Market Snapshot

Equity Snapshot

United States US equities advanced slightly, with the S&P 500 Index touching a fresh high mid-month. With almost all of the companies in the S&P 500 Index having reported first-quarter financial results, FactSet reported that nearly 90% had beaten expectations. Indeed, with earnings increasing more than 50% on a year-on-year basis, the first three months of 2021 look set to be one of the best quarters for earnings growth in a decade. Towards the month-end, the Biden administration released proposals for a USD 6 trillion budget for fiscal year 2022. The proposals, which focus on increases in spending on education, healthcare and renewable energy, will boost discretionary spending by 8.4% compared to fiscal year 2021, excluding emerging pandemic-response measures.

Treasury secretary Janet Yellen said interest rates might need to rise to keep the US economic expansion from bubbling over. While she later clarified her remarks, saying she did not foresee any inflationary problems, her comments led to a sharp sell-off in US technology stocks. At the Fed itself, the official line was that the rise in inflation would be temporary. However, minutes of the latest rate-setting meeting showed some policymakers thought the US central bank should start to discuss a plan for tapering bond purchases "at some point".

Europe European equities rose during May (in EUR terms). The EuroStoxx 600 Index hit a fresh record high, with sentiment buoyed by hopes of swift economic recovery as an accelerating vaccine roll-out and falling COVID-19 infection rates allowed restrictions to be eased. With around half of European companies having reported first-quarter financial results, earnings look to have almost doubled on a year-on-year basis, as company profits rebound after the sharp shock of the pandemic. In terms of sectors, energy, financials and consumer-related sectors were the best performers, while health care and technology were the only sectors to retreat, delivering slight losses.

The flash estimate of the IHS Markit euro-zone composite purchasing managers' index rose to 56.9 in May. This was stronger than expected and the highest reading since February 2018. Services sector activity rose to a three-year high as hospitality restrictions started to be eased. While manufacturing activity dipped slightly, it remained near the all-time high of 62.9 seen in April. Despite signs that the rebound in activity was creating capacity constraints and disrupting supply chains, European Central Bank (ECB) president Christine Lagarde dismissed the rise in inflationary pressures as being only temporary in nature. Additionally, speculation that the ECB would start to taper its bond-buying programme as early as June was dampened when policymakers signalled it was too soon to dial down their emergency stimulus.

Allianz Global Investors

Asia

Equity markets in Asia saw mixed returns in May. Several countries in the region saw new COVID-19 outbreaks, forcing them to re-impose/tighten restrictions. Inflation concerns also weighed on sentiment, although this was offset by optimism over economic recovery. Chinese equities gained modestly, with China A-shares outperforming offshore China shares due to expectations that the authorities would likely maintain policy and liquidity support. Taiwanese equities retreated, weighed down by underperforming technology stocks and a local resurgence of COVID-19 infections. ASEAN markets were generally weak, with sentiment hit by the imposition of restrictions in an attempt to tackle new virus outbreaks. The Philippines was the exception. After being one of the worst performing markets earlier in the year, when a strict lockdown curbed the country's economy, Philippine equities posted solid gains in May, on the back of optimism over more fiscal stimulus measures.

Bond

US bonds delivered modestly positive returns in May as yields declined slightly. The 10-year Treasury bond yield closed the month just below 1.6%, having initially fallen back below 1.5% on weaker-than-expected jobs data, and then subsequently rising to almost 1.7%, as inflation exceeded forecasts. Economic data indicated that the recent surge in US activity might be moderating, with jobs data and surveys of manufacturing and services sector activity failing to meet forecasts. However, headline consumer prices increased 4.2% year-on-year in April, the biggest rise since 2008.

Euro-zone bond yields rose slightly over May as falling infection rates and an accelerating vaccine roll-out boosted the prospect of a swift recovery from the pandemic. The flash estimate of the IHS Markit euro-zone composite purchasing managers' index rose to 56.9 in May. This was stronger than expected and the highest reading since February 2018. European Central Bank (ECB) president Christine Lagarde dismissed the rise in inflationary pressures as being only temporary in nature. Additionally, speculation that the ECB would start to taper its bond-buying programme as early as June was dampened when policymakers signalled it was too soon to dial down their emergency stimulus.

Outlook

The subject of inflation is currently filling countless column inches in financial publications; what is driving it, which sectors are most impacted, and how should investors position themselves? At the heart of the questions though, is whether the phenomenon is a transitory one or more permanent.

Sustained inflation drives up the cost of raw materials and erodes the future value of earnings. This, in turn, boosts the prospects for more cyclical stocks providing industrial inputs, while weakening the appeal of price-takers, whose long-term value is contingent on future growth. As a team, we focus more on the latter, with an investment philosophy geared towards quality stocks with a proven history of strong cash flow returns, as well as high visibility revenue and earnings growth.

This preference has thus resulted in some short-term performance headwinds. However, we do not see this as a reason to alter our positioning or approach. Experience and academic research show us that over the long term, stock prices follow earnings growth. Similarly, stocks, the valuations of which have inflated away from their fundamentals, ultimately revert to the mean. Our goal is thus to own companies with consistently higher earnings than competitors and share prices that offer a relative margin of safety in their valuations.

More cyclical stocks are by contrast largely benefiting from the strength of base effects. While our aim is to own stocks that make the need for economic forecasting irrelevant, it is clear that companies whose activities all but ceased are now seeing immense year-on-year growth. As the impact of Covid-19 runs its course though, this is unlikely to be sustained. Yet the market is affording these companies increasingly premium valuations, while stable compounders of the type we prefer move sideways.

The US CPI data of 4.2% has made it clear that inflation is here. However, long-term trends like digitalisation, ageing populations and the weight of global debt are clear countervailing forces. Similarly, by owning stocks with strong pricing power, even the volatility that companies like Ecolab and Assa Abloy are likely to see will be offset in time. In the meantime, we remain open to the opportunities that volatility presents.

Sources: 1 Eurostat 2 Bloomberg 3 Office for National Statistics