Market Update

May 2021

One year on from the Covid crash and virus-related news remains the primary driver of markets. Despite short term bursts of volatility, global equities continue to grind upwards, with the US based NASDAQ index still posting the largest year on year returns versus other major indices.

Following a seven month rally, dominated by the commonly coined 'stay at home' stocks – technology, healthcare, online retail – the first positive vaccine related announcements in November 2020 triggered a short sell off, and an ensuing rotation into areas that suffered as a result of widespread lockdowns.

01/05/2020 - 30/04/2021 Data from FE fundinfo2021

As vaccine programmes have continued to pick up and economies have begun to successfully re-open, the associated growth in global activity is providing ballast to markets, with some equity indices hitting all-time highs in April. Through Q1, the strength of the market's recovery led to a widespread preference for value stocks over growth, and small caps over large caps. In the US, the Russell 1000 Value index is up 15.48% year to date, while its growth counterpart, the Russell 1000 Growth index ended April up only 7.73% (both in local currency terms).

More recently, better than expected Q1 corporate earnings have buoyed growth stocks higher, although with prices already elevated, the extent to which these earnings beats are filtering through to markets is relatively limited.

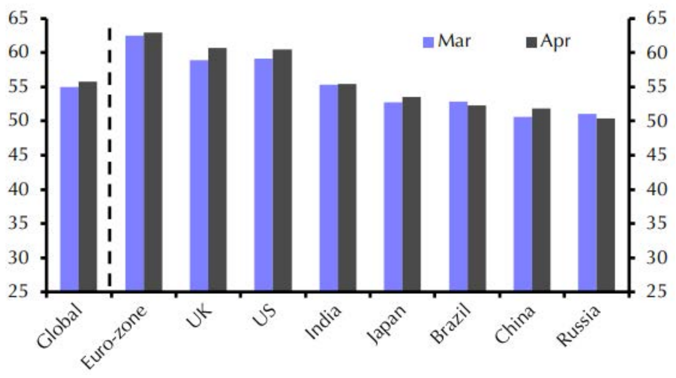
On a regional basis, activity continues to pick up in the US and UK, where vaccine programmes remain strong. Stock market gains through April are reflective of this, with major indices in the two countries outperforming other regions. Eurozone and Chinese equities traded sideways through the month, while poor earnings releases exerted downward pressure on Japanese stocks.

Fixed income markets have faced headwinds through 2021, with the UK gilt index suffering one of its worse quarters on record in Q1. Yields across the board have picked up (prices and yields move in opposite directions) in reaction to mounting fears of rising interest rates and growing inflationary pressures. Despite central banks maintaining their dovish tones and inferring rates are to remain low, bond prices have struggled to make up ground, with governments bonds returning little through April and investment grade and high yield credit faring only marginally better.

The global recovery has caused a surge in demand for commodities, with commentators speculating we are at the start of a commodities super cycle – an indication that there is strong upward price pressure to come.

Gains have been seen across industrial metals, while gold and other precious metals that saw outperformance last year have been subject to losses through the first months of 2021.

Chart 2: Manufacturing PMIs



Global manufacturing Purchasing Managers' Indexes (PMIs) indicate industrial production remained strong through April, despite rising input prices. Supply constraints, caused by shutdowns and weak demand through 2020, do not yet appear to be affecting production output, however recently released forward guidance from some manufacturing firms indicates supply issues are expected through the remainder of the year.

As the lifting of lockdowns continues to raise demand, any such supply issues are likely to compound the already mounting price pressures.

Despite relatively positive PMI data, rising Coronavirus cases and a further set of lockdown restrictions have led the Eurozone into a 'double-dip' recession, with Q1 GDP in the region reportedly falling -0.6%. Having struggled with both capacity issues and public take-up, Europe's vaccine programme is finally taking off, paving the way for countries to re-open in time for the much-needed summer tourism season.

In the UK, recent supply issues have caused a slowdown in the vaccine roll-out, nonetheless, Boris Johnson's roadmap to re-opening remains on track. It is hoped that this will allow GDP in the region to expand at a rate of near 5.4% through 2021, although as business support schemes are pared back, unemployment levels are set to rise.

Looking to the virus itself, global case numbers have once again begun to escalate. Swathes of new cases are being reported daily across many emerging market countries, with rates in India rising at a faster rate than during their first wave. The effect that this and resultant lockdowns will have on global markets is yet to be seen, likely being masked by the success of other nations in their fight against the virus.

As April came to a close, the UK and US had provided at least one vaccine dose to 50.6% and 43.3% of their populations, respectively, this is versus just 7.7% globally.

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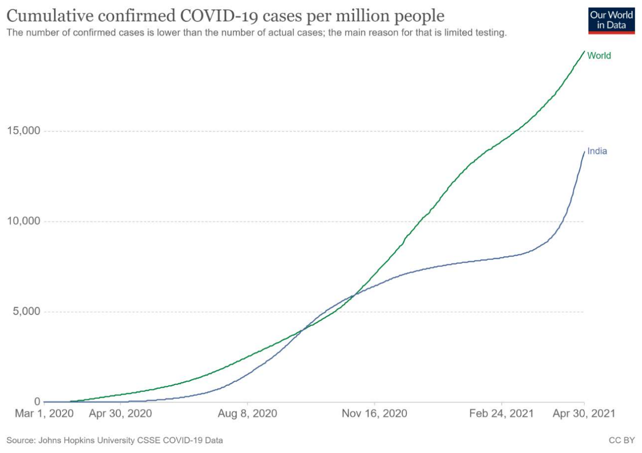


Looking back at April in more detail, equities generally made good gains, particularly in the UK and US as they led the charge on vaccination rates. The S&P 500 rose by nearly 4% during the month with the FTSE 100 and 250 indices just behind. European equities also performed relatively well, rising by 3.6% as sentiment improved, while Asian and Japanese markets saw more muted returns.

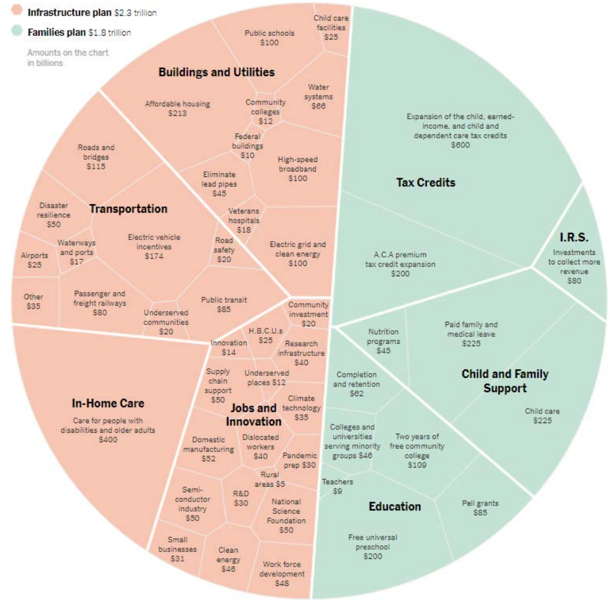
Bond markets saw more volatility, with UK Gilts and index-linked Gilts holding just above the zero bound having given up their intra-month gains. Corporate bonds performed marginally better but these riskier fixed income sectors are now richly valued relative to history.

As in previous months, the US provided many of the talking points that drove financial assets' returns as President Biden unveiled two additional stimulus plans totalling more than $4tn in size, designed to boost infrastructure spending and help less well-off workers, families and children.

At the beginning of the month, the four-part, eight-year $2.3tn infrastructure plan was unveiled in Pittsburgh, and included huge sums to improve public transportation, access to clean water and high-speed broadband in homes, provide manufacturing upgrades and to improve care for the elderly and people with disabilities. The plan would be paid for through a mooted corporate income tax increase to 28% from 21%, with a proposal also put forward for minimum tax of 21% on global corporate earnings.

Then, at the end of the month, details of the sweeping $1.8tn American Families plan were released, designed to expand educational opportunities through the expansion of child care subsidies and tax breaks for working families. To fund the plan, President Biden is proposing almost doubling the rate of Capital Gains Tax for wealthy individuals earning $1m or more to 39.6% from the current base rate of 20%.

The complexity and scope of these plans is captured in the graphic below, which shows the wide range of areas the proposed funding will reach:



Note: The plan released by the White House did not include estimated costs for the expansion of the child tax credit, earned-income tax credit, or child and dependent care tax credit. The $600 billion estimate is the difference between the total tax cuts mentioned in the plan ($800 billion) and the $200 billion included for Affordable Care Act premium tax credits. • Source: The White House

Both plans will face tough paths through Congress where garnering Republican support in either the House or Senate, both of which Democrats control by narrow margins, will be difficult. Corralling moderate and progressive Democrats will also be a challenge. Republicans are staunchly opposed to tax increases, and the breadth of measures will invite partisan and even internal Democratic battles.

As before with the $1.9tn Covid plan passed earlier in 2021, the Biden administration does not necessarily need Republican support to pass the plans under the potential re-use of the budget reconciliation process. However, the challenge will be that not all elements would fit into such a process, which sets certain requirements for inclusion, while the optics of the plans being 'forced through' without any partisan support at all may play negatively for Biden in the medium term.

This ever-increasing level of spending comes even as coincident data related to growth and inflation are all rising sharply. US inflation as measured by the Consumer Prices Index rose by 2.6% year-on-year, driven by big gains in energy prices, while retail sales accelerated in March by 10% month-on-month; the most in 10 months and the second largest increase going back to 1992. Indeed, the Government's retail sales report showed all 13 broad categories posting gains through March, with the total value of receipts in each category now above pre-pandemic levels, bar those for restaurants:

Finally, on the employment front, the US economy added more than 900,000 jobs in March, with improvement across most industries expected to continue through the second quarter.

Looking forward, the outperformance of risk assets is expected to persist through 2021 as we move further into the recovery and corporate earnings improve; with companies taking advantage of weak year-on-year comparisons. Regionally, we see the greatest opportunities outside of the US on a valuation basis as post-virus catch-ups continue. This view will undoubtedly be subject to volatility however as the virus continues to cause disruption.

Ongoing growth in activity is set to persevere, with rising demand and constrained supply in multiple sectors causing supply chain issues and inflationary pressures. While the consensus is that these pressures are temporary, with global fiscal and monetary policy continuing to run very hot the risk remains that a more structural problem could emerge.

In this environment we see returns from conventional fixed income continuing to lag, and portfolios benefiting from holdings in real assets and value equities.

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