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The Next Chapter

Highlights:

- **As we approach the mid-point of the year, it is vaccine rates that are largely determining the emergence of countries into the post-Covid era. As they dig out from the rubble of forced business closures, empty offices, and fundamentally altered lifestyles – what will the search parties find?**
- **The desire to write the next chapter of recovery and economic growth is real, but it is like trying to write a textbook without knowing the syllabus. Covid's dominance in news cycles and in every home over the past 15 months has made it hard to have perspective on the other seismic forces shaping change. Will the rising awareness of climate change fundamentally alter supply chains, energy sources and how we work? Will demand patterns have shifted so much that certain land uses simply disappear? Do the recent hints of skills shortages point to a swing in the pendulum from capital to labour after decades of labour having little sway?**
- **Faced with this ongoing uncertainty, markets seem to be less plumbing for a bottom than fishing for answers. The noise of bitcoin and other cryptocurrencies rise and fall, while a spectacle, is unlikely to move the needle much for institutional investors who have broadly steered clear of this area.**
- **Supply chain disruptions and rising energy prices have stoked inflationary concerns again, although the fact that expectations ratcheted downwards as actual inflation rose, suggests it may be a temporary phenomenon.**
- **Equity markets continue to inch higher – although perhaps with a few more jitters over past weeks, as a breather seems overdue. Bonds also seem priced for perfection, while the demand for private market assets endures.**

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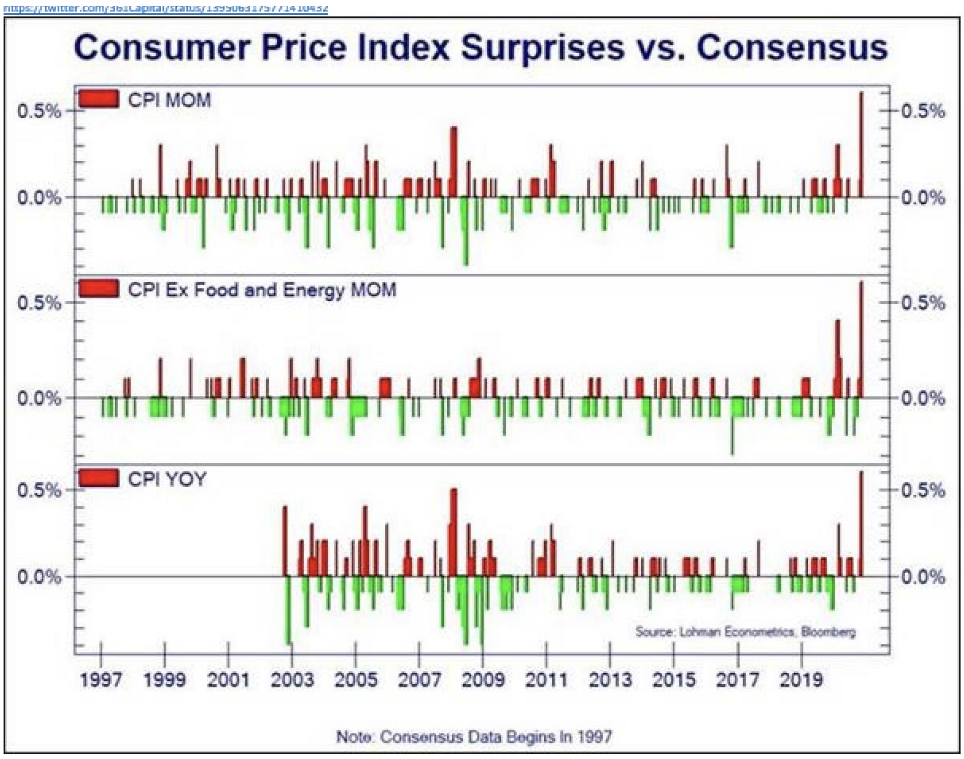
Current Macro Snapshot

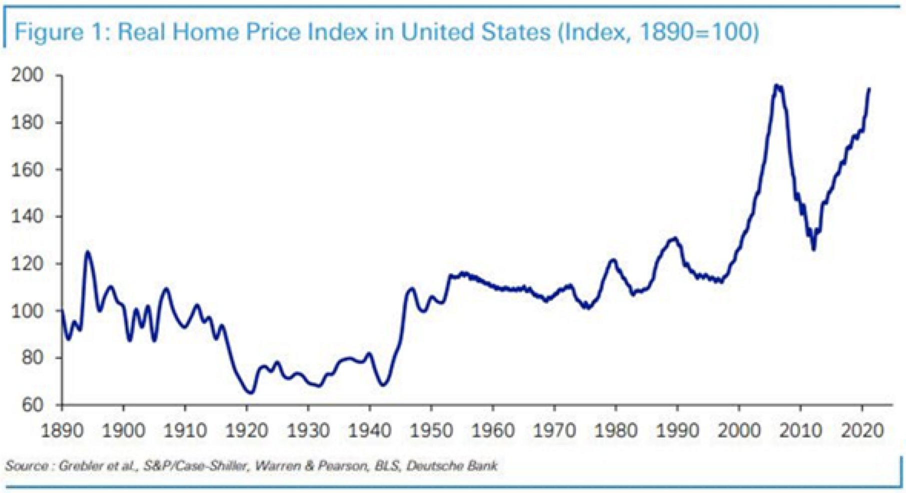
While last quarter we cautioned about inflationary expectations, it suddenly appeared that expectations were eclipsed and inflation was well and truly upon us. That then, in turn, caused future expectations to subside suggesting that whatever spike was being seen was a temporary one. It may have been temporary and caused by supply shortages, Covid disruptions, rebounds in energy prices and in underlying components such as lumber. It may have been caused by temporary demand surges as savings are finally spent. Either way, until its duration and long-term impact is known (e.g. will it lead central banks to raise rates?) inflation is likely to spook markets periodically in the months ahead.

As the graph below shows, recent CPI figures in the US since data is available (1997) the red bars showing where CPI exceeded consensus expectations:



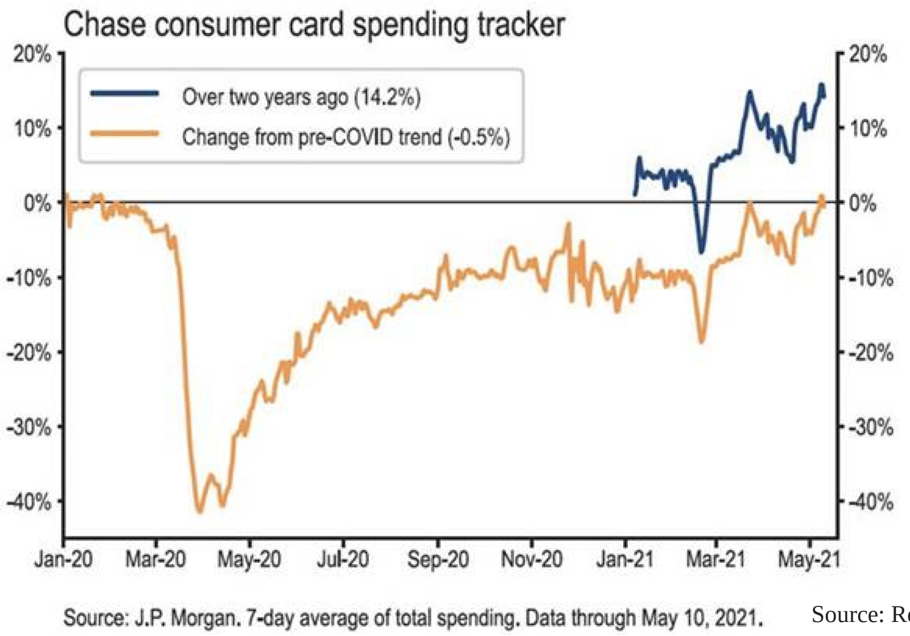
Source: Redburn

There is also rising chatter about worker shortages, and is clear that there is also abundant froth around house prices, with US house prices near an all time high (since 1890):



Source: Redburn

It is also quite clear that the consumer is back, and seems even unstoppable, with credit card spending in the US above pre-Covid level, and significantly higher than two years ago.



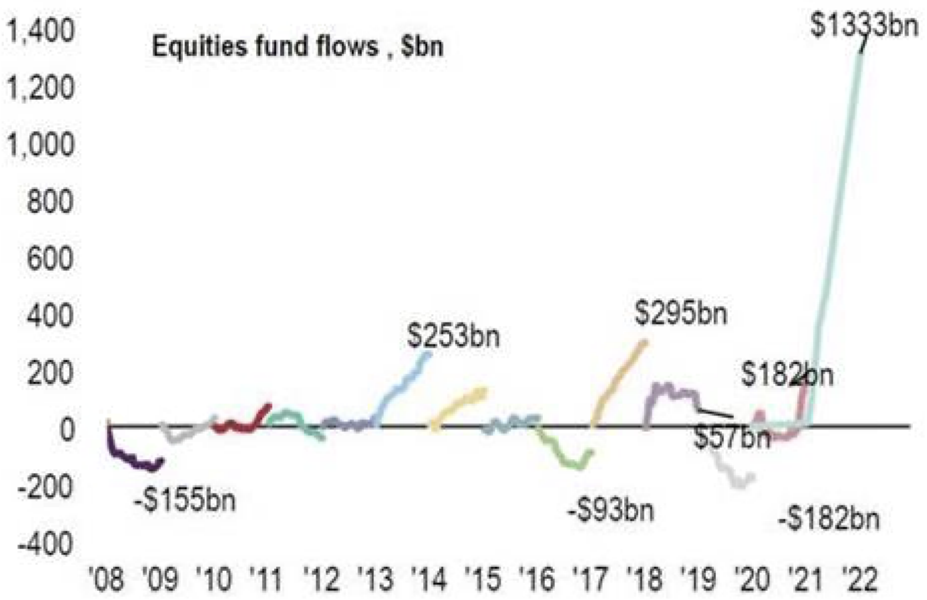
Source: Redburn

Flows continue – boosting risk assets

In the last quarterly letter we noted that despite dire GDP growth numbers for 2020, the stock market had stayed buoyant, and even hinted at bubble valuations as it reached new highs. It is clear that despite some shine coming off the tech sector in particular, this level of buoyancy is still very much present. Buoyancy is reflected both by flows and the readiness of investors to discount bad news and base valuations on an expected rebound and future forecasts. The charts below show that equity inflows have shown no sign of abating, driving by both retail and institutional flows. The fascination with "meme" stocks such as Gametop and AMC has not abated either, and this segment saw intense activity over recent months, as did cryptocurrency related stocks, which were seen to be heavily sensitive to sentiment around the entire area.

Chart 3: Equity flows annualizing $1.3tn in '21

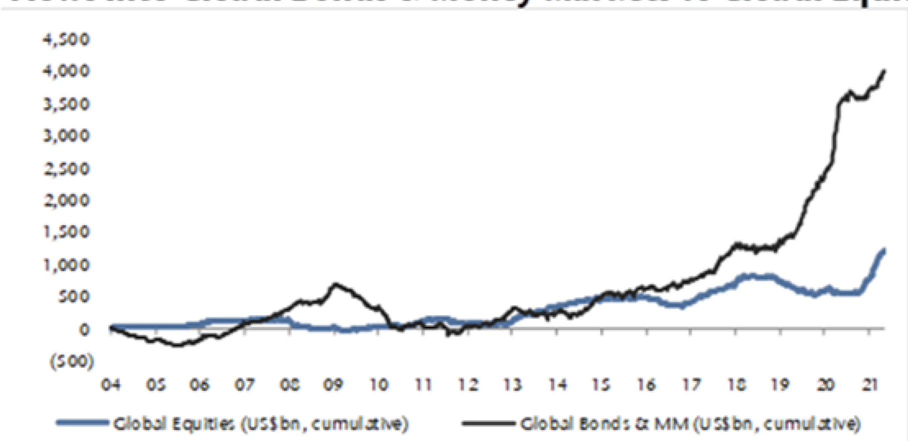
Annual equity flows since '08 ($bn)



Source: BofA Global Investment Strategy, EFPR flows   Source: Redburn

It is also clear that risk seeking behaviour has also been shoring up fixed income and even low-yielding cash like assets.

Flows into Global Bonds & Money Markets vs Global Equities



Source: EPFR, ICI, Jefferies   Source: Redburn

Note: We used ICI US MM data as a proxy for global MM from 2004 to 2006.

The hint of a correction in early May which saw volatility rise (as expressed by the VIX, see below) was driven by rising inflation concerns:

Source: Yahoo Finance

The falls in the more speculative cryptocurrency sector were more spectacular however, but charts such as the one started to appear that reminded investors (again) of the fact even in strong markets, meaningful corrections could be witnessed, particularly in its second year (which is what we are in).

Truist via https://twitter.com/Rob_Hager/status/[illegible]

Bull market returns and drawdowns			
Year bull market began	**First year return**	**Second year return**	**Second year: largest intra-year pullback**
1957	31.5%	11.2%	-9.2%
1962	33.9%	15.7%	-6.5%
1966	32.9%	6.2%	-10.0%
1970	45.7%	5.8%	-11.0%
1974	33.2%	27.7%	-5.1%
1982	56.3%	1.5%	-14.4%
1987	21.7%	26.1%	-7.6%
2002	33.1%	9.4%	-8.2%
2009	68.3%	16.0%	-16.0%
2020	76.1%		
Average	**43.3%**	**13.3%**	**-9.8%**

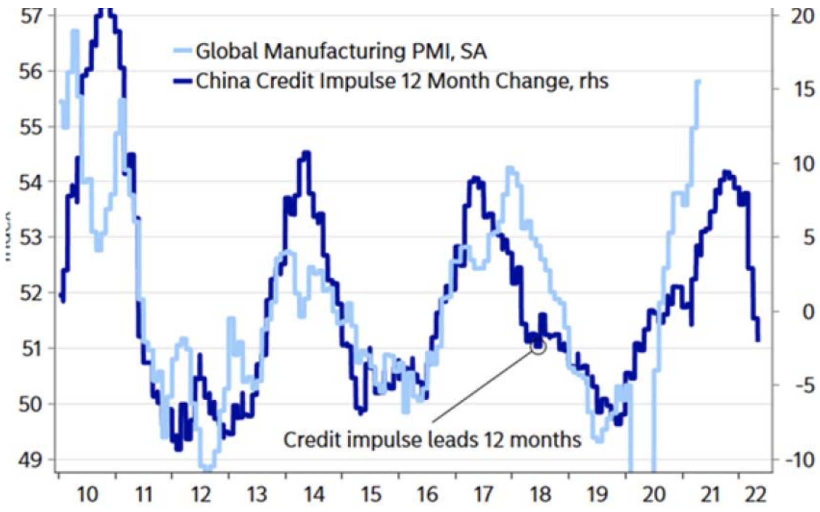
Data Source: Truist IAG, Strategas, Bloomberg. Past performance does not guarantee future results

Source: Redburn

Some attention continues to be on China and its overtures towards Taiwan, the flare up of tensions in the Middle East, although at the time of writing a cease fire is in effect, as well as brazen violations of international law by Belarus and its far-right regime. These serves as reminders that geopolitical tensions have not surrendered to Covid disruptions, although they have perhaps removed them from top of mind.

China now seems to be a leading indicator

We spoke last quarter about the "first in/first out" status of China, and there is increased attention on the extension of credit in the country and how it acts as a leading indicator of global GDP:



Source: Redburn

Currency movements and what they mean for the portfolio?

Last quarter we spoke about the slow but steady decline of the US dollar since the onset of the Covid-19 crisis, and as noted in the equity discussion below the UK stock market has been slightly weighed down by the strength of Sterling. As noted last quarter, ongoing Sterling strength will erode, somewhat, some of the considerable returns that global equity market exposure will provide to a broader portfolio.

GBP v. USD for past three months. Source: Marketwatch

Are we there yet? And now, is it finally time for rates to rise?

There are also indications that central banks are finally seriously considering raising rates in response to inflationary pressures, and this was as good as hinted by the Bank of England recently. All eyes will be on the US Fed meeting in Jackson Hole later in the summer, where rate rises are likely to be on the discussion agenda

Individual Asset Class Performance

- Equities
- Fixed income
- Spotlight: Shareholder Engagement has its Day in the Sun

Equities: Is the market starting to run "hot"
May 2021 was a fairly chilly one in the UK – with rain and snow and weather more like February. It wasn't the most inviting months in markets either, although by month end the intra-month volatility didn't seem that significant after all. The FTSE had only modest gains in May rising by close to 1% in the month but it has been steadily gaining strength all year as the relative strength of the UK recovery distinguished itself. It is true that a strong Sterling weighed on markets (Sterling gained 2.4% in the month v the US dollar.) however. Year to date the index has risen by 9% which shows it is gaining ground on the Stoxx Europe 600, which is up 13% for the year to date (ahead of mainstream US indices). Among the strongest sectors of the FTSE were homebuilders, banks, oil and mining stocks.

In the US, tech stocks sputtered, but mainstream indices rose – with both the Dow Jones and the S&P rising for a fourth straight monthly advance. Nasdaq ended the month down 1.5%, but had actually rallied towards month end and despite the rout in tech stocks is still up 7% for the year (compared to around 12% for the S&P and DJIA). So-called "Meme" stocks such as AMC and Gamestop continued to display exorbitant volatility, as did cryptocurrency. In contrast Asian markets were rather subdued and are still towards the modest end of year to date returns globally – at around 4 – 6% year to date across the region. Stronger Emerging Market currencies may have something to do with this as could the ongoing challenged tourism sector (as well as the supply chain pressures cited earlier).

Fixed Income/Credit: little to do as risk seems perfectly priced
Last quarter we noted the potential for rising rates to be negative for fixed income returns and many traders consider bonds currently to be priced for perfection. While during the early days of the pandemic there was a spate of investment grade stocks "falling" into high yield territory as credit agencies cut their credit rating, this is reversing as the agencies are equally synchronous in providing upgrades. Many credit managers are wary at current valuations, while in the private credit area, like other private areas, the demand continues to be extremely strong, which is driving larger fund sizes, little flexibility on fees and heightened competition for deals (which may compress returns in time).

Spotlight: Shareholder Engagement has its Day in the Sun
In what has been described as a historic vote in late May active ownership as a strategy was vindicated when a majority of ExxonMobil shareholders voted to replace two of the oil major's board of directors with candidates from a slate nominated by climate activist shareholder Engine No.1 in a bid to "reenergize Exxon". Large shareholders who supported the slates included other LGPS funds such as the Lothian Pension Fund who cited their support of the slate of directors proposed due to their innovation in "low carbon business models", alongside Blackrock, NEST, Church Commissioners for England and California teachers' pension funds CalSTRS and CalPERS as well as New York State Common Retirement Fund

This is concrete evidence of the effectiveness of shareholder engagement and action and should serve to bolster the impression of engagement as a tool now that actions such as this have gained what some have termed "critical mass". When Blackrock summarized its position it cited the recent net zero 2050 scenario from the International Energy Agency (IEA), saying Exxon and its board needed to further assess the company's strategy and board expertise against the possibility that demand for fossil fuels may decline rapidly in the coming decades.

In a news article relating to the action, NEST's spokesperson said the following: "Yesterday's Exxon AGM sends a clear message to companies that investors want to see real action on climate change and if they don't, then we'll vote against boards. I hope this unprecedented vote sends a strong signal to other big oil companies that investor concerns on climate change shouldn't be ignored."

This evidence of the success of positive collaborative shareholder action is likely to bolster further collaboration and provoke further attempts to accelerate the energy transition among fossil fuel companies and decarbonization across the board.

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Outlook:

Last quarter we suggested that the real economy remained in a form of deep freeze, although financial markets are operating mostly as normal. There has been notable change in the activity in the real economy this quarter, but progress is still tentative.

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

- **The patient is awake, and is partying. . . but what about the morning after**? Last quarter we talked about the challenges of 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.

- **Watching for a different kind of recovery from a different kind of recession.** We have spoken before about the K shaped nature of the recovery in the immediate aftermath of Covid hitting – while knowledge workers generally thrived and amassed savings in a seamless shift to remote work, lower paid workers, particularly in the service industry, suffered the most setbacks in terms of income and job security. Now, as economies reopen, this segment remains under strain, although US unemployment numbers have dropped from 15% at their peak to only 6% now (it never rose this much in the UK due to the furlough), and as noted above there are staff shortages anticipated for lower paid roles. Other positive indicators are the relatively high savings and low debt levels, not just for consumers but also among corporates. These are significant differences with the previous recession in 2008, in which financial institutions were in the cross-hairs of the crisis. This time, they remain well capitalized and supported and the pain is more generally being felt in consumer facing roles.

- **Watch for the sub-plots:** While Covid has dominated headlines, the sub-plots of geo-political tensions (with some inequalities only exacerbated through the impact of Covid around the world) as well as environmental awareness will start to come to the fore. As noted above, these plots are fast-moving and few companies and shareholders are sufficiently equipped to react appropriately. This is likely to be an area with much more newsflow over the balance of the year.

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May 31, 2021