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What Delta Delivered, and a Late Summer Booster.

It hasn't been the easiest of summers. With many of us expecting clarity, and some hoping for a long overdue overseas break, the worldwide spread of the Delta variant threw a wrench into plans. The geopolitical picture has also been troubled, and the past quarter has seen tragic scenes of chaos and confusion as the Taliban regained control over Afghanistan and foreigners rushed for the doors, along with a significant body of Afghan refugees. The warning signs of aberrant climate events were also in evidence, with historic flooding in Germany and devastating forest fires in Greece and Turkey as well as on the West Coast of the US.

As we look to the end to the year, and flu season beckons, it seems inevitable that Covid numbers will rise and that a return to full economic activity will remain halting. With economic activity comes consumer confidence, and it is true that at times this year market confidence has seemed at odds with worries on the ground (with US markets the S&P 500 has seen 50 record closes in 2021 alone, although European and UK markets have been more muted). Consumer confidence will drive equities and consumer demand will drive inflation as well as real estate valuations, and the picture is not yet as clear as we might like.

Highlights:

- **Vaccine roll-out remains a mixed picture, with countries such as Israel and the US about to launch booster (third) doses, countries such as Ireland nearing 90% take up and developing countries largely lagging. Vaccine passports, mandates and incentives are increasingly seen as bridges to the new normal as well as means of shaping behaviour and, while breakthrough infections continue and case numbers are rising, it is clear that the vaccine does provide broad protection from serious disease.**
- **This "vaccines as a path to full economic recovery" narrative seems one that markets and investors wish to latch on to, and has fuelled an extraordinary resilience in equity markets, particularly in the US, and particularly among growth-oriented stocks.**

- **Interest rates remain at record lows and seem set to remain there for some time – this is leading investors to seek alternatives to already anaemic bond yields that are further eroded by inflation, but the signal that can be taken is a caution that is still prevailing despite the occasional signs of equity market euphoria.**
- **The regulatory interference in China sent a chill through Chinese stocks in the quarter, and this remains a significant source of exogenous risk which should further undermine confidence in emerging markets more broadly.**
- **Supply chain disruptions remain, which are shoring up prices, and inflation is still a key barometer to watch as an indication of policy action and consumer spending power.**
- **Geopolitical upsets, while they generate a lot of media coverage, do not seem to impact markets at this juncture.**

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Current Macro Snapshot

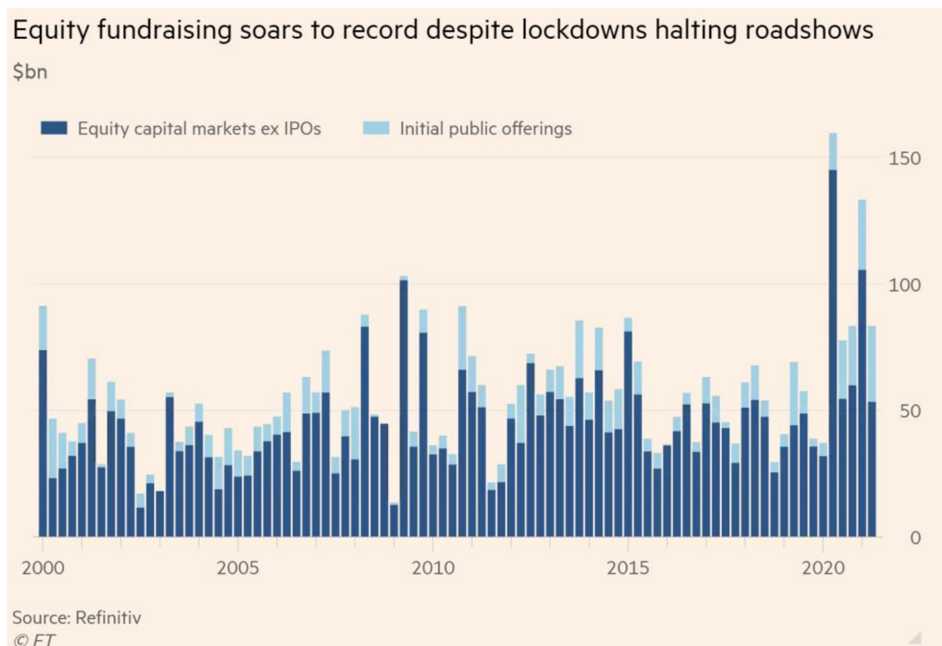
Equity markets in stubborn health

Global markets are riding high on the back of solid corporate earnings, renewed consumer spending and successful vaccine rollouts in developed economies. With central banks still operating a quiet consensus around accommodative monetary policy and governments still in support, and not austerity, mode the music of pandemic measures continues to play.

I have spoken before about the "pandemic pass" which I term as the tendency of consumers, investors and pundits to disregard or play down bad corporate news, due to the extraordinary "act of God" event of the pandemic. Unpredictable and unprecedented, it distorted the ability for true measures of company health to be revealed – furlough support and rent holidays allowed companies to stave off defaults, while the drop in earnings and demand could be explained if it was universal. As we noted last quarter, when these measures are removed we will see the true extent of the damage, and until then, we wait. Meanwhile, as the chart below shows, data is fairly mixed and leaning towards disappointing.

Economic indicators aside, though, certain companies remain flush with cash both in the US and Europe and this is now being used for dividends, share buybacks and to explore mergers and acquisitions. In the UK, dividends for the second quarter of 2021 jumped 61% compared with the low of the same period in 2020, as many companies began to reinstate payouts. They are also being sustained and growing in the US.

Equity fund-raising is also at record levels – all of which points to the stubborn health of the equity markets.



Inflation – Yeah or Nay?

Last quarter, we spoke about inflation being well and truly upon us, and then, true to its potential to surprise, the figure for UK inflation in July fell to just over 2%, down from 2.4% in June, although indications were firm that wages had started to rise. For months now the key word has been "transitory" – i.e. that inflation was borne out of temporary, pandemic-related, supply disruptions and would return to the lower trend figure over time. The more long-term component might be the cost of labour, which is only mounting as worker shortages persist. Again, this may be the "pandemic pass" that enables companies to exist without increasing staff numbers and forcing higher staffing costs to hit their margins. This won't last forever either.

The strength of Sterling in recent months has also dulled the impact of "imported" inflation and overall it would seem, at this stage, that the spectre of runaway inflation is not a credible threat to markets.

Flows continue at a fast pace

As noted now for three quarters in a row, flows have remained solid and even buoyant into equity funds, and the activity in "meme" stocks such as Gametop and AMC remains strong, suggesting that there is a lot of money both active in markets and on the sidelines. As the chart below shows July was extraordinarily strong for retail flows into US equities, which has no doubt shored up equity market valuations there.

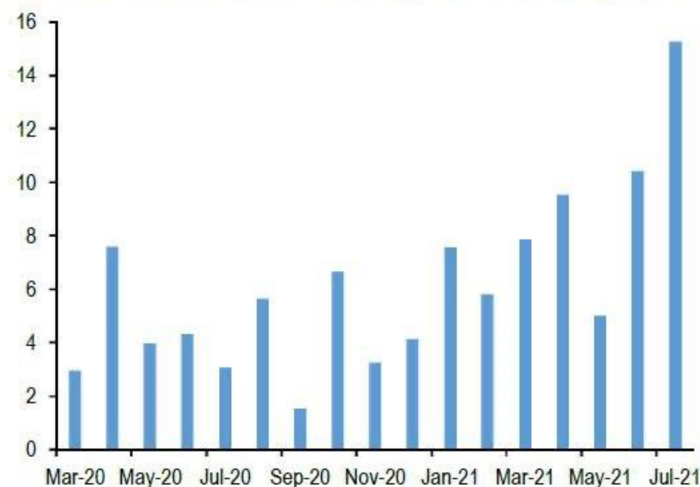


Figure 13: Estimated retail flow into US equities and ETFs – by month

$bn per month, constructed by our colleagues in Global Quantitative and Derivatives research, "*A (Sub)Penny Saved: Tracking Retail Trading* Activity *in US Equities and ETFs*" , January 2021, Peng Cheng et al).

Source: J.P. Morgan Global Quantitative and Derivatives Strategy

A tragic reminder in Afghanistan

The Covid-19 pandemic was a great leveller in that no country was immune from the havoc wreaked even if the responses laid bare the inequalities between regions. Geopolitical news flow outside Covid was relatively subdued, until the withdrawal of schedule of US troops from Afghanistan saw a rapid return to power of the Taliban after almost two decades. The chaotic scenes at Kabul airport, which preceded a suicide bombing late in August, only brought into question the reliability of the intelligence of the US and others, who had underestimated the speed of the Taliban's ascent. It didn't have much impact, if any, on markets but it did serve as a reminder of that certain regions will not bend to a narrative that involves an easy resolution.

Individual Asset Class Performance

- Equities
- Fixed income
- Other asset classes
- Spotlight: Real Estate – do we know the full picture yet?
- A footnote on ESG

Equities: Records still being broken

In the UK a strong recent month (1.65%) lifted year to date performance to 10.6%, which is still lagging other developed markets. European markets were more subdued than they had been in the past few months, due to disappointing economic data. This blunted some of the enthusiasm from the first part of the year although not enough to undo the strong performance year to date.

In the US, markets continued be strong with the S&P now having registered over 50 records so far in 2021, and the NASDAQ touching 15,000 for the first time ever. Both indices were up strongly over the past three months (and 5.8% and 10%, respectively) and are in solid high teen territory for the year to date.

Asia remains a laggard year to date, with performance in Japan negative over the past three months, which saw the much scaled-back Olympic games in Tokyo, and Chinese markets reflecting the shock of increased regulatory intervention, and barely registering a positive performance year to date now (1.6%) after a negative three months (-2.4%). This is particularly notable in that many emerging markets exposures now have a dedicated exposure to China, which now represents roughly 20% of the MSCI Emerging Markets index.

Fixed Income/Credit: low rates, but demand firms

Fixed income has stayed popular despite low rates, tighter spreads and little clear upside. As noted before this speaks to the wariness that continues to pervade markets and the preference to retain some hedge against a market correction – even if it costs something to maintain (i.e. negative real (post-inflation) yield or returns foregone

Other asset classes

While oil prices remained strong and maintained their strength over the quarter so far, (they remain up 41% year to date), stoking inflation fears, gold continued its disappointing streak of performance and is now -4.4% on the year to date. What is fascinating about this is its complete decoupling from inflation – as traditionally gold was considered to be a decent inflation hedge. It could be that it was actually more of a hedge against the effect that inflation has on a currency – whereby it cheapens. Now that other alternatives such as cryptocurrencies etc. exist, perhaps gold is a (still glittering) but not so new distraction and this accounts for its relative demise. Sterling had a slightly negative month against the dollar losing close to 1% in August and 3% over the three-month period. It is more or less flat on the year now.

Spotlight: Whither the Real Estate Asset Class

More ink has been spilled and more hands have been wrung over real estate than perhaps any other asset class in the past 12 months, and it seems the best way to describe the outlook for real estate is "nuanced". While office property is undergoing fundamental changes (see chart showing the uptick in vacancies below) and will likely see upheaval in the next 5-10 years, residential property remains out of reach for many, pointing to robust demand and constrained supply. Retail has also been a mixed picture, as high-quality retail, especially stores with solid online sales capabilities, have thrived, while lower quality B grade properties will have continued to slump. Industrial properties such as distribution centres and logistics operations continue to be extremely well valued, especially so called "last mile" distribution centres located in cities.

This snapshot of the US listed property REIT (Real Estate Investment Trust) market indicates just how meaningfully these groups have come back, particularly in those segments that were already popular such as self-storage. With extremely high margins and sustained demand this segment delivered over 36% in the first half of the year. It is also clear that no group really lagged this year – retail was extremely strong at 32.8% year to date. This suggests that we should be careful of "conventional wisdom" in the case of an area such as real estate that was significantly impaired by the pandemic.

REIT Returns – 2Q 2021 and YTD

Index/Property Sector	Weighting	QTD	YTD
All Equity REITs		12.0%	21.3%
Infrastructure	17.4%	14.1%	20.9%
Residential	14.9%	14.1%	27.6%
Retail	11.7%	12.5%	32.8%
Industrial	11.2%	12.0%	19.1%
Data Centers	9.5%	14.1%	11.4%
Health Care	8.8%	6.3%	13.3%
Office	7.4%	9.5%	15.1%
Self Storage	6.3%	23.6%	36.4%
Specialty	4.2%	12.0%	28.0%
Diversified	3.4%	9.6%	18.9%
Lodging/Resorts	2.7%	-0.6%	17.3%
Timber	2.5%	-0.3%	6.8%
Home Financing	3.1%	5.7%	17.0%
Commercial Financing	2.0%	-1.8%	23.3.%

Source: FTSE/NAREIT

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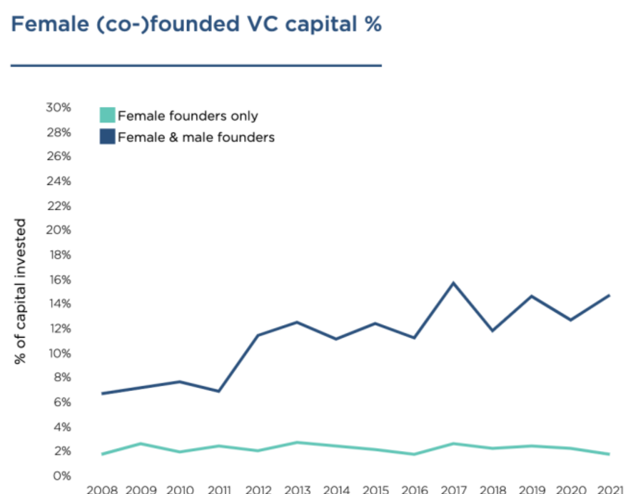
A footnote on ESG

Before moving to the outlook, it is worth mentioning an aspect of investing with an ESG lens that is often overlooked but sometimes interesting to measure. Gender diversity in the City of London (as well as other financial centres) is an area of scrutiny, and many well publicized efforts are underway to increase the number of women on public company boards. I thought this chart below was interesting as it indicates the slow progress in funding for female founders – especially if they are part of an all-female team.



This chart depicts venture capital funding for female founders, but is a decent indication of the lack of representation within the founder community, the venture capital industry that backs them and the investment industry as a whole. The impact of this state of affairs for an investor such as the fund is not clear – but what this does indicate is the lack of diversity of perspective that may exist among investors that are backed by venture capital.

As ESG issues rise to the fore these may well be areas that are taken up by institutional investors – e.g. many UK-based institutional investors recently combined efforts to encourage asset managers to sign a charter to commit to better diversity and inclusion in their workforces. The headline below covered this development, and we can expect this, as well as other governance issues, to increasing rise up the due diligence agenda when managers are being chosen.

UK pension funds warn diversity will count when choosing asset managers

Group with investments of £1tn says gender and ethnic mix of workforce will be factored in when awarding contracts

Outlook

The months ahead are likely to be characterised by VUCA - **volatility, uncertainty, complexity, and ambiguity.** We are entering the traditional flu and respiratory virus season and with that is bound to come more echoes of 2020 and its disruption. We are particularly on the lookout for:

- **Inflation – how are companies coping and what is the base level of consumer demand?** As companies re-discover normal operations and figure out what a consumer that is not "rebounding" from months of deprivation looks like and acts like, much will be revealed. The actual level of inflation and who is bearing its brunt will also become clear and this will enable us to really assess the economic picture. We can expect equity market volatility as winners and losers emerge and more differentiation between stocks becomes inevitable.

- **When Fear of Missing Out turns to Fear?** The tremendous support equity markets have had year to date has generally come from money on the sidelines directed by investors who fear not being invested and who have money to put to work where yields everywhere are low. Not many investors "sold in May" this year as markets continued their march upwards. We can expect some profit taking and less market support in the second half, which will, again, cause equity markets to be more volatile.

- **All eyes on Glasgow.** COP 26 – the United Nations Climate Change Conference will take place in Glasgow in November, and that will be a key forum for setting environmental standards and expectations. With the US administration likely to be active and participating this year we can expect strong statements on sustainability, commitments to net zero carbon emissions strategies and new ambitions that are likely to govern ESG strategy for the medium term.

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August 30, 2021