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Vaccines, variants and volatility

Highlights:

- **As the Covid-19 disruptions near their one-year anniversary, the conversation, as well as the virus, continues to mutate. Last quarter we warned of the pending tsunami of 'vaccine politics' that seemed likely to eclipse 'lockdown politics', and indeed the divergence in roll-out between the UK and its European neighbours may portend a divergence in economic re-openings and growth.**
- **The dominant mood in equity markets is one of enduring ebullience, particularly despite some staggering disparities in consumer behaviour and demand – e.g. while new car sales fell by 26% in Europe in January 2021 (the worst January on record), consumer demand was robust in the US as stimulus checks were spent and retail sales jumped 5.3%.**
- **Market chatter turned from the Gamestop showdown which evidenced the brief moment in the sun for the retail investor or Reddit user, to rising interest rates (and Gilt yields) as well as unmistakeable hints of pending inflation.**
- **The existential threat of Covid-19 has pushed environmental and sustainability concerns to the forefront of the investor agenda, and as metrics and transparency improve and engagement gains increased participation and traction, we are moving towards more standardization of metrics and expectations in this emerging space.**
- **As we move towards the end of the first quarter, the year is suspended in perhaps even more uncertainty than 2020, as the endemic nature of Covid-19 now seems certain, the hopes for the impact of the vaccine seem high, even if rollout is uneven, and the severity of the impact on the economy seems set to unfold.**
- **As the shock of the Covid-19 upset subsides and recovery commences, we expect to see ongoing political agitation, dissatisfaction with incumbent governments and a desire to shift to alternative solutions for post-crisis management. The new US administration under President Biden has a challenging path ahead as it seeks to reopen schools and the economy, while with the performative second impeachment of President Trump over without a conviction, ongoing polarisation seems to be the order the day.**

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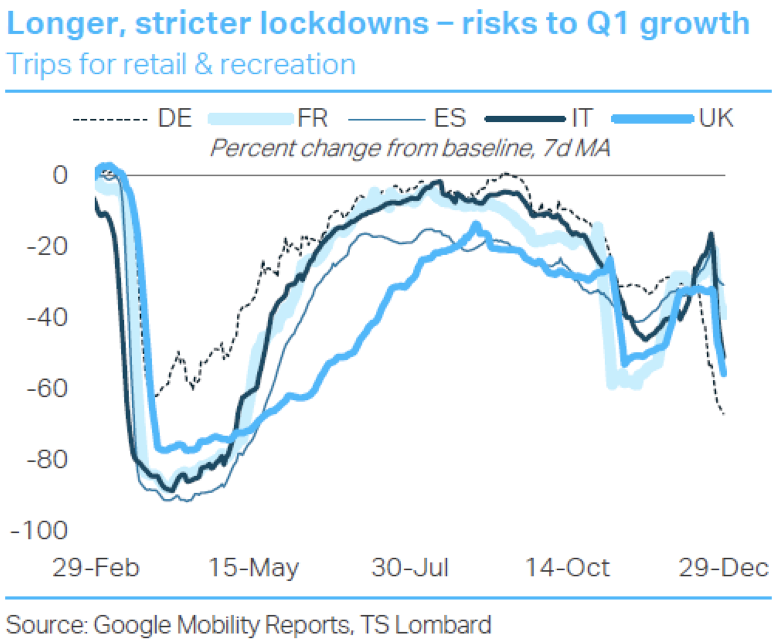
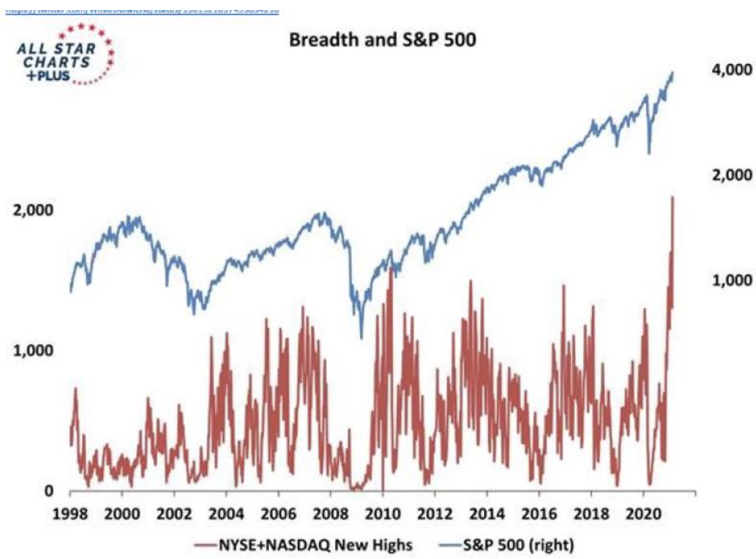
Current Macro Snapshot

Full Blown Stock Mania – or hints of a bubble?
It is clear that as Covid-19 passes its first anniversary and continues to evolve its status is moving from a pandemic to an endemic disease – as living with it and its seasonality seems to be inevitable. This has sparked uneven responses across the world although it was clear that the first quarter lockdowns were more sudden and more severe than might have been predicted as 2020 drew to a close. It is also leading to a redrawing of the "lines of battle" as some countries put schools at the forefront, such as in Europe, while border closures and restrictions on movement distort the ways of commerce and daily life.

Global deaths and cases numbers now near 2.4 million and 111 million, respectively, and as the chart below from European economies show, mobility has slowed significantly, and the longer lockdowns and renewal of "stay at home orders" seem to threaten Q1 growth, after a decent recovery at the end of 2020. Final figures show that the **US economy shrank by 2.5% in 2020, worst since WWII, while the UK experience was worse, with GDP sinking by 9.9%, the steepest annual drop since the Great Frost of 1709.**

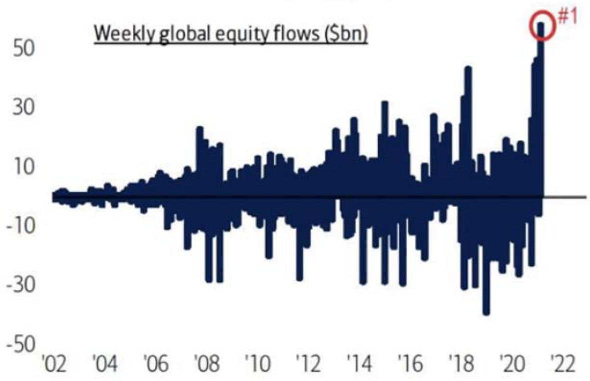


That said, corporate earnings look set to stage a recovery globally and market performance has been robust year to date and is growing in breadth, which indicates greater market robustness and staying power.



Money is continuing to flow into global equities, chasing the upwards momentum and adding to it, and risk appetite seems to be at the high end of the spectrum as the two charts below indicate. The enthusiasm of retail investors for equities has been a theme now since the early days of the post-pandemic disruptions, which some might see as a democratisation of equity markets. This was accentuated in the extraordinary spate of trading in Gamestop and other stocks which had been targeted by shortsellers and then massively run up by retail investors sparked by online organized campaigns. The swift run up – during the depths of winter – was described by one commentator as "full-blown stock mania" one of the "traditional warning signs" of a market top.

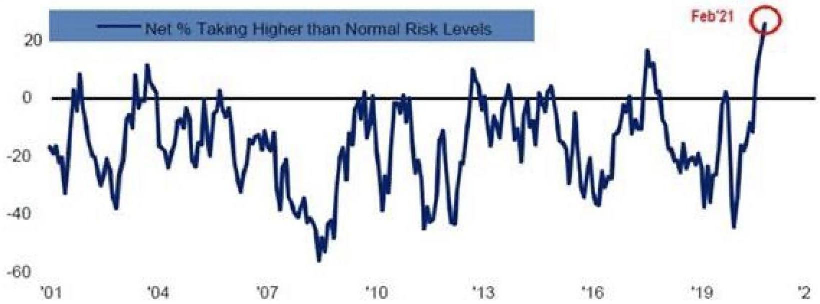
Chart 5: Largest week of global equity inflows ever
Global equity inflows, $bn



Source: BofA Global Investment Strategy, EPFR Global

BofA GLOBAL RESEARCH

Exhibit 11: All-time high in investors taking "higher-than-normal" risk Net % Taking Higher than Normal Risk Levels

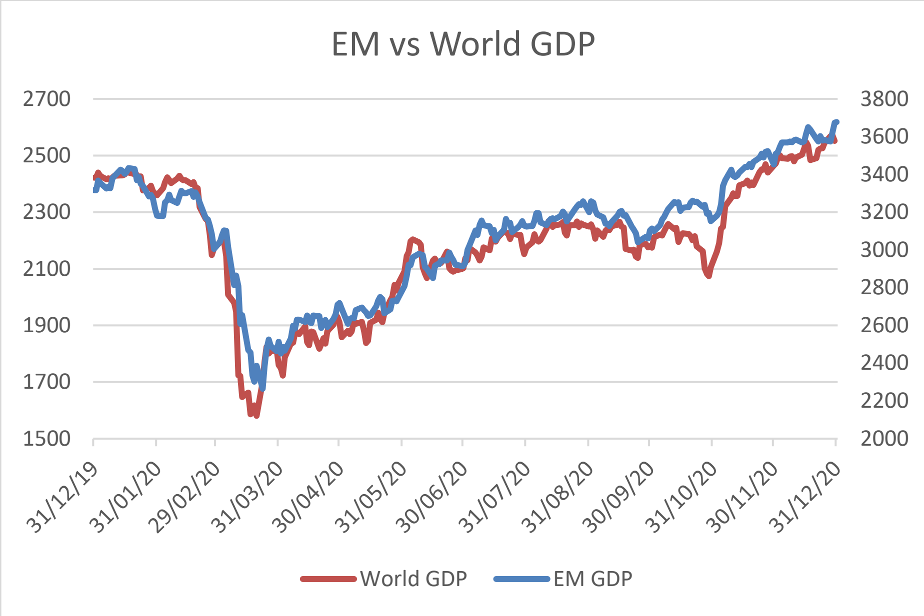


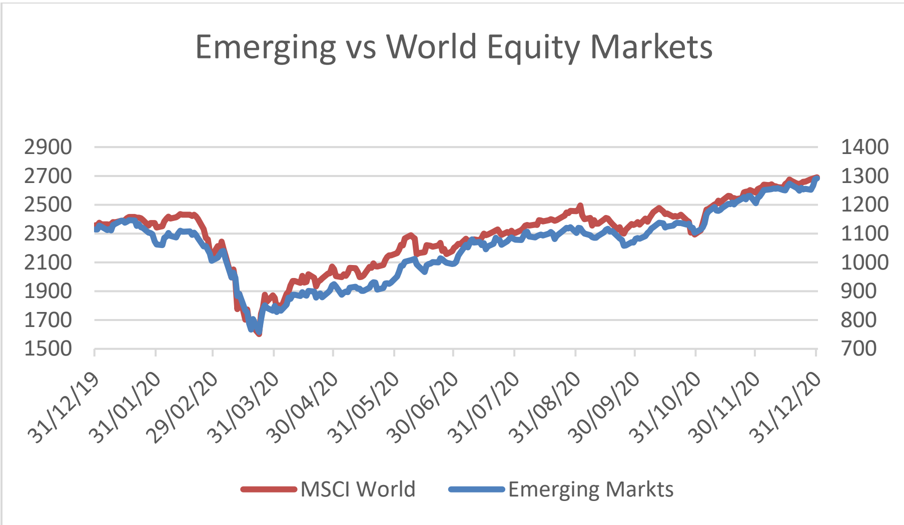
Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

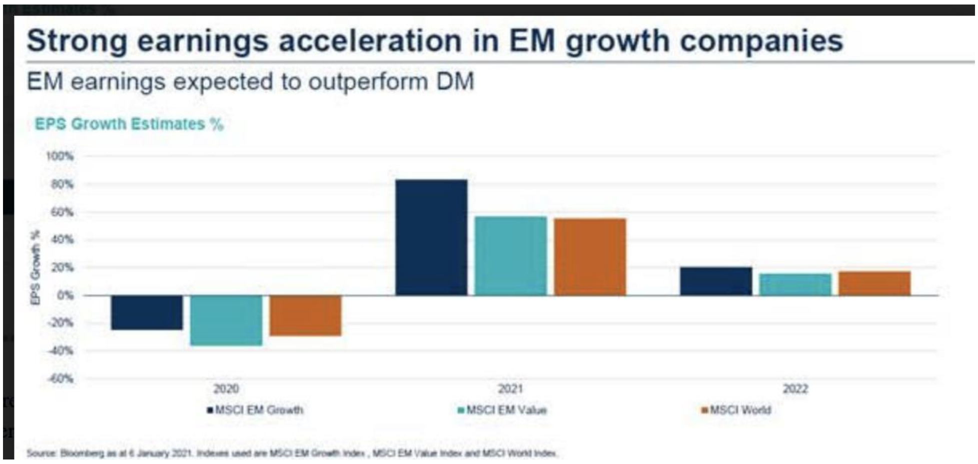
Emerging Markets emerge from the background

Emerging markets have received only occasional attention as the pandemic has evolved, partly due to the "first in/first out" status of China, and partly due to the region's exposure to commodities (prices rising) and the US dollar (falling). It can be seen that this time out of the spotlight has been a time of quiet consolidation of those markets – having lagged developed markets for some time, they fell by less in relative terms and grew steadily in line with the recovery in the rest of the world. GDP there has also fallen by less in broad terms, as economies such as India did not close as drastically as elsewhere due to economic constraints.

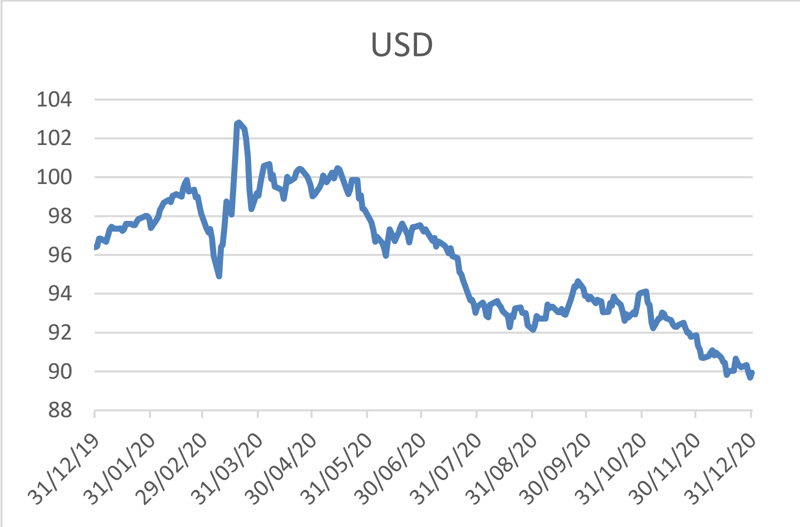




There is even the expectation that EM earnings, particularly in growth sectors will outperform developed markets in 2021 and 2022.



A falling dollar, inflation in the wings?

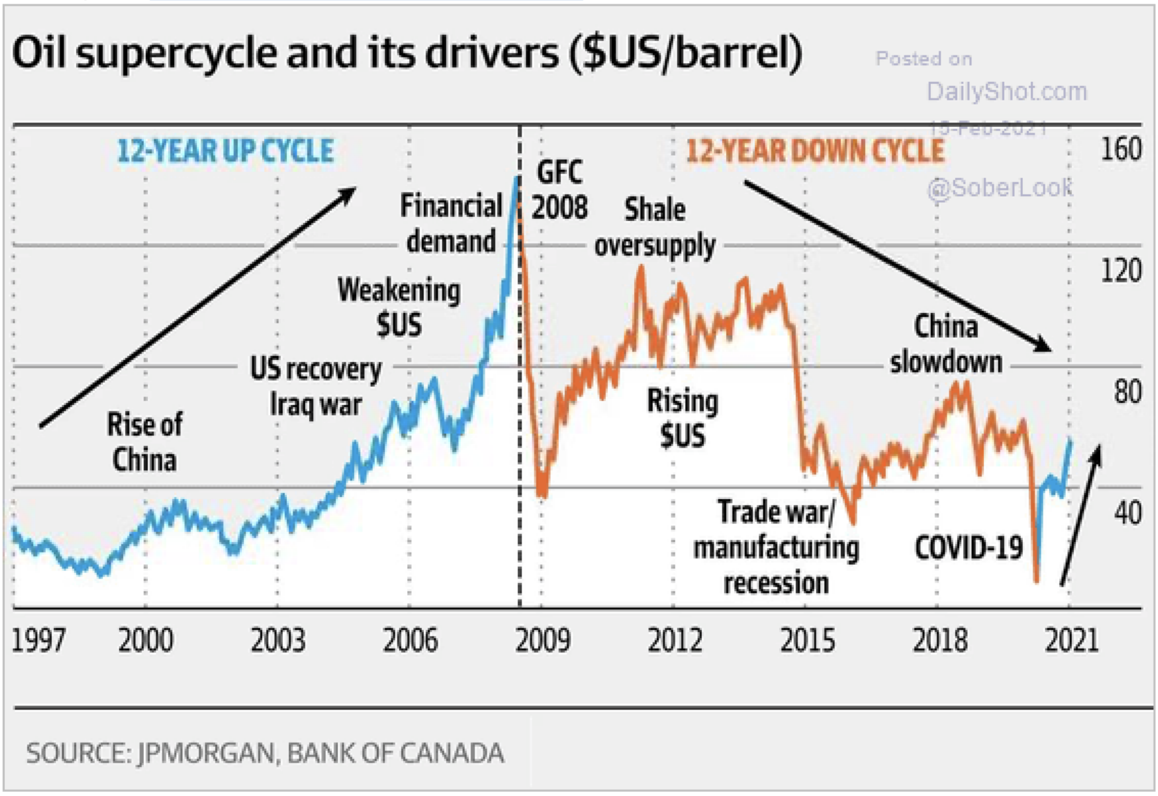


The US dollar has been in a steady mode of decline since the onset of the Covid-19 crisis, as the chart below shows, and this is not only a boost for emerging markets, many of which rely on exports as well as servicing US dollar debt. It also will erode, somewhat, some of the considerable returns that global equity market exposure will provide to a broader portfolio.

A falling dollar has implications for commodity markets, which tend to move in opposite directions to the direction of the dollar. The chart below charts the past 24 years of oil prices – an upwards super cycle and a more volatile down cycle. A question remains as to whether we are poised to enter another supercycle – and certainly while oil fell dramatically and even into negative territory briefly in 2020, it is up 23% year to date and all indications are that commodities including lumber are currently set to rise in the short to medium term. Lumber recently hit an all-time high rising by 104% this year to $828 per thousand board feet (almost four times gold's % increase).

Commodity super cycle? Not sure the cycle has to be a symmetrical 12 years up, 12 down, but still

JPM via Daily Shot via https://twitter.com/RonStoeferle/status/1361702833691779073

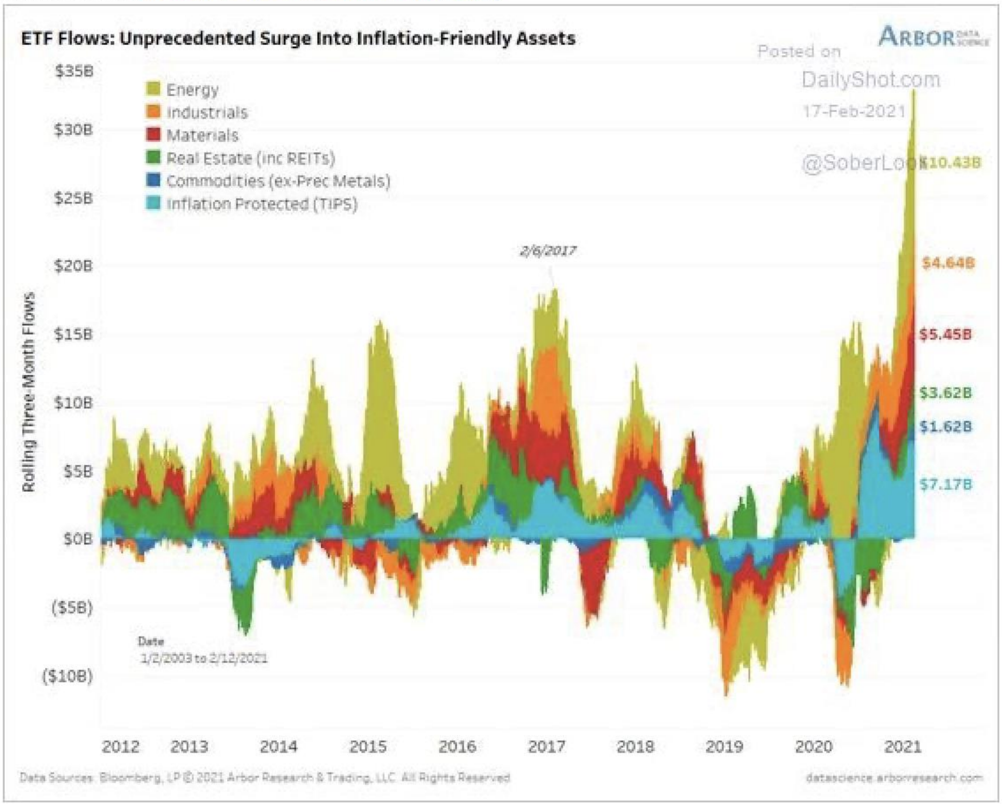


This has two important implications – one is for inflation, and the other is for ESG/Sustainable investing. Commodity prices drive inflation and as supply chains have become disrupted due to Covid-19 inflation is on the rise (this has been the case in the UK for some time due to a weaker Sterling). Most portfolios are somewhat hedged against inflation – through real estate, infrastructure and (loosely) equity holdings, but the most successful active equity managers have tended to be underweight energy and utilities recently, and overweight areas such as technology and healthcare stocks. The chart below indicates that inflation expectations are mounting, as evidenced by flows into inflation related ETFs. It is also notable that the producer price index rose sharply in the US in January (+1.3%, the most since 2009) as the costs of goods and services rose. In the UK CPI rose by 0.9% in the 12 months to January 2021, up slightly from 0.8% in December.

The other implication of rising inflation expectations and a rise in commodity stocks is the implications for ESG scoring and implications – usually those managers who employ an integration of ESG risk factors across their portfolios will be underweight stocks such as commodity stocks and industrials. As these sectors appreciate managers with higher ESG scoring may perform less well.

Flows into "inflation related" ETFs – "an unprecedented surge".

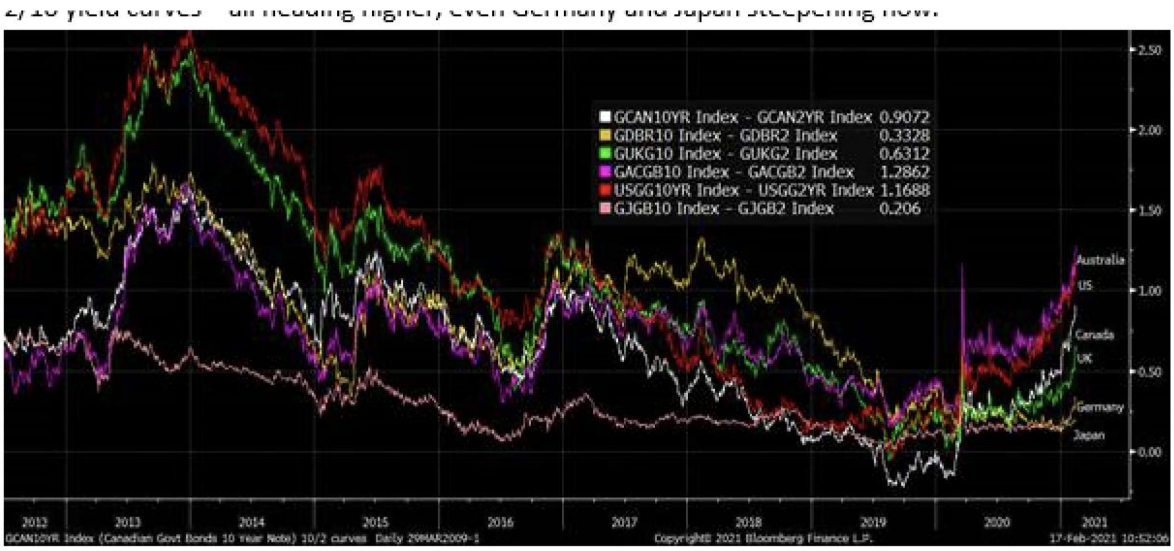
Arbor via Daily Shot via https://twitter.com/jsblokland/status/1362133571880763405



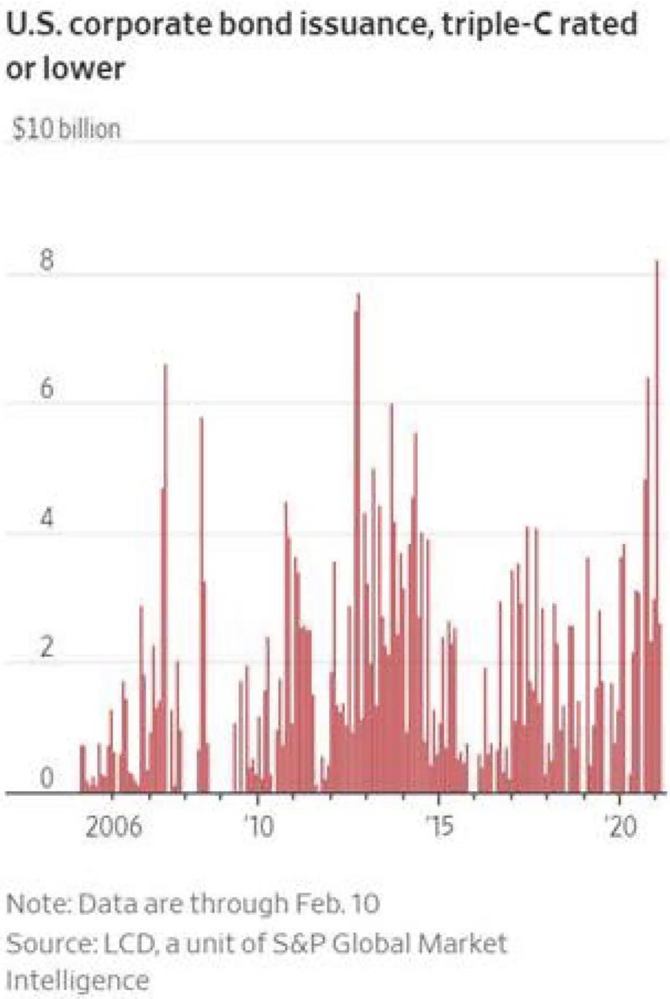
There are also indications that the US Fed is undergoing a subtle shift in policy, with a new framework under which it would not tighten pre-emptively in response to higher anticipated inflation. This would perhaps pave the way for higher inflation in the future.

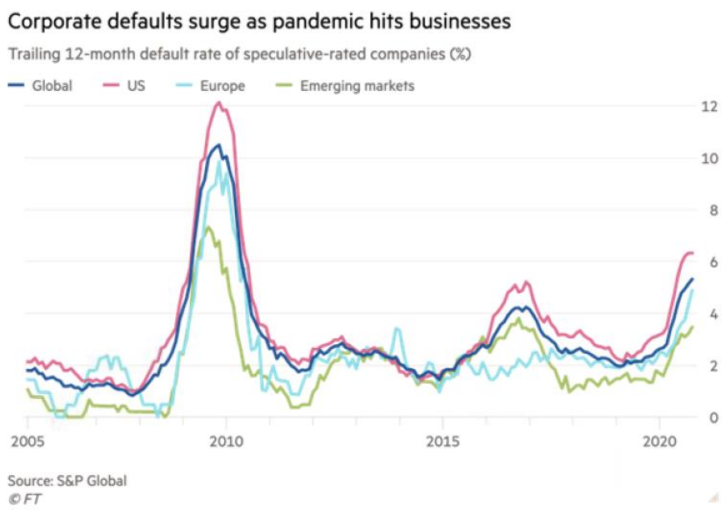
Is it finally time for rates to rise?

After over a decade of low rates, there are indications of a pattern of rising rates – see chart below – even in countries beleaguered by low rates such as Japan and Germany. This is an indicator to watch, as it typically can precede a correction in the stock market as investors shift away from stocks in favour of now higher yielding bonds.



The relatively strong state of equity markets and support of credit issuance has led to a spate of issuance of lower rated bonds, which is indicative of non-discriminating risk appetite. These are further indicators of frothiness in risk assets and should be closely monitored going forward, particularly in the context of rising defaults as pandemic-related woes continue to affect businesses.





Individual Asset Class Performance

- Equities
- Fixed income
- Spotlight on ESG monitoring

Equities: A strong and broad start

Markets had a strong start to the year globally, with tech again leading the way, as was the case in 2020. The FTSE has delivered 2.53% year to date with the main European markets more or less in line with that, while the S&P was stronger at +4.22% year to date and the Nasdaq led with close to 8% for the same period. Reflecting the resurgence in economic activity in emerging markets, the Hang Seng was strong (+12.54% year to date) while the Nikkei 225 was up 9.4%. As noted above, market demonstrated both breadth and depth over the past few months, while the aberrant price action by stocks such as Gamestop was fairly contained and did not do too much to interrupt still subdued levels of market volatility. ‘

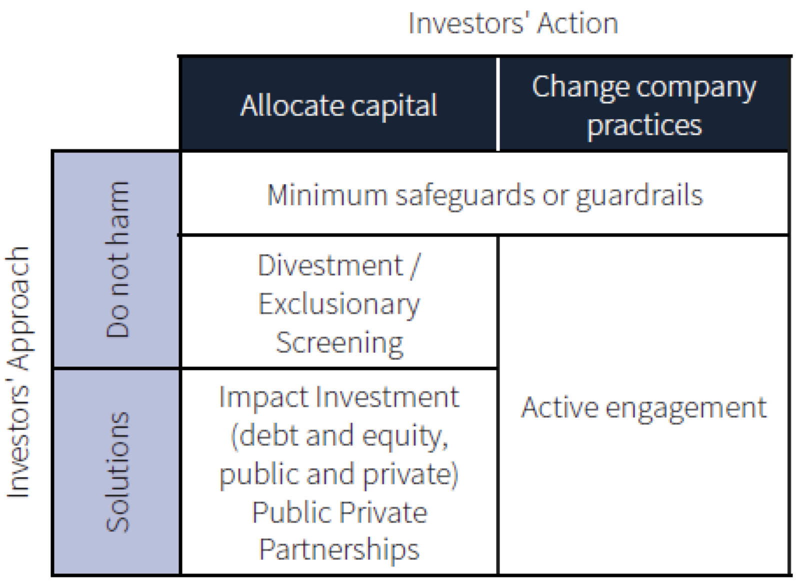
Fixed Income/Credit: as rates tick upwards, return is subdued

Rising rates are negative for fixed income returns and the slow rise in the US 10 -year rates indicate an expectation of a “jumpstart” in the economy as recovery starts to kick in post Covid. This is typically initially bearish for bonds as investors integrate their inflation expectations into their investment approach. With $600 stimulus checks already finding their way into the economy (and the stock market, apparently), and more stimulus on the way, this is leading to extended expectations for higher rates and inflation going forward.

Spotlight on ESG monitoring

Most institutional investors now are at a point of establishing a responsible investment policy and attempt to measure the ESG risks of a portfolio as well as its positive impacts. There is a considerable amount of jargon and confusion around taxonomy, best practice in terms of investment and manager and company engagement.

The framework below is a useful one to think about how investor action and approach can be aligned both in terms of harm avoidance and in positively impactful solutions.



Source: Beyond Alpha, It's Time to Talk, January 2021

Active engagement is a key tool of the drive towards sustainable investing, but has been criticized due to the absence of conclusive evidence of the causal link between engagement and changing company behaviours. This will only be improved over time through better metrics, transparency and enforced accountability.

Currently our use of responsible investing dashboards enables tracking and monitoring of progress in levels of engagement, as well as the progress of companies in their transition from fossil fuels and towards lower carbon targets. On November 9 Rishi Sunak announced three new measures to place the UK at the forefront of green finance and enable a transition to net zero. The steps included requiring all major UK companies and financial institutions to disclose their climate risk in linked with the Task Force on Climate-related Financial Disclosures[1] by 2025, the introduction of a "green taxonomy" to better understand the impact of firm activities on the environment and the issuance of the first UK sovereign bond in 2021.

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Outlook:

Last quarter we noted the "warp speed "of vaccine development. Unfortunately the roll-out has in some regions been anything but, and the UK has led the field thanks to the impressive coordination of the NHS. With uncertainty around the lifting of lockdown extending and the furlough scheme in the UK extended until at least summer 2021, the real economy remains in a form of deep freeze, although financial markets are operating mostly as normal.

In the months ahead it will be interesting to watch for the following:

- **Withdrawing life support and waiting for the patient to wake up** Just as emergency business loans and furlough schemes have dulled the pain of business closures, it is only when this life support is withdrawn that we will see the patient's ability to wake up and return to functioning. This will be a critical moment for global economies, especially those dependent on tourism, and sectors such as hospitality and airlines still face a severely uncertain future.

[1] The TCFD's remit is to develop a set of voluntary climate-related disclosures to assist in understanding the associated material risks of climate change

- **Green shoots** The new Biden administration in the US has issued a record number of Executive Orders and is firmly committed to a net zero economy by 2050. It has appointed the eminently capable John Kerry as climate czar and will integrate climate change resilience into its planned infrastructure spending program. After a winter of extreme weather, particularly in the fossil fuel hub of Texas, the urgency of this focus is apparent. The actions of Rishi Sunak noted above are evidence that this is a global movement and the robust level of fund flows into ESG strategies for the past 12 months show that investors are following the money. We expect to see renewed pressure on asset owners to not just develop responsible investment policies but to evidence change and progress towards them.

- **Contending with inflation and rising rates.** As noted above the past few months have seen clear reversals in trends that persisted for years, and portfolios have been arranged according to the lower (inflation, rates, volatility) for much longer narrative. As this narrative comes under pressure, but growth continues to outperform value, it will be interesting to watch whether assets are realigned accordingly.

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February 19, 2021