Market Overview

The ping pong in US markets between yield hike bears and sector rotation bulls distracts from a bigger story: the Hype Wave smashing cryptos ever upwards just as the FAANG (Facebook, Apple, Amazon, Netflix, Google) stocks' lockdown surge peaks. But that is what markets have always done to fundamental technological changes—from railways and oil through to motor cars. The technology then percolates into the mainstream economy. Even tulip mania fits with the pattern, preceding cultivation of repeatable plant varieties at scale. Likewise, the wreckage of the dot-com boom's collapse seeded the infrastructure on which today's social network giants are built. The pulse we see today heralds further massive change. Instances right now look frivolous: bitcoin, immersive online concerts, augmented reality multiplayer games. But Facebook and others are betting the ranch on hardware and related tech that will play a part in opening the gates to a new digital metaverse. Next come commercial applications and powerful validation tools for luxury goods, high-end brands, breaking open and disintermediating payment systems. Rapid processing evolution is driving this with massive force. Today, for instance, the average teen's PS5 or Xbox has the rendering capacity of a 2016 Hollywood studio, and the pace is only accelerating.

Digitisation is about to be joined by energy as a source of deflation. How long can oil trade around $50 when the equivalent solar price is $20 and falling? When fusion power is looming? The scale of change is so great it is not just commercial operations being disrupted, but whole societies and economic systems. All this, it goes without saying, should be music to long-term investors' ears.

Unfortunately, it looks much bumpier close-up. GDP growth and developed economy interest rates have been declining for 40 years thanks to globalisation and digitisation, with high debt, ageing demographics, and inequality among the results. The only one that appears in reverse at

present is globalisation. COVID-19 has reintroduced politicians to a whole new toybox, and the issue bouncing markets round is whether putting the pedal to the metal with fiscal largesse will cure secular stagnation, trigger excessive inflation, or both. The fiscal response has been extraordinary: in the US over 25% of GDP, 20% in Germany, and 16% in the UK. Using Japan as a yardstick, there is plenty of room for more. As a proportion of GDP, Japan's central bank liabilities total 135%. Europe is a mere 60%, the UK and the US, 40%. The GFC stimulus was followed by restraint, but this time a return to austerity is politically impossible and, in any case, likely to hurt. Japan's attempts to impose fiscal rectitude have hit real consumer spending every time.

What will the new world look like? Bonds yield next to nothing now—sometimes less—and will be unable to generate equity-like returns from today's prices. Leverage will be much less attractive as rates rise, which will exacerbate a likely end to the era of bonds rising when equities fall. Portfolio construction will need to change as investors cease being paid for bond insurance, either through yield or negative correlation protection.

There is a ray of light. Equities tend to have low valuations when interest rates are very high or very low. US FAANGs are the exception,

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thanks to above-market growth in earnings per share (EPS). Indeed, the rising valuation of the FAANGs explains the entire outperformance of US markets over the last few years, without which US equities would have been in line with the rest of the world, on a low valuation. So, as rates rise, the theory goes, non-FAANGs should start to see valuations rise, while FAANGs fall back to where they should have been. This is the great rotation, and every day, as bond and equity markets gyrate, the battle is being fought between rotation hopes and fears that "magic money tree" fiscal policy will cause inflation. This would be bad news, because both equity and bond values slump as inflation rises above moderate levels. Inflation is complex but made more likely by two factors. One is a policy shift aiming to increase labour's share of profits in a bid to deal with inequality, and the other the risk of a reduction or even collapse in faith in the fiat currencies so recklessly being printed. Which brings us back to bitcoin and other exotica. The heart of the issue is that there is enough worry out there to suggest that, despite the froth, there is still cash sitting things out and ready to come in. Which means the bull market that started in March 2020 may still have legs.

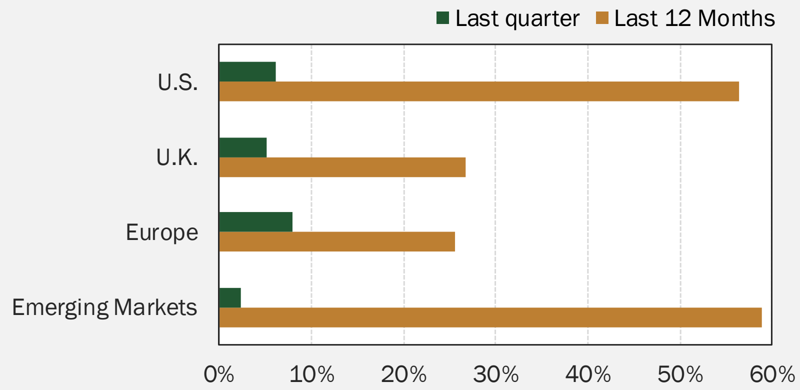
Asset Classes

Equities

Global stocks recorded a strong start to 2021, with a rotation out of "stay-at-home" themes powering market gains in 2020 (growth stocks and consumer staples) and into shares in lagging sectors trading at bargain prices (energy, financials, and industrials). These gains were driven by investors' optimism that vaccine rollouts underway throughout the world have finally given us the upper hand in the fight against COVID, paving the way for continued recovery in the global economy. US stocks added 6.2% in Q1, benefiting from success on the vaccination front, as well as Biden's $1.9 trillion stimulus bill and the promise of a $2 trillion spend on infrastructure that put US shares up a staggering 56% over the last 12 months (see Figure 1). UK and European equities rose 5.2% and 8.0%, respectively, in the last three months, exhibiting a similar rotation into value. EM stocks, although almost 60% higher since last March, trailed in Q1 with a gain of just 2.3%, weighed down by comparatively weak progress on vaccinations, a strong dollar, and the threat of rising interest rates.[1]

Figure 1 | Equity Market Performance

Returns as of 31 March 2021



Source: S&P 500 (USD), FTSE All-Share (GBP), EURO STOXX 50 (EUR), and MSCI EM (USD) via Bloomberg.

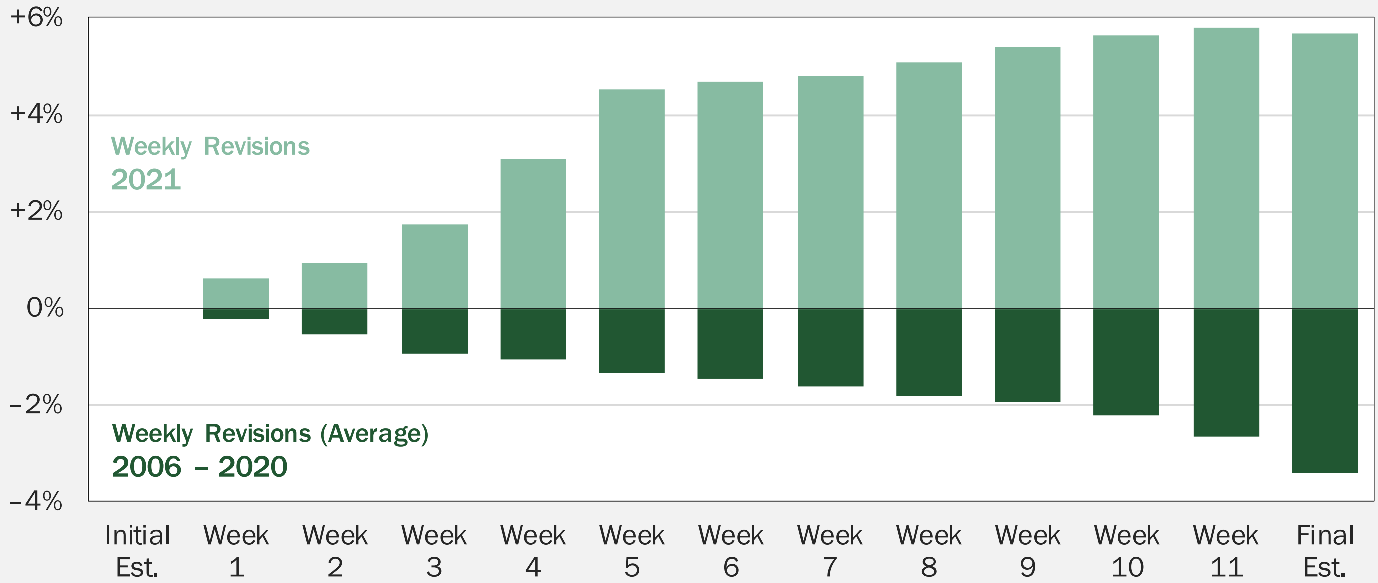
[1] Of course, in countries with a high degree of mispricing, active investors will find opportunity despite broad market weakness. That was certainly true for the Rayliant Quantamental Emerging Markets Equity Fund, managed by Henderson Rowe's parent company, which earned a substantially higher return of 6.4% in USD terms for Q1.

Improving sentiment has been an increasingly important theme during the last year, as global markets recovered from the coronavirus sell-off in March 2020. Analyst forecast revisions under the pandemic offer a nice example of the perverse incentives and behavioural bias often at play in financial markets. Around this time last year, sell-side researchers were frantically slashing earnings forecasts, imagining the worst with little guidance from companies on just how bad things might get. This overreaction led to unreasonably pessimistic year-end predictions for companies' 2021 full-year EPS, which analysts have progressively bumped up in the course of the first quarter, raising their pessimistic initial forecast by nearly 6% over the last three months (see Figure 2). That pattern stands in stark contrast to the usual "walk-down" in earnings projections, whereby analysts intentionally set the initial forecast too high—exuberant numbers induce bank clients to trade more—then gradually lower that target to give companies an easier number to beat.

Figure 2 | Biased Analysts Spend Q1 Correcting Overly Gloomy 2021 Forecasts

If professional analysts were truly unbiased, we would see random revisions to their forecasts over time, as news surprises bumped estimates up or down from week to week. Instead, Wall Street banks are found to play an "earnings guidance game", starting January with full-year EPS forecasts that are far too optimistic, then gradually "walking down" those estimates to an easier target for companies to beat. That's exactly what we saw, on average, over the last 15 years, with analysts gradually lowering their beginning-of-year estimates for S&P 500 earnings over the first quarter, ending with a full-year forecast around 3.4% less than their original guess. During the first quarter of 2021, by contrast, analysts seem to have been overly pessimistic at the end of last year—failing to price in vaccine rollouts and reopenings—forcing them to progressively boost their full-year earnings targets, ending Q1 with an estimate 5.7% higher than the initial forecast.

Percentage change in consensus S&P 500 analyst full-year earnings forecast, from beginning to end of Q1

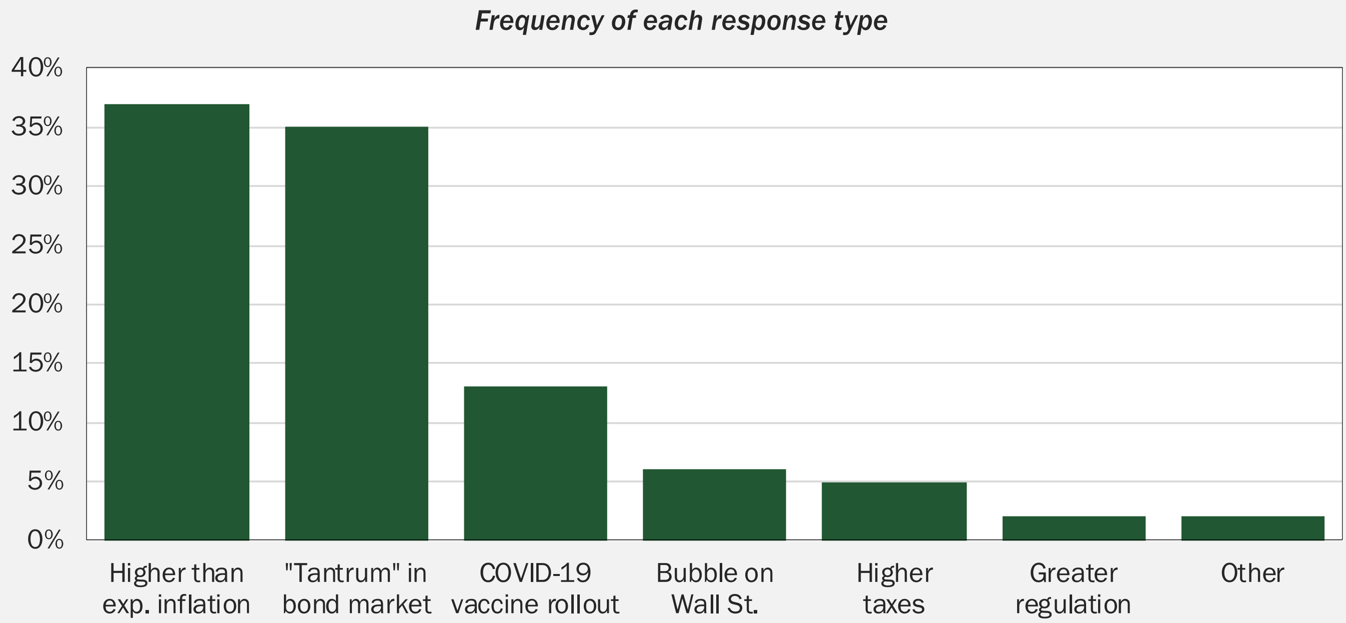


Source: Bloomberg

Analyst bias aside, a steady stream of positive economic news over the course of Q1 knocked vaccine rollout concerns—which, as of February, were seen as the biggest “tail risk” by asset managers—down the list of market anxieties, with the focus squarely shifting to monetary questions about inflation and the inevitable end of stimulus (see Figure 3). Interestingly, despite the risk of a bubble receding in perceived importance relative to other concerns, lofty valuations clearly remain on investors’ minds. According to a mid-January poll of professional investors by Deutsche Bank, nearly 90% of respondents reported sightings of bubbles (see Figure 4). Web searchers seem to have felt the same way, with queries of the phrase “stock market bubble” spiking to record highs in the first three months of 2021. No doubt the GameStop drama, which brought throngs of retail netizens into the world of stock trading, contributed to collective anticipation of a market crescendo.

Figure 3 | Fear Over the Pandemic Takes a Back Seat to Inflation Concerns

In March, Bank of America conducted its Global Fund Manager Survey, polling 197 professional investors with assets totaling $597 billion on their financial market fears. When asked what they consider the biggest “tail risk”, respondents—who only a month earlier were most concerned with the successful ramp up of COVID-19 vaccine distribution—expressed worries about inflation and the possibility of a bond market “taper tantrum” as central banks turn down their easing. Anxieties related to financial bubbles and harmful government interference were much less pronounced.

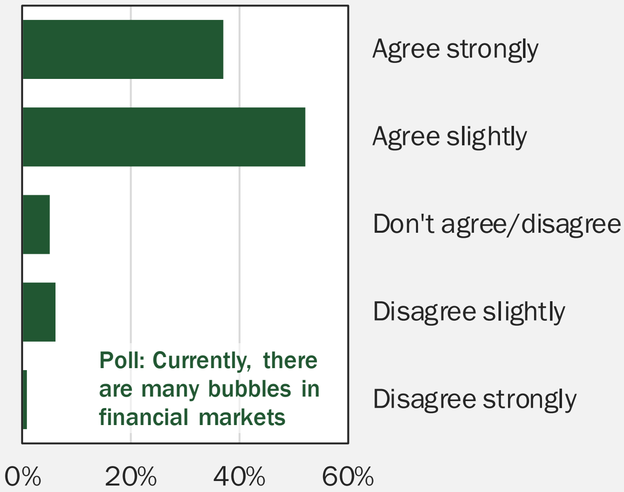


Source: Bank of America

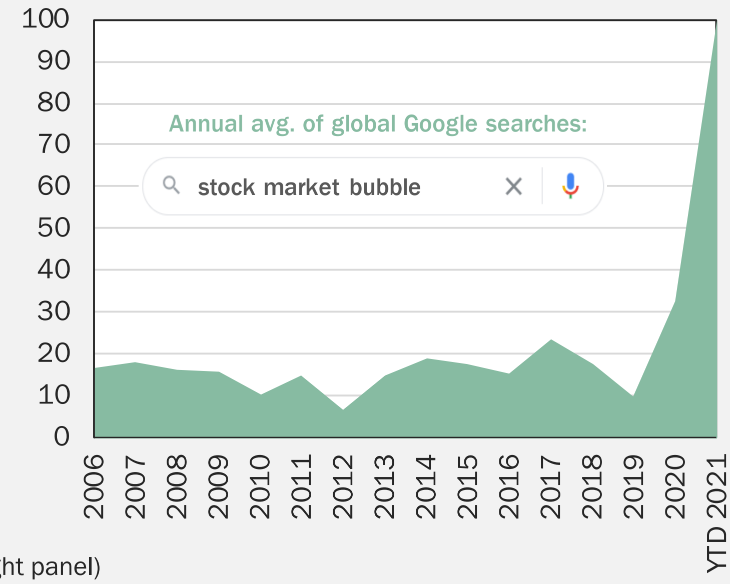
Figure 4 | The Pros Perceive Bubbly Markets...Google Users Apparently Agree

The rally back from last year's pandemic panic sent asset prices skyrocketing, leading investors to wonder if markets might have moved too far. Deutsche Bank, in its mid-January poll of over 600 investment professionals, asked whether "there are many bubbles in financial markets", with nearly 90% agreeing that things look frothy. DB didn't ask individual investors for an opinion, although Google data are revealing. Global web searchers averaged over three times as many queries of the phrase "stock market bubble" in the first quarter of 2021 than the average in 2020—which had already seen 40% more searches than the average in any of the prior 14 years.

Polling the professionals on market bubbles
Frequency of each response type



Retail investors weigh in via Internet search
Scaled quantity of searches, Jan. 2006—Mar. 2021



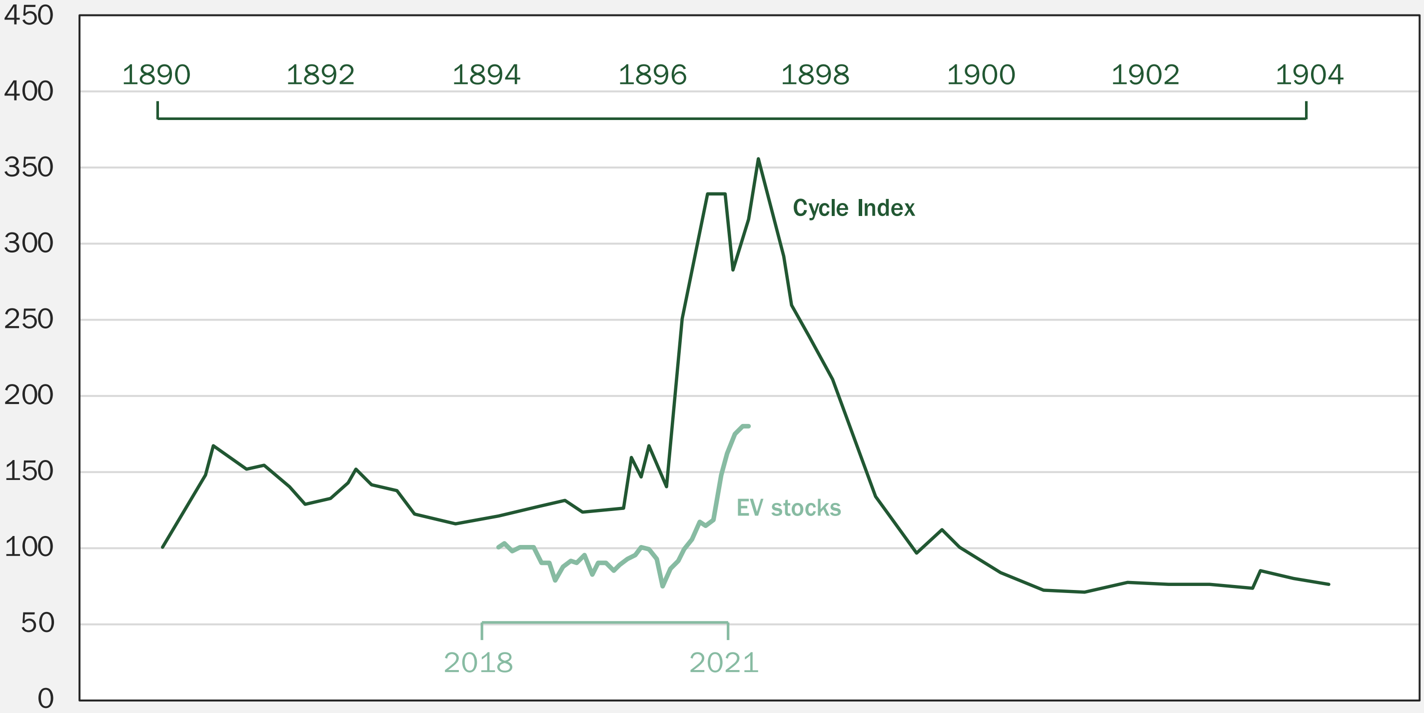
Source: Deutsche Bank AG (left panel), Google Trends (right panel)

A recurring theme of conversations about overexuberance in equities is the run-up in prices of electric vehicle (EV) stocks, which accelerated at the end of last year. A number of market observers with keen awareness of financial history have pointed to a remarkable parallel between today's boom in EV and a similar theme from the late-1800s: Britain's infamous "Bicycle Bubble" (see Figure 5). Economists William Quinn and John Turner at Queen's University Belfast have gone to the trouble of compiling data on the hundreds of bicycle companies listed on London's exchange during this period, reporting a doubling of prices in the first half of 1896, which eventually gave way to a decline of more than 70% from the peak, by the end of 1899. Those trying to line EV stocks up with the path of the ill-fated Cycle Index might note that despite climbing nearly 80% since the start of 2020, the rise in EV shares pales in comparison to the Victorian green transport bubble. On the other hand, there is mounting evidence of irrational EV enthusiasm. In a sign of these strange times, an April Fools' prank by Volkswagen of America that it would change its name to "Voltswagen" sent shares in the company's US-listed ADR 12% higher, adding $10 billion to the firm's market cap before investors finally got the joke.

Figure 5 | EV Enthusiasm Can't Match "Great British Bicycle Bubble" of 1896–97

Those observing the recent boom in electric vehicle (EV) stocks—up almost 80% since the beginning of 2020—and wondering how it will unfold might consider the history of another green transport innovation: the bicycle. The late-1880s introduction of the "safety bicycle", with a chain drive and pneumatic tyres, kicked off a bike mania that quickly spilled over to UK financial markets, and far surpassed current hype over EVs. Between 1895 and 1897, the year prices peaked, over 700 companies in the bicycle business listed stock on the London exchange. In the first half of 1896, shares of a "Cycle index", compiled by economists William Quinn and John Turner, more than doubled; by the end of 1899, it had fallen more than 70% off its peak as financial fact failed to match investors' unrealistic expectations.

UK bicycle stocks (1890—1905) vs. EV stocks (Apr. 2018—Mar. 2021)



Source: Cycle index data reproduced from Chapter 6 of Quinn and Turner (2020); EV stock performance represented by the Global X Autonomous & Electric Vehicles ETF, via Bloomberg.

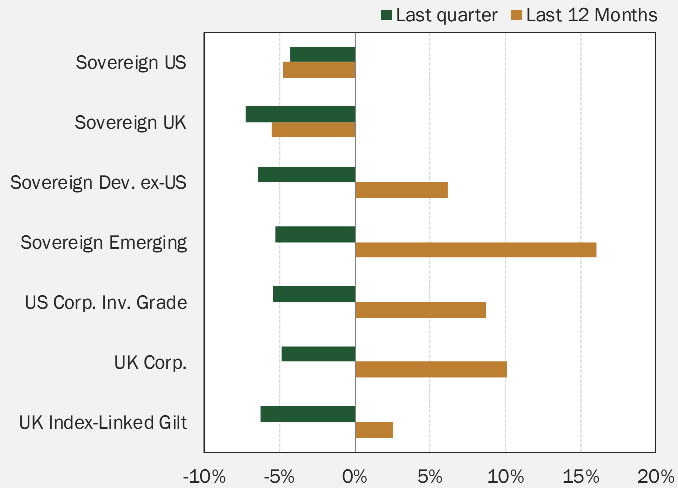
Fixed Income

Bonds posted negative returns across the board in the first quarter (see Figure 6). Continued easing by central banks, the announcement of large fiscal support, and the success of vaccination programmes has resulted in a sharp economic rebound and heightened concern about inflation and the possibility of an earlier end to stimulus. In turn, rising rates have given way to falling prices, leading to a brutal quarter for bond investors. Increased expectations for future rate hikes sent the yield curve steeper, with longer-maturity 10-year notes spiking from 0.91% to 1.74% and short-term rates falling modestly. That brought the spread between 10- and 2-year US Treasuries to its highest level in half a decade. UK and European bonds saw a similar pattern, albeit somewhat moderated in the case of the latter, given comparatively slow progress in vaccine administration. One upshot of rising yields was a decrease in the balance of negative-yielding debt, which dropped from $18 trillion in December 2020 to around $13 trillion at the end of March.

To get a sense for just how bad the first quarter was for fixed income investors, it is worth noting that the Bloomberg Barclays US Aggregate Bond Index, a composite of investment grade government and corporate debt, has generated

Figure 6 | Fixed Income Market Performance

Returns as of 31 March 2021



Source: Bloomberg, expressed in USD except for UK Gilts and UK Corporate in GBP.

Figure 7 | Against Four Decades of Bond Returns, 2021 Isn't Stacking Up Very Well

Bonds usually offer investors predictably positive returns. Indeed, in 41 of the last 44 years, investment grade U.S. bonds, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, have delivered a profit to investors. Exceptions include the 1999 dot-com bubble (–0.8%), the 2013 "taper tantrum" (–2.0%), and a 1994 bear market in bonds (–2.9%). Unfortunately for fixed income investors, if the last three months are any indication, 2021 will likely join the list of outliers. Debt market turmoil in late February led to a spike in yields and a steep drop in prices, putting the YTD return at –3.4% through March.

Investment grade U.S. bonds, sorted by yearly performance, Jan. 1977—Mar. 2021

					2020								
					2019								
				2017	2011								
				2014	2010								
			2018	2012	2007								
			2016	2009	2001								
			2015	2008	1998								
			2005	2006	1992								
			1987	2004	1990	2002							
		2013	1980	2003	1988	2000		1991					
		1999	1979	1996	1983	1997		1986					
	2021 YTD	1994	1978	1977	1981	1993	1989	1984	1995	1985			1982
From	–6%	–3%	+0%	+3%	+6%	+9%	+12%	+15%	+18%	+21%	+24%	+27%	+30%
To	–3%	+0%	+3%	+6%	+9%	+12%	+15%	+18%	+21%	+24%	+27%	+30%	+33%

Source: Bloomberg Barclays US Aggregate Bond Index (USD)

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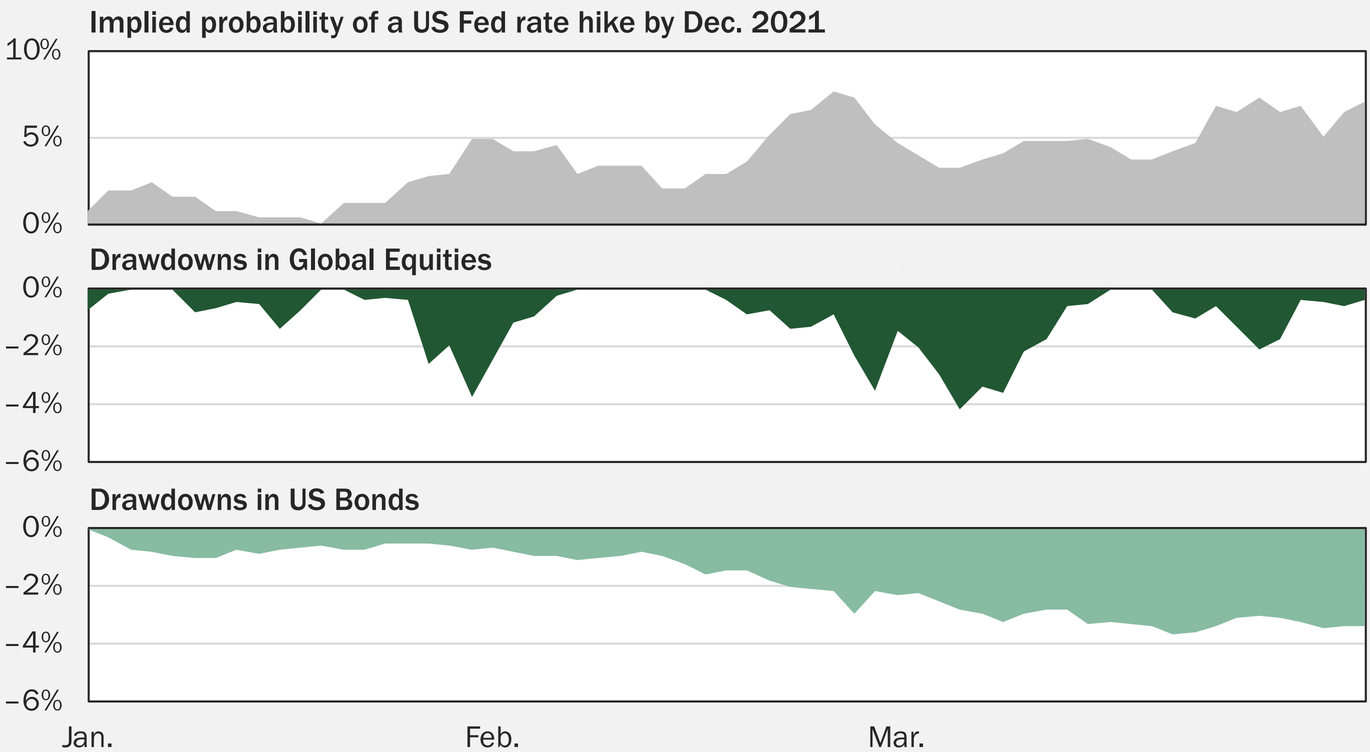
positive returns in all but three years over the last four decades, with the only negative returns coming during the 1999 dot-com bubble, a bond bear market in 1994, and the infamous 2013 “taper tantrum” (see Figure 7). At the end of Q1, with a YTD return of −3.4%, the composite was well on course for its worst year on record.

This pain was particularly acute near the end of February, when a weak auction for 7-year Treasuries sparked a panic that sent 10-year yields 14 basis points higher—a monumental move for one of the least volatile financial assets. This and other gyrations can be seen in the trading of Fed Funds futures, which have increasingly priced in the possibility of rate hikes in 2021 since the end of last year, despite the Fed’s insistence that rates won’t rise for years to come (see Figure 8). With the climb in equity valuations since last March, stocks have shown a particularly strong sensitivity to changes in the perceived timeline of Fed support, selling off with each jump in the implied probability of a rate hike.

Figure 8 | Rate Rise Spooks Investors Accustomed to Non-Stop Stimulus

Despite continued messaging from the Fed that rate hikes won’t happen for another few years, massive stimulus and the success of COVID vaccines have combined to power an unexpectedly strong U.S. economic recovery, leading investors will suspect tapering to begin sooner. Since December 2020, Fed Funds futures began to price in a non-zero chance of rising rates by the end of 2021. Equities have been particularly sensitive to the prospect of a pullback in easing, with jumps in the probability of a rate hike mirroring drawdowns in global stocks. Bond returns, in the red throughout Q1, also map to market expectations for tighter monetary policy, highlighting the challenge facing central banks and investors, alike.



Source: Rate change probabilities from FedWatch via CME; global equities represented by MSCI World Index (USD), US bonds by the Bloomberg Barclays US Aggregate Bond Index (USD), both via Bloomberg.

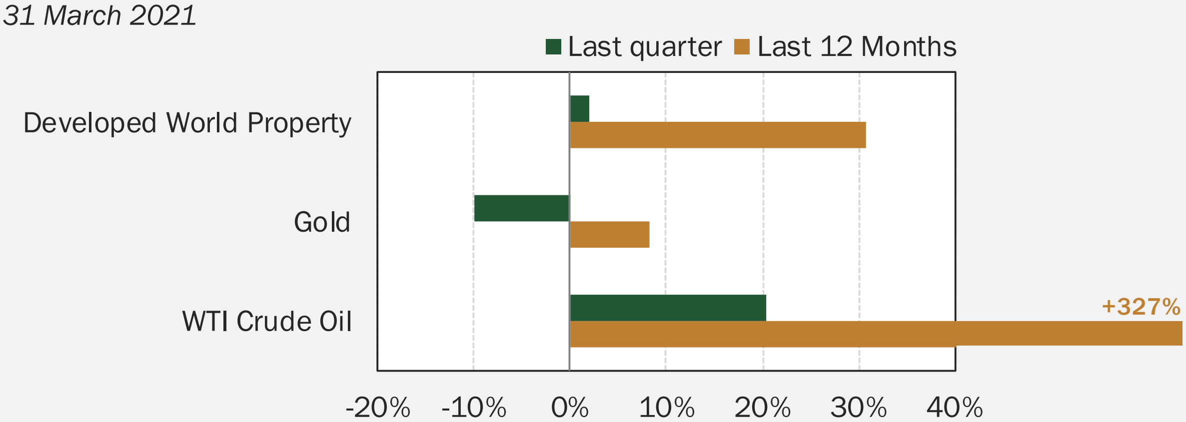
Alternatives

Although the US dollar was strong in Q1—generally a bad thing for commodities, which are often priced in dollars, since more expensive goods result in less trade—an economic resurgence on the heels of widespread distribution of COVID vaccines boosted demand, leading to signs of inflation and a rally in many commodities. Energy was among the best performers, as demand from economies reopening coupled with more stability on the supply side powered oil to a 20.3% gain on the quarter (see Figure 9). Industrial metals like copper also posted strong performance, while precious metals declined; gold slipped –10.0% YTD through the end of March. Real estate gained modestly as a whole, up 2.0%, with rotation from "stay-at-home" segments (e.g., health care, infrastructure, industrial, and data centers) into properties associated with the "out-to-play" economy (e.g., commercial retail and hotels).

Casual observers of the recent rally in commodities will likely view this as the start of a rebound from the severe shock to demand beginning with early-2020 lockdowns, similar to the comeback equities have made throughout the last 12 months. Those tracking the asset class over longer periods will note that just prior to the emergence of COVID-19, commodities traded at long-term lows relative to equities, at what appears to be a trough in a series of commodity value cycles stretching back at least as far as the early 1970s (see Figure 10). Bears argue that a range of factors—from greater cost-consciousness in manufacturing to accelerating uptake of renewable energy—justify a permanent discount in the price of many commodities. Bulls point to a short-run resurgence of demand, inflation, and dollar weakness as potential drivers for a rotation from stocks to commodities.

Figure 9 | Alternatives Performance

Returns as of 31 March 2021

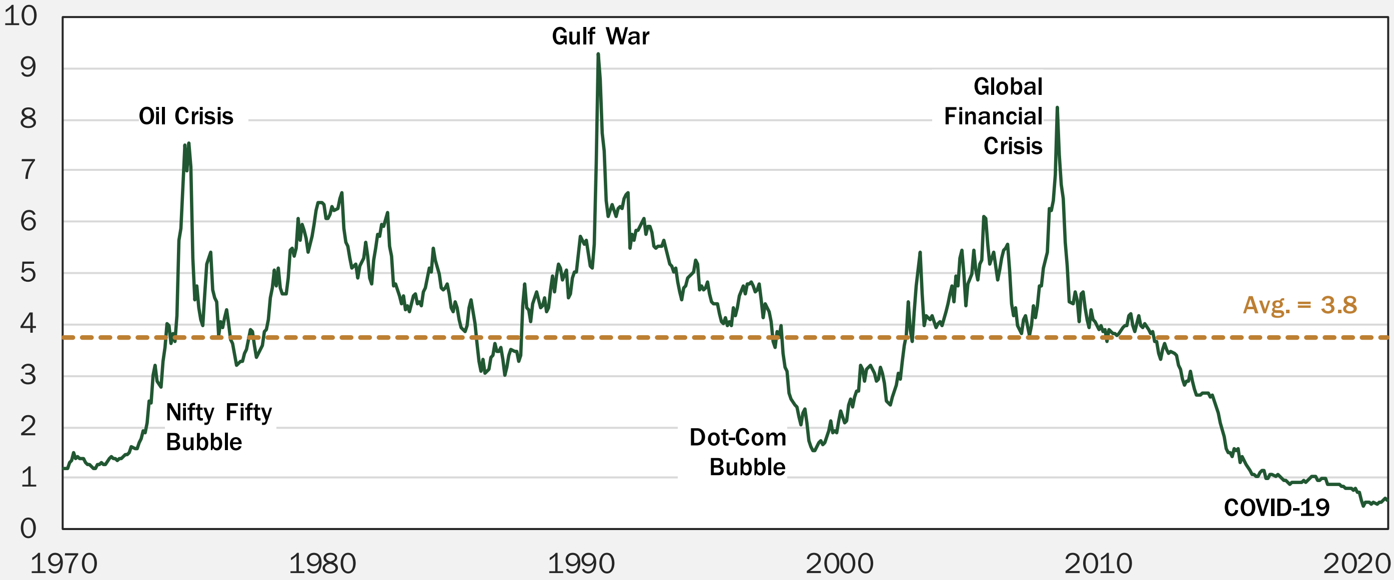


Source: iShares Int'l Dev. Real Estate ETF (USD), WTI Crude (USD), Gold Spot (USD) via Bloomberg.

Figure 10 | Commodities Bottoming Out? Pundits Tip Possible "Supercycle"

Restrictions imposed to combat COVID-19 resulted in an extreme shock to demand for many commodities, sending prices sharply lower in 2020, even as stocks rallied back in the second half of the year to reach record highs. This resulted in a series of new record lows for the commodity-equity ratio, which had been in steady decline since the Global Financial Crisis. While there are plenty of reasons to believe "this time is different"—a push toward renewables, substituting cheaper commodities for more expensive ones, and utilizing them more efficiently, to name a few—five decades of data reveal commodities often trade cheap in times of market exuberance. Commodity bulls point to pent up demand as economies reopen, signs of inflation, and a weakening dollar as possible catalysts for a stock-to-commodity rotation.

Ratio of commodity to equity prices, Jan. 1970—Mar. 2021)



Source: Commodities represented by S&P GSCI (USD), equities by the S&P 500 Index (USD), both from Bloomberg.

Looking Ahead

As developed economies battle through third waves, hesitantly shuffling towards the light, sectors that have been badly pummelled have begun to twitch back to life. The pummelling has been brutal. Rolls Royce lost £1.9bn and saw a £4.2bn cash outflow, justifying its November £5 billion refinancing including a £2 billion begging bowl rights issue, while John Lewis lost £500m and is abandoning swathes of the high streets it once occupied. Only one-fifth of UK commercial rent due was paid in 2020's final quarter and we can expect a very corrugated bottom. Similar stories hold in other developed markets.

In the rotation, it is not so much value stocks per se that should benefit, but ones with operational leverage able to take advantage of rising physical activity in the way tech firms took advantage of the move online during lockdown. Onshoring to replace Chinese supply chains and address local social issues, in tandem with green investment, are likely to be increasing investment themes and probably packaged in ways that will need careful inspection. Beware large-scale misallocation of capital by profligate politicians, distorting prices with supposedly enlightened subsidies. 'Help to Buy' springs to mind. Long term, tech remains critical for growth.

Key Economic Releases and Events for Q2 2021

UNITED KINGDOM

Bank of England Official Bank Rate Release: 6th May, 24th June

PMI Figures: 7th April, 6th May, 3rd June

EUROZONE

YoY GDP: 30th April, 18th May, 8th June

PMI Eurozone: 7th April, 23rd April, 5th May, 21st May, 3rd June, 23rd June

Unemployment Report: 6th April, 30th April, 1st June

ECB Monetary Policy Meeting: 22nd April, 10th June

UNITED STATES

FOMC Rate Decision: 28th April, 16th June

GDP Figures: 29th April, 27th May, 24th June

PMI Figures: 5th April, 23rd April, 5th May, 21st May, 4th June, 23rd June

Closing Comments

The Fed's claim that rising rates signal optimism about the economic recovery seems supported by the rotation genuinely in progress. Despite signs of overexuberance, which certainly make for good financial entertainment, hard economic data show a fundamental basis to the last year's growth in asset values. That expansion is giving way to a steeper yield curve, as investors take on more risk, with cyclicals and financials in line to outperform, as should Emerging Markets. The UK's recovery seems to represent good value, though better relations—or, at least, fewer fights—with large trading partners would help. Overall, decent medium-term returns remain likely from current levels and, even if liquidity shifts from financial markets to real economies as lockdown fades, a technical correction would not derail today's valuation opportunity as the new, recovering, world takes shape.

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