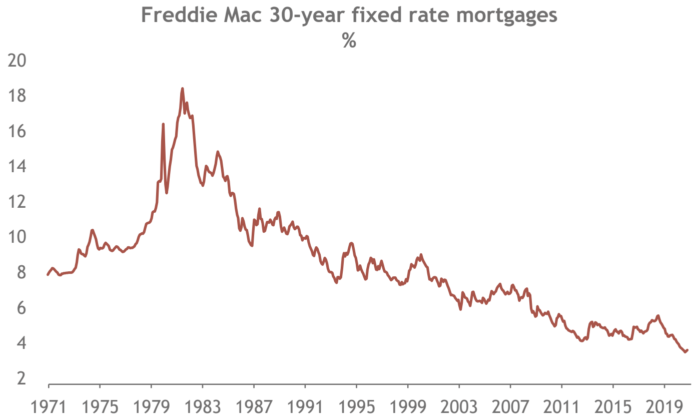
UK equities have outperformed global peers year-to-date (in GBP terms) as the rotation from growth into value has accelerated. When the long-awaited announcement that phase 3 trials of COVID-19 vaccines were completed and showed substantial efficacy rates, a style rotation occurred in equity markets. Previously unloved areas of the market came into favour, providing a tailwind to UK equities. The UK has a high weighting to value and cyclical sectors such as financials, energy and materials which have appreciated relative to growth and defensive sectors such as tech and healthcare. Year-to-date, value has outperformed growth significantly with the MSCI ACWI value index returning 9.2% in sterling terms and growth returning just -0.8%.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 31 March 2021

Fixed interest

The increase in long bond yields may not be a threat to economic activity. For example, if we look at the US housing market, where mortgage debt servicing cost remains at historically low levels, US 30-year fixed rate mortgages have increased to 2.8%, marginally higher than the all-time low level of 2.7% reached in December last year (see chart). At 2.8%, the rate is still below the 2017 average of 4.3%, during a period of synchronised global economic growth.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 31 March 2021

FX and commodities

GBP has appreciated nearly 5% compared to the EUR since the start of the year, rather more than relative to the USD (0.8%). This GBP strength is likely a reflection of the more positive recent developments in the COVID-19 situation in the UK relative to that of the European bloc. Earlier vaccine approvals helped to facilitate a faster rollout of vaccines in the UK. This, in turn, has allowed the government to forge ahead with its ‘roadmap’ for reopening the UK economy, as many European nations announce new or extended lockdowns as they battle a third wave of the virus. The UK also recently reached a deal with the EU on how they might co-operate in terms of rules for banking and financial markets. This is a key pre-requisite before further discussions on how the City of London, an important part of the UK economy, will access European markets.

Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 31 March 2021

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	4.1	3.7	39.6	98.9
MSCI UK	4.1	5.2	20.1	29.1
MSCI UK Broad	4.0	5.4	24.4	32.4
S&P 500	5.8	5.2	40.5	121.6
MSCI Europe ex UK	4.7	2.7	34.4	70.6
MSCI Japan	2.5	0.8	26.0	74.4
MSCI Pacific ex Japan	2.3	3.7	38.5	65.4
MSCI Emerging Markets	-0.2	1.4	42.8	87.6
Bonds				
iBoxx GBP Gilts	0.0	-7.3	-5.7	16.4
iBoxx USD Treasuries	-0.1	-5.5	-14.7	16.6
iBoxx GBP Corporate	-0.2	-4.4	10.1	28.7
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-3.9	22.4	181.1	59.0
Gold ($/ounce)	-1.3	-10.2	5.8	38.1
GBP/USD	-1.3	0.9	11.3	-4.0
GBP/EUR	1.9	5.1	3.9	-6.9
EUR/USD	-3.2	-3.9	7.1	3.1
USD/JPY	3.7	7.0	2.4	-1.7

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	31-Mar	Yields (%)	31-Mar
UK GDP (YoY%)	-7.3	4.70	GBP/USD	1.38	MSCI UK	3.08
UK CPI Inflation (YoY%)	0.4	1.50	GBP/EUR	1.17	MSCI UK broad	1.95
Bank of England Base	0.10	0.10	EUR/USD	1.18	10 Year Gilt	0.88

All values and charts as at 31 March 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

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