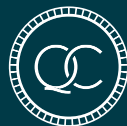

MARKET COMMENTARY - AUGUST 2021

QUILTER CHEVIOT

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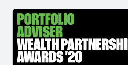

Past performance is no guarantee of future returns.

With the global backdrop remaining supportive, US and European equity markets produced positive returns last month. UK equities also rose with a particularly strong performance from mid-cap companies. Japan was down 2% with the start of the Tokyo Olympics overshadowed by rising COVID infections. Asia and emerging markets fell 7%, reflecting further weak economic data from China and intervention by policymakers in several high-profile technology/media companies in the private sector.

Companies are on track to report record Q2 earnings growth and a number of equity markets reached new all-time highs in July albeit with increased volatility. While the rate of economic growth may have peaked before reverting to more normal levels in 2022, the rapid recovery has caused major disruption to the "just in time" global supply chain and led to cost pressures ranging from raw materials to skilled labour. However, central banks continue to regard this as transitory.

The International Monetary Fund's latest World Economic Outlook reaffirmed its previous estimate of 6% GDP growth this year with 2022 increased to 4.9%. Within these headline numbers, advanced economies - principally the US - were upgraded and emerging economies downgraded. Global growth expectations, particularly outside the US, appear to be easing marginally on further evidence of slowing activity in China and rising Delta variant infections. For several months the Chinese authorities have been restricting credit and reducing fiscal stimulus measures to limit the build up of leverage and curb property speculation. A new development is the slowdown among smaller private enterprises which are being squeezed by higher producer prices at a time when retail spending is weakening. Some countries - notably those with relatively high vaccination rates such as North America, the UK and parts of Europe - are learning to live with COVID but for others the pandemic remains a threat to economic recovery as can be seen

in Australia, Japan and parts of Asia. Q2 GDP numbers are beginning to filter through and, although the US surprised on the downside in part because of inventory adjustments, the strong underlying trend continues.

Inflation concerns peaked in May and appear to have stabilised in recent weeks. A combination of unprecedented government stimulus, vaccination rollouts and the gradual easing of restrictions has resulted in a sharp increase in demand for goods - and more recently services - with inevitable disruption to supply chains that are not designed to cope with a super-charged event. Manufacturing processes should gradually return to normal as raw materials shortages ease, but the labour outlook is more unpredictable. Changes in employee preferences, a prolonged period of lost training and lingering nervousness over the virus mean labour participation is lagging pre-COVID levels even as furlough schemes are wound down. Although the pandemic distortions impacting CPI and wages may take time to abate, we are not anticipating a re-set to sustained higher prices.

Most central banks have so far avoided unwinding the extra-ordinary measures taken to provide liquidity and prevent disorderly markets. However, despite further strict lockdowns, the Reserve Bank of Australia has broken ranks and announced it will reduce weekly asset purchases by 20%. Several US Federal Reserve governors have also suggested that - with economic output back to pre-pandemic levels - the time is approaching to rein in excess liquidity. With real yields in negative territory and over-stimulative, tapering asset purchases is expected be debated at the Fed's Economic Symposium in late August and some participants would like this to start as early as October. By contrast, the European Central Bank recently announced its intention to maintain current polices and this has led to negative yields on 70% of EU sovereign debt and over 50% of investment grade corporate debt. Unless there is another dip in economic activity, market expectations for interest rates appear too low and heading in the wrong direction - the yield on US 10-year Treasuries started 2021 just below 1%, rose to 1.7% in March and has since fallen to 1.2%. We expect it to end the year nearer 2% than 1% and UK yields to rise from 0.6% towards 1%.

Q2 corporate results will confirm that global earnings have rebounded strongly and are close to new highs. US companies continue to generate the strongest earnings growth from last year's low and are currently 10% above their pre-pandemic peak, whereas the EU and UK are around 10% lower albeit recovering rapidly. Materials have seen the sharpest earnings' recovery - some 50%

Source: Refinitiv Datastream 04/08/2021

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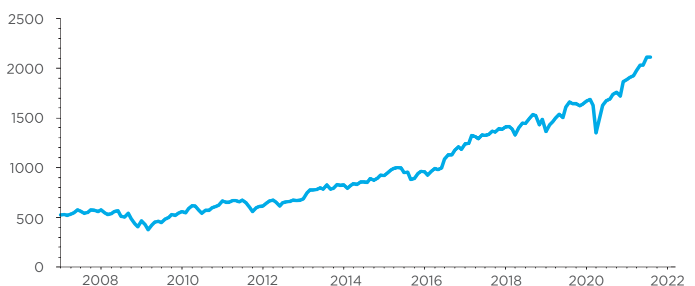

Source: Refinitiv Datastream 04/08/2021

above 2019. Energy has been the weakest and remains well below previous peaks but the sector could make further headway if Brent stays above $75. Although technology companies lost momentum as the “reflation trade” prompted interest in cyclicals, they are now racing ahead again thanks to secular tailwinds with earnings some 30% above 2019 levels. Consumer discretionary, industrials and financials should have benefitted more from the recovery but have been held back for various reasons including travel restrictions and negative real interest rates. As COVID infections fall, yields rise and growth continues to be above trend, the cyclical/value “reflation trade” could resume market leadership.

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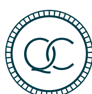

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