Smith & Williamson

Investment outlook

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

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Investment outlook

Equities are well placed to outperform bonds in the second half of 2021

Like a football manager giving a pep talk during the European Championships currently underway, it is perhaps an opportune time to take a half time assessment of markets and pan out to the remainder of 2021. Although there is the risk of complacency, investors likely head into the rest of the year in a relatively buoyant mood. After all, the MSCI All Country World global equity index gained 11% (total return sterling) so far this year, supported by accommodative policy and rising growth expectations[1].

Though the global growth spurt caused by the receding pandemic may peak sometime in 2021, the fundamental backdrop remains positive for equities, despite some concerns over valuations. Private consumption, the driving force for the GDP expansion and company earnings, is underpinned by healthy finances. For instance, after falling $6.5trn in the first quarter of 2020 during the start of the pandemic, US aggregate household net worth has since recovered a cumulative $25.5trn up to the first quarter of 2021 on the back of rising asset prices: in May, existing house prices rose a staggering 24% from a year ago, the fastest rate from over 50 years of data[2]. Putting together financial resources available to consumers from housing wealth, take-home pay (income after tax is deducted) and consumer credit, this measure of US real consumer purchasing power rose at a record annual rate of 12.0% in the first quarter of 2021[3].

Not surprisingly, government bonds have performed poorly during the strengthening global expansion and rising inflation concerns. Arguably, the bond market has yet to discount a much higher inflationary environment. The 5% annual May headline US CPI inflation has left 10-year Treasury real yields at -3.5%, its lowest reading since 1980[4]. With nominal Treasury yields at 1.5%, the bond market seems to think that inflation is transitory and does not warrant higher yields to compensate for negative rates[5].

Nevertheless, should inflation take another leg up, it could lead to more market volatility, since there would be growing expectations for central banks to reign back on monetary stimulus. This is happening already in China, where state banks have been instructed to pull back on credit growth. Nevertheless, Beijing's leadership is unlikely to want to slam on the monetary brakes too tightly so soon after the pandemic and during the centennial anniversary nationwide celebrations on the 1 July to mark the foundation of the Chinese Communist Party.

Elsewhere, the Fed decided in June that it would continue to keep policy accommodative, but the FOMC talked about tapering asset purchases and brought forward the FOMC's expected interest rate increases into 2023 from 2024. Equally, the BOE left monetary policy unchanged last month and expressed no particular concern about inflation. For now, while higher inflation is a market risk, the macro outlook continues to support equities over bonds.

Opportunities in non-US stocks

Drilling beneath the performance data, a landmark was reached last month when non-US equities finally recovered to their pre-Global Financial Crisis peak at the end of October of 2007. To put that flat return into perspective, US equities rose more than 180% in that time, largely to reflect the ability of US companies (and particularly Big Tech) to deliver better earnings than non-US firms.

Going forward, non-US equities could outperform their US peers from here for three key reasons. First, the period of US EPS outperformance may be ending. Taking consensus estimates, non-US EPS is forecast to grow by 20% per annum on average during 2021-23, compared to 19% for the US[6]. Second, superior historic US EPS growth is already discounted in market valuations. US stocks trade on elevated Price-to-Earnings multiple that is around 40% higher than non-US[7]. And third, US companies are caught in the crosshairs to pay higher taxes on their global earnings, making their current valuations even more demanding. This follows an historic agreement by G7 leaders last month in a summit in Cornwall to seek a minimum 15% global tax on "stateless" multinational corporations (i.e. Facebook et al) in each country they operate. A sample of firms in the MSCI All Country World Index from Bloomberg showed that 66% of listed companies that pay less than 15% tax were from the US[8]. Moreover, oligopolistic US Big Tech earnings are also vulnerable from the increased chance of greater regulations in a post-pandemic world.

Arguably, there is more potential downside risk to future US economic growth. The Biden administration wants to raise taxes and has scaled back ambitious fiscal expenditure legislation to garner the support of centrist Democrats. In contrast, non-US stimulus has got further to go. For example, the EU's flagship €750bn (5.5% of GDP) Next Generation EU multi-year fiscal package was finally ratified by member countries in May[9]. The fund is front loaded with non-repayable grants (rather than loans) and can now be spent by national governments.

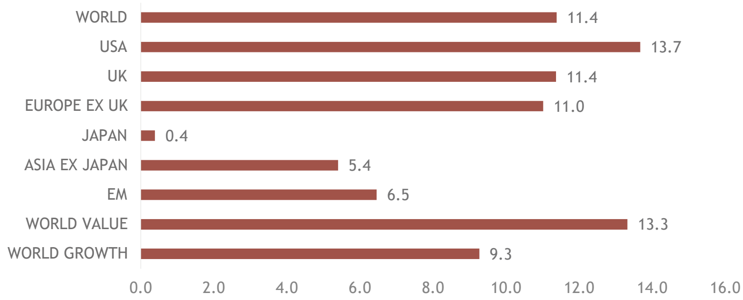
In short, the start of a new business cycle creates opportunities outside the US. And given the prospect of higher interest rates that could disproportionally affect the US at some point, this should work to the benefit of non-US stocks.

[1-7] Refinitiv Datastream, data as at 29 June 2021
[8] HSBC, Bloomberg, Five in Five: Corporate Taxes, data as at 10 June 2021
[9] UBS, European Commission, EU recovery fund: Where will all the money go? data as at 14 June 2021

Equities

Global equities have performed strongly in the first half of 2021 increasing 11.4% (total return, GBP). Despite periods of underperformance, the US has edged ahead of other equity regions, up 13.7% as easy fiscal and monetary policy and an accelerated COVID-19 vaccine rollout allowed the economy to open up faster than other developed countries. However, UK and European equities are not far behind, up 11.4% and 11% respectively, due to their heavy weighting in value stocks. Value equities have performed poorly in broad terms since the GFC, until this year when they have experienced periodic outperformance. The current environment of rising inflation expectations and the global economic recovery should continue to be conducive for these value stocks, creating an opportunity for non-US equities to outperform.

Year-to-Date total return performance %, sterling terms

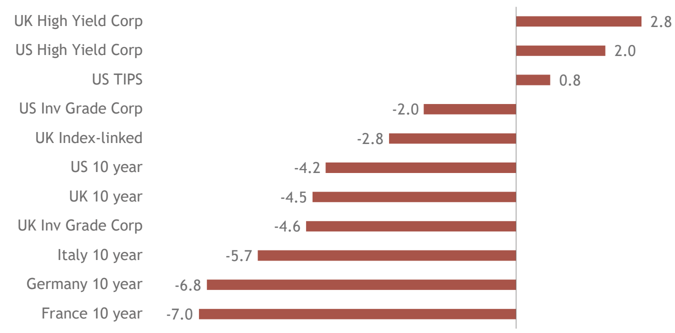


Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 July 2021

Fixed income

Most fixed income assets have had a poor first half of 2021 as interest rates (inversely proportional to prices) rise on the back of better growth outlook and inflation concerns. The chart on the right-hand side shows Eurozone 10-year government bonds fell as much as 6.8% to 7% over the last 6 months (France, Germany) whilst US and UK counterparts fell around 4%. Meanwhile, lower duration fixed income such as High Yield bonds were less affected by rising rates and benefited from economic recovery and liquidity provision by central banks. Higher oil prices also keep default rates in the energy sector low.

Bonds - 2021 total return %, sterling

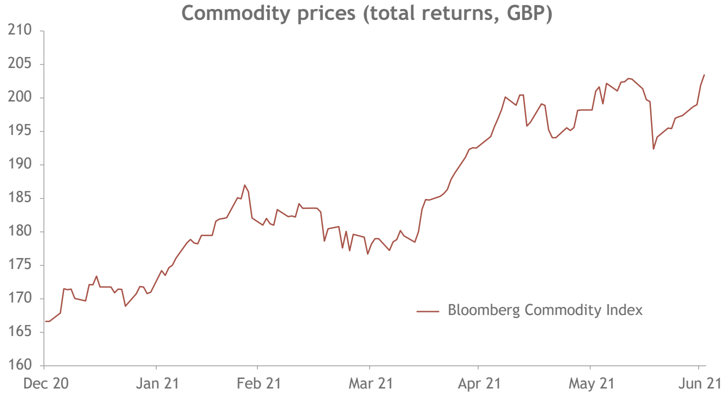


Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 1 July 2021

FX and commodities

Commodities have a long and complex history with inflation. As 'real' assets, they are generally considered to be a good hedge for inflation, but there have been periods when certain commodities have not lived up to this expectation. Recently though, commodities have broadly registered significant price increases as inflation expectations have picked up. The Bloomberg commodities index has risen 21% in the year to date (total return, GBP). Within this, the energy components have increased 45%, agricultural commodities have risen 20%, and industrial metals 16%. Precious metals have been the laggard, falling 6.3%.

Commodity prices (total returns, GBP)



Source: Bloomberg/Smith & Williamson Investment Management LLP, data as at 1 July 2021

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	4.3	7.4	25.1	96.4
MSCI UK	0.4	5.8	17.5	28.0
MSCI UK Broad	0.0	5.5	20.3	32.6
MSCI USA	5.8	8.8	27.5	122.8
MSCI Europe ex UK	1.9	8.1	22.6	76.8
MSCI Japan	2.6	-0.4	12.0	60.0
MSCI Pacific ex Japan	1.3	4.7	20.1	59.9
MSCI Emerging Markets	3.1	5.0	26.4	81.7
Bonds				
iBoxx GBP Gilts	0.8	1.8	-6.5	11.3
iBoxx USD Treasuries	3.7	1.9	-13.4	7.0
iBoxx GBP Corporate	0.9	1.9	2.9	25.6
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	8.0	18.5	82.4	51.7
Gold ($/ounce)	-7.4	3.6	-1.0	33.6
GBP/USD	-2.8	0.1	11.8	3.3
GBP/EUR	0.2	-0.8	5.9	-3.2
EUR/USD	-3.0	0.9	5.6	6.7
USD/JPY	1.5	0.4	2.9	8.2

Market commentary

Inflation has been a hot topic in markets recently, which continued into June. The May US CPI reading came in at the higher end of expectations at 5.0% year-on-year which is the largest gain since August 2008. Markets remained calm on the release as this figure was largely driven by one-off factors including base effects from depressed prices last year and supply disruptions. Markets reacted more to an update on the Fed's expectations for the first interest rate hike, which has been brought forward from 2024 to 2023, and that they are "talking about talking about" reducing asset purchases. This news led to a style rotation from value to growth which boosted US equities to end the month up 5.8% and left the UK the laggard increasing 0.4%, with Europe (1.9%), Japan (2.6%), Asia (1.3%) and Emerging Markets (3.1%) between. US 10-year government bond yields moved lower from 1.61% to 1.44%, whereas in the UK yield movements were more muted and went from 0.88% to 0.75%. Amongst other assets, Gold suffered on the month, down some 7.4% as stronger global growth and easing of inflation expectations fuelled appetite for riskier assets.

Key macro data	Latest	2021 Consensus forecast	Spot rates	30-Jun	Yields (%)	30-Jun
UK GDP (YoY%)	-6.10	6.70	GBP/USD	1.38	MSCI UK	3.02
UK CPI Inflation (YoY%)	2.10	1.60	GBP/EUR	1.16	MSCI UK broad	1.90
Bank of England Base	0.10	0.10	EUR/USD	1.19	10 Year Gilt	0.75

All values and charts as at 30 June 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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