06/2021

Market Snapshot

Equity Snapshot

United States US equities advanced, with both the S&P 500 Index and the technology-focused Nasdaq Index reaching fresh highs on news that President Joe Biden had secured bipartisan support for a USD 1 trillion infrastructure deal. The deal will focus on upgrading roads, bridges and broadband networks over the next eight years.

While the Federal Reserve (Fed) kept interest rates on hold at its June meeting, policymakers changed their projection on the path of future rates to two rate rises in 2023 – previously they had forecast that rates would not rise until 2024. Fed chair Jay Powell also confirmed that officials were "talking about talking about" reducing the Fed's USD 120 billion-a-month asset purchases. US stocks initially lost some of their earlier gains on the news, but Fed officials subsequently moved to reassure financial markets, insisting that the recent increase in inflation was expected to be transient and that the US central bank would not act pre-emptively to counter the possible onset of inflation.

Europe European equities rallied modestly over June (in EUR terms). The EuroStoxx 600 Index hit a fresh record high amid optimism over economic recovery. Falling COVID-19 infection rates across the region allowed restrictions to be eased, although there were concerns that the Delta variant, first found in India, may become dominant and cause case numbers to spike once more. Almost all sectors advanced, with financials and utilities the only ones to retreat. Technology companies were among the strongest performers, as they benefited from renewed interest in growth stocks.

The ECB raised its forecasts for economic growth and inflation, but officials continued to signal that they were in no hurry to taper the central bank's emergency stimulus measures. ECB president Christine Lagarde said that the recent rise in inflation was largely due to base effects, transitory factors and an increase in energy prices. However, the head of Germany's Bundesbank called for the ECB's bond-buying programme to be reduced and warned that inflationary pressures were mounting in the euro zone.

Asia Equity markets in Asia traded sideways over June, with mixed performances at a country level. Sentiment was lifted by ongoing optimism over the global economic recovery, although this was countered by higher inflation data as well as the US Fed's revised interest rate hike forecast. Both China and Hong Kong equities were weak. In terms of the macro economy, the official purchasing managers' index slid to its lowest reading since February. At the same time, China's producer price index jumped 9.0% year on year in May, the steepest rate of increase since September 2008, signalling inflationary pressure and supply chain bottlenecks. The rebound in tech shares helped South Korea and Taiwan, although a fresh Covid-19 outbreak spread to Taiwan's electronics factories, threatening to delay shipments of semiconductors. ASEAN markets were generally weak, with the Philippines a notable exception. Elsewhere, however, markets retreated, with several countries introducing new restrictions to curb fresh Covid-19 outbreaks. In Malaysia, the government imposed a two-week national lockdown in an attempt to curb a rise in infections – the lockdown was later extended as daily infections failed to decline.

Bond

US bonds rose modestly in June, with the yield on the 10-year Treasury bond falling around 13 basis points over the month to trade below 1.5%, a level last seen in March, amidst growing speculation that the recent spike in inflation will be temporary. The yield curve flattened, with yields falling at the long end of the curve, whilst yields rose for shorter maturities. Whilst the Federal Reserve (Fed) kept interest rates on hold at its June meeting, policymakers changed their projections of the path of future rates to two rate rises in 2023 – previously they had forecast that rates would not rise until 2024. Euro-zone bonds rose modestly during June as bond yields trended lower. Growing optimism over the strength of the recovery in the euro-zone economy and rising inflation placed upward pressure on bond yields, although this was countered by indications from European Central Bank (ECB) officials that they were in no hurry to taper emergency stimulus measures.

Outlook

As regular readers of these comments know, short-term economic forecasts play no role in how we construct portfolios. Even so, they help to frame our past performance and expectations for the months to come. Therefore, with six months of 2021 left, now is a good time to revisit our views from January and see how the rest of the year may shape up.

Mercifully, history has been kind. While our expectations were for "some level of economic and political normality by the middle of 2021", they were also tempered by a belief that "market conditions [may] remain volatile". In this respect, inflation has emerged as the key protagonist.

Reactivating a global economy is a slow process. Supply chain pressures have pushed commodities like iron ore and copper to multi-year highs, as well as many food products, and timber and oil. More lasting consequences of Covid-19, such as social distancing or labour shortages driven by wage inflation, may sustain these further. Some capacity may also have been destroyed permanently, with the result that businesses that closed have granted operators greater pricing power.

On balance, the long-term environment may be less deflationary than it was during the 2010s, but we believe it is not yet an inflationary one. More expansionary fiscal policies and a less favourable environment for global trade still contend with long term structural forces such as digitalisation, automation and rising debt burdens. In combination, these trends not only exert deflationary pressure but also offer highly visible and long-term growth prospects.

In any case, we believe owning quality companies on sensible valuations, which are harnessing these trends, provides the best defence against a volatile and unpredictable inflationary environment. Such business models typically enjoy strong pricing power, making them well equipped to pass on the impact of higher costs to their end customers. In contrast, highly capital-intensive business models may suffer as they grapple with cost pressures and rising capex bills.

As the economy transitions slowly but surely into the post Covid-19 era, we anticipate that the wild swings in stock markets will become less pronounced. By 2022, it is likely that a more normal environment will exist for the vast majority of companies. At the same time, long-term secular forces, such as the growth of the digital economy and demographics, will reassert themselves. With Covid-19 no longer available as an excuse, earnings disappointments are likely to be punished much more severely. Against such a backdrop we expect share prices to be driven much more by underlying longer-term fundamentals, rather than shorter-term cyclical considerations.

Sources: 1 Eurostat 2 Bloomberg 3 Office for National Statistics

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