Smith & Williamson

Investment outlook

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

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Investment outlook

Releasing the inflation genie out of the bottle comes with market risks

Year-to-date, MSCI All Country World Index (ACWI) total equity returns (including dividends) are up 8% in sterling terms, buoyed by the vaccine rollout and reopening from lockdowns.[1] Of the major economies, the UK leads the way with over 70% of the population having received at least one vaccine dose and non-essential stores now being allowed to reopen, in England at least.[2] Globally, the picture is mixed, with the US only just behind the UK, but the slow pace of vaccinations in Europe has seen a third wave and more lockdowns, while the pandemic is spreading rapidly again in India.

On balance, very accommodative fiscal and monetary policy, as well as easing lockdowns (outside of Europe), provide a backstop of support for the global recovery during these uncertain times. Moreover, fiscal policy could be eased further in the US, where the Biden Administration has proposed a new infrastructure plan worth $2.65trn and a further $1trn directed to healthcare and education to be spent over eight years that is being debated in Congress.[3] Some commentators are starting to voice concerns about too much stimulus. Another potential disconnect is that while the world's largest economy continues to add to what are already the most stimulative policies in history (outside war times), the authorities in China, the second biggest economy, are tightening policy, including guiding banks to control credit growth for the rest of the year. This has already seen some stretched firms, like bad debt manager Huarong Asset Management, get into financial difficulty. Can both sets of policy makers be right?

Looking forward, the IMF recently forecast global real GDP to grow by 6.0% in 2021, which if achieved would be the fastest rate since records began in 1980, and another strong print of 4.4% is expected in 2022.[4] This potential rapid economic growth is leading to overheating concerns. For example, in the US annual Consumer Price Inflation accelerated to 2.6% in March, the fastest pace in nine years, from a low point of just 0.1% last May.[5]

Higher inflation is exactly what the Fed wanted when it introduced its new Average Inflation Targeting in September 2020. However, given the unprecedented global stimulus combined with pandemic-led supply disruption, inflation risk is likely skewed to the upside. Some early warning inflation indicators include: i) annual global food prices rising by 25% in March[6]; ii) crude oil prices are back at pre-pandemic levels; iii) March used car prices in the US are 26% higher than a year ago[7], following car production disruption and a shortage of computer chips; iv) US lumber futures prices have more than quadrupled over the past year to record the biggest increase in 50 years of data.[8]

The Fed is essentially betting that there is sufficient slack in the economy to take away pricing power from companies so that any inflation will prove transitory. However, some pricing surveys show that this may not be the case. In March, the National Association of Independent Businesses, a body that represents small firms, showed that surveyed companies expected selling prices to reach their highest level in 13 years.[9] Businesses are rationally taking the opportunity to raise prices amid low inventories, weak competition and pent-up demand, while incomes have been boosted by stimulus cheques.

Even if inflation continues to accelerate in the US over the summer, Fed officials expect that short-term interest rates will remain at zero until "maximum employment" is achieved and "inflation has risen to 2% and is on track to moderately exceed 2% for some time". These targets are not likely to be met in 2021. The March unemployment rate was 6.0%, well up from its pre-pandemic level of 3.5%, and it will also take time to determine whether there is any follow-through after the expected initial inflation spike.[10] The Fed futures market currently does not expect the first full interest rate hike before 2023.[11] However, it is possible for the Fed to consider reducing its accommodative policy alternatively by scaling back its current $120bn monthly pace of asset purchase (i.e. tapering) later in 2021, but this could lead to market volatility, as we saw in the so called taper tantrum of 2013, when the then Fed chairman Ben Bernanke first talked about reducing Quantitative Easing. The Fed is aware of this risk, however.

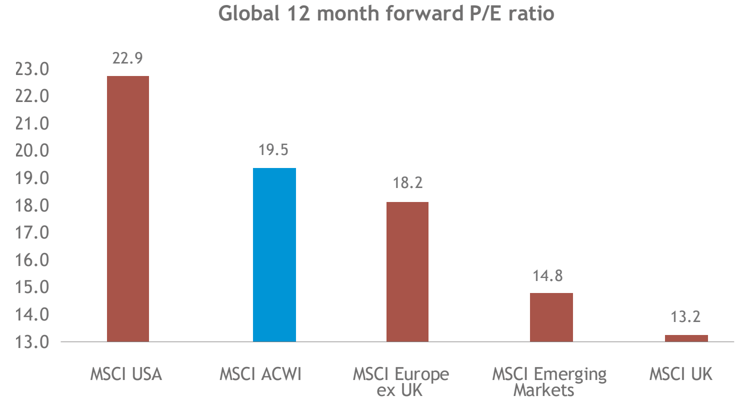
For markets, the longer the Fed continues to run loose monetary policy, the more difficult it may be to control inflation and longer-term interest rates. Moreover, low interest rates justify higher equity valuations, and the MSCI ACWI equity index is currently trading on 19.5 times forward earnings, compared to its pre-pandemic peak of 16.8x.[12] Also positioning is already very positive, investors have poured $569bn into global equity funds over the past 5 months to end-March, compared to $452bn in the past 12 years![13] Should the Fed be forced to tighten policy aggressively, it could lead to a correction in equities from elevated levels.

To conclude, the vaccine rollout, favourable policy and strong economic recovery is likely to drive company earnings and thus equities up further over the coming months, even though inflation risks have risen. At some stage the global economy will have reopened. It remains to be seen what impact the permanent economic changes caused by the pandemic will have on the growth and inflationary outlook.

[1, 2, 4, 5, 6,7, 8, 8, 10, 11] Refinitiv, data as at 4 May 2021
[3] RenMac Policy: No Bridge to Republicans in Biden Infrastructure Plan, 6 April 2021
[12,13] BofA, Flows Booming in Spring, 6 April 2021

Equities

Price/Earnings (P/E) is the ratio of a company's share price to its earnings per share. A higher (P/E) ratio suggests that a company's shares are more expensive than one with a lower P/E. In aggregate, UK-listed equities are trading on 13x forward earnings, and therefore look more attractive relative to the US trading at 23x which is well above its long-term average of 15.7x.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 4 May 2021

Fixed income

As investors price in greater inflation risks due to unprecedented monetary and fiscal stimulus, US inflation-protected government bonds (US TIPS) have outperformed other fixed interest assets over the last twelve months (up 5.9%, see chart). Meanwhile, inflation risks and better growth outlook have negatively impacted nominal government bonds – UK & US 7-10 year government bonds are down 4.0% and 5.3% respectively. Interestingly, UK inflation-linked government bonds fell 1.8%, due to higher starting valuation and a stronger pound.

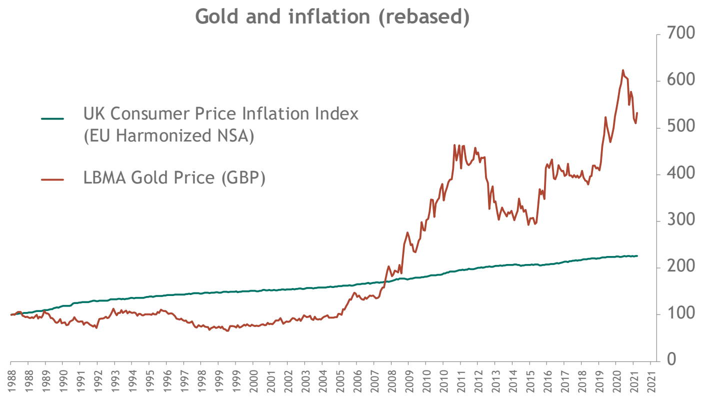
Fixed interest assets - 1-year performance (%)

Fixed interest assets	1-year performance (%)
UK government bonds 7-10 year	-4.0
UK inflation-linked government bonds 5-10 year	-1.8
UK investment grade corporate bonds	4.6
US government bonds 7-10 year	-5.3
US inflation-protected government bonds 5-10 years	5.9
US investment grade corporate bonds	5.6

Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 4 May 2021

FX and commodities

Gold is one of the few commodities which has proven itself to be a hedge against inflation over the very long term. There are various reasons why other commodities have not stood up to the ravages of inflation quite as well. First, we tend to become more efficient over time at using commodities (for example, more efficient combustion engines), and second when the price of a commodity gets too high, then we are often able to find lower cost substitutes for the job. Gold, with its few industrial applications, largely escapes these pitfalls. The chart shows how the price of gold in sterling terms has grown ahead of UK Consumer Price Inflation index since 1988.



Source: Bloomberg/Smith & Williamson Investment Management LLP, data as at 4 May 2021

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	4.0	8.9	33.4	107.8
MSCI UK	4.0	10.2	20.8	32.3
MSCI UK Broad	4.4	10.8	24.4	36.4
S&P 500	5.0	12.1	33.0	136.2
MSCI Europe ex UK	4.4	9.6	34.2	77.5
MSCI Japan	-1.9	0.3	19.3	66.7
MSCI Pacific ex Japan	3.9	7.4	31.0	71.5
MSCI Emerging Markets	2.1	0.9	35.9	94.2
Bonds				
iBoxx GBP Gilts	0.5	-5.3	-8.2	18.5
iBoxx USD Treasuries	0.6	-3.6	-13.3	19.3
iBoxx GBP Corporate	0.8	-2.6	4.4	28.8
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	6.0	20.4	163.9	41.8
Gold ($/ounce)	3.9	-4.7	3.9	37.0
GBP/USD	0.4	0.8	9.8	-5.5
GBP/EUR	-2.0	1.8	-0.1	-10.1
EUR/USD	2.4	-0.9	9.9	5.1
USD/JPY	-1.1	4.4	2.2	2.2

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	30-Apr	Yields (%)	30-Apr
UK GDP (YoY%)	-7.3	5.50	GBP/USD	1.38	MSCI UK	3.08
UK CPI Inflation (YoY%)	0.7	1.50	GBP/EUR	1.15	MSCI UK broad	1.85
Bank of England Base	0.10	0.10	EUR/USD	1.20	10 Year Gilt	0.87

All values and charts as at 30 April 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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